

GDP-linked government bonds some simulations for EU countries

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European Commission – OECD workshop
on GDP-linked government bonds

Brussels, 17 January 2018

Views are those of the speakers only

Context

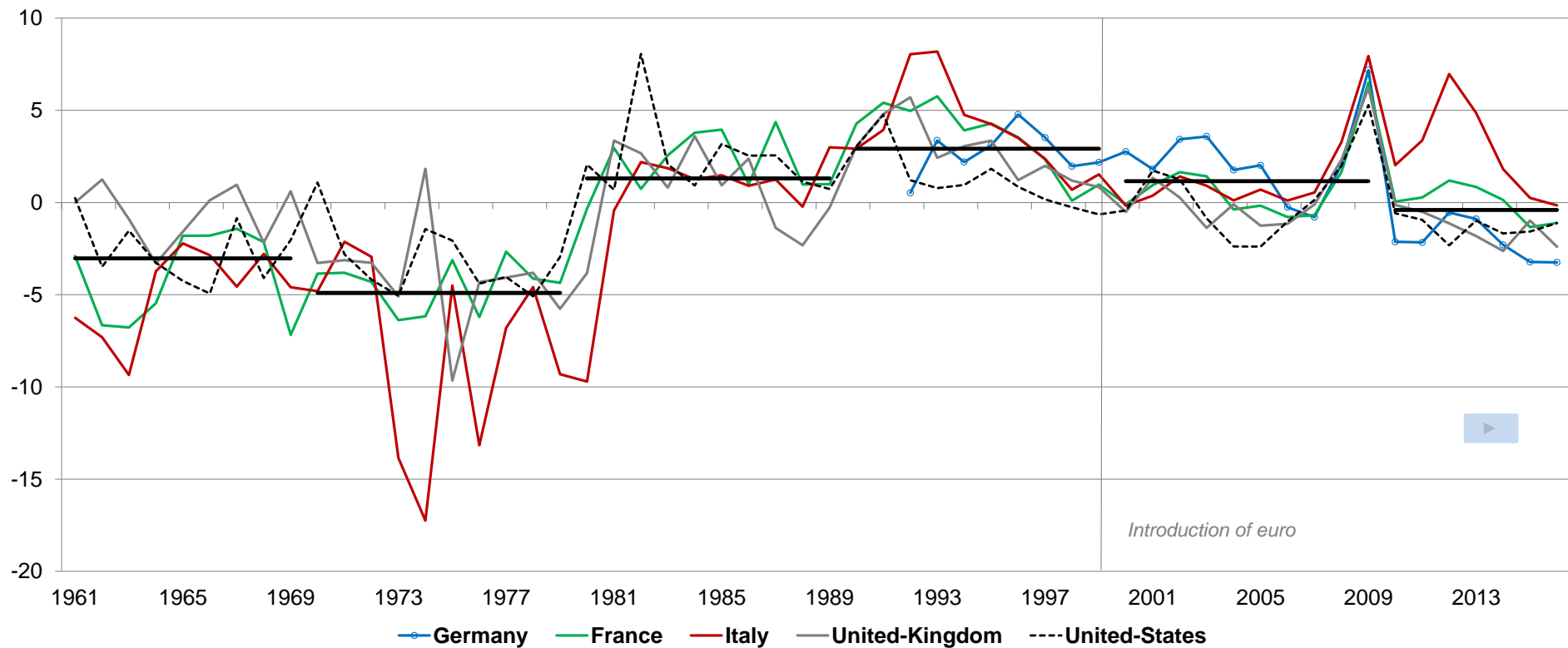
- Some momentum for GDP-linked government bonds (GLBs)
 - Academic research
 - G20 Compass for GLBs
- Recognised need for fostering the resilience of the EU and the euro area
 - Still high public debt in several EU countries
 - Need to foster resilience to shocks particularly acute in the context of a monetary union

The paper

- *GDP-linked bonds – some simulations on EU countries, Carnot and Pamies Sumner, EC European Economy Discussion Paper, no. 073, December 2017.*
 - Exploring the potential macroeconomic benefits for EU countries building on the European Commission Debt Sustainability Monitor
 - Discussing the issue of the risk premium

The interest – growth rate differential is a major source of macroeconomic uncertainty

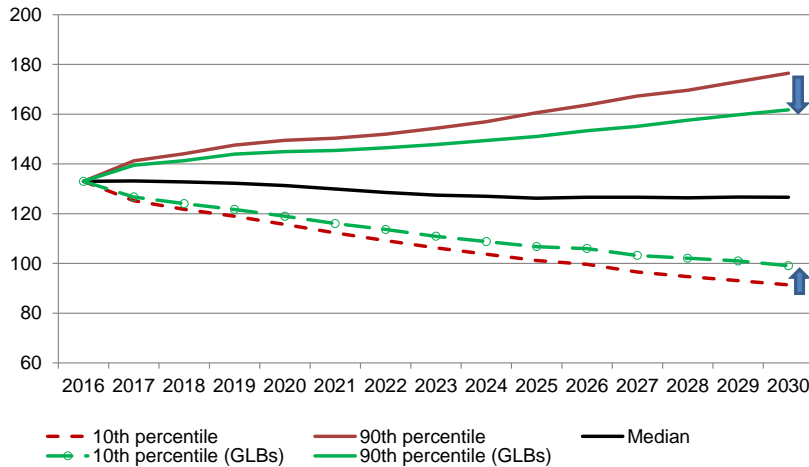
Interest – growth rate differential (%)



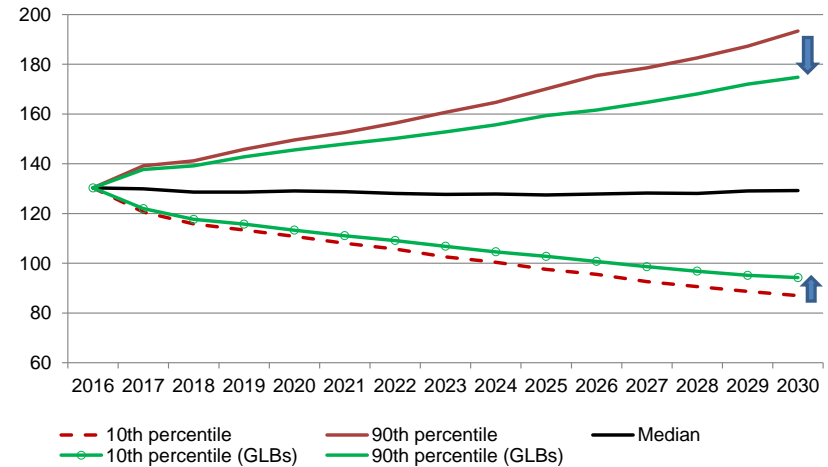
Source: AMECO, authors' calculations. The interest - growth rate differential is calculated based on the nominal long-term market interest rate on government bonds and the nominal GDP growth rate.

Even a limited share of GLBs could help reducing debt uncertainties

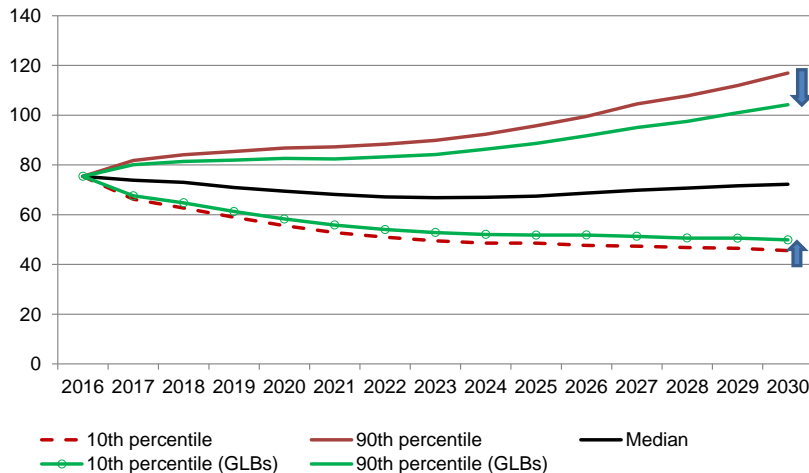
Stochastic debt projections Italy (% of GDP)



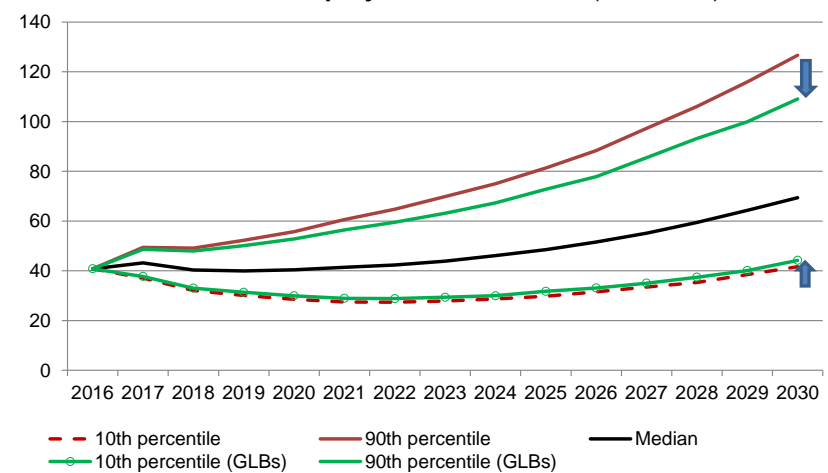
Stochastic debt projections Portugal (% of GDP)



Stochastic debt projections Ireland (% of GDP)



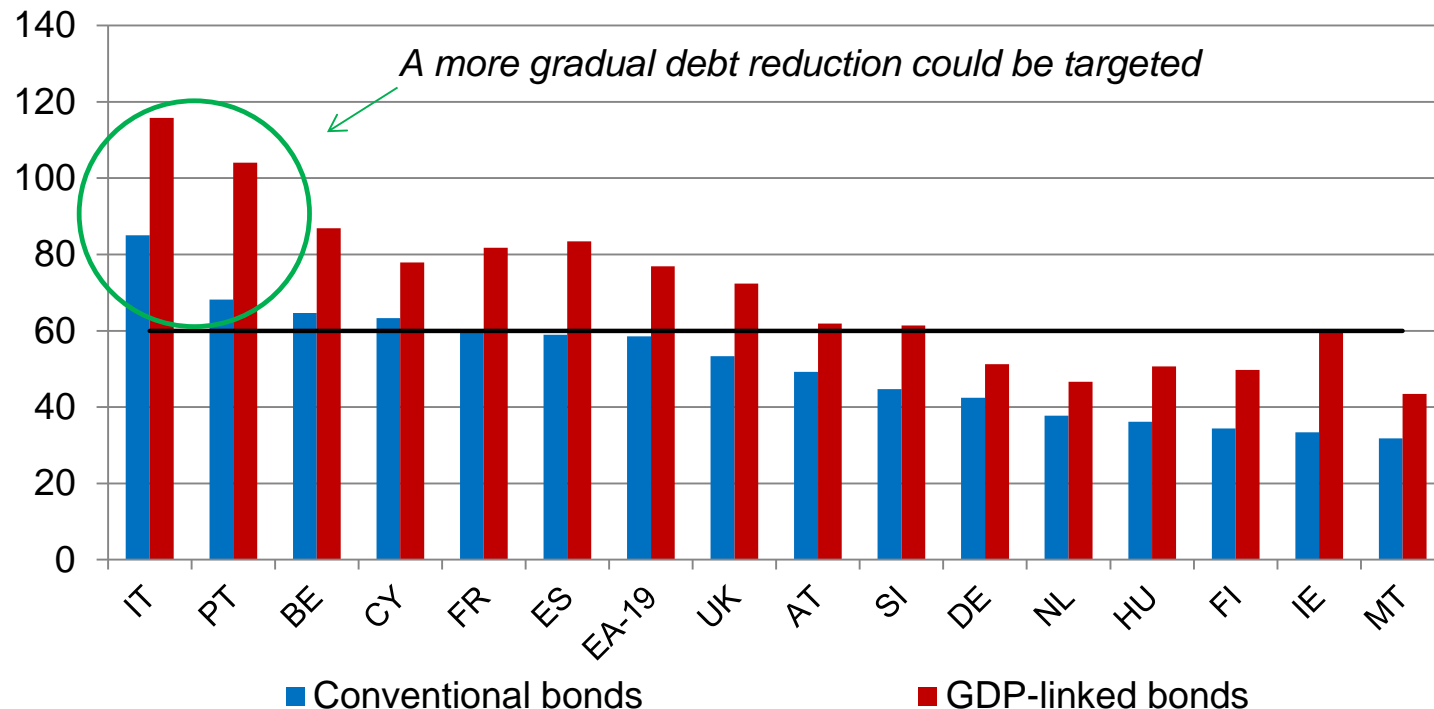
Stochastic debt projections Lithuania (% of GDP)



Source: Debt Sustainability Monitor, authors' calculations. The fan charts report the debt to GDP paths corresponding to the 10th, 50th and 90th percentiles of the distribution. The case with GLBs assumes that **one-third** of public debt is composed of GLBs.

Anchoring fiscal policies to more realistic long-term debt targets?

Non-increasing debt caps (%)



Source: Debt Sustainability Monitor, authors' calculations. Non-increasing debt caps are defined as the level that should be targeted in 2030 to ensure that in case of adverse shocks, debt would not increase (as compared to now) with a 90% probability.

GLBs and the risk premium

Liquidity and novelty premium

- Could be high but quickly decrease over time (market size)
- *Based on current maturity of debt and projected financing needs, around 20 – 30% of EU debt stock could be in GLBs after two decades*

Growth risk premium

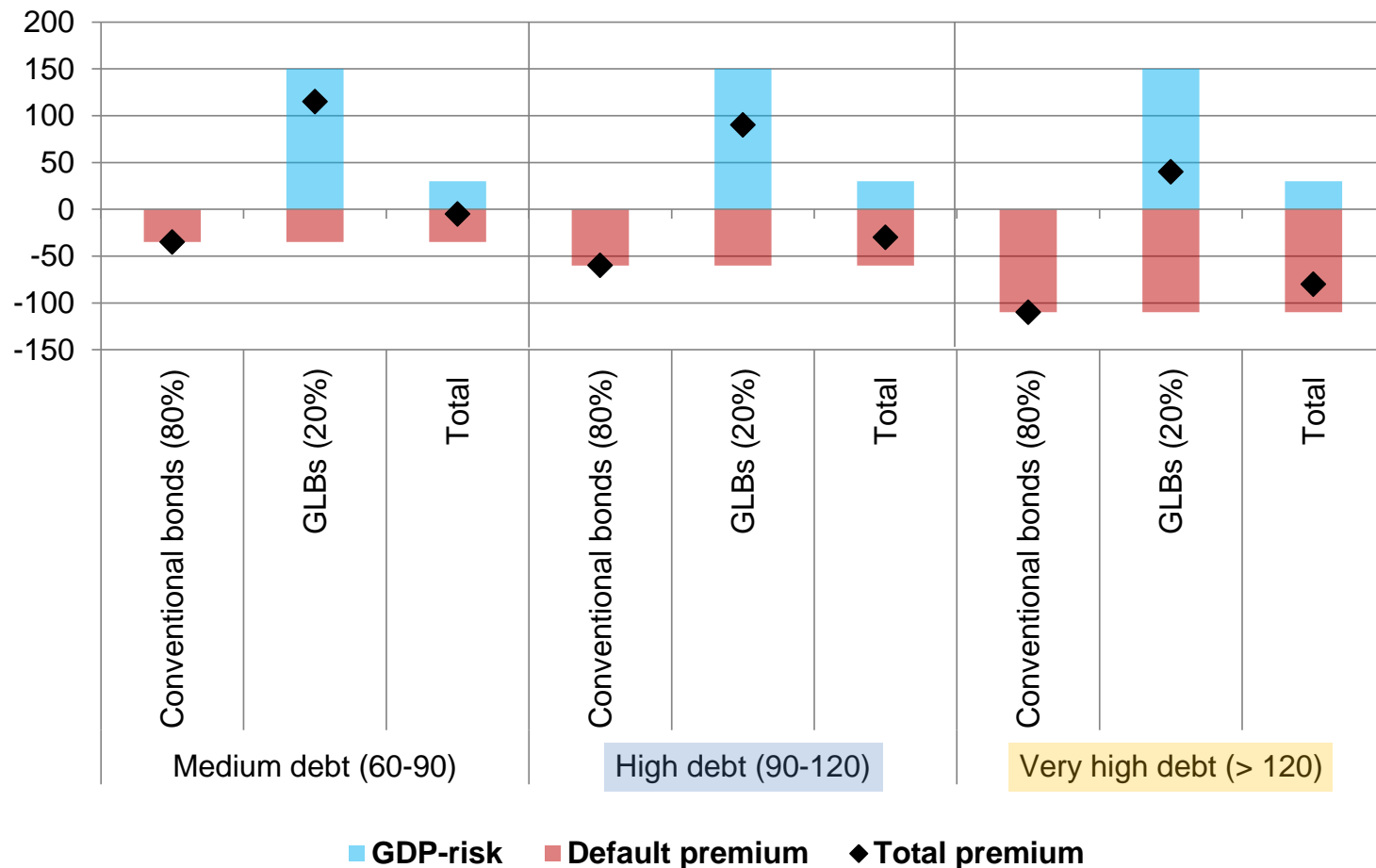
- Estimations vary a lot depending on model, assumptions, design, sample, etc.
- *Simulations based on a conventional, 'prudent' value of 150 bps*

Default risk premium

- GLBs could result in a *reduction* of default risk premium, including on conventional bonds

A reduction in the default premium could potentially neutralise the GDP-risk premium

Change in the risk premium after the issuance of GLBs (bps.)



Source: Authors' calculations

Conclusions

- A potentially interesting tool
 - Contributes to stabilise debt path, and reduces the likelihood of sovereign debt crises
 - Benefits particularly high in medium- to high-debt countries and volatile economies
 - GDP-risk premium could erode expected benefits but spillover (reducing) effects on (all) bonds' default premium could somehow 'neutralise' this effect
 - Part of overall strategy to reduce debt in line with EU fiscal rules
- However, such a debt-management tool cannot substitute for responsible fiscal policies

Thank you for your attention