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Comparing International Bond Yields

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In mid-2012, yields on 10-year Italian and Spanish government bonds were more than 4 percentage points higher than yields on German government bonds (bunds) and U.S. Treasury securities of the same maturity (see the figure). Investors perceived that Spain and Italy had serious fiscal problems, and thus they required compensation in the form of higher yields to protect against the risk of these governments defaulting on their debt.

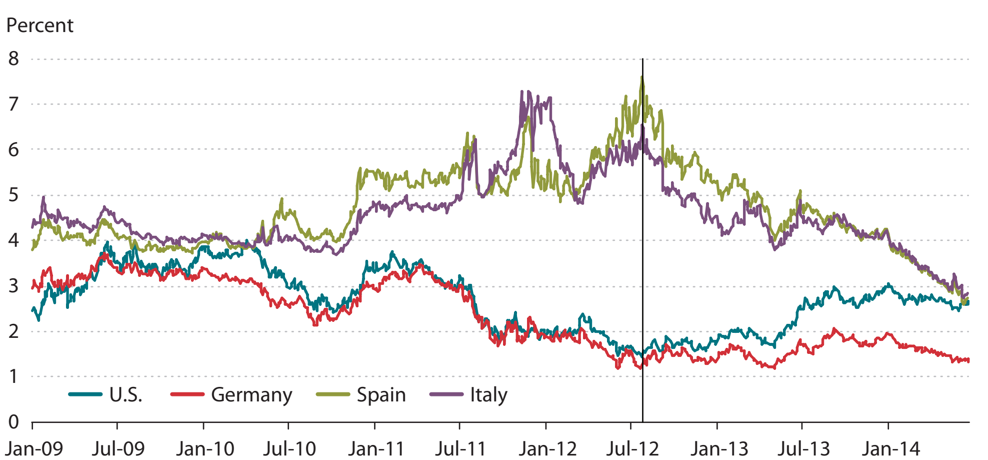
Spanish and Italian government bond yields are not directly comparable to those of U.S. Treasuries because the bonds are paid in different currencies.

Such a default might endanger the existence of the euro, and it became a matter of great concern for the European Central Bank (ECB). In July 2012, ECB President Mario Draghi stated: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." This statement was widely interpreted as a pledge to use the full resources of the ECB—by lending money and/or buying securities—to prevent a default by any euro area government.

The figure shows that yields on Italian and Spanish 10-year government bonds have declined compared with yields on U.S. bonds since Draghi's statement. Now (as of late June 2014) yields on these securities are nearly equal to those on U.S. bonds, despite the seemingly much greater risk of default for Spanish and Italian government bonds. Do the similar yields mean that the default risk for Spanish or Italian government bonds is comparable to that for U.S. Treasuries?

Although the differences in euro area yields (i.e., German, Spanish, and Italian bonds in the figure) are almost entirely due to default risk, the yields on U.S. Treasuries are not, in fact, directly comparable to those on Spanish or Italian

Yield Convergence: 10-year Government Bonds



NOTE: The figure shows the daily 10-year government bond yields from the United States, Germany, Spain, and Italy from 2009 through June 20, 2014. The vertical bar marks ECB President Draghi's statement on July 26, 2012.
SOURCE: Haver Analytics.

government bonds. Why not? The difference lies in the fact that U.S. Treasuries pay in dollars and Spanish and Italian government bonds pay in euros. Italian and Spanish 10-year government bonds yield about 1.5 percentage points more than very low-risk German bunds that also pay in euros. Comparing international yields requires investors to also consider the expected return on the exchange rate, as well as any other risk involved.

Exchange rate changes are essentially unpredictable over any short period, but there is reason to believe the changes reflect bilateral differences in inflation rates over long periods, such as 10 years.[1] In fact, the year-over-year euro area consumer price index (CPI) inflation rate is lower than that of the United States—0.5 percent versus 2.1 percent in May 2014—and is expected to remain lower. Inflation swaps—derivatives that provide market-based measures of expected inflation—predict 2.6 percent inflation in the United States and 1.7 percent inflation in the euro area over the next 10 years.[2] Lower inflation in the euro area suggests the euro might be expected to appreciate 0.9 percent annually against the dollar, mostly offsetting the 1.3-percentage-point difference in yields between U.S. Treasuries and German bunds.

In summary, Italian and Spanish government bonds still have a non-negligible risk premium compared with either lower-risk German bunds that also pay in euros or U.S. Treasuries after accounting for the expected changes in the exchange rate.[3] ■

NOTES

[1] See Pakko and Pollard (1996), for example.

[2] Data from Bloomberg Professional services; http://www.bloomberg.com/professional/.

[3] Substantial ECB and Federal Reserve asset purchases also influence yields; these purchases complicate the problem of deriving simple measures of default risk from bond yields.

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