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Special Comment

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Sovereign

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Sovereign Risk: Review 2009 & Outlook 2010

Fasten Your Seat Belts: Tumultuous Times Ahead

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Summary

2010 may prove to be a tumultuous year for sovereign debt issuers given the uncertainties surrounding the likely pace and intensity of fiscal and monetary "exit strategies" as governments start to unwind quantitative easing programs. Indeed, the only certainty is that the exit strategies will be fraught with a good deal of execution risk. In our view, the key policy challenge facing advanced economies is therefore to time the exit perfectly: not too quickly or too soon so as to prevent choking off growth; and not too slowly or too late so as not to unsettle financial markets.

This report first provides a brief review of 2009, focusing on Moody's interpretation of the truly challenging set of events that followed the bankruptcy of Lehman Brothers in late 2008, and then identifies the ten key themes that will, in our view, shape the state of sovereign risk in 2010.

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Of these, the main themes developed in this paper are as follows:

- As the global economic recovery attains a more solid footing, 2010 will at best see a "normalization" and at worst a severe tightening in government financing conditions. Long-term interest rates may increase more rapidly than expected because of an over-reaction to economic news, which we believe will be mildly positive overall. Moreover, the slow unwinding of "quantitative easing" will accelerate this credit repricing process.
- The end of exceptionally low financing conditions will expose the true cost of the crisis on government debt affordability across the world.
- Aaa governments will probably not have the luxury of waiting for the recovery to be secured before announcing and perhaps also implementing credible fiscal consolidation programs.
- As most governments simply cannot afford another financial crisis, they will attempt to ring-fence their balance sheets from selected contingent liabilities. This could in some cases create disorderly market conditions.
- EMU membership will protect some countries against liquidity risk but not against long-term insolvency risk.
- Despite a slow process of global sovereign risk convergence – i.e. a narrowing of the ratings gap between rich and poorer G20 countries – BRIC countries are unlikely to replace the large Aaas' role as anchors to the system any time soon.
- The crisis has once again revealed the dangers of financial globalization for emerging markets – namely, the upside of the recurrence of asset price inflation after the downside of precipitous outflows of capital. However, the arsenal of policy levers has not expanded.

Review 2009

How Has Our Analytical Framework Fared Throughout the Crisis?

Even before the demise of Lehman Brothers in September 2008, the world economy was already slowing down, government balance sheets in some advanced economies were starting to swell and central banks were reacting by rapidly lowering interest rates.

During this period, we applied limited rating downgrades to the debt of some Eastern European countries[1] that were growing above speed limits, aided by a private debt boom.

After the collapse of Lehman Brothers, the state of sovereign risk changed dramatically:

- The debt of large Aaa countries was purchased *en masse* at any price, even though this was the public debt of countries that were at the epicentre of the crisis.
- The local currency debt of highly creditworthy but small economies became equally frantically sought after.
- For the rest, an evaporation of dollars in the world posed difficulties for many governments, which had to intermediate the foreign currency needs of their banking and corporate sectors – in the best case thanks to swap lines from the Fed, and otherwise through the depletion of official foreign reserves and/or international assistance.

[1] Please refer to Moody's rating action press release entitled "*Moody's changes rating outlooks on Estonia and Latvia to Stable from Positive*", published on 12 September 2008.

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At the time, the key question for us was whether the woes afflicting international financial markets would lead to credit events – defaults by governments – and whether our rating constellation should be entirely recast. We deliberately opted for a selective approach, reflecting what we perceived to be structural impairments to creditworthiness in a through-the-crisis perspective, as compared to a broad-based downgrade approach based on clearly alarming cyclical trends.

Against this background, our approach during 2009 followed, as previously explained,[2] the strands outlined below:

Liquidity risk vs. structural impairments to creditworthiness

Since October 2008, we have endeavoured to differentiate as much as possible between **liquidity** problems – which we did not deem to be "lethal" for most sovereign debt issuers – and **structural** changes in the "economic model" and long-term debt profiles. As a result, we took very limited rating actions in response to liquidity tensions, but implemented decisive rating actions for some emerging European countries (such as Latvia[3] and Hungary[4]).

Losing altitude in the Aaa space

We also strived to clearly explain the attributes of a **Aaa-rated sovereign** and to emphasize that the Aaa zone has no upward limit (i.e. there is no limit to improvements in creditworthiness). Accordingly, some previously "high-flying" Aaa countries saw their debt metrics deteriorate without being downgraded because they had merely lost altitude within the Aaa space. Naturally, this triggered the question: when is the Aaa-Aa boundary crossed? We provided a clear response in our "Aaa Sovereign Monitor" and a companion paper,[5] both of which explained why Ireland was the only Aaa government to be downgraded.[6]

Upgrading countries in the midst of a once-in-a-century global crisis

Despite the crisis, we have continued to upgrade or signal positive momentum for the ratings of those countries that have shown a greater capacity to withstand the crisis than expected. In fact, it would be more appropriate to state "in light of the crisis" rather than "despite". Indeed, the crisis arguably represented the ultimate stress test for countries that are strongly rooted in the global economy and the global financial system. It was thus an incontrovertible test of their "shock-absorption capacity" – which is exactly what our ratings measure. So, while some Aaa governments were losing altitude on the absolute scale of creditworthiness – but not enough to be materially riskier and to justify a downgrade to Aa – we have identified **"ordinal winners"** further down the rating scale: namely, Chile, Brazil, China, Hong Kong, Peru, Turkey, Indonesia and others.

We believe this framework has served us well. However, it is going to be tested by the trends we describe below.

[2] Please refer to Moody's Special Comment entitled "*Rating Sovereign Risk Through a Once-a-Century Crisis*", June 2009.

[3] Please refer to Moody's rating action press release entitled "*Moody's downgrades Latvia's rating to A3 from A2*", published on 7 November 2008.

[4] Please refer to Moody's rating action press release entitled "*Moody's downgrades Hungary's sovereign ratings to A3 and assigns negative outlook*", published on 7 November 2008.

[5] Please refer to Moody's quarterly publication entitled "*Aaa Sovereign Monitor, Q3 2009*", as well as our Special Comment entitled "*Why Aaa Sovereigns Get Downgraded*", both published in September 2009. Please also refer to "*Aaa Monitor, Q4 2009*" published in December.

[6] Please refer to Moody's rating action press release entitled "*Moody's downgrades Ireland to Aa1; outlook negative*", published on 2 July 2009.

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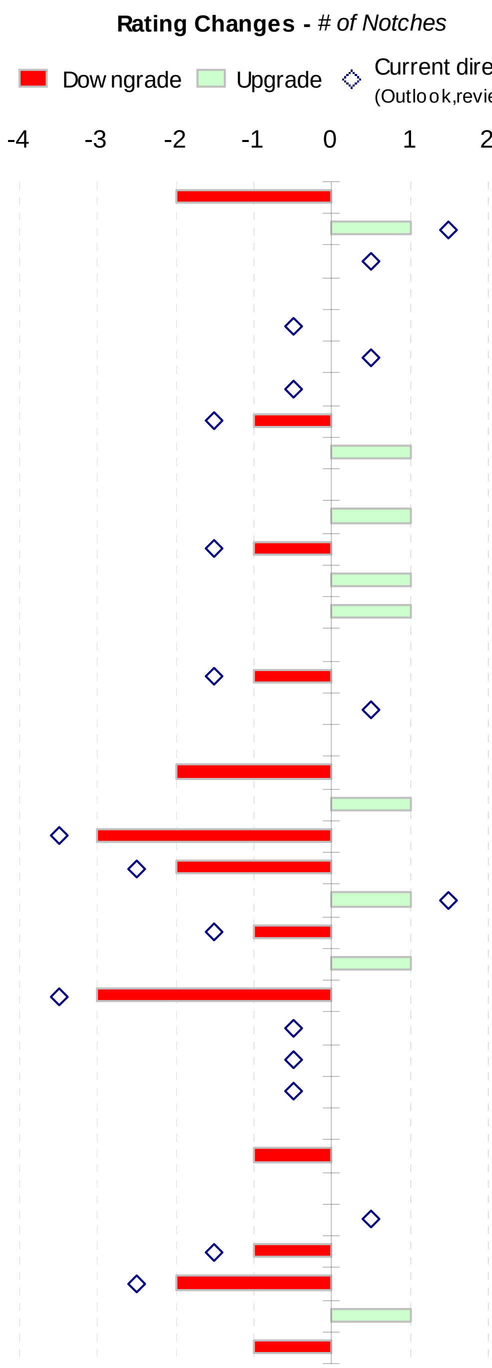
Sovereign Rating Actions in 2009 (1 January- 1 December)[7]



Country	Current Rtg	2008 Rtg	Rank - GG Debt (USD bn)
Japan[7]	Aa2/STA	Aaa/STA	11,067.92
Brazil	Baa3/POS	Ba1/STA	1,096.79
China	A1/POS	A1/STA	649.02
Belgium	Aa1/STA	Aa1/POS	505.64
Greece	A1/RUR-	A1/POS	422.23
Turkey	Ba3/POS	Ba3/STA	301.46
Portugal	Aa2/NEG	Aa2/STA	192.90
Ireland	Aa1/NEG	Aaa/STA	165.78
Indonesia	Ba2/STA	Ba3/STA	157.27
Egypt	Ba1/STA	Ba1/NEG	137.13
South Africa	A3/STA	Baa1/POS	115.17
Hungary	Baa1/NEG	A3/NEG	113.95
Philippines	Ba3/STA	B1/POS	95.66
Lebanon	B2/STA	B3/POS	47.11
Slovakia	A1/STA	A1/POS	35.18
Ukraine	B2/NEG	B1/STA	34.16
Peru	Ba1/RUR+	Ba1/STA	31.31
Slovenia	Aa2/STA	Aa2/POS	19.10
Iceland	Baa3/STA	Baa1/NEG	16.66
Uruguay	Ba3/STA	B1/RUR+	16.39
Jamaica	Caa1/NEG	B1/RUR-	14.77
Lithuania	Baa1/NEG	A2/NEG	12.06
Chile	A1/POS	A2/RUR+	11.74
El Salvador	Ba1/NEG	Baa3/STA	10.03
Ecuador	Caa3/STA	Ca/DEV	9.48
Latvia	Baa3/NEG	A3/NEG	9.32
Kuwait	Aa2/NEG	Aa2/STA	8.73
Kazakhstan	Baa2/NEG	Baa2/STA	7.77
Bahrain	A2/NEG	A2/STA	4.96
Azerbaijan	Ba1/STA	Ba1/POS	3.33
Barbados	Baa3/STA	Baa2/STA	2.63
Botswana	A2/STA	A2/POS	2.38
Hong Kong	Aa2/POS	Aa2/STA	2.35
Montenegro	Ba3/NEG	Ba2/NEG	2.12
Fiji Islands	B1/NEG	Ba2/NEG	1.50
Belize	B3/STA	Caa1/STA	1.14
Bermuda	Aa2/STA	Aa1/STA	0.68

**Note: Outlook/Review change normatively "scored" at 0.5. +/- indicates the direction of the change.*

[7] Note that the decision on Japan was to align the local currency bond rating (previously Aa3) and the foreign currency bond rating (previously Aaa) at Aa2.

Outlook 2010

The context for sovereign risk assessment has changed dramatically since the beginning of the crisis in mid-2007. In large part, this highlights the fact that the crisis of public finances that has beset many rich countries is the final – and disturbingly long-lasting – stage of the global crisis after the financial and subsequent economic crises.

The 10 Key Themes That Will Shape Sovereign Risk Analysis in 2010

Theme 1

Aaa countries will probably not have the luxury of waiting for the recovery to be secured before announcing credible fiscal consolidation plans.

Over the next few years, many rich Aaa economies' governments will have to repair their balance sheets in the difficult context of lower growth (our "hook-shaped scenario" for the global economy)[8] and without the benefit of the tail-wind of declining interest rates as in the past.

However, for most of 2009, the assumption was that governments could decide on the timing: first react to the crisis, then announce future plans, and finally implement.

Such a (sensible) schedule is predicated on the fact that international financial markets will keep on financing extraordinarily large borrowing needs at historically low prices.

While this may be the case, such an assumption may be proven wrong. A key concern is naturally an abrupt increase in real long-term interest rates after a long period of very low yields which has enhanced public debt affordability. We will address this risk in future publications and also discuss the unlikely risk of the dollar abruptly losing its predominant reserve currency status.

However, this type of risk is not certain. After all, Japan has now lived for many years with elevated public debt, deflationary pressures and very low interest rates. Also, large economies are hoping to durably influence long-term interest rates through skilful quantitative easing (QE).

But the risk is significant enough to focus governments' minds. "All" this would require for the risks to materialise, is the combination of a global economy that is closer to (the new) economic potential, perhaps some *ex ante* change in the saving-investment balance at the world level (with China and surplus savers having to purchase fewer US bonds) and/or an inflation-led panic.

Therefore, it is very likely that most governments will not have the luxury to wait until 2012 to start cleaning up public finances. 2010 will probably see the inflexion point in highly accommodative policies. In the meantime, tactical changes in debt management strategies will help. The US Treasury is trying to re-profile the maturity of its debt in order to lengthen it with the aim of reducing its vulnerability to such a possible shock.[9]

[8] Please refer to Moody's report entitled "*On the Hook – Update on Moody's Global Macroeconomic Risk Scenarios, 2009-2010*", May 2009.

[9] Please refer to Moody's Issuer Comment entitled "*US Treasury's Intention to Lengthen Debt Maturity Reduces Vulnerability to Interest Rate Shocks*", published December 2009. This article was originally published in the Weekly Credit Outlook on 2 November 2009.

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Theme 2

The "growth versus adjustment" debate is artificial: advanced economies will need as much adjustment as necessary, and as much growth as possible.

The debate in Europe and to some extent in the US is focused on the virtues of fiscal adjustment (raising taxes and/or cutting spending) as compared to a strategy of trying to "grow out of the debt".

A case in point is France where a "Grand Emprunt" (large debt program) will be launched in 2010: the goal is to facilitate long-term investment that will hopefully pay for itself through an increase in long-term growth potential.[10] Germany is also contemplating similar measures, but through tax cuts. In effect, the idea can be summed up as "more debt today in return for (hopefully) less debt tomorrow".

Although there is clearly some economic logic behind such approaches, it is unclear whether the growth potential of wealthy and very well-equipped economies can be increased meaningfully in such ways. After all, governments have little direct influence over total factor productivity, the main source of economic growth in such economies.

In fact, all the headwinds that constrain economic recovery in mature economies suggest that growth is unlikely to solve the problem. Most advanced economies will need to consolidate as much as is needed for them to keep debt at affordable levels – which in turn will slow down the rebound.

In conclusion, any further debt-fuelled growth strategies will have to reap immediate rewards to avoid unsettling increasingly volatile markets and placing governments' backs against the wall.

Theme 3

For countries operating at sharply lower output levels and with reduced growth potential, the debt equation will look increasingly complicated.

The crisis has reduced most countries' output level, but, in some cases, it has also dented their potential growth rate. This is the idea that underpins our global macroeconomic scenario of a "hook-shaped" growth.[11]

As shown in the stylized graphs on page 9, operating at a different output level has potentially far-reaching implications for public finances. While public outlays are rather insensitive to output level – in fact spending grows as unemployment increases – taxes are indexed on economic activity. A lower output level and, even more, a lower growth trend open wider structural gaps in public finances. So, with all variables remaining equal, the effort to return to fiscal balance is much more significant.

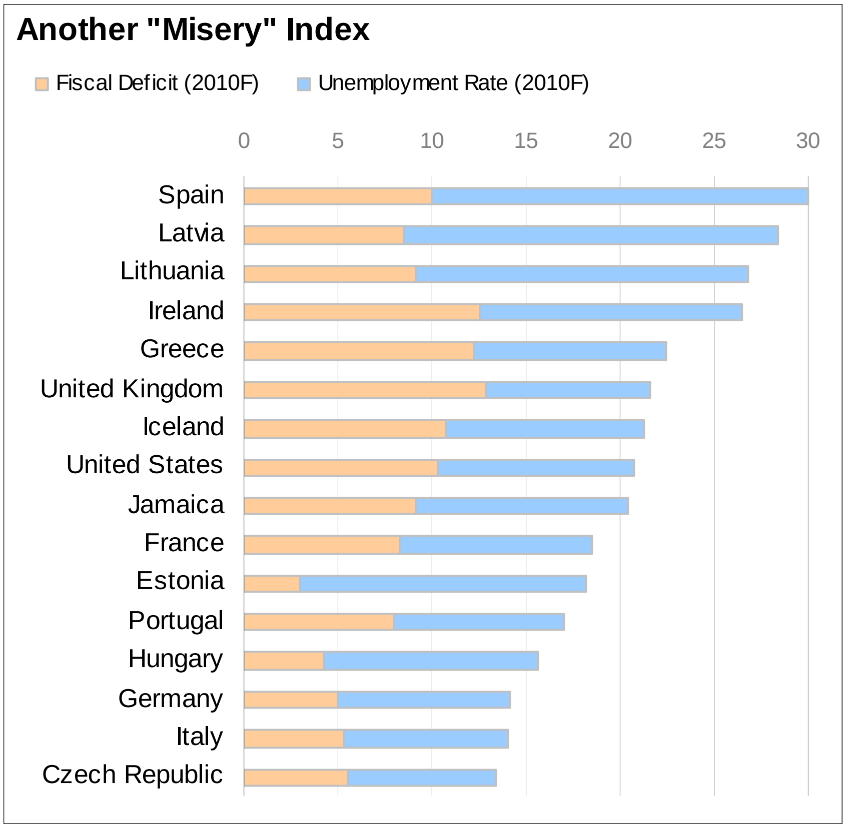
This issue is aggravated in cases where the output trend prior to the crisis was inflated by a rapid increase in private sector debt (e.g. the UK, Ireland, Spain, several European emerging economies, perhaps the US, etc.).

Naturally, the ability to allow the exchange rate depreciate, while susceptible to raising trade tensions, can facilitate the adjustment process – an option not available to EMU countries.

The chart below takes the 1970s concept of the "Misery Index", which reflected inflation and unemployment rates, and adapts it to present-day circumstances by focusing on the fiscal deficit and the unemployment rate. We believe this "New Misery Index" is a good measure of the challenges facing some economies in the coming decade.

[10] Please refer to Moody's Special Comment entitled "*France's Grand Emprunt: A Short-Term Cost for an Uncertain Long-Term Gain*", November 2009.

[11] Please refer to Moody's report entitled "*On the Hook – Update on Moody's Global Macroeconomic Risk Scenarios, 2009-2010*", May 2009.



Therefore, in 2010 it will become clearer which new growth regime the countries that are heavily affected by the crisis have embarked on. This will influence our assessment of the long-term debt outlook.

Theme 4

Most governments cannot afford another financial crisis. Attempting to ring-fence balance sheets from contingent liabilities will keep policy makers busy.

To say that Aaa governments have lost altitude within the Aaa space simply means that their shock-absorption capacity – while still high enough to rule out any meaningful default risk – has been reduced.

In other words, many Aaa governments, starting with the UK and the US, cannot afford another financial crisis *at current rating levels*. This is another reason why the reform of the financial sector has taken on such importance.

But this is also true of lower-rated governments, and more generally reflects the explosion of the size of financial sectors over the past decade as compared to governments' balance-sheets. The key factor in this context is support capacity.

As a result, we believe that these governments are going to try a different tactic and make the preservation of their balance sheets – and perhaps of their rating – a primary objective. This will entail, from time to time, initiatives to share the burden with bondholders. There have been some attempts at ring-fencing government balance sheets in 2009, with varying rates of success (e.g. in Iceland, Ukraine, Kazakhstan, Dubai, etc.). One could even argue that allowing Lehman Brothers to default was a way of drawing a line in the sand – although, as in many cases of "ring-fencing", the outcome was disorderly.

We have analyzed the Dubai World precedent[12] as an early example of an "exit strategy" by governments, and have reconsidered the comprehensiveness of protective policies. As a result, our bank and corporate credit risk analysis is increasingly taking this into consideration.

Theme 5

Very large public debt and low economic vitality will prompt unprecedented questions about how governments can discharge their obligations without changing the rules of the game.

A very important long-term question is: could a combination of lower trend growth, ageing and, more generally, a relentless increase in the demand for services that are provided or intermediated by the state lead to a progressive "suffocation" under the weight of public debt? This question is often raised with reference to Japan, but Japan may simply be a precursor.

The issue is ultimately: could very rich countries default on their debt? In fact, there is no historical record of "rich" countries defaulting on their debt.

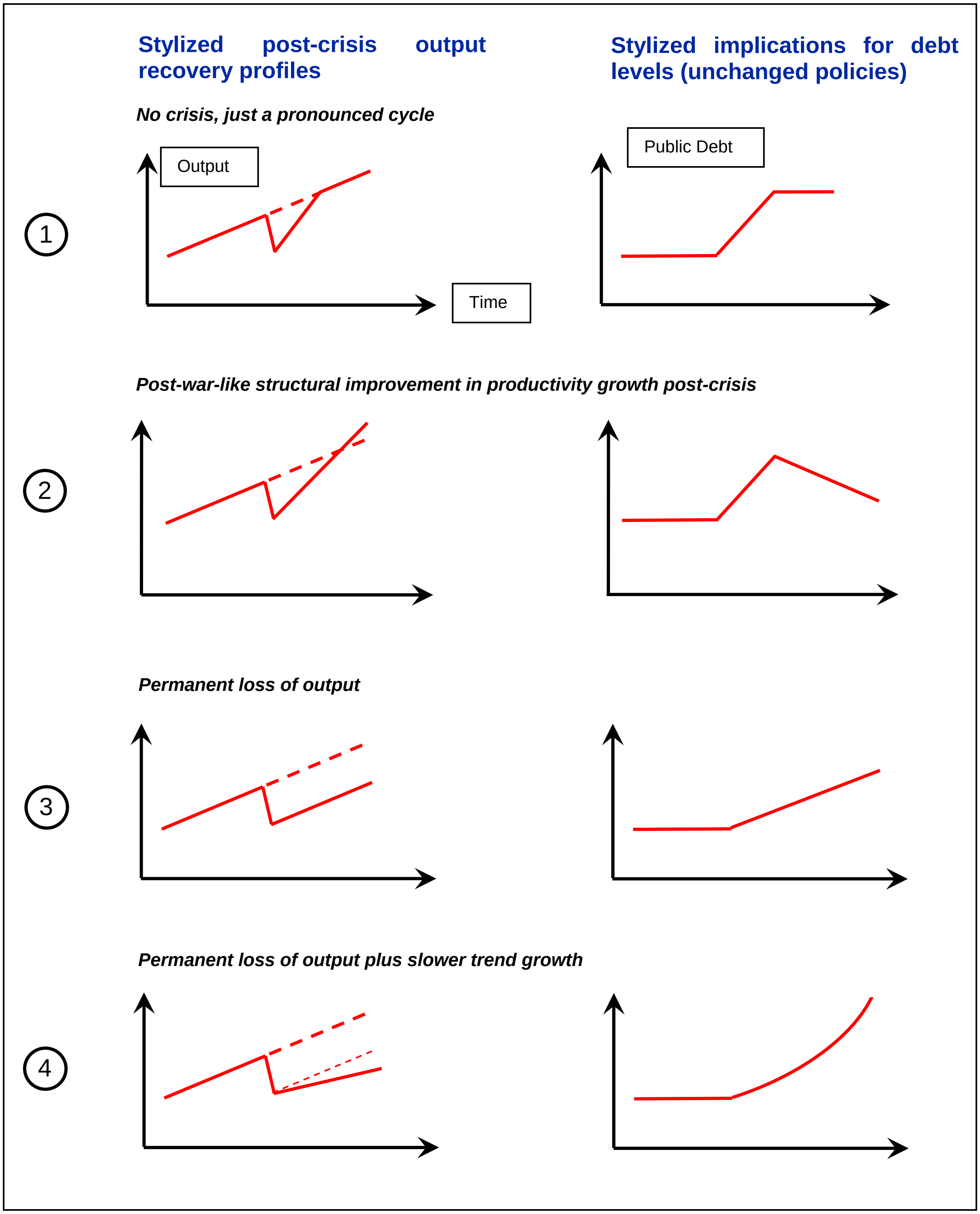
Even though this is not a pressing issue for 2010, we suspect investors will increasingly try to "think the unthinkable". A recent Moody's report explored some of the potential implications of a possible downgrade of a large Aaa country.[13] More on this later.

One way of looking at this is to realize that governments are more willing to default on social obligations – such as changing the retirement age – than on financial obligations.

[12] Please refer to Moody's Special Comment entitled "*Dubai Inc: Assessing the Fallout*", December 2009.

[13] Please refer to Moody's Special Comment entitled "*Why Aaa Sovereigns Get Downgraded*", September 2009.

Shape of economic rebound and debt implications



Theme 6

EMU participation protects against liquidity risk but not against long-term insolvency.

We recently took action on the sovereign ratings of Portugal (negative outlook)[14] and Greece (review for downgrade)[15] for similar reasons.

These countries have weathered the crisis and have proved earlier concerns about their liquidity situation to be exaggerated. (In February 2009, we stated our view that a scenario involving a break-up of the eurozone was hardly conceivable).[16]

However, a new environment with even more debt and lower growth prospects combined with a limited appetite for reform has put these countries on a negative credit path.[17] *In extremis*, as debt becomes increasingly unaffordable, governments can be tempted to take decisions that are harmful to creditors' interests.

While the euro has been protective during the liquidity crisis, it will not help these countries rebound. Indeed, it could even be a hindrance. The risk now is that a slow but inexorable erosion of economic vitality could occur, similar to what could befall small and uncompetitive towns or regions in a large country.

The way in which the ECB will unwind some of its operations will lead to an increase in the funding costs for many banking systems – and, as a result, for governments themselves. This will be a test that we will be monitoring, possibly from as early as January.[18]

Theme 7

The dangers of a rapid and debt-fuelled income convergence process will lead to renewed emphasis on total country debt.

As evidenced by and at the expense of several European Emerging countries, a process of rapid income convergence based on break-neck financial deepening generates vulnerabilities.

While it was hard to foresee the spark that would so violently derail the process, there was wide agreement, even before the crisis, that these countries were exceeding recommended speed limits.

Also, during the few months after Lehman's demise, the seizing-up in the international dollar market forced governments to step in and intermediate their credit in order to help their banks and corporates gain access to funding. This type of crisis, which used to be the balance-of-payment problem typical of emerging markets, engulfed many countries, including some advanced economies.

As a result, both central bank and government officials (in their macro-prudential monitoring) and outside analysts are now focusing on total country debt (both of the private and the public sectors) rather than analyzing debt sector by sector as if they were hermetically separate.

This is likely to lead to more cautious leverage – at least over the near future.

[14] Please refer to Moody's rating action press release entitled "*Moody's changes the outlook on Portugal's Aa2 rating to negative*", 29 October 2009.

[15] Please refer to Moody's rating action press release entitled "*Moody's places Greece's ratings on review for possible downgrade*", 29 October 2009.

[16] Please refer to Moody's Special Comment entitled "*Impact of Global Crisis on EMU: Risk of Eurozone Break-Up Negligible*", March 2009.

[17] Please refer to Moody's Special Comment entitled "*Investor Fears About Liquidity Crisis in Greece Are Overdone*", December 2009.

[18] Please refer to Moody's Sector Comment entitled "*Central Bank Exit Strategies May Gradually Exert Pressure on European Government Finance-ability*", November 2009. This article was originally published in Moody's Weekly Credit Outlook on 30 November 2009.

Theme 8

Global sovereign risk convergence is at play, but only slowly.

Despite the sorry state of public finances in the rich G20 countries and the enviable economic health of many emerging G20 economies, we believe it is premature to announce the dawn of a New Order in terms of sovereign creditworthiness.

Even though the gap between ratings has been narrowing, it is much too early to envisage that China, let alone Russia, India or Brazil could any time soon dislodge the current large Aaa economies as anchors to the global economic and financial system.

The last few miles that need to be covered to move from A or Aa to Aaa are the most arduous.

In particular, the combination of sustained economic prosperity, effective policies and robust as well as predictable institutions that are protective of creditors' interests are even harder to nurture than it is to control debt metrics. Moreover, higher prosperity usually entails greater demands on public services and hence higher public spending – although advanced Asian economies have so far been able to contain the state's use of taxation by limiting the scope of social welfare programs and by channelling ample private savings more directly into such programs.

Therefore, we should expect continued rating convergence within the G20, but at a measured pace.

Theme 9

While the crisis has confirmed the dangers of financial globalization for emerging markets, the arsenal of policy levers has not expanded.

A related concern is that, in a world in which mature market economies are nursing their wounds and emerging economies are catching up fast, asset price bubbles may sporadically appear in dynamic economies, threatening their economic fortune.

Such risk seems most significant in the region that recovered first and at the fastest rate: Asia. But Brazil is also feeling the drawbacks of being too attractive.

In fact, this situation is nothing more than the consequence of the existence of mobile capital flows in a globalized economy: the disproportion between the demand of capital chasing high return and the limited supply of financial assets is bound to generate sharp price adjustments – and in turn misalignments with "fundamentals". Naturally, such a tendency is magnified by the extremely low interest rates in advanced economies and by the fact that quantitative easing has the effect of generating additional demand for financial assets.

The experience of Asian economies in 1997 and of Central and Eastern Europe (CEE) during the five years before the crisis illustrates the dangers of such developments. But more critically, it also highlights the absence of an obvious policy solution. While the crisis has once more illustrated the dangers of asset price misalignments, it has not given rise to the emergence of a new set of economic and financial tools – beyond a few counter-cyclical measures that are unlikely to be up to the task given the size of capital inflows in some countries.

As a result, we do not expect emerging market economies to abandon a policy that served them well: accumulating foreign exchange reserves. It is ironic that G7 governments are asking these economies to reduce their liquidity protection while they exhort their banks to do the opposite. Yet, this slows the process of a winding down of global imbalances…

In conclusion, the pace of the probable rating convergence explained above will largely depend on how emerging market economies will intensify economic integration while managing some of the imported "viruses" of international financial interdependence.

Theme 10

Debt hang-hover will test social and political cohesiveness.

In those countries whose debt has increased significantly – and especially those whose debt has become unaffordable – the need to rein in deficits will test social cohesiveness. The test will be starker as growth disappoints and interest rates rise.

In several countries – including some highly advanced ones like Iceland or Ireland, but also Latvia or Hungary, as well as in some much poorer countries like Jamaica – a great sacrifice is required from the respective populations. Cohesive and/or very enduring societies like the Baltic countries, Iceland or Ireland have accepted sacrifices (salary cuts, public spending cuts, etc.) that would have seemed unimaginable a few years ago and continue to seem hardly replicable in comparable societies. Indeed, such countries have an extremely high pain threshold.

In 2010, the ongoing crisis will further test such fortitude. We are closely monitoring signs of economic rebound as well as of political and social tension as early indicators of the sustainability of fiscal efforts.

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