منتدى الاستراتيجيات الأردني
JORDAN STRATEGY FORUM

Policy Paper

Sovereign Risk Ratings: What are they? & Where Does Jordan Stand?

February 2019

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JORDAN STRATEGY FORUM

The Jordan Strategy Forum (JSF) is a not-for-profit organization, which represents a group of Jordanian private sector companies that are active in corporate and social responsibility (CSR) and in promoting Jordan's economic growth. JSF's members are active private sector institutions, who demonstrate a genuine will to be part of a dialogue on economic and social issues that concern Jordanian citizens. The Jordan Strategy Forum promotes a strong Jordanian private sector that is profitable, employs Jordanians, pays taxes and supports comprehensive economic growth in Jordan.

The JSF also offers a rare opportunity and space for the private sector to have evidence-based debate with the public sector and decision-makers with the aim to increase awareness, strengthening the future of the Jordanian economy and applying best practices.

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1. Introduction

Governments spend their money on several things including pensions, health care, state education, defense, transport, social protection, public order and safety, foreign aid, and others. To finance such spending, governments must rely on tax and other sources of revenues.

Within the context of public spending and public revenues, it is only natural to expect that sometimes, governments do run budget deficits. Indeed, in such cases, governments have several options including tax increase, spending decrease, and local and foreign borrowing. Moreover, and given the right economic circumstances, there is nothing wrong with public borrowing. Indeed, in addition to borrowing (from banks, governments and international organizations), most governments operate what is called a public debt market by issuing **BONDS**.

A bond (fixed-income security), is a **debt instrument** created for the purpose of raising funds. A bond is a loan agreement between the issuer (government) and the investor, in which the government is obligated to pay a specified amount of money at specified future dates.

When a sovereign government (i.e. Jordanian) needs to raise money, issuing bonds is one way to do it. Moreover, bonds can be issued locally or externally. Naturally, issuing debt in international market and in foreign currencies has advantages and disadvantages. For example, issuing foreign currency debt is a method to finance domestic investment which otherwise, may not be possible. However, accumulating foreign currency debt obliges the government (borrower) to repay investors in a currency over which it has no control. In addition, the country in whose currency the debt is denominated may set interest rates according to its domestic situation, and this may not suit the borrower.

Notwithstanding the fact that issuing debt in foreign currency (as well as local) has advantages and disadvantages, the fact remains that borrowing in general, irrespective of source, exposes the government to **SOVEREIGN RISK.** This concept focuses on the risk of a sovereign government **"defaulting on its debt obligations".**

"The requirement to guarantee exercise and to monitor contract compliance obviously differs from the requirements governing credit for private agents or subnational and non-sovereign sectors in the public sphere. Moreover, the determinants for payment capacity and of willingness to repay debt are of a different nature, reflecting macroeconomic variables such as the available stock of foreign currency reserves and balance of payments flows, economic growth prospects and capacity to generate tax receipts, a variety of political factors etc." (World Bank).

The fact that sovereign risk is different, some official and private credit risk rating agencies have made it part of their services to measure and publish sovereign credit ratings of more than 200 economies. The principle agencies are **Standard & Poor's (S&P), Moody's, and Fitch Group.** Essentially, these credit rating agencies evaluate sovereigns on the basis of four to five dimensions. These include economic structure and growth outlook, fiscal policy and debt burden, institutional efficiency, and external balance. Ratings are then given as a ranking. AAA is the highest, then AA and A, right through to C and then D (default).

For several reasons, credit rating agencies matter for developing countries, like Jordan.

First, the ratings act as a disciplining device that compels countries to pursue more prudent and responsible fiscal and monetary policies. Indeed, performance on these policies is an integral part of the rating methodologies.

Second, a favorable rating enables a government to raise capital in the international financial market. Institutional investors in both the developed and developing world rely heavily on rating agencies in making investment decisions. In addition, an unfavorable rating increases the cost of borrowing.

Third, the international experience shows that when a country's sovereign risk rises, local companies with a large public-sector ownership, and companies that borrow heavily from banks, are affected (risk spillover).

The objectives of this JSF policy paper are three-fold. **First,** to make a case of why the credit rating of Jordan is relevant and important. **Second,** to explain the indicators used by the three credit risk rating agencies. **Finally,** to recommend some policy measures whose objective is to improve the credit rating of Jordan.

2. PUBLIC DEBT IN JORDAN: THE CONTEXT:

The subject matter of Jordan's public borrowing in general, and external borrowing in particular, should not be underestimated. This is based on several observations.

First, total public debt has reached 94.3% of Gross Domestic Product (GDP) by the end of 2017 (Figure 1). Based on the World Bank's International Debt Statistics, Jordan's public debt is relatively high (Figure 2).

Figure 1: Public Debt to GDP

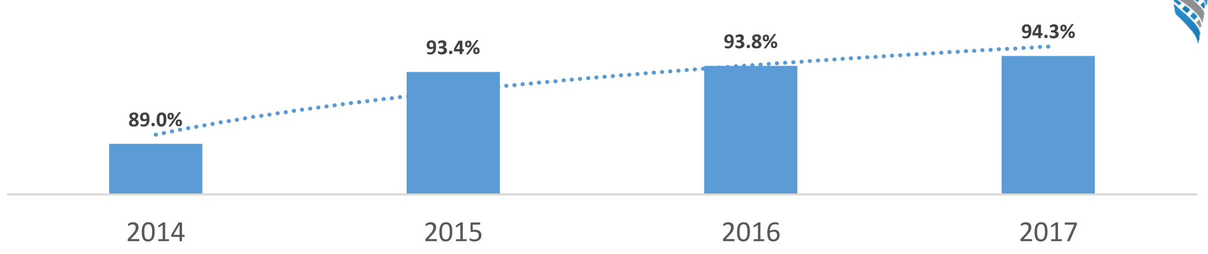
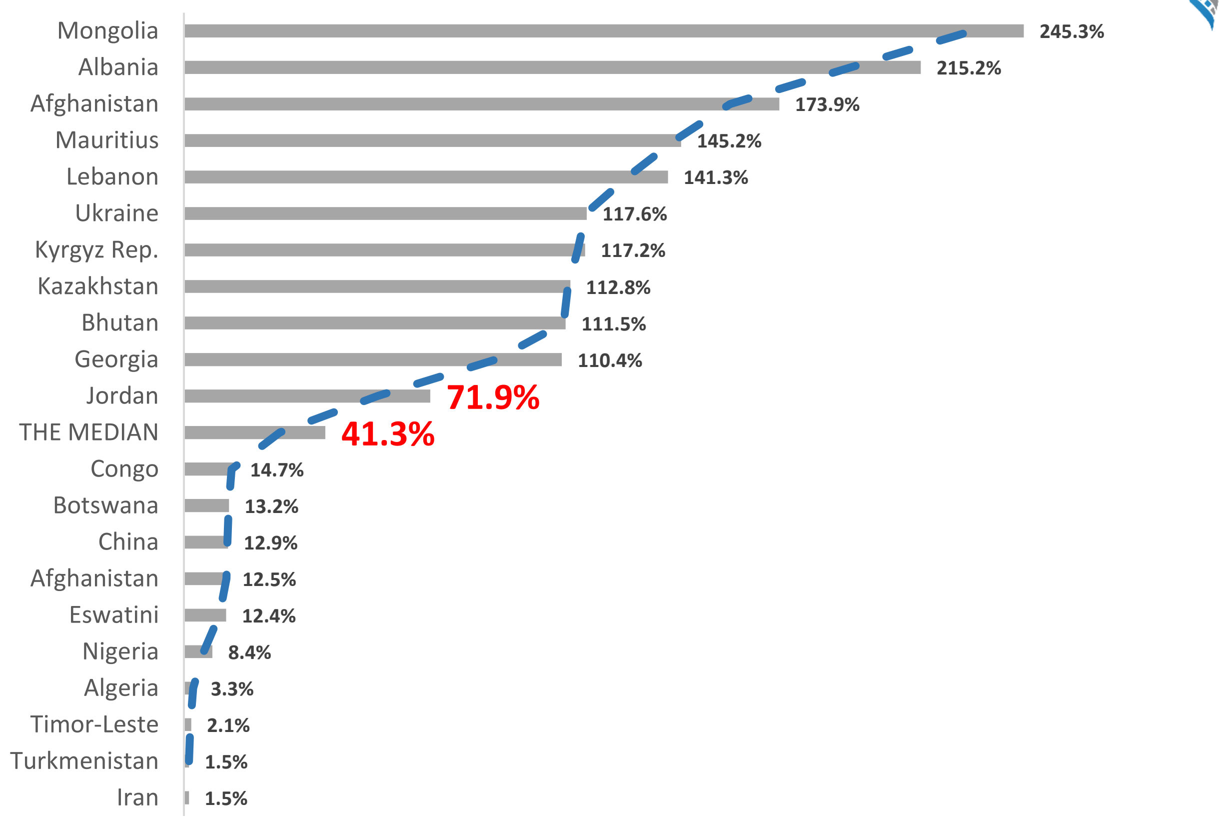
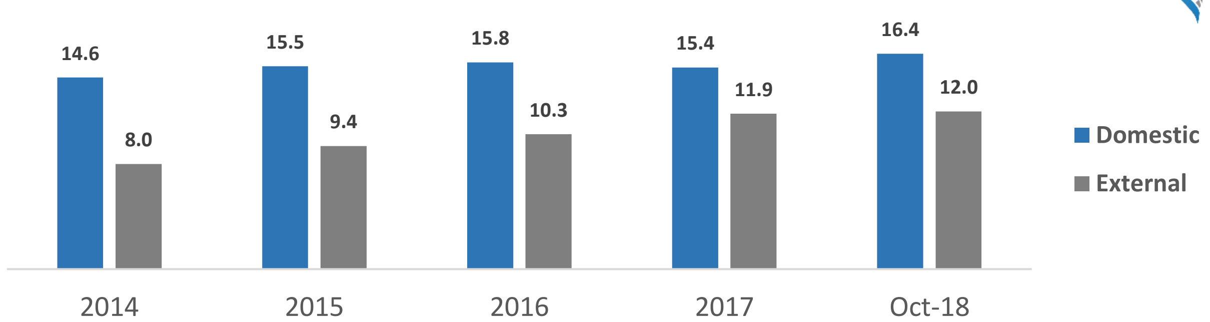


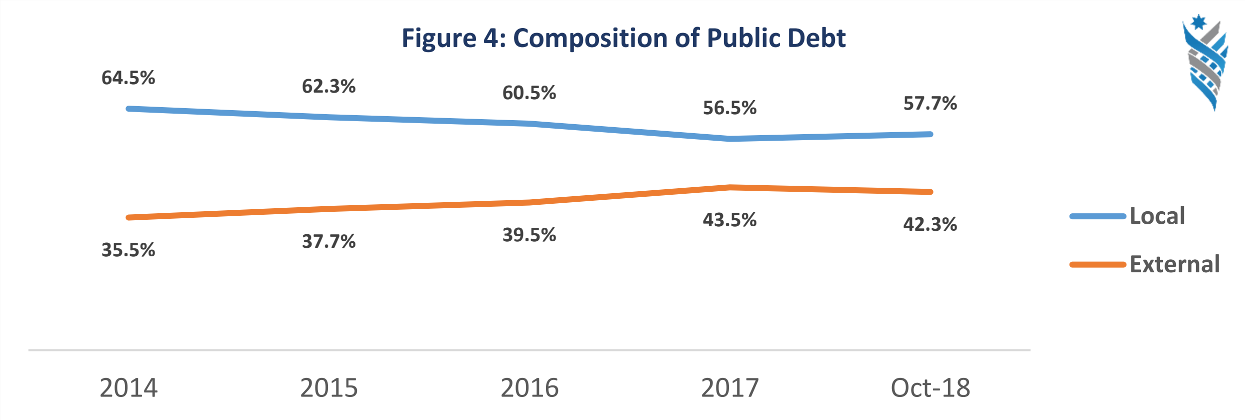
Figure 2: Debt to GNI: Highest & Lowest 20 Countries in the World



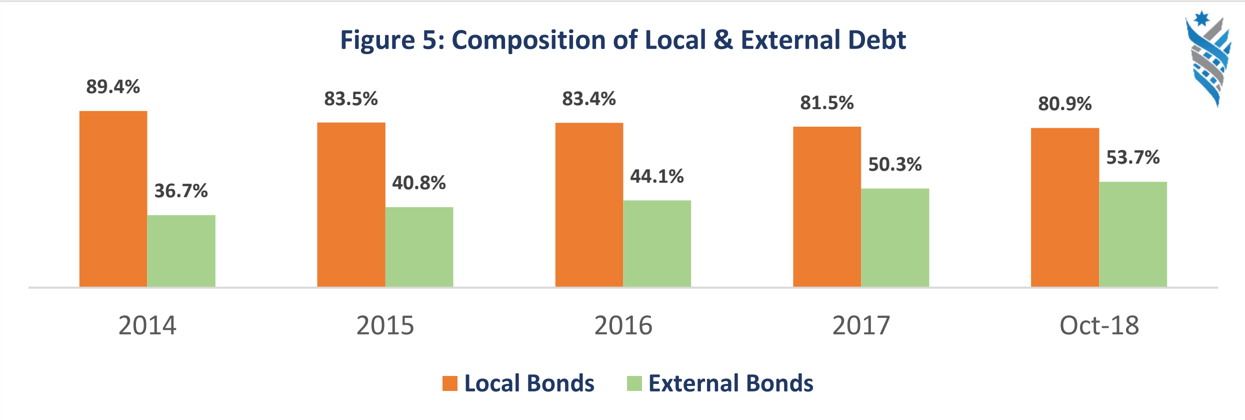
Second, by the end of October 2018, total public debt has reached JD 28.4 billion (Figure 3). However, what is more interesting is the fact that during the period 2014 – October 2018, the ratio of external debt to total debt has increased from 35.5% to 42.3% (Figure 4).

Figure 3: Domestic & External Debt (JD Billion)





Third, locally issued treasury bills and bonds (debt) constitute about 80% to 90% of total local public debt. However, external debt in the form of bonds has been increasing relative to total external debt. Indeed, in 2014 and October 2018, the ratio of external debt in the form of bonds to total external debt was equal to 36.7% and 53.7% respectively (Figure 5)! The rest of the external debt is from bilateral loans from Arab and foreign countries, Arab Funds, export credit guarantees, foreign banks, and multinational institutions.



The fact that Jordan's external public debt, especially in its international bonds' dimension, has been rising, it is useful to understand what indicators enter into the credit rating of economies. Indeed, if Jordan can improve some of these dimensions, international issues of debt (bonds) would only become cheaper!

3. SOVEREIGN CREDIT AGENCIES: THE METHODOLOGICAL FRAMEWORK

The principle credit agencies are **Standard & Poor's (S&P), Moody's, and Fitch Group.** Essentially, these credit rating agencies evaluate sovereigns on the basis of four to five dimensions. These include economic structure and growth outlook, fiscal policy and debt burden, institutional efficiency, and external balance. Ratings are given as a ranking. AAA is the highest, then AA and A, right through to C and then D (default). In Table 1, for example, we outline the S&P ratings.

Table 1: Standard & Poor's Ratings

Grade	Rating
Prime	AAA
High Grade	AA+
	AA
	AA-
Upper Medium Grade	A+
	A
	A-
Lower Medium Grade	BBB+
	BBB
	BBB-
Non-Investment Grade Speculative	BB+
	BB
	BB-
Highly Speculative	B+
	B
	B-
Substantial Risks	CCC+
	CCC
	CCC-
Extremely Speculative	CC
In Default	D

All three credit rating agencies utilize a large number of economic and other ratios when assessing a sovereign. This information can be summarized as follows:

(A) Debt Characteristics

The relative debt size and structure, as well as the government's degree of liquidity affect a sovereign's ability to meet debt obligations. The key indicators include:

1. Debt to GDP ratio.
2. External debt as a proportion of total debt.
3. Interest payments as a proportion of GDP and revenue.
4. Foreign reserves as a proportion of short term debt.

5. Foreign currency reserves in terms of months of imports.
6. Average time to maturity.
7. Years since last default.

(B) Economy Characteristics

Its is only natural to expect that the performance of the national economy is instrumental in financing the public spending and hence the government's resilience to meet its obligations (debt). This is why, the key indicators which are used by the credit rating agencies are:

1. Gross Domestic Product (GDP) or Gross National Product (GNP).
2. GDP per capita and GDP per capita growth trend.
3. GDP growth rate and volatility.
4. Sectorial distribution of the GDP and the weight of industrial production.
5. Global competitive index.
6. Government effectiveness.

(C) Foreign Trade

Trade and capital flows affect the foreign exchange resources available to the government. In other words, this activity has a direct impact on the government's ability to pay its foreign debt. The key indicators include:

1. The economy's openness to trade and capital flows.
2. Balance of payments.
3. Debt to export ratio.
4. Cost of recycling debt to export ratio.
5. Real and nominal exchange rates.
6. Terms of trade.

(D) Monetary Environment

The monetary environment has a direct impact on the yields of locally issued bonds, and indirectly on real economic activity. Therefore, the key indicators used by the credit rating agencies include:

1. Inflation rate and volatility.
2. Domestic interest rate
3. Supply of money.
4. Volume and growth of credit to private sector.

(E) Government Budget

The fiscal balance of the government directly affects its debt burden. In addition, the fact that the budget deficit requires the government to raise additional funds in the capital markets, falling bond prices and rising yields would only be the expected result. As a result, a profound deficit or fear of future deficits can cause a downgrade of a country credit rating. Therefore, the key indicators used by the credit rating agencies include:

1. Revenues and expenditure.
2. Deficit to GDP ratio.
3. Deficit trend over time.
4. Government expenditure to GDP ratio.
5. Savings to GDP ratio.

In addition to the above-mentioned five indicators, domestic and external political characteristics are used in the rating of countries. Political instability may lead to increased risk and rating downgrade. This is why public support in the government, election year, and geopolitical and external security risk enter countries' credit ratings.

Within the context of the subject matter of sovereign risk, it would be useful at this stage to report what Jordan's risk looks like. In Table 3, we report Jordan's risk since 2011. It is indeed encouraging to note that the ratings have been improving. Moreover, the outlook seems to be stable.

Table 2: Credit Rating of Jordan (S&P)

Date	Rating	Outlook
8 February 2011	BB	Negative
20 May 2013	BB-	Negative
31 October 2014	BB-	Stable
22 April 2016	BB-	Negative
20 October 2017	B+	Stable
21 January 2019	B+	Stable
Forecast 2019-2021	B+	Stable

4. In a Nutshell

Sovereign ratings have some important implications. They act as a disciplining device that compels countries to pursue more prudent and responsible fiscal and monetary policies. A favorable rating enables governments to raise capital in the international financial market. In addition, an unfavorable rating increases the cost of borrowing. This is why; it is in the interest of countries including Jordan to improve their performance in their **Debt Characteristics, Economy Characteristics, Foreign Trade, Monetary Environment, and Government Budget.**

Within this context of improving ratings, it is informative to note that , it is useful to note that in a recently published, **ARE THE CREDIT RATING AGENCIES BIASED AGAINST MENA COUNTRIES?,** Yalta and Yalta (2018) examine the determinants of sovereign risk for a total of 99 countries, including 11 Arab countries. Based on their analyses, it is concluded that the main "factors responsible for the differences in the rating behavior are found as the **budget deficit to GDP ratio, the debt to GDP ratio, and the current account to GDP ratio".**

Similarly, in their paper, **DETERMINANTS OF SOVEREIGN CREDIT RATINGS: EVIDENCE FROM CEE COUNTRIES,** Jošić and Mlinarić (2019) investigate the determinants of the sovereign credit ratings in Central and Eastern European countries (CEEC). Based on a total of 11 CEEC countries over the period 2000 to 2016, they state that "public debt to GDP and external debt to GDP variables play the major role in determining the sovereign credit ratings of CEE countries".

The implications are clear. Present and future Jordanian government should always take the subject matter of public finance (revenues and expenditures) a lot more seriously. Indeed, budget deficits result in growing local and foreign debt!

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