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The effect of political communication on European financial markets during the sovereign debt crisis☆

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ABSTRACT

We quantify all statements by major European politicians reported by Reuters during the August 2011 to December 2011 period and show that political communication significantly affects the EUR–USD exchange rate as well as European stock and bond markets. Communication with respect to Italy induces the strongest market reactions. Financial markets consider the German bond market a safe haven.

1. Introduction

We analyze whether the communication of European politicians with respect to the sovereign debt crisis affects the EUR–USD exchange rate as well as the European stock and bond markets. For the August to December 2011 period we quantify all statements by major European politicians that refer to the debt crisis and are reported by the news agency *Reuters*. We then explain the changes in the EUR–USD exchange rate as well as eight national stock and bond markets in the 15 minutes period following each statement by the content of the communication. The empirical results show that positive communication regarding the periphery countries or the Eurozone (EZ) as a whole leads to a significant appreciation of the EURO against the US dollar. More specifically, the exchange rate reaction is the strongest with respect to communication regarding the periphery countries and, in particular, in response to negative statements.

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Further, the stock markets of the core European countries (Germany, France and Belgium) as well as the periphery countries (Greece, Ireland, Italy, Portugal and Spain) instantaneously increase in response to positive communication regarding the stance of the economy in the periphery countries or positive communication with respect to the EZ as a whole. In sharp contrast, the response of the national bond markets is asymmetric, whereby mainly the Italian and German bond markets are affected. While negative communication regarding the economic situation in Italy leads to an immediate increase in 10-year Italian government bond yields, German government bond yields decrease. This finding is in line with the view that financial market participants consider the German bond market a safe haven and highlights that Italy plays a pivotal role among the periphery countries. During our sample period, Silvio Berlusconi's Italian government was under strong political pressure and finally had to resign in November 2011. Moreover, our results show that political communication concerning the periphery countries evokes stronger market reactions than statements on the EZ. While statements that suggest an expansion of the European Financial Stability Facility (EFSF) or shared liability for national debts do not lead to decreasing bond yields in the periphery countries, communication about the introduction of further austerity measures does reduce Italian yields.

Our results extend upon and complement the recent work of Mohl and Sondermann (2013) and Beetsma et al. (2013) on the effects of political communication on sovereign bond spreads. In contrast to Mohl and Sondermann (2013) we distinguish between positive and negative communications. In addition, in contrast to Beetsma et al. (2013) we obtain bond market response coefficients for each individual country. Most importantly, while both studies employ daily data, we take a high-frequency perspective. Using high-frequency data allows us to monitor the effects of political communication on financial markets in real time and bypass problems with respect to identification and causality. In particular, we do not have to worry about potential control variables.

Other related papers are Smeets and Zimmermann (2013), Ehrmann et al. (2014) and Kilponen et al. (2015). Smeets and Zimmermann (2013) investigate the effects of crisis meetings of European heads of state and government on stock and bond markets, while Ehrmann et al. (2014) study the determinants of the volatility of the EUR-USD exchange rate during the crisis. However, both studies again focus on daily data. Finally, Kilponen et al. (2015) focus on the effects of policy announcements on bond markets. Thus, all these studies can be seen as complementary to ours.

2. Data and methodology

Our data set starts on August 01, 2011 and ends on December 06, 2011, i.e. it covers 92 trading days. We consider statements and the corresponding asset price changes lying within the trading hours from 9:00 a.m. to 5:30 p.m. Central European Time (CET). Although our sample period is relatively short, we believe that it allows for some unique insights from a subperiod of the sovereign debt crisis that was characterized by the severe uncertainties around the Italian government under Silvio Berlusconi.

2.1. Quantifying statements by European policy makers

We search all news reports from *Reuters* for statements by the EZ's 17 Heads of Government, their respective Finance Ministers, and the four leading EU representatives—the President of the EU Commission José Manuel Barroso, the President of the Euro Group Jean-Claude Juncker, the EU Economics Commissioner Olli Rehn, and the President of the European Council Herman Van Rompuy.

We separate the statements into two groups. In the first group, we collect all statements that refer to the economic situation or austerity measures in the following periphery countries: Italy (IT), Spain (ES), Portugal (PT), Ireland (IE) and Greece (GR). We code each statement, C_t^P, as $+1$ if the statement implies a positive outlook for the specific country or the introduction of new austerity measures, and as -1 otherwise.[1] For example, the Reuters report: "*Italian PM Berlusconi says new agreement on austerity package confirms solidity of ruling coalition*" on August 30, 2011 at 12:44 is coded as $C_t^P = +1$. The second group contains all statements that refer to the EZ as a whole, in particular to the EFSF, Eurobonds, the role of the ECB or the EURO as a currency. We code statements, C_t^{EZ}, as $+1$ when they – broadly speaking – suggest a shared liability for national debts within the EZ, e.g., statements that support the introduction of Eurobonds or the expansion of the EFSF. Statements with content opposed to such ideas are coded as -1. For example, the Reuters report: "*Germany's Merkel says Eurobonds are absolutely wrong*" on September 15, 2011 at 10:47 is coded as $C_t^{EZ} = -1$. We disregard all statements that are either neutral or do not portray a clear message. Overall, Reuters reported 778 statements of which 164 were unanimously quantifiable.[2]

Table 1 provides a summary of the statements. Among the 164 statements, 77 (87) refer to the periphery countries (the EZ as a whole). 101 (or 62%) of the statements are coded as being positive ($+1$). Interestingly, for the EZ positive and negative statements are almost balanced. On the contrary, 75% of the statements referring to the periphery countries are positive. Since these countries are at the center of the debt crisis, the high number of *positive* statements might be surprising at first sight. However, this can be explained by the fact that a large share of these statements refers to the introduction of new austerity measures. Finally, among the statements that refer to the periphery countries the majority are related to Italy (37) and Greece

[1] This approach of coding statements is commonly referred to as Content Analysis and has been used by, among others, Ehrmann and Fratzscher (2007) and Conrad and Lamla (2010) for analyzing the effects of central bank communication.

[2] Although this means that only 21% of the statements are used in the empirical analysis, we thereby avoid problems of potential misclassification. Further, we excluded multiple communications that were released at the same time or communications that we pure announcements of, e.g, a further summit.

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