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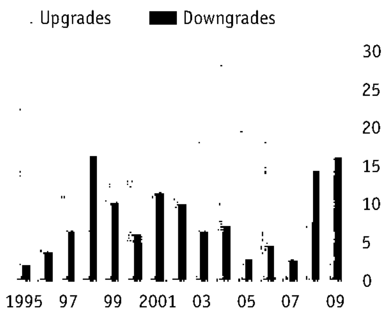
Sovereign-debt ratings

The grim rater

Countries don't like bad news about their creditworthiness

Degrading

Foreign-currency sovereign ratings upgraded or downgraded, % of total



Source: Standard & Poor's

all countries could default on their debts.)

That stable record may not persist. Investors have been buying government debt for years in the belief it is "risk-free", almost regardless of the economic fundamentals. But if they lose faith in a government's policies, the situation can change very quickly. "Countries can go bust in a matter of weeks if the markets close to them," says one rating-agency executive.

Governments and investors may well be attaching too much importance to the totemic AAA grade, however. "People's perception is that a downgrade from AAA to AA means minutes later you default," says David Beers of S&P. "In fact it means only a slight increase in long-term default risk." Canada lost its AAA rating in the 1990s but regained it during the past decade. And Japan has managed to keep borrowing at a cheap rate, despite losing the highest level of approbation.

The agencies are well aware that ratings changes are highly sensitive. Decisions are made by committee, rather than by an individual, to reduce the scope for outside pressure. Consensus is generally sought before a downgrade is made. The agencies also seek to protect themselves from criticism by being as transparent as possible.

A number of factors helps determine whether a country's AAA status can be maintained, including economic and institutional strength, the government's financial strength and susceptibility to "event risk", or specific shocks. In the eyes of Pierre Cailleteau, Moody's chief economist, the key ratio is not debt-to-GDP but interest payments as a proportion of government revenues. Once that gets beyond 10%, a government may face difficulties.

That does not mean a downgrade is inevitable, however. If the government is implementing a credible plan to cut its deficit, then it may maintain its AAA status. Of course, what seems a credible plan to a government may appear less plausible to an agency. Agencies also have to make qualitative judgments about a range of other factors such as, for example, the willingness of euro-zone governments to bail out the likes of Greece (which unveiled another austerity plan on March 3rd, in part to head off a further downgrade).

Trickiest of all perhaps is the question of contingent liabilities such as bank-insurance schemes, public-sector pension schemes and the like. Even when the agencies are aware of such commitments, the scale of the problem may not be clear. "The state of public-finance accounting is extremely rudimentary relative to private-sector accounting," says Mr Cailleteau. As more of those contingent liabilities become due, the agencies will be forced to make further decisions that could raise the cost of government debt and make budget-balancing even harder. The agencies will be in the limelight for a while yet. ■