Implications of IMF and Commission views of debt sustainability

1. This note sets out the latest debt projections from the European Commission and the IMF. It explains the IMF's change to using Gross financing need as the key metric of Greek debt sustainability, and the Fund's proposal to make Greek debt "sustainable" by doubling the maturity of EU loans.

Updated IMF Debt projections

2. Prior to the breakdown of negotiations last week, the IMF produced a new preliminary debt sustainability analysis, providing forecasts for Greek debt out to 2060. The new IMF baseline includes a number of significant changes relative to the most recent programme review in June 2014:

- It uses the primary surplus targets used in recent proposals by both Greece and the creditors (1% in 2015, 2% in 2016, 3% in 2017, 3.5% thereafter).
- It incorporates near-term downside news to GDP, which is forecast to grow at -1.2% in 2015 and 2.8% in 2016, (previously 4.5%). However, these forecasts were made prior to Greece's implementation of capital controls on Monday, a clear near-term downside risk to growth.
- Of greater significance for long-term debt sustainability are downgrades to projections for Greece's long term growth rate. Fund staff have downgraded their long-term GDP forecast by 0.5pp to 1.5%, on the basis of Greece's poor demographics, weakening reform effort, and poor historic TFP performance. This substantially worsens long term debt dynamics. For example, there is a 10% downward revision to the level of nominal GDP in 2020, which pushes up on the debt-to-GDP ratio in 2020 by 15pp.
- It reflects lower expected interest payments on Greece's debt, as a result of declines in market interest rates that will be passed on to Greece's (floating rate) GLF and EFSF loans. Lower nominal interest rates push down on Greek debt by almost 9% by 2020. However, these savings are frontloaded, because market interest rates are assumed to return towards their 1999-2014 averages by the mid-2020s.
- Privatisation revenues have been revised down substantially (by 2022 this downward revision is worth €18bn). A significant part of that (around two-thirds) stems from an assumption that given the deterioration in the health of the Greek banking sector, previously assumed revenues from sale of banking shares will not materialise. The remaining is on this basis of previously disappointing revenues, and the current government's opposition to privatisation.

European institutions DSAs

3. The European Institutions have also produced an updated debt sustainability analysis, leaked to the media on Wednesday. This document contains three scenarios, set out in the table below, where the most adverse (scenario 3) corresponds to the IMF's baseline. All three use the same assumptions for primary surpluses, but they differ in their assumptions for growth, privatisation revenue and interest rates.

Table: Projections for the path of Government Debt-to-GDP

	2015	2016	2017	2018	2020	2022	2030
IMF 5th Review	171.0	160.5	152.0	144.6	127.7	117.2	n.a.
Commission Scenario A	175.1	172.1	163.4	153.7	137.1	125.4	85.0
Commission Scenario B	176.8	175.5	168.3	160.3	146.5	135.0	100.9
IMF June 15/Commission Scenario C	176.7	176.2	169.7	162.3	149.9	142.2	118.0

4. The Commission's Scenario B uses a similar nominal growth path to the IMF. However, privatisations revenue is close to the assumptions in the 5th programme review, which reduces debt by around 5pp by 2030. The remaining difference, around 11pp, comes from assuming a lower cost of borrowing when Greece regains market access. On top of this, Scenario A makes much smaller downgrades to the projections for nominal growth, which by itself reduces debt-to GDP by 10pp by 2030, as well as making even more favourable assumptions on privatisations and Greece's market borrowing costs.

Defining Debt sustainability

5. In previous analysis, both the IMF and the European Institutions have tended to focus on bringing debt-to-GDP below 120% within an agreed timeframe, previously 2020, in order to conclude that debt was sustainable. Downgrades to growth and primary surplus targets mean that this target no longer looks achievable without measures to reduce the face-value of Greek debt.

6. As has been highlighted elsewhere, the debt-to-GDP ratio has become less useful as a measure of the burden of Greece's debt, as it has been given increasingly concessionary terms in recent years. In general, lowering interest rates and extending maturities has only a small impact on the debt-to-GDP ratio in the short-term, but they can have a substantial impact in the longer term, as interest savings from concessionary funding costs cumulate.

7. On this basis, the IMF's latest DSA suggests focussing on Greece's annual gross financing need (GFN) as a more relevant benchmark for debt sustainability. The Fund's standard DSA framework uses a GFN of 15-20% as a benchmark, and Fund staff argue that the lower threshold (15%) is appropriate for Greece, given its "weak policy framework and easy loss of market access". However, while the near-term path for debt-to-GDP is de-emphasised in this approach, the long-run path of debt remains important, as it will ultimately need to be refinanced in the market.

8. In the IMF baseline outlined above, even an extension of (concessionary) official loans to cover new borrowing over the 2015-18 period would not be sufficient to put GFN on a sustainable path "with high probability"; GFN would rise above 15% of GDP per year by 2030. However, the path for GFN could be defined as sustainable (based on the IMF criteria) in the two more optimistic Commission scenarios.

IMF proposals for achieving a sustainable debt path

9. Since Greece does not meet the IMF's benchmark for sustainability under the baseline scenario, the document goes on to suggest methods of making debt sustainable. An additional €50bn of financing would need to be provided from 2015-2018 at highly concessionary terms (AAA interest rates, long maturities, and a long grace period before any amortisation). Further to this, significant falls in the long term path for debt-to-GDP (and the near-term path for GFN) could be achieved by doubling the maturity of existing EU loans to Greece to 40 years, and extending the grace period to 20 years[1]. This would allow the debt stock to fall further before needing to be replaced by more expensive market borrowing.

10. In the IMF baseline, the impact on debt-to-GDP would grow over time, from less than 5% in 2030 to 20% of GDP in 2050, and 30% of GDP by 2060. If we use a discount rate of 6 ¼%[2], the gain in 2060 is equivalent to a fall in the NPV of Greece's debt of €16bn, or 10% of 2015 GDP. At as lower discount rate of 5%, the gain is almost €30bn.

12. The IMF also note that if the medium-term primary surplus targets were cut below 3%, or projections for real GDP growth fell further (e.g. as a result of a weaker reform agenda), then maturity extensions would not be sufficient to make debt sustainable, and in this case face-value haircuts would likely be required.

13. The European institution's document on debt sustainability makes note of the Fund's suggestions (although the method of achieving debt relief is not explained), and notes that "reprofiling of payment flows does not imply nominal haircut or budgetary costs for creditors". As noted above, such reprofiling would not be required to ensure sustainability under the more optimistic Commission debt projections.

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[1] With exception of bank recap loans, where the grace period would be extended from 30 to 39 years.

[2] The IMF's estimate of the funding cost Greece will face on regaining market access