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Pernicious effects: How the credit rating agencies disadvantage emerging markets

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ABSTRACT

This paper provides a synthesis of the literature on biases in sovereign credit ratings. Credit rating agencies favor their home countries and the homes of their major shareholders to the detriment of foreign countries. These home and foreign biases have multiple sources, each of which is especially at the disadvantage of emerging markets. While the characteristics of emerging debt markets make these countries particularly vulnerable to a downward bias in their sovereign credit rating, the consequences of a bad rating are especially severe here. A low credit rating increases borrowing costs, hampers access to international capital markets and inflates risk.

1. Introduction

A country's ease of access to international debt markets depends to a great extent on its (perceived) country risk, which is reflected in the sovereign credit rating and determines the borrowing cost. As a consequence, credit rating agencies play a crucial role in the access to capital markets for bond issuers and provide investors with valuable signals concerning borrowers' creditworthiness (Williams et al., 2013). The accuracy of sovereign credit ratings has been the topic of continuous debate since the financial crises in Mexico (1994), East Asia (1997) and the Eurozone (2009–11). Amongst others, Gültekin-Karakas et al. (2011) and Ozturk (2014) find that ratings are biased, which is problematic given their crucial role in today's international financial markets. Existing literature suggests that rating agencies assign a higher rating to their home country and that ratings are influenced by cultural ties after controlling for economic and political fundamentals, which translates into a home and foreign bias in sovereign credit ratings (Fuchs and Gehring, 2013) . Dalsgaard et al. (2014) show that the home bias demonstrated by American rating agencies intensified during the global financial crisis of 2008–2012. Gültekin-Karakas et al. (2011) find that there also is a consistent rating bias favoring the developed countries and disfavoring emerging markets. In this paper we argue that both internal and external characteristics of the credit rating business are at the origin of these home-biased credit ratings and the downward rating bias for countries that are more distant from the United States.

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Because distant countries are in general the ones with less developed financial markets, this rating bias poses a potential threat for emerging markets in their attempt to access the international debt market and to obtain a fair borrowing cost.

The literature on sovereign credit ratings has mostly focused on the informative value of the credit rating and studies in this area can be divided into two areas. The first area focuses on the fundamentals explaining the determinants and variations in ratings (amongst others Feder and Uy (1984); Haque et al. (1998); Cantor and Packer (1996); Ferri et al. (1999); Afonso et al. (2011)), and the second area focuses on rating actions and their impact on sovereign yield spreads (amongst others Reisen and Maltzan (1999); Kiff et al. (2012); Gartner and Griesbach (2012)). This paper builds on the literature of the first area by reviewing the key insights and conclusions on the bias in sovereign credit ratings. More specifically, based on a thorough survey and synthesis of the relevant literature, we demonstrate that (i) internal and external factors of the credit rating business influence the behavior of rating agencies, (ii) the specific characteristics of the sovereign bond markets of emerging countries may impact sovereign rating decisions for these countries more than for the established economies, (iii) the interactions between (i) and (ii) can lead to a downward bias in the ratings of emerging market sovereign bonds, which hampers the access of the respective country to international debt markets, increases the borrowing costs and, as a consequence, slows down the pace of financial development.

The remainder of the paper is structured as follows. In Section 1 we provide an overview of the literature that analyses the determinants of sovereign credit ratings. In Section 2 we illustrate the bias in sovereign ratings. We next discuss in Section 3 the internal and external factors that lead to biased ratings and we show that these factors are especially relevant for emerging market sovereigns. This becomes even clearer in Section 4, where we discuss the characteristics of the bond markets in emerging economies that make them particularly vulnerable for biased credit ratings. Section 5 concludes with policy recommendations and pathways for further research.

2. Determinants of sovereign credit ratings

Credit rating agencies are not fully transparent in their disclosure of the methodology used for assigning a credit rating to a sovereign. Therefore researchers have tried to identify the specific factors behind the creditworthiness assessment of rating agencies. The literature on the determinants of sovereign credit ratings dates back to Cantor and Packer (1996) who determined the economic variables explaining the sovereign credit ratings of 49 countries in 1995. Their study was later extended to a sample of 81 countries by Afonso (2003). Cantor and Packer (1996) and Afonso (2003) find that high ratings are associated with high income per capita, low inflation, a high GDP growth rate, a low ratio of external debt to exports, the absence of a default history and a high level of economic development (industrialized or not). A significant weakness in the models of Cantor and Packer and Alfonso is that the economic development dummy, which can only take on a value of zero or one, is unable to differentiate between levels of development. Also, the explanatory variables used were limited to macroeconomic indicators, hereby ignoring the fact that sovereign ratings should depend not only on a country's economic variables, but also on political risk variables. This is because the sovereign debt market is distinguished from the corporate debt market by the absence of a bankruptcy code, which implies that the willingness of a government to repay its debt is crucial. In a more recent study, Mellios and Paget-Blanc (2006) add the corruption perception index to proxy for one aspect political risk, but, as they acknowledge, this measure is still unable to capture the effect of a government's willingness to pay. Ozturk (2014) resolves this by using six different governance indicators to capture the various aspect of political risk. His results show that institutional quality is a strong driver for sovereign credit ratings, and is best captured by an indicator for the effectiveness of the government and the quality of the regulatory framework.

Some researchers specifically focus on credit ratings of emerging markets. Gültekin-Karakas et al. (2011) apply their methodology to developed and emerging markets separately and show that rating agencies are inconsistent in assigning sovereign credit ratings. In that sense, Gültekin-Karakas et al. (2011) are the first to indicate that rating agencies disfavor emerging markets relative to developed economies. Erdem and Varli (2014) use a sample of only emerging markets and demonstrate that the ratings of these countries' sovereign debt are determined by the ratio of budget balance to GDP, GDP per capita, governance indicators, the ratio of foreign reserves to GDP and the ratio of external debt to export.

3. Biased credit ratings and spillover effects

Based on previous literature and on a cross-country comparison of sovereign credit ratings issued by various rating agencies, we find that country ratings are biased in different ways: (1) rating agencies assign a higher rating to their home country relative to foreign countries, i.e. there is a *home bias* in sovereign credit ratings, (2) rating agencies favor countries that are close to them which corresponds to a *proximity bias* and (3) rating agencies under-rate developing countries which results in a *foreign bias* in credit ratings. The following paragraphs discuss each of the rating biases in turn.

First, from a simple comparison of the rating history issued by the US-based (Moody's, Fitch and S&P) and Chinese-based (Dagong) rating agencies, we observe that the sovereign rating differs depending on the home country of the rating agency.[1] On average, Fitch and Moody's rate the United States as being *AAA*, whilst Dagong issues a *A+*rating, 4 notches below the

[1] We have collected and compared the sovereign rating history of Moody's (from 1949 onwards), Fitch (from 1994 onwards), S&P (from 1993 onwards) and Dagong (from 2010 onwards). The rating history of S&P was obtained from Datastream and for the other agencies ratings were downloaded from their company website. Fitch is dual-headquartered in New York and London, but the majority of its business is done in New York.