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# European Sovereigns: Living on Borrowed Time

Rating Sovereigns Through Extraordinary Times

# European Sovereigns: Living on Borrowed Time

1. **This time it is different: it is worse**
2. **The long-term has become much nearer: solvency matters**
3. **Exit path: the debate is over**
4. **Update on Aaa governments ... and the others**

## This time it is different? It is worse

The current (Greek) crisis has challenged (though not invalidated so far) assumptions long held by the market:

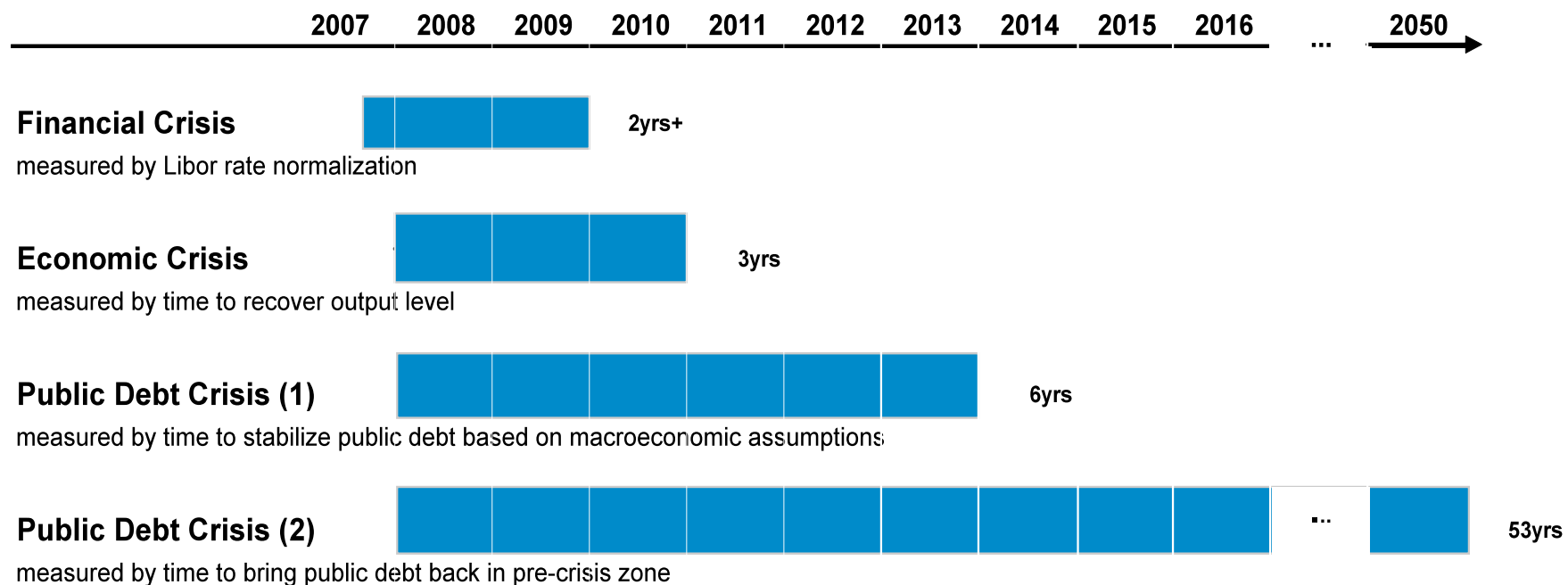
- » Rich governments cannot default;
- » Rich governments are price-constrained, not liquidity-constrained;
- » Governments with long-term solvency problems have time to address those problems.

Rise in public debt is not unprecedented, but...

- » No support to be expected from a fall in interest rates;
- » Fiscal crisis is global;
- » Additional challenges are looming (ageing, climate change)

## The Third Stage of the Crisis Will not be Over Anytime Soon

### The Three Stages of the Crisis - the example of the United States



## True, We've Been There Before...

### UK net public debt

As a % of GDP



Sources: ukpublicspending.co.uk; IMF from 1980 with forecasts to 2014

### US gross federal debt

As a % of GDP

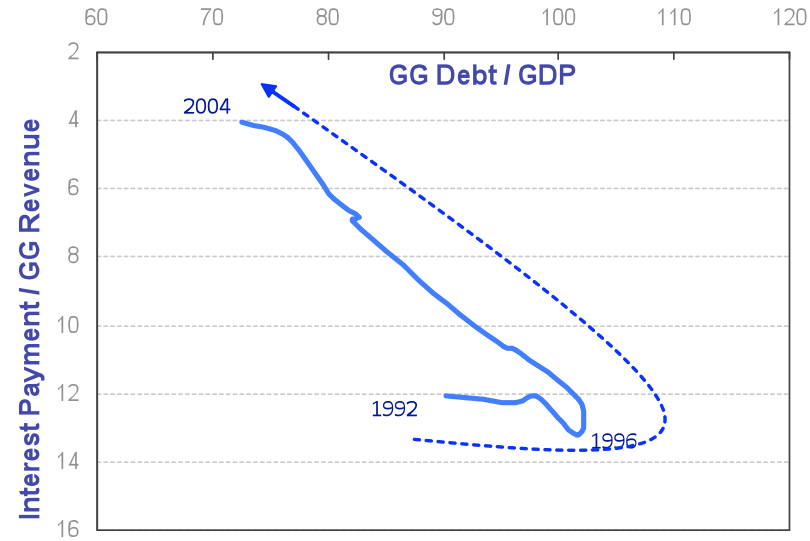


Sources: usgovernmentspending.com; OMB from 1980 with forecasts to 2014

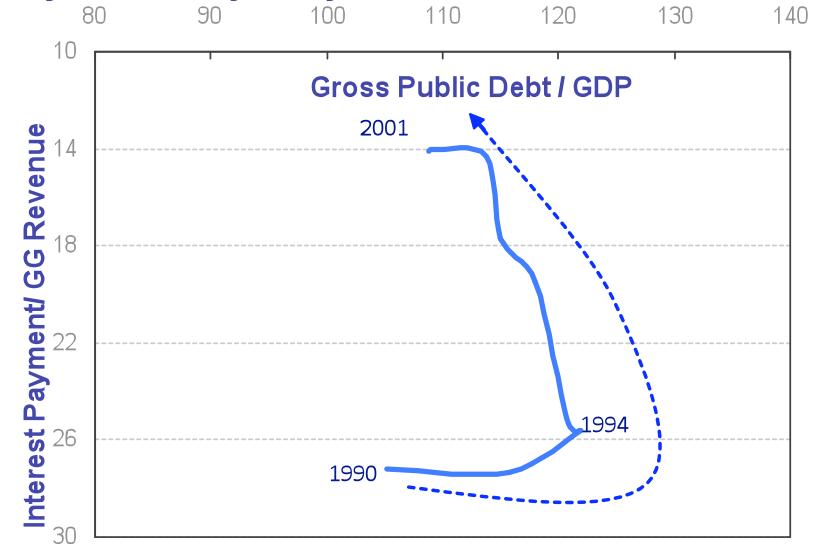
Source FT

## And some countries have rebounded in the past. But....

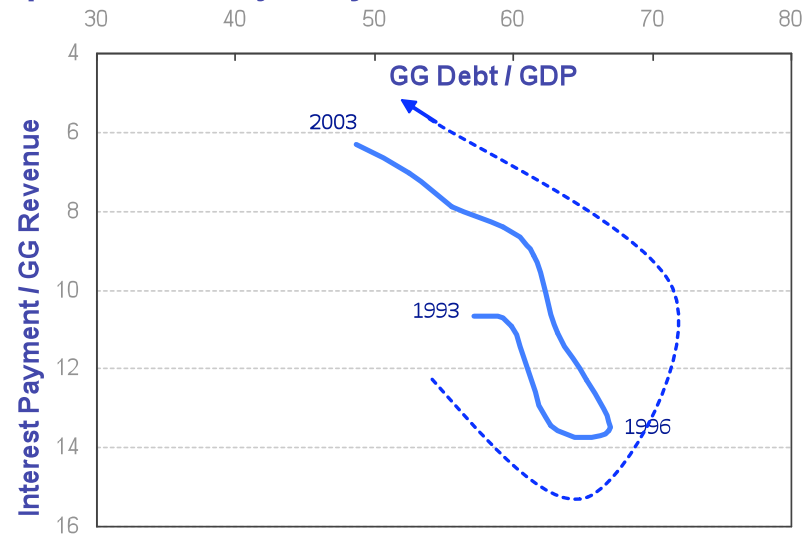
### Canada - Debt Trajectory- 1992-2004



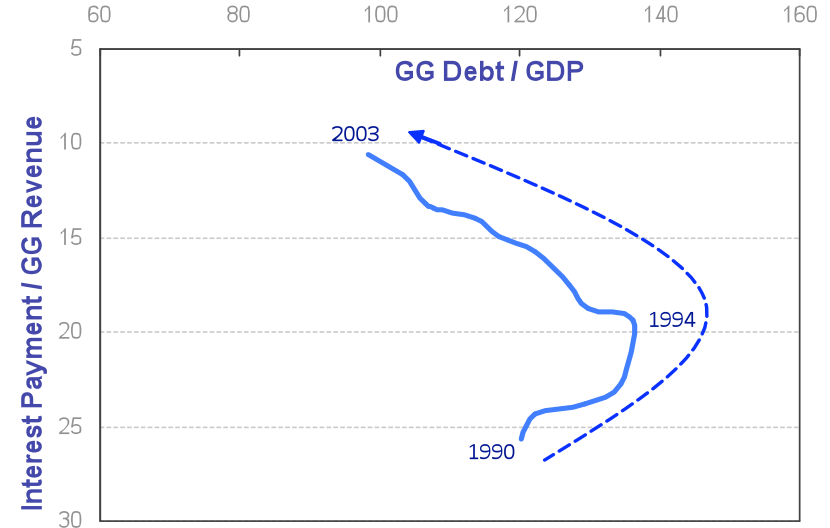
### Italy - Debt Trajectory - 1990-2001



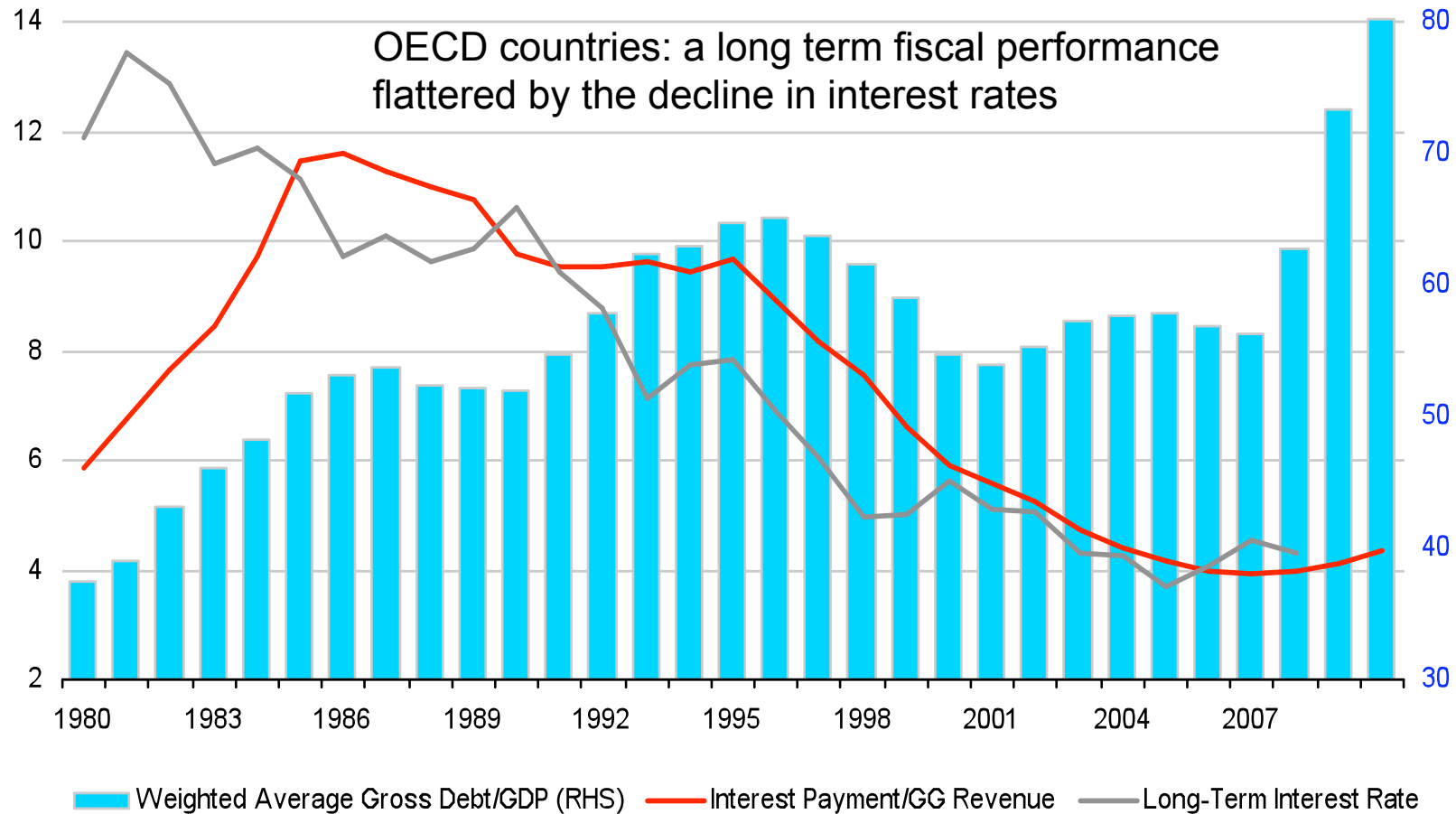
### Spain - Debt Trajectory- 1993-2003



### Belgium - Debt Trajectory- 1990-2003

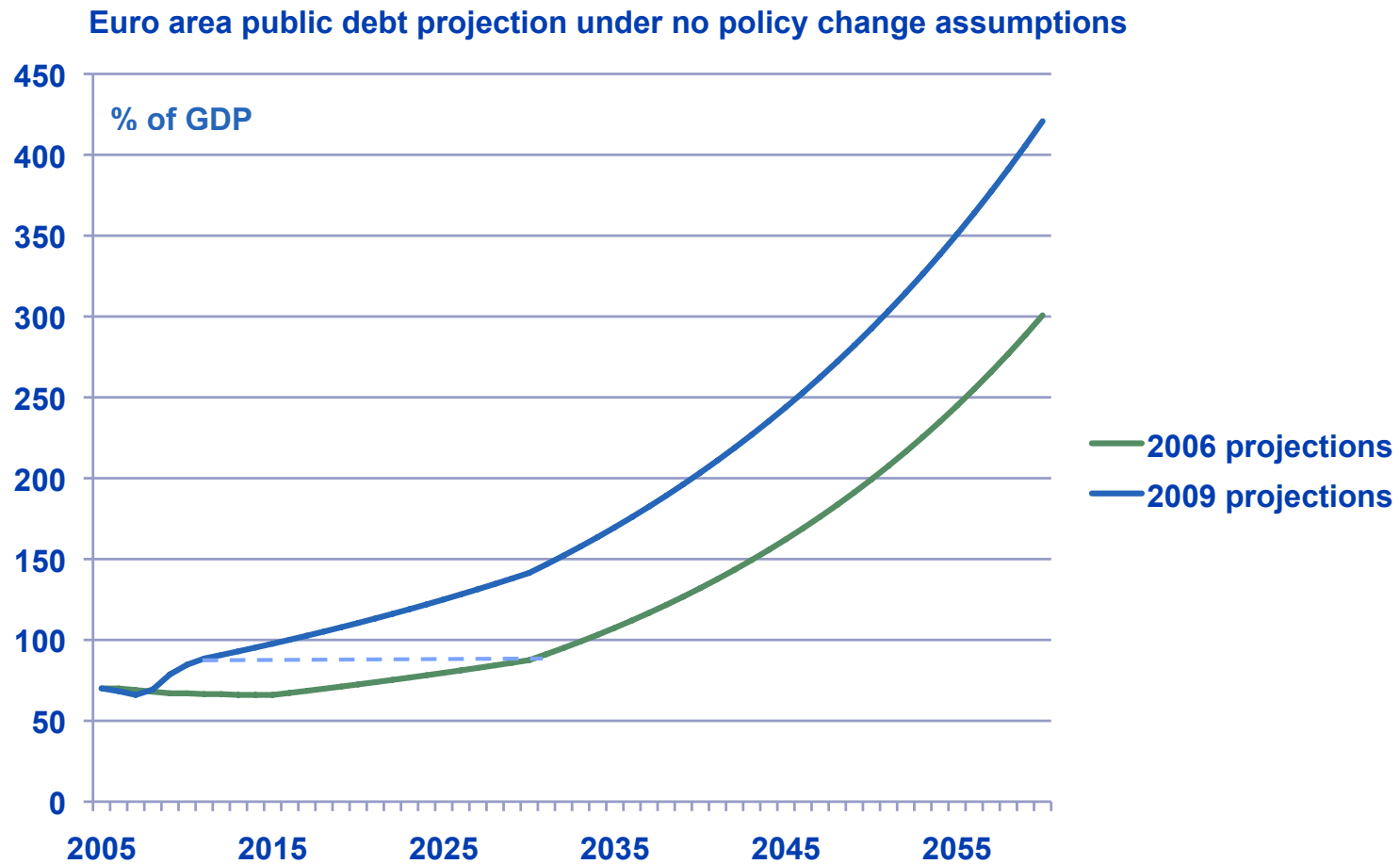


## ...Interest Rates Will Not Help Much



## The long-term has become much nearer

We are facing fiscal challenges that were only expected to materialise in 15-20 years

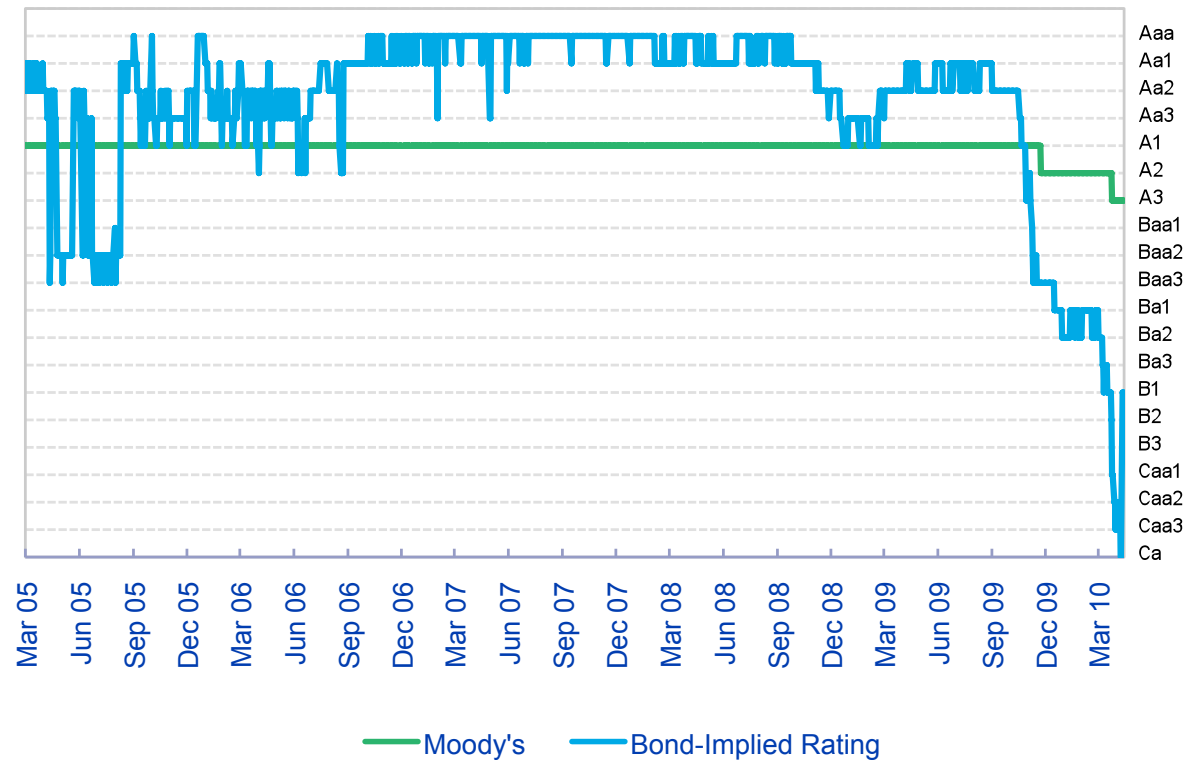


Source: Moody's, based on Eurostat and European Commission data

## From exuberance to panic?

U-turn in market perception of the Greek sovereign risk

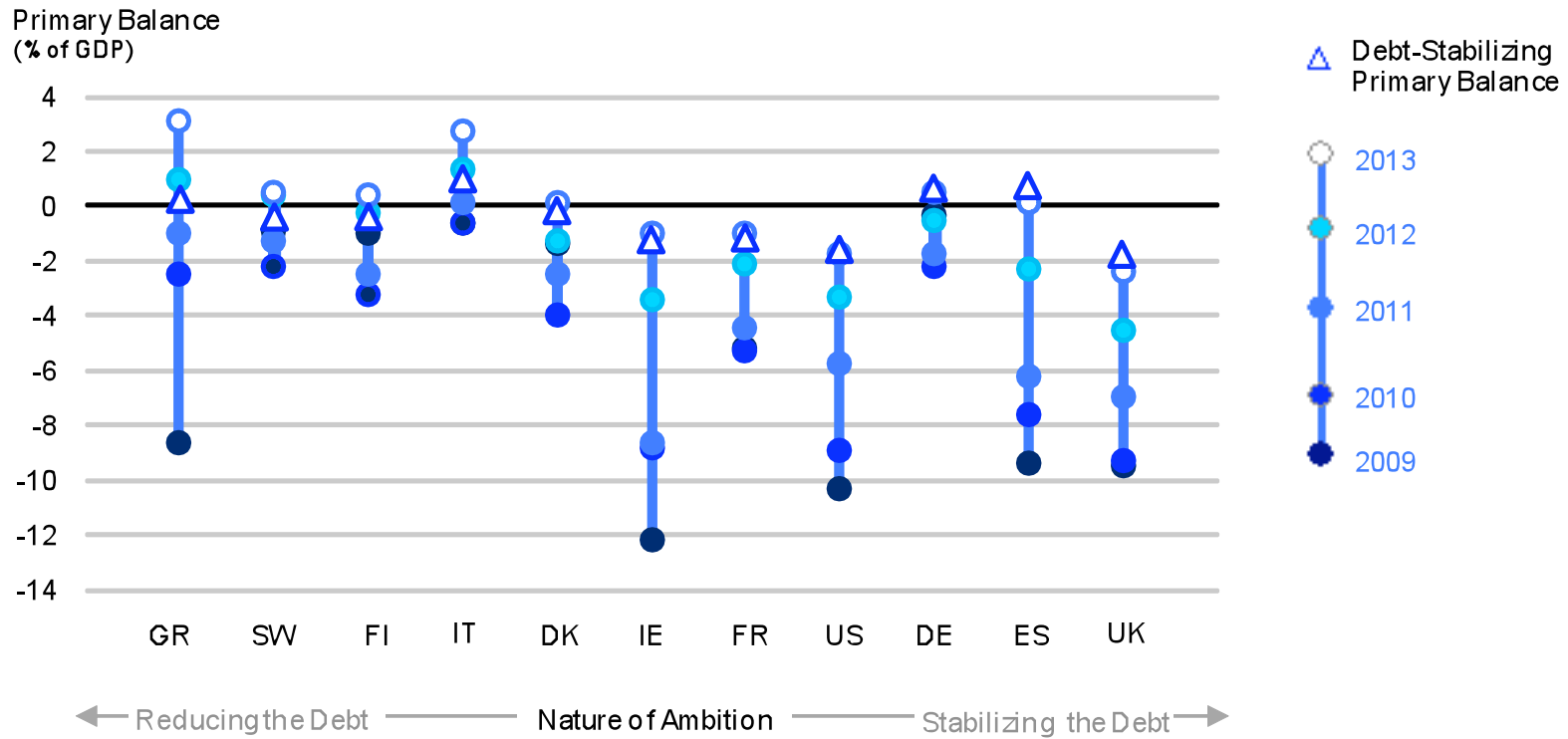
Greek government: Moody's rating V market-implied rating



Source: Moody's

# The Counter-Offensive Has Started

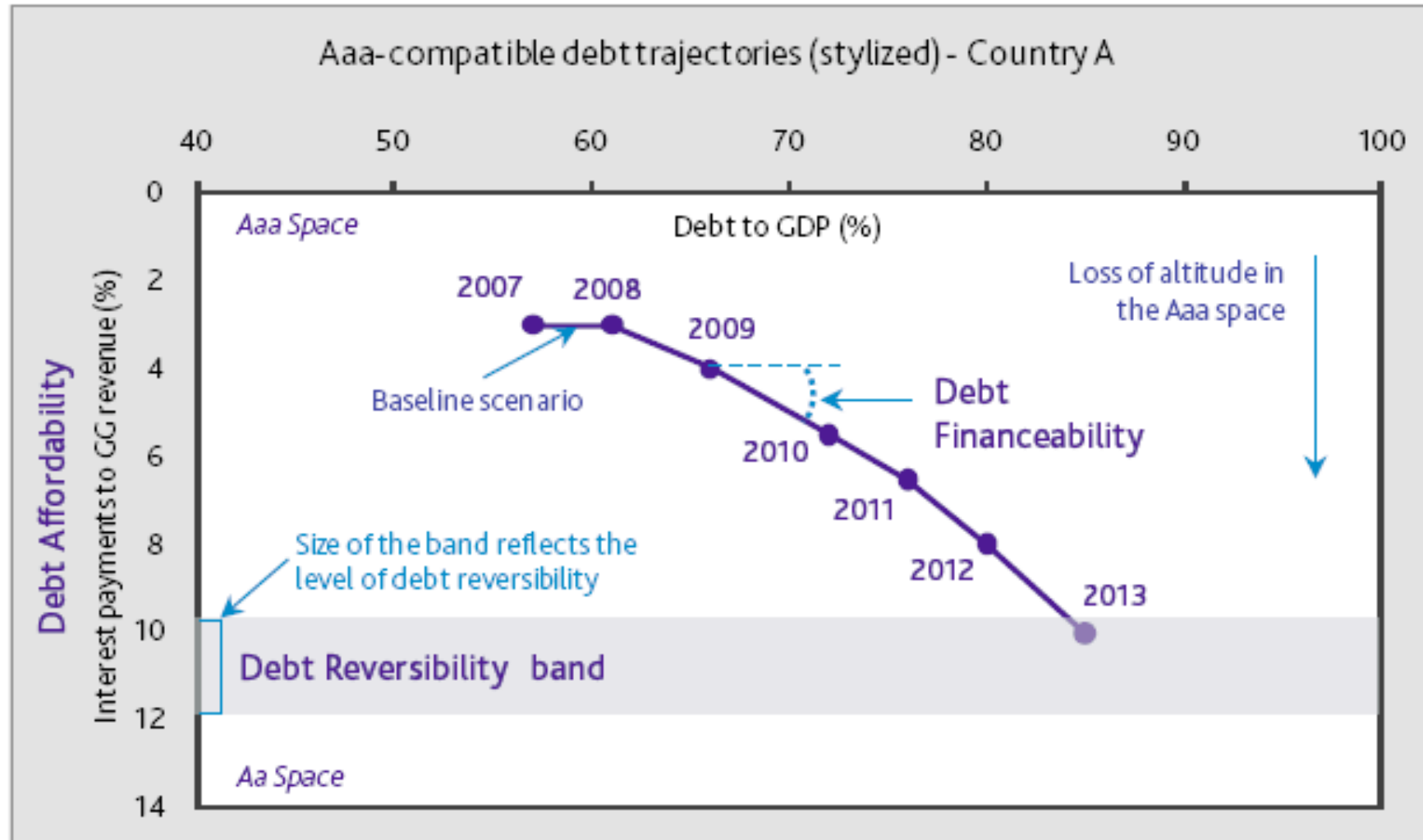
**Fiscal Ambition Programme (2009-13)**



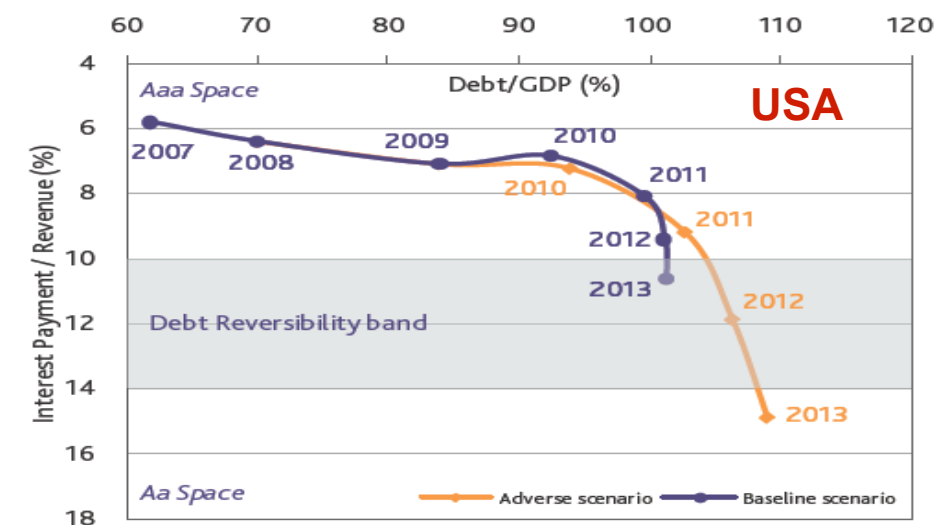
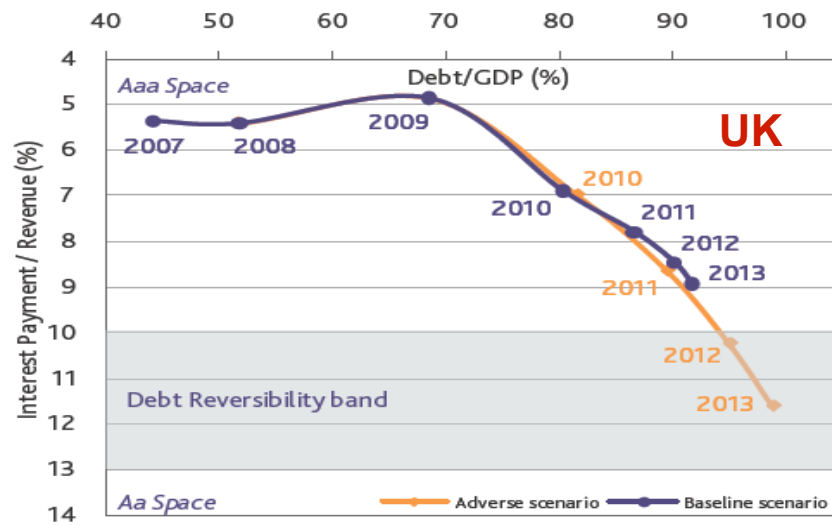
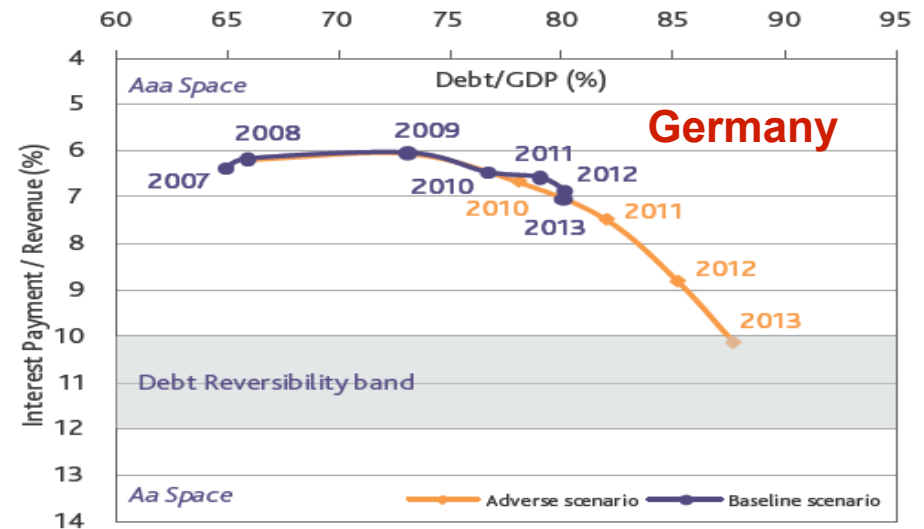
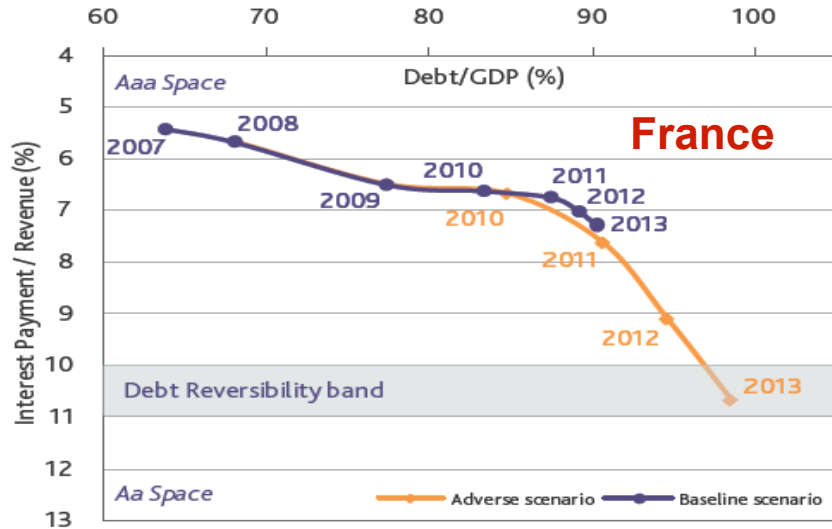
## Exit path: the debate is over

- » Economic growth will not resolve fiscal problems
  - » Global recovery under way, but at variable speed, and generally moderate in fiscally-challenged countries.
  
- » Large Aaa governments too are vulnerable to a rise in their cost of funding
  - » Risks are very asymmetric and particularly for governments funding themselves at the short end of the curve.
  
- » Tail risk remains substantial
  - » Skilful policy-making cannot make the debt go away fast;
  - » But policy errors can quickly complicate an already delicate debt equation.
  
- » Anchoring fiscal expectations is key to an orderly exit from the fiscal crisis.
  - » Market confidence is key to keeping debt affordable;
  - » Simultaneous move towards a defensive fiscal stance.

## Why do we not downgrade more Aaa governments?



# Flying Lower, But Still within the Aaa Space



# Conclusions

Rating governments through extraordinary times

1. Painful adjustment will test social cohesion across advanced economies
2. Tail risk has increased but can be contained – with the help of central banks
3. Sovereign ratings remain based on medium-term solvency assessment: High debts are (very) burdensome, but not unsustainable, nor unbearable
4. ‘Compression of time’ available for fiscal adjustment results in acceleration of rating trajectories (Greece, Portugal)
5. Low-probability/ high impact event risk conveyed through Moody’s research
  - » Tail event have to be plausible rather than merely possible to affect sovereign ratings
6. Aaa governments remain well positioned (Spain, UK, US, France, Germany)



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