Improving economic policy

How have pandemic and war-related shocks impacted fiscal sustainability?

PIIE-IMF conference “Rethinking Fiscal Policy”
31 May, 2023

Jeromin Zettelmeyer
Drawing on joint work with Grégory Claeys, Zsolt Darvas, Gon Huertas, Lennard Welslau and Stavros Zenios

bruegel.org

Objective

Higher debt and higher interest rates implies higher effort to maintain fiscal sustainability and higher risks of debt distress. But how much higher?

Aim of presentation: to give a rough quantitative answer for advanced and large emerging economies for which long-term market interests are available, based on

1. Changes in projected medium-term debt drivers and implied steady-state debt-stabilising primary balances (based on 5 year IMF WEO and market interest rate projections in October 2019 vs. April 2023)
2. Changes in the gap between medium-term projected and debt stabilising primary balances
3. The IMF's fanchart-based indicator of the medium-term risk of debt distress

Bonus:

- Adjustment needs versus adjustment plans in EU countries.

Result 1: In advanced economies (AEs), debt-stabilizing primary balances (DSPBs) have risen by 0.5-0.8 percent, mainly reflecting higher expected interest rates. But DSPBs remain negative in most AEs

	Debt-to-GDP expected in 5 years (% of GDP)			Real growth expected in 5 years (%)			Expected long-term real interest rates (%)			Exp. debt-stabilising primary balance (% GDP)		
	2019	2023	***Diff.***	2019	2023	***Diff.***	2019	2023	**Diff.**	2019	2023	***Diff.***
75th pc	92.8	111.2	***18.4***	2.6	2.6	***0.0***	-0.2	1.5	***1.7***	-1.0	-0.4	***0.5***
Median	53.3	59.0	***5.7***	1.7	2.0	***0.3***	-0.7	0.9	***1.6***	-1.3	-0.7	***0.7***
25th pc	31.8	36.0	***4.1***	1.5	1.5	***0.0***	-1.2	0.5	***1.7***	-1.7	-0.9	***0.8***

Note: Sample consists of 33 advanced economies for which forward interest rate data is available

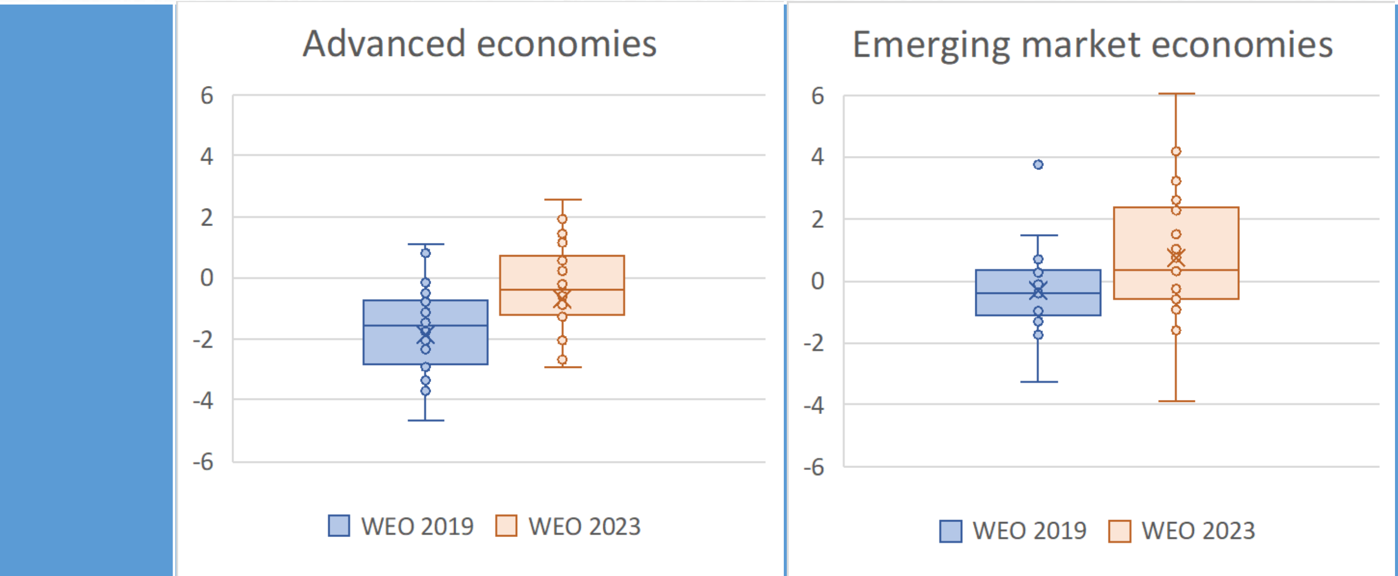
Result 2: In emerging market economies (EMEs), DSPBs have risen by 0.3-1.4 percent due to (1) higher expected interest rates and (2) lower expected growth in fast-growing EMEs. They are now mostly positive.

	Debt-to-GDP expected in 5 years (% of GDP)			Real growth expected in 5 years (%)			Expected long-term real interest rates (%)			Exp. debt-stabilising primary balance (% GDP)		
	2019	2023	*Diff.*	2019	2023	*Diff.*	2019	2023	**Diff.**	2019	2023	*Diff.*
75th pc	65.0	76.8	***11.7***	5.1	3.7	***-1.3***	4.3	5.8	***1.5***	0.2	1.6	***1.4***
Median	47.4	57.3	***9.9***	3.5	3.1	***-0.4***	2.5	4.3	***1.8***	-0.8	0.2	***0.9***
25th pc	36.3	46.3	***9.9***	2.3	2.6	***0.3***	-0.3	1.9	***2.2***	-1.5	-1.2	***0.3***

Note: Sample consists of 21 EMEs for which forward interest rate data is available

Result 3: The gap between *t+5* projected and debt-stabilizing primary balances has widened, and is high in the top quartile of EMEs

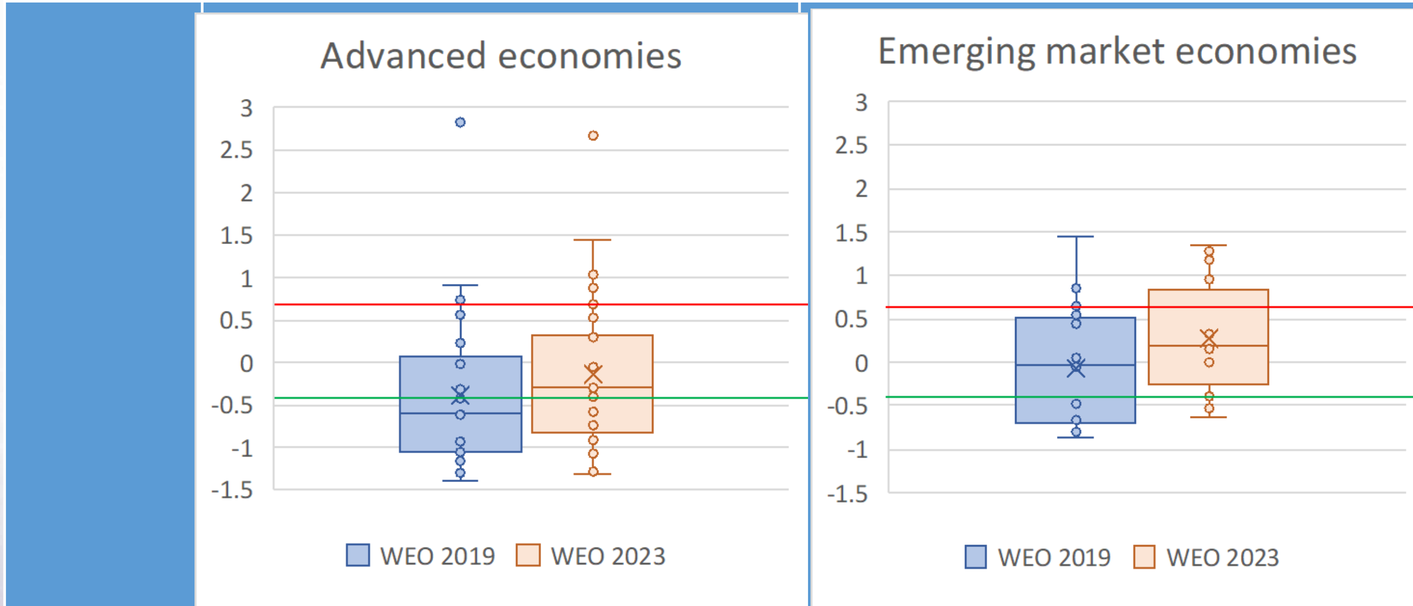
Steady state debt stabilizing primary balance in t+5 minus projected primary balance in t+5



	2019	2023	***Diff.***	2019	2023	***Diff.***
75th pc	-0.7	0.7	***1.5***	0.3	2.4	***2.0***
Median	-1.6	-0.4	***1.2***	-0.4	0.4	***0.8***
25th pc	-2.8	-1.2	***1.6***	-1.1	-0.6	***0.5***

Result 4: The medium-term risk of debt distress has grown, but remains low or moderate in most AEs and EMEs

Changes in the IMF's "fanchart index" (z-score).



	2019	2023	*Diff.*	2019	2023	*Diff.*
75th pc	0.07	0.31	***0.2***	0.51	0.83	***0.3***
Median	-0.59	-0.30	***0.3***	-0.03	0.20	***0.2***
25th pc	-1.05	-0.83	***0.2***	-0.70	-0.25	***0.5***

Note: index averages three debt stress predictors:

- Prob{Pb(t+5)<DSPB};
- fanchart width, and
- debt ratio (t+5) weighted by institutional quality.

Risk zones:

<-0.41: low risk (average probability of debt distress = 0.04)

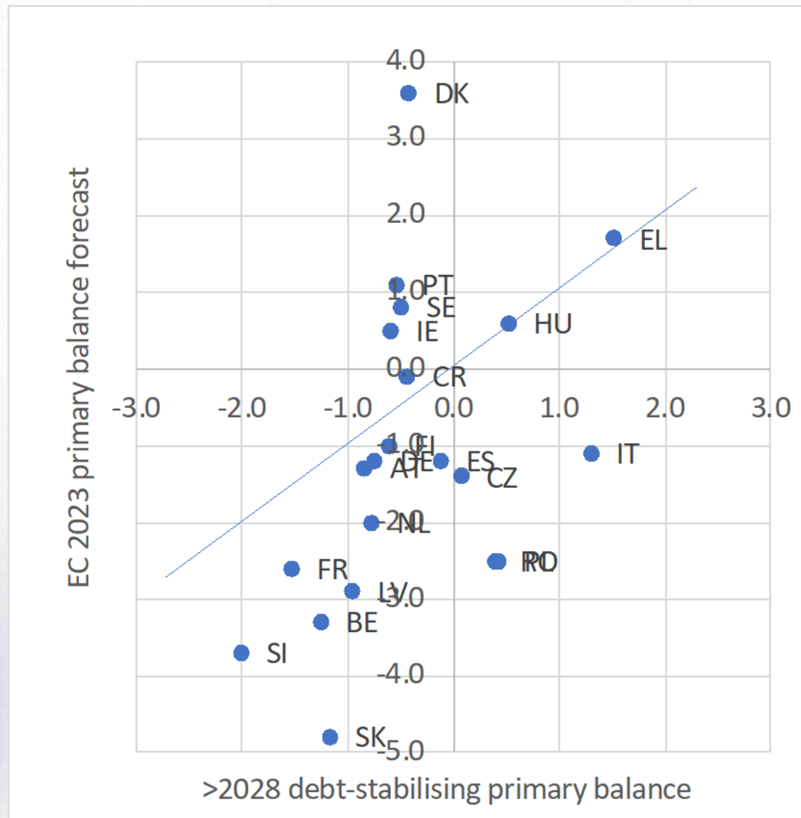
-0.41 to 0.67: moderate risk (average probability of debt distress = 0.1)

>0.67: high risk (average probability of debt distress = 0.43)

Caveat: EM sample excludes countries in or near debt distress: Argentina, Egypt, Pakistan, Lebanon, Ukraine, Sri Lanka

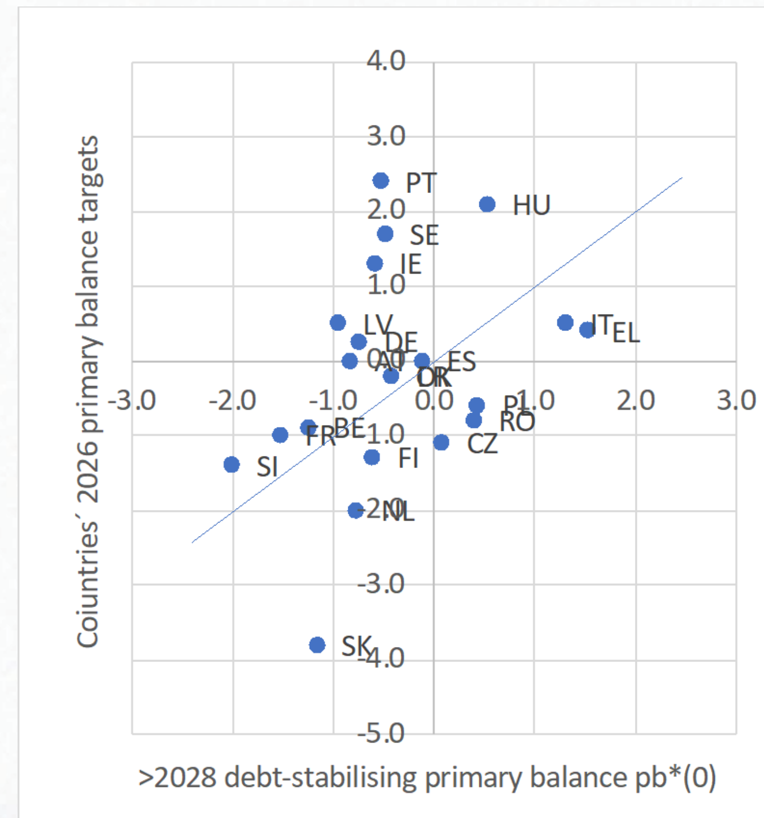
Result 5: debt stabilization should be feasible for all EU countries …

>2028 DSPB plotted against 2023 projected PB



11 countries with adjustment needs >1% of GDP,
5 countries with adjustment needs > 2% of GDP

>2028 DSPB plotted against 2026 targeted primary balances

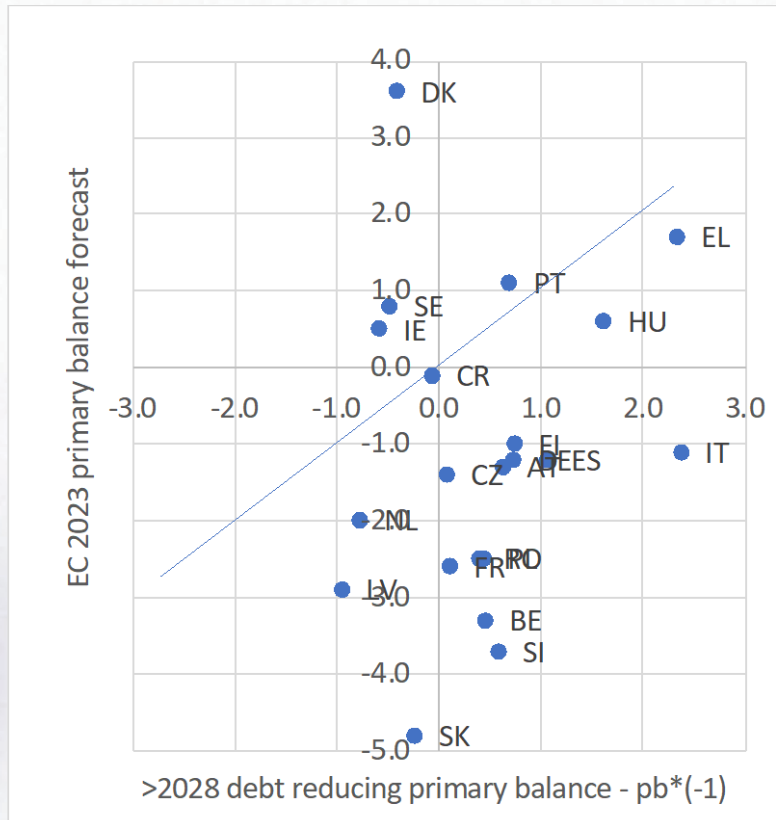


6 countries with adjustment needs > 1% of GDP,
1 country with adjustment need > 2% of GDP

bruegel.org
Improving economic policy

Result 6: … but meaningful debt reduction (as likely required under reformed EU fiscal rules) will be harder

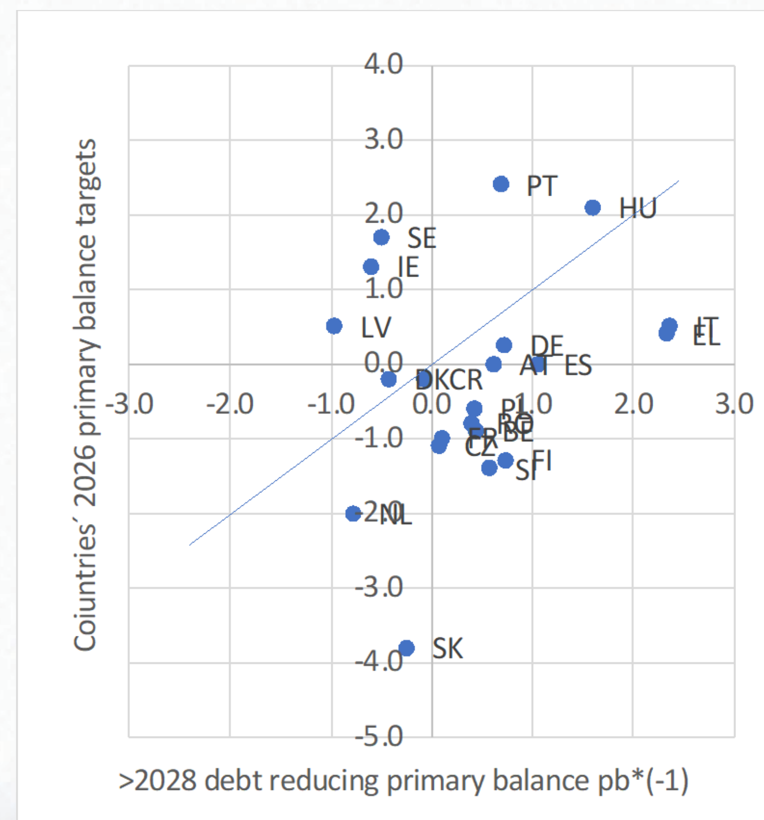
>2028 PB required to reduce debt by ≥ 1 percent of GDP per year against 2023 projected PB



15 countries with adjustment needs >1% of GDP,

8 countries with adjustment needs > 2% of GDP

>2028 PB required to reduce debt by ≥ 1 percent of GDP per year against 2026 targeted PB



12 countries with adjustment needs > 1% of GDP,

2 country with adjustment need > 2% of GDP

bruegel.org

Improving economic policy

Summary and conclusion

1. Higher interest rates, higher debt and (in fast-growing EMEs) lower growth have raised medium-term debt-stabilizing primary balances (DSPBs) by ≈1 percent of GDP
2. Compared to the pre-pandemic period, the additional adjustment needed to get to the DSPBs—over and above the medium-term adjustment already predicted by the IMF—has risen by 1-1.5 percent of GDP in AEs (but just 0.2-0.4 percent of GDP in EMs).
3. According to the IMF's fanchart index, about a quarter of EMEs are at high risk of debt distress – on top of the half dozen that are already in debt distress. Not a systemic debt crisis, but bad.
4. Debt in EU countries remains sustainable. But lowering it significantly will require more effort than plausible in some countries.

Bottom line: a lot tighter, particularly for countries with high investment needs and/or high spreads. But not a disaster.

Backup slides

Future real interest rates are wildly uncertain. They may go down again, but don't bet on it.

10-year euro swap rate (in percent)

Source: Bruegel based on Danske Bank and Bloomberg (data retrieved on 31 March 2023). Notes: the 10-year euro swap rate reflects the markets' expectations of the average short-term nominal rate over the next 10 years and can thus be interpreted as a proxy for the 10-year risk-free rate of the euro area

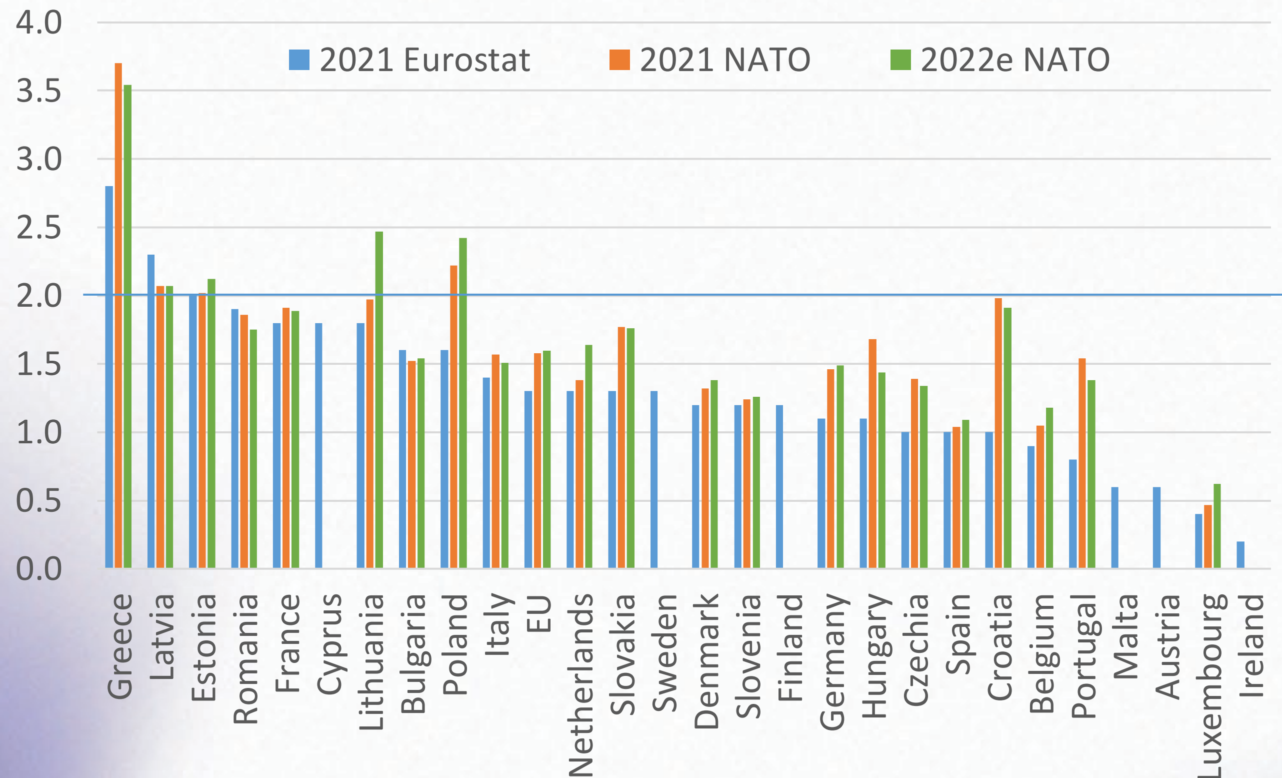
Structural why longer-term real interest rates may be higher in the next decade(s):

- Higher investment due to climate change, reshoring
- Higher bargaining power of workers in advanced countries reduces saving
- Demographic transition (fall in fertility, dissaving of the old).
- Increase in retirement age

All uncertain. For example higher green investment could be more than offset by lower brown investment.

EU future public investment needs are higher than appears incorporated in baselines, mainly due to climate and defence

Defence spending (percent of GDP)



Source: Bruegel based on Eurostat and NATO

- Public investment needs related to climate change estimated at 0.6-1.8 percent of GDP per year over next decade (Darvas and Wolff 2022, Baccianti 2022)
- Significant additional defence spending needs if 2 percent target is taken more seriously, in the range of 0.3-1.5 percent of GDP per year.