Caribbean Information &
Credit Rating Services Limited

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METHODOLOGY FOR SOVEREIGNS

The following rating methodology is the generalized version of the methodology that CariCRIS would use to analyse sovereigns domiciled in the English-speaking Caribbean and key Central American countries such as Panama, Belize, Costa Rica as well as the Dominican Republic.

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Sovereign ratings are reflective of the relative ability of sovereigns to repay their debts vis-à-vis other borrowers in the given frame of reference. CariCRIS' frame of reference is a regional one and includes nineteen countries in the region namely the English-speaking Caribbean and key Central American countries such as Panama, Belize, Costa Rica as well as the Dominican Republic.

CariCRIS' local currency rating reflects the ability and willingness of the sovereign to meet all its local currency denominated financial obligations on a timely basis while the foreign currency rating reflects the ability and willingness of the sovereign to meet all its foreign currency denominated financial obligations on a timely basis. In that sense an assigned rating is a forward-looking estimate of default probability and therefore should not only be reflective of current performance but also an estimate of future ability and willingness to pay.

The rating evaluation of a sovereign is therefore a combination of several 'hard' macroeconomic indicators as well as other 'soft' issues like quality of economic leadership and political stability.

Sovereign ratings address the credit risk of national governments and are not to be seen as a "country rating". Indeed, ratings assigned to corporate entities within a country can be the same as the sovereign's or lower, but may also be higher.

The CariCRIS framework for assigning a credit rating for debt issued by a sovereign is closely aligned with rating methodologies which are fairly well established internationally, and include an analysis of five broad issues:

1. income and economic structure
2. fiscal policies
3. monetary policies
4. balance of payments and external liquidity
5. political risks

The schematic below provides a simple overview detailing some of the key parameters under each risk category.

------------------------------- Risk Categories ------------------------------------->

Income & Economic Structure	Fiscal Policy	Monetary & Exchange rate Policy	Balance of payments & External Liquidity	Political Environment
Quality of economic management	Coherence	Central Bank Independence	Trade competitiveness	Transparency in economic policy
Economic diversity & resilience	Robustness & stability of Gov't Revenue	Financial system soundness	Investment attractiveness	Continuity of policies
Human Development Index	Expenditures effectiveness & pressures	State of the insurance industry	Reserves & External debt position	Stability of political institutions
Size (in terms of GDP)	Overall deficits	Capital market development	Adequacy of reserves	
Growth prospects	Overall indebtedness	Record on inflation management		
Efficiency: ▪ Private sector participation ▪ Social infrastructure ▪ Physical infrastructure	Debt culture: ▪ Past default history ▪ Readiness to default ▪ Implications of default	State of the banking system: ▪ Regulation ▪ Capitalization ▪ Asset quality		

A brief description of each risk assessment parameter follows.

Income and Economic structure

A strong economic structure gives a country a cushion in adversity, enabling demand compression, reduced imports, and other measures enabling a generation of foreign exchange. Living standards and equitable income distribution are potential indicators of social tensions and unrests and also good indicators of a country's ability to make sacrifices, should the need arise. The presence of a large and developed private sector provides an entrepreneurial thrust to the economy, diversifies the output sources, and facilitates growth in the country's output. A large and possibly inefficient public sector could lead to diversion of resources away from a more productive private sector, constraining economic development.

The prospect for economic growth is another key assessment category for sovereign ratings. Countries with significant potential for economic growth would typically witness increased capital flows, offer more employment opportunities and by and large, have a greater capacity to service a given level of public sector debt. Furthermore, countries with strong growth potential may be in a better position to absorb economic and political shocks relative to countries with lower growth potential.

Fiscal policy/Indebtedness

The second category of risk assessment parameters in CariCRIS' sovereign ratings methodology is fiscal flexibility, as measured by an examination of government revenue, expenditure and overall fiscal performance. Coherence and consistency of government policy along with methods of deficit financing and their inflationary impact, are important indicators of sovereign credit quality. Effective government policy provides quality public services, the infrastructure and education levels needed to underpin and generate stable growth, diversify the economic revenue streams, and facilitate increased output and investment by the private sector. Simple and effective tax regimes that also address concerns of equity in income distribution are characterized by low tax rates and a broad base, enabling effective tinkering without administrative difficulties. Besides, these regimes are typically well positioned to increase/decrease revenues without serious political and constitutional impediments.

Increased indebtedness and continual fiscal deficits are usually funded out of private savings, possibly leading to a crowding out of the private sector and the possibility of increased inflation and high interest rates. Off-budget and contingent liabilities can also be important rating considerations, with attention focused on the size and health of non-financial public sector enterprises (NFPEs). If the quasi-fiscal activities of the NFPEs are sizeable, the usefulness of general government statistics as an indicator of fiscal performance and position and the role of the government in the economy is diminished.

Monetary stability and macroeconomic policy

Monetary stability is an important leading indicator of sovereign creditworthiness. Significant monetization of budget deficits often fuel price inflation and as a result policymakers usually respond with containment measures. Government's ability to monitor and control inflation is critical to maintaining the confidence of the citizens in the currency, and providing a stable economic environment in which citizens do not need to unnecessarily postpone investment decisions. Besides, high inflation could result in reduced public trust in financial institutions leading to possible default.

The ability of the central bank to independently pursue sustainable exchange rate and monetary policies to maintain low inflation is critical to providing greater monetary stability vis-à-vis central banks which are highly dependent on government's whims and fancies. Ability to use monetary policy to achieve desired ends like increasing/decreasing liquidity in the market, increasing/decreasing interest rates provide the central bank with effective tools to move the economy in a given direction.

Towards this end, the development of capital market and capital market instruments, liquidity in the bond and foreign exchange markets, etc facilitates the achievement of monetary policy objectives. Developed capital markets, with the presence of a diversified set of investors like mutual funds, pension funds, local and foreign banks, create significant disincentive for a government to default locally on account of its widespread implications for a larger cross section of the population.

Balance of payments and external liquidity

Balance of payments analysis focuses on the impact of economic policy upon the external sector, as well as the external sector's structural characteristics. The position of the current account reflects the relative competitive position of exports vis-à-vis imports. It also reflects the relative savings / investment position of the country and signals the need for external funds to fund these deficits. While the presence of high import barriers and export subsidies would promote improved BOP in the short run, it can result in a significant increase in the deficits over the long term due to diminishing competitiveness of local products relative to foreign imports.

Current account deficits arising out of fiscal mismanagement leading to public sector dissavings would necessarily imply increased foreign indebtedness to fund consumption expenditure. By comparison, current account deficits arising out of significant investment expenditure could provide long terms benefits which would repay the presently increasing indebtedness.

Capital account movements are also an indicator of the shortfalls on the current account. Investor sentiment and interest in a country drive capital inflows, which is a double-edged sword, as capital outflows can dry up with a change in sentiment. Further current account deficits funded substantially by debt (and worse short term debt) substantially increases the debt vulnerability of the country.

Ideally, foreign direct investment in long gestation projects, long-term debt, concessional long term financing would be preferred sources on the capital account. External liquidity is critical since it drives the ability of a government to repay its debts. Countries could be solvent, but because of low liquidity and low reserves, could default on their debt obligations. An analysis of the reserves vis-à-vis exports and imports, and debt repayments provides insights on the overall liquidity position of the country.

Further, the external indebtedness of the country vis-à-vis the reserves also provide insights into the relative debt protection provided to the country by its reserves.

Political Risk

This is perhaps the most important parameter in the analysis as it is a key determinant of all other parameters directly or indirectly. The political environment has a profound impact on every aspect of a sovereign's operations and consequently its credit quality.

The stability, predictability and transparency of a country's political institutions are important to evaluate the process of economic policy making and its impact on sovereign creditworthiness. Continuity of policies, and a general consensus on the direction of economic decision making across political parties provides direction to an economy and ensures consistency of decision making over time. The nature of politics in a country and the degree of social cohesiveness are important indicators of the "political process" and the acceptability of decisions by the populace. Intra country tension are areas of concern which could impede the process of economic policy making and impact the quality of economic decisions taken by the political leadership. National security concerns may reduce the inflow of potential investment and put the balance of payments under stress.