# News Spillovers in the Sovereign Debt Market

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## Summary

During the 1990s a fundamental shift occurred in the nature of cross-country linkages. While the trend toward trade liberalization continued, many observers have noted that financial flows are now the dominant vehicle of interdependence. Indeed, capital flows have been central in the crises of the Exchange Rate Mechanism (ERM) in 1992, the Tequila crisis in 1994-95, the Asian crisis, and the Ruble crises of the latter half of the 1990s. Moreover, it has been widely documented that, at least during crisis periods, cross-country transmission contributed to financial market turmoil beyond individual country borders.

The purpose of this study is to examine the nature of cross-border financial market linkages in both crisis and non-crisis periods. Typically, studies of spillovers examine co-movements of stock market returns. In the context of contagion, these studies test whether stock market correlations increase during contagious episodes. This study focuses on the transmission of news concerning sovereign credit ratings, to sovereign bonds issued by other countries.

The ratings events we study are for 155 ratings changes 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. Interestingly, the magnitude of the spillover effect following a negative ratings change is amplified by recent ratings changes in other countries.

Conceptually, we distinguish between *common information* and *competitive* components of spillovers. While common information spillovers imply that sovereign spreads move in tandem, competitive spillovers are expected to result in a differential effect of ratings events across countries. Despite the predominance of common information spillovers, we also find evidence of competitive 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 relative to other countries 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 blocs, common-law legal systems), physical proximity, or rule of law traditions across countries do not seem to affect estimated spillover effects.