Autoridad Independiente de Responsabilidad Fiscal

# Debt Monitor

## July 2022

- *The unprecedented fiscal measures taken to address the Covid-19 pandemic, together with the operation of automatic stabilisers, have led to a very significant deterioration in public accounts worldwide, generating a significant increase in debt ratios.*

- *Fiscal stimuli measures and the relaxation of an already accommodative monetary policy have contributed to mitigating the economic consequences of the pandemic and have placed central banks' balance sheets at unprecedented levels of expansion, both in absolute levels and in relation to GDP.*

- *Against this backdrop of high indebtedness and expansionary monetary policy, 2022 has surprised with higher and more persistent inflation than initially expected, leading to a major shift in the monetary policy decisions of the main central banks. Over 60 entities have already raised their interest rates this year.*

- *The Spanish debt ratio has recorded four consecutive quarters of falls and stood at 117.7% of GDP in the first quarter of 2022. Compared with the level prior to the pandemic, the debt ratio has risen by 19.4 points.*

- *The cumulative reduction in the last year is 7.5 points, of which 0.7 points have been recorded in the last quarter. This significant reduction is mainly due to the denominator effect, given the strong upturn in economic activity and prices.*

- *In absolute terms, public debt has continued to grow, adding €26.62bn to reach a new all-time high of €1.45tn.*

- *AIReF's projections show a reduction of 9.6 points in the debt ratio over the next four years, placing it at around 114% at the end of this year and at 108.8% in 2025.*

- *The reduction in the ratio in the coming years will be mainly supported by growth in nominal GDP, where the deflator will play a very significant contribution.*

- *The risk of deteriorating financing conditions is materialising. The tightening of monetary policy is leading to sharp upturns in global sovereign debt yields, with a trend that has accelerated over the year as inflation has continued to record unexpected increases and communications from central banks have become more hawkish.*

- *So far this year, the yield on the Spanish ten-year bond has risen by 180 basis points (exceeding 250 on June 14th), reaching values that had not been seen since 2014. In the case of Italy, Portugal, France and Germany, the increase was of 210, 185, 157 and 140 bps respectively. Outside the euro area, US debt yields have also risen sharply, by 142 bps.*

- *In recent months, there has been a sharp increase in the volatility of sovereign debt. The scenario of major uncertainty that has emerged in 2022 is triggering sharp movements and overreactions in financial markets, and in particular in debt markets, with much more intense daily movements.*

- *In addition, there is an upward trend in risk premiums, which is exacerbated by the announcement of the end of the asset purchase programmes.*

- *The end of the ECB's purchase programmes (PSPP and PEPP) and the future, albeit distant, reduction in sovereign debt on the central bank's balance sheet poses a significant challenge to the yield on Spanish debt, as it requires the return of a large part of the investor base (mainly the resident base) that has been displaced in recent years.*

- *Through instruments such as the reinvestment of PEPP maturities towards countries with stressed debt and the implementation of a new (under development) anti-fragmentation tool, the ECB has announced its willingness to contain the disorderly increase in risk premiums that poses a risk to the transmission of monetary policy.*

- *The deterioration in financing conditions will eventually be transferred, albeit gradually, to the deficit and debt. Higher financing rates impact the new debt issues, and will be transferred gradually (given the high average maturity) to the average rate of the portfolio. Compared with the latest Stability Programme scenario, an increase in the average issuance rate of 100 bps in line with recent developments would raise the forecast for the implicit debt rate by 0.3 points (up to 2.2% in 2025), the financial burden by 0.4 points of GDP (up to 2.4%), and the debt ratio by 0.7 points.*

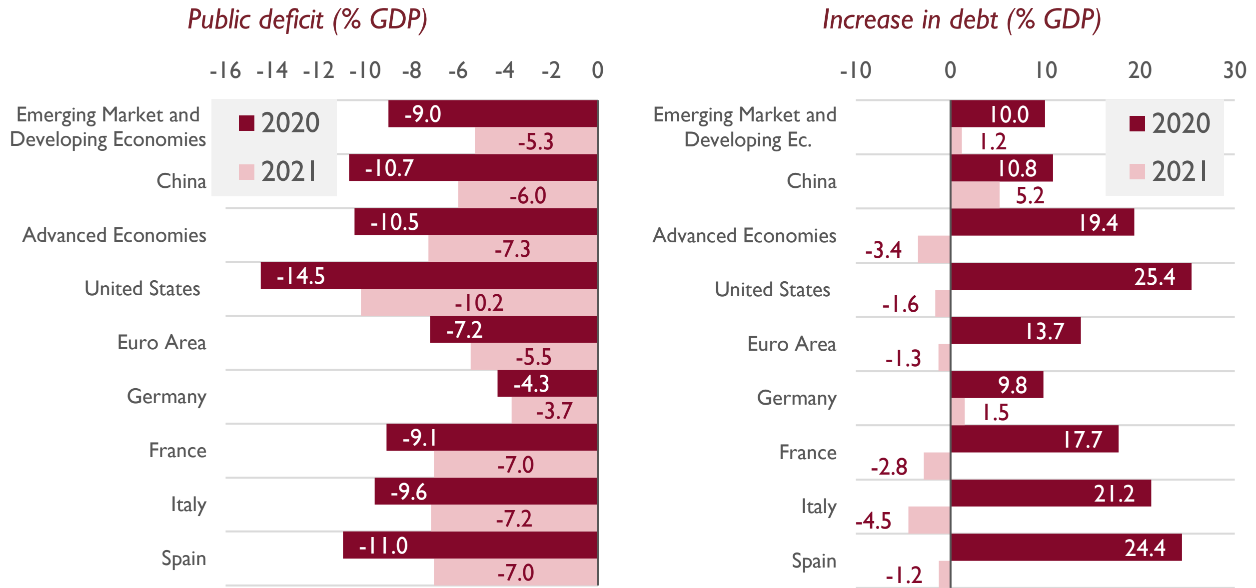
- *AIReF's projections paint an unfavourable trend in the medium and long-term debt ratio under a no-policy-change scenario. Beyond the reduction in the debt ratio that is expected in the short term, once the boost to growth ends, the debt-to-GDP ratio will resume an upward path under the assumption of a no-policy-change scenario.*

- *The simulations performed by AIReF show that a structural primary deficit of between 1.5% and 2.5% of GDP from 2025 (in line with the latest estimates by the Government and AIReF, respectively) would place the debt ratio between 125% and 140% of GDP in 2040.*

- *Expectations of higher interest rates accentuate the trend in the debt by generating a greater financial burden, which, if not offset by an adjustment, will end up having an impact on the debt ratio.*

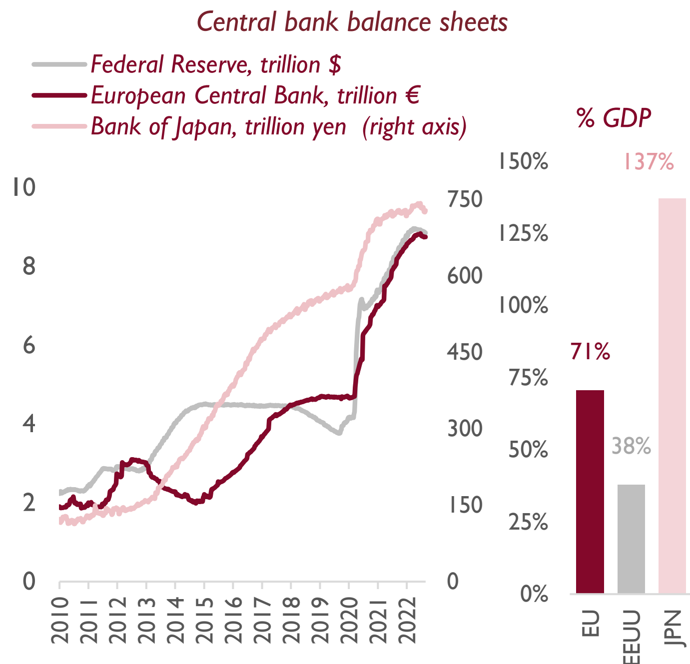
- *The simulations show that a financial burden between 1.3 and 1.8 points higher (depending on the scenario of the evolution of the primary balance) results in an increase in the debt ratio of between 12 and 16 points in 2040.*

**The unprecedented fiscal measures taken to address the Covid-19 pandemic, together with the operation of automatic stabilisers, have led to a very significant deterioration in public accounts around the world.** Very significant government deficits were recorded in 2020 and 2021, which have contributed to a considerable increase in public debt ratios in economies around the world. In particular, the euro area ratio has risen by 12.5 points of GDP from the pre-pandemic level, to close to 100%. Countries such as France, Spain and Italy far exceed these figures. In 2021, there was some stability in the debt ratios due to the denominator effect as a result of the boost in economic activity following the shutdown during the pandemic. In the short term, the expected significant nominal growth (albeit with a downward outlook for real growth and an upward deflator) will continue to generate tailwinds in the evolution of the debt ratio.




Source: IMF (WEO April 2022)

**The relaxation of what was already an accommodative monetary policy has contributed to mitigating the economic consequences of the pandemic.** In addition to fiscal stimuli measures, the policies of accelerating quantitative easing on both sides of the Atlantic have contributed to mitigating the economic consequences in the toughest phase of the pandemic, placing the balance sheets of the central banks at unprecedented levels of expansion, both in absolute levels and in relation to GDP. Official money rates at historic lows in a context of low inflation, together with bond purchase programmes, have allowed Treasuries to borrow in 2020 and 2021 at minimum rates, with most rate curves in negative territory during this period, even in the long term.

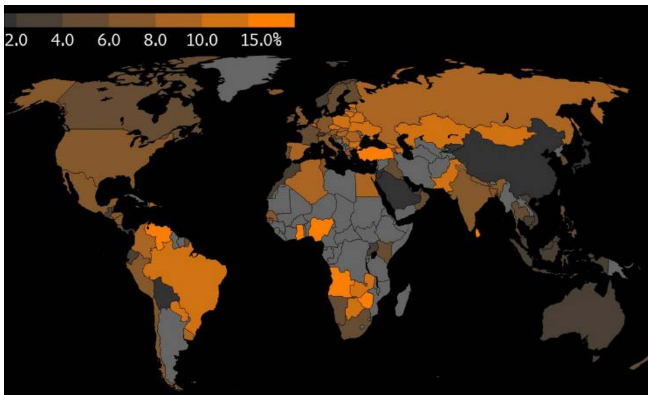



Sources: ECB, FED and BoJ

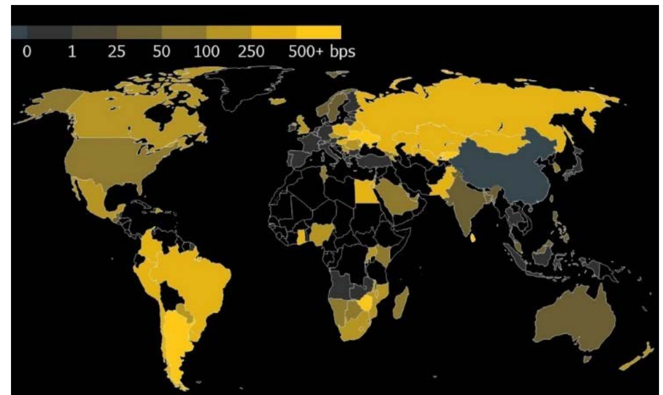
**Against this backdrop of high indebtedness and expansionary monetary policy, 2022 has surprised with higher and more persistent inflation than initially expected, leading to a major shift in the monetary policy decisions of the main central banks around the world.** The economic recovery after the health crisis led to an initial increase in inflation related to bottlenecks in global logistics and shortages of supplies at a time of strong demand. Inflation was considered to be of a temporary nature. However, factors such as the Russian invasion of Ukraine have driven up the already high price of energy, deepening and accelerating the increase in prices across the world. In this context, inflation has reached record levels. Central banks around the world have been reacting by joining in, to a greater or lesser extent, with the tightening of monetary policy in response to this record inflation. Although the temporary nature of this inflation is increasingly questioned, medium-term expectations remain anchored at contained values. More than 60 central banks, according to Bloomberg's calculations, have already raised rates this year.

## International context:

*Map showing the latest inflation data available for the different economies (%)*



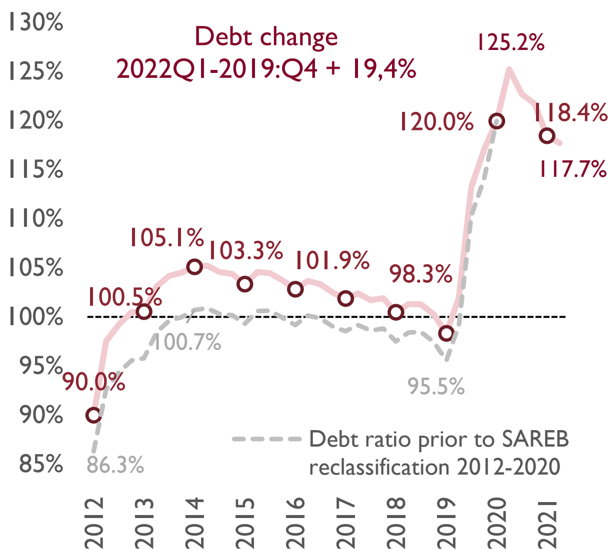

*Map showing the change in central bank interest rates in 2022 (bps)*




Source: Bloomberg

## Evolution of Spanish debt

*Debt (GDP), quarter-on-quarter evolution*




Source: INE and Bank of Spain

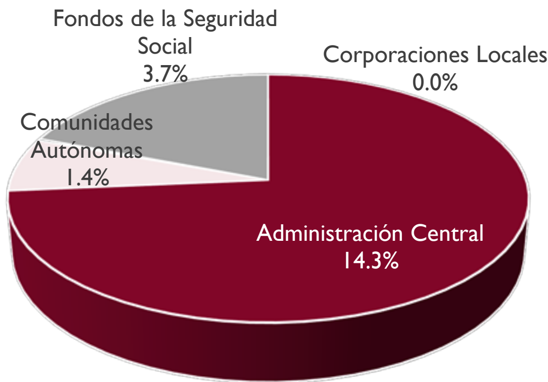
**In the case of the Spanish economy, the debt ratio has recorded four consecutive quarters of falls and stood at 117.7% of GDP in the first quarter of 2022.** The cumulative reduction in the last year is 7.5 points, of which 0.7 points have been recorded in the last quarter. This significant reduction is mainly due to the denominator effect, given the strong upturn in economic activity and prices. In absolute terms, public debt has continued to grow, adding €26.62bn to reach a new all-time high of €1.45tn.

**The Bank of Spain has revised the historical series of EDP debt incorporating the effects of the reclassification of the Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB) to the General Government sector since its creation in 2012, increasing the ratio up to 2020 by an average of 3.7 points of GDP.**

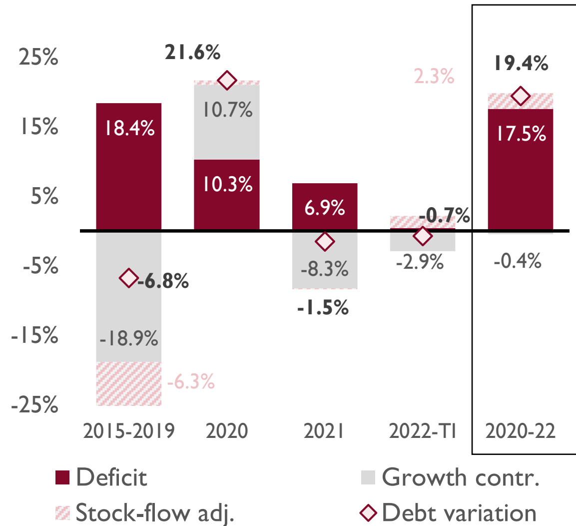
The EDP debt data from the end of 2020 are not affected by moving the reclassification of SAREB back in time, but the previous data are affected. This retrospective revision has raised the stock of debt as a result of the previous financial crisis by an average of 3.7 points of GDP in the revision period (2012-2020), raising the previous all-time high of late 2014 to 105.1% (from 100.7% previously) and placing the pre-pandemic debt stock three points higher.

**Compared with the level prior to the pandemic, the debt ratio has risen by 19.4 points.** GDP, the denominator of the ratio, has already stopped contributing negatively to the increase resulting from the pandemic, with the public deficit causing almost all the change. At a sub-sector level, the largest increase in the debt ratio has taken place in the Central Government and the Social Security Funds. The debt ratio of the LGs has remained stable, while that of the ARs has recorded a slight increase.

*Increase in debt (GDP points) between 2022-I and 2019 by sub-sector*




*Contribution to the change in debt (% GDP)*



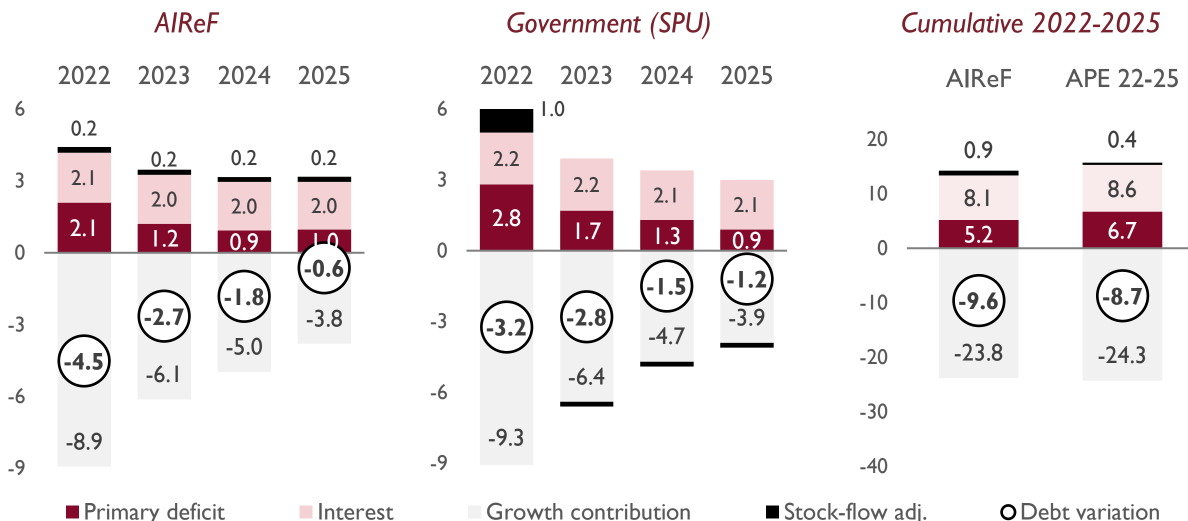

Source: AIReF

**Under the macro-fiscal forecasts prepared by AIReF to assess the Stability Programme, the debt-to-GDP ratio is projected to fall by 9.6 points over the next four years to 108.8% in 2025.** After reaching its peak value in the first quarter of 2021 (125.2%), the debt ratio has started a downward path, to stand at 118.4% of GDP at the end of 2021. AIReF's projections show a continuation of this trend over the next four years, with the ratio expected to stand at around 114% at the end of this year, and in a range between 107% and 111% in the central interval of AIReF's stochastic projections for 2025.



**The reduction in the ratio will be mainly supported by the growth in nominal GDP, where the deflator will play a very significant contribution.** Most of the reduction in the debt ratio (7.2 out of the 9.6 points forecast up to 2025) takes place this year and next, coinciding with the economy's sharp nominal growth, while it is forecast to stabilise somewhat as from 2024. The government deficit will continue to contribute significantly to the increase in debt, with a financial burden that will rise in absolute terms, but will remain stable relative to GDP due to the sharp nominal increase in the latter. It should be noted that 2020 already saw a turning point in the evolution of the level of the interest expense, starting an upward path after the long period of continuous falls that began in 2013.

*Contributions to the change in the debt-to-GDP ratio (pp)*

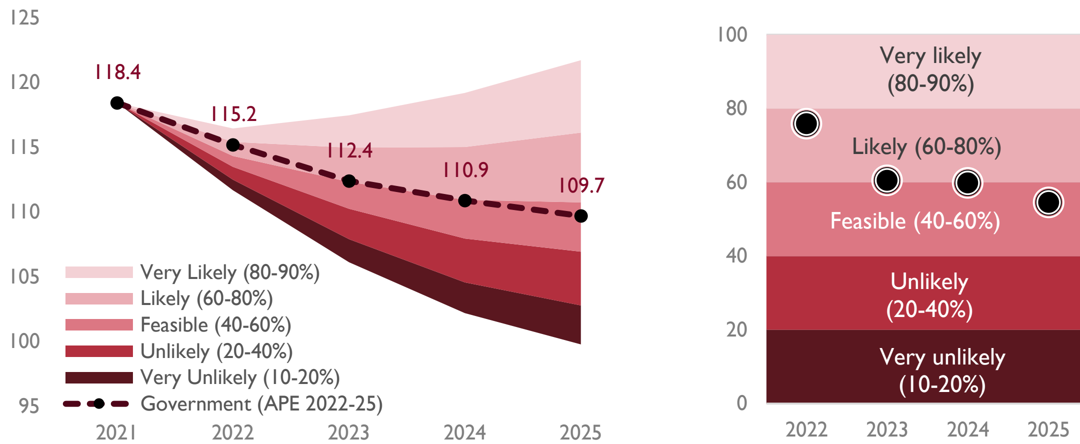



Source: Government and AIReF

## Short-term forecasts

**AIReF considers the debt projection included in the Stability Programme Update (SPU) for 2025 to be feasible.** According to AIReF's stochastic projections, achieving a debt-to-GDP ratio equal to or lower than that projected by the Government in 2025 is considered feasible. Over the period as a whole, both the reduction in the ratio projected by AIReF and the composition of the factors that determine its evolution are similar to those estimated by the Government.

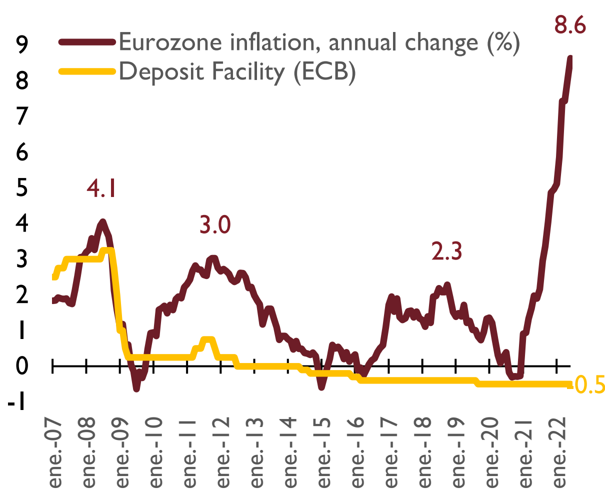
*Stochastic debt forecasts (% GDP) and likelihood of reaching a ratio equal to or lower than that projected by the Government in the 2022-2025 SPU*




Source: Government and AIReF

## Changes in financing conditions: inflation, monetary policy and interest rates

*Inflation and euro interest rate (%)*

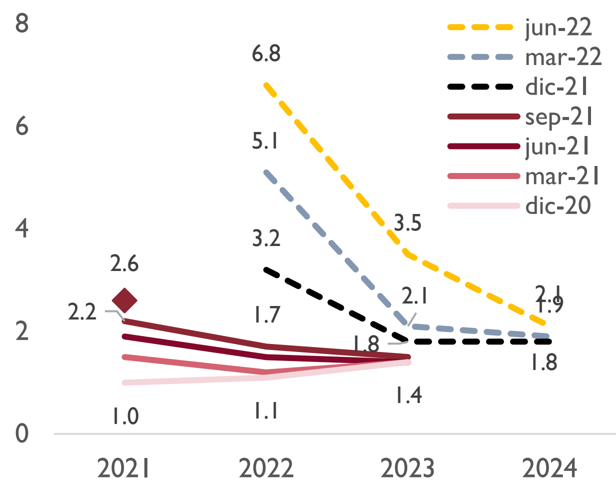



Source: Refinitiv

**A much higher and more persistent inflation than initially expected (in June year-on-year rates stood at their highest values for decades: euro area 8.6%, Spain 10.2%, Germany 8.2%, US 8.6%, United Kingdom 9.1%,) is leading to an acceleration and intensification of the monetary policy decisions of the main central banks around the world.** In order to stimulate the low inflation over recent years, central banks have long maintained interest rates well below inflation, which has led to very negative real interest rates. A worse-than-expected evolution of inflation coupled with a very expansive monetary policy has generated the need for a sharp shift in central banks' decisions and outlook.

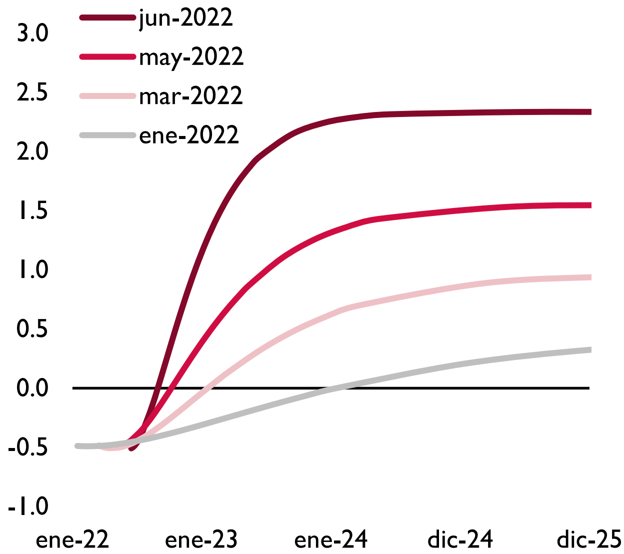
**Most of the main central banks around the world have started (or announced) a path of increases in the price of money, adding to a greater or lesser extent to a reduction in liquidity.** With these movements, central banks aim to reduce lending, lower asset prices, contain inflation expectations by reducing the risk of inflationary spirals, and cool down the economy (without plunging it into a recession) so that inflation will return to its path in a "soft landing" scenario. However, supply-side problems that are also contributing to global inflation are beyond the control of central banks.

*Evolution of ECB inflation forecasts (%)*




Source: European Central Bank

*Expected deposit facility rate discounted (*) by the market (%)*



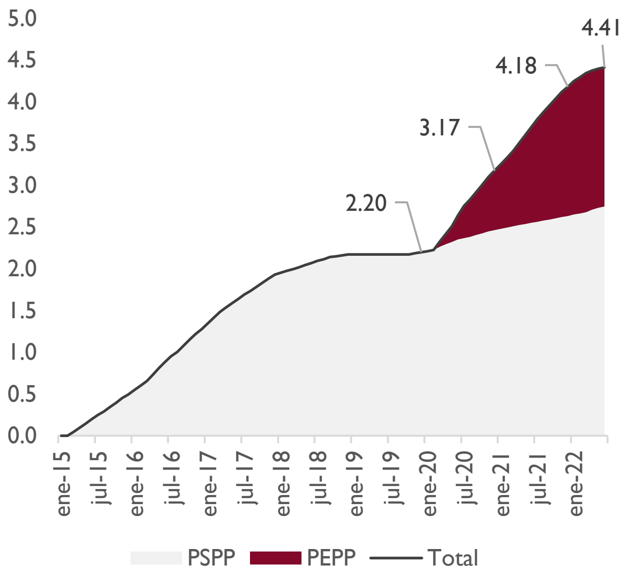

Source: Refinitiv and AIReF

(*) Through the instantaneous forward curve of the OIS

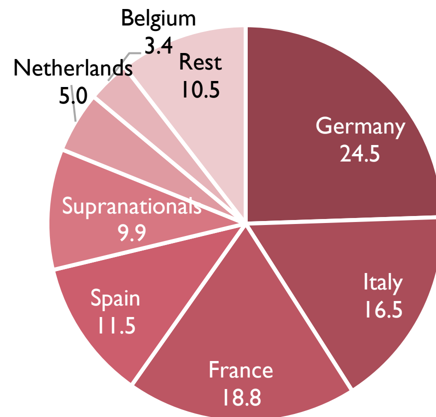
**Within the euro area, at its last regular meeting on June 9th, the ECB announced that it would be ending the net asset purchase programmes (APPs) on July 1st, confirming that in its next meeting on July 21st it will raise official interest rates by 25 bps.** The meeting of June 9th was full of changes, unanimously approved, in the various monetary policy tools. Despite no changes in interest rates, the ECB signalled developments in the coming months and raised the possibility of a more aggressive rise in September. Beyond Q3, the ECB estimates that interest rates will need to continue to rise gradually but steadily. This would be consistent with 25-bp hikes at each meeting. Over the year, the market has been pricing in increasingly aggressive hikes, taking the deposit facility to the 2% level (from -0.50%) by mid-2023, i.e. a 250-bp rise in one year.

**At the end of June, the ECB's accumulated net purchases under the umbrellas of the PSPP and the PEPP amounted to €4.4tn, of which €2.2tn corresponded to acquisitions over the last two and a half years.** The ECB ended its public debt purchase programmes on July 1st, although it will continue to reinvest its maturities, which will mean financing of around €600bn per year for the euro area countries as a whole, given an average life of just under seven and a half years.

*Cumulative net purchases of public assets by the ECB (PSPP+PEPP), trillions of euros*



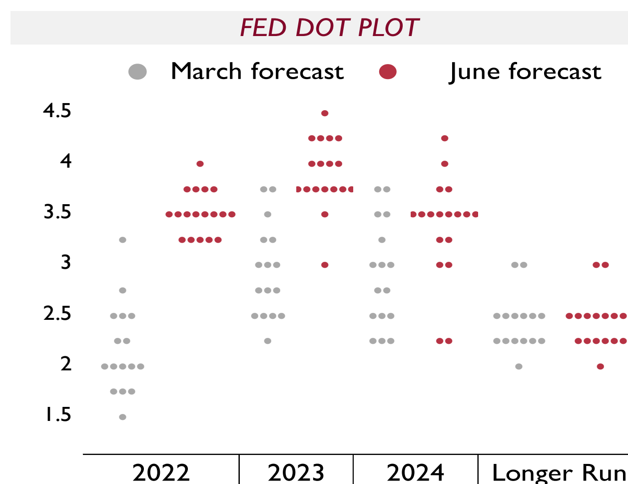

*Distribution by country of PSPP and PEPP (%).*




Source: ECB

**In the United States, the FED decided at its meeting on June 15th to raise the official rates by 75 bps, and expects them to stand at over 3% at the end of 2022.** The Federal Reserve decided to raise official interest rates by 75 bps to the range of 1.50% - 1.75%, the first time it has approved an adjustment of this size since 1994. In addition, the dot plot shows the Fed's median voter in favour of official interest rates being in the 3.25%-3.50% range by the end of the year, which is twice the current level. This would be consistent with increases of at least 50 bp at the next two meetings. Over the next two years, the median voter expects the interest rate to stand at 3.9% and 3.4%, relatively in line with what the financial markets were pricing in.

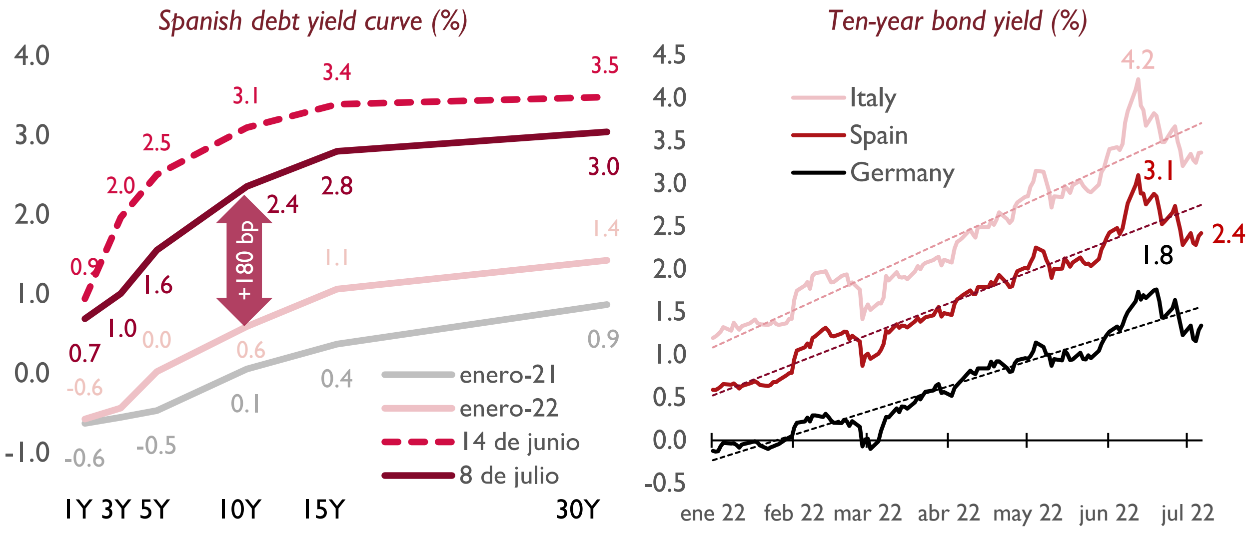
*Interest rate forecasts for participants in the FED Open Market Committee ("dot plot")*




Source: Federal Reserve

**In the United Kingdom, the Bank of England (BoE) has taken a new step in tightening its monetary policy after executing the fifth consecutive interest rate hike.** After its meeting on June 16th, the BoE announced a rise in the price of money of 25 bps, which leaves the Bank Rate at 1.25%, the highest figure for 13 years. The Bank of England is thus continuing the global monetary tightening that began at the end of 2021 with a much more aggressive stance than other central banks and which is materialising in 2022 with intense rate hikes and quantitative tightening.

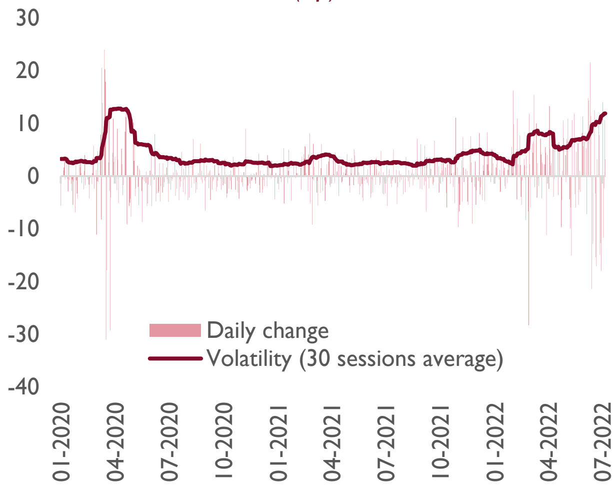
**The risk of deteriorating financing conditions is materialising.** The tightening of monetary policy is leading to sharp upturns in global sovereign debt yields, with a trend that has accelerated over the year as inflation has continued to record unexpected increases and communications from central banks have become more hawkish. So far this year, the yield on the Spanish ten-year bond has risen by 180 bps (exceeding 250 on June 14th), reaching values that had not been seen since 2014. Between July 8th (close prior to the ECB's regular meeting) and July 14th, the ten-year yield accumulated a rise of 62 bps in just four sessions. On July 15th (extraordinary meeting), the yield fell by 21 bps. After this initial reaction, the yield continued to fall (47 bps) to the level of 2.4% as at the date of this Monitor (July 8th). The ten-year yield for Italy, Portugal, France and Germany has risen by 210, 185, 157 and 140 bp, respectively, so far this year. Outside the euro area, US debt yields have also risen sharply, by 142 bps.



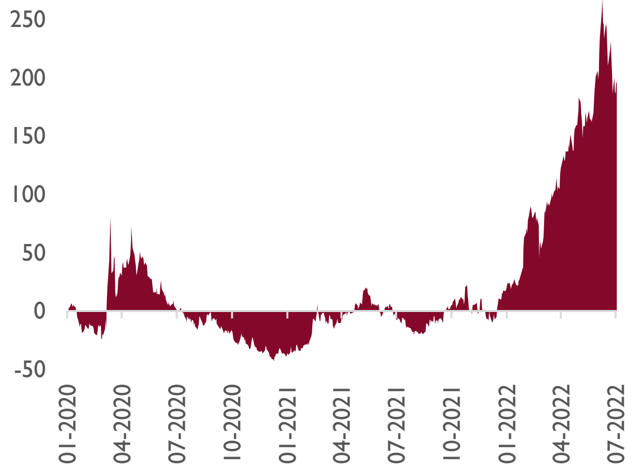

Source: Refinitiv and AIReF

**In recent months, there has been a sharp increase in the volatility of sovereign debt.** The scenario of major uncertainty that has emerged in 2022, with background trends that have worsened following the Russian invasion of Ukraine, is triggering sharp movements and overreactions in financial markets, in particular in debt markets, with much more intense daily movements. While throughout 2021 there were daily movements in the ten-year yield of around +/-2.5 bps, in 2022 these movements have reached an average of +/-10 bp.

*Daily change and volatility of the Spanish ten-year yield (bp)*




*Cumulative change in ten-year Spanish yield (bp)*



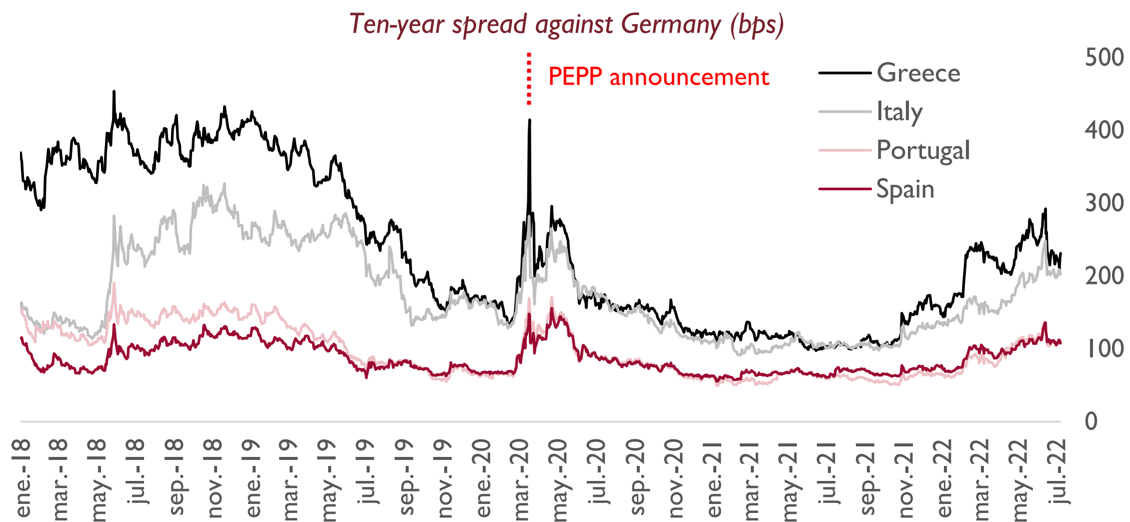

Source: Refinitiv and AIReF

**There is an upward trend in risk premiums, which is aggravated by the announcement of the end of the asset purchase programmes.** The ECB's sovereign debt purchases (PSPPs since 2014, together with the emergency PEPP acquisitions during the pandemic) have kept peripheral debt spreads at bay, thus preventing credit fragmentation. This widening of spreads *vis-à-vis* Germany over 2022 - which has been accentuated following the announcement of the end of asset purchases - has attracted the attention of the ECB, giving rise to the extraordinary meeting on June 15th.

**The ECB's extraordinary meeting marked a verbal escalation in the will not to allow the financial fragmentation of the euro area.** Through instruments such as the reinvestment of PEPP maturities towards countries with stressed debt and the implementation of a new, under development, anti-fragmentation tool, the ECB is willing to contain the disorderly increase in risk premiums that poses a risk to the transmission of monetary policy.

**In the case of Spain, the spread on the ten-year bond against the German bond has risen by 37 bps so far this year.** Of greater concern is the case of Italy, with a rise of 71 bps. Between July 8th (close prior to the ECB's regular meeting) and July 14th, the risk premium rose by 23 bps in just four sessions. On July 15th (extraordinary meeting) the spread dropped by 12 bps. Following this initial reaction, the premium continued to fall by 15 bps to the level of 108 bps as at the date of this Debt Monitor (July 8th).

*Ten-year spread against Germany (bps)*

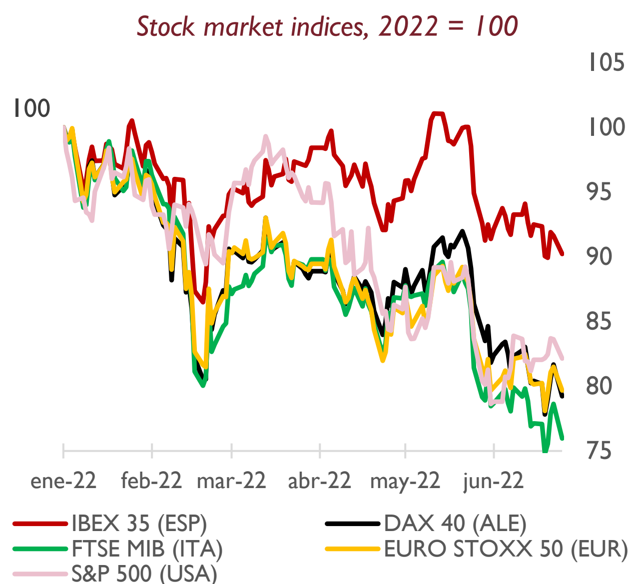



Source: Refinitiv



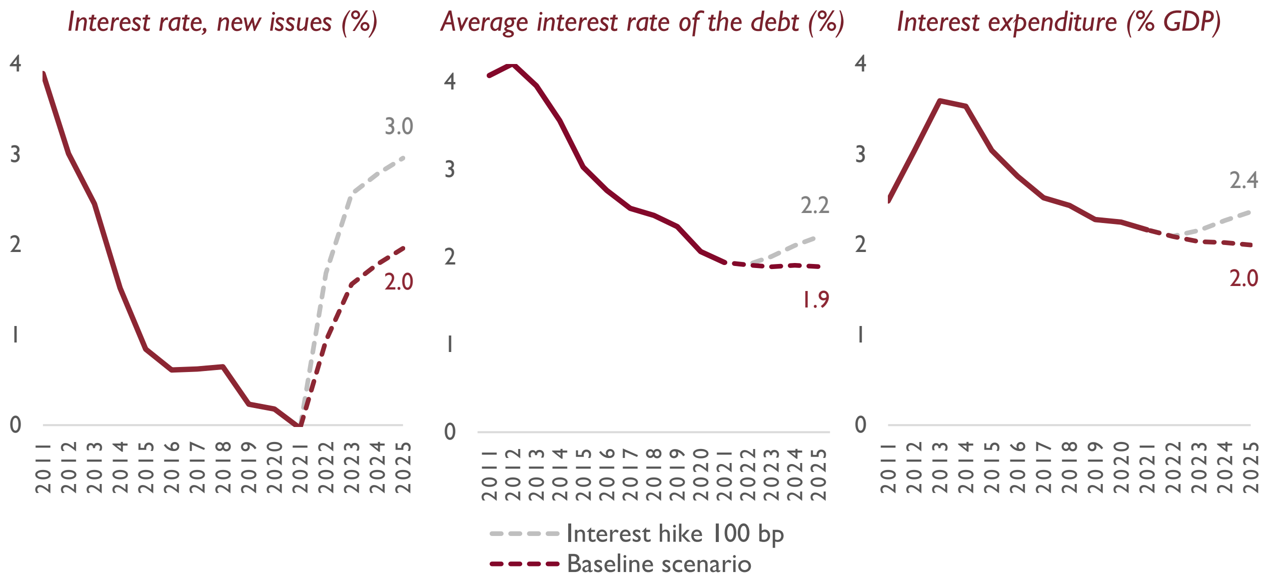
**The expectation of higher inflation and monetary tightening has resulted in a sharp correction in all financial assets.** The main stock market indices are pricing in high inflation and monetary policy tightening with a sharp correction (in many indices from record highs), with falls of between 20-25%. The Spanish index (IBEX35) is holding up better due to its sectoral composition (strong weight of energy companies, tourism and banking) and the fact that it was one of the indices that had least risen before, benefiting in this case from the shortcomings that at other times have left it behind its European neighbours.

*Stock market indices, 2022 = 100*



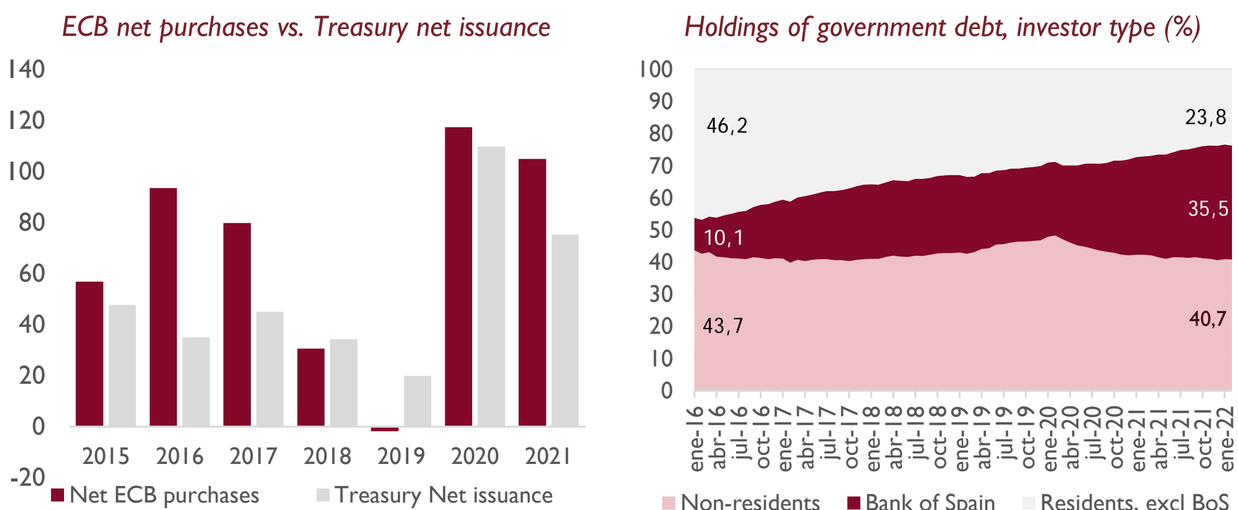

Source: Refinitiv

**With regard to the fiscal implications, the deterioration in financing conditions will eventually be transferred, albeit gradually, to the deficit and debt.** The tightening of monetary policy is having a major impact on sovereign debt yields, which will result in a higher financial burden. Higher financing rates impact the new debt issues and will be transferred to the average rate of the portfolio gradually given the high average maturity. Compared with the SPU scenario, an increase in the average issuance rate of 100 bps in line with recent developments would raise the implicit rate forecast by 0.3 points (up to 2.2% in 2025), the financial burden by 0.4 points of GDP (up to 2.4%), and the debt ratio by 0.7 points.




Source: AIReF

**The end of the ECB's purchase programmes (PSPP and PEPP) and the future, albeit distant, reduction of sovereign debt on the central bank's balance sheet poses a significant challenge to the yield on Spanish debt, as it requires the return of a large part of the investor base (mainly the resident base) that has been displaced in recent years.** This may imply an increase in interest rates demanded by investors. **Over recent years, the ECB has made net purchases of Spanish debt for an amount greater than 100% of net borrowing needs.** The various public asset purchase programmes of the ECB that began in 2015 and intensified in 2020 and 2021 have made the Bank of Spain one of the main holders of Spanish public debt. In the last five years, its share of the total debt has risen by 25 points to around 35%. This has displaced part of the resident investor base, with non-resident investment in securities remaining stable at slightly over 40%.

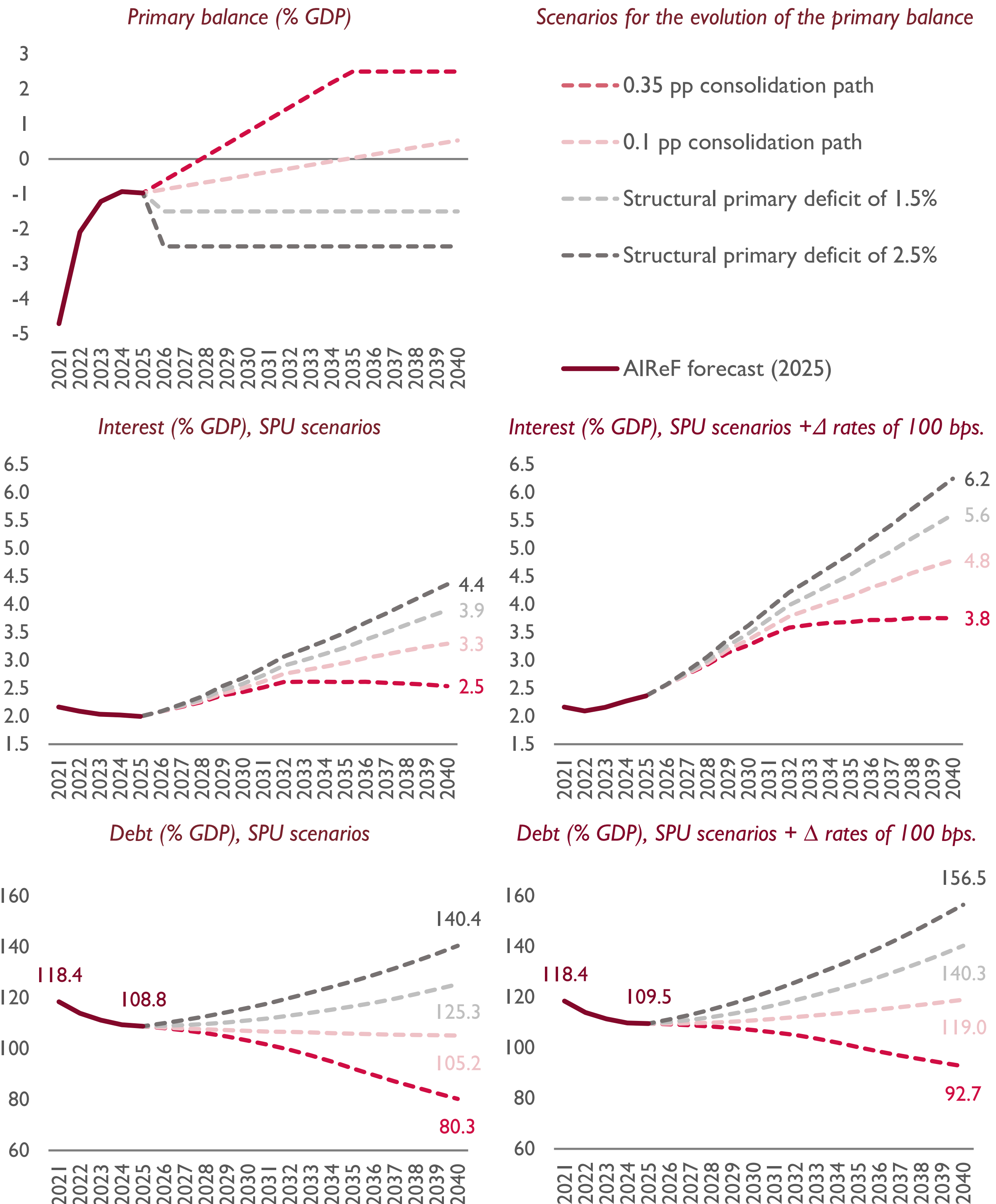



Sources: ECB, Treasury, Bank of Spain and AIReF

**AIReF's projections paint an unfavourable trend in the medium and long-term debt ratio under a no-policy-change scenario.** Beyond the reduction in the debt ratio that is expected up to 2025, once the boost in growth as a result of the rebound in activity following the shutdown during the pandemic ends, the debt-to-GDP ratio will resume an upward path under the assumption of a no-policy-change scenario. The simulations performed by AIReF show that a structural primary deficit of between 1.5% and 2.5% of GDP from 2025 (in line with the latest estimates by the Government and AIReF, respectively) would place the debt ratio between 125% and 140% of GDP in 2040.

**Expectations of higher interest rates aggravate debt dynamics.** Higher interest rates will generate a greater financial burden, which if not offset with some adjustment, will end up having an impact on the debt ratio. The simulations show that a financial burden between 1.3 and 1.8 points higher (depending on the scenario of the evolution of the primary balance) results in an increase in the debt ratio of between 12 and 16 points in 2040.

*Long-term projections based on different primary balance paths, SPU scenarios and rate hikes*




Source: AIReF