Germany's Failed Bond Auction Doesn't Signal the End of the World

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REUTERS

Even though it set off alarms in global financial markets Wednesday, Germany’s failed bond sale doesn’t appear to be nearly as dire of a development as some believe -- and doesn’t necessarily mean the poison infecting Europe’s periphery has spread to the heart of the euro zone’s core.

That’s because bond sales that don’t sell the maximum desired is nothing new of late in Germany, where yields remain at extremely low levels -- under 2% on the 10-year bund -- indicating cash isn’t exactly fleeing Europe’s largest economy.

“What people want us to believe is this a capital strike against Germany. I don’t think so,” said Marc Chandler, global head of currency strategy at Brown Brothers Harriman. “I don’t think any rubicon was crossed.”

To be sure, already-shaken investor confidence can’t be helped at all by the news that Europe’s strongest economy and the fourth-largest in the world was unable to sell its entire basket of 6 billion euros of 10-year debt earlier on Wednesday. It could be a further sign of higher borrowing costs across the rattled euro zone.

'Not the End of the World'

However, that doesn't mean Germany is set to become the epicenter of the scary sovereign debt crisis gripping Europe and rattling much of the world. German equity investors don't seem to be panicking as the DAX was off less than 1.5% in late trading.

"I think it's fair to say the inability for German bond sales to be a success is a minor issue," said Jack Goldstone, a senior fellow at George Mason University.

According to Chandler, six out of the last eight German bond auctions have failed sell the maximum amount desired. Of course, the backdrop to this failure is more ominous given worsening conditions in Europe and the fact the magnitude of the failure – a 35% shortfall – was greater than previous ones.

Yet it's important to remember that the Bundesbank, Germany's central bank, doesn't have the luxury provided by primary dealers, which in the U.S. are required to buy American debt at auctions.

"It's not the end of the world for Germany," said Chandler. "Out of all the problems we have to worry about in Europe, a failed German bond sale is probably not the top issue."

Instead, Chandler points to a number of other issues hurting the global market psyche on Wednesday, including ugly manufacturing data out of China, the possible collapse of the bailout of lending giant Dexia and ugly growth prospects for the euro zone, including Germany.

It's also worth noting that the debt that Germany did sell was gobbled up at extremely low interest rates. The notes sold at 1.98%, just north of the ultra-low yield on the 10-year Treasury note of 1.938%. Those aren't exactly crisis levels, especially compared with scary yields of 5.74% on Spanish debt and 6.7% on Italian bonds.

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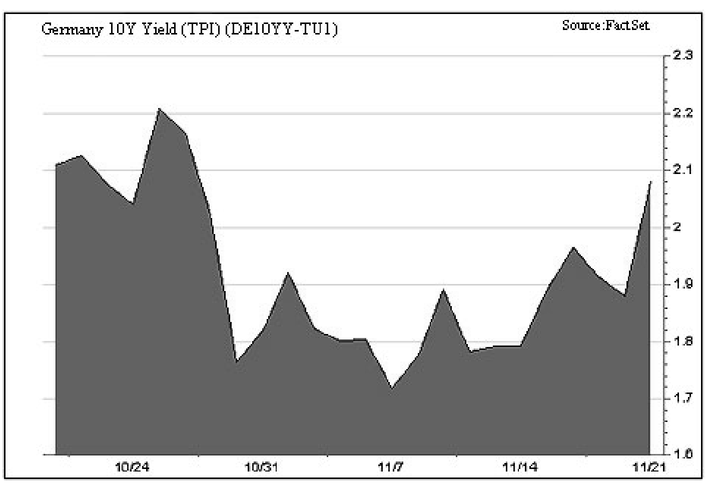
>
> *- Marc Chandler, global head of currency strategy at Brown Brothers Harriman*



Joined at the Hip

Others believe the reaction to the failed German bond sale was appropriate and signals the crisis is spreading to the euro zone's core of Germany, France, Belgium and the Netherlands.

"German bonds are losing their safe haven status and the reason is simple. Germany faces a lose-lose situation. If the Eurozone falls apart, German exports would get hammered. If the EZ (stays) together, it will be Germany bankrolling failed countries," Cam Harvey, a finance professor at Duke University, wrote in an email.

All of this is not to say that the failed bond auction shouldn't serve as a wake-up call for European politicians, who have been accused of dragging their feet to bring this crisis to a credible resolution.

"Once Europe created a united currency, the notion of core and periphery is less meaningful because they are all in the same currency union now," said Goldstone. "If the liabilities in one part of the euro zone create risk and problems, that's going to spill over into other parts of the zone."

The political logjam has raised speculation that one or more of the 17 nations making up the euro zone will choose to leave.

While the stakes have clearly been raised, Goldstone believes the economic consequences of leaving the euro or an all-out collapse of the currency union remain prohibitively high, increasing the chances for an eventual solution.

"There's just too much cost damage to undo the euro and replace it with another currency," said Goldstone.