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Rating Politics: the Political Economy of Increased Rating Scrutiny over Domestic Politics and Policy-making in Developed Economies since the Economic and Financial Crisis

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Abstract

Rating agencies have played a prominent role in the sovereign debt crisis currently besetting Europe. Sovereign rating downgrades contributed to the fall of the first domino, Greece, and have since continued to fuel anxiety both in markets and among governments. Policy-makers in the prosperous developed countries that are now under greatest pressure vehemently protest against the immense power of rating agencies over the immediate and longer-term fiscal viability of their countries. While *Standard and Poor's*, *Moody's* and *Fitch* had previously been given a central role within regulatory frameworks to monitor risk, they are now seen as undesirable meddlers in policy-making. But is government room for manoeuvre more tightly constrained by the pronouncements of the agencies now than it was before, or is it more that the usual constraints have become more uncomfortable for policy-makers under the adverse new economic conditions? This paper contends that rating agencies have significantly changed their attitude towards prosperous developed countries since the start of the crisis. Agencies now treat these prosperous developed countries in precisely the same way that they used to treat developing countries in the decades before the crisis. This implies far greater and more inquisitive scrutiny of political developments and politically-loaded policy-decisions in developed countries than before. This contention is built on an analysis of the sovereign rating methodologies of the three large rating agencies and the press releases issued over the rating evolution of four countries: the US, Italy, Hungary and Romania. This analysis suggests that, before the crisis, a divide existed in the approach of rating agencies to developed *versus* developing countries, but they have applied the same standards to these different categories since the start of the crisis, although the evidence is ambiguous at times.

Keywords

Rating agencies; economic and financial crisis; sovereign debt; international regulation; economic policy.

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Max Weber Fellow, 2011-2012

Introduction

In the past two years, rating agencies have come to play an unprecedented role in determining the economic and fiscal fates of prosperous developed countries. In Europe, they have been an important factor both in setting off and perpetuating a prolonged series of sovereign debt crises. The decision of the three large sovereign rating agencies – *Standard and Poor's* (S&P), *Moody's* and *Fitch* – to downgrade Greece by several notches within months, significantly contributed to the self-fulfilling confidence crisis that triggered the fall of the first domino in the spring of 2010. Subsequently, similarly drastic rating actions considerably weakened the ability of other troubled European states to finance themselves from the markets and led to the need for repeated bailout packages to several Member States. Recently, even the highest-rated European sovereigns have come under the agencies' scrutiny, and a series of new announcements about adverse rating and outlook changes continue to fuel anxiety both in the markets and among governments. Elsewhere in the world, too, prime-rated countries have been more critically evaluated. New Zealand's and Japan's scores were adjusted downwards several times. More importantly, however, *Standard and Poor's* decided to lower the United States' triple-A rating for the first time in a century, and the other two agencies also placed a negative outlook on the US's ratings. Many of these developments have caused great turbulence on debt and stock markets.[1]

Beyond being highly visible and consequential, these recent actions of rating agencies have also raised a lot of controversy and criticism. Policy-makers in the prosperous developed countries that are now under great pressure are taken aback by and vehemently protest against the immense power of rating agencies over the immediate and longer-term fiscal viability of their countries. They have not only intensely debated the validity and the timing of the concrete unfavourable rating changes, but have also been bent on revising regulation both to limit and to control the power of rating agencies in both the US and Europe. While such efforts partially relate to corporate debt markets, and therefore mostly reflect the unflattering track-record of agencies in correctly assessing the creditworthiness in these market segments before the crisis, the European regulatory proposals also pay considerable attention to controlling the way sovereigns are rated, and, importantly, to restricting the timing and form of new announcements.[2] In the current atmosphere, the activities of rating agencies are clearly seen as a de-stabilising factor that needs to be controlled and tamed.[3] Earlier, however, the same countries that now suffer most from the agencies' actions enhanced the influence of these

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[1] The downgrade of the US as a sovereign issuer was seen as an especially momentous decision, because US treasury bonds had previously been considered *the* benchmark risk-free asset relative to which other financial assets could be priced. Therefore, the move was feared to trigger profound re-adjustments of investor behaviour in both bond and equity markets.

[2] The European Commission Public Consultations of late 2010 called for:

- increased transparency in the sovereign-rating process: agencies need to disclose the assumptions, parameters, limits and uncertainties surrounding the methodologies used, and to have regular meetings with the interested parties – rated countries, financial institutions, and other users of ratings – to discuss these items;
- more advanced warning for the rated sovereign: agencies would need to inform the country for which they are in the process of issuing a rating at least three working days before the publication of the rating, in order to give the country the opportunity to draw the attention of the credit-rating agency to any factual errors and to any new developments which may influence the rating;
- the publication of sovereign-debt ratings only after the close of business of European trading venues.

(de Haan and Amtenbrink 2011). These proposals were subsequently incorporated into the new European draft directive and regulation of June 2011.

[3] For example, President of the European Commission, José Manuel Barroso commented that "ratings appear to be too cyclical, too reliant on the general market mood rather than on fundamentals - regardless of whether market mood is too optimistic or too pessimistic" (Barroso 2010).

organisations by making ratings integral parts of their national and international frameworks for monitoring financial risk.[4] The tide has clearly turned.

While the momentousness of the change in the relationship between the rating industry and prosperous developed countries seems obvious, its nature and scope is less clear. What has really changed in the political economy of ratings? Is it the behaviour of the agencies that has been altered? Are raters more aggressively commenting and acting upon domestic policy decisions and political developments than before, and thereby unduly meddling with the policy sovereignty of countries? Alternatively, are they doing what they have always done? Is it only the adversity of the economic and financial crisis and the new policy challenges that make governments of developed countries suddenly conscious of, and sensitive to, the constraints on policy-making generated by the scrutiny of rating agencies? If it is true that agencies are more inquisitive, what does this imply for the policy-making environment in prosperous developed countries? Will governments in developed democracies be subject to closer and stricter market-based control in the long run?

This paper contends that the current conflicts between rating agencies and governments in developed countries (probably) reflect a long-term shift in the approach of rating agencies towards evaluating the creditworthiness of prosperous developed sovereigns and therefore foreshadow permanently tightened external constraints on domestic policy choices, which go well beyond the monitoring of broad macro-economic indicators and entail scrutiny over various politically-charged policy-decisions. The paper argues that this shift in rater-behaviour is triggered by a fundamental change in basic market sentiments towards developed countries in the midst of the profound uncertainties generated by the recent years of recession and financial turmoil.

Before the crisis, market actors consensually assumed that full-scale default was a practical impossibility for developed sovereigns. Therefore, rating-agencies – just like investors themselves – could afford to concentrate on a limited set of indicators that helped them gauge non-default types of risks to the value of their investment in government debt, such as inflation or exchange-rate risk. They narrowly focused on macro-economic variables that captured monetary and fiscal stability in the given country. This practice allowed the governments of prosperous countries to have a free hand in a large range of supply-side policy choices, and made their ratings subject to keeping a handful of macro-economic indicators within acceptable ranges.[5] However, in the wake of momentous shocks to the general investment environment as well as to the economic and financial prospects of rich countries themselves, the comfortable no-default assumption was abandoned. This change in the underlying market sentiment necessarily led to a wholly different approach by raters towards assessing the creditworthiness of developed sovereigns – even those whose solvency remains indubitable. The oversight of rating agencies is now more inquisitive and is extended over not only a broader range of policy areas – most crucially, the issues of structural reforms in labour and product markets and in welfare provision – but also over the domestic political conflicts and debates that influence choices in these areas. In other words, the practice of rating developed sovereigns is now based much less upon a macro-economic analysis, and increasingly gains political overtones.

By making and evaluating this argument, the paper seeks to contribute to knowledge about rating constraints on policy-making in two ways. First, it contends that rating agencies used to subject prosperous developed countries to limited – mostly indicator-focused – oversight in the decades before the crisis, whereas less developed countries were subject to closer, broader and more qualitative scrutiny. Second, it shows that the crisis ended the lighter treatment of rich countries and thereby ushered in more intrusive agency-interference in their policy-making. This is the change that policy-makers are now protesting throughout the developed world.

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[4] The use of ratings as a risk-assessment tool was sanctioned by the legislation pertaining to nationally-recognised rating organisations in the US (Sinclair 2005). Ratings also form an integral part in determining capital adequacy ratios under the Basle II Agreement and in the European Capital Requirement Directive (de Haan and Amtenbrink 2011). Furthermore, the use of ratings to set rules for eligible collateral by central banks, such as the European Central Bank, also enhance the significance of ratings.

[5] This claim is based upon Mosley (2000 and 2003) and is elaborated on in more detail in the next section.

The next section shows that the decision process behind rating actions remains a relatively under-researched area. Several quantitative models have been produced that show the correlation between rating scores and a range of macro-economic variables. At the same time, what factors count beyond these variables, in what ways they affect the rating score, and whether there are differences in the approach taken towards different categories of sovereigns, have received much less attention. Answering these questions is crucial for a better understanding of how the activities of rating agencies constrain policy-makers' freedom of choice. Therefore, the next section proposes a handful of hypotheses about the probable decision-making approach of agencies, drawing on the work of Timothy Sinclair (2005) and Layna Mosley (2000, 2003).

The third section evaluates these hypotheses upon the basis of qualitative evidence. It first draws on the published rating methodologies of the three big rating agencies in order to gain a better understanding of how the rating process works in each, and – wherever subsequent editions of the methodologies are available – how the processes have changed in response to the crisis. Then, it analyses the evolving approach of the three agencies to four countries – the US, Italy, Hungary and Romania – in the light of the press releases issued about the rating actions (upgrades and downgrades) affecting these countries, in order to identify possible differences in the way these four countries with different levels of development and different fiscal performance are treated. The last section concludes.

Passing judgement: What do we know about rating agency decision-making?

Understanding why and how rating agency scrutiny might constrain national policy choices requires answering two questions. First, do rating changes make a difference to the outcomes that policy-makers care about? In other words, do ratings matter? Second, how are rating scores affected by the political and policy choices that a country takes? Do rating agencies consistently reward some types of policy choices and penalise others? Are the factors taken into consideration limited to the macro-economic indicators that have direct bearing on the solvency of a country – such as income, debt, deficit, etc., – or do they encompass a broad range of policy areas that only indirectly relate to the ability, and, more importantly, the willingness, of governments to mobilise the necessary resources to service their debt in the longer term?

The first question can be easily answered in the affirmative. Sovereign credit ratings have been found to affect sovereign bond prices and national stock markets in several quantitative studies (Brooks *et al*. 2004, Sy 2002, Gande and Parsley 2005, de Haan and Amtenbrink 2011). The effect of ratings arises from a variety of ways in which they influence the decisions of financial market actors. Beyond generally orienting investors about the risk properties of a given bond, ratings also play important institutionalised roles. They are often used in portfolio mandates to set risk-limits for institutional investors, in regulatory systems to specify capital adequacy ratios in the balance-sheets of financial institutions and in minimum eligibility standards for assets to be accepted as collateral for loans by commercial and central banks (Sinclair 2005, de Haan and Amtenbrink 2011). These institutionalised roles trigger automatic selling and buying adjustments – and, consequently, changes in interest rates – even if market actors were to entertain doubts about the validity of certain rating changes. Therefore, policy makers can be expected to care about their countries' rating score and take the rating consequences of their policy choices into consideration.

However, the second question – how policy choices affect ratings – is difficult to answer. Firstly, the rating process has been shrouded in considerable secrecy in the past.[6] This is partly due to the fact that rating models – the embodiment of the core competence of these privately-owned, profit-oriented businesses – constitute proprietary information that agencies are keen to keep to themselves (Archer, Biglaiser, DeRouen 2007, de Haan and Amtenbrink 2011). Furthermore, based upon interview evidence Archer *et al*. (2007) also point out that the raters themselves have difficulties in pinning down the more qualitative aspects of their decision-making process (or, perhaps, they are simply reluctant to do so).

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[6] Notably, current efforts of the EU to tame rating agencies have focused strongly on forcing them to provide more transparency about their rating procedures. (See Footnote 2).

Secondly, the correlation between policy choices and rating changes is confounded by the documented large differences in the outputs of the three major agencies. These differences affect both the scores that the agencies assign, and the timing of the changes which they make in response to new developments (Brooks *et al*. 2004, Gande and Parsley 2005, Hill, Brooks, Faff 2010, Afonso, Gomes, Rother 2007). Therefore, one cannot specify the effect of policy choices on "ratings" in general. Instead, this link has to be established for each of the three agencies separately. Furthermore, in principle, a sovereign issuer does not have to be rated by all three agencies in order to sell bonds successfully. Thus, the divergence between agencies can lead to "rating shopping" amongst issuers. This ability of the sovereign to choose between different rating scores can further complicate the relationship between policy choices and the relevant rating outcome for the given sovereign. At the same time, the practice of the major rating agencies to issue "unsolicited" ratings for most large sovereigns *de facto* subjects most countries to the influence of all three agencies and eliminates the confounding effect of "rating shopping".

The third difficulty in establishing a clear link between the policy choices of a country and the rating scores which it receives is the rather lose connection between political and policy developments and rating changes in time. Cantor and Packer (2007) and Archer *et al*. (2007) note that rating agencies are inclined to keep their ratings stable and to iron out shorter-term variations, because they expect that the users of their ratings incur costs when acting upon a rating change. Therefore, there is a trade-off between the perceived accuracy and the stability of ratings, and changes that might need to be reversed in the short or medium term are undesirable. Accordingly, some political or policy choices might not trigger changes in the rating scores for a long time before their long-term or cumulative effects finally outweigh the desire to keep ratings stable.

These difficulties notwithstanding, a considerable number of quantitative studies have shown a strong correlation between rating scores and a handful of variables, suggesting that getting these variables "right" secures a better rating for a given sovereign. These studies find that variation in GDP, GDP *per capita*, inflation, the size of public debt, the external debt of private and public actors, the size of external reserves, the track record of past defaults, government effectiveness indicators, and EU membership explain a considerable share of the variation in rating (Cantor and Packer 1996, Afonso 2003, Block and Vaaler 2004, Afonso *et al*. 2007). While these results are important in showing that ratings are anchored in economic fundamentals that ultimately determine the ability of a given sovereign to honour its debt obligations – or, in other words, that they are in no way arbitrary or completely subjective – they say little about what other factors potentially enter into the decision-making process to explain the rest of the variation in ratings. The significance of the government effectiveness indicators and EU membership variables introduced by Afonso *et al*. (2007) suggests that non-economic factors play an important role, but it is not clear how they are assumed to affect creditworthiness. Furthermore, these studies do not test whether different categories of countries might be treated differently in the rating process.

Studies that look at the effect of non-economic variables on ratings return no clear results. Haque *et al*. (1998) only find weak evidence that *coup d'états*, assassinations, general strikes, guerrilla warfare, the downfall of the regime, purges, riots, revolutions, anti-governmental demonstrations, *etc*., have an impact on ratings. Archer *et al*. (2007) find no significant quantitative evidence that political variables such as regime type, undivided government, executive ideology, the honeymoon-effect or the years remaining in office for the executive affect bond-rating scores. At the same time, they underline that their interviewees confirmed the importance of political factors in the rating judgement. Archer *et al*. hypothesise that the lack of consistent quantitative evidence arises from the fact that political variables enter the decision-making process in highly complex, non-standardisable ways, which, to a great extent, depend on the historical, political and social context relevant to a given country. Interestingly, they point out that their definition of political variables seems to fail to capture what raters themselves refer to as political factors.[7]

[7] "Raters seemed proud of the fact that their agencies considered the political situation, historical context, and economic health of a country when assigning ratings. But the raters seemed uncomfortable making broad statements about the political variables we identified, namely, democratic systems of government. They had a difficult time defining what they

In sum, the existing research leaves as much in the dark as it reveals about the decision-making variables driving ratings. To understand fully the constraints that the rating industry places upon national policy-making would require investigating the least tangible, least-easily quantifiable factors documented by interview evidence, which are independent of economic fundamentals and seem to have little to do with the extraordinary disruptions that Haque *et al.* focused on or the formal characteristics of the policy-making procedures of the type that Archer *et al.* were investigating. Clearly, primary debt servicing capacity matters for ratings, but it would be important to know if agencies claim the right to comment and adjudicate on policies that are only indirectly related to maintaining the debt servicing capacity – such as welfare policies, labour-market structures, the overall size and composition of spending and taxation, *etc.* – and on party-political, institutional or societal circumstances that influence such policy choices.

The hypothetical answer to these questions that this paper examines is the following:

- As a rule, rating agencies do seek to take into consideration all – even indirectly related – political and policy factors that might have a bearing on the long-term likelihood of repayment. They systematically reward or penalise choices deemed to be "right" or "wrong" in various policy fields, and also form judgement about political constellations leading to "right" and "wrong" choices.
- Developed countries, however, were subjected to a much more limited scrutiny in the past decades, because of the generally accepted market assumption that rich developed economies have both the capacity and the willingness to honour their debt obligations. Commenting and acting upon other than the most directly relevant set of macro-economic variables would have been seen by investors – the primary "consumers" of ratings – as noise that decreases, rather than augments, the value of the information service provided by the rating agencies.
- With the disappearance of the no-default assumption in the midst of the economic and financial crisis, the special status of developed countries ended, and they are now increasingly subjected to the same frequent and inquisitive scrutiny as developing countries.

These hypotheses rest on two pillars: the work of Sinclair (2005) on the special role of rating agencies in reducing uncertainty in markets via operating shared "mental frameworks"; and on Mosley's (2000, 2003) insight about the fundamentally different assumptions of market actors about the probabilities of default for developed and developing sovereigns.

Rating agencies fulfil a special function in the markets for sovereign debt by providing authoritative judgements of sovereign creditworthiness (Sinclair 2005). While creditworthiness should be the most fundamental determinant of investors' decisions about the acceptable price of government debt, it is surrounded by ambiguities and uncertainty, because assessing it involves making assumptions not only about long-term future growth and interest rates, but also about the willingness and capacity of future governments to mobilise the necessary resources from their citizens.[8] Rating agencies' judgements about sovereign creditworthiness are not more "correct" or "incorrect" than anyone else's, but they do orient market expectations and provide an important anchor in a market in which decisions are often made in anticipation of, and in reaction to, decisions made by others.[9] In other words, rating agencies allow markets to function by facilitating transactions through co-ordinating the expectations of buyers and sellers. This special role – and thereby the business model – of rating agencies is based upon the intellectual authority that the agencies possess, which is

(Contd.)

meant by 'politics'. There is an apparent disconnect between the importance that the bond raters put on political variables and their ability to identify the specific political variables that they considered relevant for a positive rating. This might be a fruitful line of inquiry to explore in further studies since we were constantly told in interviews that politics mattered, but that the political characteristics of states that we were interested in exploring did not seem to fit the raters' idea of what was 'political'." (Archer, Biglaiser, and DeRouen 2007, p357).

[8] For a complete overview of the literature on the difficulties entailed in assessing sovereign creditworthiness, see Barta (2011).

[9] See also Mosley (2000) and Blyth (2011) on the need to reduce uncertainty in financial markets where investors are engaged in the Keynesian "newspaper beauty contest" of trying to anticipate the actions of the median.

maintained through cultivating shared "mental frameworks" of what constitutes appropriate policies on the part of borrowers (Sinclair 2005, Chapter 1). This entails a complex, mutually-reinforcing two-way interaction between market sentiments and rating judgements: even if rating judgements are crucial in anchoring market expectations, they cannot depart very far from the general market sentiment and the mental models of the majority of investors, lest they lose their authority.

Mosley's (2000 and 2003) work on investor perceptions about different categories of sovereigns helps us to understand better how the shared "mental frameworks" that the rating agencies employ work. Mosley contends that, as financial integration allowed investors to diversify their portfolios across an ever-greater number of sovereign issuers, the informational requirements of investment activities became ever-heavier and more costly. Therefore, investors increasingly came to rely on information shortcuts in the case of those sovereigns, whose default risk was seen to be practically zero (that is, in the case of the prosperous developed countries). Since the most important risk to the value of investment in developed debt was assumed to be inflation and currency risk, investors focused on those broad macro-economic policies (and the relevant indicators) that influence these risks, leaving rich governments considerable "room to move" in other policy areas. In the case of developing countries, however, default risk was perceived to be great enough to justify close scrutiny of broad macro- and micro-policy areas as well as political conditions that might affect governments' long-term capacity and willingness to honour their obligations. For these countries, market orthodoxy about certain institutional configurations and specific "virtuous" policy choices remains a strongly binding constraint.

The argument that the basic mental framework has to be shared between rating agencies and markets suggests that the same dichotomy was present in rating agencies' approach to different categories of countries in the decades before the crisis, and that this dual approach was adjusted once the market sentiment was affected by the shock of the past years of economic and financial upheavals. The turmoil and the extreme uncertainty generated by the crisis is likely to have overwritten old mental models and fuelled a drive towards greater risk aversion and an increased hunger for reliable information among investors. Accordingly, the previous lighter treatment of developed countries in the rating process is likely to be phased out and the "room to move" independently of rating scrutiny is likely to shrink progressively. The next section evaluates these hypotheses based upon qualitative evidence.

Rating along double standards

Although the secrecy surrounding the actual decision-making processes and proprietary rating models of rating agencies has been noted – and can be experienced first-hand by anyone trying to approach agencies for an interview – there exist important sources of information about the broad rating framework and the most important factors that drive specific rating actions. These sources are provided by the rating agencies themselves in the form of (i) publicly available rating methodologies, and (ii) press releases about the background of rating actions. After all, the rating business is about providing information to investors. Therefore, even though the composite measure of the rating score is the single most consequential element of the rating agencies' output, the consumers of that composite indicator need to be given sufficient background information if the authority and credibility of the agencies is to be maintained in the long run. These two types of agency-issued documents are used in this section to gain qualitative evidence about the hypotheses formulated above.

Sovereign rating methodologies

Unsurprisingly, the rating methodologies of the three agencies build on fundamentally the same approach towards assessing sovereign creditworthiness. All of them emphasise the need to combine economic and political factors in order to gauge both the *willingness* and the *ability* of governments to honour their sovereign obligations adequately. They underline that the two aspects of creditworthiness are inseparably intertwined and therefore claim the right to evaluate and comment on *all* aspects of policy-making in a given country in forming their rating opinion. All three methodologies order the relevant economic and political factors broadly around the same categories of political risk, economic structures and macro-economic indicators (such as fiscal, monetary and external conditions). The

methodologies differ in the specificity and the normativeness of the requirements that they put forward as a basis for evaluating these three sets of aspects, but the divergences in the set of factors to consider is immaterial.

In terms of political factors, Moody's only cites a few general, mostly non-normative, features of political systems to consider, such as respect for property rights, the predictability of government and transparency. At the same time, its methodology underlines that ratings are, to a great extent, driven by the evaluation of the general "effectiveness of governance" in a given country.[10] This vague formulation implies "large room" for subjective assessment of an undefined range of possible political factors. Beyond the basic features listed by *Moody's*, *Standard and Poor's* makes a number of additional normative requirements, ranging from the separation of powers, independent judiciary and civil institutions, to the independence of the press (S&P 2006, p7). Fitch quotes the legitimacy of the political regime, the effectiveness of government, control of corruption and the likelihood of severe civil conflict or war as important factors (Fitch 2009, p9). All three methodologies emphasise that deep divisions within society and among political groups, conflict and a lack of consensus on the structure of policies and on re-distribution are a major threat to creditworthiness. Fitch also explicitly mentions the detrimental effect of vested interests on reform capacity (Moody's 2008, p8; S&P, 2006 p7; Fitch 2009, p9). The insistence of the three agencies on the importance of these socio-political factors suggests that their rating judgement involves in-depth analysis of the political situation in a given country, rather than just an evaluation of economic outcomes that are directly linked to a country's ability to pay.

In terms of economic structures, Moody's methodology makes general comments about policy choices and structural features that favour the "economic resiliency and shock-absorption capacity" of a country, such as general prosperity (measured by GDP *per capita* levels), economic diversification, innovative capacity, trade integration and investment into human capital (Moody's 2008, p2 and pp7-8). These factors are also emphasised by S&P and Fitch (S&P 2006, pp7-8; Fitch 2009, p8), but S&P also goes into considerable detail about the desirable features of spending and tax systems.[11] Again, these remarks suggest that the rating process involves an inquisitive and value-laden examination of policies in a very broad range of – potentially politically-loaded – policy areas as well as of fundamental economic institutional choices.

In terms of macro-economic performance, the three methodologies display almost complete convergence. They all monitor not only a broad range of fiscal and monetary variables, but also indicators which gauge the external debt and liquidity position of a country – or, in other words, a broad set of factors that have direct impact on the ability of a given country to finance its upcoming debt obligations in the near and medium term (Moody's 2008, pp10-14; S&P 2006, pp10-16; Fitch 2009, pp11-16). These indicators are mostly the ones that quantitative studies of the determinants of ratings have found to have a significant influence on rating scores.

In sum, despite the documented variations in rating scores across the three agencies, their rating methodologies reflect nearly identical "mental frameworks" for assessing creditworthiness.

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[10] "Monitoring 'institutional strength' does not entail a value judgment about the type of government in any given country – democracies as well as autocracies or other political regimes default alike. Rather, this assessment constitutes an informed opinion about the effectiveness of governance and the extent to which certain situations can degenerate into credit disruptions at times of stress." (Moodys 2008

[11] "Typically, the least-distortionary and most-growth-friendly tax system that also addresses equity concerns has a broad tax base and low tax rates. Sovereigns with strong scores in this category can adjust tax bases and rates without serious constitutional, political, or administrative difficulties. Effective expenditure programs provide the public services demanded by the population and the infrastructure and education levels needed to underpin sustainable economic growth, all within the confines of tax and fee resources and affordable financing. Procurement and tendering procedures are transparent. Any arrears are quantified, and deficits can be reconciled to trends in debt. A high score may be assigned, despite significant financing needs, if astute investment in public infrastructure and in an educated workforce underpins sustainable prosperity. Lower scores are given where government money is not spent as effectively because of constitutional rigidities, political pressures, or corruption, and where revenue flexibility is constrained by already-high taxes or tax-collection difficulties. The environment is less conducive to sustainable economic growth and more suggestive of debt-servicing difficulties." (S&P 2006, p9).

Rather than concentrating only on a handful of macro-economic indicators with direct relevance to debt repayment, these frameworks call for the close examination of a whole range of political factors as well as of fundamental policy choices about the structure of the economy, public spending and re-distribution, arguing that they have indirect and long-term effects on both the capacity, but, more importantly, also on the willingness of sovereigns to pay their debts in time and in full.

Importantly for the hypothesis evaluated here, up to their most recent updating in 2011 and 2012, all three methodologies made more or less explicit references to the special status of developed countries from a rating perspective. All imply that in advanced democracies, structural political and economic factors are conducive to low default risk. While they do not explicitly state that these countries would not be individually rated on these structural factors, the logical conclusion is that rating variation among rich democracies would only arise from variation in the non-structural macro-economic indicators. *Fitch's* 2009 methodology refers to advanced economies in general:

> These intangible influences on sovereign creditworthiness in part explain why so-called advanced economies are able to sustain much higher debt burden, even after taking into consideration *per capita* income (Fitch 2009, p5).

Moody's uses the example of the EU to underline how institutional settings associated with developed countries lead to better rating performance:

> Key examples of the importance of institutions have been the improvements witnessed in those Central and Eastern European countries that have joined the European Union. The EU convergence process – implementing the "*acquis communautaire*" – has considerably improved the quality of governance in those countries. (Moody's 2008).

Similarly, *Standard and Poor's* 2008 methodology, uses the EU as an example to elucidate why developed countries are expected to score highest on both political and economic structures:

> A political risk ranking of "1" [most favourable] for most European Union (EU) sovereigns reflects the broad public backing for their open political frameworks, in which popular participation is high, the process of succession is clear, and the conduct of government is transparent and responsive to changing situations. […] Market reforms in the transition economies of Central and Eastern Europe have brought the economic structure scores of the Republics of Slovenia and the Czech Republic (among others) to, or close to, those of Western European sovereigns, whose market economies are well entrenched. (S&P 2006, p7).

This latter reference is absent from the revised methodology of *Standard and Poor's* published in 2011, which reflects the changed attitude of the agency to optimistic assumptions about the superior structural features of developed – and especially European – economies (S&P 2011).

Interestingly, *Standard and Poor's* and *Fitch* found it important to publish and widely publicise new versions of their methodologies in the summer of last year, whereas *Moody's* has so far kept its pre-crisis methodology. Adjustments to *Standard and Poor's* methodology mainly reflect on the lessons of the crisis for risk assessment, and on the challenges involved in rating countries belonging to a monetary union (S&P 2011). These adjustments draw on comments and criticism from stakeholders – such as customers and regulatory bodies – as well as on a wider and more explicitly referenced range of academic literature. *Fitch*'s methodology is substantially unchanged, but it now includes the description of an ordinary least squares model that helps users to approximate the agency's decision-making process (Fitch 2011). These moves clearly reflect the efforts on the part of the agencies to re-inforce their expert credentials and their authority in the wake of profound shocks to the established mental models shared by market actors.

In sum, the analysis of the rating methodologies of the three agencies provides evidence in support of the hypotheses formulated above. The findings confirm the existence of a shared mental framework for evaluating sovereign creditworthiness that all three agencies follow. The framework prescribes examining a wide range of political and economic factors and policy choices in the rated

countries. At the same time, there are indications that the three agencies used to agree that developed economies would automatically receive top scores on the systemic factors. This consensus has now evaporated in the light of the recent changes to *Standard and Poor's* sovereign rating methodology and, more importantly, in light of the recent controversial rating action of *Standard and Poor's*, when it downgraded nine eurozone Member States on 13 January 2012, quoting the deterioration of their political scores as the main reason for the downward adjustment.

Rating action commentaries

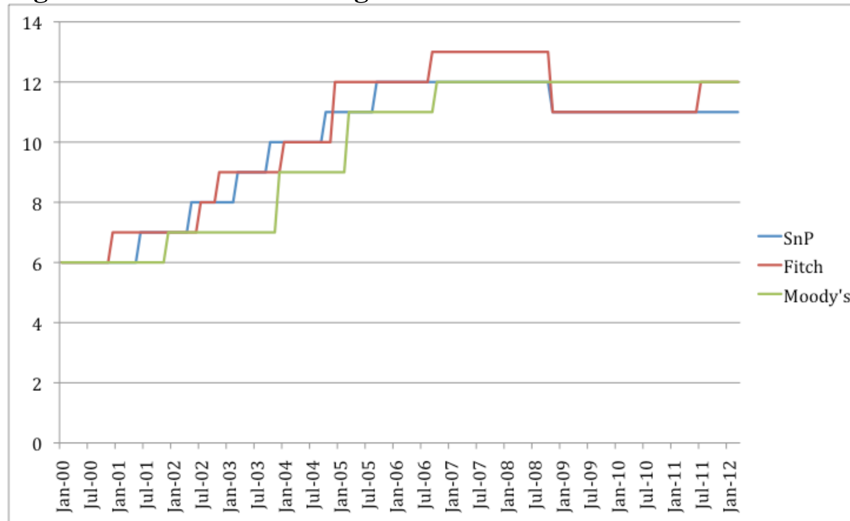
While sovereign rating methodologies give useful clues about the abstract features of the rating process, actual rating decisions and the rationale provided in accompanying press releases offer information on the concrete key factors that drive individual rating actions. This subsection reviews the experiences of four countries with rating agencies in the past ten years in light of the press releases issued about changes in their ratings. Romania and Hungary represent less developed countries. The former had relatively low levels of debt before the crisis, the latter had been struggling with a high debt stock ever since the fall of Socialism. Italy and the US are prosperous, long-established democracies. Italy's entrenched debt problems are well-known, whereas the US's debt stock was comparatively moderate until the most recent years. The four countries also occupy four distinct positions along the rating scale. Given these variations and similarities, their track-record with the three rating agencies promises to capture some of the important variations in the approach of raters towards different categories of countries. Table 1 provides their average rating scores with the three different agencies for the 5-year period before the crisis and their GDP *per capita* indicators in 2003.)

Table 1.

	S&P	Fitch	Moody's	GDP per capita in 2003	debt/GDP in 2003
US	AAA	AAA	Aaa	40,501	58%
Italy	AA-	AA	Aa2	28,022	104%
Hungary	A-	A-	A1	15,515	59%
Romania	BB+	BB+	Ba2	7,000	21%

Romania's rating experiences have been characterised by a remarkable convergence of opinion among the three rating agencies. The agencies closely monitored the country all the way to its accession to the EU in 2007 and frequently adjusted the sovereign's rating scores in small steps (for the temporal evolution of Romania's ratings, see Figure 1). All rating reviews before the crisis centred on the country's progress with structural reforms. Privatisation, the liberalisation of trade, product, labour and financial markets were the main considerations upon the basis of which gradually higher ratings were awarded or denied. Interestingly, even though Romania was forced to resort to the IMF several times during the last decade due to its inability to secure its external financing needs from market sources, this was considered to be a positive, rather than a negative, factor by the rating agencies due to the assumed benefits of IMF conditionality on domestic policies, and primarily on structural reforms. The rating reports also often incorporated the analysis of socio-political factors from the perspective of longer-term reform prospects. Fiscal and external balance aspects were also covered in the rating action commentaries, but they only gained independent significance in the years following accession to the EU.

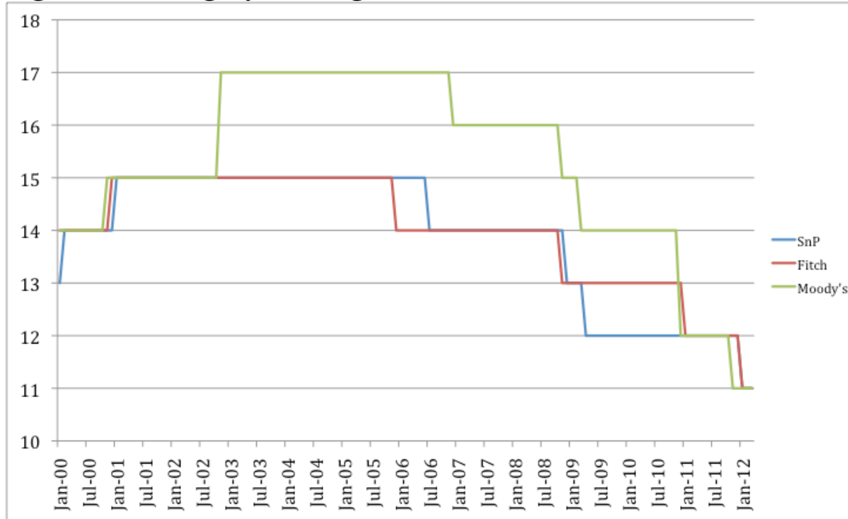
Figure 1. – Romania's rating scores since 2000



This pattern of rating behaviour suggests that the three agencies continued to see considerable systemic risks to Romania's ability and willingness to pay its debt in the long-term due to its lower levels of political and economic development. These doubts were consistently maintained all the way until the country's accession to the EU. After accession, monitoring was somewhat relaxed, but the positive connotations of IMF agreements both after and before EU membership suggest that rating agencies are re-assured by external sources of re-inforcement of the market orthodoxy in the policy choices of the country.

Despite its considerably higher debt-to-GDP ratio, Hungary was scrutinised much less anxiously than Romania after it had been pronounced a success case of structural reforms, and after its entry to the EU was confirmed in 2002. Even though its public finances were already on a progressively deteriorating trajectory from the beginning of the 2000s, it enjoyed a relatively long period of grace before it was downgraded first by *Fitch* and then *Standard and Poor's* in 2005. *Moody's* delayed its downgrade until 2006. In that year, the government admitted falsifying fiscal data – undermining its credibility, policy transparency and its commitment to longer-term macro-economic stability – and political turmoil beset the country in the wake of the scandal. Subsequent downgrades always referred to the government's ability to turn the fiscal tide and complained about the indefinite postponement of the accession to the common currency. In the crisis years, monitoring became more intense and (downward) adjustments more frequent. While the downgrades of 2009 and early 2010 were still mainly based upon the analysis of adverse macro-economic consequences of the economic crisis for the country, in late 2010 and in 2011, the agencies voiced increasing criticisms about its policy choices – especially the reforms of political and policy-making institutions – of the last government, and called for an urgent agreement with the IMF not only over future lines of credit, but over an acceptable policy path for the short- and medium-term.

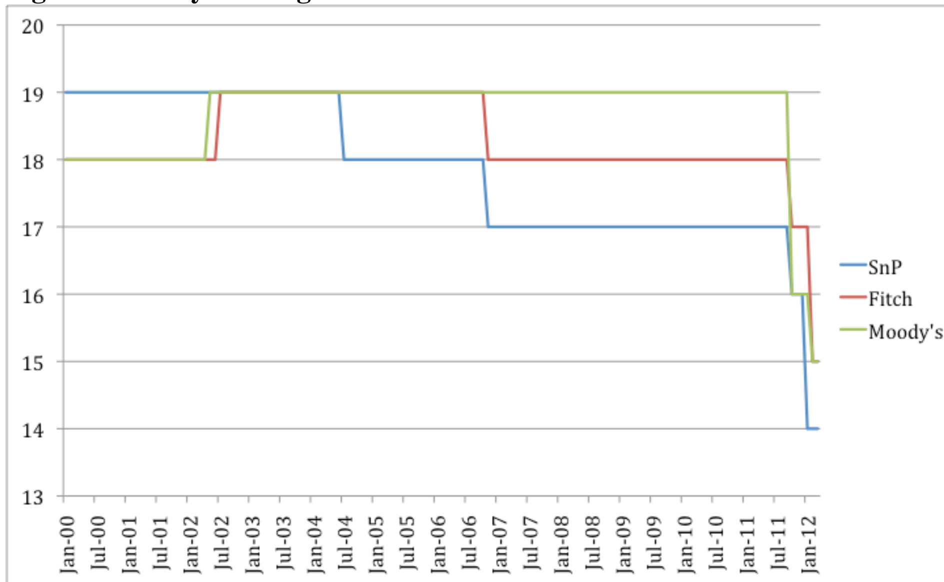
Figure 2. – Hungary's rating scores since 2000



The leniency towards Hungary's fiscal deterioration in the first half of the 2000s suggests that the three agencies saw no systemic risks to the country's general willingness and ability to honour its debt obligations after it had been secured entry to the EU. Even the first instances of downward adjustments in 2005 and 2006 were accompanied by rationales that focused narrowly on fiscal imbalances without commenting extensively on related policy choices to increase transfer spending or the developments in the political environment that had led to the abandonment of the earlier disciplined fiscal path. Normative judgements about policy choices only appeared in the commentaries accompanying the most recent downgrades.

Italy's recent rating history has been made particularly interesting by the divergence of the three agencies in their assessment throughout the 2000s. Initially, all three agencies converged on a respectable double-A rating for the country that had achieved considerable successes in reining in its level of indebtedness in the run-up to the euro-accession, although it still had a debt-to-GDP ratio in excess of a hundred per cent in the year 2000. As it became increasingly clear that the fiscal achievements of the 1990s could not be maintained in the 2000s, *Standard and Poor's* downgraded the country in 2004 and 2006. *Fitch* followed suit with some delay in 2006. *Moody's*, however, kept its high rating up for eleven years, all the way until the economic and fiscal crisis exposed the immense risks to the country's ability to re-finance its expiring debt.

Figure 3. – Italy's rating scores since 2000



Beyond the divergence of the rating scores, Italy's case also displays an interesting variability in the tenor of commentary on policy developments. In explaining its downgrade of 2006, *Fitch* mainly limited itself to commenting on the weakening fiscal trajectory of the country. *Standard and Poor's*, on the other hand, was not only the most active in downgrading the country. in the second half of the decade, it also became quite aggressive in commenting on the political and policy developments in Italy, which it perceived as major obstacles to preventing the restoration of Italy's growth potential and the reversal to a more sustainable fiscal path. The following paragraph is especially telling of the level of *Standard and Poor's*' interference with domestic political and policy developments:

> 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. (S&P, 19 October 2006, p2).

This passage not only criticises the lack of structural reform and interferes with the choice of spending patterns, it also comments in uncharacteristically frank terms on the political strategies of the prime minister as well as on the internal dynamics of the coalition in power. All of these aspects are at odds with the expectations that rating agencies would allow prosperous developed countries freedom of manoeuvre with their domestic political and policy choices and would only comment and act upon macro-economic developments.

Since the start of the crisis, the rating agencies have converged both in the frequency and severity of their rating actions, and in the tone of their rating reports about Italy. All three have strongly criticised the persistent lack of structural reforms in the country and the failure of political actors to summon broad societal support for painful changes (while, of course, strongly underlining the devastating effect of exogenous financial and economic changes on the country's fiscal viability). Furthermore, all three couched the last downgrades in harsh criticisms of the weaknesses of the functioning of decision-making institutions at European level and of the failure of European leaders in general to address the financial, economic and sovereign debt crisis forcefully. The tone of these criticisms, the fact that all three agencies decided to have summary-downgrades for groups of European countries, and the indications that agencies start to consider EU and EMU-membership as a liability, rather than an asset, all signal that the raters have definitively abandoned their earlier assumptions about the superiority of political and economic structures in developed countries and their restraint in commenting on the political and policy choices of such countries.

Finally, the US's rating history is the simplest and, at the same time, the most clearly indicative of the shifts in the approach of rating agencies to the notion of a "practically risk free" developed sovereign. The US had a triple-A rating for the entire past century. In August 2011, however, *Standard and Poor's* downgraded it to A+ in a historic and highly controversial move. In justifying its decision, *Standard and Poor's* not only quoted its – since debated projection – of the American debt trends of the medium-term future, but also sharply criticised the adversarial political atmosphere that had led to the deadlock over the debt-limit adjustment during the summer. In doing so, it has definitively denounced the assumption that the domestic choices and political conditions of certain sovereigns need not, and should not, be interfered with. *Fitch* and *Moody's* have not followed *Standard and Poor's* move, but their decision to place a negative outlook on their US ratings signals that the guaranteed rating status of the US is definitely over.

This review of four countries' experiences with rating agencies in the past decades has returned ambiguous evidence concerning the "end of the preferential treatment for developed countries" hypothesis. Romania's rating-history has been broadly consistent with the predictions of this hypothesis: it was monitored closely and all rating agencies commented intensely and inquisitively on its policy choices as well as its political conditions. Hungary, on the other hand, was treated in a way that is much more consistent with the predictions for developed countries: the

agencies restricted themselves to evaluating its macro-economic conditions and refrained from interfering with domestic choices until very recently. Perhaps the most puzzling finding is Italy's experience with *Standard and Poor's* inquisitive approach to its domestic politics. This finding is clearly at odds with Italy's level of development, whereas the approach of *Fitch and Moody's* was mainly consistent with it. Even if the evidence of the developed-developing divide before the crisis is inconclusive, rating events since the crisis show that there is no more room for preferential treatment for rich advanced economies and for self-restraint in commenting and acting upon their domestic political and policy developments.

Conclusion

This paper has provided a theoretical framework and some preliminary empirical evidence to explain both why and how the approach of rating agencies has changed towards prosperous developed countries since the outbreak of the financial and economic crisis in 2008. It has pointed out that the inquisitive approach of rating agencies towards a broad range of policy decisions and political developments that policy-makers in the developed countries are now protesting against has always been a fundamental characteristic of the general rating process as laid down in the methodologies of all three rating agencies. The reason why this approach had not caused conflicts similar to the ones brewing in the present between the policy-makers of developed countries and the rating agencies is that developed countries had not been subjected to the "normal" level of scrutiny prior to the crisis. Since it was generally assumed that it can be taken for granted that they would have both the ability and the willingness to service their debt in full and on time, advanced democracies were subjected to much lighter monitoring, which involved only a set of macro-economic indicators, but which left considerable "room to move" in politically-loaded structural policy choices. This room has been drastically constrained since the beginning of the crisis, as rating agencies have started to comment on and act upon such politically-loaded issues as the handling of the crisis by the European Central Bank and the Eurogroup politicians or the state of structural reforms in different developed countries.

Policy-makers are currently contemplating ways to free themselves of the newly imposed constraints on their policy choices by questioning the authority and the legitimacy of rating agencies and their pronouncements, by weakening the agencies' institutionalised role via reforms to financial regulation and by seeking to create new, allegedly independent, rating agencies in order to provide an alternative voice to orient the markets. However, it is questionable whether attacks on the rating industry can achieve the lost room for manoeuvre. This paper has hypothesised that the shift in the rating-agencies' approach is rooted in the changing market sentiment and fundamentally altered assumptions towards the creditworthiness of developed countries in the wake of the radical uncertainty created by the financial and economic crisis. It was argued that the rating process has to be based upon a mental framework that is shared by all market actors. Sidelining the rating agencies – even if it proved to be a viable strategy for policy-makers – would not eliminate the increased sensitivity of other market actors to the possibility of sovereign default among market actors, in which the current predicament of policy-makers is rooted. Therefore, the current endeavours of policy-makers could destroy a useful co-ordination mechanism within markets without regaining their lost freedom in policy-making.

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