THE DETERMINANTS OF COUNTRY´S RISK PREMIUM VOLATILITY: EVIDENCE FROM PANEL VAR MODEL

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Abstract— We use data for 24 European countries, spanning from 1994 to 2015, in order to examine how changes in macroeconomic conditions influence the country's risk premium volatility proxied by sovereign spreads variance. In the first part of the empirical analysis we estimate the univariate generalisedautoregressiveconditionalheteroskedasticity (GARCH) model in order to obtain the conditional variance of sovereign bond spreads. We show that the increase of this variance coincides with economic and financial crisis occurring either in the country or globally. In the second part of the empirical analysis we estimate panel vectorautoregression (panel VAR) model in order to model the interplay among macroeconomic fundamentals (inflation, output gap, public debt and interest rates) and the country´s risk premium volatility. We show that overheating of the economy, along with the unexpected increase in public debt, inflation and interest rates increase the country´s risk premium volatility. We also show that sudden increase incountry´s risk premium volatilitydepresses the economy, exerts deflationary pressures on consumer prices, and is followed by strong and permanent increase in public debt.

Keywords— sovereign bond markets, panel VAR, European Union.

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