BAGRIE ECONOMICS

Sovereign Rating and Supermarket Competition

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Comments for Monopoly Watch NZ

The notion has been put to me that New Zealand's sovereign credit rating could be adversely affected by proposals to improve competition among supermarkets.

I consider this somewhat unbelievable as a proposition.

As you would expect, ratings agencies canvass a wide variety of variables in assessing sovereign risk, to credibly assess a sovereign government's ability and willingness to service financial obligations.

Their frameworks are extensive (see page 1), and decisions are not taken lightly. New Zealand's sovereign rating has seldom changed (page 4). It is difficult to comprehend how promoting competition between supermarkets will impact the New Zealand government's ability and willingness to service its financial obligations.

Institutional arrangements and proxy variables, such as the World Bank Governance Indicators, appear the most logical place a potential undermining of property rights could affect the sovereign rating. These indicators have tended to remain stable, despite what can seem like lots of change within industries. However, industry changes do not change the aggregate governance picture for New Zealand.

The Commerce Commission enforces laws relating to competition, fair trading and consumer credit contracts, along with monitoring various regulated industries. I consider it a failure by the Commerce Commission to fulfil these objectives and standing idly by as being more likely to influence the rating than pursuing its responsibilities.

How are sovereign ratings derived?

A sovereign rating reflects an independent assessment of the government's ability and willingness to service financial obligations.

Standard and Poor's (S&P) credit analysis rests on five key pillars including:

- An institutional assessment reflecting S&P's "view of how a government's institutions and policymaking affect a sovereign's credit fundamentals by delivering sustainable public finances, promoting balanced economic growth, and responding to economic or political shocks."
- An economic assessment including income levels, growth prospects, economic diversity and volatility.
- An external assessment, including its net foreign asset and liabilities and a country's external liquidity.
- A fiscal assessment of the sustainability of the fiscal position and debt burden. It includes assessing fiscal flexibility, long-term fiscal trends and funding access and potential risks from contingent liabilities.
- A monetary assessment. This is the monetary authority's ability to fulfil its mandate. It looks at the exchange rate and credibility of monetary policy.

Each factor is assessed on a six-point scale.

The first two pillars (institutional and economic) assess the resilience of a country's economy, the strength and stability of its civil institutions, and the quality and effectiveness of its policymaking. The other three assess the sustainability of the fiscal position, within the context of the country's external position, and fiscal and monetary policy.

Moody's approach to sovereign risk is based on four factors including:

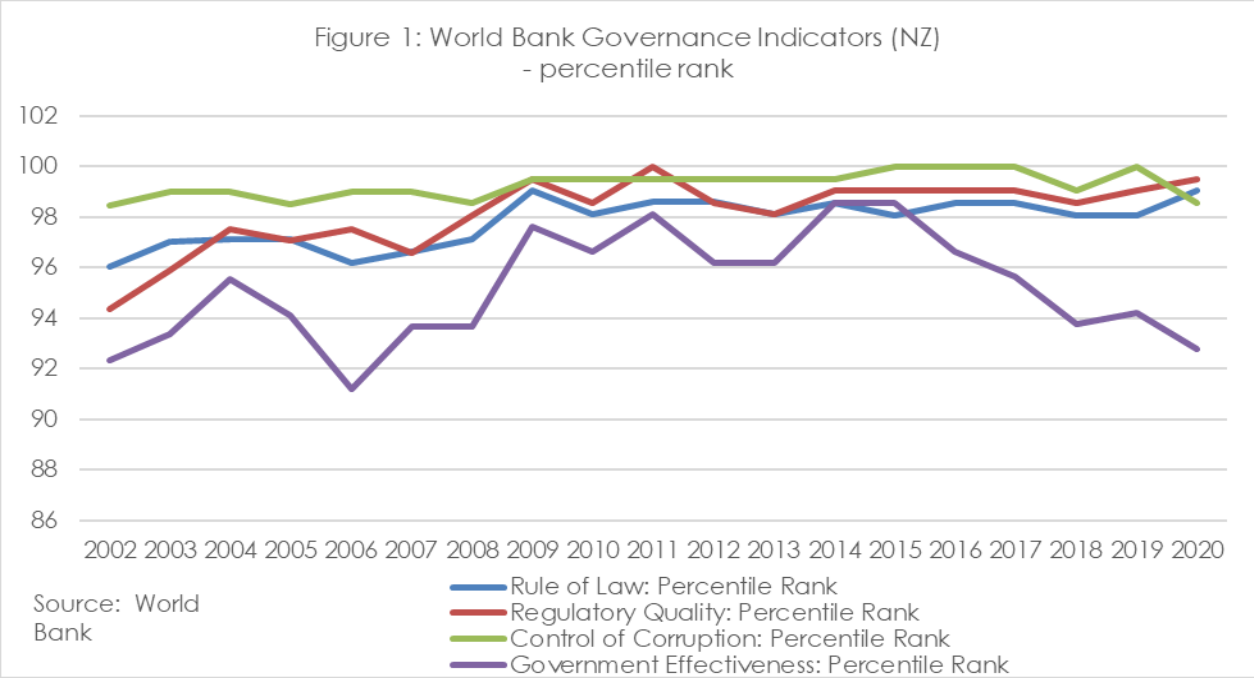
- Economic strength. Growth, the scale of the economy, national income and adjustment factors (diversification, credit boom).
- Institutional strength. This includes institutional frameworks and effectiveness, policy credibility and effectiveness.
- Fiscal strength. This covers debt burdens, debt affordability and adjustment factors such as debt trends.
- Susceptibility to event risk. This includes political risk, banking sector risk, government liquidity risk and external vulnerability risk.

Specific indicators used by Moody's under institutional frameworks, which accounts for 75% of the Institutional strength measure, include:

- Government effectiveness. World Bank governance effectiveness index. Weight 50%.
- Rule of law. World Bank rule of law index. A governance indicator to measure contract enforcement, property rights, the independence of the judiciary and trust in the judicial system. Weight 25%.
- Control of corruption. World Bank control of corruption index. Weight 25%.

From both Moody's and S&P's frameworks we can conclude a wider variety of variables are used for assessing a sovereign's credit rating but fiscal and economic strength dominate.

Given Moody's inclusion of specific governance measures in its assessment, figure 1 charts various governance measures. New Zealand sits in a high percentile position, including the rule of law. It has maintained an elevated position over an extended period of sometimes material change in regulatory settings within some industries, including telecommunications and energy.



Moody's has kept New Zealand's rating unchanged for the past twenty years. Given the global financial crisis, Christchurch earthquakes and, more recently, Covid-19, this stability signals rating movements are not taken lightly, and requires major shifts in the key pillars/variables assessed.

S&P put New Zealand on a negative outlook rating in January 2009 but left the rating unchanged. New Zealand's rating was cut from AA+ to AA in September 2011 and upgraded to AA+ in February 2021.

Could NZ's rating be cut on supermarket separation / forced sales of stores?

I consider this highly unlikely and surprised the idea has even been presented.

First, as detailed earlier, ratings agencies canvass a wide variety of variables in making such decisions. Their frameworks are extensive, and decisions are not taken lightly. It is difficult to see how promoting competition across supermarkets will impact the sovereign New Zealand government's ability and willingness to service its financial obligations.

Second, if markets sensed a sovereign rating cut were a possible outcome, the NZ dollar would have moved in an adverse fashion. It has not.

Third, World Bank Governance Indicators – one set of variables that could impact the sovereign rating – have tended to remain stable, despite what can seem as lots of change within industries. However, industry changes do not change the aggregate governance picture. Changing the competitive environment for supermarkets does not alter the broad institutional framework for New Zealand.

Fourth, the Commerce Commission is responsible for enforcing laws relating to competition, fair trading and consumer credit contracts, along with regulating various industries. Its overarching goal is to make New Zealanders better off. Driving competition and fair business practices is a critical component of that. I consider a failure of the Commerce Commission to fulfil these objectives and standing idly by as being more likely to influence the rating than pursuing its responsibilities.

Fifth, divestment of assets or separation are not unusual outcomes when it comes to enforcing competition or approving takeovers. The goal is greater competition, which should be rating positive not negative. As a common-sense test, consider the reciprocal, and policies that drive less competition and the extraction of duopoly rents. Would New Zealand be likely to receive a credit rating upgrade? No.

Twenty Year Rating History Sourced from NZ Treasury		
Date	**S&P Global Ratings**	**Moody's Investors Service**
21 February 2021	AA+ (stable outlook)	..
22 January 2020	..	..
30 January 2019	AA (positive outlook)	..
26 January 2016	..	..
8 July 2014	..	..
30 September 2011	AA (stable outlook)	..
29 September 2011	..	..
22 November 2010	AA+ (negative outlook) re-affirmed	..
16 July 2009	..	..
28 May 2009	AA+ (stable outlook) re-affirmed	Aaa (stable outlook)
13 January 2009	AA+ (negative outlook) re-affirmed	..
28 November 2008	..	..
6 August 2008	AA+ (stable outlook) re-affirmed	..
16 June 2008	..	Aaa (stable outlook)
18 August 2003	..	..

21 October 2002	..	Aaa
7 March 2001	AA+ (stable outlook)	..