ECONOMIC RESEARCH

Working Paper 179

October 22, 2014

MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

Claudia Broyer, Nicoletta Renner, Dr. Rolf Schneider, Katharina Utermöhl

Scenarios for government debt in the eurozone

Allianz

Working Paper

No. 179

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AUTHORS:

CLAUDIA BROYER
Phone: +49.69.24431-3667
claudia.broyer@allianz.com

NICOLETTA RENNER
Phone: +49.69.24431-5144
nicoletta.renner@allianz.com

DR. ROLF SCHNEIDER
Phone: +49.69.24431-5790
rolf.schneider@allianz.com

KATHARINA UTERMÖHL
Phone: +49.69.24431-3790
katharina.utermoehl@allianz.com

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1. INTRODUCTION: THE DEBT CRISIS IS OVER, BUT THE QUESTION OF DEBT SUSTAINABILITY REMAINS

The massive compression in yield spreads for government bonds issued by the EMU "problem countries" would appear to signal the end of the acute financial crisis. At the same time, the countries on the continent's periphery are climbing out of the depths of recession and making a return to positive growth. Nevertheless, the debt crisis in the eurozone has left a - sometimes substantial - legacy of debt in its wake. In 2013, for example, average government debt in the eurozone tallied up to a good 90% of GDP, off the 60% target by a long shot. In some of the former crisis countries, the debt level still corresponds to well in excess of 100% of economic output, a trend that only looks set to become more pronounced. In this sort of environment, government budget consolidation will remain a hot topic and one that will continue to put a damper on the growth outlook for the individual EMU countries, in some member states more than in others.

As the pressure of the crisis dictated, the fiscal policy rules and regulations have been extended/stepped up to include new processes and criteria. This essentially boils down to a strengthening of the Stability and Growth Pact to include the "six pack", the "two pack" and the Fiscal Compact (Box 1). The idea is that the strengthened rules and regulations will serve as the backbone for more moderate fiscal policy. The question that now begs an answer is to what extent the new, and extremely complex, rules and regulations will actually be applied in the future and whether they can save us from making the same mistakes and succumbing to the same temptations as in the past. After all, experience shows that whenever the eurozone has been riding the good waves economically, it has failed to make sufficient provisions for rainier days. What is more, it has never been difficult to find a political majority at European level in support of softening up the rules or extending consolidation deadlines when the objectives appeared to be too difficult/painful.

Now, there would appear to be a general consensus that everything possible has to be done in order to prevent events as drastic as the debt crisis - which, at its peak, threatened the very survival of monetary union - in the future. But the long period of austerity efforts, poor economic development and unemployment has left its mark on the willingness to make further sacrifices. The current efforts, particularly in two EMU heavyweights, France and Italy, to place more of an emphasis on "growth-friendly" policies show that doubts surrounding the willingness to stick to the fiscal policy rules in the future are not completely unfounded.

Below, we have used three scenarios to show the development of government debt in the major EMU economies and the problem countries. If nothing else, this helps us to assess how sustainable state finances are in the countries analyzed based on the different scenarios. It is, however, important to bear in mind that there is no established definition of what the term "sustainable" means.

Box 1: Fiscal regulations at EU level

Stability and Growth Pact

The 1997 Stability and Growth Pact (SGP) sets out upper thresholds that the public deficit and the public debt level of EU member states have to adhere to:

- Maastricht deficit threshold: 3% of GDP
- Maastricht debt ratio threshold: 60% of GDP

Before the "six pack" was introduced, an Excessive Deficit Procedure (EDP) was only initiated if the deficit criterion was breached.

"Six pack"

The SGP was stepped up in 2011 to include something known as the "six pack". In addition to the reform of the Stability and Growth Pact, the main aspects of this package include the introduction of minimum standards for national budgets to prevent manipulation and the use of a procedure to correct macroeconomic imbalances. The six pack attaches more importance to the debt level criterion, introduces a path of debt reduction and adds a medium-term objective (MTO) to the deficit criterion. It also implements a gradual system of financial sanctions. Sanctions are imposed earlier on and are virtually automatic - a sanction decision can only be reversed with a reverse qualified majority of the ECOFIN Council.

The revised Stability and Growth Pact is split into a preventive and a corrective arm. In the preventive arm, each member state undertakes to:

- Structural deficit threshold of 0.5%: submit a stability or convergence program every year setting out a country-specific medium-term objective (MTO) for the structural deficit. The national MTO cannot allow a structural deficit of any more than 0.5% of GDP in general. The countries either have to meet their MTO or at least be progressing on an appropriate path towards it.
- Spending rule: reduce the annual growth in primary spending to the potential annual economic growth, or to push it down to below the potential growth rate if a deficit procedure is ongoing. Individual measures can be used to strike a balance.

The corrective arm consists of a procedure triggered by the ECOFIN Council if the deficit level is found to be too high. It is designed to ensure that appropriate measures are taken to correct the deficit. Member states that are not subject to a deficit procedure are only affected by the preventive arm. A deficit is deemed to be excessive if the following criteria are not met:

- Maastricht deficit threshold: 3% of GDP
- Maastricht debt ratio threshold: 60% of GDP
- Debt reduction path: Reduction in excessive debt (over 60%) by an average of 1/20 per year

Member states that were involved in a deficit procedure in November 2011 are granted a transition period of three years starting from the correction of the excessive deficit. During this period, they are only required to make sufficient progress in adhering to the requirements for the debt level criterion to be deemed fulfilled.

Fiscal Compact

The Fiscal Compact, which is part of the "Treaty on Stability, Coordination and Governance in the economic and monetary union", came into force on January 1, 2013 and supplements the reformed Stability and Growth Pact to include more stringent regulations. In order to comply with the Fiscal Compact, the parties undertake to transpose the following regulations into their national legislation in the form of binding provisions with a long-term effect, preferably enjoying the same status as constitutional provisions:

- Structural deficit threshold of 0.5%: Ensuring a balanced general government budget by meeting their medium-term budget objective or progressing on an appropriate path towards it. Compared with the SGP, the upper threshold has been tightened to no more than 0.5% of GDP. The MTO can only correspond to 1% of GDP in countries with a government debt ratio that is well below 60%.

- Debt reduction path: In line with the more stringent Stability and Growth Pact, the ratio of sovereign debt to GDP should not exceed 60% and any debt in excess of this level must be reduced by 1/20 a year.

The 25 EU member states also undertake to set up an automatic correction mechanism that comes into play if they stray considerably from the MTO or the adjustment path and also to set up an independent institution to monitor the regulations and the correction mechanism. What is more, countries subject to an ongoing Excessive Deficit Procedure have to launch an economic partnership program, presenting the structural reforms they intend to make in order to correct the deficit. The European Commission and the Council also have to be notified in advance if countries plan to issue government bonds.

Two pack

The "two pack" came into force on May 30, 2013. These regulations serve to enhance budgetary surveillance and economic policy coordination in the euro area. The two-pack legislation introduces a common budgetary timeline and common budgetary rules that complement the preventive arm of the SGP and are designed to ensure the adequate implementation of the recommended measures in the budgets. The common budgetary rules are monitored by independent institutions at national level. Draft budgetary plans and the underlying macroeconomic forecasts must have been submitted to the Commission by October 15. The Commission examines the draft plans and, if it detects significant non-compliance with the SGP, is entitled to ask the member state concerned to submit a revised plan. The national parliaments nevertheless retain their budget sovereignty and are under no obligation to implement the recommendations. The enhanced surveillance is aimed primarily at countries that are experiencing financial difficulties or are exposed to imminent financial risks. Member states involved in an Excessive Deficit Procedure are subject to varying reporting requirements, depending on how advanced the procedure is,

which complement the requirements of the corrective arm of the SGP. Member states receiving financial assistance or whose financial assistance is set to expire are automatically subject to more intense surveillance until they have repaid 75% of the aid they have received. The degree of surveillance depends on the specific financial situation.

2. ROUGH OVERVIEW OF OUR METHODOLOGY AND THE SCENARIOS

2.1 Methodology

We have used three scenarios to show the development of government debt in the euro area in the period leading up to 2025 based on different overall conditions. The individual scenarios are mainly characterized by different assumptions regarding growth expectations and fiscal discipline, as these two factors have a decisive impact on the three variables responsible for debt development, namely the primary balance (net lending/borrowing, excl. the interest burden), nominal economic growth and average interest rates.

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

The 2014 revision of the national accounts, which primarily serves to implement the new "European System of Accounts" (2010 ESA) (box 2), has a far from insignificant impact on both the calculation of gross domestic product and the calculation of several key fiscal policy parameters, such as the state deficit and the debt level. Since not all of the data used in this analysis is available based on the new rules and regulations, some of the historical/pre-crisis comparisons, in particular, are based on data taken from the old national accounts system.

Box 2: 2014 revision of the national accounts (ESA 2010)

The European System of Accounts (ESA) has been applicable to national accounts within the European Union since September 2014 and has a direct legally binding effect for all EU countries. The ESA sets out the concepts, definitions, classifications and accounting rules to be used in the preparation of national accounts within the European Union.

The move to the 2010 ESA is associated, among other things, with a number of conceptual changes that have a direct impact, and one that is far from insignificant in quantitative terms, on key macroeconomic variables:

- Spending on research and development (R&D) will be considered to constitute gross fixed capital formation from now on. This expenditure was previously reported as intermediate consumption during the production process. This pushes GDP up due to the production of R&D services within the corporate sector and the increased need for state amortization.

- Military weapons systems are to be treated as capital goods, meaning that their acquisition is considered an investment. This increases GDP by the resulting depreciation. In the past, all military goods, excluding military systems that can be used for civil purposes, were considered to constitute intermediate consumption by the state and were included in government consumer spending.

- New criteria were introduced for allocation to the state sector, expanding the sector and increasing sovereign debt as a result.

- New regulations on the reporting of pension entitlements have come into force. If the state assumes pension liabilities, the difference between pensions to be paid in the future and one-off payments received will be included in the state deficit.

Impact on economic parameters in Germany and in the euro area

Based on the calculations performed by the European statistics office, Eurostat, the changeover to the new calculation method has increased German GDP by 3.3%, largely due to the reclassification of R&D expenditure. The average increase in nominal GDP in the eurozone comes in at 3.5%. The revision also has an impact on the calculation of fiscal policy parameters, as additional economic entities are allocated to the state sector under the ESA 2010, along with their gross debt. This puts a damper on the positive effect of higher GDP on the debt ratio. In Germany, for example, net lending/borrowing will only have benefited marginally from the change in methodology, according to initial estimates from the German Federal Statistics Office (*Statistisches Bundesamt*). In 2013, for example, the revised surplus is only slightly, namely 0.3%, higher (0.2% of economic output before the revision). Based on the new calculation method, the German sovereign debt ratio is 1.6 percentage points lower. The deficit ratio for the eurozone as a whole has improved by 0.2 percentage points, while the debt ratio comes in 1.6 percentage points lower.

2.2 **Base scenario: A long and rocky road with no shortcuts** – moderate economic growth and moderate fiscal discipline turn debt reduction into a very drawn-out process

In the base scenario, we expect to see moderate economic growth in the euro area, as the debt reduction measures being taken in the private and public sector alike will have a negative impact on aggregate demand in most EMU countries throughout the entire forecast period - albeit to an ever lesser extent. While the economic recovery firms up, gradually gathering pace, in the core countries, the former crisis countries that have stuck to their reform plans in recent years, despite particularly hefty economic slumps, will start a race to catch up economically from 2015 onwards. The export-oriented core countries, such as Germany, will also benefit from the above-average growth rates in the

former program countries. Economic growth in the eurozone will return to normal as of 2018. In the base scenario, we expect EMU inflation to remain just under the envisaged 2% mark on average given that only moderate growth is on the cards.

We also expect to see only moderate fiscal discipline in the base scenario. On the whole, the EMU states are succeeding in reducing their new borrowing. The first round of consolidation successes and the ongoing - albeit only gradual - economic recovery are, however, lulling countries into a premature sense of self-satisfaction, meaning that the reform and consolidation efforts - but also EMU integration efforts - will be taken down a notch very soon. As the reform plans will not be implemented in full, the EMU economies will not be able to achieve their maximum growth potential. Some of the gains made in terms of competitive standing will also prove not to be sustainable. As a result, potential growth will remain below the pre-crisis level in most of the countries included in our analysis.

Average interest rates will chart a moderate increase in the former EMU crisis countries in the period leading up to 2025. The marked decline in risk premiums will be more than offset by the gradual increase in key interest rates. Risk premiums that had benefited from "undershooting" in the early days of monetary union, however, will remain higher than the pre-crisis level, with the combination of moderate economic growth and reform and integration fatigue set to prompt investors to start taking a closer look at the national fundamental data again as steps are gradually taken to break with the ultra-loose monetary policy. In Germany and other core countries whose bonds reaped the benefits of increased demand for safe-haven investments during the acute phase of the euro crisis, average interest rates will rise slowly during the forecast period in tandem with the ongoing economic revival in the eurozone and the gradual departure from the loose monetary policy.

2.3 **Risk scenario: Euro crisis 2.0** – Recession, reform fatigue, re-escalation of the debt and confidence crisis

In the risk scenario, economic growth in the eurozone will be substantially weaker. The pause in growth in the second quarter of 2014, which was initially seen as a mere dent in the economic recovery, will prove to be a precursor of an economic downturn that will become increasingly widespread. This will result in the entire eurozone slipping into a recession in 2015. Fueled by fears regarding the economy and hindered by growing reform fatigue, consolidation and reform plans will be shelved. This means that, although the eurozone will make a return to a growth path as early as 2016, both consolidation successes and trend growth will be much less impressive in the medium to long term. The grim growth outlook will be reflected in an average EMU inflation rate of well below 2%.

In an environment marred by meager growth prospects, low inflation and mounting opposition to reform, risk premiums in the peripheral countries will soon start to rise sharply, gradually pushing average interest rates up. Core countries like Germany and France will benefit from their safe haven status, meaning that average interest rates will remain stuck at record lows for most of the forecast period.

In this environment, debt reduction in the eurozone will drag its heels at best, with no progress whatsoever being made in some countries. Particularly on the continent's periphery, sovereign debt will start to climb, sometimes considerably, jeopardizing the debt sustainability of some member states. The financial markets will increasingly lose confidence in the EMU countries. The ECB will take further unconventional measures to

secure price and financial stability in the eurozone. However, since the central bank has already used up most of its ammunition, it will ultimately be down to policymakers to ensure the survival of monetary union.

2.4 **Positive scenario: Brave new world** – Dynamic economic growth, rapid debt reduction, concrete progress towards EMU integration

In our positive scenario, the eurozone economy will benefit from above-average momentum in global economic growth. This will allow the former crisis countries to rack up considerably higher catch-up growth in the aftermath of the prolonged recession than in the base scenario. The favorable economic framework will also enable the EMU countries to exceed the EU's austerity requirements, encouraging them to implement brave structural reforms. In 2018, economic growth in the eurozone will start gravitating towards the potential growth rate, which is much higher than in the base scenario due to the successful implementation of national reform plans. The gains made by the EMU countries in terms of their competitiveness will be largely sustainable. In the positive scenario, we predict average EMU inflation of 2%.

The positive economic and structural developments in the eurozone, coupled with the clear progress made in whittling down the debt level, will boost financial market confidence in monetary union as a whole, and particularly in the former crisis countries. Risk premiums in the countries on Europe's periphery will drop considerably, in some cases slipping below the pre-crisis level due to a willingness to take and implement decisive economic, financial and political integration steps at European level. The favorable overall economic environment will allow an earlier, faster exit from the expansionary monetary policy compared with the base scenario. ECB monetary policy will largely return to normal during the forecast period. The pick-up in interest rates will be reflected in a rise in average interest rates on government debt.

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

3. DEVELOPMENTS IN INDIVIDUAL COUNTRIES

3.1 Germany: Chance of a considerable reduction in the debt ratio

Germany	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	1.5%	2.6%	1.8%	3% deficit limit: from 2011 0.5% structural deficit limit: from 2013	74%	60%	49%
Risk case	1.0%	2.2%	1.2%	3% deficit limit: from 2011 0.5% structural deficit limit: from 2013	75%	69%	61%
Positive case	2.0%	3.0%	2.3%	3% deficit limit: from 2011 0.5% structural deficit limit: from 2013	74%	55%	42%

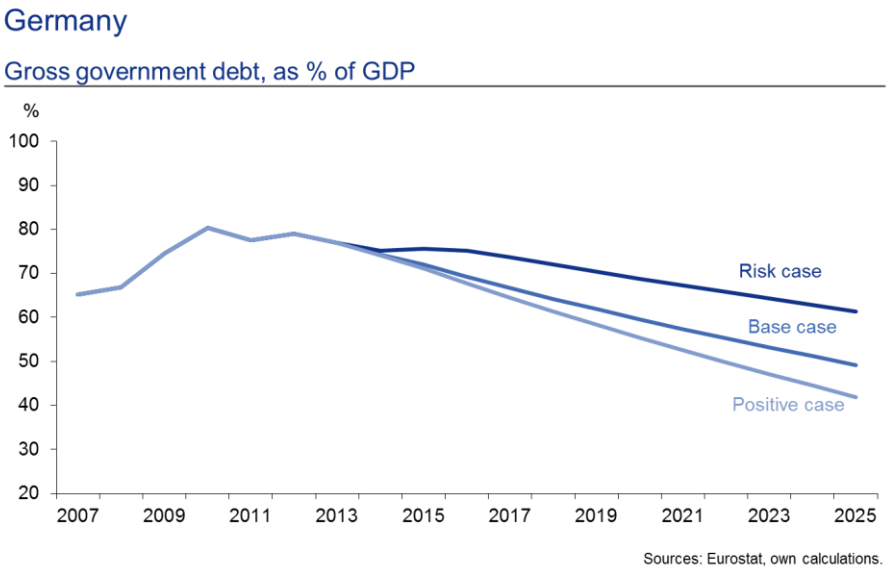
2013 was the first year since 1950 that saw Germany's mountain of debt contract. But the reduction in the liabilities of the German federal government, federal states and municipalities cannot be attributed exclusively to austerity successes in the core budgets, but rather also to the progress made in winding up the German bad banks FMS Wertmanagement and Erste Abwicklungsanstalt. Over the next few years, the portfolio

reduction measures and reduction in debt at the bad banks that is likely to ensue will have a positive impact in terms of pushing down German sovereign debt (although the effects are difficult to quantify). What is more, the good starting position that the German economy enjoys, the incentive to stick to the debt cap and the extremely rosy financing conditions should give the debt reduction process an additional boost.

German economic growth in the base scenario will average 1.5% in the period leading up to 2025. The primary budget surplus, which came in at 2.0% last year, will average 1.8% over the next few years owing to a largely consistent fiscal policy course and the fairly promising growth outlook. As far as average interest rates on German sovereign debt are concerned, we have assumed a downward trend in the first instance due to the extremely favorable financing conditions, with rates set to drop back from 2.7% in 2013 to 2.2% in 2016. As the ECB gradually breaks away from its expansive monetary policy and capital market yields chart a moderate rise, the average interest rate will also start to rise again, climbing to 3.0% in 2025. In this environment, Germany will manage to balance its budget, or maintain a slight surplus, over the next few years. In 2025, the surplus will come in at 0.3% of GDP. This will bring Germany's government debt ratio down to around 49% of GDP, down considerably on the pre-crisis level of 67% in 2008. This will allow Germany to successfully remain firmly on the debt reduction path throughout the entire forecast period. By 2025, Germany will not only have the lowest debt ratio out of all of the countries in our analysis, but will also be the only economy to meet the 60% debt criterion (as of 2020).

In the risk scenario, the German economy will temporarily slip into a recession in 2015. Reform and consolidation plans will be axed due to worries over the fragile economy. Negative effects on potential growth will soon make themselves felt: in the negative scenario, we expect to see real average growth of only 1.0%. Due to a loosening of the fiscal discipline reins and less dynamic economic growth, we expect to see the primary balance slide to 1.3% in 2025 in the risk scenario. The gloomy outlook for the eurozone economy and renewed doubts as to the survival of monetary union will fuel strong demand for German "safe haven" bonds. This will slash the average interest rates for Germany in the first instance, from 2.7% in 2013 to 1.9% in 2018. As the eurozone economy bounces back from 2018 onwards, the average interest rate in Germany will creep up to 2.4% in 2025. Under these conditions, the German budget will consistently remain ever so slightly in the red. Nevertheless, Germany will manage to adhere to both the upper structural deficit threshold of 0.5% and the 3% deficit criterion throughout the entire forecast period. In the negative scenario, reducing German sovereign debt will be a much more drawn-out process. Germany will, nonetheless, have managed to nudge its debt ratio down to around 61% by the time 2025 arrives.

In the positive scenario, the German economy will benefit from more dynamic economic growth, which will outstrip the base scenario by ½ a percentage point on average. The country will also manage to implement long overdue structural reforms and do even more to forge ahead with budget consolidation. In this environment, the primary balance could well expand to 2.3% of GDP in 2025. In the positive scenario, average interest rates will rise considerably from 2.7% in 2013 to 3.5% in 2025 as monetary policy returns to normal and capital market interest rates start to climb on the back of positive economic developments. This will allow Germany to increase its budget surplus from 0.1% in 2013 to 0.8% of GDP in 2025. Debt reduction will make even faster progress than in the base scenario, allowing Germany to meet the 60% debt level criterion as early as 2019 and to push its debt ratio down to around 42% by 2025.



3.2 France: Pace of debt reduction far from satisfactory

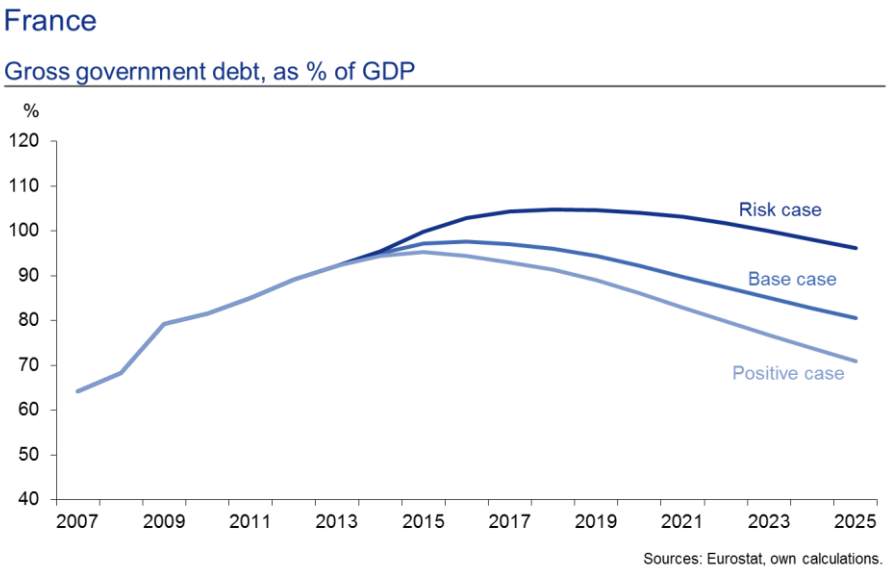
France	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	1.2%	2.7%	0.8%	3% deficit limit: from 2017 0.5% structural deficit limit: from 2019	95%	92%	81%
Risk case	0.6%	2.4%	0.2%	3% deficit limit: from 2018 0.5% structural deficit limit: from 2022	95%	104%	96%
Positive case	1.7%	3.1%	1.3%	3% deficit limit: from 2016 0.5% structural deficit limit: from 2018	94%	86%	71%

Whereas former EMU crisis countries like Spain and Portugal are already likely to be reaping the benefits of their reform efforts, France is lagging behind with the implementation of far-reaching economic reforms. But without these reforms, life looks set to become hard for the French economy. Since the outbreak of the euro crisis, France's sovereign debt has risen by more than 35% in relation to its economic output, hitting 92% of GDP in 2013 with no signs of a turnaround in this trend. At 57%, the government spending ratio still ranks among the highest in Europe. France's budget consolidation efforts clearly leave a lot to be desired (even though stringent austerity measures certainly would not be the right medicine in the current situation either). In 2013, France reported a deficit ratio of 4.1% and the government recently announced that the ratio is predicted to come in at 4.4% this year. In 2015, the ratio looks set to dip ever so slightly to 4.3%. France now wants the European Commission to give it two extra years, namely until 2017, to push its deficit below the 3% mark, citing the economic situation as the main motivation behind this wish: the economic recovery is dragging its feet and unemployment is stuck at a high level. But these problems are hardly new developments. France has been suffering from a deteriorating competitive standing for years now, something that is also reflected in the shrinking global market share attributable to French exports. The country needs to catch up with economic reforms, even though President Hollande has admittedly made some real progress on this front, especially in terms of taking pressure off the corporate sector.

In the base scenario, we expect the economic recovery to make only gradual progress, with average economic growth tipped to come in at 1.2%. Unlike in the days before the crisis, real trend growth on the French economy will be just shy of Germany's. Budget consolidation will be a sluggish process in the base scenario due, for one thing, to the moderate growth outlook and, for another, to the opposition to painful austerity measures. (In Brussels, the French leadership is currently calling for the consolidation requirements to be relaxed and for a growth campaign to be launched at European level.) Given these conditions, we expect the average primary balance to come in at 0.8% of GDP. The average interest rate on French sovereign debt will remain below the 2.5% mark until 2017 before rising to 3.2% in 2025. In this sort of environment, it will be 2017, two years later than originally planned, before France can meet the 3% deficit criterion and start to eat into its mountain of debt. From 2019 onwards, France will be able to adhere to the upper threshold for its structural deficit and will also comply with the guidelines for the debt reduction path from 2020 onwards. Nevertheless, its sovereign debt will still be sitting at around 81% of GDP, well in excess of the 60% mark, in 2025. This means that, out of all of the countries in our analysis, France joins Italy in coming bottom of the debt reduction league by the end of the forecast horizon, based on the tip of the debt mountain.

In our risk scenario, we have assumed that the French economy will experience much slower growth throughout the forecast period, at an average of 0.6%. The cloudier growth outlook for the medium term will hinder both the implementation of structural reforms and the country's budget consolidation efforts, ultimately creating something of a vicious circle. In this scenario, the French primary balance will be much lower, averaging 0.2% of GDP; the average interest rate will come in at around 2.4%, 0.3 basis points lower than in the base scenario. The latter will be due not only to monetary policy, but also to our assumption that French bonds will maintain, and reap the benefits from, their "safe haven" status. In this scenario, France will not be able to force its deficit ratio down to below the 3% mark until 2018. Although France will be able to adhere to the upper threshold for its structural deficit from 2022 onwards, this will have little impact in terms of eroding away the debt mountain: it will correspond to 96% of economic output in 2025. The country will be unable to land on target on the debt reduction path.

Our positive scenario features average real GDP growth of 1.7%. France will take the good economic times as an opportunity to implement unpopular reforms that will make its economy more flexible, competitive and better equipped to tackle the challenges of the future. The higher primary surpluses that are likely to come as a result (averaging 1.3% of GDP) will more than compensate for the higher average interest rates compared with the base scenario (3.1% over the forecast period). France will be able to hit the 3% deficit target in as early as 2016. Despite impressive progress in forcing the debt ratio down to 71% of GDP by 2025, France will still be unable to hit the 60% target. Unlike in the base scenario, however, the debt ratio will come within striking distance of the pre-crisis level (2008: 68%).



3.3 Greece: The tightrope walk continues

Greece	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	2.0%	3.2%	4.4%	3% deficit limit: from 2014 0.5% structural deficit limit: from 2013	178%	142%	118%
Risk case	1.0%	3.3%	3.8%	3% deficit limit: from 2014 0.5% structural deficit limit: from 2013	179%	167%	152%
Positive case	2.7%	4.7%	5.0%	3% deficit limit: from 2014 0.5% structural deficit limit: from 2013	177%	131%	96%

2014 is likely to signal a return to positive economic growth for Greece for the first time in six years. The long-awaited economic recovery is likely to make a key contribution to stabilizing the country's colossal debt since, in addition to the belated implementation of austerity measures and structural reforms, the dramatic slump of the Greek economy was largely responsible for the steep rise in the debt ratio since the outbreak of the debt crisis. Despite all austerity efforts and the 2012 haircut, government debt has climbed from 113% of GDP in 2008 to 175% in 2013.

The Greek government is nevertheless pinning its hopes on being able to wrap up the IMF aid program in December of this year - 15 months ahead of schedule. What is more, Prime Minister Samaras hopes not to apply for any further EU rescue packages after the current one runs its course at the end of the year. The IMF is urging Greece not to terminate the program prematurely. The ECB is also calling on Greece to continue the aid program for the next two years - the planned minimum term of the covered bond and ABS purchase programs. Otherwise, Greece risks not being included in the purchase program because its credit rating does not make investment grade. In order to be able to continue to check up on the country's reform progress, there is now talk of an ESM Precautionary Conditioned Credit Line for Greece. This would exert the necessary pressure and also help to reassure investors - even though the controls would no longer be as stringent as under the bailout program.

The issue of five-year and three-year Greek government bonds in April and July of this year were the country's first successful steps towards the capital market. Nevertheless, market confidence in Greece is still on shaky ground: rumors regarding the early termination of the program sent the yields on Greek bonds soaring by around 100 basis points. In particular, there are doubts that Greece will be able to cover its future financing requirements on the capital market, as the interest rates being charged are still very high for the Greek budget. As we see things, the country will only be able to finance itself on the market within narrow boundaries in the near future. This makes it essential for the country to continue to toe the consolidation line unwaveringly.

In the base scenario, Greece will wave goodbye to the recession in 2014 and embark on the race to catch up economically. Given the considerable need for investments and private consumption to catch up, the economy is likely to pick up significant speed in the period leading up to 2017. Growth rates will normalize from 2018 onwards and, given the structural reforms that have been made, we see real trend growth of 1.8% as a realistic possibility. In this environment, and provided that the will to achieve consolidation does not wane, the primary balance could, realistically, expand steadily from 3% in 2015 to 4.9% in 2025.

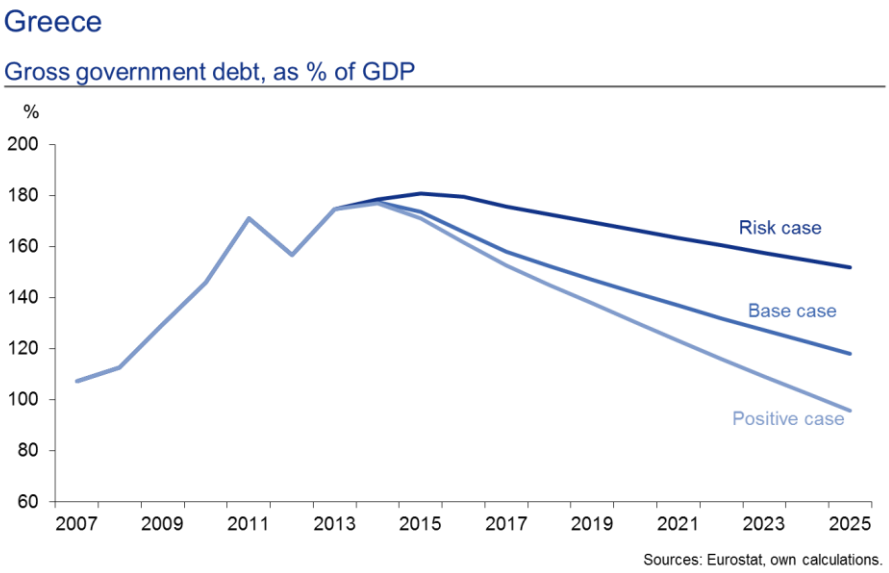
The level of interest on sovereign debt is extremely important for Greece's debt sustainability. Due to the generous interest subsidies contained in the rescue packages, the average interest rate in the Greek budget came in at only 2.3% in 2013. Since large parts of Greek government debt will remain subject to favorable conditions for some time thanks to the aid programs, this average interest rate is unlikely to change to any considerable degree over the next few years. As Greece gradually makes a comeback on the capital market, however, average interest rates look set to chart a moderate increase in the medium term. In 2025, for example, around one third of Greek government debt is likely to be directly linked to the country's credit rating again. This, combined with a general increase in yields, will push the average interest rate in the Greek budget up to 3.4% in 2020 and 3.8% in 2025.

In this sort of overall framework, Greece will manage to achieve a virtually balanced budget in only a few years' time, even managing to clock up a surplus from 2020 onwards. This means that Greece will comply with the 3% deficit criterion over the entire forecast period. Due to marked under-utilization, Greece will also manage to comply with the structural deficit target of 0.5% of GDP set out in the Fiscal Compact in as early as 2013 - earlier than required. In the base scenario, the government debt ratio will clamber to a high of 178% of economic output in 2014. The improved outlook and further austerity measures will allow Greece to whittle down its mountain to debt to around 118% of economic output by 2025, in line with the 1/20 debt rule set out in the Fiscal Compact. This should allow the country to avoid another haircut. The state interest burden, in relation to GDP, will fluctuate between 4% and 5% in the period leading up to 2025. This is still a considerable amount, but nevertheless one that the country can manage.

Our risk scenario features a much lower level of growth, with the Greek economy actually set to contract again slightly in 2015. Only a limited number of reform and consolidation plans will be implemented as worries surrounding the ailing economy mount, the zeal for reform wanes and social unrest starts to take root among the population at large, resulting in lower trend growth of 1.2% in the period between now and 2018. The anemic economic growth will undermine the Greek government's consolidation efforts, which is why we expect to see a less sizeable primary surplus in the risk scenario. Far higher risk premiums compared with the base scenario will push the average budget interest rate

up from 2.3% in 2013 to 4.0% in 2025 - although the general yield level is lower than in the base scenario. Government interest expenditure, expressed in relation to GDP, will creep up from around 4% at the moment to around 6% and more from 2020 onwards. The current interest burden proves to be a real weight on the country's shoulders. In the risk scenario, Greece will not manage to generate a budget surplus, with the deficit ratio still sitting at 1.4% in 2025. Due to the huge overhang of debt - which will still correspond to around 152% of GDP in 2025 - Greece will remain very vulnerable to changes in investors' risk appetite. In this sort of scenario, it is likely that Greece will experience real difficulties securing financing on the financial markets for some time to come. Another haircut is a likely prospect.

In the positive scenario, the Greek economy will benefit from dynamic global growth and will manage not only to hit its austerity targets but also to use this window of opportunity to implement ambitious structural reforms. This will push real trend growth in Greece up to 2.5% from 2018 onwards, much higher than in the base scenario. The primary surplus will also be much more generous than in the base scenario. Concrete steps towards more EMU integration, paired with the systematic implementation of planned reforms, will nudge Greek risk premiums down considerably. We deem an increase in the average interest rate in the Greek budget from 2.3% in 2013 to 3.8% in 2025 to be realistic in the positive scenario thanks to the ECB's swifter exit from its expansive monetary policy and general rise in capital market yields. Greece will start reporting a budget surplus in 2016, expanding it to 2% of GDP by 2025. The country will comply with the 0.5% upper threshold for the structural deficit from 2013 onwards, also coming into line with the 3% deficit criterion as of 2014. In this scenario, Greece will be able to reduce the debt mountain to around 96% of GDP by 2025. Although this is still streets ahead of the 60% mark, it will see Greece comply with the required debt reduction path. The interest burden in the budget will come in at only 3.5% of GDP in 2025, ensuring the country's debt sustainability.



3.4 Ireland: Very vulnerable to shocks

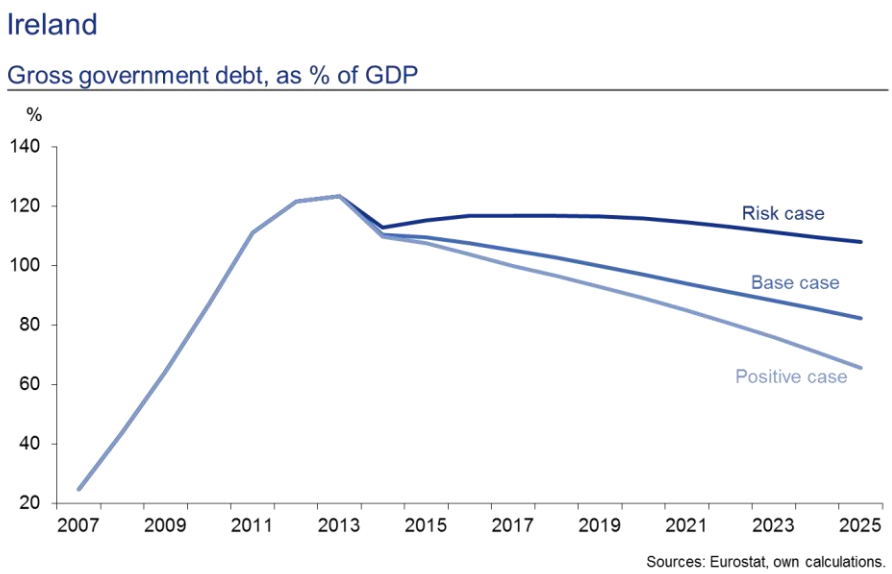
Ireland	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	2.6%	4.1%	2.3%	3% deficit limit: from 2016 0.5% structural deficit limit: from 2020	110%	97%	82%
Risk case	1.6%	4.1%	1.7%	3% deficit limit: from 2020 0.5% structural deficit limit: no	113%	116%	108%
Positive case	3.0%	4.0%	3.0%	3% deficit limit: from 2016 0.5% structural deficit limit: from 2018	110%	89%	66%

After Ireland sought refuge in the rescue fund in 2010, the country is now back on its own two feet in financial terms. The Irish crisis was sparked by the bursting of its property bubble, triggering a severe banking crisis that forced the state to use public funds to save the financial sector from ruin, racking up enormous debt in the process. Despite a dismal recession, Ireland has been able to largely comply with the austerity and reform requirements imposed as the conditions for financial aid. In December 2013, Ireland became the first European crisis country to leave the rescue fund again. Since then, both the Irish government and the country's banks have succeeded in placing bonds on the market. The rating agencies Standard & Poor's and Moody's have also upgraded Ireland's credit rating and the country is no longer reduced to "junk" status. But economic problems and risks to the Irish economy continue to lurk alongside these positive signals. Irish sovereign debt has now risen to 123% of GDP. Despite its enthusiastic austerity efforts, Ireland is still grappling with a substantial budget deficit, which is even likely to overshoot the budget deficits of Greece, Italy and Portugal this year. This mass of debt will leave the Irish economy in an extremely vulnerable position if the European debt and confidence crisis rears its head again. What is more, the export-oriented Irish economy is heavily dependent on the global and EMU economy, not least due to its lackluster domestic demand. Extreme shocks, such as a global economic slump or the renewed emergence of doubts on the financial markets, could send the economy into free-fall again. Another problem lies in the unemployment rate, which was still stuck at over 11% in September 2014.

In the base scenario, Ireland will start a race to catch-up economically in 2014, initially benefitting from very dynamic growth rates after emerging from the prolonged recession. Economic growth will return to normal as of 2018,moving into line with trend growth. Looking at the forecast period as a whole, we expect to see real average growth to the tune of 2.6%. While the Irish government will stick to its reform and consolidation plans on the whole, the marked economic revival will tempt it to loosen its purse strings a little and make it less committed to implementing ambitious reforms. Ireland will manage to generate a primary surplus in as early as 2014, expanding this surplus to 3% of GDP in the long term. The average interest payable on the country's sovereign debt will rise to 4.2% in 2018, where it will remain until 2025. In this scenario, Ireland will be able to push its deficit ratio down to below the 3% mark in 2016. It will be able to adhere to the upper structural deficit threshold of 0.5% of GDP from 2020 onwards. By 2025, Ireland will have shaved around 41 percentage points off its debt ratio, whittling it down to around 82% of GDP. Although Ireland will manage to stick to the debt reduction path from 2018 onwards, cutting its excess sovereign debt by 1/20 a year, it will not be able to reach the 60% target in the base scenario.

In the risk scenario, economic growth in Ireland in 2015/16 will be much weaker. Reform and consolidation plans will be axed due to worries over the fragile economy. The drop in economic output will also undermine the success of the austerity efforts. Negative effects on potential growth will soon make themselves felt: in the negative scenario, we expect to see real average economic growth of 1.6%. It will be impossible to generate a substantial primary balance in this environment: it will average 1.7% of economic output. The average interest rate will climb during the forecast period from 3.7% in 2013 to 4.2% in 2025. In this scenario, Ireland will not be able to get its budget deficit down to below the 3% mark until 2020. The upper structural deficit threshold of 0.5% set out in the Fiscal Compact will not be met throughout the entire period included in this analysis. By 2025, Ireland will only be able to push its debt ratio down to 108%. This means that the country will not be able to achieve either the 60% debt ratio criterion or the average reduction in excessive debt of 1/20 a year at any time during the forecast period.

In the positive scenario, Ireland will benefit from an exceptionally rosy economic outlook. The reform efforts made by the Irish government will bear fruit and support the economic catch-up race in the aftermath of the drawn-out recession. Ireland will also plow ahead with its reforms, with a positive impact on trend growth. Average economic growth in the positive scenario will come in at 3.0%. The primary balance will correspond to 3.0% of GDP in the positive scenario. Interest rates are expected to climb in general, although Ireland's risk premiums compared with Germany will fall. The average interest rate on government debt will chart a steady increase over the next few years, averaging 4.0%. In this environment, Ireland will be able to achieve the 3% deficit target for the first time in 2016. Starting in 2021, Ireland will be able to report budget surpluses, increasing them to 2% of GDP by 2025. From 2018 onwards, the Irish structural deficit will be lower than the upper threshold of 0.5% of GDP laid down in the Fiscal Compact. By 2025, Ireland will have reduced its debt ratio to 66% in the positive scenario, almost half the 2013 level. Although the country will miss meeting the 60% debt criterion by a whisker, it will be able to stick to the debt reduction path from 2016 onwards.



3.5 Italy: Weak growth standing in the way of debt reduction

Italy	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	0.9%	3.8%	3.3%	3% deficit limit: from 2013 0.5% structural deficit limit: from 2016	132%	125%	112%
Risk case	0.4%	4.1%	2.6%	3% deficit limit: from 2021 0.5% structural deficit limit: from 2017	133%	141%	142%
Positive case	1.2%	4.0%	3.9%	3% deficit limit: from 2013 0.5% structural deficit limit: from 2015	131%	117%	97%

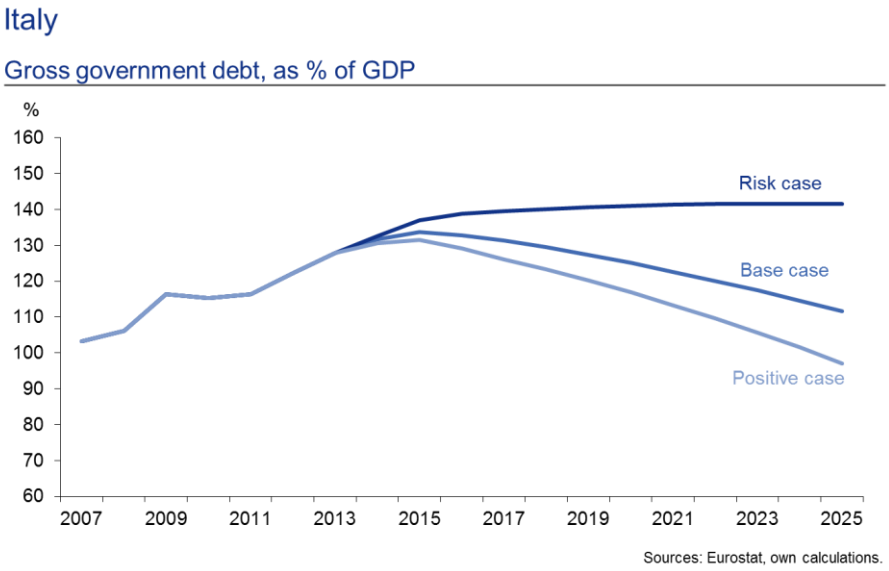
Italy's state finances have still not made any sustainable improvements. The country's government debt ratio, which, at 128%, was the second-highest in the eurozone in 2013, is still headed north. This is largely due to the pronounced growth slump in the Italian economy. Italian GDP has contracted by 9% since 2007, whereas most euro area economies have bounced back to their pre-crisis levels. The high unemployment rate of over 12% is also putting a damper on domestic demand, and key reform efforts are urgently required if Italy wants to have any hope of at least stabilizing its share of global trade. If its economic momentum does not manage to shift up a gear, Italy will also find itself unable to forge ahead with its sovereign debt reduction measures, but will, at best, have to use any primary surplus it generates to cover the relatively hefty interest burden of around 5% of GDP. Prime Minister Matteo Renzi, who took over at the helm of the government in Rome in February 2014, will certainly provide Italy with an opportunity to buck past trends and initiate the necessary reforms. While some decisions on key structural reforms have been given the green light to date, Italy has ultimately failed to implement them. Renzi's greatest achievement so far could possibly be the fact that he has managed to boost confidence in Italian policy both within the country itself, as his good European election results show, and abroad.

In the base scenario, we expect the economic recovery in Italy to make only gradual progress. In this scenario, the Italian government will implement at least some of its ambitious reform plans, plowing ahead with budget consolidation. We predict average annual growth of 0.9% for the Italian economy looking ahead to 2025. During this period, the primary surplus will come in at 3.3% - a realistic level given the gradual economic recovery and moderate fiscal discipline that appear to be on the cards. As far as average interest rates on Italian sovereign debt are concerned, we have assumed a downward trend due to the extremely favorable financing conditions in the first instance, with rates set to drop back from 3.9% in 2013 to 3.5% in 2017. As the ECB gradually breaks away from its expansive monetary policy, the average interest rate will also start to rise again, climbing to 4.2% in 2025. In this environment, Italy will just be able to achieve the 3% deficit target as early as this year. Italy will be able to push its budget deficit down to 0.1% of GDP in 2025 in this scenario. In the base scenario, the debt ratio will fall from 128% in 2013 to around 112% in 2025, although this will not be enough to allow Italy to adhere to the required debt reduction path (reduction of excessive debt by 1/20 a year).

In the risk scenario, economic growth in Italy in 2015/16 will be much weaker and the government will only implement its envisaged reform and austerity plans to a very limited extent. Real economic growth throughout the entire forecast period will only average 0.4%. The average primary surplus in the risk scenario now comes in at only 2.6% across the entire observation period. At the same time, we expect the average interest rate to increase markedly from 3.7% in 2014 to 4.6% in 2025. In this scenario, Italy will not

be able to force its budget deficit down to below the 3% mark until 2021. In the period leading up to 2025, the government debt ratio will climb 14 percentage points up the ladder to 142% of GDP, meaning that both the debt reduction path and the 60% debt level target will remain but a distant hope for Italy. In the negative scenario, substantial doubts are likely to surface regarding Italy's debt sustainability.

In our positive scenario, average Italian economic growth is tipped to come in at 1.2%. The government will take the rosy growth outlook as an opportunity to implement almost all of the announced package of reforms and to drive ahead with even more ambitious budget consolidation efforts. The resulting primary surpluses (averaging 3.9%) and an average interest rate of 4.0% over the period covered by our analysis will allow Italy to bring its budget deficit down to below the 3% mark in as early as 2014, even generating a surplus from 2022 onwards. In this scenario, Italy will be able to reduce the debt mountain to around 97% of GDP by 2025. Although this will still not allow the country to reach the debt level target of 60% of economic output, Italy will be able to stick to the debt reduction path starting in 2020.



3.6 Portugal: A long way to go until the debt ratio falls below 100%

Portugal	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	1.8%	3.8%	3.1%	3% deficit limit: from 2015 0.5% structural deficit limit: from 2019	128%	108%	92%
Risk case	1.0%	3.9%	2.6%	3% deficit limit: from 2017 0.5% structural deficit limit: from 2023	129%	125%	116%
Positive case	2.3%	4.0%	3.6%	3% deficit limit: from 2015 0.5% structural deficit limit: from 2017	127%	100%	77%

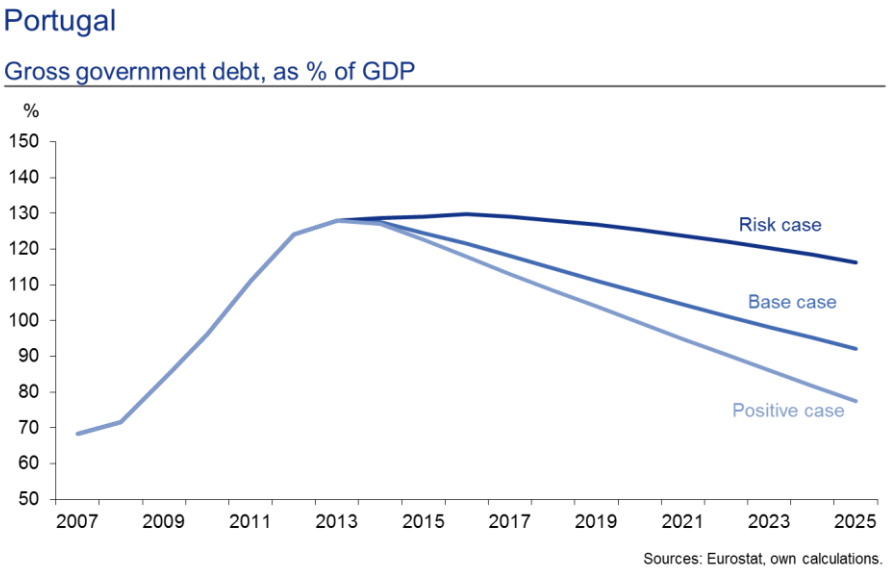
In Portugal, the reform efforts made to date are bearing fruit. In the second quarter of 2013, Portugal was able to say goodbye to the two-and-a-half year recession. The gradual acceleration in the economic upswing has, to date, been driven largely by the dynamic growth in exports, which allowed the country to achieve a positive current account

balance in 2013. But domestic demand, too, is gradually gathering pace and making its contribution to overall growth. The positive economic development is also having an impact on the risk premiums for ten-year Portuguese government bonds. The marked drop in yields since mid-2012 has allowed Portugal to secure independent refinancing on the capital market again. This meant that Portugal was able to follow in Ireland's footsteps, leaving the euro rescue fund in May of this year. Nevertheless, there is no reason to be complacent when it comes to turning the austerity and reform plans into a reality. Portugal still has a worryingly high level of state and personal debt. Although the labor market trends are pointing in the right direction, unemployment remains dizzily high at around 14%. Portugal's economic upswing and financing options also remain vulnerable to any mounting uncertainly on the financial markets or a renewed loss of confidence.

In the base scenario, we expect Portugal to report fairly robust economic growth of up to 2.5% in 2016 and 2017 (as the economy bounces back after the recession). We put trend growth at 1.7% from 2018 onwards. Since moderate fiscal discipline is one of the hallmarks of the base scenario, we see a primary surplus corresponding to 3.1% of GDP as a realistic prospect. We predict that average interest rates will rise at a rate of 0.1 percentage points a year, increasing from 3.3% to 4.3% between 2014 and 2025. In this scenario, Portugal will be able to nudge its budget deficit down to below the 3% mark in 2015, although it will take the country until 2025 to generate a budget surplus. Nevertheless, Portugal's structural deficit will come in below the upper threshold of 0.5% of GDP starting in 2018. The ratio of sovereign debt to GDP will have reached its peak in 2013 at 128%, dropping back to 92% by 2025. This is still light years away from the 60% target. Portugal will start cutting its excess debt by 1/20 a year as early as 2017.

Our risk scenario features a much gloomier growth outlook for the Portuguese economy, with a negative knock-on effect on the government's reform and consolidation efforts and, as a result, for potential growth. In the negative scenario, we expect to see average real economic growth of 1.0%. The average primary balance will correspond to 2.6% of GDP. Due to the newly-awakened mistrust on the financial markets and, as a result, the higher risk premiums that come hand-in-hand with the risk scenario, average interest rates on sovereign debt will rise steadily to 4.4% in 2025, although the European Central Bank will stick with its loose monetary policy. In this scenario, Portugal will meet the 3% deficit criterion in 2017. The sovereign debt ratio will rise to 130% in 2016, before falling back to 116% by 2025. Under these conditions, Portugal will be unable to either meet the 60% debt criterion or stick to the required debt reduction path. In the negative scenario, doubts are likely to arise as to the sustainability of Portuguese sovereign debt.

In the positive scenario, we are much more optimistic about economic growth. The government will continue to take effective measures to achieve budget consolidation and to improve the economy's competitive standing, fueling a very strong economic upswing in the aftermath of the prolonged recession. We expect average growth to the tune of 2.3%. In this scenario, the primary surplus will correspond to 3.6% of GDP. Despite a drop in risk premiums, the interest payable will rise in the course of time, averaging 4.0% In this scenario, Portugal will likely be able to push its budget deficit down to below the 3% mark in as early as 2015, and will be able to adhere to the upper threshold for the structural deficit (0.5% of GDP) from 2017 onwards. These circumstances will allow Portugal to reduce its government debt ratio to 77% by 2025 in line with the debt reduction path. While the 60% target will move within striking distance, Portugal will not be able to meet it.



3.7 Spain: In the base scenario, the debt ratio could be the lowest of all of the problem countries

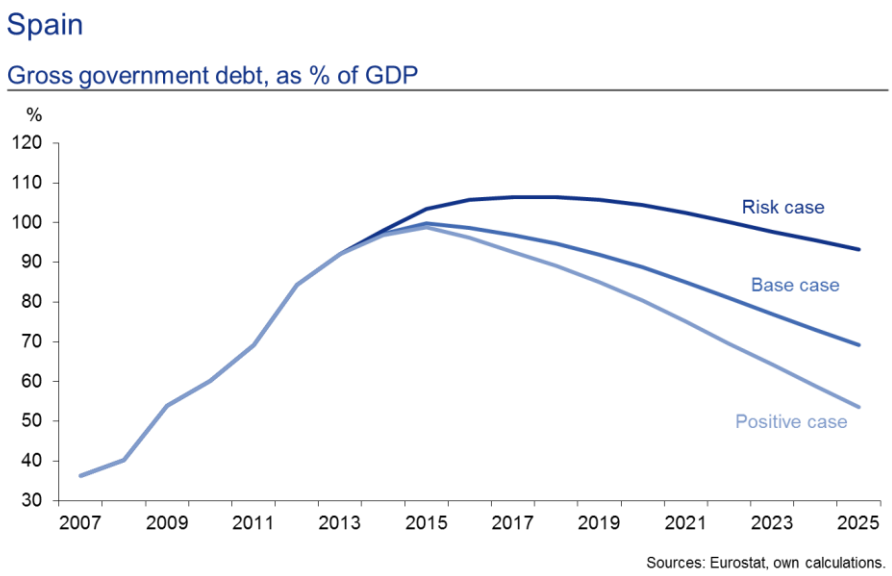
Spain	Real GDP growth 2014-2025	Average interest rate 2014-2025	Primary balance as % of GDP 2014-2025	Adherence to 3% deficit limit and 0.5% structural deficit limit	Debt-to-GDP ratio		
					2014	2020	2025
Base case	2.1%	3.6%	2.0%	3% deficit limit: from 2017 0.5% structural deficit limit: from 2018	97%	89%	69%
Risk case	1.1%	3.8%	1.6%	3% deficit limit: from 2018 0.5% structural deficit limit: from 2024	98%	104%	93%
Positive case	2.6%	3.8%	2.8%	3% deficit limit: from 2016 0.5% structural deficit limit: from 2018	97%	80%	54%

Only two years ago, the financial markets were extremely dubious regarding the sustainability of Spain's sovereign debt and the creditworthiness of the country's banking sector. In the meantime, risk premiums have plummeted from a high of more than 600 basis points to barely over 100 basis points. What is more, January 2014 signaled the successful conclusion of the Spanish program to recapitalize and restructure its financial sector. Increasing signs are now suggesting that Spain has not only overcome the acute financial and banking crisis, but has actually managed to achieve an economic turnaround. After a five-year recession, the Spanish economy has found its way back to the path to growth and the economic upswing has its foot firmly on the accelerator. The implementation of ambitious structural reforms, such as moves to make the labor market more flexible, and tough austerity measures has allowed Spain's government to win back the confidence of the markets and, at the same time, lay the foundation for a sustainable economic recovery. Exports are one of the engines driving the economic revival. The fact that the Spanish economy is now more competitive is testimony to how effective the reform efforts have been. Nevertheless, a number of risks continue to lurk in the background. Private and public-sector debt remains very high. Public-sector debt came in at 92% of GDP in 2013 and is still on the rise. The economy also needs considerable additional reforms if it wants to boost its flexibility and competitiveness. Although the economic recovery is starting to make itself felt on the labor market, the unemployment rate is still sitting at just under 25%. This means that there is a need for additional labor market reforms, particularly for reforms that address the duality of the market.

In the base scenario, we expect the Spanish economy to remain on a relatively steep upward trend in the period between 2015 and 2017. The strong economic growth, which will also be boosted by the reforms implemented to date, will increasingly fall back to normal levels, putting trend growth at 2.0% between 2018 and 2025. This dynamic economic development will allow Spain to achieve constant improvements in its primary balance in the base scenario, pushing the primary surplus up to 4.0% of GDP in 2025. As far as average interest rates are concerned, we expect a gradual increase from 3.3% in 2016 to 4.0% in 2025. Under these conditions, new borrowing will fall below the required 3% mark for the first time in 2017. From 2021 onwards, Spain will actually manage to generate budget surpluses which will have risen to 1.2% of economic output by 2025. Spain will adhere to the upper threshold for the structural deficit (0.5% of GDP) from 2019 onwards. The government debt ratio will reach its peak at around 100% in 2015. Although Spain will be able to slash its debt ratio to 69% by 2025 in the base scenario, this will still put it some way off hitting the 60% target. Nevertheless, by 2025, Spain will have the lowest debt ratio out of all of the countries in our analysis with the exception of Germany.

In the risk scenario, Spanish economic growth will be much weaker in 2015/16 and we expect to see average real economic growth to the tune of 1.1% during the forecast period. Due to a loosening of the fiscal discipline reins and less dynamic economic growth, we expect to see the primary balance average only 1.6% of GDP in the period covered by our analysis. Average interest rates will rise on the back of mounting concerns regarding the sustainability of Spanish sovereign debt. We expect average interest rates to creep up gradually from 3.4% in 2015 to 4.2% in 2025, 0.2 percentage points higher than in the base scenario in the long run. This is because, even if the European Central Bank fails to break away from its loose monetary policy, rising risk premiums will push up the yields on government bonds issued by the EMU crisis states. This means that, in the negative scenario, it will be 2018 before Spain can get its budget deficit down to less than 3% of GDP and meet the Maastricht deficit criterion. It will not, however, be able to report a balanced budget between now and 2025. Sovereign debt in 2014 will be roughly on a par with Spanish economic output, rising to 106% in 2018. Although the debt ratio will drop to 93% by 2025, Spain will not be able to slice the 1/20 off its excessive debt a year, as it is required to do. Consequently, the country will be unable to play by the more stringent European fiscal regulations for debt reduction.

In the positive scenario, Spain is characterized by high real growth rates of up to 4% in 2016. The country will experience dynamic growth after the long recession, playing catch-up with those EMU members that were not hit as hard by the crisis. The reform efforts will start to bear fruit and will also be continued systematically, putting average real growth at 2.5% from 2018 onwards. From 2022 onwards, Spain will be able to generate substantial primary surpluses corresponding to 5.0% of GDP thanks to the growth impetus. Based on our assumptions, the average interest to be paid on the country's sovereign debt will rise gradually from 3.5% in 2016 to 4.2% in 2025. This development will be fueled by monetary tightening on the part of the European Central Bank and a general marked increase in yields. This will allow Spain to meet the deficit criterion from 2016 onwards and then to go as far as to generate sizeable budget surpluses from 2020 onwards. This will have a positive impact on the development of sovereign debt. The government debt ratio will fall to around 54% in 2025 after hitting 97% in 2014. 2024 will see Spain break through the 60% debt level barrier for the first time, meaning that it will more than meet all of the debt criteria. Starting in 2016, Spain will be able to stick to the debt reduction path, chopping more than 5% off its excessive sovereign debt every year.



4. CONCLUSION: WHITTLING DOWN THE MOUNTAINS OF DEBT WILL REQUIRE REAL DISCIPLINE FOR SOME TIME TO COME

- Although the acute phase of the financial crisis has been laid to rest and investor confidence in the crisis-ridden EMU countries is starting to return, the European debt crisis is far from over and a number of risks remain on the scene. A large number of EMU member states are still sitting on huge mountains of debt that were accumulated during the financial and debt crises of recent years - and even beforehand, for the large part. In 2013, for example, the government debt ratios of the EMU countries included in this analysis were still well above the pre-crisis level and showed no signs of changing direction. With the exception of Germany, all of the countries in our analysis will see a further increase in their debt level this year, too.

- Achieving a sustainable reduction in the government debt ratio will be a very long and drawn-out process in a large number of EMU member states: in our base scenario, which is shaped by moderate economic growth and measured financial discipline, Germany will be the only country in our analysis to be able to adhere to the 60% debt level criterion prescribed by the Stability and Growth Pact at all - and will only manage to do so 2020. Despite making commendable progress on the consolidation front, Greece and Italy will still be grappling with debt corresponding to more than 100% of their national economic output in 2025. Germany is the only country that will manage to slash the debt ratio to below the pre-crisis level in the base scenario (from 2018 onwards). Even in 2025, Spain, Italy and Portugal, in particular, will still be faced with debt ratios well above the pre-crisis level.

- Given the high levels of sovereign debt, some EMU countries run the risk of falling victim to the financial markets again in the event of a negative growth shock. In our negative scenario, even a brief relapse into recession coupled with slightly lower trend growth would result in a marked increase in the debt mountain to over 100% of economic output by 2025 in the vast majority of the countries included in our

analysis. In this scenario, the debt sustainability of several EMU economies is likely to be called into question, once again raising serious doubts as to whether the European Monetary Union has what it takes to survive. This scenario highlights the fact that the debt crisis remains very much with us and that there is still no reason to be complacent when it comes to turning national austerity and reform plans into reality.

- The moderate performance reported by France and Italy in the base scenario shows just how much these countries need to tackle structural reforms and forge ahead systematically with consolidation. In our base scenario ("moderate growth, moderate fiscal discipline"), both countries will only manage to shave 13% off their debt ratio between 2013 and 2025, compared to a reduction in the government debt to GDP ratio of 36% in Germany, 33% in Ireland and 33% in Greece. At the same time, however, these figures show that the reforms made in the EMU program countries based on the stringent bailout requirements are bearing fruit.

- In most of the countries in our analysis, the debt reduction process will drag on, requiring iron fiscal discipline and a resolute will to stick to ambitious reform plans. But there is a big question mark hanging over whether Europe's governments can really maintain a systematic focus on pushing austerity and reform plans through over a period of ten years and more. The temptation - particularly once the first few signs of success start to emerge - to stray from the promised consolidation path is all too great. This could produce a scenario in which the ECB is forced to pursue a low interest rate policy in the long run in order to compensate for the complacency of national EMU governments.

- Belgium serves as an impressive example from the past as to how a country can achieve sustainable debt reduction under its own steam. In the period from 1993 to 2007, the country used a combination of spending discipline and reforms to cut its debt ratio from 135% to 84% of gross domestic product. During this period, however, the export-driven nation of Belgium was able to benefit from an extremely favorable macroeconomic environment, namely a booming global economy and low interest rates. As a result, growth-enhancing structural reforms should also be the top priority in the eurozone when it comes to cutting debt levels. Further fiscal policy integration moves could also lend support to this process, such as the appointment of an EU currency commissioner with the right to intervene in key fundamental data relating to national budget management and fiscal planning. Despite the massive mountains of debt, decisive steps towards fiscal union should make the EMU countries far less susceptible to crisis.

These assessments are, as always, subject to the disclaimer provided below.

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This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events) (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the Euro/U.S. Dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.