BANK AND SOVEREIGN RISK INTERDEPENDENCE IN THE EURO AREA

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We develop a dynamic stochastic general equilibrium model to study bank risk and sovereign risk interdependence in the Euro Area. We find that an increase in capital investment risk shock, results in a considerably deeper recession when sovereign risk is also present. This result has three policy implications. First, Euro Area policies dealing with failing banks aggravated the recession. Second, although there has been a supranational effort with the creation of the EFSF/ESM to provide loans to sovereigns, as long as there is no direct mechanism for financial sector rescues, Euro Area policies continue to exacerbate the recession. Third, in favor of austerity measures used in the EA, we find that government spending multipliers are smaller in the presence of sovereign risk.

The full working paper can be found here.