

# Currency Returns, Credit Risk and its Proximity: Evidence from Sovereign Credit Default Swap\*

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*Abstract* This paper examines whether credit risk and its proximity are priced in currency returns by making use of information in the term structure of sovereign credit default swap (CDS). Building upon and modifying a CDS pricing model, we construct two risk measures explaining different aspects of risk perception – “risk level”, measured by the level of CDS curve, represents whether the expected loss given credit events is high or low, and “risk proximity”, measured by the slope of CDS curve, captures how soon a specific credit event is likely to be materialized. Combining with asset pricing models for defaultable bonds and exchange rate, we set up the model where exchange rate is determined by credit risk level and proximity. Using a broad data set between 2004 and 2017 for 20 countries, we show that risk level and proximity individually can explain considerable amount of variation in currency returns and two risk measures together improves the predictive ability over a single CDS spread. Comparing the two, risk level broadly plays a stronger role during normal times, while risk proximity gains its significance when financial crisis is near in time. These findings suggest that not only credit risk level but also its proximity should be considered to better understand the exchange rate dynamics.

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Keywords: Exchange Rates, Sovereign Credit Default Swap, Term Structure, Risk Proximity

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