Journal of International Money and Finance 47 (2014) 239–267

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Are European sovereign bonds fairly priced? The role of modelling uncertainty☆

Leo de Haan*, Jeroen Hessel, Jan Willem van den End

De Nederlandsche Bank, Economics and Research Division, P.O. Box 98, 1000 AB Amsterdam, The Netherlands

JEL Classification:
E43
E44
F34
G15

Keywords:
Sovereign bond
Interest rate
Risk premium

A B S T R A C T

This paper examines the extent to which large swings of sovereign yields in euro area countries during the debt crisis can be attributed to fundamentals, focusing on the inherent uncertainty in bond yield models. We show that the outcomes are strongly affected by modelling choices with regard to i) the confidence bands for the model prediction, ii) the assumption whether the model coefficients are similar across countries or not, iii) the sample selection, iv) the inclusion of financial variables and v) the choice of time-varying coefficients. These choices affect the explanatory power of macro fundamentals and the extent of mispricing.

© 2014 Elsevier Ltd. All rights reserved.

1. Introduction

Developments of bond yields are an issue for monetary policy as its effectiveness depends on the transmission of money market rates into long-term bond yields (Cœuré, 2012). Disorderly market conditions can disturb this mechanism, if they go in tandem with excessive volatility in bond yields. Strong swings in bond yields may be due to (fair) changes in required compensation for credit risk,

☆ The views expressed are those of the authors and do not necessarily reflect official positions of DNB. We thank an anonymous referee, Jan Marc Berk, Christophe Blot, Jakob de Haan, Alex Kostakis, Issouf Soumare, Peter van Els, seminar participants at DNB, participants of the 63rd conference of the Midwest Finance Association (Orlando), the 2nd International Conference on Debt Crises and Financial Stability (Toulon) and the 5th World Finance Conference (Venice) for useful comments and advice. Martin Admiraal, René Bierdrager, and Zion Gorgi provided data assistance.

* Corresponding author. Tel.: +31 20 5243539; fax: +31 20 5242526.
E-mail addresses: l.de.haan@dnb.nl (L. de Haan), j.p.c.hessel@dnb.nl (J. Hessel), w.a.van.den.end@dnb.nl (J.W. van den End).

http://dx.doi.org/10.1016/j.jimonfin.2014.06.001
0261-5606/© 2014 Elsevier Ltd. All rights reserved.

market volatility and liquidity tensions. However, during periods of high market turmoil, bond yields may also reflect risks associated with excessive risk aversion that is out of sync with economic fundamentals and market conditions.

Occasionally this may have been the case during episodes with extreme stress in European bond markets (Fig. 1). At the peak of the debt crisis – in the summer of 2012 – government bond markets were thought to be severely distorted due to investors' fears on the reversibility of the euro (ECB, 2012). They took into account redenomination risk and this led to self-reinforcing upward spirals in bond yields. The disorderly market conditions threatened the singleness of the ECB's monetary policy and the transmission of the policy stance to the real economy. This increased the risk of funding shortages for governments in the periphery of the euro area and for European banks that had large amounts of government bonds on their balance sheets (Allen and Moessner, 2013). At the time, several peripheral countries experienced sudden stops in external financing, which were reflected in the accumulation of large imbalances in the TARGET2 settlement system (Merler and Pisani-Ferry, 2012).

In response to the disruptions in the monetary transmission mechanism, the ECB announced Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area. Under appropriate conditions the OMTs are intended to be an effective backstop to avoid destructive scenarios with potentially severe challenges for price stability. The ECB does not target a specific yield level with OMTs, but considers a range of variables in planning any interventions (ECB, 2012). The level of yield ceilings, but also risk spreads, market liquidity conditions and measures of volatility will be considered. Such variables may indicate whether government bond markets are distorted and bonds mispriced.

The announcement of OMTs has arguably contributed greatly to the decline of intra-EMU bond spreads since the summer of 2012. Yet OMTs are not uncontroversial among policymakers, even within the ECB Governing Council. While some see OMTs as “probably the most successful monetary policy measure undertaken in recent times” (Draghi, 2013b), others remind that money creation – which could result from the use of OMTs – has been a policy advice from Mephistopheles in Goethe's Faust (Weidmann, 2012).

One important reason for these differences is the lack of consensus among policymakers on the exact nature of the fragilities in European bond markets (De Grauwe and Ji, 2013b). On one end of the

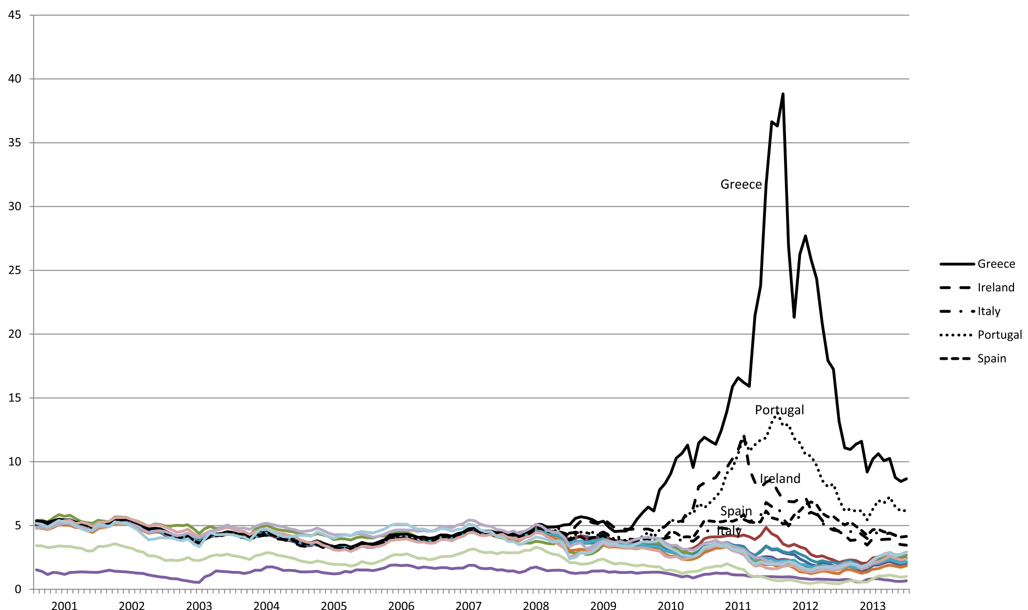

Fig. 1. Government bond yields.

Download English Version:

https://daneshyari.com/en/article/964665

Download Persian Version:

https://daneshyari.com/article/964665

Daneshyari.com