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

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Abstract : Changes in the global risk appetite cause co-movement in emerging market risk premiums. However, the sensitivity of the changes in risk premium to the global risk appetite may vary across emerging markets. In this study, how the global risk appetite affects Credit Default Swap (CDS) premiums in emerging markets are analyzed using Principal Component Analysis (PCA) and rolling regressions. The PCA results indicate that the first common component derived by the PCA accounts for almost 76 percent of the common variation in CDS premiums. Additionally, the explanatory power of the first factor seems to be high over the 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 used to identify the macroeconomic factors driving the heterogeneity across emerging markets. The panel regression results point to the significance of government debt to GDP and international reserves to GDP in explaining sensitivity. Accordingly, countries with lower government debt and higher reserves tend to be less subject to the variations in the global risk appetite.

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