Analysis of Korean Sovereign Credit Risk Indicators*

The two Korean sovereign credit risk indicators, the sovereign credit default swap (CDS) premium and the sovereign foreign currency bond (Foreign Exchange Stabilization Fund Bond) spread, remained very low up until mid-2007. Following the onset of the subprime mortgage crisis in July 2007, they rose sharply, however. Compared to other Asian emerging countries, the Korean sovereign CDS premium rose more rapidly and its volatility was higher during the current global financial crisis.

Against this backdrop, this paper examines the relationship between the two Korean sovereign credit spreads. It also conducts an analysis as to why the sovereign CDS premiums of emerging countries including Korea have shown high volatility since the outbreak of the global financial crisis.

The analysis results have unveiled that the two Korean sovereign credit spreads, the sovereign CDS premium and the sovereign foreign currency bond spread, cointegrate in the long run, and that the sovereign CDS market, in which liquidity is relatively abundant, leads the sovereign foreign currency bond market in price discovery when prices deviate from their long-run equilibrium in the short run. In addition, it is analyzed that the sharp increase in the volatility of CDS premiums of emerging markets after the global financial crisis was mainly due to global factors including international investors' increased risk aversion. Cross

country differentiation in the crisis impact on sovereign credit spreads, reflecting country-specific variables, including inflation and the ratio of total external debt to GDP.

This result suggests that new information regarding the credit risk of Korea is first incorporated in the sovereign CDS premium. Moreover, it also implies that the higher volatility of the Korean sovereign CDS premium than those of other Asian emerging markets is associated with Korea's relatively high external exposure.

In this sense, policy authorities need to manage Korea's external exposure at an appropriate level, to prepare against recurrence of a global financial crisis. In addition, they need to raise international investors' confidence in Korea through the prudent management of international reserves. Moreover, the monitoring of the sovereign CDS market should be strengthened further and attention needs to be paid to the regulatory initiatives by the international community to reinforce supervision of the CDS market.

* The contents of this article represent the personal opinions of the author and do not necessarily reflect the official view of the Bank of Korea.