Box 1.2

THE VULNERABILITY OF HIGH PUBLIC DEBT IN THE CONTEXT OF THE REFORM OF THE EU ECONOMIC GOVERNANCE FRAMEWORK

Following the agreement between the European Council and the European Parliament, the proposed reform of the EU economic governance framework, which will affect the fiscal rules in particular, is set to be ratified in the coming weeks.[1] Its design is especially important for ensuring the sustainability of EU countries' public finances,[2] thus averting risks to financial stability. This is all the truer given that, following the activation of the escape clause, several EU countries (including Spain) have built up large structural deficits (euro area average of 3.1% in 2023, according to European Commission forecasts, and 3.7% in Spain, according to the Banco de España's projections) and high levels of government indebtedness (more than 100% of GDP in some cases, including Spain).

The new framework is intended to normalise the euro area's fiscal position by adopting a differentiated approach to national consolidation plans, taking into account each country's debt levels and fiscal risks. To this end, each Member State will draw up a medium-term fiscal-structural plan that will include commitments in terms of expenditure paths, structural reforms and public investment plans.

For the most indebted countries, the expenditure path must ensure that the public debt-to-GDP ratio is on a plausible downward path towards the reference value of 60%, on the condition that the budget deficit remains below 3% of GDP over the medium term. The fiscal adjustment period to reach these targets is four years, although that period can be extended to seven years if the Member State implements structural reforms and investments that benefit potential growth and fiscal sustainability over the medium term.

The fiscal stabilisation targets are expressed by means of a single instrument: the multi-year net primary expenditure path,[3] which is set based on a reference trajectory prepared by the European Commission and country-specific debt sustainability analysis. The new framework also includes additional requirements (safeguards) to ensure that the expenditure path delivers ex ante minimum deficit and/or debt adjustments to guarantee the predictability of the framework and that fiscal buffers are built up.

In the case of Spain, public debt stands at very high levels, above those in most euro area countries (see Chart 1). Indeed, at end-2023 the country's public debt-to-GDP ratio of 107.7% was more than 30 percentage points (pp) (17 pp) higher than the euro area simple (weighted) average, and slightly above the 75th percentile of the euro area distribution.

Against this background, identifying the risks to fiscal sustainability linked to this level of indebtedness – one of the cornerstones of the multi-annual adjustment plans under the new EU economic governance framework – is all the more important. At present, there are both medium and long-term sources of vulnerability for public debt dynamics going forward.

One centrepiece of these dynamics is the differential between the cost of government financing and a country's economic growth.

The differential between the implied interest rate on the total stock of debt and the nominal economic growth rate (the interest rate-growth rate differential) has improved since 2019 and in 2023 stood at negative levels (around -6.2 pp in the case of Spain, according to the latest data, and -5.8 pp in the euro area, according to European Commission forecasts). However, the outlook for the coming years points to a significant trend reversal. Based on the Banco de España and European Commission's latest forecasts, that differential could correct by nearly 5 pp in Spain over the next two years and by more than 3 pp in the euro area, albeit still holding in negative values (see Chart 2).

From a longer-term standpoint, gradual population ageing will exert increasing pressure on public spending (e.g. pension-related and health-related costs). In the case of

1 See European Council press release.

2 Mario Alloza, Javier Andrés, Pablo Burriel, Iván Kataryniuk, Javier J. Pérez and Juan Luis Vega. (2021). "The reform of the fiscal governance framework of the European Union in a new macroeconomic environment". Documentos Ocasionales, 2121, Banco de España.

3 The concept of net primary expenditure referred to in the new economic governance framework excludes (in addition to interest expenditure) EU-funded expenditure and national expenditure on co-financing of programmes funded by the EU, cyclical unemployment expenditure, one-off or temporary measures and discretionary revenue measures.

4 See Independent Authority for Fiscal Responsibility. (2023). "Opinion on the long-term sustainability of public administrations: The impact of demographics", which includes the changes stemming from the recent pension reform in Spain, and European Commission (2021). "The 2021 Ageing Report. Economic and Budgetary Projections for the EU Member States (2019-2070)", respectively.

Box 1.2

THE VULNERABILITY OF HIGH PUBLIC DEBT IN THE CONTEXT OF THE REFORM OF THE EU ECONOMIC GOVERNANCE FRAMEWORK (cont'd)

Chart 1
Spanish public debt in the European context (a)

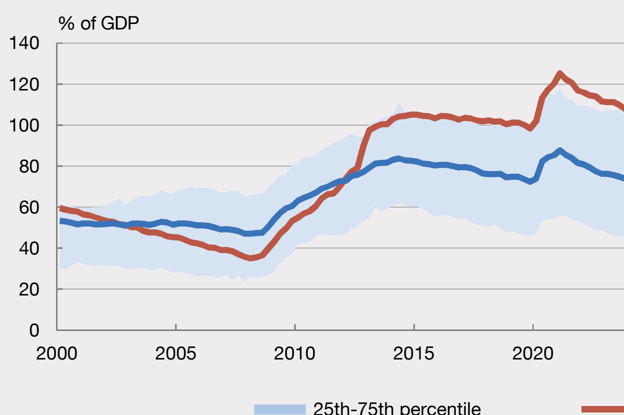
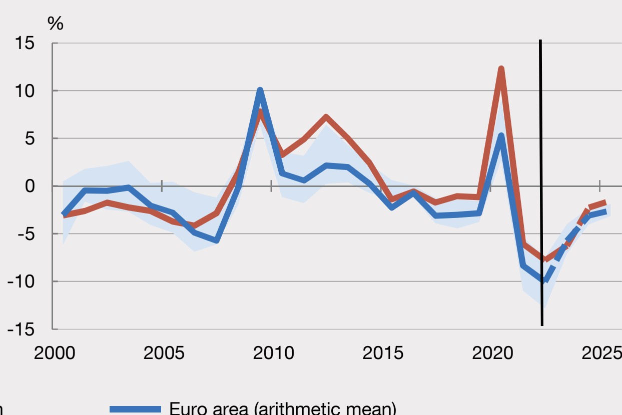


Chart 2
Interest rate - nominal growth rate differential (b)



25th-75th percentile — Spain — Euro area (arithmetic mean)

SOURCES: Eurostat, European Commission and Banco de España.

a European Commission November 2023 estimates for 2023 Q4 (except for Spain).
b Differential calculated using the implied interest rate on public debt and the nominal GDP growth rate. The implied interest rate is calculated as the ratio between the interest burden and the stock of public debt in the previous period.

Spain, it is estimated that pension expenditure could increase by more than 2 pp of GDP over the next two decades (and by almost 1 pp in the euro area),[4] in the absence of significant reforms. In addition to these demographic trends, countries face other long-term challenges such as higher defence spending[5] and the public investment required for the green transition.[6]

A more formal analysis of the medium and long-term implications of these developments for the sustainability of public finances can be conducted using Debt Sustainability Analysis (DSA) tools. These are stylised models that, taking into account the interplay between economic activity, financial conditions and fiscal policy, can project different debt dynamics to identify fiscal sustainability vulnerabilities. In particular, these models relate public debt developments to the expected paths of their determinants using equations that describe the course of real GDP, inflation and interest rates.[7]

To achieve a more complete characterisation of these dynamics in the case of Spain, a model that explicitly captures the uncertainty stemming from developments in the macro-financial environment is considered. Thus, taking recent empirical evidence, this model can be used to project numerous debt paths that illustrate the vulnerabilities related to the macro-financial environment and how these change over time and under different fiscal adjustment assumptions.[8]

Thus, Chart 3 shows the expected changes in Spain's public debt ratio up to 2040 under the assumption of unchanged fiscal and budgetary policies (which would entail non-compliance with the new fiscal rules). This would foreseeably take government debt to levels close to 108% of GDP in 2026 and around 120% in 2040.

Moreover, considering the uncertainty stemming from the macro-financial environment, in the vast majority of the possible simulated paths (85% of cases), even in many of

5 Demosthenes Ioannou and Javier J. Pérez (eds.) (2023). "The EU's Open Strategic Autonomy from a central banking perspective. Challenges to the monetary policy landscape from a changing geopolitical environment". Occasional Paper Series, 311, European Central Bank.

6 European Commission. (2024). "Securing our future. Europe's 2040 climate target and path to climate neutrality by 2050, building a sustainable, just and prosperous society", Staff Working Document, 63.

7 See Pablo Hernández de Cos, David López Rodríguez and Javier J. Pérez. (2018) "The challenges of public deleveraging". Documentos Ocasionales, 1803, Banco de España; and Pablo Burriel, Iván Kataryniuk and Javier J. Pérez (2022). "Computing the EU's SURE interest savings using an extended debt sustainability assessment tool". Documentos Ocasionales, 2210, Banco de España, for a specific use case.

8 Mario Alloza, Jorge Martínez, Juan Rojas and Iacopo Varotto. (2024). "Public debt dynamics: a stochastic approach applied to Spain". Documentos Ocasionales, Banco de España. Forthcoming.

Box 1.2

THE VULNERABILITY OF HIGH PUBLIC DEBT IN THE CONTEXT OF THE REFORM OF THE EU ECONOMIC GOVERNANCE FRAMEWORK (cont'd)

Chart 3
Simulated public debt-to-GDP path in Spain. No fiscal consolidation plan

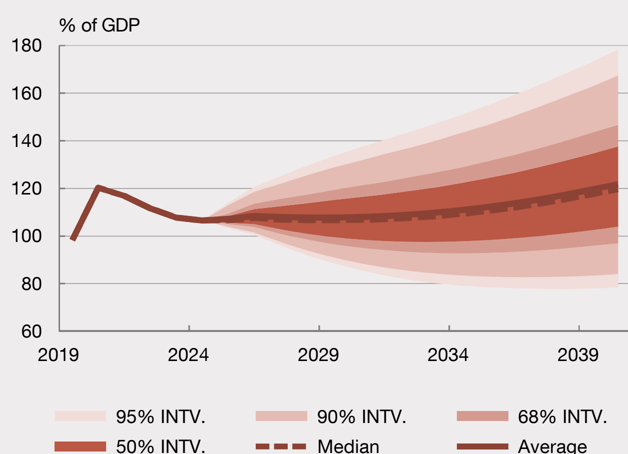
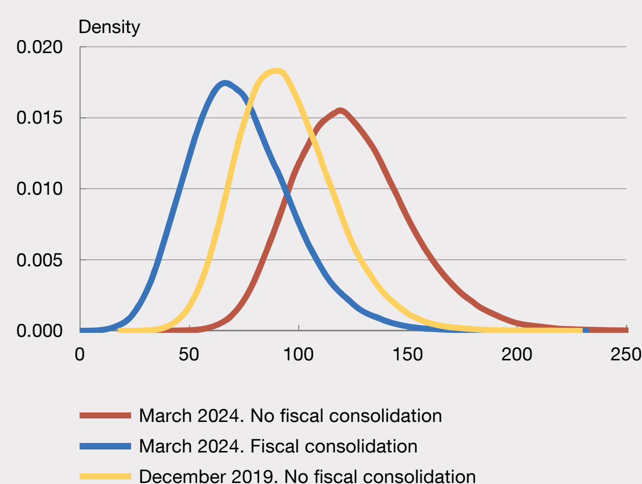


Chart 4
Distribution of Spanish debt-to-GDP ratios in 2040 under different scenarios



SOURCES: INE, IGAE, AIReF and Banco de España.

those which include more intense and longer-lasting expansionary phases than the baseline scenario or more favourable financing conditions, this ratio would stand above the pre-pandemic levels (98% of GDP in 2019).

As a result of the current more adverse starting point of public finances and the changes in financing conditions, the long-term scenario envisaged in this simulation is significantly less favourable than that which would have been projected with the information available at December 2019. In that case (yellow line in Chart 4), the distribution of possible public debt-to-GDP ratios would have shown a more benign picture, where debt levels of 120% of GDP would only have been reached in slightly more than 10% of the possible simulated paths (the most adverse ones).

That said, based on the information available in the Banco de España's latest projection exercise of March 2023, the implementation of a fiscal consolidation plan characterised by an adjustment of 0.5% of GDP to achieve equilibrium in the structural balance[9] would lead to substantially different dynamics.[10] Under this scenario, the public debt-to-GDP ratio would follow a sustained and declining path, reaching, on average, levels close to 75% of GDP in 2040 (red line in Chart 4). Against this backdrop, despite possible changes in macro-financial conditions, this fiscal consolidation effort would succeed in bringing the government debt ratio below pre-pandemic levels in nearly 90% of the simulated paths.

An analysis of these debt dynamics shows the need to implement, as quickly as possible and in the setting of the new EU economic governance framework, a fiscal consolidation plan that gradually reduces indebtedness and improves the Spanish economy's resilience to address future challenges.

Implementing this consolidation plan is key for monetary policy to function properly within the euro area.[11]

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9 Structural balance refers to the difference between government revenue and expenditure after adjusting for the effects of the economic cycle.

10 This adjustment would be broadly consistent with the new EU economic governance framework, according to some preliminary estimates by Bruegel for a seven-year plan.

11 For instance, Fernando Broner, Aitor Erce, Alberto Martin and Jaume Ventura. (2014). "Sovereign debt markets in turbulent times: Creditor discrimination and crowding-out effects". *Journal of Monetary Economics,* 61, 114-142, analyse the setting of financial turmoil that leads to the replacement of private credit with public debt, resulting in a crowding-out effect of productive private investment.

Box 1.2

THE VULNERABILITY OF HIGH PUBLIC DEBT IN THE CONTEXT OF THE REFORM OF THE EU ECONOMIC GOVERNANCE FRAMEWORK (cont'd)

Also, maintaining a high level of government debt limits the ability of fiscal policy to respond to future economic shocks. A simple descriptive analysis of international data on government debt behaviour following a recession highlights the need to generate sufficiently large fiscal buffers to allow for possible future fiscal policy action. By way of example, euro area government debt has increased, on average, by around 20 pp in the five years following a recession.[12]

Maintaining a high level of debt and a large budget deficit also remains a source of vulnerability when faced with changes in the financial markets' perception, which would increase the public sector's financing costs, with the risk of this passing through to the private sector, including the banking sector.[13, 14] These scenarios could affect real economic activity and thus further worsen the outlook for the sustainability of public finances.

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12 Mario Alloza, Javier Andrés, Pablo Burriel, Iván Kataryniuk, Javier J. Pérez and Juan Luis Vega. (2021). "The reform of the European Union's fiscal governance framework in a new macroeconomic environment". Documentos Ocasionales, 2121, Banco de España.

13 Giancarlo Corsetti, Keith Kuester, Andre Meier and Gernot J. Mueller. (2013). "Sovereign risk, fiscal policy, and macroeconomic stability". *Economic Journal,* 123(566), pp. F99-F132.

14 See Chapter 5 of Kris J. Mitchener and Christoph Trebesch. (2021). "Sovereign Debt in the 21st Century: Looking Backward, Looking Forward". NBER Working Paper Series, WP28598. National Bureau of Economic Research, for a review of the literature and empirical evidence. Also Emmanuel Farhi and Jean Tirole. (2018). "Deadly Embrace: Sovereign and Financial Balance Sheet Doom Loops". *Review of Financial Studies,* 85 (3), pp. 1781-1823.