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Ivo J.M. Arnold , Saskia E. van Ewijk

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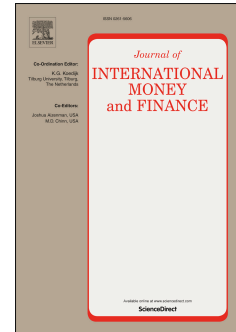
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A state space approach to measuring the impact of sovereign and credit risk on interest rate convergence in the euro area¹

Ivo J.M. Arnold

Erasmus University Rotterdam, Rotterdam, The Netherlands

and

Saskia E. van Ewijk

De Nederlandsche Bank, Amsterdam, The Netherlands

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Abstract

This paper employs a time-varying parameter state space model to explore the impact of the crisis on bank retail rates in the euro area. We show that σ -convergence in interest rates has been adversely affected by the crisis and quantify the role of sovereign and credit risk as two alternative explanations for the increase in financial fragmentation. A key finding is that the heterogeneity in sovereign risk across member states accounts for a sizable part of the increase in the cross-sectional dispersion of various lending and deposit rates. In contrast, the impact of the increased heterogeneity in credit risk on bank retail rates is negligible. Our results suggest that efforts to reduce sovereign tensions - as exemplified by the ECB's OMT program - may help to reduce financial fragmentation.

Keywords: bank retail rates, σ -convergence, sovereign risk, credit risk, state space model

JEL Codes: E43, G21, H63

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