

## Chapter 7

# Developing the Financial Infrastructure in an Emerging Market Economy: The Role of Credit Rating Agencies

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### ABSTRACT

*This chapter examines the role of credit rating agencies in capital-market development and on the conduct of monetary policy. Rating agencies in developed capital markets provide quality certification to issuers, while their role in emerging capital markets is mainly to enhance informational efficiency in the marketplace. The authors highlight some indirect macroeconomic consequences from the presence of a rating agency, including its monetary surveillance role and the positive implications for foreign investments. The chapter also outlines the conditions for an effective rating agency in an emerging market economy, discusses the benefits of security ratings to constituencies, and proposes a scenario for a rating agency's design. The collaboration of regulators, central bankers, and issuers is especially critical to the success of a rating agency.*

### INTRODUCTION

A number of Emerging Market (EM) countries have introduced various financial market reforms to attain a more efficient and stable economy in the short-to-medium term and a sustainable economic growth in the longer run. Among these reforms, initiatives for developing the country's broad financial and

institutional infrastructure have played a central role in effecting financial deregulation efforts and promoting financial stability. By financial and institutional infrastructure we mean the minimum legal, tax, accounting, and regulatory requirements necessary for the efficient functioning of a country's financial sector.

Deregulation of the financial sector without parallel advancements in the country's broad financial infrastructure, although it provides a fertile envi-

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ronment for developing new financial products, it could nonetheless inhibit the necessary quality differentiation among institutions and instruments. To correct resulting inefficiencies and avoid fraud in the financial sector, government authorities often try to implement disclosure requirements and enforce stricter regulatory guidelines. However, such prescriptions might have short-lived benefits, because they generally have negative effects on financial-sector growth.<sup>1</sup>

Between the two extreme modes of financial-sector development -- namely uncontrolled deregulation of financial services and their government-directed growth, authorities should preferably allow an appropriate mix of government regulatory activity and self-regulatory discipline. Academic research has long suggested that self-regulatory discipline, always under the auspices of the government, is especially desirable for the efficient development of the financial sector in EM economies (Bossone and Promisel, 1999). As such, self-regulation is considered as an integral part of a country's financial infrastructure.

One important element of the self-regulatory financial infrastructure is the development of a rating agency. In an evolving financial sector, lack of quality differentiation among financial institutions and services leads to inefficiencies. In this sense, a rating agency in an EM country may contribute to the speedy development of the financial sector by providing a "discriminating mechanism" for institutions and instruments according to their creditworthiness (Elkhoury, 2008).

The debate on the presence of a credit rating agency in an EM economy is in the domain of both public policy and financial economics. From the public-policy point of view, rating financial institutions and instruments according to their creditworthiness is sometimes perceived as a regulatory barrier restraining speedy development of an emerging financial sector. From the perspective of financial economics, a rating agency enhances conditions of informational efficiency and, by appropriately allocating risks, contributes to the development of capital markets.

In this chapter, we develop the rationale for the presence of a credit rating agency in an EM economy, while we outline conditions for an effective agency and discuss some potential economic benefits to various constituencies. Also, we discuss some macroeconomic implications from the presence of a rating agency and propose steps that regulatory authorities should follow, such as commissioning a feasibility study, on the creation of the agency. Finally, we present some challenges that may be faced in the process (International Monetary Fund, 1999).

The chapter is organized as follows: Section II, provides a background discussion of the evolving development of emerging financial markets, and contrasts their informational efficiency with that of developed capital markets. It also presents the role of a credit rating agency in emerging markets. Section III presents some considerations for creating an effective rating agency within the context of capital-market development. Section IV provides a detailed analysis of the benefits from the presence of a rating agency in an EM economy at both the micro and macro levels and highlights the role of rating agencies in the conduct of a country's monetary policy. Finally, section V proposes a design for a rating agency in an EM country and recommends a close collaboration between regulatory authorities, the central bank, and institutional investors.

## **FINANCIAL MARKET DEVELOPMENT AND INFORMATIONAL EFFICIENCY**

In an EM economy, the full development of the financial market, especially of capital markets, is accomplished through an evolutionary process. Academic research suggests that a country's financial and capital markets evolve in distinct phases. Each phase is characterized by a different level of informational needs for economic agents. Because a rating agency accelerates the evolution-

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