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# TREASURY TRENDS

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## SOVEREIGN CREDIT RATINGS

*“He who will not economize will have to agonize”* **Confucius**

### Role of credit rating agencies

The European debt crisis has kept sovereign debt firmly in focus. Government debt used to be thought of as the safest form of investment; now this is not necessarily the case. Credit rating agencies have been criticised for their role in the Global Financial Crisis and have come under intense scrutiny. This has led to reforms in the way rating agencies operate, and they now play a more proactive role. Many believe the three major agencies – Moody’s, Standard & Poor’s and Fitch – have too great an influence in financial markets and that there needs to be more competition. Their independence has also been questioned.

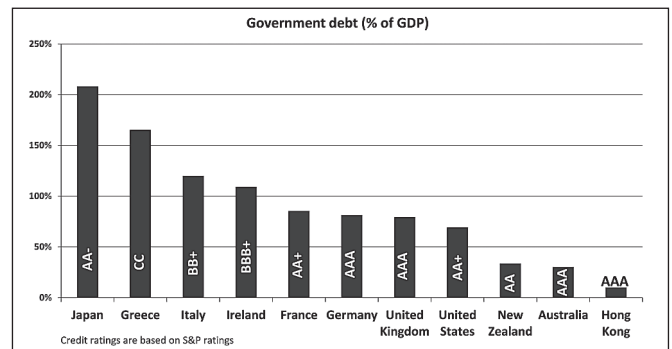
These institutions have influenced financial markets for almost a century. Standard & Poor’s has published credit ratings since 1916 and Moody’s expanded to evaluate companies and utilities in 1913. Fitch, the smallest of the three, entered the market around the same time. Each company has different assessment methodologies and ratings categories.

In the past year, all three agencies have slashed national debt ratings and faced a political backlash from those countries that have been downgraded. In August last year, Standard & Poor’s cut the US rating from the coveted AAA to AA-, for the first time in its history, on concerns over the country’s ability to get its debt under control. Portugal and Greece are now ‘junk’ status; both countries have seen their debt funding costs soar with 10 year bond yields reaching highs of around 16.50% and 33.0% respectively. Even New Zealand was not immune, losing its AA+ rating last year with credit rating agencies citing concerns about government and household debt. Although rating downgrades typically result in higher borrowing costs, this is not always the case. Despite the US rating downgrade, yields on US Treasuries have remained low, pushed down by strong investor demand for such ‘safe haven’ assets.

### Credit rating factors

When credit rating agencies review sovereign ratings they consider both qualitative and quantitative factors. Moody’s process involves three steps: determining the country’s economic resiliency, the government’s financial strength and susceptibility to event risk. It then compares the sovereign bond rating with peers along with

considering any other relevant factors. Standard & Poor’s analysis uses mainly quantitative indicators for economic, debt, fiscal and external liquidity and mainly qualitative for political factors.



The level of government debt and the government’s ability to generate income (by selling assets, raising taxes etc) are key influences in determining sovereign credit ratings. However there is no direct correlation between an indicator such as ‘government debt to GDP’ and a specific rating as a range of factors are taken into account. For example, Japan has the highest level of government debt to GDP at 208% and a AA- rating, compared to Italy, which has 120% of government debt to GDP and a BB+ rating (refer to chart above).

In terms of private debt, the level of external (foreign) debt is particularly relevant as it exposes the country to the whims of foreign markets and investors. New Zealand has a high level of external debt (net external debt to GDP at 73.4% at 30 September 2011) although a large portion of this is funded in New Zealand dollars and a high level of foreign currency liabilities is hedged.

Fitch cited concerns about the level of household indebtedness relative to disposable income and a need to narrow the current account shortfall as reasons for downgrading New Zealand’s rating. Rating agencies also look at a government’s susceptibility to event risk, such as New Zealand’s Christchurch earthquakes.

### How credible are credit ratings?

A credit rating is an opinion on the creditworthiness of a country. All credit ratings agencies have disclaimers over credit ratings such as they are “not intended as guarantees of credit quality or as exact

**Continued on back page**

# AUSTRALASIA ECONOMY & MARKETS

## What happened in 2011, and what will happen in 2012?

In 2011, Australia and New Zealand sat conveniently in the South Western Pacific away from the problems in Europe and the US. Australia was riding the wave of a boom in hard commodity prices which it could produce in seemingly limitless quantities, and New Zealand grew food in abundance for a world which required ever more of it.

For both countries such a summary is overly simplistic, seen through rose tinted spectacles. Central banks have had to be more pragmatic.

The Reserve Bank of New Zealand ("RBNZ") cut the OCR by 50 basis points in response to the February Christchurch earthquake, taking it back down to its all-time low of 2.50% where it remained for the rest of the year. However the markets and the RBNZ were at odds over the future direction of monetary policy, with the central bank generally having a far more optimistic view of the New Zealand economy. This divergence of opinion has continued into 2012. The latest RBNZ assumptions for the 90 day bank bill rate indicate that it will reach 3.60% by December 2012. Although this is admittedly a significant reduction from its June 2011 assumptions, which showed a level of 4.60% by December 2012, its figure contrasts with the 90 day bank bill futures market which is now pricing in a rate of only 2.86% by December 2012, a mere 12 basis points higher than its current level.

The Reserve Bank of Australia's ("RBA") cash rate started 2011 at 4.75%, but was lowered by 25 basis points in both November and December. It was left unchanged at 4.25% in February 2012, with Governor Stevens citing inflation close to target, growth close to trend, and strong US economic data as the main reasons for the 'no change' decision. Looking ahead, the market's view of the direction of rates is interesting. The 90 day rate is currently 4.36%, just 11 basis points above the cash rate. That low premium indicates a strong view that the cash rate will be cut over coming months. However pricing for December 2012 is somewhat

different. The implied cash rate for that date is at 3.59% and the 90 day bank bill futures price is 3.94%. That premium of 35 points is mildly indicative of a tightening bias. But in the near term, to quote the RBA, "*The Board remains open to the possibility of lowering rates in the future to assist economic growth.*"

## The drivers and the challenges in 2012

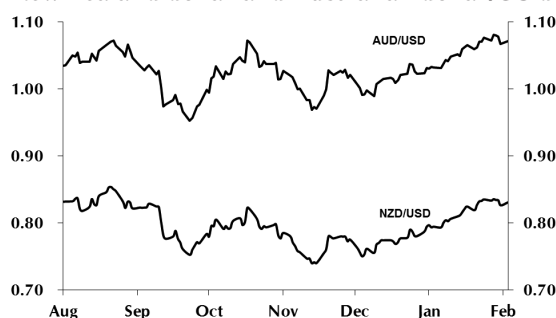
The RBA is recognised as being one of the more pragmatic central banks in the world. Its February statement was decidedly dovish and gave a good summary of the drivers in the year ahead. It noted worsening market conditions in Europe, increasing unemployment, declining commodity prices, moderating Chinese growth, and falling inflation.

Certainly the two inextricably linked factors of hard commodity prices and Chinese growth are somewhat pessimistic. Coal and iron ore prices are down sharply from the 2011 highs; for example the official 'set' for premium coking coal is now USD235 per tonne, down from USD315 per tonne in mid 2011. Chinese GDP growth projections have declined to 7.0% p.a. for the next four years. The December quarter's figure of 8.9% was the lowest year on year figure since June 2009 but still significantly above that official projection/target.

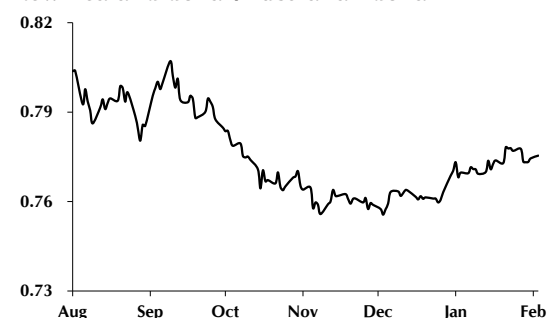
In New Zealand it is difficult to see any justification for an increase in the OCR in 2012. Inflation is comfortably contained at 1.8% p.a. (the headline figure having dropped as the GST rise fell out of the calculation), Europe is still dragging the rest of the world's growth down and the rebuild of Christchurch, for months now seen as the saviour for the New Zealand economy, is being constantly put back, with continuing aftershocks and insurance issues being two of the main contributing factors. Also bank funding costs are increasing, a point noted by the RBNZ in its January 'OCR Review' and which in effect is a de facto tightening of monetary conditions.

Nonetheless, our spectacles retain a mildly rosy tint and from a currency perspective the AUD and NZD remain well supported due to Australasia's relative isolation from global trouble hot-spots. We see little reason to dispute that assessment.

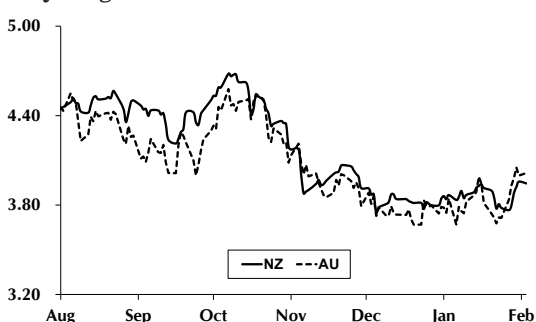
New Zealand dollar and Australian dollar/US dollar



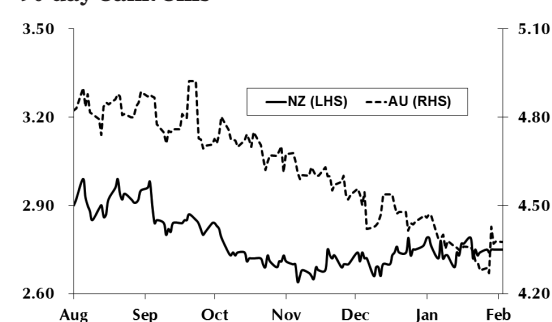
New Zealand dollar/Australian dollar



10 year government bonds



90 day bank bills



# WORLD ECONOMY & MARKETS

## Central banks steer an unconventional path

The post-GFC reality has forced central banks to burrow into the hidden corners of their toolkits in search of viable support mechanisms. An odd assortment of instruments and unconventional policy has emerged, thrusting economic theory beyond its usual academic confines. With the policy rates of the world's major central banks already stuck near zero and the global recovery again coming under renewed pressure, what can we expect from the guardians of sovereign economic wellbeing in 2012?

The Bank of England has already announced that it will expand its quantitative easing ("QE") programme from GBP275 billion to GBP325 billion, injecting money into the economy by purchasing government bonds from financial institutions. The Fed too has hinted that it may launch another round of QE this year, on top of its two previous rounds and "Operation Twist," under which it swapped short-term for long-term bonds. Providing quarterly interest rate projections and communicating a clear long-term monetary policy position has also become part of the Fed's process.

Such unorthodox measures are not without their critics. Some argue that QE has failed to provide an economic boost, debases the currency and pushes up inflation. Committing to an interest rate setting until 2014, as the Fed has done, comes with its own obvious dangers.

The ECB has also (reluctantly) been a buyer of government bonds on the secondary market and has lent generously to the region's banking sector. At the end of 2011, European banks lapped up a cheap 3-year funding facility to the tune of almost half a trillion euros. The offering was instrumental in freeing up stressed interbank markets, which were all but frozen at the end of last year. European banks will get another opportunity to access this cheap term borrowing in late February, a welcome hand at a time of increasing threats.

After tightening monetary policy over much of 2011, the People's Bank of China is now looking to ease liquidity conditions as growth in the world's second largest economy cools. The central bank cut the required reserve ratio for big banks by 50 basis

points in November, the first cut in 3 years. The move took the rate down from a record 21.5% and has been followed by a gradual relaxation of some controls on credit at smaller regional institutions in recent months to support the slowing economy.

Chinese policymakers remain wary of the inflation threat however and are mindful of the credit excesses caused by a massive economic stimulus programme in 2008. Economists see as many as six cuts to the reserve ratio this year but much will depend on how severe the global downturn gets. The People's Bank of China sets bank reserve requirements as a tool for managing market liquidity. Few analysts believe the central bank will cut interest rates this year, with annual inflation staying stubbornly higher than the one-year deposit rate of 3.5%.

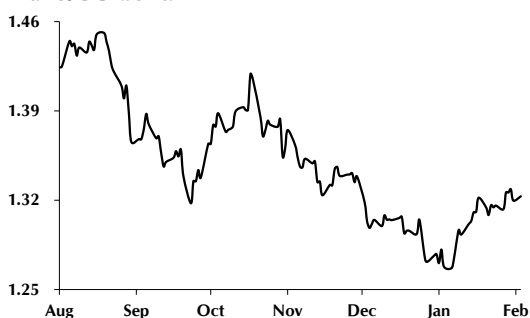
In Japan, where interest rates have been near zero almost continuously since 1999, the Bank of Japan is under growing pressure to combat persisting deflation and a strong yen. The central bank has undertaken a JPY1 trillion lending programme to help companies hurt by last year's tsunami and increased the size of its asset-buying programme three times last year to JPY55 trillion.

## More levers than Willy Wonka in a chocolate factory?

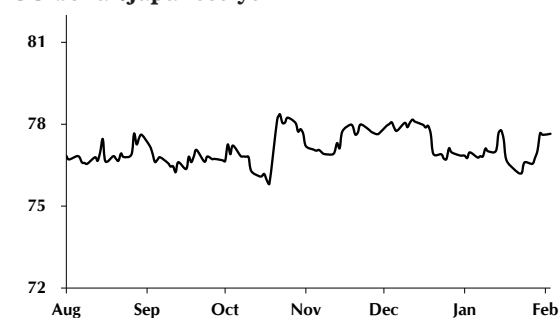
A broadening of central bank powers beyond the traditional setting of interest rates and inflation targeting has fostered differentiation among monetary policies, despite most economies facing similar shocks. Growth and job creation now feature as common priorities, along with the usual inflation fighting mandate.

The continued call on unconventional levers such as QE, liquidity operations and foreign exchange intervention has done little to rebuild market confidence or central bank credibility. Such heavy manipulation of market forces comes with its own set of risks and uncertainties and there is little precedent for what may happen when these policies need to be unwound. Historical comparisons mean little in such an environment, leaving those responsible for managing corporate treasury risks with few meaningful guides. Treasurers and policymakers alike should be mindful of the risks going into 2012.

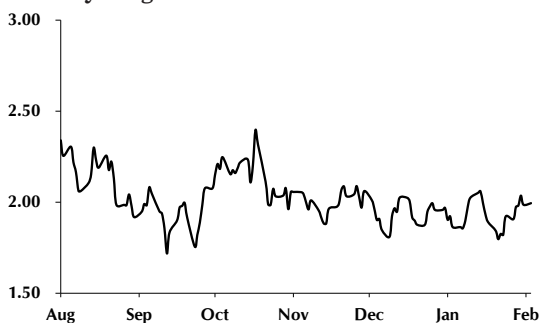
**Euro/US dollar**



**US dollar/Japanese yen**



**US 10 year government bond**



**Standard & Poor's Goldman Sachs Commodity Index**



measures of the probability that a particular issuer or particular debt issue will default" [Standard & Poor's]. Many portfolio managers use credit ratings as an investment screening tool and restrict what can be bought. Therefore credit ratings are important for countries in attracting foreign investment and accessing funding in international bond markets. As mentioned earlier, this is important as it influences funding costs.

Markets can place their own assessment on the creditworthiness of countries regardless of credit ratings. This was evidenced recently with Eurozone bond issues. Markets had for a while perceived France to be a greater credit risk than Germany. The agencies then moved in line by downgrading France. This further pushed up yields on French government bonds while German bonds remained near record lows.

## Risk management and credit ratings

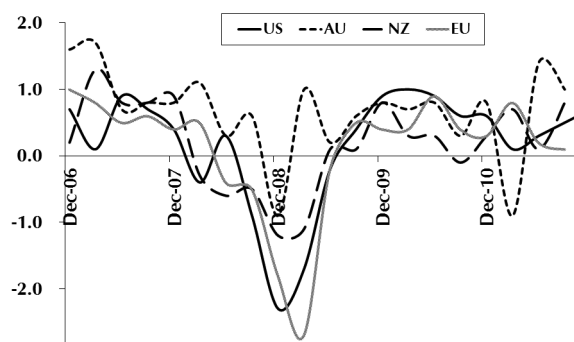
A company may request a credit rating to reduce the cost of funding. For example if a company is considering a bond issue, a credit rating may be beneficial in order to appeal to those investors who are restricted to investing in rated issues. However the cost of obtaining a credit rating needs to be weighed up against the benefit it may provide in terms of reducing funding margins and widening

the investor pool. All banks, credit unions, building societies and finance companies in New Zealand are now required to have an approved credit rating, although some smaller institutions are exempt.

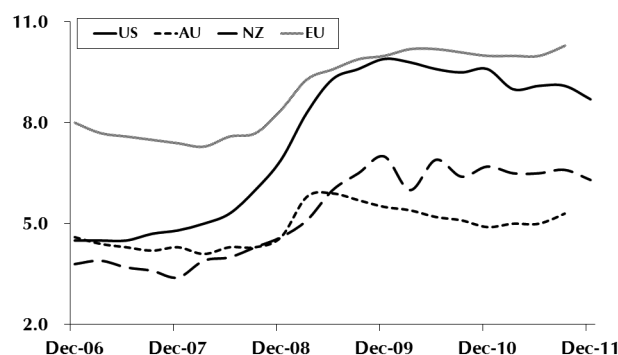
Credit ratings are used not only for governments but also for many companies. A counterparty may default on its contractual obligations on financial instruments and this risk needs to be managed. Credit ratings can help in managing such counterparty risk. For example, a company's treasury policy should specify that it can only invest with counterparties above a certain credit rating. This may also apply to commercial activity undertaken under the protection of documentary credits. It is also best practice to specify suitable diversification among counterparties to mitigate the impact of any default.

For good treasury risk management, given that many banks have recently been downgraded, it is important to review counterparty credit ratings and your treasury policy requirements in order to assess whether any action needs to be taken.

GDP growth (QoQ)



Unemployment rates



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