The Term Structure of Country Risk and Valuation in Emerging Markets

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Abstract

The prevailing valuation technique in Emerging Markets adds the country risk to the discount rate. This practice ignores the term structure of default risk. The mismatch between the duration of the project being valued and the duration of the measure of country risk used leads to an overvaluation (undervaluation) of long-term projects when the term structure of default risk is upward (downward) sloping. Using sovereign bond data from five Emerging Markets, we estimate a model that captures the variation of expected collection at different horizons at one point in time, which can be used to solve the misestimation problem.

JEL classification codes: G15, G31

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