

Euro Debt Crisis Contagion in Central and Eastern Europe

Risk Insights

- The EU, IMF and ECB have adopted a substantial rescue package for the euro-zone to reduce financial risk stemming from the Greek debt crisis.
- Despite this package, the risk of contagion among the newest EU members remains high.
- A number of countries in Central and Eastern Europe (CEE) face similar problems to Greece: weak export competitiveness, rising unemployment and high household indebtedness.
- Key factors likely to increase risk in CEE include uncertain economic growth prospects, financial stability issues and delays to adopting the euro.
- Based on the probability of contagion: **Higher risk countries:** *Latvia, Hungary, Romania*; **Moderate risk:** *Lithuania, Bulgaria, Slovenia, Slovakia, the Czech Republic*; **Lower risk:** *Poland, Estonia*.
- We recommend increased vigilance, particularly in the higher and moderate risk countries, especially with regard to payment and exchange rate risks.

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Recommendations

Although the large IMF/EU rescue package has mitigated potential short-term liquidity problems in Euroland (also referred to as the euro-zone or euro area, i.e. countries that use the euro as their currency¹), the risk of contagion to Central and Eastern Europe (CEE) remains high. As such, the CEE countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia, the last two of which are also euro-zone members) remain vulnerable, especially given the interconnectedness of supply chains in Europe. Moreover, even if fiscal mismanagement was not an issue in these countries (as it was among the so-called PIIGS: Portugal, Ireland, Italy, Greece and Spain), the problems in non-euro-zone economies are similar: a loss of competitiveness and excessive allocation of resources towards non-tradable (mostly services) sectors. In order to reduce exposure to potentially troubled markets, the following points should be kept in mind:

1. Ratings given by credit rating agencies such as S&P, Moody's and Fitch are primarily concerned with sovereign risk (i.e. the creditworthiness of sovereign governments); however, in the current economic climate we believe that country risk (i.e. the risk to trade and investment returns when doing business in a country) requires a much broader perspective. 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) that companies exposed to European economies need to be aware of, not just sovereign risk.
2. We advise companies to monitor their exposure to European countries carefully. High insolvency levels have raised the risk of non-payment, while the already-challenging business environment in CEE undermines payments performance in the

The risk of contagion from the Greek crisis in CEE is still high

¹ The countries using the euro are: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Italy, Ireland, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

region compared with Euroland economies. We therefore advise tightening payment terms when trading with counterparties in the region, especially the higher risk economies (see **Outlook: What Will Happen Next?**).

3. In light of increased exchange rate volatility, especially with regard to the euro, companies exposed to euro-zone trade and trade with CEE countries might find currency hedging a helpful strategy for protecting themselves.

Background: What is Happening and Why?

Market Turmoil and Rescue Packages

The initial systemic crisis was triggered in May 2010 by Greek public debt...

In April and May 2010, European markets were thrown into turmoil as financial investors feared that several euro-zone countries faced severe difficulties in financing their large budget deficits and growing public debt burdens, especially Portugal, Ireland, Italy, Greece and Spain (the PIIGS). This triggered 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. These levels were much larger than the government's earlier estimates, and exposed the country's lack of statistical transparency and thus reduced confidence in the Greek government. These developments prompted increased concern over potential problems in other economies within the euro area (in particular the PIIGS), forcing EU leaders to act rapidly in order to prevent a wider financial crisis.

...forcing EU leaders to create a substantial rescue package for the euro-zone

After the initial EUR110bn package failed to ease investors' fears about contagion, on 10 May the EU unveiled a bigger 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 also promised to help ease liquidity risks by buying European sovereign bonds and reintroducing unlimited offers of three-month and six-month liquidity. The deal provided the necessary assurance to financial markets, with spreads on weaker euro-zone sovereign debt falling significantly almost overnight.

Structural Threats Persist

Although immediate financing risks have been mitigated, structural threats persist...

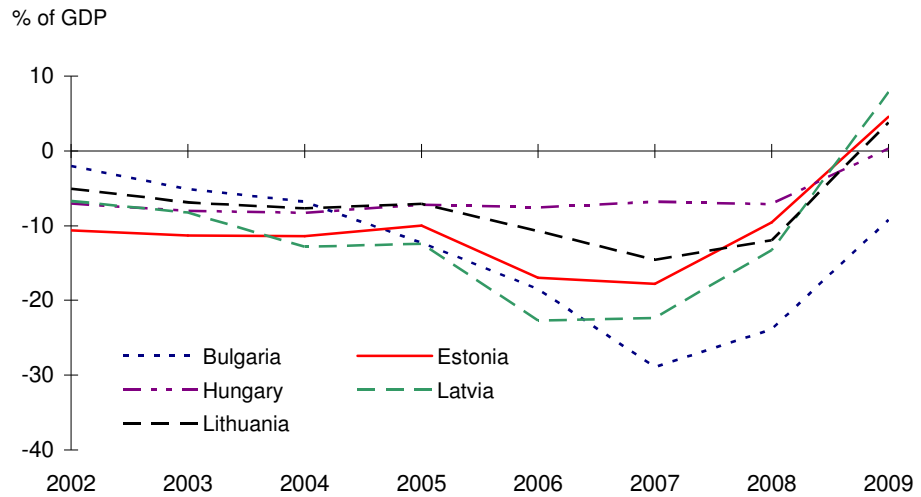
However, although the immediate financing risks have been mitigated, medium- to long-term structural threats persist. Indeed, the sharp deterioration in public finances in the euro-zone is the result not only of the large fiscal stimulus packages adopted across Euroland, but also of other structural problems. A deeper analysis highlights lagging productivity within the less advanced economies, the lower competitiveness of their products, and a lack of strict fiscal supervision within the EU as a whole. Moreover, growing external debt, which derives from high levels of public, corporate and household indebtedness, reflect the imbalances created within many of the EU countries, which are spending much more than they produce, while relying on foreign financing. This in turn has led to creation of deep current account deficits: Greece's current account deficit reached 11.2% of GDP in 2009, the Baltic states (Estonia, Latvia and Lithuania) ran deficits averaging 14.0% of GDP in 2005-08, while Bulgaria's current account gap peaked at 28.9% of GDP in 2007.

...especially since economies in the CEE region face similar challenges to Greece

Some economies in the CEE region face similar challenges to Greece and the other PIIGS: weak export competitiveness; unfavourable exchange rates (e.g. the Polish and Czech currencies have appreciated strongly against the euro) or the inability to devalue the currency (as in the countries whose currencies are pegged to the euro: Estonia, Latvia, Lithuania and Bulgaria, the 'peggers'); rising unemployment; and high household indebtedness. The process by which the newer EU members (Bulgaria, Estonia, Latvia, Lithuania and Romania) lost their competitiveness was similar to that in the PIIGS, whereby low labour costs, security derived from EU membership and lower currency exchange risk (for the peggers) attracted large volumes of capital, which in turn fuelled excessive growth in domestic demand.

High rates of private consumption growth are normal in developing economies, leading to a rapid increase in standards of living, but at the cost of greater indebtedness. Moreover, higher demand created significant inflationary pressures and drove up unit-wage costs. The fact that labour costs were rising much faster than productivity led to the creation of imbalances and a loss of competitiveness.

Current Account as a Percentage of GDP

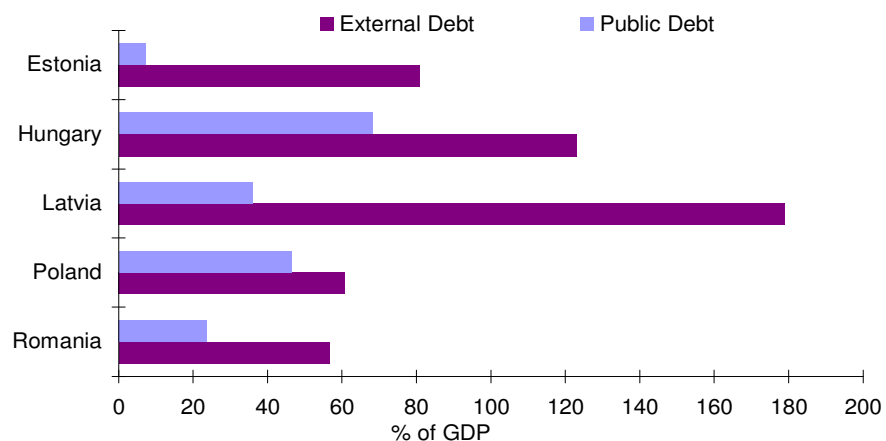


Sources: IFS, Central Banks

High levels of FX-denominated debt further increase the CEE region's risk

In 2009, loans denominated in foreign currency accounted for over 80% of total lending in Latvia and Estonia and more than 60% in Lithuania, while Hungary and Romania have large euro-denominated debts. Moreover, Greece's big four banks, National Bank of Greece, EFG Eurobank, Piraeus Bank and Alpha Bank, have built up a large market presence in the Balkan region, which could prove risky for Greece (given the economic vulnerability of the Balkan region) as well as for the borrowing economies (if Greek banks ran out of liquidity and were forced to cease operating in the region). This extensive reliance on foreign capital was exacerbated by the financial crisis in late 2008, as scarce liquidity across the major banking groups in Europe posed the risk that, despite their declared long-term interest in the region, the banks would seek to cut their losses and withdraw from the troubled economies.

Public and External Debt Levels, 2009



Note: External debt is based on Q1 2010 data.
Sources: National Statistics Offices; Central Banks; Eurostat

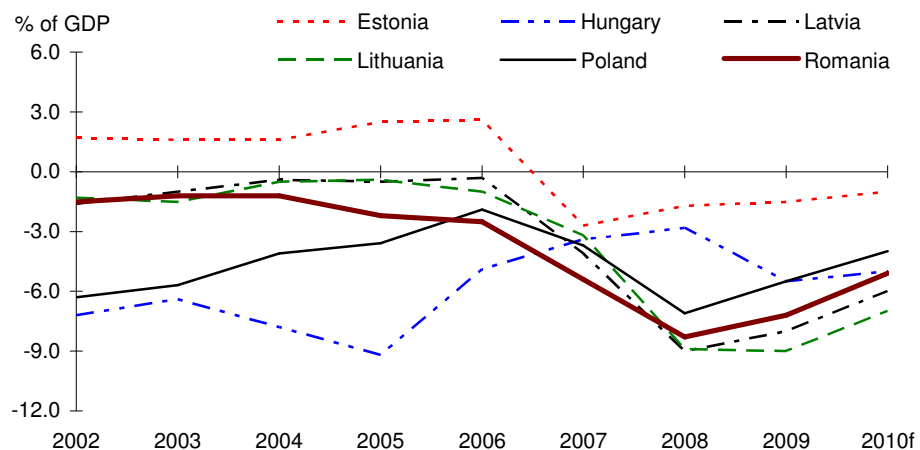
Positively, the European Bank for Reconstruction and Development (EBRD), the IMF, the European Commission and other international financial institutions have provided special facilities to these vulnerable economies, commonly known as the ‘Vienna Initiative’. In the face of mounting worries, the international financial institutions met with the commercial bank operating in CEE to discuss the measures needed to reaffirm the banks’ presence in the region. Commitments emerging from these meetings have proved successful, with parent banks making rollover and recapitalisation commitments in many countries. This initiative has played a significant role in creating a dialogue between the private and public sectors, and helped short-term stability; nevertheless, high levels of external debt could threaten the medium- and longer-term risk outlook.

Outlook: What Will Happen Next?

The most immediate risk stems from limited government access to borrowing

A number of key factors are likely to play a role in mediating the CEE region’s exposure to potential fallout from the recent crisis in the euro area. The most immediate risk is derived from governments’ limited access to borrowing to finance their fiscal shortfalls. Indeed, due to the economic and financial crisis many economies in CEE have run deep budget deficits (Latvia and Lithuania’s budget deficits reached 9.0% of GDP in 2009, Romania’s fiscal shortfall reached 8.3%, while the majority of other economies in the region breached the 3.0% limit imposed by the European Commission). This has increased the risk that borrowing to meet budget financing needs will be curtailed/more expensive, which could also lead to stricter fiscal cuts to further reduce levels of borrowing.

Fiscal Position



Sources: Eurostat; D&B

The second risk is the impact of reduced export demand from the euro area

The second likely factor is that reduced export demand from the euro area will delay the recovery in the CEE countries, as many economies have been relying on greater exports to Euroland in 2010-11 to drive growth. Indeed, with domestic demand still subdued by reduced fiscal spending, rising unemployment and weak investment (due to diminished business growth prospects), external demand from Euroland is the only likely contributing factor to overall growth in the region. A large part of CEE has diverted exports from Eastern to Western Europe, and countries such as the Czech Republic, Hungary, Poland and Slovenia send 50-60% of their exports to the euro area. Pressure on governments to implement strict fiscal austerity plans could lead to a prolonged recession not only in the euro area but also outside it (see **Moderate Risk Countries**). Indeed, as euro area members cannot devalue their currencies to correct internal and external imbalances, the European Commission and the IMF will impose strict fiscal consolidation measures (including dramatic wage and public spending cuts). These measures could stifle domestic demand, thereby curtailing the demand for exports from the CEE countries, amid already-weak economic prospects.

The overhang of bad debts from the real estate bubble also poses risks

Another important risk is the overhang of bad debts from the real estate bubble, which led to an economic slowdown in 2007 in countries like Latvia and Estonia. Due to significantly lower demand, properties in Riga and Tallinn lost more than 50% of their value from their peak in late 2007. Moreover, credit quality has deteriorated substantially, with high numbers of non-performing loans (NPLs) and negative asset write-offs, especially for banks exposed to those markets. Indeed, the Swedish SEB bank's exposure to the Baltic countries will continue to represent the largest individual risk in the next two years, despite a reduction in lending levels in the region from 2009; meanwhile, according to the ECB, euro area banks will be required to write-off around EUR195bn throughout 2011 due to NPLs, with the IMF estimating similar losses in 2010. Banks will have to deal with their balance sheets before starting to lend again, and we expect credit availability to remain low during our two-year forecast period (with Latvia, Lithuania, Estonia and Romania particularly affected).

Conditions on euro-adoption could be tightened

Finally, the Greek crisis also offers lessons about allowing unprepared countries to adopt the euro. EU leaders are likely to impose tighter conditions in future, which is bad news for the CEE economies waiting to join the euro area at the earliest opportunity. Even Estonia, whose euro-membership was approved by the European Commission in mid-May, still faces problems: some existing euro members think that allowing an ex-communist economy to join a currency union should not be a priority during this uncertain period, arguing that a potential one-year delay would not harm the country.

Levels of Risk

On the basis of the above-mentioned factors, D&B has identified three groups of countries, each with differing levels of risk.

Higher Risk Countries

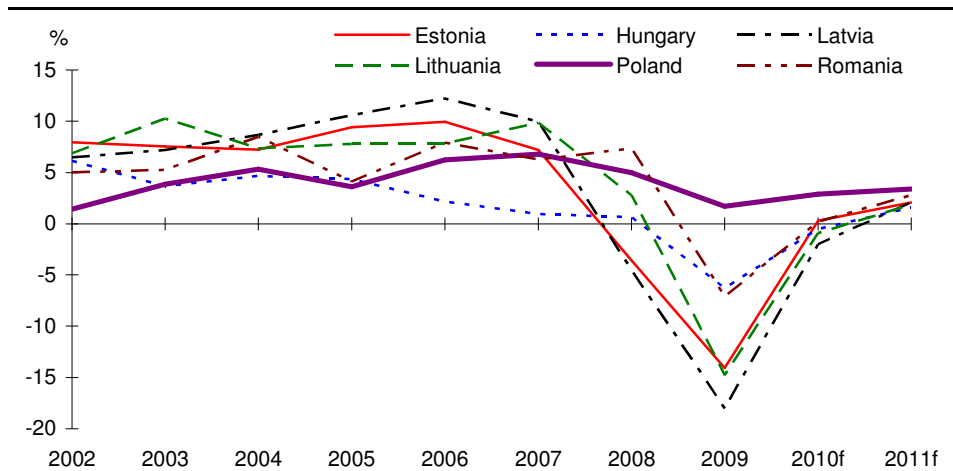
Hungary, Latvia and Romania. These economies have run deep budget deficits, resulting from years of excessive public spending and a lack of reform to their extensive bureaucracies. This, allied to economic and financial crisis in late 2008, led these economies to seek support from the IMF; as a result, they must meet strict fiscal conditions in order to receive further instalments from agreed rescue packages. Moreover, these countries are particularly vulnerable given the large proportion of FX-denominated debt in total gross external debt. This exposes some of these economies to the current exchange rate risk and means dependence on financing from abroad. Romania seems particularly vulnerable to falling FDI, which dropped by more than 50% in 2009. Romania needs substantial foreign investment to boost recovery in its crisis-hit economy and (more importantly) to cover its extensive current account deficit: in January-April 2010 only 55.0% of the current account deficit was covered by FDI.

Moderate Risk Countries

Bulgaria, the Czech Republic, Lithuania, Slovakia and Slovenia. Lithuania's economy contracted steeply in 2009 (real GDP fell by 14.8%), leading to a significant deterioration in the country's fiscal position. Despite relatively low public debt (29.3% of GDP in 2009), we expect this level to rise rapidly during 2010-11 due to the country's high borrowing requirements to finance its large budget deficit. Similarly, Bulgaria's economic outlook remains challenging due to the reversal of the pre-2008 FDI boom, when large capital inflows generated greater credit accessibility and led to strong domestic demand. As such, the renewed slowdown in the euro area will increase the downside risks to our current growth forecast for Bulgaria. Moreover, the relatively strong position of Bulgaria's public finances is offset by external financing vulnerability, in particular the private sector's high indebtedness (which exceeds 100% of GDP). In Slovenia, Slovakia and the Czech Republic economic growth prospects depend heavily on demand in Euroland due to their heavy integration in the European supply chain. Subdued demand in 2009 in the euro area led to a 7.8% contraction in Slovenia's real GDP, and the mild growth we envisage for this year could be subject to downward revision. Similarly, Slovakia and the Czech Republic depend largely on the German and French automotive industries, which currently face reduced demand.

Lower Risk Countries

Estonia and Poland. Among the lowest risk countries is Poland, which thanks to its size (it is the biggest economy in the CEE region) and fortunate currency developments (the zloty depreciated on average by 23% in comparison to the euro in 2009) was the only European country to achieve economic growth in 2009. Despite this, its budget deficit widened to 7.1% of GDP, which will increase the borrowing requirement and inevitably raise public debt. That said, the government is committed to reducing its borrowing needs quickly, while reduced dependency on external demand will lead to another year of relatively strong economic growth. Although Estonia's economy contracted by 14.1% in 2009, the government managed to achieve a budget deficit of only 1.7% of GDP, enabling the country to meet the economic conditions for euro entry. This was due to the large fiscal cuts implemented throughout the year; however, these will further undermine domestic demand and delay the economic recovery. Nevertheless, Estonia's membership of the single currency (possibly in 2011) will bring medium-term benefits to the country, especially given its low public debt (the lowest in the EU in 2009).

Real GDP Growth

Sources: Eurostat; D&B

Implications for D&B Customers

There are numerous implications for doing business in the CEE region

The repercussions for companies doing business with/in the CEE region are manifold, with the most immediate effects being a weakening economic outlook, heightened exchange rate volatility and deteriorating payments trends. However, there are also some opportunities deriving from the weaker state of governments' finances, such as privatisation programmes and prospects for higher returns on government bonds.

1. The EUR750bn package will not remove the medium-term need for a painful adjustment process to correct domestic and external imbalances in some European economies. This will involve many years of public and household spending restraint as well as lower imports and investment inflows, implying much weaker prospects for CEE exporters to Euroland (in turn implying weaker growth prospects in the CEE region).
2. Heightened volatility in the currency markets raises uncertainty about trade and investment returns. The weakening of the euro (which in our opinion is likely to continue during 2010-11) makes euro-zone exports more competitive on international markets, but economies whose currencies are not pegged to the euro (Poland, Hungary, the Czech Republic) are likely to see decreased demand for their exports, as their own currencies will grow stronger in relation to the weaker euro. As such, we believe the weaker euro could be beneficial for Euroland's exports, as well as for CEE economies with currencies pegged to the euro. We therefore advise companies to remain vigilant with regard to currency movements.

3. The economic recovery in CEE will be delayed further as domestic demand will be subdued by fiscal austerity and rising unemployment, while the region's heavy reliance on exports to the euro-area (in some cases in excess of 50% of total exports) is likely to delay any export-driven recovery.
4. Tighter borrowing conditions will limit businesses' ability to expand or find new financing to cover existing obligations.
5. Companies exposed to doing business in the worst-affected economies should be vigilant, as counterparty risk (such as insolvency risk and payment risks) will remain elevated throughout 2010-11. According to D&B's proprietary payment performance data, countries like Latvia and Lithuania recorded a marked increase in the proportion of payments received both 30 and 60 days over terms. Moreover, credit availability will remain limited due to scarce liquidity amongst foreign banks and underdeveloped local capital markets. As such, we recommend stricter trade terms when doing business with counterparties based in higher risk economies.
6. The economic and fiscal crises will offer some opportunities. For example, as part of its fiscal measures to reduce its debt burden, the Polish government has embarked on a privatisation programme for a number of state-owned companies (which has been postponed for many years), giving opportunities for businesses to expand their operations in the region. Many of the privatised companies lie within the core national infrastructure, particularly in the airline, rail transport, postal, energy and paper sectors, offering opportunities for astute investors.
7. Another opportunity lies with investment in EU members' government bonds (including those of CEE countries), which in light of increased risk in the euro area have been trading at higher interest rates, giving more scope for market speculation and enabling some financial investors to secure higher yields at a relatively low risk. Indeed, in our opinion the risk of government default within any of the EU economies is small, reduced as it is by membership of the Union and cushioned by the rescue package from the IMF. However, long-term risks remain elevated due to the two-year expiry of the EUR750bn IMF/EU rescue package, as well as greater uncertainty over the long-term fiscal management plans in the euro-zone and in the CEE region itself.

D&B Country Risk Services

D&B Country Risk Services has 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.

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