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Contagion of the eurozone debt crisis

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ABSTRACT

This paper examines the contagion of the eurozone debt crisis to developed and emerging stock markets around the world. Using the VAR methodology, and changes in sovereign bond yields and stock returns of the crisis countries as proxies for the eurozone debt crisis, this paper finds strong and pervasive evidence of negative contagion from the crisis countries to other stock markets. Consistent with risk-on risk-off hypothesis, changes in sovereign bond yields of crisis countries impact stock returns positively during normal times and negatively during the crisis, providing strong evidence of negative contagion. The impact of equity returns of crisis countries on other equity markets is large and positive during normal times and less positive during the crisis, suggesting evidence of negative contagion and decoupling of stock markets during the crisis. The Asian markets do not show pervasive evidence of contagion from the eurozone crisis.

1. Introduction

The eurozone debt crisis has been the dominant economic and financial event in the most recent economic history of the world. This crisis is primarily about unsustainable budget deficits and government debt of a number of eurozone nations, and as such this is the first experience with an economic crisis in a currency union in the modern history of the world. Concerns about an impending debt crisis began to surface around November 2009 after Greece announced previously undisclosed large budget deficits. Over the subsequent three years, deficit and debt concerns spread to Ireland, Portugal, Italy, Spain and Cyprus. Greece, Ireland and Portugal received bailouts by the IMF and the European Commission. The crisis-hit countries began implementing various financial and economic reforms that include large austerity programs. The most visible facets of the crisis have been sharp increases in sovereign bond yields of crisis countries (see Fig. 1), stock market volatility (see Fig. 2), and anti-austerity protests and social unrests. Concerns over possible break-up of the eurozone and the high sovereign bonds yields began to dissipate in July 2012 with the promise by the ECB president Mario Draghi to do "whatever it takes to preserve the euro."

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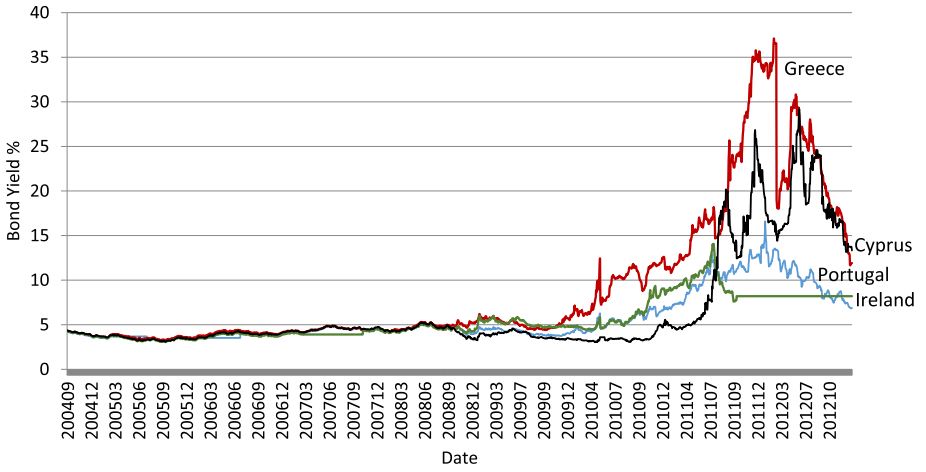

Fig. 1. Daily sovereign bond yields of crisis countries (November 2004–December 2012).

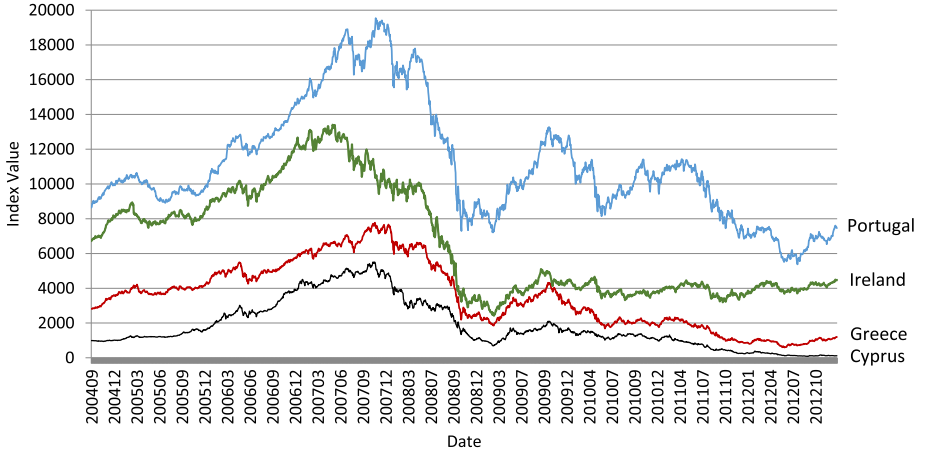

Fig. 2. Daily stock market indices of the crisis countries (November 2004–December 2012).

The eurozone debt crisis provides a unique opportunity to examine the spillover of a debt crisis associated with a currency union to equity markets around the world. Specifically, this study raises the following empirical questions. How did the eurozone debt crisis affect stock markets around the world? Is there evidence of contagion of the debt crisis to other markets? If so, what is the nature and magnitude of such contagion? By investigating these questions, this paper sheds light on the impact of the eurozone debt crisis on all developed and emerging stock markets.

The importance of understanding the nature and the extent of contagion of the eurozone debt crisis has been underscored out by many researchers and policy makers. Glover and Richards-Shubik (2014) point out that existing assessments of contagion in the European debt crisis are limited and primarily descriptive in nature and that quantifying the risk of such spillovers is necessary to assess whether the benefits of a sovereign bailout outweigh the costs. Black et al. (2013) also point out that understanding contagion is crucial given that sovereign defaults potentially pose systemic risks to banks and the overall financial system. Constancio (2012) emphasizes that contagion is crucial for policy-making, and that crisis management by all competent authorities should focus on the policy measures that are able to contain and mitigate contagion. Further, Missio and Watzka (2011) highlight that identification of contagion effects are crucial for the choice and timing of policy intervention. Hence, a study of contagion of the eurozone debt crisis enhances our understanding of the magnitude and effects of spillover of debt crisis to other countries and provides important insights into the design of appropriate policy measures to deal with such crisis.

Contagion has been defined in much of the empirical literature as a significant increase in cross-market linkages after a shock to one market or group of markets.[2] Consistent with literature, this paper defines contagion as the incremental impact of

[2] See, for example, Forbes and Rigobon (2002) and Bekaert et al. (2005).

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