

Sovereign risk and macroeconomic stability in the euro area

Giancarlo Corsetti, Keith Kuester, André Meier and Gernot Mueller

Abstract

Sovereign risk premia have risen sharply in several European countries, contributed to increased credit spreads in the private sector. If monetary policy cannot offset these credit spreads because it is constrained by the zero lower bound, sovereign risk threatens macroeconomic stability: private-sector beliefs of a weakening economy may become self-fulfilling. In this paper, we put forward a two-country model of a monetary union featuring a "sovereign risk channel" and analyze how sovereign risk affects macroeconomic stability. We explore to what extent a) fiscal austerity and b) measures to pool sovereign risk are suited to contain sovereign risk and restore macroeconomic stability.