

Comments on Kate Kisselev and Frank Packer's paper "Minding the gap in Asia: foreign and local currency ratings"

Tom Byrne

To understand the ratings gap phenomenon, or lack thereof, the historical dynamics of local currency ratings need to be explored, in addition to a static look at key indicators as rating drivers. I will also comment on a number of related points made by the authors.

In assigning local currency ratings, the practice in general is to notch up from the foreign currency rating on the grounds that there is no foreign exchange constraint or risk of capital controls being imposed on local currency payments. Governments have the power to tax, and so can take on a higher local currency than foreign currency debt burden. Domestic purchasers of government securities, especially banks, are a much more stable investor base than foreign creditors. However, Moody's is mindful that the recent historical record of sovereign default, beginning with the 1998 Russian case, shows that governments have defaulted on obligations in both foreign and local currency, or in one but not the other, as well. This means that stylised approaches to rating local currency obligations are not reliable or accurate. A government's fiscal and debt position, economic growth prospects, institutional strengths (in particular, Moody's takes into account the World Bank's indicator of government effectiveness) and policy capabilities need to be taken into account on a case by case basis.

Moody's big push for expanding local currency ratings in Asia took place in the aftermath of the 1997 Asian financial crisis. This was a time when a number of sovereign foreign currency ratings were many notches (up to six, in the most extreme case, Korea) lower than their pre-crisis peak. Of course, the lower foreign currency ratings reflected a diminished capacity to service external debt. (It should be pointed out that, although ratings fell too rapidly, the Asian financial crisis did not result in any government bond defaults.) Against this background of "abnormally" low foreign currency ratings, local currency ratings for most of the Asian emerging market economies were assigned.

Likewise, the assignment of local currency ratings in Asia was also constrained to some degree by the 1997 crisis. Moody's recognised that the fiscal cost of the crisis was not fully reflected in government budgets or debt in early 1998, so we tried to anticipate future fiscalisation from financial sector restructuring as well as the rise in government debt from the shift to fiscal stimulus and large budget deficits as governments offset the contractionary effect of the crisis. Nevertheless, Asian countries' local currency ratings were generally assigned two or three notches higher than their foreign currency government ratings in 1998.

The relatively quick adjustment in the external payments position of most countries affected by the crisis, compared with their slower fiscal consolidation, explains the reduction in the original notching differential. In general, multi-notch upward movement took place in the foreign currency ratings, while upward movement in local currency ratings was not as pronounced, or was absent. Korea and Thailand, for example, sharply reduced external debt and accumulated large holdings of official foreign exchange reserves. Accordingly, Korea's foreign currency government rating was raised four notches, and Thailand's three notches, post-crisis. In contrast, Korea's local currency government rating was raised only one notch post-crisis, and Thailand's has remained unchanged, reflecting the large accumulation of domestic debt and less robust prospects for debt reduction over the long term.

The authors' rejection of the argument that governments can easily inflate their way out of a local currency debt problem is well taken. The historical record does not show that this

remedy is painless, either economically or politically, or readily taken. This view has carried little weight in rating committee deliberations. In contrast, default may be better fiscal policy, in extremis, than inflation.

The key indicators guiding the movement of local currency government ratings have been, first, general government debt to GDP and, second, general government debt to general government revenue. Both indicate the capacity of the government, immediately, and the economy, ultimately, to service the government's debt obligations. The former indicator is especially relevant because it is unique to Moody's rating consistency model that attempts to explain the ordinal rankings of local currency government ratings.

There was an "Asian bias" embedded in Moody's foreign currency ratings, although it is difficult to quantify in a statistical sense. Moody's Sovereign Risk Unit had for a long period emphasised savings/investment balances as key rating support factors. Asian countries have high saving rates compared with other regions. Large savings available to absorb government debt make recourse to foreign borrowing less necessary, supporting local currency ratings. Large savings can also be channelled into domestic investment. Economic growth and the level of national income are also key rating determinants for both local and foreign currency government ratings.

Lastly, regarding political risk, Moody's has explicitly incorporated this into the ratings of Taiwan (China) and Korea. In both cases, geopolitical risks constrain both the foreign and local currency government ratings equally, with no ratings gap.