Should Japan be rated below Botswana?

Economy's four ace cards no longer cover its glaring weaknesses, expert says

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The downgrading of Japan's sovereign credit rating in May to below Botswana and other less-developed countries embarrassed the Finance Ministry into demanding detailed explanations from Standard & Poor's, Moody's Investor Services and Fitch IBCA -- the three major international credit rating agencies that dumped Japan.

In response, Moody's representatives testified in the Diet. S&P sent a detailed reply, and Fitch took its case public.

Did the world's second-largest economy deserve to be cut to this level?

To answer that question, it is important to understand the methodologies and assumptions upon which sovereign ratings are determined and then do a sort of SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis of Japan's current and future financial and economic scenarios.

Sovereign ratings crucial

Like all other credit ratings, sovereign ratings indicate the relative likelihood that a borrower will default on its obligations. Sovereign ratings address the credit risk of national governments, which are generally seeking to ease their own access (and that of other issuers within their borders) to international capital markets.

Sovereign ratings are important not only because some of the largest issuers in international capital markets are national governments, but also because these assessments affect the ratings assigned to borrowers of the same nationality.

Sovereign ratings receive considerable attention in financial markets and the press. The ordering of risks they imply is broadly consistent with the macroeconomic factors.

Weight of criteria differ

In their statements on rating criteria, the rating agencies list numerous economic, social and political factors that underlie their assessments.

Identifying the relationship between their criteria and the actual ratings, however, is more difficult -- in part because some of the criteria are not quantifiable.

Even for quantifiable factors, determining the relative weights as assigned by the agencies is complicated because they rely on several criteria.

Researchers have used regression analysis to measure the relative significance of the major variables repeatedly cited in the agencies' reports as determinants of sovereign ratings.

Assessing the individual and collective significance of these eight variables, the statistics show that six correlate directly with the ratings assigned by Moody's, S&P and Fitch.

The eight variables commonly cited in the rating reports are:

* Per capita income
* GDP growth
* Inflation
* Fiscal balance
* External balance
* External debt
* Economic development
* Default history

The accompanying chart shows the relationship between each credit-rating variable and a country's ability and willingness to service its debt.

Just as in public life, small or middle-income people can be more creditworthy than the CEOs of big blue-chip firms. Similarly, a tiny country like Botswana could be credit-rated higher than a global player like Japan.

Eight variables considered by key to sovereign credit ratings

	JAPAN	BOTSWANA
Per capita income	High	Low
GDP growth	Negative	Strongly positive
Inflation	Deflation	Moderate
Fiscal balance	Alarming deficit	Surplus
External balance	Surplus	Surplus
External debt	Low	Low
Economic development	High	Low
Default history	Nil	Nil

Note: Each agency uses a different standard. Japan was rated AA minus by Standard & Poor's, A2 by Moody's, and AA by Fitch.

Japan vs. Botswana

On the surface, Japan looks pretty comfortable in most of these variables. However, as pointed out earlier, the weights accorded to each variable cannot be uniform, because the implications of some of them are more serious.

In Japan's case, a huge fiscal deficit, negative economic growth and deflation outweigh the other variables, resulting in the downgrading of its sovereign rating.

Japan's shrinking economy, supplemented by deflation, rising unemployment and precarious banking and corporate profitability, and most important, the lack of political will to undertake bold structural reform make it difficult for credit analysts to think otherwise.

By stating that Botswana is receiving aid from Japan in the form of ODA but is rated higher by the Agencies can't be a reason to upgrade Japan's rating.

Botswana has had the fastest growth in per capita income in the world. Economic growth averaged over 9 percent a year from 1966 to 1999. Botswana has maintained budget surpluses for 12 of the last 13 years, has no domestic debt, an insignificant foreign debt, and has stockpiled foreign-exchange reserves amounting to over three years of current imports.

Having a well-managed economy, with low domestic and future obligations, Botswana's sovereign rating is capped only by its level of development and the size of its economy.

Japanese politicians should put their house in order instead of trying to grab headlines by using false and stereotyped images to paint a picture of a struggling, little African country and undermine the credibility of an objective credit-rating analysis.

The bottom line

The bottom line is, Japan's stated "strong points" aren't strong enough!

The defensive arguments given by the Japanese officials revolve around the four main strengths:

1) Japan is world's largest creditor nation;
2) Japan has the highest foreign reserves in the world;
3) Japan has the biggest external balance in the world;
4) and the largest pool of domestic savings.

These strengths have been duly noted but do not have a big impact on Japan's creditworthiness.

These funds belong to the both the Japanese government and private entities, and have been increasing for reasons arising out of low investment returns in Japan, overseas expansion by Japanese businesses on account of static and falling domestic demand, the shedding of Japanese assets by foreign investors, and many other reasons.

These do not explain any of the government's achievements to help improve its finances or economy, so why should they be used to justify the mismanagement of its finances and creditworthiness?

In the absence of any impressive moves to curtail the public spending or improve its revenues, the credit-rating agencies rightly have downgraded the credit rating of the Japanese government. Special interest groups in the agriculture, construction and retailing sectors, blocking necessary reforms, are holding the government hostage, which has consequently resulted in an unsustainable level of public debt -- the same debt used by politicians to accommodate these groups.

What needs to be done?

Where Japanese authorities clearly miss the point is in understanding that its strengths are not enough to counter the negative influences of its weaknesses and threats: a large fiscal deficit, huge

nonperforming loans at banks, deflation, record unemployment and rising bankruptcies.
The agencies have to be forward-looking in their assessments of the future debt repayment capacity of the Sovereigns, just as they do with corporations. They weigh Japan's strengths and opportunities against its weaknesses and threats to determine its ability to meet obligations to investors.

Any modern economy is driven by capital investment, consumer spending, public spending and exports. This applies to the Japanese economy as well, where consumer spending and capital investment account for more than three-fourths of the economy.

Unless the government takes bold steps to realign its economic structure, the two main driving forces of economic growth -- consumer spending and corporate investment -- cannot take the lead. Public spending on "white elephant" projects in the 1990s has not helped turn the economy around.

The lack of progress on tax reforms, the slack attitude in collaborating with the private sector to create new industries and jobs to accommodate the ever-increasing joblessness, and the apparent lack of preparedness for dealing with the graying population all have to change, and quickly.

Hurdles to a higher rating

The government has to stand alone in presenting and implementing a convincing economic model. A decade steered by a messed-up public finance system with an alarming trajectory of debt only worsens the prospects for its debt-servicing capacity in the future.
The agencies' downgrading judgments are also based on an analysis of the government's failure to carry out the reforms promised by Prime Minister Junichiro Koizumi. Without them, the economy won't be able to climb out of its deflationary spiral.

The slogan of "no gain without pain," which Koizumi trumpeted upon assuming office last April, has faded, as shown by the steady slide in his popularity.

This lack of political will cannot be rewarded by the credit-rating agencies. Increasing bad debts in the banking sector and the disappointment rightly expressed by the agencies on the FSA's inspections reinforce the point that urgency in reforms and restructuring aren't the priorities of this administration.

The fiscal deficit, which is forecast to become 140 percent of Japan's GDP in March 2003, is already the highest among the Group of Eight countries. Experts forecast that the deficit will keep on galloping even beyond 200 percent. The government has to reduce spending on several unremunerative projects and enforce fiscal discipline.

The complacency of the political class is creating an atmosphere of uncertainty that discourages people from spending.

Worse, the labor force is shrinking by 0.6 percent a year as the population enters a rapid aging phase that will further reduce consumption, impact public finances and shrink the economy.

False scenarios of the economy "bottoming out" have been presented many times to this country since the 1990s.

A few years ago, while doing credit analysis at a foreign bank here, many of our Japanese clients (including Fortune 500 companies) boasted of their huge size, large asset levels and turnover. They found it hard to digest that improvements in cash flows, profit margins, and operating efficiency were essential for them to get better credit scores from us.

Unhesitatingly, I recommended limit cuts on these companies and forecasted restructuring for them in the near future, which subsequently happened. The same logic applies to Japan. Its "strong points" are not very relevant in this situation, and at this stage nobody has said yet that it is going to default. The agencies have duly cited these strengths in their reports.

To earn higher credit ratings, the government has to improve not only its financial strength, but also its future debt-servicing prospects.

With the pressure groups of Japanese voters, domestic industry and even foreign governments having been ineffective for their own different reasons, it is left to the credit rating agencies to enforce fiscal discipline and reforms on the Japanese government.

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