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Abstract

The European economy was hit by a confidence shock in 2009 when the Greek government of Papandreou discovered the true amount of public deficit. The subsequent loss of trust in European fiscal governance reduced financial markets' willingness to lend to indebted governments. The European Union established the Financial Stability Facility to support debt-ridden states but without lasting success. The continuously rising Greek bond yields suggest that the information transmitted from political leaders did not reduce investors' risk perceptions. We develop a theoretical framework, in which financial market participants do not know the real rate of return on Greek assets but infer it from the signals emitted by informed European governments. Based on a unique news dataset, we investigate the impact of good and bad news from the European institutions on the Greek interest spread. The results demonstrate that the noise around the European decision-making process substantially raised the bailout cost.

Keywords: Sovereign debt bailout ▪ Euro Area ▪ Greek crisis ▪ political communication ▪ Garch models

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