



The Business Impact of a Greek Euro-Zone Exit

Risk Insights

- Although the situation has improved in the past weeks, especially in Italy and Spain, the euro-zone debt crisis is still far from over.
- Low competitiveness, rigid labour markets and high household and company debt levels continue to aggravate the crisis, which started as a mere sovereign-debt crisis in Greece two years ago.
- An immediate disorderly Greek default was avoided in March 2012, but because of the uncertain political outlook the picture can change quickly.
- Worryingly, and despite being on track with the EU-imposed reform programme, Portugal seems to need a second bailout package in the near-to medium-term.
- A complete break up of the euro zone seems unlikely, given the high costs.
- The intervention of the ECB has increased the resilience of the European banking sector and reduced the danger of contagion from Greece.
- If Greece undergoes a disorderly default and leaves the euro zone, the consequences for Greece will be extremely harmful, at least in the short term, and business operations in Greece will break down almost completely.
- We recommend increased vigilance, especially with regard to payment and credit risks.

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Two years on from the emergence of the euro-zone debt problems, the crisis continues

Background: the Euro-Zone Crisis, Two Years On

The euro-zone debt crisis continues, more than two years after the initial turmoil in European markets on the back of financial investors' fears that several euro-zone countries faced severe difficulties in financing their large budget deficits, and growing public debt burdens. The crisis originated in January 2010 in Greece when the EU found 'severe irregularities' in the country's accounting procedures. As a result, Greece's 2009 government deficit was revised up from 3.7% of GDP to 12.7% (and later to 13.6%). Amidst this shocking news, financial markets became increasingly risk averse and yields on government bonds of several EU members rose sharply, most notably Portugal and Ireland (rising yields are an indication that markets see more risk in investing in the bonds). In April 2010, the Greek government were forced to ask the EU/ECB/IMF (the Troika) for assistance, and on 2 May 2010 the Troika agreed on a EUR110bn bailout package (followed by a second bailout package worth EUR109bn in July 2011), subject to compliance with Troika-imposed and -controlled tough austerity measures.

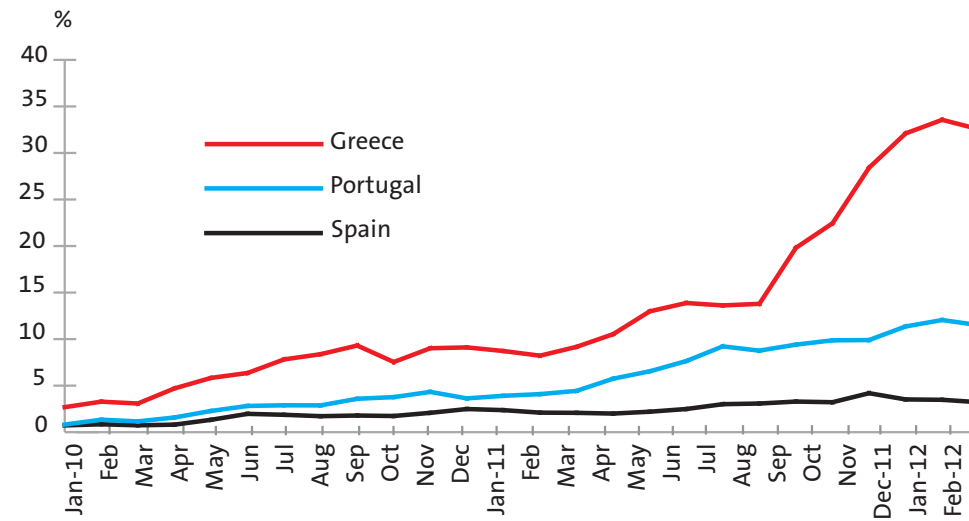
After Greece, Ireland and Portugal had to seek assistance

The EU was aware of the danger of contagion to other countries of the 'Greek debt crisis' and as a response set up a temporary EUR440bn bailout fund called the European Financial Stability Facility (EFSF), which rapidly came into action when the Irish government asked for financial assistance in November 2010, followed by the Portuguese government in May 2011. As in the case of Greece, the Portuguese and Irish governments agreed to tough austerity measures as a condition of the loan. Disbursements are scheduled on a quarterly basis and are only made if the Troika is satisfied with the progress the country has achieved. Because the EFSF's firepower was no longer sufficient to calm markets after the Irish and Portuguese bailouts (which cost EUR190bn combined), EU policy-makers decided to enlarge the Facility to EUR780bn in July 2011 in the wake of the second bailout package for Greece.

EU rescue packages did not reduce the financial market's concerns

However, these rescue packages failed to provide sufficient confidence to the financial markets, as the problems facing the PIIGS (Portugal, Italy, Ireland, Greece and Spain) remained and were aggravated as GDP growth rates were falling and unemployment rates were rising. When the Troika asked for the participation of private bondholders in the second Greece bailout package, yields on Italian and Spanish government bonds soared as investors became increasingly aware of potential losses when investing in these assets. Importantly, thanks to a combination of policy reforms and intervention by the ECB, yields have come down in the past weeks. At the time of writing, it seems unlikely that Spain and Italy (which account for 12% and 18%, respectively, of Euroland's GDP) will need access to the European bailout funds in the short term, thereby relieving pressure on the stressed public finances of the donor countries. The survival of the euro zone will not be determined by Greece or Portugal (because of their relatively small size and refinance needs), but by Spain and Italy. It remains crucial that neither states requires access to European bailout funds, as their size, even after a new enlargement in March 2012, is not sufficient to provide long-term support for both Italy and Spain. Italy needs EUR220bn on the markets in 2012, while Spain needs EUR90bn.

Government Bond Yield Spreads



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

Worryingly, the problems of the PIIGS stem not just from a short-term liquidity squeeze (i.e. finding new loans to repay existing loans in the next 12 months) but also from more deep-rooted, structural mechanisms. These include weak export competitiveness; the inability to devalue their currency (the euro); poor labour cost competitiveness; high household indebtedness (Ireland); and high corporate indebtedness (Portugal and Spain). In addition, labour and goods' markets are relatively inefficient by European standards.

World Economic Forum's Competitiveness Indicators 2011–12

	Overall ranking (out of 142)	Labour market efficiency	Goods market efficiency
Greece	90th	126th	107th
Portugal	45th	122nd	62nd
Italy	43rd	123rd	58th
Spain	36th	119th	66th
Ireland	29th	17th	13th
France	18th	68th	38th
Germany	6th	64th	26th

Note: The World Economic Forum assesses the competitiveness of 142 countries on an annual basis. Labour market and goods' market efficiency are 2 out of 12 sub-rankings.

Sources: World Economic Forum

These factors, together with (and very often the reason for) low GDP growth and a weak commercial environment, have induced a couple of downgrades over the past 12 months. D&B Country Risk Services has lowered the rating for most EU economies between April 2011 and March 2012; in particular Italy and Spain suffered from significant downgrades. Most European countries are ranked lower than before the outbreak of the euro-zone crisis in early 2010. Despite being on track with their reform packages and austerity measures, Ireland, and more so Portugal, are still in a very weak position and could be forced to leave the euro zone at some stage. However, we believe that the country with the highest risk of leaving the euro zone is Greece.

D&B's Country Risk Ratings History

	March 10	April 11	January 10
Greece	DB5a	DB4d	DB3c
Portugal	DB4c	DB4c	DB3c
Ireland	DB4a	DB4a	DB3b
Spain	DB4d	DB3d	DB3a
Italy	DB3d	DB3a	DB3a
France	DB2b	DB2a	DB2a
Germany	DB1d	DB1c	DB2a

Sources: D&B

Greece's economy contracted for the fourth consecutive year

Greece

Of the five PIIGS countries, Greece is by far in the weakest position. Even compared with Ireland and Portugal (the two other countries which asked the Troika for financial support), Greece's current situation and economic outlook are extraordinarily grim. Data published by the National Statistics Service of Greece shows that the economy contracted for the fourth consecutive year in 2011. After a contraction by 0.2% in 2008, 3.2% in 2009 and 3.3% in 2010, Greece's real GDP fell by a stunning 7.0% in 2011. In Q4, the economy shrank by 7.5% year on year (y/y) amidst tough austerity measures, low industrial and consumer confidence and faltering demand from the euro zone.

Unlike Portugal and Ireland, where support for the EU-imposed austerity measures is widespread (at least among politicians), Greece's political risk is heightened because of the upcoming parliamentary elections, which will likely take place on 6 May. Early elections have become necessary because the old government, under Socialist Prime Minister Georgios Papandreou, was forced by the markets to step down in November 2011 in order to make way for an independent technocrat government headed by former ECB vice president, Lucas Papademos. The main opposition party, the Conservatives, supports the Papademos government, but has made it clear it wants to oust Papademos as prime minister in the snap election. At the time of writing, it is unclear who will win the elections as polls are unclear. Many Greeks are unhappy with the austerity measures and support politicians who are calling for the measures to be overthrown. An unlikely but not impossible victory of the anti-compliance camp could end Greece's reform package and compliance with EU-set austerity measures and the new government could decide to leave the euro zone.

Credit risk in Greece is extraordinarily high

In addition to the political and macro-economic problems, Greece's poor commercial environment is a serious worry. According to February 2012 data from D&B's Sales and Marketing Solutions Team, credit risk is extremely high in Greece. Because of complicated access to finance, a gloomy macro-economic outlook, and several other factors, only nine (representing less than 0.1%) out of 88,559 companies rated enjoy a minimal credit risk, while 7,870 (representing 8.9%) enterprises have a low credit risk. This is significantly worse than Portugal, where the share of companies with a minimal or low credit risk amounts to 4.3% and 25.7%, respectively.

We expect the euro to survive, but uncertainty is very high

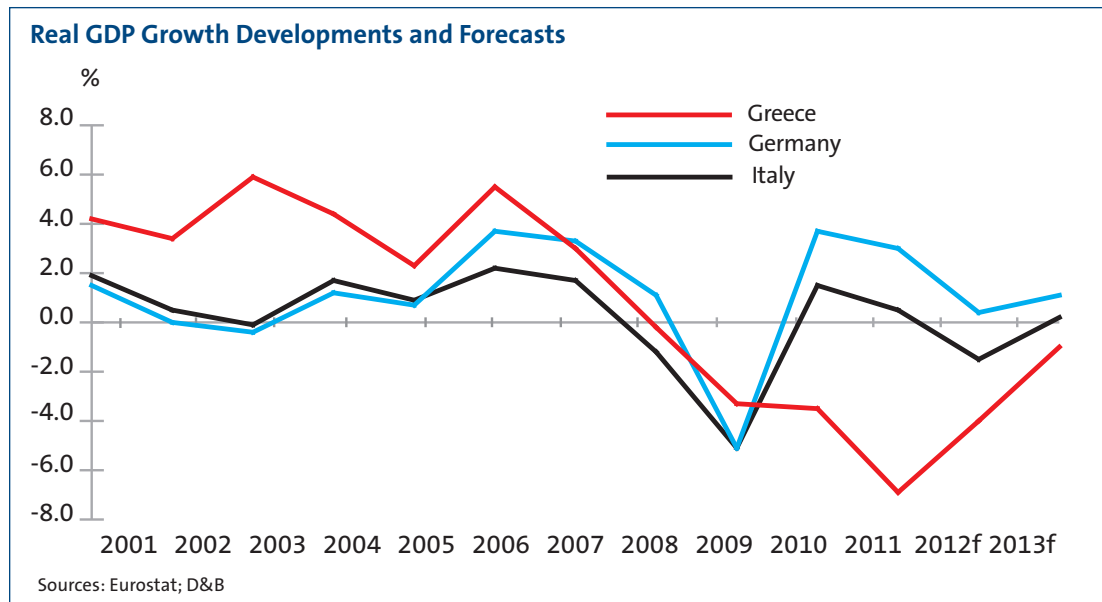
The Outlook for Euroland

The question of whether the euro will survive the next years is extremely difficult to answer as there is immense uncertainty about timing and consequences of future developments. However, D&B remains cautiously optimistic that the euro zone will overcome its current problems in the short term (or at least survive them) as the cost of a break-up of the euro zone are very high. A December 2011 study from Dutch bank ING estimates that Euroland's GDP would contract by 12% in the first two years after the break-up (9% in the first year). The survival of the common currency area depends not only on macro-economic issues but to a large extent on policy-making. However, it cannot be ruled out that several member states will decide/be forced to leave the euro, which in turn could cause a chain reaction, ending with a complete break-up.

Macro-economics

Real GDP growth is slowing and the euro zone is already likely to be in recession

Euroland has already faced stronger headwinds in Q3 and Q4 2011 and we expect this trend to last into the first half of 2012. We predict a technical recession (defined as two consecutive quarters of GDP contraction) for most euro-zone economies for Q1 2012 (data have not been released at the time of writing), and for the currency area as a whole we expect real GDP to contract by 0.3% in 2012. However, there will be significant differences between the member states; while economies in the north of the euro area will be able to display (albeit modest) growth, the PIIGS will experience another downturn, aggravated by the latest round of austerity measures.



Monetary Policy and Financial Sector Risk

Importantly, the ECB has taken appropriate measures to react to the macro-economic slowdown. Since late 2011, the Bank has:

- cut the key policy rate to 1.0% (having increased it by 50 basis points to 1.5% in mid-2011);
- injected EUR1,000bn into the domestic banking system via its three-year long-term refinancing operations; and
- bought a significant share of government bonds through its Securities Markets Programme.

All three measures have helped to stimulate growth, reduce yields on government bonds (especially in Italy and Spain) and increased the liquidity in the financial sector, and, thereby, its resilience against adverse developments originating in Greece.

Political Developments

While macro-economic and banking-sector developments are indisputably important for the survival of the euro zone, the euro's fate largely depends on political developments. Without the willingness of the wealthy, Triple-A rated countries (Germany, Finland, Luxembourg, the Netherlands) to support the PIIGS, the euro will collapse. The reverse is also true; without the PIIGS' commitment to budget discipline and reform, the donor countries (in particular Germany, but also Austria, the Netherlands and Finland) could be unwilling to provide funding for the bailout mechanisms.

In the past few weeks, political developments have been relatively favourable and have substantially increased the chances of the euro-zone's survival. Technocrat governments in Italy and Greece, both headed by economists, made substantial progress in reforming labour markets and implementing austerity measures, while Ireland and Portugal are on track with their programmes. In addition, the EU made progress in adopting a new fiscal treaty. According to the plan (masterminded by Germany and France), fiscal deficits must not exceed 0.5% of GDP and, for member states violating the rule, EU institutions have significant powers to intervene in domestic fiscal policy. Twenty-five out of the EU-27 have signalled approval (with the UK and the Czech Republic not joining).

The developments in Greece also reduced the risk of a euro-zone break-up, at least in the short term: in March 2012, the Greek government reached agreement with almost 86% of its private creditors about debt restructures which will reduce Greece's debt by EUR107bn. Although this triggered another downgrade by the big sovereign risk rating agencies (and Greece will very likely face legal action due to the debt restructuring), the arrangement is positive news as it enables the disbursement of further aid by the Troika. This has prevented an immediate disorderly default (which seemed possible in the run-up to the arrangement) and secured the stability of the euro zone for the next weeks.

However, there are still several question marks about the survival of the euro zone. The most important ones stem from two upcoming elections, in Greece and France. Greece will face parliamentary elections in early May, the first one since the outbreak of the crisis two years ago. With public sentiment increasingly opposing compliance with the Troika, it cannot be ruled out that the anti-compliance camp will win the elections and abandon the austerity measures. For the majority of Greece's electorate, the short-term pain of a disorderly default on the remaining debt could appear more attractive than a further decade of austerity under the supervision of the Troika. However, if Greece abandons reform and austerity, it is likely that financial aid from the EU will stop as public opinion in Germany and elsewhere would strongly oppose further support.

Political developments endanger the survival of the euro

Greek solvency is guaranteed for the next few weeks...

...but a new government could abandon the austerity path, and default

The second political risk to the survival of the euro zone originates from the upcoming presidential elections in France in April/May 2012. While President Nicolas Sarkozy is a close ally of German Chancellor Angela Merkel, and supports the new fiscal treaty, Francois Hollande, the Socialist Party candidate and frontrunner in the polls, opposes it. Hollande has announced that he will not sign the fiscal treaty if elected, leaving Germany in an uncomfortable position. Although the fiscal treaty would still likely come into effect for all 25 states (as, by law, only 12 out of the 25 have to ratify it for it to come into effect), it seems politically impossible for Germany to pursue its plan if France objects to it. This leaves the question open as to whether Germany (the key figure in the rescue plans for the euro zone) will continue with its attempts if austerity measures in member states cannot be imposed by the fiscal treaty.

A complete break up of the euro zone will cost between 9% and 50% of Euroland's GDP

Scenario: the Consequences of a Greek Exit from the Euro Zone

We believe that the euro zone will not break up completely in the foreseeable future as the economic cost is high. Recent studies have quantified the cost of a complete break-up: depending on the econometric model used and assumptions made, costs will amount to between 9% and 50% of Euroland's GDP. Therefore, we believe that member states will defend the common currency at almost any cost. Policy-makers have several tools (e.g. joint liability for government debt, so-called 'eurobonds') which they can use to calm the situation if necessary.

That said, it is more uncertain whether ailing peripheral states such as Ireland, Portugal and Greece stay in the euro area over the medium to long term. Greece is by far in the worst position and the most likely candidate for an exit. Even if the country sticks to the very painful austerity measures over the coming years, public debt will still stand at more than 120% of GDP in 2020, twice the amount that the EU considers as acceptable and sustainable. Worse still, in D&B's view this scenario is based on overly optimistic assumptions regarding GDP and revenue development.

We believe that a Greek exit has become more likely over the past months, regardless of the welcome progress the country has made during this period. We investigate below the consequences of a potential Greek exit, focusing on macro-economics, financial-sector stability and, most importantly, the risk of doing business. We concentrate on Greece and the euro zone, but it should be noted that global trade flows and GDP will also be adversely affected.

Consequences for Greece

Before analysing the consequences, it should be noted that Greece cannot be forced out of the euro zone against its will. According to the EU treaties, a member cannot be expelled from the euro zone, it can only withdraw voluntarily. If Greece decides to leave the euro zone at some stage, the consequences are uncertain. Overall, we believe that the negative effects will, by far, outweigh the beneficial effects, particularly in the short term.

Our scenario is based on the assumption that a Greek exit from the euro zone is accompanied by a disorderly default on its remaining debt. Due to the exorbitant Greek government debt stock, an exit from the euro zone without a default makes no sense: without the announcement of a default, Greece's debt stock will rise further because it is denominated in euros and its new currency will depreciate significantly.

1. Impact on its New Currency

If Greece leaves the euro zone and introduces a new currency (presumably the new drachma), it will depreciate massively against other currencies, due to capital flight, a collapsing banking sector and a complete breakdown of business activity. ING Bank estimates that the new drachma will lose 80% against the euro in the first few days. This has positive effects on the price competitiveness of Greece's

A Greek exit from the euro zone would lead to a sharply depreciating new Greek currency...

exports (such as tourism and the shipping industry), however, we believe that the disadvantages will outweigh these benefits. Inflation will soar to record levels as prices for imported goods (such as oil, machinery and consumer goods) will rocket. Greece has almost no industrial sector or natural resources and thereby has a high import bill. Standards of living will decline for the vast majority of the population as imported goods will become unaffordable. From a business point of view, Greek producers which import a large share of their input factors will face problems; as a consequence supply chains will face problems.

2. Impact on the Greek Financial Sector

A Greek exit from the euro zone will have devastating effects on the domestic banking sector. Because Greek households have lost their faith in the stability of the banking sector and fear a collapse, deposits have been shrinking rapidly since the outbreak of the crisis in early 2010 (by 32%). Households are also afraid of a forced exchange of their euro-denominated deposits in new drachma-denominated deposits at an extremely unfavourable rate. This trend will accelerate as rumours about a Greek exit spread.

The Greek banking sector can no longer raise funds from domestic markets and now depends largely on the ECB. If Greece leaves the euro zone, this last source of finance will be eliminated and the whole banking sector will collapse. This is made worse as Greek banks still hold a substantial amount of Greek government bonds, which will be worthless: a Greek exit from the euro zone will only happen if the government defaults on its government debt. Greek banks will be heavily impacted by such a move and face extremely high write-offs. Without external help (e.g. from the IMF), a Greek exit from the euro zone will lead to a collapse of the domestic banking sector, with unforeseeable but unquestionably severely harmful effects on doing business in the country.

3. Impact on Greece's Public Finances

If Greece decides to leave the euro zone and defaults on its remaining government debt, the long-term consequences might be positive. Currently, Greece's government debt amounts to 162% of GDP. This is unsustainably high, and even if it complies with the EU plan, Greece will still have debts of more than 120% of GDP in 2020. If the debt-to-GDP ratio falls significantly due to a default, Greece can slash interest-rate payments and invest this money in infrastructure and its educational system, thereby increasing the long-term growth potential. However, these benefits will only materialise (if ever) in the long term. In the short term, a Greek default and exit from the euro zone will stop financial aid from the Troika, the main source of finance. If the aid flows stop, the need for a sharp fiscal adjustment increases even further as other sources of finance do not exist; a default will close the door to the financial markets for many years. Even tougher fiscal adjustment (more spending cuts and tax increases) could lead to civil unrest, which, in a worst-case scenario, could interrupt business activity completely and interrupt international supply chains.

4. Effect on Cross-border Trade

EU law does not deal with an exit from the euro zone. According to the opinion of the legal service of the EU institutions, the only way that Greece can leave the euro zone is by leaving the EU. Therefore, a Greek exit from the euro zone will also impact the legal framework for cross-border trade. Even though Greece could, theoretically, apply for membership in the EU again, it seems likely that the country will have to stay outside the EU for a while as the re-accession procedure (an unprecedented event in the EU's history) will take some time. Therefore, exports to and imports from Greece could face tariffs while the free movement of capital and labour force is no longer guaranteed. As a consequence, cross-border trade and investment will become more complicated and the expected returns will become more uncertain.

...and a collapse of the Greek banking sector

Cross-border trade would get more complicated as Greece would also have to leave the EU

To conclude, a Greek exit from the euro zone will lead to:

- the collapse of the domestic banking sector;
- complicated and higher costs for cross-border trading;
- a sharply depreciating new currency;
- higher inflation; and
- increased austerity measures, which could trigger civil unrest.

The beneficial long-term effects and the higher price competitiveness of export sectors will not outweigh these negative effects. Overall, the Greek economy will face a sharp downturn after the departure from the euro zone: ING Bank estimates that Greece's real GDP will contract by a sizeable 10.5% in the first year after the exit. We believe that the costs will be even higher as ING's scenario is based on overly optimistic assumptions (such as continued support from the IMF/ECB for the Greek banking sector). However, as mentioned earlier, all forecasts about potential losses of a break-up of the euro zone or a Greek exit should be treated with caution as the situation is unprecedented in modern history.

Consequences for Euroland

The consequences of a Greek exit from the euro zone will, in our opinion, remain manageable for the rest of the euro area, and it is likely that the developments can be contained to Greece.

1. Effects on Euroland's Financial Sector

Over the past quarters, European banks have reduced their exposure to Greece significantly. Data from the Bank for International Settlements show that between Q3 2010 and Q3 2011 (latest available data), the exposure of the German banking sector to Greek government debt has halved. The overall exposure of German banks to total Greek debt (government, banks and private) has fallen from USD61.4bn to only USD22.9bn. The trend is similar for the French banking sector (from USD92.0bn to USD55.7bn) and the Italian and Spanish banking sectors also reduced their exposure (with was already smaller). It is likely that this trend has continued into Q4 2011 and Q1 2012. This increases the resilience of the European banking sector against a Greek default and exit from the euro. Due to the ECB's Long-Term Recovery Organisation (LTRO) in December 2011 and February 2012, the European banking sector has access to sufficient levels of liquidity and we are optimistic that tougher accounting rules in the aftermath of the 2008-09 financial crisis also contribute to a higher resilience of the whole financial sector. Nonetheless, if Greece's leaves the euro zone, significant write-offs of Greek debt will reduce profitability of European banks and will have a negative impact on credit growth as banks rebuild their balance sheets (and thereby payments performance and credit risk). In addition, a Greek departure from the euro zone could also trigger bank runs in states like Portugal and Spain, which would require additional emergency liquidity injections by the ECB.

Outside the euro zone, a Greek exit from the euro zone (triggering a collapse of the Greek banking sector) will have a severe impact on the Balkan region, where Greek banks are active. Greek banks (via their local subsidiaries) hold a substantial share of banking-sector assets in particular in Romania, the Former Yugoslavian Republic of Macedonia and Bulgaria. This will fire back when the Greek banking sector collapses.

2. Effects on Euroland's Macro-economic Outlook

If, as we currently forecast, the harmful effects of a Greek default and exit from the euro zone on the European financial sector and bond markets (especially in Italy and Spain) can be contained successfully, the overall impact on the euro-zone's macro-economic outlook will be relatively small. We estimate that GDP growth in the first three years after the break-up will slow in all euro-zone economies: 1.5 percentage points (for the three years combined) lower in Germany to 2.0 percentage points lower growth

The effects of the default on global and EU growth prospects are small, but uncertainty remains

in Italy, Spain and Portugal. Outside the euro zone, the UK would lose 1.9 percentage points of growth while the US will lose 1.7%, given their trade links and financial exposure to Euroland. The British pound and the US dollar will experience an appreciation against the euro which will lead to a loss of price competitiveness. With economic activity slowing and unemployment rising modestly, there will be beneficial effects on the inflation rate (without causing deflation) in the years after a Greek exit, bringing the inflation rate close to the ECB's target of 2.0%.

Recommendations: What Should Companies Do in Order to Minimise Their Exposure?

The euro-zone crisis has manifold implications for companies, with risks including a weaker economic outlook and deteriorating payments trends.

1. A Greek exit from the euro will herald a collapse of the domestic banking sector and will lead to an almost complete breakdown of business operations. Greek companies will struggle to repay euro-denominated debt (in the case of an exit from the euro zone) as the domestic currency will depreciate sharply. Exporters to the country should consider taking appropriate action early (e.g. tightening credit terms to 'Cash in Advance') to reduce payment risks.
2. Depending on their degree of risk aversion, investors and traders should consider withdrawing completely from the Greek market. If acceptable alternatives can be found, companies should switch to suppliers outside Greece in order to make their supply chains more resilient.
3. Outside Greece, we predict economic developments in the euro zone will remain very sluggish. Customers should expect a deterioration of the macro-economic environment in all euro-zone economies in the coming months. The outlook for Germany, France and other northern European countries is slightly better than for southern European countries, but growth rates will be significantly lower than in 2011. As a result we recommend customers factor in longer payment delays and increased risk of non-payment, not only in southern Europe but also in Germany and other northern euro-zone countries.
4. Companies exposed to other southern European countries will have to be extremely vigilant, as counterparty risk (such as insolvency and payment risks) will reach even higher levels through 2012–13. It is likely that cross-border payments will continue to deteriorate in the months ahead as the economy slows and (according to the ECB's latest Bank Lending Survey) gaining access to credit gets more complicated.
5. Given the close trade and financial links between all European countries, regardless of whether they are inside or outside the euro zone, the danger of quick contagion of the Greek debt crisis remains substantial, despite having lessened recently. We recommend customers to monitor the development in Greece and the whole euro zone vigilantly and frequently. D&B Country Risk Services offers a wide range of products that give a precise insight on recent events and expected developments. This will help you to minimise your risks and increase your expected revenues.

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.

Credits: This paper was produced by D&B Country Risk Services, and was written by Markus Kuger.

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