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Systemic Sovereign Risk: Macroeconomic Implications in the Euro Area

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Concerns over containing or reducing the perceived riskiness of sovereigns have been an important driver of recent policy debates in advanced economies - motivating fiscal consolidation and, in Europe, central bank intervention. However, despite the relevance for such policies, there is not a breadth of empirical evidence describing what happens to economic activity when the sovereign government's cost of borrowing changes. Furthermore, there remains uncertainty over the relative importance of the various channels which drive any pass-through from a sovereign's borrowing costs to the real economy.

The challenge with any empirical study addressing these issues is determining causality. For example, it could be that a rise in the riskiness of the sovereign is itself a reaction to economic weakness and a worsening the fiscal outlook. Alternatively, a loss of confidence on the part of investors could undermine the budget and damage the economy. This paper is concerned with addressing this causality issue and providing a quantitative assessment of the causal macroeconomic impact of a change sovereign borrowing costs.

Specifically, I focus attention on a sample of four countries that experienced elevated and variable sovereign borrowing costs during the recent financial crisis in Europe. To address causality, I rely upon high frequency bond market reactions to events I can plausibly argue to be exogenous of local economic conditions; namely, contagious political events that happened abroad. For example, the immediate market reaction of the Italian bond yield to a vote in the Greek parliament is not causally linked to contemporaneous Italian economic shocks. To do this on a systematic basis, the paper builds a new narrative dataset of key, country specific events in crisis-hit economies over the crisis period.

The results can be summarized as follows. First, I show that the macroeconomic consequences of changes in sovereign borrowing costs were sizeable: they were a critical driver of recent unemployment dynamics among the sample countries, explaining a substantial proportion of the recent increase in unemployment and close to 40% of the variation.

Second, I document the pass through of the sovereign's cost of borrowing onto the private financial system. I show that 20-40% of the variance in a composite measure of private borrowing costs was due to fluctuations in sovereign risk. Although the results are conditional on the policy regime in place, this evidence does support the notion that measures to insulate the private financial system from the riskiness of the sovereign is an important part of diminishing the macroeconomic impact.

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Third, I conduct a counterfactual analysis and ask: what would the sovereign bond yield have been absent the identified impact from events in other countries. I find that 40-60% of the trough to peak move in borrowing costs across my sample of crisis-hit countries was a result of innovations external to the local economy. This effect peaked in July 2011 at the height of the crisis. However, from a policy perspective, the ECB interventions in the Summer/Autumn of 2012 appear to have been effective: by the end of that year, yields appear to be at a neutral setting in line with local macroeconomic conditions.