New Study Shows Rating Agencies have Undue Influence on a Country’s Economic Outlook

A new study from the University of St Gallen shows that rating agencies do have an influence on a country’s economic outlook as a low rating, whether appropriate or not, leads to higher interest rates on its debt. This creates a self fulfilling prophecy to an extent that due to the low rating a default and consequently an economic collapse become more likely.

The study, entitled PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies, shows that a country’s poor credit rating generally leads to higher interest rates on its sovereign debt even when a country’s economic situation derived e.g. by its debt ratio, budget deficit, economic growth, etc. only partially justifies this assessment. The capital market, on which the interest rates for sovereign debt are determined, appears to accept the rating agency’s judgment even when the fundamental data for a country disagree.

This can lead to a self fulfilling prophecy. If the capital market accepts the rating agency’s judgment over the available data on the country’s economy - even if the rating is not completely justified by fundamentals - the country is perceived to be at risk for future default on payments. It also means that the country has to pay higher interest on sovereign debt both now and in the future. This can create the environment for the original prediction from the rating agency to come true without anyone doing anything more about it.

"Consider a hypothetical thought experiment on Greece," said Prof Dr Manfred Gärtner, one of the three authors of the study. "If the Greek rating was the same as Germany, then the absolute interest payment on its current debt of EUR 329bn could be 3% instead of its current 17%. That would mean an absolute annual interest payment of EUR 10bn instead of EUR 56bn."

To make a comparison: the Greek budget deficit of 11% of the gross domestic product, which is frequently criticised as being too high, amounts to EUR 24bn.

The study also reveals that in the last two years rating agencies have indeed downgraded to an unjustifiably low level, the creditworthiness of Portugal, Ireland, Greece and Spain - the so-called PIGS countries. This means that countries with similar fundamental values as the PIGS, may have received significantly better ratings.

It is also worth noting that rating agencies themselves admit that it is extremely difficult to determine countries’ creditworthiness and caution investors against the accuracy of their judgements. One could be forgiven for believing that rating agencies pursue something that is purely an end in itself: they are unable to predict a national bankruptcy ex ante, but in certain situations they are able to induce, and thus also to forecast, one.

"This study concludes that taking into account the 'self-fulfilling prophecy' problem, the oligopoly of the three big rating agencies Moody’s, Standard & Poor’s and Fitch, as well as their fatal misjudgement of numerous derivatives during the financial crisis, the question seems to arise," said Manfred Gärtner, "whether governments shouldn't enforce a higher degree of transparency and diversification in the rating agency market."
The study is entitled “PIGS or Lambs? The European Sovereign Debt Crisis and the Role of Rating Agencies” by Manfred Gärtner, Björn Griesbach and Florian Jung, published in the journal International Advances in Economic Research 2011/3 (forthcoming) and is available online at www.springerlink.com/content/p7102pv44172k117/

University of St.Gallen (HSG)
Internationality, practical relevance and an integrative perspective have been the trademarks of education at the University of St.Gallen in Switzerland ever since it was established more than a century ago. Today, the University of St.Gallen (HSG) educates 6,700 students from 80 nations in the fields of Business Administration, Economics, Law and Social Sciences. The HSG has shown itself to be highly successful, having been consistently ranked among Europe's leading business universities. In the 2010 Financial Times European Business School ranking, the HSG was in 16th place among the 75 universities included in the ranking. Its holistic education, which meets the highest academic standards, has earned it the seal of approval of the EQUIS and AACSB accreditations. Academic degrees can be obtained at the Bachelor's, Master's and Doctoral Levels. In addition, the University of St.Gallen offers first-class and comprehensive courses in Executive Education. Thanks to an increasing number of programmes taught in English, the HSG has shown itself to be attractive to international students. The focal points of research at the University of St.Gallen are crystallized in its 40 institutes and research centres, which constitute an integral part of the University. The institutes, which are largely autonomous and mostly self-financing, still remain closely connected to university operations. www.unisg.ch