Belgian Financial Forum

Finishing quantitative easing: Impact on Belgium's government debt[1]

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ABSTRACT

The Eurosystem has spent 73.4 billion euros on Belgian Public Sector Securities between March 2015 and December 2018. It is believed that these purchases concerned mainly, if not entirely, Belgian OLOs issued by the federal government. Together with other non-standard measures taken by the ECB, this quantitative easing has exerted downward pressure on Belgian bond yields. Now that net buying of public sector securities has come to an end, it is worth looking at interest rate developments. Interest rates did not increase until now, and the federal government debt servicing costs which were for the first time lower than 2.0% of GDP in 2018, would further decline in 2019. Projections by the Belgian Debt Agency show that debt servicing costs would not materially rise, not even in the long term, when scenarios of rising rates are combined with very conservative debt management strategies.

[1] This article is based on presentations given to the Belgian Financial Forum in Antwerp and Hasselt in 2018.

1. Introduction

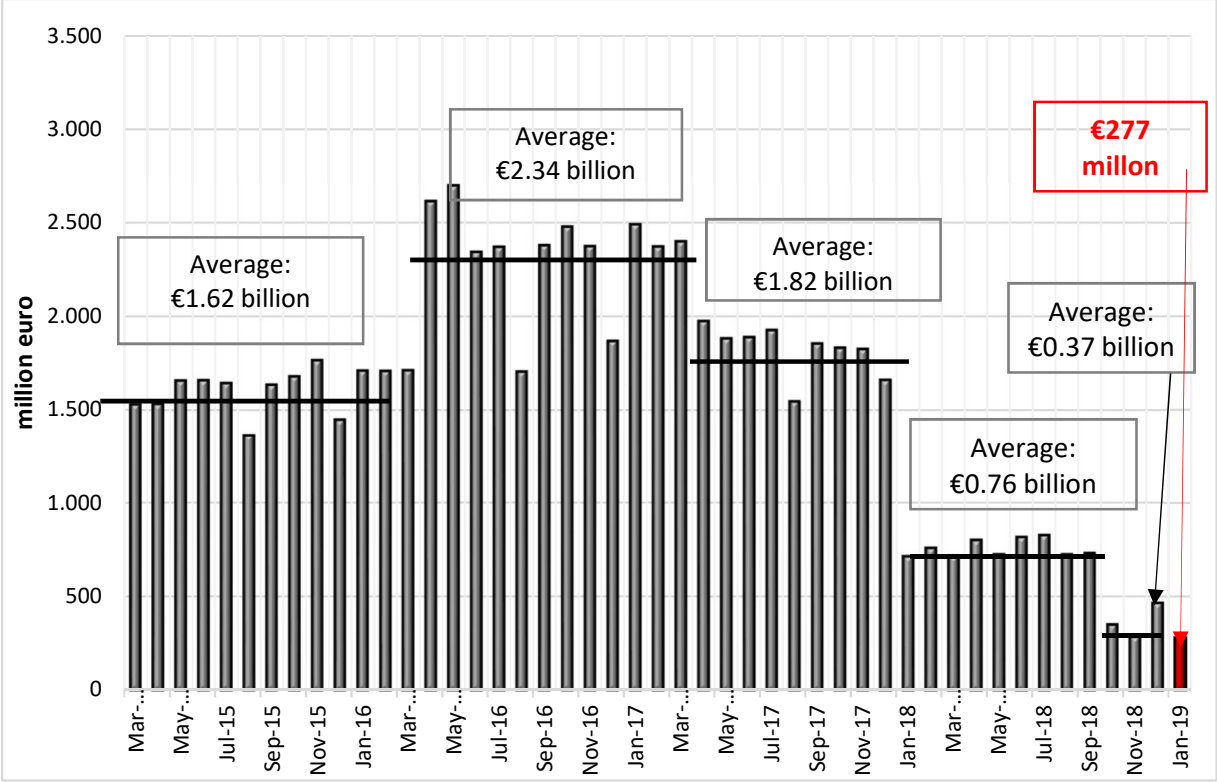
The Eurosystem started buying public sector securities under the PSPP (Public Sector Purchase Program) on March 9, 2015. The PSPP gave a significant boost to the Asset Purchase Program (APP) which had started earlier, as the volumes of public sector securities are much higher than those of the Asset Backed Securities and Covered Bonds with which the program started.

In the case of Belgium, this meant that the Eurosystem purchased, in net terms, EUR 73.4 billion of public sector securities by December 2018. These were mainly, and possibly exclusively, Belgian OLOs, of which there were EUR 337.9 billion outstanding at year end 2018. These figures suggest that 21.7% of all OLOs were detained by the Eurosystem by year end 2018, but as the figure of EUR 73.4 billion is equal to the cash price paid by the Eurosystem for OLOs of which most have been trading above par in recent years, the part of OLOs owned by the Eurosystem in terms of nominal values is less than that. Yet the Eurosystem's holdings are still very material.

2. Execution of the PSPP for Belgian Public Sector Securities

The graph below shows that the intensity of the purchases has varied according to different phases and to the Eurosystem's targets in terms of overall asset purchases.

Graph 1: Purchases of Belgian Public Sector Securities by the Eurosystem



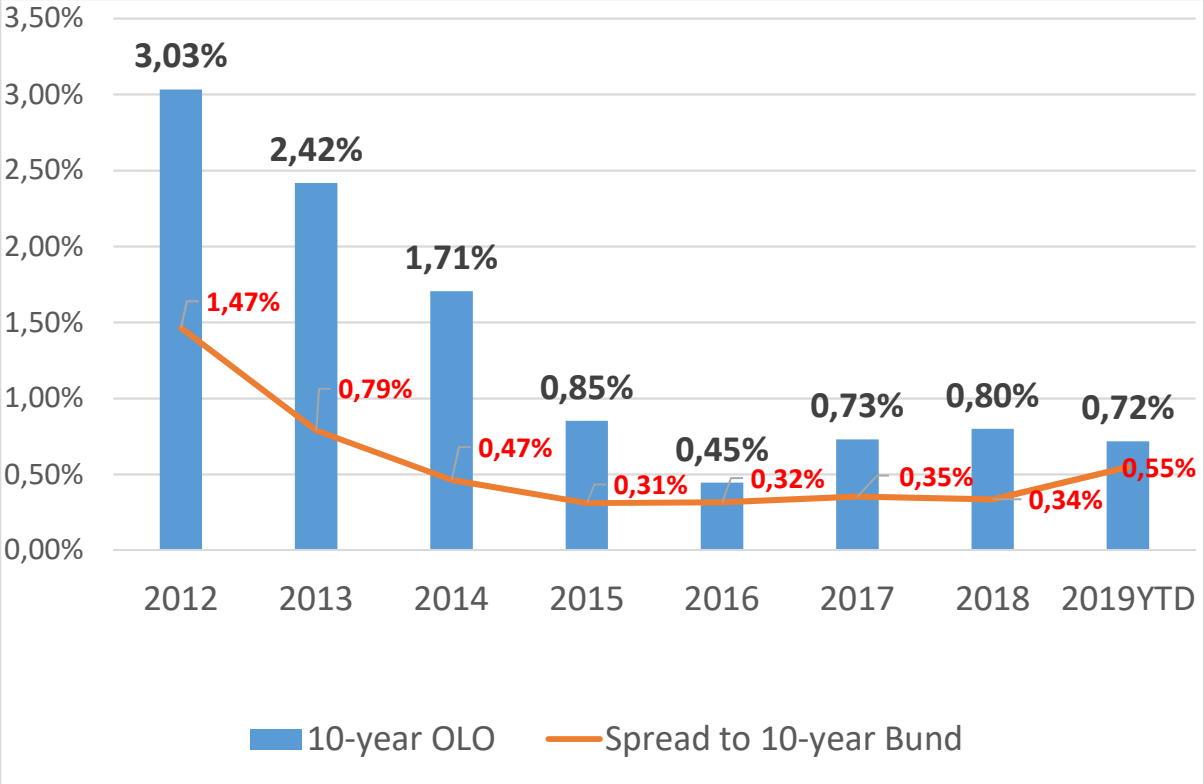
From March 2015 to March 2016 included, the Eurosystem targeted EUR 60 billion per month, and it spent on average EUR 1.62 billion per month on OLO purchases. As from April 2016 onwards, the monthly APP target increased to EUR 80 billion. In the subsequent period, OLO purchases on average amounted to EUR 2.34 billion per month. One year later, in April 2017, the Eurosystem started to slow down its net purchases to EUR 60 billion. Later on, purchases were again reduced, to EUR 30 billion in January 2018, and to EUR 15 billion in October 2018. The monthly purchases of OLOs accordingly decreased to EUR 1.82 billion, EUR 0.76 billion, and EUR 0.37 billion respectively.

Finally, by year end 2018, the Eurosystem stopped buying public sector securities in net terms. It would however continue to reinvest securities coming to redemption, in an orderly and smoothed way. As such, in January 2019, EUR 277 million of OLOs were bought with a view of preparing the reinvestment of the two OLOs coming to maturity in 2019.

3. Impact on interest rates

Quantitative easing was one of the main non-standard (or unconventional) measures taken by the ECB since 2008. Others included longer term refinancing operations, Outright Monetary Transactions, and the negative interest rates on the deposit facility. These measures affected the whole constellation of interest rates in the Euro Area, with most interest rates reaching historical lows in recent years.

Graph 2: Evolution of Belgium's 10-year rate and spread to Bunds



Graph 2 shows that the yields on Belgium's government bonds had already sharply declined in 2012, after having peaked in 2011. They continued their descent thereafter, partially because the spreads to the German government bond yields decreased. In 2014 the market

started to expect quantitative easing, and yields decreased further. Belgium's OLO yields were at their lowest in 2016, when the PSPP was at its maximum and when the negative interest rates on the deposit facility were brought to their current level of -0.40%.

In 2017, yields were again rising, coinciding with a reduction of PSPP, yet they remained relatively unchanged during the strong decline in the Eurosystem's purchases in 2018. The reinvestment phase of PSPP in 2019 did also not result in higher bond yields up to now.

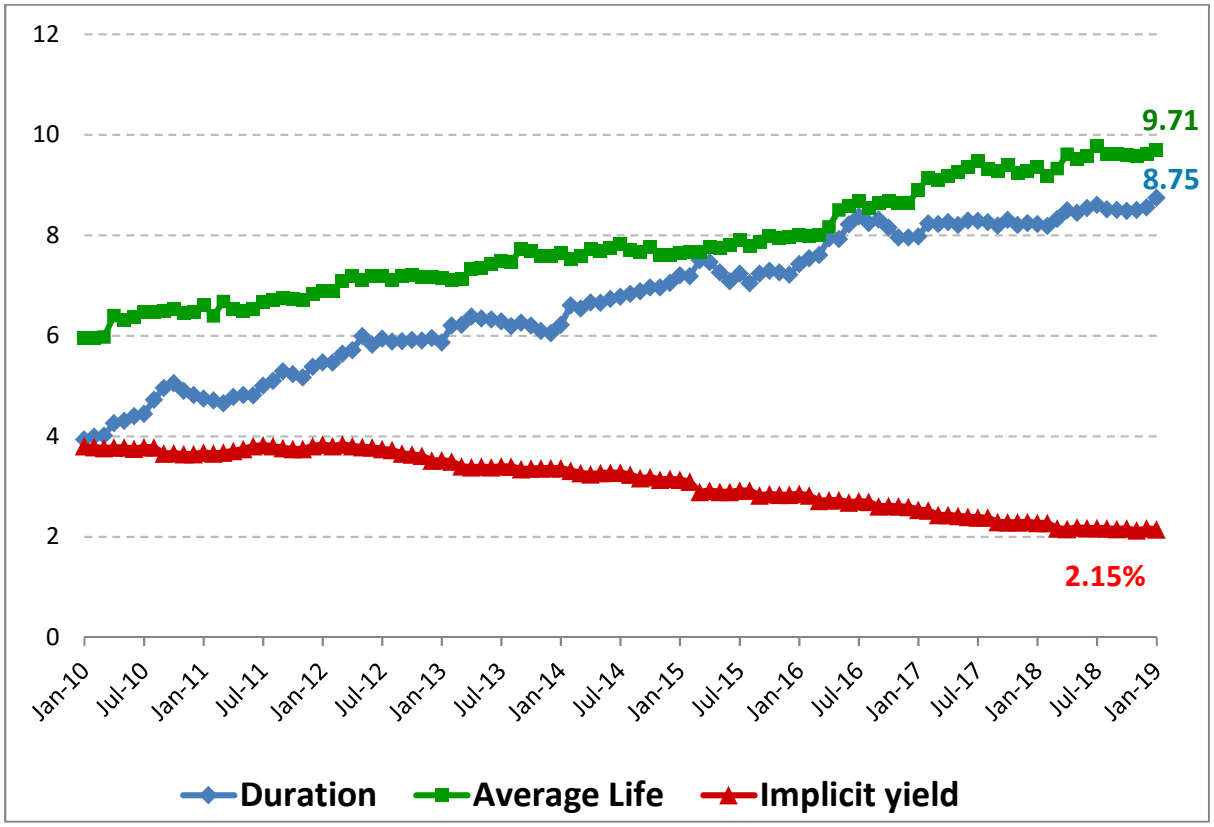
The decreasing growth picture and the negative sentiment about the economy of course explain this lack of pressure on bond yields, but it is still striking that the much bigger involvement in the funding of the Kingdom by investors outside QE did not lead to higher rates. Indeed, in 2017, investors bought only EUR 12.7 billion of OLOs, whereas they bought EUR 26.7 billion of OLOs in 2018.

4. Impact on debt servicing costs

While interest rates failed to increase during the ECB tapering, they may still start doing so should the ECB take a less accommodative stance in the future, for instance by not or not entirely reinvesting its bonds coming at maturity any more, or by increasing its main interest rates. The ECB made it clear that the latter will precede the phase of declining bond holdings.

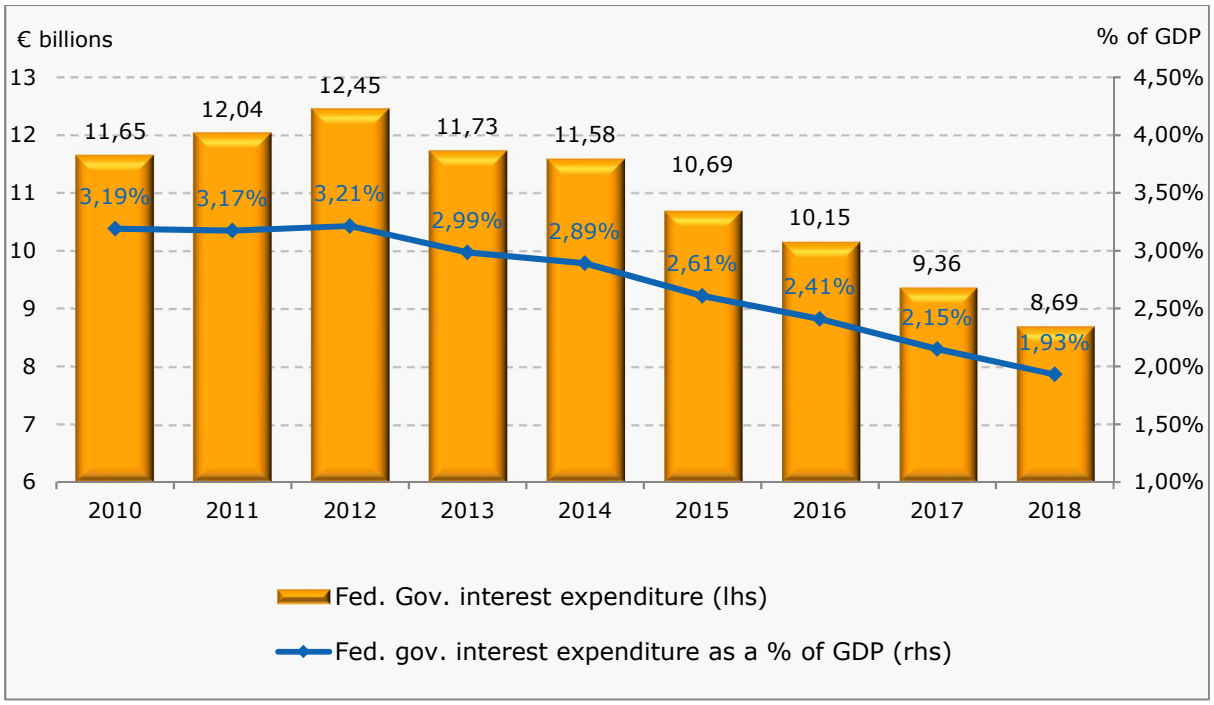
But the average life and duration of the federal government debt is much higher now than in the past. This is protecting the government budget from the effect of a possible rise in interest rates. Graph 3 exhibits the evolution of the federal government's debt structure: as of 31 January 2019, the average maturity of the government debt stood at 9.71 years, compared to 6.00 years in early 2010. It is worth noting that the average yield of the debt instruments continued to decline during this process, to 2.15%.

Graph 3: Debt structure and implicit yield (federal government debt)



The declining implicit cost of the portfolio was the main driver for the rapidly decreasing federal debt servicing costs (graph 4). In 2018, they amounted to less than 2.0% of GDP. General government debt servicing costs were only a little higher (2.2% of GDP).

Graph 4: Federal Government Debt Servicing Costs 2010 - 2018



5. Future debt servicing costs

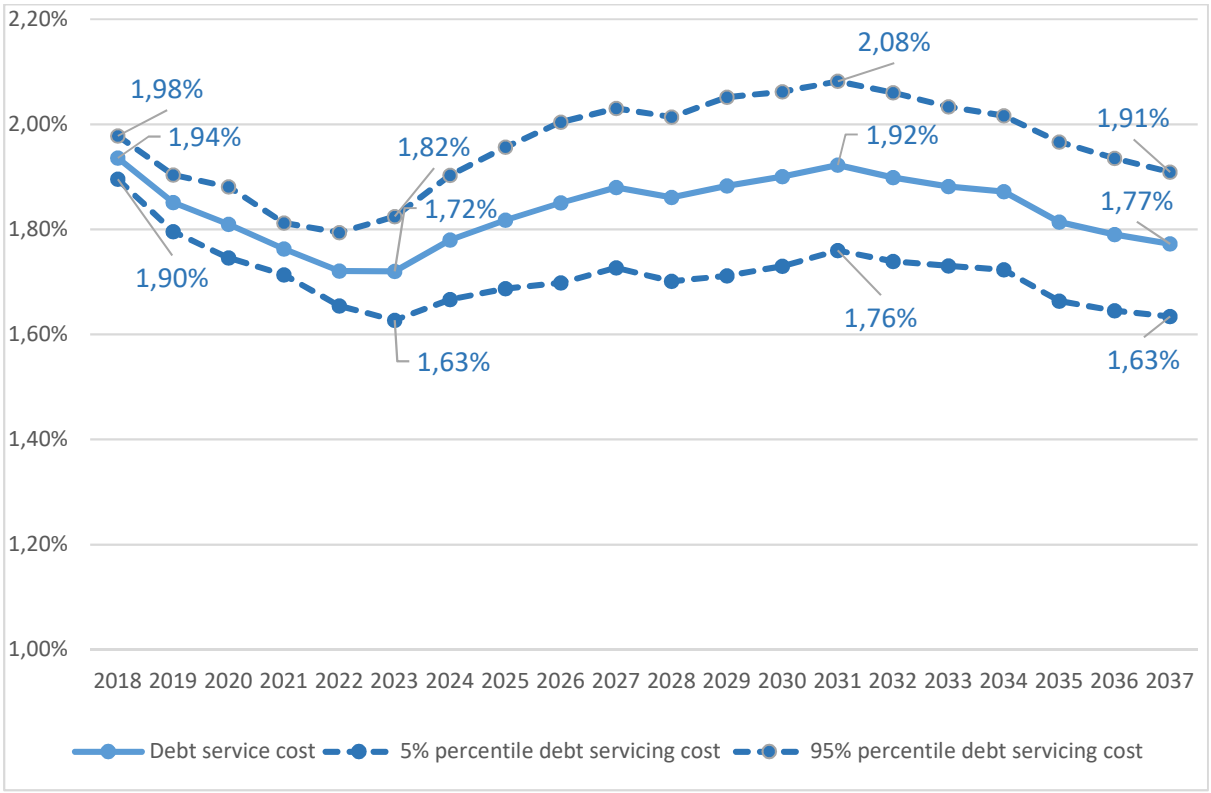
An important question is then if the evolution of debt servicing costs could reverse in the future, should market interest rates rise as a reaction to a less accommodative stance by the ECB.

The Belgian Debt Agency made some long-term projections in the course of 2017, whereby it assumed that interest rates would start rising from 2018 onwards, in order to reach 1.45% for the 3-months rate and 2.90% for the 10-year rate in 2022, after which the average interest rates would remain constant at these levels. The model assumed an average real GDP growth rate of 1.50% on average, and a GDP-deflator of, on average, 1.50%. Interest rates are modelled to be positively correlated to the output gap while the GDP deflator is less

dependent from other variables, as long as the output gaps are not significantly high or low. Furthermore, a constant federal primary surplus of 1.00% of GDP was assumed.

Using a very conservative debt management strategy, consisting of an average new long-term issuance maturity of 14.5 years and a gradual winding down of short-term debt to 2.5% of the overall debt portfolio by 2023 (from 7.5% in 2018), federal government debt servicing costs would still continue to decrease from their expected – and already confirmed - value of 1.94% of GDP in 2018 to 1.72% in 2023, when they would reach a minimum (graph 5). Afterwards, the higher interest rate environment starts to feed through and costs would rise to 1.92% of GDP in 2031, in order to decline again to 1.77% in 2037. The limited rise of debt servicing costs and the decline as from 2031 onwards are the result of the predicted decrease of the (federal) government debt-to-GDP ratio under these circumstances.

Graph 5: Federal Government Debt Servicing Costs 2018 – 2037 (modelled)



Moreover, the 95%-percentile of the federal debt servicing costs barely exceeds 2.0% of GDP in 2027-2034; in other years it would not reach that level. Also, the Belgian Debt Agency is not reducing its short-term debt, and it is not planning to do so, which means that the debt servicing costs (as expected by this model) resulting from its current strategy would be somewhat lower than those shown in graph 6.

It is of course possible that rates would rise to higher levels than assumed, and this may even happen in an environment of less growth and inflation. This could be the case, for instance, if the swap spreads and/or the spreads with German Bunds would rise for Belgium. Yet these spreads have recently been rising, and the federal government currently enjoys rates that are lower than those assumed for 2019 (which were -0.40% for the short term and 1.06% for the 10-year rate). So, it does look quite unlikely that debt servicing costs will rise over the course of the next five years, and a scenario with almost constant debt servicing costs – in terms of GDP - for many years to come is certainly possible and may even be expected.