Introduction

1. What we have learnt in terms of rating policy
2. What we know
3. What we think we know
4. What we do not know
1. What we have learnt in terms of rating policy?

- Modesty
- Transparency
- Focus
Enhanced focus

- Definition of sovereign ratings
- Probability and severity of default
- Key rating factors
- Debt payment schematic

How do we determine government bond ratings?

<table>
<thead>
<tr>
<th>Shock absorption capacity</th>
<th>Public debt vulnerability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factor 1: GDP/capita</td>
<td>Factor 3: Strength of government balance-sheet</td>
</tr>
<tr>
<td>Factor 2: Institutional maturity</td>
<td>Factor 4: Susceptibility to risk events</td>
</tr>
</tbody>
</table>

Local currency and foreign currency sovereign bond rating
Debt payment schematic

<table>
<thead>
<tr>
<th>WHAT HAS TO BE REPAYED</th>
<th>WHAT ARE THE RESOURCES AVAILABLE?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local currency debt</td>
<td>Local currency debt</td>
</tr>
<tr>
<td>1. Debt stock</td>
<td>1. Fiscal resources: static and dynamic analysis of the country’s fiscal depth</td>
</tr>
<tr>
<td>2. Debt flow: financial balance</td>
<td>2. Liquid assets (privatization...)</td>
</tr>
<tr>
<td>3. Debt dynamics including FC indexation and maturity structure</td>
<td>3. Sellable but illiquid assets</td>
</tr>
<tr>
<td>4. Contingent Liabilities (pensions...)</td>
<td></td>
</tr>
<tr>
<td>5. Future liabilities (pensions...)</td>
<td></td>
</tr>
</tbody>
</table>

**SPILL OVER RISK**: balance-sheet effects of currency and maturity mismatches, capital outflows, impact on fiscal revenues of contraction resulting from external crisis...

<table>
<thead>
<tr>
<th>Foreign currency debt</th>
<th>Foreign currency debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Debt stock (public and private)</td>
<td>1. Liquid and unencumbered foreign exchange reserves</td>
</tr>
<tr>
<td>2. Debt flow: balance of payment trends (current account, competitiveness...)</td>
<td>2. Access to additional external finance at tolerable price</td>
</tr>
<tr>
<td>3. Debt dynamics: vulnerability of external financing (nature of financing...)</td>
<td></td>
</tr>
</tbody>
</table>

2. What do we know?

- **Liquidity matters (a lot)**
- **Risk management approaches pay off**
- **Economic and trade integration enhances resiliency**
Liquidity matters (a lot)

Risk management approaches pay off

- The risk management approach to economic policy – analogy with banking

- Scope:
  - Refining macro-financial surveillance tools
  - Defusing crisis triggers and amplifiers
  - Building a sound financial infrastructure
  - Devising new financial (including ALM) strategies

- Limitations
Economic integration enhance resiliency

- Reduces the probability of crisis
- Reduces the severity of crisis – creating counter-cyclical features
- Examples: the EU anchor, Asia’s rebound after the crisis

3. What do we think we know

- Not all current account imbalances are alike
- Liquidity risk and solvency risk
- Local currency debt is generally less risky than foreign currency debt
- Banking integration provides more stability than financial market integration, but financial market development remains key
Not all current account imbalances are alike

- **A simple analytical approach:**
  - The nature/stability of financing is key
  - How vulnerable is the CA deficit? How robust is the financing and how susceptible to an external shock?
  - How sustainable is it? The determinants of the deficit (the S-I gap), the “Lawson doctrine” and the question of competitiveness
  - How severe should an hypothetical crisis be from the point of view of the government’s balance sheet?

- **Examples: Central and Eastern Europe**
- **Is that right after all?**

---

**Liquidity risk and solvency risk**

- Liquidity crisis: price and volume effects
- Mature market economies are not vulnerable to financing discontinuities, but “simply” to price adjustments
- Implications: net debt versus gross debt
- How robust is this observation?
Local versus foreign currency debt

- The many benefits of raising funds in one’s currency
- But in a context of open capital accounts, the superiority of LC debt should not be exaggerated
- Example: Latin America

Banking integration versus financial integration (1)

- The value of international banking integration in terms of systemic strength
- Example: EU-wide banking integration
- However, this remains largely untested
Banking integration versus financial integration (2)

Financial market development is yet critical

- Although it opens the way for potentially sharp reactions to domestic developments and also creates linkages with global finance...
- It instills healthy controversy in asset price valuations
- Example: Gulf countries’ stock markets
4. What we still do not know

- Disentangling cyclical and structural factors
- Understanding crises dynamics and the micro-macro nexus
- The understanding of political risk remains elusive

Disentangling cyclical and structural factors

- What is cyclical?
- What is structural?
- Can cyclical improvements turn into structural one?
- The ordinal and cardinal nature of ratings
Fundamental versus exogenous factors

Understanding crises dynamics

- The micro-macro nexus:
  - Government’s off balance sheet liabilities
  - Ratings’ interaction at Moody’s
- Contagion remains mysterious
Political risk remains elusive

- Ability to pay versus willingness to pay: are they really distinct?