Credit rating agencies and central banks: Does better central bank governance reduce the cost of capital?

Cristina Bodea
Michigan State University

Raymond Hicks
Princeton University

Importance of bond ratings

- Governments rely on bond financing – concerns about trustworthiness
- Expansion of countries seeking ratings in last 20 years & importance of ratings to institutional investors
- Ratings provide information to investors about probability of bond repayment

Previous work

- More favorable credit rating when debt likely to be repaid (but methodology proprietary)
- Ability to repay debt
  - Economic conditions
- Willingness to repay (e.g. Ecuador 2008
  - Reputation & signals by IOs or foreign banks
  - Constraints on government & quality of domestic institutions
    - Democracy (Beaulieu et al. 2012)
    - Courts and rule of law (Biglaiser & Staats)

Argument

- Do rating agencies care about the central bank?
  - Hungary 2011-2012
- Central bank governance
  - Independence
  - Transparency
  - Outright conflict with government
- Why these features may matter
  - Broad signals of quality of governance that increase macroeconomic and political stability

- Independence
  - By late 90s becomes metric of macro-economic quality
  - CBs can serve as veto players and constraints on governments
  - This increases price stability, predictability of deficits & investor rights protection, and durability of governments
- Transparency
  - Clarifies who is the principle of the bank & increases predictability of monetary policy reactions
- Fire a central banker
  - Broad signal of conflict over macroeconomic policy that raises uncertainty over future policy choices

Hypotheses

- H1: *Countries with more independent central banks will see higher credit ratings*
- H2: *In non-OECD countries, the irregular turnover of central bank governors will be associated with lowered credit ratings*
- H3: *Countries with more transparent central banks will see higher credit ratings*

Data and operationalization

- DV: Credit rating (S&P or Moody's)
  - Updated Beaulieu et. al data
  - 16-point scale
    - Higher values = better credit rating
- Central bank independence
  - Legal CBI- Updated based on Cukierman, et al. (1992) index [0 to 1]
  - Central bank transparency (Eichengreen & Dincer 2010) [0 to 15]
  - Irregular turnover of CB governors (Dreher, Sturm, and De Haan 2008) [0 or 1]

Model

- Years cover: 1974 to 2007
- 78 for CBI; 100 countries for transparency
  - Use both full sample and non-OECD sample
- Regression with random effects
- Include lagged DV in all models
  - Has a pretty sizeable effect on current rating
- Controls for economic and political factors

Legal CBI

	All countries		Non-OECD	
	Moody	S&P	Moody	S&P
CBI	0.363**	0.277***	0.343	0.316*
	(0.146)	(0.104)	(0.219)	(0.178)
5-year average	0.322**	0.252**	0.329	0.350*
	(0.129)	(0.098)	(0.226)	(0.191)
5-year reform	0.130**	0.095	0.180**	0.128
	(0.065)	(0.059)	(0.087)	(0.078)

CB Transparency

	All countries		Non-OECD	
	Moody	S&P	Moody	S&P
Transparency	0.043**	0.034*	0.027	0.027
	(0.022)	(0.019)	(0.029)	(0.024)

CB governor turnover

	All countries		Non-OECD	
	Moody	S&P	Moody	S&P
Irregular turnover	-0.587***	-0.411***	-0.736***	-0.481**
	(0.126)	(0.128)	(0.155)	(0.191)
Regular turnover	0.027	0.025	0.027	0.006
	(0.071)	(0.054)	(0.138)	(0.088)

- CBI does affect credit ratings
- Legal measures have effect in full sample
- Behavioral measures matter in non-OECD countries
- Future work: CBI itself or broader neoliberal reforms