Box 11

GOVERNMENT DEBT PROJECTIONS IN PORTUGAL

The third review mission of Portugal's economic programme took place from 15 to 27 February. The assessment of staff members from the European Commission, ECB and IMF is that the programme is on track, with good progress having been made on the fiscal, financial and structural front. In the context of the ongoing adjustment from previously accumulated imbalances, a determined implementation of reforms remains essential to ensure economic recovery and fiscal sustainability. This box presents a set of scenarios for government debt dynamics in Portugal and focuses on the path of GDP. The scenarios cover the years from 2012 until 2020; a period of eight years is usually considered sufficient to assess debt sustainability.

Assumptions underlying the baseline calculations

The macroeconomic assumptions used in the baseline scenario are the same as those in the recently completed review, and envisage a contraction of real GDP in 2012. The scenario foresees a slow cyclical recovery in 2013 which becomes more robust by 2015. To construct a baseline for the medium-term debt projections, from 2015 onwards GDP growth is assumed to be limited to the modest average rate that the country achieved in the decade before the crisis, i.e. between 1999 and 2008, of 1.6% per annum. This was 0.5 percentage point below the euro area average and well below the growth rate of the catching-up countries. The figure corresponds to the "pre-reforms" estimate of long-term potential growth for Portugal. In other words, the baseline scenario does not include any positive growth effects from structural reforms. It can be considered a low estimate of possible GDP growth outcomes, given the significant progress already made by the Portuguese government in the field of structural reforms.

In line with the programme assumptions, the projection is based on a gradual improvement in financial market conditions from the second half of 2013, reflected in a decline in interest rate spreads as well as a continuation of the government's prudent fiscal stance. In the baseline scenario, the government reaches a budget deficit of 0.5% by 2015, as specified in the August 2011 Fiscal Strategy Document. The resulting consolidation effort translates into a primary budget surplus which amounts to 4.5% of GDP in 2015 and remains at around 4% of GDP afterwards. This primary surplus is not particularly high compared with those that other European countries have been able to maintain in the past for relatively long periods of time.[1] The baseline scenario also factors in the impact of ageing-related spending estimated by the European Commission.

Chart B shows that in the baseline scenario government debt rises from 93.3% in 2010 to around 115% of GDP in 2013 and progressively declines thereafter. The decline is particularly pronounced from 2014 onwards and the stock of debt reaches about 96% of GDP in 2020. The sharp decline is mainly the result of a protracted primary budget surplus. If that surplus

1 Many European countries have been able to maintain primary surpluses in the range of 4% to 5% of GDP for a very long period of time. In the euro area, for example, this has been the case for: Belgium, with an average primary surplus of 4.6% between 1989 and 2007; Finland, with an average primary surplus in the order of 5.5% in the periods 1970-1990 and 1998-2008; Italy, with an average primary surplus of 4.9% between 1995 and 2001; Ireland, with an average surplus of 4.7% between 1988 and 2000. See the box entitled "Past experience of EU countries with sustaining large primary budget surpluses", *Monthly Bulletin,* ECB, June 2011, pages 94-95.

Macroeconomic and fiscal assumptions underlying the baseline scenario

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-1.6	-3.3	0.3	2.1	2.0	1.8	1.6	1.6	1.6	1.6
GDP deflator growth	0.7	1.1	1.2	1.4	1.5	1.5	1.5	1.5	1.7	1.7
Primary balance-to-GDP ratio	0.1	0.5	2.2	3.3	4.5	4.4	4.3	4.1	4.0	3.9
Interest payments-to-GDP ratio	4.1	5.0	5.2	5.1	5.0	4.9	4.7	4.6	4.5	4.4
Average effective interest rates	4.4	4.6	4.7	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Fiscal balance-to-GDP ratio	-4.0	-4.5	-3.0	-1.8	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5

is assumed to be 1.5 percentage points lower, i.e. at about 2.5% on average between 2014 and 2020, under the same growth assumptions debt would stabilise at slightly below 110% of GDP by 2020 (see Chart B).

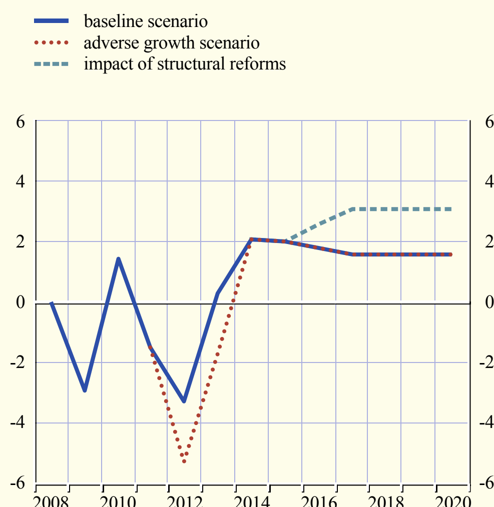
Assuming a more adverse GDP decline in the short term

Two further departures from the baseline scenario are analysed below. First, it is assumed that a very negative shock to GDP takes place between 2012 and 2013. This shock is calibrated to broadly match the current lower bound of GDP forecasts among market analysts for 2012 and 2013. This corresponds to a two-percentage-point reduction in GDP growth per year compared with the baseline scenario (see Chart A).

This scenario shows that such a shock to GDP, which is summarised by a cumulated GDP fall of 7% until the end of 2013, would lead to a temporary increase in the stock of debt to 124% of GDP in 2013. In this adverse scenario, it is assumed that there is no recovery in the loss of GDP and that fiscal policy remains passive, i.e. there is no extra consolidation effort in response to the worsening macroeconomic scenario, which leads to a two-year delay in achieving the 3% deficit

Chart A GDP growth scenarios

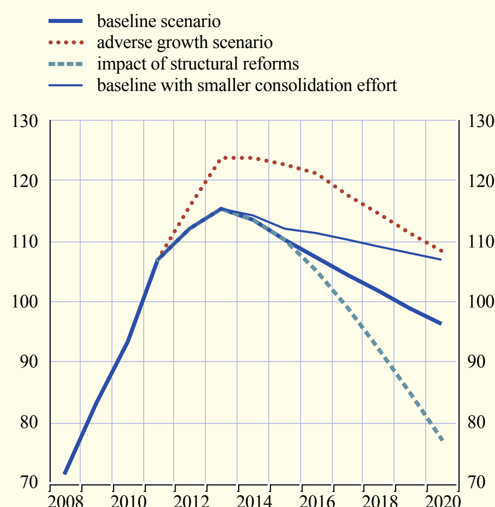
(annual percentage changes)



Sources: Eurostat and ECB calculations.

Chart B General government debt scenarios

(as a percentage of GDP)



Sources: Eurostat and ECB calculations.

target under the excessive deficit procedure (from 2013 to 2015). Chart B shows that in the adverse scenario the declining profile of government debt starts to accelerate from 2015 onwards and the debt ratio reaches around 110% of GDP by 2020.

Potential impact of structural reforms

The second scenario tries to capture the impact of structural reforms on GDP growth and thus on debt dynamics. This impact is calibrated by including in the baseline scenario the effect of a reduction in the wage and price mark-ups obtained with simulations using the ECB's Euro Area and Global Economy model.[2] While structural reforms are currently being implemented in Portugal and progress has been already made in a number of key areas, analytical models usually indicate that their effects on GDP are not immediate. Hence, following the indications from model-based results, the baseline scenario is adjusted upwards only from 2015 onwards (see Chart A). The calibrated upward adjustment is such that real GDP growth reaches 3% by 2017 (i.e. five years after the implementation of structural reforms).[3] Higher growth has a positive budgetary impact and the fiscal balance as a percentage of GDP improves substantially, from -0.5% in 2015 to a surplus of about 3.5% by 2020.

Chart B shows that the impact of higher GDP growth in the medium term has a large impact on debt dynamics. The decline of the government debt ratio in this case is substantial and the stock of debt falls to below 80% of GDP by 2020, i.e. close to the pre-2009 crisis level. This illustrates that the full implementation of the structural reform programme can make a major contribution to achieving a sustained and swift decline in the government debt ratio.

Conclusions

The above analysis shows that under prudent assumptions regarding GDP growth, primary balance and stock-flow adjustments,[4] government debt dynamics for Portugal would quickly stabilise, with a subsequent steady decline in the debt ratio. Even in the absence of higher growth arising from structural reforms, government debt would fall below 100% by the end of the scenario horizon. In the case of a decline in GDP significantly larger than in the baseline and assuming a two-year delayed adjustment to the fiscal balance, the debt ratio would also stabilise in 2013, and visibly decline from 2015 onwards. In the scenario which includes the effect of structural reforms on GDP, government debt would reach about 77% of GDP by 2020.

Portugal's primary fiscal structural adjustment has been significant so far (at around 3.5% of GDP) – a fact also reflected in a large correction of the current account. This result has been obtained with a more limited fall in GDP in 2011 than initially envisaged. Moreover, privatisation receipts have been larger than estimated and the structural reform programme is on track. While the achievements so far have been very positive, the strong resolve shown

2 See S. Gomes, P. Jacquinot, M. Mohr, M. Pisani, "Structural reforms and macroeconomic performance in the euro area countries. A model-based assessment", *Working Paper Series,* No 1323, ECB, 2011.

3 According to the Euro Area and Global Economy model, the impact of a reduction of 15% in wage and price mark-ups lead to a cumulated increase in GDP of about 8% over seven years.

4 About 66% of the privatisation receipts expected for 2012 and 2013 materialised at the beginning of 2012. Moreover, debt projections include €12 billion, a sum which under the financial assistance programme has been earmarked for banks' capitalisation needs (Bank Solvency Support Facility). If only part of this amount were to be used, a downward correction of the debt-to-GDP ratio should be made.

up to now needs to be maintained. In particular, on the fiscal side continued efforts are needed to strengthen measures to prevent arrears accumulations, to further strengthen tax administration and to streamline public administration. Given the key role of structural reforms in boosting GDP, determined implementation of reforms, especially to reduce rents in the non-traded sectors, is also essential for the success of the programme.