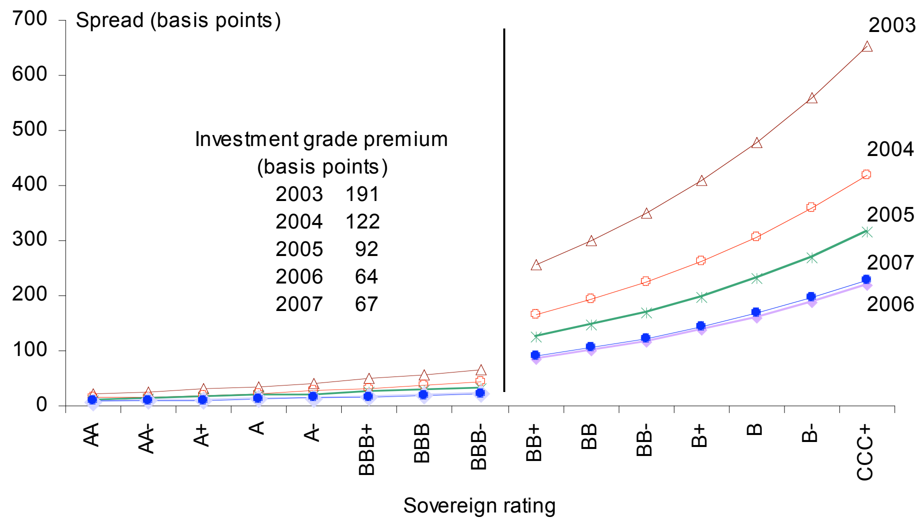
Sovereign Spread and Sovereign Rating

Borrowing costs rise exponentially as the credit rating deteriorates (figure). There is also a threshold effect when borrowing spreads jump up as the rating slides below the investment grade. A borrowing entity with a low credit rating, therefore, can significantly improve borrowing terms (i.e., lower interest spread and increase maturity) by paying up front for a better credit rating.

Figure. Launch spreads decline with an increase in sovereign rating*



* Assuming $100 million sovereign bond issue with a 7 years tenor. Borrowing costs have fallen steadily since 2003 with a slight reversal more recently reflecting changes in the global liquidity situation. The investment grade premium indicates the rise in spreads when rating falls below BBB-. The relationship between sovereign ratings and spreads is based on the following regression: Log(Launch spread) = 2.58 - 1.20 Investment grade dummy + 0.15 Sovereign rating + 0.23 Log(Issue size) + 0.03 Maturity - 0.44 Year 2004 dummy - 0.73 Year 2005 dummy - 1.10 Year 2006 dummy - 1.05 Year 2007 dummy; N = 200; Adjusted R^2 = 0.70. All the coefficients were significant at 5 percent. A lower numeric value of the sovereign rating indicates a better rating.

Sources:

"Beyond Aid: New Sources and Innovative Mechanisms for Financing Development in Sub-Saharan Africa." Dilip Ratha, Sanket Mohapatra, and Sonia Plaza. November 2007.

"Shadow Sovereign Ratings for Unrated Developing Countries." Dilip Ratha, Prabal De and Sanket Mohapatra* World Bank Policy Research Working Paper 4269. June 2007.