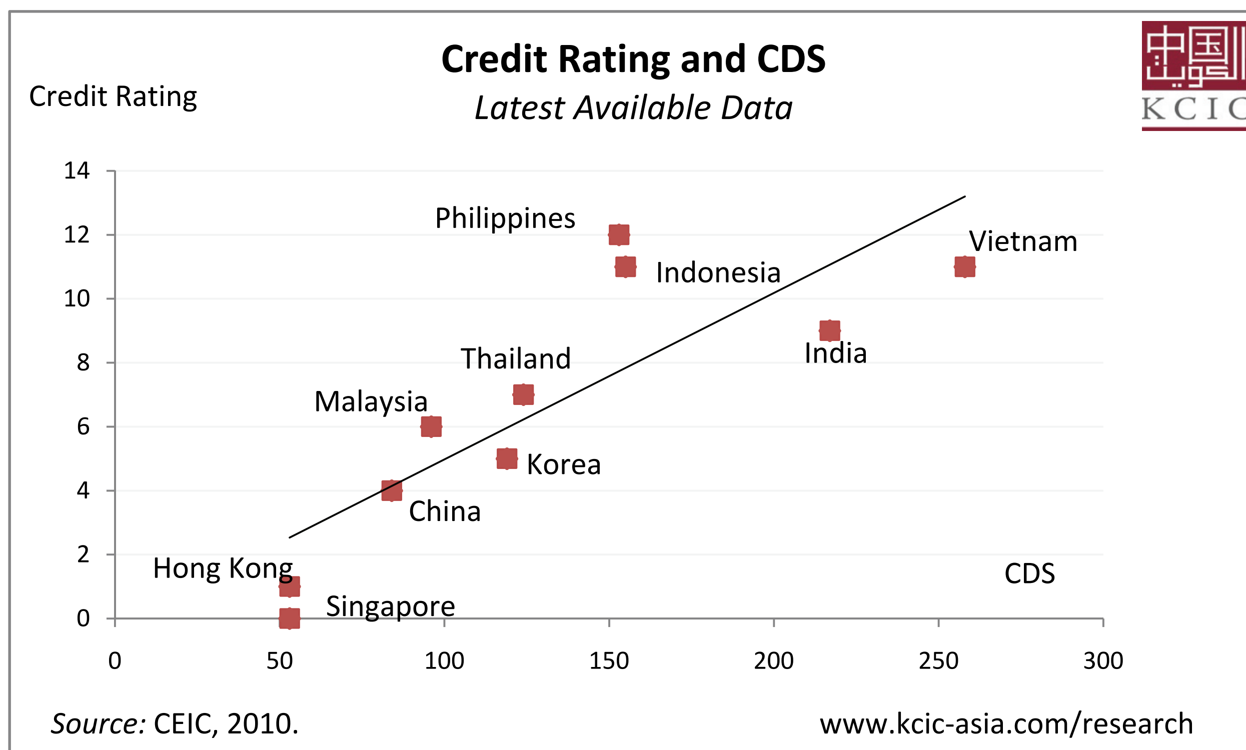
# Indonesia and Philippines: rating upgrades upcoming




### Why is this graph important?

In the past few years, the economies of Indonesia and the Philippines have outperformed many of their peers - as well as market expectations. Both countries achieved impressive growth levels in the first quarter of 2010 and are expected to do even better in the second quarter. We expect this positive performance to continue in the near future.

The graph shows the *Credit Default Swap* (CDS) levels as well as the *Credit Ratings* of most Asia Ex Japan countries. The credit ratings of both Indonesia and Philippines suggest a higher risk than what is implied by their CDSs. In other words, the CDS market attributes a lower risk than the rating agencies to these economies. As the markets are normally ahead, we expect both countries' sovereign credit rating to be upgraded soon - to reflect the positive developments in their economies.

### What does the indicator tell us?

A *sovereign credit rating* is generally defined as a measure of credit worthiness of a national government. It indicates the level of 'perceived risk' when investing in that economy. It takes both economic factors (growth, inflation, unemployment) as well as political risks into account. A credit rating is assigned by independent rating agencies such as Standard&Poor's (S&P), Moody's and Fitch. The vertical axis shows – via a numeric index - the credit rating of each country. The lower the score (i.e.: the lower the 'perceived risk'), the higher the rating.

In its simplest form, a *Credit Default Swap* (CDS) is a bilateral contract between a buyer and a seller, where the buyer protects himself against credit default. The buyer of the protection pays a premium to the seller, and this premium is called CDS spread. In the case of sovereign risk, the premium is paid over the price of government bonds, to protect the investor in case of default of that government. Thus, a CDS is also a measure of the risk of investing in a given economy. The graph displays the CDS levels of each country on the horizontal axis. The higher the CDS, the more risky it is to invest in that economy. Credit rating and CDSs differ in that credit ratings are done by rating agencies while the price of a CDS is determined by the markets.

It is fairly intuitive that there is a direct relation between credit rating and CDS - as both are measures of risk. The graph shows, however, that the credit ratings of Indonesia and Philippines are implying a higher risk than what would be expected given their CDSs. Usually, the financial markets are a better judge of risk, and agencies are often delayed in updating their ratings. Hence, we can claim that Indonesia and Philippines should have a higher credit rating, and that are likely to get one soon.

### What are the economic and financial implications?

If Indonesia and Philippines were to be upgraded in their credit ratings, a direct result of the upgrade would be a lower risk perception of the status of the economy and hence higher capital flows. If these countries are upgraded, more money will flow to their economies from abroad, in particular into their stock markets. This in turn would increase the share prices of individual companies, yielding higher returns on investments. It would also cause currency appreciation, given a higher demand for the local currency and lower demand for foreign currency within that economy. Another direct result would be higher foreign investment in these economies, which would boost growth and make them more competitive.

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