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Self-fulfilling dynamics: The interactions of sovereign spreads, sovereign ratings and bank ratings during the euro financial crisis

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ABSTRACT

During the euro-area financial crisis, interactions among sovereign spreads, sovereign credit ratings, and bank credit ratings appeared to have been characterized by self-generating feedback loops. To investigate the existence of feedback loops, we consider a panel of five euro-area stressed countries within a three-equation simultaneous system in which sovereign spreads, sovereign ratings and bank ratings are endogenous. We estimate the system using two approaches. First we apply GMM estimation, which allows us to calculate persistence and multiplier effects. Second, we apply a new, system time-varying-parameter technique that provides bias-free estimates. Our results show that sovereign ratings, sovereign spreads, and bank ratings strongly interacted with each other during the euro crisis, confirming strong doom-loop effects.

Keywords: euro area financial crisis, sovereign spreads, rating agencies
JEL Classification: E63, G12

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