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The new normal for European sovereign debt markets

Eurozone sovereign debt markets have evolved through distinct regimes: convergence; crisis; and the current new normal. In the latter, spreads are driven by idiosyncratic country risk and debt issuance. France's recent experience embodies this shift, with an increase in borrowing costs occurring without broader contagion.

Key Takeaways

- Eurozone sovereign debt markets have entered a regime in which idiosyncratic country differences are the main determinant of each country's bond yield.
- This is in contrast to previous regimes. During the convergence period they were treated as perfect substitutes, and later, during the crisis one, it was a country's "core" or "peripheral" status that largely determined market performance.
- The recent widening of French government debt illustrates these dynamics. The lack of contagion to other European debt markets shows that the market was not pricing denomination or credit risk. Instead, the expectation of higher future debt supply meant prices had to fall to clear the market.
- These dynamics also reflect the fact that the distinction between "core" and "periphery" has become less important. Our analysis suggests that France is better thought of as peripheral, but that is not what is driving its bond market.
- The current regime probably represents a stable equilibrium, but future regime shifts cannot be ruled out. Full capital markets union would probably see a return to convergence dynamics, while a political and fiscal crisis in a systemically important European country could trigger a return to crisis dynamics.

The Eurozone debt market has traded under three different regimes

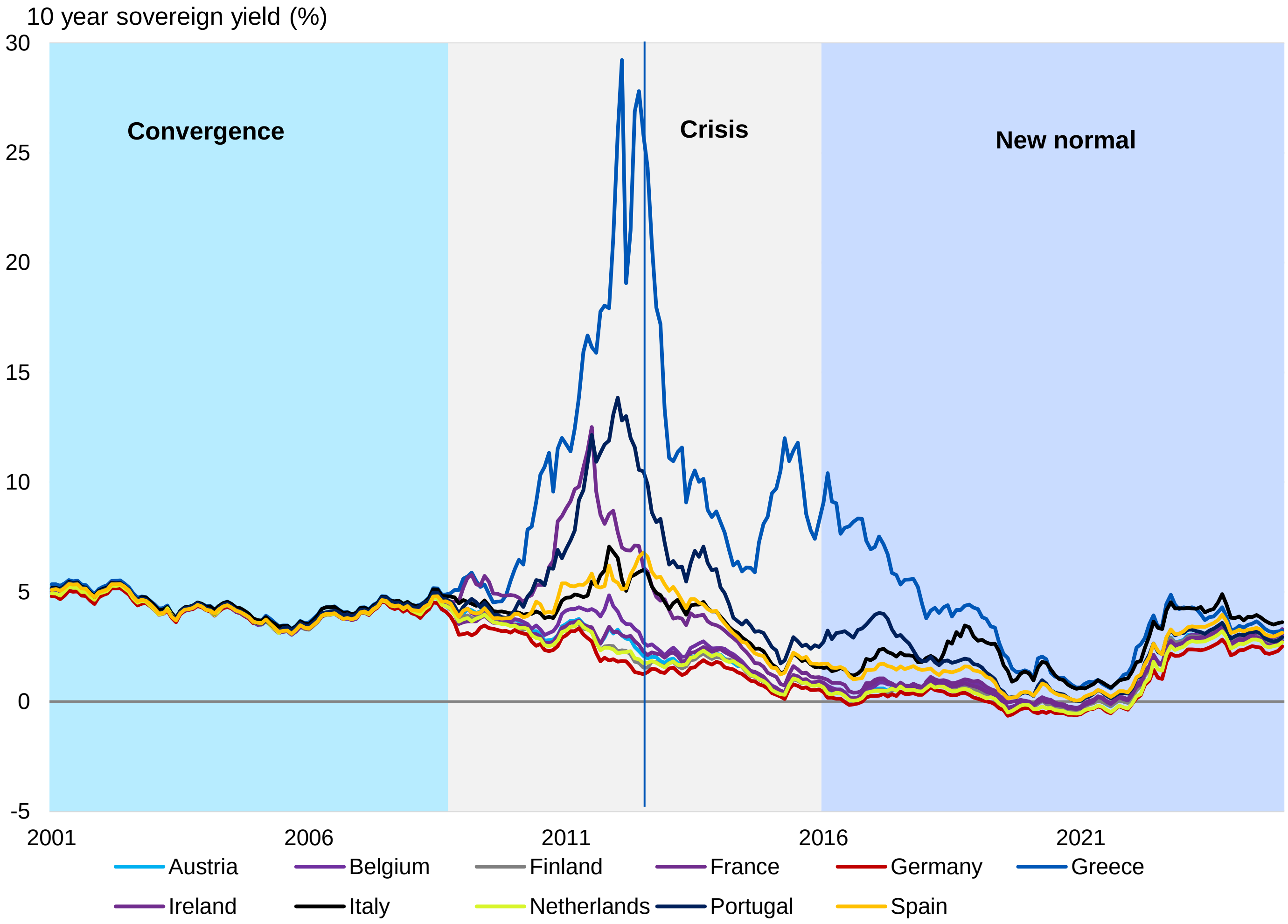
The behaviour of Eurozone sovereign debt markets over the history of the euro can be categorised under three regimes (see Figure 1).

From 1999 to 2008, markets traded in a "convergence" regime, where the borrowing cost spread between different countries' debt was extremely tight, suggesting that investors perceived very similar risk characteristics between different markets. In particular a shared currency and monetary policy meant that all Eurozone countries had identical interest rate and inflation risks, and so could broadly be treated as perfect substitutes for each other.

In the 2008-2016 period, a "crisis" dynamic prevailed during which spreads widened materially (and at times chaotically) for some countries, with different credit and redenomination risks between peripheral and core countries driving different market outcomes.

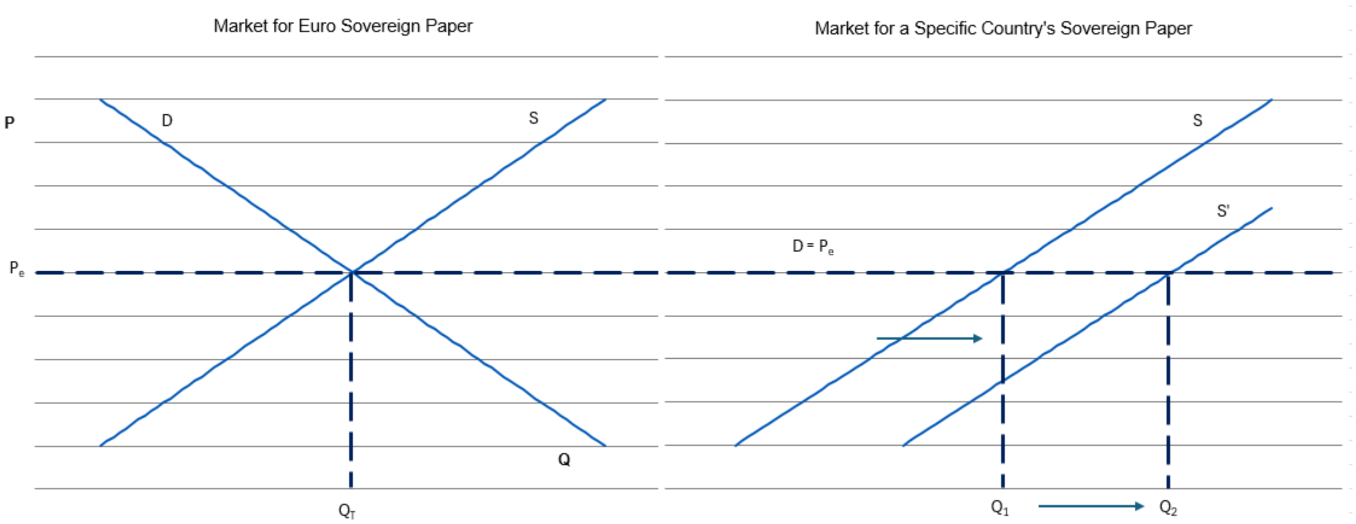
From 2016 to the present, markets have traded under what we call a "new normal" regime, where European Central Bank (ECB) policy interventions have largely removed redenomination risk, but idiosyncratic country risk is still reflected in different spreads. In particular, debt issuance seems to be a key driver of relative spreads.

Figure 1: Spread behaviour is materially different under the three different market regimes



Source: Haver, abrdn, February 2025

Figure 2: Under convergence, countries face no price penalty for issuing more debt



Source: abrdn, February 2025

From perfect substitutes to habitat constraints

With redenomination risk having been removed as a pressing concern for markets, it is arguably somewhat surprising that rates markets have not returned to the pre-crisis convergence regime. Or, put another way, we need to explain why debt issuance is a driver of idiosyncratic country risk now but wasn't in the "convergence" regime.

The convergence period can be modelled as if any individual Eurozone country was effectively a price taker within the context of the wider Eurozone bond market. Each country's debt was a perfect substitute for another and an increase in supply of any one country's debt did not impact the price of that country's debt, because the price for all Eurozone debt was determined collectively in the entire Eurozone market (see Figure 2).

By contrast, in the new normal regime, European debt markets have become less integrated, with the marginal price for each country's debt set in the market for that specific country's bonds.

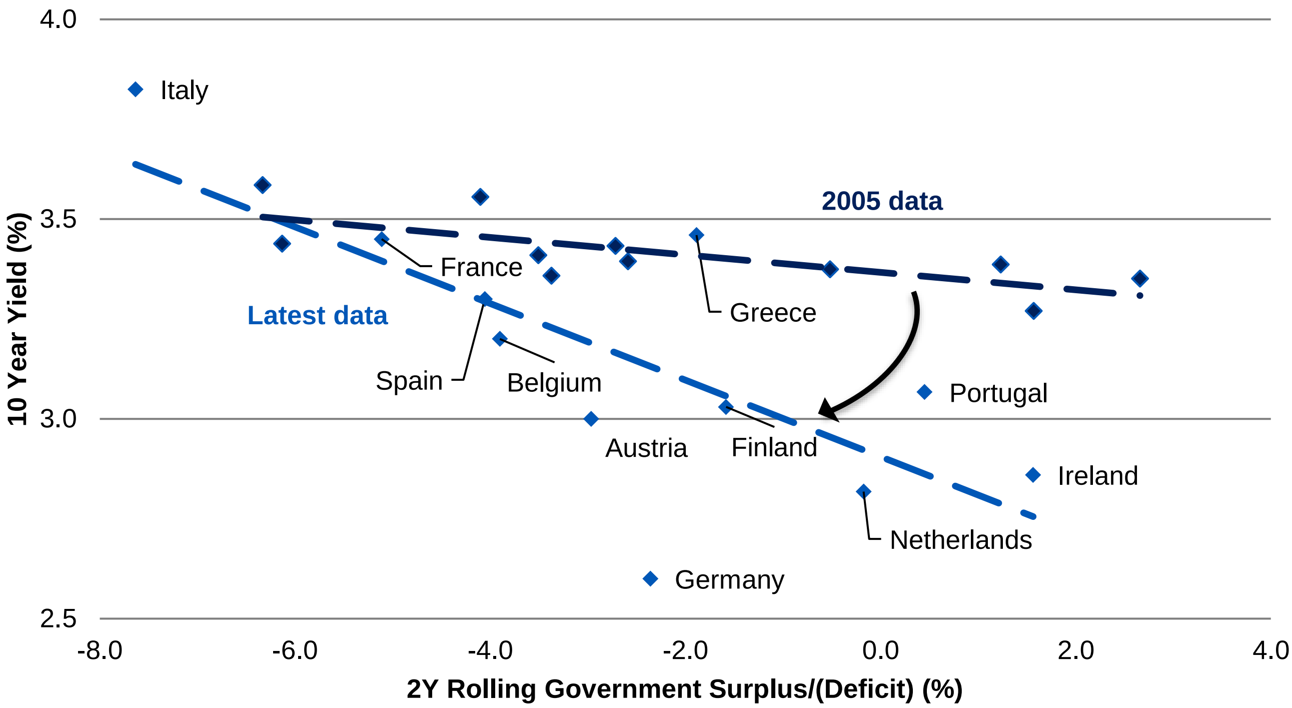
This shift to a less integrated Eurozone debt market is perhaps in part the result of the crisis period itself, where the empirical fact of country divergence had a lasting impact on the perception of how these bond markets should behave.

Crucially though, as European debt levels have increased since the financial crisis, domestic habitat biases have also become much more important in driving individual markets.

If holders of euro government paper prefer to hold debt issued by their own country – perhaps for cultural reasons, regulatory obligations, or to meet the stipulations of mandates – then bonds from different sovereign issuers are *not* perfect substitutes.

Governments therefore face downward-sloping demand curves when issuing debt (see Figure 3), and at high-debt levels these curves are potentially quite steep. In other words, an expected increase in debt supply necessitates a fall in the price of government debt securities (a rise in yields) for markets to clear.

Figure 3: Investors now impose a greater penalty on governments in proportion to their deficits



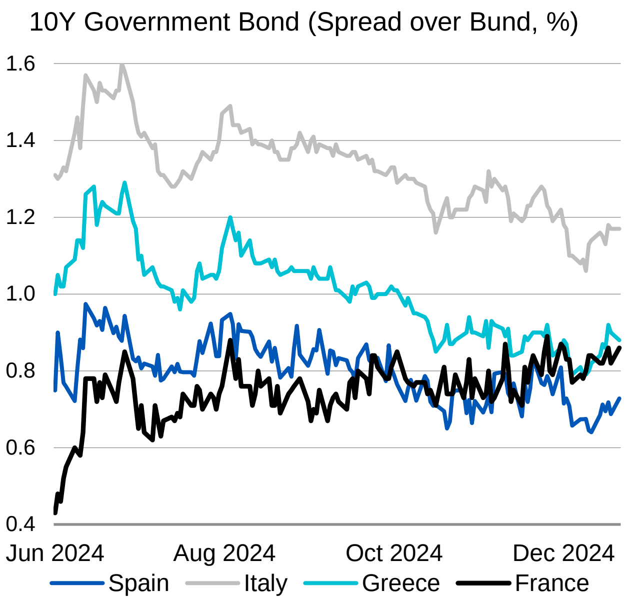
Source: abrdn, Haver, Bloomberg, February 2025

France as a case study of the new normal

These new-normal dynamics are nicely illustrated by the recent movements in the French government bond market, where OAT spreads rose 30bps from July to December.

Critically, redenomination risk does not seem to have played a significant role in the move. France is, of course, systemically important to the Eurozone, so, if there had been genuine concerns about French credit risk and Eurozone membership, there would have been much bigger existential concerns about the Eurozone as a whole. This would have caused significant contagion to the traditional peripheral markets, with spreads widening significantly. However, these countries' ten-year spreads actually fell back a touch over this period (see Figure 4).

Figure 4: French disruption didn't lead to contagion



Source: abrdn, Haver, February 2025

Instead, the widening was largely restricted to France, and reflected changing expectations about future French debt issuance. Rather than being driven by credit risk concerns, these issuance concerns were a case of higher supply interacting with a downward-sloping demand curve, causing a downward price adjustment to clear the market.

Rethinking the periphery and core

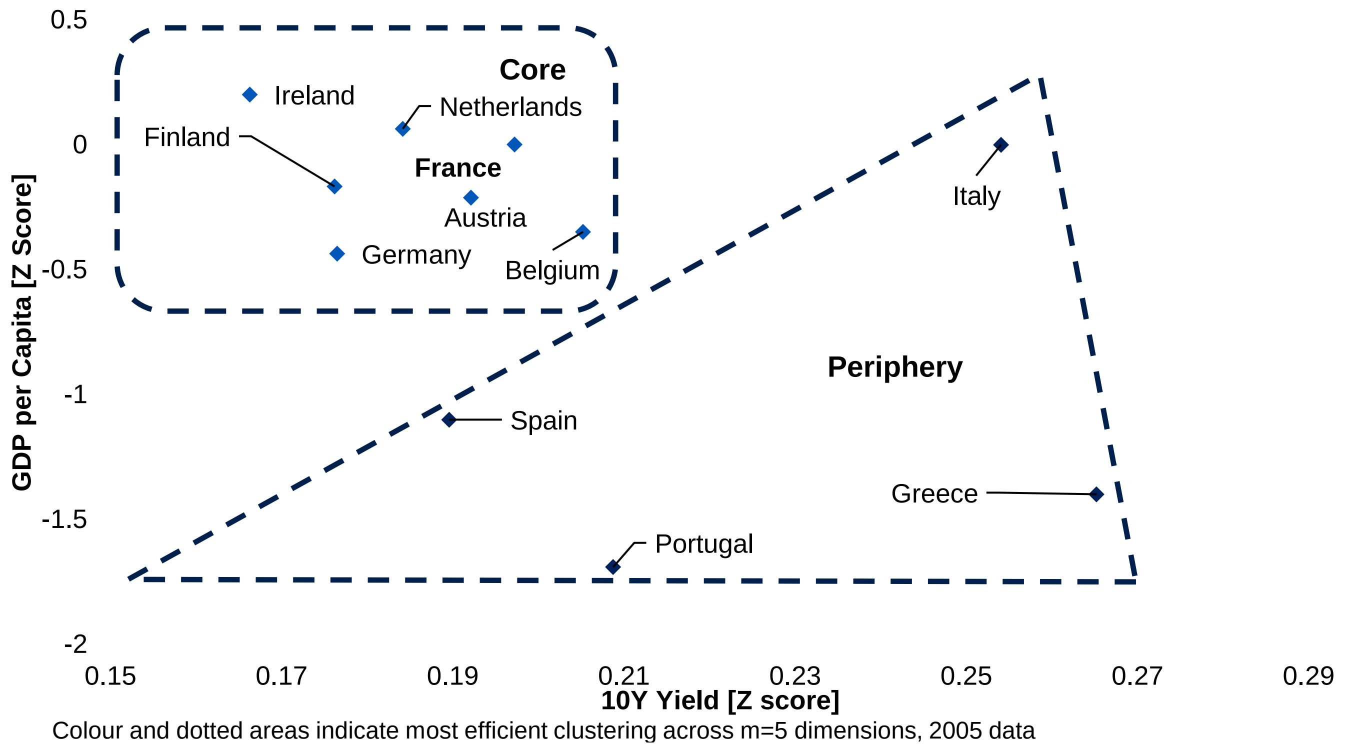
Interestingly, France now pays higher yields on its debt than Spain and Greece, which rather calls into question the old notion of a Eurozone core and periphery.

As such, we use k-means clustering across eight variables[1] to analyse similarities between the Eurozone countries to assess how notions of "core" and "periphery" might have changed over time.

These results confirm that France now has more in common with the periphery than the core, following a sharp rise in borrowing costs and the fiscal deficit. This comes in sharp contrast to 2005, when France had far more in common with the Netherlands and Germany (see Figures 5 and 6).

France's shift toward the periphery serves as a reminder that membership of any particular subgroup is not permanent. Indeed, our results suggest that France is not the first country to move from the core to the periphery (see Figure 7).

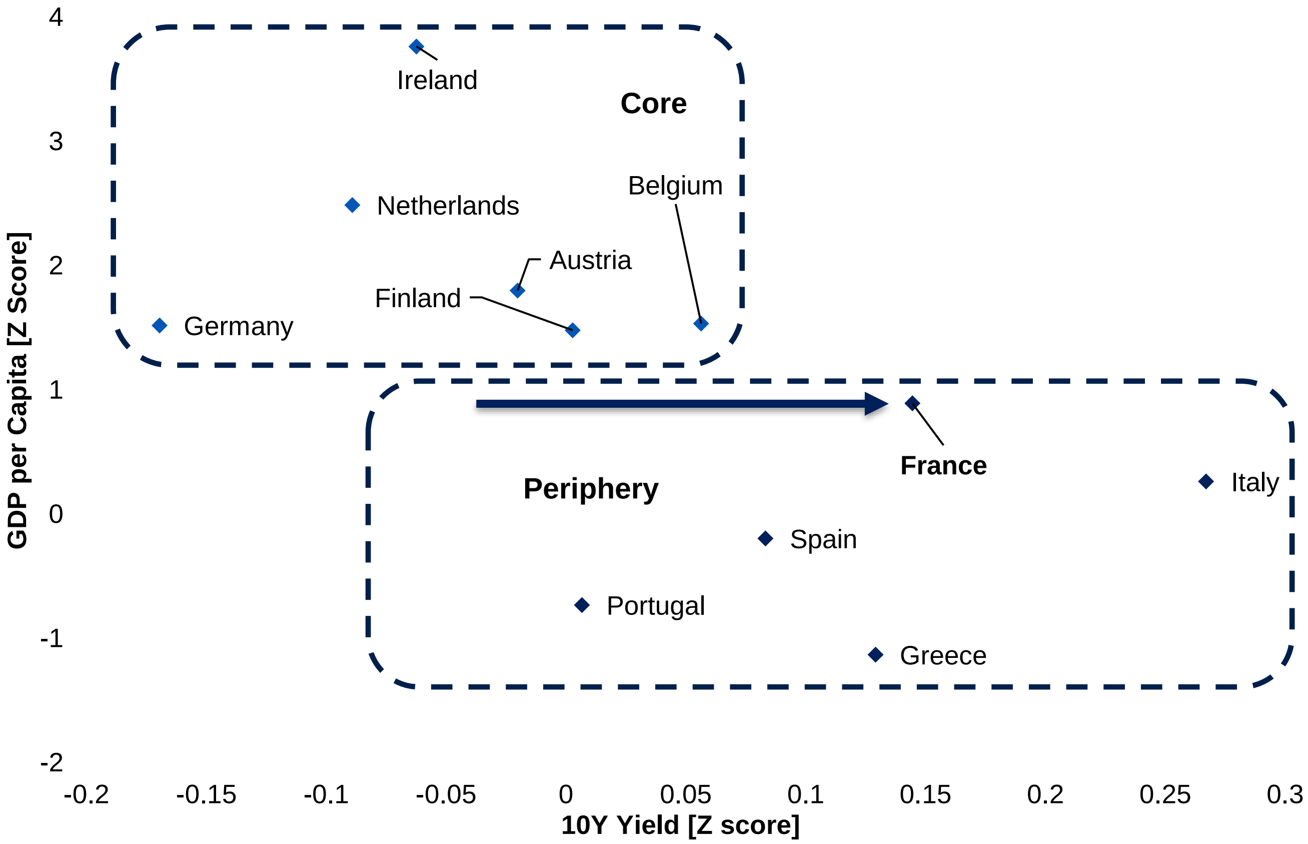
Figure 5: France was once firmly counted among Eurozone "core" members



Source: Haver, February 2025

1 These are 10y yield, GDP per capita, deficit-GDP ratio, debt-GDP, intra-EU balance of trade, purchasing power parity, unemployment rate, and the hourly cost of labour

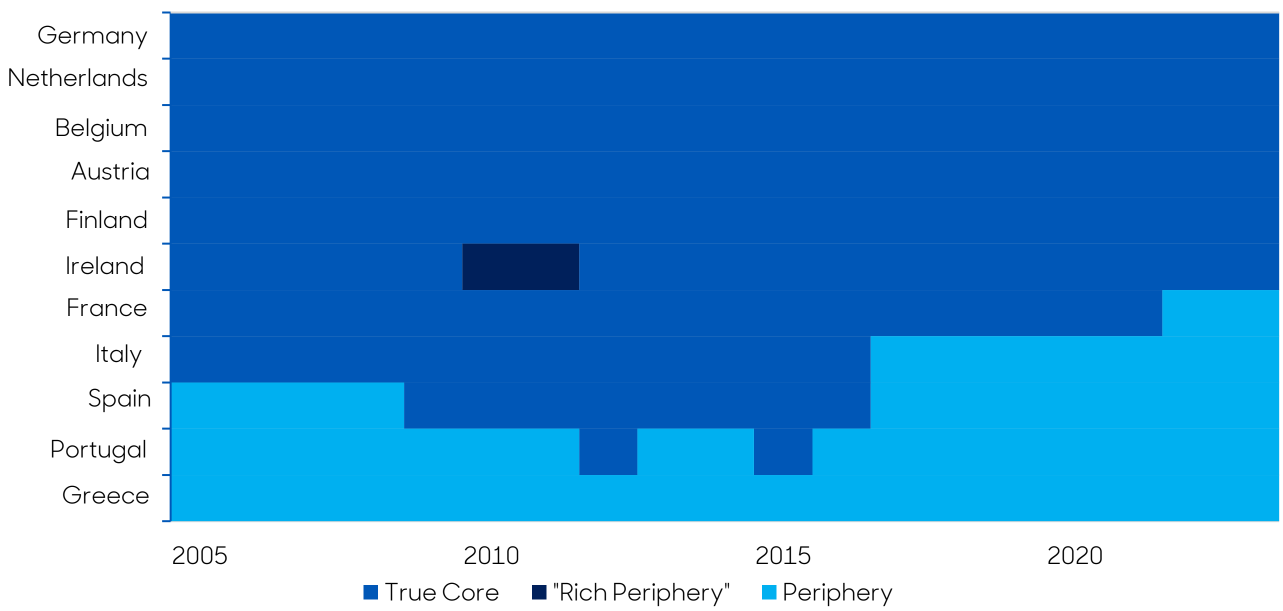
Figure 6: France now has more in common with the periphery



Colour and dotted areas indicate most efficient clustering across m=5 dimensions, latest data

Source: Haver, February 2025

Figure 7: "Periphery" and "core" status is not set in stone



Source: Haver, abrdn, February 2025

Not only can countries shift from “core” to “periphery”, but the importance of that distinction can change over time.

During the convergence period, it mattered little, with spreads universally tight. But during the crisis period, spread levels and volatility were ultimately determined by core or periphery status. Every peripheral market was highly correlated with every other peripheral market as spreads were driven by the perception of “peripheral risk” rather than country-specific factors.

In the new normal period, idiosyncratic country factors are much more significant, so cross-correlation between markets may be weaker, with little contagion from one market to another. So, there may be more volatility both in the level of interest rates and in cross-country spreads.

Regimes matter for incentives

Different market regimes also mean different incentives for governments.

Under convergence, a surprise increase in expected issuance from one country had a very limited impact on that country’s borrowing costs.

This creates an incentive to over-issue debt in each individual country and fiscal sustainability thus becomes a coordination problem. It was this problem that European Union (EU) fiscal rules were designed to overcome.

Under the new normal, the story looks a little different. Governments face a very real trade off: more borrowing leads to higher yields, and vice versa.

This market discipline will likely please the EU authorities, especially the ECB. The presence of a market mechanism to disincentivise fiscal largesse lightens the load on the EU’s recently relaxed fiscal rules to ensure time-consistent fiscal sustainability.

In addition, the lack of contagion to the traditional periphery will reassure policymakers that a decade of “whatever it takes” muscularity on the future of the euro and a beefed-up ECB toolkit has successfully deterred investors from moving to price in redenomination risk in response to political uncertainty.

What’s next for the euro?

We think the current new normal regime will continue to pertain and expect markets to continue dynamically re-pricing and re-ranking countries’ sovereign paper as news pertinent to issuance comes out.

For France, this probably means a period of slow-burn volatility over the first half of this year at least, given President Emmanuel Macron’s inability to dissolve the deadlocked National Assembly until June.

Likewise, there is some uncertainty around the outlook for Spanish sovereign debt given the fiscal stasis the governing coalition finds itself in.

By contrast, Germany’s relatively low outstanding debt stock and the fiscal conservatism of the (very likely) incoming CDU party should insulate the bund curve from domestically generated volatility even if the debt brake is relaxed or abolished.

However, regime shifts are by their nature difficult to predict, and we cannot rule one out.

If a regime shift does come, it might be part of a deliberate effort from EU institutions to return to convergence.

In particular, Mario Draghi, former prime minister of Italy and president of the ECB, has proposed complete capital markets integration and the issuance of joint EU debt to fund investment. The ultimate outcome of this policy could be a Eurozone with a single debt instrument and no-cross country risk that needs pricing.

We see this regime shift as unlikely in the near term, given the hostility of German politicians to the issuance of joint-EU debt, and the broader rise of populist, euro-sceptic political forces across the EU.

Alternatively, it is possible that a regime shift back to crisis dynamics occurs. Of course, the ECB is much better armed to deal with a resurgence in redenomination risk than it was in the past, and its various intervention tools should be able to comfortably deal with a crisis in a small European country.

However, the ECB’s scope to intervene in markets is ultimately bounded by politics. It is one thing for the ECB to ensure that market dynamics do not make euro membership unsustainable for any country that should otherwise still wish to continue with Eurozone membership. It is quite another when market dynamics just reflect a very real political desire in a country to leave the Eurozone.

So, the reemergence of credit risk as a consequence of a euro-sceptic turn in the domestic politics of a Eurozone country, especially a systemically crucial one, could test the limits of ECB firepower.

In particular, France may be too big to fail, and too big to bail out. The ECB’s Transmission Protection Instrument is designed with small countries in mind, and requires they be outside of an excessive deficit procedure (EDP). Applying it to a large country in an EDP (as France is) is untested and could prove ineffective. So, a full-scale fiscal crisis in France would probably lead to the abolition of the EU fiscal rules themselves.

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