What Makes Systemic Risk Systemic? Contagion and Spillovers in the International Sovereign Debt Market

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Summary

The recent U.S. subprime crisis and the subsequent European debt crisis have had adverse consequences for sovereign borrowers around the world. Spreads on credit default swaps (CDS) written on sovereign names rose sharply at the time of the Lehman default in September 2008 and again in 2011 during the height of the debt crisis in the euro area. This study seeks to examine the mechanisms by which such credit crises spread to sovereign borrowers in different parts of the world.

To do so, we distinguish between two views of the cross-border propagation mechanism of systemic risk. The first is the contagion mechanism in which the realization of a shock to one country triggers a cascade of falls in other countries. The second is the systemic spillover effect across countries when common shocks occur. Both mechanisms have been associated with financial crises. In this paper, we examine both mechanisms, using event studies to analyse the contagion mechanism and using factor analysis to analyse the common shock mechanism.

We find strong evidence of intra-regional credit contagion stemming from specific sovereign credit events. Occasionally credit events do lead to global contagion but for the most part "fast and furious" contagion appears to be a regional phenomenon. In our sample period, we find these episodes of regional contagion to be concentrated in the period between 2010 and 2012, the very period in which the European sovereign debt crisis was unfolding. The common global risk factor does rise during this period when there was a high incidence of contagion, suggesting that the mechanism for global spillover effects played a key role in transmitting the recent debt crisis.