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The influence of rating levels and rating convergence on the spillover effects of sovereign credit actions

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Abstract

This paper assesses contagion and competition as alternative types of stock market spillovers arising from sovereign rating actions. Our research design is based on the premise that the type of spillover effects within and between groups of countries will be influenced by the sovereign rating level, split ratings and the extent of rating convergence i.e. specific types of rating action will induce different and/or stronger effects. The results reveal a clear pattern whereby downgrades of high-rated countries induce contagion to both high and low-rated countries, while downgrades of low-rated countries reveal the opposite i.e. they induce competitive effects. Split ratings are found to intensify stock market spillover effects. Rating convergence/divergence across similarly-rated sovereigns has a meaningful influence on the spillover effects. For the downgrades of high-rated countries, rating convergence mitigates the contagion effect to other high-rated countries in the region, but has very limited effect on the contagion to low-rated countries. For downgrades of low-rated countries, rating convergence strengthens the competitive effect on other low-rated countries but has little effect on the competitive impact on high-rated countries.

JEL classification: G11, G14, G15.

Keywords: Contagion versus Competition; Spillovers; Sovereign credit signals; Split rating; Rating convergence.

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