Discussion of "Does sovereign risk in local and foreign currency differ?" by M. Amstad, F. Packer and J. Shek

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Disclaimer: The views expressed are not necessarily shared by the ECB or the Eurosystem.

What they do

- The authors document the steady convergence of sovereign risk for debt in foreign vs local currency (henceforth *gap*)
- Test for some key hypotheses:
  - Does higher inflation reduce the gap? **No**
  - Is more banking-sovereign nexus associated with lower gap? **Yes**
  - Is the spread lower with a more solid financial position (higher FX reserves, lower FX borrowing)? **Yes**
  - Is the spread lower with global volatility? **Yes**
  - What drives the observed gaps decline? **Mainly the rise in FX reserves**

The econometrics

- Panel regressions, annual data 1996-2015, 73 emerging markets
- Convert ratings into linear variables, multinomial ordered logistic regressions

$$Pr(gap_{it} > 0) = F(X_{it}, Z_{it}) \tag{1}$$

- Controls: government debt to GDP, government spending, cross-border bank claims with maturity up to one year, GDP per capita, corruption index, years since latest default, FX regime

A clear and useful paper

- Clear and well executed paper on a question that is obviously important and has a long history (e.g., literature on the original sin)
- I learnt a lot from it, including on the data
- However, four questions for the authors
  - Net foreign currency position as the missing variable
  - Who can issue in local currency?
  - Foreign held debt vs. foreign currency debt
  - Why do we care about rating agencies?

Net foreign currency position: The missing variable?

- The paper finds that FX reserves are crucial to explain the decline in the gap
- But why should FX reserves matter on their own? Should it not the *net foreign currency position (NFC)* be more important and encompassing?
- Use the Benetrix et al. (2014) data on NFC
- Probably most of the foreign currency debt is in USD: add USD-related controls?

Which theory of the gap?

- The paper elaborates on the reasons why sovereign ratings are more positive for local currency bonds
- Some of these considerations, however, seem at odds with the literature on the "original sin"
- Could there be a simpler explanation: only safer countries are allowed to issue in local currency? Consistent with the view that the decline in the gap is mainly due to the decline in local currency debt ratings, not to an improvement in foreign currency debt ratings
- And how do the authors explain the rise in issuance of local currency bonds in EME?
- Add more measures of country vulnerability to the controls (corruption index could capture some of this, but not all)?

Foreign currency and foreign held debt are not synonyms

- Local currency and domestic debt are not necessarily the same; see Greek PSI (and I speak by personal experience!)
- Foreign debt may less protected for political reasons (Broner et al., 2014); not due to currency
- (On the other hand, legal protection could be higher for foreign currency debt)
- How to distinguish these two elements? Perhaps add, where possible, a control for foreign held debt (as, e.g., in Presbitero and Panizza, 2014)

Do rating agencies anticipate default? Is the gap priced in and do we care about it?

- With the data the authors have, one could look at whether rating agencies are effective at anticipating default in local and foreign currency
- In this paper, or even in a new paper
- See Jeanneret et al. (2014): default in local currency bonds is frequent and related to country fundamentals, and not to global factors - do the rating agencies "price in" these fundamentals?
- Moreover, are rating differences reflected in sovereign and CDS spreads? Do they matter after all?

Conclusions

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