Debt Sustainability Analysis and the EU fiscal framework

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Outline

• Context: current and future challenges
• New fiscal rules fit for the future
• The DSA as a budgetary planning tool
• Some lessons from illustrative simulations
Context: current and future challenges
High debt levels and tightening financing conditions

**Euro area general government debt ratio (%)**

Source: Debt Sustainability Monitor 2022

**Financing conditions in the EU**

Source: QREA 2022 / 4
Population ageing and climate change

Projected total (public) age-related spending

EU - total age-related expenditure (%GDP)

Fiscal impacts of acute physical risks in the EU, based on stylised scenarios (estimated impact on public debt ratio, pps. of GDP)

Note: The aggregate includes pension, health care, long-term care and education spending

Source: Ageing Report 2021

Source: Fiscal Sustainability Report 2021
New fiscal rules fit for the future

• Key objectives and principles
• Focus on the technical trajectories / information and planned fiscal path
Key objectives and principles of the reform

Key objective of the reform: strengthen **debt sustainability** and promote **sustainable and inclusive growth**

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Revised process for coordination of economic and multilateral surveillance

Common framework

Technical trajectory
- Commission multi-annual technical trajectory anchored on debt sustainability

Design of the plan
- Member State medium-term fiscal structural plan, incl. reforms and investments

Assessment/adoption
- Council endorses plan or requests revised plan based on Commission assessment

Implementation
- Commission and Council monitor compliance with the endorsed plan
Technical trajectories or information, and planned fiscal path

• **Fiscal path**, over at least 4 years: put forward by the **Member States** in their plans, and to be endorsed by the **Council**. Should ensure that:
  
  – **Debt** is put on a downward path or stays at prudent levels, with sufficient certainty (“plausibly”)
  
  – **The deficit** is (brought and) maintained below 3% of GDP over the medium term

• To guide the preparation of the plans, retain a multilateral approach and ensure equal treatment, the **Commission** provides:
  
  – For Member States with debt > 60% of GDP or deficit > 3% of GDP: **Technical trajectories** based on a common methodology i.e. the **Debt Sustainability Analysis (DSA)**
  
  – For others: **Technical information** related to the deficit criterion
The DSA as a budgetary planning tool

• What DSA are we talking about?
• Advantages for fiscal surveillance
• De-mystifying the DSA (usual criticisms)
Key features of the Commission’s DSA in the context of the EU fiscal framework:

- Currently mainly used to identify risks that debt will not stabilise in the future, based on current policies, and highlight the need for policy action.
- Risk assessment depends on the projected debt level and trajectory, the room for corrective action if needed (an indication of fiscal consolidation space), and vulnerability to shocks.
- The Commission’s DSA provides a medium-term multilateral public debt projection framework, based on common assumptions and methodologies including a range of scenarios (a ‘no-fiscal-policy-change’ baseline and stress tests capturing ‘normal’ uncertainty).
Advantages of using the DSA toolkit for setting / assessing the plans

- Strengthening debt sustainability is the key objective of the fiscal rules
  ➔ the DSA as the state-of-the-art tool to contribute to this objective (e.g. Blanchard et al., 2021; IMF, 2022)

- Given current debt levels and future fiscal headwinds, need to anchor fiscal policy in a credible medium-term perspective: high debt will not be brought to ‘safe levels’ in one or two years, future fiscal pressures and uncertainty

- The DSA, as a medium-term public debt projection framework, presents several advantages for this purpose:
  - Fundamental / economic concept at its core
  - Commission’s DSA is well-established, based on common assumptions and methodologies, and is already used in the EU fiscal framework
The DSA is based on a fundamental economic concept relevant for the fiscal rules: the debt dynamic and its drivers.

The debt dynamic is driven by a few key variables: the initial debt level, the current/projected ‘r-g’ differential, the current/projected primary balance (including costs of ageing) and stock-flow adjustments.
The Commission’s DSA is a well-established framework

2000/01: Fiscal sustainability analysis introduced, with a focus on long-term risks (population ageing / S1-S2 indicators)

2006: First Fiscal Sustainability Report (FSR) published (ECOFIN mandate ➔ EPC / AWG)

Since 2010-11: Introduction of a multidimensional approach, focusing on short- and medium-term fiscal sustainability risks (EA sovereign debt crisis)

- Early-warning indicator (S0 indicator)
- Debt Sustainability Analysis (DSA)
- First Debt Sustainability Monitor circulated to the EFC

Since 2016: FSR published every 3 years; Debt Sustainability Monitor published every “non-FSR” year

Fiscal sustainability: Council adopts conclusions - Consilium (europa.eu)
The DSA integrates available information, and relies on common assumptions and methodologies

- Commission short-term **forecast** (T+2)

- **Medium-term GDP growth projections**, based on the *EU commonly agreed methodology with the EPC Output Gap Working Group* (i.e. the standard ‘T+10’ projections)

- **Ageing costs** projections, based on the latest available Ageing Report *(jointly prepared with the EPC Ageing Working Group)*

- **Interest rates** and **inflation** reflect financial markets’ expectations and agreed convergence values (e.g. ECB target)

- ‘No-fiscal-policy-change’ baseline and stress tests, including stochastic analysis
The DSA already plays a role in the EU fiscal framework

Corrective arm SGP

- One of the relevant factors considered in the excessive deficit procedure (Art. 126(3) report)

Preventive arm SGP

- In principle, also informs the adjustment path towards the MTO

European Semester

- Also used in the context of the European Semester (Country Reports, PPS/ES, fiscal CSRs)
De-mystifying the DSA: 1) Does it rely too much on the assumptions?

- The DSA reflects *fundamentals* including the current level of indebtedness, the capacity to repay debt (notably linked to economic growth), risk premium, contingent liabilities, and policy orientations.

- Results can change depending on the (evolving) macro-financial environment and policy orientations.

- Is that bad?

Public debt projections in the UK: before and after the ‘mini-budget’ announcement

Public sector net debt (% of GDP)

Source: OBR (Economic and fiscal forecast, November 2022)
2) Is it too complex?

• A certain degree of complexity is needed to **rightly capture risks**: e.g. the snapshot level of debt alone is a poor predictor of debt sustainability risks (IMF, 2021; ECB, 2017)

• Yet, **high degree of transparency**:
  – Regular publications with extensive explanations on the assumptions and the methodologies

Debt Sustainability Monitor 2022 (europa.eu)

Fiscal Sustainability Report 2021 (europa.eu)

The 2021 Ageing Report: Economic and Budgetary Projections for the EU Member States (2019-2070) (europa.eu)

[...]

  – Most of the analysis can be **replicated** in Excel spreadsheets
Some lessons from illustrative simulations

- Approach used in practice
- Stylised illustrations and results
Criteria to design the technical trajectories

Fiscal path (with respect to the ‘no-fiscal-policy-change’ baseline) ensuring:

Key criteria

• By the end of the adjustment period, at the latest, the 10-year debt trajectory in the absence of further budgetary measures is on a *plausibly* downward path, or stays at prudent levels
• The government deficit is brought and maintained below the 3% of GDP reference value in the absence of further budgetary measures over the same 10-year period

Safeguards

• 0.5% of GDP minimum adjustment for as long as the deficit is above 3% reference value
• Debt at the end of the planning horizon (4 years) lower than at the beginning
• No-backloading provision and no-expansion safeguard
Methodology to assess ‘plausibility’

• “Public debt ratio should be declining, or stay at prudent levels, under the deterministic scenarios of the Commission’s medium-term public debt projection framework described in the Debt Sustainability Monitor 2022”:
  • The baseline and three stress tests (adverse ‘r-g’, financial stress, lower structural primary balance)

• “The risk of the public debt ratio not decreasing in the 5 years following the adjustment period of the national medium-term fiscal-structural plan is sufficiently low. The risk is assessed with the help of the Commission’s stochastic analysis”:
  • 2,000 shocks on interest rates, growth, primary balance and exchange rate
  • Based on country-specific historical data (variance-covariance matrix)
  • ‘Sufficiently low’ means a probability of debt decline of at least 70%, in line with the Commission’s DSA
Stylised results for a high-debt country, 4-year adjustment period (no extension)

Under technical trajectory (0.65 pp of GDP per year)

Debt: technical trajectory and deterministic stress tests

Debt: stochastic projections around technical trajectory

71% of the distribution below T+4 level
Stylised results for a high-debt country, 7-year adjustment period (extension)

Under technical trajectory (0.4 pp of GDP per year)

Debt: technical trajectory and deterministic stress tests

Debt: stochastic projections around technical trajectory

71% of the distribution below T+7 level
EGR adjustment requirements on average similar to current fiscal rules, but better differentiated by sustainability risks

**Fiscal adjustment requirements**
(average across Commission DSA risk category)

Source: Commission services based on COM AF 2022
Lessons learnt from illustrative simulations

• Requirements better differentiated, reflecting country-specific fundamentals

• Still ambitious fiscal adjustment for Member States with larger public debt challenges, reflecting:
  • Current (negative) fiscal position
  • Structural trends: population ageing, increasing interest rate (adjusted for growth)
  • Vulnerability to shocks (need for fiscal buffers)

• Allowing putting debt on a decisive downward path

• Incentives for investments and reforms through more gradual adjustment in case of extension to 7 years