Measuring sovereign credit risk in emerging economies

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Transcript

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Abstract

A sovereign credit rating is a compact translation of one number: the probability that a national government defaults on its debt. That single grade sets the government's cost of borrowing, and through a "sovereign ceiling" it caps the ratings of the banks and firms that live inside the country. Prabesh Luitel, Assistant Professor of Finance at the ESSEC School of Management, uses this starting point to question a common assumption in the field: that credit risk only travels downward, from the sovereign to everyone else.

Drawing on his paper "A Circular Model for Credit Risk Contagion," Luitel argues the relationship is a loop. Distress in large corporates can climb back up and threaten the sovereign, so firms are not only receivers of risk but also transmitters of it. This matters practically because corporate data arrives far more frequently than quarterly macroeconomic data, which means market signals from firms can serve as an early warning of sovereign trouble.

The conversation moves from this circular framing to the institutions that price the risk. Luitel examines the gatekeeping power of the three large rating agencies, the danger of embedding their opinions too deeply in regulation, and the split between the objective and subjective components of a rating. He closes on a concrete problem for emerging markets: how to measure credit risk when the instruments that developed markets rely on, such as credit default swaps, are still thin or missing.

Supplementary Resources

- **Pernicious Effects: How the Credit Rating Agencies Disadvantage Emerging Markets** by Prabesh Luitel, Rosanne Vanpée and Lieven De Moor (Journal article) [3]
- **Subjectivity in Sovereign Credit Ratings** by Lieven De Moor, Prabesh Luitel, Piet Sercu and Rosanne Vanpée (Journal article) [1]

- **Sovereign Credit Rating Provision and Financial Development** by Oskar Kowalewski, Prabesh Luitel and Rosanne Vanpée (Journal article) [2]

Contents

What a sovereign credit rating measures **4**

Credit risk runs in a loop between the sovereign and its firms **5**

Corporate data can flag sovereign distress before macro data **5**

Rating agencies are gatekeepers, but over-reliance carries a cost **6**

Separating objective from subjective, and measuring risk where instruments are thin **7**

What a sovereign credit rating measures

[00:00:08] Interviewer: Hello everyone. I'm very happy to be interacting with Dr. Prabesh Luitel today.

[00:00:13] Interviewer: Dr. Prabesh is an Assistant Professor of Finance at the ESSEC School of Management. He has recently written a paper titled "A Circular Model for Credit Risk Contagion." In this paper, you talk about sovereign risk ratings and using a kind of credit risk assessment for both corporate firms and for the nation's rating.

[00:00:45] Interviewer: So could you start off by explaining to us what a sovereign credit rating is and why it matters at all?

[00:00:53] Prabesh Luitel: Thank you, Jay. It's a very nice question. Let's start with the sovereign credit rating. Before starting with the sovereign credit rating itself, we need to understand what credit rating means.

[00:00:53] Prabesh Luitel: Credit rating means the default probability. You are translating the default probability into one alphanumerical scale, like triple A or double A or D or C, whatever it is.

[00:01:15] Prabesh Luitel: On the high end, you have investment grade, and on the lower end, you have speculative grade, or junk, as they call it. Once your rating increases, your cost of borrowing decreases. And when the rating decreases, your cost of borrowing increases. That's a direct link.

[00:01:15] Prabesh Luitel: That's what the investor looks into: the cost of borrowing. For the investor, it will be yield. It's just a mirror image, from two sides of the mirror.

[00:01:43] Prabesh Luitel: Now, sovereign credit rating is simply the credit risk of the government itself, the national government. The government issues the bond. And what is the default probability linked to the issuer, that is the government itself? Default simply means, am I able to pay on time, my principal and my coupon, or not?

[00:01:43] Prabesh Luitel: If I default, what is the likelihood that I will default? That's what the rating is about.

Credit risk runs in a loop between the sovereign and its firms

[00:02:13] Interviewer: And the economy is made up of corporate firms too, there are banks. So does this sovereign credit risk matter for these firms and banks as well?

[00:02:25] Prabesh Luitel: True. So generally, we have this sovereign ceiling approach, which rating agencies deny, but at least in practice for the emerging market, we see it. The sovereign ceiling means, if you look at the ceiling of your room, that's the highest level. So that will be the credit rating of the sovereign, the government.

[00:02:25] Prabesh Luitel: And the rating of the corporate sectors, which are domiciled inside that country, will have a lower rating.

[00:02:49] Prabesh Luitel: It means the credit risk of the government will be at the lowest point, and the credit risk of the corporate sector will be above the government itself. So a sovereign rating matters for the corporate credit ratings, or corporate sectors. And it also impacts financial market development.

[00:03:07] Prabesh Luitel: But at the same time, we need to think that corporate sectors also impact the sovereign. The credit risk that is linked with the corporate sector can influence or can lead to distress of the sovereign itself. So there's a loop going on that we need to understand. Traditionally, what we see, and also in academia, is that the spillover goes from the sovereign credit risk to the banking sectors and to the corporate sectors.

[00:03:34] Prabesh Luitel: But we can also say, hold on, there's distress in the corporate sector, especially the big firms, then it can move up. So the sovereign is not only the transmitter; the corporate can also be a transmitter back to the sovereign.

Corporate data can flag sovereign distress before macro data

[00:03:51] Interviewer: Very well. And do you think there's another case to use this, which is that corporate data is available a lot more timely? It is available at a much higher frequency compared to macro data on which traditional modeling is done, which is usually quarterly. Could you comment?

[00:04:10] Prabesh Luitel: That's a very valid question, and that's one of the ideas of the paper. The corporate data, if you look at different data portals, is available at a very high frequency, relatively high compared to the macroeconomic data, like GDP or fiscal deficit or anything else. Those provide the hardcore information to understand the sovereign credit risk.

[00:04:32] Prabesh Luitel: But the corporate data also gives a signal about what could be the sovereign distress in the future. Imagine if a corporate CDS moves today; what will be the movement of the sovereign CDS in the future, or tomorrow? That's the idea. Corporate data is more frequent, so it is useful to understand any incremental information that comes from it to explain the variation of this sovereign credit.

[00:05:02] Interviewer: Could you tell us a bit about how we can see early signs of sovereign distress?

[00:05:08] Prabesh Luitel: There are different ways. The most prominent is the banking sector. You can look at the banks, but again, you should not rely too much on the credit ratings. There should be an internal model, bank stress tests, and all those things.

[00:05:08] Prabesh Luitel: So the balance sheet of the banks, or the corporate sectors, especially the firm size, the big firms, they have the bigger impact on the economy.

[00:05:34] Prabesh Luitel: So you can look at those things. Anything like the liquidity position of the corporate sectors or the capital buffer of the bank, those kinds of things, which can lead to stress or affect the proper functioning of the economy. These things can provide a signal about what the sovereign situation would be, whether it will be in distress mode or functioning smoothly.

Rating agencies are gatekeepers, but over-reliance carries a cost

[00:06:03] Interviewer: So in this entire situation, the credit rating agencies seem to have an important signaling role. Do you think they act as gatekeepers? And are there any political implications if we rely too much on these agencies?

[00:06:22] Prabesh Luitel: That's a very good question. So we wrote a paper similar to this, I think around 2016. It's a synthetic paper, synthetic in the sense that it synthesizes different literature. The rating agencies definitely act as a gatekeeper.

[00:06:22] Prabesh Luitel: Gatekeeper in the sense that the role of the rating agencies is to provide the rating. That's the very basic, fundamental role.

[00:06:46] Prabesh Luitel: Now, they have to keep monitoring the market. That's their job: to keep monitoring the market annually or frequently, and to provide the signal to the investors in advance so that the investor can properly make an informed decision about their investment. Now, there are three big rating agencies: Moody's, Standard & Poor's, and Fitch.

[00:07:11] Prabesh Luitel: And they occupy a very large portion of market share, close to 90%. Now, if you rely too much on them, which we have also seen in the 2008 crisis, relying too much on them will be like only depending on the information that is provided by them. This should not be too much embedded in the regulatory framework.

[00:07:32] Prabesh Luitel: There should be additional tools also to cross-check it, like internal modeling, or banks designing their own internal models, or the government or regulatory body working together with the banks or the corporate sector to see what is going on, different stress tests. Those kinds of things can also be done. So rating should be one part of it, but it should not be too dependent on it. It can be used as a check and balance.

[00:07:59] Prabesh Luitel: So relying too much on it will lead to a position that if things go well, everyone is happy, but the moment things go south, the blame will be mostly on the rating agencies, that they were not able to provide information in advance. But there is a blame on the investor also, which they should take responsibility for, because they relied too much only on the rating itself.

Separating objective from subjective, and measuring risk where instruments are thin

[00:08:22] Interviewer: So just hopping off that, how should emerging markets be thinking about some sort of fairness in credit risk assessment? Or is this an important issue according to you?

[00:08:34] Prabesh Luitel: Yes. So what we can see is that rating agencies claim they have a very objective view of providing a fair rating. But there have been studies which also say that there is a bias. So what we can do is divide how the rating is done.

[00:08:34] Prabesh Luitel: One can be from the hardcore data, objective information, like the macroeconomic data or financial market data or corporate sector data.

[00:09:02] Prabesh Luitel: So the data that you can get from the market can be used to understand the objective part of the rating. Now, the subjective part is the less quantified part, which works as a soft information channel. That can be used to understand what portion of the rating is subjective. Let's say there's a double A, and out of this double A, what portion is coming from the objective part and what portion is coming from the subjective part.

[00:09:26] Prabesh Luitel: But please note that in the market, when you look at the pricing, the market prices mostly on the objective part. The subjective part is not priced; we can say it is not priced at all. Maybe it can have an influence, but it is less priced. What the subjective part, or the soft information channel, is helpful for is providing whether there will be a default in the future or not.

[00:09:26] Prabesh Luitel: Not in the long term, but at least in the short term, it can give you a signal, because there's a soft information channel going on. That would help you to transmit the information internally or informally about the default.

[00:10:07] Interviewer: Okay. So just some closing questions. Since your paper suggests that you use credit default swap spreads as a measure of the credit risk that both firms and the sovereign possess, and in emerging markets these instruments are relatively new or lacking, but we would be very much interested in measuring these risks, could you brainstorm and tell us about the potential ways to measure this credit risk?

[00:10:44] Prabesh Luitel: There are different ways. One is the ratings, which we have been talking about. But the downside is that the ratings are sluggish, in the sense that they don't change frequently. The market will not have a frequent update on the rating itself.

[00:10:44] Prabesh Luitel: If you look at the calendar of the rating agencies, they provide a yearly calendar for when the rating will be updated.

[00:11:07] Prabesh Luitel: Unless there's a big event going on that would demand a change in the rating, only then will the rating be changed. Otherwise, there is a calendar which they provide, and on that specific calendar they provide a rating. So let's say it's on an annual basis. If there's a big event going on, then depending on the situation, they first go with the outlook, positive, negative, or stable, and next will be the rating change.

[00:11:07] Prabesh Luitel: The outlook gives you a quick signal about what the potential rating will be in the near future.

[00:11:39] Prabesh Luitel: Now, this is sluggish. If you work as a data analyst or credit analyst, then this information will not be too useful, although it has a lot of information in it. Another is the bond yield. That is also not very high; it's not frequently traded.

[00:11:39] Prabesh Luitel: So what will be useful for the investor is the credit default swap.

[00:12:04] Prabesh Luitel: This is very frequently traded, so it's more liquid in the market. That means the pricing is done very frequently, on market demand and supply. And this already gives you a signal about what the economy looks like. That would be helpful to understand the credit risk in a quicker way than the others.

[00:12:04] Prabesh Luitel: Although all of them are equally good; it's just a matter of which one is providing the information ahead, which comes fast.

[00:12:33] Interviewer: Thank you. This was very informative.

[00:12:36] Prabesh Luitel: Thank you very much.

[00:12:36] Interviewer: Nice talking to you.

[00:12:37] Prabesh Luitel: Thank you, Jay, very much. It was a pleasure to talk with you.

References

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[3] Prabesh Luitel, Rosanne Vanpée, and Lieven De Moor. Pernicious effects: How the credit rating agencies disadvantage emerging markets. *Research in International Business and Finance*, 38:286–298, 2016. doi:10.1016/j.ribaf.2016.04.009.