Spillover effects of debt issuance and the importance of fiscal rules

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Debt issuance in major euro area countries whose bonds are considered relatively safe drives up interest rates in both the issuing country and in other 'safe' countries. This new type of spillover, which differs from the contagion effects and default risk spillovers that took centre stage during the euro sovereign debt crisis, implies that total debt issued in 'safe' countries matters more for sovereign interest rates than which country issues it. This insight strengthens the case for common fiscal rules, not only to preserve low interest rates and debt sustainability and safeguard euro area financial stability – the core mandate of the European Stability Mechanism (ESM) – but also to ensure the fair sharing of fiscal burdens in non-crisis times.

Ripple effects of one country's debt issuance

When one major 'safe' euro area country suddenly issues more debt, interest rates rise

the response of interest rates on sovereign bonds in secondary markets is nearly as large in many neighbouring countries as in the country issuing the debt.

Figure 1 illustrates the magnitude of such spillover effects. On 14 December 2022, the German debt management office announced a surprisingly large debt issuance planned over the course of the following year. This led to a jump in the German 10-year yield, reflecting investors' demand for a higher return to absorb more German debt. Spillovers ensued within minutes despite the news being Germany-specific: the French yield moved in lockstep with the German yield, while the Italian yield also rose but tracked the German yield less closely. Our findings show that these spillover effects are prevalent over many similar announcements and across many countries, and they work in both directions as issuance in other safe countries also affects German yields.

Figure 1: German debt issuance announcement has spillover effects

(change in percentage points relative to 9:55 CET on [illegible]4 December 2022)

Source: ESM calculations based on Bloomberg data

Our analysis focuses on the countries whose bonds are typically deemed safe, as reflected in very low default risk premia, [illegible]called ‘core’ countries – such as Germany, France, and the Netherlands. [1] These countries even earn a premium, called a convenience yield, reflecting that their bonds provide investors not only with a cash flow but also with convenient ancillary services. Most importantly among these services, their bonds are reliably liquid and generally appreciate in value during recessions or crises. This appreciation typically results from investors’ “flight-to-safety” behaviour, particularly well documented during the euro sovereign debt crisis. These countries also tend to maintain low risk premia in recessions even when risks surge in some of their neighbouring countries, demonstrating that they are less prone to contagion effects (a different type of spillover propagated through risk premia).

Not just one, but several euro area countries benefit from this safe-haven-status and issue bonds that investors perceive as safe assets. Hence, investors wanting to buy a safe asset can buy sovereign bonds from different issuers, which can be potentially treated as substitutes. The interaction of supply and demand implies that an increase in the supply of one of these bonds raises interest rates on both this bond and its substitutes. In the European macrofinancial context, this substitution by investors explains the spillover effects of debt issuance in Figure 1. Other shocks, for example to the perceived riskiness of a country, move that country’s convenience yield without necessarily generating spillover effects.

Non-core countries: less impact

Non-core countries, such as Italy and Spain, were most affected by contagion effects during the sovereign debt crisis because their fiscal situations were relatively weaker compared to core countries. Therefore, they were more vulnerable to additional shocks, such as those that would follow from the default of another euro area country. This led to interconnected default risk premia and sovereign interest rates in non-core countries.

In contrast, non-core countries are less exposed to the newly documented spillovers. We find that their interest rates respond much less systematically to changes in debt supply in Germany or France. We argue that this is because non-core countries' bonds are imperfect substitutes to core countries' bonds. They pay higher interest rates, have different risk profiles, and are generally a poor hedge against recession risks. Therefore, a larger supply of bonds from core countries does not divert demand from these countries' bonds.

Dangerous liaisons? Fiscal rules are needed, also in non-crisis times

Since core countries' bonds are treated as interchangeable, what matters for their interest rates is the total amount of these bonds and, therefore, it matters less which core country issues them. Of course, this is only true up to a certain point, as an unjustified surge in a core countries' debt would eventually undermine the safe-haven status of the country, change investors' view on how interchangeable its bonds are with other core bonds, and trigger a host of other issues.

In practical terms, core countries that issue more debt increase the interest burden of other core countries. Conversely, countries that reduce their debt effectively contribute to lowering the interest paid by other safe countries.

As a result, the full cost of issuing more debt extends beyond the issuing country, a concept known as a "negative externality". This may lead to excessive debt issuance and [illegible] good reasons. Excessive debt can lead to crises and, even in the absence of a debt crisis, unequal issuance activity creates lopsided effects with more debt driving up interest rates for other countries.

Addressing negative externalities and containing the risk of excessive issuance requires coordination among countries. Such coordination can be achieved through fiscal rules. The Stability and Growth Pact aimed to provide coordination by requiring governments to have debt levels below 60% of gross domestic product. Today, debt levels in most European countries exceed this level, vary greatly across countries, and have led to the recent revision of European fiscal rules. The effectiveness of these revised rules in containing risks remains to be seen, and the outcome will have consequences not only for the risk of a crisis but also for burden sharing in non-crisis times – important considerations [illegible] preserving euro area financial stability.

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Further reading

Cristian Arcidiacono, Matthieu Bellon, and Matthias [illegible]ewuch (2024). Dangerous liaisons? Debt supply and convenience yield spillovers in the euro area. ESM Working Paper No. 63.

Footnotes

[1] We discuss spillovers to non-core countries, such as Italy and Spain, further below.