Flash Economics

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Euro zone: Towards a dangerous situation where German government bonds are eventually the only risk-free bonds?

In the euro zone there is a clear temptation (apart from Germany and the European Commission) to accept that countries maintain high fiscal deficits (in France, Spain, Portugal and Ireland). Currently, thanks to the ECB's very expansionary monetary policy, the fact that these public debt ratios, accordingly, are maintained and even increased is not having any dangerous effects.

But in the future, once the ECB has exited the quantitative easing programme, there is a risk of a shift to a situation where only government bonds issued by Germany (and perhaps also a few small countries such as Austria and the Netherlands) will be considered as risk-free. If many countries' government bonds change status to risky bonds, this will be a considerable handicap for the countries in question (loss of borrower solvency, problems for investors and banks, sharp rise in companies' and households' financing costs).

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The euro zone: The temptation to no longer correct fiscal deficits

Charts 1A and **B** show the **fiscal deficits of 11 euro-zone countries**, **Charts 2A** and **B** show **these countries' published debt ratios. Charts 3A** to **K** compare, for these 11 countries, **the actual fiscal deficit and the fiscal deficit that stabilises the public debt ratio.**

Chart 1A
Fiscal deficit (as % of nominal GDP)

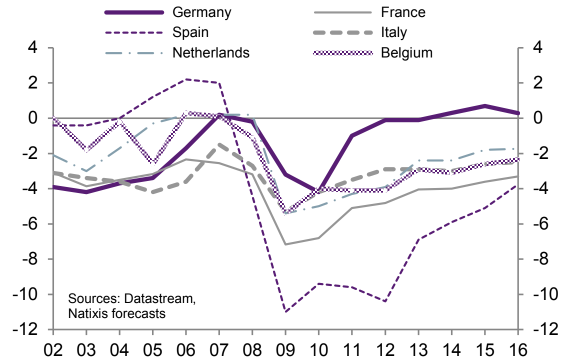


Chart 1B
Fiscal deficit (as % of nominal GDP)

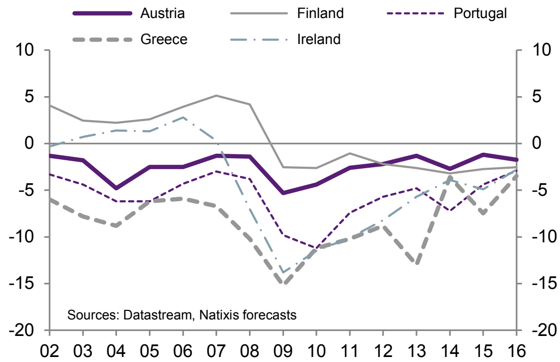


Chart 2A
Public debt (as % of nominal GDP)

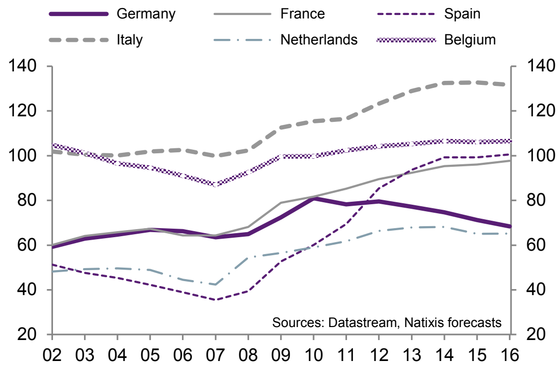


Chart 2B
Public debt (as % of nominal GDP)

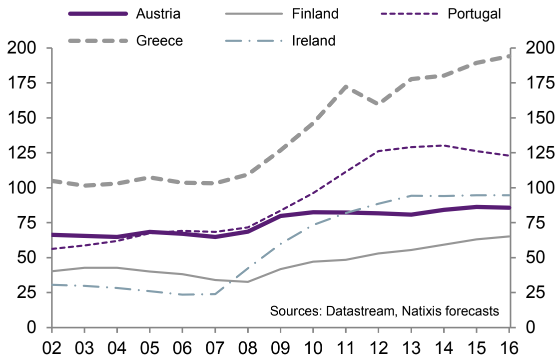


Chart 3A
Germany: Fiscal deficit (as % of nominal GDP)

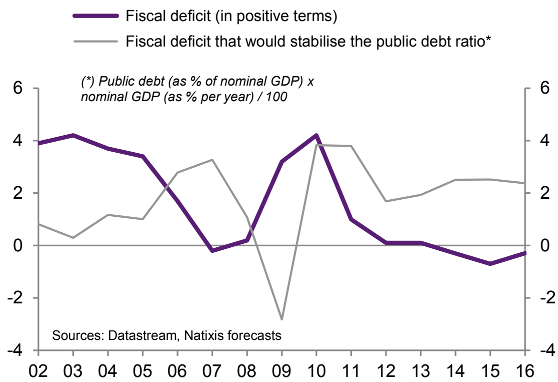


Chart 3B
France: Fiscal deficit (as % of nominal GDP)

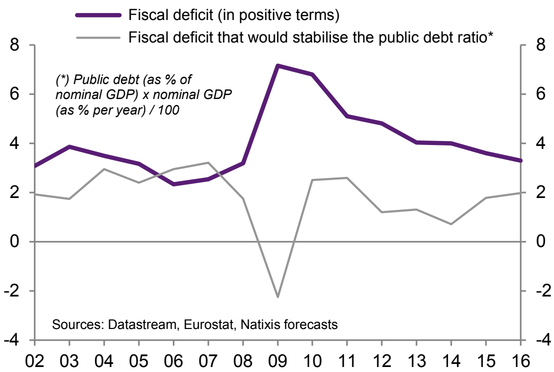


Chart 3C
Spain: Fiscal deficit (as % of nominal GDP)

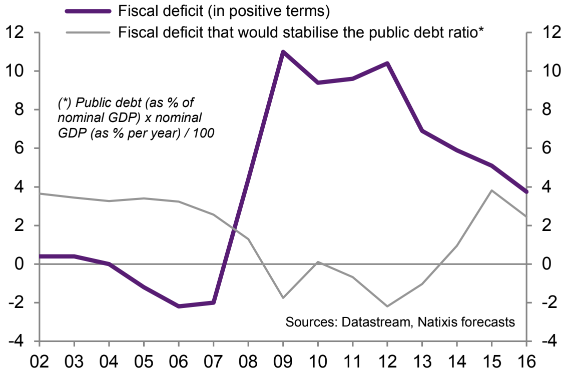


Chart 3D
Italy: Fiscal deficit (as % of nominal GDP)

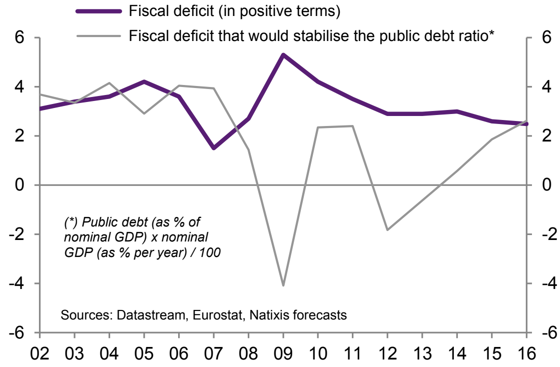


Chart 3E
Netherlands: Fiscal deficit (as % of nominal GDP)

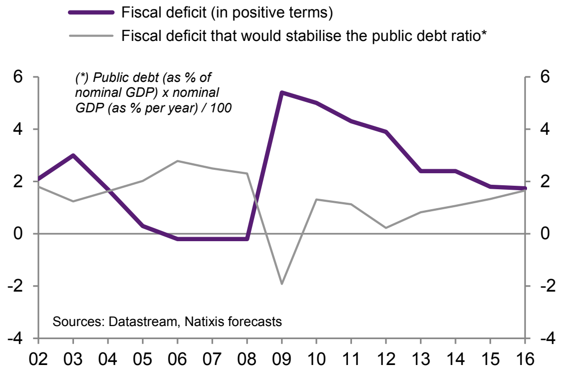


Chart 3F
Belgium: Fiscal deficit (as % of nominal GDP)

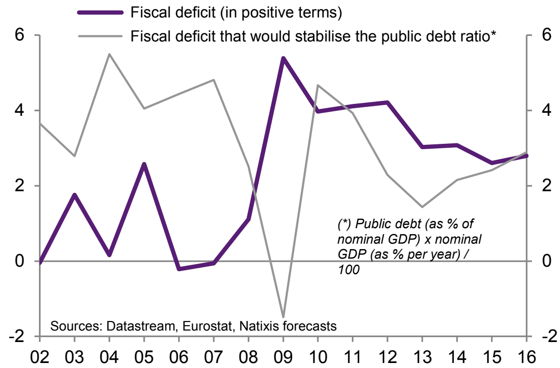


Chart 3G
Austria: Fiscal deficit (as % of nominal GDP)

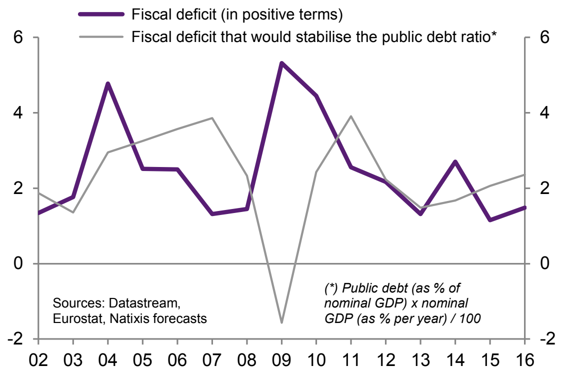


Chart 3H
Finland: Fiscal deficit (as % of nominal GDP

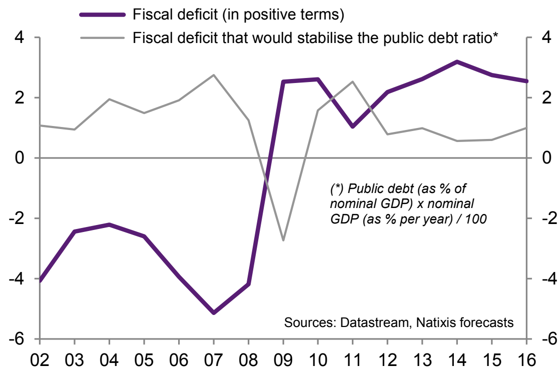


Chart 3I
Portugal: Fiscal deficit (as % of nominal GDP)

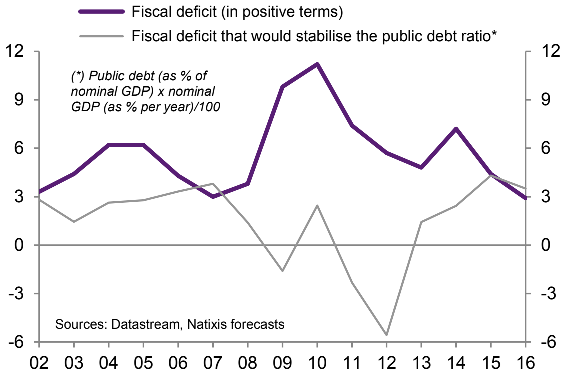


Chart 3J
Greece: Fiscal deficit (as % of nominal GDP)

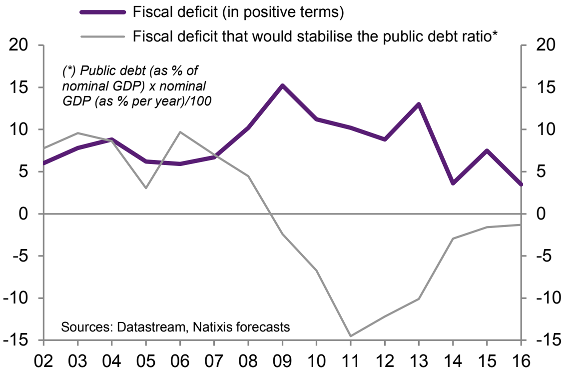
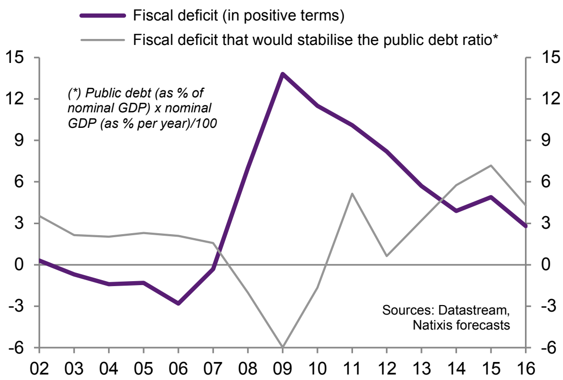


Chart 3K
Ireland: Fiscal deficit (as % of nominal GDP)



In 2016 we are seeing:

- **A fiscal deficit that is higher than the one that would stabilise the public debt ratio** in France, Spain, Finland and Greece;

- **A high public debt ratio** in Italy, Belgium, Spain, France, Greece, Portugal and Ireland;

- **A fiscal deficit in excess of 3% of GDP** in France, Spain, Portugal and Greece.

In the euro zone there is now considerable reluctance to reduce fiscal deficits, even if they are excessive. This is probably due to new estimates of the fiscal multiplier, which show that the cost of a reduction in fiscal deficits in terms of growth is high in periods of full employment; and the weariness of the population due to the slow reduction in the unemployment rate (**Charts 4A** and **B**).

Chart 4A
Unemployment rate (as %)

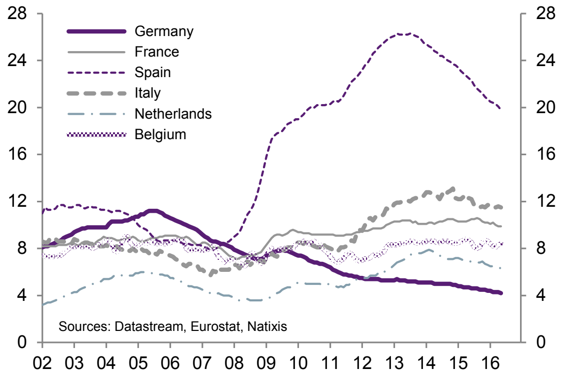
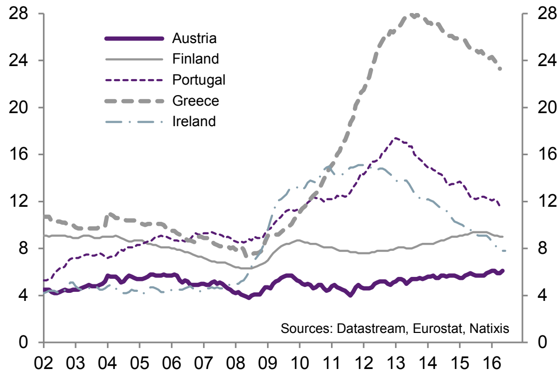


Chart 4B
Unemployment rate (as %)



Ultimately, only Germany and the European Commission are calling for compliance with the budgetary rules (Stability and Growth Pact).

The risk: The change of status for many euro-zone countries' government bonds

The euro-zone countries:

- **That are refraining from ensuring their fiscal solvency**;
- **Whose public debt ratio is high ought to be negatively affected by higher interest rates**.

But except for Greece (whose market debt is very small), this is not the case (**Charts 5A** to **F**), **except in the recent period for Portugal** (**Charts 6A, B** and **C**).

Chart 5A
Yield spread on countries' 10-year

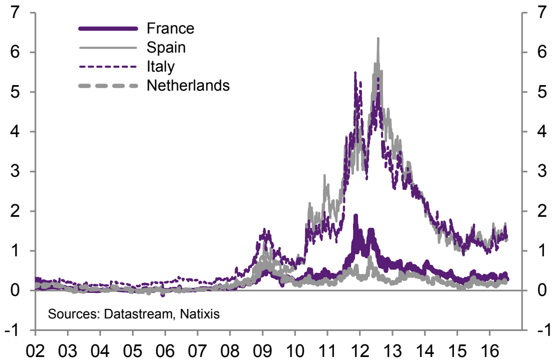


Chart 5B
Yield spread on countries' 10-year government bonds against Germany (as %)

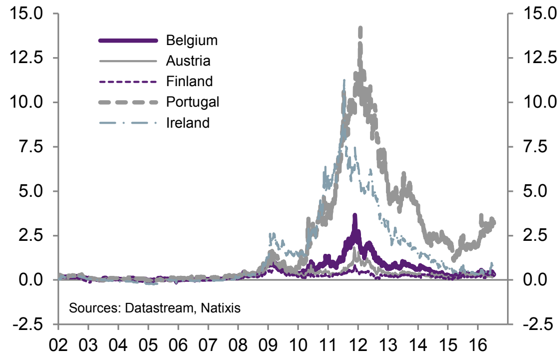


Chart 5C
Greece: Yield spread on 10-year government bonds against Germany

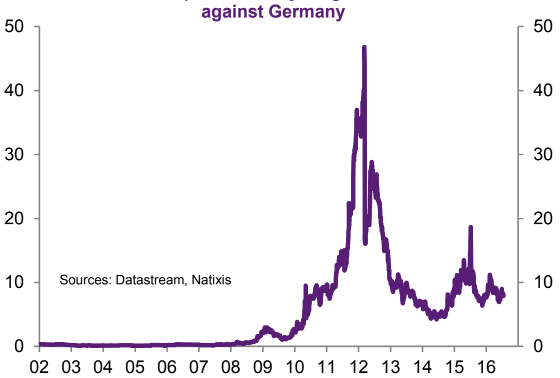


Chart 6A
Yield spread on countries' 10-year government bonds against Germany (as %)

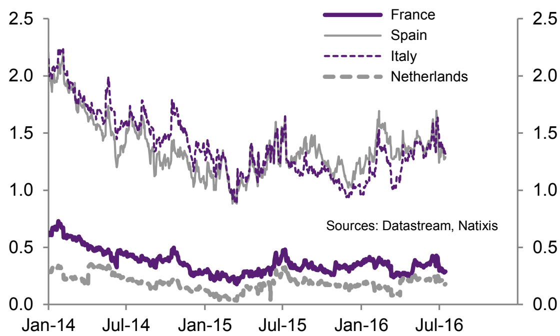


Chart 6B
Yield spread on countries' 10-year government bonds against Germany (as %)

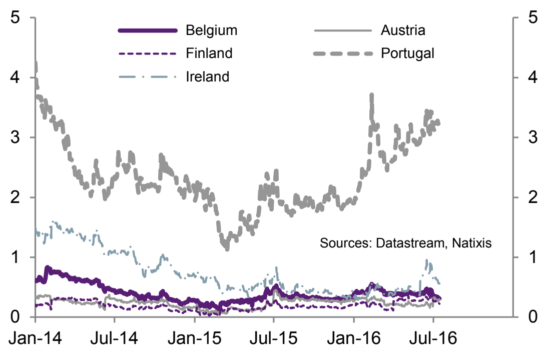
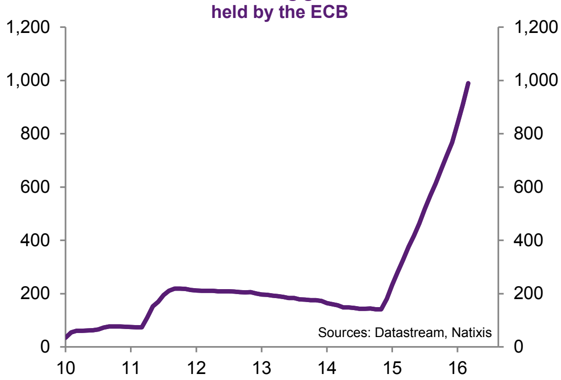


Chart 6C
Greece: Yield spread on 10-year government bonds against Germany

The fact that long-term interest rates remain low in all euro-zone countries, even those that are not ensuring their fiscal solvency, is due to the ECB's interventions: the ECB's purchases of government bonds issued by all countries (**Chart 7**) is preventing a divergence of long-term interest rates between these countries.

Chart 7
Euro zone: Outstanding government bonds held by the ECB



Sources: Datastream, Natixis

But quantitative easing cannot be maintained forever. When it comes to an end, the result will be discrimination:

- **Between the fiscally solvent euro-zone countries with low debt ratios:** Germany, Netherlands, Austria;

- **And the other countries which are fiscally insolvent or which have a high debt ratio**.

Only the government bonds of the former countries (and in terms of size, mainly Germany) **will then be deemed to be risk-free.**

Conclusion: A disastrous situation if only a small number of euro-zone government bonds (mainly German) are deemed to be risk-free.

If the government bonds of France, Spain, Portugal, Finland, Greece, Italy, Belgium and Ireland are no longer considered as risk-free, the result in these countries will be:

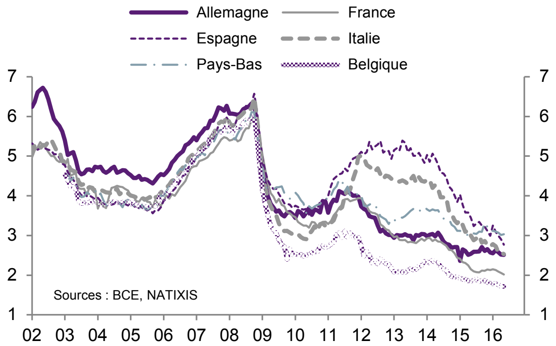
- **All interest rates will rise** (**Charts 8A** and **B, Charts 9A** and **B**), therefore leading to **solvency problem also for private borrowers;**

- Due to the rise in interest rates, **there will be capital losses for institutional investors and banks;**

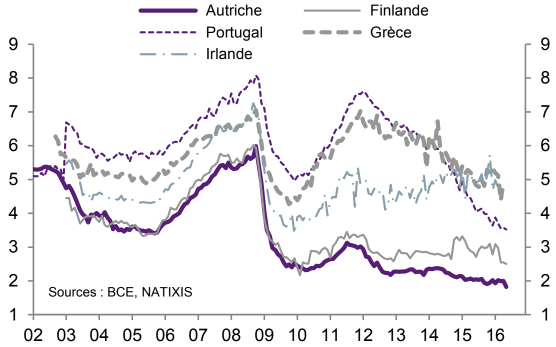
- The rise in funding costs **will reduce corporate and housing investment;**

- **Investors will no longer find risk-free bonds in the country**.

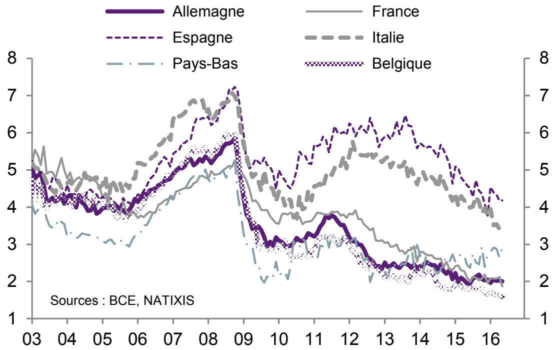
Graphique 8a
Taux d'intérêt des crédits à taux fixe aux entreprises (en %)



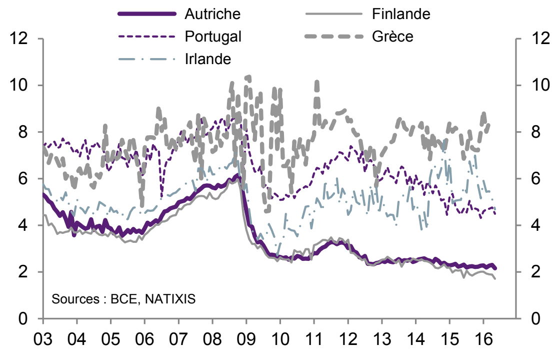
Graphique 8b
Taux d'intérêt des crédits à taux fixe aux entreprises (en %)



Graphique 9a
Taux d'intérêt des crédits à taux fixes aux ménages (en %)



Graphique 9b
Taux d'intérêt des crédits à taux fixes aux ménages (en %)



A euro zone where only government bonds issued by Germany (and also, for smaller amounts, by Austria and the Netherlands) **are seen as risk-free would be divided between a prosperous part** (Germany, Austria, Netherlands) **and in a part facing severe problems** (the other countries, where the cost of capital would be far higher).

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