

The Political Economy of Credit Rating Agencies. The Case of Eurozone Sovereign Ratings.

Stefanos Ioannou¹

Abstract

This paper investigates the nature and scope of Credit Rating Agencies (CRAs). Contrary to the mainstream perception which views CRAs as opinion providers, capable of dealing with information asymmetries, our view suggests that CRAs are of a more complicated nature. In particular, based on the concepts of power and Keynesian uncertainty, we argue that CRAs can be seen as an important and often neglected dimension of neoliberalism. To understand such dimension we need to recognise their authoritative placement in the economy and their consequent impact upon the framework of thinking and the choices of market participants. In that sense, we need to view CRAs as an active part of the dominant social convention of the neoliberal era. Moreover we claim that due the existence uncertainty, CRAs can never be in a position to genuinely grasp and forecast economic dynamics. From our perspective, although the argument can be applied to all different sorts of issuers of debt instruments that CRAs evaluate, it becomes of paramount importance in terms of macroeconomic and social implications at the level of sovereign ratings. Most notably, the importance of sovereign ratings can be seen in the case of the ongoing Eurozone debt crisis.

Key Words: credit rating agencies, sovereign ratings, neoliberalism, power, uncertainty, social conventions, Eurozone

JEL Codes: F36; G24; P16

¹ 2nd Year PhD student, University of Leeds; email: bnsio@leeds.ac.uk. This paper is part of my ongoing PhD thesis entitled as 'The Political Economy of Credit Rating Agencies: The Case of Sovereign Ratings'.

1. Introduction

Credit Rating Agencies (CRAs) form an important institution of the contemporary financial markets. By rating all sorts of debt instruments- from corporate bonds to sovereigns- CRAs come to have crucial implications on the macroeconomy. So far mainstream economic theory has recognized them as agents that can facilitate the reduction of information asymmetries and act as certifiers of the quality of credit. Moreover, both mainstream and heterodox scholars have recognized their role behind the crash of 2007/08, by focusing on the moral hazard issue that arose under the “issuer-pays” model, and the fact that CRAs got actively involved in the designing of securities they were rating. Nonetheless, this is not the whole story. What is missing is an account of the role of CRAs by means of heterodox theory. This is done in the current paper by focusing at the level of sovereign ratings. By taking up the notions of power and uncertainty, we provide a more holistic narrative that places those agencies within the historic context of neoliberalism.

Main features of the neoliberal epoch have been the processes of financialization, deregulation and internationalization. In such an environment, CRAs acquired an authoritative placement that allowed them to influence the conceptual framework of market participants and narrow down their choices.

Furthermore, Keynesian uncertainty stands as an important complement of the power dimension. In that regard we argue that uncertainty further consolidates CRAs’ authority due to the need it creates for social conventions. Moreover we stress the impossibility for accurate forecasting created by uncertainty, and point out that there is no way for CRAs to circumvent it.

Most importantly, our analysis connects with sovereign ratings and the relevant macroeconomic implications at the level of the state. In particular, it is shown that at the macroeconomic terrain CRAs can exercise pressure upon sovereign debt interest rates and capital flows. Moreover, in a broader sense it is claimed that CRAs are in a position to threaten democracy itself. At a more concrete level of analysis, the above implications are studied in the context of Eurozone. This is an attractive case study due to the ongoing European crisis and the flawed institutional structure of the Eurozone.

The rest of the paper is organized as follows: the next part provides an outline of the corporate structure of CRAs and the technical issues behind sovereign ratings; Section 3 illustrates the mainstream view on rating agencies. Following, the moral hazard theme is considered. Section 5 outlines our alternative perception on CRAs, while Section 6 picks up the peculiarities of sovereign ratings and the associated implications for Eurozone today. Section 7 concludes.

2. General Information and Specifications

Irrespectively of one's views on their usefulness, CRAs form a fundamental institution of contemporary financial markets. Although there is a plethora of such agencies across the globe (IMF, 2010 reports more than 70 credit rating entities), there are three major 'players' that dominate the market, namely Fitch Ratings (Fitch), Moody's Investors Service (Moody's), and Standard & Poor's (S&P). It is the implications of these three agencies that our paper aims to study.

To start with, all three agencies are private entities mainly belonging to US based corporations. In particular S&P is part of McGraw Hill Financial, Moody's

belongs to Moody's Corporation while Fitch belongs to Fitch Group, a jointly owned subsidiary of Paris- based and New York- based Hearst Corporation². Other than financial services, the above corporations are connected with the media industry (Hearst Corporation) as well as with education and book publication services (McGraw Hill). Furthermore, it is interesting to note that Fimalac, the holder of 50% of Fitch Group is exclusively controlled by one person who also participates in the boards of L'Oreal, Renault, and Casino Guichard-Perrachon³. As noted in White (2013), out of the three CRAs, Moody's is the only freestanding publicly traded company. For 2011 it experienced aggregate sales of \$2.3 billion, with almost 70% of its revenues coming from rating activities. Moreover it employs around 6,500 people worldwide.

Let us now provide a brief note on the technicalities behind sovereign ratings. According to the agencies' own viewpoint, CRAs' aim is to provide investors and the public with an independent opinion about the quality of credit of individual sovereigns (S&P, 2012). Attaching alphabetical scores to sovereigns (see Table 1) and claiming to be forward looking, CRAs attempt to assert a sovereign's capacity and willingness to pay in full and on time its existing and future debt obligations (see for instance Fitch, 2012b).

[Insert Table 1 here]

Quoting Bhatia (2002), all three agencies define default as:

² All information has been drawn from the agencies' websites.

³ For more information on the organizational structure of Fimalac, click <http://www.fimalac.com/group-structure.html>. Also check <http://www.forbes.com/profile/marc-ladreit-de-lacharriere/>

- Failure to pay a material sum of interest or principal on a debt instrument on its due date or within applicable principal or interest grace periods, as stipulated in the governing debt structure; or
- Rescheduling, exchange, or other restructuring of a debt instrument conducted in a manner deemed to be coercive, involuntary, and distressed, as determined on a case-by-case basis by each agency.

In order to assess the creditworthiness of a sovereign issuer, CRAs estimate either the probability of default, or the expected loss in the case of such event (Fitch and S&P follow the former methodology, while Moody's follows the latter; see S&P, 2002; Moody's, 2008; Fitch, 2012b). For such purposes, CRAs employ a wide range of variables, including economic, political and institutional ones (for a summary see IMF, 2010). For instance, S&P (S&P, 2011) attaches a score to five different groups of variables. These include: i) a political score, reflecting institutional effectiveness and political risk; ii) an economic score, which expresses the economic structure and growth prospects of the economy; iii) an external score, reflecting external liquidity and the international investment position; iv) a fiscal score, standing for fiscal performance and flexibility; and v) a monetary score. Furthermore, all three agencies emphasize the fact that their analysis is based upon both qualitative and quantitative considerations.

CRAs provide separate ratings for both the short and the long run. In addition, all of them provide ratings in both local and foreign currency⁴. Moreover, they separate between issuer ratings (also known as sovereign ratings) and debt ratings, with the first evaluating the general credit quality of a sovereign and the

⁴ However, Moody's has recently asserted that the importance of distinguishing between local and foreign currency ratings has now faded away due to the process of financial integration (see Moody's, 2012).

second providing specific ratings for particular debt instruments (Bhatia, 2002). Fitch also provides an extra category of ratings, named as 'country ceilings'. These aim to capture the 'transfer & convertibility' risk, as related with the imposition of exchange controls upon the private sector (for more see Fitch, 2012a). Similar ratings are provided by S&P as well. Apart from the above, the three agencies provide forward looking estimations of what rating changes to expect in the future, with the "review/watch" notification reflecting possible developments within the next 90 days, and the "outlook" announcement providing a similar idea for a two years horizon.

All in all, despite their methodological differences, all three agencies perform the same role. In that sense, we suggest that the three CRAs should be treated as a concrete and homogenous institution.

3. The Mainstream View

According to the mainstream perception, there are two kinds of benefits arising from the activities of CRAs. The first has to do with the reduction of information asymmetries between lenders and borrowers, while the second is related to the 'certification' role that CRAs play in the market. Let us consider each case in turn.

To begin with the logic of the first argument, relevant authors (Boot *et al.*, 2006; IMF, 2010; Deb *et al.*, 2011; Canuto *et al.*, 2012) state that without CRAs there would be an adverse selection problem in capital markets (for some cornerstone papers on adverse selection see Stiglitz and Weiss, 1981 and Greenwald *et al.*, 1984). This would be caused by the fact that a borrower would naturally be in a position to know more about the project she would like to fund, as compared with the

potential lender. Under such circumstances and in view of the high cost of individually collecting information about the borrower, the lender would either not participate in the market at all, or she would require a relatively high risk premium to compensate for the information asymmetry. Moreover, those who would be willing to pay high interest rates might do so because they might perceive the probability of paying back the loan to be quite low. This means that the prevalence of high interest rates in the market might result in the overall worsening of the quality of borrowers (hence the term adverse selection).

However, the picture can be different if all investors together pay somebody else to collect the necessary information for them. This is where the CRAs step in, being taken as a 'trusted and independent third party' (Deb *et al.*, 2011: 5). More specifically, by making use of economies of scale CRAs are in a position to collect information and monitor borrowers at a much lower cost than the individual investor. As a result, it becomes easier for borrowers to issue debt- since investors will now require lower risk premia- while the liquidity of the market increases thanks to the augmented number of lenders that is now willing to participate in funding activities (IMF, 2010)⁵.

According to the second argument, CRAs play a role of certification of debt instruments. This is of course enforced by the fact that ratings are now 'hardwired' into the regulatory system. More specifically, by establishing different grades of ratings, like the investment and speculative grades, CRAs set the standards for the liquidity requirements of financial institutions, the conditions for eligibility to access the capital market, the portfolio composition of hedge funds and so on (see Deb *et*

⁵ Interestingly, it can be seen that such a line of thought is identical with the way mainstream scholars view the usefulness of a bank in the case of banking credit (see for instance Diamond, 1984; 1996).

al., 2011; Ryan, 2012, as well as the discussion below). In that sense, certification is thought to facilitate transactions by setting some clear standards and by promoting transparency. Furthermore, as discussed by Deb *et al.*, certification helps to solve a moral hazard between individual investors and the agents they appoint to manage their portfolios, since the former can now keep track of the latter's investment actions based on some clear parameters.

4. Conflicts of Interest and Moral Hazard

Criticizing CRAs is far from new. Rather, CRAs were one of the first players to be blamed for the financial crisis of 2007/8. For instance Crotty (2009) points out that the way ratings were attributed to mortgage-backed securities and Collateralised Debt Obligations CDOs- with CRAs receiving an income fee from the issuers of such securities- gave rise to conflicts of interest. Thus it is said that since CRAs' income was streaming from the issuers, the agencies had an incentive to be 'nice' to them by attributing inflated ratings to their securities.

As observed by White (2010) the "issuer pays" scheme arose in the States during the early 1970s, replacing the previous "investor pays" model. White lists a number of possible explanations as to why such a shift occurred. One scenario is that in view of the uprising widespread use of the photocopy machine, CRAs were afraid of a free riding behaviour on the part of the investors who would now be in a position to photocopy the rating manuals from their friends. Another view is that CRAs might have realized that due to their incorporation into financial legislation, ratings were something like a "blessing" for bond issuers. This would imply that

issuers would be happy to pay something in order to ensure the acceptability of their papers.

Whatever the cause of the switch of the CRAs' payment scheme it is by now well known that credit ratings were a key cause behind the fuelling of subprime mortgage lending. It was the triple-As that made those toxic securities marketable by standing as guarantees of their quality. Nonetheless, as noticed by White (2010), in comparison with the traditional bond rating activities of CRAs, there were now three main differences. First, the agencies themselves got actively involved into the design of the securities they rated by prescribing to the issuers what kind of mortgages and what size of tranches would earn favourable ratings. Secondly, the oligopolistic structure of the mortgage-related securities market gave the issuers the power to threaten the agency they were doing business with that they could easily move to one of its competitors. Third, CRAs had no prior experience over the products they were asked to evaluate (on this also see Arestis, 2009).

Interestingly, there is now some analytical support of the moral hazard arising under the "issuer pays" scheme. By building a mathematical model Bolton *et al.* (2012) show that competition in the ratings market can prove to be counterproductive since it can facilitate what is called as "rating-shopping" for securities issuers. In addition they point out that important issuers- either in terms of repetition or in terms of size of issues - tend to get inflated ratings. The second point has also been supported econometrically. For instance Hau *et al.* (2013) show that bank characteristics exhibit a significant influence over the ratings received by banks. In particular, Han and his colleagues show that there is a positive correlation between the size of banks and the ratings they earn. Secondly they show a positive link between the volumes of business related with asset-backed securities that banks

give to CRAs and the ratings those banks obtain. Eving and Hau (2013) extend such results for the ratings of the issued securities themselves. As with the previous paper they point out the existence of more favourable ratings for the products of the big issuers. They also show that such effects became more severe right before the financial crisis of 2007/8.

From our side, we sympathise with the above mentioned critical voices against the CRAs. Conflicts of interest were definitely out there, and indeed the operations of CRAs in evaluating toxic securities were an important factor behind the financial crash of 2007/8. However, we reckon that such a narrative does not capture the full extent of the role performed by those agencies. The main logical implication of the discussion- as conducted so far- is that ratings ought to be earned in fair terms, rather than being bought. Then one can go on arguing on how the regulatory framework needs to be reformed in order to achieve such an aim. Most importantly however, what we need to ask is: can there really be a fair rating? Do CRAs really have the knowledge and capacity to generate such a product? Are there any deeper implications of CRAs activities for the stability and the performance of the economic system? If yes, do we have any reason to suspect that those implications would persist even if ratings were distributed in a transparent way?

To answer such questions, we need to expand our theoretical arsenal. Although the conflict of interest theme can be scrutinized by means of mainstream theory, to go deeper we need to allow for the concepts of power and uncertainty to enter the picture. This is done in the following section.

5. An Alternative Perception of CRAs

As illustrated earlier, the mainstream view of CRAs as agents that can deal with information asymmetry issues has some merit if the question looking for an answer is what gives birth to those institutions. However, if one wants to grasp the full picture behind the nature of CRAs, she also needs to consider their development within a specific historical context. In our case, the historical context of interest is the neoliberal era, with a starting point conventionally identified at the late 1970s, and the era going up to the current economic crisis (see for instance Harvey, 2010). A dominant feature of this epoch has been the process of financialization, a process associated with the 'increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies' (Epstein 2005: 3), and mainly driven by 'Anglo-Saxon' economies like the US (FESSUD, 2011). Although financialization has not been homogenous across countries, Fine (2011) reports two general consequences. These have been the slowdown in growth of global economic activity, and the subordination of policy towards conservatism and commercialization.

During the neoliberal era CRAs came to be hardwired into the regulatory system, therefore affecting in a compulsory manner the behavior of individuals and institutions. More specifically, even though the process of connecting investment decisions with CRAs had started long ago- with the US regulators originally forcing banks to hold investment graded bonds during the 1930s- it was only after the mid-70s that the three agencies were recognized as official indicators of creditworthiness (for more details see Sinclair, 2005 and White, 2010). Since then, the trend has been accelerated thanks to the process of financial globalization and deregulation, raising the importance of the services provided by the CRAs as a form of private regulation (see Cooley, 2003 and Sinclair, 2005). Indicative of the CRAs'

internationalization has been the fact that both S&P and Moody's started expanding their branches across the world during the late '80s and early '90s (for an analytical table check Sinclair, 2005: 28). In addition, as depicted in Figure 1, and based on evidence from Moody's it can be seen that throughout the early and mid '90s the number of countries obtaining a sovereign rating increased substantially. At the level of international regulation, the Bank for International Settlements (BIS) and the European Union have incorporated ratings as determinants of the capital adequacy requirements for banks and other financial institutions since the establishment of Basel II in 2004 (see for instance Van Roy, 2005)⁶.

[Insert Figure 1 here]

As a result of the above, CRAs have been playing the role of the gatekeeper by exercising power over the private and public sectors, based on the latter's need to access the financial market. To understand such power, it is important to conceptualize authority not only as a set of legally binding actions of governments, but also as a social process that involves intentionality and voluntary compliance (Sinclair, 1993). In that regard, Sinclair points out that a nongovernmental entity can equally well acquire an authoritative status, pushing towards a situation of 'governance without a government', or even more towards a 'government without a governance' (1993: 3- 4).

A consequence of the placement of CRAs into an authoritative position has been the fact that investors and governments do not only need to comply with the agencies' views, but have also re-shaped the way they think and act (also see

⁶ Interestingly, the EU has recently started taking some hesitant steps in reducing its reliance on ratings; for more information see http://ec.europa.eu/internal_market/rating-agencies/index_en.htm

Kundu, 2001 and Cooley, 2003). Based on the notion of structural power, this means that market participants come to adopt the conceptual framework of CRAs and thus limit their range of choices in what would be considered to be acceptable (Sinclair, 1993). From the side of CRAs this implies that those agencies do not only care about “getting the numbers right”, but also get involved in evaluating the overall effectiveness of management- with the term effectiveness linking here with financial prudence. From the side of investors and governments it means that ‘[m]akers of public policy, like corporate executives that want access to cheap finance, must acknowledge the structural power of disintermediated finance [and thus of CRAs] and incorporate debt security markets into their policy agendas and market plans at the earliest stages, and not as an afterthought’ (Sinclair, 1993: 11).

Understanding the dimension of power behind CRAs is a crucial step towards a more comprehensive way of viewing them. However our account would be left incomplete if we would not combine it with the implications of Keynesian uncertainty. In particular, it is argued here that uncertainty acts as an additional causal factor behind the rise of CRAs’ importance and power, due to the necessity it creates for social conventions. In addition uncertainty reminds us that there is no economic agent whatsoever capable of escaping the impossibility it creates for accurately predicting the future.

Starting with Keynes’s own definition of uncertainty, Keynes writes (1937: 241):

“By “uncertain” knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or, again, the expectation of life is only slightly uncertain. Even the

weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.”

Shackle (1955) would identify cases like the game of the roulette and the Victory bond draw as repetitive and uniform performances. In those cases, Shackle argues we can obtain knowledge by observing the outcomes of a numerous series of events. Such knowledge can take the form of frequency ratios, and can be applied whenever the decision-maker is about to re-conduct the experiment. In contrast with such performances, Shackle points out the possibility of having to decide in a ‘crucial’, or else ‘non-divisible non-seriable’ experiment. In this case, the experiment can never be repeated under identical circumstances because its performance cannot exclude the possibility of permanently altering the surrounding environment (Shackle points the example of a chess move). Here, the employment of frequency ratios can be of no help, and thus no rational calculations of future scenarios’ pros and cons can be conducted in a genuine way (also see Lawson, 1988). This is the sort of experiments associated with what he labels as ‘true uncertainty’. It is what Keynes has in mind when he talks about the prospect of a European war, and the price of copper after twenty years. Such experiments are the most relevant with real economic life, and with actions like investment (also see Carvalho, 1988; Crotty, 1994). Moreover, as noted by Kregel (2011) in the presence of true uncertainty there is no such thing as objective data, since actual data will be determined by expectations (the most illustrative example here is the notion of effective demand).

Or to state it otherwise, in face of uncertainty, the agent does not merely react to events, but also creates them (Carvalho, 2002/3).

Despite the existence of uncertainty, and thus of ignorance, people need to make decisions. Keynes argues that in such cases people find shelter in social conventions. According to Setterfield (2003b), conventions are primarily constructed in order to satisfy peoples' need for stability. Such practices involve the assumption that the past can be used to predict the future (Keynes, 1937). In this regard, it can be said that in the context of the neoliberal epoch, CRAs had been part of the dominant social convention. In view of market participants' ignorance of what the future will bring, CRAs and their role as certifiers of the quality of credit managed to fill this gap by providing a sense of safety and stability into the market. As a result, CRAs managed to make uncertainty look as if it could be converted to calculable risk, so that investors could choose the debt instruments to fund based on their 'ratings preferences' (also see Carruthers, 2013). As Carruthers writes, those agencies essentially managed to create the impression of homogeneity across all different debt instruments they rated, making a triple-A CDO to seem like a triple-A corporate bond.

But what if some investors were "clever" enough so as not to take the insights of CRAs seriously? Here is where the Keynesian notion of the beauty contest steps in. More specifically, as argued by Sinclair (2005, 2010) CRAs have to be considered as important not for any tangible or technical features they might possess, but simply because people view them as such. In that regard, "smart" individuals would still have an incentive to follow the rating agencies' guidance as long as they would anticipate the rest of the crowd to do the same. And this is what happened during the neoliberal era.

Social conventions however are more than that. In particular, as shown above, taking CRAs into account implies that market participants also embrace the agencies' understanding of the workings of the economy. Now, in view of the dominance of neoliberalism upon the common sense understanding of policy makers and the public throughout the last thirty years, it should come as no surprise that CRAs embraced and further consolidated this dogma (also see Sinclair, 2005). One way of showing the attachment of those agencies to the neoliberal paradigm can be by observing and recording their reactions to events throughout real time (see for instance the discussion provided in the following section). Another way can be by looking at the 'fundamentals' those agencies use in order to derive sovereign ratings. Thus, other than the fact that the existence of uncertainty makes the 'hunting' of fundamentals a futile exercise from the very beginning (on this point also see Michailidou *et al.*, 2012), we can also see that the attitude of CRAs on several magnitudes like inflation and the budget deficit converges to that of mainstream economics. For instance inflation is constantly associated with structural problems in government's finances, without any serious consideration of the distributional benefits that might arise (for relevant discussion see Cantor and Packer, 1996; Afonso, 2003). In a similar fashion, there is a quite hostile view against budget deficits, which rather than being taken as a potential tool for stabilizing and stimulating the economy- as suggested by the functional finance literature (see for instance Lerner, 1943; Arestis *et al.* 2001; Arestis and Sawyer, 2013)- are viewed as a reflection of government's inability to tax its citizenry. Other than that, there is also the issue of how one goes on to measure those 'fundamentals', since different measurements can give rise to different insights. For example, there might be the

case that a nominal budget deficit can turn into a budget surplus if taken in real terms, by allowing government debt to depreciate by inflation⁷.

Although powerful, social conventions are always liable to collapse once true uncertainty reveals itself. As argued by Carruthers (2013) it was this uncertainty that became apparent in the 2007/8 crash- an uncertainty that 'lurked beneath the surface and undermined the equivalences rating agencies were trying to construct' (2013: 542). It is in moments like that when reality stands up to remind us that there is no economic agent capable of generating knowledge by ignoring uncertainty. CRAs can be no exception. Hence, there is no such thing as a 'fair rating'.

Ironically, the collapse of conventions in the light of a crisis is far from certain. That is, there is no mechanistic process negatively linking crisis episodes with CRAs' importance. Even more, as argued by Sinclair (2005) and Bruner and Abdelal (2005) financial crises might actually create a higher demand for CRAs' services, further consolidating their authority. And indeed, we can see that despite the experience of 2007/8 and the massive critique they faced (also see the above section), CRAs have kept being taken quite seriously by the market and policy makers in the context of the European crisis that followed.

6. The Importance of Sovereign Ratings and the Case of Eurozone

As it has been seen already, CRAs are keen to evaluate all different sorts of debt instruments, ranging from traditional corporate bonds to complicated CDOs. All of those categories of ratings can potentially have significant macroeconomic effects.

⁷ This point was brought to my attention by Prof. Malcolm Sawyer.

For instance, as discussed earlier it was the ratings related with the banking sector that took a big part of the blame behind the 2007/8 crash. Nonetheless, we argue here that sovereign ratings deserve some further attention due to their systematic social and macroeconomic linkages.

To start with, there are four distinct features of sovereign ratings. First, it can be said that sovereign ratings are closer to CRAs' traditional activities, for instance in terms of opaqueness of the debt instruments that are rated. Secondly, and related with the first, sovereign ratings provide us with a good opportunity to analyse an environment where the conflicts of interest discussed earlier do not exist (not in the same scale at least), therefore making it easier to draw conclusions about the way ratings can affect the macroeconomy even under the "good case scenario" of no false incentives. For instance with reference to the Eurozone debt crisis, White (2013) states that the criticisms against CRAs have been distinctly different compared from the attacks the agencies faced in the aftermath of the 2007/08 crash, so that rather than being criticized for being too generous CRAs came to be criticized for acting too precipitously. Third, sovereign ratings provide a ceiling for all other sorts of ratings of entities existing in a country. Obviously this implies some strong correlation and causality from sovereign to all other ratings. Fourth, as pointed out by Sinclair (1993), the lack of effective regulation at the international level implies that the agencies have to attribute a higher emphasis on sovereigns' willingness to repay, rather than focusing exclusively on their capacity to do so (as a matter of fact there is a whole stream of literature focusing on the incentives of sovereigns for not paying their debt to international lenders; see for instance Eaton and Gersovitz, 1981; Eaton *et al.*, 1986; Bulow and Rogoff, 1989).

As shown already the rise of CRAs' power has influenced the thinking framework of market participants, with the agencies acting as a promoter of the neoliberal paradigm. Most importantly though at the level of public governance such development has come to threaten the degree of states' independence by narrowing down the range of public choices, and hence to limit the idea of democracy itself. Sinclair (2005) lists a number of relevant examples. At the level of local government, he discusses the cases of Philadelphia, Detroit and the Australian states, all of whom faced situations of financial distress during the early 1990s, and points out that cuts in public spending and the encouragement of privatizations were a common ground in all three cases. In a similar fashion, considering the cases of Australia, Canada and Japan, Sinclair argues that in all three cases CRAs came to blame budget deficits as the primary cause of low growth rates and unemployment.

CRAs' pressure against the state can be felt at two levels, namely at the level of sovereign debt interest rates and at the level of capital flows. Other than the explicit empirical evidence, it is important to note that irrespectively of whether sovereign ratings lead or follow the market, their effects upon interest rates and capital flows could still be justified simply on the basis of their "certification role" discussed earlier, i.e. on the basis of the fact that prudential regulation requires several institutional investors like pension funds to hold securities above a certain rating grade (usually above B++). Amongst others, this is pointed out by Carruthers (2013) who argues that such regulation 'led to unintended *synchronization* and *correlation* of the economic decisions of an otherwise uncoordinated set of actors' (2013: 539; emphasis in the original). At the econometric terrain, both channels have been investigated by a number of scholars so far. Thus, with regard to the link between sovereign ratings and interest rates, Reisen and Maltzan (1999) report a

significant effect of upgrades and downgrades upon sovereign bond yields when the activities of the three CRAs are studied in conjunction. Gande and Parsley (2004a) identify asymmetric spillover effects, with upgrade events of a given country being insignificant towards the sovereign credit spreads of other countries, and downgrades being associated with an increase in spreads. Moreover, within the context of the Eurozone crisis, similar results have been obtained by Arezki *et al.* (2011), Afonso *et al.* (2011a) and De Santis (2012), with Afonso and his fellow researchers also pointing out a persistence effect. Such effect implies that countries which have been downgraded within the last six months face higher spreads than countries that have the same rating but without experiencing similar events during the same period. Concerning the link between sovereign ratings and capital flows, Gande and Parsley (2004b) report an asymmetric effect, with downgrades causing significant capital outflows from the country under stress and upgrades remaining highly insignificant. In addition, Kim and Wu (2008) report some mixed results, depending on the type of sovereign ratings (for example foreign currency long-term ratings are found to be positively connected with capital flows, with the opposite holding true for local currency long-term ratings).

It is apparent that an important variable behind CRAs' power is a state's need to access the international financial market. This mainly relates with the currency under which a sovereign borrows money and in that sense it comes as no surprise that until recently it was mainly developing countries borrowing in foreign currency that were exposed to the humours of those agencies. Nonetheless a state's dependency on the financial market also relates with the willingness of its Central Bank (CB) to finance public debt. In that regard, a currency can come to be taken as foreign for members of monetary unions as well. This has been the case for

Eurozone member states. In particular, as argued by a number of Post-Keynesian authors (e.g. Kelton and Wray, 2009; Papadimitriou *et al.*, 2010; Lucarelli, 2011/12) the introduction of the Euro implied the loss of monetary sovereignty of Eurozone countries. More specifically, following the launch of the Euro national central banks came to be impeded from acting as the manager of government's debt. At the same time there was no substitute taking over at a central level, since the ECB is prohibited by its constitution to act as a lender of last resort. As a result, the actual probability of default of Eurozone members- which would otherwise be either impossible or very remote- was brought into the picture (see for instance Lucarelli, 2011/12; Kelton and Wray, 2009). Essentially the Euro came to be a foreign currency for its member states (Wray, 2003; Papadimitriou *et al.*, 2010) which in that sense were downgraded to the status of developing countries (De Grauwe, 2011).

[Insert Figure 2 here]

Figure 2 shows the development of the S&P sovereign ratings of the original twelve Eurozone member states from 1999 to 2012⁸. As it can be seen it has mainly been the European peripheral countries that have experienced the most severe downgrades since the outbreak of the debt crisis, namely Greece, Spain, Italy, Portugal and Ireland. Interestingly the steepness of the downgrades appears to be irrelevant of the pre-crisis ratings for all those countries. That is, although the starting and terminating points of the ratings might differ amongst those countries, as a result of the different levels of economic development, the slope of the downgrades

⁸ The ratings of Moody's and Fitch for the same countries and time span provide a similar picture.

has been quite similar in the post-2009 period for all of them. At the same time it can be observed that core Eurozone countries like Germany and Netherlands have managed to retain their triple-A status. This is not of course irrelevant with the “fly to safety” phenomenon that has been observed in Eurozone, with downgrades of periphery countries exhibiting a positive spillover effect over the interest rates of core Eurozone countries (see for instance Arezki *et al.*, 2011 and De Santis, 2012).

To clarify, the above discussion does not imply that governments and international institutions like the ones that comprise the “Troika” nowadays (IMF-ECB-EC) were relieved from any political responsibility. Quite the contrary: as mentioned by Sinclair (2005), governments often found downgrades to be a quite convenient excuse for applying austerity and privatization policies that they would not be able to promote otherwise (in a more contemporary framework, the same can be said to hold for Greece nowadays). Furthermore there should be no surprise if one were to argue that the process of consolidation of CRAs’ power was accelerated by those political forces who were ideologically attached to the neoliberal dogma and to the idea that capital markets provide a more efficient means of financing than the state’s own central bank (for instance, Toporowski, 2010 mentions that such perception prevailed behind the construction of the ECB).

7. Conclusion

Having seen that CRAs form an institution of paramount importance throughout the neoliberal era, our paper contributes by providing a more complete account of how to view those agencies by means of heterodox economic theory. In particular, by gaining an authoritative position in the social structure since the rise of

neoliberalism, CRAs came to influence the frame of thought and options of market participants. Such power was further consolidated by the existence of Keynesian uncertainty- with CRAs managing to play an active role in the construction of the dominant social convention.

Our discussion links with the level of sovereign ratings and the direct effects they can exhibit upon the state and the macroeconomy. Most notably, other than exercising pressure on interest rates and capital flows, CRAs can come to threaten democracy itself. Furthermore, CRAs' power associates with the degree of monetary independence of a country. In that sense the ongoing Eurozone debt crisis re-exposed CRAs' importance and the pressure that can arise from sovereign ratings.

8. References

- Afonso A. (2003), 'Understanding the Determinants of Sovereign Debt Ratings: Evidence for the Two Leading Agencies', *Journal of Economics and Finance*, 27 (1): 56- 74
- Afonso A., D. Furceri and P. Gomes (2011a), 'Sovereign Credit Ratings and Financial Market Linkages. Application to European Data', ECB Working Paper Series, Working Paper No. 1347, retrieved in the 10th of June 2013 from <http://www.ecb.int/pub/pdf/scpwps/ecbwp1347.pdf>
- Arestis P., A. Brown and Sawyer M. (2001), *The Euro: Evolution and Prospects*, Cheltenham: Edward Elgar

Arestis P. (2009), in 'Special Symposium on Financial Instability and Crisis',
Intervention: European Journal of Economics and Economic Policies, 6
(2): 174- 181

Arestis P. and M. Sawyer (2013), 'Prospects for Future Fiscal and Debt Policies in
the UK', unpublished

Arezki R., B. Candelon and A. Sy (2011), 'Sovereign Rating News and Financial
Markets Spillovers: Evidence from the European Debt Crisis', IMF
Working Paper No. 11/68, retrieved in the 10th of June from
<http://www.imf.org/external/pubs/ft/wp/2011/wp1168.pdf>

Bhatia A. (2002), 'Sovereign Credit Ratings Methodology: An Evaluation', IMF,
Working Paper no. 02/170, retrieved in the 10th of November 2012 from
<http://www.imf.org/external/pubs/ft/wp/2002/wp02170.pdf>

Bolton P., X. Freixas, and Shapiro J. (2012), 'The Credit Ratings Game', *The Journal
of Finance*, 67 (1): 85- 112

Boot A., T. Milbourn, and Schmeits A. (2006) 'Credit Ratings as Coordination
Mechanisms', *The Review of Financial Studies*, 19 (1): 81-118

- Bulow and Rogoff (1989), 'Sovereign Debt: Is to Forgive to Forget?', *The American Economic Review*, 79 (1): 43- 50
- Cantor R. and F. Packer (1996), 'Determinants and Impact of Sovereign Credit Ratings', *Federal Reserve Bank of New York Economic Policy Review*, issue Oct, 37- 53
- Canuto O., P Dos Santos, and De Sa Porto P. (2012), 'Macroeconomics and Sovereign Risk Ratings', *Journal of International Commerce Economics and Policy*, 3 (2)
- Carruthers B. (2013), 'From Uncertainty towards Risk: the Case of Credit Ratings', *Socio-Economic Review*, 11(3): 525- 551
- Carvalho F. (1988), 'Keynes on Probability, Uncertainty, and Decision Making', *Journal of Post Keynesian Economics*, 11 (1): 66- 81
- Carvalho F. (2002/3), 'Decision-Making under Uncertainty as Drama: Keynesian and Schacklean Themes in Three of Shakespeare's Tragedies', *Journal of Post Keynesian Economics*, 25 (2): 189- 218
- Cooley A. (2003), 'Thinking Rationally about Hierarchy and Global Governance', *Review of International Political Economy*, 10 (4): 672- 684.

Crotty J. (1994), 'Are Keynesian Uncertainty and Macrotheory Compatible? Conventional Decision Making, Institutional Structures, and Conditional Stability in Keynesian Macromodels', in Dymski G., and R. Pollin (eds.), *'New Perspectives in Monetary Macroeconomics'*, Ann Arbor, MI: University of Michigan Press

Crotty J. (2009), 'Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture'', *Cambridge Journal of Economics*, 33 (4): 563- 580

Deb P., M. Manning, Murphy G., A. Penalver and Toth A. (2011), 'Whither the Credit Ratings Industry?', Financial Stability Paper no. 9, Bank of England: London, retrieved in the 10th of May 2013 from http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper09.pdf

De Grauwe P. (2011), 'The Governance of a Fragile Eurozone', Centre for European Policy Studies (CEPS), working document no. 346, retrieved in the 10th of May 2013 from <http://www.ceps.eu/book/governance-fragile-eurozone>

De Santis (2012), 'The Euro Area Sovereign Debt Crisis: Safe Haven, Credit Rating Agencies and the Spread of the Fever from Greece, Ireland and Portugal', ECB Working Paper Series, Working Paper No. 1419, retrieved in the 3rd of June 2013 from <http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1419.pdf>

Diamond D. (1984), 'Financial Intermediation and Delegated Monitoring', *The Review of Economic Studies*, 51 (3): 393- 414

Diamond D. (1996), 'Financial Intermediation as Delegated Monitoring: A Simple Example', *Federal Reserve Bank of Richmond Economic Quarterly*, 82 (3): 51- 66

Eaton J. and M. Gersovitz (1981), 'Debt with Potential Repudiation: Theoretical and Empirical Analysis', *Review of Economic Studies*, 48 (2): 289- 309

Eaton J., M. Gersovitz and Stiglitz J. (1986), 'The Pure Theory of Country Risk', *European Economic Review*, 30 (3): 481- 513

Efing M. and H. Hau (2013), 'Structured Debt Ratings: Evidence on Conflicts of Interest', Swiss Finance Institute Working Paper No. 13-21, retrieved in the 16th of July 2013 from <http://www.haraldhau.com/SSRN-id2253970.pdf>

Epstein G. A. (2005), 'Introduction: Financialization and the World Economy' in Epstein (ed.) *Financialization and the World Economy*, Northampton: Edward Elgar Publishing

FESSUD (2011), 'Description of Work': Annex 1: Grant agreement for collaborative project Financialisation, economy, society and sustainable development: under grant agreement 266800 funded by European Union under

Framework Programme 7 Theme SSH-2010-1.2-1 Changing the role of the financial system to better serve economic, social and environmental objectives

Fine B. (2011), 'Financialisation on the Rebound?' *Actuel Marx* (Forthcoming), retrieved in the 10th of July 2013 from <http://eprints.soas.ac.uk/12102/>

Fitch Ratings (2012a), 'Country Ceilings: Cross-Sector Criteria Report', retrieved in the 11th of May 2013 from http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685029

Fitch Ratings (2012b), 'Sovereign Rating Criteria: Master Criteria', retrieved in the 11th of May 2013 from http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685737

Gande A. and D. Parsley (2004a), 'News Spillovers in the Sovereign Debt Market', *Journal of Financial Economics*, 75 (3): 691- 734

Gande A. and D. Parsley (2004b), 'Sovereign Credit Ratings and International Portfolio Flows', Owen Graduate School of Management, Vanderbilt University, retrieved in the 15th of May 2013 from <http://www.imf.org/external/np/seminars/eng/2004/ecbimf/pdf/parsle.pdf>

Greenwald B., J. Stiglitz, and Weiss A. (1984), 'Informational Imperfections on the Capital Market and Macroeconomic Fluctuations', *The American Economic Review*, 74 (2): 194- 199

Harvey D. (2010), '*The Enigma of Capital and the Crises of Capitalism*', London: Profile Books

Hau H., S. Langfield and Marques-Ibanez D. (2013), 'Banks' Credit Ratings: What Determines their Quality?', *Economic Policy*, 28 (74), 289-333

IMF (2010), 'Global Financial Stability Report: Sovereigns, Funding, and Systemic Liquidity', Washington/ DC: International Monetary Fund, retrieved in the 15th of May 2013 from <http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf>

Kelton S. and R. Wray (2009), 'Can Euroland Survive?', Levy Economics Institute of Bard College, Public Policy Brief No. 106, Retrieved in the 5th of June 2013 from http://www.levyinstitute.org/pubs/ppb_106.pdf

Keynes J. M. (1937), 'The General Theory of Employment', *The Quarterly Journal of Economics*, 51 (2): 209- 223

Kregel J. (2011), 'Evolution Versus Equilibrium', *Journal of Economic Issues*, 45 (2): 269- 275

Kundu A. (2001), 'Politics and Economics of Credit Rating', *Economic and Political Weekly*, 36 (4): 293- 295

Lawson T. (1988), 'Probability and Uncertainty in Economic Analysis', *Journal of Post Keynesian Economics*, 11 (1): 38- 65

Lerner A. (1943), 'Functional Finance and the Federal Debt', *Social Research*, 10 (1): 38- 51

Lucarelli B. (2011/12), 'German Neomercantilism and the European Sovereign Debt Crisis', *Journal of Post Keynesian Economics*, 34 (2): 205- 224

Michailidou D., N. Naqvi, and R. Borghi (2012), 'Animal Spirits or Fundamental Followers? The Role of Credit Rating Agencies in the Current Financial Crisis', paper presented in the 16th Conference of the Research Network Macroeconomics and Macroeconomic Policies (FMM): The State of Economics after the Crisis 25 – 27 October 2012

Moody's Investors Service (2008), 'Rating Methodology: Sovereign Bond Ratings', retrieved in the 11th of May 2013 from http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_109490

Moody's Investors Service (2012), 'Sovereign Default and Recovery Rates' 1983-2012H1', retrieved in the 18th of May 2013 from

http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_144320

Papadimitriou D., R. Wray, and Nersisyan Y. (2010), 'Endgame For the Euro? Without Major Restructuring, the Eurozone is Doomed', Levy Economics Institute of Bard College, Public Policy Brief No. 113, Retrieved in the 5th of June 2013 from http://www.levyinstitute.org/pubs/ppb_113.pdf

Reisen H. and J. Maltzan (1999), 'Boom and Bust and Sovereign Ratings', *International Finance*, 2 (2): 273- 293

Ryan J. (2012), 'The Negative Impact of Credit Rating Agencies and Proposals for better Regulation', Working Paper FG1, 2012/Nr. 01, German Institute for International and Security Affairs, retrieved in the 10th of May 2013 from http://www.swp-berlin.org/fileadmin/contents/products/arbeitspapiere/The_Negative_Impact_of_Credit_Rating_Agencies_KS.pdf

Setterfield M. (2003b), 'Keynes's Dialectic?', *Cambridge Journal of Economics*, 27 (3): 259- 376

Shackle G.L.S. (1955), *'Uncertainty in Economics and Other Reflections'*, London: Cambridge University Press

Sinclair T. (1993), *Passing Judgement: Credit Rating Processes As Regulatory Mechanisms of Governance in the Emerging World Order*', Centre for International and Strategic Studies, Occasional Paper No. 20, retrieved in the 10th of April 2014 from <http://yciss.info.yorku.ca/files/2012/06/OP20-Sinclair.pdf>

Sinclair T. (2005), *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness*', London: Cornell University Press

Sinclair T. (2010), 'Round Up the Usual Suspects: Blame and the Subprime Crisis', *New Political Economy*, 15 (1): 91- 107

Standard and Poor's (2002), 'Sovereign Credit Rating: A Primer', retrieved in the 10th of April 2013 from <http://www.securitization.net/pdf/SovereignCreditRatings3402.pdf>

Standard and Poor's (2011), 'Sovereign Government Rating Methodology and Assumptions', retrieved in the 10th of May from [http://www.standardandpoors.com/spf/upload/Ratings_EMEA/2011-06-30_CBEvent_CriteriaGovSovRatingMethodologyAndAssumptions.pdf](http://www.standardandpoors.com/spf/upload/Ratings_EMEA/2011-06-30_CBEEvent_CriteriaGovSovRatingMethodologyAndAssumptions.pdf)

Standard and Poor's (2012), 'How We Rate Sovereigns', retrieved in the 10th of May 2013 from http://www.standardandpoors.com/spf/ratings/How_We_Rate_Sovereigns_3_13_12.pdf

Stiglitz J. and A. Weiss (1981), 'Credit Rationing in Markets with Imperfect Information', *The American Economic Review*, 71 (3): 393- 410

Toporowski J. (2010), 'Not a Very Greek Tragedy', *Re-public*, retrieved in the 4th of June 2013 from <http://www.re-public.gr/en/?p=2400>

Van Roy P. (2005), 'Credit Ratings and the Standardised Approach to Credit Risk in Basel II', ECB Working Paper Series, Working Paper no. 517, retrieved in the 11th of May 2013 from <http://www.ecb.int/pub/pdf/scpwps/ecbwp517.pdf>

White L. (2010), 'Markets: The Credit Rating Agencies', *Journal of Economic Perspectives*, 24 (2): 211- 226

White L. (2013), 'Credit Rating Agencies: An Overview', *Annual Review of Financial Economics*, 5 (1): 93- 122

Wray R. (2003), 'Is Euroland Next Argentina?', Centre for Full Employment and Price Stability, University of Missouri-Kansas City, Working Paper No. 23, Retrieved in the 5th of May 2013 from <http://www.cfeps.org/pubs/wp-pdf/WP23-Wray.pdf>

Table 1. Sovereign Credit Rating Categories

	credit quality	S&P		Moody's		Fitch	
		long term	short term	long term	short term	long term	short term
Investment Grade	highest	AAA	A-1+	Aaa	P1	AAA	F1+
	very high	AA+		Aa1		AA+	
		AA		Aa2		AA	
		AA-		Aa3		AA-	
	high	A+	A-1	A1	A+	F1 or F1+	
		A		A2	A	F1	
		A-	A-2	A3	P1 or P2	A-	F2 or F1
	good	BBB+		Baa1	P2	BBB+	F2
		BBB	A-3	Baa2	P2 or P3	BBB	F3 or F2
	BBB-		Baa3	P3	BBB-	F3	
Speculative Grade	speculative	BB+	B	Ba1	Not Prime	BB+	B
		BB		Ba2		BB	
		BB-		Ba3		BB-	
	highly speculative	B+		B1		B+	
		B		B2		B	
		B-	B3	B-			
	substantial credit risk	CCC+	C	Caa1	Not Prime	CCC+	C
		CCC		Caa2		CCC	
		CCC-		Caa3		CCC-	
	very high level of credit risk	CC		Ca		CC	
exceptionally high levels of credit risk	C		C		C		
under regulatory supervision	R						
Selective/ Restricted Default	SD				RD	RD	
Default	D				D	D	

source: author's elaboration, based on S&P, Moody's and Fitch websites

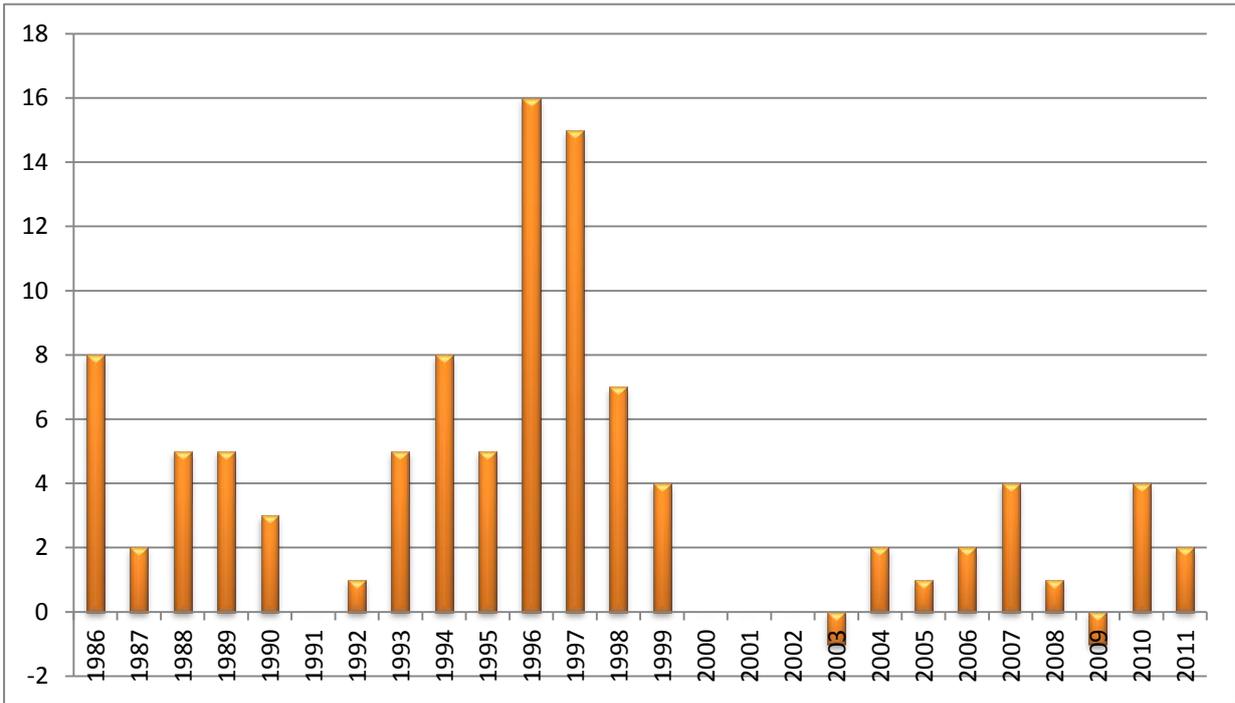


Figure 1. Number of Countries to obtain a sovereign rating from Moody's for the first time.

source: author's elaboration based on Moody's (2012)

notes: 1) between 1949 and 1985, 13 countries in total had started obtaining a rating; 2) Iran, Micronesia, Moldova and Turkmenistan withdrew from their ratings in 2001, 2003, 2009 and 2010 respectively.

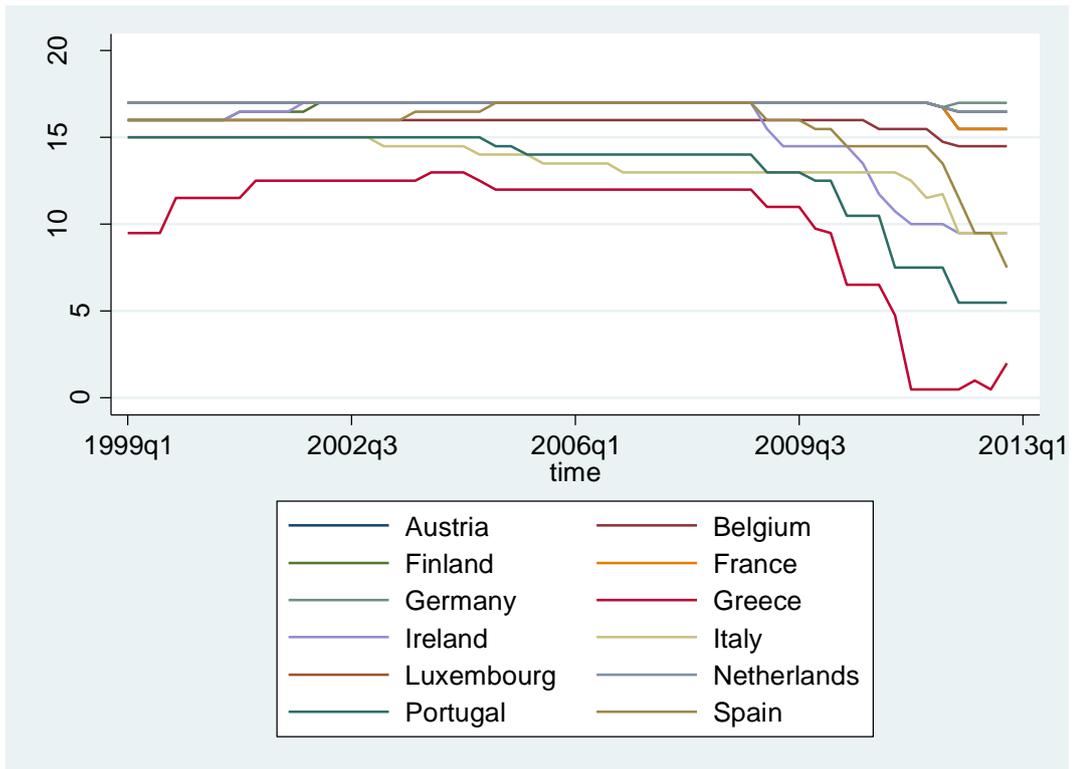


Figure 2. S&P sovereign ratings for the original twelve Eurozone countries (1999- 2012); elaboration is based on the numerical transformation of ratings to a 1-17 scale, with 17 corresponding to AAA and 1 corresponding to any rating from CCC+ and below.

source: S&P website and author's elaboration