Fitch Takes Rating Actions on Six Eurozone Sovereigns

Fitch Ratings-London-27 January 2012: Fitch Ratings has today concluded its review of the six eurozone sovereigns it placed on Rating Watch Negative (RWN) on 16 December 2011.

The rating actions on the long-term (LT) and short-term (ST) Issuer Default Ratings (IDRs) are as follows:

-Belgium LT IDR downgraded to 'AA' from 'AA+'; Negative Outlook; ST IDR affirmed at 'F1+'

-Cyprus LT IDR downgraded to 'BBB-' from 'BBB'; Negative Outlook; ST IDR affirmed at 'F3'

-Ireland LT IDR affirmed at 'BBB+'; Negative Outlook; ST IDR affirmed at 'F2'

-Italy LT IDR downgraded to 'A-' from 'A+'; Negative Outlook; ST IDR downgraded to 'F2' from 'F1'

-Slovenia LT IDR downgraded to 'A' from 'AA-'; Negative Outlook; ST IDR downgraded to 'F1' from 'F1+'

- Spain LT IDR downgraded 'A' from 'AA-'; Negative Outlook; ST IDR downgraded to 'F1' from 'F1+'

All the ratings have been removed from RWN, with the Negative Outlook on all six countries indicating a slightly greater than 50% chance of a downgrade over a two-year time horizon. The eurozone 'AAA' country ceiling has been affirmed for all six sovereigns. All senior unsecured issues of the six countries are affirmed in line with the new rating levels above. The ratings of guaranteed issuance by National Asset Management Ltd. are affirmed at 'BBB+' and 'F2' in line with the Irish IDRs.

As outlined in its rating review press release of 16 December 2011, Fitch has now considered both systemic and country-specific factors for these six sovereigns. As a result, the agency has reduced the score it assigns to capture financing flexibility in its assessment of the credit profiles of eurozone sovereigns that have large fiscal financing needs and significant financial/economic imbalances.

Moreover, rising "home bias" in the allocation of capital, the divergence in monetary and credit conditions across the eurozone, and near-term economic outlook highlight the greater vulnerability to monetary as well as financing shocks faced by these sovereign governments. Consequently, these sovereigns do not, in Fitch's view, accrue the full benefits of the euro's reserve currency status. The net impact of this revision under Fitch's sovereign rating methodology is to lower the long-term ratings of the affected sovereigns by one notch.

This one-notch revision was applied to Belgium, Italy, Slovenia and Spain, but not to Cyprus and Ireland, where their loss of market access had already been demonstrated by their need for official/bilateral support and is already reflected in their low investment-grade ratings. The downgrade for Cyprus, and the additional one-notch cuts for Italy, Spain and Slovenia (ie a total of two notches for each) reflect country-specific concerns primarily related to the banking sector in Cyprus and Slovenia; an adverse shift in the interest-rate growth differential and hence public debt dynamics in Italy; and a significantly worsened fiscal and economic outlook in Spain. A more detailed rating rationale can be found in six separate country specific press releases also being published shortly.

Overall, today's rating actions balance the marked deterioration in the economic outlook with both the substantive policy initiatives at the national level to address macro-financial and fiscal imbalances, and the initial success of the ECB's three-year Long-Term Refinancing Operation in easing near-term sovereign and bank funding pressures. Nonetheless, the intensification of the eurozone crisis in the latter half of last year undermined the effectiveness of ECB monetary policy and highlighted the financing risks faced by eurozone sovereign governments in the absence of a credible financial firewall against contagion and self-fulfilling liquidity crises.

Fitch recognises the significant commitments made at the 9-10 December and previous EU Summits to enhance economic policy coordination so as to prevent a recurrence of the severe macro-financial imbalances that arose in the euro's first decade, as well as efforts to create a long-term framework for fiscal stability over the medium to long term. Fitch also anticipates that European leaders will make good on these commitments in the forthcoming 30 January summit. In addition, the decision to bring forward the creation of the European Stability Mechanism and increase the resources of the IMF, if implemented effectively, is a step towards enhancing the capacity of the eurozone to absorb adverse shocks, such as a disorderly Greek default, although such a shock is not the agency's expectation.

In Fitch's opinion, the eurozone crisis will only be resolved as and when there is broad economic recovery. It is evident that further substantial reforms of the governance of the eurozone will be required to secure economic and financial stability, including greater fiscal integration.

As previously noted, in the absence of greater clarity on the ultimate structure of a fundamentally reformed eurozone, the gradualist approach adopted by politicians to systemic reform will continue to be punctuated by episodes of severe financial volatility, entailing a significant economic and financial cost that erodes sovereign creditworthiness. It also means that a 'break-up' of the eurozone cannot be wholly discounted, although in Fitch's opinion the risk of such an outcome remains small. Fitch will continue to adopt a balanced and incremental approach to the rating of eurozone sovereign governments in recognition of the unprecedented nature of the systemic crisis and heightened uncertainty over the economic outlook for the region.

The Negative Outlooks on eight eurozone countries (the six sovereigns in this review along with 'AAA'-rated France and 'BB+'-rated Portugal) primarily reflect the risk that the crisis could intensify further. A deeper and more prolonged economic recession than currently anticipated would undermine political support for, and public acceptance of, fiscal austerity and structural reform. It would also have the potential to weaken the commitment of the economically and fiscally strongest eurozone countries, and the ECB, to providing necessary support to eurozone peers.

Fitch currently views that the sovereign credit profiles of the remaining eurozone sovereign governments (with the exception of 'CCC'-rated Greece, which has no Outlook assigned) continue to warrant Stable Outlooks, though each will be subject to active review through the course of the year. Fitch will consider on a country-by-country basis the extent to which the risks associated with the crisis, as well as the limitations on monetary and financial flexibility within the eurozone revealed by the crisis, may impact their long-term sovereign credit profiles.