

## The Fallout from the Debt Crisis in the Euro-zone

### Risk Insights

- Concerns have been mounting over the ability of governments to fund their public debts, especially in Portugal, Ireland, Italy, Greece, Spain (the PIIGS).
- The EU, IMF and ECB have adopted a large rescue package for the euro-zone to contain contagion risks from the Greek debt crisis.
- The package has reduced imminent financing risks in the most vulnerable countries, but only addresses the liquidity problems rather than the structural causes behind the debt crisis.
- The necessary adjustment process to reduce domestic and external imbalances implies much weaker prospects for both exporters to and potential foreign investors in the most vulnerable countries.
- Contagion risks remain a source of concern, particularly relating to financial sector stability and economic growth prospects.
- The sovereign debt crisis entails both risks and opportunities for companies exposed to these markets.
- We recommend increased vigilance, especially with regard to payment and exchange rate risks.

### Contents:

- Recommendations
- Background: What is Happening and Why?
- Outlook: What Will Happen Next?
- Implications for D&B Customers

### Recommendations

*We recommend increased vigilance, especially with regard to payment and exchange rate risks*

If your company is trading in the PIIGS (Portugal, Ireland, Italy, Greece, Spain) and other euro-zone economies, or if you are planning to invest in these markets, we recommend you keep the following points in mind: the importance of looking at country risk rather than just the much more narrow sovereign risk; increased payment risks and the potential for tightening payment terms; the need to closely monitor developments in the PIIGS even if you are not directly exposed to them; and protecting against exchange rate volatility through currency hedging.

1. Downgrades by risk rating agencies such as S&P, Moody's or Fitch, are primarily concerned with sovereign risk (i.e. the creditworthiness of sovereign countries). In the current heightened market turmoil, we recommend to keep in mind that country risk (i.e. the risk to trade and investment returns when doing business in a country) is much more comprehensive. At D&B Country Risk Services we also look at the political, economic and commercial risks affecting businesses dealing in a country. It is this mix of political risks (e.g. political violence), economic challenges (e.g. debt repayment) and commercial factors (e.g. deteriorating payments performance) of which companies exposed to the PIIGS should be aware, not just sovereign risk.
2. We advise companies to monitor their exposure to euro-zone countries carefully. Rising insolvency levels have raised the risk of non-payment in the PIIGS. Given weak payments performance trends by businesses in the PIIGS, companies might want to tighten payment terms with counterparties in these countries.
3. The risk of contagion even beyond the PIIGS remains a problem due to the interconnectedness of European production and supply chains. Even if your

company is not exposed to the PIIGS directly, it is advisable to closely monitor country risk developments in the PIIGS.

- In light of increased exchange rate volatility and the uncertainty about the euro, currency hedging might be a useful strategy for companies exposed to euro-zone trade in order to protect themselves from increased volatility.

**Background: What is Happening and Why?**

*Concerns have been mounting over sovereign debt financing in Portugal, Ireland, Italy, Greece and Spain*

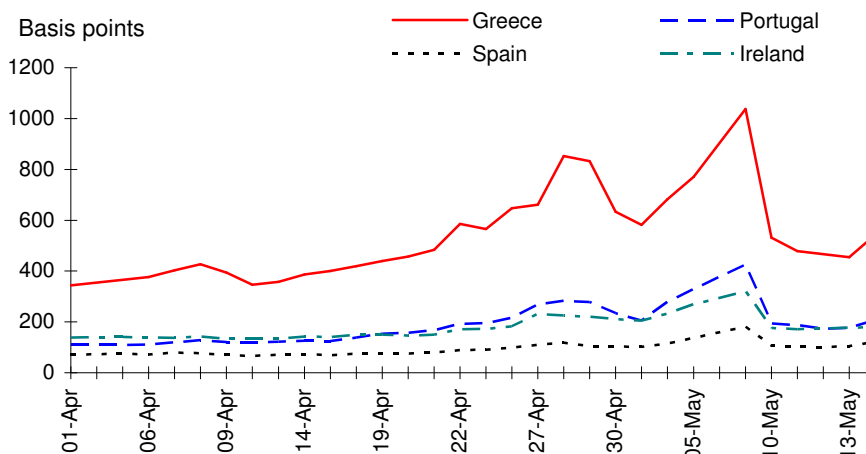
European markets have been thrown into turmoil as financial investors fear that several euro-zone countries will face severe difficulties in financing their large budget deficits and growing public debt burdens, especially Portugal, Ireland, Italy, Greece and Spain (the PIIGS), triggering Euroland’s first systemic crisis. As a consequence, borrowing costs in the PIIGS increased substantially, reflected in much higher government bond yields. The debt crisis was triggered by Greece, whose substantial public debt (115% of GDP in 2009) and budget deficit (14% of GDP) far exceeded sustainable thresholds and reflected sharp revisions of the government’s earlier estimates; the country’s lack of transparency about the scale of its debt burden has been a constant risk factor, with the government regularly revising its budget figures downwards. In late April the debt crisis intensified when sovereign ratings agency S&P cut Greece’s sovereign rating to below ‘investment grade’ status.

Unable to access funds at sustainable interest rates in financial markets, Greece requested support from the EU and IMF, which adopted a three-year rescue package worth EUR110bn for the country. However, Greece’s move also raised serious contagion risks for the euro-zone as a whole, reflected in the sharp increase in borrowing costs for these countries. Investors fear that the other PIIGS, which face similar structural problems, will soon run into similar funding problems as Greece. These structural problems include: weak export competitiveness, the inability to devalue their currencies (as these countries are in the euro-zone), rising unemployment, high household indebtedness, and a propensity to serious social unrest in protest at fiscal austerity. Widespread uncertainty, along with extensive lending to governments, is also affecting the availability of credit to the private sector, with risk premiums rising not only on government bonds but also on corporate bonds in the most vulnerable countries.

*The EU has unveiled a large rescue package for the euro-zone*

As the initial EUR110bn package failed to ease investors’ fears about contagion, on 10 May the EU unveiled a large rescue package worth around EUR750bn for the euro area as a whole. The package consists of: government-backed loan guarantees and bilateral loans (up to EUR440bn) provided by euro-zone member states; EUR60bn through the EU’s balance of payments facility; and up to EUR250bn from the IMF. The ECB will also help ease liquidity risks by buying European sovereign bonds and reintroducing unlimited offers of three-month and six-month liquidity.

**Government Bond Yield Spreads (April-May 2010)**



Note: Chart shows 10-year government bond yield spreads vis-a-vis the German benchmark. Sources: Financial Times, Haver Analytics

*Sentiment in equity, credit and money markets remains volatile*

The EUR750bn deal lowered spreads on weaker euro-zone sovereign debt. The yield on two-year Greek government bonds fell from 22.4% to below 8% within 48 hours, with the yields on Irish, Italian, Portuguese and Spanish debt also falling, as the risk of refinancing woes was allayed. The significant exposure of European banks to this government debt had already affected credit markets, the cost of insuring against losses on European bank bonds hitting a record on 7 May, and the CDR (Credit Derivatives Research) Counterparty Risk Index rising by 46 basis points during the prior week. A severe debt crisis has been averted, and credit markets have calmed slightly, but the risk to the financial system remains (see **Outlook: What Will Happen Next?**). Sentiment in equity, credit and money markets will remain volatile in the short term.

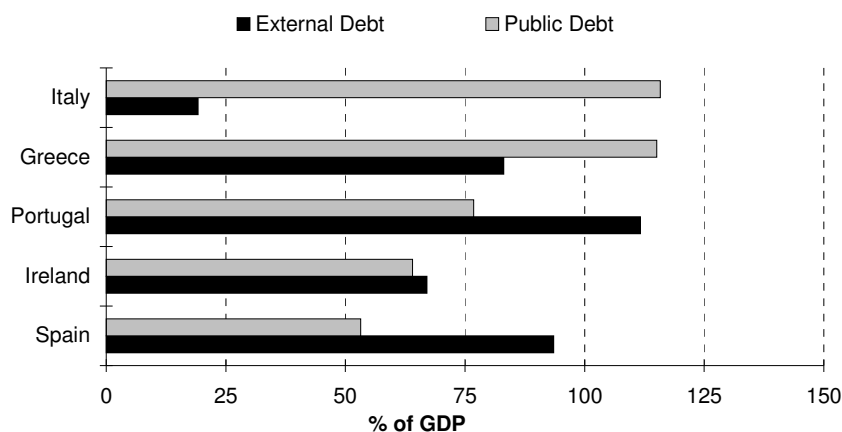
*A deeper analysis of the debt crisis must also consider the structural imbalances within Euroland, such as wide current account deficits in the PIIGS*

The sharp deterioration in public finances in the euro-zone has been the result of the large fiscal stimulus packages adopted across Euroland as well as the recession that has lowered tax revenues and increased welfare costs. A deeper analysis of the debt crisis must also consider the structural causes behind the crisis. First, the euro-zone lacks both a centralised fiscal system (a joint finance ministry, for example) and high levels of labour mobility that could help the currency union to adjust to the asymmetric shock it is currently facing, whereby some member states (the PIIGS) have been hit harder than the others by the debt crisis. Second, high levels of public, corporate and household indebtedness are also reflected in growing external debt: economic agents (government, businesses, and households) in the PIIGS spend much more than they produce, leading to wide current account deficits: Greece's current account deficit reached 11.2% of GDP in 2009, followed by Portugal (10.5%) and Spain (5.5%). This has led to the accumulation of external debt: the net international investment positions (the difference between external financial assets and liabilities) of Portugal (-112% of GDP in 2009), Spain (-94%) and Greece (-83%) are very weak. Hence, the key economic agents in the PIIGS (not just the government) have struggled to finance large debts, reflected in growing dependence on external financial support. Meanwhile, other member states, such as Germany, produce significantly more than they spend, reflected in large current account surpluses, thus exacerbating the imbalances within the currency union.

*We have been warning about the deteriorating economic, political and commercial risk outlooks in these countries for many months*

Credit ratings agencies, government bond investors and the EU have primarily focused on public finance issues (domestic imbalances) in the PIIGS. What we are witnessing now is a serious crisis of confidence in the ability of the PIIGS to refinance their large public debt burdens. But signs of deep economic, political and commercial problems in the PIIGS emerged much earlier. D&B Country Risk Services, which looks at political, economic and commercial risk factors affecting countries across the world (in addition to sovereign risk, the key focus area of the ratings agencies), has been warning about the deteriorating economic, political and commercial risk outlooks in these countries for many months. For example, we have been warning since last year about the fragile economic outlooks and the risks entailed in the rising fiscal imbalances in Euroland.

**Public and External Debt Levels (2009)**



Note: External debt is based on the net international investment position. Sources: National Statistics Offices, Central Banks, Eurostat

**Outlook: What Will Happen Next?**

*Key areas of focus include: risks to economic growth, effects for the corporate sector, political risks and exchange rate risks*

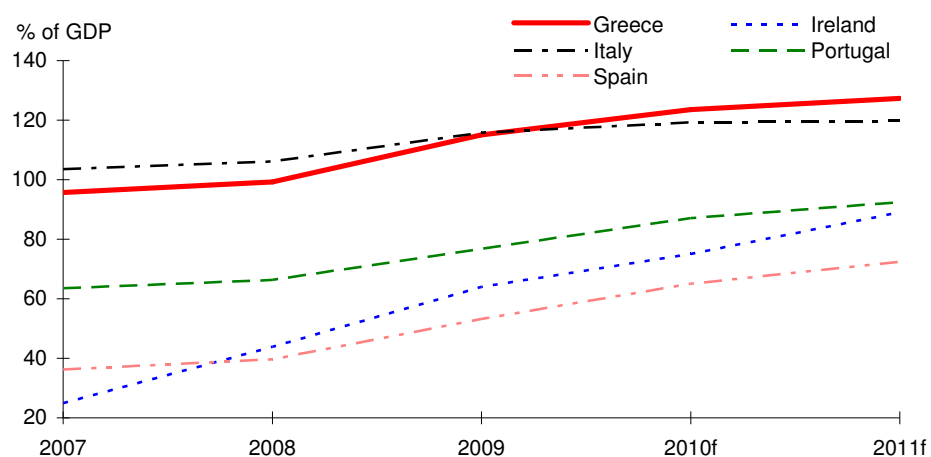
Although the large size of the rescue package has eased investor concerns, the euro has continued to depreciate against the US dollar and stock markets have remained unsettled. Concerns persist over contagion risks. We expect the following risk factors to play a key role in the sovereign debt crisis in the euro-zone in the near future: the risk of 'moral hazard' deriving from the rescue package; risks to the economic recovery in Euroland; the effect of the debt crisis on the corporate sector, especially the financial sector; rising political risks; and increasing exchange rate risks. There are also now growing contagion risks from the euro area's debt problems, even beyond the PIIGS.

1. The large rescue plan increases the risk of 'moral hazard', whereby countries do not implement the necessary steps to reduce domestic imbalances on the assumption that the EU, ECB and IMF will bail them out. This could lead to a re-emergence of financing risks in the medium term.
2. The emergency measures by the EU, ECB and IMF will decrease imminent financing risks in the PIIGS, but will not address the underlying structural causes for the euro-zone's debt crisis (see **Background: What is Happening and Why?**). Credit ratings agencies, government bond investors and the EU have primarily focused on rising public debts and budget deficits in the PIIGS. However, large external imbalances have also contributed to the crisis. Therefore, concerns about governments' ability to repay their debts are only one dimension of the debt crisis. The EUR750bn package will not remove the medium-term need for a painful adjustment process to correct domestic and external imbalances, which will involve many years of public and household spending restraint as well as lower imports and investment inflows.
3. The pressure on governments to implement strict fiscal austerity plans (exacerbated by pressure from debt investors, other EU countries and, in Greece's case, the IMF) could also lead to a prolonged recession: as euro-zone members cannot devalue their currencies to correct internal and external imbalances, the EU and the IMF will impose strict fiscal consolidation measures (including dramatic wage and public spending cuts). These measures could stifle domestic demand in the PIIGS at a time when economic prospects there are already at weak levels.
4. Beyond the PIIGS, Germany and other countries with surpluses will need to raise domestic demand to facilitate this process; however, key risks (including political) threaten to undermine this (demonstrated by Germany's reluctance to adopt comprehensive tax cuts to boost demand). There is a rising risk that the general fear around budget deficits in the EU leads to fiscal restraint even in countries that have much more sustainable debt levels. This could undermine the economic recovery in Euroland as a whole.
5. Companies face further stock price declines and rising costs for insuring against default (reflected in prices for credit default swaps), especially in Greece, Portugal and Spain. This means that companies will face increasing cash flow problems as their market capitalisation and profitability decline.
6. Contagion risks are especially prevalent in the financial sectors across Euroland, which have just started to recover from the global financial crisis and whose balance sheets remain vulnerable. European banks' exposure to debt in the PIIGS is substantial. According to data from the Bank for International Settlements (BIS) and Danske Bank, the total exposure of foreign banks to the PIIGS stood at almost USD3trn at end-2009 (around 21% of Europe's GDP), with French and German banks accounting for a combined 53% of the total exposure. The Greek government, for example, has outstanding securities of around EUR290bn, over twice those of US investment bank Lehman Brothers when it went bankrupt in late 2008. The fact that Greek government bonds are mostly held by Western European banks helps to create stock market tensions across the euro-zone: as investors are losing trust in the PIIGS' government debt paper, banks' balance sheets look much

more risky if they include large amounts of government debt, which, in turn, makes banks less able to lend to households and businesses. These tensions could eventually trigger another credit crunch, especially if Spain and Italy face increasing financing problems (signs of which are already emerging). This threatens a return to financial instability in the euro area as a whole.

7. Political risk will remain a problem. Civil unrest (especially in Greece) has already had negative implications for businesses operating in the most vulnerable countries. Widespread strikes threaten to paralyse daily life in the countries affected and undermine their governments' ability to implement fiscal policies and broader structural reforms, particularly in Greece and Portugal. Moreover, policy-making will remain problematic in most PIIGS. For example, the current minority government in Portugal needs to find partners among the opposition parties to pass legislation, which could hamper implementation of the fiscal plan. The Portuguese austerity plan has already triggered industrial action by trade unions, and we expect further social unrest as unions protest against spending cuts and pay freezes.
8. Finally, the debt problem in the euro area will keep currency volatility at high levels: the debt crisis has already led to a significant depreciation of the euro, which continued despite the large EUR750bn rescue package (in mid-May the euro fell to a four-year low against the US dollar amid ongoing concerns about sovereign debt and the upcoming budgetary restraint in Euroland); the risk of further exchange rate volatility increases uncertainty in trade and investment dealings with euro-zone countries.

### Public Debt



Sources: Eurostat; D&B

### Implications for D&B Customers

#### *The sovereign debt crisis entails both risks and opportunities*

The sovereign debt crisis in Euroland has manifold implications for companies. There are potential risks but also opportunities for companies exposed to the PIIGS, in particular, and other euro-zone countries in general. Companies should bear in mind: the weakening economic outlook; deteriorating payments trends; the opportunities deriving from privatisation programmes; and heightened exchange rate volatility.

1. As mentioned above (see **Outlook: What Will Happen Next?**), the EUR750bn package will not remove the medium-term need for a painful adjustment process to correct domestic and external imbalances in the PIIGS. This will involve many years of public and household spending restraint as well as lower imports and investment inflows; in turn, this implies much weaker prospects for both exporters to and potential foreign investors in the PIIGS.
2. We expect the economic recoveries in the PIIGS to be very fragile in 2010-11. Indeed, the Greek, Irish and Spanish economies are likely to contract again in 2010, while economic growth in Italy and Portugal will only be shallow. Hence, muted

domestic demand in the PIIGS will continue to undermine prospects for exporters to these markets. Meanwhile, economic prospects for potential investors in these markets are not very promising in the short term. For example, as public spending projects are delayed or scrapped, opportunities for investment in infrastructure projects (a key area of investment in recent years) will deteriorate.

3. Companies exposed to Greece and the other PIIGS will have to be extremely vigilant as counterparty risk (such as insolvency risk and payment risks) will remain at heightened levels throughout 2010-11. D&B's cross-border payments data (recording trends for intra-European trade) show that the payments performance of companies in Portugal and Spain in particular deteriorated sharply in Q1, while it remained weak in Ireland and Italy. We expect payments performance in the PIIGS to deteriorate further as credit conditions remain tight, while business profitability will remain muted.
4. However, the economic and fiscal crises in the PIIGS will also offer some opportunities. For example, as part of its fiscal measures to reduce its debt burden, the Portuguese government plans to raise EUR6bn through a privatisation programme, particularly in the airline, rail transport, postal, energy and paper sectors. This and similar privatisation programmes that have been and will be adopted in the PIIGS will open the doors for investors. There are also niche industries, such as the growing renewable energy industry in Portugal, that will offer opportunities for astute investors.
5. The heightened volatility in the currency markets raises uncertainty about trade and investment returns. However, if the decline of the euro continues (which we think is likely in the short term), this would raise revenues for exporters from the euro-zone. The export sector has been the key driver of the nascent recovery in Euroland and a weaker euro will boost export price competitiveness further. However, exporters from non-Euroland European countries will lose competitiveness if their currencies appreciate vis-a-vis the euro; for example, the Swiss franc has appreciated markedly against the euro, posing a significant risk to Switzerland's export recovery. Another 'safe haven' currency, the US dollar, has also appreciated significantly against the euro, making US products less competitive in Euroland. We advise companies to remain vigilant with regard to currency movements.

#### **D&B Country Risk Services**

At D&B Country Risk Services we have a team of economists dedicated to analysing the risks of doing business across the world (we currently cover 132 countries). We monitor each of these countries on a daily basis and produce both shorter analytical pieces (Country RiskLine Reports), at least one per country per month for most countries, as well as more detailed 50-page Country Reports. For further details please contact Country Risk Services on +44 (0)1628 492595 or email [CountryRisk@dnb.com](mailto:CountryRisk@dnb.com).

#### **Additional Resources**

The information contained in this publication was correct at the time of going to press. For the most up-to-date information on any country covered here, refer to D&B's monthly *International Risk & Payment Review*. For comprehensive, in-depth coverage, refer to the relevant country's Full Country Report.