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Research Report

The long haul: Managing exit from financial assistance

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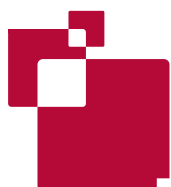
THE LONG HAUL: MANAGING EXIT FROM FINANCIAL ASSISTANCE

ZSOLT DARVAS, ANDRÉ SAPIR AND GUNTRAM B. WOLFF

Highlights

- Countries can make a clean exit from financial assistance, or enter a new programme or a precautionary programme, depending on the sustainability of their public debt and their vulnerability to shocks.
- Ireland made a clean exit in December 2013, supported by significant budgetary and current-account adjustment and signs of economic recovery. But Irish debt sustainability is not guaranteed and prudence will be needed to avoid future difficulties.
- A clean exit for Portugal is not recommended when its programme ends in May 2014, because compared to Ireland it faces higher interest rates, has poorer growth prospects and has probably less ability to generate a consistently high primary surplus. A precautionary arrangement would be advisable. In case debt sustainability proves difficult to achieve later, some form of debt restructuring may prove necessary.
- It is unlikely that Greece will be able to exit its programme in December 2014. A third programme should be put in place to take Greece out of the market until 2030, accompanied by enhanced budgetary and structural reform commitments by Greece, a European boost to economic growth in the euro-area periphery and willingness on the part of lenders to reduce loan charges below their borrowing costs, should public debt levels prove unsustainable despite Greece meeting the loan conditions.
- Even assuming all goes well, the three countries will be subject to enhanced post-programme surveillance. Managing such decades-long relationships will be a key challenge.

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THE LONG HAUL: MANAGING EXIT FROM FINANCIAL ASSISTANCE

ZSOLT DARVAS, ANDRÉ SAPIR AND GUNTRAM B. WOLFF, FEBRUARY 2014

HOW MUCH EUROPE HAS CHANGED: two years ago, GREXIT, or potential Greek exit from the euro area, was the main discussion. Today, policymakers are again discussing exit, but with a decisively positive meaning: how, when and under what conditions countries will exit from Troika financial assistance programmes.

Four euro-area countries lost market access and were forced into full macroeconomic financial assistance programmes in 2010-13: Greece in May 2010, Ireland in December 2010, Portugal in May 2011 and Cyprus in April 2013¹. Financial assistance was combined with economic adjustment programmes designed to put countries on a sustainable debt path by means of a combination of fiscal policy measures, financial and corporate sector reforms and growth-enhancing structural reforms.

All four programmes were scheduled to last three years, but the initial Greek programme was terminated in March 2012 and replaced by a second programme that runs until December 2014. At the end of their programmes, countries face in principle three options: a full or 'clean' exit, a new programme or a precautionary credit line.

Ireland reached the end of its programme in December 2013, and was able to make a clean exit, which prompted understandable declarations of victory by the government. The Eurogroup also declared the Irish exit a victory and proof that Troika programmes work. However, critics have pointed to the continuous risks to Ireland from lingering financial problems arising from its high debt level and the significant adjustments costs.

The Irish success led governments in Portugal and Greece, which have programmes that are due to expire in 2014, to announce that they are also planning for clean exits. The issue of exit for Cyprus is still remote as the programme will only

expire in May 2016, though hopes of a clean exit are no less there than elsewhere.

But despite the upbeat mood, all four countries face public debt levels of more than 120 percent of GDP and uncertain growth conditions (linked in part to their high levels of private debt), which could jeopardise the sustainability of their public debt. If so, the current positive market sentiment towards these countries could easily turn negative.

A defining feature for all countries will be that, even after the end of a programme, the financial relationship between them and their creditors will persist for a long time. In fact, the maturities of the European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) loans have been extended to around 20 years average for Ireland and Portugal, or even in excess of 30 years for Greece. Cyprus has a current average maturity of about 15 years.

The first and most fundamental issue is if a country can return to, and remain in, the market at an affordable rate. This is, above all, a question of the sustainability of public debt. The sustainability of debt depends on the debt and deficit levels and on future growth and future interest rates. However, debt sustainability is also a question of market confidence in the stability of European Monetary Union (EMU) and the stability of the country in question.

The second central issue is how strong the country's post-programme prospects look. While exit might look feasible at the time the decision is made, global shocks or country-specific setbacks might subsequently derail market access. A country's prospects will thus depend on an assessment of the likelihood of different shocks occurring and on an accurate assessment of the country's strengths and weaknesses.

1. Spain also entered a financial assistance programme in summer 2012, which was specifically aimed at supporting the recapitalisation of financial institutions. Since this is a special assistance programme, we do not cover it. See: http://ec.europa.eu/economy_finance/assistance_eu_ms/spain/index_en.htm.

Finally, and perhaps most importantly, higher economic growth and greater job creation will be of central importance for the success of the country and its citizens. Far-reaching domestic reforms are necessary and many deep structural failings, which have driven a country into financial assistance, have been only partially addressed in the course of the programme.

This Policy Contribution assesses the risks for Ireland, Portugal and Greece of exit from financial assistance programmes. Beyond domestic reform, what can be done to improve growth prospects? What support should a country receive after exiting a financial assistance programme, and under what conditions? The actual practice of long-term surveillance and post-programme support are major issues that will determine both the political acceptance of surveillance and the effectiveness of the implementation of reforms.

EUROPEAN POLICY OPTIONS AND THE EU FRAMEWORK

Greece, Ireland and Portugal will continue to have close relationships with their European creditors for a long time post-programme, given that the average maturities of official EU loans are in excess of 20 years.

The exact nature of the relationship between creditors and debtor EU countries is laid down in EU rules but depends on which of the three options (clean exit, new programme or precautionary credit line) is chosen at the end of the relevant programme. But what is clear is that, for all countries, the priority for a long period will be to keep public finances in check and increase growth potential to ensure debt sustainability.

Countries, like Ireland, choosing a clean exit, enter into post-programme surveillance (PPS)², which stays in force until 75 percent of the outstanding European Financial Stability Facility/European Financial Stabilisation Mechanism/European Stability Mechanism (EFSF/EFSM/ESM) loans have

been repaid. The European Commission expects the PPS of Ireland to last until 2031, given the current repayment schedule³. PPS is integrated with European surveillance but goes beyond it, with more frequent missions. Similar surveillance mechanisms have been implemented for non-euro area EU countries that have left financial assistance. Their experience suggests that the surveillance is somewhat tighter than standard European surveillance in the European Semester, but that, de facto, there is only limited leverage over national policy.

Instead of a clean exit, countries can opt to exit financial assistance programmes with a precautionary arrangement from the European Stability Mechanism (ESM), which might be provided via a Precautionary Conditioned Credit Line (PCCL) or via an Enhanced Conditions Credit Line (ECCL). Countries need to fulfil more conditions to be eligible for a PCCL than for an ECCL, in exchange for which fewer conditions are imposed on PCCL than on ECCL beneficiaries⁴. A precautionary facility could be a powerful way of making exit from a programme more robust. When a country has regained market access, it might be tempted to ask for a clean exit. However, if debt levels are high and significant negative shocks cannot be excluded, the precautionary credit line allows the country to issue debt safely. In case of a shock, the country could draw on the ESM credit line without having to undergo a full new application for a new financial assistance programme. Precautionary support could be perceived well by markets, leading to lower borrowing costs and thereby improved post-exit prospects. Furthermore, an ECCL (but not the PCCL) might qualify the country for the European Central Bank's Outright Monetary Transactions (OMT), which could further boost market confidence. However, the ECB has said that it will decide on OMT purchases case-by-case.

Although Portugal, Greece and Cyprus might meet some of the criteria for a PCCL when they plan their programme exits, they are unlikely to meet all. Nonetheless, they could still obtain precautionary

2. PPS mirrors the International Monetary Fund's Post-Programme Monitoring, laid down in IMF Decision 13454-(05/26). For euro-area countries, the details of PPS are set out in Article 14 of Regulation 472/2013 on the strengthening of economic and budgetary surveillance. PPS entails specific reporting requirements, which can be extended on a case-to-case basis in the country-specific Memorandum of Understanding of a programme. Moreover, the member state under PPS will be subject to regular Commission review missions, in liaison with the European Central Bank. These report to the Economic and Financial Committee, the European Parliament and the relevant national parliament. The Eurogroup, on the basis of a Commission proposal, can recommend that the member state under PPS adopts corrective measures. For information on IMF procedures, see <http://www.imf.org/external/np/exr/facts/ppm.htm>.

3. See page 40 of European Commission (2013c).

4. The criteria for judging whether an ESM country is eligible for a PCCL are: (a) that it respects the commitments under the stability and growth pact; (b) a sustainable general government debt; (c) that it respects the commitments under the excessive imbalance procedure (EIP); (d) a track record of access to international capital markets on reasonable terms; (e) a sustainable external position; and (f) the absence of bank solvency problems that would pose systemic threats to the stability of the euro-area banking system.

'Greece, Ireland and Portugal will continue to have close relationships with their European creditors for a long time post-programme, given that the average maturities of official EU loans are in excess of 20 years.'

financial assistance through an ECCL, which only requires that the country's general economic and financial situation remains sound.

Countries granted an ECCL are subject to enhanced surveillance by the European Commission while the credit line is available. Such surveillance is less intrusive than under a regular (as opposed to a precautionary) assistance programme, but more intrusive than standard post-programme surveillance of countries exiting EFSM, ESM or EFSF programmes. Exit with a precautionary programme would thus both smooth the path back to market access and would help ensure that the reform process triggered by the Troika will continue to be implemented, and domestic structural reforms to boost growth will be carried out. This is the reason why countries that receive an ECCL are eligible for an ECB OMT programme, which would give them an additional safety net.

In common with all euro-area countries, fiscal rules also apply to countries exiting financial assistance programmes, whether they do so fully or with a precautionary credit line. In addition to the Six-pack and Two-pack rules that relate to the Excessive Deficit Procedure (EDP) of the EU Treaty, euro-area countries are also subject to the Fiscal Compact enshrined in the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)⁵.

The Six-pack introduced a debt rule that requires high-debt countries to reduce their debt in excess of 60 percent of GDP at an average rate of at least 5 percent per year. For example, if the debt-to-GDP ratio is 120 percent in a year, then the rule should result in a debt level of 111 percent three years later. For countries in an EDP, the debt rule only kicks in three years after the EDP is ended. For example, Ireland and Portugal would only be obliged to comply with the debt rule in 2019, if they comply with their commitment and correct their excessive deficit in 2015, which would result in the EDP being dropped in 2016.

Debt sustainability requires not only fiscal adjustment but also measures to foster growth. The capacity of programme countries to continue undertaking growth-enhancing measures after

programme exit will be crucial, because it would be an illusion to assume that countries have been able to address all their long-standing structural problems during the three-year period of the programme. Many of the problems, such as inefficient state sectors, that resulted in low productivity growth before the crisis in some of the programme countries will take years to correct. Surveillance, including by the EU, can play an important role by pointing to the necessary reforms and encouraging and influencing national discussions. The weakest level of surveillance is the post-programme surveillance, while under a precautionary credit line, surveillance would be more intrusive, and a new programme would come with a full set of conditions.

Beyond surveillance, there are also 'task forces' for Greece and Portugal. These aim to provide technical assistance for the implementation of reforms in combination with EU support mechanisms such as Structural Funds. The Greek task force also provides support to the national anti-corruption strategy and the sound functioning of tax administration and government reform⁶. Such forms of technical assistance could be available also after programme exit, and could be combined with assistance from the EU budget and the European Investment Bank.

COUNTRY ANALYSES

When they lost affordable market access and in the face of sizable bond repayments, the governments of the four countries were forced to make formal requests to the IMF and to European authorities for financial assistance. All four programmes cover three separate areas with different emphases according to the country: (1) deficit reduction and structural fiscal reform; (2) financial sector reform; and (3) structural and competitiveness reform. Substantial financial assistance has already been granted (€215 billion to Greece, €70.6 billion to Portugal and €66.7 billion to Ireland).

The four countries have a number of fragilities that make exit and post-exit challenging: (a) high public debt levels; (b) high private debt levels; (c) high external debts; (d) socio-political issues linked to high unemployment and inequitable

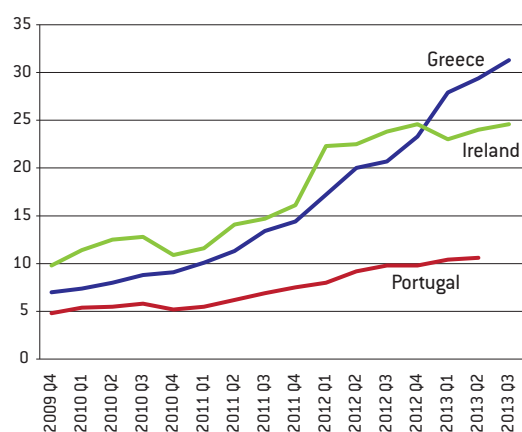
5. See http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

6. The last task force report on Greece: http://ec.europa.eu/commission_2010-2014/president/pdf/qf5_en.pdf.

income and tax-burden distribution, which imply that the public debt burden is not equitably distributed. In each of these areas, the situation has significantly deteriorated since the end of the unsustainable booms (see Table 1). The deterioration is a result of a combination of a collapse in GDP levels and the continued accumulation of new liabilities, now mostly from the government sector. Financial sector reform has progressed yet non-performing loans in all countries have increased and are now at record highs, foreshadowing further potential stress (Figure 1).

However, much has been achieved. The countries have reduced deficits to more sustainable levels, current-account deficits have been corrected, the public sector has in some cases been reformed and structural reforms have been implemented. Consequently, the return to markets might be more feasible now, notwithstanding questions about debt sustainability.

Figure 1: Non-performing loans to total gross loans in Greece, Ireland and Portugal



Source: Bruegel based on IMF Financial Soundness Indicators.

We perform a debt sustainability analysis to identify which countries face the greatest challenges, and what measures would help deal with them. Box 1 details the key assumptions. In addition to a baseline scenario, we simulated the sensitivity of the public debt-to-GDP ratio trajectory to four adverse scenarios, singly and in combination: (1) GDP growth is 1 percentage point slower than in the baseline scenario in each year from 2014-30; (2) the primary surplus is 1 percentage point of GDP lower than in the baseline scenario in each year from 2014-30; (3) interest rates for the floating-rate liabilities are 100 basis points greater than in the baseline scenario in each year from 2014-30; (4) at the end of 2014, governments have to provide an additional 5 percent of GDP for bank recapitalisation (which would amount to between €8-€9 billion in the three countries); (5) these four adverse scenarios in combination.

Ireland

Ireland was the first euro-area country to leave a financial assistance programme and has been under post-programme surveillance since January 2014⁷. The key aim of the programme, namely a return to the market, has been achieved. Figure 2 shows the results of our debt sustainability analysis for Ireland. It highlights that in the baseline scenario, debt-to-GDP levels will fall to 80 percent of GDP by 2030, while in the four adverse scenarios, the debt ratio would still fall well below 100 percent by 2030. However, when we combine a number of negative shocks, the debt to GDP level would stabilise and increase slightly by 2030.

Considering the Six-pack's debt-reduction rule, the baseline scenario will comfortably satisfy the

Table 1: Main macroeconomic indicators, 2009 and 2013 (% of GDP), Greece, Ireland and Portugal

| | Greece | | Ireland | | Portugal | |
|--|--------|--------|---------|--------|----------|--------|
| | 2009 | 2013* | 2009 | 2013* | 2009 | 2013* |
| General government gross debt | 129.7 | 176.2 | 64.4 | 124.4 | 83.7 | 127.8 |
| Net international investment position (NIIP) | -89.6 | -108.8 | -92.4 | -112.0 | -110.3 | -115.4 |
| Private debt | 122.5 | 129.1 | 309.2 | 331.8 | 250.7 | 254.6 |
| General government balance** | -15.4 | -4.9 | -11.7 | -7.2 | -9.9 | -5.8 |
| Current account balance | -14.4 | -2.3 | -2.3 | 4.1 | -10.8 | 0.9 |
| Unemployment rate | 9.5 | 27.0 | 12.0 | 13.3 | 10.6 | 17.4 |
| Ease of doing business ranking | 96 | 72 | 7 | 15 | 48 | 31 |

Source: Bruegel based on Eurostat, AMECO, World Bank. Note: * Figures only up to 2012 for NIIP and private debt. ** Cleaned of the impact of one-time items. Unemployment rate is in percent of labour force; Ease of doing business rank is among 181 countries in 2009 and 189 countries in 2013.

7. On 14 November 2013, the Eurogroup concluded that the Irish economic adjustment programme had been successful and that Ireland would be able to exit. Statement by the Eurogroup on Ireland, November 14 2013.

http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/1395

8. For Greece, the Commission expects €21 billion privatisation revenue between 2014-20. The stock-flow adjustment is sizable in all three countries from 2014-17: -6.4 percent of GDP for Greece, -7.1 percent of GDP for Ireland and -4.5 percent of GDP for Portugal. For Ireland, most of this adjustment is due to the expected reduction of the government's cash balances from 13 percent of GDP to 6 percent of GDP.

9. Consensus Economics (2014).

10. Some of the loans are indexed to the three-month EURIBOR, which is expected to increase from its current 0.3 percent per year value to 2.7 percent by 2019. For 2020-30, we linked EURIBOR to the expected short term German yields. The new Irish government bonds, which replaced the earlier Promissory Notes, are linked to the six-month EURIBOR, while the bilateral loan from the United Kingdom to Ireland is linked to UK borrowing costs. We will report full details about our assumptions in a forthcoming Bruegel working paper.

BOX 1: DEBT SUSTAINABILITY ANALYSIS

We take the European Commission's November 2013 forecast for 2013 as the starting point for the main economic indicators, and use the IMF's October 2013 forecast for the primary balance and nominal GDP growth for 2014-18 (the Commission's forecast runs only until 2015). We consider the privatisation schedule reported in the Commission's country reports and also the so-called stock-flow adjustment of debt⁸.

For the longer term, it is difficult to set baseline scenarios for growth and primary balance. For Greece, the Commission expects a 4.0 percent of GDP persistent primary surplus during the 2020s and 3.9 percent nominal GDP growth. For Portugal, the Commission's baseline is 2.6 percent primary surplus and growth between 3.5 and 4.0 percent. For Ireland, the expected primary surplus is 4.6 percent of GDP in 2020, but we have no information on the Commission's longer-term expectations.

Such differences in assumptions make it difficult to compare the debt trajectories for the three countries. For example, Portugal might have a higher than a 2.6 percent primary surplus should debt sustainability be in danger, and for Ireland it might prove difficult to sustain a 4.6 percent primary surplus throughout the 2020s. We therefore chose to assume the same long-run values for all three countries.

There are few examples of advanced countries (except oil-rich Norway) being able to sustain high levels of primary surpluses over long periods of time. As Abbas *et al* (2013) show, the average primary surplus for successful consolidations in advanced economies is 3.1 percent of GDP. We therefore assume that the three countries will gradually converge to this level by 2022, starting from the 2018 IMF forecast primary surplus, and will remain at 3.1 percent until 2030.

Similarly, it is difficult to forecast GDP growth for the 2020s. Market-based forecasts for the euro area suggest 3.1 percent per year growth for 2022-26, according to Consensus Economics⁹. For Spain, the figure is 3.7 percent per year, but unfortunately Consensus forecasts are not available for Greece, Ireland and Portugal. Given their structural weaknesses, it is difficult to see how the three countries would be able to achieve much faster growth than the rest of the euro area in the long term, after the current negative output gaps have been corrected. Therefore, and for simplicity, we assumed that, taking the IMF's forecast for 2018 as the starting point, annual growth in these countries will gradually converge to 3.7 (ie the Consensus Economics forecasts for Spanish growth) by 2022 and will remain at this level throughout the 2020s.

As for interest rates, we track the various liabilities of the three countries. We linked the interest rate of floating-rate liabilities to the 6-year German Bund yield, which is expected to increase from its 0.8 percent value in February 2014 to 2.8 percent in 2020 and 3.3 percent in 2030. The EFSF spread over the Bund is about 40 basis points, and we assumed this will remain the case. For newly issued debt, we assumed the following spreads over the Bund: 100 basis points in Ireland (2014 onwards), 150 basis points for Portugal (to be reached by 2015) and 200 basis points for Greece (to be reached by 2022)¹⁰.

For Greece, the 27 November 2012 agreement included the deferral of interest payments of most EFSF loans by 10 years, in order to reduce the funding needs during this period. But the deferred interest has to be paid back and therefore it does not constitute a debt reduction. Therefore we do not consider the interest deferral in our simulations.

requirement and instead of our 3.1 percent of GDP long-run primary surplus assumption (Box 1), a 2.2 percent primary surplus (and an even lower surplus later) would be sufficient during 2020-25 to meet the debt rule. But if the primary surplus has to react to the combination of the other three adverse scenarios (lower growth, higher interest

rates and additional bank recapitalisation), then a 4.9 percent of GDP primary surplus would be needed on average in 2020-25 to achieve the debt-reduction rule. This would be challenging. Ireland previously (from 1988-2000) had a 4.6 percent of GDP average primary surplus, but during that time, the primary surplus was supported by

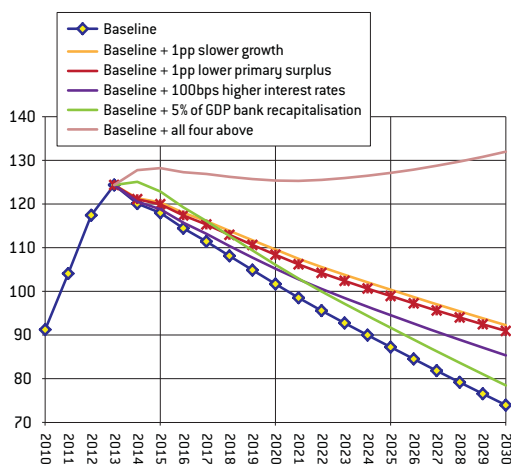
7.0 percent per year real (and 10.8 percent nominal) growth.

To achieve debt sustainability and enable a return to the markets, it was important to improve the terms of financial assistance in favour of the Irish (and also the Portuguese) government. The lending rate margins on the EFSM and EFSF loans were eliminated and the average maturity extended from 7.5 to 12.5 years in 2011 and again to 19.5 years in 2013. In addition, Ireland does not have to repay any EFSM/EFSF principal before 2026, leading to a smaller borrowing need from markets. These measures facilitate market access and reduce the burden on taxpayers.

A second important factor in re-establishing market access was the tremendous success in the export sector. The flexibility of the Irish economy allowed for a relatively quick adaptation of the country to the different circumstances. It also meant the impact of the fiscal adjustment on the economy was reduced. Recent employment figures are encouraging.

A cash buffer of €20 billion was deemed sufficient to guarantee the robustness of programme exit as it would cover the estimated financing needs for about one year. Yet, the robustness of the exit is not guaranteed. The most significant risks relate to the financial sector and the global economic recovery. Ireland's good external performance depends on economic growth in its most important trading partners. There are now increasing

Figure 2: Irish public debt ratio scenarios (% GDP)



Source: Bruegel. Note: see Box 1 for main assumptions.

doubts about the robustness of the global recovery, including in emerging economies, in the euro area and even the US. The financial sector could be further hit by non-performing loans, which have been increasing almost steadily since 2010¹¹. Cleaning these loans out of the banking system will be a central task for the new EU Single Supervisory Mechanism¹². Changes in the personal insolvency law and institutional changes in the mortgage markets are ongoing, which will hopefully address the non-performing loan problem. However, perhaps too much hope has been put in bank profits to achieve the recapitalisation of banks¹³. Therefore, the planned reduction of the cash buffer by more than one half, which is the major factor behind the expectation of a debt ratio fall in 2014, could weaken the positive market sentiment towards Ireland, and therefore we suggest instead to keep the cash buffer and borrow at the present favourable rates.

Overall, we conclude that Ireland successfully exited the programme but that the exit is not completely robust. The adjustment left behind major social problems¹⁴. A central post-exit objective is to finish the clean-up and the recapitalisation of the financial system, a task in which the new common supervisor will play a central role. The medium-term debt dynamics look quite benign even under an adverse scenario.

Portugal

Despite a number of political difficulties, Portugal has implemented the Troika's budgetary recommendations. Its deficit will not return below 3 percent of GDP in 2013 as originally foreseen by the programme, nor will it in 2014, but it is on track to do so in 2015. The debt-to-GDP ratio may have peaked on schedule in 2013, but by that time it was 13 points higher than initially foreseen. The main reason for this slippage is Portugal's continued growth under-performance, which is also the main reason why unemployment has reached nearly 18 percent, well above programme expectation. Nevertheless, markets remain well disposed towards Portugal. In January 2014, Portugal successfully issued €3.25 billion of 5-year debt at a 4.657 percent yield, and 10-year bond yields in secondary markets are now around 5 percent, though still 175 basis points above Ireland.

11. Although the European Commission reports that data on the last quarters of 2013 shows a stabilisation of non-performing loans, they remain at very high levels: European Commission (2013c).

12. If weak balance sheets lead to an evergreening of loans and a zombification of the banking system, then the recovery will prove illusory (Merler and Wolff, 2013).

13. The Commission (2013c, p 29) argues that a "return to profitability is essential for banks to meet their future capital thresholds..."

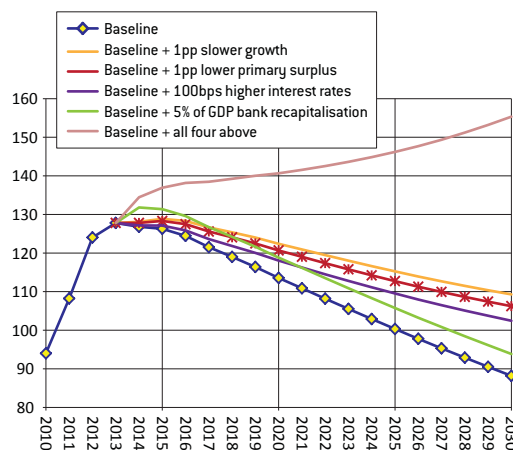
14. For example, the share of children aged 0-17 living in jobless households was the highest in Ireland among EU countries in 2012.

There are three reasons for positive market sentiment towards Portugal. First, there is increased market confidence in the stability of the euro area in general and in programme countries in particular. Second, there has been throughout the programme a high degree of mutual understanding and close cooperation between the Portuguese authorities, the Troika and institutional market participants. Third, and because of the trust that Portugal has managed to build, market participants believe that Portugal will receive all the necessary support to be able to exit the programme on schedule in May 2014.

Despite this positive sentiment, based on our analysis (Figure 3), it would be unwise for Portugal, and for the euro area, if Portugal were to exit the programme in June 2014 without having secured precautionary financial assistance from the ESM via its enhanced conditions credit line (ECCL) facility. This view should not be taken as a negative judgement on what Portugal has achieved since the start of the programme. It has corrected major macroeconomic imbalances. But it continues to suffer from long-standing structural weaknesses that were already evident when the country adopted the euro and that should have been corrected during the benign years that preceded the crisis. For this reason, the Portuguese economy will remain weak and vulnerable to potential shocks for some time to come¹⁵.

Portugal's predicament can be judged by comparing the situation expected by the Troika for 2014-

Figure 3: Portuguese public debt ratio scenarios (% GDP)



Source: Bruegel. Note: see Box 1 for main assumptions.

15 and the situation before the crisis, when according to Blanchard (2007) "Portugal faced an unusually tough economic challenge: low growth, low productivity growth, high unemployment, large fiscal and current account deficits". Although the current-account deficit will be much lower and public deficit will also be somewhat lower than before the crisis, unemployment and public debt will be about double what they were pre-crisis. Debt and social sustainability will be central and sustainability depends on growth. The problem that Portugal faces is that it needs to change its pre-crisis growth model, which produced stagnation after the country joined the euro. Such change takes time. But without it, the combination of high debt, high nominal interest rates and low nominal GDP growth would render the debt unsustainable. Major weaknesses of the Portuguese economy are the low degree of competition in non-traded activities, the very small size of firms and the difficulty in obtaining financing. The Troika programme's structural reform agenda aimed precisely to boost competitiveness and redirect economic activity from non-traded to traded activities. However, these measures take time to implement and will need to continue after exit.

Based on this analysis, we believe Portugal and its euro-area partners should be cautious when the issue of exiting the Troika programme is on the ECOFIN Council's April 2014 agenda, one month before the programme expires. All parties might be tempted by a clean exit in order to claim political success, but the economy's continued structural weakness makes it desirable that the exit be accompanied by a precautionary programme and related enhanced surveillance, which could help Portugal as it continues to pursue a deep structural reform process that will be necessary for many years. A further reason for caution is that Portugal has no history of maintaining high primary surpluses over extended periods. In addition, creditor countries should offer Portugal even longer maturities on EFSF/ESM loans to reduce its future debt burden.

Greece

Greece faced an extraordinarily difficult situation when it entered a financial assistance programme in May 2010. Its debt and deficit problems and its

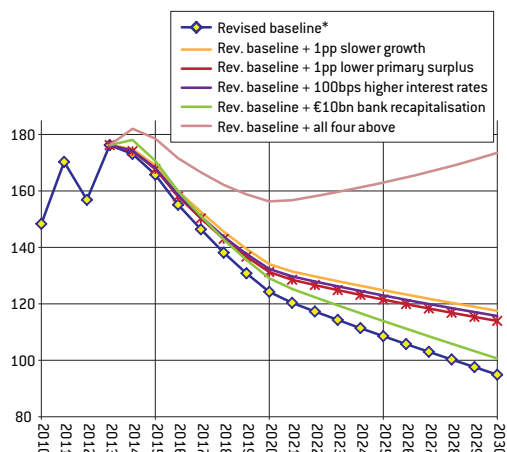
15. We note that in our baseline scenario, Portugal will just meet the debt reduction rule in the early 2020s. Note however that our 3.1 percent of GDP long-term primary surplus baseline is higher than the European Commission (2013b) assumption. Should the primary surplus need to react to the combination of the other three adverse scenarios (lower growth, higher interest rates and additional bank recapitalisation), then a 6.1 percent of GDP primary surplus would be needed on average in 2020-2025. This will probably not be achievable.

serious external imbalances were significant. Greece underwent a significant adjustment of both its current account and its public deficit, yet in the process, GDP fell very significantly and unemployment increased very substantially. It is difficult to envisage an exit from financial assistance at the end of the current programme.

Greek public debt cannot be financed under the current programme assumptions. As highlighted in the media, there is a short-term financing gap in the next few years amounting to about €12 billion. For this reason, the possibility of a third programme has been raised along with extending the maturity of the Greek loan facility to 50 years and reducing its spread over the three-month EURIBOR to zero. In our scenarios we have already taken into account this maturity extension and spread reduction, and we also take into account a further extension of EFSF loans to Greece so that Greece does not have to repay any principal to European lenders until 2030. To indicate a change in the current financing conditions, we talk about a 'revised baseline' instead of 'baseline' as we did in the cases of Ireland and Portugal.

According to this revised baseline scenario, Greek public debt will be reduced to 124 percent of GDP by 2020, 120 percent by 2021 and 95 percent by 2030. By 2030, Greece would need to accumulate €74 billion of newly issued debt, partly to pay back maturing debt to the IMF, the ECB, national central banks and private creditors.

Figure 4: Greek public debt ratio scenarios (% GDP)



Source: Bruegel. Note: see Box 1 for main assumptions. * Revised baseline with extended maturity of bilateral loans with zero lending spread.

If borrowing such an amount at a rate of 200 basis points above the Bund (as we assumed, Box 1) is feasible is an open issue. But what is even more important is that there is a more fundamental problem with the financing of the debt: the baseline debt trajectory is exposed to risks, which can easily jeopardise a more significant reduction in the debt ratio and may even put it on an escalating path (Figure 4). Such risks make it difficult to imagine how Greece can borrow at an affordable rate from the market after the expiry of the second financial assistance programme in late 2014.

Scenario (4) would push up the level of debt by 5 percentage points of GDP in 2014 (and slightly more in later years due to interest payments on this new debt), while the first three scenarios each would lead to an approximately 120 percent of GDP debt ratio by 2030, with accumulated new market borrowing at about €145 billion. Under the four scenarios in combination, it would not be possible to stabilise even the debt ratio after 2020, when nominal GDP growth rate is assumed to slow down and the primary surplus is reduced. In this combined scenario, the debt ratio is expected to climb back above 170 percent of GDP by 2030 with an accumulated stock of new private borrowing of €253 billion. One can say with great confidence that markets would not lend to Greece with a 200 basis points spread over the Bund (our maintained assumption) in such a scenario.

Therefore, while the revised baseline scenario could lead to a major reduction of debt, it would be very sensitive to adverse shocks. The uncertainty concerning the financing of public debt would have a negative impact on the economy and would likely hinder investment.

The preferred option would be to take Greece out of the market until 2030 under a third programme, and develop a contingency plan in case the debt trajectory worsens beyond the control of the government. Such a plan should consist of:

- 1 Greece should be required to reach a balanced budget by 2018 and to avoid any subsequent deficit. According to our calculations, if the primary-surplus plans and the full amount of €21 billion privatisation revenue during 2014-20 are realised, this would necessitate a primary

16. The New Greek bonds, which resulted from the March 2012 debt restructuring, are safeguarded by a cofinancing clause with the EFSF, ie any Greek government debt service arrears have to be distributed *pro rata* by the New Greek bonds and the service of the EFSF loans which were granted to finance the PSI Payment Notes and Accrued Interest Notes. See Zettelmeyer *et al* (2013).

17. Darvas (2012) also proposed zero-interest lending, but not conditionally, and he also proposed indexing the notional amount of all official loans to Greek GDP, which would help to avoid a rise in the debt ratio if GDP disappoints, but would also benefit European lenders if growth turns out to be faster than expected. Such an indexing continues make sense, but there does not seem to be political support for it.

18. The recent plan of Páris and Wyplosz (2014), which would involve borrowing from the market €4.5 trillion, acquiring at face value a large share of existing public debts of all euro-area countries in a neutral country-composition, and swapping them into zero-interest perpetuities whereby the losses made on these operations (borrowing has a cost, while zero interest is earned) would be financed by ECB losses and future profits, would likely reach resistance, because several policymakers would view these operations as quasi-fiscal operations contaminating the balance sheet of the ECB.

surplus of about 4 percent of GDP from 2022 onwards. Under this scenario, the Greek budget would reach an overall surplus of about half a percent of GDP by 2030.

- 2 In such a scenario, a third financial assistance programme amounting to about €40 billion up to 2030 would fill the financing gap, ie Greece would not need to borrow from the market. Maintaining the 4 percent primary surplus would not necessitate borrowing in the 2030s either, since the overall budget surplus would increase and would cover the maturing private debt.
- 3 European partners should help Greece (and also other periphery countries) with much more forceful programmes for supporting economic growth. In particular, much greater European investment in Greece should help kick-start growth. In the near term, the European Investment Bank (EIB) seems to be the best institution to carry out such an investment programme, since the EIB has the expertise to invest. Therefore, much more capital should be provided to the EIB beyond the €10 billion agreed at the 29 June 2012 European Council. The internal procedures of the EIB should be revived to allow faster deployment of investment.
- 4 Even if Greece fulfils its fiscal adjustment, privatisation and structural reform commitments, and Greek growth is supported from Europe, the debt trajectory is subject to shocks and therefore a contingency plan is needed. Requiring a steady-state primary surplus much in excess of 4 percent is not realistic. Since the share of remaining private sector creditors in Greek public debt is very low and creditors are safeguarded by strong legal provisions¹⁶, only certain forms of official sector involvement (OSI) would remain. We propose that if Greece fulfils its commitments, but there is a sizable deviation from the baseline debt ratio reduction, interest payments to European lenders should be forgiven to the extent necessary to return the debt ratio to the baseline¹⁷.

According to our calculations, forgiving interest payments on loans from European lenders would provide sufficient room for manoeuvre even under

sizable adverse shocks. In our view, such an approach would be the least unacceptable to European lenders. An outright debt reduction would face major resistance from lenders and its necessity is unclear at the moment, since in our revised baseline the debt ratio declines steadily and with a third programme Greece could be taken out of the market until 2030 and beyond. A retrospective bank recapitalisation by the ESM (whereby the ESM would purchase banks shares from the Greek government, which would use the money to pay back loans), would face similar resistance¹⁸.

At the same time, an announced European support plan underpinning a mutually agreed debt reduction ratio, along with the lack of any need for market-based funding and a major European investment programme in Greece, would help to alleviate the negative impact on economic performance of Greece's still high public debt. European lenders would maintain their leverage over Greece, since any decision on interest forgiveness would be made when needed, ie when there is significant negative deviation from the baseline. In addition the continuous presence of the Troika would keep up the momentum for reform.

Certainly, this plan would be subject to moral hazard, but we think the moral hazard involved would be less than for other debt reduction options. Greece might not meet its commitments, either deliberately or unintentionally, and may count on European support to forgive interest payments. Other OSI options would result in one-time and much larger debt relief, and European leverage over Greece would be reduced compared to our proposal. And if Greece does not comply with its commitments and the European partners do not yield, the alternative is a possibly messy default and exit from the euro area, which would be particularly painful for Greece, even if it would have also negative impacts for the euro area.

OVERALL CONCLUSIONS AND RECOMMENDATIONS

To conclude, Ireland, Portugal and Greece continue to be vulnerable to sovereign debt problems because of their high debt levels, though to different extents. In particular, we have shown that under the IMF growth and primary balance projections up to 2018, and longer-term assumptions

based on historical experience with the primary balance and Consensus Economics forecasts on growth, the public debt ratio is set to decline in all three countries. However, the debt trajectory is vulnerable to negative growth, primary balance and interest rate shocks – though we do not examine extremely negative scenarios – especially in Greece and Portugal, though also in Ireland. In all three countries, annual monitoring of the debt-to-GDP ratios and projections is therefore necessary.

In the case of Greece, we propose a four-point plan: Greece will need to reach a balanced budget by 2018. Since a return to markets will likely prove impossible, a third financial assistance programme amounting to about €40 billion up to 2030 would fill the financing gap, ie Greece would not need to borrow from the market at all. Such a baseline would include further lengthening of European lending to Greece and the reduction of the interest rate spread to zero on the Greek Loan Facility. Greece could be taken out from the market until 2030 and even beyond by such a third programme amounting if the primary surplus and privatisation targets are reached. Continued effort is needed to increase Greek growth. Continued surveillance will be beneficial to foster change and could also be a positive signal to investors. Further measures to kick start growth will be necessary and should include additional funding for investment. New ideas – such as introducing a competition among regions on good governance to access funds – should be explored. Further measures to enhance competition should be pursued¹⁹.

Greece's debt trajectory would still be vulnerable to negative shocks, in which case debt dynamics would derail. In such a case, the funding gap could only be closed by reducing interest rates below funding costs or touching the principal. The Eurogroup should announce its readiness to reduce EFSF/ESM lending rates to zero if there is a significant deviation from the baseline scenario, provided the country implements the required reforms and achieves the required primary budget surplus. Announcing such readiness is crucial. Otherwise the risk is that high public debt will continue to undermine investment. What should be

borne in mind, however, is that zero lending rates go against EFSF/ESM rules, which would need to be modified. In addition, obviously, EFSF/ESM shareholders would have to pick up the tab to make up for the difference between lending rates and borrowing costs.

For Portugal, a clean exit in May 2014 is not advisable. Instead, a precautionary credit line would help to make the exit more sustainable and robust while at the same time keeping up the momentum for economic reform through stronger surveillance. Such an exit represents a rational choice in the face of large re-financing needs, even after significant progress in the last three years. Yet, if a less optimistic scenario materialises, debt dynamics could become unsustainable. In such a case, appropriate measures such as debt restructuring would need to be put in place. There is also still room to lengthen maturities on EFSF/ESM loans to Portugal.

Ireland has already exited and the challenge will be to increase the resilience of its economy to new shocks. Recapitalising and restructuring the banking system will be a central part of this. We also would advise the maintenance of a significant cash buffer as an insurance against shocks. Overall, debt dynamics in Ireland look healthy, though combined negative shocks could reverse the debt-ratio reduction.

The euro-area periphery will continue to need support. Programme countries are in for a very long-term relationship with creditors under PPS. Defining PPS well will be the key to the political and economic success of exit. This should focus on triggering growth, and the EIB, the European Bank for Reconstruction and Development and the World Bank could play more prominent roles. But the euro-area periphery will also depend on the recovery of the euro area as a whole. Bringing inflation back to the target of two percent is of fundamental importance for the sustainability of debt for the countries exiting financial assistance programmes, as well as for Spain and Italy. Higher economic growth in the core euro-area countries will also be important, to different degrees, for the trade performance of periphery countries.

19. See OECD (2013).

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