Sovereign Credit Risk and Exchange Rates: Evidence from CDS Quanto Spreads

Patrick Augustin, Mikhail Chernov & Dongho Song

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Sovereign CDS quanto spreads—the difference between CDS premiums denominated in U.S. dollars and a foreign currency—tell us how financial markets view the interaction between a country's likelihood of default and associated currency devaluations (the Twin Ds). A noarbitrage model applied to the term structure of quanto spreads can isolate the interaction between the Twin Ds and gauge the associated risk premiums. We study countries in the Eurozone because their quanto spreads pertain to the same exchange rate and monetary policy, allowing us to link cross-sectional variation in their term structures to cross-country differences in fiscal policies. The ratio of the risk-adjusted to the true default intensities is 2, on average. Conditional on the occurrence of default, the true and risk-adjusted 1-week probabilities of devaluation are 5% and 77%, respectively. The risk premium for the euro devaluation in case of default exceeds the regular currency premium by up to 0.3% per week.

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Contact Us
1050 Massachusetts Avenue
Cambridge, MA 02138
617-868-3900
info@nber.org
webaccessibility@nber.org