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Sovereign Risk: Is the Global Economy Facing Fiscal Austerity or Fiscal Crisis?

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Key Points

- 2010 may prove to be a turbulent year for sovereign debt given the uncertainties surrounding the pace and intensity of fiscal and monetary exit strategies. The next two years will be a critical test for heavily indebted countries to start implementing a credible plan. If the market loses confidence in this plan, we expect further challenges to the recovery and new challenges to political and social cohesion.
- As the sovereign story has gathered steam over the last few weeks and investors have become concerned about the possible systematic implications of fiscal problems in Europe, bank CDS began to move in tandem with sovereign CDS. The correlation between the two clearly has spiked and remains elevated. For the foreseeable future, we expect that sovereign risk will remain a key source of volatility for the global banking sector.
- Lowering fiscal deficits and debt to a more appropriate level will take time and face plenty of systematic obstacles. This effort is further complicated by an overall lack of liquidity in the banking sector and diminished access to certain funding markets. While there is still time for governments to act to avoid the situation, we don't believe they have the luxury of waiting for a sustained global recovery to fully implement credible fiscal consolidation. We expect NRSROs to increase negative rating actions on certain sovereigns to levels not seen in several decades.
- A fundamental and rigorous reassessment of sovereign credit risks is required before investment in most sovereign debt becomes advisable for our clients. We are looking for further certainty around the following key credit considerations: political risk, economic structure and growth prospects, monetary flexibility, general and external debt burden, and susceptibility to event (primarily political) risk.

From PIGS to Global Contagion

The recent turbulence amongst the so-called PIGS economies (Portugal, Ireland, Greece and Spain) has caused much consternation among market participants. Current movement in credit spread, sovereign CDS (see figure 4) and a rapid decline in the euro has contributed to a worry about contagion in the area, underscoring a lack of clarity on how the problem will be solved. Given the systematic nature of the current crisis, the EU has to be cognizant that default of one EU member could potentially weaken the market access of the others, particularly in an already weak euro zone economy. Nonetheless, politicians in Europe's largest economies are loath to increase the tax burden on their own citizens in the name of European unity.

The 1991 Maastricht agreements which govern the European Union, include a "no bail out" clause, which prohibits direct monetary financing of governments and other public institutions by the central bank. However, this restriction does not prevent some form of mutual fiscal solidarity between member states, such as mutual liquidity assistance or extension of loans over longer maturities to each other. In addition, there are other means whereby euro zone governments can receive support from other members such as through IMF loans and central banks' purchase of the other sovereign debt in the secondary market. That said, if public assistance is provided to Greece, then it should include punitive sanctions that clearly raise the incentive for other countries to pass tough austerity measures on their own. This crisis has uncovered that the euro zone

has no clear mechanism to help a member country that encounters liquidity issues, making default plausible. The monetary union will have difficulty withstanding financial crisis until members agree to a closer political union with an executive capable of setting fiscal policy across regions. We feel this is very unlikely, as most European governments are understandably reluctant to lose control over their tax and spending policies.

This effect has ignited the debate about debt affordability and raises the question of the end game. Will taxpayers or investors bear the pain, and will it be through inflation or capital losses? Ultimately, being an EU member will most likely protect the indebted countries against liquidity risk, but nothing on the table will help these countries deal with the greater issue: long-term insolvency risk.

Is Financial Austerity in our Future?

Sovereign debt crises are not new to international finance. The global economy weathered them in Russia, Mexico and Asia during the 1990s and in the last decade when Argentina defaulted. The nations most at risk in Europe are countries such as Greece (expected by the EU to reach a debt to GDP ratio of 120 percent in 2010), Ireland and Portugal. However, these countries are not outliers. Government balance sheets in some advanced countries are starting to swell as a result of unprecedented assistance to their banking institutions. As a result, central banks were reacting by rapidly lowering interest rates (see figure 2). IMF figures showed an increase of 20 percent in the ratio of aggregate debt to GDP for the G-20 from 2007 to 2009 (see figure 1). Some of the world's largest economies including the U.S., UK and Japan are already above 90 percent mark or will be soon, suggesting that the economic drag from sovereign indebtedness will be global (see figure 3). For now, investors appear confident that the sheer power of these countries and the autonomy of their central banks will enable them to escape the debt trap. Most central banks can print money and buy government debt. Since 4Q09, rating agencies have been taking negative rating actions on a number of countries (Iceland, Greece, Ireland, Portugal, Spain, UK) and commented that sovereign ratings will likely be scrutinized even more closely than usual. We continue to opt out of exposure to financial institutions and the sovereigns with the clear potential for headline risk and downgrade risk.

No Easy Way Out

The central banks will have to walk a tightrope. If they withdraw the monetary stimulus too quickly, they could undermine the recovery and put renewed pressure on the already bloated public sector deficits

and the banking sector. If they withdraw too slowly, they could ignite concerns about inflation and push bond yields up quickly and sharply. Given that the markets are focusing on when and how the stimulus is to be withdrawn long before it actually is, the various governments will need to outline a credible plan to do so. During this very low interest rate environment, debt affordability has not deteriorated as much as it would otherwise have. However, if the markets were to switch concerns about fears in inflation and market rates were to rise significantly, more highly indebted countries could find their ratings tested. Over the next few years, many countries will have to repair their balance sheets in the difficult context of lower growth and without the benefit of the declining interest rates of the past.

Key Credit Consideration for Sovereigns: Ongoing Surveillance Matters

Key fundamental analysis on a sovereign's creditworthiness focuses the country's ability and willingness to service its debt obligations in full and on time. The analysis focuses on both quantitative and qualitative factors.

Political risk: stability of the political system, transparency and effectiveness of economic policy decisions, public security, geopolitical risk, history of lacking the willingness to repay its debt, orderliness of leadership succession, existence of an independent judiciary body.

Economic structure and growth prospects: market economy with legally enforceable property rights, high per capita GDP, effectiveness of the financial sector in intermediating funds, availability of credit, labor flexibility, profitability and competitiveness of non-financial sector, size and composition of savings and investment, rate of economic growth, efficiency of public sector.

General government revenue flexibility and expenditure pressure: the size and the growth trajectory of general government deficits, size, currency composition and maturity profile of the debt burden, share of revenue devoted to interest, the contingent liabilities posed by the financial system and public sector enterprises, growth of pension obligations and the breadth and depth of local capital markets.

Monetary flexibility, external liquidity and trends in public and private sector liabilities to non-residents: debt maturity profile, currency composition and sensitivity to interest rate changes, composition of capital flows, debt service burden, reserve adequacy, structure of current account, availability and the appetite of domestic investors to absorb the debt.

What Could Go Wrong

In an extreme situation, as debt becomes increasingly unaffordable, governments can be tempted to make decisions that are harmful to creditors' interests. At the same time, in the countries whose debt has increased significantly and whose debt has become unaffordable, the need to rein in deficits will test social cohesiveness, especially as growth disappoints and interest rates rise. Sovereigns can choose to default, up to a certain extent, if the economic, social and political cost of repaying public debt becomes higher than the economic and reputational cost of non-payment. In this case, creditors will have only limited legal recourse.

Contagion of the global financial market can occur when pressure is transferred from one set of financial assets to another as investors react to losses by liquidating other assets in their portfolios. Banks holding the bonds of troubled countries would suffer as would companies doing significant business in those troubled countries. Asset liquidation was a big reason for the contagion that followed the financial crisis in Russia in 1998.

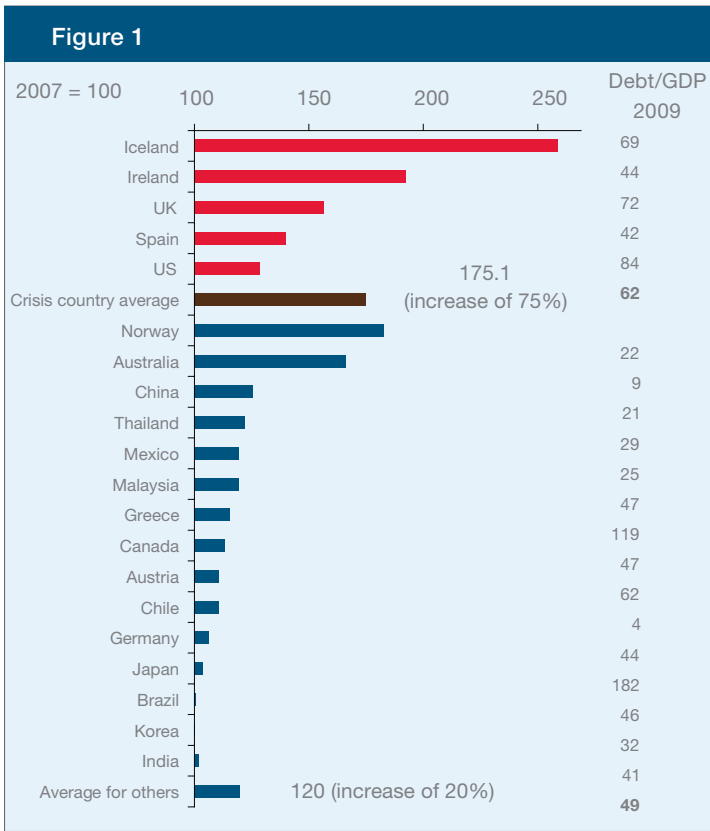
Contagion can also happen when a crisis prompts investors to exit investments that seem similar to those losing value. Losses in the price of debt in one country can prompt investors and speculators to examine other countries with similar weaknesses. In the Asian crisis of 1997, which was triggered by a devaluation in Thailand, a series of countries with large current account deficits suffered attacks on their currencies.

Global financial market contagion is vicious and tends to be self-reinforcing, if offsetting policy actions are not taken quickly. Ultimately, the responsibility lies with the countries to solve their own issues. After withdrawing the stimulus, both the monetary and fiscal policy will have to be carefully managed or these heavily indebted countries risk undermining market confidence and triggering a rise in bond yields that could transform many countries' currently manageable debt into an unmanageable burden.

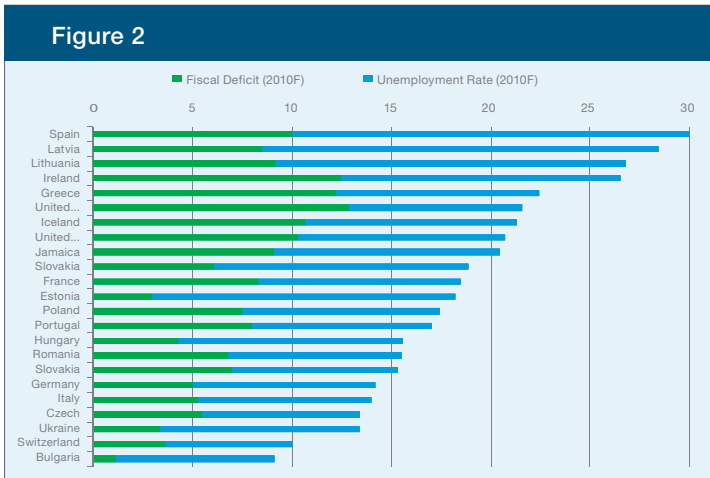
SVB Asset Management's Conservative Record on Sovereigns

Since early 2008, we have taken a careful approach on European financial institutions for the approved list. Our main criteria for financial issuers are: a strong franchise value with dominant position in each respective country, diversified business lines, and strong capital, asset quality and liquidity profile. The sovereign macroeconomic factors are a crucial part of the analysis as well. We have purposely avoided any financial institutions in countries that have structural challenges stemming from highly indebted households, sharp contraction of housing, construction and high exposure to the financial sector (such as Ireland, even though it is highly rated). Ireland's domestic operating environment has been very weak and will continue to be challenged. The property bubble that developed over the last decade has burst, with commercial property values falling by 50 percent and residential property values down by more than 25 percent. In addition, many Irish banks entered this crisis with relatively low levels of capital, substantial exposures to property sectors and high reliance on wholesale funding. The severe stress in the banking sectors has resulted in multiple notches of downgrades in the ratings for major Irish banks — more severe than other European peers, despite strong support from the Irish government. Although there are signs of stabilization, economic activity is still contracting on the back of a severe correction in the housing market, as well as faltering consumption and a decline in investment.

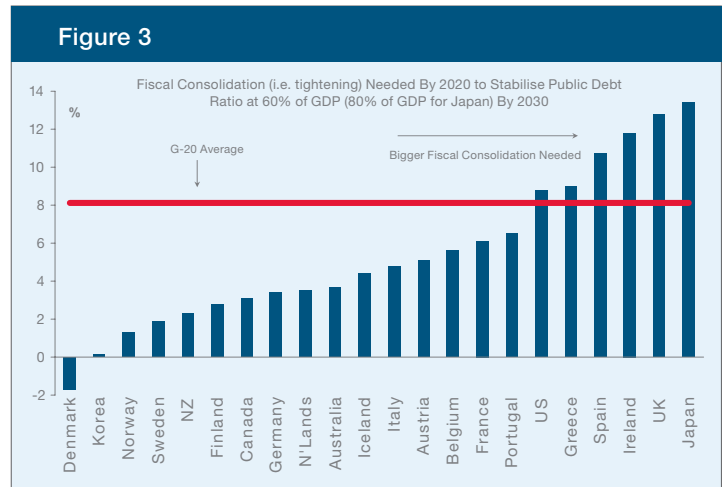
Given the continued economic and fiscal challenges faced by many sovereigns, we expect more of a divergence between the relative economic performances of many European countries. We continue to opt out of exposure to financial institutions and the sovereigns with the clear potential for headline risk and downgrade risk.



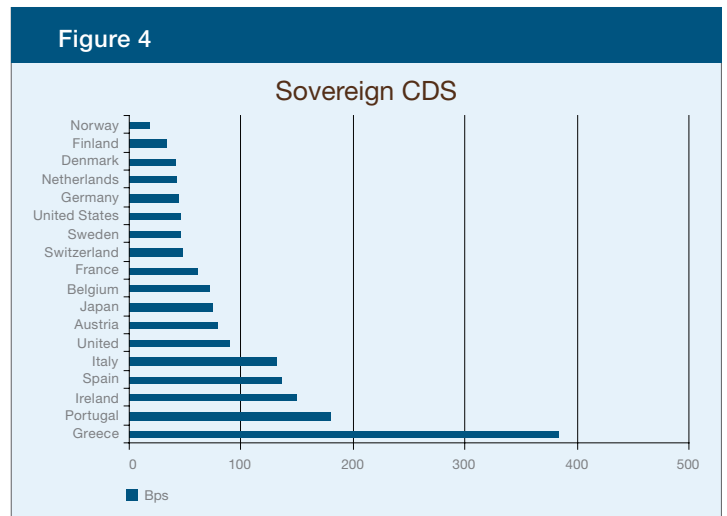
Source: Reinhart and Rogoff (2009)



Source: Moody's, January 2010



Source: International Monetary Fund (IMF), February 4, 2010



Source: Bloomberg, Feb 23, 2010

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