Box 3

RECENT DEVELOPMENTS IN GOVERNMENT BOND YIELD SPREADS IN EURO AREA COUNTRIES

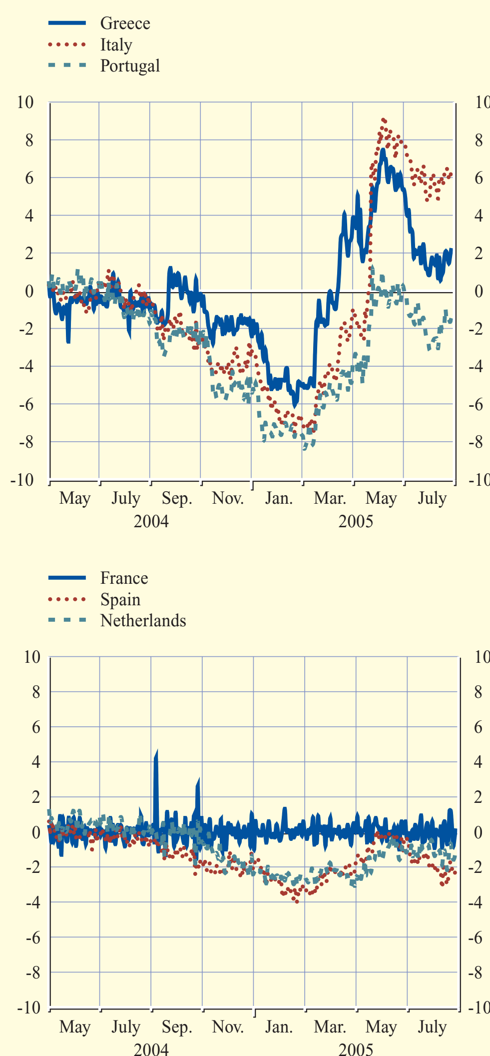
Since the introduction of the euro in January 1999 and the resulting elimination of exchange rate risk, the yield spreads between long-term government bonds of euro area countries have remained relatively narrow. However, some yield differentials still exist, indicating that investors do not generally consider government bonds of individual euro area countries to be perfect substitutes. In particular, investors differentiate between bonds in terms of liquidity and, to some extent, in terms

of credit risk. With regard to the latter, for example, if investors become concerned about the fiscal position of a country, then the long-term interest rates paid on bonds issued by that country should increase relative to those of other countries, reflecting a higher premium demanded by investors to compensate for the increased risk of default on the part of the issuer. Hence, this credit risk premium should normally represent the opinion of market participants regarding the sustainability of fiscal positions. In 2004 and in 2005 to date, a few euro area countries experienced a change in the rating of their government bonds, reflecting developments in their fiscal positions. This box investigates whether these rating changes, and recent political events which have potential fiscal policy implications in the eyes of market participants, have led to corresponding changes in the spreads between long-term government bonds of the countries concerned vis-à-vis a benchmark bond.

German ten-year government bond yields have thus far generally been the lowest among euro area countries, primarily on account of their higher liquidity and their corresponding benchmark status, but also due to limited concerns about the sustainability of public finances within the issuance horizon. In Chart A, the cumulative changes in yield spreads against German bonds, corrected for the changes in the underlying instrument of the benchmarks, are shown for a few countries from May 2004 to August 2005. Several observations can be made. The spread between French and German bonds has remained very stable throughout that period. The spreads for Greece, Italy, the Netherlands, Portugal and Spain, by contrast, all first declined until around mid-March 2005 and rebounded thereafter, all in all. The countries that showed the largest increases in yield spreads against Germany between March and August 2005 were Greece, Italy and Portugal. These countries have been the latest to report growing budgetary imbalances and to become subject to the excessive deficit procedure. Spreads for Greece, Italy and Portugal were highest immediately following the referenda on the European Constitution in France and the Netherlands and have since then again come down somewhat. The spreads for French and Dutch bonds did not show any significant reaction to the outcomes of their respective referenda on the European Constitution.

Chart A Cumulative changes in selected government bond spreads against Germany since May 2004

(in basis points; daily data)



Source: Reuters and ECB calculation.
Note: These are accumulated changes in spreads excluding the days on which changes in the underlying benchmark bond occurred, since benchmark changes usually lead to jumps in the measured spreads.

Sovereign credit ratings for the euro area countries

	Standard and Poor's		Moody's	
	May 2004	Aug. 2005	May 2004	Aug. 2005
Belgium	AA+	AA+	Aa1	Aa1
Germany	AAA	AAA	Aaa	Aaa
Greece	A+	A (Nov. 2004)	A1	A1
Spain	AA+	AAA (Dec. 2004)	Aaa	Aaa
France	AAA	AAA	Aaa	Aaa
Ireland	AAA	AAA	Aaa	Aaa
Italy	AA	AA- (July 2004)	Aa2	Aa2
Netherlands	AAA	AAA	Aaa	Aaa
Austria	AAA	AAA	Aaa	Aaa
Portugal	AA	AA- (June 2005)	Aa2	Aa2
Finland	AAA	AAA	Aaa	Aaa

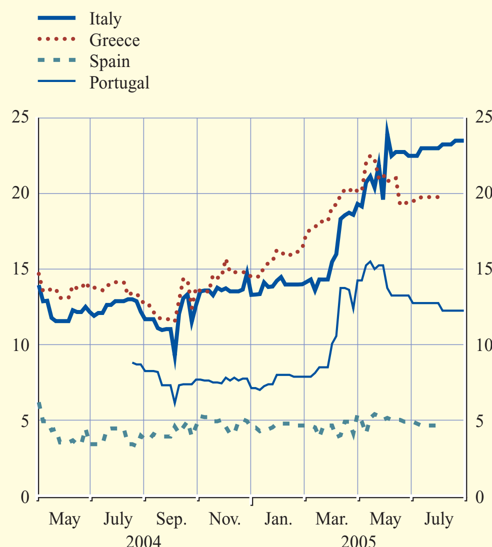
Source: Bloomberg.
Note: The ratings refer to the long-term debt in local currency. Dates in parenthesis denote the last change in the ratings.

Since May 2004 the sovereign ratings have also changed, reflecting financial investors' concerns about the deteriorating budgetary positions of some countries. The table shows the sovereign ratings by two rating agencies: Standard and Poor's and Moody's. According to the former, eight of the twelve euro area Member States are rated AAA, while Belgium is rated AA+, Italy and Portugal are rated AA- and only Greece is rated A. Between May 2004 and August 2005, the ratings of Greece, Italy and Portugal were lowered, while the sovereign rating for Spain by Standard and Poor's was revised upwards. The downgrading of the long-term credit ratings for Greece and Italy as well as the upgrading of Spanish bonds seem to coincide with the overall increase and decline, respectively, in the respective yield spreads over that period, although a significant immediate reaction in the bond market to the announced rating changes was not discernible.

Developments in sovereign credit default swap (CDS) spreads provide further evidence of the recent widening of the government bond yield spread (see Chart B).[1] By construction, sovereign CDS spreads can also be considered as measures of the credit risk associated with holding corresponding government bonds. For the specific purpose at hand, sovereign CDS spreads have the advantage of not being distorted by changes in the benchmark bonds of the countries concerned. Consistent with the above analysis on yield spreads, CDS spreads for the three above-mentioned countries also started to increase in spring 2005.

Chart B Ten-year sovereign credit default swap spreads

(in basis points)



Source: Bloomberg.

1 In CDS contracts, the protection seller promises to buy the reference bond at its par value when a pre-defined credit event occurs. In return, the protection buyer makes periodic payments to the seller until the CDS matures or until a credit event is triggered. The periodic payments are determined as a certain percentage of the principal of the underlying contract. This rate of payment, measured in annualised terms and in basis points, is called a CDS spread. In theory, the CDS spread should approximately equal the corresponding yield spread between the bond of a reference entity and a risk-free bond.