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In The Debt Debate, Our Sovereign Ratings Have No Austerity Bias

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Table Of Contents

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Few economic controversies in recent decades have been as divisive as the current debate regarding the appropriate policy mix to lead the European Economic and Monetary Union (eurozone) out of its current financial and economic crisis. In essence, the question is this: Should governments make budgetary cuts an urgent priority in light of historically high public sector borrowing needs among advanced-economy sovereigns and limited market appetite to absorb rising debt? Or does austerity undermine a nation's growth, putting it on a self-defeating downward spiral of deepening recession and budgetary tightening, in turn sucking out more economic dynamism. Understandably, the debate is particularly intense in Europe, where growth and employment have been particularly lackluster, and which is generally regarded as the epicenter of the current problems. (Watch the related CreditMatters TV segment titled "In The Debt Debate, Our Sovereign Ratings Have No Austerity Bias," dated June 27, 2012.)

The Greek election last weekend indirectly put this very question to the voters. Would it be preferable to commit to continued fiscal austerity in an uncertain effort to convince creditors that debt to GDP might eventually stabilize without further restructuring? Or should the main focus be on quickly restoring growth, leaving fiscal rectitude for later? The results suggest that the Greek electorate proved to be just as divided on the issue as European policymakers appear to be.

These issues are difficult to disentangle and in our view are unlikely to be solved by simple one-size-fits-all solutions. We consider it certainly the case that the balance between fiscal consolidation on the one hand and stimulating growth on the other are important in assessing sovereigns' fundamental creditworthiness. However, it is not the role of a credit rating agency such as Standard & Poor's to provide policy advice. Deciding on policy choices is the domain of governments and their advisors; the rating agency's role as a neutral observer is to express its view on the impact of these choices on the sovereigns' creditworthiness. Consequently, we strongly reject the suggestion by some commentators that Standard & Poor's has taken sides in the growth versus austerity debate, with some saying we have "demanded" more austerity. This groundless assertion assumes that rating agencies have not only the desire, but also the ability, to effectively prescribe policy choices on whole societies. The explicit claim that rating agencies have a budget-cutting bias is easily exposed as baseless by reviewing our published analysis.

Fiscal Austerity Alone Is No Solution

A look at the ratings on eurozone sovereigns puts the debate on a factual basis. When Standard & Poor's lowered the rating on nine euro area sovereigns in January 2012, among them the economic heavyweights of France, Spain, and Italy, we clearly stated our opinion that the European policy choices as agreed in the EU summit on Dec. 9, 2011, had focused too narrowly on restrictive fiscal policy, with the fiscal compact as the cornerstone of this approach. Indeed, at the time we stated our belief that "an effective strategy that would buoy confidence and lower the currently elevated borrowing costs for European sovereigns could include, for example, a greater pooling of fiscal resources and obligations as well as enhanced mutual budgetary oversight". We have also stated that we believe that "a reform process based on a pillar of fiscal austerity alone would risk becoming self-defeating, as domestic demand falls in line with consumers' rising concerns about job security and disposable incomes, eroding national tax revenues" (see "Credit FAQ: Factors Behind Our Rating Actions On Eurozone Sovereign Governments," published Jan. 13, 2012, on RatingsDirect on the Global Credit Portal). More recently, when we lowered the rating on Spain in April 2012, we stated our view that "front-loaded fiscal austerity in Spain will likely exacerbate the numerous risks to growth over the medium term, highlighting the importance of offsetting stimulus through labor market and structural reforms"(see "Ratings On Spain Lowered To 'BBB+/A-2' On Debt Concerns; Outlook Negative," published on April 26, 2012). The essence of these statements is quite obviously at odds with the claim that Standard & Poor's is biased towards, or even "demands", an all-out fiscal austerity drive, without regard to the consequences.

Policy Choices Influence Creditworthiness

Another source that shows our approach to the subject is our published sovereign ratings' methodology. In addition to willingness to pay, what matters ultimately for a sovereign's creditworthiness is whether a government will be able to service its debt load. A government's ability to achieve sustainable economic growth is an important factor in analyzing this question under our criteria. After all, the public debt-to-GDP ratio is a ratio, and the denominator (nominal GDP) matters as much as the numerator (debt). Our methodology makes this balanced approach clear: indeed, when deriving the rating on a sovereign, we explicitly assign a somewhat higher weight to economic factors than to fiscal ones. This is a long way from single-mindedly "demanding" more austerity, even if it were to significantly undercut a country's economic prospects.

While Standard & Poor's does not advise on, let alone demand certain policies, we recognize that policy choices do, of course, matter. They also have a bearing on our opinion on the likelihood that a given sovereign will service its debt in a timely manner. And in many cases, the consolidation of public finances may indeed be a key ingredient in safeguarding sovereign creditworthiness. In an optimal world, advanced-economy sovereigns would have entered the global financial crisis with low levels of public debt (which indeed was the case for Ireland and Spain, before they assumed high private sector debts). We recognize, however, that in the world as we experience it, fiscal space is not infinite, particularly for sovereigns with limited monetary flexibility. Governments with lower debt to GDP have more room to maneuver as a simple algebraic matter of the debt-sustainability formula. Experience has shown that they also would have greater credibility in the market. A government that has run countercyclical fiscal policy in good times can enjoy countercyclical fiscal policy in bad times. We have seen that, for countries with a structural current account deficit, it is important to raise public sector savings to help restore external equilibrium.

Our recognition of this reality should not be mistaken for policy advice. But even in instances where we consider that fiscal consolidation is an important element contributing to safeguarding creditworthiness, under our criteria we would not change the ratings if there were to be a temporary slippage in the consolidation progress as long as we were to see that a viable and credible strategy is in place to secure sustainable public finances over a longer term.

In short, contrary to views expressed by some market commentators, Standard & Poor's has no bias in favor of pro-growth or pro-austerity policies. In line with our published criteria, we look at a large array of factors, including both economic and growth factors as well as fiscal performance factors. The impact of policy choices on sovereign creditworthiness will depend on the economic and institutional circumstances. Therefore, we will continue to analyze the impact of policy choices on a case-by-case basis rather than adopting sweeping and ideological positions in favor of a particular policy orientation.

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