S & P – if arguing macro, rating practice must be consistently macro, too

The rating agencies are selecting between macroeconomic strategies, rather than assessing their consequences for the investor

By Hans-Joachim Dübel, Finpolconsult, Berlin

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The core argument of the rating agency S & P when downgrading France and other euro-zone sovereigns has been that not enough has been done to tackle the differences in competitiveness, which impede the reduction of debt, and too much focus has been placed on curing the symptoms in the form of fiscal deficits.

This criticism goes certainly in the right direction. The single-sided pressure inside the euro-zone on fiscal adjustment neglects the causes for the continuing high levels of debt in both credit and real economy. In addition, an imbalance within the zone will unlikely correct by simultaneous contractive fiscal policies in all of its Member States.

Yet, the argument deserves to put under the spot regarding whether S&P rates sovereigns inside and outside the euro-zone equitably. More importantly, entering such macro argumentation has fundamental implications for the broader sovereign rating methodology.

For all agencies, including S & P, so far refuse to accept macroeconomic and in particular market risk, such as arising from currency devaluation and inflation, as impact factors for the capital loss risk of investors. They focus instead on risk arising from legal-technical measures, such as debt restructuring or haircut, taken by the debtor. Macro is of interest only to the extent that such measures become less or more likely. Such a methodology could be called a 'legalistic', as opposed to an ‘economic’, rating.

Thus, the rating agencies today not only fail their primary business objective of investor protection, because the latter will be indifferent over whether a real capital loss hitting their accounts has been caused by a debt haircut or inflation. They also create a conflict with the goals of a large majority of sovereigns worldwide that follow some concept of exchange rate fixing, or at least stabilization, with their key partners in order to deepen trade and credit relations.

It is true that common currencies like the euro-zone, but also informal unilateral exchange rate pegs as practiced by Asia and Latin America inside the ‘dollar-zone’, are prone to debt crises. First, in the presence of (supposedly) fixed exchange rates, the interest rate risk premium for devaluation is diminished and there is greater scope for risk amnesia spreading among foreign investors giving rise to imprudent autonomous capital imports. Second, within a zone pursuing low inflation monetary policy, there is greater risk of real exchange rate appreciation through lack of wage and price discipline resulting in larger trade deficits and derivative capital imports to finance these. Third, entering with high levels of domestic debt into such a zone will have greater solvency effects because its real value will fall only slowly. IMF analysis suggests that the vulnerability of countries with flexible exchange rates to debt crisis is lower, although also here dramatic events occur as expected devaluation risk are often dwarfed by interest rate differentials (e.g. Mexico, Turkey).

The greater systemic vulnerability of common currencies and peg arrangements deserves a certain rating discount; alternatively, it requires stricter control of debt levels of their members - well beyond the hot-topic sovereign debt issue. However, the current downgrades imposed on euro-zone Member States by the agencies go well beyond what is necessary to balance the incentive disadvantages. They are selective and discriminatory.

Facing high levels of external debt, economies at some point need real exchange rate depreciation. This can either take the internal form - through lower wages, property prices, and – as a last resort – debt haircuts for borrower, or the external form – via a change in the nominal exchange rate and 'imported' inflation. The difference between internal and external devaluation from the investor perspective is basically the probability and the legal vs. factual nature of the capital loss.

To give an example, the British pound since the end of 2006 has lost 20% against the euro with a corresponding capital loss for euro-zone investors in British government securities. Britain also in 2011 ran a 2% higher inflation rate higher than the euro-zone, which - extrapolated over 5 years – would mean a factual haircut for its domestic investors of 10%. Taking the five years since the outbreak of the financial crisis, 2007-11, the inflation differential to the euro-zone is still above 6%. The inflation differential between Britain and Germany, which hasn't seen tax increases of the scale of other euro-zone members, has been significantly larger.

Would the comparably indebted sovereign Italy implement a haircut of similar size as what the Britain has already been implementing for years vs. both foreign and domestic investors, within a context of internal devaluation using debt haircuts, the rating agencies would speak of a default and downgrade the country to CCC or D. The increased likelihood of such a move has already led to the current downgrades of Italy into the A / BBB-range. Britain, however, remains unchallenged with its devaluation and inflation strategy and continues to enjoy a AAA-rating. Moody's even praised this repetition of earlier comparable policies in December 2011 without a whiff of irony as 'a very strong record of reversing increases in debt '.

The economic absurdity of the 'legalistic' methodology, shared by all agencies, is obvious. So is its explosive power for every form of coordinated exchange rate and inflation control policy. Thought to the end, there is no role for currency zones and pegs in the world of S&P. Instead, every sovereign borrower is strongly advised to run its own monetary policy and currency in order to retain ability to inflate out of debt.

An economically sensible approach, in contrast, would base the rating on the net present value of *real* expected future cash flows of securities. This would consider the likelihood of both economic-factual (inflation) as well as legal capital haircuts. The result would certainly be far lower rating differentials, such for example in the case of Britain vs. Italy, than what currently is the case.

It remains to be seen whether the sovereigns that decide on the future regulation by the agencies will accept the drastic narrowing the macroeconomic policy options implied by the current rating practice. In the short term, certainly, those who follow a factual debt haircut strategy via devaluation and inflation will benefit from the distortions in the methodology. Yet, it is likely that the long-term interests of a far larger number of states in integration with their major trading partners at low inflation levels, as well as the interest of investors in a more realistic assessment of their capital loss risk, will force the agencies already in the medium term to rationalize their approach.

Memorandum item: Fiscal position before interest payments (primary deficit / surplus)
Source: Fitch.