EUROPEAN CENTRAL BANK

EUROSYSTEM

The shadow of fiscal dominance: misconceptions, perceptions and perspectives

Eurofi conference and
Centre for European Reform,
11 September 2020

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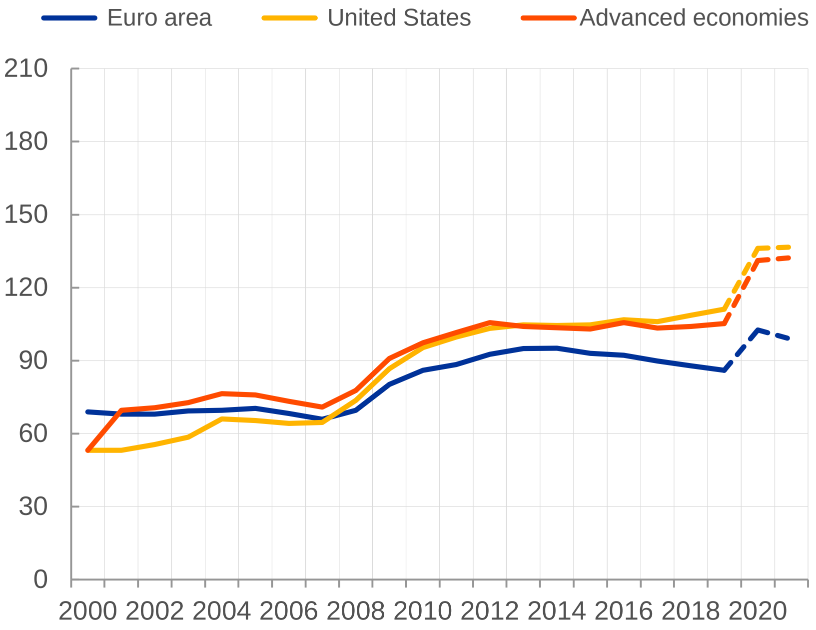
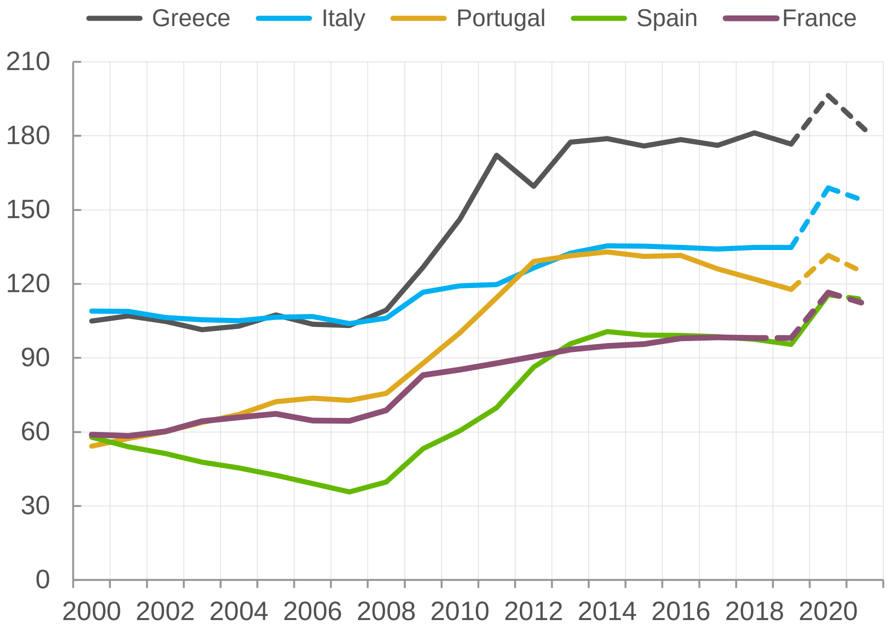
Global trend towards higher government debt ratios with substantial heterogeneity across euro area countries

General government gross debt (% of GDP)



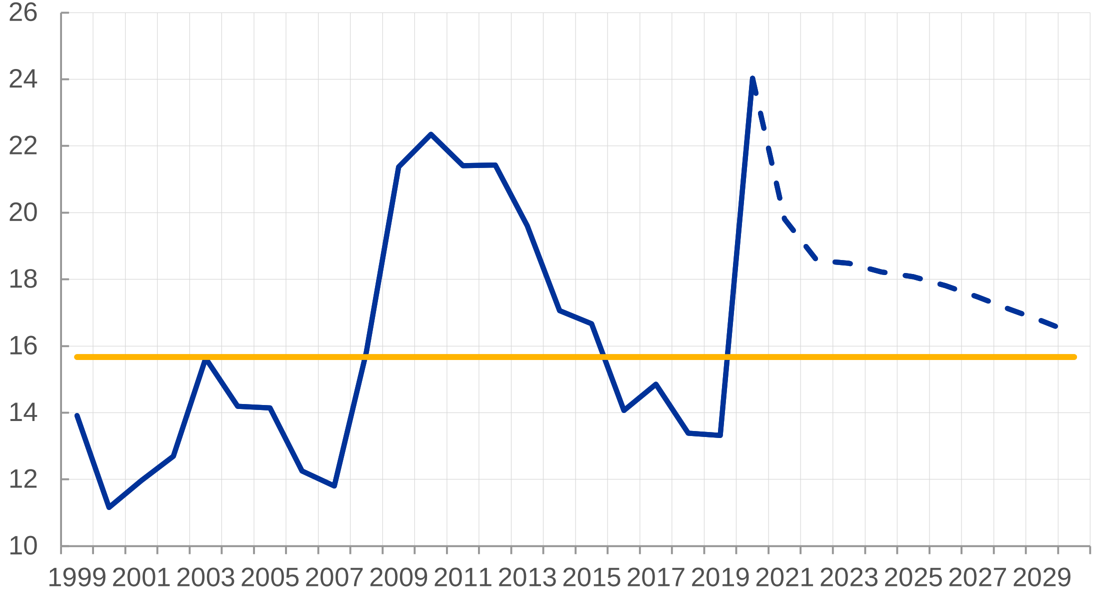
Sources: European Commission Economic Forecast Spring 2020 and IMF. Dashed lines are projections.



Source: European Commission Economic Forecast Spring 2020. Dashed lines are projections.

Government financing needs likely to remain elevated for a considerable period

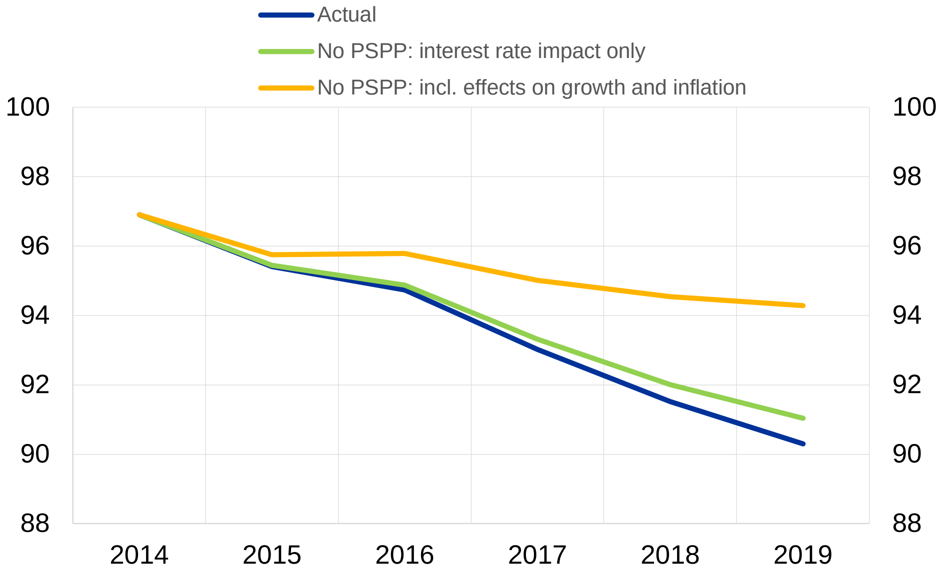
Euro area sovereign gross financing needs (% of GDP)



Source: ECB staff calculations.
Note: Gross financing needs are calculated as the sum of redemptions and the change in government debt. Future deficits are assumed to broadly comply with the Stability and Growth Pact. The dashed lines are projections. The yellow line indicates the average between 1999 and 2019.

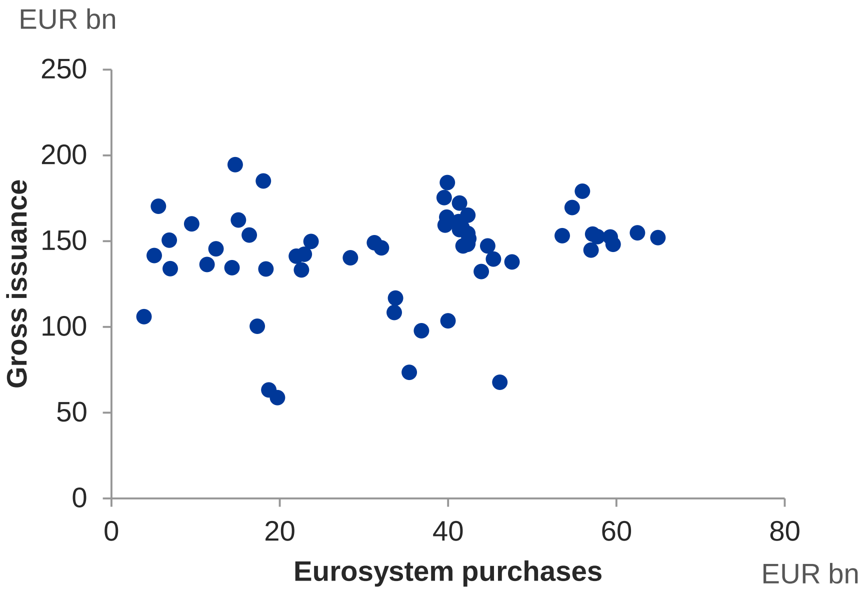
Central bank asset purchases affecting economic growth and public debt ratios, but no systemic relationship with public debt issuance

Government debt: actual and counterfactuals (% of GDP)



Source: ECB staff calculations.
Note: The counterfactual exercise of no-PSPP is based on internal estimates of the impact of the PSPP on the main sovereign financing rate (green line) and its impact on real GDP growth and inflation (yellow line).

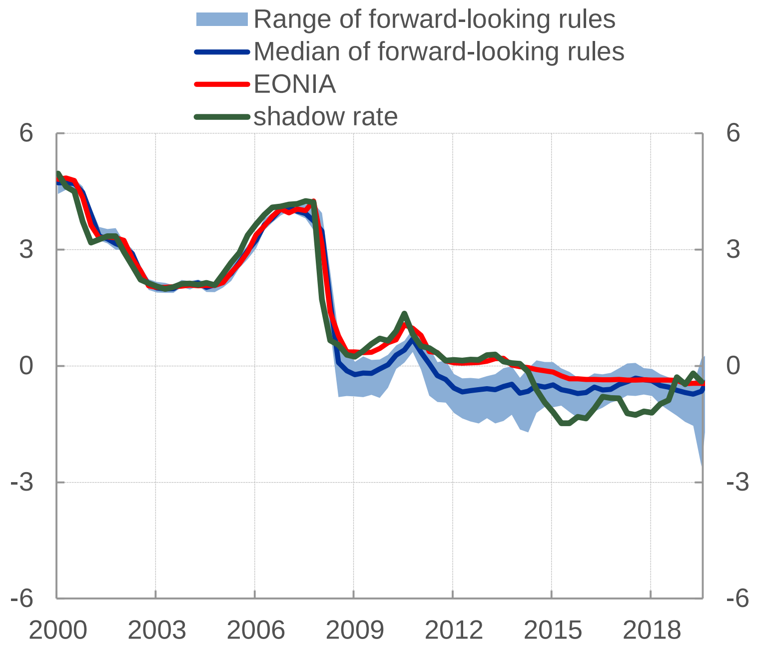
Debt securities issued by euro area central governments and Eurosystem purchases, 2015-2019



Source: ECB.
Note: Monthly data between March 2015 and December 2019. Eurosystem purchases refer to central government debt securities under the PSPP. Gross issuance covers euro-denominated debt securities by central governments in the euro area.

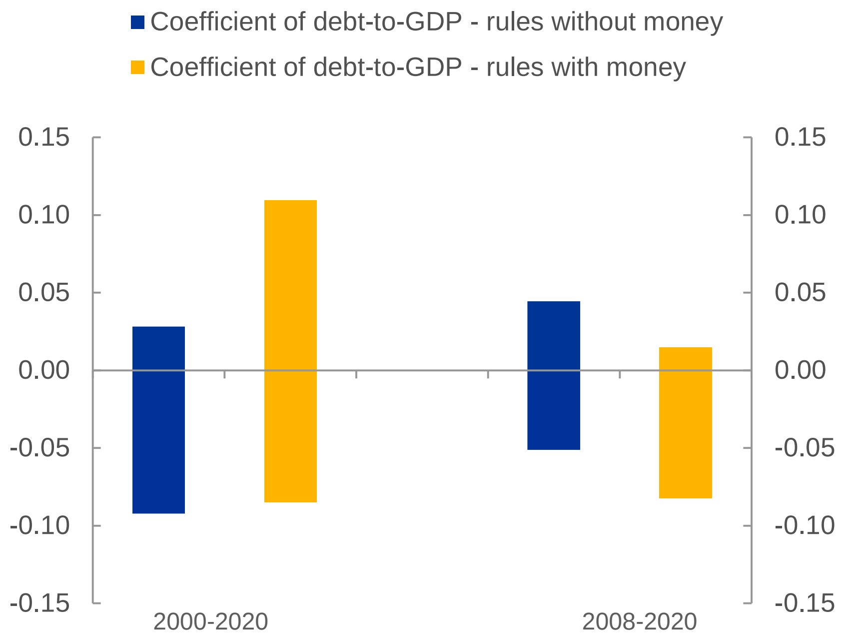
No change in the ECB's reaction function in response to rising debt levels

Taylor-type policy rules (%)



Sources: European Commission, ECB and ECB computations.
Notes: The estimated policy rules are derived using a real-time framework which estimates a variety of plausible specifications, using initially six measures of expected economic activity, four indicators of inflation expectations, and two credit variables. The light blue range shows the resultant min/max range of all rules, which are estimated over the sample 2000Q3 to 2008Q2. The shadow rate represents an estimate for the short-term interest rate that would prevail in the absence of the lower bound, see Lemke and Vladu (2017), "Below the zero lower bound: a shadow-rate term structure model for the euro area", ECB Working Paper No 1991.
Latest observation: 2020Q2, June BMPE.

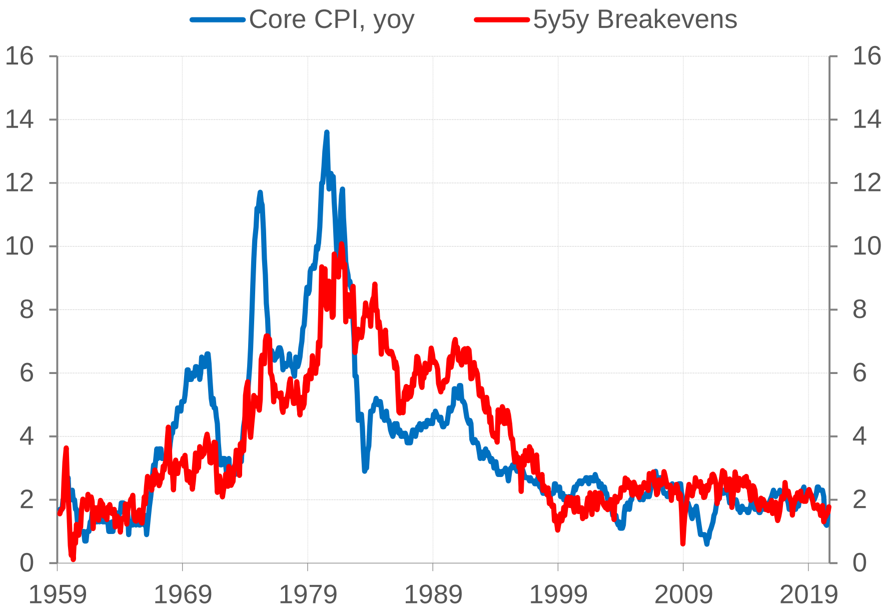
Confidence intervals of policy rules with sovereign debt



Source: European Commission, ECB and ECB computations.
Notes: The confidence intervals were derived using the set of rules shown on the left-hand side with the additional inclusion of the debt-to-GDP ratio.

No signs of sharply rising inflation expectations

US core CPI and 5y5y breakeven inflation rates (%)



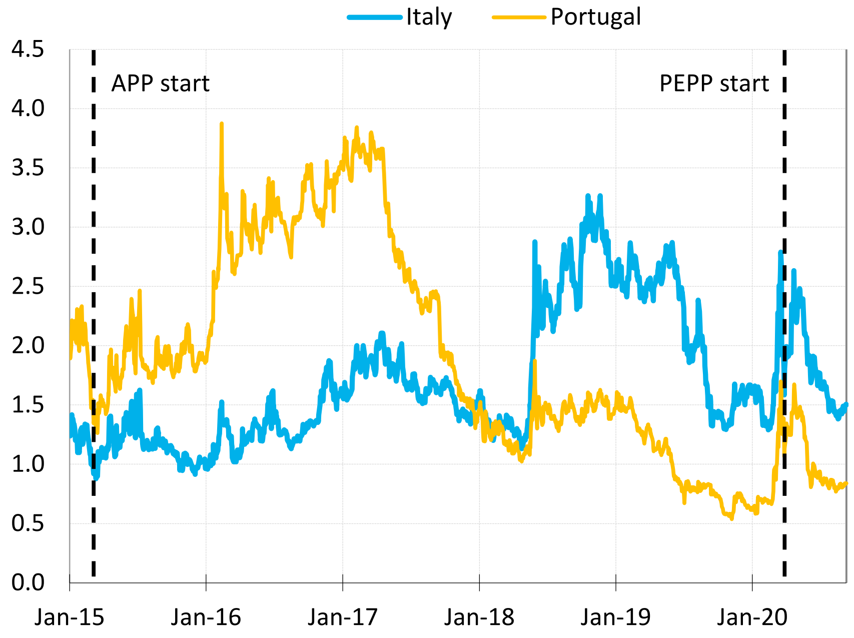
Source: Goldman Sachs.
Notes: Backcasting of inflation breakevens based on a methodology proposed by Groen, J. and M. Middeldorp (2013), "Creating a History of U.S. Inflation Expectations", Liberty Street Economics, 21 August.
Last observation: August 2020.

Euro area 5y5y breakeven inflation rates (%)

Source: Refinitiv, ECB calculations.
Notes: The BEIR is calculated by subtracting seasonally adjusted real rates of HICPxT inflation-linked bonds from same-maturity nominal bond yields of the same issuing country. Latest data: 8 September 2020.

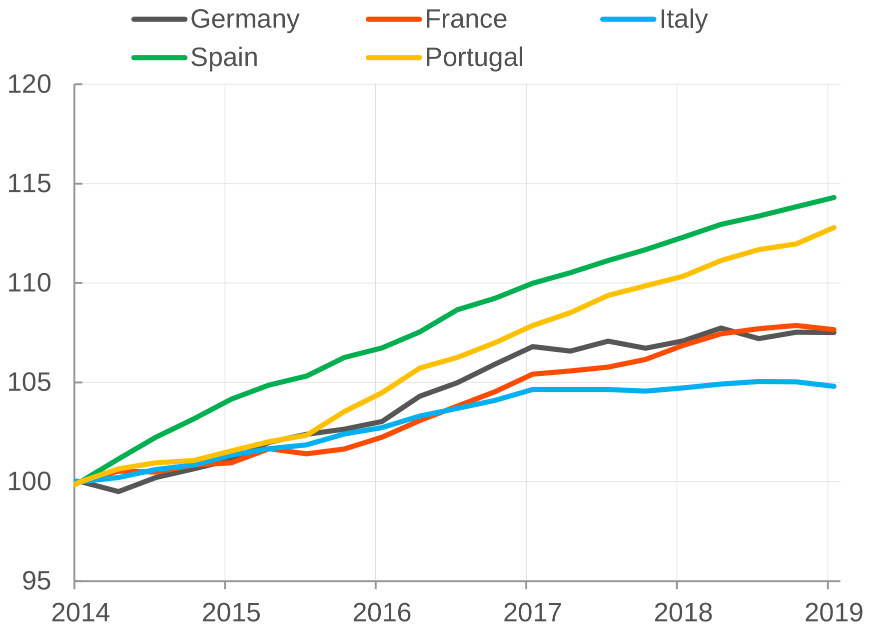
Sovereign bond spreads reflecting fundamental factors

10-year yield spreads of selected government bonds over German equivalents (%)



Source: Bloomberg.
Last observation: 31 August 2020.

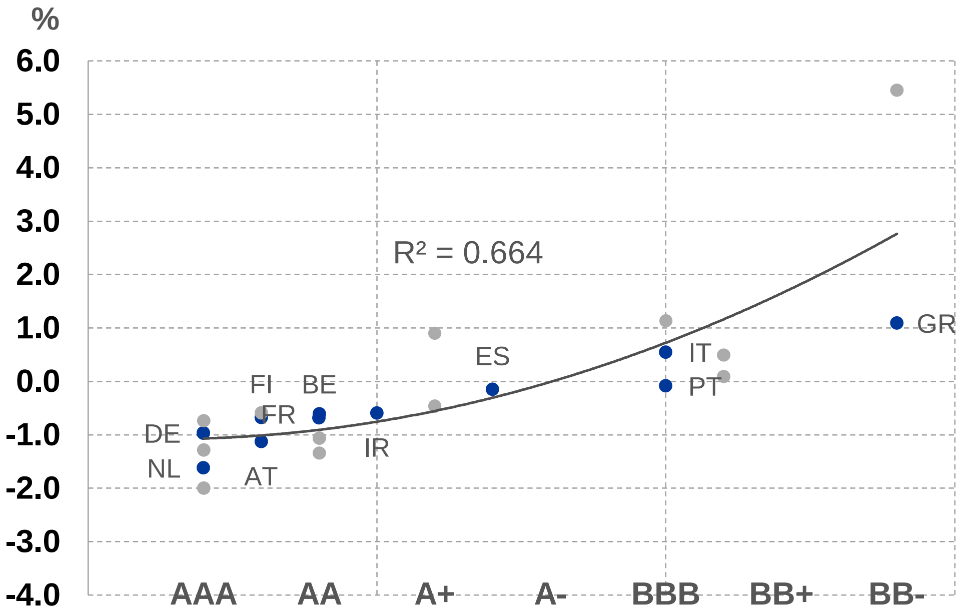
Real GDP (index: 2014Q4 = 100)



Source: Eurostat.
Latest observation: 2019Q4.

Euro area sovereign bonds trading in line with international peers

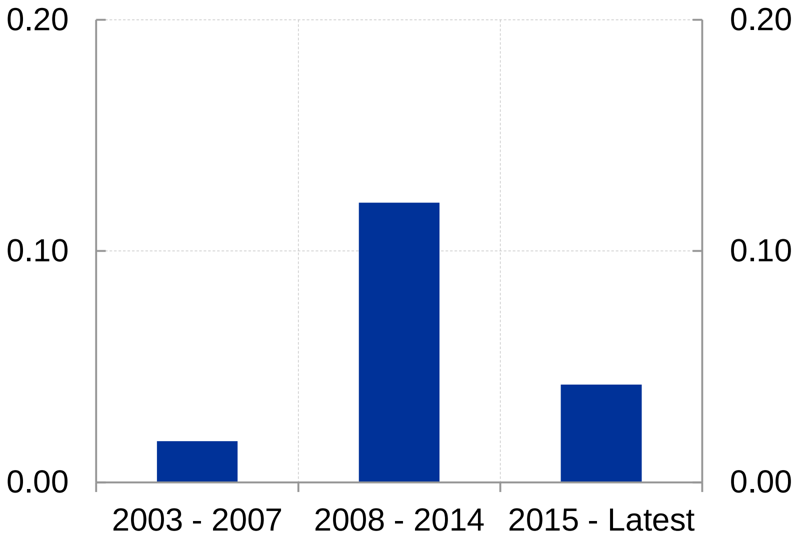
Risk premia and credit ratings



Sources: Bloomberg, Refinitiv Datastream and ECB staff calculations.
Notes: The ratings are the foreign-currency long-term ratings from S&P. Term premia are estimated based on zero-coupon sovereign bond yields using the Dynamic Nelson-Siegel model. For the euro area, the expectation component is estimated from euro OIS data. Data points from non-euro area countries are marked in grey. The trendline represents the estimated term premium based on a second-order polynomial regression of the term premium on discretely scaled S&P ratings.
Latest observation: July 2020.

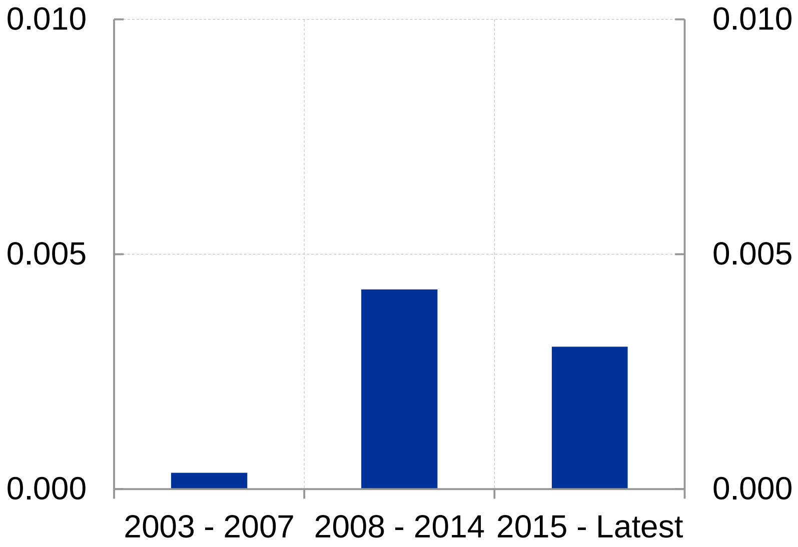
Euro area sovereign spreads remaining sensitive to macroeconomic and financial factors

Sensitivity of euro area sovereign spread to macroeconomic surprises (sum of regression coefficients)



Sources: Bloomberg, Refinitiv and ECB calculations.
Notes: Sensitivity is defined as the sum of absolute values of estimated coefficients, where coefficients result from univariate regressions, spanning the indicated time period, of daily changes in the 10-year EA GDP-weighted sovereign spread over the 10-year OIS on euro area macroeconomic surprises. Macroeconomic surprises are standardised deviations of Bloomberg median survey of analysts' forecasts from actual release values.

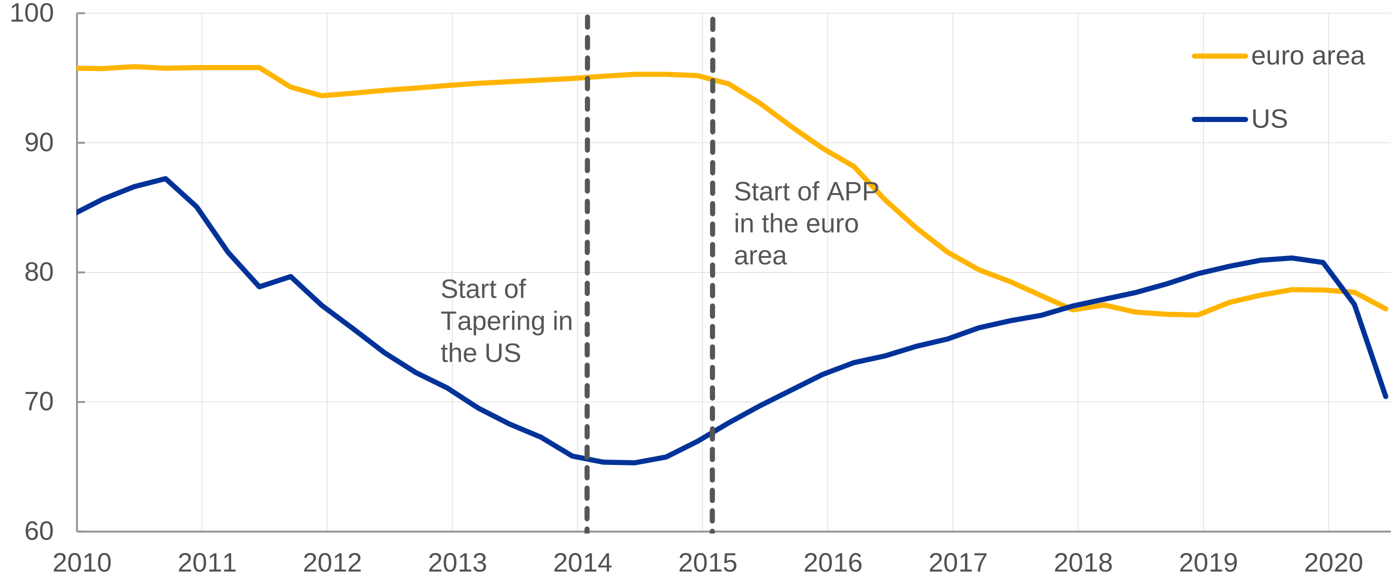
Sensitivity of euro area sovereign spread to financial market risk (regression coefficient)



Sources: Refinitiv and ECB calculations.
Notes: Sensitivity is defined as the regression coefficient from a regression of the daily changes of the 10-year euro area GDP-weighted sovereign spread over the 10-year OIS on daily changes in the VSTOXX. Latest observation: August 2020

Largest part of sovereign debt held outside of central banks, supporting price discovery

Developments in the bond free float (percent)

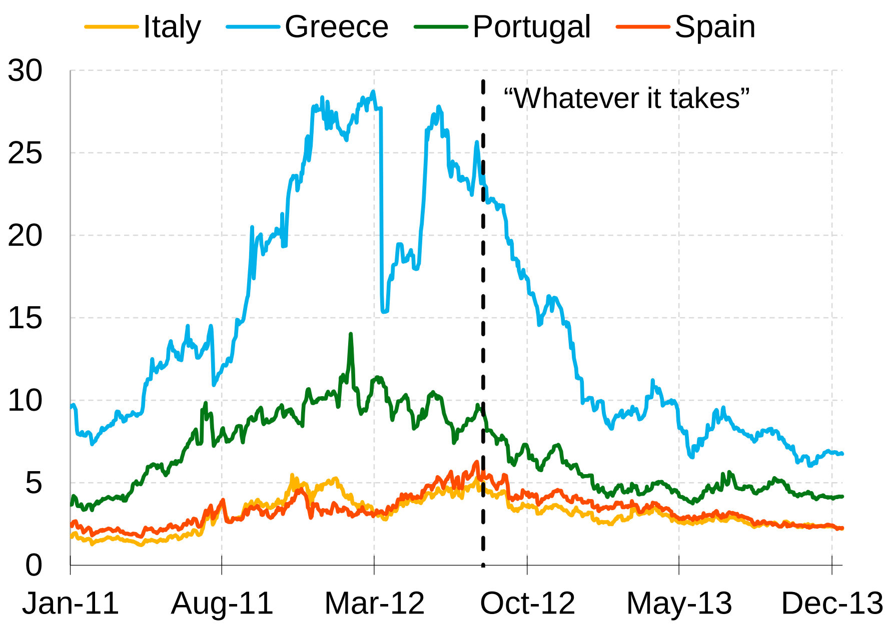


Sources: SHS, ECB, ECB Calculations.
Notes: The free float measure is defined as the ten-year equivalent holdings of general government bonds by all investors other than the domestic central banks as a share of total supply. The bond free float for the euro area refers to the big-4 (Germany, France, Italy and Spain).
Last observation: Q2 2020.

Central bank actions allowing markets to coordinate on the "good" equilibrium

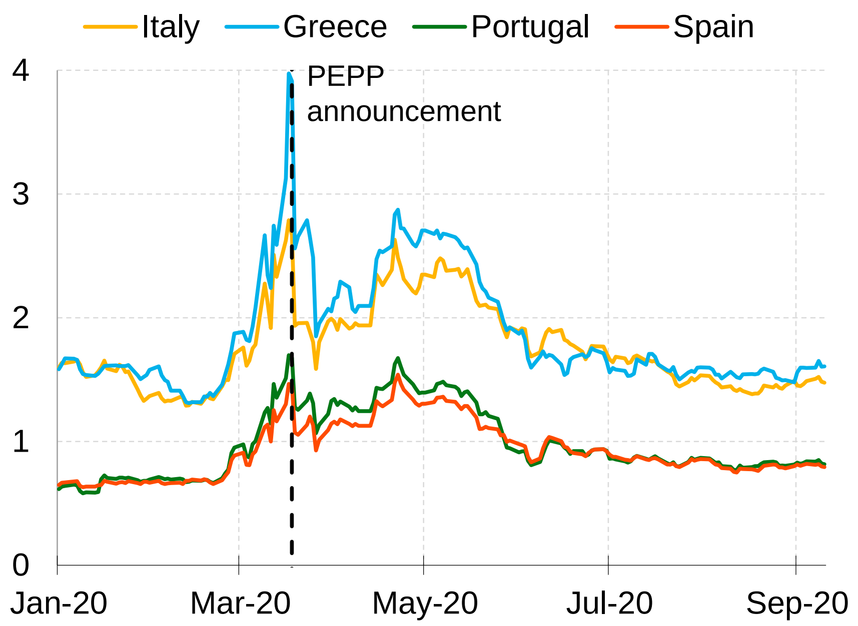
10-year yield spreads of selected government bonds over German equivalents (%)

OMT announcement



Source: Bloomberg.

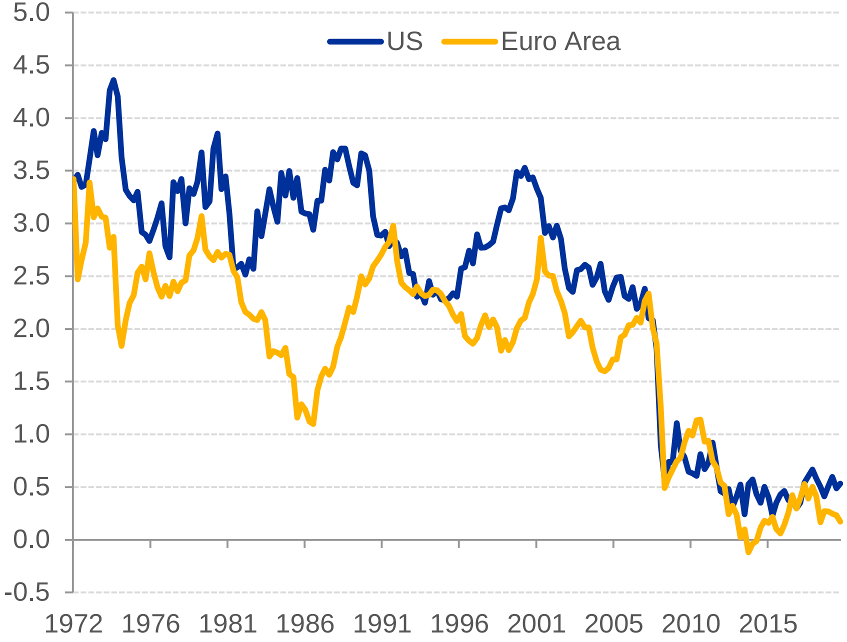
PEPP announcement



Source: Bloomberg. Last observation: 10 September 2020

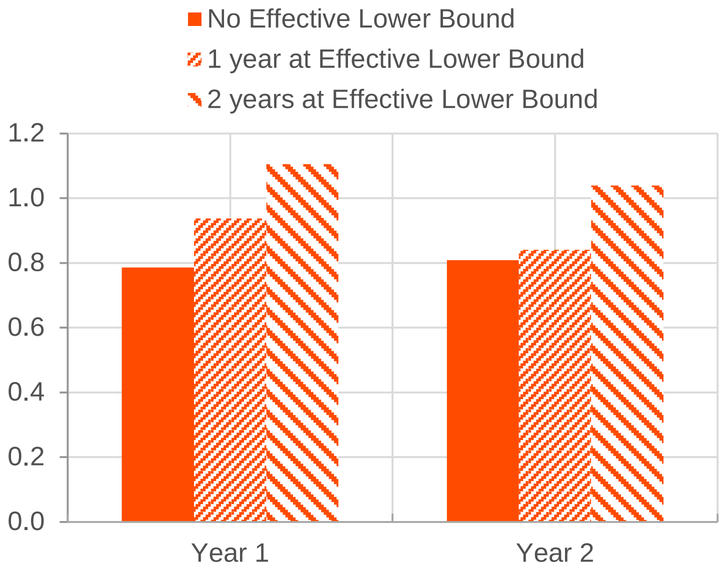
Less conventional monetary policy space rendering fiscal policy more important and more effective

Real natural rate (%)



Source: Holston et al. (2017), "Measuring the Natural rate of Interest: International Trends and Determinants", Journal of International Economics, Vol.108, Supplement 1, pp. S59-S75.

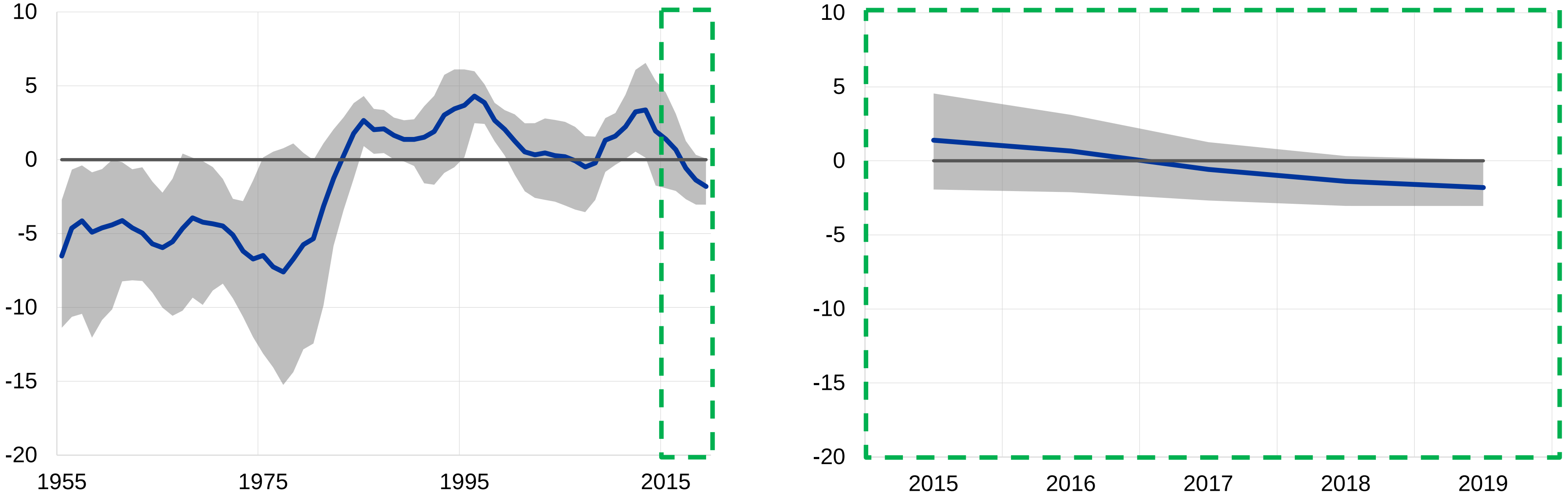
Government spending multipliers (%)



Source: ECB.
Notes: In % deviation from steady state levels.
The assumed shock is an increase of the government consumption-to-GDP ratio by 1pp.
Model simulation based on: New Area Wide Model with a range of fiscal instruments, see Coenen et al. (2008), "Tax reform and labour-market performance in the euro area: A simulation-based analysis using the New Area-Wide Model", Journal of Economic Dynamics and Control, Vol. 32, I. 8, pp. 2543-2583.

Negative “r-g” not to be taken for granted

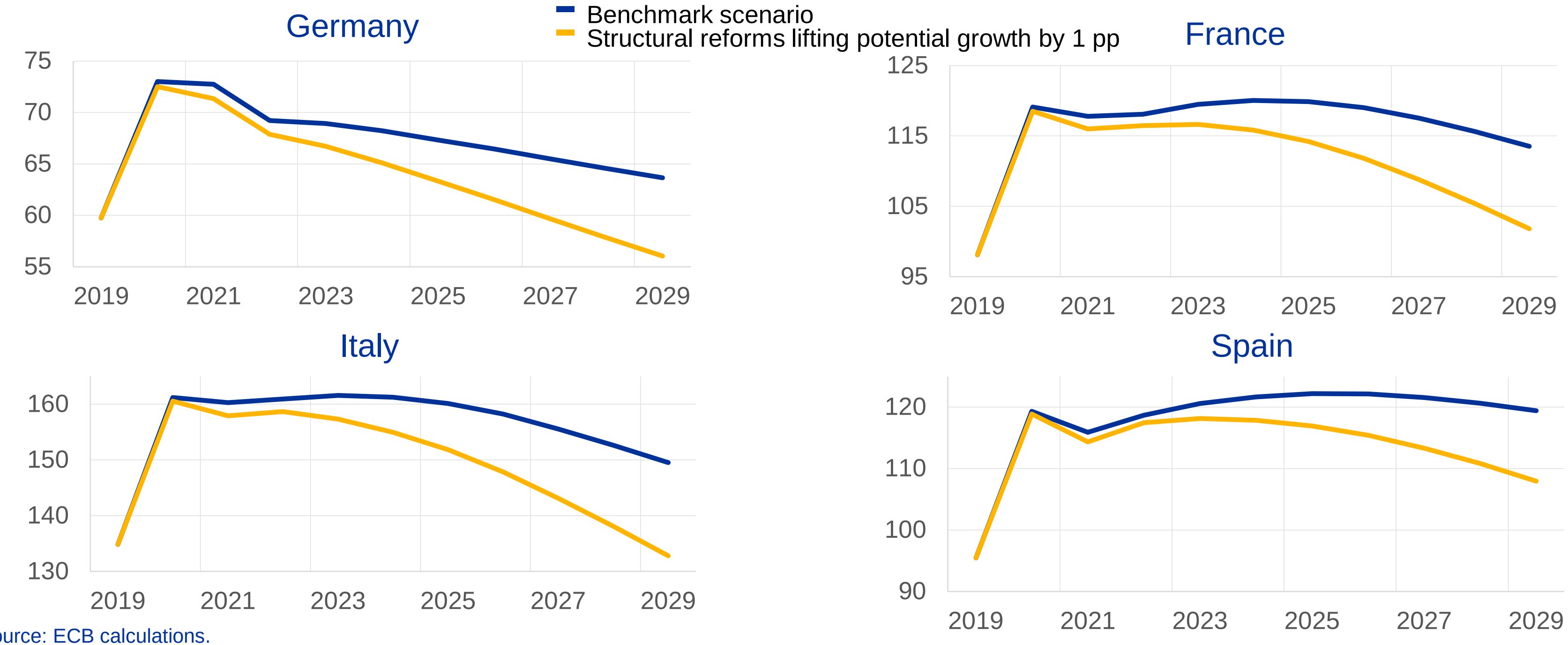
Euro area interest-growth differential (percentage points)



Source: European Commission’s AMECO database and Jordà et al. (2017), “Macrofinancial History and the New Business Cycle Facts”, in NBER Macroeconomics Annual 2016, Vol. 31, edited by Martin Eichenbaum and Jonathan A. Parker. Chicago: University of Chicago Press.
Note: Long-term interest rate on government debt minus nominal GDP growth. The grey band represents the minimum and maximum values among DE, FR, IT and ES.

Improving debt dynamics through structural reforms

Government debt (% of GDP)



Source: ECB calculations.
Note: Benchmark of compliance with Stability and Growth Pact requirement (blue line). Yellow lines assumes that the economy will improve permanently its potential growth rate by 1 pp as of 2021.

Thank you!