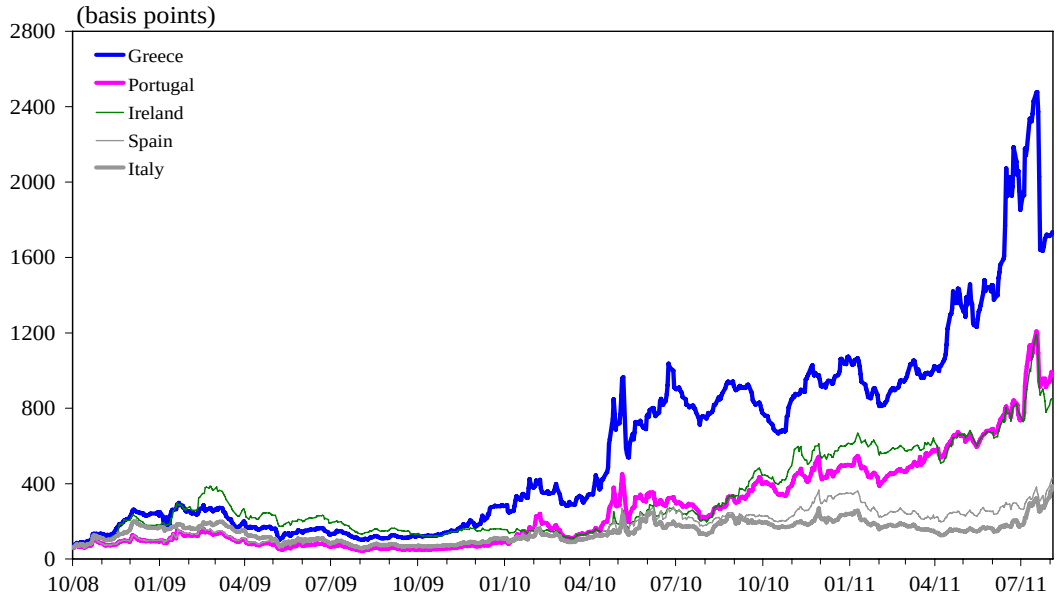
Box 2.1

An update on the eurozone sovereign debt situation

The eurozone sovereign debt problem worsened noticeably during the second quarter, posing a threat to the global economy (see ***Box 2.2*** of the ***2010 Economic Background and 2011 Prospects*** for earlier developments). In April 2011, Portugal became the third country to seek financial aid from the European Union (EU) and International Monetary Fund (IMF). Thereafter concerns over a possible Greek debt restructuring intensified, pushing the credit default swap (CDS) spreads on the more vulnerable countries (i.e. Greece, Ireland and Portugal) to all-time highs, virtually shutting them off from private funding in the capital markets (***Chart 1***). This in turn prompted further credit rating actions (notably, the downgrading of Portugal and Ireland to junk status and trimmed outlook on Italy), which generated a vicious cycle and drove up their bond yields further, making these countries' debt burdens even more difficult to re-finance (***Table 1***).

Chart 1: CDS spreads on selected eurozone countries rose to new highs in July



The intensification of the sovereign debt problem sent another shockwave to the global financial markets in the second quarter. Markets were concerned about the fiscal sustainability of the highly-indebted eurozone economies, and whether the eurozone governments could come up with a credible medium-term plan to resolve the crisis. While the Greek parliament's passage of an austerity bill in late June enabled it to receive another aid tranche to tide it over till end-August, the decision on a second bailout for Greece to meet its funding needs up till 2014 had been held up for some time by differing views about the extent of voluntary rollover of Greek debt by private bondholders or buyback by EU governments and the bailout fund. Finally, EU leaders agreed on a new bailout for Greece on 21 July, comprising a €109 billion package from the EU and IMF and voluntary contribution of some €50 billion from the private sector during 2011-14 through bond exchange and buy-back. The European Central Bank (ECB) also expressed willingness to accept Greek bond as collateral for its fund provision even if Greece were to be placed on selective default by rating agencies.

Box 2.1 (Cont'd)

Table 1 : Summary of more recent events and credit rating actions

1 Apr	Fitch downgraded Portugal's rating to BBB-, outlook negative; Standard and Poor's (S&P) downgraded Ireland's rating to BBB+
5 Apr	Moody's downgraded Portugal's rating to Baa1, outlook negative
Early Apr	Portugal officially sought financial aid from the EU/IMF
14 Apr	Fitch downgraded Ireland's outlook to negative
15 Apr	Moody's downgraded Ireland's rating to Baa3, outlook negative
Mid Apr	Concerns over possible Greek debt restructuring intensified
9 May	S&P downgraded Greece's rating to B, outlook negative
Mid May	EU finance ministers endorsed a €78 billion bailout package to Portugal; EU and ECB at loggerheads over Greek "debt reprofiling" (maturity extension)
20 May	Fitch downgraded Greece's rating to B+, outlook negative; S&P trimmed Italy's outlook to negative
23 May	Fitch cut Belgium's credit outlook to negative
Late May	Greek government endorsed €6 billion budget cuts and committed to accelerate asset sales to raise €50 billion by 2015; Spain's ruling party suffered defeat in local elections
1 Jun	Moody's slashed Greece's rating to Caa1
Early Jun	Portugal's Social Democrats defeated the incumbent in general election; EU and IMF considered second aid package for Greece
13 Jun	S&P slashed Greece's rating to CCC
17 Jun	Moody's trimmed Italy's outlook to negative
Mid Jun	Greece reshuffled cabinet; Germany opened up to voluntary rollover of Greek debt; EU withheld €12 billion payment tranche in exchange for more austerity
29 Jun	Greek parliament passed a €28 billion austerity package and subsequently secured the next payment tranche from EU/IMF
4 Jul	S&P issued warning that debt rollover proposal could result in a selective default for Greece
5 Jul	Moody's cut Portugal's rating to Ba2 (junk), outlook negative
11 Jul	Concerns deepened over Italy's fiscal position
12 Jul	Moody's cut Ireland's rating to Ba1 (junk), outlook negative
13 Jul	Fitch cut Greece's rating to CCC
15 Jul	Stress test results of European banks were released. Eight out of 90 banks failed the test, with an overall tier 1 capital shortfall of €2.5 billion.
21 Jul	EU leaders agreed on a new bailout package for Greece
25 Jul	Moody's downgraded Greece's rating by three notches to Ca
27 Jul	S&P downgraded Greece's rating to CC, two levels above default; Moody's cut Cyprus' rating from A2 to Baa1, outlook negative
29 Jul	Moody's put Spain's Aa2 rating on review for a possible downgrade; S&P cut Cyprus' rating from A- to BBB+, outlook negative
Early Aug	CDS spreads on Italian and Spanish government bonds rose to new highs

Under the new bailout package, the near-term refinancing needs of Greece, Ireland and Portugal, will be relieved through lower interest rates (down 200 basis points to 3.5%) and extended maturities (to at least 15 years). Also, the increased flexibility of the European Financial Stability Facility (EFSF) to buy eurozone bonds on secondary markets and to lend money to finance bank recapitalizations is a clear attempt to stem the risk of contagion to other larger economies with fragile fiscal positions, notably Italy and Spain. Yet, markets may still be sceptical about the ability of the highly-indebted countries to bring down their debts to sustainable levels and to generate growth. As such, financial markets will likely be

Box 2.1 (Cont'd)

subject to bouts of gyrations as and when market sentiments shift. While Greece, Ireland and Portugal together account for only about 6% of the eurozone's GDP, Italy and Spain are the third and fourth largest economies respectively in the eurozone. For Italy, the gross public debt ratio is currently around 120% of GDP (***Table 2***), and the nation is also faced with the problem of anaemic growth. Indeed, to tackle the root problem of the crisis, the debt-ridden countries would need to undergo structural reforms to restore their competitiveness in order to generate enough growth to avert a ballooning of debt, in addition to pursuing austerity measures. But austerity and reform measures could be painful and meet with significant social and political resistance.

Table 2 : Economic and fiscal situations in selected European economies

	Real GDP Growth		Fiscal balance as % of GDP			Government gross debt as % of GDP		
	2010	2011(*F*)	2010	2011 (*F*)	2015 (*F*)*	2010	2011(*F*)	2015(*F*)*
	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Eurozone	1.7	2.0	-6.0	-4.3	n.a.	85.3	87.9	n.a.
Portugal	1.3	-1.5^	-9.1	-5.6*	-5.8	93.0	90.6*	103.7
Italy	1.3	1.0	-4.6	-4.1	-3.1	119.0	120.6	118.7
Ireland	-1.0	0.5^	-32.4	-10.8*	-4.3	96.2	114.1*	123.5
Greece	-4.5	-3.0^	-10.5	-7.4*	-2.1	142.8	152.3*	149.4
Spain	-0.1	0.8	-9.2	-6.2	-4.6	60.1	67.5	74.1
World	5.1	4.3	-5.5	-4.6	n.a.	67.0	69.3	n.a.
Advanced economies	3.0	2.2	-7.5	-6.8	-3.4	96.8	101.9	106.6
Emerging economies	7.4	6.6	-3.7	-2.7	-1.4	35.3	34.6	31.2

Notes: 2010 figures for Europe are sourced from Eurostat; the rest from IMF's *World Economic Outlook (WEO) Update* and *Fiscal Monitor Update*, June 2011.
(*) Projected by the IMF in April 2011's *Fiscal Monitor*.
(^) Sourced from IMF's *Regional Economic Outlook on Europe*, May 2011.
(n.a.) Not available.

The eurozone sovereign debt problem would remain a major source of downside risk to the global outlook, not least due to the drag on the eurozone's recovery stemming from fiscal consolidation across Europe. Although the eurozone economy expanded by a better-than-expected 0.8% quarter-to-quarter (2.5% year-on-year) in the first quarter of 2011, the recovery continued to proceed in a two-speed manner, characterised by a clear divergence between the vibrant core (Germany and France) and sluggish peripheral economies. With the re-intensification of the sovereign debt problem in the second quarter, growth in Hong Kong's exports to the EU market slowed visibly. In addition, if the eurozone debt problem were to worsen abruptly, there could be spillover to the global financial and banking systems through banks' exposures to debts of highly-indebted European countries, even though the exposure of Hong Kong's banks to such debts is not significant (Portugal, Ireland, Italy, Greece and Spain together accounting for only 1.3% of the total external claims of Hong Kong's banks at end-March 2011). Nevertheless, despite the increased challenges to the global economy, the still rather robust conditions in the Mainland and other Asian economies should continue to render support to the Hong Kong economy.