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Attachment 2 - Speculation on interest rate spreads and risks of public debt crises*

The European response to the economic and financial crisis caused by the Covid-19 epidemic, to date, is largely based on the increase in national public debts. Even cooperation measures within the EU, such as the SURE program or the new ESM credit line, envisage that the Commission or an *ad hoc* fund issue securities on the markets to find resources that would be then lent to the Member states. As we write, negotiations are still ongoing concerning the Recovery Fund and the Commission's proposal for the new multiannual financial framework of the EU, so the impact of these schemes on national public debts is still unclear. States that will make use of these schemes will thus experience a further increase in public debt, even though not in the form of securities traded on the financial markets. Therefore, the sustainability of debt, or conversely the risk of a debt crisis, is becoming topical again.

In the history of public debt, for a long initial period, control of fiscal policy was entrusted to the nation states; debt securities could be eligible for underwriting by the public but they could also be underwritten by the central bank, partly making the public deficit a monetary issue. In this situation, a debt crisis could not break out, except when the debt was issued in a foreign currency and/or underwritten by foreign investors. In Italy, as in other countries, a phase follows in which the 'divorce' between the central bank and the government requires the latter to finance its budget deficits on the market only. In this phase it may happen that to have the public underwrite debt securities, high yields have to be offered, resulting in an increase in financing costs that can trigger an explosive growth in the share of public debt on GDP.

Finally, in the last couple of decades we have entered a third phase, in which the management of public debt, like all financial securities, relies more on financial speculation than on the presence of a large base of savers-underwriters. Asset management is entrusted to financial institutions, which (also through derivative instruments, without the need to directly own debt securities) speculate on the prices trends. Consequently, very short-term expectations take on crucial importance in the determination of returns, and therefore of the cost (and of the very possibility) of continuously refinancing the maturing securities, even at a given level of public debt. In this context, due to "light" or often non-existent regulation, instability grows, and with it the risks of sudden financial crises.

Financial crisis risks are many-sided. First, there is the ever-lurking issue of the spread on public debt securities of different countries (i.e. the yield difference between the securities

of a country and those of the reference country, today Germany) within a currency area such as the euro, with the risk of its disintegration. Then there is the problem of the solidity of financial institutions: Lehmann's bankruptcy triggered the 2008 world crisis; what would happen now if a large European bank failed? Finally, there is the problem of the transmission of financial strains on the real economy, with the drop in investments due to the difficulty of financing them and the increase in uncertainty aversion, and the risk of bankruptcy due to the liquidity crisis of firms (possibly notwithstanding their being solvent).

Tensions on interest rates spreads are considered a marker of risk of a public debt crisis in a country. Although this is often taken for granted, the innovation is not trivial: instead of considering the value of the debt, for example in relation to the population or the income of a country, today we consider instead the market price of these debt securities. This means that the riskiness of such debt changes every second, even if the debt itself is not changing at all, and that the perception of such a risk becomes, especially in moments of stress on the markets, more important than macroeconomic and financial variables. So it happens that the risk of a debt crisis is not exclusively linked – and perhaps not even primarily – to the size of public debt: Japan, which has a much larger debt than Italy, does not have problems of refinancing even at very low rates.

Risks come from the way the euro was built, with a centralized management of monetary policy (entrusted to the European Central Bank) but with separate fiscal policies and national public debts, even if denominated in the common currency. Actually, no one noticed these risks until the case of Greece exploded, suddenly and after several years of close-to-zero spreads for all eurozone Member states. That is, until international financial speculation has made the imperfect architecture of the euro into an easy source of profit opportunities (since the possibility of speculating on exchange rates between the European currencies was no longer available).

Furthermore, the sudden and violent nature of spread increases that occurred on various occasions depended on the economy's financialisation. Speculation has been based on CDSs, a derivative contract that allows "betting" on a country's default without owning the respective securities, and which changes its price continuously, thus allowing to speculate not on the actual occurrence of a default but on the increase or decrease of its perceived probability as estimated by the market. This applies even if such occurrence is deemed unlikely: for example, an increase in the risk of default from 2% to 4%, according to the subjective estimates of the market, could grant a speculator who own the CDS a gain of even 100%. Due to arbitrage, the price changes of the CDSs are shifted to the yields of public debt securities. This, however, has consequences on the real economy. When the spread increases, the higher yields produce an increase in the costs for public finances. This is transmitted to private liabilities too, worsening the competitiveness of the banks and businesses of the country involved compared to reference country. Such a consequence has generated political and, in times of crisis, even institutional tensions between the Member States.

In addition, a significant increase in the spread can trigger a self-fulfilling expectations mechanism: the increase in public debt servicing makes a default more likely, generating a further increase in the spread, and so on, up to making the cost of debt unsustainable. For example, an increase of 500 basis points in the spread implies for a country with a public debt equal to 100% of its GDP an increase in debt service cost equal to – if that persists in the long-run – 5% of GDP. In the case of Greece, at one point the spread had reached 1700 basis points. During the sovereign debt crisis, the ECB openly considered this problem, in light of the fact that the excessive increase in spreads could entail such high costs in some countries as to seriously substantiate the risk of these countries leaving the euro area. To counter and, practically, prevent this type of self-fulfilling speculation, the ECB created the OMT program in 2012, through which it professed its being ready to buy short-term public debt securities of any eurozone country, without limits.

To date, however, the problem of the cost differentials of public debt due to the market evaluation of its riskiness remains open, based on the so-called “fundamentals”, i.e. variables that can be reasonably believed to be relevant in the evaluation. In fact, a range of the ECB’s monetary policy operations largely rely on market valuations of securities, in particular with an explicit role for the credit rating assigned by the three main international agencies. On this depends the ECB’s willingness to buy securities with its *quantitative easing* operations, from which Greece has so far been excluded due to the “junk” rating of its public debt securities. This also influences the extent to which the ECB accepts securities as collateral in the loans it makes to banks: by not accepting junk securities (except for the very recent schemes introduced during the Covid pandemic), and by imposing a discount (the so-called *haircut*) on the value of securities, which depends on their rating.

Ultimately, the possibility to go back to the situation prior to the sovereign debt crisis, in which spreads within the eurozone were virtually zero, must be judged against one’s judgment on the efficiency of the financial markets (including rating agencies). It must be considered as desirable to the extent that stock prices do not consistently and correctly reflect the appropriate value of financial assets. With the Covid-19 crisis, the Federal Reserve bought large amounts of junk bonds; without yet reaching this, the ECB agreed to immediately include Greek securities in its main stimulus program, and then clarified that “self-imposed limits”, such as the rating of the securities accepted as collateral from banks, can be removed or ignored during this crisis. However, it has not gone so far as to purchase significant quantities of junk bonds yet, and in a recent contribution its chief economist restated that the ECB’s goal is to limit “non-fundamental volatility in spreads” only.¹ So, for the moment, a return to the situation before the 2008 global financial crisis is unfortunately not to be expected.

The simultaneous drop in income and production due to the epidemic has already produced speculative waves in financial markets that kept growing as the EU’s response began to appear inadequate. The defence against such waves, however, was not consistent: the spreads were allowed to rise, fluctuating in synchronicity with the tone of confrontation between the governments of the European countries that had asked for the issuance of joint

¹ Statement available at <https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200501~a2d8f514a0.en.html>

European bonds and those who opposed it. The warning is clear: *no European country has full sovereignty over its fiscal policy*. Such a limitation may be discriminating, but it has to be taken into account.

The ECB has immediately adopted interventions aimed at avoiding liquidity crises among financial institutions, while the problem of ensuring the transmission to firms of the liquidity required to overcome the crisis remains unsolved. As we have mentioned, EU countries are tackling this problem individually, through guarantees on bank loans to businesses. At least in part, however, the increased liquidity created by the ECB (such as that created by the US Federal Reserve and the central banks of the other major countries) remains available for financial speculation. Without a revision of the euro-area architecture, *the dramatic problem shall remain of how to prevent the burst of public debt, already underway, from generating a crisis when the Stability Pact comes back into force after the end of the epidemic (predictably at the end of 2021)*.

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* Attachment 2 to the Statement “The Covid crisis and a possible turning point for the European Union” by the Lincei Committee on Covid-19