GLOBAL: WHY THE LEVEL OF PUBLIC INDEBTEDNESS MATTERS – A MARKET PERSPECTIVE

It is quite likely that, going forward, fighting recessions will be the remit of governments with central banks facilitating this task by creating cheap financing conditions. As a consequence, public indebtedness may very well remain high.One should wonder whether this could end up having negative consequences. A possible transmission channel is the pricing of government debt via a sovereign risk premium. Another factor can also play a role. Since 2015, when German bond yields increase, the rise in Italian yields have been even bigger -so the spread widens- whereas French yields has increased in line with German yields. These results suggests that, even in an environment of public sector securities purchases by the ECB, the high level of Italian debt influences the reaction to movements in Bund yields. Clearly, in the absence of QE, one would expect this effect to be at least as powerful.

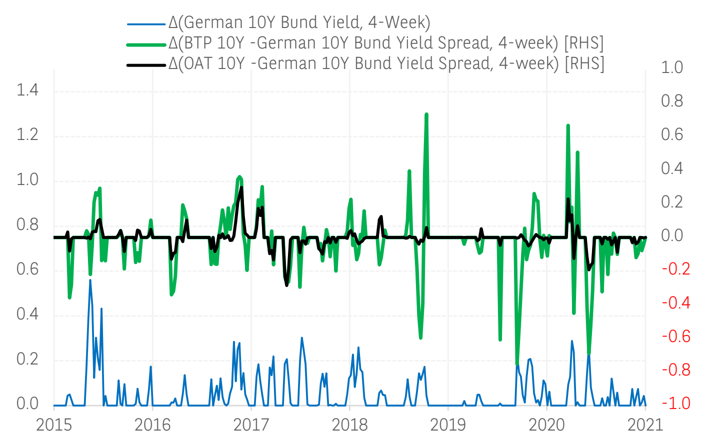
The victory of both Democratic Party candidates at the run-off elections in Georgia for the US Senate has triggered a strong rally in small caps and other cyclically sensitive stocks. It reflects the expectation that, with the Democrats also controlling the Senate, more fiscal stimulus will be provided. It is one illustration amongst many that, in addressing the economic consequences of the Covid-19 pandemic, fiscal policy is now in the driving seat. This observation applies not only to the US but also more globally. We can safely assume this situation will prevail in a post-pandemic world. The current monetary policy stance –the level of official interest rates, QE, forward guidance- is likely to remain very accommodative in major jurisdictions for several years to come. Moreover, it is extremely unlikely that conditions would be met justifying a tightening cycle that would create enough room to cut rates subsequently when circumstances require. Going forward, fighting recessions will be the remit of governments with central banks facilitating this task by creating cheap financing conditions[1]. Cheap government borrowing is instrumental in securing sufficient leeway for fiscal policy to boost growth. The bigger the negative difference between this cost (r) and average nominal GDP growth (g), the larger the primary budget deficit than can be sustained with a stable level of public indebtedness. There is a certain similarity with the effect of interest rates on the stock market: under certain conditions, low interest rates justify higher valuation levels. However, high price/earnings multiples will increase the sensitivity to interest rate and growth shocks. The same applies to public finances where a higher interest cost or slower growth will trigger an increase in the debt/GDP-ratio, unless the primary deficit were to be cut.

Even under the (heroic) assumption of a world without shocks, one should wonder whether a high, albeit stable, level of public indebtedness could end up having negative consequences. A possible transmission channel is the pricing of government debt whereby the borrowing cost would be higher when governments accept a higher level of sovereign debt. For the time being, extensive purchases of public securities by central banks have, to a large degree, removed this concern. Yield curve control policies –as conducted by the Bank of Japan- offer an even better protection for debt agencies. In the eurozone, the ECB's Pandemic Emergency Purchase Programme has been instrumental in keeping a lid on Bund yields and in causing a narrowing of sovereign spreads, but this begs the question of what will happen when the net purchases will stop at the end of March 2022 or a later date[2]. The decision to end this programme would signal the confidence of the ECB in the growth outlook, so it should not raise concern about an increase in sovereign risk, quite to the contrary. However, Bund yields should increase due to a less negative term premium, so the question is what this could mean for sovereign spreads. *Chart 1* shows the reaction of the spread between French and German bond yields and between Italian and German yields when German yields are up over a 4-week period.

1. This point was recently made by Laurence Boone, OECD chief economist: "*governments should take on the primary role of stabilising the economy in the recovery with independent central banks relegated to a supporting role*" (source: *OECD warns governments to rethink constraints on public spending,* Financial Times, 4 January 2021).

2. At its December meeting, the ECB Governing Council decided to extended the horizon for net purchases under the PEPP to at least the end of March 2022, adding that in any case, the net purchases would be conducted until it judges that the coronavirus crisis phase is over (source: ECB).

SPREAD OAT AND BTP VERSUS BUND 10-YEAR YIELD



SOURCE: REFINITIV, BNP PARIBAS

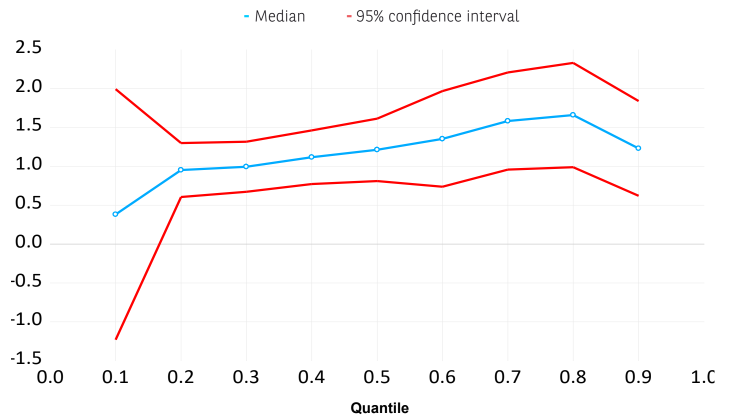
> Were a government to opt for the stabilization of the debt/GDP-ratio at current levels, a stress test of the difference between borrowing cost and GDP growth is recommended in order to assess the sustainability of such a policy

It is difficult to draw any conclusion, except that the OAT-Bund spread is less volatile than the BTP-Bund spread. To explore this further, a specific regression methodology was used, which allows for a non-linear relationship. As shown in *chart 2*, using weekly data starting in 2015, there is mostly a one-for-one relationship between the change in the 10-year OAT yield and the change in the yield on 10-year Bunds. However, the yield on Italian government bonds rises more than the yield on German bonds –the spread widens- and the difference is larger the bigger the increase in the Bund yield. These results suggests that, even in an environment of public sector securities purchases by the ECB, the high level of Italian public indebtedness plays a role in the reaction to increases in Bund yields[3]. Clearly, in the absence of QE, one would expect this effect to be at least as powerful. It is a reminder that, were a government to opt for the stabilization of the debt/GDP-ratio at current levels –rather than striving for a significant reduction of this ratio-, a stress test of the difference between r and g is recommended to assess the sustainability of such a policy.

William De Vijlder and Tarik Rharrab

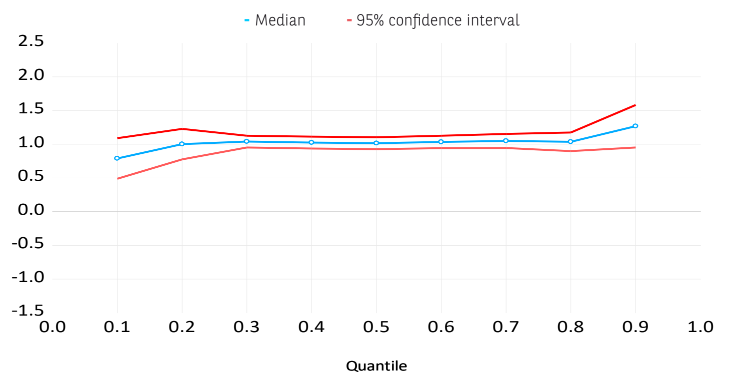
3.In theory, other factors, such as fiscal policy credibility, could also play a role.

QUANTILE REGRESSION COEFFICIENTS FOR BTP 10-YEAR WHEN CHANGE IN BUND 10Y IS POSITIVE



SOURCE: BNP PARIBAS CALCULATIONS

QUANTILE REGRESSION COEFFICIENTS FOR OAT 10-YEAR WHEN BUND 10-YEAR IS POSITIVE*



SOURCE: BNP PARIBAS CALCULATIONS

**The relationship between, on the one hand, the 10 year Bund yield and, on the other hand, the 10 year OAT yield and the 10 year BTP yield was analysed by means of a quantile regression so as to take into account the possibility of a non-linear relationship. Moreover, it is possible that the reaction of French and Italian yields depends on whether the Bund yield rises or declines. The charts show the regression results in case of an increase in Bund yields. Weekly data have been used, starting in 2015. The variables have been expressed in difference terms, i.e. the change in yields in a given week versus 4 weeks earlier.*