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Scenarios for government debt in Europe

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Scenarios for government debt in Europe

Almost two years since the outbreak of the government financing crisis in the euro area, the long-term debt sustainability of some member states on the area's geographical periphery remains clouded by uncertainty.

The spotlight has even landed on the eurozone's third-largest economy, Italy. One question that is frequently raised is how Italy will be able to break out of the "debt spiral" in an environment of "stagnating growth" and "interest of up to 7%". The average interest rate on sovereign debt that is relevant to the change in the debt ratio is likely to have come in at 4% last year, a far cry from the now prevailing market interest rate of 7% (2012e: 4.4%).

While the considerable easing on the Italian bond market shows that the ambitious austerity program prescribed by the new government under Mario Monti has gone some way to building trust in the country's policies, the fact that the refinancing costs for Greek and Portuguese bonds, in particular, remain high suggest that the markets are not yet entirely convinced that the debt crisis can be overcome.

A cloud of uncertainty is not only hanging over the successful implementation of the planned measures in the countries affected; it is also casting its shadow over the potential scope of the financial support to be provided by the EU and the IMF.

The agreement on the second rescue package for Greece marks some element of progress in terms of the country's "debt sustainability". In order to be able to achieve the debt ratio of 120% by 2020, in line with the demands made by the IMF and the EU, Greece will, of course, have to ensure - even with a new government at the helm - that it can fulfill the requirements of the troika, which consists of representatives from the EU, the IMF and the ECB, and finally get down to business when it comes to reforming its economic structure to make the country competitive again. At the moment, it is still too early to speak of any real easing of the tense situation on the financial markets, particularly also in respect of Spanish government bonds.

It is crucial for the highly-indebted countries to continue to systematically pursue their growth reforms and consolidation measures if they want to start eroding the mountain of debt that is towering over them. The figures for last year show that the austerity measures implemented by the EMU countries have pushed new borrowing down further, despite only moderate economic growth.

What primary balance is required to stabilize government debt?

Country	Real GDP growth		General government debt ratio		Primary balance as a % of GDP		Average interest rate		Government deficit		Required primary balance
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	
Germany	3.0	1.0	81.2	79.8	1.6	1.8	3.3	2.9	-1.0	-0.5	-0.2
France	1.7	0.5	85.8	88.5	-2.6	-1.7	3.2	3.2	-5.2	-4.5	0.3
Greece	-6.9	-4.4	165.3	156.5	-2.2	-2.0	4.4	3.3	-9.1	-7.3	1.4
Ireland	0.7	0.5	108.2	114.8	-9.7	-4.3	3.3	3.9	-13.1	-8.6	0.5
Italy	0.5	-1.0	120.1	121.3	1.0	2.9	4.1	4.3	-3.9	-2.3	1.8
Portugal	-1.6	-2.5	107.8	113.8	-0.3	0.5	3.8	4.5	-4.2	-4.5	1.8
Spain	0.7	-1.3	68.5	73.8	-6.1	-2.8	3.8	3.5	-8.5	-5.3	0.6

But what sort of savings have to be made before we can talk of a long-term return to debt sustainability? Under what sort of conditions is a substantial reduction in the government debt ratio to a sustainable level realistic? As the table shows, Greece would have to generate a primary surplus of almost 1.5% a year in the period leading up to 2025 to merely stabilize its debt ratio, i.e. to keep the debt level as it is, even following debt reduction measures involving private creditors and assuming moderate economic growth.

We want to use our scenario-based analysis to take a closer look at these questions. We have produced forecasts for the debt and interest burdens of the countries in question for the period leading up to 2025 based on varying overall conditions.

SCENARIOS

Assumptions

We have used three scenarios to estimate the development of government debt in the period leading up to 2025 based on different overall conditions. The three scenarios adjust the parameters that have a key impact on a country's debt momentum: fiscal policy discipline, a country's economic growth and the average refinancing costs.

The first parameter is the primary balance (net lending/borrowing excluding interest expenditure). This first of all shows how determined the government is to implement the austerity measures and achieve the associated consolidation targets. Second, the primary balance (in addition to the interest burden) allows direct conclusions to be drawn as to future new borrowing.

As well as fiscal policy stamina, a country's growth outlook is the second factor that exerts considerable influence over the government debt ratio. In general, debt can be expected to show positive development in a climate of high (nominal) economic growth.

The third variable lies in the costs associated with the refinancing of existing debt and/or new borrowing on the capital markets. The relevant parameter for the debt burden is the average interest rate paid on sovereign debt and not, as is often assumed to be the case, the current market rate.

In formal terms, the change in the debt ratio Δb_t can be calculated as follows:

$$\Delta b_t = p_t + \frac{(i-g)}{(1+g)} b_{t-1}$$

p_t : primary balance as a % of GDP

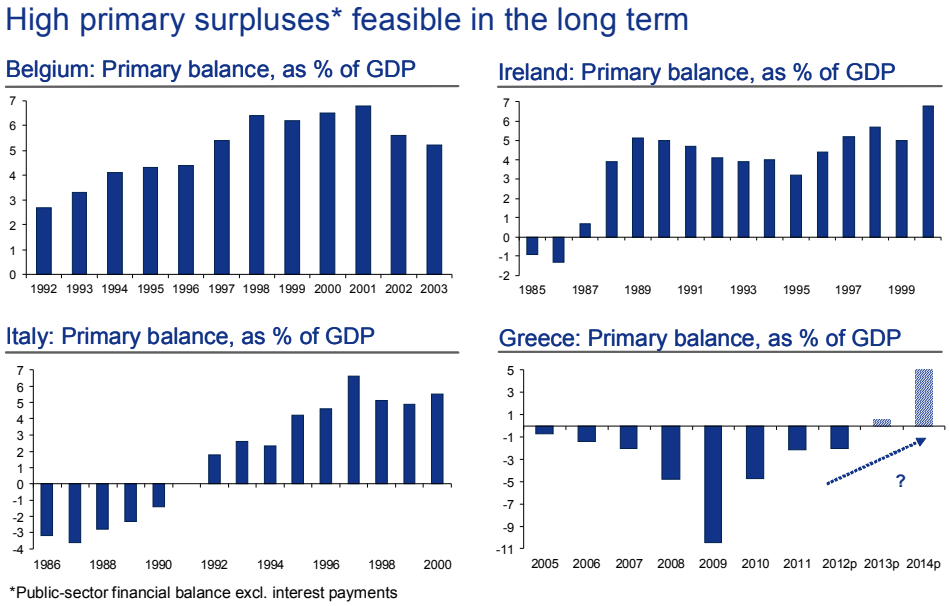
i : average effective interest rate on public-sector debt

g : nominal GDP growth rate

b_{t-1} : debt ratio in the previous year

Base scenario: "Spending discipline, slow reduction in risk premiums, moderate economic growth"

In our base scenario, we expect the countries to achieve a sustainable reduction in new borrowing by meeting the requirements set out in the consolidation programs that were drafted last year. Accordingly, we expect the individual states to meet the requirements of the EU deficit procedure. This means that the base scenario is characterized by stringent budget discipline, with the highly-indebted countries in particular (i.e. countries with a government debt ratio in excess of 100%) achieving high primary surpluses of between 3.5% and 5%. The historical examples provided in the graphic below show that primary surpluses on this scale are by no means unrealistic.



This spending discipline is countered by relatively moderate growth prospects. Between 2014 and 2025, we expect average growth in real gross domestic product (GDP) to come in at between one and two percent. As far as inflation rates are concerned, we expect to see values of around 2% in line with the ECB price stability norm. In line with the reduction in new borrowing that follows from the assumptions set out above, our assumptions provide an indication of the development of average interest rates on sovereign debt. The financial markets will reward the consolidation successes, pushing the risk premiums on the government bonds of the crisis-ridden countries down in the medium term. These premiums will, however, remain at a high level for some time. As a result, the average interest rate will increase moderately in the period leading up to 2020 before the interest burden starts to stabilize.

Risk scenario: "Insufficient consolidation efforts"

We have assumed higher average interest rates in the risk scenario, based on a lack of the required spending discipline. The low primary surpluses push the implicit effective interest rates on net government debt up compared with the base scenario. After all, given circumstances such as those described here, the financial markets can hardly be expected to calm down. In this scenario, the primary surpluses in Germany, France and Spain are two percentage points lower, and those in the periphery countries that have undergone considerable debt restructuring as much as three percentage points lower, than in the base scenario. While German government bonds are not affected by an

increase in interest rates, because they are likely to provide something of a safe haven in the future, it is primarily the countries on the eurozone periphery that will suffer as a result of the marked increase in average interest rates. We have assumed that the average interest rate on the sovereign debt for Ireland, Italy and Spain will climb by 1.5 percentage points in each case in the period leading up to 2020. Germany's average interest rates will remain unchanged as against the base scenario, whereas France's average interest burden will rise by 0.5 percentage points.

This means that in this scenario, the aim of achieving a swift reduction in the debt level is undermined by two problems. First, the lower primary balances mean that it takes longer to reduce the mountain of debt while, second, the costs of the necessary refinancing are far higher.

Positive scenario: "Spending discipline, stronger economic growth"

Our positive scenario is characterized by stronger economic growth. In this scenario, we have assumed that both real and nominal growth will be one percentage point higher than in the base scenario (meaning that the ECB's price stability norm will be adhered to here, too). In the countries on Europe's periphery, in particular, brave structural reforms boost the competitive standing of the economies in question and pave the way for structural changes that will propel the countries on to a higher growth path in the medium term. As in the base scenario, the governments show resolve and staying power, allowing the countries to meet the consolidation requirements set out in the EU deficit procedure and achieve solid primary surpluses. As in the base scenario, the financial markets will start to regain trust in Europe's ability to get to grips with the debt crisis. This means that average interest rates remain at a relatively low level.

Below, we have applied the details of all three scenarios to each individual country.

Greece

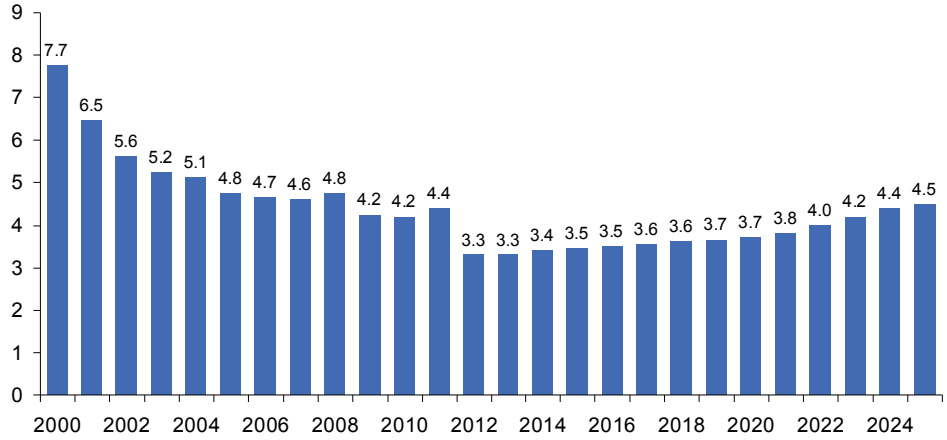
Greece	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	1.0%	5.0%	EU deficit target* met in 2013-2014, well-balanced budget in 2016, budgetary surpluses from 2017.	3.8%	120%	102%
Risk case	1.0%	2.0%	EU deficit target* not met in 2014, budget deficit of more than 3% 2014-2025.	3.9%	142%	142%
Positive case	2.0%	6.0%	EU deficit target* met, budgetary surpluses from 2014.	3.6%	104%	72%

*2012: 7.3%; 2013: 5.6%; 2014: 3.1%.

Greece is still coming under fierce criticism for not going far enough with moves to consolidate its budget and make structural returns to its economy. It is, nevertheless, important not to lose sight of the significant progress that has already been made in Greece's public coffers. Excluding interest expenditure, the state financing deficit tumbled from 10.4% of GDP in 2009 to around 2.2% last year. This year, too, consolidation appears to be progressing well to date, with the central budget deficit below the planned figures in the first three months of the year. Lower spending and higher tax revenues meant that the budget deficit was EUR 1.3bn lower than expected, at EUR 7.3bn. This has, however, done nothing to change the fact that the debt ratio has been on a steep upward incline until only recently, and would have climbed to more than 180% at the end of 2012 had it not been for the debt cancellation - compared with around 129% at the close of 2009. For some time now, new borrowing has no longer been the only force driving the debt ratio. The downward spiral in the country's gross domestic product carries its fair share of the responsibility for pushing the debt ratio up. Moves to recapitalize the country's banks are also imposing an ever-increasing burden upon debt levels, especially if we consider that we have yet to see any real return on the privatization measures. We have assumed that Greece will generate only EUR 25bn in revenue from its privatization projects in the period leading up to 2020 - half the amount originally hoped for.

Private creditor involvement will, however, drive the Greek debt ratio on the way down in 2012. The waiver of receivables in the amount of 53.5% (107bn) is almost a done deal now, with the subsequent introduction of "collective action clauses". Greek's debt will not, however, be slashed to the same extent. Some EUR 50bn of the second aid package for Greece is likely to be swallowed up by the need to recapitalize its banks and compensate for the losses incurred by the country's pension funds. We put the Greek debt level at around 157% of GDP at the end of 2012, only some 10 percentage points lower than at the end of 2011, in spite of the debt cancellation.

Average interest rates within Greek budget in base scenario



Sources: EcoWin, own calculations.

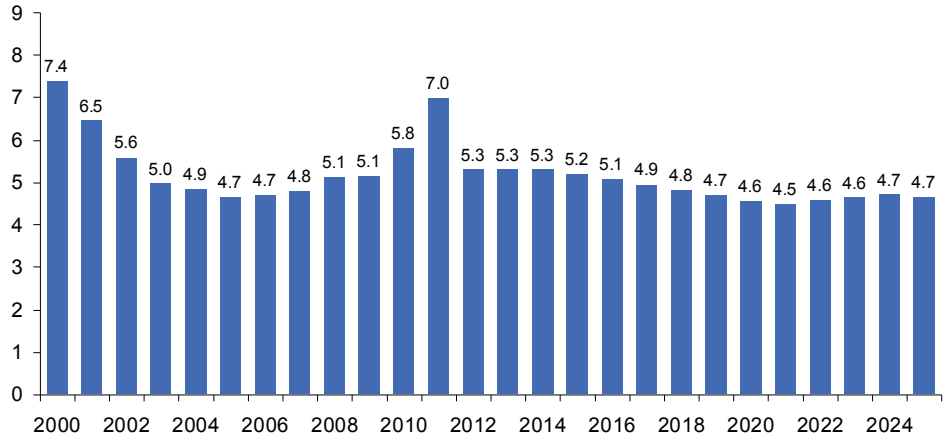
For Greece's future debt sustainability the reduction of interest rates is just as significant as the haircut. The interest rate on the newly issued bonds initially stands at a mere 2%. Moreover, both retroactively and in future, Greece now has to pay substantially lower interest rates on the loans taken up in the framework of the aid packages – the interest rate top-up for the EU's Greek loan facility was lowered to 150 basis points and standardized. Previously, Greece had been paying a premium of 200-300 basis points on the three-month Euribor rate, depending on the term of the assistance loans. As both components will soon make up the lion's share of Greek government debt, the average interest rate on outstanding Greek debt is set to fall from just short of 4½% to date to below 3½% in the coming years.

The aid packages made available to date will cover Greece's financing needs up until 2014, with the country expected to return to the capital market the next year. Greece's first steps back on to the capital market, however, are likely to come in the form of short-dated bonds. This is because the successful placement of medium to long-term government bonds on the capital market is likely to be hindered by several factors: for one, the gloomy economic prospects for the coming year are likely to push the government debt ratio up further, putting a temporary dent in bond investor confidence in debt sustainability - it is not until 2014 that we expect to see debt fall in relation to economic output. For another, the appeal of newly issued Greek bonds is likely to suffer as a result of the seniority of restructured bonds vis-à-vis their newly issued counterparts.

In a report published in early March when the IMF granted the country its EUR 28bn loan, the IMF warned of a financing shortfall of between EUR 8bn and EUR 21bn in the period between 2015 and early 2016 - i.e. once the second rescue package provided by Greece's European partners has expired - which is expected to burn a hole in the Greek budget. The IMF will be providing around EUR 8bn to help plug the hole in Greece's budget. If Greece is unable to find funding on the capital market at a manageable cost, the eurozone countries will have to cover the remaining EUR 13bn.

Given the above, there is every chance that Greece will need a third rescue package, delaying the country's return to the capital market by a few more years. Greece's first steps back on to the capital market are unlikely to come until around 2018.

Greece: Interest payments in relation to GDP in base scenario



Sources: EcoWin, own calculations.

The massive reduction in interest expenditure to only an estimated 5% of GDP from 2013 onwards means that, based on growth of 1% in real terms and 3% in nominal terms - which we have applied to our base scenario from 2014 onwards - a primary surplus of 1.4% would be sufficient to stabilize the debt ratio.

In our base scenario, we have assumed that Greece will manage to shape a political majority and that the new government in Athens will toe the line set by the Troika, generating a relatively high primary surplus of around 5% (of GDP) as of 2014. Despite moderate economic growth, the debt ratio will then fall fairly quickly, coming in at around 120% in 2020 and 102% in 2025. The country's gradual return to the capital market starting at the end of this decade will bring the average interest rate in the budget back up to 4½% by 2025. Interest expenditure, expressed as a proportion of GDP, will remain just below the 5% mark in the long term. Although sizeable, this sort of interest burden in a budget is manageable. This scenario does not point towards any sovereign default in the future.

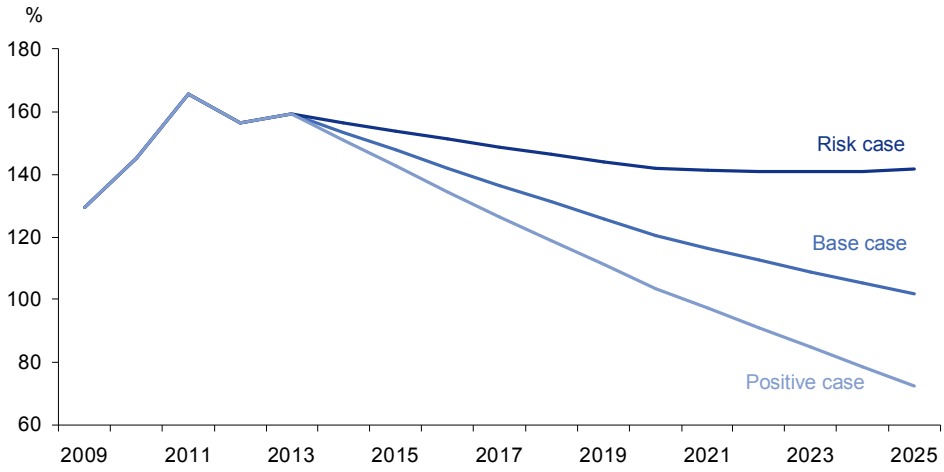
It is, however, by no means certain that Greece will be able to get to grips with its budgetary problems. With this in mind, our risk scenario assumes that Greece will only achieve a primary surplus of 2% from 2014 onwards. In this scenario, Greece proves unable to meet a key requirement, namely cutting its budget deficit of 3% of economic output by 2014. Greece then continues to breach the Maastricht criterion in the years that follow, with budget deficits to the tune of an estimated 3-5%. In this scenario, the debt ratio falls only marginally to 142% in 2020 and stays more or less put at this level up until 2025. Given circumstances such as those described here, the financial markets can hardly be expected to calm down. This pushes government interest payments, as a percentage of GDP, up from 5.3% in 2013 to around 7% in 2025. This sort of situation would be impossible to handle without another haircut.

Although it is hard to envisage as things stand at the moment, it is possible that Greece will show more positive development than that described in our base scenario. The inevitable economic cuts and reform efforts could trigger higher growth in the medium term. In this positive scenario, we have assumed that Greece will achieve real growth of 2% as of 2014, which is certainly not an overly positive assumption. On the back of a strong economy and ongoing consolidation efforts, Greece should then actually be able to generate considerable budget surpluses averaging 2%. The government debt ratio will fall

to 104% in 2020 and to as little as 72% in 2025. In this scenario, Greece would have managed to get rid off its debts for the long term.

Greece

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

Ireland

Ireland	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	2.0%	3.5%	EU deficit target* met: 8,6% in 2012, 7.0% in 2013, from 2014 close to 1%.	4.4%	96%	80%
Risk case	2.0%	0.5%	EU deficit target* not met, budget deficit in 2014-2025 between 4.7% and 7.5%.	5.5%	124%	134%
Positive caseT	3.0%	4.5%	EU deficit target* exceeded, budgetary surpluses from 2017.	4.4%	82%	57%

*2012: 8.6%; 2013: 7.5%; 2014: 5.1% 2015: 2.9%.

Ireland, which had turned into one of the eurozone's biggest debt culprits after a brutal banking crisis, is well on its way to squeezing its budget deficit down to below the 3% mark by 2015, as agreed with the EU. Tight budgetary discipline actually enabled the Irish government to overshoot the 10.6% deficit target set by the Troika last year, in spite of slackening domestic demand. Nevertheless, the country, which is home to 4.5 million people and was one of the first to tap into the EFSF rescue fund at the end of 2010, still has the highest level of new borrowing in the eurozone at 9.8% of its economic output. This is the official national figure, whereas Eurostat puts the Irish budgetary shortfall in 2011 at 13.1% of its GDP. This discrepancy can be explained by the differences in how the costs of saving the banking sector are assessed. This year, consolidation efforts should whittle the deficit ratio down by just under 3% of GDP to 8.6%. Debt servicing for bank recapitalization will continue to impede efforts to restore the country's public finances to good health in the future.

The Troika's latest report gives Ireland, when has received lending commitments worth EUR 67.5bn, good marks. In addition to ambitious savings plans, the government is ploughing ahead with the agreed structural reforms, particularly on the labor market. The country's high unemployment rate (14.5%) and subdued domestic demand are two downside risks to the Irish economy. At the same time, Ireland's improved competitive standing, thanks - inter alia - to rising productivity levels is reflected in robust export demand. Ireland has returned to current account surpluses after ten years plagued by persistent deficits. This year, we expect real economic output to increase by 0.5%. Since more than 70% of Irish exports are destined for its European neighbors, the growth of the Irish economy depends, to a significant degree, on the European debt crisis being brought under control. One additional source of uncertainty is the outcome of the referendum on the fiscal pact, which will be held on May 31.

In line with the base scenarios for the other countries, we expect to see real growth of 2% by 2025 in this base scenario. Thanks to further public budget cuts, a primary surplus of 3.5% as of 2014 is a scenario that we consider to be realistic. The Irish prime minister Enda Kenny has, for example, announced that further cuts in the areas of social benefits, healthcare and education are on the cards for 2012. What is more, the government intends to use a VAT hike from 21% to 23% to take some of the strain off the budget. The restored investor confidence in Ireland's ability to rein in its debt burden in the long run, not least thanks to the successful implementation of the Troika adjustment program, has calmed things down on the Irish bond market. Furthermore, Ireland, like Greece, is on the receiving end of EFSF loans at low premiums and, as a result, based on favorable interest rate conditions. As a result, we expect the interest burden (implicit effective interest on sovereign debt) to increase only moderately in the period leading up to 2020, settling at a level of 4.5%. Based on these assumptions, the Irish debt ratio will reach its peak in 2013, at 118%. With budget deficits of less than 1% of GDP from 2020 onwards, Ireland will manage, all in all, to slash around 28 percentage points off its debt ratio, bringing it down from 108.2% in 2011 to around 80% in 2025.

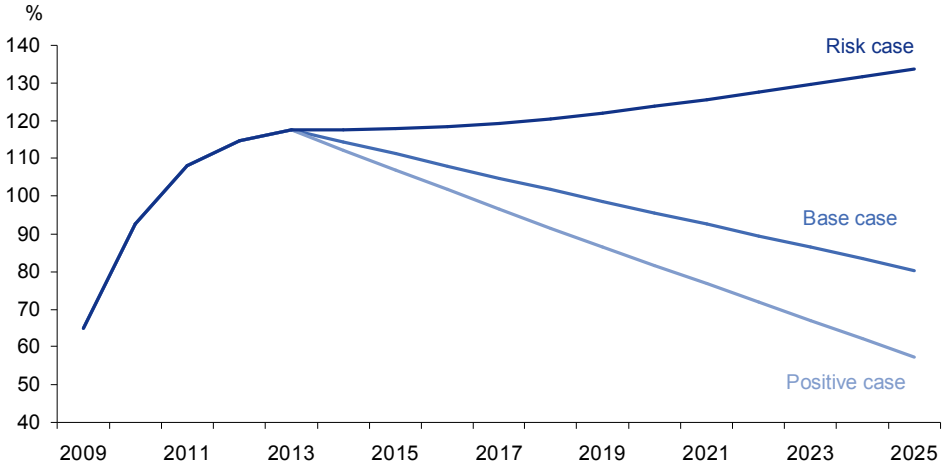
Risk scenario: Assuming that the government is unable to deliver on its savings promises, the Irish will only achieve primary surpluses corresponding to 0.5% of the country's economic output in the period from 2014 to 2025. Insufficient consolidation efforts will not only hinder Ireland in its endeavors to conquer its debt mountain, but will also send refinancing costs/risk premiums up. Assuming that the average interest rates are very high, increasing to 6% by 2020, Ireland will be unable to adhere to the deficit target of 3% in 2015. With sustained financing deficits of a good 6% of GDP on average from 2014 onwards, the Irish debt ratio will have increased by around 26 percentage points to just shy of 135% by 2025. In these simulated circumstances, Ireland will be unable to achieve a sustainable debt level and debt restructuring would be extremely likely.

In our positive scenario of stringent spending discipline coupled with stronger economic growth, Ireland's austerity efforts bear fruit quickly and with long-term effects. Structural reforms such as moves to make wages more flexible boost the growth potential of the country once dubbed the celtic tiger - a reduction in unemployment bolsters the domestic economy while, at the same time, the country's improved competitive standing allows it to generate more revenue from exports, meaning that the Irish economy grows by 3% in real terms (5% in nominal terms). Based on the same budgetary discipline as in the base scenario and rising government revenue, we believe that a primary surplus of 4.5% is within the realms of possibility as of 2014. In this environment, the Irish government manages to achieve an almost balanced budget in 2014, followed by a budget that is slightly in the black in the years that follow, rising to almost 2% of GDP in

the period leading up to 2025. In our positive scenario, Ireland is able to cut its debt ratio by 51 percentage points to 57% - well below the 60% requirement.

Ireland

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

Portugal

Portugal	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	1.0%	4.0%	EU deficit target* met.	4.5%	98%	84%
Risk case	1.0%	1.0%	EU deficit target* met in 2012, budget deficit in 2014-2025 between 4.3% and 6%.	4.8%	121%	128%
Positive case	2.0%	5.0%	EU deficit target* met, budgetary surpluses from 2015.	4.5%	83%	59%

2012: 4.5%; 2013: 3%.

The Troika has confirmed that Portugal is on track with its program of reforms. This country on the EU's periphery is set to be handed a total of EUR 78bn from the rescue fund over a period of three years. The country could actually slightly overshoot the Troika requirement of a deficit ratio of 5.9% in 2011 - albeit thanks to a one-off effect: the government deficit came in at 4.2% of GDP, but this includes a transfer from bank pension funds to the state accounting for 3.5% of GDP. In its most recent audit report, the European Commission writes that Portugal managed to pull off considerable structural consolidation last year (3.5% of GDP), in spite of this one-off payment. Thanks to the austerity measures embarked upon by Passos Coelho's government, Portugal is, in our view, certainly in a position to meet the targets set by the Troika as regards its budget deficit - despite the fact that the country faces a deeper recession in 2012. As far as this year is concerned, we expect new borrowing to account for around 4.5% of GDP. Portugal will be able to improve its international competitiveness by means of labor market reforms, as well as the restructuring and partial privatization of its public sector. In our

view, it is likely that these efforts will be rewarded by 2014 at the latest. Even though we expect to see a return to slight economic growth in as early as 2013, we forecast moderate, but stable average real growth of 1% from 2014 onwards.

Portugal's commitment has, however, only brought it limited rewards on the financial markets to date (in January, all three major rating agencies rated Portuguese bonds as below investment grade, i.e. as junk). The markets are currently fixated instead on the drastic, but virtually inevitable, slump in domestic demand and the recession that has been ushered in as a result. Portugal's risk premium for 10-year government bonds currently stands at around 11% (albeit far lower than the high of 17% reached at the end of January of this year). Such premiums make the country's planned return to the market to secure partially independent financing in 2013 an unlikely prospect. But Portugal is not Greece and fares better in many fundamental economic indicators (government debt ratio, new borrowing ratio, current account deficit, unemployment rate). Even more importantly, Portugal's economic policy bears testimony to a will to implement far more fundamental reforms than Greece's does. The government has already begun to tackle structural reforms on a grand scale, or is at least in the process of drawing up very specific plans. If Portugal is unable to alleviate market misgivings in the long term, we believe that the rescue fund is likely to be extended for an additional period, a move that would make sense in light of Portugal's reform efforts. As a result, we have assumed in our calculations that this problem child will continue to seek EU assistance for some years to come, at least in part. We are therefore working with an average budget interest rate of 4.5% in the period from 2014 to 2025 in all our scenarios.

Thanks to extensive consolidation measures, it was possible to all but eliminate the primary budget deficit, which had reached 7.3% of GDP in 2009, in the course of last year. For 2013, we therefore expect a primary surplus of around 2% of economic output. In our base scenario, we have assumed that Portugal will be able to maintain its exemplary budget discipline, thus generating primary balances of 4% from 2014 onwards. If this is the case and provided that average interest remains constant in the period leading up to 2025, Portugal will be able to report a slight budget surplus at the end of the period covered by our assessment. It will manage to push its debt ratio below the 100% mark in as early as 2020, falling to just under 85% in 2025.

Although the unemployment rate reached a new record high of 15.3% in March, resistance among the Portuguese population to the government's austerity program is limited, unlike in Greece. It is nevertheless questionable whether Portugal will be able to maintain its stringent budget discipline in the medium term. Given these considerations, we have assumed more lax financial discipline in our risk scenario, with primary surpluses of a mere 1% of GDP. Portugal, however, needs at least 1.8% just to keep its debt ratio constant at 2012 levels. We also expect average interest rates to start climbing in 2020, rising to 5.5% by 2025. In this scenario, government interest payments as a percentage of GDP would rise by 2 percentage points in the period from 2012 to 2025. The budget deficit will therefore also take a turn for the worse, climbing to

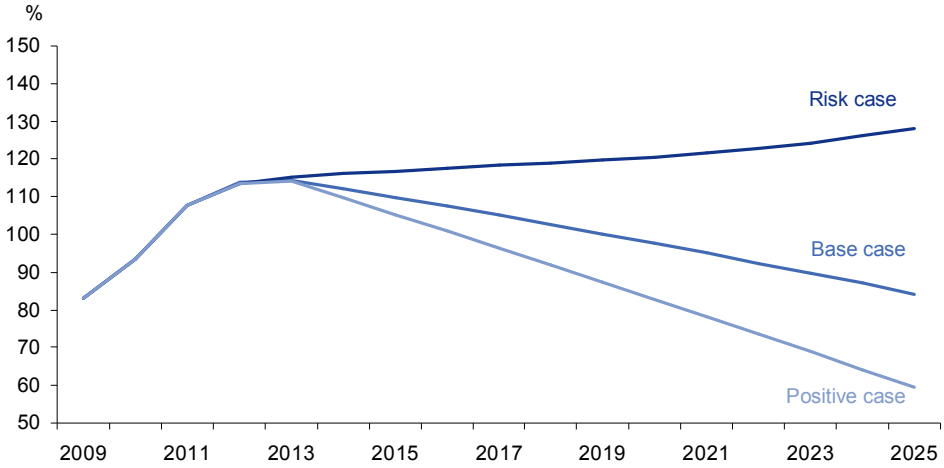
6% by 2025. At the same time, the debt level will increase to just under 130% of GDP, a debt situation that can hardly be described as sustainable.

In our positive scenario, even further-reaching structural reforms, such as the deregulation of the energy sector or the liberalization of protected service sectors, pay off. Real growth of 2% makes primary surpluses of 5% a possibility. If this were the case, Portugal's budget would be balanced by as early as 2015. The debt ratio would slide to

around 60% by 2025 - meaning that Portugal would almost have halved its debt ratio compared with 2012, thus also fulfilling the Maastricht criterion.

Portugal

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

Spain

Spain	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	1.5%	2.0%	EU deficit target* met, budget deficit of 0.8% in 2014.	4.3%	65%	58%
Risk case	1.5%	0.0%	EU deficit target* met, increasing budget deficit from 2014.	5.4%	84%	94%
Positive case	2.5%	3.0%	EU deficit target* met, budgetary surpluses from 2014.	4.3%	53%	38%

*2012: 5.3%; 2013: 3.0%.

Spain has once again been thrust into the firing line of the euro debt crisis: yields on its government bonds have risen considerably (e.g. from around 5% for 10-year Spanish bonds two months ago to almost 6% of late). The markets seem to be concerned, in particular, about a vicious circle of budget consolidation and economic weakness. The Spanish economy grew by 0.7% in 2011, only half the EMU average, and is likely to contract by 1.3% this year. Unlike on the economic front, substantial progress has been made from a political perspective. The government led by premier Zapatero had already begun to trim new public borrowing as a percentage of GDP, which had reached its zenith in 2009, albeit not to a sufficient degree. The deficit ratio in 2011 was higher than planned at 8.5% and the target for this year has been lifted from the original level of 4.4% to 5.3%. In order to achieve this, Rajoy's government committed itself to an austerity budget in late March. This includes, among other things, spending cuts affecting government ministries, savings at regional level, fewer depreciation and amortization options for the corporate sector and an amnesty for tax evaders.

We believe that the country's main problems lie in its federal structure/autonomous regions, which are responsible for much of the excess deficit, as well as in the country's high unemployment level and ailing banking sector. Reforms have been initiated in all three areas (including a "stability pact" with certain regions, moves to make dismissals financially less dissuasive, shorter working hours model; provisions for problem loans). So far, Spain has not yet had to fall back on emergency loans and is also unlikely to have to do so in the future. Given its fairly favorable starting position - out of the group of countries included in our analysis, Spain had the lowest debt level last year, at 68.5% of GDP - the current yield level does not yet pose any fundamental threat to the country's debt sustainability. At around 2 ½% of GDP, Spain's interest payments are roughly as low as Germany's.

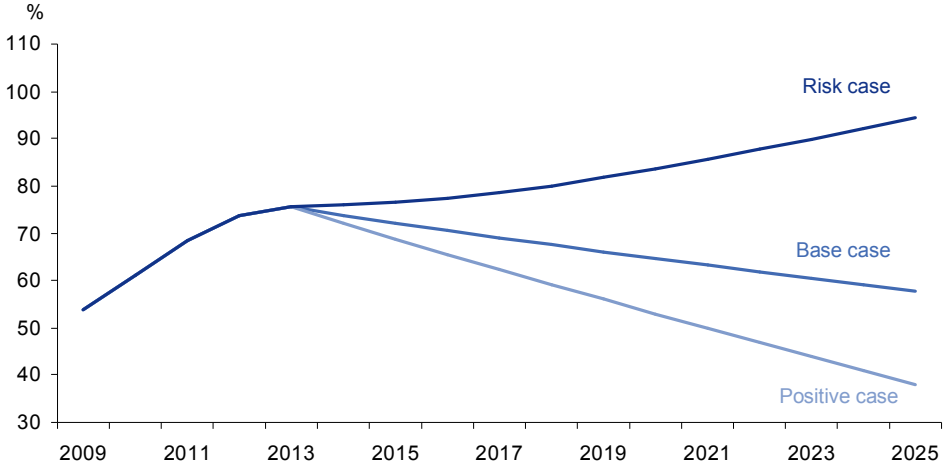
If nothing else given the announcement that Madrid intends to significantly improve the competitiveness of the Spanish corporate sector by reforming both the labor market and the banking sector, our base scenario assumes that nominal growth rates of 3.5% will be realistic as of 2014. Swelling government revenue on the back of this growth momentum will mean that Spain can be expected to report a primary surplus of 2% of GDP from 2014 onwards. As far as average interest rates are concerned, we have assumed an increase to 4.5% in the period leading up to 2020. Given that the debt ratio will have dropped to around the 65% mark by 2020, average interest rates should, however, remain constant in the years that follow. In our base scenario, Spain will manage to meet the Maastricht criterion in 2025, with a debt level of 58% of GDP. This means that, in our base scenario, this country on the EU periphery will have the lowest debt ratio of all, bar Germany. From 2014 onwards, Spain would be able to achieve new borrowing levels of just under 1%, thus slashing more than 7.5 percentage points off its deficit ratio compared with 2011.

In our risk scenario, we have assumed that the reforms embarked upon bear little fruit. As in the base scenario, real growth is predicted to come in at 1.5% during the observation period, but it proves impossible to generate any primary surplus. This means that primary balances will be zero. Simultaneously, as a result of poorer budgetary discipline and mistrust on the financial markets, average interest rates are assumed to rise: initially, this will entail a gradual rise to up to 6% in 2020, followed by subsequent stabilization. In this scenario, government debt would swell to approx. 95% of GDP by 2025. Due to high refinancing costs and similarly high capital requirements, the deficit ratio would clamber its way up to around 5½% in 2025. This makes debt sustainability an impossibility.

In our positive scenario, we have assumed a significant improvement in competitiveness. Thanks to wage cuts, a better framework for the shorter working hours model and moves to facilitate dismissals, the flexibility and thus the competitiveness of the Spanish economy improves significantly in this scenario. The country also benefits from the rationalization of the public sector and successful liberalization/privatization moves. This has a direct impact on the growth outlook, prompting us to assume real annual growth of 2.5%. This, in turn, will allow Spain to generate a higher primary surplus. These trends will have a positive impact on new borrowing: in 2014, Spain will already be able to report a slight budget surplus of 0.2%, which is likely to have risen to 1.2% of GDP by 2025. Under conditions like these, we believe that Spain could have achieved a debt ratio of less than 40% by 2025.

Spain

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

Germany

Germany	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	1.5%	2.0%	EU deficit target* exceeded, budget deficit of 0.2% in 2013.	3.3%	62%	52%
Risk case	1.5%	0.0%	EU deficit target* exceeded, budget deficit above 2% from 2014.	3.3%	76%	76%
Positive case	2.5%	3.0%	EU deficit target* exceeded, budget deficit of 0.2% in 2013, budgetary surpluses from 2014.	3.3%	50%	33%

*2012:1.5%; 2013: 1%, 2014: 0.5%.

The solid economy whittled Germany's state deficit down to 1% of GDP in 2011. In spite of the debt crisis, the German economy is likely to prove robust in 2012. Thanks to stable domestic demand, real GDP growth to the tune of 1% would appear to be a realistic estimate for this year, while next year could see the growth rate edge up to 2% again.

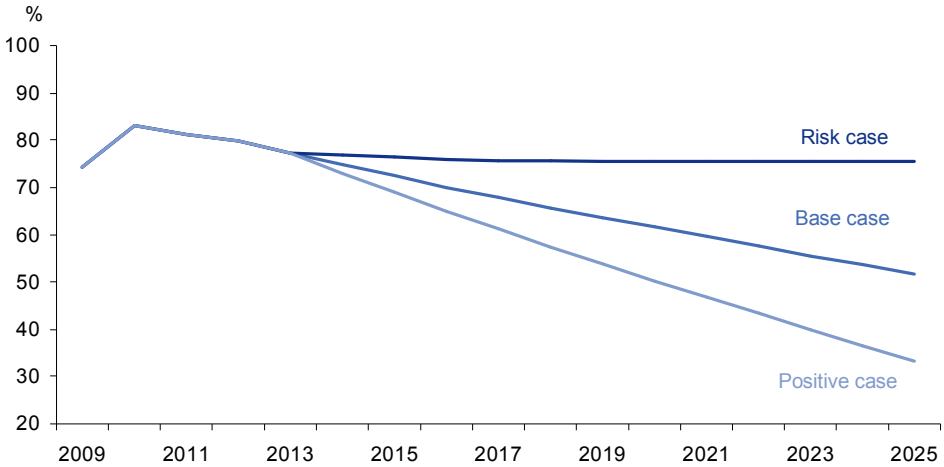
In our base scenario, however, we have assumed that real growth will average only 1.5% a year from 2014 onwards. As far as average interest rates on sovereign debt are concerned, we have assumed a slight increase from 2.9% in 2012 to 3.5% in 2020. In the case scenario, we expect a further improvement in the primary surplus to 2% in 2014. With the interest burden headed south and primary surpluses that are expected to remain stable, we expect Germany to be able to hit the debt brake target (structural budget deficit, i.e. not due to economic factors, of close to zero) in as early as 2014. At just over 60%, the debt ratio in 2020 will be within spitting distance of the Maastricht criterion, which it will actually undercut by a considerable margin in 2025, when the debt ratio is likely to come in at around 52%. This means that by 2025, Germany will have the lowest debt ratio out of all of the countries in our analysis.

The downgrading of France and Austria in early 2012 has further enhanced the "safe haven" status of German government bonds. The yields on five-year and thirty-year bonds have fallen to all-time lows. In our risk scenario for Germany, fiscal discipline is therefore slackened, while the implicit effective interest rates on sovereign debt remain unchanged as against the base scenario. In this scenario, we have assumed that Germany will not manage to generate primary surpluses. This means that outstanding payments to the euro rescue fund and laxer spending discipline driven by faith in a supposedly solid cash situation could drive net borrowing up. With primary balances of 0% as of 2014, the budget deficit will therefore deteriorate, rising slowly but surely to 2.6% by 2025. This scenario would see Germany unable to either adhere to the debt brake or to meet the debt level criterion. A debt level of around 75% is reached in 2025 in this projection.

In the positive scenario, the German economy grows at a faster rate than expected. Germany's economy is currently being driven by strong domestic demand. Rising corporate investment and higher consumer demand are both testimony to this trend, with low unemployment and rising salaries providing further impetus. It is certainly within the realms of the conceivable that this positive momentum will continue, pushing real growth rates up. It is also plausible to assume that the debt problems faced by the countries on Europe's periphery will subside, which would have a positive impact on German exports. In this scenario, the German economy grows at an annual rate of 2.5% in real terms. This in turn, means that higher primary budget surpluses can be expected. This benefits Germany's net lending/borrowing and debt levels. In this scenario, a budget surplus would be achieved in as early as 2014, with the debt level in 2025 sitting at no more that 33%, a level last seen in the 1980s.

Germany

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

France

France	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	1.5%	2.5%	EU deficit target* met, budget deficit of 0.6% in 2014.	3.9%	73%	62%
Risk case	1.5%	0.5%	EU deficit target* met, budget deficit of 2.7% in 2014.	4.2%	89%	90%
Positive case	2.5%	3.5%	EU deficit target* met, budgetary surpluses from 2014.	3.9%	61%	42%

*2012: 4.6%; 2013: 3%.

At the latest when France lost the top AAA rating awarded by Standard & Poor's in January, it became clear that the second-largest EMU country is also battling to uphold its image and economic performance. But a comparison with the country's neighbor, Germany, had sent the alarm bells ringing even before the downgrade: France economic growth lagged well behind German growth in 2011 and, at the same time, the country's deficit ratio was much higher than of Germany. To add insult to injury, the French debt level, expressed as a percentage of GDP, is not on the decline, but is actually climbing further.

Our base scenario does not assume any fundamental change in this situation in 2012, although Germany's lead on the economic growth front is expected to narrow. Looking ahead to 2013, we expect France to meet the 3% deficit criterion and to more or less stabilize its debt ratio. In the longer term, historical experience suggests that economic growth will be similar to that seen in Germany - we have assumed a nominal growth rate of 3.5%. Taking this as a basis, we believe that a virtually balanced budget from 2014 is a realistic budget consolidation goal. This rests on the assumption that the average interest on sovereign debt will rise over time from its current level of around 3% to 4% (i.e. will be about 50 basis points higher than in Germany in the long run). In this environment, public debt will have fallen to around 73% of GDP by 2020, approaching the 60% mark by 2025.

This is subject to the proviso that we do not see a fundamental change of direction in France in the wake of the presidential elections. The run-off on May 6 between former president Nicolas Sarkozy and his socialist challenger François Hollande saw the latter emerge victorious. As far as reducing new borrowing is concerned, Hollande's objectives and schedule do not deviate to any considerable degree from those of his predecessor (the aim is to hit the 3% deficit mark in 2013). During his election campaign, Hollande became a talking point in particular with his proposal of a 75% tax rate for incomes in excess of 1 million euros. He also intends to renegotiate the European fiscal pact to include growth promotion measures as well. He is in favor of "project bonds" (eurobonds) to finance certain projects to benefit industry and infrastructure. Although the shift of power in France is associated with some degree of uncertainty, Hollande will ultimately have to adjust to the pressure exerted by the financial markets and the realities of European politics.

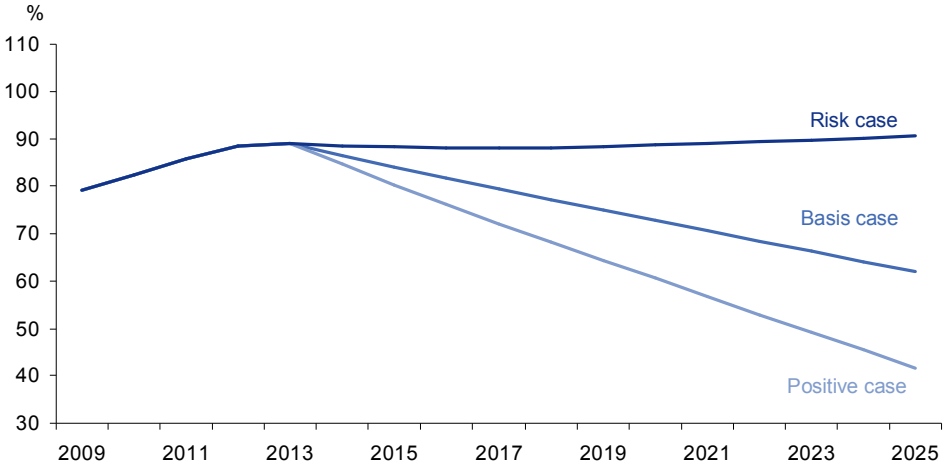
Our risk scenario differs from the base scenario in the sense that it assumes an interest rate on sovereign debt that is around half a percentage point higher – which is still, nevertheless, a moderate interest rate level in a historical comparison. Although France does not have the same sort of "safe haven" status as Germany, the size of its economy and the bond market serve to enhance the appeal of the country's government bonds.

What is more, from a political perspective, Germany and France have reaffirmed their combined status as Europe's engine - a relationship that is unlikely to change to any considerable extent in the foreseeable future. Our risk scenario also assumes primary surpluses of only 0.5% (as opposed to 2.5%) of GDP in the longer term. This means that the budget balance, as a proportion of GDP, is not close to zero, but rather that the deficit ratio rises to 3.5% in the period leading up to 2020, only to continue to linger there in the ensuing period (in implicit terms, this means that the tighter European rules would ultimately not be applied properly). This would put the debt ratio in 2020 more or less at the current level, before climbing slightly to around 90% in the period leading up to 2025. A lack of budgetary discipline would see France's debt continue to pile up, making the country unable to escape the negative spiral.

Our positive scenario features long-term real economic growth rates of 2.5% as opposed to 1.5%, putting primary surpluses at 3.5% of GDP, as opposed to 2.5% in the base scenario. In order to achieve this, France would have to be successful in overcoming its weaknesses, for example the worrying drop in its share of world trade, its oversized public service or it labor market regulations, which manifest themselves in high youth unemployment, for example. In the positive scenario, the debt level would have fallen back to 60% of GDP by as early as 2020, falling to a good 40% by 2025. These results show how important it is not to focus solely on savings and, in the process, neglect growth promotion measures. This does not have to be a contradiction in terms, because for one, structural reforms do not necessarily cost money and for another, it can prove worthwhile to check government spending and loopholes on the revenue side.

France

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

Italy

Italy	Real GDP growth 2014-2025	Primary balance as % of GDP 2014-2025	General government deficit as % of GDP	Average interest rate 2014-2025	Debt-to-GDP ratio	
					2020	2025
Base case	1.0%	4.0%	EU deficit target* met.	4.5%	103%	90%
Risk case	1.0%	1.0%	EU deficit target* met, budget deficit of 4.6% in 2014.	5.6%	132%	147%
Positive case	2.0%	5.0%	EU deficit target* is exceeded, well-balanced budget in 2015.	4.5%	88%	65%

*2012: 2.3%; 2013: 1.3%.

The fact that the Italian bond market has calmed down considerable shows that the extensive austerity and reform program passed by the technocratic interim government led by Mario Monti has boosted confidence in the country's policymakers. At the end of last year, when Italy's credit rating was downgraded first of all by Standard & Poor's (BBB+), and later also by Fitch (A-) and Moody's (A3), the financing costs for 10-year Italian government bonds had risen to more than 7%. By contrast, in the first quarter of this year, Italy was paying interest averaging 5.3% on 10-year bonds, compared with the average of 6.2% that it had to promise in the closing quarter of 2011 to access fresh funds.

In our base scenario, we have assumed that the ambitious "Salva Italia" austerity program worth a total of EUR 30bn, combined with the "Cresci Italia" reforms designed to promote growth will put the nail in the coffin of the country's debt misery in the medium term. Despite the lackluster growth outlook for this year (-1%), which forced the Italian government to slightly tweak its medium-term budget plans in April, Italy complies with the EU deficit procedure in our base scenario, and will have already pushed its new borrowing down to less than 3% of GDP by the end of this year. Next year, Italy is expected to achieve an almost balanced budget in 2013 (budget deficit corresponding to 1.2% of GDP). This year, the restrictive fiscal policy is likely to cause the economy to contract by 1%, although economic stabilization is on the cards for as early as next year. As of 2014, we expect to see moderate real growth to the tune of 1% in our base scenario. Last year saw Italy managed to achieve a slight primary balance surplus (1.0% of GDP) for the first time since 2008. Against the backdrop of Monti's reform policies, we believe that a positive primary balance of just shy of 3% is a realistic goal for 2012. Looking at the period from 2014 onwards, its strict consolidation course is likely to allow the Italian state to generate a primary surplus of 4% of GDP - as it managed to do back in the period from 1997 to 2001. The financial markets are likely to reward the consolidation successes, pushing risk premiums down in the medium term. These premiums will, however, remain at a high level for some time. As a result, the average interest rate will chart a moderate upward course to 4.5% in 2013, but should then remain constant as debt levels continue to stabilize.

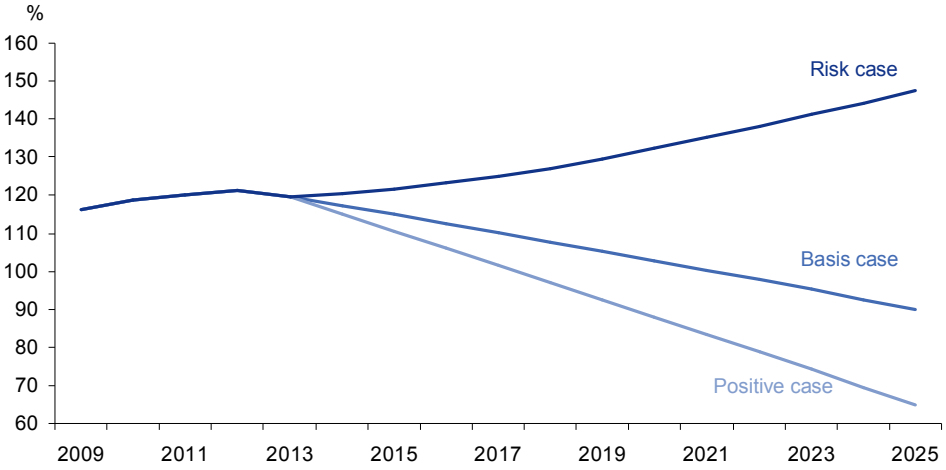
Based on these assumptions, the Italian debt ratio will reach its high of around 121% in the course of this year, falling to somewhere in the region of 90% by 2025. Given its unfavorable starting position as the country with the second-highest debt ratio in the euro area after Greece, however, the country will not be able to meet the Maastricht criterion of a debt ratio of 60% by 2025 in our base scenario. This scenario does, however, ensure Italy's debt sustainability: interest expenditure in 2025 will account for only around 4% of GDP.

One risk to the stabilization of the debt ratio lies in the possibility that the Italian government will show less fiscal policy resolve than we would hope for, meaning that it fails to meet its ambitious primary surplus targets. Consequently, a lack of budget discipline will translate into only meager primary surpluses of around 1% of GDP in the risk scenario - three percentage points lower than in the base scenario - pushing the average interest on sovereign debt up. In an environment of moderate growth, rising interest payments and higher new borrowing, the debt level will increase to around 147% of GDP. This would put Italy in a similar situation to the one in which Greece finds itself today.

Our positive scenario shows just how much Italy would benefit from stronger economic growth. Brave structural reforms boost Italy's competitive standing and pave the way for structural changes capable of propelling the country on to a higher growth path in the medium term. In this environment, real economic growth of 2% from 2014 onwards certainly does not seem beyond the realms of reality. As long as Italy can demonstrate the same budget discipline as in the base scenario, this would result in a higher primary surplus compared with the other scenarios. From 2015 onwards, the Italian government will generate budget surpluses, pushing the debt ratio down below the 100% mark in as early as 2018. By 2025, Italy will have managed to get its debt level down to around 65% of GDP, just a fraction off the 60% set out in the Stability and Growth Pact as the target for 2025. If the country continues to benefit from growth impetus, however, it is more than likely to meet this criterion in the years that follow. In this scenario, Italy would have managed to almost halve its debt ratio within the space of 13 years.

Italy

Gross government debt, as % of GDP



Sources: Eurostat, own calculations.

AN OVERVIEW OF THE KEY RESULTS

Greece

- If Greece manages to adhere to the Troika targets, its debt ratio should start to fall fairly quickly, touching on the 102% mark, give or take, by 2025. This means that, even in a not overly optimistic economic environment, Greek could manage to slash its debt ratio by more than 50 percentage points - this scenario does not have any sovereign default mapped out for the future.

- If Greece fails to straighten out its budgetary problems, the debt ratio can only be expected to have edged down ever so slightly by 2025 compared with this year's level, making further debt cancellation a very likely prospect.

- The reform efforts could catapult the Greek economy onto a higher growth path in the medium term. Economic impetus and commitment to consolidation moves in the longer term would allow Greece to achieve sustainable debt reduction.

Ireland

- In the base scenario, Ireland is able to cut its debt ratio by around 28 percentage points from 108.2% last year to more or less 80% in 2025.

- If it is unable to summon up the necessary budgetary discipline and the country is plagued by high average interest rates, Ireland will be unable to achieve a sustainable debt level and debt restructuring would be extremely likely.

- Strong economic growth and a tight rein on spending would allow Ireland to cut its debt ratio to 57%, well below the 60% target.

Portugal

- If Portugal is able to maintain its exemplary budget discipline, a debt ratio of less than 100% of GDP is possible as early on as in 2020.

- Poor financial discipline would hit the country hard: with government debt touching on 130% of GDP in 2025, the country could more or less forget any ideas of achieving debt sustainability.

- Stronger real economic growth of 2% and high primary surpluses as a result would push Portugal's debt ratio down to such an extent that it could be almost halved as against 2012.

Spain

- With a debt level of around 60% of GDP, Spain will have the lowest debt ratio of all, bar Germany, by 2025 in our base scenario.

- In the risk scenario, a debt ratio of around 95% and a deficit ratio of around 5½% banishes debt sustainability to the realms of the unachievable for Spain.

- Stronger economic growth, stemming, for example, from an improved competitive position thanks to a more flexible Spanish labor market, makes a debt ratio of less than 40% a realistic target.

Germany

- In our base scenario, Germany will be able to hit the debt brake target in as early as 2014.
- If the country proves too lax with its spending discipline, resulting in primary balances of zero, Germany's debt level would come in at 75% of GDP in 2025 - a situation that would see Germany unable to either adhere to the debt brake or to meet the debt level criterion (Maastricht).
- Brisker economic growth and higher primary surpluses would get the debt ratio down to 33% in 2025 - the sort of level last seen in the 1980s.

France

- In the base scenario, France is able to achieve a virtually balanced budget from 2014 onwards, with its debt ratio falling to almost 60% in 2025.
- Failure to maintain the required budgetary discipline could plunge France into a downward spiral. Insufficient consolidation measures would see the debt level rise to more than 90% of economic output by 2025.
- Stronger real growth of 2.5% would make a 60% debt ratio a realistic target for France in as early as 2020.

Italy

- The base scenario ensures Italy's debt sustainability: with a debt ratio of around 90%, interest expenditure in 2025 will account for only around 4% of GDP.
- In a scenario in which the tense situation on the financial markets continues and Italy proves unable to maintain budgetary discipline, the debt ratio rises to around 147% in 2025 - putting Italy in a similar situation to that faced by Greece today.
- If it could achieve stronger economic growth, Italy would come within a hair's breadth of hitting the 60% Maastricht debt ratio criterion.

CONCLUSION

The three scenarios for the development of government debt show that reversing the debt momentum both in the EMU countries that have been hit particularly hard by the crisis (Greece, Ireland, Portugal and Spain) and in the core monetary union states (Germany, France and Italy) is not an insurmountable task. Even in a macroeconomic environment that is not overly optimistic, the member states that are currently plagued by debt could make a return to long-term debt sustainability by 2025. This will, however, require the eurozone countries to resolutely pursue their consolidation drive over an extended period and plough ahead with the envisaged economic reforms. It is also important that the EU provides the necessary support for the amount of time needed for these countries to prove that their consolidation efforts have been successful.

Our positive scenario is an impressive example of the effect that growth impetus of as little as one percentage point can have on making consolidation a success. Stronger economic growth would not only help to reduce the mountains of debt that the country

has accumulated - rather, sustained economic growth and the viable, non credit-driven jobs that this would bring would foster more acceptance among the population at large as far as the reform efforts and the euro project are concerned.

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