

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

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## Abstract

*This paper investigates the nature and scope of Credit Rating Agencies (CRAs), and in particular the macroeconomic implications of sovereign ratings. 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. Following the insights of Marx and Keynes on power and uncertainty respectively, we argue that CRAs are an important and often neglected dimension of financialization. Such a dimension links with the authoritative placement of CRAs in the social structure, as well as the destabilizing effects that can arise from their activities.*

**Key Words:** credit rating agencies, sovereign ratings, neoliberalism, power, uncertainty, instability

**JEL Codes:** B51, B59; E69, H69

# 1. Introduction

Our paper aims to offer a coherent account of the role and importance of Credit Rating Agencies (CRAs) throughout the neoliberal era, focusing here on the level of sovereign ratings. For our purposes, the notions of power and uncertainty are drawn from the theories of Marx and Keynes respectively. Our view differs from the mainstream account that takes CRAs as a sort of financial intermediary. First, identifying them as part of financial capital, and placing in the historical context of the neoliberal epoch, we argue that CRAs came to be in a position where they could control the terms of financing of sovereign states. Hence we assert that such agencies have been an active promoter of the interests of financial capital towards the state during the neoliberal era. Secondly, the existence of genuine uncertainty raises the issue of whether CRAs (or any other agent) can truly produce accurate ratings. Once it is established that CRAs are liable to feelings of euphoria and panic similarly to all other agents, the potential for destabilizing effects steps in the picture.

The rest of the paper is organized as follows: the next section outlines the necessary specifications related with CRAs and their activities; furthermore section 3 illustrates the mainstream view; in addition section 4 discusses the role of CRAs behind the financial crash of 2007/8; most importantly, section 5 outlines our perception of CRAs; section 6 concludes.

## 2. Specifications

Irrespectively of one's views on their usefulness, CRAs form a fundamental institution of modern 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 Fimalac, S.A. and New York- based Hearst Corporation<sup>1</sup>. 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-Perrachon<sup>2</sup>.

According to the agencies' own viewpoint, their 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). Quoting Bhatia (2002), all three agencies define default

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<sup>1</sup> All information has been drawn from the agencies' websites.

<sup>2</sup> 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/>

**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
Speculative Grade		BBB-		Baa3	P3	BBB-	F3
	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

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- 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 currency<sup>3</sup>. 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 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/

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<sup>3</sup> 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).

watch” notification reflecting possible developments within the next 90 days, and the “outlook” announcement providing a similar idea for a two years horizon (IMF, 2010).

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 one 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 (s)he 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 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)<sup>4</sup>.

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 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.

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<sup>4</sup> 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).

## 4. Conflicts of Interest and Evidence of Corruption

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 explicit empirical evidence of the corruption arising from the “issuer pays” scheme. More specifically, Hau *et al.* (2013) show that bank characteristics exhibit a significant influence over the quality of the ratings they receive. To start with, Han and his colleagues show that there is a positive correlation between the size of banks and the ratings they earn. Secondly the writers 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. Eling and Hau (2013) extend such results for the ratings of the 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.

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, in order to go deeper into the issue we need to allow for Marx and Keynes to enter the picture. This is done in the following section, where we analyse CRAs by focusing on sovereign ratings. Our choice of sovereign ratings is partly based on the fact that such field is closer to CRAs' traditional activities (for instance in terms of opaqueness of the debt instruments that are rated). This means that we can analyse an environment where the conflicts of interest discussed above do not exist in the same scale, and thus make it easier to draw conclusions about the systematic connection of CRAs with the rest of the economy.

## **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, CRAs can be much more than mere financial intermediaries facilitating capital and information flows. Rather, they can obtain a 'life' of their own, promote the values and interests of certain social groups, and oppose that of others. This view becomes clearer if one takes a class

perspective, understood here in a Marxian sense. In particular as shown in the introduction of the chapter, all three CRAs are subsidiaries of US and French corporations. Hence, by their existence those agencies have a specific placement within the social structure, primarily hostile against the working class. They are not 'simply' on the side of capital in terms of exhibiting a policy bias in their proposals, as with institutions like the IMF, but they are part of capital itself<sup>5</sup>. Furthermore, although in the age of conglomerates the links between pure industrial and financial firms become blurred it can be seen- based on the main activities of the corporations behind them- that CRAs stand as a fraction and representative of financial capital. Thus, based on the insights of Marx and Keynes on the role and nature of financial capital (see Marx, [1894] 1981 and Keynes, [1936] 1973) it can be argued that CRAs can equally well oppose the interests of non-financial firms and promote financial speculation.

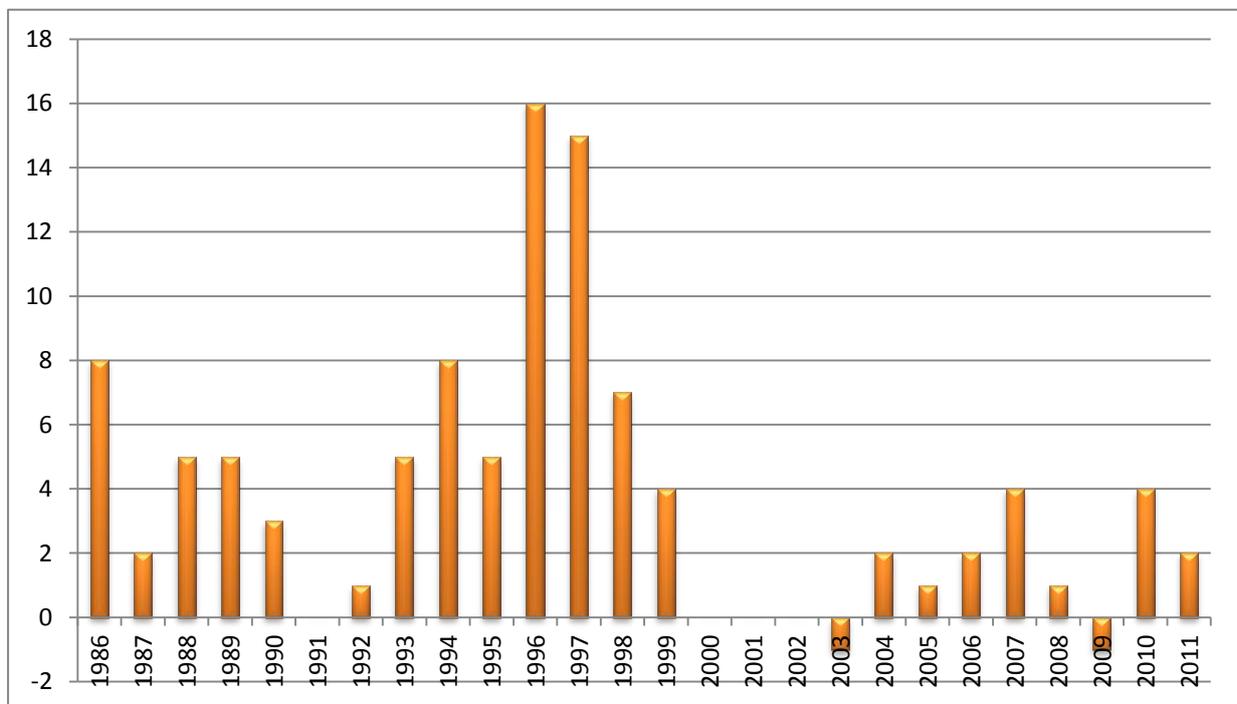
Furthermore, if one wants to grasp the full picture behind the nature of CRAs, (s)he also needs to study their development placed within a specific historical context. In our case, the historical context of interest is the neoliberal era, with a starting point conventionally identified at the late 1970s, 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

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<sup>5</sup> More specifically, following the insights of the Monopoly Capital school (for a cornerstone see Baran and Sweezy, 1966), it can be argued that although CRAs might not participate directly on the extraction of surplus value, they are a contemporary 'exogenous investment outlet' in the sense of being capable of absorbing part of the surplus value extracted elsewhere.

(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-



**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.

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, which raised 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. Furthermore, 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)<sup>6</sup>.

## **CRAs under the Prism of Asymmetry**

Marx and Keynes are two of the first thinkers in economics that manage to incorporate aspects of real world dynamism into their schemata. In particular, the quintessence of Marx's analysis is his understanding of power, and its potential to obtain exploitative dimensions, while the core of the Keynesian theory revolves around Keynes's understanding of genuine uncertainty. Based on such perception we argue that the fundamental notion we need to employ from Marx in order to conceptualize effectively the importance of CRAs is that of *asymmetry of power*, while the relevant notion to be utilized from Keynes shall be labeled as *asymmetry of time*<sup>7</sup>.

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<sup>6</sup> 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](http://ec.europa.eu/internal_market/rating-agencies/index_en.htm)

<sup>7</sup> For a more thorough analysis on Marx and Keynes, see the working paper Ioannou (2013).

Starting with the first, and following Macpherson- as found in Varoufakis (1991)- we can claim that the most simple and inclusive way of identifying asymmetry of power at the locus of the market is by posing the following question: 'Did both sides of the transaction have a viable alternative before agreeing?' Or to state it otherwise, 'Did both sides have the option to say 'no' to the transaction?'. The direct implication of such inquiry is that the mere willingness of somebody to enter into a transaction is not enough to tell us whether the transaction was conducted in a free manner. In that sense, Marx argues that the worker systematically enters into his relation with the capitalist voluntarily, but not freely.

Furthermore, it can be argued that asymmetry of power does not exhaust itself in the sphere of production. Rather, it can be systematically found in the sphere of circulation as well. For instance, with regards to the developments of the neoliberal era, Lapavistas (2009) argues that the process of financialization gave rise to what he labels as 'financial expropriation' of the worker (as noted by the author, although of a similar context, the word 'expropriation' is used instead of 'exploitation' to avoid confusion). Such expropriation is associated with the systematic extraction of financial profits directly out of workers' income. Consistent with our suggested way of identifying asymmetry of power, Lapavistas argues that in view of the withdrawn of welfare provisions (to which we could also add the stagnation of wages), workers were left with no choice other than engaging into huge amounts of debt- in view of their need to satisfy elementary needs like housing.

Coming back to CRAs, Sinclair (2005) asserts that within the context of the neoliberal epoch, those agencies have played the role of the Leviathan by exercising power over the private and public sectors, based on the latter's need to access the financial markets. Sinclair claims that such power has largely been 'camouflaged', as

compared with other seemingly more imperative institutions such as the IMF and the World Bank, due to the agencies' existence as private entities and the way they participate in the market. In addition the author argues that CRAs' role has been highly political, with the agencies acting as a promoter of the neoliberal paradigm.

Most importantly however, we believe that what marks a fundamental difference with previous epochs- like the pre-1929 era- is the fact in today's economy financial capital has established- via the CRAs- an additional channel of influence over policy making. The important difference to point out here is that in contrast with public institutions like the IMF which financial capital can 'just' try to affect, CRAs form a part of capital itself, therefore making its influence more direct and powerful. This development is crucial in order to understand how financialization came to push social and economic policy towards conservatism as pointed out above by Fine (2011). Thus, even though the neoliberal common sense is quite similar to that of the pre-1929 era<sup>8</sup> (e.g. in terms of acceptance of the doctrines of 'sound' finance), the mechanisms of its promotion differ, with the contemporary ones being much more powerful and persistent.

As a result of the placement of CRAs into an authoritative position, investors and governments do not only need to comply with their views, but have also re-shaped the way they think and act (also see Kundu, 2001 and Cooley, 2003). Especially in the case of governments, such development has come to threaten their degree of independence, 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

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<sup>8</sup> For a classical account of the social environment before and after the 1929 crisis, see Galbraith (1954).

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.

Extending the argument of Sinclair we can identify a qualitative difference between private investors and the state. In particular, we can see that although credit rationing exists for the private investor both before and after of the process of disintermediation, where banking lending is being replaced by capital market transactions (for discussion and figures see Sinclair, 2005 and King and Sinclair, 2003), it is a rather new development for the state. Thus, we could say that although in the pre-financialization era the only real constraints faced by the government in expanding its debt are those given by the behaviour of the private and external sector imbalances (e.g. whether there are enough private savings to buy government bonds, see Arestis and Sawyer, 2013), and the willingness of the Central Bank to refinance such debt (on this point see Toporowski, 2010), by the time a government starts depending on private banks and the market to cover its financial needs, the question of creditworthiness is more emphatically posed by the CRAs who are now in a position to influence the terms and conditions of its financing. Such dependency directly links with currency sovereignty. In that sense it is interesting to note that nowadays it is not only developing countries denominating their debt in foreign currency that have become vulnerable to the humours of the CRAs, but the set of Eurozone countries as well. As argued by a number of authors (e.g. Kelton and Wray, 2009; Papadimitriou *et al.*, 2010; Lucarelli, 2011/12) this is because the introduction of the Euro has implied the loss of sovereignty of Eurozone member states, with national central banks being impeded from acting as the manager of

government's debt and no substitute taking over at a central level (since the ECB is prohibited from acting as a lender of last resort).

All in all, the above discussion indicates a qualitative transformation of the financial and political constraints faced by the state during the neoliberal era. Thus, one can argue that financialization has managed to create an asymmetry of power between the CRAs and the state. Following the discussion provided earlier, the point to highlight is that in view of the increasing importance of capital markets, sovereigns have to a great extent lost the option to say 'no' to the dictates of CRAs.

It is important here to clarify that the sovereigns' transactions with CRAs and the consequent element of expropriation does not have to do with possible pecuniary gains for the agencies<sup>9</sup>, but rather with the promotion of financialization itself. In addition, the above argument does not imply that governments themselves have been 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 could hold nowadays for Greece). Furthermore there should be no surprise if one were to argue that the above process was accelerated by those governments who were ideologically attached to the neoliberal dogma, and 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).

Let us now move into the discussion of asymmetry of time and its importance for genuinely conceptualizing the implications of CRAs. In particular, Keynes's

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<sup>9</sup> Even if there were such gains in the form of rating fees, these are of secondary importance from the point of view of our theory.

perception on asymmetry of time is nothing else than his fundamental proposition that future is by definition uncertain. But what do we really mean when we use the word 'uncertainty'? Let us start by considering Keynes's own definition. Keynes (1937: 241) writes:

"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', or with what I label as asymmetry of time. 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 the asymmetry of time, 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). However, due to their artificiality, conventions and the associated institutions are always liable to collapse. As expressed by Keynes (1937: 214-5), the practice of conventionally assuming stability, as...

..."being based on so flimsy a foundation, it is subject to sudden and violent changes. The practice of calmness and immobility, of certainty and security, suddenly breaks down. New fears and hopes will, without warning, take charge of human conduct. The forces of disillusion may suddenly impose a new conventional basis of valuation".

Having defined true uncertainty, we can now claim that during the last two decades CRAs have played an active role promoting the convention associated with the values of neoliberalism. 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 in the market. As a result, investors were now in a position to choose the debt instruments to fund based on their 'ratings preferences' (risk aversion in a more textbook tongue). Such a perception fits well with the stance taken by Sinclair (2005, 2010). More specifically, Sinclair asserts that 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. Following the Keynesian concept of the beauty concept, Sinclair writes that even if the individual is 'clever' enough not to believe the evaluations of CRAs, (s)he still has an incentive to follow their guidance as long as (s)he anticipates the rest of the crowd to do so.

Most importantly, the connection between CRAs and the neoliberal convention can be illustrated by looking at the 'fundamentals' those agencies use in order to produce their 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 viewpoint of CRAs on several magnitudes like inflation and the budget deficit converges to that of neoclassical 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 (see for instance Cantor and Packer, 1996 and 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 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 inflation<sup>10</sup>.

As discussed by Keynes conventions are always liable to collapse. In that sense Sinclair (2005) argues that CRAs' biggest fear is the loss of their reputation. Financial and economic crises can of course be quite harmful for CRAs. However, in an uncertain world there is no space for determinism, implying here that there is no mechanistic process negatively linking crisis episodes with CRAs' importance. Ironically, as argued by Sinclair (2005) and Bruner and Abdelal (2005) financial crises might actually create a higher demand for CRAs' services, therefore further consolidating their authority.

Furthermore, despite the fact that CRAs are convention makers, they are still part of the world within which they operate. This means that in a period of euphoria, CRAs are liable to over-optimistic expectations similarly with any other economic agent. In addition, since there is nothing to guarantee that the convention associated with the perception of CRAs' judgement will collapse during a crisis, their evaluations and actions can aggravate rather than improve the economic environment. Thus, throughout the course of the business cycle, CRAs can contribute to a higher degree of financial fragility and volatility.

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<sup>10</sup> This point was brought to my attention by Prof. Malcolm Sawyer.

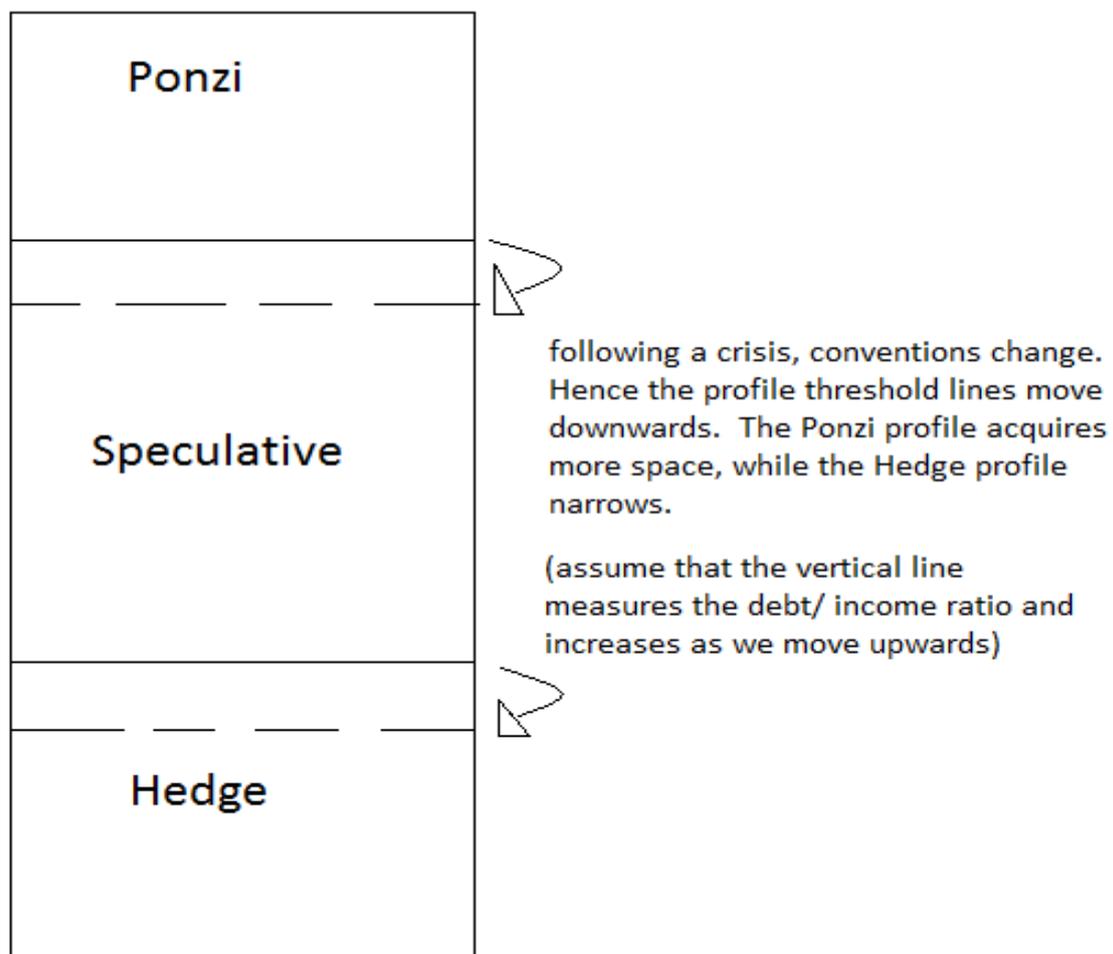
## Concrete Channels of Influence

From our viewpoint three distinct channels of influence can be observed at the macro level:

1) At the level of banking King and Sinclair (2003) assert that the attachment of ratings to capital adequacy requirements- as dictated by Basel II- can produce a higher degree of financial instability in the case of a downturn, given the possible procyclicality of CRAs. This means that in the 'good times' overoptimistic ratings can allow banks to hold relatively low capital reserves, whereas in the case of a crisis the reverse can occur. As a result banks can be pushed by regulators and CRAs to hold too much capital reserves right at the point of time where they face the highest stress from the market.

2) In accordance with Minsky's theory and his celebrated Financial Instability Hypothesis (FIH; see Minsky, 1975; 1986), one can expect CRAs to promote Speculative and Ponzi financial profiles. To start with the broader picture, the point to illustrate here is that although the Minskian classification is a genuine tool at the level of theory, it is not what real economic agents have in mind when taking decisions and conducting business. Thus, there is no banker that assigns loans based on a Hedge/ Speculative/ Ponzi analysis. Similarly well, there is no reason why CRAs have to diagnose a Speculative or Ponzi situation and shape their ratings accordingly. As with the Beauty Contest metaphor, what you are is not necessarily what others think about you. Hence, during the good times what would be classified as a Speculative or Ponzi financial profile for the Minskian economist might look like a Hedge one in the eyes of the CRAs, with the reverse holding true when for whatever reason a crisis occurs and panic spreads across the agents. This implies that in functioning terms, the interplay between the different financial profiles can be

much more volatile than what suggested in theory. An economic unit can be seen as if it is switching its profile irrespectively of the actual behaviour of its debt to income ratio, since the threshold lines between the three profiles can be taken as variable rather than constant (see Figure 2).



**Figure 2.** Illustration of the interplay between different financial profiles

Based on the above, it can be argued that in the case of sovereign countries a speculative and/ or Ponzi position can be accompanied with a relatively high rating for an extended period of time<sup>11</sup>. For instance Argitis and Nikolaidi (2011) find that

<sup>11</sup> Although Minsky's analysis was conducted with reference to the level of the firm, there have been several authors extending his scheme at the level of the sovereign (see for instance Ferrari-Filho *et al.*, 2010 and Argitis and Nikolaidi, 2011). We reckon that as long as the question of sovereignty is

the Greek state had reached a Ponzi profile during the late 1990s and early 2000s, which since 2003 escalated to an 'Ultra-Ponzi' one. However by looking at the sovereign ratings of that period one can see that during the decade 1999-2009, Greece was consistently obtaining 'investment grade' ratings by all three CRAs (for example by 1999 Moody's was attributing Greece an A2 rating, which in 2002 was upgraded to A1, staying there up to the public debt crisis that began in 2009)<sup>12</sup>. Hence rather than controlling the accumulation of public debt, CRAs can have an active role in encouraging its escalation<sup>13</sup>.

3) Following the outbreak of a crisis, CRAs can generate further pressure on an economy by raising the sovereign debt interest rates and driving capital out of the country under stress. Interestingly both channels have been investigated econometrically by a number of authors 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.*

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posed, like in the case of Eurozone countries nowadays, with the probability of default being brought into the picture, the use of the Minskian schema is legitimized.

<sup>12</sup> ratings' data drawn from CRAs' websites.

<sup>13</sup> A natural extension of the argument could be done for private non-financial firms. However we reckon that the idea is not as straightforward as it might seem. In particular, CRAs might have different dynamics in different sectors. If that is the case, no representative firm can be employed for a theoretical model, while no straightforward aggregation of the different business sectors can be conducted. Thus the project might suffer from the very beginning from a fallacy of composition, a point of critique also raised for Minsky's FIH itself (see Lavoie and Seccareccia, 2001). Other than that, there is some empirical literature on the link between corporate debt and credit ratings. More specifically, Sufi (2009) finds that the introduction of loan ratings corresponds to an increase of corporate leverage ratios. In addition, Kisgen (2006) shows that when a firm is near a change of its credit rating, it is likely to issue less debt relative to equity, while Kisgen (2009) points out that firms bring down their leverage ratios in the aftermath of a downgrade.

(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, but upgrades remaining highly insignificant. Following, 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).

Despite their contribution, a limitation of the above studies is the fact that all of them stay within the locus of the financial market, without studying the wider implications of their findings. For instance in the case of capital flows an interesting question to explore could associate with the way fluctuations affect the overall imbalances of the economy, based on the ex post identity  $(G - T) = (S - I) + FA$  (where  $FA$  stands for the financial account). Connecting here with the argument on the endogeneity of the budget deficit as put forward by the functional finance literature (see Lerner, 1943; Arestis *et al.* 2001; Arestis and Sawyer, 2013), one could claim that a capital flow reversal in a country with a budget deficit might 'help' balance the budget. However, in view of the functional role of the budget deficit as a means to boost economic activity and employment, and its potential to run in a counter cyclical manner (contrary to private investment), such a balancing might

have devastating effects for the economy, driving it to a persistent unemployment equilibrium.

## 6. Conclusion

Contrary to the mainstream view that takes CRAs as an intermediary between lenders and borrowers, our paper suggests that those agencies have a specific placement within the social structure, in favour of the interests of financial capital. With their importance being raised throughout the course of the neoliberal era, CRAs came to dictate the terms of financing for sovereign states, which were nothing else than the doctrines of 'sound finance'. In addition, the existence of genuine uncertainty explains how the activities of CRAs can destabilize an economy, especially when this is already into a recessionary spiral.

Our research is far from complete, and in that sense several extensions can be done. One idea can be to further investigate econometrically the destabilizing effects of sovereign ratings, for instance in conjunction with the financial account of downgraded countries. Such exercise can then relate with the broader context of macroeconomic stability and with issues like persistent unemployment and poverty.

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