Annex 3

External Sustainability Assessment

(Article 2(2)(e) of the ESM Guideline on Precautionary Financial Assistance)

As part of the upfront assessment of the eligibility of euro area Member States for the Pandemic Crisis Support based on the Enhanced Conditions Credit Line (ECCL) of the European Stability Mechanism (ESM), the Commission services have assessed at technical level the sustainability of the external positions of euro are Member States. As a starting point, the assessment focuses on euro area Member States under MIP surveillance for which imbalances regarding the external sector were identified in the latest in-depth reviews (IDRs) published in February 2020. According to the Commission services' Spring forecast, there is no evidence of significant deterioration in external balances in other euro area Member States so far, and hence it is concluded that there are no risks to the sustainability of their external positions. The analysis therefore focuses on the following countries: Cyprus, Greece, Spain, Ireland, Portugal. The analysis builds on findings in IDRs, complemented by a fresh assessment using more recent data and forecasts. The main conclusions from IDRs are broadly confirmed in light of recent data. Overall, the external sustainability position of these Member States is assessed to be sustainable although subject to risks in Cyprus, Greece, Portugal.

The assessment of external sustainability builds on the analysis contained in the 2020 IDRs, complemented by a fresh assessment in light of the Commission services' Spring forecast aimed at assessing the most recent current account outturns against relevant benchmarks.[1] It focuses in particular on analysing:

- *whether the NIIP is at prudent levels*, by comparing actual values to a prudential NIIP threshold (taking also into account the composition of the NIIP (in particular whether largely negative positions are accounted for by debt or equity). A comparison is also made to an NIIP 'norm' that represents the level in line with economic fundamentals.
- *whether current account balances imply prudent dynamics in the NIIP*. The cyclically-adjusted current account is compared to the required current account to ensure that the NIIP converges to a prudent level within a given time period under unchanged policies and available projections for the relevant economic variables. The analysis also looks at how current accounts compare with values that can be explained by fundamentals (current account norms).
- *whether statistical issues are to be taken into account* in interpreting external sector data, in light of evidence reported in IDRs. This is notably and not exclusively the impact of operations of multinational enterprises or special purpose vehicles on the size and composition of NIIPs or current accounts with little implications for the domestic economy. These considerations apply especially to two Member States under analysis: Cyprus and Ireland.

The external position is assessed to be sustainable if the NIIP is at a prudent level or projected to converge to a prudent level, taking into account needed statistical adjustments and the speed of convergence.

Cyprus. The 2020 IDR analysis for Cyprus found that the NIIP position in 2019Q3, at -115% of GDP, was below its prudential threshold and its norm. The IDR acknowledges though that the NIIP of

[1] The approach is consistent with the one described in the Commission non-paper" The external sustainability criterion in ESM precautionary financial assistance: broad options" discussed at the May 2019 meeting of the task Force on Coordinated Action.

Cyprus is significantly affected by the external liabilities of non-financial (ship-owning) special purpose entities (SPEs), which arguably have limited links with the domestic economy and have real assets (ships) collateralising their liabilities.[2] Excluding the impact of these SPEs, the NIIP of Cyprus, was found to stand close to -35% of GDP, above the NIIP prudential threshold of -57% of GDP. Moreover, the fact that government debt is partly held by official creditors mitigates liquidity risks. However, the current account balance at -7.4 % of GDP in 2019Q3 (around -4 % cyclically adjusted) was assessed as too low to ensure prudent NIIP dynamics. A fresh look at the data confirms that the NIIP net of the impact of special purpose entities' operations is not far from values that could be considered as prudent, but the expected current account developments imply further deterioration in the NIIP position. The headline NIIP reached -116% of GDP in 2019 and is projected to deteriorate to around -135% by 2021. Excluding the effect of non-financial SPEs, the NIIP is projected to be somewhat above its prudential threshold. However, the current account balance, which amounted to -6.7% of GDP in 2019, is expected to worsen over the period 2020-2021, which would imply a deterioration in the NIIP position if kept at that level. **Overall, the external sustainability position is assessed to be sustainable, although subject to risks.**

Greece. The 2020 IDR for Greece revealed that the country's net international investment position remained strongly negative (about -150% of GDP in 2019), mostly due to foreign holdings of government debt. The fact that government debt is held to a large extent by official creditors was considered to mitigate liquidity risks. The current account balance of about -1.4% of GDP was assessed not to be sufficient to ensure a correction of the NIIP towards a more prudent position at sufficient pace. A fresher look at the data confirms that the NIIP of Greece is below the prudential NIIP threshold and that a correction in the NIIP would take place at slow pace and with significant downside risk. The NIIP, at -151% of GDP in 2019, is still beyond its prudential threshold and its norm and is projected to stay close to the 2019 level in 2021, after some deterioration in 2020. The cyclically-adjusted current account, expected to remain around -3% of GDP for the period 2020-2021, is below the balance needed for the NIIP to reach its prudential threshold within 10 years. If this current account balance is maintained going forward, there would be an NIIP improvement over time in the baseline scenario, but such correction would take place at slow pace and with significant downside risk in case of any further deterioration of the fiscal position, shocks to the trade balance or nominal GDP growth. **Overall, the external sustainability position is assessed to be sustainable, although subject to risks.**

Spain. The 2020 IDR for Spain showed that the NIIP stood at -79.6% of GDP in 2019Q3, more negative than the NIIP prudential threshold. However, it was assessed that the composition of Spain's external liabilities in terms of instruments and maturity mitigated some of the vulnerabilities. The net international investment position excluding non-defaultable instruments (NENDI) declined relatively fast since 2011 and stood at -54% in 2018. In addition, most of the external debt had maturities of one year or more (about 76% of general government and private sector external debt, excluding intercompany loans), with the average maturity increasing. Overall, the vulnerabilities were found to be limited and the NIIP to be improving, assisted by a positive current account position. A fresh look at the data confirms that the NIIP of Spain is below the prudential NIIP threshold, but current account projection would imply a correction of the NIIP at satisfactory pace. The NIIP stood at -74% of GDP in 2019, not far from the prudential threshold, and is not expected to deteriorate significantly by 2021. The current account balance, at 2.6% of GDP in cyclically adjusted terms in 2019, is projected to remain in surplus over the period 2020-2021, thereby being supportive of a gradual improvement in

[2] Financial SPEs, on the other hand, although greatly inflating both the asset and the liability side, have no visible impact on the overall net position (but affect its composition).

the NIIP, at a pace that would permit reaching the prudential threshold. **Overall, the external sustainability position is assessed to be sustainable.**

Ireland. The 2020 IDR for Ireland found a very negative NIIP position, at -168% of GDP in 2018, but acknowledged that the figure is distorted by activities of multinationals (MNEs) and financial services firms headquartered in the Dublin International Financial Services Centre (IFSC), that have no major implications for external sustainability despite affecting statistics.[3] Estimates report that net of such effects, the Irish NIIP would be between -80% to -110% of GNI*.[4] The NIIP without non-defaultable instruments (NENDI) was found to be negative, but turning positive once excluding the operations of firms in the IFSC. While the headline current account balance is very volatile, estimates of the modified current account balance developed by the Central Statistics Office (CSO), which to a large degree strips out MNE activities, suggest an underlying surplus that increased moderately from 2.3% of GNI* in 2017 to 4.0% in 2018.[5] This modified current account balance was assessed as supportive of the reduction of the domestically relevant part of the NIIP (excluding MNEs and the IFSC). A fresh look at the data confirms that the Irish NIIP, when taking into account the presence of MNEs, is not far from a prudent value for the NIIP, and that current account surpluses are likely to support the adjustment. Following a large temporary deficit in 2019, the current account position is expected to go back to surplus over the 2020-2021 period. Under the central scenario, the NIIP is projected to improve. **Overall, the external sustainability position is assessed to be sustainable.**

Portugal. The 2020 IDR for Portugal assessed the NIIP, which stood at -101.5% of GDP in 2019Q3, as more negative than its prudential threshold. However, the NIIP was improving since the economic recovery, notably for what concerns debt instruments (the NENDI improved from -78% in 2014 to -47% in 2019). The current account balance, which was deteriorating (from 1.0% of GDP in 2017 to 0.1% in 2018 and a mild deficit in 2019) was projected to deteriorate further to a deficit of around 1.0% by 2021, below the estimated surplus of 2.4% of GDP required to reach the country-specific prudential NIIP threshold over a 10-year period. A fresh analysis confirms that the NIIP of Portugal remains below prudent levels, with a projection for the current account implying an improvement of the NIIP at a relatively slow pace. The NIIP stood at –101% of GDP in 2019 and is expected to remain close to -100% (about 50pps beyond the prudential threshold). The cyclically adjusted current account balance, at 0.7% of GDP in 2019, is anticipated to remain close to balance by 2021. This value would imply a gradual improvement in the NIIP in the baseline scenario, but the pace of adjustment for the NIIP would be relatively slow, not sufficient to ensure a correction towards the NIIP prudential threshold within 10 years. **Overall, the external sustainability position is assessed to be sustainable, although subject to risks.**

[3] The positions of MNEs with headquarters in Ireland represent a large share of the International Investment Position, with external liabilities that are particularly volatile (e.g., linked to intellectual property) while not always being associated with activities carried out in Ireland. The IFSC in Dublin is a leading location for a range of internationally traded financial services.

[4] Modified Gross National Income (GNI*) is an adapted measure of GDP that reflects more accurately the income of Irish residents, as it excludes, inter alia, the depreciation of foreign-owned, but Irish resident, capital assets (notably intellectual property and assets associated with aircraft for leasing) and the undistributed profits of firms that have re-domiciled to Ireland. For more details see Central Statistics Office (2018), "National Income and Expenditure 2018".

[5] The headline current account balance swung from 0.5% of GDP in 2017 to 10.6% of GDP in 2018. The main activities affecting this figure include intellectual property trade, trade in aircrafts related to leasing, depreciation of capital assets of MNEs and repatriated global income of companies that moved their headquarters to Ireland.