Conselho das Finanças Públicas
Portuguese Public Finance Council

**Public Debt Markets – Key Challenges in a Context of Deepening the EMU**

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In the more recent months, we have been confronted with the idea that monetary policy adopted by the ECB in the last years is already exhausted, it can no longer give the required impulse to the European economy, and so governments should play their role by promoting more fiscal stimulus.

On the other hand, we have been also been confronted with the question on whether European countries, in particularly countries that were more severely affected by the recent crisis (like Portugal), have gained ´fiscal space' to meet a new crisis or to face an economic slowdown. Note that according to the European fiscal rules, a country should achieve the structural balance in order to obtain a safety margin vis-à-vis the deficit limit of the Stability and Growth, of 3% of GDP, allowing that country to accommodate the impact of a recession and allowing the functioning of automatic stabilizers in that situation.

I think that the capacity to promote some fiscal stimulus and in the first place to have some fiscal space should be seen primarily as a function of the level and dimension of public debt. Then, it is very important to understand the debt dynamics, and the way the factors that explain variations in the debt dimension interact with each other: these factors are, in the one hand, the interest payments on debt adjusted by economic growth (r-g, or the snowball effect) and, on the other hand, the primary balance. The latter should be positive and higher than the former in order to ensure a gradual reduction of the debt ratio to GDP. Debt is 'swallowed' by a favourable combination of these two factors.

Precisely on this regard, there were produced by the IMF, since the sovereign debt crisis hit some EMU countries, some studies with the preoccupation of linking the notion of fiscal space with the country's public debt level. Fiscal space is here defined as the difference between the current level of the ratio of public debt to GDP and a certain debt limit (note that this debt limit is a specific limit for each country and is a result of the country's historical record on fiscal adjustment, that is, it results from the past capacity of the country to address a situation of debt increase by adopting effective fiscal adjustment).

An important implication of this definition is that the capacity of the primary balance to reduce debt over a consolidation period, converging to its long-run level, depends on the level of debt itself. If the country's debt level is high but not that high that passes the country's debt limit, then the capacity of the primary balance to reduce that excessive amount of debt in principle remains. In principle, the government can still obtain a primary balance that is enough to offset the rising interest payments that the government has to bear. This means, therefore, that the country has some remaining fiscal space.

If, on the contrary, the debt to GDP ratio passes the debt limit, this means that fiscal space is exhausted: public debt became unsustainable, in the sense that the sovereign faces a situation of default and loses market access. In this case, the capacity to generate primary balances higher than the interest payment is definitely impaired, and that is why the government faces a default.

The intuition behind this is straightforward. You get to a point where, due to the level of debt, the risk of default increases so much (implying the increase in the risk premia and so in the interest rates), and so you have to make tougher fiscal adjustments - until a point of fiscal fatigue - and to issue more debt, which will again feed back onto the interest rates, aggravating them more, and so on, that is, causing a vicious debt-financing cycle, that eventually will stop with the formal recognition of a default.

Additionally, this approach is interesting because it also highlights the fact that the primary balance reaction capacity is also a function not only of the debt level and dimension, but of other factors, including the output gap, and other more structural factors, like for example economic fundamentals, the external balance and the dependence ratios related to ageing population. When for example economic fundamentals suffer a deterioration, due to some kind of shock, this lowers the primary balance reaction capacity to address an increase in the debt ratio to GDP – ultimately implying that the debt limit is passed more easily, leading to the abovementioned vicious debt-financing circle.

Finally, an interesting observation, is that not only the primary balance capacity to react to debt increase depends on the debt dimension, as the debt limit itself depends both on the capacity to make fiscal adjustment and on the prospects regarding the snowball effect. Usually countries with a better historical record on fiscal performance benefit with a higher debt limit, which means, in fact, a higher degree of tolerance from the market.

I consider that this approach is insightful and helps to explain the Portuguese situation in the last decade. In particular, we can verify that in the last years a positive shift in our debt limit occurred and this implied the increase of the available fiscal space.

Indeed, in 2011, when the adjustment program was applied to Portugal, the ratio of debt to GDP was around 111%. By then, with this level of debt, we were technically in a situation of default and the government lost access to the financing market. After the implementation and conclusion of the program, we could observe an increase of the same ratio – in the years between 2014 and 2016 - for around 130% of GDP. However, this not prevented Portugal to return to the market and to normalize the relationship with debt markets, so that level was not considered prohibitive. As a consequence, Portugal was able to seize the primary balance reaction capacity, in order to reduce that same debt ratio, in a context where the snowball effect became also more favourable for this debt dynamic.

We can say that this result was, of course, firstly due to the ECB monetary policy, because interest rates were significantly reduced. But the improvements in some of the country's economic fundamentals and mostly the improvement in the historical record on fiscal adjustment also made a difference – this helped to change the perception on the market.

I believe that in the future, the ability of the primary balance to reduce more and more the debt level (which is still very high), will mostly depend on the government's capacity, and of the country as a whole, to maintain this kind of credibility. Fiscal adjustment is still required if we wish to have more fiscal space - a space that governments can eventually use to other range of purposes, including some fiscal stimulus whenever needed. But for that, we have for the time being to maintain this path, of lowering more the debt ratio and at the same time by being able to keep our debt limit as high as possible (in between, we find the fiscal space) - the perception of the market is here a critical factor.

As a final remark, I should say that we must be aware that potential shocks to the primary balance or to economic fundamentals can occur, putting into jeopardy all efforts previously done and conducting the country again, *rapidly,* from a situation of sustainability to unsustainability.