Review report on 'Sovereign Credit Ratings and the Transnationalization of Finance – Evidence from a Gravity Model of Portfolio Investment'

Summary: This paper examines whether sovereign credit ratings contribute to allocative efficiency or to excessive volatility of asset prices and cross-border portfolio investment. A gravity model of such flows is derived and estimated. The authors find that sovereign ratings have affected inward portfolio investment stocks and flows in host countries, while predicting the degree of investors' home bias and considering before and after the global financial crisis.

Comments:

1. This is an interesting line of thinking in making use of the gravity model meant for trade flows in the context of international financial flows. Sovereign credit rating is an important indicator to reflect country risk. Higher ratings mean lower country risk and therefore higher inward flows to the host country. This appears to be the case in the empirical exercise. Besides the credit ratings which can be dependent on macroeconomic fundamentals of the host country, it might be useful to supplement this with other country risk indicators that can capture political and institutional differences across countries.

2. Since we are thinking about the degree of international financial flows, a country's external imbalance can play a big role in the ease of capital controls. If a country has higher current account deficit, that country is more likely to keep lower capital controls or more liberalised capital account in order to attract more foreign inflows. It may be informative to use an indicator reflecting a country's current account position (current account balance as % of GDP) or a country's degree of capital account openness, separating the sample into developed and emerging markets. In this context, there is a possibility of difference in results depending on whether a country is an emerging or a developed economy.