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Exploring the relationship between macroeconomic indicators and sovereign credit default swap in Pakistan

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Abstract

Purpose

This paper aims to empirically examine the long- and short-run relationship between macroeconomic indicators (exchange rates, interest rates, exports, imports, foreign reserves and the rate of inflation) and sovereign credit default swap (SCDS) spreads for Pakistan.

Design/methodology/approach

The authors apply the autoregressive distributed lag (ARDL) model to explore the level relationship between the macroeconomic variables and SCDS spreads. The error correction model is estimated to examine the short-run effects of the underlying macroeconomic variables on SCDS spreads. Finally, the long-run estimates are obtained in the ARDL framework. The study uses monthly data covering the period January 2001-February 2015.

Findings

The results indicate that there is a significant long-run relationship between the macroeconomic indicators and SCDS spreads. The estimated long-run coefficients reveal that both the interest rate and foreign exchange reserves are significantly and negatively, whereas imports and the rate of inflation are positively related to SCDS spreads. Yet, the results suggest that the exchange rate and exports do not have any significant long-run impact on SCDS spreads. The findings regarding the short-run relationship indicate

The results suggest that State Bank of Pakistan should design monetary and foreign exchange rate polices to minimize unwanted variations in the exchange rate to reduce SCDS spreads. The results also suggest that it is incumbent to Pakistan Government to improve the balance of payments to reduce SCDS spreads. The findings also suggest that the inflation targeting policy can also help in reducing SCDS spreads.

Originality/value

This is the first study to examine the empirical determinants of SCDS spreads for Pakistan. Second, it estimates the short- and long-run effects in the ARDL framework. Third, it considers both internal and external empirical determinants of SCDS spreads.

Keywords

- Interest rates
- Inflation
- Exchange rates
- Exports and imports
- Foreign reserves
- Sovereign credit default swap
- F31
- G13
- C13
- E44
- G12

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