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How Sovereign Is Sovereign Credit Risk?

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Is sovereign credit risk primarily a country-specific type of risk, or is it driven by global macroeconomic forces external to the country?

Understanding the nature of sovereign credit risk is of key importance given the large and rapidly increasing size of the sovereign debt markets. Furthermore, the nature of sovereign credit risk directly affects the ability of financial market participants to diversify the risk of global debt portfolios and may play a central role in determining both the cost and flow of capital across countries.

We study sovereign credit risk from a novel perspective by using an extensive new data set of sovereign credit default swap (CDS) contracts on the external debt of 26 developed and less-developed countries. Sovereign CDS contracts function as insurance contracts that allow investors to buy protection against the event that a sovereign defaults on or restructures its debt. An important advantage of using sovereign CDS data (rather than sovereign bond data) is that the sovereign CDS market is typically more liquid than the corresponding sovereign bond market, resulting in more-accurate estimates of credit spreads and returns.

We find that most sovereign-credit risk can be linked to global factors. A single principal component accounts for 64% of the variation in sovereign credit spreads. Furthermore, sovereign credit spreads are more related to the U.S. stock and high-yield markets than they are to local economic measures.

We decompose credit spreads into their risk-premium and default-risk components. On average, the risk premium represents about a third of the credit spread.

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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