The Philippines has finally reached “investment grade” status. The recent decisions by Fitch Ratings and Standard & Poor’s (S&P) to upgrade the country’s sovereign credit rating to “BBB-“ from “BB+ “ grabbed news headlines. What does this mean for the government, the economy, and business? More importantly, what is in store for the ordinary Filipino struggling to make a living?

In a nutshell, credit ratings represent assessments by credit rating agencies (CRAs) on the risk that a borrower (in our case, a sovereign nation, the Republic of the Philippines) would default on its debts. Governments and firms need to get a credit rating to raise funds from bonds, and ratings influence borrowing costs.

Financial regulators also look at credit ratings to enforce capital standards. Investors, meanwhile, depend on credit ratings to determine which financial instruments are safe bets. For instance, big US pension funds invest only in investment-grade securities to protect their retirees.

Behind the ratings

Three agencies dominate the global market: S&P and Moody’s of New York, and London’s Fitch Ratings. The ratings are based on letters (see Table 1). S&P and Fitch follow a scale wherein triple-A or “AAA”, “AA”, “A”, and “BBB” are considered investment grade, which means little to no risk of default. “Speculative grade” or “junk” ratings start from “BB” all the way to D (default).

CRAs employ quantitative and qualitative methods, as there is no single reliable indicator of creditworthiness. Rich countries could still go on default due to political and other factors, while developing countries could be willing to do everything to honor their obligations. CRAs thus look at a borrower’s “willingness” and “capacity” to pay.

Fitch Ratings considers macroeconomic performance and prospects, political risk and governance, public finances and sustainability of public debt, and external finances. The clincher for the Philippines, Fitch said in a report, was its “persistent” current account surplus, supported by dollars from overseas Filipinos. The domestic economy, Fitch said, has been resilient and government finances have improved.

Philippine debt is still considered speculative or risky by Moody’s, although the government expects it to follow Fitch and S&P. The Philippines has a “Ba1” from Moody’s, just a notch below investment grade.

Spotlight on CRAs

Locally, these credit watchers command authority. Government officials roll out the red carpet, so to speak, for their regular visits. But overseas—in the United States and Europe in particular—CRAs have come under scrutiny because of their role in the 2008 global financial crisis sparked by the collapse of the US housing market.

Debt issuers pay to get rated, an arrangement that presents conflicts of interest. Like other private firms, CRAs aim to hike profits and widen market share.

Ahead of the crisis, securities backed by US housing mortgages were “blessed” by CRAs, only to be downgraded later. An investigative body concluded in 2011 that the “failures of credit rating agencies were essential cogs in the wheel of financial destruction.” Lehman Brothers and AIG were in fact investment grade prior to collapse and bailout, respectively.

The Philippines, which had never reached investment grade since it began receiving ratings in the early 1990s, pays its debts religiously. The country debuted with a “BB–” from S&P on July 2, 1993, and was upgraded to “BB +” on February 21, 1994.
1997 ahead of the Asian financial crisis. The Philippines was downgraded to “BB” in 2003 and “BB-” in 2005 as its fiscal condition deteriorated, before being placed back to “BB” in 2010 and “BB + ” in 2012. Fitch followed a similar track.

A study by International Monetary Fund (IMF) researchers found evidence of “rating stability failure” in the recent global financial crisis, during which highly rated sovereigns had to be downgraded by as much as five notches. Other studies, however, have found CRAs to be effective in reducing information gaps between investors and borrowers, as well as in promoting fiscal discipline among developing countries. An investment-grade rating, according to another paper by IMF researchers, cut “financing costs significantly”, and based on data across several countries, reduced spreads by 36 percent.

**Seal of good housekeeping**

Given the history of CRAs, it is imperative to clarify what ratings are and what they are not. Credit ratings are not to be taken as “buy” or “sell” recommendations. S&P makes its clear on its website that credit ratings are merely “opinions” about credit risk. At most, an investment-grade rating can be regarded as a “seal of good housekeeping” as far as the government’s financial stability is concerned.

The bottomline for the Philippines is that a good credit rating could mean more portfolio investments and a buoyant financial market. Moving up the credit rating ladder means less default risk, and achieving investment grade opens the door to a wider and more diversified base of portfolio investors. This is good news for the stock market, whose main index has repeatedly broken records.

For the government, this means greater access to the big pool of offshore funds, at a lower cost. One study found that at least 1.6 percentage points could be knocked off interest rate spread of an investment-grade sovereign.

It should be noted, however, that credit ratings do not necessarily speak of improved economic well-being, much less the quality of economic growth. Ratings, in fact, have been “sticky”, or slow to react to economic and business conditions as well as market sentiment (Elkhoury 2008).

Investments that are expected to immediately come in, moreover, are portfolio investments, as distinguished from direct investments. “Hot money” can fly at the slightest hint of danger, but can also serve as harbingers of confidence.

If the government plays its cards right, direct investments will not be far behind. The government would do well to sustain the reform momentum by further widening the fiscal space through improved tax collection, and the introduction of new tax measures such as the rationalization of investment incentives.

There is a lot of work to do, in particular, in making the Philippines a good place to do business in. Reforms should also include harmonizing tax and investment policies and streamlining processes for obtaining business permits.

Policies to encourage bank lending to small and medium enterprises are still needed. In the short term, the government can assist aggressively in project development efforts for sectors needing low-cost financing.

It will take time before the goodwill earned by the Philippines in financial world translates to the real economy. The government still needs to invest wisely to create conditions that will lead to increased economic activity and more jobs. Whether a good credit rating leads to inclusive growth or not remains to be seen.

**References**


**The Economic Issue of the Day is one of a series of PIDS efforts to help in enlightening the public and other interested parties on the concepts behind certain economic issues. This dissemination outlet aims to define and explain, in simple and easy-to-understand terms, basic concepts as they relate to current and everyday economics-related matters.**

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