Chapter 16
After 2008 Global Financial Crisis, Short–Term Dynamics of CDS, Bond, and Stock Markets in South Eastern European Economies: Evidence from Panel VAR Methodology

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ABSTRACT
Credit risk pricing is perhaps an understudied topic in comparisons to its profound impact on the world’s financial markets and economies. This study uses established price discovery techniques to develop a method of price discovery for credit risk in three financial markets: equity, debt, and credit derivative. This chapter is motivated by the development of credit-related instruments and signals of stock price movements of South-Eastern European countries—Bulgaria, Croatia, Greece, Hungary, Romania, Slovenia, Slovakia, and Turkey—during the recent financial crisis. In this study, the authors evaluate the dynamics of fiscal risk or country risk measured by sovereign Credit Default Swap (CDS), liquidity risk measured bond markets, and stock markets for the monthly based September 2008 – February 2011 period. The study examines monthly data observing 38 months and 8 countries. A panel vector autoregression model is proposed for changes in Long-Term Interest Rate (LTIR), changes in CDS spreads (CDS), and changes in stock index. In conclusion, CDS markets and stock markets are more significant than bond markets in explaining the post-crisis relationship among developing South-Eastern European countries. The analysis displays that long-term monetary policy did not affect CDS premium and stock index level. A strong relationship is found between the CDS spread and stock market. During financial

DOI: 10.4018/978-1-4666-3006-2.ch016
INTRODUCTION

Following mortgage credit debt crisis in August 2007, credit markets have witnessed an unprecedented repricing of credit risk. This credit market crisis has affected all sectors. This financial market turbulence reached a peak in the wake of the collapse of Lehman Brothers in September 2008. After this extremely devastating event, many major banks in the US, Euro area, Non-Euro area, and Asia countries were in major distress and massive state intervention was required in order to mitigate systemic risk and its adverse macroeconomic consequences.

During the last financial crisis, government exposure to weakness in the financial sector may have also become a factor in explaining sovereign spreads in the world. Developed and developing countries’ governments have committed large resources to guarantee financial institutions, thereby establishing a potentially important link between financial sector distress and public sector bailouts.

First the global economic crisis began in US and the Dollar fell in value with respect to other currencies. When the crisis reached Europe it effected European economies and weakened the paper currencies in European countries, resulting in a relative increase in the Dollar. Thereby the Dollar rise is relative to the weakness of the European economies. The greater the impact of the crisis on an economy the more its currency will fall relative to other currencies.

Since the beginning of the financial crisis, Euro area sovereign risk premium differentials have been widening, depending on US based investment banks and hedge funds has switched investments to US economy instead of other economies to support US domestic financial systems. Although the perceived risk of default for Euro area countries remains generally low, financial markets appear to have been increasingly discriminating among government issuers while requiring overall higher risk premiums. In particular, the spreads on the yield on Euro area members’ 10-year government bonds accompanied by downgrades of sovereign debt ratings for three countries: Greece, Spain, and Portugal.

The global financial and economic crisis placed again in the centre of attention on the EU stability in the beginning of 2009 and expansion of the Euro area, on monetary and fiscal integration of new countries and their resistance to various types of shocks. In the few years before the onset of the crisis, the EU enlargement moved without significant disruptions and according to the institutional frameworks needed for the next step - the enlargement of the euro zone. The main theoretical discussion was limited generally to the question of how different types of monetary and exchange rates regimes are able to fulfill criteria for nominal and real convergence and to protect against asymmetric shocks. As a rule, the monetary policies of the EU new member states closely followed the ECB’s inflation targeting, or currency boards or quasi fixed exchange rate policies. The convergence of monetary variables, particularly interest rates was relatively well developed, and generally satisfactory nominal integration was observed. This concerned especially the interbank money market for interbank risk and for overall confidence in the banking system (Chobanov, Lahiani and Nenovsky, 2010).

Several interesting theoretical and practical issues appear. First one is, whether there is a link in the EU new member states and Balkan countries between expectations about the condition of the public finances and the dynamics of money markets, including integration of their money markets.