FOCAL POINT

2024 budget deficits to keep euro area bond issuance close to record high

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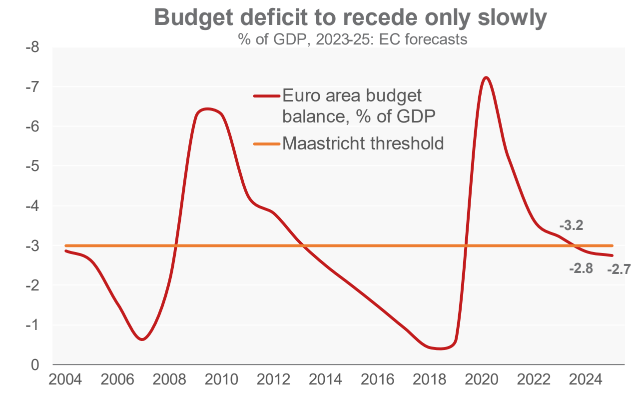
Our Focal Point series explores topical issues on macro, markets and investment

- **In 2024, European economies are set to start consolidation as the suspension of the Stability and Growth Pact comes to an end. Given the European Commission's forecast of an average euro area deficit of -2.8% of GDP in 2024, the supply of government bonds will remain ample.**
- **We expect the ECB to start PEPP non-reinvestments at a moderate pace in 2024, still absorbing € 120bn out of an estimated € 180bn. A more aggressive QT could lead to a more substantial lack of demand.**
- **Gross issuance of government bonds will remain at a sky-high level of around € 1275bn in 2024, as a moderately declining net issuance is balanced by higher redemptions. Moreover, the net-net issuance will even increase again (€ 680bn vs. € 640bn) as a higher volume of Quantitative Tightening is expected.**
- **Additionally, the EU will moderately increase its net issuance volume in 2024. As a result, the technical situation will remain tight next year, preventing yields from falling significantly.**

The fundamentals of the government bond market have changed significantly in recent years. With the ECB having shifted from Quantitative Easing (QE) to Quantitative Tightening (QT), and debt ratios as well as budget deficits still elevated by the pandemic-related and energy-price-induced expenditures, the scarcity of government bonds has come to an end. In contrast, there are concerns that in times of higher policy rates, the abundant supply will additionally contribute to high yields at the long end of the curve.

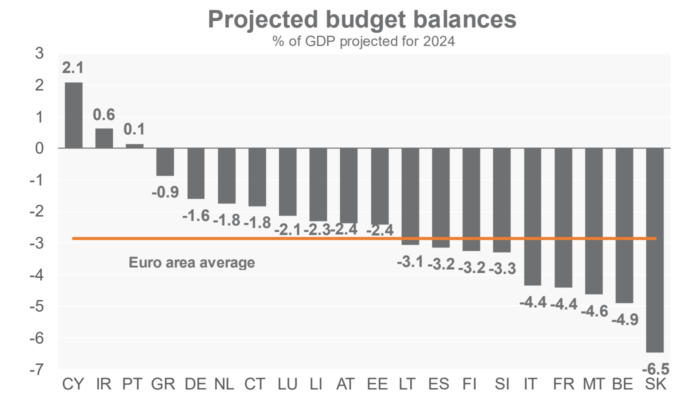
In this publication, we will take stock of the expected supply of government bonds as indicated by the 2024 budget plans and assess the impact of QT. If the ECB reduces PEPP reinvestments throughout 2024, the net-net issuance will increase slightly compared to the record year of 2023. Additionally, the EU's net issuance as part of the further disbursements of the Recovery and Resilience Facility (RRF) is also contributing to a tight supply/demand ratio in euro area (EA) bond markets.



Source: Datastream, EC, GIAM

EA budget deficit to decline only slowly in 2024

In the autumn, the governments submitted their budgets to the European Commission as part of the European Semester. In 2024, the pandemic-related suspension of the Stability and Growth Pact (SGP) rules come to an end. Member States will have to respect the 3% deficit criterion again, with the threat of an Excessive Deficit Procedure (EDF) looming. The overall **budget balance is projected to decline by only -0.4 pp to -2.8% in 2024** (see chart on previous page). This implies financing needs of € 426bn.



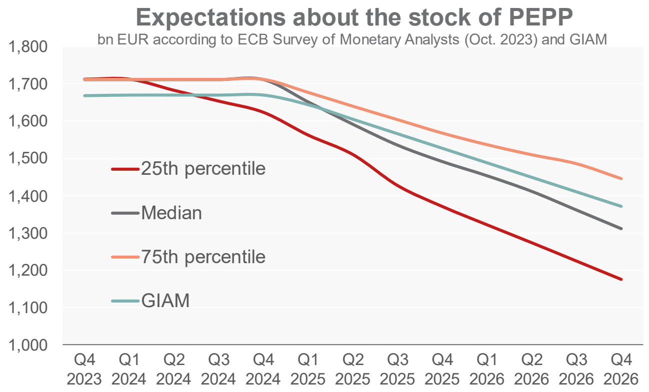
Source:Datastream, EC, GIAM calculations

This aggregate number masks significant differences between countries. Most notably, among the larger economies, France and Italy (-4.4% of GDP or € 131 bn/€ 95bn) as well as Spain (-3.2% of GDP or €53 bn) are set to exhibit budget deficits above the 3% threshold, hinting at ample supply.

We consider the **risks to these budgets to be rather limited**. Proposals to reform the current fiscal framework are still under discussion. However, even if a new framework were to be agreed upon, it would still need to be adopted by the European Council and the European Parliament would still require medium-term consolidation and is unlikely to enter into force as early as 2024. We do not expect the SGP reform to have a major impact on the 2024 budgets. However, given more subdued economic activity (the EC forecasts growth of 1.2% in 2024 vs our call of 0.5%), the aggregate deficit could be higher. That said, the German deficit is likely to be somewhat lower in 2024. The German Constitutional Court's ruling on the national debt brake forces the government to finance a gap of € 17bn in the 2024 budget. This could potentially come on top of the €58 bn deficit projected by the EC. But this is intended to be done through spending cuts and some tax increases, e.g. on CO_2 emissions. All in all, we see only limited risks to the supply of government bonds in 2024 from a fiscal perspective.

More important is the ECB's QT. So far, it only conducts passive QT on its APP portfolio (with monthly redemptions averaging € 25bn per month) but has left PEPP reinvestments untouched. In the official policy statements, the end of full PEPP reinvestments is scheduled for the end of 2024. However, recent comments by GC members suggest that this is about to change. Most importantly, President Lagarde has stated that this topic would be on the agenda in the not-too-distant future and that the Governing Council would review the issue. We now deem it **most likely that PEPP non-reinvestments will start as early as 2024.** To signal that this is a structural issue and not a means to shape the policy stance, we expect non-reinvestments to start in April 2024. We assume a moderate number of € 5bn out of an estimated average € 15bn per month (to be increased as the year progresses). Hence, € 60bn out of the € 180bn of PEPP redemptions are likely to be non-reinvested.

While not our base case, there is some **risk that passive QT on the PEPP could become much more aggressive,** for instance in exchange for a steeper easing cycle. We are currently looking for 100bps of cumulative cuts in 2024, but the ECB may proceed much faster (markets expect 130bps) in exchange for stronger QT on the PEPP.



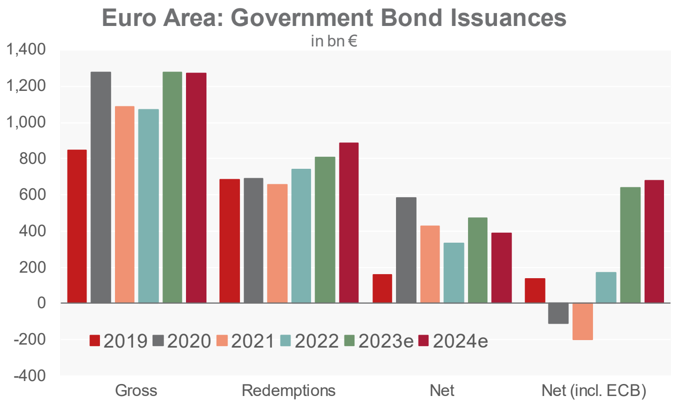
Source: ECB, GIAM

Net-net bond issuance to rise further in 2024

Based on the 2024 draft budget plans, we provide an initial assessment of the EA government bond supply. It should be noted that the **net issuance will fall slightly** (from € 475bn to a still high level of € 390bn) **given the moderately lower budget deficits** described above.

It is important to stress that the level of net issuance is by no means fixed and may change (as has been the case in previous years). One reason for this is that the estimated budget deficits may still change (e.g., the amount of energy subsidies is difficult to predict). This also applies to Germany, which is unlikely to pass its 2024 budget through Parliament before the end of the year. Furthermore, it is also unclear to what extent governments will fund not through bonds but via T-bills (in the following calculations we refer exclusively to bonds with an original maturity of more than one year, hence excluding T-bills).

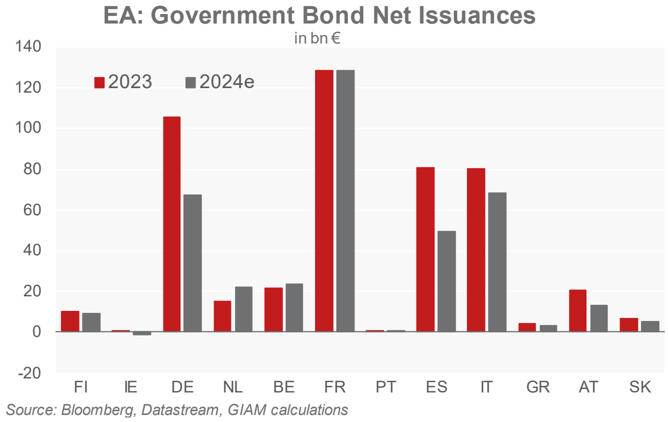
Having said this, the **gross government bond supply will remain at around the same level as in 2023 (€ 1275bn),** as the lower net issuance is balanced by higher redemptions. However, the utilisation of the government bond market is more evident in the net-net issuance (i.e., taking the ECB into account). Our expectation for the PSPP QT is that the ECB will continue on the path it has taken since July 2023 (full passive QT, no reinvestment of maturing bonds). Uncertainty is much higher for the PEPP QT, as the official ECB guideline is still full reinvestment until the end of 2024. For the time being, we assume a cautious start of PEPP QT totalling about € 60bn (see above), bringing the volume of non-reinvested bonds to more than € 290bn in 2024. Accordingly, the **net-net issuance will increase again compared to the record year 2023 and amount to around € 680bn**. As usual, we expect treasurers to be most active at the start of the year and issuance activity to be rather front-loaded. Almost a third of the issuance activity is likely to take place in Q1.



Source: Bloomberg, Datastream, GIAM calculations

The overall numbers conceal some interesting features of individual countries. Germany and Spain will see the largest reductions in net issuance. Italy is also expected to be able to reduce funding by a low double-digit billion amount. Against the background of the discussion taking place in Germany on the suspension of the national debt brake, it is noteworthy that Italy's new borrowing is almost exclusively for debt service (the primary budget is close to balance). Finally, **France will have by far the highest net issuance volume with an almost unchanged volume of around € 130bn** (followed by Germany with less than € 70bn).

Despite the high volume of issuance, we expect the **markets to digest the upcoming supply well**. Higher yield levels have generally made fixed income bonds more attractive. We also expect bond market volatility to decline somewhat, further supporting demand. Additionally, in Italy in particular, the share of non-residents, whose demand is particularly elastic in case of a deteriorating environment, has declined significantly (below 30% in Italy). On the contrary, retail bonds have become more important in 2023. We expect retail investors to help to absorb part of the bond supply next year again.



Source: Bloomberg, Datastream, GIAM calculations

EU issuance to increase moderately in 2024

According to initial estimates, the gross issuance by euro area SSAs will rise again to around € 380bn in 2024. However, the total volume somewhat masks the fact that the main momentum is generated by the EU. Net issuance by SSA issuers excluding the EU is close to zero next year and thus slightly lower than in 2023. However, the EU will again make significant use of the bond market and is even expected to slightly increase its net issuance volume. Of course, the EU's actual issuance volume will be closely linked to the RRF disbursements. For our calculations we consider that in 2023 the EU has issued more than it has disbursed under the RRF, leaving it with a cash balance of around € 40bn.

Given this fact and the possibility of further delays, the uncertainty about the final amount of EU issuance is very high. Assuming that there are no further delays (but that countries do not catch up with existing ones), we expect **gross EU issuance to exceed € 140bn** (including the funding of the – not yet approved – Ukraine Facility). The bulk of the issuance activity is likely to take place in H1. Given the low level of redemptions, this is also close to the net issuance. This means that net issuance is seen to increase moderately compared to the current year and would stabilise at a level similar to the record in the year 2021.

The main difference, however, is that the ECB absorbed some of the issuance in that year. As a result, the **supply/demand ratio on the euro area bond markets will remain tight** and will even deteriorate slightly compared with 2023.

Imprint

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