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Risk assessment on euro area government bond markets: The role of governance quality

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Abstract

Since the announcement of the outright monetary transactions program (OMT), government bond yield spreads have decreased substantially but have not fallen to pre-crisis levels. This paper argues that the debt-to-GDP ratio has become less relevant as a determinant for government bond spreads, while financial markets have become more concerned about the willingness and capability to cooperate with the institutions that conduct the adjustment programs since the announcement of OMT. This paper links the willingness and capability to cooperate to political stability and quality of governance, for which indicators are available from the World Bank. By means of a time-varying coefficient approach, it can be shown that the coefficient for a composite World Bank indicator on the quality of governance has outpaced other possible determinants of government bond spreads since the announcement of OMT.

JEL classification: C32, G12, E43, E62

Keywords: euro area, bond spreads, debt crisis, OMT, time-varying coefficients, good governance, default risk

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