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Eurozone in new crisis as ratings agency downgrades nine countries

Standard & Poor's strips France of its AAA credit rating, rekindling fears in the markets over future of single currency

Larry Elliott and **Phillip Inman**
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France's loss of its top-rated status leaves Germany as the only other major economy inside the eurozone with a AAA credit rating. Photograph: Scott E Barbour/Getty Images

Europe has been plunged into a fresh crisis after France was stripped of its coveted AAA credit rating in a mass downgrade of nine eurozone countries by the ratings agency Standard & Poor's.

S&P said austerity was driving Europe even deeper into financial crisis as it also cut Austria's triple-A rating, and relegated Portugal and Cyprus to junk status.

The humiliating loss of France's top-rated status leaves Germany as the only other major economy inside the eurozone with a AAA rating, and rekindled financial market anxiety about a possible break-up of the single currency.

S&P brought an abrupt end to the uneasy calm that has existed in the eurozone since the turn of the year by downgrading the ratings of Cyprus, Italy, Portugal and Spain by two notches. Austria, France, Malta, Slovakia and Slovenia were all cut by one notch.

The agency said that its actions on eurozone ratings were "primarily driven by insufficient policy measures by EU leaders to fully address systemic stresses". It added that fiscal austerity alone "risks becoming self-defeating".

But French finance minister François Baroin downplayed the move, saying it was "not a catastrophe".

European finance ministers tried to control the crisis by pledging to agree a new treaty to tighten fiscal rules at a summit at the end of this month.

However, the deputy prime minister, Nick Clegg, said that what Europe needed was more concerted action by all 27 EU member states rather than "more treaties". "Just dealing with the fiscal side of things which of course is absolutely essential – it is one side of the equation – must be accompanied by a more concerted effort, which I believe is best done with all 27 countries involved, to raise our productivity."

Speaking on a visit to Dublin, Clegg said: "We don't need to reach for new treaties or agreements or policies. We know what we need to do. We need to complete the single market and create a dynamic and greater growth in the EU to help us out of these problems."

Britain was not at risk of a downgrade from S&P, but Berlin sought to soften the blow to French pride when a German politician close to Angela Merkel said the UK should have been first in line for a cut in its AAA status on the grounds that its collective private and public sector debts are the largest in Europe.

Michael Fuchs, deputy leader of the Christian Democrats, said: "This step is out of order. Standard and Poor's must stop playing politics. Why doesn't it act on the highly indebted United States or highly indebted Britain?"

He added: "If the agency downgrades France, it should also downgrade Britain in order to be consistent."

City analysts predicted that some European banks will be downgraded in the coming week, reflecting the fact that their national governments are now seen as riskier. The French and Austrian downgrades will also reduce the firepower of the region's main bailout fund, the European Financial Stability Facility.

Mohamed El-Erian, head of the bond trading giant Pimco, predicted serious long-term consequences. He told Newsnight that the move "places a wedge in the centre of the eurozone, making a solution much more difficult".

Rumours of S&P's move had earlier sent shares falling, pushed the euro down to a 16-month low against the dollar, and forced the European Central Bank to step in to buy Italian bonds again.

The FTSE 100 dropped 100 points before recovering late in the day to finish down 26 points at 5636, while the Dow Jones in New York fell 120 points to 12350 by afternoon trading before recovering some ground by the close.

Investors piled into safe haven assets such as the dollar, while the UK was rewarded with even lower borrowing costs as 10-year bonds slipped below 2%.

The new technocratic government in Athens added to the gloom after talks over a second major bailout to rescue Greece's finances broke up without an agreement. Officials from the International Monetary Fund, the European Union and the ECB arrive in Athens on Tuesday for talks on a new €130bn bailout package, which will be impossible unless Greece first strikes a deal with the banks, insurance companies and hedge funds that have lent it money.

The Greek government said talks with its creditors would resume on Wednesday, but analysts voiced concerns that hedge funds were blocking a deal that involves them writing off 50% of their loans.

Germany considers Greece to be the main faultline in the euro crisis and is urgently

seeking a resolution to talks over a deal, but has insisted Brussels holds out for a private sector deal. Officials hinted on Friday night that Greece could default on 100% of its loans if the private sector refuses to come back to the negotiating table and accept a voluntary agreement.

A spokesman for the troika said: "We very much hope, however, that Greece, with the support of the euro area, will be in a position to re-engage constructively with the private sector with a view to finalising a mutually acceptable agreement on a voluntary debt exchange consistent with the October 26/27 agreement, in the best interest of both Greece and the euro area."

Unprecedented action by the European Central Bank in recent weeks had reassured many investors that policymakers were getting on top of the crisis. The ECB has lent more than €400bn to eurozone banks to bolster their reserves and prevent a repeat of the 2008 credit crunch.

But the S&P downgrades are likely to undermine these efforts and make foreign banks wary of lending to their counterparts in Europe.

Graham Neilson, chief investment strategist at Cairn Capital, warned: "This is just the start. There will be more to come, and not just in Europe – there is simply still too much debt and not enough growth in developed economies."

France has already shown its anger at the prospect of a downgrade. Central Bank chief Christian Noyer raised eyebrows in London before Christmas when he said Britain "has more deficits, as much debt, more inflation, less growth than us".

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