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European Local And Regional Government Debt To Surpass €1.2 Trillion In 2009

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European Local And Regional Government Debt To Surpass €1.2 Trillion In 2009

We expect European local and regional governments (LRGs) to increase their borrowing considerably in 2009. High refinancing needs coupled with issuance of new debt to balance deteriorating financial performance are, in our view, likely to result in a 26% increase in gross borrowing across Europe compared with 2008. If the economic environment deteriorates further than we currently expect, this could lead to even higher borrowing needs than projected in this report. We expect overall debt for European LRGs to edge above €1.2 trillion by the end of the year.

This is our fifth LRG borrowing survey, and consolidates data and estimates of borrowing by LRGs in 24 European countries. We have collected data from various statistical offices to present our approximations. As these countries account for the bulk of sub-sovereign government borrowing in Europe, the data should, in our view, represent a good proxy for total European LRG debt. The data include estimates of debt outstanding (bonds and bank loans) of LRGs in the 24 countries, as well as estimates of gross borrowing.

We rate 158 LRGs in Europe, including almost all large European LRG borrowers, and particularly those active in the capital markets. For a full list of the European LRGs that we rate, see "Ratings History List: European Local and Regional Government Ratings Since 1975", published on RatingsDirect and updated monthly. The reported figures are our estimates and do not necessarily reflect the issuers' own projections.

Reduced Borrowing By Largest Issuers And Turbulent Financial Conditions Provide For Stabilization Of European LRG Debt in 2008

In last year's report, we forecast that European LRG debt would stabilize below €1.2 trillion in 2008 (see "European Local And Regional Government Debt To Stabilize Below €1.2 Trillion In 2008", published March 6, 2008 on Ratings Direct). A stabilization took place but at a slightly lower-than-expected level, which we believe is largely attributable to reduced issuance by German states and Italian regions, two of the traditionally bigger borrowers in Europe. Moreover, deteriorating economic and financial conditions in the second half of 2008 created uncertain conditions in capital markets around Europe, in particular in countries in Central and Eastern Europe (CEE) and the Commonwealth of Independent States (CIS). Our view is that these developments had a dampening effect on borrowing by European LRGs with the total stock of debt ending up short of our forecasts at €1.1 trillion.

In 2008, total gross borrowing fell 7% year on year, but we noted considerable differences between countries. In our view, significantly lower volumes of issuance by Italian regions (which almost halved their issuance) and, to some extent, by German states, had a marked aggregate impact. Swiss LRGs also reduced their gross borrowing significantly in 2008, largely, we believe, because of high liquidity and good economic performances by individual cantons. Conversely, Spanish LRGs borrowed significantly more in 2008: according to our analysis, gross borrowing increased by 74% compared with 2007. In CEE/CIS, we saw gross LRG borrowing rising by 9%, although these countries continued to represent a low share of only 3% of the total European LRG debt stock. Leading the way in terms of issuance were Russian LRGs which, despite challenging market conditions, increased borrowing by 32% in comparison with 2007, according to our data.

We Expect Gross Borrowing To Increase Considerably In 2009

We estimate borrowing by European LRGs in 2009 at €215 billion, up by 26% relative to 2008. Western European LRGs are likely in our view to increase borrowing significantly to balance deteriorating financial performance, whereas CEE/CIS LRGs' debt issuance is, we believe, set to remain broadly stable.

In 2009, we currently expect the borrowing of German LRGs to surpass the €100 billion mark and Spain to become the second largest borrower in Europe with an expected material increase in gross borrowing of 56% relative to 2008. Swiss cantons are expected to increase borrowing to past levels following a temporary decrease in 2008. We expect Swedish and Russian LRGs to show slight increases in gross borrowing whereas French and Italian LRGs are expected to borrow less relative to 2008. These predictions are our own approximations based on information from various statistical offices as well as our evaluations of forecast borrowing needs across the European LRG sector. In each case, these expectations are based on information we currently have. Future developments could have an impact on these views (see table 1).

Table 1

European Gross Borrowing By Country

(Mil. €)	Ranking 2009	2009e	As a % of total	Ranking 2008	2008	As a % of total	2007	As a % of total	2006	As a % of total
Western Europe										
Germany	1	100,860.30	46.95	1	79,628.30	46.72	85,000.00	46.51	94,962.00	46.36
Spain	2	27,113.00	12.62	3	17,432.00	10.23	10,027.00	5.49	9,396.00	4.59
France	3	17,400.00	8.10	2	19,000.00	11.15	17,700.00	9.68	17,100.00	8.35
Switzerland	4	15,727.08	7.32	5	7,557.46	4.43	12,968.45	7.10	13,539.21	6.61
Sweden	5	8,525.31	3.97	6	6,871.48	4.03	8,512.91	4.66	9,480.50	4.63
Italy	7	6,800.00	3.17	4	8,438.00	4.95	15,594.00	8.53	26,960.00	13.16
United Kingdom	8	5,996.26	2.79	8	5,218.77	3.06	7,159.93	3.92	8,396.77	4.10
Denmark	9	5,567.90	2.59	9	4,695.44	2.76	5,288.71	2.89	5,283.65	2.58
Belgium	10	5,059.70	2.36	10	3,702.20	2.17	2,360.20	1.29	2,041.60	1.00
Austria	11	4,500.00	2.09	12	3,000.00	1.76	3,136.00	1.72	3,375.40	1.65
Finland	12	3,870.80	1.80	11	3,160.50	1.85	2,940.00	1.61	2,705.50	1.32
Norway	13	3,459.39	1.61	13	2,166.85	1.27	3,315.34	1.81	2,811.20	1.37
Total Western Europe		204,879.75	95.37		160,870.99	94.40	174,002.54	95.20	196,051.84	95.70
Central and Eastern Europe & Commonwealth of Independent States										
Russia	6	7,266.27	3.38	7	6,870.31	4.03	5,192.46	2.84	4,857.65	2.37
Turkey	14	1,456.21	0.68	14	1,054.74	0.62	263.94	0.14	320.51	0.16
Poland	15	487.10	0.23	23	25.94	0.02	964.12	0.53	1,745.10	0.85
Czech Republic	16	304.36	0.14	19	170.01	0.10	380.42	0.21	564.12	0.28
Ukraine	17	158.05	0.07	17	249.31	0.15	184.93	0.10	40.41	0.02
Lithuania	18	56.07	0.03	22	46.66	0.03	105.30	0.06	37.46	0.02
Hungary	19	52.93	0.02	15	408.70	0.24	1,095.95	0.60	796.82	0.39
Romania	20	51.12	0.02	18	215.33	0.13	287.65	0.16	279.75	0.14
Croatia	21	47.89	0.02	21	57.31	0.03	77.5	0.04	11.50	0.01

Table 1

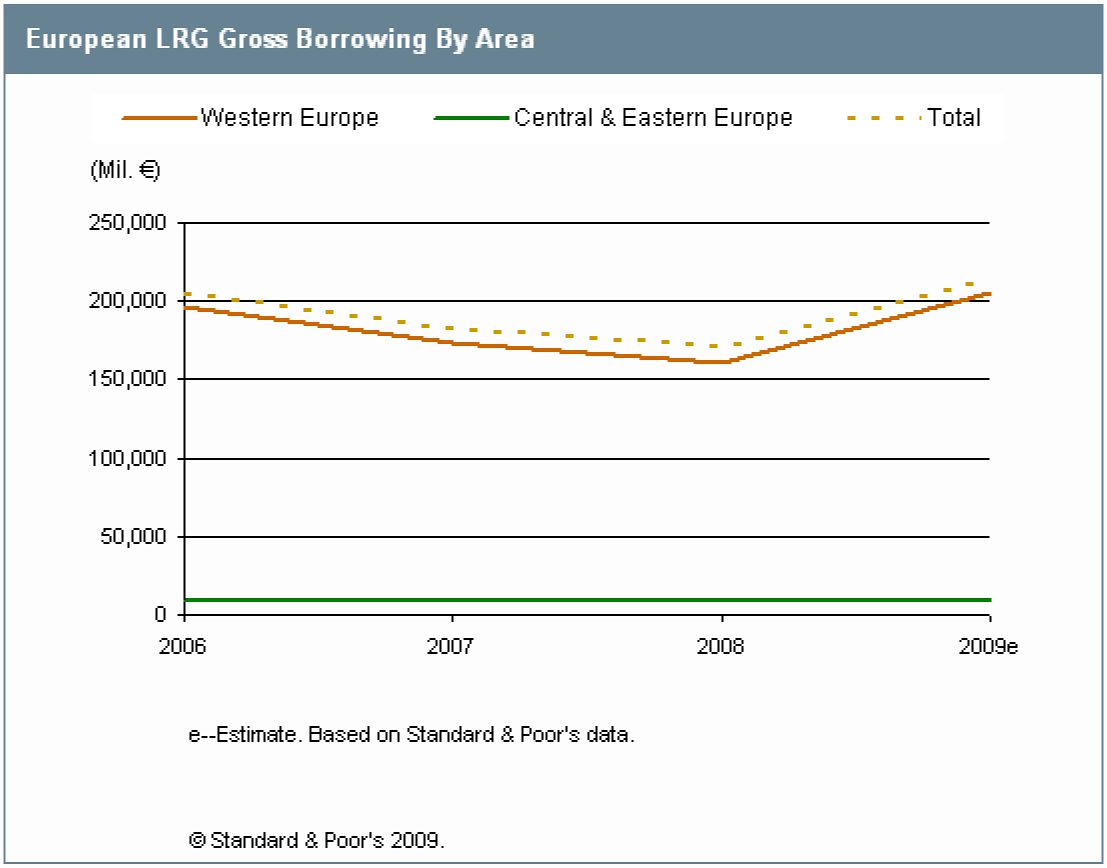
European Gross Borrowing By Country (cont.)										
Bulgaria	22	30.10	0.01	20	64.35	0.04	67.03	0.04	28.46	0.01
Latvia	23	15.78	0.01	16	386.59	0.23	152.21	0.08	118.86	0.06
Macedonia	24	9.77	0.00	24	0.00	0.00	0.00	0.00	0.00	0.00
Total CEE/CIS	--	9,935.6	4.63		9,549.2	5.60	8,771.5	4.80	8,800.6	4.30
Total Europe	--	214,815.4	100.00		170,420.2	100.00	182,774.1	100.00	204,852.5	100.00

e--Estimate. Based on Standard & Poor's data.

European LRG borrowing remains highly concentrated in five countries, according to our data. Germany, with debt mostly issued by states, is by far the largest borrower; we estimate that it will account for 47% of total European LRG gross borrowing in 2009, followed by Spain (12.6%), France (8.1%), Switzerland (7.3%), and Sweden (4%). In Germany, gross borrowing is, we believe, driven by roll-over of maturing debt as well as net borrowing needs compensating for tax revenue shortfalls and capital injections into state banks. The increase in borrowing by Spanish LRGs is mainly driven by an acute deterioration of LRG accounts, in our view. Net new borrowing in Europe was broadly stable in 2008 but we believe it will increase in 2009 by about 10%.

According to our analysis, CEE/CIS LRGs' gross borrowing needs amount to 5% of total European LRG borrowing needs for 2009, slightly down from 6% in 2008. Russia leads in terms of debt issuance in CEE/CIS and we expect it to account for 3.4% of the European borrowing total in 2009. In several countries, Ukraine in particular, LRGs have debt denominated in foreign currencies. Following the depreciation of their national currencies relative to the U.S. dollar and the euro, this will lead to currency effects on their existing debt stock. Whereas the total stock numbers have increased, we have made adjustments to the gross borrowing figures only to reflect net new borrowing absent these exchange rate fluctuations.

Chart 1



More details of our views on European LRG borrowing trends by country can be found below. For our views on the credit quality of European LRGs in the year ahead, see "Testing Financial And Economic Conditions Put Pressure On Creditworthiness Of European LRGs", published on Dec. 4, 2008 on RatingsDirect.

Debt Stock Set To Increase In Our View

If borrowing increases in 2009 compared with 2008 as we expect, so will LRG debt. While the refinancing of maturing debt will, we believe, remain high, increased borrowing to accommodate deteriorating economic conditions is likely, on the basis of our current estimates, to require net new borrowing of about 10% in 2009. Consequently, absent other developments, we expect European LRGs' total debt stock to edge above €1.2 trillion by the end of 2009 (see table 2).

Table 2

European Local And Regional Governments Debt Stock By Country

(Mil. €)	Ranking 2009	2009e	As a % of total	Ranking 2008	2008	As a % of total	2007	As a % of total	2006	As a % of total
Western Europe										
Germany	1	592,205.40	48.68	1	560,200.00	50.25	560,000.00	49.79	561,366.00	50.84
Spain	2	120,558.00	9.91	4	100,290.00	9.00	89,023.00	7.91	85,413.00	7.74

Table 2

European Local And Regional Governments Debt Stock By Country (cont.)										
France	3	117,000.00	9.62	3	112,400.00	10.08	105,100.00	9.34	98,600.00	8.93
Italy	4	115,085.00	9.46	2	115,761.00	10.38	115,859.00	10.30	106,905.00	9.68
Switzerland	5	68,341.13	5.62	5	55,647.87	4.99	65,534.54	5.83	67,154.10	6.08
Norway	6	37,169.00	3.06	8	23,730.84	2.13	33,171.94	2.95	29,423.40	2.66
Sweden	7	34,442.25	2.83	6	27,744.60	2.49	34,077.88	3.03	38,349.54	3.47
Belgium	8	29,525.60	2.43	7	26,499.70	2.38	25,542.10	2.27	25,751.00	2.33
Denmark	9	22,467.65	1.85	9	19,202.46	1.72	21,792.78	1.94	21,695.66	1.97
Austria	10	20,200.00	1.66	10	18,700.00	1.68	18,904.00	1.68	18,398.00	1.67
U.K.	11	17,364.56	1.43	11	15,567.86	1.40	18,313.93	1.63	17,719.47	1.60
Finland	13	9,800.00	0.81	13	9,677.00	0.87	9,030.00	0.80	8,400.00	0.76
Total Western Europe	--	1,184,158.6	97.34	--	1,085,421.3	97.36	1,096,349.2	97.47	1,079,175.2	97.74
Central and Eastern Europe & Commenealth of Independent States										
Russia	12	13,502.70	1.11	12	11,997.96	1.08	10,317.69	0.92	9,401.92	0.85
Poland	14	5,784.08	0.48	14	5,154.14	0.46	7,153.83	0.64	6,610.94	0.60
Czech Republic	15	4,190.16	0.34	15	3,998.94	0.36	3,412.58	0.30	3,194.30	0.29
Turkey	16	2,941.35	0.24	17	1,862.83	0.17	1,320.56	0.12	1,082.24	0.10
Hungary	17	2,568.6	0.21	16	3,211.1	0.29	3,120.51	0.4	2,248.76	0.20
Romania	18	1,129.10	0.09	18	1,091.82	0.10	1,202.05	0.11	932.14	0.08
Ukraine	19	712.00	0.06	20	618.36	0.06	705.84	0.06	584.00	0.05
Latvia	20	670.51	0.06	19	711.46	0.06	532.77	0.05	384.53	0.03
Lithuania	21	423.20	0.03	21	348.52	0.03	283.82	0.03	181.07	0.02
Croatia	22	250.70	0.02	22	241.16	0.02	220.39	0.02	183.09	0.02
Bulgaria	23	123.29	0.01	23	210.20	0.02	175.93	0.02	112.98	0.01
Macedonia	24	9.77	0.00	24	0.00	0.00	0.00	0.00	0.00	0.00
Total CEE/CIS	--	32,305.5	2.66	--	29,446.5	2.64	28,446.0	2.53	24,916.0	2.26
Total Europe	--	1,216,464.1	100.00	--	1,114,867.8	100.00	1,124,795.1	100.00	1,104,091.2	100.00

e--Estimate. Based on Standard & Poor's data.

German LRGs account for slightly less than one-half of total European LRG debt, according to our data. The German states have high debt stocks, which need constant refinancing.

We estimate that bond issuance accounts for about 70% of the total debt stock. European LRG capital market activity is dominated, in our view, by German states, which account for about 70% of issuance. Distant followers are Spanish and Italian regions in the euro market, and Swiss cantons in the Swiss franc market, with issuance targeted primarily at domestic investors.

Unlike the large bond-issuing LRGs, most European LRGs tend to rely heavily on bank loans to cover their financing needs. In the Nordic countries, we note that a substantial part of LRG borrowing is conducted through municipal funding vehicles which provide the lion's share of the funding to the sector.

The largest European issuing entities, the German states, remain very active in the capital markets. However, following recent national rescue packages provided to banks, there are now more state-guaranteed bonds in the market. Even so, we believe the German states can still borrow, but at higher margins. We note that total borrowing costs are still lower than in previous years thanks to low interest rates. It is perceivable that investors distinguish between centrally guaranteed bank volumes, which are usually short- to medium-term, and LRG debt, which tends to be longer term.

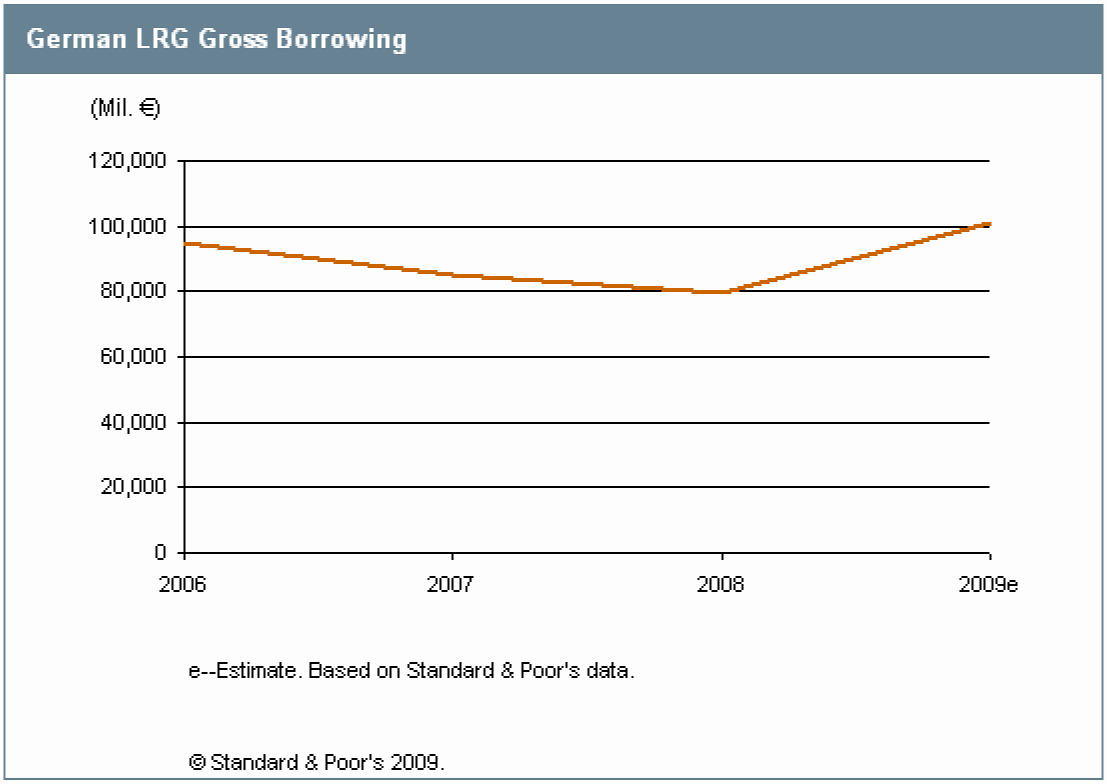
German LRGs Account For Almost 50% Of European LRG Borrowing

In 2009, we believe German states will continue to lead European sub-sovereign government borrowing, accounting for 47% of the European LRG gross borrowing. This dominance is, in our view, due to the country's decentralized federal system, large expenditure responsibilities, and ongoing high refinancing needs. In 2008, tax revenues remained strong for the first three quarters due to solid German and global economic growth, high natural resource prices, and high employment levels. However, in the fourth quarter of 2008, negative spillover effects from the global financial downturn on the real economy led to a sharp decline in global and domestic economic activity.

Having peaked at more than €104 billion in 2005, gross German LRG borrowing fell significantly to €85 billion in 2007, and continued to decline in 2008 according to our approximations of official statistical figures. In 2008, gross LRG borrowing is thought to have stood at €79.6 billion (see chart 2). In 2009, we expect a sharp increase in net new borrowing with gross borrowing again expected to pass the €100 billion mark. Besides large gross borrowing due to high LRG refinancing needs, we expect that German states and municipalities will need to return to net new borrowing as a result of lower-than-budgeted tax revenues in 2009 and higher co-financing needs for investment expenditure under a federal economic stimulation package (Konjunkturprogramm 2).

We include all capital injections announced by April 2009 or projected by us into German Landesbanks in 2009 as part of sub-sovereign issues. We have done so, even if the capital in question is to be raised via special purpose entities outside a given state's official budget. Examples include a proposed €3 billion capital injection into HSH Nordbank AG (BBB+/Negative/A-2) and a mooted €5 billion injection into Landesbank Baden-Wuerttemberg (A-/Negative/A-2).

Chart 2



Most German states are large borrowers in an international context, and three can be compared with sovereign issuers: North Rhine-Westphalia (NRW; AA-/Stable/A-1+), Berlin (not rated), and Lower Saxony (not rated). NRW is the largest European sub-sovereign borrower, with needs amounting to €20.8 billion in 2009. This represents about 10% of the European total, according to our analysis. On top of this figure, we forecast additional sizeable borrowing requirements by NRW for capital support to WestLB AG (BBB+/Negative/A-2).

The city-state of Berlin is the second-largest borrower among German states, with projected borrowing of about €8 billion in 2009. Although Berlin is much smaller than NRW, it has suffered from weak budgetary performances and rapidly increasing debt, mostly due, in our view, to structural imbalances related to the merger of the former administrations of West Berlin and East Berlin. Over the past three years, Berlin has made progress towards budget consolidation. However, we believe refinancing requirements remain high. Lower Saxony, the third-largest borrower, intends to reduce its budgetary deficits and to balance its budget without net borrowing by 2010, which we believe may be overly optimistic considering the current weak economic outlook. Lower Saxony's expected borrowing needs in 2009 are still high, at €6.5 billion.

German states primarily cover their funding needs through the capital markets. We expect their issuance volume to account for almost 70% of total LRG Eurobond issuance in Europe in 2009. Typically, German states issue benchmark bonds with principal in excess of €1 billion for a single issue. Pricing, liquidity, and credit quality have tended to make such issues viable investment alternatives to sovereign bonds. We have observed that tightening financial markets in the second half of 2008 and much higher margins requirements on the part of investors led to increased demand for state bond issues. Declining interest rates may have compensated for increased margins.

Despite the ongoing financial market turmoil we have so far not observed any problems in the refinancing of German state bonds and do not currently believe that such problems are likely to occur. The considerable size of funding needs has led to an expansion of the investor base, which we understand now includes domestic investors and foreign investors, particularly European investors, but also, for example, Asian central banks.

We believe that states with a public rating tend to have much better market access than those without as transparency and comparability assist investors in their investment and pricing decisions. Following a trend of increasing credit quality on the part of German states in recent years we see a likelihood of increasing fiscal uncertainties and large tax revenue shortfalls in 2009 and 2010.

Nevertheless, in our view, most German states are undergoing the global economic downturn with a high degree of financial leeway, and we expect that this will help them to cope to some degree with severe economic conditions 2009 and 2010. In our analysis, the robustness of the intergovernmental system and the states' ready access to a highly liquid capital market have to date helped to sustain the ratings on German states, which are concentrated in the 'AA' category.

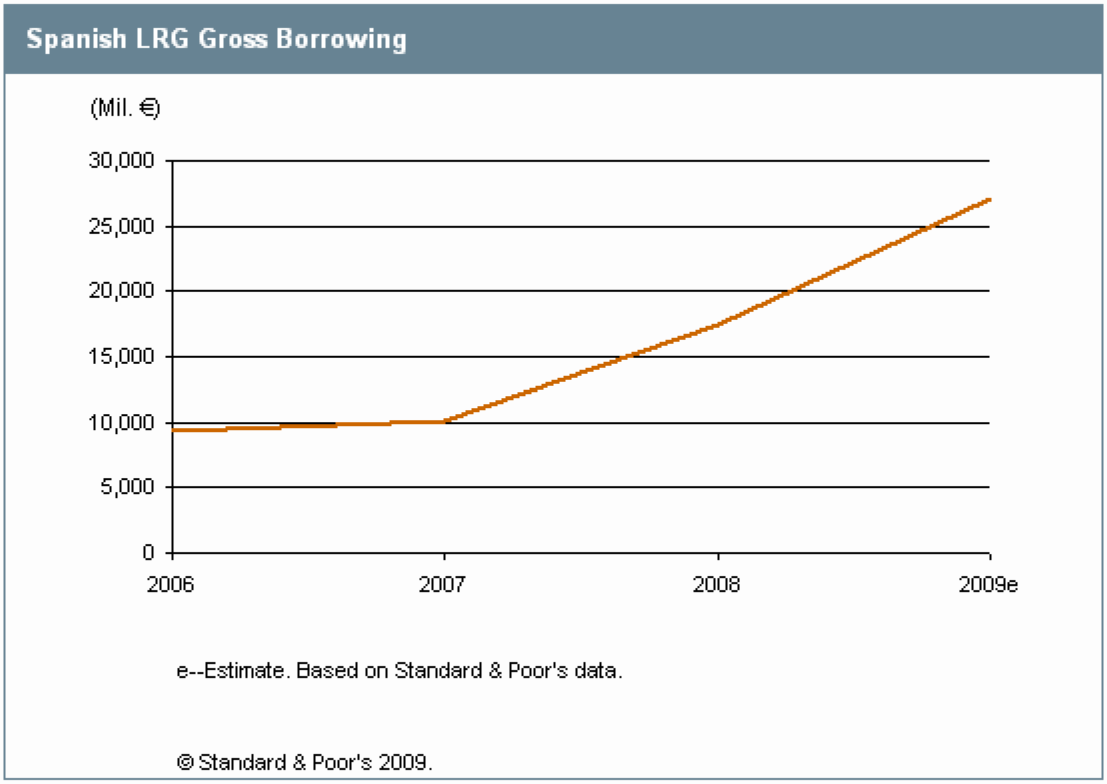
Spanish LRG's Likely To Become Second Largest Borrowers In Europe In 2009 Due To Unprecedented Deficits

We have noted a substantial increase in the borrowing needs of Spanish LRGs, which in 2008 borrowed about €17.4 billion in gross terms after several years of stable financing needs. This is almost 74% more than they borrowed in 2007 (see chart 4). As a result of this resort to external funding, Spanish LRGs' aggregate debt exceeded €100 billion for the first time at year-end 2008. We believe this increase is directly linked to an acute deterioration in the accounts of the country's LRGs during 2008, which is reflected in an aggregate deficit of €20 billion.

A reduction in tax revenues explains the bulk of this deterioration, in our view. All the tax revenues shared by the central government and the regions decreased in 2008, particularly value added tax, which fell by 14%, according to regional accounts. Real estate taxes, which are fully managed and collected by the regions, fell by about one-third due to a collapse of the real estate sector in the course of the year. Against this backdrop, the regions and most municipalities have decided to adopt counter-cyclical policies such as civil works. Consequently, we believe that Spanish LRGs have funded the bulk of their capital programs through external financing, as opposed to virtual self-financing in recent years.

In 2009, we expect Spanish GDP to decline by a record 3.2%. In addition, we expect the country's LRG sector to incur gross borrowing amounting a record high somewhere in the order of €27 billion. With total maturities of about €7 billion, the total debt stock may reach about €120 billion. In a European context, this figure exceeds for the first time our estimates for France and Italy, which have historically been the two leading European borrowers behind Germany.

Chart 3



Catalonia (AA/Negative/--), which we understand has planned gross borrowing of €4.1 billion (about 15% of the Spanish LRG total), is likely to be the country's single largest issuer during 2009, followed distantly by the other four largest regions, the autonomous communities of Andalusia (AA/Stable/--) with about €2.5 billion; Madrid (AA+/Negative/A-1+) with €2.2 billion, Valencia (AA-/Negative/A-1+) with €2.7 billion, and Galicia (AA/Stable/A-1+) with €0.85 billion. Over the medium term we expect Catalonia to remain the most important issuer, as it has a sizable debt stock with related refinancing needs, and what we believe to be a willingness to pursue an ambitious capital program.

A large proportion of the overall municipal deficit was attributable to the City of Madrid (AA-/Negative/A-1+) in 2008. The city did not meet the terms of its 2005-2008 restructuring plan, which prescribed balanced accounts in 2008 and posted a sizable overall deficit amounting to about €1 billion at year-end 2008, leading to a downgrade in February 2009. Within the wider municipal sector, we expect deficits to grow in 2009 in the absence of a long-awaited reform of the LRG financing system, that we currently see as uncertain. A royal decree approved in April 2009 allowing the funding of existing negative fund balances (basically commercial debt) through financial debt could entail a larger-than-expected increase in the financial debt of municipalities. The amount is uncertain since disaggregated data are not available. Although the aggregate amount is a positive €6.8 billion, it hides enormous differences among the country's 8,114 municipalities. The six biggest cities, which account for about one-third of the total debt of the LRG sector, are likely to resort to external funding but, we believe, in fairly moderate amounts. An exception is Barcelona (AA+/Stable/--), which has been amortizing debt for the past 14 years and is not likely to increase its debt stock in 2009.

We believe bond issuance is likely to remain dominated by large regional governments, while cities and provinces will tend to rely on banks to fund their financing needs: bonds account for only 10% of city and provincial financial liabilities compared with about 50% for the regions. However, during 2008 there appears to have been increased reliance on bank loans, probably reflecting a lack of liquidity in the markets particularly in the second half of the year.

Large Spanish LRG borrowers still enjoy robust credit quality, with all ratings in the 'AA' and 'AAA' categories, reflecting our view of their consistently good average budgetary performance until 2008 and debt levels that have been low or moderate by international standards. However, we perceive that the combination of narrower operating balances and sizable deficits is weakening the main debt ratios: we expect that debt will account for about 52% of operating revenues at year-end 2009 (compared with 40% in 2007), or 6.6x the regions' budgeted operating balance, when the level was barely 3x in 2007. Our negative expectations have been reflected by six consecutive negative rating actions (Catalonia, the Autonomous Community of Madrid, Baleares, Aragon, Valencia and the City of Madrid) since July 2008.

Given that we expect depressed revenues over the medium term (we see at least two years of recession in Spain), we have a negative view on the evolution of the country's regional finances. In this context, it is possible, absent other factors, that there could be further negative rating actions. This may be less likely if powerful and enduring cost cutting measures are adopted in forthcoming LRG budgets. The likelihood of such measures is, however, unclear in view of the high rigidity of regional budgets. Discounting other factors, downgrades are, on the basis of the information we have at the moment, most likely in regions with negative outlooks. However, regions with weak budgetary performances during recent years and with revenues that are heavily linked to the real estate sector could also be affected, especially those that have seen steep declines in housing transactions.

We believe that the proposed regional financing reform is unlikely to be able to offset, by itself, the declines that we expect in real estate revenues. It is likely that other measures, such as cost cutting, will be needed. Furthermore, we are still uncertain about the timing of the implementation of the reform (some delays have taken place in recent months) as well as the implications for the financial results of the regions.

Declining Budgetary Performance Is Likely To Boost Swiss LRGs' Gross Debt Issuance To Past Levels In 2009

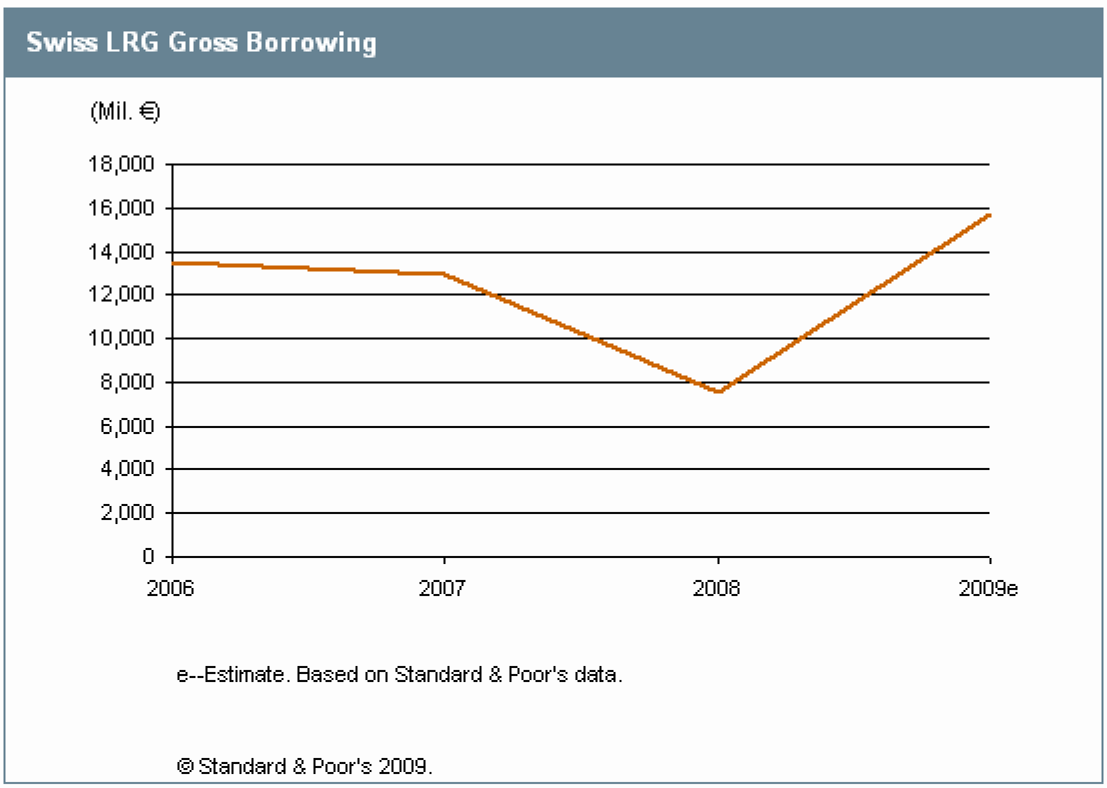
Traditionally large borrowers, Swiss LRGs cut debt issuance considerably in 2008. We believe they were still benefiting from high liquidity after receiving proceeds from a gold sale by Swiss National Bank in 2005. We have observed that exceptionally good economic performance leading to high tax revenue proceeds led to a significant reduction in net borrowing needs for cantons. We understand that some cantons such as the Zurich (AAA/Stable/--) could even reduce gross borrowing to zero using liquidity reserves for repayments.

Large variations between cantons persist, according to our analysis. We believe some of them have used high liquidity cushions to refinance debt falling due or to fund unfunded parts of pension funds. Accordingly, the need for debt issuance is likely to increase over the next few years, starting in 2009, while other cantons will probably be able to avoid using the capital markets. We expect close to CHF23.8 billion in gross issuance by LRGs in 2009, significantly up from CHF13.5 billion in 2008, depending on market conditions for public sector entities and the budgetary effects of a domestic downturn. As tax revenues are likely to decline in 2009 and further in 2010, the resulting financing needs may lead municipalities to issue debt again in the footsteps of the cities of Zurich (not rated) and Biel (not rated).

However, due to what we view as structurally balanced finances in most cantons and a supportive and predictable intergovernmental system, absent other factors, we do not think it likely that the credit quality of rated LRGs will weaken. Depending on the length and depth of the current recession, some LRGs might face a deterioration in their financial standing and/or that of their respective pension funds which, in turn, may prompt them to use part of their cash reserves and/or increase their debt. We will continue to watch the effects of the downturn on individual LRGs. Swiss cities, municipalities, and small cantons typically finance borrowing through bank and insurance loans.

Swiss LRGs' debt stock is one of the largest in Europe. On the basis of published information, we estimate that it amounts to CHF103.5 billion as of 2009, or 6% of the European total. The decentralized federal system and high financing needs of the largest cantons have, in the past, tended to be the main drivers of this high debt. Swiss LRGs have traditionally been active in the domestic bond market to meet their borrowing needs. In particular, cantons and bigger cities frequently use the Swiss franc bond market, attracting mostly domestic investors.

Chart 4



We rate most large Swiss LRG issuers. Their credit quality is robust, and we upgraded three in 2008; the Republic and Canton of Geneva (A+/Stable/--), the Canton of Vaud (AA/Stable/--), and the Canton of Lucerne (AA+/Stable/A-1+). In addition, we revised the outlook on the Canton of Basel-City (AA+/Positive/A-1+) and assigned a new rating of AA/Stable/A-1+ to the Canton of Solothurn.

Central Government Legislation Limits Italian LRG Debt Issuance

We estimate that Italian LRG debt stood at €115 billion as at year-end 2008, little changed from a year earlier. This was contrary to our expectations one year ago and probably due to government legislation that came into effect in mid-2008 and effectively put a halt to debt issuance by LRGs.

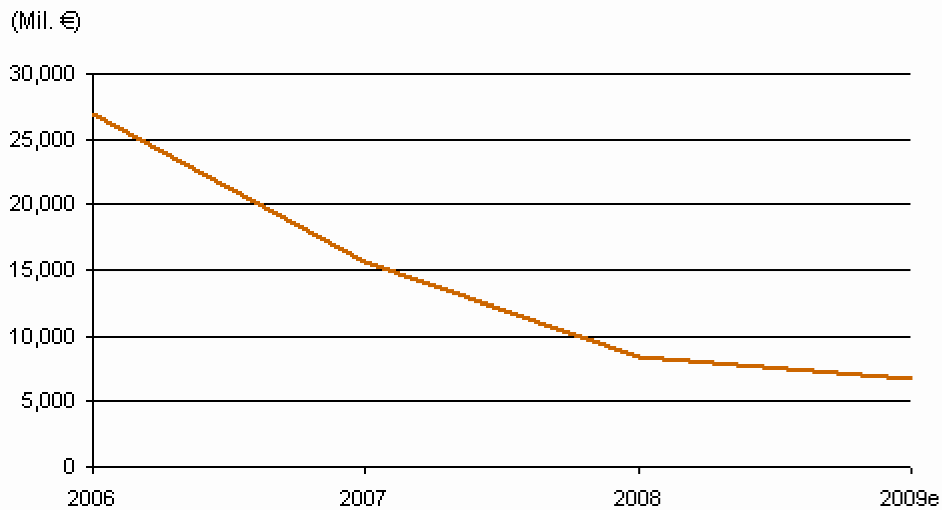
More specifically, in June 2008, a newly elected national government adopted a decree, which further limited Italian LRG financial autonomy.

The decree blocked the ability of LRGs to issue loans, bullet bonds, and bonds carrying an amortization profile of more than 30 years. We understand that the use and renegotiation of outstanding derivative contracts have been frozen pending further legislation.

In addition, we believe that the economic downturn, which generated increasing interest costs in the first part of 2008, prevented LRGs from tapping the markets.

Chart 5

Italian LRG Gross Borrowing



e--Estimate. Based on Standard & Poor's data.

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Assuming the status of the legislative framework for Italian LRGs and debt legislation remains unchanged, we expect LRGs to resort to loans, specifically preferring the government's financial arm, Cassa Depositi e Prestiti, rather than private banks, whose lending to LRGs has been directly curtailed by recent legislation. We expect limited recourse to debt in 2009.

Gross borrowing by regions, which have by far the highest level of LRG borrowing nationally, is, in our view, likely to drop due to delays in the planning of investments, which are partly funded by the EU's 2007-2013 funding program.

Moreover, local governments, principally cities and provinces, have been directly impacted by a national stability pact that has effectively constrained recourse to debt since 2007. Since then, local government debt has stabilized or only slightly increased.

We expect gross Italian LRG borrowing to reach about €7 billion in 2009, slightly below the level reached in 2008, resulting in broadly stable total debt stock.

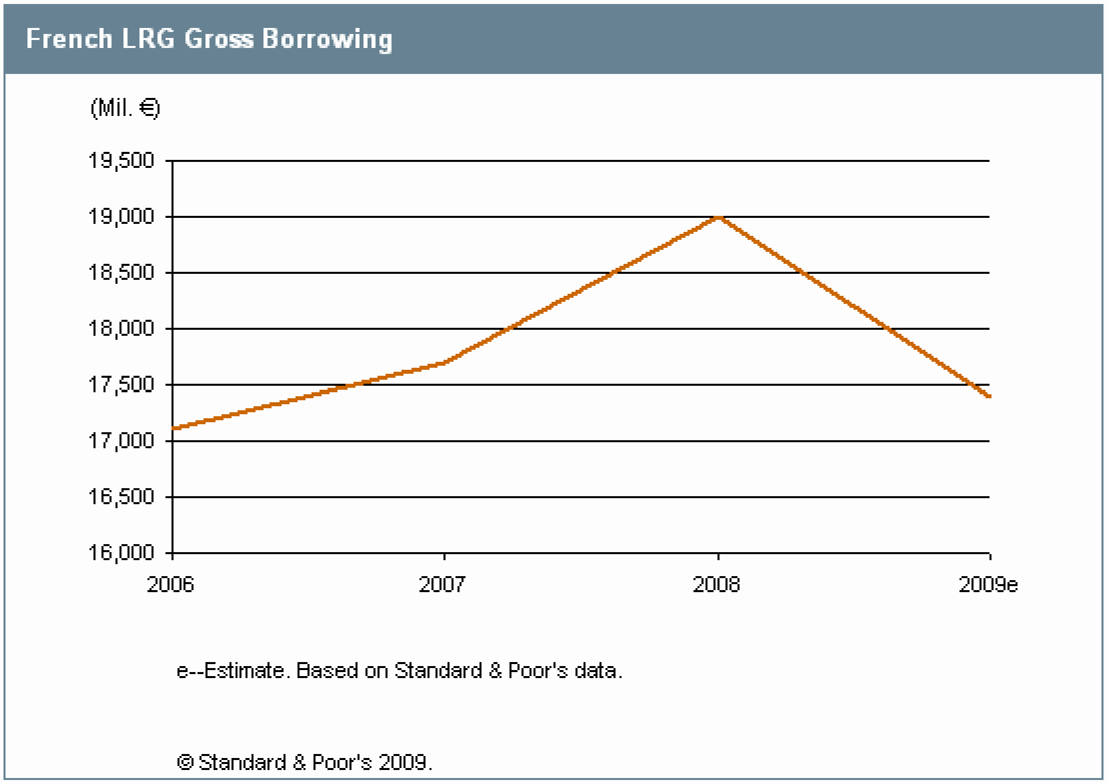
French LRG Borrowing Could Fall This Year; Bond Issuance Could Rebound

In France, municipal elections (as well as partial departmental elections) took place in March 2008 leading to many changes in municipal and intercity councils. The cities' and intercities' capital expenses, which account for nearly two-thirds of French LRG investments, should markedly decrease as newly elected teams are still defining their capital programs. Accordingly, we expect French LRGs to borrow somewhat less in 2009 than 2008 despite incentives to maintain their investments and despite a likely erosion of their self-financing capacity.

As part of a national stimulus plan, the central government will consent in 2009 to shorter delays in value added tax rebates on investments by LRGs that commit to maintain their 2009 investments at the level of the 2004-2008 average. This exceptional capital revenue should in our view alleviate LRG borrowing needs in 2009.

We expect French LRG self-financing capacity to continue to narrow in 2009 as a result of the gap between increasingly sluggish recurring revenues and more dynamic expenditures inflated by transfers of additional responsibilities. The self-financing capacity of the departments is, in our view, particularly exposed to the current downturn in the real estate and job markets through real-estate derived taxes and social welfare allowance. Higher nationwide revaluation of the direct tax base (2.5% in 2009 compared with 1.6% in 2008) and, in our view more importantly, significant direct tax rate increases, one year after elections at the municipal/intercity and departmental level should, however, support the resilience of French LRGs' self-financing capacity. We believe this should remain strong by international standards, covering about 90% of investments on average.

Chart 6



French LRG borrowing is typically concentrated in bank loans, according to our data, with very few entities accessing the capital markets on a regular basis. Extremely competitive loan conditions and the lack of critical mass have, we believe, accounted for the reduced attractiveness of bond issuance for LRGs, at least until the current financial downturn. Since the onset of the downturn, we believe that more LRGs are considering issuing debt, whether directly or potentially through a funding vehicle to diversify their funding base and benefit from more competitive rates.

The credit quality of the largest French borrowers is, in our view, robust, and we rate most of them in the 'AAA' and 'AA' categories. In a context of decreasing flexibility, we believe political will and managerial ability to enforce strong budgetary discipline and adjust expenses is likely to be increasingly important to the preservation of French LRGs' self-financing capacity and financial strength. Long-expected reforms in the institutional and financing framework could be discussed in parliament by year-end 2009; we intend to monitor the impact of any such restructuring on LRG creditworthiness.

Nordic LRGs Set To Increase Debt To Keep Investment Volumes Up

In Denmark and Norway, LRGs typically raise debt through municipal funding vehicles such as Denmark's KommuneKredit (AAA/Stable/A-1+), which has a market share of about 90%, or Norway's KBN Kommunalbanken Norway (AAA/Stable/A-1+) with a 50% market share, Kommunekreditt (not rated), or Eksportfinans ASA (AA+/Watch Neg/A-1+).

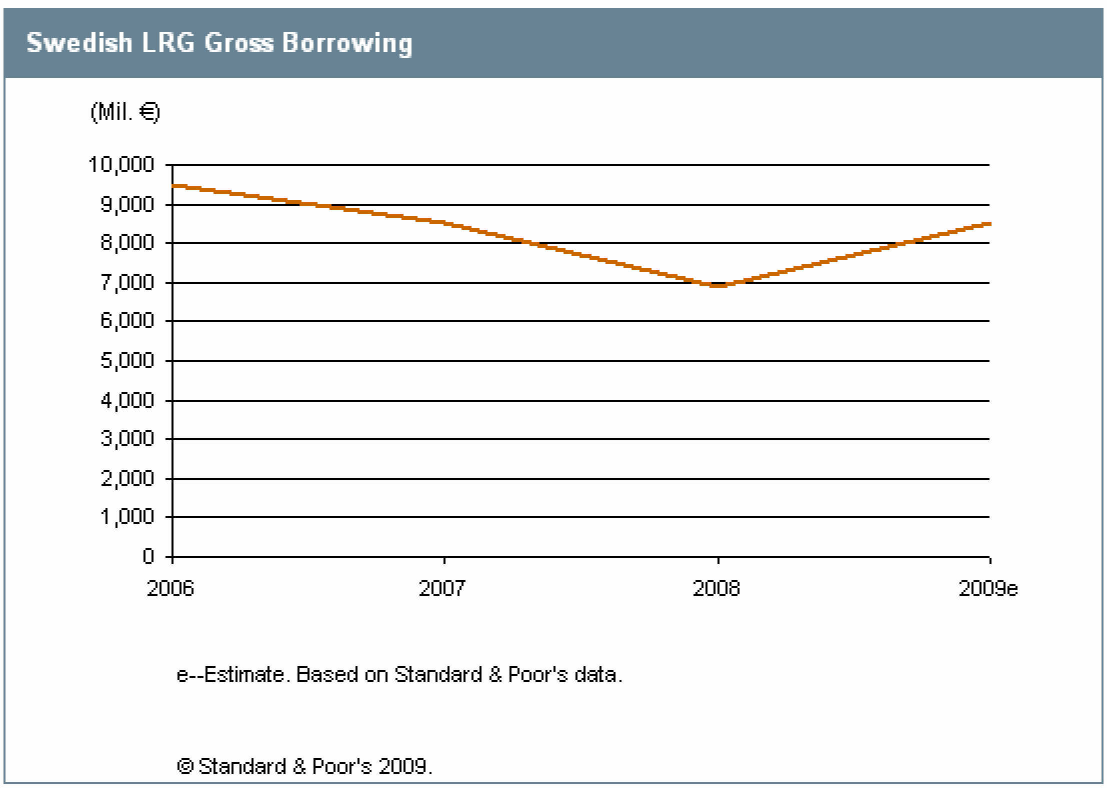
LRGs in Finland generally fund their needs through traditional bank loans as well as through Municipality Finance PLC (AAA/Stable/A-1+), which provides the lion's share of total lending to the LRG sector. Large Swedish municipalities, such as Stockholm (AAA/Stable/A-1+) and Goteborg (AA+/Stable/A-1+) tap the capital markets through euro-denominated medium-term note and commercial paper programs, while the Swedish municipal funding vehicle Kommuninvest i Sverige AB (AAA/Stable/A-1+) has a market share of about 30%.

Debt maturities in Scandinavia, particularly in Sweden, have historically been somewhat short-term. Consequently, gross borrowing has mainly constituted refinancing of maturing debt. However, as economic conditions are broadly deteriorating we think it likely that net debt will increase in 2009.

In Denmark, we estimate that total LRG debt decreased slightly. We believe this was mainly due to a decrease in loan conversions emanating from a structural reform of the LRG sector in January 2007. The reduction in borrowing was, in our view, offset by large borrowing needs in the utility sector which were met by loans guaranteed by local governments. In 2009, we expect Danish LRG debt to remain fairly stable, as the need for investment in utilities is slowing.

For Sweden, deteriorating financial and economic conditions (like those in other Nordic countries) will probably test the credit strength of LRGs in 2009 and beyond. We believe tax revenues are likely to be negatively affected, leading to a decline in revenue growth for LRGs in the years ahead.

Chart 7



A comprehensive equalization system, the ability to increase tax rates, and expected extraordinary state support are mitigating factors that are likely, in our view, to help rated LRGs sustain adequate fiscal balances. For this reason, our outlook on all rated Swedish LRGs is stable. In spite of the economic downturn, we expect, by and large, rating stability in 2009.

However, we think it likely that Swedish LRGs will maintain investment volumes throughout the economic downturn which in combination with declining operational performance may lead to increases in loan financing. Accordingly, we expect to see a slight increase in debt for 2009.

In Norway, we estimate that total LRG debt grew by about 10% in 2008 due to high investment, and similar growth figures are likely in 2009, according to our analysis. Moreover, the Norwegian central government has extended a support scheme to the LRG sector to stimulate investment. For example, the central government will pay all interest costs on loans taken out to refurbish swimming facilities owned by LRGs.

In Finland, we estimate that LRG debt will show slight increases in 2008 and 2009. The majority of debt is raised through the country's national municipal funding vehicle, Municipality Finance, which increased its market share considerably in 2008.

U.K. Borrowing Slowed In 2008 But Is Set To Grow Significantly Over The Medium Term

U.K. LRG borrowing slowed in 2008, reaching its lowest level in several years, according to our data. This fall was, in our view, partly a consequence of increased borrowing in 2006, when many LRGs decided to take advantage of low interest rates and borrow several years' worth of capital requirements. With the related cash held in reserves, and higher interest rates in 2008, we believe local authorities had little motivation to significantly increase their borrowing.

In 2009, we expect net borrowing to decline even further as LRGs in many cases are likely to scale back their capital programs in response to the economic downturn. The downturn in the U.K. property market has, we believe, particularly affected LRGs, which generate fees from property transactions and capital payments from new developments. In addition, some LRGs will realize significant losses from investments in failed Icelandic banks.

Furthermore, all U.K. LRGs are likely to see a decline in investment income in 2009, with domestic interest rates at historic lows. On the other hand, currently low interest rates could represent a good opportunity to take out fixed borrowing, and many LRGs may refinance. Some LRGs may respond to the current downturn by keeping to their capital plans, and borrowing a higher proportion of the costs to make up for lost capital receipts. We do not believe, however, that this will be sufficient to offset an overall decline in net borrowing.

Over the long term, however, absent other factors, we expect a pick-up in borrowing levels. By 2018, for instance, about £9 billion is to be issued by the Greater London Authority (AA+/Stable/--) and Transport for London (AA/Stable/--) alone. Most of this will be used to fund Crossrail, a major rail project.

CEE/CIS LRG Debt Accounts Set To Stagnate And Remain A Marginal Percentage Of The European Total

Due to turbulent financial and economic conditions, we expect recent gradual growth in CEE/CIS LRG debt to stagnate. Moreover, considering existing debt restrictions, financial uncertainty resulting from unsettled intergovernmental systems, and still relatively low financial sophistication, it is, in our view, unlikely that LRG debt in any of the CEE/CIS countries will reach significant volumes in 2009-2011. We estimate the total debt of LRGs in the 12 CEE/CIS countries covered in this study (Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Russia, Turkey, and Ukraine) at €32 billion at end-2009 or only 2.7% of total LRG debt in Europe.

According to our analysis, CEE/CIS debt is primarily concentrated in Russia (41% of total CEE/CIS LRG debt outstanding), Poland (18%), Czech Republic (14%), and Hungary (11%). Russia accounts for 67% of total LRG bonds outstanding in CEE/CIS.

We believe that due to longer debt maturities and smaller budgets, the refinancing of LRG debt in CEE countries outside CIS is smaller than for their Russian and Ukrainian peers. As a result, although Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, and Turkey were responsible for almost 60% of total CEE/CIS LRG debt in 2008, they accounted for only 25% of gross CEE/CIS issuance and 22% of all CEE/CIS refinancing.

CEE/CIS LRGs are moderately exposed to foreign exchange risk, in our view. Debt denominated in foreign currency represents about 25% of total CEE/CIS LRG debt, a proportion that remains constrained by a ban on net foreign currency borrowing in Russia, and complicated foreign currency issuance procedures in Ukraine.

Russian LRG Debt Set To Stabilize In Euro Terms In 2009

In 2009, we expect total Russian LRG debt to increase by a high 34% in domestic currency terms for a second consecutive year as a result of high refinancing pressure and infrastructure investment needs. This is the fastest growth rate since 2003. However, we believe that Russian ruble depreciation against the U.S. dollar and the euro will likely offset the accumulation of Russian ruble denominated debt and that, in euro terms, Russian LRGs' debt outstanding will stabilize at about €13.5 billion. Russian LRG debt structures are expected to change in 2009; notably we believe they may come to rely more heavily on loans from the federal budget and bonds.

High inflation in the construction sector coupled with urgent infrastructure needs put pressure on Russian LRGs in 2008 and, in our view, led to rapid debt accumulation. In our view, worsening borrowing conditions in international capital markets and rising uncertainty about the medium-term trend of macroeconomic indicators reduced the duration of new sub-federal borrowing as short-term bank loans became a dominant source of funding as of the second quarter of 2008, thereby increasing refinancing risks for 2009-2010.

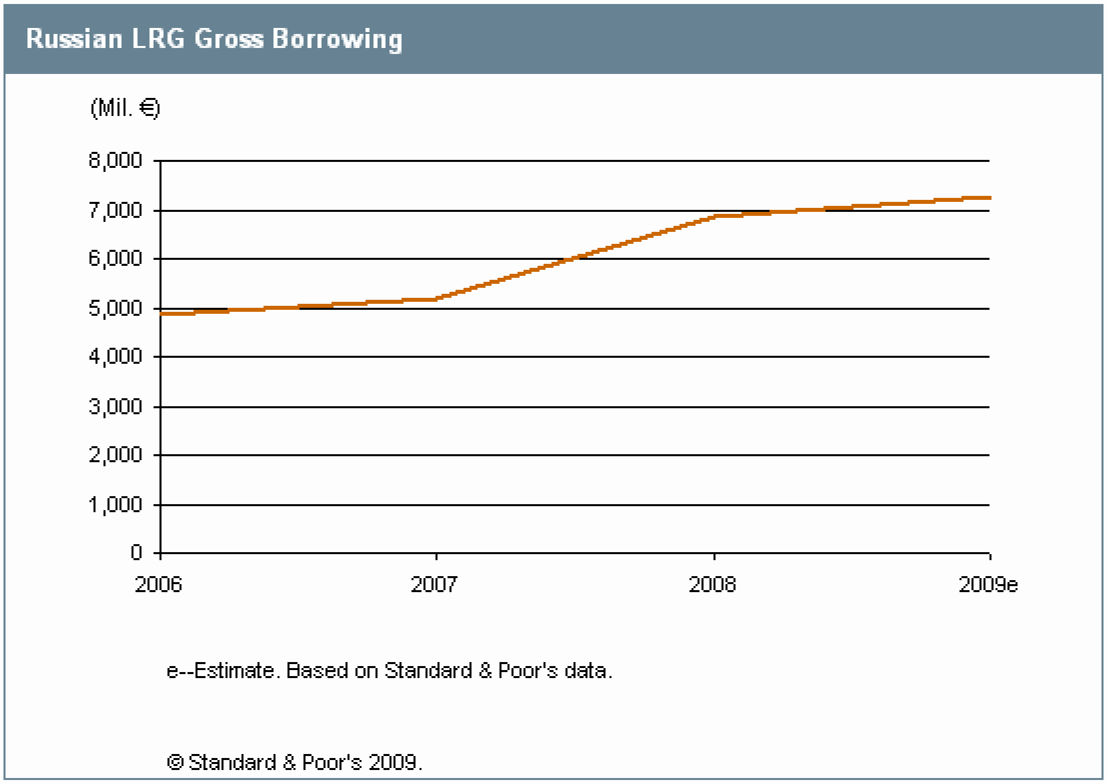
In 2008, Moscow Oblast (not rated) led the rapid accumulation of sub-federal debt: its net borrowing accounted for Russian ruble 48 billion (€1.15 billion), or 37%, of total Russian LRG net borrowings. In April 2009 the ratings on Moscow Oblast were suspended due to insufficient information about its liquidity and consolidated financial policy.

The Russian LRG debt market is dominated by the City of Moscow (BBB/Negative/--) and Moscow Oblast, which together account for more than 40% of Russian LRG debt outstanding, according to our data. The two LRGs will likely retain their leading positions over the medium term. The City of Moscow plans to place bonds to avoid a dramatic reduction of a capital program, while Moscow Oblast needs to raise funds to refinance direct and guaranteed debt falling due in 2009.

Rapid accumulation of short-term bank loans in 2008 has, we believe, led to rising refinancing risk for Russian

LRGs. In 2009, we believe it is likely that Russian regions and municipalities will extend maturing bank loans, but limit recourse to new loans, as the conditions tend to be less favorable than those for budget loans and bonds.

Chart 8



We expect deleveraging of government-related entities and Russian municipalities to further fuel the increase of regional government debt. Extraordinary support to regional companies and budget loans to municipalities in financial distress will probably exert additional pressure on regional governments and may force them to take on additional debt.

We believe that Russian LRGs may pursue different debt strategies in 2009. Regions with low exposure to refinancing risk and moderate operating performances will likely place bonds to boost investment needed to revive local economies, despite what we see as currently negative market sentiment as a result of uncertainty about exchange rate and inflation rate trends. Although such entities as St. Petersburg (BBB/Negative/--) and Khanty-Mansiysk Autonomous Okrug (BBB-/Negative/--) have not tapped the capital market for years due to consistent over performance of revenues as a result of unexpectedly favorable world commodity prices, we believe that they are unlikely to face difficulties raising capital due to their high quality financial management.

LRGs with higher refinancing risk and budget pressure will likely rely on the federal government for soft budget loans, in our view. The Ministry of Finance has already announced that in 2009 it will grant up to Russian ruible 170 billion (€3.43 billion) in budget loans on preferential conditions to help Russian regions bridge liquidity gaps. The interest rate on budget loans will not exceed one-third of the refinancing rate (currently 12.5%) and the maturity may be extended to up to three years. These conditions are much more favorable than interest rates on bank loans with maturities rarely exceeding one year.

We believe that regular bond issuers suffering from high refinancing risk, such as Irkutsk Oblast (B/Negative/--), Moscow Oblast, and Tomsk Oblast (B-/Negative/--), may place bonds privately with state banks, as, according to our analysis, the amount of federal budget loans to be provided in 2009 falls short of the financing needed to compensate for shrinking budget revenues.

In our view, entities with low debt service and moderate deficits may opt to deleverage during unfavorable borrowing conditions and either finance deficits with accumulated cash reserves or delay capital projects.

A ban on net foreign exchange borrowing by Russian LRGs imposed in 2000 has led to a stabilization of sub-federal foreign currency denominated debt. Foreign debt is represented almost exclusively by credit-linked notes issued by the City of Moscow and we expect it to decrease to a small 5.4% of Russian LRG debt outstanding by the end of 2009. In accordance with Russian legislation, the ban may be lifted by 2011 for those Russian regions that receive small or no equalization transfers from the federal budget. Until then, Russian regions' foreign currency debt will likely remain stable.

Ukraine's LRG Debt Market Is Stagnant

In late 2008, we lowered our foreign currency rating on Ukraine to 'B' from 'B+'. As a direct result, we downgraded, six LRGs (except Lugansk, which was already rated 'B') to 'B', to reflect our assessment of their high dependence on central government decisions on their revenue and expenditure responsibilities. This includes dependence on transfers, and central government decisions on salaries. A further lowering of the sovereign foreign currency rating to 'CCC+' in February 2009 resulted in downgrades of all seven LRGs to 'CCC+'. The outlooks on all Ukrainian LRGs are now negative, reflecting the outlook on the sovereign.

In terms of debt profiles, rated Ukrainian entities can be divided into three groups on the basis of our analysis: Kyiv and Odessa, which have foreign currency-denominated debt, and are exposed to foreign exchange risk; Lugansk, Ivano-Frankivsk and Lviv, with modest domestic debt through bond issues; and the Autonomous Republic of Crimea and Dnipropetrovsk, which have zero debt. In 2009, the country's rated LRGs will face only interest payments, with the next principal payments scheduled for 2010 (Odessa), and 2011 (Lugansk, Odessa, Kyiv, Ivano-Frankovsk). Despite limited liquidity (in March 2009, cash reserves averaged 3%-4% of operating expenditure), debt service is not likely to exceed a modest 1%-3% of total revenues for Lugansk, Ivano-Frankivsk, and Lviv in 2009-2010. Kyiv and Odessa will face larger debt service levels, yet these LRGs are economically stronger and should, in our view, be capable of accumulating cash reserves sufficient to meet debt service demands.

We rate seven Ukraine LRGs, which account for more than 90% of all LRG debt in the country, according to data. Kyiv remains the country's only LRG Eurobond issuer and accounts for more than 90% of all LRG bonds outstanding.

Most Ukrainian LRGs typically rely on short-term treasury loans for liquidity and do not have recourse to the bond market and long-term bank debt. Debt accumulation is constrained by a ban on foreign exchange borrowing for all but the six largest cities. Debt is also kept down by other regulations and the conservative and somewhat undeveloped financial management of many potential borrowers.

In addition to Kyiv, only Odessa among rated LRGs has foreign exchange-denominated direct debt, a CHF50 million bank loan. We believe that several cities, including Odessa, Dnipropetrovsk, and Lviv, have issued foreign currency guarantees to support local infrastructure companies borrowing from international financial institutions, but most LRGs have zero or very modest domestic direct debt only.

We view the likelihood of any large issuance in 2009 as very low at the moment, given the weak credit quality of LRGs in the current economic environment and market conditions. However, we expect Ukrainian LRG debt to increase over the medium term, as a result of large infrastructure needs, including the preparation costs for the Euro 2012 soccer tournament, and several infrastructure projects to be financed by loans from international financial institutions. In addition, Kyiv recently received a Ukrainian hryvnia (UAH) 900 million loan provided by banks with central government support, and expects a further UAH300 million loan. As a result, we expect LRG direct debt to rise to a level equivalent to €710 million by the end of 2009, from an estimated €600 million as of year-end 2008, and expect it to grow further in 2010-2012.

The Ukrainian LRG debt market was stable in 2008. In 2007, Kyiv was the driver of overall Ukrainian LRG debt growth, placing $250 million in Eurobonds. However, in 2008 it placed no new debt, due, we believe, to market conditions. Although Kyiv announced plans to issue a $200 million Eurobond or a UAH1 billion domestic issue, neither took place. Small domestic issues were placed by several other cities, but the domestic LRG bond market has declined to UAH530 million, a 9% decline in nominal terms. There were, however, 14 issuers by the end of 2008, up from 13 a year earlier.

Several cities have announced preliminary plans to issue domestic bonds in 2009, including a UAH300 million bond by Lviv and a UAH100 million bond by Dnipropetrovsk. However, we expect only very moderate domestic private placements, if any at all, with total local bond refinancing needs in 2009 at only UAH48 million.

CEE

LRGs in Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Macedonia and Turkey, where we rate 16 LRGs in total, have been gradually accumulating debt over the past several years. LRG debt in these countries reached almost €17 billion at end-2008, and we expect it to rise slightly but remain close to the €18 billion mark this year. We expect growth in 2009 to be dampened by the economic downturn and tough financial conditions. We expect this to be particularly the case in Latvia, Hungary, and Romania, which are restricted by International Monetary Fund standby arrangements and have reduced ability to take on debt.

Debt accumulation has been historically slow in CEE as budgets are small and medium-term planning and financial management are limited in scope. However, infrastructure requirements combined with the need for EU members to co-finance a growing number of EU-sponsored projects have, in our view, generally catalyzed growth in debt. We believe LRGs in CEE are more likely to borrow from banks, notably international financial institutions, rather than issuing bonds to fund their investment needs. As a result, bonds represent less than 20% of their debt compared with about 50% for Russian LRGs, according to our data. The notable exception to this trend is Romania, where bonds represent almost 45% of total LRG debt thanks to a large Eurobond (bullet maturity in 2015) issued by Bucharest (BB+/Negative/--) combined with the rapid growth of the domestic bond market since the country's EU entry. Romania's domestic bond market has grown in the past two years, albeit from a low level, thanks to LRG participation.

We believe a trend of shifting debt off balance sheet from LRG budgets to municipal enterprises is increasing among CEE LRGs, and could contribute to a slowdown in direct debt accumulation over the medium term, while increasing tax-supported debt.

The structure of CEE LRG debt is, we understand, gradually changing and moving toward Western European benchmarks. Particularly in EU countries where LRGs are taking on a rising amount of amortizing loans with lengthened tenors. We expect Polish LRGs to retain the largest CEE debt stock outside the CIS, but for its gross borrowing to remain behind that of Turkey in terms of volume in 2009.

2009 And Beyond

We expect LRG debt in Europe to increase in 2009 and to edge above €1.2 trillion by the end of the year. This expectation depends on increased borrowing by German and Spanish LRGs in particular. Overall, LRG access to the capital markets for refinancing and borrowing needs should remain stable, in our view, as investors seemingly make a distinction between LRG debt and debt issued under central government guarantee programs. Annual funding should remain constant throughout Western Europe to refinance existing debt.

We expect CEE/CIS LRGs' borrowing requirements to stabilze as they weather the downturn in the financial markets but continue to trend upwards as their borrowing needs increase over the medium term. Their share of total European LRG debt stock should remain low, however.

If economic conditions deteriorate further across Europe in 2010 and beyond, an additional increase in new borrowing may be required to offset worsening balances. However, there are uncertainties about the effects of various stimulation packages across Europe and the corresponding involvement of LRGs. As such, the borrowing needs of the LRG sector are very hard to predict in 2010 and beyond.

Overall, and on the basis of the information we currently have, we expect LRG debt to remain under control, and we believe significant credit deterioration is unlikely. Absent new developments, European LRG funding strategies are unlikely to change significantly over the short term. European bond issuance will likely be concentrated in German states and Spanish regions. Meanwhile, the vast majority of municipalities and provinces in Europe will, we believe, continue to rely on traditional bank loans.

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