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The State Dependent Impact of Bank Exposure on Sovereign Risk*

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Abstract

The theoretical literature remains inconclusive on whether changes in bank exposure to the domestic sovereign have an adverse effect on the sovereign risk position through a *diabolic loop* in the sovereign-bank nexus, or reduce perceived default risk by acting as a *disciplinary device* for the sovereign. In this paper we empirically analyze the impact of exogenous changes in bank exposure on the risk position of the sovereign within a Markov switching structural vector autoregressive in heteroscedasticity (MSH-SVAR) framework for a set of EMU countries. We add to the methodological literature by allowing for regime dependent shock transmissions according to the volatility state of the financial system. Finding support for both, a stabilizing and a destabilizing effect, we document a clear clustering among the country sample: Rising bank exposure increased default risk for the EMU periphery, but decreased credit risk for the core EMU countries during times of financial stress.

JEL classification: C32, E44, G10.

Keywords: Markov-switching, heteroscedasticity, identification, sovereign-bank interlinkages, sovereign risk, credit default swap, contagion.

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