The Sovereign Debt Crisis: Flights or Market Freezes?

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Abstract

This paper examines trading behavior in the European sovereign bond markets. Using high-frequency data we document that episodes of market turmoil are associated with large increases in trading costs. On average, in times of turmoil trading volume falls. The response in trading volume to market stress is conditional on transaction costs. Low transaction cost turmoil episodes are associated with volume increases (investors rebalance), while high transaction cost turmoil periods are associated with abnormally low volume (market freezes). Overall, our results suggest that the recent sovereign debt crisis was not associated with large-scale investor flights.