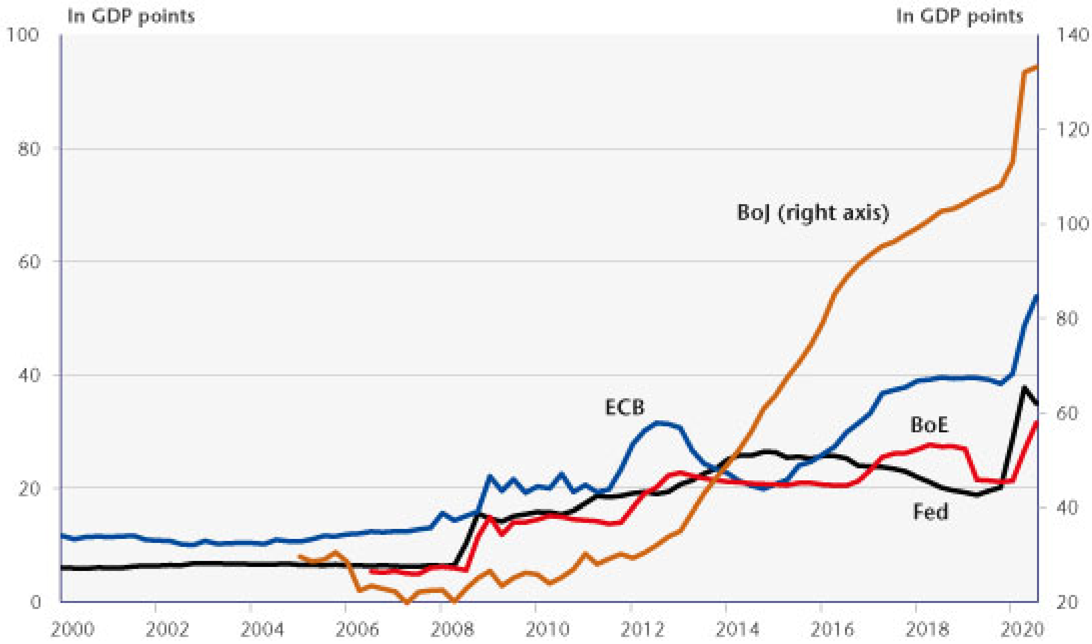
Public debt: Central banks to the rescue?

By Christophe Blot and Paul Hubert

In response to the health and economic crisis, governments have implemented numerous emergency measures that have pushed public debt up steeply. They have nevertheless not experienced any real difficulty in financing these massive new issues: despite record levels of public debt, the cost has fallen sharply (see *Plus ou moins de dette publique en France ?, by Xavier Ragot*). This trend is the result of structural factors related to an abundance of savings globally and to strong demand for secure liquid assets, characteristics that are generally met by government securities. The trend is also related to the securities purchasing programmes of the central banks, which have been stepped up since the outbreak of the pandemic. For the year 2020 as a whole, the European Central Bank acquired nearly 800 billion euros worth of securities issued by the governments of the euro zone countries. In these circumstances, the central banks are holding an increasingly high fraction of the debt stock, leading to a de facto coordination of monetary and fiscal policies.

Figure 1. Size of central bank balance sheets

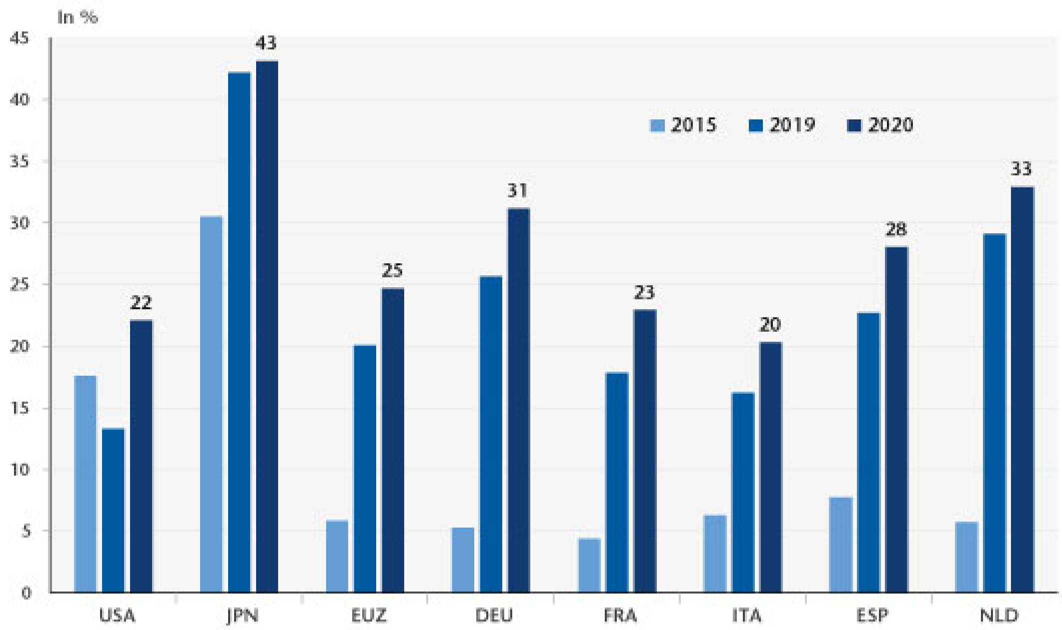


Source: Thomson Reuters Datastream.

Back in 2009, central banks launched asset purchase programmes to reinforce the expansionary impact of monetary policy in a context where the banks' key interest rates had reached a level close to 0%[1]. The stated objective was mainly to ease financing conditions by holding down long-term interest rates on the markets. This resulted in a sharp increase in the size of the banks' balance sheets, which now represents more than 53 GDP points in the euro zone and 35 points in the United States, with the record being held by the Bank of Japan, at 133 GDP points (Figure 1). These programmes, financed by issuing reserves, have focused heavily on government securities, meaning that a large proportion of the stock of government debt is now held by central banks (Figure 2). This proportion reaches 43% in Japan, 22% in the United States and 25% in the euro zone. In the euro zone, in the absence of euro bonds, the distribution of securities purchases depends

on the share of
each national central bank in the ECB’s capital. The ECB’s distribution key stipulates
that the purchases are to be made pro rata to the share of the ECB’s capital
held by the national central banks[2]. Consequently, the purchases of securities are
independent of the levels and trajectories of public debt. As the latter are
heterogeneous, there are differences in the share of public debt held by the
national central banks [3]. Thus, 31% of Germany’s public debt is held by the
Eurosystem compared to 20% of Italy’s public debt.

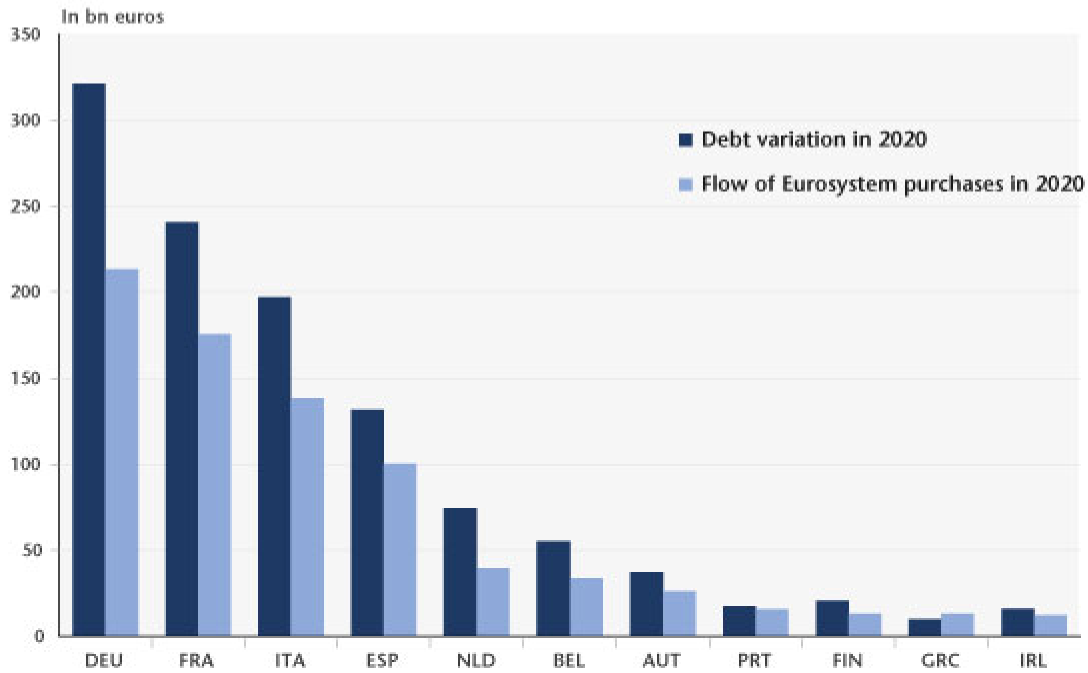
Figure 2. Stock of public debt held by the central banks



Note: The 2020 figures are calculated based on the data available in Q3 for the United States and in Q4 for Japan. In the euro zone, the level of debt in 2020 is taken from the forecast made by the European Commission (AMECO database).
Sources: Federal Reserve (flow of funds), Eurostat, ECB, AMECO, Bank of Japan.

The decentralization of fiscal policies in the euro zone is also leading to tensions in the sovereign debt markets of some member countries, as seen between 2010 and 2012 and more recently in March 2020. This is why Christine Lagarde has launched a new asset purchase programme called the Pandemic emergency purchase programme (PEPP). While the distribution key is not formally abolished, it may be applied more flexibly in order to allow the ECB to reduce the sovereign spreads between member countries. Analysing the flows of securities purchases made by the euro zone central banks and the debt issues of the member states, it can be seen that the Eurosystem has absorbed on average 72% of the public debt issued in 2020, i.e. 830 billion euros out of the 1155 billion of additional public debt. The share amounts to 76% for Spain, 73% for France, 70% for Italy and 66% for Germany (Figure 3).

Figure 3. Flow of issues of public debt absorbed by the Eurosystem



Note : The level of debt in 2020 was taken from the forecast made by the European Commission (AMECO database).
Sources: ECB, AMECO.

Unlike purchases made under the APP programme,
which aim to hit the inflation target, the PEPP's objective is first and
foremost [to limit rate spreads](), as Christine Lagarde reminded us on 16 July 2020.
In fact, even if there is a structural downward trend in interest rates, some
markets may be exposed to pressure. The euro zone countries are all the more
exposed as investors can arbitrate between the different markets without incurring
any exchange rate risks. This is why they may prefer German

securities to
Italian securities, thereby undermining the homogeneous transmission of
monetary policy within the euro zone. In addition to arguments about the risk
of fragmentation, these operations also reflect a form of implicit coordination
between the single monetary policy and fiscal policies, providing countries
with the manoeuvring room needed to take the measures required to deal with the
health and economic crisis. By declaring on 10 December that the allocation
to the programme would increase to 1850 billion euros by no later than March
2022, the ECB sent a signal that it would maintain its support throughout the
duration of the pandemic[4].

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[1] This policy, generally referred to as
quantitative easing (QE), was launched in March 2009 by the Bank of England and
the US Federal Reserve. Japan had already initiated this type of so-called
unconventional measure between 2001 and 2006, and resumed this approach in
October 2010. As for the ECB, the first purchases of securities targeted at
certain countries in crisis were made from May 2010. But it was not until March
2015 that a QE programme comparable to those implemented by the other major
central banks was developed.

[2] In practice, this share is relatively close
to the weight of each member country’s GDP in euro zone GDP.

[3] Securities purchasing operations are decentralized at the level of the national central banks. Doing this reduces risk-sharing within the Eurosystem since any losses would be borne by the national central banks, unlike assets held directly by the ECB, for which there is risk-sharing that depends on the share of each national central bank in the ECB's capital.

[4] The initial allocation was 750 billion euros, which was increased in June 2020 by a further 600 billion. As of 31 December 2020, securities purchases under the PEPP came to 650 billion.

Waiting for the recovery in the US

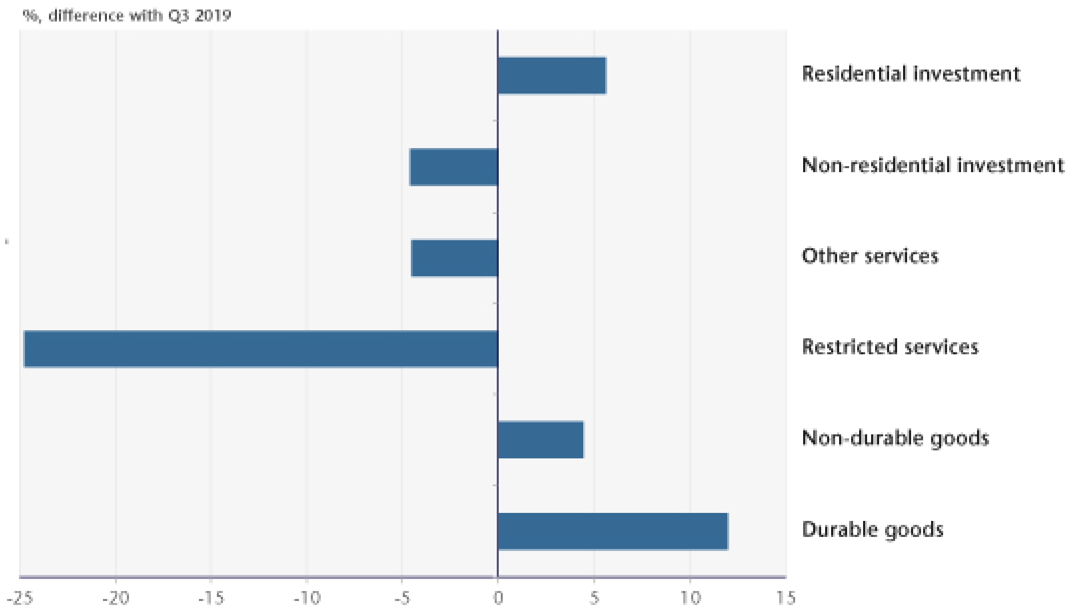
By Christophe Blot

As with the economic performance of all the industrialized countries, economic activity fell off sharply in the second quarter of 2020 across the Atlantic before rebounding just as sharply the following quarter. The management of the crisis in the US is largely in the hands of the different States, and the election of Joe Biden should not change this framework since he declared on November 19 that he would not order a national lockdown. However, the health situation is continuing to deteriorate, with more than 200,000 new Covid-19 cases per day on average since the beginning of December. As a result, many States are adopting more restrictive prophylactic measures, although without returning to a lockdown like the one in the Spring. This situation could dampen economic prospects for the end of the year and also for the start of the mandate of the new President elected in November. Above all, it makes it even more necessary to implement a new recovery plan, which was delayed by the election.

As in the euro zone, recovery in the US kicked off as soon as the lockdown was lifted. GDP grew by 7.4% in the third quarter after falling by 9% in the previous quarter. Compared with the level of activity at the end of 2019, the economic downturn amounted to 3.5 points, versus 4.4 points in the euro zone. The labour market situation also improved rapidly, with the unemployment rate falling by 8 points, according to data from the Bureau of Labor Statistics for November, from its April peak of 14.7%. These results are the logical consequence of the lifting of restrictions but also of the large-scale stimulus plans approved in March and April, which have massively absorbed the loss of income for households and to a lesser extent for US companies (see here). However, the upturn in consumption is still being dampened by some ongoing restrictions, particularly in sectors with strong social interactions, where

spending is
still nearly 25% lower than it was in the fourth quarter of 2019 (Figure 1).
As for the consumption of goods, it has been much less
affected by the crisis and is down only 12% from its pre-crisis level for
durable goods and 4.4% for non-durable goods. Nevertheless, most of these
support measures have come to an end, and as of this writing the discussions
that began in late summer in Congress have not yet led to an agreement between
Republicans and Democrats. Despite the rebound, the health impact of the pandemic
and the economic consequences of the lockdown on the labour market require a discretionary
policy in a country where the automatic stabilizers are generally considered to
be weaker[1]. New support measures will be all the more
necessary as a further tightening of restrictions is looming and the recovery
seem to be running out of steam. The initial consumption figures for the month
of October point to a fall in the consumption of services, and employment also
stabilized in November, remaining well below its level at the end of 2019.

Figure 1. Private domestic demand in Q3 2020



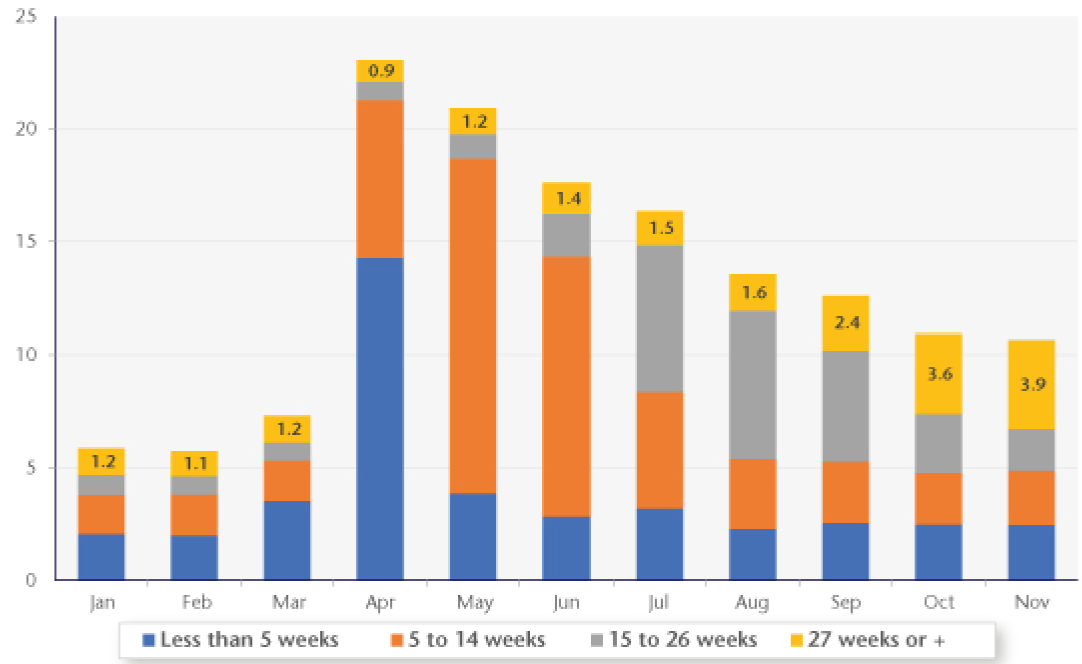
Note: Restricted services including recreational services, hotels and restaurants and transport.
Source: BEA (NIPA Table 156).

However, after the setback of the discussions in Congress, it will now be necessary to wait until the first quarter of 2021 for a new support plan to be approved and for a possible reorientation of US fiscal policy after Joe Biden's victory. In the Autumn, the Democrats proposed a 2 trillion dollar (9.5 GDP points) package, almost as much as the 2.4 trillion dollar (10.6 GDP points) package adopted in March-April 2020[2]. The aid would, among other things, support the purchasing power of the unemployed through an additional federal payment.

Although unemployment is much lower than in the second quarter, it remains above its pre-crisis level and is now characterized by an increase in long-term unemployment for which there is generally no compensation. In November, the share of those who had been unemployed for at least 27 weeks was 37 per cent (or 3.9 million people, Figure 2), and the median duration of

unemployment had risen from 9 weeks at the end of 2019 to almost 19 weeks in November 2020.
In addition, States whose tax revenues have decreased with the crisis could benefit from a federal transfer, thereby avoiding spending cuts[3].

Figure 2. Number of jobless by duration (weeks of unemployment)

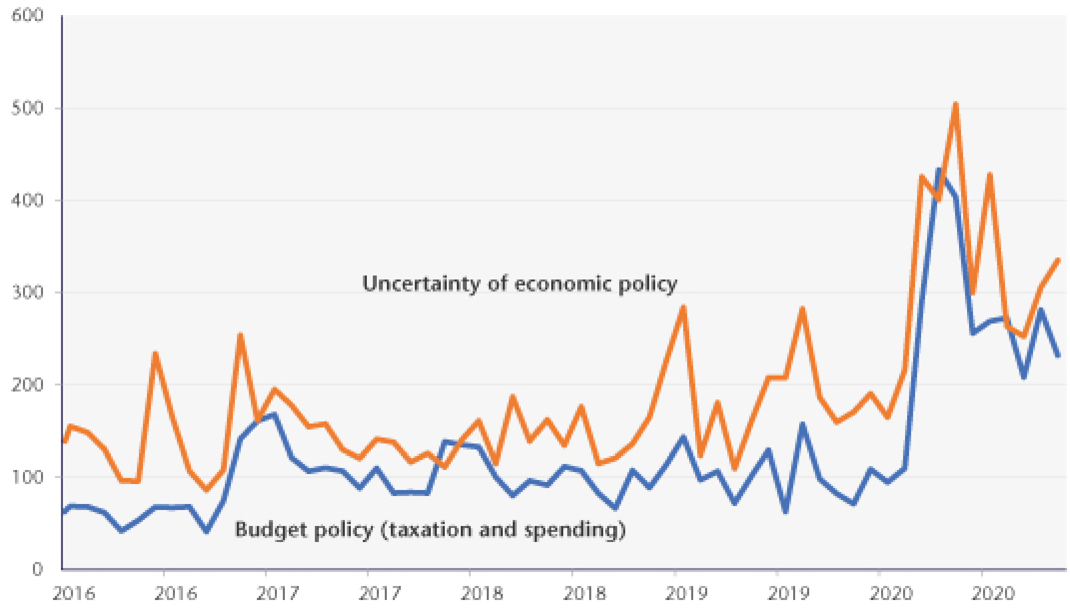


Source: Bureau of Labor Statistics.

However, despite the end of the suspense over the outcome of the presidential elections, the political and economic uncertainty has not been completely resolved. Indeed, it will not be known until early January whether the Democrats will also have a majority in Congress. They have certainly kept the House of Representatives, but it will be necessary to wait until the beginning of January for the Senate, with a ballot planned in Georgia that will determine the political colour of the last two seats [4]. Both seats are now held by Republican senators.
However, Joe Biden won Georgia by 0.2 points against Donald

Trump, the first victory in the State for a Democratic candidate since 1992. With both State-wide senatorial elections to be contested directly, the results are likely to be close. If one of the Democratic candidates is defeated, Joe Biden will be forced to contend with the opposition. But, as Paul Krugman points out, the Republicans are generally more inclined, once in opposition, to promote austerity. This is reflected in the uncertainty indicators of Bloom, Baker and Davies, whose economic policy uncertainty rose in November (Figure 3).
This uncertainty is certainly lower than in the Spring but remains higher than that observed between 2016 and 2019. During this period, growth could weaken, and then a strong recovery is likely to be followed by more subdued growth, which will have repercussions on the labour market. Regardless of the outcome, a plan will likely be approved in the first quarter of 2021, but its adoption could take longer if it is conditional on an agreement between Republicans and Democrats in Congress. However, this could be lengthy given the urgency of the health and social crisis, and could plunge a significant proportion of the most vulnerable into poverty.

Figure 3. Indicators of uncertainty about economic policy



Source : Baker, Bloom & Davis. https://www.policyuncertainty.com/index.html

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[1] See for example Dolls, M., Fuest, C. & Peichl, A., 2012, “Automatic stabilizers and economic crisis: US *vs.* Europe”, *Journal of Public Economics*, 96(3-4), pp. 279-294.

[2] By comparison, the European programmes are weaker, ranging from 2.6 GDP points for France to 7.2 points for the UK.

[3] Note that the States generally have fiscal rules limiting their capacity to run a deficit.

[4] Of the 100 seats in the Senate, the Republicans already hold 50. In the event of a tie between the two parties, it is the voice of the Vice-President-elect Kamala Harris that will decide between them. A single victory in Georgia would therefore allow the Republicans to retain the majority.