

Box 9

FISCAL SUSTAINABILITY CHALLENGES IN THE EURO AREA

This box presents three scenarios for possible developments in the general government debt-to-GDP ratio for the euro area until 2030. The aim is to provide a rough estimate of the amount of fiscal consolidation needed in the euro area to put public finances back on a sustainable path. The scenarios focus on euro area aggregates and thus abstract from the existing heterogeneity among the euro area countries. This heterogeneity, however, must be fully accounted for when designing exit strategies from the crisis-related fiscal measures and when discussing the appropriate timing, pace and composition of fiscal consolidation at the country level.

The macroeconomic assumptions underlying the three scenarios are as follows: the real GDP growth rate is based on the path for the real potential growth rate of the euro area, as projected by the European Commission and the Economic Policy Committee.¹ According to this source, real potential growth will decline gradually from the (rather high) value of 2.2% in 2011 to 1.5% in 2030. The increase in the GDP deflator is assumed constant at 1.9% over the scenario period. The nominal implicit interest rate on government debt is assumed constant at 4.3%, which is the value recorded in 2008 (as the values for the period 2009-10 could be distorted by the financial crisis).

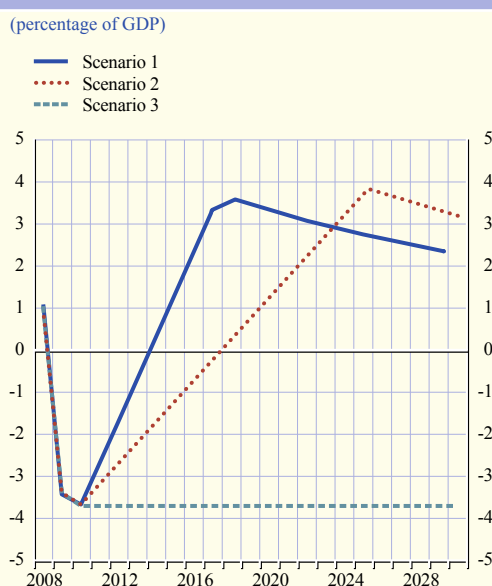
All three scenarios use the European Commission's autumn 2009 forecast² for euro area general government debt in 2010 (84% of GDP) as a starting point. The starting value of the primary balance in 2010, based on the same source, is -3.7% of GDP. Given the macroeconomic assumptions and this unfavourable fiscal starting position, the debt ratio is set to increase further unless a sufficiently high primary surplus (i.e. overall budget balance minus interest payments) is established in order to stabilise the debt ratio and put it on a downward path.

1 See the "2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2008-2060)", *European Economy*, No 2, European Commission and Economic Policy Committee, 2009.

2 See the "European Economic Forecast Autumn 2009", *European Economy*, No 10, European Commission, 2009.

Fiscal developments as of 2011 are determined by three alternative scenarios shown in Chart A. Scenario 1 assumes a rather rapid fiscal consolidation process, with the primary balance improving by 1.0 percentage point of GDP per year until an overall balanced budget is reached (in 2018). Thereafter, the primary surplus is assumed to decline slightly in order to maintain the budget in balance until the end of the simulation period (i.e. 2030). Scenario 2 assumes a less ambitious consolidation path, with the primary balance improving by only 0.5 percentage point of GDP per year until an overall balanced budget is reached (in 2025). Primary surpluses compatible with a balanced budget are then assumed until 2030. Finally, Scenario 3 assumes that no consolidation efforts are made. The primary balance remains at -3.7% of GDP, i.e. constant at the forecast value for 2010, over the whole simulation period.

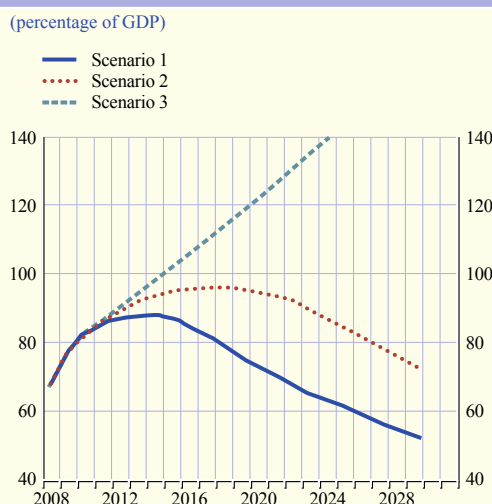
Chart A Primary balance assumptions



Source: ECB calculations.

The results of these scenarios for euro area debt are shown in Chart B. The government debt ratio in Scenario 1 peaks at 89.3% of GDP in 2013 and in Scenario 2 at 97.2% of GDP in 2017. Subsequently both these scenarios lead to a gradual decline in the government debt-to-GDP ratio. The 60% of GDP reference value is reached within the next two decades (i.e. in 2026) only in Scenario 1. Scenario 3 would lead to a steady rise in the government debt ratio to over 100% of GDP in 2015, 120% in 2020 and 150% in 2026.

Chart B Government debt scenarios



Source: ECB calculations.

The results of these scenarios are sensitive to the underlying assumptions on economic growth and (implicit) interest rates. They are based on pre-crisis calculations, and their actual values may differ substantially in the aftermath of the crisis. However, they may well serve to illustrate the increased risks to fiscal sustainability in the euro area stemming from a rapidly rising euro area government debt-to-GDP ratio. Unchanged fiscal policies (i.e. Scenario 3) would pose a clear threat to the longer-term sustainability of public finances. These risks may be compounded by negative feedback effects if rising government debt ratios were to trigger higher real interest rates and/or reduce economic growth. The true risks to fiscal sustainability are even more pronounced, as the three debt scenarios take into account neither the projected rise

in ageing-related costs, nor the risks associated with contingent liabilities stemming from the guarantees provided to the financial and non-financial sectors in the context of the crisis. However, banks may still be faced with further write-downs³ and, after 2020 in particular, strong pressures on public finances are to be expected on account of ageing populations.⁴

Member States that wish to adopt the euro are required to maintain a government debt-to-GDP ratio that is below the reference value of 60%, or else ensure that their debt ratios are diminishing and approaching the reference value at a satisfactory pace. As a consequence of the crisis, many euro area countries that fulfilled this criterion upon joining EMU will need to realign their fiscal policies in order to put their debt ratios back onto a steadily declining path and to limit the debt servicing burden for future generations. Even with average consolidation efforts of 0.5 percentage point of GDP per year (Scenario 2), the return to the pre-crisis euro area debt ratio is likely to take two decades. Annual consolidation efforts would thus need to be substantially higher to ensure a more rapid decline in the debt-to-GDP ratio towards the reference value of 60% or below. The challenges are particularly pronounced for euro area countries with high or very high government deficits and/or debt ratios as a result of the crisis and for those facing relatively high interest rates or low potential growth.⁵

- 3 See the box entitled “Estimate of potential future write-downs on securities and loans facing the euro area banking sector” in the ECB’s Financial Stability Review, December 2009.
- 4 See the box entitled “The 2009 Ageing Report: updated projections for age-related public expenditure” in the June 2009 issue of the Monthly Bulletin and the box entitled “The European Commission’s 2009 Sustainability Report” in the December 2009 issue of the Monthly Bulletin.
- 5 For a review of successful experiences with debt reduction in euro area countries in the run-up to EMU, see the box entitled “Experience with government debt reduction in euro area countries” in the September 2009 issue of the Monthly Bulletin.