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# SUGGESTIONS ABOUT SOVEREIGN RATING IN SOUTH EASTERN EUROPE

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**Abstract**

*Since the beginning of the financial and economic global crisis, the governments started to protect the Country's economic stability by saving those banks that were at risk of bankruptcy on one hand and by intervening on raising public spending. The public debt of many European Countries was high before the outbreak of the financial crisis and after that, those debts rose for many Mediterranean Countries. In this situation in EU and in the Balkan region grew a debate about measuring the sovereign credit risk. Rating agencies were at the center of the debate. Ireland had a quite low GDP rate of public debt but the crises in the financial system pushed the country to risk an economic collapse. Should we consider only the Public Debt for the "Country Risk" evaluation or should we also include the private ones? We will analyze the general levels of public and private debt for the Countries of the Balkan region from 2006 to 2019 and we will verify the compatibility of the ratings and credit spreads, proposing new credit ratings that will take into account the level overall debt in each Country. Finally, we will underline similarities and differences of the new evaluations.*

*Keywords: Public Debt, Private Debt, Economic Crisis, Balkans, Rating*

## INTRODUCTION

The economic and financial crisis forced the governments of the most developed Countries to intervene in order to save their banking and financial systems, which were close to collapse. Governments intervened through subsidies and other forms of assistance to help the poorest part of the population and the real economy. The purpose of this paper is not to address all governments interventions in their respective economies. This paper is focused only on the links between financial institutions (banking system) and state institutions, as the ultimate guarantors, against the financial destruction of a country.

The credibility and ability of state institutions to respond to the commitments undertaken and to honor the debts contracted has always been highly appreciated in recent years by the rating agencies. These institutions are specialized at the evaluation of financial instruments issued by public and private institutions. The most important rating agencies are Standard and Poor's, Moody's and Fitch. Even if with some variations on the evaluations, the variables on whom the rating agencies outlook is given remains the same.

Ribeiro (2006) categorized some standard economic variables that could be found in diverse approaches adopted by financial institutions and rating agencies into:

1. External sector variables such as: exports, imports, debt services, direct investments, loans, repayment of loans, external debt and flow of foreign reserves, foreign exchange rate.
2. Internal sector variables (public and private) such as: interest rate, public debt and its service, level of investments, budget deficit, internal savings (domestic saving), consumption, GDP/GNP, inflation rate, money supply, etc,
3. Qualitative variables that take into account social aspects such as: population, life expectancy (birth rate), unemployment rate, level of education, etc.

These estimates have a very high, if not decisive, influence on the spread of government bonds. In other words, specifying the interest rates that governments have to pay for their loans. However, there have been many criticisms on the results of the evaluations carried out by these agencies. The two main criticisms of these agencies were the unpredictability of the economic crisis and the sovereign debt crisis.

The element of the total credit or loans (government + private) for the economy in relation to GDP is not one of the variables these agencies consider. One of the reasons why the rating agencies did not predict the sovereign debt crisis could be that they do not analyze (take into consideration) this element.

This paper analyses the cumulative level of debt made by the public debt and by the private one. We will mention also some theories on the optimal rates of this aggregate debt in developed and developing countries. Our goal is to analyze the data from 2006 to 2019 (before the global crisis to nowadays) of the possible variations of the new indicator in the Balkan Countries. The expected results will be compared with the Sovereign Ratings provided by the agencies. We will analyze than if these ratings would change positively or negatively for each Country in relation to the results of this new indicator. Each rating has a corresponding spread that can change over time depending on the perception of risk that the market has. After assigning a new rating to each country in South East Europe, we will show an average spread that corresponds to it taking into account market data in 2019.

Changing country spreads could make each country's debt service more or less expensive. A lower cost of public debt could free up liquidity that could be better used in capital investments or in tax cuts, giving important impulses to the economy. A higher cost of public debt, a symptom of a highly indebted private economy, could open the eyes of the rating agencies in evaluating more consistently the risks that financial crises can bring.

## THE EVALUATION OF PUBLIC AND PRIVATE DEBT

The public debt of many European countries was already high before the outbreak of the financial crisis in the United States. It increased and became almost unsustainable for many Mediterranean Countries. In that situation in E.U. and in the Balkan region there was a debate about measuring the risk level of each Country. One of the most important questions was: Should we calculate just the public debt or we must look at the cumulative level of debt including the private sector debt?

Indeed, the last financial crisis was born out of private debt, with Lehman Brothers going bankrupt at the end of 2008. If we refer to the McKinsey Institute, between 2000 and 2008 in the most developed economies, total debt increased significantly. At least 75% of this debt was generated not by governments through public debt, but by the private sector, corporate debt, banks and household debt.

The most developed countries such as the US, UK and Germany, even though they have higher aggregate debt (public and private) than other developed countries, are paying lower interest rates. While countries like Italy and Spain, there are very large fluctuation in interest rates. These countries, along with Greece, are characterized by deteriorating estimates, speculation and the growing risk of not attracting investments.

"The European Union has left Greece increasingly affected by the crisis by not acting from the first moments of its emergence or by acting with very weak measures. What we can affirm is that only the Greek crisis originates mainly from public sector debt. In the meantime in all the other developed countries, the financial crisis and its consequences on the real economy passed from private to state debt" (Fortis M. 2012).

According to a study by the Boston Consulting Group, aggregate debt is expected to fall below a limit of 180% (60% of GDP, government debt, corporate and household debt) for developed countries. This limit would be a very important theoretical indicator in terms of debt sustainability, but indirectly this debt mix shows how country ratings should be recalculated so that all variables that take into account the links between private and public debt.

If we take as example the case of Ireland, the country had a rate on the public debt/GDP quite low (28.7% in 2007) while due to the crises in the financial system and the bailout of some important banks the country was pushed to the brink of economic collapse and bankruptcy (public debt in 2012 increased to 126.9%). Referring to the IMF for developing countries, a public debt/GDP ratio of no more than 40-45% is recommended. By analogy, if another 80% D/GDP made up of loans to businesses and individuals could be added to this measure, this limit should be 120% total debt/GDP. So in the future for the Balkan countries (developing countries) the public and private debt limit we propose would be 120% of the total debt / GDP. Referring to this new global indicator we will see how and to what extent this would affect the change in the ratings provided by the Rating Agencies.

## EMPIRICAL DATA ANALYSIS

Following the theories above, we obtained GDP credit data for Albania and the countries in the region. We mean here, credit granted to businesses and households excluding loans to the public sector. As can be seen from the table in recent years, lending rates relative to GDP have increased causing an increase in credit risk and potentially weighing on public debt itself in the event of a systemic credit crisis.

Various studies have concluded that the financial and public debt crisis originates from loans to the private sector and as we know government and institutions are ultimately guarantors (Jorda, O. et al., 2013; 2014).

This picture would look even worse if we take into account the outbreak of the economic crisis and its arrival in the Balkans since the end of 2008. Note that after 2008 there has been a steady level of lending with few exceptions. It is noted that post-2009 EU countries experienced a decrease in the lending rate on GDP in line with the concept of risk reduction through credit reduction.

Table 1: Private Sector Loans/GDP

| Loans/GDP | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Albania | 21.8 | 30.0 | 35.2 | 38.2 | 39.1 | 41.2 | 40.8 | 39.8 | 39.3 | 37.2 | 36.6 | 34.8 | 33.0 | 34.4 |
| Bulgaria | 42.4 | 58.5 | 67.0 | 69.0 | 68.6 | 65.6 | 66.1 | 66.5 | 59.4 | 54.9 | 52.2 | 50.0 | 50.5 | 50.3 |
| Bosnia H. | 47.7 | 60.2 | 65.6 | 64.1 | 61.8 | 60.5 | 61.7 | 60.8 | 60.2 | 58.7 | 57.9 | 58.3 | 57.5 | 58.4 |
| Greece | 76.2 | 84.5 | 89.3 | 88.0 | 111.6 | 117.2 | 116.8 | 118.1 | 116.2 | 112.2 | 107.4 | 99.1 | 89.2 | 79.2 |
| Croatia | 58.4 | 61.4 | 64.1 | 66.8 | 68.3 | 70.1 | 70.9 | 69.6 | 68.1 | 64.4 | 60.2 | 57.2 | 55.8 | 54.7 |
| North Macedonia | 29.3 | 35.7 | 42.4 | 43.9 | 44.5 | 45.1 | 48.1 | 47.6 | 50.5 | 52.0 | 49.0 | 49.9 | 50.5 | 50.9 |
| Montenegro | 36.0 | 80.0 | 86.5 | 76.2 | 66.5 | 55.3 | 55.1 | 53.1 | 51.3 | 49.8 | 48.8 | 48.7 | 49.1 | 49.5 |
| Serbia | 26.3 | 31.8 | 36.8 | 40.2 | 47.2 | 44.9 | 46.6 | 41.0 | 40.8 | 40.7 | 41.0 | 40.3 | 41.4 | 42.1 |
| Kosovo | 22.6 | 28.4 | 32.9 | 34.3 | 35.4 | 36.4 | 35.9 | 34.9 | 35.4 | 36.4 | 38.7 | 41.3 | 44.1 | 46.5 |

Source: World Bank, 2019

The following table shows the annual data of the public debt related to GDP from 2006. In some Balkan countries the amount of the public debt is due to the rising of public expenditure in order to mitigate the economic and social crisis. While for the countries of the European Union the increase in public debt is caused not only by the increase in public spending but also by taking bailouts of banks and financial companies, such as in Ireland with Anglo Irish bank, Allied Irish bank (Aib), Ebs and Inbs1, in Belgium Dexia, in Spain Bfa/Bankia, Ncg Banco, Catalunya Banc and Banco de Valencia.

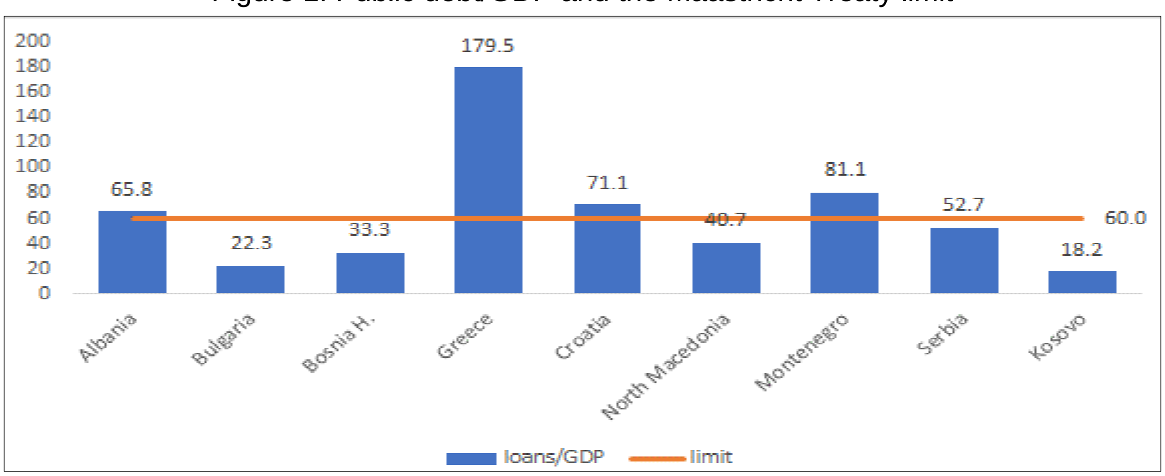
In case of economic crisis as well as in the latter case it can be noted that the loan granted to the private sector can be "transformed" into Public Debt. The reason there was no risk of bankruptcy in the Balkans was because most of the banks were western parent subsidiary banks, well audited by Central Banks and the size of loans to GDP were lower than in EU countries. In south-eastern Europe the Bank portfolios did not contain derivative instruments to a significant extent. A convergence towards Western European norms and practices is expected in the future and consequently the issues will be the same.

Table 2: Public Debt/GDP

| Debt/GDP | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Albania | 56.1 | 53.4 | 54.7 | 59.5 | 58.5 | 69.6 | 63.7 | 70.6 | 71.9 | 73.7 | 73.3 | 71.8 | 69.9 | 65.8 |
| Bulgaria | 23.4 | 18.6 | 15.5 | 15.6 | 14.9 | 15.4 | 17.5 | 17.6 | 26.3 | 25.6 | 27.4 | 23.3 | 20.4 | 22.3 |
| Bosnia H. | 21.2 | 18.7 | 30.9 | 35.8 | 39.1 | 45.8 | 49.1 | 42.7 | 45.9 | 45.5 | 44.1 | 39.2 | 34.3 | 33.3 |
| Greece | 107.5 | 107.2 | 112.9 | 129.7 | 148.3 | 170.3 | 157.2 | 173.8 | 178.9 | 175.9 | 178.5 | 176.2 | 181.2 | 179.5 |
| Croatia | 35.4 | 32.9 | 29.3 | 35.8 | 42.6 | 47.4 | 54.0 | 59.8 | 84.0 | 83.7 | 80.5 | 77.8 | 74.6 | 71.1 |
| North Macedonia | 32 | 24 | 20.6 | 23.8 | 24.2 | 27.9 | 34.1 | 35.8 | 38.0 | 38.1 | 39.8 | 39.5 | 40.5 | 40.7 |
| Montenegro | 32.6 | 27.5 | 29 | 38.2 | 40.9 | 46.0 | 54.0 | 56.8 | 63.4 | 69.0 | 66.6 | 66.3 | 72.6 | 81.1 |
| Serbia | 42.2 | 34.6 | 33.4 | 38.1 | 46.5 | 49.5 | 62.4 | 65.8 | 67.6 | 71.3 | 68.9 | 58.7 | 54.5 | 52.7 |
| Kosovo | n.a. | n.a | n.a. | 7.7 | 7.6 | 6.8 | 8.3 | 9.0 | 10.6 | 13.0 | 14.3 | 16.3 | 17.0 | 18.2 |

Source: World Bank, 2019

Figure 1: Public debt/GDP and the Maastricht Treaty limit




Source: Author’s compilation

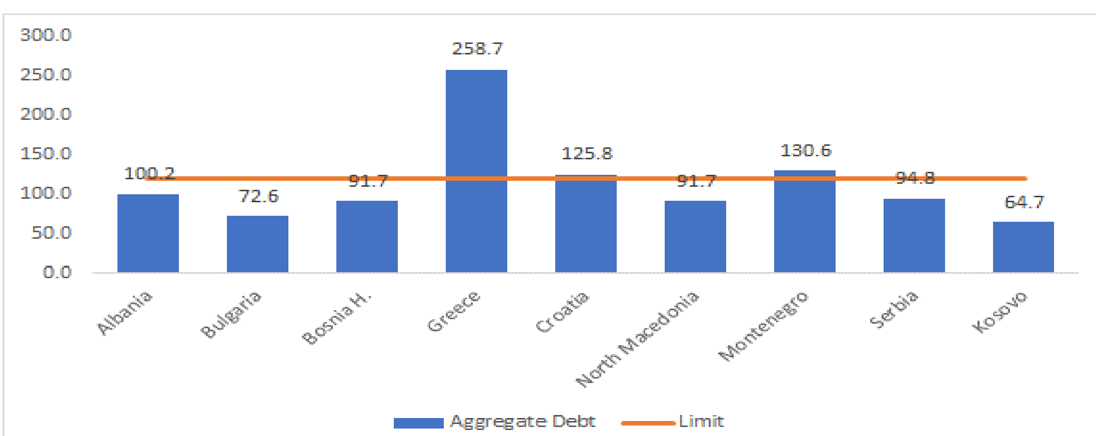
After the analysis and observation of data on private and public debt in the table below, it is calculated the total debt to GDP ratio. The sum of the two debts brings a broader and more significant risk framework and as confirmed by the theories mentioned above and the factual reality after the global crisis. It is precisely on these indicators that a new overall assessment or a new "rating" has to be calculated. In the second graph we can see the total debt / GDP ratio and a 120% limit of the total debt / GDP assumed for developing countries. The countries that crossed this border were, in addition to Greece (can be considered as a developed Country, not a developing one), which represents an anomaly in our analysis, Croatia and Montenegro. These two countries, however, exceeded slightly the limit of the total debt on the gross domestic product of 120% and cannot be considered at high risk or in a particular danger zone. In general, these data show that the Balkan countries do not have an aggregate debt above this limit, i.e. they have no high risk of bankruptcy. Although Albania has a public debt of 65.8% of GDP, in aggregate debt this result stops at 100% and the country's risk is reduced by a relative low credit to the private sector.

Table 3: Total Debt/GDP

| Total Debt/GDP | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Albania | 77.9 | 83.4 | 89.9 | 97.7 | 97.6 | 110.8 | 104.5 | 110.4 | 111.2 | 110.9 | 109.9 | 106.6 | 102.9 | 100.2 |
| Bulgaria | 65.8 | 77.1 | 82.5 | 84.6 | 83.5 | 81.0 | 83.6 | 84.1 | 85.7 | 80.6 | 79.5 | 73.3 | 70.9 | 72.6 |
| Bosnia H. | 68.9 | 78.9 | 96.5 | 99.9 | 100.9 | 106.4 | 110.8 | 103.5 | 106.1 | 104.2 | 101.9 | 97.5 | 91.8 | 91.7 |
| Greece | 183.7 | 191.7 | 202.2 | 217.7 | 259.9 | 287.5 | 274.0 | 291.9 | 295.1 | 288.1 | 285.9 | 275.3 | 270.4 | 258.7 |
| Croatia | 93.8 | 94.3 | 93.4 | 102.6 | 110.9 | 117.5 | 124.9 | 129.4 | 152.1 | 148.2 | 140.7 | 135.0 | 130.3 | 125.8 |
| North Macedonia | 61.3 | 59.7 | 63.0 | 67.7 | 68.7 | 73.0 | 82.2 | 83.4 | 88.5 | 90.1 | 88.8 | 89.4 | 90.9 | 91.7 |
| Montenegro | 68.6 | 107.5 | 115.5 | 114.4 | 107.4 | 101.3 | 109.1 | 109.9 | 114.7 | 118.7 | 115.4 | 115.0 | 121.7 | 130.6 |
| Serbia | 68.5 | 66.4 | 70.2 | 78.3 | 93.7 | 94.4 | 109.0 | 106.8 | 108.4 | 112.0 | 109.8 | 99.1 | 96.0 | 94.8 |
| Kosovo | n.a | n.a | n.a | 42.0 | 43.0 | 43.2 | 44.2 | 43.9 | 46.0 | 49.5 | 53.1 | 57.6 | 61.1 | 64.7 |

Source: World Bank, 2019

Figure 2: Aggregate debt and the limit of 120% Debt/GDP




Source: Author's compilation

As rating agencies have their ratings based on the data they have available, the market at each rating level has assigned different spreads. The term spread refers to the difference between a benchmark (for Europe, Germany), a symbol of safety and efficiency and the concrete risk of a country's failure with respect to the Benchmark.

For example, Albania has an average spread of 351 points or 3.51% more than Germany. When German government bonds give an interest of 1%, to calculate the interest of the respective Albanian bond, we must add 3.51% to this rate with a final result of around 4.51%. Table 4 shows the average spread on the benchmark for each rating level and we can see for the Balkan Countries the respective rating with the corresponding average spread. The rating of the Balkan countries belongs to 2019, while the spread is an average of the spreads of the last 10 years.

Table 4: Rating and Correspondent Spreads.

| Country | D/GDP | Rating | Av. Spread |
|---|---|---|---|
| Albania | 65,8 | B+ | 351 |
| Bulgaria | 22,3 | BBB | 156 |
| Bosnia | 33,3 | B | 421 |
| Croatia | 71,1 | BBB- | 175 |
| Greece | 179,5 | BB- | 283 |
| Kosovo | 18,2 | n.a. | n.a. |
| North Macedonia | 40,7 | BB- | 283 |
| Montenegro | 81,1 | B+ | 351 |
| Serbia | 52,7 | BB+ | 200 |

For each country we have calculated the corresponding Total Debt in relation to the Public Debt. This means that at the factor 1.52 in the case of Albania, for 1 USD of public debt 0.52 USD of debt is given to the private sector.

Bulgaria has the highest result not because of a skyrocketing amount of private debt but because the government debt is quite low, just 22% of GDP. This means that if we take the 120% rate of total debt to GDP as the healthy limit, the evaluation for Albania should be improved because private debt is quite low while Bulgarian debt is a little riskier that it seems because of a private debt higher than the public one (the total amount of debt however is quite low).

Since the new recommended limit is twice higher the old limit of the Maastricht Treaty, the multiplication coefficient should be half of the initial ratio of total debt to public debt, or 0.76 for Albania. In other words, to give an opinion on the country's total debt, we can halve the value of the debt amount and the result for Albania would be 50.1%. To have a balanced judgment by the rating agencies, precisely because of the strong link that exists between public and private debt, it is 50.1% that must be taken into consideration by the rating agencies.

Therefore, the assessment should be made on this new level of indebtedness and in the case of Albania it would pass from a Rating B+ to an improvement in the BB-. The new spread would be lower and would go to a new level of 283 basis points or 2.83% compared to the old spread of 351 basis points or 3.51%.

That would mean a reduction in the cost of debt service, with a spread of 68 basis points or 0.68% less. In the case of Bulgaria, the rating would deteriorate from BBB to BBB-, which would imply an increase in the credit spread from 156 basis points to 175 basis points with an increase of 19 basis points or 0.19%. This is because Bulgaria, despite having a very low public debt, has a higher private debt rate.

Table 5: New evaluation alternatives

| Countries | Total Debt/Pub debt | Mult coef | Coef Rez(%) | New Rating | New spread | Old spred | Spread diff |
|---|---|---|---|---|---|---|---|
| Albania | 1,52 | 0,76 | 50,1 | BB- | 283 | 351 | -68 |
| Bulgaria | 3,25 | 1,63 | 36,3 | BBB- | 175 | 156 | 19 |
| Bosnia & H. | 2,75 | 1,38 | 45,9 | B | 421 | 421 | 0 |
| Greece | 1,44 | 0,72 | 129,3 | BB | 240 | 283 | -43 |
| Croatia | 1,77 | 0,88 | 62,9 | BBB | 156 | 175 | -19 |
| North Macedonia | 2,25 | 1,12 | 45,8 | BB- | 283 | 283 | 0 |
| Montenegro | 1,61 | 0,81 | 65,3 | BB- | 283 | 351 | -68 |
| Serbia | 1,80 | 0,90 | 47,4 | BBB- | 175 | 200 | -25 |
| Kosovo | 3,56 | 1,78 | 32,4 | n.a | n.a | n.a | n.a |

Source: Author's compilation

Montenegro would have the same level of spread and rating improvement as Albania with a gain of 68 bp. Greece itself, despite being in a difficult situation due to public debt, would improve its level of evaluation due to its relatively low debt to the private sector. Serbia and Croatia would also benefit slightly, while Bosnia and Herzegovina and North Macedonia would have the same ratings as before with the same corresponding spreads.

Giving a concrete and applied example on the meaning of practical application of these theoretical indicators we would have the following results:

According to the sources of the Albanian Ministry of Finance, the Albanian public debt has been 1,112,044 million ALL (about 10 billion dollars) and 68 basis points with less spreads mean lower interest equivalent to 0.68%.

From a simple multiplication between the spread reduction and the total amount of public debt, it turns out that the Albanian Government would pay about 7.56 billion leke (65 million dollars) less interest every year.

The spread reduction creates positive effects also in making cheaper to private enterprises their debt and enhance asking for new lending. That creates premises for more investments and faster economic growth. Montenegro would have equivalent benefits to Albania in terms of interest, and Greece would also benefit an important reduction of his debt servicing.

Bulgaria would make its public debt service more expensive due to its downgraded rating and a higher 19 bp spread. That would mean spending $ 28 million more, while Greece would earn a lot in its debt service (which is a huge amount of 370 billion dollars) saving almost 1.5 billion dollars a year. Croatia's 19 bp gain would imply 89 million USD lower costs on debt service. The government of Montenegro would spend 25 million dollars less every year. Finally, Serbia with a difference of only 25 bp, would spend $ 74 million less on debt service each year.

If we make an exception of Greece, that has its own particular dynamics, the reduction in the cost of debt servicing by the countries of South Eastern Europe would amount to over 280 million USD per year. This numbers in a global context would seem not important but if we consider that the inhabitants of the countries analyzed (Greece apart) are less than 28 million, this saving would not be indifferent. This money could be left in the consumers' pockets and could increase the demand and consequently the supply of local products. This amount of money could also be used by governments to reduce public debt or to enhance capital investments, so needed in South Eastern Europe.

## CONCLUSIONS

The experience of the last economic crisis has shown that the gap between public and private debt is narrowing. This fact is supported by the events happened in Ireland, Belgium and Spain, where government has been forced to bear the losses of private banks converting these losses into new public debt.

Looking at the aggregate level, the Balkan countries, with the exception of Greece, do not significantly exceed the limit of 120% of total debt on Gross Domestic Product. The results of the new indicator would significantly improve the rating and the position of the most part of the South Eastern European Countries in the public and private debt market.

This change would show a very significant effect on the lowering of public debt service costs and consequently on the lowering of interest rates on loans to private individuals and companies. The reduction in the cost of debt servicing by the countries of South Eastern Europe would amount to over 280 million USD per year.

For this reason, is needed a coordination between the respective Central Banks, Supervisory Authorities of the Financial Markets and the respective Ministries of Finance of each country because the evaluation of the debt cannot be referred only to the public debt but in relation to the total debt. These institutions should advocate these new concepts to the Rating Agencies, International Institutions (IMF, WB...) and to the International Markets where government bonds are listed in order to have a better comprehensive evaluation of total Country Debt.

Accepting a new indicator is a complicated process that takes time. It needs to be considered Globally and specially by rating agencies. Beyond the element of conviction of the experts, there is another issue perhaps more important that hinders the success of this indicator. The countries in which the most important rating companies dwell are often developed countries. These countries, in addition to a public debt that is not very high for their capacity, have much higher private debts. If we had an average of these two debts, the costs for their service would be significantly higher.

The developed countries were the ones that caused the greatest damage from a financial and economic point of view. These same countries have a natural influence on rating agencies. According to them, public debt is a big problem, while private debt is synonymous with healthy and vibrant economy. Private debt too, creates the same effects as public debt if governments intervene to save the national economy, and this often happens.

Meanwhile, in developed countries, credit is taken at low rates by governments that have a manageable public debt and consequently by private individuals, who on the contrary have a much higher, perhaps too high, debt. While in developing countries governments are forced to pay high interest rates for public debts considered high and consequently also private individuals have to pay high bank interest rates even though the total credit to individuals is much lower, in relation to GDP. This is an important brake on the economic development of poor countries.

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