ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

February 25, 2011

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Euro area sovereign debt – road to ruin or salvation?

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EURO AREA SOVEREIGN DEBT – ROAD TO RUIN OR SALVATION?

The risk premiums that have to be paid by a number of EMU countries on the capital market remain stubbornly high. This is testimony to the lack of confidence in these countries' ability to get to grips with their debt problems without the need for debt restructuring. It is not, however, just the financial markets, but also policymakers that seem increasingly convinced of the need for debt restructuring. There are signs that the EU and major national governments are starting to consider debt restructuring for Greece.

To date, however, no generally applicable criteria for sovereign debt restructuring have been defined. So what criteria can be used to determine when sovereign debt restructuring is advisable or even imperative? Greece's government debt ratio came in at 140% of GDP last year, but then, Japan's was as high as 200%. As the Japanese example shows, high debt levels do not necessarily translate into a considerable interest burden for a country's budget if investors on the capital market are prepared to lend the state money at a low interest rate. Greek interest payments in 2010 totaled around 6% of GDP – back in 1995, they were still hovering at around 11% of GDP. These examples show that pinpointing generally valid criteria for debt restructuring poses something of a challenge. It is a challenge that has eluded even the IMF in the many years of its existence.

The advocates of debt restructuring tend to cite the following arguments:

- The Greek consolidation program will fail in its implementation because the domestic political opposition is too great.
- Debt restructuring is less painful than the austerity programs that have been imposed. The provision of financial support to Greece to prevent its "inevitable" insolvency, they claim, does not come without risks and costs either. Debt cancellation would allow Greece to clamber back out of its trough more quickly.
- Even if the austerity programs are implemented and measures are taken to contain new borrowing, the reduction of the extremely high debt level is a task of Herculean proportions that would take decades. Given the substantial debt servicing payments, sustained high primary surpluses (net government balance, excluding interest expenditure) are indispensable. These are difficult to achieve in a low-growth environment.

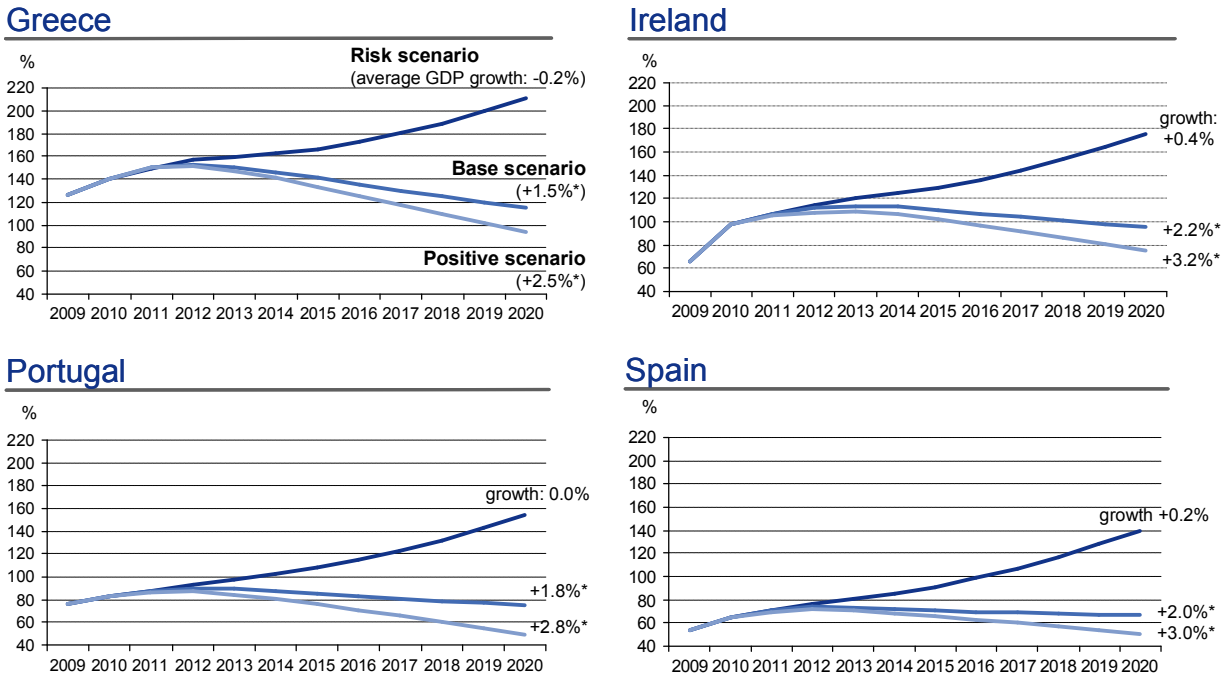
The best way to look at the need for debt restructuring is to build scenarios to see whether a country is tangled up in a debt spiral in which it can no longer reduce its debt level and interest burden. We have produced scenarios for the debt and interest burdens of Greece, Ireland, Portugal and Spain.

The development in debt levels and interest burden depends on fiscal policy discipline, future economic growth and the financing conditions prevailing on the financial markets.

In our base scenario, we have assumed a resolute commitment to consolidating fiscal policy in all four countries, coupled with moderate growth prospects (average growth rates for 2011-2020: Greece 1.5%, Ireland 2.2%, Portugal 1.8%, Spain 2.0%), given the far-reaching supply-side reforms that are being undertaken.

Following the consolidation successes seen last year in Greece (primary deficit of 10% of GDP in 2009 cut to 3½% of GDP in 2010), in Portugal (primary deficit cut from 6½% to 4½%) and Spain (primary deficit cut from 9% to 7%), these countries should also be able to push their new borrowing down to below the 3% mark in 2013/14, in line with the consolidation plan. Ireland is not expected to be able to hit this target until 2015.
We have also assumed ongoing fiscal policy discipline until 2020. This means that government spending will not increase at a faster rate than nominal economic growth – the government ratios that were reduced in the first half of the decades will remain in place in the long term. Risk premiums are likely to decline gradually but remain high for some time to come. But due to the longer duration of government liabilities and the use of the rescue fund, the overall increase in the interest burden will be moderate. The implicit interest rate on Greek debt (interest payments/gross debt) will rise from presently 4.5 % to 5% by 2020 (assumption of the EU Commission: 4.8%. Occasional Papers 72, December 2010).

Sovereign debt scenarios
Gross government debt as % of GDP



*) Average annual real GDP growth 2011-2020.

Base case/Positive case: EU consolidation requirements are met.
Risk case: EU consolidation requirements are *not* met.

In this base scenario ("Spending discipline, moderate economic growth"), the debt level (as a % of GDP) reaches its peak in all four countries in 2012/2013 before declining on an increasingly downward slope in the period leading up to 2020. Greece's debt level will fall – this is no mean feat – from 150% (2011) to 115% (2020).

These countries would not, however, be able to reduce their debt burden in a sustained period of flat growth. In the risk scenario ("Less spending discipline, sustained flat growth"), we have assumed that Greece and Portugal will on average report no economic growth between 2011 and 2020, and that Spain and Ireland will grow at a rate of only around 0.5% in real terms. In this scenario, which we however consider to be an extremely unlikely one, the debt level in all four countries will increase from 140% to more than 200% of GDP. Debt restructuring – whatever its timing – would be ineluctable.

In the event of sustained structural reforms, the debt-ridden countries could find their way to a growth path that exceeds our base scenario in only a few years' time. In our positive scenario ("Spending discipline, stronger economic growth"), the government debt ratios show more favorable development than in our base scenario and Greece could even undershoot the 100% mark in 2020.

Despite the risks, the scenarios show that reversing the debt momentum in the EMU countries that currently find themselves with a crisis on their hands is not an insurmountable task. Prolonged periods of strict government consolidation policy, coupled with structural reforms, do not translate into weak economic growth in the long run. Rather, regained confidence among the corporate sector and private households bolsters growth potential in the medium term.

Consequently, it remains up to the policymakers to prevent debt restructuring. Attempts to railroad individual countries into urgent debt restructuring are not very productive. The dangers of contagion are immense. On the other hand, a "painless" debt restructuring for Greece, in the form of a buy-back of government bonds on the secondary market would not cause contagion and at least provide the country with a little relief. A further step could be the reduction of interest rates for the loans given to the highly indebted countries. Although consolidating the Greek budget without debt restructuring is a major effort, it would provide a long-term boost to the country's economic policy reputation and, in doing so, help promote the stability of the euro. The same applies to the other countries that have overloaded sovereign debt.

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