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Financial openness, domestic financial development and credit ratings

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ABSTRACT

This article shows that financial openness significantly affects corporate and sovereign credit ratings and that the magnitude of this effect depends on the level of development of the domestic financial market. Issuers located in less financially developed economiesi stand to benefit the most from opening up their capital accounts, whereas the impact of this effect decreases as the level of development of the domestic capital market improves.

1. Introduction

The last four decades have witnessed a process of global financial integration, which is believed to have fostered economic development due to easier and cheaper access to capital in international markets. However, the unconditional merits of this process have recently come under scrutiny. A rich body of research emphasizes that financial openness is effective only under certain circumstances and that the average effects associated with financial openness hide important heterogeneities (Chinn and Ito, 2006; Baltagi et al., 2009; Fischer and Valenzuela, 2013).

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The main contribution of this study is to empirically investigate the effects of financial openness on both corporate and sovereign credit ratings and to examine whether these effects depend on the degree of domestic financial development. Understanding the determinants of credit ratings is crucial because ratings affect the issuer's cost of capital by signaling its likelihood of default (Denzler et al., 2006) and the pool of international and institutional investors that firms and governments can access (Kisgen and Strahan, 2010).[1]

Recent studies have documented that capital account restrictions affect foreign currency credit ratings. Furthermore, as Fig. 1 illustrates, preliminary evidence shows a positive relationship between ratings and financial openness. The main mechanism behind this effect is that capital controls tend to make access to capital in international markets more difficult and/or expensive, increasing default probabilities and lowering both corporate and sovereign credit ratings (Prati et al., 2012; Ostry et al., 2009). In fact, credit rating agencies have publicly stated that they positively evaluate governments whose economies are financially integrated with the rest of the world as restrictions on capital flows are likely to constrain the ability of firms to meet offshore debt obligations.

We further investigate the link between financial openness and credit ratings and examine whether this nexus is shaped by domestic financial development. We find that financial openness has a positive effect on credit ratings and that this effect depends on the level of development of the domestic financial market. Issuers located in economies with less-developed financial markets stand to benefit most from opening up their capital accounts, although this effect weakens as domestic capital markets become more developed.

Since policymakers' decisions to liberalize the capital account are usually linked to their countries' economic performance, potential endogeneity is a relevant concern. In spite of the lack of a suitable instrument, we manage to attenuate endogeneity concerns in five different ways. First, we employ panel data models to control for a comprehensive set of firm and country time-variant variables. Second, we include firm and country fixed effects to reduce potential endogeneity arising from omitted time-invariant characteristics; and time fixed effects to control for global factors that may simultaneously affect ratings and the use of capital controls. Fourth, we use microeconomic data to attenuate potential reverse causality. Fifth, we explore a non-linear effect that is more consistent with a causal interpretation than with a simple correlation.

From a policymaker's perspective, the standard instrument to improve the credit conditions faced by firms and sovereign states is the development of domestic capital markets. However, domestic financial development is challenging due to the infrastructure and time required to successfully achieve this goal. In fact, government-led initiatives to promote domestic financial markets have had mixed success (Laeven, 2014). Our results draw attention to the fact that the easing of capital account restrictions may be an alternative policy tool for improving access to international capital for firms and governments, particularly in economies with underdeveloped financial systems. Furthermore, capital controls have the additional advantage of being reversible if the country needs to reenact them. Of course, liberalizing the capital account must be a decision considered within a thorough analysis of the optimum policy toolset for the economy.

2. Financial openness, domestic financial development and credit ratings

There are at least three reasons to expect a non-linear effect of financial openness on credit ratings based on the level of domestic financial development. First, when a country imposes capital controls, a well-developed domestic financial system can act as a substitute for both firm and sovereign financing needs. Therefore, the benefits from removing capital account restrictions should be greater in less financially developed countries. Second, the international finance literature suggests that capital account liberalization reduces risk premiums due to improved risk sharing and enhanced market liquidity (Bekaert and Harvey, 2000; Chari and Henry, 2004). A lower cost of capital reduces an issuer's default probability and improves its credit rating. However, issuers from well-developed local markets already benefit from considerable risk sharing and liquidity; thus, the room for further improvement in this regard is less

[1] Credit ratings can also impose additional costs on firms. Kisgen (2006) argues: "A firm's rating affects operations of the firms, access to other financial markets such as commercial paper, disclosure requirement for bonds . . . and bond covenants".