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# Sovereign bond yield spreads and market sentiment and expectations: Empirical evidence from Euro area countries



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## ABSTRACT

The paper investigates the determinants of sovereign bond yield spreads in the Euro area and extends the models commonly used in empirical analyses by focusing on the impact of market expectations and behavioral factors.

Using monthly panel data for ten European countries over the period 2000–2012, the analysis adopts a pooled mean-group approach to estimate non-stationary dynamic models of spreads determinants, allowing for country heterogeneities in short-run dynamics.

Results show that the behavioral indicators considered, proxies of consumer and market sentiment and expectations, strongly affect spreads behavior, especially during the crisis. Specific attention is also paid to check the robustness of the estimated effects of behavioral indicators and to assess the impact of global financial crisis on the determinants of government bond rate differentials.

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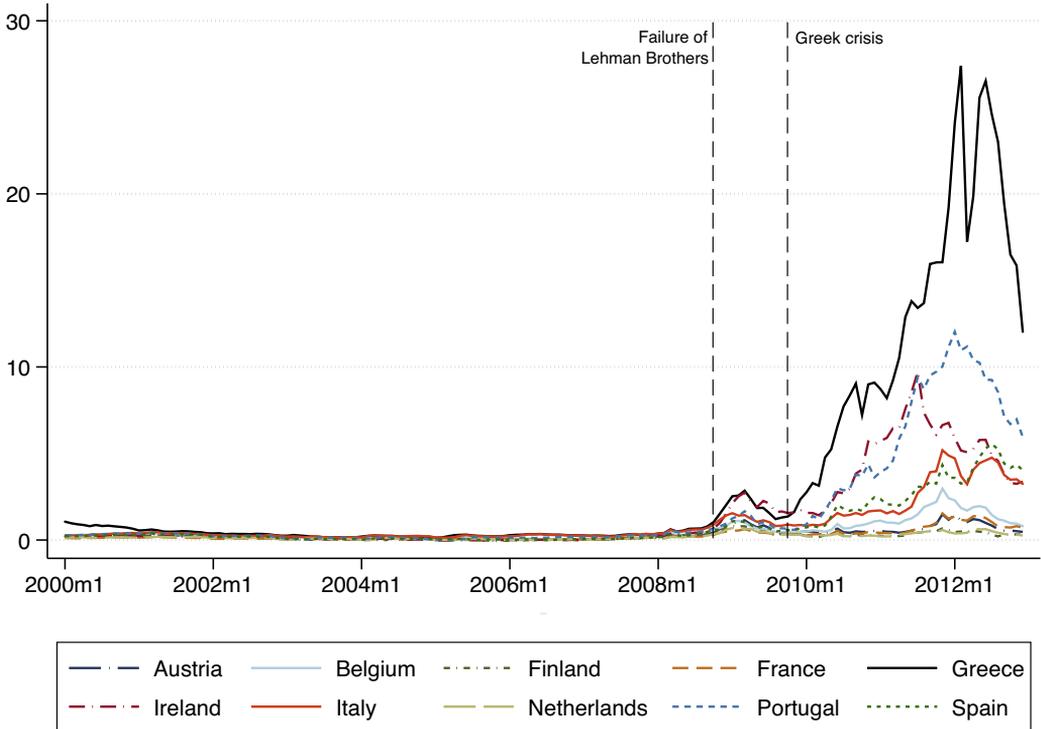
## 1. Introduction

The recent financial crisis has drawn attention in Europe to an indicator of credit risk that only a few years ago had seemed to have almost disappeared: the spread, the difference between the interest

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**Fig. 1.** Ten-year sovereign bond yield spreads of Euro area countries (monthly data; in % points; M1 2000–M12 2012).  
Source: Datastream.

rate offered by securities and a benchmark. In the course of this paper, the term spread will be used in reference to the market for bonds issued by sovereign states in the Economic and Monetary Union (EMU). In this case, therefore, the term spread is used to indicate the difference between the yields on long-term (10 years) securities issued by individual countries that are part of the EMU, as compared to those on securities of equal residual maturity issued by the German government (the Bund), which represent the benchmark and are seen as a safe haven, as they have a low credit risk and high liquidity.

Before the introduction of the Euro, the interest rate differential compared to Germany (on medium and long term securities), touched levels of just under 10 percentage points. The main reasons for the high interest rates offered by government bonds of some states were exchange rate risks and the fear of systematic devaluations, which investors had to face. The spreads saw a gradual reduction in the 1990s, before reaching historically low levels around 1999, the year of the introduction of the single currency, despite many countries registered a deterioration in terms of levels of deficits and national debt.

Although there is an overwhelming consensus that these reductions primarily reflected the elimination of currency risk, there still remains the enigma of why these differences continued to fall after that date, as it is shown in Fig. 1. This has led to the hypothesis that the process of financial integration had finally eliminated the element of credit risk for Euro-zone countries, regardless of their individual national fiscal policies. Yet after the collapse of Lehman Brothers, and the intensification of the financial crisis, spreads began to widen considerably. While the timescales and impacts involved may vary, the interest rate differential against German bonds has affected all members of the EMU, beginning with those characterized by fundamental economic and fiscal weakness. Since then, the containment of the spread of individual national bonds against the German Bund has represented the biggest challenge facing the EMU, as the interest rate differential also has repercussions in countries with strong fundamentals.

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