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Journal of Banking & Finance 30 (2006) 2041–2062
Journal of BANKING & FINANCE
www.elsevier.com/locate/jbf

Sovereign credit ratings: Guilty beyond reasonable doubt?

Nada Mora *

Department of Economics, The American University of Beirut, c/o New York Office, 3 Dag Hammarskjold Plaza, 8th Floor, New York, NY 10017-2303, United States

Received 17 March 2004; accepted 5 May 2005
Available online 10 August 2005

Abstract

This paper questions the view that credit rating agencies aggravated the East Asian crisis by excessively downgrading those countries. I find that ratings are, if anything, sticky rather than procyclical. Assigned ratings exceeded predicted ratings before the crisis, mostly matched predicted ratings during the crisis period, and did not increase as much as predictions in the period after the crisis. Ratings are also found to react to non-macroeconomic factors such as lagged spreads and a country's default history. Therefore it is questionable that ratings exacerbate the boom-bust cycle if they are simply reacting to news, whether macroeconomic or market.

JEL classification: F34; G15; G29

Keywords: Credit rating agencies; Sovereign debt; International financial markets

1. Introduction

In the aftermath of the Asian crisis of 1997 followed by Russia in 1998 and Brazil in 1999, much attention by the media and policymakers has turned on sovereign

* Tel.: +961 3 574390; fax: +961 1 744461.
E-mail address: nm32@aub.edu.lb

0378-4266/$ - see front matter
doi:10.1016/j.jbankfin.2005.05.023

credit ratings. Rating agencies have been criticized for failing to predict the Asian crisis, and for exacerbating the crisis when they downgraded the countries in the midst of the financial turmoil. The International Monetary Fund (1998)[1] highlights how the rating agencies reacted late when they downgraded the Asian countries. No sovereign credit rating was downgraded throughout 1996 and the first half of 1997 for the East Asian countries, with the exception of Thailand by Moody's in April 1997. During the crisis, Indonesia, Korea and Thailand were downgraded to below investment-grade.

A recent paper by Ferri et al. (1999), hereafter FLS, argues that in addition to failing to predict the Asian crisis, the credit rating agencies unduly amplified the crisis when they excessively downgraded the countries later and more than the worsening in their economic fundamentals would justify. This would occur if as a result the cost of borrowing increased and if the potential pool of investors declined due to statuary requirements.[2] The question motivating this paper therefore is whether ratings have "tremendous power to influence market expectations on a country" (as pointed out by FLS) or whether they are simply reacting, without contributing, to news.

Despite their alleged non-effectiveness and possible guilt, the Basel II proposals give increased prominence to ratings in bank capital requirements. The most recent proposals will allow banks to use ratings by either credit rating agencies or their own internal assessment in determining the amount of capital they need to put aside for different types of loans. The rationale seems to be that although credit ratings have performed worse than their aim, they are still a second-best solution. Because they are readily available, their use will probably improve the current Basel standards that do not accurately account for risk.[3] More generally, sovereign credit ratings have important implications for international capital flows and for the linkages between company ratings and sovereign ratings.

The objective of this paper is to investigate the behavior of sovereign credit ratings. I focus on the East Asian crisis and whether the rating agencies aggravated the crisis by excessively downgrading those countries. The key advantage of this study is the extension of the period of analysis to the post-crisis period, 1999–2001, allowing for a comparison of pre- and post-crisis rating behavior.

In order to understand how ratings behave, it is first important to ask what do the sovereign ratings assigned by the agencies really capture? The two main rating agencies are US-based, Moody's and Standard & Poor's that have been publishing ratings since 1909 and 1923, respectively. Only recently have they begun rating sovereigns, and only in this past decade for many developing countries. Clearly, the ratings they offer must be of some value since investors pay to subscribe to their credit reports.

[1] Capital Markets Report, September 1998. Box 2.13, p. 52.

[2] An alternative interpretation is that East Asian sovereign ratings may have reflected forward-looking behavior by the rating agencies (without contributing to the future realized negative fundamentals). For example, ratings during the crisis period from 1997 to 1998 could have been better associated with next year's fundamentals than the current year's, potentially adding value for investors. I thank an anonymous referee for this point.

[3] Although this has been questioned in recent papers, see for example Ferri et al. (2001).