Summary for non-specialists
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The EMU sovereign-debt crisis: Fundamentals, expectations and contagion

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We offer a detailed empirical investigation of the EMU sovereign-debt crisis up to February 2010. We address five distinct questions. First, what are the driving forces of EMU spreads before and after the onset of the global financial crisis in August 2007? Second, why did the Greek spread escalate in such a dramatic fashion since November 2009? Third, why has the Greek spread been so much higher compared to other periphery EMU countries with similar macro-outlook, such as Portugal? Fourth, has the Greek crisis caused contagion to other EMU countries? Finally, what is the role of speculation in the CDS market?

Our analysis is based on the theoretical model by Arghyrou and Tsoukalas (2010). Using monthly data covering the period January 1999 – February 2010 and a range of estimation techniques we reach the following findings:

First, prior to the global credit crunch (January 1999 – July 2007) markets priced neither macro-fundamentals nor the very low at the time international risk factor. Markets, however, have changed drastically their pricing behaviour since August 2007. During the crisis period, markets have been pricing both the international risk factor and macro-fundamentals on a country-by-country basis.

Second, the Greek debt crisis is due to a background of deteriorating macro-fundamentals over 1999-2009 and a double shift in private expectations. Starting from November 2009, Greece was transferred from a regime of fully-credible commitment to future EMU participation under the perception of fully guaranteed (by other EMU countries) fiscal liabilities, to a regime of non-fully credible EMU commitment without fiscal guarantees. This regime-shift not only explains the sudden escalation of the Greek debt crisis in November 2009 but also the difference in spread values observed between Greece and other periphery EMU countries. In short, Greece's problems are as much about trust as they are about economics.

Third, the majority of EMU countries have experienced contagion from Greece, most prominently Portugal, Ireland and Spain: The Greek problem has become an EMU-wide problem.

Finally, we do not find evidence in favour of the hypothesis that speculation in CDS markets is a major force driving the euro debt crisis. This does not imply that CDS speculation is not taking place or it does not drive EMU spreads at higher data frequencies. But it does imply that in the longer-term perspective captured by our monthly data frequency, EMU spreads are mainly driven by accumulated intra-EMU macroeconomic imbalances and international risk conditions.

Our findings have policy implications both at the national as well as the union level. First, for the spreads of EMU-periphery countries to decline a marked improvement in fiscal position and external competitiveness is necessary. Second, periphery EMU countries must pursue a reversal of private expectations to a more favourable status than the present one. This can only be achieved through a credible strategy of structural reforms, backed by evidence of determined implementation. Without such evidence markets will continue to doubt the sustainability of these countries' participation in the EMU, and the risk that these expectations will become self-fulfilling will remain.

At the union level, the crisis has highlighted the necessity of institutional reforms in two directions. First, to prevent future debt crises the EMU must develop effective mechanisms of fiscal supervision and policy co-ordination. Second, if a crisis does occur, it is important to prevent its escalation in the affected country and its contagion to others. This can be achieved through the creation of a permanent EMU-run mechanism of emergency financing. For such a mechanism to be successful in stabilising expectations, its rules and terms must be transparent and known ex-ante. At the same time, the terms of emergency finance must be such as to eliminate the risk of moral hazard discouraging fiscal discipline and necessary reforms. Identifying rules achieving both objectives simultaneously is a challenging task calling for significant attention from academics and policy-makers alike.