

When is debt a menace? The economic and political aspects of debt sustainability

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Abstract

Just when it seemed like sovereign default was a virtual impossibility in the developed world, the turmoil in sovereign debt markets triggered by explosive debt growth in the wake of the financial crisis raised new fears about fiscal prospects in many advanced economies. However, assessing the severity of the situation is complicated by the fact that no definitive empirical or theoretical benchmark exists for sovereign solvency. This paper reviews the literature on solvency, sustainability and default as well as recent expert contributions about the severity of the present fiscal situation in the developed world and finds that the difficulties involved in determining the dangers entailed in outstanding debt include not only the need to deal with economic uncertainty surrounding the *ability* of the given sovereign to pay, but also – and the paper argues in the case of developed countries more importantly – gauging the political context determining the *willingness* of the sovereign to service debt. It then goes on to explore the ways in which markets gauge this degree of willingness, using rating agencies' sovereign rating methodologies as a proxy for markets' approach to creditworthiness and quoting examples of ratings changes in the recent past to see to what degree the considerations listed in the rating methodologies are applied in practice. It concludes that increased nervousness about sovereign default might lead to a more intrusive influence by market actors on a broader range of policy and institutional issues in developed countries than before.

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Introduction

“How close is America to fiscal crisis?” asked The Economist ten Economics professors and practitioners earlier this month². If the question-setting betrays the gloomy mood that beset many developed countries in the midst of the economic downturn and in the face of Greece’s and Ireland’s debt crises, the array of answers given by the respondents – ranging from “America is bankrupt” to “There is no fundamental deficit crisis” – speaks even more clearly of the scope for divergence of opinion of policy experts about the seriousness of the situation and, accordingly, about the best ways out of the present predicament. Given the recentness of the awakening from the illusion that prosperous developed countries do not fall victim to sovereign debt crises, the gloom is not surprising, but the wide scope for disagreement about the fiscal position bears explaining. Why is it so difficult to tell if a fiscal crisis is likely or not? How much debt is too much? At what levels of public indebtedness should one start to worry about markets getting cold feet and denying the state further financing? How do we know when times are so desperate that desperately painful measures are warranted to avert a meltdown?

This paper reviews the literature on default, solvency and sustainability as well as recent expert contributions about the severity of the present fiscal situation in the developed world to better understand the reasons for the lack of empirical or theoretical benchmarks for solvency and the numerous economic and political aspects involved in determining a country’s creditworthiness at a given level of indebtedness. It finds that in the case of developed countries, the uncertainties regarding the *willingness* of the given sovereign to service its debt on time and in full – or in other words the likelihood of a given polity to make and enforce decisions needed to set aside the necessary resources for debt service – place stronger constraints on the debt carrying capacity of the sovereign than its *ability* to pay – determined by the income generated by its economy. Therefore, the lack of a reliable method for benchmarking is not so much due to the

² http://www.economist.com/economics/by-invitation/questions/how_close_america_fiscal_crisis&fsrc=nwl

difficulties involved in economic forecasting but due to the uncertainties involved in gauging the market's perceptions about the political constraints and incentives guiding future governments in their decisions to repay or to default.

The paper then enumerates a range of possible approaches creditors could take in assessing the political risks to repayment, compares and contrasts these with the criteria discussed in the rating methodologies of the three large agencies issuing sovereign ratings and uses anecdotal evidence to see to what extent the agencies have applied any of these considerations in their recent rating decisions concerning developed countries. It concludes from this exercise that the appraisal of the willingness to pay seems to be based on a cost-benefit analysis of default for the country as a whole, on the country's track record of fiscal policy, the presence of a willingness to undergo painful measures in order to signal readiness for sacrifices and adjustment and on the general political environment in the country, such as the degree to which political and economic institutions conform to the ideals of democracy and market-economy, the level of political stability and consensus, the country's policy choices in non-fiscal areas and the relationship of the country with international financial institutions. It concludes by asking whether Mosley's earlier finding that financial markets exercise "strong but narrow" control³ over developed countries' policy choices might become a thing of the past in light of the new-found worries about creditworthiness, if rating agencies are induced to comment on and act upon developments in the broader political and policy scene of debtor countries.

The problems of gauging creditworthiness

In the turmoil of the past year, amidst all the talk about contagion, loss of market confidence and rescue packages, there was little mention of how little is empirically known about the capacity of mature economies to carry public debt without the risk of losing creditworthiness and suddenly being shut out of financial markets. Since no developed economy had been involved in debt crises since the war before events got out of hand in Greece last spring, no empirical

³ Mosley (2003)

experience had been available for predicting when markets would become uneasy about providing further financing for a developed sovereign. Several studies investigated the triggers for debt crises in developing countries, but the findings of these are not readily applicable to developed economies. They point to the importance of risky financing structures – short maturities and predominantly foreign denomination of the outstanding debt – and to adverse country-specific factors, especially a history of defaults, but also political, economic and policy uncertainty in driving debt crises, and they emphasize that “fiscal fundamentals” in themselves turn out not to be a good predictor of default⁴. Since developed countries have been default-free since the war and are considered stable in terms of their political and economic conditions, they are arguably free of the specific risk factors that make borrowing dangerous for many developing countries. Furthermore, they tend to be able to finance their debt via instruments denominated in their domestic currencies and characterized by long maturities and a low share of indexed debt, limiting risks to public finances from sudden changes in interest and exchange rates⁵. Therefore, existing empirical evidence – confounded by these extra constraints on debt carrying capacity – cannot be extended to them.

Unfortunately, the absence of empirical clues for judging the riskiness of countries’ debt position is compounded by the inability of theory to provide practical guidance. Theoretically, access to credit markets is predicated upon the sovereign’s ability to retain its creditworthiness, or in other words its ability to credibly commit itself to generate the necessary funds in the future – by running primary surpluses – to service debt on time and in full⁶. Therefore, the maximum debt that a sovereign can amass without losing its creditworthiness needs to preserve the sovereign’s solvency, i.e. the balance between long-term debt service and long-term primary surpluses⁷. Since the former is determined by the

⁴ On the effect of maturity structures, currency denomination and liquidity see also Detriagache and Spilimbergo (2001), Manasse et al. (2003) and Krueger and Messmacher (2004), on the country specific effects contributing to “debt intolerance” – i.e. the incapacity to carry substantial amount of debt – see Reinhart et al. (2003) and Manasse and Roubini (2005).

⁵ Cottarelli et al. (2010).

⁶ Chalk and Hemming (2000).

⁷ Chalk and Hemming (2000), Roubini (2001), Ostry et al. (2010)

outstanding stock of debt and long-term interest rates, whereas the latter is a function of the size of the gross domestic product and the proportion of it that the government will appropriate for paying its interest bill, the maximum safe level of debt depends on long-term expectations about future interest rates, about the future growth rate of GDP and about primary surpluses that successive governments will run⁸. Finding reliable values for these variables to calculate the maximum solvency-preserving level of debt is extremely difficult for two reasons.

The lesser – technical – reason is that the formula requires gauging expectations about future variables, which are partly exogenous to the model, but partly determined within the model, so that change in one is likely to affect the others in destabilizing ways. The economic variables of interest and growth rates are dependent on forces exogenous to fiscal policy decisions – such as global monetary conditions, global business cycles and local structural factors – but also on the size of the debt itself⁹ and, eventually, on markets' expectations about future surpluses and their compatibility with the solvency criterion. In the worst case, a changing appraisal of future primary balances can lead to an escalation of the risk premia and induce a self-fulfilling solvency crisis by driving up interest rates to levels that are incompatible with existing primary balances, debt levels and growth rates¹⁰. Creditworthiness is thus subject to considerable uncertainty both from possible changes in exogenous factors and also from self-reinforcing mechanisms within the model.

The more important reason why the concept of solvency is an impracticable way of generating a benchmark for safe and unsafe levels of debt is the problem of understanding and predicting market sentiments about likely levels of future

⁸ Formally, solvency is preserved if $b \geq (i-g) \cdot d_{\max}$ where b is the expected long-term average future primary surplus expressed as a percentage of GDP, i is the expected long-term average future interest rate on outstanding debt, g is the expected long-term average rate of future growth of GDP and d_{\max} is the maximum debt at which solvency is still preserved, expressed as a percentage of GDP (Buiters, 2004)

⁹ Higher debt has been shown to be correlated with higher interest on average (Caselli et al 1998), whereas it has also been indicated that debt levels above 90 percent of the GDP retard growth. (Reinhart et al., 2010, Kumar et al, 2010)

¹⁰ Cohen and Portes (2004)

primary surpluses. Primary surpluses – understood as the share of the total domestic product set aside by the sovereign for debt service – are limited by both economic and political factors. Economic factors determine the prosperity of a country and thereby circumscribe its *ability* to pay – assuming that from a larger income a higher proportion can be set aside for debt service. Political factors determine the extent to which the necessary surpluses are in fact mobilized to service debt and thereby indicate the sovereign’s *willingness* to pay¹¹. The “sovereign’s willingness” to pay is possibly but not necessarily synonymous with the given government’s willingness to pay. The government’s cost-benefit analysis might motivate it not to take the required fiscal policy measures to appropriate the necessary resources from citizens to service debt. However, it is also possible that the government is unable to raise the necessary taxes or make cuts in the face of societal resistance (which might manifest itself as mass tax evasion, instability of governments, vetoes by vested interests etc.). In order to be able to form expectations about future surpluses, markets need to assess both the ability and the willingness to pay. Evaluating the latter necessarily involves subjective mental models of how societies work and policies evolve. Therefore, it is difficult to estimate this component of the theoretical benchmark.

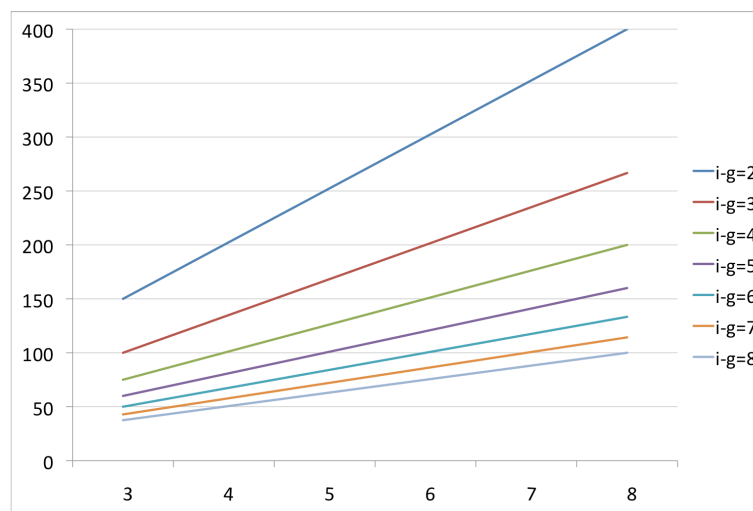
Figure 1. gives an illustration of how the maximum levels of debt that respect the solvency criterion depend on primary surpluses (as a percentage of GDP) and on different long-term future values of interest and GDP growth rates using a range of values possibly realistic for judging the maximum level of safe debt for developed countries. The upper end of the possible range for future surpluses goes up to eight percent, based on the argument that there is no reason why rich developed countries should not be able to set aside such a large proportion of their income (or even higher) for debt service without jeopardizing the basic welfare – health, safety, education – of their population. In recent decades, the highest primary surpluses sustained for a period of several decades by European countries were around four to five percent of the GDP¹², but surpluses of over

¹¹ Buitier and Rahbari (2010)

¹² In Belgium, Denmark, Finland or Ireland.

nine percent of the GDP are not unprecedented either¹³. The lower end of the scale is at three percent, representing the fact that for most European countries, the actual primary surpluses in the past decades (pre-crisis) were in much lower range than what they could theoretically afford. The two top lines correspond to the differential between interest and growth rates that characterised European countries in the past decades. Lower lines stand for considerably darker scenarios.

Figure 1. – The maximum solvency-preserving debt-to-GDP ratio as a function of credible future primary surpluses



The graph shows possible combinations of primary surplus ratios (horizontal axis) and maximum debt-to-GDP ratios (vertical axis) that satisfy the solvency criterion of $b=(i-g)d_{max}$, assuming different values of interest and growth rates (i-g). Based on the ability to pay and assuming that historic interest-growth rate differentials persist, developed countries belong in the upper right-hand quadrant. Doubts about the willingness to pay, however, would move them towards the lower left-hand quadrant and onto lower lines, representing higher interest rates.

The figure shows that, based on their theoretical capacity to pay (assuming historical interest- and growth-rate differentials) European economies should be able to sustain debts well beyond a hundred percent of their GDPs. However, if the markets' assessment of their willingness to pay was based on their past fiscal track record, their debt-carrying capacity is in much lower ranges. Furthermore, if the confidence in the sovereign's commitment to repay is weakened, the risk-

¹³ Denmark ran surpluses ranging from seven to twelve percent of the GDP throughout the second half of the eighties.

premium component of the interest rates charged on its outstanding debt is likely to go up, further eroding its debt carrying capacity. Therefore, investigating the ways markets estimate the willingness to pay is crucial to getting a better understanding of how much debt developed countries can safely carry. The next section enumerates possible approaches and the one after the next looks at the criteria that rating agencies apply in their sovereign credit rating practices.

Theoretical considerations about judging the willingness to pay

The most straightforward method for judging future willingness to generate high enough primary surpluses to service debt is to look at past or present performance. The sustainability approach¹⁴ looks at present performance. It investigates whether present (average) primary surpluses cover present debt service payments. If they do, fiscal policy is sustainable, the country is solvent and will stay so, because the debt load is not increasing. By running sustainable fiscal policies, the country is, on the one hand, demonstrating in the present that it can set aside resources in the necessary amount and (implicitly) guarantees that it will not need higher surpluses in the future, as its debt will not ratchet up. While sustainability analysis is a good way of judging present policies, it is not suitable for assessing the willingness to produce high enough surpluses to preserve solvency in the future. On the one hand, the sustainability criterion is too strict: a country with presently unsustainable policies but a low debt level might be solvent if it changes its ways at a later point in time. On the other hand, it is too lenient: given the fact that exogenous changes in interest and growth rates could increase the required primary surpluses in the future, living up to today's requirements is no guarantee that the country will be willing to pay if the costs of debt go up¹⁵.

¹⁴ Blanchard 1990

¹⁵ Chalk and Hemming 2000

The dynamic version of the sustainability approach¹⁶ corrects these shortcomings by shifting the emphasis from assessing the ability of fiscal policy to live up to the demands of debt servicing at any one point in time to the general ability to adjust policy to growing debt burden by responding to higher debt-to-GDP ratios with higher primary surpluses. Based on past ability to adjust, future ability to raise primary surpluses to the required levels to ensure solvency can be predicted. Ostry et. al use this approach to build an econometric model to predict – based on a country’s economic and political characteristics and past track record of adjustment – the extent to which the given country will change its primary surplus in response to growth in debt¹⁷. They emphasize that since adjustment to debt growth cannot be uniform across all levels of debt – as the primary surplus cannot grow to accommodate ever higher debt without bound – this method also produces a way to gauge the maximum primary surplus that a country is likely to be willing and able to produce to service its debt. This ceiling on the willingness to pay defines the maximum level of debt a country can credibly commit to service in the future. This modelling approach goes beyond predicting future performance from past track record, since it also incorporates into its predictions certain structural characteristics of a given country – such as economic openness, age dependency, political stability – that are expected to influence both its ability and willingness to raise primary surpluses commensurate with debt¹⁸.

At the same time, given the limited number of political variables that can be safely included in econometric modelling, the country specific fixed effects – i.e. the given country’s past track record in fiscal adjustment – are bound to have a fundamental effect on the predictions about its future willingness to pay. The predominance of this “track record” or “reputational” effect in modelling is likely to approximate quite well markets’ approach to assessing willingness to pay. Reinhart et al. show that for developing countries the effect of past credit

¹⁶ Bohn (1991, 1995)

¹⁷ Ostry et al. (2010)

¹⁸ Their estimates for safe debt ceilings – based on backward looking data going back to 1970 and on forecasts of GDP growth rates and interest – range from around 150 percent of the GDP, up to 250 percent.

servicing behaviour plays a crucial role and past defaults can create considerable “debt intolerance” – i.e. very low limits on the capacity to carry debt without default¹⁹. Even though developed countries do not have a history of past defaults, their past inability to adjust primary surpluses to a growing debt burden is likely to have a similar impact on market perceptions²⁰.

On the other hand, the effect of past performance is unlikely to be deterministic on the assessment of future behaviour. In fact, markets seem to be quite receptive to sovereigns’ signalling of their willingness to endure fiscal pain and thus to make the necessary adjustments in the future. Ardagna²¹ shows that large fiscal consolidations are rewarded by immediate decreases in the yield on government debt, suggesting that a signal that there is willingness to correct past trajectories can restore market confidence. Furthermore, markets might also incorporate into their expectations – even in the absence of a signal for a break in the policy trend – the experience that countries characterized by long-standing fiscal imbalances often abruptly consolidate under pressure from imminent crisis²² and therefore their future willingness to service debt is likely to be much higher than what is suggested by their track records²³.

The anticipation of one-off sudden consolidations is likely to be based on cost-benefit analyses of default that conclude that the given country has a lot to lose from not servicing its debt. For example, if interest rates are low and present day debt accumulation is driven by primary deficits, the country has a strong incentive not to default but gradually consolidate its finances, because default would temporarily shut it out of financial markets, radically increase its financing costs and decrease its debt tolerance for the future, while it would not

¹⁹ Reinhart et al. (2003)

²⁰ This could explain, for example, why Greece fell into a debt crisis at a debt-to-GDP ratio that Belgium was easily able to sustain at the beginning of the 1990s, despite the fact that general interest rate conditions are much lighter now than they were then. Belgium has had a track record of making severe adjustments even in times of economic problems, whereas Greece was unwilling to rein in its public finances even at a time of economic prosperity.

²¹ Ardagna (2009)

²² The reasons behind such abrupt turnarounds are explained by Alesina and Drazen (1991) and Drazen and Grilli (1990)

²³ Examples of such an abrupt turnaround include Italy, that improved its primary balance by 7 percentage points of the GDP within the course of six years, or Belgium that achieved an improvement of 12 percentage points of the GDP within eight years.

eliminate the need to stabilize the primary balance. Similarly, if a large part of the public debt is held by domestic agents, the country is likelier to be interested in appropriating the necessary funds for debt servicing, because default would impose losses on the domestic constituencies. Lastly, default might harm domestic economic and political institutions and have long-term costs for the economic health of the country²⁴.

A final set of considerations influencing the assessment of the willingness of sovereigns to generate high enough primary surpluses includes intangible, unquantifiable factors such as the level of social conflict, social norms about redistribution, the presence of vested interests, political structures and so on²⁵. It is of course an immensely complicated question how exactly – through what mental models – such considerations might enter market perceptions of creditworthiness. It is probably a safe assumption that some of them form part of the more general “reputational” factor mentioned above. Others, especially the most “visible” problems such as government instability or widespread tax evasion could be explicitly considered in forecasting future surpluses. The way it is done in practice and the weight given to each of the above considerations is examined through a study of rating agencies methodologies in the next section.

Willingness-to-pay in sovereign ratings

Notwithstanding doubts about the extent to which rating agencies’ pronouncements influence market behaviour, studying the way they evaluate creditworthiness and their explicit approach to assessing sovereigns’ willingness to pay is likely to yield insights about how markets themselves conduct these assessments, because even if agencies were just following rather than leading market events²⁶, they still have to rationalise their rating changes or the lack thereof by referring to factors influencing the ability and willingness of sovereigns to honour their debt commitments. If they are to retain their authority – which is the basis of their business success – their reasons for rating

²⁴ See Cottarelli et al 2010 and Buitier and Rahbari (2010)

²⁵ See Buitier and Rahbari (2010)

²⁶ Which is not necessarily always true, as the Greek events of April 2010 show.

actions need to be broadly in line with the assessment of other market actors. By publishing their rating methodologies, they recognise as valid a range of considerations to be taken in judging sovereign creditworthiness. This section reviews the sovereign rating methodologies of Moody's, Standard and Poor's and Fitch to see how and to what extent the above mentioned aspects feature in the agencies' approach towards assessing willingness to pay and draws on examples in which specific considerations played central role in rating actions in the recent past.

First of all, it is important to point out that all agencies explicitly underline the importance of evaluating countries *willingness*, not just their *capacity* to pay. As expected, countries' present fiscal policies and track record plays an important part in assessing their future ability to run surpluses, but with great variance across agencies. S&P draws an especially strong link between an observed practice of unsustainable policies and the lack of willingness to pay²⁷, and emphasizes the significance of demonstrated effort to deal with existing imbalances and of signalling the willingness to attack existing problems head-on²⁸. Fitch mentions the role of a proven record of paying up on time and in full, but qualifies its importance²⁹. It also talks about the importance of longer-term sustainability, but focuses on the need for a credible commitment to restore sustainability, rather than on the present degree of sustainability of policies³⁰. Moody's does not explicitly address this issue. Several rating actions exemplify this divergence in opinion about the importance of a good or an improving track

²⁷ "A government that is unwilling to repay debt is usually pursuing economic policies that weaken its ability to do so." (p4, S&P 2008)

²⁸ "A strong policy response that identifies and addresses sources of instability is key to maintaining credit quality in the face of negative shocks or trends. [...] a robust policy response is crucial for strengthening both the economic environment and sovereign creditworthiness." (p17, S&P 2008)

²⁹ "Payment record is the most visible, albeit backward-looking, indicator of willingness to pay... [T]he influence on the rating of even recent episodes of default will be greatly moderated if it is judged that the default is not symptomatic of a continuing weakness in the political capacity and will of the sovereign authorities to mobilize resources to honour debt obligations." (p9, Fitch 2009)

³⁰ "The sustainability of a given level of government debt is also a function of its path over time. If there is weak credibility that fiscal policies will be sufficient to adjust the primary budget balance (ie the budget balance excluding net interest payments) to establish and sustain the debt ratio on a downward path over the medium to long term, the long-run solvency of the government will also be under pressure."(p13, Fitch 2009)

record. In 2004, when Greece was downgraded by both S&P and Fitch, the press releases of the rating decisions cited as a reason the country's reversal to its earlier, inferior fiscal habits after a short period of consolidation that had led to successive upgrades. In 2005, S&P downgraded Portugal due to worse-than-expected fiscal results, but Fitch, after having put the country on a negative outlook, consequently confirmed the old rating, arguing that Portugal's new budget signalled credible commitment to stabilize public finances. Importantly, Moody's did not act upon the new fiscal developments and data in either of the cases.

The three agencies also show considerable difference in the extent to which they believe that the structural characteristics of present fiscal policies determine the future willingness of the sovereign to generate surpluses. S&P takes the most conservative approach by considering, for example, pension obligations as a serious threat to future balances that need to be tackled in order to retain high ratings³¹. For instance, in its justification for Italy's downgrade in 2006, it cited as one of the most important reasons, the country's failure to deal with rising pension expenditure. Fitch also argues for the need to keep an eye on pension liabilities, although it does not specify the implications for rating scores³². Moody's takes a far more relaxed approach, arguing that policies should only be incorporated into ratings when they are put into practice – i.e. the present pension policy can be reformed before the real effects of population aging kick in and therefore, the possible future expansion of pension expenditure should not put pressure on present ratings³³. In general, while Moody's attaches much less importance to present fiscal performance and structures, it seems to put the

³¹ "Pension obligations represent a fiscal pressure of growing significance for countries with rapidly aging populations. Standard & Poor's believes that the credit ratings of some highly rated sovereigns 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." (p10, S&P 2008)

³² "Unfunded pension liabilities will be considered in periodic reviews of medium- and long-term sustainability of public finances if official projections (either by the government or an internationally recognised institution such as the OECD) imply that such liabilities are material"

³³ "[W]e take into account implicit liabilities such as public pension system deficits only to the extent that they will materialize into an actual debt or payment obligation; governments have many ways to alter the net present value of pension liabilities, such as postponing retirement age, increasing contributions and lowering pensions." (p12, Moody's 2008)

greatest emphasis on the capacity to adjust to new circumstances from among the three agencies³⁴.

As far as the intangible, political aspects of creditworthiness are concerned, the rating methodologies reveal interesting differences in the different agencies' approaches. All three engage with the characteristics of political institutions and stress their crucial importance in determining future willingness to service the debt. However, while Moody's only cites general, explicitly non-normative³⁵ features of political systems that prop up compliance with debt obligations – such as respect of property rights, predictability of government, policy or transparency – S&P lists quite normative requirements for the credibility of a sovereign to pay, ranging from the separation of powers, independent judiciary, civil institutions to the independence of the press³⁶. Criteria used by Fitch are generally more neutral³⁷.

While changes of these institutional factors are unlikely to elicit rating adjustments in the case of most developed countries³⁸, other socio-political factors are likely to play a more important role. All three agencies emphasize that deep divisions within society and among political groups, conflict and a lack of consensus on the structure of policies and or redistribution are a major threat to creditworthiness³⁹. Fitch also calls attention to the significance of the presence

³⁴ p13, Moody's 2009

³⁵ „Monitoring “institutional strength” does not entail a value judgment about the type of government in any given country – democracies as well as autocracies or other political regimes default alike. Rather, this assessment constitutes an informed opinion about the effectiveness of governance and the extent to which certain situations can degenerate into credit disruptions at times of stress.“ p8, Moody's 2008

³⁶ p7, S&P 2008

³⁷ Rule of law and respect for property rights provide confidence that political (and civil) institutions have a strong commitment to honouring financial obligations. Political risk factors relevant to sovereign creditworthiness include the legitimacy of the political regime; the effectiveness of government (in terms of the formulation, implementation and credibility of policy); control of corruption; and an assessment of the likelihood of severe civil conflict and “war risk”. (p9 Fitch 2009)

³⁸ At the same time, it is possible that the two-notch downgrade of Hungary at the end of 2010 by all three agencies might have had to do with the country's decisions to curtail the freedom of the press, to levy a large extraordinary tax on multinational enterprises and to nationalise pension savings in private pension funds, even though these issues were not explicitly stated in the press releases.

³⁹ “ From the perspective of sovereign risk, what matters is [...] the degree of consensus on the key goals of political action – are conducive to honoring contracts. The last point is particularly

or absence of vested interests⁴⁰, whereas S&P discusses the importance of having large constituencies with strong interest in debt repayment and in financial and monetary stability, influencing the calculus of making efforts to service debt⁴¹. The presence or intensification of disruptive political tensions has often been the reason given for downgrades. Most recently, the Flemish-Walloon conflict has caused S&P to threaten Belgium with a downgrade. Previously, Italy was downgraded in 2006 because of the government's inability to assert authority or cobble together a social coalition to solve contentious issues.

Finally, S&P – alone among the three agencies – brings up an important political factor embedded in current fiscal policy choices. It asserts that since countries' administrative and socio-political ability to flexibly adapt to increased demands on public finances strongly depends on the specific characteristics and content of taxation and spending, these specificities also need to form part of the appraisal of the given country's future ability to pay, beyond judging their effect on overall balance of public finances. It claims that broad-based tax systems characterized by low rates are superior because they provide more redistributive equity, a more growth-friendly economic environment and a flexible adaptability of rates and bases. It also implies that some forms of public spending are more effective than others and evaluating spending effectiveness should be part of the rating process⁴². In other words it contends that the assessment of creditworthiness of countries needs to involve the evaluation of these quintessentially political policy choices, possibly independently of their effect on present public finances.

important: adjustment efforts such as raising taxes or cutting public expenditures will be easier in countries that exhibit a high level of political consensus." (p8, Moody's 2008)

"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." (p7, S&P 2008)

⁴⁰ "Political and social tensions can have an important bearing on sovereign creditworthiness. A high degree of consensus on major social and economic issues is associated with stable and predictable economic policies. [...] Account is also taken of powerful vested interests that may block essential structural reforms." (p9 Fitch 2009)

⁴¹ "A sovereign has fewer incentives to default on local currency obligations when they are held by a broad cross-section of domestic investors [...] [E]ven 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" (p12, S&P 2008)

⁴² P9, S&P 2008.

Conclusion

This paper has shed light on important political aspects of sovereign creditworthiness and argued that these are currently likely to have greater significance on the debt carrying capacity of developed countries than economic ones. It presented an array of political considerations – ranging from institutional and socio-political factors to politically charged policy decisions – that enter the decision making process of rating agencies and possibly other market agents. Given the sudden nervousness of markets about developed countries' creditworthiness, is the political and policy diversity of these countries come under pressure? Alternatively, are certain political characteristics and politically charged policy choices going to threaten the financial stability of developed states? In 2004, Layna Mosley wrote: *“Investors assume that OECD governments will repay their debts, leaving these governments with measurable policy autonomy. Governments of developed countries that conform to capital market pressures in certain macro-policy areas, particularly overall inflation and government budget balances, are relatively unconstrained in supply-side policies.”*⁴³ Is this blissful freedom of choice now over?

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