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Procedia Economics and Finance 30 (2015) 283 – 293

Procedia Economics and Finance

www.elsevier.com/locate/procedia

3rd Economics & Finance Conference, Rome, Italy, April 14-17, 2015 and 4th Economics & Finance Conference, London, UK, August 25-28, 2015

Analysis of Moody's Sovereign Credit Ratings: Criticisms Towards Rating Agencies Are Still Valid?

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Abstract

With the increasing international financial and economic integration, sovereign credit ratings have become one of the most important elements in directing global capital flows. Effects of credit rating agencies on both sovereign economies and the global economy have increased. On the other hand, CRAs have been heavily criticized for their poor performance in the crises of 1990s and the recent global financial crisis that started in 2008.

The aim of this study is to examine the systematic and consistency of sovereign credit ratings given by CRAs and to identify the determinants of sovereign credit ratings. As a result of panel data analysis conducted by reverse engineering methodology within this context, GDP per capita, governance quality, current account balance, growth performance and growth expectations, being an industrialized country and having a reserve currency were identified as factors affecting sovereign credit rating positively. On the other hand; exchange rate volatility, interest payments, debt stock and default occurrences were the factors effecting credit ratings negatively.

The findings of the analyses support the critiques against CRAs about being unable to foresee the economic crises and about deepening the existing crises by making sudden rating cuts.

Peer-review under responsibility of IISES-International Institute for Social and Economics Sciences.
Keywords: Ssovereign credit ratings; credit rating agencies; Moody's; credit risk

1. INTRODUCTION

With the globalization and deepening of financial markets, a saver in one part of the world can make a loan to a borrower in another part of the world with different kinds of financial tools and intermediaries. On the other hand, it is impossible for lenders to have full information of all the borrowers in the world about their financial positions. For ensuring the sustainability and the continuation of confidence in financial markets, investors should know borrowers' capacity to fulfill their obligations and the existing risks. This need creates a new business and raises the demand for

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doi:10.1016/S2212-5671(15)01296-4

credit rating agencies (CRAs). As their role, CRAs has become the routers of the global capital with international financial integration and globalization. Taking in to account that investors match sovereign credit risk with country risk and 25 percent of the non-US companies rated by CRAs are in the developing countries, the importance and effects of CRAs increases (Setty and Dodd, 2003:14). To emphasize the impact of CRAs on world economy and politics Friedman (1995) indicates that "you could almost say that we live again in a two-superpower world. There is the U.S. and there is Moody's. The U.S. can destroy a country by leveling it with bombs; Moody's can destroy a country by downgrading its bonds".

Although there are many publications about credit ratings in the literature, researches on this topic has also increased along with the increasing financial integration, especially since the 1990s. Asian and Russian financial crises in the late 1990s and European debt crisis following the global financial crisis that erupted in 2008, has made CRAs and credit ratings debatable. It is expressed widely in the literature that grades given by the CRAs remains far from reflecting the real risk perception of the countries.

CRAs which have been operating for more than 100 years in financial markets, has been the subject of criticism for many reasons. The recent global financial crisis that erupted in 2008 has led to a further increase in the dose of these criticisms. Since it became evident that the bonds of companies and governments with high credit ratings carry high risk, the reliability of the ratings given by the CRAs began to be questioned. These critics can be summarized as follows;

- The grading method of CRAs is not sufficiently transparent,
- Lack of competition in credit rating market,
- Conflicts of interests because of income model of CRAs,
- Failure of CRA's to anticipate the crisis and their further deepening of current ones.

In this context, this paper aims to scrutinize the determinants of sovereign credit ratings by making reverse engineering and to question the consistency of CRAs by making country comparative analysis. Panel data analysis is used to analyze credit ratings of 69 countries given by Moody's with related economic and social data of 1996-2012 period.

2. DATA, MODEL AND METHOD

Rating agencies take into account a lot of factors to determine the sovereign credit rating of a country. In the documents published by CRAs, numerous economic, political and social factors are listed to underlie their sovereign credit ratings. In this paper, based on previous studies and Moody's Rating Methodology (2013) document, thirteen economic and six governance indicators and three dummy variables are used to predict sovereign credit ratings (Table 1). In order to include countries as much as possible, annual data after between 1996 and 2012 is used. Concerning the lag between the realization and announcement of economic data and the correlation between the ratings and economy, one year lag data are used to predict sovereign credit ratings. Stata 11.1 statistical program is used for econometric calculations, significance tests and predictions in panel data analysis.

Table 1. List of the variables used in the study and their sources

Variable	Source
Control of Corruption: Percentile Rank	Worldwide Governance Indicators
Voice and Accountability: Percentile Rank	Worldwide Governance Indicators
Government Effectiveness: Percentile Rank	Worldwide Governance Indicators
Rule of Law: Percentile Rank	Worldwide Governance Indicators
Regulatory Quality: Percentile Rank	Worldwide Governance Indicators
Government Effectiveness: Percentile Rank	Worldwide Governance Indicators
Real GDP Per Capita, USD Dolar	World Development Indicators