Talking point

Government debt: Better at home or abroad?

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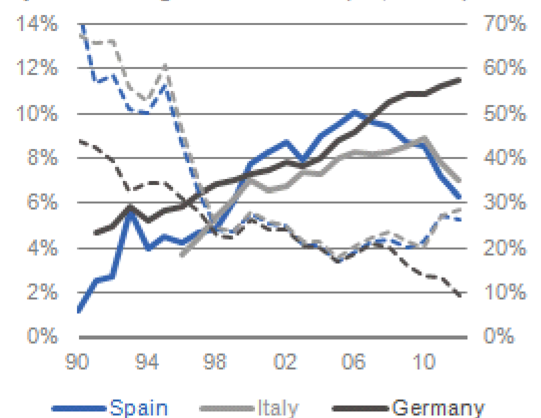
After two decades of international financial integration, foreign investors have decided to pull out of Italy and Spain. In this context two central questions arise: what is the cause of this development and what are its consequences?

The introduction of the European Monetary Union helped many countries with weaker currencies to rapidly gain greater credibility and stability. What followed were a dramatic reduction in government bond yields as well as a decline in inflation – circumstances that make a country attractive to foreign investors. Consequently, an internationalisation of government debt holdings set in. Its effect was most pronounced in countries that up to that point had been less attractive to foreign investors, among them Spain and Italy. In Spain, the share of foreign creditors increased nearly tenfold over the course of 15 years. While in 1990 it amounted to just 6%, by 2006 it had grown to more than 50%. Italy observed a very similar development. Notably, the internationalisation of the creditor base accelerated markedly around the time of the euro's introduction in 1999. Chart 1 illustrates how this acceleration coincided with the convergence of government bond yields.



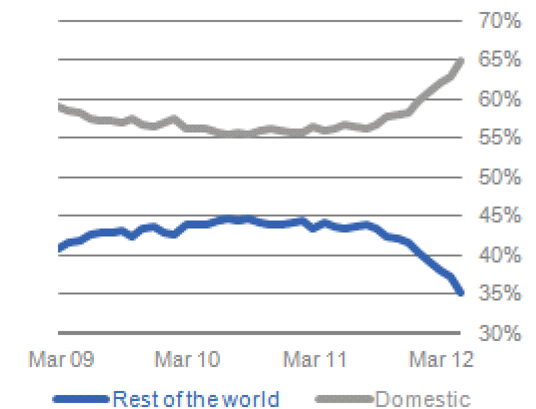
Sources: Eurostat, Bundesbank, Banca d'Italia, Banco de España, DB Research

Germany, too, has seen an international diversification of its investor base over the past 20 years. The share of government debt held by foreign creditors grew from only 20% at the beginning of the 1990s to more than 57% in 2012. However, while Germany stayed on track, the financial and economic crisis that set in in 2007 led to a change of direction for Italy and Spain.

The turnaround

With trust dwindling and yields on Spanish and Italian government bonds rising again, the internationalisation of the creditor structure slowed down markedly. Even though the absolute value of Spanish debt held abroad rose until 2010, a stronger increase in total government debt led to a slide in the share of foreign creditors already from 2006. In Italy, foreign debt relative to total sovereign debt has shrunk since 2010; since last year, it has declined in absolute terms. Recently, this trend has even accelerated: in the first quarter of 2012 alone, the share of foreign creditors plunged by nearly 4 percentage points (see chart 2). Contrary to the development in the peripheral countries, Germany became a sought-after "safe haven". Due to high demand, yields on government bonds declined even further as the share of international creditors rose. In a European comparison, Germany thus became one of the countries with the highest rates of external debt. Nonetheless, there is still a significant gap vis-à-vis countries such as Austria and Finland, whose share of external debt is 74% and 81%, respectively.

Spain is not Italy or: The consequences of the reversal



Sources: Banca d'Italia, DB Research

In itself, a renationalisation of government debt is not necessarily a bad thing. Especially at a time of excessive public debt it can be an advantage if most of this debt is held at home. In principle, this allows the state to always service its debt and thus evade default, simply by imposing a lump-sum tax (such as a wealth tax) on its domestic creditors. At the same time, a high share of domestic debt makes it politically very difficult for a government not to honour its payment obligations. The most prominent example in this context is Japan. At about 230% of GDP, its public debt in 2011 was higher than anywhere else in the world. Still, Japan is able to fund itself at very low interest-rate levels. This may partly be due to the exceptionally high share of domestic creditors (over 90%) which keeps up investor confidence in the country's ability to continue servicing its debt.

Italy, too, was able to withstand high interest rates at the beginning of the 1990s, because a large proportion of its public debt was held domestically. To be able to bear the current high rates, it is essential for the Italian government to sell newly issued debt at home. As the worst case then would "only" be a redistribution of income from domestic savers to taxpayers rather than sovereign default, a renationalisation of debt would strengthen market confidence and bring down interest rates. Italy's advantage in this situation is its households' ownership of significant foreign assets. To fund the domestic rollover of public debt, households could therefore simply sell their foreign stocks and bonds. Hence, the migration of Italian debt back to Italy would, in principle, not require any additional domestic savings – mobilising the already accumulated wealth would suffice. These circumstances may well enable Italy to withstand even a longer period of elevated risk premia.

In fact, however, currently it is largely domestic banks rather than private households that drive the renationalisation of Italian government debt. Contrary to the former case, the latter carries substantial risks, though, as it deepens the already tight inter-linkages between banks and the state even further, without providing long-term stability.

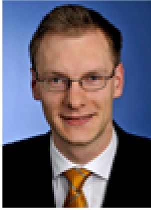
The decisive difference

In Spain, periods of higher interest rates do not have a threatening direct impact on the servicing of government debt either, thanks to the still solid household savings rate. However, unlike Italian households, Spanish households do not own considerable foreign assets that could be sold to refinance public debt at home. This decisive difference could severely hamper the capability of the domestic private sector to step in for foreign buyers of Spanish government bonds.

Whether the share of external debt also has a direct effect on bond yields is unclear as yet. Empirically, there is a significant negative correlation between government bond yields and the share of foreign creditors (see chart 1). On average, a 10% increase in the share of external creditors is associated with a decline in yields of 32 to 43 basis points. However, the direction of the causality is problematic. Statistical tests suggest that low yields, as an indicator for low default risk, attract foreign investors. Likewise, it is highly probable that yields fall because foreign investors are buying government bonds.

On the whole, macroeconomic research provides some encouragement as regards a country's ability to withstand even (limited) periods of high interest rates – under the condition that a large share of government debt is held at home.

See also:
Presentation: Where public debt is held



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