Accepted Manuscript

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PII: S0014-2921(18)30105-3
DOI: 10.1016/j.euroecorev.2018.07.002
Reference: EER 3165

To appear in: *European Economic Review*

Received date: 6 October 2017
Accepted date: 1 July 2018

Please cite this article as: Stéphane Auray, Aurélien Eyquem, Xiaofei Ma, Banks, Sovereign Risk and Unconventional Monetary Policies, *European Economic Review* (2018), doi: 10.1016/j.euroecorev.2018.07.002

Banks, Sovereign Risk and Unconventional Monetary Policies*

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July 9, 2018

Abstract

We develop a two-country model with an explicitly microfounded interbank market and sovereign default risk. Calibrated to the core and the periphery of the Euro Area, the model gives rise to a debt-banks-credit loop that substantially amplifies the effects of financial shocks, especially for the periphery. We use the model to investigate the effects of a stylized public asset purchase program at the steady state and during a crisis. We find that it is more effective in stimulating the economy during a crisis, in particular for the periphery.

Keywords: Recession, Interbank Market, Sovereign Default Risk, Asset Purchases.
JEL Classification: E32, E44, E58, F34.

1 Introduction

In this paper, we analyze the interaction between an integrated interbank market and sovereign default risk using a two-country dynamic general equilibrium model, with a focus on the transmission of the recent financial crisis, and unconventional monetary policies in the Euro Area. Our model is rich of financial interactions in the intermediation process, and gives rise to a sovereign risk / interbank market feedback loop. Calibrated to the Euro Area, the latter amplifies the transmission of a large negative capital quality shock with respect to alternative models with financial frictions, especially for the periphery. We then use our model to assess the potential effectiveness of unconventional monetary policies in the form of an sovereign bonds purchase program. The program is more effective when implemented during a crisis, and stimulates macroeconomic conditions of the periphery more strongly. As such, the welfare gains of the program are larger when the latter is implemented during a crisis, and larger for the periphery.

*We thank the editors Eric Leeper and Florin Bilbiie, the associate editor as well as two anonymous referees for useful remarks that led to substantial improvements of the paper. We also thank Gregory Corcos, Olivier Loisel, Thepthida Sopraseuth and Pedro Teles for insightful feedback. We also appreciate helpful discussions with Jordan Roulleau-Pasdeloup and Antoine Vatan. All errors are our own. The authors gratefully acknowledge financial support of the Chair ACPR/Risk Foundation: "Regulation and Systemic Risk".

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