Media release, 25 July 2012

Rating agencies responsible for Europe’s “debt crisis”

HSG study about the rating agencies’ role in the sovereign debt crisis

Inexplicable downgrades of European countries are a central cause and driving force of the European debt crisis. This is revealed by a study conducted by the Institute of Economics at the University of St. Gallen. The study written by Manfred Gärtner and Björn Griesbach evaluates data for 25 OECD countries in the period of 2009-2011. It provides empirical evidence for the first time that the Eurozone’s fight against insolvencies and systemic risk is taking place in a fragile environment of multiple equilibria.

The central results of the empirical study are the following:

**There are several equilibria in the government bond market**
The first, good equilibrium gives rise to low interest rates and good ratings. In the second, bad equilibrium, interest rates become unaffordable, ratings collapse and the country becomes insolvent. In between, there is an insolvency threshold. If a country is pushed across this threshold, there is a pull in the direction of insolvency from which it is powerless to escape on its own.

**Even slight “errors of judgement” can trigger off an insolvency dynamism**
Insolvency thresholds are very high. Countries with a rating of A or poorer are in extreme danger. Even the slightest negative interest-rate or rating signals can push these countries into the insolvency maelstrom – and even if they are unfounded. However, countries with top ratings cannot feel entirely secure. Even a country with an AAA rating can be jeopardised by an unintentional or abusive downgrade by four notches, i.e. from AAA to A+.

**The downgrades of many European countries between 2008 and 2011 are arbitrary**
Many European countries have been rated according to other yardsticks than were used earlier or like non-European countries. Their downgrades cannot be justified on the grounds of a decline of their economic situation and public finances: Spain, for instance, should have been downgraded by half a notch but lost three. Ireland should have lost one and a half rating levels but was downgraded by seven. In Portugal’s case, the loss of half a level was justified, but in fact the country dropped eight levels. Even Greece’s rating should only have gone down by 0.14 on the strength of objective economic indicators at the time, but actually it plummeted by 12 notches, from A to CCC.

**The systematic nature and extent of arbitrary rating downgrades leave agencies with a central responsibility for the debt crisis**
If the above pieces of the puzzle are fitted together – the existence of multiple equilibria, the existence of an insolvency threshold, the latter’s dangerous proximity even to financially healthy countries, and the severe downgrades of European countries that appear largely unjustified – then the rating agencies must be regarded as the central triggers and drivers of the European debt crisis.
The study entitled Rating agencies, multiple equilibria and self-fulfilling prophecy? An empirical model of the European sovereign debt crisis 2009-2011 by Manfred Gärtner and Björn Griesbach has been published as a discussion paper of the School of Economics and Political Science of the University of St.Gallen.

You can also find the whole study in the net: [http://ideas.repec.org/p/usg/econwp/201215.html](http://ideas.repec.org/p/usg/econwp/201215.html).

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