

Press Release/ Comunicato Stampa

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## 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, **the Editors touch upon some of these issues and discuss why they are important.**

In his essay, ***Sovereign debt in times of crises***, **Carmin Di Noia**, OECD, explores the dynamics of sovereign debt in crisis times. In particular, he describes how sovereign debt markets react to pressures caused by the war in Ukraine and the COVID-19 pandemic. In doing so, it highlights the key uncertainties facing countries and debt managers and lessons learned so far. It also addresses possible risks on the horizon.

**Ludger Schucknecht**, Asian Infrastructure Investment Bank, in his essay, ***A new look at public debt sustainability***, points out that public debt sustainability is essential for economic growth and prosperity. Anyway, due to recent economic and political turmoil, sustainability risks may be even higher than we think. Moreover, debt sustainability has become a global and systemic challenge: highly indebted, large countries account for as much as 60% of the global economy. Therefore, the sustainability of public finances should feature more prominently in countries’ strategies to boost their economic, financial and social resilience.

**William R. Cline**, Peterson Institute for International Economics, in his essay, ***Debt sustainability in emerging market economies after the Covid-19 shock***, examines debt burden metrics for 11 major EMEs to gauge the severity of the shock. A crucial difference from debt crises in the 1980s and 1990s is that most EME sovereign debt is now primarily in domestic currency and owed to domestic holders, reducing vulnerability to exchange rate depreciation and the relevance of externally coordinated debt relief. Notwithstanding the sensitivity of debt burdens to upward pressure on real interest rates, overall, so far, there has been no generalized slide of the major emerging market economies into unsustainable debt burdens requiring debt renegotiation with partial forgiveness.

However, it will be important for the countries more at debt risk to achieve their baseline improvements in primary fiscal balances currently projected by the International Monetary Fund.

**Lorenzo Codogno, and Giancarlo Corsetti**, LSE and European University Institute, respectively, in their essay, *Debt sustainability analysis is back. Sudden shifts in underlying factors may push high-debt countries into a bad equilibrium*, point out that the fundamental drivers of debt sustainability are back. Higher interest rates, lower economic growth and the need for fiscal support for cyclical and structural reasons may push debt dynamics into bad equilibrium. A sustainable fiscal outlook will rest on two pre-conditions over the next few years: first, reforms and investments should be accelerated to benefit from early returns within a reasonably short time horizon; second, a prudent fiscal policy and a smart macro prudential policy are of the essence to reduce and possibly rule out the risks of sudden shifts in financial market sentiment.

**In his essay, *The (un)sustainability of public debt: the elusive reality of an intuitive concept*, Martin Larch** investigates the question of the constraints on public finances. While they are easy to define in theory, they do not offer any practical clues. In the EU/euro area, severe risks to the sustainability of member states' public debt, especially large ones, can threaten the independence of the central bank and the integrity of the economic and monetary union. Mechanisms to restrain the political bias to accumulate debt yielded mixed results. Member states are polarized, 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.

**Cecilia Gabriellini, Gianluigi Nocella, and Flavio Padrini**, in their essay, *A post-Covid-scenario analysis of Italy's public debt ratio dynamics*, illustrate possible scenarios for Italy's post-Covid public debt as a ratio of GDP using the main tool by Italy's Parliamentary Budget Office (PBO) to assess public debt dynamics in the short-to-medium term, i.e. the deterministic DSA framework. If it is assumed that GDP returns to pre-pandemic or higher trend levels, the decline of the debt ratio should continue in the medium term. Conversely, if it is assumed that the pandemic has inflicted a permanent negative 'shift' on trend levels, the debt ratio would stabilize at high levels. If it is assumed that, in addition, the trend GDP growth rate converges to the lower Consensus medium-term forecast, rising public debt dynamics cannot be excluded. As a result, a neutral fiscal stance from 2025 would not suffice to ensure declining debt dynamics in more conservative but still realistic scenarios. On the other hand, a significant structural fiscal consolidation from 2025 (half a percentage point each year) could ensure a declining debt ratio in all scenarios except that with lower trend levels and growth. Thus, effective use of the NGEU funds contributing to both a strong recovery and higher trend growth in the medium term than the current Consensus projections would be key to guaranteeing a declining path for the public debt ratio.

**Marzia Romanelli, Pietro Tommasino, and Emilio Vadala**, in their essay, *The future of European fiscal governance: a comprehensive approach*, review the reasons for limiting the discretion of national fiscal policies in the context of a monetary union, assessing the shortcomings of the current euro-area fiscal framework as well as the merits of the main proposals for its reform. Taking into account the elements of consensus that emerged in the debate, the authors outline a possible revision of the European fiscal rules. The new framework would be based on a medium-term debt target and a multi-annual headline deficit profile consistent with that target. The new rules should be complemented with a common fiscal capacity to compensate for the national government's loss of policy discretion and to internalize cross-country fiscal spillovers. In particular, it is suggested to introduce a contingent facility, which would only be activated in cases specified ex ante or for the implementation of common projects of an exceptional nature (e.g. in the energy sector).

**Angelo Baglioni, and Massimo Bordignon**, in their essay, *Public debt sustainability, fiscal rules and monetary policy*, start observing that 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.

**In his essay, Reconciling fiscal and environmental sustainability in the Eurozone**, Paul Van den Noord observes that fiscal restraint looks inevitable in the Eurozone following the pandemic, especially if the fiscal rules are reinstated. How to match this with the need to finance the climate transition? Two possible routes are explored. One is the adoption of a 'green golden rule', with the structural deficit limit (or 'Medium Term Objective') increased by 1% of GDP. Alternatively, new borrowing capacity could be created at the center through a 'European Climate Fund', involving some redistribution towards countries most in need of abatement. Either way, financing the energy transition – now more urgent than ever in view of the Ukrainian war – could be achieved within the confines of the 60% of GDP debt constraint.

Complete the number two short papers not related to the monographic topic: **Mariano Bella e Luciano Mauro**, Confcommercio, deal with stagflation. **Fabrizio Guelpa**, Intesa Sanpaolo, analyses how a big bank can support the export of the Italian middle companies.

Rome, October 2022

**ECONOMIA ITALIANA** is a Journal, founded by Mario Arcelli, in 1979, with the aim to deepen and broaden the debate on the structural nodes and problems of the Italian economy, also in order to develop appropriate strategic and policy proposals. The publisher “Editrice Minerva Bancaria” is committed to taking up this challenge and making “Economia Italiana” the most lively and open tool for dialogue and reflection among academics, policymakers and leading exponents of the Country’s various productive sectors.

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