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ARTICLE

A Pyrrhic Victory? Bank Bailouts and Sovereign Credit Risk

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ABSTRACT

We model a loop between sovereign and bank credit risk. A distressed financial sector induces government bailouts, whose cost increases sovereign credit risk. Increased sovereign credit risk in turn weakens the financial sector by eroding the value of its government guarantees and bond holdings. Using credit default swap (CDS) rates on European sovereigns and banks, we show that bailouts triggered the rise of sovereign credit risk in 2008. We document that post-bailout changes in sovereign CDS explain changes in bank CDS even after controlling for aggregate and bank-level determinants of credit spreads, confirming the sovereign-bank loop.

Supporting Information

Additional Supporting Information may be found in the online version of this article at the publisher's website:

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jofi12206-sup-0001-Appendix.pdf 408.9 KB	**Appendix S1**: Internet Appendix.

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