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Standard & Poor's Recent Rating Actions On Highly Rated Sovereigns

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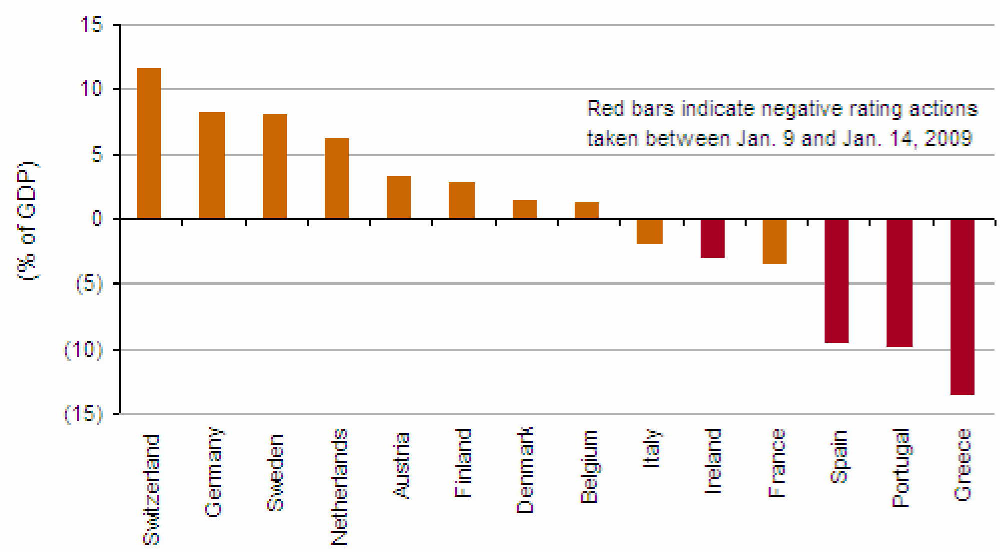
Between Jan. 9 and Jan. 14, 2009, Standard & Poor's Ratings Services affirmed the 'AAA' long-term ratings on Australia, Austria, Canada, Finland, France, Denmark, Germany, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. We also affirmed the 'AA+' long-term rating on Belgium, the 'AA' long-term rating on Japan, and the 'A+' long-term rating on Italy. We lowered the long-term rating on Greece one notch to 'A-'. In addition, the outlooks on the 'AAA/A-1+' ratings on Ireland and the 'AA+/A-1+' foreign currency ratings on New Zealand were revised to negative from stable. We also placed the 'AAA' long-term rating on Spain, and the 'AA-' long-term rating on Portugal on CreditWatch with negative implications pending further information on these governments' economic and financial sector policies.

While the need to recapitalize banking systems and to administer fiscal stimulus will, in our view, push up net general government debt levels in highly rated sovereigns over the near term, we are also of the opinion that substantial levels of wealth and diversification in Australia, Austria, Canada, France, Denmark, Germany, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States put them in a strong position to weather difficult economic conditions and to maintain their high creditworthiness, in spite of intense pressures on their domestic financial systems. Implicit in this judgment is our view that 'AAA' rated governments will adopt credible exit strategies from fiscal stimulus programs in order to consolidate public finances once growth recovers to potential. Specifically, we expect these governments will increase primary surpluses, rather than trim the debt stock by letting inflation rise significantly.

Negative ratings actions on Greece, Ireland, Portugal, and Spain reflect their economies' higher susceptibility to a tightening external credit channel. Over the last half decade, all four of these Economic and Monetary Union (EMU) members have, in our view, lost competitiveness relative to their European peers, leading to a rise in their imbalances (see chart). In the current environment, we believe that the sizeable capital inflows necessary to finance these imbalances may not be forthcoming at attractive rates, forcing a sharp and possibly dislocating economic correction that will likely take its toll on public finances. We see the absence of flexible exchange rate regimes in these four EMU countries, moreover, shifting the onus of the adjustment onto the domestic economy. Hence, in our view, national price and wage levels must rise less than (or productivity must rise by more than) those of trading partners in order for these economies to improve their competitiveness within the framework of monetary union. This difficult adjustment will likely need to occur during a period of sharp private sector deleveraging.

Selected European Highly Rated Sovereigns' Current Account Balances



In general, we assume that more highly levered countries will experience more severe recessions and more anemic recoveries in output compared with countries with lower financial leverage, and relative to past trends. These assumptions are important because in our view they influence the projected path of fiscal balances, excluding the fiscal cost of bank recapitalizations.

Some sovereigns entered the current period of turmoil from a position of relative strength, with increasing economic competitiveness (for example, Germany), sustained fiscal surpluses (Denmark), or high current account surpluses (Japan). Other sovereigns entered the current period of turmoil from a position of relative weakness, with weak productivity growth (Portugal), high current account deficits (Spain), or persistent fiscal deficits (Greece).

Ireland (AAA/Negative/A-1+) was the first European country to enter the current recession, with sharp deteriorations in commercial and residential real estate prices. Its recession is likely to be a protracted one. According to the European Commission, property-related tax (capital gains tax and stamp duty) accounted for 15% (3.8% of GDP) of total tax revenues in 2006, falling to 8% in the first eight months of 2008. This was the single most important factor in the deterioration in the general government balance. We have observed that general government debt levels also increased substantially between 2007 and 2008--by more than 16% of GDP--as a result of the widening fiscal deficit, although a substantial portion of the increased indebtedness (10% of GDP) remains in exchequer cash balances as a liquidity buffer. The government has also extended guarantees to seven domestic credit institutions through to Sept. 29, 2010, increasing general government guaranteed debt to an estimated 228% of GDP in 2009. Banking system exposure to the property and construction sector of about one-third of total loans (excluding interbank lending) suggests a high risk of asset deterioration for these institutions.

The Kingdom of Spain's (AAA/Watch Neg/A-1+) strong growth performance in recent years was facilitated by the rapid expansion of domestic credit, leading to a build-up of imbalances. Such imbalances are reflected in the country's sizeable current account deficit at around 10% of GDP in 2008. Due to the need for the private sector to restructure and deleverage balance sheets, we believe that the unwinding of the deficit increases the probability of a protracted economic slowdown. In any case, we expect the rebalancing of the economy towards a more sustainable growth model will lead to weak growth over the medium term. Given the government's relatively strong fiscal balance sheet, we expect the Kingdom to adopt countercyclical measures, with the general government deficit rising well above 3% of GDP until 2011, and peaking above 6% in 2009. Over the medium term, there appears to be a need for a reduction in expenditure to a level more commensurate with lower revenues and a weaker growth outlook.

In Portugal (AA-/Watch Neg/A-1+), the government has announced a €2.2 billion (1.3% of GDP) stimulus package in an effort to soften the impact of the economic downturn, thereby reducing the fiscal flexibility it had won in recent years. Notwithstanding the need to provide stimulus to the economy during a recessionary phase, we believe the pace of fiscal consolidation had already begun to slow and overall public sector reform has proved less successful than hoped. Based on our expectations of higher social expenditure and weaker revenue growth compared with official forecasts, we forecast the general government deficit to rise well above 3% of GDP over the next two years, while the already high debt burden is expected to rise above 70% of GDP, further reducing fiscal flexibility. Moreover, we expect the outcome of the 2009 general election may be less conducive to the implementation of structural reforms, particularly if the ruling Socialist Party has to operate with a reduced majority.

In Greece (A-/Stable/A-2), a strong growth performance in 2002-2007 was accompanied by a worsening of large structural imbalances, mirrored in persistent inflation differentials within the Euro-area, rising unit labor costs, and a large and growing current account deficit, estimated at above 14% of GDP in 2008. These factors reflect an underlying loss of competitiveness in the Greek economy. We believe Greek public finances are weakly positioned to weather a sustained economic slowdown. We see Greece entering the economic downturn with a fiscal deficit and gross debt estimated, respectively, at 3.5% of GDP and 94% of GDP in 2008. We are of the opinion that the growth forecasts underlying the 2009 budget are optimistic and that the 2% of GDP deficit target is not likely to be attainable next year, with the deficit likely to be significantly higher. The government's ability to react is, we believe, further limited by its current low parliamentary support and eroding public support, especially since the onset of the economic crisis and the December 2008 riots.

In New Zealand (foreign currency AA+/Negative/A-1+), central government balances on a cash basis averaged 1.0% of GDP in the 10 years to fiscal 2008. As a result, we estimate that the general government ended 2008 in a net asset position of 4.5% of GDP, the bulk of the assets being pension fund holdings. Furthermore, the Reserve Bank of New Zealand has kept inflation within the target band of 1%-3% on average over the course of the cycle, the New Zealand dollar floats freely, and its largely foreign-owned banking sector appears sound. That said, New Zealand's high level of external debt is, in our view, a relative weakness compared with that of its peers. We observe that current account deficits have been about 25% of current account receipts (CAR) in each of the past four years, and have been financed by rising private sector external debt. In the five years to fiscal 2008, net financial sector external debt doubled to about 200% of CAR. Net nonfinancial private sector external debt has also risen in the same period. We project that the gross external financing requirement (current account deficit plus short-term external debt by remaining maturity) will rise to about 225% of 2009 CAR. Such a high level of external debt may, in our view, cause funding costs for private sector borrowers to rise, depressing investment and deepening the country's economic downturn should there be a change in investor sentiment. In this regard, the next budget, due May, will in our view be a key indicator of the government's intent regarding medium-term expenditure cuts and reprioritizing of policy initiatives.

The rating actions we recently took follow a review of 20 highly rated sovereign governments by Standard & Poor's. Our review entailed:

- Estimating the possible costs to governments of recapitalizing their banking systems. Our baseline scenario looks at the programs the majority of governments have already announced and presumes that the size of sovereign bail-outs will be capped at that level. In the alternative stressed scenario, we assume a higher recapitalization cost in line with a much sharper-than-anticipated deterioration in banking system asset quality. Baseline and stressed recapitalization costs were estimated in coordination with Standard & Poor's Financial Institutions group. As part of the stressed scenario, we include projections of future net general government debt levels under assumptions of weaker growth, lower inflation, and wider fiscal deficits for 2009 and 2010. The analysis includes assumptions distinguishing liquidity operations (which we assume will ultimately not result in a permanent rise in net government debt) from solvency operations (which may result in a steep rise in the government debt burden). We also assume that sovereign guarantees on banking liabilities will not be called. Note that Standard & Poor's definition of "net general government debt" nets out only easily liquidated arms-length assets, including cash and tradable securities of entities receiving no form of government support. This differentiates our net general government debt ratios from those of other institutions' in a more conservative direction.

- Examining financial leverage in each economy. This entails estimating the potential gross problematic assets in a banking system using metrics developed by Standard & Poor's Financial Institutions group, adjusted for a system's size, and comparing the result with the size of announced and projected government recapitalization programs. These comparisons are important because the degree of financial leverage in the different economies is correlated with the likely severity of economic contraction, and with the risks that additional capital injections by governments into banks will be needed above what we are assuming.

- Projecting real GDP growth rates for these economies in the 2009-2013 period. Our projections incorporate our current forecasts for 2009, plus our expectations about the shape of recession and recovery in each country. In general, we assume that more highly levered countries which lack monetary flexibility will experience relatively more severe recessions and anemic recoveries in output compared with countries with lower financial leverage, and relative to past trends. These assumptions are important because they influence the projected path of fiscal balances, excluding the fiscal cost of bank recapitalizations.

- Evaluating fiscal stimulus packages. A number of governments have announced plans to cut taxes and to raise spending with the aim of moderating a decline in output. Others are likely to follow suit later this year. We have incorporated our assumptions of such measures into our fiscal scenarios, which in turn allow us to calculate the growth of government debt burdens as measured by net general government debt as a percentage of GDP.

- Placing these results alongside the existing relative credit strengths and weaknesses of each sovereign. Some sovereigns entered the current period of turmoil from a position of relative strength, with growing economic competitiveness (for example, Germany), sustained fiscal surpluses (Denmark), or high current account surpluses (Japan). Others entered from a position of relative weakness, with anemic productivity growth (Portugal), high current account deficits (Spain), or persistent fiscal deficits (Greece). Starting positions within a particular rating level were important in the outcome of the stress test.

As part of our review, we ran a baseline and a stressed scenario for the 20 sovereigns, the results of which are found in tables 2 and 3. For those governments whose ratings we affirmed, we believe that the current ratings are consistent with our reasonable stressed scenario. For all of these highly rated sovereigns, we believe that they will eventually raise their primary fiscal balances to stabilize their debt burdens at levels consistent with their ratings.

In the baseline scenario for each of the 20 highly rated sovereigns, we simulated the first-round impact on government debt burdens of actual and potential government equity injections and other bank support operations that are likely to have a fiscal impact. We combined this with the potential for government fiscal stimulus measures and the projected path of contractions and recoveries in real GDP. In the stressed scenario, we assume higher banking system losses and hence higher recapitalization costs for all 20 sovereigns. In addition to the stressed simulation, we assume a one percentage point decline for 2009 and 2010 in (1) average GDP growth; (2) the general government balance; and (3) deflator growth. As can be seen in the tables, both the baseline and stressed scenarios suggest rapid growth in net general government debt burdens in the 2008-2013 period for the U.S., U.K., and some of the smaller sovereigns in the Eurozone relative to other key sovereigns (such as Germany and France). This is because of (1) above-average levels of private sector indebtedness in these countries at the start of the current period; (2) the rapid growth of the financial sector in recent years; and (3) related to these factors, our expectations, even taking account of likely fiscal stimulus and banking recapitalization packages, of significantly slower rates of real GDP growth in the medium term.

We recognize that the simulations--particularly the banking recapitalization stressed scenario–-are indicative and may not fully capture the full extent to which government indebtedness may grow in the future. Estimating the need for additional government equity injections is inherently uncertain. The cost of recapitalizing national banking systems is not a proxy for the projected loan and operating losses of domestic financial systems. Hence, the estimates of the cost of government-financed bank recapitalization programs must, in our opinion, be viewed alongside measures of potential additional financial distress to assess the risk that government debt burdens in some countries may grow even faster than shown in the simulations. These potential measures are reflected not only in our estimates of levels of gross problematic assets as a percentage of GDP, but also by the size of total banking system assets (both domestic and external) as a percentage of GDP. In our view, other material factors include the prior level of capital and reserves in the banking sector, as well as the specific approach taken by the government in response to the downturn. Intuitively, the larger a banking system in proportion to the underlying economy, the higher the risks of contingent liabilities to the sovereign.

Table 1

Recapitalization Amounts For Highly Rated Sovereigns

	Recap. baseline case amount* (Bil. LC)	Recap. base case* (% of GDP)	Recap. worst case amount (Bil. LC)	Recap. worst case (% of GDP)	Lower bound of GPA applied to 2008 dom. credit (% of GDP)	Upper bound of GPA applied to 2008 dom. credit (% of GDP)
Australia	11	1.0	39	3.5	6.7	20.2
Austria	6	2.0	15	5.3	12.1	24.2
Belgium	21	6.0	27	7.8	4.7	14.0
Canada	0	0.0	76	4.8	6.4	19.3
Denmark	0	0.0	70	3.9	10.1	30.4
Finland	0	0.0	2	1.0	4.3	13.0
France	12	0.6	40	2.0	6.1	18.4

Table 1

Recapitalization Amounts For Highly Rated Sovereigns (cont.)

Germany	80	3.2	120	4.8	5.2	15.6
Greece	5	2.0	13	5.1	10.5	20.9
Ireland	8	4.0	15	8.0	10.9	32.6
Italy	18	1.1	60	3.8	11.2	22.4
Japan	2,500	0.5	7,500	1.5	20.4	40.9
Netherlands	14	2.3	20	3.4	10.9	32.7
New Zealand	2	1.0	6	3.5	15.8	31.7
Portugal	4	2.4	10	6.0	19.5	39.0
Spain	12	1.1	48	4.3	8.8	26.3
Sweden	0	0.0	65	2.0	6.5	19.6
Switzerland	6	1.1	26	4.9	9.2	27.5
U.K.	40	2.8	83	5.7	10.1	30.4
U.S.	1,040	7.3	1,900	13.3	7.7	23.0

*Including purchases of impaired assets. 3.5% assumed for Australia and New Zealand; 1% for Japan. GPA--Gross problematic assets.

Table 2

Highly Rated Sovereigns' Baseline Scenario

	Net general gov't debt (% of GDP)			General gov't balance exc. recap (% of GDP)	Real GDP (% change)	GDP Deflator (% change)
	2008 (with 15% asset cut & pre recap)	2008	2009	2009	2009	2009
Australia	(1.8)	(0.8)	0.3	(1.0)	0.5	3.7
Austria	65.2	65.2	69.8	(3.0)	(1.0)	0.0
Belgium	77.4	83.4	86.6	(2.5)	(0.8)	0.0
Canada	27.6	27.6	28.6	(1.3)	(0.6)	1.6
Denmark	14.9	14.9	15.2	(0.1)	(0.7)	0.0
Finland	(20.9)	(20.9)	(21.6)	0.7	(1.1)	0.7
France	60.2	60.8	66.1	(4.5)	(1.3)	0.0
Germany	62.5	64.0	69.9	(3.0)	(2.0)	0.0
Greece	90.6	90.6	93.9	(4.0)	0.5	1.5
Ireland	21.0	23.0	37.2	(9.7)	(2.0)	0.0
Italy	101.6	101.6	108.5	(4.3)	(2.0)	0.0
Japan	109.9	110.4	114.9	(3.9)	(0.5)	0.0
Netherlands	38.0	40.4	43.2	(2.0)	(2.0)	0.0
New Zealand	(3.3)	(3.3)	1.6	(4.5)	0.8	1.3
Portugal	60.7	60.7	65.8	(3.6)	(1.5)	1.0
Spain	26.9	26.9	34.6	(6.6)	(2.0)	0.0
Sweden	(1.4)	(1.4)	(0.6)	(0.8)	(1.1)	0.0
Switzerland	20.3	20.8	23.7	(1.5)	(1.0)	0.0
U.K.	49.4	50.8	63.5	(8.8)	(2.2)	0.0
U.S.	43.7	46.2	59.0	(10.0)	(2.0)	1.1

Table 3

Highly Rated Sovereigns' Stressed Scenario*						
	Net general gov't debt (% of GDP)			General gov't balance exc. recap (% of GDP)	Real GDP (% change)	GDP Deflator (% change)
	2008 (with 15% asset cut & pre recap)	2008	2009	2009	2009	2009
Australia	(1.8)	1.7	3.7	(2.0)	(0.5)	2.7
Austria	65.2	65.2	73.8	(4.0)	(2.0)	(1.0)
Belgium	77.4	85.1	91.0	(3.5)	(1.8)	(1.0)
Canada	27.6	27.6	31.7	(2.3)	(1.6)	0.6
Denmark	14.9	14.9	18.4	(1.1)	(1.7)	(1.0)
Finland	(20.9)	(20.9)	(20.7)	(0.3)	(2.1)	(0.3)
France	60.2	61.2	69.8	(5.5)	(2.3)	(1.0)
Germany	62.5	64.8	73.9	(4.0)	(3.0)	(1.0)
Greece	90.6	90.6	98.2	(5.0)	(0.5)	0.5
Ireland	21.0	25.0	44.8	(10.7)	(3.0)	(1.0)
Italy	101.6	101.6	113.0	(5.3)	(3.0)	(1.0)
Japan	109.9	111.4	119.1	(4.9)	(1.5)	(1.0)
Netherlands	38.0	40.4	46.0	(3.0)	(3.0)	(1.0)
New Zealand	(3.3)	(3.3)	3.4	(5.5)	(0.2)	0.3
Portugal	60.7	60.7	69.8	(4.6)	(2.5)	0.0
Spain	26.9	26.9	37.8	(7.6)	(3.0)	(1.0)
Sweden	(1.4)	(1.4)	1.4	(1.8)	(2.1)	(1.0)
Switzerland	20.3	22.7	30.9	(2.5)	(2.0)	(1.0)
U.K.	49.4	52.3	70.1	(9.8)	(3.2)	(1.0)
U.S.	43.7	50.4	69.5	(11.0)	(3.0)	0.1

*Includes stressed case recapitalization cost plus 2009-10 deficits 1% of GDP higher than baseline forecast plus 2009-10 growth and inflation 1% lower than baseline forecast.

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