Finances

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# SOVEREIGN CREDIT RATINGS AND THEIR INFLUENCE ON FOREIGN DIRECT INVESTMENTS INFLOW

The understanding of what drives national prosperity has evolved over time. Natural resources, population growth, industrialization, geography, climate and military might have all played a role in the past. A relative newcomer to this list of drivers — identified as perhaps one of the most important modern engines of productivity and growth — has been the innovation excellence of a country. The "discovery" of innovation as a driver of prosperity is not only an indication of the rising social welfare awareness of nations. It also constitutes an unexpected shift towards a more equitable world and a fairer distribution of the fruits of global prosperity at this critical stage of world economy development. The prosperity of country no longer depends solely on raw materials, capital and other structural endowments, as the current unequal distribution suggests, but increasingly mirrors a nation's innovation strength [1]. In such a manner an innovative development of a country has became a fundamental tool in improving its competitive position at a marketplace, making able to emerge from crisis in a stronger position and face new challenges of increasingly complex global economy in a better way.

Surely, nations have come to recognize the importance of innovative development for productivity growth. Indeed, the global race for excellence in terms of innovative development is already on. However, the recognition of this importance and desire alone is not sufficient to "win the race", as usually, besides the adequate structures, policies and institutions, innovative development requires huge monetary injections.

In terms of this the internally accumulated resources could be the cheapest way to finance the innovative development, however, in the condition of their permanent insufficiency, countries are laid under necessity to use the opportunities of international capital flow and to attract the external capital, either in form of foreign debt or foreign direct investments (FDI).

Applying the capital structure theory, both these means of external financing have their own peculiarities, and are interrelated. An external debt usually, as opposed to equity source of financing — foreign direct investments, to a lesser extent dilutes the national government control over the economy, a lender is entitled only to repayment of the agreed-upon principal of the loan plus interest, which can be forecasted and planned for, and has no direct claim on future repatriation of profits of business, in which the foreign capital is invested. In addition, raising of debt capital is usually less complicated in comparison to attracting the foreign investors capital.

From other side, debt and interest must be at some point repaid, regardless of the financial difficulties of the country, while equity providers will probably expect returns only when business, they invest in, becomes profitable. Government debt instruments usually contain restrictions on the state authorities' actions, or vice versa, impose strict requirements regarding the policies, laws and regulations to be introduced.

A significant debt overhang in the external capital structure of the country may not only diminish the credit position of the country, leading to higher interest rates embodying larger risk premiums for lenders, but also discourage the country's foreign direct investments attractiveness, as the foreign investors will either do not wish to invest at all to the country or will expect significantly higher investment returns as a result of higher risks associated with huge amount of external debt payable in the agreed time in future.

At the same time, while sovereign credit risks have been intensively discussed in the literature on external debt, the correlation of these two concepts, i.e., sovereign credit risk impact on the foreign direct investments inflow has been largely neglected in studies on the determinants of FDI [2].

The World Investment Reports, published by United Nations Conference of Trade and Development on an annual basis, have been mainly dedicated to analysis of reasons and trends of foreign direct investments flows at international and regional levels, the World Development Report has described the results of global World Bank research on the foreign direct investments determinants and indicators of country's investment climate [3, 4]. James K. Ho in his study "Maximum resolution dichotomy for investment climate indicators" [5] has tried to convert the investment climate indicators into quantitative measures and to show the interrelation

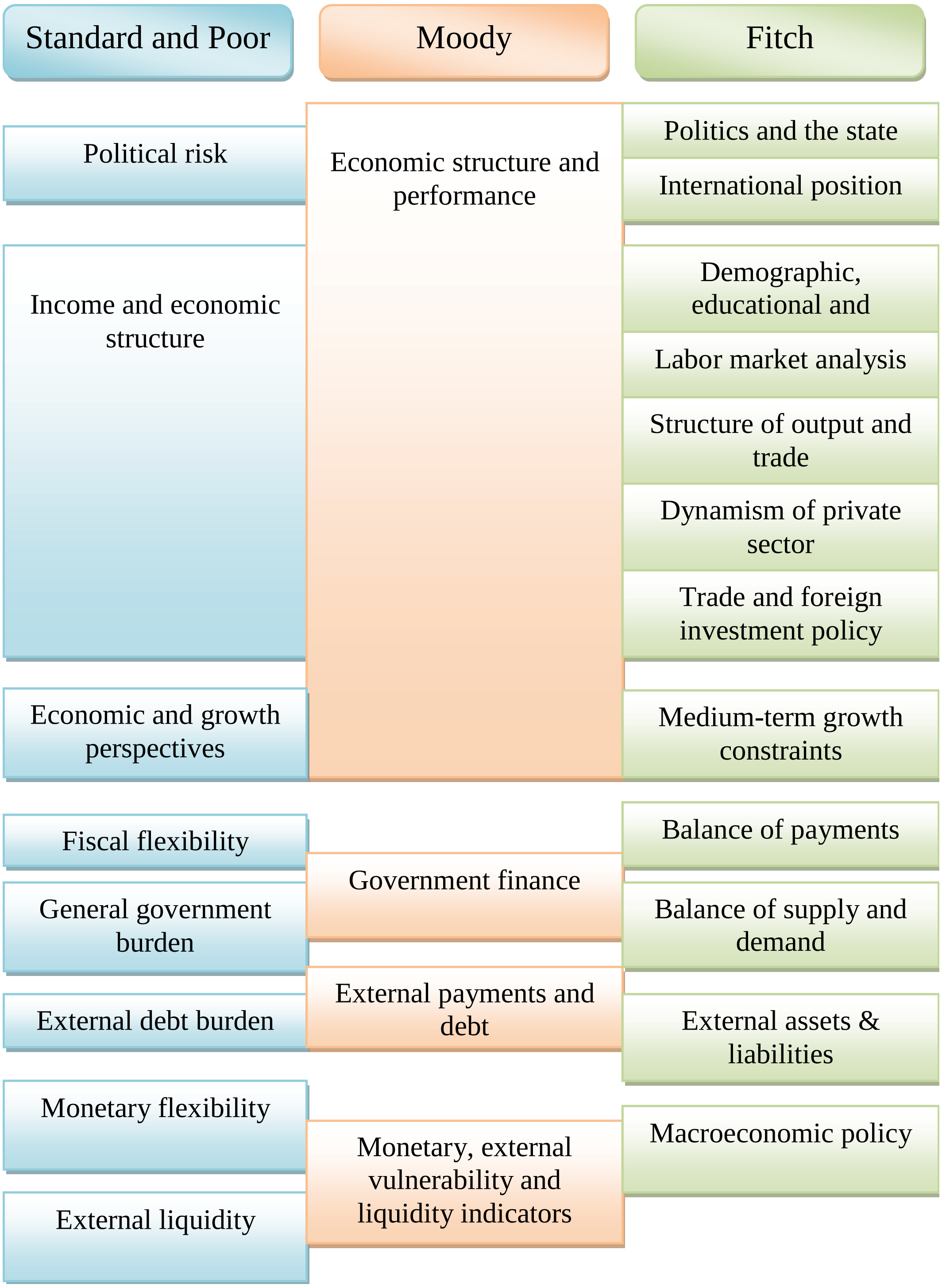


**Fig. 1. Comparison of Standard and Poor's, Moody's and Fitch's sovereign ratings methodology profile**

between them using the graphical visualization as a multi-attribute dichotomy and exploratory data analysis tools.

Other studies investigated the influence of foreign debt overhang and associated credit risks on countries sovereign credit ratings and cost of subsequent external borrowings [6] or criticized the methodologies of recognized Credit Rating Agencies (CRAs) in assigning the specific credit ratings to the countries. The first attempts to combine these two categories have been made by Jeffrey Kirk [7] and Peter Nunnenkamp [8], though, their researches have been dedicated to empirical analysis of 1980s and has been build on various hypothesis, which are no more applicable to current situation at global marketplace.

The current need of tackling the problem of external capital attraction for the purpose of innovative development and insufficient reflection of interrelation between the sovereign credit ratings and foreign direct investments inflow has predetermined the objective of the present study: to reveal the similarities in constraints used by recognized CRAs in assigning the sovereign credit ratings to countries and investment climate indicators and, thus, to substantiate the influence of these ratings on foreign direct investments inflow to the country.

In theory, investment decisions should be determined by the investment opportunities itself, and countries do not need to consider how to finance the investment projects as the external capital markets could always provide sufficient money with a fair charge to cover their internal capital shortfalls [8, p. 5]. However in reality capital markets are not entirely efficient and information does not flow freely among investors and firms. In terms of this, credit rating agencies (CRAs) may play a key role in capital markets by helping to reduce the informative asymmetry between lenders and investors, on one side, and issuers on the other side, about the creditworthiness of companies and countries [7].

The point is that in making their ratings, CRA's analyze public and non-public financial and accounting data, as well as information about economic, social and political factors that may affect the willingness and ability of a government or firms to meet their obligations in respect of the external debts in a timely manner. Traditionally, CRAs have relied on quantitative and qualitative measures; however, recently there has been an increased reliance on quantitative statistical models based on publicly available date, so that assessment process has become more transparent and free from bias.

Though the process and methods vary widely among CRAs, the factors, being assessed by the world biggest recognized Credit Rating Agencies — Standard and Poor, Moody and Fitch — to establish the country sovereign ratings are found to have great similarities (Fig. 1) [9 — 11].

Broadly speaking, factors used by leading CRAs in determination of sovereign credit rating fall into five general categories: political risks and international position of the state; economic structure, performance and growth perspectives; fiscal flexibility and government finance; monetary flexibility; external debt burden.

A number of economists have estimated econometrically the determinants of credit ratings of different CRAs for both mature and emerging markets [12 — 15]. In these studies small number of variables explained up to 90% of the variation in the ratings: GDP per capita and GDP growth (falling into the economic structure, performance and growth perspectives category), inflation (monetary flexibility category), the ratio of the current account balance to GDP and the default history (external debt burden category), level of economic development (economic structure, performance and growth perspectives category). Another factors, like, for example, political stability, membership in international organizations, trading blocks, or fiscal flexibility indicators improved the explanatory power of the regressions, but have not been affecting the credit rating change significantly [15]. Regardless of this fact, market appears to reward issuers when CRAs assign rating, especially when the rating is high or increasing over the periods.

The point is that CRAs provide "independent and reliable judgments" [16] in the form of credit ratings, which are "coordination mechanisms" [17] for all members of international credit market, including investors, as they capture the overall state and significant shifts in countries economic conditions, as well as potential risks associated with them. In terms of investors, this coordinating function appears mainly as a result of sovereign credit ratings intersecting with investment climate indicators.

The Investment Climate Survey conducted by the World Bank measured specific constraints facing firms in over 50 countries, and related them to measures of firm performance, growth and investment. The World Development Report 2005 summarized the results of the survey by identification of six main categories of indicators (investment climate indicators — ICI), shaping the investment climate and influencing the foreign direct investments inflow to a specific country: security and stability, regulation, taxation, finance, infrastructure, labor [4, p. 14].

Security and stability category of the Report has described the "concerns about policy uncertainty due either to vagueness and ambiguity in current policies and laws, or how even well-defined policies will be implemented in practice or evolve over time, reflecting the credibility and ability of governments to deliver what is promised". Regulation reflected "procedures and costs in obtaining business licenses and permits in compliance with government regulations", taxation — "function of the size of government and the way the burden is allocated among alternative sources". Infrastructure has been defined as "indicator of how well governments are working to improve management of public resources when they finance or subsidize infrastructure services", finance captured the level of "financial markets development providing payment services, mobilization of savings, and allocation of financing to firms wishing to invest". Labor represented a "skilled and healthy

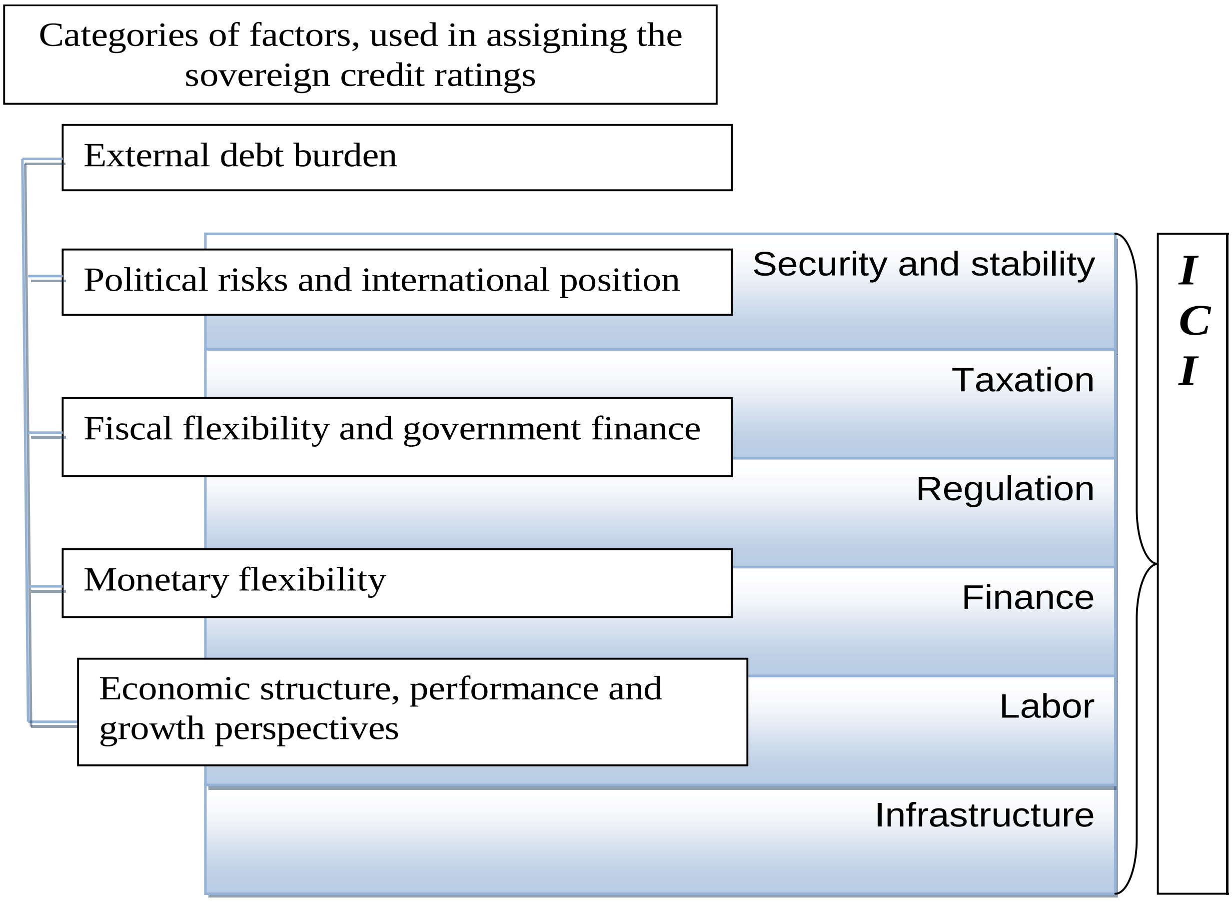


**Fig. 2. Interrelation between sovereign credit ratings factors and investment climate indicators**

workforce, with government taking the lead in making education more inclusive and relevant to the needs of firms, is essential for productivity and growth" [4].

The nature of these categories reveals that investment climate indicators include but are not limited to the group of factors, used by Credit Ratings Agencies in establishment of the sovereign credit risk for a specific country (Fig. 2).

Generally speaking, sovereign credit ratings provide investors with an overall snapshot of the investment environment in different countries and regions, which together with deeper insight in other factors, such as infrastructure and regulation systems can shape countries' investment attractiveness and provide guidance on possible risks and opportunities of the environment.

In making their decision whether invest into particular business in a particular country, foreign direct investors suffer from information asymmetries of capital market, so they would rather use the publicly available information of Credit Rating Agencies on countries credit ratings historical trends and projections, then gather additional information to capture the countries investment climate and finally determines the peculiarities of the business, they aimed to invest in. In other words, sovereign credit ratings represents a base "brick", shaping the investors' perception of the country and influencing to a significant extent on foreign direct investments inflow.

The current study determines the innovative development as a key to success towards national prosperity, which is, however, impossible without significant foreign capital injections either in form of external debt or foreign direct investments. And while, usually external debt is easier attractable, the debt overhang in country's external capital structure may lead to several negative consequences, as possibly will diminish the sovereign credit rating of a country, established by Credit Rating Agencies. First, the deterioration of ratings will lead to increase of interest on future external borrowings, imposing additional unavoidable fixed costs on economy, and, second, will deter foreign investors from investing to particular country. This can be proven by the fact that factors, used by CRAs in establishing the sovereign credit ratings, are shaping the base indicators of investment attractiveness of the countries, so that decline of country rating would signal to investor of the local investment environment deterioration, and, vice versa, their improvement would facilitate the attraction of foreign direct investments to the country's economy.

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**Baranenko I. O. Sovereign Credit Ratings and their Influence on Foreign Direct Investments Inflow**

The factors, assessed by the world biggest recognized Credit Rating Agencies, to establish the country sovereign ratings have been analyzed and categorized; the investment climate indicators, identified by World Bank Investment Climate Survey have been described; the similarities between these two groups of categories have been revealed; and the influence of sovereign credit ratings on foreign direct investments inflow has been substantiated in the article.

*Key words:* sovereign credit rating, credit rating agencies, investment climate indicators, foreign direct investments, innovative development.

**Бараненко І. О. Суверенні кредитні рейтинги та їхній вплив на прямі іноземні інвестиції**

У статті проаналізовано фактори, оцінені найбільшими світовими визнаними кредитними рейтинговими агентствами з метою формування суверенних рейтингів; описано індикатори інвестиційного клімату, що були ідентифіковані Світовим Банком у його дослідженні інвестиційного клімату; визнано загальні риси цих двох груп категорій; обґрунтовано вплив суверенного кредитного рейтингу на збільшення іноземних інвестицій.

*Ключові слова:* суверенний кредитний рейтинг, кредитне рейтингове агенство, індикатори інвестиційного клімату, прямі іноземні інвестиції, інноваційний розвиток.

**Бараненко И. А. Суверенные кредитные рейтинги и их влияние на прямые иностранные инвестиции**

В статье анализируются факторы, оцениваемые крупнейшими мировыми признанными кредитными рейтинговыми агентствами для целей формирования суверенных рейтингов; описываются индикаторы инвестиционного климата, идентифицированные Мировым Банком в исследовании инвестиционного климата; определяются общие черты данных двух групп категорий, приводится обоснование влияния суверенного кредитного рейтинга на приток иностранных инвестиций.

*Ключевые слова:* суверенный кредитный рейтинг, кредитное рейтинговое агентство, индикаторы инвестиционного климата, прямые иностранные инвестиции, инновационное развитие.

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