



# The euro area sovereign debt crisis: Identifying flight-to-liquidity and the spillover mechanisms



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## ABSTRACT

Looking at the daily period between January 2006 and December 2012, besides the traditional credit and liquidity risks, which explain the developments of sovereign yields relative to the Bund for Greece, Ireland, Portugal, Spain and Italy, two additional factors have played a key role in the developments of euro area sovereign yield spreads: flight to liquidity benefiting the German Bund and the spillover effect from Greece. The flight to liquidity premium, which is estimated by constructing the spread between a German state guaranteed agency bond and the Bund, is behind the pricing of all euro area spreads and, specifically, is the only factor explaining the sovereign spreads for Finland and the Netherlands. The spillover effect from Greece, which is identified using complementary approaches, has contributed to developments in spreads of countries with weaker fiscal fundamentals, a lower degree of competitiveness and a higher need of foreign financing. However, a large fraction of the spillover across countries remains unexplained.

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## 1. Introduction

With the intensification of the financial crisis in September 2008 after the collapse of Lehman, government bond yields relative to the German Bund have been rising after ten years of stability at very low levels (see Fig. 1). The situation started to improve in the course of the spring 2009 as global uncertainty receded. On 16 October 2009, the Greek Prime Minister George Papandreou in his first parliamentary speech disclosed the country's severe fiscal problems and immediately after on 5 November 2009 the Greek government revealed a revised budget deficit of 12.7% of GDP for 2009, which was double of the previous estimate. Since then, the sovereign spreads rose sharply for most of the euro area countries.

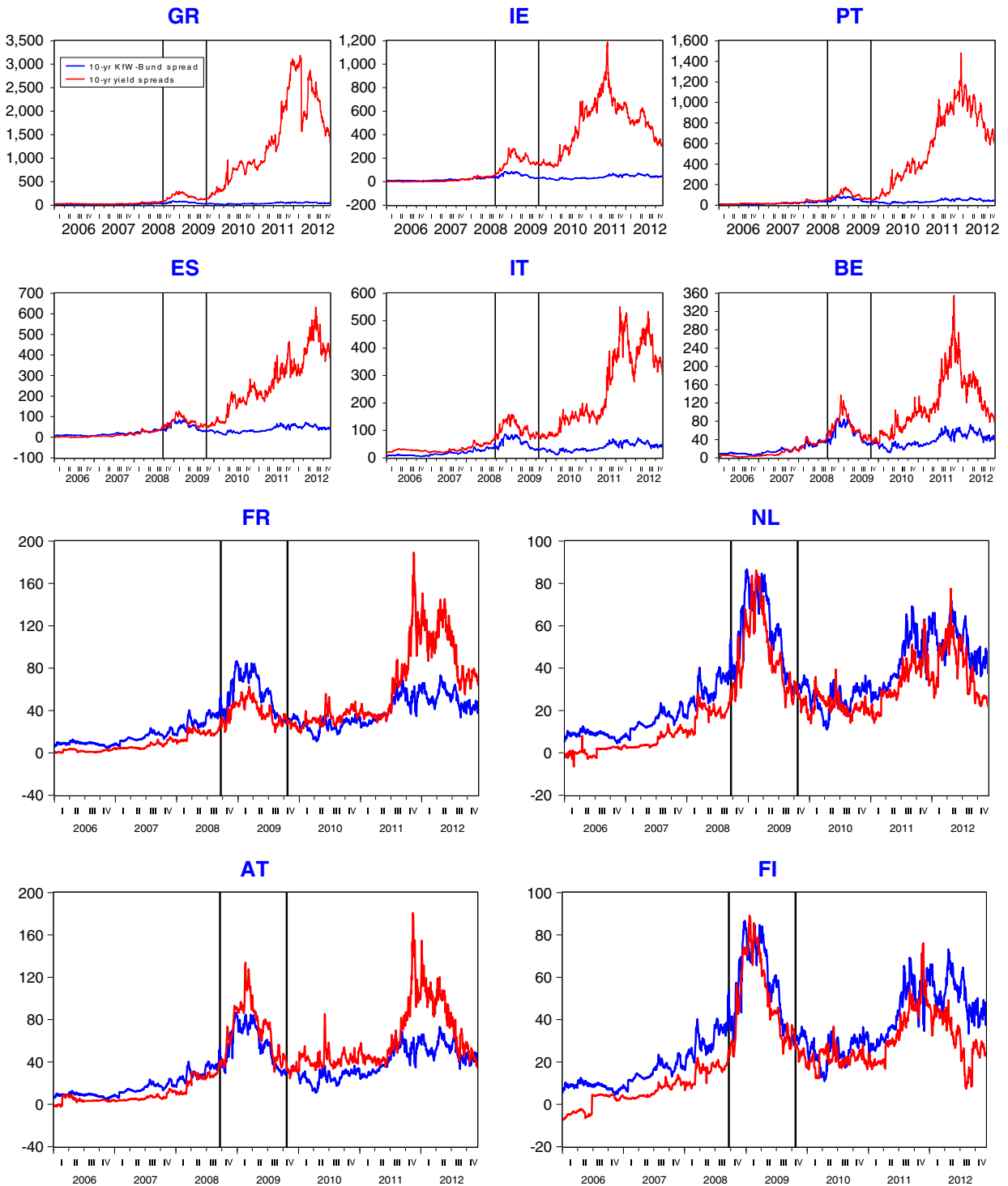
The developments in 2010 and 2011 were remarkable with the Greek, Irish and Portuguese 10-year sovereign spreads hitting in July 2011 respectively 1600, 1200 and 1100 basis points. Similarly, Spanish and Italian spreads reached 400 basis points, Belgium hit 200 basis points and France hit 90 basis points. The market players have singled out the debt sustainability issue and have argued that the solvency risk for these countries deteriorated in the course of 2010 and 2011. After July 2011, the Irish spreads started a steady decline, while Austrian, Belgian, French, Greek, Italian, Portuguese and Spanish spreads recorded in the course of the year new high levels.

The tension is further illustrated by the reaction in more highly rated sovereign papers. Benchmark French, Dutch, Austrian, Finnish and German yields have turned round to fluctuate with a declining trend over the 2008–2012 period. However, the spreads vis-à-vis the German Bund have been rising also on bonds issued by countries with solid fiscal fundamentals, such as Austria, Finland and the Netherlands.

Given such developments in spreads, this study aims at answering the following four main questions: Why did the spreads of countries with solid fiscal fundamentals rise with the financial crisis? Why did the spreads of countries with weak fiscal

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**Fig. 1.** The 10-year sovereign yield spread vis-à-vis the Bund and flight to liquidity. Source: Bloomberg, Reuters DataStream, own calculations. Notes: Sample period: 1 Jan. 2006–4 Dec. 2012. The spread is defined as the difference between the 10-year benchmark bond yield in country  $i$  and the German Bund. Flight to liquidity is defined as the difference between the 10-year KfW-Bund spread. The first vertical bar on 15 September 2008 denotes the beginning of the global financial crisis after the Lehman's bankruptcy. The second vertical bar on 16 October 2009 denotes the beginning of the euro area sovereign debt crisis after the parliamentary speech by the Greek prime minister George Papandreu.

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