What Is The Relation Between Systemic Risk Exposure and Sovereign Debt?

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Abstract

Using new risk measurement techniques such as Adapted Exposure CoVaR and Marginal Expected Shortfall (MES), we show that the aggregate systemic risk exposure of financial institutions is positively related to sovereign debt yields in European countries. We find evidence of a simultaneous relation between systemic risk exposure and sovereign debt yields. This finding suggests that models of sovereign debt yields should also include the systemic risk of a country's financial system in order to avoid potentially important mis-specification errors. Further, we find a "flight to quality" effect where increased systemic risk exposure in financially troubled European countries leads to lower sovereign debt yields in economically stronger nations such as Germany, the U.K., and France. This effect on sovereign debt yields occurs despite the finding that increased systemic risk exposure in weaker nations has a positive spillover effect on other European nations' financial systems and leads to greater systemic risk exposure throughout Europe. Thus, the riskiness of a country's financial institutions and its sovereign government are inter-related and suggests there are multiple ways for risk spillovers to occur.

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