SUSTAINABLE PUBLIC FINANCES
EU PERSPECTIVES

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Global financial stability and public debt

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About this series

The joint ICAEW-PwC initiative **Sustainable Public Finances: EU Perspectives** started in 2013 and is designed to address a wide variety of public sector financial management and accounting challenges. To date, over 200 high level policymakers and stakeholders participated in this series.

We aim to draw constructive insights from a variety of perspectives and from a range of different stakeholders to help move the EU's reform agenda forward in the interest of achieving more robust public finances.

Introduction

On 6 December 2017, a senior group of policymakers and stakeholders came together to exchange views on the issue of global financial stability and public debt. The discussion provided an opportunity to debate whether there is a long-term trend of increasing public debt in Europe and worldwide which could ultimately undermine global financial stability – and how such a scenario could best be avoided.

The discussion considered the role of governments and the financial information they provide, in the context of public debt being the largest asset class in international financial markets and the proportion of public debt in the liquidity portfolios of banks, not least due to the low risk weightings of these assets. We also considered the impact of the interest rate policy of central banks as well as their extensive purchasing of governments bonds as part of Quantitative Easing (QE). The implications of flat consumer price inflation rates as well as potential stability risks from QE withdrawal were also discussed.

The debate benefitted from a wide range of different perspectives, including key financial market actors, the accountancy profession and academic experts. Public bodies provided both a worldwide and European perspective on the latest empirical evidence regarding public debt levels and shared updates on regulatory and policy measures.

The discussion underlined the considerable complexities around the role of public finances within the global financial system. Drawing overall conclusions is difficult, but the benefits of taking action to stabilise public finances in periods of favourable economic conditions are very clear. In turn, having complete and comprehensive public financial information which helps the financial decision-making of governments themselves, as well as of those investing in them, can only be conducive to a more stable financial system. Ultimately, this all has important implications for society, as shown in previous discussions, for instance on intergenerational fairness.

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The increase of global public debt

‘Debt is like wine, when you had too much of it, you know it. The problem is that while drinking you often don’t realise it before it is too late.’

When yields spike for public debt, it is already too late. Discussion on the global debt situation is very important, as public debt levels around the world have climbed as part of a long-term trend. The implications of this for both the global financial system, as well as for individual countries, are still to be understood.

In the decade since the financial crisis, the increase in public debt was largely attributable to an expansionary fiscal policy in many countries. This trend was further facilitated by favourable funding conditions, as governments took advantage of historically low interest rates. In Europe, public finances are now less in the spotlight than they were at the height of the crisis, but substantial challenges remain in the medium and long term. Although some progress has been made, several European countries still rank among the top 20 countries with the highest level of public debt.

In the current positive economic climate, tackling public debt may not seem to be of great urgency though the more it increases, the greater the associated risks. High debt makes countries more vulnerable to international shock waves caused by unforeseen events, so called *Black Swans*, which may require a sudden increase in government borrowing. In such circumstances, a high government debt burden limits the room for counter-cyclical fiscal policy and can make countries more prone to liquidity shocks and sovereign default risks, in particular if they do not have the option to devalue their currencies.

In this context, a positive agenda is needed to address the ‘legacy sins’ of government decisions which built up public debt in many countries over many years, as well as the specific repercussions of public interventions to address the financial crisis. The latter clearly exacerbated public debt accumulation. In times of low interest rates this may not seem like a big problem, as servicing costs are low, but it can transform into a bigger risk when interest rates rise again. So, even though the aim of crisis intervention was to promote financial stability, it has resulted in further risk to public finances in some cases.

While situations clearly differ between countries, there appears to be a common element which is often neglected in policy debates about public debt: the behavioural challenge. Put simply, it comes down to the willingness to adapt behaviour and therefore decision-making in light of financial sustainability needs. Do we, in societal terms, sufficiently understand the potential risks and consequences of high public debt levels and behave accordingly? Or have we fallen victim to the illusion that ever-increasing public debt directly translates into ever-increasing wealth creation? Do we sufficiently consider what happens when interest rates rise?

Are we mindful enough of future generations and the financial obligations we leave behind for them? There also seems to be an accountability challenge to be addressed in policy-making, as increasing public debt often is a tempting way to postpone difficult decisions. Is there sufficient democratic accountability and scrutiny of the consequences of postponing? And last but not least, are all debts properly and comprehensively reported in government balance sheets? Is the long-term impact of political decisions transparent enough, is it properly reflected in government financial statements?

When does public debt become unsustainable?

'There is no one-size-fits-all definition for public debt sustainability.'

Analysing present and prospective public debt developments and the risks that arise from them has to be a fundamental part of sustainable policy-making. In Europe, the European Commission's Debt Sustainability Monitor (DSM) provides an overview of the challenges to public finance sustainability faced by member states in the short, medium and long term. This initiative is effectively mirrored by the work of the OECD and World Bank at the wider international level. In its latest DSM edition (published in January 2018, available here), 10 EU countries were considered to have a high fiscal sustainability risk in the medium term, partially as a result of high legacy debt burdens and, in some cases, because of weak projected fiscal positions. The 10 countries are: Belgium, Croatia, France, Finland, Hungary, Italy, Portugal, Romania, Spain, and the UK. More broadly, the report recommends that the current positive economic conditions should be used to rebuild fiscal buffers in time to absorb new shocks when they come, referring to potential risks from a foreseeable rise in interest rates.

Over the past years, many commentators have pointed out that some countries seem to be able to accommodate higher public debt levels than others. The large size of Japan's public debt, which lies at about US$9.5 trillion, has been frequently referenced in this context. But why has Japan avoided a major crisis of confidence compared to Greece which had a significantly lower debt to GDP ratio?

It stands to reason that public debt becomes most problematic when it is rooted in a malfunctioning economy. The underlying strength of the economy is a critical factor in a country's ability to repay, service and refinance its debt. Economic growth erodes the relative size of the public debt burden. The source of ownership of debt can be a determining factor too. Some commentators have alluded to the relevance of debt being primarily held domestically, as is the case with Japan. Whatever the source of ownership, there is no escape from what *The Economist* terms 'a recurring popularity test for individual governments'.

The popularity test involves a wider set of actors than the domestic electorate. It draws in financial markets where considerable reliance is placed on sovereign bond ratings, for risk assessment. Credit ratings are known to be based on a swathe of different criteria over and above public debt levels, including broad economic and political indicators. Rightly, ratings recognise the importance of looking at a wider picture. But is sufficient attention paid to the current and projected financial situation of the governments themselves? Do investors and analysts give enough consideration to the current level of public debt? And is public debt properly and comprehensively reported in government balance sheets? While statistical data provide a relative measure of public debt (as a percentage of GDP), government balance sheets – to the extent they are prepared according to best international accounting practices – provide an absolute measure of government indebtedness.

In the interests of global financial stability, these questions merit more detailed consideration. Any improvements upon the existing mechanism of investors ceasing to buy public debt would be of broad public interest.

Global financial stability in the light of new trends

'Governments are the largest creditors on financial markets. This makes public debt an issue of global systemic importance.'

We start from the perspective of public debt being the largest asset class in international financial markets. This is a historic norm. Recent years have seen the emergence of important new trends, over and above the generalised growth in the volume of public debt within the global financial system. Firstly, the conscious decision of major central banks to lower interest rates in an effort to stimulate investment and economic growth. Secondly, the launch of QE when central banks bought government bonds and other securities from financial markets in order to further lower interest rates and increase the monetary supply. As a result, major central banks now hold historically high levels of public debt on their balance sheets. Thirdly, the wider context of economic transformation in the digital age and the implications for employment, wage growth and consumer price inflation. All these trends have created a context in which investors aim to preserve yields and are more risk tolerant.

Central banks' interest policy and QE has significantly altered global financial markets dynamics: we are still understanding the long-term consequences of such interventions. The conscious decision to lower interest rates amid sluggish economic growth and low consumer price inflation, as well as the 'success' of QE in keeping interest rates at the lowest level for the longest period of time in recent economic history, has made it cheaper and thereby feasible for governments to borrow or roll over existing debt more, or at least reduce debt levels more slowly. With refinancing costs at historically low levels, a key debt control mechanism has essentially been put on hold.

While monetary policy has helped to stimulate economic recovery and employment growth, consumer price inflation levels have largely remained flat – until now. This prolonged period of low consumer price inflation remains a conundrum for central bankers and policymakers alike and one which may suggest that a more structural change is underway or has taken place already. The practical impact of technology, automation and modern distribution capacities which have shrunk the globe may have fundamentally altered the supply and demand mechanism on which consumer price inflation has worked historically. New forms of flexible working, the so called 'gig economy', may also have contributed to the seemingly growing disconnect between consumer price inflation and employment. While it is clearly premature to declare the end of consumer price inflation as we know it, it is a factor which has played in favour of the stability of public finances and the global financial system despite the increase of public debt.

In turn, the cumulative effect of QE, low consumer price inflation and low interest rates appears to have affected investor appetite for risk and so inflated prices for financial assets. There seem to be two major trends. On the one hand, some investors appear not only to have accepted very modest returns but also negative returns from investing in governments, effectively paying governments just to hold their capital, on the basis that certainty is better than reward. On the other hand, some investors have gone in the opposite direction of greater risk, in the search for rewards in other parts of the economy and global financial system. Warnings over the impact of stimulus efforts on investors' risk-taking attitudes have grown louder over the last few years and inflated stock prices are widely regarded as a symptom of this — although we are seeing some signs of a correction lately. A major concern is that investors engage in ever riskier endeavours in the search for return, and financial market instability ensues beyond the capacity of public authorities to remedy.

For all actors involved, central banks, governments and investors, this new nexus between interest rates, consumer price inflation, public debt and central bank balance sheets is uncharted territory. Central banks seem to be very attentive to the risks involved, as they try to manage the withdrawal from QE without hurting the real economy or sending shockwaves through international financial markets. In the meantime, though, questions remain over the management of government finances – and whether the reference point of public debt which is generally used within financial markets to make decisions on the allocation of capital is the right one, or at least the right one alone.

Public debt is the tip of the iceberg

'Public debt is the visible tip of the iceberg while the overall financial situation of governments lies largely unseen beneath the surface.'

It is positive that there is now greater tracking of public debt than ever before, with detailed international comparisons available, as well as information on future projections. However, there remain two significant challenges in the way in which public finances are analysed today. The first may derive from the success of efforts to track public debt – in the sense that the size of public debt has become the overwhelming focal point in itself. Is sufficient attention paid to what the public debt is used for and what it is managed against? This in turn raises the question of whether there is too narrow a segmentation in the discussion on public finances centred on debt. We also need to understand the overall balance sheet, including assets and liabilities.

Measuring public debt is clearly not a straightforward matter and progress has been made in aligning practices. This being said, further consideration is needed on how governments can promote confidence in the way they manage their public finances through greater democratic accountability and transparency. While there will always be debate and room for judgement, it is perhaps appropriate to distinguish what can appropriately be referred to as investment, and what is borrowing for consumption. The dividing line is very fine. Some social programmes can be regarded as both, depending on the perspective taken. As an example, supporting jobless people during economic hardship might be seen as consumption of public resources, as there is no immediate or guaranteed return. However, it can also be regarded as an investment in people ie, a precondition for reintegrating people quickly into the workforce when economic growth picks up.

From a statistical reporting point of view, public debt is mostly expressed in relation to GDP. GDP is used as a measure of the government's ability to pay back debt, as it provides some indication of the economic activity which governments are, in theory, able to tax. But how reliable and accurate a measure is GDP? GDP figures depend on methodological choices about what exactly is included and how. Not all economic activity can be measured by observation of market transactions, so this activity is either excluded (reducing GDP's coverage) or estimated (increasing GDP's uncertainty). It appears that significant features of the new economy are particularly in danger of being omitted from GDP figures. This is not to suggest that GDP is obsolete: despite the current flaws, GDP remains an important economic measure and it allows for a certain level of comparison across countries. But perhaps we should be more mindful of the limitations of GDP when putting it in relation to public debt figures. Better measurement of the economy is a key factor for investors and also ratings.

A fundamental concern arises from the fact that it is very difficult to assess and communicate the real state of public finances, and to assess their sustainability, without more comprehensive information. In short, it is necessary to look at the iceberg beneath the surface, to consider all assets and liabilities with agreed recognition and measurement as well as disclosure. The statistical measures on which current public debt figures are based only convey a partial picture here. There is thus much to be gained from complementing our current understanding by also taking into consideration numbers based on financial reporting, which would provide a clearer view of the underlying sustainability of public entities as well as providing a more comprehensive picture of the long-term consequences of financial decisions.

While many of the discussions of public debt are now accompanied by projections based on expected demographic changes, these are no substitutes for comprehensive balance sheets and accompanying financial information which take account of government commitments. Similarly, discussions of net public debt – the position calculated as gross debt minus financial assets – can only be meaningfully pursued on the basis of sound financial information.

The EU reform project working on public sector accounting standards[1] aims to move Europe firmly in this direction by regulating accounting based on high-quality harmonised financial information. This information would be complementary to the statistical information currently available and enhance fiscal monitoring at macro level, thereby helping support sound financial management. It would also enhance comparability between levels of governments within each member state as accounting practices currently often diverge from one government level to another. By producing transparent accrual-based financial statements, governments would reflect the long-term impact of their decisions and can be held accountable for the good use of public funds towards citizens who elect them through the democratic process and other stakeholders, such as fund providers. Currently, only very few countries produce such information.

The reform project has the support of many member states. However, unanimous consensus seems difficult to achieve and some member states need further convincing in order for the project to advance as a Europe-wide initiative. Still, there is much to be learnt from countries which have already put in place such comprehensive accounting and reporting and those which are taking clear steps in this direction.

1 The Budgetary Framework Directive requires implementation of robust accrual accounting systems in all member states for all sub-sectors of general government that will generate comprehensive and reliable data that can be used for the ESA 2010 reporting, and so enhance budget surveillance and fiscal monitoring in Europe. The EPSAS (European Public Sector Accounting Standards) project aims to develop harmonised accrual accounting rules for all member states based on IPSAS (International Public Sector Accounting Standards).

A window of opportunity towards sustainability

'We should avoid the mistake of designing good policies largely in bad times and bad policies in good times.'

The current economic climate provides a window of opportunity to firmly place public finances on a sustainable footing for the long term. A wider acknowledgement that the continuing proliferation of global public debt risks undermining financial stability can help seize this opportunity. Introducing reforms without the driver of an immediate crisis is always a challenge: good policies often tend to originate from unavoidable choices in bad times, while favourable conditions can encourage postponement of difficult choices.

Public debt sustainability and the sustainability of public finances overall are largely determined by investor confidence and the confidence of citizens at large, who in many cases directly own bonds from their own government. As noted, though, central banks – the lenders of last resort – are increasingly holding government bonds on their own balance sheets. All these actors are ultimately dependent on the financial health of the underlying entities emitting bonds, upon which confidence is either built or lost. Confidence can be seen as a somewhat nebulous factor – as indeed can money itself when considered in light of the functioning of international financial markets. Financial transactions in a context of confidence are based on an expectation of a return in an agreed timeframe; when confidence is low or shattered, a most immediate cash in hand concept of money prevails. In short, a liquidity crisis shows.

In the interests of global financial stability, more attention is therefore needed on the way in which governments empower public scrutiny of public finances. It is an area where a broad consensus can be envisaged between the different actors: citizens, investors, ratings agencies, central banks and regulators – with the accountancy profession playing its role. Ultimately, however, it requires governments to recognise that comprehensive and accurate financial information is key to their capacity to meet current and future public needs – and to retain the confidence of those who put their savings in government hands. This can only be achieved if the information is used throughout the financial management cycle, including budgetary preparation. In the interests of overall sustainability, it is to be hoped that the window of opportunity opened by the current economic climate is used to the full.

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