A D&B Special Report
July 2011

Decide with Confidence

# The Euro Debt Crisis, One Year On

## Risk Insights

- The euro debt crisis continues, over a year since the first serious concerns were raised about debt problems in some of the euro-zone economies (especially in the PIIGS: Portugal, Ireland, Italy, Greece, and Spain). More economies have started to receive EU/IMF support in order to meet their growing debt obligations.
- Concerns over the Greek government's ability to repay its substantial public debt have increased following the renewed political crisis in May/June 2011.
- Large household and corporate indebtness in Ireland and Portugal pose a risk to financial sector stability.
- The necessary adjustment process to reduce domestic and external imbalances implies much weaker prospects for 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.
- We recommend increased vigilance, especially with regard to payment and exchange rate risks.

## Contents



*The great uncertainty over the euro debt crisis makes it important to monitor country risk*

## Recommendations

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 that you are mindful of the following factors: it is important to look at country risk rather than just (narrower) sovereign risk; payment risks will be elevated, while payment terms might be tighter (especially as default in one of the PIIGS economies will trigger a liquidity squeeze in the world's financial markets); it is necessary to closely monitor developments in the PIIGS even if you are not directly exposed to them; and it is advisable to reduce the risk of extreme exchange rate volatility through currency hedging.

1. Amid heightened market turmoil, we recommend maintaining close monitoring of country risk (i.e. the risk to trade and investment returns when doing business in a country), which is a more comprehensive picture of a country's risk compared to sovereign risk. At D&B Country Risk Services we look at the political, economic and commercial risks affecting businesses dealing in a country. It is this mix of political risks (e.g. political crisis), economic challenges (e.g. debt repayment) and commercial factors (e.g. deteriorating payments performance) that companies exposed to the PIIGS need to be aware of, not just sovereign risk.
2. We advise companies to monitor their exposure to euro-zone countries carefully: the increased risk of insolvency has raised the possibility of non-payment in the PIIGS. Given weak payments performance trends by businesses in the PIIGS (as well as the threat of a potential default in Greece, Ireland and Portugal), companies doing business within the PIIGS may 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 directly exposed to the PIIGS it is advisable to closely monitor country risk developments in these economies.
4. In light of increased exchange rate volatility and uncertainty about the euro, currency hedging may be a useful strategy for companies exposed to euro-zone trade in order to protect themselves from increased volatility.

*One year on from the emergence of the euro-zone debt problems, the crisis continues*

## Background: The Crisis, One Year On

The euro-zone debt crisis is continuing, one year on from the initial turmoil in European markets on the back of financial investors' fears that several euro-zone countries would face severe difficulties in financing their large budget deficits and growing public debt burdens (primarily Portugal, Ireland, Italy, Greece and Spain, the PIIGS). Furthermore, the risk of a systemic crisis in Euroland's financial sector looms more prominently than ever. Triggered by Greek public sector imbalances (which, in 2009, far exceeded sustainable thresholds and reflected sharp revisions of the government's earlier estimates), in May 2010 the EU unveiled a substantial rescue package of around EUR750bn for the euro area as a whole. The package consisted 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 also agreed to help ease liquidity risks by buying European sovereign bonds and reintroducing unlimited offers of three-month and six-month liquidity.

However, the rescue package has so far failed to provide sufficient confidence to the financial markets, as the problems facing the PIIGS stem not just from a short-tem liquidity squeeze but also from more deep-rooted, structural mechanisms. These include: weak export competitiveness; the inability to devalue their currencies (as these countries are in the euro zone); poor labour cost competitiveness; high household indebtedness (in the case of Ireland); and high corporate indebtness (in the case of Portugal and Spain). As such, Greece, Ireland and Portugal are in the most vulnerable position and are most likely to be affected by the repercussions of the potential Greek default, while Spain and Italy have so far managed to gather sufficient funds to cover their public obligations in the financial markets.

**Competitiveness indicators (2010)**

| | D&B risk rating (end-2010) | Unit labour costs index | Export growth: real % change |
|---|---|---|---|
| Greece | DB4b | 137.9 | 10.8 |
| Ireland | DB4a | 127.5 | 6.2 |
| Portugal | DB4a | 125.4 | 8.8 |
| Spain | DB3d | 129.4 | 17.4 |
| Italy | DB3a | 131.5 | 9.1 |
| France | DB2b | 122.9 | 13.6 |
| Germany | DB1d | 105.8 | 19.2 |

Sources: Eurostat; D&B

***Greece***

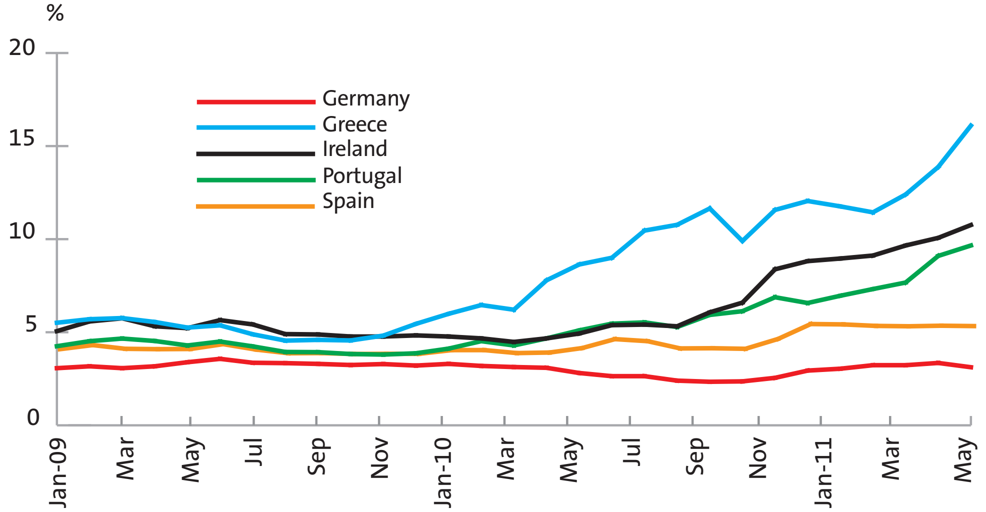
*The first crisis was triggered in May 2010 by Greece's large public debt...*

A combination of factors led to the ongoing Greek debt crisis that began in early 2010: the traditionally weak state of public finances; the global financial crisis; revelations about deliberate misreporting by the Greek authorities on the true extent of the country's debt burden; and the country's lack of competitiveness (which has made it difficult for the country to generate sufficient funds to finance its debt without external aid). In late April 2010 the debt crisis intensified when sovereign ratings agency S&P cut Greece's sovereign rating to below 'investment grade' status, with other agencies following suit; these downgrades came around nine months late and intensified the debt crisis at the time (D&B had already downgraded the country several times in 2009 to reflect the rising economic, political and commercial risks). The downgrades by the ratings agencies further increased borrowing costs for the government (reflected in record-high spreads between Greek 10-year government bond yields and the German benchmark, see chart). Unable to access funds at sustainable interest rates in financial markets, Greece requested support from the EU and IMF, which generated a three-year rescue package worth EUR110bn for the country in May 2010.

*...and exacerbated by further financial pressures in mid-June 2011*

However, in mid-June 2011, the EU has been pressured to negotiate a new three-year, EUR80bn bailout package as the country struggles to implement the fiscal austerity plan imposed by the first EU-IMF bailout package (amid rising social unrest and political instability) and is unable to service its increasing debt. Negatively, the EU and IMF have decided to temporarily hold off on disbursing the latest EUR12bn tranche of the bailout deal until the Greek parliament adopts fresh fiscal austerity measures (which occurred on 29 June). However, even with the new plan in place, the short-term future for Greece remains uncertain, while the risk of a default continues to be high. In fact, every quarter that a loan instalment is due, Greece will either hit deficit targets or be forced to pass further reforms to get the plan back on track.

10-year Government Bond Yields




Sources: Eurostat; D&B

*Ireland's debt problems stemmed from troubles in the banking sector...*

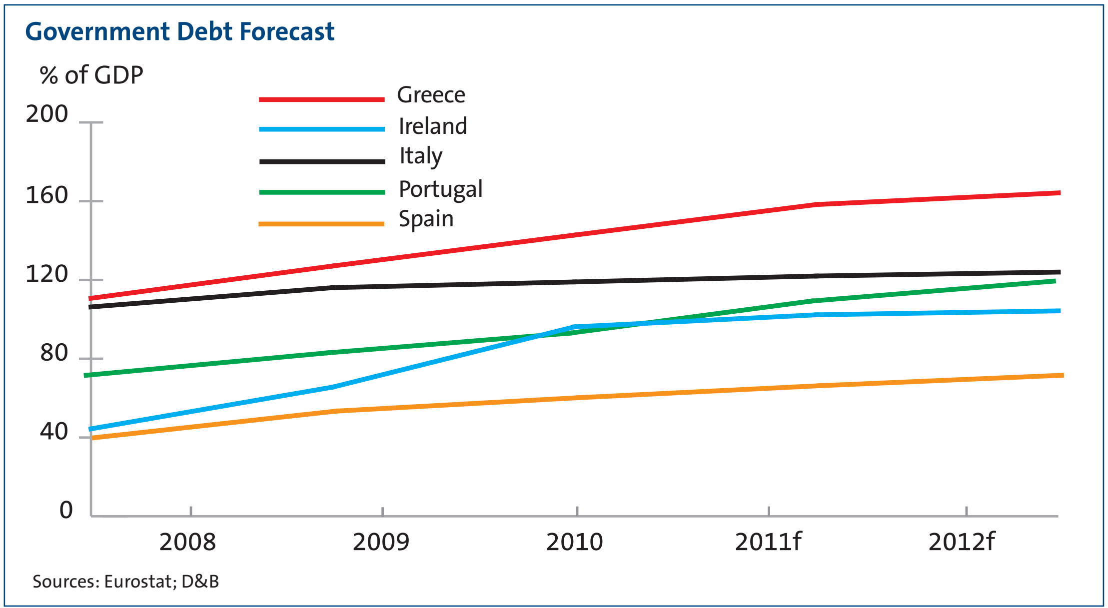
### *Ireland*

Irish public debt rose from 40.6% of GDP in 2008 to 96% of GDP in 2010. This was driven by a crisis in the country's banking sector (which suffered from unsustainably high household indebtedness: 211% of household income in 2009) and rising levels of non-performing loans (over 11.0% of total loans were in the non-performing category in Q1 2011). As a result, the authorities had to inject capital into all the major banks (Allied Irish Bank, Bank of Ireland and Anglo Irish Bank), effectively nationalising almost the entire banking sector. However, the cost of rescuing the Irish banking system has far exceeded the initial estimates of EUR25bn, and in November 2010 the government had to secure EUR80bn in bailout funds from the EU and IMF in order to help finance rapidly-rising public debt. The EU/IMF funds were partially financed from the EUR750bn European Financial Stabilisation Mechanism (EFSM) set up in May 2010, and partially from bilateral financing from the UK; all this took the form of a three-year package of loans with an interest rate of 5.8% (about 260 basis points lower than the interest rates demanded by private investors at that time).

Positively, according to the stress tests carried out by the central bank of Ireland in May 2011, the two most troubled banks (Anglo Irish Bank and Irish Nationwide Building Society) are unlikely to require more than the EUR34.7bn already received from the Irish government in 2010, bringing the total bill for rescuing the banking sector to EUR70.0bn (less than the previous estimates of EUR80.0bn). However, the centre-right government hopes to rescue some of the capital by imposing a degree of burden-sharing and losses on creditors (so-called 'haircuts'). In early June 2011 the government announced that under the most recent plans, not only will junior bondholders have to face losses, but the burden-sharing may also affect senior bond holders (who traditionally ranked above junior debt holders and on the same level as depositors).

*...but the country is better placed to generate growth and repay its debt as it matures*

Positively, the amount of unsecured senior debt has been reduced and (as of February 2011) stood at EUR3.1bn for Anglo Irish Bank and EUR600m for Irish Nationwide, according to figures from Barclays Capital. That said, the risk of Irish default remains high (we expect the spill-over effect from the potential Greek default to increase Irish borrowing costs and lead to debt restructuring), but we believe that Ireland is better placed than Greece and Portugal to generate growth, given its strong export competitiveness and the presence of foreign investors, and as such it is likely to be able to repay its debt as it matures.




*Political turmoil forced Portugal to seek international financial support*

***Portugal***

The debt crisis in Portugal has been exacerbated by political turmoil; in mid-March 2011 the Portuguese Prime Minister Jose Socrates resigned from office after the country's parliament rejected his government's austerity measures (which were intended to avoid a bailout). As a result, the caretaker Socialist administration had no choice but to secure a bailout package from the EU, as emergency external funding was needed to meet the costs of redeeming and refinancing Portugal's external debt obligations. A EUR78bn bail-out programme was agreed in early May, which focuses on three pillars of the economy: fiscal adjustment; strengthening the solvency of the banking sector; and improving competitiveness.

Positively, the centre-right coalition government that emerged after the general election on 5 June) is committed to the EU/IMF programme. With a healthy parliamentary majority, the government is likely to improve financial market confidence in Portugal and avert the country's economic and financial collapse. However, the challenge is substantial: the EU bail-out plan sets a budget deficit-reduction target of 3% of GDP (by 2013, from more than 9% in 2010), via implementing another set of tax hikes, spending cuts, labour market reforms, bank recapitalisations, and an accelerated privatisation programme. The reforms enjoy broad political support, but we expect the risk of labour unrest to increase in coming months, particularly given that the coalition's Social Democratic Party does not have close links to trade unions. Moreover, a weak economic outlook will remain the country's biggest challenge (overall we expect the economy to contract by an average of 1.9% in 2011-12), while high corporate indebtedness (see Debt Levels in the PIIGS chart) poses the risk of increased bankruptcy levels.

**Debt Levels in the PIIGS (2010)**

| | Public sector (% of GDP) | External sector (% of GDP) | Non-financial corporations (% of GDP) | Household debt (% of GDI) |
|---|---|---|---|---|
| Greece | 142.8 | 183.8 | 71.5 | 84.8* |
| Ireland | 96.2 | 1,093.5 | 283.7 | 211.3** |
| Spain | 60.6 | 162.7 | 197.9 | 125.3 |
| Portugal | 93.0 | 229.3 | 147.3 | 133.7 |
| Italy | 119.0 | 116.9 | 116.1 | 71.6 |

Notes: GDI = Gross Disposable Income; * data for 2008; ** data for 2009.
Sources: Eurostat; D&B

## Outlook: What Will Happen After a Greek Default?

The outlook for the euro zone remains uncertain; however, it is clear that the current levels of sovereign debt cannot be sustained, and this is likely to lead either to some form of debt restructuring or to the establishment of closer fiscal ties with the EU/euro zone.

### *Re-profiling, Restructuring, Default*

*The possibility of Greece defaulting is higher than ever...*

Despite Greek's favourable vote on the first austerity package (which will focus on raising taxes to secure some EUR14.1bn over the next five years and introduce EUR14.3bn in public spending cuts), the country is still a long way from solving its debt problems. Apart from the EUR12.0bn tranche (which the IMF will most likely pay out in July), the public finances will require a further three-year bailout of around EUR80bn on top of last year's funds in order to meets Greece's financial obligations (and even that may prove insufficient).

Accordingly, as of mid-June, suggestions emerged about including an element of private sector participation, which will amount to a 'soft restructuring' of Greek debt (some call it 're-profiling'). A consensus is emerging over a voluntarily debt roll-over whereby current bondholders agree to replace maturing Greek government bonds with new bonds. Despite the fact that a voluntary roll-over may not be regarded as a credit event (default), it could still prompt sovereign credit rating agencies to downgrade Greece to 'default' status, which could trigger payments on credit default swaps (insurance against default).

*...as the scale of fiscal retrenchment will not support economic recovery in the medium term*

Despite any 'soft restructuring' it is very likely that there will also be a 'hard restructuring' (forced default) on a substantial part of Greek debt in the medium term. This is because the debt and its current servicing costs are so high that the amount of fiscal tightening that Greece would have to undergo to cater for them is unsustainable in the medium term. Indeed, dealing with such a serious debt problem requires increased taxation as well as reductions in government spending. According to Nomura Bank's Europe Will Work report, the projected fiscal consolidations in the euro periphery will be too large to enable the country to return to growth in the medium term; in order to reduce the current level of debt to the EU's recommended debt-to-GDP ratio of 60.0% Greece would have to carry out fiscal consolidation of 16-18 percentage points (pp) between 2009 and 2030. The numbers are similarly large for Ireland (at 14-16pp of GDP) and Portugal (8-10pp).

These calculations assume that the differential between interest rates and real GDP growth rates would level at around 1pp; however, the actual differential could be much higher (especially given the steep increase in the cost of borrowing for these three governments since April 2011; see the 10-year Government Bond Yields chart). Indeed, with yields on Greek 10-year government bonds averaging 15.5% between April and June 2011, the increase in public debt has outpaced any fiscal adjustment that the government could achieve. As a result, the government debt, which was expected to peak at about 150% of GDP, it is now likely to grow to over 160% of GDP (even if the tough budget targets set in the bailout deal are met). As such, talks about some form of a default are well grounded.

### *Fiscal Union*

*The alternative to default is closer fiscal ties in the entire euro-zone...*

The alternative to debt restructuring is a creation of greater union, which would take the current economic and monetary union (EMU) one step further and also involve greater fiscal controls. While a few years ago it would have been impossible to consider that a country would surrender a part of its fiscal sovereignty, today this idea no longer seems so unbelievable. In fact, this could happen even if any of the PIIGS economies were to default, as the immediate consequence of a default would be a large fiscal transfer from the creditor countries, who are than likely to demand some kind of assurance that their funds would be repaid. Therefore, even if the debt is permanently rolled-over, or if a default occurs in the indebted economies, we expect the EU (or at least Euroland) to eventually arrive at some kind of fiscal union. However, for greater fiscal integration to work, significant changes are required: in the euro-zone institutions; in EU policies; and in the approach to dealing with future crises.

According to some experts, the EU (and in particular the euro area) requires the creation of a supra-national office, with powers that would override national policies (even if only in times of emergency). This would enable the EU to deal with the crisis in a more timely manner and reduce its repercussions (such as rapid movements of the euro or higher yields on government bonds). However, the European Council (which comprises the heads of state or government of EU members) has not proved itself during the current crisis, as swift consensus among 27 representatives is difficult to obtain.

*...but significant changes are required in key areas relating to fiscal policy*

Moreover, for the fiscal union to function more efficiently it is essential that key policy areas related to fiscal policy are centralised. These would most likely include greater centralisation of financial sector supervision (the beginnings of which already exist in the new EU-wide European System of Financial Supervision, which came into force in January 2011). Lastly, there has to be an instrument which could enable a fiscal transfer between euro-zone members, and which would have to be combined with an assurance that this fiscal 'credit' would not lead to contagion to the lender. The idea of the 'euro-zone bond', proposed by Jean-Claude Juncker (Luxembourg's prime minister) and Giulio Tremonti (Italy's finance minister) is one possible solution. The bond (issued by some form of EU debt agency) would be able to raise the necessary funds required for easing liquidity pressure in the euro periphery, while insuring against a risk of contagion (when the default of an indebted euro-member triggers a default of the creditor due to the size of the losses).

Overall, it is clear that the euro-zone crisis is no longer only about Grece or Ireland's ability to service their mounting debt levels: the crisis is also now linked to the political predicament of what direction the EMU should take in the medium term. The concern that was expressed at the time of the euro's introduction in 1999 is once again being voiced: that no monetary union can be successful without a fully supportive fiscal policy.

**Implications**

*Banks will bear the biggest impact from any Greek default...*

***Private sector implications:*** amongst the private sector players the biggest impact of the Greek default will fall upon banks, which have been key creditors to the peripheral euro-zone governments for a number of years. Although trading volumes in euro-zone government bonds issued by Greece, Ireland and Portugal fell to record lows in May 2011 (as new disagreements over another international bail-out for Greece came to light), the exposure of the private sector to sovereign debt is still substantial. According to the OECD working paper *The EU Stress Test and Sovereign Debt Exposures*, the biggest exposure to Greek government debt is held by German banks (at 12% of their Tier 1 capital by end-2009). Moreover, the same paper estimates that Greek banks' exposure to their own sovereign debt is substantial (at 226%); the largest exposures to Tier 1 capital are associated with Agricultural Bank of Greece (807%) and TT Hellenic Postbank (418%). The same problem (albeit at a significantly lower level) exists in Portugal and Ireland, where each country's own banks hold about 69% and 26% of their Tier 1 capital respectively. As such, we expect feedback loops between the public sector and the banking sector in the defaulting country, as well as impacts on banking sectors in creditor countries.

Positively, it is unlikely that Greece (or any other peripheral economy) will default on its debt with a 100% loss to creditors. So far, nobody (not even the most euro-sceptic ratings agencies) argues that Greece would need to impose a 100% haircut to restore its debt sustainability and, as such, we expect the impact on other countries' banks' capital base to be serious but not fatal. In fact, if the recent plan of voluntarily debt roll-over is agreed, the creditor banks might have sufficient time to boost their capital ratios and therefore be able to withstand the loss on the Greek debt to a great extent. However, in the unlikely scenario of all three of the PIIGS imposing significant haircuts, the impact on some European banks and insurance companies could be damaging.

*...while the corporate sector would be affected by a credit squeeze...*

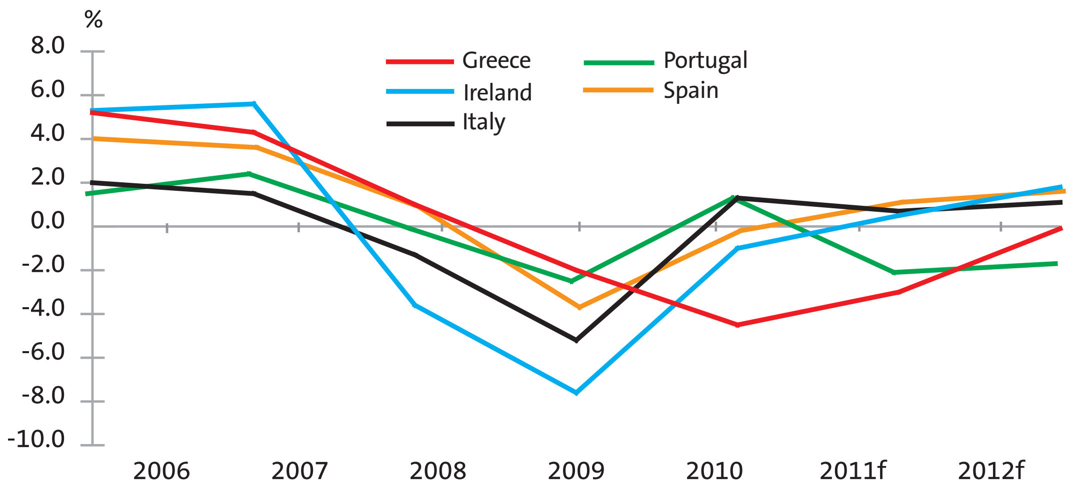
Meanwhile, we believe that the impact of a default on any non-financial Greek company that is currently doing well would be not significant, with companies being as creditworthy as they were prior to the Greek crisis. Unlike in a scenario in which a crisis of confidence can lead to sharp depreciation/devaluation of the currency (and increased transfer/FX transaction risk), default within the euro framework could still be managed and lead only to debt-restructuring rather than to a general Greek default. That said, a financial credit squeeze (which would most likely follow a government default) could eventually lead to higher number of bankruptcies among non-financial companies.

Lastly, any default would probably have a destabilising impact on the entire European financial sector. Under the current set-up the ECB cannot accept 'restructured' (i.e. de facto 'defaulted' debt) as collateral when providing additional financing to the central bank of Greece. With net claims by the Greek central bank on the ECB standing at EUR87.1bn as of December 2010 (and an even larger EUR146.1bn for the Irish central bank), the impact on liquidity in the national banking sector could be substantial and could result in a capital squeeze for banks and short-term implications for banks in the wider region (before national crisis management steps are undertaken).

*...and prospects of slower growth in the forecast period*

*Slower economic growth in the region*: In either scenario (default or debt roll-over) it is clear that all of the PIIGS will have to continue subjecting their public finances to steep cuts for the next few years. However, not only the size but also the form of fiscal retrenchment is important. Fiscal consolidations that cut expenditure (rather than raise taxes) are generally expected to produce a better growth outcome over the long term; however, fiscal consolidation in the peripheral economies has so far tended to concentrate on the revenue side. As such, we expect fiscal consolidation to have a short-term effect on growth levels (see Growth Forecasts chart) but also potentially hit long-term growth potential.

**Growth Forecast**




Sources: Eurostat; D&B

*The default will also impact the wider region, the EU and the CEE region*

*Repercussions across Europe:* Any potential default in the euro periphery will also have an impact on the wider EU; countries in Central and Eastern Europe (CEE) will see reduced export demand from the euro area (which will impact on economic recovery), still-fragile credit availability may suffer again, while economies with a large exposure to foreign currency-denominated loans may suffer from rapid currency movements. For example, the Swiss franc hit a new historic high against the euro in mid-June, trading at CHF1.20:EUR as of 16 June, and impacting on credit repayments in countries such as Poland and Hungary. Also, a liquidity squeeze among the Greek banks would inevitably affect countries such as Romania, Bulgaria and Macedonia, where the banking sector relies heavily on Greek banks' participation.

*The crisis has numerous implications for companies*

## Implications for D&B Customers

The sovereign debt crisis in Euroland has manifold implications for companies, with potential risks including a weaker economic outlook, deteriorating payments trends, and heightened exchange rate volatility.

1. As mentioned above, despite the Greek government's successful passing of the austerity plan, the size of the debt and the level of interest rates will eventually lead to some form of a default. This will imply a painful adjustment process to correct domestic and external imbalances in the PIIGS, and involve many years of curtailed public and household spending. As such, we expect import demand to remain muted, while investment inflows from abroad will be subdued; in turn, this implies much weaker prospects for both exporters to and potential foreign investors in the PIIGS.
2. We expect economic recoveries in the PIIGS to be very fragile in 2011-12. Indeed, according to our forecast, the Greek, Irish and Portuguese economies will contract again in 2011, while economic growth in Italy and Spain 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 2011-12. 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, and remained weak in Ireland and Italy. We expect payments performance in the PIIGS to deteriorate further as credit conditions stay tight and business profitability remains muted.
4. Heightened volatility in the currency markets raises uncertainty about trade and investment returns. The euro's nominal effective exchange rate (according to J.P. Morgan's trade-weighted currency index) shows that the euro appreciated by almost 7% against a basket of other major currencies between early 2011 and April 2011. This appreciation came on the back of a slight easing of concerns about the sovereign debt crisis in the euro zone, as well as the expectation of sharper-than-expected interest rate hikes by the ECB. However, the euro then depreciated sharply in May 2011 as concerns about sovereign debt resurfaced, before undergoing a mild appreciation again since late May.

   We expect the forces behind appreciation and depreciation to balance each other over the rest of 2011–12, although there remains a risk of a return of the sharp exchange rate volatility witnessed since the outbreak of the global financial crisis. We expect the euro's exchange rate vis-a-vis the US dollar to average EUR0.71:USD in 2011 and EUR0.70:USD in 2012; in 2010, the euro had been weaker, at EUR0.75:USD (a higher exchange rate means a weaker home currency). Worryingly, exchange rate volatility decreases the predictability in trade and investment dealings with businesses in the euro zone. Currency hedging might be a useful strategy for companies to protect against high levels of volatility.

## 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**.

## 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.