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Rethinking Debt Sustainability?

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Public debt sustainability, fiscal rules and monetary policy

Angelo Baglioni[*]
Massimo Bordignon[*]

Abstract

The sustainability of the Italian public debt is not a source of concern for the next few years. In the longer run, however, sustainability will depend on reaching a structurally higher rate of growth for the Italian economy. While the investments and reforms related to the Italian RRP could achieve this objective, several doubts arise about the ability of future Italian governments and institutions to guarantee its successful implementation. At the EU level, the reform of the SGP should provide the chance to make a deal among EU countries: a rigorous set of fiscal rules should be balanced with a common fiscal capacity to provide some European public goods. In the meantime, the Ecb has introduced a new instrument (TPI) to cope with speculative attacks on high-debt countries. In addition, the Eurosystem will not withdraw its support to the government bond market: the repayment of the outstanding LTROs implies a significant downsizing of the Eurosystem's balance sheet, reducing the necessity to implement quantitative tightening.

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Sintesi - Sostenibilità del debito pubblico, regole fiscali e politica monetaria

La sostenibilità del debito pubblico italiano non è motivo di preoccupazione per i prossimi anni. Nel lungo periodo, tuttavia, la sostenibilità dipenderà dal raggiungimento di un tasso di crescita strutturalmente più elevato dell'economia italiana. Se da un lato, gli investimenti e le riforme relative al PNRR italiano potrebbero consentire di raggiungere questo obiettivo, dall'altro, sorgono diversi dubbi sulla capacità dei futuri governi e istituzioni italiani di garantire il successo nell'attuazione del Piano. A livello UE, la riforma del Patto di Stabilità e Crescita (PSC) dovrebbe offrire l'opportunità di trovare un accordo tra i paesi dell'UE: un insieme rigoroso di regole di bilancio dovrebbe essere bilanciato da una capacità fiscale comune per fornire alcuni beni pubblici europei. Nel frattempo, la BCE ha introdotto un nuovo strumento (TPI) per far fronte agli attacchi speculativi ai paesi ad alto debito. Inoltre, l'Eurosistema non ritirerà il suo sostegno al mercato dei titoli di Stato: il rimborso delle LTROs in essere implica un significativo ridimensionamento del bilancio dell'Eurosistema, riducendo la necessità di attuare una stretta quantitativa.

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1. Introduction

Despite the worsening of the economic situation induced by the Ukraine war, with the resulting shock in the terms of trade, increased inflation and lower growth, the sustainability of the Italian debt does not look like a serious issue in the short term (EU Commission Fiscal Sustainability Report, 2022). Economic growth, although subsided, should remain positive in both 2022 and 2023 (EU Spring Forecasts, 2022). And despite increasing interest rates, several factors -the long duration of the Italian debt, the large share of the Italian debt held by the national central bank, and the same sharp increase in inflation implying a positive and relatively large snowball effect- should maintain the evolution of debt under control. However, the story is different if one moves to a longer-term perspective. Here, as pointed out by several authors (see, for instance, Bordignon, 2021 and Gabbriellini et al., 2022) debt sustainability crucially depends on the capacity of the Italian economy to increase its potential rate of growth, overcoming the long period of dismal performance. In turn, this very much depends on successfully implementing the Italian Recovery and Resilience plan, both on reforms and investments. This is already a difficult bet. The likely political scenarios after Mario Draghi's government are not conducive to much optimism. More fundamentally, the structural reasons (cultural, political, and institutional; see Bordignon and Turati, 2022 for a book-length discussion of these issues) that had led Italy to accumulate a very large debt in the past are still very much there. Without the scrutiny of markets and/or by the European Commission, nothing might stop Italian politicians from accumulating even more debt in the future if they were allowed to do so.

However, the evolution of the European scenario will also matter a lot.

European institutions reacted surprisingly fast and well to the pandemic crisis, supporting countries with a combination of common monetary and fiscal policy, including the launch of the NG-EU (Bordignon, 2020). This has allowed European countries, including countries with very little fiscal space such as Italy, to exit quickly and relatively unharmed by the sharp recession induced by the pandemic. Unfortunately, European countries do not seem to be able to maintain the same unity when confronted with the new crisis and the looming risks of stagflation. While it would seem somewhat obvious that EU countries, faced with a common threat such as the Russian invasion and its economic consequences, should react by investing collectively more in the provision of EU public goods (e.g. defence, energy security, refugees, control of the borders), this is not happening, or at least, not yet. No new European funds are at the moment allotted to face new challenges. The Council has recently approved a set of measures (REpowerEU) to use existing unspent EU resources and support energy security. The reform of fiscal rules has been postponed, together with the Growth and Stability Pact, maintaining the general escape clause in place also for 2023. Political and economic heterogeneity weighs heavily on the possibility of further integration. All this might also have potential negative consequences on the sustainability of Italian debt, as we discuss below. Faced with the new inflationary threats, the ECB's exit strategy from the long period of hyper-supportive monetary policy will also play an important role. In what follows, we briefly discuss these issues in turn.

2. The macroeconomic scenario

Let us start with the macro-economic scenario. After the strong recovery of the Italian economy in 2021 (+6,6%), the prospects for the future have become dimmer. The increase in the prices of energy and primary commodities, which began in the second semester of 2021 but were initially thought to be temporary, has become more persistent because of the war in Ukraine and the strategic manipulation of the price of gas by the Russian authorities. Inflation soared to 8% in 2022, but it is still assumed by the leading official forecasters to decline in the next years. Expected growth in 2022 has declined with respect to what was initially foreseen (-1.6 percentage points according to the Commission), and growth was, in fact, slightly negative in the first quarter of 2022 (-0,2%), but still positive in the second (+1%). The forced savings accumulated during the pandemic and the buoyancy of the labor market should still support private consumption, despite the increase in consumer prices. Government intervention in support of poorer households and energy-intensive sectors should also support production and consumption. Public investment should also be on the rise after the robust rebound in 2021, thanks to the resources of the Recovery and Resilience facility. But uncertainty clouds all these forecasts, particularly concerning the evolution of the war in Ukraine and its effect on energy provision and trade of primary commodities. For the first time, the Commission, in its 2022 Spring Forecasts, has accompanied its central forecasts with two negative scenarios, the most severe implying a recession for the European economy, accompanied by higher inflation. The level of uncertainty has remained high even in the Summer Forecasts.

These developments have again raised concerns about the sustainability of the Italian debt. As anticipated, barring the most extreme negative scenarios connected to the duration and the consequences of the War in Ukraine, the situation still looks quite favorable in the short term. Because of the higher nominal growth and, therefore, higher tax revenues, public finance indicators turned more positive in 2021 than expected, with a deficit at 5.5% on GDP and a (gross) debt over GDP of about 151%, down from 155% in 2020. In 2021, the borrowing cost reached a minimum of 2,4% (3,5% in terms of interest payments over GDP), with an average net cost at the emission close to zero (0,10%). Based on current expectations on the evolution of interest rates (UPB, 2022), the share of interest payments over GDP should also remain roughly unchanged in the next years. This is also because the Italian Treasury managed to increase the average duration of debt to more than 7 years, thus isolating a larger share of the debt from the current sharp increase in the interest rates. Finally, as we discuss in more detail below (see Section 4), the Eurosystem by now holds about one-third of the Italian public debt due to the quantitative easing policy followed by the ECB since 2015 and the anti-pandemics PEPP program. As long as monetary institutions hold these bonds, Italy de facto does not even pay interests on this debt, as interest payments are returned to the national coffer, although not automatically.

Consequently, according to the forecasts of the Italian government presented in official documents (e.g. MEF, DEF 2022), but also largely confirmed by independent institutions (e.g. UPB, 2022), debt over GDP should remain on a declining path for the next few years, reaching about 142% in 2025[1], as a result of high nominal growth and declining headline deficits[2]. This pattern of debt reduction over GDP is also broadly confirmed by the Commission for

[1] Stochastic simulations assign a probability of 80% that debt over GDP will fall in the next two years and slightly above 70% that this reduction will continue in 2024-25.

[2] So far, the Italian government has been careful not to expand public deficit in 2022, finding other resources (including a new tax on the extra profits of energy producing companies) to finance support for poor households and company mostly hit by the increase in energy price.

a shorter time span (EU Spring Forecasts, 2022). On the other hand, expectations of further policy interest rate increases, and the announcement by the ECB of a less expansionary monetary policy immediately affected financial markets, with a spread between the Italian BTP and the Bund that rapidly rose above the 200 basis points, the highest level since 2018. This does not raise immediate concern for the reasons explained above (the snowball effect is still favorable, and even a sharp increase in the interest rate would have small effects in the short run). In the longer run, however, the combination of lower growth and higher interest rates might again put debt sustainability at risk[3].

In this risk assessment, future growth will turn out to be essential. The simulations by the UPB (2022) are telling. According to them, should economic growth after 2026 (the last year of the RRP) fall back to the pre-pandemic trend of 0.6% per year (still the Consensus forecast for Italy's potential growth rate), debt over GDP would start increasing again, reaching 151% in 2031[4]. If, instead, growth would resume a more satisfactory trend of 1.1% per year (the average rate of growth in the period 2014-19), debt over GDP would decline, but it would still be about 134% in 2031. Finally, if potential growth accelerates, reaching the Euro area average growth trend (estimated at

[3] What matters for debt sustainability are of course *real* interest rates not nominal ones. These are still strongly negative in the Euro area on all durations, including for Italy. What would happen in the future is an open question. With the more restrictive stance of monetary policy chosen by the ECB, they will probably increase in the medium term, but nobody knows up to which point. See the simulations in UPB (2022) for the effect of different hypotheses on debt sustainability and see Blanchard (2022) for a more general discussion on why real interest rates are historically so low. Of course, for Italy what really matters is the spread, not the policy rate; unfortunately, this is likely to be an increasingly and convex function of the level of debt over GDP (Gros, 2021).

[4] The simulations assume a *no policy change scenario* for the years after 2025, keeping unchanged the structural primary surplus announced by the government in 2025. For the cases of low growth, this would imply a headline deficit above 3%, that is, above the EU threshold. Interestingly, according to simulations, assuming that in this case Italy would be forced to reduce it at 3%, debt over GDP would fall faster, even considering the negative effects of more restrictive fiscal stance on GDP growth.

1,9%), debt over GDP would fall to 125% by 2031.

Which of the different growth scenarios will prevail depends a lot on the implementation of the Recovery and Resilience Plan for Italy. On the bright side, many simulations, made by the government in the presentation of the Italian plan (2021), by the UPB (2022) and the Bank of Italy (2021) suggest that a "catching up" of the Italian economy with the euro area as a result of the successful implementation of the Plan belongs to the realm of possibilities. In the first period, the acceleration of growth should result from a Keynesian stimulus to aggregate demand. In the second period, it is the complementarity between public and private investments, raising productivity growth, that would play the trick. Finally, even after the conclusion of the program, the several reforms that should be introduced to implement the plan (concerning civil justice, competition, public administration, regulation, tax evasion, but also research, education, and health care) would support a structural higher growth of the economy (Bank of Italy, 2021).

The question is whether such a successful implementation is feasible. So far, Italy has been able to meet all the conditions set up in its Plan, receiving the agreed funds from the Commission. But most of these objectives (the "milestones") had to do with parliamentary approval of some pieces of legislation; the serious challenges lie in the future when projects have to be approved and completed within the strict time constraints imposed by the Plan. For instance, about a third of expenditure has been allocated to local governments (regions and municipalities), and about 40% of the total resources should be spent in the South of the country. The lack of administrative capacity of many of these local governments is a serious source of concern. The risk that some of these funds will not be spent or end up wasted in inefficient projects is concrete. A lot will depend on the determination of the central government to control the implementation of the Plan and remove the obstacles as they appear, for instance, supporting local administrations and re-allocating unspent resources before they are wasted. And while there is little doubt about the determination of the Draghi government[5], it is an open question whether future governments will be able to act likewise. Indeed, the declared intention by some political parties to renegotiate the PNRR casts some doubts on the ability of the new government to implement the plan within the agreed deadline.

A similar story could be said for structural reforms. They are generally progressing in line with the Plan, but it is unclear whether they will be able to reach the stated objectives. Finding the necessary consensus in the large and divided parliamentary majority that supports the present government has meant striking several compromises that have often watered down the innovative contents of the reforms. And even if a reform is approved today, there is always the possibility of a reform reversal in the future, when a new political government will be in charge. Indeed, it is not a coincidence that many of these fundamental and long-awaited reforms have not yet been passed; they conflict with the interests of many constituencies that typically find strong representation in the Italian political parties. These political economy considerations are likely to weigh on the plan's implementation and, therefore, on future growth and debt sustainability.

[5] For instance, the Draghi government already intervened with additional money to counteract price increases for the implementation of projects.

3. EU Fiscal governance

On the international side, the EU seems to have lost the momentum that had supported it during the pandemics. EU countries presented a unitary front towards the Russian invasion, passing a set of common sanctions and new legislation to accept Ukraine refugees. But political and economic heterogeneity has delayed the process, and more stringent sanctions (for instance, on gas imports from Russia) are still to be approved. Moreover, the unanimity constraint makes it difficult to make substantial progress in many policy domains. While there has been a lot of talk at the political level about reforming decision rules (Sholtz, 2022) or about starting enhanced cooperation agreements among subsets of EU countries willing to move forwards faster, no concrete steps have yet been taken.

Somewhat paradoxically, even in the fields more directly affected by the Russian invasion, such as defense and energy security, there has been little progress towards a common European approach. For example, the EU countries have (at the time of writing) failed to use their market power toward Russian gas exports[6], imposing a cap on gas price or a tariff on exports (see Gros, 2022). And for the resistance of several EU countries, no common funds or additional money has been set up to address these challenges, including Ukraine's (future) reconstruction[7].

This difficulty has also affected the reform of fiscal rules. As is well known,

[6] If Russian is the only provider of gas for some European countries, the EU as a whole is the only buyer of Russian gas. This might offer market opportunities that have yet not been exploited (see Gros, 2022 and Blanchard and Pisany Ferry, 2022).

[7] As anticipated, one important proposal made by the Commission (Repower EU) is to use the part of the RRF that has not been taken yet as loans by EU countries from the original Ng-Eu (at the moment, 220 billion) and make it available as loans to countries to use to decouple from the Russian fossil fuels sources of energy. A part of the structural funds could also be re-allocated to the same aim. While important, note that this proposal does not envisage extra EU money.

the Growth and Stability Pact (GSP) was suspended in March 2020 by invoking the "general escape clause" envisaged by the Treaties to offer countries more leeway in spending against the pandemic. With the end of the pandemics and the economic recovery, the GSP should have been re-instated (revoking the general escape clause), starting in January 2023. The Commission planned to use this opportunity to propose a deep revision of the fiscal rules, considering the pitfalls of the present GSP (see EFB, 2019), and to address the new scenario created by the pandemics. For instance, debt over GDP has increased substantially in several EU countries because of the pandemic (the average is close to 100% and for six Euro countries is at around or above 120%), making some of the present rules obviously not enforceable (like the 1/20th rule, imposing each country to reduce by 1/20th each year the difference between current debt over GDP and the 60% target). Moreover, the experience of the NG-EU seemed to offer a new paradigm for the relationship between the Commission and the countries that could also be exploited for reforming the rules (see below).

Indeed, the Commission launched a public consultation on the reform of the fiscal rules that ended in December 2021, collecting more than 200 proposals (EU Commission, 2022c). Elements of consensus on how rules should be reformed emerged from these proposals (see, for instance, Darvas et al., 2018; Darvas and Wolff, 2022, Martin et al., 2021, Bordignon and Pisauro, 2021, Giavazzi et al., 2021). Building on that, the Commission was expected to present a set of reform proposals in June 2022, to provide clear fiscal guidance to EU countries for 2023. However, the lack of consensus among countries and the uncertainty concerning the duration and effects of the war in Ukraine eventually convinced the Commission not to revoke the general escape rule and to postpone the presentation of its reform proposals.

All this is not without effects for a high-debt country such as Italy. The lack of a common EU approach to the Ukraine crisis leaves a fragile economy, like the Italian one, more exposed to the energy threat of Russia than others, in a difficult situation. Furthermore, the lack of precise fiscal guidance by the Commission, supported by the fiscal rules, coupled with the uncertainty of the economic and political situation, increases uncertainty for the potential investors in Italian debt. Particularly because, as discussed in more detail below, the ECB has also decided to terminate the various bond purchasing programs and start increasing the policy rate. By contrast, we believe that the introduction of a common fiscal capacity, contributing to the production of some EU public goods, should go together with the definition of a simpler but more rigorous set of fiscal rules (see for detail, EFB, 2021 and Bordignon and Pisauro, 2022).

Specifically, along the lines of the present national recovery and resilience plans, high debt countries could propose a *fiscal adjustment plan*, supported by technical analysis, pertaining to a reasonable objective of debt over GDP reduction in the mid-term (revising the present debt rule). The Commission and the national fiscal council would assess the validity of the plan, and the Commission make a proposal along these lines to the Council. With the approval by the Council, the high debt country would take a political commitment to enforce the plan, which would be further reinforced by conditioning the access to elements of the common fiscal capacity with respect the plan. The Commission would verify the respect of the plan by means of a revised expenditure rule (Lane, 2021), thus inducing an automatic anti-cyclical orientation to fiscal policy. We believe that this fiscal framework would assuage the worries of financial markets about the sustainability of Italian public debt. It would also facilitate the task of the ECB and its interventions to prevent speculative attacks on high-debt countries, by making use of the newly introduced Transmission Protection Instrument (see below).

4. Monetary policy and debt sustainability

The sustainability of public debt is significantly affected by the central bank's operations in the government securities market. As we remarked above, the asset purchases made by the Eurosystem have been quite substantial since March 2020, at the outset of the pandemic crisis. The purchases of government securities under the Pandemic Emergency Purchase Programme (PEPP) added to those also made under the Public Sector Purchase Programme (PSPP), initiated in 2015[8]. Unlike PSPP, the PEPP has allowed the Eurosystem to implement its purchases of government securities by deviating from the capital keys, the share of ECB capital held by the national central banks. The capital keys provide the benchmark allocation of asset purchases. Still, the Governing Council allows for some flexibility in the distribution of asset purchases across countries (as well as across types of bonds and through time).

According to the Bank of Italy (2022), under the PEPP, the Eurosystem has purchased over 1.700 billion euros of securities; of these, 280 billion of Italian government bonds. As a result of both programs, PEPP and PSPP, the share of outstanding Italian government bonds held by the Eurosystem reached one third by the end of 2021, mostly accounted for by the share held by the Bank of Italy (29.9%). This is the outcome of the following risk

[8] The program was temporarily suspended in 2019.

allocation, agreed upon for the PSPP and also applied later to the PEPP. Risk-sharing within the Eurosystem is applied to 20% of the asset purchases: national government bonds purchased by the ECB (10% of the programs) and securities issued by European supranational institutions (another 10% of the programs). The remaining share of the asset purchases (80%) is made by the national central banks, buying domestic government bonds.

The PEPP has played two important roles: 1) it provided the monetary accommodation needed to support the Euro economy hit by the pandemic crisis, 2) it preserved the correct transmission of monetary policy throughout the euro area by limiting cross-country spreads. As far as the second objective is concerned, the use of the above-mentioned flexibility is crucial. The available evidence[9] shows that such flexibility was actually used to a significant extent at the outset of the crisis: the sum of the deviations from the national capital keys (in absolute value) was almost 15% in March-May 2020. However, the allocation of the asset purchases converged towards the capital keys in the next months: the cumulated deviations have stabilized around 5-6% since April 2021.

The asset purchases made by the Eurosystem have significantly contributed to limiting the cross-country interest rate spreads during the pandemic crisis: for example, the BTP-Bund spread reached 2.3% in the spring of 2020 due to the tensions related to the crisis, and it converged to pre-crisis levels, around 1.3-1.4%, by October of the same year. In addition to limiting the market level of interest rates, the asset purchases made by the central bank reduced the cost of public debt funding through an additional channel. The interests paid by the Government on those securities held by the central bank are paid back by the latter to the former: the final effect is that the cost for the

[9] See Bank of Italy (2022).

Government of funding public spending through this channel is almost zero.

In 2022, the Eurosystem started implementing its exit strategy from the exceptionally accommodative monetary policy of previous years. By looking at the ECB's and other central banks' experience in the past,[10] we can say that the exit process from quantitative easing policies typically follows several steps. 1) *Tapering*: the size of periodic net purchases of securities is gradually reduced and finally set to zero. 2) *Roll-over*: when some securities in its policy portfolio come to maturity, the central bank buys other securities (generally of the same kind) to keep the size of the policy portfolio unchanged. 3) *Interest rate tightening*: policy interest rates are increased. 4) *Roll-off*: the size of the policy portfolio decreases as long as the central bank reduces and finally stops the roll-over of maturing securities. Those steps can be taken at different times, enabling the central bank to implement a gradual exit strategy.

The Eurosystem has driven down to zero the net asset purchases made under the PEPP by March 2022 and those made under the PSPP by the third quarter of 2022. The forward guidance of the Governing Council makes it clear that the roll-over of the securities purchased under the PEPP will continue until at least the end of 2024. As far as the PSPP is concerned, the roll-over will last "for an extended period of time past the date when it starts raising the key ECB interest rates and, in any case, for as long as necessary to maintain favorable liquidity conditions and an ample degree of monetary accommodation". In addition, "in the event of renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time."[11] Based on this forward guidance, we can expect that the downsizing of the Eurosystem's balance sheet,

[10] For an analysis of the QE policies and of the exit strategies implemented by the Ecb and by the Fed, see Baglioni (2021).

[11] See ECB (2022).

through the roll-off of its securities portfolio, will be delayed over time, and gradually implemented to avoid any destabilizing impact on financial markets.

It should also be considered that in the coming years, up to December 2024, a considerable downsizing of the Eurosystem balance sheet will come because of the repayment of the outstanding Targeted Longer Term Refinancing Operations (T-LTROs). As of April 2022, the stock of these central bank loans to the banking sector (with a three-year maturity) amounts to 2.200 billion euros, and they should be repaid – in several tranches – before the end of 2024. Since the total size of the Eurosystem balance sheet, as of April 2022, is 8.800 billion euros, it is easy to see that the repayment of the T-LTROs will result in a 25% reduction of the central bank's balance sheet in less than three years: this can be considered as a quite significant degree of quantitative tightening, that justifies delaying and taking a soft approach to the roll-off of the securities portfolio. This feature is overlooked in the discussion about how managing the government securities portfolio accumulated by the Eurosystem. Indeed, in the Italian debate, several proposals have been put forward to transfer the Eurosystem's public bonds to an EU debt agency.[12] However, these proposals generally imply some degree of risk-sharing among the euro area countries; for this reason, we believe those proposals will face significant political opposition.

The repayment of the outstanding T-LTROs will substantially impact the excess liquidity accumulated during the years of QE policy. As is well known, excess liquidity is defined by the sum of excess reserves (current account balances held by the banking system at the Eurosystem in excess of the compulsory reserve requirement) and the balances held on the overnight deposit

[12] See, for example: Giavazzi *et al.* (2021), Micossi (2021), Amato and Saraceno (2022).

facility. As of April 2022, these two items amount to 4.500 billion euros. The repayment of the T-LTROs would imply an almost 50% reduction of this excess liquidity in the coming period up to December 2024. How far will the ECB go in implementing a further reduction, if any, of the excess liquidity?

The answer to this question depends on the outcome of the normalization of monetary policy in the euro area. This is an issue that the ECB should hopefully clarify by means of its forward guidance. The exit from QE policies will presumably imply a convergence towards a "new normal", where the operational framework of the ECB will still follow the "floor system" inherited from QE policies. In a floor system, the money market features structural excess liquidity, and the relevant policy rate is that paid on the deposit facility. This implies that the excess reserves will not be driven down to zero (as it used to be in the old operational framework known as "interest rate steering" or "corridor system"). In the USA, the Federal Reserve has already made clear[13] that the "new normal" way of implementing monetary policy is an "ample reserves regime", namely a floor system where the policy rates are those paid on excess reserves.[14] Therefore, we believe that the ECB should provide more information about the normalization of its operational framework, particularly about the level of excess liquidity needed to implement monetary policy in the euro area. This information will provide crucial hints regarding the management of the Eurosystem's securities portfolio.

Another issue that deserves some clarification is the degree of flexibility in the allocation of reinvestment of the proceeds of maturing securities, relative to the capital keys. The Governing Council should clarify whether this flexi-

[13] See Fed (2019).

[14] Given the institutional features of the money market in the US, the Fed makes use of two policy rates called "administered rates": the rate paid on bank excess reserves and the rate paid on overnight reverse repos made by the Fed with non-bank financial intermediaries. See Baglioni (2021) for details.

bility can be used to address any market fragmentation due to shocks different from the pandemic, like the Russia-Ukraine conflict. Market tensions related to the conflict have driven the BTP-Bund spread to levels above 200 basis points in the summer of 2022. Addressing cross-country spreads of this size requires a significant degree of flexibility by the Eurosystem in implementing the roll-over of its government bond holdings.

If the flexibility related to the roll-over of the securities holdings turns out to be insufficient to address market fragmentation, other tools would be needed. The Outright Monetary Transactions (OMT) program, introduced ten years ago following the celebrated "whatever it takes" statement made by President Mario Draghi, has never been used (which did not prevent it from having a great impact on market expectations and securities prices). A crucial reason is the conditionality attached to the use of the OMT: a necessary condition for OMT is that the government of the relevant country agrees to a program (macroeconomic adjustment or precautionary program) with the European Stability Mechanism (ESM). In addition, purchases of sovereign bonds under OMT should be limited to those with a maturity of between one and three years. These limitations are self-imposed by the ECB, as they come from a decision of the Governing Council.[15] They are problematic since governments are generally reluctant to apply for financial assistance to the ESM, fearing incurring a stigma effect and being forced to take hard consolidation programs[16].

The above difficulties have been partly overcome by the adoption of the

[15] See Ecb (2012).

[16] As a proof of this difficulty, one should recall the destiny of the special line of precautionary support set up by the ESM in June 2020 to allow Euro countries to fight the pandemics by investing in health care. To date, no Euro country has used this facility. On the contrary, 12 Euro countries have used the SURE facility set up by the Commission, even though the two lines of funding in terms of financial conditions were very similar (except that SURE had to be used to support employment rather than health care; a tiny difference if one recalls that money is fungible). See Bordignon, 2021 for a discussion.

Transmission Protection Instrument (TPI) in July 2022. The TPI will enable the Eurosystem to make secondary market purchases of Government securities (with a maturity up to ten years) issued in countries experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. Unlike the OMT, the TPI will not be conditional on the agreement of an adjustment program between the Government and the ESM: this is a remarkable improvement over the OMT. However, in deciding whether to activate the TPI, the Governing Council will consider four eligibility criteria.[17] (1) Compliance with the EU fiscal framework, in particular not being subject to an excessive deficit procedure (EDP). (2) Absence of severe macroeconomic imbalances, in particular not being subject to an excessive imbalance procedure (EIP). (3) Fiscal sustainability, based on the debt sustainability analyses by the European Commission, the ESM, and the IMF, together with the ECB's internal analysis. (4) Sustainable macroeconomic policies: complying with the commitments submitted in the recovery and resilience plans and with the European Commission's recommendations under the European Semester. These criteria are quite reasonable, since they require that a country complies with the EU fiscal and macroeconomic framework. The third criterion, however, introduces a remarkable degree of discretion in the decision-making process leading to the activation of the TPI.

After a long period during which the policy rates have remained close to the Effective Lower Bound, the ECB is tightening policy as part of its exit strategy from the easy monetary policy followed in recent years. The ECB's approach to interest rate tightening is softer than that of other central banks, particularly the Fed. The reason is that the negative impact of the Russia – Ukraine conflict on the business cycle is stronger in the euro area than in the

[17] See the Ecb's press release of July 21, 2022.

US. The economies of the euro area are also suffering a strong inflationary impact from the price increases of energy and raw materials. In contrast, in the US the inflationary process seems to be linked more to strong aggregate demand dynamics during the exit phase from the Covid-19 restrictions, leading to tight conditions in the labor market. This justifies a stricter monetary policy stance in the US than in the euro area.

One should also consider the interaction between monetary and fiscal policy, as suggested by Blanchard and Pisany-Ferry (2022). Implementing fiscal measures to support the level of real wages in front of specific price increases (e.g. energy prices), like those introduced by the Italian government, should reduce the pressure for nominal wage adjustments, thereby limiting "second-round inflation". This, in turn, should reduce the need to tighten monetary policy.

5. Concluding remarks

The sustainability of the Italian public debt is not a source of concern in the short run. The evolution of the debt-to-GDP ratio should remain under control in the next few years, thanks to several factors: the long average duration of Italian government securities, limiting the impact of increasing interest rates; the large share of the Italian debt held by the Eurosystem, on which de facto the Italian Government does not pay interests; the sharp increase in inflation, implying a positive and significant snowball effect. The newly introduced TPI by the ECB should also limit the risks of a sovereign debt crisis, at least as long the country respects its commitments with the European institutions. However, the long-run scenario is more problematic. A crucial role will be played by the ability of the Italian institutions, including local governments, to implement the envisaged investments under the RRP. The approval and concrete implementation of the related reforms will also be crucial. This issue raises a high degree of political risk, considering the possible scenarios after the conclusion of the current technocratic Government.

At the European level, the response to the tremendous shock represented by the Russian invasion of Ukraine seems weaker and less unitary than that taken in front of the pandemic crisis. Except for the recent "REpowerEU" initiative (still underway) the EU countries still lack a common approach to the provision of some public goods like defense, energy security, immigration (refugees) policy and border control. The reform of the SGP should provide the chance to make a deal among EU countries. A clear and rigorous set of new fiscal rules should be balanced with the introduction (and expansion through time) of a common fiscal capacity to offer some public goods at the EU level and provide the necessary stabilization policy.

The Eurosystem has purchased one third of the outstanding Italian government securities under the PSPP and the PEPP programmes, contributing significantly to reducing the interest burden for the Italian government through two channels: 1) the impact on market interest rates and 2) the repayment of the interests received by the central bank on its securities portfolio. During the exit process from QE policies, the forward guidance of the ECB has made clear that the roll-over of its holdings of government bonds will continue for a few years, thus contributing to the stability of the market for government securities. Furthermore, the repayment of the outstanding LTROs will imply a 25% reduction of the Eurosystem's balance sheet by the end of 2024. This reduces the necessity to implement a quantitative tightening through the roll-off of the securities portfolio, even if the ECB should decide to implement a more restrictive policy stance to face the ongoing inflationary pressure. While this is good news for the sustainability of public debt in the years to come, it remains true that the control of cross-country interest rate spreads remains an issue. A limited contribution may come from the flexibility in the allocation of reinvestments of the proceeds from maturing securities. A potentially stronger tool is the recently adopted TPI, which comes with a softer conditionality than the OMT.

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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.

ECONOMIA ITALIANA nasce nel 1979 per approfondire e allargare il dibattito sui nodi strutturali e i problemi dell'economia italiana, anche al fine di elaborare adeguate proposte strategiche e di *policy*. L'Editrice Minerva Bancaria si impegna a riprendere questa sfida e a fare di Economia Italiana il più vivace e aperto strumento di dialogo e riflessione tra accademici, *policy makers* ed esponenti di rilievo dei diversi settori produttivi del Paese.

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