Global Macro Views – The End of the Great Fiscal Illusion

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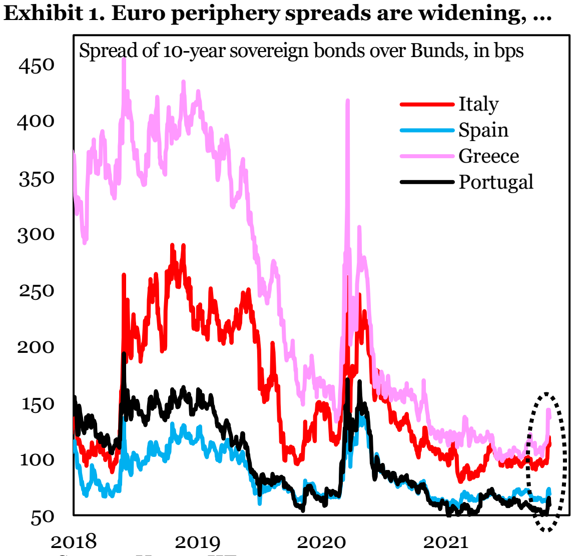
- Over the summer we wrote extensively about the great *"fiscal illusion,"* …
- whereby low sovereign bond yields were seen as signaling ample fiscal space.
- We showed that low bond yields were misleading, distorted by central bank QE, …
- especially on the Euro periphery where ECB QE absorbed 100 percent of issuance, …
- even as foreign investors used ECB QE to sell their holdings of Italian and Greek bonds.
- Among the G10 central banks, the ECB faces the biggest hurdles to normalizing policy, …
- given that an end to QE could see periphery yields rise sharply on weak demand.

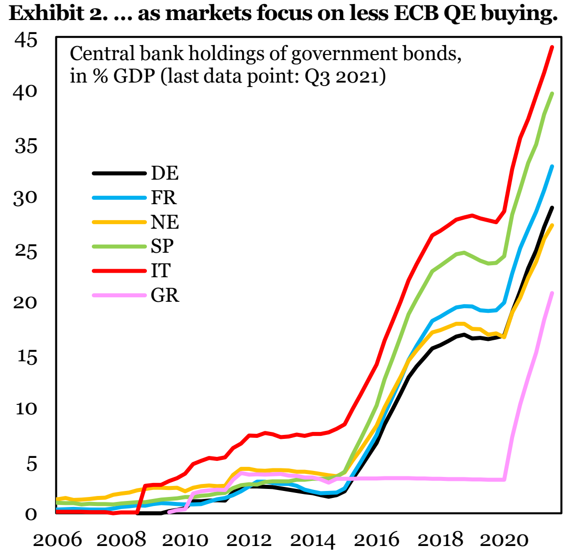
We spent this past summer writing about the great *"fiscal illusion,"* whereby low government bond yields were mistakenly seen by some as a signal that fiscal space remains ample. We showed that low sovereign bond yields were sending a misleading signal in this regard, given the distorting effects of central bank QE, which in the case of the Euro periphery absorbed 100 percent of 2020 debt issuance, even as foreigners used ECB QE to sell their holdings of Italian and Greek government bonds. Markets are now zeroing in on Italy and Greece as expectations build that QE will be scaled back. The process of policy normalization will prove especially difficult for the ECB, given that potential for an overshoot in Italian and Greek bond yields is real and the resulting tightening in financial conditions would be highly undesirable.

Exhibit 1. Euro periphery spreads are widening, …



Source: Haver, IIF

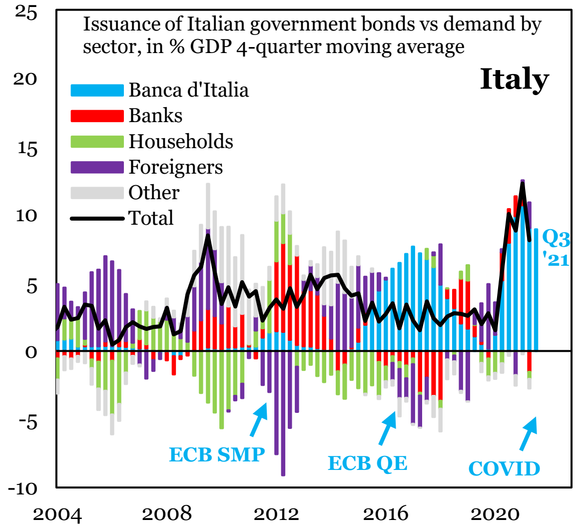
Exhibit 2. … as markets focus on less ECB QE buying.



Source: Haver, IIF

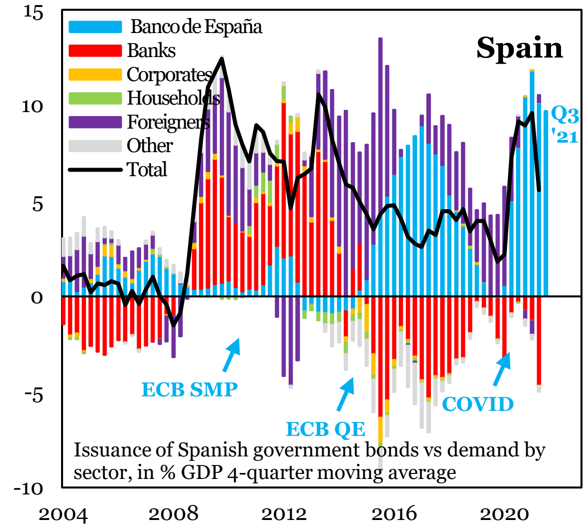
The spread on Italian and Greek 10-year sovereign bonds over German Bunds has risen sharply in recent weeks (Exhibit 1), as expectations build that the ECB will scale back its QE buying. We spent the summer warning that low sovereign bond yields on the Euro periphery were potentially misleading, given the large size of ECB QE purchases (Exhibit 2). Indeed, using flow of funds data across the G10, we showed that countries on the Euro periphery in 2020 relied almost entirely on the ECB to fund debt issuance, including Italy (Exhibit 3) and Spain (Exhibit 4). The weak picture for private demand – beyond ECB buying – worried us, especially for Italy and Greece where foreign investors used ECB QE as an opportunity to sell their holdings of sovereign bonds at attractive prices.

Exhibit 3. This marks an end to the fiscal illusion, ...



Source: Haver, IIF

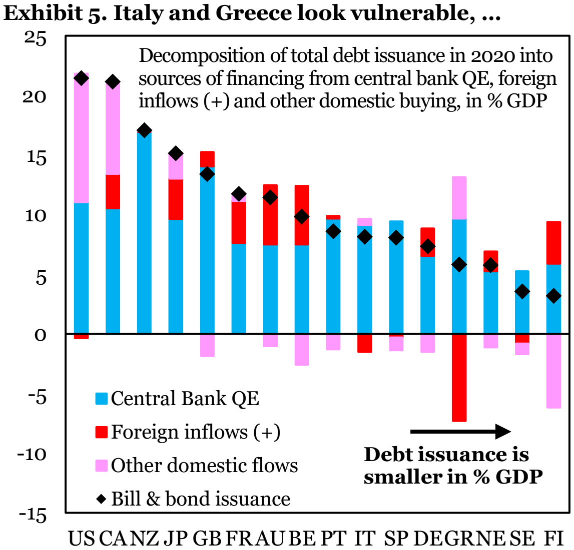
Exhibit 4. ... whereby ECB QE kept bond yields low.



Source: Haver, IIF

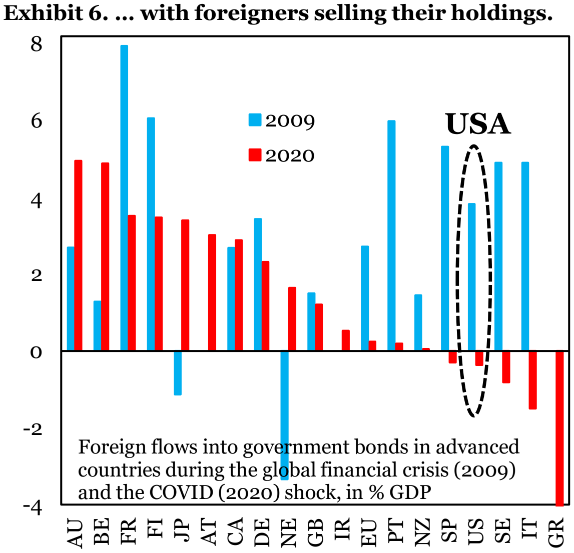
We use flow of funds data to systematically compile all 2020 debt issuance across the G10 (Exhibit 5). Our analysis folds in issuance of short-term bills plus medium- and longer-term bond issuance. We break down this issuance into demand from central bank QE (blue), foreign investors (red) and other domestic buyers (pink). This snapshot shows that the US and Canada look relatively benign despite large debt issuance, as private demand absorbed 40 percent of issuance. In contrast, ECB QE funded the bulk of Euro periphery debt issuance, leaving countries vulnerable to a reduction in central bank buying. A particular concern is that foreign investors sold Italian and Greek sovereign bonds in 2020, using the cover of ECB QE to reduce their holdings at attractive prices (Exhibit 6). We see foreign investors as an especially good proxy for unencumbered private demand, given that they are less exposed to moral suasion and regulatory capture. Overall, the process of monetary policy normalization will be difficult everywhere, but especially so in the Euro zone, where ECB QE play a pivotal role in anchoring periphery yields. The risk of an overshoot in periphery yields, especially for Italy and Greece, is real and would be highly unwelcome given still very large output gaps, a hangover from the 2011/2 Euro zone debt crisis.

Exhibit 5. Italy and Greece look vulnerable, ...



Source: Haver, IIF

Exhibit 6. ... with foreigners selling their holdings.



Source: Haver, IIF