Everything on sovereign risk in six questions

Why countries with low debt do not always have the highest ratings

Question 1. What is a sovereign rating and what makes up a sovereign credit risk assessment?

A sovereign credit rating refers to a rating agency’s opinion on the ability and willingness of a sovereign issuer to pay its debt obligations. The focus is on debt owed to private creditors, whose ability to influence the government and seek debt repayment at the national and supranational levels is extremely limited. In the case of sovereign defaults, investors usually face losses (haircuts) but not the full cancelation of debts (write-off), which acts as a mitigating factor for them. This is because in a default situation, sovereign issuers, unlike companies or banks, do not cease to exist.

Throughout more than a century of sovereign rating history, the factors used to determine ratings have changed as knowledge about the causes of sovereign defaults has accumulated and new solutions have emerged regarding the collection and standardization of macroeconomic data for rated countries. The assessment of sovereign risk today is usually based on analyzing the following analytical blocks: macroeconomics, budget and debt positions, the country’s external position, and the institutional environment.

- The analysis of the macroeconomic position focuses on the sustainability of the country’s long-term growth and the willingness of authorities to conduct a balanced monetary and structural policy that allows the sovereign issuer to withstand various shocks.
- When assessing budget and debt positions, rating agencies examine the government’s ability to conduct a balanced budget policy and maintain public debt at a safe level for the country.
- The analysis of a sovereign issuer’s external position assesses its resilience to external shocks. The external position is evaluated in the context of all segments of the country’s economy, taking into account the relationship between the public and private sectors given their propensity to act as agents of external shocks for each other (in this regard, the banking sector deserves special attention).
- The assessment of the institutional environment and state policies analyzes their focus on ensuring the sovereign’s sustainable growth and the ability to counter shocks.

Question 2. Why are these factors taken into account?

The starting point for analyzing and systematizing the factors listed above is the history of sovereign defaults and their circumstances. According to ACRA, over the past 30 years, 68 cases of sovereign defaults have been recorded. Their circumstances are so diverse that it is not easy to formalize and transform them into a set of indicators, which allows rating agencies to reach a final assessment, or sovereign rating.
Examples of the circumstances surrounding sovereign defaults show the diversity of the overall picture. At the end of 1997, Russia’s public debt was about 54% of GDP, and in August of 1998, the country had already announced a restructuring of its public debt. In Greece, public debt reached 180% of GDP in the year before its 2011 default. In addition, a few years before the Greek default there was a decline in GDP, on average about 6% between 2009 and 2011. However, Mozambique’s 2016 default occurred amid high economic growth rates. Over the three years prior, the country’s GDP grew by about 7% annually.

In the case of defaults in Uruguay and Argentina, the high level of public debt in foreign currency and debt to non-residents played an important role, although the size of the debt of these countries was different. Uruguay’s external debt at the end of 2001 was about 29% of GDP (default was declared in 2003), while Argentina’s was 38% of GDP at the end of 2019 before its 2020 default. In the case of Cyprus and Mozambique, problems with the government’s contingent liabilities became a decisive factor. In the first case, difficulties arose in the banking sector. In the second, the company that received state guarantees became insolvent, which resulted in late payments from the sovereign.

The example of Argentina’s default in 2014 is a good illustration of a sovereign default amid sufficient resources to repay the debt. The court’s decision on holdouts threatened a sharp increase in payments on the obligations of other debt holders due to a cross-default clause in the bond issue prospectuses. Therefore, in 2014, Argentina decided not to make payments on the debt due, despite that fact that the country was able to do so.

The variety of circumstances surrounding sovereign defaults makes it difficult to formalize the analysis of sovereign risk factors and requires adjustments to selected indicators, as well as expert judgments for calculating the final rating. Adjustments and a wide range of expert assessments are an integral part of the sovereign risk assessment methodologies used by rating agencies.

**Question 3. How are different circumstances combined in the final assessment?**

When calculating the final rating assessment, macroeconomic indicators that most accurately differentiate a country on the verge of default from a more stable sovereign issuer are selected first. Usually these are economic indicators like the growth rate of GDP, GDP per capita, inflation, the amount of public debt and budget deficit, the level of external public debt and private sector debt, etc.

These indicators are weighted. Both the indicators themselves and individual analytical blocks have their own weights. The magnitude of these weights usually correlates with the significance of a given indicator for explaining sovereign defaults.

All of this — a variety of economic and social indicators adjusted by expert judgements and weighted according to their significance — makes up the final rating, or sovereign credit rating. Since the rating is a combination of indicators, the strong metrics of a sovereign issuer are balanced by weak ones, which results in a moderate final rating.
Question 4. How do public debt and reserves affect the sovereign rating?

There is an opinion that countries with low debt levels will end up at the top of the rating scale, especially if they have large reserves, and vice versa, high debt leads to a downgrade. This is not entirely true. The key criterion for assessing sovereign credit risk is the government’s ability to service its debt. The amount of accumulated debt is only one of its characteristics, while cost and maturity are equally important. The longer the maturity and lower the cost, the more debt the country can afford (as noted above, Greece and Russia came up with very different levels of public debt by the time of default).

Practice shows that countries with developed and diversified domestic capital markets can afford a higher level of public debt. Despite relatively high levels of debt, these countries have much lower debt servicing costs than sovereigns with less developed domestic capital markets. For example, Japan, a country with one of the highest levels of public debt in the world (236% of GDP), spent 5% of its revenues on debt servicing in 2019. However, in the same year, Brazil spent about 26% of revenues on similar expenses with a debt level of 76% of GDP. Rating agencies make adjustments to ensure that the level of debt is balanced against its servicing costs.

As for the correlation between the size of a sovereign’s debt and the level of its credit rating, the following should be noted: a relatively small debt level and the cost of servicing it will increase the country’s credit rating, but the final rating will depend on the assessment of all analytical blocks.

A significant amount of reserves serves as a kind of security cushion that helps countries with less developed capital markets to control the build-up of public debt. However, these reserves are not infinite and only diversified capital markets can ensure debt refinancing in significant amounts and at any time. This is traditionally inherent in countries whose currencies have reserve status.

Question 5. Why is reserve currency status important for assessing sovereign credit risk, and how do rating agencies take it into account?

In their budgets, governments allocate funds for interest payments only, whereas debt principle is usually refinanced. Consequently, continued access to the debt market and acceptable borrowing conditions largely determine the government’s ability to refinance its debt.

The peculiarity of reserve currencies (global reserve currencies include the US dollar and the euro, whereas examples of regional reserve currencies are the yen, the Swiss franc, and the yuan) is that during periods of crisis, the demand for assets denominated in these currencies increases, otherwise known as “flight to quality.” High demand for these assets leads to appreciation of a reserve currency and lower government bond yields. The current crisis once again confirmed the existence of the “flight to quality” concept. Unlike most currencies (especially developing countries), the US dollar strengthened as the crisis unfolded, having appreciated by 3.7% to the basket of currencies from the beginning of the year to
May 2020. The US ten-year bond yield reached a historic low of 0.5% in mid-July 2020.

Reserve currency is taken into account by rating agencies when assessing the stability of a sovereign’s external position. For example, for countries whose currency has reserve status, a low level of reserves will not be a risk factor, unlike countries with non-reserve currencies. In addition, the relatively high share of non-residents in public debt is not a risk factor for those countries whose obligations are used as an asset in the international reserves of other countries’ central banks.

Global reserve currencies have their quantitative characteristics. Among the important quantitative indicators are the share of reserve currency assets in global international reserves, the use of the reserve currency in OTC settlements and, bond issues in a reserve currency by non-resident issuers.

Some statistics. At the end of Q1 2020, USD assets in global international reserves amounted to 62%, while the share of bonds issued by non-residents in the international market in USD reached 47.4%. At the end of 2019, USD in OTC settlements was about 44%. In addition, an important factor is the predominant use of USD for payments under oil contracts.

**Question 6. Does this mean that USD dominance in global capital markets will last for an extended period, and what are the prospects for other currencies to receive reserve status?**

According to the above indicators, the dollar is significantly ahead of the euro, pound, yen, and yuan. However, as history shows, a currency that has received reserve status does not always manage to maintain it: for example, at one time the dollar replaced the pound in this regard.

Two modern potential contenders for the role are the euro and the yuan, whose use in global international reserves amounted to about 20% and 1.2%, respectively, at the end of 2019. Although the scale of their use is far from dollar, ACRA notes that over the past 20 years, the share of USD in international reserves has been steadily declining (e.g., at the end of 1999, this figure reached 71%). This is largely due to the decline in the role of the dollar as an anchor currency to which local currencies are linked at fixed exchange rate regimes. Over the past decade, quite a large number of countries have abandoned these regimes. The trend to settle payments in national currencies also plays a role.

As for the widespread use of the dollar for international bond issues by non-US residents, this is due, on the one hand, to the narrowness of the domestic markets of many countries for large issuers (governments, large banks, and companies), and the liquidity and infrastructure of the international bond market on the other. Since the 2008 crisis, the governments of many developing countries have switched to domestic debt financing and are actively developing their own capital markets, which may lead to a decline in the use of the dollar in international markets over time.

Finally, the dollar’s current dominance in oil contract settlements may be challenged in the future. Given China’s demand for oil (10% of world imports), competition could come from oil futures trading, which was launched in 2018 and...
is gaining momentum on the Shanghai stock exchange. In addition, some major oil and gas companies (such as Russia’s Rosneft and NOVATEK) have already switched to payments in euros instead of dollars due to geopolitical considerations.

Rating agencies closely monitor the quantitative indicators of reserve currencies and their dynamics. If and when the changes become significant, they will be reflected in the ratings.
The Analytical Credit Rating Agency (ACRA) was founded in 2015, with its 27 shareholders representing major Russian corporate and financial institutions and its authorized capital exceeding RUB 3 bln. ACRA’s main objective is to provide the Russian financial market with high-quality rating products. Methodologies and internal documents of ACRA are developed in compliance with Russian legislation and with regard to global rating industry best practices.

The provided information, including, without limitation, credit and non-credit ratings, rating assessment factors, detailed credit analysis results, methodologies, models, forecasts, analytical reviews and materials, as well as other information placed on the ACRA website (further referred to as Information), coupled with the ACRA website software and other applications, are intended for information purposes only. Information must not be modified, reproduced or distributed by any means, in any way or form, either in whole, or in part, in marketing materials, as part of public relations events, in news bulletins, in commercial materials or reports without prior written consent from, and reference to, ACRA. Any use of Information in violation of these requirements or the law is prohibited.

ACRA credit ratings reflect ACRA’s opinion about the ability of a rated entity to meet its financial obligations or about the credit risk of individual financial obligations and instruments of a rated entity at the time of publication of the relevant Information.

Non-credit ratings reflect ACRA’s opinion about certain non-credit risks assumed by interested parties interacting with a rated entity.

The assigned credit and non-credit ratings reflect all material information pertaining to a rated entity and known by ACRA (including the information received from third parties), the quality and reliability of which ACRA considers appropriate. ACRA shall not be responsible for the accuracy of information provided by clients or relevant third parties. ACRA does not audit or otherwise verify the provided data and shall not be held responsible for their accuracy and completeness. ACRA conducts rating analysis of information provided by customers using its own methodologies, with the texts thereof available on ACRA’s website – www.acra-ratings.com/criteria.

The only source that reflects the latest Information, including the one about credit and non-credit ratings assigned by ACRA, is ACRA’s official website – www.acra-ratings.com. Information is provided on an “as is” basis.

Information shall be considered by users exclusively as ACRA’s statement of opinion and must not be regarded as advice, recommendation or suggestion to buy, hold or sell securities or other financial instruments of any kind, nor shall it be viewed as an offer or advertisement.

Neither ACRA, nor its employees and persons affiliated with ACRA (further referred to as the ACRA Parties) provide any direct or implied guarantee expressed in any form or by any means regarding the accuracy, timeliness, completeness or applicability of Information for making investment and other decisions. ACRA does not act as a fiduciary, auditor, investment or financial advisor. Information must be regarded solely as one of the factors affecting an investment decision or any other business decision made by any person who uses ACRA’s information. It is essential that each of such persons conduct their own research and evaluation of a financial market participant, as well as an issuer and its debt obligations that may be regarded as an object of purchase, sale or possession. Users of Information shall make decisions on their own, involving their own independent advisors, if they deem it necessary.

ACRA Parties shall not be responsible for any action taken by users based on Information provided by ACRA. ACRA Parties shall under no circumstances be responsible for any direct, indirect or consequential damages or losses resulting from interpretations, conclusions, recommendations and other actions taken by third parties and directly or indirectly connected with such information.

Information provided by ACRA is valid only as of the date of preparation and publication of materials and may be amended by ACRA in the future. ACRA shall not be obliged to update, modify or supplement Information or inform anyone about such actions, unless the latter was recorded separately in a written agreement or is required by legislation of the Russian Federation.

ACRA does not provide advisory services. ACRA may provide additional services, if this does not create a conflict of interest with rating activities.

ACRA and its employees take all reasonable measures to protect all confidential and/or material non-public information in their possession from fraud, theft, unlawful use or inadvertent disclosure. ACRA provides protection of confidential information obtained in the course of its business activities as required by legislation of the Russian Federation.