

**AN ANALYSIS OF THE IMPACTS OF SOVEREIGN RATINGS
ON COUNTRIES' ECONOMIES: THE CASE OF TURKEY**

by

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STATEMENT OF AUTHORSHIP

This thesis contains no material which has been accepted for any award or any degree or diploma in any university or other institution. It is affirmed by the candidate that, to the best of her knowledge, the thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

Alev Özer

ABSTRACT

The present study aims to provide a political economy approach to the sovereign rating concept, questioning the influence the sovereign ratings have on economies. The business and economics literature have regarded the rating agencies as significant actors of world economy, while frequently criticizing their failures. Taking these criticisms into consideration, this political economy explanation focuses on the political and economic implications of sovereign rating changes for countries and for this purpose, Turkish economic outlook between the years 1993 and 2006 is studied in light of the sovereign rating changes within corresponding periods. Turkish economy is considered in this study with regard to three economic indicators as: export records, foreign direct investment levels and capital flow; since these economic activities are arranged as a result of decisions that are influenced by the sovereign ratings. Moreover, the political environments within these periods of rating update and the policy changes are provided in this study in order to evaluate the political aspect of the rating influences. As a result of these analyses, this study argues that those three indicators do not have a general tendency to change in line with the rating updates; however, among the three, export levels are revealed to be mostly influenced by the sovereign rating changes. These implications suggest, that the impact of sovereign ratings is limited on economies and that the agencies should be considered only within the framework of information provision. In addition, some policy recommendations are presented in this study in line with the criticisms within the relevant literature.

Keywords: Sovereign rating, credit rating agencies, rating updates, Turkish economy, export, foreign direct investment, capital flow, investment decisions.

ÖZET

Bu çalışma, ülke kredi derecelendirmesi kavramına politik ekonomi açısından bir açıklama sağlama amacıyla hazırlanmıştır. Bu bağlamda, kredi notlarının ülke ekonomilerine olan etkileri üzerinde çalışılmıştır. İşletme ve ekonomi literatürleri, kredi derecelendirme kuruluşlarının hatalarını eleştirmekle beraber, bu kuruluşları dünya ekonomisinin önemli aktörleri arasında değerlendirmektedir. Bu eleştiriler de göz önünde bulundurularak, bu çalışma, politik ekonomi açısından, kredi notlarının ülkelere politik ve ekonomik açıdan etkileri üzerinde durmakta, bu nedenle de Türk ekonomisinin 1993 ve 2006 yılları arasında not değişim dönemlerindeki görünümünü incelemektedir. Bu çalışmada Türk ekonomisini görünümü, ihracat rakamları, doğrudan yabancı yatırım seviyeleri ve sermaye akımları gibi üç gösterge üzerinden araştırılmıştır. Bu göstergeler, işaret ettikleri ekonomik aktiviteler kredi notlarından etkilenen karalar sonucunda gerçekleştiğinden seçilmiştir. Ayrıca, not değişimleri sırasındaki Türkiye'nin iç politik durumu ve politika değişimleri de, kredi notlarının politik etkisini değerlendirmek amacıyla incelenmiştir. Bu analizler sonucu, bu çalışmaya göre incelenen üç göstergenin hiçbirisi ülke kredi not değişiklikleriyle paralel bir değişim göstermemektedir. Ancak, göstergeler arasında en çok ihracat rakamları kredi notlarındaki değişiklik dönemlerinde yakın değişimler göstermiştir. Bu incelemelerle, kredi notlarının etkilerinin kısıtlı oluşu ve derecelendirme kuruluşlarının uluslararası ekonomide bilgi sağlama rollerinin dışında değerlendirilmemesi gerektiği sonucuna varılmıştır. Ayrıca, derecelendirme kuruluşlarına yönelik değişiklikler için bazı politika önermelerinde de bulunulmuştur.

Anahtar Sözcükler: Ülke notu, kredi derecelendirme kuruluşları, not değişikliği, Türkiye ekonomisi, ihracat, doğrudan yabancı yatırım, sermaye hareketleri, yatırım kararları

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CHAPTER 1

INTRODUCTION

1.1. AIM OF THE STUDY AND THE RESEARCH QUESTIONS

This thesis is about one of the significant actors of the globalizing economy, the credit rating agencies. The research aims to analyze specifically the sovereign rating process in Turkey and the implications on both the economic outlook and policy making following the rating announcements. It will provide an insight to what the sovereign rating is, how the credit rating agencies work and what their ratings' significance for a country's economy is. These questions will contribute to the understanding of the power exercised by the agencies and where the source of this power comes from.

Having provided the general framework of the sovereign rating issue, it will be questioned how the sovereign rating system works in Turkey, by focusing on the specific sovereign rating changes. This will be a case study including an analysis of the past rating records given by the three major agencies Standard and Poor's, Fitch Ratings and Moody's for Turkey between the years 1993 and 2008 and the related main macroeconomic data, on which those ratings were announced to be based. By doing this, a comparison between the three agencies' decisions on Turkey's sovereign rating will be achieved. This comparison will be useful in order to have a better understanding about the widespread critiques on the rating methodologies, that there is no specific formula for the determination of the credit ratings, leading to a variety in the

timing and features of the rating updates and thus questioning the ‘attached’ power of the rating system in general. In addition, the resulting changes on Turkish economy will be provided by using three most relevant indicators, so that the exercise of this ‘power’ is better observed. Following the study of the sovereign rating changes for Turkey, it will be investigated whether and, if any, how and to what extent the rating announcements had an effect on the economic conditions and later economic bureaucratic policies in Turkey. This will help us to see whether the role of the rating agencies for the countries is exaggerated or deserves the expectations. The significance of the sovereign rating results and their functioning in general will be questioned in the light of this Turkish case.

What the credit rating agencies serve for is simply to provide information as a basis for economic and financial decisions of major investors and economic actors. They have a grading mechanism with a wide ranging scale, according to which they determine certain grades for both countries and corporations as a result of their calculation processes and decision making analyses. In this way, the rating system is supposed to fulfill the ‘guide role’ within the international economics for the involving players. They are, in fact, not very recent outcomes of the international financial system. Their history dates back to the late 1880s, yet their significance increased with the early 1930s’ economic conditions. It was the major economic turmoils related to the increasing debt problems contributing to the emerging necessity of the credit rating service in general. More detailed information about the CRAs’ historical background will be provided in the following chapter. However, at this point, it would be more

useful to have a shortcut focus on their definition and their functioning mechanism.

For a proper definition of what the credit rating means, Beers and Cavanaugh from the Standard and Poor's (2004: 1) stated that "[Standard and Poor's] sovereign credit ratings reflect its opinions on the ability and willingness of sovereign governments to service their commercial financial obligations in full and on time." With specific reference to their own company, they claimed that:

"Standard & Poor's appraisal of each sovereign's overall creditworthiness is both quantitative and qualitative. The quantitative aspects of the analysis incorporate a number of measures of economic and financial performance and contingent liabilities, although judging the integrity of the data is a more qualitative matter. The analysis is also qualitative due to the importance of political and policy developments and because Standard & Poor's ratings indicate future debt service capacity" (2004: 2).

Since it is the same what the rating agencies do in common, this definition applies to the whole system of the sovereign rating. In addition, Kucukkocaoglu (a) (2005: 10) clearly listed the main features of how the credit rating agencies (CRAs) function for sovereigns. *Firstly*, CRAs measure the government ruling systems' and their central banks' credit values. This seems to be the main source of power for the agencies within the international arena. *Secondly*, as already mentioned, they calculate and determine the probability of debt repayments by the debtors and the probability of debts, tangible assets, exporting foundations to be repayed. In addition, they evaluate the extent to what these assets can be invested on. These aspects can be applied also to the individual governments taking their central banks and ministries of finance into account, since this study is mainly focusing on CRAs' situations at the government level, instead of the company basis. CRAs perform these activities

periodically and make analyses and final evaluations leading to the credit ratings.

Many investment decisions, determination of credit availabilities and finance opportunities are likely to be the analyzed results of the calculations by the rating agencies, because the economic players usually do not have other alternatives and opportunities to look for information in shorter time. From this perspective, they are recognized as being useful data sources for the business environments and the entities, where the depending investments are assumed to flow. The quality and function of the data remains to be discussed further, as by doing so, it is possible that the agencies provide too much data, which are far from being the final points for the investors to look at for their decisions. However, the investors or financial actors are quite ready to adopt the outcomes provided by the agencies for their strategic choices. For instance, by looking to the rating scores of the relevant country, an investor finds it easy to decide on whether the country he has chosen is safe to be invested in terms of security or whether the credibility of the host government, where the company is located, is sufficient to repay its debts.

At this point, it needs to be ensured that the provided information is appropriate according to the established mechanism of the agencies themselves. The grades and ratings provided by the CRAs are published and provided as official valid information to the international business environment. Yet, many critiques argue that the shape of this guidance has changed with time and turned to be far more effective than being simply a source of information. “Although the credit rating agencies themselves often argue that they are merely in the business of information provision, in practice these informational ratings

function as exclusive providers of global regulatory licenses” (Sinclair 1994 cited in Cooley 2003: 678). In this statement, Sinclair referred to the idea that the observed functions of the rating agencies exceed their pre-assumed responsibilities and they have somehow become authorities by publishing ratings, whose attached values have gradually increased. This aspect will be elaborated in the following chapters while discussing whether the CRAs fulfill their responsibilities in the expected manner. By this ‘expected manner’, the original point of establishment for this mechanism was intended to mean, where the initial responsibility of the rating agencies is to provide the relevant and efficient information for the economic actors and to provide a final evaluation about these actors’ economic outlooks for a well functioning world economy.

While there are obviously quite enough reasons to attribute expectations and responsibilities to the rating agencies, there are also certain points where the power of rating agencies become questioned. Critiques are raised mainly deriving from the assumption that, unless the system works properly enough, the credit rating activity can easily turn to be an ineffective and inefficient one. Strikingly, the system itself is very likely to deviate from its informative nature, as the grounds on which operates, that are the rating criteria, are keen for this.

Coming to this aspect of rating grounds, there are two types of rating criteria applied by all agencies in general: these are political and economic ones. The economic criteria, which will be detailed in the following chapters, are mainly based on numerical and statistical data, that are chosen from a very large list of economic indicators as a result of a decision making process not likely to be purely apolitical at all. The point is that although the choice of the data to be used for the rating process looks a little biased and political, at the very end, the

final outcome is reached as a result of the real data obtained from government officials and mathematical formulas applied to them. The political criteria, on the other hand, are relatively far from being ‘neutral’ in nature, and exposed to be dependent on the perception of the people interpreting them. The political criteria are only judgments in nature and thus even only this aspect would be sufficient to regard them as being less powerful than the meaning attached to them. In order to clarify this aspect of the political criteria, Sinclair (2005: 137) can be quoted here, arguing that “debt repayment is premised on both *capacity* and *willingness* to repay. Thus, judgments about officials’ ability to manage and govern – and likelihood of them being willing to repay – are central.” The managerial capacity stated here would be the aggregate whole of different political criteria. Such political criteria are determined taking into account, that the political events indirectly affect the economic decisions susceptible to the regulatory environment of the relevant country. They are mostly determined taking the possible risky political circumstances into consideration.

The risky political factors were listed by Kucukkocaoglu (b) (2005: 3) as: election system and election times, foreign policy developments and the level of democratic consolidation, the changes on the political leadership or agenda, the structure of the coalition, the situation of the opposition party and the degree of central bank independence. In addition, Kucukkocaoglu (c) (2005: 18) listed the political subjects on which the ability and willingness of the country to fulfill its obligations depend on as: the program of the governing political party and the length of their governing period, the character of the political system, the outlook of the political parties within the country, the comparison of the people’s expectations from the government and the consequent outcomes of

that government's services with regard to the voters' satisfactions, the possible existence of influential external political powers, the activities of the organized religious and ethnic groups in the domestic politics, the legal traditions and regulations in the country, the geopolitical/ strategic importance of the country, the qualifications of the bureaucrats with whom foreign investors would be in contact, the international integration of the country and the relations of the country with its neighbors and trade partners.

Taking these explanations into account, while the relevant economics literature tends to regard the rating agencies (CRAs) mainly as among the major economic/ financial actors in the global system, this thesis will question their role and investigate to what extent their power has an implication for the countries' economies, taking Turkey as the main case study. From this perspective, this will be an attempt to provide a political economy explanation of the sovereign rating issue. In addition, it will be indirectly elaborated and revealed at the end, that all these efforts of the CRAs as being a major party of the global financial system is only to guarantee the repayment of the debts by the borrower side to the creditor and to provide the most useful information for the investors and other economic actors worldwide. Their power is, and should be, limited to the information and insight provision, and the definition of what constitutes a country's economic well being, and thus they shouldn't have an authority of having the final say about a country's economic outlook. While this proves to be useful and meaningful, that the rating agencies are in favor of the debt repayment, which is in fact their starting point of emergence, there are common critiques towards the system as being concerned with the interests of key players at the expense of the others, who need to be rated the most in order

to survive within the international economic system. This was pointed out also by Kerwer (2001: 5), referring to the epistemic authority perception of the rating agencies by Sinclair (2000). “Most importantly, this epistemic authority has a political dimension. It justifies financial markets as neutral and efficient means for allocating resources, even though they in fact favor the financial elite and disfavor redistribution.” The striking point in this argument is that the authority of the agencies is transformed, consciously or not, into a biased one and they succeed in making this look as if it is the appropriate one.

This research also aims to provide an insight to the general criticisms, which have gradually increased with the major economic crises starting in the late 1990s by questioning why they whether the agencies do not fulfill their responsibilities towards the international economics they had proclaimed beforehand. This was mostly reflected by the concept of ‘pro-cyclical behavior’, that is easily observed on the agencies’ rating behavior, as they tend to make most of their announcements after the crisis-inclined situations. The major research question, as indicated above, asks whether the rating agencies are in fact so much significant for the countries’ economies or their role is exaggerated by the actors of the system exposed to overabundant information and following justifications of economic activities, which prevent them from accessing to the most relevant data for their decisions. This question will be attempted to be answered with reference to the Turkish case of the aforementioned three agencies. By doing so, it is attempted to base the critical claims on an analysis of the data provided by the agencies themselves and the following rating announcements.

The data and information allocated for this research will be evaluated in the light of the critiques with the following general and specific questions:

1. In order to understand the system of the credit rating, it is significant to learn how the rating agencies collect their data and how they analyze it to decide on the rating results. On which grounds do the credit rating agencies (CRAs) base their sovereign rating scores? What are the pre-determined political and economic criteria for the sovereign rating?

2. Related to this previous question, it would be necessary to ask, why are those criteria chosen for the rating process and not some other ones? Is there a related transnational elite class determining on these criteria and thus indirectly leading the process itself? What lies behind the decision making process of the agencies leading to certain credit scores? The reason why this question was chosen is to have a general understanding about the rating process in order to evaluate the final rating outcomes.

2.i.)With whom are the agency officials communicating, when they go in a country to hold meetings for the data collection and analysis of the situation in order to determine the rating scores? Answer to this question would provide an insight for the assessment of the rating behavior with reference to the 'actor-network theory'. How the agencies collect their data is important to know for the following analysis of the resulting information obtained from this data.

3. Why does every rating agency not always produce the same results for the same periods of any country? Why do the sovereign rating decisions show a variety between different rating agencies' announcements? This is important to ask, because striking differences between the ratings of agencies would weaken

the impact of the rating announcements, questioning the basis of the rating methodology.

4. What implications are observed in the Turkish economy after certain rating updates?

5. To what extent there are increases or decreases observed on the capital inflows, export levels and foreign investments to Turkey in line with the sovereign rating changes? This question is necessary to ask in order to understand the power of the rating agencies for the Turkish economy, so that a conclusion can be drawn about whether it is appropriate to expect such responsibilities which were commonly expressed by the critiques.

6. Do the economic-policy makers take the possible rating repercussions of their decisions into consideration when determining certain policies?

1.2. JUSTIFICATION OF THE RESEARCH

The reason why this topic was specifically chosen is that the credit rating agencies have increasingly become influential actors in the global financial system. The significance of the global economic and specifically financial system and their recently observed failures starting with the twenty first century has brought many questions to be answered. Not necessarily referring to the rating agencies, Porter in his book *Globalization and Finance* discusses the significance of a regulatory mechanism in the global economic and financial system. According to Porter (2005: 25), it would be impossible without governing entities and rules to ‘transfer millions of dollars electronically’, which is at the heart of today’s finance. Only this reason alone would be

sufficient to focus on the regulatory governance in the system, leading to the credit rating industry. While how the system operates and how the major actors involve in the scenarios of this system is to be left to the field of the international finance itself, some overlapping issues are considered within the framework of the international political economy. This derives from the very nature of these actors having transactions among each other and thus reflecting diverse implications for the worldwide economies. Public authorities, financial institutions, multinational or local corporations are among the most popular ones, whose conducts usually have a variety of consequences for the global economic system. Together, they constitute the community within which the rating agencies operate and which they serve for.

In line with this list of actors, the ‘global system theory’ (Sklair 2001: 4) suggests a similar notion grounded on “the concept of transnational practices, practices that cross state borders but do not originate with state agencies or actors. Analytically, they operate in three spheres: the economic, the political and the cultural-ideological.” The credit rating agencies are one type of these actors, and indeed, they are assumed to direct the system in an informative way. Basically, these rating agencies are expected to provide the necessary data and information for the other actors of the system, so that it functions in its most correct and efficient way.

It has strikingly become unavoidable to encounter any daily statement by a rating agency, mainly being Standard and Poor’s, Moody’s and Fitch Ratings, about a country’s economic situation especially with regard to the financial stabilities. Under this exposure, major financial players do very carefully follow the statements made by these agencies, so that they keep up with the recent

developments in the world economy in a supposedly most efficient way. This derives from the fact that these rating agencies' main motivation is to follow each and every political, economic or financial news, events and speculations to provide the correct explanations for their decisions and announcements. As mentioned before, many investors make their decisions in line with the results obtained from the credit scores, which are accepted to reflect the economic conditions in the country, besides the significant political events and changes. Moreover, the financial borrowing system is also highly based on the information coming from the rating agencies. According to the statistics articulated by Sen (03.07.2008), a debt amount of almost 20 trillion dollars, that is the 40 per cent of the total debts worldwide, was released only according to the rating grades given by the CRAs. This clarifies the inevitable effect of the agencies on the countries' economies, as the number of indebted countries increase every year. Especially for the developing countries, foreign debts constitute a large part of the government financing, such as the import expenses. Furthermore, it is the developing countries, where the political issues are largely intervened in the economic outlook. Thus, it would be significant to focus on these political aspects of the sovereign rating process.

In addition, in this thesis, the rating agencies' role as political actors will be elaborated with reference to the potential correlation between the rating announcements and the following implications on the economies and the further related economic policy making. By questioning this, the purpose of this research is to review the role of the agencies within the international political economy. While their main function is to provide a fair and efficient basis for the international financial transactions, whether too many responsibilities are

loaded far beyond their original designations will be evaluated. A good justification for these questions would be the 1994 economic crisis in Turkey, one reason of which was considered to be in fact the downgrade announcement by the rating agency Moody's. Deriving from this case, it would be expected to assume that the rating announcements are so effective that they can even lead to raise economic crises. On the other hand, as it can be observed, that rating announcement was only one of the other factors causing the 1994 crisis. Thus, this complicated situation needs a clarification in order to have a better insight about the rating agencies and to indirectly allow them to function properly in the way they were designed to be. This study would further contribute to the literature by questioning the efficiency of getting low or high grades for these emerging markets, who try to set their policies in line with these grades in order to obtain better economic conditions.

Argument of the Study:

The main argument of this research is that the power and significance of the rating agencies are exaggerated and their announcements are considered to be much more significant than it is observed in the real cases by attaching too much meaning to the rating results, taking the current criticisms into account. As stated before, the sovereign rating system was initially established as a guide for the investors and it was not intended to make them the sole authority for the economic players to make their economic decisions and to turn them into rule makers or regulators within the international economy. What was originally planned was a mechanism to provide insight for the international investors, who

otherwise would not be able to be that much easily informed about the countries in which they decide to make investments. However, bureaucrats, policy makers, investors and scholars have an increasing tendency to expand the territories of the effects of rating announcements and the critiques are raised when these expectations are not fulfilled. This view also derives from the question of whether the rating agencies influence the worldwide political outcomes by representing certain interests, mainly the U.S' ones. It was also asserted, that the rating scores are used by the agencies and their home-countries or indirectly the ones whose interests they are assumed to serve for as a stick to make their preferred policies to be implemented. According to the analysis of the data made in this study, which will be explained in a detailed way in the later chapters, the issue of the military permit to the American soldiers to enter Iraq from the Southern Turkey in 2003 could be considered as an example for this suggestion. A further explanation of this case will be provided in the following parts of the thesis.

1.3. PREVIOUS STUDIES ON CREDIT RATING AGENCIES

Despite being a relatively new issue on the agenda of the international economics, many scholars have focused on the credit rating issue from various perspectives. The most part of the literature on this issue belongs to the field of economics and international business, including large numbers of empirical and statistical studies deriving from numerical data and further analyses based on their evaluations. Mainly, they focus on a detailed investigation of rating functions and the significance of the credit rating for the global economy. Yet,

what they usually tend to undermine is a critical evaluation of the rating practices in real life with a comparison of the theoretical basis, although there is an increasingly growing critique about a significant existence of such an overlap. An evaluation of such an argument can be achieved after a good analysis of what the rating agencies theoretically are designed for and how they operate in the field. There is a quite large literature on these issues in order to make such a comparison. The relevance of this idea to the thesis question is that the power of the rating agencies can be better evaluated when having enough information about what they were designed to do at the beginning and what they serve for in practice. The diverse themes within the literature on the credit rating issue can be mainly classified as follows: what the credit rating is, how the agencies work and where their source of power comes, their significance within the economic and financial governance, critiques about how they better should be organized and a broader literature on the financial and economic governance. The data about the rating agencies will be provided separately in the literature review chapter of this study.

There is an additional point to be made when trying to explain the role of the sovereign ratings for a country's economy. Other than referring to the general economic environment of the country as a whole, the sovereign ratings also provide an idea about the single firms operating within the country and their performance affected by the economic conditions. The rating used for this purpose is called as 'country ceiling', different from the sovereign rating, and it implies the limits of the ratings firms can have within definite countries. Accordingly, country ceiling "captures the specific risk of controls being imposed by the sovereign authorities on the conversion of local into foreign

currency and on transfer abroad in order to meet external debt service obligations” (Fitch Ratings Criteria Report, 2007: 1). In fact, “they are not ratings, but rather act as the effective ‘cap’ on the Foreign Currency Rating that can be assigned to any issuer or transaction originating in the country; hence Country Ceilings do not have rating Outlooks. Transactions and entities can only achieve Foreign Currency Ratings above the Country Ceiling if there are specific features that materially reduce the credit vulnerability to Transfer and convertibility risk” (Fitch Ratings Criteria Report, 2007: 4). Thus, the country ceiling enables the issuers within a country to be rated higher than the official rating grade of the sovereign in which they are located. This significance of the credit ratings for governments is well expressed by Audino (1996: 22) as: “A sovereign government’s foreign currency debt rating often serves as a cap on the maximum rating for most foreign obligations of issuers domiciled in that nation. This concept reflects the extremely broad range of financial powers and resources available to a sovereign government”. The reason why the sovereign countries need these ratings derives mainly from the main premises of the financial globalization. Financial globalization’s effect contributing to the significance of the rating agencies was noted by Bissoondoyal- Bheenick (2005: 252) that “in recent years, the demand for sovereign ratings has increased mainly due to the inevitable globalization of markets. Investors and particularly managed funds are increasingly focused on international diversification. A change in sovereign ratings can be a major input in the re-weighting of international portfolios.” A similar view was also held by Sassen (2002: 26), referring to the impact of globalization on the increasing significance of the credit rating agencies. According to Sassen, the agencies contribute to the

establishment of transparency and order within the global market and thus exercise a kind of authority. This argument can be explained by connecting the financial globalization to the increasing necessity of transparency within the system, a gap supposed to be filled by the credit rating agencies. Sassen's argument in favor of the rating agencies' important responsibility is among the driving motives behind choosing to evaluate this process. However, to what extent it is appropriate to trust in their explanations is the striking aspect of this evaluation.

The role of the rating agencies within this notion of globalizing economy and the nature of the authority they exercise need to be elaborated. The concept 'embedded knowledge networks' introduced by Sinclair suggests the significant role played by the CRAs in the financial system. What is meant with this concept is that the actors providing information for the international financial system are interacting and the resulting information is endogenous to the system. (See also Kerwer 2001: 4). They provide the grounds for the key financial organizations to conduct their financial transactions. In addition, they indirectly determine for the economic players what data and information is necessary to look for their activities and decisions.

At this point, CRAs contribute to this system, first by setting the standards about the definition of the necessary information and then by rating the companies and countries based on those standards, so that, for example, the investors would have a significant insight about the investment conditions. According to Sinclair (2005: 15), "the agencies' views on what is acceptable shape the actions of those seeking their positive response". In fact, it is this assumption leading to this research's major concern, as to whether such

important information becoming ‘embedded’ in the system is a correct and objective one. In a similar manner, it was stated by King and Sinclair (2003: 358), that “according to S&P’s President, Leo C. O’Neill (1992), the rating agencies see themselves as ‘quasi-regulatory institutions’. They are well placed to defer or modify government challenges to their authority, as the hesitancy with which any new effort (including Basel II) to pull them further into regulation demonstrates.” This possibility of the ‘modification of government challenges’ inevitably leads to questioning them analytically. The same view was held by Barry Hindess (cited in Larner and Walters 2004: 35), that it is “the use of financial markets (and credit-rating agencies) to regulate the conduct of states...” accepted as one of the main critical behavior of the CRAs. Such a criticism can, however, be supported in the thesis after analyzing the data in later chapters, because only then it can be understood how the ratings affect a country’s economy.

There is a broad literature of the critiques on the rating agencies from various perspectives. The mostly criticized aspect of the CRAs is related to their decision making process when finalizing the rating scores of certain countries. This is related to a critical evaluation of the predetermined qualitative and quantitative criteria applied by the rating agencies. Bissoondoyal- Bheenick (2005: 279) referred to this criticism, arguing that “qualitative and judgmental aspects of analysis are unavoidable even in the interpretation of quantitative indicators. Every measure of economic performance is the result of a complex interaction of economic, political, and social forces as reflected in the policy formation process within the government and in the reactions of private-sector economic actors to policy parameters.” In fact, the numbers on which the data

is based are also the results of choices made by the rating analysts. It is inevitably a choice of including some data and not some others for the finalization of the ratings that leads to the determination of countries' economic outlooks. Such choices indeed have a qualitative nature contrary to the attached value to them as being numerical side of the criteria. However, the involvement of some qualitative process does not necessarily mean that there is a tendency for the manipulation of the data used by the agencies.

The rating decision making process, as observed above, consists of different components with various aspects. It requires, as mentioned before, both analytical data and the interpretation of it what makes meaning of the grades. "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" (Bissoondoyal- Bheenick 2005: 279). At this point, whether a CRA official can successfully manage the quantitative data, which has an unquestionable nature, with the qualitative skills in its correct way is important for the accuracy of the rating behavior. This is critical, because, as also mentioned by Bissoondoyal- Bheenick (2005: 251), the political and cultural factors are quite likely to influence the outcome of the decision by intervening as a bias-generating effect. He further strengthens his argument, claiming that purely economic and financial criteria are not sufficient to determine the rating scores and that these same criteria do not apply to several countries in the same way. Furthermore, as Cantor and Packer (1996: 39) have argued, another problem related to the applied criteria is the ambiguity in the relative weight given by the different agencies to each single factor. The decision of what

criteria plays a more important role in the final rating score can also be regarded as a political act, far from being objective at all. This indirectly implies the critical assumption, that the agencies can have certain foreign policies with regards to the sovereign ratings.

Kerwer refers to this critical notion from a different perspective, viewing the rating behavior as a 'voluntary' action exercised within the globalizing finance inevitably. The reason why it is regarded as being 'inevitable' derives from the increasing significance of the credit rating in the global credit transactions and investment patterns, where a third actor is necessary to set the rules and provide the effective functioning of the system. According to Kerwer (2001: 20), "third-party enforcement can cause an accountability gap whenever voluntary expertise based standards are converted into coercive rules" What he argues is, that the system itself created this 'accountability gap' by establishing a newly arranged mechanism as the regulatory standard. However, in contrast to what Kerwer criticized, Larner and Le Heron (2004: 216) argued that the results of these third-party involvement lead to the establishment of the standards, which are necessary for further comparative evaluation in the system, possibly deriving from the huge international market and information problems.

Giselle Datz is a scholar whose works were specifically focused on as a guide of this study's arguments and questions. A related point in the literature like the abovementioned ideas is made by Datz about the source of power of the rating agencies, which is a necessary aspect for evaluating their behavior. Datz (2004: 311) refers to Sinclair's argument regarding the CRAs as part of these 'embedded knowledge networks', having become authorities in terms of specific problem solving experiences. Their power derives from the limitations

they put on the investment behavior and the changes they lead on the financial markets by using the available information and expert knowledge. Datz further explains that the risk assessment and sovereign rating are part of the embedded neo-liberal strategy of development, leading to the financial liberalization. This newly emerging system, as can be obtained from this view, contributed to the increasing power of CRAs. Indeed, building on Datz's argument, it can be claimed that the source of rating agencies' authority derives also from their identification of economic well being for a country and what may constitute problems for any country's economy. In fact, this problem definition can be highly interpreted as a judgment of the analysts working for the agencies. On the other hand, there is an argument put by Datz (2004: 304) that “the power of credit ratings agencies has little to do with the efficiency of their work, or the accuracy of their estimations. It has a lot more to do with what they represent: a business of self-validation that plays with a panic-prone environment where the word ‘risk’ resonates loudly, and where ‘development policies’ are held hostage by the standards set by these agencies and their clients.” A very good point in this statement is that the CRAs are assumed to ‘represent’ a system of ‘self-validation’, where the agencies serve for the interests of these represented entities and they do this indeed in a standardized mechanism.

A significantly differing criticism related to the accountability problem was also made by Kerwer (2001: 25) from the neo-institutionalist perspective, arguing that “rating agencies have to be observed with a dose of skepticism because their standard-setting activities largely go unchecked. Thus, the reason to be critical is not because they engage in ‘ideological uncertainty transformation’ which provides legitimacy for organizing the financial world in a way that

favors the interests of a capitalist class. It is because rating agencies may not adapt their standard of credit-worthiness fast enough to avoid harm to borrowers and lenders.” There is, in fact, a mechanism checking the works of the CRAs. Yet, the problematic point is that this mechanism is also an U.S - based institution, called as Security Exchange Commission. This control mechanism does not satisfy some of the major critiques, arguing that these agencies simply reflect the interests of certain parties, as mentioned before, and mostly these parties are U.S. ones. This issue is in fact a part of a larger literature as in the case of many other global institutions mainly as the IMF or the World Bank, arguing that there is a need for a further mechanism ‘to rate the raters’ and to control the inspection responsibilities of the relevant institutions.

Apart from the specifically focused literature on credit rating, there is a broader literature on financial and economic governance, of which the rating agencies themselves are a part. The mostly articulated aspect of this economic governance concept for the rating agencies is their regulatory nature within the system. Their power deriving from their unique mission in the globalizing economy attributes them an additional and indirect regulatory feature. Their decisions become so embedded, that they have inevitably started to create their own regulatory framework, within which the actors behave accordingly. “Although the credit rating agencies themselves often argue that they are merely in the business of information provision, in practice these informational ratings function as exclusive providers of global regulatory licenses” (Sinclair 1994 cited in Cooley 2003: 678). What is intended to mean here with the ‘licenses’ is the rating records given for the countries as indicators of debt

repayment capacities and broader economic outlooks. This grading mechanism makes them powerful actors within the system, where there is no other alternative institution serving solely for this purpose.

Although studies that focus on the credit rating system are rich in number, there are few works that include a further analysis supporting the criticisms taking both the political and economic aspects of the ratings agency power into consideration. So far, the economics literature has large number of statistical analyses on the economic data and information, yet mostly neglecting impact of the rating agencies on the policy making by the bureaucracies or only slightly mentioning it. On the other hand, political science works and articles have had a tendency to focus on the power relations aspect of the agencies and assuming that they had already taken place in the global capitalist system. Yet, for the evaluation of this power, it would be necessary to focus on a real case and compare this theoretical ground with the data provided by the agencies. This is what will be explained in the next section ‘methodology’ as an attempt to humbly fulfill such a gap in the literature.

1.4. METHODOLOGY APPLIED

For the main case study, that is Turkey’s sovereign rating outlooks between the years 1993 and 2008, the primary sources are the most useful data having a numerical basis to compare the rating results, in terms of being expected or not. Sovereign rating scores by different rating agencies given for Turkey are analyzed in this study as the primary data with regard to particular periods of times. These chosen dates are the exactly corresponding time periods for up-

and downgrades in Turkey's rating history. The economic conditions of those same periods are analyzed, so that an insight about the economic outlook of a country and the resulting rating scores can be obtained. By focusing on the economic conditions, three specific and most commonly affected economic indicators as capital flow (portfolio investment), foreign direct investment and export levels will be analyzed individually and the changes in their levels corresponding to the rating update announcements will be detailed. Furthermore, the changes on the economic policies in Turkey following certain rating upgrade and downgrade announcements will be analyzed. The possible answers to them would lead the study to a further outcome supporting or rejecting the main argument.

In addition to the primary sources, some important news was selected as secondary sources implying the possible correlation between the significant national and 'transnational' political and economic events, as in the case of Turkey, and the sovereign rating results. The relevant writings and comments of major columnists from both the domestic and international press were also followed and analyzed with regard to those transnational events. Especially, the writings evaluating the possible economic outlooks following the relevant political events were chosen to provide an insight about how to interpret the primary data in line with the rating changes. Mainly, news from the local press such as *Hürriyet*, *Radikal* and *Sabah* newspapers were followed. The major sources chosen for this study from the foreign press are *The Economist*, *Financial Times* and *Wall Street Journal*, which are well known and sometimes criticized as being the main supporters of the international capital. One of the reasons why they are specifically chosen is their being the most popular sources

of financial news and allocating quite large place for news about the credit rating issue. The archives of *the Economist* are especially focused on for this study, as they regularly provide the developments in the sovereign ratings of countries.

Case study of Turkey's rating scores will be the main reference point of this thesis. In order to improve the main case study's explanatory power, some historical political events as the possible military intervention in the Northern Iraq are determined and how they affect the total economic conditions of the country. This proves to be necessary deriving from the statement by Ul Haque, Mark and Mathieson (1998: 12) that only the political events having a considerable effect on the economic conditions would be a matter for the rating criteria. Thus, the past evaluations of political events and economic conditions would provide an insight for the evaluation of further political events and the following sovereign rating scores, as there is an assumed 'path dependency' on these relational aspects.

In order to include real life experiences that would contribute to the knowledge of rating practices and the country experiences, some interviews were conducted with the official staff working at these agencies, such as with *Dr. Botan Berker*, the general manager of the Fitch Ratings Turkey and with *Dr. Selim Seval*, the chairman of the board of directors of Finar/ Dun & Bradstreet. These people were specifically decided to make interviews with, because Fitch Rating is the only one among the 'big three' international rating agencies having a subsidiary in Turkey and Finar/ Dun & Bradstreet is the rating company having representatives in Turkey, though conducting only corporate ratings and not sovereign ratings. Besides, another interview with *Ali İhsan*

Gelberi will be provided, who is currently working at the Economic Research Board of Garanti Bankası, and had previously worked at the Treasury for several years and thus had many experiences with / about the credit rating agencies. In addition, the results of another interview with *Dr. Mahfi Eğilmez*, who has a bureaucratic past and served as the undersecretary of the Treasury will be presented within this thesis, contributing to the recent evaluation of the rating agencies and an understanding of how they interact with the economic bureaucracies in the countries. All these interviews provide this thesis with a strong ground to base the theoretical arguments on. By sharing their experiences and opinions about the credit rating system, these respectful officials also help to understand the critiques better and to evaluate their authenticity.

1.5. ORGANIZATION

Within this framework, the thesis is composed of *this introduction chapter*, *the following three chapters* and a *conclusion* part: *Chapter I* will provide a historical background to the credit rating issue by revealing the reasons behind its emergence and the purpose it is assumed to serve for. *Chapter II* will provide the literature review of the theories applied to the thesis and the statements made by scholars and journalists about the credit rating issue, usually in a critical manner. *Chapter III* will deliver both the process of working of the rating agencies – Fitch Ratings in this case – and an analysis of the changes of Turkey’s rating grades between the years of 1993- 2008 and the corresponding implications for the Turkish economy taking three specifically

chosen economic indicators as a basis. The findings of this analysis will help to make a general statement about the influence of the sovereign ratings for the countries' economies and whether their responsibilities and the expectations should be reinterpreted. In the light of these evaluations, there will be some further recommendations on any possible revision and necessary restructuring of the credit rating agencies, so that they function properly. In the *Conclusion* part, the revealing facts will be clarified and following comments on the answer of the main research question and attempt to arrive at a final argument about the credit rating issue.

Before moving to the literature review, it is important to note again, that there is an obvious need for the credit rating mechanism that provides the necessary and efficient information for the global economy and directs the world economy by putting some rules in the form of the rating criteria. However, according to the major criticisms, the already existing system has some observable deficiencies that prevent the economic actors to obtain the initial benefit from the rating mechanism. These criticisms will be the major driving points of this research by forming the literature to be applied to the analysis. This thesis, first and foremost, questions the real basis of the rating agency power in order to reveal that this power has limits on the countries' economies in terms of both reflections on the economic policy making and the economic outlooks. In addition, it will be tried to evaluate to what extent the rating announcements have an influence on the economic conditions and following policies of a country with special reference to Turkey, taking Turkey's ratings by the three major rating agencies and more specifically Fitch Ratings as the case study. Having analyzed the current rating industry, some

recommendations on the potential restructuring procedure of the rating agencies will be provided at the end of this study.

CHAPTER 2

LITERATURE REVIEW

“Rating agencies produce knowledge that is socially and politically partial, and then objectify this knowledge, making it authoritative.” (Sinclair 2005: 59)

This literature review is designed to provide the theoretical ground of the arguments made within this research study. This part is significant in that it helps the rating practices and real cases to be based on ideational aspects. The major points of information about the rating agencies and criticisms are listed here under certain topics.

2.1. HISTORICAL BACKGROUND ON THE CREDIT RATING AGENCIES

This section is about the first establishments of the rating agencies and explains the intentions why they were designed for the international economic system. A broad view of historical background enables us to have a better understanding about the significance of the rating system and the initial points they were assumed to serve for. This would also provide a ground to evaluate the current situation of the rating agencies with regard to the first motivations of their establishment. The credit rating agencies have a long history as of their creation, yet it was a comparatively short period of time that their significance

was recognized seriously by the major actors of the globalizing economy. Their history dates back to the early 1800s, however their significance increased with the early 1930s' economic conditions. It was the major economic turmoil related to the increasing debt problems experienced by the countries that contributed to the necessity of the credit rating service. One issue is important to note here, that their importance was not embedded by their emergence, in fact it gradually increased with the heightening of the necessity for a guidance mechanism with the break out of certain crisis-throne events in the world economy.

Originally, it can be argued, that the first notion of the credit rating system emerged in 1841 following the financial crisis of 1837. Following this first initiative, two separate rating agencies Dun and Bradstreet were established by the year 1857. They, however, in 1933 merged under the name of Dun & Bradstreet, that later owned another rating corporation, Moody's Investors Service, one of today's most famous agencies (Cantor and Packer 1994: 1). While these developments can be considered to have signaled the emergence of this big industry, the rating activities in a real sense began only in 1909, when John Moody began with the ratings of the U.S railroad bonds, followed by Poor's Publishing Company in 1916, Standard Statistics Company in 1922 – who later merged into today's Standard and Poor's - and the Fitch Publishing Company in 1924 (Cantor and Packer 1994: 2). This long story of almost 200 years enjoyed by the rating agencies was dominated mostly by the corporate credit ratings. However, the issue of economic credibility became more and more important for the countries, as the following economic crises started to weaken the countries' economies and a kind of measurement of debt repayment

became necessary. As Kunczik (2001: 13) noted, “after the second oil price shock (1979/80) debt servicing problems of developing countries became the focus of banks, international institutions, governments and, not to forget, the general public and science. Since the 1980s the global capital market included more and more developing countries which were not richly endowed with capital and skilled labor (cf. Krugman and Obstfeld 1997, 683ff). Between 1981-1983, the world economy suffered the worst recession since the 1930s, which was followed by a quick recovery and emerging markets became more and more important.” This adds to the assumption that the rating agencies play a more significant role for the emerging economies, as they need to attract more foreign investment for their economic development, and those investors are the key correspondents for whom the rating agencies mainly serve.

Apart from the historical development of the ‘rating’ concept, some improvements were also observed on the demand side. Those developments and the later ones altogether led to further changes in the credit rating industry such as significant increases in the number of rated countries. The globalizing economy required more countries to be rated in order to attract the sufficient amount of capital abroad or run their industrial economies with the existing domestic companies, while government bonds, whose value highly depends on the sustainability and success of the relevant country’s economy, also started to be issued in 1980s. According to Lehmann (2004: 256), the number of the countries to be rated increased dramatically as a result of the sudden boom in the emerging market finance. While this number was in the 1970s very small, it reached to a number between 87 and 106 sovereign ratings in early 2004. On the other hand, as it will be later observed, the work process of the rating

agencies did not used to be in the same way as it is today. In line with the technological advances and the relevant developments in the rating system's functioning, the history of the agencies witnessed certain transformations in the rating behavior. In order to be able to comment on the historical developments, it is necessary to focus first on the definition of what the credit rating agencies are and for what they serve in the world economy.

2.2. THE LITERATURE ON THE DEFINITION OF CREDIT RATING AGENCIES

There is a limited literature by a relatively small number of scholar works on the definition of the credit rating system, as the remaining part mostly focuses on the criticisms and the evaluation of the rating methodology, taking different countries as case studies. Basically, credit rating agencies are firms responsible for calculating and determining the credit rating scores of both the companies and countries for economic purposes. The rating given for countries is called as 'sovereign rating', while the other type is called as corporate rating. There is also 'country rating' other than the 'sovereign rating' designed for the countries. Sovereign ratings mainly reflect the economic outlook of countries with respect to their ability to repay their debts, so that they can borrow easily further or attract more foreign investors to invest within their boundaries. In other words, according to Afonso et al. (2007: 9), sovereign ratings indicate the evaluations of default likelihoods. The ratings are determined as a result of various factors reflecting the ability and willingness of the sovereign to repay debt. (see also Lehmann 2004: 255).

The difference between the sovereign rating and country rating should be noted here, as this study will focus on the concept of ‘sovereign rating’ deriving from the political economic approach, and not the ‘country rating’, yet the country rating is also important when the corporations are the case. “Sovereign ratings are not ‘country ratings’, an important and often misunderstood distinction. Sovereign ratings address the credit risks of national governments, but not the specific default risks of other issuers. A rating assigned to a non-sovereign entity is, most frequently, the same as or lower than that assigned to the sovereign in the main country of domicile, but may be higher” (Beers and Cavanaugh, 2004: 1). For this reason, as mentioned before, the concept of ‘country ceiling’ was designed recently to give the corporations the chance to be rated higher than the government, when necessary. Since this study is about the countries’ general economies and it is an attempt to make a political economic explanation of the rating system, the data chosen here is based on the ‘sovereign ratings’ provided by the agencies.

For the rating process, the agencies have predetermined political and economic criteria, according to which they make their calculations in line with the most recent developments about the rated entities and their capacities for debt repayment or credibility for doing business with/ within or investment. These criteria help them to provide information for further investment decisions of other actors. Most of all, the rating outcomes serve for the investment decisions in case of both lack of information and excessive information experienced by the investors. As Sinclair (1994: 452) remarked, “rating agencies can be considered endogenous solutions to the uncertainty that exists when a lender does not know the reputation of a borrower, due to the lack of

community in capital markets (Taylor and Singleton, 1993: 198). Rating agencies operate as the agents of investors in these situations (Pratt and Zeckhauser, 1985).” Yet, it can also be argued that the information already available to the international economic community may be too confusing to make decisions for the players. This may also derive from the fact, that with the increasing technological improvements, the world economy is exposed to more data and information than what is necessary. Under these circumstances, a mechanism becomes necessary to separate the relevant and useful information from the irrelevant ones. Of course, as previously mentioned, in this case, the determination of the relevant information is a result of individual judgments of rating analysts. This aspect will be elaborated later.

There is a large literature on the main premises of the credit rating system and what they are supposed to be responsible for. It would be wrong to argue, that there is a convergence in the literature on that issue, as many scholars view the rating agencies from different perspectives. This eventually leads to a debate, as will be detailed in a separate discussion in this study, about the power and capability of the rating agencies as to whether they provide strict information about the rated entity’s economic situation or only a foresight or opinion about the possible repercussions of certain economic or political indicators. Partnoy (2006: 83) stated, that the credit rating agencies regard their work as being simply a financial publishing. The Nationally Recognized Sovereign Rating Organizations have always claimed their business to be only about publishing purposes. Accordingly, their job consists of collecting relevant data, analyzing and evaluating them and then making the results of the analysis publicly available with their final opinions. From this point of view, what they

produce as a result of their long processes is nothing more than an opinion based on obvious data which are already publicly available. Supporting this argument, “in July 1995, Leo O'Neill, S&P's president, stressed that ratings are opinions issued to inform investors rather than to protect them. Moody's emphasized in August 1999: “Because it involves a look into the future, credit rating is by nature subjective” (Kunczik 2001: 26). This ‘forward looking’ nature of the agencies was also articulated by Bissoondoyal- Bheenick (2005: 279) as being a feature specifically of the sovereign ratings. It is important to note here, that such ‘defensive’ statement made by Moody’s simply refers to the very commonly addressed criticism about the rating agencies on making ‘subjective’ decisions.

Apart from the commonly known credit rating agencies, “there are further actors in the risk rating business. The Business Environment Risk Intelligence (BERI Institute in Geneva) was developed about 1975. “Foreland” (Forecast for Country Risk for International Lenders) is according to Peter Hoffmann (1991, 87) reliable, because the index predicted the problems of countries like Poland, Mexico, Hungary and Brazil years before their financial system got into troubles. Another important evaluation of country risks is done by *Institutional Investor* (a banking and investment journal; cf. Feder and Ross 1982). Since 1979 the American magazine has been publishing the risk-evaluation of countries by about 100 leading banks, investment firms and brokers twice a year (March and September)” (Kunczik 2001: 17). Such an overall insight on the definition of the credit rating enabled the basis upon which the next section will be built. The next section provides more details about the functioning mechanism of the rating system.

2.3. THE LITERATURE ON HOW THE RATING AGENCIES OPERATE

The criticisms within the literature mostly refer to the deficiencies on the working process of the rating agencies. Thus, it would be appropriate firstly to focus on this aspect and analyze the details provided by the literature. As briefly aforementioned, the rating behavior is based on two types of criteria: economic and political ones. The Fitch IBCA Sovereign Rating Methodology Report (p.9) clearly listed their criteria under certain topics, which are similarly used by other rating agencies as well. These are mainly: *demographic, educational and structural factors, labor market analysis, structure of output and trade, dynamism of the private sector, balance of supply and demand, balance of payments, analysis of medium-term growth constraints, macroeconomic policy, trade and foreign investment policy, banking and finance, external liabilities, politics and the state and the international position.*

As it can be observed, there are multiple categories for the criteria to be applied. This can be explained with reference to Mitchell (1998: 91), that “the emergence of the economy, then, should not be examined merely as a conceptual innovation within the discipline of economics or in general social theory. These intellectual developments accompanied and interacted with a broader discursive change in which political and social practice constructed a new object.” The assessments made by the rating agencies depend on multivariate types of indicators and it is an interdisciplinary work. This can be explained based on the motivations behind the credit rating mechanism, which was established mainly for the foreign investors and creditors. Since these

actors have multiple interests in different areas, the rating process should correspond to the indicators beneficial for their final analyses. In other words, the points upon which the rating criteria are built on are the results of the needs of the investors and creditors for their decision makings.

“A quick glance at common rating methodologies reveals that sovereign ratings are designed for a very different class of investors than those that are currently invested in low-income countries. The rating process evaluates countries on a broad range of criteria, including for instance structural factors impeding the functioning of markets, political stability, resilience to external shocks, prospects for economic growth and the health of the financial system. However, there is a clear emphasis on the liquidity of public finances through the assessment of budgetary flexibility, of public sector debt, and of any outstanding contingent liabilities, for instance due to guaranteed debt to state-owned enterprises of potential banking sector recapitalization requirements (Bhatia, 2002)” (Lehmann 2004: 256).

As also observed here, it is inevitable that the majority of the criteria consist of the economic and financial aspects. Ul Haque, Mathieson and Mark (1997: 10) similarly argued, that the ratings are the results of a comprehensive analysis reflecting different types of indicators such as rate of economic growth, current account balance and other ratios, mainly to GDP. Vulnerability to external shocks is usually measured by the extent to which the country depends on foreign trade or investment. In addition, the political criteria were listed generally as the government’s capacity to implement the economic policies, policies towards the foreign investors and creditors and the possible political instabilities. “For example, S&P determines the rating by evaluating the country’s performance in each of the following areas: political risk, income and economic structure, economic growth and prospects, fiscal flexibility, general government debt burden, off-shore and contingent liabilities, monetary flexibility, external liquidity, public-sector external debt burden and private sector external debt burden” (Afonso et al. 2007: 9). Here also, the dominance of the economy-related factors is interesting to observe. On the other hand,

Kunczik (2001: 25) laid out the significance of the political criteria by detailing its components.

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

A parallel argument was made by Sinclair (1994: 457) referring to the rating agency Moody's, that some countries such as Argentina, South Africa, the Philippines and Poland have defaulted on their foreign debts for some other reasons,, rather than simply economic or financial ones. Among those factors, political, social and cultural concerns such as existence of radical uprisings, lack of public confidence in central authorities and inability to impose austerity were counted for a country's liquidity problems. On the other hand, there are still arguments suggesting that the political events may not be that much effective for the sovereign rating process and indeed going beyond that, some claim, that at the end, it is purely economic indicators leading to the final credit ratings. On of the leading arguments in this line was made by Ul Haque et al. (1998: 12) with a related research study. At the end of their work, they claimed:

“Our significant finding is that creditworthiness appears to be determined primarily though the observation and analysis of economic events. Political events and variables do not add any additional information once economic factors have been accounted for. There could be two explanations for this. First, the raters are primarily concerned with the "ability to service debt" and hence are concerned with political events only when they affect this variable. However, coups, crises, law and order problems may not affect this ability and hence raters do not react significantly to these. Second, while country economic performance is affected by political events, it offers a more continuous barometer of the evolving economic

situation. It is not surprising then, to find that the raters attach more weight to the economic variables. The few discreet events such as coups, crises and revolutions and strikes may contribute some information to the extent that they have not already been reflected in economic variables.”

Their study is interesting, because in the same article, they had declared, that according to the rating agencies themselves, political factors are significant for the final rating of a country and that sudden political events can have unanticipated effects on a country's rating (1998: 4). In addition, Ul Haque (1997: 13) stated that a country's ratings are affected by international factors independent of the developments inside. For example, both some regional considerations and export profiles can strongly affect the ratings. Thus, ratings do not specifically focus on one of the theoretical explanations, rather incorporate both aspects. As can be observed here, there is no clear cut consensus on the factors influencing the rating process at most. This also explains why that the rating officials very carefully try to refrain themselves from disclosing single details about the rating determination. There is no publicly available information about the exact rating procedures and this prevents the system from being evaluated with regard to the weights of the rating criteria, either economic or political or also social. While these statements very clearly express the main rating methodology, there are certain details, where critical points are hidden.

The rating process, on which there is not enough information, takes a long time, since it is an outcome of long lasting research, data collection and calculations. “Sovereign rating, according to IMF (1999, 193), begins with meetings between the agency's staff and government officials in order to evaluate the sovereign's creditworthiness. This information is used to prepare a presentation for the rating committee. After the initial rating the agencies

continue to monitor the economic developments of a sovereign. In recent years e.g. Duff & Phelps, Moody's and S&P have supplemented their ratings with watches and outlooks. The rating process includes three steps: 1. identification of risk factors; 2. prognosis of future developments and 3. determination of risk-weight. The main problem of the rating process is that the agencies don't give full information about the rating process, which is regarded as a kind of trade secret" (Kunczik 2001: 19). As mentioned above, this hidden nature of the rating process brings more questions into line. Parallel to this point, Sinclair (2001: 444) asks how the rating works, which Kunczik (2001: 27) believes to be belonging to the field of the sociology of knowledge. Bhatia (2002: 51) provides a further perspective to the issue of rating process:

"In essence, sovereign ratings are a product of a one-size-fits-all ranking process. The analysis is disaggregated into a number of categories, each of which is assessed in relation to the strengths and weaknesses of other rated sovereigns. Analytical categories cover political stability, the real economy, and the fiscal, monetary, and external sectors. The interface between the corporate and financial sectors and the sovereign balance sheet is institutionalized via a careful process of contingent liabilities estimation. The interface between market developments and sovereign vulnerabilities is institutionalized via detailed scrutiny of international liquidity factors. In an effort to protect the process from business related pressures and to preserve an element of discretion, all ratings decisions are taken by committee vote."

These rating committees analyze the obtained information and finalize the rating results.

When turning to the technical aspect of the rating process, the rating committees are in charge of data collection and decision making. Since the major rating agencies have many branches in different countries in order to conduct both sovereign and corporate ratings more effectively, there is an inevitable coordination issue between the headquarters and the local branches. Whether there is a real necessity for such a coordination and consensus concerns is open to discussion, because it is mostly believed that the final

ratings are determined by the authorities other than the local officials. As of the main critique towards the rating system of being under the influence of the U.S headquarters and indirectly the government policies, Sinclair (1994: 453) clarifies that there is generally no complete independence for these branches from their headquarters. “Although both agencies endeavor to hire mainly local officials in order to establish regional specialization, training and the all important rating committees, where rating determinations are actually made, are routed through New York. The objective in the case of both agencies is globally comparable ratings (so that an AA on a steel company in South Korea is equivalent in credit risk terms to an AA on a pulp mill in British Columbia, or a similar rating on a software company in California). New York remains the analytical core, where rating expertise is defined and reinforced.” So, the headquarters are inevitably the ones who finalize the rating reports. However, the rating agency officials usually have a tendency to reject this aspect. Bruner and Abdelal (2005: 198) explain the process with specific reference to the Standard and Poor’s’ rating process, calling it as ‘broadly representative’. Accordingly, “Once a sovereign seeking a rating has entered a formal agreement with Standard & Poor’s and forwarded preliminary economic and financial data, a team of two or more analysts visits the country for three to four days to meet with finance ministry and central bank representatives (including top officials), as well as a range of constituencies outside the government thought to be knowledgeable on politics and economic policy. The analysts then prepare for the rating committee a report including a suggested rating and rationale, which the committee assesses through a number of quantitative and qualitative lenses representative of ‘economic risk’ (the sovereign’s ability to

repay) and ‘political risk’ (the sovereign’s willingness to repay). There is ‘no exact formula’ through which such considerations factor into the eventual rating (see Abdelal and Bruner 2005b).” Marie Cavanaugh from Standard and Poor’s explained that the governments invite the agencies and a team is sent to the country to collect economic and political data both from the government and the organizations. They talk to different economists of the country visited and then the committee consisting of specialists finalizes the rating¹. According to the interview made with Botan Berker, director of board of Fitch Ratings in Turkey, the final ratings are determined by a virtual committee consisting of people from different origins. After long phone calls among these eight or nine people, the rating is determined, but the public announcement is done either from London or New York. “The coordination effect of EKNs (embedded knowledge networks), as exemplified by rating agencies, is to narrow the expectations of creditors and debtors to a well-understood or transparent scope of thought, comprising a set of norms shared among all parties. Accordingly, the agencies do not merely constrain the capital markets but actually provide significant pressures on market participants themselves, contributing to their internal constitution as agents. This transformation of the merital infrastructure operating in markets is key to understanding the quasi-regulatory significance of rating agencies” (Sinclair 2001: 448).

Another significant point about the credit rating industry is about the employed staff in these agencies responsible for calculating and determining the rating scores. It is important to have information about this aspect, because most critiques are focused on the rating agencies’ competencies and assume

¹ *Radikal* Newspaper, “Marie’nin Not Defteri”, 25.01.1999

that they have certain connections with bureaucracies or large corporations which they are responsible to rate. At this point, Botan Berker also argued, that those analysts working at the rating agencies are working only with numbers and numerical scales in very simple terms, so that they have no relation with any bureaucratic people. She added that most of them are very young indeed, even almost new graduates with least experiences of the governmental affairs. “IMF (1999, 149) reports that in terms of educational work and background, most sovereign analysts have a master's degree, and on average they have 10-12 years of work experience in country risk analysis. This implies that with a high probability the analysts have a homogeneous view of the world” (Kunczik 2001: 27).

Such information about the rating analysts is significant also because “the judgment of the rating analysts plays an important role, both in evaluating economic and political variables (e.g., drawing conclusions about the degree of political stability) and in determining how much weight should be attached to different variables within each group of factors. Thus, a fair amount of subjective judgment goes into the final evaluation” (Ul Haque et al.: 11). While the interpretation of the collected data is left in the hands of these analysts, the possibility of a potential manipulation of these data by them is articulated very often. In a defensive manner and pointing out specifically this aspect, “S&P emphasizes that the agency operates with no government mandate and is independent of any investment banking firm, bank or similar organization” (Kunczik 2001: 16). One point should be made clear, yet, that it is inevitable for a credit rating outcome to include some subjective interpretation of the rating committee, as in many other social sciences conducted by personal

determinations. “Qualitative and judgmental aspects of analysis are unavoidable even in the interpretation of quantitative indicators. Every measure of economic performance is the result of a complex interaction of economic, political, and social forces as reflected in the policy formation process within the government and in the reactions of private-sector economic actors to 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” (Bissoondoyal-Bheenick 2005: 279). At the end, according to Kunczik (2001: 27), “all use a qualitative approach based on quantitative indicators and qualitative factors.” The credit rating staff has a different and unique language used in the rating process and specifically during the finalization meetings. This is reflected on how they use certain criteria and incorporate them so that a final analysis is obtained. Since it is a work simply done by a committee as a result of long meetings, it requires a specific framework, according to which every data and observation is properly communicated. “With certain institutions, effective communication may require voluntary compliance with distinctive rules of language, mathematics, or science” (Porter 2005: 25). Sinclair (2001: 449) similarly adds to that, that “regulation, as achieved by these quasi-regulatory mechanisms, results from coordination. Coordination, as accomplished by the agencies, consists of adjustment to the scope of thought, a narrowing in expectations among different social interests.” In addition, Kunczik (2001: 41) argues, that “Ann Swidler and Jorge Arditi (1994, 313) point out, that scattered evidence suggests that those who must regularly deal with an impersonal, distant cultural world organized by

abstract principles such as individualism or rationality construct knowledge differently than do those located socially and intellectually in more parochial settings.”

Apart from the quality issue, a further point made related to the rating agency staff is about the quantity. “S&P has about 700 analysts and produces more than a third of the earnings of McGraw Hill. Governments of countries belonging to the category of emerging markets, e.g., have to pay between \$100,000 and \$150,000 for a rating.” (Kunczik 2001: 16) At this point, however, “it is worth remembering that before the 1970s, the agencies’ business model was radically different from what it is today. Before the 1970s, when the Securities and Exchange Commission created the NRSRO designation and various regulations began to depend on NRSRO ratings, credit rating agencies made money by charging subscription fees to investors, not ratings fees to issuers. In contrast, today roughly 90 percent of credit rating agencies’ revenues are from issuer fees” (Partnoy 2006: 62). While these huge amounts are earned from the sovereign rating alone, there is the view, also held by the IMF, that more qualified and larger number of human resource should be employed by the rating agencies. Kunczik (2001: 27) expressed this, that “concerning the resources devoted to analysis it was found that 70 Sovereign ratings were done by only 12 country analysts and 5 research assistants. IMF (1999, 149) sums up: ‘On average, each rating agency analysts is responsible for seven sovereigns.’ IMF (1999, 150) argued that ‘the number of countries followed by agency analysts is excessive in the light of the challenges associated with analyzing sovereigns.’ IMF’s proposal to solve this dilemma is quite naive from a social scientist’s point of view. IMF recommends to enlarge the number of

analysts (1999, 150: “The issue is that more of them are needed.”).” On the other hand, the issue of payment has sometimes created ethical concerns for the scholars on credit rating field. “In the 1970s rating agencies began charging fees to those companies whose debt they rated. Tom McGuire, an executive vice-president of Moody's, argued: ‘The pressure from fee-paying issuers for higher ratings must always be in delicate balance with the agencies' need to retain credibility among investors.’ IMF (1999, 191f) sees the danger that ‘issuers and intermediaries could be encouraged to engage in rating shopping – a process in which the issuer searches for the least expensive and/or least demanding rating. Such rating shopping can be particular dangerous when the ratings are used as a substitute for adequate disclosure requirements.’” (Kunczik 2001: 38). “The potential for abuse is obvious, and the agencies have sought to defuse criticisms through various internal processes and procedures, including merit-based pay for analysts and ‘firewalls’ separating them from consulting work and fee negotiations, asserting that reputational concerns are sufficient to check such temptations (Smith and Walter 2002, 289; SEC 2003a; Economist 2005a; Economist 2005b)” (Bruner and Abdelal 2005: 195). Similarly, in the interview, Botan Berker claimed that there are “Chinese walls” between the rating analysts and the business development staff responsible for fee negotiations. Until becoming managing director, no one within the analyst groups can have an idea about the fees required.

There is a further dimension about the mentality of the rating process. Sinclair (1994: 457) clearly expressed that “the analysis of sovereign rating methodology presented in *Global Credit Analysis* suggests that Moody's favors what Gill has called the 'new constitutionalism' (Gill, 1993: p. 10). New

constitutionalism is a doctrine and associated set of social forces which seek to place restraints on the democratic control of public and private economic organization and institutions... The new constitutionalism is intended to guarantee the freedom of entry and exit of internationally mobile capital with regard to different socio-economic spaces...The scope of these constraints in an era of substantial mobility of capital mean that political leaders will need to be perhaps as accountable to international market forces as they are to electorates (Gill, 1993: pp. 10-11).” It is related to the concern of the credit rating system in that it aims to serve for the freedom of movement of capital, goods and services.

2.3.1. The Problem with the Rating Calculation: weights of criteria

The major criticisms with regard to the credit rating sector are expressed pointing to the complex nature of rating calculation and determination with the predetermined criteria. There are, as referred to before, economic and political criteria which are composed of different indicators. Each indicator signals a different aspect and thus it is very complicated to see an outcome with regard to their calculation. As stated in the S&P Criteria Report (p.2), “there is no exact formula for combining the scores to determine ratings. The analytical variables are interrelated and the weights are not fixed, either across sovereigns or over time.” While the rating agencies use special models to adjust these different indicators in order to obtain a final conclusion, it is usually very difficult for the ‘outsiders’ to grasp that this is a completely scientific methodology, since human knowledge and interpretation is very much involved in the process. In other words, the literature tends to regard the rating methodology as being

rather vague because of this complexity. Kunczik (2001: 25) explains this issue as,

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

While incorporating the economic data to the political ones, one of the most striking difficulties to understand is on what basis the rating officials can compare these very different types of indicators to draw a conclusion. This was expressed by Ul Haque et al. (1998: 7) that it is the difficulties of measuring various types of political events, systems or concepts that make it complicated to incorporate political variables into economic ones, as some political events such as a military coup have discrete nature, while others do not. Cantor and Packer (1996: 39) also referred to this issue of being ‘not quantifiable’, criticizing that the agencies also refrain from clarifying the weights they give to different indicators. Moreover, Bruner and Abdelal (2005: 194) stated, that those regulatory agencies should be required to base their ratings on a more nuanced system so that the users can distinguish between the quantitative economic analysis and the qualitative aspects deriving from the analysts’ interpretations. Bhatia (2002: 51) adds, that “the limited predictability of economic behavior in general and of political developments in particular leaves

the task of credit ratings assessment poorly suited to formulaic straightjackets, and the decision-making methodologies of S&P, Moody's, and Fitch blend objective, numerical analysis with subjective, informed debate.” Taking the defensive response of the rating agencies into consideration, Sinclair (1994: 454) argued that “the assumption is widely held that quantitative indicators will be the exclusive form of data incorporated into the determination process, and that that process is therefore technical rather than judgmental in nature. However, as John Diaz, a Vice President at Moody's has commented, 'ratios really are a starting point... all a ratio gives you is a historical look at a company...And by the time an account comes out, it is old anyway' (quoted in Bruce, 1992). Although raters do on occasion make comments such as this which support the idea that rating mixes qualitative and quantitative data producing a fundamentally qualitative result, a judgment,' they are adept at using the cloak of economic and financial analysis to hide behind the numbers when it is easier than justifying a judgment to a hostile audience.”

There is another argument, however, suggesting that the same methodology cannot be applied to all countries in a ‘one size fits all’ policy. The same weight given to same indicators cannot be of the same significance for every country’s economy and credibility. As Bissoondoyal- Bheenick (2005: 279) also argued, “the weight assigned to different measures depends on whether we are looking at a high rated country with a long institutional stability or at a low rated country that is still undergoing rapid structural change.” This view refers to the differences on the understanding of ‘improvement’ between the developed and developing countries. The same changes in different countries would not be evaluated in the same way and thus, it would be wrong to expect them to have

similar rating updates. In addition, the weight given to the indicators also depends on the rating agency itself and shows variety. Ul Haque et al. (1998: 4) argued, that “the relative importance of political factors in the credit rating process varies considerably (Table 1). For example, the Euromoney magazine states that political risk factors are given a weight of 15 percent in the overall evaluation of a country's credit ratings. In contrast, the Economic Intelligence Unit (EIU) assigns a 40 percent weight to political and policy risk factors it considers.” This can also lead to some problems, especially when there are significant divergences between the final ratings given by different agencies. It automatically raises the question of the weight of criteria and whether there is or should be, in fact, an official basis to determine the totality of the criteria.

One final problem with regard to the weight issue is called in the literature as ‘pro- cyclical behavior’. Basically, what is meant with this notion is that the rating agencies usually have a tendency to downgrade a country’s ratings, if there are obvious economic problems already observed within that country or upgrade vice versa. However, what is in fact expected from them is to function as an early warning mechanism and downgrade before everything in the country’s economy turns out to be very problematic, such as an economic crisis.

“Stiglitz and colleagues G. Ferri and L.G. Liu have also argued that before and after the Asian financial crisis the ‘rating agencies attached higher weights to their qualitative judgment than they gave to the economic fundamentals’ (Ferri, Liu and Stiglitz 1999, 349). More specifically, they argued that Indonesia, South Korea, Malaysia and Thailand received ratings before the crisis that were ‘consistently higher than the economic fundamentals would warrant’, and ratings following the crisis that ‘dropped much more sharply’ than such fundamentals required. Stiglitz and his colleagues speculated that the agencies had downgraded these sovereigns all the more harshly after the crisis in an effort to ‘protect their reputation capital’, having largely failed to see the crisis coming (Ferri, Liu and Stiglitz 1999, pp. 347, 349, 352- 353). Such results, taken together with the empirical data on economic determinants of sovereign ratings, sketch an interesting composite picture. In general, these studies suggest, sovereign ratings summarize basic economic data that the market already possesses” (Bruner and Abdelal 2005: 201).

As stated, this tendency by the rating agencies derives from their main asset which is mainly reputation and credibility. The more their behavior is consistent with the reality and fulfill the role of guide, the more they gain credibility within the international system and demand for their practice increases in this way. While there are certain questions remained about the rating process, those aspects inevitably lead to a further issue of whether the rating agencies are still that much important for the countries or their roles and responsibilities are already exaggerated from the very beginning.

2.4. THE SIGNIFICANCE AND NECESSITY FOR COUNTRIES' ECONOMIES (TOO MUCH MEANING ATTACHED? TOO MANY EXPECTATIONS EXCEEDING THEIR CAPACITY?)

The significance of the rating agencies is related to their function and filling the gap within the globalizing finance as providing a guide. Previously, bank lending was the sole way of intermediation, where the two sides of lenders and borrowers were brought together. However, disintermediation has become widespread in recent years. Deriving from the globalization's competitive pressures and increasing costs of bank intermediation infrastructure, depositors started to look for alternative ways to do with their money, while borrowers preferred to borrow from non bank sources. "Given the high costs of gathering suitable information with which to make an assessment by individual investors, it is no surprise that institutions have developed to solve the information problem in capital markets by providing centralized judgments on creditworthiness." (Sinclair 2001: 444) In this way, the role of the rating agencies has changed in line with the changing trends within the financial

system. According to Löwenheim (2008: 265), the growth of the international neoliberalism can be counted for the spread of the rating activities. The increase in the international investment in developing countries brought the need for secure information. End of Cold War, on the other hand, revealed the negative implications of bad governance for the Third World and required the search for the guarantees of funds given by the donor countries. “Rating agencies are an important study of EKNs, because the capital markets in which they operate are increasingly central to the raising of funds by corporations, municipalities, and national states. As a consequence, rating agencies influence the products we buy, the public infrastructure we use, and the responsiveness of our democratic institutions. This development is increasingly a global concern as these institutions spread out from their US base to influence policy in Asia, Europe, and Latin America. They are important private makers of global public policy (Sinclair, 1994a, page 451).” (Sinclair 2000: 488) This also explains the demand-side for the rating system.

Kunczik (2001: 26) adds that “the ratings are crucial for the decision making of many international investors. To emphasize again: the better the rating, i.e. the lower the country risk, the easier the access to the international capital market. A good rating means that a country can be well provided with capital. A bad rating on the other hand can stimulate a flight of capital. The worse the rating the higher the interest on capital. The classifications create the impression of rationality and reduce uncertainty in decision making. Transactions on the global market become easier if an investor believes to have an objective basis for an investment-decision. But sovereign ratings biased by organizational routines can increase the risk of investors by giving a false sense

of security. Categorization of countries by rating agencies may lead investors to believe that they are being provided with all the information they need. The consequence can be a reduction of the inclination to search for further information.” At this point, there are arguments referring to the limitations of the power and capability of the rating agencies. For example, Bruner and Abdelal (2005: 205) stated, that “the agencies continually emphasize that a rating is just an ‘opinion’, that it is a relative rather than absolute measure of credit risk, and that as such, a rating is only one of many variables that an investor should consider before arriving at a decision to buy, sell or hold a debt security. In Moody’s view, ‘informed investors who come to their own conclusions *Sovereign Credit Ratings, National Law, and the World Economy* about credit quality make more effective use of ratings in managing financial risk’, and ‘the probability of default is only one factor that investors legitimately consider in making their decisions to lend.”

On the other hand, if properly functioned, there is the expectation that “undoubtedly, the process of obtaining and maintaining a sovereign credit rating enhances the transparency of macroeconomic policy, and as such may exert a certain discipline to manage the macroeconomic framework in a sustainable fashion” (Lehmann 2004: 253). Cantor and Packer (1996: 49) stated that since the sovereign ratings provide macroeconomic observation based on data, the outcomes are highly related to the ‘market-determined credit spreads’. The significance for countries derives from the impact made by the rating announcements on different economic activities happening within the borders of the country. “The stock market should be expected to react to a sovereign rating downgrade because a downgrade can affect a country’s ability to borrow

in international markets, and thus contribute to a credit crunch, which negatively impacts the stock market. Other mechanisms as well reveal a link between sovereign rating and stock markets. Sovereign rating can provide information on the future economic health of the rated country that is not otherwise available to stock market participants, and governments can take policy actions that directly affect companies' future prospects (e.g., raising corporate taxes to compensate for increased debt service following a downgrade). Moreover, because many institutional investors can hold only investment-grade instruments, rating downgrades and (upgrades) may have a negative (positive) impact on security prices" (Ferreira and Gama 2007: 3164). "The availability of accurate and timely macroeconomic and financial data is of course a key objective in the ongoing reform of the international financial system, following a number of emerging market crises" (Lehmann 2004: 264).

Furthermore, the countries increasingly try to adopt their macroeconomic policies in line with the rating announcements and the rules applied by the agencies. This research focuses on this aspect, questioning whether the bureaucracies really take the rating issue into account during the economic policy making. "A key difference, however, between the 'epistemic community' as traditionally conceptualized, and credit rating agencies, is that the epistemic community tends more to inform and influence policy decisions that ultimately are taken by government officials, whereas rating agencies have effectively been deputized to make decisions themselves that have direct policy consequences. Perhaps a more apt theoretical approach would be that of so-called 'coordination service firms' – that is, 'firms that operate to coordinate the behavior of other firms', of which additional examples would include

‘multinational law, accounting, management, and insurance firms, stock exchanges . . . and financial clearinghouses’ (Cutler 2002: 28; also see Sinclair 1999: 153, 161).” (Bruner and Abdelal 2005: 207) In addition, it is not only the countries’ public economies and economic relations that are affected by the sovereign rating. The companies functioning within the boundaries of the rated country is also influenced by the sovereign ratings, as they provide a ceiling for their own corporate ratings and indirectly affecting their business. “Sovereign ratings are important not only because some of the largest issuers in the international capital markets are national governments, but also because these assessments affect the ratings assigned to borrowers of the same nationality” (Cantor and Packer 1996: 38). However, there are still arguments against this, claiming that not all announcements by rating agencies have the same influence over the countries’ economies during both policy making and afterwards. Ferreira and Gama (2007: 3179) marked that “ratings upgrades abroad have no discernible impact on stock market return spreads, but rating downgrades are associated with an economically and statistically significant negative return spread. This suggests that only downgrades abroad convey information to stock markets.”

Altogether, the suggested critical importance of the credit rating agencies is not, yet, free from doubts and questions. For example, according to Kerwer (2001: 20), “third-party enforcement can cause an accountability gap whenever voluntary expertise based standards are converted into coercive rules.” Kerwer (2001: 25) adds, that “neo-institutionalist organization theory suggests that rating agencies have to be observed with a dose of skepticism because their standard-setting activities largely go unchecked. Thus, the reason to be critical

is not because they engage in 'ideological uncertainty transformation' which provides legitimacy for organizing the financial world in a way that favors the interests of a capitalist class. It is because rating agencies may not adapt their standard of credit-worthiness fast enough to avoid harm to borrowers and lenders.”

2.5. POWER OF CREDIT RATING AGENCIES

One of the significant aspects of the rating agency power comes from the data they base their calculations on and the knowledge they produce at the end of the rating process. Sinclair (1994: 460) stated that “there is a transformation occurring in the knowledge structure in which economic and financial analysis takes place outside the US. Strange introduced the notion of knowledge structures (Strange, 1988: pp. 115-134). She considers that a knowledge structure 'determines what knowledge is discovered, how it is stored, and who communicates it by what means to whom and on what terms' (Strange, 1988: p. 117). The structure consists of a certain pattern of incentives and constraints on the development of forms of knowledge, determined by the dominant social forces in terms of their major interests.” “Knowledge is key to understanding where the authority of EKNs [Embedded Knowledge Networks] is derived. Market actors in the new global finance are overwhelmed with data. EKNs supplement and organize readily available aggregate information through expert and local knowledge” (King and Sinclair 2003: 4). Sinclair (2001: 443) himself declared that “EKNs derive epistemic authority from the expert and local forms of knowledge they offer the market. The second form of knowledge—of

"particular circumstances of time and place"—is not systematic but remains vital to the authority claims of the agencies.” Soederberg (2003: 14) very clearly expressed the knowledge aspect of the CRA power.

“The significance of S&P arises when viewed in concert with the OECD and the World Bank. The World Bank and OECD have effectively granted S&P de facto policing rights vis-a-vis corporate governance, or what James Rosenau refers to as 'control mechanisms'." Similarly to the ins, the authority of S&P derives from its specialized knowledge upon which their judgments are based, and the fact that 'capital markets acquiesce to and conduct themselves on the basis of their ratings'. The rating agency's appearance as a partisan institution, devoid of political affiliation and thus motive, also conceals its disciplinary nature in terms of ideologically reproducing the 'international' standard of corporate governance. Aside from its powers of moral suasion, S&P wields coercive power as well. Its ability to inflict potentially great economic harm to a country by downgrading a country's debt rating has serious ramifications for governments and markets alike; the most obvious one being a negative signal to international creditors, institutional investors, and traders, which is usually followed by capital flight and/or investment strikes. To take a recent example, in order to punish Japan for its slow progress on structural reform, S&P recently downgraded Japan's long- term debt rating, which has put it on par with the only G-7 country with a rating below the top-grade AAA, namely, Italy. Upon the release of this news, institutional investors engaged in the so-called 'Wall Street Walk' out of Japan, while others stayed away (investment strike).”

In addition, there is a further dimension, that the rating announcements are accepted usually without being questioned. Since they are the sole source of information within the sector in which they function, usually their opinions are taken for granted, although there are increasing criticisms about their produced outcomes. “Rating agencies almost never have to justify their decisions, let alone provide compensation to others for the adverse consequences of their mistakes” (Kerwer 2001: 3). This derives from the fact, that there is no substitute institution that can produce relevant information to the world finance, which is in great necessity for a reliable source. “There are a number of processes in which the personage of the expert, embodying neutrality, authority and skill in a wise figure, operating according to an ethical code ‘beyond good and evil’ has become so significant in our society. In our argument the rise of

expertise is linked to a transformation in the rationalities and technologies of government. Expertise emerged as a possible solution to a problem that confronted liberal mentalities of government” (Rose and Miller 1992: 187). Bruner and Abdelal (2005: 207) add to that, that “the various roles that ‘ networks of knowledge based experts’, sometimes called ‘epistemic communities’, have played in policymaking, particularly with respect to conditioning ‘ the manner in which problems are understood by the policymakers or are represented by those to whom they turn for advice under conditions of uncertainty’ (Haas 1992, 2- 3). The ‘epistemic’ concept has been employed to explain ‘the authority exercised by [rating] agencies and its relationship to knowledge’, the point being, as Timothy Sinclair (1999) puts it, that ‘they do not seek to persuade, but to make judgments’.” This knowledge-based authority has another dimension that is the act of standard setting. “Whenever standards are made mandatory the legitimacy pattern should shift to the hierarchical model. However, often this is not the case, because third party enforcement is also justified by the legitimacy of expertise. In this case, the standard setter acquires power by third-party enforcement, which is not checked by corresponding accountability: “Even if standardizers bear relatively little responsibility, they may have great power. In such cases standardization may become a form of fairly strong organization, with concentrated power but diluted responsibility and little room for complaints” (Brunsson 1999: 124)” (Kerwer 2001: 7-8).

Deriving from the last point, it can be argued that their power also comes from the community to whom they serve for. Their business happens usually with the transnational financial and economic community, who in a sense are

regarded as forming a transnational elite group. “In this sense, rating agencies have epistemic authority (Sinclair 2000, see also Strulik 2000). Most importantly, this epistemic authority has a political dimension. It justifies financial markets as neutral and efficient means for allocating resources, even though they in fact favor the financial elite and disfavor redistribution” (Kerwer 2001: 5). This situation attaches to them a different notion and empowers them with new capabilities, while changing the nature of their authority. “Bond rating agencies are being transformed into private makers of public policy, as rating institutions acquire power and authority within a context of a global economy of mobile financial resources. Rating agencies, like national states, are an example of what Cox has termed a 'transmission belt' in the process of globalization (Cox, 1992: p. 31).” (Sinclair 1994: 448) At a further stage, it can be claimed, that their formation of this transnational group gives them a sense of public nature. Bruner and Abdelal argued (2005: 208), that “governments - particularly the U.S. government, but also the G12 representatives meeting in Basel - have deputized the rating agencies. Public authority has not been privatized. Indeed, it is just the reverse: Private authority that emerged spontaneously, and which previously had no public counterpart, has been given public standing through laws and codes.” Sinclair (1994: 453) relevantly sees the authority of the rating agencies as a hybrid form between the state and the market. In his another work, Sinclair (2001: 443) stated that “EKNs exercise authority in market transactions in two senses. First, they control, by constraining thinking to a specific range of acceptable possibilities, and as a consequence shape what market actors do.” However, this mentality can sometimes turn out to be prone to be abused and exceed the initial intentions,

such as “that there are potentially unexpected consequences from using private rating agencies as a substitute for state-based regulation, due to the organizational incentives that shape the ratings industry. Cementing these organizational incentives into the emerging financial architecture will give rise to negative social and economic consequences” (King and Sinclair 2001: 2).

In this way, the rating agencies automatically construct their own framework and adjust the data they collect to fit within this framework, so that they can make their analyses and produce the rating scores. “Analysts live in a ‘world of literary images’ and get their information about a certain country mostly from the news media – even if they are specialized on certain countries. The news media on the other side publish the ratings – and so a system of self-references (in German: *selbstreferentielles System*) develops. The result is a perpetuation of stereotypes of certain countries. Furthermore it can be hypothesized (empirical studies still missing) that analysts/raters adhere to a common ideology – which they don't call ideology, because they even don't know that it is an ideology” (Kunczik 2001: 31). Thus, it can be argued, that the rating agencies determine their own ideology and operate within this framework, which they believe to be encompassing the best indicators of countries’ or corporations’ performance. This is, in fact, the identification of what is the best for countries and corporations. As Löwenheim (2008: 256) stated, “these examinations not only reflect certain knowledge and ideas about ‘good governance’ but are also imbued with power, and they aim to shape and guide examined states’ conduct. That is to say, it is materially powerful economic and political actors who carry out examinations of governance.”

2.5.1 Literature on ‘Power’

The broader literature on power is provided here to have a general idea about what is meant with the power for the CRAs. According to Bruno Latour, “a powerful actor, agent or institution is one that, in the particular circumstances obtaining at a given moment, is able to successfully enrol and mobilise persons, procedures and artifacts in the pursuit of its goals” (Rose and Miller 1992: 183). Being a powerful actor, the rating agencies become a part of the group forming the rules of the globalizing financial system. Since their announcements are considered by the countries as a benchmark for policy making, they inevitably involve in the political scene. As Rose and Miller (1992: 174) also argued, “political power is exercised today through a profusion of shifting alliances between diverse authorities in projects to govern a multitude of facets of economic activity, social life and individual conduct...because most individuals are not merely the subjects of power but play a part in its operations.”

For the rating agencies, it is the power of knowledge which they produce for their rating practices approved globally. The kind of authority exercised by the agencies derives from their role of examiner. “The examiner decides what aspects will be examined from the outset, what sources of information will be included, the weight of each source in the final scores, and the methods of operationally defining standards and measuring them. Such methodological issues are inseparable from the production of truth and, therefore, according to Foucault, are interlinked with power” (Löwenheim 2008: 260).

2.6. FINANCIAL REGULATION AND GOVERNANCE

As aforementioned, the credit rating industry belongs to the field of financial regulation and economic governance, being one of the actors of them. Thus, their literature has a tendency to see the place of the agencies within the broader framework of the governance and evaluate the agencies on this basis. The need for the rating also derived from the governance issue, as the worldwide economics has transformed into a disintermediation nature, which makes it harder to communicate between the actors. The rating agencies enable here the language. “The capital market moves from intermediation to regulation of firm and household behavior” (Porter 2005: 23).

From another perspective, the rating agencies can be considered as forming a part of the financial regime. “Although the regime concept has most often been used to refer to the rules created by states to govern their interactions, it has also been expanded to include the rules created by private-sector actors. (Porter, 1993; Cutler, Haufler, and Porter, 1999)” (Porter 2005: 27). “Institutions exist within the data gathering processes of investors which have the effect of coordinating capital allocation behavior by structuring information and subsequent decisions in particular ways. These institutions affect the thought and action of those trying to borrow funds, and can be understood as governance mechanisms; that is, as non-state means through which authority is exercised in markets and a form of policy created (Miller and Rose, 1990; Ferguson and Mansbach, 1991; Rosenau, 1992; Sinclair, 1994). In a context of dynamic economic activity, this structuring of information is giving rise to changes in the ways major features of economic and political life are arranged,

with implications for the maintenance of hegemonic forces” (Sinclair 1994: 447).

In terms of the rating behavior, in line with the famous accountability problem, there is a debate over the nature of this accountability which is a very significant component of ‘governance’. It is commonly argued, that the agencies’ responsibility and being aware of the fact that they are usually the most important information providers makes them cautious about their calculations and thus there is no necessity for a separate audit mechanism. “According to the perspective of standard economic theory, there is no accountability gap since the agencies are adequately controlled by reputation. By contrast, critical political economy identifies the accountability problem as a major problem for analysis” (Kerwer 2001: 4) Furthermore, “the ‘private’ authority of the rating agencies is not so private after all. Governments have both valorized and codified their authority. Indeed, governments define the market for ratings and help to determine their influence. As John Ruggie observes, the scholarly literature has overstated the process of regulatory privatization, “obscuring the fundamental fact that in many instances of ‘private governance’ there has been no actual shift away from public to private sectors” (Bruner and Abdelal 2005: 193). “Global finance has a number of characteristics that make professional associations important in its governance. First, it is highly knowledge-intensive, and professional associations devote much effort to ensuring that their members are adequately trained. Second, it relies to a very important degree on trust, because of the large, intangible complex transactions involved, where the purchaser often has difficulty understanding or controlling the risks associated with the transaction.

Professional associations can function to certify their members as trustworthy. Third, as global financial markets have expanded, professionalization, accreditation, and licensing have become more important relative to alternative forms of organizing knowledge or to risk-management activities such as relying on old-boys' networks or the informal in-house knowledge that many large banks possess" (Porter 2005: 105).

2.6.1. Literature on Economic Governance

"What is distinctive about contemporary sovereign rating is that it is no longer a realm of AAA countries only, as it once was" (Sinclair 2004: 138).

Beside the financial regulation, a broader literature on economic governance is necessary in order to have a better insight about the place of the rating agencies within the globalizing economy. It is well known, that today's world economy is not solely governed by the states themselves, but also the international and transnational organizations have much influence on the shaping of regimes and institutions. "In a very real sense, the economy is brought into being by economic theories themselves, which define and individuate a set of characteristics, laws and processes designated economic rather than, say, political or natural. This enables 'the economy' to become something which politicians, academics, industrialists and others think can be governed and managed, evaluated and programmed in order to increase wealth, profit and the like" (Rose and Miller 1992: 182). This governance has many components responsible to participate by both determining and applying the

rules and regulations. There are both states and non- state actors. “States seem to coexist rather uneasily with rating agencies, as sovereign downgrades demonstrate. Rating institutions offer states a vehicle through which parts of society, such as capital allocation, can be separated off as 'not political' in a new constitutionalist manner. They also discipline states themselves by conducting surveillance and sending signals about policy and performance to internationally mobile capital” (Sinclair 1994: 462). Mitchell (1998: 90) reasons clearly the emergence of this form of governance. “The collapse of empire and the growing hegemony of the United States created a new order, consolidated first by the League of Nations and then by the UN, the World Bank and the International Monetary Fund, in which the world was pictured in the form of separate nation-states, with each state marking the boundary of a distinct economy. Again, the new macro-economics took these imagined objects as its untheorized referents: international trade was measured in terms of aggregates (imports and exports of goods and capital) and averages (terms of trade, exchange rates) that were defined in terms of the transactions between national economies (Radice, 1984: 121). The UN and the World Bank helped construct the new global imaginary through the publication of statistics and the proliferation of programs defining as their object these separate economies.” Obviously the organizations coming first to minds when considering the world economic governance are the IMF and the World Bank. “In response to the recent spate of financial crises in East Asia (1997-98), the IMF has established a core set of international standards to regulate market behavior in the global South. These standards are embodied in 11 modules that comprise the IMF's Reports on the Observance of Standards and Codes (Roscs). Both content and

form of the ROSCS warrant further consideration. That said, the main objective of this paper is to explain how and why one particular ROSC, namely corporate governance, has become standardized. And, more importantly, to address the question of whose interests are served. In doing so the essay suggests that, despite the claim that the international standard of corporate governance embodies 'universal principles', the definition advanced in the ROSCs intentionally draws on the Anglo-American variant. This imposed standardization of corporate governance serves two overlapping goals. First, it seeks to stabilize the international financial system by ensuring that emerging markets adhere to the principles of a neo-liberal open market economy. Second, by placing a greater emphasis on 'shareholder value' than other types of corporate governance, it protects the interests of institutional investors based in market-centric systems such as that of the USA" (Soederberg 2003: 7).

2.6.2. Actor- Network Theory – How these Networks Create their own Power and Perform

Since these rating agencies work within a network in order to obtain the relevant data and then communicate it among themselves as a committee, the theory of actor network is relevant to study in order to understand this aspect of their work better. In addition, in the light of the actor- network theory, the criticisms can be evaluated from a different perspective. Mainly, actor- network theory is about "the multiple and delicate networks that connect the lives of individuals, groups and organizations to the aspirations of authorities in the advanced liberal democracies of the present" (Rose and Miller 1992: 176). "The

study of collective action problems and principal-agent relationships is increasingly displacing purely functional neoclassical assumptions about institutions (March and Olsen, 1984; Yarbrough and Yarbrough, 1990; Pratt and Zeckhauser, 1985; White, 1985; Ostrom, 1990; Taylor and Singleton, 1993)” (Sinclair 1994: 452). The agencies need to get the information for the sovereign ratings from the countries themselves, and thus establish regular connections specifically with the economic bureaucracies within the country rated. “Leading financial firms may work closely with their governments, especially in the USA, in aggressively pushing international rules and ideas that help these firms profitably expand their activities around the world, such as rules and ideas supporting unrestrained cross-border capital mobility and requiring debtor countries to adjust to the demands of global financial markets” (Porter 2005: 22)

2.7. GENERAL CRITICISMS

The most part of the credit rating literature consists of the criticisms made towards their functioning. “The industry literature is full of criticism of the agencies as being unresponsive, backward looking, and so forth (*Euromoney*, 1991; Elliott, 1988)” (Sinclair 1994: 453). One of the most frequently encountered criticisms is about the lack of enough information on the rating criteria applied. “The rating process itself remains largely opaque to the outside world. There is some variation between the major agencies on this issue. Moody's, true to its corporate culture, tends to be much less revealing about the criteria it uses to arrive at its determinations than its major rival. The reason for

this, according to Moody's, is that publishing rating criteria which indicate, for example, acceptable financial ratios for particular industries tend to distort expectations amongst issuers (Abbott interview). Criteria based on quantitative information tend to 'confuse people' when their issue does not achieve the expected rating for other than quantitative reasons. In contrast to this position, S&P publishes a great number of criteria books that are packed with guidelines on appropriate financial ratios for different types of credits" (Sinclair 1994: 454).

Another much articulated aspect attached to the rating issue is the lack of scientific notions observed on the rating agencies' behavior. This is related to the idea that the rating methodology has a rather subjective nature and thus inevitably includes personal interpretations of the data by the rating agencies themselves. "Rating agency judgments, and the views of the world within which these arise occur within an ideological context and have ideological significance. Such an acknowledgement by no means implies a conspiratorial view of the agencies" (Sinclair 1994: 455). "Given the highly subjective nature of credit rating – especially with sovereigns, for which politics and willingness to repay are of special concern (Beers and Cavanaugh 2004; Truglia, Levey, and Mahoney 1995, 4–5) – it follows that the process is permeated by ideologically conditioned judgments. Numerous observers, particularly those from outside the United States, have argued that despite their objective posture, the major agencies' credit ratings reflect a U.S.-centric, liberalist ideology (Murphy 2000; Kerwer 2002, 43; Sinclair 1994, 454- 455; Subramanian 2002). For instance, while a sovereign rating will inevitably reflect the analyst's general perception of political stability and institutional transparency, Standard

& Poor's looks more specifically at whether governmental 'separation of powers' and 'civil institutions, particularly an independent press', have developed such that 'policy errors' can be 'identified and corrected' quickly (Beers and Cavanaugh 2004). Standard & Poor's also favors 'a market economy with legally enforceable property rights' as 'less prone to policy error' (Beers and Cavanaugh 2004)" (Bruner and Abdelal 2005: 199).

The fact that there has been a need for the credit rating agencies and the information they provide has been the starting point for the establishment of this mechanism in the world economy. They are still the sole autonomies having the authority to publish announcements related to the economic situations of both the countries and companies. However, their uniqueness attracts some criticisms as well, handling this competence as a reflection of a hegemonic power. "Because rating agencies want comparability across credits and across countries, despite attempts to create local knowledge by the agencies, there will increasingly be an 'operating system' (Lipschutz, 1992: 418) around which judgments will be derived that will be centered on hegemonic norms and values. Because the US agencies are most likely to express this framework convincingly, they will dominate 'local' agencies and eventually eliminate or incorporate them, other things being equal. More broadly, the hegemonic norms and values reinforced by the rating institutions will, most probably, add to pressures to shift the prevailing patterns of financial organization in various localities to arrangements more in line with the capital market form described by Zysman (1983)" (Sinclair 1994: 461). In a similar manner, Kunczik (2001: 29) argued that "although no systematic research has been conducted up to now, it can be hypothesized that raters/analysts are living

in a world where similar (economic) values dominate the way of thinking and the way of seeing the world. Since ratings are made from a certain point of view – normally the Western perspective – the focus is on economic efficiency. Important characteristics of a society like quality of life are – if at all – only indirectly taken into account.” Yet, in order to be able to evaluate the correctness of these assessments, it is necessary to see to what extent the agencies are successful in promoting their opinions and analyses for the countries’ policy making. This will be the next concern in this paper.

The pro-cyclical behavior that was explained before is another very common point of criticism within the literature. “The IMF (1999, 136f) identified three explanations for the failure to predict the Asian crises: ‘First, rating agencies are said to be influenced by the compensation they receive from rated issuers. According to this argument, the agencies would hesitate to downgrade issuers from fear of spoiling business relationships that underpin their income stream. Second, the agencies purportedly are reluctant to downgrade sovereigns for fear of precipitating self-fulfilling crises. ... finally, some argue that the rating agencies are inadequately staffed and therefore not up to the task.’” (Kunczik, 2001: 33). “The debate about the IFA [International Financial Architecture] that emerged out of the financial crises of 1997- 1999 put the spotlight on rating agencies in two ways: first, as potentially pro-cyclical institutions accused of initially ignoring latent problems, then of offering an exaggerated reaction via a succession of downgrades, contributing to the deepening of these crises” (Sinclair, 2001: 442).

CHAPTER 3

DATA ON SOVEREIGN RATINGS

“A key conclusion from [this] investigation of rating agencies’ effect on governments is that ‘sovereignty-free actors’ enter into complex relations with the ‘sovereignty-bound’ (Sinclair 2005: 147)

This chapter will mainly provide an informational part of the long-term rating change announcements made by the big three rating agencies for Turkey. The reason why Turkey was chosen as the case country is the easier access to data and information and the ability to analyze the data in light of the daily political and economic issues. The credit rating records for Turkey between the years of 1993 and 2009 will be provided and the changes on three economic indicators as foreign direct investment-, export- and capital flow levels within the corresponding periods will be analyzed. Information about these impulses will be obtained both through numerical data and the news and columns on the related dates. This section is important in that it forms the basis of a further analysis in the next chapter, which will finalize the evaluation of the main argument of this study. According to the results achieved through these data, a general idea about the relation between the rating grades and a country’s economic activities and performance will be laid out.

3.1. CHANGES ON TURKEY'S RATING RECORDS BETWEEN THE YEARS 1993 AND 2009

The fact that sovereigns are rated as a general requirement without their specific demand for sovereign rating when entering certain bond markets makes it also inevitable for Turkey to be rated. Actually, the initial designation of the sovereign rating system can be considered a quite crucial component of Turkey's economic openness, as it provides a kind of acceptance towards the international market. For a developing economy like Turkey, the rating system may prove to be very effective in acquiring a sense of license within the system of the developed economies. For these and similar concerns, Turkey engaged in the sovereign rating system in late 1980s. This section will start with a brief history of Turkey's rating experience and then continue with the changes on sovereign rating changes for Turkey separately in deteriorating and improving trends. An analysis of these data in the next chapter will help to have a better idea about the rating grades and the following policies, taking lessons from the previous policies leading to the rating updates.

3.1.1. Turkey's Early Experience with the Sovereign Rating Concept

In the interview made for this study, Mahfi Eğılmez, a former undersecretary of Turkish Treasury, states that the first sovereign rating experience for Turkey was realized in 1990, when it was decided to enter the Yankee bond markets². As a requirement, it was necessary to get a sense of 'approval' certificate from one of the rating agencies when entering the Yankee

² Market for dollar-denominated bonds issued in the U.S. by foreign corporations, banks and governments. (http://www.investorwords.com/5356/Yankee_bond_market.html)

bond markets (see Cantor and Packer, 1994: 2). Eğılmez argued that the agencies themselves came for the rating and proposed the rating agreement, when he himself was in office of undersecretary. After the rating process was done, just when Turkey was about to enter the Yankee market, the Gulf war started within the same year and thus the entrance to the Yankee market was postponed. The sovereign rating Turkey received on that date was BBB, which is the 'investment level'. This means that an investment in this country is safe and would provide expected results. However, since the entrance was not realized, the rating grade was not announced also publicly. It was only late 1992, when this rating grade BBB was publicized. Tansu Çiller was the prime minister at that time and she proudly declared to be the first official borrowing with the rating BBB. Following this first experience with the notion of sovereign rating, Turkey faced with several rating changes, and mostly in decreasing trends. The next part will mainly focus on the further history.

It is a commonly known fact, that political concerns have always played an important role for Turkey's sovereign rating, as for many developing countries and transition economies. As Şirvan (2003: 4) explained, one of the causes for the high political risks in Turkey has been the very often elections. Between the years 1990 and 2003, there have been two presidency and five local or general elections held in Turkey. While this was an opportunity for the reconstruction renovation and reform of democracy, these elections have always created uncertainty in Turkey. The financial costs of those elections have usually been in excessive amounts, that the elections economy was not well managed. That is also an example of how politics have been very much involved in the economic aspect of sovereign rating for Turkey.

TABLE – 1: Turkey’s Rating Updates by the Major Rating Agencies

Updates	S&P	Fitch	Moody’s
Jan1994	BBB→BBB-	-	Baa3→Ba1
Mar 1994	BBB-→BB	-	-
Apr 1994	BB→B+	-	-
Jul 1994	-	-	Ba3→B1
Sept 1995	-	B→BB-	-
Dec1996	B+→B	BB-→B+	-
Mar 1997	-	-	Ba3→B1
Apr 2000	B→B+	B+→BB-	-
Feb 2001	B+→B	-	-
Apr 2001	B→B-	BB-→B+	-
Aug 2001	-	B+→B	-
Mar 2003	-	B→B-	-
Jul 2003	B-→B	-	-
Sep 2003	-	B-→B	-
Oct 2003	B→B+	-	-
Feb 2004	-	B→B+	-
Aug 2004	B+→BB-	-	-
Jan 2005	-	B+→BB	-
Dec 2005	-	-	B1→Ba3

As can be observed from Table 1, the rating agencies as S&P, Fitch Ratings and Moody’s have usually announced their rating updates for Turkey in different time periods and in fact the letters they determined also showed variety. However, when announced in same months, the determined updates are the same such as an upgrade or downgrade by two rating agencies. The next sections will provide detailed explanations for these rating changes observed for Turkey.

3.1.2. Upgrades in Turkey’s Sovereign Rating Grades

This section will provide the historical improvements in the announcements made for Turkey’s sovereign rating by the major rating agencies namely as

Standard and Poor's, Fitch Ratings and Moody's. The upgrades provided by each three agencies will be detailed so that more room for interpretation about corresponding economic consequences will be achieved. In other words, the Turkish economy cannot be claimed to react according to one specific rating agency's announcements. Thus, it is necessary to provide all upgrades made by three of them. Additionally, the corresponding situations in Turkey's political and economic scenes most possible to lead to those changes will be detailed in order to have a better insight about those changes. Since, as also mentioned before, the rating agencies do not very clearly disclose the explanations for the rating updates, these evaluations about the potential causes can not be argued to reflect more than a 'possibility'. When looking in general, it can be easily observed, that there were not very often rating upgrades for Turkey, compared to the frequent downgrades. This mainly derives from the situation, that the first ratings given for Turkey were the highest ones, which Turkey could not succeed in getting in later years. Besides, the aforementioned dominance of political aspects in Turkey's sovereign ratings has contributed to this complicated situation of rating updates in a negative trend. The explanations provided for each rating change are the results of a research made from the Turkish almanacs, mainly from Hürriyet Newspaper's almanac. The relevant events possible to contribute or directly lead to those rating updates were listed as a result and the necessary connections were produced. There are also some expressions made by the rating agencies themselves for specific rating changes.

To begin with, there was an upgrade by Standard and Poor's (S&P) on 25 April 2000 after the last rating record on 10 December 1999, from B to B+. According to the almanacs, there were two possible relevant points leading to

this outcome: A new IMF stand-by agreement in December 1999 and the approval of Turkey's candidacy for EU membership within the same period. An IMF agreement has always been regarded as critical for Turkey's economic stability and has served as an instrument for an insight about the future of the economy. On the other hand, any positive steps taken with regard to a future EU membership has been appreciated as possible improvements in Turkish economy with the following EU aids, employment opportunities or better trade and investment relations.

Another upgrade was observed on 28 July 2003 given by S&P, following the previous announcement on 7 November 2002, from B- to B. There can be provided several reasons to be attributed to this change as a result of the research. First of all, there was a further announcement with regard to Turkey's relations with the EU. It was stated in the Copenhagen Summit on 13 December 2002, that if Turkey would fulfill the necessary criteria by December 2004, then the negotiations would start as soon as possible. .On the other hand, the new Turkish government (59th) headed by Recep Tayyip Erdogan was founded on 24 March 2003. The results of national elections are usually regarded as an implication of domestic political stability and thus, play a significant role in a positive change of rating scores. However, whether this derives from the general stable environment or should be attributed to the specific persons elected is open to discussion, indeed. On the following days, the Iraq War started right on the southern borders of Turkey. Actually, this should have had a negative impact on the credit ratings, being a conflict in the neighborhood. Yet, this can be interpreted to be used as a 'carrot' by the US officials for a possible assistance demand from Turkey in the future. Proving this assumption in a way,

five days after the beginning of the war, US president Bush declared, that an amount of 8.5 billion dollars would be allocated from the Iraq war budget for Turkey in response to a possible consignment of Turkish soldiers. Furthermore, on 20 July 2003, the fifth IMF revision was agreed upon.

A third rating upgrade was realized on 16 October 2003 by S&P, only four months after the last rating change on 28 July 2003 and this was an improvement from B to B+. The only possible explanation for this change other than the economic criteria found from the almanacs would be the agreement on the credit allocation of 8.5 billion dollars by the US government in Dubai. This was a credit of four years- non repayment and with ten years maturity.

The last upgrade by S&P was on 17 August 2004, after the last rating announcement on 8 March 2004, from B+ to BB-. The main significant event within this period was the achievement of getting a negotiation date (3 October 2005) from the EU for membership. The municipal elections on 28 March and the victory of Justice and Development Party (JDP)

While there were four upgrades by S&P, it is observed that Fitch Ratings (FR) applied five times rating upgrades within almost the same period. The first upgrade by the FR was recognized on 26 September 1995, right after the first grade given by the FR on 10 August 1994, an improvement from B to BB-. During that period, one of the most striking events occurring in Turkey was the Customs Union agreement signed with the European countries on 6 March 1995. There has no doubt both within Turkey and the international arena, that any improved economic relations with European countries would contribute largely to the Turkish economy. It was believed, that this agreement would facilitate the export activities between the two sides and this directly would lead

to an increase in the export revenues on behalf of Turkey, leading to better economic performance indicators at the end. In addition, on 30 January 1995, with a surprising decision, United States declared its support for the project of Baku - Ceyhan pipeline to be passed through Turkey. This indirectly reflected a possible positive insight about the U.S – Turkey relations and may have contributed to the understanding by the rating agencies, that the trust atmosphere in Turkey would improve deriving from the guarantor perception of the U.S.

Another upgrade by FR was realized on 27 April 2000, right after the last rating on 10 April 2000, a transition from B+ to BB-. Apart from the economic indicators, the most noticeable event during that period can be claimed to be the case when five parties in the Turkish assembly nominated Ahmet Necdet Sezer as the candidate for the presidency. This was perceived by the public environment in a way as an indicator of democracy applied in Turkey. Such a perception might be also held within the international community, and regarded as an improvement of Turkey's democratic structure, signaling at least better investment patterns as a result of investor confidence.

A third upgrade was made by the FR on 25 September 2003, after 6 August 2003, from B- to B. A striking event corresponding to this period can be given as the financial agreement of an 8.5 billion USD credit to be provided by the U.S government to Turkey. This agreement was signed in September, that is a period of time for the rating change.

The following rating upgrade by the FR was realized on 9 February 2004, after the previous rating on 25 September 2003 and this was an improvement from B to B+. Within this four months period of time, some changes were observed in

Turkey in both political and economic realms. In December 2003, Saddam Hussein was arrested and this event led to a large decrease in the oil prices. In the same month, the IMF approved the sixth revision of the agreement with Turkey. A credit amount of 502 million USD was released additionally. On the other hand, on January 2004, the inflation in Turkey decreased to a number of lowest in last 29 years. All of these events may have contributed to the rating upgrade decision by the Fitch Ratings other than the pure economic indicators.

The Fitch Ratings announced its final rating upgrade on 13 January 2005 as BB, after the last rating on 25 August 2004 as B+. The possible turning points in the economic arena leading to this decision can be counted as the followings: On 14 December 2004, a new stand by agreement with the IMF was agreed on as a 3 year program of 10 million USD. On 3 January 2005, it was declared that the inflation target of the year 2004 was met in Turkey. Finally, on 13 January 2005, the Eurobond export of Turkey got a proposal of 13 million USD, breaking a record in a sense.

Coming to the last rating agency, Moody's, there was only one rating upgrade observed during the whole history of Turkey's rating updates. After the last rating on 21 December 2000, a rating upgrade was realized on 14 December 2005 from B1 to Ba3. Since it is a very long period of five years, any comment about the possible causes leading to this rating change is very difficult to make.

The list of this rating upgrades provided in this section helps this study to form an understanding about the reasons for an improvement in the rating process. In this way, the government policies with the concern to get rating upgrades can be analyzed better, as some policies resulting improved ratings are already familiar. On the other hand, the policies to avoid in order to prevent the

sovereign ratings from falling can be observed better when focusing this time on the rating downgrades. The next section basically provides this aspect.

3.1.3. Downgrades in Turkey's Sovereign Rating Grades

As also mentioned before, Turkey has experienced more downgrades than the upgrades in its sovereign rating history. This mainly derives from the possible idea that it is easier for the rating agencies to downgrade the ratings than to upgrade them for certain countries, such as the developing economies. It has one explanation: improved ratings bring always more responsibility in terms of a possible future crisis, when the rating agencies are among the first ones to blame for. This was mainly observed during the 1997 Asian crisis, when the rating agencies had not reflected the deteriorating outlook of the Asian economies before the crisis. From this fear of being criticized of not responding on time, the rating agencies developed a tendency to hold the ratings lower for the developing countries, whose economies do not guarantee a risk-free environment. Being among such economies, Turkey also experienced similar results by the rating agencies. The rating agencies seem to have hesitated to upgrade Turkey's sovereign rating for similar purposes. While this is an issue left with full uncertainty deriving from the lack of complete information provided by the rating agencies about their rating procedures, an analysis of the rating downgrades would provide a better insight about the possible cause-effect scenarios.

To begin with, the first rating downgrade by Standard and Poor's for Turkey was experienced on 14 January 1994 as a BBB-, after the last rating on 3 May

1993 as a BBB, which is accepted as the investment level threshold. Within this one year period, some developments in the internal politics were observed. For example, on 16 May 1993, right after the last rating, the president of Right Way Party, Suleyman Demirel was appointed as president of Turkish Republic. Technically, however, this would not imply any deterioration within a country. On 5 July 1993, Tansu Ciller founded the coalition government of Right Way Party and Social Democrat Publicist Party. Whether a coalition government can be counted as one of the factors in determination of a rating downgrade is far from being a judgment. It is well known, that the ratings reflect both political and economic indicators when finalizing the grade, and by focusing even on single pure economic data, it still becomes very difficult to make a judgment about which indicators would have led to the rating changes within certain periods.

The second rating downgrade was observed on 22 March 1994, after the previous rating on 14 January of the same year, showing deterioration from BBB- to BB. As it can be seen, this downgrade followed immediately the last downgrade. A striking event within this period can be given as the resignation of the head of Central Bank, Bulent Gultekin, as a result of his criticism about the devaluation decision of the government. This is a negative event, as the resignation within the government can be regarded by the rating agencies as an impediment towards the political stability.

The next rating after that downgrade was also a downgrade on 29th April of the same year (1994), from BB to B+. The major significant event within this period, that is the local elections on 27 March 1994, is difficult to assess within the framework of a possible effect on the rating update. The Right Way Party

got 22.39% of the total votes, while the Homeland Party very closely followed it with 21.83% of the total votes. However, this was still an important development for Turkey's internal politics, which may lead to a change on the perception of the rating officials about Turkey. A following political change in Turkey was experienced on 13 April 1994, when Necmettin Erbakan made a statement of his future predictions about the ruling party. He argued, that it was certain that their party will become the ruling one, yet whether this transition would be a nice one or not, a live one or not and a bloody one or not is uncertain. This expression attracted opposition and Ankara State Security Court sued him for his statement. Such short periods of rating changes would imply the idea, that more political factors than the economic ones would be effective in the determination of these changes, as it would take more time for the economic indicators to show changes and lead to rating updates. However, the economic decisions announced on 5 April 1994, known as 5 April decisions, were also very striking and had significant reflections in Turkey. The government led by Tansu Ciller took serious economic decisions and measures such as large price increases and devaluation, since the economy was in very bad conditions. This created an explosive effect in Turkish economy, possibly leading to a sudden change in the sovereign ratings.

The following rating downgrade was observed on 13 December 1996 as a grade of B, after the last rating on 18 July 1996 as B+. In such a short period of time, there was only one significant internal event, the famous "Susurluk" scandal. Since this event created explosive reflections on the public and led to questioning the government politics in Turkey, this may have had also an effect on the political stability criteria for the rating agencies.

The next rating downgrade was quite interesting in terms of the period of time in which the changing patterns were supposed to be observed. This rating change was initiated on 23 February 2001, after only two days of the latest rating on 21 February 2001, from B+ to B. Two days seem to be very unconventional for a rating update, as it would usually take longer time for some striking political and economic changes to lead to rating revisions. However, when analyzing, two significant political events become potential factors for such a rating change. First of all, it was stated, that foreign capital outflow from Turkey in February 2001 increased enormously. Secondly, on 22 February 2001, Turkish Central Bank announced the transition to the fluctuating exchange rate. Although the IMF chairman declared their full support for the transition to the fluctuating exchange rate and the value of the stock market increased in line with these developments, it was also observed that the US dollar exchange rate increased suddenly from 689,000 lira to 949,000 lira. Basically, it is more possible to regard the last event as a contributor to this rating decision, adding to the increasing capital outflow.

The last rating downgrade initiated by the S&P was announced on 17 April 2001 as a B-, after the last rating on 23 February 2001 as a B, which itself was also a downgrade. In general, March 2001 was regarded as the period of fiscal deterioration, loss of confidence and IMF mistakes. Additionally, within the corresponding period, Kemal Dervis was appointed as the minister of economy on 2 March 2001 and the program called 'Transition to Strong Economy' was initiated on 14 April. However, these two events still cannot be counted as being among the factors leading to worse sovereign ratings. At this point, it proves to be useful to restate further, that the sovereign rating decisions are not

the results of pure economic calculations, evaluation of economic policies or political determinants. Thus, it would be a mistake to attempt to make a certain assessment of the rating decisions by the agencies, who do never make all the explanations publicly available.

As in the case of the rating upgrades, the rating downgrades by the two other major rating agencies will be analyzed here. The first downgrade by the Fitch Ratings was observed on 20 December 1996 as B+, after the previous rating on 29 July 1996 as BB-. Within this period, in terms of the striking nature, the famous ‘Susurluk scandal’ on 3 November 1996 can be given again as among the factors influencing the decision of this rating change.

The next rating downgrade by the Fitch Ratings was realized on 2 April 2001, after the last rating on 22 February 2001, from BB- to B+. As mentioned before, the Turkish economy had experienced a transition from the fixed exchange rate to the flexible exchange rate system on exactly 22 February 2001 and was perceived as an improvement by the other countries, mainly U.S. What happened afterwards should be effective in leading to this rating deterioration. The other case within this period was the appointment of Kemal Dervis as the minister of economy, which, however, is difficult to regard as a factor to influence the sovereign rating change. Interestingly, S&P also declared a rating downgrade in a similar period, where these two events were again key to the Turkish agenda.

Fitch Rating announced its next rating downgrade on 2 August 2001, after the last rating on 2 April 2001, deteriorating from B+ to B. Within this period, first of all, a credit amount of 3.9 billion dollar was received from the IMF on 18 May 2001, yet this would not imply any deterioration for the sovereign rating.

Secondly, the Virtue Party was closed down on 22 June 2001 and the ‘national sight’ was divided into two from this moment. Such a closure of a political party would have meant for the rating agencies an impediment towards democracy. Furthermore, Kemal Dervis made the mini-economic program public on 26 July 2001.

The final downgrade by the Fitch Ratings was realized on 25 March 2003, almost after one year of the rating on 5 February 2002, from B to B-. Since this was a comparatively long period, yet not necessarily extraordinarily long when looking to other countries, there were several events possible to have affected the result of the rating downgrade. To begin with, on 11 June 2002, the dollar exchange rate increased deriving from the political uncertainty. Additionally, on 16 July 2002, it was stated that the number of the majority seats within the cabinet decreased to 276 as a result of increasing resignations. On 3 November 2002, there was an early election, in fact 1.5 years earlier than the usual end of the term of office. Indeed, only 60 % of the deputies who took the decision of the early election succeeded in being reelected. On the other hand, there were several significant events within the March 2003 for the Turkish politics and economy. First of all, the inflation ratios of this month were over the expected ratios. However, on 8 March, it was agreed with the IMF on the intention letter as a result of the fourth revision. Most importantly, however, the U.S entered into Iraq on 20 March 2003 and this was very critical for Turkish politics and security, being one of the neighbor countries of Iraq, with whom the U.S was supposed to have developed partnership agreements and good relations. Any war-like cases on the neighborhood would be expected to create certain problems for Turkey, as for other countries.

Coming to the last but not least rating agency, Moody's, the first downgrade was observed on 13 January 1994, after the previous rating on 8 October 1993, a change from Baa3 to Ba1. The main explanation for this change by Moody's was the deterioration in the public financing. This announcement was among the factors leading to the financial crisis, including the well-known '5 April decisions', or in other words, the tight economic policies.

The second downgrade by Moody's was initiated on 2 July 1994, after the last rating on 6 April 1994.

The following announcement about the rating deterioration was made on 13 March 1997 as B1, after the last one on 9 January 1997 as Ba3. The most possible internal political event having a potential effect on this change would be the National Security Council's act on 28 February 1997. Those initiatives were taken in order to fight with the political reaction and the supposedly emerging Islamic organizing.

The last rating downgrade was realized on 14 December 2005 from Ba3 to B1. In fact, that date is unique in terms of presenting also a rating upgrade on the same day, departing from the last rating of B1 on 21 December 2000. On this date, relations with the EU, which was seen as critical for the sovereign ratings of Turkey, were improving strikingly, such as the official initiation of the membership negotiations on 3 October 2005.

3.2. AN EVALUATION OF THE TURKISH ECONOMY BETWEEN THE YEARS 1993 AND 2009 (WITH REGARD TO KEY INDICATORS)

This section is about the data of the certain economic indicators as the foreign direct investment levels, export levels and the capital flow levels

(portfolio investment) observed in Turkey between the years 1993 and 2009, and specifically on the corresponding dates of the rating changes. It is aimed to provide an informational background to the effects of the rating changes and the power of the rating agencies through their announcements. At the end of the day, what is significant for the countries to be rated by the 'reputable' agencies is their impact on their economies in terms of growth and development and also on the economic relations with other countries. This certification process has a final goal of nothing more than a better economic performance reflected on key economic indicators.

For this study, while focusing on Turkey, the aforementioned three aspects are taken as the basis for further analysis. The reason of this choice is that they are assumed to reflect the economic status of a country with respect to the relations with other countries, which is the key concern of the sovereign rating activity. Foreign direct investment is one of the major fields where the sovereign rating plays the most significant role by indicating the key elements for the investor confidence and attractiveness of the entity to be invested in/on. Export levels are also very critical for rating purposes, as a country's economic performance, especially for export-oriented countries like Turkey, is highly related with the export amounts and the income achieved as a result. A well functioning economy would be expected to have good export records. Finally, capital flow, that is portfolio investment, is also related aspects of the economic development, or financial development indeed. This activity is also a very likely result of confidence by the foreign capital investors, who usually have the sovereign rating as a guidance for their decision making process. For this reason, whether the changes on sovereign ratings are followed by parallel

changes on these economic aspects are very crucial for this study's analysis about the rating agency power and influence. Thus, in order to reveal a proper analysis, the numerical data on these indicators is necessary, which will be provided in this section.

In order to observe the real impact of the sovereign rating changes, the changes on the aforementioned economic indicators after one month period of the rating announcement will be taken into consideration. The relevant dates are as follows:

- For Standard and Poor's; the upgrade dates of 25 April 2000, 28 July 2003, 16 October 2003 and 17 August 2004, and the downgrade dates of 14 January 1994, 22 March 1994, 29 April 1994, 13 December 1996, 23 February 2001 and 17 April 2001.
- For the Fitch Ratings; the upgrade dates of 26 September 1995, 27 April 2000, 25 September 2003, 9 February 2004 and 13 January 2005, and the downgrade dates of 20 December 1996, 2 April 2001, 2 August 2001 and 25 March 2003.
- For Moody's; the upgrade date of 14 December 2005, and the downgrade dates of 13 January 1994, 2 July 1994 and 13 March 1997.

Taking these dates as the reference point, the status of the aforementioned economic factors with respect to the following one-month period will be detailed. The data part will start with the documentation of the export levels, then move on to the foreign direct investment in numbers and finally give information about the capital flows within these periods. The following three

tables below provide the data in number with the corresponding dates of rating changes.

TABLE -2 Monthly Export levels (1994-2005)

Month & Year	Rating Change	Export Level (million USD)	Export Level of next month
January 1994	Downgrade	1,312.7	1,193.5
March 94	Downgrade	1,320.1	1,232.8
April 1994	Downgrade	1,232.8	1,219.5
July 1994	Downgrade	1,578.2	1,517.0
September 1995	Upgrade	1,750.0	1,936.8
December 1996	Downgrade	2,399.7	2,044.4
March 1997	Downgrade	2,176.3	2,026.3
April 2000	Upgrade	2,438.6	2,338.2
February 2001	Downgrade	2,515.8	2,546.1
April 2001	Downgrade	2,616.1	2,884.7
August 2001	Downgrade	2,579.5	2,595.7
March 2003	Downgrade	3,908.256	3,662.183
July 2003	Upgrade	4,236.114	3,828.726
September 2003	Upgrade	4,114.678	4,824.388
October 2003	Upgrade	4,824.388	3,969.697
February 2004	Upgrade	3,663.958	5,217.226
August 2004	Upgrade	4,694.244	5,645.109
January 2005	Upgrade	4,996.684	5,651.596
December 2005	Downgrade	7,246.3	5,133.0

Source: www.tuik.gov.tr , ekutup.dpt.gov.tr

TABLE - 3 Monthly FDI levels (1994-2005)

Month & Year	Rating Change	FDI level (million USD)	FDI level of next month
January 1994	Downgrade	65	66
March 1994	Downgrade	90	235
April 1994	Downgrade	235	65
July 1994	Downgrade	194	36
September 1995	Upgrade	193	67
December 1996	Downgrade	2,635	197
March 1997	Downgrade	126	133
April 2000	Upgrade	66	360
February 2001	Downgrade	252	268
April 2001	Downgrade	121	276
August 2001	Downgrade	206	607
March 2003	Downgrade	264	334
July 2003	Upgrade	117	253
September 2003	Upgrade	158	198
October 2003	Upgrade	198	309
February 2004	Upgrade	443	110
August 2004	Upgrade	175	290
January 2005	Upgrade	186	384
December 2005	Downgrade	2376	440

Source: www.treasury.gov.tr, www.tcmb.gov.tr

TABLE - 4 Monthly Capital flows (1994-2005)

Month&Year	Rating Change	Capital Inflow (million USD)	Capital Inflow of next month
January 1994	Downgrade	317	79
March 1994	Downgrade	1014	151
April 1994	Downgrade	151	-79
July 1994	Downgrade	-19	-252
September 1995	Upgrade	290	134
December 1996	Downgrade	38	772
March 1997	Downgrade	-252	-300
April 2000	Upgrade	622	-142
February 2001	Downgrade	-3578	-470
April 2001	Downgrade	-550	-145
August 2001	Downgrade	-110	131
March 2003	Downgrade	-802	-292
July 2003	Upgrade	-242	632
September 2003	Upgrade	1217	253
October 2003	Upgrade	253	-656
February 2004	Upgrade	220	918
August 2004	Upgrade	12	496
January 2005	Upgrade	3068	1479
December 2005	Downgrade	2290	2069

Source: www.tcmb.gov.tr

To begin with, as seen on Table 2, assumingly following the S&P announcement about the upgrade in Turkey's sovereign rating on April 2000, the export level in Turkey was observed as 2,338.2 million USD on May, with a slight decrease from the previous month of 2,438.6 million USD. On the same date, the FDI level in Turkey showed a tremendous increase from 66 million USD to 360 million USD. The capital inflow within that period reflected a large decrease, from 622 million USD to -142 million USD. Upon the next rating upgrade, on August 2003, the export level was observed as 3,828.726 million USD, far 400 million USD less than the last month when the rating change was announced. The capital inflow in this month showed a tremendous increase, from -242 million USD to 632 million USD. Next, on November 2003, the export level showed also another decline, from 4,824.388 million USD to 3,969.697 million USD, while the amount of FDI received in Turkey increased from 198 to 309 million USD . The capital inflow interestingly showed a decrease from 253 million USD to -656 million USD. The final rating upgrade by S&P was observed on August 2004, and the September export records indicated an increase of almost 1,000 million USD. The portfolio investment, capital inflow in other words, increased significantly from 12 million USD to 496 million USD and the FDI numbers from showed an increase from 175 to 290 million USD.

Coming to the downgrades by S&P, following the first downgrade on January 1994, the export level on February 1994 was 1,193.5 million USD, with a slight decrease from 1,312.7 million USD of the last month of rating. On the same date, the FDI level showed a very slight increase, from 65 million USD to 66 million USD. The level of capital inflow reflected a similar decline

as in the rating downgrade, and decreased from 317 million USD to 79 million USD. The second downgrade was on March 1994, when the export level was 1,320.1 million USD, and the export level on April 1994 was 1,232.8 million USD. The FDI level, besides, showed an interestingly significant increase from 90 million USD to 235 million USD. Within that period, the capital flow accounts decreased sharply, from 1014 million USD to 151 million USD, as expected. Furthermore, the export number on May 1994, after the rating change on April was 1,219.5 million USD, with a small decrease from 1,232.8 million USD. On this date, the FDI accounts went downwards from 235 million USD to 65 million USD. Similarly, the portfolio investment level decreased from 151 million USD of April to -79 million USD of the next month. Almost three years later, on January 1997 the export level in Turkey was observed as 2,044.4 million USD, following the downgrade on December 1996 and the export level as 2,399.7 million USD. On this date, there was a huge change observed on the FDI records. The FDI accounts showed a striking decrease from 2,635 million USD to 196 million USD. Interestingly, despite the downgrade, the capital inflow in the form of portfolio investment increased from 38 million USD to 772 million USD. After four years, another rating downgrade by S&P was observed on February 2001 with an export account of 2,515.8 million USD and the export records on the following month, March 2001 showed an amount of 2,546.1 million USD. The FDI accounts on this date pointed a slight increase from 252 million USD to 268 million USD. Another interesting case for the capital inflow is this period of rating downgrade, when the portfolio investment showed a relevant increase from -3578 million USD to -470 million USD. The last downgrade by S&P was on April 2001 with an export level of 2,616.1

million USD and the supposedly following export level was 2,884.7 million USD. The FDI level on May 2001 doubled, compared to the previous month; from 121 million USD to 276 million USD, while the capital inflow surprisingly increased from -550 million USD to -145 million USD.

When moving to the rating records by the Fitch Ratings, the first upgrade was on September 1995. Thus, the export records on October 1995 is the reference date here and it points an amount of 1,936.8 million USD for the total exports, with an increase from 1,750.0 million USD. The FDI levels in this period decreased from 193 million USD to 67 million USD. Despite an upgrade, the capital inflow numbers interestingly showed a decrease from 290 million USD to 134 million USD. The following upgrade on April 2000 and the export level of 2,438.6 million USD were assumed to be followed by an export level of 2,338.2 million USD on May 2000. On this date, the FDI records showed a sharp increase from 66 million USD to 360 million USD. In contrast, the capital inflow accounts indicated a sharp decrease from 622 million USD to -142 million USD. The next upgrade was on September 2003 and the October 2003 export records show 4,824.388 million USD, an increase of 700 million USD from the last month. The capital flow showed a surprising decrease from 1217 million USD to 253 million USD. Only after a few months, there was another upgrade on February 2004 and the export level on March 2004 was observed as 5,217.226 million USD, a far large increase from the previous month being 3,663.958 million USD. The capital flow in this period increased from 220 million USD to 918 million USD. The last upgrade by the Fitch Ratings was on January 2005 and thus, the export level on February 2005 was looked for and it was observed, that this number was 5,651.596 million USD,

experiencing an increase of 600 million USD. Besides, the portfolio investment very sharply decreased from 3068 million USD to 1479 million USD.

Coming to the rating downgrades announced by the Fitch Ratings, there are four downgrades. The first one was on December 1996, when the export record was 2,399.7 million USD and the following export level in January 1997 was 2,044.4 million USD. The FDI levels, furthermore, experienced a significant decrease from 2,635 million USD to 196 million USD. The portfolio investment in December 1996 was 38 million USD, while the next month had an account of 772 million USD. The second one was on April 2001 with an export record of 2,616.1 million USD and to see the potential effect of this announcement, the export level on May 2001 is looked for and it points to an amount of 2,884.7 million USD. Within that month, there was an FDI record of 276 million USD, doubling compared to the 121 million USD of the previous month. The capital flow for the same period increased from -550 million USD to -145 million USD. The next downgrade was on August 2001 with 2,579.5 million USD export number, followed by an export level of 2,595.7 million USD on September 2001. On the same date, the FDI accounts almost tripled, moving from 206 million USD of the last month to 607 million USD, while the capital flow increased from -110 million USD in August to 131 million USD in September. The final downgrade by the Fitch Ratings was on March 2003 and the corresponding export records on the next month, April 2003, was 3,662.183 million USD, a small decrease from the number of the last month, 3,908.256 million USD. However, there was an increase in the FDI levels, moving from 264 million USD to 334 million USD. The capital flow interestingly also increased from -802 million USD to -292 million USD.

Finally, data for the last but not least agency, Moody's and the rating changes announced by them will be provided here. The only rating upgrade was announced by this agency on 14 December 2005. In line with this, the export accounts on January 2006 point an amount of 5,133.0 million USD, with a decrease from 7,246.3 million USD. The portfolio investment within this period decreased from 2290 million USD to 2069 million USD. On the other hand, three downgrades by Moody's are as follows: the first one was realized on January 1994 with an export level of 1,312.7 million USD and the following month, February 1994 witnessed an export number of 1,193.5 million USD. The FDI level on February was 66 million USD, a slight increase from the last month of 65 million USD, while the portfolio investment decreased from 317 million USD to 79 million USD. The next downgrade was in July 1994 with an export level of 1,578.2 million USD and the export records on August 1994 were 1,517.0 million USD. In this month, there was an FDI account of 194 million USD recorded in Turkey, followed by an FDI number of 36 million USD in the next month, while the capital flow showed a significant decrease from -19 million USD to -252 million USD. The final downgrade was realized on March 1997 when the export account was 2,176.3 million USD, while the export level on April 1997 was 2,026.3 million USD. The FDI level observed in April was 126 million USD, followed by an amount of 133 million USD next month. The capital flow record of March 1997 was -252 million USD and this decreased to -300 million USD in the following month.

**TABLE 5: Cumulative FDI, Export and Capital Inflow Levels at the year
end (million USD)**

Year	FDI Level	Export Level	Capital Inflow
1994	636	18,106.1	1,123
1995	934	21,635.9	703
1996	914	23,224.5	1,950
1997	852	26,261.1	2,344
1998	953	26,974.0	-5,089
1999	813	26,587.5	4,188
2000	1,707	27,774.9	1,615
2001	3,290	31,334.2	-3,727
2002	590	36,059.1	1,503
2003	671	47,252.8	3,851
2004	1,233	63,167	-1,388
2005	6,412	73,122	-1,233

Sources: ekutup.dpt.gov.tr, www.treasury.gov.tr

Additionally, Table 5 provided above shows the cumulative levels of the three indicators on a yearly basis. This was added in order to broaden the scope of the indicators and to have a more general idea about how the sovereign ratings affect theses selected indicators in a broader time period.

The data provided above was only for descriptive purposes and formed the basis of a later discussion integrated within the literature of the criticisms towards the sovereign rating system. The next chapter will be on the analysis of this data and the aim will be to form a relation between the rating outcomes and the following economic factors and policies. As the data part is finished here, the next section will be about the economic policies in Turkey with respect to the fields, on which the rating agencies make recommendations and analyses.

3.3. SIGNIFICANT CHANGES ON KEY ECONOMIC POLICIES IN TURKEY BETWEEN THE YEARS 1993 AND 2009

The effect of the sovereign rating announcements for the countries is assumed to be a twofold one within this study. The effect stated above was an indicator of this effect on the economic side and was about to observe the direct impact of the ratings after their announcement. This section, however, aims to provide an insight to the power of the sovereign rating in shaping the decision making behavior of the related officials/ bureaucrats while determining the relevant economic policies for Turkey by listing the key policies. The next analysis chapter will mostly evaluate these policies with regard to the previous rating announcements.

The policies stated here are selected among the policies related to the export, foreign direct investment and foreign capital investment in the corresponding policies. The policies will be also listed with regard to the rating agencies' recommendations or criticisms about the existing ones while making their rating announcements. To what extent the recommendations were taken seriously by the policy makers will be helpful in making the final judgment of this study. How the already existing ones changed and some measures were taken or to what extent they remained the same will be significant for achieving. Although the point to attach any change on the policy making behavior to the rating announcements is quite difficult to assess, it would still make sense to have an insight about the potential effect of the sovereign ratings on the policy making authorities. For descriptive purposes, this section will only list the corresponding policies, while the next analysis chapter will focus

on the possible relation between the sovereign rating announcements and the implications on the policy making agenda in Turkey.

During the interview made for this study, Mahfi Eğilmez argued, that the sovereign rating concerns play a very critical role for the policy makers, both the bureaucrats and the politicians. According to Eğilmez, this mainly derives from the fact that a rating downgrade means worse borrowing conditions and increasing costs of debt, which in turn would refer to the failure of the policy makers and politicians. Thus, the policy makers inevitably very carefully follow the rating announcements regarding them as a sense of early warning mechanism. Moreover, improved sovereign ratings add to the justification of their ruling and authority by helping their reputation to be certified.

To begin with, the first four rating downgrades in 1994 can be obviously regarded as both the cause and the effect of the economic crisis of 1994. The April 1994 crisis was obviously a result of the improper policies for that period's economic conditions. "Since 1992, expansionary policies had been at work, public investments and government expenditures were kept relatively high with increasing budget deficits and the need to finance this deficit. To encourage private investments as well as private consumption expenditures foreign exchange and interest rates were both repressed. All of these policies were unsound to start with" (Hiç, 2008: 159). Since the downgrades started in January 1994, adding to the already deteriorating economic conditions of that period, the negative outlook provided by the agencies led to further economic problems, weakening the confidence in the economic management. The crisis of April itself brought worse sovereign rating results, followed by a later rating downgrade in July 1994. Turkey's sovereign rating could not recover itself in

the following one year period, until the September 1995 upgrade. Kazgan (2002: 16) argued that Turkey made its economy grow between 1990 and 1997 to the expenses of two economic crises, yet in return, the increasing internal and external debts made the financial sector more fragile. Departing from this explanation, and taking the rating following the crisis in 1994, a general statement can be made, that even a downgrade did not make the policymakers to leave the already operating policies, as the ambition for economic growth sustained itself until 1997.

The downgrades in the late 2000 and early 2001, as of the ones in February-, April- and August 2001, are the inevitable consequences of the crises experienced in those years. Since these crises were mainly banking-rooted ones, the measures taken thereafter were also banking-related. One of the most important policies in 2002 was the Istanbul Approach, which basically refers to the source flow through the banks to the industrial sectors that have undergone heavy debt burden and experienced loss of sources. It was mainly a restructuring of the financial assets and liabilities. On the other hand, in order to restore the weakened economic confidence, a new stand-by agreement was signed with the IMF on February 2002, comprising the period of 2002-2004. The stand-by agreements are usually regarded as an improvement by the foreign investors, and since the sovereign rating mainly serves to the foreign investors' need for information, this agreement might have had some rating concerns in itself as well.

These policies will be more widely elaborated within the next chapter while analyzing them with regard to the corresponding rating changes. For this chapter's purpose, the next section will provide a sense of the sovereign rating

perception by key officials and intellectuals, with whom some interviews were conducted, with regard to certain aspects of criticisms generally held in Turkey.

3.4. THE SOVEREIGN RATING PERCEPTION IN TURKEY

The concept of ‘sovereign rating’ has developed in Turkey in the late 1980s as a result of a requirement when entering into the Yankee bond markets, as also mentioned before. However, the significance of the sovereign rating system was realized later further, as it provided the rated countries with a sense of ‘approval’ within the global economy in terms of the foreign capital and investment attraction. This aspect was very critical for Turkey, since these factors have always been among the crucial ones for Turkish economic growth and development.

The perception referred to here is the one observed among certain intellectuals, economists and bureaucrats based on their explanations and/or columns they are writing. Arguably, the credit rating agencies do not receive much approval by the intellectuals and thus cannot enjoy their authoritative reputation in Turkey. As in the case of the IMF, these agencies are regarded as being a reflection of the U.S policies and thus a sense of bias towards their policies is inevitably added to this perception. Former president of Capital Market Board (SPK) Ali İhsan Karacan also referred to this issue, that the credit rating agencies reflect the Anglo-Saxon monopoly and conduct their analyses according to the long established traditional criteria. Additionally, the most important ones of them are U.S- originated³. It is mostly proposed, that the

³ www.haberturk.com 14.11.2008 (“S&P’yi Kim Denetliyor?”)

ratings and expressions by these agencies involve the already calculated consequences of the U.S related policies and work in advance of the U.S expectations. While the credibility of these entities is already eroded also in their home countries, the Turkish aspect of this broader view is not hard to understand. The point is, that the agencies' policies are attached to the U.S' ones and thus, more political issues are assumed to intervene in the rating process in Turkey, as the U.S is a major actor within the international politics, with whom Turkey has developed closer relations. On the other hand, Ali İhsan Gelberi, director of the Economic Research Board at Garanti Bankası, holds a different view, arguing that the rating agencies cannot have nationalist motives in their behavior, as not all staff working there are of American origin and these agencies are quite international organizations, which shall not succeed in having nationalist thinking at all. However, according to Gelberi, some lobbying activities are observed on the rating behavior and the influence of these strong lobbies, especially in the U.S is easy to observe.

Another aspect for the Turkish prejudice towards the agencies derives from the fact, that except Fitch Ratings, the agencies do not have any office settled in Turkey. One of the assumptions for this argument is that more credible information can be achieved when operating within the boundaries of a country and experienced the internal events and the responses to the external events from the inner side. Since the rating process is one consisting of a very exposure to different information, the nature of this information in terms of correctness and reliability is significant. However, at this point, Botan Berker, the managing director of the Fitch Ratings Turkey office claims contrarily to the expectations, that the office would not be that much significant, as Turkish

office does not function independently from the headquarters and other offices worldwide. She states, that a sovereign rating is determined on by a group consisting of agency representatives from different countries after long phone calls. This means, that these staff connect on line, discuss the key elements of the rating change among each other and finalize the rating. On the other hand, Selim Seval, the managing director of Dun & Bradstreet Turkey office claims the opposite in the interview. Dun & Bradstreet has also an office in Turkey, yet only corporate ratings are conducted here and no sovereign rating is concerned. Being quite objective, Seval argues that a national scale is very important for the sovereign rating process. What Seval means for national scale is that some international standards may not be that much critical for the assessment of Turkish economy and thus specifically chosen criteria might produce more confidential information. Such a 'national' type of information can be, however, achieved only through people experiencing the conditions within Turkey. He further states that a rating official coming from abroad in order to determine the sovereign rating asks him and other officials in the Turkish office what uniquely needs to be focused on in order to be able to evaluate the economic outlook of Turkey.

This chapter provided the background of the next chapter by detailing the data, on which a further analysis is necessary in order to make an argument about this study's main questions. An analysis of the data with regard to possible relations between the rating announcements and the economic results will be the main point of the next chapter.

CHAPTER 4

DISCUSSION AND ANALYSIS

“A country tends to retain its rating over time unless significant adverse or positive developments occur” (Ul Haque, Mathieson and Mark 1997: 13).

The previous chapter provided the necessary information to be evaluated throughout this discussion chapter. That information included changes on Turkey’s rating records, evaluation of Turkish economy with regard to key indicators, significant changes on key economic policies and sovereign rating perception in Turkey. These have established the necessary background to form an understanding about the key question of this research with regard to the case study of Turkish economy: to what extent are the credit rating agencies effective and influential on key developments in economies. Their capacity was intended by their establishment to maintain a sense of authority for the economic actors while setting the rules through their highly complex measurement and evaluation procedures. Today, the main prospect towards the rating agencies points out the idea, that they yield a certain power of guidance for investment and borrowing activities in terms of their role of ‘information provider’. However, there should be a basis for determining this ‘information’ such as the real effect observed in different previous cases. At this point, the case of Turkey would be quite helpful in having an understanding about the assumptions on rating agencies, as Turkey is among the top preference

countries of foreign direct investment and capital flow at the global level and also a major borrower, especially from the IMF.

This chapter will be an attempt to make necessary connections between the data sets provided in the previous chapter and the corresponding observations on Turkish economy in certain time periods. In light of the literature reviewed so far and this case study of Turkey, an answer to the main concern of this study will be concluded. The chapter will begin with a section as an overview of the sovereign rating changes in Turkey between 1993 and 2009 and the relevant outlook of Turkish economy with regard to key economic indicators while deriving a relevant relation between these two main variables. The next section will be about a similar discussion, this time on the possible relation between the sovereign rating changes and the significant economic policy changes in Turkey observed in the same periods. By doing this, the significance of the credit rating agencies for an economy, in this case for Turkey, will be inferred at least as an insight. In the third section, an overall political economy explanation of the sovereign rating concept will be detailed with regard to the Turkish case within the framework of the existing literature. Finally, the last section will provide a policy recommendation part about the credit rating agencies in light of different criticisms and recommendations stated by scholars, economists and professionals.

4.1. SOVEREIGN RATING CHANGES AND ECONOMIC OUTLOOK IN TURKEY BETWEEN 1993 AND 2009

This section will provide an insight to the possible and also necessary relation between the sovereign rating grades and the economic outlook of Turkey with respect to certain dates of rating changes. The reason why it was stated as being ‘necessary’ is the fact that the rating records are supposed to be the good analyzed results of mainly economic indicators combined with specific political circumstances and thus highly related to the progress in these indicators. Contrary to the previous data chapter, where the relevant data was provided according to the categorization of the three rating agencies, this section will be organized as a total outlook to the downgrades by all three agencies and the chosen economic indicators in a chronological order by attempting to reach an argument as to whether the rating changes have been effective in the development of these factors as expected. By doing this, it is intended to see the regarded influence of the rating announcements on key economic indicators. Key possible political explanations to those rating changes are also provided in this section, as an attempt to see the political aspect of the political economic implications of the sovereign ratings. It needs to be clarified, that other than the specific announcements made by the rating agencies themselves, the explanations given here do not go beyond being predictions as a result of analyses of those periods’ political and economic conditions. The corresponding significant events and changes are listed having made a detailed research from different almanacs that specifically present chronological changes in Turkey.

To begin with, the study will focus on the rating upgrades by the three agencies and the corresponding periods' economic indicators. Not surprisingly, during the upgrade periods, it would be expected from the three economic indicators to also show an increasing trend, as all of these three are largely the outcomes of foreign investor confidence. Especially the foreign direct investment highly depends on how the investor perceives the conditions in a country in terms of stability and sustainability of the existing conditions. Capital outflow, being another type of investment, is also quite affected by those necessary conditions in terms of the sustainability of the interest rates and the credibility of the sectors invested. Specifically for Turkey, it was articulated by Boratav (2003: 194), that foreign capital flows have been a major reference point for Turkey's national income level. There has been usually a connection observed between these two factors in Turkish economy. Within each period when the capital inflows slowed down, as of the years 1994, 1998-99 and 2001, the national economic growth rates decreased or turned into negative growth. Furthermore, export levels do also carefully follow the price stability and the exchange rate developments, of which an insight can be achieved with the sovereign rating announcements. As observed, these aforementioned factors can be regarded as components of the sovereign rating determinations and thus, it would be not wrong to argue that developments in these three categories are expected to be influenced by the rating scenarios. Whether this is the case for Turkey will be studied in this section.

The charts provided below indicate the changes on key economic indicators as export, FDI and capital flow (portfolio investment) levels with regard to the rating update periods for Turkey. They are followed by the analyses made from

the data obtained from the charts. The resulting conclusion from this analysis is to be presented later in this study.

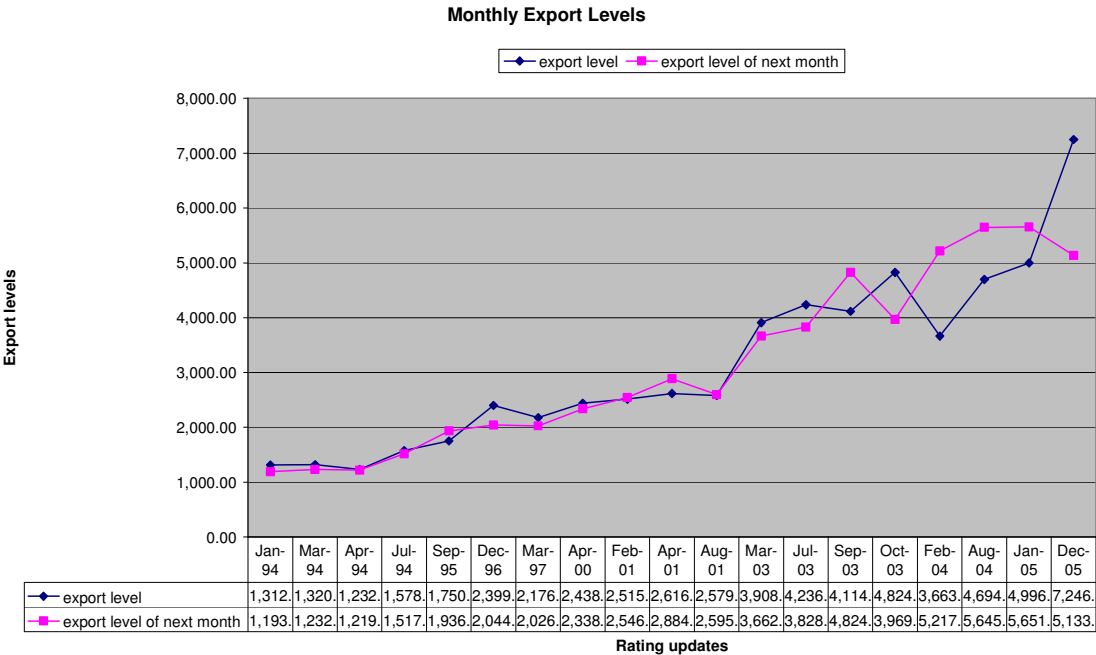


FIGURE 1: Changes on Monthly Export Levels (million USD)

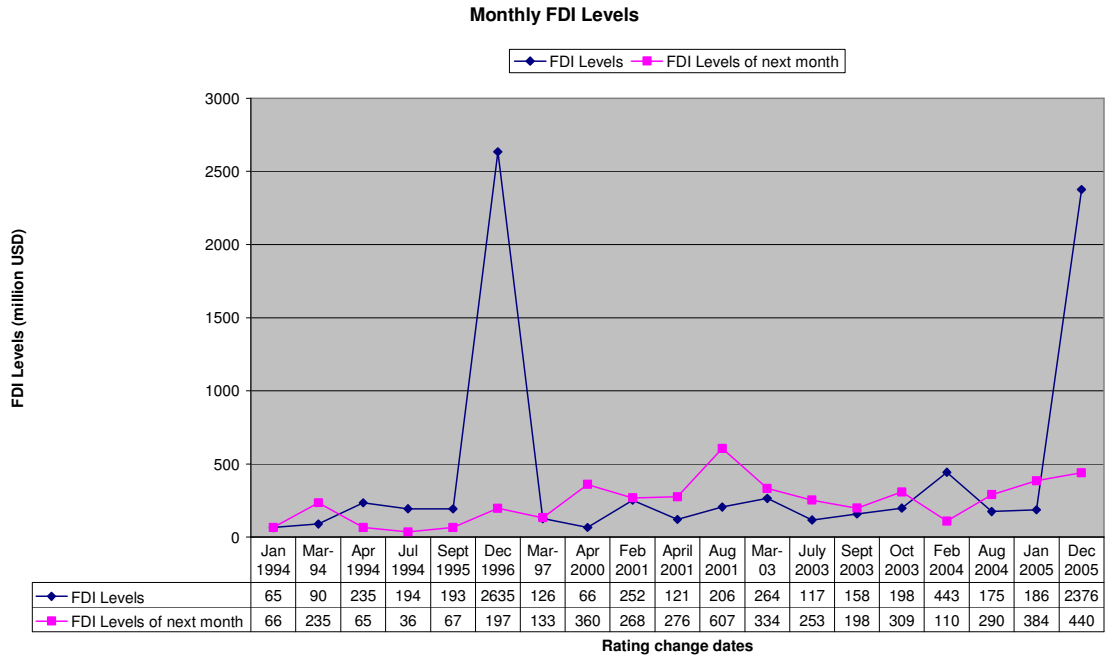


FIGURE 2: Changes on Monthly FDI Levels (million USD)

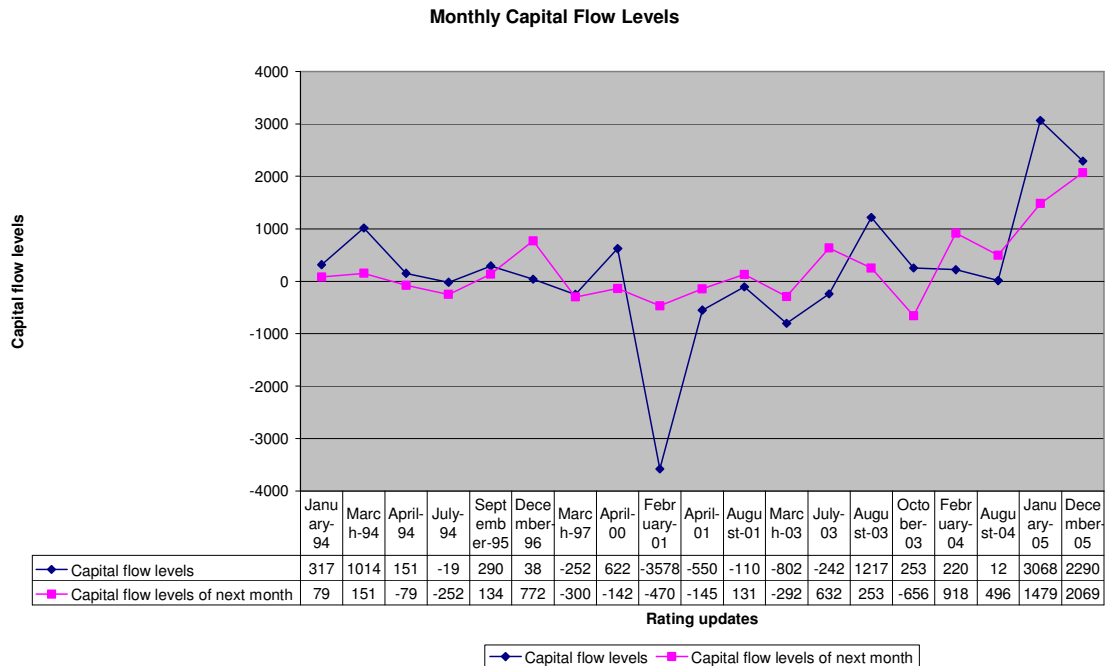


FIGURE 3: Changes on Monthly Capital Flow Levels (million USD)

Turkey experienced its first rating downgrade in January 1994, which was followed by a decrease in the export levels of the next month, while the FDI results remained slightly the same. “On account of the negative indications caused by [these] policies that already appeared in the market towards the end of 1993 and the beginnings of 1994, and in view of the rumors about a devaluation, the Governor of the Central Bank at the time, Bülent Gültekin resigned in late January 1994 to serve as a warning to the government” (Hiç: 159)

The following rating announcement was also a downgrade in March 1994, and this time, there was a decrease in the export levels, as expected; but surprisingly the FDI level showed a sharp increase as it almost tripled. Taking these results into consideration, it can be argued that the FDI dynamics might not necessarily show a reflection with regard to the sovereign rating changes. Furthermore, this increase in the direct investment should be explained with regard to the unique context of economic crisis.

April 1994 was the period of financial crisis and the following announcement of the 5 April economic decisions. There has been an inevitable rating downgrade in this month, as a result of the deteriorating economic conditions. The export level slightly decreased in the following month. On the other hand, there was a tremendous decrease in the export levels.

The first rating change after the 1994 crisis was announced in September 1995 as an upgrade. This was an expected outcome of the recovery period following the recovery period after the crisis, as economic conditions following a crisis are usually assumed to be advancing. The export levels showed an increase, while there was a reverse situation observed for the FDI records, reflecting a

sharp decrease. On the other hand, the short term capital flows on the same date showed a tremendous increase, reflecting the point that the capital flows have a nature to change more dynamically according to some factors, compared to other economic indicators.

A rating downgrade was observed in December 1996 with a slight decrease in the export levels of the next month and an enormous decrease in the FDI levels of that month. It was recorded by Yentürk (2003: 120), that the trade deficit had reached its peak point within the year 1996. The reason for this turnaround is that the 5 April policy package did not include any reforms aimed at decreasing the short term capital flows and the appreciation of the Turkish lira. On the other hand, capital flows reflected a sharp decrease in this period, followed by another sharp increase in the following period. Yentürk (2003: 120) stated, that in total, the foreign capital inflows increased during the 1995- 1996 period by exceeding the level observed during the crisis-period, leading to the appreciation of Turkish lira. Since an appreciated Turkish lira would naturally lead to less export and FDI records, it was no surprise that those decreases were realized within that period. These outcomes are finally in line with this rating downgrade.

March 1997 was the last rating update of the 1990s with a resulting increase in the export levels and a slight increase in the FDI accounts. As mentioned before, this month corresponds to the following period after the fall of Welfare Party on 28 February 1997, which may inevitably have an influence on this rating downgrade. In this case, such an issue would mean political instability which would directly lead to a rating deterioration.

In general one thing can be manifested, that direct investments during the 1990s' Turkey turned to be ineffective because of the completely liberalized import activities. Additionally, the direct investments in 1990s proved to be inefficient, because they were not oriented to the production industry, to which they would provide technology transfer and additional employment opportunities. Instead, they preferred to invest in the sectors of wholesale and retail trade or banking at very high profit margins (Kazgan 2002: 246). Furthermore, the year 1994 witnessed a total decrease in economic growth and net capital inflow. As indicated by Özatay (in Duran, 2000: 159), the economic growth in the 1994 was -6.1 and the net capital inflow was observed as -4.1. Özatay argued that, especially not during the whole year but in the first quarters when the crises reached their peak points, the capital outflows were easily recognized. It was also stated by Yentürk (2003: 104), that the capital account deficit in the year of financial crisis, 1994, was recorded as 4 billion dollars. The capital inflow fluctuation, however, continued in a different trend in the following year and this number increased to a surplus of 4.6 billion dollars. Coming to the 2000s, April 2000s, the first rating downgrade was observed in February 2001, right during the economic crisis period. "On the surface, the reason for the eruption of the economic crisis in February 2001 was political" (Hiç, 2008: 193). There were increases recorded in both export and FDI levels, however. These records may have derived from the fact that the crisis effects can not be observed immediately. The next April 2001 was another rating downgrade, when both the export and the FDI levels interestingly increased, and indeed FDI records doubled. An explanation for these unexpected increases is difficult to find, however, one

needs to bear in mind, that the rating changes do not necessarily lead to immediate changes on these certain economic factors at all. Mahfi Eğilmez referred to this rating downgrade in a column⁴, stating that the reason why the Fitch Ratings announced a rating downgrade was that the public debt stock ratio over the gross national product of Turkey had increased sharply. This situation was inevitably affecting the debt affordability of Turkey in a negative way.

A following rating upgrade was observed in August 2001 and there was a slight increase in the export records, while the FDI numbers almost tripled. There is no need for further explanation of this situation, as a rating upgrade is normally expected to contribute to enhancements in these economic indicators.

The last downgrade until 2005 was observed in March 2003, when the export levels in the following month decreased, while the FDI records interestingly increased. That period, yet, corresponds to the U.S invasion in Iraq and thus, there are some political factors in effect leading to this downgrade, in response to Turkey's stance with regard to the U.S policies.

A rating upgrade was announced in July 2003 with a following decrease in the export levels and an in the FDI records.

The following upgrade was in September 2003, when the export levels slightly increased. It was stated by Ala'a Al-Yusuf⁵, an S&P analyst, that the reason for this rating upgrade could be regarded as a reflection of the government's commitment to realize its fiscal targets for the end of the year and the declaration to be likely to continue with the IMF supported program next year.

The last rating update was a downgrade in December 2005 and it was followed by a sharp decrease in the export levels of the next month. This upgrade was

⁴ *Radikal* Newspaper, 05.05.2001.

⁵ *Yeni Şafak* Newspaper, 17.10.2003.

realized by the agency Moody's and as a justification, it was stated by the company, that the reason was the positive transformations enabled on economic, political and societal areas within the last 4 years, such as the privatization activities. Moreover, Moody's argued that the start date for the negotiation process with the EU was regarded as a significant step for the Turkish economy as well⁶.

All in all, one point can be concluded, that among the three indicators listed above, changes on the foreign direct investment movements are not likely to reflect the rating changes as an immediate response, compared to capital flow and export levels. Naturally, it is not intended to argue that the rating updates should be expected to be the sole indicator for the foreign investors for their decisions, and that they can change their decisions in line with the rating announcements; however, the evaluation of this study points to this observation. Obviously, since the capital flows are less time consuming by nature and can be realized faster through only some banking procedures or public bond issues, they have a tendency to reflect the rating changes more immediately. On the other hand, the trade activities (export in this case) are like middle-range ones in terms of the time spent for their decisions, compared to both the capital flows and the FDI activities. However, it was revealed, that according to the data in the previous chapter, export activities have showed the most parallel trend among the three indicators to the sovereign rating announcements. This situation can be better observed in the Table 6, where the trends in three indicators are summarized. The ones having similar trends of increase or decrease are indicated with "+", while the relations in opposite directions are

⁶ *Sabah* Newspaper, 16.12.2005

reflected as “-”. Accordingly, the export levels have reflected parallel trends with regard to the sovereign rating changes 13 times among 19 cases, while this number was 9 for the capital flow levels.

TABLE 6: The trend in three selected economic indicators and the rating changes

Rating Change Date	Export Levels	FDI Levels	Capital Flow Levels
January 1994	+	-	+
March 1994	+	-	+
April 1994	+	+	+
July 1994	+	+	+
September 1995	+	-	-
December 1996	+	+	-
March 1997	+	-	+
April 2000	-	+	-
February 2001	-	-	-
April 2001	-	-	-
August 2001	-	-	-
March 2003	+	-	-
July 2003	-	+	+
September 2003	+	+	-
October 2003	-	+	-
February 2004	+	-	+
August 2004	+	+	+
January 2005	+	+	-
December 2005	+	+	+

According to the Table 6, the export levels have a tendency to be in the same changing trends with the sovereign updates the most, while the FDI and capital flow records do not. Surely, as also mentioned before, this does not definitely mean that the export activities strictly follow the rating announcements, while the foreign investors very slightly take the sovereign ratings into consideration when making investment decisions. It needs to be remarked, that this research is

only a concern of evaluation and it is not aimed to calculate any possible correlation. However, this table still provides an insight for the extent of the sovereign rating influence and reveals that the export levels do quite highly show a parallel trend with the rating changes.

TABLE 7: Trends in the Cumulative Levels of Three Indicators on a Yearly Basis

Rating Changes	FDI	Export	Capital Flow
1994			
1995	+	+	-
1996	+	-	-
1997	+	-	-
2000	+	+	-
2001	-	-	+
2003	+	+	+
2004	+	+	-
2005	+	+	+

Interestingly, Table 7 suggests, that on a yearly basis, FDI levels are more in line with the rating changes, while this time export ranks the second and the capital flows are the least parallel indicators to the yearly sovereign changes. Again here, the ones having similar trends are identified as '+', while the opposite directions are signed as '-'. This analysis is made on looking to majority of the rating changes in a year, and then regarding the status of the year as a 'rating downgrade' or 'rating upgrade'. It was observed, that FDI activities almost followed all the rating changes in a similar trend. This can be explained, as the foreign investments are results of long-term decisions and in case of a total calculation, the investors can react better to the sovereign rating changes for a country. On the other hand, since capital flows are more short-term activities, they are less affected by the yearly sum of the sovereign ratings. In other words, it would be better to look on the yearly rating status in order to

make an evaluation about FDI reactions, while for capital flows, the specific monthly rating changes would be more meaningful for such a comparative purpose.

The next section will continue with a further assessment of the economic policies in the corresponding time periods of the rating announcements. It needs to be noted again, that there is no concern for finding a correlation between the rating changes and the policy changes in a very parallel trend. On the other hand, it is clear that if the policy makers do not reflect any worries about the possible or past rating changes or imply that they take them seriously into consideration, it can be assumed that the rating agencies do not perform the expected influence on the policy makers. The following section will be an answer to this question.

4.2. SOVEREIGN RATING CHANGES AND SIGNIFICANT ECONOMIC POLICY CHANGES IN TURKEY BETWEEN 1993 AND 2009

The most important aspect to evaluate the influence of the rating agencies would be to focus on how their announcements or warnings lead to certain changes on the governments' macro- and microeconomic policies and to what extent the policy makers take the possible following sovereign ratings into consideration. One thing was asserted by Tevfik Güngör in one of his columns⁷, that the two points at which Turkey loses points is the political risk and the economic policies. For this statement, he referred to the list made by the

⁷ *Dünya* Newspaper, 29.09.1999.

Euromoney journal about the risk points of Turkey, who got 48.54 points out of 100 in the year 1999 (see Table 8). It needs to be noted, that the policy changes referred to here cannot be argued to be completely dependent on the previous rating announcements, as there are no explanations indicating such correlations. The following analysis will only be an evaluation of the economic policy changes in Turkey with respect to the significant sovereign rating updates.

**TABLE 8: Turkey's Risk Points according to the Euromoney Journal
(1999)**

RISK CRITERIA	TOTAL POINTS	TURKEY
Political Risk	25.00	11.36
Economic Policies	25.00	7.07
Borrowing Policies	10.00	9.27
Trustworthiness (debt)	10.00	10.00
Credit Reliability (rating)	10.00	1.67
Credit Usage Capacity	5.00	1.68
Short-term Credit Strength	5.00	3.04
Long-term Credit Strength	5.00	2.25
Deferred Commercial Debt Strength	5.00	2.20
TOTAL	100.00	48.54

Source: Tevfik Güngör, *Dünya* Newspaper, 29.09.1999.

To begin with, it needs to be indicated, that Turkish politics faced several critical developments in the 1990s and early 2000s. Kucukkocaoglu (b: 21) stated that in the period between 1990 and 2000, there have been two presidency elections and four general and local elections held in Turkey, and within the 11 years period, there have been ten government changes. The average of a government's ruling period was not even 1,5 year. Such short period of government ruling prevented new developments in the economic field

from being initiated, because the sustainability of successful economic programs, the developments of key projects and coherent reforms require a ruling period of at least 3-4 years. He added that the frequently changing governments prioritized the daily internal politics and short-term political interests over the main economic problems. Furthermore, the changes money-, exchange rate and fiscal policies in pursuit of short-term political interests and the postponement of structural reforms led the political instabilities to be transferred to the economy. Taking these influences into account, it would be quite difficult to regard any changes on policies as being concretely the results of political developments or rating announcements. To differentiate between these factors is confusing in the sense that the policy making initiatives cannot be measures on scale basis. However, as the main attempt of this study, it will be only an evaluation within a broader framework of how the rating announcements in certain periods intersected with the relevant economic policies in Turkey.

The economic policies are conducted in Turkey through some key organizations as the Central Bank, Treasury as well as the government itself. Yaman Törüner, a former governor of the Central Bank of the Turkish Republic, argued in a column⁸, that there has been a disagreement between the rating agencies, yet this disagreement reflects in fact the conflict between the key policy making authorities over some problematic policy areas in Turkey. He made this statement following a rating upgrade announcement for Turkey in 2004. According to Törüner, the agency Moody's has obviously developed close contacts with the Central Bank, while Standard and Poor's has usually been

⁸ *Milliyet* Newspaper, 02.09.2004. "*Stfırcı Hocalar Savaşının Gerçek Yüzü*".

more likely to support the Treasury and the government policies and also has had a more optimistic manner in general compared to Moody's. An example to this assumption was experienced in 2004, when the Central Bank wanted to pressure the government in order to agree on the IMF program to be implemented according to its own - and also IMF's - demands and interests. Moody's' interests were also in line with this demand. On the other hand, S&P made expressions supporting the government, arguing that the three year-government program was already in line with the IMF requirements and the EU would determine a negotiation date for Turkey soon. These statements by S&P brought the issue of 'decrease in interest rate' by the Central Bank to the surface. However, in fact, the Central Bank was in favor of an 'increase in interest rate' and was planning to make this made by the Treasury. In this case, Moody's for the first time in its history with Turkey's rating had to withdraw from its interests. However, according to Törüner, at the end of the day, what matters is that the bureaucracies in Turkey show a tendency to make use of these foreign organizations in order to make their policies approved.

It was articulated by Yentürk (2003: 114), that the role the government played with regard to the financial crisis starting to emerge in 1994 was very critical in the continuation of the crisis. The mistakes in the interventions to the capital inflows and the improper crisis management contributed to the already existing instabilities in the Turkish economy since the early 1990s. Yentürk (2003: 117) further argued that the financial liberalization period in Turkey was not managed well by the ruling authorities. The government pursued not only non-interventionist policies, but also attempted to increase its popularity by income transferring between different segments of the society. The financial policies

were not sustainable even in the middle-term periods. It was added as the external reactions, that the credit rating agencies started to respond with rating downgrades in the January 1994. The agencies signaled negatively to the foreign investors and caused a confidence deterioration leading to the short term capital outflow.

In general, Kazgan (2002: 219) stated, that Turkey moved to apply a mixed methodology starting with the dire 1994 financial crisis until the stand-by agreement with the IMF in 1999. There was no limitation or control on the capital movements, yet both monetary independence and free fluctuating exchange rate were kept relatively under control.

Eğilmez (cited in Duran 2000: 164) argued in one of his columns⁹, that Turkey was searching for economic stability, which is normally more permanent, when there is less intervention in the market. However, in a country as Turkey, where there is no economic, fiscal or monetary discipline, there is a need for the rebalancing the intervention of the political side and the realization of the market rules, which will be conducted by the market itself. According to Eğilmez, the major problem Turkey faced in 1990s was the inability to solve this paradox, which would be solved only when the politicians would risk not being elected for the sake of the establishment of the market economy rules.

⁹ *Radikal* Newspaper, 13.04.1999.

4.3. A POLITICAL ECONOMY EXPLANATION OF SOVEREIGN RATING IN TURKEY

As mentioned before, the sovereign rating issue is usually discussed within the field of economics and finance. The literature is largely composed of the empirical analyses of the sovereign rating results and the necessary calculations leading to those results. Sovereign rating is believed to be highly reflecting a country's economic conditions with respect to the effects of certain political developments. However, this study will take both aspects into consideration referring to the political economy literature dealing with the sovereign rating issue. It is asserted that pure economic science or political science cannot prove to be sufficient at all times to clarify some rating changes that are the results of various economic and political changes at once. The reason why this section was added to this discussion chapter is that such a theoretical basis of international political economy can better explain how the influence of the sovereign rating is explained with regard to key policy changes and economic consequences. The section will be also based on some explanations of rating changes with regard to their political reasoning.

There are certain premises on which the idea that the sovereign rating issue can be explained with the political economy is built. Cohn (2005: 6) very clearly explained the international political economy in his book *Global Political Economy*. Accordingly, "as the political component of IPE, the state is a sovereign, territorial unit with a government and population. As the economic component, the market is a coordinating mechanism where sellers and buyers exchange goods and services at prices and output levels determined by supply

and demand.” From this point of view, the sovereign rating issue is highly related to the political economy field, as it comprises three aspects for being so: it focuses on individual states (and also deriving from the nature of ‘sovereign’), its main functioning is to serve for the economic system and it has some political considerations. For these purposes, the sovereign rating system can be studied within the field of ‘international’ political economy, having also an ‘international’ nature in terms of reflecting internationally accepted results. Practically, the international political economy¹⁰ mostly deals with the economic relations between governments and how these relations are affected or affect their political concerns. It is mainly studied as an analysis about “who gets what, when, how and why” with a multi-actored, multi-disciplinary and multi-level approach. Foreign policies are mutually good analyzed outcomes of both economic and political interests of countries. Once a country cannot prove itself to be politically coherent, foreign economic actors would not be very willing to involve in economic activities with that specific country. Similarly, the idea of sovereign rating lies in the perception that political affairs largely interrupt in the economic relations of the countries, especially the internal political stability. The rating system, in fact, helps the other actors to have a general idea about that country’s situation in both political and economic terms. A parallel view was articulated in the Fitch IBCA Sovereign Ratings Report (p.3), that although the government defaults (of debt) mostly derive more from economics compared to political issues, the influence of the political developments still maintains its significance. Indeed, it was stated that the

¹⁰ In fact, international political economy is multi-actored between states, firms, non-state actors and markets. It is a multi-level systemic discipline comprising regional, national and also local, besides its main focus on international. However, for this study’s purpose, the focus will be the on intergovernmental aspect of political economy.

sovereign rating depends more on the art of ‘political economy’ than the science of econometrics. On the other hand, there is another explanation for regarding the credit rating system as being a part of the international political economy, deriving from the very nature of these agencies and their assumed role to be played in the international economy. The credit rating agencies can be regarded as one of the actors of the multi-actored political economy. Within the literature, as stated in the previous chapters, they have a tendency to become standard-setters of the globalizing economic system and thus contribute to this ‘globalization’ process. In his argument about the global network society, Castells divided the networks into five types, one being *standard coalitions*. Accordingly, standard coalitions are the kinds “which are initiated by potential global standard setters with the explicit purpose of locking-in as many firms as possible into their proprietary product or interface standards” (1996: 191). Arguably, the credit rating agencies have attempted to provide some rules and regulations for the economic system through their warnings, announcements and the criteria they express to depend on. These rules and regulation mechanism serves for both countries and companies, which are the key actors of the international political economy.

For the Turkish case, this ‘political economy’ aspect becomes clearer, as Turkey has been mostly warned by the rating agencies, when there are critical political moments she faced. That the political conditions and economic developments are necessarily interrelated is a very frequently articulated idea in Turkey. In a column¹¹, Mahfi Eğilmez stated that although it is not always clearly listed by the agencies among the criteria list, the political sustainability

¹¹ *Radikal* Newspaper, 09.03.2006

is always a hidden factor for their determinations. According to Eğılmez, without the 'political stability' factor, the continuation in the economic conditions seems not possible. The political stability alone cannot account for the improvements in economy or cannot be sufficient for economic development, yet, without this factor, the economic stability cannot also be achieved. While this explanation refers to more internal political aspect, the foreign policy issue is also very critical for the economic situation of a country as Turkey. This derives from the geopolitical situation of Turkey and the neighborhood policies she needed to determine, when the neighbor countries are involved in specific political circumstances such as civil wars, foreign military interventions or diplomatic crises. The reason why the foreign investors would take the political outlook that much into consideration is the fact that any political threat would make a government to take political measures and to concentrate on defense expenditures. The best example would be the 2003 United States' military intervention in Iraq and the rating agencies' response to Turkey's stance towards her neighbor Iraq and her assumed ally U.S. It was stated by Standard and Poor's during the times when Turkey's permit to the U.S. soldiers to enter Iraq from Turkey was discussed, that such an allowance would not have an effect on Turkey's sovereign rating. However, obviously enough, such a possible military affair would have dire consequences for Turkish economy and the turmoil in the neighbor would inevitably bring a chaotic environment to Turkey as well.

Mahfi Eğılmez referred to this example in one of his columns¹², arguing that an announcement by Moody's about a possible rating downgrade in case of

¹² *Radikal* Newspaper, 18.03.2003

opposition by Turkey to the military permit would not be surprising at all. He stated that Moody's is known as being the nearest agency to the U.S. government and thus, the indirect statement by Moody's about this issue could be regarded as a warning. Eğılmez reminded, that Moody's stressed, that this war would bring high economic burden to Turkey and if Turkey could not afford that burden, the economy would face difficult times. In this expression, the implication that the burden can be afforded when supporting the U.S. government in this case is quite obvious to interpret, if not being strictly depended on the dominance of economic considerations in sovereign rating calculations. In the interview made for this study, Eğılmez had also pointed to this aspect, that the rating agencies are inevitably affected by the American policies, since they are all U.S.- originated companies. The employment strategies of these agencies and the government work in a circle: as an example, Eğılmez told that an ex-governor of U.S. Eximbank, whom he used to know before, was later appointed as the president of Moody's. Thus, even only these types of interactions between the government and the agencies would inevitably lead to reciprocal influence and some following reflections on the rating announcements. On these grounds, he had argued that these agencies should be made more independent for a more effective functioning. This will be further elaborated in the later section on policy recommendations.

Another field where the political issues are intersected with the economic consequences would be the internal political developments such as changes in the government, ruling parties or coalitions. For example, the elections held in a country would inevitably affect the sovereign rating, as the already ruling government would have a tendency to focus highly on public expenditures by

almost ignoring the external debt and liabilities of the country. The reason can be given as the ruling party's primary concern with the election results and the worries that it may not be reelected. An example for Turkey can be given as the parallel rating updates corresponding to certain government changes. Apart from the Turkish case, there are other examples providing the notion that the sovereign rating decisions are very likely to be intersected with the government's political issues. An example from the Australian experience was provided in Sinclair's book (2005: 103). He stated, that "in the relationships between the credit rating agencies and Australian state governments, the agencies have played a 'prominent role' in Australian politics. Rating downgrades have been costly in Australia." This also implies how the rating agencies can 'exert' a certain political power over the governments. It was further articulated, that "Hayward and Salvaris argue that rating agencies' analyses are 'value-laden' and that these 'values have a strong political bent'...Hayward and Salvaris observe that it was easy to see Moody's decision as an overtly political one that helped the new state government get public support for its tough approach to the budget."

Interestingly, there are also views arguing, that political circumstances depending on the ruling governments do not necessarily affect the economic conditions in a country. Ali İhsan Gelberi mentioned this in the interview, that especially in Turkey political considerations should not be taken so significantly into considerations when focusing on the economic policy decisions. According to Gelberi, in a country like Turkey, where certain economic authorities have become independent organizations such as the Banking Regulatory and Supervision Agency, Central Bank of Turkey and

Savings Deposit Insurance Fund, political issues would not be expected to have any connection with the political arena. For this reason, Gelberi claimed, that it is not appropriate any more for the rating agencies to look on the political developments in Turkey in order to make a further insight for the future economic outlook. It is intended to mean, that although there may be some internal political instabilities in Turkey at any time, or any problems faced by the ruling party, it would not have some reflections on Turkey's economy.

Additionally, as for other candidate countries, the European Union membership process is also a very critical aspect of Turkey's sovereign rating results for the rating agencies. Turkey's being a developing country is a significant point for this aspect, as it is commonly perceived within the international arena, that Turkey simply needs this membership for her sustainable development. Since the membership requires the adherence to certain criteria which refer to political stability, especially political ones, any progress about these criteria would mean an improvement for the rating agencies. The approval by European Union may also be regarded by the rating agencies as a guarantee to improve herself to the level of the European countries, of which the rating results are usually likely to be higher. Mahfi Eğılmez¹³ also referred to this idea in one of his columns, that the progress report prepared by the Union would possibly lead to a more immediate upgrade in Turkey's sovereign rating.

¹³ *Radikal* Newspaper, 21.10.2003

4.4. KEY POLICY RECOMMENDATIONS FOR CREDIT RATING AGENCIES' FUTURE OUTLOOK

It has become a very common and largely accepted idea, that currently the credit rating agencies do not function properly well and cannot fulfill their expected responsibilities determined by their establishment. While the burden of the late 1990s economic crises is attempted to inflict upon the 'irresponsible' manner of the rating agencies, their rating processes and criteria calculations also attract quite high number of criticism. The interference of political aspects and interests and the assumed authoritative role played by the United States are the key points where the criticisms with regard to further adjustments mostly concentrate on. On the other hand, there is a tendency to view the credit rating system still as necessary for the international economic system, as this mechanism of approval by a globally known authority is still very significant for every single economic actor. Thus, there is no point remarked so far about putting an end to this rating system. However, it is an inevitable fact, that this system needs certain adjustments for its further survival.

This section illuminates some possible policy adjustments key to the restructuring of the rating system. At this point, the officials interviewed for this study suggested very arguable and also plausible recommendations for the rating agencies' further restructuring process in the future and these suggestions will be detailed in this section. In line with their arguments, the explanations of what these suggestions may add to the existing system will be discussed. Such a discussion will be also effective in evaluating the significance of the rating agencies for the economic system. One issue needs to be clarified here, that

none of these suggestions below were technically tested, deriving from the inability to do so because of the lack of expertise in sovereign rating. These recommendations are only the analyzed responses of some insights about the weaknesses of rating system.

One of the most frequently articulated criticisms towards the rating agencies is the assumed possible involvement of certain interests of both countries and individuals in the rating process. There is a widely held idea that the rating agencies inevitably concern for the U.S. political interests at the end of the day, as the U.S. is the origin country of these most reputable agencies. This notion has led to a broader criticism, that the agencies should operate independently and there should be no possibility for any country to influence or be involved throughout the rating process. At this point, during the interview, Mahfi Eğılmez argued, that there is a need for the maintenance of independency of the rating agencies, as the closely connected relations with the private sector make the agencies far from being completely independent. Sharing the same argument, Ali İhsan Gelberi and Selim Seval made also similar comments by adding some ways to reach to such a possible 'independence'. Gelberi approached to this issue in terms of the payment issue. He stated that the sovereign rating should be conducted by a separate and independent organization, where all countries automatically become a member and pay annual fees. Furthermore, Gelberi suggested that this sovereign rating can also be made free of charge, and the salaries of the agency staff would be paid from the accumulating annual fees. In this way, the rating authority would not be involved in some monetary issues with the governments. Seval agreed at this point, when asking the same question, adding that a fund can be organized for

this payment system. Such an adjustment would inevitably bring some relief to the discussion of the rating defaults deriving from the so-called economic considerations.

While talking about the independence, there is the question of to whom the authority of the sovereign rating should belong. By referring to ‘independence’, it is intended to mean that the entity responsible for the sovereign rating should not have any connection with any government, company or organization. Since most criticisms are focused on the agencies’ relations with the U.S. government and significant economic actors reflecting the U.S. interests, such a perception should be overcome with a reestablishment of the control power or authority to another entity, in which no country should have a priority at the decision making. Obviously, such an organization should be a supranational one, where all interests are represented on an equal basis. At this point, Seval argued that a public organization having a supranational status such as the United Nations would prove to be more objective in these terms. The significant aspect is that this organization should be international in terms of representation issue and supranational in terms of the authority question. Instead of today’s large number of private credit rating agencies, such a restructuring would also provide a more coherent manner with regard to the rating grades given for countries. The point is, that several rating agencies today determine different rating changes at different time periods for the same countries and this leads to further questions in terms of the rating methodologies. Such a renovation would also contribute to the necessary standardization idea, leading to the recovery of the agencies’ reputation.

Apart from the above mentioned suggestion to establish a rating authority under one entity, a third point to be made is also related to the previous standardization issue, but this time about the standardization of the data and criteria. The rating mechanism usually functions within the coordination among several officials gathering data. While standardization among the rating agencies is difficult to achieve and needs further attempts, the standardization of the criteria and data for all countries is also open to discussion. It is arguable that the same criteria should be applied to all countries while determining their sovereign ratings, as not all factors might have the same effect on the economies. In other words, some specific economic and political criteria can be very significant to evaluate a country's economy and for some countries, the same criteria may not be that much important in order to have an insight about their economic outlook. For this issue, a recommendation can be that the criteria applied during the rating process should be identified separately for each country as indicators of the credibility and stability. An investor would like to invest in a country, but the sector in which he/she will work may not prove to be worthy to make any investment. On the other hand, a country may have very poor sovereign ratings as a result of deteriorating economic indicators such as export levels or gross domestic product, yet a specific sector may be quite profitable to invest in. One thing is important, however, to note that it should be manifested that this suggested sector would not be directly affected by those stated economic indicators. For this purpose, the rating grades can also be determined according to the individual sectors for a country, as Eğılmez also mentioned during the interview. The main sectors in each country

would have a separate rating, so that an investor, especially a foreign one, would make a profitable investment decision easier.

Selim Seval articulated a similar view, that some local scales should be adapted by local professionals in every single country, since it would depend on the country how the variables are perceived. Furthermore, according to Seval, these nationally adopted ratings should be adjusted according to an international calibration at the end. This is very important to note, that at the end, these ratings should be controlled by an internationally recognized and independent authority, if the previous suggestions of establishing the one and only public and supranational rating entity is not realized. This recommendation is a supplementary one, if the system still works as it is today, operating through different private rating agencies. Additionally, in order to establish such a national scale, the rating staff working with that government should also be very familiar with the country's conditions and daily dynamics, yet this requires the agencies to open new branches in the relevant countries, as Seval also argued. For example, that no rating agency other than the Fitch Ratings has an office in Turkey might be a constraint for the agencies to follow up the most recent developments in politics and economics, although they favorably argue that the rating decisions are made among a group of staff from different countries, having gathered all necessary information. However, Eğılmez stated that the establishment of local offices in every rated country for only sovereign rating purposes would be very difficult for the agencies, unless several firms are rated by them additionally. The application of BASEL II in fact requires all companies to get credit ratings.

Another recommendation is related to the rating procedures and represents more technical aspects. The rating agencies are mostly criticized for not reflecting the economic changes on time and being usually 'late' to announce the rating changes or to warn the countries beforehand. It can be assumed that the reason why the rating changes are not realized on time might be that there is not enough room to maneuver from a rating grade to another easily. The ranges between which the up- and downgrades are realized may not be sufficient to enable the correct rating changes. In other words, the characters varying from AAA to D may not prove to be appropriate to reflect the real changes. Thus, as also suggested by Eğılmez, a change on the rating procedure may be useful in a possible restructuring process. Eğılmez pointed to three main weaknesses and argued that the rating changes can be made more often showing a trend, the grade ranges can be maintained at a lower level and the variety of the grade characters can be increased by adding further letters following D. This would contribute to overcome the hesitation by the rating agencies observed on the rating change behavior. In such way, the immediate reflections to the political and economic changes in a country's outlook can be better observed and the governments can take more efficient measures, which are arguably supposed to be one of the main premises of the rating concept in fact.

A final policy recommendation, and also a broader one, would be about the rating agencies' explanations of their announcements. When their rating changes and announcements turn to be wrong or inappropriate, they very often claim to be providing only 'an insight' but not an absolute argument on the countries' economic outlook. In a manner to avoid responsibility and a following deterioration of their reputations, they have a tendency to make

themselves look as nothing more than a guide to the foreign investors and lenders. As Seval also pointed, it would be more appropriate when they provide better explanations following also their mistakes. Taking all these criticisms into account, it can be argued that the credit rating mechanism is still very significant for the international economy and thus it should sustain itself by some modifications as mentioned above. Except Gelberi, who stated that the credit rating agencies would better not exist in the system and the investors or lenders better look for their own information, there is a consensus also within the literature and the people interviewed with, that the credit rating agencies are very useful for the international economic activities.

This chapter identified the key arguments on the sovereign rating in light of the data provided for the Turkish case. Although a one-country study may not prove to be enough for an evaluation of the sovereign rating manner of agencies, as a case study, it endeavored to present how the rating changes can produce an economic and policy environment within a country. Since Turkey is a developing country, as also indicated previously, the idea of sovereign rating in the sense of an approval certificate is supposed to be very critical for its relations with the rest of the world. For the foreign investors, it is assumed that the rating announcements have been very important signals for a country's economic outlook and the potential future benefits of a possible investment. It was articulated, that one of the dire consequences of the global crisis for the developing countries is the decrease in foreign investments. The best example for this effect would be Bulgaria, whose sovereign rating was downgraded as BBB-. The main reason for this update was suggested as an approaching possible economic recession deriving from the decrease in the foreign capital

(finance) inflow. Furthermore, the reason for South Korea's rating downgrade was explained as the possible economic crisis as a result of the potential decrease in foreign reserves.¹⁴ On the other hand, obviously it also depends on the government and bureaucracy to what extent the rating announcements are taken into consideration for determining further economic policies. All considered, it can be argued that there is no necessary relation between the rating change announcements and certain economic indicators. On the one hand, there were some parallel points observed in some of the periods and the outcomes were realized as expected. However, on the other hand, this does not prove to be sufficient to argue that the rating agencies are key players of the Turkish economy, although their expressions are usually among the significant criteria for the economy's evaluation.

¹⁴ *Sabah* Newspaper, 11 November 2008.

CHAPTER 5

CONCLUSION

“Little irks companies and governments more than a visit from the man from Moody’s” (The Economist)¹⁵.

This thesis has mainly utilized an analysis of the credit rating agencies with regard to the rating updates observed for Turkey between the years 1993 and 2009. The aim was to provide an insight to the possible impacts of the rating announcements on the three selected economic indicators as being the most relevant factors reflecting a country’s economy. A conclusion about these indicators planned to be reached was an evaluation of to what extent they would be affected by the rating changes. On the one hand, such an evaluation alone would not prove to be useful to make any argument about the sensitiveness of these indicators to the sovereign rating mechanism. However, it is important to note that there are some impacts of the rating announcements on the specific economic conditions of countries. In conclusion, it can be argued that the export levels have the highest tendency to react to the rating changes in Turkey, while capital flow numbers follow them as the second and the FDI records do not act very in parallel to the rating announcements.

¹⁵ “The use and abuse of reputation”, 6 April 1996.

5.1. WEAKNESS OF THE RESEARCH

At the very beginning, this research was initiated as the study of the credit rating agencies and their impact on the sovereigns. For this purpose, Turkey was selected as the case country and the relevant rating changes were planned to be mainly focused on solely with regard to the Turkish experience. However, the effect of the rating changes on these indicators would be different for other countries and thus a generalization is quite difficult to be made. For this purpose, a further comparison can be effective in order to see further examples of sovereign rating cases.

Another weakness of this study derives from the nature of the credit rating agencies and their principles of functioning. They have a tendency to not make full declarations of the reasons underlying the rating changes. It is usually kept within the agencies which factors are more important in determining certain rating changes, but this further complicates an assessment of what elements of the economy would be affected the most by the rating announcements. For this reason, this research was conducted choosing three indicators among the ones assumed to be reflecting economic conditions for any country at most. However, it can be also added, that these same factors may not have the same implications for all the countries' economies. While changes in the export levels may be very critical for a country, for another country, it can be the some other aspects important for reflecting the economic environment. Relevant to this problem, a further difficulty was encountered when analyzing the political events in Turkey corresponding to the rating changes. Since the rating agencies do not make further explanations about the political issues and cannot give

numerical measurements to the certain political aspects other than simply calling ‘political instability’ in general when necessary. Only an evaluation can be made based on the general ideology of the sovereign rating system, that any political uprisings or problematic elections, including the early ones, are considered as an impediment towards the country’s political and relevant economic stability.

Additionally, that the literature on the sovereign rating system is not very large and there are no comparative studies done so far on this issue was an impediment for this research’s flow. A very detailed literature on how the agencies affect the world economy by their functioning does not exist and thus, it is complicated to derive the results based on broader literature which is only criticizing the rating behavior.

5.2. POTENTIAL FUTURE RESEARCH AREAS

The initial concern of this study was an evaluation of the rating agencies in light of their announcements and how these announcements affect countries’ economies. This idea had emerged out of the concerns of the critiques held so far within the literature. As a next step, a regression study can be done among variables of different economic factors also including this thesis’ ones; export, FDI and capital flow levels. In this way, the research can be broadened and the aforementioned problem with these three indicators may be better solved.

On the other hand, in order to be able to make further generalizations, a comparative analysis of two cases including Turkey could provide a better insight on the rating behavior of the agencies, at least an understanding of

whether the Turkish case was a unique one or their manner was standardized for all the sovereigns. Such a future research can be built on a comparative study of Turkey and a similar country such as a Latin American country in terms of economic indicators and political conditions. In such a study, the rating announcements of one specific agency can be taken as the reference point.

Another possible issue to focus on would be the idea that the rating agencies reflect the interests of a whole system including the IMF, World Bank and other financial institutions. For example, a further study can be done in line of this argument, detailing the statements by the IMF and comparing them with the announcements by the credit rating agencies. For this purpose, a country can be selected, which may be Turkey as well, and the developments of this country's relations with the IMF and the sovereign rating updates for this country can be compared. The analysis of how the IMF viewed that country's economic outlook and how the sovereign ratings changed in parallel to that view can provide an insight to the assumed perception of the IMF – rating agency connections.

One of the frequently discussed critiques about the rating agencies is the question of to what extent they act accountable and objective. It is very often articulated, that the rating agencies may manipulate the criteria they apply, since they have a tendency not to totally disclose the methodology. Moreover, the uncertainty about the weights of the criteria and the difficulty of defining the weight of political aspects indeed enables them the possibility of adjusting the methodology accordingly. Thus, a following study can focus on this issue and review the results of the sovereign ratings by focusing on the individual criteria producing the final grades. This would definitely require some

economic models and mathematical applications, where the weights of the criteria would be calculated and the total outlook would be obtained.

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