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THE PUBLIC DEBT OUTLOOK IN THE EMU POST COVID: A KEY CHALLENGE FOR THE EU FISCAL FRAMEWORK

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This paper was prepared by an ad-hoc working group of the Network of the EU Independent Fiscal Institutions (IFIs) under the coordination of Nicolas Carnot (High Council of Public Finances). Vladimir Borgy (High Council of Public Finances) was the lead contributor on the simulation exercise. Other direct contributors were Christos Axioglou (Hellenic Fiscal Council, Greece), Inna Oliinyk (Secretariat of the Network of EU IFIs), Esther Gordo (Independent Authority for Fiscal Responsibility, Spain), Panagiota Koliousi (Hellenic Fiscal Council) and Ricardo Vicente (Estonian Fiscal Council).

The group was composed by the High Council of Public Finances (France), the Estonian Fiscal Council (Estonia), the Hellenic Fiscal Council (Greece), Italy's Parliamentary Budget Office (Italy), the Portuguese Public Finance Council (Portugal), the Independent Authority for Fiscal Responsibility (Spain) and the Secretariat of the Network of EU IFIs.

What the paper does and concludes

The paper makes two contributions:

- It investigates the dynamics of the public finances in 10 year illustrative projections for the euro area and selected countries
    - This suggests a challenging debt outlook, particularly with respect to the debt rule, under a ‘no policy change assumption’
    - With large differences between countries and between scenarios
- It examines the future of the debt rule
    - It reviews options for alternative specifications of the debt rule – all with some pros but none entirely convincing
    - It argues that a superior approach is to pursue long-run debt objectives by strengthening other operational rules such as net expenditure

Projections

Illustrative projections to 2030

- Illustrative projections, not forecast.
- Focus on 10-year trends, not short-term outcomes
- Assumptions
  - Three GDP scenarios: catch up, limited loss, persistent weakness
  - Public finances follow a ‘no policy change assumption’
  - Interest rates: Consensus Forecast

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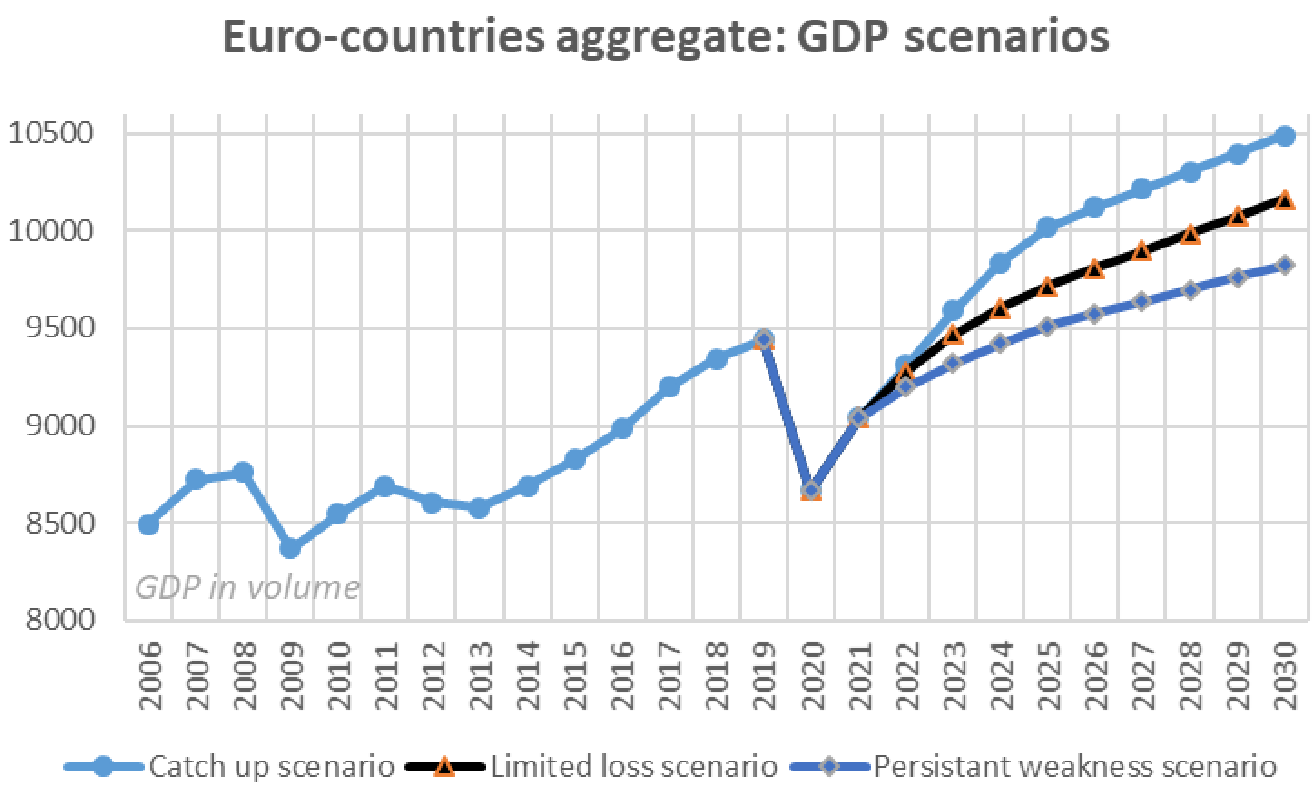
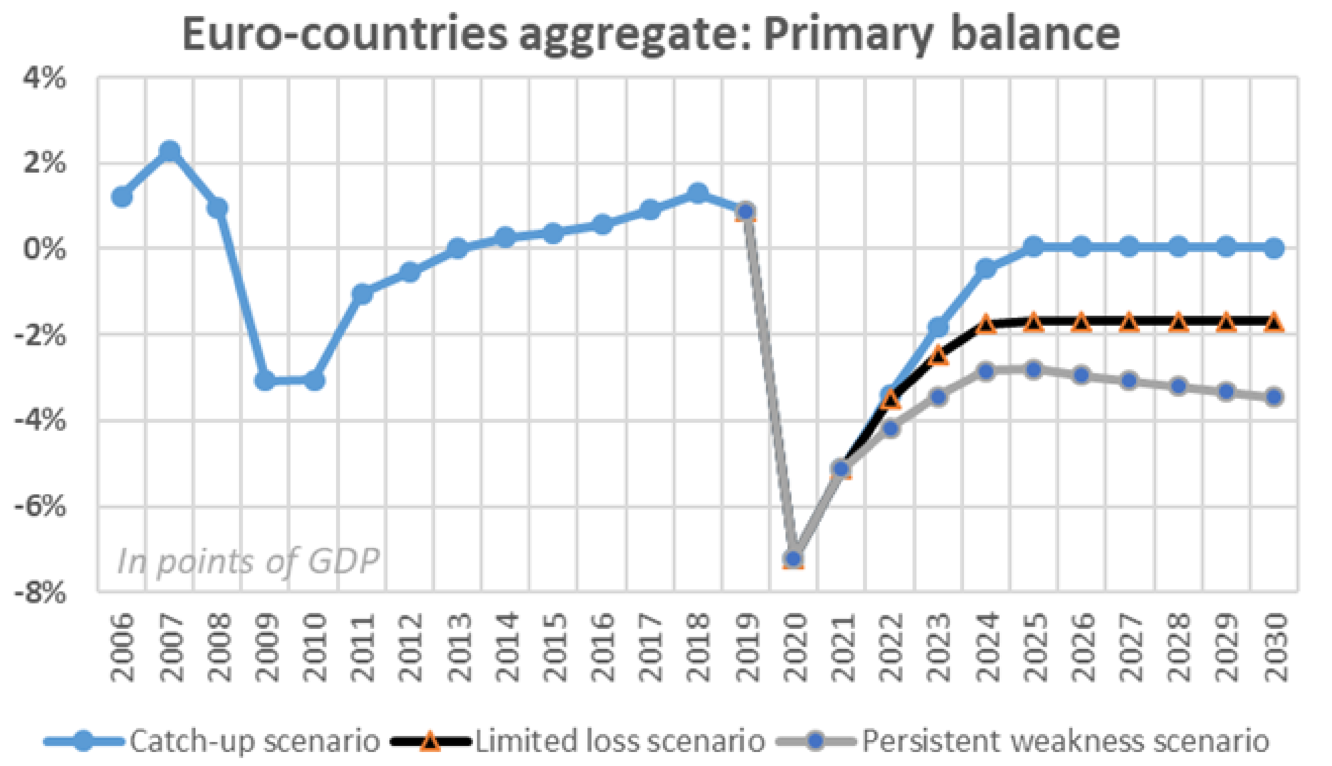
Illustrative projections to 2030



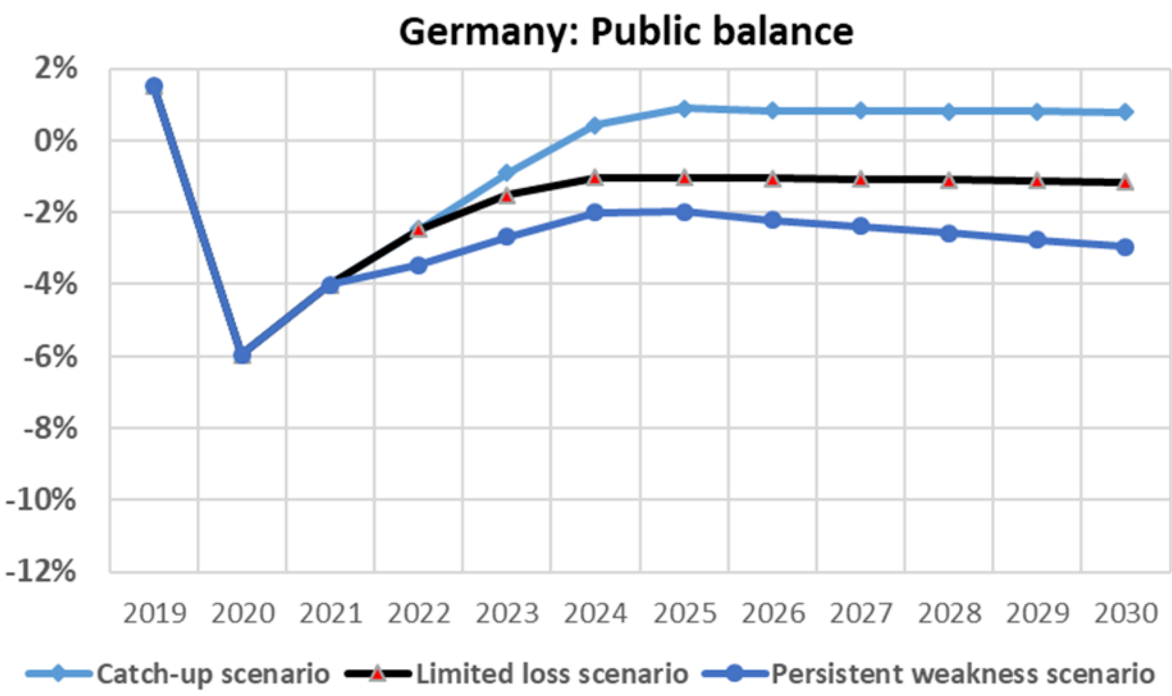
Note: The "catch-up" scenario assume a convergence of GDP in level towards pre-crisis potential GDP based on the Debt Sustainability Monitor, January 2020. In the "limited loss" scenario, GDP would return to the pre-crisis growth rate after a permanent level loss of 3 points of GDP. In the "persistent weakness" scenario, GDP levels would deviate over time from the path followed in the other scenarios as the GDP growth rate would be persistently lower than in the two other scenarios.

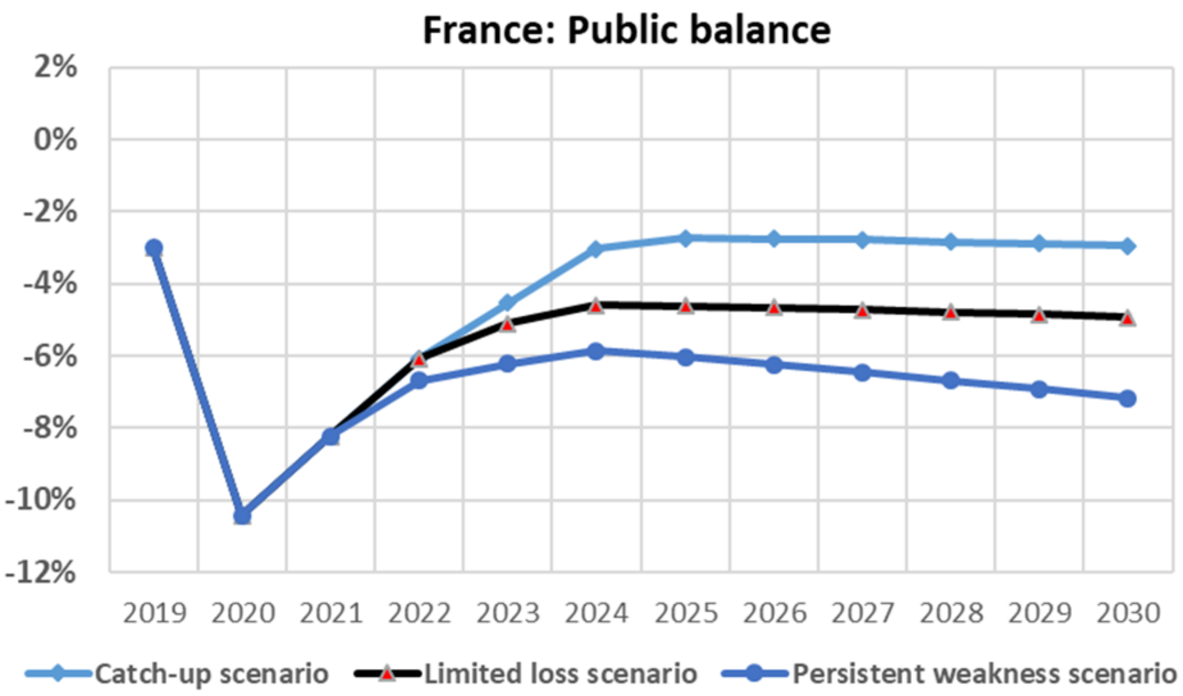
A « no policy change » assumption



- Constant structural primary balance post-Covid
- No further consolidation, no further deterioration (ageing…)
- Remains above pre-crisis level if
  - GDP doesn't fully revert to pre-crisis trend
  - Crisis measures not merely temporary

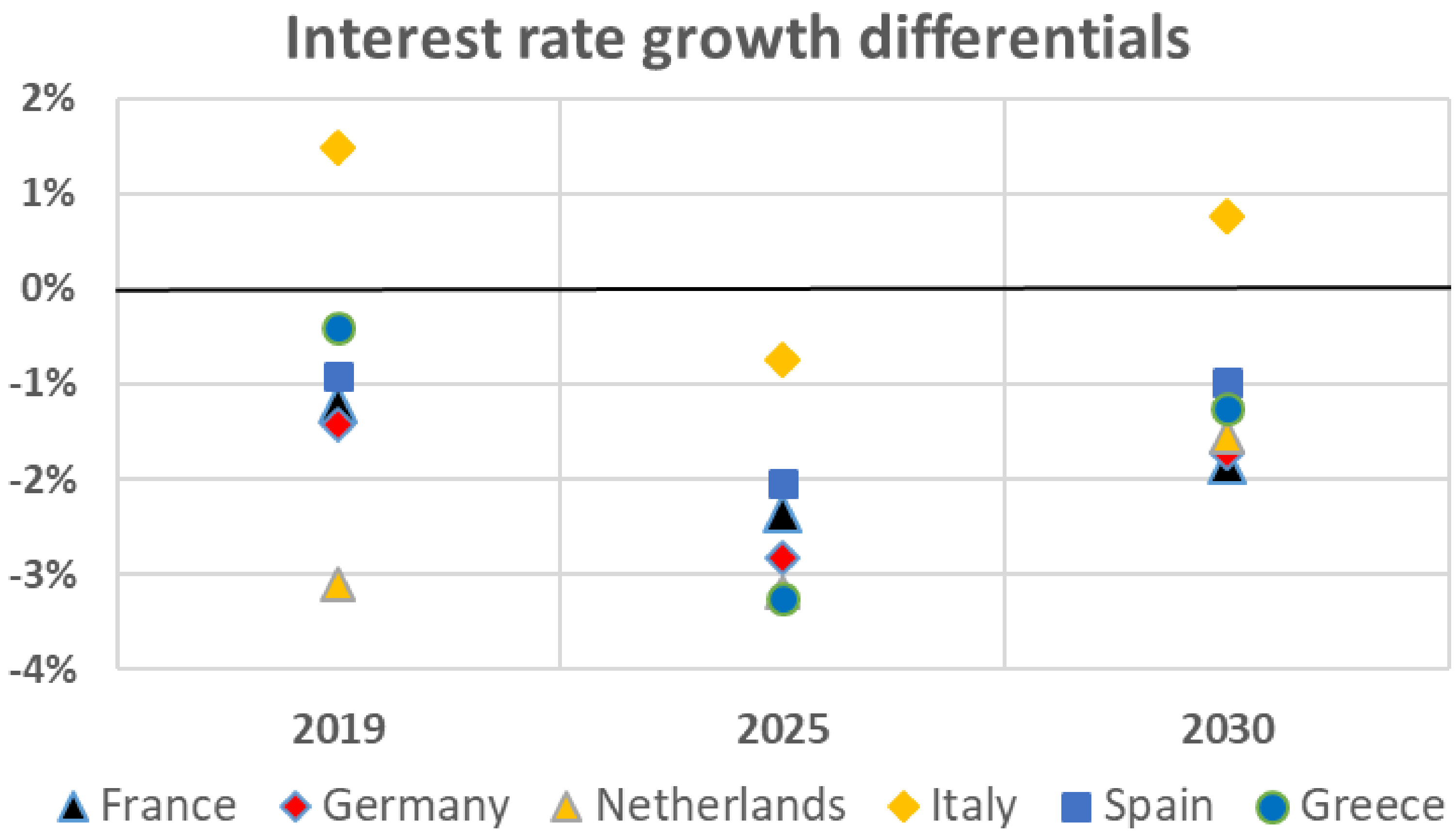
Heterogeneity



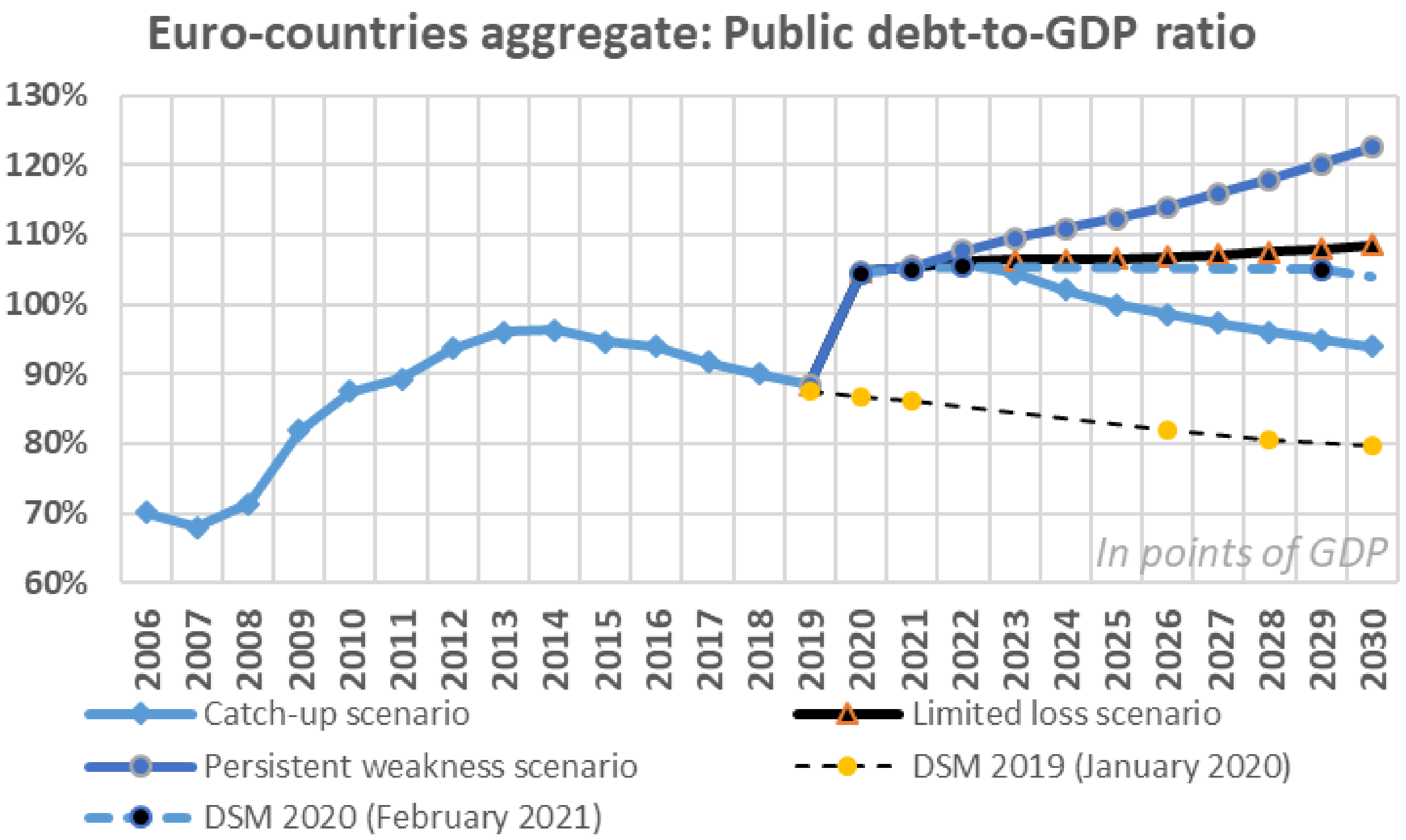


Low r-g

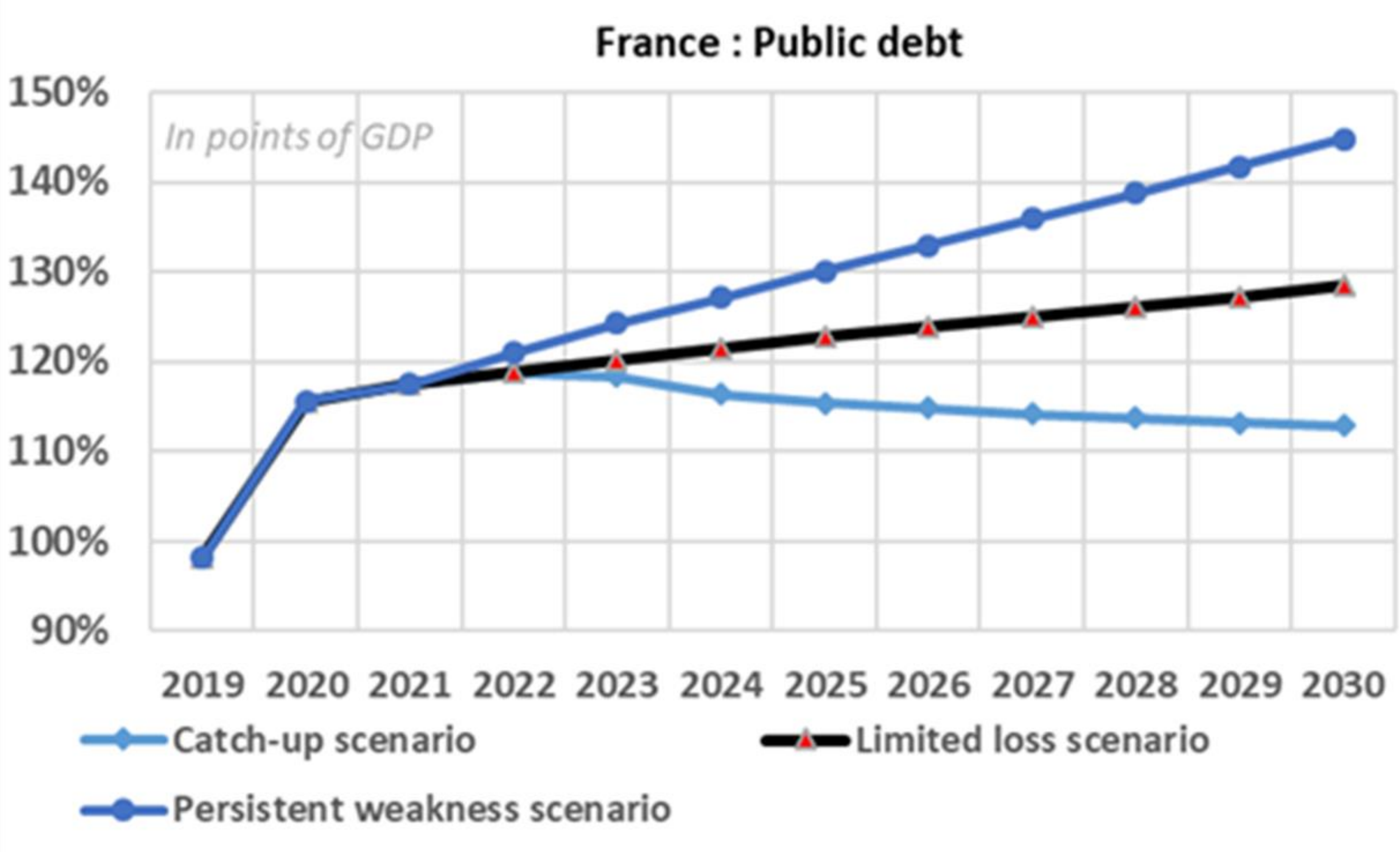
But with uncertainty as horizon extends and again, heterogeneity



Debt path:
The benign outcome is not the only one …

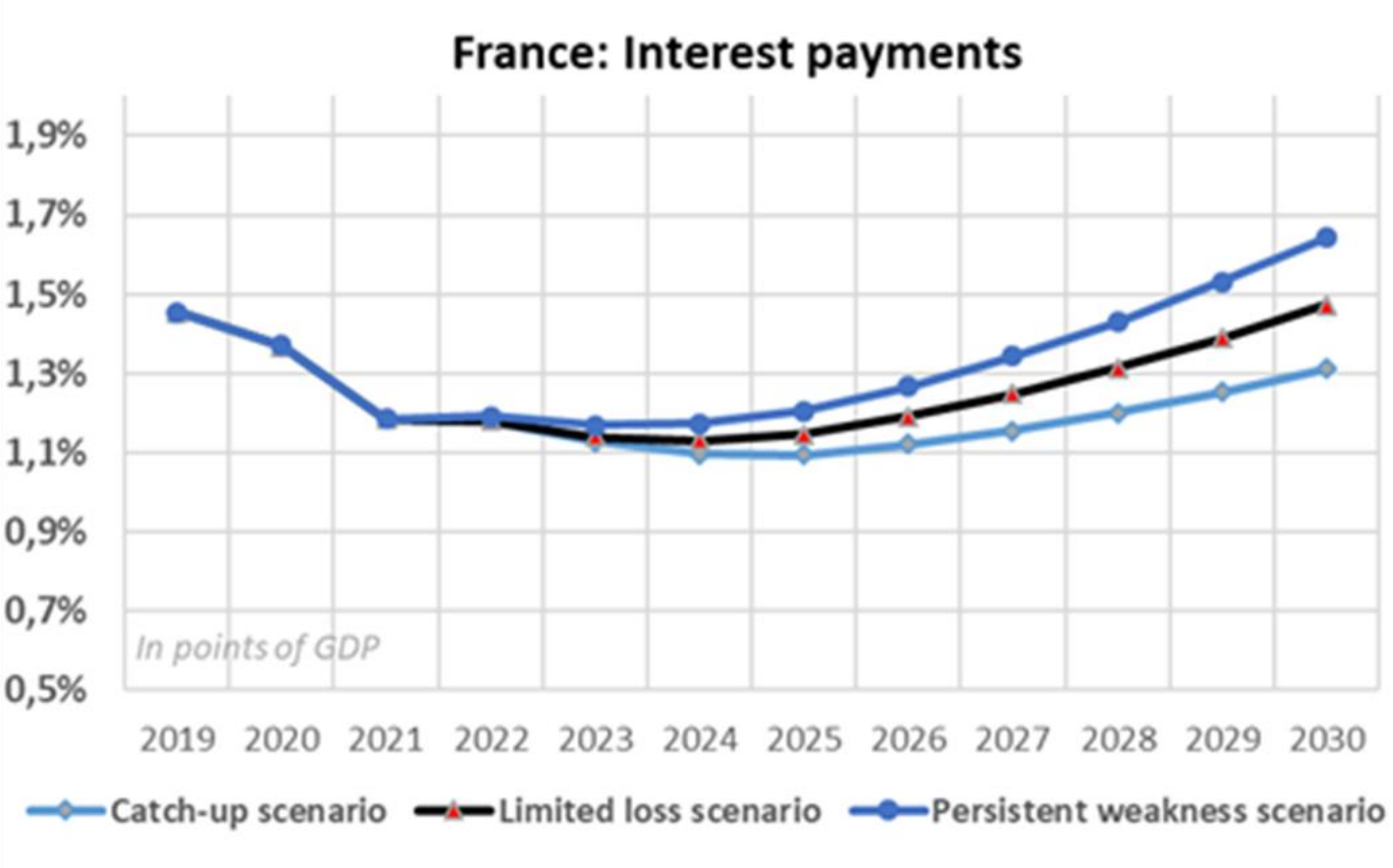


Debt path: the case of France



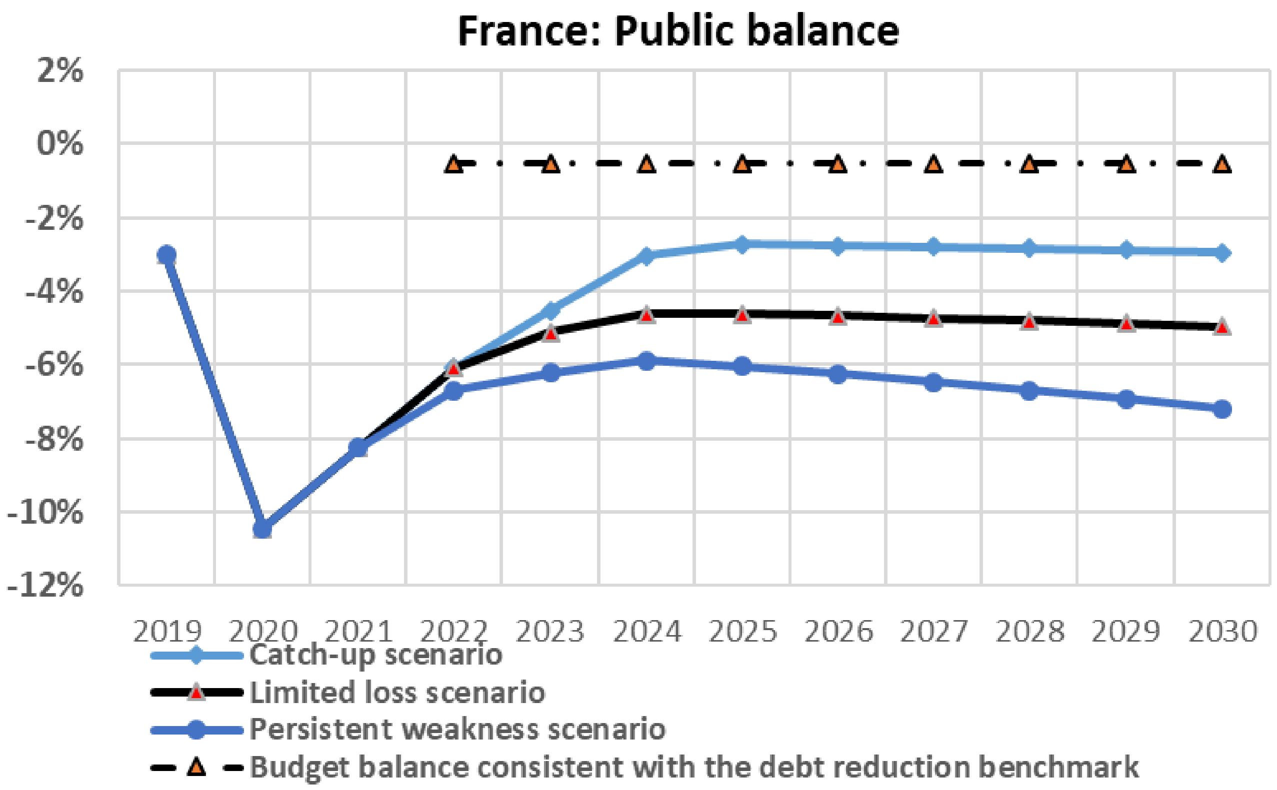
Interest payments: the case of France

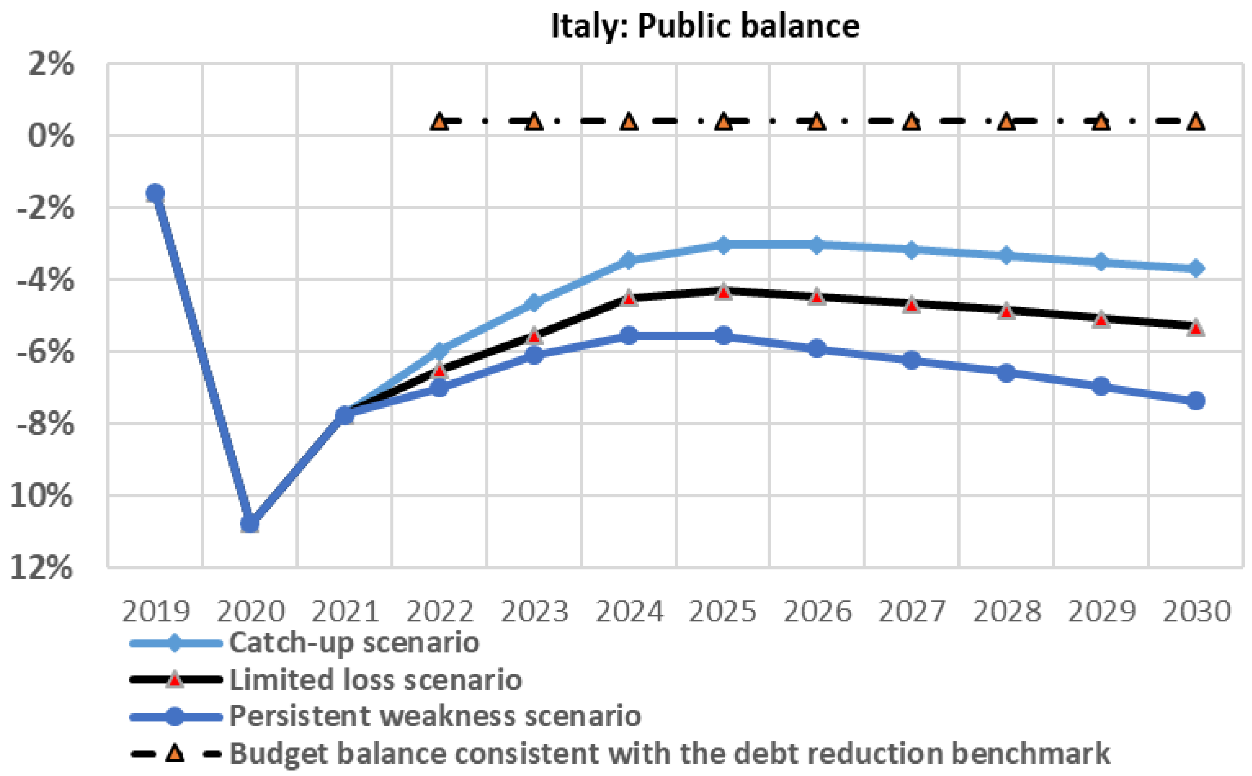
- Further falls not excluded in short-term
- Ten-year rise limited and uncertain
- But slope of curve a concern



“Debt rule”

The debt reduction benchmark: the gap to close is large …





Budget balance consistent with the 1/20th debt reduction rule in the limited loss scenario (with GDP growth: 3%)

What to make of the « debt rule »?

- Urgent discussion
- Two questions are often conflated and should not be

  (1) Is the debt rule a sensible long-run guideline, possibly after a transition period ? If not, how to revise it?

  (2) Is it a good idea to have a debt rule – in the sense of a rule monitored on a continuous basis with potentially strong procedural consequences?
- Start with question (2)

A debt objective is key; does a debt rule in annual surveillance processes make sense ?

- The debt ratio cannot be “controlled” over a one-year horizon, even not over a “3-year” horizon
  - Volatility due to shocks (inflation, growth, DDA…)
  - Self-defeating effect of fiscal consolidation in short to even medium-term: policies start making a clear difference only after 5 years or more
- Case for systemic reform of rules
  - Long-run debt objective with a (preferably single) operational annual target
  - Question of calibration of long-run debt objective remains

Options for revisiting the debt reduction benchmark (as a long-run objective)

1) No change
2) Parametric changes:
   - 60% $\rightarrow$ 90%, 5% $\rightarrow$ 3%
3) Gross debt $\rightarrow$ Net debt
   - Removing liquid assets
   - Removing public capital [alternative: specific treatment of PI in operational target]
4) Rules-based differentiation
   - Higher debt, lower pace? Higher r, lower pace? Or the opposite?
5) Judgement with governance safeguards
   - Who does what? Technical vs political tasks

Concluding remarks

- Benign view of post-Covid public finances holds that
  - Covid-induced increase in deficits is temporary
  - Level increase in debt is permanent but unproblematic given low rates

- Paper takes a more sceptical stance
  - Deficits are unlikely to wind down magically – or at least, there is a high chance that they won't
  - Low interest payments likely for a while but misguiding reassurance. Long term risks may actually have increased
  - Heterogeneity across Member States makes the problem much harder

- "Debt rule" arguably the acid test of forthcoming discussions
  - Containing debt ratios remain a sensible objective, but long run
  - Views will need to be reconciled on calibration

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