# The impact of financial conditions on Spain's public debt burden

One of the hot economic topics of today is the impact that a tightening of the financial conditions will have on the cost of Spanish public debt. Since the beginning of the year, we have witnessed a rebound in euro area sovereign yields and in risk premiums of the periphery, including that of Spain. Thus, the question arises as to how sensitive the general government's cost of financing will be to a changing and highly uncertain macro-financial environment.

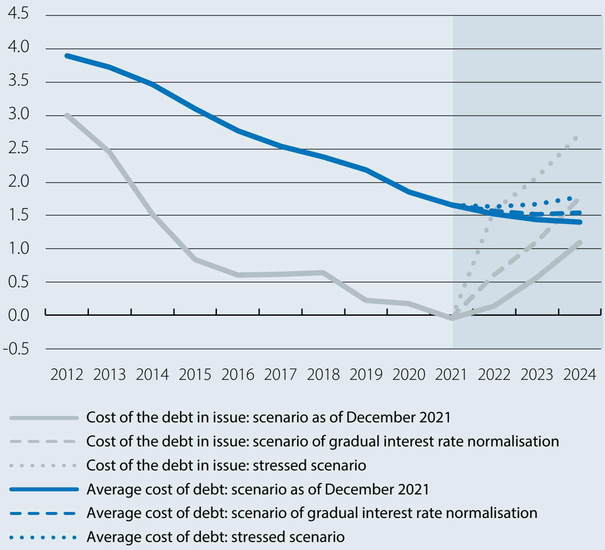
## The average cost of debt will remain contained

We have analysed the sensitivity that the cost of Spanish public debt has historically shown to changes in financial conditions and we have carried out an exercise to assess how the next few years could pan out. In particular, we analysed three scenarios. The first is based on the interest-rate forecasts that were envisaged at the end of 2021, before the ECB changed its forward guidance on its monetary policy and prior to the outbreak of the military conflict in Ukraine. This scenario was characterised by interest rates that were expected to remain very low throughout the forecast period, as the ECB was not expected to begin to raise the benchmark rate until late 2023. The second scenario provides for a gradual normalisation of financial conditions over the coming years. This is a scenario that would occur, for example, if the economic impact of the conflict in Ukraine were limited and inflation concerns became the main focus of attention during the second half of the year. As a benchmark, this would be consistent with the ECB beginning to raise interest rates at the end of 2022, followed in 2023 by two additional rate hikes. The third scenario assesses the impact of a tightening of financial conditions, which could occur if the ECB were to pursue a more rapid increase in interest rates due to inflation remaining high for longer than expected and the risk premium rising substantially.[1] In the first chart, we can see the evolution of the cost of debt in issue and the average cost of overall debt in these three scenarios.[2]

In the scenario with a gradual normalisation of financial conditions, the cost of new debt issued would increase sharply, reaching above 1.7% by the end of 2024. For reference, this scenario assumes that the cost of 10-year debt rises to 2.55% at the end of 2024, while at the end of December it is expected to stand at around 1.55%. In the third scenario, the cost of new debt issued would increase even more sharply, above 3.5% in 2024.

### *Spain: cost of public debt according to the financial conditions*

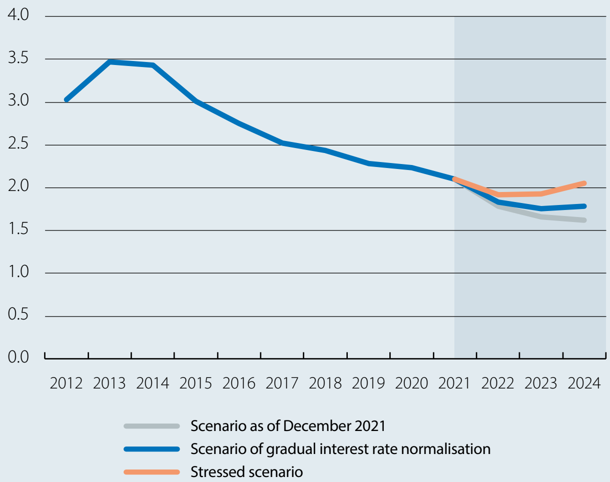
*(% of public debt)*




***Notes:*** *Each year, the Treasury issues debt to finance the new deficit (estimated using our forecasts) and everything that matures. The maturity structure with which the new debt is issued mirrors the current time structure. We have taken into account the refinancing of bills that has to be carried out each year.*
***Source:*** *CaixaBank Research.*

### *Spain: public debt interest bill*

*(% of GDP)*

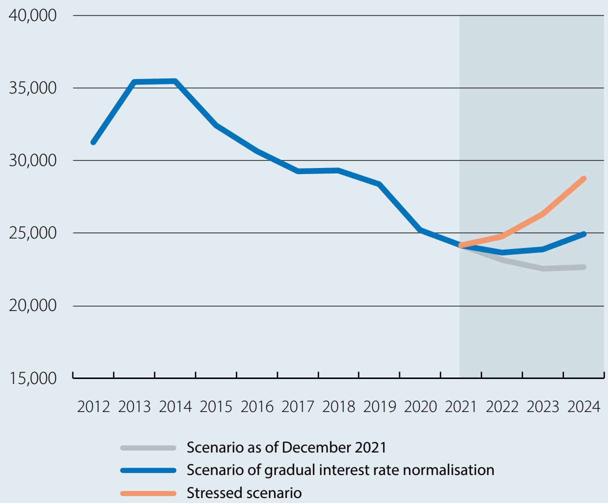



***Source:*** *CaixaBank Research.*

1. In particular, it would be an additional increase of 100 bps throughout the length of the yield curve.
2. The key assumptions we have use are: (i) each year the Treasury issues debt to finance the new deficit (estimated using our own forecasts) and to refinance maturities, (ii) the maturity structure with which the new debt is issued mirrors the current time structure and (iii) we have taken into account the refinancing of bills that has to be carried out each year.

This contrasts with the evolution of the cost of outstanding debt in circulation, which remains moderate in all scenarios. The difference between the evolution of the cost of outstanding debt and issued debt is largely explained by the fact that the higher issue costs are offset by the maturity of debt that was issued years ago at higher rates. Another factor to be taken into account is the increase in debt maturities in recent years. In 2021, the average term of Spanish public debt securities was above eight years for the first time, a figure which ought to stabilise or could even increase slightly in 2022. The Treasury has taken advantage of the favourable financing conditions that have prevailed since 2014, thanks to the ECB's unconventional monetary policies, to issue debt securities in the longer sections of the yield curve at very low rates.

**Spain: interest on public debt**
*(EUR millions)*




**Source:** *CaixaBank Research.*

### The interest bill as a percentage of GDP: an increase, but not in excess

Similarly, it is interesting to analyse how the burden of interest charges on public debt might evolve relative to GDP in the various scenarios. We conclude, with a high probability, that the debt burden would remain low or moderate. Specifically, in the scenario with a gradual normalisation of financial conditions, the interest burden of public debt as a percentage of GDP would continue to fall until 2023, before stabilising in 2024 below 2.0%. In the stressed scenario, the interest bill as a percentage of GDP would increase moderately to around 2.0% in 2024, a level very similar to that of 2021 and well below the 3.0% registered in 2012, when public debt as a percentage of GDP was much lower. That said, it would likely lead to a steepening of the yield curve if this situation were to persist in subsequent years.

Ultimately, in the short term, there are important factors that will temper the rise in public debt financing costs. However, the trend points towards higher debt costs, and while this is unlikely to lead to a substantial increase in the public sector's interest burden in the coming years, it will be essential to design a strategy for gradual yet sustained fiscal consolidation.

*Javier Garcia-Arenas and Ricard Murillo Gili*