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An Analysis on the Recent European Sovereign Debt Crisis: How Are Assets Prices Related?

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Abstract

At the end of 2009, just when global economy is gradually getting rid of the turmoil from the US sub-prime mortgage crisis and slowly moving to recovery, another serious debt crisis has swept the whole Europe before the financial crisis' dropping away. Europe's economy recovery has been overshadowed by the debt crisis in PIIGS of euro zone. Serious budget deficits and government debt problems in PIIGS are far higher than the limits laid down by the Stability and Growth Pact. Many studies believe current debt problems are related to the global economic downturn, and the collapsed confidence on the chronic fiscal deficits and accumulating debts in these countries. There is less concern on the roles of financial markets and assets prices in current literature. To investigate the relationship of assets prices and sovereign debt crisis, this paper constructs sets of debt crisis index. This study applies pooled mean group (PMG) estimators to explore relationships among variables representing assets prices and economic fundamentals. On the analysis of economic fundamentals, empirical results suggest a country with long-run economic growth is related to lower probability of debt crisis, and a country with chronic indebtedness is related to higher probability of debt crisis, but in short run the relationships are ambiguous and may be reversed. On the analysis of assets prices, the empirical results suggest a country with long-run increasing prices on equity assets is related to lower probability of debt crisis, and a country with long-run increasing prices on the housing is related to higher probability of debt crisis.

Keywords: sovereign debt crisis, financial assets, pooled mean group estimator

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