Impacts of COVID-19 pandemics on sovereign risk : Time-varying correlations of the CDS spreads in emerging economies

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Abstract:

Along with the rise of credit market derivatives, credit default swaps (CDS) were introduced as an insurance instrument to the investors to hedge or trade their risk. This risk is incorporated with either government or corporate bond borrowers' default. This study examines the dynamic relationship of sovereign CDS spreads between Brazil, Mexico, Russia, Turkey and the US during the post global financial crises era. It employs time varying GARCH volatility approach and Granger causality to find out whether significant increases occur among correlations between CDS rates throughout specific periods. A rise in the CDS rates' correlation backed with a significant dynamic causality might imply contagious effects through the countries financial markets. The results show that CDS spreads generally show relatively high correlations in emerging markets, while the particular events that affect financial markets in different countries might lower the correlations. This study also indicates these idiosyncratic events and analyzes how they affect the cross-country CDS correlations. Besides estimated time-varying correlations provide some preliminary results how the countries' sovereign risk levels have been related during the COVID-19 outbreak.

Keywords: CDS, sovereign risk, time-varying correlation

JEL Codes: E51, E44