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Citation for final published version:

Afonso, António, Arghyrou, Michael Georgiou, Bagdatoglou, George and Kontonikas, Alexandros 2015. On the time-varying relationship between EMU sovereign spreads and their determinants. *Economic Modelling* 44, pp. 363-371. 10.1016/j.econmod.2014.07.025

Publishers page: <http://dx.doi.org/10.1016/j.econmod.2014.07.025>

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On the time-varying relationship between EMU sovereign spreads and their determinants*

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Abstract

We use a dynamic multipath general-to-specific algorithm to capture structural instability in the link between euro area sovereign bond yield spreads against Germany and their underlying determinants over the period January 1999 – August 2011. We offer new evidence suggesting a significant heterogeneity across countries, both in terms of the risk factors determining spreads over time as well as in terms of the magnitude of their impact on spreads. Our findings suggest that the relationship between euro area sovereign risk and the underlying fundamentals is strongly time-varying, turning from inactive to active since the onset of the global financial crisis and further intensifying during the sovereign debt crisis. As a general rule, the set of financial and macro spreads' determinants in the euro area is rather unstable but generally becomes richer and stronger in significance as the crisis evolves.

JEL: C22, C52, E43, E62, G12.

Keywords: euro area, crisis, spreads, time-series analysis, time-varying relationship.

* We are grateful to participants in presentations at the Central Bank of Greece, the INFINITI Conference 2013 on International Finance and the UECE Conference 2013 on Economic and Financial Adjustment in Europe. The opinions expressed herein are those of the authors and do not necessarily reflect those of the ECB or the Eurosystem.

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1. Introduction

The European sovereign debt crisis started in Greece in the autumn of 2009 and has since spread across the whole of the Economic and Monetary Union (EMU). Over the last five years policy makers have taken significant measures both at national as well as at the European level to contain the crisis. These include ambitious national adjustment programmes; the creation of the European Financial Stability Fund (EFSF) and of the European Stability Mechanism (ESM) providing financial assistance to countries whose sovereign bonds have come under intense market pressure; and extensive intervention on behalf of the European Central Bank (ECB) in the European sovereign bond markets. These measures, however, have so far achieved only partial success.

Motivated by these developments, a growing empirical literature has attempted to identify the factors affecting EMU government bonds yield spreads against Germany, the variable often used to measure the crisis' severity and extent. The main existing findings can be summarised as follows: First, increased international financial risk has played a major part in the widening of spreads versus Germany, with banking risk being a major channel transforming the global financial crisis of 2007-2009 into a sovereign debt crisis in subsequent years (see e.g. Caceres et al, 2010; Gerlach et al, 2010; Schuknecht et al., 2010; Acharya et al., 2011). Second, market pricing behaviour has shifted considerably, with fiscal and other macro-imbalances now being more heavily penalised as compared to before the crisis (see e.g. Barrios et al., 2009; Schuknecht et al., 2010; Favero and Missale, 2011; Arghyrou and Kontonikas, 2012; De Grauwe and Ji, 2012). Third, liquidity risk has played a role, mainly in the periphery economies during the later stages of the crisis (see e.g. De Santis, 2012; Afonso et al., 2014). Finally, there exist significant cross-country contagion/spill-over effects across euro area government bond markets (see e.g. Caceres et al, 2010) as well as a significant response of spreads to changes in credit ratings (see e.g. De Santis, 2012).

The majority of the early studies on the European debt crisis capture the structural instability in the relationship between spreads and their determinants by imposing on the data exogenous break points and estimating sub-sample regressions differentiating between a pre-crisis and a crisis period (see e.g. Barrios et al., 2009; Arghyrou and Kontonikas, 2012; Caggiano and Greco, 2012). More recent studies have provided evidence that structural instability is not restricted to a simple pre-versus post-crisis differentiation but is a more complex process. Afonso et al. (2014), still working with exogenously imposed breaks, identify two breaks in the process of spreads' determination, respectively occurring in summer 2007 and spring 2009. On the other hand, Bernoth and Erdogan (2012) use a semiparametric time-varying coefficients panel data model to examine whether euro area spreads movements are linked to a shift in macroeconomic fundamentals or to increased risk pricing reflected in a stronger market reaction to shifts in the value of the various risk factors. They provide evidence of time-varying slope coefficients and show that since the onset of the global

financial crisis the market reaction to fiscal imbalances increased considerably. Similar findings are reached by Aßmann and Boysen-Hogrefe (2012) who use a time-varying coefficients model to capture changes in the weights of spreads' determinants in the euro area over the period 2001-2011.

By highlighting the continuous nature of structural instability characterising the process of spreads' determination Bernoth and Ergodan (2012) and Aßmann and Boysen-Hogrefe (2012) have contributed to the study of the European debt crisis. Their studies, however, are subject to an important limitation. Their adopted panel-based econometric framework cannot uncover country-specific heterogeneity in the time-varying relationship between spreads and their determinants. Beyond the innovative feature of endogenous slope time-variation these studies are in line with previous panel-based studies that assume slope homogeneity across countries and common break points in time for all the countries in the panel.¹ However, it is probable that the links between sovereign risk and the various risk factors are activated/deactivated at different points in time across different countries; and/or the importance of each risk factor may differ across countries. These can be the result of many factors including, but not restricted to, differential changes in market expectations regarding a country's commitment to EMU as discussed by Arghyrou and Tsoukalas (2011), differences in the timing of the revelation of the fallout of a national banking crisis on a country's fiscal outlook, differences in the introduction of uncertainty regarding the objectives of economic policy among different EMU countries or other factors relating to political risk. Thus, an econometric approach that allows for this plausible scenario is likely to provide important country-specific information.

In this paper we deal with country-specific heterogeneity in an explicit manner based on time-series regressions for ten euro area countries. In line with existing literature (see e.g. Manganelli and Wolswijk, 2009) we model spreads on proxies of international financial risk, credit risk and liquidity risk. We implement, however, a novelty to the study of government bond spreads, using a dynamic version of the general-to-specific (GETS) model selection methodology (see Hendry, 2000), allowing us to capture changes in the statistical significance and size of the coefficients of spreads' determinants over time. To the best of our knowledge, with the exception of the study by D'Agostino and Ehrmann (2012), our paper is the first to capture the changing relationship between spreads and their fundamentals on a country-specific basis. D'Agostino and Ehrmann (2012), however, model government bond yield spreads against the US and Germany for G7 countries. Therefore, although they provide important insights relating to the French and Italian spread versus Germany, they do not study developments in EMU periphery countries such as Greece, Portugal and Spain, whose role in the European debt crisis has crucial. By contrast, we put EMU

¹ In panel estimations of the determinants of euro area spreads, country-specific heterogeneity is typically allowed for only in the intercept via country fixed effects (see e.g. Attinasi et al., 2009; Manganelli and Wolswijk, 2009).

developments at the heart of the analysis. Our findings provide new evidence suggesting significant heterogeneity across countries, both in terms of the factors determining spreads over time as well as the size of their impact on national spreads. As a general rule, the set of financial and macro spreads' determinants in the euro area is rather unstable but becomes richer and stronger in significance as the crisis evolves.

2. Data description

We model the monthly 10-year government bond yield spread relative to Germany (*spr*) for ten euro area countries: Austria, Belgium, Finland, France, Greece, Ireland, Italy, Netherlands, Portugal and Spain. Our sample covers the period January 1999 - August 2011 (monthly frequency). Figure 1 presents the movements of our dependent variable for each of our sample countries. Before the financial crisis erupted in late 2007 spreads against Germany had stabilised at very low levels despite the fact that macroeconomic fundamentals were deteriorating in many euro area countries, especially in the periphery (see Arghyrou and Kontonikas, 2012). Since the onset of the global credit crunch in summer 2007 increased throughout the euro zone, with this increase being particularly pronounced in Greece and the rest of the periphery countries.

Following the bulk of existing literature (see e.g. Manganeli and Wolswijk, 2009), we model spreads on their own first lagged value² and proxies the international risk factor, liquidity risk and idiosyncratic credit risk. More specifically, the set of explanatory variables used in our analysis includes the following:

vix denotes the logarithm of the S&P 500 implied stock market volatility index (VIX). In line with previous studies (see e.g. Beber et al., 2009; Afonso et al., 2014) this variable is used to measure the international risk factor. We expect a higher value for the international risk factor to cause an increase in government bond spreads.

ba is the bid-ask spread of 10-year government bonds. This variable is extensively used as a proxy for bond market illiquidity (see e.g. Barrios et al., 2009; Favero et al. 2010). A higher value of *ba* indicates a fall in liquidity leading to an increase in government bond yield spreads.

² Using one lag is a standard practice in the literature on spreads, as it is regarded enough to account for dynamics and remove any autocorrelation from the residuals of the equation modelling them (see e.g. Condogno et al 2003, Attinasi et al 2009, Gerlach et al, 2012). There are also good intuitive reasons to expect that any spread lags should be set to be of order 1: in efficient financial markets price changes occur upon arrival of new information – this is particularly relevant in the context of sovereign bond markets in which, unlike corporate equity and private bond markets, the scope for inside information, and the price discovery trading the latter implies, is limited: in the case of sovereign bonds the bulk of the relevant information refers to macro and financial indicators, data which is typically publicly available. It is therefore very difficult to justify lagged terms extending beyond the first lag, particularly when dealing with monthly data which in the finance literature is classified as low frequency. As we argue below, in the context of our analysis the first lag of spreads is very likely not to capture any unjustified inertia in bond price movements but the effect of unobservable risk factors, additional to the right-hand side variables, priced by markets.

bal and *debt* respectively describe the expected (one-year ahead) government budget balance-to-GDP ratio and government debt-to-GDP ratio, respectively, both measured as differentials versus Germany.³ The use of expected, as opposed to historical fiscal data, is in line with a number of recent studies on EMU government bond yield spreads including Attinasi et al. (2009) and Sgherri and Zoli (2009) and is justified on the grounds that the literature on sovereign bond markets consider investors to be forward- rather than backward-looking. Fiscal conditions are related to credit quality with an expected fiscal deterioration implying higher credit risk. Hence, a higher (lower) value for the expected government budget balance is expected to reduce (reduce) spreads. By contrast, a higher (lower) lever of expected government debt is positively (negatively) associated with spreads values.

gind is the annual growth rate of industrial production, measured as differential versus Germany. This variable is used as a proxy for the state of business cycle and captures the effect of economic growth on spreads according to which sovereign debt becomes riskier during periods of economic slowdown (see Alesina et al., 1992 and Bernoth et al., 2004). Hence an increase (reduction) in *gind* should reduce (increase) spreads by improving (worsening) credit worthiness.

Finally, *q* is the log of the real effective exchange rate. An increase (reduction) in *q* denotes real exchange rate appreciation (depreciation) expected to increase (reduce) spreads as theoretically justified in the analysis of Arghyrou and Tsoukalas (2011) and empirically documented by Arghyrou and Kontonikas (2012).⁴

³ The expected fiscal position data is published bi-annually in the European Commission's Economic Forecasts. This semi-annual dataset is transformed into monthly frequency by keeping the expected debt and budget balance observations constant (equal to the last forecast) for the months between a projection announcement and its subsequent revisions, when new information becomes available. This is consistent with the idea that before a new projection arrives, investors can only use the latest available projection to form their expectations. We would ideally like to have used fiscal projections revised on a monthly basis, however to the best of our knowledge there exists no publicly available expected debt/budget balance to GDP ratio series on a monthly or quarterly basis. Therefore, using the data published by the European Commission on a bi-annual series appears to be our only feasible option. The same series have been used by previous research in the same area. For example, Attinasi et al. (2009) attribute to the European Commission's fiscal forecasts a prominent role as they argue that investors use them as a source of information to form their fiscal expectations, in which case they are a valid empirical measure of sovereign credit risk.

⁴ Our specification does not capture contagion/spill-over effects among national spreads. We did try to capture such effects by testing for the statistical significance of an empirical measure of spill-over effects used in previous studies, namely the second principal component in the movements of the ten EMU countries (see Arghyrou and Kontonikas 2012, Afonso et. al, 2014). However, this variable did not show up as statistically significant in our rolling estimations. This finding may be reconciled with the statistical significance of the same variable in the papers cited above on the grounds of a smaller number of degrees of freedom involved in our rolling estimations (60 observations in each estimation round). Small-sized rolling windows have the advantage of picking up in a superior way any significant changes in the factor loadings of the statistically significant variables, however due to the increased estimated standard errors implied by their small sample size they may fail to pick up the effect of right-hand side variables of marginal statistical significance. As we explain below, the effect of such variables is picked up by the first autoregressive component of the dependent variable which, according to Stock and Watson (2007) operates as a proxy for the combined effect of unobserved/omitted determinants of the modelled series.

3. Empirical framework

We capture time variation in the link between spreads and their determinants through a dynamic GETS modelling procedure developed by D. Hendry and his co-authors (see e.g. Hendry, 2000). The GETS methodology is a multipath model selection algorithm similar in spirit to *Autometrics* (see Doornik, 2009), a model selection algorithm embedded in PcGive/OxMetrics (see Hendy and Doornik, 2007).⁵ The starting point of the searching process is the definition of a general unrestricted model (GUM). This should be formulated on the basis of theory, encompass competing models and provide sufficient information on the process that is being modelled (see Hendry and Krolzig, 2005; Doornik, 2009). The search algorithm proceeds by reducing the GUM towards one or more terminal models, considering in principle the whole model space. Terminal models are located when all variables in a particular search node are statistically significant.

[Figure 2]

In order to demonstrate how the multipath model selection works, consider for example that the GUM includes four explanatory variables (A, B, C and D) as shown in Figure 2. If all four variables are statistically significant at the 1% level the GUM coincides with the terminal model and the search stops. If, on the other hand, the GUM includes statistically insignificant variables, these are deleted one at the time based on their individual significance. If, for example, only variable A is insignificant, the GUM is reduced to BCD, which itself becomes the basis for another search. If all variables in the GUM are statistically insignificant, the algorithm removes each of them, one at the time, considering four three-variable models: BCD, ACD, ABD and ABC.

The reduction process is repeated at each of these four nodes. For instance, if all three variables are insignificant at node BCD, the algorithm will consider three two-variable models: CD, BD and BC. If statistically insignificant variables are included in these two-variable models the search will continue. For instance, if both variables are insignificant at node CD the algorithm will proceed to two one-variable models: C and D. If at each node all variables are insignificant there would be 16 ($=2^4$) potential unique models represented by the solid dots in Figure 2.⁶ Note that it is possible that the search algorithm will yield more than one terminal models. If an explanatory variable appears in more than one terminal model its impact on the dependent variable is calculated by averaging the slope coefficients of that variable across all terminal models.

In our setup, the GUM is given by the following equation:

$$spr_t = \alpha + \phi spr_{t-1} + \mathbf{X}_t \boldsymbol{\beta} + \varepsilon_t \quad (1)$$

⁵ Autometrics is the second generation model selection algorithm in OxMetrics following PcGets (Hendry and Krolzig, 2001).

⁶ There are 15 unique models with at least one variable and one empty model omitted from Figure 2. Hollow dots represent duplicated models and can be ignored.

where $\mathbf{X}_t = [vix_t, ba_t, bal_t, debt_t, gind_t, q_t]$ denotes the matrix of bond market related fundamentals, as defined in Section 3, and $\boldsymbol{\beta}$ is the coefficient vector.⁷

The algorithm is applied dynamically using a 60-month rolling window always starting from the GUM shown in Equation (1). In the absence of structural instability in the relationship between spreads and fundamentals, the algorithm should reach the same terminal model(s) across all different sub-samples. In that case, the set of explanatory variables that the algorithm will identify as statistically significant and the size of their coefficients would not change over time. On the other hand, in the presence of shifts risk factors may be activated or deactivated at different points in time across different countries. This would give rise to different terminal models across different rolling estimation windows characterised by different statistically significant explanatory variables and/or different magnitudes for the estimated coefficients.

There are three additional key ingredients in our GETS methodology. First, as suggested by Hendry and Krolzig (2005), we impose theory-consistent sign restrictions on the model space: if a variable is statistically significant but exhibits the ‘wrong’ sign, then it is deleted. Effectively, the sign restrictions impose priors on the model space to ensure that the terminal model conforms to economic theory, at least in terms of coefficient signs. This aims to safeguard against reaching terminal models that reflect data artefacts as opposed to fundamental economic relationships.⁸ In line with the discussion in Section 3, the theoretically appropriate signs for the explanatory variables’ coefficients are as follows: *vix* (+), *ba* (+), *bal* (-), *debt* (+), *gind* (-), and *q* (+).

Second, in line with the recommendation of Hendry and Santos (2005), the algorithm automatically detects and corrects for any outlying observations, defined by estimated residuals exceeding 3.5 standard deviations, via impulse dummy variables. Outliers may reflect the impact of events which are not captured by our explanatory variables, such as bailout news, or news about country-specific political developments.

Finally, since spreads and the various fundamentals exhibit high persistence, asymptotic inference will tend to over-reject the null hypothesis of no-relationship between them (see e.g. Granger et al., 2001). Therefore we used Monte Carlo simulations to calculate 1% critical values for *t*-tests that account for the observed persistence in the series.⁹

⁷ Due to the persistent nature of spreads, lagged spreads are typically included in the set of regressors (see e.g. Attinasi et al., 2009; Gerlach et al., 2010). The algorithm allows fixing variables in the models irrespectively of their statistical significance. In our estimations, a constant and the first lag of the spread are always included in the models.

⁸ The sign deletion criterion is considered before the individual variable significance criterion, which is ignored if one or more variables are removed as a result of the sign deletion strategy.

⁹ We generate seven independent AR (1) processes with autoregressive coefficients calibrated to the empirical first order autocorrelation function parameters of the spreads and the six fundamentals. In turn, a model corresponding to Equation (1) was estimated using the artificial data for each of the countries in our sample using a sample size equal to 60 observations. We generate 50,000 Monte Carlo iterations and collect the *t*-statistic of each fundamental’s coefficient

4. GETS results

Panels A to E in Figure 3 plot the estimated coefficients of the explanatory variables, obtained from the application of the GETS searching algorithm, when the associated variables enter at least one terminal model at the 1% level of statistical significance.¹⁰

[Figure 3]

Figure 3 - Panel A indicates that while prior to the credit crisis the link between spreads and international financial risk was not active, it became strongly active following the intensification of the credit crisis in 2008. Ever since the international risk factor has been a statistically significant determinant of spreads in all sample EMU countries. The degree of exposure of spreads to international financial risk, as indicated by the magnitude of the coefficient of *vix*, tends to be higher in periphery economies. The peak in the values of the *vix* coefficients observed in the immediate aftermath of the Lehman Brother event is followed by a stabilisation at lower levels in all countries. The only exception to this rule is Greece, where the impact of international financial risk on spreads continues to increase until the end of the sample period. Indeed, Greece provides a good example of the information gains obtained from employing the dynamic GETS methodology relative to models not accounting for structural breaks or models with time-varying but homogenous (across countries) slope coefficients, such as the one by Bernoth and Erdogan (2012).

The results presented in Figure 3 - Panel B suggest that liquidity risk has been priced mainly in the periphery EMU countries (Greece, Italy, Ireland, Portugal and Spain) during the sovereign debt crisis period with increasing coefficients over the period 2009 to mid-2010. It is interesting to note that over the same period French bonds also appear to have incorporated an illiquidity premium, which they did not incorporate before or after. Since mid-2010, the coefficient of *ba* has generally declined in the periphery countries and reverted to zero in the case of France. Once again, Greece is an exception to this rule, with the estimated illiquidity effect increasing towards the end of our sample period. The timing of the reversal in the estimated values of *ba*, but also those of the *vix* depicted in Panel A, approximately matches the creation of the EFSF in May 2010 and the initiation of the Security Markets Programme by the ECB. This indicates that the introduction of a systemic response to the European sovereign debt crisis weakened the relationship between the international risk factor and liquidity on the one hand; and sovereign risk on the other. Overall, our findings suggest that, with the exception of Greece, the measures taken at a European level since mid-2010, combined with the reduction in the exposure to international financial risk observed over the same period, have had a moderating impact on spreads.

for the null hypothesis of zero effect on the dependent variable. Finally, we calculate the 1% critical value using the empirical distribution of the relevant *t*-statistics for each country and regressor (results available upon request).

¹⁰ The corresponding graph for the real exchange rate is not shown since overall, with the exception of few instances in Spain and Ireland, that variable was statistically insignificant over time across the sample countries.

Panels C and D in Figure 3 present the estimated coefficients of fiscal fundamentals. Both panels suggest that the expected fiscal position was not statistically significant in explaining euro area sovereign risk prior to the financial crisis. Panel C suggests that the link between spreads and the expected fiscal balance became active during the period 2009-2010. However, we observe significant country-specific heterogeneity in the response of spreads to the expected budget balance both within the core as well as within the periphery group. For example, while the expected budget balance is overall statistically insignificant in explaining spreads in Finland and the Netherlands, the French and Austrian spreads are consistently related to the expected fiscal balance since 2009. Moreover, although markets have been penalising higher expected budget deficits with increasing strength in the case of Portugal, the relationship between spreads and the expected budget balance is not particularly strong in Spain and Ireland.

For Greece and Italy, the expected fiscal balance does not appear to be statistically significant after the end of 2010. Since then, Greek fiscal risk appears to be priced via the expected debt channel (see Figure 3 - Panel D). In particular, the estimated coefficient on the Greek debt has registered a particularly pronounced increase over the last sample year (2011), in line with the increase observed in the value of the *vix* and *ba* coefficients for the same country (see Figure 3 - Panels A and B, respectively). For the remaining countries, our findings do not support the existence of a strong link between EMU spreads and the expected debt-to-GDP ratio. Thus, it appears that the credit risk channel mainly operates via the expected budget balance, as opposed to expected debt. Finally, output growth is a significant determinant of spreads only in Greece and Spain and only during the debt crisis period (see Figure 3 - Panel E).

All in all, in line with previous studies our findings suggest that the relationship between euro area sovereign risk and the underlying fundamentals is strongly time-varying, turning from inactive to active since the onset of the global financial crisis and further intensifying during the sovereign debt crisis.¹¹ Our results are in line with those reported by Bernoth and Erdogan (2012) and Aßmann and Boysen-Hogrefe (2012) who used a time-varying coefficients panel approach to capture structural instability in spreads determination within the euro area. The contribution of our approach is to highlight the additional dimension of country-specific heterogeneity, namely the differentiation of the coefficients' time variation and impact upon spreads across individual countries. This dimension of intra EMU heterogeneity has not been addressed in previous literature.

¹¹ Arghyrou and Kontonikas (2012) argue that the finding of non-pricing or mispricing of related fundamentals prior to the crisis is supportive of the 'convergence trading' hypothesis, according to which investors purchased periphery bonds in the hope that these economies would converge towards Germany. The increased demand for periphery bonds led to lower spreads and the expectation of convergence became self-fulfilling, generating profits for bond market investors and lower borrowing costs for periphery governments, even in the presence of deteriorating fundamentals.

4.1 Robustness checks

We tested the robustness of our findings with respect to the specification of the dynamic multipath search algorithm in a number of ways. To save space the results are not reported here but are available upon request. First, we repeated the multipath search using a less tight significance level (5% level). Second, we utilised a longer (72-month) rolling window for the estimations. Third, we did not include outliers in the regression models. Fourth, we conducted recursive, as opposed to rolling windows, estimations. Fifth, we did not impose sign restrictions on the model space. Our benchmark results are overall robust to these sensitivity checks.

5. Conclusions

In this paper we have used a dynamic multipath general-to-specific algorithm to capture structural instability in the link between euro area sovereign bond yield spreads against Germany and their underlying determinants over the period January 1999 - August 2011. Following the bulk of existing literature, we modelled spreads on proxies of international financial risk, liquidity risk and credit risk. Our approach allows us to identify country-specific time-variation in the relationship between spreads and fundamentals. We obtain new evidence suggesting significant heterogeneity across countries, both in terms of the risk factors determining spreads over time as well as in terms of the size of their impact on national spreads.

As a general rule, the set of financial and macro spreads' determinants in the euro area is highly unstable but generally becomes richer and stronger in significance as the crisis evolves. Compared to the period preceding the global financial crisis, the significant increase in the magnitude of the fiscal variables' impact upon spreads, indicates higher market sensitivity to idiosyncratic national credit risk. Overall, the main implication of our findings is that given the recent market pricing behaviour the European debt crisis will very likely not be fully resolved as a result of improved global risk conditions. For this purpose, a significant improvement in national fundamentals seems a necessary condition.

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Figure 1: 10-year government bond yield spreads

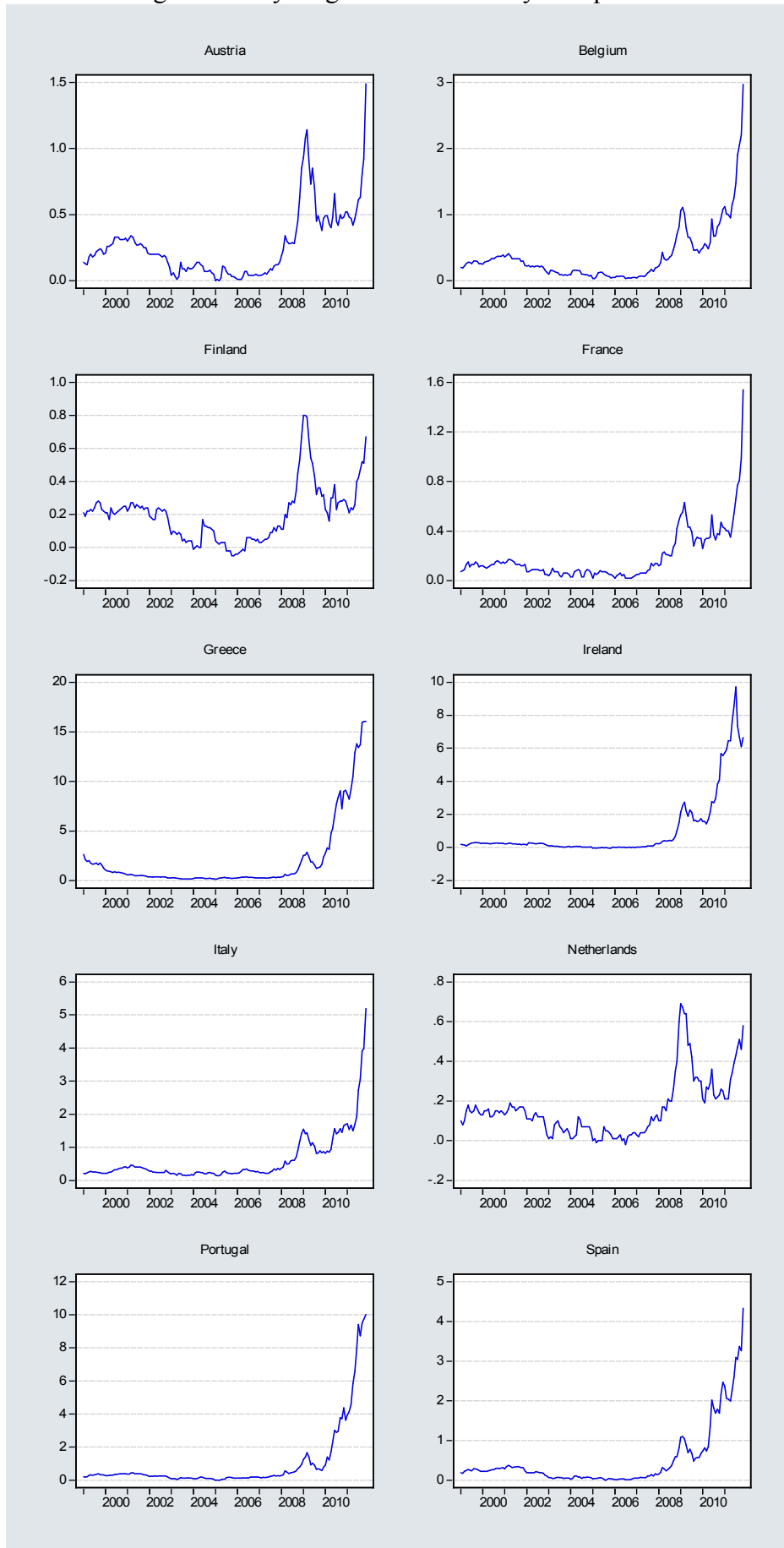
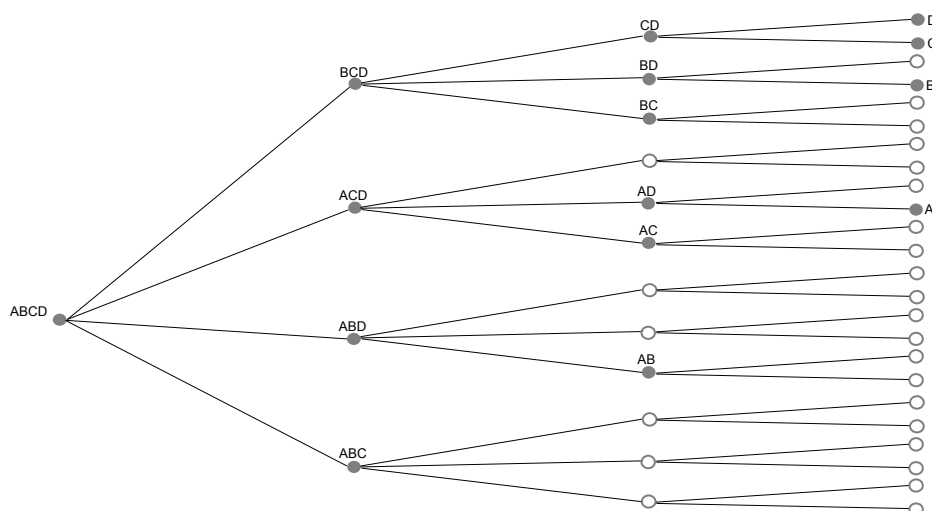


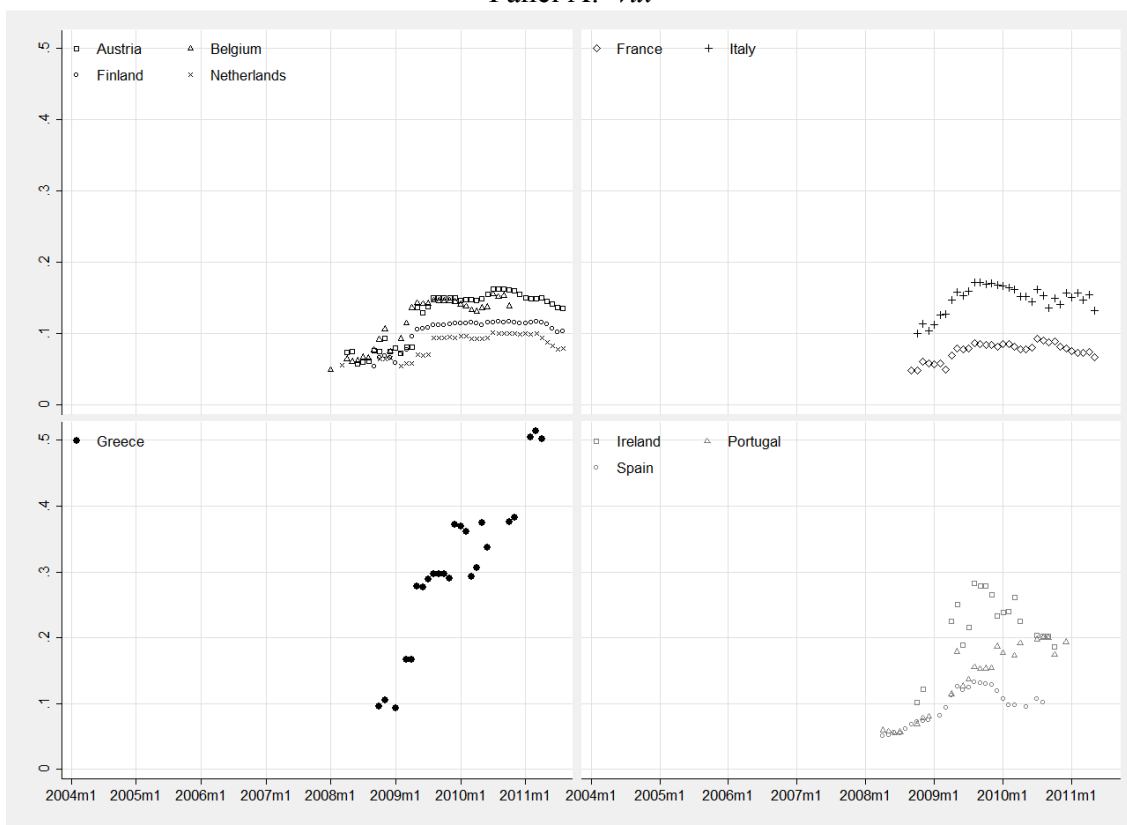
Figure 2: Multipath model space



Note: Figure 2 has been reproduced from Doornik (2009). It shows all unique models starting from a general unrestricted model (GUM) with variables ABCD.

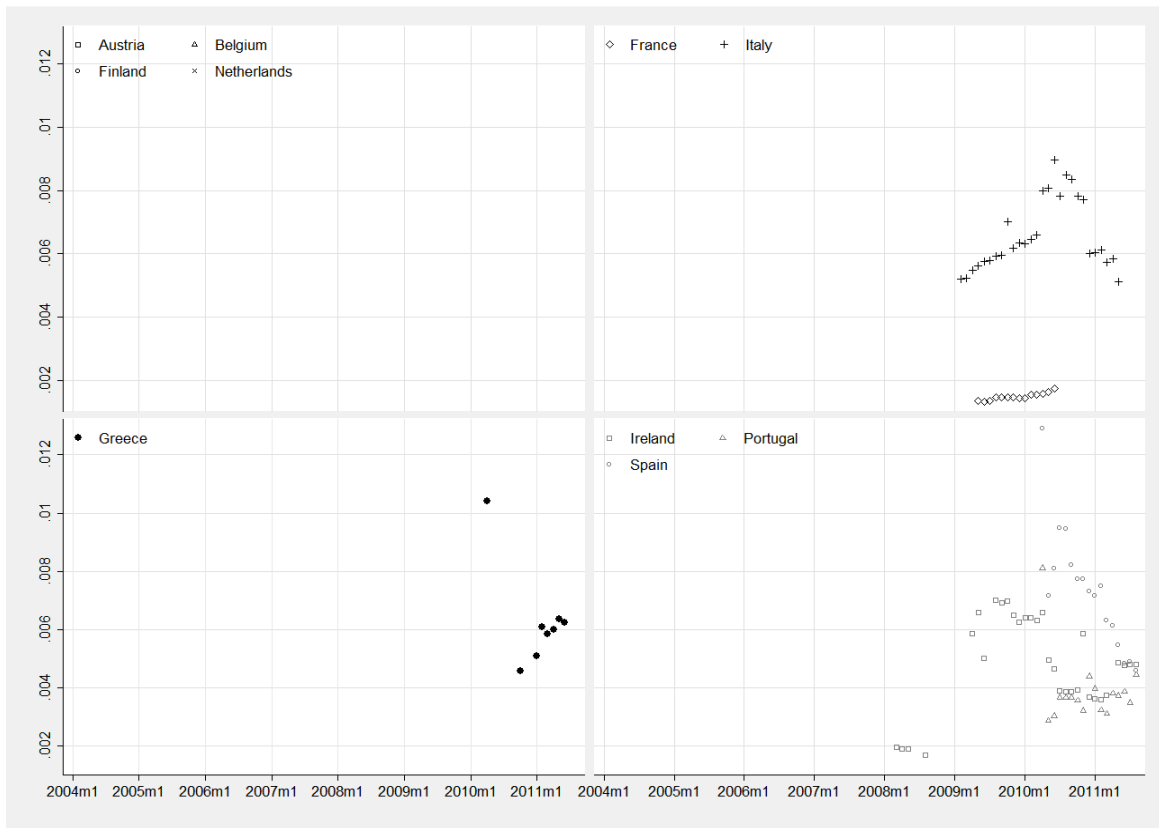
Figure 3: Dynamic GETS modelling results

Panel A: *vix*

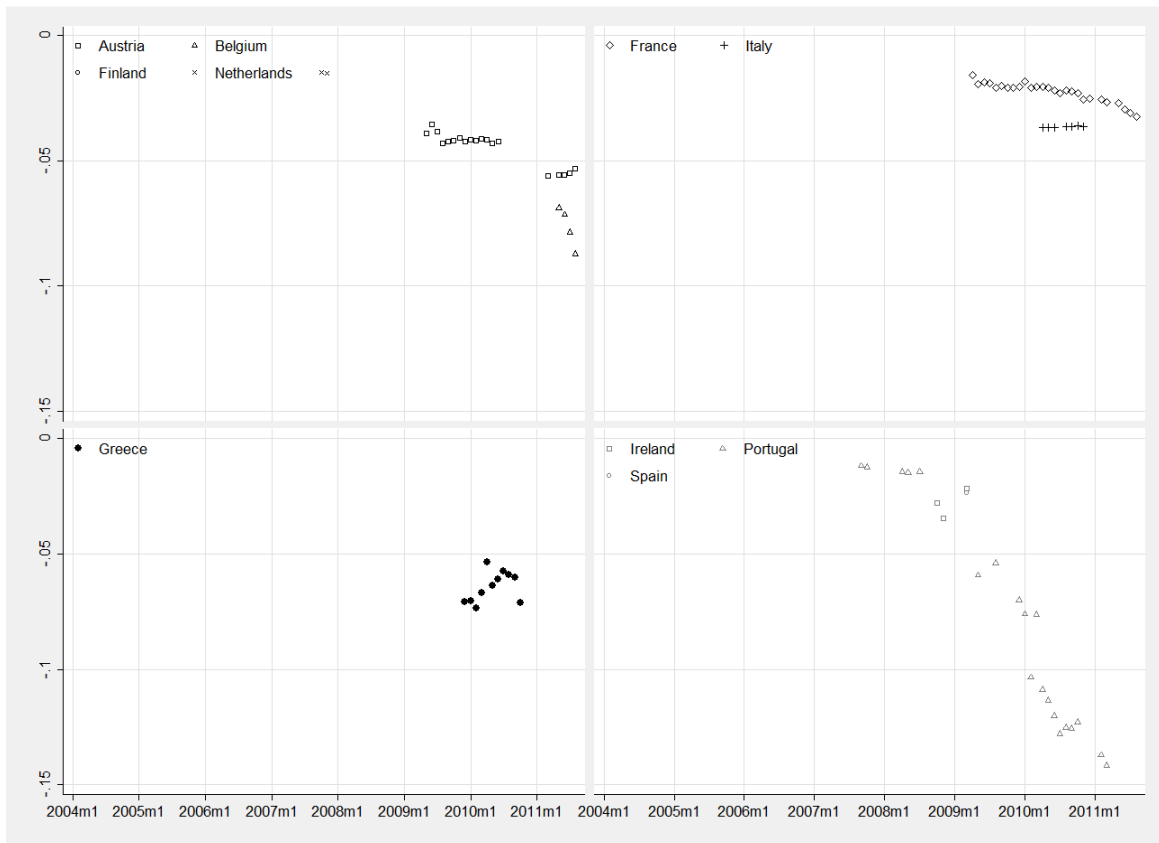


Note: Panels A to E in Figure 3 show the coefficients of the spreads-related fundamentals when they are statistically significant at the 1% level in the terminal model(s) after applying the dynamic GETS algorithm using 60-month rolling windows and Equation (1) as the GUM. Monte Carlo based critical values that account for persistence in the series are used in the *t*-tests. The period under investigation is January 1999 - August 2011.

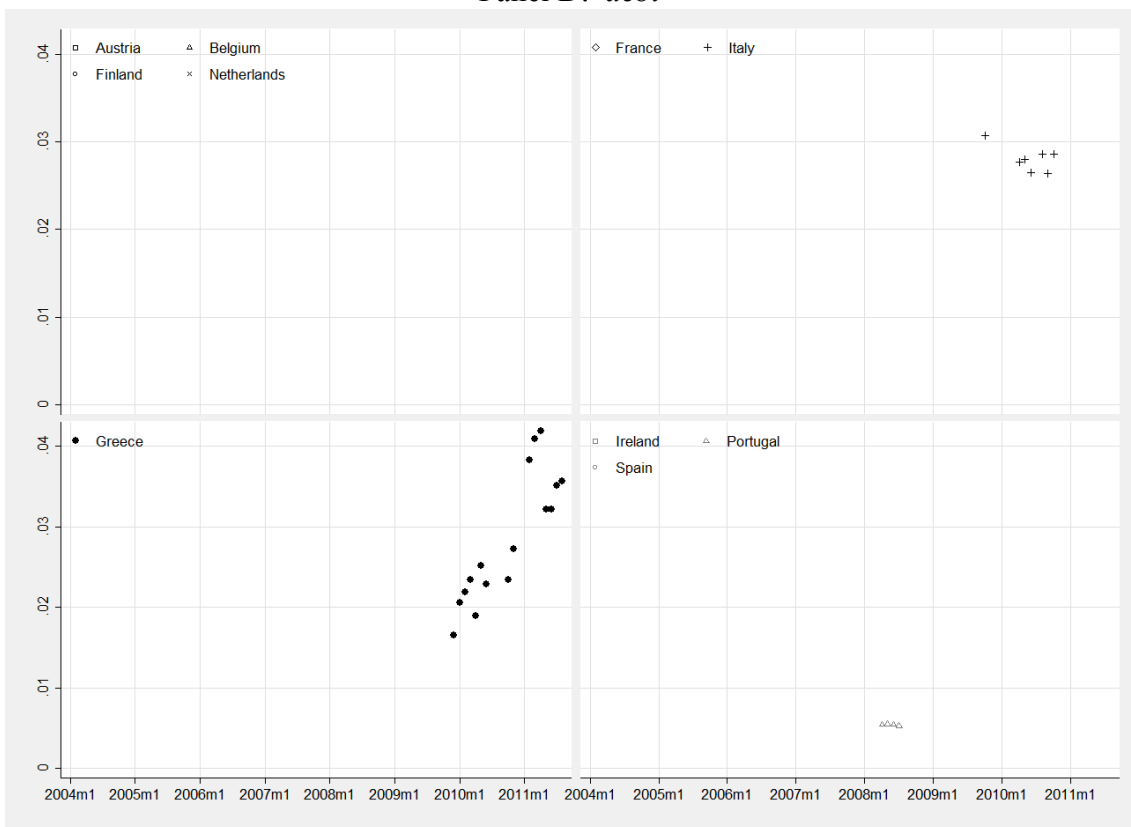
Panel B: *ba*



Panel C: *bal*



Panel D: *debt*



Panel E: *gind*

