

Economic Outlook Committee

- 19th February 2010 -

Hélène Baron

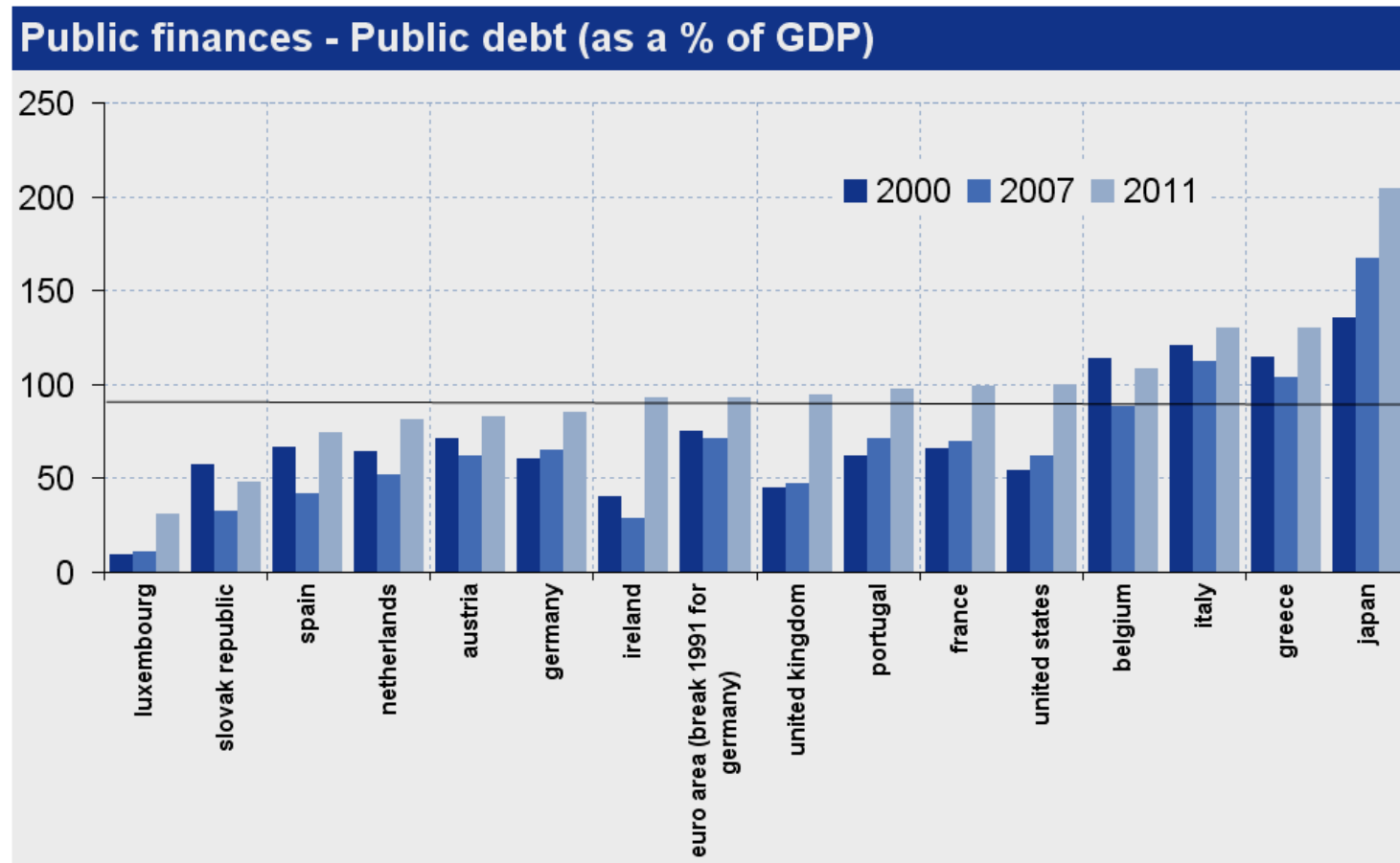
Guilhem Bentoglio

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A quantitative ranking of sovereign risk across developed

The sustainability of public finances is a widespread concern accross developed countries

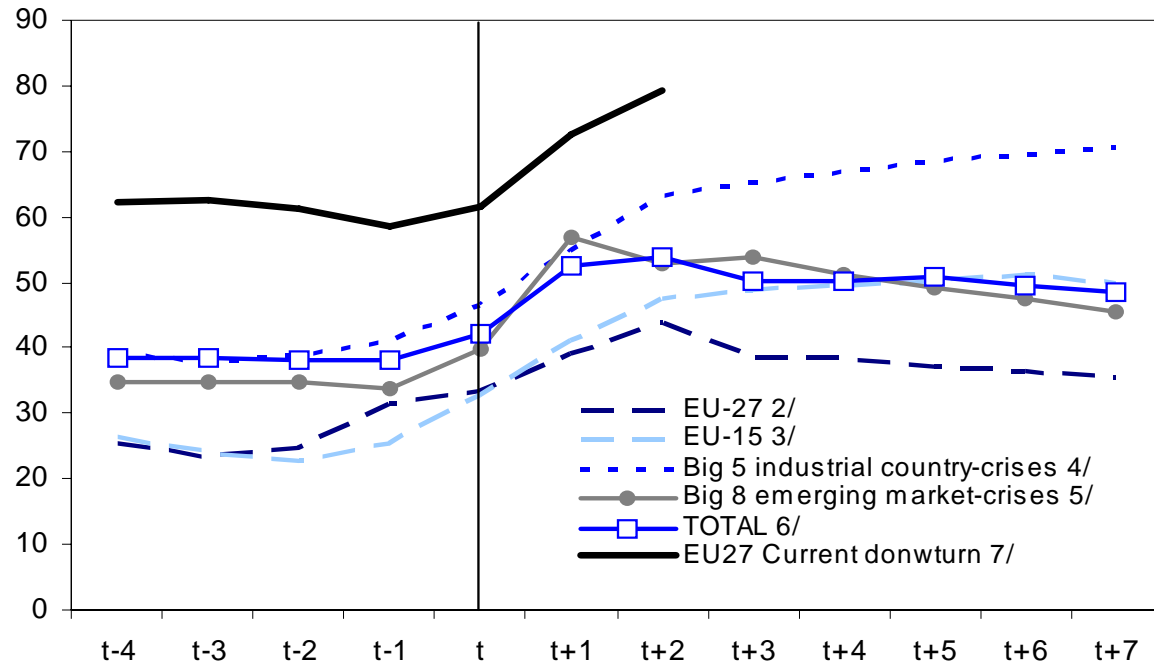
- When government debt-to-GDP goes over 90%, it reduces future potential GDP by over 1% (*This Time It's Different* by Reinhart and Rogoff).



The effect of crises on debt

- Large fiscal deficits contributed to public debt-to-GDP ratios ratcheting them up by 20 points of GDP, on average. This impact has taken a long time to reverse in the past.

Gross public debt crises episodes (% of GDP) 1/



Notes: 1/ Based on 49 crises episodes as presented in the 2009 Public Finance Report Unweighted country averages. t = start of the crisis.

2/ Includes crisis episodes in Czech Republic, Finland, Hungary, Latvia, Poland, Slovak Republic, Spain and Sweden. For new Member States data from 1991.

3/ Includes crisis episodes in Finland, Spain and Sweden.

4/ Includes crisis episodes in Finland, Norway, Sweden, Japan and Spain.

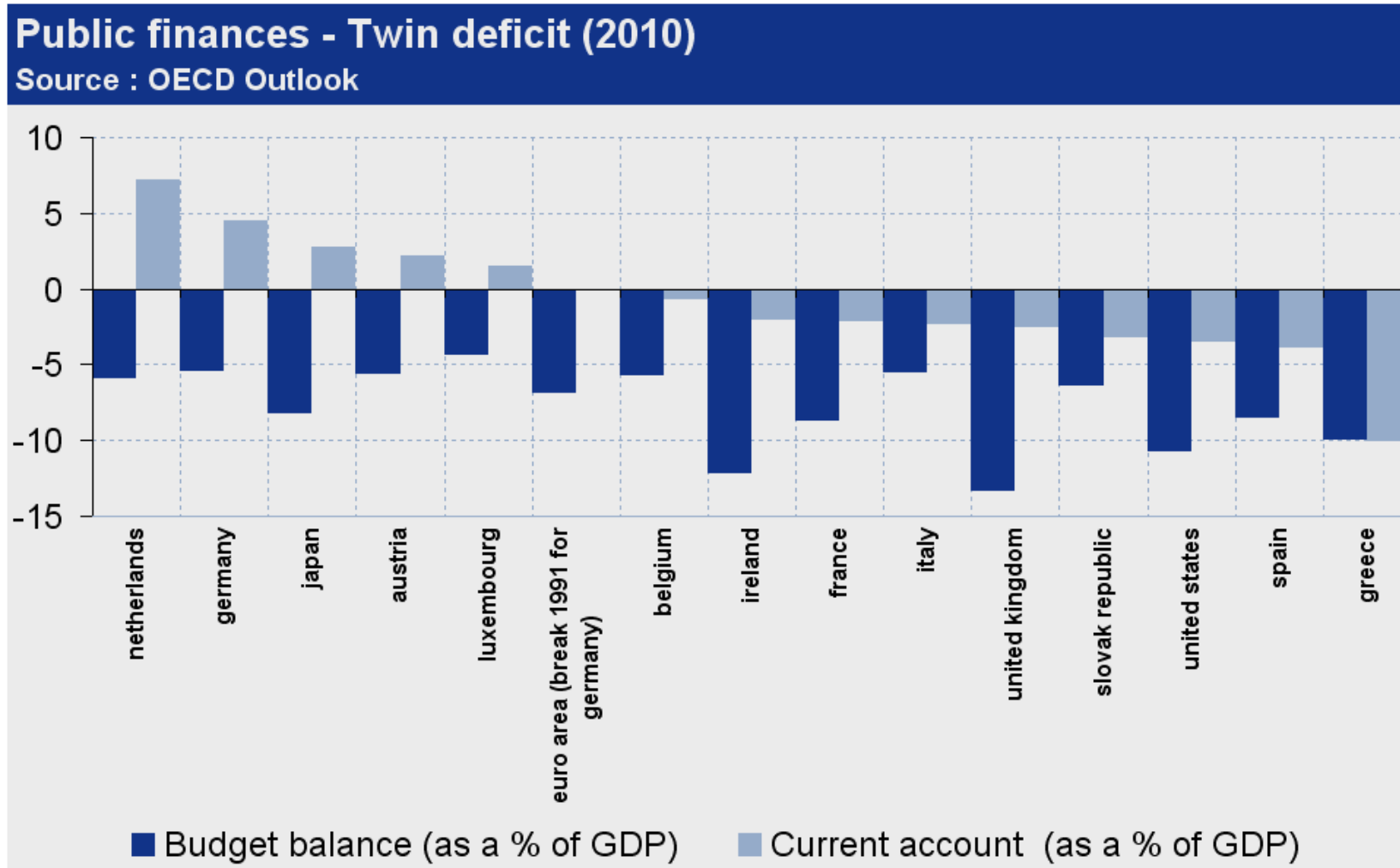
5/ In principle includes Argentina (2001), Indonesia, Malaysia, Mexico (1994), Turkey (2000), Philippines and Thailand. But data for the last three are missing.

6/ Excludes Nicaragua which in 2003 (t+4) received a public debt relief.

7/ All EU27 countries, t = 2008

Sources: Calculations based on IMF International Financial Statistics and AMECO.

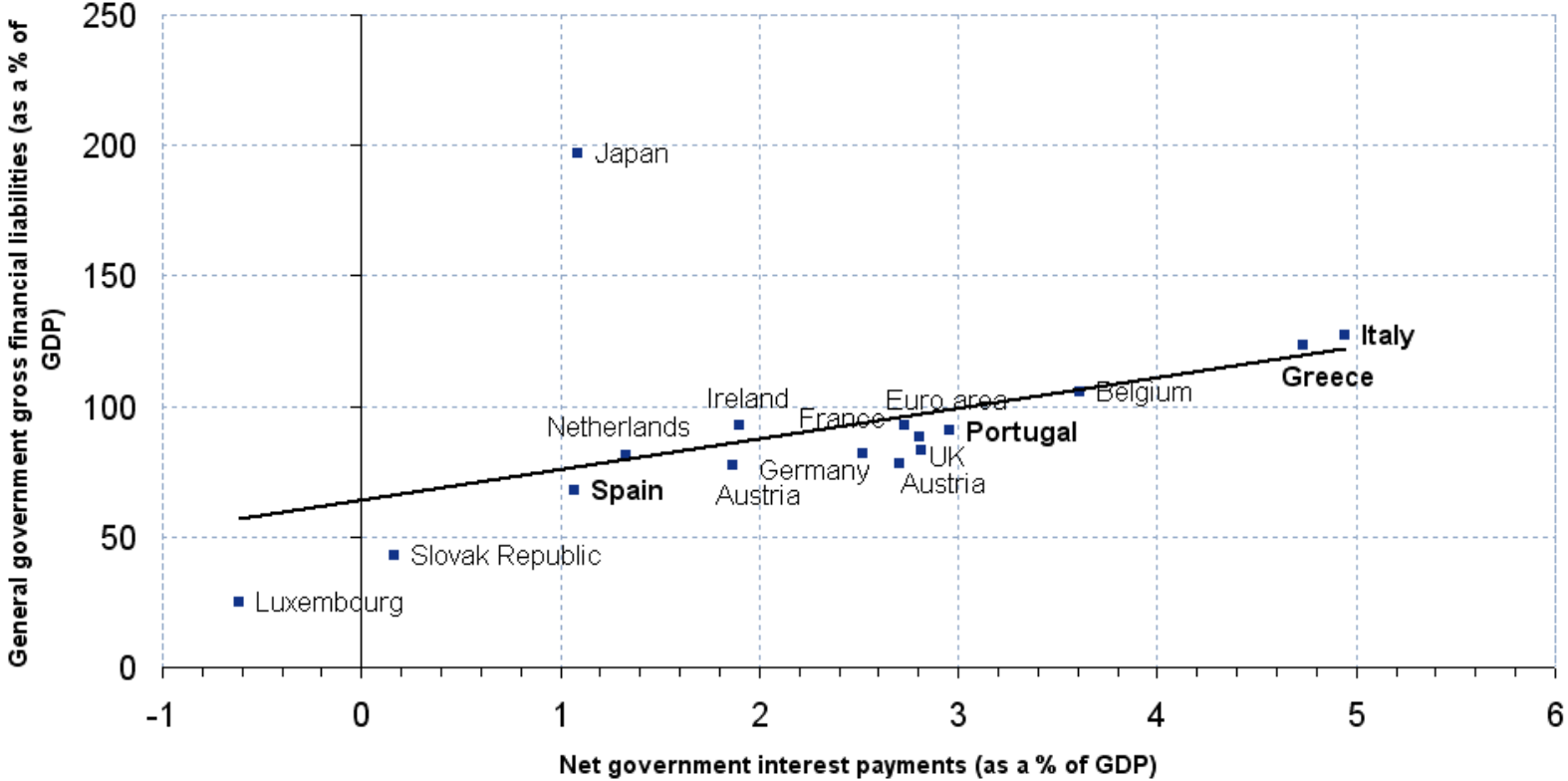
**Large deficits lead to rapid increases in debt.
Financial markets have to discriminate between countries.**



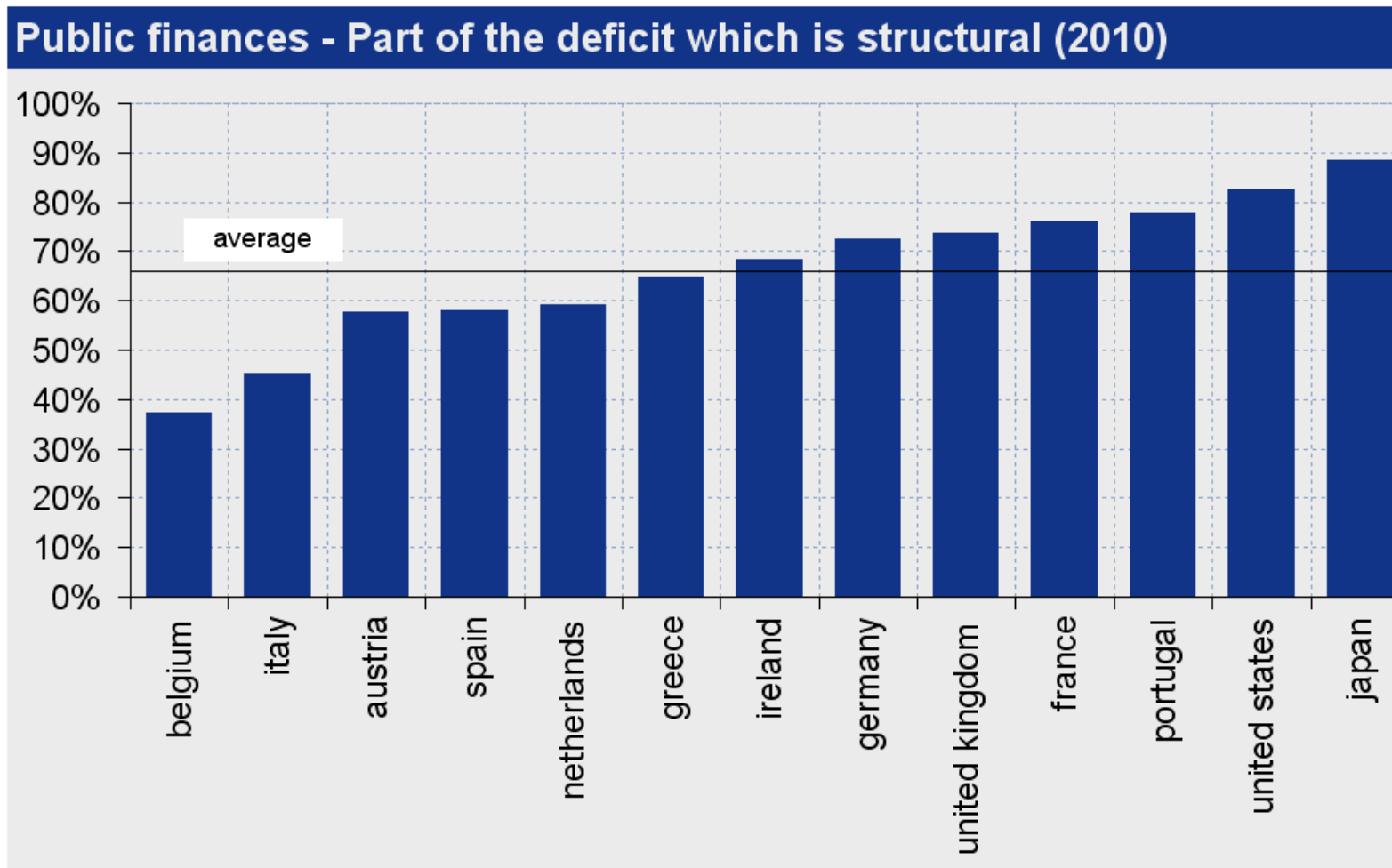
Except in Japan, more debts lead to even more debts (vicious circle)

Public finances - Debt sustainability

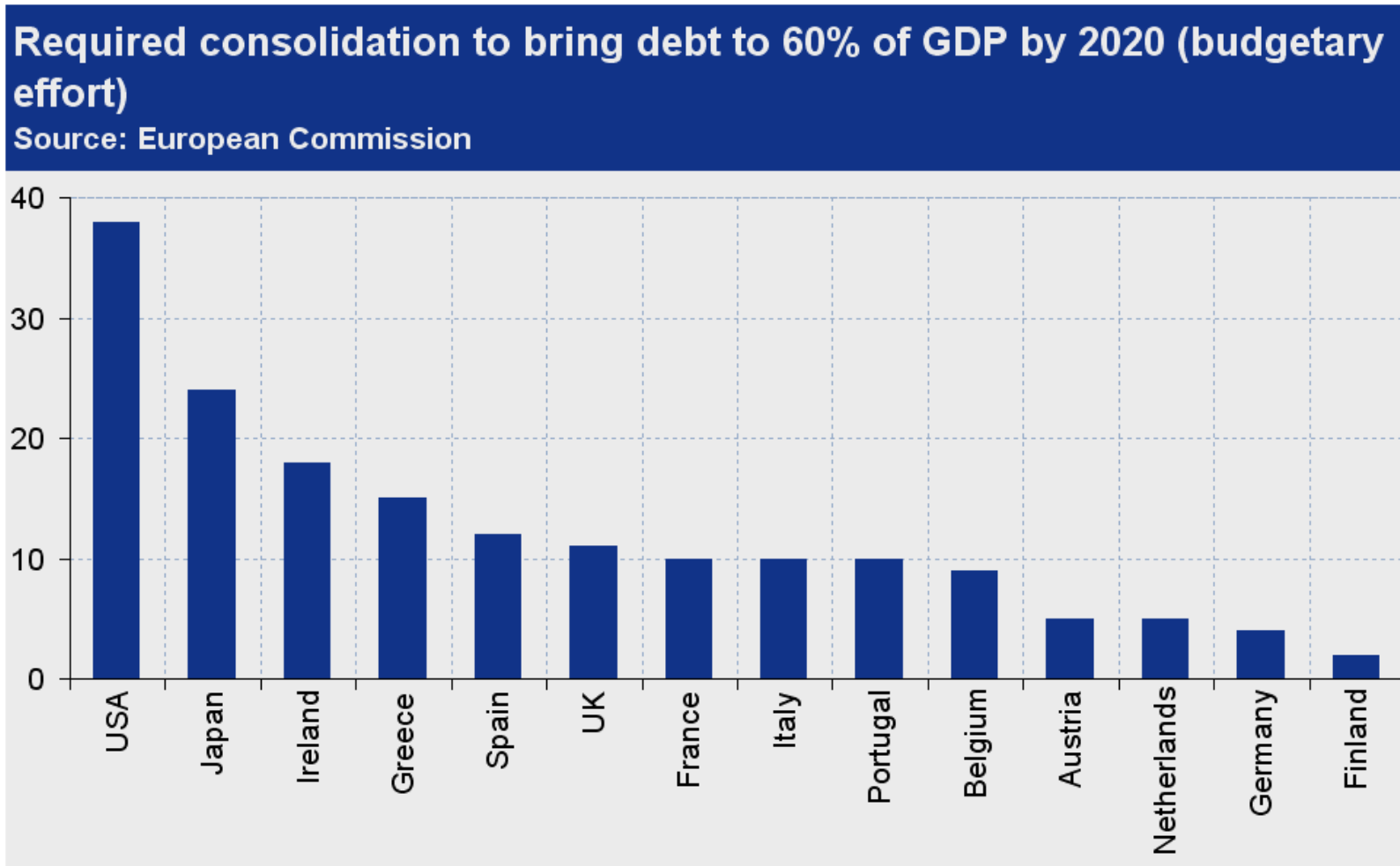
Source: OECD Outlook



Portugal and the UK have to make more structural reforms to reduce their public deficit

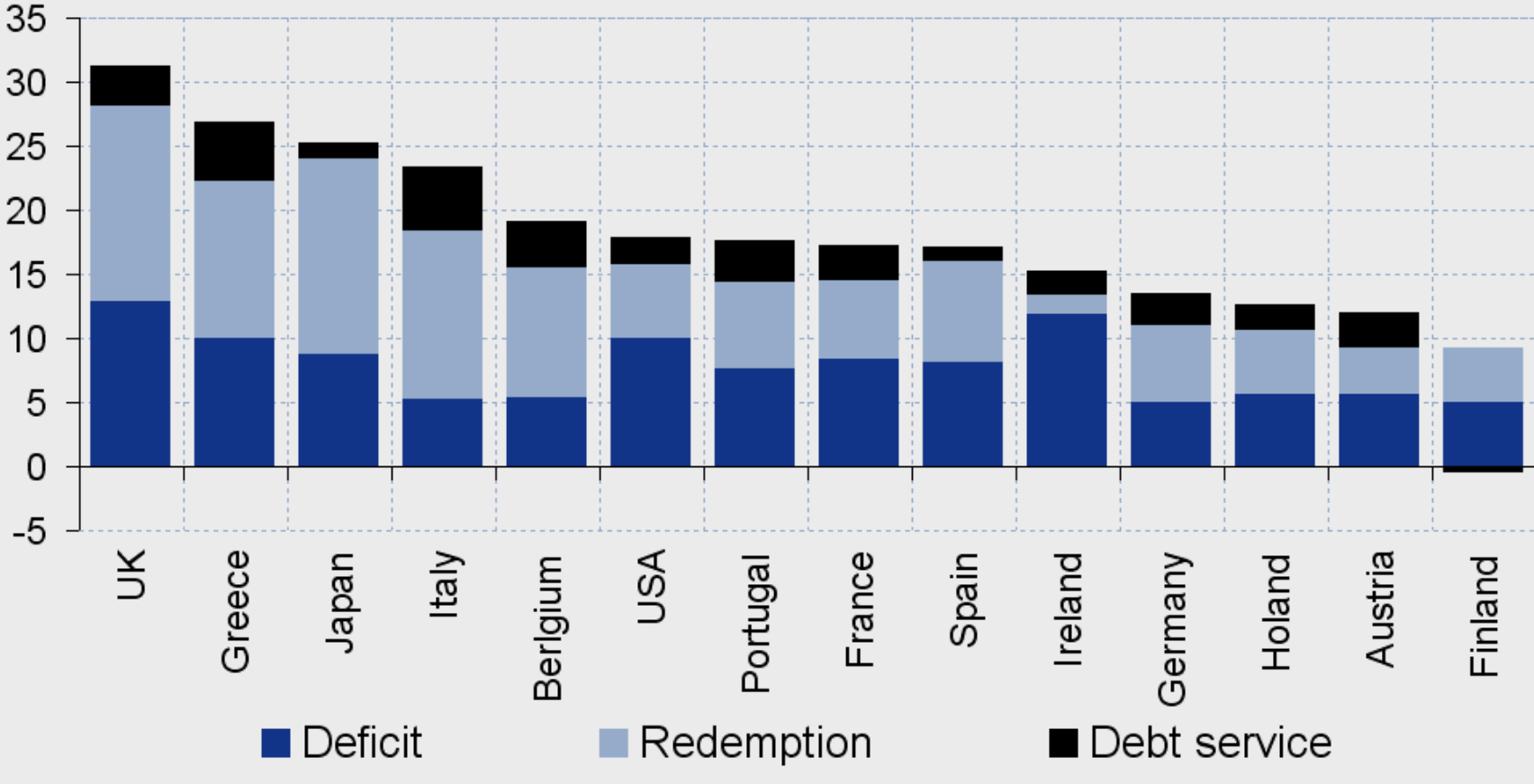


The effort required to bring debt to 60% of GDP by 2020 is substantial

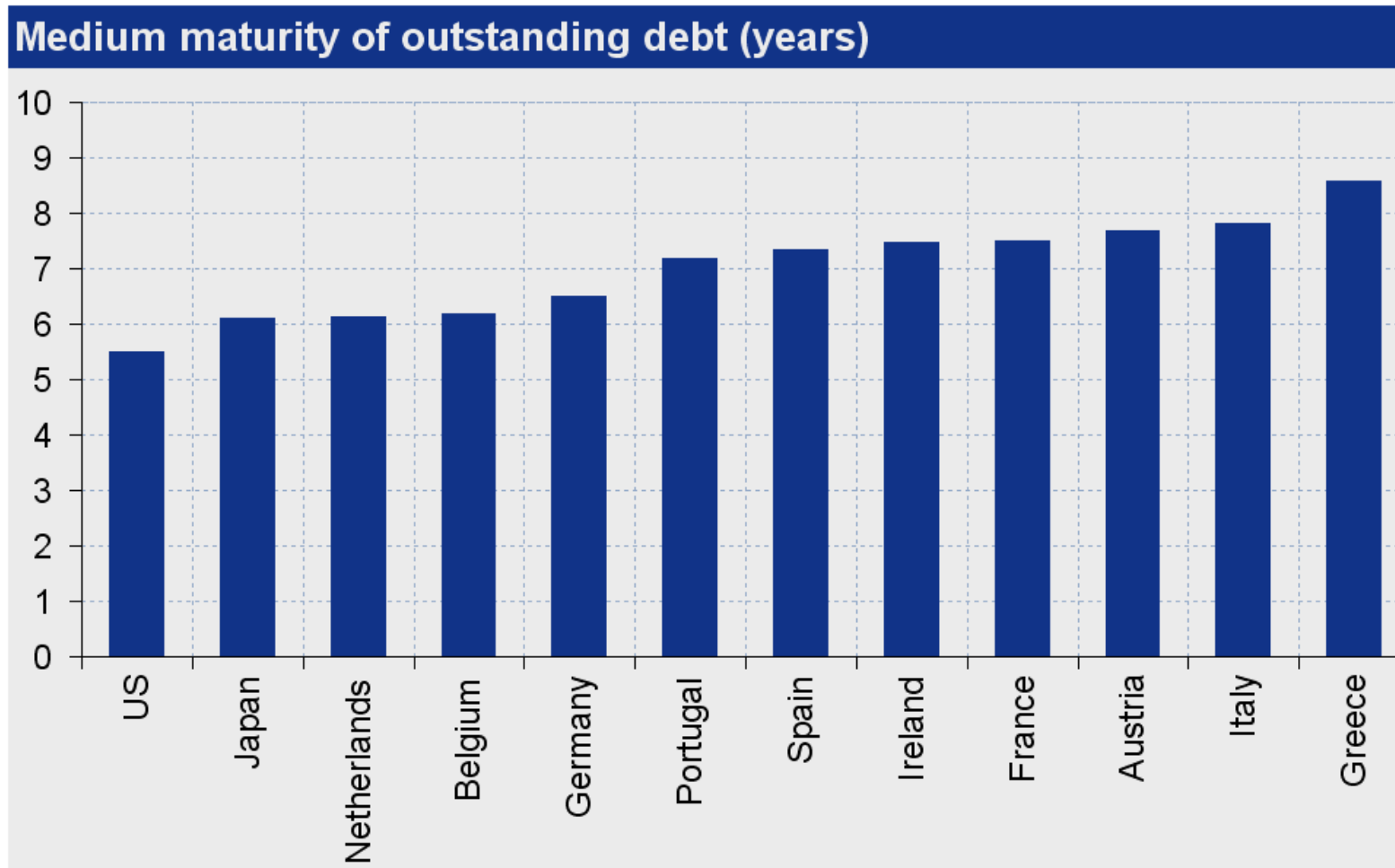


In the short-term, the financing needs are particularly important in the UK, Greece, Japan and Italy

Total financing need of general government (2010-2011 average), % of GDP
 Sources : European commission, Bloomberg

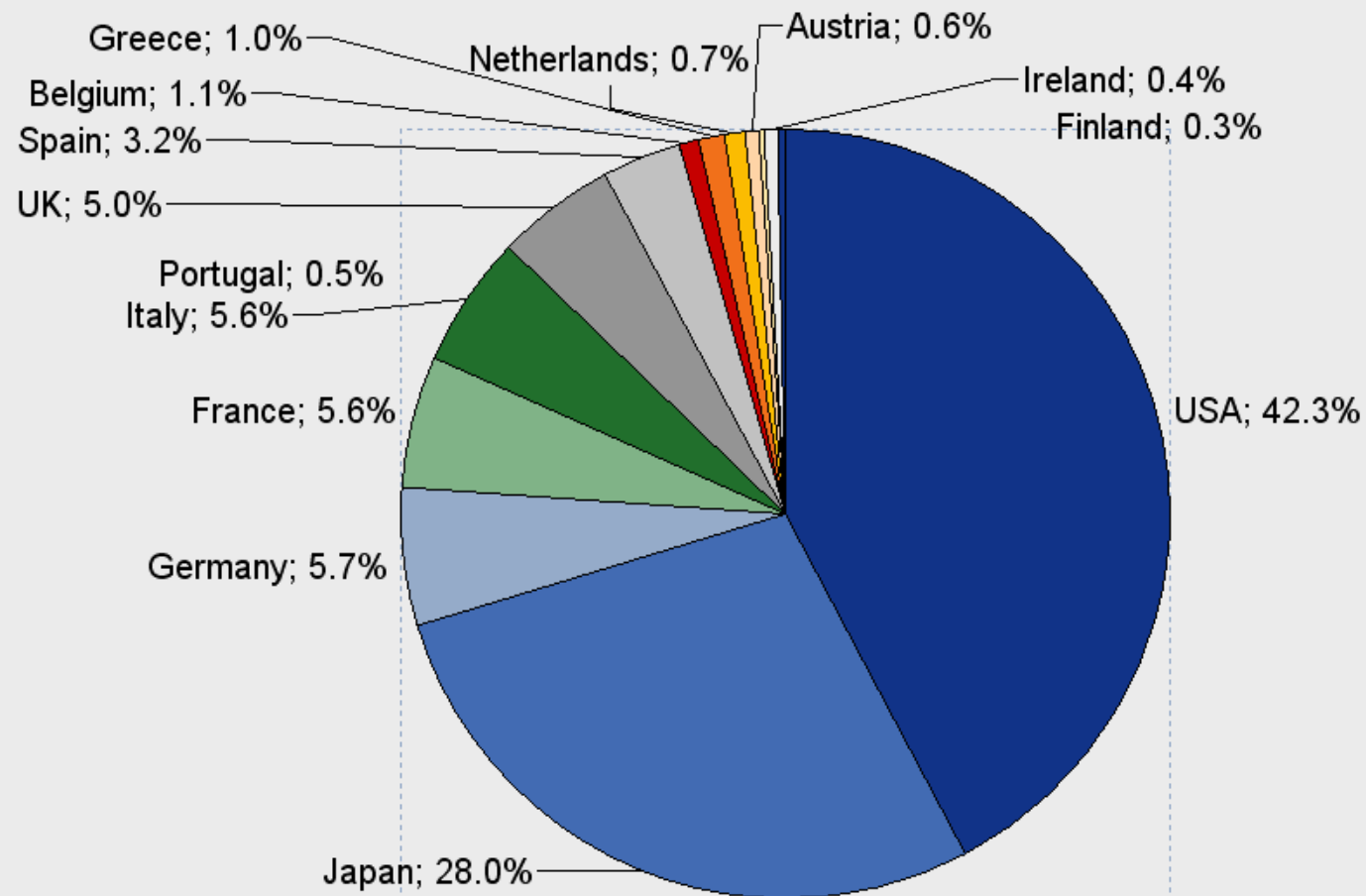


« Large-scale debt buildups pose risks because they make an economy vulnerable to crises of confidence, particularly when debt is short term and needs to be constantly refinanced. » (*This Time It's Different* by Reinhart and Rogoff).



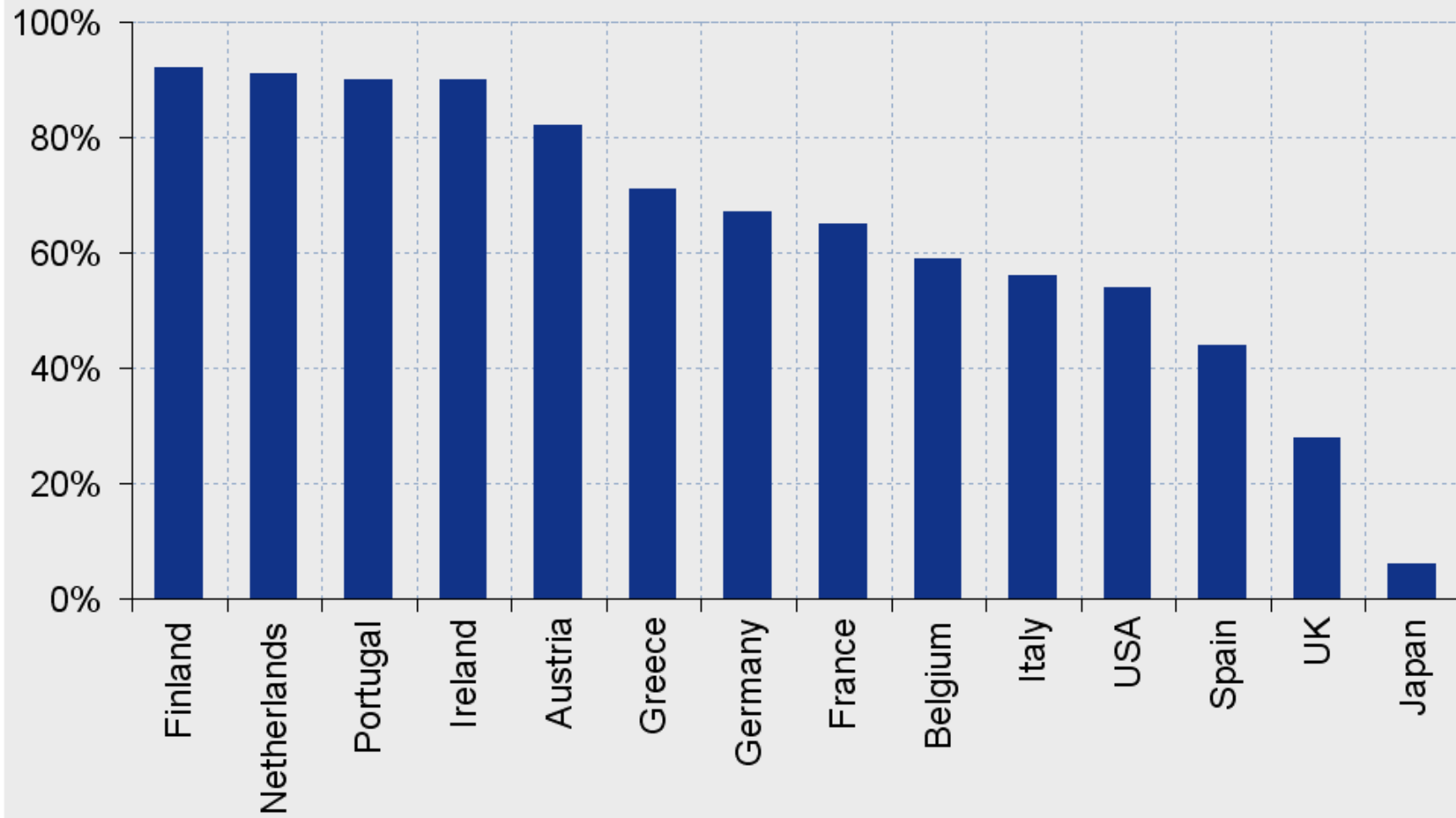
Smaller bond markets are easier to attack

Share of domestic issuance in total developed issuance (2010-11)

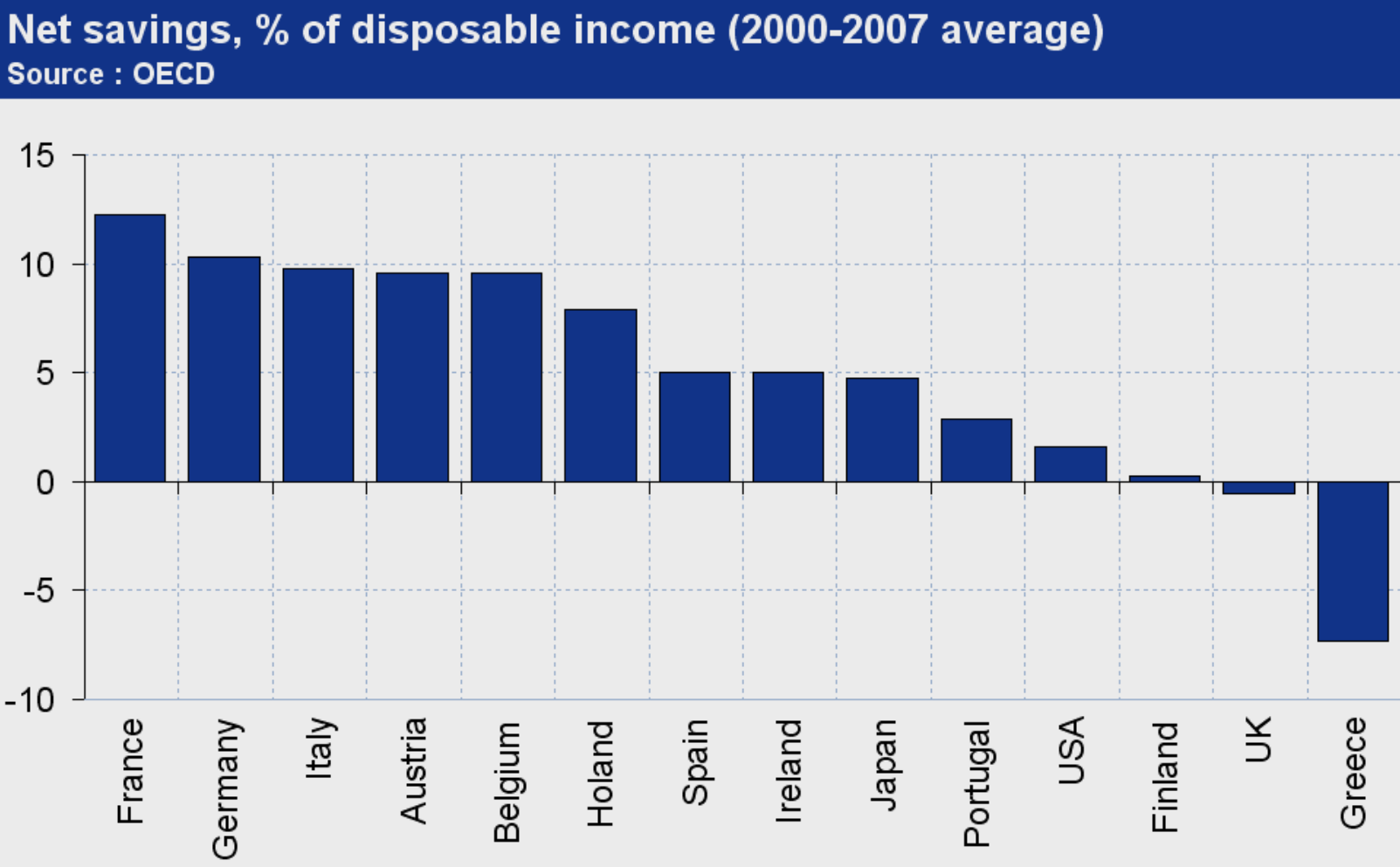


Portugal, Ireland and Greece are largely dependant on foreigners to finance their debt

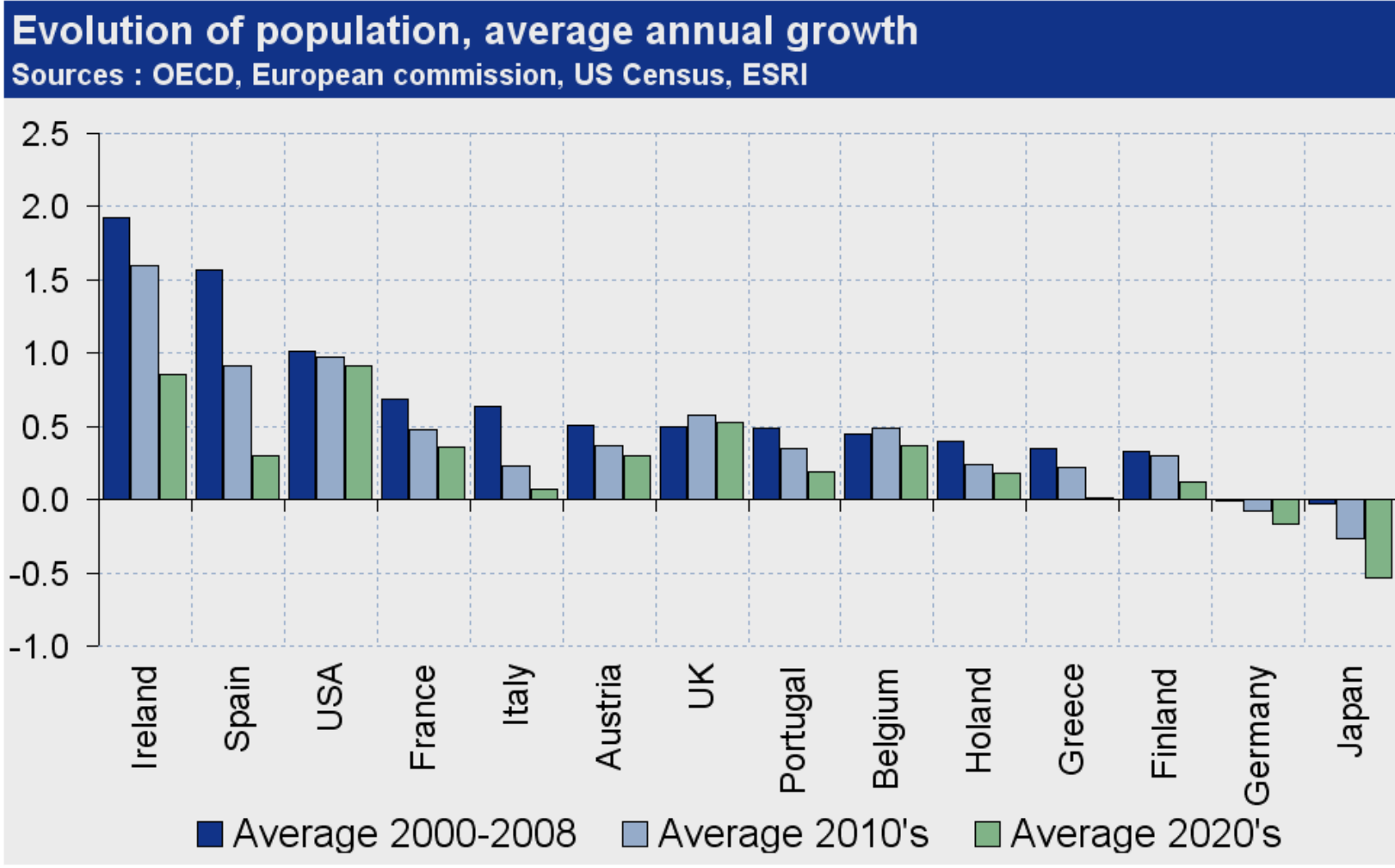
Share of foreigners in public debt holders



Greece cannot rely on internal demand to finance its debt

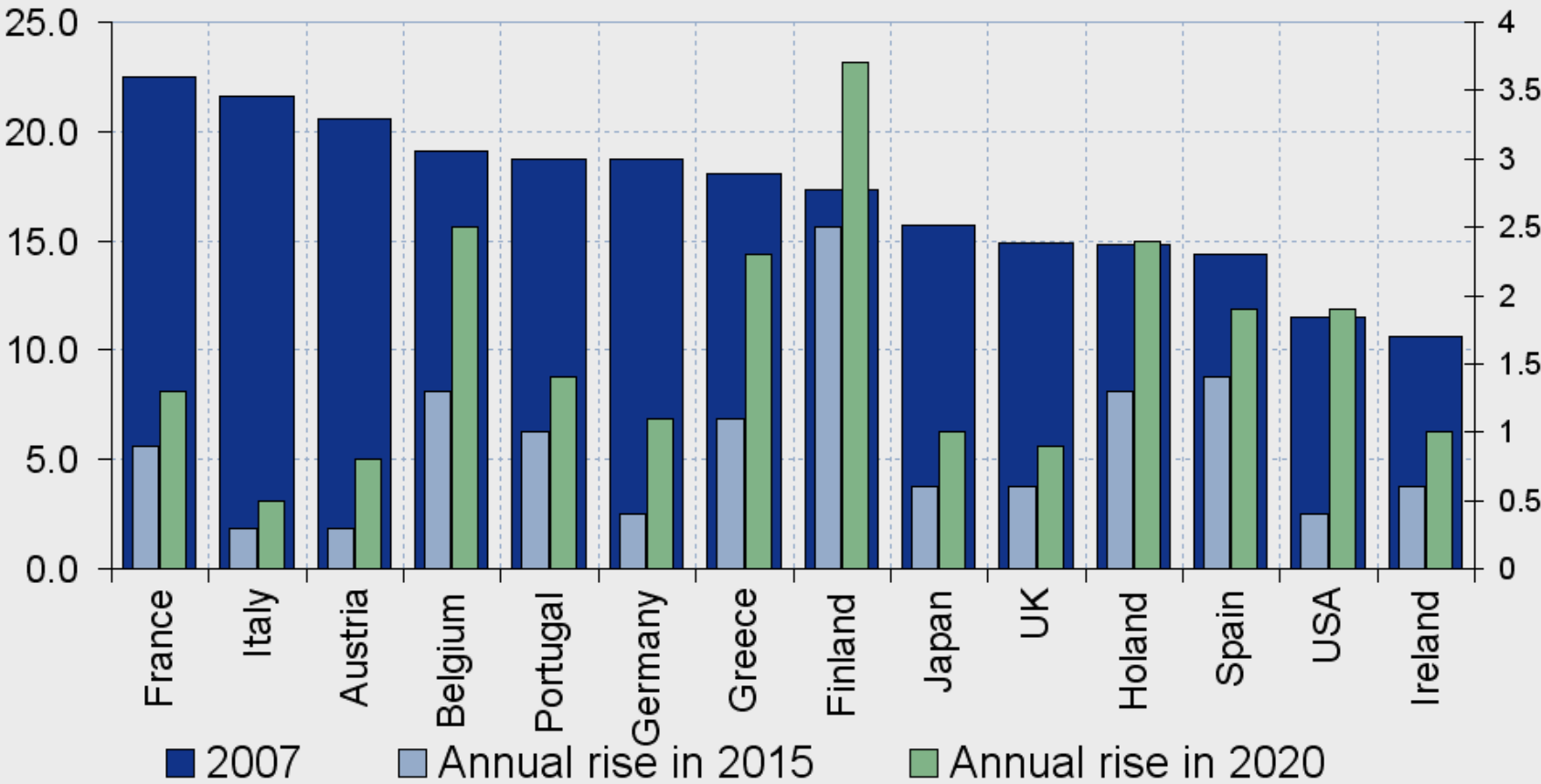


**The existing challenge of ageing looms large over the future.
Demographic pressures will push saving rates lower.**

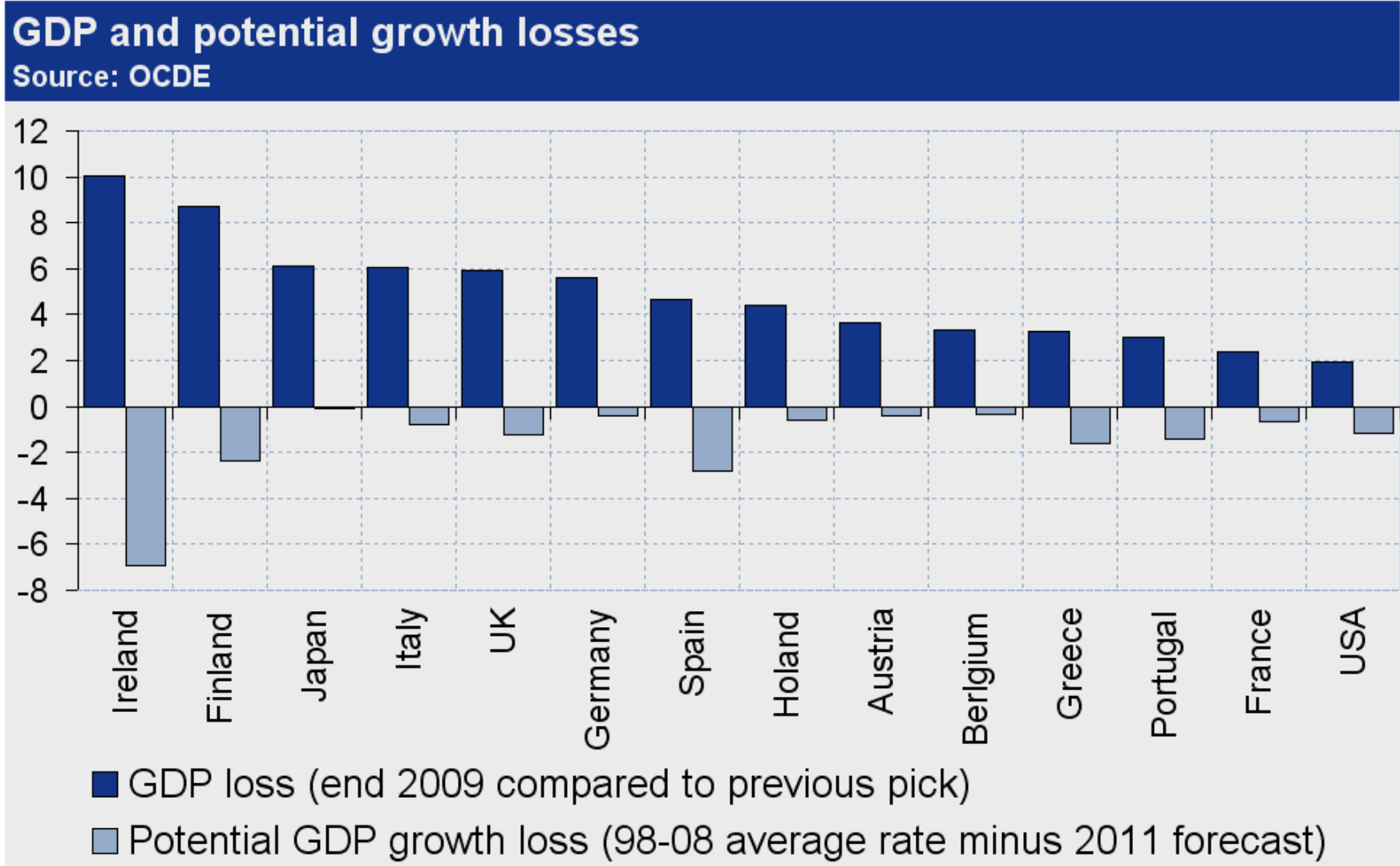


Budgetary costs of population ageing are set to increase substantially but with wide variation between countries

Cost of ageing, pension, health and long term care annual public spending, % of GDP
 Sources : European commission, IMF

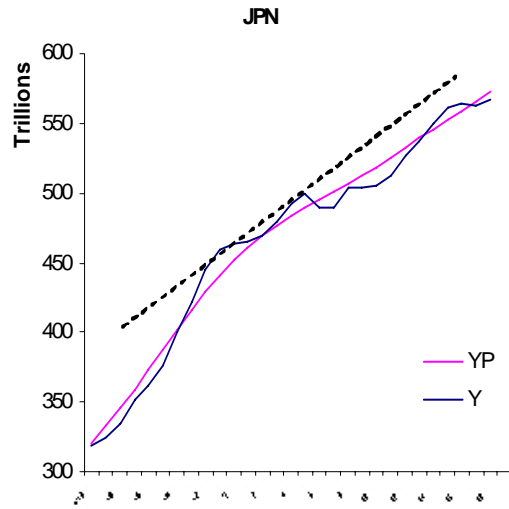


Will the loss on potential GDP level and/or growth rate be permanent after the crisis ?

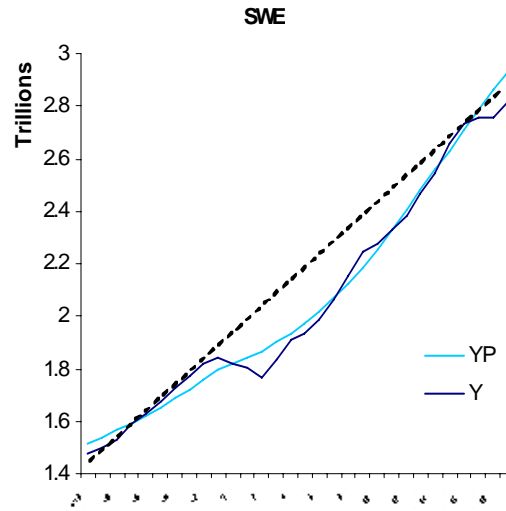


The path of actual and potential output in previous financial crises in Japan, Sweden and Finland

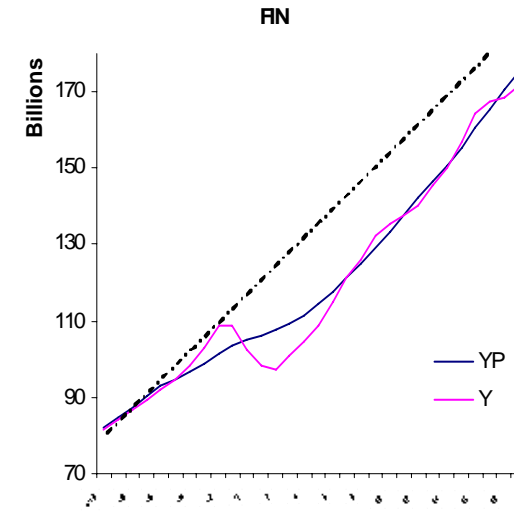
Permanent loss in GDP level



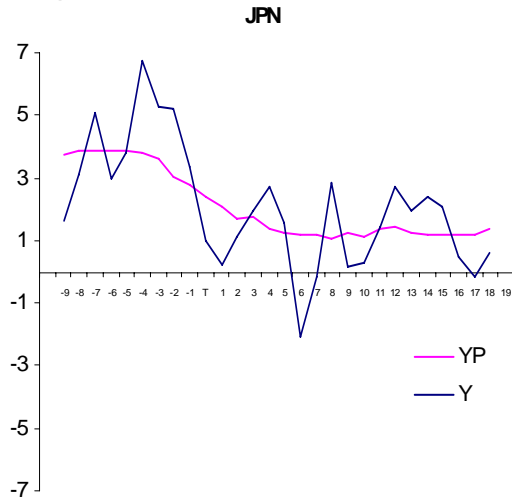
Full return to earlier path



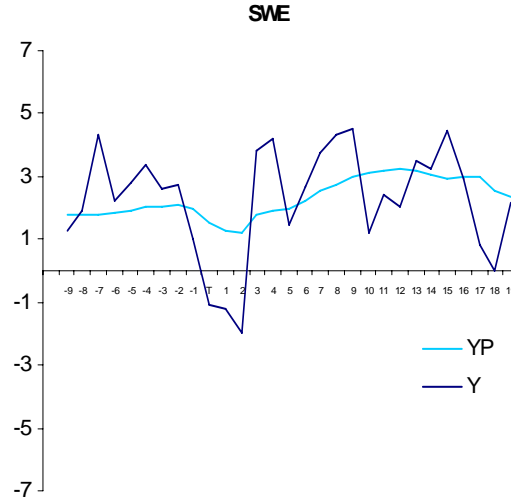
Permanent loss in GDP level



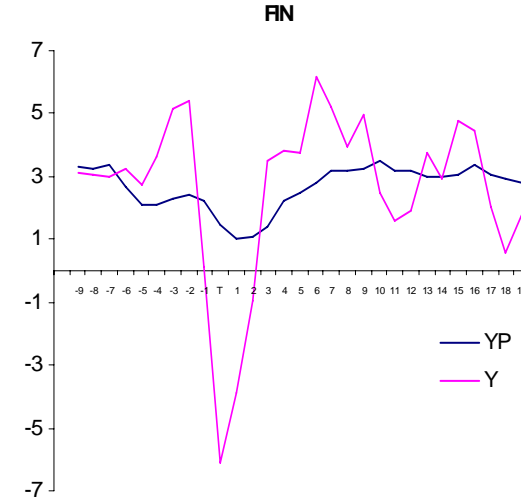
Lower long-term potential growth after the crisis



No loss of potential output level after some time



Same long-term potential growth after the crisis



A quantitative ranking of sovereign risk in developed countries

	Financing sources				Fiscal situation			Behaviour during crisis		Outlook			Governance	Global risk rating	
	Share of foreigners in public debt holders	Current account (2009)	Share of domestic issuance in total developed		Deficit (2010-11)	Redemption (2010)	Debt service	Debt evolution 2007-2011	GDP loss remaining (end 2009 compared to previous pick)	Loss in potential GDP (98- ageing for 08 average compared to 2011 projection)	Annual cost of public finance, 2007-2015 evolution	Required consolidation to bring debt to 60% by 2020 (budgetary effort)	SRI rating (Government effectiveness from 1 to 10)		
			% of total	% of GDP											% of total
Germany	8		2	3	2	1	8	7	2	9	3	3	2	5	4.2
Austria	10		4	11	4	6	3	8	3	6	4	2	4	4	5.3
Netherlands	13		1	10	6	5	5	5	9	7	5	12	4	2	6.5
France	7	8	4	1	1	9	7	9	8	2	6	8	8	10	6.7
Belgium	6	6	8	5	5	4	10	12	5	5	2	12	5	8	6.8
Japan	1	3	2	9	9	10	13	3	11	12	1	7	13	9	7.2
Finland	14		5	14	12	2	2	1	4	13	12	14	1	1	7.3
Italy	5	10	5	3	3	3	14	14	1	11	7	1	8	14	7.4
USA	4	12	1	11	12	12	6	6	12	1	8	4	14	7	7.5
Spain	3	11	7	7	7	8	9	2	10	8	13	13	10	11	8.6
UK	2	9	6	13	13	14	13	10	13	10	9	5	9	3	8.9
Portugal	12	14	12	10	10	7	4	11	6	3	10	9	8	12	9.1
Ireland	12	7	13	8	8	13	1	4	14	14	14	6	12	6	9.5
Greece	9	13	9	14	14	11	11	13	7	4	11	10	11	13	10.5

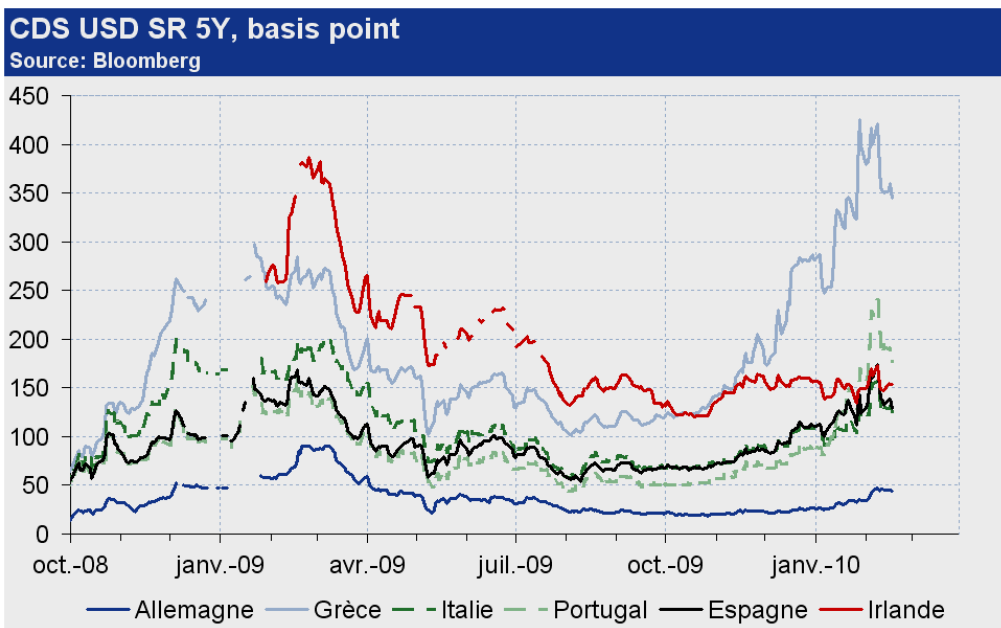
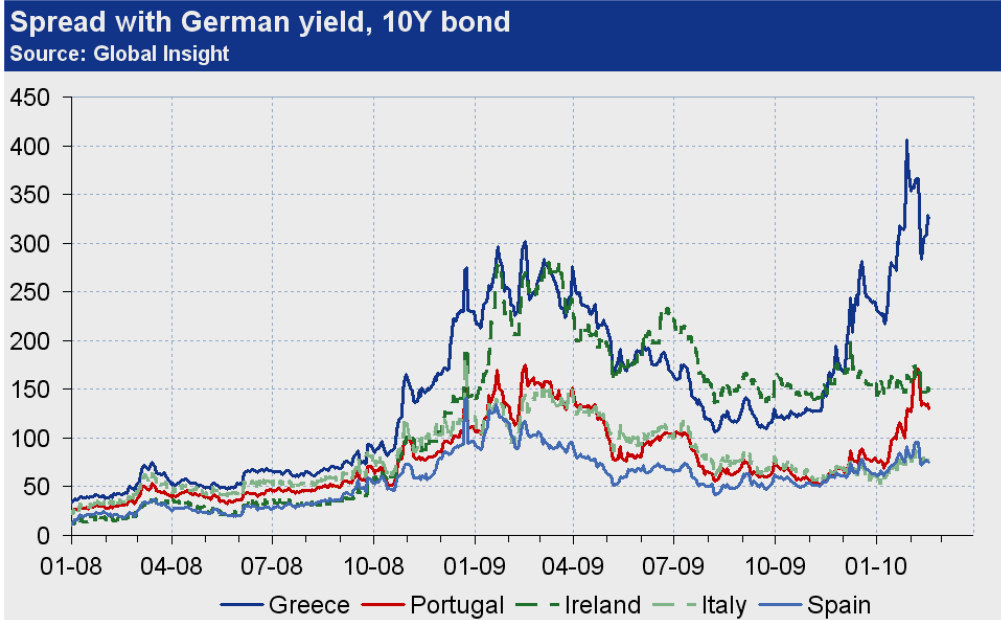
A quantitative ranking of sovereign risk in developed countries

Key points

- **Italy** is the European peripheral country which is in best shape:
 - Small part of the public deficit is structural
 - Relatively low dependence on foreigners
 - Relatively high net savings
 - But high level of public debt (and interest payments)
 - And highly impacted by the ageing of population
- Among the PIGS, **Spain** is the one which is in best shape:
 - Low level of public debt (and interest payments)
 - Low part of the public deficit which is structural
 - Low central government tax revenue
 - Low dependence on foreigners
 - But substantial losses of potential output
- Among the PIGS, **Greece** is the one which is in worst shape:
 - High level of public debt (and interest payments)
 - Large efforts needed to consolidate public finances
 - Strong financing needs in the short-term
 - Negative net savings
 - Big loss of potential output
 - Highly impacted by the ageing of population
 - Poor government effectiveness
- **Portugal** is between Spain and Greece:
 - High level of public debt (and interest payments)
 - High dependence on foreigners
 - Low net savings
 - Big loss of potential output

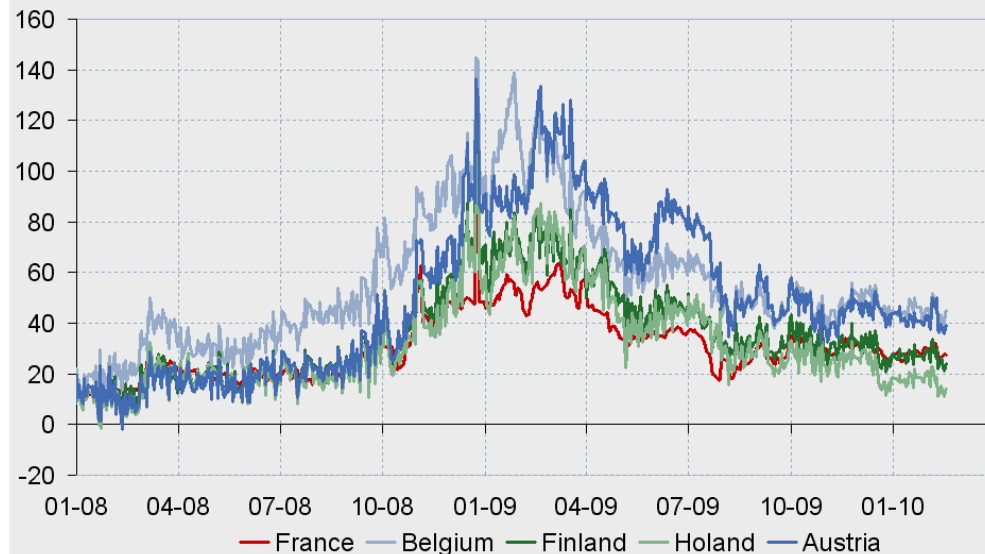


PIGS spread and CDS consistent with our rating, Italy seems a bit high

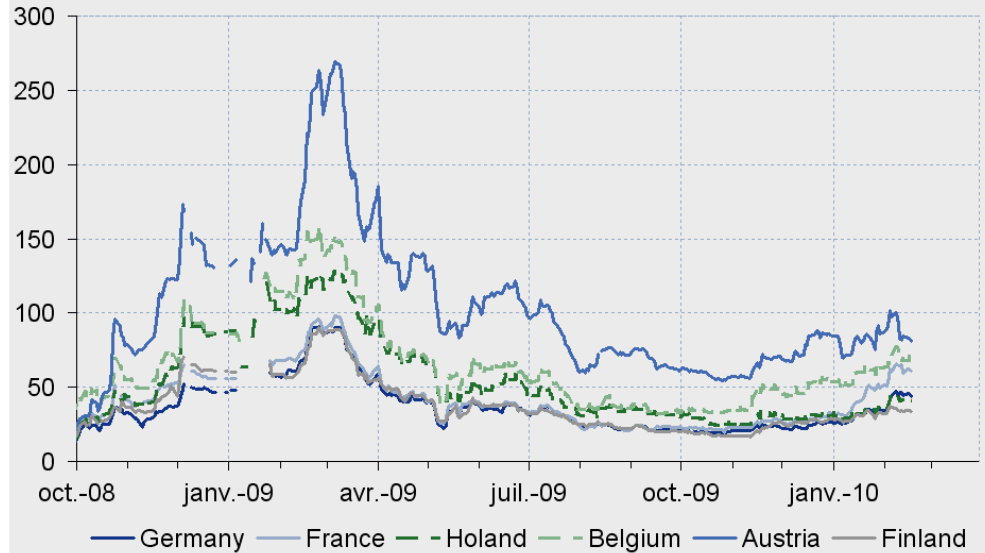


Core euro area countries spread little changed but CDS up in Austria, Belgium and France

Spread with German yield, 10Y bond
Source: Global Insight



CDS USD SR 5Y, basis point
Source: Bloomberg



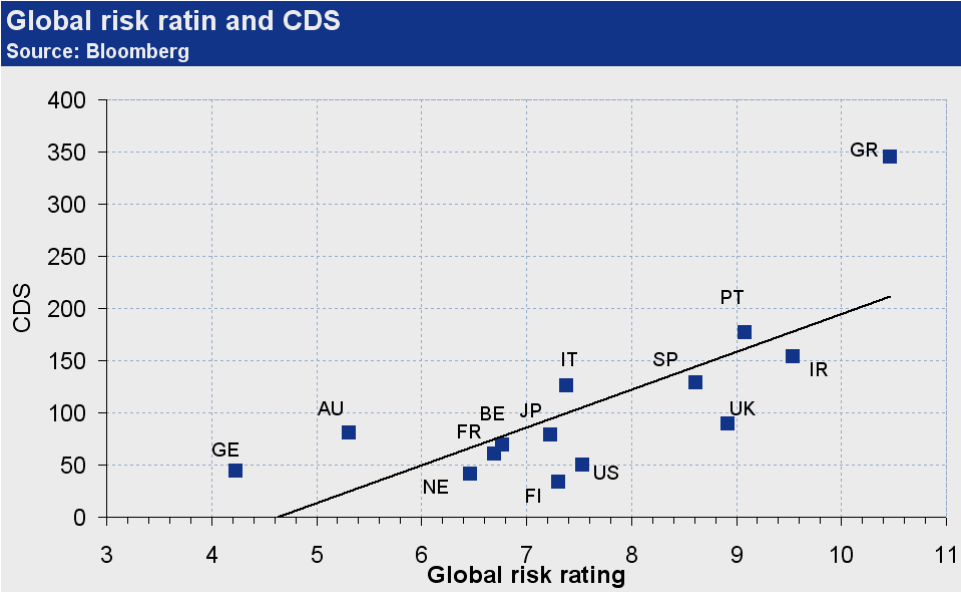
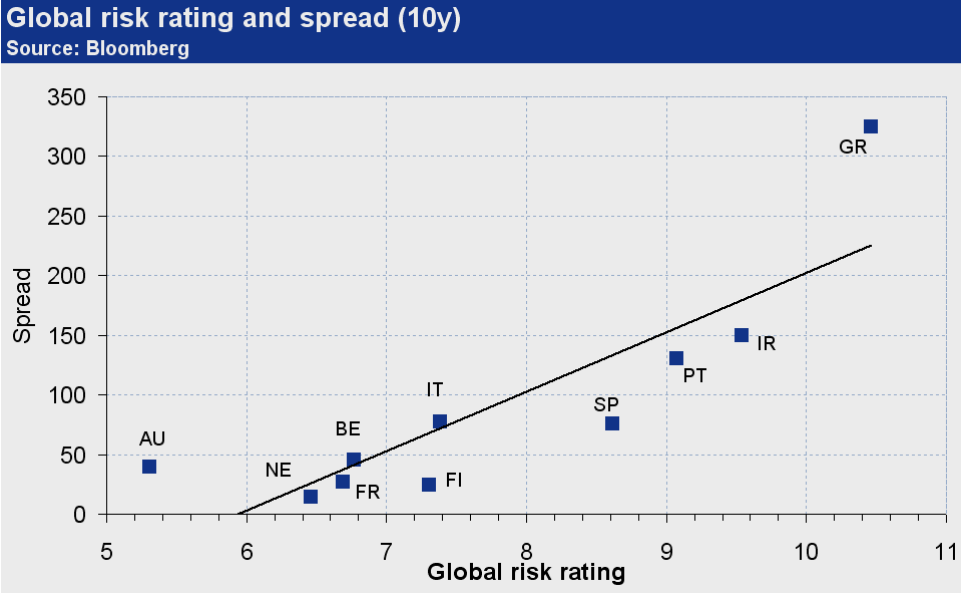
Japanese and UK CDS are trending higher

CDS USD SR 5Y, basis point

Source: Bloomberg



Global rating fairly consistent with market pricing



Eurostoxx index shows little impact from the bad news coming from sovereign risk

