

# Monetary Trends



## Convergence in the Euro-zone?

During the three months leading up to the Jan. 1, 1999, debut of the euro, market yield spreads between participating countries' government bonds and the German benchmark government bond narrowed to 0.25 percentage points or less. The top chart shows vanishing yield spreads for the bonds of Italy, the Netherlands and France relative to Germany, a phenomenon that was widely anticipated. By meeting the Maastricht criteria for economic and fiscal convergence, the 11 participating countries had provided a basis for financial-market convergence, as well. If investors continued to believe that the pre-existing currencies would remain locked together forever in the form of the euro, then all exchange-rate risk premiums should vanish from bond yields. In recent months, however, yield spreads have increased. Why?

Positive yield spreads between a euro-zone member country's sovereign debt and German bonds could be due to any of several factors, including: (1) differences in market liquidity, (2) the risk of loss due to government default on bond payments, or (3) the risk that a country might leave the euro and devalue its new currency against the currency of Germany. Bond-market turbulence in the fall of 1998 and ensuing flight to highly liquid securities, such as German government bonds, clearly showed that differences in market liquidity contribute to yield spreads. The relative stability in the ranking of euro-zone members' yield spreads over time suggests that country-specific default risk is probably another component of the spread. Finally, devaluation risk is a plausible contributor to euro-zone yield spreads. For example, market speculation about Italy's long-run suitability for monetary union has caused periodic spikes in the Italian yield spread that have no counterpart in, say, French yield spreads.

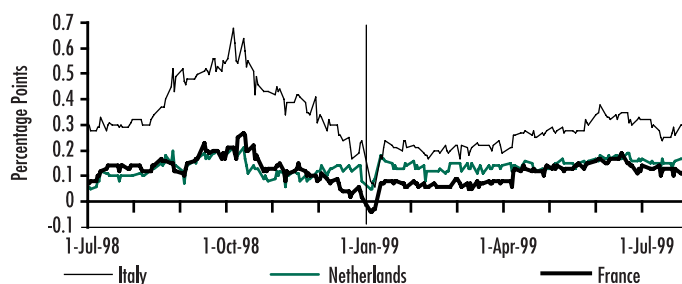
How important is membership in European monetary union for maintaining low bond yields? The bottom chart shows that during 1999, the bond yield spreads (relative

to German government bonds) of two European Union countries that are not currently participating in the monetary union—the United Kingdom and Sweden—have increased relative to the yield spread of Finland, a monetary-union participant. This suggests that countries firmly entrenched in the monetary union benefit from the market's view of the euro as a hard currency.

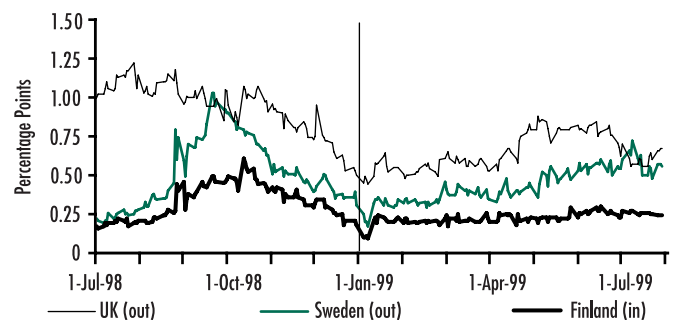
Persistent positive yield spreads against the German bond across the euro-zone indicate, however, that, despite initial "europhoria" at the outset of European monetary union, true bond-market convergence has failed to occur. Indeed, after six months, yield spreads on non-German euro-zone benchmark bonds were slightly higher than they were six months before monetary union took place.

—William R. Emmons

**Government Bond Yield Spreads vs. Germany**



**"In and Out" Yield Spreads vs. Germany**



Source: Financial Times, various issues