

OCTOBER 2024 FISCAL MONITOR – A DISCUSSION

SUERF BAFFI Bocconi e-Lecture

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SUMMARY

Global public debt set to increase towards 100% of GDP

- Optimism bias distort the outlook
- “Unidentified” debt limits the capacity of markets to adapt expectations

Challenging fiscal adjustment

- Links with inclusive growth and political uncertainty
- Global factors dominant in yields dynamics in AEs

Important methodological progress brought into policy-making

- Debt-at-risk methodology
- HANK-based package design



MAIN TAKE-AWAYS

- ❑ **The FM makes clear how risk evaluation is now one of the dominant elements of fiscal policy making**
 - FM makes an excellent job in modelling risk and in making its results operational for policy purposes (balance of risks, adjustment needs)

- ❑ **How to effectively align new risk modeling tools with judgment and more traditional tools (eg DSA)?**
 - How to position in the stochastic distribution? Supply- or demand-driven cyclical shocks, or long-term trends
 - Dynamics of interest-growth differentials remain key

- ❑ **The next step: insurance**
 - Pooling risk geographically helps – important for climate and to address fragmentation risks
 - Precautionary arrangements for exposed countries, especially during periods of transition



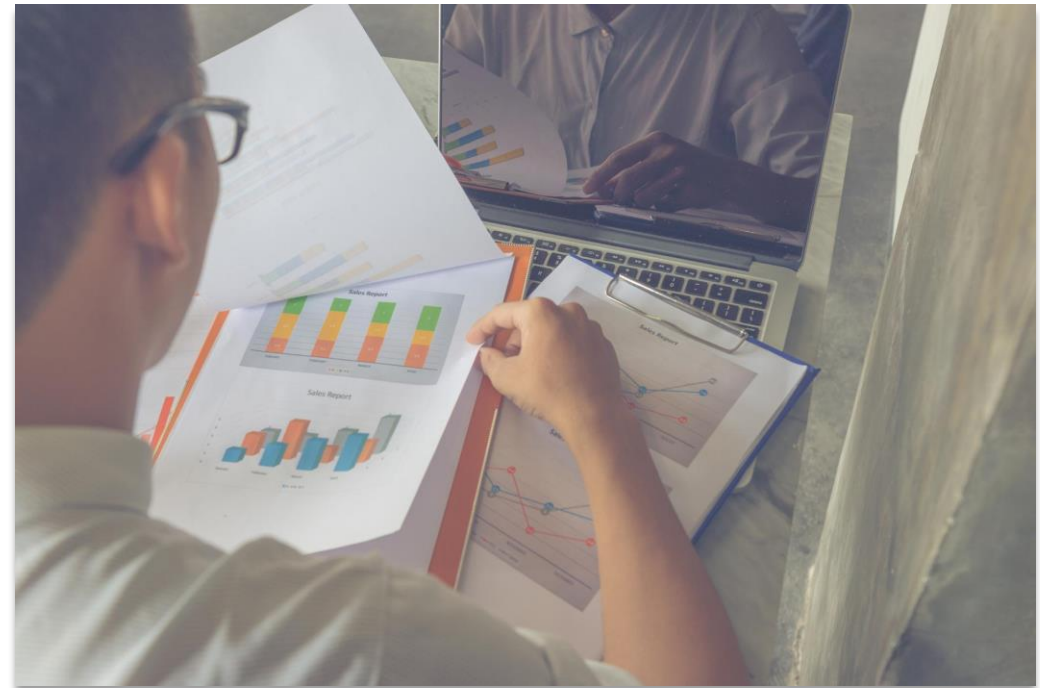
MY FOCUS

Focus on two main parts of the FM:

Debt-at-Risk

Adjustment needs

Policy implications at the end...



DEBT-AT-RISK METHODOLOGY



DEBT-AT-RISK – RESULTS

Debt-at-risk Methodology

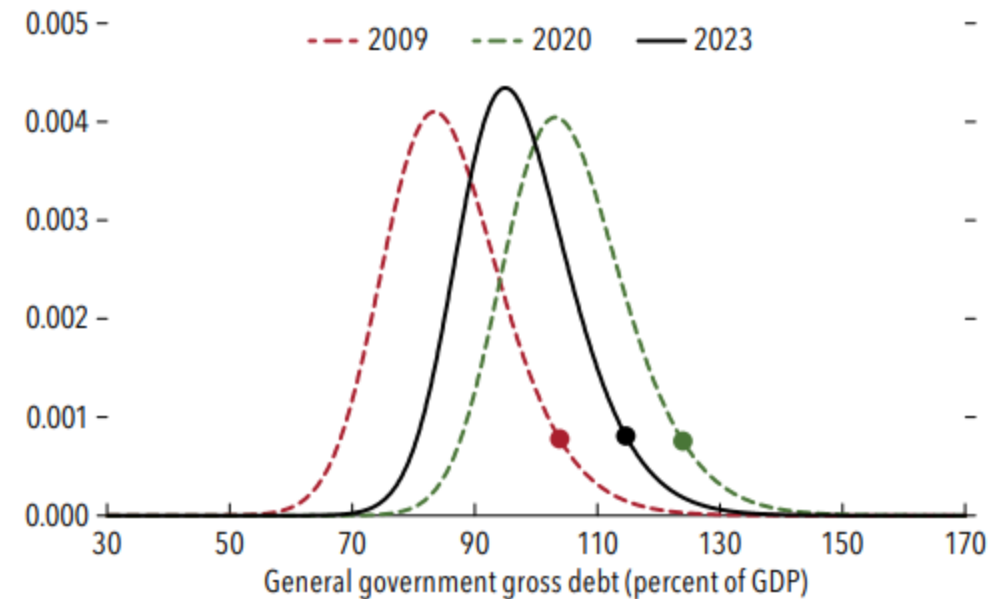
Important step towards a *conditional* assessment of risks: how current conditions affect the distribution of risks?

Conditions results to country characteristics (income level, fiscal rules etc.)

Important results

1. Tighter financial conditions disproportionately affect the right tail of the distribution of future debt
2. Sovereign spreads also significantly predict upside debt risks in the near term (one to three years)
3. Financial and economic factors have a larger impact on debt risks when initial debt levels are higher.

Figure 1.4. Global Debt-at-Risk and Its Evolution
(Probability density of three-year-ahead government debt-to-GDP ratio)



Source: IMF staff calculations.

DEBT-AT-RISK - RESULTS

Debt-at-risk Methodology

Important step towards a *conditional* assessment of risks: how current conditions affect the distribution of risks?

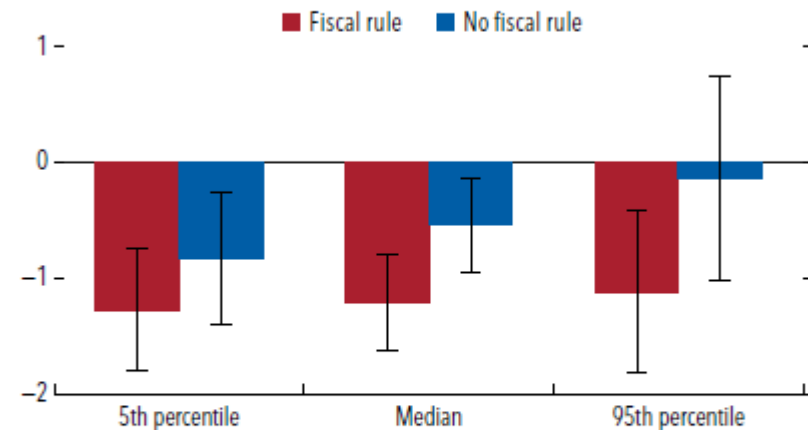
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“The analysis also finds that a higher primary balance is associated with lower debt-at-risk, especially when countries have fiscal rules in place, as well-designed fiscal rules mitigate the risk of fiscal slippage”

Figure 1.8. Primary Balance and Debt-at-Risk by Fiscal Rules
(Coefficients on primary balance for three-year-ahead debt-to-GDP ratio)



Source: IMF staff calculations.

Note: The figure shows estimated coefficients for the 5th, 50th, and 95th percentiles based on panel quantile regressions (Online Annex 1.1). It shows the results for the primary balance for country-years in which fiscal rules are in place versus those in which they are not. Whiskers in bars show 90 percent confidence intervals for estimated coefficients.

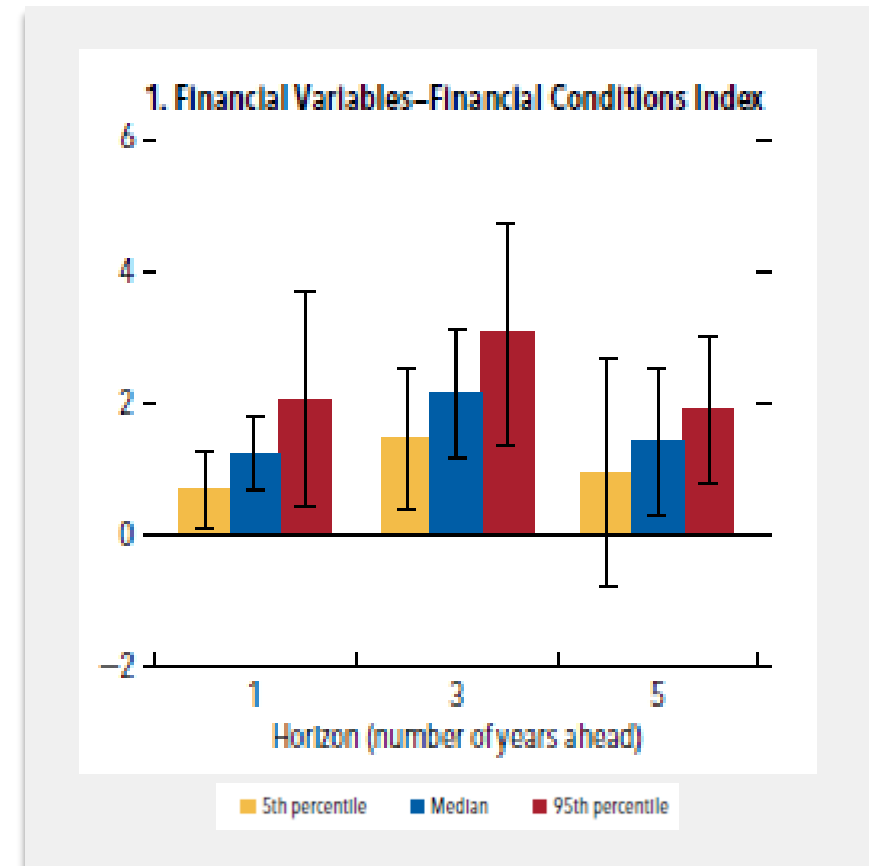
DEBT-AT-RISK – SOME QUESTIONS

Debt-at-risk and Sovereign Risk Debt Sustainability Framework (SRDSF)

- How to combine the D-a-R and SRDSF results? How D-a-R affects the SRDSF assessment?

Drivers

- To what extent are the results dependent on interest growth differentials? In particular, is Growth-at-Risk the main driver of Debt-at-Risk?
- Tighter financial conditions increase risks on debt also in the medium-term, while they tend to reduce growth risks: how to reconcile these results?



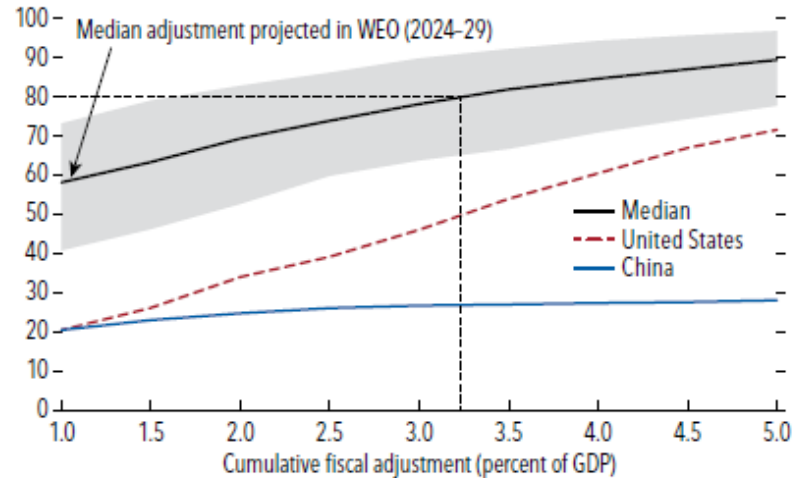
REQUIRED FISCAL ADJUSTMENT – A PROBABILISTIC APPROACH



LINKING ADJUSTMENT NEEDS TO PROBABILITIES

Figure 1.18. Median Fiscal Adjustment and Probability of Stabilizing or Reducing Debt by 2029

(Probability for median and interquartile range in percent)



Source: IMF, World Economic Outlook database.

Note: The cumulative median fiscal adjustment in the *World Economic Outlook* (WEO) is about 1 percentage point of GDP cumulative over six years (2023-29). Additional fiscal adjustments are the same for all countries and are applied to those countries' baseline projections. A country's probability of keeping debt from rising is calculated as the number of debt paths for which the baseline primary balance is higher than or equal to the debt-stabilizing primary balance as a percent of the total number of debt paths (See Online Annex 1.5).

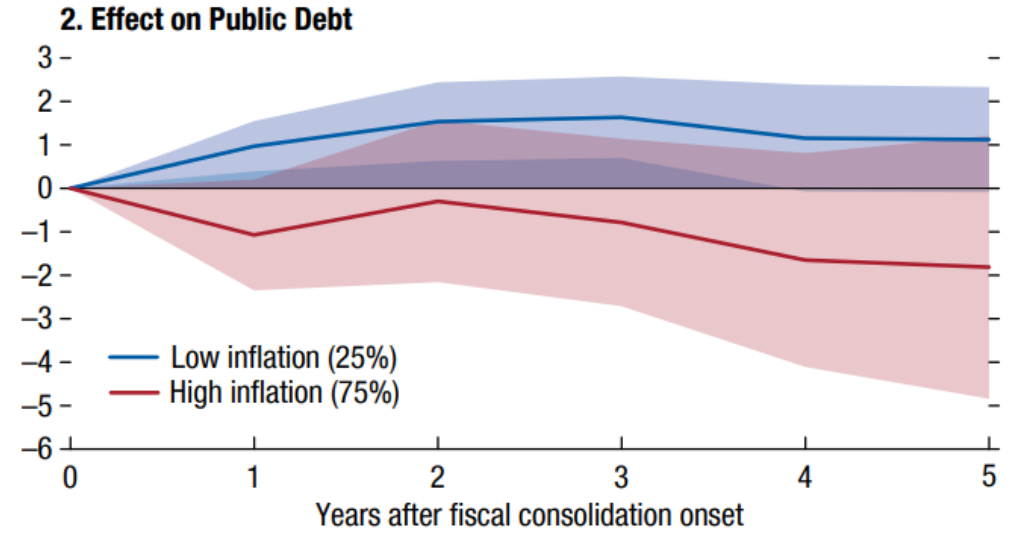
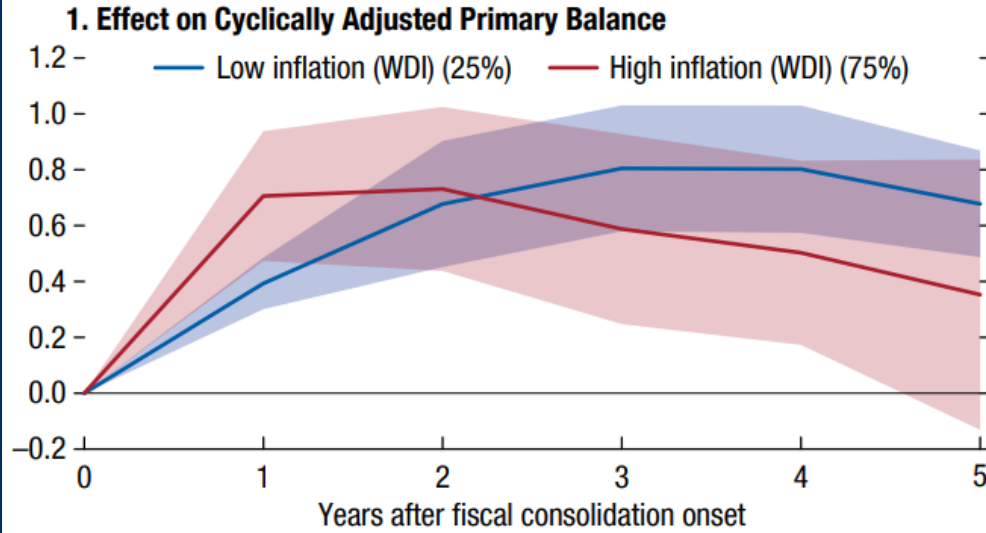
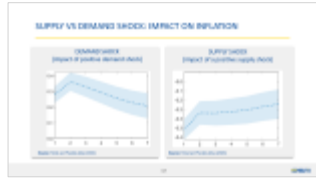
Organically translating uncertainty and volatility into adjustment needs

- EU: already part of the EGR toolkit
- But here assessed as time T not at the end of the adjustment period
- Challenging adjustment but also challenging communication

How to integrate judgment? The case of supply vs demand shocks

- Predicting shocks almost impossible...
- ... but the environment does affect the distribution of shocks
- And the type of shock has very different impact on debt dynamics

EFFECTS OF CONSOLIDATION: HIGH VS LOW INFLATION



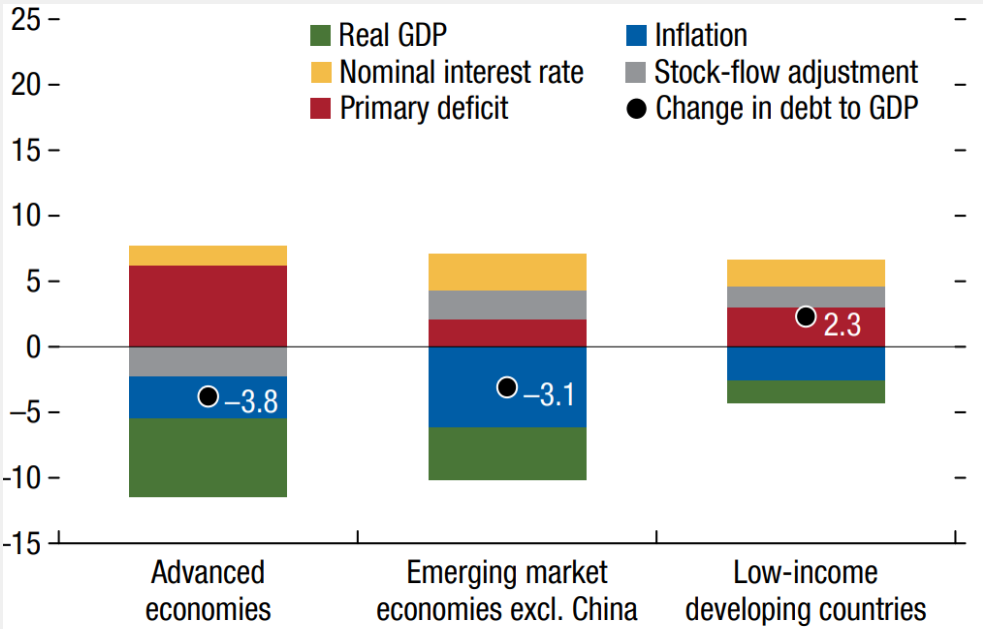
Source: IMF staff calculations.

Note: Based on fiscal consolidations in 25 countries (15 advanced economies and 10 emerging market economies) from 1985 to 2016. Fiscal consolidation episodes and sizes are constructed using a news-based narrative approach from DeVries and others (2011), Alesina and others (2013), and David, Guajardo, and Yépez (2022). Coefficients measure the impact of fiscal consolidations on the cyclically adjusted primary balance and debt-to-GDP ratio in low- and high-inflation periods (defined as the 25th and 75th percentiles of Consumer Price Index inflation, respectively) using panel local projection estimations, controlling for two-way fixed effects and lags of real GDP growth and real GDP per capita. Shaded areas denote 90 percent confidence intervals for the respective scenarios. Standard errors are clustered at the country level.

Source: April 2023 Fiscal Monitor

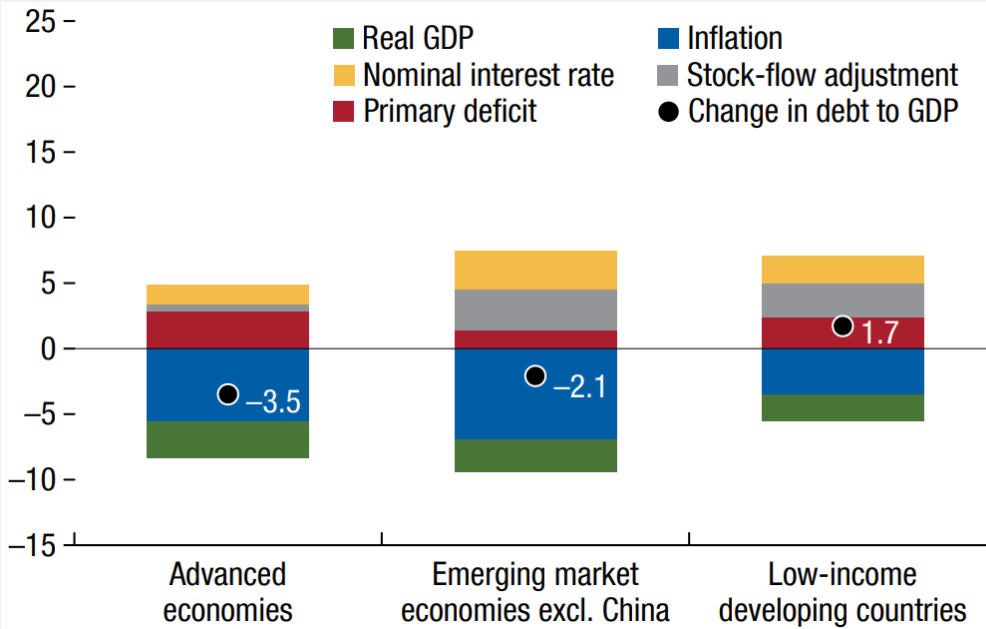
SUPPLY-SHOCK – INFLATION SURPRISES

Change in General Government Debt – 2020-21
 (Change in end-of-year debt stocks as percentage of GDP)



Source: IMF April 2023 FM

Change in General Government Debt – 2021-22
 (Change in end-of-year debt stocks as percentage of GDP)



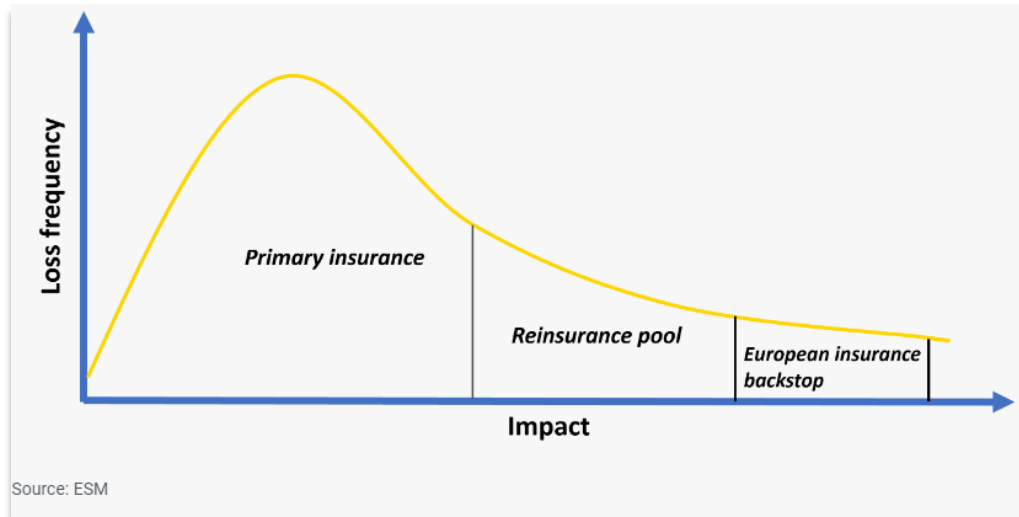
Source: IMF April 2023 FM

DEALING WITH RISKS



POOLING HELPS!

Natural catastrophe insurance loss bearing hierarchy (in %)



Pooling risks of critical importance in volatile times

Different exposure to risk should be used to mitigate its effects

- Precautionary financial arrangements as a way to redistribute risks

Role of backstops

- Mind the gap: how a European risk-sharing scheme could bolster private insurance coverage of natural catastrophes

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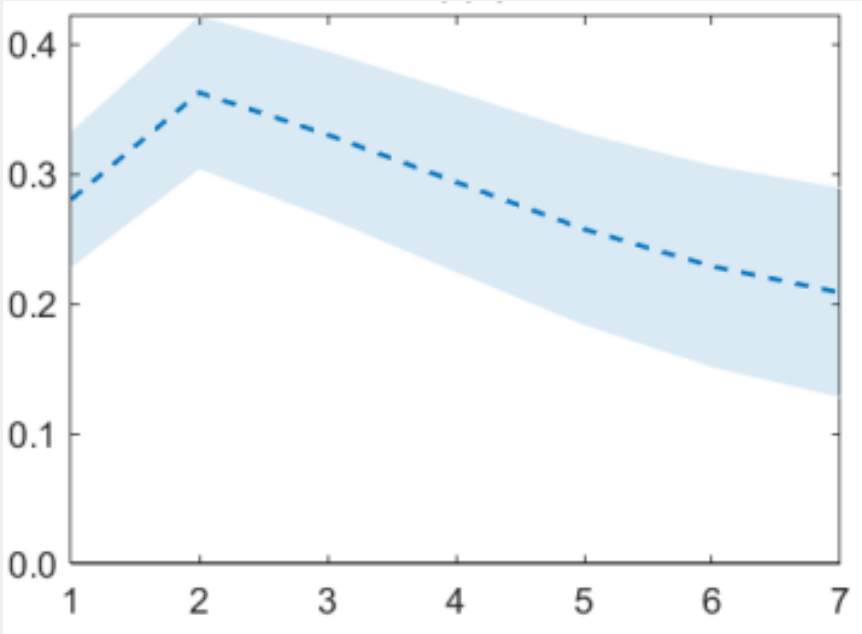
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ADDITIONAL SLIDES



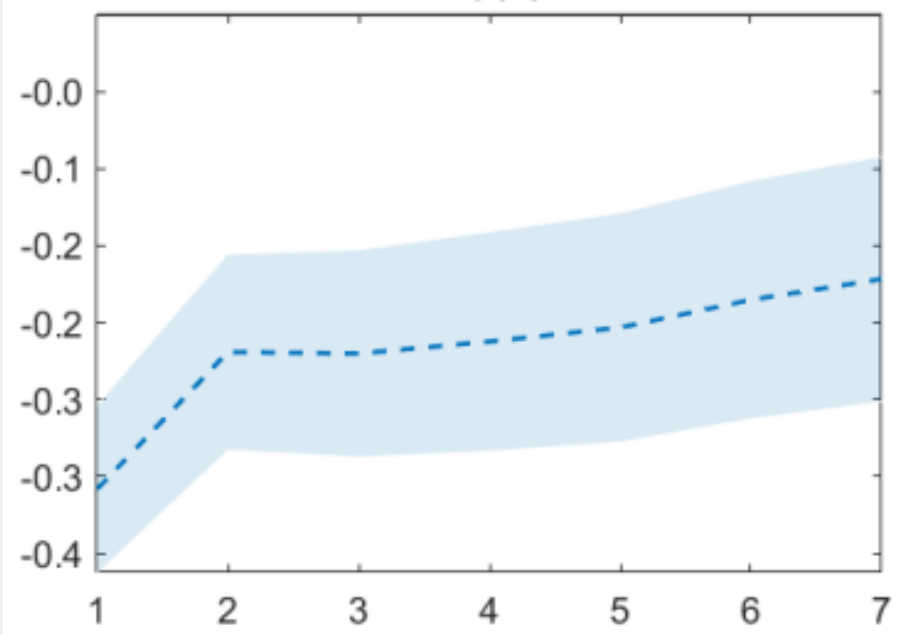
SUPPLY VS DEMAND SHOCK: IMPACT ON INFLATION

DEMAND SHOCK
(impact of positive demand shock)



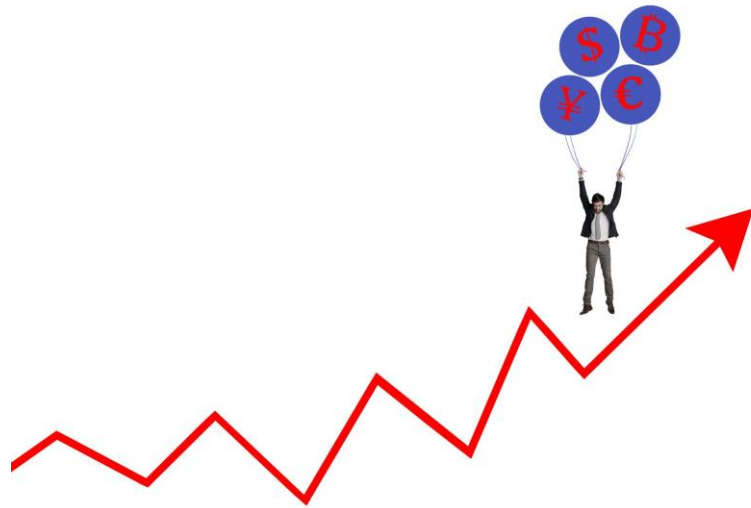
Source: Patel and Peralta Alva (2024)

SUPPLY SHOCK
(impact of a positive supply shock)



Source: Patel and Peralta Alva (2024)

REPORT SUMMARY AND MAIN MESSAGES



Overview of the Report

This section will provide an overview of the report, including its main messages and recommendations for improving a country's fiscal resilience to shocks.

Assessing Fiscal Adjustment Needs

It is important to assess the fiscal adjustment needs of a country early on to ensure that the necessary measures are taken to stabilize the economy.

Adjusting Composition of Spending

Adjusting the composition of spending early on can help to create fiscal space and reduce the need for more drastic measures in the future.

Increasing Buffers and Resilience to Shocks

It is important to increase buffers and resilience to shocks to help protect the economy from external factors that may affect it negatively.

OVERVIEW OF THE REPORT



The report analyzes the debt-at-risk methodology to assess the fiscal adjustment needs of a country. This methodology provides insights into the factors that may lead to deteriorating debt metrics and the extent of adjustment required to stabilize the debt.