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Measuring Systematic Risk in EMU Government Yield Spreads *

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Abstract

This paper focuses on the joint dynamics of yield spreads derived from government bonds issued by member states of the European Monetary Union (EMU). A descriptive analysis shows that there are substantial and volatile spreads between zero coupon yields of EMU member countries and German Bund yields. These yield spreads form an important source of additional risk that has to be taken into account by any pricing or risk management model dealing with EMU government bonds. We extract risk factors driving observed yield spreads by employing a multi-issuer version of the model originally proposed by Duffie and Singleton (1999). We adopt a state-space approach to implement the model whereby we can extract factor series and model parameters simultaneously. Our findings indicate that a parsimonious two-factor version of the multi-issuer model sufficiently captures the main features of the data. In this model the first factor turns out to be related to long term yield spreads across different issuers, whereas the second factor is related to short term yield spreads. Our evidence suggests that EMU government bond spreads are related to corporate bond spreads and swap spreads whereas we do not find evidence for a significant impact of macroeconomic or liquidity related variables. JEL classification codes: C51, E43, G13, G15.

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