Introductory statement at the Committee on Economic and Monetary Affairs of the European Parliament Public Hearing

On shrinking the public balance sheet and the use of debt sustainability analyses

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Dear Members of the ECON Committee,

Thank you for the opportunity to speak on debt sustainability in the context of the macroeconomic review. In the following, I will first discuss what the orientations published by the European Commission identify as goal of fiscal surveillance — debt levels —, then point out three issues with the proposed centre piece of the new rulebook — debt sustainability analyses (DSAs); and conclude with a suggestion for the constructive use of DSAs.[1]

Focusing on debt stock

The objective of fiscal surveillance is now debt sustainability, interpreted as convergence to a debt to GDP ratio of 60%.

Coordinating the fiscal stance between countries to secure monetary stability and prevent imbalances, objectives of the Delors Report,[2] takes a back seat. Abandoning the attempt to coordinate the fiscal stance to ensure monetary stability is certainly noteworthy in times of inflation.

But I would like to focus on the goal for fiscal surveillance outlined by the Commission: shrinking the size of the public balance sheet. This is what limiting the debt to GDP ratio to 60% does; at least if there is no permanent fiscal capacity at the European level.

It is *assumed* that reducing debt to GDP is compatible with the required increase in investment in defence, secure energy supply and a competitive green economy. This assumption may be false. Our analysis suggests that rising financing costs and growing costs of ageing will cause the debt ratio to rise to the level of 2021 – even *without any incremental* climate and defence spending.[3] *With* incremental public climate spending of 1% of GDP[4] and an increase in defence spending to 2% of GDP by 2031, debt to GDP is likely to rise significantly above its prior peak of 92% in 2020.[5]

[1] European Commission (2022): Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final.
[2] Delors Commission (1989): Report on economic and monetary union in the European Community
[3] 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.
[4] Darvas and Wolff (2021): A green fiscal pact: climate investment in times of budget consolidation, Policy Contribution 18/2021, Bruegel. This estimate by Bruegel precedes the rise in interest rates which commenced in 2022. Rising interest rates lead to rising financing costs for private investors. This is particularly problematic for capital intensive projects like wind parks, which may not generate sufficient returns under existing subsidy schemes. Hence an increase in public subsidies for private investments could add to public spending pressures.
[5] Ameco, data code: UDGG

Limiting the public balance sheet stands in stark contrast to what the United States do: two thirds of the spending under the Inflation Reduction Act (IRA) is allocated to financial incentives whose fiscal volume is *uncapped*.[6]

Debt Sustainability Analysis

The proposal by the Commission puts debt sustainability analyses (DSAs) at the centre of the fiscal rules and suggests using them to determine multi-year fiscal adjustment paths. I want to highlight three challenges for this approach: multi-year fixing of fiscal policy under uncertainty; the continued use of unobservable variables; and self-fulfilling prophecies.

First, the issue of uncertainty: The proposal by the Commission suggests using DSAs to define fiscal adjustment paths which may only be revised after a minimum period of four years. Hence, DSAs should be able to project future debt developments with some certainty. This is not the case. Take the example of Italy: According to the latest projection, Italian debt will move from 151% (in 2021) to somewhere between 126% and 168% within five years with 80% probability.[7] Under the new framework, debt dynamics for the coming 14 years would have to be projected.[8]

Second, the usage of DSAs still requires estimating unobservable variables. Estimating potential output is required to compute the structural primary balance. The projection of real growth relies on an estimate of potential growth. The Commission itself criticises those as "undermining transparency and hampering ownership and predictability"[9]. And because they cannot be observed, they necessarily leave space for discretion.

Third, DSAs may create self-fulfilling prophecies: The projection of a rising debt ratio or even declaration of unsustainable debt by the Commission would most likely lead to rising financing costs, if not worse. This would in turn make increasing debts a certainty.[10] A similar mechanism is at play for growth: If low real growth is projected, a tight fiscal balance will be required to ensure falling debt. A tight fiscal balance reduces demand and hence makes low growth more likely. There is not one correct assumption for real growth and inflation. Instead, there are *multiple equilibria*: Several plausible combinations of fiscal stance and growth.[11]

Summing up, the assumptions that DSAs build on still rely on unobservable variables and are partly endogenous to policy. For most inputs, the question is not which assumption is the correct one, but which one is consistent with future policy. All of this introduces significant discretion into the conduct of DSAs.

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[6] Credit Suisse (2022): US Inflation Reduction Act US Inflation Reduction Act - A Tipping Point in Climate Action

[7] European Commission (2022): Commission Staff Working Document. 2022 Country Report – Italy, SWD(2022) 640 final

[8] European Commission (2022): Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final, p. 7

[9] European Commission (2022): Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final, p. 9. The use of unobservable variables, potential output in particular has led to controversy for several reasons: understanding how potential output is calculated requires advanced econometric knowledge. Small tweaks in statistical parameters -which cannot be explained based on economic phenomena- can have a significant impact on the result. Potential output estimates are frequently subject to substantial revisions, making it very difficult to budget based on them.

[10] Guzman (2018): The Elements of Sovereign Debt Sustainability Analysis, CIGI Papers No. 196 — November 2018, p. 4

[11] Guzman (2018): The Elements of Sovereign Debt Sustainability Analysis, CIGI Papers No. 196 — November 2018, p. 6

Concluding thoughts

DSAs are not an apolitical algorithm for defining the optimal fiscal policy. They can be a useful *analytical* tool, though, showing what is likely to happen to debt dynamics *given* certain assumptions.

One way to use their analytical insights without overstretching them could be to use a DSA for calibrating a *common fiscal benchmark* — e.g. the primary fiscal stance — for all countries based on *agreed assumptions*. The benchmark could be set in a way to make debt reduction likely for all countries, including those with high interest payments.[12] Countries with low debt ratios or significant slack could be subject to exemptions.

Yet, even the most intricate fiscal rules will not be able to resolve the conflict between shrinking balance sheets and strengthening European sovereignty. Ensuring a low-cost and secure energy supply, ramping up defence spending and supporting the growth of green industries will require public spending, while interest rates and costs of ageing put national budgets under pressure.

[12] Sigl-Glöckner et al. (2022): A proposal for reforming the Stability and Growth Pact, Dezernat Zukunft