

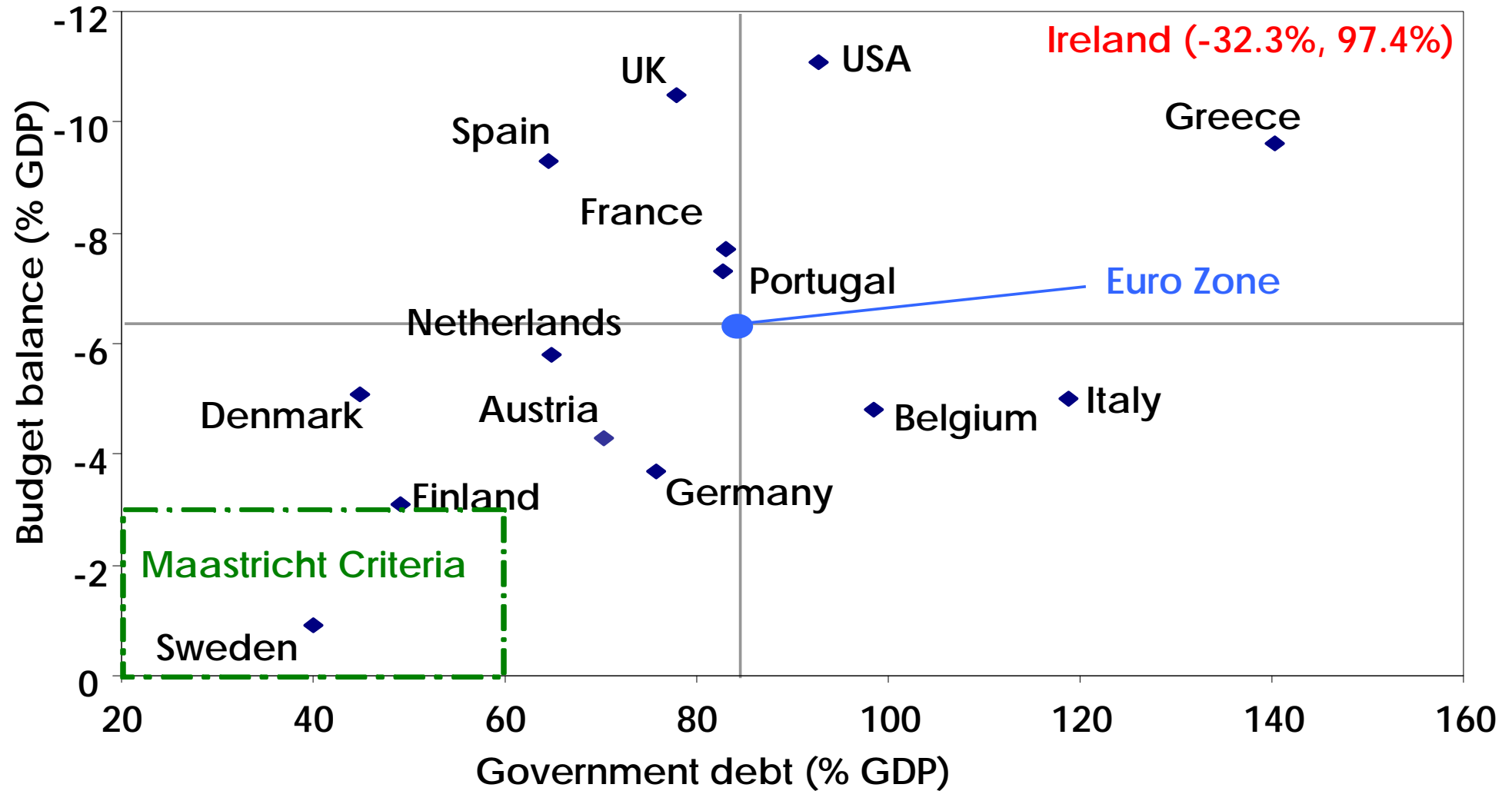
Assessing sustainability of public debt and consolidation needs of Euro area countries

24 May 2011

Gottfried Steindl

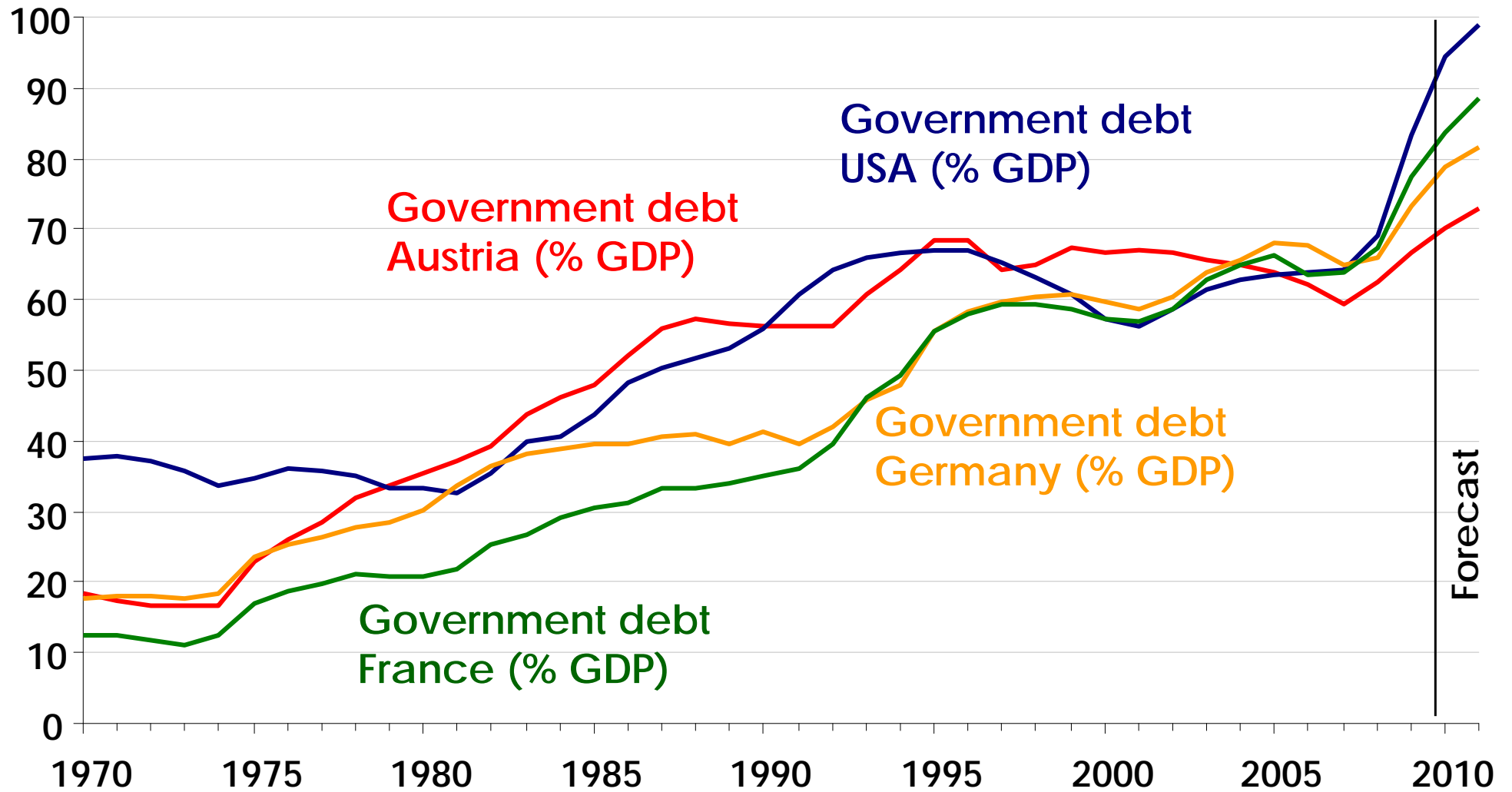
CURRENT ENVIRONMENT

Where do we start from?



Source: EU Commission, Raiffeisen RESEARCH

DEBT LOAD still rising



Source: EU Commission, Raiffeisen RESEARCH

PUBLIC DEBT

What is unsustainable?



=> Get no (re)financing

- Liquidity Risk
 - Short profile of outstanding debt
 - Dependent on external means...

 - Political risk
 - No reliable government
 - Government /Society has weak record on reforms

 - Debt is on explosive path
 - Primary deficit too high
 - Interest payments too high
 - GDP growth too low
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Liquidity Risk

GOVERNMENT BONDS

Maturity profile (EUR bn.)



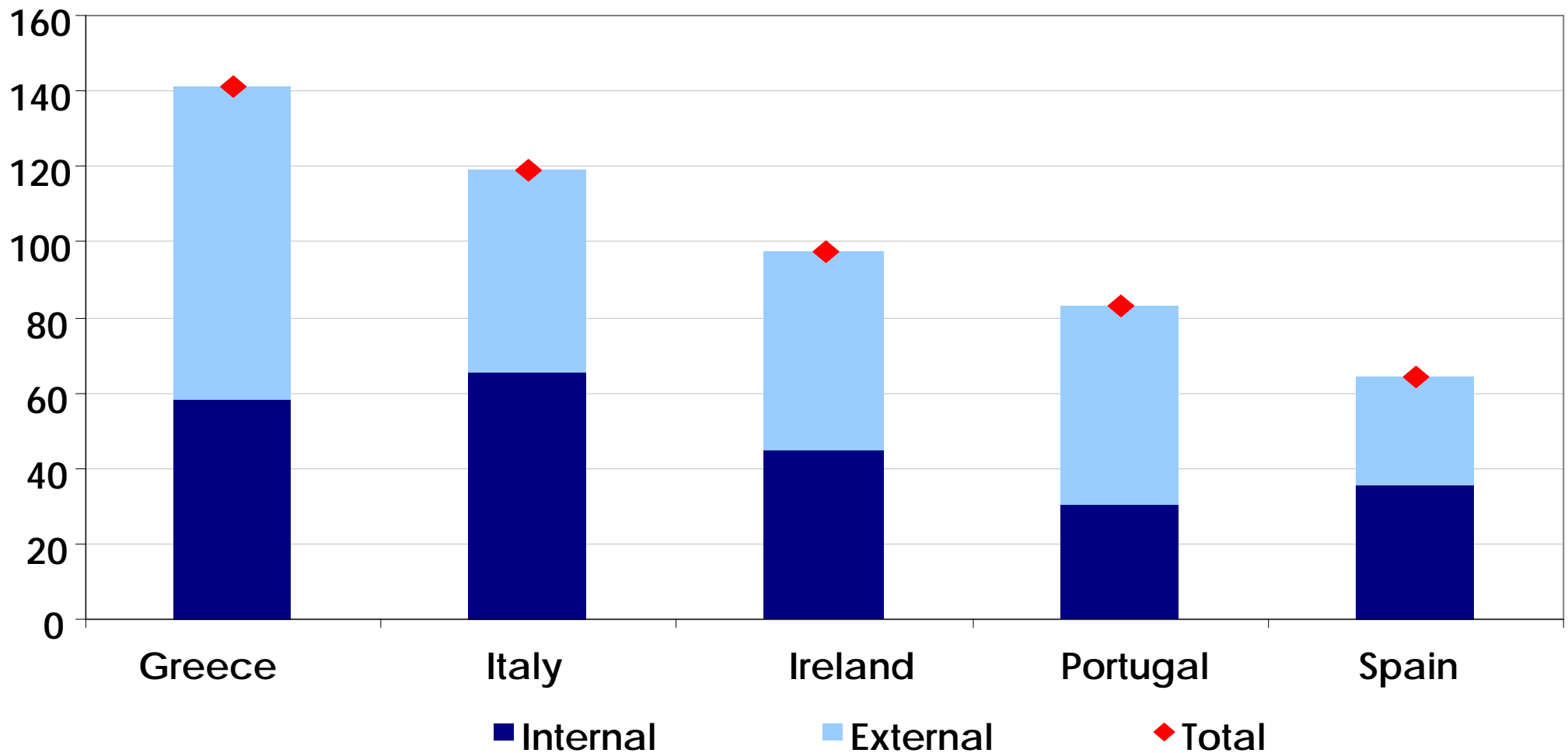
	Greece	Portugal	Ireland	Spain	Italy	TOTAL
2011*	31.3	15.6	4.5	109.4	219.3	380.1
2012	33.7	18.0	5.6	94.1	231.9	383.4
2013	30.6	10.8	6.1	73.0	135.9	256.5
2014	31.8	15.8	11.9	62.2	94.8	216.5
2015	20.6	11.5	0.2	40.6	137.7	210.6
2016	15.8	10.0	10.2	30.4	59.0	125.3
2017	23.8	7.0	0.0	30.9	86.0	147.6
2018	10.3	6.9	9.9	16.5	52.1	95.7
2019	25.7	8.7	14.5	28.8	86.5	164.2
2020	5.3	9.2	19.6	31.3	70.0	135.3

* Between May-December 2011 maturing government bonds

Source: Bloomberg, EU Commission, Raiffeisen RESEARCH

EXTERNAL vs. INTERNAL FINANCING

Do standard measures apply?



* in % GDP

Source: World Bank, Raiffeisen RESEARCH

LIQUIDITY RISKS: EURO AREA

Additional sources of funds



- Aid package for Greece: EUR 110bn
 - Supplementary package ???
 - Until mid 2013: European Financial Stabilisation Mechanism EFSM: EUR 60bn
 - Until mid 2013: European Financial Stability Facility EFSF (New): EUR 250-260bn (EUR 440bn)
 - Starting from mid 2013: European Stabilisation Mechanism ESM: EUR 500bn
 - International Monetary Fund: EUR 250bn (increase of EU funds in relation 2:1)
 - Bilateral loans of EU countries
-

Political Risk

POLITICAL & SOCIAL FRAMEWORK

Ability to implement reforms



GOVERNMENT STABILITY

- Time until next parliamentary/presid. election
- Form of government (weak/strong coalition, minority/majority government)
- Avg. historical duration of government

Source: Raiffeisen RESEARCH

EFFICIENCY OF GOVERNMENT & PUBLIC ADMINISTRATION

- Transparency of government policymaking
- Wastefulness of government spending
- Parliamentary control over administration
- Pervasiveness of corruption

Source: World Economic Forum, World Bank, Corruption Perception Index

PUBLIC OPINION

- Public awareness of reform needs
- Public awareness of aging related costs & necessary reforms
- Attitude towards expenditure cuts and tax increases
- Avg. yearly number of strike days & lock outs

Source: Eurobarometer, ILO

POLITICAL & SOCIAL FRAMEWORK Evaluation



EVALUATION

Favourable
socio-
political
environment

Unfavourable
socio-
political
environment

CRITERIA

Score of governance indicators

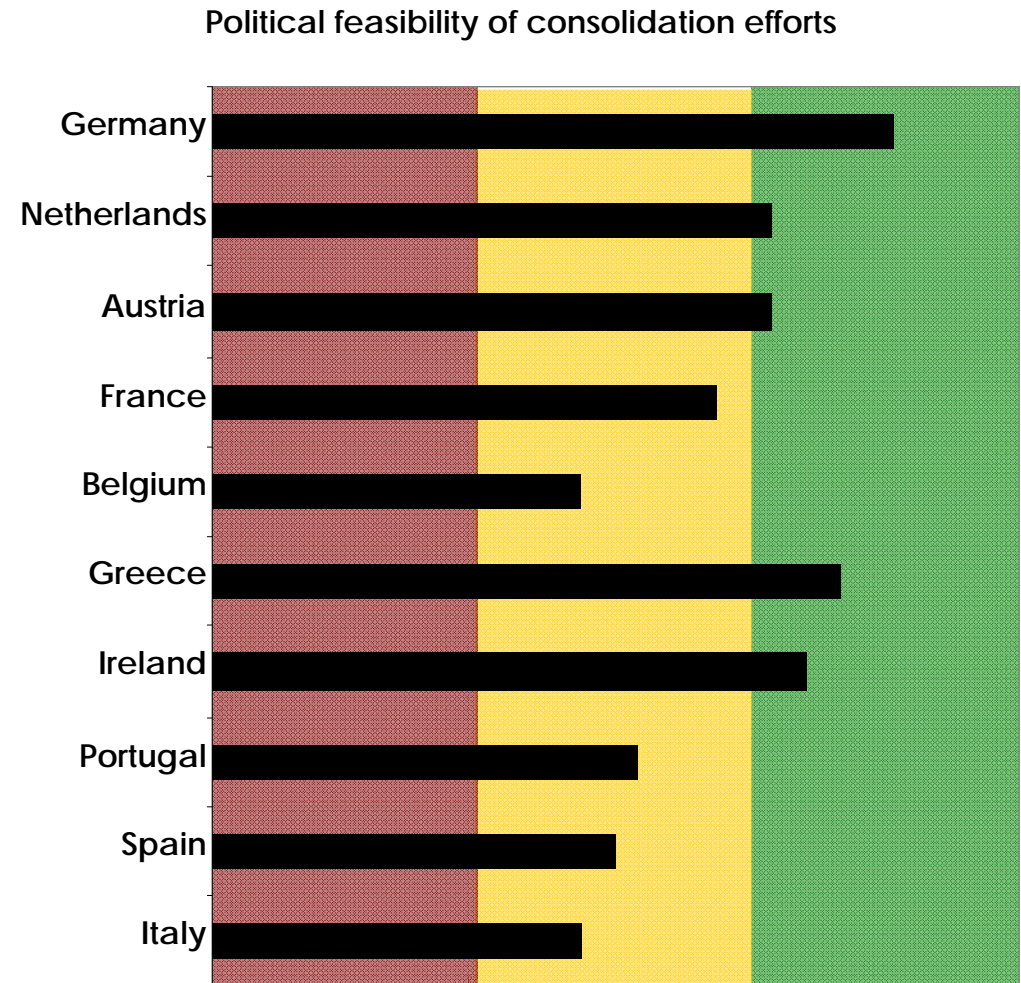
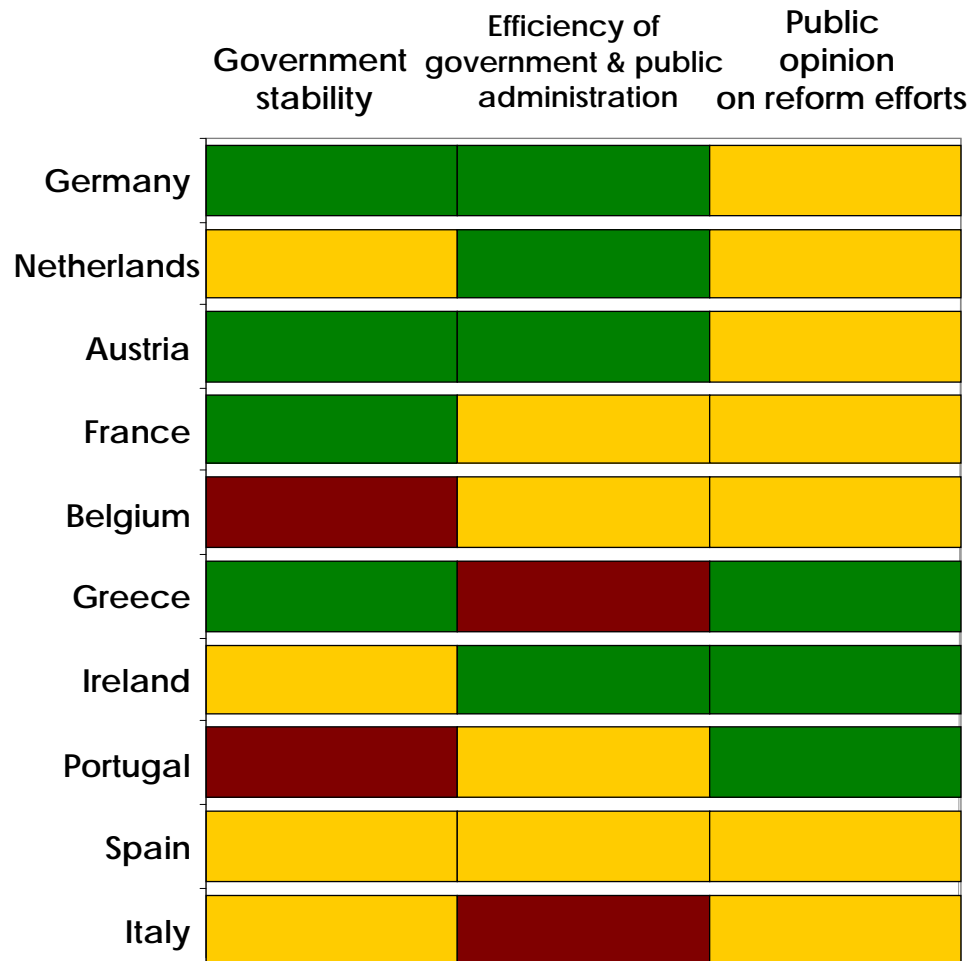
Better than
global mean +
one standard
deviation

In between
global mean +/-
one standard
deviation

Worse than
global mean - one
standard deviation

AGGREGATION

POLITICAL & SOCIAL FRAMEWORK Assessment



Source: Raiffeisen RESEARCH

Sustainability of debt load

DEBT DYNAMICS: DEPEND ON
budget balance, interest & growth rates

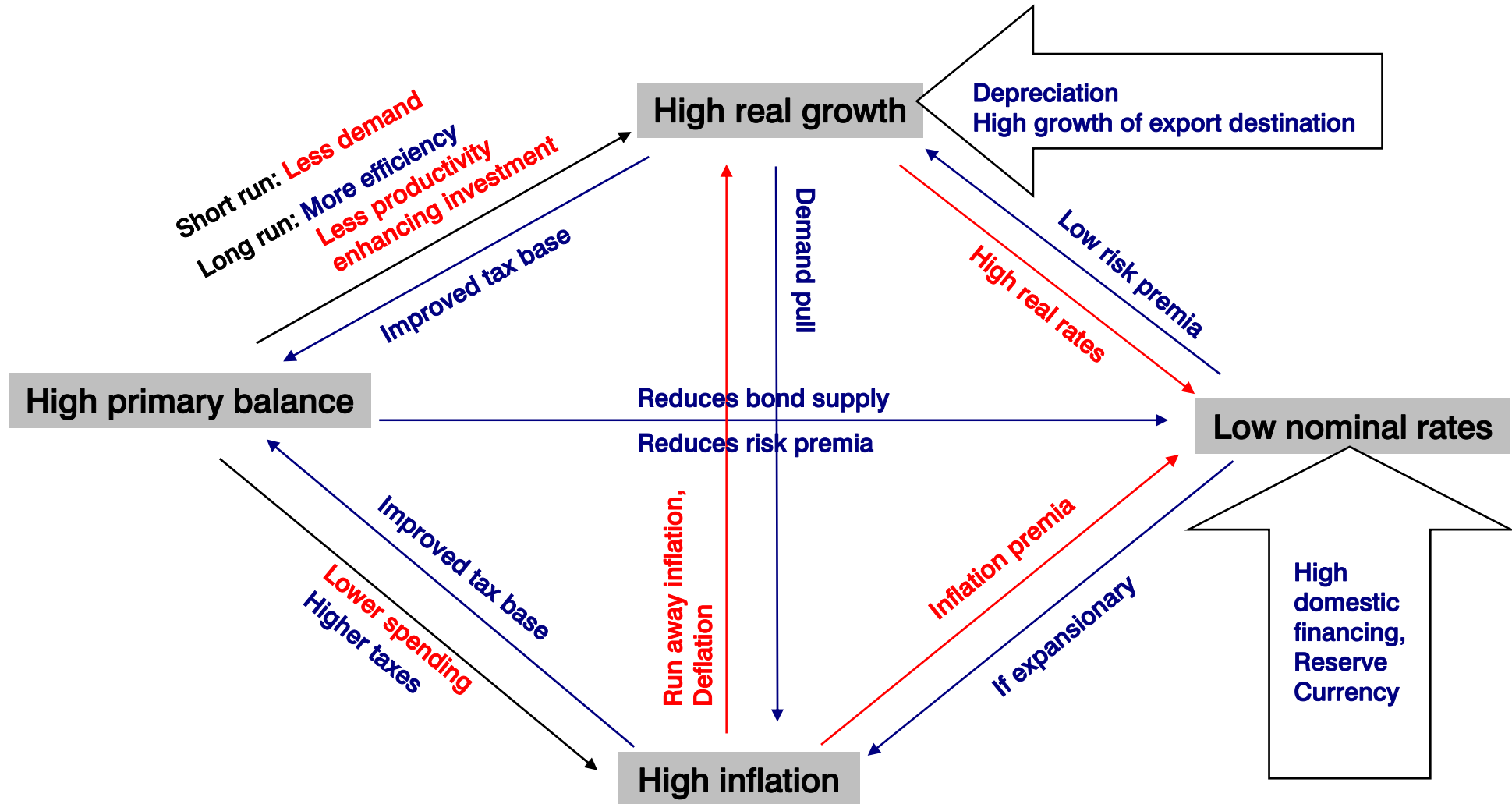


$$\begin{aligned} \text{Debt \% of GDP}_t &= \\ &= \text{Debt \% of GDP}_{t-1} \frac{1 + \text{average interest rate}}{1 + \text{nominal GDP growth rate}} + \\ &+ \text{Primary budget balance \% of GDP}_t \end{aligned}$$

Looking at the maths the relationship looks linear but
considering the economics it's not!

DELEVERAGING

Drivers are interlinked



Source: Raiffeisen RESEARCH

DRIVERS OF LEVERAGE are interrelated!

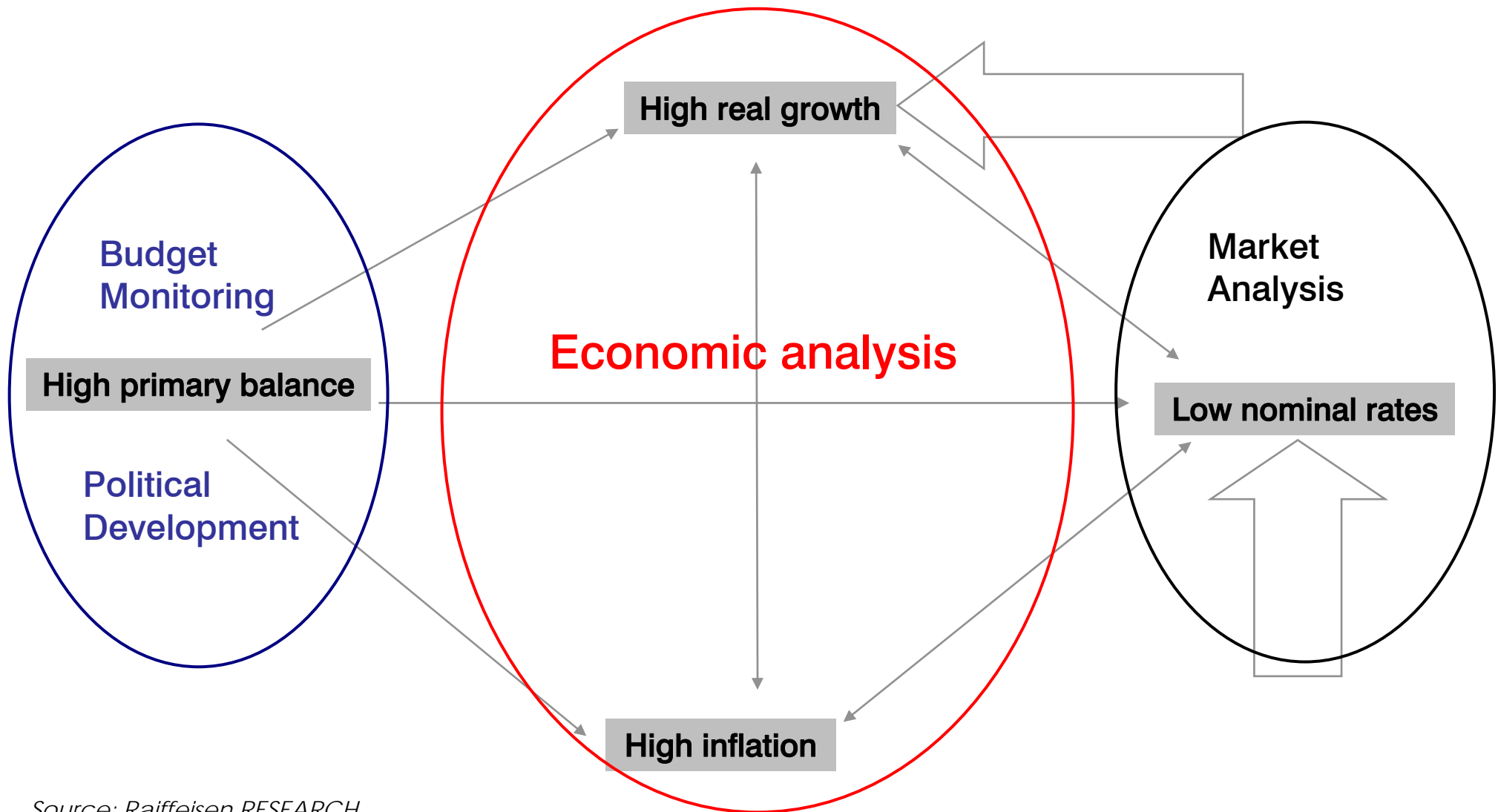


Some examples:

- Rising interest payments (risk premia) dampen GDP growth prospects.
 - Higher inflation reduces leverage ratio (higher nominal GDP) and increases the primary balance. BUT it reduces in a common currency area competitiveness and hence growth. Moreover it may increase interest rates for new public financing.
 - Higher GDP growth increases the primary balance and lowers the leverage but raises interest rate.
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DRIVERS OF LEVERAGE

What to watch?



Possible policy strategies to reduce public leverage:

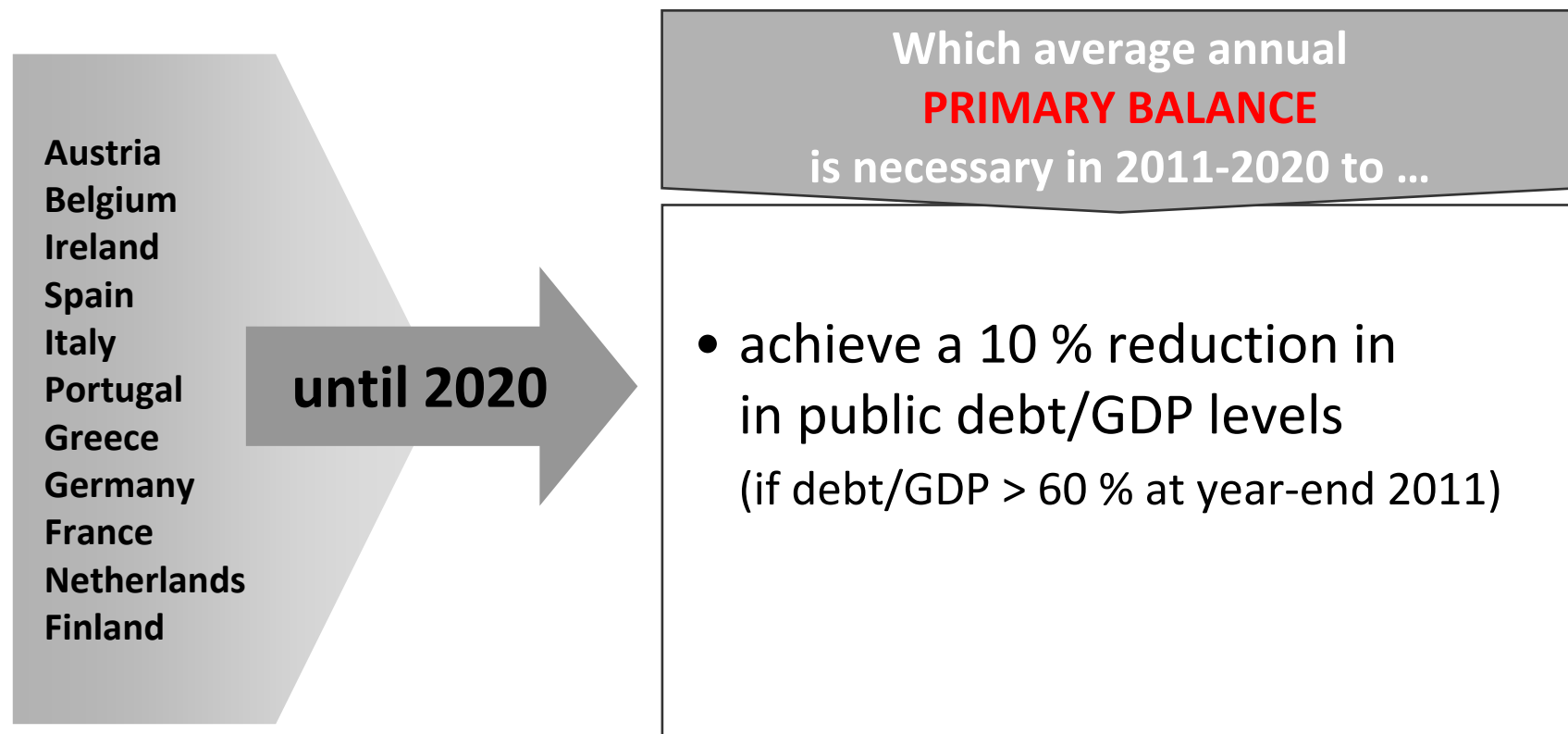
- Austerity measures -> Improvement of primary balance
 - Sell assets (Privatization) -> Reduction of debt load
 - Economic reforms -> Higher nominal GDP growth
 - Expansionary Monetary Policy -> Lower interest rate
-> Higher nominal GDP growth
 - Surprise inflation -> Higher nominal GDP
-> Dilution of debt load

 - Default / restructuring -> Reduction of debt / interest load
-

BUDGET CONSOLIDATION

Evaluation of austerity measures

- How to re-establish confidence given our economic framework?



ASSUMPTIONS



	General government debt**		avg. 2011 - 2020 (% yoy)		interest rate				Necessary primary balance
	Debt 2010	Target 2020	GDP (real)	Inflation	current yield (5Y)	implicit rate 2010	upper bound	lower bound	
Germany	83.2	75	1.6	2.0	2.6	3.7	3.7	2.6	0.7
France	81.7	74	1.4	2.0	2.9	3.4	3.4	2.9	0.8
Austria	72.3	65	1.5	2.0	2.8	4.3	4.3	2.8	1.1
Belgium	96.8	87	1.2	2.0	3.6	4.0	4.0	3.6	1.7
Netherlands	62.7	56	2.0	2.0	2.9	3.9	3.9	2.9	0.4
Finland	48.4	48	1.5	2.0	2.6	2.6	2.6	2.6	0.1
Portugal	93.0	84	1.6	2.0	11.7	4.1	6.5*	4.1	2.9
Ireland	96.2	87	2.5	2.0	11.4	4.3	6.5*	4.3	2.3
Greece	142.8	129	1.1	2.0	21.4	4.7	6.5*	4.7	5.5
Spain	60.1	54	1.5	2.0	4.7	4.1	4.7	4.1	1.2
Italy	119.0	107	1.3	2.0	3.9	4.0	4.0	3.9	2.1

* Long term average ESM rate

** in % of GDP

Source: EU Commission, Thomson Reuters, Raiffeisen RESEARCH

EVALUATION

Comparison to history, current & plan

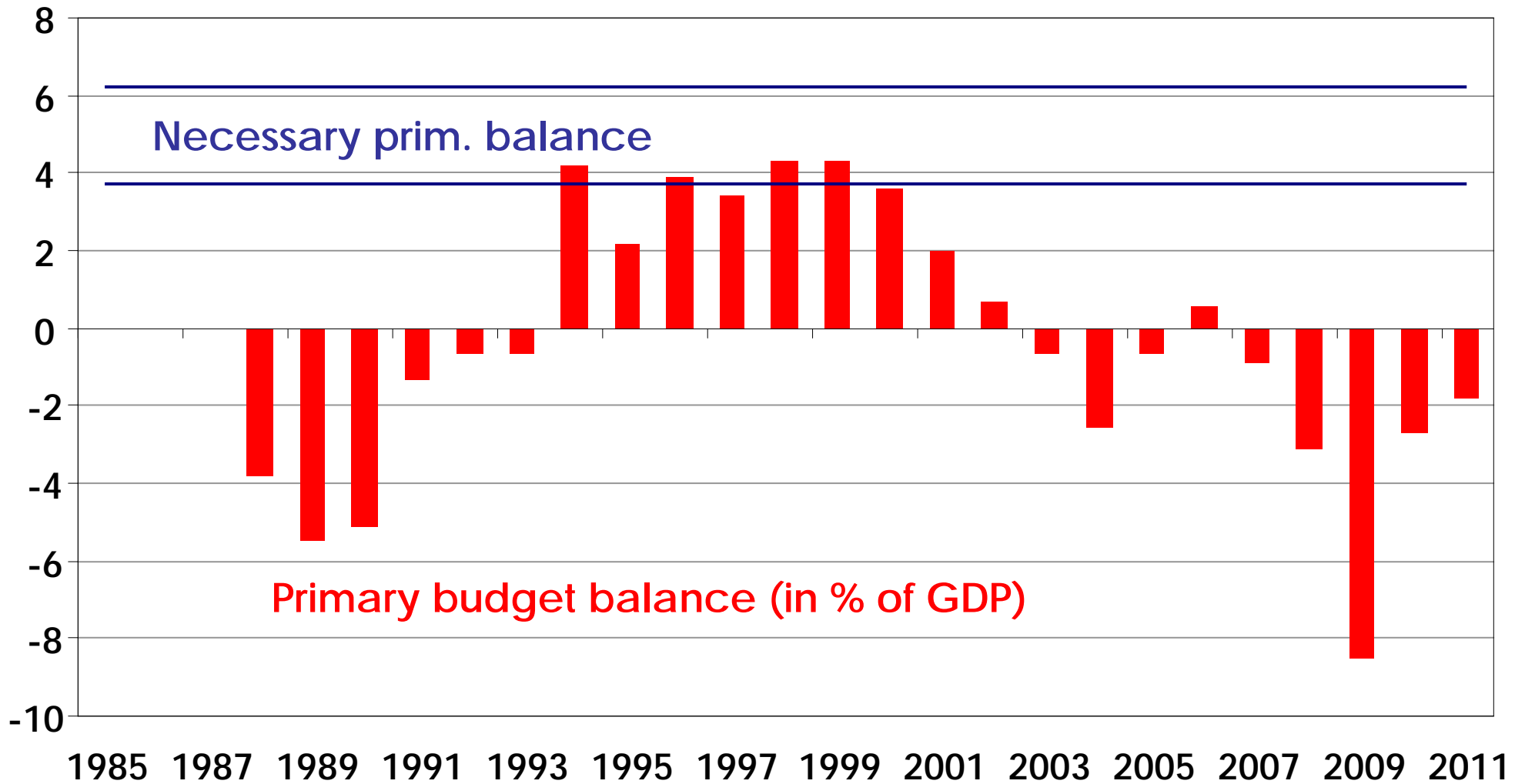


in % of GDP	Consolidating primary balance until 2020		Historic primary balance		actual primary balance	Planned consolidation		
	min	max	avg	avg. 00 - 10	Max. year	2011	Prim. balance year	
Germany	0.1	0.9	0.7	0.48	4.50	2000	-2.00	1.5 2013
France	0.5	0.8	0.8	-0.96	1.50	2001	-4.50	-0.1 2013
Austria	0.4	1.4	1.1	1.10	3.40	2001	-1.70	0.1 2013
Belgium	1.4	1.8	1.7	3.35	6.80	2001	-1.20	1.9 2013
Netherlands	0.2	0.8	0.4	1.12	5.60	2000	-2.80	0.8 2013
Finland	-0.4	-0.4	-0.4	4.53	9.60	2000	-1.70	0.8 2013
Portugal	1.4	3.6	2.9	-1.57	3.60	1992	-1.10	-0,4 2013
Ireland	1.2	3.4	2.3	-0.41	6.80	2000	-6.50	-1.6 2013
Greece	3.7	6.2	5.5	-1.12	4.30	1998	-1.80	3.1 2013
Spain	1.0	1.3	1.2	0.15	3.70	2006	-3.40	-0.3 2013
Italy	2.0	2.1	2.1	1.99	6.60	1997	2.10	3.9 2013

Source: EU Commission, Raiffeisen RESEARCH

GREECE

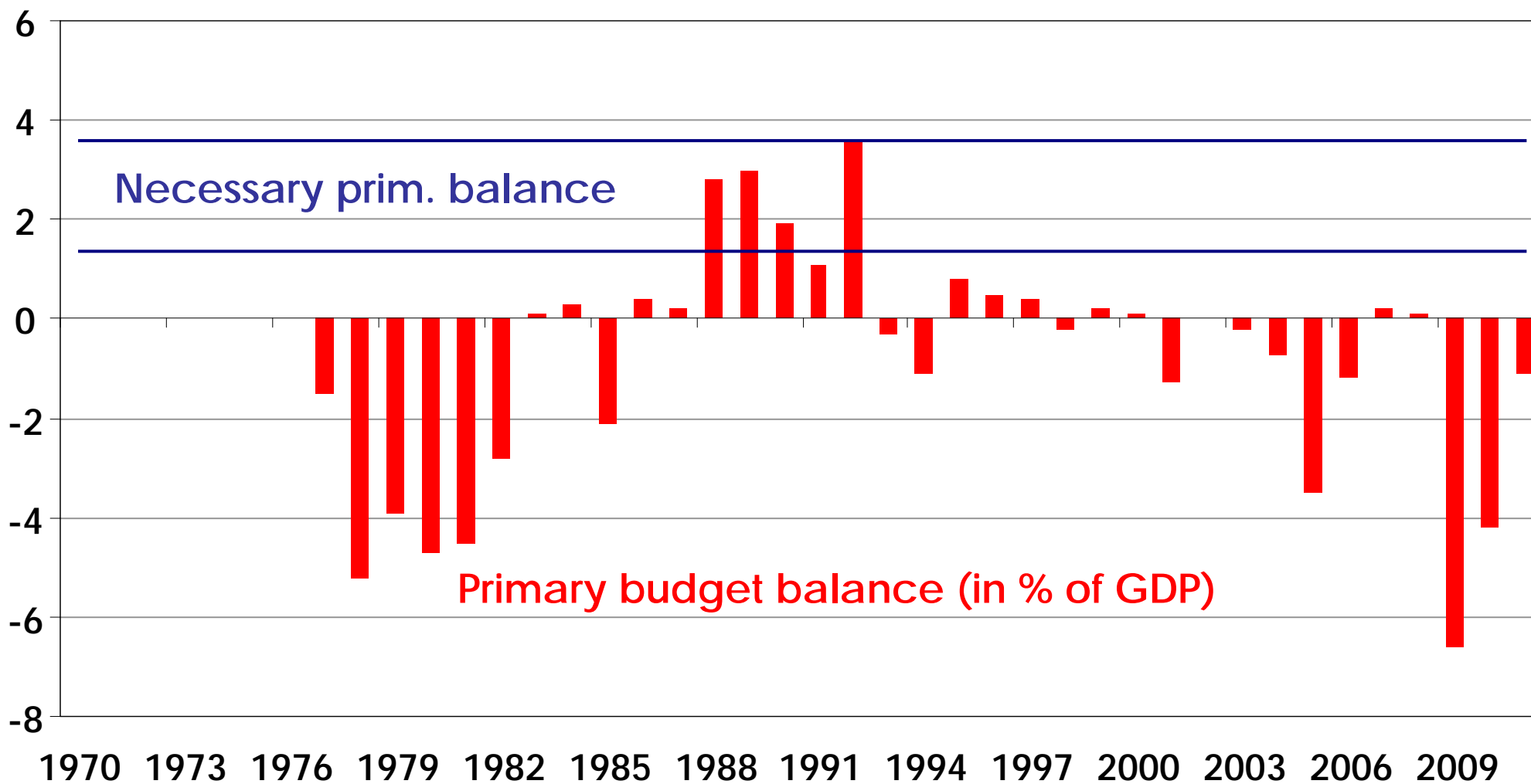
Future need vs. historic performance



Source: EU Commission, Raiffeisen RESEARCH

PORTUGAL

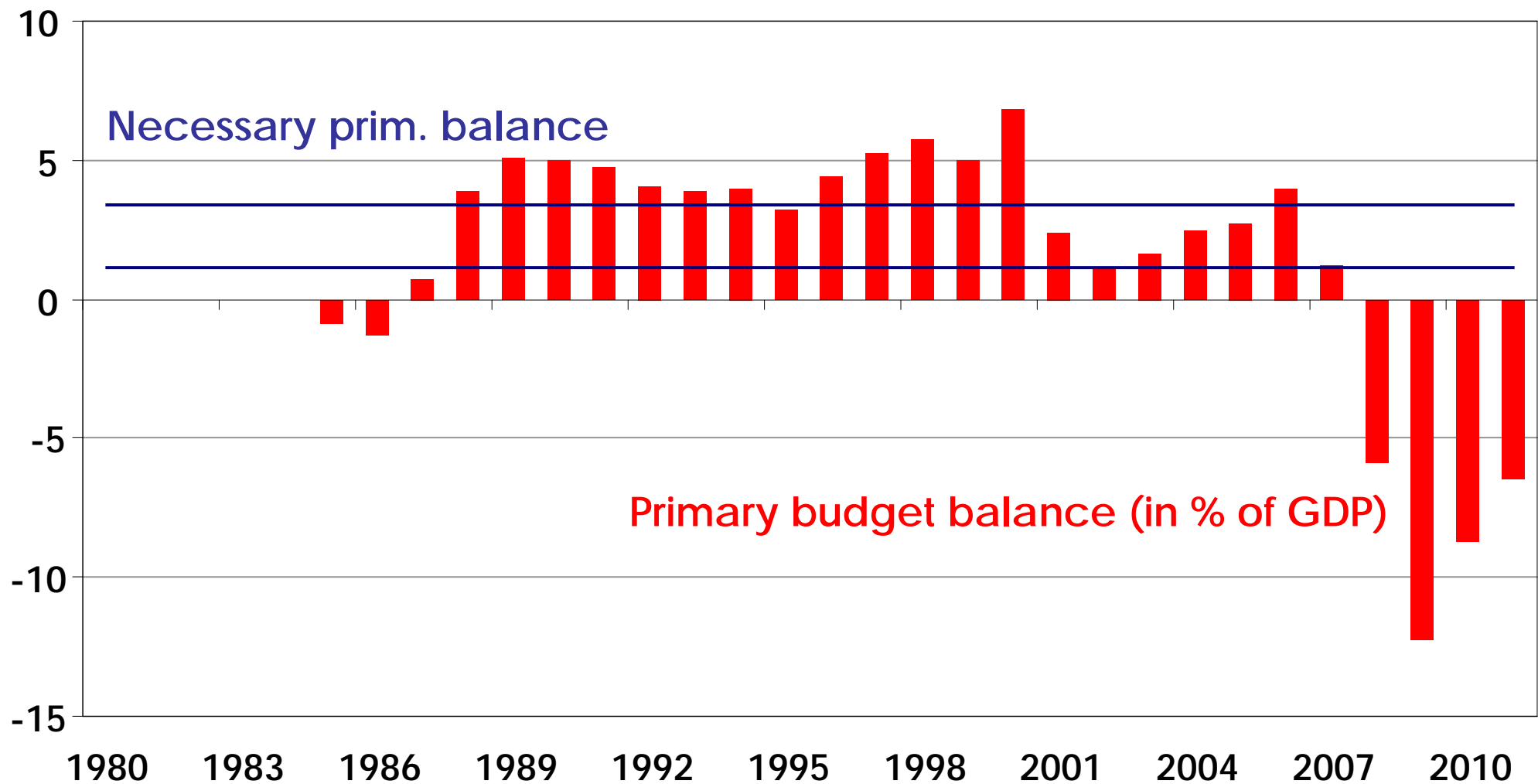
Future need vs. historic performance



Source: EU Commission, Raiffeisen RESEARCH

IRELAND

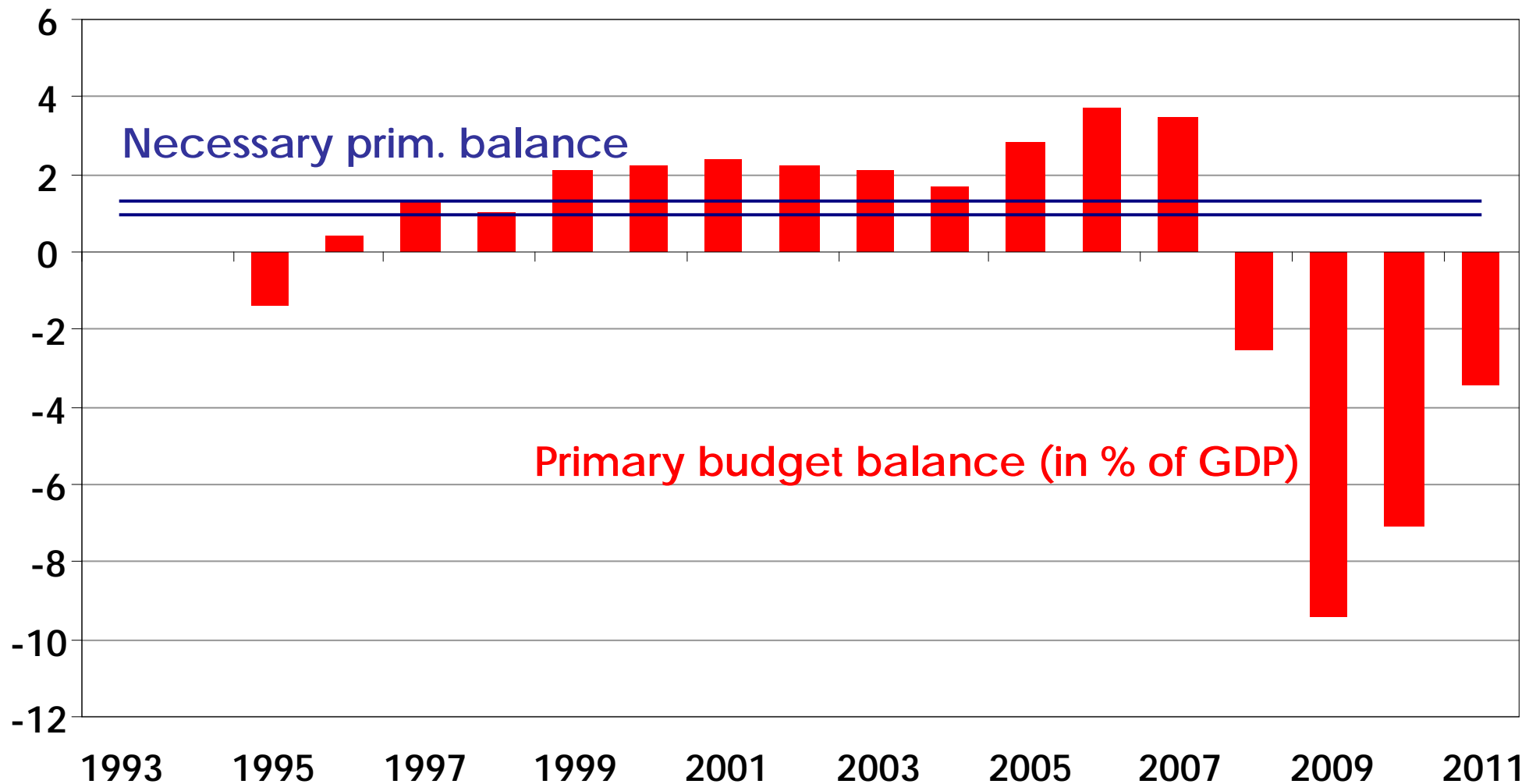
Future need vs. historic performance



Source: EU Commission, Raiffeisen RESEARCH

SPAIN

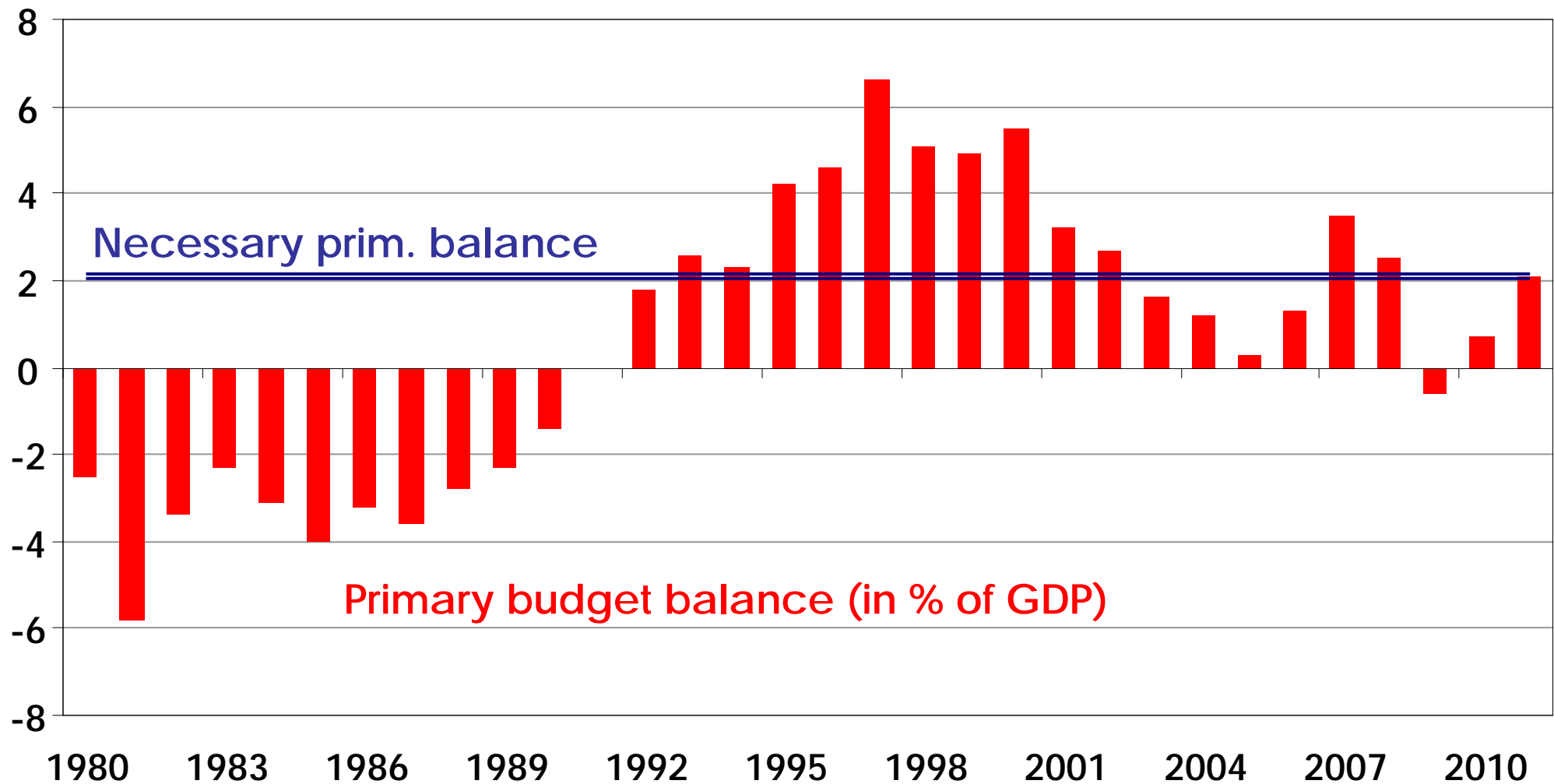
Future need vs. historic performance



Source: EU Commission, Raiffeisen RESEARCH

ITALY

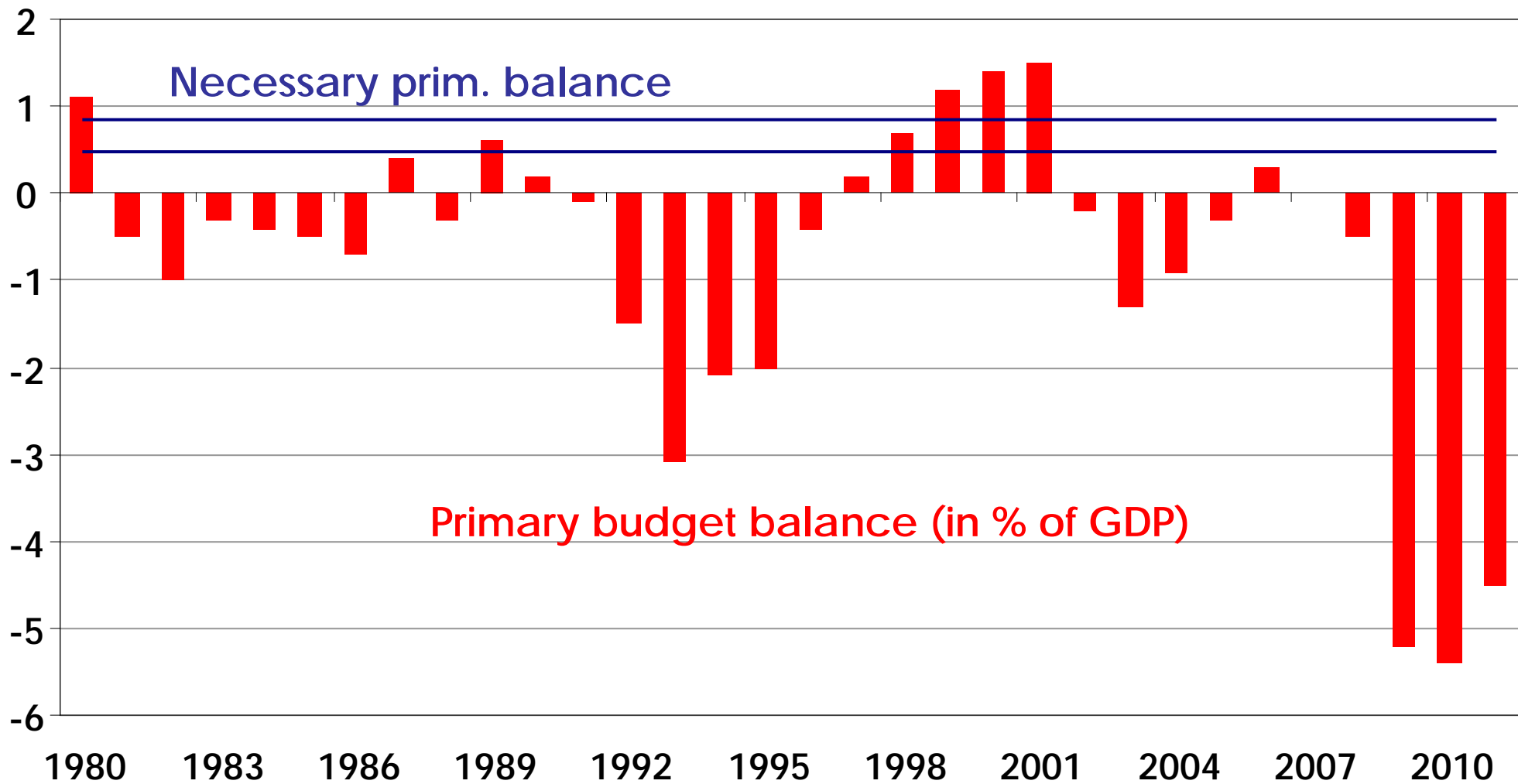
Future need vs. historic performance



Source: EU Commission, Raiffeisen RESEARCH

FRANCE

Future need vs. historic performance



Source: EU Commission, Raiffeisen RESEARCH

EVALUATION

Conclusion



- Despite the favourable growth environment, public finances in the Eurozone are still on an explosive path in 2011.
 - Greece, Ireland, Portugal, Spain, France and Austria will have to augment their austerity measures. Right now, the planned consolidation is not able to establish sustainability of public finances.
 - Countries struggling with a long-term lack of sustainability are France, Ireland, Greece, Portugal and Spain. Tough structural reforms will be necessary.
 - In Austria, Germany and Italy budgetary stress is predominately a consequence of the recent economic crisis. Sustainability can be reached with modest reforms.
 - Finland, Belgium and the Netherlands are the countries with the highest degree of sustainability.
 - Italy seems to be much more capable of decreasing its debt level than France
-

GREECE

Hair cut vs. lower interest rate



■ Scenario 1: Cheaper funding – interest subsidy by EU/IMF

General government debt*		avg. 2011 - 2020 (% yoy)		interest rate		Necessary primary balance
Debt 2010	Target 2020	GDP (real)	Inflation	ESM funding without pickup		
Greece	142.8	129	1.1	2.0	4.0**	2.8

* in % of GDP

** rate for calculation of necessary primary balance

■ Szenario 2: Haircut to debt/GDP level of Ireland and Portugal

General government debt*		avg. 2011 - 2020 (% yoy)		interest rate		Necessary primary balance
Debt 2010	Target 2020	GDP (real)	Inflation	ESM funding		
Greece	96	86	1.1	2.0	6.5**	4.2

* in % of GDP

** rate for calculation of necessary primary balance

Source: EU Commission, Thomson Reuters, Raiffeisen RESEARCH

GREECE

Interest subsidy



Average ESM funding rate without pickup

Assumption

Necessary primary balance	nominal GDP growth (in % yoy)								
	5.0	4.5	4.0	3.5	3.0	2.5	2.0	1.5	
interest on debt (in %)	4.0	4.5	5.0	5.5	6.0	6.5	7.0	7.5	
	0.2	0.9	1.6	2.2	2.9	3.6	4.4	5.1	
	0.9	1.6	2.2	2.9	3.6	4.3	5.1	5.8	
	1.6	2.2	2.9	3.6	4.3	5.0	5.8	6.5	
	2.2	2.9	3.6	4.3	5.0	5.7	6.5	7.2	
	2.9	3.6	4.3	5.0	5.7	6.4	7.2	7.9	
	3.6	4.3	5.0	5.7	6.4	7.1	7.9	8.6	
	4.3	5.0	5.7	6.4	7.1	7.8	8.6	9.3	
	5.0	5.7	6.4	7.1	7.8	8.5	9.3	10.0	

Average ESM rate

Necessary primary balance with haircut

With interest subsidy (i.e. German lending rate + 0.2%), the planned primary balance of 3.1% of GDP until 2013 is sufficient to reduce the Greek government debt to 130% of GDP until 2020 (2010: 143% of GDP).

Greece is indifferent between a haircut and an interest subsidy to 5%. Under both scenarios, consolidation efforts to REDUCE debt are the same.

- Politically it would be difficult to apply a haircut on Greek debt which results in Greece having a smaller debt load than Ireland or Portugal.
 - The consolidating/sustainable primary balance is much more sensitive to the interest rate than to the debt level.
 - A interest subsidy is more favourable for budget consolidation than a haircut. With funding costs below 5%, budget consolidation needs will be less than with a haircut and 6.5% ESM funding.
 - A haircut does not lead to sustainable public finances!
 - If sustainability of debt is not the ultimate aim, a haircut is favourable. Greece would buy time and end up with comparable high debt levels in a couple of years again (probably in the next recession).
-

BUDGET CONSOLIDATION

Lessons from History



- * Denmark, Ireland, Belgium, Sweden, Finland reduced their budget deficits by 10 %-points or more.
 - Emphasis on reduced spending instead of tax increases – spending cuts weighs less on private sector activity in the mid to longer run
 - Restoration of international competitiveness via currency depreciation and wage moderation (real depreciation)
 - Structural reforms (e.g. repositioning of economy towards fast growing areas) which lead to increased potential growth
 - At the start of a budget consolidation process GDP growth is dampened but kick-starts later on
 - Leverage increases at first but falls back later on
 - Strong social consensus supporting fiscal retrenchment is a crucial prerequisite for successful consolidation
-

BUDGET CONSOLIDATION

Current headwinds compared to history



- Less support from global growth for countries which export to matured economies
 - Within Euro area: No tailor made monetary policy and no nominal depreciation vs. other members
 - Low inflation rates
 - Regaining competitiveness via falling real wages more difficult to achieve (outright reduction of nominal wages)
 - In many countries public sector less dominant than 30 years ago (e. g. Sweden)
 - Less potential for cuts
-

ESTLAND: REGAINING COMPETITIVENESS within the currency union



- Economic & housing boom, current account balance at -17.2% of GDP in 2007
- Bust of housing bubble, financial crises starting in 2008
- Dramatic economic crises: real GDP Q4 07 – Q1 10: -26.4%

No devaluation: Estonian crown was fixed to Euro, since 2011 member of Euro area

- Dramatic wage cuts (20% in public sector)
- Reduction of unit labour costs (2008-2010: -5.6%)
- Unemployment rate from 4% (2007) to 18.9% (start 2010) back to 14.3% (end 2010)
- Public budget deficit increased only to 2.8 % in 2008
- Public debt at 8% of GDP in 2010
- Current account balance since 2009 (4.5% of GDP)
- Real GDP growth 2010 at 2.4%

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