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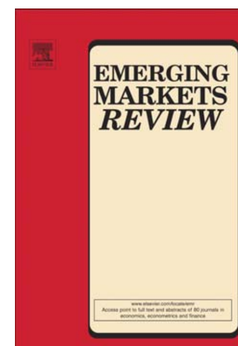

Local currency systemic risk

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Abstract

Emerging country governments increasingly issue local currency denominated bonds and foreign investors have been increasing their holdings of these assets. By issuing debt denominated in local currency, emerging country governments eliminate exchange rate risk. The growing stock of local currency government debt in the financial portfolios of foreign investors increases their diversification and exposure to fast growing economies. In this paper, we highlight some of the risks associated to this recent trend. First, we adopt the $CoVaR$ risk-measure to estimate the vulnerability of individual countries to systemic risk in the market for local currency government debt. Second, we show that our country-level estimates of vulnerability increase with the share of local currency debt held by foreign investors. A version of the old adage "When New York sneezes, London catches a cold," used often to describe the relationship between the stock markets in these two cities, still applies between individual emerging countries and the aggregate market for local currency government debt.

Keywords: CoVaR, emerging markets, local currency debt, contagion, systemic risk
JEL Classification: C58, F21, F34, G11, G15, G32

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