Sovereign Credit Ratings, Transparency and International Portfolio Flows

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June 2014

Summary

This study examines the response of equity mutual fund flows to sovereign rating changes. Using monthly data from 85 countries we find that sovereign rating changes are valuable in terms of their information. We find that rating changes are associated with significant changes in contemporaneous portfolio flows. This finding is robust to the different ways of measuring capital flows. We also find that the effects are asymmetric; sovereign downgrades are strongly associated with outflows of capital from the country being downgraded while improvements in a country's sovereign rating are not associated with discernable changes in equity flows. High levels of transparency (i.e., low levels of corruption) however, are associated with a statistically significant reduction in the responsiveness of equity flows to downgrades. Moreover, observed flows are consistent with a flight to quality phenomenon. That is, aggregating rating changes across event countries, we find that more transparent (i.e., less corrupt) non-event countries are net recipients of capital inflows, and that these inflows increase with the severity of the aggregate downgrade abroad. These results do not appear sensitive to country size, legal traditions, market liquidity, or crisis versus non-crisis periods, and are robust to different assumptions regarding the within-month distribution of equity flows, monthly predicted benchmark flows, or persistence of equity flows. Taken together, the results suggest that increasing transparency could mitigate some of the perceived negative effects often associated with global capital flows.

Our analysis has several implications related to the impact and value of sovereign credit rating agencies, as well as (a) how countries are likely to be affected, (b) which subsets are most impacted, and (c) the ultimate influence on the cost of capital to firms. At a broader level, it is clear that the impact itself can be affected by public policy – such as encouraging more competition, regulation, and transparency. In particular, our results suggest that improving transparency (i.e., reducing corruption) could mitigate some of the widely perceived negative effects of greater financial market integration.