Breakup and Default Risks in the Great Lockdown

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discussion by Paul Ehling
The paper in a nutshell

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- Since 2014 (!) CDS take this into account through first-to-default swaps on redenomination and default; for G7 countries or AAA-rated OECD sovereign debt both type of contracts exist.
- When both contracts are available we can decompose the risk traded in CDS into redenomination and default risk.
- Redenomination is likely to come before default for some countries while others might not default after redenomination.
- One of the main findings: an increase in the redenomination risk in one country is associated with an increase in default premia and bond spreads in other Eurozone countries.
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- Dollar redenomination premium is the Euro redenomination premium plus currency redenomination premium, which is the difference between Euro and Dollar CDS premium.

The first peak is on March 14, 2017 and can be traced back to the UK Parliament vote clearing way for “Brexit” talks. This was also a period of political turmoil in Italy, after the constitutional referendum of December 2016 brought down the incumbent pro-Europe government, which culminated on June 11, 2018 with the election of a new euro-skeptic government.
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Figure 2: Decomposition of the Redenomination Premium (Italy)

Notes:
This Figure plots the redenomination premium for Italy based on CDS contracts with a horizon of 5 years (solid black line), along the two components from the decomposition in equation (3): the euro redenomination premium and the currency redenomination premium.

The vertical dashed lines mark the dates for the Wuhan lockdown (1/23/2020); the first phase of the Italian lockdown limited to parts of the North (2/24/2020); the U.S. ban on EU travel and ECB PEPP asset purchase program (3/17/2020); the Fitch sovereign credit rating downgrade (4/28/2020); the ECB announcement of an increase in the funds available for the PEPP program (6/4/2020); and the announcement of the EU recovery fund (7/21/2020). All series are smoothed with a 5-day moving average and reported in basis points. Data are daily from Markit for the period 1/1/2020-9/14/2020.

Table 2 presents descriptive statistics for the redenomination premium, along the two components identified in Equation (3), for France, Germany, Italy and the Netherlands. The top panel reports mean, standard deviation, minimum and maximum values and 95 percent VaR for the variables in levels. The bottom panel reports mean, standard deviation, skewness, kurtosis and 95 percent VaR for the variables in first differences. We summarize the information...
CDS market intricacies

- What is the economic importance of this market? (Say relative to outstanding debt. Who are the end-users and major players?)

- Volumes are only available on an aggregated basis rather than by contract type (2014 clause versus default clause)

- Net notional market for Italy is about twice as large as for France or Germany.

- Differences across the contracts: liquidity and recovery clauses.

- What is the correlation between denomination and default?

- Has denomination risk increased over time?
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- Since this is hard to disentangle it is hard to interpret some of the results.
- ‘Redenomination risk is mostly idiosyncratic to each Eurozone sovereign.’
- Shocks to France are associated with a higher default premium for Germany, Italy and the Netherlands; shocks to Germany are associated with a higher default premium for the Netherlands; and shocks to Italy are associated with a higher default premium for Germany.