Sovereign credit risk is when a government is under threat of being unable to meet its loan obligations and going bankrupt. Traditional ways of measuring such risk are fundamentally flawed. Researchers Manish K. Singh from IIT Roorkee in India, Marta Gómez-Puig from the University of Barcelona, and Simón Sosvilla-Rivero from the Complutense University of Madrid, Spain propose a new measure of sovereign risk which pays particular attention to euro area (EA) countries. After all, the recent European sovereign debt crisis and the COVID-19 pandemic highlight that these countries need a robust and accurate measure of their own financial health.

Traditional measures fail to differentiate between types of creditors when calculating a government’s risk of bankruptcy. For example, governments will have less flexibility when debts must be paid in a foreign currency or have short-term contracts. In such cases, sovereign countries cannot inflate their currency to ease the burden of debt, and unlike short-term and domestic debt, they cannot trade below their contractual liabilities for a significant period of time. Such an imbalance was demonstrated in the Greek debt restructuring of 2012, in which the losses experienced by creditors depended on their level of seniority.

To address these gaps in traditional indicators, three researchers with a common interest in international finance and macroeconomics have collaborated: Manish K Singh, Assistant Professor at IIT Roorkee in India, Marta Gómez-Puig, Professor at the University of Barcelona, and Simón Sosvilla-Rivero, Full Professor at the Complutense University of Madrid in Spain.

To determine a country’s risk has limitations, including their vulnerability to political interference. For example, financial authorities have banned certain purchases of sovereign CDS and, in times of crisis, central banks have provided support for sovereign bonds.

Traditional indicators of a country’s ability to repay debt have been based on market factors, such as the pricing of credit default swaps (CDS) – a form of insurance against credit risk – and sovereign yields – the interest rate paid by governments to buyers of their bonds. However, measuring these financial factors to determine a country’s credit risk has limitations, including their vulnerability to political interference. For example, financial authorities have banned certain purchases of sovereign CDS and, in times of crisis, central banks have provided support for sovereign bonds.

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Researchers propose the distance to default indicator as a more comprehensive means to estimate sovereign credit risk in currency union countries.

**Personal Response**

How might the distance to default indicator be used to help EA countries to avoid bankruptcy?

The distance to default indicator offers the most comprehensive and forward-thinking metric for evaluating sovereign credit risk in the Eurozone. It clearly illustrates the number of standard deviations that set a sovereign apart from default.