Sovereign ratings and the solvency of states: a case of structural power

D I S S E R T A T I O N
of the University of St.Gallen,
School of Management,
Economics, Law, Social Sciences
and International Affairs
to obtain the title of
Doctor of Philosophy in International
Affairs and Political Economy

submitted by

Giulia Mennillo

from

Germany and Italy

Approved on the application of

Prof. James Davis, PhD

and

Prof. Dr. Manfred Gärtner

Dissertation no. 4546

Zeitdruck, Dortmund 2016

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The University of St.Gallen, School of Management, Economics, Law, Social Sciences and International Affairs hereby consents to the printing of the present dissertation, without hereby expressing any opinion on the views herein expressed.

St.Gallen, May 25, 2016

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IN MEMORY OF

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Angela Piccininno

Giulia Pizzarelli

Acknowledgments

This dissertation would not have been written without the encouragement and relentless support of the many people I was blessed to meet. In particular, I want to thank my supervisor James Davis for investing time and energy in accompanying me through this process of intellectual growth. Further, I want to thank Manfred Gärtner for being my co-supervisor and mentor. I greatly enjoyed working as a research and teaching assistant at his Institute of Economics. I will never forget our intense, passionate, and fruitful discussions about the many pressing societal issues of our times.

I owe a debt of gratitude to Rawi Abdelal, Mark Blyth, Timothy Sinclair, Jeffry Frieden, Andrea Grisold, Daniela Gabor, Patrick Emmenegger, Cornel Ban, Michał Krzyżanowski and Rose Barbour for scholarly advice and constructive feedback on my work.

In particular, I want to thank all of my friends and colleagues who accompanied me during this journey and supported me endlessly: Alexander Heppt, Suryapratim Roy, Lotte Westermann, Björn Griesbach, Katrin Schamun, Yuka Hamaguchi, Raphael Rauch, Jackson Mohlopheni Marakalala, Anne Monier, Muhamed Almaliky, Petra Thiemann, Alexa Tiemann, Berit Gerritzen, André Blondiau, Christine Scheidegger, Larissa Zierow, Beatrice Mäder, Giovanni Mellace, Björn Müller, Silke Schön, Sebastian Plappert, Karl Hampel, Florian Jung, and Dirk Burghardt. I know that I have forgotten to mention some people and apologize in advance.

For the merciless editing of my English sincerest thanks to Ilse Evertse. In addition, I want to thank the Institute of Economics at the University of St. Gallen (FGN-HSG) and the Weatherhead Center for International Affairs at Harvard University for providing an inspiring academic home. I also thank the Swiss National Science Foundation (SNSF) for the Doc.Mobility grant, which allowed me to spend more than a year abroad working on my research.

Finally, my deepest thanks go to my family and my husband Björn. Their unconditional support and belief in me made this dissertation possible.

St.Gallen, July 2016

Giulia Mennillo

Summary

The politics of finance culminates in the assessment of the creditworthiness of sovereign states. This dissertation examines the structural non-intentional power exerted through the practice of sovereign ratings in the discursive construction of the solvency of states. I argue that sovereign ratings, conceived as an intersubjective practice, shape shared understandings, norms and beliefs about the constitutive parts of a state's creditworthiness, and play a codifying role in the process of the financial market's political opinion formation. Indirectly prescribing the rules of the game, the practice incorporates the potential to shape the fiscal and economic policy agenda and to ascribe to states which role to play in the economy.

This thesis undertakes a conceptual-theoretical deconstruction of sovereign ratings with regard to the admixture of quantitative and qualitative criteria of assessment. The inquiry into the published rating drivers and rationales, as well as into the communicated rating sensitivities and conditions to be rated differently, reveals not only the normative predispositions but also the imputed notions of causality inherent in the sovereign rating methodology. The latter are critical for problem identification, i.e. the diagnosis, and hence for the choice of the prescribed therapy for the states under concern.

With the problematization of public budgets and government debt since 2009, sovereign rating events could stylize restrictive fiscal policies as an inevitable therapy to overcome the crisis, thereby reviving public budget consolidation as an unquestioned overarching norm of fiscal and economic policy. As a result, the effects of the financial crisis of 2008 could be decoupled from its actual origins—allowing for a redefinition of the financial crisis into a crisis of sovereign debt.

Zusammenfassung

Die politische Dimension der Finanzmärkte kulminiert in der Bewertung der Kreditwürdigkeit souveräner Staaten. Die vorliegende Dissertation untersucht die strukturelle, nicht-intentionale Macht, die von Staatenratings in der diskursiven Konstruktion staatlicher Zahlungsfähigkeit ausgeübt wird. Es wird argumentiert, dass Staatenratings, aufgefasst als intersubjektive Praktiken, geteilte Verständnisse, Auffassungen, Normen und Glaubenssätze über staatliche Kreditwürdigkeit konstitutiv prägen und eine kodifizierende Rolle im politischen Meinungsbildungsprozess der Finanzmärkte einnehmen. Hierdurch entfalten die Staatenratings das Potential, die fiskal- und wirtschaftspolitische Agenda zu beeinflussen und damit den bewerteten Staaten zuzuschreiben, welche Rolle sie in der Ökonomie zu spielen haben.

Die vorliegende Dissertation unternimmt eine konzeptionell-theoretische Dekonstruktion der Staatenratings im Hinblick auf die Vermengung quantitativer und qualitativer Bewertungskriterien. Die Untersuchung der veröffentlichten Ratingtreiber und Begründungen sowie der kommunizierten Ratingsensitivitäten und der aufgestellten Bedingungen wieder besser geratet zu werden, gibt nicht nur die normativen Prädispositionen, aber auch die implizierten Ursache-Wirkungs-Zusammenhänge der Staatenratingmethodologie preis. Letztere sind wiederum entscheidend für die Problemdiagnose und damit für die Wahl der verschriebenen Therapie für die betroffenen Staaten.

Mit der Problematisierung öffentlicher Haushalte und der Staatsschulden seit 2009 konnten Staatenratingaktionen restriktive Fiskalpolitik als eine unumgängliche Therapie zur Überwindung der Finanzkrise stilisieren. Dadurch wurde das Ziel der Haushaltskonsolidierung als unhinterfragte fiskal- und wirtschaftspolitische Norm wiederbelebt. Im Ergebnis konnten hierdurch die Auswirkungen der Finanzkrise von ihren eigentlichen Ursachen entkoppelt werden, was eine Redefinition der Finanzkrise in eine Staatsschulden nach sich zog.

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Chapter 1

Introduction

I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.

—John Maynard Keynes (1936, p. 383)

1.1 Primacy of politics and politics of finance

Unlike so-called 'normal' times, when the politics of finance seems to be invisible to the outside observer, this dissertation has been able to take advantage of a moment that the history of global finance laid at our doorstep. The financial crisis that started in 2007 and its ramifications offer a unique empirical opportunity to observe the "political forces at work beneath financial markets" (Pauly 1997).

Understanding markets as a social and political construction motivates this inquiry into the implications of an alleged technical exercise, namely the practice of sovereign ratings. Sovereign ratings are issued by the three largest credit rating agencies (CRAs)—Fitch Ratings, Moody's Investors Service and Standard and Poor's Ratings Services—which have acquired "more than 90% of the market share on the basis of volume of activity" in the rating market (Mattarocci 2014, p. 121).[1] In the aftermath of the financial crisis, sovereign creditworthiness was questioned, which made the credit rating agencies' role in setting the terms of "orthodox economic policy-making" visible in a way never experienced before.[2]

A further motivation for this dissertation is to delve into the CRAs' type of authority, its causes, modus operandi, and political consequences. Starting with the notion of the "highly subjective nature of [sovereign] credit rating" this work examines the "ideologically conditioned judgments" inherent in the rating process (Bruner & Abdelal 2005, p. 199) and visible in the sovereign rating events following the financial crisis. Besides the ideational influence on a common sense understanding of fiscal and economic policy, the

[1] In financial market jargon, CRAs are commonly referred to as the 'Big Three.'

[2] This does not hold for countries affected during the East Asian crisis in 1997/98 (Ferri et al. 1999).

problem identification procedures inherent in the sovereign rating methodology have a straightforward political dimension, as they redefine the winners and losers of the financial crisis in a specific way: The sovereign rating practice has facilitated or even been necessary to redefine the financial crisis into a crisis of sovereign debt.

It is the interplay between the sovereign rating, i.e. a judgment about sovereign creditworthiness expressed by oligopolistic, transnational non-state actors, and the process of the market's (political) opinion forming that informs the core of this analysis: If sovereign solvency is the result of a social construction of sovereign creditworthiness that exists because of commonly shared ideas, understandings, norms, and beliefs about it, then the type of influence that the sovereign rating practice exerts in this process deserves particular attention.

Especially in the Euro area, the market and regulatory reliance on sovereign ratings materialized at the moment when CRAs started changing their perception of the creditworthiness of sovereign states, which broke up the tacitly assumed unquestionability of European sovereign debt.[3] Driven by the problematization of public finances and debt, sovereign rating events could stylize restrictive fiscal policies as an inevitable therapy to overcome the crisis, and decouple the consequences of the financial crisis from its actual origins—redefining the crisis into a crisis of sovereign debt.

The theoretical part of this work applies the concept of structural power in the understanding of Strange (1998) to the practice of sovereign ratings and to its role in the discourse of sovereign creditworthiness. First, the concept serves as a theoretical tool to explain the origins of the CRAs' authority. Second, it delivers an analytical basis to relate the interaction of the (structural) power sources at play with the diffusion of the effects of the sovereign rating practice.

The Strangean structural power term starts with the premise that four "structures" condition key processes in the global political economy (Cutler 2014, p. 3). "Strange's insight into the political significance of access to credit" is emblematic of the growing relevance of the "finance" and "knowledge" structure in the global political economy.[4] These are the same two structures that are of particular interest in the analysis of the sovereign rating practice and the politics of creditworthiness.

By influencing market perception through its codification, sovereign ratings do not only drive credit spreads materially, but also set the terms of the fiscal and economic policy agenda ideationally, prescribing the role that states (should) play in the economy.[5]

[3]For example, the assumed risk freeness of European sovereign debt is essential for the eligibility of sovereign bonds as collateral in both private and central bank repurchase agreements, the former also known as repo markets (Mennillo 2015).

[4]The other two structures conceptualized in Strange's structural power term are "security" and "production." For a discussion of the structural power term, see chapter 5.

[5]This argument can be developed further: CRAs increasingly problematize general political occurrences going beyond fiscal policy, suggesting an intensified "politics of sovereign ratings." Empirical evidence for the CRAs' hyperactivity in terms of sovereign rating actions can be found in Gaillard (2014). The net effect of this higher visibility of CRAs in terms of their epistemic authority and reputation may be ambiguous.

Via the finance structure, sovereign rating deterioration creates the material pressure to pursue a specific policy. Via the knowledge structure, the ideational basis which legitimates this specific policy is provided.[6] The material pressure translates into a political reaction which is driven by the normative predispositions inherent in the sovereign rating. As investor perception tends to reproduce the "reality" that the sovereign rating is presumed to describe, this kind of structural power invalidates the measurement of the ratings' performance, distorting the presumptive 'track record' of ratings.[7] Ratings gain validity because investors believe in their relevance (and not necessarily in their predictive power) and act accordingly (Thomas & Thomas 1928, p. 572).[8]

Third, these dynamics may provide a further piece of the puzzle of the "redefinition of the crisis": the focus shifting from the necessity to reinvent the wheel of the global financial architecture to the imperative to rebalance the fiscal budget—a process Blyth & Shenai (2010) label the "ironic turn" of the global financial crisis:

> [T]he same large multinational financial firms that sought government bailouts are now shocked and surprised by the spending of 'profligate' governments. Indeed, these actors are now speculating against the very governments who brought them back to life by shorting their debt. As a consequence, governments across Europe are adopting austerity measures to outflank the positions of these speculators.

What is the role of the sovereign practice in all of this? This work argues that it is extensive. Not only does the sovereign rating practice have a role to play in the perception of sovereign creditworthiness and in the construction of shared ideas, understandings, norms, and beliefs about it, but through its methodology it has the power of definition in problem identification—the power to diagnose credibly where the shoe pinches, and where not. Thus, it is not only the re-problematization of sovereign debt which constitutes the societal dimension of the described discourse dynamics, but also the imputed notions of causality inherent in rating which led to the prescriptions of therapies that did not meet the origins of the malaise.

At this point, it may be worth mentioning that the consensus on the resolution of the crisis, which the sovereign rating practice facilitated, incorporates an implicit contradiction with respect to the understanding of the state's role in the economy: The type of state that market participants and the CRAs desired after the bailout of the

[6]The incorporation of ratings into financial regulatory regimes strengthens this 'going hand-in-hand' of coercive financial/material force and normative-political implications. Mennillo & Roy (2014) undertake an analysis of the rationales and legitimacy of the regulatory use of credit ratings.

[7]The measurement of a track record of ratings would only make sense if any interaction effect between the rating, the consumer of rating, and the object of rating can be excluded. Indeed, the measurement of a track record of a meteorological forecast makes sense since a weatherman has no impact on the weather situation.

[8]The exact wording of the "Thomas theorem" reads: "If men define situations as real, they are real in their consequences."

financial system seems hardly compatible with the *payer of last resort*-type of state they were crying out for shortly before this moment.

When states worldwide were faced with multinational financial institutions' desperate calls for financial rescue, observers celebrated as well as deplored this moment in history as the resurrection of the state after its apparent retreat from a globalizing world economy. The allegedly regained primacy of politics was only short-lived in the eyes of those who interpreted the effectiveness of the 'too big to fail' (TBTF) argument as policymakers' susceptibility to blackmail by 'systemically important financial institutions.'

For different reasons, a few, but very different, proponents of the political spectrum considered the financial bailouts as the state's unnecessary intrusion into market mechanisms. By following the TBTF 'mantra,' states would have prevented market forces from working properly, and facilitated the emergence of new systemically important oligopolies with even larger political leverage than those previously considered TBTF.[9]

Although this diagnosis was unanimous, the inferred policy recommendations were divergent: The disastrous systemic consequences of market failure may substantiate the necessity that societies need to be safeguarded from the vagaries of integrated capital markets. The policy prescription would be extensive financial regulatory reform, and perhaps even a paradigm shift to less integrated capital markets à la Ruggie's (1982) "embedded liberalism" framework of thought, inherent in the restrictive financial order of the Bretton Woods era (Helleiner 1994, p. 3). The reading from a Schumpeterian perspective of creative destruction is quite different (Schumpeter 1994, pp. 81-86): Without buying into TBTF, allowing a series of Lehman Brothers-like bankruptcies could have guaranteed that market forces really worked. Regardless of the adjustment cost, such a laissez faire strategy would have led to a more efficient and desirable outcome.

Regardless of whether these banking bailouts were deemed as a necessary evil, or just illegitimate, policymakers' crisis management illustratively confirms Pauly's analysis (1997, p. 4) that "policies of national governments" are, in the end, the crafting and shaping forces of integrated capital markets. In this vein, the fiscal policy constraints governments faced after the de facto re-empowerment of global finance, are not only the "consequences of national debts and deficits" (ibid.), but the political implications deriving from the norm of international capital mobility, which implies obedience to the financial market's dictate. In this regard, referring to Kirshner (2003), Grabel (2003), and Abdelal (2007), Abdelal et al. (2010, pp. 9-10) note:

> [P]olicies that are deemed illegitimate by the international financial community [...] simply cannot succeed: capital outflows sparked by an out-of-bounds-policy can undermine a choice that, at another historical moment, may have been a perfectly plausible response to a policy challenge.

[9]Owing to the huge uncertainty in terms of the interdependence between global finance and systemic stability, TBTF was commonly accepted as inescapable. Consequently, questioning TBTF in the retrospective may lead to the then existing practical and political realities being disregarded.

Whether governments are sufficiently aware of these implications remains an open question. The irony, or paradox, of all of this lies in the fact that the crisis moment re-affirmed the state as the "locus of ultimate political authority in the modern age" (Pauly 1997, p. 34). However, this did not prevent concerned governments from (again) subjugating their policies to the tastes of freely floating capital. Governments subordinating themselves to the dictate of global finance, even after rediscovering their primacy and bailing out the same subjugating forces, opens a wide spectrum of questions: What motivated governments, despite the legitimacy problems posed to their political authority and the already incurred material cost? Was it the fear of huge opportunity costs if they were to deviate from the deep-set norm of financial openness? Was it their confidence in effective multilateral economic governance? Or was it their firm belief in the long-term benefits of financialization? This dissertation focuses, first and foremost, on the role of sovereign ratings in the construction of the financial market dictate that states faced after the financial meltdown in 2008, therefore these questions remain mostly unanswered. Nevertheless, I consider it important to keep this discussion about the primacy of politics in mind when analyzing the politics of finance in the specific case of the sovereign rating practice. After all, the CRAs' influence on the market perception of sovereign creditworthiness with all its implications is just a small piece in the puzzle of the general tension between domestic politics and global financial capitalism.

Therefore, when the market obedience of policymakers is bemoaned, a victimization of the state as a passive actor in this process may not really be an accurate account. None other than the state, intentionally or not, facilitated the "reemergence of global finance as a major force in international [and domestic] politics" (Bruner & Abdelal 2005, p. 7), and upheld this force exactly at the moment in history when it could have done otherwise. Again, this work does not undertake a systematic analysis of the reasons why states continued to empower capital markets. However, it claims that sovereign ratings mattered because they facilitated the non-decision of states to promote a paradigm shift, and acted as a status quo force in the consensus building regarding the taken-for-grantedness, and the unanimity of the financial market's dictate. Put differently, without the CRAs as the financial market's 'mouthpiece,' which announce and homogenize the imperative of what 'markets want,' a paradigm shift might have been more likely.

1.1.1 The relevance for International Relations (IR)

One of the main purposes of this dissertation is to advance the current state of knowledge in terms of new forms and fusions of state power emerging in the 21st century. In the following, the implications of the financial market's dictate, including the role of sovereign ratings in it, for international relations are pondered. According to Strange (1997, p. 3), the relevance of the finance dictate lies in the "uncertainty that rules in the financial world" may spill over into the "fortunes of governments [...] and sooner or later into the relations between states." Historically, the Great Crash of 1929 of the

New York stock market, with all its infamous implications, may be emblematic of such a type of spillover. As of writing, the final consequences of the financial crisis of 2008 for interstate relations may not have unfolded entirely. However, it can be ascertained that the meltdown of trust between financial institutions spilled over into the questioning of sovereign creditworthiness by financial markets themselves, which has had a huge impact on the domestic politics of states. At the same time, the spillover of distrust in terms of the relations *between* states may most prominently have taken shape in the form of the sovereign debt crisis in Europe. Its consequences for the European Union remain unknown to date.

According to Helleiner (1994), financial markets have been mainly shaped by the policies of a handful of powerful states. Instead of being driven by a "quasi-natural market force," global finance represents a playground on which states can compete "to promote their own national interests" (Porter 2014, p. 15). In such a political perspective on finance, what role can be assigned to the sovereign rating practice? Apart from the controversy of whether sovereign ratings serve the interests of powerful states,[10] sovereign ratings may be co-constitutive of the application of a realistic logic in global finance (Morgenthau 1948). Through their ordinal-relative scale, sovereign ratings offer a convenient device by which national states can conceive each other as competing entities for different types of power—be it for material (financial-economic) power, or for softer versions, such as reputation.[11]

To affirm the inseparability between economic and political power lies in a long tradition of International Political Economy (IPE) scholarship. For Strange (1998, p. 15), the globalizing world economy blurs the lines between political and economic power to a hitherto unknown degree.[12] It would be impossible to "divorce politics from economics [i.e. markets]" (ibid.). However, the dichotomy between 'state' and 'market' is an inherent construction of neoclassical economics, and sovereign ratings seem to promote this dichotomy (Paudyn 2013). With respect to IPE, the notion of the inseparability between economic and political power is not only subfield-specific, but can also be found in the core IR literature. The usefulness of the dichotomy between economic and political power has been questioned, for example, by Waltz (1979, p. 94):

> [E]conomic capabilities cannot be separated from the other capabilities of states. The distinction frequently drawn between matters of high and low politics is misplaced. States use economic means for military ends; and military and political means for the achievement of economic interests.

The fungibility of economic power, particularly its contingent capacity to be trans-

[10] This question is, among others, addressed in chapter 4.

[11] These two power versions are inseparable when it comes to sovereign ratings and the politics of creditworthiness. How the two dimensions are inherently related to each other is discussed in chapter 5.

[12] Consequently, powerful market institutions also obtain increasing political power.

lated into military clout,[13] ultimately nourishes its political salience for the international system. Although the link between political and economic power is not something new in the history of international relations, the mix may have changed, and thus the proportion of the classical ingredients of state power in the 21st century. Globalization may have undoubtedly played a part.[14]

Economic variables, such as the gross domestic product (GDP), mainly determine affiliation to novel intergovernmental institutions as the informal G-20 forum—not regime-type or military capabilities. As Gelb (2010) states, it appears that GDP nowadays matters more than force. If globalization prioritizes economic strength above political power, competition for market shares and mercantilist export promotion may be the consequence. Guérot (2012, p. 13) observes that with advancing globalization, foreign policy gradually comes down to trade policy for many industrialized states, of which Germany and China are prominent examples. Such dynamics corroborate the notion of the amalgamation between political and economic power. States do not only compete with each other like companies in the marketplace, but the state conceives *itself* as a "business location" (in German: *Wirtschaftsstandort*).[15]

From the above follows, first, the competition between states to attract capital—be it domestic or foreign. This is in line with the view of Strange (1996), who "argued that access to credit has become a central term of competition in the world, replacing the geopolitics of competition over territory and ushering in a new kind of politics that requires new ontological and epistemological understandings about the nature of power" (Cutler 2014, p. 3). In such a type of competitive setting, the construction and perception of sovereign creditworthiness are crucial. Sovereign ratings fulfill a signaling function for investors and a gate-keeper function in terms of market access for states that seek funding. Second, conceiving the state increasingly as a company contributes to a normative convergence towards commercial principles in terms of how the state should be run (Rügemer 2012*b*, p. 83). This convergence delivers the rationale and possibly creates even the need for the subjection of a sovereign state to the judgment of a private CRA.[16] Third, and related to this, the state's orientation towards market criteria

[13]According to Waltz (1979), this is the reason why it would not be "unnatural" for a rising power to strive for economic power in the first place.

[14]For a critical discussion of the concept of "globalization" see Bourdieu (2005, pp. 224-229), who outlines the double meaning of the concept as both descriptive and normative.

[15]It may be over-deterministic to identify several structural factors that impact the changing conception of the state. However, owing to an inter-disciplinary concern, the business ethics perspective in philosophy should also be mentioned briefly: For example, Thielemann (2012, 2011) relates this shift in the understanding of the state to the concept of "economism." Sandel (2012) uses the term "market triumphalism" to describe the transition from the "market economy" to the "market society," the latter being subject to "economization." Economization means an economic approach to life in democratic societies, in which markets expand to different realms of everyday life, including the political sphere, by hollowing out moral and civic goods. I refrain from analyzing the direction of the causal relationship between globalization and economism/economization since this would go beyond the scope of this dissertation.

[16]The acceptance of this subjection opens up a series of questions in terms of political legitimacy, as elaborated below.

intentionally or unintentionally leads to competition with market institutions. In terms of creditworthiness, this means that the state competes for funding with its peers as well as with private companies; on debt markets, government bonds vie with corporate bonds for investor confidence.

As competition implies comparison, harmonization may result.[17] Through their normative dimension, sovereign ratings can have homogenizing effects on their objects of measurement. Informed by the desirability of obtaining and keeping a high rating, governments orient themselves towards presumed criteria of measurement, i.e. aspects deemed relevant for the rating.[18] What is deemed critical for sovereign creditworthiness can develop a normative impetus via the sovereign rating opinion and result in the alignment of policies across countries. As empirical evidence suggests, "nearly all democratic countries seemed to converge programmatically on the path of fiscal consolidation" since 2010 (Armingeon 2012). After all, the question of whether and how this convergence can be related to the sovereign rating practice led to this dissertation.

Returning to the aspect of comparison as an inherent feature in the competition for creditworthiness, let us take a closer look at the question of the comparability of sovereign ratings. Sovereign ratings suggest the comparability of results through the letter-grade system of representation. The underlying ordinal scale stylizes the objects under consideration in comparable units. This scale transforms the rating, which is still a judgment, into a relative concept.[19] Sovereigns are made comparable through the created impression of measurement.

An implicit assumption that lends validity to the notion of comparable results is related to the belief in the comparability of input variables for the rating: the reliability of standardized measures. The operationalization of a variable can differ significantly across countries in the sense of 'same label different content.' Consequently, the extent to which features measured by standardized variables can still be regarded as comparable to each other may be debatable. Moreover, in different countries, there are different definitions for the same macroeconomic variables.

Admittedly, international organizations like the OECD are aware of the divergent methodologies used to determine macroeconomic variables on the national level (Coicaud & Zhang 2011). Also Eurostat may be a prominent example of continuous standardization efforts with the aim "to obtain reliable and comparable statistics across the European Union," which have become visible in the revised "European system of national and regional accounts in the European Union" (Eurostat 2013).[20] In particular, the calculation

[17] This applies to the state-state dyad, as well as the state-firm dyad.

[18] In theory, this does not need to be limited to the issue area of fiscal and economic policy of countries, but to all issue areas constructed as such.

[19] To what extent a judgment, unlike a measurement, can consistently follow a relative logic is an issue worthy of discussion. Due to its judgmental nature, the rating always incorporates an element of absoluteness.

[20] Also known as ESA 2010, cf. Regulation (EU) No 549/2013. For the implementation of ESA 2010 in terms of public finances, see "Manual on government deficit and debt published (MGDD)" (Eurostat

of GDP differs considerably across countries (Coyle 2014, Fioramonti 2013). For example, historically in the U.S. military spending scored as part of investment in the GDP accounting, whereas military spending in other countries featured exclusively as government expenditure (Mügge 2015, Lequiller & Blades 2014). Considering the pervasiveness of GDP as input—starting with deficits or public debt in percentage of GDP—many figures deemed relevant for sovereign ratings can be questioned in terms of their comparability (Karabell 2014).

Besides the potential unreliability of the content delivered by standardized variables, a selection bias in terms of the aspects deemed relevant for the creditworthiness assessment of a country further compounds the comparability of sovereign ratings. There is a certain risk that factors may be neglected, which may, from a different perspective, be regarded as critical in a given context.[21] It lies in the nature of such idiosyncratic factors to not be comparable.

Against this background, it may not be surprising that CRAs repeatedly emphasize the relevance of the committee meetings for the rating decision—this is where these idiosyncrasies are taken into account in the ideal case. These idiosyncrasies are usually taken as a legitimizing discursive strategy to not reduce the sovereign rating to an output of an econometric algorithm (Krämer 2012*b*,*a*):

> Standard & Poor's, for one, long ago rejected an algorithmic approach to sovereign ratings as simplistic and unable to account for the subtleties of a sovereign's political and institutional behavior.

Put differently, the comparability illusion, which correlates with the endeavor to capture creditworthiness on an ordinal, metric scale, conditions the rating's ontology as judgment. The dilemma is that if CRAs take into account the idiosyncrasies of the sovereigns under consideration—including "intangibles" critical for creditworthiness, the comparability of the results may be even more contested. Consequently, the scope for accusations of arbitrariness regarding sovereign ratings may even widen, regardless of the fact that the creditworthiness judgment may be regarded as more reasoned and contextualized.

A prominent example in this category was the "dolce vita" investigation initiated by Italy's state auditor (Corte dei Conti) after the CRAs downgraded the Italian sovereign rating in the aftermath of the financial crisis. The state auditor accused the CRAs of "failing to consider Italy's rich cultural history," and, related to it, the value of the artistic, cultural, and historical heritage (Financial Times 2014*a*, La Repubblica 2014).[22]

2014).

[21] Similarly, Porter (2010, p. 57) mentions the "transnational" perspective inherent in "[c]redit rating practices [which] do not map well onto national boundaries."

[22] The estimated damage mentioned in the investigation amounts to EUR 234bn (Financial Times 2014*a*). The investigation takes exception, for example, to the Italian rating downgrade on 13 January 2012 by Standard & Poor's (2012*b*), to the preceding placing of the rating on 'Credit Watch Negative'

Let us return to the bigger picture of this subsection, namely the relevance of the sovereign rating practice with respect to inter- and transnational relations. Under the assumption that the sovereign rating is regarded as a competitive benchmark, sovereign ratings may develop different conflict dynamics between states, but also between the state and corporate bond issuing firms.

In the former case, in a self-explanatory manner, rating actions animate states to regard each other as competitors to attract capital through comparison. As Donnelly (2014) observes, perceiving each other as rivals may contribute to a revival of power politics in Europe.

In the latter case, it can be argued that the frequent downgrading of sovereigns literally discredits sovereign bonds compared to corporate bonds and securities as a single investment class.[23] If frequent sovereign rating changes in developed countries become normal, the previously assumed notion of the risk-freeness of government bonds becomes history. Destroying the notion of the safe asset status may not only come at the cost of the sovereign borrowers whose creditworthiness is questioned, but also at the cost of countries that are not in the spotlight of downgrades as they may also have to demonstrate 'more effort' in the future to compensate for the loss of confidence in order to please investors.

However, overall, it is to assume that the downgrade of a sovereign is accompanied by a flow of capital both to corporate bonds and to sovereigns regarded as "safe havens," which benefit by paying lower yields (Boy 2015). In order to compare the size of capital outflow fractions, apart from the difficulty of empirically quantifying these substitution effects, inferring from such an exercise which of the two effects of a downgrade prevails, i.e. inter-state competition or the crowding-out effect of sovereign bonds by corporate bonds, may still be problematic. At least theoretically, two fundamental points of sovereign ratings oppose the logic of the latter conflict scenario. First, sovereign ratings are a relative measure in the same investment class; they can only be understood in relation to each other. Therefore, by definition, a collective downgrade of sovereign issuers in their entirety is not possible. This implies that, via sovereign ratings, a degradation of sovereign bonds as an investment class is unlikely. Second, sovereign ratings are used as a so-called "sovereign ceiling" for the rating of a concerned country's corporate bonds, including those of financial institutions (Borensztein et al. 2007). The concept of sovereign ceilings does not only undermine the firm-state crowding-out logic, but makes a domestic firm strongly dependent on the perception of its own government's creditworthiness. From this follows, first, that domestic firms, driven by the self-interest to preserve their refinancing

on 5 December 2011 (Standard & Poor's 2011), to statements by S&P on 1 July 2011 that "there is a roughly one in three chance that its ratings on Italy could be lowered within the next 24 months" (Reuters 2011*b*), and to the prior revision of the rating outlook to negative on 20 May 2011 (Bloomberg 2011).

[23]For example, see the investment strategy of the Swiss bank UBS, which has focused increasingly on corporate securities since the fourth quarter of 2013 and relatively less on government bonds (Frankfurter Allgemeine Zeitung 2014).

ability on capital markets, are inclined to pressurize their government if its sovereign rating is at risk of deteriorating.[24] Second, to mitigate this dependence on the own sovereign, financial institutions in particular have an incentive to diversify their sovereign bond portfolio, thus contributing to the international mobility of sovereign debt and rendering "investor loyalty" an outdated concept (Gabor & Ban 2014).

To summarize, the use of sovereign ratings as an input for corporate ratings multiplies the impact of sovereign rating downgrades, bringing whole national economies close to a cliff edge in a self-reinforcing manner. Indeed, empirical evidence suggests a positive correlation between sovereign ratings and national stock market indexes (Brooks et al. 2004). Therefore, rather than stimulating the competition between sovereign and corporate bonds, sovereign ratings serve the logic of a realist-type of competition between sovereign states.

1.1.2 The legitimacy question

As the object of scholarly inquiry long before the financial crisis, the tension between international economic integration and the "practical possibilities of national politics" has continually challenged the "legitimacy of our contemporary political order." For example, Pauly (1997) addresses the question of how "truly global capital markets" pose a risk to the "legitimacy of the state itself," pointing to the basic puzzle that the process of enhancing capital mobility was politically driven, regardless of the limited room for political maneuver.

The question of political legitimacy appears even more exacerbated in the aftermath of the financial crisis, as it manifested the apparent helplessness of the political class with respect to global finance: Be it when systemically important financial institutions were considered 'too big to fail,' putting policymakers under pressure to bail them out as mentioned above, or when pursuing fiscal consolidation in response to market pressure was legitimized with the TINA ('there is no alternative') rhetoric.

According to a comparative study of the market's 'taste' in the aftermath of the 2008 financial crisis (Armingeon 2012), markets honor political stability, lean and right governments, and dismantling big government when determining a country's risk premium, giving away the highly political dimension of the "disciplinary function of the market."[25] If the sovereign rating practice shapes the market perception of the creditworthiness of states, then CRAs steer the direction of the market disciplinary function indirectly, playing a crucial, advocating role in the politics of finance.

The political implications of such steering are striking: Although policymakers are

[24] The resignation of former Italian prime minister Silvio Berlusconi at the end of 2011 may be an illustrative case of the possible consequences of market pressure on a domestic government (The New York Times 2011).

[25] As the dependent variable, Armingeon (2012) uses the spread between the national and the German nominal interest rate of long-term government bonds. His cross-sectional data set of EU-27 members and mature OECD democracies covers the period from 1960 to 2011.

formally only accountable to their electorate and not to the CRAs' ideas, this logic collapses when the same policymaker is judged on the basis of a public perception shaped by the practice of sovereign ratings. By reproducing the creditworthiness perception and normative predispositions inherent in the sovereign rating, the fiscal and economic policy agenda may bow to the agencies' criteria after all, and create pressure which tends to undermine the democratic deliberative process.

How can the tacit consensus on subordination to the practice of sovereign ratings at the cost of the democratic deliberative process be explained? If the impossibility of market efficiency, i.e. the perennial existence of information asymmetries, constitutes the CRAs' raison d'être, how can their power to dislike certain economic or political conditions, and to induce markets to punish states accordingly with higher interest rates, be legitimized? In the light of rating failure and the oligopolistic structure of the rating market, which bears the risk of market power abuse, CRAs seem to be the source of new inefficiencies. Even if the latter was hypothetically not the case, it seems all the more puzzling that the belief in market efficiency, rationality, and objectivity persists against the background of the financial crisis. It continues to provide normative legitimization for the disciplining function of the market, and implicitly for the sovereign rating practice.

The ongoing obedience to, or trust in, the stabilizing effect of the "market discipline" is even more surprising in the light of the "disconnect puzzle"—the empirical observation of the inability of financial (bond) markets to appropriately reflect the macroeconomic situation in a country by means of market prices (Bofinger 2011, p. 815). Bofinger (2011) concedes the possibility that the disciplinary function of the market may exist ex ante, i.e. as policymakers' anticipatory obedience. He suggests that the belief in this disciplinary function relies on a myth that empirical evidence cannot substantiate. Since the disconnect puzzle reveals a lack of a systematic relationship between economic fundamentals and interest rates on sovereign bond markets, the existence of a *disciplinary* function of the market is, at best, questionable. In other words, it is the *belief* in the steering ability of the financial market which lends validity to the notion of its disciplinary function. Drawing attention to the lack of consistency in the supposedly disciplinary function, calls the whole notion of its *desirability* and legitimacy into question.

If markets do not necessarily reward a 'good' and punish a 'bad' economic policy consistently, irrespective of the definition of these, the effect of financial markets on risk premia is more accurately labeled 'arbitrary,' instead of 'disciplinary.'[26] In the light of the disconnect puzzle, this does not mean that market perception and the assessment of a given macroeconomic situation in a country could not be consequential—quite the contrary.

Let us include the role of CRAs here. In an 'ideal' world, sovereign ratings (if believed or followed) would realign the macroeconomic conditions with the market's risk percep-

[26]In a similar vein, Blanchard (2011) refers to the inconsistency of financial markets: "[F]inancial investors are schizophrenic about fiscal consolidation and growth. They react positively to news of fiscal consolidation, but then react negatively later, when consolidation leads to lower growth."

tion. Sovereign ratings would render the arbitrary taste of the market more consistent, making the financial market dictate reflect the ideal of its disciplinary function more closely.

Empirical evidence suggests that the sovereign rating changes in the course of the financial crisis exacerbated the disconnect puzzle, instead of functioning as a corrective (e.g., see Gärtner et al. 2011). CRAs were criticized for sovereign rating actions worsening, or at least reproducing, the market's inability to price consistently in macroeconomic conditions, which contributed to the excessive risk premia spreads certain countries in the euro area faced. Even if we theoretically assume that CRAs 'follow' the market by telling the market what it already knows, and exclude the option of voluntary market steering, the CRAs' raison d'être would not only be undermined, but they would also be complicit in the perpetuation of the disconnect puzzle.

The counter-factual scenario that may legitimize the CRAs' role in financial markets is the hypothesis that without their interference in bond markets, the spreads that the market would have claimed would have been even more pronounced. Such a reading would suggest that CRAs act as a corrective, and above all, do not follow market perception, but steer it. In line with their self-set mandate to mitigate the market's volatility in terms of risk perception (Hinrichs 2012), fulfilling this mandate presupposes that CRAs can drive markets, otherwise they would make themselves complicit by omitting to function as a corrective. In other words, sticking to the 'CRAs do not matter' or 'CRAs only follow the market' rhetoric harms their legitimacy.

1.2 Why constructivist International Political Economy (IPE)?

This book is positioned in International Political Economy (IPE), which is institutionally categorized as a subfield of International Relations (IR). Analytically, it is based on the assumption that what occurs in the economy reflects and affects social power relations. This implies that the field looks at the politics behind the seemingly material and technical nature of the economic sphere, arguing that issues of international relations cannot actually be separated from those of international economics (Strange 1970).

Such a disciplinary categorization may be regarded as unnecessary. It is the scholarly lack of interest in issues of political power of mainstream economics, which scholarly eminences such as Rogoff (2012) also observe, which makes the disciplinary affiliation of this book to IPE inevitable.[27]

An epistemological dimension certainly contributes to this scholarly neglect, which is nourished by the inherent problem of measuring power (Baldwin 2002, 2013) and

[27] This statement requires some differentiation considering that rational-choice-based, microfounded game theory deals with certain forms of 'power' which can be transferred to the political realm. For a renowned example of such a synthesis, see Hirshleifer (1991).

the positive-quantitative orientation of modern mainstream economics. Remarkably, the trend of quantification goes beyond the disciplinary boundaries of economics, becoming increasingly pervasive in the social sciences. IPE scholars, who work in a positive tradition,[28] have also faced criticism for neglecting the issues of political power behind the seemingly mechanistic scenery of the market (Katzenstein & Nelson 2013, Keohane 2009). According to Vaitsos (1976, p. 114) "economic [or positive] reasoning often ascribes to markets a spontaneity of origin and a determinism in operations that originate from economic necessity." Conversely, a constructivist approach to IPE stresses 'the market' as a political product, and as "one of the world's most compelling social, not natural, facts" (Abdelal 2009, p. 66).

Vaitsos (1976, p. 114) states:

> Yet if markets are viewed as creatures of social and political systems, then their operations, given certain economic parameters and technological constraints, can be understood as being induced or suppressed through political decisions and institutional mechanisms, both at the national and international level.

Specifically, traditional IPE scholars focus—particularly *in contrast to* the subfield of comparative political economy (CPE) on (Campbell 2009, p. 267):

> [H]ow *international* pressures operate on states and other international actors to constrain or drive their behavior. They view the structure and functioning of national political economies as being very much embedded in international processes, particularly as state power in the international arena has come to depend increasingly on economic power (e.g. Gilpin 1987).

This work is interested in the pressures which national governments face through the example of sovereign ratings. It is particularly interested in how CRAs help diffuse "normative principles and practices [...] across nation-states in ways that lead to isomorphic [...] outcomes" (ibid.), and less in the degree of variety of these outcomes, i.e. of the national responses to these pressures, which CPE scholars usually problematize. This book is therefore thoroughly aligned with the IPE subfield.

By focusing on the political implications of the different aspects of economic life, IPE's legacy as a subfield should not suffer from the "Tobin curse." Wyplosz (2009, p. 5) defines this "curse" as the divorce between macroeconomics and finance, which he considers "the fundamental reason for the current crisis." Referring to Susan Strange's legacy, Brown (1999, p. 532) notes that in order "to understand the global economy it is, first and foremost, necessary to understand the world's financial markets." Not only can markets in general be seen as political and social phenomena, but so can financial markets and, specifically, credit ratings.

[28] A multitude of labels are attached to these scholars: 'Open Economy Politics (OEP),' the 'new IPE,' or 'American IPE' (Cohen 2007).

Maintaining that a credit rating is political, regardless of whether its object of assessment is a corporation or a state, can be regarded as a "diachronic-constructivist principle" of a mental framework of rating, which Sinclair (2005, p. 70, Table 5) developed. This is in contrast with the "synchronic-rationalist principle," which—in line with the orthodoxy—regards a rating as non-political.[29] From a "diachronic-constructivist" perspective, the normative potential of the rating to establish "government-at-a-distance" (ibid.) deserves attention.

Regarding financial markets as a social-political product implies not regarding individual rationality, or the pursuit of material interests, as the main factors that shape the behavior of actors. Instead, this perspective pays attention to the role of "norms and ideas of various sorts" (Campbell 2009, p. 266) and to the constitutive rules of finance (Kessler 2013).[30] This perspective acknowledges that "economic performance is as much determined by market participants' beliefs as it is by fundamental indicators or textbook policy" (Blyth & Shenai 2010). This may sound like an unorthodox insight from a constructivist political economy scholar interested in finance, but is all but unknown from a practitioner's viewpoint (ibid.):

> In the parlance of technical traders, prices can move on 'momentum,' whereby disequilibrating price movements compound one other, further driving market prices away from their true worth—a dynamic that is visible in sovereign debt markets today.

This analytical standpoint has a straightforward implication for the argument this dissertation makes: In terms of financial markets' pricing mechanisms, the assessment of sovereign creditworthiness is *not only* led by what is usually referred to as economic fundamentals. Instead, other factors, such as beliefs, norms, and ideas, *also* matter in the pricing of sovereign default risk. Since CRAs assume a special role in the discourse of creditworthiness, in which beliefs, norms, and ideas about creditworthiness are shaped and exchanged among market participants, taking the sovereign rating practice into account allows us to far better understand how 'on momentum' developments can occur on sovereign bond markets.

This is not to say that the CRAs' contribution to shaping those beliefs is not desirable, or erroneous. Rather that market perception of sovereign creditworthiness is not to be understood in a deterministic and material way, but that it is subject to forces on which the CRAs have influence. At this point, I therefore emphasize that this work is not an attempt to discover the 'true' creditworthiness of states subjected to the CRAs' scrutiny.

[29] From this perspective, privatization is, for example, seen as "politically neutral" and therefore unproblematic.

[30] According to Campbell (2009, p. 266), such an approach is inherent in sociological approaches, differing from the approach of conventional [i.e. predominantly positive] IPE scholars. In order to minimize unnecessary academic disciplinary line-drawing, I use the epistemological adjective 'constructivist' instead of 'sociological' or 'sociological institutionalist' (Meyer & Rowan 1977, DiMaggio & Powell 1983) where appropriate.

The work makes no claim regarding whether the CRAs were 'wrong' or 'right.' However, it argues that the questioning of sovereign creditworthiness would have occurred and materialized differently without the CRAs' interventions in the discourse of sovereign creditworthiness.

Even though referring to the replacement of paradigms of economic thought, Abdelal (2009, p. 66), in a similar vein, regards the following as the contribution of "fifteen years' worth of scholarship informed by constructivist theorizing:"

> [T]hat this globalized world of empowered markets, retreating governments, and embattled, skeptical societies could have been, sociologically, otherwise. The ideas could have been different: so, too, could the practices. We know because they were before. As this era of globalization was made by a revolution in doctrines and practices, however, the compromise of embedded liberalism was unraveled. One set of social constructions replaced another.

In other words, constructivist approaches in IPE take the contingency inherent in socio-economic life seriously. In this sense, Kessler (2013, p. 45, own translation) emphasizes the value added, and the necessity, of constructivist analysis, which is able to reconstruct

> [...] the constitutive line-drawing and the mechanisms of inclusion and exclusion. It shows the marginalization and the 'making invisible' of other realities and rationalities. It emphasizes the biases, abridgments, and relations of power, which 'write themselves in,' naturalize and, thus, become invisible. Constructivist reconstructions therefore try to take the 'improbability of reality' as starting point, in order to reveal the contingency of today's reality making the related processes, structures and operations visible.

It may not be surprising that positive social science research does not focus on the above mentioned redefinition of the crisis from a financial one into a crisis of sovereign debt, not to mention the problematization of the financial crisis definition in the first place. De Goede (2009, p. 259), for example, undertakes a critical reflection of how "historical lineages in notions of excess and greed in financial markets" facilitated the constitution of the financial crisis as a problem "of exorbitant bonuses paid in the financial sector."

I do not critically address the constitution and construction of the financial crisis itself—for example, whether to conceive of it as a problem of incentive structures, information asymmetries, efficiency problems, or market and regulatory failures (Kessler 2013, p. 47). However, the link to my argument exists to the extent that the established common understanding of the financial crisis, which is borrowed from the diagnostic lenses of economics, paved the way for the subsequent redefinition of the financial crisis into a crisis of sovereign debt. Let me elaborate this in the following paragraphs.

Maintaining that the construction of the causes of the financial crisis, its constitution, and dominant meaning are the product of the epistemological position predominant in economics, suggests that a well-defined set of tools and concepts of diagnosis is unquestioningly applied to social world phenomena. The belief in these tools leads to the diagnosis of the presumed causes of the financial crisis, which have persisted over time. Dogmatic insistence on information asymmetries, or conflictual incentive structures, as the causes of the crisis, runs the risk of being void of empirical content (since these problems exist permanently). Further, this belief obscures the perspective on historical relationships between events and favors a punctual and static world view ('history doesn't matter'). From such a perspective, the critique of the redefinition of a financial crisis into a sovereign debt crisis, the decoupling of the consequences of the financial crisis from its actual origins, and the unwillingness to see both crises as a causal chain, necessarily falls on deaf ears; the presumed causes of the first crisis continue to exist, while the causes of the second one already existed before.

This brings us to an ironic aspect: Insisting on specific causes of the financial crisis allows, unconsciously, a redefinition of the crisis itself. The more the financial and sovereign crises are seen as independent occurrences with their own rationales that have nothing to do with each other, the more the imputed notions of causality gain credibility, obscuring the links and causal chains between the two crises even further. If this argument is applied to the concrete case of the CRAs, it is therefore consistent that the main critique of the rating industry relates again to the problems of conflicts of interest, transparency, information asymmetries, etc. (and originated from the toolbox of economics).[31] A constructivist account of the subject can, on the other hand, make a distinct contribution by considering the CRAs' role in shaping mutual expectations on financial markets (Kessler 2013, p. 32). Such an endeavor takes contingency, or more precisely, double contingency, seriously in social relations.[32]

Referring to the role of CRAs in financial markets, and developing the terminology of Keynes (1936) further, Abdelal (2007, p. 164) describes the interaction effects between participating parties' (here, CRAs and market actors) expectations (here, credit risk perception) as expectations of the "fourth degree." This means that not only do the CRAs' expectations of the market's expectations play a role in the rating-decision making process, but the market's expectations of the CRAs' expectations of the market's expectations also play a role in the market's credit risk perception. This chain of interdependent expectations, which orient themselves to each other—without necessarily doing so—can be perpetuated in an infinite loop. Sinclair (1999, p. 161) classifies these anticipation effects, which develop self-reinforcing tendencies and automatic rules of behavior, as symptoms of the CRAs' structural power.[33]

[31] An overview of the 'CRA critique' can be found in chapter 4.

[32] For an illustrative application of the double contingency concept, see the empirical study of Berger & Hammer (2007).

[33] According to Keynes (1936, p. 156) expectations of the "third degree" are defined as: "We have

According to Straubhaar & Vöpel (2011, p. 817, own translation), the described dynamics of anticipatory expectations can explain financial markets' self-referential and immanent tendency towards herd behavior and self-fulfilling prophecies. Moreover, taking double contingency into account, this can explain why the CRAs' impact on the market's sovereign creditworthiness perception and, thus, on the interest rates of sovereign bonds cannot be grasped easily in econometric terms, and is difficult to 'prove' quantitatively.[34] CRA moves—beginning with announcements, on watches, insider information, rumors, and outlook changes—flow discursively into the market's credit risk perception. Such discursive elements may be captured empirically via measurable changes in the risk premia, but the origins of these elements are not. Therefore, even if, for example, credit default swap spreads were regarded as a valid proxy for sovereign risk, as is often done in empirical studies (e.g., see Afonso et al. 2012) and by the CRAs themselves in order to downplay their market impact (Krämer 2012*b*), the fact that a widening of these spreads precedes the actual rating change is actually not a falsification of the hypothesis of the CRAs' influence on the creditworthiness perception. If the actual sovereign rating downgrade happens after the market perception seems to have already changed, this does not imply that CRAs 'do not matter' for this perceptional change. Considering that the rating change is accompanied by ex ante announcements, on watches, outlook changes, etc., and the market's anticipation and expectation are *compounded* by these CRAs' actions, a discursive lens, as adopted in this book, takes double contingency seriously in order to explain the CRAs' authority and impact on the market's expectations.

The consequentiality of discursive acts is not something completely unfamiliar to a purely functionalist perspective on the role of CRAs. This perspective emphasizes the transaction-cost-reducing role of ratings as the industry rationale. As a regular and permanent feature of financial markets, information asymmetries render these markets susceptible to information cascades (Straubhaar & Vöpel 2011, p. 817, own translation), and thus vulnerable to cliff effects and market crashes. If, expressed in functionalists' words, the CRAs' role is to reduce the information asymmetries between investors and bond issuers, the CRAs' role is, according to the approach taken in this book, to generally communicate the information to the market (in the sense of making it common), thus to *codify* the market's perception and opinion forming about sovereign creditworthiness.

Through the act of codification of the CRAs, i.e. by generally (commonly) communicating with market actors, the CRA communication recipient knows *ex post* that the information is now officially available to everyone; he or she receives confirmation that now everybody knows. Consequently, it becomes irrelevant whether the information was

reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be." Applied to the case of the CRAs, this reads: CRAs try to anticipate what the market's average perception of credit risk expects the market's average perception of credit risk to be.

[34] This may also explain why to date large parts of the economics profession hesitates to claim causality of credit ratings regarding interest rates. In terms of the 'who follows whom' question, the drawn conclusion from the alleged 'lack of evidence' is that CRAs would not move the markets.

individually known *ex ante* or not, the intersubjective component of the information makes the difference. In experiments, Berlemann & Vöpel (2011) show that although information may be known individually, the occurrence of bubbles can be attributed to the additional effect of intersubjectively known information. If we conceive of creditworthiness as a construct (a.k.a bubble) (co-)built via CRA communication, then at the moment the CRA communication changes in a way which destroys the commonly shared belief, regardless of whether individual doubts about a sovereign's creditworthiness may have existed before, the construct ceases to exist and the bubble bursts.

CRAs are enabled to fulfill the function of codification because they distinguish themselves decisively compared to other institutions on financial markets: They invented and continue to provide the "common language of risk," thus fulfilling a constitutive role in the discourse of creditworthiness. Such an understanding of rating and CRAs goes beyond a functionalist logic—not denying, but comprising it. The economic historical developments over the last 40 years, often referred to as 'financialization' (Krippner 2011) and 'disintermediation,'[35] have increased the need for "centralized judgments on creditworthiness" (Sinclair 1999, p. 155). Given "the high costs of gathering suitable information with which to make an assessment by individual investors" (ibid.), the role of CRAs as information intermediaries, and, thus, as the new intermediators in disintermediated markets, has become central for the system to work.

As mentioned above, in a functionalist perspective, the rating is an instrument with which to reduce information asymmetries in financial markets. It is used to solve an exogenously given problem. Such an approach does not assume interactions between the rating and the rated, i.e. the object of rating. A priori, it thus excludes the rating influencing the course of events, in the sense of influencing the creditworthiness perception of investors and in the sense of rated entities' anticipatory 'obedience.'

From a constructivist perspective, the establishment of "normative criteria about appropriate behaviour" are at the center of attention (Lehmkuhl 2011, p. 2). The normative implications which the sovereign rating practice transmits include the ideational level. Thus, credit ratings are not only seen as a reaction to a given problem, but also as an action that itself causes specific reactions by the rating object and by the rating consumers, i.e. investors. Here lies the power dimension that can be attributed to the sovereign rating: The rated state is pressurized to react in line with the CRAs' opinions in order to obtain a better rating, or not be downgraded. In this sense, CRAs can have a crucial impact on the alignment of politics since governments tend to orient themselves towards the measurement criteria. At the same time, investors' creditworthiness perception reproduces the rating opinion, leading to the rating object's responsive action becoming even more likely, given the material pressure.

[35] 'Disintermediation' describes a process characterized by a transition from a bank-based to a market-based financial system.

1.2.1 "Perception molds reality"

Conceiving of sovereign creditworthiness as a social construction implies that "countries might vary substantially for non-material reasons" (Abdelal et al. 2010, p. 2) in terms of their assigned ratings. The perception of creditworthiness varies with different interpretations of the world, and of aspects deemed critical and worth considering for the rating. Interpretation therefore matters at various levels: It influences the CRAs' forming of a sovereign rating decision, and the sovereign rating provides an interpretation of creditworthiness for market actors. Therefore, my argument values the influence of collectively held ideas and beliefs on "both individual preferences and societal practices" (Abdelal 2009, p. 75).

Attributing a causal effect to social facts to shape "the social, economic, and political world in which we live" (Abdelal et al. 2010, p. 2) allows for the possibility that the reference to 'hard' facts is not sufficient to explain the problematization of creditworthiness (Gärtner et al. 2011, Wendt 1999, Hacking 1999). If creditworthiness is, to a certain extent, "of our making" (Onuf 2012), or what actors "make of it" (Wendt 1992), creditworthiness itself becomes a social fact which "exists because of collectively shared ideas" (Abdelal 2009, p. 73). This does not deny the relevance of materiality, i.e. of material facts which exist independently of interpretation. Indeed, constructivist approaches harbor a core assumption "that the world economy consists of both material *and* social facts" (ibid., emphasis added). Applied to the argument presented here, the crucial role of CRAs comprises having an impact on the interaction between meaning and materiality. Put differently, CRAs make the difference in the discourse of creditworthiness as they, similar to a catalyst, have the power to enable the transformation of a self-initiated social fact into a material one.[36] Sovereign solvency can therefore be regarded as the materialized consequence of the social fact 'creditworthiness.'

Since the construction of creditworthiness hinges critically, or better, sensitively, on the notion of trustworthiness, the inherent vulnerability of trust-based transactions may explain the necessity for and the empowerment of epistemic authorities, such as CRAs, on whose judgment can almost blindly be trusted. Bill Gross (2012), the founder of the 'Pacific Investment Management Company' (Pimco), states in the Financial Times:

> The dirty little secret that sovereign debt issuing nations need to remember most of all is that credit and maturity extension is based upon trust. After all, 'credere' is a Latin word meaning just that.

The sovereign rating discourse contributes decisively to the construction of such trust. The reliance on this discourse also forms the basis of its material consequentiality. At the moment CRAs change their opinions about the creditworthiness of sovereign states, the

[36] To be able to redefine market orthodoxy, or to initiate a new social fact, CRAs first have to reproduce orthodoxy successfully, confirming their credibility as an epistemic authority. For a discussion about the construction of market orthodoxy and 'common sense,' see chapter 5.

tacitly assumed unquestionability of sovereign debt risks breaking up. The peculiar point about such discourse dynamics is that, in the end, it becomes irrelevant whether individual market actors agree with a given sovereign rating judgment. Everyone knows, or believes (that others know or believe) that the codified rating perception of creditworthiness is the one that dominates the rating discourse; therefore, it becomes real in its consequences (Thomas & Thomas 1928, p. 572). To summarize, the material fact 'sovereign solvency,' is the product of the materialization of the perceptions, expectations, and notions of creditworthiness (i.e. trustworthiness) which the discourse of sovereign ratings forms and shapes.

The constructivist insight that social constructions matter in the sense of "perception molds reality" can also be transferred to concepts of economics, such as multiple equilibrium models (Blanchard 2011):

> [P]ost the 2008-09 crisis, the world economy is pregnant with multiple equilibria—self-fulfilling outcomes of pessimism or optimism, with major macroeconomic implications.

In particular, Gärtner & Griesbach (2012) apply an econometric model to sovereign debt markets, and find that ratings have a nonlinear effect on interest rates, which suggests that these markets are susceptible to multiple equilibria and, thus, self-fulfilling prophecy scenarios.[37]

What economists label "multiple equilibria" is a well-studied concept in financial sociology and constructivist political economy scholarship, however with a different label: "performativity." For example, MacKenzie et al. (2007), Callon (2007), MacKenzie (2005), and MacKenzie (2004) apply the concept in an epistemological sense to the performativity of economics and finance. The internalization of "financial models that were [originally] constructed to present a stylized view of financial markets" (Abdelal 2009, p. 75) transforms the theory from a "camera" into an "engine" (MacKenzie 2006); the theory therefore becomes self-fulfilling. Theories that were "originally designed to explain how markets work" trigger behavioral changes in market participants who consume such theories. Consequently, the self-actualization of the theory does not mean that the "theory has proven to be right." The data derived from the world are thus not evidence of the theory, "but rather evidence of the discursive structure [that the theory] helped to construct" (Abdelal 2009, p. 75).

This logic can be transferred to sovereign ratings: They can be regarded as theories that market participants consume. Although originally designed and intended to issue an informed opinion about sovereign creditworthiness, the sovereign rating triggers a market reaction that reproduces the discursive structures which the sovereign rating helped

[37] Further studies on the occurrence of multiple equilibria in sovereign debt markets are De Grauwe & Ji (2012, 2013). Moreover, Gärtner (2014) links self-fulfilling outcomes to insights of behavioral economics, which suggests that market participants are characterized by adaptive rather than rational expectations (Haruvy et al. 2007).

construct. Taking performativity effects into account, particularly calls the possibility of an *ex ante* calculation of probabilities of default into question.[38] The sovereign rating itself becomes an ingredient of the actual probability of default.[39]

As mentioned above, at the moment investors act in response to a threatened or de facto lowered sovereign rating by demanding a higher risk premium for newly issued bonds—thus increasing the refunding costs of a sovereign (BIS 2011)—investors unconsciously reproduce the scenario the CRAs predicted: the deterioration of the sovereign bond issuer's creditworthiness (Gärtner et al. 2011). The increased distrust indirectly leads to a higher probability of default.

Although the sovereign rating is supposed to describe the reality exogenously, i.e. without having influence on the course of events, those investors' perception shaped by the sovereign rating tends to reproduce the "described opinion about the future solvency" (Hinrichs 2012, own translation, and Rona-Tas & Hiss 2010). Such "self-validating feedback loops" have "self-generative effects" on CRAs (Paudyn 2013, p. 14). On the one hand, these loops confirm and legitimize the CRAs' epistemic authority, and on the other hand this authority conditions them. In other words, self-fulfilling prophecies—or as Guzzini (2010) puts it, "reflexivity on the macro level"—can be regarded as both the cause and the consequence of the CRAs' epistemic authority in terms of sovereign creditworthiness. By implication, ex ante 'unjustified' ratings can therefore be 'justified' ex post, improving the CRAs' credibility and reputation. The measurement attempts of 'rating performance' and 'track-record' become a 'reductio ad absurdum.'

The invalidation of supposed rating performance via self-fulfilling prophecies enforces the CRAs' epistemic authority as one without 'checks and balances.' Besides the regulatory incorporation of ratings undoubtedly increasing the reflexivity on the macro level, even in a world without the regulatory use of ratings, in which ratings are merely used as voluntary investment thresholds, self-validating rating feedback loops may persist. The only remaining 'corrective' to the CRAs' quasi-unimpeachable authority may be the moment in which the bubble of creditworthiness which they helped construct, bursts. Put differently, the deconstruction of their epistemic authority is much more likely in the case of certainty illusion, i.e. risk underestimation, than in the case of risk overestimation. Applied to sovereign ratings, this means that excessively severe and pessimistic ratings do not only tend to be self-fulfilling, thus contributing positively to the CRAs' authority, but are particularly inclined to not be 'corrected.' An uncertainty bubble, which can lead to economic stagnation and depression, can hardly burst; but can be outlived without impairing the CRAs' authority.

Long before the financial crisis, the main theoretical debate between scholars inter-

[38]Supposedly known ex ante probabilities of default can also be categorized as social facts as they rely on certain interpretations of the world.

[39]Chapter 3 elaborates the difficulty of measuring sovereign creditworthiness, which performativity particularly aggravates. Ultimately, this relates to the interaction between aspects of epistemology and ontology, i.e. the social construction of knowledge and the construction of social reality (Searle 1995, Berger & Luckmann 1966).

ested in CRAs as an object of study was focused on questions relating to the CRAs' constitution and the ultimate source of their authority. There is currently no consensus in the literature on the type of authority exerted and its origins. The main issue of controversy is whether the authority is attributable to the "regulatory license hypothesis" developed in Partnoy (1999, p. 623), or instead to factors related to global reputation. Drawing on Adler & Haas (1992), the latter explanation is inherently related to the CRAs' position as an "epistemic authority," or, in the words of Sinclair (2005, p. 64-65), as an "embedded knowledge network." As "one of the most prominent epistemic authorities in financial markets" (Kessler & Wilhelm 2013, p. 260), CRAs have the power to define the relevant knowledge about credit risks and to influence how creditworthiness is perceived (Sinclair 1994*b*, 2000, 2001, 2005).[40] The regulatory license hypothesis regards the CRAs' institutional "authorization and delegation" by regulatory regimes such as Basel as constitutive of the rating market (Abdelal & Blyth 2015, Besedovsky 2012, White 2010). For example, Bruner & Abdelal (2005, p. 200) maintain that:

> [T]he significance of a rating in today's global economy derives not from the ideas or information conveyed so much as from the various social, financial, and legal institutions that favor dominant agencies' opinions by hinging various financial and regulatory consequences on their ratings.

The contribution of a social constructivist perspective to the 'source-of-CRAs' influence' debate may entail suggesting a process of co-constitution—i.e. regarding the CRAs' authority as a co-constituted product. By conceiving markets as social and political constructs, and not as ahistorical, mechanistic creatures working according to law-like forms of behavior (Krippner 2011), the monocausality imperative regarding social realities is assumed away. Hence, the source of the CRAs' authority is not necessarily reducible to a single, decisive factor. The two existing, competing explanations can therefore also be regarded as complementary. Reputational effects and the regulatory incorporation of ratings may reciprocally enforce each other to co-constitute the CRAs' authority. Regulatory reliance on CRA ratings legitimizes the market practice of relying voluntarily on them in private contracts. At the same time, the regulatory practice orients itself towards the market practice of credit risk assessment. For example, in regulatory frameworks, such as the Basel regime, the (private) market practice of using CRA ratings for credit risk assessment was one of the main rationales for the institutional, regulatory reliance on them (Mennillo & Roy 2014).

1.2.2 Discourse as invisible censorship

Another contribution this book wishes to make is to build a synthesis between the "agential quality of constructivist scholarship that stresses ideas" (Abdelal 2009, p. 75) and a

[40] Other scholars using a similar approach are, for example, Kerwer (2001, 2005), Strulik (2000), and Willke (2001). Conceiving of CRAs as an epistemic authority can be directly related to the fourth source of the Strangean structural power concept, i.e. knowledge.

post-modern IPE scholarship that stresses "the constraining and structural role of discourses." The latter makes "discourse central to its narration of political economy, and the position a subject takes within that discourse then defines the subject's identity" (ibid.). For example, how the function of norms is conceived in both constructivist and post-modern approaches shows the similarity between them. While in a rationalist understanding, norms fulfill a regulative function, a constructivist understanding stresses their constitutive function, which can be embraced by a post-modern reading which conceives of norms as (ibid.):

> objects of power that determine the boundaries of possible speech and action and operate by exclusion of alternatives as much as by constitution of identities. [...] [T]he context—the structure, or the discourse within which agents are situated—is decisively influential for the very 'thinkability' of options.

The argument that the sovereign rating practice shapes norms regarding sovereign creditworthiness, as well as fiscal and economic policy, resonates implicitly with such a conception. Let me illustrate this with an example: The term "casino capitalism," coined by Susan Strange in 1986 in the book with the same name[41] was thinkable, and freely sayable, in 2010 by Sinn (2010), a renowned economist, above suspicion of being heterodox or a Marxist. At the time of writing, the term has quite a polemic connotation and is associated with leftist, globalization-critical activists, as well as groups such as "Attac" and "Blockupy." The former IMF head and former German president Horst Köhler's 2008 characterization of global financial markets as "a monster" that "must be put back in its place" is another example which suggests that the boundaries of 'thinkability' were reset over the last few years (Financial Times 2008).

Norms seem to have changed, and among competing discourses one has come to dominate and has developed its own constraining role. In the meantime—which is exactly the time period the sovereign debt crisis has lasted—a wide consensus has emerged that public budget consolidation is necessary to overcome the financial crisis (the monster's legacy). Fiscal homework has become top priority in many countries (e.g. Ireland, Spain, and Portugal) that the financial crisis affected seriously. Such developments pose the question about the dominating themes in the discourse about the crisis. According to De Goede (2009, p. 295), "the material practices of financial markets and financial regulation intimately depend upon the ways in which discursive understandings of financial crisis unfold." I suggest that the discourse of sovereign creditworthiness constituted by the practice of sovereign ratings is an essential element of this process.[42] Discourses can therefore be described as "processes of signification" which "produce particular actors and behaviors as meaningful" (Bially Mattern 2008, p. 694). CRAs are thus not powerful agents in global finance due to given (material) interests and "specific ways of behavior,"

[41] The second edition was published in 1997.

[42] For a post-structuralist approach to finance which adopts a historical and cultural perspective, see De Goede (2005).

but because they play a particular role in the discursive process which produces agents and interests (Digeser 1992).

To conclude this subsection, the central motivation behind the choice of a constructivist perspective for the argument of this book is briefly explained. This choice is related to what Best (2005) called "intersubjective ambiguity," one of three ways of how to make sense of financial crises. Best differentiates three forms of ambiguity in international finance: technical, contested, and intersubjective. Depending on the type of ambiguity someone selects as the main problem in the system, this determines the normative position regarding how to respond to and solve crisis situations. "Technical ambiguity" is best handled by increasing the transparency in the system, whereas "contested" ambiguity emphasizes the importance of negotiations.[43] "Intersubjective ambiguity" refers to a basic disposition to admit that (own) norms and ideas shape practices. This ambiguity thus presupposes, a priori, a self-reflective readiness to question the constitutive elements of the system from the meta-level.

According to Kessler (2013, p. 37, own translation), these three forms of ambiguity can explain the corresponding reactions to the crisis on the part of the main schools of thought in the IR field. Neorealism, especially hegemonic stability theory, focuses on shifts in the global power distribution as an independent variable with which to explain economic crises, and may therefore most likely resonate with the technical ambiguity concept. Neoliberalism, in the sense of neo-institutionalism, puts the role of informational distribution and, thus, the threat of information asymmetries at the core of its analysis; such a perspective may instead be associated with the contested ambiguity concept. Constructivism, as meta-theory, deals especially with the social construction of intersubjective meaning, and thus resonates with the third form of Best's ambiguity taxonomy. Assuming intersubjective ambiguity in global finance therefore implies a reading of crises as moments in time in which established meanings—that ontologically precede categories of power and interest as drivers of behavior—are destabilized (Kessler 2013, p. 37, own translation).

The financial crisis and its consequences have inescapably stimulated me to reflect on how certain practices have re-stabilized certain meanings which were deemed as defeated by the 'meltdown' experience. Indeed, considering something as a puzzle is hardly a deliberate choice. In other words, what I considered as puzzling with regard to what happened during the few years after 2008 is already embedded in the epistemological and analytical perspectives that inform this book. During the research process, I gradually learned that such research interests are labeled social-constructivist.

[43] Best (2005) defines the distinction between uncertainty and risk as forms of "technical ambiguity." For a contrasting juxtapositioning of uncertainty and risk, and intersubjective and contested forms of ambiguity, see Best (2008) and chapter 3 of this book.

1.3 Structure of the monograph

The chapter following this introduction provides a brief but descriptive account of the CRA industry in terms of its historical roots and different business segments. The financial markets' developments over the last decades will also be discussed. This background is crucial for understanding the CRAs' key role in contemporary finance.

The third chapter is dedicated to the core difficulty of the sovereign rating practice, namely the 'mission impossible' of *measuring* sovereign creditworthiness. The definition and genesis of a sovereign rating are illustrated by drawing on the different methodologies the CRAs use. I elaborate how the methodology incorporates the traits of a "black box." The tolerance of a certain degree of opacity is inherently related to trust in the CRAs' ability and competence, conditioning and testifying to their epistemic authority. This chapter also problematizes the representation of sovereign ratings, which I argue forms the basis of the difference between what a sovereign rating is and what it is commonly thought to be. As qualitative information in a quasi-quantitative guise, sovereign ratings reveal a lack of congruence between the signifier ('AAA') and the significant (opinion). The market participants' tacit acceptance of this, including the CRAs themselves, contributes not only to the CRAs' authority, but is also a consequence of the 'mission impossible' to quantify sovereign default risk.

An econometric algorithm can hardly retrace rating decisions despite their "distinctively portable format and scientific appearance" (Carruthers 2013, p. 544) concealing their actual nature as a judgment. Indeed, the measurement problem of sovereign default risk and creditworthiness is one *raison d'être* for sovereign ratings. Simultaneously, because CRAs seem to use public information as their basic data for unsolicited ratings, the judgmental dimension constitutes their added value. Put differently, the signifier signals the 'mission impossible' of measurement, the significant incorporates the judgment, which someone has to pass on.

Chapter 4 analyzes the discourse *on* CRAs, emphasizing the years following the financial crisis, from 2007. In this period, CRAs were in the public spotlight and faced harsh criticism that they have never experienced before in their history. Sinclair (2010) characterizes the rhetorical tendency to 'bash' the CRAs as a "blaming the usual suspects." I call the loud criticism that the CRAs face the "CRA critique." This is not to say that the criticism faced is a monolithic bloc. The arguments often relate to different aspects and segments of the rating business, and to different moments of the crisis. The issues of controversy in this chapter cover four macro topics of the CRA critique: the accusation of the U.S. American bias, of the lack of competition, of conflicts of interest which relate to aspects of the issuer-pays business model,[44] and the criticism relating to the timeliness of ratings (metaphorically speaking, the 'delayed weatherman' narrative).

Why should this exercise be undertaken? Without contextualizing the argument pre-

[44]The problem of the conflicts of interest does not apply to the business segment of unsolicited sovereign ratings.

sented in this dissertation in the existing debate, it would just add up another line of argument to the CRA critique without any knowledge gained. At the same time, the purpose of this chapter is not to evoke sympathy, agreement, or disagreement with the issues raised, but to show, first, how the different facets of the CRA critique draw on certain conceptions of rating. By doing so, the dominant meaning of what a rating is supposed to be reveals much about the dominant epistemology of our times and constrains the range of possibilities regarding how to understand the CRAs' authority.[45]

Second, its purpose is to illustrate how the CRA critique's discourse dynamic stagnates on two well-established orthodoxies concerning the CRAs' power: overdetermination on the one hand and denial on the other. As mutually exclusive as these orthodoxies are, they ultimately seem to neutralize each other, leading to the debate being deadlocked and corroborating the existence of 'blind spots' in terms of the decisive features of the CRAs' authority. A major aimed contribution of this work comprises the revelation of these blind spots in order to advance the knowledge of the specificity and the puzzle of the CRAs' authority.

Since this dissertation applies Strange's (1998) concept of structural power to the practice of sovereign ratings, chapter 5 recapitulates the purposefulness of such an undertaking by drawing on the power debates in IPE and IR (Baldwin 2002). Post-financial crisis research has opened structural power analysis to a wide spectrum of political economy issues, which may suggest its explanatory power in contrast to more traditional power concepts. The rationales are discussed for the choice of the structural power approach in general, and in terms of Susan Strange's version in particular. Other power approaches to the issue area of CRAs and credit ratings are also highlighted. This chapter furthermore discusses the concept of "intersubjectivity," incorporating it into the theoretical lenses of the structural power concept.

As common knowledge and certain scholarly traditions suggest, the CRAs' authority can only be claimed if it can be shown that the markets follow the CRAs. If markets do not, sovereign ratings are imputed to have no independent influence on the interest rates of bonds, and CRAs thus 'do not matter.' Therefore, this chapter is also an attempt to disentangle the question of the CRAs' authority from the 'who follows whom' question by considering the concept of intersubjectivity, which problematizes the role of CRAs in the construction of shared ideas and the common sense in the realm of fiscal and economic policy.

The last chapter discusses the possible impact of sovereign ratings in the redefinition of the financial crisis into a crisis of sovereign debt. This line of argument is compared with other scholarly explanations of the transition from the financial to the sovereign

[45]Depending on scholarly traditions and paradigms, competing understandings of rating are found in the literature: From opinions, judgments, standards (in the sense of voluntary investment thresholds), certificates, regulatory requirements (in the sense of law), technical products, and metrics. For a discussion on how the polysemy of rating contributes to the ineffectiveness of regulatory efforts of the credit rating industry, see Mennillo & Sinclair (2015).

debt crisis.

The dissertation ends with concluding remarks.

Chapter 2

An account of the credit rating industry

> *"to rate;" Assign a standard or value to (something) according to a particular scale*
>
> —Oxford Dictionary of English

2.1 Who are the credit rating agencies?

This section discusses the CRAs' ontology mainly descriptively. As mentioned earlier, depending on epistemological positions, there are different ways of how to conceive of credit ratings, CRAs, and their raison d'être. A functional perspective regards CRAs as "coordinators between those having funds to invest and those seeking funds to use" (Sinclair 1999, p. 164). In this vein, CRAs provide orientation and guidance by creating predictability in terms of the chances of investment; ratings serve as a practical device to solve the problem of informational asymmetries. Given that disintermediated capital markets[1] have increased the degree of such asymmetries, the necessity for someone to provide informational intermediation has substantiated the CRAs' raison d'être even more (Abdelal & Blyth 2015).

At the same time, a merely functional conception of rating neglects aspects, such as the embeddedness of CRAs "in networks of social interest representation" (Sinclair 1999, p. 158):

> [Although CRAs] do not represent the interests of globalizing elites in a conscious, conspiratorial fashion, battling the evil hordes of the welfare state and socialism, [...] rating is an ideology in that its assumptions privilege a system of values and knowledge tied to particular social forces.

Such a broader conception of rating and of CRAs does not contradict the narrower functionalist perspective, but can comprise it. Related to this, the idiosyncrasy of the

[1] For more background information on "financial disintermediation," see section 2.3 below.

oligopolistic market structure is another feature of the ontology of rating which goes beyond the functional logic.[2] Although there are smaller agencies, these "are normally specialized in one country or sector and can survive only if they develop distinctive skills in their market niche" (Mattarocci 2014, p. 121). Furthermore, given the network of strategic alliances in the rating market, these small agencies are not 'real' competitors for the CRAs (ibid., p. 38, Table 3.3).

The high concentration of market shares and the low degree of competition suggest that the CRAs' success story has depended on at least two types of market failures: The codification of the market's creditworthiness perception by the CRAs does not only presuppose the existence of information asymmetries, but also of market power, which ontologically follows the necessary ingredient to allow a CRA to survive, namely reputation. Instead of being interpreted as a proxy for the presumptive track record, reputation can implicitly be regarded as both a result of market failure and as its cause. Reputation conditions the rationale of the rating business model. Put differently, the raison d'être of the rating market relies on a limited number of rating suppliers. Since reputation is inherently exclusive, it can only privilege a few players. The entry barriers to the rating market "related to reputation requirements" (Mattarocci 2014, p. 16) are thus not only the cause of the low degree of competition, but are constitutive of the rating market itself.

2.1.1 Standard & Poor's Ratings Services (S&P)

The headquarters of "Standard & Poor's Ratings Services" is located in Manhattan, New York City. Herewith a few figures that convey a sense of the order of the monetary magnitude involved: In 2011, the agency's revenue amounted to USD 1.77bn, of which 52% was generated in the U.S. and 48 % internationally. In the same year, its profits amounted to USD 719mn. At the end of 2010, 1,345 analysts worked for the company (Wirtschaftswoche 2012, own translation). The credit rating agency is part of the American financial services company with the same name. The turnover of "Standard & Poor's Financial Services LLC" was USD 3,1bn in 2011. Standard & Poor's Financial Services is a division of "McGraw-Hill Financial," "a financial intelligence company" with "approximately 17,000 employees in 27 countries."[3] Standard & Poor's Ratings Services employs approximately 500 analysts in Europe. The "McGraw-Hill publishing Company" acquired the previously named "Standard and Poor's Corporation" in 1966.

In 1941, the "Standard & Poor's Corporation" was founded as the result of a merger

[2] An insightful numerical overview of the predominant role of the CRAs in the rating market can be found in Mattarocci (2014, pp. 40-41, Table 3.5); the ratios of the ratings issued and of the customers served by the respective agency on the overall market are shown over time.

[3] On 1 May 2013, the shareholders of the company originally called "McGraw-Hill" voted to change its name to "McGraw-Hill Financial" (McGraw-Hill 2013). Beside Standard and Poor's Ratings Services, other subsidiaries of McGraw-Hill Financial are: "S&P Capital IQ," "S&P Dow Jones Indices," "Platts and J.D. Power." Source: www.mhfi.com

between the two firms "Poor's Publishing Company" and "Standard Statistics Company" (Mattarocci 2014, p. 33, Box 3.1). However, the historical origins of debt security rating go back to the mid-19th century. Originally fueled by the "public controversy and market turbulence created by failed railroads, dubious Florida land schemes, and other property deals in the newly opened lands of the western United States" (Sinclair 2005, p. 23), American financial markets already experienced "an information explosion" during the years before World War I. "Poor's American Railroad Journal" of the mid-1850s preceded the "History of the Railroads and Canals of the United States," which Henry Varnum Poor published in 1860.[4] This book contained detailed information about "the track length of railroads," "investors' share capital," and "a record of the railroads' profit and loss" (ibid.). Having founded the "H.V. & H.W. Poor Company," only few years later in 1868, Henry Varnum Poor (1812-1905) and his son Henry William Poor (1844-1915) launched the "Poor's Manual of the Railroads of the United States:"

> [W]ithin few months, they sell all 2,500 copies of the first issue. Each copy, at 442 pages, is priced $5 and contains essential information for investors in the U.S. railroad industry. The *Manual* is updated annually, keeping investors current and allowing them to chart a company's progress over the years.[5]

The manual came to enjoy great popularity, as can be derived from the 5,000 subscribers in early 1880 (Kirkland 1961, p. 233). In the meantime, Henry Varnum Poor retired, moving to Brookline, MA, in 1873 and, in 1899, the company was renamed "H.W. Poor & Company." At some point after 1908, the year in which it became public that H.W. Poor's "mergers didn't succeed" (The New York Times 1908), the successor company "Poor's Railroad Manual Company" was founded.[6] It issued the "first rating" in 1916 (Sinclair 2005, p. 24). In 1919, the company merged with "Moody's Manual Company" to form "Poor's Publishing Company," one of the two predecessor companies from which "Standard & Poor's Corporation" emerged. Roy Ward Porter not only played a crucial role in achieving the merger, but also in preparing it: In 1914, he acquired the company after having worked as the editor of "Moody's Manual Company" since 1908. Owing to the merger with Poor's in 1919, the rival company had "the legal right to use the Moody's name" until 1925, when "Moody's bought back the rights to use the name exclusively for $100,000" (Sinclair 2005, p. 25). In this context, Sinclair also notes that "the complicated lineage of what we know today as Moody's and S&P has rarely been mentioned in print and seems little known among rating agency staff."[7]

[4]For an insightful biography on Henry Varnum Poor, see Chandler (1956).

[5]Source: "A History of Standard and Poor's," Beginnings, 1830-1869, http://www.standardandpoors.com/about-sp/timeline/en/us/, retrieved 11 June 2015.

[6]This should not to be understood in a causal, but in a temporal sense. No trace of an exact founding date has been found for "Poor's Railroad Manual Company."

[7]For an overview of the historical links between the two rivals, Moody's and S&P, see Sinclair (2005, p. 25, Figure 1).

In 1906, Luther Lee Blake (1874-1953) found the other predecessor institution, "Standard Statistics Bureau." Having bought the "Stock and Bond Card System" from Roger Babson in 1913, the Standard Statistics Bureau was incorporated as "Standard Statistics Incorporation" in 1914. The Babson Stock and Bond Card System had published "financial reports on stocks and bonds, similar to cards published by Standard Statistics." Between 1922 and 1923, the Standard Statistics Incorporation started to rate corporate bonds and municipal securities.[8] In 1941, the merger with "Poor's Publishing Company" took place, forming "Standard & Poor's Corporation."

2.1.2 Moody's Investors Service

The holding company of "Moody's Investors Service" is "Moody's Corporation," which is listed on the New York Stock Exchange (NYSE), and generated a revenue of USD 2.97bn in 2013.[9] The shareholders are largely similar to those of McGraw-Hill Financial (Wirtschaftswoche 2012, own translation), amongst others, "Capital World," "Vanguard," and "Black Rock." Since 1998, Moody's Investors Service has been the bond credit rating subsidiary of Moody's Corporation. Between 1962 and 1998 it belonged to the "Dun & Bradstreet Corporation," a business information provider.

With its headquarters at 7 World Trade Center in New York City, Moody's Investors Service generated a revenue of USD 1.569bn in 2011, of which 56 % in the USA, and 44% internationally. That year, the profits amounted to USD 690mn. The company's ratings cover 130 countries, 11,000 corporate issuers, 21,000 public finance issuers, and 76,000 structured finance obligations.[10] At the end of 2010, it employed 1,204 analysts.

"John Moody and Company" was founded in 1900 (Mattarocci 2014, p. 33, Box 3.1). Its first publication was "Moody's Manual of Industrial and Miscellaneous Securities." "[W]hile information on the railroads was available, there was a poverty of useful data on the emerging industrial combinations" (Sinclair 2005, p. 23), which is how John Moody's business idea was born:

> The manual provided information and statistics on stocks and bonds of financial institutions, government agencies, manufacturing, mining, utilities, and food companies. Within two months the publication had sold out. By 1903, circulation had exploded, and Moody's Manual was known from coast to coast.[11]

As mentioned above, the histories of the two rivals, Moody's and S&P, are closer than one might think: Their paths crossed directly in the year 1908, when Roy W. Porter

[8] Source: "A History of Standard and Poor's," Beginnings, 1915-1940, http://www.standardandpoors.com/about-sp/timeline/en/us/, retrieved 11 June 2015.

[9] The other operating division of the holding is "Moody's Analytics," a financial analysis software and services provider.

[10] Source: Moody's Investors Service, https://www.moodys.com/Pages/atc002.aspx, retrieved 12 June 2015.

[11] Source: Moody's History, https://www.moodys.com/Pages/atc001.aspx, retrieved 12 June 2015.

became editor of Moody's manuals after the founder, John Moody, left after of the stock market crash of 1907, which forced him to sell "John Moody & Company" (Sinclair 2005, p. 24).

In 1909, John Moody came up with a new business idea, and he published the "Moody's Analyses of Railroad Investments." Compared with the competitors' timing, be it of "Poor's Railroad Manual Company" or "Standard Statistics Company," John Moody "became the *first* to rate public market securities" (Moody's History, emphasis added):[12]

> [I]nstead of simply collecting information on the property, capitalization, and management of companies, he now offered investors an analysis of security values. His company would publish a book that analyzed the railroads and their outstanding securities. It offered concise conclusions about their relative investment quality. [...] [It] described for readers the analytic principles that Moody used to assess a railroad's operations, management, and finance.

According to Harold (1938, p. 9), Roger Babson and Freeman Putney, Jr. "during or before 1901 [...] conceived the idea of security ratings," however, "neither exploited the concept before Moody" (Sinclair 2005, p. 24). As "two young men," Roger Babson and Freeman Putney, Jr. (ibid.):

> [F]or years [had] been interested in investment securities, their quotations, and financial statistics. The rapid growth of the market and the glamorous possibilities of financial captaincies gripped their imaginations. Many times they traveled together by rail to Boston, financial center of New England [...].

During these travels, they discussed the idea of security ratings (Harold 1938, p. 9).

> It was not, however, until 1909 that security ratings were published on a scale large enough to be called to public attention, and it was done neither by Mr. Babson nor Mr. Putney [...].

It was done by John Moody.

Going beyond pure description, "Moody's Analyses Publishing Company" expressed conclusions based, as the name implies, on an analysis of the stocks and bonds of the U.S. railroads. These conclusions gave rise to express the results of the creditworthiness analysis in the format of the letter rating symbol, and legitimized its usage. In other words, the "transition between issuing compendiums of information and actually making judgments about the creditworthiness of debtors" (Sinclair 2005, p. 24) informs the representation of ratings in letter grades. The way of representation, however, was adopted from the "mercantile credit rating of retail businesses and wholesalers," as issued by credit-reporting firms, such as the "R.G. Dun & Company" since the late 1800s

[12]Source: Moody's History, https://www.moodys.com/Pages/atc001.aspx, retrieved 15 June 2015.

(ibid., Moody's History).[13] In 1913, the name of the company changed to "Moody's Investors Service," which more accurately reflected the expansion of the base of analyzed companies to industrial companies and utilities. In 1914, Moody's Investors Service was incorporated. At that time, it had already started expanding the "rating coverage to bonds issued by US cities and other municipalities" (Moody's History).

2.1.3 Fitch Ratings

"Fitch Ratings" is part of the "Fitch Group," which is a jointly owned subsidiary of the "Hearst Corporation," a U.S. mass media group, and "Fimalac SA," a French holding company.[14] At the time of writing, Fitch Group is majority-owned by the Hearst Corporation, which has a 80% stake, while Fimalac owns 20%. On 12 December 2014, it was announced that the Hearst Corporation would buy control over the Fitch Group (The New York Times 2014).[15] Since 12 April 2012, Hearst Corporation and Fimalac have each owned a 50% stake in Fitch Group (Reuters 2012). Before that, Fimalac was the majority owner. Hearst purchased its initial 20% stake for USD 592mn in March 2006, and increased its stake to 40% in the second half of 2009 (Reuters 2009*b*, Folio Magazine 2009).

In 1992, Marc Ladreit de Lacharrière, i.e. FIMALAC, acquired the "IBCA" (International Bank Credit Analysts), "a small London-based agency with 38 employees," with a supposed good reputation in European bank ratings.[16] At the time, this was regarded as "the first step toward the creation of a true European rating agency," given that both "Standard & Poor's" and "Moody's" were North American (The New York Times 1992, Sinclair 2005, p. 29). Having gradually "built an international network of offices, mainly in continental Europe but also in South America," IBCA, still headquartered in London, generated revenues of over USD 30 million by the end of 1997, and employed approximately 180 employees (Fimalac, History of the Group).

In order to grow further and to achieve a global market presence, access to the world's largest rating market, namely the U.S. market, was inevitable. Regulatory measures of the U.S. Securities and Exchange Commission (SEC), however, prevented IBCA from rating U.S. issuers—IBCA did not appear on the list of "Nationally Recognized Statistical Rating Organizations" (NRSROs). This implied that the idea of establishing a

[13] "R.G. Dun & Company" is the predecessor company of the later "Dun & Bradstreet Corporation" that owned "Moody's Investors Service" between 1962 and 1998.

[14] Fitch Group includes the credit rating agency "Fitch Ratings;" "Fitch Solutions," a provider of credit market data, analytical tools, and risk services; "Fitch Learning," a training and professional development firm; and "BMI Research," a provider of country risk and industry analysis specializing in emerging and frontier markets. Source: Fitch Group 'About,' https://www.fitchratings.com/about, retrieved 16 June 2015.

[15] Hearst Corporation includes holdings such as: "The Oprah Magazine," "Good Housekeeping," "Cosmopolitan," and numerous TV stations and newspapers.

[16] Source: Fimalac, History of the Group, http://www.fimalac.com/History-of-the-group-1992-2005.html, retrieved 16 June 2015.

'purely' European CRA had to be abandoned less than a decade after the goal to create a leading global rating agency: In 1998, IBCA merged with the U.S.-based Fitch Ratings, whose history went back to the beginnings of the 20th century. John Knowles Fitch founded the "Fitch Publishing Company" in New York City on 24 December 1913 (Mattarocci 2014, p. 33, Box 3.1). Having published "security quotations" and financial statistics, the company issued the first ratings in 1924, which were initially "limited to bonds," but afterward also included "stock ratings" (Harold 1938, pp. 13-14).

Owing to the merger in 1998, the two companies formed "Fitch-IBCA" with dual headquarters in New York (USA) and London (UK).[17] One year after the merger, the number of employees grew to 750, and the revenues increased from USD 156mn in 1998 to USD 172mn in 1999 (Fimalac, History of the Group). Fimalac's strategic goal "was to raise Fitch-IBCA to a position alongside Moody's and Standard & Poor's, the two U.S.-based agencies that dominated the global market." In the year 2000, two acquisitions were undertaken that were critical in terms of achieving this goal. In April, Fimalac successfully took over the Chicago-based "Duff & Phelps Credit Rating Company," the fourth largest rating agency at the time. In December, "Thomson Financial Services" sold its "BankWatch subsidiary" to Fimalac.

As the smallest player of the 'Big Three,' Fitch Ratings succeeded in becoming the world's third largest rating agency. In 2011, its revenue amounted to USD 733mn, of which 39% was generated in the U.S. and the rest internationally (Wirtschaftswoche 2012, own translation). In that year, the profits were USD 227mn. At the end of 2010, the company employed 1,049 analysts.

Given that, at the time of writing, Fitch is majority-owned by an American corporation, the establishment of a 'truly' European CRAs has therefore not succeeded (questions of desirability aside). Yet, when, on 12 December 2014, it was announced that the American Hearst Corporation would be the majority owner of Fitch Group, Fimalac that same day announced that its CEO, Marc Ladreit de Lacharrière, would remain chairman of the Fitch Group's board of directors. As a further part of the deal, Fimalac would have 50% of the votes on the Fitch Group's board of directors until 2020 (Fimalac 2014). Hence, ceteris paribus, the Franco-European legacy will only gradually fade from the supposedly most European CRA of the 'Big Three.'

2.2 What credit rating agencies do

A credit rating agency *rates* the creditworthiness of a bond issuer. What does 'to rate' mean exactly? Common knowledge in this business suggests that it concerns a specific type of creditworthiness assessment which relies on figures deemed relevant, including industry estimates (Wirtschaftswoche 2012, own translation). According to the "Oxford

[17] At the time of writing, Fitch Ratings is the only CRA of the 'Big Three' that is dual-headquartered in the U.S. and Europe.

Dictionary of English," the verb 'to rate' signifies the assignment of "a standard or value to (something) according to a particular scale." In the credit rating context, 'something' refers to any entity seeking access to capital markets in order to issue bonds to satisfy its funding needs, i.e. ranging from companies, banks, municipalities, and sovereigns to supranationals.

The classification of the objects of rating already reveals that the activity of rating is not only context-specific (financial markets) to create meaning, but is also related to the ways that concerned entities refinance themselves (bonds). This aspect becomes particularly important in the case of public entities since states or municipalities face different refinancing options, among which issuing bonds is one of many (e.g., unlike taxes). By voluntarily choosing this way of funding, submission to the rating assessment is implicitly taken into account—being quasi 'part of the game.'

If rating implies assigning a standard or value to a particular scale, the specificity of the CRAs' rating scale consists in the fact that it is self-made by the CRAs themselves, as is the assigned value (i.e. the rating content). Put differently, the scale constitutes the rating content; scale and value do not exist independently from each other.

According to the general definition of 'to rate,' and particularly in CRA representatives' self-descriptions (e.g., see Hinrichs 2012, Krämer 2012*b*), a rating amounts to an independent, 'objective' opinion about future solvency—being a quasi-metric that is fungible and transferable to other units of measurement. However, the particularity of credit ratings is that they create predictability themselves by facilitating the "description of an opinion about future solvency" (Hinrichs 2012, own translation). If this thought is developed further, future solvency and creditworthiness come to mean "credit rating."[18] Credit ratings have gained power of definition over creditworthiness: A bond issuer is deemed creditworthy *because* of the assigned top rating, rather than the assignment of the top rating reflecting a preconceived notion of creditworthiness.

How did ratings come to mean and therefore be constitutive of creditworthiness? In his autobiography, John Moody summed up investors' dilemma at the time, which motivated him to realize his actual business idea: "A high percentage of corporation securities had to be bought on faith rather than knowledge" (Moody 1933, p. 90 cited in Sinclair 2005, p. 23). If almost a century later, credit ratings have come to constitute creditworthiness, then, in the words of John Moody, 'knowledge' has, to a certain degree, become 'faith' again. The representation of ratings in letter grades may, as an irony of history, have been crucial in this regard. Through their "distinctively portable format and scientific appearance" (Carruthers 2013, p. 544) as relative measures on an ordinal scale, credit ratings provide a universal, easy-to-understand language of credit risk. Or, as Bruner & Abdelal (2005, p. 206) phrase it, credit ratings constitute "a simplified

[18]Illustrative evidence for the claim that 'creditworthiness' has come to mean 'credit rating' can be found in "The Free Dictionary." The online dictionary and encyclopedia paraphrases the adjective 'creditworthy' as "having an acceptable credit rating." Source: http://www.thefreedictionary.com/creditworthy

vocabulary and conceptual framework through which to talk about credit risk." Letter grades are prone to develop a life of their own when compared to 'qualitative descriptions.' The signifier (AAA) can diverge from its significant (qualitative information); consequently, the quasi-quantitative, metric guise can hide the fact that its content is legally deemed as opinion. A lack of congruence between what a rating actually is and what it is commonly thought to be is thus revealed.

Paradoxically, going beyond pure description about the creditworthiness of debtors by "making judgments" informs the business idea of rating, and motivated the use of letter grades (Sinclair 2005, p. 24). However, the insistence on paraphrasing the rating content as 'qualitative (nominal) information,' 'description' or 'opinion,' misleads historically the unique selling point of rating.[19] Admitting that CRAs issue judgments would not only be a more accurate account of their success, but would likewise reveal their epistemic authority. Their unwillingness to do exactly this suggests an ambivalent relationship between the CRAs and their power.[20]

The Long-Term Rating Scales

The rating scales of the CRAs[21] shown in Table 2.1 refer to long-term ratings, the relevant rating type that applies to sovereign ratings. In the case of Fitch Ratings (2013*a*, p. 9), sovereign issuers are "generally assigned Issuer Default Ratings (IDRs)" according to the Long-Term Rating Scale (beside financial and non-financial corporations and insurance companies):

> IDRs opine on an entity's relative vulnerability to default on financial obligations. [...] IDRs provide an ordinal ranking of issuers based on the agency's view of their relative vulnerability to default, rather than a prediction of a specific percentage likelihood of default.

In the case of Standard & Poor's (2012*c*, p. 6), "[c]ounterparty credit ratings, corporate credit ratings and sovereign credit ratings are all forms of issuer credit ratings." An issuer credit rating is defined as:

> [F]orward-looking opinion about an obligor's overall creditworthiness in order to pay its financial obligations.

[19]The rhetorical insistence on publishing 'opinions' can also be explained by means of CRAs' legal status as First Amendment 'opinion-expressing' entities, which serves as a protective shield against accountability (Bruner & Abdelal 2005, p. 210).

[20]For example, in the aftermath of the financial crisis, CRAs' representatives welcomed the idea of reducing the reliance on CRA ratings in regulatory frameworks, such as Basel III (Hinrichs 2012, Mennillo & Roy 2014). This move can be interpreted as a confession and as a shying away from the CRAs' power. Chapter five discusses the ambivalence between the CRAs and their power in greater detail.

[21]Sources: Fitch Ratings (2013*a*, p. 20), Standard & Poor's (2012*c*, p. 7), and Moody's Investors Service (2013*b*, p. 5).

Table 2.1: Long-Term Rating Scales

Fitch	S&P	Moody's
AAA	AAA	Aaa
AA+	AA+	Aa1
AA	AA	Aa2
AA-	AA-	Aa3
A+	A+	A1
A	A	A2
A-	A-	A3
BBB+	BBB+	Baa1
BBB	BBB	Baa2
BBB-	BBB-	Baa3
BB+	BB+	Ba1
BB	BB	Ba2
BB-	BB-	Ba3
B+	B+	B1
B	B	B2
B-	B-	B3
CCC	CCC+	Caa1
CC	CCC	Caa2
	CCC-	Caa3
C	CC	Ca
RD/D	SD/D	C

Both "the obligor's capacity *and* willingness to meet its financial commitments as they come due" are taken into account in this rating category (ibid. emphasis added). In theory, "[i]ssuer credit ratings can be either long-term or short-term" (ibid.). However, in practice—taking the usual maturity of the bonds into account—the "Long Term Issuer Credit Ratings" are deemed relevant for sovereigns.

In the case of Moody's Investors Service (2013*b*, p. 4), the "Global Long-Term Rating Scale" also applies "to issuers or obligations with an original maturity of one year or more." In general, the assigned ratings are defined as:

> [F]orward-looking opinions of the relative credit risks of financial obligations issued by non-financial corporates, financial institutions, structured finance vehicles, project finance vehicles, and public sector entities.

Both Moody's and S&P have nine major rating categories each, Fitch has ten. These categories can be additionally differentiated through the usage of modifiers. Fitch Ratings (2013*a*, p. 10, emphasis added) states that the "modifiers '+' or '-' *may* be appended to a rating to denote relative status within" those major categories. Likewise, Standard & Poor's (2012*c*, p. 7, emphasis added) notes that ratings "*may* be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating

categories." Both CRAs thus emphasize the latent character of the usage of modifiers, which allows the possibility of a more fine-tuned differentiation of the rating scale, apart from outlook changes and further differentiation tools like 'on watches,' announcements, and comments.

Although slightly augmented by tripling and doubling, the basic usage of letter grades and plus and minus modifiers triggers the involuntary association with school grades predominantly used in the Anglo-Saxon education system (The Guardian 2009):[22]

> These companies act like teachers, grading every nation according to the state of their economy, their public finances and the risk of things going wrong in the future. The lower the credit rating, the higher the cost of borrowing.

As an aside, the potential association of ratings with school grades points to an interesting parallelism in terms of the euro crisis: 'Doing one's homework' (The Guardian 2012, EUobserver 2012), which is a metaphor for undertaking prescribed reforms in order to restore sovereign creditworthiness (and, thus, the rating), is also part of the semantic field 'school.'

Moody's uses an alternative rating scale. Not only does it deviate from the classical school grades by combining the capital letters (A, B, C) with the lowercase letter 'a' to form the major rating categories, but it uses numerical modifiers (1, 2, 3) instead of plus and minus (Moody's Investors Service 2013*b*, p. 5): "[M]odifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category." The numerical format leads to a compelling, visible assignment of modifiers, whereas, in the case of S&P and Fitch, the usage of plus and minus, again, emphasizes the potential to differentiate, and allows the visibility of 'mid-range' categories without any modifiers.

Despite these differences, in all three cases, the application of modifiers excludes the top end of the rating scale: In case of Moody's, modifiers range from rating category Aa to Caa; in case of S&P, from AA to CCC; and, in case of Fitch, from AA to B. In the case of Moody's and S&P, the low end of the rating scale stops using modifiers one rating category before default (or selective default). Fitch, on the other hand, stops assigning modifiers three categories before default (or restricted default).

Another commonality of the three rating scales refers to the subtle logic of quantification inherent in the apposition of the latter grades: The tripling and doubling of the letters points to a 'the more letters, the better rating' logic in each original letter grade rating group. This also holds for Moody's, as the higher the number of the lower case letter 'a' associated with the original letter grade, the better the rating in the original letter grade rating group. However, the further differentiation by the numerical modifiers, with '1' ranking the best in the concerned major rating category reflects the ordinal character of the overall rating scale on the small scale.

[22] One could argue that school grades are, to some extent, also subject to a latent arbitrariness.

Taking a step back, let us look at the 'big picture' of the long-term rating scale. Table 1 is divided by a horizontal line in the middle of the rating categories, which depicts the so-called 'investment grade threshold.' Ratings above the line comprise the investment grade category, ratings below the line belong to the so-called 'speculative grade category.' For example, Standard & Poor's (2012*c*, p. 7) states that ratings ranging from BB to CC are "regarded as having significant speculative characteristics." At the same time, they relativize that although the concerned obligors "will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions" (ibid.).[23]

This differentiation is commonly considered, for example by Fitch Ratings (2013*a*, p. 6), as a market convention which "established [...] over time as shorthand to describe the categories 'AAA' to 'BBB' (investment grade) and 'BB' to 'D' (speculative grade)." However, it matters greatly for the investment standards of institutional investors, such as pension funds, and for public monetary authorities. For example, the ECB's credit quality step 3, which is defined according to the Eurosystem's harmonized rating scale and ultimately refers to the CRAs' investment grade threshold, plays a crucial role in the collateral eligibility standards and other ECB operations, such as the expanded asset purchasing program (European Central Bank 2015). Mapped onto the CRAs' rating scales, credit quality step 3 in Fitch or S&P terms means a minimum long-term rating of BBB-, and in Moody's terms, Baa3.[24] Moody's Investors Service (2013*b*, p. 5) notes that "[o]bligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics."[25] Table 2.2 and Table 2.3 display the meaning of the single rating categories across the CRAs in detail.[26]

[23]In the jargon, the speculative grade category is commonly referred to as 'junk.' In an academic panel discussion (2012), a high CRA representative noted that the use of the word 'junk' does not belong in his company's official communication (even though he used it involuntarily during the discussion).

[24]See Guideline ECB/2011/14, Annex I, Section 6.3.2.

[25]With regard to sovereign ratings in particular, Moody's Investors Service (2009, p. 31) questions the applicability of the 'investment grade' concept.

[26]Sources: Fitch Ratings (2013*a*, pp. 9-10), Standard & Poor's (2012*c*, p. 7), Moody's Investors Service (2013*b*, p. 5).

Table 2.2: Meaning of the investment grade rating categories

Rating agency	Rating category	Quoted Meaning (elliptical)
Fitch	AAA	highest credit quality, lowest expectation of default risk, exceptionally strong capacity for payment, highly unlikely to be adversely affected by foreseeable events
S&P	AAA	obligor's capacity to meet financial commitment extremely strong
Moody's	Aaa	obligations judged to be of highest quality, subject to lowest level of credit risk
Fitch	AA	very high credit quality, expectations of very low default risk, very strong capacity for payment of financial commitments, capacity not significantly vulnerable to foreseeable events
S&P	AA	differs from [above] only to a small degree, capacity to meet financial commitment very strong
Moody's	Aa2	judged to be of high quality, subject to very low credit risk
Fitch	A	high credit quality, expectations of low default risk, capacity for payment of financial commitments strong, capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than [above]
S&P	A	somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than [above], however, capacity to meet financial commitment still strong
Moody's	A2	judged to be upper-medium grade, subject to low credit risk
Fitch	BBB	good credit quality, expectations of default risk currently low, capacity for payment of financial commitments adequate but adverse business or economic conditions more likely to impair capacity
S&P	BBB	adequate protection parameters, however, adverse economic conditions or changing circumstances more likely to lead to a weakened capacity to meet financial commitment
Moody's	Baa2	judged to be medium-grade, subject to moderate credit risk, may possess certain speculative characteristics

Table 2.3: Meaning of the non-investment grade rating categories

Rating agency	Rating category	Quoted Meaning (elliptical)
Fitch	BB	speculative, elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions; however, business or financial flexibility exists which supports the servicing of financial commitments
S&P	BB	less vulnerable in the near term than [below], however, ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to inadequate capacity to meet financial commitments
Moody's	Ba2	speculative, subject to substantial credit risk
Fitch	B	highly speculative, material default risk present, but a limited margin of safety remains, financial commitments are currently being met; however, capacity for continued payment is vulnerable to deterioration in the business and economic environment
S&P	B	more vulnerable than BB, but capacity to meet financial commitments; adverse business, financial, or economic conditions will likely impair the capacity or willingness to meet financial commitments
Moody's	B2	speculative, subject to high credit risk
Fitch	CCC	substantial credit risk, default a real possibility
S&P	CCC+	see below
Moody's	Caa1	see below
Fitch	CC	very high levels of credit risk
S&P	CCC	vulnerable, dependent upon favorable business, financial, and economic conditions to meet financial commitments
Moody's	Caa2	speculative of poor standing, subject to very high credit risk
Fitch	C	default of some kind appears probable
S&P	CC	currently highly vulnerable
Moody's	Ca	highly speculative, likely in, or very near, default, with some prospect of recovery of principal and interest
Fitch	RD/D	Restricted default/Default
S&P	SD/D	Selective default/Default
Moody's	C	typically in default, with little prospect for recovery of principal or interest

2.3 Historical and contemporary conditions

The historical context plays a significant role in understanding the rise and the expansion of the credit rating industry. Turning points in history and crises in particular, were crucial in this regard. As stated above, in the beginning of the 19th century, "failed railroads and dubious land schemes in the United States" originally opened up the market gap that CRAs could fill (Sinclair 1999, p. 156). The business idea was to reduce the degree of uncertainty of investments by lowering the information asymmetries between investors and investment opportunities.

In 1971, the beginning of the end of the Bretton Woods system represented a further turning point in the rating industry. The concomitant liberalization of capital contributed to the "agencies' spectacular expansion," which went hand in hand with "the growth in private capital flows over recent decades" (Bruner & Abdelal 2005, p. 194). Simultaneously, starting in the United States in the 1970s, ratings were increasingly used as a regulatory tool "to limit exposure to risk" (Abdelal 2007, p. 171). This trend to delegate regulation to the CRAs also spilled over to the EU, with the result that to this day "securities regulations and rules [...] as well as prudential regulations" (International Monetary Fund 2010) rely on external ratings. For example, central bank practices of relying on CRA ratings in terms of their lending facilities ultimately also fall into this category, including the usage of minimum sovereign rating requirements as one of the eligibility criteria for collateral assets, such as government bonds in repo transactions (Financial Stability Board 2014, International Monetary Fund 2010).

The increasing complexity of financial markets and the growing amount of data to process have not only boosted the information asymmetries for investors and borrowers to the same extent, but have also substantially increased the value added of ratings. The more dispersed the information, the higher the marginal utility of the abstraction. Market participants, above all smaller financial entities, can save immense information costs by relying on the filtered information codified in the rating letter grade. Specifically, it is the attempt of abstraction which helped construct the rating business model in the first place: "[T]he agencies developed to sift through large volumes of information and present it in an easily digested format to investors, over time this information sorting function evolved into rating" (Sinclair 1999, p. 156). Ratings can thus be regarded as saviors in the data jungle, conferring a sense of increased certainty in times of ever increasing uncertainty.

The need for ratings as 'credit risk stamps' is inherently related to the shift from "relationship to transactional banking and the emergence of shadow banking" (Cutler 2014, p. 20). Through the transition from a bank-based to a market-based financial system, "the information-gathering role previously played by banks" has been outsourced, and taken over by "a small number of prominent rating agencies" (Bruner & Abdelal 2005, p. 196). An "abstract relationship between a multitude of issuers and buyers of securities" (Kerwer 1999, p. 7) that replaced the relationship between borrowers and banks

is a process also known as "disintermediation" (Sinclair 1994*b*, p. 136). This process conditions and constitutes the functional role of CRAs as new informational intermediators in disintermediated capital markets, on which ratings are central for the system to work. Whereas "banks lost their role as gate-keepers" (Lehmkuhl 2011, p. 10), the CRAs gained it (Partnoy 2006, Coffee Jr 2004), with the result that CRAs gained "substantial influence over private capital flows" between borrowers and lenders (Bruner & Abdelal 2005, p. 196), which seems the price that has to be paid for avoiding banks as intermediaries. Further, since disintermediation did not only take place in the United States, it "greatly heightened the scope to exercise authority" on a global scale (Sinclair 1999, p. 165).

Financial disintermediation brought about an enhanced demand for informational services on capital markets, given that both investment and refinancing devices changed in the process (Sinclair 1999, p. 154). By becoming "active market participants" themselves, banks gradually delegated their traditional task of due diligence to a third party: the CRAs (Bruner & Abdelal 2005, p. 196 and Sinclair 1994*a*, p. 450).[27] In order to solve the emerging information problems between lenders with funds and borrowers seeking them, the CRAs provided an efficient solution "because of the economies of specialization inherent in rating and the clearly disinterested nature of analysis" (Sinclair 1999, p. 155).

The decisive difference between the old and the new intermediators is that the latter are devoid of concerns about maturity transformation deriving from the financial intermediator's classical challenge to cope with both sides of the balance sheet, i.e. granting credit (assets) and deposits (liabilities). In disintermediated financial markets, those seeking funds may have an incentive to underestimate the financial riskiness of their projects, whereas those with funds may have an incentive to over-estimate the financial risks of different investment possibilities. Thus, an 'independent' third-party opinion can minimize theses biases by reporting credit risks. Put differently, the CRAs' task is to balance the distorted perceptions of risk in order to provide a 'neutral' judgment devoid of conflicts of interest. Or, in Kerwer's (2002, p. 43) words, a CRA assumes the key role as the "neutral information provider." This is, at least, the theory.

Although taking conflicts of interest into account, which derive from financial intermediation, the above discussion disregards the conflicts of interest deriving from the different rating business models that gained prominence in the course of the financial crisis. The rating failures leading up to the crisis, especially the over-optimistic ratings of complex, highly structured products, which turned out to be 'toxic assets' during the crisis peak, almost gained the status of the rating industry's emblem (Sinclair 2010, White 2010, Partnoy 2006). These failures have been largely related to the conflicts of interest inherent in the issuer-pays business model, according to which the bond issuer

[27] The replacing of bank finance with market finance is a process also called "marketization of banking." Typical associations are loan securitization, the use of credit ratings, or assessments that make use of "approved risk tools that are sensitive to publicly available prices" (Persaud 2008).

purchases the rating instead of the investor. The alternative business model, also known as the 'investor-pays,' 'subscriber-pays,' or 'user-fee,' bears other conflicts of interests, such as free-rider problems due to the public good character of the rating information (Coffee Jr. 2011). According to Mattarocci (2014, p. 74), "[i]n more than 86% of cases, agencies charge fees mostly or exclusively to the issuer."[28] For example, Standard & Poor's (2012*a*, p. 8, disclaimer) states that "S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors." The issuer-pays model became the predominant business model, especially among the CRAs in the late 1960s and early 1970s (Marandola & Sinclair 2014, p. 2). The investor-pays model lost its significance in the course of the last decades.

Basically, it should be pointed out that there is a general tension between the actual, informational function of rating for the investor and the commodification, i.e. commercialization of rating. From this tension follows, not least, the trade-offs that CRAs face between aiming for transparency and profitability.

The 'securitization' of banks' assets, in which the banks and CRAs were complicit, is directly related to the overoptimistic ratings of structured financial products, which sparked criticism against the rating industry (Thiemann 2014, Nesvetailova 2015, Rethel 2014).[29] Such practices can also be contextualized against the background of financial disintermediation. Through the marketization of banking, the 'originate and distribute' business model has gradually superseded the traditional 'hold and buy' business model of banks. The reclassification of loans and the shifting of assets off the banks' balance sheets have not only allowed the emergence of 'shadow banking activities,' but also the apparent possibility to separate credit from market and liquidity risk. Facilitating the pricing and selling of credit risks, ratings have become crucial for the construction of the trade-ability of credit risks and, thus, for the circulation and mobility of securitized assets.

Given that the practice of scrutinizing borrowers existed long before disintermediated markets, one could argue that the delegation of credit risk assessment to a third party does not differ that much from past practice. However, no one could foresee that the type of actors (CRAs instead of banks) would have crucial consequences for the delegated task: Since credit risk assessment was delegated to an oligopoly of three markets players, *homogeneous* knowledge about borrowers is the cost of financial disintermediation.

[28]For detailed background information about the different pricing policies of rating agencies (not only of the 'Big Three'), and also about different rating products, see Mattarocci (2014, pp. 67-80).

[29]In the aftermath of the financial crisis, a certain mindfulness is exhibited concerning conflicts of interest related to the company's organizational structure. For example, Standard & Poor's (2012*a*, p. 8, disclaimer) affirms that it "keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process."

Chapter 3

Measuring sovereign creditworthiness: Mission impossible?

"It always seems impossible until it's done."

—Nelson Mandela

3.1 The specificity of sovereign ratings

The liberalization of capital and the concomitant growth in private capital flows during the 1970s contributed to the emergence of a global sovereign bond market. The internationalization of these markets not only meant that sovereigns borrowed abroad, but also that sovereign bonds could circulate internationally among investors.[1] The need for an independent third-party opinion about sovereign creditworthiness, i.e. a 'stamp of credit risk,' is thus inherently related to aspects of the international mobility of sovereign bonds in disintermediated financial markets.

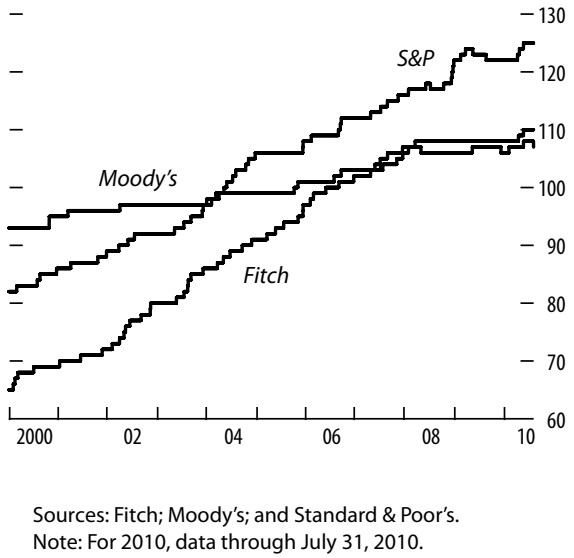
Hence, the international circulation of sovereign bonds informs the pervasiveness of sovereign ratings and their 'propensity [...] to affect sovereign debt markets' (International Monetary Fund 2010).[2] Put differently, the states' subjection to sovereign ratings is an accompanying phenomenon of the globalization of a deregulated finance industry. According to Rügemer (2012*b*), and in line with many conventional accounts, the politics of global financial deregulation can be seen as an American project, whereas Cox (2012) and Abdelal (2007, p. 3) stress the multi-faceted nature of the consensus behind "liberal rules for global finance." Without the norm of capital mobility which transcended political and territorial borders, sovereign ratings would not have gained their prominent

[1] For example, on repo markets, sovereign bonds function as trade-able collateral for the short-term, wholesale funding of financial institutions.

[2] Gaillard (2012) provides a concise account of the history of sovereign ratings, see also Abdelal (2007, pp. 174-175).

status in the discourse of sovereign creditworthiness.

Figure 3.1: Number of rated sovereigns across time



Source: International Monetary Fund (2010, p. 87)

Figure 3.1 (International Monetary Fund 2010, p. 87) shows the development of the sovereign rating business area according to the increasing total number of sovereigns that CRAs rated between 2000 and 2010. In this time span, S&P increased its number of rated countries by 43 (from 82 to 125), Moody's by 17 (from 93 to 110), and Fitch by 42 (from 65 to 107) (ibid.). Despite this expansion, sovereign ratings do not belong to the core CRA business area (Hinrichs 2012, own translation) at the time of writing. Sovereign governments are usually not CRA customers; most sovereign ratings are issued 'unsolicited,' i.e. without a government explicitly asking (i.e. paying) for it. For example, there is no formal, contractual relation exists between S&P and the concerned governments in the case of Germany, France, or the U.K. (ibid.). This does not mean that there is no cooperation at all between sovereigns and the CRAs. A high-ranking CRA representative in charge of sovereign ratings described the relationship as an "interactive process" between the CRA and the respective governments (own translation from German). Especially in the case of unsolicited sovereign ratings, a rationale for engaging in a practice that seems, at first sight, unprofitable, is the use of sovereign ratings as the "benchmark for other issuers of debt" (Moody's Investors Service 2012, p.

3). Whether bonds of corporations or banks, these ratings include the sovereign ceiling, i.e. the sovereign rating of the corporation's domestic government (Borensztein et al. 2007). In other words, in its function as the sovereign ceiling, the sovereign rating also impacts the global bond market access and refunding possibilities of the country's own corporations.[3]

Although unsolicited ratings do not generate direct revenue for the CRAs, another rationale for providing them is to offer investors a complementary service. The Guardian (2009, emphasis added) states, "when investors want to assess how risky their investment might be in a particular country in debt they turn *for help* to one of the [CRAs]." This shows that, despite the shifts in the rating business models of rating from investor-pays to issuer-pays, the 'investor' still plays a central role as the CRAs' addressee, which is also visible in names and slogans, such as "Moody's Investors Service" and Fitch's "Know your risk."

Moreover, because the issuer-pays business model does not apply to unsolicited sovereign ratings, this might have favored the perception of an alleged accuracy of sovereign ratings, and enhanced their credibility. The solicited rating, for which the issuer usually pays, has, since the financial crisis, been associated with conflicts of interest and flawed incentive structures, which tend to undermine its credibility. The absence of the issuer-pays business model in the case of sovereign ratings thus reverses the conflict of interest logic. It is, therefore, not surprising that a perspective that emphasizes the role of incentives as motives for individual behavior infers a less biased sovereign rating assessment; because the sovereign rating is unsolicited, CRAs do not have an incentive to underestimate risks.

The notion that CRAs may nevertheless overestimate risks in the case of sovereign ratings despite the lack of conflicts of interest, but for example due to reasons beyond the individual level of analysis (e.g. ideas), is an explanation derived from a different epistemological approach.[4]

Indeed, in the midst of the sovereign debt crisis in Europe, the then CEO of the German branch of S&P, Torsten Hinrichs, stated that the ratings would "currently, and more than ever, be regarded as impartial and not influenced by political, economic, or other interests" (Hinrichs 2012, own translation). This statement suggests that CRAs try to create the impression that they learned their lesson from the crisis. In a reaction to the rating failures that led to the financial crisis, the CRAs' reputation saving instinct induces them to provide more conservative assessments (Ferri et al. 1999). From this perspective, the CRAs' reaction is therefore understood as a correcting one, and not as an overshooting.[5]

[3]As an illustrative case of how the downgrading of a sovereign affects the rating of, for example, a financial institution, see the downgrade of Italian banks by Fitch a few days after the Italian sovereign downgrade on 8 March 2013 (Reuters 2013*c*).

[4]The following practitioner comment may be food for thought: "Of course sovereign ratings are ideologically driven."

[5]In a recent publication, the higher sensitivity to the lower bound of the rating scale is also conveyed

Inferring a decrease in sovereign ratings' credibility if they are solicited, is also in line with a perspective that emphasizes actors' given interests as drivers of behavior. In such a scenario, sovereign issuers would be CRAs' usual customers, and the typical conflicts of interest attributed to the issuer-pays business model would probably be imputed to the CRAs; states may be rated too gentle and not as severe as would be fitting.

Since sovereign ratings are unsolicited, this not only has implications for their perceived unbiasedness, but also for their added value: Being unsolicited, CRAs officially rely solely on publicly available data as the basis on which they form their sovereign rating decisions. Paradoxically, this knowledge induces inferences that CRAs only follow the market (The Economist 2013). The argument goes that since sovereign ratings only comprise public information, they cannot have an effect on the market's risk perception. This argument fails to add that *because* the sovereign rating decision is based on public data, the actual added value of the sovereign rating is its judgmental dimension.[6] It lies in the very nature of the sovereign rating to "condense complexity" and to deliver "interpretive frameworks" (Abdelal 2007, p. 176-181) in order to provide orientation in the light of big data and the ever increasing dispersal of information that needs to be processed on global bond markets. The room for interpretation increases proportionally with complexity since abstraction implies both selection and simplification. In other words, the more public data available about sovereign creditworthiness, the more condensed judgments are needed and desired about sovereign creditworthiness. Simultaneously, sovereign ratings are more likely to be less value-free and to reflect just one of many possible interpretations about a sovereign issuer's creditworthiness.

3.2 The methodology of sovereign ratings

3.2.1 Definition and ontology

In the following, I clarify how the CRAs define sovereign ratings by analyzing their published methodologies. Such an exercise is inevitable in order to understand why certain political, economic, or social occurrences affect a country's sovereign rating. Let us first consider what a sovereign rating actually is, and what the assessment comprises.

Sovereign ratings deliver *qualitative* information about a "sovereign government's willingness and ability to service its debt on time and in full" (Standard & Poor's 2012*a*, p. 3). Fitch Ratings (2012, p. 1) defines a sovereign issuer default rating as "a forward-looking assessment of a sovereign's capacity and willingness to honour its existing and

visually (Moody's Investors Service 2015). The cover page of the publication is noticeably focused on the "speculative grade" category. However, older versions of the same publication showed photographs of the founder John Moody with the general rating symbols, or a skyscraper (Moody's Investors Service 2013*b*, 2009).

[6] I want to thank Mark Blyth for capturing this function in a nutshell as "pricing the priceless."

future obligations in full and on time." Moody's Investors Service (2013*b*, p. 4) defines sovereign ratings as "forward-looking opinions of the relative credit risks of financial obligations issued" by the respective sovereigns. Moody's Investors Service (2002, p. 3) notes the importance of the *forward-looking* character of the sovereign analysis when evaluating the risk of default over a medium- to long-term time horizon. Merely using backward-looking quantitative data of the "historical performance of the economy" would not be enough:

> [E]xamination of past experience has to be supplemented by [...] the construction of a range of scenarios that stress-test the vulnerability of a country's economic, political and financial situation.

Therefore, a sovereign rating is *not* a quantitative measurement of sovereign default risk, but a nominal opinion of an anticipated future in a quasi-quantitative guise.

Moody's emphasizes the distinct role of national governments as "the largest borrowers" of the "vast majority of the world's debt capital markets" (Moody's Investors Service 2012, p. 3):

> A number of characteristics distinguish sovereign bond issuers from other debtors and inform the approach to assessing creditworthiness. These characteristics include (i) a sovereign's ability to modify the taxation of its citizenship in order to generate revenue with which to service outstanding debt; (ii) freedom from a higher authority to compel debt resolution and relieve the obligation of collateral; and (iii) the high probability of survival even after an event of default (i.e. countries rarely disappear).

Figure 3.2 (International Monetary Fund 2010, p. 99) summarizes the main ingredients that the CRAs use for their sovereign creditworthiness assessment.

Figure 3.2: Main ingredients of sovereign ratings

Fitch	Macroeconomic policies, performance, and prospects; structural features of the economy; public finances; external finances
Moody's	Economic strength; institutional strength; financial strength of the government; susceptibility to event risk
Standard & Poor's	Political risk; economic structure; economic growth prospects; fiscal flexibility; general government debt burden; offshore and contingent liabilities; monetary flexibility; external liquidity; external debt burden

Source: International Monetary Fund (2010, p. 99)

According to the external communication of Standard & Poor's (2012*a*, p. 3), a "series of quantitative factors and qualitative considerations form the basis for assigning [...] forward-looking scores." The different scores consist of the following:

- "Political score"="Institutional effectiveness and political risks"
- "Economic score"="Economic structure and growth prospects"
- "External score"="External liquidity and international investment position"
- "Fiscal score"="Fiscal performance and flexibility, as well as debt burden"
- "Monetary score"="Monetary flexibility"

After the numerical scores have been assigned, "the average of the political score and the economic score" delivers a "sovereign's political and economic profile," and "the average of the external score, the fiscal score, and the monetary score" delivers "its flexibility and performance profile." These two profiles determine the "indicative rating level" (Standard & Poor's 2012*a*, p. 4), which is then used as a basis for discussion at the committee meeting preceding the rating decision.

Assigning scores, calculating averages, combining them in an additive fashion suggests the transparency and traceability of the sovereign rating methodology. However, many of the inputs of these scores actually escape from quantification, which can already be interpreted as a legitimizing step at the early construction stages of a figure that conceals the degree of controversy about the inputs it consists of, and mimics calculation.

How are these scores constructed in practice? For example, let us consider the genesis of the "political score." The S&P methodology states that (p. 3):

> [T]he political score reflects our view of how a government's institutions and policymaking affect a sovereign's credit fundamentals by delivering sustainable public finances, promoting balanced economic growth, and responding to economic or political shocks.

If an election, for example, leads to "inconclusive" results, as in Italy (Fitch Ratings 2013*b*), or an immigration referendum implies risks in terms of the "growth potential,

wealth and overall economic strength," as in the case of Switzerland (Financial Times 2014*b*), or a referendum on the political independence of Scotland may have implications for the U.K. sovereign rating (Fitch Ratings 2014), this may decrease (or not) the country's "political score," and affect (or not) its outlook or rating. It is almost impossible to detect a methodology-deviating pattern suggesting the assessment is arbitrary or biased. The CRA's "view" legitimizes rating action and inaction: To a certain extent, the sovereign rating methodology is self-immunizing with respect to criticism since arbitrariness, in the sense of discretionary room for maneuvering, is anchored in the sovereign rating methodology (Walton 1996).

Finally, the "committee meetings" are the last stage in the preparation of a sovereign rating decision. The "final rating assigned by the committee is primarily determined by applying the rating criteria to the information that the analysts have collected and evaluated" (Standard & Poor's 2012*a*, p. 6). According to a high-profile CRA representative in charge of sovereign ratings, the rating decision is the product of a "democratic process" (own translation from German). The committee board consists of an uneven number of members; hence, when they vote, the majority decides. This board is composed of international analysts and senior staff (American, French and German in the case of S&P), which suggests the agency is concerned about impartiality. Rating criteria are critically discussed in those meetings. Ultimately, the assessment of a government's "willingness" to repay its debt cannot be quantified (Paudyn 2013, p. 22) and requires deliberation.

In terms of the committee meetings, Standard & Poor's (2012*a*, p. 7) stresses:

> However, rather than providing a strictly formulaic assessment, Standard & Poor's factors into its ratings the perceptions and insights of its analysts based on their consideration of all of the information they have obtained. This process helps the committee to form its opinion of an issuer's overall ability to repay obligations in accordance with their terms.

The committee discussion gives the impression of a well-thought out process behind the sovereign rating decision. It conveys the impression that the sovereign rating is a well thought through, informed opinion, and not an ad hoc, spontaneous whim. Consequently, awareness of this methodological element tends to enhance the credibility of the rating, instead of casting more doubt on it. Simultaneously, precisely because the committee element is so dominant and, probably, decisive in the sovereign rating process, especially in times of crises, it is hardly possible to retrace rating decisions by means of an econometric algorithm. While emphasizing the centrality of the qualitative element, the lack of a strict "formulaic" methodology ensures that the "qualitative part" makes the difference.

Through the "*admixture* of quantitative and qualitative data," the rating becomes a product of "a process of judgment" (Sinclair 2005, emphasis added).[7] The CRAs do

[7]The actual ontology of sovereign ratings as judgments, as opposed to objective measures of credit

not entirely reveal "how the quantitative and qualitative parameters are accommodated and synthesized" (Paudyn 2013, p. 21). CRAs seem to be aware of this transparency gap, which is an inherent, necessary feature of a judgment. Indeed, in the aftermath of the financial crisis, Moody's, for example, made efforts to reveal "how key quantitative and qualitative risk factors map to specific rating outcomes," and how "factor scores are combined to jointly determine a scorecard-indicated rating range" in its revised sovereign rating methodology (Moody's Investors Service 2013*a*). Nevertheless (Moody's Investors Service 2002, p. 5):

> [Q]ualitative and judgmental aspects are unavoidable even in the interpretation of quantitative indicators. Every measure we look at [...] is the result of a complex interaction of economic, political and social forces as reflected in the policy parameters. Consequently, sovereign risk analysis is an interdisciplinary activity in which the quantitative analytical skills of the analysts must be combined with sensitivity to historical, political and cultural factors that do not easily lend themselves to quantification.

3.2.2 The invisible in the visible

As can be inferred from the above, despite the transparency and traceability efforts, the published sovereign rating methodology shows the traits of a "black box." As seen with the example of the political score as a rating ingredient that follows a self-referential logic that legitimizes both rating action and inaction, the rating opinion is, at first sight, the product of a white box, which, however, on closer examination, constitutes several 'black box' elements.

Being an opinion that does not rely on an additive or probabilistic calculation, but on an unknown admixture of publicly known and unknown data, reveals the first limit to the CRAs' self-set ideal of objective verifiability. Second, the sovereign rating definition itself poses serious challenges in terms of the practical possibilities of transparency and verifiability. Even though the 'ability' of a sovereign debtor to repay its debt obligations can be better expressed in terms of economic fundamentals and be quantified, the prediction of the political 'willingness' to do so, is—to the best of one's knowledge and belief—mere conjecture. Here too, there is no indication of how the two aspects of the definition are amalgamated with each other and whether this occurs on a case-by-case basis. Moreover, the two aspects of the definition may be difficult to disentangle. A preconceived notion of the willingness to do so may color the judgment about the ability, while a preconceived notion of the ability to do so, may color the judgment about the willingness.[8] An independent, separate operationalization of these aspects may therefore be scarcely feasible in practice.

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risk, also holds for credit ratings in general.

[8]The interaction between willingness and ability points to a philosophical question: Does willingness follow ability, or vice versa?

The committee deliberation, which precedes a sovereign rating decision, is a further black box element in the sovereign rating methodology. The minutes of these meetings are not available to the public. Bruner & Abdelal (2005, p. 198), citing Bhatia (2002, pp. 26-27), maintain:

> [The] actual committee discussion remains the 'invisible ingredient in the ratings process' across the agencies, though reportedly it often center[s] around intangible issues such as a government's propensity for 'orthodox' vs. 'heterodox' policy responses when under acute debt-service pressure.

Hence, the attempt to anticipate policies in reaction to a crisis situation is anchored in the sovereign rating methodology as a crucial point of discussion. Pondering the willingness, quality, and timeliness of policy responses in stress scenarios reveals an ex ante reactive logic with an inherent blind spot regarding detecting the origins of a stress scenario; the stress scenario is seen as an exogenous event. Regarding the time period after 2008, the CRAs being largely unable to link the deterioration of many sovereigns' public indebtedness with the financial crisis—an aspect which favored the redefinition of the crisis—was therefore in line with the sovereign rating methodology. The financial crisis was seen as an "exogenous" event. Conditioned by the relative scale, the incumbent number ones (e.g. U.S., Germany) establish the orthodoxy. However, in times of a systemic, global financial crisis, which affects all sovereigns, the absence or presence of policy errors is difficult to diagnose when an exogenous shock happens. The 'best practice' therefore needs to be redefined, which renders the CRAs' epistemic authority visible.

The representation of the rating itself can be regarded as a fourth black box element. Even though CRAs may not explicitly claim to be fully objective in their assessments when insisting that their ratings are just opinions, the conversion of their opinions into the letter grade system makes their endeavor to be objective particularly visible. This conversion effectively produces ratings represented as stylized quasi-scientific technical products that, supposedly, indicate relative measures of credit risk. Instead of using cumbersome text to reproduce what a rating actually is declared to be, i.e. a nominal opinion, the easy-to-understand letter grade rating format conveys the impression of 'objectively' calculated probabilities. Metaphorically speaking, the guise seduces the rating consumer into believing that ratings are unambiguous figures.

Sinclair (2005, p. 46) maintains that "agencies assert that rating determinations are opinions but simultaneously seek to objectify and offer their views as facts." It is therefore no surprise that this balancing act leads to tensions about the CRAs' self-understandings. In the context of a 2012 academic panel discussion, a CRA managing director of European sovereign ratings confirmed that regarding credit ratings as technical products and opinions at the same time, would not imply compatibility problems. This stance underlines the CRAs' (unconscious) self-conception as an epistemic authority.

The market participants' and the CRAs' tacit tolerance of the inherent tension between the signifier (AAA) and the significant (opinion), seems to form the crux of the

CRAs' epistemic authority. The "distinctively portable format and scientific appearance" of ratings (Carruthers 2013, p. 544) conceal their actual nature as judgments. This disguise helps the ratings pretend to be the result of an applied quasi-scientific method—to seem something they are not.

Paudyn (2013) notes that the idiosyncrasy and the contingencies of "fiscal temperaments" cannot be captured in a "probability distribution." One could go further: If this probability distribution does not even exist in terms of sovereign ratings (admittedly according to the CRAs' own accounts), the entire rating exercise becomes a farce as it suggests a positivist epistemology that is not followed. CRAs also do not seem to meet their transparency requirements with regard to their access policy. For example, S&P's previous press releases are not publicly available online. In the internal area of their homepage, only the press releases of the "last seven days" are available. Notwithstanding S&P's verbal declarations, neither the public nor (normal) subscribers can retrieve the rationales for sovereign rating decisions more than a week old. Moody's, for example, only makes "issuer comments" available through expanded access, or after payment of USD 150.[9] In addition, Moody's updated sovereign bond rating methodology published in September 2013 is only available to subscribers (Moody's Investors Service 2013*a*). Such a divergence between the CRAs' communication strategy that cherishes the common value of transparency, and their access policy, suggests pseudo transparency. In order to meet common expectations and neutralize criticism, an apparent transparency legitimately disguises a lack of transparency.

The transparency narrative in the CRAs' communication strategy regarding their methodology and rating criteria may contribute to the general treatment of ratings as objective measures. At the same time, for example, Standard and Poor's declares that for civil liability reasons, "credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact" (Standard & Poor's 2012*a*). Sovereign ratings are widely treated as if they were objective measures, or metrics. They are simultaneously accepted as opinions and technical products. Although the media and the public may, on reflection, be aware that these assessments are to a certain degree discretionary, this ambivalence is silently overlooked. Unconsciously, tolerance of a certain degree of opacity seems to be based on a taken-for grantedness and general acceptance of the CRAs' professional integrity, which conditions, testifies to, and confirms their epistemic authority, thus contributing to the ratings' validity. In the light of the harsh criticism the CRAs faced in the course of the financial crisis, which not least questioned also the CRAs' professional integrity, their apparent immunity to these attacks seems all the more puzzling (Gärtner 2014).

If the CRAs' views are treated as objectified facts in the discourse, i.e. they gain the status of "statements of fact" once expressed, their actual status as "statements of opin-

[9]Moody's has outsourced the commercialization of reports and comments to an external information intermediary company ("Alacra").

ion" is obsolete, and CRAs become opinion leaders (possibly reluctantly). On the other hand, the CRAs' reliance on the freedom of speech facilitates their self-legitimization. Relativizing their product as an opinion, their statement "we do not want to influence the market" becomes credible. At the same time, this rhetoric immunizes the CRAs against criticism and legal accountability. Their epistemic authority and their related power to move markets are underplayed, which enables them to exert it.[10] CRAs may be very conscious of the effects of their opinions. However, presenting themselves as producers of "informed opinions" that a reported methodology and published criteria justify, allows the CRAs to cloak the (inter-)subjective and discretionary character of sovereign ratings.

Paudyn (2013, p. 22) questions whether "such opaque procedures" could "establish methodological rigorousness." Kiff et al. (2012) also call for "more transparency with regard to the quantitative parameters used in the rating process." The CRAs' black box is, ultimately, bound to open the flood gates to "ambiguous and superficial conclusions" (Paudyn 2013, p. 22). Therefore, a regulatory mission could focus on opening (Bruner & Abdelal 2005, p. 212):

> [T]he methodological 'black box' only dimly understood notwithstanding the major agencies' publications on ratings criteria, [...] its contents [should be] scrutinized, the true nature and extent of uncertainty reduction made more clear, and its ideological biases opened for discussion.

Paradoxically, a methodological black box could fortify the CRAs' epistemic authority and their consequential capacity (Bon 1982). By not revealing the production chain and its inputs fully, the unspoken theory seems to constitute the "company secret of sovereign ratings." At the same time, in order to invalidate criticism which may damage their reputation, CRAs never tire of ensuring that their rating decisions are traceable and transparent. Ironically, the published methodologies and the endeavor to update them can be understood as a protective shield hiding the CRAs' company secret. But what if the latter does not exist? Would this be a case of much ado about nothing? Or would this simply imply that all the CRAs' visible efforts to increase their transparency and modify their methodologies are exclusively aimed at restoring their reputation? According to a former senior analyst at Moody's, William J. Harrington, the "recent attempts to reform itself are nothing more than a pretty-looking PR campaign" (Blodget 2011).[11]

[10] I owe this thought to Alexander Heppt.

[11] For example, Moody's updated its sovereign rating methodology in September 2013: "The changes include more detail on how Moody's thinks about economic, institutional and fiscal strength, as well as vulnerability to shocks such as banking and foreign-exchange crises that could increase the risk of default" (Bloomberg 2013).

3.3 Scientistic trap

> *"Scientism;" The belief that the investigative methods of the physical sciences are applicable or justifiable in all fields of inquiry.*
>
> —The Free Dictionary

The mission impossible of *measuring*, or quantifying, sovereign credit risk is related to the complex nature of the "creditworthiness" concept. According to Lehmkuhl (2011, p. 12):

> [R]atings of rating agencies implicitly transport a model of how to transform their interpretation of creditworthiness into practice. This transformation may include specific forms of organization or operation. But always is the underlying idea a subjective one, deriving from specific assumptions on chains of causal relationship between factors, on an inclination towards specific policy models or on a specific socialization and education background of actors.

As stated above, CRAs seem to be thoroughly aware of the difficulties accompanying sovereign analysis, and show a healthy skepticism regarding their ability, even in terms of the interpretation of so-called hard facts (Moody's Investors Service 2002). This is why it would be presumptuous to reproach the sovereign rating analysts of being caught in a "scientistic trap."

Nevertheless, by vowing to stick to a scientistic methodology in their official communication, the CRAs can portray their ratings as metrics and products of stochastic calculations. Becoming an accomplice to scientistic approaches, ratings can gain legitimization. Paradoxically, the more ratings pretend to be something they are not, the more credible they become. The more credibly the impression of stochastic calculations based on hard facts is conveyed, the more the judgmental, inconclusive character of the creditworthiness assessment is glossed over.

That is why it is not surprising that Fitch Ratings (2002, pp. 3-4) warns investors that:

> It is important, though, that investors realise the limitations of this [sovereign rating] exercise, which is necessarily far less certain than our ability to analyse either bank or corporate risks of default. The essential problem is that the world of sovereign borrowers is far smaller than the world of large banks or corporations, and that the number of instances of default in the modern period when we have reasonable national accounts is tinier still. [...] So the rating of sovereigns depends more on the art of political economy than on the science of econometrics.

Consequently, the Fitch warning suggests that if there were sufficient 'n,' an indication of the probability of sovereign default would be based 'more' on econometric calculations; the opinion, would become, so to speak, less opinion, and more 'scientific.' Against the background that the proportion of the admixture between quantitative and qualitative data as well as interpretive elements remains unknown, the differentiation regarding whether the rating judgment is based on the "art of political economy," or the "science of econometrics," is actually obsolete, whether with 'small' or 'large n.' Further, the rating symbol conveys the impression of calculated predictability and comparability, whether with 'small' or 'large n.'

Therefore, Fitch's statement can be understood as a concession regarding the limits of the positivist stance that CRAs usually adopt. However, the statement can also be regarded as an invocation of the positivist stance that CRAs need to be credible: The infeasibility of calculation in the special case of sovereign ratings is attributed to the 'not enough n-problem,' and not to its inherent judgmental nature. 'Small n' glosses over and thus excuses the inherent judgmental nature.

From a stochastic perspective, the 'not enough n-problem' implies that there is no wrong or right rating since an evaluation of the hit rates is not possible. Owing to the lack of sufficient data, the probabilities that the ratings are supposed to indicate are not verifiable.[12] Therefore, the perception of ratings as measured probabilities of default is a fallacy, even from a perspective that a priori assumes the computability of the future, i.e. the feasibility of reliable prediction on the basis of enough (quantitative) data.

And if there were 'enough n'? The fallacy risk remains. The rating would remain a forward-looking 'opinion,' and would not be a calculated probability of default despite the sufficient backward looking data. Moreover, due to self-fulfilling prophecy mechanisms (Gärtner 2014), an endogeneity problem would nonetheless arise between the rating actions and the larger cases of default: Because the sovereign rating has an impact on sovereign default risk, the idea that the former can independently measure the latter is flawed. Self-fulfilling prophecies invalidate ratings' track record, therefore a rating's predictive power remains undetectable, whether with 'small' or 'large n.' Implicitly, the question of 'what is a good rating' remains unanswered. Put differently, there is a tradeoff between the quality of a rating and the existence of epistemic authority, as the latter renders the former self-fulfilling.

One could even go a step further and question the "predictionism" inherent in rating, whether with 'small' or 'large n,' altogether. The very "existence of rating agencies necessarily assumes predictability" (Sinclair 1999, p. 164). The impression that the future is presentable is conveyed in both cases, whether with 'small' or 'large n.' According to McCloskey (1983, p. 487), predictionism is a symptom of scientism (modernism). Drawing on Mises (1949, p. 867), McCloskey notes that prediction of the economic future

[12] I owe this thought to Manfred Gärtner, who used the following metaphor to make the impossibility of falsifiability in terms of prediction without enough data comprehensible: The probability that X and Y will enter paradise is, respectively, 80% and 60%.

is "beyond the power of any mortal man," and thus "impossible for economics," not to mention for CRAs.[13] The rating symbol invokes this predictionism by conveying the impression of a knowable, anticipate-able future and a law-like repeatability of history, assuming away the contingencies of social reality. The dilemma is that the rating symbol does so without resorting to stochastic measurements (regardless of whether these calculations are even possible).

Another scientistic trap in which sovereign ratings are caught relates to the aspect of comparability. Via the conferred impression of measurement, sovereign ratings suggest that the results are comparable. The ordinal scale portrays the sovereigns under consideration as comparable units. However, because rating is a judgment, the rating's ontology reveals the comparability illusion behind the endeavor to measure creditworthiness on an ordinal, metric scale. Although their genesis lacks an a priori comparative method, ratings establish comparability ex post. Here, too: The more CRAs take the idiosyncrasies of the sovereigns into account in their deliberations of creditworthiness, the more thorough their analysis would be. The alleged comparability of ratings would simultaneously suffer even more. In a nutshell: The scientistic trap that contributes to the CRAs' credibility essentially constrains their freedom to do their job properly.

To this day, econometric research faces difficulties with quantifying, or objectively measuring, sovereign default risk. There is as yet no academic consensus on the 'formula' that underlies sovereign creditworthiness. The optimal levels of public indebtedness are still central issues in the scholarly controversy, which the debate on government debt and its relationship with economic growth illustrated in the context of the "Reinhart-Rogoff coding error" (Herndon et al. 2014, Pollin & Ash 2013, Financial Times 2013, Reinhart & Rogoff 2010). Which debt-to-GDP and deficit-to-GDP ratios are thresholds which a sovereign should not cross are, therefore, unsettled, controversially discussed issues in economics.[14]

One the one hand, the limited number of sovereign defaults can explain the contested state of knowledge about issues related to sovereign creditworthiness, making reliable stochastic calculations virtually impossible, as discussed above. From a different epistemological standpoint, it can be argued that uncertainty characterizes "unique national contingencies" (Paudyn 2013, p. 19), which thus "elude being captured through quantitative techniques" (ibid., p. 22)—measuring sovereign creditworthiness thus becomes mission impossible.

Ironically, this might be one reason for many social scientists' conviction that political

[13]Owing to the questionable feasibility of economic prediction, Porter (1995, p. viii) claims the "need for a more profound consideration of the relations between economic mathematics and the practices that support forecasting and policy advice."

[14]The political realities are the converse: The European Stability and Growth Pact criteria regarding fiscal policy and anchored in the Treaty on the Functioning of the European Union (including the Maastricht criteria), but also the stricter rules codified in the "European Fiscal Compact," which came into force in 2013 (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union), suggest that policymakers have a clear idea of the optimal government debt and deficit levels.

variables are merely correlates of economic variables, thus having no significant effect on the sovereign rating of a country (Rosenbaum 2008, p. 41).[15] Indeed, the measurement problem of sovereign default risk and creditworthiness may be another reason for the existence of sovereign ratings, for their added value, and for the difficulty substituting them; as if someone 'has to do the job' if the social sciences have no recognized or clear answers.

The intersubjective quality of the rating knowledge contributes somewhat to solving the measurement problem of sovereign creditworthiness, and explains the consensus on overlooking the divergence between the representation of ratings as metric, ordinal variables and the ontology of sovereign ratings as judgments. This intersubjective quality allows the rating to simultaneously be opinion and technical product. The reported methodology is thus a *necessary* lip service to the canon of commonly considered relevant knowledge in the sovereign creditworthiness discourse. The published methodology helps pretend that an act of measurement occurs, although none is undertaken, and helps overcome the mission impossible of measuring sovereign creditworthiness.

It is an open secret that this measurement problem prevents the CRAs from strictly applying a rule-based, self-binding algorithm to the decision-making process preceding the rating action. Indeed, the CRAs themselves admit that the sovereign analysis is very complex. Consequently, either changing the way of representation (signifier) and keeping the significant (judgment), or keeping the former and changing the object of measurement to something more suited to metric representation, could solve this Gordian knot.

However, there is a clear-cut limit to this thought experiment. This limit is one-to-one related to the impossibility of conceiving of the rating judgment as the product of the mere summation of an 'objective' (often labeled the quantitative) and a 'subjective' (often labeled the qualitative) part. A considerable quantity of the macroeconomic fundamentals may, of course, be beyond debate (apart from a few exceptions, e.g. the degree of external and internal indebtedness). These fundamentals could be seen as the 'usual suspect variables' used in the quantitative part of the rating. Admittedly, the quantitative data also require interpretation (Moody's Investors Service 2002, p. 5). Therefore, even if CRAs were to exclusively use a quantitative algorithm for sovereign ratings, they would still not be objective, but inter-subjective, socially constructed measures of sovereign default risk.

'Economicism,' n.: The Intrusion of Economics Into Everything Else

According to Kessler (2013, p. 47), the task of constructivist political economy is to examine how the terms and concepts of economics can shape social reality. An inquiry into the practice of sovereign ratings reflects this mission directly—CRAs borrow the lan-

[15] Armingeon (2012) and Gärtner et al. (2011) challenge the conventional wisdom, and find that political conditions and qualitative components do have an independent influence on the assessment of the creditworthiness of a sovereign bond issuer, even after controlling for economic fundamentals.

guage, the concepts and variables they use to talk about sovereign creditworthiness from the discipline of economics. This is no coincidence. Speaking the language of economics results in the privilege of being perceived as an epistemic authority, which produces the relevant and dominant knowledge of our times (Fourcade et al. 2014, Mitchell 2008, 2005).[16] There is another parallel between economics and the CRAs: Economics (similarly to the CRAs) faced harsh criticism in the wake of the financial crisis (Skidelsky 2014, Hodgson 2009, Lawson 2009). Whether this criticism had any meaningful effect on both economics and the CRAs, is still an open question.[17]

The developments in economics over the last decades, "from interwar pluralism to postwar neoclassicism" (Wade 2009), contributed to the intellectual basis required to tacitly approve disguising a judgment as a technical metric, which absorbs the normative implications inherent in judgment (Fourcade 2006). Of all the social sciences, economics may be the discipline which aspires most to be equal to the natural sciences. A step in achieving this aim, is to deny its inherent political nature and to claim objectivity (Piketty 2014, pp. 573-575).

According to McCloskey (1983), in so doing, economics, resonates with the "precept of modernism," for example, with "Kelvin's Dictum" which maintains: "When you cannot express it in numbers, your knowledge is of a meager and unsatisfactory kind." The predominant position of quantified knowledge implies a "trust in numbers" also for governance purposes (Porter 1995, Löwenheim 2008, Fioramonti 2014, Kelley & Simmons 2015). One-sided orientation towards quantification is not a substitute for judgment, experience, and practical reasoning (Rödder 2010, own translation). However, the trend towards quantification with its categories of 'more or less' has crowded out the qualifying power of judgment with its categories of "right or wrong" (ibid.). Further, since "quantification is a technology of distance," it legitimately allows "governance at distance." Applied to CRAs and sovereign ratings, this means that the desire for quantification, which the clear-cut rating format facilitates, can assume away the normative ideas of right or wrong inherent in judgment. Regardless of its normative implications (Frydman 2013), a judgment is disguised as a figure for credibility's sake.

Economics could adopt a scientistic stance by means of the methodological dimension and by rejecting methodological pluralism. Not only is the dogma of quantitative research methods necessary to meet the self-set scientistic requirements, but the claim of absoluteness of the own methodological approach can also obscure world views. Methodological monoculture can keep the ideal of value-freeness of social science research alive, thus disregarding common beliefs, normativity, and the inherent political nature of the

[16] According to Cutler (2014, p. 28), the predominant position of financial expert knowledge, which is intellectually derived from the language of financial economics (Fourcade & Khurana 2013), will ultimately also undermine the primacy of politics over economics.

[17] The "International Student Initiative for Pluralism in Economics" (ISIPE) and the "Institute for New Economic Thinking" (INET) are examples of attempts to change the status quo of the economics discipline in reaction to the financial crisis (Handelsblatt 2014*a*). See the respective homepages: http://www.isipe.net & http://ineteconomics.org

discipline with its potential to shape social reality (Callon 2007, MacKenzie et al. 2007, MacKenzie 2006).[18] This is not to say that statistical techniques and mathematical models are per se problematic; instead, the insistence on them as the only legitimate tool of how to think and make sense of the social world increases the risk of being caught in a scientistic trap. Consequently, if an academic discipline conditions its scientific nature by means of a methodology, or even equates itself with it, then this allows the fallacy to infer value-freeness from the discipline through the method itself. Moreover, equating economics with a methodology legitimizes the application of economics' methods to objects of inquiry which go beyond the economic sphere (The Atlantic 2014, Sandel 2012). Objectivity is claimed tautologically "because it is economics."

This does not mean that 'anything goes' is the better answer to these challenges. Scientific principles can be applied in different methodological approaches, and do not disappear the moment normative considerations are expressed.[19] Quite the contrary: Claiming objectivity exclusively and feeling superior to any normativity reduce a social science discipline to dogmatism, and could transform it possibly into the least scientific of all disciplines. It is, for example, an open secret that "[n]eoclassical economics has built-in biases in favor of self-adjusting systems" (Wade 2009). Even though regarded less 'mainstream,' the same may hold for post Keynesian economics in terms of its focus on aggregate demand. According to the "bias blind spot," being too confident about the own powers of objectivity runs the risks of being less able to correct the own biases (Pronin et al. 2004, 2002). Insistence on the own objectivity makes the own biases even larger, and critical self-reflection less likely (Sandberg 2013, p. 153).

McCloskey (1983, p. 488) also links susceptibility to beliefs to modernism, which "promises knowledge free from doubt, metaphysics, morals, and personal conviction." Giving the "Scientific Method" credit would largely result in renaming "the scientist's and especially the economic scientist's metaphysics, morals, and personal convictions." "Belief" trumps the "evidence of a suitably modernist and objective sort" (ibid., p. 493). The "strength of prior beliefs" is therefore the basis from which economic and econometric conclusions are derived (ibid., p. 495). Put differently, results and conclusions that are not in line with prior beliefs may have a hard time, for example, in peer-review processes.

By not revealing normativity for the sake of not compromising putative objectivity and scientific-ness, constantly jeopardizes the level playing field of debates. The scrutiny depends on the result (Wade 2002, p. 219), and varies to the degree that the results are in line with the own beliefs. Unequal requirements are the consequence. Furthermore, unexpressed value-loadedness allows critics to frame any coding or calculation error as evidence of the ideologically driven-ness of research. Likewise, unexpressed value-loadedness allows the accused to deflect critique and interpret it as ideologically driven, which cor-

[18] I thank Thilo Zimmermann for pointing out the contingent instrumental character of mathematical methods in economics regarding cloaking ideology.

[19] I owe this thought to Alexander Heppt.

responds to the popular belief that 'only others are ideological' (Handelsblatt 2014*b*).[20] As in the Reinhart-Rogoff (Die Zeit 2013) and Piketty cases (The Guardian 2014, Die Zeit 2014*b*), mistakes may be mistakes in the real sense, i.e. unintended and involuntary. Paradoxically, this option may become the least likely suggested case in a culture, in which acknowledging normativity is taboo. Reciprocal accusations of deception and data manipulation thus become the rule.

If an academic discipline were to allow a plurality of approaches, such shortcomings may be leveled out through a system of checks and balances. However, the moment a core or mainstream is established, it becomes tricky. As stated above, the demanded scientific rigor may vary with the degree of conformity with the mainstream.[21] Consequently, the scientific debate becomes hypocritical at worst, and scientific progress procyclical at best.

No degree of formal abstraction, or mathematical rigor, can prevent economics from being instrumentalized under the pretense of objectivity, whether by its creators or users. Therefore, improving the state-of-the-art in terms of formal modeling and econometric techniques, and simultaneously allowing more methodological pluralism, could be a possible exit strategy. The linchpin is, however, that the social sciences need to acknowledge that absolute objectivity and value-freeness is impossible. Debates may become more fruitful and productive, but also more authentic and honest. Scientific scrutiny would then be equally critical across approaches. By making all camps' normative implications of their assumptions and world views explicit (Schlefer 2012), no camp could exclusively claim to be objective. Actors outside the academic realm, for example, lobby groups, financial institutions, international organizations, NGOs, policymakers, and, to close the circle, CRAs themselves, would then be less inclined to (unconsciously) politically instrumentalize economics. To put it briefly, economics would lose its sharpness as a latent ideological weapon. It might gain in terms of its approximated degree of scientific-ness, objectivity, and, not least, in terms of credibility. By revealing, instead of concealing, its value-loadedness, world views would be exposed and permanently questioned. The consequence may be real attempts of trying as hard as possible to falsify the own theories—self-reflection included (Schulmeister 2013).

The presented argument raises many practical questions in terms of its implementation. For example, how can the normative implications of the own assumptions and conclusions be acknowledged if one is caught in a scientistic trap, i.e. if the language to do so is not part of the legitimate toolbox? It is no coincidence that this is also the very dilemma CRAs face.

[20] I owe this thought to Andrea Grisold and Wolfgang Maderthaner.

[21] In the sense that a severity is applied to unconventional results and approaches, which may not be applied to results and approaches that are in line with the mainstream.

3.4 Uncertainty and risk: Taming or confounding?

A simplistic letter grade does not only give the impression of the apparent application of scientistic methods, which is conducive to the rating's credibility, but also supposes "a much greater reduction in uncertainty than can really be the case" (Bruner & Abdelal 2005, p. 211). By visualizing credit risk, ratings reduce investors' uncertainty, even though uncertainty has de facto not been tamed. The confounding of risk and uncertainty is tacitly taken into account in exchange for an impression of tamed uncertainty. As Fitch Ratings' slogan, "Know your risk," suggests, ratings presume that the very know-ability of risks contributes to a reduction in uncertainty.[22]

The rating representation via the rating format, which renders the incurred risk expressible, informs the optical illusion that creates the impression of reduced uncertainty. "[C]ondensing the highly complex contingencies of credit risk" into a letter grade, conveys the certainty of computable and, thus, controllable risks (Kerwer 2002, p. 43). The domestication of uncertainty is equated with the calculation and measurement of risks (Carruthers 2013). The "ostensible precision" of pseudo-quantified knowledge suggests certainty to investors. Although "risk signifies a method for acting on the basis of a calculation of the probability of a future occurrence and thereby to exercise control over an uncertain future" (Porter 2010, p. 56), CRAs can claim authorship of the common language of risk, even though no measurements take place. In its effect, uncertainty seems reduced.

Put differently, an accurate differentiation between risk and uncertainty (Katzenstein & Nelson 2013) would imply the end of the letter grade format. As long as investors regard the "analytical basis" of the rating as reliable, i.e. as long as investors are seduced by the measurement illusion and caught in the scientistic trap that makes them conceive of the rating as a metric, the rating seems capable to absorb uncertainty (Strulik 2002). Consequently, investors' risk aversion decreases and their risk appetite increases. Since the uncertainty does not de facto disappear, but is only undervalued, "unpleasant surprises about credit risk" and the emergence of certainty bubbles become likely (ibid.).

According to Katzenstein & Nelson (2013, p. 1117), this is exactly what happened in the years preceding the financial crisis. During the great moderation, uncertainty "had simply been assumed away." The opposite happens in situations of distress and crises: Uncertainty is overvalued, inciting excessive risk aversion in investors.

This is also in line with Sinclair (2009) and Marandola & Sinclair (2014), who classify the exaggeration of uncertainty as the main trigger for the crisis. The construction of "risk euphoria" during good times is the basis for the overreaction in bad times. From this perspective, the two patterns are not regarded as the consequence of "rule-breaking behavior." Instead, these patterns are seen as the consequence of the constitutive role

[22] Uncertainty has different meanings, depending on the epistemological approach. This subsection does not discuss the game theoretic concept of uncertainty, which refers to incomplete information about other actors' actions.

that ratings play in finance, which comprises the obfuscation of risk and uncertainty.

The concept of risk is based on a law-based idea of human behavior and social reality—assuming away contingencies and contexts, as well as historical dimensions. Instead, the concept implies an automatism in social relations, as if fiscal and economic policies, public budgets, governments, economic growth, etc. work according to exogenously given rules. Moreover, according to this implications, events such as systemic crises are virtually not existent. According to McCloskey (1983, p. 484) this idea is deeply rooted in the precepts of modernism, in which the "scientific explanation of an event brings the event under a covering law." The same logic can be transferred to the practice of scientistic prediction by means of deterministic indicators. The repeatability of results is assumed. In turn, predictions incorporate an apparent preciseness about the course of future events, and, can have performative effects by reproducing the world view they helped to predict (MacKenzie 2011, 2006).

The recognition of stand-alone uncertainty that exists beyond the (apparent) calculation of risk, makes practical knowledge and intersubjective processes the focus of inquiry (Kessler 2013, p. 36, own translation). As stated above, the intersubjective quality of the rating knowledge explains the tacit agreement to overlook the divergence between the representation of ratings as metrics and their ontology as judgments. Their intersubjective quality allows the rating to simultaneously be opinion and technical product. Similarly to the reported methodology, a set of intersubjective ideas may inform the legitimacy of overlooking the overall uncertainty of the rating assessment. These ideas, which are interwoven in the rating, help stabilize expectations and deal with uncertainty. According to Abdelal (2009, p. 73), "the pervasive uncertainty" faced by "agents and groups leads them to adopt heuristics, rules of thumb, and other devices to guide their decisions." Therefore, although it may be commonly known that CRAs operate "behind the veil of highly technical analysis" (Katzenstein & Nelson 2013, p. 1117), ratings seem to be nonetheless needed as heuristics and rules of thumb—not for the sake of uncertainty reduction, but for uncertainty navigation. Implicitly, it is in investors' interest that the veil of technicality of ratings is maintained in order to maintain a social construction that delivers the "stability that makes political and economic transactions possible" (Abdelal 2009, p. 73).

Drawing on Hayek (1976), Kessler (2013) notes that this epistemological dimension of uncertainty even goes beyond the Knightian concept of uncertainty (Knight 1921), which assumes that "agents cannot [..] estimate the probabilities of various outcomes" (Abdelal 2009, p. 74).[23] Going beyond the Knightian concept implies the rejection of the idea that any "part" of uncertainty can be absorbed, reduced or circumvented by actual (and alleged) risk calculation. New uncertainty is produced with every presumed risk calculation. Further, as a Knightian legacy, the risk-uncertainty dichotomy "tend[s] to

[23] According to Abdelal et al. (2010, p. 12), the Knightian concept of genuine uncertainty, in which "no basis for forming 'calculable probabilities' over a certain range of possibilities" exists, resonates with the one used by Keynes (1937) (see also Kessler 2013, p. 35).

downplay the interpretive dimensions of the limits of knowledge," therefore Best (2008) suggests rather taking "intersubjective and contested forms of ambiguity" into account.[24]

The construction of safety: the case of the sovereign debt crisis

According to Bruner & Abdelal (2005, pp. 194-195), historically, the CRAs

> have depended, perhaps paradoxically, on some instability in sovereign bond markets: Crises and defaults increase the potential value to investors of the agencies' expertise at the same time that they threaten to dry up the market or expose agencies to criticism.

For the CRAs, sovereign debt crises in particular represent both a reputational exposure *and* an opportunity to restore damages to their reputation. During the Asian financial crisis this became visible for the first time, when "rating agencies attached higher weights to their qualitative judgment than they gave to the economic fundamentals" (Ferri et al. 1999, p. 394).

It seems that in the course of the European sovereign debt crisis, history repeated itself: An increase in the frequency of sovereign rating events and the attention paid to them accompanied the crisis endogenously. In the media coverage on CRAs, which almost indulged in 'CRA bashing' (Sinclair 2010), professionals, practitioners, and policymakers found different reasons to criticize them (Alessi et al. 2013). Concerning the sovereign rating practice in particular, economists' criticism related directly or indirectly to the difficulty of quantifying sovereign default risk. For example, CRAs faced accusations of arbitrariness for having downgraded countries more severely after 2008 than the economic fundamentals apparently justified (Fuchs & Gehring 2013, Gärtner et al. 2011). The 'qualitative' component of the assessment seems to have again made the difference, as it had done in the Asian financial crisis.[25] Another strand of criticism related to the timeliness of sovereign rating events; changes would have occurred too late, thus merely reflecting the information already known in the market (Gaillard 2014).

A possible explanation for the CRAs' more "conservative" assessments of sovereign creditworthiness is that they have been trying to compensate for past mistakes, and are demonstrating their learning capability in order to restore their credibility after the rating failures that led to the financial crisis (Bruner & Abdelal 2005, Ferri et al. 1999). Such a reading of the deterioration of sovereign ratings points to their procyclical effect on the market's sovereign risk perception. Instead of mitigating and correcting this perception, ratings seem to have favored herd behavior in bad times, and conferred 'false' certainty in good times.

[24] In contrast to Best (2005), Best (2008) conflates the concepts of intersubjective and contested ambiguity.

[25] Gärtner et al. (2011) undertook an arbitrariness check and found a lack of consistency: During the sovereign debt crisis, economic fundamentals could not explain sovereign ratings. Deviating patterns were found with respect to the past and across countries.

In the run-up to the financial crisis, the most notorious safety illusions which CRAs helped create, were the highly rated mortgage-backed securities and collateralized debt obligations. These safety constructions occurred on a large scale in the context of short-term wholesale funding activities, i.e. in the shadow banking sphere. From such a perspective, the financial crisis can be read as a run on the shadow banking system, starting in 2007 with the questioning of collateral (Tarullo 2013, Blyth 2013, Pozsar et al. 2010, Mehrling 2010). Contagious distrust in the soundness of securitized collateral and in the "solvency of borrowing entities" led to "dramatic short-term wholesale funding runs [with a] cascading, self-reinforcing quality."

This logic can likewise be applied to the subsequent sovereign debt crisis in Europe (Gabor & Ban 2015). Analogously, the latter can be understood as a run on repo markets, in which sovereign bonds became the collateral in question following the CRAs' problematization of sovereign creditworthiness,[26] which was visible in the sharp downgrades of European sovereigns. For example, in April 2010, S&P downgraded Greece to BB+, Portugal to A-, and Spain to AA within two subsequent days. A month later, Fitch downgraded Spain to AA+.[27] The private repo market reacted very strongly to these downgrades, revealing its sensitivity "to changes in the perceived riskiness of the collateral [i.e. sovereign bond]" (BIS 2011, p. 18).

However, this book argues that, unlike in the 2007 events, sovereign ratings were pivotal in triggering the turn to distrust and fueling the confidence crisis in sovereign debt, which led to the sovereign debt crisis. Whereas the "sharp downgrades of structured credit products [...] *followed in the wake of* the subprime mortgage crisis" (International Monetary Fund 2010, emphasis added), the sovereign rating practice itself facilitated the *excessiveness* of sovereign risk problematization by constructing an uncertainty bubble. In the case of the mortgage crisis, CRAs were not pivotal in correcting the safety illusion, which they had helped to create. It may have happened in any case.

From such a perspective, the continuous and permanent interference of sovereign rating actions on the bond markets could have acted as self-validating feedback loops, or self-fulfilling prophecies in terms of the deterioration of sovereign creditworthiness, which re-enforced the repo run on collateral bond markets, and deepened the confidence crisis in sovereign debt in general (Paudyn 2013, Gärtner & Griesbach 2012).

Regarding the interbank and repo market, the resolution of this confidence crisis is usually linked to the ECB's long-term refinancing operation that began in December 2011. This kind of monetary policy, which the ECB has adopted during the last few years, has sparked sharp opposition from the fraction of economists who regard these confidence-reconstruction attempts as meaningless. These economists believe they only postpone the fundamental problems of certain European sovereigns. If, however,

[26]Between May 2007 and June 2010, the main rating drivers and communicated rationales for the sovereign downgrades were public finances, deficit figures, gross public debt, and the general macroeconomic situation and growth (International Monetary Fund 2010, p. 103).

[27]For a timeline of key sovereign debt events, see BIS (2011, Annex 3, p. 46).

sovereign risk concerns were to a great extent constructed, also through the excessive sovereign rating downgrades and the procylicality of risk perception, then the central bank interventions might have had their raison d'être.

This is neither to deny that there are structural weaknesses, nor to annihilate the possibility of questioning sovereign creditworthiness fundamentally: Since the notion of risk-free government bonds in the past could be constructed via the CRAs—perhaps more than fundamentals could justify—also the CRAs' excessive sovereign downgrades might have constructed the perception of excessive riskiness of sovereign bonds.

Chapter 4

The credit rating agency critique

"When two people quarrel, a third rejoices."

4.1 What does the critique teach?

This chapter analyzes the discourse *on* the CRAs, with a special emphasis on the years following the 2008 financial crisis. In this time, the CRAs have been in the public spotlight and faced criticism, possibly the harshest ever experienced in their history. Sinclair (2010) considers this 'CRA bashing' as "blaming the usual suspects." In its entirety, I label the loud criticism that the CRAs faced, the "CRA critique."[1] The CRA critique is not a monolithic bloc. The raised arguments often relate to different aspects and segments of the rating business, each pointing to different conceptions of "rating failure" and to different moments in the crisis.[2] Even though contradictory, the common denominator in these controversies consists in the principal problematization of the agencies' work, their role on financial markets, and, lastly, their responsibility for the financial crisis in one way or the other, although for different reasons. The issues of controversy analyzed in this chapter cover four macro topics of the CRA critique: the accusation of U.S. American bias, the problematization of the conflicts of interest, which are related to the issuer-pays business model, the admonition regarding the lack of competition due to the oligopoly of the "Big Three," and the criticism of the "delayed weatherman," which relates to the timeliness of ratings. Each subsection illustrates the main points of criticism that the CRAs faced in the context of each macro topic, and attempts made to invalidate them.

The spectrum of this "CRA critique" ranges between two poles, namely the over-determination of the CRAs' power (and sometimes even its quasi-demonization) on the one hand (Horstmann 2013, Rügemer 2012*b*, Dittmer 2011*a*), and the underplaying of

[1]The term "CRA critique" is not to equate with, for example, the term "CRA controversy" that the Council on Foreign Relations uses (Alessi et al. 2013), or the term "rating complex" that Rügemer (2012*a*) uses. These articles are not meta-analyses of the discourse on CRAs. They are themselves part of my data corpus.

[2]For example, for empirical evidence suggesting rating failure during the last global financial crisis, see Kiff et al. (2012).

it on the other (Gaillard 2014, Soudis 2015, The Economist 2013). Although these poles are mutually exclusive, in sum they seem to neutralize each other. The whole discourse dynamic seems to be stuck in a dead end, having stagnated in the face of the above mentioned established orthodoxies, thus corroborating that there are 'blind spots' in terms of the CRAs' authority.

As illustrated below, the different facets of the CRA critique, including the attempts to invalidate the concerned issues of controversy allude to one type of orthodoxy or the other. This dynamic may impede a constructive debate on a better understanding of the CRAs' authority, rather than facilitating it. Therefore, the meta-analysis of the CRA critique presented in this chapter aims at finding an exit strategy out of the currently deadlocked debate, one that suggests that a more thorough understanding of the CRAs' authority allows us to circumvent these two extremes.

At the same time, the purpose of this meta-analysis is not to evoke or demonstrate disagreement or agreement with the different issues raised in the CRA critique, or to question their validity. Filtering out certain aspects which go unnoticed in the mainstream CRA critique does not imply that other points of criticism are necessarily excluded. However, in order to enhance the state of knowledge about the CRAs' authority, I regard unveiling these blind spots of the debate as an indispensable exercise. Put differently, those aspects which the dominant CRA critique grasps may be necessary, but not sufficient, to understand the CRAs' role in contemporary global finance. Therefore, this meta-analysis provides a basis for assessing how (and whether or not) the dominant categories and narratives of the mainstream CRA critique address the core of the CRAs' authority. Ultimately, the deemed relevance of the mentioned blind spots in terms of the CRAs' authority will determine the meaningfulness of the social constructivist approach adopted in this book.

Moreover, the definition of the problems in the sense of the main issues of controversy which emerged in the aftermath of the crisis, and likewise their rejection, reveal much about the analytical perspectives that the different discourse participants adopted. For example, when CRAs respond to criticism, their counter arguments can often be deduced from the "synchronic-rationalist" principles in the mental framework of rating orthodoxy, according to which "knowledge is objective, cross-cultural and instrumental" (Sinclair 2005, p. 70, Table 5). From such an understanding, it is no surprise that the need for the CRAs' services (Sinclair 2005, p. 120) is one discursive strategy for legitimizing, for example, unsolicited sovereign ratings.

The presented narratives in the problematization of the CRAs do not only reveal a specific conception of the CRAs' role in financial markets, but also constrain the range of possible solutions for the type of selected problem. The different points of criticism imply a specific exit strategy out of the problem considered most compelling. For example, if the main problem deriving from the CRAs' authority really consisted in its American-ness, then the solution would lie in establishing a European CRA.

The last section discusses the common denominator across all the different camps of the CRA critique, namely the unanimous call for "more transparency." Remarkably, or perhaps not so accidentally, this 'mantra' has materialized both in the light of new attempts at CRA regulation and in the CRAs' external communication. Whether these apparently answered calls are able to effectively 'check and balance' the CRAs' authority is another question.

4.2 The U.S. American bias

One of the most prominent criticisms that CRAs face is related to their apparent "lack of cultural awareness" and "U.S.-centric orientation" (Bruner & Abdelal 2005, pp. 203-204). The roots of this type of accusation can be found long before the financial crisis of 2008. Especially the sovereign debt crisis in Europe could revive this narrative. In the context of the Asian financial crisis, CRAs were criticized for being unable to "really 'understand' Asian business practices" (Sinclair 2001, p. 443). Asian governments complained about the CRAs' sovereign downgrades, which they regarded as driven by U.S. standards and, thus, as an illegitimate intrusion into their domestic political affairs (Bruner & Abdelal 2005, pp. 203-204 and Sinclair 2003, pp. 151-155).

As the world's two largest CRAs, S&P and Moody's are exclusively headquartered in the United States. "[T]he epistemic predilections" of the U.S. are inferred from this geographical positioning and attributed to the CRAs (Sinclair 1999, p. 160). In this vein, sovereign ratings can be characterized as "a U.S. phenomenon" (Sinclair 2005, p. 120). By "subjecting all [differently institutionalized forms of capitalism] to the expectations inherent in the American model" (Sinclair 1999, p. 162), sovereign ratings can have "profound effects over time," resulting, for example, in more homogenous policies and practices. For example, specific characteristics of the bank-based financial system in terms of "European accounting or [...] financial ratios" gave rise to CRA criticism in Europe before the financial crisis (Bruner & Abdelal 2005, p. 204).[3]

In the wake of the financial crisis, especially when the CRAs started downgrading European sovereigns at a high rate and frequency, complaints about the CRAs' putative U.S. bias grew ever louder. For example, in 2011, German politicians of the then CDU-FDP governing coalition criticized the CRAs for their politically biased perception. These politicians consequently claimed the establishment of a European CRA (Die Welt 2011, Süddeutsche Zeitung 2011*a*).[4]

Folker Hellmeyer, chief analyst of the "Bremer Landesbank," a regional German bank,

[3]For an account of how "[b]ad experiences with the Anglo-Saxon–oriented raters have built up resentments among companies and financial institutions on the [European] Continent," see Engelen (2004, p. 69).

[4]Original quote by FDP politician Rainer Brüderle in German: "Da gibt es offenbar einen politischen Knick in der Optik." Own translation: There is obviously a political kink in the way the CRAs perceive Europe.

has become known for his criticism of the CRAs, characterizing them as "advocates of U.S. American interests" (Weserkurier 2010). Since CRAs are themselves part of the U.S. centric financial system and its institutional setting, their self-preservation instinct is therefore to maintain the system. Despite the high public indebtedness of the U.S., which is higher than that of some countries with a worse rating, the CRAs are not interested in questioning the creditworthiness of their domicile country. The CRAs' presumptive "clearly visible political agenda" would consist in weakening the relative position of the Euro with respect to the U.S. dollar in a competition for the status as international reserve currency. Without the Euro, the U.S. dollar would be almost unrivaled (Dittmer 2011*a*, own translation). In order to save the Euro from being a puppet of U.S. interests, the need for a European CRA is thus beyond question. Although this sounds like a weird conspiracy theory, Stephan Schulmeister, an economist of the Austrian Institute of Economic Research, states soberly: "The U.S. does, of course, have an interest in weakening the Euro's position as a reserve currency because the role of the U.S. dollar has weakened over the last few years" (ibid., own translation). Indeed, Levey & Brown (2005) emphasize that the dominance of the U.S. dollar is one of the main ingredients of U.S. hegemony.[5] However, Schulmeister leaves the question open of the extent to which the CRAs specifically function as an extended arm of the U.S. government in terms of downgrading European sovereigns in order to apparently protect its strategic interests.

At the same time, Hellmeyer relativizes the alleged U.S. interest in the "complete failure of the Euro," due to potentially systemic risks of a "Lehman-like" event. Rather, he interprets the CRA downgrades as "pricks" aimed at upholding the hegemonic position of the U.S. and the dollar (ibid., own translation).[6]

The empirical study by Vernazza et al. (2014) finds that sovereign ratings are biased, given that the "Eurozone periphery" is the CRAs' "biggest casualty." Measured against economic fundamentals, the relevant countries were "on average rated almost five notches" too strictly between 2009 and 2011. Further, according to Fuchs & Gehring (2015, 2013), empirical evidence suggests that sovereign ratings are biased "in favor of the respective home country, culturally more similar countries, and countries in which

[5] One of the contributing authors to Levey & Brown (2005) is a retired Managing Director of Moody's Sovereign Ratings Service. According to ibid. (p. 7), it will still be a long time before the "pre-eminence of the dollar and US capital market is challenged." They predict that although the U.S. is a net debtor hegemon, "no plausible challenger to its economic leadership exists, and its share of the global economy will not decline." Levey & Brown (2005) also question the competitiveness of "the euro as a threat to the dollar's status as the world's central reserve currency [...] the continuing strength of the U.S. economy relative to the European Union's and the structure of European capital markets make such a prospect highly unlikely." To what extent such prophecies can be self-fulfilling is a question beyond the scope of this book.

[6] At the time of writing, neither the CRAs nor the U.S. government seems to be deliberately pursuing a strategy in favor of a fragmentation of the euro zone. Against the background of the escalation of the situation with the Greek government in 2015 and the official U.S. position, the contrary seems to be the case. However, if the "pricking" theory is correct, then this could also be interpreted as a case of the proverbial experience of Goethe's "The Sorcerer's Apprentice": "Spirits that I've cited My commands ignore."

home country banks have a larger risk exposure." These results do not only apply to the CRAs, but also to smaller agencies, such as the German "Feri Eurorating Services," and the Chinese rating agency "Dagong." These authors also find evidence that, especially in the aftermath of the financial crisis, U.S.-based CRAs gave European states excessively severe sovereign ratings compared to the U.S. sovereign rating (Die Zeit 2014*a*). That is why the authors not only call for more competition, but also for a greater variety in rating agencies' domiciles. Different national and regional backgrounds could balance the biases, making the ratings more 'objective' and reliable.

In the light of the presumed home bias of the dominant rating oligopoly, practitioners' and academics' call for a more heterogeneous landscape of rating agencies is understandable. Questions of desirability aside: Although a European-based CRA still seems out of reach despite the harshness of the recent CRA critique, the criticism CRAs faced in the course of the Asian financial crisis led indeed to the development of domestic agencies (Bruner & Abdelal 2005, p. 204).[7] For example, the Beijing-based Chinese rating agency, "Dagong Global Credit," was founded in 1994 with the support of state and public research institutions.

In October 2013, Dagong gained prominence in the Western world due to its downgrading of the U.S. from A to A- with a negative outlook (Reuters 2013*a*). Despite the "last minute agreement in Congress" in the context of the debt ceiling and shutdown debates that prevented the default, according to the Dagong press release at that time, "the government is still approaching the verge of default crisis [...] a situation that cannot be substantially alleviated in the foreseeable future." Debt growth in the U.S. would still outpace fiscal income and GDP (ibid.). Given the CRAs' deviating benign U.S. sovereign ratings at the time, Dagong Chairman and founder, Guan Jianzhong, blamed the CRAs for "having lost their professional ethics" (Süddeutsche Zeitung 2013*b*, own translation).[8] For example, he criticized the CRAs' approval of the expansive monetary policy of the Federal Reserve. He believed the CRAs were effectively acting as a prolonged arm of the U.S. government.

In the midst of the sovereign debt crisis in Europe, Guan also commented on the CRAs' putative ideologically driven standards. According to him, the applied sovereign rating criteria would, to a great extent, have nothing do with a sovereign's practical capacity to repay its debt (nota bene, not willingness). According to Guan, aspects such as central bank independence, the openness of the economy or of the financial sector, and currency convertibility are irrelevant factors for a sovereign's creditworthiness (Die Tageszeitung 2011, own translation). According to his account, the CRAs would equate sovereign creditworthiness standards with the Western standards of liberal democracies.

[7] For a concise overview of why simultaneous efforts to build a European CRA failed in the decades preceding the financial crisis, see Engelen (2004, p. 65).

[8] At that time, Moody's rated the United States Aaa with a stable outlook, Fitch AAA with a negative outlook, and S&P AA- with a stable outlook (Reuters 2013*b*, Böcking 2013). S&P's downgrade to AA- had occurred two years before in the course of the previous debt ceiling debates (Reuters 2011*c*).

Deviation from this ideal type would therefore inform the ordinal rating scale. Guan felt that it would not be "sensible" to stylize an ideology as a benchmark for the assessment of sovereign credit risk. Instead, Dagong takes factors such as the policy effectiveness of the "system" on its economic management into account, or the extent to which the financial sector serves the needs of the real economy (ibid.). Unlike the CRAs, Dagong seems to factor out the tricky task of assessing a sovereign's "willingness" to repay its debt. Instead, the Chinese CRA presents its sovereign analysis as an apparent de facto capability approach. However, the focus on output legitimacy in terms of the practical capacity to repay the sovereign debt cannot hide the fact that rating assessments are, nonetheless, subject to normative and controversial considerations. For example, given Guan's deviating opinion in terms of what constitutes a 'good' monetary policy, depending on circumstances and historical situations, reveals that the politics of creditworthiness and its ambiguities remain.

Guan suggests a "reform of the international rating system" as an answer to his criticism of the CRAs. An explicit international rating institution could provide a platform where the rating agencies of all countries could work together in order to guarantee the safety of the "global credit systems" (Die Tageszeitung 2011, own translation).

Although privately owned, Dagong has faced criticism for not being independent and for being the extended arm of its domestic government. Chairman Guang never tires of repeating that there are no ties between the Chinese government and Dagong (Süddeutsche Zeitung 2013*b*,*a*, Tages-Anzeiger 2013, Die Tageszeitung 2011). Dagong opened its European branch in Milan in 2013.

Counter arguments

For Hackhausen (2012, own translation) the "fairy tale of the American conspiracy" has many flaws. He believes the exaggerated hostility towards the U.S.-based CRAs can be explained in the light of the series of downgrades of European sovereigns, which many policymakers had interpreted as an affront.[9] Quoting former EU commissioner Michel Barnier, who criticized the CRAs for not taking many EU governments' unprecedented reform measures sufficiently into account, Hackhausen infers that the EU is unwilling to accept "bad grades."[10] The policymakers' discomfort is the reason for accusations of partiality, and even for conspiracy theories about U.S. imperialism that not only leftists make, but also practitioners, such as asset managers. It is a fact that the CRAs are privately organized and are not officially linked to the government in Washington D.C. However, conspiracy theories are hard to falsify and are therefore persistent. The actual

[9] According to Brummer & Loko (2014), this explains the higher intensity of EU reforms of CRA regulation compared to those of the U.S. (Dittmer 2011*b*).

[10] In 2011, Michel Barnier, the European internal market commissioner at the time, proposed a temporary ban on the issuing of sovereign ratings for countries in bailout talks (The Wall Street Journal 2011).

problems that need solving are the regulatory, institutional, and market reliance on CRA ratings.

With regard to criticism of sovereign ratings, "a curious dialectic in rating agency–state relations" manifests itself. Sinclair (1999, p. 160) notes that "when states are downgraded by the major global agencies they are often vocal in their denunciation of the judgments." Naturally, when states tacitly enjoy and welcome their AAA status, thus acknowledging the validity of the judgments, they lose credibility when they dislike the ratings, or even question their validity, when the tide turns. The entity being judged is therefore not best positioned to criticize the judgment. The political class loses credibility if it enjoys the benefits of sovereign ratings in good times and rejects them in bad times. A sovereign debt crisis is therefore not the best time to address the societal problems arising from the politics of sovereign ratings since policymakers will always be accused of wanting to take revenge on their judges.

Another argument which calls the criticism of the CRAs' U.S. home bias into question, is related to the potential over-emphasis of the vested interests argument. Sovereign rating downgrades may weaken the Euro, from which the U.S. dollar may benefit, but this does not automatically imply that the U.S. government, or the CRAs, pursues a political agenda.

As mentioned above, in line with the "synchronic-rationalist" mental framework of rating orthodoxy that Sinclair (2005, p. 70) developed, the CRAs' insistence on the cross-cultural nature of their sovereign ratings implies, by definition, the impossibility of having a U.S. American bias from their perspective. Unsurprisingly, CRAs therefore also dismiss such criticisms as conspiracy theories. For example, S&P rejects accusations of partiality in its sovereign risk analysis. Moritz Krämer, Head of EMEA Sovereign Ratings at S&P, asserts: "We do our work" (Hackhausen 2012, own translation).

S&P downgraded the U.S. on 5 August 2011, which is taken as further evidence to falsify the U.S. home bias reproach (Hackhausen 2012, citing German politician, and former ECB board member, Jörg Asmussen). The weakness of this argument lies in the fact that the CRAs were already criticized for being less strict with the U.S. in their sovereign analysis at the time. Nevertheless, it is difficult to assess to what extent this rating action can be interpreted as a reactive attempt to weaken the accusation of home bias. The market reactions to the downgrade were remarkable: Treasury bills (T-Bills) rose in value, and yields went down (Reuters 2011*c*, CNN money 2011). Market reactions to downgrades of euro area sovereigns usually move exactly the other way around.

The American case almost suggests the unshakable firmness of the market's belief in the dollar and in the U.S. creditworthiness—as if what is perceived as a home bias in sovereign rating outside the U.S. may actually only be the CRAs' reproduction of this market belief. However, these beliefs do not come entirely out of the blue. Material reasons definitely also inform them. To this day, the U.S. dollar has a unique position as the world's leading reserve currency (Norrlof 2014). It therefore enjoys certain privileges,

which makes a straightforward comparison with its peers difficult, i.e. compounding the idea of relative ratings.[11] Moreover, the Federal Reserve's political commitment to guarantee domestic sovereign creditworthiness by not questioning the eligibility of U.S. government bonds as collateral for its central bank operations, practically undermines the CRAs' epistemic authority in terms of U.S. sovereign creditworthiness—which differs greatly from the European counterpart: The ECB seems to need an independent third party opinion on the sovereign creditworthiness of its member states.

The call for a European CRA due to the revived CRA critique in terms of its supposed U.S biased-ness, remains unanswered at the time of writing. The main challenges of such a project are the CRAs' dominant market position, and the potentially implied conflicts of interest of such a European institution, which would undermine its credibility. If the European Union, or other public institutions, were to promote a European CRA, its independence, especially in terms of sovereign analysis, would be questioned (Bartels & Weder di Mauro 2013). Given the importance of reputational capital for the rating market, the prospects of a "Quasi-Public European Union Credit Rating Agency" being a success are deemed very low (Paudyn 2011). Moreover, a European CRA would only "entrench" the principal problems with rating—from the amplification of systemically destabilizing "cliff effects," to ceding "further sovereign authority to market forces," and the maintaining of the "fallacious analytics of rating" (ibid., p. 259).[12]

From a different perspective, Bartels & Weder di Mauro (2013) question the usefulness of a European agency. They find evidence "that European countries would have received an even tougher treatment from a European rating agency than from the US-based ones." They come to their findings by analyzing the sovereign ratings of the smaller German agency, "Feri." Although the extent to which Feri really reflects "an unbiased *European* view" (emphasis added) may be questionable, it nevertheless shows the propensity for biases in sovereign rating analysis in general. According to Bartels & Weder di Mauro (2013) Feri seems susceptible to a negative "neighbourhood bias," which even tends to outperform the CRAs' presumptive home bias: During the crisis, "Feri was even more aggressive both in terms of a lower level and a higher propensity to quickly downgrade Eurozone problem countries than the Big Three."

According to Sinclair (2005, p. 120), the global expansion of CRAs with subsidiaries and allies all over the world contributes to an increasingly "transnational" character of rating. With differences between rated entities diminishing because of the converging dynamics in the global financial system and of globalization, the question remains whether these convergences are partially also the consequence of a harmonizing force derived from a common measure, for example, from the rating itself. At the same time, if the degree of variation between countries decreases, it may be difficult to infer the

[11] From this follows that the CRAs, at least theoretically, would do themselves a favor if they withdrew their U.S. rating.

[12] Economists tend to frame the latter point as CRAs "not understand[ing] or adequately model[lig] the economic fundamentals" (Bartels & Weder di Mauro 2013, Afonso et al. 2012).

kind of bias the sovereign rating actually suffers. Sinclair (2005, p. 120) conceives of the "transnational view" an affirmation of "the agencies' US origins, norms and practices." He thus infers that "the mental framework of rating remains largely American." Such an equation hinges critically on the understanding of "American" and "transnational."

Abdelal (2007, p. 3) maintains that there is an "important misconception of the conventional account" of the role of the United States concerning the origins and politics of financial globalization. What if the criticism of the CRAs' U.S. American bias is based on this misconception and the CRAs should instead be regarded as crucial players in the general development of global financial capitalism? For example, Ouroussoff (2010) constructs the CRAs as a counterpart to the executives in charge of the world's largest corporations. According to Ouroussoff (2010), the dichotomy lies between the CRAs as representatives of a new model of capitalism, "whose task it is to enforce the criteria on investors' behalf" and "the old model of the risk-taking entrepreneur." On Wall Street, the "silent war" between these two counteracting forces would shape the global economy.

Also Abdelal & Blyth (2015, p. 25) point out that "[i]t is not the American-ness of the [CRAs] that creates the key problematique. The challenges are more fundamental to the practices of regulatory delegation and producing market conventions." That said, a global market convention of relying on a third-party opinion on sovereign creditworthiness, whoever issued that opinion, can exert normative influence on the rated sovereign once the opinion is thought to be relevant to a critical amount of investors. Put differently, the politics of sovereign ratings and finance will probably survive also without credit rating agencies based in the U.S., but based somewhere else. As the CRAs' discursive participation in the debt ceiling debates in the U.S. has shown, an intrusion in domestic politics can happen both by maintaining a triple A rating when the course of events matches the CRAs' view, and by issuing warnings to withdraw it when the situation evokes the CRAs' disapproval.

4.3 Conflicts of interest

At the latest since the financial crisis, CRAs have come under the spotlight for their apparent "positive bias in rating." This perspective, which may already have achieved common sense status, regards the highly optimistic ratings of structured instruments, which were later revealed to be 'toxic assets,' as one of the main causes of the financial crisis, or at least as a significant contributor to it. Such an attempt to explain the crisis derives from the toolbox of neoclassical economics, which emphasizes traditional microeconomic problems of incentive structures and asymmetric information (Dullien 2013). These approaches classify the problem of "bad incentives," given the assumption of rent-seeking behavior, as the main cause of the experienced "rating failure" (Bartels & Weder di Mauro 2013).

"Systematic misjudgments" are explained as due to the conflicts of interest inherent

in the issuer-pays business model of rating (ibid.). "Rating inflation" is interpreted as "an attempt to attract issuers and increase fee revenues," and as an "unintended consequence" of the predominant business model, in which the same issuer whose bonds the CRA rates, also pays the CRA (Bartels & Weder di Mauro 2013, Mathis et al. 2009). Furthermore, the "cross selling" of consultancy services in terms of the structuring and the securitization of financial products, may have exacerbated the conflicts of interest and the positive issuer-pays rating bias (Amtenbrink & Heine 2013, de Haan & Amtenbrink 2011). Dullien (2013) argues that the auxiliary consultant service that issuers were offered also comprised direct ex ante suggestions on how to modify complex structured products in order to obtain a better rating. As a result, CRAs were first complicit in enhancing the complexity of financial products and thereafter in overrating them (Marandola & Sinclair 2014)—two aspects which burden the CRAs in terms of their contribution to the financial crisis.

This perspective is in line with the statements that the former senior analyst at Moody's, William J. Harrington, made. He confirmed that the conflict of interest deriving from the issuer-pays business model "pervades every aspect of Moody's operations." According to his accounts, "[t]his culture of conflict [...] is so pervasive that it often renders Moody's ratings useless at best and harmful at worst" (cited in Blodget 2011).[13]

The rating industry's regulatory reform efforts are specifically aimed at increasing the separation requirements between the different CRA business units, i.e. a "Chinese wall" between marketing and rating production. The reason for this separation is that incentive problems are deemed as the main cause of the misrepresentation of credit risk. The prevention of "moral hazard" in practices of securitization is thus regarded as key for the quality of ratings. Put differently, the existence of conflicts of interest is regarded as one of the main causes of rating failure. According to Dullien (2013), the policymakers' problem identification also reveals a neoclassical analytical perspective.

As causes of rating failure, conflicts of interest are not only related to the issuer-pays business model, but also to the structure of ownership. The argument is that ratings would not be determined independently, but strategically in order to maximize the shareholders' return on equity. Put differently, CRAs would not be the extended arm of the U.S. government, but of its owners. According to Rügemer (2012*a*,*b*), the positive development of the CRAs' profits during the crisis suggests such dynamics.

Due to the public good character of rating and related free-rider problems, a reintroduction of the investor-pays business model seems unlikely, and would lead to other conflicts of interest. Downward biases could occur since CRAs might be inclined to please their customers, i.e. the investors in this case, by being excessively strict when assessing bond issuers.

As discussed elsewhere in this book, there is an inherent tension between the

[13]See also "Comments on Proposed Rules for Nationally Recognized Statistical Rating Organizations" by the SEC, to which William J. Harrington, at the time of writing, had submitted two comments (29 May 2014 and 8 August 2011). Source: http://www.sec.gov/comments/s7-18-11/s71811.shtml

informational function of rating (i.e. intermediation between those with and those seeking funds) and its commercialization. Regardless of which business model is chosen, because of this basic conflict, rent-seeking behavior can never be excluded. However, this does not mean that rent-seeking behavior can explain everything related to rating failure.

Counter arguments

To what extent is the argument of the conflicts of interest based on an over-emphasized logic of vested interests? Does it undervalue the factors outside the CRAs' control, and does it implicitly exaggerate the CRAs' power? Just because the CRAs profited over-proportionally during the crisis years compared to other financial market institutions, this does not automatically imply that their ratings were causal to this and manipulated accordingly.

The conflict of interest logic does not apply to sovereign ratings since they are usually unsolicited. Thus, even today sovereigns cannot go "rating shopping" (Bartels & Weder di Mauro 2013). In turn, warnings have been issued against introducing solicited sovereign ratings. The argument is that, in such a scenario, sovereign ratings would be more inflationary as sovereigns would become the CRAs' direct customers. In line with this logic, which emphasizes the role of incentives as drivers of individual behavior, unsolicited ratings should be the most unbiased version of ratings because of the absence of incentives to underestimate (or overestimate) risks.

Nevertheless, one could construct a rent-seeking behavior explanation for rating bias even if ratings are unsolicited. According to Rügemer (2012*a*), unsolicited ratings would lead to conflicts of interest and, thus, a negative bias for the sake of customer acquisition. CRAs would strategically allocate bad ratings to those institutions that are not yet their customers, and, once they are in a contractual relationship with a CRA, reward them with better ratings. Rügemer's 'blackmailing' reproach refers to cases of U.S. municipalities' ratings.

However, if we consider that unsolicited sovereign ratings are, for example, subject to a home bias, this suggests that conflicts of interest cannot explain everything related to rating failure. The notion that a negative bias of sovereign ratings may occur beyond a logic of rent-seeking behavior and material interests, is an explanation derived from a different epistemological toolbox.

4.4 The lack of competition

Another prominent criticism of the rating industry relates to the oligopolistic market structure. Depending on ways of measurement, the market share attributed to the CRAs varies between 90 and 95%, of which Fitch owns approximately 15%, and the rest is divided more or less equally between S&P and Moody's (Bartels & Weder di Mauro

2013). Since the degree of competition would be too low, market power abuse and rating failure are difficult to prevent.

Drawing on the rent-seeking behavior of the CRAs and adopting a functionalist approach to rating, Straubhaar & Vöpel (2011, p. 817, own translation) infer from the CRAs' dominant market position, which enables them to trigger stock market crashes, that they may be tempted to manipulate the market in order to increase their profits. Insider information on pending rating changes, the strategic setting of ratings, and a smart communication strategy offer many competitive advantages in this regard, for example, 'going short' if a downgrade is pending.

How can direct intention be inferred from the market impact of ratings? Just because ratings can move markets, this does not imply that CRAs have an interest in doing so, even if they benefit from it. However, from a moral hazard perspective, the temptation following from market power cannot be ignored. According to Bartels & Weder di Mauro (2013): "In principle, these are ideal conditions for collusive behaviour." It is therefore no surprise that policymakers from the whole ideological spectrum, including free market-liberals, have asked for the CRA oligopoly to be broken up and for higher CRA's accountability (Süddeutsche Zeitung 2011*a*, Merkur 2011).

If rating failure is linked to the CRA oligopoly, it seems all the more puzzling that certain policies of recognition, such as the "NRSRO" (Nationally Recognized Statistical Rating Organizations) status in the U.S. and the recognized "ECAIs" (External Credit Assessment Institutions) by the ECB, support entry barriers to the rating market. However, the initial intention behind these regulations of registering was to guarantee the quality of ratings.

Another explanation for the CRA oligopoly refers to the regulatory use of ratings for the risk differentiation of banks' capital requirements, for example, in the standardized framework of the Basel regime (Lall 2012). In the scholarly literature on CRAs, the explanation of the CRAs' oligopoly by means of institutional and regulatory "authorization and delegation," is commonly referred to as the "regulatory license hypothesis," developed in Partnoy (1999, p. 623). Some scholars even regard the outsourcing of the regulatory tasks of systemic credit risk management to CRA ratings even as constitutive of the rating market (Abdelal & Blyth 2015, Besedovsky 2012, White 2010).

Counter arguments

Is the promotion of competition really the solution to prevent rating failure? From a conflict of interest perspective, an increase in competition may even exacerbate rating inflation. The demand side (i.e. bond issuers) would have a wider spectrum of suppliers from which to choose from, therefore CRAs would be under even more pressure to attract customers with favorable ratings. The reverse logic would apply to the investor-pays business model. CRAs might then compete to be the strictest in their assessments of

issuers. Therefore, the promotion of competition would not really lead to a decreased likelihood of rating failure.

But, what if there is already competition in the rating market? The CRAs' oligopoly can be hardly questioned considering the distribution of market shares. Nevertheless, in February 2015, ESMA, the European Securities and Markets Authority in charge of CRA regulation, launched a "call for evidence" of competition, choice, and conflicts of interest in the CRA industry (ESMA 2015). Purpose of the call was to "collect information from market participants about the functioning of the credit rating industry and the evolution of the markets for structured finance instruments as required by Regulation 1060/2009 on credit rating agencies as amended (the CRA Regulation)." Such initiatives illustrate that the CRAs' concentration of market shares does not necessarily mean that there is no competitive pressure in the rating market. According to CRAs' statements, there is no market concentration problem in their industry; "there is vigorous competition among CRAs in relation to price, quality and service" (Moody's Investors Service 2011, p. 13). Admittedly, these statements need to be treated with caution given the interests at stake for the CRAs to maintain their dominant market position. Nevertheless, such statements reveal that, in order to gain legitimacy, the CRAs try to construct their oligopoly as a result of market competition, and not of market failure. Competition is not understood as a process characterized by many players. Competition is understood in terms of its outcome which legitimizes the status quo.[14]

Although the rating market to date consists of almost 80 players worldwide (Mattarocci 2014, p. 35), the oligopoly of the CRAs seems persistent, which further suggests that a lack of competition is not the main cause of rating failure, even though smaller agencies "are normally specialized in one country or sector and can survive only if they develop distinctive skills in their market niche" (Mattarocci 2014, p. 121). Moreover, there seems to be a win-win situation between smaller players and the CRAs in the form of agreements. By building strategic alliances (ibid., p. 38, Table 3.3), small agencies can benefit in terms of the CRAs' reputation and degree of fame, whereas the CRAs can ensure their dominant market position.

4.5 The delayed weathermen

CRAs have not least been criticized for rating failure in terms of their ratings' timing (Hackhausen 2012). During the sub-prime mortgage crisis in the U.S. and the sovereign debt crisis in Europe, downgrades would have happened too late (Gaillard 2014, Eijffinger 2012, Tichy 2011). The common explanation for their deficient timing is that CRAs would only follow the market and would not provide any additional information. Critics are convinced that CRAs only reflect information that is already known in the market

[14]Crouch (2011) regards this way of thinking as symptomatic of the Chicago school of economics and in contrast to an ordo-liberal understanding of competition.

(Tichy 2011). This is the reason why a discussion on the CRAs' influence on markets would be rather meaningless. According to this logic, informational advantage is the main ingredient of influence. A lagged state of knowledge translates into a lack of influence.

Besides the metaphor of the delayed weathermen used to capture the timeliness problematique, CRAs are also associated with a notary image. CRAs would announce ex post what everybody knows, without influencing the course of events (Dittmer 2011*a*). The argument is that the act of predicting the weather would also not impact the weather. CRAs sometimes also use the image of a thermometer to describe their work. They argue that ratings would only indicate the temperature of a fever, not causing it (Hackhausen 2012, own translation).

Whether CRAs influence the market's perception of sovereign creditworthiness, and thus, the interest rates of sovereign bonds, cannot be easily grasped in econometric terms, which often holds true for econometrics and causality. The hesitation to claim causality relates to the difficulty of falsifying that CRAs do *not* influence the sovereign risk premia on a meaningful statistical significance level. This leads to the simple question of 'who follows whom,' the market the CRAs or vice versa? A simultaneity problem arises since both the market and the CRAs process new information. The belief in market efficiency assumes, by definition, that the market processes faster than the CRAs, and are, thus, also faster with pricing in new information. According to economic theory, CRAs need to be always late, and follow the market. Since causality is difficult to 'prove,' the dogmatic belief that "CRAs do not matter" is not falsifiable, and establishes the orthodoxy.

This orthodoxy is, in part, relativized in the case of solicited corporate ratings. Since the issuer would provide the CRA with insider information, the additional informational value of ratings would explain why markets also follow the CRAs, and not the other way round. Here too the CRAs' impact on the market is equated with informational advantage. In the case of unsolicited sovereign ratings, however, the irrelevance of the rating information is assumed to an even greater extent, given that sovereign ratings are based on publicly available information. From a nonexistent informational added value it follows that sovereign ratings cannot matter in terms of sovereign creditworthiness perception. The argument is that the market impact of a judgmental component is simply assumed away as only economic fundamentals matter; CRAs can thus be regarded as 'delayed weathermen.'

In line with orthodoxy, the Bank for International Settlements (BIS 2011), for example, circumvents the 'who follows whom' question by using the terms "sovereign risk" and "sovereign ratings" equivalently. The BIS does neither explicitly claim that investors' concerns about sovereign risk are subject to CRA assessments, nor that investors form their own opinion. However, in the context of the beginning of the euro crisis in the EU, the International Monetary Fund (2010, p. 103) commented on the market reactions to the CRA events slightly more explicitly: "[S]ome of these negative rating changes appear to have surprised markets, particularly the scale of the change."

Counter arguments

In the following, I elaborate why the comparison between CRAs and weathermen is misleading. First, a weatherman is, by definition, unable to influence meteorological laws. In terms of the very similar thermometer metaphor, an asset manager characterizes ratings, instead, as a thermometer that does not measure fever, but passes it on and affects confidence in a recovery (Hackhausen 2012, own translation).

CRAs *can* influence the perception of creditworthiness if they are believed or followed for whatever reason, otherwise their business would make no sense. For example, mechanistic market responses to rating changes result from the regulatory incorporation of ratings and from market practice, which voluntarily incorporates ratings as investment standards.[15]

Second, the delayed weathermen metaphor is in sharp contrast with the empirical evidence. For example, the erroneous French downgrade by S&P on 10 November 2011, can be seen as a quasi controlled laboratory experiment, which illustrates how much CRAs matter (Reuters 2011*a*):

> Standard & Poor's mistakenly announced the downgrade of France's top credit rating on Thursday, frightening investors already anxious over Europe's worsening debt crisis. The erroneous alert, which S&P said was sent to some of its subscribers, fed concerns that Europe's debt problems had engulfed the region's second-largest economy. It contributed to the worst day for France's government bonds since before the euro was launched in 1999.

If CRAs do not matter, why would the FSB launch an initiative to end the excessive rating reliance by public institutions and market participants (Financial Stability Board 2010)? Furthermore, there is a range of quantitative research that suggests empirical evidence of the effect of sovereign ratings on borrowing costs, i.e. bond yields, of a sovereign issuer (Afonso et al. 2012, Kiff et al. 2012, Gärtner & Griesbach 2012, Gärtner et al. 2011, Reisen & Von Maltzan 1999, Cantor & Packer 1996).

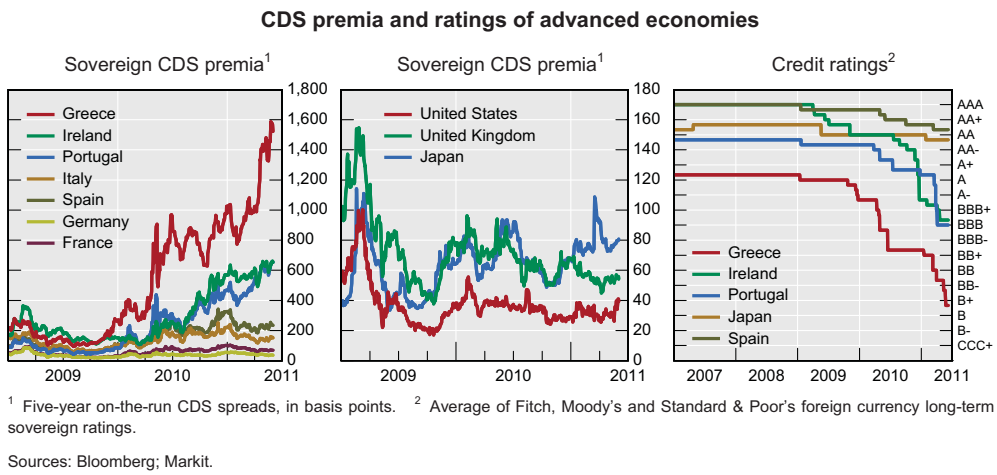
Third, even if the market has all the information about economic fundamentals on which basis CRAs decide, this does not prevent the market from reacting in any case. Bruner & Abdelal (2005, p. 201) state that "their 'announcements' continue to have impact." The informational added value is not necessarily the reason why the market reacts. Although sovereign ratings contain commonly known information on macroeconomic indicators, Cantor & Packer (1996, p. 49) find "evidence that the rating agencies' opinions independently affect market spreads." The CRAs seem to have an additional

[15]Even if, in line with the regulatory license hypothesis, one were to argue that the demand for ratings is purely regulation driven, this is not to deny that "[r]ating changes would, and do, literally move markets, particularly in the case of downgrading a security from just-above-investment-grade to just-below-investment-grade, prompting a sell-off by institutional investors" (Abdelal 2007, p. 171).

effect on market perception, which cannot be linked to "market information." Thus, the market does not seem to be immune against judgmental components that neither fundamentals can capture, nor the market can anticipate. Precisely because CRAs only use public information as their basic data for unsolicited ratings, it must be the judgmental dimension of sovereign ratings which accounts for the additional market move.

Another argument which questions the "delayed weathermen" metaphor relates to the incalculable character of the discursive elements that CRAs inject into the market. In the literature, credit default swap (CDS) spreads compete with sovereign ratings in their function as metaphorical 'clinical thermometers' for investors' concerns about sovereign credit risk (Hull et al. 2004). As Figure 4.1 (BIS 2011, p. 3) illustrates, the 'who follows whom' question cannot be answered satisfactorily by just comparing the concomitant deterioration of sovereign ratings with the increasing CDS spreads. If these increase before a credit rating event, this may be taken as evidence that CRAs follow the market and not vice versa.[16]

Figure 4.1: Credit Default Swap Spreads vs. Sovereign Ratings



Source: BIS (2011, p. 3)

Although the appropriateness of CDS spreads as a proxy for sovereign creditworthiness concerns may be debatable, such a comparison neglects that moves by the CRAs—starting with announcements, on watches, insider information, rumors, and outlook changes—flow "discursively" into the market's credit risk perception. Therefore, even if a widening of CDS spreads hypothetically precedes the actual rating change, this cannot be taken as a falsification of the CRAs' influence.[17] Discursive elements may

[16] In a panel discussion in 2012, a senior CRA manager used this argument to neutralize allegations that CRA drive markets by fueling investors' concerns about sovereign creditworthiness.

[17] Empirical evidence suggests that CDS spreads also react to rating announcements, which raises even more questions about the delayed weathermen narrative (Hull et al. 2004).

be captured empirically via measurable changes in the risk premia and spreads—their origins are not.

As mentioned above, the reproach of "CRAs are always late" draws on an implicit, strong belief in market efficiency; the market knows everything in advance, CRAs can, therefore, at best reproduce the already existing level of knowledge. In this vein, a CRA's basic function is that of a neutral observer, of a weatherman, with no type of influence on the course of events. At the same time, the weatherman perspective equates the CRAs' influence with the ratings' informational added value, disregarding institutional factors such as the regulatory incorporation of ratings. Further, this perspective reveals a functionalist understanding of the rating business, which regards the reduction of information asymmetries as the main task of credit rating agencies. Strictly speaking, this is contrary to the idea of market efficiency. If this argument is thought through to the end, there would actually be no demand, i.e. no market, for rating services.

To sum up, even if the market knew everything in advance, and CRAs were late, this would not prevent them from wielding structural power. The source of influence goes beyond the question of the informational added value of CRAs, and beyond the inclusion of ratings in regulatory regimes. In other words, the question 'who follows whom' misses the fundamental point in terms of the CRAs' authority. Hence, the inquiry into the relationship between CRAs and markets should neither be approached in a one-dimensional fashion, i.e. in a 'who follows whom' logic, nor in terms of informational added value, but from an intersubjective perspective. Such a perspective denies the idea of a "one-way determinism," linking the question of the CRAs' influence to aspects of reciprocity and reflexivity of social reality.

In line with their actual mission to mitigate the market's perception, CRAs function as a consensus machine. If this machine, however, falls into the confirmation bias trap in the sense of serving preconceived ideas, this can actually even exacerbate market movements. "Intersubjective reflexivity" brings about circularity in creditors' and CRAs' "world views" or "market beliefs and sentiments." These are reflected in the ratings "which are themselves demanded by the agents affected by the ratings" (Abdelal & Blyth 2015, p. 3). The "codifying" of these views, norms, and values thus constitutes *the* distinct feature of the CRAs' influence.

4.6 The alleged panacea: Transparency

A spectrum of claims, as manifold, and sometimes as contradictory as the points of criticism, follow all these different "focuses" in the problematization of the CRAs' work and authority. However, different discourse participants, whether practitioners, policymakers, or scholars of different social science disciplines, called for enhanced "transparency"—in other words, the demand to rise the curtain, and to open up the black box.

For example, Kiff et al. (2012) call for "more transparency with regard to the quanti-

tative parameters used in the rating process." Vernazza et al. (2014) even demand that "the ratings agencies should be forced to substantially increase transparency, including publishing a separate breakdown of the objective and subjective components of ratings, the minutes of the rating committees, and the voting records."

The dominant imputed notion of the CRA authority can be inferred from the common denominator in terms of the demands for reform, i.e. transparency. The common understanding on which the majority of discourse participants agrees relates to the informational function of rating. In order to increase rating quality, transparency has to be increased. The consequentiality of this understanding is visible in the reforms of CRA regulation in both the U.S. and the EU, and in the revised IOSCO "Code of Conduct Fundamentals for Credit Rating Agencies" (IOSCO CRA Code 2015). Such an approach to problem identification and solution is consistent with the toolbox of economics, which constructs the reduction of information asymmetries as the main rationale of the rating industry.

The voluntary changes that CRAs undertake themselves in terms of their sovereign rating methodology and their access policies can also be interpreted as a reaction to this strand of CRA critique. CRAs present themselves as actors that reduce the information asymmetries on financial markets. It is consistent with such an identity construction to demonstrate efforts aimed at fulfilling this function—thus by increasing transparency.

"Transparency" as a cherished value in the CRA discourse may also correspond to what Weaver (2008, p. 29) refers to as "espoused theories" (drawing on Argyris & Schon 1974):

> [E]spoused theories construct and portray external norms that signal conformity with external expectations about the appropriate behavior of organizational staff. These ideologies and norms are supported by carefully crafted and maintained rhetorical language that attempts to hide internal contradiction or dissent that may blur or undermine the organization's public image and message. [...] Espoused theories, in contrast [to theories-in-use], may change very quickly to external shocks on the organization's market environment or the demands of its political masters.

Chapter 5

Structural power

> *Von Macht will man bei Moody's nichts wissen – und schon gar nicht darüber reden. (Nobody at Moody's wants to know anything about power – and even less talk about it.)*
>
> —Süddeutsche Zeitung, 16 November 2011, own translation

5.1 Why structural power?

Structural power analysis aims at filling a gap in the social sciences, which could emerge from a blind spot in conventional power approaches. Guzzini (2010) argues that "different 'structural power' approaches have demonstrated the need to conceive of more encompassing power concepts so as to capture important, but otherwise neglected facets of international rule."[1] Guzzini (2010, p. 5) maintains:

> Poststructuralist and constructivist approaches focus on power as authority and legitimacy not through the establishment of an open social contract, but in the habitual working of discourses and practices which dis/empower agents [...] concepts of structural power redefine the context within which strategic interaction takes place, the resources considered important for assessing capabilities in the first place, and the outcomes which should be included in power analysis.

It is no coincidence that Guzzini explicitly selects credit ratings as an object of interest for "the analysis of how international standards, which are often established by private actors, are practices of rule once they become accepted convention and interact with the actors and issues they were supposedly only neutrally measuring" (Guzzini 2010, p. 9)

Sovereign ratings are therefore not to be regarded as a direct instrument of power which is used by the CRAs intentionally to force states to do what they otherwise

[1] Beside Strange's version, other conceptualizations of structural power are: "indirect institutional power," "systematic bias," and "impersonal power." For a critical discussion of power analysis in International Relations, see Guzzini (2013, 2010, 2000).

would not do, but rather as an *intersubjective practice* of it. Guzzini (2010) suggests that unquestioned practices are the "most effective power relations." If the practice of sovereign ratings is assumed to widely be a practice of "tacit legitimacy," then structural power analysis aims at revealing the "origins of consent" (Guzzini 2010, p. 9). Such an approach suggests that power resources have no intrinsic value, but depend on the actual value systems of the interacting parties such as CRAs, investors, policymakers, media, and the public. This is in line with Sinclair (2005, p. 46), who classifies CRAs as "embedded knowledge networks," in the sense that "rating knowledge" is "very much a social phenomenon." Therefore, as non-state actors, CRAs are not powerful per se, or omniscient when they rate states: If nobody shared the same ideas and values regarding the creditworthiness of a sovereign or a fiscal policy that a government wants to pursue, the application of a structural power concept would not make much sense.

This is not to say that policymakers cannot generally use sovereign ratings as a relational power instrument to enforce certain behaviors in bargaining situations. The experience of the European sovereign debt crisis after 2009 revealed quite bluntly that the policymakers and EU institutions themselves absorbed, internalized, and advocated the CRAs' prescriptions. The successful materialization of these prescriptions is visible in the new Fiscal Compact of the EU and in the type of conditionality for credits that the EU Commission, the ECB, and the IMF (also known as the 'troika') set up. In part, the policymakers' internalization invalidates the theory of an intentional instrumentalization of CRAs as external standard enforcers by policymakers. It is no coincidence that austerity and fiscal consolidation seem to be more associated with the 'troika' than with the sovereign rating practice in Europe (BBC News Europe 2012).[2]

Guzzini (2010, p. 15) argues that a shared idea about what counts in world affairs "will strongly influence the status [...] of particular actors." In this perspective, it is not *primarily* the material influence to move markets, or the coercive force of finance which empowers actors such as the CRAs, but rather the shared ideas. If there is intersubjective consensus on what 'sound' fiscal policy means, this legitimates the CRAs' practice when they demand certain reforms and not others. At the same time, these reforms are legitimized through the practice of sovereign ratings. Thus, one purpose of the structural power analysis is to peer behind the curtain of the discourse of sovereign creditworthiness which at first glance seems to be solely based on supposedly objective categories of economic data.

Prager (2012, p. 30) undertakes an alternative classification of CRAs as a case of structural power. In particular, Prager applies Bourdieu's concept of symbolic power, which is exclusively based on acceptance and acknowledgment of the CRAs' authority. By attributing symbolic capital to CRAs, they are able to maintain prevailing power structures. Symbolic power is based on the influence exerted on the field, i.e. on financial

[2] Addendum: In the meantime, the perceptional association may be focused exclusively on the German government (apropos discourse dynamics).

markets—both as a tool for overcoming information asymmetries as *habitus*, and by including ratings in regulatory regimes as the objective constitution of the *field*.

Before explaining Strange's structural power in more detail, the implicit synthesis of different forms of power will be briefly discussed, due to the centrality of the undertaken synthesis to the argument of this dissertation. Simply put, one could argue that I confound the "third face" of power (Lukes 2005) with the "fourth face" (Digeser 1992), and amalgamate it with structural power coined by Strange (1998), which is true to a certain extent. As different these conceptualizations may appear, which were developed over the course of several years of scholarship intensely dedicated to power analysis, nevertheless, their overlaps may allow the above mentioned synthesis regarding the practice of sovereign ratings. The third face of power does not only influence the preferences of actors, but also includes the first face of power, i.e. behavioral changes that power induces (Dahl 1957), as well as the second face, i.e. non-events that power induces (Bachrach & Baratz 1962). According to Norrlof (2014, p. 1064), the third face of power is "passive and unintentional" in its character as "[c]hallenging how things work is too cumbersome and potentially costly." With respect to the fourth face, it can also be noted that Foucault "focuses on what is accepted knowledge" as wielded power, and less on individual intention (Wodak & Meyer 2009, p. 9). These features are compatible with Strange's structural power, which emanates from a non-intentional conceptualization. This is one reason, among others, why motivations, interests or intentions of CRAs are omitted from the argument of this dissertation.

Drawing on Digeser (1992), Bially Mattern (2008) emphasizes the "nonessentialist epistemology" of the fourth face of power:

> Power is expressed diffusely through the discourses that create social meaning and make society possible. Power thus is not an exercise carried out by interested agents, but a discursive process through which agents and their interests are produced in the first place.

Therefore, with their emphasis on the construction of preferences and identities, the convergence of constructivist research agendas with Foucauldian approaches "in their understandings of order as diffused practices of rule" (Guzzini 2010, p. 9) does not automatically amount to a mission impossible. Quite the contrary is true as scholarly tradition in IR and IPE shows.[3] For example, with their conceptualizations of epistemic communities, King (2005) and Haas (1992) suggest "the significance of ideas and norms as mechanisms of global governance" (Cutler 2014, p. 12). Further, "the role of intersubjective meanings in governance" and "norm diffusion" have also been at the center of scholarly attention (Finnemore & Sikkink 1998). In the wake of the financial crisis, Drezner & McNamara (2013) claim that "the content of economic ideas will shape any emergent global financial order."

[3]This is not to say that formal hierarchies do not matter.

Returning to Strange's structural power, Cutler (2014) states that "critical post-structuralist contributions to IPE can perhaps more fully realize Strange's vision of a new analysis of power in the IPE." Strange's legacy in terms of the knowledge-power nexus (Langley 2009), and power conceived as a discursive process, is not necessarily an oxymoron—notwithstanding its challenges of commensurability (Paolini 1993, Bially Mattern 2008).

5.2 Structural power according to Strange

Strange (1998, pp. 24-25) defines structural power as "the power to shape and determine the structures of the global political economy within which other states, their political institutions, their economic enterprises and (not least) their scientists and other professional people have to operate." Strange (1998, p. 18) assumes that "social, political and economic arrangements affecting the global systems of production, exchange and distribution, and the mix of values reflected therein" are not exogenously given, but are "the result of human decisions taken in the context of man-made institutions and sets of self-set rules and customs."

Structural power confers the authority to the relevant players in the global political economy to decide how things shall be done. The concept tries to address questions such as: What are the constitutive rules of the political economy? Who sets these rules that trigger biases and determine the "competent players and their effective moves" (Guzzini 2010, p. 9)? Who chooses the game? The possessor of structural power can change the range of choices by, for instance, imposing costs. This often occurs without pressurizing others directly to take a specific decision rather than another. Structural power is less visible and more subtle than relational power narrowly understood. Drawing on Weber, relational power implies causality in visible changes of behavior: A has power over B to the extent that A induces B to do something that (s)he would not otherwise do (Dahl 1957).[4]

Applied to the case of CRAs, the subtle quality of structural power is also mentioned in Sinclair (1999, p. 165):

> [A]n important feature of [...] bond-rating agencies is their epistemic authority and closely related structural power, rather than direct 'power wielding.' The reason for this is that authority and structural power are built upon a certain base of consent. This is a more robust structure upon which the social forces associated with coordination can generate legitimacy for their view of the world, for their approach to problems and their distribution of payoffs to

[4]The original definition of power by Weber (2002, p. 28, paragraph 16) states "Macht bedeutet jede Chance, innerhalb einer sozialen Beziehung den eigenen Willen auch gegen Widerstreben durchzusetzen, gleichviel worauf diese Chance beruht." Baldwin (2013) provides a concise account of the far-reaching power debates in International Relations.

> allied social interests. Epistemic authority and structural power are, however, much harder to specify than the variables international political economist are used to. Not only is authority seemingly more intangible, it is also constantly being both constructed and worn away.

In a similar vein, Sinclair (1999, p. 161) argues that

> [CRAs] adjust the ground rules inside capital markets and thereby shape the internal organization and behavior of those institutions seeking funds. Their views of what is acceptable shape the actions of the resource-deficient in anticipation. This anticipation effect, or structural power, is reflected in the minds of capital-market participants in terms of their understandings of the views and expectations of the agencies.

The distinctive feature of Strange's structural power consists in the idea that its origins are diffused across four structures, namely: the control over security, over production, over credit (finance), and over knowledge, beliefs and ideas. Such a notion of power is primarily defined in a functional, and not in a territorial sense, which implies that power manifests itself (or not) in the control over risks which go beyond immediate political risks, for example, currency or financial stability risks (Bieling 2010, p. 407).

The four structures, i.e. resources of structural power, indicate where social power relations are at play. Yet, more importantly, they suggest the cause of these power relations. Moreover, through each structure, "power is exercised on particular relationships," and these "four separate distinguishable but related structures" interact with one another (Strange 1998, p. 26). These interactions lead to a high diffusion of the effects of the respective power structures.

As *the* distinct characteristic of CRAs, structural power, in the form of "knowledge, beliefs and ideas," is exerted within the finance structure—a case of interweaving structural power sources.[5] This specific conjuncture of the two structural power sources suggests that the effects of such kind of power are highly diffused. This conjuncture explains the epistemic authority of CRAs not only in the *field* of finance, but also in the public discourse on sovereign creditworthiness. The structural power concept suggests why the sovereign rating practice can shape shared understandings, norms, and beliefs about a state's creditworthiness, and, implicitly about fiscal and economic policy. At the same time, the finance structure provides the monetary leverage which helps the epistemic dimension materialize, thus enabling the perception inherent in the sovereign rating assessment to mold the reality it pretends to describe neutrally.

According to Sinclair (1999, pp. 161-162, emphasis added), "through a process of consent-generation *and* coercion" CRAs coordinate creditors' and debtors' perceptions "to a certain well-understood or transparent set that is shared among themselves." This,

[5]For the sake of the argument, I refrain from analyzing the relationship between knowledge and finance and the two other power structures (security and production).

which I label process of codification "is a reflection of the structural power of the agencies, the anticipation of the agencies' views by others and their action to meet these anticipated judgments."

Also Cutler (2014, p. 3) emphasizes the extraordinary "relevance" and "political significance" of the finance and knowledge structure among the four structures of Strange's structural power term:

> [O]ne of [Strange's] major contributions to our understanding of the global political economy and its contemporary condition [is her notion] that access to credit has become a central term of competition in the world, replacing the geopolitics of competition over territory and ushering in a new kind of politics that requires new ontological and epistemological understandings about the nature of power.

Therefore, CRAs represent powerful agents in the discourse on sovereign creditworthiness as they derive their "power to shape and determine the structures [...] within which other states, their political institutions, their economic enterprises [...] have to operate" from the encapsulation of the knowledge and financial structure (Strange 1998, p. 18).

In this context and related to this, Cutler (2014, p. 7) also notes that Strange suggests cross-cutting the Marxist dichotomy between capital and labor, and replacing it with access to credit versus non-access. Further, she suggests de-endogenizing the dependence of the knowledge structure from capital, therefore implying an autonomous influence of the knowledge structure:

> Strange's perception of the equiprimordial nature of power in political economy complements and contrasts with traditional Marxian interpretations that understand the production and security structures of the economic base to be constitutive of the knowledge and finance of the political economic superstructure.

In the following, the definition of the knowledge and finance structures is briefly discussed. Structural power in the form of "knowledge, beliefs and ideas" manifests itself in the control of the channels by which "knowledge respected and sought by others" is communicated (Strange 1998, p. 30). Since the business model of CRAs is based on the processing and filtering of relevant market information about credit risk, CRAs can be categorized as a transnational epistemic community (Haas 1992). Due to their oligopolistic position in the finance structure, CRAs can control the channels of communication through which investors receive information they want on sovereign creditworthiness.

For Sinclair, the decisive power source of the CRAs consists in the knowledge structure. Sinclair (1999, p. 159) endogenizes the "authority exercised by the agencies" by means of its relationship to knowledge. By defining knowledge as the main source of this

authority, the dichotomy of private vs. public authority becomes less relevant. Although the state gave the agencies a quasi-legal status, this move can be primarily explained by the epistemic dimension of the CRAs' authority within the finance structure. The ratings' incorporation into regulatory frameworks was only possible because of the prior recognition of the CRAs' knowledge. In other words, the CRAs' epistemic authority enables the ratings to be used for regulatory purposes.

As Bruner & Abdelal (2005, p. 193) put it:

> The agencies created a new way to talk about credit risk. Investors adopted it as a simple code through which to describe and grapple with the uncertainties inherent in investment. Regulators saw the agencies' analysis as a straightforward, putatively objective framework for the regulation of financial institutions' exposure to credit risk. And issuers came to see the agencies as points of access to international capital flows. But all of this happened not because Moody's and Standard & Poor's usurped the authority of states; instead, the agencies created something new, and governments consented both implicitly and explicitly.

Put differently, the apparent 'objectivity aura' deriving from the rating representation in letter grades offers a value-free, unproblematic, and practical solution to the ever increasing policy challenges of financial risk regulation—assuming away the normative implications inherent in technocratic modes of governance. In terms of the politics of sovereign ratings, it follows that "until governments are willing to take on the regulatory and informational burdens borne by the rating agencies, sovereigns will continue to live by the rules as interpreted by the very agents they have empowered to do the things that they do not want to do" (Abdelal & Blyth 2015, p. 5).

The finance structure, as a source of structural power, is defined as the sum of all the arrangements regulating the provision of credit and currency relations. Those who are "able to control the supply and distribution of credit" (Strange 1998, p. 26), i.e. the financial elites and their institutions, exert this type of power. Besides the CRAs, these organizations include, for example, systemically important financial institutions and universal banks, the world's largest accountancy, law and consultancy firms, and transnational regulatory authorities such as the "Basel Committee on Banking Supervision" (BCBS). Or, as Cutler (2014) puts it:

> [A]n alliance of self-interested bankers and investors, complicit governments and international organizational bureaucracies and a network of credit rating-agencies and other private associations [...] developed the institutions and rules of the game for global finance.

CRAs have been characterized as capital market's distinct "gatekeepers" (Partnoy 2006) or "global monitors" (Sinclair 2003), not least due to their power to move markets.

Furthermore, "[s]uch control of credit is important because through it, purchasing power can be acquired without either working for it or trading for it, but it is acquired in the last resort on the basis of reputation on the borrower's side and confidence on the lender's" (Strange 1998, p. 26). As can be seen, access to credit (finance) is inherently linked to reputation (knowledge), which shows how both power structures are intertwined.

Metaphorically speaking, reputation is the currency with which credit is obtained, and the more it depreciates, the more expensive it is to obtaining funding. In the realm of sovereign ratings, the CRAs are the setters of the exchange rates to which governments are obliged to stick. If sovereign ratings do matter for the reputation of a sovereign borrower and for the confidence investors have in that borrower, then CRAs have a critical role in tightening (and relaxing) the fiscal room for maneuvering since the value of circulating sovereign bonds decreases and the interest rates for newly issued ones increases. In other words, sovereign ratings impact fiscal sovereignty.

The systemic risks deriving from global financial markets as an issue of academic inquiry has a long tradition in the field of IPE. The financial market crisis that started in 2008 proved that many of the raised concerns were justified, especially in terms of the political and societal relevance of what seems to just be technical issues. In 1997, Pauly saw in the (already back then) global nature of money markets "the harbinger of things to come." Strange (1997) coined the term *casino capitalism*, which IPE scholars adopted and which is nowadays frequently used in the public debate.

Over the last decades, the finance structure—in comparison to the other power structures—has been particularly prone to substantial transformation processes. The strand of literature focusing on the finance structure as a type of structural power in IPE coined the term "financialization" for this process. In a financialized economy, capitalism is affected by the dominance of the financial sector over the productive sector (Nölke 2012, Krippner 2011, Palley 2007, Nölke & Perry 2007). The transnationalization of control and power structures—the diffusion and decentralization of authority—is visible in the deregulation and liberalization of money and credit relations, which have increasingly eluded national control. The control by public authorities decreases and the global finance structure can take on a life of its own. The more sophisticated the finance structure, the worse the power imbalances. This leads to a decoupling from the functional necessities of the real economy: With respect to the market-authority nexus, this translates into a balance of power shift to the benefit of the finance structure.

5.3 Epistemic authority and common sense

Among the different players in global finance, CRAs crucially shape "common sense understandings about the governance of global capitalism" (Cutler 2014). They are part of the "dominant knowledge structures that [condition] belief systems about the nature and function of finance and credit, as well as about the acceptable means of governing

them and the proper role of the state therein" (ibid., p. 4). Thus, when it comes to the rating of sovereign bonds, CRAs play a crucial role in the "diffusion of norms and common understandings" of sovereign creditworthiness, and implicitly of fiscal and economic policy. "Financial market common sense" is, amongst others, the product of the communication of the CRAs. Drawing on Kerwer (2002, p. 45), ratings "in the aggregate" would generate a "common understanding of what constitutes creditworthiness" (Bruner & Abdelal 2005, p. 206). The "legitimacy of the underlying expertise" gives them the ability to shape perceptions of sovereign creditworthiness.

This implies, not least, that in order to be able to redefine common sense, i.e. market orthodoxy, CRAs first have to reproduce orthodoxy successfully. The reproduction of orthodoxy preconditions the credibility as an epistemic authority, which opens up the possibility to change orthodoxy. This argument relates to the very characteristic of epistemic authorities since the acknowledgment of new social facts and the perceived logic of a statement "has to comply with a prerogative financial knowledge" (Kessler & Wilhelm 2013, p. 260 and Haas 1992).

The remarkable aspect of CRAs is that they represent a 'passive' form of an epistemic authority. As of writing, the CRAs have no lobby institution that represents their interests in the political process of decision-making such as the accountancy industry, or other sectors of the financial industry. Nevertheless, CRAs obtained a "regulatory license" from governments without explicitly asking for it, as discussed above.

According to Sinclair (1999, p. 159), CRAs "do not seek to persuade, but make judgments." This translates remarkably into a "process of consent generation," although the actual intention was not to create this consent (Sinclair 1999, p. 162). As a result, CRAs "quell doubts and win the trust." At the same time, the limits of orthodoxy constrain the range of judgments CRAs can make. Sinclair (2005, p. 64) cites Lincoln (1995):

> [T]he consequentiality of authoritative speech actually has little to do with the form or content of what is said. [...] 'Authority is not persuasion. [...] The exercise of authority need not involve argumentation and may rest on the naked assertion that the identity of the speaker warrants acceptance of the speech.'

Taking into account that discourses in the broadsheet media are increasingly susceptible to trends of personalization, this may even increase the CRAs' authority.

CRAs are not, by definition, an executive epistemic authority (such as university professors). However, they have in common that they produce "consequential speech" (Sinclair 2005, p. 63)—a characteristic of such type of authority. In the broadest sense, this refers to the co-constitution between meaning and materiality, or to the interaction between the social construction of knowledge and the construction of social realities.[6]

[6]For example, if the deregulation of financial markets is classified as a constructed social reality,

Applied to the CRAs, the reflexivity between knowledge and social reality manifests itself, for example, in the production of commonly shared ideas about what 'sound' fiscal policy means. Consequently, the increased presence of CRAs in the public discourse authorizes decision-makers in their self-understanding to pursue exactly the type of fiscal policy that is authorized through the common understanding of fiscal policy, and that the CRAs promote and communicate.

Paudyn (2013, p. 12) categorizes sovereign ratings as "discursive practices" with performative effects. According to Paudyn (2013, p. 27), the methodology underlying the ratings facilitates performativity. Such discursive practices "help constitute a social facticity which may otherwise not exist." From this perspective, intersubjective meaning is reproduced in the discourse, and not firmly anchored in language. For example, that what is intersubjectively meant by a 'fact' can change through the discourse, as discourses are not static, but dynamic.[7] If meaning making is subject to the dynamics of discourses, then the things we know about events are also discursively constructed. In this logic, there are always more versions of these events—narratives. Which version prevails, is a question of power (Diez 2003, p. 474). CRAs can be regarded as messengers of certain versions of reality, which many actors in the discourse share. Presenting themselves as the producer of 'opinions,' which common knowledge informs and justifies, CRAs can hide the arbitrary character of sovereign ratings (Paudyn 2013)—not because their statements are objective, but because they are inter-subjective.

The pillars of consent on which the CRAs' epistemic authority is based comprises a general set of "ideological and cultural preconceptions," which "few (at least in the West) will query," such as "the general wisdom of encouraging the dispersal of political power, a free and vigorous press, meaningful property rights, and an efficient marketplace" (Bruner & Abdelal 2005, p. 199 citing Sassen 2002, p. 99). These commonly intersubjectively shared beliefs and norms inform the notion of rating objectivity. In turn, those ideas which do not fit this alleged canon are politicized, i.e. referred to as 'political.' It also explains why CRAs' representatives reject objection to their sovereign rating actions as being political. Consequently, CRAs can identify and represent themselves as a-political agents by invoking, reproducing, and redefining a common understanding of sound fiscal policy.

The construction of common sense: An illustrative downgrade

This dissertation suggests that sovereign ratings contributed to the idea of fiscal con-

the reflexive relationship with the social construction of knowledge becomes visible by means of the assumption often made in financial economics about the efficiency of financial markets. This assumption may lead to the normative policy implication that financial deregulation is desirable. The moment policymakers act according to this 'knowledge,' deregulation becomes a social reality. Concerning the performativity of economics in general, see Callon (2007).

[7]This is not to say that material facts do not exist. The key problematique in terms of ratings is that they are social facts, but disguised as material facts.

solidation as a solution to the financial crisis. According to Armingeon (2012), the "only broadly accepted idea [in the public discourse] is that public policy should be based on fiscal prudence." If CRAs wield structural power in the construction of the creditworthiness of states, then the practice of sovereign ratings (including announcements, warnings, and comments) may have contributed decisively to the understanding of public budget consolidation as a panacea for the crisis. The practice of sovereign rating legitimates 'austerity,' which, in turn, as an intersubjective consensus on sound fiscal policy, legitimates the CRAs' practice.

A list of the required conditions with which a state is supposed to comply in the future if it aims at being regraded differently, usually accompanies every sovereign rating event. Paudyn (2013) refers to this as "prescriptive normativity." In the following, I consider the Fitch Ratings downgrade of Italy to "BBB+, Outlook Negative" on 8 March 2013 as an exemplary case. Key occasion of the downgrade were "inconclusive" election results, following Monti's resignation in December 2012. This seems to be in line with the allegation raised by Paudyn (2013, p. 14) that "technocratic governments are seen by CRAs as typically superior in implementing the structural reforms necessary to manage the crisis." In this vein, sovereign ratings would act as a depoliticizing socio-technical device, promoting "a [fictitious] bifurcation between politics and economics." This suggests that if the election results had unambiguously supported Monti's coalition, a downgrade would perhaps not have happened.

The Fitch Ratings' press release stated that "future developments that may, individually or collectively, lead to a revision of the Outlook to Stable include:

- Sustained economic recovery that supports ongoing fiscal consolidation.
- Confidence that the public debt to GDP ratio is on a firm downward path.
- Further structural reforms that enhance the competitiveness and growth potential of the Italian economy."

Such claims suggest that fiscal consolidation, or austerity, is a taken-for-granted, overarching aim. Although Italy was at the time in a deep recession, and GDP growth was not (ceteris paribus) in sight in the short and medium term, the soundness of a restrictive fiscal policy was assumed. The role the state has to fulfill, is to restrain itself and cutting back. Public investment in education, research, and infrastructure drop out as options for boosting growth and competitiveness. Instead, the press release insinuates (although not explicitly) that this should happen differently. This example supports Paudyn (2013, p. 26), who characterizes sovereign ratings as an "internal form of governmentality aligned with self-systemic, disinflationary logics of neoliberalism."

However, in the last bullet point above, it becomes especially clear that the concepts a CRA uses for its prescriptions are quite abstract. What kind of structural reforms are meant? Probably those that will not burden the public account. Higher taxation?

Labor market reforms, and the privatizations of public enterprises? It is not explicitly specified how to boost growth, or to what kind of growth potential Fitch refers to, or how to enhance competitiveness. In other words, the communication ventures on hermeneutics that make the implicit reproduction of shared beliefs and values possible. This can also be understood as a way of CRAs' self-immunization against critique. As a tactic, abstractness helps and maintains credibility. Ultimately, abstract notions are a way to exert structural power via subtle pressure, which does not directly force a state to do one thing or another. For example, the press release does not explicitly ask to cut back the welfare state.

The set of key assumptions underlying a certain sovereign rating action is another channel through which the therapy to restore creditworthiness is subtly prescribed. These key assumptions can function as implicit warnings. In particular, when assumptions reflect an optimistic view of the course of events, subtle pressure is exerted. Ex post, these assumptions can serve as justifications for future rating actions. Since all the participants in the discourse anticipate this, governments are already warned to comply with these assumptions in order to prevent a worsening of the rating.

In this concrete case, the assumptions included were, for example, "that Italy will retain market access and, if needed, EU intervention would be requested and provided to avoid unnecessary strains on sovereign liquidity" (Fitch Ratings 2013*b*). Implicitly, Fitch presupposes the political solidarity between EU (nota bene, not eurozone) member states in case that the markets punish Italy prohibitively. Moreover, "Fitch assumes there will be progress in deepening fiscal and financial integration at the eurozone level." If this is realized, it could politically lead to either "a two-speed Europe," or a fragmentation of the euro area. Since Fitch assumes that the risk of the latter "remains low," Fitch indirectly asks for the former.

Chapter 6

Sovereign ratings and redefining the crisis

"The road to hell is paved with good intentions."

6.1 What is the puzzle?

Let me start this chapter with a metaphor: Think of the financial system as the nervous system of an organism. Suddenly the nervous system is on the verge of collapse, but physical forces are mobilized in order to prevent the apparent total catastrophe from happening. After a successful rescue, the muscles have been affected—some more, some less. The lesson drawn is that some muscles have to train harder to be better prepared for the future, even though the cause of the collapse was due to the nervous system. This is not to say that trained muscles are not desirable per se. However, if the goal is to fix the nervous system, then painful physical adjustment simply will not contribute to achieving the original goal. The time and effort which is invested in the gym simply reduces the available time and energy to spend on studying psychology.

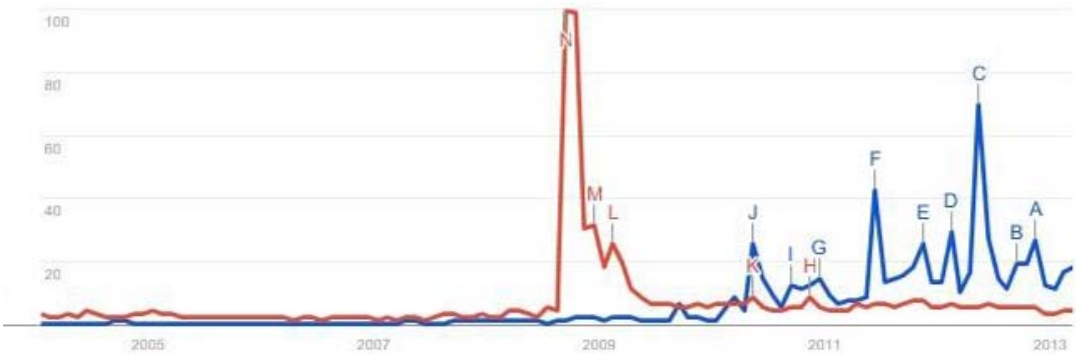
Over the past century, economic crises have served as the basis to supplant existing paradigms of economic thought, be it the Keynesian turn in the 1930s and 1940s or the neoliberal turn in the 1970s and 1980s (Helleiner 1994, pp. 15-16). Schmidt (2014, p. 197) maintains that at the peak, or in the midst of a financial crisis, "ideas seem in flux, new policy ideas are being tried, and the dominant 'paradigm' is under attack."

This time seems different since there is reason to suggest that the predominant pre-crisis paradigm "is emerging from the financial collapse more politically powerful than ever" (Crouch 2011). The point of no return that Schmidt (2014, p. 196) describes is characterized as follows: "[M]any thought that a new progressive neo-Keynesian paradigm was about to take hold. But this hope faded in May 2010, when neo- (or ordo) liberal austerity was re-imposed." Implicitly, the non-establishment of a "post Washington Con-

sensus" can also be regarded as a consequence of the redefinition of the financial crisis to a crisis of sovereign debt. The financial crisis has been "politically constructed as a crisis of excessive spending [...] which it never was" (Blyth 2013), "whereas the financial crisis concerned banks and their behavior, resolution of the crisis has been redefined in many countries as a need to cut back, once and for all, the welfare state and public spending" (Crouch 2011).

Figure 6.1 shows this attention shift where I plotted the search commands for "bail out" (red) against the commands for "austerity" (blue) in Google trends.

Figure 6.1: Google trends: "bail out" versus "austerity"



This process of redefinition could not have occurred without the diagnosis-therapy logic inherent in the interpretive framework of the sovereign debt problematization of sovereign ratings. Sovereign ratings could thus have facilitated the austerity imperative. As a result of this redefinition, both crises seem to have developed an own raison d'être, each with its own causes, subtly drawing attention away from the interlinkages and contradictions in terms of what actually led us into the crisis and of how to solve it. Not only the bail outs of banks, but also the spill-overs from the financial sector to the real economy, which required increases in the current government expenditures in the form of stimuli and recovery packages, are hardly mentioned and used as arguments for questioning the CRAs' prescribed panacea for the crisis.[1]

A quote by the German chancellor Angela Merkel during one of the many EU summits is emblematic of this redefinition: "Fighting against the causes of the crisis, the

[1]Ireland, which had a debt to GDP ratio of 25 per cent in 2007, is a good example. In 2012, it still recorded a ratio of 115 per cent. Source: Eurostat. For a detailed analysis of Ireland's crisis experience, see Gärtner et al. (2013).

lack of fiscal discipline, and the lack of competitiveness is crucial" (Source: Newsticker, 9 December 2011, 17:57 CET, own translation from German). The apparent taken-for-grantedness of her causal analysis reveals the re-formulation in the semantics of the crisis. This redefinition seemed to have led to a wide consensus that fiscal homework needed to be prioritized over the questions the global financial crisis posed to the international community and which needed answering. Put differently, the primacy of the austerity imperative (Blyth 2013, Blyth & Shenai 2010), which can be regarded as a result of the problematization of public debt, may have favored the decreasing political pressure over time to implement the reforms formulated at the G20 summit in Washington DC in 2008 regarding the macro-prudential regulation of global financial markets (Leaders of the Group of Twenty 2008). Instead, a wide consensus emerged that public budget consolidation was necessary to overcome the financial crisis. Fiscal homework was prioritized to battle "a monster" that had to "be put back in its place," as the former German president Horst Köhler asserted with respect to the global financial markets in 2008 (Financial Times 2008). Put differently, the G20 intentions could also not be fulfilled because sovereigns were distractedly busy putting their balance sheets in order, instead of dedicating their energy to thinking deeply about how they had landed in the situation in the first place, and, on this basis, making plans and implement policies to prevent the next systemic financial crisis.

Porter (2014) finds that "its overly technical and incremental character, the persistence of tensions between transnational processes and state-centered politics, and the ongoing power of private actors, have made the regulatory response fall short of what is needed." Rethel (2014, p. 72) concludes that "the record of reform has at best been mixed." As of writing, the 85th Annual Report 2014/15 of the Bank for International Settlements (BIS) criticizes the world's political leaders for having lost the big picture in terms of the dysfunctional financial system (Neue Zürcher Zeitung 2015).[2] The argument of this dissertation does not necessarily contradict other explanations for the transnational regulatory response to the financial crisis, such as those that, for example, Baker (2015) provides, but it can complement them.

6.2 The narrative fallacy of sovereign ratings

How did the redefinition of the financial crisis to a crisis of sovereign debt occur? I argue that the sovereign rating practice was the required mechanism to bring about this redefinition. Due to the narrative fallacy inherent in rating, the financial and sovereign debt crises could have been treated increasingly separately from each other.

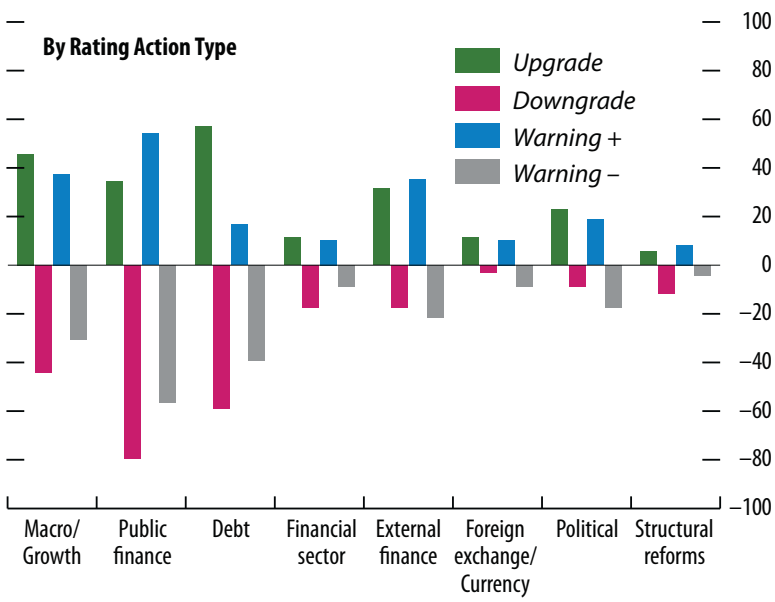
Taleb (2010) describes the ex post creation of a narrative in order to give an event a plausible cause or explanation, a "narrative fallacy." In other words, discursive strategies are capable of triggering and legitimizing a shift in problem identification; they redefine

[2]For details see: http://www.bis.org/publ/arpdf/ar2015e.htm

the problems, its causes, and, thus, their solution. The argument of the "deterioration of the public finances" serves usually for the construction of the cause-effect chain of the increased investors' concerns about sovereign risk; it serves for their rationalization, their making sense. That this can, in turn, be regarded as a consequence of the financial crisis and of the subsequent recession has been forgotten in the course of the ongoing crisis (BIS 2011).

The continuous sharp downgrades of European sovereigns made the self-reinforcing questioning of sovereign creditworthiness visible. For example, in April 2010, Standard & Poor's downgraded Greece to BB+, Portugal to A-, and Spain to AA within two days. A month later, Fitch downgraded Spain to AA+.[3] As can be seen in Figure 6.2 (International Monetary Fund 2010, p. 103), the public finances (deficit), gross public debt, and the general macroeconomic situation and economic growth were the main rating drivers of, or rationales for, the downgrades in the period between May 2007 and June 2010.

Figure 6.2: Main Rating Drivers 2007-2010



Source: International Monetary Fund (2010, p. 103)

As outlined above, the "committee deliberation" is the "invisible ingredient" of the rating process (Bhatia 2002, p. 26): At these meetings the political, economic, or social occurrences that may affect the sovereign rating of a country are discussed and detected. At these occasions, the last word is spoken with respect to "willingness—as distinct from capacity—to honor debt," but also with respect to the "quality and timeliness of policy responses in stress scenarios." These dimensions of assessment, which are, in the real sense of the word, "worthy of discussion" are based on a reactive logic with an inherent

[3]For a timeline of the key sovereign debt events, see BIS (2011, Annex 3, p. 46).

blind spot regarding detecting, for example, the origins of a stress scenario. This blind spot provides the hermeneutic space for the CRAs' definition power regarding problem identification. For example, S&P lowered the British *outlook* to negative in May 2009 (Reuters 2009*a*) providing the following rationale:

> The rating could be lowered if we conclude that, following the election, the next government's fiscal consolidation plans are unlikely to put the UK debt burden on a secure downward trajectory over the medium term [...] Conversely, the outlook could be revised back to stable if comprehensive measures are implemented to place the public finances on a sustainable footing, or if fiscal outturns are more benign than we currently anticipate.

Although, according to the BIS (2011, p. 46), this step occurred "owing to concerns about the cost of supporting the UK banking system," reforms of the financial system were not the center of attention of the sovereign rating media coverage, while (medium-term) deficit reduction was.

If epistemic power allows the CRAs to diagnose credibly where the shoe pinches and where not, this enables them to proclaim certain medicine as a conditio sine qua non for overcoming the crisis. If this medicine is widely accepted as a factual constraint, the therapy apparently becomes unavoidable, and gains priority status. Measures against the financial pressure become compulsory, making policies homogeneous across states. As empirical evidence suggests, Armingeon (2012) finds that, after 2010, "nearly all democratic countries seemed to converge programmatically on the path of fiscal consolidation."

Therefore, if CRAs wield power in the construction of credible cause-effect chains, they can establish necessary conditions to overcome the crisis: "Financial consolidation" becomes desirable as financial consolidation is *supposed* to please the market sentiments. Thus, CRAs can help construct financial consolidation as a way to emerge from the crisis, as a solution. The construction of the "problem of the public budget" provides the rationale to justify austerity policies. In the moment markets start to rewarding those states which comply with the CRAs' demands with lower interest rates, the redefinition becomes real and valid.[4]

The possibility of a crisis redefinition is not a completely novel phenomenon in the sovereign rating business. The experience with the Asian financial crisis at the end of the 1990s, in which "sovereign governments [...] have seen their policy making discretion curtailed," induced Moody's to make the following admission: "[I]f the true causes of the crisis have been misdiagnosed, then the prescriptions for remediation may be wrong as well" (cited in Bruner & Abdelal 2005, p. 211). The European sovereign debt crisis may lend itself to a re-application of this logic: A misdiagnosis may have influenced the prescription for remediation as well.

[4]See the Thomas theorem (Thomas & Thomas 1928, p. 572): "If men define situations as real, they are real in their consequences."

Through the narrative fallacy of sovereign ratings, prodigal fiscal policy has been redefined as the source of the crisis, taking the place of the expensive rescue of the financial sector. By defining the symptoms for the cause, the mechanisms that had led to a certain situation do not only disappear into oblivion, but narratives that legitimize this obliviousness are also (re-)activated—this is easiest done with 'problems' that may already have existed in the past, such as "structural problems" in certain countries of the Euro area (e.g. Italy).

In the following, I discuss how the sovereign rating methodology can contribute to a redefinition of the crisis in more detail. The economic policies of countries that enjoy the highest ratings are often described as "cautious, flexible, and market-oriented." In terms of the rating methodologies Bruner & Abdelal (2005, p. 199) note that "little in the way of substance is provided beyond affirmation of the liberalist commitment to openness." If "orthodoxy" is equal to best practice, then it "appears simply to be a positive term describing the absence of 'policy errors'." Bruner & Abdelal (2005) call this "the implied litmus test—that countries that have gotten this right will be identifiable because they will not make 'policy errors'." The orthodoxy follows a tautological logic: By definition, 'triple A' countries lack policy errors, and because they do, they are 'triple A.' In other words; the incumbent top sovereigns constitute the orthodoxy, limiting the CRAs' problem identification.

As the rating is usually disclaimed as merely an opinion, which, per se, cannot be 'precise' or 'correct,' the absence of an objective policy error screening tool (e.g. explicit thresholds) cannot be used as a criticism against the CRAs. Instead, I suggest that the CRAs' successful reproduction and redefinition of the intersubjective terms of orthodox policy-making, supplants such a screening tool. However, as mentioned above, there are certain limits to the shaping of such a consensus: Since sovereign ratings are, by definition, *relative* expressions, there always has to be a role model, a benchmark; a sovereign that does 'everything right' and that constitutes and reflects the orthodox mindset. A prominent example is Germany's role in the EU. Its export-oriented growth model has served as a role model for the promotion of internal deflation in order to increase competitiveness of the other EU countries.[5]

At the same time, the relative character of the rating implies that if there are deviations between a 'triple A country' and the current orthodox mindset, this can give rise to a 'home bias' reproach or inconsistency accusations against the CRAs (Fuchs & Gehring 2013). Otherwise, if the market sticks to a role model, for example, because it may anticipate the impossibility of not having such a model, the CRA's opinion behind the decision to downgrade a concerned country may not be shared, and the relevant bond values may rise, as happened when S&P downgraded the U.S. in 2011 (Reuters 2011*c*, CNN money 2011). To sum up, the degree of flexibility of orthodoxy (intersub-

[5]The feasibility of all countries in the EU being net exporters while trading with each other is another story (Blyth 2013).

jective ideas, common sense) and the incumbent 'number ones' determine the CRAs' hermeneutic space for the diagnosis procedure regarding sovereign rating changes.

It is quite predictable that in times of systemic shock, such as a financial crisis, to which all sovereigns are exposed, the 'business as usual' of the sovereign rating practice will be challenged. The absence and presence of policy errors are difficult to diagnose. As stated elsewhere in this book, the sovereign rating methodology does not provide a "road-map" in this regard. Methodology-deviating and conforming patterns cannot be detected via the political score or committee deliberations: The CRAs' views legitimize sovereign rating action or inaction. The CRAs have the discretion to decide whether (and which) occurrences should be regarded as critical for the rating—such as the causes or, rather, the consequences of a global financial crisis. The best practice has to be redefined in any case in order to constitute sovereign creditworthiness. Therefore, not by accident, the CRAs' epistemic authority becomes extremely visible in times of crisis.

Chapter 7

Concluding remarks

> *"An eye-watering USD 50 trillion in outstanding sovereign debt is guided by sovereign credit ratings."*
>
> —Vernazza et al. (2014)

Even though this work draws its relevance from the constitutive role of the sovereign rating practice in the discourse on sovereign creditworthiness, the quote above only conveys a rough idea of the monetary dimensions of the topic. Furthermore, since sovereign ratings "set the benchmark for all other credit ratings, the implications of sovereign ratings extend much further" (Vernazza et al. 2014).

The aim of this work is not to criticize the CRAs for the sake of criticism. If this were the case, it would just add up a further—probably unnecessary—line of argument to the already existent and extensive CRA critique. This book is an attempt to go beyond the usual suspect points of criticism in the CRA debate. The public attention paid to the CRAs in the course of the financial crisis may not only have contributed to the prominence and constant repetition of these points, but may even have led to the corroboration of pre-conceived notions about the CRAs among policy-makers, practitioners, the media, and scholars.

This critical engagement with the issue is aimed at revealing certain blind spots in the CRA debate in order to advance the state of knowledge about the specificity of the CRAs' authority in global financial capitalism. The puzzle of the CRAs' authority appears even more exacerbated against the background of the financial crisis experience. While doing this, the questioning of the CRAs' expertise in the sovereign rating practice is not the center of analysis. Through the entire research process, I proceeded from the notion that sovereign rating analysts and officials "are thoughtful and focused individuals with an excellent grasp of the wider economic world" (Sinclair 1999, p. 164). Such an assumption implies neither the impossibility of a critical inquiry into the CRAs' epistemic authority, nor does it automatically render the inquiry apologetic.

This book argued that the prescriptive normativity of sovereign ratings provides the ex post rationale for identifying an alternative cause for the crisis. The narrative fallacy of

sovereign ratings has redefined prodigal fiscal policy as the source of the crisis, replacing the collapsing financial system. By defining the symptoms as the cause, not only do mechanisms fall into oblivion which had led to a certain situation, but narratives are also (re-)activated which legitimize this obliviousness—this is done, most convincingly, by shifting the focus to problems that had already existed in the past.

In the whole discussion on the redefinition of crisis and the social powers behind it, exclusively considering the sovereign rating practice as the independent variable may appear severely reductionist. Certainly, it is not only due to the CRAs that simplistic debates, such as 'more or less state,' have become one of the dominant issues in the economic and fiscal policy discourse after the financial crisis. The CRAs did not invent these controversies, but I argue that their structural power gave them the unique capacity to put this old debate in the pole position of the political agenda. This is not to say that policy-makers may have not instrumentalized the crisis and its rhetoric in order to realize their own political ends that they may find difficult to implement in normal times. It requires certainly further research to analyze the general 'politics of crises,' their discursive construction in the media, and their instrumentalization in greater depth (Peltzer et al. 2012, Kepplinger et al. 2012).

Given that specific arguments and narratives can be recontextualized, can travel across discourses, and be diffused, it may be no surprise that not only policy-makers, but also international and supranational organizations, such as the IMF, the OECD, and the EU commission, have internalized and unconsciously promoted the CRAs' sovereign rating rhetoric. The effect has been that the origins of certain problems have fallen into oblivion. Rather than regarding such discourse dynamics as competing with the explanation of the redefinition of the crisis of this book, I consider them complementary. For example, Barnett & Finnemore (2004) discuss the role of international organizations in fixing meanings, "thereby constituting the legitimate boundaries of policymaking" (Abdelal et al. 2010, p. 10).[1] Also Campbell (2009, p. 268) argues that "the transnational arena is increasingly becoming what sociologists call a *field*—that is, a network of organizations that creates certain normative and cognitive meaning systems that govern the behavior of individual actors within the field."

Therefore, further data to analyze are reports and policy recommendations of international organizations in comparison to the CRAs' sovereign rating events. In order to analyze the timeliness and degree of responsiveness, connecting and comparing discourses produced synchronically and diachronically (interdiscursivity), but also across different contexts, may reveal findings that refine, or even revise, my theory.

Further research could also be done on the politics of sovereign ratings in Asia. The CRAs' role in setting the terms of "orthodox economic policy making" in Asia was first the object of inquiry during the East Asian crisis of 1997-98 (Ferri et al. 1999). With the

[1]For example, Abdelal (2007) identifies the OECD as one of the main drivers of the codification of the norm of capital mobility.

emergence of new credit rating agencies—beside the oligopoly of the CRAs—the rating market is not only becoming more competitive and global, but possibly also more heterogeneous, not least in terms of sovereign rating opinions. Prominent examples are the Chinese rating agency "Dagong," and the regional "Association of Credit Rating Agencies Asia" (ACRAA) with its 26 members (Rethel & Sinclair 2014, p. 574). How does the understanding of sovereign creditworthiness differ (or converge) across the global rating industry? How do different world views and normative assumptions translate into the rating practice? Will the CRAs remain the world's predominant epistemic authority in terms of sovereign creditworthiness, or will there be a power shift? If rating agencies are regarded as representatives of investors' interests (Ouroussoff 2010), and given that investors' national and cultural backgrounds are changing, other understandings of creditworthiness may come to dominate.

The question of what transpires from the sovereign rating practice to the media is highly crucial for retracing the CRAs' role in the discursive construction of sovereign creditworthiness. When rating actions are reported in the media, CRAs' expertise and epistemic power is silently underpinned in the discourse. This happens already in the form of references in media reports, such as "CRAs praise successful crisis management" (Spiegel online 2013, own translation), but above all in the reproduction of explicit warnings ("rating sensitivities"), such as "Fitch warned it could downgrade Italy's sovereign rating further if the recession ran deeper and longer than expected" (The New York Times 2013). These illustrative examples suggest that media coverage, and especially headlines, are less concerned with the actual rating triggers and rationales, but instead with emphasizing the CRAs' 'carrot-and-stick' rhetoric.

Further, a redefinition of the problem at hand can already occur by curtailed and catchy headlines such as "Highly indebted Cyprus," which insinuates a prodigal fiscal policy rather than a bankrupt financial sector. In a nutshell: The contribution of the narrative fallacy of sovereign ratings to the redefinition of crisis, and, last but not least, the contribution of the CRAs to the sovereign debt crisis cannot be fully clarified without assessing the influence of the media on the market perception and the production of meaning (Grisold 2009). Further research is therefore required to systematically assess the filtering that occurs in the media coverage on sovereign rating events.

At the same time, the extent to which the media, press agencies, and relevant financial market information providers (e.g. Financial Times, The Wall Street Journal, The Economist, Bloomberg, Thomson Reuters etc.) exert structural power on CRAs deserves closer scrutiny. This aspect becomes even more compelling when the CRAs' ownership structures are considered, which suggest that publishing houses and media concerns are showing an increasing interest in the rating business (e.g. the Hearst Corporation in the case of Fitch). Engelen (2004, p. 65, box) maintains that "[h]aving a large publishing concern as a parent was considered to be a structure under which S&P–a subsidiary of Mc-Graw-Hill–maintained a position of independence and credibility." Thus, the nexus

and interactions between the different cells of epistemic authorities on financial markets, of which the CRAs are one, may shape global financial capitalism more than is assumed.[2]

Contrary to conventional wisdom, CRAs are not discredited players in financial markets in the post-financial crisis era. Market participants, institutional investors, central banks, and regulatory authorities continue to rely on external ratings for credit risk assessments. Efforts to end the market and regulatory reliance on CRA ratings, such as the FSB initiative, do not seem to deliver what they promise (Financial Stability Board 2010).[3]

In its peer report, the FSB criticized the hesitant progress of the initiative, and its lacking success (Financial Stability Board 2014). The replacement problem seems to undermine the 2010 political consensus on the systematic risks deriving from a CRA oligopoly. Time may work in favor of the status quo, rendering the realization of the initiative less likely. Put differently, in normal times when cliff effects and mechanistic market responses are absent, there seems to be no reason to deprive the CRAs of their epistemic authority in terms of creditworthiness assessment.

Sovereign ratings have come to represent an essential element of global disintermediated financial markets in which government bonds are traded internationally. As long as sovereigns seek access to these markets in which the trade-ability of risks is a constitutive feature, subjection to a 'credit risk stamp,' i.e. to a rating, may be difficult to circumvent. The pervasiveness of government debt in the financial system leads to the pervasiveness of sovereign ratings, and, thus, their consequentiality.

The mission impossible of calculating an objective probability of sovereign default renders the entire sovereign rating practice a pleasant fallacy of precision. It suggests a positivist epistemology without entirely following it—at the cost of assuming away contingencies, unforeseeable events, and idiosyncracies, as if the rating users desire the rating object to be such. Moreover, the relative ordinal letter-grade rating format does not only confound risk and uncertainty by pretending computability, but also conveys the impression of a clear-cut separability of 'quantitative' and 'qualitative' elements. In turn, this dichotomy disguises the actual judgmental nature of rating. The inherent value-loadedness, the normativity and political dimension of sovereign ratings, can thus also be assumed away.

Although the CRAs can claim authorship of the "common language of credit risk," the rating language has, due to its popularity, taken an own dynamic that is visible in its reproduction and use by other financial institutions.[4] Thus, regardless of optical

[2]Not least the research divisions of the world's largest banks (e.g. Goldman Sachs) and consulting companies (e.g. McKinsey) may be further cells in the network of epistemic authorities on financial markets.

[3]For example, the Eurosystem credit assessment framework with its harmonized rating scale and credit quality steps amounts to no more than a translation of the common language of credit risk, i.e. of CRA ratings, instead of representing an invention of a new language.

[4]For example, in the advanced internal ratings based approach (A-IRB) within the Basel framework, banks themselves generate ratings in order to undertake risk differentiation to calculate capital

illusions, the common language of risk (and thus the politics of sovereign ratings) may probably outlive its inventors. However, it remains to be seen who will, in such a case, usurp the epistemic authority in terms of sovereign creditworthiness.

requirements.

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Giulia Mennillo

Personal Information

Date of birth	March 3, 1986
Citizenship	German-Italian
Postal address	University of St. Gallen, FGN-HSG, Bodanstrasse 8, CH-9000 St.Gallen
E-mail address	giulia.mennillo@unisg.ch

Research Interests

International Political Economy, politics of finance

Education

09/2010 - 12/2015	**University of St.Gallen (Switzerland)**
	Doctorate in International Affairs & Political Economy (supervisor: Prof. James Davis)
01/2014 - 06/2015	**Harvard University**; Predoctoral fellow, Weatherhead Center for International Affairs
09/2014 - 12/2014	**Brown University**; Visiting Researcher, Watson Institute for International and Public Affairs
05/2014 - 06/2014	**University of Warwick**; Visiting Research Student in Politics & International Studies
10/2005 - 06/2010	**Eberhard Karls University of Tübingen (Germany)**
	Degree in International Economics; minor in Political Science
09/2007 - 07/2008	**Bocconi University (Italy)**; student exchange

Publications

Book chapters

Mennillo, G. & T. Sinclair, "Financial Crises and World Politics," in *Issues in 21st century world politics*, Beeson, M. & N. Bisley (eds.), Palgrave Macmillan, 3rd edition (forthcoming).

Articles

Mennillo, G. & S. Roy (2014), "Ratings and regulation: a case of an irreversible marriage?," Working Paper Series, No. 14-0004, Weatherhead Center for International Affairs, Harvard University.

Gärtner, M., B. Griesbach & G. Mennillo (2013), "The near-death experience of the Celtic Tiger: A model-based narrative from the European sovereign debt crisis," Intereconomics, *Review of European Economic Policy* 48(6).

Books

Mennillo, G., T. Schlenzig & E. Friedrich (2012), "Balanced Growth: Finding Strategies for Sustainable Development," Springer, Berlin Heidelberg.

Textbooks materials

Gärtner, M., B. Griesbach, G. Mennillo & I. Pavlova (2013), "Instructor's Manual: to accompany Macroeconomics, 4th edition by Manfred Gärtner," Pearson Education (Harlow, England), London.

Work in Progress

Articles

Mennillo, G. & S. Roy, "Understanding the Agency Paradox: Looking behind the regulatory license hypothesis in the relationship between ratings and regulation."

Mennillo, G., "You can have the cake and eat it: The role of sovereign ratings in the construction of sovereign bonds as 'liquid and safe' collateral."

Mennillo G. & T. Sinclair, "A Hard Nut to Crack: What Regulatory Failure Reveals about How Rating Really Works."

Books

Mennillo, G., "Sovereign ratings and the solvency of states: a case of structural power."

Teaching Experience

January 2014	Macroeconomics II, Examination review course (600 students), University of St.Gallen
Spring 2012, 2013	International Relations Theory, Tutorial, University of St.Gallen
Fall 2011, 2012, 2013	Macroeconomics II, Tutorial, University of St.Gallen
Spring 2011, 2012, 2013	Macroeconomics III, Tutorial, University of St.Gallen

Work Experience

11/2010 - 12/2013	Research and Teaching Assistant, University of St.Gallen
01/2011 - 02/2011	European Commission Representation Office, London
08/2009 - 10/2009	German Embassy, Washington D.C.
08/2008 - 10/2008	German Federal Foreign Office, Berlin

Grants

09/2015	Swiss Academy of Humanities and Social Sciences, conference grant
01/2014 - 01/2015	Swiss National Science Foundation, Doc.Mobility research grant
11/2011	Emil Zaugg Fund, publication grant
09/2007 - 07/2008	Scholarship awarded by the Italian Government (DAAD)
01/2007 - 06/2010	Scholarship awarded by the German Government (Cusanuswerk)

Presentations

03/2016	Political Science Department Seminar, National University of Singapore
12/2015	Research Seminar, Political Science Department, University of St.Gallen
09/2015	111th American Political Science Association Annual Meeting (APSA), San Francisco
07/2015	22nd International Conference of Europeanists (CES), Sciences Po, Paris
10/2014	Watson Political Economy Forum, Brown University
09/2014	Workshop on Shadow Banking and Systemic Risk in Global Finance, Boston University
07/2014	SASE 26th Annual Conference, Northwestern University and University of Chicago
11/2013	DocNet Symposium, University of St.Gallen
03/2013	Political Academy Tutzing (Germany)

08/2011	Workshop on Foreign economic policy, Cusanuswerk, Regensburg (Germany)
07/2010	20th Freudenstadt Symposium, University of Tübingen and University of Edinburgh

Extracurricular Activities

04/2015	Assessor, assessment days, coaching program, University of St.Gallen
03/2011 - 02/2012	Executive Board of Doctoral Network, University of St.Gallen
09/2010 - 07/2011	Student representative, Ph.D. program commission, University of St.Gallen
10/2008 - 07/2009	Student representative, Council of the Faculty of Economics, University of Tübingen
10/2008 - 07/2009	Deputy president, Students' parliament, University of Tübingen

July 2016