Accounting for Sovereign Tail Risk in Emerging Economies: The Role of Global and Domestic Risk Factors

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Summary

This paper employs a panel logistic regression to evaluate the role of global and domestic risk factors in explaining sovereign tail risk for 18 emerging economies (EMEs). Sovereign tail risk is defined as the likelihood of a sharp rise in sovereign credit risk. We find that both global and domestic risk factors are important for explaining sovereign tail risk, with explanatory power increasing with the severity of tail risk. Moreover, most of the risk factors have become more important following the global financial crisis. In particular, global liquidity conditions, US dollar appreciation, banking sector leverage, and economic growth are ranked as the major risk factors for sovereign tail risk among the EMEs. The result implies that a normalisation of the unconventional monetary policies adopted by advanced economies, which would tighten global liquidity and increase currency volatility further, could generate stronger headwinds for EMEs, particularly for those economies with higher banking sector leverage and weaker macroeconomic fundamentals.

*The views expressed in this paper are those of the authors, and do not necessarily reflect those of the Hong Kong Monetary Authority, Hong Kong Institute for Monetary Research, its Council of Advisers, or the Board of Directors.