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Do credit rating agencies add to the dynamics of emerging market crises?

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Abstract

This study investigates the role of credit rating agencies in international financial markets. With an index of speculative market pressure it is analyzed whether sovereign ratings changes have an impact on the financial stability in emerging market economies. The event study analysis indicates that sovereign rating changes 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 rating actions than in the case of agencies' positive rating adjustments. Sovereign rating changes anticipated by market participants have a smaller impact on financial markets in emerging economies.

JEL classification: E44; E47; G15

Keywords: Credit ratings; Event study; Financial crises; Sovereign risk

> "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."
>
> Thomas L. Friedman on 28 March 1999, in the New York Times Magazine

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1. Introduction

During the 1990s, global securities markets have become an increasingly important source of external funding for many emerging market countries. As a result, the portfolio preferences of institutional investors have been vital determinants of the scale and composition of capital flows to emerging markets, and of the terms and conditions under which those markets can be accessed. In this regard, credit rating agencies such as Standard & Poor's (S&P) and Moody's Investors Service (Moody's) have been perceived by both market participants and policymakers as having a strong impact on both the cost of funding and the willingness of institutional investors to hold certain types of financial instruments.[1]

The severe adjustments of sovereign ratings for many emerging market economies throughout the Asian financial crisis of 1997–1998 have raised anxiety about the credit rating process, particularly about the usefulness of country ratings. Critics argue that the improvements in sovereign ratings during the first half of the 1990s and the subsequent sharp declines in the latter half initiated a pro-cyclical element into global capital flows. The behavior of credit rating agencies accelerated capital inflows during the mid-1990s and contributed to the collapse of these inflows after the Asian crisis emerged. To examine these concerns, this study analyzes the specific experience with sovereign ratings for emerging markets.

In a detailed empirical study the question is addressed whether credit rating agencies aggravate the dynamics of financial market crises. This aspect is crucial in emerging markets where investor confidence is not particularly strong. Moreover, investors' behavior is more volatile, given that some institutional investors are constrained to hold securities that have been classified as investment-grade by the agencies as a result of either official regulations or commercial banks' internal risk management practices.

This study complements earlier research on the impact of sovereign rating changes on financial markets in emerging economies in multiple ways. Most of the previous studies (e.g., Reisen and von Maltzan, 1999) have focused on quantifying the effects of changes in country ratings on sovereign risk as measured by the yield spreads of domestic financial instruments relative to mature market benchmarks. However, the studies fail to scrutinize whether credit rating changes for one type of security have an effect on other asset markets. Consequently, this study specifies an index of speculative market pressure consisting of daily changes in the nominal exchange rate, daily changes of the short-term interest rate, and daily changes in the major national stock market index. Additionally, in contrast to the analysis by Kaminsky and Schmukler (2002), the following empirical study examines not only implemented sovereign rating changes, but also imminent rating actions by the agencies, such as credit watches and rating outlooks. Furthermore, the following event study analyzes whether anticipated or unanticipated and whether contaminated or uncontaminated sovereign credit rating actions have a stronger effect on the financial markets of emerging economies. As a result of the rapid growth in the agencies' sovereign risk assessments, such a detailed analysis has only recently become feasible.

[1] While there are several credit rating agencies, the industry is dominated by just two who operate in global financial markets: S&P and Moody's. Reflecting this supremacy, the following discussion and analysis is for the most part confined to these two businesses.