

# ECONOMIA ITALIANA

Fondata da Mario Arcelli

## Rethinking Debt Sustainability?

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*“He who will not economize will have to agonize.”*

(Confucius)

# A new look at public debt sustainability

**Ludger Schuknecht\***

## **Abstract**

Public debt sustainability is essential for economic growth and prosperity, for social stability and for mastering decarbonisation and geopolitical challenges. However, public debt is at record highs and the most indebted countries are the largest advanced economies. Moreover, sustainability risks may be even higher than we think: Tightening government financing conditions amidst major financial imbalances could stoke further costly financial crises. Ineffective and uncompetitive public sectors undermine growth and stability prospects. Corporate zombification and the disintegration of global value chains adversely affect long-term growth and inflation prospects. And there is the risk of more crisis like COVID or the military conflict in Ukraine. Finally, debt sustainability has become a global and systemic challenge: highly-indebted, large countries account for as much as 60% of the global economy. The sustainability of public finances should, therefore, feature more prominently in countries' strategies to boost their economic, financial and social resilience.

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## Sintesi - Un nuovo sguardo alla sostenibilità del debito pubblico

*La sostenibilità del debito pubblico è essenziale per la crescita economica e la prosperità, per la stabilità sociale e per affrontare la decarbonizzazione e le sfide geopolitiche. Tuttavia, il debito pubblico è a livelli record e i Paesi più indebitati sono le maggiori economie avanzate. Inoltre, i rischi di sostenibilità potrebbero essere ancora più elevati di quanto pensiamo: l'inasprimento delle condizioni di finanziamento pubblico, in presenza di forti squilibri finanziari, potrebbe alimentare ulteriori e costose crisi finanziarie. Settori pubblici inefficienti e poco competitivi minano le prospettive di crescita e stabilità. La zombificazione delle imprese e la disintegrazione delle catene globali del valore incidono negativamente sulle prospettive di crescita e inflazione a lungo termine. E c'è il rischio di nuove crisi come la COVID o il conflitto militare in Ucraina. Infine, la sostenibilità del debito è diventata una sfida globale e sistemica: i grandi Paesi altamente indebitati rappresentano ben il 60% dell'economia globale. La sostenibilità delle finanze pubbliche dovrebbe quindi occupare un posto più importante nelle strategie dei Paesi per aumentare la loro resilienza economica, finanziaria e sociale.*

**JEL Classification:** E60; F30; H11; H50; H60.

**Parole chiave:** *Sostenibilità del debito; Invecchiamento della popolazione; Crisi finanziaria; Crescita economica; Efficienza della spesa pubblica; Interdipendenza finanziaria; Stabilità sistemica.*

**Keywords:** Debt sustainability; Population aging; Financial crisis; Economic growth; Government spending and efficiency; Financial interdependence; Systemic stability.



## **1. Introduction**

Why is the sustainability of public debt important? Given that this issue has not been on the “front page” for a long time, it is worthwhile recalling the main arguments. It creates an environment for governments to provide high-quality public goods and services and favourable “rules of the game”. It also avoids the risk of stop-and-go politics. This gives the private sector the necessary stability and financing space to fund (profitable) investment. It also ensures the functioning of financial markets which “lubricate” the economy. Sustainable public finances are a prerequisite for credible social security systems. By underpinning economic strength and social stability, the sustainability of public debt also ensures political stability and international influence.

The question of the “optimal” or “maximum” level of public debt to maintain sustainability is at the heart of the debate. A few economists have been arguing that there may already be too much of it whereas the mainstream has been less concerned in recent years. While the former focus on the risks from high public debt, limitless spending demands and the risk of policy errors, the latter emphasize the potential benefits from higher debt that would finance itself through more growth (Brunnermeier, 2021; Schuknecht, 2020 and 2022; Eichengreen et al., 2021; Tanzi, 2018).

What underpins the sustainability of public debt? It is mainly three things: i) reasonably low deficits and debt and financeable liabilities in the future, ii) favourable financing conditions for governments, and iii) robust economic growth that facilitates growing out of debt. Sustainability can contribute to a virtuous circle of fiscal soundness underpinning growth, low interest rates and stability. Doubts about sustainability are bound to have the opposite effect.

The first objective of this short study is to take stock of key facts on debt

and sustainability risks, as reflected in the economic data and analysis (Section 2). In addition, there are a number of facts and challenges that warrant a deeper discussion:

First, the huge impact of the financial crisis on national public finances suggests that we need much higher debt-related safety margins than traditionally assumed (Section 3). Second, the size of government is typically seen as neutral for debt sustainability. But this may not be so: more efficient governments with lower taxes would be better able to attract investment, finance high debt and deal with new challenges in the future (Section 4).

Third, corporate zombification and over-indebtedness, and tendencies to undo global value chains are bound to have a longer-term dampening effect on economic growth and potentially raise inflation and financing costs more durably (Section 5).

Fourth, the most highly-indebted countries that also face some of the biggest challenges from population aging include the largest advanced and emerging economies. These, together, account for a majority of global output. Debt sustainability is thus a global, systemic challenge. Open global capital markets increase the potential for international spillovers and spillbacks (Section 6).

It is understandable that at a time of successive and over-lapping crises — the COVID-19 pandemic and then the Ukraine military conflict — long-term issues such as debt sustainability take the back seat. But shocks with major fiscal effects can happen time and again while we have chronically neglected the use of good times for debt reduction. At some point, this pattern will catch up with us. This study sheds light on the challenges around debt sustainability, drawing on a new book of mine, “Debt sustainability: A Global Challenge” (Schuknecht, 2022).

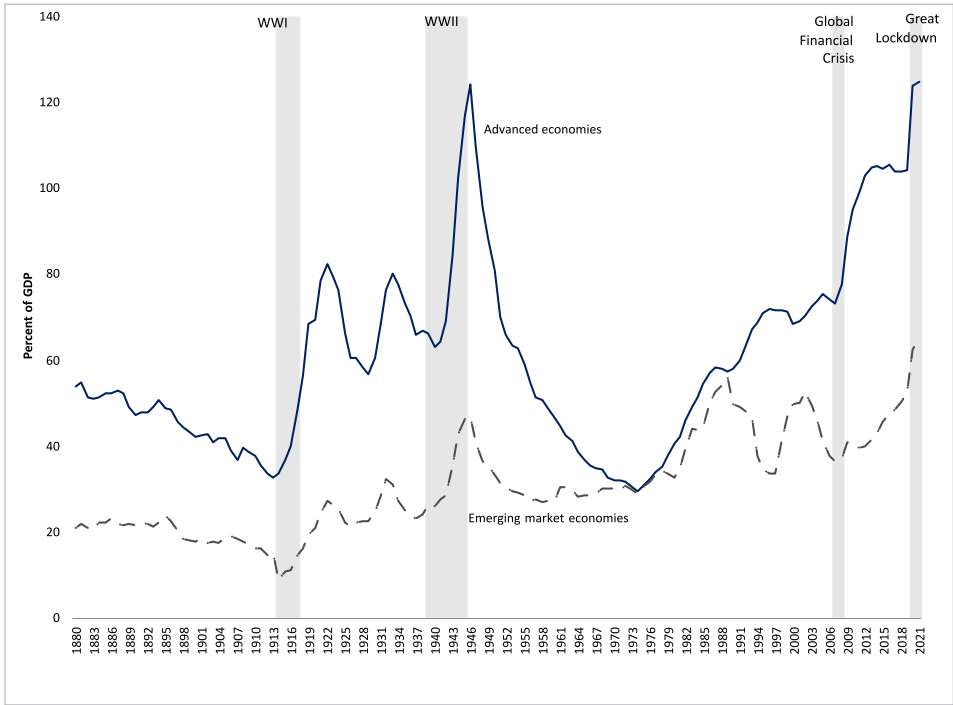
## **2. Debt sustainability, public debt and population aging**

Public debt and future liabilities are the first set of key variables for debt sustainability. Where do we stand in 2022? Public debt in the world is undoubtedly at historic highs. Global public debt averaged almost 100% of GDP in the early 2020s according to latest IMF figures (2022, Fiscal Monitor). Advanced country public debt averaged above 120% of GDP, and the G7 even reached about 140% (Figure 1). This follows five decades of almost uninterrupted increases in public debt ratios in advanced countries. Debt rose from 30-40% of GDP in the 1970s to over 70% of GDP in the early 2000s and a further 50% of GDP in the past 14 years (Table 1). Japan, Italy, the United States, Spain, Canada, France and the United Kingdom all reported public debt well above 100% of GDP — which is more than the indebtedness of Italy just before the global financial crisis.

Public debt, thereby, is broadly back to the same level as after World War II. Moreover, there is little prospect of reversing this trend via high growth, as experienced after World War II. The IMF (2022) and the European Commission (2021) see little scope for debt reduction in the coming years, also because of the persistent high fiscal deficits in many countries.

The debt ratios in emerging economies are on average lower than in advanced countries. However, their financing potential is likely to be lower as well, and the outlook for fiscal deficits is not favourable (IMF, 2022). Three of the largest countries, India, Brazil and Argentina, post public debt ratios of 90% to above 100% of GDP.

Figure 1 The history of general government debt



Sources: IMF, Historical Public Debt Database; IMF, World Economic Outlook database; Maddison Database Project; and IMF staff calculations.

Note: The aggregate public-debt-to-GDP series for advanced economies and emerging market economies is based on a constant sample of 25 and 27 countries, respectively, weighted by GDP in purchasing power parity terms.

The outlook for future fiscal obligations is strongly determined by the way population aging translates into social (and overall) expenditure. In most advanced and many emerging economies, population aging is predicted to bring about a major increase in public expenditure. The magnitudes differ across countries and projection methodologies. On average, social expenditure has been increasing by 2 percentage points per decade in advanced countries over the past 40 years and now comprises over half of total spending (Schuknecht

and Zemanek, 2020). Optimistic models predict an increase of another 2-4 percentage points of GDP, with the figures for more pessimistic ones much higher. An extrapolation of past trends under a middle-ground scenario would imply an increase of 5-6% of GDP by 2050.

Table 1 **General government gross debt and overall balance**

	Gross debt (percent of GDP)			Overall balance (percent of GDP)		
	2007	2019	2020	2021	2020	2021
G7	84,4	118,0	136,7	139,5	-13,2	-11,9
Canada	65,0	86,8	117,8	116,3	-10,7	-7,8
France	63,8	98,1	113,5	115,2	-9,9	-7,2
Germany	65,0	59,6	68,9	70,3	-4,2	-5,5
Ireland	24,9	57,4	59,8	63,2	-5,3	-5,5
Italy	103,4	134,6	155,6	157,1	-9,5	-8,8
Japan	187,7	234,9	256,2	256,5	-12,6	-9,4
Spain	36,1	95,5	117,1	118,4	-11,5	-9,0
Switzerland	43,6	39,8	42,9	44,8	-2,6	-3,4
United Kingdom	44,1	85,2	103,7	107,1	-13,4	-11,8
United States	62,1	108,2	127,1	132,8	-15,8	-15,0

Source: IMF

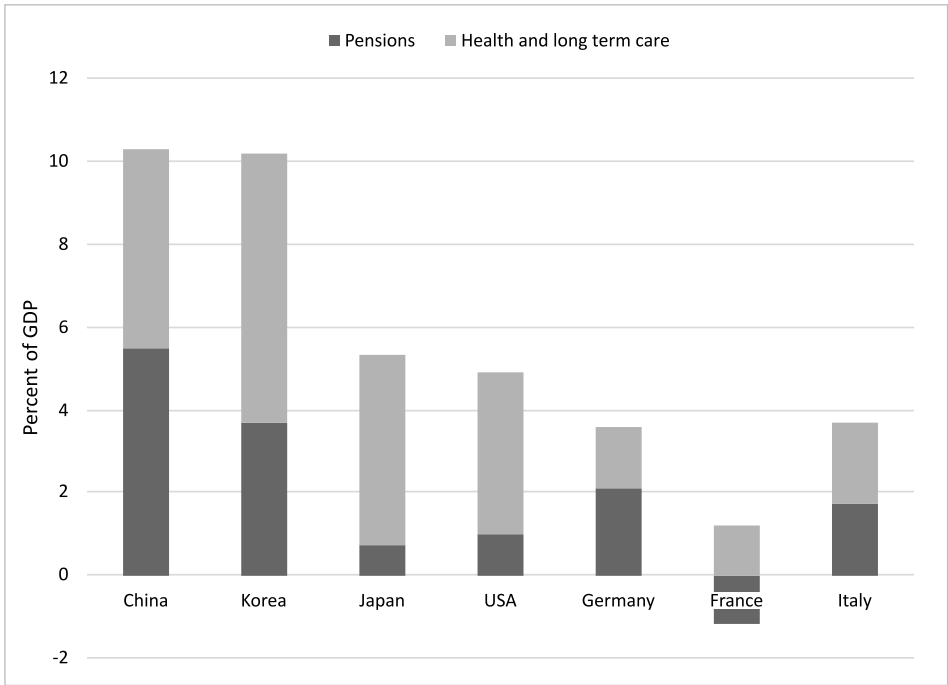
This potential increase in social expenditure ratios exceeds the total average public expenditure of advanced countries on education. Given this trend and the fact that this would need to be financed by higher taxes, higher debt, or the reduction in other (often more productive) spending, there is a risk of social spending dominating budgets and undermining macroeconomic stability.<sup>1</sup>

<sup>1</sup> Schuknecht and Zemanek (2020) have referred to this risk as “social dominance”. Social spending stokes unsustainable spending and fiscal dominance as regards monetary policies.

Most advanced countries project increases in the order of 2-5% of GDP between 2015/20 and 2050 (Figure 2). Health spending will exert the largest upward influence. However, some of the fast-aging East Asian and Eastern European countries could experience much stronger increases on the basis of current social security systems and spending plans.

Private debt is also an important potential factor for the sustainability of public debt if there is a risk of “socialization” through government support via, e.g., bail-outs of companies and banks. Private debt is also at record highs globally. I will come back to this and the related fiscal risks in Section 3.

Figure 2 **Expected increase of public expenditure on pensions, health and long-term care, 2015-50**



Sources: EU ageing report (2018), OECD, IMF

The second factor that determines debt sustainability is the financing environment for government debt. This has been extremely favourable for most countries ever since ultra-low interest rates and government debt purchases by central banks entered the picture after the global financial crisis. In fact, despite record high public debt, debt service costs for advanced country governments are almost as low as in the 1970s, when debt ratios were only about one third of today. This is due to low re-financing costs of most governments over the past decade. In the euro area, the “safest” government debt yielded negative rates and spreads between high debt and low debt countries became very compressed again in recent years.

However, the most recent government financing cost developments show that levels and spreads may change faster than had been anticipated. With inflation expected to stay higher for longer than anticipated, levels and spreads have been rising. In spring 2022, they were still low by historic standards but the windfalls for governments from ultra-low debt service costs may be a thing of the past. Much depends on how confidence in price stability and in debt sustainability will develop.

The speed and extent to which changes in financing costs can affect debt sustainability depends on debt and deficit levels (discussed above), and the maturity structure of public debt. These factors determine the short-term financing needs of governments and the speed at which higher rates mean higher interest spending. Most advanced countries have financed much of their debt long term with average maturities of 5-15 years so that high rates will take a long time to feed through to budgets. However, the massive central bank purchases of government debt have effectively turned long-term debt into short-term debt as these holdings are renumerated at central bank rates. This can yield increasing fiscal losses as central bank rates rise.

Confidence in government finances strongly depends on short-term financing needs. In advanced countries, the magnitude of public debt has raised short-term financing needs to what the IMF and the European Commission consider risky levels, i.e. above 15 or 20% of GDP. In 2020, for example, European countries on average obtained financing of about 25% of GDP from the markets, with the ECB buying roughly an equivalent amount (Table 2). The United States and Japan feature even higher short-term financing needs in markets than Europe.

Table 2 **Gross financing needs, 2020, % of GDP**

	<b>Budget deficit (percent of GDP)</b>	<b>Maturing debt (percent of GDP)</b>	<b>Stock flow adjustment (percent of GDP)</b>	<b>Gross financing needs (percent of GDP)</b>
Austria	9,6	8,5	0,3	18,4
Belgium	11,2	13,5	1,2	26,0
Finland	7,6	9,1	1,2	18,0
France	10,5	15,8	0,2	26,5
Germany	6,0	12,4	3,7	22,0
Ireland	6,8	7,8	-2,1	12,4
Italy	10,8	20,7	1,3	32,7
Netherlands	7,2	8,9	2,4	18,4
Spain	12,2	15,8	-0,2	27,8

Source: European Commission (2021)

Finally, debt dynamics and sustainability depend on economic growth. For reasons of space, I remain very short here. Trend growth in advanced countries has come down significantly. Long-term Commission (2021) projections assume the real growth potential of EU countries to be around 1% of GDP for this decade. Even slightly higher growth rates will not provide much sup-



port for growing rapidly out of public debt.

As a result of this, sustainability projections are rather dire. The US Congressional Budget Office (2021) sees a significant risk of explosive debt dynamics in the United States. The European Commission (2021) sees 11 EU countries at high risk of short-term financing difficulties, and 8 countries at high medium-terms risks (Table 3). This includes the highly-indebted euro area countries that already experienced fiscal difficulties in the context of the global financial crisis, except Ireland. The European Commission also sees France and a few smaller countries at high risk.

**Table 3 Countries at sustainability risk, European Commission analysis**

Risk matrix for EU countries	Short term (1 year) (S0)	Medium term (2031 horizon) (S1 and DSA)	Long term (2070 horizon) (S2)
High risk	Belgium Spain France Hungary Italy Cyprus Latvia Portugal Romania Slovakia Finland	Belgium Spain France Italy Portugal Romania Slovenia Slovakia	Belgium Luxembourg Romania Slovenia Slovakia
Medium risk		6 countries (including the Netherlands)	16 countries (incl. all large countries)
Low risk	15 countries	12 countries (including Germany)	5 countries

Source: European Commission (2021)

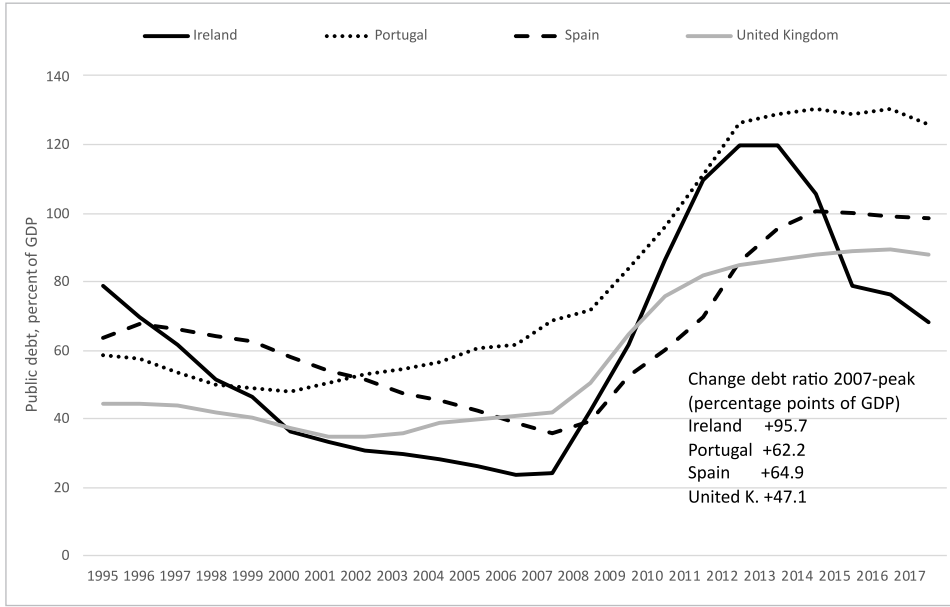
### 3. Further risks: financial crises and other major, costly events

Debt sustainability can also be affected by major events that do not feature sufficiently in the standard analysis of fiscal prospects and risks. The main and most costly is probably the risk of financial crisis. Only since the European fiscal crisis has more attention been paid to this risk in advanced countries.

Financial crises have typically emerged from high private debt, high asset prices and rising financing costs. When booms turned to busts, financial systems became over-burdened and the government stepped in. Financial crises have always had major effects on public finances (Reinhard and Rogoff, 2009; Borio et al., 2016; Schuknecht, 2020). In some cases, for example during the Asian financial crisis, the costs of bailing out banks or higher spending exceeded 50% of GDP. However, advanced countries saw themselves largely immune to this risk even though there were warning signs: the Nordic crisis of the 1990s had also been very costly.

The European fiscal crisis broke all records in terms of fiscal implications. Greek bailout packages summed up to 150% of GDP. While the packages for Ireland, Portugal and others were smaller, they were also much larger than those for the emerging market crises of the past. During the crisis, Irish public debt increased by almost 100% of GDP, and debt in Spain and Portugal rose by over 60% of GDP (Figure 3). The United Kingdom added almost 50% of GDP to its indebtedness although it could avoid an outright fiscal crisis.

Figure 3 Public debt in Ireland, Portugal, Spain and United Kingdom, percent of GDP



Source: OECD and Schuknecht (2020)

The pattern displayed in Figure 4 is quite typical. In the good times from the mid-1990s to 2007, debt ratios were broadly flat as governments spent the fiscal windfalls (Schuknecht, 2020). Then the crisis hit and debt exploded. In the next recovery phase that started in 2010, in the less affected countries and in 2014 for crisis countries, there was again no expenditure restraint and debt reduction (European Fiscal Board, 2020). The COVID-19 pandemic provided the next major boost to public debt ratios.

This lack of preparedness for major financial shocks and the lack of willingness to use good times for debt reduction is perhaps the most important blind spot in much economic analysis for the sustainability debate. There are a few exceptions (EFB, 2020; Schuknecht, 2020). Borio et al. (2016) see the

need for a debt safety margin of 40-60% of GDP to prepare for severe financial crisis which is in line with my work quoted above. This also has important implications for optimal debt ratios from a risk management perspective. The 60% threshold of the EU Treaties is perhaps more convincing as an “optimal” “safe” public debt ratio than many economists think. However, there is still little recognition that such risks should be taken into account in the considerations on “optimal, safe” debt and safety margins.

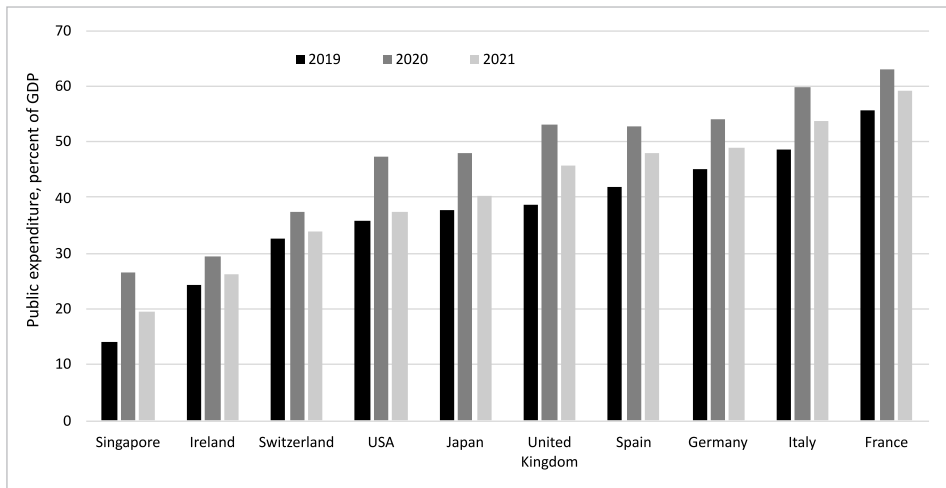
And where do we stand as regards the risk of renewed financial crises? Many observers postulate such risks, especially regarding the non-bank financial sector. Asset prices are at record levels in many countries, and especially real estate prices have boomed in the ultra-low interest rate phase while debt has risen strongly as well. Moreover, we have just gone through a major pandemic that has brought up public spending, deficit and debt ratios and we do not know the fiscal costs of the Ukraine military conflict. All this underlines the need for debt safety margins for drastic, unexpected events.

#### **4. Further risks: unproductive government**

The debate on debt sustainability typically does not comment on the size and efficiency of government. This is not convincing for three reasons. First, higher government spending implies higher taxes. Public spending ratios in advanced countries are mostly high and much higher than in emerging economies. Average spending ratios, depending on the definition and sample are around 40% of GDP in advanced countries and little over 30% of GDP in emerging economies. During the COVID-19 pandemic, many advanced

countries posted spending above 50% or even 60% of GDP (Figure 4). With spending ratios like this, you are bound to have high and distortionary taxes that undermine incentives to work and invest, and thus economic growth. This affects sustainability.

Figure 4 **Public expenditure, general government, percent of GDP**



Source: IMF fiscal monitor (April 2021)

In addition, public spending ratios in several countries are so high that their sustainable financing is hardly possible. From a macro perspective, there has not been any advanced country that was able to raise revenue of much more than 50% of GDP on a sustainable basis (Schuknecht, 2020). In many countries, the maximum revenue that can be raised is much lower for political reasons: there would simply not be enough support in Parliament. At the micro level, several countries feature marginal income tax rates, corporate tax rates and VAT rates that are near or above the threshold of revenue maxi-

zation (Akgun et.al. 2016).

If countries were to use higher spending to provide their citizens with better services, this might countervail the distortionary effect of taxes. But this is mostly not the case (Afonso et al., 2005, Schuknecht 2020; Afonso et al., 2022). The literature on expenditure effectiveness and efficiency provides ample evidence that there is no positive correlation between the size of government and outcomes in health, education, infrastructure or administrative quality. If anything, some indicators and aggregate performance measures tend to be better in small government countries than in those with big governments. Low spending Switzerland, Ireland and Australia feature often higher-quality services with much lower spending than Italy or France. This implies a large margin of expenditure savings in many countries that can well be 10% of GDP and more (Afonso and Schuknecht, 2019).

What about the new challenges, such as defense and decarbonization? There is no compelling reason for bigger government to deal with these policy challenges. It is clear that the adequate defense of a country requires proper resourcing. The 2% of GDP objective for NATO countries is probably a rather reasonable minimum. Germany and some other defense laggards have to raise spending by  $\frac{1}{2}$  to 1% of GDP. However, this can easily be financed with expenditure savings elsewhere. It is much less than the savings margin mentioned above and it is less than the increase in health spending alone in many countries in recent years. Prioritised and better spending, not more spending per se, are urgently needed.

Decarbonisation is another important global policy challenge. The advantage governments have here is that it can be achieved without any net fiscal costs if done in the right way. It is by now well known that an appropriate carbon pricing across all sectors is the best way to achieve market-based

and cost-minimising decarbonization. This could yield significant revenue to compensate vulnerable groups, finance important research and public good components and still return some money to citizens/tax payers.

Finally, as regards the size of government and sustainability, it should not be forgotten that countries compete with each other over bricks and brains. Government taxation and spending can become important factors in this equation. A low tax, high-quality-of-life jurisdiction will attract a larger share of the global talent pool that less attractive jurisdictions will tend to lose. This provides a growth and demographic dividend to attractive countries while it exacerbates these challenges in countries that lose investment and talent. Hence, the size and effectiveness of government is everything but neutral for sustainability.

## **5. Further challenges: zombification, protection and growth**

While the COVID pandemic and the Ukraine military conflicts dented short term growth prospects, the IMF (WEO, 2022) also warns of the longer-term implications of a fragmented global economic order. This would imply lower economic growth and, consequently, less scope to grow out of high debt and fiscal liabilities. The drivers of lower potential growth, however, have already been at work for quite a while without being much reflected in long term growth forecasts.

First, the low interest environment of the past decade has resulted in a huge increase in so-called zombie firms that do not sustainably earn their debt service costs (Banerjee and Hofman, 2020). Meanwhile, corporate in-

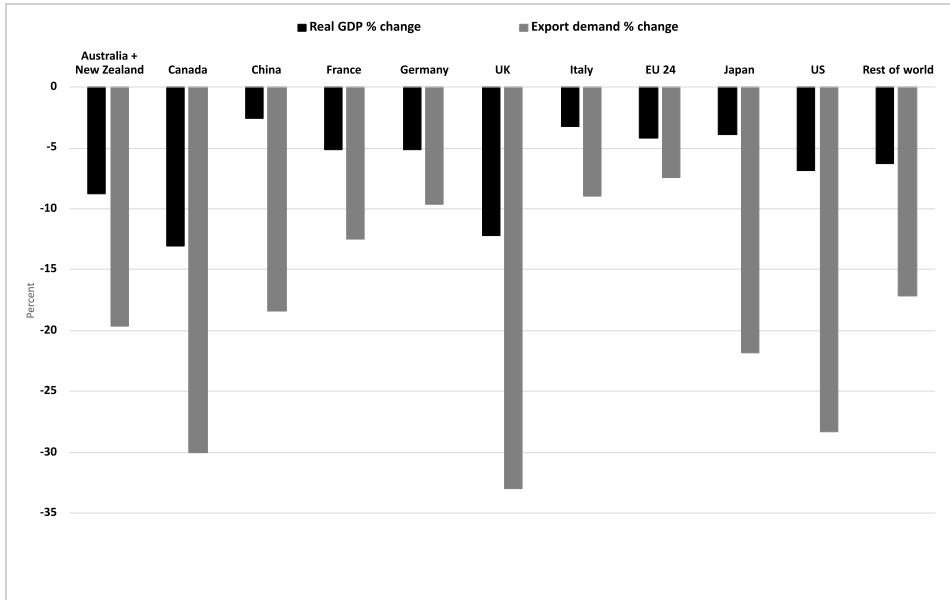
debtedness has increased enormously while credit quality has declined and short-term financing needs increased before and during COVID (Czelik et al., 2019; Schuknecht, 2022). Adalet McGowan et al. (2017) already found significant scope for more investment if zombie firms were to be eliminated. This potential benefit should have increased strongly further in recent years with the further rise in the presence of zombie firms.

Second, there has been a tendency towards increasing protectionism together with calls for a re-nationalisation of value chains during the pandemic. The conflict in Ukraine has reinforced this tendency and resulted in significant further disruptions of value chains and calls for more autarky and industrial policies. It has also demonstrated the strongly inflationary effect of all forms of supply disruptions and trade protection. In the resulting political lobbying process, it will be hard to distinguish the siren call of special interests from the justified creation of buffers and diversification. But, in any case, de-globalisation will not be without costs for the global and national growth potential.

An OECD study illustrates the costs of additional trade protection. Protectionist policies that include 25% tariffs, 1% subsidies for renationalizing industries and some obstacles to relocation would result in a GDP loss of between 5 and 10 percentage points and export demand would fall by 5-30% (Figure 5). These assumptions are not modest but they are also not radical: the protectionist policies during the 1930s Great Depression were even greater and the Ukraine conflict-related trade impact is also very significant.



Figure 5 OECD METRO model simulations of GDP and export demand with de-globalisation



Source: OECD (2020); Shocks, risks, and global value chains: insights from the OECD METRO model, Trade and Agriculture Policy Brief, <https://issuu.com/oecd.publishing/docs/metro-gvc-final>.

## 6. Further challenges: the global relevance of sustainability risks and global financial markets

There is yet another challenge related to fiscal sustainability that is insufficiently on the radar of economists and policy analysts. This relates to the fact that most of the large advanced and emerging economies are amongst the most indebted countries facing the highest aging-related liabilities. They also face financial stability risks, as discussed above. If the vulnerable countries are

mostly large and interconnected, the risks are not just national but global and systemic: problems in one country are likely to spill over to its neighbours and back via trade and financial channels.

The IMF Global Financial Stability Reports of 2021 analysed the sectoral vulnerabilities in the biggest 29 economies. The IMF finds that 80% of the countries feature vulnerable government sectors. Some countries are seen to have vulnerable government, corporate and financial sectors. These include most of the large economies.

The global dimension can be illustrated by adding the global (and regional) income share of all the countries that the IMF sees as highly indebted. Based on the IMF data, one can perhaps see 240% of GDP as a threshold of high indebtedness, with public debt above 80 or so percent of GDP. Six of the G7 countries (Germany being the only exception) belong to the group and so does Spain. This group comprises over 40% of global GDP and over 45% of euro area GDP (Table 4). Adding countries with very high private debt — China, Korea, Australia — where there is a risk that part of that debt migrates to public balance sheets, the share of vulnerable economies exceeds 60% of global GDP. Add Portugal, Belgium and Greece to the euro area figure and the highly-indebted group exceeds 50% of euro area GDP.

Table 4 Share of highly indebted countries in global and euro area economy, 2019

Countries with public debt well above 100% of GDP or public and private debt around or above 240% of GDP in 2019	Total debt (public and private) in % of country GDP	Share of national economy in global economy	Share of national economy in euro area economy, high public debt countries
1) All IMF high debt countries/all high debt euro area <sup>1</sup>		62,2%	51,5%
Advanced countries (IMF)			
United States	259	24,5%	x
Japan	401	5,8%	x
United Kingdom	249	3,2%	x
France	313	3,1%	20,3%
Italy	245	2,3%	15,0%
Spain	246	1,6%	10,4%
Canada	304	2,0%	x
2) IMF, High private sector debt only			
China	245	16,3%	x
Korea	253	1,9%	x
Australia	238	1,6%	x
3) Memo: Other euro area high public debt			
Portugal	278	x	1,8%
Belgium	307	x	4,0%
Greece	289	x	1,5%

Source: IMF fiscal monitor (October 2020), and World Bank - world development indicators

<sup>1</sup> Countries as in IMF Fiscal Monitor, Oct 2020 (Fig 1.1.1) (groups 1+2), and high debt countries in the euro area (groups 1+3)

All this would matter less for global economic and financial stability, if financial sectors were robust everywhere and global trade and financial interdependence was low. This, however, is clearly not the case. The share of imports plus exports over GDP in the global economy and investment interlinkages (no matter how you measure them) are today much higher than they were decades ago. While the banking sector today is healthier than before the global financial crisis, risks have shifted to the non-bank financial sector. The Bank for International Settlements (2018) calculated that run prone assets in the non-bank financial sector amounted to roughly US\$ 50 trillion or about 70% of global GDP.

The speed with which financial markets react to shifts in sentiment has also increased and it is probably even faster than during the global financial crisis. Various BIS publications describe how in March 2020, in the “dash for cash”, money market funds, hedge funds and central banks liquidated several hundred billion dollars of assets within days, forcing the Federal Reserve to undertake huge interventions to keep the US Treasuries market liquid.

We have no clear idea, how the loss of confidence in the public finances of one or several large advanced economies would reverberate through the system. But, given the amount of turmoil and anxiety that the relatively small European fiscal crisis economies caused between 2009 and 2015, one can imagine how much more violent and harder to manage such turmoil could be if globally important countries were to suffer from a loss of confidence.

## **7. Conclusion**

There are a number of reasons why we should value debt sustainability. It is essential for economic growth and prosperity, for social stability, and for mastering decarbonisation and the geopolitical challenges. It is therefore disquieting that amongst the most indebted countries with high future liabilities are the largest advanced economies.

Moreover, there are reasons to believe that sustainability risks may be further increased by a number of additional factors. Tightening government financing conditions combined with record asset prices could stoke the risk of financial crises which, in the past, have brought many advanced and emerging countries to their “fiscal knees”. Other major shocks like the COVID-19 pandemic could occur and the costs of the military conflict in Ukraine are highly uncertain. Large and inefficient public sectors undermine the attainment of important policy objectives and are likely to be difficult to finance in a number of countries. These countries will also be at a disadvantage in the global competition over talent and investment. Corporate zombification, protectionism and the disintegration of global value chains are likely to affect global output, inflation and financing prospects more than we currently believe. The size of vulnerable countries and their compound share in the global economy is as high as 60% of global GDP — and together with high financial interdependence, is likely to turn national sustainability concerns into regional and global challenges if large countries were to be affected.

All this calls for the timely and ambitious rebuilding of fiscal buffers, especially in the large economies. The prevailing view is that this would cause major adverse economic and social hardships. But this does not need to be so: there is ample experience with comprehensive economic and fiscal reform

that has boosted growth and stability at little or no social cost (Schuknecht and Tanzi, 2005; Alesina et al., 2019; Schuknecht, 2020).

Currently, advanced countries rely on financial repression with interest rates below inflation to bring down the real value of their debt. However, this is a risky strategy and it can lead to credibility loss and destabilisation even in large advanced economies, as the 1970s so clearly showed. It is better to take reasonable precautions, prepare for the challenges of the future and enhance resilience in the fiscal sphere. The “optimal, safe” public debt level is not unlimited and may be lower than we think.

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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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