

Conditional euro area sovereign default risk*

André Lucas[†], Bernd Schwaab[‡], Xin Zhang[§]

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Abstract

We propose an empirical framework to assess the likelihood of joint and conditional sovereign default from observed CDS prices. Our model is based on a dynamic skewed-t distribution that captures all salient features of the data, including skewed and heavy-tailed changes in the price of CDS protection against sovereign default, as well as dynamic volatilities and correlations that ensure that uncertainty and risk dependence can increase in times of stress. We apply the framework to euro area sovereign CDS spreads during the euro area debt crisis. Our results reveal significant time-variation in distress dependence and spill-over effects for sovereign default risk. We investigate market perceptions of joint and conditional sovereign risk around announcements of Eurosystem asset purchases programs, and document a strong impact on joint risk.

Keywords: sovereign credit risk; higher order moments; time-varying parameters; financial stability.

JEL classifications: C32, G32.

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[†]VU University Amsterdam and Tinbergen Institute, De Boelelaan 1105, 1081 HV Amsterdam, The Netherlands, Email: a.lucas@vu.nl.

[‡]Financial Research, European Central Bank, Kaiserstrasse 29, 60311 Frankfurt, Germany, Email: bernd.schwaab@ecb.int.

[§]Research Division, Sveriges Riksbank, Brunkebergstorg 11, SE 103 37 Stockholm, Sweden, Email: xin.zhang@riksbank.se.