RATING THE STATES: CREDIT RATING AGENCIES AND THE AUSTRALIAN STATE GOVERNMENTS[1]

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Two major Credit Rating Agencies (CRAs) operate in Australia - Moody's Investor Services, and Standard and Poor's (formerly Australian Ratings). They offer credit risk assessments of public and private organisations seeking to borrow funds on the capital markets. Their tasks are seemingly dry, technical and financial in nature, far removed from the political process. Yet in recent years the CRAs have come to enjoy a high political profile. In part this is because they rate the credit worthiness of governments, a task which by its very nature is going to have a political impact. But it is also because the CRAs have begun to offer views on topics which could reasonably be seen to be beyond their financial realm. In recent months, the CRAs have offered a view on whether Sydney can afford to have the Olympic Games (*The Australian Financial Review*, 12 November, 1993); praised the Kennett Government for its public sector austerity program (*The Australian Financial Review*, 15 November, 1993); supported the Fahey government's decision to sell the NSW State Bank (*Sydney Morning Herald*, 3 September, 1993); and even offered views on whether the Australian Senate should delay passing the Federal budget (*The Age*, 25

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October, 1993). Similar tendencies are also evident in New Zealand. During the run up to the close general election in 1993, one CRA implied mid-campaign that, should the Bolger government be re-elected, a credit rating upgrade was all but assured *(The Australian Financial Review*, 8 October, 1993). Another CRA has been publicly warning that, by proceeding with its electoral system reforms, decided by a national referendum, the New Zealand Government could expect its credit rating to be downgraded *(The Australian Financial Review*, 23 February, 1994).

One intriguing aspect is the strong criticisms recently levelled at the CRAs, even from those who might normally be expected to be supportive, or who have previously explicitly backed the CRA rating process as desirable and useful. For example, the Victorian Treasurer, Alan Stockdale was a strong supporter of the CRAs up until August 1993. Stockdale regularly used the CRA downgradings of Victoria during the early 1990s to lambaste the previous Labor administration, and has on many occasions used the CRA reviews to justify his own tough budget strategy. Then, mid-way through 1993, in one of the most remarkable backflips in contemporary Victorian politics he became one of the CRAs harshest critics. The Melbourne *Age* reported the Treasurer's change of views in the following way:

> The major credit rating agencies' rating of different states has 'gone mad' according to the state Treasurer, Mr Stockdale...(Mr Stockdale) argued that differences between states' finances had 'virtually zero impact' on their credit risk because the Commonwealth would not let a state default on a major financial obligation...Mr Stockdale defended the Government against claims that it should slash debt faster through major privatisations...Mr Stockdale wants to convince the ratings agencies that they should focus less on quick reductions in Victoria's ...debt, and less too on differences between states (*The Age*, 16 August, 1993: 25).

How and why have the CRAs become such powerful players in Australia's political economy? This article explores this issue by focussing on the relationships between the credit rating agencies and Australian State governments in recent years. In the process, we also want to offer an explanation as to why former CRA defenders and advocates have become such harsh critics. First, we plot the rise of the CRAs in Australia. We demonstrate the prominent role they now play in Australian State politics. Next, we take a critical look at the criteria the CRAs use to rate Australian governments. We argue that these criteria are rubbery and inappropriate, and that they are applied by the CRAs in an inconsistent way. Finally, we offer an explanation as to why the CRAs have become so influential despite the dubious nature of the credit rating process.

A Potted History of the CRAs.

The rise of the CRAs in Australia's political economy must be placed in the context of global financial deregulation, the explosive growth of international capital markets, and the increasingly speculative nature of capital flows. Between 1980 and 1991 the stock of international bank lending increased from US$324b to US$7.5 trillion, and the total value of international bonds outstanding increased from US$259b to $1.65 trillion. These rates of growth far outstrip global economic growth during this time period (c/f *The Economist*, September, 19th, 1992). It was during these growth years that the CRAs came to assume a much higher public profile in business circles, for their seal of approval (in the form of a AAA credit rating) became crucial for Australian private and public enterprises seeking access to rapidly growing finance markets such as the Eurocommercial paper market (Juttner, 1992: 123-124). Their views were and continue to be eagerly sought. They were also expensive. Cohen (1988) estimates that a rating in the late 1980s cost approximately US$40,000, and a re-rating US$25,000.

It was in the climate of this internationalisation and rapid growth of finance markets that the CRAs came to establish themselves in Australia in the early 1980s. This was a time when Australian businesses were seeking out alternative and diverse sources of debt funding following financial deregulation. It was also a time when a range of new financial investment opportunities were made available to local and international investors. The CRAs provided information that was of use both to borrowers and lenders. Borrowers could solicit reviews of their company from a CRA, and then use their rating as a way of attaining credibility in the finance markets. Lenders could buy information from the CRA about the riskiness of potential investment outlets.

In these early years, Australian Ratings, at this stage wholly Australian owned, concentrated on reviews of private and public organisations for subscribing investors. Competing with Australian Ratings was the Australian branch of Moody's Investors Service, a New York based subsidiary of the giant Dun and Bradstreet Corporation. Moody's initially focused on reviewing particular debt issues by companies seeking to raise finance through the Euro markets. Australian Ratings sought to make profits from subscriptions; Moody's either through fees from companies raising debt capital or from fees paid by potential investors in new debt issues (Hutchinson, 1992: 17; Anderson, 1992).

During the second half of the 1980s, the CRAs began to turn their attention toward public debt. In 1986 they reduced the credit rating of Australian government overseas debt for the first time ever. They also began to focus more closely on domestic debt markets, with Moody's turning away from its European focus, and beginning to do work on local debt issues. In this way the two credit rating companies first entered into full scale competition with one another locally (Hutchinson, 1992: 17; Anderson, 1992).

During the early 1990s, Australian Ratings[2] was acquired by the giant US ratings agency, Standard and Poor's, itself a subsidiary of McGraw-Hill and the AM Best Insurance Rating Company. The CRAs began to engage in a highly publicised battle for market share. During this time, while still getting most of their business from private debt issues, the CRAs shifted attention away from the Commonwealth government and focused instead on the States (Anderson, 1990a; 1990b; 1992; Toohey, 1992). In June 1990, the CRAs first began to differentiate State government credit ratings when they stripped Victoria of its AAA rating. In February 1991 South Australia was also stripped of its AAA rating, as was Western Australia in December 1991. In April 1992, South Australia's rating was again reduced. In October 1992 Victoria was the first State to be given a double notch reduction in the one month, although in late 1993 and early 1994 it was the first State to receive a credit rating upgrade.

2 In the initial years following the takeover, the name of Australian Ratings was changed to Australian Ratings/Standard and Poor's. Now that the takeover has been bedded down, the company is now simply called Standard and Poor's. In the remainder of this paper, this is the name that we use.

Australian State governments have increasingly looked to the CRAs for AAA ratings, have worked hard at retaining or regaining this status, and frequently make mention of CRA assessments to legitimise austere budgets. Three examples show how deeply the CRAs have become embedded in State politics. In 1991 the Greiner government admitted that the threat of an imminent credit downgrading had prompted it to issue an urgent mini-budget statement promising public sector job cuts of 12,500 and spending cuts of $6.2 billion over three years (*The Australian Financial Review*, 3 July, 1991: 5; Anderson, 1990; 1992; Greiner, 1993). In Victoria in 1992, the Kennett government, at a cost of $2 million, set up a Commission of Audit to examine the State's finances and, among other matters, "make recommendations as to a course of action...to secure restoration of Victoria's AAA credit rating" (Victorian Commission of Audit, 1993: 212). The Audit Commission recommended that spending cuts of $1 billion would be necessary "to ensure an eventual upgrading to AAA within ten years" (Victorian Commission of Audit, 1993: 140). In February 1993 the Court Government announced a similar Commission of Audit into Western Australian government finances. It too recommended a sweeping austerity package, in the process commenting that, "It has been universally recognised that the State's minimum performance requirements should have the objective of regaining a AAA domestic rating" (Independent Commission to Review Public Sector Finances 1993: 102; see also South Australian Commission of Audit, 1994, Vol 2: 20).

The high profile of the CRAs at the State level has a political dimension. Politicians have readily used the credit rating process either as a way of justifying austerity measures (as is the case in Victoria) or as a way of shoring up voter support, as is the case with phrases such as, "New South Wales - the AAA State" (Greiner, 1993). But the State governments are also keeping an eye on their credit ratings for financial reasons. Ratings and re-ratings influence debt financing costs. Lower rated States pay a higher interest rate on debt issues than do more highly rated States. One notch differences in ratings translate into additional interest costs of approximately 0.2 percentage points. Prior to its initial credit rating down grade in 1990, interest rates on Victorian government 10 year bonds were approximately 0.1 of a percentage point higher than New South Wales' 10 year bonds. After the downgrade, this difference has consistently been over 0.4 of one percentage point. As a result of Moody's double notch reduction of Victoria's rating in October 1992, this difference widened from 0.6 of a percentage point to over 0.8, although it subsequently has fallen again to approximately 0.2 by April 1994 (Independent Review of Victoria's Public Sector Finances, 1992: 96; Victorian Commission of Audit, Volume 1, 1993: 44ff; Victorian Government, 1994: 6-17ff).

The cost of such interest differentials to a State budget is difficult to measure. This is because the costs vary according to the size of the Government's borrowing program, the duration of its debt issues, and the nature of its refinancing strategy. Using a variety of assumptions about South Australia's debt profile, the South Australian Commission of Audit (1994, Volume 2: 18) estimated the cumulative additional cost to the South Australian government from its credit rating downgrades in 1991 and 1992 at "$1.5 million after 1 year, $9 million after 4 years and $21.5 million after 8 years". It also estimated that, "the potential benefit to the State from a single notch upgrade...is $0.75 million after year 1, $4.5 million after 4 years and $10.75 million after 8 years".

How Do the CRA Ratings Rate Governments?

The credit rating process involves each CRA evaluating government financial performances against a set of criteria. While Moody's only make their criteria available to investors who are prepared to pay the going market price (Anderson, 1992), Standard and Poor's are more open. The key factors they take into account are the "willingness and capacity (of the State governments) to make timely payment of interest and repayment of principal in accordance with the terms of its debt obligations" (Standard and Poor's, 1993: 5).

How these principles are operationalised is instructive. In their February 1993 *Monthly Review of the States*, Standard and Poor's provide details of their methodology and explain why they use particular financial and economic indicators in their assessments. They point out that they try to take account of fluctuations in the economic cycle, which have an impact on short and medium budgetary positions. They also consider budget forecasts and the success with which governments have met their targets in the past; and they emphasise the importance of State economies in affecting budgetary fortunes. "Fiscal flexibility" is another factor taken into account. This is defined loosely to include political factors which might inhibit a government from implementing austerity measures. The key financial indicators they use to assess the State's credit worthiness focus on indebtedness (net debt to revenue ratios), interest burdens (net interest payments as a percentage of operating revenues), and operating surplus (excess of current revenues over current expenditures). Table 1 summarises Standard and Poor's key credit rating indicators for each State government for 1991/2.

These indicators of credit worthiness are tabulated and summarised so that a credit rating can then be applied to each State. The ratings range from AAA, which indicates a strong capacity to repay debt, down to D, which indicates default. Each of these grades can also be qualified by the attachment of a "+" or "-" sign. Credit watch and Rating Outook indicators can also be used by Standard and Poor's to further distinguish between governments on the basis of medium to long term developments or imminent events which can affect government finances. Table 2 summarises Standard and Poor's credit rating definitions.

The actual definitions given of each rating grade are not clear. AAA rated entities are said to have an "extremely strong" capacity to repay debt, while AA rated agencies are meant to have "a very strong" repayment capacity. What this means in practice is not spelt out. Even more perplexing is the significance of a plus or minus sign, and what the difference is between an entity with, say, a AA+ rating and one with only a AA rating, or one with a AA rating and one with a AA rating but which has been put on a negative credit watch.

The Ratings

This distinct lack of clarity in what the ratings mean has not prevented the CRAs from regularly rating and re-rating Australian governments, nor many commentators from accepting these decisions uncritically. Table 3 shows the actual long term credit ratings of each State government and the Commonwealth government in December 1992. The credit ratings are split into two categories: domestic ratings (for debt issued locally), and foreign ratings (for debt issued in foreign currency). The CRAs distinguish between these two types of debt issues to take account of the additional risks to foreign investors arising from currency movements. For the States, local ratings are the focus of interest; for the Commonwealth it is the foreign ratings which figure prominently in press coverage.

Table 1: Standard and Poor's Key Credit Risk Indicators for the Australian State Governments, 1991/2

Indicator	NSW	Vic	Qld	WA	SA	TAS	6 States
Net Debt ($b)	$22.9	$32.5	$8.8	$9.2	$8.6	$3.5	$85.6
Payback period (years) (a)	7	>40	3	9	22	14	10
Net interest paid ($m)	$2231	$3518	$529	$907	$869	$377	$8431
Adjusted operating surplus ($m) (b)	$2280	-$570	$2518	$595	$145	$110	$5078
Adjusted net budget deficit ($m) (c)	$343	$1992	-$673	$60	$360	$15	$2097
Internal financing ratio (%) (d)	63.1	14.3	120.9	76.1	38	73	65

Notes: (a) Net debt expressed as a multiple of a State government's estimated funds flow from operations.
(b) The excess of a State government's operating revenues over its operating expenditures, excluding abnormal transactions
(c) Budgetary expenditures less budgetary revenues, excluding abnormal operating and capital transactions
(d) The percentage of a State government's capital expenditures financed by its estimated funds flow from operations.

Source: Standard and Poor's *Monthly Ratings Bulletin*, February. Table 3.

Table 2: Standard and Poor's Definition of Its Long Term Credit Ratings

AAA	Extremely strong capacity to pay interest and repay principal in a timely manner.
AA	A very strong capacity to pay interest and repay principal in a timely manner an differ from the highest rated entities only in small degree.
BBB	A satisfactory or adequate capacity to pay interest and repay principal in a timel manner. Protection levels are more likely to be weakened by adverse changes i circumstances and economic conditions than for borrowers in higher ratin categories.
BB	Ongoing uncertainties or exponsure to adverse business, financial, or econom conditions which could lead to a less adequate capacity to meet timely debt servic commitments.
B	More vulnerable to adverse business, financial or economic conditions than entiti in higher rating categories. This vulnerability is likely to impair the borrower capacity or willingness to meet timely debt service commitments.
CCC	A currently identifiable vulnerability to default and dependent upon favourat business, financial and economic conditions to meet timely debt servi commitments. In the event of adverse business, financial or economic conditio they are not likely to have the capacity to pay interest and repay principal.
CC	Debt subordinated to senior debt that is assigned an actual or impleid CCC rating.
C	A high risk of default or are reliant on arrangments with third parties to prev defaults.
D	In default. The rating is assigned when interest payments or pincipal payments not made on the due date, even if the applicable grace period has not expired. T D rating is also used upon the filing of an insolvency petition or a request to appc a receiver if debt service payments are jeopardized.
Plus (+) Minus (-)	The ratings from AA to CCC may be modified by the addition of a plus or mi sign to show relative standing within the major rating categories.
Credit-Watch	An emerging situation which may materially affect the profile fof a ra corporation and can be designated as positive, developing or negative.
Rating Outlook	Assesses the potential direction of an issuer's long-term debt rating over intermediate term..."Positive" indicates that a rating may be raised; "negati means a rating may be lowered; "Stable" indicates that ratings are not likel change; and "developing" means ratings may be raised or lowered.

Source: Standard and Poor's *Monthly Ratings Bulletin*, February.

Table 3 shows that domestic bond issues by the Commonwealth government enjoy a top rating from both agencies. Only for foreign borrowings does the Commonwealth receive a less than perfect score. All of the States enjoy the same foreign rating as the Commonwealth, except Victoria which receives a lower rating from Moody's. There does, however, appear to be considerable variation in the local ratings received by each State. New South Wales and Queensland appear to be the most credit worthy governments, whereas South Australia, Tasmania and Victoria are the least credit worthy. Wedged in the middle is Western Australia. The Table highlights an interesting difference of view between the CRAs: Moody's rates Victoria as less credit worthy than Tasmania and South Australia, whereas Standard and Poor's put Tasmania at the bottom of the scale and Victoria on a par with South Australia.

Table 3: Credit Ratings of Australian Governments, December, 1992

	Moody's Rating		S&P Rating	
	Local	Foreign	Local	Foreign
New South Wales	Aaa	Aa2	AAA	AA
Queensland	Aaa	Aa2	AAA	AA
WEstern Australia	Aa1	Aa2	AA+	AA
South Australia	Aa2	Aa2	AA	AA
Victoria	A1	Aa3	AA	AA
Tasmania	Aa2	Aa2	AA-	AA
Commonwealth	Aaa	Aa2	AAA	AA

Source: *Australian Financial Review*, December 11, 1992: 30.
Note that Victoria's rating was upgraded by Moody's one notch to Aa3 in Juanuary 1994.

There are some other intriguing ambiguities and inconsistencies in the relative rankings. According to Standard and Poor's, all the States and the Commonwealth enjoy an identical foreign currency rating (in Standard and Poor's case, AA), implying that all these governments represent an identical credit risk. Moody's take a similar view, although Victoria is singled out as being one notch lower than all the other governments. In their local ratings the CRAs reach a different conclusion, with only Queensland and New South Wales receiving a AAA rating. Victoria and Tasmania languish several notches lower on the rating scale. According to Standard and Poor's, Tasmania's credit risk is equal best when it comes to bonds issued in foreign currency, yet the worst when it comes to local bond issues. According to Moody's, Victoria is much less credit worthy than the other states when it comes to domestic bond issues, but only slightly less of a credit risk when it comes to overseas bond issues.

This raises the question of the relationship between the local and foreign ratings and the degree to which they are comparable. Does the Commonwealth's AA foreign currency rating imply that it is less credit worthy than those State's which enjoy a AAA domestic rating? On the face of it, foreign and local ratings should not be comparable. This is because the first takes account of currency fluctuations, and the second does not. It follows that the Commonwealth's AA foreign currency rating should not be compared with the AAA local rating enjoyed by New South Wales and Queensland. However, this view is not apparently shared by the CRAs themselves. In defending his company's recent decision to up-grade Victoria's local credit rating to Aa3, the new Managing Director of Moody's Australia, Mr Thomas Marshella, was quoted by the press as saying:

> It (Victoria's rating) is still very high in relation to all the other States, only two notches separate the top-rated States from the bottom..*Even at the old A1 rating, Victoria was rated higher than many sovereigns such as Korea, which is a very strong economy* (*The Australian Financial Review*, 2 March, 1994: 4. Our emphasis).

Ratings given to sovereign governments in foreign currency and ratings given to regional governments in local currency are, it seems, comparable. According to Mr Marshella's reasoning it is possible to interpret his company's ratings as suggesting that the Commonwealth's ability to repay its debts is below that of Queensland, New South Wales and Western Australia, and only on a par with South Australia. Such a view would be difficult to defend on any reasonable financial criteria.

How Adequate are the Criteria?

These inconsistencies draw attention to the adequacy of the criteria used by the CRAs to rate governments. Underpinning these criteria and the indicators used to operationalise them is the assumption that governments can be treated like businesses - indeed Standard and Poor's admit that the measures they adopt are versions of similar measures they apply to private companies. There are many conceptual problems with this assumption, problems which have been documented by a number of commentators (Heilbroner and Bernstein, 1989: Chapter 5; Evatt Research Centre, 1989). Governments are not like businesses. Unlike the latter, governments have access to a steady stream of income (in the form of taxation), which they can increase or decrease by fiat should the need arise; unlike businesses, governments need never repay their debts (they can simply refinance the debt through another bond issue). Whereas businesses always owe borrowed funds to an economic agent that is legally and financially independent of them, in the case of governments debts are owed to citizens (assuming, as is the case in Australia, that most of the debt is issued locally) whose interest receipts are subject to taxation, and whose economic fortunes are affected by the economic and social policies financed by the funds they have lent. Most importantly of all, while it makes sense to talk about an operating surplus when it comes to business, the opposite is true when it comes to governments; their task is to provide goods and services which the private market will undersupply due to market failures, and whose overall financial situation must be located within the context of cycles in economic activity. During recessions government finances can be expected to decline, and during upturns they can be expected to improve. What appears from the point of view of the CRAs as an 'operating deficit' during a slump that warrants a credit downgrade, is better viewed as a 'Keynesian' counter-cyclical boost, which helps prevent private sector activity from declining even further.

Some of these problems could be addressed by using different criteria to assess credit worthiness. Government bonds are effectively a certificate which entitle the holders of bonds to a share in a government's tax revenues. What is important is not the level of debt, but the durability of

the income tax stream, and whether this revenue can be increased should the need arise. A more appropriate measure of credit worthiness than debt levels and interest costs would be the income levels of tax payers, existing government spending and revenue commitments, and whether tax payers would be able to afford higher taxes. In the context of the States, revenues and outlays as a percentage of Gross State Product (GSP), and levels of economic growth and incomes would be very useful measures of credit worthiness.

Table 4: Credit Rating and Various Fiscal Indicators, Australian States and the Commonwealth Government (General Government Sector).

	GSP Growth 1981/2-1991/2[1]	GSP per capita Growth 1981/2-1991/2[2]	GSP per capita 1992/3[2]	Outlays/GSP (average for three years to 1991/2)[3]	State taxes/GSP (average for three years to 1991/2)[3]	Moody's Rating[4] December 1992	S&P Rating[4] December, 1992
NSW	19%	6%	$23,044	15.1%	6.4%	Aaa	AAA
Q'land	31%	5%	$20,922	15.0%	5.0%	Aaa	AAA
WA	53%	23%	$24,992	15.6%	5.0%	Aa1	AA+
SA	28%	17%	$21,005	19%	5.4%	Aa2	AA
Victoria	21%	9%	$23,703	13.4%	5.7%	A1	AA
Tasmania	18%	8%	$18,276	22.9%	6.3%	Aa2	AA-
Australia	26%	6.1%	$22,857				

Notes and sources: [1] Australian Bureau of Statistics, *Australian National Accounts, State Accounts*, Cat. No. 5220.0
[2] Australian Bureau of Statistics, *Australian National Accounts, State Accounts*. Cat. No. 5220.0
[3] Victorian Commission of Audit (1993), *Report of the Commission of Audit, Volume 1*. Tables 3.2 and 3.4.
[4] *Australian Financial Review*, December 11, 1992: 30. Note that Moody's upgraded Victoria's rating one notch to Aa3 in January 1994.

Table 4 provides these data for each State in 1991/2 as well as the actual long term local credit rating given by each CRA. When these indicators are compared with the credit ratings, it is clear that some States have been treated harshly, while others seem to have been treated generously. Victoria seems to have been harshly treated by Moody's in particular.

Victoria's GSP per person is second only to Western Australia, its public sector outlays are the lowest of all the States, and its tax revenues are significantly below that of New South Wales. Both CRAs also seem to have treated Western Australia harshly. Its gross state product per head is above the national average and its economic performance during the last decade has been outstanding, yet it enjoys only a middle credit worthiness ranking. New South Wales, on the other hand, seems to have been treated quite generously. Its economic performance during the last decade has been relatively poor, its taxes are high, yet it enjoys a AAA rating.

Political Values and CRAs.

Although the CRAs try to defend their ratings by trotting out the variety of statistical indicators mentioned above, in practice their analyses are value laden. These values seem to have a strong political bent to them, which operate against interventionist, social democratic principles. The clearest example of this is Moody's decision to down-grade Victoria's rating just after the October 1992 State election and before the first, very tough Economic Statement on October 26. Moody's decision was rare: it involved a very unusual two notch reduction, which created an unprecedented degree of spread between the credit ratings of Australian States (*Australian Financial Review*, 26 October, 92). It also helped to generate an impression of a debt crisis, which the newly elected Kennett government used to great political effect (Hayward, 1993). Consider, for example, the following statement by the Victorian Treasurer, Alan Stockdale, shortly after the Moody's decision and immediately prior to the Economic Statement:

> The budget situation we have discovered since the election is beyond our worst fears in opposition... Last week, Moody's downgrading of Victoria two rungs on the credit rating ladder graphically illustrated the consequence of excessive debt...There is no alternative to fundamental reform of the Victorian public sector...Victoria is facing a financial crisis because of Labor's mismanagement and incompetence (quoted in *The Age*, 28 October: 15).

It does not take too much imagination to interpret Moody's decision as an overtly political one which helped the incoming State government to get public support for its extraordinarily tough budget strategy. Davidson (1992) has pointed out the apparently cosy relationship between Messrs Stockale, Kennett and the CRAs before the State election, suggesting that they may have encouraged a down-grading for political reasons.

Nor did the CRAs' questionable intervention in Victorian politics end here. In its subsequent Autumn Economic Statement in 1993, the Kennett government announced another round of severe cuts to public expenditure, which were to be bedded down over the following Christmas break. During the summer months, some $730m was trimmed from a range of public sector functions, including education, health and community services. Just at the point in the political cycle where these cuts might have been expected to be subjected to strong community opposition, first Standard and Poor's (in November) and then Moody's (January) announced credit rating upgrades. The Victorian Premier, Mr Kennett, greeted these announcements in a rather revealing way, commenting that they were,

> the single most important endorsement to date of the Government's financial management...*(Australian Financial Review*, 15 November, 1993: 1).

The problematic nature of the CRA assessments is made clear when consideration is given to some of the statements made by senior CRA executives when commenting on recently revised ratings. For example, after down-grading the Victorian Government's credit rating for the first time in 1990, a Moody's official was quoted in *The Age* (21 June, 1990: 1) as citing "factional problems" within the ALP as a key reason for the down-grading. Equally revealing is the recent comment by Standard and Poor's that it chose not to down-grade Victoria's credit rating in the way Moody's had recently done because, following the election of the Kennett Government, Victoria now has a government in place "which is ideologically committed to downsizing the government..." (Standard and Poor's, 1993: 12).

Also of concern is the recent statement by a senior Moody's executive about the link between a government's rating and its social policy. The executive in question, Assistant Vice-President of the Sovereign Risk Unit, Stephen Taran, commented that,

> We are not in the game of giving approval to one or another approach to economic management or type of political system. It may not be worth it to a government to have a Triple-A if it means abrogating certain social objectives that it wants to achieve... (quoted in the *Australian Financial Review*, 12 February, 1992).

Or as Kenneth Wiltshire has recently pointed out,

> [The States] are starting to realise that if they want five-star ratings from Moody's, the pressure will be on to cut social expenditure and move resources to the economic side of the budget because Moody's weights its analysis by classifying social infrastructure as non-revenue earning and, therefore, non-productive (quoted in Anderson, 1990b).

Governments, it seems, must choose between a Triple-A or an elaborate welfare state, but they can't have both.

Should the States be Rated?

The problem with the CRA ratings of the Australian governments goes deeper than the criteria the CRAs use, and the way they apply them. Underpinning the rating process is the assumption that it is possible that Australian governments either individually or collectively can go broke, or experience a serious debt crisis which makes it difficult or impossible for them to repay their debts. Yet there is no realistic prospect of any Australian State government or the Commonwealth experiencing a debt crisis, as is readily acknowledged by those who might be expected to be strong supporters of the CRAs. In answering the rhetorical question of what represents a debt crisis in relation to the States, prominent right wing economists Des Moore and Michael Porter (1992) comment that,

> At one end of the spectrum the most obvious answer is that a debt problem exists when there is an incapacity to service and/or repay outstanding borrowings; a "problem" of that order would, however, be not a problem, but a crisis. In the case of a State Government *it is most unlikely that such a situation would ever arise...*, given the assets held and the power to tax (our emphasis) (1991: 6-2).

Moreover, in attempting to give each State as well as the Commonwealth separate ratings, the CRAs imply that each Australian Government exists independently of the other financially. The high degree of vertical fiscal imbalance that exists in Australia means that the States are dependent on the Commonwealth for 40% of their revenues (no other federation sees the States so financially dependent on central government) (Walsh, 1992). Moreover, the Commonwealth enjoys considerable control over the total fiscal position of each State government by virtue of both the Premiers Conference (which deals with the size and distribution of financial assistance to the States), the Loan Council (which controls all public sector borrowings), and, more recently, through the preparation of an annual National Fiscal Outlook (in which the States basically need Commonwealth approval for their medium term budgetary strategies). In such a tightly bound fiscal context, it seems completely misplaced to even attempt to give each government a separate rating.

Standard and Poor's seem well aware of the criticisms raised here. They readily acknowledge that governments are not like businesses, noting that "a Government's unique ability to appropriate the wealth of individuals and businesses through taxation and regulation confers greater financial flexibility on governments than generally (sic) available to individuals and corporations" (1993: 7). They also acknowledge the severe conceptual difficulties in trying to apply the private sector concept of net worth to governments because of "imponderable asset valuation issues... (associated with) government owned land and mineral rights, the present value of future planned tax revenues, and...future entitlement programs" (1993: 8). They claim to recognise the important counter cyclical role that governments perform, and the way that revenues and outlays can oscillate during the course of the economic cycle. They warn against taking a short term view of government finances, and imply that there is a need to distinguish between cyclical deficits (those caused by recessions) and structural ones (those caused by policy decisions) (1993: 6). They also recognise the financial interdependencies between the Commonwealth and the States, and the impact of these interdependencies in providing a floor under State finances (see the Victorian Commission of Audit, 1993: 134).

But having make all these points, they then proceed to undertake their credit rating reviews as if they were irrelevant.

An Explanation.

As noted earlier, the rise of the CRAs must be placed in the context of global financial growth during the 1980s which facilitated their entry into the Australian markets. Not until the late 1980s did they turn their attention to public debt, and not until the 1990s did they begin to focus on the States. The CRAs have subsequently become very influential players in State politics, with their reviews of State finances receiving prominent coverage in the daily press, and being used to justify harsh budgetary measures. What is yet to be explained is how and why the CRAs have been able to turn their attention on the States and why they have done so with such enthusiasm.

Three factors have played a part. First are important institutional changes that have taken place within Australian public sector debt markets on both the demand and supply sides. On the supply side, the State governments now preside over approximately $100b of debt, which must be managed and refinanced on an on-going basis. In recognition of this, the States have over the last decade all established centralised authorities responsible for debt management across the public sector. These debt management authorities have considerable financial clout, and in some cases have become very entrepreneurial in their operations. Some are so profitable that they manage to pay a dividend each year to their State governments. The South Australian Financing Authority (SAFA), perhaps the most entrepreneurial of them all, has successfully embraced higher risk arbitrage techniques (borrowing at cheap rates to buy financial assets paying higher rates) to make speculative gains on

finance markets. At one point during the 1980s, SAFA is reported to have owned all of Tasmania's public debt (Anderson, 1994)!

Important changes have also occurred on the supply side of the public sector debt markets. Most of the purchasers of Government bonds are the large financial institutions, such as life offices and superannuation funds. In previous decades these institutions took a long term view of these bonds, seeing them as secure and safe investments. This, however, is no longer the case. In line with changes in the international finance markets, these finance institutions have come to assume a much more fickle and speculative role, and now actively participate not just in the primary market for Government bonds, but also in the rapidly growing secondary market in which existing bonds are bought and sold, often with a view to making speculative gains. Their focus has shifted from regular flows of interest payments toward the capital gains that can be made by speculating in the purchase and sale of bonds. Credit rating changes play a crucial role in enabling participants in the secondary market to make speculative gains in this way. As Anderson (1994) explains:

> The borrowing business is going to be a lot tougher for all the States in the nineties...The marketing war is not just about getting the most attractive rates when bonds are first issued to the private market. The big action is concentrated on secondary markets for debt - where semi-government bonds change hands hourly as investors gamble on interest rate implications of government policies and credit rating outlooks. Big fund managers are dramatically changing the way they deal government debt. They used to buy and hold. Now they are fickle customers - buying and selling fast in the increasingly desperate chase for relative values (Anderson, 1994).

The second factor enabling the CRAs to become so deeply embedded in State politics, somewhat paradoxically, concerns one of the CRAs earliest and most trenchant critics, the Commonwealth government. The rise of the CRAs in Australia was encouraged by the Commonwealth's enthusiasm for financial deregulation, and the rapid bout of credit growth this facilitated during the entrepreneurial paper boom of the mid-1980's (which in turn must be seen in the context of broader global financial market changes discussed above). It is no coincidence that it is during this phase of Australia's history that Standard and Poor's experienced rapid growth, and Moody's decided to set up shop, apparently servicing the needs of our entrepreneurs.

In addition, it was deliberate Commonwealth government policy to make the States open to CRA evaluations. This the Commonwealth did at the 1990 Premiers' Conference by implementing new Federal-State financial arrangements in which the States would be required to take over their portion of the Commonwealth debt that had been built up under the 1927 Financial Agreement. This move exposed the States' soft underbellies to the sharp teeth of the CRAs, who immediately began to rate and re-rate the States with some enthusiasm. Victoria was the first to feel the heat, having its credit rating down-graded almost as soon as the 1990 Premiers' Conference had concluded. As the Victorian Commission of Audit explains,

> the agreement at the June 1990 Premiers' Conference that the States would progressively take over responsibility for debt previously issued by the Commonwealth on their behalf resulted in the rating agencies, and the financial markets in general, scrutinising more closely differences in the credit worthiness of the States. Before this agreement, all the States were rated AAA, the same as the Commonwealth (1993: 134).

As a consequence of this remarkable decision, the Commonwealth managed in a single blow to increase dramatically the power of the CRAs, and also increase public sector borrowing costs. On the day following the two notch down-grading of Victoria in 1992, the *Australian Financial Review* ran a story hinting at the problems this down-grading might cause for the public sector as a whole:

> London investors holding government issued Eurobonds were said to be greatly confused (by) the Moody's decision to drop Victorian paper to A1 from AA2... Mr Michael Aubrey of Hambros Bank in London said that 'Moody's have created a most confusing situation... We were expecting a Moody's down-grade of Victoria to AA3, but not to A! and that quickly led to a widening of the spread on Victorian paper on Friday'...*Mr Aubrey said the decision also left international investors confused about Australia. 'We now have NSW with a Triple-A rating and Victoria with a single-A rating and that is a wide gap for States within the same country. It could make Australian debt less attractive to international investors'* (*Australian Financial Review*, 26 October, 1992. Emphasis added).

The Commonwealth's decision to turn the CRAs' heads in the direction of the States was not the product of an oversight which is likely to be reversed in the near future. At the 1993 Premiers' Conference the Commonwealth with the approval of the States agreed to put in place new Loan Council arrangements which require the States' financial dealings to be completely transparent to the money markets, while at the same time establishing new 'benchmarking' criteria by which it will be possible to identify those States that spend 'too much' on social policy (*Australian Financial Review*, 6 July 1993). As the press releases following the Loan Council Meeting and Premiers' Conference made clear, the Commonwealth has decided to shift the burden of regulating and overseeing State social and budgetary policy from accountable inter governmental forums to the money markets and their representatives within the CRAs:

> The new arrangements are designed to enhance the role of financial market scrutiny as a discipline on borrowings by the public sector...The major feature of the new Loan Council arrangements is the change in philosophy of how the Loan Council operates, from an approach based on rigid compliance, to one based on the establishment of a framework that is both credible and transparent...This evolution in Loan Council arrangements broadly reflects the evolution of financial markets and their interaction with the public sector (quoted in the *Australian Financial Review*, 6 July, 1993: 10)

The final set of factors enabling the CRAs to become so influential concerns the CRAs themselves. During the late 1980s, the CRAs began to enter into full competition with one another within Australia. This process paralleled the time that the Commonwealth decided to introduce the new financial relations with the States. The problem for Moody's in particular was how to increase their market share, given that their business depended on being invited by companies to do an evaluation of them, rather than (as with Standard and Poor's) by selling reviews to subscribers. The option they seem to have embraced enthusiastically was to turn their evaluative powers into a major marketing tool, by carrying out highly contentious ratings on entities that had not invited them to do so. Rather than go down the path of price competition, Moody's chose the more logical one for a duopolist, that of competition through marketing (or product differentiation). Between 1990 and 1992, Moody's took on the Victorian Government three times, the NSW Government, Coles-Myer, James Hardie, and some other smaller private sector players. Their efforts earnt them a lot of publicity, but also a string of criticisms from prominent politicians, bankers and industrialists. In response to a credit down-grade, the head of James Hardie's, David Say, was quoted as saying "It's absolutely outrageous...(Moody's) are trying to create a market for themselves" (*Australian Financial Review*, 19 November, 1992: 1). And in response to a similar down-grade of his company, Brian Quinn, the then head of Coles Myer had this to say:

> I would have thought that the responsible course of action would have been to wait to find out the facts of our performance before making a pre-emptive judgement....The proposed announcement was not discussed with the company before the decision was made, and we frankly believe that it flies in the face of the facts. (*The Age*, 6 March, 1992)

Nor has it been only those who have been down-graded who have voiced their reservations. In March 1992, the *Australian Financial Review* ran a lead article in its banking and finance section with the headline, "BT chief blasts rating agencies". The report went on to say that,

> A leading banker has claimed that ratings agencies are answerable to no-one and have a greater influence on bank management than shareholders or official regulators...Earlier this week Mr Ferguson (head of Bankers Trust) said the agencies were the regulators operating in the private sector (but) 'they are much tougher in their approach than public sector regulators, harder to get to, answerable to nobody and not particularly interested in seeing banks lend aggressively again to get an economy going' (*Australian Financial Review* 6 March, 1992: 54).

Interestingly, each of the two major CRAs has been critical of the way the other operates. In an extraordinary report carried in the *Australian Financial Review*, the head of Standard and Poor's was quoted as being highly critical of Moody's. The report is worth quoting at length:

> The chairman of Standard and Poor's, Mr Duncan Andrews, yesterday defended the Treasurer... by criticising... Moody's Investors Service over its sensational threat last month to down-grade Australia's credit rating. Mr Andrews...said he was extremely cynical of Moody's announcement...'It seems to me that the most fundamental aspects of the ratings process have not been satisfactorily handled', Mr. Andrews said. 'First, Moody's announced publicly that they were considering downgrading Australia. This was done prior to discussion with Canberra. Second, Moody's knew, believe me, that this announcement would get them enormous international publicity...Third, Moody's-oriented stories have been appearing in some newspapers. The source is unknown, but these have tended to defend Moody's position. The $A is the fifth most traded currency in the world', he said...Mr Andrews said he believed independence, objectivity, absence of conflict of interest and impartiality were the fundamental requirements of a ratings agency. 'Moody's appear to have foregone this critical element as regards its rating of Australia' (*Australian Financial Review*, 28 July, 1989: 8).

This is strong stuff, especially from those who might normally be expected to be guarded in their criticisms.

Conclusions

We have argued that CRAs have come to acquire considerable influence in Australian State politics, yet their actions are based on narrow and contestable financial criteria which are applied inconsistently and often inappropriately to the public sector.[3] We have argued also that the CRAs do not carry out impartial and objective assessments of the public sector (nor, indeed, does this appear to be the case with many private companies).

We have also drawn attention to the arbitrary nature of the credit rating process. In this respect we agree wholeheartedly with Michael Pusey (1991) when he says that the whole credit rating process when applied to governments is a "potent ideological fiction". In the Australian context it is a fiction that the CRAs themselves have helped to manufacture, albeit under conditions (explosive growth in increasingly deregulated and speculative global finance markets) which made this possible. The CRAs operate in a highly concentrated industry, in which profits can only be had by differentiating the products being rated; if this means manufacturing differences then so be it. Only in this way, we argue, is it possible to understand the inconsistencies in the ratings revealed in Tables 3 and 4 above. It is precisely in this context that the role of the CRAs should be understood. With considerable assistance from the Commonwealth, and in the context of the white heat generated by the increasingly speculative global capital flows, the CRAs have successfully managed to help create the conditions for their own existence.

There is one additional factor that has played a part in the rise of the CRAs, which warrents more emphasis. The State governments represent

3 The focus of this paper has been on the Australian States. Similar inconsistencies are evident in CRA ratings of different nations. For example, in 1992 Australia's general government public debt and deficits were both less than half the size of the UK's, yet whereas the UK enjoyed a AAA rating, Australia was rated a full two notches below this level. More dramatic still is the case of Belgium, with a debt/GDP level 500% higher than Australia's, but still a better credit rating. Nor can currency risk explain this discrepancy: during 1992 and 1993, for example, all the major European nations experienced considerable currency fluctuations as a consequence of serious flaws in the European exchange rate mechanism (ERM). Britain and Italy ended up having to leave the ERM, and the pound was promptly devalued by over 10% (*The Economist*, September 26th-October 2nd, 1992; August 7th-13th, 1993). Throughout this period, the Australian dollar remained firm and was being referred to in the financial press as a "safe haven" *(The Australian Financial Review*, 2 August, 1993: 1).

fertile ground for mischievious political players like the CRAs. For individual politicians and political parties, the CRAs often have appeared to be a powerful weapon which they can use to launch blistering attacks on political foes, and to defend even the most vicious of fiscal programs like the one being put into place by Treasurer Stockdale in Victoria. Almost every reduction in public spending and employment, every cut to an existing social program, every harsh new labour law, can be defended on the basis that it is necessary to maintain or restore the State's credit rating. The problem, however, for politicians like Mr Stockdale, is that the CRAs are a weapon that comes with a heavy price. It is a fickle weapon, which derive from inconsistent and rubbery assessment criteria. Like Tolkien's magic ring, it can begin to exert an alarming influence on the autonomy of its possessor, and it demands ever more sacrifices even when there are no more sacrifices that can be made.

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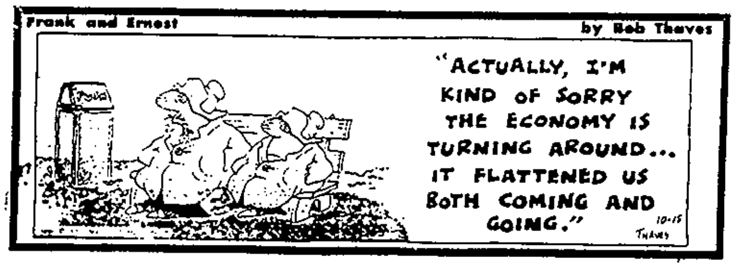

PRIVATISATION: A RE-ASSESSMENT

R.G. Walker

The idea of 'privatising' government trading enterprises ('GTEs') or other agencies has gained momentum and been popularised by a variety of interest groups, and supported by politicians across a wide range of the political spectrum. Yet, to date, there has been little detailed analysis of the *financial* implications to vendor governments (and, ultimately, the real owners, the public) of privatisation.

This paper seeks to contribute to a more informed debate by examining the financial implications of privatisation to vendor governments. It is suggested that privatisation may involve a substantial financial loss to the community. This is because the present value of the sale proceeds from GTEs, plus the present value of cash flows from post-privatisation taxes and charges, will generally be substantially less than the value of the cash flows which might be derived by government from retaining those organisations.

It is recognised that financial factors are only a sub-set of the factors which are relevant to decisions about selling or retaining public sector enterprises - just as initial government involvement in particular activities and enterprises would have been based on factors other than the evaluation of costs and benefits in purely financial terms. The paper is, in effect, an 'economic rationalist' analysis of financial issues relevant to the privatisation decision.

In order to focus on the fundamental differences in the circumstances of public sector and private sector enterprises, the discussion proceeds by analysing a series of scenarios in which a hypothetical GTE will generate a known stream of future cash flows. This enables the 'value' of a GTE to a private sector purchaser to be examined under a range of assumptions.