Centrum für Europäische Politik

cepStudy

CEP Default Index – 2012 Update

Creditworthiness Trends in GIPS Countries: Greece, Italy, Portugal and Spain

Lüder Gerken & Matthias Kullas[1]

Centrum für Europäische Politik (CEP)
Kaiser-Joseph-Straße 266 | 79098 Freiburg | Germany
Telephone +49 (0)761 38693-0 | www.cep.eu

---

[1] Prof. Dr. Lüder Gerken is president of Centrum für Europäische Politik. Dr. Matthias Kullas is head of the department "Economic and stability policy" at Centrum für Europäische Politik.

Preface

In July 2011, the CEP Default Index[2], measuring creditworthiness trends of euro zone countries, was first published. The key findings of the first Index show that the creditworthiness of all Southern European economies has decreased alarmingly since the creation of the Economic and Monetary Union due to an erosion of these countries' competitiveness. Even France proved unable to escape this downturn while the creditworthiness of the remaining euro countries mainly rose.

The CEP Default Index has played an important role in bringing the real cause of the crisis to the fore. While in the beginning the crisis was deemed a state debt crisis in the first place, it is now generally understood that the diverging competitiveness throughout the euro zone is the actual cause. High public debts are a symptom only. At the same time, there is a growing awareness that a state cannot reduce public debts if the economy suffers from constant deficits in the balance of payments due to a lack in international competitiveness and therefore permanently depends on new and higher foreign credits.

Since its publication, the findings of the CEP Default Index have been confirmed by numerous events.

With its Index, the CEP detected Italy's and even France's eroding creditworthiness at an early stage. Meanwhile, both CEP forecasts are generally accepted in political circles. Italy is facing serious trouble in refinancing itself at the capital market. In November 2011, the yield rate for state bonds with a term of 10 years was temporarily above 7%. Although it had dropped in the meantime, it rose again substantially.

Spain, for which the Index attested a significant erosion of creditworthiness, will receive an emergency credit by the European Financial Stability Facility (EFSF) in a few days – for the purpose of recapitalising the Spanish banking sector for the time being. Nonetheless, the yield rate for Spanish state bonds with a remaining maturity of 10 years exceeded 7% – which is the threshold at which Portugal and Ireland were forced to seek financial aid.

The CEP Default Index also detected an erosion of Cyprus' creditworthiness. The fact that the island state has not sought European aid yet, is due to Russia's granting bilateral credits to Cyprus because Russian banks are very active in Cyprus. A refinancing of Cyprus on the capital market under viable conditions has become almost impossible though. Its current yield rate for long-term bonds is also at 7%. Indications are growing that Cyprus – like Spain – will apply for EFSF funds to bolster its banking sector.

Last but not least, the findings of the CEP Default Index were confirmed by the credit quality assessments of the large rating agencies. For instance, the downgrades of several euro states by Standard & Poor's (S&P) in January 2012 exactly reflect what the CEP Default Index predicted in July 2011: already then the CEP Default Index detected an erosion of creditworthiness for France, Spain, Italy, Malta, Cyprus and Portugal. Six months later, S&P graded down exactly these countries. On the other hand, the CEP Default Index attested positive creditworthiness trends for Germany, Luxembourg, the Netherlands, Finland, Belgium and Estonia. S&P fell into line with the CEP findings: these countries were not graded down.[3]

The reliable forecast capability of the CEP Default Index is based on the fact that not only the creditworthiness of the public sector is measured but that of the entire economy. This is essential be-

[2] Cp. Gerken/Kullas (2011): CEP Default Index, online under: http://www.cep.eu/analysen-zur-eu-politik/wirtschafts-und-stabilitaetspolitik/cep-default-index/.

[3] Austria is an exception due to the special foreign risks of Austrian banks.

cause an economy increasing its debts year after year cannot remain creditworthy; it is even secondary whether the debts are accumulated in the public or private sector. Moreover, there is an interdependence between the two sectors. For instance, the creditworthiness of the public sector depends on the degree to which a state is capable of generating funds from the national economy by virtue of its tax collection power. Where the private sector shrinks due to a lack in competitiveness and fails to generate profits, the public sector runs short of taxable sources. Many economies in the euro zone suffer from this problem.

In autumn 2011, the CEP updated its Default Index for Greece, Portugal, Spain and Italy with data of the first half of 2011. The present publication is an update for these countries, comprising the entire year of 2011.

Structure and Methodology of the CEP Default Index

The CEP Default Index measures the development of the individual country's capability to pay back foreign credits, in other words, their creditworthiness. This does not depend only on the state debt but rather on the solvency of the entire economy. Therefore, the CEP Default Index takes into account the credit behaviour of banks, companies and consumers as well and thus measures the creditworthiness of the country as a whole. National economies are sub-divided into four risk categories.

The Index assesses (1) the net lending or net borrowing of the total economy (NTE), reflecting the foreign credit needs of an economy, and (2) the resources used to increase the physical capital stock, i.e. the capacity enhancing capital formation (C) for a certain period.

Housing construction, in particular, does not form part of capital formation. This allows for an approach measuring the creditworthiness trends of economies without distorting the outcome through price bubbles in the housing market.

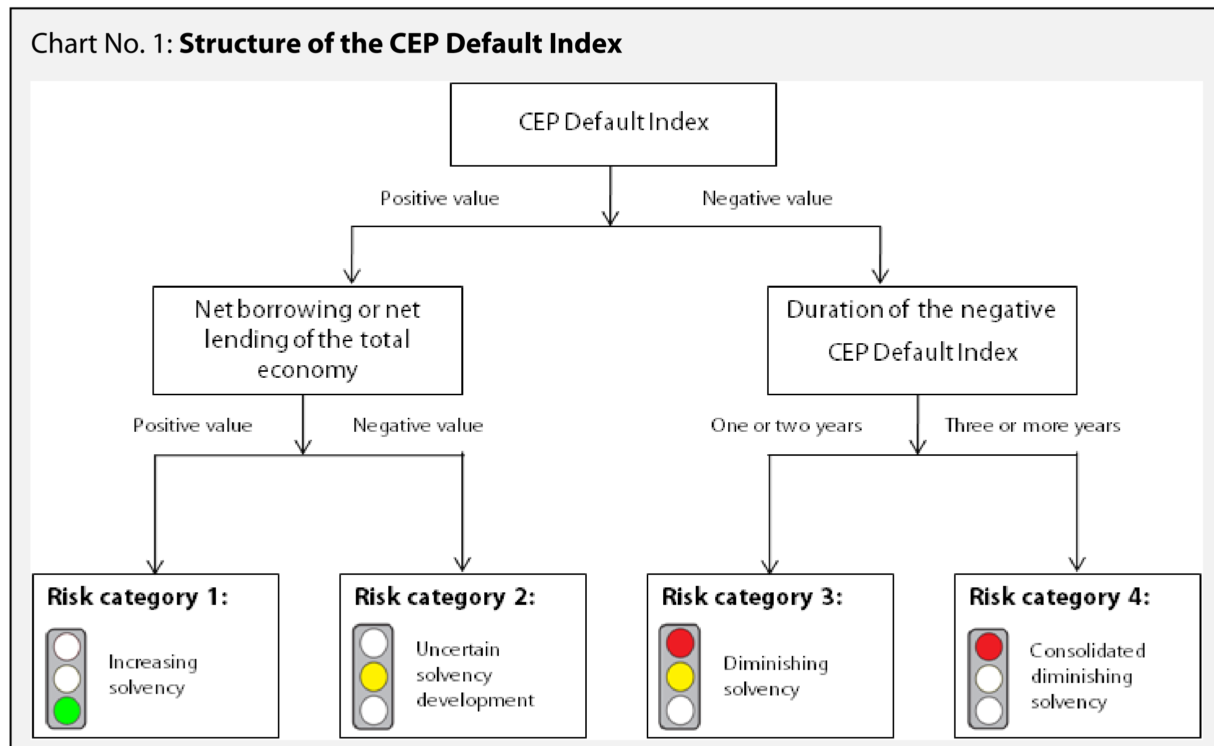
A net borrowing can be created through import excesses – caused by a lack in competitiveness – in commodities trading financed through foreign credits. Moreover, it can be caused by net transfers from profit, dividend and interest payments to foreign capital investors or creditors. Such a net transfer is normally created in countries where more foreign capital is invested than their inhabitants have invested in foreign countries. In order to prevent a net borrowing, it must be compensated for by export excesses in commodities trading. However, this option too is subject to the precondition that a country is sufficiently competitive.

The Index is formed by the sum of NTE and C. Both values are indicated as a percentage of the gross domestic product (GDP).

Countries with current account surpluses export capital and thus have a positive NTE. Since they do not need any foreign credits, they are not at risk of insolvency (risk category 1).

Countries with current account deficits need foreign capital in order to finance such deficits. Therefore, they are net borrowing countries (indicated through a negative NTE). To determine their medium-term creditworthiness, it is vital to know whether or not the foreign capital is used to increase the national capital stock to the effect that the value created generates the means to repay the external credit, or whether it is used to import consumer goods which are used up by consumption.

Chart No. 1: **Structure of the CEP Default Index**



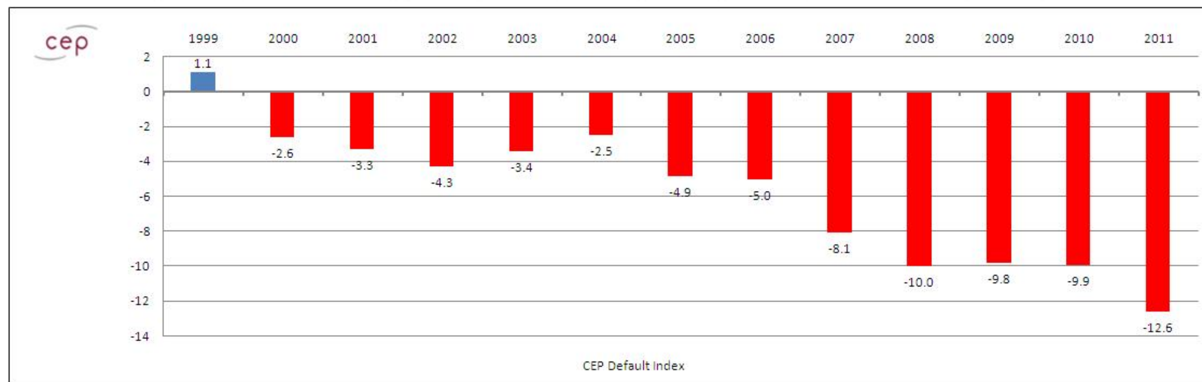
A positive value of the CEP Default Index for a net borrowing country means that net increase of the physical capital stock in any one year exceeds net borrowing. In this case, it is not possible to say in general if the creditworthiness of the economy is under threat (risk category 2).

A negative value on the CEP Default Index means that the net borrowings exceed the increase of the physical capital stock. That means the country concerned consumes not only 100% of the domestic income but also a part of the net borrowings on top of that. Hence, the national economy accumulates debts in order to finance consumption. That threatens solvency (risk category 3).

A CEP Default Index that has been negative for three or more years means: the erosion of creditworthiness is not a temporary but a structural problem; the solvency risk has hardened or has even been factually established (risk category 4).

Greece

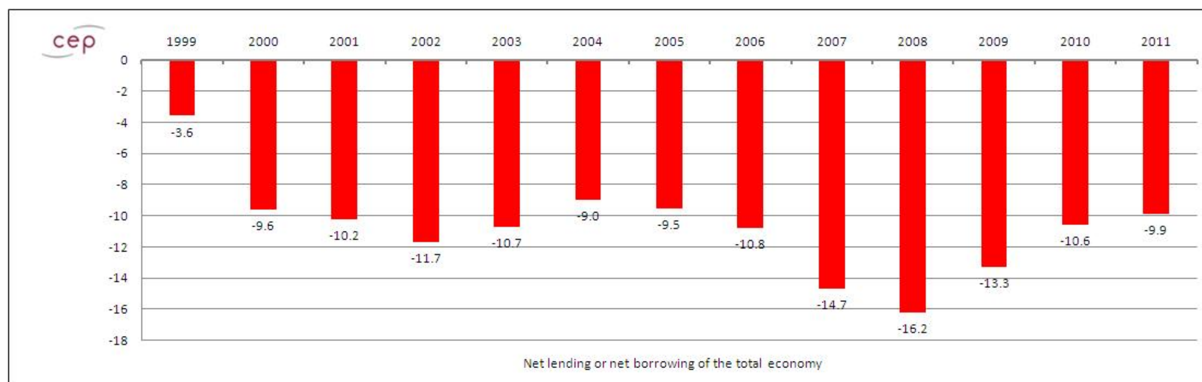
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
NTE	-3.6	-9.6	-10.2	-11.7	-10.7	-9.0	-9.5	-10.8	-14.7	-16.2	-13.3	-10.6	-9.9
C	4.7	7.0	6.9	7.4	7.3	6.5	4.6	5.8	6.6	6.2	3.5	0.7	-2.7
CEP Default Index	**1.1**	**-2.6**	**-3.3**	**-4.3**	**-3.4**	**-2.5**	**-4.9**	**-5.0**	**-8.1**	**-10.0**	**-9.8**	**-9.9**	**-12.6**
Risk category	2	3	3	4	4	4	4	4	4	4	4	4	4



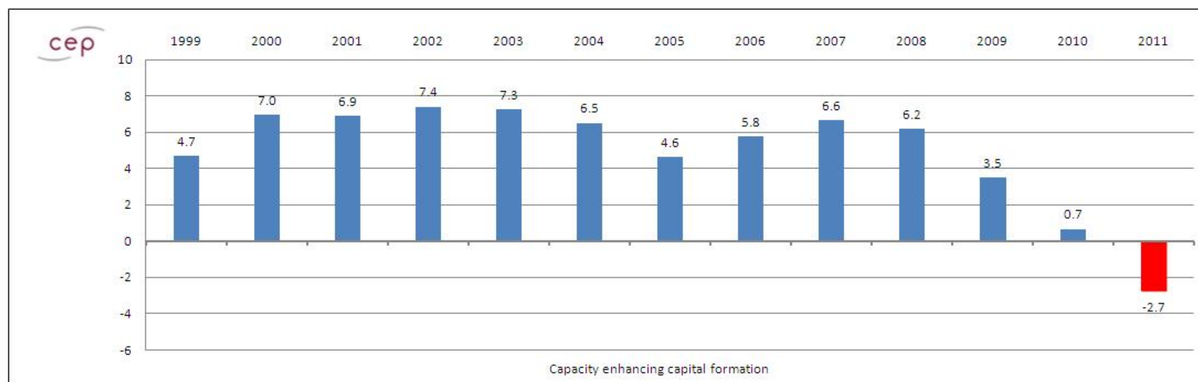
CEP Default Index for Greece: Findings

- The creditworthiness of the Greek economy has decreased steadily since 2000. Since 2007 this trend has become even more critical. In 2011, the CEP Default Index dropped to a new low point of –12.6. The negative trend of recent years keeps growing. The debt cut in March 2012 was inevitable.
- The key factors of this development in 2011 were:

  NTE: The net borrowing amounted to 9.9% of the GDP in 2011 which was only slightly lower than in 2010.



C: The Greek economy de-invested significantly in 2011. The capital stock diminished by 2.7% of the GDP.



Conclusion

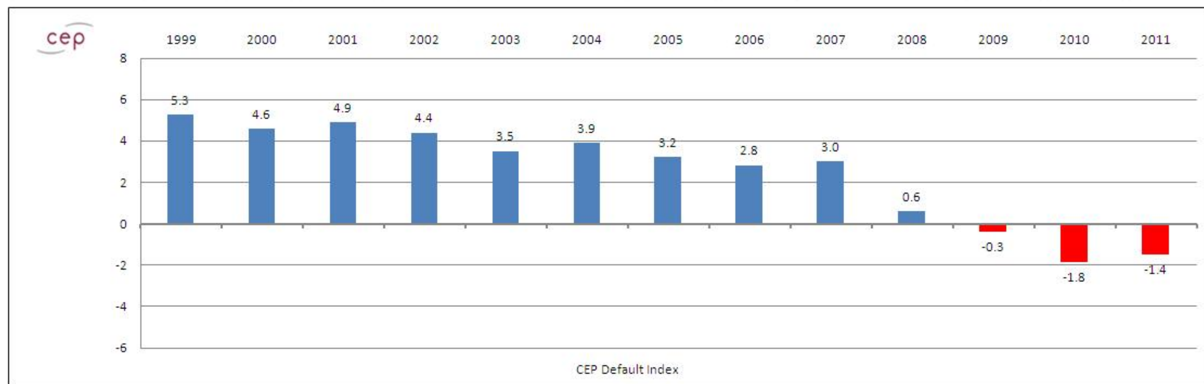
- There is still no turnaround visible in Greece.
- Greece's creditworthiness gap grew by 4.6 to 27.2 billion Euros. Hence, the dependence on foreign aid further increased. Whether or not the debt cut will change this negative trend is by no means certain.
- Without fundamental reforms, the Greek economy will not be able to regain its competitiveness – not even in the medium run – which is a precondition for deficit reduction and for closing the creditworthiness gap.
- The cause of Greece's current crisis does not lie in the austerity and reform measures agreed upon with the creditors, but in Greece's lukewarm efforts to implement them.

Reform measures and outlook

- Greece failed to sufficiently implement the measures – that it had promised to undertake for getting financial assistance. Several reforms such as an extensive modernisation of the tax system have not even been started. Also the planned privatisation of state-owned companies has not been carried out.
- A further difficulty is that numerous measures have been adopted by the Parliament or by ministries but have not or only partially been carried out by the competent authorities. For instance, at the beginning of 2011 it was agreed to simplify the access to 108 professions significantly. However, the implementation of this intention failed in most sectors due to the resistance of the parties affected or a lacking political will. Also measures to combat tax evasion were implemented only insufficiently.
- Due to its lacking willingness or ability to carry out the agreed reforms, Greece will not be able to remain a member of the euro zone unless a permanent system of fiscal transfers between Member States is established.

Italy

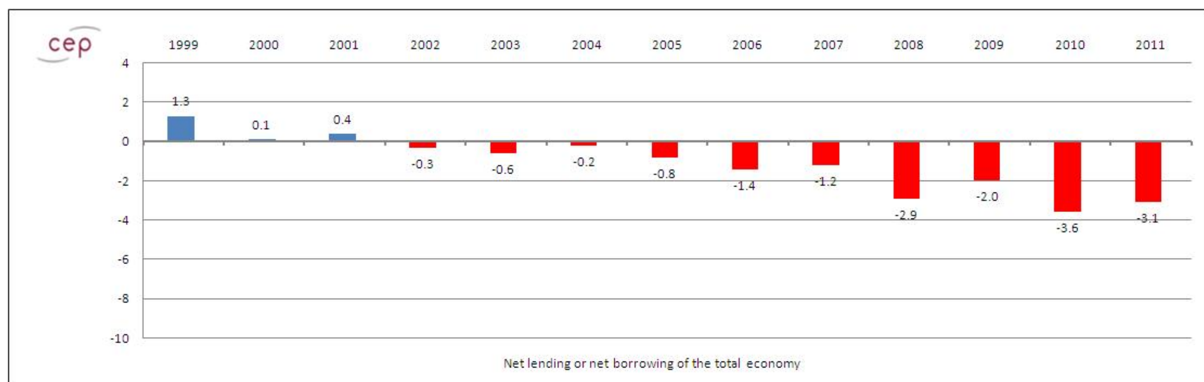
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
NTE	1.3	0.1	0.4	-0.3	-0.6	-0.2	-0.8	-1.4	-1.2	-2.9	-2.0	-3.6	-3.1
C	4.0	4.5	4.5	4.7	4.1	4.1	4.0	4.2	4.2	3.5	1.7	1.8	1.7
CEP Default Index	**5.3**	**4.6**	**4.9**	**4.4**	**3.5**	**3.9**	**3.2**	**2.8**	**3.0**	**0.6**	**-0.3**	**-1.8**	**-1.4**
Risk category	1	1	1	2	2	2	2	2	2	2	3	3	4



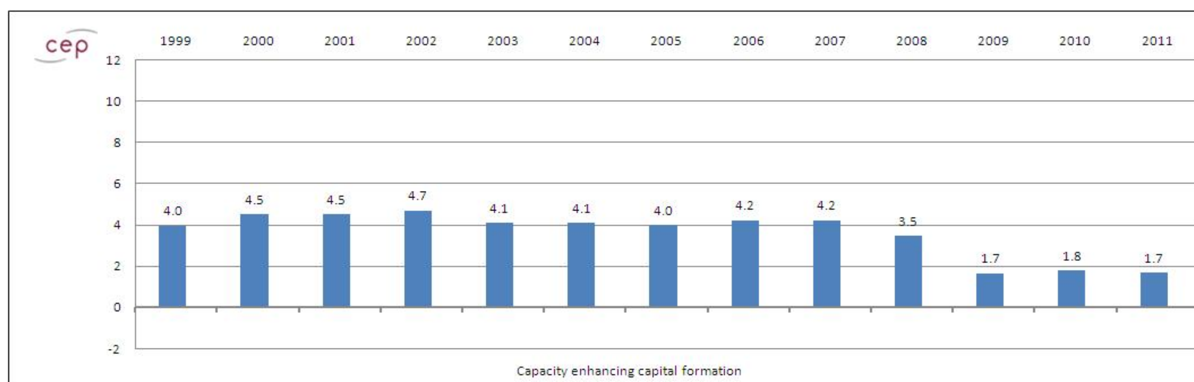
CEP Default Index for Italy: Findings

- The erosion of Italy's creditworthiness continued in 2011, though it slightly slowed down compared to 2010. However, the CEP Default Index attained a value of –1.4 and thus has been negative for three straight years. The decline of solvency of the Italian economy has therefore consolidated. There is no recognisable turnaround given the development of recent years, even more so as substantial reforms were started not until autumn 2011.
- The key factors of this development were:

NTE: The Italian economy has steadily accumulated new additional debts through foreign credits each year since 2002. Last year the net borrowing demand slightly dropped to 3.1% of the GDP.



C: Since 2009, capital formation has been less than half of that before 2007. Last year this situation persisted.



Conclusion

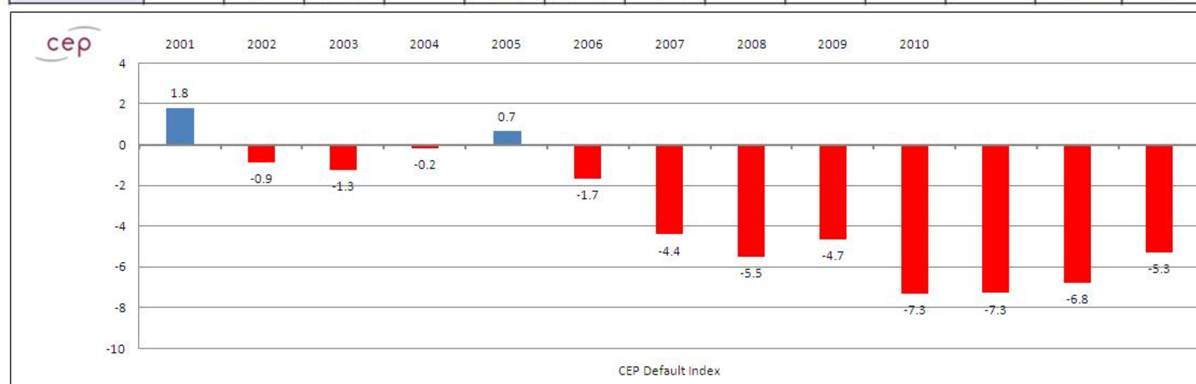
- The future of the entire euro zone depends on Italy's willingness to reform its economy, as Italy's size would simply blow the volume of the rescue package.
- In 2011 the creditworthiness gap amounted to 22.6 billion Euros.
- Like all other Southern European economies, Italy must urgently reduce its net borrowing. This requires a reduction of the current account deficits which is subject to the restoration of competitiveness.

Reform measures and outlook

- Quite a few problems have been addressed in Italy, since Monti took office in autumn 2011. One of his first measures was a reform of the pension system with a general raise of the retirement age. This was absolutely necessary as the costs of the Italian pension system are much above the European average.
- A debt brake aiming at a balanced state budget was incorporated into the Constitution. The success of the projected budget consolidation will, however, also depend on substantial cost-cuttings.
- The reform of the labour market which is still in the legislative process is a step forward. However, it was mitigated already in the run up. For instance, a court is still obliged to approve operational redundancies. The resistance to this reform is particularly strong since there is no substantial unemployment insurance in Italy.
- The same holds true for the measures to combat tax evasion and the liberalisation of many professions.
- The support for the reforms has dropped dramatically during the last few weeks, the willingness of the Italian people and parties to reform came to a halt. In order to solve its problems, Italy must revert to its reform programme. This might prove to be difficult since in view of parliamentary elections in 2013, Italian parties dread unpopular measures already today.

Portugal

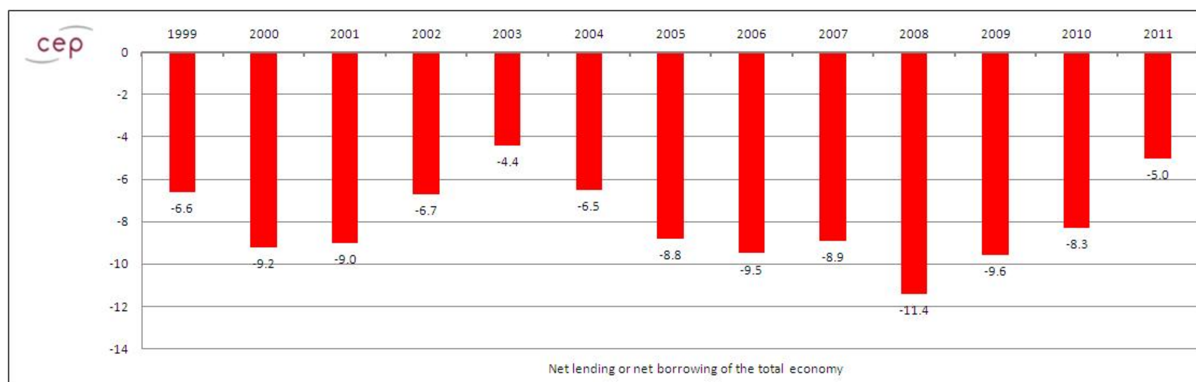
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
NTE	-6.6	-9.2	-9.0	-6.7	-4.4	-6.5	-8.8	-9.5	-8.9	-11.4	-9.6	-8.3	-5.0
C	8.4	8.3	7.7	6.5	5.1	4.8	4.4	4.0	4.2	4.1	2.3	1.5	-0.3
CEP Default Index	**1.8**	**-0.9**	**-1.3**	**-0.2**	**0.7**	**-1.7**	**-4.4**	**-5.5**	**-4.7**	**-7.3**	**-7.3**	**-6.8**	**-5.3**
Risk category	2	3	3	4	2	3	3	4	4	4	4	4	4



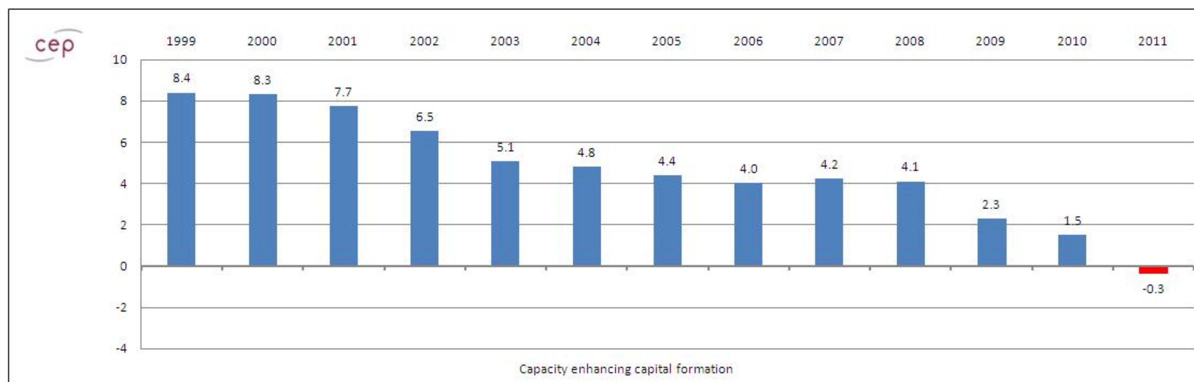
CEP Default Index for Portugal: Findings

- The erosion of Portugal's creditworthiness already started in 2004 and has continued since then. Since 2009, however, an upward trend can be observed: the CEP Default Index rose from –7.3 in 2009, to –6.8 in 2010 and to –5.3 last year. If this trend continues, Portugal will not be able to return to the capital market in 2014 as projected in the reform programme, but in 2015, i.e. by that time it will no longer need any foreign financial assistance provided that the private investors will rely on this positive trend to be sustainable.
- The key factors of the 2011 development were:

  NTE: The net borrowing amounted to 5.0% of the GDP in 2011, which was significantly lower than in 2010.



C: At the same time the capacity enhancing capital formation dropped to –0.3% of the GDP, i.e. it took a negative value for the first time; the capital stock diminished.



Conclusion

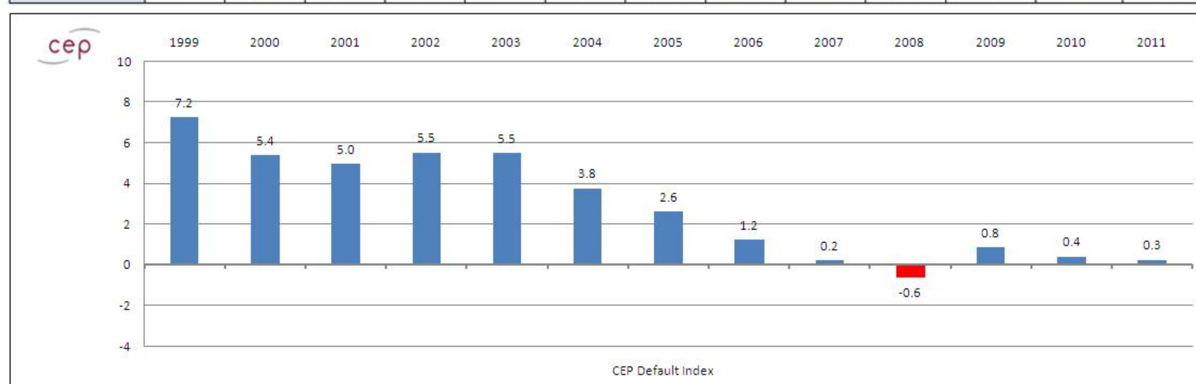
- It is rather unlikely that the target to restructure the country's economy by 2014 will be achieved. However, if Portugal continues its reform course pursued so far, it will be able to get along without foreign assistance as of 2015, provided that the private investors are convinced that the trend will continue to be positive beyond 2015.
- The creditworthiness gap decreased by 2.6 billion Euros to 9.1 billion Euros last year.
- In order to not lose sight of the target of becoming creditworthy again by 2015, Portugal must rigorously continue to pursue the reforms monitored by the troika.

Reform measures and outlook

- To date, Portugal has implemented the reforms required as a precondition for the provision of foreign assistance.
- This includes austerity measures such as the suspension of the 13th and 14th monthly salaries for employees in the public sector and for retired employees with pensions exceeding 1100 Euros per month as well as a decoupling of pensions from inflation for a period of two years.
- The required privatisations are also being carried out. Portugal has already generated 3.3 billion Euros through privatisations, out of 5.5 billion Euros agreed upon under the adjustment programme.
- A comprehensive labour market reform is on its way. Rigid working time limits were relaxed and wage negotiations at enterprise level facilitated.
- The energy and postal service sectors were liberalised and the tenancy law was reformed. An opening of regulated professions was also launched. However, there are still considerable barriers to entry, in particular in the construction and telecommunications sectors.
- Portugal is on the right track. Whether or not this positive trend will continue, mainly depends on whether or not Portugal will carry out the remaining reforms which it has undertaken to implement.

Spain

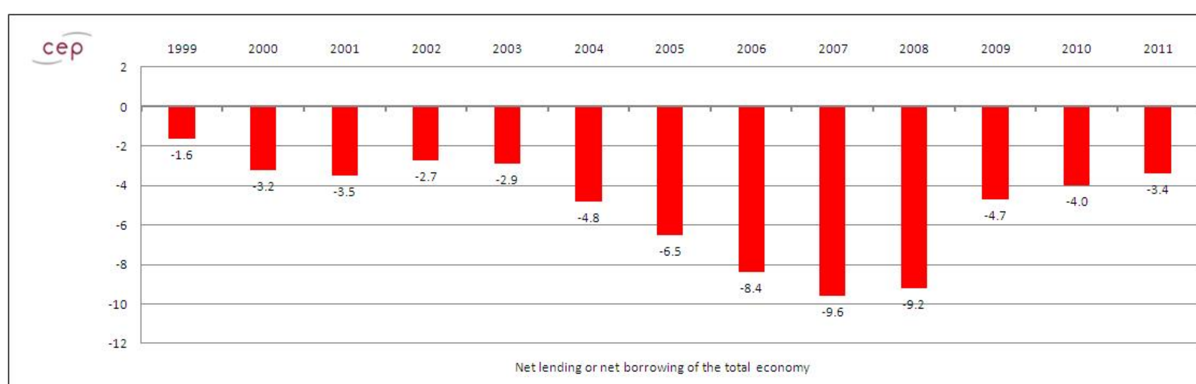
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
NTE	-1.6	-3.2	-3.5	-2.7	-2.9	-4.8	-6.5	-8.4	-9.6	-9.2	-4.7	-4.0	-3.4
C	8.8	8.6	8.5	8.2	8.4	8.6	9.1	9.6	9.8	8.6	5.5	4.4	3.7
CEP Default Index	**7.2**	**5.4**	**5.0**	**5.5**	**5.5**	**3.8**	**2.6**	**1.2**	**0.2**	**-0.6**	**0.8**	**0.4**	**0.3**
Risk category	2	2	2	2	2	2	2	2	2	3	2	2	2



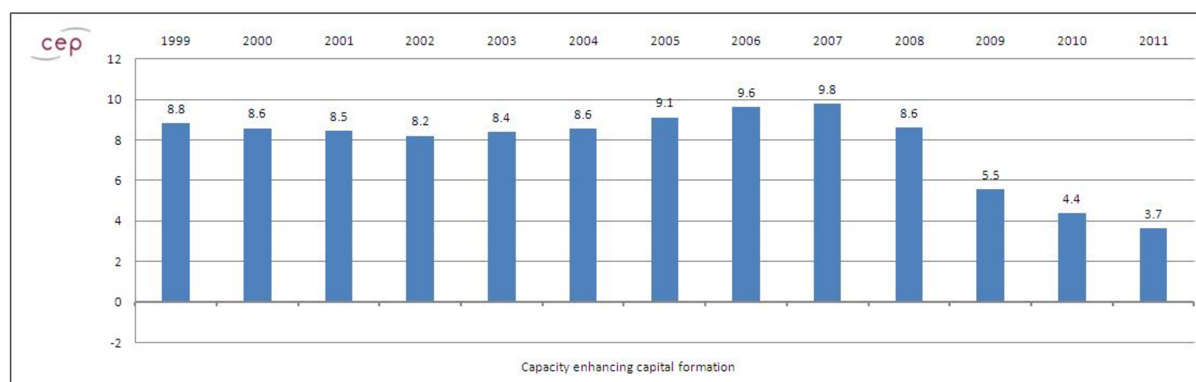
CEP Default Index for Spain: Findings

- The CEP Default Index for Spain was negative only in 2008. In the subsequent years, the values were slightly positive. In 2011, the index dropped to 0.3. The current trend of Spain's solvency is therefore uncertain. The tendency, however, is downward.
- The burdens of Spanish banks in the estimated amount of 60 billion Euros resulting from the real estate crisis – which the CEP Default Index includes to the extent that they lead to foreign credit demand – impose excessive financial burdens on the Spanish state by costly contingency and rescue measures. However, these burdens were created in the past and although their full volume is still unknown, they are "on-off" costs which – unlike Spain's competitiveness problems – do not reiterate or even exacerbate each year. In order to curb these "on-off" costs, Spain will receive EFSF loan assistance.
- The key factors for the 2011 development were:

  NTE: In 2011, the foreign credit need decreased by 0.6 percentage points to 3.4% of the GDP.



C: The Spanish rate of capacity enhancing capital formation – cleared of housing figures – was very high in the past. In 2009, it collapsed and since then has diminished continuously to 3.7% of the GDP last year. However, it is still well above the values of Italy or even Germany.



Conclusion

- If Spain wishes to restore its creditworthiness, it must reduce its foreign credit needs. However, this is possible only if the current account deficits are reduced which is subject to a restoration of competitiveness. The reform efforts of the past years must therefore be pursued consistently.
- The EFSF loan assistance will be granted in conjunction with a sector-specific adjustment programme only. Requirements to increase competitiveness in general are not set. Against this background the question arises whether Spain is planning to relax its reform efforts.

Reform measures and outlook

- In 2010, 2011, and 2012 in particular, Spain carried out labour market reforms. Statutory redundancy payments were cut and the procedures for collective redundancies and individual dismissals were eased. Moreover, companies were enabled to replace collective bargaining agreements by individual agreements. Although there is a risk that such measures lead to a rise in unemployment in the short term, they will create a positive employment development in the medium term and thus help restore competitiveness.
- The pension reform carried out in 2011 will have a positive effect, too. The retirement age was raised from 65 to 67. Moreover, early retirement was made more difficult. Nonetheless, pension expenditures will exceed the European average until 2060.
- Spain has introduced numerous measures in order to restore its competitiveness. However, it is still facing enormous challenges as it has to re-direct large parts of its economy: away from the building industry towards the tradable goods sectors. This structural change will take time. For the time being, this change is unnecessarily impeded by statutory regulations regarding the access to many professions.