



News spillovers in the sovereign debt market[☆]

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Abstract

We study the effect of a sovereign credit rating change of one country on the sovereign credit spreads of other countries from 1991 to 2000. We find evidence of spillover effects; that is, a ratings change in one country has a significant effect on sovereign credit spreads of other countries. This effect is asymmetric: positive ratings events abroad have no discernable impact on sovereign spreads, whereas negative ratings events are associated with an increase in spreads. On average, a one-notch downgrade of a sovereign bond is associated with a 12 basis point increase in spreads of sovereign bonds of other countries. The magnitude of the spillover effect following a negative ratings change is amplified by recent ratings changes in other countries. We distinguish between common information and differential components of spillovers. While common information spillovers imply that sovereign spreads move in tandem, differential spillovers are expected to result in opposite effects of ratings events across countries. Despite the predominance of common information spillovers, we also find evidence of differential spillovers among countries with highly negatively correlated capital flows or trade flows vis-à-vis the United States. That is, spreads in these countries generally fall in response to a downgrade of a country with highly negatively correlated capital or trade flows. Variables proxying for cultural or institutional linkages (e.g., common language, formal trade

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blocs, common law legal systems), physical proximity, and rule of law traditions across countries do not seem to affect estimated spillover effects.

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1. Introduction

During the 1990s a fundamental shift occurred in the nature of cross-country economic linkages. While the trend toward trade liberalization continued, many observers note that financial flows are now the dominant vehicle of interdependence. Capital flows have been central in the crises of the exchange rate mechanism (ERM) in 1992, the Tequila crisis in 1994–1995, and the Asian and the Ruble crises of the latter half of the 1990s. Moreover, at least during crisis periods, cross-country transmission contributes to financial market turmoil beyond individual country borders.

In part, because of readily available high frequency data from organized exchanges, studies of financial market spillovers frequently examine co-movements of stock market returns. In the context of contagion, these studies test whether stock market correlations increase during contagious episodes.¹ In contrast, this paper contributes to a more recent literature on bond market contagion and spillovers. Empirically, we focus on the transmission of news concerning sovereign credit ratings, to sovereign bonds issued by other countries. As these rating changes occur sporadically throughout our sample period, we can examine the nature of cross-border financial market linkages in both crisis and noncrisis periods.

The study of the sovereign bond market offers some obvious advantages. First, sovereign debt serves as the benchmark for all other interest rates in the local economy, e.g., the cost of corporate borrowings, thus developments in this market have wider implications for credit conditions in general. Second, sovereign spreads reflect the default risk of borrowing countries (in addition to other risks, such as liquidity risks). Thus, conceptually, sovereign debt affords a primary channel for the transmission of spillovers of ratings.

¹A vast literature exists on stock market contagion. Examples of theoretical models include Allen and Gale (2000), Kodres and Pritsker (2002), and Kyle and Xiong (2001). In the empirical literature on stock market contagion, substantial debate is ongoing about the definition of contagion as well as its measurement. For example, in contrast to the typical tests of a post-event increase in correlations, Bae et al. (2003) propose a multinomial logistic regression approach to measure contagion. Forbes and Rigobon (2002) draw a conceptual distinction between contagion and interdependence and suggest a sharper empirical test methodology to test for contagion. Also, see Karolyi and Stulz (1996) for an analysis of stock return co-movements between the United States and Japan, and Mauro et al. (2002) for an analysis of the co-movement of emerging market yield spreads in the 1990s as compared with 1870–1913, a previous era of global capital market integration.

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