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PROPERLY PRICING COUNTRY RISK: A MODEL FOR PRICING LONG-TERM FUNDAMENTAL RISK APPLIED TO CEE COUNTRIES

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Abstract

The private sector has used proxies such as sovereign credit ratings, spreads on sovereign bonds and spreads on sovereign credit default swaps to gauge country risk, even though these measures are pricing the risk of default of government bonds, which is different from the risks facing private participants in cross-border financing. Under normal market conditions, the CDS spreads are a very useful source of information on country risk.

However, the recent crisis has shown that the CDS spreads might lead to some underpricing or overpricing of fundamentals in case of excessively low or excessively high risk aversion. In this paper we develop an alternative measure of country risk that extracts the volatile, short-term market sentiment component from the sovereign CDS spread in order to improve its reliability in periods of market distress. We show that adverse market sentiment was a key driver of the sharp increase in sovereign CDS spreads of CEE countries during the most severe phase of the crisis. We also show that our measure of country risk helps explain the observed stability of cross-border bank flows to CEE banks during the crisis.

Keywords: country risk, credit default swaps, credit ratings, cross-border flows; financial crisis, central and eastern Europe; foreign-owned banks

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