TILL DEBT US DO PART

Some governments are borrowing so much that markets are becoming wary and may stop lending to them. Could this be the next leg of the crisis, ask **David Smith and Jenny Davey**

When Brian Lenihan, Ireland's finance minister, stood up on Wednesday to deliver his third tough budget in just over a year, his attention was firmly fixed on a crisis in southern Europe.

Despite the protective blanket of euro membership, serious questions were being asked in the markets about whether Greece could default on its debt — and could Ireland follow?

On Tuesday, Greece's sovereign debt had been downgraded by one of the credit rating agencies, Fitch, reducing it from A- to BBB+. Moody's and Standard & Poor's, the other two agencies, let it be known that they, too, would be considering a downgrade.

George Papaconstantinou, the Greek finance minister, insisted that the government in Athens would do whatever was necessary to get the budget deficit down from 12.7% of gross domestic product. But Fitch said it had little faith in this assurance "given the weak credibility of fiscal institutions and the policy framework in Greece".

After the downgrade, Greece had a torrid week, made worse by street demonstrations to mark the anniversary of protests last year. Greek government bonds suffered their biggest weekly fall for 11 years.

The problem for Lenihan is that the markets think that if Greece goes, Ireland will be next. So the Irish finance minister unveiled an eyewatering €4 billion (£3.6 billion) of spending cuts in his budget.

Borrowing had to be brought down. "International debt markets have become more crowded and more fragile," he said. "If lenders were to lose faith in our ability to restore order to the public finances, the consequences for our economic wellbeing would be profound."

Even on radio phone-ins, the prospect of a downgrading of Ireland's sovereign rating appeared to have convinced most people that the tough medicine — sweetened by a cut in the tax on alcohol — was necessary.

Neither Greece nor Ireland is out of the woods yet, despite Lenihan's insistence that the worst was over. On Friday, Steve Barrow, an economist at Standard Bank in London, said in a report that both faced "intolerable" difficulties, including a possible exit from the euro, something strongly denied by both governments.

"We question the ability of countries like Ireland and Greece to grow out of the current crisis," Barrow wrote. "With interest-rate cuts, exchange-rate depreciation and significant fiscal support all off limits for these countries, it seems likely that bailouts — or even pullouts from EMU [European Monetary Union] — are likely."

The tough Irish budget was in marked contrast to the pre-budget report delivered just a few hours earlier in London by Alistair Darling, the chancellor of the exchequer.

Lenihan, like Darling, had a career as a lawyer before entering politics. But while the Cambridge-educated Irish finance minister decided to own up to his country's debt problems and do something about them, his British counterpart relied on the markets and the agencies to suspend judgment.

That option may not be open to Darling (or his successor) for long. Though Moody's said Britain's AAA rating was not under immediate threat, fears of a downgrade persist after the do-nothing pre-budget report.

Economies with swollen budget deficits and sharply rising debt are under pressure. The markets are becoming more wary about buying and holding their government bonds and the rating agencies have made clear that without further action their sovereign ratings will be under threat. Some say this is the next leg of the global financial crisis.

WHEN Dubai World, the government-owned holding company in the small Gulf emirate, requested a six-month postponement of its debt repayments last month, most of the attention focused on Dubai's astonishing boom-bust cycle. But the Dubai crisis also shone an unwelcome light on sovereign debt. If neither Dubai nor Abu Dhabi, its ultra-rich co-emirate, could protect bond holders in Dubai World, how safe was the debt apparently guaranteed by governments elsewhere?

"Markets are starting to take away the message that fundamentals matter and that if something looks out of line there is cause for concern," said Gerard Lyons, head of research at Standard Chartered, the emerging-markets bank. "In the case of Greece, the fear is that there is not going to be any direct support from the central bank. In the case of other countries such as Ireland, Italy and Portugal, what are the shock absorbers?

"Britain has been able to devalue its currency, but for those in the eurozone who don't have the ability to devalue like the UK, or to make policies to suit their economic circumstances, there will be some painful economic adjustments."

In a report last week, Moody's distinguished between "resistant" AAA countries such as Canada, France and Germany, "resilient" economies whose public finances are deteriorating rapidly such as America and Britain, and "vulnerable" economies such as Ireland before its own downgrade earlier this year.

Britain and America, in other words, are not at immediate risk of a downgrade but they have already shifted down from the top tier of AAA economies. If they were to move into the vulnerable category, a downgrade would be all but inevitable — and the potential consequences are already being felt.

"Broad credit metrics suggest there is downward rating pressure for several developed market economies and, even if we don't see rating downgrades, increasingly the markets are pricing in the risk of credit deterioration anyway," said Rashique Rahman, head of emerging-markets macro strategy at Morgan Stanley, the investment bank.

The big fear is that, if economies such as America and Britain were downgraded by the agencies and their borrowing costs rose, the effect would be felt throughout the credit markets, making it more expensive for businesses and emerging-market economies to borrow. It could set back the global economic recovery.

It is not all one-way traffic. Some economies in Asia and Latin America have received upgrades or are about to get them. So far, however, they are outnumbered by countries facing downgrades.

Spain, once vaunted along with Ireland as an EU poster-child, has suffered a brutal reversal of fortune. For a time it was the single largest creator of jobs in the EU. The bonanza was led by a construction boom that has now bust. Nearly 1m flats sit empty from the costas to the big cities.

In October unemployment hit 19.3%, the highest in the eurozone. Last week Standard and Poor's downgraded the Madrid government's outlook to "negative", based on fears it will have a "more pronounced and persistent deterioration in its public finances" that requires "strong policy actions, which have not yet materialised".

José Luis Rodriguez Zapatero, the prime minister, has spent liberally to try to stanch the bleeding. It hasn't worked. The government expects the public deficit to hit 9.5% of GDP this year, more than triple the EU-imposed "limit". Just two years ago it had a 2.2% surplus.

Zapatero downplayed the difficulties last week, but for Edward Prescott, the Nobel prize-winning economist, the country's predicament is dire. "Spain isn't in a recession," he told a recent conference in Pamplona. "It's in a depression."

Spain is not alone. Portugal was also put on negative watch last week. Standard & Poor's warned that "high fiscal deficits may drive Portugal's government debt to over 90% of GDP by 2011".

IS Britain also vulnerable? The question of whether it can prevent itself from being dragged into a sovereign debt crisis will dominate the economic and political debate into next year.

Analysts said the pre-budget report had done nothing to remove doubts about Britain's AAA rating. A downgrade, when the markets are this year absorbing £225 billion of UK government bonds, would be hugely damaging, pushing up the cost of financing the UK's debt, scheduled to climb to £1,473 billion, 78% of GDP, by April 2015.

David Cameron, the Tory leader, said last month that a downgrade was "the greatest single risk to sustained economic recovery . . . If investors see there is no will at the top of government to get a grip on our public finances, they are going to seriously doubt our country's creditworthiness".

That is what happened after Darling's pre-budget report. Gilts suffered a sell-off on Thursday on disappointment that he had not taken firmer action.

"The government still does not have a credible and detailed plan — or, indeed, any plan at all — to deliver that medium-term spending squeeze," said Michael Saunders, an economist with Citigroup. "Worries over UK sovereign credit quality and medium-term inflation trends are likely to grow. Gilts and sterling remain vulnerable, especially since the UK's fiscal slippage will be accompanied by a marked rise in inflation — to well above target — in coming months."

Other economists agree. "Although the government's room for manoeuvre may have been constrained by the political cycle, its reluctance to announce more aggressive consolidation measures carries economic risks," said Simon Hayes of Barclays Capital, the investment bank. "Question marks are likely to persist regarding its willingness to impose the requisite adjustment, and the UK's AAA sovereign credit rating and the currency are likely to remain vulnerable."

Some analysts say too much attention is being paid to the views of the rating agencies. After all, their own judgments have been far from perfect.

"The irony is that so much in the financial markets and in policy should now hang on the judgments of institutions, the credit rating agencies, that less than two years ago were almost universally reviled for their part in bringing the global financial system to crisis point," said Stephen Lewis, chief economist at Monument Securities, a City broker. "Investors should not become fixated on sovereign credit ratings."

Even so, worries over sovereign debt will continue to cloud sentiment. Governments, in bailing out the banks, have taken on more debt than is comfortable. Getting it down before the markets and the rating agencies deliver their verdict is the challenge.

What rating agencies do

AT the height of the financial mayhem last year, a handful of anonymous executives were hauled before the Senate, *writes Danny Fortson*. They weren't bankers. They were the bosses of the three top credit-rating agencies — Standard & Poor's, Moody's and Fitch Ratings.

These were not the corporate villains the public has come to know and loathe, yet they hold immense power.

The agencies are the arbiters of the creditworthiness not only of companies and financial products but of countries. Their opinions are vitally important. Get a "junk" rating from the agencies and a company or government will be able to get loans only with exorbitant interest rates. If deemed a safe bet, banks gladly offer far more generous terms.

Between them the three agencies control virtually all of the ratings market. It was their glowing approval of supposedly low-risk financial products backed by subprime loans that landed them in hot water. They were also criticised for being too close to the banks, which paid them hefty fees in exchange for their opinions.

They retain powerful influence. A downgrade of a country's creditworthiness, such as happened to Spain and Greece this year, sends shockwaves through the financial markets.

However, oversight has increased. On Friday the US Congress passed a sweeping overhaul of financial regulation, including a clause that allows individuals to sue the agencies for flawed evaluation of financial products.

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