Box 3

Recent developments in spreads between euro area government bond yields

In the run-up to Stage Three of Economic and Monetary Union, which started on 1 January 1999, there was a significant convergence in the long-term government bond yields of those countries which subsequently adopted the euro. This convergence was driven by the anticipation of the introduction of the euro and the corresponding elimination of intra-euro area exchange rate risk. Since then, government bond yield spreads between euro area countries have remained, although they have been significantly smaller than those observed before 1999. This suggests that investors differentiate between government bonds across euro area countries in terms of liquidity and to some extent in terms of credit risk.

Spreads in long-term government bond yields between euro area countries and Germany [1)]

(basis points)

	Jan. 1999	Oct. 2003	Change from Jan. 1999 to Oct. 2003
Belgium	22	6	-16
Spain	19	1	-18
France	8	2	-6
Ireland	21	0	-21
Italy	23	13	-10
Netherlands	11	2	-9
Austria	18	5	-13
Portugal	22	10	-12
Finland	21	-1	-22
Average	18	4	-14

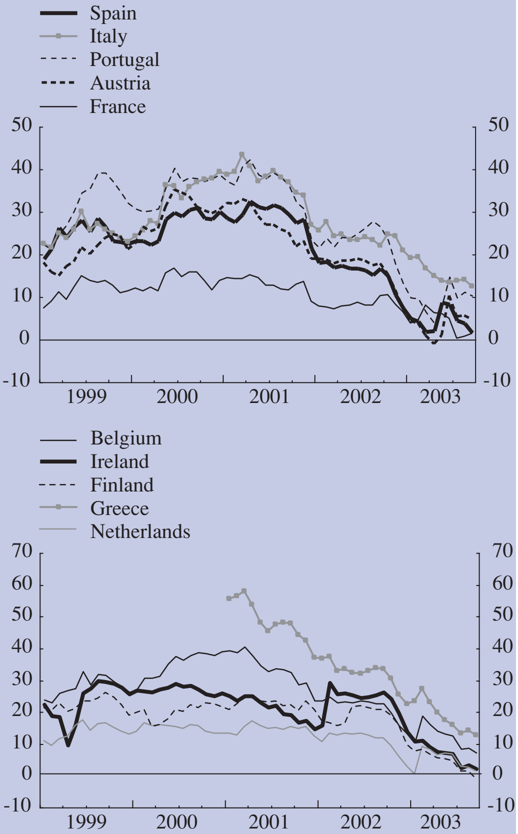
Sources: Reuters and ECB calculations.

1) Long-term government bond yields refer to ten-year bonds or the closest available maturity.

In 1999, German long-term bond yields were the lowest in the euro area, partly due to the relatively high liquidity of German government bonds. With the exception of France, the financing advantage of the German government compared with other euro area governments in terms of basis points was in the double-digit range. This picture, however, has changed somewhat in recent years. The table above shows that the spreads between ten-year government bond yields of euro area countries against comparable German bond yields narrowed markedly between January 1999 and October 2003. In that period, the average spread fell from 18 to 4 basis points. The countries that in October 2003 showed the largest yield spreads against Germany were Greece, Italy and Portugal. The largest declines in yield spreads since 1999 were observed for Finland, Ireland, Spain and Belgium (see Chart A). There was also a significant decline in Greek government bond spreads after Greece adopted the euro on 1 January 2001.

Chart A: Long-term government bond yield spread against Germany [1)]

(basis points; monthly data)



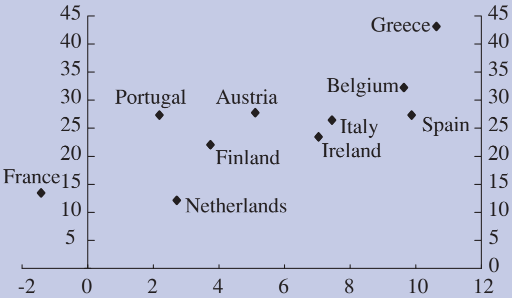
Sources: Reuters and ECB calculations.

1) Long-term government bond yield refers to ten-year bonds or the closest available maturity.

The convergence in yield spreads since 1999 has not occurred in a continuous manner. Looking in more detail at Chart A, the pattern most noticeable for all countries is that from early 2001 onwards spreads started to decline. Among other factors, fiscal developments in the euro area might have contributed to the observed yield convergence since 2001. For example, in Germany the debt-to-GDP ratio worsened relative to that of other euro area countries, except France, between 2001 and 2003.

Chart B: Changes in relative debt-to-GDP ratios against Germany [1] and changes in yield spreads [2] between 2001 and 2003

(x-axis: percentage points; y-axis: basis points)



Sources: Reuters and ECB calculations.

1) *X-axis: change in the difference between the debt-to-GDP ratio of Germany and the debt-to-GPD ratio of other euro area countries between 2001 and 2003 (figures for 2003 refer to the October 2003 Commission forecasts).*

2) *Y-axis: decrease in the yield spreads against German ten-year government bonds between January 2001 and October 2003.*

Chart B provides some evidence for the relationship between fiscal positions and yield spreads since 2001. It compares the relative change in debt-to-GDP ratios of euro area countries versus the German position over this period with the corresponding change in the government bond yield differential. Chart B indicates that countries which have experienced an improvement in their debt-to-GDP ratio relative to Germany also experienced declines in yield spreads against German government bonds.

Although some technical factors (e.g. related to the liquidity of certain bonds) may have also played a role in the observed decline of some of the spreads, Chart B suggests that market participants seem to take into account the relative fiscal positions of euro area governments when pricing bonds issued by these entities. Bond market investors thus seem to reward – although only moderately – those euro area countries that have followed more prudent fiscal policies, by offering improved financing conditions.