Very preliminary draft

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BALANCE SHEET EFFECTS AND THE COUNTRY RISK PREMIUM : AN EMPIRICAL INVESTIGATION

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Abstract

This paper tests empirically the hypothesis of recent theories of imperfect capital markets (in particular Céspedes, Chang and Velasco, 2000), which expect a negative relationship between a country's risk premium and its net worth, in the presence of financial imperfections. We find robust evidence that balance sheet effects (i.e., the increase in the debt burden because of an unexpected real depreciation), and not necessarily the debt burden as such, significantly raise the risk premium. While the result is true for the whole sample, we show that it is driven by those countries with the largest financial imperfections, as argued by imperfect capital market theories.

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