STRATEGY FOCUS

Monetary policy and the financing of public sector deficits

During the pandemic, developed economies put in place economic policies that were unprecedented in their scale. The financing of such large fiscal packages depended in part on central banks helping out with asset purchase programs. This policy mix resulted in major financial transfers between economic agents, resulting in a sharp rise in government debt, a similar surge in household and corporate savings, and a new and important role for central banks in funding the government.

Now, with the return of inflation pressures, central banks are winding down their support and governments are struggling to normalize their fiscal policy. At first sight, it is hard to see how public debt can continue to increase at the current pace when central banks are shrinking their balance sheets. But this bean-counting approach with its assumptions that finance moves in closed loops does not tell the whole story. Other factors are at play:

- Central banks are providing less liquidity, but governments continue to create liquidity by issuing new debt. This cash continues to fuel demand for financial assets among the private sector and foreign investors.
- The bond market is also a self-regulating mechanism and has adjusted prices to reflect the changes. As interest rates have risen investors are increasing their bonds holdings into their portfolios.
- Cross-border financial balances are shifting but an influx of plentiful savings from Asia, the Gulf and Europe continues to sustain demand for financial assets, particularly bonds.

That said, the new monetary policy of higher rates for longer undoubtedly puts greater pressure on the financing of public deficits and hence on interest rates, raising two kinds of risk:

- **Risk of financial stress.** A slide in confidence could put pressure on the rates of certain countries' debt, as the United Kingdom found out in autumn 2022. At this stage, we see limited risk of this happening in the world's major countries. Central banks can always adjust their balance sheets to head off excessive tensions. In the euro area there is a higher risk to specific countries, such as Italy and France, where public debt ratios are projected to continue to increase rapidly. The framework provided by the single currency has however been beefed up since the 2011-12 euro debt crisis and should be able to handle any turbulence of this kind.
- **Risk of sharp budget cuts.** Countries at risk of losing investors' confidence could be tempted to radically tighten fiscal policy. Any such policy retrenchment would worsen the economic slowdown. We think this risk is particularly relevant in the euro area.

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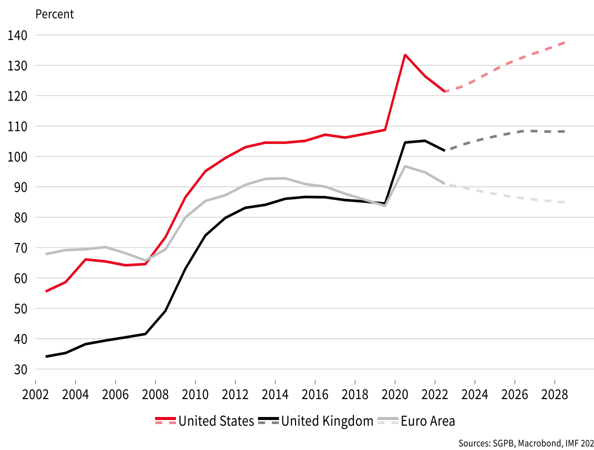
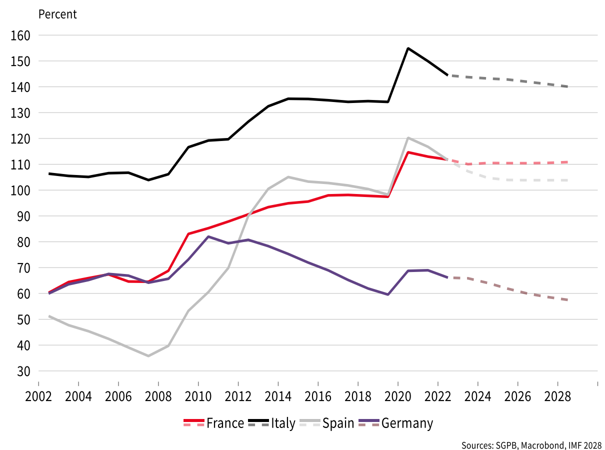
SOCIETE GENERALE
Private Banking

THE COVID POLICY MIX AND ITS IMPLICATIONS (1/2)

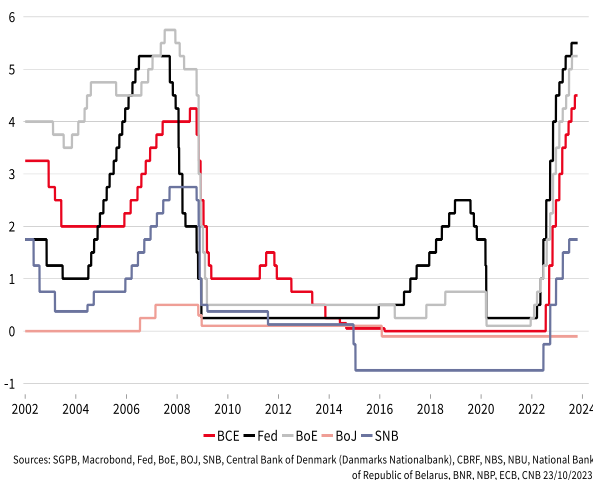
Massive fiscal support packages... In 2020 the developed economies rolled out important fiscal programs to support their economies during the lockdowns. The nature of the crisis and the lessons learnt from the previous one encouraged countries to act faster and more radically than in 2008. In 2020 public sector debt leapt hence by 24 percentage points of GDP in the United States, 23 points in Japan, 22 points in the United Kingdom and 16 points in the euro area (Spain by 28 points, Italy 25, France 20 and Germany 10).

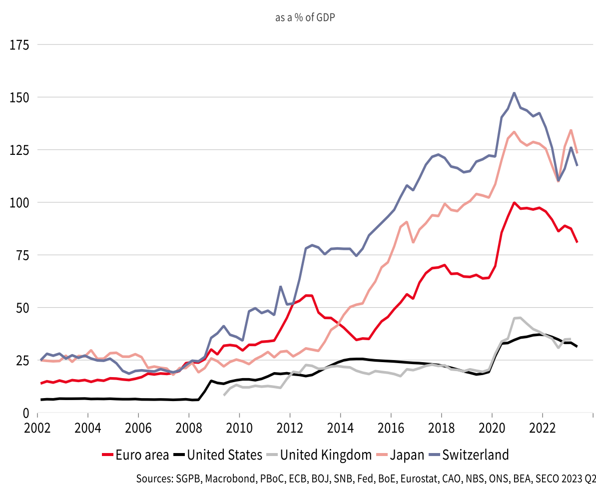




... made possible by massive monetary support. Central banks backed these fiscal packages with major policy measures of their own.

- **Policy rates cut to all-time lows**. This mainly applied to the Fed and Bank of England as rates were already negative at the ECB, SNB and BoJ.
- **Increasing balance sheets** through the asset-purchase programs that had been gradually put in place since the 2008 crisis. The technical details and nature of each program differed from region to region, but they consisted of buying up public and private debt securities (quantitative easing) and expanding existing bank financing schemes, such as the ECB's TLTRO programs. The result was that central bank balance sheets increased in 2020 by 16 percentage points of GDP in the United States, 25 in the United Kingdom, 27 in Japan and 33 in the euro zone, the steeper increase at the ECB being explained by its TLTRO program.

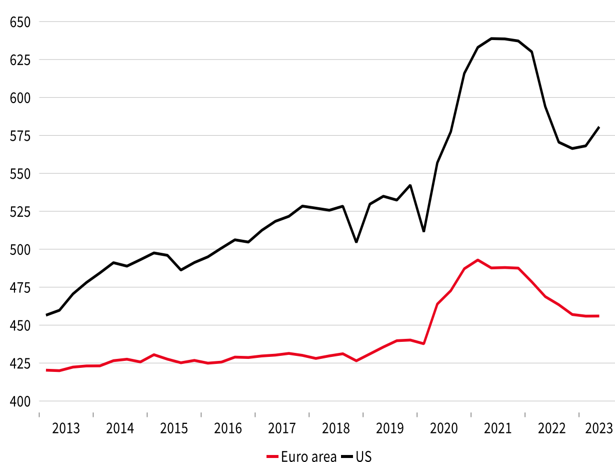


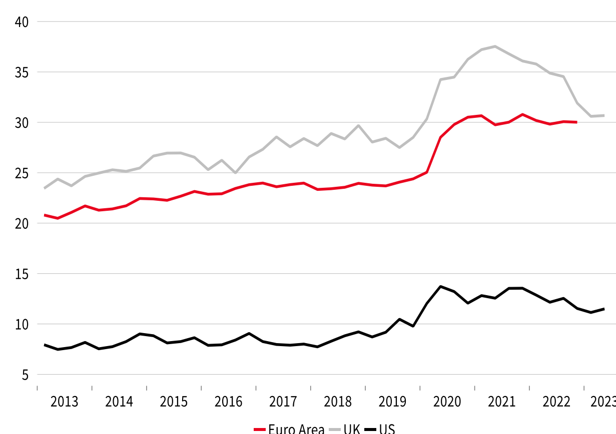


THE COVID POLICY MIX AND ITS IMPLICATIONS (2/2)

Massive financial transfers between economic agents. These wide-ranging economic policies inevitably meant big flows of money between economic agents, but the movements were so fast that there were no instant impacts on prices.

- **Rise in central bank holdings of government bonds.** Large asset purchases programs implied a larger holding of government debt by central banks. The Fed went from holding 13% of all sovereign issuance to 25%, the ECB from 20% to around 30% (over 37% in Germany) and the Bank of England from 20% to 31%.
- **Rise in corporate and household savings.** The fall in consumption caused by the lockdowns and the maintenance of household's incomes made possible by the economic policy mix led to a significant increase in the stock of household savings, measured by the rise in households net wealth. The government support for households in the United States was particularly generous and drove a 5% year-on-year rise in household incomes in 2020 despite the GDP contraction. Households' incomes in European economies held steady. Coporates also benefited from grants or loans which fed through to a substantial boost in their liquid assets.





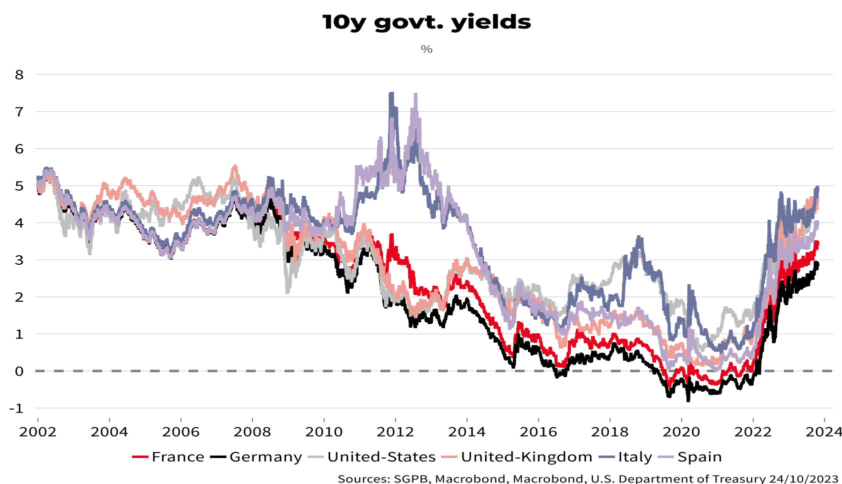
RECENT AND FUTURE BALANCES
GRADUAL WITHDRAWAL OF CENTRAL BANKS

Tightening of monetary policies and the start of Quantitative Tightening (QT)

Since 2022, central banks have simultaneously hiked their key interest rates and cut their balance sheets. Although they are not yet actively selling bonds (except at the Bank of England) they are applying QT by not reinvesting all or part of the proceeds when bonds mature. The BoE began in February 2022 and is currently shrinking its balance sheet by GBP 80 billion a month. This has reduced the size of its bond portfolio by over 11% so far. The Fed followed suit in June 2022 and has thus far shrunk its balance sheet from around USD 8,500 billion to USD 7,500 billion, and continues to do so at a monthly pace of USD 95 billion (USD 60 billion of T-bonds and USD 35 billion of MBSs). The ECB began to reduce its balance sheet in the summer of 2022 and has so far reduced from EUR 7,800 billion to EUR 6,000 billion, mostly through TLTRO redemptions. It is currently reducing its bond portfolio by EUR 30 billion a month.

The decline in central bank holdings of public sector debt has been offset by other investors eager for the attractive interest rates on offer.

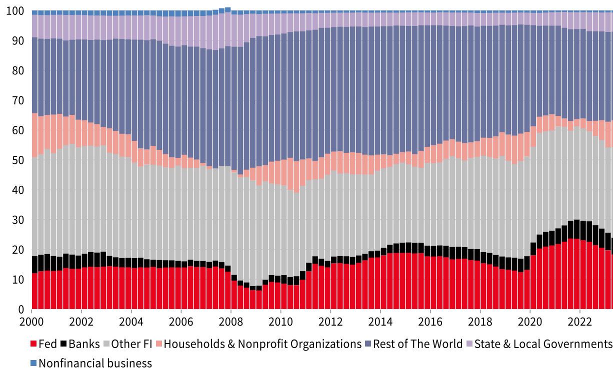
QT means central banks holding a lower share of government debt. This has so far been achieved without putting without significant financial pressures on the bond markets– except for the UK's crisis of autumn 2022 which had a political in origin. However, it has certainly helped push up yields across all maturities. QE happened very fast during Covid, but QT has been a much more gradual process which has allowed the bond markets to adjust supply to demand through price movements. Specifically, it has accentuated the upward drift in interest rates adding to the current appeal of sovereign bonds for investors.



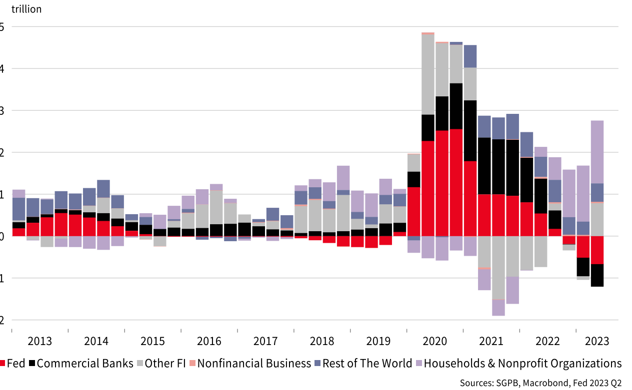
The charts below show recent changes in the holders of public sector debt (left-hand chart shows amount outstanding; right-hand shows net purchases). There is a clear decline in net purchases by central banks which has so far been offset by domestic investors (households in the in both Italy and the US) or by foreign buyers. This underlines how investors sitting on substantial savings have been tempted into buying bonds by the current attractive yields on offer (as we have been recommending to our clients).

RECENT AND FUTURE BALANCES
GRADUAL WITHDRAWAL OF CENTRAL BANKS

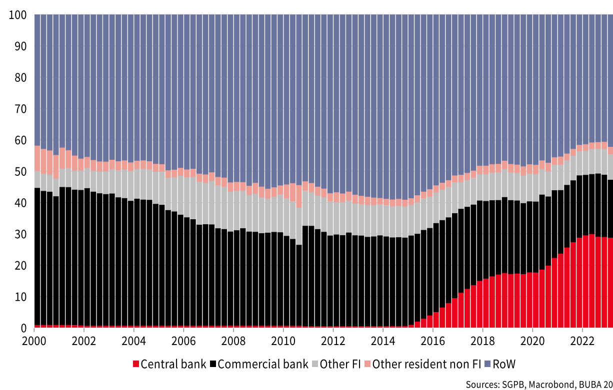
U.S Debt Holdings, Stocks



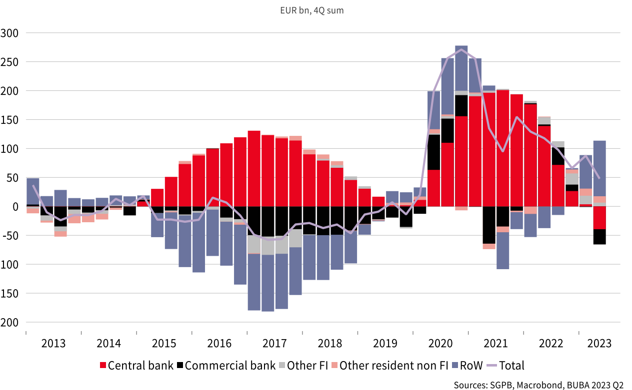
U.S Debt Holding, Flows



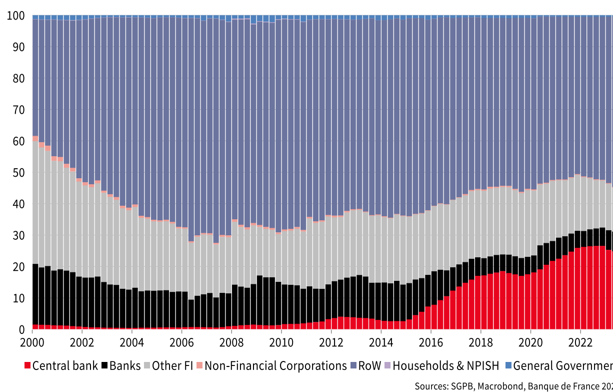
Germany Debt Holdings, Stocks



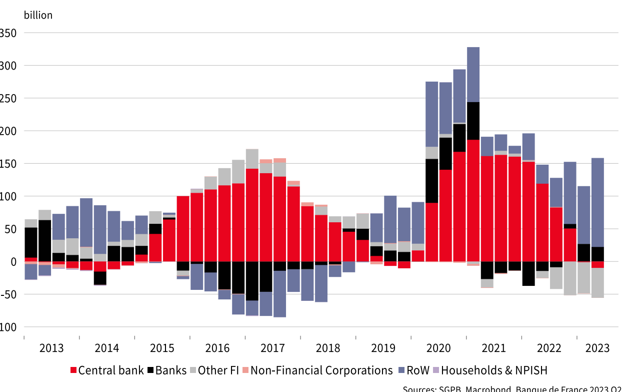
Germany Debt Holdings, Flows



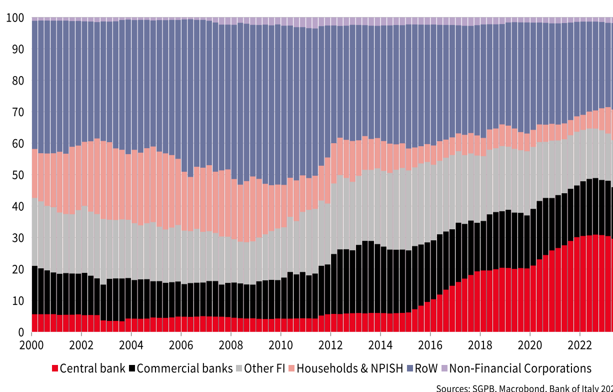
France Debt Holdings, Stocks



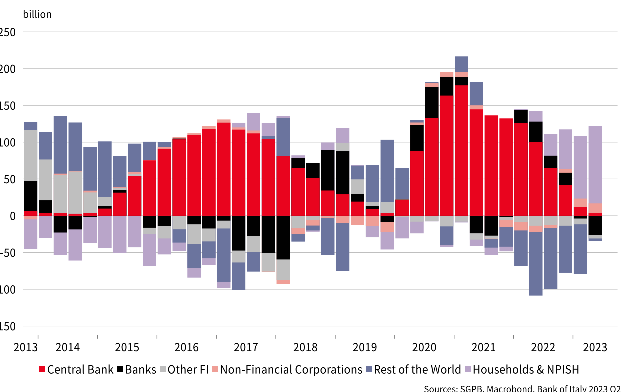
France Debt Holdings, Flows



Italy Debt Holding, Stocks



Italy Debt Holding, Flows

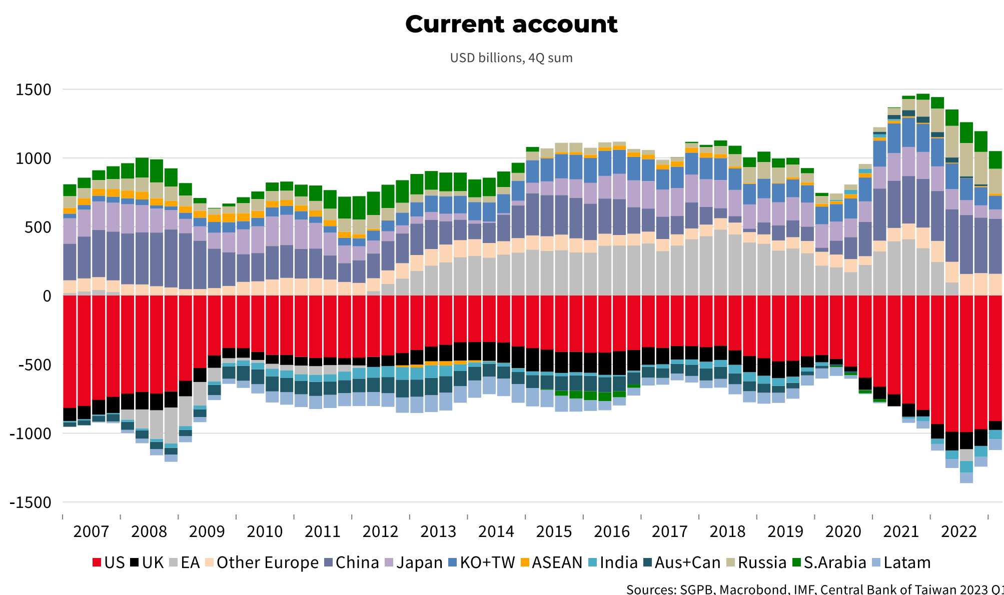


RECENT AND FUTURE BALANCES
FOREIGN INVESTOR DEMAND

Looking beyond these adjustments, global imbalances remain and will continue to fuel demand among non-domestic investors.

Since globalization took off in the 1990s, the world economy has seen a massive rise in current account imbalances. These financial imbalances – where a country or region's savings fail to match its investment – are mainly being driven by trade surpluses and deficits, such as the export surpluses run by countries like China and oil-producing states. Despite successive crises, these global imbalances remain large and persistent.

An imbalance in current account transactions is not always a sign of an unhealthy economy. But "excessive" imbalances can be cause for concern, for instance if there is a danger of a sudden stop of current account deficit economies or financial bubbles caused by over-saving. As we saw with the euro zone sovereign debt crisis in 2011 and the tensions in the United Kingdom last autumn, such vulnerabilities are not restricted to emerging market economies.



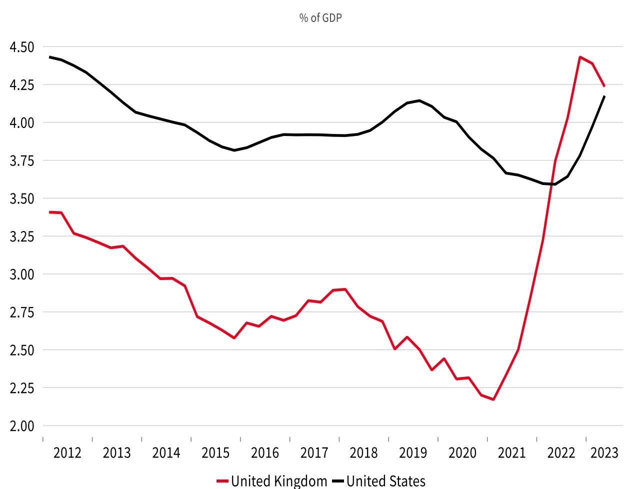
Today, the pattern of global trade is changing. The United States is friend shoring its imports, looking to Latin America and Southeast Asia rather than China. This in turn has raised fears that China might start to dispose its US assets. However, China continues to post a strong trade surplus and therefore a significant excess savings that it must reinvest abroad if it wants to maintain a competitive RMB.. It is therefore continuing to invest money in different markets and remains a big investor in US bond markets.

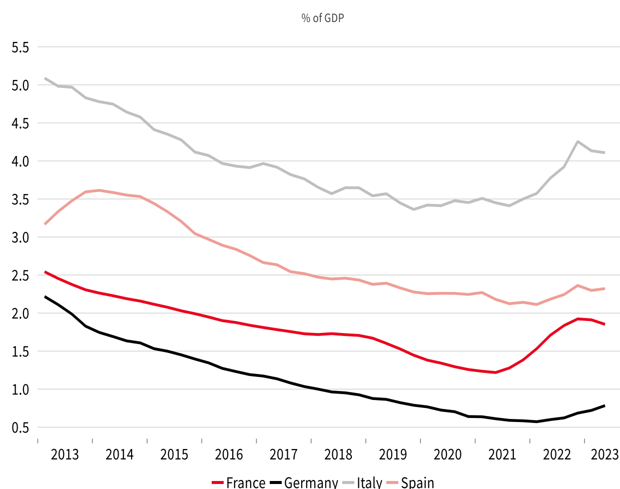
RECENT AND FUTURE BALANCES
MORE COMPLEX BUDGET TRAJECTORIES

Rising interest rates are making fiscal trajectories harder for some countries.

Government will not face financing issues in the short term in main developed economies. The world's biggest economies have been stretching out their debt maturities which should allow them to smooth the impact of higher interest rates over time. Also, nominal GDP growth (real growth plus inflation) should continue at a fairly robust pace, albeit less strongly than in 2021-23. This means the big developed economies can count on a positive snowball effect, i.e. all else being equal and assuming public sector deficits (ex interest) are not too high, when nominal GDP grows faster than debt service costs it results in falling debt/GDP ratios.

Heavily indebted countries are more vulnerable. Several euro area countries - France, Italy, Spain and Belgium - are nearing the point where their public sector debt could start to snowball negatively (i.e. lock into a self-reinforcing uptrend) unless offset by significant budget surpluses (ex interest). Fiscal retrenchment has begun but is proving a very gradual process. The recent rise in interest rates could crank up the pressure further, potentially forcing them to take more drastic fiscal adjustment measures.





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