Spanish Borrowing Costs Rise

By EMESE BARTHA

The Spanish government’s 10-year borrowing costs increased at its debt auction Thursday, reflecting investor concerns about its ability to cut its budget deficit as planned amid rising unemployment and falling economic output.

The rise in 10-year yields, which was expected, also casts doubts on the effectiveness of the European Central Bank’s giant injection of cash into the euro zone’s banking system, which appears to be running out of steam as banks have used up most of the cheap funds made available to them by buying government bonds.

The Spanish government’s 10-year borrowing costs increased at its debt auction reflecting investor concerns about its ability to cut its budget deficit as planned as new data suggests problems remain in the banking sector. David Enrich and Martin Essex discuss. Photo: Reuters

However, the government managed to sell slightly more bonds than it planned, bringing its bond issuance so far this year close to 50% of its annual target and indicating that there is still some demand from Spanish banks.

Spain's debt sales have been under close scrutiny as the market doubts over the ability of the Spanish government to reduce the budget deficit to the desired 5.3% of gross domestic product in 2012 has pushed its 10-year yields above 6%, a level that is seen as unsustainable in the long run.

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The surge in yields to levels unseen since before the European Central Bank’s first three-year refinancing operation has fanned fears that Spain might be the next country finding itself in a need of external help, although several euro-zone politicians have defended the government’s deficit cutting and reform efforts.

The government also warned Monday that it could seize control of finances in regional governments, which account for about one-third of public spending in Spain and make up the bulk of the 2011 budget overrun.

Thursday Spain auctioned €1.5 billion ($1.97 billion) to €2.5 billion of the 3.3% October 2014 and 5.85% January 2022 bonds, an understandably small volume given the advanced funding and the recent surge of yields. It sold slightly more than planned €2.541 billion, as its offer attracted €7.11 billion of bids.

The average yield came in at 5.743% on the 2022 bond, up from 5.403% at the previous auction Jan. 19. Since that auction, Spain has also sold a €4 billion tranche of this bond via a syndicated tap.

The average yield on the 2014 bond came in at 3.463%, compared with 3.495% at the previous auction Oct. 6. However, the maximum yield of 3.52% on the two-year bond was in line with the previous 3.519%.

"A reasonable set of results which will go some way to allaying fears the domestic bid for Spanish bonds has dried up," said Richard McGuire, senior fixed income strategist at Rabobank. "That said, as evidenced by the accepted yield on the 10-year, this support
does come at a price." Analysts said the relatively small size of the offering was key to keeping yields from rising more sharply.

"The modest size of today's auction clearly helped mitigate the growing nervousness surrounding Spain," said Nicholas Spiro, managing director at Spiro Sovereign Strategy said. "Right now, the overriding concern for the Treasury is to ensure that its issuance targets are met and it achieved this today with continued support from domestic banks."

Despite the recent rise in yields, the European Central Bank hasn't reactivated its Securities Market Program, through which it buys government bonds, a decision analysts believe is intended to maintain pressure on the Spanish government to act on its deficit.

"The ECB will wait for concrete action by Spain and a further deterioration in the market before considering a resurrection of the SMP," wrote BNP Paribas economist Ricardo Santos.

Some investors, however, haven't shunned Spanish bonds. Pimco Chief Executive Mohamed El-Erian said in an interview with German weekly Die Zeit Thursday that Pimco is buying and holding Italian and Spanish sovereign debt.

"It is important to make a clear distinction between individual countries; Spain isn't insolvent! Italy isn't insolvent!," El-Erian told the newspaper. "If Spain can convince investors that it is making progress in restructuring its banks, it won't need external help."

But Jeffrey Sica, president and chief investment officer of SICA Wealth Management said investors are becoming increasingly wary of holding euro-zone government bonds.

"The longer this crisis continues and the more potential defaults from distressed EU nations, you will see less participation from investors and a continued surge in borrowing costs," he said.

Thanks to its advanced funding completion, Spain can get by with relatively small auction sizes, according to analysts. Citi analysts calculate an indicative average size for the remaining 16 scheduled auctions is around €2.6 billion. Spain has issued higher amounts than that at all of its bond auctions this year, except for the tender on April 4, when it allocated €2.589 billion.

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