Box H: Irish debt fares reasonably well on a "fiscal standards" assessment

This Box explores recent proposals by Blanchard, Leandro and Zettelmeyer (2021) to redesign the EU fiscal rules. Their proposal has generated significant debate and attention in the context of discussions as to how the rules might be reformed. Their proposal entails abandoning fiscal rules in favour of fiscal standards. The fiscal standards they envisage would see the rules replaced with qualitative prescriptions, more room left for judgement, and a process to decide whether the standards are met or not. Using the Fiscal Council's macro-fiscal model, the Maq (Casey and Purdue, 2021), this box explores how these standards might be applied to the official forecasts for Ireland.

How to apply fiscal standards

The primary tool proposed to assess fiscal standards is "stochastic debt sustainability analysis" – a way to model multiple debt paths with different probabilities attached to each path. The basic idea is to:

1. Generate a distribution of paths for debt. This distribution takes into account a government's policy plans and the interactions between growth and fiscal policies. The main focus is on the paths for the primary balance and the debt-stabilising primary balance.
2. Use the paths generated to assess the probability that the debt-stabilising primary balance exceeds the actual primary balance. The debt-stabilising primary balance is the budget balance excluding interest costs that is sufficient to prevent the debt ratio from rising from existing levels.[61] If the actual primary balance is above this debt-stabilising level, this would indicate risks to debt sustainability. If the probability were low (with the example given of less than 5 per cent), then the fiscal standard is satisfied. If higher, the country would need to adjust its policies to achieve debt sustainability.[62]

Applying the standards and stochastic debt sustainability analysis to Ireland

We can use the Maq model to estimate debt paths with various probabilities. These estimates are based on the official *SPU 2021* forecasts and allow for the complex interactions between macro-fiscal variables as well as using detailed information on individual debt securities issued by the State. As with any analysis of this sort, it relies on the central forecasts being reasonably unbiased and realistic. The probabilistic debt paths are generated within the model.

The results suggest that there is a 15 to 20 per cent risk of being on an unsustainable debt path by 2025 under the policies set out in *SPU 2021* (Figure H1).

This probability would fail the indicative fiscal standards set out by Blanchard, Leandro and Zettelmeyer (2021). Their standards consider keeping the probability of being on an unsustainable debt path to below 5 per cent. In this context, and with the policy stance set out in SPU 2021, this would be consistent with gross debt ratios at least as high as 120 per cent of GNI*. The standards would therefore suggest that Ireland would need to adjust its budgetary policies, with the speed of adjustment depending on the risks to sustainability, the state of the economic cycle, and the capacity of monetary policy to offset the contractionary impact of adjustment on the EU as a whole.

Importantly, however, as Blanchard, Leandro and Zettelmeyer (2021) note, a violation of the fiscal standard would generally not imply that debt is unsustainable, only that fiscal adjustment is required to achieve a high probability of debt sustainability. This is a crucial point. While there is a

[61] The debt-stabilising primary balance is given as: $PB_t = D_{t-1}(\frac{i_t - g_t}{1+g_t})$ where PB is the primary balance, D the debt ratio, i the effective interest rate on debt, and g the nominal growth rate.

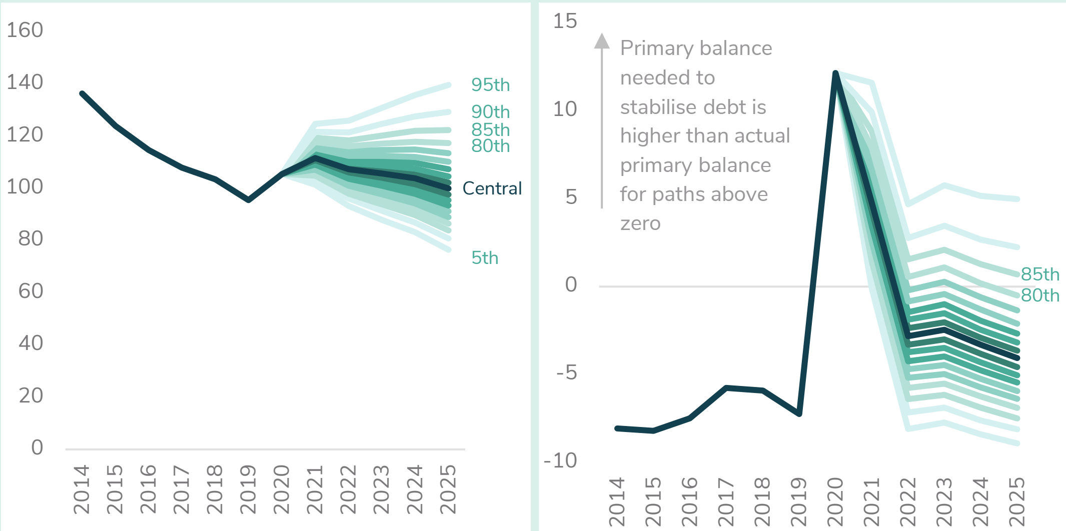
[62] The speed of adjustment would depend on the risks to sustainability, the state of the economic cycle, and the capacity of monetary policy to offset the contractionary impact of adjustment on the European Union as a whole.

higher probability estimated for Ireland ending up on an unsustainable path than is required by the fiscal standards, it may not necessarily be high enough to warrant a much tighter fiscal policy in the immediate period after the Covid crisis. An appropriate fiscal stance would take into account the wider context, including the need to return the economy to near full employment, which would also reinforce debt sustainability.

Figure H1: Reasonably low risk of debt being unsustainable

Gross debt as % of GNI*

Gap between debt-stabilising primary balance and actual primary balance (p.p. of GNI*)



Sources: Fiscal Council workings based on Department of Finance (SPU 2021) forecasts.
Notes: Each line shows a path for debt dynamics at various percentiles. The "Central" line represents the official SPU 2021 forecasts.

The fiscal stance in the coming years

The deficit is most likely going to close to a large extent in the coming years. This would be likely to happen with no need for large-scale fiscal adjustment or for much wider stimulus measures beyond those already set out. If Covid-19 disruptions are largely addressed by the vaccine and other measures, the economy should recover swiftly in 2021, and the economy should resume growth at a healthy pace. This would tend to close much of the deficit. However, some permanent structural deficit could remain as indicated by the Council's "adjusted" SPU projections (Section 2).

If the SPU proves accurate, the economy should recover, the deficit should close and the need for a large-scale, untargeted stimulus would be weaker

Most of the gap between the economy's actual level of activity and its potential is expected to be closed by next year. That is, overall activity in terms of output and spending in the economy would be expected to return to levels in line with medium-term potential. However, unemployment would be slower to recover, with the Department forecasting it at about 7 per cent by end-2022 and only recovering to low levels of about 5½ per