1 Robustness checks

This section contains a series of robustness checks for the results presented in the paper both at a daily and a monthly frequency.

1.1 Daily frequency

At a daily frequency results remain unchanged if we allow for eight lags of the controls instead of four. Moreover, the domestic and international results remain robust to using either CDSITA03 or CDSITA14 as an instrument and indicator variable, denominated in euros or dollars. Domestic results are also robust to removing from the list of selected dates those for European elections and for the submission to the European Commission of the draft budget because they are common to all the euro-zone countries (the baseline results for the spillover effects – see Section 6.4 of the paper – are already derived by excluding those dates). In addition, as a robustness exercise for both the CDS spread and the 10-year bond yield spread relative to the Bund, we report results in which we have been more drastic in reducing the list of dates using in constructing our instrument. More specifically, we removed from our instrument all dates that fall in a 2-sided window of seven days centered around election dates of other euro countries (47 events in total), the Brexit referendum and other key events in the Brexit process (32 additional events). The domestic daily results are also robust to this robustness exercise, but to limit the length of the Online Appendix, we have only included the results for the spillover effects. Furthermore, for all results at a daily frequency, the
estimated impulse response functions are virtually unchanged if we employ a Cholesky identification strategy and order our instrument after the VIX and the first principal component of euro-zone countries’ CDS spreads, and before the other financial variables. Finally, the domestic results at a monthly frequency are invariant to using the average of the last 5-days or the monthly average instead of the end of period observation.

1.1.1 Additional number of lags

At a daily frequency results remain unchanged if we allow for eight lags of the controls instead of four. In this section we present both domestic and international results.

Figure 1: Financial variables: impulse responses at a daily frequency, 8 lags

Impulse response functions of financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 8 lags of the instrument and all the endogenous variables and the present together with 7 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 2: Redenomination spread and quanto spread: impulse responses and variance decomposition at a daily frequency, 8 lags

The first row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in dollars. In each regression, we control for 8 lags of the instrument and all the endogenous variables and the present together with 7 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. The second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
Figure 3: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency, 8 lags

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 8 lags of the instrument and all the endogenous variables and the present together with 7 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 4: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency, 8 lags

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 8 lags of the instrument and all the endogenous variables and the present together with 7 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.

1.1.2 Dollar-denominated CDSITA03 as an alternative instrument

At a daily frequency, domestic and international results remain robust to using dollar-denominated CDSITA03 as an instrument (and indicator variable).
Figure 5: Financial variables: impulse responses at a daily frequency, CDSITA03 USD as an instrument

Impulse response functions of financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enter in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 6: Redenomination spread and quanto spread: impulse responses and variance decomposition at a daily frequency, CDSITA03 USD as an instrument

The first row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. The second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
Figure 7: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency, CDSITA03 USD as an instrument

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enter in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 8: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency, CD-SITA03 USD as an instrument

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.

1.1.3 Euro-denominated CDSITA14 as an alternative instrument

At a daily frequency, domestic and international results remain robust to using euro-denominated CDSITA14 as an instrument (and indicator variable).
Figure 9: Financial variables: impulse responses at a daily frequency, CDSITA14 EURO as an instrument

Impulse response functions of financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in euros. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enter in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 10: Redenomination spread and quanto spread: impulse responses and variance decomposition at a daily frequency, CDSITA14 EURO as an instrument

The first row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in euros. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. The second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
Figure 11: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency, CDSITA14 EURO as an instrument

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in euros. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 12: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency, CD-SITA14 EURO as an instrument

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates and the indicator variable is CDSITA14, denominated in euros. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.

1.1.4 Euro-denominated CDSITA03 as an alternative instrument

At a daily frequency, domestic and international results remain robust to using euro-denominated CDSITA03 as an instrument (and indicator variable).
Impulse response functions of financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in euros. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enter in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 14: Redenomination spread and quanto spread: impulse responses and variance decomposition at a daily frequency, CDSITA03 EURO as an instrument

The first row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in euros. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. The second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
Figure 15: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency, CDSITA03 EURO as an instrument

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in euros. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 16: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency, CD-SITA03 EURO as an instrument

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in euros. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.

1.1.5 Experimenting with the selection of dates

Domestic results are also robust to removing from the list of selected domestic dates those overlapping European elections or the dates of submission of the draft budget to the European Commission. Because the deadline is common to all the euro-zone countries, the submission of the draft budget may be shared by other European countries. In addition, international results are very similar if we further reduce the list of selected dates in constructing our instrument. More specifically, we removed from our instrument all dates that fall in a 2-sided window of seven days centered around election dates of other euro countries (47 events in total), the Brexit referendum and other key events in the Brexit process (32 additional events). This is also true for the
domestic daily results for Italy. To limit the length of the Online Appendix we have only included this robustness exercise for the spillover effects.

Figure 17: Financial variables: impulse responses at a daily frequency, excluding common EU dates

Impulse response functions of financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates minus eight dates common to the ones of other euro-zone countries and the indicator variable is CDSITA14, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 18: Redenomination spread and quanto spread: impulse responses and variance decomposition at a daily frequency, excluding common EU dates

The first row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates minus eight dates common to the ones of other euro-zone countries and the indicator variable is CDSITA14, denominated in dollars. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. The second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
Figure 19: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency, excluding those that are close to political dates for other European countries

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates minus 15 dates that fall within a week-long 2-sided window around political dates for European countries. The indicator variable is CDSITA14, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.
Figure 20: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency, excluding those that are close to political dates for other European countries.

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on the selected dates minus 15 dates that fall within a week-long 2-sided window around political dates for European countries and the indicator variable is CDSITA14, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enter in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars.

1.1.6 Cholesky identification

At a daily frequency, the estimated impulse response functions obtained with LP-IV are similar to those obtained by putting our instrument after the VIX and the first principal component of euro-zone countries’ CDS spreads, and before the other financial variables, and using a Cholesky identification strategy.
Impulse response functions of domestic financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Cholesky where the order is: (i) the VIX, (ii) the first principal component of the change in the sovereign dollar-denominated CDS spread of the 2014-clause contract for euro countries, (iii) our instrument (the change in the CDS spread for the 2014-clause contract on the selected dates), (iv) the indicator variable (CDSITA14, denominated in dollars), and (v) the above endogenous variables. In the reduced-form VAR we control for 4 lags. Confidence bands are estimated with 2000 bootstrapped simulations. All the variables, except for the instrument enters, in the VAR in first differences. The estimated responses are then cumulated in the graph above.
Impulse response functions of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Cholesky where the order is: (i) the VIX, (ii) the first principal component of the change in the sovereign dollar-denominated CDS spread of the 2014-clause contract for euro countries, (iii) our instrument (the change in the CDS spread for the 2014-clause contract on the selected dates), (iv) the indicator variable (CDSITA14, denominated in dollars), and (v) the above endogenous variables. In the reduced-form VAR we control for 4 lags. Confidence bands are estimated with 2000 bootstrapped simulations. All the variables, except for the instrument enters, in the VAR in first differences. The estimated responses are then cumulated in the graph above.
Figure 23: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency, Cholesky identification

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Cholesky where the order is: (i) the VIX, (ii) the first principal component of the change in the sovereign dollar-denominated CDS spread of the 2014-clause contract for euro countries, (iii) our instrument (the change in the CDS spread for the 2014-clause contract on the selected dates), (iv) the indicator variable (CDSITA14, denominated in dollars), and (v) the above endogenous variables. In the reduced-form VAR we control for 4 lags. Confidence bands are estimated with 2000 bootstrapped simulations. All the variables, except for the instrument enters, in the VAR in first differences. The estimated responses are then cumulated in the graph above.
Figure 24: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency, Cholesky identification

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Cholesky where the order is: (i) the VIX, (ii) the first principal component of the change in the sovereign dollar-denominated CDS spread of the 2014-clause contract for euro countries, (iii) our instrument (the change in the CDS spread for the 2014-clause contract on the selected dates), (iv) the indicator variable (CDSITA14, denominated in dollars), and (v) the above endogenous variables. In the reduced-form VAR we control for 4 lags. Confidence bands are estimated with 2000 bootstrapped simulations. All the variables, except for the instrument enters, in the VAR in first differences. The estimated responses are then cumulated in the graph above.
1.2 Monthly frequency

The domestic results at a monthly frequency are invariant to using the average of observations for the last 5-days of the month or the monthly average, instead of the end of the month observation for the endogenous variables.

Figure 25: Financial variables: impulse responses at a monthly frequency, mean of last 5 observations

Impulse response functions of financial variables to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above.
Figure 26: Redenomination spread and quanto spread: impulse responses and variance decomposition at a monthly frequency, mean of last 5 observations

First row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations.

Second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
Figure 27: Financial variables: impulse responses at a monthly frequency, mean across the month

Impulse response functions of financial variables to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above.
Figure 28: Redenomination spread and quanto spread: impulse responses and variance decomposition at a monthly frequency, mean across the month

First row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on the selected dates and the indicator variable is CDSITA03, denominated in dollars. Confidence bands are estimated with 2000 block-bootstrapped simulations. Second row shows the lower bound of the variance of redenomination spread and quanto spread explained by political risk shocks.
2 Placebo test

In this section, we conduct a standard placebo test in which we apply our IV-LP procedure to a randomly selected set of dates equal in number to those included in our own original set. We then repeat this procedure 2000 times and present the 2.5th (5th) and 97.5 (95th) percentile for the impulse response functions obtained using the change of the CDS spread on the randomly selected dates as an external instrument in the same local projection context. The solid black line is the median. Both 90th and 95th confidence intervals include the zero at all horizons of the impulse response functions for all the variables, with one exception. The exception is the response of the change in the spread of the sovereign CDS on impact which is significant at the 10% level but not at the 5%. Note however, that the CDS is our indicator variable and by construction its coefficient on impact is normalized to be one and basically we are regressing the change in the CDS spread on itself on a subset of dates. Therefore this finding is neither surprising nor worrisome. In sum, the placebo test suggests that our results are not driven by background shocks we do not control for.
Figure 29: Financial variables: impulse responses at a daily frequency; placebo

Impulse response functions of financial variables to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on random dates and the indicator variable is CDSITA14, denominated in dollars. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
Figure 30: Financial variables: impulse responses at a monthly frequency; placebo

Impulse response functions of financial variables to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on random dates and the indicator variable is CDSITA03, denominated in dollars. The estimated responses are then cumulated in the graph above. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
The first row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on random dates and the indicator variable is CDSITA14, denominated in dollars. We control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
Figure 32: Redenomination spread and quanto spread: impulse responses at a monthly frequency; placebo

First row shows impulse responses of redenomination spread and quanto spread to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on random dates and the indicator variable is CDSITA03, denominated in dollars. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
Figure 33: Spillover effects on sovereign CDS spreads for euro-zone countries: impulse responses at a daily frequency; placebo

Impulse response functions of euro-zone country sovereign CDSs to a political risk shock at a daily frequency. All CDS contracts are denominated in dollars and use the 2014 clause. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on random dates and the indicator variable is CDSITA14, denominated in dollars. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
Figure 34: Spillover effects on gov. bonds yields relative to the Bund for euro-zone countries: impulse responses at a daily frequency; placebo

Impulse response functions of the difference between the 10-year sovereign bond yield and the 10-year bund yield of a series of euro-zone countries at a daily frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2014-clause contract (CDSITA14) on random dates and the indicator variable is CDSITA14, denominated in dollars. All the variables enters in the LP-IV regressions in first differences. The estimated responses are then cumulated in the graph above. In each regression, we control for 4 lags of the instrument and all the endogenous variables and the present together with 3 lags of a measure of international volatility (VIX) and the first principal component of the change in the sovereign CDS spread of the 2014-clause contract for euro countries, denominated in dollars. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
Figure 35: Real variables: impulse responses at a monthly frequency; placebo

Impulse response functions of real variables to a political risk shock at a monthly frequency. The solid black line is estimated via Local Projections - Instrumental Variables where the instrument is the change in the CDS spread for the 2003-clause contract (CDSITA03) on random dates and the indicator variable is CDSITA03, denominated in dollars. The endogenous variables are the log-transformation of the Purchasing Manager Index of the manufacturing sector (PMI Manufacturing), the log-difference between the Italian PMI Manufacturing and the Global PMI Manufacturing, the level of the Composite Leading Indicator from OECD database (OECD CLI), and the log-transformation of a survey of firms’ confidence (Firm Confidence). For more information on the sources and interoperability of those variables see Appendix A. Results are shown using different detrending techniques: (i) **BP Filter** is the High Pass filter removing periodicities above 24 frequencies; (ii) **Differences** as presented for the financial data results; (iii) **Quadratic Trend** is a standard time quadratic trend; (iv) **Level** is variables without being treated and controlling for the past value of the dependent variable in each regression. The exercise is repeated 2000 times in order to select confidence interval and point estimate (median).
3 Other

Figure 36: Distribution of the difference between impact and 4th day response coefficient

Distribution of the difference between the impact and the 4th day response of the dollar-denominated CDSITA14 constructed using 2000 block-bootstrap replications.