Scenario Planning of the Eurozone Crisis: A Risk Template Approach

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The Eurozone sovereign debt crisis is far from over. It will take years, not months, for excessively high government debt-to-GDP ratios to stabilize, much less begin to decline. Eurozone political leaders recently agreed upon a second multilateral assistance package that is designed to give the Greek government a respite when the first tranche is paid in. Subsequent disbursements, however, are subject to reviews by the IMF, which will check on progress in many areas; poor compliance by the Greek government on tax reform or privatization, for example, could derail the program.

There are many other potential pitfalls that could upset the post-agreement calm in the European financial markets. The Irish referendum to approve the recently negotiated fiscal compact could fail, sending negative signals to markets about the resolve and unity of the EU. Banking systems of many countries are far from healed even after ample liquidity was provided by the European Central Bank. A banking failure that could ricochet through the pan-European financial network cannot be ruled out. And finally, political stability might yet break down in some countries, unnerving the European Union and the wider public already fatigued by the ongoing crisis.

Companies with substantial operations in Europe should plan for contingencies. While it is impossible to predict the timing or nature of the next "Lehman moment" in Europe, corporate risk managers can map out simple trigger categories and match them with commonly perceived risks. Scenario analysis can aid in understanding threats to overseas operations; Table 1 (on the following page) offers a template. The columns list four crisis triggers: a country leaving the euro, a major bank failure, a sovereign default, and political upheaval. These are simple stylized events, and real life might supply variations on these themes. The rows list risk categories that can affect corporate balance sheets. The expected magnitude of the risk is shown at each intersection.

The matrix is a framework for analysis and not a definitive quantification of risk. Companies capture threats individually and will thus assign differing metrics of exposure. Table 1 is a forecast of risk for a hypothetical multinational with substantial manufacturing and distribution operations in Europe.

On the microeconomic side of the table, direct impact of any of the triggers on the immediate credit of customers and vendors should be moderate. By contrast, a sudden collapse or a change of government might lead to a revision of that country's tax regime at a faster clip. Indirectly, impending trouble will shape the competitive position of a market or company or its foreign exchange (FX) hedging regime to a higher degree. Also, political instability could impair transportation and logistics links to distributors and vendors via strikes and blockages. Finally, some types of crises might lead to profound regulatory changes, although the timing of new rules is obviously uncertain.

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Moving to macroeconomic risks (those that flow through the economy first), we see that the impact appears much more severe. For example, any type of crisis would profoundly affect the level of interest rates and exchange rates. Likewise, companies might find that access to credit becomes impaired rather quickly. Indirectly, any type of crisis is bound to affect demand conditions through changes in consumer and business sentiment as well as cost of capital.

The split between direct and indirect impact is subjective, and companies can customize this matrix in numerous ways. Different variables or subcategories can be inserted depending on what matters to any one operation and cells may serve other purposes. For example, instead of measuring the

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force of impact, risk managers could experiment with proposed remedies, action plans, or personnel in charge.

What appeared as a manageable crisis just one year or so ago now looks far more ominous.[1] Companies may want to prepare for more upheavals and develop planning scenarios.

Table 1 – Scenarios of Four Types of European Financial Crises

			Crisis Type			
			A country leaves the euro	Major bank failure	Single sovereign default	Political upheaval
Microeconomic risk	Direct impact	Supplier credit	low	low	medium	low
		Customer credit	low	low	medium	low
		Tax change	low	low	medium	medium
	Indirect impact	Competitive position	high	low	medium	low
		FX hedging regime	high	medium	high	medium
		Transportation/logistics	low	low	low	high
		Regulation	low	low	medium	high
Macroeconomic risk	Direct impact	Interest rate	high	medium	high	high
		Exchange rate	high	medium	medium	high
		Access to bank credit	medium	high	medium	low
	Indirect impact	Growth conditions	high	medium	low	low
		Banking operation	medium	low	medium	low
		Sentiment	high	medium	medium	high

1 For further analysis on the various aspects of the European crisis, see the following MAPI publications: *Central Europe's Biggest Risk Lies in Banking Woes,* E-638, December 2011; *Potential Default by Greece Would Adversely Impact U.S. Manufacturers,* E-630, September 2011; *Europe's Nascent Recovery Threatened by Sovereign Debt Turmoil,* E-623, August 2011.

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