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Downgrading Japan
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The bond rating agencies are yet again considering a move to downgrade Japanese sovereign debt. It is no secret that the Japanese economy remains moribund, facing its third recession in a decade and with rising unemployment, price deflation, and persistently stagnant growth. And in spite of near-zero interest rates, large fiscal deficits, and a series of economic reforms, the prospects for recovery remain dim. However, anyone who understands the nature of sovereign debt knows that none of these factors should play any role in assessment of default risk on local currency denominated sovereign debt of any nation with a floating exchange rate.

Moody's Investors Service last downgraded Japan's yen-denominated bond rating to Aa3 from Aa2 in December, 2001. At the time, the rating agency justified its move on the basis of "fiscal strains that will likely persist owing to the country's on-going economic weakness and the elusiveness of effective policy remedies." It also hinted that if the country's economic outlook remained negative, it would consider further downgrading-which it now seems to be prepared to undertake.

What is the logic used in downgrading sovereign debt? As a report from Mizuho Securities says, "Moody's and other prominent foreign credit agencies have used historical default ratings for corporate entities.... On the other hand, regarding sovereigns (particularly highly rated OECD countries) there is a lack of data which would provide a statistically (sic) explanation as it does for the corporate sector." (www.mizuho-sc.com /english/ebond/reports/mi010910.html) John A. Bohn, president of Moody's, explained that a "rating is at bottom an opinion. At Moody's Investors service.... This opinion is defined as the future ability and legal obligation of an issuer of debt to make timely payments of principal and interest on a specific fixed-income security. Our rating measures the probability that the issuer will default on the security over its life...." (Bohn 1995, www.cipe.org/ert/e15/across.php3) He went on to argue that the likelihood of default for an Aa2-rated debt should be the same across issuers, without regard to "a borrower's country, industry, or type of fixed-income obligation". Hence, it is clear that the primary consideration used in determining whether to downgrade sovereign debt-or any other debt--must be an assessment that risk of default has increased. And Japan's default risk has supposedly risen because its persistent government deficit has increased "fiscal strains" by raising debt-to-GDP ratios.

However, a sovereign nation that issues government debt denominated in the home currency will never experience difficulty in "making timely payments" so long as it lets its currency float. All such sovereign nations spend by crediting banking system reserves. Hence, the large Japanese fiscal deficits resulting from government purchases and interest payments lead to large reserve credits for the banking system. If nothing further were done, these credits would just sit in the banking system as excess reserve holdings. However, most of the created excess reserves are actually drained from the banking system through treasury sales of new JGBs. The result of such sales is to provide banks with an interest-earning alternative to non-interest-earning bank reserves. (It is telling that in spite of the largest budget deficits among OECD nations, Japan's overnight interest rate is the lowest. It accomplishes this by leaving some excess reserves in the banking system.) The government could at any time stop issuing new sovereign debt and simply leave more excess reserves in the system. This would also reduce the government's net interest payments. Given the state of the Japanese economy and the lack of safe domestic assets that earn a positive return, such a policy would likely depress growth further. Nor is it likely that the government would ever need to pursue such a policy, for the banking system would almost assuredly prefer earning assets over non-earning excess reserves. But in any case, the government will always be able to pay interest (and roll-over principal) simply by crediting bank reserves.

Note that one can think of sovereign debt as nothing more complicated than reserves that pay interest. In all modern nations that operate with a domestic currency and a floating exchange rate, governments spend by issuing reserves without promising to convert those reserves to anything. This is quite different from a nation that operates on a gold standard, with a currency board, or on a fixed exchange rate, in which case the government essentially promises to exchange reserves for gold or a foreign currency at a fixed exchange rate. Such a nation faces the possibility that it will run out of the required gold or foreign currency reserves-in which case it will be forced to default on its promise to convert. However, countries like the US or Japan do not promise to convert reserves of dollars or yen (respectively) to anything at a fixed exchange rate. Hence, there is no possibility of default on reserves. And because sovereign debt issued by a US or a Japan is really nothing more than reserves that pay interest, there is no greater possibility of default on sovereign debt than on reserves. It makes as much sense to rate Japanese government home currency debt as it would to rate the Bank of Japan reserves held by the Japanese banking system. Indeed, could one imagine that a ratings agency would downgrade Japan's banking system reserves if the BOJ decided to pay interest on excess reserve holdings? Yet, such a policy would eliminate the Treasury's need to issue JGBs to soak up excess reserve holdings.

This should make it clear that Japan's "deteriorating" fiscal deficit and rising government debt ratios are not relevant to the probability of involuntary default. Unlike a corporation, which must (eventually) obtain revenues to service its debt, the issuer of a currency does not need revenue to credit interest or roll-over principal. The Japanese government will be able to service its debt regardless of fiscal deficits or debt ratios. Note that by this we do not mean to imply that a sovereign nation should run large deficits in all circumstances, nor do we deny that there might be negative consequences of large fiscal deficits (such as inflation, although that is highly unlikely for Japan in the foreseeable future). What we do deny, however, is that ability to service debt is in any way compromised by the size or persistence of Japanese government deficits. According to Moody's own reports, it uses assessments of "future ability and legal obligation" to make payments when it decides to downgrade sovereign debt. By this standard, credit agencies have already erred in downgrading Japan's debt in the past, and there is no reason for further downgrades.

Finally, it should be clear that this analysis does not apply to private sector debt; the ratings agencies have accumulated an immense amount of data on private defaults and we do not question their logic in rating nonsovereign debt. In addition, there is no doubt that foreign holders of Japanese sovereign debt face currency risk, and it is possible that fiscal deficits might be related in some complicated way to currency values. However, by their own admission, the ratings agencies are rating default risk, not currency risk. Fluctuation of the foreign exchange value of the yen cannot affect default risk on home currency denominated sovereign debt. Thus, currency risk should be included in assessments only of foreign currency denominated sovereign debt-such as dollar denominated Argentinian sovereign debt. Finally, one might distinguish between ability to pay and willingness to pay. It is conceivable that a sovereign issuer that has the ability to service its debt might instead choose to default-perhaps for political reasons-as Russia did. We believe it is inconceivable that any major OECD nation would voluntarily choose to default on sovereign debt. If Moody's and other rating agencies believe that Japan has become more likely to voluntarily default on home currency sovereign debt, they should present some argument in justification for this belief.

In conclusion, we believe that ratings agencies have seriously erred in their assessment of home currency denominated debt issued by sovereign governments that operate with floating exchange rates. All such debt should receive the highest rating, if the ratings agencies follow their own guidelines for generating ratings, for the simple reason that involuntary default is not possible. We urge ratings agencies to be consistent in applying their ratings criteria for sovereign debt denominated in domestic currency. ◆

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