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Sensitivity of Credit Default Swaps Premium to Global Risk Factor: Evidence from Emerging Markets

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Abstract : Risk premium of emerging markets are moving altogether depending on the momentum and shifts in the global risk appetite. However, the magnitudes of these changes in the risk premium of emerging market economies might vary. In this paper, we focus on how global risk factor affects credit default swaps (CDS) premiums of emerging markets using principal component analysis (PCA) and rolling regressions. PCA results indicate that the first common component accounts for almost 76% of common variation in CDS premiums of emerging markets. Additionally, the explanatory power of the first factor seems to be high over sample period. However, the sensitivity to the global risk factor tends to change over time and across countries. In this regard, fixed effects panel regressions are employed to identify the macroeconomic factors driving the heterogeneity across emerging markets. There are two main macroeconomic variables that affect the sensitivity; government debt to GDP and international reserves to GDP. The countries with lower government debt and higher reserves tend to be less subject to the variations in the global risk appetite.

Keywords : emerging markets, principal component analysis, credit default swaps, sovereign risk
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