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# Price discovery in euro area sovereign credit markets and the ban on naked CDS ☆

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**Abstract**

The sovereign debt crisis in the euro area saw credit spreads on sovereign bonds and credit default swaps (CDS) surge for a number of member states. The rise in sovereign yields was accompanied by a significant increase in sovereign CDS market activity. This pattern raised concerns that destabilising speculation via outright short-selling of CDS (so-called 'naked CDS') was behind the increase in bond yields. In response policy-makers introduced a ban on naked CDS trading. We investigate the effect of the ban on the price discovery process of sovereign credit risk, contrasting results for the post-ban period with those obtained prior to the ban. We use intraday data on sovereign CDS and bonds across a number of euro area countries. Our first main finding is that the CDS market dominates the bond market in terms of price discovery. That is, CDS premia in most cases adjust quicker to reflect new information than bond spreads. This result holds also when taking into account transaction costs. Our second main finding is that the ban on short-selling did not alter price discovery dynamics or reduce the efficiency of the market. Finally, we find that prior to the ban, CDS spreads were persistently higher than bond credit spreads, even after controlling for transaction costs. This points to the presence of market frictions that limit the ability of arbitrage forces to fully close pricing gaps between the two markets. However, these pricing discrepancies were in many cases largely eliminated following the introduction of the ban.

*Keywords:* Sovereign credit risk, credit default swaps, price discovery, intraday data.

*JEL:* G12, G14, and G15.

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