Making sovereign DSA operational: Conceptual and practical aspects in an EMU perspective

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Ettore Dorrucci (European Central Bank) inputs from V. Valenta and O. Bouabdallah are gratefully acknowledged
Two types of questions:

1. **Why** should DSA be made operational in the EMU context? *(Objectives)*

2. **How** should DSA be made operational? *(Implementation)*
   - Limits we should acknowledge…
   - …strengths on which we can build…
   - …and challenges to be addressed (e.g., DSA for fiscal governance)
Part 1

**Why** should sovereign DSA be made operational?
EU institutions (COM, ESM, EFB, ECB) and national authorities (MoFs, IFIs) need to assess fiscal sustainability as precondition for:

(i) smooth functioning of EMU under monetary dominance;

(ii) EMU financial stability (sovereign-corporate-bank nexus)

The fiscal authority should be ready and willing to adjust revenues and primary spending to stabilise debt at safe level, for any interest rate path that the central bank may consider suitable to deliver price stability.
Why sovereign DSA? The established and the novel objectives

DSA is *already operational* for:

- Financial assistance – crisis resolution
- Fiscal and financial surveillance – crisis prevention
- Monetary policy assessment

DSA *may/will in future be further operationalised* for:

- New EU fiscal governance – definition of public debt trajectories
- Implementation of unconventional ECB monetary policy instruments
Part 2

*How* should sovereign DSA be made operational?
“Debt sustainability” as such is not observable (ambiguous definition)

Many definitions of sovereign debt sustainability, with focuses on:
- Present value of future primary balances vs initial level of public debt (intertemporal budget constraint)
- Present value of the public debt level (transversality condition)
- Liquidity risk
- Feasibility of necessary fiscal adjustments without undue growth losses
- Other…

In essence: **The government must be able and willing to service public debt at all times and circumstances**…

⇒ ... **but operationalisation of this definition is complicated!**
Example - IMF definition of public debt sustainability

“In general terms, public debt can be regarded as sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level.”

(2013 Staff guidance note for DSA, unchanged in the 2022 update)
Limit 2: DSA results as good as their methodological choices and assumptions

- DSA, like any other economic tools, reflects methodological choices
  - How assumptions are derived
  - Calibration of stress scenarios
  - Aggregation scheme

- Any DSA is, by design, dependent on assumptions
  - Assumed fiscal path, financial assumptions, long-term growth and inflation, etc.
  - In programme or fiscal governance context: degree of implementation

- Current DSA tools:

  **so far used to gauge fiscal risks...**
  - Less attention paid to: (i) growth model and its resilience; (ii) institutional quality; (iii) macro-financial vulnerabilities

  **... and with limited benchmarking against observables**
  - Fiscal stress/default episodes are rare in the EU history
Significant methodological progress made over the last decade

- Probabilistic approach to DSA (risks to debt sustainability assessed, not a binary exercise)
- Multiple time horizons, criteria (quantitative and qualitative) and methods (deterministic, stochastic, additional indicators)

Transparent methodologies should in principle allow for: (i) appropriate interpretation and replication by users; (ii) comparison of different assumptions; (iii) more rational policy debates

Harmonised approaches adopted by international/EU institutions make cross-country comparisons easier

Strengths: significant progress made, transparency, harmonisation
Comparison across institutions – similarities

Realistic baseline projection
Stress scenarios
Stochastic DSA
Additional indicators

Risk classification
Visualisation
Write-up
Comparison across institutions – differences are relatively minor

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A conclusion à la Churchill?

- DSA is the worst – except for all the others that have been tried

- DSA: no guarantee that mistakes cannot be made – but there is room for correction