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Sovereign credit ratings, capital flows and financial sector development in emerging markets ☆

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Abstract

How does the sovereign credit ratings history provided by independent ratings agencies affect domestic financial sector development and international capital inflows to emerging countries? We address this question utilizing a comprehensive dataset of sovereign credit ratings from Standard and Poor's from 1995–2003 for a cross-section of 51 emerging markets. Within a panel data estimation framework, we examine financial sector development and the influence of sovereign credit ratings provision, controlling for various economic and corporate governance factors identified in the financial development literature. We find strong evidence that our sovereign credit rating measures do affect financial intermediary sector developments and capital flows. We find that i) long-term foreign currency sovereign credit ratings are important for encouraging financial intermediary development and for attracting capital flows. ii) Long-term local currency ratings stimulate domestic market growth but discourage international capital flows. iii) Short-term ratings (both foreign and local currency denominated) retard all forms of financial developments and capital flows. There are important implications in this research for policy makers to encourage the provision of longer-term credit ratings to promote financial development in emerging economies.
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1. Introduction

Financial crises in the past decade have drawn a great debate about the role of financial flows in emerging market economies. It is generally believed that improving a country's transparency, information control, financing costs and sovereign risk levels is expected to increase international capital inflows and improve the general level of development in financial markets and their financial integration with world capital markets. Reinhart and Rogoff (2004) find that the flows of capital from developed to emerging countries are influenced by, among other factors, sovereign default risk, which is typically measured by sovereign credit ratings. Whilst episodes of financial crises have shown that these ratings fail in predicting sudden changes within emerging markets we hypothesize that they have significant information value to improve institutional quality for facilitating long-run financial and economic development. To our best knowledge, this has not been investigated to date. Accordingly, our primary contribution is to fill this surprising void and investigate the influence of sovereign ratings on the development of financial intermediary sectors in emerging markets and on the nature of international capital inflows.

Previous studies have found sovereign credit ratings across countries to encapsulate various fundamental aspects of a country's debt history and macroeconomic strength such as the amount of debt outstanding, GDP per capita, economic growth, inflation and debt repayment ability (see *inter alia* Cantor and Packer, 1996; Afonso, 2003; Mora, 2006). As such, sovereign credit ratings are deemed to be a reference measure of country risk. Much of the literature has focused on its short-term information (predictive) content for financial market returns, interdependence and crises (see for example, Kaminsky and Schmukler, 1999; Brooks et al., 2004; Mora, 2006; Gande and Parsley, 2005; Ferreira and Gama, in press). It is conceivable that there are many risk factors simultaneously influencing a country's credit rating including political and other expropriation risk, inflation, exchange rate volatility and controls, the country's industry composition, economic viability and sensitivity to global economic shocks. This arguably makes sovereign credit ratings a good proxy for the degree of transparency and future country risk.[1] In support of this view, Erb, Harvey and Viskanta (1999) find a high correlation between the country credit ratings and the sovereign bond yield spreads of emerging markets.

Financial development is important for financial intermediation and the efficient allocation of capital within global economies. It is clearly a crucial element to the overall economic development of emerging capital markets. The extent to which financial intermediation is developed and proceeds in emerging capital markets is often hampered by domestic political tensions or a lack of macroeconomic and government transparency. There exists a well-established literature assessing financial development, the bank or market orientation of financial systems and particularly their promotion of economic development and growth at the aggregate, industry and firm level (see *inter alia* Greenwood and Jovanovic, 1990; Levine, 1997; Levine and Zervos, 1998; Rajan and Zingales, 1998; Beck et al., 2000a,b; Carlin and Mayer, 2003; Claessens and Laeven, 2003; Fisman and Love, 2004; Ndikumana, 2005). In this vein, Demirguc-Kunt and Maksimovic (2002) show a positive link between financial development and firms' access to external finance and Wurgler (2000) highlights financial development and capital allocation efficiency.

Motivated by its key role in economic development, there is also a burgeoning literature on the determinants of financial development — covering institutional, economic, political, religious,

[1] In a similar spirit, Morgan (2002) in studying banking industries interpreted a greater dispersion of bond ratings as greater opaqueness of banks.

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