



GREECE

AN UPDATE OF IMF STAFF'S PRELIMINARY PUBLIC DEBT SUSTAINABILITY ANALYSIS

July 14, 2015

Greece's public debt has become highly unsustainable. This is due to the easing of policies during the last year, with the recent deterioration in the domestic macroeconomic and financial environment because of the closure of the banking system adding significantly to the adverse dynamics. The financing need through end-2018 is now estimated at Euro 85 billion and debt is expected to peak at close to 200 percent of GDP in the next two years, provided that there is an early agreement on a program. Greece's debt can now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far.

This preliminary DSA has been circulated to, but neither discussed with nor approved by the IMF's Executive Board.

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Greece's public debt has become highly unsustainable. This is due to the easing of policies during the last year, with the recent deterioration in the domestic macroeconomic and financial environment because of the closure of the banking system adding significantly to the adverse dynamics. The financing need through end-2018 is now estimated at Euro 85 billion and debt is expected to peak at close to 200 percent of GDP in the next two years, provided that there is an early agreement on a program. Greece's debt can now only be made sustainable through debt relief measures that go far beyond what Europe has been willing to consider so far.

1. The IMF staff's most recent DSA was published less than two weeks ago (attached [here](#)). It noted that:

- (i) About a year ago, if program policies had been implemented as agreed, no further debt relief would have been needed to reach the targets under the November 2012 framework (debt of 124 percent of GDP by 2020 and "substantially below" 110 percent of GDP by 2022).
- (ii) But the significant shortfalls in program implementation during the last year led to a significant increase in the financing need—by more than Euro 60 billion—estimated only a few weeks ago. As a result, debt-to-GDP by 2022 was projected to increase from an estimate less than a year ago of about 105 percent to a revised estimate of 142 percent, significantly above the target of 110 percent of GDP. This would under the November 2012 agreement have implied significant additional measures to reduce the face-value of debt.
- (iii) However, as detailed in the published DSA—in view of the fact that most of the debt was now owed to official European creditors on non-market terms—a case could be made for changing from the stock-of-debt framework agreed in November 2012 to a framework focused on the path of gross financing needs. This would support the conclusion that haircuts could be avoided if instead there was a significant further extension of the maturities of the entire stock of European debt (GLF, EFSF), in the form of a doubling of grace and repayment periods, with similarly concessional terms on new financing. At the core of this conclusion is the fundamental premise that public debt cannot be assumed to migrate back onto the balance sheet of the private sector at interest rates consistent with debt sustainability until debt is much lower. Greece cannot return to markets anytime soon at interest rates that it can afford from a medium-term perspective.

2. The events of the past two weeks—the closure of banks and imposition of capital controls—are extracting a heavy toll on the banking system and the economy, leading to a further significant deterioration in debt sustainability relative to what was projected in our recently published DSA. A full and comprehensive revision of this debt sustainability analysis can

only be done at a later stage, taking into account the deterioration in the economic situation as a result of the closing of the banking system and the details of policies yet to be agreed. However, it is already clear at this stage that there will be a significant increase in the financing need. The preliminary (mutually agreed) assessment of the three institutions is that total financing need through end-2018 will increase to Euro 85 billion, or some Euro 25 billion above what was projected in the IMF's published DSA only two weeks ago, largely on account of the estimated need for a larger banking sector backstop for Euro 25 billion. Adjusting our recent DSA mechanically for these changes, and taking into account the agreed weaker growth path for the next two years, gives rise to the following main revisions:

- a. Debt would peak at close to 200 percent of GDP in the next two years. This contrasts with earlier projections that the peak in debt—at 177 percent of GDP in 2014—is already behind us.
- b. By 2022, debt is now projected to be at 170 percent of GDP, compared to an estimate of 142 percent of GDP projected in our published DSA.
- c. Gross financing needs would rise to levels well above what they were at the last review (and above the 15 percent of GDP threshold deemed safe) and continue rising in the long term.

3. Moreover, these projections remain subject to considerable downside risk, suggesting that there could be a need for additional further exceptional financing from Member States with an attendant deterioration in the debt dynamics:

- (i) **Medium-term primary surplus target:** Greece is expected to maintain primary surpluses for the next several decades of 3.5 percent of GDP. Few countries have managed to do so. The reversal of key public sector reforms already in place—notably pension and civil service reforms—without yet any specification of alternative reforms raises concerns about Greece's ability to reach this target. Moreover, the failure to resist political pressures to ease the target that became evident as soon as the primary balance swung into surplus also raise doubts about the assumption that such targets can be sustained for prolonged periods. The Government and its European partners need to address these concerns in the coming months.
- (ii) **Growth:** Greece is still assumed to go from the lowest to among the highest productivity growth and labor force participation rates in the euro area, which will require very ambitious and steadfast reforms. For this to happen, the Government—which has put on hold key structural reforms—would need to specify strong and credible alternatives in the context of the forthcoming program discussions.
- (iii) **Bank support:** the proposed additional injection of large-scale support for the banking system would be the third such publicly funded rescue in the last 5 years.

Further capital injections could be needed in the future, absent a radical solution to the governance issues that are at the root of the problems of the Greek banking system. There are at this stage no concrete plans in this regard.

4. The dramatic deterioration in debt sustainability points to the need for debt relief on a scale that would need to go well beyond what has been under consideration to date—and what has been proposed by the ESM. There are several options. If Europe prefers to again provide debt relief through maturity extension, there would have to be a very dramatic extension with grace periods of, say, 30 years on the entire stock of European debt, including new assistance. This reflects the basic premise that debt cannot be assumed to migrate back onto the balance sheet of the private sector at interest rates close to the current AAA rates before debt levels have been brought to much lower levels; borrowing at anything but AAA rates in the near term will bring about an unsustainable debt dynamic for the next several decades. Other options include explicit annual transfers to the Greek budget or deep upfront haircuts. The choice between the various options is for Greece and its European partners to decide.