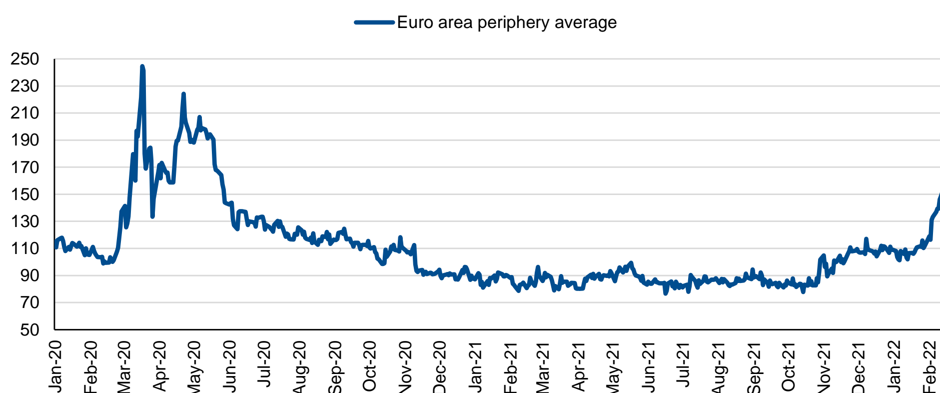
Stronger EU architecture and debt profiles shield euro area periphery from further financial fragmentation

Yields on euro area peripheral countries' government bonds have sharply increased from very low levels in February, reflecting a wider rise in euro area bond yields largely discounting a rate hike before the end of the year. However, the risk of severe financial fragmentation in the euro area remains low. Flexibility as a core element of ECB monetary policy during the Pandemic Emergency Purchase Programme (PEPP) reinvestment phase, strengthened fiscal integration and materially improved debt profiles in the euro area periphery limit the widening of risk premia as well as the impact of rising market yields on debt sustainability.

Risk premia in euro area peripheral countries – Greece (BB+/Stable), Italy (BBB+/Stable), Portugal (BBB+/Stable), Spain (A-/Stable) – as measured by their 10-year government bond yield spreads to German Bunds, have increased sharply from very low levels since end-2021, discounting tighter future monetary policy (**Figure 1**). This increase has further accelerated after ECB February announcements confirmed a halt of net asset purchases under the Pandemic Emergency Purchase Programme by March 2022. The central bank has also shifted its guidance towards the possibility of a rate hike before year end.

Highly indebted euro area governments are comparatively more reliant upon central bank asset purchases to retain favourable funding conditions and are more sensitive to rising financing costs, given frequent need to roll over large volumes of debt as well as a modern history of restricted market access during the euro area sovereign crisis.

Figure 1: Euro area periphery 10-year government bond yield spread, bps
Average among Italy, Spain, Portugal, Greece; spread to Germany



Source: Macrobond, Scope Ratings GmbH

We do not see a scenario of significant further financial fragmentation in the euro area sovereign debt markets as likely presently. Supportive elements that ought to cap ultimate widening of risk premia and associated impact on debt sustainability reflect a stronger EU architecture since the global financial crisis and improved debt structures across the euro area peripheral countries. We expect elements of higher flexibility to remaining in the toolkit of the ECB while Next Generation EU (NGEU) funding asymmetrically favours countries with more fragile economies.

Over the medium-to-long run, other challenges will affect debt sustainability of the euro area periphery, such as adverse demographic trends and moderate-to-weak economic growth potential. In the absence of further meaningful reforms, such structural factors become growing constraints on the reduction of public debt, which, in the context of future rate hikes and normalisation of monetary policy, will increase these countries' vulnerabilities to financial shocks.

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Rising risk premia in euro area periphery

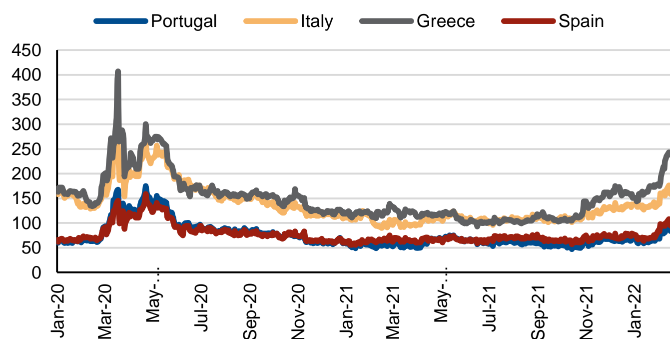
Expectations of monetary policy tightening drive higher yield spreads

Risk premia in euro area peripheral countries – Greece, Italy, Portugal, Spain, as measured by the yield spread on their 10-year government bonds vis-à-vis equivalent German bonds, have increased since end-2021, reflecting expectations of tighter monetary policy (**Figure 2**). The increase has markedly accelerated over a past several weeks, after ECB February decisions confirmed an expected halt of net asset purchases under the PEPP by March. The yield jump is visible especially in the case of Greece, with the risk premium de-linking from that of Italy. This reflects the exclusion of Greek government securities from the Public Sector Purchase Programme (PSPP), which remains active, and moreover with temporarily higher net purchase volumes per month in the second and third quarters to compensate for the exit from the PEPP.

ECB asset purchases have supported favourable market access in peripheral countries

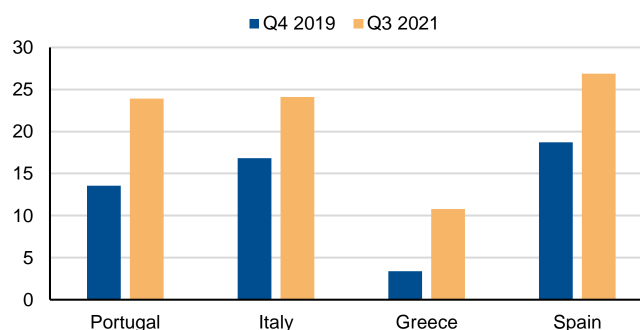
Highly indebted euro area governments are comparatively more reliant upon central bank asset purchases to retain favourable market conditions and are more sensitive to rising funding costs, given in general a need to roll over a larger volume of debt and a legacy of restricted market access during the euro area sovereign crisis. The ECB's accommodative monetary policy stance was instrumental in ensuring these countries observed highly favourable financing terms during the Covid-19 pandemic. The central bank's PEPP and PSPP together resulted in strong demand in the secondary market, low borrowing costs and a significant transfer of government debt to the central bank balance sheet (**Figure 3**). This supported liquidity for peripheral governments and allowed them to respond to the crisis with countercyclical fiscal policies, in protecting businesses and households from a full impact of the shock.

Figure 2: 10-year government bond yield spread to German equivalent security, bps



Source: Macrobond, Scope Ratings GmbH

Figure 3: Central bank holdings of government securities, share of total debt, %



Source: IMF, Scope Ratings GmbH

After recent rate hikes by other major central banks, market participants are now discounting a rate increase by the ECB before the end of this year, further contributing to rising risk premia of the euro area periphery amid a more generalised increase in yields. But there is still plenty of uncertainty about the inflation outlook and the ECB's response. Key elements here to watch will be geopolitical risks in the context of rising energy prices as well as supply-chain bottlenecks though they are starting to clear. More clarity on the ECB medium-term view on the inflation outlook will come in March with the updated forecasts that serve as an input for the central bank's decision-making.

Low risk of severe financial fragmentation in the euro area

Several factors shield euro area periphery from more severe financial fragmentation

Significant financial fragmentation in euro area sovereign debt markets is unlikely recognising multiple factors compared with those present immediately after the global financial crisis. Crucial differences today include a strengthened EU architecture, including the flexibility of the ECB's toolkit during the PEPP reinvestment phase and NGEU funds

asymmetrically favouring those countries with more fragile economies, and significantly improved debt structures across the euro area peripheral countries. In our view, these elements will cap the widening of risk premia and their impact on debt sustainability.

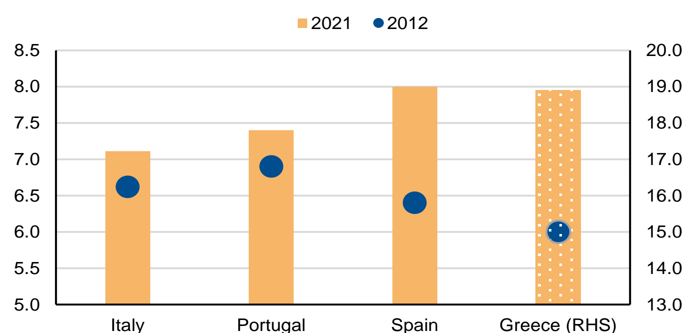
Flexibility of purchasing remains active ECB instrument during PEPP reinvestment phase

The Covid-19 crisis has accelerated financial convergence in the euro area on several aspects, including via monetary policy tools such as the PEPP, with core elements including flexibility in purchased volumes by country and waivers to collateral requirements to allow for the inclusion of Greek securities in the programme. We are entering a phase of monetary policy tightening in view of the higher rates of inflation and robust economic recovery, but the ECB is likely to ensure tightening will be gradual. Flexibility has become a core element of ECB monetary policy since the crisis and an element likely to be retained if required. The PEPP reinvestment phase was extended until at least 2024, alongside ECB announcement of temporary increase in net asset purchases under the PSPP to smoothen an exit from PEPP. In addition, the ECB can re-start the PEPP in cases in which the monetary transmission mechanism was compromised and has communicated its readiness to adjust flexibly reinvestments under cases of renewed market fragmentation. Such factors point to stronger commitment and clearer path towards financial integration in the euro area.

Fiscal integration supports economic convergence

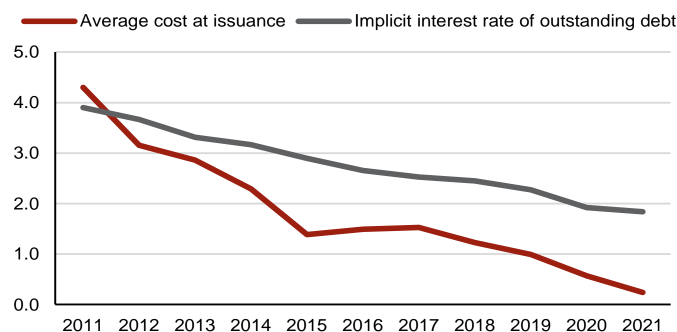
Another crucial step towards financial integration in the EU are the NGEU funds, which asymmetrically favour countries with weaker economies and higher rates of pre-crisis unemployment, underpinning an encouraging near-to-medium-term economic outlook. Economic growth will, however, inevitably slow over time from the rapid rebound since spring 2020. However, successful implementation of public investment funded via joint European bond issuance could support economic convergence in the broader EU, boosting regional economic growth potential.

Figure 4: Average debt maturity (years)



Source: Macrobond, Scope Ratings GmbH

Figure 5: Average euro area periphery financing costs, %



Source: Macrobond, Scope Ratings GmbH

Improved debt profiles, reducing sensitivity to market rate increases

An element of the euro area periphery's enhanced financial resilience is the improved structure of government debt, which mitigates risk associated with the elevated and increased stock of debt after the pandemic. Governments in Greece, Spain, Portugal and Italy have significantly prolonged average debt maturities (**Figure 4**). The rolling in of higher costs affecting the aggregate debt portfolio is therefore spread over a longer period. The average cost of issuance remains moderate under historical standards even after the rise in yields this year – and still, in many cases, around or below the cost of the outstanding debt portfolio.

Together, these supportive elements represent a significant enhancement of the resilience of the euro area periphery from rising risk premia, which should prevent an increase in yields from spiralling into steeply higher financing costs as we saw in the sovereign debt crisis.

Impact on debt sustainability and rating implications

Debt sustainability outlooks are challenged via higher rates, but declining debt ratios anticipated near term

In our debt-sustainability analysis, we work with alternative scenarios including more adverse and optimistic assumptions on the key input variables, including government financing costs. The impact of higher rates on debt sustainability needs to be seen in the context of more favourable debt structures for the euro area peripheral countries. We expect robust nominal growth over the next three to five years. With the return of inflation, real yields remain negative despite the recent rise in risk premia.

Obstacles to euro area solidarity are a principal credit risk

Still, under more adverse scenarios, we acknowledge downside risks from higher inflation as far as future growth, rising financing costs as well as reductions in ECB monetary space to intervene. Future political instability in Greece, Italy, Portugal and Spain is another risk that could undermine the implementation of investment projects and structural reforms related to the NGEU programme, with potential adverse effects on euro area cohesion. Euro area solidarity, in the form of crucial step towards financial integration, is the key element supporting creditworthiness for euro area peripheral countries with elevated debt loads.

Structural challenges impede long-term debt reduction

Over the medium-to-long run, however, other challenges will emerge in terms of the ability of government in Greece, Italy, Portugal and Spain to sustain high levels of public debt, including the country's adverse demographic trends and moderate-to-weak potential growth. Without the implementation of important reforms, these structural factors will impede any substantial reduction in debt, which in the context of future rate hikes and normalisation of monetary policy, will increase these countries' vulnerabilities to financial shocks.

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