On the Sustainability of Ireland's Sovereign Debt

John McHale
National University of Ireland, Galway
Irish Fiscal Advisory Council

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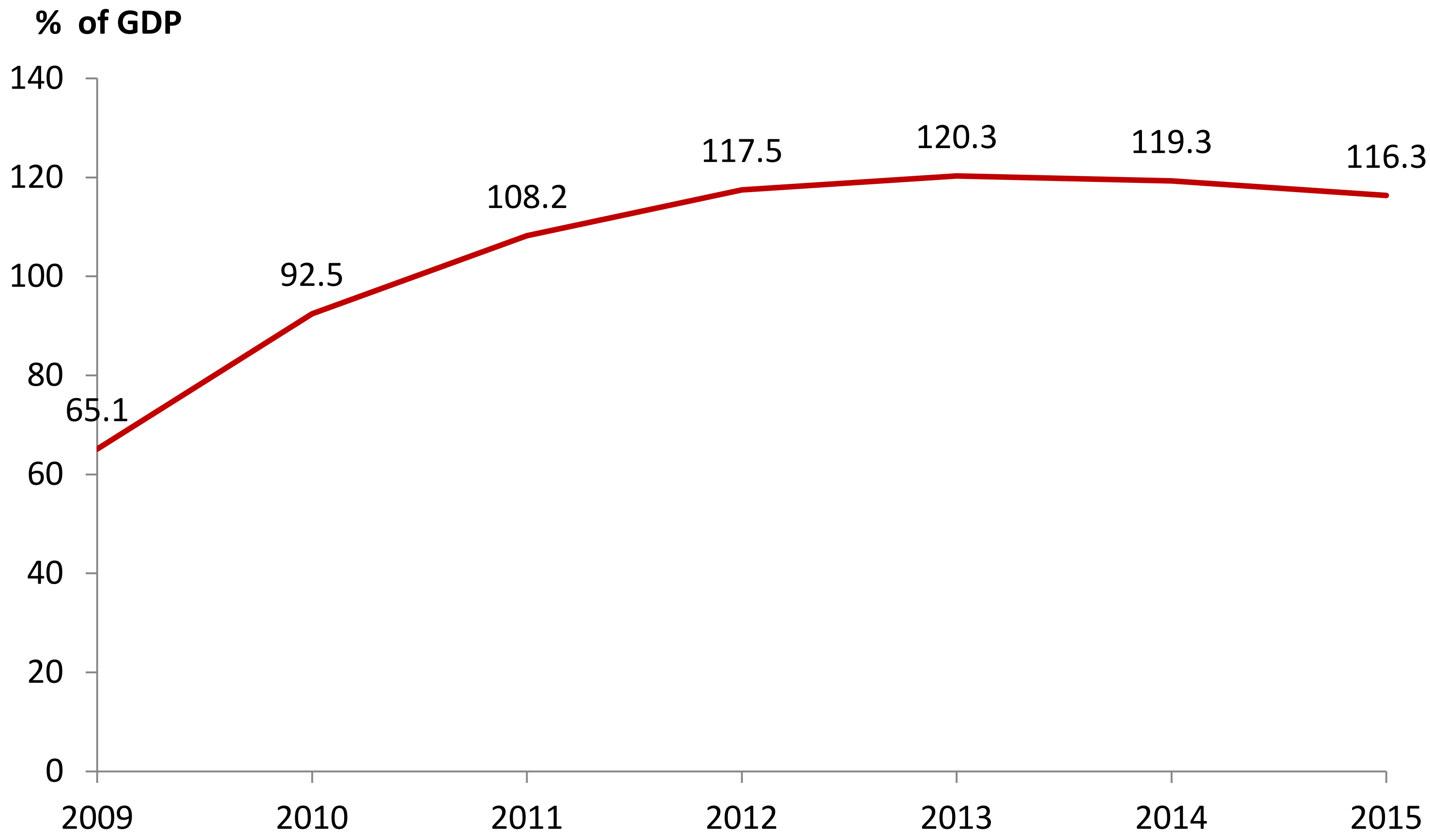
Overview

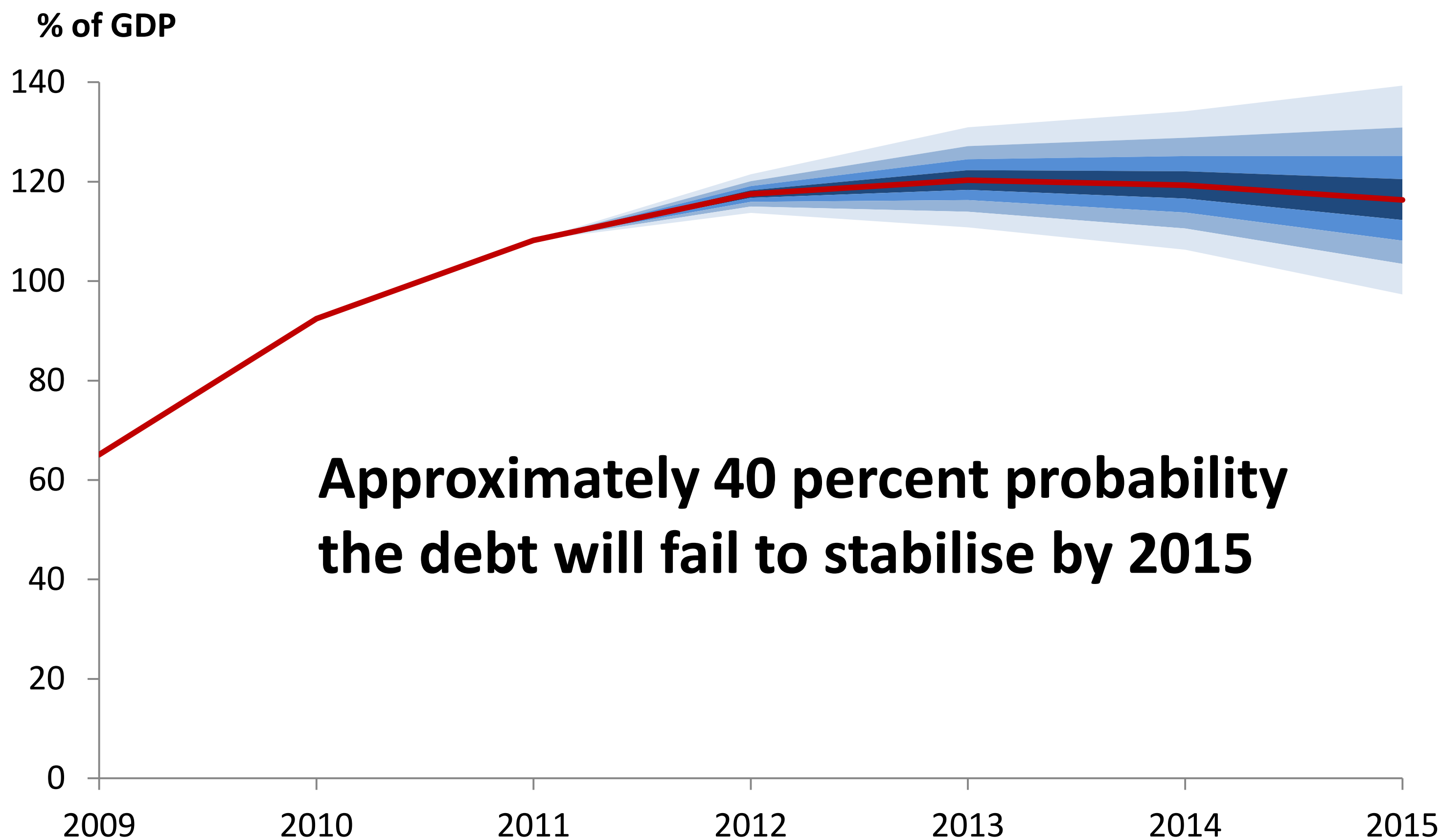
- Some different looks at debt sustainability drawing on the recent *Fiscal Assessment Report*
- Market creditworthiness as a key measure of sustainability
- A model of debt sustainability and creditworthiness in the Euro Zone
- Implications for reducing the fragility of Ireland’s creditworthiness

Debt to GDP ratio: 2009 to 2015

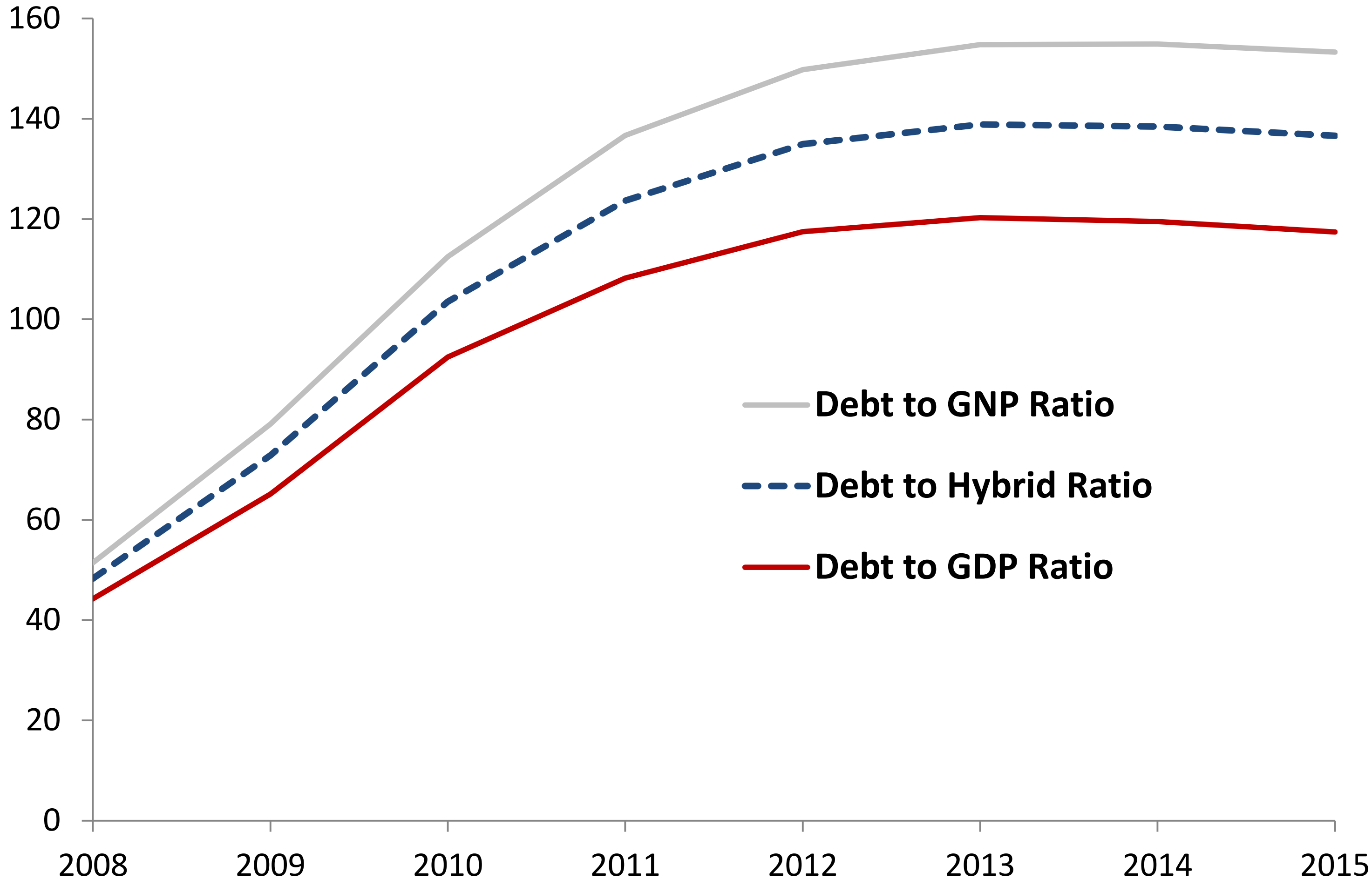


Source: Stability Programme Update, April 2012

Growth uncertainty → uncertainty around projections



Is GDP the right measures of fiscal capacity?



Extended scenario to 2020

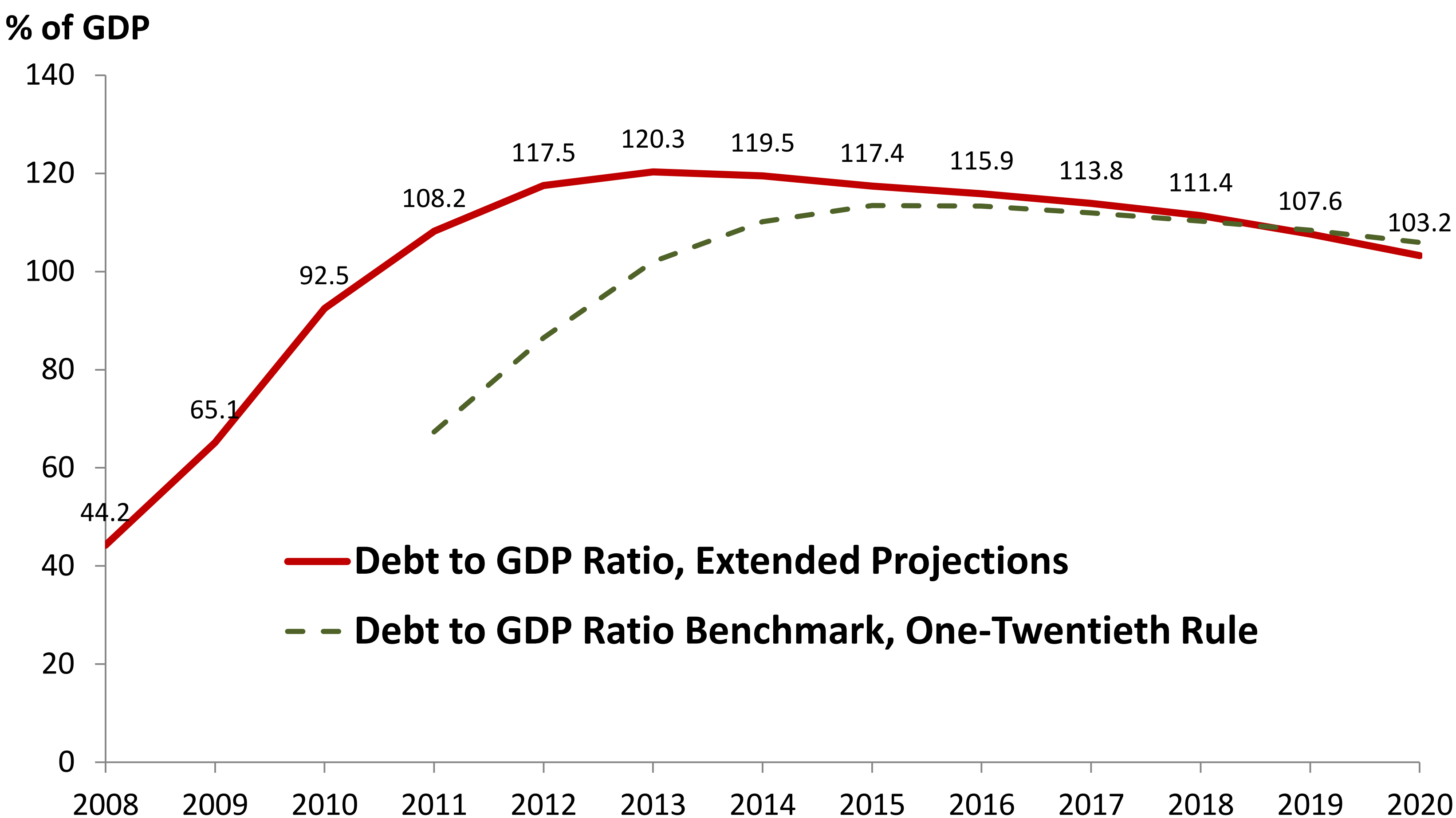
<u>2012-2015</u>

- All assumptions as in SPU

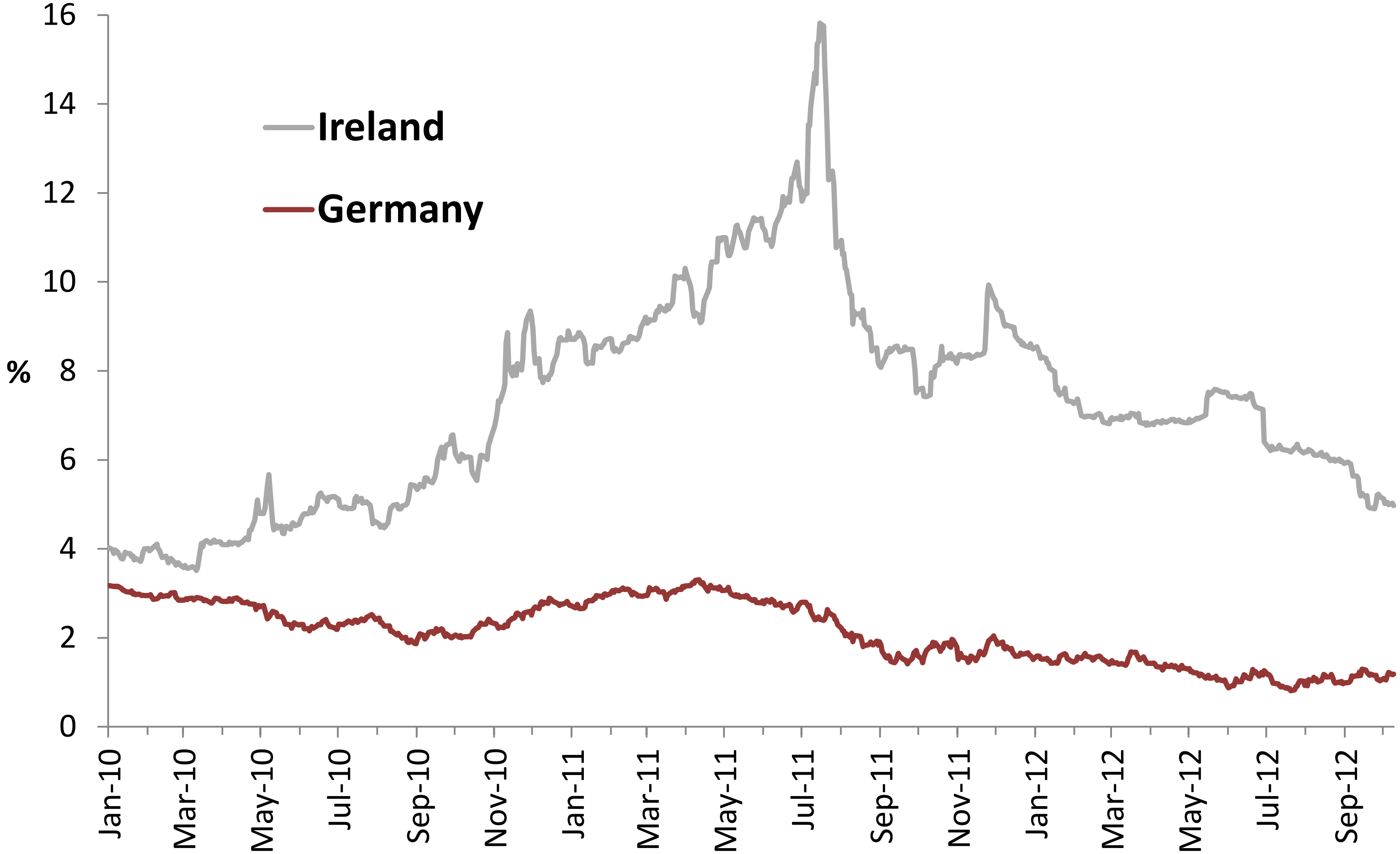
<u>2016-2020</u>

- Nominal potential growth rate = 4 percent
- Output gap closes by 2018
- Expenditure approximately flat in real terms
- Interest rate = 4.9 percent

Debt to GDP ratio, Extended scenario



8-year bond yields



Implied default probability

Risk-neutral investors; 50 percent recovery rate; German rate = risk-free rate

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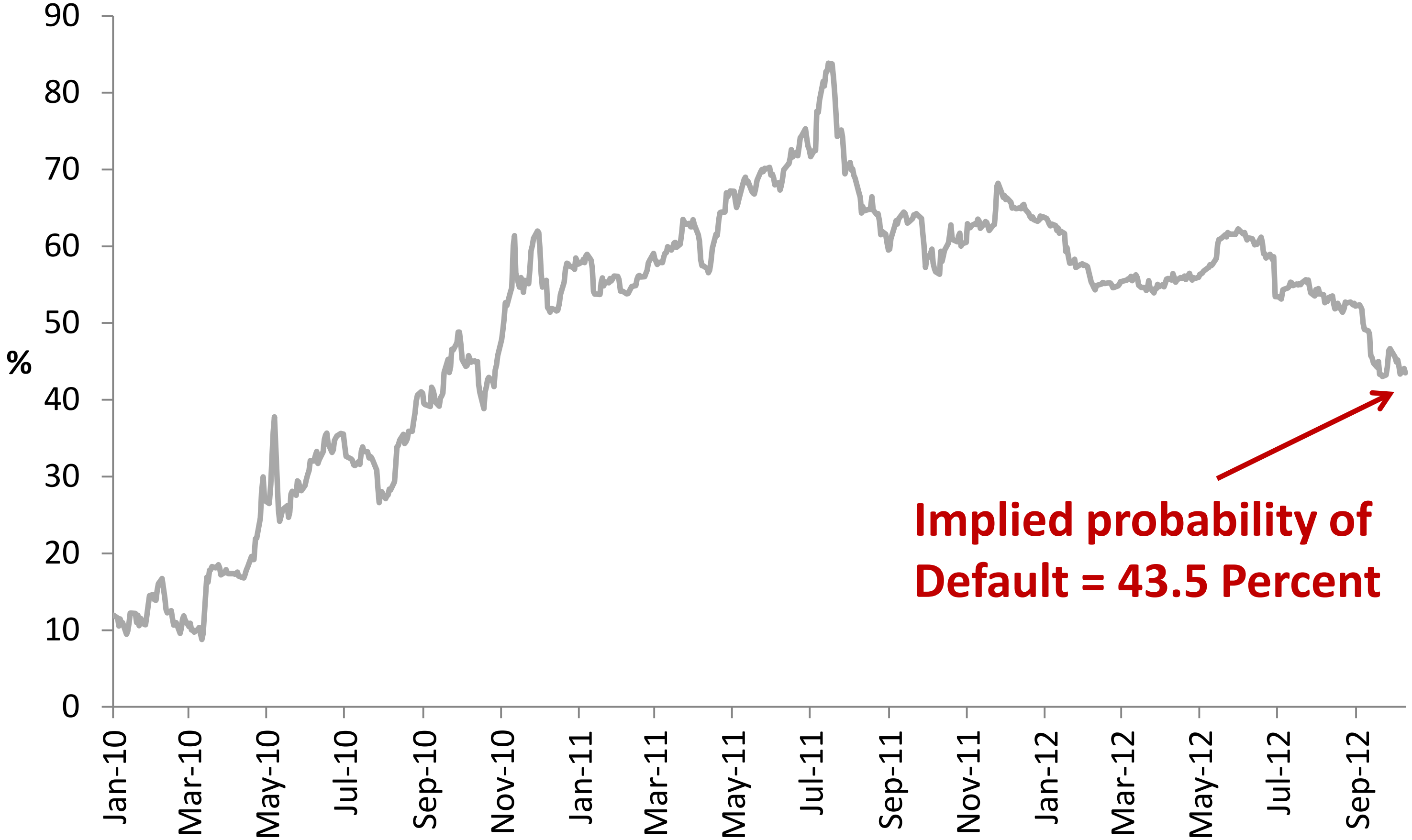


Sketch of a model of creditworthiness

- Second-generation currency and debt crises models
  - Optimising government weighing the costs of fiscal adjustment (Plan A) against the costs of default (Plan B)
- Focus on the role of conditional official lending
- Recognition of the two-way feedback between growth and the primary balance

Optimising government

Political Loss to Government =
γ (Fiscal Adjustment)^2 + δ (Cost of default)

Availability of conditional official-sector support

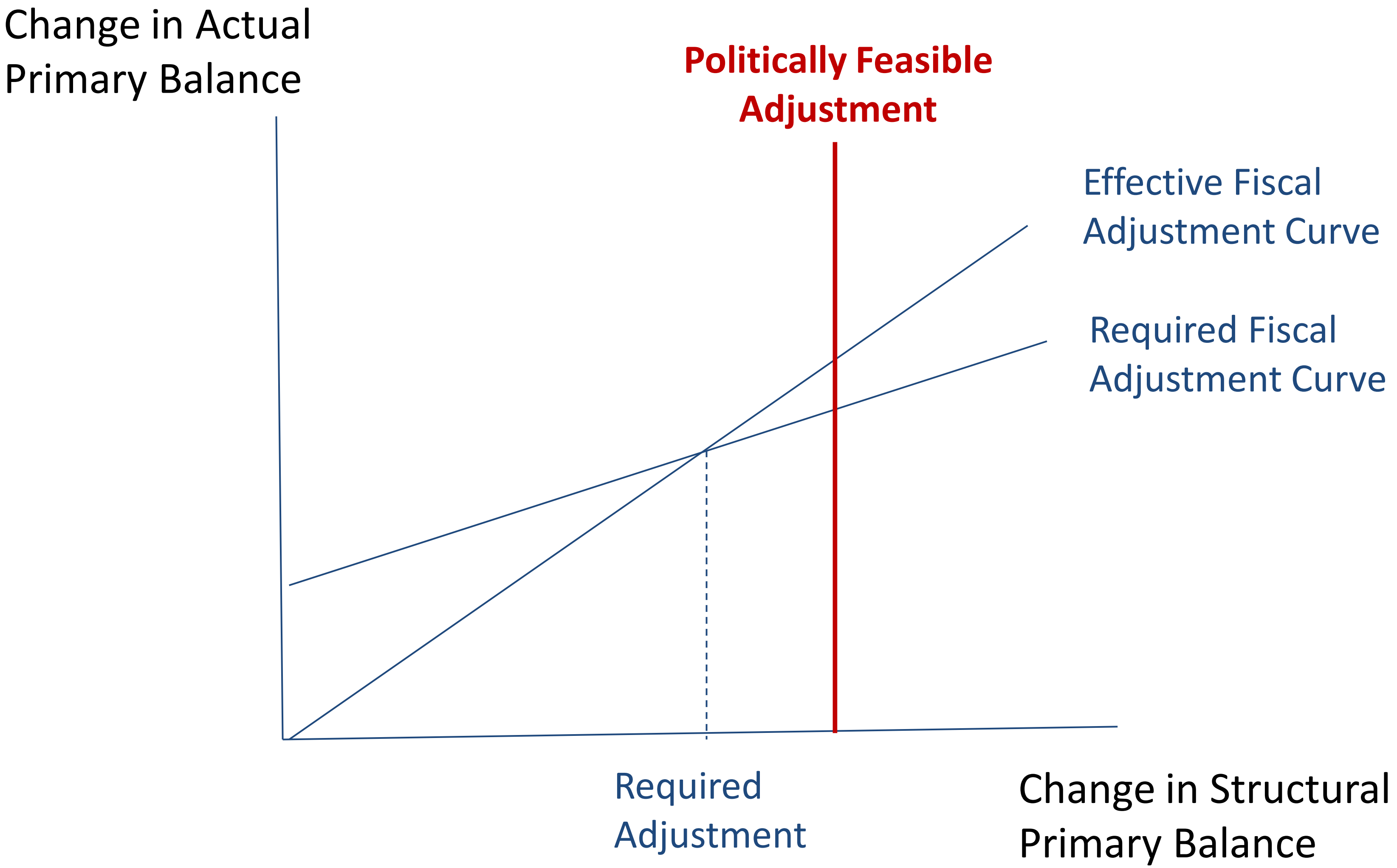
Change in Debt to GDP Ratio =
($i - g$)(Initial Debt to GDP Ratio) – Primary Balance as Share of GDP

= Required improvement in debt to GDP ratio
demanded by official creditors

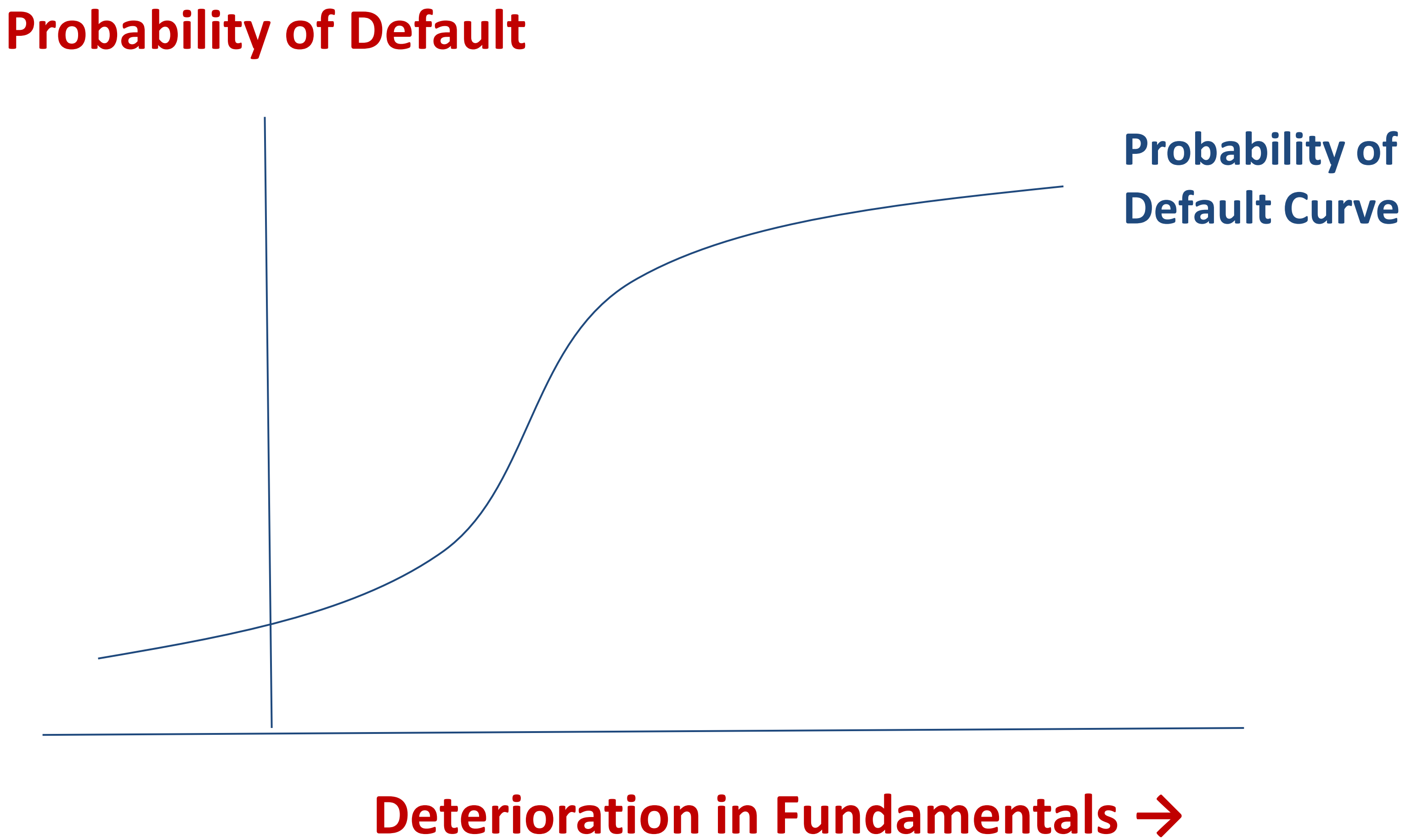
Two-way feedback between GDP and the primary balance

GDP $\rightleftarrows$ Primary Balance

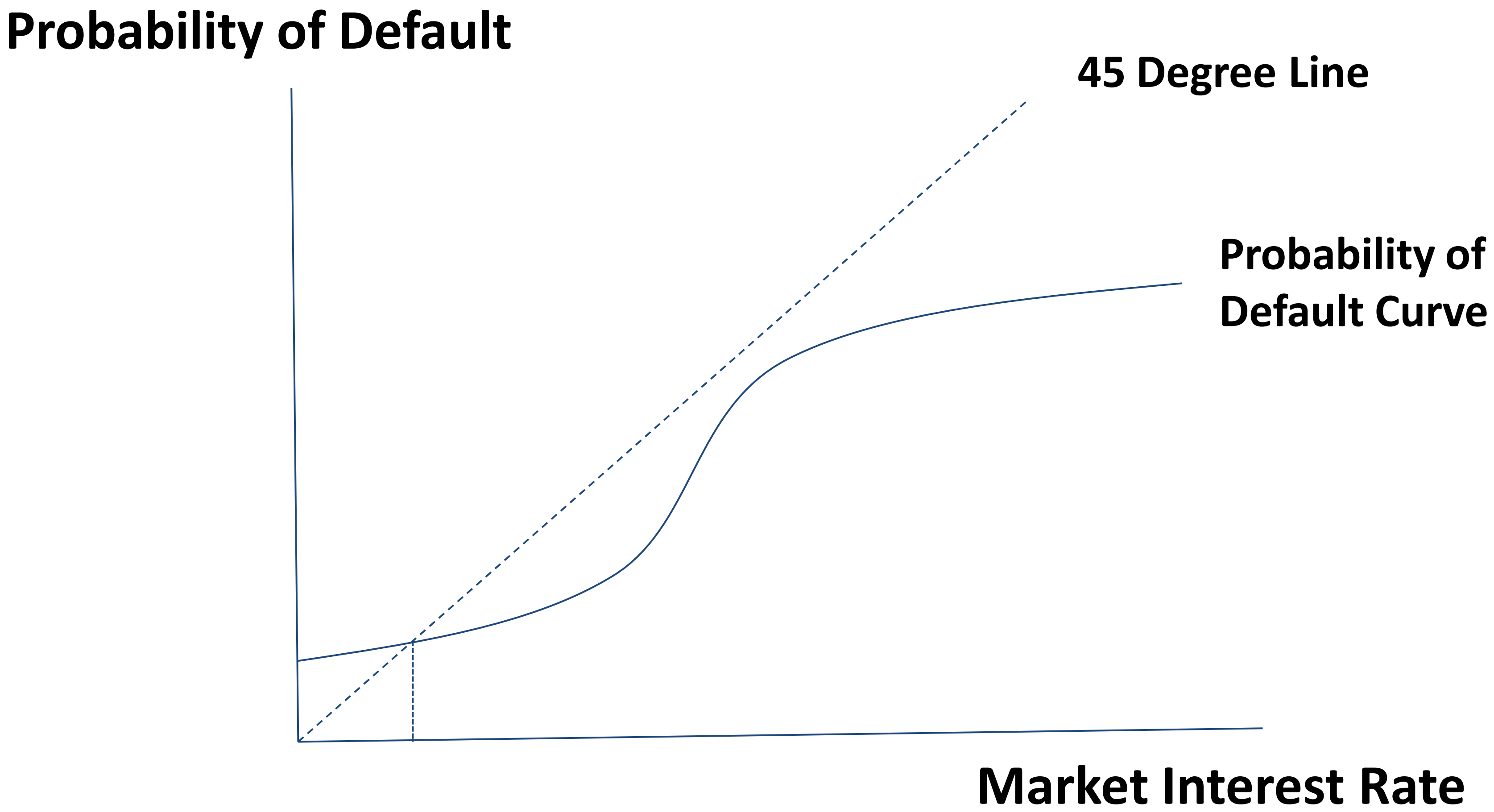
The default decision



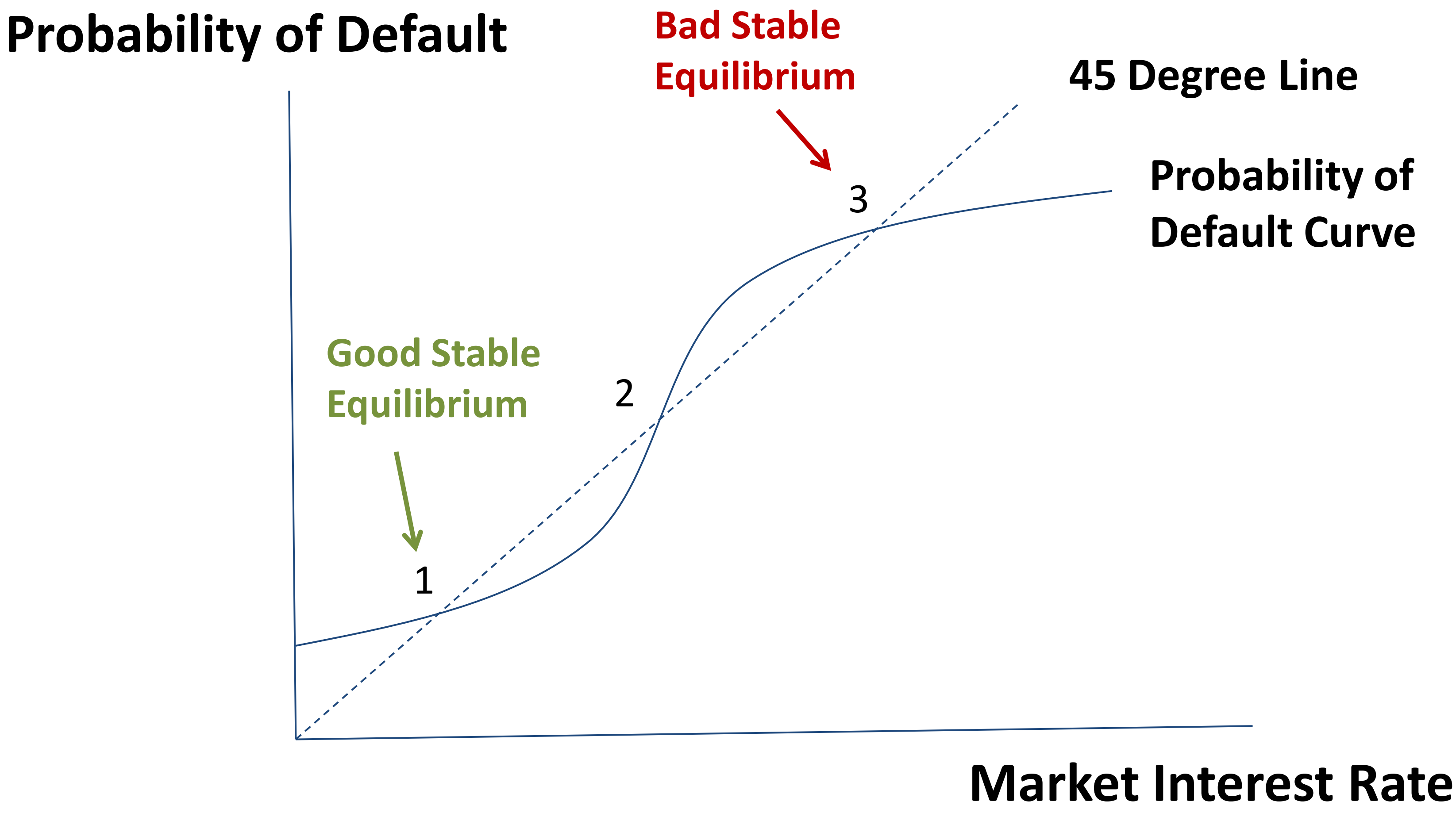
Growth uncertainty → Probability of default



Equilibrium interest rate



Multiple self-fulfilling expectational equilibria



Implications of the model for reducing the fragility of creditworthiness

(1) Reduce the political costs of fiscal adjustment

- Avoid taking adjustment options “off the table”

(2) Increase the costs of default

- Ex ante vs. ex post
- Political vs. economic costs

(3) Less strict conditionality for official support

- Make conditionality “growth contingent”

(4) Relief on <u>official</u> debt

- Value increases with the uncertainty surrounding growth

(5) Role of ECB’s OMT programme in avoiding the bad expectional equilibrium

Summing up

- Ireland’s debt sustainability/creditworthiness remain fragile
- Critical role of official support
- Model suggests various policy efforts to improve creditworthiness
  - Avoid raising the political costs of fiscal adjustment
  - Value of raising the political costs of default
  - Value of dependable and growth-contingent official lender conditionality
  - Value of relief on official debt (especially under highly uncertain growth)
  - Value of ECB’s OMT programme in avoiding a “bad equilibrium”