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Top 10 Investor Questions On The Eurozone Sovereign Debt Crisis

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Some signs are emerging that the eurozone (European Economic and Monetary Union) could be starting to sustainably overcome the economic, financial, and budgetary stress that has affected it over the past few years, Standard & Poor's Ratings Services believes. Rising exports appear to be leading the way for a more rapid rebalancing of eurozone debtor economies than we previously envisaged. We think this year could also see the return of some so-called "program countries"--member states that have benefitted from official financial support--such as Ireland and Portugal, to more substantial primary issuance in the capital markets. Still, implementation risks loom large, in our view. For this reason, our outlooks on seven eurozone sovereign ratings are still negative (for a full list of current long-term credit ratings see table 1).

Here, we respond to the most frequently asked questions that we've received regarding the prospects for the development in eurozone sovereign debt markets. These answers complement our opinions expressed in particular in our most recent reports "The Eurozone Debt Crisis: 2013 Could Be A Watershed Year", and "Exports Lead The Way For European Economies' Rapid Rebalancing", published Jan. 9, 2013 and Feb. 4, 2013, respectively, on RatingsDirect on the Global Credit Portal.

1. If Spain were to apply for a full ESM bailout, would you lower the sovereign ratings?

There's nothing in our criteria that would automatically require us to lower the current 'BBB-' rating with a negative outlook. Ireland, for example, has been a program country borrowing from the European Financial Stability Facility (EFSF AA+/Negative/A-1+) since 2011 and we maintained our rating at 'BBB+', three notches within investment grade. Earlier this month, we also revised the outlook on Ireland to stable from negative. Spain has already requested, and been granted, European Stability Mechanism (ESM) support of up to €100 billion for its banking system. Should Spain decide to request a full bailout in direct support of the government's budget to complement its own sovereign bond issuance, we believe this would constitute an official acknowledgement that the government considers that it is encountering risks to securing capital markets financing at sustainable rates. However, we think that the potentially advantageous terms Spain could receive under a full bailout could enhance the chances that its ambitious and politically challenging fiscal and economic reform agenda would succeed. Nevertheless, we expect increasing regional and national resistance to this agenda as disposable incomes continue to decline in the near term and as Spain's labor market remains very weak (for further details see: "A Request For A Full Bailout Would Not Affect Spain's Sovereign Ratings," published Aug. 22, 2012).

Should it receive a full ESM bailout program, Spain could also benefit from the European Central Bank's (ECB) outright monetary transactions (OMT). These give the ECB capacity for unlimited purchases of sovereign securities of a tenor of up to three years in the secondary market, subject to Spain fulfilling its policy commitments. The ECB's bond holdings purchased under the OMT would rank pari passu with senior unsecured debt holders, in contrast to the preferred creditor treatment the ECB had enjoyed during the Greek restructuring. We believe that the availability of

ESM and OMT support could help stabilize the euro area government bond market as a whole and strengthen the resolve of governments of the so-called "periphery" member states to continue their budgetary and economic reform endeavors. In our view, sustained reform progress could enhance the credit prospects of those sovereigns (see "The European Central Bank's Policy Initiatives Could Benefit Some Sovereigns, But Implementation Risks Remain," published Sept. 7, 2012).

2. When will you issue a rating on the ESM?

We haven't been asked to rate the ESM and it is our current policy not to assign unsolicited ratings to entities such as the ESM. In the meantime, we continue to rate the ESM's predecessor, the EFSF, based on the latter's sovereign shareholder guarantee structure.

3. What prompted your recent outlook revision on Ireland to stable from negative?

We believe that the February 2013 exchange of promissory notes, which the Irish government had provided to the Irish Bank Resolution Corporation (IBRC) for long-dated Irish government bonds, should reduce the government's debt-servicing costs and lower refinancing risk. We believe the success of the exchange increases the likelihood of a full return by Ireland to private financing and, therefore, of Ireland successfully exiting the EU/IMF bailout program at the end of 2013. We expect that the liquidation of IBRC could modestly weaken the general government fiscal balance in 2013. But we project savings on interest payments on the promissory notes will narrow the Irish government's fiscal deficits in 2014 and 2015 by at least 0.6% of GDP--probably somewhat more--given that delayed refinancing reduces compound interest payments. We note Ireland's strong commitment to meeting its fiscal targets, as well as the Irish economy's openness and flexibility. The latter is evidenced, for example, by the strong improvement in Ireland's current account position. We expect that it will record the fourth consecutive year of current account surpluses in 2013, exceeding 3% of GDP, from a deficit above 5% of GDP in 2007 and 2008. The stable outlook balances our view of Ireland's progress toward rebalancing its economy and consolidating its fiscal position on the one hand against the downside risks we see to its financial sector stability and its highly leveraged balance sheet, as well as what we view as the uncertain growth prospects for Ireland's domestic economy on the other (see "Ireland Outlook Revised To Stable On Promissory Notes Exchange; 'BBB+/A-2' Ratings Affirmed," published Feb. 11, 2013).

4. Why, then, did Standard & Poor's recently confirm its negative outlook on Portugal, despite its successful reentry into commercial debt markets?

All 126 sovereigns rated by Standard & Poor's globally are rated under the same published criteria. Portugal (BB/Negative/B), in our view, has achieved a lot since 2010. It consolidated its fiscal position by more than 5% of GDP (excluding one-off items), with most of this occurring on the expenditure side. At the same time, strong export performance and contracting imports have enabled the current account to narrow from a deficit of 10% of GDP on average between 2000-2010 to what we believe will be a small surplus in 2013. This rapid improvement in Portugal's current account position has occurred on the back of strong export performance--complemented by the disciplined

implementation of structural reforms--alongside a significant drop in imports due to weak domestic demand. We expect the Portuguese government to remain committed to meeting the terms attached to the EU/IMF program. In our view, Portugal's economy will continue to rebalance.

However, in our view the key constraint for the ratings is still the high public and private net external debt as a share of current account receipts, which remains among the highest of all rated sovereigns. In our opinion, risks to the social contract also remain. Disposable incomes continue to decrease as wages and employment rates drop, the tax burden rises, and difficult domestic credit conditions persist. We believe a key policy risk is the possibility that upcoming decisions by the Portuguese Constitutional Court regarding important measures of the 2013 budget could prevent the government from proceeding with its ambitious expenditure-led budgetary consolidation program.

We could revise the outlook to stable if we observe continued progress in Portugal's economic rebalancing and fiscal consolidation, underpinned by a Constitutional Court ruling that does not cause a fiscal gap that can't be addressed by the government (see: "Portugal Ratings Affirmed At 'BB/B'; Outlook Remains Negative On Fiscal Risks," Jan. 21, 2013).

5. How significant are France's recently announced labor measures for Standard & Poor's sovereign rating?

According to the European Commission's Autumn 2012 forecast, French unit labor costs rose approximately 1.5% faster per year than Germany's during the decade leading up to 2007. Even after the onset of the global financial crisis in 2008, French total economy compensation rates expanded faster than its underlying productivity. European Commission figures also record that France's trade balance, which was in broad balance during the first years of eurozone membership, has turned into a deficit of more than 3% of GDP since 2011 (although France continues to operate a significant services surplus). By comparison, the overall eurozone's trade surplus has remained broadly unchanged in this period. Since the onset of the crisis, unit labor costs have dropped fast in Spain and other "periphery" countries, making France's declining relative competitiveness appear ever more prominent. At the same time, the mismatch between French wages and productivity has cut into the French economy's gross value added, pressuring corporate margins and weakening GDP and labor demand.

Consequently, it is our impression that for the first time in many years, measures to increase the competitiveness of French companies have moved to the top of the political agenda. The government-commissioned Gallois report released in November 2012 laid out a possible blueprint for reversing the recent trends. The government chose to adopt some selected measures of that report's recommendations, including payroll tax relief for companies. The government also announced in January 2013 what we view to be important labor reforms including greater flexibility for employers to cut hours and wages during an economic downturn in exchange for job guarantees. We believe the labor reform proposal--which has yet to become law--could help employers better align wage costs with economic conditions. It has fewer implications, in our view, for staff employment rates or for eliminating the duality of France's labor market. But we still believe that the proposal could, if implemented, contribute to ending and possibly even reversing the trend of rising French unit labor costs.

We affirmed the 'AA+' rating and negative outlook on France on Nov. 23, 2012. At that time, we indicated that the outlook could return to stable if the authorities can reduce the general government deficit such that the public debt ratio stabilizes in the next two to three years. Substantial structural reforms that improve economic competitiveness and support growth could also help stabilize the ratings.

6. What effect could the general election have on your sovereign rating on Italy?

We believe that Italy's history of weak and fragmented coalition governments helps to explain its high public debt, estimated at 127% of GDP as of year-end 2012. Even so (and partly because Italy is now operating primary budgetary surpluses), we currently see economic growth rather than fiscal performance as Italy's key credit risk. We believe that the risk exists that after the Feb. 25 elections there may be a loss of momentum on important structural reforms to improve Italian growth prospects.

Despite the reforms Mario Monti's technocratic government has introduced over the past year, we see that the Italian economy's growth prospects remain constrained by labor market rigidities, a heavily protected services sector, and a high tax burden on labor and industry. Although fiscal policy delivers a primary surplus, the composition of public spending has added to Italy's economic challenges. The tax burden has traditionally funded current expenditures that have in our view not delivered lasting improvements in potential growth. Even before the 2008 global financial crisis, Italian GDP growth was only just over 1% per year. European Commission estimates indicate that during the first decade of the eurozone, Italy registered the lowest per capita growth of any EU member. Export performance has improved recently, but the Italian economy, which is dominated by small and midsize enterprises, is facing a series of pressures. In our opinion, those include restricted availability of credits, structural bottlenecks, constrained financial institutions, and poor demographics. The implementation of measures to boost Italy's medium-term growth prospects depends, in our view, on the strength of the next government's mandate in both houses of parliament.

Our negative outlook on the 'BBB+' sovereign rating on Italy reflects what we view as mostly downside risks to its reform policy agenda, overall economic outlook, and debt reduction plans (see: "Italy (Republic of)," published Dec. 12, 2012).

7. Greece defaulted twice in 2012. Do you think that it can avoid defaulting again?

We rate Greek government debt 'B-' with a stable outlook, as we do not see a third default as imminent. Greece's credit standing could improve gradually with continued support from its eurozone partners, improvement in its tax administration, privatization of public assets, and liberalization of its protected professions, all of which we believe would bolster Greece's growth potential.

Even after Greece's sovereign debt buyback in late 2012 (which we classified as a distressed debt exchange and thus a second default following the restructuring in the spring of 2012), Greece's end-2012 net debt-to-GDP ratio of over 160% of GDP remains onerous. Nevertheless, subject to Greece meeting program conditions, we believe that eurozone

member states would contemplate further improving official lending terms to the government. This would be an effective write down of the Greek public debt stock in net present value terms. We expect any such "reprofiling" of the debt would affect official creditors (EFSF and bilateral loans from eurozone governments) only, which would not fall under Standard & Poor's "default" definition. Accordingly, we would not lower the sovereign rating on Greece to 'D' in such a scenario (see: "Ratings On Greece Raised To 'B-/B' From Selective Default On Completion Of Debt Buyback; Outlook Stable," Dec. 18, 2012).

8. Will Cyprus default? What would be the implications for the rest of the eurozone?

We rate Cyprus 'CCC+' with a negative outlook. With the government's financing options increasingly limited--coupled with what appears to be a hesitant attitude of Cyprus' eurozone partners toward sharing the cost of a severe Cypriot banking crisis--we view the risk of a sovereign debt default as material and rising. We see at least a one-in-three chance that we could lower the Cyprus sovereign ratings again in 2013, for example if official financial assistance from the ESM and/or IMF is not forthcoming, leaving the Cypriot authorities few choices apart from to restructure its financial obligations. We could also lower the ratings if we believe the government is not able to fulfill the conditions that would be attached to an official assistance program (see: "Cyprus Rating Lowered To 'CCC+' On Intensifying Liquidity Risks And Burgeoning Debt Burden; Outlook Negative," Dec. 20, 2012).

If financial support were to be forthcoming, we would expect it to reach about €15 billion, which is more than three-quarters of Cypriot GDP (see: "Cyprus' Support Package Could Total Upwards Of €15 Billion Through 2014," July 17, 2012). The size of such a bailout could push the general government debt potentially beyond 140% of GDP. The official lender might consider such a high burden unsustainable taking into account the sovereign's medium-term growth potential (even though the natural gas findings off the Cypriot coast may lead to significant as yet uncertain revenue). In that case, the troika of the EU, ECB, and IMF could ask Cyprus to restructure its existing debt before taking on this new official debt. However, a significant proportion of government paper is held domestically. Private sector involvement would therefore add to bank recapitalization needs, hence lowering net savings to the government from a sovereign default.

We appreciate that a financial support package is controversial among Cyprus' EU partners. Some policymakers appear to have argued that Cyprus, accounting for merely 0.2% of eurozone GDP, is not systemically important enough to merit exacerbating perceived moral hazard problems through a bailout--all the more so as capital market conditions across the so-called "periphery" seem to have improved, at least for sovereign borrowers. There are also allegations that the business model of Cypriot banks is based on lax standards regarding money laundering and tax evasion. We understand that some European partners also seem to harbor misgivings about Cyprus attracting significant numbers of "brass-plate" enterprises through its advantageous tax and regulatory framework. We are furthermore aware that the German parliament will have to approve any ESM financing package. We believe that the upcoming general election in Germany on Sept. 22, 2013, could throw parliamentary approval for such a controversial deal into doubt.

Cypriot banks have financed themselves predominantly via large nonresident deposits (many of which originate from

the Commonwealth of Independent States) rather than through an interbank or bond market. Therefore, any debt write-off--be it because of no bailout being forthcoming or a debt restructuring precondition being set at the outset--would in our view likely entail uninsured depositors suffering losses. This would be a new dimension of the eurozone crisis management, where depositors and even senior bondholders in other distressed bank situations have been effectively protected in order to minimize contagion risk. In these circumstances, we believe that eurozone policy makers would consider taking action and try to prevent a demonstration effect that could, for example, reverse the recent stabilization of deposits in other periphery countries. While the structure of the Cypriot banking system is different in many ways from those of Greece and other periphery sovereigns, contagion risk remains, in our view.

We believe that Cyprus' short-term financing position is becoming ever tighter. The government has a €1.4 billion (over 8% of GDP) bond maturity due in early June. We believe that the option of a significant increase of the €2.5 billion (14% of GDP) bilateral loan from the Russian Federation is unlikely and would at best buy the government some more time. We would expect that any ESM lending would stipulate preferred creditor treatment, as codified in the ESM treaty. Given that the size of the ESM lending is likely to be very large (compared to Cyprus' GDP and government revenues), we believe that the credit risks for the de facto subordinated holders of the Cypriot sovereign international law bonds could rise significantly. This could potentially render Cyprus' return to private financing more uncertain. We have previously noted that we consider preferred-creditor treatment of the ESM potentially detrimental to sovereign creditworthiness (see: "Credit FAQ: Why The European Stability Mechanism May Have A Negative Impact On Some Sovereign Ratings In The Eurozone," April 8, 2011).

9. Could you comment on the 'AAA' rating on Germany considering its rising contingent liabilities from the various eurozone support mechanisms?

We assign a stable outlook to the 'AAA' rating on Germany. This indicates that in our view a downgrade is unlikely over the next two years. The rating on Germany is based on our view of a wealthy, modern, highly diversified, and competitive economy, on the government's track record of prudent economic and budgetary policies, and our view of the sovereign's ability to absorb large-scale economic shocks (see: "Germany (Federal Republic) of," published Nov. 27, 2012). What is often overlooked, in our view, is that the contingent liabilities shouldered by Germany (such as for EFSF guarantees, ESM callable capital, or loan losses from the bilateral loans to Greece) are higher than for any other eurozone member in absolute terms only. However, in relative terms, as a share of the country's GDP, Germany's contingent liability is broadly the same as that of any other eurozone sovereign that has not stepped out of the EFSF (that is, everyone except Ireland, Portugal and Greece).

Given that Germany's public finances are among the eurozone's strongest and its refinancing costs among its lowest we believe that Germany should be able to more easily absorb any contingent liabilities should they crystalize. We estimate that the maximum contingent liability from EFSF and ESM for Germany could amount to €223 billion, or 8.5% of Germany's 2012 GDP estimate. This would require a worst case scenario in which both rescue funds lend up to their respective capacity limits and have to write off 100% of those loans with no recovery, an outcome which we consider extremely remote. The worst case contingent liabilities are broadly comparable in size to those that the German government incurred in 2010 when it had to establish two "bad banks" in support of two large troubled German banks (Hypo Real Estate and WestLB). In line with our criteria, we are of the opinion that the German

government's balance sheet is strong enough to absorb this type of contingent loss without, by itself, jeopardizing the 'AAA' rating.

The pro rata distribution of losses, according to the ECB's subscription key, would also be applicable should a sovereign leave the euro area, leading to its national central bank's Target 2 balance with the Eurosystem (the eurozone's monetary authority) having to be written off. The actual Target 2 balance of the Deutsche Bundesbank (€656 billion at year-end 2012) is not relevant for this loss-sharing calculation, unless we assume a complete dissolution of the euro area and a return to a world of pre-1999 monetary arrangements, which we also consider an implausible assumption.

10. What is the probability of one or more sovereigns leaving the eurozone in the near term?

At the height of the crisis we were of the opinion that there was at least a one-in-three probability of Greece leaving the eurozone, despite our assessment that the social, political, and economic consequences would probably be adverse to Greece (see: "Credit FAQ: Sovereign Rating Implications Of A Possible Greek Withdrawal From The Eurozone," published June 4, 2012). The policy initiatives that have been undertaken since have in our view reduced the likelihood of a Greek exit from EMU. These initiatives include:

- The eurozone governments' agreement to move forward with a banking union with a common backstop (even if concrete progress is to date slower than originally expected);
- The ECB's announcement of outright monetary transactions (OMT) in September 2012 and its clarification that OMT bond purchases would be held pari passu;
- Official creditors' substantial net present value debt and interest cost relief granted to Greece in late 2012;
- Provision of 'AA+' rated EFSF floating-rate notes to recapitalize the Greek commercial banking system, helping to moderate Greek banks' exposure to Greek sovereign risk; and
- Progress on wage competitiveness and fiscal consolidation, despite limited headway on structural reforms.

This revised assessment is consistent with our current 'B-' rating on Greece. Historically, a sovereign rating in the 'B' category has coincided with a default probability of 12% after five years and 29% after 10 years (see tables 8 and 9 of "Sovereign Defaults And Rating Transition Data, 2011 Update," published March 2, 2012). We believe that an exit of Greece from the eurozone would coincide with a sovereign default. Assuming that historical default rates remain stable, we therefore consider that the likelihood of exiting is not higher than the historical likelihood of default. Given that much of the cost in terms of political capital has already been invested through successive rounds of austerity measures, an exit after all those sacrifices is now less likely, in our view, than in the summer of 2012.

Apart from Greece, we continue to believe that the incentives for another eurozone country to return to a national currency remain even weaker. We do not anticipate a political movement acceding to power in any of the member states in favor of what we would view as a radical step into the unknown.

Table 1

Eurozone Sovereign Ratings

Sovereign	Long-term rating*	Outlook*	CDS¶	Bonds¶	Date of latest rating action	Latest rating/outlook action
Austria (Republic of)	AA+	Stable	aa+	aa	29-Jan-13	Outlook revised to stable from negative, ratings affirmed
Belgium (Kingdom of)	AA	Negative	a	aa	29-Jan-13	Ratings affirmed, outlook remains negative
Cyprus (Republic of)	CCC+	Negative	ccc	cc	20-Dec-12	Ratings lowered to 'CCC+' from 'B'. Outlook is negative
Estonia (Republic of)	AA-	Stable	aa-	n.a.	19-Oct-12	Long- and short-term ratings affirmed, outlook revised to stable from negative
Finland (Republic of)	AAA	Stable	aaa	aa+	14-Jan-13	Outlook revised to stable from negative, ratings affirmed
France (Republic of)	AA+	Negative	a-	aa	23-Nov-12	Ratings affirmed, outlook remains negative
Germany (Federal Republic of)	AAA	Stable	aaa	aaa	2-Aug-12	Ratings affirmed, outlook remains stable
Greece (Hellenic Republic)	B-	Stable	cc	cc	18-Dec-12	Long-term ratings raised to' B-' from SD. Outlook stable.
Ireland (Republic of)	BBB+	Stable	bbb-	bbb-	11-Feb-13	Outlook revised to stable from negative, ratings affirmed
Italy (Republic of)	BBB+	Negative	bb+	bbb-	13-Jan-12	Long-term ratings lowered to 'BBB+' from' A'. Outlook is negative
Luxembourg (Grand Duchy of)	AAA	Stable	n.a.	aa+	14-Jan-13	Outlook revised to stable from negative, ratings affirmed
Malta (Republic of)	BBB+	Stable	n.a.	a-	16-Jan-13	Long-term ratings lowered to 'BBB+' from 'A-'. Outlook revised to stable from negative
Netherlands (The) (State of)	AAA	Negative	aa	aa+	14-Jan-13	Ratings affirmed, outlook remains negative
Portugal (Republic of)	BB	Negative	b+	b+	21-Jan-13	Ratings affirmed, outlook remains negative
Slovak Republic	A	Stable	a-	a+	3-Aug-12	Ratings affirmed, outlook remains stable
Slovenia (Republic of)	A-	Stable	bb	bb+	12-Feb-13	Rating lowered to' A-' from 'A'. Outlook is stable
Spain (Kingdom of)	BBB-	Negative	bb	bb+	10-Oct-12	Long-term ratings lowered to 'BBB-' from 'BBB+'. Outlook remains negative

*As of Feb. 18, 2013. ¶Implied "ratings" derived from market pricing of credit default swaps (CDS) contracts or bond markets; as of Feb. 15, 2013, 4.30 EST. For details see "How Standard & Poor's Arrives At Market Derived Signals", published in May 2009, which can be retrieved from the abovementioned sovereigns' landing page on globalcreditportal.com.

Related Criteria And Research

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- Portugal Ratings Affirmed At 'BB/B'; Outlook Remains Negative On Fiscal Risks, Jan. 17, 2013
- Ireland Ratings Affirmed At 'BBB+/A-2' On Stabilizing Fiscal And Economic Environment; Outlook Negative, Jan. 11, 2013
- The Eurozone Debt Crisis: 2013 Could Be A Watershed Year, Jan. 9, 2013

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