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PRESS RELEASE

Decomposition of the dynamics of sovereign yield spreads in the euro area
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At the height of the sovereign debt crisis, yields on euro area long-term sovereign bonds in some Member States reached levels not seen since the start of Economic and Monetary Union. Similarly, sovereign yield spreads in relation to the German Bund, a key measure of sovereign risk, widened dramatically during the crisis. However, those yields have now subsided to historically low levels, while the spreads have become much smaller, even though these are still significant, particularly for peripheral euro area countries.

In this article, we analyse how these wide fluctuations and the sovereign debt crisis have affected various sectors of the economy, and then proceed to focus on analysing the risk premiums (hence yield spreads) seen on the sovereign debt markets during that crisis. Apart from the general government sectors in the respective countries, other sectors were also hit by the debt crisis. In this respect, banks saw their own funding conditions become tighter. Moreover, in the euro area, households and non-financial corporations faced a tightening of credit conditions, manifested, for instance, in a widening of the margins on new bank loans.

To understand how tensions on the sovereign debt markets are transmitted to the real economy (households and non-financial corporations), we use a macrofinancial model to break down the dynamics of sovereign yield spreads, which reflect various risk premiums. We analyse the contributions of various types of factors, particularly fundamental economic factors (such as GDP growth or the ratio of public debt to GDP) and non-fundamental factors (such as the redenomination risk – i.e. the risk that a Member State may leave the euro area). Among other things, our estimates show that sovereign yield spreads were to a large extent determined by fundamental factors, although non-fundamental risks also had a significant impact. In particular, the redenomination risk seems to have made a clear contribution towards sovereign yield spreads in the case of peripheral euro area countries during the sovereign debt crisis.

Given the importance of the sovereign debt market for the transmission of monetary policy, this article also highlights the role played by the ECB in the sovereign yield spread developments. On this subject, we show the effectiveness of the ECB’s OMT programme (announced in September 2012), designed to tackle the redenomination risk. As a result, in mid-2014, the non-fundamental components of the spreads seemed to have greatly diminished in Belgium, Spain and Italy. In June 2014, the ECB also launched a programme of targeted longer-term refinancing operations (TLTROs), and in January 2015 it expanded its asset purchase programme (APP) in order to encourage banks to lend more to households and non-financial corporations and to restore inflation to levels below, but close to, 2 %.

Since the announcement and implementation of these non-standard measures of monetary policy, sovereign yield spreads and their non-fundamental component have continued to shrink in the three countries mentioned above. In April 2015, the contribution of the non-fundamental components appeared to be minimal in the three countries. However, that of the fundamental economic components still seems to be significant in Spain and Italy. Consequently, sovereign yield spreads could narrow further if there were a structural improvement in the economic fundamentals, with favourable potential spin-off effects on borrowing costs for households and non-financial corporations.

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