European Stability Mechanism
esm

SUMMARY NOTE: POLICY IMPLICATIONS FOR SUSTAINABLE FINANCES

The new EU fiscal governance under review relies on two main pillars: fiscal sustainability and national ownership. Stronger ex-post enforcement of fiscal rules should compensate for greater ex-ante national fiscal autonomy.

The reform of EU fiscal rules can be summarized as a four-stage process where in stage i) the EC publishes a technical fiscal adjustment trajectory for member states with debt over 60% of GDP or excessive deficits (over 3% of GDP) which satisfies the debt sustainability criterion; in stage ii) member states discuss the trajectory with the EC and submit their fiscal-structural plans usually covering 4-7 years depending on the agreed horizon; in stage iii) the EC assesses the submitted plan mainly against sustainability criterion and the Council endorses the plan and; in stage iv) the plan is carried out, with EDP as an enforcement tool in case of noncompliance.

In this setting the DSA serves to define the fiscal path over the adjustment period. Ultimately, the adjustment plan endorsed by the Council is the sole basis for assessment of compliance with the new rules and possible enforcement (EDP). However, it's important to keep in mind the limitations of the DSA, with regards to both baseline and stochastic debt projections, and in particular the sensitivity to underlying assumptions, data quality and model choice. In addition, the DSA is not free from judgment and should be conducted in dialogue with the member states. Imposing DSA-derived numerical targets (e.g. structural primary balances) on member states could backfire.

In the end, the success of the reformed rules could depend more on an effective implementation of the fiscal-structural plans and the willingness to carry out EDP enforcement for high-risk countries rather than on refining the DSA methodology itself.

The new approach needs to be even-handed across countries, replicable but also flexible enough to allow for inclusion of country-specific factors. Country ownership is likely to be enhanced by using commonly agreed inputs into the DSA, such as potential GDP growth and ageing costs which are outcomes of working groups with member states. However, DSA-based fiscal rules are likely to suffer from communication challenges as the DSA carries stigma from debt crises and official lending, and can be viewed as a black box. To mitigate these concerns, increasing ownership by allowing for replicability of the DSA and using advanced tools that remain intelligible for policy-makers will be important.

The use of the DSA as a tool to shape fiscal behaviour introduces a distinction between a normative DSA and a positive DSA, where the former is mainly used for operationalizing the definition of sustainability while the deals with capacity to identify sustainability risks from the DSA and as such is a more technical approach.

Overall, DSA can contribute to the following policy objectives; i) *crisis resolution* where DSA is mostly normative and helps in program design, debt restructuring and post-program surveillance; ii) *fiscal governance/surveillance* where the DSA is used for impact assessment of monetary&fiscal policy

decisions, detection of fiscal dominance, or for ex-ante identification of a country's eligibility for monetary policy instruments (TPI).

However, debt sustainability is not an observable concept (not a universal debt level condition can be specified) and the DSA is only as good as its underlying assumptions. For this reason, it is important to make DSA methodology and assumptions transparent and to acknowledge its limitations (e.g. normative DSA compliance doesn't necessarily mean that the debt sustainability condition is met).

The DSA methodology and assumptions might need to be tailored to various institutions' own mandates, as the risks that it needs to capture might be different across different policy institutions owing to their policy objectives. A call for a universal DSA across different institutions addressing all the policy objectives, would be a call for a "super DSA".

Furthermore, there are three main issues that need to be managed in the DSA as a policy tool: i) model misspecification risk; ii) risk of reverse engineering, and iii) communication challenges linked with DSA assessment to the public.

Model misspecification risks could stem from structural breaks (especially in LICs) that undermine models' forecasts. Good DSAs should disclose the risks and disincentivize users from not accounting for these risks in the DSA which could be done by i) asking users to explain deviations from standardized models calibrations; ii) introducing stress testing of modelling risks, such as natural disasters or financial crises which are typically not included in the baseline or the fan chart; iii) penalizing optimism/pessimism of the baseline (tilting the fan charts towards baseline), and iv) including information on modelling risks into the framework through judgement.

The risk of reverse engineering can materialize both in "normative" DSAs for policy use and "positive" DSAs where the assessment can turn out less informative. Overall, judgment is part of the DSA but needs to be appropriately constrained as it otherwise could compromise frameworks. Similarly, sharp thresholds need to be avoided as they create incentives for users to push model findings towards their desired outcomes.

DSA needs to be well communicated, especially when it comes to the nature of risks assessed (including time horizon), any uncertainties in the analysis (macro-fiscal projections or DSA model shortcomings to be compensated by judgement), and its implications for policy (fiscal policy space, debt management implications). Ideally, the DSA needs to be intelligible to various audiences (high-level messaging vs. technical details).

Despite its comprehensive surveillance system, the EU can improve on it by introducing a consensus DSA for common reference, carrying out liability sustainability analysis (based on public sector balance sheet data), giving more power to the European Fiscal Board, removing political incentives (reverse-engineering of risks) from the DSA and running DSAs with counterfactual assumptions (alternative policies/reforms). The fines introduced under the new fiscal rules framework might be less credible than in the past with rising populism but well-designed fund contracts for high-risk countries can be a silver lining.