Summary for non-specialists
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Assessing Public Debt Sustainability in EU Member States:

A Guide

The aim of this paper is to illustrate the methodological approach used by the Commission services (DG ECFIN/C2) to carry out, in a systematic and harmonised way, public debt sustainability analysis (DSA) for EU Member States.

Analysing recent and prospective public debt developments and risks to debt sustainability is crucial for EA countries and the EU as a whole to be able to formulate appropriate policy responses. To this aim, the Commission services (DG ECFIN) prepare on a regular basis (twice a year, following autumn and spring Commission forecasts) an internal "Debt Sustainability Monitor" report (DSM) presenting, for each Member State, a detailed public debt sustainability analysis, accompanied by the analysis of fiscal sustainability indicators. The DSM provides key information for regular budgetary surveillance. The assessment of Member States' debt developments is indeed a key component of fiscal surveillance under the Stability and Growth Pact, the European semester and the Europe 2020 strategy.

Public debt dynamics is analysed in the DSM through traditional (deterministic) debt projections, accompanied by sensitivity analysis, and stochastic debt projections. Brand new tools have also been introduced in the DSA framework with the aim of ensuring a more comprehensive assessment of risks to public debt sustainability (capturing risks arising, for instance, from the structure of public debt financing and from governments' contingent liabilities). Other new tools have been introduced to make it possible to assess the realism of underlying macroeconomic assumptions.

Main features of the renewed Commission's DSA framework are the following:

1) Criteria are used to identify "vulnerable" countries from the point of view of public debt sustainability. For the latter, the DSA is "enhanced" with a detailed write-up, in which the macro-fiscal assumptions used in the projections are illustrated and debt projection results, and risks to debt sustainability more broadly, are discussed.
2) The framework is designed in a way to allow for a comprehensive assessment of risks to public debt sustainability. Sensitivity analysis around baseline public debt projections, for instance, is extensive, covering downside and upside risks to the main macro-fiscal determinants of debt dynamics (possibly emerging from fiscal fatigue, tightening/relaxing of governments' financing conditions on the markets, shocks to GDP growth, inflation and the exchange rate, bank-related contingent liability shocks).
3) Variables capturing risks potentially arising from the structure of public debt (public debt by maturity, holder, currency of denomination) are integrated in the DSA through heat maps, thus usefully complementing the analysis of risks related to the projected public debt dynamics.

4) The analysis of governments' contingent liabilities features prominently in the DSA framework. An overview of overall contingent liabilities for the public sector is provided based on most recent data on state guarantees. Contingent liability risks arising from the banking sector are captured indirectly through heat maps of variables that measure banking sector vulnerabilities, as well as through estimates of the probability of bank losses hitting public finances in a simulated bank crisis.

5) Commission forecast accuracy analysis on the main macro-fiscal determinants of public debt dynamics (real GDP growth, primary balance and inflation) is included in the DSA. This analysis aims at providing some indication on whether forecasts, incorporated in baseline public debt projections, tend to be systematically biased in one direction or the other in a sign of persistent optimism or pessimism.

The paper provides an accurate description of the new Commission – DG ECFIN's DSA framework, and all the analytical and reporting tools it encompasses.