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## Germany's Bonds May Feel Strain of Its Weak Economy

LONDON -- Who would trade a Mercedes for a Renault, a Fiat or a Vauxhall? Well, in the government-bond market, that may be a trade you'll have to consider.

Germany's once-mighty economy is going nowhere. Its once-vaunted banking system is awash with problems -- three of the country's four biggest banks are unprofitable. And a growing number of analysts believes that if the credit-rating agencies can find their collective spines, Germany could lose its cherished triple-A credit rating.

"Combined with various other problems, a weak financial sector could contribute to an official negative-ratings outlook for Germany by one or more of the rating agencies," says John Butler, chief market strategist at Dresdner Kleinwort Wasserstein in London. Press this fellow a little further, and he'll acknowledge that Germany actually could be downgraded to double-A status next year.

Such a fall from grace would place the nation that once prided itself on having stopped Rome's legions on par with Belgium, Spain, Italy and Portugal. A downgrading would rank Germany below France, the Netherlands, Britain, Austria, Finland, Denmark, Ireland, Luxembourg, and, of course, the U.S.

Don't forget, the Germans are the folks who, like stern school masters, used to lecture all of Europe and the U.S. on the merits of fiscal and monetary rectitude and the proper way to manage an economy.

What's more, if Germany's credit rating is cut and if financial markets believe there will be a sustained period during which Germany will be rated below, say, France, then French government bonds eventually could replace German bonds as the benchmark, or reference point, off which all other euro-denominated bonds and derivatives are priced, Mr. Butler says.

Germany also is capable of spreading its pain to its neighbors. If Germany loses its triple-A credit rating, "you're talking about the whole downgrading of Europe," says John de Garis, head of European fixed income at Credit Suisse Asset Management. Adds Luigi Speranza, an economist at BNP Paribas in London: "The first question markets will ask is, 'Who's next?'"

If Germany is downgraded, Dresdner analysts say their next securities of choice in the European-government-bond pecking order would be French bonds, followed by Dutch bonds, and Spanish securities third. If, however, an investor thinks the boys from Berlin can escape the wrath of the rating agencies, the gurus recommend sticking with German Bunds because of the liquidity their benchmark status offers -- especially in these politically turbulent times.

This may sound like a bunch of financial gobbledygook to the average investor. But if Germany loses its benchmark status, any outstanding German bonds you own will be worth less, relative to other euro-zone bonds; and if you have a mortgage in Germany, odds are the interest rate you pay will be higher.

"It will ripple through the country and affect everybody in every shape and form: the federal government, the states, agencies, banks and German corporations," Mr. Butler says. "It's unlikely other borrowers can escape higher borrowing costs as a result of a German-government downgrade. The cost of borrowing for Germany Inc. will go up and make Germany less competitive. It can even hurt German companies' share prices."

Let's you think Mr. Butler is just some whacko working for a German bank, Mr. Speranza of BNP Paribas also believes the rating agencies will hit Germany with a negative outlook on its debt, though he doesn't go so far as to predict an actual downgrade.

In a presentation to fund managers and analysts last month, David Riley, head of sovereign ratings at Fitch Ratings, said his firm's coming annual review of Germany's credit status mostly will focus on issues that could erode the country's triple-A rating. "Making the economy more flexible and competitive would enhance its resilience and further underpin Germany's triple-A status," he said. "The danger is that failure to implement structural reform ... renders Germany more vulnerable to adverse shocks and ultimately could undermine Germany's triple-A status."

Last September, Standard & Poor's said Germany's ratings "are expected to remain secure against virtually all foreseeable medium-term downside economic and political risks." Less than three months later, the ratings agency's language was a lot less definitive, BNP's Mr. Speranza notes. "A continuation in the reform backlog could put increasing pressure on the ratings," S&P said in December.

So what's wrong in the land of sauerbraten, beer and apple strudel? One, the economy stinks. Two, the banking system is laden with high costs and weak revenue; battered by deteriorating credit quality and the declining value of equity holdings; and riddled with bad debts and rising loan-loss provisions. Three, a fossilized government is either too weak or unwilling to deal with the country's structural problems, such as the rigid labor market and overly generous welfare system.

At 0.2%, BNP forecasts 2003 German growth to be one-quarter of the 12-nation euro-zone average; and unemployment stands at a five-year high of 4.7 million. Mr. Speranza also notes that German growth and government-spending trends compare unfavorably with virtually all other major triple-A-rated countries. Indeed, except for the important ratio of total debt to gross domestic product, "Germany's performance is in line or even below the median of double-A countries," Mr. Speranza says.

Stuck within European economic and monetary union, Germany is forced to live with interest rates that are too high and limits on deficit spending that are too low. Meanwhile, high payroll taxes and stiff employment-protection laws discourage job creation and make German labor expensive relative to other European countries, notes Fitch's Mr. Riley. The most competitive part of the German economy is exports, but even that is threatened by the strengthening euro.

As for the future, the title of a recent report by consultants Smithers & Co. sadly says it all: "Things could be worse in Germany, and they probably will be."

Still, betting on a German downgrading isn't a sure thing. Last month, Moody's Investors Service reaffirmed the country's triple-A rating. Figuring that Germany would have little trouble servicing a higher debt load, Guy Skinner, a fund manager at Morley Fund Management in London, puts the odds of Germany being downgraded at 10% to 20%. That didn't stop the big British fund manager from switching cash from German bonds and investing in those of faster-growing economies, such as Spain and Greece. However, now that the difference in yields between those countries' securities and Germany's have narrowed, he is switching back into German bonds.

Matt King, a fixed-income strategist at J.P. Morgan, says a downgrading could affect German companies more than the country itself -- especially "better-quality" companies like **Siemens**, **BASF** and **E.On**. Noting that "low-rated companies like **HeidelbergCement** and **ThyssenKrupp** have already been hit," he says that investor "worries about a default are so company-specific that worries about Germany's own ratings make barely any difference."

Managers at Credit Suisse Asset Management have been underweight German bonds for some time and overweight those of the Netherlands, Belgium, Spain and Italy. Nonetheless, they are relatively sanguine about Germany's credit status. Noting that "France is going down the same path as Germany, with increased budget deficits," Mr. de Garis says, "France might not be a long-term substitute for Germany. Italy certainly isn't a substitute for Germany."

Some money managers and strategists believe a demotion from the exclusive triple-A club might come with a silver lining and spur German politicians into finally addressing the economy's labor-market rigidities, high taxes and costly pension-and-welfare systems. But don't hold your breath. This is a government that refuses to help out in a war against Iraq, even if the United Nations endorses one. Stubborn? Yes. Creative? No.

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