Global Macro Views – Fiscal Space and Market Access

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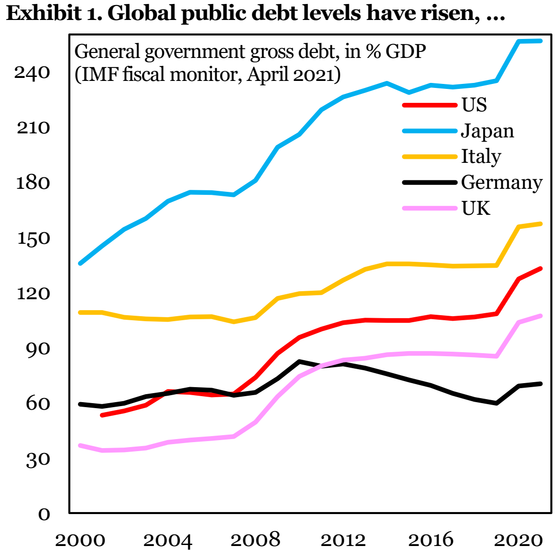
- The COVID shock caused debt levels around the world to rise sharply, ...
- even as yields on government bonds have fallen to unprecedented levels.
- The low level of yields is causing some to advocate for more deficit spending, ...
- on the grounds that US fiscal space may be much larger than previously thought.
- This ***Global Macro Views*** starts a series on how much fiscal space is left after COVID.
- We come at this using our EM perspective, where fiscal space equals market access, ...
- meaning how much new debt issuance can governments sell to markets at low yields.
- Market access deteriorated across advanced economies during the COVID shock, ...
- which means that low yields overstate the remaining amount of fiscal space.

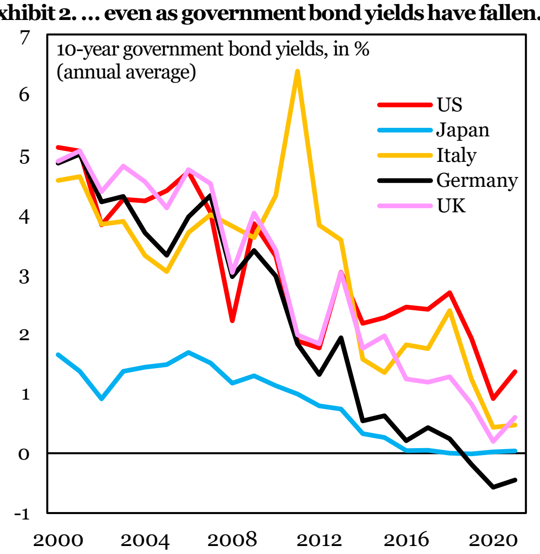
Government debt levels have ballooned around the world, even as interest rates have fallen near record lows. This puzzle is reshaping how economists see *"fiscal space,"* with some advocating more aggressive deficit spending going forward, given that fiscal space may be a lot larger than previously thought. This ***Global Macro Views*** starts a series on how to think about remaining fiscal space in advanced economies. We come at this question from an EM perspective, where fiscal space boils down to market access, i.e. how much new debt can governments sell to markets at low yields. We use flow of funds data across advanced economies to split out central bank purchases from total demand for government bonds. The remainder is what markets were willing to finance and that number – for the US – has declined versus the global financial crisis. Fiscal space may thus still be plentiful, but it is less than a decade ago.

Exhibit 1. Global public debt levels have risen, ...



Source: Haver, IIF

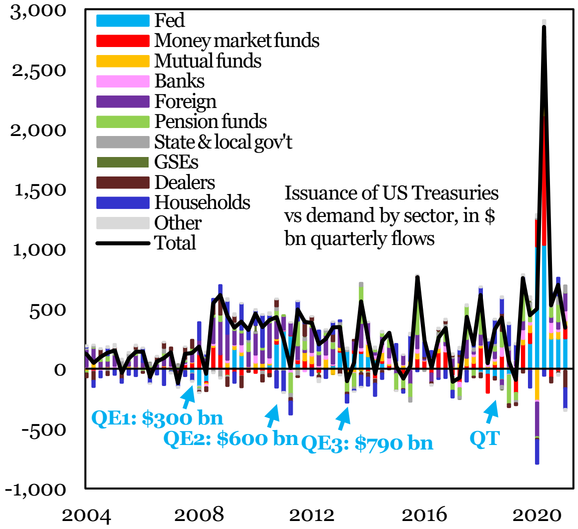
Exhibit 2. ... even as government bond yields have fallen.



Source: Haver, IIF

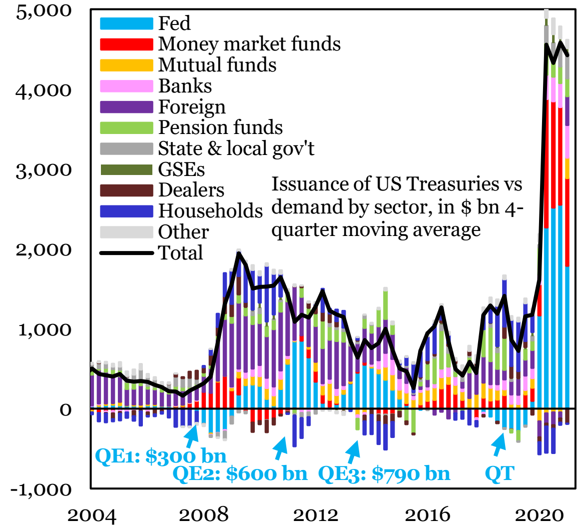
How much fiscal space we have left is perhaps one of the most important questions in the aftermath of COVID. It determines how aggressive deficit spending can be in future crises and whether we are nearing a tipping point. The headline evidence on this is completely unclear. Debt levels have risen sharply around the world (Exhibit 1), yet sovereign bond yields have fallen to record lows (Exhibit 2). A complicating factor is that many central banks are doing QE, which – in some cases – absorbs the bulk of new debt issuance, so that yields may not be a market price. We adopt the EM definition of fiscal space, which boils down to market access, i.e. how much new debt are markets willing to buy at low yields. We use flow of funds data to decompose debt issuance across advanced economies into that absorbed by central bank QE and that going to the market. Exhibit 3 shows this decomposition for the US using quarterly flows, showing the rise in issuance in Q2 2020, which was funded by the Fed (blue) and money market funds (red). For all of 2020, Fed QE absorbed about 60 percent of issuance, followed by money market funds, which absorbed another 35 percent (Exhibit 4). The bulk of issuance was therefore off-market, suggesting that low yields may signal little on the matter of fiscal space. A comparison with the global financial crisis is also instructive. For all of 2009, Fed QE absorbed 20 percent of issuance, so the bulk of debt was sold to the market. Maybe fiscal space is still ample, but it is less than a decade ago.

Exhibit 3. We follow the EM definition for fiscal space, ...



Source: Haver, IIF

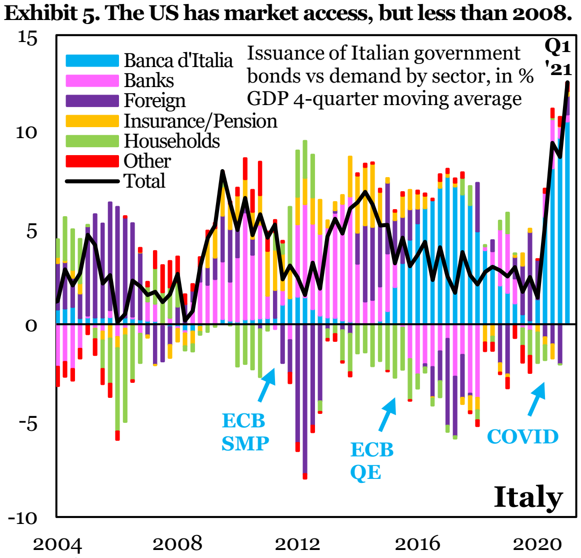
Exhibit 4. ... which defines fiscal space as market access.



Source: Haver, IIF

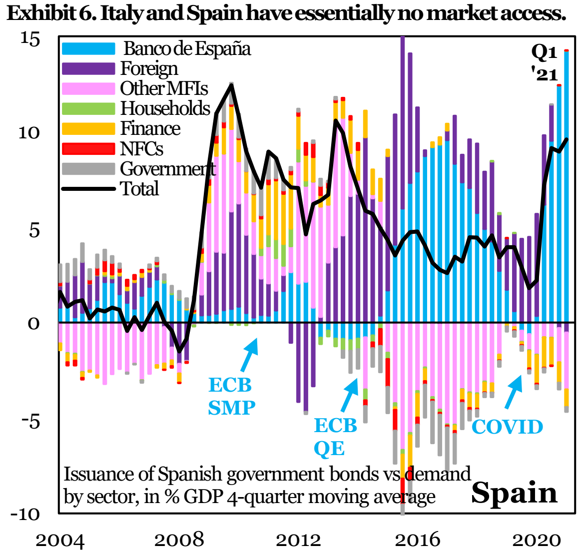
Perhaps the most extreme examples are Italy (Exhibit 5) and Spain (Exhibit 6) where ECB QE purchases are essentially absorbing all issuance, so that fiscal space is likely very limited, even in the presence of very low sovereign bond yields. Next week's ***Global Macro Views*** will expand this analysis across all advanced economies and compare the level of yields to the scale of market access in 2020. It will assess how market access has changed from the global financial crisis, how it compares across countries and – ultimately – what this says about remaining fiscal space.

Exhibit 5. The US has market access, but less than 2008.



Source: Haver, IIF

Exhibit 6. Italy and Spain have essentially no market access.



Source: Haver, IIF