Journal of International Money and Finance 31 (2012) 845–864

Contents lists available at SciVerse ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Foreign exchange market reactions to sovereign credit news

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JEL classification:
F31
G15
G24

Keywords:
Foreign exchange market
Emerging economies
Sovereign credit signal
Regional spillover effect
Credit outlook/watch

A B S T R A C T

We analyse the reaction of the foreign exchange spot market to sovereign credit signals by Fitch, Moody's and S&P during 1994–2010. We find that positive and negative credit news affects both the own-country exchange rate and other countries' exchange rates. We provide evidence on unequal responses to the three agencies' signals. Fitch signals induce the most timely market responses, and the market also reacts strongly to S&P negative outlook signals. Credit outlook and watch actions and multiple notch rating changes have more impact than one-notch rating changes. Considerable differences in the market reactions to sovereign credit events are highlighted in emerging versus developed economies, and in various geographical regions.

1. Introduction

Currency crises in emerging markets highlight the importance of exchange rate behaviour for economic stability and attract interest in exchange rate dynamics. Such events include the depreciation of Latin American currencies in the 1980s, the collapse of the Mexican peso in 1994, the crashes of the Turkish Lira in 1994 and 2001, the 1999 currency crisis in Brazil, and the collapse of the currency board in Argentina in 2002 (Loría et al., 2010). During the 1997 Asian crisis, unstable exchange rates were partly responsible for the collapse of the trade and other sectors of the economies in Indonesia, Korea and Thailand. The recent global financial crisis was accompanied by exchange rate volatility, including the US$-euro.

Credit rating agencies (CRAs) play a central role in international financial markets through disclosing credit information, not only via rating changes but also via outlook and watch actions.

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doi:10.1016/j.jimonfin.2012.01.007

While rating changes communicate permanent changes in issuer credit quality, credit outlook and watch are supplemental instruments to signal potential rating adjustments.[1] Prior studies show that outlook and watch signals are at least as important as rating changes in their market impact (e.g. Hand et al., 1992; Kaminsky and Schmukler, 2002; Sy, 2004). Each CRA has a clear reputational goal of providing timely and high quality signals to financial markets. Nevertheless, CRAs were criticised for failing to properly assess the risks in the securities backed by sub-prime mortgages prior to the recent financial crisis. In response to the perceived role of CRAs in the crisis, the International Organisation of Securities Commissions (IOSCO) revised the Code of Conduct Fundamentals for CRAs in 2008, and a formal regulation on CRAs was approved in 2009 by the European Parliament. These actions seek to increase competition in the rating industry, and imply ongoing scrutiny of the relative performance of CRAs.

This paper analyses the relative information content of sovereign credit actions of the three major players in the rating industry: Moody's Investors Service, Standard and Poor's (S&P) and Fitch Ratings. Using an extensive data sample for 1994–2010, we examine how the foreign exchange spot market reacts to credit events for 124 developed and emerging economies, and also investigate spillover effects (i.e. the impact on other countries' exchange rates). Sovereign ratings are particularly important for emerging economies because risk is greater and information flows can be of lower quality than for developed economies. Investors pay close attention to sovereign ratings when investing capital in emerging countries. Credit risk changes are more frequent in emerging economies and large changes can occur quickly and unpredictably.

Many market participants believe that there is an added value in multiple ratings (Baker and Mansi, 2002). We examine relative CRA reputations, by investigating whether sovereign credit signals released by a particular CRA have a stronger influence than those of other CRAs. We also analyse whether any information lead of one CRA relates to specific type of signals, and whether it is evident for developed and/or emerging economies. Alsakka and ap Gwilym (2010) examine the relative timeliness of sovereign rating actions by five CRAs (Moody's, S&P, Fitch, and two Japanese agencies JCR and R&I), and show that Moody's is the first mover in upgrading sovereigns, while S&P rating changes are the most independent of other CRAs. Alsakka and ap Gwilym (2012) find that Moody's tends to be the first mover for positive outlook and watch signals, while S&P (Fitch) shows the least (most) links with other CRAs' outlook/watch actions.

We focus the analysis on two perspectives: (i) the relative information content of the sovereign actions by the major CRAs for the foreign exchange market, highlighting any informational lead of a given CRA in a specific economy (developed or emerging), particular geographical region or a specific type of credit signal (positive versus negative events, and rating changes versus outlook actions versus watch announcements); and (ii) the own-country exchange rate responses and the regional spillover effects. We contribute to the existing literature on the market impact of credit ratings in five respects. First, while prior studies on the information content of sovereign ratings have considered equity and bond markets and currency crises, the literature offers little evidence on foreign exchange market reactions.[2] Second, we provide evidence on both national and regional spillover effects of sovereign credit signals. Third, whereas prior research on CRAs' actions has mainly centred on rating changes, we investigate the relative impact of rating changes, outlook signals and watch events. Fourth, we extend the methodology previously applied in the literature on the information content of ratings by employing a logit-type transformation of the numerical rating scale to account for non-linearity (see Sy, 2004). Finally, there has been a little prior empirical analysis of the relative information content of the credit signals of different CRAs.

The main findings are summarised as follows. First, positive and negative sovereign credit signals affect the own-country exchange rate and other countries' exchange rates. Second, there are unequal responses to the three CRAs' signals. In the case of the own-country reactions, we find that Fitch signals

[1] Outlooks reflect a CRA's medium-term (one to two years) view on the development of a credit rating, while watch lists are stronger indications focused on a typical ex-ante target horizon of three months.

[2] Brooks et al. (2004) and Hooper et al. (2008) study stock market reactions to CRA signals, but offer some indirect evidence on the foreign exchange market reaction.