NEW FISCAL GOVERNANCE FRAMEWORK-

ensuring proper implementation

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Proposal overview

- Single indicator: net primary spending rule.
- Adjustments to ensure that the 10-year debt trajectory is on “a plausibly declining” path or “stays at prudent levels”.
- The 3% and 60% of GDP reference remain unchanged.
- The debt ratio must decline by the end of the period of the plan (example: 2028 debt ratio < 2024 ratio).
- In extended fiscal adjustment periods, the majority of adjustment measures must be delivered in the first four years. (4/7)
- A minimum fiscal adjustment of 0.5% of GDP per year if deficit > 3% of GDP.
- Net expenditure growth < below medium-term output growth.

Successfully addresses key weaknesses of current system, including the

widespread tendency to ignore CSRs and absence of corrective mechanisms.

Differentiated Obligations

Commission will publish:

- The underlying medium-term public debt projection framework and results;
- Its macroeconomic forecast and assumptions;
  - For high debt countries (>60%): net expenditure technical trajectory for adjustment period (4 years) and its possible extension (+3 years);
  - Low debt (<60%) technical information regarding the structural primary balance;

Successfully differentiates national obligations based on particularities.

This is the core from which “national ownership” emerges.

Role of IFIs

- Producing/endorsing the **annual and multiannual macroeconomic and budgetary forecasts** underlying the government’s medium-term planning
- Producing/endorsing **debt sustainability assessments** underlying the government’s medium-term planning
- Producing/endorsing assessments on the **impacts of policies on fiscal sustainability and sustainable and inclusive growth (**but no micro-policy costing)
- In the annual progress reports, IFIs “provide an assessment of compliance of the budgetary outturns data […]with the net expenditure path.”
- The medium-term fiscal-structural plans “should ideally be defined **following an extensive and in-depth political and technical debate** at national level and taking into account the advice of national independent fiscal institutions.”

Pending questions

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Model Assumption	Model Blindspot
How do we establish national spending paths?	Will these be set as growth rates relative to each t-1 period? What about risks of ratcheting up spending (overruns). How does the control account work in this context?
What does the 0.5% minimum adjustment to 3% deficit refer to?	Is it the change in the structural balance, the adjustment to the allowed net spending growth rate, the debt ratio change?
Will one-offs be excluded from the net spending measure?	This could push necessary sudden expenditures off balance sheet. It could lead to easier adjustments to debt and deficits if one-off spending is initially high.
How will inflation be treated?	Will the expenditure path be assessed on a “real” basis and allow for actual inflation? GDP deflator?
The fiscal adjustment effort over the period of the national medium-term fiscal structural plan being “…at least proportional to the total effort over the entire adjustment period”?	How do we define “…at least proportional to the total effort over the entire adjustment period”?
Mechanics and timing	Spring? Winter? Early forecasts?
Still have not seen a dry run or a test run of models	Needs to be both common and differentiated

Risk Blindness and model assumptions

We acknowledged the need for a **differentiated approach in national paths, but not in models.**

Need for qualitative inputs on **unobservable or hard-to-estimate data** and metrics (even though under the new proposal, these are relegated in importance)
(cyclical unemployment, NAIRU, output gap, potential output, cyclical surplus, structural balance etc).

Need to balance neutral, honest, **non-political, but technically normative analysis**, with sterilized quantitative analysis. (Question: How political should IFI inputs be? For example, tracking on performance in CSR implementation, policy performance against KPIs and state goals)

Need to take into account additional challenges not fully grasped by models
–market risk, credit conditions, geopolitical risks, regional issues etc that pose emergent risks for national economies (e.g. energy security, defense, Ukraine, regional instability, impact of climate change, GVA composition, access to markets).

Need to review model assumptions and the relationship between different metrics which is different in different economies.

Risk Blindness

Model Assumption	Model Blindspot
Quantitative analysis to be enhanced with normative analysis	Not only how much is spend, but also on what- crises usually emerge from the latter; the former is manageable.
Debt composition analysis based on standard notions from past events (maturity profile, foreign currency, foreign held etc)	The percentage of debt held in the form of loans rather than bonds is often pegged on Euribor or otherwise floating (Cy: 28%). Debt servicing cost sensitivity is understated. **Accessibility to markets, national debt liquidity and political risk are key.**
Implicit, unreported risks	e.g. SOE pension funds guaranteed by employer- hence ultimately by taxpayer: **Formal structure is irrelevant**.
“No policy change scenario”	Necessary but problematic.
Emerging risks – “revert to the mean” assumptions in LT projections	Emerging issues include cost of ETS, infrastructure needs imposed by energy security, defense and physical risk of climate change
Official data (availability and quality)	Implicit guarantees, contingent liabilities, below-the-line spend, unconsolidated debt data: **not captured by models**. Structural issues and political dynamics are crucial.
Differentiated relationships between fundamental metrics	e.g. import composition, imported inputs: CA deficit as proxy for growth, climate impact (transition v. physical risk),

ROLE of IFIS: Challenges

1. <u>Independence and resources are crucial-</u> But opportunity for collaboration with Parliaments in securing early warning observations. Power of data collection must be enhanced

2. <u>Crises come from structural issues</u>: History tells us that never has there been a crisis (banking, sovereign, currency, BoP, payments, etc) due to a bad budget or a weak adjustment path. While these are the catalysts, the underlying cause of crisis is always a combination of

a) Underlying structural weaknesses, and
b) Political risk.

3. Need to look at **<u>quality of economic and fiscal policy</u>**
<u>But</u> not become a politicized institution. (eg CSRs, reforms, emerging challenges, model blind spots, policy effectiveness against KPIs). Difficult balancing act.

4. <u>Revisions</u> must be possible but difficult- like an obstacle course: maintain overall trajectory, aggregates on spend and policy effectiveness
(German objection on new government optionality and emerging conditions like wars, security, health, exogenous crises etc)

New role for IFIs:
What can they do that other players cannot?

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1. Preventive Arm: AWACS

IFIs are the key for **early warning** on divergence from path, especially under the "no policy change" approach, which ensures that divergence is introduced in the models too late.

2. Address issues not captured by CAM and models

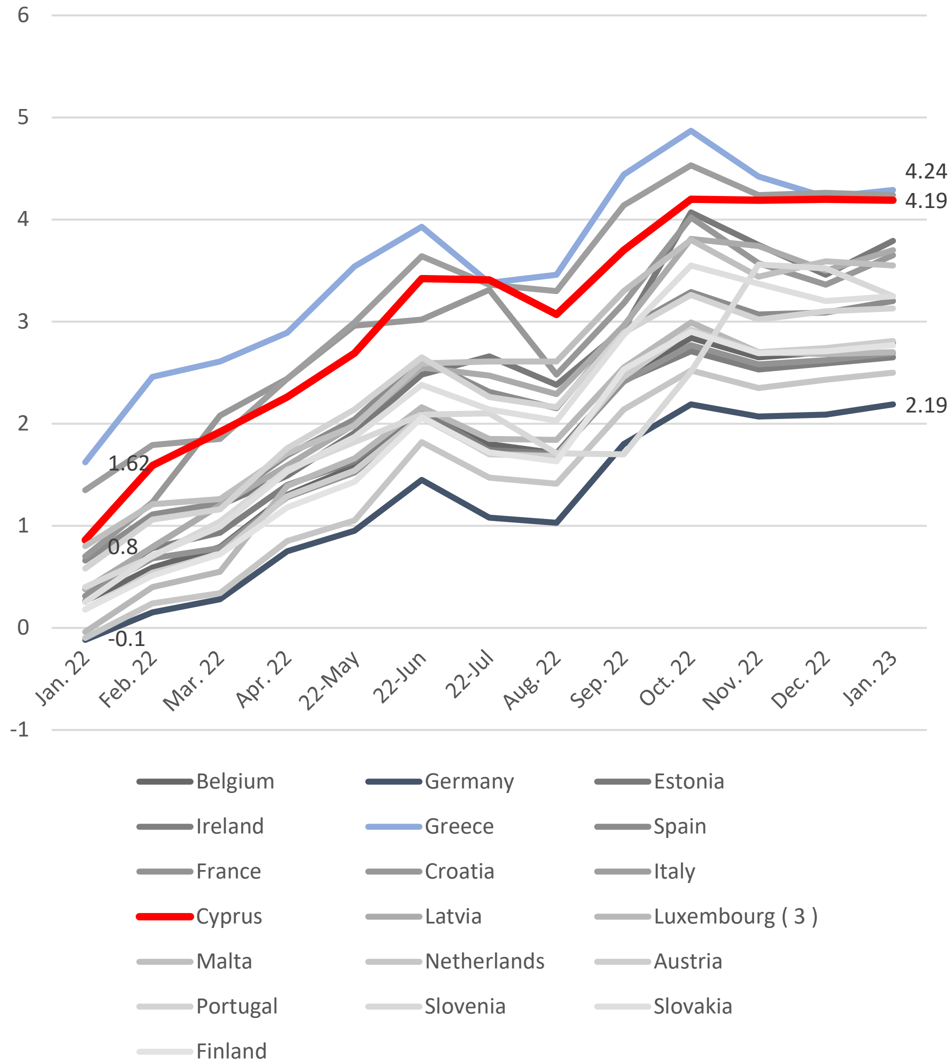
Address model adjustments, differences in key relationships (eg climate impact, CA-GDP, U, P).
Address model blindness and policy KPIs as national economy experts, evaluate analysis, including trajectory deviations.

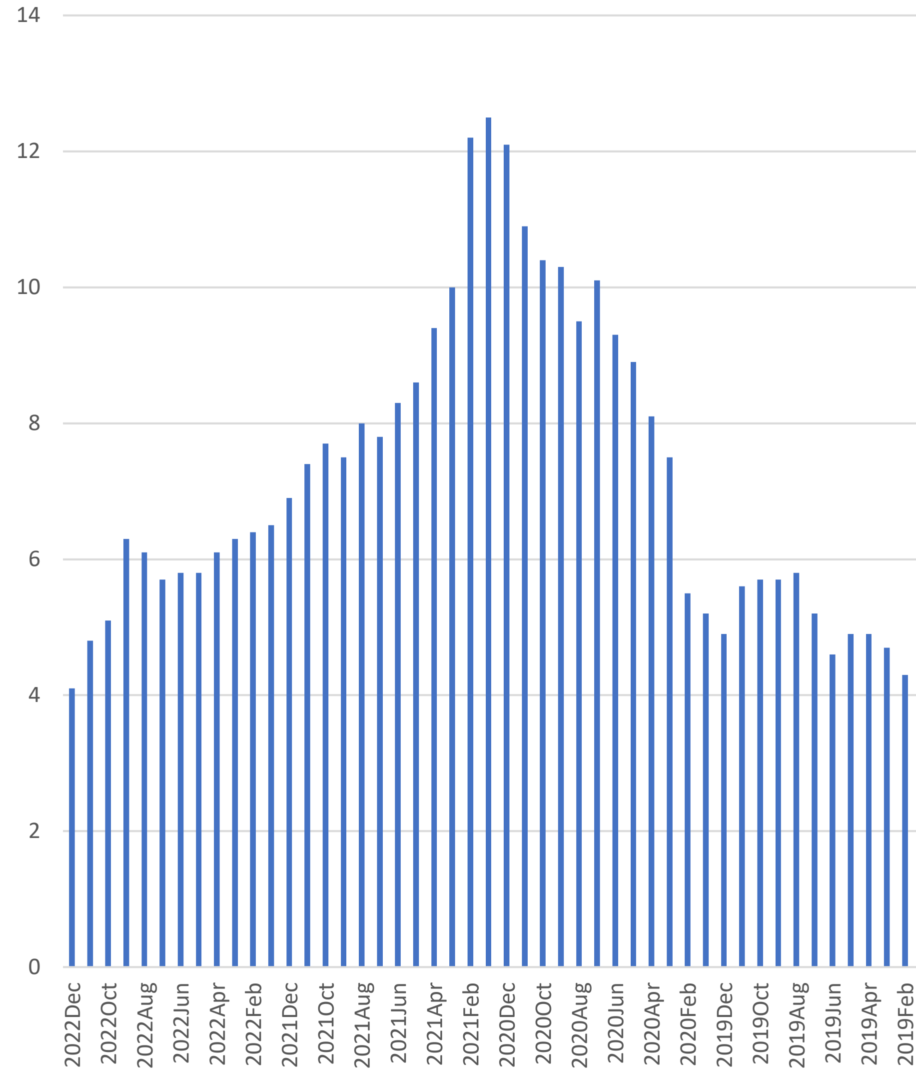
3. Ensure that national ownership is balanced with collective accountability.

As third interlocutor between governments and Commission. Honest third voice.

4. Provide **live tracking and monitoring** of debt trajectories within agreed path, including ex-ante policy change warnings.

Must work closely with Parliaments and Commission, including structured but informal exchanges of observations.





ECB policy is working despite initial concerns that the transmission mechanism would be slow.

This is painful good news and regrettable good news.

The challenge still orbits around growth.

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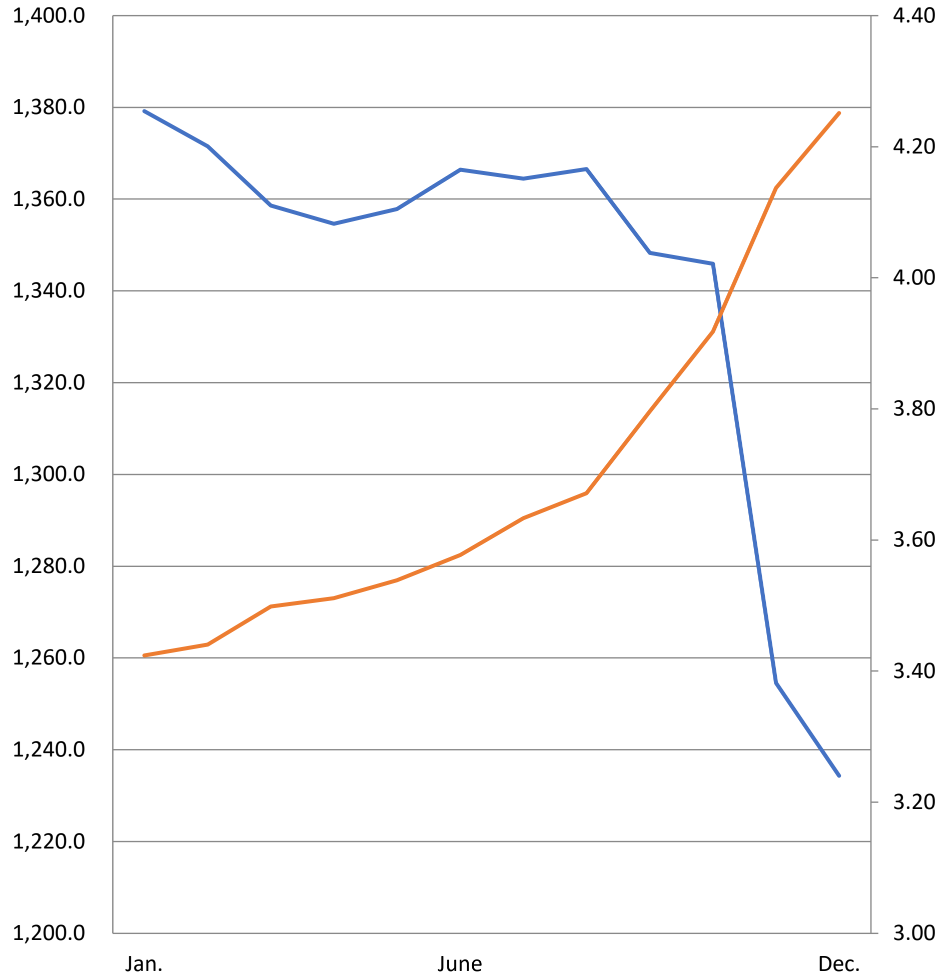
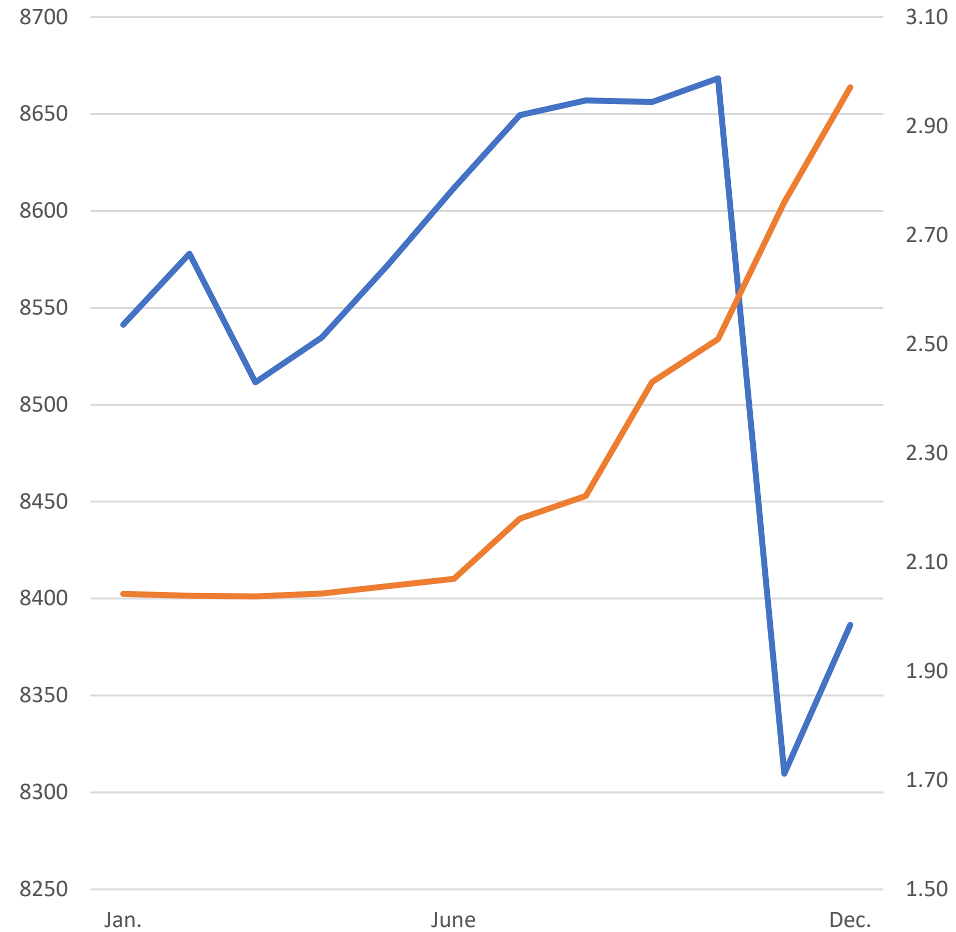
(%)	Ez	Cy
CET1	14.74	17.3
Tier1	16.03	19.25
Total Cap	18.68	20.94
Liq coverage	162.3	354.68
Cost to Income	61	84.7
Cost of risk	0.48	1.13

Fundamentals appear strong in Cypriot banking and the shift to a "vanilla ice cream" banking style has protected Cy banks from significant upheaval.
However, vigilance is always well advised as the external environment remains dynamic and unpredictable.
NPE increases are expected, but these will initially affect provisioning and π more than fundamentals





Growth assumptions will be heavily affected by both the volume and the nature of credit growth. As rates increase, adverse selection and risk are becoming higher, both in total and comparatively to total stocks.

The strength recovery of Cy banks in the last 4 years is now critical for their resilience.