Geopolitical Risk and Sovereign Credit Pricing: Evidence from the Marginal Spread per Rating Notch

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ABSTRACT

This study examines the relationship between geopolitical risk, measured by the Geopolitical Risk (GPR) Index, and market pricing across levels of sovereign creditworthiness in sovereign bond markets. Whereas existing studies have primarily focused on the level of sovereign risk premia, such as EMBI and CDS spreads, or on heterogeneity in their responses, this study focuses on the slope of market pricing using the marginal spread per rating notch, estimated from the relationship between sovereign credit ratings and spreads at each point in time.

The results show that increases in the GPR Index are positively associated with the marginal spread, and that this relationship remains evident after accounting for its strong persistence. The level of the marginal spread also increased significantly following Russia's invasion of Ukraine. Furthermore, when the GPR Index is decomposed into geopolitical threats (Threat) and realized geopolitical events (Act), the positive relationship is most clearly observed for Threat, whereas the relationship with Act is limited. The local-projection results likewise show that the marginal spread responds positively to increases in geopolitical risk from the initial horizon and that the response persists for several months. This dynamic relationship is also most clearly observed for the Threat component. These findings suggest that geopolitical risk is associated not only with the level of sovereign risk premia but also with more stringent relative pricing of lower-credit-quality sovereigns, and that threats and tensions preceding realized geopolitical events may play a particularly important role.

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