GREECE: DEBT SUSTAINABILITY SUMMARY NOTE

I. DEBT SUSTAINABILITY FRAMEWORK AND OBJECTIVES

- Debt sustainability is assessed in the context of the gross financing needs framework proposed in June 2015: achieving sustainability requires maintaining gross financing needs at very low levels for a prolonged period to allow debt to decline sufficiently before Greece can return to markets on a larger scale.
- A first key objective is to maintain gross financing needs well within the 15-20 percent of GDP thresholds defined in the MAC DSA for emerging-advanced economies throughout the projection period. The lower bound would need to be binding at least for the next two to three decades, until Greece's institutional framework is sufficiently strengthened to bring it to the standard of advanced economies.
- A second objective is to maintain the debt ratio on a sustained downward path. In other words, solutions that provide only temporary flow relief but do not deliver a declining debt path would not be consistent with sustainability.
- Finally, any restructuring solution should be robust to downside shocks to ensure sustainability with a high probability.

II. BASELINE SCENARIO ASSUMPTIONS

- The primary balance reaches 1½ percent of GDP by 2018 and stays the same thereafter. This is in line with cross-country evidence of maintaining primary surpluses for prolonged periods.
- GDP grows above potential in the medium term as it rebounds from a low base. It settles at the long-run potential rate of 1¼ percent suggested by demographics, capital accumulation and TFP growth (which is assumed to rise to the euro-area average).
- The GDP deflator converges to the ECB target and the euro area average of 2 percent.
- Market interest rates vary endogenously with the level of debt ratio (about 1 bp change for each 1 ppt change in the debt ratio). The starting rate—reflecting a risk-free rate of 1-1½ percent and a risk premium of 4¾ -5¼ percent—is comparable to that faced by Greece in 2014 and Italy and Spain in 2011-12.
- Official interest rates gradually converge to 3.8 percent, consistent with long-run averages of yields on AAA rated securities.
- Given the high level of NPLs and weak quality of capital, additional bank capital needs are projected to emerge, which could be covered from the unused bank buffer in the ESM program (up to €20 billion).
- Privatization proceeds are projected at €5 billion during 2015-2030 (€2 billion until 2018).
- Other financing needs include clearance of arrears (€7 billion) and rebuilding cash buffers (€7.7 billion).

Table 1: Baseline Scenario

	2015	2016	2017	2018	2019	2020	2022	2030	2035	2040	2045	2050	2055	2060
	(percent of GDP)													
Debt to GDP Ratio	176.9	183.8	185.4	179.8	173.8	168.6	162.5	159.1	167.0	179.3	196.9	220.4	251.5	293.8
GFN	22.5	18.5	19.7	11.9	14.0	9.7	8.4	20.8	28.5	35.1	42.3	48.5	57.2	67.4
Primary Balance	0.7	-0.5	0.3	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Real GDP														
(percent change)	-0.2	0.0	2.9	3.2	2.8	2.4	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
GDP Deflator														
(percent change)	-0.6	-0.2	0.8	1.3	1.5	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9

III. PROPOSED DEBT RESTRUCTURING

- **Payment deferrals**: Principal and interest payments on all European loans (GLF, EFSF, ESM) should be deferred until at least 2040 as follows:
  - Extension of the grace period on repayments of EFSF loans by up to 17 years, ESM loans by up to 6 years, and GLF loans by 20 years. This is expected to reduce amortization payments by about 5 percent of GDP during 2020-2040 (from 13 to 8 percent of GDP).
  - In addition, the current deferral of interest payments on non-PSI EFSF loans should be extended by a further 17 years, and interest payments on GLF, ESM and PSI-related EFSF loans should also be deferred by 24 years. This is expected to reduce Greece's interest burden by 4½ percent of GDP during 2016-2040 (from 6 to 1½ percent of GDP).
  - To minimize the need for upfront fiscal transfers, the stock of deferred interest will be remunerated at a new lower fixed interest rate for the duration of the loan (see below).
- **Maturity extensions**: The maturity of European loans should be extended as follows: (i) for GLF loans by 40 years from 2040 to 2080; (ii) for EFSF loans by up to 24 years from 2056 to 2080; and (iii) for ESM loans by 20 years from 2060 to 2080. This will help to keep gross financing needs below 20 percent by 2060.
- **Fixing the interest rate**: For EFSF/ESM loans, the interest rate should be fixed at a maximum level of 1.5 percent at least until 2045; for GLF loans, the spread over Euribor (50 bp) should be eliminated. This can be achieved via a combination of exchanging ESM short-term bonds with new long-term ones and engaging in interest-rate swaps. Given the size of the European loans to Greece, these operations would have to be executed gradually during the program period. To the extent that market-based solutions are not possible, other ways should be found to transfer the interest rate risk from Greece to member states. The reduction in interest rate is critical to allow for a debt reduction of 30 percent of GDP by 2040 and 70 percent by 2060, and for a reduction in GFN by 4 percent by 2040 and 14 percent by 2060.
- **Delivery**: The details of the debt relief package would need to be agreed upfront. The delivery will need to be comprised of an upfront component and a conditional component based on policy implementation (at each end-year review). All relief contingent on broad policy implementation will need to be delivered by the end of the program period, in line with the Fund's objective that the country should not be dependent on official assistance

post program. This would be comprised of the first two categories of relief noted in the Eurogroup statement of May 9. An automatic mechanism linking relief to GDP but not to an assessment of policies could be considered after the program (this would be the third category referred to in the Eurogroup statement). A desirable combination of upfront and conditional relief could be:

- *Program request*: A commitment to fix interest rates should be provided upfront to take advantage of the currently low rates.
- *End-of-year reviews*: At the end of each year of the program, contingent on satisfactory program implementation, the debt service and maturities of one third of GLF/EFSF/ESM loans could be restructured, with priority given to tranches with shorter maturity.
- *End of program*: An automatic mechanism linking further relief automatically to non-policy related factors (such as GDP) could be considered upon completion of the program. This can help to address shocks after the program, providing additional reassurance that debt sustainability can be maintained with a high probability.

Table 2: Restructuring Scenario with Deferrals and Fixed Rates

	2015	2016	2017	2018	2019	2020	2022	2030	2035	2040	2045	2050	2055	2060
	(percent of GDP)													
Debt to GDP Ratio	176.9	183.7	185.3	179.7	173.7	168.4	161.1	140.8	130.2	119.3	110.0	106.8	105.6	106.1
GFN	22.5	17.9	19.1	11.2	13.1	8.3	5.8	7.6	7.3	9.9	12.0	14.8	17.3	19.5
Primary Balance	0.7	-0.5	0.3	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Real GDP *(percent change)*	-0.2	0.0	2.9	3.2	2.8	2.4	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
GDP Deflator *(percent change)*	-0.6	-0.2	0.8	1.3	1.5	1.7	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9