

Sovereign Risk, Credit Ratings and the Recent Financial Crises in Emerging MarketsRoman Kräussl¹²

This study analyzes the role of credit rating agencies in international financial markets, particularly whether sovereign credit ratings have an impact on the financial markets in emerging market economies. The experience in the period during and after the Asian crisis of 1997-98 has provoked an extensive debate about the credit rating agencies' evaluation of sovereign risk in emerging markets lending. Several financial market observers have criticized that in the credit rating agencies' reports on the Southeast Asian crisis countries there was an inconsistency between the often unfavorable, and subsequently proven accurate, comments of the financial sector weaknesses in the Asian emerging market economies and the investment-grade sovereign credit ratings that were assigned. Moreover, the credit rating agencies were blamed for behaving pro-cyclically, i.e., for basically following the euphoric sentiment prevailing in financial markets and thereby contributing to boom-bust cycles in emerging markets lending.

The results of the empirical study indicate that credit rating agencies have substantial influence on the size and volatility of emerging markets lending. The empirical results are significantly stronger in the case of government's downgrades and negative imminent sovereign credit rating actions such as credit watches and rating outlooks than positive adjustments by the credit rating agencies while by the market participants' anticipated sovereign credit rating changes have a smaller impact on financial markets in emerging economies. Moreover, the findings show that sovereign credit rating changes in a ground-zero country have a significant contagious impact on the financial markets of other emerging market economies.

The empirical evidence casts doubt on the usefulness of credit ratings in determining commercial banks' capital adequacy requirements, as proposed by the BCBS in its Basel II framework. The event study and panel regression results indicate that credit rating agencies react with a lag to financial market developments in emerging market economies. The findings of a first attempt to assess the potential implications of Basel II on the volatility and size of foreign lending to emerging market countries suggest that the standardized approach to credit risk would lead to more divergence rather than convergence between investment-grade and speculative-grade borrowers.

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