Indebted Countries See Borrowing Costs Edge Up

Associated Press

By DAVID McHUGH Associated Press
FRANKFURT, Germany June 21, 2013 (AP)

Europe's indebted countries have seen their borrowing costs edge higher after the U.S. Federal Reserve signaled it could start phasing out its bond-buying program.

The market shift raises concerns that governments will face a bigger financial burden in their struggle to escape the financial crisis that has plagued Europe for the last 3 ½ years. But borrowing costs are still far below crisis levels from last summer, and some analysts say home-grown problems are the bigger risk.

The Fed's stimulus, which was aimed at boosting the U.S. economy, has also helped financial markets around the world. The Fed — along with other central banks — cut short-term interest rates to near zero and pushed newly created money into the financial system by buying longer-term bonds with the aim of stimulating the economy.

The bond-buying — which is known as quantitative easing, or QE — has driven down longer-term interest rates. It als sent money flowing into stocks and riskier bonds as investors sought higher returns than the near-zero rates available on safe investments.

Thanks to QE, bonds issued by the shakier governments — such as Portugal, Italy and Spain — rose in price, sending their interest yields lower, since price and yield move in opposite direction For a time, governments enjoyed those lower interest costs each time the borrowed on bond markets, taking some pressure off their finances. The yield on Italy's 10-year bond, for example, fell from 4.72 percent in February to 3.78 percent at the beginning of May. Spain's fell from 5.35 percent to 4.06 percent over the same time.

Bernanke said this week that the Fed expects to begin tapering the purchases at end of this year — and end them around middle of next year — so long as the economy improves according to its forecasts.

This has sparked the fear that the end of the Fed's stimulus will erode Europe's bond-market respite — that bond prices will fall and yields and rate costs will rise.

Portugal, Italy, and Spain saw bond market borrowing rates rise Thursday as the Fed's new message made stocks and bonds plunge worldwide. Yields on 10-year Italian, Spanish and Portuguese bonds rose about a thir of a percentage point. By Friday, they had stabilized — Italian bonds were little changed Friday, yielding 4.50 percent, while Spanish bonds saw yields decline slightly to 4.80 percent. Bonds in bailed-out Portugal bonds are yielding a higher 6.41 percent.

Eswar Prasad, professor of trade policy at Cornell University, says rising interest rates in the United States as the Fed tapers down its QE could be bad news for countries such as Greece and Portugal, which are struggling with big government debts.

"Distressed economies on the periphery of the eurozone could face a spike in borrowing costs if higher U.S. interest rates divert a greater share of global capital flows toward the U.S.," Prasad said.

But these countries' new, higher borrowing rates remain far below the levels that last year made people fear the eurozone might break up. Then, Italy's 10-year yield was at 6.36 percent and Spain's had hit 7.38 percent.

Those yields fell after the European Central Bank offered to buy government bonds. No bonds were bought, but the mere proposal helped send yields lower.

"I think what we saw yesterday was an overreaction," said Luca Cazzulani, deputy head of fixed income strategy at UniCredit Research. "In terms of borrowing costs, I don't see a source of concern right now."

Analysts also stressed that the reason Bernanke has made this announcement was because the U.S. economy is currently showing signs of improvement — and that is good news for Europe. A healthier U.S. will buy more European exports. And the end of the Fed's bond purchases will likely push up the value of the U.S. dollar against the euro, making European products less expensive in America.

"A stronger U.S. economy and a weaker euro could be a net plus for the eurozone as a whole," Prasad said.

Ultimately it is growth that will help Europe reduce its debt. European leaders are also working to strengthen oversight of their banking system, while national governments have been making halting progress toward making their economies more business-friendly so they can grow faster.

Carsten Brzeski, senior economist at ING, pointed out that Europe's weak economy means that the European Central Bank will be keeping its rates down or even cutting them from the current record low of 0.5 percent to support the weak eurozone economy.

That will tend to keep rates lower in Europe. He said bond yields "should not be affected by tapering. I personally expect that markets will calm down again.

"The biggest worries for peripheral bond yields is clearly homemade stuff and not Bernanke tapering."

_____

AP Business Writer Paul Wiseman in Washington, DC contributed to this report.