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DEBT SUSTAINABILITY ANALYSIS FOR THE GREEK ECONOMY

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Debt dynamics in Greece have deteriorated substantially since 2007 (Figure 1). Moreover since the inception of the adjustment program and even post-PSI, Government Debt dynamics remain on an unsustainable trajectory. To this end, less than encouraging growth prospects coupled with program implementation slippages (primary deficit to the tune of 1.0%-1.5% this year) suggest that the Medium Term Fiscal Strategy (2012-2015) program target of Debt/GDP at 120% by 2020 cannot be attained without targeted policy interventions. In addition to the necessity to resume growth by gradually eliminating the existing negative output gap and the generation of substantial primary surpluses throughout to 2020, the analysis presented hereunder lends strong support for the case of employing auxiliary means towards the attainment of the Debt/GDP reduction goal. These include -but are not confined to- a reasonable time extension of the economy's fiscal consolidation program, the potential decrease in the debt-bearing interest rate for the existing stock of debt, the acceleration of a realistic plan for privatizing key State owned enterprises and last but not least, the possibility of transferring responsibility for Greek Banks' recapitalization directly through the EFSF/ESM.

DEBT SUSTAINABILITY: SENSITIVITY ANALYSIS

The sensitivity analysis of the Debt dynamics that follows expands over a number of eight, internally consistent assumptions-based, scenarios. All Scenarios adopt the same set of initial conditions for 2012 based on a combination of most recent data estimates from official sources and adopting KEPE's latest projections (derived from a small scale macro-econometric model). The results are depicted in Figure 2.

One of the key assumptions concerning the debt sustainability analysis is the evolution of the growth rate of real GDP. In the case where the 11.6 bn euros agreed government spending cuts (MoU2) are implemented in a two-years period (2013-2014), –the initial scenario- we adopt the hypothesis that the 2012 recession (at approximately -6.0% of GDP[1]) will continue in 2013 (at -2.5%) and 2014 (at -1.5%), the Debt/GDP stands at 166.45%, the GDP deflator at 0.13%, the primary deficit at 1.2% of GDP and the nominal debt burden at 4%.

In an alternative, slightly more optimistic set-up where fiscal consolidation expands over a four-years horizon, and spending cuts are equiproportionally distributed over this period (2013-2016), recession is estimated at -1.8% in 2013 and nil in 2014. In both alternatives real growth resumes in 2015 at a moderate 2.0% and expands by 0.5% every two years to reach 3.0% in 2020. The GDP deflator is estimated at approximately 2.0% during 2013-2014 according to the forecasts of KEPE's small scale macro-econometric

[1] The authors' estimate that the 2012 recession will be near (if not higher than) -7.0%.

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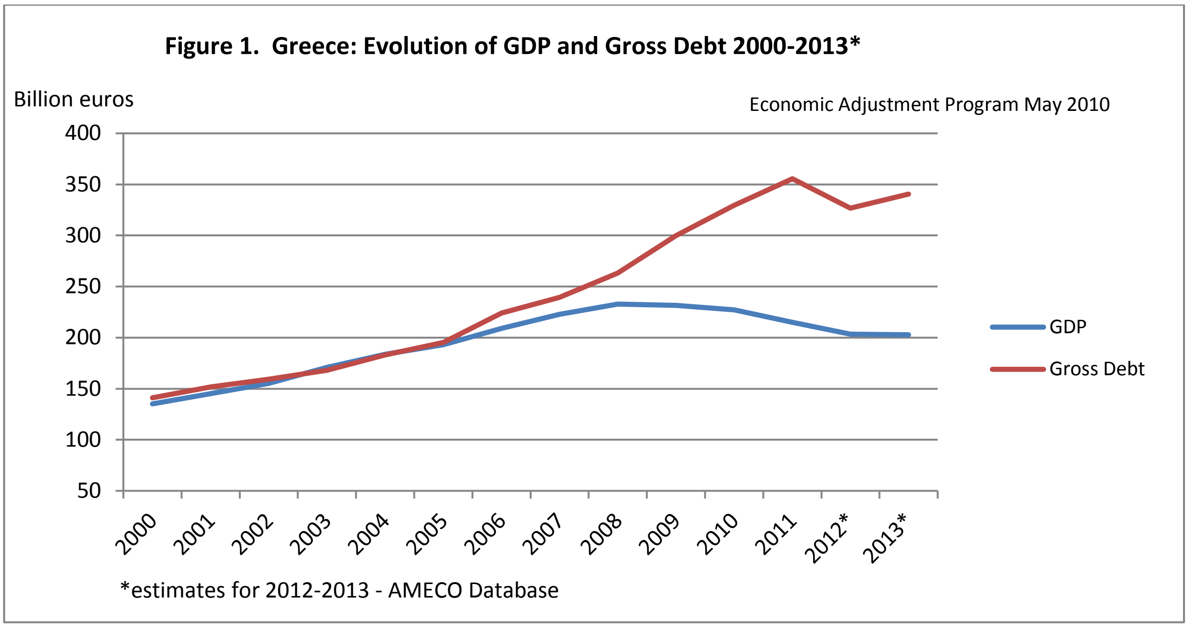
model and is assumed 1.5% in the years 2015-2020. Finally, the Government's net new borrowing through to 2020 is assumed zero.



Based on the above:

In Scenario 1, where adjustment expands over two years, and starting from an initial Debt/GDP level of 166.45% and a real GDP growth averaging 1.37% for the period 2013-2020, the creation of an (average 3.6% of GDP) primary surplus throughout the reference period reduces the Debt/GDP ratio to 151.22% (Debt/Y (1)); a performance far off the mark of 120.0% required for sustainability in 2020. As in Scenario 1, Scenario 1a assumes further a 50 bps lower interest rate (at 3.5%) throughout to 2020 that yields a much improved Debt/GDP profile, falling to 144.79% (Debt/Y (1a)) in terminal 2020.

Scenario 2 adopts the improved growth projections (averaging 1.65% over 2013-2020) along with the four years adjustment hypothesis to produce a Debt/GDP ratio at 147.33% (Debt/Y (2)), somewhat lower than that in Scenario 1. Within the same adjustment framework, Scenario 2a adopts the improved growth projections combined with a lower interest rate for the whole period (at 3.5%) to generate a Debt/GDP ratio at 141.05% (Debt/Y (2a)). In both cases the primary surplus required throughout the period 2013-2020 averages 3.6% of GDP.

Scenarios 3 and 3a adopt the hypotheses of the initial and the improved growth projections with two years and four years for the 11.6 bn euros spending adjustment respectively, a 3.5% interest rate flat out to 2020 and a 45 bn euros reduction in the 2012 stock of debt, accepting that the ongoing Banks' Recapitalization envelope will be assumed in total by the EFSF/ESM (this adjustment yields a significant reduction of the

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initial debt stock in 2012 and thus an initial Debt/GDP ratio of 144.22%). Scenarios 3 and 3a drive the Debt/GDP to 121.65% (Debt/Y (3)) and 118.41% (Debt/Y (3a)) respectively in 2020. This represents a significant improvement in the Debt/GDP trajectory and concomitant debt sustainability prospects.

Finally, Scenarios 4 and 4a, duplicate the assumptions of the basic scenarios (initial and improved growth projections and the two and four years spending cuts adjustment respectively), the lower interest rate at 3.5% throughout to 2020, but assumes, in addition, a realistic stream of privatization proceeds for the planned Privatizations of the SOEs to the tune of 15 bn euros equally spread during a three years period 2013-2015. In Scenarios 4 and 4a the Debt/GDP reaches 137.58% (Debt/Y (4)) and 134.0% (Debt/Y (4a)) respectively.

CONCLUSIONS AND POLICY IMPLICATIONS

Given the adverse initial conditions in 2012 and the on-going recession in 2013, the test to attain the Debt/GDP target of 120.0% by 2020 appears to depend on a combination of specific 'helpful' assumptions which include:

- the time extension of the economy's fiscal consolidation program to four years (2013-2016),

- a lower interest rate on debt outstanding

- a reduction of the 2012 stock of debt provided that the recapitalization of the Greek Banks is materialized directly through the EFSF/ESM (as expected in the Spanish case) instead of through the Greek Public Debt,

- the prospects regarding privatization revenues which will directly reduce the existing stock of debt.

Under a combination of these assumptions, that form a framework for 'negotiations', it may be feasible to attain the 120.0% Debt/GDP target by 2020, or even end-up below that threshold, with 'manageable' primary surplus requirements. In any event, however, under any 'helpful' assumptions (in which one could add the OSI), substantial fiscal adjustment in the form of primary budget surpluses throughout the designated time-framework is a *sine qua non.*

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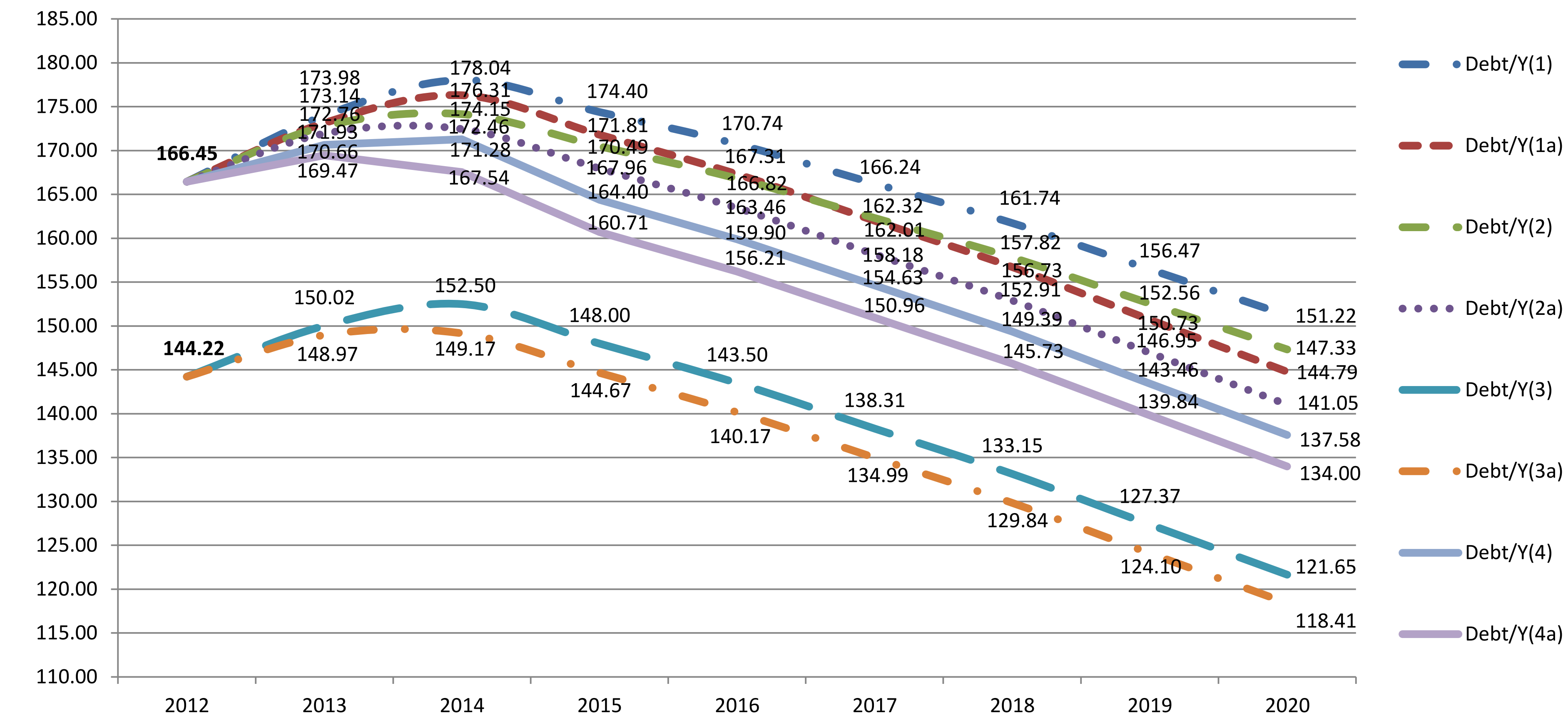
Figure 2. Greece: Debt/GDP Dynamics to 2020 based on alternative scenarios



KEPE: Authors' calculations