Indian Economy · GS - III

Analyse the role of credit default swaps in signalling financial stress and assessing market perceptions of credit risk.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 24/11/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
15	~250 words

BECOME IAS
AI POWERED UPSC PREP

Answer Hint

Credit derivatives, CDS spreads, sovereign and corporate risk, market sentiment, financial stability, systemic risk

Model Answer

Introduction

Credit Default Swaps (CDS) are financial derivatives that provide protection against specified credit events. Changes in their spreads offer insights into investors' perceptions of the creditworthiness of governments and corporations.

Role of CDS in Financial Markets

1. **Credit Risk Assessment:** Rising CDS spreads generally indicate increasing market concerns about a borrower's ability to meet debt obligations, while declining spreads may reflect improving confidence.

2. **Early Warning Indicator:** Significant increases in CDS spreads can signal deteriorating credit conditions before these concerns become evident in other financial indicators.

3. **Risk Management:** CDS allow financial institutions and investors to transfer or hedge credit exposure without necessarily selling the underlying debt securities.

4. **Market Sentiment:** Changes in CDS spreads reflect investors' assessment of economic conditions, corporate performance and geopolitical developments. For instance, optimism regarding AI-driven growth may improve risk appetite and reduce perceived credit concerns.

5. **Price Discovery:** CDS markets provide an additional source of information for assessing the relative credit risk of sovereign and corporate borrowers.

Limitations and Risks

1. **Market Volatility:** CDS spreads may fluctuate due to speculation, liquidity conditions and changing investor sentiment.

2. **Counterparty Risk:** Protection buyers remain exposed to the possibility that the protection seller may fail to honour contractual obligations.

3. **Systemic Risk:** Excessive interconnected exposures through derivatives can transmit financial distress across institutions.

4. **Incomplete Assessment:** A decline in CDS spreads does not necessarily establish an improvement in underlying economic fundamentals.

Conclusion

CDS markets are valuable instruments for risk management and financial surveillance, but their signals must be interpreted alongside debt levels, economic fundamentals and banking-sector conditions. Effective regulation and transparency are essential to contain systemic vulnerabilities.

BECOME IAS
AI POWERED UPSC PREP