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Sovereign defaults by currency denomination

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ABSTRACT

This paper explores the drivers of sovereign default in 100 countries over the period 1996–2012. We build a new data set of sovereign defaults and find that default events for local and foreign currency bonds are equally likely. However, governments default under different economic and financial conditions depending on the currency in which bonds are issued. The explained variation in default probability rises from 43% to 62% when we account for differences in currency denomination. We also provide evidence that global factors and market sentiment, which are known to drive sovereign spreads, do not help explain the probability of sovereign default. Hence, these factors appear to affect the price of sovereign credit risk, although not the risk itself.

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1. Introduction

Investors are today paying close attention to the default risk embedded in the local sovereign debt market. Bonds denominated in local currency play an increasingly important role for sovereign issuers in emerging markets, and international investors are currently holding record levels of local currency debt (see Fig. 1). This recent trend highlights the importance of identifying the drivers of default on local currency debt and exploring whether a government's decision to default varies with the currency of indebtedness.

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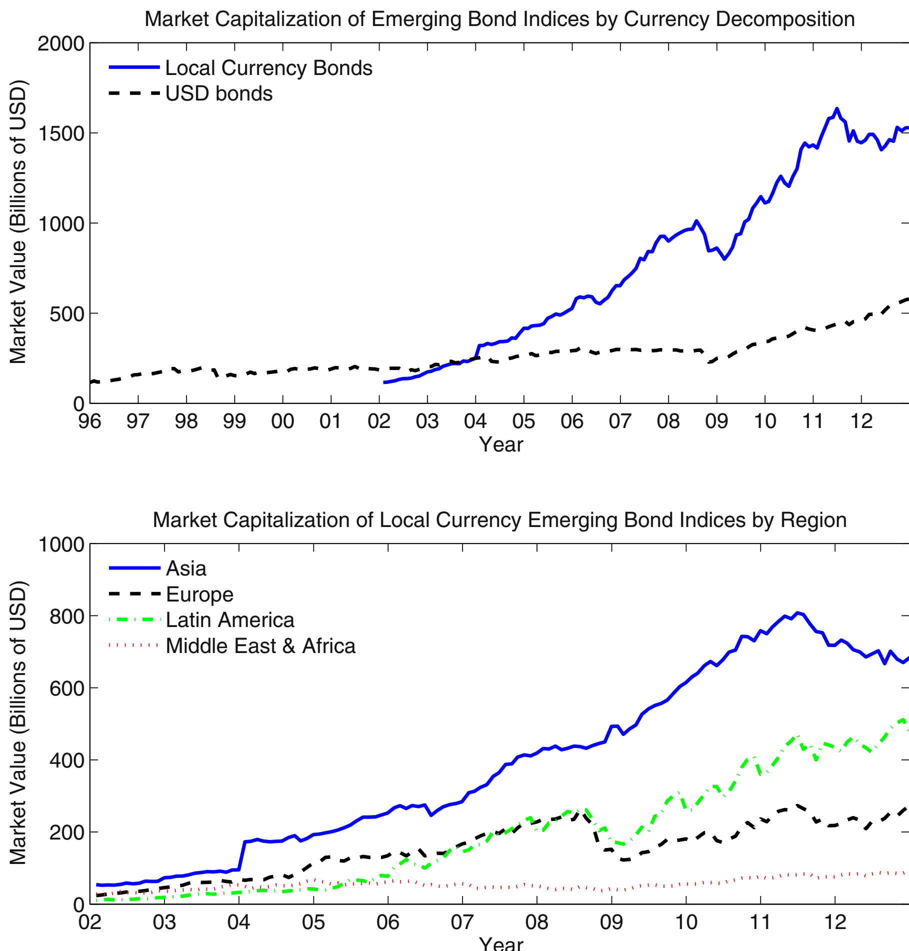

Fig. 1. Government bonds in emerging markets by currency denomination. This figure displays the evolution of the local currency government bond market in emerging countries. The upper panel illustrates the relative size of local currency and USD-denominated government bonds. The lower panel decomposes the local currency government bond market by regions. The data consist of the market value of government bonds included in the JP Morgan emerging bond indices.

The goal of this study is to analyze the determinants of sovereign credit risk with a detailed investigation of the default events observed over the period 1996–2012. We examine the drivers of defaults on sovereign bonds by currency denomination. The approach of this paper differs from the existing literature in three important dimensions.

First, previous studies have exclusively focused on the determinants of sovereign credit ratings and sovereign spreads. On the one hand, ratings face growing criticism for their (in)ability to adequately reflect default risk (e.g., see Xia, 2014). On the other hand, spreads observed in the bond or the credit default swap (CDS) market do not only capture default risk but also a compensation for liquidity risk and the premium required by investors for bearing these risks (e.g., see Longstaff et al., 2011). Unfortunately, disentangling these different components is not straightforward. To circumvent these issues, we analyze the risk of default directly using observed sovereign default events.

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