AIReF Autoridad Independiente de Responsabilidad Fiscal

Debt Monitor

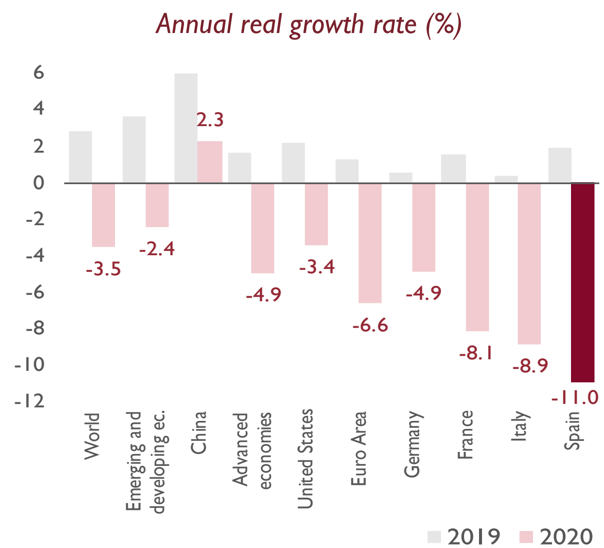
March 2021

- *The COVID-19 pandemic has caused an unprecedented economic crisis worldwide, with global GDP falling by 3.5% in 2020. The Spanish economy recorded a contraction in real terms of 11%, and is therefore among the economies most punished by the pandemic.*
- *The adoption of unprecedented fiscal measures alongside the operation of automatic stabilisers has made it possible to soften some of the adverse effects of the pandemic, while at the same time leading to a very significant deterioration in the public accounts. The public deficit in 2020 stands at over 10% of GDP in a large number of economies, and government debt ratios have risen considerably in all countries.*
- *The Spanish debt-to-GDP ratio stood at 117.1% in 2020, an increase of 21.6 points on 2019. Almost half of this increase (10.6 points) is due to the fall in GDP. This large denominator effect is one of the biggest in the international comparison. In contrast, the contribution of the fiscal balance to the worsening of the debt ratio (10.9 points) is in line with that of the main comparable economies.*
- *The outbreak and development of the health crisis set the tone for financial markets throughout 2020. Despite the severity of the crisis, large-scale monetary policy support has helped stabilise the financing conditions of sovereign and corporate debt.*
- *The gross borrowing needs of the Public Treasury rose significantly in 2020, reaching an all-time high both in monetary terms (€277bn) and in relation to GDP (25%). Borrowing needs are expected to stabilise over the coming years as the fall in net borrowing resulting from the normalisation of the health situation will be offset by the higher repayments associated with a much higher level of debt.*
- *The various public asset purchase programmes of the ECB that began in 2015 and intensified in 2020 have made the Bank of Spain one of the main holders of Spanish public debt. The volume of net purchases made in 2020 and planned for 2021 will cover over 100% of the net borrowing needs of these years.*
- *The global fall in interest rates and the lengthening of debt maturities have alleviated to some extent the risks associated with maintaining high levels of debt. The financial burden, one of the main indicators of a country's debt sustainability, has fallen for the sixth consecutive year both in absolute terms and as a percentage of GDP, with interest expenditure at the end of 2020 standing at 2.3%.*
- *The current low interest rate environment will favour the dynamics of the debt ratio, helping to generate a positive "snowball" effect over the coming years. A negative interest rate differential over growth will allow the debt ratio to remain stable even while maintaining a structural primary deficit in the medium term.*

- *The current expectations of a lasting low interest rate environment offer greater room for manoeuvre when designing a medium-term consolidation strategy, and in theory make it possible to return to a balanced budget in a gradual manner that is not detrimental to growth.*
- *Achieving a balanced budget will be essential in order to cope with the debt pressure associated with the increase in pension expenditure resulting from the ageing population and to avoid maintaining the debt level above a threshold, which, according to economic literature, might be associated with a negative impact on growth.*
- *The expected rebound in economic activity in the coming quarters, together with some improvement in the cyclical component of the government balance, project a stabilisation and even a reduction in the debt ratio in the next two years.*
- *However, the pandemic has heightened the challenges associated with the high levels of public debt, the future sustainability of which is strongly linked to the policies of the European Central Bank. The withdrawal of non-conventional monetary policy instruments in the future may lead to an upturn in interest rates to levels more in line with their historical trend.*
- *High debt levels increase vulnerability to possible changes in the economy's borrowing conditions. Therefore, a medium-term consolidation strategy that will help mitigate those risks needs to be designed as soon as possible. The increase in the average life of the debt portfolio provides some protection against future interest rate increases by allowing these rises to be transferred to the actual financial burden very gradually over several years. However, in the medium and long term, an upturn in interest rates may have an extremely large impact on the financial burden given the high accumulation of debt, which would eventually feed back into higher levels of debt.*
- *The amortisation of a larger stock of debt will in turn imply an increase in gross borrowing needs over the coming years, although the intensification of long-term securities issues in recent years will allow this risk to be adequately mitigated. In the long term, the reduction of sovereign debt on the ECB's balance sheet might pose a major challenge that is not without risk as it will require the return of a significant part of the investor base that has been displaced over recent years.*
- *Although there is a significant risk that part of the COVID-19 Guarantee Lines will be enforced, the impact of the materialisation of these contingent liabilities on government debt is limited and does not endanger its sustainability.*
- *The increase in structural expenditure linked to an ageing population is one of the major risks for the sustainability of public finances in the medium term. Higher expenditure on healthcare and on pensions that is not covered by additional revenue will lead to a very significant rise in debt from historically very high levels.*

❶ The COVID-19 pandemic that erupted in the first quarter of 2020 has triggered an unprecedented global economic crisis. Recent estimates point to a contraction in global GDP of between 3% and 4% in 2020. In the last 40 years, the world economy had only recorded a slight fall (0.1%) in 2009, in the period of the Great Recession following the financial crisis.

According to the flash estimate of GDP growth published by the National Statistics Institute (INE), the Spanish economy recorded a contraction in real terms of 11% in 2020, thus ranking among the world economies most affected by the pandemic according to the latest figures published by Eurostat and the latest forecasts by the International Monetary Fund (WEO of January 2021). The size of the fall in GDP in Spain is twice that estimated for countries such as Germany and considerably higher than in the Eurozone as a whole (-6.6%).

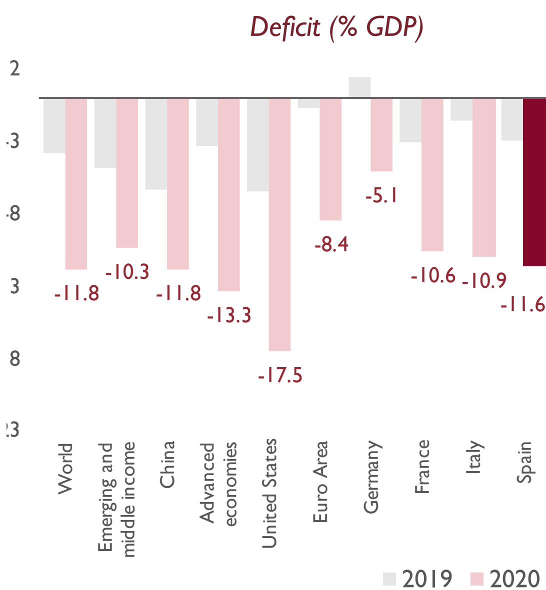


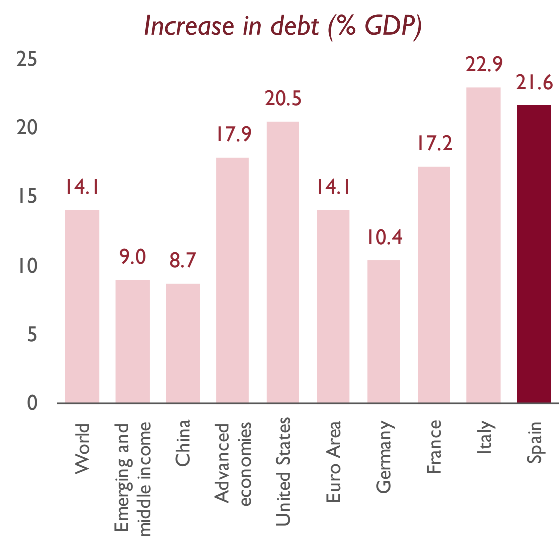
Source: INE, Eurostat and IMF (WEO Jan 2021)

Uncertainty about the prospects for recovery will remain particularly high as long as the pandemic continues to condition economic activity. According to the main international institutions, growth should resume in 2021-22. However, the recovery is expected to be incomplete over this time horizon and to differ widely across countries.

❷ In order to address the health crisis, ensure liquidity support and assistance to companies and avoid mass redundancies, governments have taken unprecedented fiscal measures, which, together with the operation of automatic stabilisers, have resulted in a very significant worsening of public accounts. The government deficit will exceed 10% of GDP in a large number of world economies in 2020. Given the exceptional nature of the situation, the "general escape clause" of the EU Stability and Growth Pact has been activated, with adjustment requirements temporarily suspended. The gradual disappearance of the emergency measures related to the pandemic, as well as the expected rebound in economic activity, will result in a significant improvement in government balances in 2021 and 2022.

The deterioration in public accounts has led to a significant increase in the government debt ratios of economies worldwide in 2020. In particular, it is estimated that the global and the Eurozone debt ratios will increase by close to 15 points of GDP, which in both cases stand at around 100%. In 2021 and 2022, some stabilisation at these record high levels is projected.



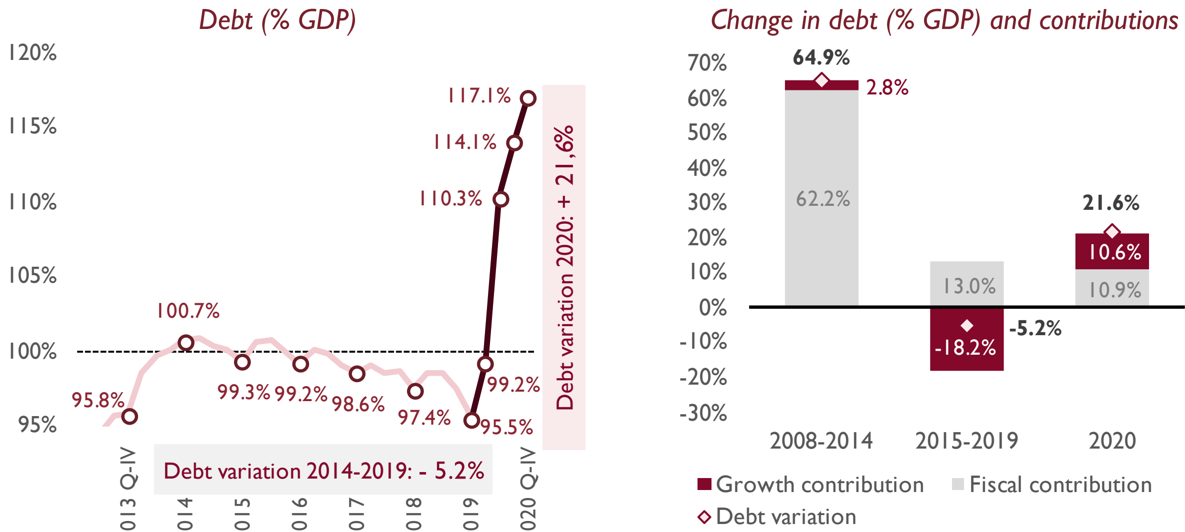


Source: Bank of Spain and IMF (WEO Jan 2021)

Evolution of Spanish debt in 2020

❸ The Spanish debt-to-GDP ratio stood at 117.1% in 2020, an increase of 21.6 points on the level of the previous year. Almost half of this increase (10.6 points), one of the largest in the international comparison, is due to the fall in GDP, the denominator of the ratio. For its part, the fiscal balance contributed almost 11 points to the rise in the debt ratio, in line with the main comparable economies.

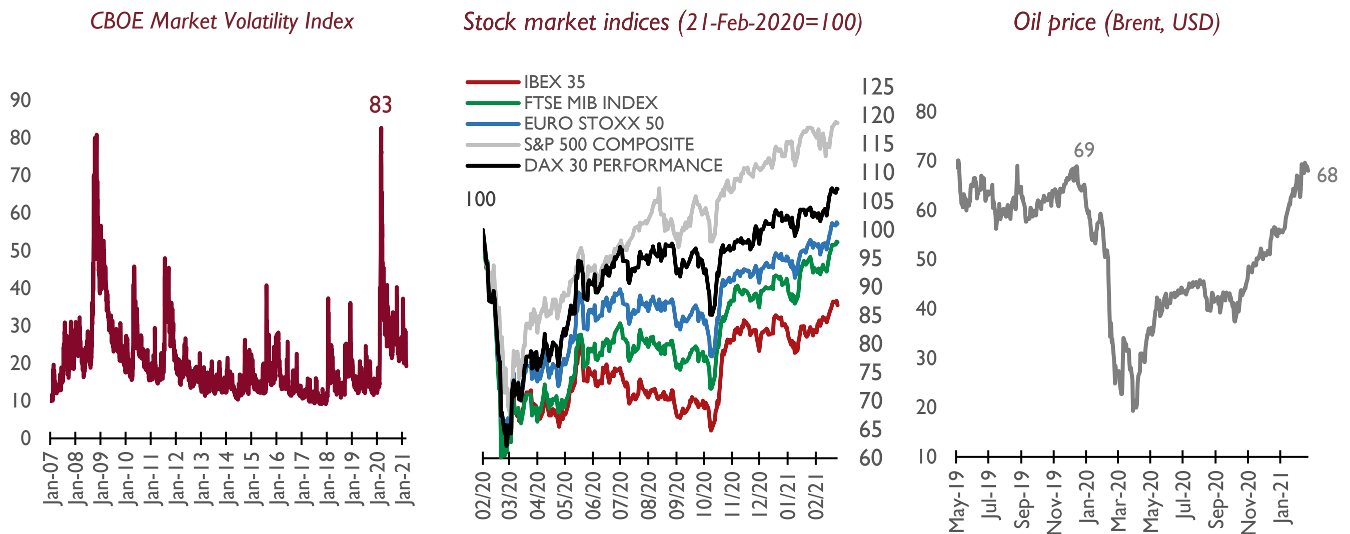
Central Government has borne the bulk of the debt increase by financing, through extraordinary transfers, a major part of the expenditure associated with the coronavirus pandemic. In addition, it has not passed on the fall in fiscal revenue in the instalment payments made to the Autonomous Regions under the ordinary regime. Accordingly, the debt ratio of the Autonomous Regions only rose by 3.4 points – to stand at 27.1% of GDP – of which 2.6 points are attributable to the denominator effect.



Source: Bank of Spain, INE and AIReF

Evolution of financial markets

❹ The health crisis has set the tone for financial markets throughout 2020. At the end of February, stock markets, commodities and bond prices recorded very fast and deep drops, while volatility indices, which measure fear and uncertainty, rose to all-time highs. After the uncertainty of the first few months, a period of consolidation and uneven recovery between assets and markets began. The announcements last November about the effectiveness and authorisation of several vaccines, together with excess liquidity and the approval of new stimulus packages, have led to sharp increases in financial asset prices, with many of them trading at levels higher than those recorded before the crisis.



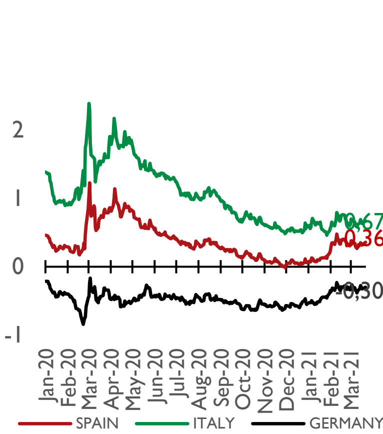
Source: Refinitiv

Evolution of sovereign debt markets

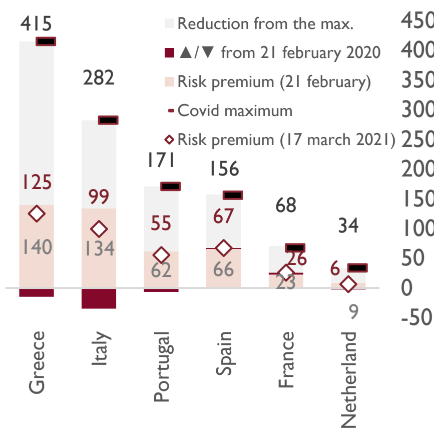
❺ Sovereign debt markets recorded a sharp rise in yields at the beginning of the crisis, mainly in the case of "peripheral" countries. In particular, the yield on the Spanish 10-year bond rose by over 100 basis points in just fifteen days. The rapid and strong reaction of the ECB in March with the announcement of the Pandemic Emergency Purchase Programme (PEPP) and its subsequent extensions has prevented the fragmentation of European bond spreads. Sovereign debt spreads have recovered to pre-health crisis levels and the term yield curve has even fallen below the pre-pandemic level, standing firmly in negative territory for terms of less than five years.

Despite the seriousness of the crisis, large-scale monetary policy support has helped stabilise debt financing conditions, both for sovereign and corporate debt, in a year when European governments have issued over €1 trillion of net debt.

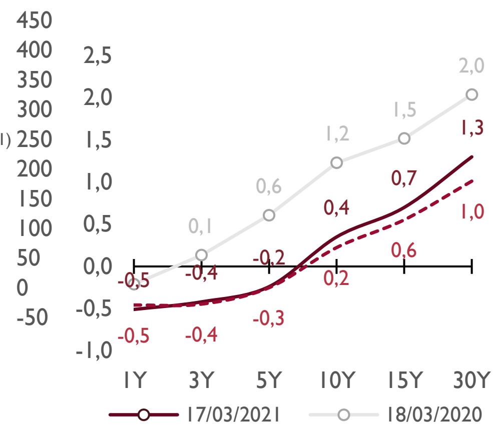
Yield on 10-year sovereign bond (%)



Risk premium from feb-2020 (bp)



Spanish interest rate curve (%)



Source: Refinitiv

Borrowing needs

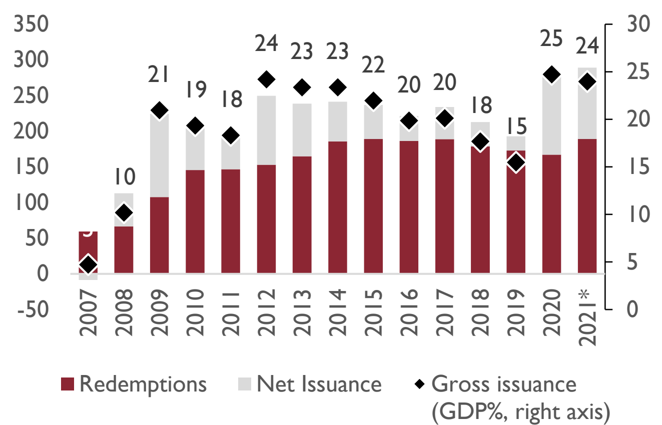
❻ The borrowing needs of the Public Treasury increased significantly in 2020. As a result of discretionary spending measures and the counter-cyclical evolution of automatic stabilisers, the programme announced at the start of the year was revised in May. Gross issuance (€277bn) recorded its all-time high in both monetary and GDP terms (25%) in 2020. For 2021, a slight increase in gross borrowing needs is estimated despite the €10bn decrease in net issuance compared with 2020, as a result of the increase in refinancing and greater use of short-term instruments.

After rising sharply as a result of the global financial crisis – from 5% of GDP in 2007 to more than 20% in 2010 – borrowing needs stabilised (lower as a percentage of GDP) over the following years. They then shot up in 2020 to 25%. Over the coming years, net borrowing needs are forecast to fall as a result of the normalisation of the health situation, which will be partly offset by higher repayments associated with a much higher level of debt. This will lead to a stabilisation of gross borrowing needs in monetary terms, which will gradually decline relative to GDP.

Treasury borrowing in 2020 and 2021 (€bn)

(In billion euros)	Forecast 2020	End 2020	Forecast 2021
Total Net Issuance	**32.5**	**109.9**	**100.0**
Total Gross Issuance	**196.5**	**277.1**	**289.1**
Medium- and Long-term			
Gross Issuance	117.5	183.5	184.4
Of which SURE	-	*10.0*	*11.3*
Amortisation	85.0	85.0	94.4
Net Issuance	32.5	98.5	90.0
Of which SURE	-	*10.0*	*11.3*
Letras del Tesoro			
Gross Issuance	79.0	93.6	104.8
Amortisation	79.0	82.2	94.8
Net Issuance	0.0	11.4	10.0

Treasury borrowing needs (€bn and % GDP)



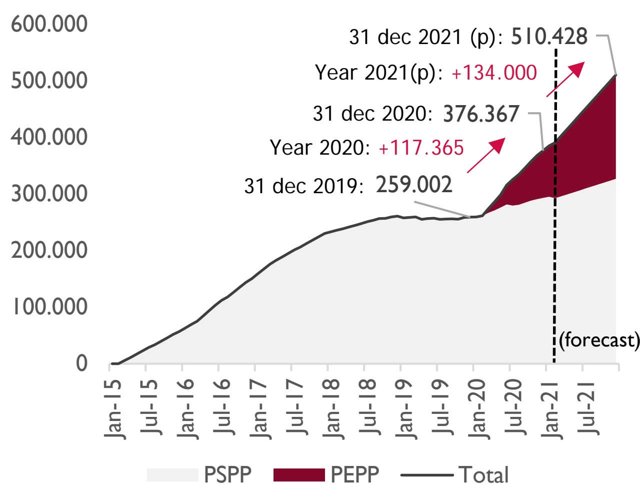
Source: Public Treasury

Debt purchases & holdings of the Central Bank

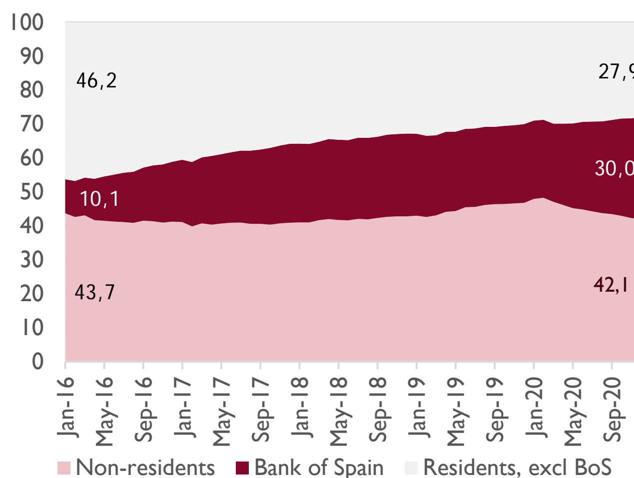
❼ The ECB's various public asset purchase programmes initiated in 2015 and intensified in 2020 have made the Bank of Spain one of the main holders of Spanish government debt, increasing its share of total debt by 20 points in the last five years to around 30%. This increase in holdings has displaced part of the resident investor base, with non-resident investment in securities remaining stable at slightly over 40%.

Over 2020, the ECB has made net purchases of Spanish debt for an amount greater than 100% of the net borrowing needs. Similarly, it is expected that in 2021 it will make purchases for an amount greater than the net needs for the year.

ECB net purchases of Spanish debt (€m)



Holdings of government debt by investor type (%)



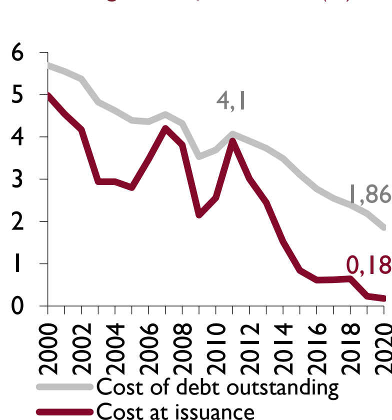
Source: European Central Bank and Bank of Spain

Financial burden of the debt

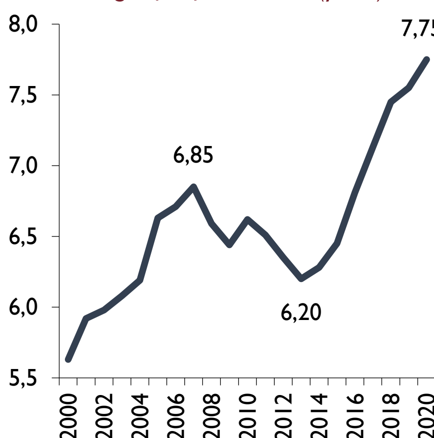
❽ The global fall in interest rates and the lengthening of debt maturities have mitigated in recent years some of the risks involved in maintaining high debt levels. In 2020, despite higher borrowing needs, the cost of borrowing continued to fall, recording a new all-time low. Specifically, the average cost of outstanding State Debt stood at 1.86%, below the 2.19% at the end of 2019. The average cost of new issues fell to 0.18%, compared with 0.23% in 2019. This has been helped by the fact that just over 50% of the State debt issued during the year was allocated at negative rates, resulting in record low yields along practically the entire curve. It should be noted that at the end of the year, the Treasury managed to auction off a 10-year bond at a negative interest rate.

As a result, the State's financial burden has been reduced for the sixth consecutive year, with interest expenditure at the end of 2020 standing at 2.3% of GDP. Since mid-2012, the effective cost of financing General Government debt has been systematically reduced by a cumulative total of 210 basis points. This has made it possible to reduce interest expenditure both in absolute terms and as a percentage of GDP - one of the main indicators of a country's debt sustainability.

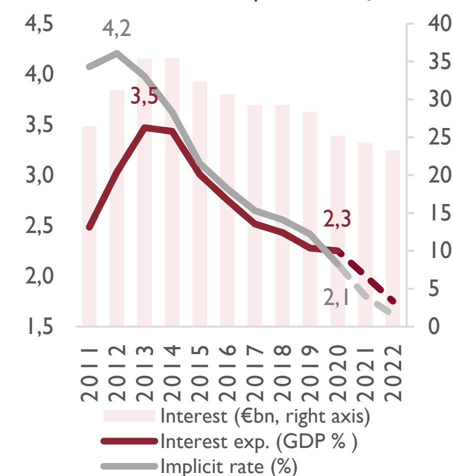
Average cost of State debt (%)



Average life of State debt (years)



Financial burden and implicit rate of the debt



Source: Public Treasury, General Intervention Board of the State Administration (IGAE) and AIReF

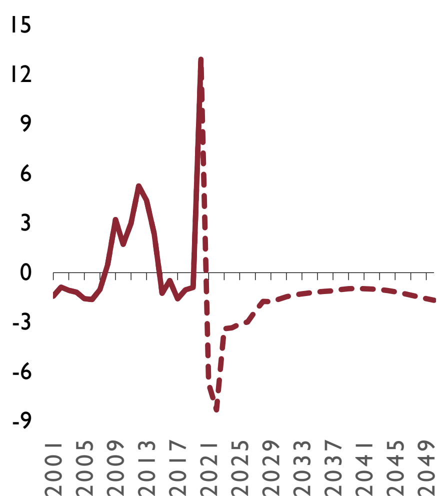
❾ The forecast that the current low interest rate environment will be maintained over a long period of time favours the dynamics of the debt ratio, helping to generate a positive "snowball" effect over the coming years. A negative interest-rate differential over growth allows the debt ratio to remain stable even while maintaining a structural primary deficit in the medium term.

The current expectations of a lasting low interest rate environment offer greater room for manoeuvre when designing a medium-term consolidation strategy, and in theory make it possible to return to a balanced budget in a gradual manner that is not detrimental to growth. Achieving a balanced budget will be essential in order to cope with the debt pressure associated with the increase in pension expenditure resulting from the ageing population and avoid maintaining the debt level above a threshold, which, according to economic literature, might be associated with a negative impact on growth.

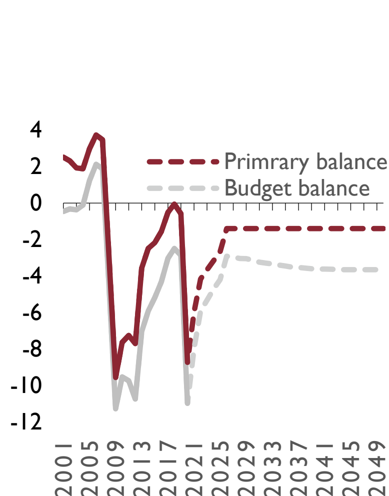
Snowball effect and debt dynamics

Snowball effect and debt dynamics

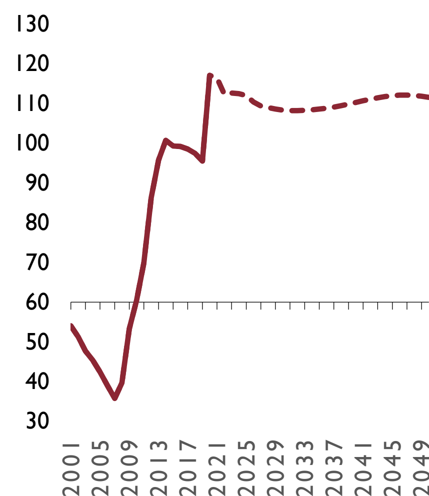
Interest-growth differential (contribution to change in debt, GDP points)



Debt stabilising primary deficit (% GDP), under current interest rate expectations



Debt Simulation (% GDP) consistent with a primary deficit of 1.5%, in the current context of the interest-growth differential



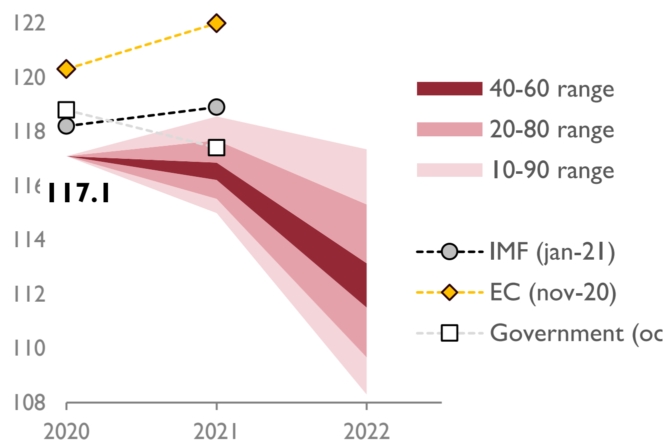
Source: AIReF

Short-term forecasts

❿ The rebound in economic activity that is expected in the coming quarters, together with the boost of the Recovery, Transformation and Resilience Plan and the improvement of the cyclical component of the public balance, project a stabilisation of the debt ratio in 2021 and a reduction in 2022.

The estimates by the main international bodies place the debt ratio above the range of AIReF's stochastic projections in 2021. This is mainly due to the fact that at the time these projections were made, the final figure for 2020 was not known. This figure has turned out to be between two and three points lower than initially estimated. In addition, the Government's estimate of the 2021 debt ratio in the Draft Budget (117.4%) is considered feasible.

Stochastic debt projections (% GDP) and forecasts by the Government and other international bodies



Source: IMF, EC, Government and AIReF

⓫ The pandemic has heightened the challenges associated with high levels of public debt, the future sustainability of which is strongly linked to the policies of the European Central Bank. The emphatic and swift action by the monetary policy body has avoided the resurgence of any doubt about the sustainability of historically high debt levels. The purchase of public assets through the Pandemic Emergency Purchase Programme (PEPP) has covered most of the extraordinary borrowing needs of 2020, while managing to place the entire yield curve at historic lows, minimising spreads between Euro area countries.

Beyond the normality of the current functioning of sovereign debt markets, there are risks and challenges in the medium and long term. Once non-conventional instruments such as the PEPP have fulfilled their role (net purchases are expected to cease in 2022) and inflation forecasts converge to higher levels, interest rates might rise to levels more in line with their historical trend. The increase in the average maturity of the debt portfolio provides some protection against possible interest rate rises which, should they occur, would be transferred to the effective financial burden very gradually over several years. However, increases in interest rates would eventually have a major impact on the financial burden over the medium and long term, given the high accumulation of debt.

This crisis has raised, albeit not very significantly, refinancing risk. Gross borrowing needs will grow in the coming years as a greater stock of debt is repaid. Once again, the strategy implemented by the Public Treasury of lengthening the average maturity of the debt portfolio will adequately mitigate this risk. In the long term, the reduction of sovereign debt on the ECB's balance sheet might pose a major challenge that is not without risk as it will require the return of a significant part of the resident investor base that has been displaced over recent years.

In 2020, the Government approved the implementation of two lines of guarantees for a joint amount of up to €140bn aimed at guaranteeing the financing granted to self-employed workers and Spanish companies affected by the economic effects of COVID-19. This has led to a significant increase in contingent liabilities. By the end of February 2021, the COVID-19 Guarantee Lines had deployed guarantees for an amount in excess of €90bn. Although there is a significant risk that part of these guarantees will be enforced, the impact of the materialisation of these contingent liabilities on public debt is limited and does not in itself endanger its sustainability (see Monitor of November 2020).

In contrast, higher expenditure on healthcare and on pensions as a result of the ageing population is one of the major risks for the sustainability of public finances in the medium term. Higher structural expenditure that is not covered by additional revenue will lead to a very significant rise in debt from levels that are already historically very high.

Risk matrix

	Short term		Medium/long term	
	Probability of occurrence	Impact on public debt	Probability of occurrence	Impact on public debt
Refinancing risk	Very low	Medium	Low	Medium
Interest rate risk	Medium low	Low	Medium high	Medium high
Contingent liabilities, public guarantees	Medium	Low	Medium high	Medium low
Contingent liabilities, ageing population	Medium low	Medium low	High	High