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Sovereign Credit Ratings: A Primer

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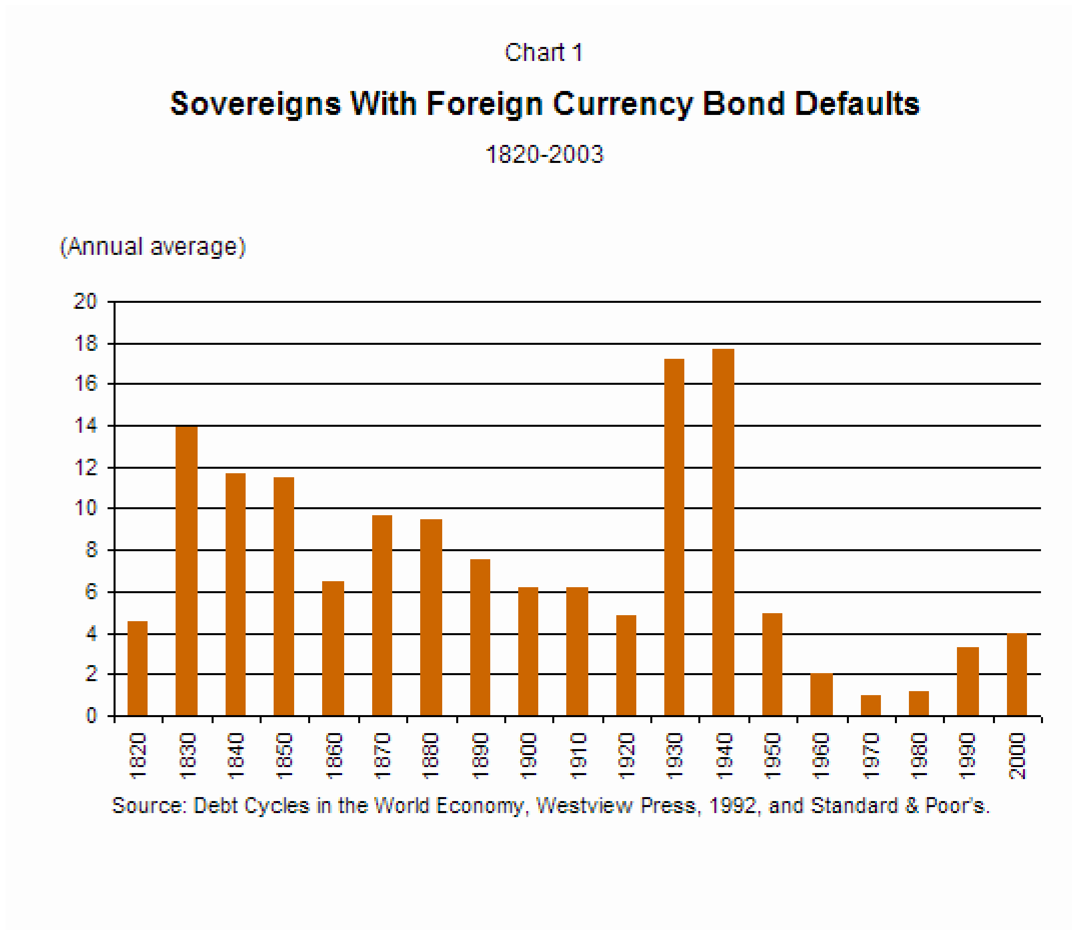
Sovereign Credit Ratings

Standard & Poor's sovereign credit ratings reflect its opinions on the ability and willingness of sovereign governments to service their commercial financial obligations in full and on time. Ratings coverage continues to expand, with the 100th sovereign rating recently assigned to Burkina Faso (see "Sovereign Ratings History Since 1975," available on RatingsDirect, Standard & Poor's Web-based credit research and analysis system).

A rating is a forward-looking estimate of default probability. Sovereign ratings are not "country ratings," an important and often misunderstood distinction. Sovereign ratings address the credit risks of national governments, but not the specific default risks of other issuers. A rating assigned to a nonsovereign entity is, most frequently, the same as or lower than that assigned to the sovereign in the main country of domicile, but may be higher. Foreign currency ratings may be higher whenever the nonsovereign entity has stronger credit characteristics than the sovereign and when the risk of the imposition of debt-service-limiting foreign exchange controls is less than the risk of sovereign default. Examples of such cases include a highly creditworthy private sector issuer located in a sovereign that is a member of a monetary union with a higher-rated central bank, an issuer with a significant percent of assets and business offshore, or an issuer with a very supportive offshore parent. Similarly, an issue benefiting from specific structural enhancements can be rated above the sovereign.

Defaults by rated sovereign issuers of bank and bond debt include those of the Republic of Argentina and the Russian Federation; the Dominican Republic (local currency only); and the Islamic Republic of Pakistan, the Oriental Republic of Uruguay, and the Republics of Indonesia, Paraguay, and Suriname (foreign currency only), although other rated sovereigns have defaulted in the years before they were rated. Default and transition studies (see "2003 Transition Data Update for Rated Sovereigns," RatingsDirect, Jan. 30, 2004) indicate that, compared with corporate ratings, sovereign ratings show more stability at most rating levels. In most instances, the sovereign default record is lower than the corporate default record. However, such comparisons are affected by the small sample size of sovereign defaults. Standard & Poor's expects sovereign default probabilities to converge with corporate ratios over time as the number of sovereign observations increases, something one would expect given the same rating definitions.

If, as we expect, defaults occur more frequently in the sovereign sector in the future, this will not be an unprecedented development. Defaults on sovereign foreign currency bonds occurred repeatedly, and on a substantial scale, throughout the 19th century and as recently as the 1940s. Sovereign bond default rates fell to low levels only in the decades after World War II (see Chart 1), when cross-border sovereign bond issuance also was minimal. Defaults on bank loans, the main vehicle for financing governments in the 1970s and 1980s, peaked in the early 1990s and have since fallen fairly steadily.



Past defaults reflect a variety of factors, including wars, revolutions, lax fiscal and monetary polices, and external economic shocks. Today, fiscal discipline, debt management, structural inefficiencies constraining productivity, and contingent liabilities arising from weak banking systems are among the significant economic policy challenges facing many sovereigns. The associated credit risk, which may seem manageable for a time, can quickly mushroom—as events in a number of emerging market countries in the late 1990s have shown. Standard & Poor's believes an understanding of sovereign ratings—what they mean and the criteria behind them—is as relevant now as ever.

Behind the Ratings

Standard & Poor's appraisal of each sovereign's overall creditworthiness is both quantitative and qualitative. The quantitative aspects of the analysis incorporate a number of measures of economic and financial performance and contingent liabilities, although judging the integrity of the data is a more qualitative matter. The analysis is also qualitative due to the importance of political and policy developments and because Standard & Poor's ratings indicate future debt service capacity.

Standard & Poor's divides the analytical framework for sovereigns into 10 categories (see "Sovereign Ratings Methodology Profile," below). As part of the committee process that Standard & Poor's uses to assign credit ratings, each sovereign is ranked on a scale of one (the best) to six for each of the 10 analytical categories. There is no exact formula for combining the scores to determine ratings. The analytical variables are interrelated and the weights are not fixed, either across sovereigns or over time. Most categories incorporate both economic risk and political risk, the key determinants of credit risk. Economic risk addresses the government's ability to repay its obligations on time and is a function of both quantitative and qualitative factors. Political risk addresses the sovereign's willingness to repay debt.

Sovereign Ratings Methodology Profile

Political Risk
- Stability and legitimacy of political institutions
- Popular participation in political processes
- Orderliness of leadership succession
- Transparency in economic policy decisions and objectives
- Public security
- Geopolitical risk

Income and Economic Structure
- Prosperity, diversity, and degree to which economy is market-oriented
- Income disparities
- Effectiveness of financial sector in intermediating funds; availability of credit
- Competitiveness and profitability of nonfinancial private sector
- Efficiency of public sector
- Protectionism and other nonmarket influences
- Labor flexibility

Economic Growth Prospects
- Size and composition of savings and investment
- Rate and pattern of economic growth

Fiscal Flexibility
- General government revenue, expenditure, and surplus/deficit trends
- Revenue-raising flexibility and efficiency
- Expenditure effectiveness and pressures
- Timeliness, coverage, and transparency in reporting
- Pension obligations

General Government Debt Burden
- General government gross and net (of assets) debt as a percent of GDP
- Share of revenue devoted to interest
- Currency composition and maturity profile
- Depth and breadth of local capital markets

Offshore and Contingent Liabilities
- Size and health of nonfinancial public-sector enterprises
- Robustness of financial sector

Monetary Flexibility
- Price behavior in economic cycles
- Money and credit expansion
- Compatibility of exchange-rate regime and monetary goals
- Institutional factors such as central bank independence
- Range and efficiency of monetary policy tools

External Liquidity
- Impact of fiscal and monetary policies on external accounts
- Structure of the current account
- Composition of capital flows
- Reserve adequacy

Public-Sector External Debt Burden
- Gross and net public-sector external debt, including structured debt, as a percent of current account receipts
- Maturity profile, currency composition, and sensitivity to interest rate changes
- Access to concessional funding
- Debt service burden

Private-Sector External Debt Burden
- Gross and net financial-sector external debt, including deposits and structured debt, as a percent of current account receipts
- Gross and net nonfinancial private-sector external debt, including structured debt, as a percent of current account receipts
- Maturity profile, currency composition, and sensitivity to interest-rate changes
- Access to concessional funding

Willingness to pay is a qualitative issue that distinguishes sovereigns from most other types of issuers. Partly because creditors have only limited legal redress, a government can (and sometimes does) default selectively on its obligations, even when it possesses the financial capacity for timely debt service. In practice, of course, political risk and economic risk are related. A government that is unwilling to repay debt is usually pursuing economic policies that weaken its ability to do so. Willingness to pay, therefore, encompasses the range of economic and political factors influencing government policy.

As the default frequency of sovereign local currency debt differs significantly from that of sovereign foreign currency debt, both are analyzed. While the same political, social, and economic factors affect the government's ability and willingness to honor local and foreign currency debt, they do so in varying degrees. A sovereign government's ability and willingness to service local currency debt is supported by its taxation powers and its ability to control the domestic financial system, which give it potentially unlimited access to local currency resources.

To service foreign currency debt, however, the sovereign must secure foreign exchange, usually by purchasing it in the currency markets. This can be a binding constraint, as reflected in the higher frequency of foreign than local currency debt default (see "Sovereign Defaults: Heading Lower Into 2004," RatingsDirect, Sept. 18, 2003). The primary focus of Standard & Poor's local currency credit analysis is on the government's economic strategy, particularly its fiscal and monetary policies, as well as on its plans for privatization, other microeconomic reform, and additional factors likely to support or erode incentives for timely debt service. When assessing the default risk on foreign currency debt, Standard & Poor's places more weight on the impact of these same factors on the balance of payments and external liquidity, and on the magnitude and characteristics of the external debt burden.

Local and Foreign Currency Rating Factors

Key economic and political risks that Standard & Poor's considers when rating sovereign debt include:

- Political institutions and trends in the country and their impact on the effectiveness and transparency of the policy environment, as well as public security and geopolitical concerns;
- Economic structure and growth prospects;
- General government revenue flexibility and expenditure pressures, general government deficits and the size of the debt burden, and contingent liabilities posed by the financial system and public sector enterprises;
- Monetary flexibility; and
- External liquidity and trends in public and private sector liabilities to nonresidents.

The first four factors directly affect the ability and willingness of governments to ensure timely local currency debt service. Since fiscal and monetary policies ultimately influence a country's external balance sheet, they also affect the ability and willingness of governments to service foreign currency debt—which is also affected by the fifth factor above. Balance-of-payments constraints are often among the most binding. (For more information on differences among rating categories, please see "Sovereign Credit Characteristics by Rating Category," RatingsDirect, Nov. 19, 2003.)

Sovereign Ratings Methodology Profile

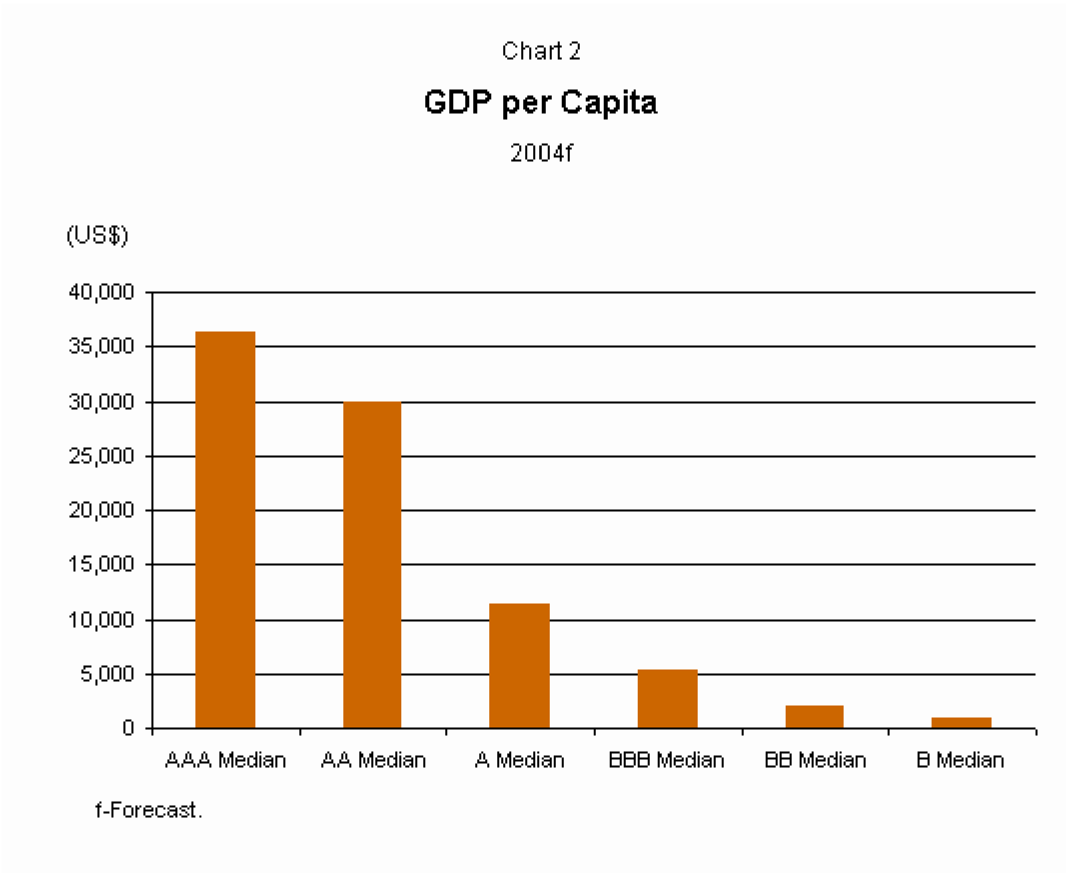
Political risk.

The first of the 10 analytical categories in the sovereign ratings methodology profile (see "Sovereign Ratings Methodology Profile," above) is political risk. The stability, predictability, and transparency of a country's political institutions are important considerations in analyzing the parameters for economic policymaking, including how quickly policy errors are identified and corrected. The separation of powers, particularly judicial, is an important factor, as is the development of civil institutions, particularly an independent press. Standard & Poor's examines the degree to which politics is adversarial and the frequency of changes in government, as well as any public security concerns. Relations with neighboring countries are studied with an eye toward potential external security risk. National security is a concern when military threats place a significant burden on fiscal policy, reduce the flow of potential investment, and put the balance of payments under stress.

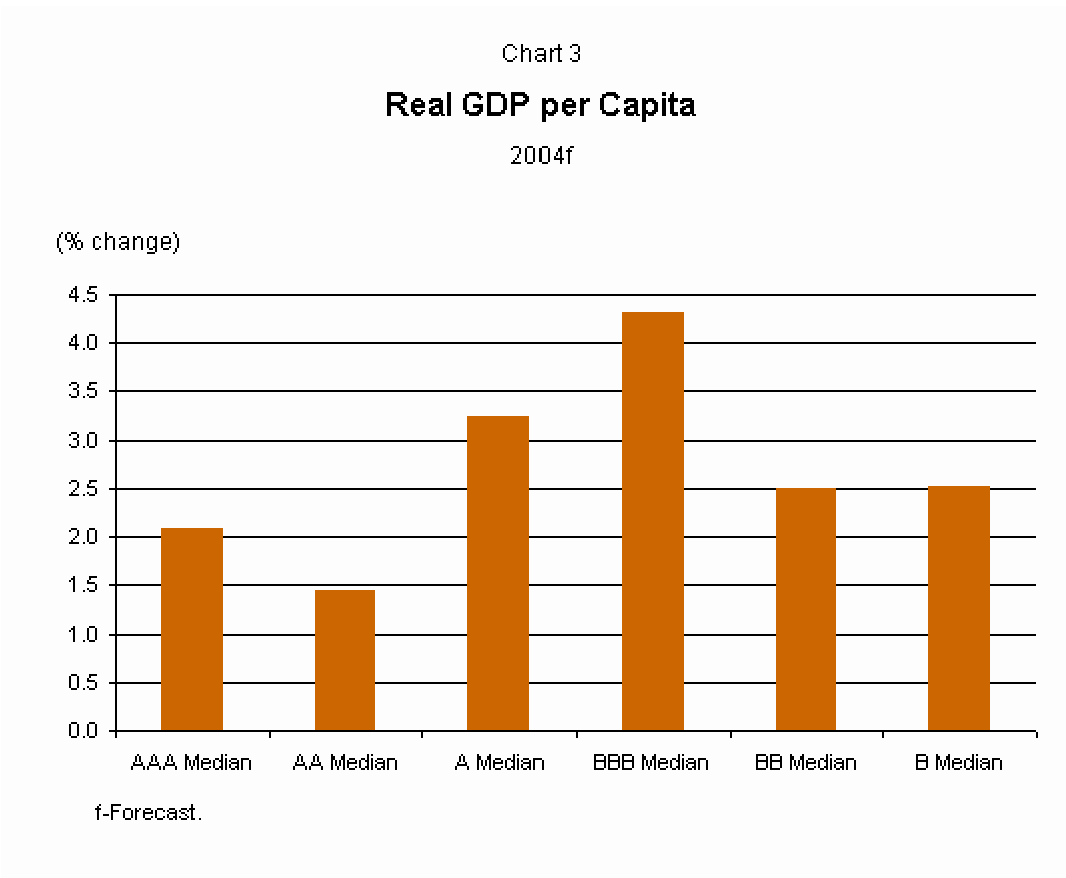
A political risk ranking of "1" for most EU sovereigns reflects the broad public backing for their open political frameworks, in which popular participation is high, the process of succession is clear, and the conduct of government is transparent and responsive to changing situations. Well-established institutions provide transparency and predictability, particularly with regard to property rights, in a relatively efficient manner. At the weaker end of the scale, political institutions may have a short track record and/or be considerably less open and effective. Political decision-making processes may be highly concentrated, or a significant portion of the population may be marginalized. There may be internal divisions along racial or economic lines, some geopolitical risk, or public security concerns. Political and external shocks are more likely to disrupt economic policy than at higher rankings. For example, the Republic of Indonesia's short track record with democracy, its problems with secessionist movements and terrorist-related bombings, its sometimes-strained relationship with its donor group over economic policy and military reform, and the divisions between the indigenous and Chinese populations result in a weak political-risk ranking.

Income and economic structure.
The second of the 10 sovereign criteria categories is economic structure. Due to its decentralized decision making processes, a market economy with legally enforceable property rights is less prone to policy error and more respectful of the interests of creditors than one where the public sector dominates. Market reform in the transition economies of Central and Eastern Europe has brought the economic structure scores of the Republics of Slovenia and Hungary and the Czech Republic (among others) to, or close to, those of Western European sovereigns, whose market economies are well entrenched. Rankings in this category are highly correlated with per capita GDP (see Chart 2), with a negative adjustment made for narrow economies, weak or less-developed financial systems, and wide income disparities. Weaker rankings may also reflect highly leveraged or undeveloped private sectors, structural impediments to growth, and large and somewhat inefficient public sectors.

For countries undertaking substantial economic reform, the sequencing of the various measures may be key to their effectiveness. While there have been successful variations, the most common starting point is the reduction of fiscal imbalances with the aim of macroeconomic stability; measures to improve labor market flexibility, to strengthen the domestic financial sector, and to open trade and services globally generally follow. Past economic crises, particularly in Asia in the late 1990s, suggest capital account liberalization should take place in conjunction with current account liberalization, but at an orderly pace that meshes with transparent progress in the other areas.



Economic growth prospects.
Standard & Poor's third analytical category for sovereign ratings is economic growth prospects. A government in a country with a growing standard of living and income distribution regarded as broadly equitable can support high public sector debt levels and withstand unexpected economic and political shocks more readily than a government in a country with a poor or stagnant economy. Trend growth exceeding 4.5% per year in the Republic of Estonia and a handful of other countries provides considerably more policy flexibility and a superior economic prospects ranking than Standard & Poor's ascribes to Japan, where economic growth prospects will remain comparatively weak until private sector restructuring is more entrenched. Chart 3 illustrates how growth prospects are generally highest in the 'BBB' and 'A' categories. At top rating levels, the advanced level of development usually precludes high trend rates of growth. In what is commonly referred to as the speculative rating categories ('BB' and lower), growth is more likely to be erratic and suffer from structural impediments. Note, too, that Chart 3 illustrates just 2004, which is expected to be an economic recovery year in many countries. In its analysis of growth prospects, Standard & Poor's examines historical economic trends and projects into the future, based upon scrutiny of how fundamentals affecting investment and competitiveness have evolved.



Fiscal flexibility.
The fourth category in Standard & Poor's sovereign ratings methodology profile is fiscal flexibility, as measured by an examination of general government revenue, expenditure, and balance performance. Fiscal trends, along with methods of deficit financing and their inflationary impact, are important indicators of sovereign credit quality. Scores in this category are a function not only of surpluses and deficits, but also of revenue and expenditure flexibility and the effectiveness of expenditure programs. General government is the aggregate of the national, regional, and local government sectors, including social security and excluding intergovernmental transactions. Noncommercial off-budget and quasi-fiscal activities are included to the extent possible, with significant omissions noted.

Typically, the least-distortionary and most-growth-friendly tax system that also addresses equity concerns has a broad tax base and low tax rates. Sovereigns with strong scores in this category can adjust tax bases and rates without serious constitutional, political, or administrative difficulties. Effective expenditure programs provide the public services demanded by the population and the infrastructure and education levels needed to underpin sustainable economic growth, all within the confines of tax and fee resources and affordable financing. Procurement and tendering procedures are transparent. Arrears are quantified and deficits can be reconciled to trends in debt.

The Republic of Singapore receives a top score of "1" in the fiscal flexibility category, despite significant financing needs in its history, because astute investment in public infrastructure and an educated workforce have, over the past 40 years, transformed the country into a prosperous manufacturing- and service-based center. Lower scores are given where government money is not spent as effectively because of constitutional rigidities, political pressures, or corruption, and where revenue flexibility is constrained by already-high taxes or tax-collection difficulties. The environment is less conducive to sustainable economic growth and more suggestive of debt-servicing difficulties. The Republic of India's sizable deficits and limited revenue and expenditure flexibility give it a weak score in this category. As Chart 4 illustrates, deficits tend to be highest in the speculative-grade categories. Deficits may not be as high at the lowest rating levels ('B' and below), with the fiscal flexibility score affected more by quasi-fiscal activities, lack of transparency, and limited revenue and expenditure flexibility.

Pension obligations represent a fiscal pressure of growing significance for countries with rapidly aging populations. Standard & Poor's believes that the sovereign credit ratings of some highly rated EU members could begin to come under downward pressure over the medium term if there is no further fiscal consolidation and structural reform to counter the financial problems of aging societies (see "Western Europe Past Its Prime–Sovereign Rating Perspectives in the Context of Aging Populations," RatingsDirect, Jan. 9, 2002).

Chart 4

General Government Balance/GDP

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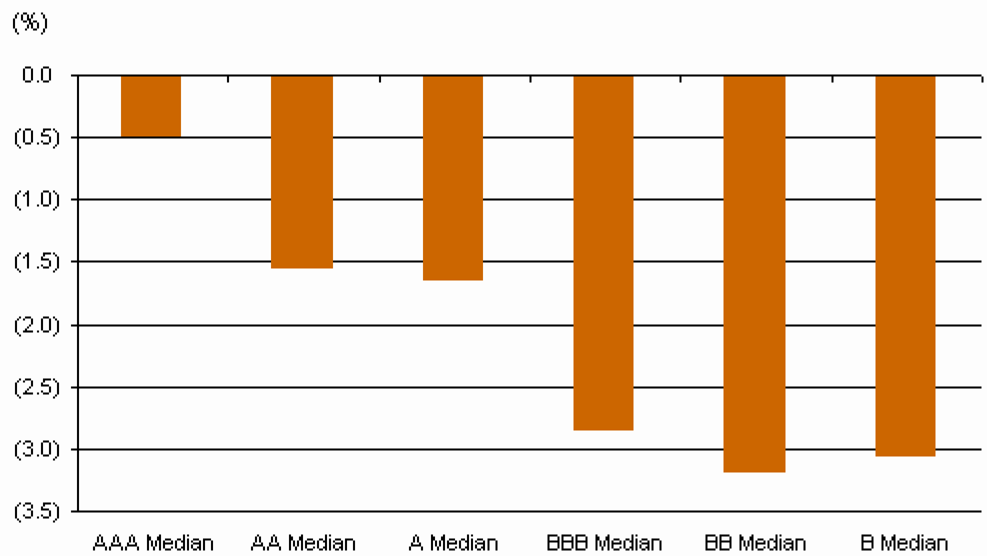

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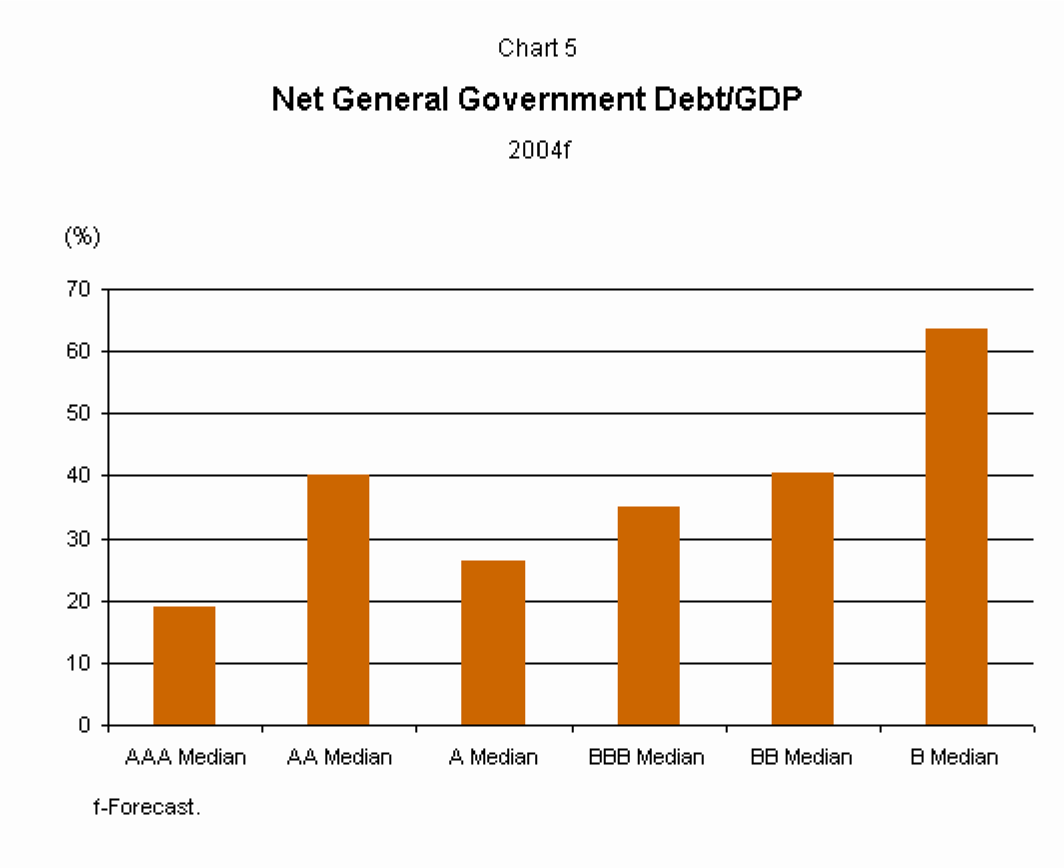
General government debt burden.

The fifth sovereign criteria category is the general government debt burden. Typically, governments borrow to finance combinations of consumption and investment that increase general government debt. Analysis of public finance is complicated by the fact that the taxation and monetary powers unique to sovereigns can permit them to manage widely varying debt levels over time. A sovereign such as Canada (with a substantial, albeit declining, debt burden but an unblemished track record of honoring debt obligations and a strong domestic capital market providing fairly low-cost financing) receives a better score in this category than some sovereigns in Latin America, which may have lower debt to GDP ratios but have higher and more variable debt-servicing burdens. Japan, the Kingdom of Belgium, and the Republic of Italy, all in the 'AA' range and among the most indebted of the rated sovereigns, bring the 'AA' median for general government debt above what one might expect, as shown in Chart 5; however, these countries have the wealth, level of development, and revenue-raising ability that allow their governments to support such high debt levels.



Off-budget and contingent liabilities.

Off-budget and contingent liabilities, the sixth sovereign criteria category, can be important rating considerations, with attention focused on the size and health of nonfinancial public sector enterprises (NFPEs) and the robustness of the financial sector. NFPEs pose a risk to the sovereign because they generally have been formed to further public policies and often suffer from weak profitability and low (or virtually nonexistent) equity bases, which leave them highly vulnerable to adverse economic circumstances. To varying degrees, NFPEs may collect and expend funds that further public policies outside of the budgetary process. If such quasi-fiscal activities are sizeable, the usefulness of general government statistics as an indicator of fiscal performance and position and the role of the government in the economy is diminished. Quasi-fiscal activities generate implicit contingent liabilities. The indebtedness of nonself-supporting NFPEs is a useful measure of the contingent liability, but account is also taken of profitable enterprises that price their products to further budgetary objectives, provide noncommercial services, and/or pay higher-than-commercial prices to suppliers.

The financial sector is a contingent liability because problems can impair a sovereign's credit standing when they lead to an official rescue of failing banks. The impetus to assist banks is strong when there is a systemic crisis, since banking-system soundness is essential to macroeconomic stability, effective demand management, and sustained economic growth. The sovereign foreign and local currency ratings of the Republic of Korea were sharply downgraded in 1997-1998, in part because of the escalating costs of supporting the country's banking sector. Standard & Poor's financial sector analysts regularly examine global financial sector risk (see "Global Financial System Stress," RatingsDirect, Dec. 11, 2002), and their assessments of the potential for a systemic crisis are a crucial input in this category of sovereign analysis. Public sector banks may weigh heavily in this category when they engage in various quasi-fiscal activities such as subsidized lending, bank rescue operations, or exchange-rate guarantees that are not provided for in the government's budget.

Modest off-budget and contingent liabilities provide the Kingdom of Denmark with a "1" ranking in this category. In contrast, the government of the People's Republic of China's heavy involvement in troubled state-owned enterprises and poor lending standards in its banking sector (albeit with some recent reform) justify a low ranking in this category.

Monetary flexibility.
Monetary flexibility, the seventh risk category in the sovereign ratings methodology profile, can be an important leading indicator of sovereign credit trends. Significant monetization of budget deficits often fuels price inflation, which can undermine popular support for a government and cause serious economic damage. Chart 6 shows higher levels of inflation at lower rating categories, although the discrepancies are much smaller than in the past because world inflation has dissipated. This is the result of a number of factors including greater central bank independence, improved monetary policy practices, increased global competition, and higher productivity growth. However, a combination of rising commodity prices and higher deficits and debt burdens suggest potentially greater inflation going forward than the very low levels of the recent past.

Chart 6

CPI

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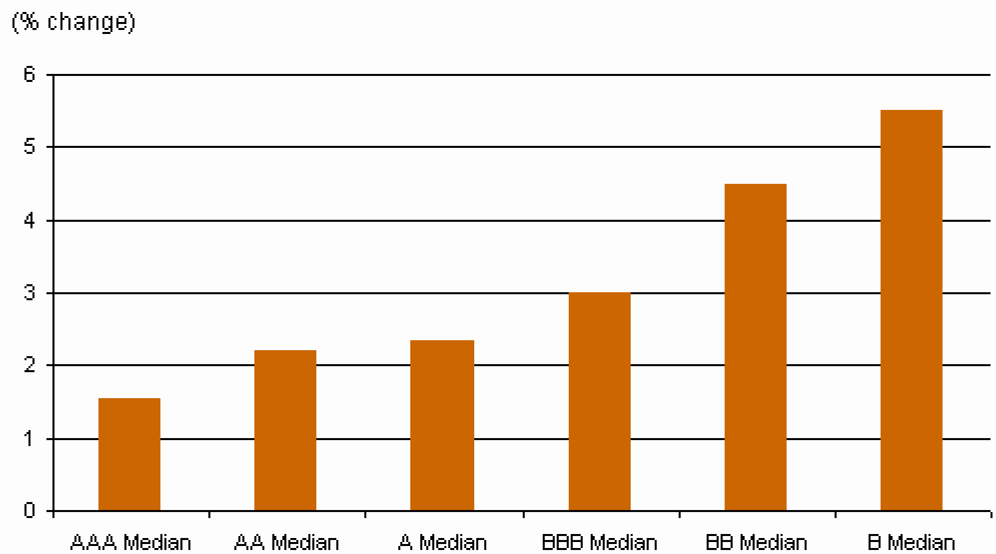

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In evaluating monetary flexibility, Standard & Poor's considers:

- Price behavior in economic cycles and relative to trading partners;
- The market orientation of monetary policy tools and the degree to which their effectiveness is facilitated by a transparent, well-developed, and well-regulated financial sector and debt market;
- Institutional factors, such as the operational independence of the central bank; and
- The compatibility of the exchange-rate regime with monetary policy goals.

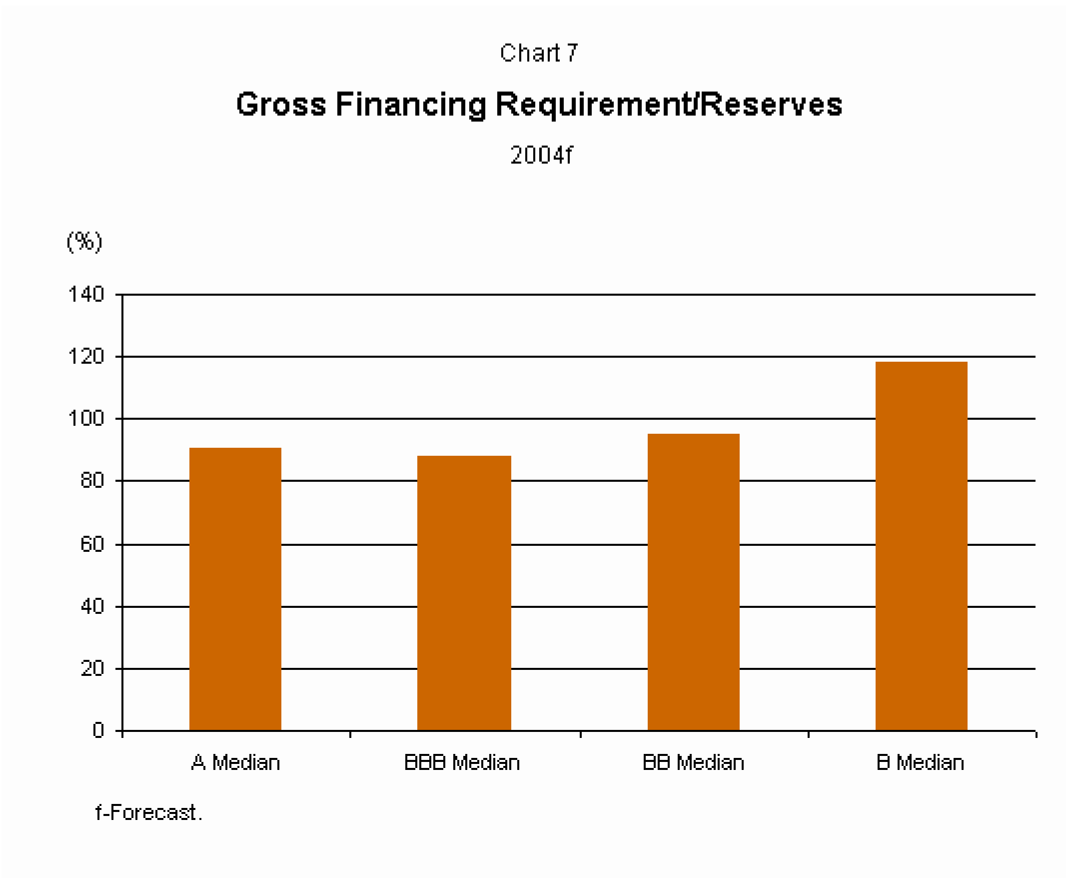
The top ranking of "1" is assigned to the European Central Bank and the U.S., among others. Low inflation is supported by independent central banks pursuing sustainable monetary and exchange-rate policies, and monetary flexibility is bolstered by transparent and well-developed capital markets. On the other hand, the Central Bank of Russia's conduct of monetary policy is constrained by a weak financial sector and less-sophisticated capital markets, and the country continues to be plagued by double-digit, albeit declining, inflation—resulting in a much-weaker monetary stability score.

In conjunction with enhancing monetary flexibility and the effectiveness of monetary tools, the depth and breadth of a country's capital markets can also act as an important discipline. A sovereign has fewer incentives to default on local currency obligations when they are held by a broad cross section of domestic investors, rather than concentrated in the hands of local banks. For this reason, the establishment of mandatory, privately funded pension funds in a number of countries (such as the Republic of Chile) helps bolster the sovereign's credit standing by creating an influential new class of bondholders. The experience of many Organization for Economic Cooperation and Development (OECD) countries suggests that, even when public debt is high, creditworthiness can be sustained over long periods when policymakers are responsive to constituencies with vested interests in safeguarding the internal value of money and financial contracts.

External liquidity.
The eighth risk category in the sovereign ratings methodology profile is external liquidity. Standard & Poor's balance-of-payments analysis focuses on the impact of economic policy upon the external sector, and on the external sector's structural characteristics. In the short run, the ability of policymakers to manage financial pressure from abroad depends partly upon the structure of the current and capital accounts. Yet, balance-of-payments pressures neither appear spontaneously nor reach large magnitudes for structural reasons alone. In most cases, they can be traced back to flawed economic policies. Standard & Poor's approach reflects the premise that the macroeconomic and microeconomic policies discussed earlier affect balance-of-payments behavior.

For this reason, the size of a country's current account deficit, which reflects the excess of investment over savings, may not by itself be an important rating consideration. The tendency for some countries to run current account surpluses and others to run current account deficits is well documented. It is the product of many factors, not all of them negative and not all related to government policies. Some of countries in Central and Eastern Europe that are slated for EU membership on May 1, 2004, run large current account deficits that are financed with little difficulty because they are not the byproduct of fiscal mismanagement. However, the Kingdom of Thailand's 1997 foreign exchange crisis is a sharp reminder that large current account deficits can also be a symptom of serious underlying weaknesses—in this case, a financial sector whose asset quality had weakened dramatically after years of rapid domestic credit growth. And, as the United Mexican States' 1995 debt servicing crisis illustrated, current account deficits are a concern when government policies result in a public sector external debt structure that is vulnerable to sudden changes in investor sentiment.

A key quantitative measure in this criteria category is the gross external financing gap (the current account deficit plus short-term liabilities to nonresidents, including deposits and principal due on medium- and long-term public and private sector debt) as a percent of usable foreign exchange reserves, as shown in Chart 7. The ratio tends to be below 100% for investment-grade sovereigns and above that for speculative-grade sovereigns. Factors that may mitigate the risk of a high financing gap include substantial foreign direct investment (FDI), particularly green-field, and expectations of stronger export growth, presumably the result of the investment that is contributing to the gap.



Usable foreign exchange reserves, which include only those reserves available for foreign exchange operations and repayment of external debt, usually act as a financial buffer for the government during periods of balance-of-payments stress. Whether a given level of reserves is, or is not, adequate is judged not only in relation to the gross external financing gap, but also to the government's financial and exchange-rate policies and, consequently, the vulnerability of reserves to changes in current and capital account flows. Reserves deposited with national banks, pledged as security, or sold forward in the exchange markets are not included in usable reserves. In addition, for sovereigns that have adopted a currency board or have a long-standing fixed peg with another currency, some adjustment is made for the fact that a portion of reserves may be needed to underpin confidence in the exchange-rate link.

The U.S. maintains very low reserves. It can do so because the U.S. dollar generally has floated against other currencies since 1971. The dollar's unique status as the key currency financing global trade and investment also reduces the need for gold and foreign exchange. Most other high-investment-grade sovereigns with floating currencies and little foreign currency debt also require relatively modest reserves. This explains the exclusion of the top-two rating categories from Chart 7. The 10 sovereigns slated for EU membership on May 1, 2004, are also excluded. Many of them have large external financing gaps, but the credit risk these gaps pose are mitigated by heavy offsetting FDI inflows and by the fact that the probability of a balance of payments shock will diminish as these sovereigns move closer to EMU membership.

However, international liquidity is more critical at lower rating levels when, as is often the case, government debt is denominated in foreign currencies or significant amounts of local currency debt are held by cross-border investors. Fiscal setbacks and other economic or political shocks can, consequently, impair financial market access. Most Latin American sovereigns fall into this category and, as a result, generally maintain above-average reserves.

Public and private sector external debt burdens.
The ninth and tenth sovereign criteria categories are the external debt burdens of the public and private sectors. Standard & Poor's examines each sovereign's external balance sheet, which shows residents' assets and liabilities vis-à-vis the rest of the world alongside an analysis of its balance-of-payments flows.

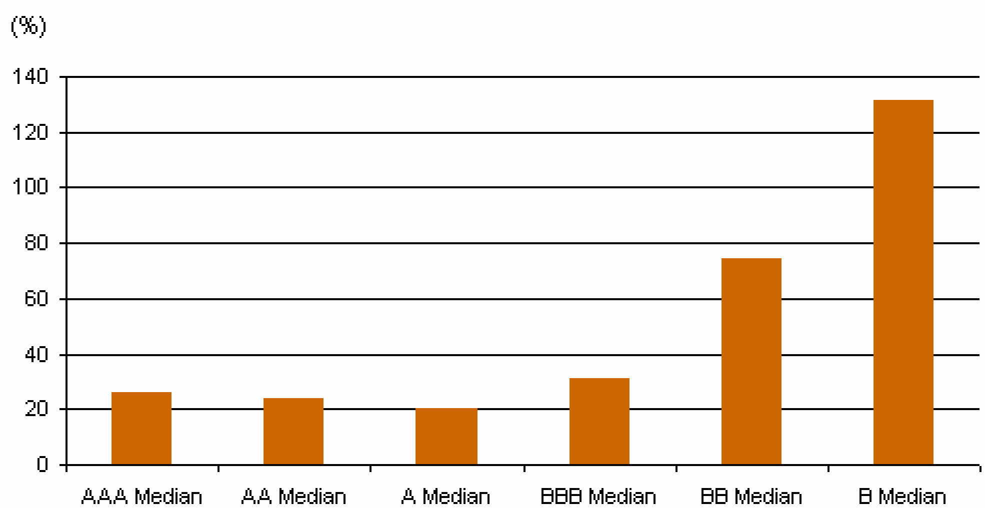
The main focus is on trends in the public sector external debt position, the magnitude of the government's contingent liabilities, and the adequacy of foreign-exchange reserves to service both public and (particularly in a crisis) private sector foreign currency debt. To complete the picture, Standard & Poor's calculates an international investment position. This is the broadest measure of a country's external financial position. It adds the value of private sector debt and equity liabilities to public sector external indebtedness denominated in local and foreign currencies.

Public sector external debt includes the direct and guaranteed debt of the central government, obligations of regional and local governments, and the nonguaranteed debt of other public sector entities. Net public sector external debt equals total public sector external debt minus public sector external financial assets, including usable reserves. To measure the magnitude of the public sector external debt burden, Standard & Poor's compares it to current account receipts (CAR) (proceeds from exports of goods and services along with investment income and transfers received from nonresidents), as shown in Chart 8. The presence in the 'A' category of a few sovereigns with public sectors in strong net external creditor positions (in particular, the Republic of Botswana, the Czech Republic, the Hong Kong Special Administrative Region, the State of Kuwait, and the Kingdom of Saudi Arabia) keep the 'A' debt burden below what one might otherwise expect. However, the ratings of these sovereigns are constrained by a combination of geopolitical risk, economic concentration, and other factors.

Chart 8

Total Public-Sector External Debt/Current Account Receipts

2004f



f-Forecast.

Private sector external debt burdens are measured as follows:

- Financial institutions' net external debt equals their borrowings from nonresidents (including nonresident deposits in resident banks) minus financial institutions' deposits with and lending to nonresidents.
- Net external debt of the nonfinancial private sector equals its borrowings from nonresidents minus nonfinancial private sector deposits with and lending to nonresidents.

Private-sector debt is examined because it can pressure reserves and, in some cases, ultimately become a liability of the state.

External debt also is evaluated in terms of its maturity profile, currency composition, and sensitivity to changing interest rates. Along with new borrowings, these factors influence the size of future interest and amortization payments. Debt service, including interest and principal payments on both short- and long-term debt, is compared with projected CAR. Debt contracted on concessional bilateral terms can, to some extent, offset a high public sector external debt burden. The Republic of Senegal, for example, has high public sector external debt, estimated at around 155% of exports in 2004, but favorable terms on restructured foreign currency debt mean that interest plus amortization (excluding short-term debt) is moderate at 11% of CAR.

While private flows to emerging markets afford great benefits, sharp and sudden variations in these flows can cause great distress. High proportions of foreign-currency-denominated and short-term debt magnify a country's vulnerability to changes in investor sentiment. While funding from the International Monetary Fund (IMF) and other multilateral official sources can be a mitigating factor, the availability of official resources is limited in relation to the funds deployed by banks and cross-border investors. Reserve levels and the strength of CAR deserve particular scrutiny during periods of global financial volatility. Other sources of protection for macroeconomic performance are robust domestic sources of finance, a sound financial sector that obviates capital flight, and productive FDI. Capital account liberalization is generally viewed positively in the context of sensible economic policies, an appropriate exchange-rate regime, and a sound financial system.

Local and Foreign Currency Rating Distinctions

Any divergence between a sovereign's local and foreign currency ratings reflects the distinctive credit risk of each type of debt. For example, stable, predictable political institutions, fiscal and monetary policies resulting in relatively low inflation, and prosperous and diversified economies are characteristics of sovereign issuers of 'AAA' rated local currency debt. The manageable public sector external debt burdens of these issuers, in turn, result in foreign currency debt ratings at the upper end of the investment-grade spectrum. New Zealand ('AA+' foreign currency and 'AAA' local currency ratings) is an example of a government shouldering a moderate public sector external debt burden of 41% of CAR in 2004, but where fiscal flexibility is substantial and the political commitment to low or moderate rates of inflation is well entrenched.

The differences between foreign and local currency debt ratings may widen to some degree with sovereigns that are further down the ratings' scale. These sovereigns, typically, fall into one of two categories:

- Those with long records of timely service on both local and foreign currency debt. Inflationary pressures are moderate and public finances are relatively sound, but foreign currency indebtedness may be relatively high or is likely to become so over time.
- Those that also have unblemished local currency debt-servicing track records, but histories of foreign currency default. The foreign and local currency debt ratings assigned to these sovereigns balance often substantial improvements in inflation and public finances with the risk inherent in still-heavy foreign currency debt burdens.

These rating differences sometimes narrow at the lower end of the rating scale. A number of sovereigns in this category have emerged from foreign or local currency debt default within the last decade, and still carry the risk of policy reversals that can result in renewed default. Other sovereigns in this category may not have defaulted, but face high inflation and other forms of social and political stress that carry a material risk of local currency default after payment of foreign currency debt can no longer be assured. Across the rating scale, the existence of a transparent, well-developed, domestic market—offering long-term borrowing in local currency at low cost—underpins the widest spreads between foreign and local currency sovereign ratings.

Ratings of EMU members present a special case. Sovereigns in EMU have ceded monetary and exchange-rate responsibilities to the 'AAA' rated European Central Bank. As a result, Standard & Poor's rates each government's euro-denominated and foreign currency debt the same. Economic and fiscal factors are the dominant criteria for differentiating the credit quality of sovereigns inside EMU (see "Local and Foreign Currency Ratings Converge for EMU Issuers," RatingsDirect, May 6, 1998). The local currency rating is also the same as the foreign currency rating for the Principality of Liechtenstein, because it uses the euro for its currency; the same holds true for the Isle of Man, because it uses British pound sterling; the Cook Islands, because it uses the New Zealand dollar; and the Republics of Panama, El Salvador, and Ecuador, because they use the U.S. dollar.

A number of factors must be examined when considering whether distinctions between foreign and local currency ratings are appropriate. Governments default on local currency debt less frequently because the ability to tax and control over the domestic banking system give them access to some finance, even when foreign currency debt is in default. Sovereigns must also have the political will and influence to use these powers. The Russian Federation defaulted on its ruble debt in August 1998, in part, because a substantial portion was held by nonresidents seeking to reduce their holdings of both government debt and rubles. In such cases, the flexibility needed to meet local currency obligations is more limited, and Standard & Poor's usually rates local currency debt the same as, or only slightly higher than, foreign currency debt. The same considerations constrain the rating of dollar-indexed local currency debt, which usually is (at most) one notch higher than the foreign currency rating. The cost of servicing such debt is similar to the cost of servicing foreign currency debt.

In cases where the primary rating constraint is geopolitical risk there also may be little or no distinction between foreign and local currency ratings, because the special powers of a sovereign in its ability to tax and its control over the monetary and financial systems may count for little in the event of geopolitical stress. Hong Kong's foreign and local currency ratings are both constrained by China risk and are only one notch apart.

Sovereign Rating Changes

Rated sovereigns formed an exclusive club of the world's most creditworthy governments until the 1990s. Standard & Poor's rated just a dozen sovereign issuers in 1980—all at the 'AAA' level. Rating downgrades were relatively rare over the remainder of that decade and, when they occurred, were usually of modest dimensions. Today, the sovereign sector is far more heterogeneous. The 100 sovereigns Standard & Poor's monitors carry ratings between 'AAA' and 'SD' (Selective Default). Given this range of credit quality, rating changes occur more frequently. Standard & Poor's recently introduced an internal early-warning system to assist in rating surveillance.

Sovereign ratings measure future debt service capacity, and rating committees therefore consider reasonable "worst-case" scenarios over a five-year time horizon to gain a better understanding of future downside risk. A government's medium-term financial program, when available, is scrutinized alongside independent forecasts. Standard & Poor's then examines the interaction between public sector finances, external debt, and other variables, such as real export growth, asset-quality trends affecting the local banking system, and changes in overseas interest rates. Standard & Poor's incorporates risks arising over economic, political, and commodity cycles in its ratings. Rating changes occur whenever new information significantly alters Standard & Poor's view of likely future developments. This usually results from the policy response or the degree of latitude in a given area being different from what was expected.

One of the lessons of recent years for sovereigns is that a strong policy response that identifies and addresses sources of instability is key. Whether the problem is a weak banking sector, excessively leveraged corporates, inflexible exchange-rate regimes, or high fiscal imbalances, a strong policy response is crucial for strengthening both the economic environment and sovereign creditworthiness.

Sovereign Ratings and Nonsovereign Risk

Sovereign credit risk is a consideration in assessing the credit standings of nonsovereign entities, but sovereign ratings do not cap nonsovereign ratings. Sovereign risk comes into play in analyzing nonsovereign creditworthiness because the unique, wide-ranging powers and resources of each national government affect the financial and operating environments of entities under its jurisdiction. Past experience has shown that defaults by otherwise creditworthy borrowers can stem from the imposition of exchange controls that impede debt service—often, although not always, linked to a sovereign default.

In the case of foreign currency debt, the sovereign has first claim on available foreign exchange and controls the ability of residents to obtain funds to repay creditors. As a result, absent a monetary union with a higher-rated central bank or special considerations insulating the issuer or issue (such as a supportive foreign parent, substantial offshore business, or structural features), the credit rating of an international borrower most often is at, or below, the rating of the sovereign in the country of domicile. In some cases, Standard & Poor's may decide that the risk of sovereign interference is less than the risk of sovereign default, and rate a nonsovereign entity higher than the sovereign even without the special features noted above; however, such instances have been rare. Moreover, as the international community considers various sovereign bankruptcy plans that may include the imposition of foreign exchange controls, the scope for assigning higher sovereign interference ratings (lower sovereign interference risk) is likely to remain limited.

In contrast, sovereigns are not very likely to interfere directly in the service of nonsovereign debt when access to foreign exchange is not involved. As a result, the potential for rating a nonsovereign entity higher than a sovereign on a local currency basis is much greater. Nonsovereign local currency ratings speak to the willingness and ability of the entity to service its debt (both foreign- and local-currency denominated) in full and on time, absent foreign exchange controls. However, indirect sovereign risk continues to be an important consideration; this is because economic and business conditions are apt to be quite hostile for all entities when a sovereign is in distress. The economy likely will be contracting, the currency depreciating, taxes increasing, public services deteriorating, inflation escalating, and interest rates soaring. In the most difficult situations, bank deposits will be frozen. Thus, only nonsovereigns with exceptional operational and financial flexibility that diminish this risk are likely to be rated higher than the sovereign. (For more details, please see "Credit FAQ: Foreign/Local Currency and Sovereign/Nonsovereign Rating Differentials," RatingsDirect, Sept. 22, 2003, and "Local Currency Rating Criteria Update: The Importance of Country Risk for Corporate and Infrastructure Sectors," RatingsDirect, Nov. 6, 2002.)

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