Rating politics

Zsófi Barta
Max Weber Postdoctoral Fellow
European University Institute
“[W]e 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.”

The power of rating agencies
(Sinclair 2005)

ROLE
• in public and private regulation
• in orienting market sentiment

AUTHORITY
• “embedded knowledge network” does not produce new information, only evaluates
The content of sovereign credit ratings

Number crunching OR qualitative assessment?

1. regression analysis of rating scores
2. review of rating methodologies
3. case studies
Numbers matter... to some extent

- key fiscal and economic indicators correlate with ratings

BUT

- deficit and debt indicators can vary within large margins without affecting the rating score within one agency
- large deviations across agencies
Rating methodologies

- publicly available
- effort to provide some transparency
Moody’s: broad-brush approach

- rather general criteria about the “economic resiliency” and “shock absorption capacity” of a country
- current fiscal and economic figures declared secondary
- long-term systemic approach – qualitative assessment
S&P - the inquisitive

- detailed, normative criteria for political institutions and political climate
- detailed criteria for policy analysis beyond the key figures – including politically loaded choices such as taxation and spending
Fitch – the moderate

• heavy on quantitative indicators
• general political and institutional criteria – measured by existing external indicators (IMF, WB)
• relations with international financial community
Case studies

- Italy
- Belgium
- (Hungary)
Italy – the happy 1990s

• convergence of all three agencies
• stepwise upgrade
  – fiscal consolidation & credible political
    commitment to fiscal balance
  – privatization and structural reform
  – EMU-membership
Italy – the slide of the 2000s

- considerable deviations between the 3
- S&P – stepwise downgrade throughout decade
  - 2003-2004 deteriorating numbers (AA-)
  - 2005-2006 political climate unfavourable to structural reform (A+)
  - 2011 political gridlock (A)
  - 2012 EMU-policies & explosion of financing costs (two notches to BBB+)
- F – hesitantly follows S&P lead: downgrade in 2006 (AA-) and 2011 (A+) – same reasons as S&P
- M – keeps up rating until 2011, then downgrades by 3 notches to just above junk – citing the explosion of financing costs
More important than the expected mild slippage on fiscal targets in 2007 is the fact that the budget may have undermined the prospects for meaningful reform aimed at curtailing current expenditure in the areas of pensions, health care, public administration, and fiscal federalism. The budget antagonized the centrist middle-class voters who swung the April 2006 election in Mr. Prodi's favor, thereby reducing his political capital for further tough measures. Moreover, the upfront tax-and-spend concessions to the reform-skeptical members of the center-left coalition have effectively reduced the bargaining power of the modernizers in the cabinet. The Ministry of Finance's unwavering commitment to reduce the budget deficit below 3% of GDP in 2007 may further undermine reform prospects, as the sense of urgency to press forward with unpopular reforms will weaken once Italy is perceived to be exiting from the EU's Excessive Deficit Procedure."
Belgium

- S&P and Moody’s
  - kept rating at remarkably high AA+/Aa1 despite tremendous debt since early 1990s citing credible commitment to persistent consolidation
  - downgrade in November and December 2011 due to bank problems and political uncertainty

- Fitch sceptical
  - downgrade in December 1998 – citing liquidity risks within EMU
  - only aligns with others in 2006
Hungary

• full circle from junk to investment grade to junk
• S&P and Fitch completely in lockstep: improvement of figures triggers optimism, deterioration invites ever more analysis of politics
• Moody’s only seems to concentrate on EU-membership (upgrade of 2006), no reaction to deterioration until 2009
Changes in the wake of the crisis

- SnP: completely new methodology (June 2011)
  - incorporates client comments
  - reference to standard literature
  - reliance on indicators and forecasts produced by supranational organizations (IMF, WB, UN)
  - reflects on the lessons of the crisis
  - (belatedly) acknowledges the peculiarities of a currency union

- Fitch: disclosure of quantitative (OLS) model

- Moody’s: no visible change
Conclusions

• no uniform approach on behalf of rating agencies
• emphasis on technical research and expertise BUT focus on fiscal and economic developments intermingled with thoroughly political assessments
• crisis seems to shape accepted practices
Appendix 1 – The indeterminacy of creditworthiness

Solvency: \[ b = D^* (i-g) \]

Lack of empirical experience on how to judge future behaviour from past track record
Appendix 2 – Quantitative method

- OLS
- EU-members only
- dependent variable: foreign currency rating score (rating + outlook) for each agency!
- explanatory variables:
  - net lending (4yr-avg, %GDP)
  - debt (%GDP)
  - GDP/capita (EUR $10^3$)
  - GDP (EUR $10^9$)
  - external balance (%GDP)
  - EMU membership
  - new members
  - elections
Appendix 3 - Regression results

<table>
<thead>
<tr>
<th>Results of OLS&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Fitch</th>
<th>Moody’s</th>
<th>S&amp;P</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R&lt;sup&gt;2&lt;/sup&gt;</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.79</td>
<td>0.8</td>
<td>0.82</td>
</tr>
<tr>
<td></td>
<td>Coeff.</td>
<td>Sign.</td>
<td>PCSE</td>
</tr>
<tr>
<td>Net lending (4-year avg.)</td>
<td>0.508</td>
<td>*</td>
<td>0.026</td>
</tr>
<tr>
<td>Current debt</td>
<td>-0.034</td>
<td>*</td>
<td>0.003</td>
</tr>
<tr>
<td>EMU</td>
<td>2.635</td>
<td>*</td>
<td>0.259</td>
</tr>
<tr>
<td>New member</td>
<td>-7.601</td>
<td>*</td>
<td>0.235</td>
</tr>
<tr>
<td>Election period</td>
<td>-0.658</td>
<td>no</td>
<td>0.676</td>
</tr>
<tr>
<td>GDP per capita</td>
<td>0.108</td>
<td>*</td>
<td>0.012</td>
</tr>
<tr>
<td>GDP</td>
<td>0.002</td>
<td>*</td>
<td>0.000</td>
</tr>
<tr>
<td>External balance</td>
<td>0.165</td>
<td>*</td>
<td>0.032</td>
</tr>
</tbody>
</table>

<sup>a</sup> The OLS results reported here are consistent with results from the ordered probit regressions (available on request.)

no not significant
* significant at the 0.1% level