# Special Report 2008/06

## Sovereign rating - The next framework for African countries?

*The HIPC debt relief initiative aimed to help low-income countries with their unsustainable debt. But even more important, it also provided a framework that pushed governments to focus on macroeconomic stability[1]. As countries reach the HIPC completion point, however, the risk of fiscal slippage and loser monetary policy increases again. Now that several governments of HIPC countries have requested a sovereign rating, it raises the question whether a sovereign rating can be seen as a new framework to promote macroeconomic stability?*

### Graduating to the capital market

The creditworthiness of a country's government can be expressed with a rating, just like corporates. A so-called sovereign rating is a must for governments to enter the international capital market. In Sub-Sahara Africa, interest is growing. The Ghanese government issued its first foreign currency bond in September 2007, thereby opening the primary market for Sub-Saharan countries[2]. As the bond was oversubscribed by 400%, it signalled strong investor interest in African sovereign bonds. Gabon followed Ghana's lead in December 2007. The buzz in the market is that more debut foreign currency bonds are to follow in Africa.

### How to get a sovereign rating

In general, governments turn to Fitch, Moody's and/or Standard & Poor's to apply for a sovereign rating. Although the rating agencies differ somewhat with respect to their methodology, they all focus on a combination of the ability and willingness to pay. The willingness to pay is more important when assessing a sovereign than a corporate. As sovereigns are able to change or overrule the law, creditors have few legal possibilities to reclaim debt. International law is also limited in its ability to enforce payment from a country. Despite the importance of the willingness to pay, political factors seem to have relatively little impact on the rating. Macoeconomic data and the government bond default history are more important.

### Implications of having a rating

The drive of several African countries to acquire a sovereign rating overlooks the fact that it is not all roses. The following advantages and disadvantages should be taken into consideration.

*1. Signalling the market*

Senegal was the first African country to obtain a sovereign rating in 2000, quickly followed by Botswana in 2001. Currently, 17 sovereigns have a rating, although so far only Ghana and Gabon have issued a foreign currency bond. Governments use a rating to demonstrate the financial markets their intention to keep macroeconomic stability and to show financial transparency. They intent to attract more business and foreign investment that way.

*2. Easier access to international capital market*

Attaining a sovereign rating will lower the cost of capital compared to having no rating. Moreover, many (institutional) investors will not or can not purchase sovereign bonds that are not rated. But why would a country want to tap into the international capital market if it can borrow from the IMF and World Bank? In general, concessional debt comes at lower costs than market debt. The main advantage is the flexibility. The structure and amount can be determined by the government itself without additional (non-financial) conditions. IMF and World Bank set a maximum to the amount a country can borrow at the institutions. Ghana, for example, issued the

[1] As explained in special report 2008/05 by H. Loman.

[2] South Africa is not included in this report.

**Table 1: HIPC vs. sovereign ratings**

| *HIPC* | *Sovereign rating* |
|---|---|
| - Initiative from international community | - Initiative from government |
| - Only for heavily indebted low-income countries | - For all countries |
| - Non-financial and macroeconomic conditions<br><br>- (International) political pressure | - Market discipline |
| - Government agrees reform program with IMF<br><br>- Accompanied by technical assistance | - No assistance |
| - Multilateral institutions determine progress | - Commercial agencies determine rating |
| - Reward of debt relief | - Reward of market access and benchmark |

Eurobond to acquire extra capital on top of its concessional debt.

A setback of tapping into the international capital market is the risk of being drawn into the volatility of the financial markets. The current turmoil on the international financial markets negatively affects the portfolio investments in several African countries.

*3. International benchmark*

Another reason for Ghana to issue the Eurobond was to set a benchmark for domestic corporates. Even without a bond issue, a sovereign rating functions as a benchmark. Investors often perceive the government as having the lowest credit risk in a country. Therefore, it becomes a standard against which corporates issues from the same country are priced. By obtaining a sovereign rating, a government can thus open up international capital market to the local private sector. A positive side effect is that the extra inflow of capital will stimulate financial sector development. However, it also raises the questions whether the underdeveloped financial markets of many African countries can handle the extra inflow of capital.

*4. Ratings are pro-cyclical*

Within the rating methodology, macroeconomic data takes a centre stage. By its nature, therefore, ratings are pro-cyclical. While logical –and perhaps also inevitable– it increases the risk of a boom-bust pattern in emerging markets. For example, institutional investors are often forced to sell funds if a rating drops below a threshold. Moreover, a downgrade (or upgrade) is likely to spill over from sovereign bonds to the corporate bond and stock markets due to the benchmark effect. This risk should have a disciplinary effect on governments.

*5. Too much money*

The access to international capital markets could lure countries into rebuilding external debt too quickly. After the HIPC debt relief initiative, many African countries started again with relatively low debt levels. However, many countries still struggle with development costs. Debt financing is one of the ways to bridge that gap.

## Conclusion

*Is a sovereign rating a viable framework to promote macroeconomic stability? First, requesting a sovereign rating is often seen as a signal that the government is serious about macroeconomic stability. With the central role for macroeconomic data in the rating process, this seems a valid argument. Second, on the downside, a sovereign rating may also increase the risk of instability. Easy access to money can be too attractive and the pro-cyclical nature of ratings increases the risk of a boom-bust pattern. Third, the promise of debt relief motivates more than the threat of a sovereign rating downgrade. The carrot of HIPC is much bigger than the stick of a rating downgrade. Overall, although a sovereign rating will not be as strong as the HIPC framework and there are some considerations to be kept in mind, a sovereign rating could certainly help a country to keep macro-economic stability on track.*

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