





Question #1 of 5

Question ID: 1751579

Regarding the consequences of sovereign default, which of the following statements is incorrect?

- A) Sovereign default can cause trade retaliation. 
- B) Sharp currency appreciations often follow defaults. 
- C) Gross domestic product (GDP) growth falls between 0.5% and 2% following a sovereign default, and the decline is short lived. 
- D) Ratings of countries that have defaulted at least once since 1970 are one to two grades lower than the ratings of similar countries that have not defaulted. 

Explanation




Sharp currency devaluations often follow defaults. While studies have not examined political change following defaults per se, there are studies of political change following currency devaluations. Countries that default on debt are more likely to see a change in the president or prime minister (a 45% increase in probability) and the top finance minister or head of the central bank (a 64% increase in probability).

(Book 2, Module 26.2, LO 26.d)

Question #2 of 5

Question ID: 1751580

An investment analyst has been asked to contribute to a written report on country risk assessment. Specifically, he is required to research and report on the factors that influence the level of sovereign default risk. Which of the following statements should the analyst make in his report?

- A) Countries with greater pension commitments and health care commitments have lower default risk. 
- B) Countries with less diversified economies are more likely to have stable tax receipts. 
- C) The greater the tax receipts, the less able a country is to make debt payments. 

- D)** One must consider the amount the country owes its own citizens when evaluating default risk. 

Explanation





One must consider not only the country's debts to foreign banks and investors, but also the amount the country owes its own citizens when evaluating default risk. Countries with greater pension commitments and health care commitments have higher default risk. The greater the tax receipts, the more able a country is to make debt payments. Countries with more diversified economies are more likely to have stable tax receipts.

(Book 2, Module 26.2, LO 26.e)

Question #3 of 5

Question ID: 1751577

When analyzing how a country's political risk, legal risk, position in the economic growth life cycle, and economic structure affect its risk exposure, which of the following statements is correct?

- A)** One component of political risk is continuous versus discontinuous risks. 
- B)** Regarding legal risks, the protection of property rights does not affect default risk. 
- C)** Regarding the economic growth life cycle, more mature companies are more risky than firms in the early stages of growth. 
- D)** Regarding economic structure, a disproportionate reliance on a single commodity or service in an economy decreases a country's risk exposure. 

Explanation





Regarding political risk, one component of political risk is the continuity of risks versus discontinuous risks. Risks in democracies are continuous, but generally low. In contrast, risks in dictatorships are discontinuous (i.e., policy changes are less frequent, but often more severe). Regarding the economic growth life cycle, more mature markets and companies within those markets are less risky than those firms and countries in the early stages of growth. Regarding legal risks, the protection of property rights and the speed with which disputes are settled affect default risk. Regarding economic structure, a disproportionate reliance on a single commodity or service in an economy increases a country's risk exposure.

(Book 2, Module 26.1, LO 26.a)

Question #4 of 5

Question ID: 1751581

Which of the following statements most likely describes an advantage of using the sovereign default risk spread as a predictor of defaults?

- A) An analyst can compare local currency bonds with each other when using default risk spreads. 
- B) Default risk spreads are not volatile, so changes in spreads are not affected by variables unrelated to the default risk of the sovereign. 
- C) When calculating a default risk spread, there is no need for a risk-free security in the currency in which the bonds are issued. 
- D) As bonds trade and bond yields rise and fall, default risk spreads change, revealing information about the market's perception of risk. 

Explanation





Market-based spreads are more dynamic than ratings. As bonds trade and bond yields rise and fall, default risk spreads change, revealing information about the market's perception of risk. To calculate a default risk spread, there must be a risk-free security in the currency in which the bonds are issued. Local currency bonds do not have a risk-free security with which to compare. Default risk spreads are volatile, and changes in spreads may be affected by variables that are unrelated to the default risk of the sovereign.

(Book 2, Module 26.2, LO 26.g)

Question #5 of 5

Question ID: 1751578

Regarding instances of sovereign default in foreign currency debt, which of the following statements is incorrect?

- A) In dollar terms, Eastern Europe has accounted for the largest proportion of sovereign defaults in the last 50 years. 
- B) A large proportion of sovereign defaults are foreign currency defaults. 
- C) Countries are more likely to default on funds borrowed from banks than on sovereign bond issues. 
- D) Over the last 200 years, there have been many instances of default. 

Explanation

Except for the 1990s, in each of the last five decades, Latin America has accounted for at least 60% of foreign currency defaults. In fact, Latin America has been at the center of sovereign defaults for the last 200 years.

(Book 2, Module 26.2, LO 26.c)