

Sovereign Risk and Financial Risk

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This paper examines the evidence on the relationship between sovereign bond spreads, economic activity, and global financial risk. Using an extensive data set of prices of outstanding sovereign bonds trading in the secondary market, we construct a comprehensive country index for sovereign bond spread dataset. Using an empirical framework, we disentangle the intricate relation linking the country sovereign bond spreads, economic fundamentals, and global financial risk index. The global financial risk is proxied by the Gilchrist-Zakrajsek bond spread, VIX index, as well as the CDS spread for major financial institutions. Our results indicate that the global financial risk component accounts for a large fraction of variation in sovereign bond spreads. When the global financial risk is high, sovereign bonds are more risky. Moreover, countries who experience a worse economic condition at the same time face a bigger increase in their financing cost. Furthermore, through the linkage between sovereign bond spreads and the domestic economy, the global financial risk in turn affects the macroeconomic variables significantly. We construct a general equilibrium model of sovereign debt and default to rationalize the empirical findings. The model features include risk-averse global investor, optimal default, and endogenous output dynamics for multiple countries. The sovereign default and bond prices depend on the borrower's economic conditions as well as the lender's risk aversion and riskiness. The sovereign default and spreads in turn affect the business cycles in borrowing countries in the model.

References

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