Sovereign Privilege:
The Puzzle of Local-Currency Corporate Debt

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Extended Abstract

Why does the currency composition of external debt differ so sharply between sovereign and corporate issuers? This paper studies the empirical and theoretical mechanisms behind this gap and its implications for sovereign risk and macroeconomic stability.

I first document systematic differences in the currency denomination and pricing of external debt across sovereign and corporate issuers. Sovereigns are substantially more able to borrow from foreign investors in local currency, while corporate issuers remain considerably more reliant on foreign-currency debt. These differences are reflected in relative borrowing costs. Over the last decade, the yield differential between corporate and sovereign debt has been, on average, 77.3 basis points larger in local currency than in foreign currency. This pricing gap points to a form of sovereign privilege in local-currency borrowing that does not extend to private issuers.

To measure these differences consistently across countries, I construct a Gilchrist–Zakrajšek-style corporate-sovereign credit spread for a panel of 24 countries using daily bond-level data from 2008 to 2026. For each country and date, I estimate a Nelson–Siegel sovereign yield curve and use it to construct maturity-matched corporate-sovereign spreads separately for local- and foreign-currency bonds. To improve comparability across issuer types, I restrict the analysis to sovereign and corporate bonds with the same credit rating category. This framework allows me to isolate differences in the relative pricing of sovereign and corporate debt while accounting for maturity, sovereign yield-curve dynamics, and observable differences in credit risk.

I then exploit episodes of sovereign bond-index rebalancing that generate shifts in international investor demand to study how sovereign and corporate bond markets interact. The response differs sharply across currencies. In local currency, the evidence suggests that sovereign and corporate bonds are complements: increases in investor demand associated with sovereign index inclusion are accompanied by stronger demand for corporate local-currency debt. In foreign currency, by contrast, sovereign and corporate bonds behave as substitutes, with shifts toward sovereign bonds crowding out demand for corporate debt. These results reveal that the interaction between public and private external borrowing depends critically on the currency in which debt is denominated.

Motivated by these empirical findings, I develop a model in which governments and firms issue debt in both local and foreign currency and compete for international investors. Uncertainty in corporate bond pricing generates an endogenous role for the sovereign in shaping the allocation of investor demand across issuers and currencies. I discipline the model using the empirical evidence and use the framework to study how external bond-market structure affects government borrowing choices, fiscal adjustment, and sovereign default risk.

The analysis shows that the currency composition of sovereign and corporate debt cannot be understood independently. The sovereign's ability to borrow in local currency affects private-sector financing conditions and, through this interaction, changes government incentives to issue debt, adjust fiscal policy in response to shocks, and default. The paper contributes to the literature on convenience yields by studying a broad cross-country sample and documenting how the sovereign-corporate pricing differential varies across local- and foreign-currency debt. It also contributes to the literature on portfolio choice by highlighting that investor demand differs systematically not only across issuers, but also across currencies, and that these demand differences shape the interaction between sovereign and corporate bond markets.

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