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## Measuring the impact of the crisis on public debt

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The financial crisis and economic downturn has left a hole in the public accounts of EU Member States. Governments across the EU have taken unprecedented measures, assuming important liabilities for years to come. Jointly organised by the **Chartered Institute of Public Finance & Accountancy** (CIPFA), the **European Capital Markets Institute** (ECMI) and the **Institute of Chartered Accountants in England and Wales** (ICAEW), a high level seminar was recently held in Brussels to promote a better understanding of the current status of public finances in Europe. More transparency – through high-quality and comparable information – is one of the key issues to ensure long-term sustainability. The seminar was a timely opportunity to discuss key questions, including:

- What impact has the financial crisis had on public debt?
- Are fiscal statistics sufficiently transparent and comparable to enable good quality policy-making across the EU?
- Have the public measures to address the financial crisis across the EU been accounted for appropriately and in a comparable fashion?
- What are the exit strategies to bring fiscal policies back to the path of long-term sustainable public finances?

With EU government deficits expected to rise to an average of 7.5% of GDP in 2010 and public debt projected to steadily increase during the next decade, the fiscal impact of the crisis across EU member states has been severe. **Marco Buti,** the European Commission's Director General for Economic and Financial Affairs, focused on the different challenges facing European governments. In the short-term, automatic stabilisers and discretionary policies in response to the crisis have led to a rapid enlargement of budget deficits. All Member States – except Bulgaria – are expected to be put under 'excessive deficit procedures', triggered when government deficits no longer meet the 3% ceiling set by the Stability and Growth Pact. The crisis has also had an impact on the European gross debt, which is rising on average from 68% in 2007 to 84% in 2011.

Looking at past crises, large fiscal deficits have contributed to an average increase of public debt of around 20% of GDP. The impact on public debt has typically taken a long-time to reverse. In the medium term, average debt in the EU is expected to reach 120% of GDP by 2020, if no fiscal consolidation measures are taken. In addition, many Member States have already been facing high 'starting points' and will face significant challenges in responding to an aging population. Turning to the question of fiscal exit strategies, Marco Buti stressed the importance of a coordinated approach between consolidation, starting in 2011, and economic recovery, whenever it takes place. However, withdrawing fiscal stimulus alone will not be sufficient to ensure long-term sustainable public finances. Member States will need to look at reducing public deficits and/or age-related spending. Consolidation based on expenditure cuts tends to take longer time, although tax-based consolidation will also be an important tool for some governments. Gradual adjustments are generally more effective, particularly if accompanied by structural reform and action to tackle public sector pensions.

Responding to a reported quote by an official at the Bank for International Settlements describing financial regulators 'driving while just looking in the rear-view mirror', the presentation by **Ad van Riet,** Head of Fiscal Policies Division at the European Central Bank, looked at some of the substantial risks lying ahead. Assessing the fiscal costs of the crisis for the Eurozone, Ad van Riet agreed that, given the impact of automatic stabilisers and various fiscal stimulus packages, this

crisis has come at a very high cost for public finances across the EU. In addition, there remain a number of significant fiscal risks from the crisis. Primary balances could be affected by several factors, including prolonged or expanded fiscal stimulus measures, ongoing costs associated with automatic stabilisers and a trend towards growing government spending. Member States might also try to downplay or reduce the size of their fiscal deficits by engaging in window dressing or creative accounting. Economic growth is key: if economic growth is permanently lower, a higher primary surplus will be needed to reverse the rise in public debt ratios. A further fiscal risk is linked to probable changes in interest payments – as interest rates rise once financial conditions normalise – and monetary conditions.

Ad van Riet also pointed out the persisting uncertainties about the need for further government intervention in the banking sector, whether in the form of additional bank recapitalisation or further asset purchases. Past experience shows that recovery rates in past banking crises seldom reached 100%. EU Member States have also made extensive use of implicit and explicit guarantees to stabilise the financial sector, as well as non-financial firms. Contingent liabilities have taken four forms: (a) higher levels of retail deposit insurance; (b) recapitalisation of banks and guarantees on bank loans; (c) guarantees for special purpose entities such as 'bad banks'; and (d) guarantees to non-financial firms. These are 'off balance' until called and consequently not recorded in government accounts. In conclusion, Ad van Riet reminded participants that major challenges have been managed before by Member States, including most recently in the run-up to European Monetary Union.

Providing a statistical perspective, **John Verrinder,** Head of Unit (Government and sector accounts) at Eurostat, clarified that, in principle, fiscal statistics are transparent enough to provide a basis for comparison across the EU. The statistical basis is set in international standards and European legislation. However, the statistical basis still leaves room for interpretation which can impact on comparability. For instance, key questions relate to whether statistics cover government or public sector, what should be included in national accounts and how items should be calculated, and whether gross or net figures should be used. Eurostat figures focus on 'governments' and therefore do not include their assets in central banks or public corporations. Likewise, whilst some member states, such as the UK, present both gross and net debt measures, Eurostat does not publish net debt.

John Verrinder stressed the importance of distinguishing between traditional impact on debt due to the economic downturn and the specific impact of this financial crisis. The former is covered by existing statistical rules. The latter has led to specific guidance, issued by Eurostat in July 2009. An overview of the statistical treatment of various measures, taken during this financial crisis, indicates that some activities have had an immediate impact on public debt (asset purchase and capital injections), whereas others have not. Government guarantees, in particular, only hit debt figures when they have been used, otherwise they would just 'measure clouds, rather than rain.' Liquidity schemes are assessed in a different way, according to whether they are undertaken via central banks or based on the longevity and risks associated with the measures. Likewise, special purpose entities are generally excluded from government figures when they are privately owned, temporary and low-risk. In order to increase transparency, Eurostat has issued supplementary data to better clarify the impact of the crisis on deficits and public debt, as well as to provide information on wider government risks.

**Ian Carruthers,** International Public Sector Accounting Standards Board (IPSASB) Member (designate)**,** considered whether public measures to address the financial crisis across the EU have been accounted in an appropriate and comparable fashion. Better reporting by governments on the financial implications of the crisis is critical to ensure fiscal credibility and public support. However, convergence of reporting standards with statistical data is still in progress. Current work should focus on a single set of high-quality and globally accepted international public sector accounting standards (IPSAS) to ensure consistency of standards. IPSASB and the IMF are currently working together on a joint government reporting initiative to look at how governments are accounting and reporting on assets, obligations and commitments acquired during the financial crisis. The ability of existing accounting standards to report on the variety of government actions,

as well as the differences between reporting and valuation approaches are also under consideration. Particular issues being considered include the reporting entity (coverage of financial statements), valuation of financial assets and liabilities, treatment of valuation gains, losses and guarantees, and other contingent liabilities.

Considering the long-term sustainability of public finances, Ian Carruthers contended that it is important to encourage Member States to go beyond traditional financial statements in order to report the breadth of government expenditure. Looking at the long-term sustainability of public finances, initially defined as 'the ability of government to meet its service delivery and financial commitments both now and in the future', IPSASB is looking at how information on fiscal sustainability may enhance financial positions statements. A number of reporting models are being considered and a list of possible reporting indicators has been identified. A consultation period will be launched during the first quarter of 2010, while an OECD seminar on this work has been scheduled for March 2010.

The event was chaired by **Caroline Mawhood**, Immediate Past President CIPFA. Opening and closing remarks were provided by **Karel Lannoo**, ECMI Secretary General and **Martin Manuzi,** Director of the ICAEW European Office.