FOCUS · Where are interest rates headed? The ECB and macroeconomic fundamentals

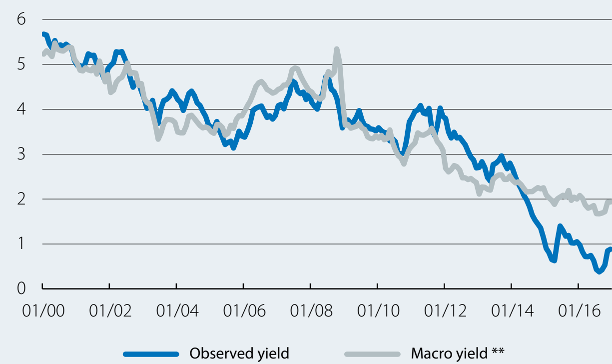
Global macroeconomic fundamentals and also those of a particular country largely determine the interest rate on its sovereign debt. For instance, a state's ability to pay depends on its current level of debt and on expectations regarding its public surplus or deficit and its future economic growth. The state of Europe's economy also determines the benchmark interest rate set by the European Central Bank (ECB), used to influence a constellation of interest rates. Global factors are also important (such as the yields for other economies, insofar as they offer alternative investment opportunities) and investor risk appetite. Consequently all these ingredients, as well as their historical relationships, are used to estimate the yield on 10-year government bonds in line with macroeconomic fundamentals; i.e. the macro or fair-value yield.[1]

As the first chart shows, macroeconomic fundamentals tend to be good indicators of the yield observed in the market. An analysis by component shows the fair-value yield's key determining factors to be the level of public debt, global financial conditions (yield on US Treasury bonds and financial volatility) and the ECB's benchmark interest rate. In the past few years, while the level of debt has pushed up interest rates, the major factors pushing down fair-value yields have been the highly accommodative financial conditions at a global level (mainly due to US accommodative monetary policy) and the reduction in the ECB's benchmark interest rate. However, since mid-2014 the ECB's use of unconventional monetary policy has pushed government bond yields down to levels significantly lower that would be warranted by such macroeconomic fundamentals, primarily in the euro area's core countries.

It is therefore likely that the eventual withdrawal of the ECB's unconventional monetary policy will lead observed yields to converge upwards towards fair-value yields. Less accommodative financial conditions in the US and the normalization of the ECB's interest rates will also push up fair-value interest rates. So what will happen to the risk premia throughout this process? The second chart shows that, after the financial and sovereign debt crisis, macroeconomic fundamentals justify higher risk premia than in the 2000-2007 period (essentially due to high public debt and less dynamic economic activity). In the core countries, the risk priced in market valuations reflects these differences in fundamentals: observed premia today are in line with macroeconomic fundamentals. However, in the periphery the observed spreads are higher than the risk premia predicted by economic fundamentals. This is because investor sentiment,[2] which heavily penalized peripheral countries in the sovereign debt crisis, still acts as a drag on peripheral sovereign yields. Although in the Focus «ECB monetary policy and sovereign risk premia» in MR03/2017 we noted that, in the short term, the ECB's tapering might lead to upswings in risk premia, the macroeconomic fundamentals suggest these should fall again in the medium term.

10-year European government bond yields *

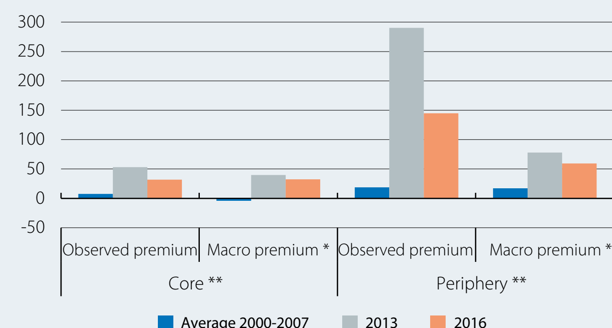
(%)



Notes: ** Weighted average for Germany, Austria, Belgium, Spain, France, Italy, the Netherlands and Portugal. ** Yield predicted by macroeconomic fundamentals (global financial conditions, ECB's monetary policy, public debt and expected growth).*
Source: *CaixaBank Research, based on data from Thomson Reuters, Eurostat and Consensus Economics.*

10-year sovereign debt risk premia

(bp)



Notes: ** Risk premium predicted by macroeconomic fundamentals (global financial conditions, ECB's monetary policy, public debt and expected growth).*
*** Core: weighted average for Austria, Belgium, France, and the Netherlands. Periphery: weighted average for Spain, Italy and Portugal.*
Source: *CaixaBank Research, based on data from Thomson Reuters, Eurostat and Consensus Economics.*

1. This is estimated based on a panel regression between 2000 and 2014 for Germany, Austria, Belgium, Spain, France, the Netherlands, Ireland, Italy and Portugal, with the following explanatory variables: market expectations for the 3-month Euribor and growth in real GDP, debt-to-GDP ratio, an indicator for stock market volatility and the 10-year Treasury yield.

2. It could also reflect a structural change in the valuation of fundamentals and their relationship with sovereign yields.