

Credit Rating Agencies, Sovereign Risk, and Financing Conditions in the Global South

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CRA assess sovereign credit worthiness and risk of debt default – essentially a judgement that: **Influences investor decisions on where to lend money to; Determines the ease or difficulty of sovereign access to external finance; and, Shapes the price of debt instruments that countries repay.**

Sovereign yields move in the direction of CRA opinions and assessment to a degree that is **statistically significant** (Cantor & Packer, 1996; Griffith-Jones & Kraemer, 2021).

A broad range of exogenous shocks, from economic and financial crises, to climate disasters, pandemics, debt restructurings, and in the current moment, oil price shocks for import-dependent countries, are key channels of risk rating downgrades.

CRA assessments, influence, channels



Cost of capital

- On average, developing countries face 3 to 5 times higher borrowing costs than rich economies—even when they have faster growth, lower debt, and strong fundamentals.
- Investment-grade credit rating:
 - 74.6 % of developed countries: 9.2 % of developing countries, of which:
 - 8.5 % of upper-middle income countries; 4 % of lower-middle income countries
 - 0 % of low-income countries.
- Investment and financing deterred away from developing countries, as \$30 trillion per year flows overwhelmingly to the economies already rich in monetary, material, infrastructure and investment capital (UN 2023).

Reforming sovereign credit ratings

Issue	Evidence / Problem	Impact	Proposed Reform
Monopoly of Big 3	Moody's, Standard and Poor and Fitch control more than 94% of outstanding credit ratings. A closed network prevents a democratic rating market; Regional African CRA and Multilateral CRA remain underdeveloped.	Concentration limits competition and the development of a more democratic rating market.	Support Regional African CRAs and Multilateral CRAs to diversify the rating market.
"Issuer pays" model	CRAs deliver rating judgments to the financial clients who pay them. This creates conflicts of interest and incentives to maximize client profits and market share.	Rating judgments may be shaped by client interests rather than objective assessment.	Eliminate the "issuer pays" model and incentivize objectivity, accountability and transparency through rules, codes and norms.
Methodology	Rating methodology is skewed by GDP and short-term trajectories.	This penalizes low-income countries regardless of investment quality or growth potential.	Revamp risk assessment toward actual risk, while incorporating the medium- to long-term trajectory.
Downgrade-austerity vicious circle	Fiscal consolidation is "credit positive"; fiscal expansion is "credit negative".	Creditworthiness entails going against long-term development objectives.	Center a mandate of economic and social development within risk assessments.
Climate vulnerability	Downgrades occur immediately after a climate disaster, exactly when concessional finance is needed urgently; climate vulnerability is treated as a risk criterion.	Climate shocks can worsen ratings when countries most need affordable finance.	Make climate financing for resilience and adaptation a core criterion that reduces risk.

Three-Driver Classification

Structural context / macro-financial baseline

- Establish the structural context for each case using a common set of baseline macro-financial variables: real GDP growth, inflation, fiscal balance, current account balance, international reserves, and public debt.
- Use these indicators to identify existing macroeconomic fragility, external constraints, liquidity pressure, and fiscal stress before a significant event.
- Consider the monetary and exchange-rate regime as a conditioning factor explaining variations in how shocks are transmitted.
- Use this structural context as the macro-financial baseline for interpreting subsequent events and rating-agency responses.

Driver events

- Define driver events as the immediate triggers that transform pre-existing vulnerabilities into intensified sovereign stress.
- Drivers may be internal (for example, government policy decisions) or external (for example, climate disasters).
- Organize the sequence from trigger, to credit-rating-agency (CRA) narrative, to sovereign-risk indicators, to financing-condition impacts.



Three driver classifications

1



Debt Restructuring Driver:

default, distressed exchange, debt reprofiling, or formal restructuring of public obligations, centered on repayment capacity and creditor relations.

2



Climate Event Driver:

acute climate-related shocks, such as floods, that significantly affect economic growth, fiscal pressures, external liquidity, and financing needs, and are explicitly linked by CRAs to a deterioration in sovereign risk.

3



Public Spending Adjustments Driver:

fiscal adjustments, expenditure rationalization, subsidy reforms, or changes in public spending priorities that affect market perceptions of fiscal credibility and debt sustainability.

Case Studies examples

Magnifying Lens: Empirical Observation

Emerging and developing economies accounted for more than 95 per cent of sovereign downgrades in 2020. During the COVID-19 crisis in 2020, developing economies, including those in Latin America, accounted for 93% of the cumulative sovereign rating downgrades (measured in notches) recorded by the Big Three agencies, while ratings for advanced economies remained largely stable (**Loussouarn & Vasse, 2025**). In Africa, 56 per cent of rated countries were downgraded in the same year.

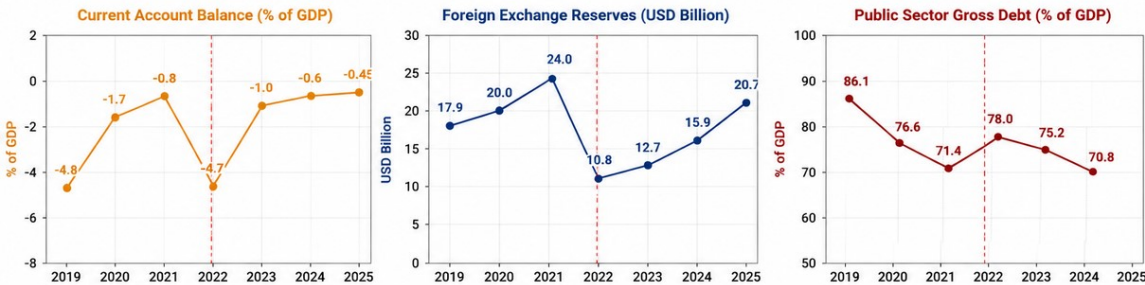
Pakistan

Driver Classification: Climate Event (CVI – 0.5)
Rating Agencies Covered: S&P / Moody's / Fitch
Date: October 2022 – February 2023

Pakistan's Macroeconomic Indicators (2019–2025)

Trends before and after the 2022 floods and subsequent credit rating downgrades

2022: Devastating floods
& Sovereign rating downgrades



Note: CG = Central Government. Fiscal balance and current account are expressed as % of GDP.
Source: Calculations based on Trading Economics, Ministry of Finance (Pakistan), and Cbonds.

Proposed Reform

Event Windows

EVENT OCCURRENCE (t0 = 1 June 2022)							
VARIABLE	0	t+1	t+5	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	1,260.00	1,300.87	1,288.25	1,276.63	1,344.121	814.324	3.99
Exchange rate (PKR/USD)	197.666363	197.47368	197.692062	01.90928	208.87660	204.623845	.77
Sovereign 10Y yield (YTM, %)	11.9650	11.9650	11.96501	1.9650	11.96501	1.9650	0.00
CREDIT RATING AGENCIES' ACTIONS (t0 = 21 November 2022)							
VARIABLE	0	t+1	t+5	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	4,073.74	4,199.92	4,011.27	4,330.75	3,637.00	2,936.27	47.49
Exchange rate (PKR/USD)	221.15000	221.15000	220.51300	220.43200	221.52	22.450	.92
Sovereign 10Y yield (YTM, %)	11.9650	11.9650	11.9650	11.96501	1.9650	12.8460	7.36

Source: Calculations using the Cbonds dataset. t0 is the first available observation on the event date; t+1, t+5, t+10, t+15 and t+30 denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between t0 and t+30, relative to the minimum level in that window.

Context & Bias/Justification

- CRAs (Fitch to CCC+, Moody's to Caa) explicitly cited climate-induced floods as a critical factor undermining external liquidity and fiscal health.
- This incorporated climate risk into evaluations, linking environmental risks directly to macroeconomic stability.
- Mix of both methodological consistency and discretionary bias.

Short-term Response & Transmission Mechanism

- Heightened default risk perception, leading to increased sovereign risk premiums and higher borrowing costs.
- Restricted access to external capital and constrained fiscal space.
- Austerity measures (IMF bailout), tied to the continuation of the IMF program, with nearly \$31 billion in concessionary capital at stake, resulted in social spending cuts and delayed investments in social and climate resilience.
- Trapped in a "climate-debt-tradeoff cycle," where climate risks reinforce negative ratings.

Effects on Financing Costs

- Increased sovereign risk premiums and higher borrowing costs.
- Need for new financing and potential risks with IMF disbursements.

Sri Lanka

SRI LANKA | Driver Classification: Debt Distress & Restructuring / Political Shock
| Rating Agencies: S&P / Moody's / Fitch | April 2022–2023

Bias / Justification	Short-term Response / Transmission Channel	Effects on Financing Costs
• Downgraded (Fitch to C, then RD) due to default, instability, depleted FX reserves, governance issues, and external shocks. • Ratings “reflected” precarious conditions but also “reinforced” austerity policies aligned with IMF support,” suggesting amplification of existing pressures. • Later upgrades (Fitch to CCC+, Moody’s to Caa1) reflecting improved conditions while implicitly validating austerity measures.	• Sharply widened sovereign spreads and higher yields immediately after downgrades. • Heightened risk perception led to increased debt service costs and liquidity pressures. • Debt restructuring provided short-term relief, but CRAs reinforced austerity, constraining social spending.	• 44% of government expenditure allocated to interest payments, “crowding out” critical sectors (infrastructure, health, education, climate). • Eroded fiscal space, with public investment only 13% of total spending.

Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
Growth (real GDP, %)-	0.3-	0.52	.7	-12.44	.3	5.4	5.4
Inflation (CPI, %) ³	.1	-4.8	3.54	7.70	.6	2.7	2.7
Fiscal balance (% GDP)	-9	-10.7-	11.7-	10.2	-8.3	-6.8	
Current account (% GDP)-	2.1-	1.4-	3.7-	1.91	.7	1.2	
Reserves (USD bn)	7642	56643	1391	898	4392	61226	838
Debt burden (Public sector gross debt, % GDP)	81.9	96.6	100	114.21	04.2	96.1	

Source: Calculations based on Cbonds data

Event Windows

GOVERNMENT ANNOUNCEMENT (t0 = 02- April-2022)							
VARIABLE	0	t+1	t+5t	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	14.811	5.55	17.47	23.64	27.812	3.56	87.75
Exchange rate (LKR/USD)	296.76	296.75	311.75	318.89	326.893	49.161	7.66
Sovereign 10Y yield (YTM, %)	17.19	17.942	0.02	26.42	30.642	6.52	78.23
Policy rate	6.50	6.50	6.50	13.501	3.50	13.501	07.69
CREDIT RATING AGENCIES' ACTIONS (t0 = 12- April-2022)							
VARIABLE	0	t+1	t+5t	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	24.762	6.64	27.81	26.97	24.732	3.20	19.84
Exchange rate (LKR/USD)	319.16	321.91	326.89	336.74	346.393	45.988	.53
Sovereign 10Y yield (YTM, %)	27.48	29.343	0.64	29.87	27.572	6.05	17.62
Policy rate	13.50	13.501	3.50	13.501	3.50	13.500	.00

Source: Calculations using the Cbonds dataset. t0 is the first available observation on the event date; t+1, t+5, t+10, t+15 and t+30 denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between t0 and t+30, relative to the minimum level in that window.

INDONESIA | Driver Classification: Public Spending Adjustments |
Rating Agencies Covered: Moody's / Fitch | January 2025–February 2026

Source: Calculations using the Cbonds dataset. t_0 is the first available observation on the event date; $t+1$, $t+5$, $t+10$, $t+15$ and $t+30$ denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between t_0 and $t+30$, relative to the minimum level in that window.

The Pillars of CRA Reform:

The African Credit Rating Agency (AfCRA)

1 VISION & OBJECTIVE

A strategic initiative by the African Union to counter the negative impacts of external credit ratings on African economies.

A technically rigorous, independent, and internationally credible institution.

Complements existing agencies by reducing information asymmetry and improving risk differentiation.

Goals: more accurate pricing of African sovereign risk, mitigating contagion, and reducing borrowing costs.

2 ANALYTICAL APPROACH

- Nuanced understanding: base analysis on African economic structures, vulnerability profiles, and pathways for structural transformation.
- Expanded metrics: combine traditional fiscal, monetary, and external sustainability indicators with forward-looking measures of climate exposure and natural capital, demographic trends, structural reforms and regional integration including AfCTA, and transparency of budget processes and data.
- Climate focus: examine how climate vulnerability interacts with debt sustainability to prevent disproportionate penalties from temporary shocks.

3 KEY PILLARS

- Institutional independence: ensure operational autonomy, protection from political influence, and methodological transparency.
- Phased implementation: begin with a legal framework, expert recruitment, and methodology publication, then broaden coverage to sub-sovereigns, development finance institutions, and specialized instruments such as green bonds.
- Legitimacy: build recognition among global institutional investors through technical excellence, a clear methodology, and independence.
- Diversified revenue: pursue multiple revenue streams for financial sustainability and analytical autonomy.

4 EXPECTED OUTCOMES

- Better risk differentiation and reduced market volatility.
- Stronger domestic capital markets and more stable financing for development.
- Reduced country-risk premiums and borrowing costs.

A Multilateral Credit Rating Agency (MCRA)

An MCRA would improve sovereign creditworthiness by addressing the inherent biases and limitations of private credit rating agencies (CRAs) through a new methodological framework and objectives. Potentially housed within the United Nations, the MCRA would have unique access to information and research, enabling a bold approach that private CRAs would find technically impossible to replicate.

1 CURRENT PROBLEMS WITH PRIVATE CRAs

- Skewed by income (GDP per capita) rather than actual risk.
- Short-term focus (5–10 years) leading to procyclical investment patterns and austerity measures that penalize long-term development spending.
- “Issuer pays” model raises objectivity concerns.
- “Home bias” towards developed countries.
- Failure to reflect developmental, social, or ecological priorities.
- African sovereign bonds burdened by “unjustified” risk premiums, incurring additional borrowing costs.

3 KEY ACHIEVEMENTS OF ESTABLISHING AN MCRA

- Enable sustainable development: recognize long-term growth to support stronger, more stable ratings.
- Reduce debt distress: diversification and employment expand revenue and ease debt management.
- Strengthen resilience: reduce reliance on single industries and external shocks.
- Stabilize ratings and investor confidence: reflect long-term potential and improve funding access.
- Improve domestic creditworthiness: stronger sovereign ratings support domestic entities.
- Facilitate social reproduction: strengthen productive sectors and sustainable livelihoods.

2 MCRA’S NEW APPROACH TO IMPROVE CREDITWORTHINESS

- Long-term time horizons: Rate 30–40-year development trajectories and recognize the positive spillovers of long-term investment.
- Real economic dynamism and diversification: Assess production structures, SMEs, the informal labour market, productivity, industrial policy, value chains, and long-term revenue capacity.
- Social and economic provisioning and equity: Value public systems, infrastructure, human capital, and strategic investment as drivers of growth and debt repayment.
- Climate and ecological dimensions: Assess climate resilience, ecological sustainability, and readiness investments such as renewable energy.
- Countering biases and promoting transparency: Use in-country expertise, support responses to shocks and restructurings, publish assessment methods, and engage stakeholders.