

SPECIAL COMMENT

Adjusting European Sovereign Ratings to Better Capture Credit Susceptibility to Downside Risks

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Ratings of nine sovereigns affected

Our decision to adjust the ratings of nine European sovereigns reflects the continued pressure on their creditworthiness emanating primarily from (i) the continued uncertainty surrounding the prospects for institutional reform of the euro area's fiscal and economic framework, (ii) the weak macroeconomic outlook across the region, and (iii) the resulting pressure on already fragile market confidence. However, the limited magnitude of our rating adjustments reflects the gradual progress that European policymakers have made in agreeing to and implementing reforms, and their demonstrated commitment and desire to resolve the underlying fundamental macroeconomic and fiscal imbalances.

Since our announcement in November 2011 of our intention to consider repositioning our European sovereign ratings where necessary, the intervening months have seen important developments in the policy framework and some improvements in financial market conditions. Nevertheless, there remains considerable uncertainty regarding the prospects for institutional reform of the euro area's fiscal and economic framework and the resources that will be made available to address market liquidity conditions.

Moreover, Europe's weak macroeconomic prospects complicate the implementation of domestic austerity programmes and the structural reforms that are needed to promote competitiveness. These factors will continue to weigh on market confidence, which we expect will remain extremely fragile with a high potential for further shocks to sovereign funding conditions. In addition to constraining the creditworthiness of all European sovereigns, the fragile financial environment exacerbates the susceptibility of a number of sovereigns to particular financial and macroeconomic exposures.

Having reviewed all of our sovereign ratings in Western Europe, we have reflected these constraints and exposures in downgrades to the government bond ratings of Slovakia (to A2 from A1), Slovenia (to A2 from A1), Spain (to A3/P-2 from A1/P-1), Italy (to A3/P-2 from A2/P-1), Malta (to A3 from A2), and Portugal (to Ba3/NP from Ba2/NP). All of these ratings remain on negative outlook given the continued uncertainty regarding financing conditions over the next few quarters and its corresponding impact on creditworthiness.

We have also changed to negative the outlooks on the Aaa ratings of Austria, France and the United Kingdom to reflect a number of specific credit pressures that could exacerbate the susceptibility of these sovereigns' balance sheets and the implementation of their ongoing austerity programmes to any further deterioration in European economic conditions and financial landscape.

An important factor in limiting the magnitude of our rating adjustments is the European authorities' commitment to preserving the monetary union and implementing whatever reforms are needed to restore market confidence. The actions announced today therefore take into account the steps that euro area policymakers have taken in agreeing to a framework to improve fiscal planning and control, as well as the measures adopted to stem the risk of contagion.

Today's actions also reflect the potential for shocks to emerge given the gradual evolution of the policy framework. As such, we would expect these repositioned ratings to exhibit some degree of tolerance to potential downside scenarios that may emerge in coming quarters, including a further modest deterioration in the macroeconomic outlook relative to our base case scenario,¹ evidence of further fiscal slippage, and occasional political set-backs in the progress towards agreeing and implementing necessary reforms to restore confidence.

We also do not anticipate that any further ratings adjustments would be necessary in response to the inevitable ebb and flow of support for further European Central Bank (ECB) or European Financial Stability Facility (EFSF)/European Stability Mechanism (ESM) interventions, to continued uncertainty over the resources that will be made available to the EFSF and ESM, to occasional political shifts that might raise new questions regarding the degree of commitment and resolve in some countries,² and to the prospect of further financial market contagion associated with disruptions emanating from Greece.

Moody's considers the ratings of the following European sovereigns to be appropriately positioned: Denmark (Aaa), Finland (Aaa), Germany (Aaa), Luxembourg (Aaa), Netherlands (Aaa), Sweden (Aaa), Belgium (Aa3), Estonia (A1) and Ireland (Ba1). Our review of Cyprus's Baa3 rating, as announced in November 2011, is ongoing, while the developing outlook on Greece's Ca rating remains appropriate as we await clarification on its debt restructuring.

As for the ratings of Central and Eastern European sovereigns outside the euro area, we will be assessing the credit implications of the fragile financial market conditions and weak macroeconomic outlook during the first half of this year.

This Special Comment explains the rationale underpinning these rating actions and also offers an assessment of the macroeconomic horizon and its impact on creditworthiness. A Press Release published today provides more granular explanations for the actions announced on the ratings of the nine affected sovereign issuers.

The implications of these rating actions for directly and indirectly related ratings will be reported through separate press releases.

¹ See [Global Macro-Risk Outlook 2011-2012: Material Slowdown in Growth](#), 11 November 2011.

² See [Finland-Greek Collateral Agreement Illustrates Euro Area Divisions](#), 22 August 2011, and [Slovakia Approves EFSF Expansion, but Government Falls, a Credit Negative](#), 17 October 2011.

Scope of Ratings Adjustment Limited by Strength of Commitment to Reform

Last November³ we announced that, as a result of the rapid and significant escalation in the European sovereign and banking crisis and the deterioration in medium-term macroeconomic prospects, we would assess the need for wide-ranging adjustments to our ratings architecture in Europe. The intervening months have seen important developments in the policy framework and, partly as a consequence, some improvement in financial market conditions.

Perhaps most significantly, the period since our November announcement has seen the ECB demonstrate its willingness to use unorthodox measures and commit large amounts of funding to preserve the stability of the euro area financial system (and, indirectly, that of the sovereign debt markets). Even if central bank liquidity can do no more than buy time for policymakers, the ECB's actions are significant from a policy standpoint, and have resulted in a marked, albeit possibly temporary, improvement in credit market conditions.

More recently, the finalisation of the treaties on Stability, Coordination and Governance in the Economic and Monetary Union and on the ESM during a summit at the end of January represents significant progress.⁴ The policy initiatives those treaties contain are politically significant and, by reaffirming policymakers' collective commitment to resolve the crisis, their agreement will bolster investor confidence. Significantly, the summit statement did not suggest any reversal in policy direction from prior summits.

The Fiscal Compact, for example, is a necessary step towards reforming the fiscal architecture of the euro area, which may bolster parliamentary support in stronger states, including Germany, for providing further financial support to the weaker states. Moreover, bringing forward the ESM's introduction to July 2012 rather than 2013, as originally planned, has the potential to improve the authorities' ability to take measures to prevent contagion in the event of further unanticipated financial market shocks.

Key policymakers have confirmed their strong commitment to achieving requisite reforms and preserving the currency union in the opportunities afforded over the past month to speak directly with them. Actions to date have provided a basis for confidence that reform will continue and that the crisis management framework will continue to be developed and strengthened. Even in the absence of delivering significant institutional change to date, policymakers have demonstrated greater clarity and confidence in responding to the crisis and, in doing so, have improved the prospect of long-term institutional reform—a precondition for any sustained return to normality in the term debt markets.

We expect that European policymakers will continue with the steady, albeit reactive and iterative, approach to introducing reforms. Our baseline scenario remains that further changes in fiscal governance and backstop facilities will be implemented, providing an increasingly effective crisis management framework and ultimately ensuring the longevity of the currency union. The prospective success of this strategy in ultimately restoring confidence has been an important factor limiting the magnitude of our rating adjustments.

Nevertheless, the outlook for many European sovereign ratings remains negative for the time being. As policymakers succeed in establishing an effective implementation record without the emergence of significant further market shocks, and as the benefits of fiscal and structural reform are realised and the

³ See [Rising Severity of Euro Area Sovereign Crisis Threatens Credit Standing of All EU Sovereigns](#), 28 November 2011.

⁴ See [Euro Summit Makes Progress, but Important Uncertainties Remain](#), 6 February 2012

susceptibility to downside risks subsides, credit risk for euro area sovereigns and other sovereigns affected will stabilise. But this stabilisation in credit risk may take many months, if not years, to materialise.

Uncertainty Persists...

Despite the strength of policymakers' commitment and recent agreement on developing a framework for fiscal planning and control, progress towards delivering fundamentally closer fiscal and economic integration remains slow. The Fiscal Compact will strengthen collective oversight and penalties will discourage fiscal profligacy, but fiscal policy remains substantially the prerogative of national governments, providing little confidence to investors that the excessive borrowing taken on by governments during the first decade of the euro's existence will not be repeated.

There also remains considerable uncertainty about the firepower available to the authorities to deal with the crisis. It is not yet clear (i) whether the funds available to the ESM and the EFSF while the two coexist will be the sum of the two or a lower amount; (ii) whether it will be possible to leverage those funds as policymakers proposed in October; nor (iii) what level of IMF funding, if any, would be available if a large euro area sovereign were to require any sort of financial support. Meanwhile, despite the restatement that private-sector involvement in Greece is 'unique,' we believe that such involvement remains an option for improving the debt sustainability of member states that suffer prolonged loss of access to private debt markets.⁵ These factors will continue to weigh on investor sentiment.

... and Reform Progress Is Highly Susceptible to Setbacks

The process of institutional reform is slow, in no small part because of the unavoidable tensions inherent in policymakers' objectives at present. Challenges include (i) the need to make collective financial support available for weaker states while maintaining pressure on those states to consolidate their finances; (ii) the need to achieve austerity while seeking at the same time to promote growth; and, most fundamentally, (iii) the need to deliver more effective collective control over nations' finances while recognising the political imperative of preserving national sovereignty.

Finding a way through these tensions requires political finesse, the drivers and results of which will rarely be transparent to external observers. Despite their statements of intent and demonstrated commitment to date, we expect policymakers in core countries to maintain deliberate ambiguity regarding the limits of their commitment in order to sustain pressure on periphery sovereigns to implement austerity programmes and structural reforms. This ambiguity creates uncertainty which will continue to exert pressure on funding conditions.

In such an environment, these tensions pose a real threat to the authorities' ability to achieve their objectives. On the one hand, the reliance on extreme market pressure to maintain the impetus for fiscal and structural reform in the periphery countries, and retain the commitment and contribution from the so-called 'core countries,' in combination with the iterative policymaking process, amplifies the potential for financial market shocks. On the other, any relief from sustained market pressure, while offering temporary comfort regarding the potential for adverse financial market volatility, reduces the urgency and motivation for implementing the necessary fiscal and structural reforms which are essential to address the underlying institutional weaknesses that caused the debt crisis, and to prevent the crisis from reviving.

⁵ See [Adherence to IMF Restructuring Practices Provides Little Comfort for Distressed Sovereign Debtholders](#), 19 December 2011.

These policy challenges and the resulting policy ambiguity carry negative credit connotations for the credit standing of euro area sovereigns. While this ambiguity remains, the resolution of the crisis will remain elusive and the risk of further shocks will persist. In the meantime, the costs of dealing with the ramifications of the crisis continue to rise – i.e. the explicit costs of establishing credible firewalls to prevent contagion, higher borrowing costs demanded by investors to compensate for persistent uncertainty, and the more aggressive fiscal and structural reforms required in a shorter amount of time to restore market confidence. The increase in costs further heightens the potential for political commitment to unravel.

Intensifying Macroeconomic Constraints

The outlook for growth across the region has steadily deteriorated as the crisis has intensified, with a recession seemingly inevitable across the euro area as a whole and large contractions possible in several of the peripheral euro area countries. The inevitable impact of the recession on both government debt metrics and investor confidence is exacerbated in the current climate, with potentially significant implications for the credit standing of weaker euro area governments.

The Focus of Rating Actions: Realignment

The announced rating adjustments reflect Moody's assessment of the strength of each country's financial and economic resilience set against the change needed to demonstrate control over government finances. The pattern of our rating adjustments –downgrades concentrated among the weaker nations, and the impact on the near-strongest reflected in negative outlooks – reflects our view that the combination of slow policy evolution and broad macroeconomic weakness is likely to have the most significant implications for the credit standing of the weaker euro area governments with the lowest adjustment and shock-absorption capacity.

Moreover, the scale of the task is not equal across sovereigns, nor are the risks evenly spread, even within the weaker and stronger groups. This unevenly distributed requirement for reform, the capacity to implement it and the accompanying risks have informed our actions, resulting in some realignment within each group.

Within the Aaa countries, for example, we have sought to distinguish the very strongest countries such as Germany and the Netherlands, which we believe possess the balance-sheet strength and economic flexibility to absorb further shocks should they emerge. The negative outlooks on the ratings of the United Kingdom and France reflect an increased uncertainty regarding their ability to meet their fiscal consolidation targets and place their debt burdens on a downward trajectory, due to materially weaker growth prospects over the next few years. The fiscal imbalance of the UK government remains particularly large in the face of much weaker growth than anticipated in the country's fiscal multi-year plan. France's task could be further complicated by a need to support other European sovereigns or its own banking system. The negative outlook in the case of Austria reflects the government's balance-sheet exposure to larger banking-sector contingent liabilities than is the case for other Aaa-rated sovereigns.

Similarly, the repositioning of a number of lower-rated sovereigns reflects the combination of the scale of the adjustment task, implementation progress, susceptibility to financial and economic shocks, and credibility of the policy response to date. We do not consider rating changes necessary for Belgium (Aa3) or Estonia (A1). However, the potential need to provide further support to their national banking systems was an important factor in repositioning Slovakia and Slovenia's respective ratings in the middle of the 'A' range. Malta's disproportionate exposure to weak macroeconomic conditions

across the European region presents challenges for its already weak debt metrics compared with 'A'-rated peers, prompting a repositioning at the lower end of the 'A' range at A3.

Comparisons between Spain and Italy are difficult given their fundamental differences. Spain's government faces a combination of weak growth and high unemployment, as well as exposures to regional governments and the banking sector, amplifying the challenges in reducing its budget deficit and arresting the rising trend in its debt burden.⁶ In contrast, Italy can comfortably deliver a primary surplus. However, the country's current low-growth environment and ongoing efforts to implement far-reaching structural reforms will make it challenging for the Italian government to continue generating the high primary surpluses that are required to compensate for higher interest payments and ultimately reduce its outstanding public debt. For these different reasons, the creditworthiness of both sovereigns implies a rating at the lower end of the 'A' range.

We have not adjusted Ireland's Ba1 rating in light of its adherence to fiscal targets and ongoing implementation of reforms, building on the acknowledged flexibility of its economy.⁷ In contrast, Portugal, while achieving its fiscal targets, still faces an extended period of weak growth and a need for continued austerity, which increases its susceptibility to economic, financial and political shocks.⁸

Our Press Release provides more granular explanations for the actions announced today on the debt ratings of the nine affected sovereign issuers. Our review of Cyprus's Baa3 rating announced in November 2011 is continuing, while the developing outlook on Greece's Ca rating remains appropriate as we await clarification on its debt restructuring. Meanwhile, as regards Central and Eastern European sovereigns and their respective ratings, we will be assessing the credit implications resulting from the fragile financial market conditions and weak macroeconomic outlook during the first half of this year.

The breadth of our rating actions reflects the far-reaching implications of the uncertainties and risks created by the challenges facing Europe's current policy framework. In determining the rating adjustment required in each individual case, we have taken into account the factors that we believe make each sovereign relatively more or less vulnerable in the current environment. The configuration of our ratings across Europe has not changed dramatically, although the dispersion of our new ratings encapsulates both (i) the downward pressure on sovereign creditworthiness resulting from the deteriorating macroeconomic environment and its impact on medium-term growth prospects as well as (ii) the ever-present threat of larger, more dire event risks, such as the possibility of further sovereign defaults, contagion, possible exits from the monetary union and the (very remote) possibility of the disintegration of the currency itself.⁹ Further progress in addressing these challenges would support a stabilisation of our assessment of economic resiliency and susceptibility to event risk.

Tolerance in Revised Ratings

These rating actions reflect the potential for shocks to emerge given the gradual evolution of the policy framework. As such, we would expect these repositioned ratings to exhibit some degree of tolerance to potential downside scenarios that may emerge in coming quarters, including a modest deterioration in the macroeconomic outlook relative to our base case scenario,¹⁰ evidence of further fiscal slippage, and

⁶ See [Spain's Deteriorating Growth Prospects Further Complicate Fiscal Consolidation](#), 30 January 2012.

⁷ See [Ireland's Credit Positive Bond Swap Reflects Sovereign's Progress in Restoring Creditworthiness](#), 30 January 2012.

⁸ See [Second IMF/EU Review Suggests Portugal's Economic Adjustment Program Still Characterized by High Implementation Risk](#), 22 December 2011.

⁹ See [Rating Euro Area Governments Through Extraordinary Times – An Updated Summary](#), 4 October 2011.

¹⁰ See [Global Macro-Risk Outlook 2011-2012: Material Slowdown in Growth](#), 11 November 2011.

occasional political set-backs in the progress towards agreeing to and implementing the necessary reforms to restore confidence.

We also do not anticipate that further ratings adjustments would be necessary in response to the inevitable ebb and flow of support for further ECB or EFSF/ESM interventions, to continued uncertainty over the resources that will be made available to the EFSF and ESM, to occasional political shifts that might raise new questions regarding the degree of commitment and resolve in some countries,¹¹ and to the prospect of further financial market contagion associated with disruptions emanating from Greece.

We expect European policymakers to continue with the current steady approach to structural reform. We are assuming that there will not be any official-sector losses on bailout loans, nor any direct fiscal transfers over the rating horizon. For this reason, the ratings of sovereigns with the strongest fiscal positions, such as Germany, Finland, and the Netherlands, are not currently expected to come under pressure.

We continue to believe that the euro area as a whole possesses considerable economic and financial strength, with its creditworthiness constrained by its institutions and by a legacy of fiscal imbalances rather than by its access to resources. Nevertheless, our ratings would not be immune to more extreme downside scenarios such as a further substantial deterioration in macroeconomic or financial market conditions, or substantial erosion in policymaker commitment to reform implementation.

EXHIBIT 1

Moody's repositioned ratings for sovereigns in the euro area

Moody's rating range	Euro area sovereign
Aaa	Austria (negative outlook), Finland, France (negative outlook), Germany, Luxembourg, Netherlands, United Kingdom* (negative outlook)
Aa	Belgium (Aa3, negative outlook)
A	Estonia (A1)
	Slovakia (A2, negative outlook), Slovenia (A2, negative outlook)
	Malta (A3, negative outlook), Italy (A3, negative outlook), Spain (A3, negative outlook)
Baa	Cyprus (Baa3, on review for possible downgrade)
Ba	Ireland (Ba1, negative outlook), Portugal (Ba3, negative outlook)
B	
Caa	
Ca	Greece (developing outlook)
C	

* Not a member of the euro area

¹¹ See [Finland-Greek Collateral Agreement Illustrates Euro Area Divisions](#), 22 August 2011, and [Slovakia Approves EFSF Expansion, but Government Falls, a Credit Negative](#), 17 October 2011.

Moody's Related Research

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- » [Euro Summit Makes Progress, but Important Uncertainties Remain, February 2012 \(139606\)](#)
- » [Adherence to IMF Restructuring Practices Provides Little Comfort for Distressed Sovereign Debtholders, December 2011 \(138332\)](#)

Issuer Comments

- » [Spain's Deteriorating Growth Prospects Further Complicate Fiscal Consolidation, January 2012 \(139459\)](#)
- » [Ireland's Credit Positive Bond Swap Reflects Sovereign's Progress in Restoring Creditworthiness, January 2012 \(139461\)](#)
- » [Second IMF/EU Review Suggests Portugal's Economic Adjustment Program Still Characterized by High Implementation Risk, December 2011 \(138469\)](#)
- » [Slovakia Approves EFSF Expansion, but Government Falls, a Credit Negative, October 2011 \(136705\)](#)
- » [Finland-Greek Collateral Agreement Illustrates Euro Area Divisions, August 2011 \(135368\)](#)

Global Risk Perspectives

- » [Global Macro-Risk Outlook 2011-2012: Material Slowdown in Growth, November 2011 \(137364\)](#)

Special Comments

- » [Rising Severity of Euro Area Sovereign Crisis Threatens Credit Standing of All EU Sovereigns, November 2011 \(137652\)](#)
- » [Rating Euro Area Governments Through Extraordinary Times – An Updated Summary, October 2011 \(136315\)](#)

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