



S&P downgrades eurozone sovereigns

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SUMMARY

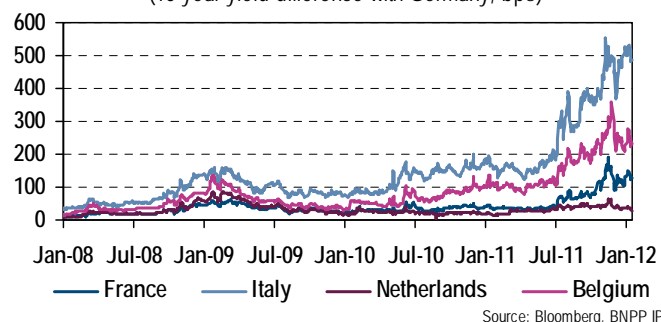
- S&P downgrades 9 eurozone countries
- France and Austria lose their AAA-rating, Italy and Spain downgraded 2 notches
- Since this was widely anticipated, we think the market impact will be limited

On 13 January, credit rating agency Standard & Poor's downgraded its rating of the sovereign debt of nine eurozone countries. The ratings of Cyprus, Italy, Portugal and Spain were cut by two notches and those of Austria, France, Malta, Slovakia, and Slovenia by one notch. The ratings of Belgium, Estonia, Finland, Germany, Ireland, Luxembourg and the Netherlands were unchanged. S&P said the reasons for the downgrades were that: *"the policy initiatives taken by European policymakers in recent weeks may be insufficient to fully address ongoing systemic stresses in the eurozone."* The other two main rating agencies, Moody's and Fitch, now give Austria, Finland, France, Germany, Luxembourg and the Netherlands the highest rating with a stable outlook.

The downgrade of France drew the most attention as the country lost its AAA rating. Specifically on France, S&P said that although its debt ratio (85.5% of GDP in 2011) is near the European average, it is harder to cut than Germany's because of the deficit (5.5% of GDP in 2011 vs. 1% in Germany). S&P doubts the official growth assumptions for France, deeming them too optimistic for

2012 (1% according to the government versus 0.5% expected by S&P) and beyond (2% from 2013 on the government's estimates). Consequently, S&P says, the measures announced to cut the deficit appear to be insufficient to achieve the targets (a deficit to GDP ratio of 4.5% in 2012 and, in the longer term, 0% in 2016). However, as the downgrade was widely anticipated, we expect the market reaction to be muted.

Eurozone spreads
(10-year yield difference with Germany, bps)



The table below shows the old and the new ratings. (Investment-grade ratings are those from AAA to BBB-, non-investment grade or junk is BB+ or lower.)



S&P sovereign debt ratings

	Old rating	New rating
Austria	AAA	AA+
Belgium	AA	AA
Cyprus	BBB	BB+
Estonia	AA-	AA-
Finland	AAA	AAA
France	AAA	AA+
Germany	AAA	AAA
Ireland	BBB+	BBB+
Italy	A	BBB+
Luxembourg	AAA	AAA
Malta	A	A-
The Netherlands	AAA	AAA
Portugal	BBB-	BB
Slovakia	A+	A
Slovenia	AA-	A+
Spain	AA-	A

* Source: www.standardandpoors.com

POSSIBLE CONSEQUENCES

In theory, countries with lower ratings pay higher interest rates as their debt is riskier. This is certainly the case for current bond yields. Portugal's yields are higher than those of Italy, while French yields exceed German yields. However, other factors such as market liquidity and investor preference also play a role. For example, Japan, which is rated at AA-, has lower yields than AAA rated Germany. In practice, yield changes after downgrades from AAA tend to be quite small, in the order of a few basis points. Firstly, AA rated debt is still seen as low risk. The chance that countries with such high ratings default on their debt is very small. Secondly, these rating changes tend to be anticipated by the markets. French risk spreads widened in the second half of last year as speculation about a downgrade grew. S&P's decision was expected, because the agency had said on 5 December 2011 that it was placing all eurozone countries under negative watch. We do not expect French spreads to widen much further as a result of the downgrade.

The debt downgrades may have consequences for the borrowing costs of the EFSF, the eurozone bailout fund. This has to borrow in the market to finance the bailouts of Ireland and Portugal and possibly an additional Greek

bailout. Since EFSF debt is guaranteed by the eurozone member states according to their economic strength (Germany 27%, France 20%, Italy 18% and Spain 12%), the downgrades of France, Italy and Spain may boost borrowing costs for the EFSF, making the fund less efficient. But here the same logic applies as for the French downgrade. Risk spreads on EFSF debt rose in the second half of last year as markets anticipated the worsening situation in the eurozone member states.

RISKS

While we expect the market impact to be limited, the downgrades underscore the risks lingering in the eurozone sovereign crisis. Bond yields are still too high in several countries to be sustainable. The focus on strict austerity without the prospect of growth, at least in the short to medium term, may worsen the situation before it gets better. Italy is currently rated only three notches above junk. If the country were downgraded further, it could lead to another wave of selling by institutional investors who want or are only allowed to hold investment-grade debt. A sharp increase in Italian yields can currently only be prevented by bond purchases from the ECB, as other rescue mechanisms are currently too small to cope with a country the size of Italy. We don't think there is currently any expectation for the rescue funds to be enlarged to such an extent that they can cope with an Italian or Spanish bailout. Given the austerity measures and the structural reforms which the new Italian administration has announced, we think that Italy will be able to improve its government finances by enough to regain investor confidence.

The situation in Greece is also still a risk. Negotiations between the Greek government and private sector bondholders about the haircut on Greek bonds have so far failed. Such an accord would have been a prerequisite for the additional bailout that Greece needs. If Greece and its creditors do not come to an agreement, Greece may default on its debt, but we expect the parties to come to a deal eventually and a default to be avoided.

Finally, the debt downgrades could affect corporate debt and the financial sector since unrest in the eurozone government bond markets could spread to credit markets. However, since we think the impact on sovereign bond markets and equity markets will be limited, we also do not expect credit markets or financials to come under pressure. In fact, we think that the funding risks for the



financial sector were reduced substantially after the ECB provided unlimited three-year loans.

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