

Box 3

ANALYSIS OF GOVERNMENT DEBT SUSTAINABILITY UNDER THE EU/IMF ADJUSTMENT PROGRAMME FOR GREECE

This box presents some key scenarios for government debt dynamics in Greece that are relevant for assessing the country's prospects for long-term fiscal sustainability under the current EU/IMF economic and financial adjustment programme. In line with the commonly used working definition, a given debt path is considered to be unsustainable if the debt-to-GDP ratio grows continuously over a certain projection horizon. Sustainability, in turn, generally requires that the debt ratio be at least stable under plausible assumptions on the key fiscal and macroeconomic variables that drive debt dynamics.¹ In cases like Greece, however, where the government debt-to-GDP ratio has already reached an extremely high level, fiscal sustainability can only be ensured if this ratio is brought on a firmly downward-sloping path.

The charts below present different scenarios for the trajectory of Greece's general government debt-to-GDP ratio over the period up to 2020. The baseline scenario builds on the fiscal and macroeconomic assumptions and policy commitments agreed in the context of the fourth review under the adjustment programme, including the government's privatisation commitments, amounting to €50 billion by 2015 (see the table below). Extended official financing is assumed to cover Greece's funding needs until mid-2014. From 2015 onwards, the projection assumes a gradual improvement in the economic environment and a continuation of the government's prudent fiscal stance, leading to primary budget surpluses of around 6½% of GDP.² While this requires considerable fiscal discipline, other EU countries were able in the past to sustain primary surpluses of a similar size over several years.³

1 Debt dynamics are driven by the government's primary budget balance, the economic growth rate, the interest rate on outstanding debt and further balance sheet adjustments that are not accounted for in the budget balance. For a detailed explanation, see the article entitled "Ensuring fiscal sustainability in the euro area", *Monthly Bulletin*, ECB, April 2011.

2 For a detailed overview on the macroeconomic assumptions and the policy commitments underlying Greece's adjustment programme, see European Commission, "The Economic Adjustment Programme for Greece – Fourth Review", *European Economy, Occasional Papers*, No 82, Brussels, July 2011.

3 For an overview, see Box 8, entitled "Past experience of EU countries with sustaining large primary budget surpluses", *Monthly Bulletin*, ECB, June 2011.

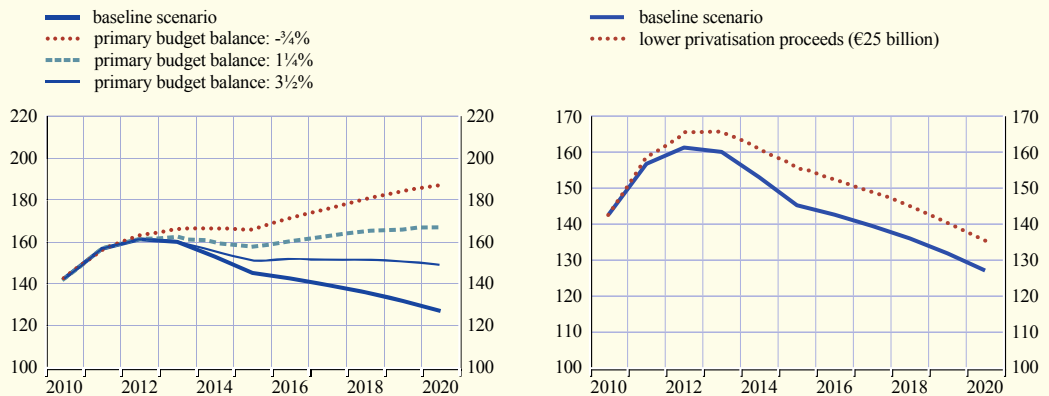
Key assumptions underlying the baseline scenario

(annual percentage changes; percentages per annum)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	-4.5	-3.8	0.6	2.1	2.3	2.7	2.9	3.0	3.0	3.0	3.0
GDP deflator	2.6	1.5	0.7	1.0	1.0	0.9	1.1	1.3	1.4	1.7	1.8
Average nominal interest rate on government debt	4.0	4.6	5.1	5.2	5.6	6.4	6.7	6.7	6.6	6.4	6.1
Primary budget balance-to-GDP ratio	-5.0	-0.8	1.3	3.4	6.1	6.4	6.4	6.4	6.4	6.4	6.4

Greece's general government debt

(percentages of GDP)



Sources: European Commission and ECB calculations.

As can be seen from the solid line, under these baseline assumptions, the government debt-to-GDP ratio will peak at 161% in 2012, and fall to 127% by 2020. Achieving this downward trajectory crucially hinges on the government's willingness and ability to persevere with fiscal consolidation and implement the structural reform and privatisation programmes in full. As the left-hand panel shows, the debt-to-GDP ratio will surge if the primary budget balance remains at a level of around -3/4% of GDP, as projected for 2011. Likewise, if the government maintains a primary budget surplus of around 1 1/4% of GDP, as targeted for 2012, the debt-to-GDP ratio will remain on a clearly upward-sloping path; it would barely stabilise at a primary budget surplus of 3 1/2%, but – given the significant risks surrounding long-term growth and interest rate projections – such a scenario would be extremely vulnerable to adverse shocks. Moreover, the Greek government cannot be expected to regain market access if the debt ratio is merely stabilised at this high level.

As the right-hand panel reveals, debt dynamics are also crucially affected by the extent to which the government implements the privatisation programme. The dashed line shows the path of the debt ratio that would result if the government were only to realise privatisation proceeds of €25 billion over the period from 2011 to 2015, rather than the envisaged proceeds of €50 billion. While the debt-to-GDP ratio would decline over the period from 2013 to 2020 under this scenario, it would do so at a slower pace than in the baseline scenario and the debt-to-GDP ratio would still exceed 135% in 2020.

Such long-term debt projections are invariably subject to considerable uncertainty, and the results are sensitive to changes in the assumed growth and interest rate paths. Nonetheless, a key conclusion remains unaffected by these caveats: debt dynamics largely depend on factors that are under the control of the Greek government. If the government decides to implement all fiscal and structural policy measures it has committed to in full and if it maintains an ambitious reform agenda over and beyond the current programme horizon, with a view to supporting long-term potential growth, the debt-to-GDP ratio can be brought on a downward path. An extended period of unrelenting fiscal discipline and major structural reforms is possible and not unprecedented in Europe. It requires a strong political consensus and determination to achieve a durable fiscal and macroeconomic turnaround, to regain competitiveness and to ensure that the programme remains on track.