How much can small sovereigns borrow?

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How much can small sovereigns borrow?

The simple answer:
there is no real constraint

➔Ireland's borrowing will always be small on a European or global scale

Borrowing will always look small, even if on an unsustainable path.

Compare **Ireland**, €18bn, to

- **Greece** €35bn (four times the population)

- **Slovenia** €1bn (half the population)

Table 1: Bond issuance based on official budget sources

	Official Supply projections (source Treasury or EC estimates)				
	Bond redemp-tions in 2009	Other redemp-tions	Net Borrowing (Deficit + other)	Total Fin-ancing needs-ex Bills	Gross Bond issuance expected without the rescue plan
Austria	9	0	18	27	16
Belgium	18	0	6	23	29
Finland	6	1	0	7	6
France	112	2	52	165	135
Germany	138	6	19	162	156
Greece	25	4	15	43	35
Ireland	5		13	18	18
Italy	139	25	41	205	180
Netherl.	35	0	4	38	38
Portugal	6	0	5	12	12
Slovenia	1	0	0	1	1
Spain	30	6	29	65	59
	522			*766*	*685*

Source: National Treasuries, European Commission, SG

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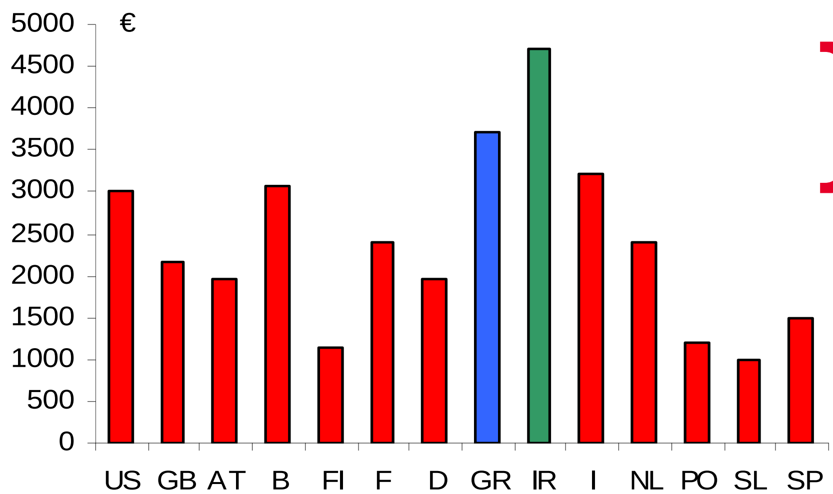
Unprecedented citizen indebtedness

Gross debt issued per capita - Ireland now leads



Can lead 1, 2
maybe 3 years
But not indefinitely

Based on forecasts in SG *Outlook 2009*. Conversion of USD and GBP figures to EUR at rates 7-Jan-2009. Excludes variable rate bonds and bills, and bonds sold/bought by central banks.

Are there any signs of Ricardian equivalence yet?

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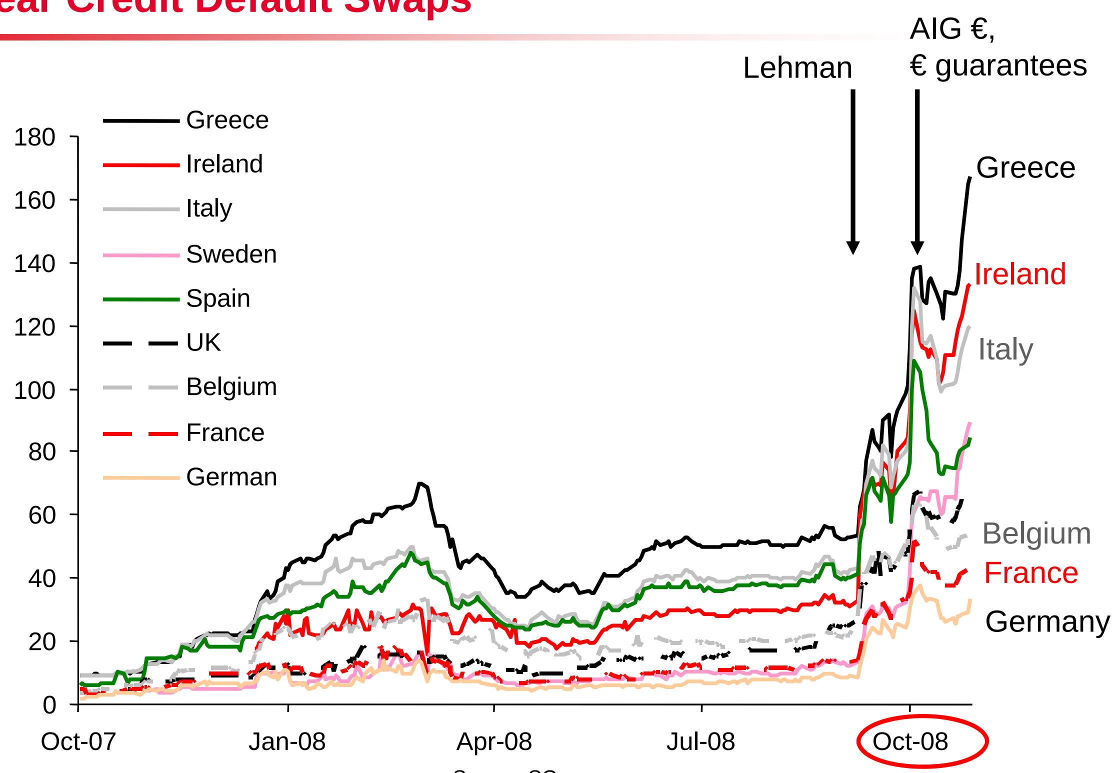
5-year Credit Default Swaps



Source: SG

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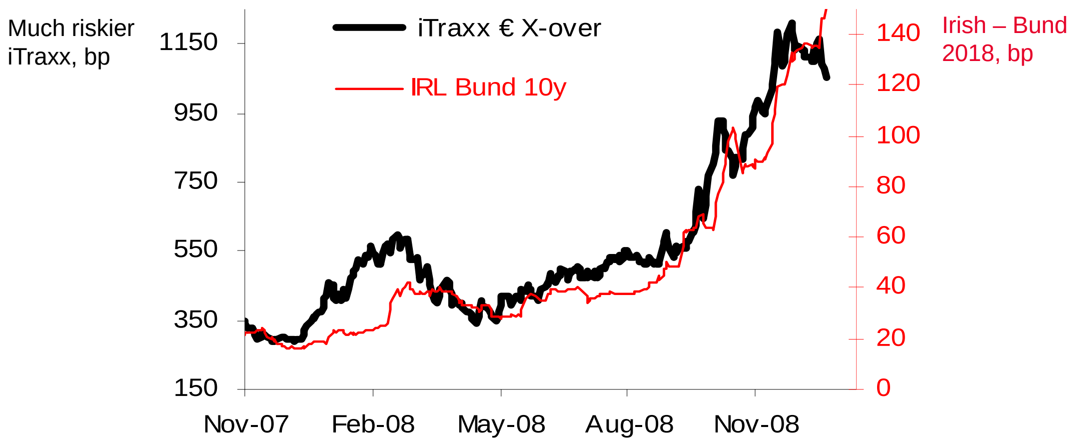
3

Irish bonds remain correlated to global risk measures ?

Irish Bund asset swap (ASW) spread correlated to corporate CDS



Source: SG

➔ **Global risk aversion** can explain a some spread moves, whether in ASW terms, whether equity or fixed income, whether near or far away

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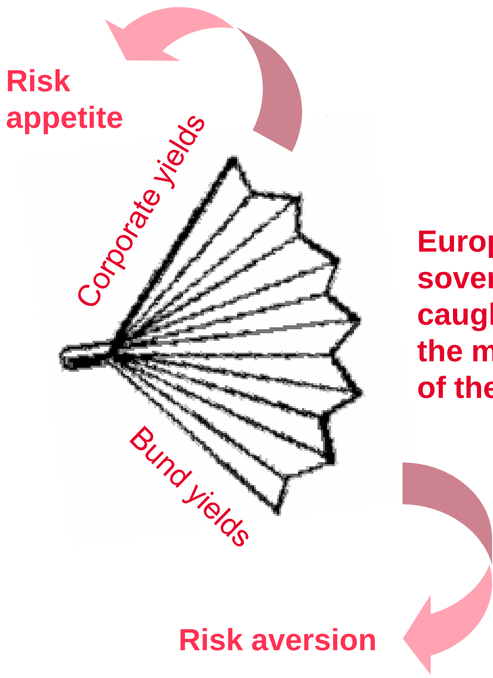
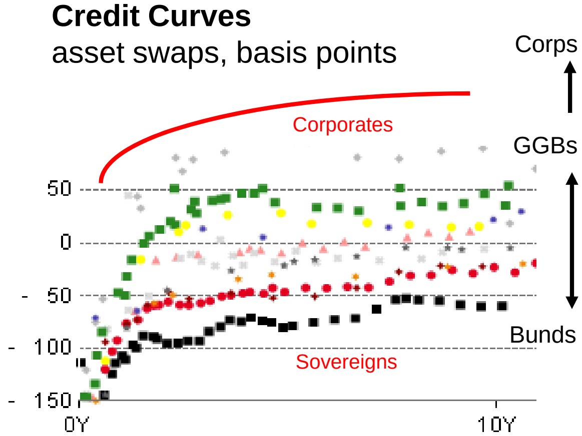
Think of spreads as a part of a fan, or hierarchy



European sovereigns caught in the middle of the fan

Credit Curves
asset swaps, basis points



Source: SG. As of September 2008

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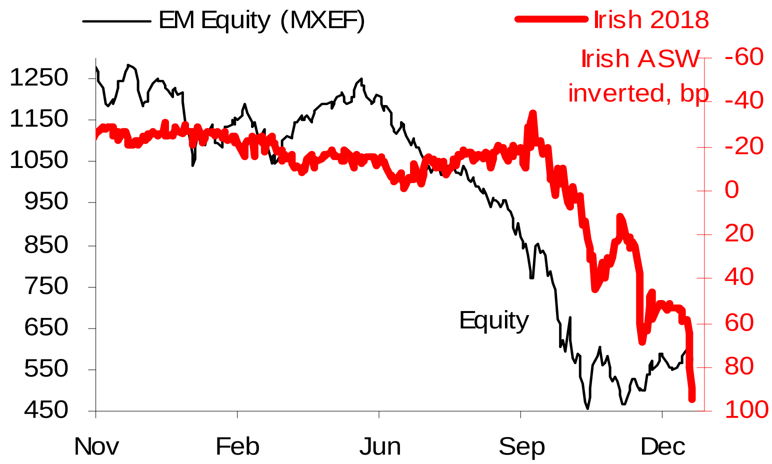
Irish bonds correlated to global risk measures ?

➔ **Irish Bund asset swap spread (2018) is even a little correlated to emerging equities. I would have expected a better relationship.**

Irish asset swap (i.e. Irish less swap) spread vs. EM equity



Source: SG

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So how much can small sovereigns really borrow?

There is no mystery… what counts are the big Cs

➔ **Credit**, Credibility, Credence … Confidence of investors. ➔ Trust

In 2008, we saw another C factor became paramount
➔ **Cashflow**. Cash difficulties were paramount in the financial failures of 2008

That lead to a dearth of **Credulity**

Such factors pose large problems for economists, investors …

- **Binary** … Confidence is there or not there, … can evaporate quickly
- **Small probabilities, unbearable consequences**
- **Hard to measure** … e.g. cashflow of BS, LB, AIG, … a function of confidence

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Market conditions determine importance of cashflow

Sales of debt need buyers of debt

If debt sales are to recover in 2009, investors will have to be present to buy the debt. Yet the past 18 months have seen

1) Precautionary savings rise sharply
2) A sharp increase in demand for cash to plug balance sheet losses.
3) Larger governments crowding out the smaller ones & private sector.

➔ Throughout 2008, eurozone redemptions ran well ahead of issuance

➔ The cumulative net cash available – but unused - to the eurozone government, agency and corporate markets over 2008 was some €250bn.

➔ It was as if all this “spare” cash fell into a black hole, with funds needing either to build up precautionary reserves or else to plug losses on their balance sheets (banks are large holders of bonds in Europe).

Sad fact: Global DCM volume was $4,300bn in 2008, down some 30% from ’07
(Dealogic)

Great news: sales of debt is off to a better start in 2009, for now

A few ways of avoiding cashflow problems

Increase competitivity

Spend less, tax more

Privatise

Diversify financing; surrogate issuance

Borrow from non-market sources

Creative accounting with ESA 95

Raise rates on domestic savings schemes

Raid domestic sources of cash

Postpone payments: pay employees later

Issue IOUs to suppliers

Restructure debt = pay less up front

Transformation of credit risk: give guarantees

Use banks to source liquidity at the ECB

Look for a bail-out or a bail-in

Currency depreciation; Restructure debt = pay less

}

Very very hard to see states in trouble;

Years likely before the worst arrives

➔ Sovereign power far reaching

➔ A sovereign "A" appears far stronger than a corporate "A"

9

Can the ECB help out a sovereign in trouble ?

The simple answer: no

TREATY ON EUROPEAN UNION: PROTOCOL on the Statute of the ECB

Article 21 Operations with public entities

21.1. In accordance with Article 104 of this Treaty, overdrafts or any other type of credit facility with the ECB or with the national central banks in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

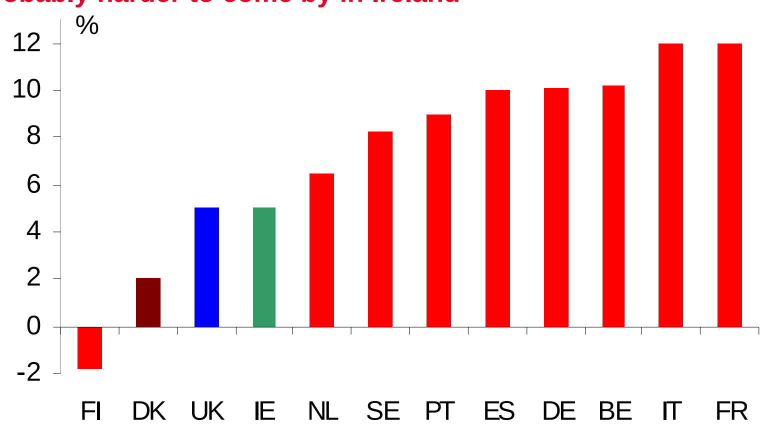
21.3. The provisions of this Article shall not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the ECB as private credit institutions.

But could banks be told to buy state bills, bonds, and place them as collateral in Frankfurt? Would the ECB mind? Would others know or care?
Is there a risk of a "bail-in"? How big might the bill become, and who pays it?

Europe sovereign risk measures – what is key ?

Reinhart & Rogoff variables for other types of crises
Use now … variables pertaining to household savings & indebtedness
… mobilisation of domestic cash savings
France, Italy and Greece score well
Ireland, the UK and Denmark score far less well.

“Personal Savings Rates” Liquid personal savings hard to measure, but probably harder to come by in Ireland



Source: Central Bank of Ireland, Financial Stability Report 2007, page 41

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Are guarantees worth much ?

There are good guarantees, bad guarantees and unclear guarantees. Look deep at guarantees. Get your lawyers working

- **Is there a law or a regulation? How detailed is it?**
- **Is timely payment likely or allowed for?**
- **Are the logistics in place to provision for same day?**
- **Is the guarantee subordinate to government debt?**
- **Can the guarantee be removed at a later stage?**
- **How easily can the guarantee be suspended?**
- **How is the guarantee Cooked or risk-weighted?**
- **Is any of the above written out? Can it be written out?**

Source: SG

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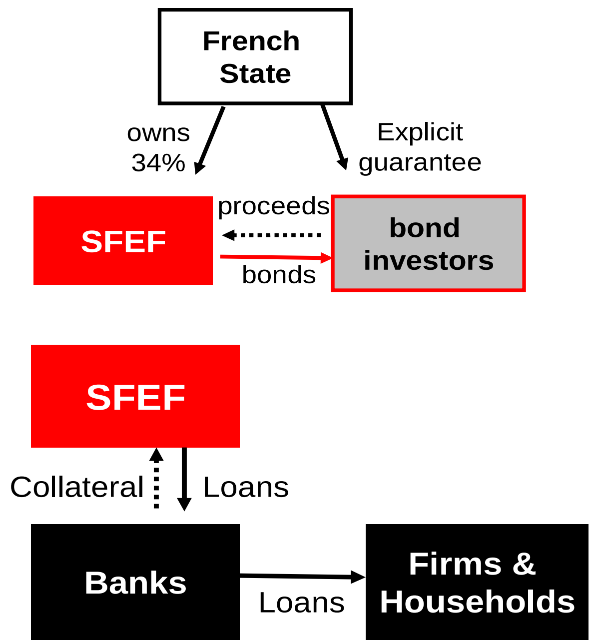
Attractive structuring of guarantees: France's SFEF

- Banks incentivised to loan to economy
- Attractive funding for even small boutiques
- Pooling creates liquid bonds for investors
- Master trust can live beyond guarantees
- Attractive sovereign accounting



Source: SG

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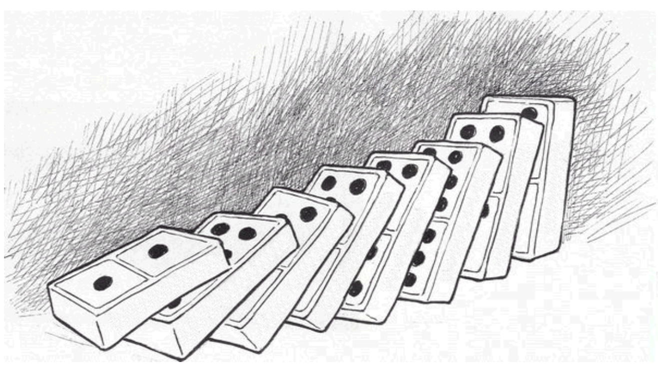
Weaker finances: more exposure to the unforeseen

- "Lower-rated entities are more exposed to external shocks", S&P
  "AAAs are better able to withstand the unforeseen", Moody's

- **The low probability of one very painful event can be discounted**
  … harder to do for several low probabilities of very painful events



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14