How (un)justified are the decisions of credit rating agencies?

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Following Standard & Poor's decision to brand Greece with the world's lowest credit rating and Moody's decision to announce a 4-notch downgrade of Portugal's debt, and then downgrade Ireland to junk status, European policymakers reiterated their growing dissatisfaction with credit rating agencies. European Commissioner Michel Barnier noted (on the 11th of July): 'Every day we are seeing the impact [sovereign ratings] have on countries: rising costs of credit, weakening of states, and possible contagion effects on neighbouring economies'.

When markets are as jumpy as they appear today, the game blame does not help. In an attempt to provide a careful assessment of credit rating decisions, we note that credit rating agencies cite a number of factors (such as per capita GDP, GDP growth rate, governance and public finance trends) but provide little guidance as to the relative weights assigned to each factor. Yet, based on modelling techniques, Afonso et al 2011 has concluded that once the above factors are taken into account, a rather large number (up to 40%) of credit rating decisions remains unexplained. Amongst others, academic work has reached the following conclusions:

First, an annual rise in gross government debt (as % of GDP) by 15 percentage points justifies half a notch downgrade in a country's credit rating. Second, an annual drop in government deficit (as % of GDP) by 3 percentage points justifies a quarter of a notch upgrade in a country's credit rating. Third, a large drop in government effectiveness (to deal, for instance, with tax evasion) justifies half a notch downgrade. Fourth, European Union membership, which improves a country's credibility through continuous monitoring of its economic policies, enjoys a 'premium' of 2 notches.

According to European Commission estimates, Greek government debt is expected to rise by some 15 percentage points (from 142.8% of GDP in 2010 to 157.7% of GDP in 2011) whereas Portuguese government debt is expected to rise by some 9 percentage points (from 93% in 2010 to 101.7% in 2011). Greek government deficit is projected to shrink by some 3 percentage points (from 10.5% of GDP in 2010 to 7.6% of GDP in 2011). Portuguese government deficit is also projected to shrink by some 3 percentage points (from 9.1% in 2010 to 5.9% in 2011). Irish gross debt is expected to rise by some 16 percentage points (from 96.2% of GDP in 2010 to 112% of GDP in 2011). However, Irish government deficit is expected to shrink by 22 percentage points (from 32.4% of GDP in 2010 to 10.5% of GDP in 2011). Based on these fiscal developments, and despite the large drop in Greek and Portuguese government effectiveness measured by World Bank indicators (which EU and IMF officials are trying to tackle by offering expert advice), it is clear that the latest dramatic downgrades appear somewhat unjustifiable. That said, the ongoing recession in Greece and Portugal risks undermining the fiscal projections above, but even so, only extremely large deviations would justify the latest downgrades.

Finally, assigning Greece with the world's lowest credit rating appears inconsistent with the credit advantage European Union countries enjoy relative to (non-EU) developing countries. The very loss of Greece's 2-notch advantage raises the issue of whether credit rating agencies take Greece's exit from the single currency bloc for granted, but are unwilling, on self-fulfilling prophecy grounds, to admit so openly. To increase transparency and avoid misinterpretation, credit rating agencies should move urgently towards providing detailed guidance on the relative weights of each factor affecting their decisions.

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References:

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