

Does sovereign risk in local and foreign currency differ? by Amstad, Packer, and Shek

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Title

The title of the paper asks a binary question.

Does sovereign risk in local and foreign currency differ?

Reaction to this title in my informal survey is almost uniformly negative—typical comments are, “Of course, obviously they are different”.

- 1 Paper attempts to explain a quite noticeable change over time in the “gap” between perceived risk in local and foreign currency debt.
- 2 Paper argues that conventional wisdom, that default in local currency is extremely improbable, is not correct.

But, readers aren't going to learn any of this if they are turned off by the title.

Determinants of sovereign risk in local and foreign debt markets

Measure of Risk

Risk from an investor's perspective:

- 1 Price fluctuations?
- 2 Inflation?
- 3 Default risk?
 - 1 Does a default occur?
 - 2 If so, how bad is it?

Do issuers perceive risk the same way as investors? What about policy makers?

This paper focuses strictly on default risk.

- 1 Certainly reasonable thing to look at.
- 2 If comparison is risk of local-currency sovereign debt versus foreign-currency sovereign debt, should we be interested in other forms of risk as well?

Typical attitude towards local currency default



Local currency defaults

Conventional wisdom—local currency default extremely improbable, as sovereign has both taxation authority and ability to print money.

Reinhart and Rogoff cite 70 examples of local currency default since 1800.

The world was a rather different place in 1800.

- 1 Gold standard or other backing of currency, versus fiat currency.
- 2 Other reasons for default
 - 1 Political disorder.
 - 2 Repudiation of debt of previous regimes?

When did these local defaults occur, and what caused them?

- 1 Did these occur during the era of fiat currencies, in the relevant data sample? (Since 1995?)

Use of Credit Rating

What are the credit agencies actually measuring?

- 1 Credit agencies generally avoid using hard, well-defined descriptions of their categories.
- 2 Generally thought to be related to probability of default occurring.
- 3 Not obvious that *severity* of default is taken into account.
- 4 Are other types of risk taken into account?

If a country has a hyperinflation in order to pay its local currency debts, then no default has occurred.

- 1 Do credit agencies include this possibility in their definition of “risk”?

Credit agencies have been criticised rather harshly in recent years—could their definition of “risk” have changed over time?

Default Risk

If we are interested in the actual likelihood of default (and perhaps its severity), the ideal measure of default risk would be based on the ex-post occurrence (and possibly also severity) of default.

- 1 Objective measure.
- 2 Use of credit ratings brings both definitional issues, as well as the competency/incentives of credit agencies into the picture.

Are defaults sufficiently common in sample period to allow use of *actual* occurrence of default?

- 1 If defaults are sufficiently rare that we can't do this, what are the credit agencies basing their ratings on?
- 2 Model-based risk?

Sample Period

Almost entirely a post-1995 phenomenon.

- 1 At beginning of this time, only 5% of the countries had a local credit rating.
- 2 A few years later, more like 50%.

Foreign currency credit ratings not all that much more prevalent in 1995.

At beginning of sample, fewer than ten countries had a measurable “gap”.

At end of sample, more than sixty (assuming the countries with the “local” rating are the same ones as those with the “foreign” rating).

Cross-section versus time-series effect?

The natural question is:

Is the decline in the credit ratings “gap” due to changes in the risks of the “local” and “foreign” creditworthiness of the countries over time, or is it due to introduction of new countries into the sample?

Country fixed effects and time fixed effects (and sometimes both) sometimes included in regressions, but results only indicate whether they were included in a particular specification, not results.

So, is the key empirical phenomenon found in the paper due to changes in individual countries over time, or due to expansion of data sample?

Possible changes in sample

A lot going on in this time.

- 1 Transition of Soviet and eastern European economies (presumably included in sample?)
- 2 Introduction of Euro (probably not included?)
 - 1 Although Euro most likely not included, how are “currency union” countries counted?
- 3 Asian crisis
- 4 Global financial crisis

Endogeneity

One of the hypotheses was that willingness to inflate away local debt would increase the “gap”, since this cannot be done with foreign debt.

Existence of inflation is taken as a proxy for willingness to inflate away local debt.

But surely these things are determined simultaneously—inflation is a consequence of macroeconomic policies of the country, which are influenced by things like fiscal condition.

Any possibility of a structural model to attempt to deal with these issues?