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Shunned Bund sale fuels debt crisis fears

By David Oakley and Tracy Alloway in London, Alex Barker in Brussels and Gerrit Wiesmann in Berlin

The worst-received bond sale by Germany since the launch of the euro fuelled market fears that the continent's debt crisis was now affecting Berlin, the region's biggest economy and key to the survival of the single currency.

The bond auction only managed to raise two-thirds of the amount targeted. Investors and banks shunned the offering due to worries that Europe's monetary union project could collapse because of deteriorating market sentiment and the vast size of the region's public debt.

The euro, which has held up relatively well despite the turmoil in the bond markets, suffered one of its biggest one-day falls against the dollar this year, while eurozone government debt was sold off across the board.

A spokesman for the German debt agency, which oversees the auctions, said: "We are seeing no indication that investors might be losing their appetite for Bunds. ... We shouldn't over-interpret today's result."

Some market participants said the low level of German yields may have put off some buyers. The average yield in the auction was a historically low 1.98 per cent. Investors have bought Bunds heavily in recent weeks as they diversified out of peripheral eurozone debt.

But as fear spread across trading floors, Germany started to trade like a risk asset with Bund yields, which have an inverse relationship with prices, rising roughly in line with French, Italian, Spanish and Belgian yields. However yields on short-term German debt went into negative territory, meaning that investors effectively are paying to hold the bills because they see Berlin as a safe haven.

Ewald Nowotny, a European Central Bank policymaker and head of Austria's central bank, was quoted by the Austria Press Agency as saying the German bond sale was an "alarm signal", while investors, traders and strategists warned it may prove a tipping point.

Don Smith, economist at Icap, the interdealer broker, said: "This is just one auction, but there is a growing feeling among many in the markets that the crisis is heading one way – and that is towards the break-up of the eurozone."

In Brussels, José Manuel Barroso, the European Commission president, warned the euro would be "difficult or impossible" to sustain without tighter economic integration and tougher tax and spending rules in the eurozone.

Arguing that the fate of the single currency was at stake, Mr Barroso presented proposals to curb the fiscal excesses of national governments and introduce a joint "eurobond" to replace national debt issuance – but was met with a frosty reception from Berlin.

His proposals will give the European Commission new powers to assess and object to national budgets before they are published – a step towards fiscal integration that is seen as a prerequisite to joint "stability bonds".

But, at least in public, Angela Merkel, the German chancellor, remained resolutely unimpressed, describing the Commission's decision to propose eurobonds as "extraordinarily inappropriate" and "troubling" in the midst of a crisis.

Adding to the gloom, data released on Wednesday showed that eurozone industry had been hit by the biggest one month fall in orders in almost three years in September, stoking fears that the region has fallen into recession.

The sale of 10-year bonds saw only €3.64bn raised, out of the targeted €6bn, which was the weakest demand for a German auction since the launch of the euro in January 1999, according to data from Danske Bank.

A senior trader at a US bank said: "We are now seeing funds and clients wanting to get out of anything that is denominated in euros and that includes Bunds because they don't know what will happen to monetary union. It is not helped by the year-end with most banks not prepared to buy anything."

Many market participants consider a bond sale that falls short of its targeted amount a failure, although the German debt agency insists otherwise. This is because the Bundesbank retained more than €2bn of the bonds to make up the shortfall. They usually sell these bonds over the following days.

The so-called failure also comes against a trend of poor auctions. It was the ninth auction that failed to meet its target this year, according to the German debt agency. However, demand was significantly weaker this time round.