Problems in bond markets - again

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Prof. Dr. Dr. h.c. Lars P. Feld

teaches at the University of Freiburg and heads the Walter Eucken Institute

Is this already the start of a financial crisis? This is what some observers of the latest developments in bond markets are asking themselves. There is talk about a currency crisis in Japan due to the strong devaluation of the yen, a government debt crisis in France and worries in the US about a lack of bidders for long-term US government bonds. The Bank of England has stopped the sale of government bonds from its portfolio, and the European Central Bank (ECB) is asked to do the same. Considering the inflationary use of the term ‚crisis', it is important to keep a cool head. Nevertheless, it is also very important to pay attention to bond markets. Markets are nervous because of the enormous private and government debt with rising interest rates and relatively weak economic growth. Supposedly safe investments are not as safe as they used to be. This is particularly true for government bonds.

The latest developments are happening in Japan, the US and in the highly-indebted countries of the European currency union. First, interest rate developments are changing our view of Japan. Japan's enormous government debt, which is still around 200 percent of GDP, was mainly enabled by the fact that most of it was held domestically. Moreover, Japanese investors held a lot of assets abroad, which resulted in significantly lower net indebtedness. Added to the above were extensive carry trades by investors who took on debt in yen at low interest rates and then invested the funds abroad for a higher return.

The change in interest rates as part of the fight against high inflation since the year 2021 has led to the collapse of the yen, forcing the Bank of Japan to respond with rate hikes. Because of the lower yen, Japan (as an energy importer) has been hit hard by the energy price shocks of 2022 and 2026; they also create considerable inflationary pressures. While higher interest rates go some way towards reducing carry trades, it is not enough to support the yen. This leads to repeated support purchases by the Bank of Japan and the US Treasury. The Bank of Japan sells US dollar and euro reserves. The Treasury sells euro reserves and replaces them with yen reserves.

Together, these processes ensure that the demand for US government bonds and the government bonds of euro states is reduced. Second, the US also has an enormous appetite for capital, since the US government continues to accumulate debt with an annual deficit ratio of 6 percent since 2022, and a government debt-to-GDP ratio of over 120 percent. Another factor is the massive US household debt, which is accelerated by AI corporations in the form of additional bond issues. The supply of capital can hardly keep up, so there are worries about liquidity for bond issues.

Third, these are not the only developments that put pressure on the highly-indebted countries in the Eurozone. Some member states are still facing excessive debt levels. This is particularly true in the case of France (where the government debt is approximately 120 percent of GDP) and Italy (approximately 135 percent of GDP). Greece's government debt is likely to fall below Italy's government debt this year (as a percentage of GDP), and the country is also financed at favorable conditions due to the rescue packages in the past. Portugal has also successfully consolidated its government finances. However, Belgium and Spain have also attracted the attention of the markets.

Particularly France has not taken any steps towards consolidation. And the political situation in the country is so messy that this is very unlikely to happen. Therefore investors are increasingly withdrawing their capital in order to park it in a safe haven - Germany. But this should not blind us to the fact that Germany too is on the way to leave the path of solid finances. For now, the dams are holding. But sooner or later the ECB might have to purchase bonds and thus give in to pressure for monetary state financing. Therefore much will depend on financial markets finding a way to discipline France without triggering a spiraling financial crisis. Turbulent times are ahead of us.

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