The investment and financing decisions of a firm are integrally related to its creditworthiness. There are two broad contexts in which these decisions need to be considered, however. The context in which those decisions are made will influence one’s understanding of the determinants and dynamics of credit or default risk. The first approach rests on a vision that investment is a stabilizing activity. This view underlies mainstream economic and finance theory. The other approach rests on a vision that investment is destabilizing, and it underlies the heterodox, nonmainstream approach(es). The implications of the two stances are explored in this chapter for how they explain and assess default or credit risk. By doing so, some of the sources of the malfunctions, which were identified (in the previous chapter) as compromising the quality of ratings, can be identified. Sluggishness, pro-cyclicality, and other methodological issues might better be explained if creditworthiness were assessed in the context of investment as an inherently destabilizing activity, rather than from a perspective in which it is a stabilizing activity. As such, the discussion yields new insights for improving methods of assessing creditworthiness.

Toward this end, this chapter has the following design. The next section revisits the current thinking on how a firm makes its decisions regarding investment and its financing. This leads us into the realm of how capital investments are assessed and the ways they could be financed. The results of these decisions are recorded in firms’ financial statements. Indicators used to assess creditworthiness are often drawn from these statements, though some methods rely on these more than others (as will be discussed). Tools that guide investment decisions involve assumptions that enable abstract thinking to become tractable or operationalized. Investments can be funded with internal and/or external finance. There is a range of funding types, where certain types of funding are better suited for particular needs of firms. The form of organization of a firm will influence its ability to access external...
finance. Corporations have a broader range of alternatives than SMEs, for instance. With this information, we assess the thinking as to the optimal mix of debt and equity. It turns out that assumptions made to give tractability to tools that support the investment decision reappear in the context of tools that guide the financing decision. The section ends with an explanation as to how investment could be stymied.

Next, the methods of gauging creditworthiness are presented and discussed. There are basically three types: scoring methods, traditional statistics, and the modern (market) approaches. Each has its own advantages and disadvantages. The more sophisticated the method, however, the more one sees the assumptions noted in the previous section (to make tools workable) emerge. Although we do not explicitly examine portfolio methods of credit risk, the assumptions are still present—and that’s what is important. If those assumptions undermine the performance of methods, in order to achieve tractability, portfolio methods are just as compromised.

With this understanding of investment and financing decisions and approaches to default risk, we clarify how they relate to a particular vision of investment. That vision holds that investment is a stabilizing activity. What if it isn’t? The analysis proceeds to remind us of Minsky’s (heterodox) analysis of investment and financing decisions in which the collective behavior of firms renders investment as destabilizing. The section brings the two approaches of investment to bear on the determinants of credit risk. In this light, the assumptions required to make both mainstream theory and applications workable ultimately undermine their performance by compromising their ability to fully capture the dynamics of production. This analysis relies on recent work by Shaikh (2010) and Soros (1994). The following section draws the implications for the methods used by rating agencies and suggest an alternative way to create benchmarks for creditworthiness of firms. The discussion leads naturally to examination of fiscal sustainability and assessment of a government’s creditworthiness in the next chapter.

**Current Thinking on Investment and Its Financing**

In a capitalist market economy, the activities of nonfinancial firms create goods and services available to sell or “realize” in the market for profit.\(^1\) Production involves combining nonlabor resources or inputs with labor. To survive in a competitive environment, firms must grow, and grow faster than their competitors. Whatever its form of legal