EUROZONE BOND MARKET SPILLOVERS FROM THE JUMP IN BUND YIELDS

26-WEEK ROLLING BETA (CHANGE OF 10 YEAR YIELD AS A FUNCTION OF CHANGE IN 10 YEAR GERMAN YIELD; WEEKLY DATA)

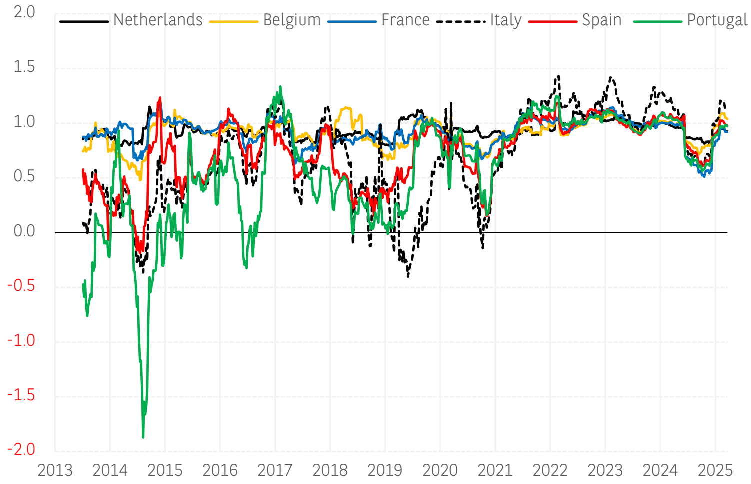

CHART 1

SOURCE: LSEG, BNP PARIBAS

THE RELATIONSHIP BETWEEN BUND YIELDS AND OTHER EUROZONE COUNTRIES

a	b	c	d	e	f	g	h
	11 March versus 4 March: observed change in yields	Weekly change in 10-year sovereign yield as a function of weekly change in 10-year Bund yield (4 February 2022-27 December 2024)			Estimated change	Observed minus estimated	Observed / estimated
		intercept	beta	adjusted R^2			
Germany	0,42						
The Netherlands	0,403	0,001	1,014	0,947	0,427	-0,024	94%
Belgium	0,362	0,002	0,989	0,951	0,418	-0,056	87%
France	0,37	0,003	0,988	0,910	0,418	-0,048	89%
Italy	0,39	-0,004	1,120	0,743	0,467	-0,077	84%
Spain	0,349	-0,001	1,002	0,887	0,420	-0,071	83%
Portugal	0,372	-0,002	0,991	0,868	0,414	-0,042	90%

TABLE 1

SOURCE: BNP PARIBAS

On Wednesday 5 March, the 10-year Bund yield increased 30bp, the biggest rise since the fall of the Berlin Wall. It continued to move higher the following days, reaching a peak on 11 March.

The trigger was the announcement by Friedrich Merz (CDU) and the heads of the CSU and SPD during an evening press conference on Tuesday 4 March 2025 that they agreed to:

- reform the debt brake

- exempt defence spending above 1 percent of GDP from this debt brake

- create a EUR 500bn fund for infrastructure investments.

The developments in the German bond market had sizeable spillover effects across markets in the Eurozone. This didn't come as a surprise. Higher Bund yields trigger a portfolio rebalancing because yield-targeting investors need less exposure to higher-yielding markets to meet their objective when German long-term rates have become more attractive. It seems that this arbitrage behaviour of investors has become more prominent in recent years, considering that since February 2022 -when Bund yields moved back in positive territory- bilateral correlations with the German market are significantly higher than before. In Italy for instance, three quarters of the weekly change in yields are explained by changes in German yields.[1] For other countries, the numbers are even higher, reaching 95% in the Netherlands and Belgium and 91% in France (*table 1, column e*). The regression beta -the change in bond yields for a given change in German yields- is also close to one for the various countries (*column d*), implying, a priori, full transmission of Bund yield changes.

As shown in chart 1, since the latter part of 2021, the beta has increased structurally and the dispersion between the country betas has narrowed significantly. This means that yields in Eurozone markets move much more in tandem than before.

This statistical relationship allows us to assess whether, given the change in Bund yields, the change in other markets has been in line with expectations (*table 1, column h*). It seems that the different markets have witnessed some underreaction compared to what happened in Germany. This was especially the case in Italy and Spain, where the increase in yields corresponded to 83%, respectively 84%, of what was expected based on the regression analysis. Nevertheless, these countries, just like the others, suffered from a significant spillover from the announcements made in Germany. It remains to be seen whether this negative financial spillover (higher borrowing costs) will be compensated, at least in part, by positive spillovers from increased trade with Germany following the fiscal boost in that country.

1 For Italy, based on the R^2 of a regression of the weekly change in Italian yields as a function of the weekly change in German yields over the period February 2022-December 2024, 74% of the former is explained by the change in Bund yields. During the era of negative Bund yields (March 2019-end of January 2022), the equivalent number was 12.5%. Between January 2013 and March 2019, it was 9.4%.

An ECB occasional paper[2] presents model-based simulations showing that an increase in German public investment by 1% of GDP for two years raises German output by almost 1.5% but the impact on the rest of the euro area is less than 0.1%. This limited spillover is due to the rise in official interest rates in reaction to the fiscal expansion. If monetary policy is not tightened, the domestic impact on growth is somewhat higher than 1.5% and the spillover is higher as well (about 0.25%). All in all, it seems that the real spillovers should be limited. Assessing the net effect on growth outside Germany is very challenging because it depends on the sensitivity of final demand to interest rates, the size of the German spending boost and the (non-European) import content of the extra expenditures. Confidence effects (a revival of animal spirits) could also play a role.

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2 Source: Mario Alloza, Marien Ferdinandusse, Pascal Jacquinot, Katja Schmidt, Fiscal expenditure spillovers in the euro area: an empirical and model-based assessment, ECB occasional paper 240, April 2020. The paper also refers to refers to research by Roel Beetsma and his co-authors published in 2006 showing that a "spending-based fiscal expansion of 1% of GDP in Germany would lead to an average increase in the output of other EU economies by 0.15% after two years." The effect would be larger (0.4% after two years) in neighbouring countries (Austria, Belgium and the Netherlands). They also mention work by the IMF in 2017 showing a positive impact on Europe of 0.26% from a 1% government spending shock in Germany.

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