

Credit rating agencies and the European sovereign debt crisis

Citation for published version (APA):

Freitag, L. (2016). *Credit rating agencies and the European sovereign debt crisis*. Datawyse / Universitaire Pers Maastricht. <https://doi.org/10.26481/dis.20160512lf>

Document status and date:

Published: 01/01/2016

DOI:

[10.26481/dis.20160512lf](https://doi.org/10.26481/dis.20160512lf)

Document Version:

Publisher's PDF, also known as Version of record

Please check the document version of this publication:

- A submitted manuscript is the version of the article upon submission and before peer-review. There can be important differences between the submitted version and the official published version of record. People interested in the research are advised to contact the author for the final version of the publication, or visit the DOI to the publisher's website.
- The final author version and the galley proof are versions of the publication after peer review.
- The final published version features the final layout of the paper including the volume, issue and page numbers.

[Link to publication](#)

General rights

Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

- Users may download and print one copy of any publication from the public portal for the purpose of private study or research.
- You may not further distribute the material or use it for any profit-making activity or commercial gain
- You may freely distribute the URL identifying the publication in the public portal.

If the publication is distributed under the terms of Article 25fa of the Dutch Copyright Act, indicated by the "Taverne" license above, please follow below link for the End User Agreement:

www.umlib.nl/taverne-license

Take down policy

If you believe that this document breaches copyright please contact us at:

repository@maastrichtuniversity.nl

providing details and we will investigate your claim.

Valorization

In this part of the thesis I will discuss the valorization of the thesis. A valorization is the process by which scientific knowledge can shape and influence the world and have practical application. In this thesis I discuss a subject that is of immediate concern not only to the academic community but also to policy makers and even to the public at large. Credit Rating Agencies were heavily discussed during the recent crisis and their behavior has sparked controversy. This was not only the case during the financial crisis, when previously rated AAA financial products defaulted and dragged banks and subsequently the world economy into the biggest recession since 1929, but also during the more recent sovereign debt crisis that can be regarded as a continuation of the financial crisis.

During the sovereign debt crisis, criticism of CRAs was again increasing. This came mainly from European politicians who accused the agencies of not rating European countries fairly and went as far as the accusation that the (US) credit rating agencies were serving a political purpose. Thus, the discussion of establishing a European rating agency as a result of the sovereign debt crisis that up until this date did not come to fruition. As it can be deduced from this narrative, the role of CRAs is an important topic that not only matters to academia, but also to political actors, policy makers in the economic sense and the society as a whole. To understand the impact of this thesis, we also need to review the rules and regulations that have enshrined CRAs in their current position within the financial system. Ratings serve to banks (and depending on the country also to other financial institutions) as a guideline to how much capital they need to retain for a given asset, dictated by the Basel rules. Thus, any change in ratings will have an impact on the price and interest rate of the rated financial asset due to changing supply and demand for said asset. This means the ratings have a direct impact on the deficit and debt evolution of a sovereign nation. This fact should give a strong indication why studying rating agencies is generally of value. Next, I will outline the valorization of the individual chapters.

In chapter 2 I discuss the issue of path dependence and procyclicality. Both should not be present in sovereign ratings. The latter because any rating that is procyclical will give too high ratings during boom time and too low ratings during a recession. The latter because it alleviates ratings of already highly rated countries and conversely makes it more difficult for countries that have low ratings

to achieve higher ratings. This has a direct impact upon the fiscal position of a country. This chapter gives policy makers an indication that there are flaws in the rating process. It should give an incentive to review this process. Also, given the flaws in the process, it should impact the future discussion of capital requirements and the connected usage of ratings for its determination.

Chapter 3 discusses the fundamental question whether sovereign ratings actually reflect default probabilities. This is done by introducing a new estimator which can be potentially of use in other applications such as testing effectiveness of central bank communication. The fundamental question is of high importance to the discussion on rating agencies and its role in the sovereign debt crisis. While the CRAs were accused of not rating correctly, this chapter shows that there is indeed a connection between default probability and rating. This again gives arguments for the discussion by policymakers on minimum capital requirements in the Basel rules. It should be noted that changing these rules has profound impact on banking behavior and thus on the overall economy.

Chapter 4 addresses a different aspect of the sovereign debt crisis. I investigate the economic impact of austerity programs for three different European countries. The results of this chapter should have profound implications on the discussion of how to approach the sovereign debt crisis in the Euro-area. Specifically its analysis gives arguments in the debate to use austerity programs when saving a country using one of the rescue mechanisms established by the ECB, the European Commission and the IMF. Given the vast impact that these programs had in some countries, as shown by the analysis, a change of direction in this matter will have big economic implications.

In Chapter 5 I analyze the behavior of rating agencies between each other. Specifically, I investigate leader-follower pattern. Similarly to chapter 2 and chapter 3, the results of this chapter can shape the debate around the Basel accord and the question whether ratings should be used for minimal capital requirements. As already stated, any change to these rules could have an enormous impact on the financial system and thus on the world economy.

In conclusion, this thesis elaborates on two separate topics that are of high importance. First of all, the question whether ratings should be given the weight that they have in the current financial architecture, where I mainly supply policymakers with argument, due to the very technical nature of the topic. Second, the question whether austerity measures are actually effective, which is a question that gets debated not only amongst policymakers, but also in political circles and in the society as a whole.