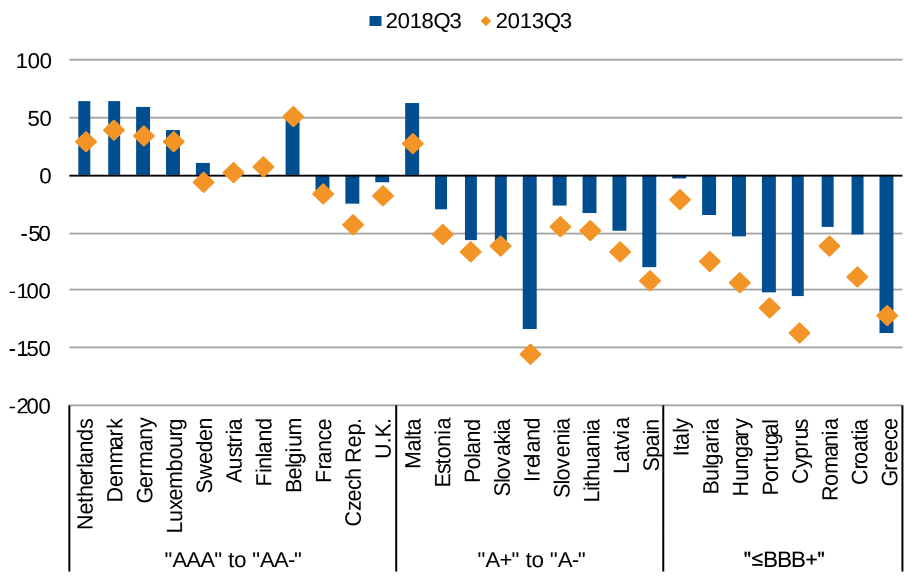
EU-28's vulnerability to external shocks diminishes but divergences prevail

European Union member states' vulnerabilities to external shocks have diminished in the past five years, but progress is uneven and reveals a lack of convergence among the 28 economies despite several years of growth.

Recent economic shocks have underscored the importance of the size and composition of an economy's external assets and liabilities. A net international investment position (NIIP) relative to GDP - the difference between the economy's stock of external financial assets and external financial liabilities relative to its size - that is significantly negative exposes an economy to international financial-market volatility if capital flows out. This can lead to liquidity shortages. It tends to be a sign of underlying vulnerabilities, including low domestic savings, a narrow export base, dependency on imports, but also high foreign direct investments (FDI). On the other hand, large net external asset positions can indicate an open, competitive economy with a liquid domestic capital market.

Figure 1: Net international investment positions, % of GDP



Source: National Banks and Statistical Offices, Scope Ratings. *Countries are shown in order of rating levels.

- ✓ Using the yardstick of a country's NIIP relative to GDP, our analysis shows that Greece, Ireland, Cyprus, Portugal and Spain remain the EU's most vulnerable economies, though there are compensating factors in each case such as improvements in current account balances and composition of liabilities.
- ✓ In contrast, Netherlands, Denmark, Malta and Germany have further improved their robust NIIPs. Italy looks less vulnerable to external shocks than it did in 2013, while France's net international debtor position has remained largely unchanged and lags the NIIPs of the strongest economies. The weakness in sterling against the dollar and euro in the aftermath of the 2016 referendum on EU membership has had a favourable impact on the NIIP position of the UK.
- ✓ We note there has been significant convergence in Central and Eastern Europe. Hungary, Croatia and Bulgaria have sharply improved NIIP ratios.

Overall, 16 EU member states, up from just 12 in 2013, currently have an NIIP ratio that is stronger than the -35% of GDP threshold, which the European Commission uses as one of the headline indicators covering the major sources of macroeconomic imbalances.

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NIIP as a proportion of an economy's size is central to the "external economic risk" assessment in Scope's core variable sovereign credit rating scorecard, which aims to capture the soundness and sustainability of a sovereign's external position and resilience to external shocks. This report analyses the recent developments in the external positions of EU28 economies, and the drivers behind them from a structural perspective.

Four major trends in external risk profiles of EU countries

As Figure 1 shows, most of the EU economies with the biggest negative NIIP-to-GDP ratios have notably reduced their external financial exposure after the euro area crisis, driven by recovery in current account[1] (CA) balances and economic performance. However, the risks to external sustainability remain elevated in some of the economies. Here are the key developments.

- **Divergence then stability among EU28:** While, on average, European economies have managed to improve their net international investment positions, heterogeneity among the EU28 remains significantly higher judging by the standard deviation (SD) of NIIP-to-GDP ratios (SD in Q3 2018=57) compared with the onset of the crisis (SD in Q3 2008=41) and having hardly changed since the crisis.
- **Euro area periphery countries**, with the largest negative NIIP positions among the European economies, have idiosyncratic risks to external sustainability reflecting differences in the structure of their economies. While their external performance improved after the crisis, the stock of NIIP remains high and makes the economies vulnerable to external shocks. The structure of external liabilities, however, mitigates financial sustainability risks.
- **Central and Eastern European Countries (CEE)** have substantially reduced their net external liabilities, driven by stronger surpluses in services account, and lower deficits in goods trade reflecting gains in world export shares.
- **Finally, the net creditor nations** have continued to build up their net asset positions due to the structural strengths of their economies, including high savings and international competitiveness, but also strong surpluses in services for financial centres such as Malta and Luxembourg.

Composition effects reduce external risks for EA periphery

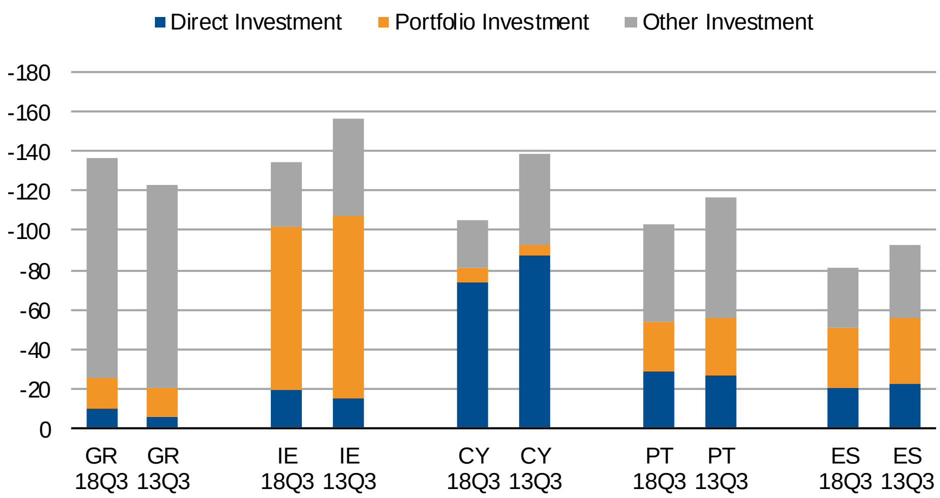
Improving structure of external liabilities but significant risks from a stock perspective

Portugal (BBB/Sta) and Spain (A-/Sta) recorded CA surpluses since 2013, due to cost competitiveness gains as well as structural improvements to the countries' export bases, reflected in a broader diversification by sector and region. This, coupled with the positive economic growth, has led to an average reduction of around 13pp in the NIIP-to-GDP ratio since Q3 2013 for both economies. While only around a quarter of assets held by foreigners are in FDI, its share has increased over the last few years, especially for Portugal. The reduction in NIIPs has been somewhat offset by valuation effects due to the increased market value of portfolio debt securities issued by residents. Still, even accounting for these effects, both economies' net IIP remains far below the European Commission's threshold of negative 35% of GDP used in its macro-economic imbalance procedure to identify external vulnerabilities[2].

[1] NIIP is the sum of past current account balances adjusted for changes in the value of stocks, exchange rate, and non-performing debt, which is written off.
[2] Excessive net foreign liabilities are a common harbinger of external crises, which often lead to severe output losses. A standard early warning model indicates that net foreign liabilities in excess of around 35% of GDP are associated with heightened risks of an external crisis. The risks become even more substantial at levels beyond 50% of GDP. https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op198.en.pdf?dd48dc2fe1941f6f88e9c75eb4becc18
https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/macroeconomic-imbalance-procedure/scoreboard_en

Yet risks have abated given the change in the composition of external liabilities. Specifically, the government and central bank's share has increased from around 28% and 44% of total external liabilities in Q3 2013 to 37% and above 45% in Q3 2018 for Spain and Portugal respectively, whereas the share held by financial institutions, in the context of ongoing deleveraging, reduced by 6pp on average to around 21% and 13% over the same period.

Figure 2: Net international investment positions, % of GDP (reversed scale)



Source: National Banks and Statistical Offices, Scope Ratings.

Cyprus's high external debt reflects its position as business and financial services hub

Despite deleveraging and improvements in the composition of Cyprus' (BBB-/Sta) international balance sheet, its negative net IIP is still high at around 105% of GDP, exposing the sovereign to shocks or sudden shifts in market sentiment. However, while gross financial flows are considerable relative to net positions and Cyprus' GDP (stocks of IIP assets and liabilities are respectively 13x and 14x GDP) these are associated with special purpose entities (SPEs)[3] (mostly financial), mainly relate to foreign direct investment (about 70% of total assets and liabilities) and are largely offsetting[4]. Adjusted for the impact of SPEs, net IIP is significantly lower at around -36% of GDP in Q2 2018, which compares favourably with peers.

Brexit and corporate tax cuts add to external risks for Ireland

Ireland (A+/Sta) has substantially strengthened its external economic performance, mainly driven by stronger performance in merchandise exports: the sum of CA balance-to-GDP ratios between Q4 2008-Q3 2013 stood at -10%, compared to 20% in the period thereafter. As a result, Ireland's NIIP fell to -134% of GDP as of Q3 2018. However, as a small and highly globalised economy, Ireland is vulnerable to adverse external shifts that can impact economic activity and revenue generation. Specific externally driven risks include those associated with Brexit. Ireland has been a favoured destination for equity investment by MNEs in past decades, including those using special tax schemes. As a result, FDI and equity liabilities together account for almost 70% of total foreign liabilities. Against this backdrop, corporate tax cuts in the US and EU may substantially slow such flows and affect MNE operations in Ireland, with potentially adverse effects for output, employment and the fiscal position.

[3] SPEs comprise i) non-financial SPEs, mainly companies owning ships leased to third parties, with real assets on balance sheets matched by financial liabilities incurred to finance the ships' purchase; ii) financial companies which belong to an international group and channel funds between non-resident entities on behalf of their non-resident parent company, thus their financial assets match their financial liabilities; and iii) factoring or invoicing companies which invoice the sales of the worldwide group on behalf of the parent. IMF Article IV December 2017.

[4] IMF Article IV December 2017.

Greece's high NIIP stock weighs on economic performance

Greece (B+/Pos) increased its net external liabilities, by 13pp of GDP in the period Q3 2013-Q3 2018 to 137% of GDP, which is high and continues to drag on the recovery as domestic savings remain limited, estimated at 12% of GDP in 2018 by IMF. These would have to be mobilised to make room for investment, potentially supported by higher FDI inflows. Currently, FDI makes only 7.4% of external liabilities, representing 1pp point increase from the same period in 2017. The dominant share of external liabilities comprises government loans worth EUR 264.7bn or 60% of total. While Greece has managed to improve its external performance due to weaker import demand but also stronger exports, its current account have been in deficit over the past few years, which is projected to continue in the medium-term.

Strong services offset high but improving goods deficits for CEE

Significant external adjustment in most CEE economies

Bulgaria (BBB/Pos), Croatia (BB+/Sta) and Hungary (BBB/Pos) have managed to materially reduce their net external liabilities, by an average of 40 pp of GDP in the period Q3 2013-Q3 2018. Almost half of this has been due to current account surpluses, driven by stronger services surplus in case of Croatia and Hungary, and higher goods exports in case of Bulgaria. The NIIP for these three CEE countries fell to -36%, -52%, and -53% of GDP respectively in Q3 2018.

In order to fully capture the risks to financial sustainability, one should also take into account the structure of external liabilities. In general, portfolio investments are more prone to flight in times of market volatility, as opposed to FDI, which create long-term interests in the recipient economy. In this context, most of the CEE countries have a similar structure of external liabilities, with around half of them in the form of FDI, the rest representing portfolio and other investments. The outliers are Bulgaria and Estonia (A+/Sta), with respectively 64% and 59% FDI shares in domestic assets owned by foreigners, and Latvia (A-/Sta), Lithuania (A-/Sta) and Slovenia (A-/Sta) with only one-third of external liabilities comprising FDI. Positively, the share of FDI in total liabilities has increased for most of the CEE economies over the past few years.

Table 1: CEE: combined cumulative current account balance, % of GDP

	2008Q4-2013Q3	2013Q4-2018Q3
Current account	-88.2	66.4
Goods	-251.1	-157.6
Services	256.1	341.8
Primary income	-143.5	-157.0
Secondary income	50.3	39.3

Source: National Banks and Statistical Offices, Scope Ratings. CEE comprises Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. Calculated as the sum of quarterly CA balances, % of non-annualised GDP of the previous four quarter.

Italy's external vulnerability diminishes, France's little changed, Brexit creates uncertainty in UK's external outlook

Italy (BBB+/Sta) has substantially reduced its net external liabilities, by 20pp of GDP in the period Q3 2013-Q3 2018, supported by strong surpluses in goods trade. As of Q3 2018, it stood close to the balance, -3.1% of GDP, far below the MIP threshold, which compares favourably with peers.

France (AA/Sta) has recorded moderate current account deficits over the past decade, reflecting deficits on the goods and secondary income accounts, partly offset by surpluses in services trade and primary income. As a result, France's net international debtor position relative to GDP has remained largely unchanged, standing at around -13% as of Q3 2018.

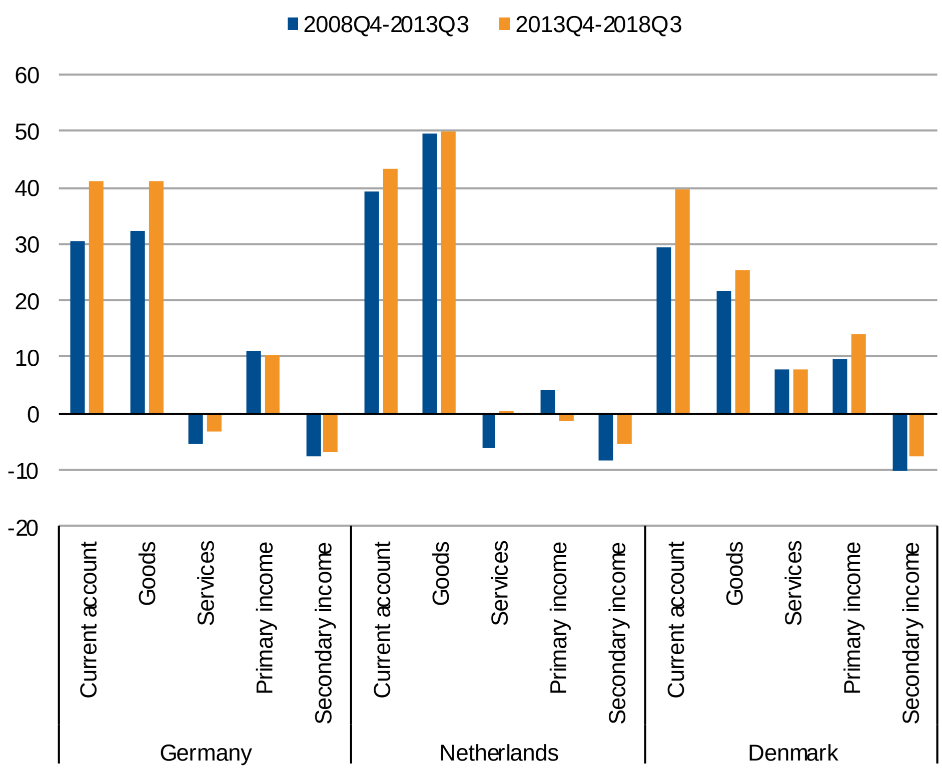
Assessing the vulnerabilities of the UK (AA/Neg) is currently particularly difficult given the uncertainty surrounding Brexit, which might now be delayed beyond a 29 March 2019 deadline. Trends in exchange rates have mostly had a favourable impact on the NIIP position of the UK, reflecting the weakness in sterling against the dollar and euro in the aftermath of the 2016 referendum on EU membership. The UK's NIIP amounted to -5.4% of GDP as of Q3 2018. The flexibility of the UK's monetary and exchange rate regime is a major credit strength, acting as an automatic stabiliser during crises.

Low and falling external risks for internationally competitive economies

Large external surpluses reflecting fundamental strength

Netherlands (AAA/Sta), Germany (AAA/Sta), Denmark (AAA/Sta) and Malta (A+/Sta) have steadily increased their net external asset positions, by an average of more than 30pp of GDP in the period Q3 2013-Q3 2018 to around 60% of GDP, driven by large CA surpluses (Annex 1). Unlike Malta, whose external position is dominated by services exports in transport, tourism and gaming, alongside large negative balance on goods trade and primary income, Netherlands, Germany and Denmark mostly benefit from very high goods surpluses. Finland (AA+/Sta) turned from net creditor to net debtor, reflecting weaker goods surplus partly counterbalanced by lower services deficit.

Figure 3: Cumulative current account balances, % of GDP



Source: National Banks and Statistical Offices, Scope Ratings. Calculated as the sum of quarterly CA balances, % of non-annualised GDP of the previous four quarter.

Annex 1: External balances, % of GDP

Net international investment positions, % of GDP

	2013Q3	2018Q3
Netherlands	28.3	65.3
Denmark	38.8	65.2
Malta	25.9	62.6
Germany	32.6	59.4
Belgium	49.4	51.4
Luxembourg	27.6	39.5
Sweden	-7.5	10.8
Austria	1.4	5.4
Finland	6.2	-1.6
Italy	-22.9	-3.1
U.K.	-19.2	-5.4
France	-17.6	-12.7
Czech Rep.	-43.4	-25.4
Slovenia	-45.7	-26.9
Estonia	-52.9	-28.9
Lithuania	-49.5	-32.6
Bulgaria	-76.2	-35.5
Romania	-62.9	-44.8
Latvia	-68.3	-48.8
Croatia	-89.6	-51.9
Hungary	-94.7	-53.1
Poland	-67.8	-56.9
Slovakia	-62.8	-65.9
Spain	-93.0	-80.6
Portugal	-117.0	-102.8
Cyprus	-138.7	-105.3
Ireland	-156.7	-134.4
Greece	-123.5	-136.9

Current account balances % of GDP, period averages

	2008Q4-2013Q3	2013Q4-2018Q3
Netherlands	7.8	8.6
Germany	6.0	8.1
Denmark	5.8	7.8
Malta	-4.0	6.1
Luxembourg	5.3	6.0
Slovenia	0.7	5.9
Ireland	-2.1	3.8
Sweden	5.8	3.7
Hungary	0.5	3.2
Croatia	-1.5	3.1
Bulgaria	-2.9	2.7
Austria	2.2	2.2
Italy	-1.8	2.2
Estonia	0.6	1.7
Spain	-2.5	1.4
Czech Rep.	-2.2	0.7
Portugal	-6.1	0.4
Lithuania	-1.4	0.2
Belgium	-0.5	-0.2
Latvia	-0.2	-0.2
France	-0.8	-0.7
Poland	-4.2	-0.8
Finland	-0.4	-1.1
Slovakia	-2.4	-1.3
Greece	-8.5	-1.7
Romania	-4.5	-2.2
Cyprus	-7.8	-4.5
U.K.	-3.5	-4.6

Source: National Banks and Statistical Offices, Eurostat, Scope Ratings GmbH. Period averages are calculated as the averages of quarterly CA balances, % of non-annualised quarterly GDP.

Annex 2: Cumulative current account balances, % of GDP

		2008Q4-2013Q3	2013Q4-2018Q3
Germany	Current account	30.5	41.2
	Goods	32.5	41.1
	Services	-5.5	-3.4
	Primary income	11.0	10.5
	Secondary income	-7.5	-7.0
France	Current account	-3.8	-3.3
	Goods	-12.3	-9.3
	Services	6.2	5.3
	Primary income	12.1	10.9
	Secondary income	-9.7	-10.3
Italy	Current account	-9.1	11.1
	Goods	0.0	15.4
	Services	-1.6	-0.7
	Primary income	-1.4	1.1
	Secondary income	-6.1	-4.7
Netherlands	Current account	39.3	43.4
	Goods	49.8	49.8
	Services	-6.3	0.4
	Primary income	4.0	-1.5
	Secondary income	-8.2	-5.3
Belgium	Current account	-2.5	-0.9
	Goods	-9.3	-1.7
	Services	9.4	5.0
	Primary income	5.3	3.9
	Secondary income	-8.0	-8.1
Spain	Current account	-12.6	7.2
	Goods	-17.6	-9.9
	Services	18.3	23.1
	Primary income	-6.8	-0.9
	Secondary income	-6.4	-5.1
Portugal	Current account	-30.3	2.0
	Goods	-41.1	-28.9
	Services	23.1	37.1
	Primary income	-14.2	-11.3
	Secondary income	2.0	5.1
Ireland	Current account	-10.3	20.4
	Goods	112.7	177.7
	Services	-29.2	-49.8
	Primary income	-85.8	-99.8
	Secondary income	-7.9	-7.6
Austria	Current account	11.1	11.2
	Goods	-3.3	2.5
	Services	17.8	14.7
	Primary income	1.8	-1.5
	Secondary income	-5.2	-4.6
Finland	Current account	-2.1	-5.5
	Goods	14.3	3.6
	Services	-13.2	-6.3
	Primary income	2.2	2.7
	Secondary income	-5.4	-5.6
Greece	Current account	-41.5	-8.3
	Goods	-62.2	-55.9
	Services	31.6	49.2
	Primary income	-9.1	-0.7
	Secondary income	-1.8	-0.9
Slovakia	Current account	-12.0	-6.4
	Goods	6.4	8.7
	Services	-1.7	2.9
	Primary income	-9.8	-9.8
	Secondary income	-6.8	-8.1
Slovenia	Current account	3.7	30.2
	Goods	-5.8	17.2
	Services	19.1	27.9
	Primary income	-6.6	-11.1
	Secondary income	-3.0	-3.8
Estonia	Current account	2.9	8.8
	Goods	-23.9	-21.7
	Services	44.1	40.6
	Primary income	-20.3	-11.2
	Secondary income	2.9	1.0

		2008Q4-2013Q3	2013Q4-2018Q3
Latvia	Current account	-2.0	-1.0
	Goods	-54.5	-45.3
	Services	36.8	43.5
	Primary income	6.2	-2.9
	Secondary income	9.5	3.8
Lithuania	Current account	-7.1	1.2
	Goods	-24.6	-23.0
	Services	18.8	30.4
	Primary income	-9.6	-18.0
	Secondary income	8.2	11.7
Luxembourg	Current account	26.7	30.5
	Goods	-22.0	-10.0
	Services	169.9	192.2
	Primary income	-120.0	-157.1
	Secondary income	-1.2	5.4
Cyprus	Current account	-38.8	-22.8
	Goods	-101.5	-96.8
	Services	83.7	96.8
	Primary income	-15.0	-10.5
	Secondary income	-6.0	-12.3
Malta	Current account	-19.7	31.9
	Goods	-88.0	-82.6
	Services	98.4	156.9
	Primary income	-27.4	-37.6
	Secondary income	7.3	-1.1
U.K.	Current account	-17.5	-23.4
	Goods	-30.1	-33.5
	Services	22.1	25.8
	Primary income	-3.5	-9.8
	Secondary income	-5.9	-5.9
Denmark	Current account	29.4	39.6
	Goods	21.8	25.5
	Services	8.0	7.6
	Primary income	9.6	14.1
	Secondary income	-10.0	-7.7
Sweden	Current account	29.2	18.6
	Goods	20.7	12.2
	Services	4.8	7.7
	Primary income	12.2	6.9
	Secondary income	-8.6	-8.2
Czech Republic	Current account	-10.9	3.5
	Goods	10.5	23.9
	Services	9.8	10.0
	Primary income	-28.6	-28.2
	Secondary income	-2.7	-2.2
Hungary	Current account	2.8	16.2
	Goods	13.7	12.1
	Services	14.3	26.6
	Primary income	-22.3	-19.3
	Secondary income	-2.9	-3.2
Poland	Current account	-21.3	-3.9
	Goods	-13.3	0.2
	Services	7.5	15.9
	Primary income	-15.1	-19.3
	Secondary income	-0.4	-0.7
Romania	Current account	-22.5	-11.6
	Goods	-35.9	-28.0
	Services	8.2	21.6
	Primary income	-6.8	-12.6
	Secondary income	11.9	7.4
Bulgaria	Current account	-14.5	14.1
	Goods	-50.1	-21.0
	Services	30.5	31.2
	Primary income	-16.0	-14.8
	Secondary income	21.0	18.8
Croatia	Current account	-7.1	15.2
	Goods	-73.5	-80.6
	Services	68.6	91.2
	Primary income	-14.7	-9.9
	Secondary income	12.5	14.5

Source: National Banks and Statistical Offices, Eurostat, Scope Ratings GmbH. Calculated as the sum of quarterly CA balances, % of non-annualised GDP of the previous four quarter.

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