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## Rethinking Debt Sustainability?

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# Sommario

## Rethinking Debt Sustainability?

### **EDITORIALE**

- 5 Rethinking Debt Sustainability?  
Lorenzo Codogno, Pietro Reichlin

### **SAGGI**

- 25 Sovereign debt in times of crises  
Carmine Di Noia
- 39 A new look at public debt sustainability  
Ludger Schuknecht
- 65 Debt sustainability in emerging market economies after the  
Covid-19 shock  
William R. Cline
- 121 Debt sustainability analysis is back. Sudden shifts in underlying  
factors may push high-debt countries into a bad equilibrium  
Lorenzo Codogno, Giancarlo Corsetti
- 143 The (un)sustainability of public debt: the elusive reality of an  
intuitive concept  
Martin Larch

- 185 A post-Covid-scenario analysis of Italy's public debt ratio dynamics  
Cecilia Gabbriellini, Gianluigi Nocella, Flavio Padrini
- 211 The future of European fiscal governance: a comprehensive approach  
Marzia Romanelli, Pietro Tommasino, Emilio Vadalà
- 265 Public debt sustainability, fiscal rules and monetary policy  
Angelo Baglioni, Massimo Bordignon
- 289 Reconciling fiscal and environmental sustainability in the Eurozone  
Paul van den Noord

## **RUBRICHE**

- 325 Appunti sulla stagflazione  
Mariano Bella, Luciano Mauro
- 335 Come una grande banca può aiutare le medie imprese esportatrici a fare il salto dimensionale  
Fabrizio Guelpa

# Rethinking Debt Sustainability?

Lorenzo Codogno \*

Pietro Reichlin \*\*

## Introduction

This issue of *Economia Italiana* deals with public debt sustainability and fiscal rules. It was written at a moment when many beliefs about the benefits of current fiscal and monetary policies could change because of the risks associated with the energy crisis, the war in Ukraine, the return of inflation and the green transition. The volume contains several contributions by leading experts on the following questions: Is debt sustainability a cause of concern within the Euro Area? How should we consider revising the Stability and Growth Pact in the European Union (EU)? Are the energy transition and the pandemic risks good reasons to build up EU-level fiscal capacity? In the introduction to this monograph, we will touch upon some of these issues and discuss why they are important.

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\* London School of Economics and Political Science, and College of Europe, l.codogno@lse.ac.uk

\*\* Luiss Guido Carli, EIEF and CEPR, preichlin@luiss.it

## 1. Public Debt Sustainability

For thirty years at least, we have lived in a low real interest rate environment and, up to 2021, low inflation. The Global Financial Crisis and the European sovereign debt problems added a new chapter and a new dimension to this phenomenon. Most governments and central authorities in advanced economies reacted with less restrictive policies. In a sharp reversal of the early conservative approach followed in the first ten years of the Euro, the European Central Bank (ECB) established itself as a *de facto* lender of last resort for governments and commercial banks ever since ‘whatever it takes’. Fears of a new sovereign debt crisis progressively waned, and slack in aggregate demand and liquidity abundance set in. Central banks of advanced economies consistently missed their inflation targets, and nominal policy rates hovered around or below zero. For many years, governments struggled (successfully or unsuccessfully) to keep primary deficits and public debt within the limits imposed by the Stability and Growth Pact. During the pandemic crisis, public debt across advanced economies soared due to the unintended effects of the sudden collapse in activity and the deliberate decision to adopt a more expansionary fiscal stance. The consequences have not been homogeneous and always positive across countries. Still, the low interest rate environment and the active role of central banks have produced complacency among investors about the stability of the monetary union (EMU) and the sustainability of public finances. Since 2015, there has been a significant compression of interest rate spreads, so the surge in public liabilities has had, to a large extent, no significant impact on debt servicing cost.



As recently as three years ago, Blanchard (2019) gave a very influential address to the *American Economic Association*. He claimed that a further increase in the debt level in advanced economies and a more lenient approach to fiscal rules within the EU might be implemented at little or no cost, i.e. there would be no adverse consequences on welfare due to investment crowding out and the reallocation of the tax burden across generations. Blanchard based his statement on the observation that, in the US, ten-year government bond yields have been lower than nominal GDP growth on average since the 1950s. Many pundits and commentators have gone further by claiming that monetary financing should be pursued with no fear of increasing inflation. Whatever the opinions about these issues, the low inflation/low rates environment brushed aside worries about possible conflicts between the central banks' two main objectives: price and financial stability. Therefore, the ECB could safely increase its purchases of sovereign bonds in the secondary market and yet be able to keep price dynamics and money supply under check. However, since the end of 2021, the situation has changed in many ways<sup>1</sup>. It is not yet clear if this change will be a long-term phenomenon or just a temporary blip. We are now facing inflation levels that were last experienced in the 1970s, together with supply-side shortages, the relative scarcity of primary commodities and energy, and intense pressure to speed up the energy transition.

Traditional debt sustainability analysis (DSA) is based on a few key variables: the nominal interest rate, the nominal GDP growth rate, the primary deficit, and government debt in the previous period (by and large, represented by the outstanding amount of government securities). A sustainability problem arises when  $i - g > 0$ , where  $i$  is the nominal interest rate and  $g$  the nom-

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<sup>1</sup> See for instance the recent paper by Akinci et al (2022).

inal GDP growth rate. If the former exceeds the latter, the ‘snowball effect’ kicks in, and the debt-to-GDP ratio is bound to grow unless the government responds with offsetting shifts in the primary balance. When the opposite inequality holds, the government can roll over the existing liabilities with zero or negative primary surpluses, a sort of ‘free lunch.’ A more sophisticated analysis considers the maturity structure of government securities. To be sure, the relation between  $i$  and  $g$  may change over time, and, most likely, it is affected by the size of public debt, as well as the size of primary surpluses. A no-arbitrage argument can be used to show that, at equilibrium, the discounted value of government debt must vanish asymptotically (a property called *transversality condition*). In a steady state, this is equivalent to the condition that the outstanding value of the debt-to-GDP ratio must be equal to the discounted sum of a constant positive primary surplus. Still, the solvency constraint implies no upper limit on the size of debt in a non-stationary environment. Hence, when  $i > g$ , and the government runs a negative primary surplus, we can only say that this policy must be compensated by a flow of positive primary surpluses sometime in the future. When  $i < g$ , there are no strong reasons to worry about the size of debt and the sign of the primary surplus.

Although useful as a *prima facie* approach, this analysis may be misleading. One problem is that, in a stochastic environment, the discount factors that one should use to derive the transversality condition (and the discounted sum of future primary surpluses) are complicated objects (growth-adjusted state contingent prices<sup>2</sup>). They typically differ from the safe rate, which is used in traditional DSA. For instance, a sustainable debt is perfectly compatible with

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2 See Bohn (1995) and Bloise and Reichlin (2022).

a safe interest rate being (much) lower than the GDP growth rate on average. Moreover, correlations between the relevant variables and volatilities play a key role. For instance, Bohn (1995) provides an example of a stochastic economy with complete markets where debt is sustainable even though the flow of future expected surpluses is negative. The bottom line is that, even if the safe rate is lower than the GDP growth rate on average, governments should still worry about balancing revenues and expenses over time, and a pure debt rollover may not be feasible. Still, a test based exclusively on primary balances may be inconclusive. These considerations shed doubts about the optimistic view expressed in Blanchard's address, i.e. a pure debt rollover may not be feasible even if the safe rate falls short of the expected growth rate. And this is especially true for countries that have to pay a yield premium relative to safe assets.

Another problem is that the above arguments ignore the legal constraints imposed within the EMU on the maximum size of the debt-to-GDP ratio (the 60% rule). These constraints may be somewhat arbitrary, but they are motivated by the EU economies' interdependence. As noted in the contribution by Larch to the present volume, in the EMU, "*the sustainability of government debt assumes additional significance due to the spillover effects national fiscal policies can produce on other member states and the effectiveness of a centralised monetary policy*". Sovereign spreads reflect investors' expectations about solvency, as governments may have a temptation (or necessity) to default, through a bankruptcy procedure, or surprise inflation, or a capital levy. A large amount of public debt and the need to comply with fiscal rules may impose a hard burden on taxpayers and generate political instability. This opens the possibility of 'multiple equilibria,' or unexpected runs on government securities that

may or may not be justified based on fundamentals. In fact, a loss of confidence in the ability of governments to roll over existing public securities is not a remote possibility. It is frequent in the case of foreign currency-denominated debt or monetary unions lacking appropriate cross-country insurance mechanisms, a centralised fiscal capacity or monetary autonomy. The EMU sovereign debt crisis is a case in point. Loss of confidence was not a consequence of excessive fiscal imbalances and debt accumulation (although these problems have arisen in some cases). Instead, it likely resulted from structural problems, external imbalances, slow productivity growth, excessive risk-taking in financial institutions, and waning political support for the EMU. In other words, government debt does not need to be very large for a solvency problem to arise.

Will the current surge in inflation change the paradigm of the debate we have just outlined? One reason to believe so is that the Fed and the ECB are now reversing their actions. Policy rates are increasing, and the discussion about reducing central banks' balance sheets has started. In terms of a traditional DSA, it will be crucial to understand whether the nominal long-term rate will rise more or less than the GDP deflator. So far, the rise in nominal rates appears to be lagging inflation developments. For instance, as reported by Gabriellini, Nocella and Padrini in this volume, the Italian debt-to-GDP ratio is expected to decrease by about ten percentage points (from about 151 to 141 per cent) from now to 2025, according to the latest estimates of the Italian government and the Parliamentary Budget Office (UPB). A similar view is expressed in the contribution to this volume by Baglioni and Bordinon: the Italian debt sustainability looks good in the short term but is uncertain in the longer term as it depends on higher potential growth, and

thus the proper implementation of Next Generation EU (NG-EU). In any case, there is no doubt that many Euro Area (EA) countries (primarily France, Greece and Italy) will have to implement a large fiscal consolidation in the near future to comply with the existing (although currently suspended) fiscal rules. This is argued in the contributions to this volume by Larch and Van der Noord. According to Van der Noord, “*the [Medium Term Objective] 1% of GDP ceiling for the structural deficit and the 60% debt rule are too tight from the point of view of long-run sustainability, which can be achieved at higher debt levels. A relaxation may thus be in order, as has also emerged from the reform debate so far.*” By extending the analysis to emerging economies, Cline identifies countries subject to more severe default risks and the main reasons for being less concerned than in the 1980s-1990s financial crisis, i.e. a higher share of sovereign debt being denominated in domestic currency and held by domestic lenders. The analysis points to CDS rates and the real debt servicing cost as crucial predictors of debt sustainability. Schuknecht gives a rather pessimistic view of debt sustainability based on other factors, such as challenges from population ageing affecting the largest advanced and emerging economies. He believes that “*debt sustainability is [...] a global, systemic challenge*” and “*open global capital markets increase the potential for international spillovers and spillbacks.*”

Turning to the Euro Area, there is no doubt that the general increase of sovereign debt and the absence of a central fiscal backstop risk hindering the independence of the ECB and creating ‘fiscal dominance.’ More specifically, the ECB’s unconventional monetary policies lowered sovereign spreads, the cost of refinancing government debt, and its market exposure. Baglioni and Bordignon report that, through the PEPP and PSPP programmes, “*the share of outstanding Italian government bonds held by the Eurosystem reached one third*

*by the end of 2021.*” Net general government interest payments as a share of GDP decreased from 2.7% to 1.7% in OECD countries (see the contribution by Di Noia). These actions stabilised markets and smoothed the monetary transmission mechanism. They also induced banks to concentrate their asset allocation on their own country’s government securities and allowed relaxed market discipline. It is hard to understand whether these policies may have had the unintended consequence of distorting the allocation of risks (across countries and financial institutions) and reducing governments’ incentives to comply with fiscal rules. Still, they certainly generated some redistribution from Core to Peripheral Europe. Orphanides (2017) stated that *“the single monetary policy necessarily pools some risks associated with its implementation.”* Whether the ECB policies are a clear example of “fiscal dominance”, i.e. the subordination of the price stability objective to the government’s borrowing costs, remains a thorny issue. The new high inflation scenario will test the ECB’s independence and ability to stabilise prices without igniting a sovereign debt crisis. In their contribution to this volume, Codogno and Corsetti argue that this will not be easy: *“Central banks have no choice but to frontload interest rate rises in an attempt to maintain credibility and avoid de-anchoring expectations and a price-wage spiral.”* Given this scenario, they deny that inflation could be *“a way to re-establish sustainability [of government debt, since] today’s inflation is mainly driven by a terms-of-trade effect that makes all energy-consuming economies poorer.”* If central banks fail to keep inflation at target, the rise in nominal market rates may increase borrowing costs and jeopardise the attempt to stabilise public debt.

## 2. Centralised Fiscal Capacity and ECB independence

The benefits of a centralised fiscal capacity (CFC), i.e. a fiscal backstop and a well-designed insurance scheme, are well known and highlighted by the European Commission and other international institutions (Juncker et al. (2015), Arnold et al. (2018)). As noted by Berger et. al. (2019), “*National governments simply have less fiscal space in currency unions, as they can become vulnerable at lower sovereign debt levels to self-fulfilling debt crises, as occurred in the 2010-2012 euro crisis*”. However, there are reasons to be sceptic about how significant these benefits can be and about the underlying costs. As noted by Larch in his contribution to this volume, “*member states are polarised, with one camp claiming that sustainability issues arise because there is not enough help from the center; the other insisting that some countries do not do enough to counter risks at the national level. Both are right and wrong at the same time.*”

One problem related to the CFC is how large this could be. The EU budget stands at about 1% of the EU’s GDP, whereas the federal budgets of advanced economies with federal constitutions hover at around 30-35% of GDP. One of the main problems with the CFC is that European countries have high levels of public spending and taxation (often close to 50% of national GDP), so that any meaningful increase in the size of the federal budget can only come about through devolution to the centre of government functions; less likely through the creation of additional tax levies and expenses. Even a marginal increase of the EU budget to 4-5% of GDP is politically costly. Hence, when we talk about a centralised fiscal policy for the EU, we refer to a fiscal policy and a minimum level of centralised spending for specific purposes. Will this

limited level of spending and tax revenue be sufficient to sustain a permanent and meaningful level of federal public debt? Is it reasonable to expect much insurance against idiosyncratic or common shocks based on a centralised budget? Some argue that the benefits from a pure insurance scheme would be small for the countries whose performance is mainly driven by low long-run growth and structural inefficiencies. By estimating the cost and the gains across EMU countries of a transfer scheme for insurance against asymmetric shocks, Arnold et al. (2018) conclude that the cost of the mechanism would be up to 1.5% of GDP, and the gains based on the experience of the past 20 years would be unevenly distributed. Although Italy would derive minimal gains (a consequence of the prevalence of structural problems unrelated to the business cycle), these estimates reveal that an insurance scheme could provide significant benefits at a small cost.

Many observers point to the US as a model. In fact, unlike the EU, the US federal government has a sizeable public liability and fiscal budget. These characteristics allow for more effective counter-cyclical policies and a much higher degree of risk sharing across States. However, the willingness and ability of the US federal government to perform these policies should not be exaggerated. First, a large share of households' consumption smoothing in the US is achieved thanks to highly integrated financial and banking markets as opposed to public policies.<sup>3</sup> Furthermore, the US federal budget is not explicitly designed to tackle business cycle shocks, and automatic stabilisers are notoriously weak. Countries in Core Europe have a much stronger capacity to use fiscal policies for business cycle stabilisation than the US under 'normal

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3 See Asdrubali, Sorensen and Yosha (1996), Sorenson and Yosha (1998), Afonso and Furceri (2008), Von Hagen and Hepp, (2013), Milano and Reichlin (2018) and Cimadoro et al. (2020).



conditions.’ According to Dolls et al. (2012), automatic stabilisers absorb the bulk of GDP and unemployment shocks (mainly the latter) in Northern Europe (between 50 and 60% on average), while the situation in Southern Europe is (quantitatively) similar to the US. However, the gap between Northern and Southern Europe is not due to different levels of public spending, but to different political choices. For instance, in 2019, social spending in Italy was aligned with the levels that prevail in Denmark and Germany, but it was biased toward public pensions. The lack of homogeneity of social models is an additional hurdle in creating a centralised fiscal space. For these reasons, the ability to stabilise the cycle through fiscal policy will mostly remain at the national level, and national public debts will remain large under any realistic scenario<sup>4</sup>.

This does not mean that specific tools and instruments provided by central EU institutions would not be useful. The European Stability Mechanism (ESM) (and its antecedents), the SURE and the NG-EU, together with the ECB programme, proved to be essential for the survival of the EMU. Other instruments are currently under discussion, such as the insurance or rainy day funds mentioned above. Lately, the ESM proposed a Euro Area stability fund that would provide loans in the event of external shocks and a lending capacity of around 2% of Euro Area GDP (Mish and Rey (2022)). This instrument would provide loans with a maturity of up to 10 years and a size of up to 4% of the national GDP. It would require beneficiary countries not to be subject to excessive deficit or imbalance procedures. According to the ESM, this scheme would minimise moral hazard (since loans from the ESM must be repaid) relative to a rainy day fund or an insurance scheme.

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<sup>4</sup> Codogno and van den Noord (2021b) suggest higher effectiveness of CFC and a safe asset as stabilisation tools under specific conditions, while limiting moral hazard.

Finally, there are two additional questions to be tackled. The first is the legacy debt problem, i.e. the difficulty of handling a large amount of national public debt of some important EU economies. Although the European Council, the EU Commission, and the ECB are strongly committed to containing the risk of speculative attacks on sovereign debt, the implicit fiscal cost of this commitment increases the resistance of some governments to establishing a common pool of resources at the EU level. The second important issue put forward in the debate about the CFC is the contention that this would exacerbate moral hazard and reduce governments' incentives to limit primary deficits. Moreover, a strict application of the no bail-out rule within the EMU is not credible since the risks associated with a sovereign default or the exit from the EMU by a major partner are too significant. This erodes the enforcement of fiscal rules and encourages excessive risk-taking of private investors. In the US, these problems have been solved by implementing a credible no bail-out clause for the member states, which, in turn, has induced self-imposed balance budget rules at the state level. However, this (implicit) constitutional arrangement was possible because the US is a genuine political federation with a legitimate central government. Given these premises, any proposal to establish a CFC should follow a preliminary discussion about how to increase the political legitimacy and the enforcement power of EU institutions. Otherwise, we run the risk of creating unfulfilled expectations and self-deception about the benefits of the EU, thereby generating negative political fallout.

### **3. European Public Goods**

Many commentators have advanced the idea that the recent exceptional events experienced in the EU have changed the terms of this debate. On the one hand, moral hazard risks now appear less critical as the pandemic and energy shocks are clearly exogenous and unrelated to governments' actions. On the other hand, the size of these shocks and the externalities they generate require a strong EU-wide initiative. For those who favour a more intense EU integration, NG-EU represents the harbinger of future fiscal mutualisation and the first step toward creating EU bonds. To be sure, the NG-EU is just a temporary federal policy of a relatively small size. It will not create a permanent EU debt, and is not designed as a tool for business cycle stabilisation. However, it is a great opportunity to boost public infrastructures and undertake structural reforms (Codogno and van den Noord (2021a)).

In fact, the debate about the EU's new governance has recently shifted from the economic and financial stability issues (considered above) to the lack of public investments related to the energy and digital transition (EDT). Moreover, recent geo-political events have added some other concerns about the ability of the EU to build up an adequate military defence system. The underlying idea is that each member country cannot address these challenges on its own, and scale economies, cross-country linkages and externalities are essential. Some of these considerations (also linked to the Covid-19 crisis) were at the basis of NG-EU, but the issue is much more general. The idea that European central institutions should expand their role to provide EU public goods and regulations is at the heart of the EU construction. But the scale of

the new projects and the way to implement them are unique in this debate. NG-EU seems to suggest that a new model is possible based on two steps: (a) creating an EU agency with the task of issuing a common liability (EU debt) which can be used to lend money to member countries to finance EDT investments and (b) an EU public authority with the task of monitoring the proper implementation of these investments at country levels. The fact that these investments are directed toward specific objectives and the monitoring activity of the EU authority would eliminate moral hazard problems.

A common effort to implement public projects has many advantages, not least the fact that it would increase the popular perception that the EU is a useful political construction and has a vital role to play. However, these benefits should be weighed against possible risks. The importance of implementing the EDT and endowing the EU institutions with the role of speeding up or incentivising investments in key infrastructures cannot be denied. However, we may face a ‘lack of accountability problem’. In democratic societies, citizens should be consulted about public policies, even if they impact other countries, and national or supranational government bodies should be held accountable for their choices. In this case, again, we are back to the problem that the EU has yet to become a (truly) political federal union.

Some commentators advocating the creation of an EU public debt and fiscal capacity have proposed a sort of ‘principal-agent model.’ Each member country transfers some resources to an EU central authority, and the latter transfers back these resources to each country under the condition that the recipient will use these resources for pre-specified objectives and in a pre-specified way. This is a ‘carrot and stick approach’ whereby recipient countries

are induced to behave well under the threat of being denied some promised amount of money coming from a resource pool. The characteristics of these two-way transfers (and who gains and who loses across and within each country or across generations) can vary based on how much EU public debt and redistribution across countries is allowed. If the mechanism is distribution-neutral, each government is getting back its own money with strings attached. Using a terminology borrowed from the theory of mechanism design, the mechanism serves the scope of establishing a relation between the EU authority and the member countries, whereby the former is the 'Principal' (P), and the latter are the 'Agents' (A). The P-A theory is typically used to represent situations in which someone (P) has some objective or interest that can only realise through the action of one or many agents (A), and A can take actions that are not in the best interest of P, or that P cannot control. The theory is, then, based on the non-alignment of P's and A's interests and the existence of A's opportunistic behaviour.

Is this the right model for the relationship between local and central institutions in the EU? The main problem is: how can we justify the idea that the central EU authority (which has no own resources) has legitimate autonomous 'interests' and 'objectives'? The only way to rationalise this idea is by assuming that the EU is stuck into some sort of 'prisoners' dilemma.' Either countries' governments are unable to commit to a pre-specified course of action, or they cannot fully internalise the impact of their policies on the EU community of States. In all these cases, countries may rationally decide to tie their own hands and delegate their authority to some non-political authority (absent any central authority that derives its legitimacy from popular consent). Although this idea is reasonable and often applied in other circumstances, we

need to understand the consequences of the implied limitation on national policies that citizens may not fully understand or share. The ‘tie-your-hands theory’ has been advocated to rationalise the adoption of the Euro, i.e. stripping countries of monetary power. This policy, it was claimed, would have forced spendthrift governments to adopt more prudent fiscal policies. Whether the theory has been proved right or wrong is still debated.

#### 4. Revising Fiscal Rules

The above discussion implies that there are plenty of reasons to be unsatisfied with the present institutional architecture in the EU and, in particular, with the effectiveness of the fiscal rules underlying the Stability and Growth Pact. Many contributions to the present volume take up this issue. A first consideration is that some of these rules, notably the 60% debt-to-GDP limit, are clearly out of reach. This does not only arise from the difficulty of reconciling restrictive fiscal policies with popular consent. Another reason is the size of investments to be implemented to reach the climate transition goals. In his contribution to this monograph, Van der Noord advocates “*a green golden rule allowing countries to increase their MTO by 1 percentage point of GDP to help fund their net green investment gap*”. Romanelli, Tommasino and Vadalà argue that the existing fiscal rules must be revised to allow for more swift and flexible responses to macroeconomic shocks and to counter political economy distortions, mainly the governments’ deficit bias. The authors’ proposal includes (1) a country-specific medium-term target for the debt-to-GDP ratio (speed of reduction over a multi-year horizon), (2) a multi-year profile for

the headline balance consistent with the debt-to-GDP consolidation target, (3) enforcement of rules based on conditional grants/loans out of European funded programs, (4) a fiscal capacity at the EU level with the objective of financing specific investment programme and counter-cyclical measures.

These issues are going to be much debated in the next few years. Therefore, we hope that the content of this volume of *Economia Italiana* will help clarify the main problems and the best way forward.

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## ECONOMIA ITALIANA 2022/2

### Rethinking Debt Sustainability?

This issue of *Economia Italiana* – editors **Lorenzo Codogno, LSE, and Pietro Reichlin, Luiss** - deals with public debt sustainability and fiscal rules. Many beliefs about the benefits of current fiscal and monetary policies could change because of the risks associated with the energy crisis, the war in Ukraine, the return of inflation and the green transition. The volume contains several contributions by leading experts on the following questions: *Is debt sustainability a cause of concern within the Euro Area? How should we consider revising the Stability and Growth Pact in the European Union? Are the energy transition and the pandemic risks good reasons to build up EU-level fiscal capacity?* In the introduction to this monograph, we will touch upon some of these issues and discuss why they are important.

### Ripensare la sostenibilità del debito?

Questo numero di *Economia Italiana* – editor **Lorenzo Codogno, LSE, e Pietro Reichlin, Luiss** - tratta della sostenibilità del debito pubblico e delle regole fiscali. Molte convinzioni sui benefici delle attuali politiche fiscali e monetarie potrebbero cambiare a causa dei rischi associati alla crisi energetica, alla guerra in Ucraina, al ritorno dell'inflazione e alla transizione verde. Il volume contiene diversi contributi dei maggiori esperti sulle seguenti questioni: *La sostenibilità del debito è fonte di preoccupazione nell'area dell'euro? Come dovremmo considerare la revisione del Patto di stabilità e crescita nell'Unione europea? La transizione energetica e i rischi di pandemia sono buone ragioni per costruire una capacità fiscale a livello europeo?* Nell'introduzione di questa monografia, gli editor trattano alcuni di questi temi e spiegano perché sono importanti.

**Essays by/Saggi di:** Lorenzo Codogno, and Pietro Reichlin; Carmine Di Noia; Ludger Schuknecht; William R. Cline; Lorenzo Codogno, and Giancarlo Corsetti; Martin Larch; Cecilia Gabriellini, Gianluigi Nocella, and Flavio Padrini; Marzia Romanelli, Pietro Tommasino, and Emilio Vadalà; Angelo Baglioni, and Massimo Bordignon; Paul Van den Noord.

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