# Sovereign risk, macroeconomic instability

Giancarlo Corsetti   Gernot Müller

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*With sharply rising sovereign risk spreads, few governments can consider their public finances beyond doubt. This column explores the macroeconomic consequences of austerity when sovereign risk is high.*

The case for immediate fiscal consolidation in Europe and elsewhere has become stronger in the last few months as financial market pressures have intensified. Some may argue that fiscal tightening is exactly the wrong policy at a time of weakening aggregate demand – especially when central banks cannot provide much extra stimulus. This thinking echoes St. Augustine's classic prayer: "*Da mihi castitatem et continentiam, sed noli modo*" ("Grant me chastity and continence, but not yet"). Governments should commit to effective adjustment in the medium run but pursue additional stimulus today (IMF 2011a, 2011b).

However, commitments alone are unlikely to be credible, and hence sufficient, in all countries. Thus, the dampening effect on output from some upfront fiscal tightening has to be weighed against the risk of inaction.

Recent experience in the Eurozone clearly shows that investor concerns about government solvency can emerge very suddenly, driving up funding costs and potentially plunging countries into a full-blown fiscal crisis (see, e.g., Pagano 2010, Wyplosz 2011).

## Sovereign risk and macroeconomic instability

The case for avoiding such dynamics through upfront consolidation measures gets even stronger once the link between sovereign risk and macroeconomic instability is recognised. We take up this issue in ongoing work with André Meier and Keith Kuester (Corsetti et al. 2011).

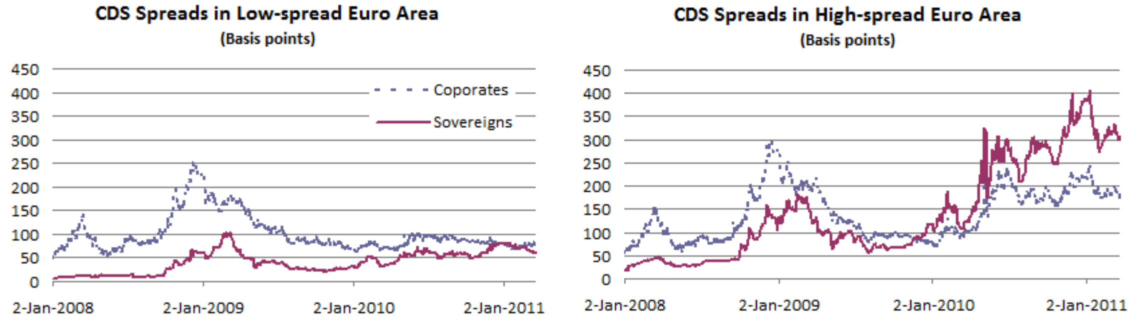
Our starting point is the observation that sovereign default risk – reflected by rising interest rate spreads – spills over to the rest of the economy. It affects adversely borrowing conditions in the private sector. These spillovers constitute a distinct channel through which fiscal policy impacts the economy, the "sovereign-risk channel". Through this channel, increasing sovereign risk may expose the broader economy to the risk of a self-fulfilling crisis as "expectations become unanchored".

In what follows, we discuss when and how this unpleasant scenario may arise. Economies are most vulnerable when sovereign risk is high and, in addition, the central bank is constrained in its capacity to lower interest rates (by the zero lower bound or by an exchange rate peg).

## Evidence for the sovereign-risk channel

We begin by providing some evidence on the sovereign-risk channel. For the Eurozone countries, the panels in Figure 1 display time-series data on credit default swap spreads for sovereign debt (solid line) and non-financial corporate debt (dashed line). The two panels distinguish between countries with relatively low sovereign spreads (Austria, Finland, France, Germany, and the Netherlands) on the left; and high-spread countries (Belgium, Greece, Italy, Portugal, and Spain) on the right.

**Figure 1** Credit default swap spreads in the Eurozone




The time series show substantial co-movement between sovereign and private sector spreads – especially in countries that face fiscal strain (right panel). Importantly, the evidence in Figure 1 may still understate the strength of the sovereign-risk channel, as most of the corporations in the underlying sample are large international players with direct access to bond markets. Such companies can free themselves to a greater extent from their national sovereign than smaller firms that rely on local bank financing.

The findings documented in Figure 1 square well with the fact that government bond yields have typically been considered a benchmark for broader financing conditions in a country – as prominently embedded in the notion of a ”sovereign ceiling". To be sure, causation may not only run from sovereign to corporate risk, but in many Eurozone countries currently in the spotlight there is little doubt that otherwise healthy non-financial corporations are weighed down by concerns about their sovereign, rather than the other way around.

## Unpleasant implications for macroeconomic stability

To explore the implications of the sovereign-risk channel, we use a variant of the model suggested by Curdia and Woodford (2009), in which private credit spreads rise with sovereign risk, as strained public finances imply a greater threat from taxation. While this is not the only possible way of envisioning spillovers via the sovereign-risk channel, it allows us to represent our idea in terms of a simple variant of the canonical New Keynesian model. In this model, aggregate demand falls with an increase in sovereign risk, unless monetary policy manages to offset the effect on private sector funding costs via a cut in the policy rate.

The normal operation of monetary policy may, however, be hampered when nominal rates are near zero. Under these circumstances, sovereign risk becomes a severe source of macroeconomic instability. The reason is straightforward.

- Suppose that private expectations about the economy turn gloomier for some (non-fundamental) reason; firms and households expect demand to fall.
- Such expectations, in turn, imply an upward revision of the projected government deficit, as weaker economic activity leads to lower tax revenue.
- Investors thus ask for a higher risk premium on public debt and, via the sovereign-risk channel, on private debt as well.
- The logic comes full circle as higher credit costs slow down activity, validating the initial adverse shift in expectations.

Under normal circumstances, this scenario of a self-fulfilling crisis can arguably be averted by a commitment of the central bank to appropriately adjust policy rates. Specifically, the central bank can stem the link between public and private credit conditions through interest rate cuts or other measures, preventing pessimistic expectations from coming true. To the extent that monetary policy is constrained, however, these expectations may become self-fulfilling if sovereign risk is high.

## Conclusion: The case against counter-cyclical fiscal policy

This consideration turns on its head the usual case for counter-cyclical fiscal policy when the central bank has little or no further room for monetary stimulus. At times of intense financial market pressure – with high risk premia on government debt – the use of expansionary fiscal stimulus is bound to worsen the fiscal outlook and, hence, jeopardise macroeconomic stability. Any desirable stimulus effects are likely to be offset by the negative impact of the sovereign-risk channel – unless the government is able to commit immediately and credibly to medium-term consolidation measures that eradicate sovereign risk at its roots.

To the extent that this seems difficult to achieve under the current circumstances, it seems instead advisable to reduce fiscal deficits even in the face of a demand contraction. Our work formalises this argument and evaluates its quantitative relevance.

In our model the most adverse effects of the sovereign risk channel materialise for levels of public debt beyond 100% of GDP. Admittedly, in our quantitative exercises we link risk premia only to the expected path of public debt and deficit – while abstracting from a number of factors which may also impact on markets' assessment of sovereign risk.

Yet, in light of the actual debt accumulation of several Eurozone members, our findings lend support to the view that immediate fiscal consolidation may be the lesser of two evils for many countries right now.

## References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