KU LEUVEN

How do sovereign credit ratings help to financially develop low-developed countries?

Prabesh Luitel, Rosanne Vanpée

Main idea: Rating agencies as information providers

Low income countries small, opaque borrowers

Credit risk assessment

- Information asymmetries
- High information gathering costs
- High monitoring costs
- Agency problems

Access to finance

Main idea: Rating agencies as information providers

Low income countries small, opaque borrowers

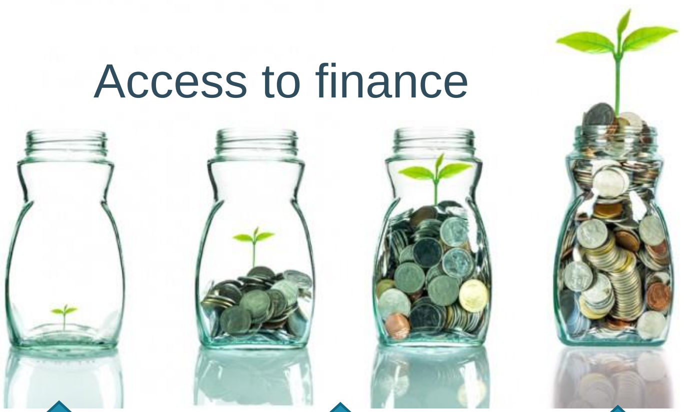
Credit risk assessment

- Inform mmetries
- High thering costs
- High m costs
- Agenc ns

STANDARD &POOR'S

FitchRatings KNOW YOUR RISK

Access to finance



Credit rating provision and financial development

- 39 “recently” rated countries: initial sovereign debt rating obtained after 2000 (Moody’s, S&P or Fitch)
- Entropy balancing approach: characteristics of unrated countries are rebalanced such that they are similar to rated countries
- WLS regression: estimate the impact of rating provision on financial development

Banking sector	Bond market	International financial integration
Bank credit to sovereign	FC bond issues (by maturity)	Foreign Direct Investment (total)
Bank credit to private sector	LC bond issues (by maturity)	FDI debt
Bank assets		FDI equity
Tier 1 capital/risk-weighted assets		Portfolio investment (total)
Liquid assets/ST liabilities		Portfolio debt
Broad money/GDP		Portfolio equity

Credit rating provision and financial development

Rated countries versus unrated counterparts:

- Banks :
  - Assets are rebalanced: lower sovereign exposure (-2%), higher private sector exposure (+2%), no growth in total assets

    => increase in risk-weighted assets

    => decrease in Tier I capital to risk-weighted assets (-3%)
- Bond markets:
  - +5% foreign currency and -11% local currency bond issues
  - +3% long maturity and -9% short maturity bond issues
- Inward foreign investments
  - +8% FDI inflows, mainly from equity investments
  - +2% portfolio investment inflows, both debt and equity

Policy implications

- CRA's are important information providers but their coverage is incomplete
    - Unrated low-developed countries
    - SME's

    $\Rightarrow$ Need for specialized (European?) rating agencies

    $\Rightarrow$ We provide shadow ratings for unrated sovereigns (machine learning based)
- Rating provision opens up international investment opportunities but doesn't lead to local financial development
    - Zero growth in bank assets, no local bond market development
    - Increase in foreign debt exposure
    - Increased dependence on (volatile) foreign capital flows
- Information provision and monitoring alone is not enough
    - How to prevent borrowers from over-indebtedness?
    - How to improve currency and maturity matching in assets and liabilities?