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Sovereign credit ratings and financial markets linkages: Application to European data

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We use EU sovereign bond yield and CDS spreads daily data to carry out an event study analysis on the reaction of government yield spreads before and after announcements from rating agencies (Standard & Poor's, Moody's, Fitch). Our results show significant responses of government bond yield spreads to changes in rating notations and outlook, particularly in the case of negative announcements. Announcements are not anticipated at 1–2 months horizon but there is bi-directional causality between ratings and spreads within 1–2 weeks; spillover effects especially among EMU countries and from lower rated countries to higher rated countries; and persistence effects for recently downgraded countries.

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1. Introduction

After the 2008–2009 financial and economic crisis sovereign bond yield spreads increased markedly in several European Union (EU) countries, notably in the euro area, and above what one would expect from the sum of inflation, real economic growth, and fiscal developments. The main cause of

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such developments has to be found in the increased awareness of capital markets towards the different macro and fiscal fundamentals of each country, notably the increase in fiscal imbalances in the aftermath of the crisis. Not surprisingly, several downgrades also occurred at the sovereign rating level, both impinging and reinforcing the upward movements in sovereign spreads.

Given that government debt crises have been less common in developed countries (Reinhart, 2010), previous work in the literature has focused on the relation between rating and yield and Credit Default Swap (CDS) spreads for emerging and developing economies. However, little work exists regarding the response of yields (CDS) spreads to rating announcements for a large group of advanced economies.

This paper tries to fill this gap. We carry out an event study analysis to examine the effects of sovereign credit rating announcements of upgrades and downgrades (as well as changes in rating outlooks) on sovereign bond yield (CDS) spreads in EU countries. We use daily data from January 1995 until October 2010.

Our contribution is twofold. First, we conduct an event study analysis looking at the reaction of yield spreads (and CDS spreads) within two days of the announcements from the rating agencies: Standard & Poor's, Moody's and Fitch. We make a distinction between the three main rating agencies to assess whether some agencies have bigger or more lagged impacts on the sovereign bond markets. We also look whether spread developments anticipate, to some extent, rating movements.

Second, with the ratings converted into a numerical scale, we run a causality test between the transformed ratings and the yield (CDS) spreads. We look at whether sovereign yields and CDS spreads in a given country react to rating announcements of other countries, and whether there are asymmetries in the transmission of these spillover effects. In addition, we also examine whether downgrades and upgrades carry more information to the market, beyond the information contained in the rating notation.

According to our analysis, the main findings include: i) a significant response of government bond yield spreads to changes in both the rating notations and the rating outlook, particularly important for the case of negative announcements; ii) rating announcements are essentially not anticipated in the previous 1 or 2 months but; iii) there is bi-directional causality between ratings and spreads in a 1–2 week window; iv) there is evidence of contagion, specially from lower rated countries to higher rated countries; and v) countries that have been downgraded less than six months ago face higher spreads than countries with the same rating but that have not been downgraded within the last six months.

The remainder of the paper is organised as follows. Section two briefly reviews the related literature. Section three describes the data and some stylised facts. Section four conducts the empirical analysis and discusses the results. Section five concludes.

2. Related literature

There are several papers analysing the behaviour of credit rating agencies (see, for instance, the survey by de Haan and Amtenbrink, 2011). More specifically, the existing studies dealing with sovereign debt ratings can be broadly grouped into two areas. First, we find papers that try to uncover the determinants of sovereign debt rating notations, notably via the estimation of both linear estimation methods and ordered response models (see, for instance, Afonso, 2003; Bissoondoyal-Bheenick, 2005 and Afonso et al., 2011; for both developed and developing countries). These studies conclude that the rating scale is mainly explained by the level of GDP per capita, real GDP growth, external debt, the public debt level and the government budget balance. Some other papers document other predictors of rating migrations such as: the outlook status, past rating changes, the rating duration or the existing rating (see Al-Sakka and Gwilym, 2009 and Hill et al., 2010).

Second, there are studies that address the explanatory power of sovereign ratings for the development of government bond spreads, which is closer to the event study analysis that we undertake here. For instance, Afonso and Strauch (2007) evaluate to which extent policy events taking place in the course of 2002, when the Stability and growth Pact was put to a test, impinged on sovereign spreads. They find some mitigated effects of policy events on the euro interest rate swap spreads, the difference between the 10-year rate for the inter-bank swap market, and the 10-year government bond yield.

Kräussl (2005) conducts an event study analysis using daily sovereign ratings of long-term foreign currency debt from Standard & Poor's and Moody's. For the period under analysis, 1 January 1997 and

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