

Market Pricing of Sovereign Risk in the Euro-Area: Self-fulfilling Expectations, Credit Rating Agencies, and Asymmetries.

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Abstract

We investigate both the pricing of sovereign default risk for the Eurozone and the meaning of the credit default swaps (CDS) which are used as the main financial instrument for this purpose. In a dynamic panel regression setting we are looking for the causalities of CDS spreads for the entire Eurozone as well as for its two discrete sub-samples, i.e. south-west euro-area periphery member countries (SWEAP, Hellas (Greece), Italy, Spain, Portugal, and Ireland) and north euro-area center (NEAC, the rest 12 member countries), using quarterly data during 2008-2012; we also address the question of an identifiable dynamic pattern to CDS spreads during the crisis or pricing differentials of CDS spreads in the Eurozone. We find evidence in favor of self-fulfilling expectations and speculative behavior in market pricing of sovereign risk, while the usual macro-fundamentals found to play a secondary role. We also find statistically and economically significant the credit rating agencies' valuations for the sampled countries, but with asymmetries detected between SWEAP and NEAC. Finally, we discuss the meaning of these instruments traded in over-the-counter (OTC) derivative markets and on the basis of logical considerations we cannot reject the research hypothesis of "speculation against sovereign countries".

Keywords: credit default swaps (CDS), sovereign debt defaults, credit rating agencies, market pricing of risk, Eurozone crisis, south-west euro area periphery (SWEAP).

JEL Classification: F30, G01, H63

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