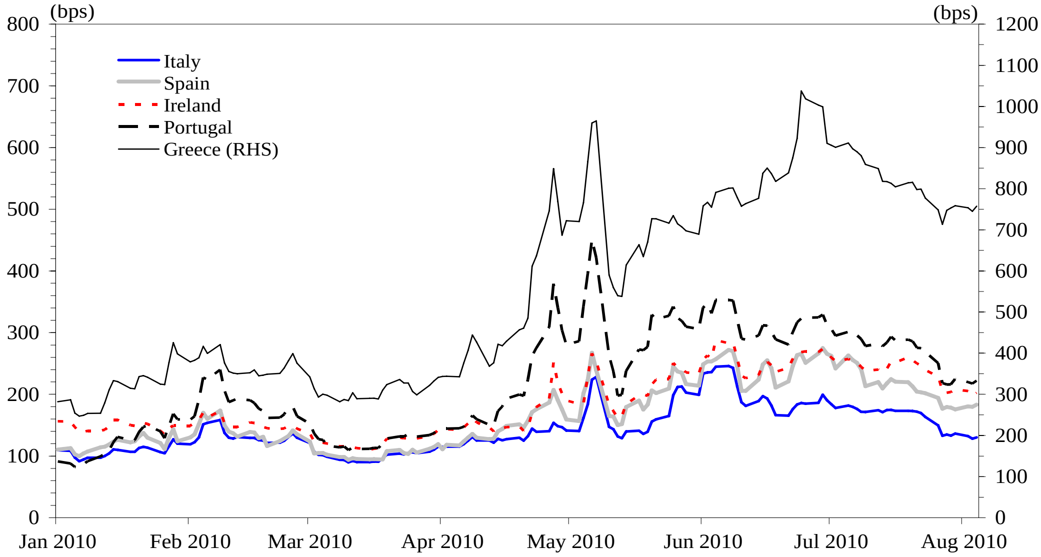
**Box 1.1**

### Recent developments regarding the sovereign debt problem in the euro area

While global economic conditions generally improved further in the second quarter of 2010, the intensification of sovereign risks in some economies in the euro area (notably Portugal, Italy, Ireland, Greece and Spain, now commonly known as PIIGS collectively) had led to renewed financial turbulence in the second quarter of 2010 and increased notably the downside risks to the global economic outlook. Indeed, the macroeconomic vulnerabilities in these economies had been built up for years. Lax fiscal management, easy credit fueled by low interest rate differentials within the euro area, low savings rate, heavy reliance on external financing and housing market bubble all contributed. With the "Great Recession" in 2008-09, these fault lines were exposed, creating pressures on the public finances of these economies as their fiscal balances deteriorated abruptly and conditions for refinancing became more stringent. With the situation in Greece first coming to the fore in late 2009, concern over other PIIGS economies also intensified in the following months, with a string of negative rating actions on Spain, Portugal, and Ireland, on top of Greece. The sovereign credit default swap (CDS) spreads of the PIIGS economies, which measure the cost of insuring against default by the governments of these economies, soared in late April and early May, when market strains were most acute (***Chart 1***).

**Chart 1 : 5- year CDS on PIIGS soared and remained higher than the levels in mid-April**




In response, massive rescue measures had been rolled out jointly by the European Union (EU) and the International Monetary Fund (IMF) since April 2010. Although a potential contagion has been contained for the time being, financial markets are still skeptical, resulting in sharp gyrations in stock, currency and commodity markets in the second quarter. While strains in the financial markets had lately receded somewhat as compared to the situation in April and May, sovereign CDS spreads for the highly-indebted European nations remained elevated and those on Greek government bonds rose to a new high in late June. The rescue package may be sufficient to relieve the near-term refinancing needs of these heavily indebted economies and prevent an imminent default, but their medium to longer term fiscal sustainability will hinge on the effectiveness of their fiscal consolidation measures, which will be challenging in view of the domestic opposition and expected sluggish growth prospects of these economies.

**Box 1.1 (Cont'd)**

The situation is still evolving and markets remain skeptical about the long-term resolution of the sovereign debt problem. Indeed, an abrupt worsening of the problem can trigger devastating chain reactions across the banking systems in the euro area and beyond, channelling through cross-border bank exposures to these economies. Based on information from the Bank for International Settlements, banks in France and Germany are the main creditors to banks in PIIGS on an immediate borrower basis (23% and 18% respectively of total claims on PIIGS at end-2009), followed by those in the UK and the US (11% and 5% respectively). Also, for some small economies such as Portugal, the Netherlands and Belgium, the exposures of their banking systems to PIIGS banks are notable (at 9%, 8% and 7% of their respective banking sector assets).

To prevent a further erosion of confidence and a downward spiraling of the debt problem, some European countries have introduced austerity measures to restore fiscal health. The key challenge is how to implement fiscal consolidation without jeopardising the recovery under way. Recovery in Europe is already lagging behind other parts of the world, growing by a mere 0.5% year-on-year in the first quarter of 2010, with unemployment rate still hovering at a high 10% in June. The fiscal tightening would inevitably weigh on the already fragile outlook for Europe. However, resilience in the core European economies such as Germany and France should render some momentum to the euro area, and their exports will also benefit from a weaker euro.

The evolving sovereign debt situation in Europe has emerged as a key risk factor to the global economic outlook, considering the sheer weight of Europe in the global economy (the EU accounted for about 28% of world GDP in 2009, even larger than the United States). Europe is also closely knit to world trade, being an important market for Asian exports of goods and services. Specifically, the EU market accounts for about 12% and 19% respectively of total merchandise exports and service exports of Hong Kong. Prolonged sluggishness in the EU economy will likely put a drag on the prevailing strong growth momentum in Asia. While the sovereign debt problem in Europe had not caused any significant dampening effect on global trade flows so far, the evolving situation needs to be closely monitored, as its negative impact on global demand may become more discernible later this year. Hong Kong's export outlook in the latter part of this year and in 2011 will also likely be affected to some extent.

***More notable developments regarding the sovereign debt problem in the euro area***

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| December 2009 | Fitch Ratings cut Greece's sovereign credit rating to BBB+ with outlook negative on deteriorating public finance, the lowest in the eurozone and the first sub-A rating for Greece, triggering a flight from Greek assets. Greek government outlined plans to cut deficit but faced resistance. |
| January 2010 | The European Commission (EC) condemned Greece for falsifying public accounts. |
| End-February | Fitch downgraded Greece's four largest banks from BBB+ to BBB. |
| Early March | The Greek government announced new austerity measures to reduce the deficit by €4.8 billion (about 2% of GDP). |

**Box 1.1 (Cont'd)**

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| Late March | Leaders of the eurozone backed a joint bailout deal with the IMF should Greece's debt troubles intensify. Fitch cut Portugal's sovereign debt rating from AA to AA- with outlook negative. |
| Mid-April | After much bickering, eurozone members agreed to provide Greece with €30 billion of three-year loans at below market interest rates upon formal request for financial assistance from the nation. The IMF agreed to provide another €15 billion loan in parallel. This, however, did not stop the yield on Greek government bonds from rising. Moody's downgraded Greece's debt rating after the country's fiscal deficit in 2009 was found to be underreported. |
| 23 April | Greece announced that it would draw on emergency aid to tide it over for the rest of the year. |
| 27 April | Standard & Poor's (S&P) downgraded Greece's rating to junk status (BB+) and cut Portugal's rating by two notches to A- with outlook negative on "weak macroeconomic structure." |
| 28 April | S&P downgraded Spain's rating from AA+ to AA with outlook negative on "protracted economic adjustment and risks to budgetary position." The IMF said the aid package for Greece could be topped up to €100-120 billion over three years, more than double the amount pledged in mid-April. |
| 2 May | A €110 billion package of emergency loans was jointly provided by the eurozone governments and the IMF in an attempt to avert a Greek default and prevent contagion. In return, Greece would adopt fiscal austerity package to cut its deficit over the next three years. The European Central Bank (ECB) also dropped the minimum credit requirement for Greek government debt collateral in the euro-system's credit operations. |
| 10 May | The EU and IMF introduced further stabilisation measures of €750 billion, comprising €60 billion of EU-backed bonds, a €440 billion fund guaranteed by eurozone countries and up to €250 billion of IMF money, supplemented by the ECB's purchase of government and corporate debt, the reactivation of unlimited fixed rate offerings of three-month loans and US dollar swap lines with the Federal Reserve. CDS of the PIIGS countries retreated as a result, but the euro accelerated its downtrend, subsequently reaching a four-year low against the US dollar. |
| Mid-May | Following Greece and Ireland, a number of European economies, including Spain, Portugal, Italy, Hungary, Germany and the UK, successively began to introduce austerity plans with a view to restoring fiscal health. |
| 17 May | In a backlash against opaque financial operations, EU finance ministers passed a draft Alternative Investment Fund Management Directive (AIFMD) to rein in hedge funds and private equity. |

**Box 1.1 (Cont'd)**

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| 22 May | The Bank of Spain took over a small savings bank, CajaSur, fanning fears of spillover to the interbank market, where three-month LIBOR had gradually climbed higher to levels back in July 2009. |
| 4 June | A Hungarian official's remark that Hungary might face risks of a Greek-style crisis stirred a renewed bout of market jitters. |
| 7 June | Eurozone finance ministers approved details of the €440 billion rescue package introduced in early May. A special purpose vehicle, European Financial Stability Facility (EFSF), was established to raise money in the markets backed by members' guarantees in proportion to their shares in the ECB, and the funds raised will be provided as loans to members in difficulty. |
| 16 June | Spain announced that it will publish bank stress test results to improve market transparency. |
| 17 June | The EU agreed to do the same by the second half of July. An interim review by the European Commission, ECB and IMF reported that fiscal developments in Greece were positive and austerity measures were being implemented as agreed. |
| 30 June | Demand for the ECB's offer of three-month funds fell short of expectations, relieving fears over banks' reliance on the ECB lifeline to stay afloat. |
| 7 July | German Cabinet approved a plan to reduce fiscal deficit by about €80 billion by 2014. |
| 17 July | The IMF and EU suspended talks with Hungary in reviewing its €20 billion stabilisation programme, indicating that more measures should be taken to shrink its budget deficit. |
| 19 July | Moody's downgraded Ireland's sovereign credit rating to Aa2 from Aa1 with outlook stable, on "government's gradual but significant loss of financial strength" and "weakened growth prospects." |
| 23 July | The results of the EU-wide stress-testing exercise were released. Only 7 out of 91 banks put under the test (comprising 5 Spanish savings banks, Hypo Real Estate in Germany and ATEbank in Greece) fell short of the required 6% Tier 1 capital ratio under the adverse scenario with additional sovereign shock. The amount of under-capitalisation was at €3.5 billion. While the results were better than expected in the financial markets, some doubts remained about the rigour of the tests. |