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

<table>
<thead>
<tr>
<th></th>
<th>All countries</th>
<th>Non-OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Moody</td>
<td>S&amp;P</td>
</tr>
<tr>
<td>CBI</td>
<td>0.363**</td>
<td>0.277***</td>
</tr>
<tr>
<td></td>
<td>(0.146)</td>
<td>(0.104)</td>
</tr>
<tr>
<td>5-year average</td>
<td>0.322**</td>
<td>0.252**</td>
</tr>
<tr>
<td></td>
<td>(0.129)</td>
<td>(0.098)</td>
</tr>
<tr>
<td>5-year reform</td>
<td>0.130**</td>
<td>0.095</td>
</tr>
<tr>
<td></td>
<td>(0.065)</td>
<td>(0.059)</td>
</tr>
</tbody>
</table>
## CB Transparency

<table>
<thead>
<tr>
<th></th>
<th>All countries</th>
<th>Non-OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Moody</td>
<td>S&amp;P</td>
</tr>
<tr>
<td>Transparency</td>
<td>0.043**</td>
<td>0.034*</td>
</tr>
<tr>
<td></td>
<td>(0.022)</td>
<td>(0.019)</td>
</tr>
</tbody>
</table>
## CB governor turnover

<table>
<thead>
<tr>
<th></th>
<th>All countries</th>
<th>Non-OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Moody</td>
<td>S&amp;P</td>
</tr>
<tr>
<td>Irregular turnover</td>
<td>-0.587***</td>
<td>-0.411***</td>
</tr>
<tr>
<td></td>
<td>(0.126)</td>
<td>(0.128)</td>
</tr>
<tr>
<td>Regular turnover</td>
<td>0.027</td>
<td>0.025</td>
</tr>
<tr>
<td></td>
<td>(0.071)</td>
<td>(0.054)</td>
</tr>
</tbody>
</table>
Conclusion

- 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