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Sovereign Risk, Bank Funding and Investors' Pessimism*

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Abstract

Evidence shows that sovereign risk increases funding cost and risk of banks highly exposed to it. I build a model that rationalizes this fact. Banks act as delegated monitors and invest in risky projects and in risky sovereign bonds. As investors hear rumors of increased asset risk, they run the bank through an information coordination game. Banks could rollover liquidity in repo market using government bonds as collateral, but as sovereign risk raises collateral values shrink. Overall banks' liquidity falls (its cost increases) and so does banks' credit. The model features a balance sheet, a collateral channel and a liquidity channel of sovereign risk. The latter two play a major role in the fiscal transmission.

JEL classification: E5, G3, E6.

Keywords: liquidity risk, sovereign risk, banks' funding costs.

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