Economic Research Department

BBVA

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Stabilizing Greek debt requires sustained adjustment

Miguel Jiménez
mjimenezg@grupobbva.com

Agustín García Serrador
agustin.garcia@grupobbva.com
Elvira Prades

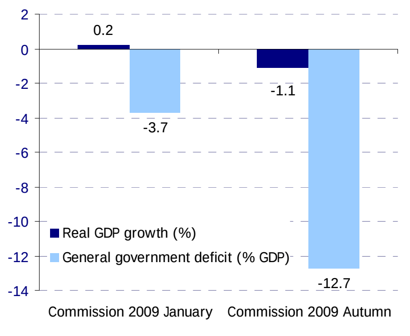
elvira.prades@grupobbva.com

- **Stabilizing Greek debt at 125% of GDP by 2015 would require sustained structural consolidation effort of almost 4pp per year**
- **Reaching the Maastricht 3% criterion by 2014 would require a softer effort, but still high (2.8pp per year). Debt ratios would jump to over 150%**
- **These results are not very sensitive to macroeconomic assumptions**

After the revision of public deficit figures for 2009 by the new government, sovereign debt spreads of Greek bonds have risen sharply, while the European Commission has launched an excessive deficit procedure and the main rating agencies have lowered their qualification of Greek public debt. Although the probability of default is small, a key issue for the months ahead is the sustainability of the public debt and the necessary fiscal adjustment to be made by the Greek government, which will weigh on the plan to be presented by Greek authorities to the EU institutions and on eventual further downgrading by rating agencies. This note examines recent measures announced by the authorities and presents some simulations on the deficit reduction path will need to be taken in order to stabilize debt.

The worsening of deficit figures for 2009 lies mostly on the re-evaluation of public accounts rather than on the worsening of the economic climate (graph). Although Greece weathered the crisis relatively better than its neighbours at the beginning of the downfall, recent figures show that the final fall in GDP (-3.7%) will be broadly in line with that of the Eurozone as a whole (-3.8%). However, this does not justify the revision in the deficit ratio of more than 11 pp in less than a year, which is mostly accounted for by the recalculation of deficit numbers published by the new government after the elections (from 6.7% of GDP to 12.7%). This revision could be partly explained by a typical reaction of charging past governments with bad numbers. However, given the magnitude of the revision and the Greek history in changing deficit and national account figures, the outlook seems to be clearly one of a deteriorated structural fiscal position, aggravated by the fact that the debt position of Greek was already very high. Indeed, other countries with high expected deficits in 2009 (Ireland, UK and, to a lower extent, Spain) had much lower debt levels before the crisis, and hence a larger room for manoeuvre, while the other country with a high debt level – Italy- has managed to limit the impact of the recession on its deficit and has not taken any fiscal stimulus measures.

Greece: Revised estimates of GDP growth and general government deficit



Source: Commission services, January 2009 update of the stability program

Measures announced

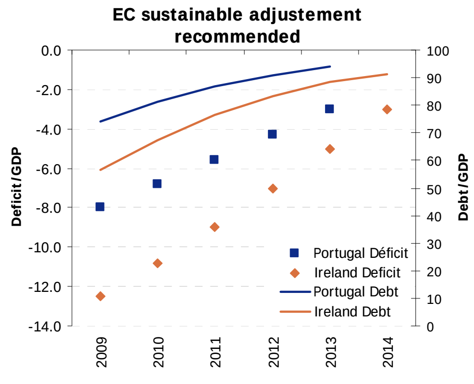
In this context, the Excessive Deficit Procedure initiated by the European Commission, together with the negative reaction of debt markets to the news and the downgrading of rating agencies of Greek sovereign debt (by two notches in the case of Fitch and Standard&Poors and one notch by Moody's have lead the government to announce a list of fiscal consolidation measures, ahead of the deadline of end-of-January set by the Commission.

The government intends to reduce the deficit in 2010 by 4pp, providing a list of measures which still have to be defined in more detail. The initial declarations of PM Mr Papandreu (where he insisted that much of the reduction was going to be achieved through the fight against tax evasion and efficiency gains) raised about the political will to tackle structural problems. The subsequent announcements provide more detail, in particular on a tax reform, which after consultation with professionals and social partners in December and January will be sent to parliament by February 2010. It is expected to lift revenues in 2010, but the full effect will only be in 2011, according to the press release published by the Ministry of Economy. The note provides also several comparative statistics across EU countries showing the extent of the tax evasion problem in Greece. The measures proposed are the following:

- Income tax: Suppression of autonomous systems of taxation and tax exemptions; joint imposition of all types of income together; treatment of distributed profits as personal income; introduction of a capital gains tax.
- Corporation tax: Consolidation and simplification of regulations; more preferential treatment for reinvested earnings; more effective transfer pricing system; obligation for professionals to maintain a bank account and access to it by the tax authorities.
- Tax administration and fraudulence: auditing system based on statistical sampling; large-scale introduction of "electronic tax services".

On the expenditure side, there will be a wage freeze for civil servants earning above 2000 € per month (but a raise for low earnings) and a reduction of special allowances of the pay bill, which are supposed to be a substantial share of wages. Public employment will be also restrained by substituting only 1 in 5 retired workers, although only as from 2011. Apart from this, there will be a range of micro-management measures in order to obtain efficiency gains and increase savings.

Other measures, like the 90% tax of bankers' bonuses and the suppression of bonuses in public corporations, are not likely to have any significant impact on deficit figures.



Source: BBVA ERD

Baseline Scenario (2009-2014)

Real GDP (% y/y)	1.0%
GDP Deflator (% y/y)	2.4%
Nominal interest rate	5.1%
Primary Balance (% GDP)	-3.1%
Public Balance (% GDP)	-9.7%

Soource: BBVA ERD

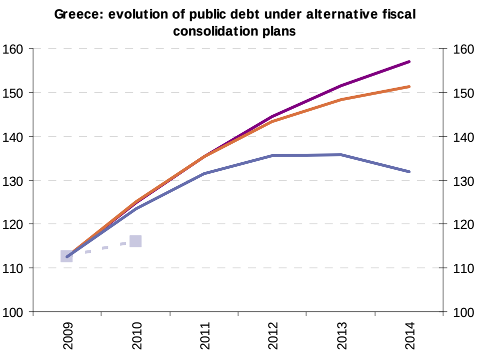
A strong fiscal consolidation process is need to stabilize debt

The deficit target for 2010 is so far 8.7% of GDP, a reduction of 4 points from the 12.7% announced for this year, which in terms of the structural primary deficit is equivalent, under our calculations to 5.5pp, a very large consolidation. This would translate into a debt ratio of close to 120% in 2010.

In order to assess the consolidation effort needed for Greece, we have carried out a simulation under three different cases:

1) First, when would the debt ratio stabilize if Greece implements a fiscal consolidation (structural primary surplus) of 2pp per year? This would be stronger than the one proposed by the EC for other countries; for instance, the EC requires annual adjustments of 1.25pp for Portugal and 1.75pp for Ireland until 2013/2014 (see graph). The answer is that public debt would continue to increase in coming years to stabilize around 160% of GDP by 2015.

2) Second, what should be done in order to comply with the 3% deficit criteria by 2014 (the same date provided to those countries with more serious fiscal problems). In this case, the structural primary deficit should fall by 2.8% per year, on average. This would stabilize debt levels at around 150% of GDP in 2015. rograms are likely to have important non-keynesian effects on activity of the same type of the Danish or Irish case in the late 80s/early 90s.



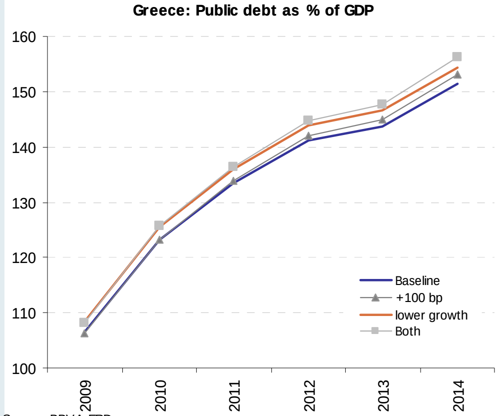
Source: BBVA ERD

3) Third, what should be done in order to stabilize the debt ratio at a level close to the one that will be prevalent in 2010, say 125% of GDP, by 2015? In this case, the annual adjustment should be of 3.8pp per year in structural terms.

The three simulations are carried out using our baseline scenario for growth, inflation and nominal interest rates, whose mean values are detailed in the table attached, and do not assume the eventual effect of such fiscal adjustment on GDP.

Sensitivity analysis

These results are not very sensitive to the growth and interest rate assumptions, as can be seen in the last graph attached, where case 2) is calculated under the case of higher nominal interest rates (100 basis points on average) or lower growth (1pp per year). The extra debt burden would not be much higher in either case, and when both are combined, the debt ratio would be 7 points higher by 214. The main reason for this result is the size of the deficit numbers, which dominates the effect of growth or debt service.



Source: BBVA ERD

Bottom line

These simulations show that the adjustment need to be serious in order to satisfy market fears and avoid further ratings cuts. Consolidation plans of 2 per cent per year (harder than that imposed to other countries would only stabilize the debt at very high levels. Complying with the 3% deficit criteria would require a difficult adjustment of almost 3 per cent per year until 2014, and even in that case the debt level would reach 150% of GDP. A much harder adjustment (almost 4% per year) is needed to stabilize the debt level at 125%.

The plan announced on a preliminary basis is even more ambitious than this latter case: 4% cuts in 2010 in the overall deficit, equivalent to 5.5pp in structural primary terms (i.e. to compensate also for the higher cyclical deficit and pay for the increased interest bill). But this plan needs 1) to be implemented and, in particular, 2) to be sustained in subsequent years, something which will be difficult to achieve. It is natural to announce tough measures for the first year in order to convince markets and analysts, but the real challenge will be to continue the effort once difficult measures have already been taken.