»» Monetary policy has reduced fiscal pressure in euro area – but interest rate turnaround is coming

No. 176, 26 July 2017

Author: Dr Philipp Ehmer, phone +49 69 7431-6197, philipp.ehmer@kfw.de

The ECB's expansionary monetary policy has significantly lowered the euro countries' funding costs. This has benefited mainly the states that were at the centre of the debt crisis. Significant differences exist in the levels of relief countries have experienced. Italy has avoided more than EUR 100 billion in additional costs since the height of the debt crisis in 2012. In Germany the funding advantage achieved from monetary policy is much lower, although mainly for the simple reason that the yields of German government bonds had already dropped previously because Germany was deemed a safe haven for investors during the debt crisis.

The reduction in interest payments is helping states with their much-needed consolidation. They should use the fiscal scope more strongly than before for reforms aimed at creating favourable conditions for growth. After all, monetary policy will tighten in the foreseeable future. Signs of an interest rate turnaround have been visible already since autumn of 2016. In the euro area, it is primarily Italy that needs to do more to generate growth and build trust in the capital market so as to be adequately prepared for rising funding costs.

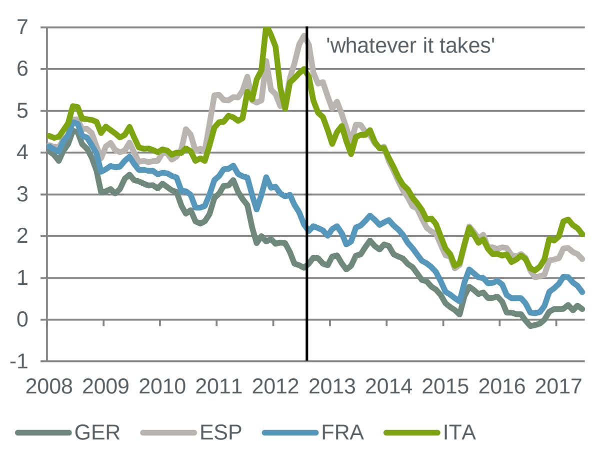
Euro area government bond yields have fallen noticeably

Today is the fifth anniversary of Mario Draghi's famous 'whatever it takes' speech of July 2012. Euro area monetary policy has been very expansionary during these five years. The economic environment has since improved and political risks have diminished. There is no need for a radical reversal in monetary policy – but adjustments will nevertheless occur soon. According to current information, the asset purchase programme in the euro area runs only until the end of the year. The ECB is expected to issue an outlook on future monetary policy in autumn and announce at least a reduction to its purchase programme.[1]

At the height of the debt crisis in 2012 some countries, including the large economies of Italy and Spain, were forced to pay high risk premiums on funds raised in the capital market. Draghi's speech marked a turning point and, in combination with the subsequent expansionary monetary policy, caused yields on government bonds to drop significantly (Figure 1). At the same time, the step brought about a convergence in the euro states' bond yields. They had been at similar levels before the financial crisis, with yield spreads among the four largest economies of just under 0.3 percentage points on average since 1999. The spreads dropped again significantly from massively increased levels with the start of the unconventional monetary policy in 2012 (Figure 2).

Figure 1: Conditions easing in the capital market

Yields on ten-year government bonds, in per cent



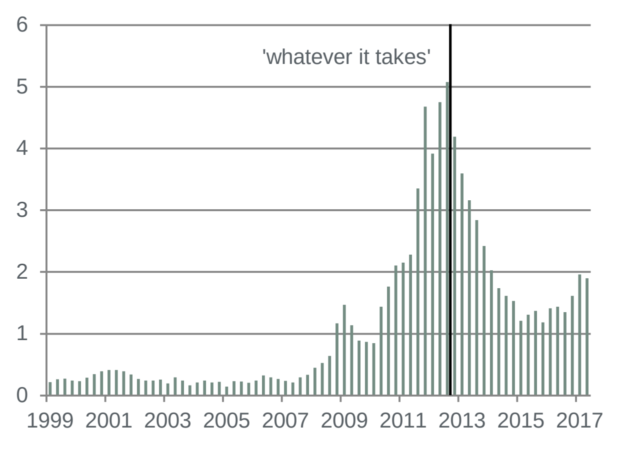
Source: OECD

States avoid billions in extra funding costs

In order to quantify how much the low-interest environment reduced the cost of funding for states, an assumption has to be made on the reference interest rate by which the states would have had to raise funds without the ECB's expansionary monetary policy. For the purpose of our calculations, we assume that this interest rate matches the

Figure 2: Funding costs are converging

Maximum yield spread among the four largest euro countries, in percentage points



Source: OECD, own calculations

yield level of summer 2012, the height of the debt crisis.[2] For all bonds issued since then, we compare the interest actually paid with the interest that was due on bonds issued with the same maturity in the summer of 2012. Our result can thus be interpreted as a cumulative funding advantage since the 'whatever it takes' speech, that is, from August 2012 to June 2017, as compared with the hypothetical case that the states had continued until today to fund themselves at the same conditions that prevailed at the height of the debt crisis (between May and July 2012).[3]

Table: Italy's cost advantage of more than EUR 100 billion

	Funding	Asset purchase programmes	Total	Total
	EUR in billions			Per cent of GDP in 2016
Germany	6.1	1.3	**7.4**	**0.2**
Spain	49.0	10.1	**59.1**	**5.3**
France	19.6	2.5	**22.1**	**1.0**
Italy	90.6	19.8	**110.4**	**6.6**

Note: Cumulative cost advantage between August 2012 and June 2017

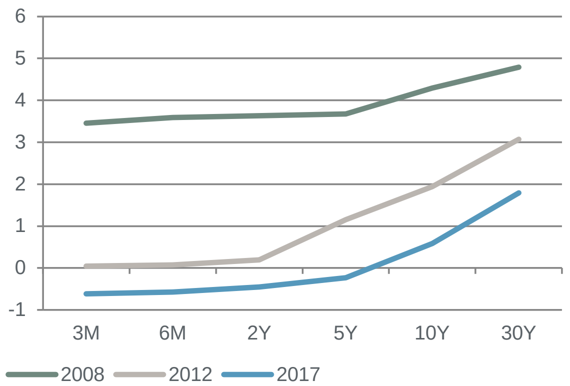
Source: own estimate

We estimate that in the past nearly five years, Italy has avoided additional costs in excess of EUR 100 billion as a result of the ECB's monetary policy (table). Spain has also experienced significant relief, which could not have been expected otherwise given the development of bond yields. The estimated benefit for France and, in particular, Germany, is much lower because of the different economic conditions in these countries at the time of the 'whatever it takes' speech (see below).

The cost advantages resulting from the repayment of old bonds and the issuance of new bonds at lower interest rates combine with direct savings from the ECB's asset purchase programmes. The current PSPP (Public Sector Purchase Programme), under which the ECB invests in government bonds of all euro member states, was launched in March 2015. In addition, the SMP (Securities Markets Programme), under which it specifically purchased bonds of states that had come under pressure during the debt crisis, including Italy and Spain, ran between May 2010 and December 2011. The coupon payments due on bonds purchased by their own central banks flow back to the respective states in the form of dividend payouts. As a result, the monetary policy generates additional benefits.[4]

Figure 3: Germany and France were safe havens for investors, with falling interest rates even before 2012

Yield curve, average of Germany and France, in per cent



Source: Thomson Reuters, own calculations

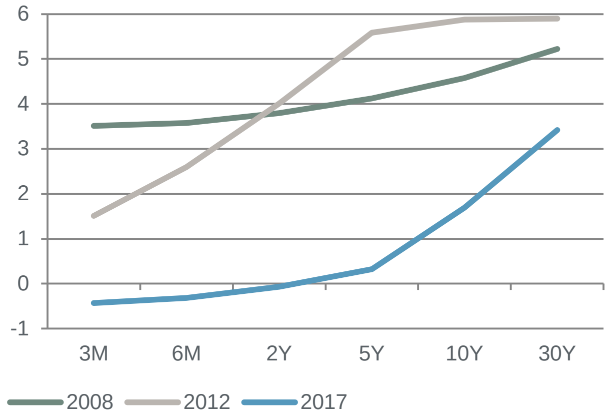
Germany's cost advantages are underrated

When interpreting the relatively low reduction in the burden for Germany, it is necessary to take into account the assumed reference interest rate. It was not until mid-2014 that the yield of German government bonds was continuously below the level at the time of the 'whatever it takes' speech. As Germany and France were regarded as safe havens for investment during the debt crisis, they benefited from significant interest rate reductions already before 2012. After that, interest rates declined less from that level than in the two southern European countries. Arithmetically, this limits the cost reduction for Germany and France in our estimate. If, in turn, the year 2008 is taken as a reference scenario, when the financial crisis began and capital markets started diverging, Germany's funding advantages even exceed those of Italy.

The different interest rate development is also reflected in the yield curves of the respective countries. In Germany and France, short-term interest rates were already near zero in 2012, long-term interest rates had already fallen sharply against 2008, and there was very little scope left for further reductions (Figure 3). In contrast, long-term interest rates in Spain and Italy rose significantly between 2008 and 2012. After that, yields on five-year bonds, for example, fell by more than five percentage points until today – nearly four times as much as in Germany and France during the same period.

Figure 4: Rising interest rates in Spain and Italy during the debt crisis – then a sharp drop

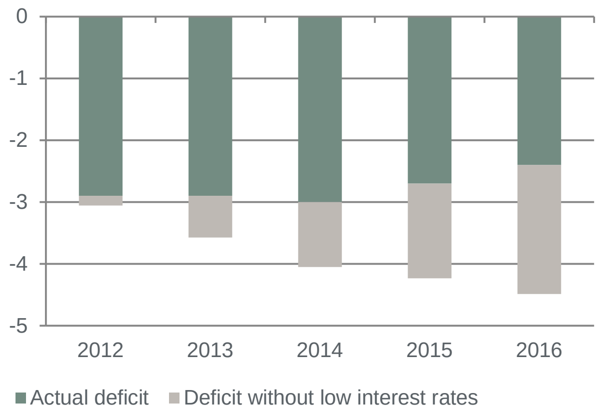
Yield curve, average of Spain and Italy, in per cent



Source: Thomson Reuters, own calculations

Figure 5: Low interest rates permit consolidation

Italy's fiscal balance, in per cent of GDP



Source: Eurostat, own estimate

Help for budget consolidation

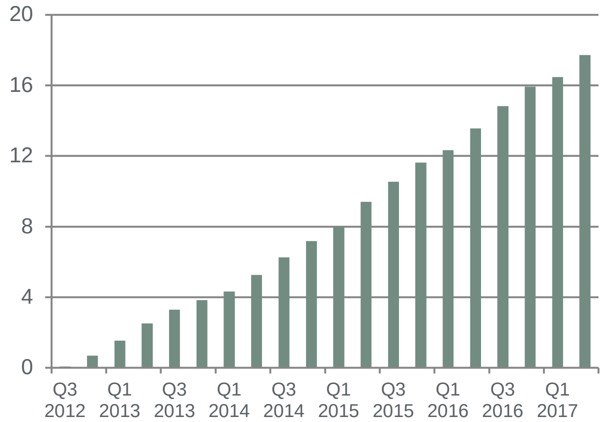
If the cost advantages the countries have realised are considered in relation to their economic output, the high fiscal adjustment pressure becomes apparent under which the countries would have been in the past years without an accommodating monetary policy. Spain and Italy would have had to consolidate their budgets by as much as 2% more of GDP per year. Italy probably would not have been able to gradually reduce its deficit in the past two years without the interest rate reduction. If the funding costs had remained on the level of 2012, our estimate is that the deficit today would be over 4% – assuming all other conditions remained unchanged (Figure 5). In an economic environment characterised by political uncertainties and low growth, the necessary consolidation measures would have become an even greater challenge for policymakers.

Benefits from expansionary monetary policy will fade in the future

So far, the funding advantages for the euro states have been growing at a relatively even pace (Figure 6). A large portion of the bonds issued by states have maturities ranging from six months to ten years. As a result, a country does not benefit immediately from lower interest rates but gradually, when old bonds fall due and are replaced by new bonds issued in a low-interest environment. The states have now rolled over a considerable portion of the bonds issued before summer 2012. In Italy and Spain the share of bonds issued prior to the 'whatever it takes' speech and still in circulation is now down to 40 and 26%, respectively (Figure 7). The yields on government bonds did fall continuously after the debt crisis reached its peak, dropping to a temporary low in early 2015 (Figure 1). Despite the now low proportion of old debt in their total assets, the states will therefore reap further benefits from monetary policy for the time being – if at a declining rate in the future.

Figure 6: Funding advantages are still growing ...

Funding advantages, sum of the four biggest euro countries, EUR in billions



Source: own estimate

Interest rate reversal will drive funding costs up, growth is important

The ECB will probably change the course of its monetary policy in the foreseeable future. In anticipation of this reversal, yields on government bonds have risen slightly since autumn of last year. But we do not expect a drastic movement of interest rates. After all, the ECB will choose a cautious exit from its expansionary monetary policy and is carefully preparing market participants. Besides, the exit will take place only if the macroeconomic environment permits, that is, if inflation normalises further and growth remains steady. In such an environment, euro states can usually manage yield increases. However, interest rates should continue to trend upwards if the central banks cease to act as buyers of government bonds to the same extent as they have in the past. That will drive funding costs in the euro area up.

In that case, the same retarding effect will of course occur as in the realisation of cost advantages in an environment of falling interest rates: funding costs change only slowly and gradually as old debt falls due. The additional burden of additional interest payments on national budgets is thus a lengthy process. States can prepare for it early and take precautions, for example by creating favourable growth conditions through appropriate reforms.

Figure 7: ... but costly old debt is being increasingly repaid

Bonds issued before the 'whatever it takes' speech as a proportion of all outstanding bonds, in per cent

Source: own calculations

In that regard, Italy in particular needs to act with urgency. Whereas the other countries considered here have recently been able to achieve robust growth and, in parts, demonstrated a new willingness to implement reforms, Italy is lagging behind on both counts. Productivity growth has been near zero for the last 20 years and reforms have recently been either stopped (referendum on the constitutional reform in December 2016) or even reversed (elements of the labour market reform of 2014). Besides, the level of debt in relation to economic output is higher than in any other euro country but Greece. Accordingly, the yields on Italian government bonds have responded most strongly to the interest rate turnaround since autumn 2016.

Italy must regain the trust of investors in order to be well prepared for an environment of steadily rising interest rates. What would be helpful is a clear political situation without endless election campaigns and with a clear no to an exit from the euro. In addition, the next government will have to urgently prioritise reforms. Unless it achieves higher growth, it will become increasingly difficult for Italy to maintain its debt levels and funding costs on a stable level without drastic spending cuts and/or tax increases when interest rates start trending upwards. ■

[1] Cf. Wanke, S. (2017), "Taper tangram" – the ECB's exit is a game of patience, KfW Research, Economics in Brief No. 134.

[2] The results of our analysis depend heavily on the reference interest rate assumption. With the argument that levels were exaggerated at the height of the debt crisis, a lower reference interest rate would be justifiable as well – as would a higher rate, since speculation over a breakup of the euro area would have potentially increased the yields of Italian and Spanish government bonds if the ECB had not intervened.

[3] Cf. Ehmer, P. (2016), ECB policy has saved euro states from severe economic hardship since 2012, KfW Research, Focus on Economics No. 126, for more on the reference interest rate assumption and details of the calculation methodology.

[4] The estimate of the cost advantages resulting from the asset purchase programmes takes into account the maturity of the assets purchased by the central banks, the corresponding yields and the holding period of the papers. As the asset portfolio from the SMP is still nearly EUR 100 billion and no coupon payments have fallen due any more on these bonds for some years now, Italy and Spain are benefiting to a particular extent from the asset purchase programmes in the euro area.