Written by Bruce Walker on October 16, 2011

S&P Again Downgrades Spain's Credit Rating

The rating downgrades of these nations over the last year have compounded their general problems of debt, because lower ratings mean that these governments must pay significantly higher interest in order to get investors to buy their bonds. In the case of Spain, the recent downgrade was the third in three years.

Standard & Poor's stated on October 13:

> Despite signs of resilience in economic performance during 2011, we see heightened risks to Spain's growth prospects due to high unemployment, tighter financial conditions, the still high level of private sectors debt, and the likely economic slowdown in Spain's main trading partners.... The financial profile of the Spanish banking system will, in our opinion, weaken further.

The Spanish stock exchange immediately declined upon the news, while the interest which the government has to pay on its five-year notes rose from 5.21 to 5.26 percent.

Yields on Italian benchmark bonds, like those on Spanish bonds, have recently risen because of the downgrade in credit rating.

Banks took a hit as well. Fitch downgraded the credit rating of Lloyds and the Royal Bank of Scotland in the United Kingdom, and also UBS (Union Bank of Switzerland). Fitch has also put a dozen banks on notice that they may face downgrades as well, including Goldman Sachs in the United States and Deutsche Bank of Germany.

Elwin de Groot, senior market economist at Rabobank in the Netherlands, noted of the danger of the debt crisis:

> It's still very fragile. It can go wrong on these different pillars and the risk that one of these pillars, there is not a clear decision, means that the whole thing can still unravel again. Basically that means that we expect yields to fall back again and possibly for the Bunds to hit the previous peaks and maybe even go above that before that final solution.

The "debt contagion," as it has been called, involves more than just the five EU PIIGS governments. Analysts note that if the stability of banks such as Lloyds and UBS — major participants in European financial transactions — begins to waver, it is difficult to see exactly what governments could do to prop them up. Moreover, as the value of the sovereign debts of the PIIGS nations continues to drop, the value of those assets on the books of major banks all over Europe (including those bonds in their portfolios) will fall as well. In that case, using reasonable asset-to-debt ratios, that would mean that those banks could not safely extend more credit.

Critics have noted that because of the obvious reluctance of European political leaders to take the only steps which can prevent an EU meltdown — cutting government payrolls and pensions, curbing entitlements, ending regulations (particularly environmental) which constrict business growth, planning a devolution of the euro back to national currencies, and tying those currencies to precious metals — the confidence that conditions can improve is plummeting almost by the week.

Compounding these problems is the increasing unwillingness of other more fiscally-responsible member-states within the European Union — Finland, Sweden, Germany, and even recently Slovakia — to undertake any more bailouts of their spendthrift fellows. Although the leader in this bloc is relatively small Finland, the psychological consequences in, for instance, Germany and Holland, are profound.

Photo: Spanish flag