

Debt Sustainability and Economic Policy

Giancarlo Corsetti

***Fifth Annual Conference of the
European Fiscal Board
Brussels, May 11 2023***





[vanceret søgning](#) / Debt Sustainability Assessments: The state of the art

Debt Sustainability Assessments: The state of the art

Studie – 15-11-2018

The approach to Debt Sustainability Assessments (DSAs) has substantially evolved after the global crisis, consistent with the goal of improving detection of high and low frequency risks. DSAs cover an increasing number of indicators, systematically look into implicit and contingent liabilities, and use statistical methods to quantify “tail events”. They also operationalize debt limits, by adopting thresholds for debt and payment flows to single out enhanced vulnerability. While these developments mark true progress, this paper focuses on liquidity risk, contagion risk and the identification of debt limits as critical areas limiting DSA effectiveness, explains why DSA should embed potentially available official support and how an incomplete lending architecture is a hurdle for DSA. The paper concludes with a comparative assessment of current standard DSAs, suggests directions for further improvement and discusses the correct use of DSAs in light of the strengths and weaknesses inherent in the underlying methodologies..

Outline

- The economic policy model after the pandemic and the war
- Back to the blackboard: sustainability analysis
 - Where do we stand? A post inflation-crisis scenario
- A virtuous fiscal and monetary framework for Europe
- Threats to stability: Insight from literature on debt crises
- Sustainability, rules and institutions

1. The economic policy model after the pandemic and the war

- “Pandemic and war have accelerated previous trends such as a rise of protectionism, regionalization of finance, decoupling of the West and China, and public debt accumulation. These trends reveal potential conflicts between the objectives of managing inflation, maintaining debt sustainability, and ensuring financial stability, while at the same time governments endeavor to safeguard the welfare of their citizens.”
- “Do they represent a structural break that calls for the reassessment of the current economic policy model, particularly given the increased role of the state as an insurer of last resort in a high-debt context?”

The economic policy model after the pandemic and the war

- “A stable fiscal outlook and a credible monetary policy provide the foundations for addressing real financial vulnerabilities and achieve macroeconomic stability.”
- “However, it will be necessary to reassess the interaction between monetary, fiscal, and regulatory policies to ensure they work together effectively. The objective should be to reduce vulnerabilities, minimize the risk of a confidence crisis, and facilitate deleveraging at minimal economic and social costs.”

Rethinking the economic policy model

- Fiscal policy needed in response to large shocks or contingent on constraints on monetary policy (ZLB)
 - Large Scale (“aggressive”)
 - Scope: guarantees, risk sharing, market maker of last resort
- This raises the social value of building fiscal buffers and preserving fiscal space, i.e. ability to leverage at stable and low borrowing costs.

Rethinking the economic policy model

- Preserving fiscal space
 - “Build and respect strong monetary and fiscal institutions”, with clear mandate
 - Role of Fiscal Councils
 - “Protecting the special (and potentially fragile) nature of public debt”
 - Greater role for the international financial architecture (official liquidity/lending frameworks)
- Monetary policy: a credible inflation strategy and **monetary backstop** of government debt, requiring a credible fiscal support to guarantee the central bank independence and ability to pursue its mandate.

Some references

- IMF many---see Finance and Development 2023 March
- Barcelona Report 2023 (June)
- London Consensus on fiscal policy (Reis and Velasco)

Rethinking the economic policy model



VS.



Rethinking the economic policy model

- Stable fiscal outlook and credible monetary policy joint goal/responsibility of independent authorities
- Backstop of government debt requires
 - a credible monetary policy---unanchored inflation expectations create destabilizing inflation and borrowing costs dynamics
 - the support of the treasury, making sure that balance sheet problems do not interfere with the ability of the central bank to pursue its mandate
 - a stable fiscal outlook conditional on the backstop, in turn requiring financial stability

(work with Dedola 2016, Schumpeter Lecture eea 2015)

2 Back to the blackboard: sustainability analysis

- Relative to 2019, higher debt, higher borrowing costs, higher uncertainty, higher prospective spending (energy crisis and transition)
- Even with $r < g$ in negative territory,
 - snowballing effects can be driven by (default/inflation) risk premia, and/or
 - primary deficits can be large enough to destabilize debt-GDP ratios.
- The end of “sustainability optimism” (Codogno Corsetti 2022)

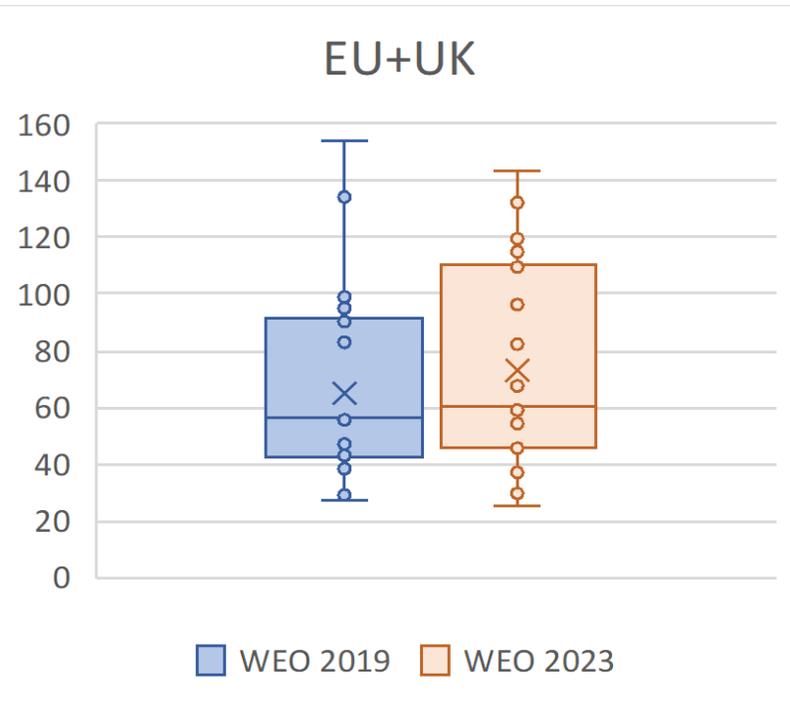
Where do we stand? A post “inflation-crisis” scenario

(Preview of the Barcelona Report 2023)

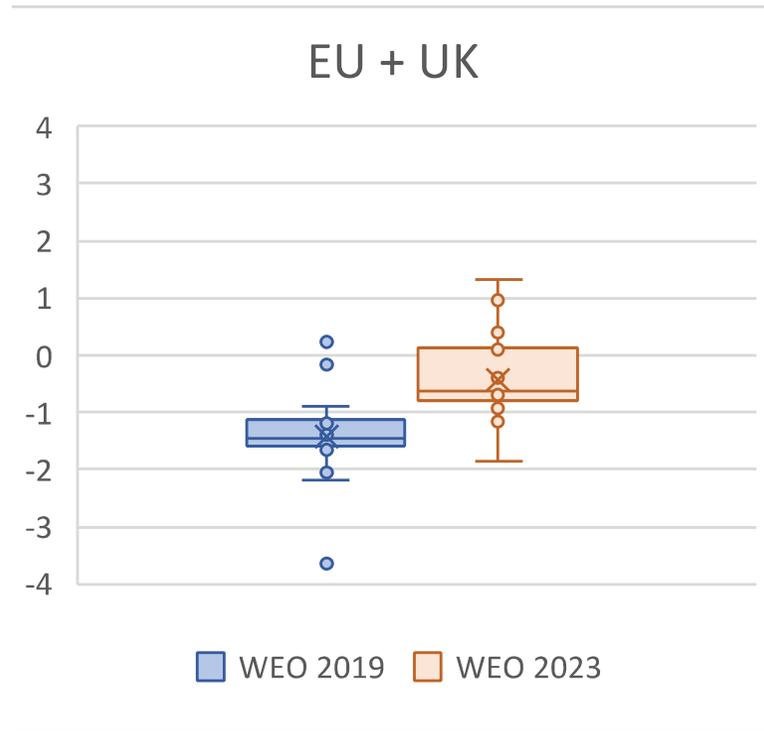
- Focus on 2027, after economic recovery, the inflation crisis and post-pandemic fiscal adjustment have all run their course (at least in our projection models).
- Based on IMF inputs, the following shows for 2019 and 2023
 - Projected Debt to GDP ratio (D/Y) in 2027
 - Primary Surplus ps^* required to stabilize D/Y at the 2027 level
 - Difference between ps^* and the projected (structural) ps in 2027, as a measured of fiscal adjustment

Debt, D-stabilizing primary surplus, difference with projected surplus, 2027

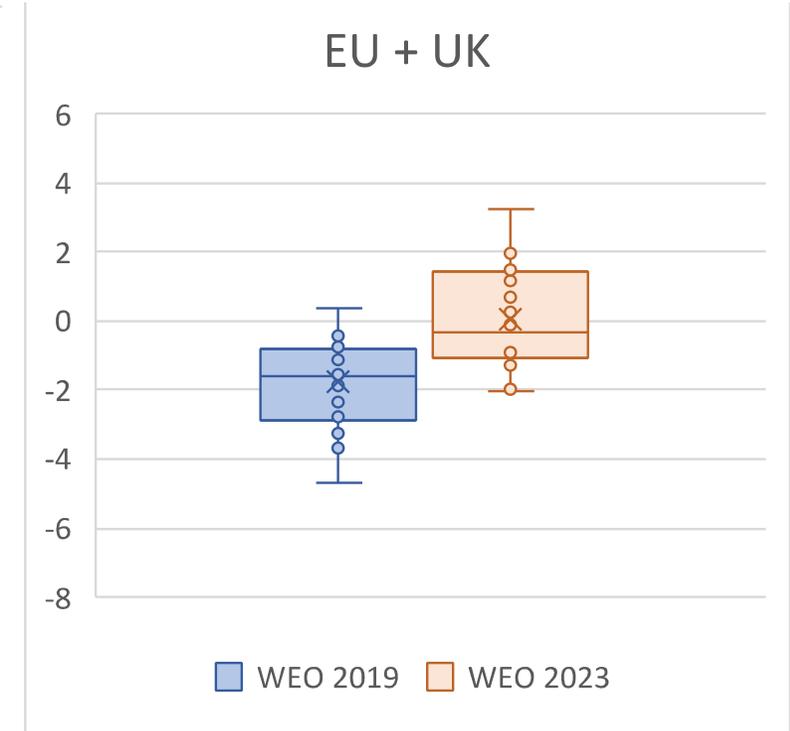
Debt to GDP



Debt stabilizing PS*

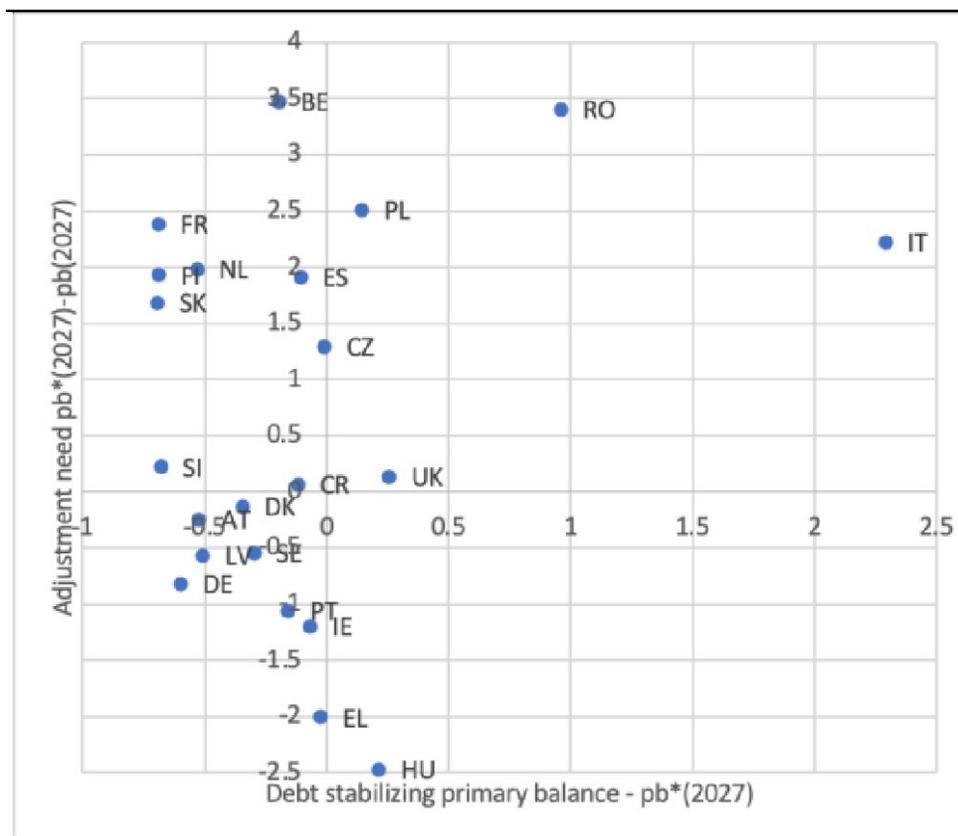


PS*-projected PS



Barcelona report 2023 forthcoming

PS_2027 vs. PS*



Barcelona report 2023 forthcoming



Take away

With all the required caveats on projections (based on conservative assumption, see the Report)

- with the exception of Italy, 2027 **ps*** remain “modest” (below 1%)
- For a number of countries the **projected ps** falls short of **ps*** by at least 1,5 percentage points.
- Quantifying uncertainty on r-g using the probability density function of the distribution of forecast errors in the past, the probability that **ps*** exceeds 3% is only significant for Italy (prob 13,4%) Romania (5,2%) and Spain (prob. 1.1%)---for the 2% threshold, also Greece (1.7%).

A narrow path, but not an unfeasible path

Take away

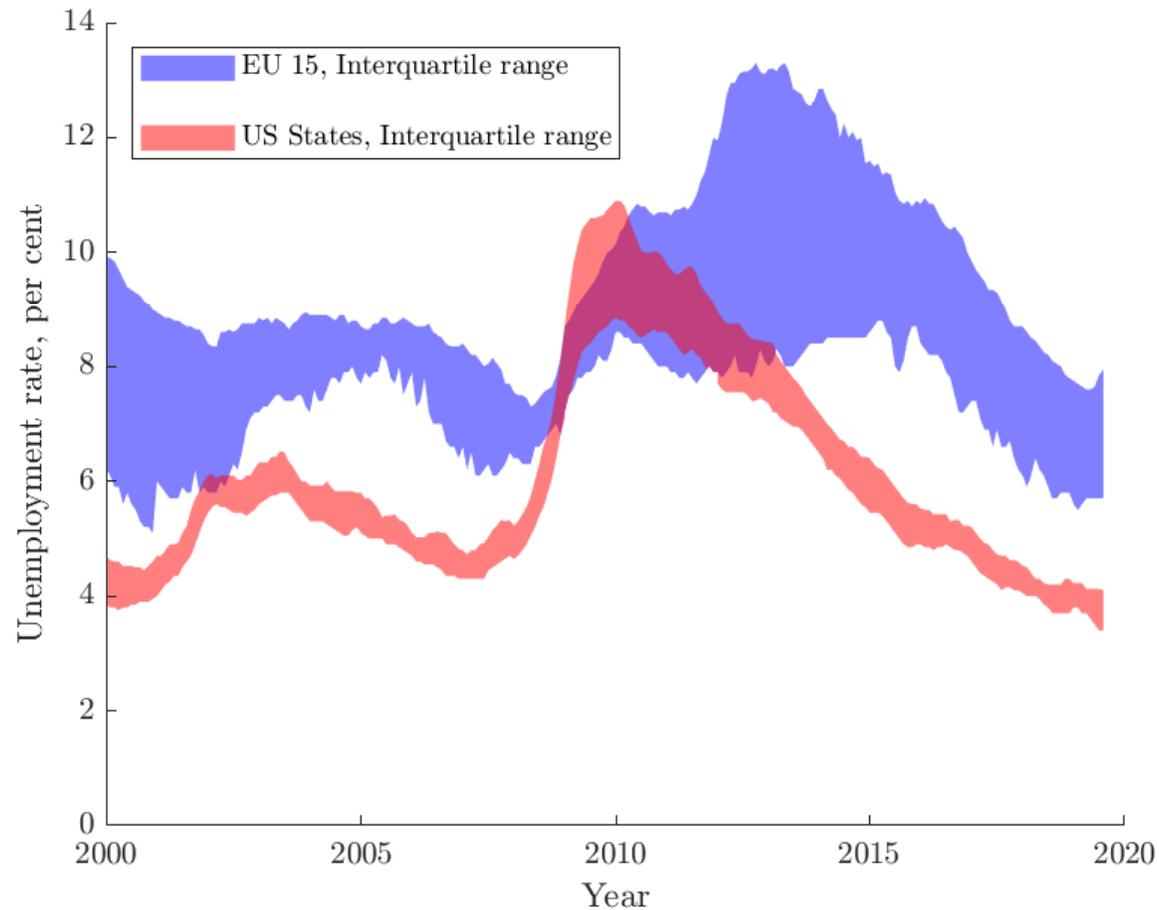
- Yet vulnerability to disruptive belief-driven sovereign risk/rollover crises potentially high
 - Transmission of sovereign to private risk premia, dragging down consumption, investment and growth
 - Financial/bank fragility

3 A virtuous fiscal and monetary framework for Europe

- The narrow path likely if and only if EA framework can structure an effective (ultimate) support of government debt by monetary authorities.
 - Not monetary financing
 - Credibly ready to intervene on a sufficient scale
 - **“Effectiveness is pre-emptive”**
 - “Value at risk”: residual fundamental risk
- Open issue: monetary authorities can only support member states on sustainable fiscal paths conditional on the support

The consequences of inefficient fiscal and monetary framework

Lessons from a US-EA comparison post GFC



4 Threats to debt stability: insight from recent literature

- Belief-driven debt crises are potentially pervasive at different levels of debt
 - Rollover liquidity crises at low level of debt/financing need (Cole & Kehoe CK Beliefs)
 - Hikes in borrowing costs accelerating debt accumulation (slow-moving debt crises) at intermediate level of debt (Calvo, Lorenzoni Werning, Corsetti Dedola)
 - Rollover risk at high level of debt (Corsetti Maeng)
- Variety of mechanisms/roots
 - From financial to fiscal risk (literature on doom loop)
 - Debt overhang and belief-driven contraction in investment (Carlo Galli)
- Assessment of vulnerability, & real and welfare costs

Deleveraging vs smoothing adjustment

- A long-standing result in the literature: from a social welfare perspective, benevolent governments optimally reduce debt even in bad times up to eliminating vulnerability to belief-driven crises
 - Welfare motivation for deleveraging---i.e., procyclical fiscal cuts
 - If debt remains high, political economy distortions
- Key lesson from new literature (in the style of Calvo 1988)
 - In general, the opposite is true: government optimally smooth adjustment by borrowing despite vulnerability (See joint work with Maeng 2020 and Mackowiak 2022)
 - Vulnerability motivates “prudential” cut in deficits, not surpluses

A numerical illustration (Corsetti and Maeng 2020)

Figures not to be taken “seriously”

Model	The maximum debt to GDP ratio immune to debt crises (%)	$\bar{B}(0)_\pi / (A\bar{y})$ (%)	Proportion of deleveraging (%)
			Long-term bonds
Baseline, $\rho \in \{opt, pes\}$	73	176	9.38
CK beliefs, $\rho \in \{opt, CK\}$	38	112	83.66
			One-period bonds
Baseline, $\rho \in \{opt, pes\}$	13	141	13.83
CK beliefs, $\rho \in \{opt, CK\}$	8	83	84.66

Incentives

- Liability flow management and debt maturity can reduce but not eliminate vulnerability to self-fulfilling crises
 - Necessity of a backstop
- Backstop does not reduce the incentive for government to undertake desirable policy/reform (Morris and Shin 2006, Corsetti Guimaraes Roubini 2005)

5 Sustainability, rules and institutions

- November proposal recognizes the new “environment”
 - Smoothing costs of adjustment through country-specific path
 - DSA as an instrument to identify and manage corrections
- Institutional framework
 - “Build and protect strong institutions” approach
 - Guaranteeing a reliability standard
- Lingering outstanding issue: Rules that protect an effective backstop at European level

Concluding remarks

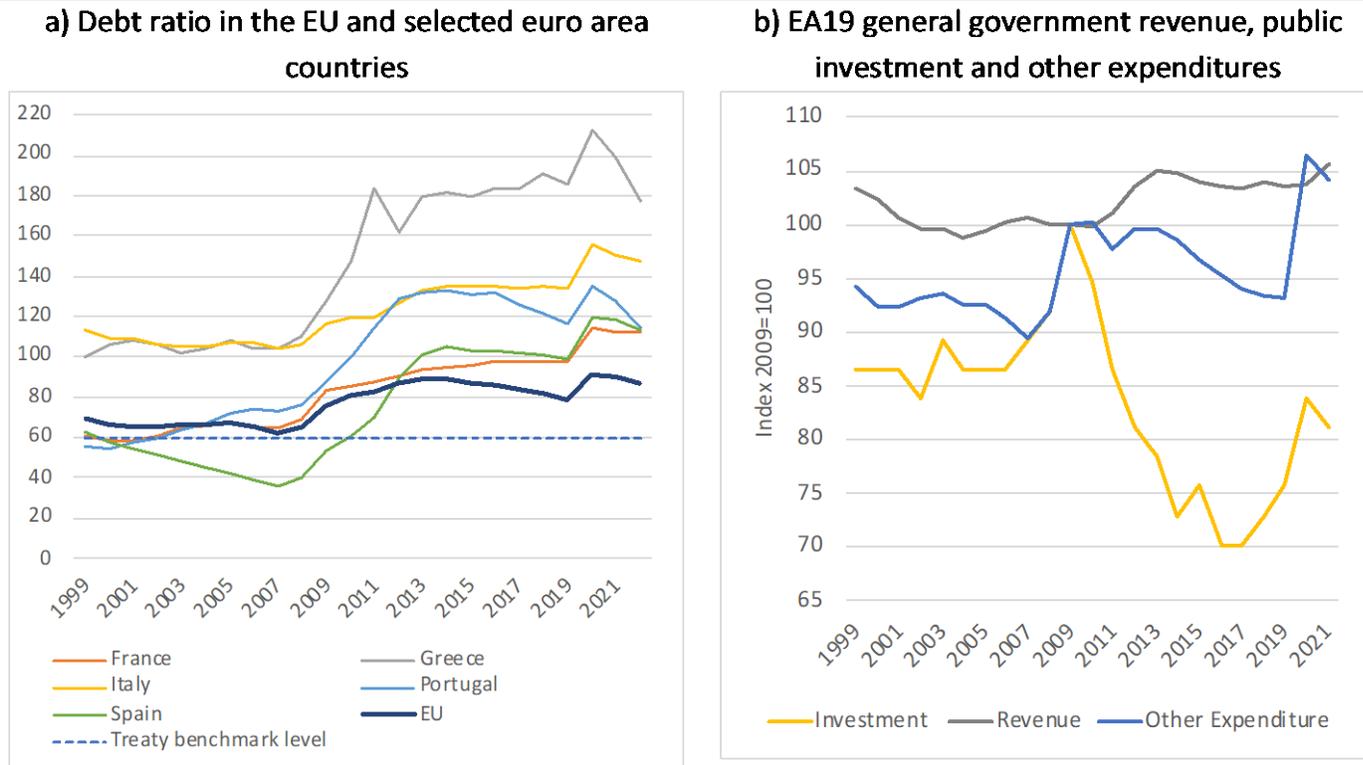
- Shocks systematically raise a trade-off between adjustment now and adjustment in the future with some probability
 - Rational gambling but
 - Size and probability of adjustment depends on investors beliefs
- After GFC, EA debt Crisis, ZLB, Covid-19 and war, debt is high:
 - no “immaculate” (i.e., costless) deleveraging
- At European level, there is a narrow path of sustainability
 - It will require a virtuous fiscal and monetary framework

Concluding remarks

- Geo-political and climate drive to strengthening policy cooperation at European level and raise the costs of failing to maintain macroeconomic and financial stability
- The (r)evolution of European public goods
 - Ex post assessment of spending

Fiscal performance in the EU

Figure 6 Debt and public investment under the SGP (percent of GDP)



Source: World Economic Outlook database, April 2023 (panel a); Eurostat (panel b).

No accumulation of buffers in good time

Catastrophic debt crisis in 2011-

Squeeze in investment

Fiscal policy largely pro-cyclical

References

Debt Sustainability Analysis: State of the Art, Study requested by the ECON Committee of the European Parliament, Economic Governance Support Unit Directorate-General for Internal Policies of the Union - November 2018

“An unconventional collaboration” in Finance and Development: Rethinking Monetary Policy in a Changing World, IMF F&D, March 1 2023

Gambling to preserve price (and fiscal) stability, with Bartosz Mackowiak, 2022, forthcoming IMF Economic Review

Debt Crises, Fast and Slow, with Seung Hyun Maeng 2023 revision

Debt Sustainability and the Terms of Official Support, Giancarlo Corsetti Aitor Erce and Timothy Uy, revised November 2019 (CEPR DP 13292, November 2018).

Bartsch, E, A Bénassy-Quéré, G Corsetti, and X Debrun (2020), It's all in the mix: how can monetary and fiscal policies work or fail together?, Geneva Report on the World Economy, No 23, ICMB and CEPR.

References

Gambling for Redemption and Self-Fulfilling Debt Crises, Conesa, J. C. and T. J. Kehoe (2017)

Self-Fulfilling Debt Dilution: Maturity and Multiplicity in Debt Models Aguiar, M. and M. Amador (2020).

The Mystery of the Printing Press: Monetary Policy and Self-Fulfilling Debt Crises, Corsetti, G. and L. Dedola (2016)

Slow moving debt crises Lorenzoni, G. and I. Werning (2019)

Sovereign Default: the Role of Expectations Ayres J, G Navarro, JP Nicolini, and P Teles (2018).