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Globalization: News media, images of nations and the flow of international capital with special reference to the role of rating agencies

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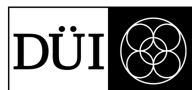

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1 Globalization

It is a common assumption that we live in “modern times”; i.e. in the age of globalization. The concept of globalization is by no means new. As Karl Marx and Friedrich Engels wrote in 1847/48 in their *Manifesto of the Communist Party* (1848, 44): “Modern industry has established the world market. ... This market has given an immense development to commerce, to navigation, to communication by land. This development has in its turn, reacted on the extension of industry...” According to Marx and Engels (1848, 45) the bourgeoisie “... resolved personal worth into exchange value, and in place of the numberless indefeasible chartered freedoms, has set up that single, unconscionable freedom – Free Trade.” Marx and Engels (1848, 46f) describe the consequences of globalization: “The bourgeoisie has through its exploitation of the world market given a cosmopolitican character to production and consumption in every country. To the great chagrin of Reactionists, it has drawn from under the feet of industry the national ground on which it stood. All old-established national industries have been destroyed or are daily being destroyed. They are dislodged by new industries, whose introduction becomes a life and death question for all civilized nations, by industries that no longer work up indigenous raw material, but raw material drawn from the remotest zones; industries whose products are consumed ... in every quarter of the globe. ... In place of the old local and national seclusion and self-sufficiency, we have intercourse in every direction, universal inter-dependence of nations.”

A century and a half have passed since Marx and Engels made their diagnosis and the worldwide interlinkages have become much more intensive. Globalization means not only the expansion of

trade between countries, but the intensive division of labor is showing more and more production factors wandering, especially the mobile capital. Economic location competition is developing between countries. Globalization in the economic sector means a development which moves the world economy closer to the theoretical ideal of perfect markets, i.e. competition no longer takes place only within the framework of national states. The OECD[1] perceives globalization as a process through which markets and production in various countries are becoming more and more inter-dependent, because of the dynamics of trade in goods and services and the movements of capital and technology. The new form of economic globalization, compared to the 19th century, is that not just trade, but enterprises themselves are crossing borders. National states have to entice the mobile capital, whereby the rule is that the better the image the higher the chances to attract foreign capital.

Economic globalization is not a process that has to happen but rather the result of a coordinated policy of liberalization and deregulation of the leading industrial states. Concepts such as global, transnational, multinational etc. often overlap. Globalization means processes of social change that have effects on humanity as a whole, in which borders no longer play more than a subordinate role.[2] In the communication sector globalization at the present time means that an oligopoly of offerers is dominating the scene. Globalization does not mean the formation of a kind of global governance. Nor is globalization a synonym for homogenization of societal conditions or for political integration. Globalization is no unidimensional process but can happen asymmetrically and contrastingly.

Globalization encompasses the mobility of people, the fast world-wide spread of new technologies, the world-spanning finance market etc. Centers of the global capital markets are places like Tokyo, Singapore, New York, London, Zurich and Frankfurt. Prototypes of new global actors are people like Nicholas Leeson, who ruined Britain's oldest private bank, Barings, with speculative trading at the Singapore International Monetary Exchange, losing 827 million pounds Sterling (Leeson describes in his “Rogue Trader” how he ruined Barings). Or George Soros who in 1992 attacked the Bank of England, speculated on a falling Sterling value, keeping his rate despite support buying by the Bank of England and with that earning a billion dollars in a very short time and at the end of the day pushing the United Kingdom out of the European Monetary System.

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[1] The Organization for Economic Co-operation and Development was founded in 1961 and about 30 leading industrial countries are members.

[2] Margaret Thatcher characterized the economic globalization trend as follows: “There is no such thing like society, there are only individuals.”

George A. Barnett et alii (1999) present a quantitative assessment of the webs of international finance, telecommunication and trade. The authors emphasize that in spite of the importance of international monetary flows there is a lack of published empirical research. Their research is the first attempt to describe the international monetary flow. The network analysis is based on world system theory which focuses on the unequal distribution of power and goods in the capitalist world system. The global structure is described in terms of three types of nations; i.e. the core, the semi-periphery and the periphery. Semi-peripheral countries are seen in engaging both in core-like activities (as exploiter) and peripheral-like activities (as the exploited). International transaction data (consumer transactions based on credit card purchases and bank-to-bank exchanges) were gathered from a US-based credit card corporation. Country-to-country transaction data were gathered for 198 countries for the third quarter of 1995.[3] Barnett et alii (1999, 42) conclude that the monetary network is dominated by the western industrial powers in the center with the less developed countries at the periphery. The semi-peripheral-countries are mainly East Asian countries. The results further suggest that there are a number of only loosely connected marginal nations which are not integrated into the global economy. A comparison of international monetary, telecommunications and trade networks suggests that these three networks are quite similar. GNP per capita was significantly correlated with centrality for all three networks.[4]

2 News media and images of nations: Structure of news flow

Images of nations have a strong influence on the flow of international capital. The relationship between news media and images of nations is not well researched, for this very reason the following discussion cannot claim to be complete. The main reason for this gap in research can be seen in the often highly sophisticated methods of states to influence world opinion (Kunczik 1997). Images of certain nations, whether right or wrong, seem to be formed, fundamentally, through a very complex

[3] Centrality is operationalized as the mean number of links required to reach all other nodes in a group; i.e. the lower the value the more central the node. The results of the "one-way flow analysis" according to Barnett et alii (1999, 15) "indicate that the monetary network is composed of a single group of 191 members. In this network the core is actually quite small when compared to the large number of peripheral countries. The semi-peripheral nations were comprised mainly of eastern countries such as Japan, Hong Kong, Taiwan, South Korea and Malaysia." The results of the "two-way flow analysis", which used monetary flows both to and from a pair of nodes, indicated a network composed of 102 nodes with the US, UK, Germany, France Italy, Canada and Spain at the center (1999, 20). The lesser developed countries and members of the former Soviet Bloc were at the periphery. Brazil, Turkey, Mexico, Argentina, South Korea and Taiwan were the semi-peripheral countries.

[4] One inconsistency is that according to Barnett et alii (1999, 30, 46, Fn. 6) in the trade network Brunei and Luxembourg are characterized as economically marginal nations with Luxembourg being a center of European financial system. Furthermore consumer transactions based on credit card purchases and bank-to-bank exchange represent only

communication process involving varied information sources. Walter Lippmann (1922, 181) wrote in *Public Opinion*: "Man . . . is learning to see with his mind vast portions of the world that he could never see, touch, smell, hear, or remember. Gradually he makes for himself a trustworthy picture inside his head of the world beyond his reach."

For the nation-state, PR means the planned and continuous distribution of interest-bound information aimed (mostly) at improving the country's image abroad.[5] So, PR for the nation-state comprises persuasive communicative acts, directed at a foreign audience. A famous comment by Lippmann (1922, 81) applies also to the changeability of images: "For the most part we do not first see, and then define, we define first and then see." In other words, from the wealth of events and information available, we select what conforms to the already existing image. But Wolfgang Donsbach (1991) published a study on the selective perception of newspaper readers that clearly confirms that the selection rule applies only when positive information is offered; when negative information is offered, both supporters and opponents of a certain position behave almost the same: They heed it. The protective shield of selective perception works against information that might result in a positive change of opinion, but not against information that might produce a negative change of opinion.[6]

Mass media reporting of foreign affairs very often governs what kind of image of a country or a culture predominates.[7] Day-topical media concentrate on short-lived events relevant to a given circle of recipients making locally or ethnocentristically oriented news choices of events, publishable with minimum delay. The widespread neglect of ongoing social processes can be explained by an analogy to perception theory. Such processes occur slowly and almost unnoticeably, functioning as part of the background. They attain attention value only when they turn into unusual events (e.g., hunger to mass dying, tensions between nations to war, social tensions to revolutions or revolts) or when everyday events are summarized in such things as annual reports. The unusual, the deviation from the norm, has particular news value.

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one aspect of global financial transactions.

[5] Trying to distinguish among advertising, PR, and propaganda in foreign image cultivation is merely a semantic game. In Harold D. Lasswell's (1942, 106) definition of propaganda as the manipulation of symbols as a means of influencing attitudes on controversial matters", one could easily substitute PR for propaganda. I treat propaganda and PR as synonyms. This means, following the tradition of one of the founding fathers of PR, Edward L. Bernays (1923, 212), who argues: "The only difference between 'propaganda' and 'education', really, is the point of view. The advocacy of what we believe in is education. The advocacy of what we don't believe in is propaganda."

[6] Winston Churchill was right when he said (Howard 1986/87): "To build may have to be the slow and laboring task of years. To destroy can be the thoughtless act of a single day."

[7] News values, the criteria by which journalists select from the flood of information what to publish, are basically nothing but intuitive assumptions about what interests their respective publics have.

International news is selected by criteria similar to those used for national news or local news: Higher ranking (superpowers) or geographically and/or culturally close states are most likely to be reported on. Economic, alliance, and ideological relations also generate more intensive coverage of another country. Selection is done by universally valid criteria, with particular emphasis on the unusual: disasters, unrest, coups, and so forth. Regionalism is particularly pronounced in all media systems. But negativism (civil war, natural disasters, debt crisis, human rights violations, electoral frauds, etc.) often remains the only important news factor dominating the coverage countries.[8]

Given the structural conditions of the international flow of news, countries with economic and/or political interests in having a positive image in a certain region, including those that are at a disadvantage from the outset because of the standard processes of gathering and selecting information, must mount publicity campaigns.[9] Although by definition, PR for states is always interest-bound communication, it can, however, offset communication deficits due to the structures of news flow. This form of PR for states, meant primarily to compensate for structural communication deficits, aims mainly to adapt the image to news values by trying to influence mass media reporting. Structural international PR aims at correcting the “false” images previously created by the mass media. Manipulative PR, on the other hand, tries to create a positive image that, in most cases, does not reflect reality, including lying and disinformation.

3 International PR and the establishment of trust

Many countries make considerable efforts to cultivate their images abroad, especially in the United States and Europe (Kunczik and Weber 1994). The main objective of international PR is to establish a (or maintain an already existing) positive image of one's own nation, that is, to appear trustworthy to other actors in the world system. Trust is no abstract concept. In the field of international policy,

[8] In the Foreign Images Study for the United Nations Educational, Scientific, and Cultural Organization (UNESCO), the selection of international news in 29 countries was examined (Sreberny-Mohammadi 1985). A replication of the foreign image study in 1995 brought similar results (not yet published completely).

[9] Just let me give an example: How is news about India gathered by the big German public broadcasters ZDF and ARD. The ARD-correspondent is located in New Delhi and has to report about India, Pakistan, Bangladesh, Afghanistan, Nepal, Bhutan and the Maledives. Not quite a small area. The correspondent of the ZDF is located in Singapore and has to report about even a much larger region: Singapore, Malaysia, Indonesia, Brunei, Papua, Thailand, Kambodsha, Vietnam, Laos, Myanmar, India, Bangladesh, Nepal, Bhutan, Pakistan, Afghanistan, Australia and New Zealand. With such an area to cover by a journalist one cannot expect an adequate reporting about these countries, which have to do structural PR in Germany in particular and in the West in general. They are really forced to wage campaigns in order to get an adequate image in the West, i.e. an image which at least partially corresponds to reality.

trust is an important factor in mobilizing resources, e.g., in receiving political and/or material support from other nations. In other words, if other actors in the world system place their trust in one's nation, in her future because of her reliability, trust becomes the equivalent of money. To put simply: Trust is money and money is trust. The positive image of a country's currency reflects confidence in that country's future. International business and currency exchange rates are not determined simply by pure economic facts (like currency reserves and gold reserves, deficit or surplus in balance of trade or balance of payment). The image of a nation-state, the rating of its business as solvent, the credibility of its politicians (i.e., can they be relied on to tame inflation by tight fiscal and monetary policies?), and so on are of decisive importance. Indeed, a country's reputation for solvency is more important to the stability of her currency than some short-term economic fluctuations.

In 1926 the French economist Albert Aftalion published his *Psychological Theory of Exchange Rates* based on the hypothesis that the exchange rate of a country's currency is determined mainly by trust in the future of that country. A deficit of the balance of payments will not cause a devaluation of the currency as long as the belief in the future of this currency will attract foreign capital and balance the deficit. Aftalion argued that there are far more qualitative elements in the determination of currency exchange rates. The determination of the value of a foreign currency is mainly a psychological process whereby the public opinion is very influential. There is one main reason for the use of a certain currency as key currency: trust in the respective country. Monetary policy is at least partially image policy. Money can be characterized as an illusion[10], nothing more than the trust people have in their respective currency. If there is no trust into a currency capital will flee. The collapse of the United States dollar in March 1995 and the rush to the German mark and the Japanese yen at least partly reflected a lost of trust in the world's major reserve currency.[11] The collapse of the new Euro has the same reason: international investors don't have trust in the currency.

Georg Simmel in his *Philosophie des Geldes (Philosophy of Money)* pointed out that money is responsible for the calculating character of modern times. Money is the tool to measure the relativity of values. Money allows to measure and compare different qualities, enables to compare on a rational basis. But Simmel (1922, 165) emphasized that the feeling of personal security associated

[10] The German economist Günter Schmölders (1966, 216ff) coined the conception of the “goldillusion of the people”, which was responsible for gold being accepted for so long a time to be the main means of payment.

[11] A German banker, Ulrich Beckmann, explained the 1995 rush to the mark: “It's not the D mark's strength. It's the weakness of all other currencies. ... People find the Mexican or the Canadian or the Spanish situation so confusing that,

with the ownership of money is nothing else but the most concentrated form of trust in a state. The positive image of a currency reflects the trust in the future of a country. If a certain state has acquired the reputation of being reliable this is more important for the stability of its currency than short-term fluctuations of its economy.

Already PR-counselor Ivy Ledbetter Lee in the 1920th was aware of the importance of trust when he argued: “Those who handle a loan must create an atmosphere . . .” (Hiebert, 1966, 266). Lee knew that simple statistics were not enough to market a loan. He handled loans for Poland, Rumania, France, and other countries. Lee considered Hungary a difficult case because too many people in America “had a mental picture of the Hungarian people as a wild, Bohemian lot, instead of the agricultural, sane, and highly cultivated people that they really are” (Hiebert, 1966, 267). His advice to Hungary was to create the image that their country was stable and civilized. Argentina had problems attracting investors because of its image of social instability. Lee advised to them to send a polo team to the United States to compete with American teams, arguing, “The vital idea is that polo is not played except where there is a very high degree of civilization and a stable society . . . The galloping gentleman would tell the story more convincingly than any amount of statistics or mere statements as to the true conditions” (Hiebert 1966, 267).

George Soros, the super-speculator, argues in the tradition of Aftalion when he emphasizes that on international financial capital markets unknown quantities which are decisively influenced by future expectations are traded.[12] I.e., the future is not only unknown but also influenced by the future expectations dominating on financial markets. According to Soros what is happening on today's markets is influencing the future which the markets try to include in their calculation. Instead of models of market equilibrium the financial markets should be analyzed by means of a model of reflexivity. In any case future expectations are a central element of the images of nation-states and strongly influence the international flow of capital. In an article in *Time* (March 7, 1994) Giovanni Agnelli, chairman of the Fiat Group, assessed Italy's future and concluded: “What the economy desperately needs is a political renaissance. Confidence is the decisive factor.” And confidence depends on having visions of a bright future, that is, a positive image.

The following are some examples of various countries' attempts to gain trust in the international community. On July 1st 1994 Banco do Brasil advertised in the leading German daily *Frankfurter*

psychologically, they feel more comfortable in the D mark” (Time, March 20, 1995, 26).

[12] Interview in: Der Spiegel, 51, 1998, 101. Soros had managed among others a hedge fund, the Quantum-Fonds.

Allgemeine Zeitung that Brazil now had a new and stable currency: the Real. This monetary reform was called the most decisive turning point in the history of Brazil's economy, an unparalleled enterprise. Brazil now offered investors more opportunities than ever before. It urged investors to have confidence in the new currency of a country, which in former times was plagued by inflation. Estonia published in *Time* (July 4, 1994) an advertisement: “ESTONIA: Rebirth of a Nation”. The main point was that Estonia in the meantime had developed into a stable democracy with a strong currency (kroon exchange rate linked to the German mark). Peru in 1993 published a special advertising section in the *International Herald Tribune* (November 24). President Alberto Fujimori emphasized the “dramatic moves his government has made to improve the country's economic and business climate”. The economic comeback of the country was emphasized. Malaysia published in *Time* (August 1994) an advertisement which explained the success of the country's capital market by the strength of the economy, political stability, and the good results shown by Malaysian companies. Anxiety about inflation had largely eased behind an effort to curb excess liquidity and currency speculation. The Finance Minister emphasized that the government is determined to broaden and deepen the capital market as a reliable source of long-term capital.

Many other nations have published similar advertisements in order to gain trust, but sometimes nations are interested in projecting a negative image. Mexico became the first country to practically declare itself insolvent by an ad in the *International Herald Tribune* (June 8, 1989). Luis Tellez, general director of financial planning in the Mexican ministry of finance, signed the text, in which the chairman of the Citicorp bank, John Reed, is attacked. The banker is accused of having too restricted a view of things: “For Mexico, the debt crisis is much more than a discussion of swaps or of the return of flight capital. It is a story of adjustment, of an extraordinary effort to transform an economy and of the hopes of millions of Mexicans for an opportunity to increase their standards of living. All parties involved should begin to look at the situation from both sides. We created the debt problem together; therefore it is up to both debtors and creditors to find a way out . . . We should all realize that there is much to gain by acting together. If banks insist on keeping their eyes closed to economic realities there will be no winners.”

4 Image and the international system

Images of nations can be understood as hardened prejudices; these are not suddenly there but often have grown in long historical processes. Such prejudices can be defined as expressed convictions of a particular group (or its members) about an alien group (or individuals because of actual or assumed membership of the alien group) without consideration of their correctness. Similarly to Boulding (1956), it is assumed here that the conception of an image means not only the conception of the image at present, but also aspects of its past and future expectations. National image, then, can be defined as the cognitive representation that a person holds of a given country, what a person believes to be true about a nation and its people. Of special importance to political action is the benevolence or malevolence imputed to other nations in the images, as well as the historical component of the image. Feelings about a country's future are important, too. Boulding (1969, 423) defined image as "total cognitive, affective, and evaluative structure of the behavior unit, or its internal view of itself and the universe".

Between the world of folk learning and the folk images derived from it and the world of scientific learning and scientific images, Boulding (1967, 5) localized another image sphere, which he described as a *world of literary images*. In this world the test of reality is the least pronounced; that is, the elimination of errors either does not take place at all or occurs only at enormous cost. It is in this world that the images of the international system are localized and in which the international decision makers mainly move. Boulding, who regarded the international system as by far the most pathological and costly part of the world system (e.g., costs of military, foreign ministries, diplomatic corps, secret services, and wars)[13], did not discuss the problem of the international flow of capital.

According to Boulding there are two main reasons for the pathology of the international system. First, neither folk learning nor science can shape adequate images of it. The simple feedback mechanisms that work in everyday life do not help in understanding the complexity of the international system. And scientists currently are unable to provide the information needed to build a realistic image of the international system, although there have been repeated efforts to that aim. Further, as a rule, political decision makers are highly mistrustful of research findings in the social

[13] In fact, decision makers are usually aware that they are living in a world of images. As the French statesman Talleyrand pointed out, in politics what is believed to be true is more important than truth itself. Ronald Reagan knew that "Facts are stupid things" and Dorothy L. Sayers wrote: "My lord, facts are like cows. If you look them in the face

sciences. Boulding wrote (1967, 9): “On the whole the images of the international system in the minds of its decision makers are derived by a process that I have described as >literary< – a melange of narrative history, memories of past events, stories and conversations, etc., plus an enormous amount of usually ill-digested and carelessly collected current information. When we add to this the fact that the system produces strong hates, loves, loyalties, disloyalties, and so on, it would be surprising if any images were formed that even remotely resembled the most loosely defined realities of the case.” Jarol B. Manheim (1991, 130) took the same position, arguing that for top decision makers in the United States, even at the highest level, receive much information from media reports: “They know little more than we know.”

There are many examples demonstrating that top-decision makers are living in the world of literary images (cf. Kunczik 1997, 50ff) with an older study of Isaacs (1958) being still relevant. Isaacs (1958) examined the attitudes of a sample (N = 181) of influential Americans – opinion leaders and policy determiners – toward China and India. He found that the American image of India was much less marked than that of China, and has been shaped in particular by the works of Rudyard Kipling, especially *The Jungle Books*. Thus Indians are seen as creatures of fable (“fabulous Indians”) living in an exotic world of maharajas, jewels, wealth, snakes, elephants, tigers, cobras, and so on. This image has also been bolstered by mass media, especially films. India also possesses an image as a country of religions, philosophers, gurus, and Eastern mysticism. Isaacs (1958, 259) wrote: “The image of the very benighted heathen Hindu is perhaps the strongest of all that come to us out of India from the past and it retains its full sharpness up to the present day. It appeared, vivid, clear, and particularized, in the mind of a large majority of our interviewees, 137 out of 181. It was evoked from distant memory or from the last week's issue of Time, from pictures and captions in the National Geographic.”

According to Isaacs' (1958) data, 54% (N = 98) of American opinion leaders questioned had more or less sharply defined negative notions of India, whereas 70% (N = 123) had a mainly positive image of China. China was a communist dictatorship and India a democracy. It must be assumed that such images will also influence political decision making. Furthermore it can be hypothesized that international investors have a similar image of India and China. In December 1998 a panel of South Asian experts discussed in New Delhi, why India's economy had not taken off. Percy Barnevik, chairman of the Swedish industrial holding Investor AB, argued: “I think India is really a much better investment destination than ist reputation suggests. ... It's partly a perception problem.

hard enough, they generally run away”; cf. Kunczik 1997, 49.

There is a long history in India of antagonism. We all remember Coca-Cola and IBM pulling out years ago. But many investors are not aware that India has changed dramatically. I ask American businessmen who spend billions of dollars in China, where there is uncertainty and lack of transparency, why they dont come to India. I don't think China is as safe, stable and reliable as India. You have millions of educated, English-speaking people here, you have a British judicial system. I think India's pitiful $2 billion in foreign direct investment could be $20 billion."[14] The low foreign investment compared to China is, without doubt, at least partly a consequence of the negative image that India has in the world of investors.

5 Eastman Kodak: A PR campaign to change exchange rates

Even rates of exchange can become the target of PR campaigns waged by MNCs. This was the case with Eastman Kodak (Dilenschneider & Forrestal, 1989). The company knew that its competitive position in the world marketplace was hurt by the then strength of the United States dollar. Kodak's communication division suggested to run a PR program targeted at this issue. Fact-finding meetings with President Reagan, high-level administration officials, and key national economic and trade groups were arranged. According to Dilenschneider and Forrestal the company funded a $150,000 study by the American Enterprise Institute, a conservative think tank (18 members of the Institute joined the Reagan Administration in 1981), to research the relationships between the strength of the dollar and the federal budget deficits. The Institute found a relationship between high interest rates required to finance the huge deficits and the dollar's strength. Dilenschneider and Forrestal (1989, 679) wrote: "Kodak believed a public affairs program could play a major role in persuading the government to pass legislation to eliminate federal budget deficit and intervene in currency exchange markets to stabilize the overvalued dollar. Kodak developed a 12-month communications program to reach members of Congress, the administration, and others in a position to influence economic policy. The message was that the overvalued dollar and escalating budget deficits were so damaging to manufacturers that a decisive action was needed."

The program, which received a Silver Anvil Award in the 1986 competition of the Public Relations Society of America, included a mailing to Kodak's shareholders, a "Write to Congress" campaign, consultations with leading politicians including Treasury Secretary Baker, and visits by Kodak

[14] Time [Indian edition], December 14, 1998, 16f.

executives to members of Congress and Cabinet members. According to Dilenschneider and Forrester the campaign played a direct role in changing the government's position and furthermore set the stage for two historic events: the September 1985 Group of Five communiqué pledging dollar stabilization, and the Gramm-Rudman-Hollings Act, aimed at eliminating federal budget deficits by 1991.

6 Rating of sovereign risks[15]

6.1 History of the problem

The following is an attempt to analyze the shifting of a country's reputation from being a good borrower to a bad borrower and vice-versa from the point of view of communications science. Eaton et alii (1986) point out that econometric analysis of international lending did not lead to the development of a model which could explain instances of so-called problem-debtors.[16] Due to globalization the volume of international loans to LDCs increased strongly between 1973 and 1982.[17] According to Daniel McFadden et alii (1988, 182) the number of official multilateral debt reschedulings in 1975 and 1976 was one for each year (amount in millions of U.S. dollars 230 and 270); in 1983 the number of reschedulings had increased to nine (amount in millions of U.S. dollars 4,219; through August). The incidence of bank debt rescheduling increased from 2 in 1978 (amount in millions of U.S. dollars 449; Peru rescheduled twice in 1978) to 20 in 1983 (amount in millions of U.S. dollars 59,288; excluding a Polish rescheduling for an amount of $1.0 billion).

The foreign debt crises faced by some LDCs (Mexico, Brazil, Argentina) at the end of the 1970s generated not only concern among economists, bankers and politicians concerning the ability of banks to distinguish between "good" and "bad" risks, but also stimulated research.[18] Krishan G. Saini and Philip S. Bates (1984) survey the technical literature that had focused on statistical techniques for determining a country's debt servicing capacity. The authors point out that prior to the first oil price shock (1973/74) developing countries received foreign funds largely in form of

[15] No distinction will be made between risk (the probabilities of various outcomes are known) and uncertainty (the probabilities associated with events that are unknown or unknowable).
[16] Econometric models are causal models depending upon the knowledge of causal linkages among variables. Such models typically "backcast" beautifully; cf. Henshel 1982, 64f.
[17] Cf. McFadden et alii 1988, 180f; figure 7-1 "The ratio of growth of international debt to 93 developing countries" and figure 7-2 "Repayment problems and crises".
[18] Jonathan Eaton et alii (1986) developed their "Pure Theory of Country Risk" which did not take into account the image of a nation or the role of rating agencies.

long-term loans from multilateral and bilateral official sources.[19] After the second oil price shock (1979/80) debt servicing problems of developing countries became the focus of banks, international institutions, governments and, not to forget, the general public and science. Since the 1980s the global capital market included more and more developing countries which were not richly endowed with capital and skilled labour (cf. Krugman and Obstfeld 1997, 683ff). Between 1981 – 1983 the world economy suffered the worst recession since the 1930s, which was followed by a quick recovery and emerging markets became more and more important.[20]

Sebastian Edwards (1984) investigated to what extent the international financial community had taken into account the risk characteristics of LDCs when granting loans between 1976 and 1980. Edwards analyzed the determinants of the spread between the interest rate charged to a particular country and the LIBOR (London Interbank Borrowing Rate). The empirical analysis used data on 727 public and publicly guaranteed loans granted to 19 LDCs. The results suggested that banks lending behavior had tended to consider some of the economic characteristics of countries, but also that banks might have had overlooked some aspects of developing countries economies. Gershon Feder and Lily V. Uy (1985) investigated the determinants of international creditworthiness. They utilized an empirical measure of creditworthiness based on bankers' perceptions to estimate the effect of various variables hypothesized to influence assessments of countries' debt-serving capacity. The data analyzed pertained to a cross section of 55 countries within the period 1979 – 1983. Feder and Uy (1985, 151) concluded that a relatively modest increase in exports growth can bring about a substantial favorable effect in creditworthiness.

One of the main problems discussed, when several LDCs with very large debts to foreign banks did not meet their payment schedules, was how contracts could be enforced. Jeremy Bulow and Kenneth Rogoff (1989) e.g. took the position that lending to small countries must be supported by direct sanctions available to creditors. According to Bulow and Rogoff a country's “reputation for repayment” will not enforce small countries to meet loan obligations, because “it is impossible for them to have such a reputation”. The authors (1989, 49) conclude “that if, through bargaining, an LDC can induce its lenders to forgive a portion of its debts it should do so. Debts which are forgiven will be forgotten.” Suk Hun Lee (1993, 358), who examined whether the credit ratings assigned by the lenders can be explained by the willingness of borrowers to repay their debt service obligations, found out that “the lenders take into account the history of foreign debt reschedulings in

[19] Country risk analysis according to Saini and Bates (1984, 342) had its origin in studies of these institutions.
[20] IMF (1999, 189) presents a listing of some of the rating agencies in emerging markets.

assigning LDCs credit ratings..." In June 1995 the Federal Reserve Bank of New York published an edition of Current Issues in Economics and Finance which dealt with basic information about sovereign rating, the development of the sovereign ratings business and the history of sovereign defaults[21].

6.2 The Rating Agencies

Credit rating agencies evaluate financial claims according to their creditworthiness, whereby the agencies not only rate long-term sovereign bonds but also a variety of other instruments. Ratings concern the creditworthiness of an obligator (S&P 1997, 2) and provide an indication of the relative risk that a debt issuer will have the ability and willingness to make full and timely payments in the future. The agencies rate corporates and sovereigns. Sovereign credit ratings[22] are the risk assessments assigned to the obligations of central governments.[23] In domestic capital markets agencies have since long rated the creditworthiness of borrowers but international credit markets ratings, according to Lee (1993, 349), were generally not publicly available until the late 1970s. Commercial credit rating is dominated by two American agencies: Standard & Poor's (S&P) and Moody's.[24] S&P's history (founded by Henry Varnum Poor) can be traced back to 1860. In 1941 the Standard'& Poor's Corporation was established which since 1966 belongs to McGraw-Hill. The two companies that merged to Standard & Poor's started their rating operations in 1916 and 1922. Moody's Investors Service was founded in 1914 (John Moody & Company in 1900). Two other important agencies are Fitch-IBCA and Duff & Phelps Credit Rating Co. (DCR). DCR became a subsidiary of Fitch-IBCA on April 12th 2000. The companies merged June 2000. The combined analytical staff worked together to harmonize the ratings and the rating approach for the new company. As a part of the process of harmonizing ratings DCR in May 2000 had adjusted

[21] A default is said to occur when an issuer does not make full and timely payment of interest or principal on a rated debt instrument.

[22] Moody's (1991, 157) defines sovereign rating as a "measure of the ability and willingness of the country's central bank to make available foreign currency to service debt, including that of the central government itself."

[23] Eaton et alii (1986) emphasize that traditional concepts of solvency and liquidity are of little help in understanding problems of sovereign debt. Creditors do not have the means to seize the assets of a borrower in default. Hence the borrower's net worth is irrelevant in determining the amount that can be recovered. The authors discuss three problems in international lending; i.e. enforcement (domestic debt are legal obligations enforceable in court whilst international debt repayment is largely voluntary), moral hazard (problems of moral hazard arise because it is difficult for the lender to monitor actions of the borrower to ensure that they do not affect adversely the prospects for debt service) and adverse selection (the difficulty of ascertaining the characteristics of a borrower relevant to designing a repayment schedule and judging whether a borrower will adhere to it).

[24] A short history of the major rating agencies is given by the IMF (1999, 188ff). The paper also gives an overview over the main local credit rating agencies; cf. also Hoffmann 1991, 141ff. According to Cantor and Packer (1994, 1f) the precursors of bond rating agencies were the mercantile credit agencies, which rated merchants' ability to pay their financial obligations. The first one was established in 1841 by Louis Tappan in New York. The expansion of the rating

Argentina's long-term local currency sovereign rating to Fitch-IBCA's rating. A list of important rating agencies can be found in table 1.

Table 1: Important Rating Agencies

	Moody's	S & P	Duff & Phelps	Fitch-IBCA	Thomson Bank Watch	Mikuni
Place of business	New York	New York	Chicago	New York/London	New York	Tokyo
Year of foundation	1900	1860	1932	1913/1978	1974	1983
Number of ratings	4860	4282	830	958	592	1300
Number of analysts	600	700	180	300	40	20
Number of offices	11	17	5	18	15	1
Owner	Dun & Bradstreet	McGraw Hill	Duff & Phelps Corp.	private investors	Thomson Corp.	private investors
Rated companies	all branches	all branches	all branches	all branches	banks	all branches
Rated countries	international	International	international	international	international	national

Original Source: Nomura Research Institute
Source used: Balzer and Ehren 1998, 66.

Whilst corporates can be regarded (in a simplified way) as being interested in profit maximization sovereigns have multiple, sometimes contradictory objectives. Sovereign risks, on which I will focus[25], consist of three different risks; namely economical, political and social risks – with the >transfer risk<[26] being of special importance. S&P's predecessors (Standard Statistical Company and Poor's Publishing Company) began rating sovereigns in the 1920s with those early evaluations based solely on publicly available information (IMF 1999, 195). Moody's has been rating bonds issued by foreign governments since 1919 and by 1929 Moody's was rating bonds issued by about fifty central governments (Cantor and Packer 1995, 2). Richard Cantor and Frank Packer (1995, 2) emphasize that sovereign lending has historically been a risky business; roughly 70 percent of all sovereign debt (excluding Canadian debt) issued in the U.S. between 1926 and 1929 defaulted before the end of 1937.[27]

The key factor for sovereign rating is the assumed stability of a country and this is the point where

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business began in 1909 when John Moody started to rate U.S. railroad bonds.

[25] Due to the lack of empirical research in this field I also will refer to research concerning corporate risk evaluation.

[26] Transfer risk is the probability that a borrower facing the obligation to make a payment in foreign currency might not be able to convert his own domestic-currency cash flow into the required foreign exchange in a timely fashion; Moody's 1991, 158.

[27] A list of sovereign defaults since 1970 is given by Cantor and Packer 1995, 3.

future expectations, i.e. images, influence the evaluation process.[28] Duff & Phelps e.g. characterizes its ratings as summary opinions of the issuer's long-term fundamental quality based on quantitative and qualitative factors.[29] The agency argues that credit ratings are based on information obtained from sources believed to be accurate and reliable.[30] Sovereign risks also are sovereign ceilings; i.e. an enterprise located in a certain country was up to now not rated higher than the country herself.[31] According to IMF (1999, 195) the sovereign rating set a ceiling on the ratings that could be achieved by other debtors – but there are some changes taking place: "a private entity could be seen as more creditworthy than the sovereign."

Rating is big business, is a "credit rating industry" (Cantor and Packer 1994). S&P has about 700 analysts and produces more than a third of the earnings of McGraw Hill.[32] Governments of countries belonging to the category of emerging markets, e.g., have to pay between $100,000 and $150,000 for a rating.[33] Rating agencies depend on their reputation among investors for objectivity and accuracy. Every time a rating is assigned the reputation of the respective agency is potentially endangered because the whole international investment industry, which wants to save costs by using the ratings, is watching. Moody's (1999, 3) emphasizes its independence and argues: "The incidence toward upwardly biased ratings is offset by a rating agency's overriding need to maintain its reputation in the market with investors, who indirectly drive the issuer's demand for credit rating."[34] S&P emphasizes that the agency operates with no government mandate and is independent of any investment banking firm, bank or similar organization."[35]

Annette Rösner (2000, 81) argues that the reputation of the agencies is especially endangered if they fail to predict negative developments; i.e. if the rating is to good. Cantwell & Company (Chatham,

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[28] Eaton (1996) develops a model in which sovereign debtors repay debt in order to maintain a reputation for repayment. Reputation for creditworthiness is maintained by repaying a current outstanding loan. Default impaires a country's subsequent access to world credit markets and thereby reduces its welfare.

[29] There seems to be even an ethnocentric bias. Vivien Beattie and Susan Searle (1992) found out that ratings seem to be biased in favor of issuers coming from the same country where the agency is located.

[30] http://www.dcro.com/ratingdefinitions.cfm

[31] Deutsche Bank Research (1999, 13) emphasized that the sovereign rating determines the sovereign ceiling of the solvency of individual debtors (corporate bond rating). Moody's (1991, 158) writes: "The country rating acts in virtually all cases as a >sovereign ceiling< or cap on ratings of foreign-currency denominated securities of any entity that falls under the political control of a particular sovereign."

[32] Cf. Manager Magazin, March 1998, 66. The Manager Magazin (1998) reports that competition between Moody's and S&P sometimes had resulted in unfair behavior. When Moody's didn't get the job to rate Denver (S&P and Fitch-IBCA got the job) the firm rated the city without having been requested (unsolicited rating) – and "by accident" the rating was worse than that of S&P and Fitch-IBCA.

[33] Manager Magazin, März 1998, 68.

[34] Moody's, Managing the risks implied by the use of ratings in regulation, in: Moody's Special Comment, New York 1999, 3; quoted in: Rösner 2000, 62.

[35] Standard & Poor's, Corporate ratings criteria, New York 1999; quoted in: Rösner 2000, 12.

N.J.), a rating advisor since about 20 years, asked about 300 issuers in its Credit Rating Survey (1999, reprinted in Rösner 2000) about their opinion of the accuracy of the current credit rating. In 1998 Moody's continued to have the highest percentage of respondents (44%) who felt that their rating was either "too low" or "much too low" with the comparable figure for S&P's at 33%. Thomson Financial Bank Watch reached the highest level of the issuer satisfaction with the accuracy of their current rating. Not surprisingly Moody's had the highest percentage of issuers with a desire to cancel their current credit rating. *The Economist* argued that ratings are good guides to relative corporate credit risk, though they are less reliable when it comes to sovereign issuers.[36] The image of the big rating agencies to be competent estimators of sovereign risks without doubt has been demolished during the Asia crises which they failed to predict.

Although I'll concentrate on sovereign risk rating by the agencies[37] it has to be mentioned that there are further actors in the risk rating business. The Business Environment Risk Intelligence (BERI-Institute in Geneva) was developed about 1975. "Foreland" (Forecast for Country Risk for International Lenders) is according to Peter Hoffmann (1991, 87) reliable, because the index predicted the problems of countries like Poland, Mexico, Hungary and Brazil years before their financial system got into troubles.[38] Another important evaluation of country risks is done by *Institutional Investor* (a banking and investment journal; cf. Feder and Ross 1982). Since 1979 the American magazine has been publishing the risk-evaluation of countries by about 100 leading banks, investment firms and brokers twice a year (March and September).[39] The scale varies from 0 (risk of credit not acceptable) to 100 (no risk at all). The risk is the arithmetical mean value of all individual estimations. The evaluation includes economic outlook, debt service, financial reserves/currency account, fiscal policy, political outlook, access to capital markets, trade balance, inflow of portfolio investment and foreign direct investment. In March 1999, e.g., 136 countries were rated. Russia had the most dramatic downgrading ever. Countries like Indonesia, Kasachstan, Nepal, Vietnam, Senegal, Pakistan, Malawi and Uganda received a better rating than Russia.[40]

[36] The Economist, July 15, 1995, 62; cf. also Cantor and Packer 1994, 10ff.
[37] Here the focus is on the NRSROs, i.e. "nationally recognized statistical rating organizations" registered by the U.S. Securities and Exchange Commission (SEC).
[38] Meyer (1986, 102) emphasized that the BERI includes qualitative factors like mentality, political risks, measures of suppression etc.
[39] Another publication, "Euromoney", ranks countries according to the average weighted spreads they pay on their Euromarket borrowings; Saini and Bates 1984, 354.
[40] Handelsblatt 19./20.3.1999, 10.

6.3 The rating categories

Rating agencies belong to an industry dedicated to measure risk and to give advice for risk management. Risk is relative and expressed in relation to other risks. Rating agencies create relationships between different countries and by that way are overcoming distances. Moody's Investors Service wrote on August 3rd 1999: "Ratings correspond to actual default experiences. The lower the rating the higher the likelihood investors will loose money."[41] Rating is the classification of debtors according to their assumed solvency. Gerald I. White, C. Sondhi Ashwinpaul and Dov Fried (1994, 1055ff) emphasize that the rating process exerts a significant influence on a firm's liability position in at least three ways: 1. The higher the ratings, the lower the interest rate associated with the offering. Rating, therefore, affects real ongoing costs to the issuing firm. 2. The covenants written into a bond agreement are often designed to obtain favorable ratings. As these covenants protect creditors by putting restrictions on the equity shareholders, ratings influence the sharing of risk and reward between equity- and debtholders. 3. Many institutional investors are restricted (legally or by internal policy) as to the type of debt they can hold; that is, the debt must have a minimum rating. Thus the success of an offering is often determined by the rating granted the debt issue. The same is with sovereign issuers. White et alii (1994, 1055ff) in their seminal study about the analysis and use of financial statements discuss only the prediction of debt risks (bond ratings) for firms but don't pay attention to the evaluation of country risk. Sovereign rating is the classification of nations according to their assumed solvency. The ratings are scaled ordinal, i.e. there is (assumed to be) a more or less clear differentiation between different countries, but the distances are not quantified. The main boundary between the different notches (a rating notch is for example the gap between a Baa1 and a Baa2 rating) is the one between investment grade and non-investment grade[42] (lowest investment grade; long-term: Moody's Baa3 [43]; Standard & Poor's BBB- [44]); cf. table 2a and table 2b.

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[41] http://www.moodys.com/moodys/mdytrack.html.

[42] Cantor and Packer (1994, 6f) discuss the traditional use of ratings for distinguishing investment grade from speculative securities. The authors stress that in 1931 the Office of the Comptroller of the Currency ruled that bank holdings of publicly rated bonds had to be rated BBB or better by at least one rating agency if they were to be carried at book value; otherwise they had to be written down to market value and 50 percent of the resulting book losses were to be charged against capital.

[43] Issuers rated Baa offer according to Moody's evaluation adequate financial security. However, certain protective elements may be lacking or may be unreliable over any great period of time (IMF 1999, 190).

[44] An obligator rated BBB has according to Standard & Poor's adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligator to meet its financial commitments (IMF 1990, 190).

Table 2a: Long-term debt rating symbols[45]

Interpretation	Moody’s	DCR, Fitch, S&P
Investment-grade ratings		
Highest quality	Aaa	AAA
High quality	Aa1	AA+
	Aa2	AA
	Aa3	AA-
Strong payment capacity	A1	A+
	A2	A
	A3	A-
Adequate payment capacity	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
Speculative-grade ratings		
Likely to fulfill	Ba1	BB+
Obligations, ongoing	Ba2	BB
Uncertainty	Ba3	BB-
High risk obligations[a]	B1	B+
	B2	B
	B3	B-

[a] The agencies do assign ratings to securities below this level of risk (very near or actually in default); however, they use different categorization systems that are difficult to compare.

Source: Cantor and Packer 1997, 1398.

Sovereign rating according to IMF (1999, 193) begins with meetings between the agency's staff and government officials in order to evaluate the sovereign's creditworthiness. This information is used to prepare a presentation for the rating committee. After the initial rating the agencies continue to monitor the economic developments of a sovereign. In recent years e.g. Duff & Phelps, Moody's and S&P have supplemented their ratings with watches and outlooks. The rating process includes three steps: 1. identification of risk factors; 2. prognosis of future developments and 3. determination of risk-height. The main problem of the rating process is that the agencies don't give full information about the rating process, which is regarded as a kind of trade secret. Ratings can have a decisive influence on the economic development of a nation-state. Upgrading or downgrading – especially crossing the boundary between investment-grade and non-investment grade – influences the interest on capital and also affects the influx of capital. Politicians are quite aware of this problem; e.g. newly elected President of Argentina, Fernando de la Rua, emphasized that the success of his planned social reforms depended decisively on the rating agencies, i.e. on Argentina's not being downgraded.[46]

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[45] For the rating categories of S&P's and Moody's cf. also IMF 1999, 190.
[46] Handelsblatt, 27.10.1999.

Table 2b: Long-term debt rating symbols

Investment Grade Ratings			Speculative Grade Ratings		
S&P and others	Moody's	Interpretation	S&P and others	Moody's	Interpretation
AAA	Aaa	Highest Quality	BB+	Ba1	Likely to fulfill
			BB	Ba2	obligations; ongoing
			BB-	Ba3	Uncertainty
AA+	Aa1	High quality	B+	B1	High risk
AA	Aa1		B	B2	obligations
AA-	Aa3		B-	B3	
A+	A1	Strong payment	CCC+		Current vulnerability
A	A2	capacity	CCC	Caa	to default, or in
A-	A3		CCC-		default (Moody's)
BBB+	Baa1	Adequate payment	C	Ca	In bankruptcy or
BBB	Baa2	capacity	D	D	default, or other
					marked shortcoming

Source: Cantor and Packer 1994, 3.

6.4 Proposed Revision of the Basel Accord on Capital Adequacy[47]

In the U.S. ratings have long been used as private-sector guides to creditworthiness.[48] Nowadays regulators of most types of financial institutions are using ratings on a daily basis. E.g. British regulators use ratings to help assessing how much capital securities firms should hold. Japan's finance ministry checks the credit rating of issuers in deciding whether or not they can sell bonds to Japanese investors.[49] Sovereign ratings will become more and more important[50] in the context of the reform of the *Basel Accord on Capital Adequacy* which momentarily is taking place. The *Accord* prescribes quotas of reserves in the international finance business. The *Basel Committee on Banking Supervision*[51] presented in Juni 1999 a working paper on "A New Capital Adequacy Framework", which aims at the revision of the 1988 *Basel Accord*. The 1988 *Accord* had been criticized for being based on crude measurements of economic risks. The proposal redesigns the risk weights assigned

[47] Cf. Basel Committee on Banking Supervision-http://www.bis.org/publ/bcbs50.htm; IMF, International Capital Markets, Washington 1999, 143ff.
[48] Cf. Cantor and Packer 1994, 5f; 1997, 1396ff; IMF 1999, 188ff.
[49] The Economist, July 15, 1995, 61.
[50] An indicator for the growing demand for rating is "Reuters Business Briefing": 1999 there were 170,000 articles concerning rating; in 1993 there were only about 20.000; cf. Everling, O., Ratingagenturen expandieren in Europa, in: Die Bank, 12, 1999 (www.bdb.de/bank/titel/htm).
[51] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of bank senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank of International Settlements in Basel, where its permanent Secretariat is located.

to asset categories. According to the Committee “the result will be to reduce risk weights for high quality corporate credits, and to introduce a higher-than-100% risk weight for low quality exposures.”[52] The new framework rests on three pillars, i.e. minimum capital requirements, supervisory review process of a bank's capital adequacy, and effective use of market discipline[53]. The crucial point of the reform is the change of minimum capital requirements. The current “Accord” differentiates risk weights for claims on sovereigns by membership in the OECD (0 weight for members 100 percent for nonmembers). The revised risk weights would be benchmarked to assessments of sovereign long-term foreign currency obligations by eligible external credit assessment institutions (rating agencies and G-10 export insurance agencies like e.g. Hermes in Germany). The proposed new risk weights for Sovereigns are (IMF 1999, 144)[54]: AAA to AA-: 0 percent; A+ to A : 20 percent; BBB+ to BBB-: 50 percent; BB+ to B-: 100 percent; Below B-: 150 percent; Unrated: 100 percent. If this reform proposal will be passed the influence of the rating agencies on the global financial markets undoubtedly will increase dramatically. Bonds without rating will have difficulties on the market.

The IMF (1999, 185) emphasizes that during the 90s global securities markets have become an increasingly important source of funding for many emerging markets: “As a result, the portfolio preference and practices of the major institutional players in these markets have been key determinants of the scale and composition of capital flows to emerging markets, as well as the terms and conditions under which those markets can be accessed. In this regard, credit rating agencies have been viewed by many market participants as having a strong impact on both the cost of funding and the willingness of major institutional investors to hold certain types of instruments. Indeed, obtaining a sovereign credit rating has often been seen as a prerequisite for issuing a eurobond, and some institutional investors are constrained to hold securities that have been classified by rating agencies as >investment grade<...” The reform of the *Basel Accord* will result in credit ratings becoming the key determinants of the risk weight attached to bank exposure of sovereign borrowers.

During the 1990s a growing reliance on sovereign credit ratings has emerged and ratings have been used to prevent institutions from holding low-rated securities. According to *The Economist* already

[52] Basel Committee on Banking Supervision, A new capital adequacy framework, Basel 1999.
[53] Basel Committee on Banking Supervision, A new capital adequacy framework, Basel 1999; IMF, International Capital Markets, Washington 1999, 143.
[54] As illustration the assessments are based on Standard & Poor's rating system.

in 1993 $1.2 trillion of developing-country debt have changed hands.[55] As a result the importance of sovereign credit ratings increased for investors task of prudential oversight, whereby according to *The Economist* countries traditionally did not seek a rating unless they were sure of a top triple-A-mark. According to Cantor and Packer (1995, 2) before 1985 most initial ratings were AAA/Aaa, but in the 1990s the median rating assigned has been the lowest possible investment grade rating BBB-/Baa3. Moody's in 1981 rated only 13 countries. S&P in 1993 rated the debt of 43 countries. In 1993 Moody's and Standard & Poor's dominated the market, their share was 90% of this market. But already then the question was asked: "Who will rate the raters?" *The Economist* emphasized that investors should know the philosophy of the rating agencies and drew attention to some inconsistencies in the rating process: "Moody's just rated China single-A, whereas S&P gives it high triple-B. ... Moody's gives the Philippines a higher rating than Argentina: S&P rates them the same. S&P has a double-B-plus rating for Mexico: Moody's gives a BA2 (the equivalent of its rival's double-B), five gradings below its rating for China." In 1995 Cantor and Packer found out that agency disagreements over sovereign ratings were quite common in the case of below-investment-grade sovereign bonds.

With economic globalization continuing to develop, the importance of national borders for the flow of international capital will continue to decrease. States are competing on a global level for investors – and that implies that a certain country's rating will become ever more important. For example in March 1999 Spain got a better rating by S & P (from AA to AA+) and in February 1999 Moody's rated government-loans of the Ukraine down from B3 to Ca . For Spain it will be easier to raise capital. For the Ukraine the not so excellent rating will result in even greater difficulties to attract capital. On July 1st 1997 the Indian *Financial Express* not only reported that Duff & Phelps Credit Rating Company had formed a three-member team to carry out a sovereign rating for India. The newspaper stressed that Moody's had put India in the investment grade with a Baa3 rating, whilst S&P had come up with a BB+, just a notch below the investment grade status. According to *The Financial Express* (July 1, 1997) in India it is widely believed that the ratings by S&P and Moody's are generally bearish and do not reflect the bullish sentiments that the country enjoys. The assessment of Duff & Phelps was supposed to clear up the split status that Moody's and S&P had conferred to India. According to a Duff & Phelps release (quoted by the *Financial Express*): "The team is scheduled to meet top officials in the finance and other ministries of the central government, the Reserve Bank of India, financial institutions, leading corporates, industry associations etc."

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[55] The Economist, October 30, 1993, 82f.

6.5 Rating as commensuration

Rating is a strategy to manage uncertainty and to adapt the wealth of information to people's cognitive limitations. Disparate informations, which create a kind of “information overload”, are reduced to simple ordinal scaled “numbers”, which can be used for decision making, i.e. investing or not investing in a certain country. Rating is commensuration, i.e. the transformation of different qualities into one common metric (Espeland and Stevens 1998). Different qualities (e.g. evaluation of future monetary and fiscal policy; expectations about the probability of a civil war; anticipations of the political stability of a certain country; the supposed efficiency of the political elite etc.) are transformed into simple unidimensional quantities. Rating means to calculate future incomes or risks and compare between different countries on a simple scale (Germany can be compared, let's say, with India, China, Russia, Mexico and Brazil). Wendy Nelson Espeland and Mitchell L. Stevens (1998, 325) argue: “Commensuration makes possible precise comparisons across vast cultural and geographical distances that allow transactions fundamental to global markets. The worldwide ascendancy of finance and service industries has propelled commensuration ...”

Concerning the estimation of risks Carol A. Heimer (1988, 491) stresses that “until quite recently no sociology of risk existed.” Up to now there is no systematic sociological study concerning the question how analysts make their decisions. There is the danger that some risks are overestimated and others are underestimated depending on the heuristics[56] used. Without doubt risk estimation is governed by one's social location. Amos Tversky and Daniel Kahneman (1974) pointed out, that a series of heuristic rules is used to process judgments about probabilities and that these rules lead to biases in the estimates. People guess at probabilities (for instance at tomorrow's weather or future quotations of shares) even if they have no adequate information for assessing probabilities. Even identical “scientifically” produced data about risk probabilities can be interpreted in totally different ways.[57] Attention is focused on some things at the expense of others. Kenneth Burke (1935, 70) pointed out: “A way of seeing is also a way of not seeing – a focus upon object A involves a neglect of object B.” Beyond doubt also the thinking of analysts estimating country risks is affected by their heuristics. Organizational routines may focus the attention of analysts on certain aspects of country

[56] Abelson (1968, 310) defines heuristics of an experienced problem solver as “a variety of cogent strategies and devices which offer reasonable promise, though no guarantee, of reaching the solution.”

[57] In 1976 American and British physicians read the evidence on the treat of a swine flu epidemic differently. In the U.S. exposure to litigation has led physicians to take the worst-scene scenario very seriously. In the U.K. a strong medical community and the bureaucracy of socialized medicine provided institutional support for risk taking. The consequence

risks. John Purcell, director of emerging-markets research at Salomon Brothers, detected a bias in Moody's toward the Asian model of development. Too little weight according to Purcell was given to the version of reform being tried by many Latin American countries.[58] May be that there are also fads in the world of analysts with the success of John Naisbitt's prophecy concerning the future of South East Asia being an example. In 1996 the former advisor of Thailand published *Megatrends Asia: Eight Asian Megatrends That are Reshaping Our World*.[59] Naisbitt (1996, 10) argued that what was happening in Asia was by far the most important development in the world. The modernisation of Asia will forever reshape the world as we move toward the next millenium because Asian economies had reached a critical mass, from which there is no turning back. According to the forecast of Naisbitt Asia will become the dominant region of the world: economically, politically, and culturally." Naisbitt's thesis was widely accepted and it can be hypothesized (a quantification is not possible) that many decision makers, investors and analysts accepted the idea. If such a bright future was to be expected not to invest would have been a failure.

All attempts to estimate risks, i.e. to predict the future[60], by means of social science in an "objective" way up to now have failed with Project Camelot[61] being the most famous attempt. It had been thought up in late 1963 by a group of high-ranking officers of the U.S. Army. The aim of Project Camelot was to develop research methods in order to be able to predict (and, more importantly, influence) politically significant aspects of processes of social change in developing countries. The objective was to make measurable, and if possible predictable, the causes of revolutions and social upheavals. Project Camelot was financed by the U.S. Army and was to have been allocated up to six million dollars for a period of at most four years. In army documents Camelot was characterized as a "basic social science research project on preconditions of internal conflict, and on effects of indigenous government actions – easing, exacerbating or revolving on – those preconditions." But, without doubt, the main aim of Project Camelot was "insurgency prophylaxis".

In order to "sell" the rating industry has to create the impression that the categorization of countries is reliable and trustworthy. This might be more or less correct concerning the "objective"

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was that the physicians read the probabilities in a different way; cf. Douglas 1985, 60f.

[58] The Economist, October 30 , 1993, 84.

[59] Naisbitt, J., Megatrends Asia: Eight Asian megatrends that are reshaping our world, New York 1996 (Simon & Schuster).

[60] For a discussion of the relationship between sociology and social forecasting see Henshel 1982.

[61] Cf. Kunczik (1990, 197ff). One of the leading personnel of the project said it was named after King Arthur's mythical domain because it connotes the right sort of things – development of a stable society with peace and justice for all.

economical risks[62] (at least until the unanticipated crises in Mexico and Asia[63]). The main problem is that rating not only implies economic data (e.g. depreciation of currency/inflation, gross national product, economic growth rate, balance of growth, exchange rate etc.) but includes also socio-political risks, i.e. image-aspects – especially the trust in the future of a certain country – become important. The IMF (1999, 148) pointed out that rating agencies do not use specific models (probabilistic or otherwise) to assign sovereign ratings. Instead their analytical approaches are said to be qualitative; aiming to assess a multiplicity of qualitative factors and quantitative indicators that affect sovereign default risk. The agencies in their ratings also take into regard aspects of foreign policy, domestic policy and the social structure of the respective country. Sometimes not even a bit of self-criticism can be found concerning the fulfillment of such a difficult task. Jürgen Berblinger (1996, 57) from Moody's argued that analysts were very competent concerning the social and cultural environment of an issuer. Such an assertion indicates a combination of arrogance and ignorance. No anthropologist would ever claim to have complete knowledge of a foreign culture (e.g. like India or China).

The evaluation of home policy i.e. includes form of government, efficiency of government, distribution of income, military budget. Foreign policy includes i.e. relationships to world powers like the U.S., international treaties, danger of war and national consciousness. Social risks include density and growth of population; infant mortality; budget for education, the chance of ethnic and/or religious conflicts and proportion of illiterates. Sovereign risk rating by S&P includes the history (development) of a country, the probability of conflicts within a society, socio-cultural factors, economic structures, international relations. Moody's takes into account the risks of civil war, stability of the legal system, the financial system, risk of inflation etc. Variables used in estimation of political risk by S&P include (IMF 1999, Annex V, 111): form of government and adaptability of political institutions; extent of popular participation; orderliness of leadership succession, degree of consensus on economic policy objectives; integration into global trade and financial system; internal and external security risks.[64]

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[62] Economic risks will not be discussed here. Economic factors used in sovereign rating analysis by S&P include: income and economic structure; economic growth prospects; fiscal flexibility; public debt burden; price stability; balance of payments flexibility; external debt and liquidity; cf. IMF 1999, Annex V, 111. Cf. also Krämer-Eis (1998, 37).

[63] IMF (1999, 212) reports that since the beginning of the Asian crises the credit risk profession has identified a number of economic factors that will receive increased emphasis in any evaluation of a country's creditworthines: “Financial system weakness, particularly the banking, have been viewed as a key source of vulnerability. Similarly, reliance on short-term external debt and other >confidence-related< capital flows by either private or public sector imply that a country can face an abrupt loss of market access.”

[64] Unknown is the theory behind the operationalization of the individual variables. How e.g. the extent of popular participation is measured? Is it voting participation? If yes; are pure acclamations in totalitarian states equated with

The ratings are crucial for the decision making of many international investors. To emphasize again: the better the rating, i.e. the lower the country risk, the easier the access to the international capital market. A good rating means that a country can be well provided with capital. A bad rating on the other hand can stimulate a flight of capital. The worse the rating the higher the interest on capital. The classifications create the impression of rationality and reduce uncertainty in decision making. Transactions on the global market become easier if an investor believes to have an objective basis for an investment-decision. But sovereign ratings biased by organizational routines can increase the risk of investors by giving a false sense of security. Categorization of countries by rating agencies may lead investors to believe that they are being provided with all the information they need. The consequence can be a reduction of the inclination to search for further information.

Vladimir Stadnyk, head of municipal ratings at S&P, remarked that ratings are prospective since they seek to predict how governments will deal with the “inevitable slings and arrows of fiscal fortune.” Thus, those that have shown resiliency in the face of changing times “get points for showing agility in coping with changing times.”[65] In July 1995, Leo O'Neill, S&P's president, stressed that ratings are opinions issued to inform investors rather than to protect them.[66] Moody's emphasized in August 1999: “Because it involves a look into the future, credit rating is by nature subjective.” According to Richard L. Henshel (1982, 60) advocates of intuitive approaches of social forecasting argue that only the human mind can cope with the intricacies and subtle weightings of factors that go into an effective rating, and that the inability to articulate the logic of the subjective process is a result of the subtlety of human thought. Furthermore according to Henshel the accuracy of intuitive approaches compares with that of apparently “advanced” objective procedures. Cantor and Packer (1996, 39) analyzed 49 sovereign ratings of Moody's and S&P's in September 1995 and found out that the ratings by Moody's and S&P can be explained by a small number of well-defined criteria, which the two agencies seem to weight similarly.[67] The authors discovered that the ordering

democratic elections? In this case one proceeds from the questionable assumption that participation in a vote is an indicator for political participation. Or is participation economic participation (Daniel Lerner in *The passing of traditional society* used this variable)? If yes, is it indicated via per-capita income? Is the aspect of income distribution taken into consideration? You can arrive at the same per-capita income if very few individuals have very high and very many have very low incomes; but also, if nearly all have equal incomes. Similar questions could be asked concerning the operationalization of each of the variables used.

[65] Petersen, John E., Riding the Rating Wave, in: Governing, June 1998, 56.

[66] The Economist, July 15, 1995, 61.

[67] Cantor and Packer (1995, 4) found out that the two big American agencies have similar views on the top-rated countries, but that their opinions vary more markedly the worse a country's credit quality becomes. Sovereigns rated the same by Moody's and S & P:

AA/Aa or above 67% (Corporate 53%)
Other investment grade 56% (Corporate 36%)
Below investment grade 29% (Corporate 41%).

of risks was broadly consistent with macroeconomic fundamentals. The following factors appeared to play an important role: per capita income, inflation, external debt, level of economic development, and default history. But concerning the qualitative aspect of the rating procedure Cantor and Packer (1996, 39) argue: "Identifying the relationship between (the two agencies') criteria and actual ratings is difficult, in part because some of the criteria are not quantifiable. Moreover, agencies provide little guidance as to relative weights they assign each factor." The homogeneous views among the raters points to social determinants of the evaluations. Karl Mannheim (1929) argued in "Ideology and Utopia" that every social position affords its own perspective, i.e. the partial truth yielded by the socially available perspective.[68] IMF (1999, 149) reports that in terms of educational work and background, most sovereign analysts have a master's degree, and on average they have 10-12 years of work experience in country risk analysis. This implies that with a high probability the analysts have a homogeneous view of the world.

In 1998 the IMF made a survey among the then four most important commercial rating agencies (Moody's; Standard & Poor's; Fitch-IBCA; Duff & Phelps). The authors, Charles Adams, Donald J. Mathieson and Garry Schinasi (IMF 1999, 145ff), found that for all rating agencies there generally is no model for predicting the future developments, only criteria. All use a qualitative approach based on quantitative indicators and qualitative factors. Concerning the resources devoted to analysis it was found that 70 Sovereign ratings were done by only 12 country analysts and 5 research assistants.[69] IMF (1999, 149) sums up: "On average, each rating agency analysts is responsible for seven sovereigns." IMF (1999, 150) argued that "the number of countries followed by agency analysts is excessive in the light of the challenges associated with analyzing sovereigns." IMF's proposal to solve this dilemma is quite naive from a social scientist's point of view. IMF recommends to enlarge the number of analysts (1999, 150: "The issue is that more of them are needed."). The realization of this proposal would be nothing else but the perpetuation of already existing distortions. To employ more analysts does not imply an embetterment in the quality of rating. Robin Monroe-Davies, Chairman of Fitch-IBCA admitted: "We can devote 10 people to every country but if they are all using the same analytical tools it might not be the solution to what is an inherent problem with market volatility." [70] This is an argument central for my further considerations: How and according to which criteria reality is constructed by members of the rating industry? It's a question belonging to the domain of the sociology of knowledge. If there is a

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[68] The idea of Mannheim (1929) that the socially unattached intelligentsia are the carriers of "objectivity" by relating of partial perspectives to form an "objective" "total perspective" will not be discussed here.
[69] Cf. IMF, 1999, Annex V, Table A 5.4, 146.

homogeneous background (education; social class etc.) then there is the danger that certain aspects will be overweighted in reality construction. The IMF (1999, 150) drew attention to the danger that "in the absence of a more probabilistic approach ... less tangible, but potentially important, risks may not be accorded the appropriate weight in rating decisions."

If the assumption concerning the construction of reality by analysts is correct, this implies without doubt that the image of a certain country can become decisive for the rating. William I. Thomas and Dorothy S. Thomas' (1928, 572) famous comment is valid on the international market of capital: "If men define situations as real they are real in their consequences." The image of a country in permanent crisis or as economically unreliable, generated perhaps by continuous negative reporting, can influence economic decision-making processes and discourage investments, which in turn can exacerbate future crises. For example, the then Prime Minister of Slovakia, Vladimir Meciar (1993), complained in an interview that due to negative reporting investments had declined. Meciar said that foreign investors didn't know much about Slovakia, but from the newspapers they learned that communist dictator Meciar was ruling and that the country was not known for its stability. If he had only this distorted information about his country, allowed Meciar, he would not invest there neither.[71] Similar complaints have been heard from Malaysia (in October 1983, e.g.) and the Philippines. Ín 1999 the Prime Minister of Bulgaria, Ivan Kostov, complained about the bad image of Bulgaria after the war in Kosovo. Nobody wanted to invest in his country. He argued that it was like the plague, although his country was an island of stability in the Balkans (Spiegel 44/1999). Thailand tried to regain the trust of international investors after the Asian crises through advertisements (e.g. in *Time* November 24, 1997 and December 22, 1997).[72]

Due to globalization one of the main problems for so called developing countries and/or emerging markets will be their image in the world of international investors. There will be a more intensive "image-fight" between nations with image polishing becoming a functional equivalent of investor relations. Even the Worldbank had to admit in February 1999 that a wrong image of a country had influenced its decisions. The economic miracle of Indonesia had resulted in overlooking signs of

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[70] Cf. Financial Times, Sept. 9, 1999, 4.

[71] Interview in: Der Spiegel, 47, No. 20, May 17, 1993, 183. Without doubt in this case the media were accused wrongly because Meciar had done his best to destroy the image of Slovakia: he was a communist dictator.

[72] The advertisements had the mottos:

Thailand Growing Pains Slow an Asian Tiger
Thailand The Right Medicine for Recovery
Thailand More Than Ever, the Place to Be
Thailand And Now More Reasons Than Ever To Consider Thailand.

danger like corruption, increasing political repression and the crisis in the banking sector. Instead managers of the institution saw only the enormous economic growth and regarded the government as being surrounded with halo.[73]

6.6 The world of analysts

Although no systematic research has been conducted up to now, it can be hypothesized that raters/analysts are living in a world where similar (economic) values dominate the way of thinking and the way of seeing the world. Since ratings are made from a certain point of view – normally the Western perspective – the focus is on economic efficiency. Important characteristics of a society like quality of life are – if at all – only indirectly taken into account. Daniel Bell (1976, 16) defines the essential characteristic of Western civilization as follows: "The fundamental assumption of modernity, the thread that has run through Western civilization since the 16th century, is that the social unit of society is not the group, the guild, the tribe, the city, but the person." Quite along the same lines is the argumentation of Harry C. Triandis (1990, 42): "Perhaps the most important dimension of cultural difference in social behavior, across the diverse cultures of the world, is the relative emphasis on individualism vs. collectivism." Collectivism means that loyalty to a group (e.g. family, tribe, nation) is rated higher than one's own personal interest. People who live in cultures that differ in this dimension exhibit some marked differences in their views of themselves, the view they hold of others and the relationship between the two (Markus and Kitayama 1991). In many Western cultures the belief in the independence of various persons dominates. In collectivist cultures by contrast, one perceives oneself as a part of a longer-lasting social relationship. Appropriate social relations hold the highest rank. In *Nebraska Symposium on Motivation* Triandis reviewed more than a hundred cross-cultural studies of individualism and comes to the conclusion that differentiation between individualism and collectivism is the key to understanding the differences between various cultures. The social psychologist pithily summed up his findings to the *New York Times* (December 25, 1990): "In short, the values that are most important in the West are least important worldwide." But the evaluation of countries is done on the basis of Western values.

Analysts are creating a taxonomy of human societies (cf. Lenski 1994), whereby the differentiation between investment grade and non-investment grade is a distinction similar to the differentiation of the early Greeks between the Greek-speaking population and the barbarians or to the differentiation

[73] Frankfurter Allgemeine Zeitung , February 12, 1999, 14.

between developed and developing countries. Investment grade is the good and non-investment grade the bad. Rating of social and political risks is not based on an unambiguous taxonomy, the criteria of which are specified. But that does not imply that there is no framework whose underlying parameters are agreed upon in the community of analysts. Research has to be done concerning the level of common sense within this community which maybe is not beyond the experience of the intelligent layman based on information collected mainly from the mass media. The German Public Relations firm Kothes & Klewes interviewed between October 1997 and January 1998 about 70 analysts in Brussels, Frankfurt, Hong Kong, London, New York, Paris, Tokyo and Zurich concerning their sources of information. Besides strong regional variations it could be demonstrated that especially news agencies and newspapers were regularly used to collect informations (cf. Kothes & Klewes 1998).

Sovereign-risk ratings are based primarily on publicly available information (levels of foreign debt, exchange reserves, political and fiscal problems; cf. Larrain et alii 1997). The media and analysts seem often to rely on the same information sources. There are only some information privileges, e.g. when a team of raters visit a country to carry out a sovereign rating there are discussions with the authorities. Helmut Reisen and Julia von Maltzan write (1999, 7): “Rating announcements may be largely anticipated by the market. This does not exclude, however, that the interpretation of such news by the rating agencies will be considered as an important signal of creditworthiness.”

The increasing power of the rating agencies is also part of the increasing global standardization process. Nation states are estimated according to a standardized routine. A small group of analysts has the power to influence the quality of life of billions of humans by rating the creditworthiness of the respective countries. There is always the danger of self-fulfilling prophecy already mentioned, which is evident when, for instance, mass media reporting convinces the rating industry that a certain developing country (emerging market) had only itself to blame for its problems because the people living there were lazy or incapable, and/or the government was corrupt[74] and incapable. Classifying such a country as investment-grade would be tantamount to squandering money (and endanger the credibility of the agency). Such a rating reduces the chances to access financial markets and thereby leads to greater poverty, which in turn reinforces the analysts' prejudice (or

[74] In 1993 Peter Eigen, former World Bank's resident director for East Africa, founded Transparency International to fight corruption globally. In 1995 TI published its Corruption Perception Index (CPI) for the first time. Countries are “rated” according to their corruptiveness . The goal of the CPI is to provide data on the perception of the level of corruption in societies (in 1999 Cameroun, Nigeria and Indonesia were perceived as the most corrupt countries; Denmark, Finland, New Zealand and Sweden as the countries with the lowest corruption). The CPI does not assess the degree of corruption practiced within a certain country. This is done by means of a separate instrument. Since 1999 a

image) and influences future ratings. Entire regions or continents can be stigmatized by such a vicious cicle; only to mention Africa (cf. Kunczik 1997, 59ff). E.g. in April 2000 the German Wirtschaftsforum started a campaign for southern Africa. Enterprises were asked to invest in that region. They should not look at the difficulties but focus on the chances.[75]

Analyst live in a “world of literary images” and get their information about a certain country mostly from the news media – even if they are specialized on certain countries. The news media on the other side publish the ratings – and so a system of self-references (in German: selbstreferentielles System) develops. The result is a perpetuation of stereotypes of certain countries. Furthermore it can be hypothesized (empirical studies still missing) that analysts/raters adhere to a common ideology[76] – which they don't call ideology, because they even don't know that it is an ideology. They will call it market economy or laws of the market or laws of supply and demand – which amounts to the belief in the “natural superiority” of an “disembedded economy”; i.e. an economy in which politics is separated from the market. The new dominant ideology is the capitalist free market economy. John Lie (1997, 341) starts his article on the “Sociology of markets” with the following arguments: “We live in the age of markets. The category of market dominates everyday discourse and political reality. ... After the collapse of communism, the market appears as the desirable and perhaps even the only viable form of exchange or coordination in a complex economy.” Lie stands not alone, for example the World Development Report 1996 was subtitled: “From plan to market”. Market laws are regarded as laws of nature, but market laws are man made. James Tobin (1980, 48) commented on the idea of the self-regulating forces of free markets: ”The view that the market system possesses ... strong self-adjusting mechanisms that assure the stability of its full employment equilibrium is supported neither by theory nor by capitalism's long history of economic fluctuations. ... That (government policies; M.K.) are the only source of shocks to an intrinsically stable mechanism is a proposition that could be seriously advanced only by persons with extravagant faith in their own abstract models and with historical amnesia.” In a similar way John Kenneth Galbraith called attention to the inadequacy of the market mechanism for regulating economies.[77]

My thesis (not yet empirically proved) is that analysts/raters evaluate human behavior as well as

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separate Bribe Payers Propensity Index is published.

[75] Frankfurter Allgemeine Zeitung, April 29, 2000, 16.

[76] Ideology is a manner of thinking characteristic of a class; i.e. a collection of beliefs and values held by a group for other than purely epistemic reasons (e.g. bourgeois ideology). Most ideologies reflect practical interests, i.e. an ideology defends the status quo and serves the interests of the dominant class. Critical thinking projecting alternative “better” worlds based on rational and/or moral principles which contains criticism of the status quo is utopian thinking.

[77] John Kenneth Galbraith argued: “The danger of liberty lies in the subordination of belief to the needs of the industrial system”; quoted in: Pugh et alii 1971, 159; cf. also Galbraith 1967.

entire societies according to their material success. Whole societies are forced in the Procrustean beds of the raters categories. If the so called laws of the economy are regarded as being of the same quality as the laws of nature then the following can happen: Natural sciences are assumed to be value-free and thereby independent of particular interests. Taken this as given, economics is nothing else but the resolution of purely technical issues. In the long run the international capital market will be a smooth process, functioning according to its laws. Short term frictions are happening because, e.g. due to state intervention, market laws are neglected. These frictions are regrettable, but the best solution is to rely on the forces of the market. Ethical issues like the misery of millions of people due to global financial crises are disethicized. According to this perspective financial crises like the Asian meltdown were caused because the laws of the market were not obeyed; and one has no chance to act against the laws of nature. One has to accept these laws or one will be eliminated, because these laws are responsible for the rationalization of modern societies.

Part of the power of the analysts does stem from the social networks they are members of. Similar education, similar social background, parallel interests and similar sources of information will create a homogeneity in thinking. Wilson and Lupton (1959) in their study about "The social background and connections of top decision makers" demonstrated the influence of custom and precedent in decision making in the world of big investors, where also a certain kind of informality was seen in the activities of directors of some (London) City merchant houses. William H. Whyte (1956) in his "Organization Man" pointed out that the characters of people are moulded by the organisation which employs them. Although the relationship between personality and occupation is fundamentally reciprocal[78], occupation affects man more than man affects occupation. The often mentioned "professional deformation" merely indicated adaptation to an occupation in which one wanted to make a career for oneself. The incumbency of a certain position in a social system influences ideologies, values, motives and so on. Karl Marx and Friedrich Engels in "The German Ideology" wrote (1959, 247): "Life is not determined by consciousness, but consciousness by life." Symbolic interactionism seems to be quite suitable to analyse how working as an analyst in the rating industry shapes personality. George Herbert Mead (1934, 140) insisted that the human individual endowed with mind and self is the product, not the creator of society: "The self is essentially a social structure, and it arises in social experience. After the self has risen, it in a certain sense provides for itself its social experiences, and so we can conceive of an absolutely solitary self. But it is impossible to conceive of the self arising outside of social experience." From this

[78] Individuals chose jobs which they believed would meet their requirements and whose requirements they believed they could meet.

point of view the learning of a vocation means "learning the ropes", developing a satisfying definition of the work situation and becoming increasingly engaged in the occupational role. But I do not know studies which have used this approach to examine socialisation of analysts.

6.7 Rating and herd behavior – the meltdown in Asia

The sovereign rating industry both failed to predict the Mexican crisis (1994/95) and the Asian financial and currency crisis of 1997/8[79], although Moody's downgraded Korea and Thailand ahead of the crisis (Reisen and von Maltzan 1999, 7). The IMF (1999, 136f) identified three explanations for the failure to predict the Asian crises[80]: "First, rating agencies are said to be influenced by the compensation they receive from rated issuers.[81] According to this argument, the agencies would hesitate to downgrade issuers from fear of spoiling business relationships that underpin their income stream. Second, the agencies purportedly are reluctant to downgrade sovereigns for fear of precipitating self-fulfilling crises.[82] ... finally, some argue that the rating agencies are inadequately staffed and therefore not up to the task."

IMF furthermore emphasized that the rating agencies during the Asian crises behaved like all other investors and reacted in panic. The rapid downgrading of the sovereign ratings[83] of South Korea and Thailand had accelerated the flight of capital: "Rather than being an important independent stabilising force, the major credit rating agencies did not behave very differently from the vast

[79] Since the big rating agencies failed to predict Asia's financial meltdown, an new rating agency located in San Francisco uses different formulas for calculating credit risks (Weinberg 1998). The new firm, KMV Corp. (owners: Stephen Kealhofer; John Mcquown and Oldrich Vasicek), argued e.g. that Singapore was not the relatively safe haven it appeared to be because the default risk of publicly traded companies has shot up. Whilst Standard & Poor's pegged the long-term sovereign debt of Hong Kong a respectable single A quality KMV has seen a rapid deterioration among Hong Kong corporations and said that the debt is mostly junk. KMV claims to spot trouble faster than rating agencies. Concerning the ratings of certain companies there are indeed big differences. Hysan Development (Hong Kong) in November 1998 was rated A- by Standard & Poor's and received a CCC+ by KMV. In September 1998 the KMV estimate on ACME Metal Inc. was equal to a D, at a time when the S&P rating was B (the company went into default on September 29th). KMV's default warning system doesn't rely on the wisdom of one person or a handful of people: "Its trick is finding a way to leverage the collective wisdom contained in equity prices into corporate debt markets, where liquidity is lower and prices are less meaningful" (Weinberg 1998, 126). The theory views equity as a call option on firm's assets. On November 1998 KMV gave little hope for a rebound in Asia: "Under KMV's model the typical default probability is 15% in Indonesia and 18% in Thailand. ... Median default probabilities for Singapore corporations have risen 35-fold since January 1997, to a 4.2% (Nov. 1998), a junk rating" (Weinberg 1998, 128). Taiwan according to KMV has gotten riskier, too, but remained easily in investment grade. Malaysia and South-Korea are said to have wrecked their economies by allowing banks to increase loan portfolio even as the banks' own stock market values were sinking.

[80] IMF 1999, 134ff, 203ff discusses the Asian crises and the behavior of the rating agencies.

[81] IMF (1999, 137) opines that rating agencies are primarily interested in their credibility which they are unlikely to trade off for short-term gains.

[82] As a prime example of this during the Asian crisis Prime Minister Mohamad Mahatir's public condemnation of the agencies following Malaysia's downgrading is mentioned; IMF 1999, 136f.

majority of participants. While the ratings assigned prior to the crisis were too high, it is arguable that the agencies overreacted and in some cases went to the other extreme."[84] After the crisis started sovereign ratings went down to "junk status" and according to Reisen and von Maltzan (1999, 7) "the downgrading of Asian sovereign ratings reinforced the crisis in many ways: commercial banks could no longer issue international letters of credit for local exporters and importers; institutional investors had to offload Asian assets as they were required to maintain portfolios only in investment-grade securities; foreign creditors were entitled to call loans upon the downgrades." The authors argue (1999,7) that if sovereign ratings lag behind rather than lead financial markets, but have a market impact, improving ratings would reinforce euphoric expectations and stimulate excessive capital inflows during the boom; during the bust, downgrading might add to panic among investors, driving money out of the country and sovereign yield spreads up.[85] If this diagnosis is correct, the agencies have played a central role in the Asian melt-down and introduced during the financial crises of 1997/98 a procyclical element into global capital flow.[86]

According to IMF (1999,135) the downgrading of Korea was perhaps the largest and sharpest in the history of sovereign ratings. The government of South Korea went to the IMF on November 21st for a $55 billion bail out package. Only afterwards the rating agencies slapped Korea with downgrades. On November 27th Moody's changed the rating for the first time since seven years. Within a month it cut Korea's long-term rating by about six notches, from a A1 to Ba1 – the same junk status as Barbados and Egypt (Weinberg 1998, 126).

Robert J. Shiller in his analysis of market volatility (1989, 7f) emphasizes that an investor's behavior is influenced by social movements[87]: "It is thus important to consider explicitly ... a major

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[83] A summary of the dynamics of rating changes can be found in: IMF 1999, Annex V, esp. 122ff.

[84] Financial Times, Sept. 9, 1999, 4. The *Annual Report* (1999, 27) of IMF points out: "Several Directors noted that key international credit rating agencies had failed to foresee the Asian crisis and then aggravated it when they sharply moved to lower the credit ratings of countries."

[85] Yield spreads refer to the difference between sovereign yields and U.S. treasury bill yields of the same maturity.

[86] IMF (1999, 186) stressed its "concerns that the agencies have been excessively sensitive to short-term development, especially during crisis periods." Furthermore IMF (1999, 191) argued: "... one concern is that if a sovereign is suddenly downgraded from investment to non-investment grade in the midst of a crisis..." Moody's argued that the ratings are not intended to predict the precise timing of a default or a financial crisis (IMF 1999, 207). According to Philip S. Bates (1999) from S&P complaints about credit ratings having contributed to destabilize global capital flows reflect an inadequate understanding of the role of credit ratings in capital market behavior: "Credit ratings are opinions of probability of default..." Bates added that prior to the onset of the Asian crises interest rate spreads for borrowers from the five Asian crisis economies had narrowed to levels below the normal spreads for issuers with credit ratings in lower investment grade and speculative grade range. At present (August 1999), the flight to quality has widened spreads to levels not witnessed over a decade. Both during the boom and bust spreads have not appropriately reflected the differences in credit risk as signaled by rating opinions.

[87] Mitchell Y. Abolafia demonstrates that traders are not rational maximizers. Financial markets are socially constructed institutions (1996; 8): "Economic actors, in the process of interaction, construct a world of norms, scripts, and strategies that shapes their future action." Joseph de la Vega (in: Fridson 1996) already in 1688, whilst explaining the breakdown

role for mass psychology in financial markets."[88] David Dreman (1979), an American professional investor, stressed that people in markets often behave like crowds at a theater fire – all running to the same exit, although many others are available.[89] According to Dreman (1977, 99) the professional investors are normally small, cohesive, and well-trained groups of decision makers: "Yet ... some of the symptoms of psychological crowds ... also seem to apply to these groups." Dreman also points to self reference (without using that term) and group dynamics (1977, 124): "If the expert's views are reasonable close to those of his clients and of other experts, even if he is wrong, he is unlikely to suffer repercussion. If, however, the expert takes a dramatically opposite point of view and proves wrong, he may lose his credibility as expert – another strong shove toward conformity and away from bold imaginative thinking that is supposed to characterize institutional research." Credibility gets a new meaning: Credibility is conformity to public opinion; to be credible one has to reflect the opinion of the majority.

Investors are in a social dilemma, that is in a situation "in which individual rationality leads to collective irrationality. That is, individually reasonable behavior leads to a situation in which everyone is worse off than they might have been otherwise." (Kollock 1998, 183) Whilst investors are faced with the outcome of loosing their money the raters are not in such a dilemma. They could at least theoretically evaluate crises in a rational way, but they also show mass behavior.

Jonathan Eaton, Mark Gersovitz and Joseph Siglitz (1986, 510) drew attention to the fact that managerial compensation schemes in which judgements concerning performance are based on relative performance may lead to "excessive correlation of risks undertaken across banks": "Assume most banks are undertaking higher yielding loans to LDC's. If all loans go into default, then it is unlikely that all (or possibly any) bank manager will be punished; each manager's judgment is confirmed by the actions of the others. On the other hand, if any one refuses to lend, and there is no default, the lower return earned by the bank will count against the manager." Risk as faced by the

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of the Dutch East India Company shares, concluded that the expectation of an event creates a much deeper impression upon the exchange than the event itself (Fridson 1996, 8). Charles Mackay (in: Fridson 1996) concluded in 1841 that investors go mad in herds and recover their senses slowly.

[88] Already John Maynard Keynes in "The General Theory of Employment, Interests and Money" (1936; 130ff) drew attention to the importance of mass psychology to explain economic behavior.

[89] Dreman extracted four principles of financial speculation (1979, 82): "First, an irresistible image of instant wealth is always presented that draws a financial crowd into existence. Second, a social reality is created that blinds most people to the dangers of the mania. Opinons converge and become >facts<. Experts become leaders approving events and strongly exhorting the crowd. Overconfidence becomes dominant, and standards of conduct and the experience of many years are quickly forgotten. Third, the LeBon image of the magic latern suddenly changes and anxiety replaces overconfidence. The distended bubble breaks with an ensuing panic. And fourth, we do not, as investors, learn from past mistakes – things really do seem very different each time, although in fact each set of circumstances was remarkable similar to the last."

firm and risks faced by the managers are not identical.

In the aftermath of the Asian crisis Moody's, S&P and Fitch-IBCA admitted that there was a need for a paradigm shift in rating technology. IMF (1999, 211) reports that between September 1998 and April 1999 a series of round-table discussions were conducted by members of the country risk profession, which identified three weaknesses:

1. Developments in global economy have outpaced improvements in the analytical capacity of the country risk profession (increased complexity and global interdependence of national economies; expansion and global interdependence of global financial markets).
2. The structure of the country risk profession, which has evolved to support securitization and trading, and has thereby decreased the individual analyst's capacity to openly provide independent, long-term assessments of country fundamentals.
3. Even when available, quality risk assessments were often not adequately integrated in decision-making processes.

As a consequence of the failure of the rating agencies both IMF and the Basel Committee try to develop criteria for the selection of agencies. IMF (1999, 136ff) proposes to evaluate agencies by tracking their record in capturing default risk. Secondly, the durability of the ratings should be checked; i.e. the stronger the predictive value of ratings, the more durable they are and the less frequently they will change. Thirdly, a market comparison is recommended; i.e. the track record and durability of ratings should be compared to the market. *The Basel Committee on Banking Supervision* (1999, 33f; IMF 1999, 147) proposes to use the following criteria for the selection of institutions eligible to produce ratings for use in the new risk weighting scheme: Objectivity, independence, transparency; credibility, international access; resources; recognition (by national supervisory authorities). Especially transparency, which means that the assessments should be publicly available, up to now is not guaranteed. The danger is that without concrete rules these proposals could remain empty talk.

Cantor and Packer (1996) evaluated the predictive power of ratings in explaining a cross-section of sovereign bond yields and measured whether rating announcements[90] directly affected market yields on the day of the announcement. They discovered that sovereign yields tended to rise as ratings declined. Furthermore they found out that dollar bond spreads responded to the agency's

[90] Between 1987 and 1994 a sample of seventy-nine announcements in eighteen countries were analyzed. Forty announcement were “outlook” (S&P) or “watchlist” (Moody's). Thirty-nine were actual rating changes.

announcement of change in their sovereign risk assessment.[91] Their results suggest that rating announcements themselves have an impact on the market's perception of sovereign risk (1996, 47): “Most strikingly, ... rating announcements have a highly significant impact on speculative-grade sovereigns but a statistical insignificant effect on investment-grade sovereigns.” Reisen and von Maltzan (1999) also investigated the power of the rating industry (Moody's; S&P; Fitch-IBCA) to influence financial markets. They reported a significant impact of imminent upgrades and implemented downgrades in emerging-market lending. Joint downgradings and upgradings by the three leading agencies have a market impact despite strong anticipation of rating events. The authors examined the links between sovereign credit ratings and dollar bond yield spreads between 1989 and 1997. The findings imply that sovereign ratings have the potential to moderate euphoria among investors in emerging-market bonds. But it is also shown that the agencies have failed to make use of this potential over the past decade.

Panic can cause stereotyping. So, during the crisis in Russia, Austria was regarded by American investors as an emerging market and the Baltic states (Estonia, Latvia and Lithuania) were treated as if still belonging to Russia (Kunczik 2000). The Russian crisis being a special case. In a “Letter to the Editor” George Soros argued in the *Financial Times* (Thursday August 13, 1998), that the meltdown in Russian financial markets had reached the terminal phase, because bankers and brokers who had borrowed against securities could not meet margin calls and forced selling swamped both the bond and stock markets. According to Soros immediate action was required. The trouble he saw was that the action necessary to deal with the banking crisis was diametrically opposed to the action that had been agreed on with the IMF in order to deal with the budget crisis: “The IMF programme imposes tight monetary and fiscal policy; the banking crisis requires the injection of liquidity.” He argued further that there was a financial gap that needed to be closed: “The gap will become bigger if the general public starts withdrawing deposits. The best solution would be to introduce a currency board after a modest devaluation of 15 to 25 percent. The devaluation is necessary to correct for the decline in oil prices and to reduce the amount of reserves needed for the currency board. It would also penalise the holders of rouble-denominated government debt, rebutting charges of a bail-out.” The IMF (1999, 135) in its discussion of the Russian crisis refers to this article and emphasizes that there was a rapid succession of downgrades – characteristic also of the Korean crisis. Stanley Fisher, director of the IMF, claimed that without Soros Russia would not have become a problem.[92]

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[91] Hand et. alii (1992) discovered that rating announcements directly affected corporate security prices. Reisen and von Maltzan (1999) cannot replicate the finding of Cantor and Packer (1996) concerning the impact of rating announcements on dollar bond spreads.

[92] Cf. Der Spiegel, 51, 1998, 101.

Expected upgrading can stimulate herd behavior as well. When in February 2000 it was rumored that Mexico would be upgraded to investment grade Goldman Sachs and other banks recommended Mexican stocks.[93] On March 7th 2000 Moody's upgraded Mexico's long-term foreign debt from Ba2 to Baa3, making it the first of the region's large economies to make the grade; within a week S&P boosted Mexico to one notch below investment grade. It was a signal that Mexico had decoupled from the more volatile Latin American economies. *Financial Times* reported that bullish strategists point to the long-term economic impacts the upgrade would have in terms of everything from debt spreads and corporate balance sheets to consumer spending and interbank lending rates. The newspaper commented: "The Mexican stock market rallied on the news and credit-starved companies headed for the Wall Street in search of cheap financing, triggered by dropping yield spreads."[94]

6.8 Rating shopping

In the 1970s rating agencies began charging fees to those companies whose debt they rated.[95] Tom McGuire, an executive vice-president of Moody's, argued: "The pressure from fee-paying issuers for higher ratings must always be in delicate balance with the agencies' need to retain credibility among investors."[96] IMF (1999, 191f) sees the danger that "issuers and intermediaries could be encouraged to engage in rating shopping – a process in which the issuer searches for the least expensive and/or least demanding rating. Such rating shopping can be particular dangerous when the ratings are used as a substitute for adequate disclosure requirements." If the reform of the *Basel Accord* will take place, there will be an increased pressure on sovereign issuers to attain higher ratings than they actually deserve. An alternative to rating shopping will be fraud. Pakistan being an example: In May 2000 the country had to pay back credits $55 mill. to the IMF because between 1997 and 1999 it had swindled concerning its budget. The government of Pakistan accused former Prime Minister Nawaz Sharif having ordered the falsification of the budget deficit.[97] Also in May 2000 the IMF made public that the Ukraine had reported wrong informations concerning her reserves in foreign exchange in order to receive IMF-credits.[98]

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[93] Handelsblatt 8.2.2000, 49.
[94] Financial Times , March 27, 2000, 26.
[95] The Economist, July 15, 1995, 62.
[96] The Economist, July 15, 1995, 62.
[97] Handelsblatt, May 2, 2000, 13.

In contrast to this Basil argued that her financial crisis was at least partly due to its honesty. Minister of Finance, Pedro Melan, in February 1999 pointed out that Brazil had committed the mistake to be to transparent in publishing her financial data.; Brazil became the victim of stereotypes.[99] Another aspect of rating shopping is demonstrated by Malaysia's Prime Minister Mahatir, who, according to a report of *Frankfurter Allgemeine Zeitung* (March 13, 1999, 3), had started a "road show" in the West. Reporters of *Newsweek* were allowed to accompany Mahatir whilst he was shopping. The enemy number one, the foreign media, should see that Malaysia is an open society and Mahatir not a dictator. Mahatir pointed out that he was no anti-semite and that many of his friends were Jewish. The control of the flow of international capital had been a success (Paul Krugman supported this point of view).

After the participation of Jörg Haider's right wing party in the new Austrian government the selling of Austrian bonds became difficult. [100] One reason was the publication of a conversation between Konrad Reuss from S&P and Reuters news agency.[101] Reuss pointed out that the conflict about the new government could result in a delay of reforms in the economic sector which in turn could endanger the AAA rating. Reuss argued that the new coalition of ÖVP and FPÖ had already resulted in an isolation of Austria. The delaying of reforms in fiscal and economic policy could endanger the AAA-rating. Reuss said, that S&P would soon meet leading representatives of Austria in order to discuss the problems. The "Wirtschaftskammer Österreich" is planning a campaign "Fairness für Österreichs Wirtschaft"[102] in order to polish Austria's image abroad.

Rating shopping will become more and more important and with this the influence of firms specialized in rating advising will increase. Rating advisor Cantwell & Company in 1999 emphasized (Rösner 2000, 97): "With the rapid growth of the number of rated entities, issuers are now finding that they are competing for ratings in much the same way that they compete for attention in equity markets." It is only a question of time when firms will specialize in rating advising for sovereigns.

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[98] Frankfurter Allgemeine Zeitung, May 6, 2000, 14.
[99] Handelsblatt, March 1, 1999, 11.
[100] Cf. Frankfurter Allgemeine Zeitung February 2, 2000, 39; February 8, 2000, 31f.
[101] The Austrian magazine *profil 6* in February 7, 2000 too reported about the activities of the big raters. The president of the "Nationalbank", Adolf Wala, commented on the endangered rating of Austria, that one main aspect of fiscal policy is the controlling of panic.
[102] Handelsblatt, February 11/12, 2000, 9.

7 Conclusions

George A. Barnett et alii (1999) emphasize that in spite of the importance of international monetary flows there is a lack of published empirical research. The authors present a quantitative assessment of the webs of international finance, telecommunication and trade. Their research is an attempt to describe the international monetary flow. The network analysis is based on world-system theory which focuses on the unequal distribution of power and goods in the capitalist world-system.[103] The global structure is described in terms of three types of nations; i.e. the core, the semi-periphery and the periphery. Semi-peripheral countries are seen in engaging both in core-like activities (as exploiter) and peripheral-like activities (as the exploited). Barnett et al. gathered international transaction data (consumer transactions based on credit card purchases and bank-to-bank exchanges) from a US-based credit card corporation.[104] Barnett et alii (1999, 42) conclude that the monetary network is dominated by the Western industrial powers in the center with the less developed countries at the periphery. The semi-peripheral nations consist mainly of East Asian countries such as Japan, Hong Kong, Taiwan, South Korea and Malaysia." The results further suggest that there are a number of only loosely connected marginal nations which are not integrated into the global economy. A comparison of international monetary, telecommunications and trade[105] networks suggests that these three networks are quite similar. GNP per capita was significantly correlated with centrality for all three networks. The problem is, that consumer transactions are not an adequate indicator for international capital mobility of investors.

James Burnham (1941) in his "Managerial Revolution" argued that the balance of power in society had slowly shifted from the owners of wealth to those who manage it like in former times feudal society gave way to capitalism. Burnham diagnosed in the 1940s a movement towards a managerial society.[106] Nowadays another shift of power seems to be taking place: a shift from the managers to investors whose behavior is guided by decisions of analysts with the rating industry being an influential part. In the new global economy the rating industry and esp. sovereign raters exercise

[103] Without a doubt the most influential theory of dependency is Immanuel Wallerstein's (1980) world-system theory, which distinguishes three types of nations; i.e. the core, the periphery and the semi-periphery with the latter engaging in both core-like activities (as an exploiter) and peripheral-like activities (as the exploited). For criticism on this theory cf. Chirot and Hall 1982; Kunczik 1991, 187ff.

[104] Country-to-country transaction data were gathered for 198 countries for the third quarter of 1995. Centrality is operationalized as the mean number of links required to reach all other nodes in a group; i.e. the lower the value the more central the node.

[105] One inconsistency which raises doubts concerning the validity is that according to Barnett et alii (1999, 30, 46, fn. 6) in the trade network Luxembourg, one of the main centers of Europe's financial system, is characterized as economically marginal nation.

[106] Already in 1932 Adolf A. Berle and Gardiner C. Means identified the problem of separation of corporate ownership from the actual controls of corporations; cf. Berg and Zald 1978, 125ff; Glasberg and Schwarz 1983, 311ff.

power by occupying a key position within the global flow of capital. At least since the 1990s raters have a decisive influence on the global flow of capital and with their ratings can affect the fate of billions of people. If a country like, let's say India, is regarded not to have investment grade, then development projects will become more difficult to finance.

If my assumptions concerning the worldview of analysts/raters are correct, the ideas of three schools of thought can be useful to guide research; namely the Frankfurt School; the sociology of knowledge and the ideas of Michel Foucault. The Frankfurt School argues that critical reason is becoming displaced by instrumental reason linked to efficiency. Instrumental reason implies a culture of means, not a culture of ends (Frankfurt 1973, 94f). Analysts/raters perhaps live a life that offers an illusion of freedom, especially from material want, but offers no access to critical reason. Theodor W. Adorno und Max Horkeimer (1979) furthermore point out that there may be a societal delusion with facts created by human beings accepted as given. But economics is not shaped by forces beyond human control. The ideas of Karl Mannheim (1929), too, could be taken into consideration. Questions should be asked concerning the correlation between ideas and their location within the social structure. According to Mannheim every social position affords its own perspective. He does not regard ideologies as distortions of truth but as complementary aspects of it (Floud 1969). Mannheim analyzed how the social location of individuals and groups shapes their knowledge.[107] It is possible that the ideas of Michael Foucault (1973) become relevant as well; i.e. can be used to guide research. Foucault's basic insight was, to put it in a simplified way, that historical eras differ not only in what people think, but in what is thinkable. So we can modify the question and ask, what is thinkable in the world of analyts/raters? Ann Swidler and Jorge Arditi (1994, 313) point out that scattered evidence suggests that those who must regularly deal with an impersonal, distant cultural world organized by abstract principles such as individualism or rationality construct knowledge differently than do those located socially and intellectually in more parochial settings. If this judgment proves right, then it should be worth researching whether analysts/raters possess a view of life akin to Oscar Wilde's definition of a cynic: “A man who knows the price of everything and the value of nothing.” It was the former Prime Minister of Czechia, Vaclav Klaus, who in 1998 drew attention to the restricted world view of the people moving global capital flows: “Another problem is the international markets and their young, quasi-sophisticated boys who think that they know everything ... and tend to oversimplify.”[108]

[107] According to Swidler and Arditi (1994, 306) the new sociology of knowledge examines how kinds of social organization make whole orderings of knowledge possible, rather than focussing in the first instance on the differing social locations and interests of individuals or groups.

[108] Vaclav Klaus; quoted in: Time, October 26, 1998, 58.

I have only scratched the problem, but one thing is for sure: actors in global financial markets (analysts/raters) are living in a world where global competition according to the law of the market is accepted – and it still has to be researched which are the consequences of this attitude for the rest of mankind. Published empirical research is still missing.

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