

# Sovereign and Financial Credit Risk

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**Viral V. Acharya**  
NYU Stern Finance  
(Half) Ph.D. Course  
Fall 2015 (1st Half)

## **Meetings:**

Thursdays 12:30-3:30pm in Gruber Conference Room.

The meetings will take place on Sep 10, Sep 17, Sep 24, Oct 8, Oct 15, and Oct 22.

NOTE THERE IS NO CLASS ON Oct 1.

There will be an ORGANIZATIONAL meeting Sep 3 during 12:30-1:30pm.

## **Overview:**

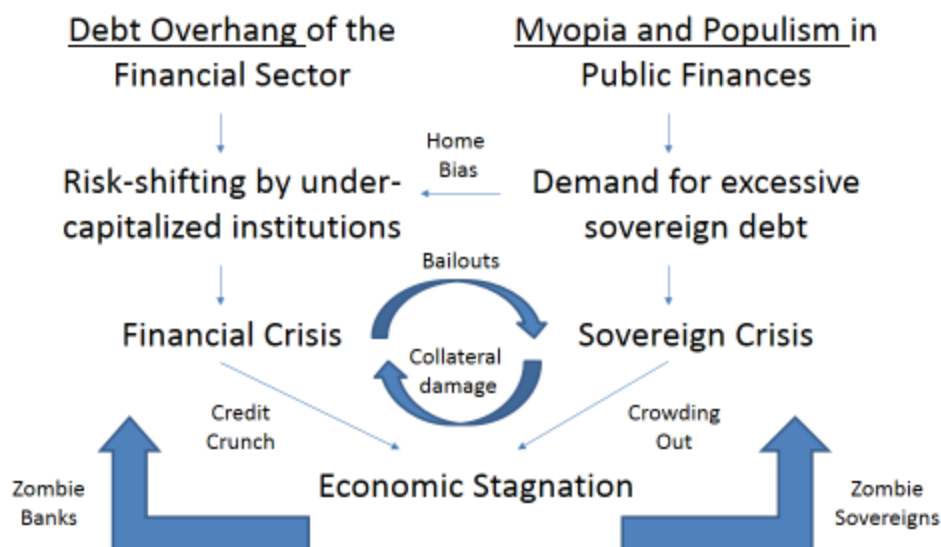
The objective of this course is to provide theoretical and empirical foundation for the nexus of credit risk between financial sector and sovereigns. This nexus has recently been at the heart of the ongoing sovereign and financial sector crises in Europe, while historically having been a greater focus in study of emerging market debt crises.

The course will focus on

- (1) Providing micro-foundations of sovereign debt given that there is no explicit institutional structure such as bankruptcy code which allows creditors to extract repayments, and how political economy considerations such as government myopia and populism affect the demand and nature of sovereign debt ;
- (2) Understanding how credit risk migrates from the financial sector to the sovereign and vice-versa, in what is increasingly being called the “unholy nexus” or “doom loop” or the “diabolical loop”;
- (3) Tying this nexus to micro-foundations of sovereign debt repayments as well as to incentives of highly-leveraged intermediaries such as banks;
- (4) Tracing out the real-sector consequences of this nexus and isolating the channel through which it affects the real-sector; and,
- (5) Finally, studying the efficacy of regulatory interventions that have been designed such as the regulatory stress tests of banks, design of risk weights in bank capital requirements, and unconventional monetary policy and lender-of-last-resort actions of central banks.

The ultimate objective is to make sense of the following flow-chart of risks and their sources, from my forthcoming Toulouse Lectures in Economics on “The Nexus Between Financial Sector and Sovereign Credit Risks”.

# Summary



## Structure of Meetings and Evaluation:

Several of the in-class presentations will be done by Viral Acharya; a few by his doctoral student, Matteo Crosignani; and the rest by the students enrolled in the course. We will sort out who presents what at the organizational meeting.

Regardless of the presentation, all enrolled or attending the course will be required to write a high-quality literature survey of up to 10 pages covering any one of the six sessions and the related papers (included below or otherwise). The survey will be due one week after the course is over, so on Oct 29.

The grade for the course will be based on assessment of this survey.

Those presenting on top of doing the survey will get a group dinner out of me! ☺

## **Week 1: Micro-foundations for Sovereign Debt Repayment**

Course overview by Viral Acharya

Students will present paper(s) based on the following literature:

1<sup>st</sup> half of class:

- EATON, J. AND M. GERSOVITZ (1981), "Debt with Potential Repudiation: Theoretical and Empirical Analysis", *The Review of Economic Studies*, 48, 2, 289-309.
- BULOW, J. AND K. ROGOFF (1989), "A Constant Recontracting Model of Sovereign Debt", *Journal of Political Economy*, 97, 11, 155-178.
- BULOW, J. AND K. ROGOFF (1989), "Sovereign Debt: Is to Forgive Forget? ", *American Economic Review*, 79, 1, 43-50.

2<sup>nd</sup> half of class:

- BRONER, F., A. MARTIN, AND J. VENTURA (2010), "Sovereign Risk and Secondary Markets", *American Economic Review*, 100, 1523-1555.
- DU, W. AND J. SHREGER (2015), "Sovereign Risk, Currency Risk, and Corporate Balance Sheets", *Working Paper*.

## **Week 2: Sovereign and Financial Sector Nexus: Role of Government Myopia**

Viral Acharya will present

1<sup>st</sup> half of class:

- ACHARYA, V. V. AND R. G. RAJAN (2013), "Sovereign Debt, Government Myopia, and the Financial Sector", *Review of Financial Studies*, 26, 1526-1560.

2<sup>nd</sup> half of class:

- ACHARYA, V. V. AND R. G. RAJAN (2015), "Dynamics of Growth, Debt and Taxation", *Work In Progress*.

Recommended related literature:

- BOLTON, P. AND O. JEANNE (2011), "Sovereign Default Risk and Bank Fragility in Financially Integrated Economies", *IMF Economic Review*, 59, 162-194.
- GENNAIOLI, N., A. MARTIN, AND S. ROSSI (2014): "Sovereign Default, Domestic Banks, and Financial Institutions", *Journal of Finance*, 69, 819-866.
- UHLIG, H. (2013), "Sovereign Default Risk and Banks in a Monetary Union", *German Economic Review*, 15, 23-41.

### **Week 3: Sovereign and Financial Sector Nexus: Banking Crises and Bailouts**

Viral Acharya will present

1<sup>st</sup> half of class:

- ACHARYA, V. V., I. DRECHSLER, AND P. SCHNABL (2014), "A Pyrrhic Victory? Bank Bailouts and Sovereign Credit Risk", *Journal of Finance*, 69, 2689-2739.

Matteo Crosignani will present

2<sup>nd</sup> half of class:

- CROSIGNANI, M. (2015): "Why Are Banks Not Recapitalized During Crises?," *Working Paper*.

Recommended related literature:

- BRUNNERMEIER, M. K. (2015), "Diabolic Loop between Sovereign and Banking Risk", *G7 Bundesbank and BMF Panel Discussion*.
- FARHI, E. AND J. TIROLE (2014), "Deadly Embrace: Sovereign and Financial Balance Sheets Doom Loops," *Working Paper*.
- GENNAIOLI, N., A. MARTIN, AND S. ROSSI (2014): "Banks, Government Bonds, and Default: What Do the Data Say?" *Working Paper*.

### **Week 4: Sovereign and Financial Sector Nexus: Bank and Regulatory Moral Hazard**

Viral Acharya will present

1<sup>st</sup> half of class:

- ACHARYA, V. V. AND S. STEFFEN (2015), "The Greatest Carry Trade Ever? Understanding Eurozone Bank Risks", *Journal of Financial Economics*, 115, 215-236.

2<sup>nd</sup> half of class:

- ACHARYA, V. V., R. ENGLE, AND D. PIERRET (2014), "Testing Macro-prudential Stress Tests: The Risk of Regulatory Risk Weights", *Carnegie-Rochester Public Policy Conference Volume of the Journal of Monetary Economics*, 65, 36-53.

Recommended related literature:

- KORTE, J. AND S. STEFFEN (2015), "Zero Risk Contagion - Banks' Sovereign Exposure and Sovereign Risk Spillovers", *Working Paper*.

## **Week 5: Real Effects of Sovereign Crises: Active and Passive Banking Channels**

Viral Acharya will present

1<sup>st</sup> half of class:

- ACHARYA, V. V., T. EISERT, C. EUFINGER, AND C. HIRSCH (2015): "Real Effects of the Sovereign Debt Crisis in Europe: Evidence from Syndicated Loans," *Working Paper*.

Students will present paper(s) based on the following literature:

2<sup>nd</sup> half of class:

- BOCOLA, L. (2015), "The Pass-Through of Sovereign Risk", *Working Paper*.
- PEREZ, D. J. (2015), "Sovereign Debt, Domestic Banks and the Provision of Public Liquidity", *Working Paper*.
- BOFONDI, M., L. CARPINELLI, AND E. SETTE (2013): "Credit Risk Supply During a Sovereign Debt Crisis," *Working Paper*.
- BECKER, B. AND V. IVASHINA (2014), "Financial Repression in the European Sovereign Debt Crisis," *Working Paper*.
- POPOV, A. A. AND N. VAN HOREN (forthcoming), "Exporting Sovereign Stress: Evidence from Syndicated Bank Lending During the Euro Area Crisis", *Review of Finance*.

## **Week 6: The Impact of Central Bank Interventions During Sovereign Crises**

Viral Acharya will present

1<sup>st</sup> half of class:

- ACHARYA, V. V., T. EISERT, C. EUFINGER, AND C. HIRSCH (2015): "Whatever it Takes: The Real Effects of Unconventional Monetary Policy", *Work In Progress*.

Matteo Crosignani will present

2<sup>nd</sup> half of class:

- CROSIGNANI, M., M. FARIA-E-CASTRO, AND L. FONSECA (2015), "Central Bank Interventions, Demand for Collateral, and Sovereign Borrowing Costs", *Working Paper*

Recommended related literature:

- ANDRADE, P., CAHN, C., FRAISSE, H., AND J. MESONNIER (2015) "Can the Provision of Long-Term Liquidity Help to Avoid Credit Crunch?" Evidence from the Eurosystem's LTROs", *Working Paper*.
- TREBESCH, C. AND J. ZETTELMEYER (2014) "ECB Interventions in Distressed Debt Markets: The Case of Greek Bonds", *Working Paper*.