

European Parliamentary Week 2023
Economic governance review

Philippa Sigl-Glöckner
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Honourable members, chairs,

Thank you for the opportunity to speak on the economic governance review. Under the framework proposed by the European Commission countries with too much debt should adopt an expenditure path that ensures falling debt.

The development of debt will be projected using debt sustainability analyses – short DSAs. Those DSAs are set to become the new analytical heart of the fiscal rules. They are an accounting exercise, which projects the development of the debt to GDP ratio based on assumptions about the budgetary balance, growth and interest rates. Since DSAs may be new to many, I would like to focus my remarks on the former and how they will be used.

Slide three shows you the envisaged process for countries with a substantial debt challenge. The expenditure path will be set based on DSAs that start in year five -counting from today- and, for countries undertaking reforms, in year eight. Hence the DSA will have to be conducted for a time quite far in the future. To illustrate: In 2015 one would have conducted a DSA for the years 2023 to 2032.

But how much can we know about the future? Slide four shows you what we can currently say about Italian debt. Italian debt will most likely move from 150% in 2021 to somewhere between 125% and 165% in 2026. Even if the ranges are not always as wide as for Italy, you can now extrapolate what the uncertainty will look like for a DSA spanning from year eight to year 17.

Another difficulty is that the projection heavily depends on long-term assumptions about interest rates and growth. Recent history may have taught us a thing or two about how well we can predict those. Who would have thought we would enter a prolonged period of very low interest rates after the financial crisis? Equally, who has been projecting the recent rise in rates?

Also: To project growth that far out, one needs to heavily rely on estimates of potential growth – an unobservable variable. Unobservable variables are one of the most criticised aspects of the current fiscal rules.

Next, I would like to look at the specific criteria countries need to meet since there may be a one-sided perception of risk: Countries need to show that their debt is falling with a 70% probability and in adverse scenarios with higher financing costs or lower growth. Hence countries need to save more than required for debt to fall in the baseline scenario. This only makes sense if one sees the only risk for the debt to GDP ratio in overly expansionary fiscal policy. But what about the risk of too little growth having a negative impact on debt to GDP? Expansionary fiscal policy is key to support the economy when demand is weak. Hence: There is no safety in surpluses, there is only a walk on a tight rope balancing growth and fiscal consolidation.

Finally, underlying the fiscal rules there is an implicit assumption: Reducing debt to GDP is compatible with meeting financing needs for decarbonisation and defence. Yet, our analysis suggests that rising financing costs and growing costs of ageing will cause the debt ratio to rise

even without any incremental spending.¹ With incremental public climate spending and an increase in defence spending, debt to GDP will most likely rise beyond their peak in 2020.²

To conclude, I would like to put forward three suggestions:

- One, DSAs have their limits. They are fraught with uncertainty. Hence, maybe it would make sense that all countries which meet a certain fiscal parameter – lets say a certain primary balance – do not need to enter the process of negotiating an expenditure path based on a DSA. The specific threshold at which the primary balance is set could be updated periodically to reflect the current growth and interest rate environment.
- Two, if you don't drop the concept of potential output, reform it. We have for instance put forward a proposal to tie potential output to reforms and investment in growth.³
- Three, retain sovereignty of national parliaments by giving them the right to vote on the fiscal path every year and if they wish to do so on the assumptions going into the DSA. DSAs should be fully public including all calculations.

Two open issues remain:

- First, how does Europe plan to marry meeting spending needs with reducing debt ratios?
- Second, an issue I haven't addressed above for the sake of time, I wonder whether there may be a problem with the interaction between fiscal and monetary policy in this new fiscal regime: To conduct DSAs, the European Commission will have to project financing costs, which depend heavily on the ECB. The ECB in turn may make government bond purchases dependent on the Commission's verdict on debt sustainability. The result could be self-fulfilling prophecies.

The proposal by the European Commission seeks to get away from one size fits all debt reduction paths, a bold and important step. However, the limits of DSAs should be considered and issues like reconciling debt reduction with spending needs and the interplay between fiscal and monetary policy should not be left unaddressed.

¹ As described further down, the estimation of debt dynamics is highly sensitive to assumptions used. Thus, one analysis cannot prove that reducing debt ratios is incompatible with scaling up investment.

² Ameco, data code: UDGG

³ <https://www.dezernatzukunft.org/a-proposal-for-reforming-the-stability-and-growth-pact/>