Euromoney Country Risk

Country Risk: Euromoney survey highlights uneven eurozone transfer risks as region splits in two

By **ECR - Jeremy Weltman**, **Wed Mar 27, 2013**

Germany (473) , Spain (444) , France (436) , Italy (403) , United States (349) , Portugal (345) , United Kingdom (325) , Ireland (313) , Slovenia (112) , Belgium (101) , Slovak Republic (100) , Austria (71) , Sweden (62) , Estonia (62) , Denmark (58) , Finland (57) , Cyprus (41) , Luxembourg (40) , Malta (14)

Uncertainty over the legal sanctity of eurozone jurisdictions for the smaller and more indebted member states is raising alarm bells for depositors and investors. But bondholders had been alerted to heighted transfer risk by Euromoney's Country Risk Survey, Jeremy Weltman reports.

Are eurozone deposits still protected by a common safety net? Seemingly not if the recent Greek-Cypriot policymaking debacle is anything to go by.

And it's a development that is only encouraging foreign-account holders to be more wary of similar controls on capital flows in other euro jurisdictions, in small offshore locations such as Malta and the indebted periphery.

These heightened risks have been evident for some time in the changing evaluations (trend score declines) in Euromoney's Country Risk Survey, a poll of economists and other experts aggregated each quarter, notably in their assessments of transfer risk.

As of late March 2013, the survey indicates that 13 of the 17 single currency nations have succumbed to increased transfer risk since Euromoney began publishing more details of the sub-factors lying behind its country risk scores some two-and-a-half years ago.

The risk of government non-payment/non-repatriation – a measure of the risk government policies and actions pose to financial transfers – is one of 15 indicators economists and other country risk experts are asked to evaluate each quarter.

It is used to compile the country's overall sovereign risk score, in combination with data concerning access to capital, credit ratings and debt indicators. **– see chart below:**

Transfer risk questioned

The sanctity of investment law in the single currency area – the very guarantee that keeps transfer risks to a minimum – is now under threat, and both the bailout countries and other, small investment locations are most at risk.

Rather than continue to place the burden of banking sector recapitalizations on taxpayers, representing an inter-generational transfer, Europe's embattled policymakers are seeking to increase the bail-in terms to private investors – senior bondholders and uninsured depositors – remarked upon recently by Euromoney (Country Risk: Five years on, banks still inflict chronic pain on eurozone).

And Cyprus is a test-case it would seem, not the "special case" Jeroen Dijsselbloem, the Dutch president of the Eurogroup of finance ministers, refers to. He added that future bank resolutions should bail in senior credit holders.

Many have perhaps forgotten that Denmark, with its own series of bank packages culminating in a bail-in approach, ultimately provided the test tube and the instruction manual.

No wonder euro account holders are dusting off the bottle of Valium, the 1990s vintage handed out to the euro's back-slapping designers – the one that also sealed in the genie.

Having stopped short of allowing banks to fail as the free market would stipulate, and agreeing to provide a rescue fund (the European Stability Mechanism) for direct recapitalizations, it would appear that Europe's flailing politicians are warming again to the principles of free market economics by encouraging investors to do the dirty work of punishing the weak banks.

This can only create more pressure on the ECB as lender of last resort and result in higher borrowing costs as the banks' funding difficulties are passed on, attenuating the eurozone's sclerotic trends. The prospect of growth this year vanished long ago, if not in Germany certainly elsewhere.

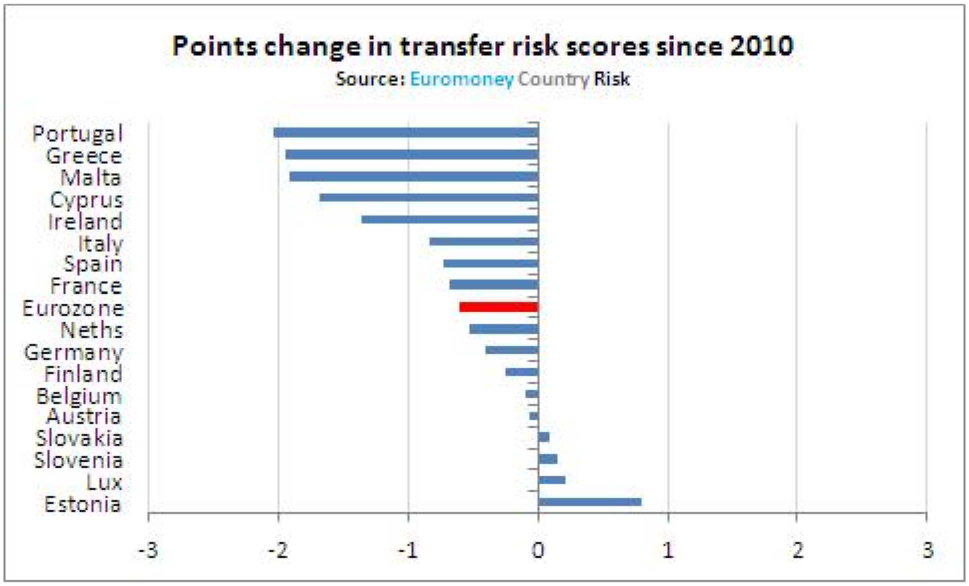
Transfer risk variation

And investors will worry that other states are about to face the same consequences, piling on yet more financial pain.

As Lorenzo Naranjo, assistant professor at the French ESSEC Business School and one of Euromoney's Country Risk Survey contributors, says: "The problem goes beyond the size of the bailout or whether the ECB can save a country from default, the problem is very political. German taxpayers are reluctant to behave as a union in bailout states."

"The problem is that one bloc wants to behave one way and the other bloc another, and this is where the transfer risk associated with the eurozone is evident."

Indeed, the ECR survey highlights considerable variation in perceived riskiness for financial transfers across the eurozone, a region that had seemingly offered the safety of pooled risks.



Luxembourg, the second safest sovereign in the world out of 186 countries on ECR's global risk data table (and within the top tier of ECR's five risk categories), is still scoring a commendable 9.7 points out of 10 for transfer risk.

The Grand Duchy was not untouched by the 2007/08 crisis. Its cross-border ownership structure put paid to that, as Icelandic, Belgian and German länder operators with Luxembourg-based subsidiaries all rocked under the pressure of high-risk exposures.

However, transfer risk was never considered a substantial risk, per se, and neither is it now, according to the experts, due to its strengths and importance to larger states that offer security. The sovereign also scores 8.0 out of 10 for bank stability, two points above the eurozone average of 6.0.

As M. Nicolas J. Firzli, an ECR survey respondent and director general at the Paris-based **World Pensions Council** (WPC), says: "In the case of Luxembourg, early accession to the euro in 2002 had very little inflationary impact, as the Luxembourg franc was a traditionally strong currency, pegged to the Belgian franc and part of the [former] West German monetary sphere of influence – the Deutschemark bloc.

"The domino effect has not reached this bloc – quite the contrary actually. De facto, that currency bloc is reforming before our eyes, leaving behind both the collapsing economies of southern Europe and the stagnating French economy, while preventing them from using the monetary and fiscal leeway needed to restart their growth engine."

At the other extreme, Greece, a tier-five sovereign in 110th place, scores just 4.1 points for transfer risk. Moreover, Cyprus, one of five countries in the 17-nation eurozone to have now received a bailout of some description (along with

Greece, Ireland, Portugal and Spain), and having fallen into the third of ECR's five tiers lately – was already below the eurozone average for its transfer risk as of the end of 2012. So, too, were the other bailout nations.

However, note that other eurozone participants with transfer risk scores below the eurozone average – as of March 2013 – are Italy (ranking 53rd on Euromoney's global risk scoreboard), Malta, an otherwise comparatively safe sovereign in 26th spot, and Estonia, placed even higher at 23rd.

Euromoney's experts are apparently just as worried about those three where financial transfers are concerned, providing one reason why an inspection of the sub-factors comprising the overall risk score can prove so illuminating.

Changing perceptions

Yet it's not just about absolute levels of risk –changing perceptions are equally important.

Absolute scores say one thing. The change in those scores says another. Estonia's score is low, but it has also improved since December 2011 (by 0.3 points) and September 2010 (by 0.8), suggesting it is not as imminently at risk.

One or two others have also strengthened during the past two-and-a-half years, including Slovakia, a touch. So a combination of absolute score and directional change is the appropriate guiding tool.

By contrast, those countries to have registered the largest falls in the past two-and-a-half years include the Piigs: Portugal Italy, Ireland, Greece and Spain. Cyprus is there too. Its transfer risk score has fallen by 1.7 points during the period, providing an early warning indicator of its current predicament.

However, nestling in among the 'known knowns' (the bailouts) are Malta and France. Both have seen their transfer risk scores decline more than the eurozone average since 2010. Worrying times perhaps, but not so much for France, which, as ESSEC's Naranjo states, "still has low borrowing costs, and the market is deep and liquid", but for Malta (down 1.9 points), another small island, the offshore centre is expecting contagion from the Cypriot crisis.

Could it be that Malta will see capital withdrawals in conjunction with the indebted periphery being nursed in intensive care? Malta, along with Luxembourg, has one of the highest bank assets-to-GDP ratios in Europe. It joined the eurozone with Cyprus on that fateful flag-waving day at the beginning of 2008.

WPC's Firzli says: "Luxembourg, Malta and Cyprus are sometimes viewed as similar member states within the EU: small countries with an oversized financial services industry and a liberal fiscal regime, the former being the consequence of the latter.

"But as the widening gap between Luxembourg and Malta across most ECR metrics clearly shows [notably in terms of capital repatriation], experts are increasingly downgrading Malta in light of the Cyprus and broader eurozone crisis.

"Luxembourg, being part of the new Deutschemark bloc, means it is still perceived as a safe haven, but Malta being completely removed from this club means it will see higher transfer risks, higher spreads on its national debt and relatively lower foreign direct investment."

Slovenia is another problem.

As Ales Pustovrh, managing director of Bogatin – a Slovenian consultancy – and another of the ECR survey's contributing experts, says: "Transfer risk is not a big risk for the larger economies, but for the smaller, peripheral ones the risk is very much real. Smaller eurozone members are more exposed to contagion risks than larger ones.

“Slovenia is on everybody’s mind for a bailout. There are significant differences between Cyprus and Slovenia, especially in terms of the size of the banking sector.

“But while I would certainly name Spain and Belgium as more risky than Slovenia, they are both large economies so there will be political solutions for these countries to remain in the euro, whereas they can certainly allow Slovenia to exit.

“We cannot talk about a common eurozone risk anymore.”

Depositors and investors in all of these countries will be scrutinizing banks more carefully than they would otherwise, particularly with safer jurisdictions lying inside and outside the currency zone.

Euromoney survey experts awarded low risk, high scores of 9.3 for Denmark, 9.5 for Sweden and 9.6 for Norway, the world’s safest sovereign, as of March 2013. The US scored 8.5 and the UK 8.4, both exceeding the eurozone average of 7.8.