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Yield spreads on EMU government bonds — How the financial crisis has helped investors to rediscover risk

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Abstract

This study analyses the determinants of EMU member states' government bond yield spreads from January 2000 until September 2010. Using a dynamic panel regression approach, the authors show that before the outbreak of the financial crisis investors generally ignored fundamental sovereign bond risk factors. However, with the beginning of the financial crisis yield spreads for many member countries escalated. The results indicate not only that investors began to re-evaluate countries' credit risks (measured by projections of debt-to-GDP ratios), but also that risk aversion in the markets, which increased significantly during the crisis, became a major determinant of sovereign bond spreads.

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