SPECIAL EDITION | HOW BAS IS THE RISE IN BOND YIELDS?

TRANSCRIPTION

0:00:10 - Emmanuel Laborde

Everyone, welcome. As we head into autumn 2026, interest rates are reaching levels never seen for many, many years. Why is this happening? Is it sustainable? And what are the implications for the economies of different countries? All these questions will be discussed over the next few minutes with the economists of BNP Paribas. Let us begin with Isabelle Mateos y Lago, chief economist of the group. Hello, Isabelle.

0:00:38 - Isabelle Mateos y Lago

Hello Emmanuel, hello everyone.

0:00:39 - Emmanuel Laborde

Thank you for being with us today. Just to begin, a simple explanation. What rates are we talking about and which countries are affected?

0:00:48 - Isabelle Mateos y Lago

Yes, it is very important to clarify this. So, we are talking about long-term interest rates, rates at 10 years or longer maturities, 30 years, etc. The rates at which sovereign states borrow on the market. And this is primarily something that is happening in advanced countries, so United States, United Kingdom, Japan, and then the Eurozone countries. And indeed, as you said, we are seeing since the beginning of the summer, interest rates reach levels we had not seen for about 20 years. But it is important to keep in mind that up until that point, up until the mid-2000s, the level of interest rates that we're seeing now were really quite common, quite normal, so one shouldn't overdramatize.

0:01:35 - Emmanuel Laborde

Why do we find ourselves in this situation and how did we get to this point?

0:01:41 - Isabelle Mateos y Lago

Yes, so the direct cause is that investors are demanding higher interest rates in order to lend their capital to governments. But why is this? Well, there's essentially three reasons for this, and not all of them are bad, and they're not mutually exclusive either. The top reason to my mind is that there's just greater competition for capital between sovereign states and the corporate sector, who are all facing simultaneously additional investment needs, in defense, in artificial intelligence, in energy transition, in resilience. And so, you just have greater competition for capital and that pushes up the price of capital, which is the interest rate.

Reason number two is because markets have revised upwards their expectations of how high central banks are going to be taking their interest rates.

And this mechanically translates into higher rates at the long end. And then there's a third reason, which doesn't apply necessarily in every case, but which is essentially higher sovereign risk, a kind of a risk premium, in cases where there are concerns arising about the sustainability of these public debts.

0:02:59 - Emmanuel Laborde

What are the implications for global economies?

0:03:03 - Isabelle Mateos y Lago

So that's exactly what we'll be discussing in the next segments. But basically, the two key issues are, one, an adverse impact on public finances. It's higher interest rates making it harder to balance the books in terms of public accounts. And then secondly, these higher rates tend to slow down economic growth. Of course, by how much and how serious it will be, depends on how high interest rates go and how long they stay there. But that's for the next segments.

0:03:38 - Emmanuel Laborde

Yes. Thank you very much, Isabelle. Having said the scene now, let's move on to the first segment with the following question. What makes debt sustainable? And let's see what Hélène Baudchon has to say.

Hello Hélène and welcome into this special edition.

0:03:58 - Hélène Baudchon

Hello Emmanuel, hello everybody.

0:04:01 - Emmanuel Laborde

When economists talk about public debt, they often refer to the sustainability of debt. As an economist, can you explain to us what that means and what is the debt trajectory deemed unsustainable?

0:04:15 - Hélène Baudchon

To begin with, I will say that a temporary increase in debt can be seen as a normal evolution, not particularly concerning, for instance during an economic crisis or more recently during a health crisis. In such cases, it acts as a buffer. A problem arises when the debt level never comes back down. An unsustainable trajectory can be therefore defined, characterized by a continuous regular rise in the debt level, both in absolute terms and as a proportion of GDP, driven by high and recurring fiscal deficits. And sometimes interest payments can exacerbate the problem.

0:05:00 - Emmanuel Laborde

In very simple terms, you are talking about the snowball effect.

0:05:03 - Hélène Baudchon

Exactly explaining why consolidation measures are needed in order to prevent such an adverse situation from occurring and in order to prevent, in fact, a sudden loss of confidence from creditors.

0:05:16 - Emmanuel Laborde

Regarding governments, what should serve as a warning sign for them? And at what point could the situation become, let's say, problematic?

0:05:27 - Hélène Baudchon

Well, simply speaking, when interest rates rise, not so long ago, up until 2022, Eurozone countries were borrowing at very low rates and in some instance, even negative rates. And although debt levels were already at high level at that time, the low rates helped manage debt servicing. Not much fiscal effort was needed to keep the public debt ratios in check.

0:05:55 - Emmanuel Laborde

Of course, we all remember this because it was a very unusual situation, but now things are very different.

0:06:01 - Hélène Baudchon

Yes, indeed, the situation today is clearly more challenging simply because bond yields are significantly higher and they are rising at the time of our discussion. This is for the part the result of the ECB's monetary tightening in 2022-2023 aimed at addressing the inflation shock then. Then long-term interest rates have risen as a consequence and have aligned more closely with GDP growth rate. And in technical terms, this is what we refer to as a narrowing of the "r" - "g" spread.

0:06:41 - Emmanuel Laborde

Why is this spread so important? Why do you, the economists, monitor it this way?

0:06:48 - Hélène Baudchon

Essentially, you have the interest rate "r", which determines the debt burden, while the growth rate "g" determines the trajectory of fiscal revenues. And if "r" is lower than "g", and this has been the case for many years, as you can see on the chart on the screen, it means that interest payments are increasing at a slower pace than the revenue component of the equation.

0:07:14 - Emmanuel Laborde

And this provides some leeway in other budgetary areas, such as education, of course, defense, maybe pensions.

0:07:22 - Hélène Baudchon

Yes, indeed. And this is what we refer to as the primary budget. However, if and when interest rates do go up while the economy isn't growing that much faster, then fiscal leeway diminishes.

0:07:35 - Emmanuel Laborde

Crystal clear. Now, just could you provide a few last words to wrap up the sustainability segment?

0:07:43 - Hélène Baudchon

Well, to conclude, we are entering a period which demands greater fiscal discipline or, as some might say, less indiscipline in order to manage debt trajectories effectively, in particular in the countries which have high debt levels. And for instance, the Italian case is an interesting one because it is well known for its high debt level ratio. But in fact, it also has an advantageous position because it has no primary deficit. In fact, it even benefits from a large primary surplus.

0:08:22 - Emmanuel Laborde

As for the countries... For the other countries... I stop you because this will be a discussion with Guillaume Derrien during the next segment. Thank you very much, Hélène.

0:08:30 - Hélène Baudchon

Thank you, Emmanuel.

0:08:36 - Emmanuel Laborde

Hello, Guillaume. Welcome.

0:08:37 - Guillaume Derrien

Thank you.

0:08:38 - Emmanuel Laborde

Hello, Emmanuel, and hello to everyone. The flexibility of fiscal policy depends heavily on interest rates, which have increased considerably over the past few months. The question is, where do we stand today?

0:08:52 - Guillaume Derrien

So, long-term rates have increased in all advanced economies, reaching levels not seen since 2008 in Europe and in the United States, and even since 1996 in Japan. Fortunately, the effective rate that states pay on their debt is lower than those headline figures suggest, simply because the average maturity of debt is relatively long. Precisely how long are we talking about? So, it's about 10 years in Japan, 13 years in the United Kingdom, and 8.5 years in France. That means that most of the debt was raised before rates started climbing.

For example, in France, the effective rate just recently rose above the 2% mark, which is significantly lower than the 10-year bond yield, which exceeded 4% for new issuances.

That said, in the United States, which has an average maturity of roughly six years, is experiencing a more rapid increase in its effective rate.

0:09:54 - Emmanuel Laborde

And this rate increase is happening in the context of high debt-to-GDP ratios and with modest growth, correct? Yes, that's correct.

0:10:05 - Guillaume Derrien

Debt levels have reached unprecedented heights since the end of World War II. And at the same time, growth is lower, hovering around 2% on average in the United States, 1% in Europe and 0.5% in Japan. What does that mean for debt servicing costs? So, debt servicing cost is already relatively high, but it is expected to grow further as debt issue before the 2022 rate hikes mature and are replaced with new instruments bearing higher interest rates. By 2030, interest costs could rise to levels last seen in 2000, specifically in France, around 4% of GDP.

Are all the countries equally affected by these trends? Actually, no. Some countries are managing to reduce their debt level.

Spain, Italy, even Japan have sufficiently improved their primary balance to achieve this, at least for the time being. And of course, we must speak about Germany. Yes, Germany is implementing investment programs that result in a higher public deficit and debt-to-GDP ratio. But this ratio started from a relatively low base at around above 60% of GDP. That said, in this current context, German bonds have risen. And because German bonds are used as a benchmark for Europe, it raises rates across all Eurozone countries. Is France the only country seeing its public debt go up?

No, it's not, Emmanuel. This is happening in the United Kingdom and in the United States. These economies, like France, are running public deficits that are ever close or exceed 5% of GDP, which is too large for debt ratio to stabilize on its own.

France and the United Kingdom are trying to gradually reduce their public deficit so as not to compromise growth. The United States is not going on that path yet, but market pressure could eventually force them to do so.

0:12:08 - Emmanuel Laborde

Thank you very much for your input, Guillaume. Thank you, Emmanuel. Let's go to the next segment. It's about the impact of rising bond yields on financing and investments in the Eurozone.

0:12:26 - Thomas Humblot

Hello, Thomas. Welcome. Hello. Thank you for having me today.

0:12:30 - Emmanuel Laborde

We've just seen what's behind the rise in Eurozone bond yields. This rise is partly attributed to the sovereign spread. What impact will this have on the economy?

0:12:42 - Thomas Humblot

Actually, this widening of some government bond spreads is obviously not good news, but it tends paradoxically to have less impact than an increase in long-term interest rates that does not include the sovereign risk premium. for example, in France, for a very long time, it has been considered that the 10-year OAT was the relevant benchmark for fixed loans. And at that time, the spread on French government bonds was relatively stable. But since 2024, that spread increased significantly and that renders the sovereign yield a less relevant benchmark.

And now the most relevant benchmark is the swap rate because it determines the cost of bank funding that backs new loans.

0:13:56 - Emmanuel Laborde

Since the end of 2024, we have seen a rise in long-term 10-year swap rates. What impact does this have on bank lending rates?

0:14:08 - Thomas Humblot

Fixed loans have obviously become more expensive, but to a lesser extent than if they were priced solely based on long-term sovereign rates. And what about existing fixed-rate loans?

There is no impact. An increase in rates for the entire maturity of a loan does not have any effect if it is a fixed-rate loan. Borrowers with outstanding loans are therefore protected. Obviously, new fixed loans are granted at higher rates. And this sharply contrasts with a floating-rates loans.

Because with floating-rates loans, borrowers experience regular rate adjustments throughout the term of the loan. And in terms of bank financing? Strictly in terms of bank financing, an increase in short-term rates has an immediate and widespread restrictive impact on borrowers, while for long-term interest rates, the impact is more gradual, and it comes gradually as the outstanding amount of fixed-rate loans are progressively renewed. And the thing is that since the beginning of the war in Iran, we have seen a combination of the two.

And in practical terms, the rate of new bank loans to non-financial corporations has increased about 25 basis points in the eurozone since the beginning of the year.

0:16:12 - Emmanuel Laborde

Just a few words about companies that borrow directly from the market.

0:16:16 - Thomas Humblot

Well, in that case, the impact is even more straightforward. The rate at which a company borrows from the market is the risk-free rate plus a premium.

0:16:28 - Emmanuel Laborde

Have risk premiums, known as corporate credit spreads, also increased?

0:16:34 - Thomas Humblot

Yes, they have increased temporarily at the beginning of the year but have returned to normal since. For the time being, the widening remains moderate for the highest-rated investment-grade issuers.

However, some significant bond issuance in the euro debt market due to some major US technology companies has increased spreads for longer maturities.

0:17:11 - Emmanuel Laborde

In particular terms, how does this affect the investment decisions of the companies?

0:17:19 - Thomas Humblot

Well, investments that were previously worthwhile due to returns sufficient to cover the cost of capital may no longer do so and in turn that might lead to a decrease in demand for financing.

0:17:40 - Emmanuel Laborde

Thank you very much Thomas. Now let us move on to the emerging economies. And it is with Cynthia Kalasopatan-Antoine.

Hello Cynthia, and welcome.

0:17:54 - Cynthia Kalasopatan-Antoine

Hi, Emmanuel. Hello, everyone.

0:17:57 - Emmanuel Laborde

Long-term bond yields rose significantly in advanced economies over the summer. What can we now say about emerging markets?

0:18:06 - Cynthia Kalasopatan-Antoine

Emerging bond markets held up well, which is quite unusual. The rise in long-term sovereign yields in emerging countries has been less pronounced than in advanced economies, including the United States and Germany. Now, there are two main exceptions, Turkey and Poland. Meanwhile, we did not witness any significant correction in emerging financial markets over the summer, and the main currencies appreciated slightly against the dollar or the euro.

0:18:37 - Emmanuel Laborde

Does this mean that public finances are more robust in emerging countries?

0:18:43 - Cynthia Kalasopatan-Antoine

Well, it depends. You see, in cases like the Czech Republic and South Korea, public debt is moderate and macroeconomic fundamentals are solid. However, these countries are now less frequently considered as emerging and tend to be viewed as newly advanced economies. By contrast, Brazil and South Africa have weaker public finances and investors have already incorporated a higher sovereign risk into their assessments. And this is reflected in the bond yields. And this assessment of sovereign risk did not really change over the summer.

0:19:26 - Emmanuel Laborde

When comparing the main fiscal metrics, what are the trends? What do you see as an economist?

0:19:33 - Cynthia Kalasopatan-Antoine

On average, the fiscal metrics in emerging markets are not substantially worse than those in advanced economies. The average budget deficit levels are similar, ranging from 4% to 5% of GDP in 2025-2026, according to the IMF. And as in advanced economies, the public debt is higher than its pre-Covid level. However, the average public debt to GDP ratio in emerging countries excluding China is close to 60%, whereas in advanced economies, it is above 100%.

0:20:12 - Emmanuel Laborde

Do you arrive at the same conclusion when comparing debt sustainability criteria?

0:20:17 - Cynthia Kalasopatan-Antoine

Well, there are significant regional differences. In emerging Asia, the factors that determine debt sustainability are more often favorable than those in advanced economies. In Central Europe, the gap between the interest rate paid on debt and the GDP growth rate is also favorable. However, the primary deficits in some countries are high.

0:20:45 - Emmanuel Laborde

In a few words, a brief overview of the situation in Latin America.

0:20:49 - Cynthia Kalasopatan-Antoine

Well, Brazil and Mexico are in a less favorable position. These countries would indeed need to generate a significant primary budget surplus each year in order to stabilize their debt in the medium term.

0:21:07 - Emmanuel Laborde

Economists use the term original sin, which refers to the situation when governments resort to borrowing in foreign currency to address the shortfall in domestic financing. Does this phenomenon continue to distinguish emerging countries?

0:21:24 - Cynthia Kalasopatan-Antoine

Yes, this is still the case. Emerging countries still have a significant share of their debt in foreign currency. This represents about 35 to 40% of their total debt on average. And in fact, now, this figure has decreased over the past decade, and this contributes to their resilience. However, governments in emerging markets have a less favorable position as regards their debt profile and their financing costs are also on average higher.

0:22:02 - Emmanuel Laborde

And finally, just a few words about a larger subject, China.

0:22:07 - Cynthia Kalasopatan-Antoine

China's public debt is significant and growing rapidly. That being said, it is denominated in domestic currency and issued in domestic markets. This debt is, however, sustainable in the medium term due to a very low effective interest rate and a high growth rate.

0:22:29 - Emmanuel Laborde

Thank you very much, Cynthia, for being with us today.

0:22:32 - Cynthia Kalasopatan-Antoine

Thank you.

0:22:33 - Emmanuel Laborde

It is now time to conclude, and we welcome back Group Chief Economist Isabelle Mateos y Lago.

It is time for our conclusion with Isabelle. Once again, just a final question, please. Could or should, I do not know which word is the good one, central banks intervene to curb this rise in interest rates?

0:22:58 - Isabelle Mateos y Lago

Absolutely not. The main contribution that central banks can bring to dealing with this situation is to restore price stability, as is their mandate, as promptly as possible. And in the current circumstances, this means keeping relatively high policy rates, in some cases, rising them further. And the responsibility for keeping public finances on a sustainable footing rests squarely with governments and any attempt by these governments to instead take the easy way out by pressuring central banks to lower interest rates prematurely would be enormously counterproductive.

0:23:41 - Emmanuel Laborde

Thank you very much, Isabelle. Thank you all for joining us today. Just a few words to remind you that additional economic research content can be found by scanning the QR code shown on your screen. Do not hesitate to use it with your smartphone. It is very easy. It was a pleasure to be with you today. Have a nice day and hope to see you so