



# DANCING TO THEIR TUNE

**CREDIT RATING  
AGENCIES,  
SOVEREIGN RISK,  
AND FINANCING  
CONDITIONS IN  
THE GLOBAL  
SOUTH**



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# Introduction

Credit rating agencies (CRAs) are conventionally understood to act as a bridge between lenders and borrowers by reducing information asymmetry through the provision of objective, independent, and expert information on issuers or borrowers of bonds and other debt instruments and fixed-income securities (Li, 2021; Elkhoury, 2008). Their primary concern is the creditworthiness of the borrower, that is, the ability of a state or an enterprise to meet its debt obligations. Upon evaluating the borrower's financial, political, and economic circumstances, CRAs provide their opinion or judgement in letter form; for example, credit ratings such as A, B, C and so forth. In the sovereign sphere, however, these judgements do more than convey information. They influence investor decisions on where to lend money, determine the ease or difficulty of accessing external finance, and shape the pricing of the debt instruments that sovereigns in the Global South repay (Elkhoury, 2008; Partnoy, 2017).

The key channels involve the cost of borrowing, determined through the sovereign yield, and maturity, or the agreed-upon date on which a financial contract or investment ends, triggering the full repayment of a bond or loan. Sovereign yields, or the cost of borrowing through the interest rate, tend to rise as ratings decline. As ratings increase, the cost of borrowing decreases while access to low-interest financing from international capital markets expands. Various indirect benefits may also accrue, such as investment attraction. Analysis of the influence of CRA issuances on investor behaviour illustrates that ratings affect credit flows and yield levels disproportionately for the Global South, in that yields move in the direction of CRA opinions and assessments to a statistically significant degree (Cantor & Packer, 1996; Elkhoury, 2008).

For developing countries, a vast range of exogenous shocks, from economic and financial crises to climate disasters, pandemics, and debt restructurings, constitute a dominant channel through which risk-rating downgrades, or warnings of an impending downgrade, translate into higher interest rates and tighter financing conditions. Emerging and developing economies accounted for more than 95 per cent of sovereign downgrades in 2020. In Africa, 56 per cent of rated countries were downgraded in the same year. The fear of such ratings downgrades prevented many African nations from accessing international capital markets in 2020, even as many developed economies were expanding deficit financing. Such a procyclical dynamic increases the burden of interest expenditure on public budgets while decreasing public funds available for critical public services and domestic economic and social objectives (Fofack, 2021; Barta, 2022).

This dynamic is structurally linked to the international monetary hierarchy, in which currencies issued by developing countries occupy subordinate positions relative to core reserve currencies. Because developing economies depend more heavily on external financing, are more exposed to balance-of-payments and exchange-rate pressures, and are less able to borrow internationally in their own currencies on favourable terms, sovereign rating actions carry particularly punitive consequences. In this sense, downgrades do not merely reflect vulnerability; they may also

reinforce a hierarchical financial order in which peripheral states face cyclically higher borrowing costs, sharper capital outflows, and narrower fiscal policy space in times of crisis. If a sovereign loses its investment-grade status, it may face a wave of selloffs, with capital exiting borders and triggering a domino chain of painful economic consequences rooted in currency depreciations, higher import bills, lower foreign exchange reserve buffers, and intensified cost-of-living pressures. To prevent national economic instability and possible crisis and recession, sovereigns, particularly in the Global South, often do “what it takes” to maintain either their investment-grade rating or relative stability in risk ratings, in order to protect their macroeconomic standing and, in turn, the cost of capital assigned to them (Barta, 2022; Fofack, 2021).

It is within this broader context that the present paper examines the structure, methodology, and consequences of sovereign rating practices in developing countries. The argument developed here is that CRAs do not simply assess sovereign risk from the outside, but operate within a wider financial architecture that shapes access to liquidity, external borrowing, and policy space in systematically unequal ways. To develop this argument, the paper first examines the structure, methodology, and bias of the dominant CRA industry. It then analyzes the implications of sovereign rating criteria for developing countries and adopts a comparative case study strategy to trace how rating actions interact with market perceptions, borrowing costs, and external debt-servicing pressures across episodes of debt restructuring, climate-related shocks, and public spending adjustment. In doing so, the paper shows that sovereign ratings are not merely informational signals, but financially consequential judgements embedded in a hierarchical international monetary system.

International organizations have long researched and debated the dynamics and effects of CRAs; however, fewer efforts have moved beyond diagnosis to call for regulatory and methodological reform of CRA practices. The United Nations initiated intergovernmental dialogues on CRAs in the aftermath of the global financial crisis of 2007–08, recognizing that credit ratings are a critical factor in the global sovereign debt architecture by way of their influence over sovereign borrowing costs, the procyclical nature of downgrades that penalize developing countries for exogenous shocks, and the central role of the cost of capital in development financing and long-term investment for climate resilience and poverty eradication. The first UN General Assembly resolution that explicitly triggered work on CRAs was passed in 2012, recognizing the significant role played by CRAs in sovereign debt dynamics, and led to a special thematic debate on CRAs in 2013. Most recently, the Fourth International Conference on Financing for Development, held in Sevilla in July 2025, led to an outcome document that called for more accurate, objective, and long-term-oriented credit ratings. The Sevilla Commitment further established the basis for a recurring special high-level meeting on credit ratings within the UN’s Economic and Social Council and urged countries to consider national regulatory frameworks to reduce over-reliance on credit ratings, improve CRAs’ transparency and accountability, and reduce conflicts of interest in the rating market (Li, 2021; United Nations, 2025).

# The Structure, Methodology, and Bias of Credit Rating Agencies

CRA exert quasi-regulatory power in global capital markets despite being private firms operating within highly concentrated, non-development-oriented incentive structures. For countries in the Global South, this often means that access to external finance is mediated through assessments that can amplify procyclicality, favour short-term fiscal adjustment, and penalize exogenous shocks. The three most dominant CRAs, Moody's, S&P and Fitch, all headquartered in the United States, control more than 94 per cent of outstanding credit ratings. This creates a highly concentrated oligopolistic structure. A conflict of interest is systematically generated by the "issuer pays model", where CRAs deliver rating judgements to the very financial clients who pay them for assessments, raising questions over the objectivity, motives, and legitimacy of the ratings methodology. Risk ratings are neither innocuous nor neutral, being the fruit of judgements made by so-called experts working in the world financial centres but with explicit and serious consequences for the world's periphery.

CRA rating assessments are generally based on a set of macroeconomic and fiscal indicators that include gross domestic product (GDP) per capita, real GDP growth, inflation, the current account balance relative to GDP, the trade balance relative to GDP, external debt, level of economic development, default history, international reserves, government debt relative to GDP, and the budget balance relative to GDP. Most of these indicators are quantitative and based on official sources of data. However, others, such as national governance, the rule of law, institutional efficiency and regulatory quality, cannot be measured quantitatively. The relatively higher cost of accessing such information in developing countries augments the probability that CRAs miss critical details and substantive understanding of the national context. It also leads CRAs to seek the information from in-house judgements from within the agencies rather than from national policymakers. Moreover, while economic and fiscal assessments may rely on quantitative indicators that involve some level of objectivity, how these indicators are interpreted by rating committees in their consideration of economic resiliency, government financial strength and susceptibility to event risk can vary greatly in process and outcome. Indeed, CRA scholars have shown that the Big Three rating agencies openly acknowledge that qualitative judgements play a significant role in their ratings. It is exactly the subjective nature of these judgements that creates a systemic bias. The significance of these qualitative and interpretive components lies not only in the discretion they allow, but also in the possibility that they transmit broader structural and geographic biases into sovereign ratings.

In the literature review of CRAs, multiple scholars have argued that ratings are subject to a "home bias", in that agencies tend to assign higher ratings to their home countries and to countries with similar economic, political, cultural, and social characteristics. This "home bias" also applies to Chinese rating agencies such as Dagong, as researchers have found that they rate non-Western countries more favourably than S&P. As Marandola and Sinclair (2017) summarize,

**“Credit rating as a mental process and set of behaviors continues to be headquartered in the US and it is this to which all newcomers are compared. As long as this mental framework persists there is a strong incentive for all new firms to adopt these norms as this is what customers expect. But the adoption of ‘global’ US norms denies the new firms any substantial claim to adding value to this US dominated industry.”**

## Rating Methodology Criteria and Implications for Developing Countries

Credit ratings are skewed by income, not actual risk. Empirical analysis shows that GDP per capita, rather than solvency indicators, is the strongest predictor of sovereign credit ratings, and particularly so over short-term trajectories of five to 10 years. (A medium- to long-term trajectory is generally understood to extend up to 30 years.) According to the scoring methodologies of the CRAs, per capita GDP is a direct determinant of the credit score for sovereign borrowers, with higher GDP per capita translating directly into a higher credit rating. The single factor of GDP per capita also plays a strong indirect role in the qualitative judgements incorporated into credit scores. This penalizes low-income countries regardless of investment quality or growth potential, inflating their cost of capital and deterring both private and public investment. Meanwhile, the debt-to-GDP ratio has not been found to be statistically significant, reflecting the fact that many high-income countries are accorded triple-A ratings despite debt-to-GDP ratios well above 100 per cent. Countries linked to the US Federal Reserve through swap lines also tend to have better credit scores. Countries with high inflation have lower ratings, even in the context of imported inflation, particularly in developing countries affected by exogenous shocks such as international monetary tightening.

Both credit and debt sustainability frameworks focus on short-term liquidity risks, not long-term structural growth potential (Elkhoury, 2008). This leads to procyclical investment patterns that funnel capital to already-rich countries and perpetuate underinvestment in high-potential regions. Developing countries in fact have a very high development potential if investment in public systems and services, infrastructure, and domestic production structures and their diversification is duly prioritized and sustained. Thus, the credit rating system is doubly penalizing, in that it ascribes the lowest ratings to the countries with the greatest prospects while intentionally ignoring the long-term structural determinants of debt sustainability, putting the focus on short-term liquidity considerations (Elkhoury, 2008).

Amid the dominance of financialization across the global economy since the 1980s, one trend, *inter alia*, is that of borrowing countries from the Global South adopting policies that address the short-term concerns of portfolio investors, even when they are in conflict with long-term development needs (Elkhoury, 2008). Within CRA methodology, fiscal consolidation is viewed as “credit positive”, generating a cyclical dynamic that has been called the “downgrade-austerity vicious-circle” (Sager & Hinterleitner, 2016). During the COVID-19 pandemic, CRAs downgraded numerous sovereigns through placement on a “negative watch”. At the height of the pandemic, “spending what is needed on pandemic response could invite ratings downgrades” (Sinha, 2020). As national policymakers enact “signals” of creditworthiness, fiscal policy is typically tightened towards an austerity bias.

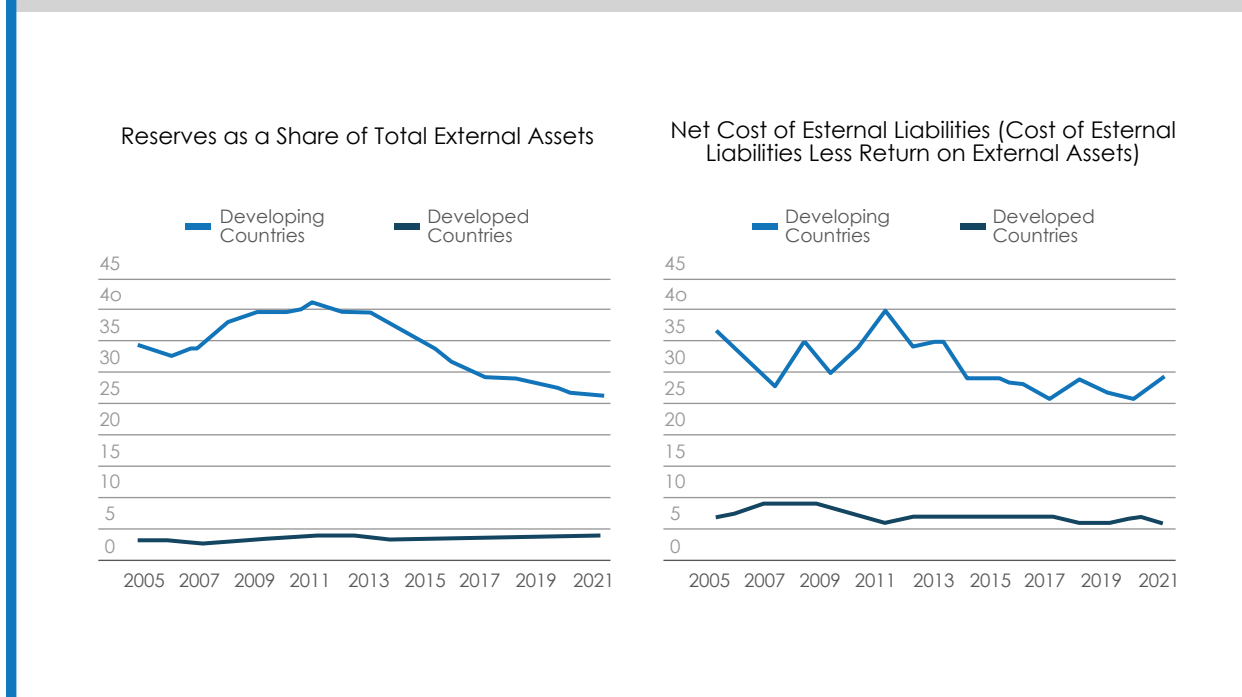
Indeed, since the early 2000s, the formulation of fiscal legislation that codifies targets on public expenditure has emerged as a global phenomenon. In over 40 middle-income developing countries, binding fiscal rules have been put into force, typically through legislation in the form of constitutional or ordinary law and subject to domestic or external regulation (Brenck & Marques, 2023). Rating reports tend to view fiscal rules legislation in developing countries favourably, often citing that binding caps or ceilings for fiscal expenditure serve the role of anchoring fiscal stability, and thereby legitimacy.

A significant rating criterion is that of foreign exchange reserves. Empirical research reveals that high reserve levels are significant for favourable ratings in developing countries but have low to no significance for developed countries (Erdem & Varli, 2014; Afonso et al., 2007). In an international financial architecture underpinned by the free cross-border flow of private capital to developing countries since the mid-1990s, external shocks can trigger volatile flights of capital, leading to currency depreciations and, ultimately, financial and economic crisis and instability. In

turn, developing countries self-insure themselves through buffers in the form of foreign exchange reserves. According to the United Nations Conference on Trade and Development (2025), over the period 2012 to 2022 reserves averaged almost 32 per cent of external assets in developing countries, which was nearly nine times the average level of developed countries over the same period. The key point pertaining to reserves is the sharp difference in material implications for developing countries, who are typically creditors in safe and low-return assets and debtors in risky and high-return ones. In other words, the returns received by developing countries on their external assets are generally lower than the payments made on their external liabilities, resulting in an ongoing net transfer of financial resources from developing to developed countries. A net transfer of approximately \$475 billion per annum occurred between 2012 and 2022 (United Nations Conference on Trade and Development, 2025). Rating agencies maintain and reinforce this net transfer by penalizing countries that choose not to invest as heavily in low-yielding reserves by issuing lower credit ratings, which have the effect of hiking up debt-servicing costs, possibly negating any net material benefit of averting reserve accumulation.

**Figure 1. North-South differences in CRA judgements of reserve levels**

The link between higher reserve holdings (left) and lower returns on external assets (right) in developing countries



Source: IMF Balance of Payments and International Investment Position database, January 2024

Recurrent financial and economic crises in modern economic history demonstrate the incompetence of CRA ratings. Ferri, Liu, and Stiglitz (1999) assess how CRAs aggravated the Asian financial crisis of 1997–98 by overlooking legitimate risks before the crisis and, once the crisis hit, downgrading Asian governments more than their macroeconomic indicators warranted, violating their own assessment criteria and exacerbating an already painful financial crisis. Preceding the global financial crisis of 2007, mortgage-backed securities were consistently rated favourably by

the Big Three CRAs, which played a part in the most “spectacular loss on structured assets” in modern economic history (Baghai & Becker, 2020). This led US authorities and policymakers to pursue billion-dollar lawsuits against the Big Three, claiming that “unfair, aggressive and harmful downgrades” were partially responsible for the 2008 recession. The US Congress created extensive regulatory oversight over CRAs, even halting the public application of credit ratings under the Dodd-Frank Wall Street Reform and Consumer Protection Act. In transatlantic resonance, the European Parliament created the European Securities and Market Authority, mandated to regulate the credit rating industry. Yet, as Barta (2022) pointed out, “more than a decade later, the Big Three are just as influential (and profitable) as ever, and once more the public braces itself for a potential new wave of sovereign debt crises triggered by downgrades”. The sticky endurance of the Big Three is all the more surprising because investors, who repeatedly suffer large losses in reaction to rating failures during financial crises, have compelling incentives to break with the Big Three’s ratings.

CRA gradings of sovereign credit risk are embedded within, funded by, and accountable to markets, not the public. Consequently, rating agencies are pressured to promote the policies that maximize client profits and market share. The absence of transparency, objectivity and accountability in the process and practice of CRAs has been grounds for critics to highlight their undemocratic nature, by even the most basic standards. These broader criticisms are not limited to traditional sovereign risk indicators such as fiscal balances, external liquidity, or institutional strength.

They also extend to the newer domains through which CRAs are expanding their evaluative frameworks, including climate-related risk. In this respect, the incorporation of climate vulnerability into sovereign ratings does not necessarily resolve the longstanding problems of discretion, asymmetry, and procyclicality. On the contrary, it may reproduce them in a new form, particularly where structural exposure to climate shocks is treated as a credit weakness without adequate consideration of historical responsibility, unequal adaptive capacity, or the development constraints faced by vulnerable economies.

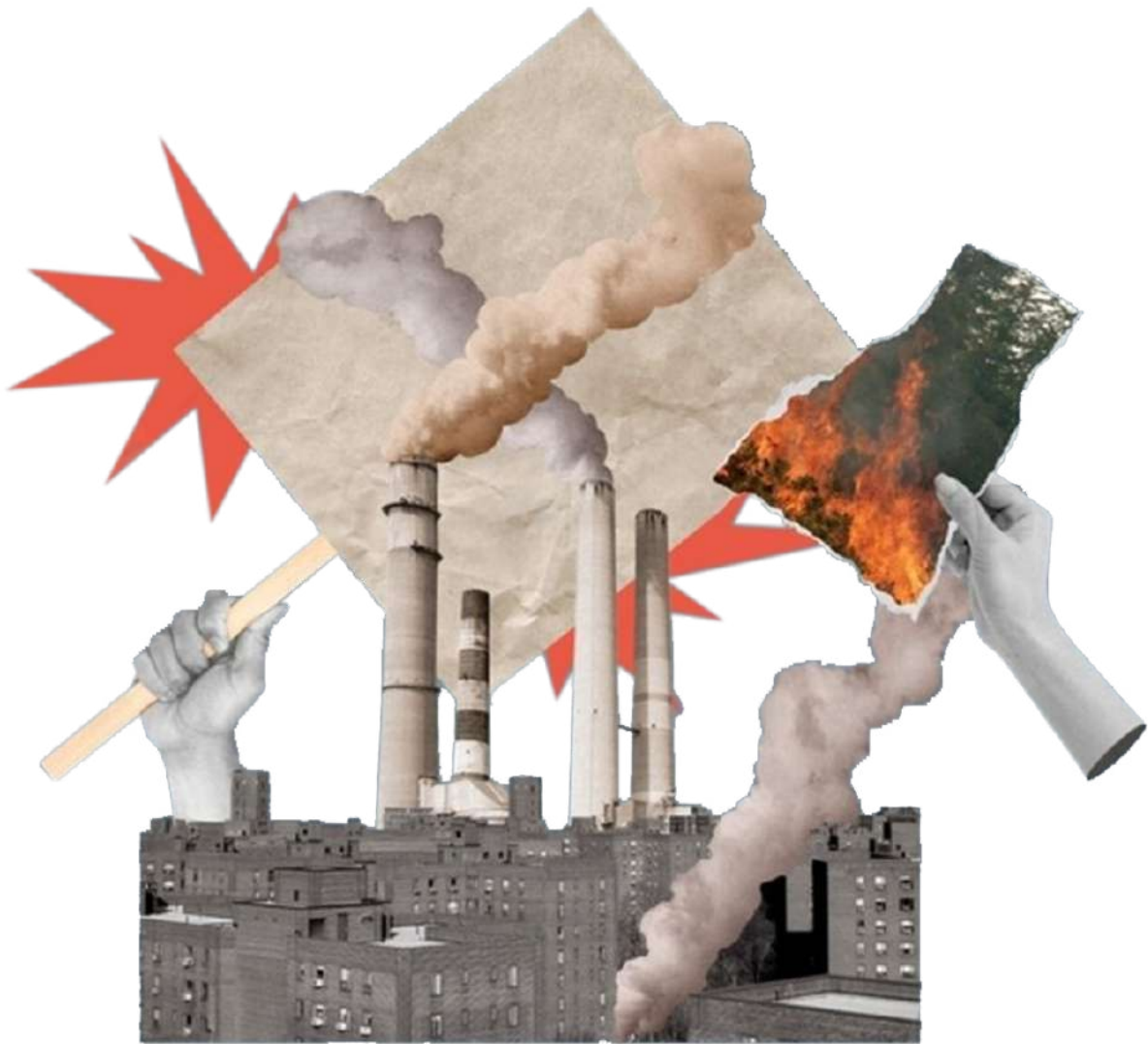
The “climate credit score” illustrates how rating agencies are, in effect, weaponizing climate vulnerability in a reversal of the Rio Principles of common but differentiated responsibilities, polluter pays, and equity. As of 2018, S&P and Moody’s stated that climate risks are now integrated into the four key risk factors used in sovereign risk analysis – economic strength, fiscal strength, institutional strength and susceptibility to event risk. In its 2016 report on Assessing Climate Change for Sovereigns, Moody’s concludes that “sovereigns’ ratings are increasingly and strongly correlated with their susceptibility to climate change”.

Moody’s also acknowledges making “explicit downward adjustments to account for sovereigns’ vulnerability to climate change”; in other words, climate vulnerability can translate into negative rating pressure even in the absence of an immediate climate disaster. Examples include small island nations, agriculture-based or weather-sensitive economies, and tourism-based economies – thus, a sizable majority of developing countries.

The methodology identifies two principal measures of climate vulnerability: the issuer’s exposure and resilience to climate change. Exposure is a function of national economic diversification and geographic location, while resilience focuses on adaptive capacity, fiscal flexibility, as well as the country’s income and development levels. According to Moody’s, “A common characteristic among the most susceptible sovereigns is their economic reliance on the agricultural sector, which is typically not irrigated and is thus rain-fed. In addition, undiversified economies are

disproportionately affected by the increasing frequency and/or severity of natural disasters impacting growth and causing lasting damage to infrastructure." While geographic location is beyond a nation's control, the aspects that are more directly policy-relevant, such as economic diversification and fiscal flexibility, are themselves constrained by a range of international factors, from trade and investment agreements that limit diversification, value chain upgrading, and productive and technological strengthening, to debt distress, fiscal consolidation, and other structural constraints with long colonial legacies.

According to Moody's, these climate vulnerabilities affect sovereign credit profiles through four main channels: weaker economic activity, for example through losses in agricultural production; damage to infrastructure assets caused by climate shocks; rising social costs associated with health crises or food insecurity; and population shifts resulting from climate-induced displacement.



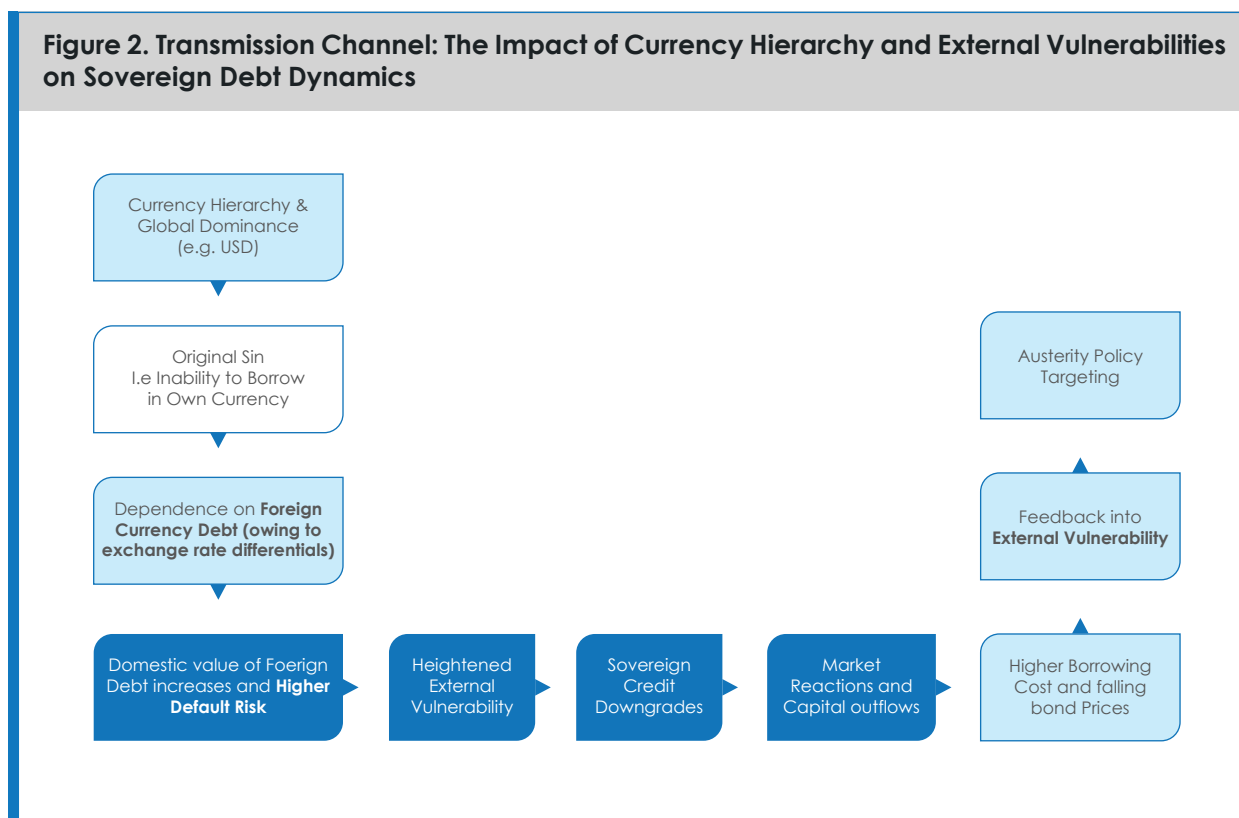
# Methodological Approach and Case Study Strategy

Sovereign credit rating downgrades are often associated with tighter external financing conditions, higher sovereign bond yields, exchange-rate pressures, and reduced market access, particularly in emerging market and developing economies (EMDEs). In these contexts, negative rating actions can carry significant financial consequences by shaping market perceptions of sovereign risk and influencing the terms under which external finance is accessed. Their importance, however, lies not only in whether they coincide with changes in financing conditions, but also in how they may validate, amplify, or prolong existing market pressures during episodes of macroeconomic stress.

These effects extend beyond sovereign borrowing to shape public investment dynamics and long-term capital formation, particularly in social expenditure and climate-related investment. By increasing the economy-wide cost of capital and restricting access to long-term external finance, adverse rating actions may discourage public investment and constrain the mobilization of private climate finance. The prevalence of sub-investment-grade sovereign ratings across many EMDEs further limits access to institutional investors, contributing to a self-reinforcing dynamic in which weak creditworthiness constrains development and climate investment, while underinvestment worsens long-run growth prospects, fiscal capacity, and structural vulnerability.

Insights from international political economy (IPE) reveal how these dynamics are embedded within a hierarchical international monetary system characterized by the global dominance of reserve currencies, particularly the US dollar. This currency hierarchy generates “original sin”, or the structural inability of many EMDEs to borrow internationally in their own currencies, leading to a reliance on foreign-currency-denominated debt. Under such conditions, sovereign rating actions may become financially consequential not as isolated exogenous shocks, but as signals embedded within broader episodes of external vulnerability, market repricing, fiscal stress, and policy adjustment. Their effects are therefore expected to vary across cases depending on exchange-rate regimes, monetary autonomy, external liquidity conditions, and the structure of sovereign liabilities. Figure 2 below sets out the analytical sequence through which sovereign rating actions may become financially consequential in structurally vulnerable economies. Situated within a hierarchically organized international monetary system, these actions can interact with external financing constraints, exchange-rate pressures, and debt-servicing burdens in ways that validate or amplify existing fragilities. The diagram therefore serves as a conceptual map for tracing these mechanisms across the case studies in this paper, rather than as a claim of strict causal identification.

**Figure 2. Transmission Channel: The Impact of Currency Hierarchy and External Vulnerabilities on Sovereign Debt Dynamics**



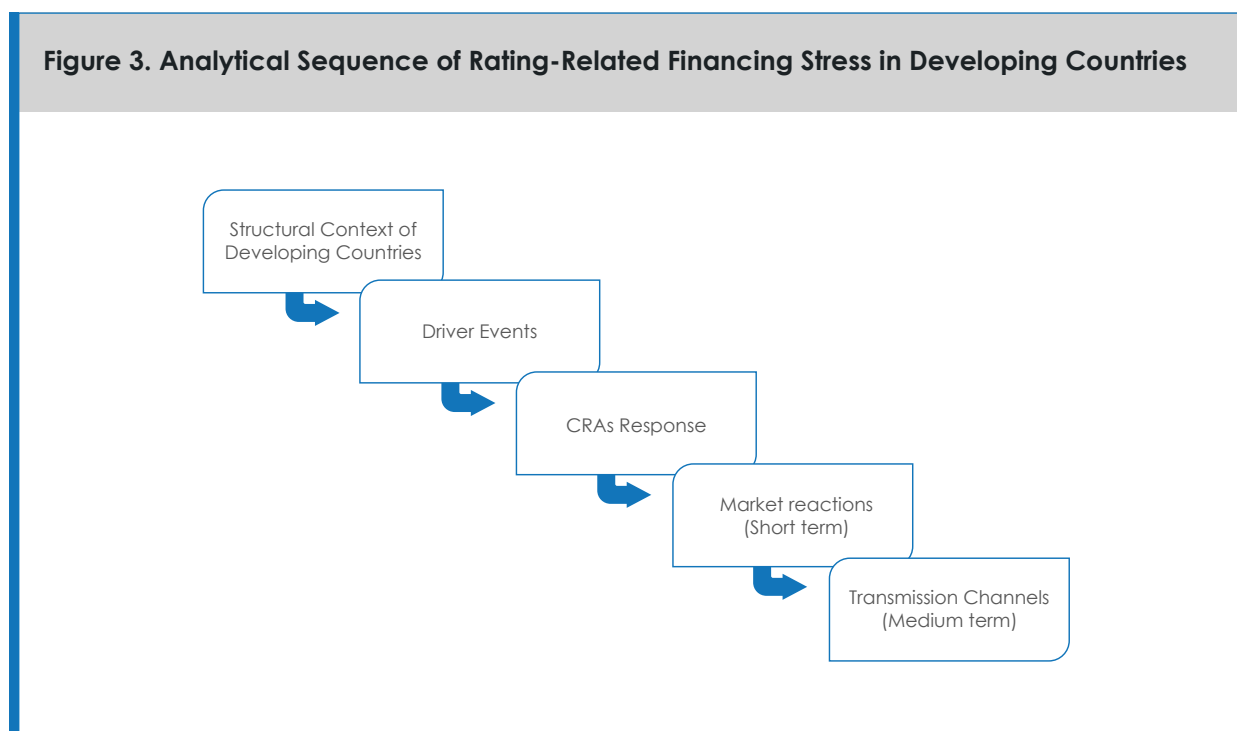
Source: Authors' elaboration based on De Paula et al. (2025), Vijaya (2025)

The literature on the international political economy of sovereign ratings shows that negative rating events are often associated with larger and more persistent market responses than positive adjustments, and that rating actions may also have wider effects on risk pricing across emerging markets through regional and asset-class contagion. In this paper, these insights are used as part of the broader analytical framework rather than as the basis for formal causal identification. Accordingly, the analysis remains focused on tracing asymmetric responses and possible spillover dynamics descriptively and comparatively across cases, particularly where rating actions appear to validate, amplify, or prolong episodes of sovereign stress.

This paper adopts a mixed-methods comparative case study design, combining descriptive analysis with in-depth country studies to examine how sovereign credit rating actions interact with financing conditions, market perceptions, and external debt-servicing constraints in EMDEs. Rather than seeking causal identification in a strict econometric sense, the analysis is designed to trace how rating actions are embedded in broader episodes of macroeconomic stress, fiscal deterioration, external vulnerability, and policy adjustment. Particular attention is given to the sequence linking the driver event, CRAs, the evolution of sovereign risk indicators, and the channels through which these dynamics affect borrowing costs and external financing conditions.

Given the structural and political character of sovereign risk assessment, as well as the embedded position of CRAs within the international currency hierarchy and the broader monetary system, the empirical strategy focuses on identifying recurring patterns and transmission mechanisms across cases. The purpose is not to isolate the effect of ratings from all other macro-financial variables, but to examine how rating actions operate within specific national contexts and how they may reinforce existing fragilities. This comparative approach makes it possible to analyze both methodology-consistent responses and more discretionary or procyclical dynamics, especially where credit rating actions interact with climate shocks, fiscal consolidation, debt restructuring, exchange-rate pressures, or constraints derived from fixed exchange-rate regimes and dollarized monetary arrangements.

The cases are analyzed through a common sequential framework that links structural conditions, driver events, CRA responses, market reactions, and medium-term transmission channels. The purpose is to situate sovereign rating actions within the broader dynamics of external vulnerability and macro-financial adjustment, rather than to read them as isolated changes in credit opinion. By organizing the analysis in this way, the paper examines how rating actions interact with existing fragilities, shape market perceptions in the short term, and affect financing conditions and debt-servicing pressures over time.



The analytical sequence presented above organizes each case study around five interrelated dimensions. Taken together, these elements make it possible to examine sovereign rating actions not as isolated announcements, but as part of a broader process through which structural fragilities, trigger events, market perceptions, and financing constraints become linked over time. Each component captures a different layer of that process.

## Structural Context

The starting point of the analysis is the macro-financial setting in which sovereign risk is assessed in each case. For comparative purposes, this setting is captured through a common set of baseline variables that are consistently used across the country studies. They are: real GDP growth, inflation, the fiscal balance, the current account balance, international reserves, and public debt as a share of GDP. These indicators make it possible to identify the degree of macroeconomic fragility, external constraint, liquidity pressure, and fiscal stress already present before the main driver event takes place.

The analysis also considers the monetary and exchange-rate regime as a conditioning feature of the structural context, especially in cases of hard pegs, dollarization, or otherwise limited monetary autonomy. Rather than functioning as a separate comparable indicator, this dimension helps explain why similar shocks generate different transmission patterns across cases.

The purpose of the structural context is not to provide an exhaustive profile of each economy, but to establish the common macro-financial baseline against which the driver event, the CRA response, and the subsequent tightening of financing conditions can be interpreted.

## Driver Events

Driver events are treated as the proximate triggers through which pre-existing macro-financial vulnerabilities are converted into episodes of intensified sovereign stress. In analytical terms, they are the events that organize the sequence later traced in each case study: the interaction between the trigger itself, the CRA narrative, the movement in sovereign risk indicators, and the transmission of stress into financing conditions and external debt-servicing pressures.

These events may be either endogenous, such as government decisions on debt operations, fiscal policy, or public expenditure, or exogenous, such as climate-related disasters or other large external shocks. In all cases, the aim is not to isolate the event as a purely exogenous causal shock in a strict econometric sense, but to identify the episode that most clearly structures the downgrade narrative and the subsequent tightening of financing conditions.

For the purposes of this paper, three driver categories are used.

**Debt Restructuring Driver.** This driver refers to episodes in which sovereign stress is organized around default, distressed exchange, debt reprofiling, missed payments, or the formal restructuring of public obligations. Operationally, it is identified through announcements of debt treatment, the use of grace periods, debt exchanges, payment suspensions, or other developments that place repayment capacity and creditor relations at the centre of the CRA response.

**Climate Event Driver.** This driver refers to episodes in which an acute climate-related shock, such as a flood or other major disaster, acts as the proximate event that intensifies sovereign stress. Operationally, it is identified where the shock significantly affects growth, fiscal pressures, external liquidity, reconstruction needs, or financing requirements, and where CRA narratives explicitly or implicitly treat the event as central to the deterioration in sovereign risk.

**Public Spending Adjustments Driver.** This driver refers to episodes in which sovereign stress is organized around fiscal adjustment, expenditure rationalization, subsidy reform, the weakening or suspension of fiscal anchors, or politically salient changes in public spending priorities. Operationally, it is identified through official fiscal announcements, budgetary decisions, or policy shifts that alter market perceptions of fiscal credibility, debt sustainability, or the state's capacity to maintain a stable macro-financial framework.

## CRAs' Response

The third component examines how CRAs interpret and codify the driver event. This involves tracing rating changes, outlook revisions, credit watches, and the narrative through which agencies justify their decisions. At this stage, the analysis considers whether the response appears broadly consistent with the agencies' stated methodologies or whether it reveals more discretionary, procyclical, or amplifying dynamics. The aim is to assess how CRAs translate macroeconomic stress into a formal signal for markets, and how that signal may reinforce rather than merely reflect existing vulnerabilities.

To guide this assessment, the paper draws on S&P's sovereign methodology as a reference point. S&P's global methodology for sovereign governments and monetary authorities sets out the criteria that, in its view, affect a sovereign's willingness and ability to repay its commercial creditors in full and on time. The framework rests on five core assessments: institutional, economic, external, fiscal, and monetary (S&P Global Ratings, 2019a). Although the three major agencies differ in terminology, weighting, and presentation, their methodologies are broadly comparable in that they evaluate similar dimensions of sovereign creditworthiness and combine quantitative indicators with forward-looking assumptions and qualitative judgement.

The institutional assessment captures how institutions and policymaking shape sovereign credit fundamentals. In practice, it reflects the government's capacity to sustain sound public finances, support balanced growth, and respond to political or economic shocks. It also includes less directly measurable elements such as data transparency, institutional accountability, and what S&P terms the sovereign's "debt repayment culture", alongside domestic and external security risks. The economic assessment evaluates the level, resilience, and adaptability of the economy through indicators such as income per capita, growth prospects, economic diversification, and macroeconomic volatility. The external assessment focuses on the economy's foreign-currency position, including its capacity to generate external liquidity, the balance between external assets and liabilities, the role and liquidity of the domestic currency, and the level and composition of international reserves.

The fiscal assessment captures deficit sustainability, fiscal flexibility, debt burden, debt structure, and access to financing, and is therefore central in cases involving debt restructuring, refinancing stress, or narrowing policy space. The monetary assessment considers the capacity of the monetary authority to preserve macroeconomic stability and cushion financial shocks, considering the exchange-rate regime, inflation performance, monetary credibility, and the depth of domestic financial markets. In comparative terms, this pillar is particularly sensitive to differences in monetary autonomy, capital-account openness, hard pegs, and fully dollarized regimes, where adjustment pressures tend to shift away from conventional monetary instruments and towards external liquidity management.

Each of these five assessments is scored on a six-point scale, from 1 (strongest) to 6 (weakest), and the resulting rating incorporates both current indicators and forward-looking judgement. This is especially important for the present analysis because sovereign ratings do not simply record existing macroeconomic conditions; they also embed expectations regarding policy credibility, political stability, recovery prospects, and future repayment capacity. In that sense, ratings are partly predictive constructions rather than purely descriptive evaluations, which creates space for both methodological interpretation and potential bias.

A central task at this stage is therefore to identify whether the CRA response is methodologically consistent or whether it reveals signs of bias. Methodological consistency is identified where the agency's decision can be clearly linked to its stated criteria, the underlying macroeconomic deterioration, and the sovereign's observable credit fundamentals. In contrast, bias is inferred

where the response appears excessively discretionary, asymmetrical, procyclical, or insufficiently aligned with the timing and substance of the underlying shock, particularly when the rating action seems to intensify rather than simply record existing vulnerabilities.

This distinction is particularly useful in the case study analysis because different driver events are likely to activate different parts of the methodology. A debt restructuring episode is expected to affect primarily the institutional and fiscal assessments, while also weakening the external assessment where restructuring is associated with shortages of foreign-currency liquidity or reserve inadequacy. A climate-related shock is more likely to be reflected through the economic, fiscal, and external pillars, given its effects on productive capacity, reconstruction costs, revenues, and the balance of payments. A public spending adjustment may be framed as evidence of fiscal fragility, but may also affect the economic and institutional assessments where expenditure compression undermines growth, social stability, or the state's capacity to sustain policy commitments.

At the same time, the five-assessment framework itself leaves room for discretion. Several of its components rely on qualitative judgement, forward-looking assumptions, and perception-based proxies, including notions such as policy credibility, governance quality, medium-term growth prospects, and "debt repayment culture". As a result, rating actions may be shaped not only by changes in measurable fundamentals, but also by how agencies interpret political risk, social conflict, reform trajectories, and the plausibility of future adjustment paths. This does not invalidate the methodology as such, but it does mean that CRA responses can operate not only as technical assessments of sovereign risk, but also as mechanisms through which broader market judgements are transmitted and, at times, amplified.

**Table 1. Mapping Driver Events to CRA Assessments and Rating Narratives**

Driver event	CRA assessments most likely activated	Indicative methodology-consistent CRA narrative
Debt restructuring	Institutional Fiscal External	The episode raises the likelihood of default or distressed exchange, weakens debt sustainability and fiscal flexibility, tightens external liquidity, and casts doubt on repayment capacity and willingness to pay.
Climate shock	Economic Fiscal External	The shock is expected to weaken growth and productive capacity, increase fiscal pressures through reconstruction costs and revenue losses, and intensify external financing needs or foreign-currency stress.
Public spending adjustment	Fiscal Economic Institutional	The shock is expected to weaken growth and productive capacity, increase fiscal pressures through reconstruction costs and revenue losses, and intensify external financing needs or foreign-currency stress.

*Note: The table identifies the principal methodological rationale a CRA may invoke in each type of driver event, together with the indicators used in the case studies to assess whether the response appears methodologically consistent or shows signs of bias.*

## Market Reactions (Short-Term)

The fourth dimension examines the short-term behaviour of key financial indicators around the main event dates. Where data are available, the analysis uses event windows to trace movements in sovereign spreads, international bond yields or prices, exchange rates, international reserves, and, where relevant, selected domestic monetary indicators such as policy rates or short-term liquidity conditions. These variables make it possible to observe whether the episode was expressed through sovereign debt repricing, exchange-rate pressure, reserve depletion, or tighter financing conditions in the immediate aftermath of the driver event or the CRA action.

The purpose of this stage is not to claim strict causality between rating actions and market movements. Rather, it is to identify whether CRA signals coincide with shifts in market sentiment, a reassessment of sovereign risk, or an observable tightening in short-term financing conditions. In several cases, market prices may already incorporate part of the deterioration before the formal rating action takes place; in others, the rating may serve to validate, amplify, or prolong an ongoing repricing of risk. The event-window approach is therefore used in a descriptive and comparative sense, allowing the analysis to trace the timing, direction, and intensity of market responses without assuming that rating actions are the sole source of the observed movement.

The interpretation of short-term reactions also depends on the monetary and exchange-rate regime. In economies with floating exchange rates, sovereign stress may be reflected more visibly through currency depreciation and yield movements. In dollarized economies or under hard pegs, by contrast, the immediate adjustment may be less evident in the exchange rate and more visible in sovereign asset prices, reserve losses, or broader foreign-currency liquidity pressures. For that reason, short-term market reactions are analyzed not as a uniform set of outcomes, but as regime-conditioned expressions of sovereign stress.

## Transmission Channels (Medium-Term)

The final dimension examines how the effects of the episode are transmitted beyond the immediate market response. The focus is on the medium-term mechanisms through which sovereign rating actions interact with borrowing costs, refinancing capacity, access to external markets, debt-servicing burdens, and wider macro-financial adjustment. In this sense, the analysis does not treat rating actions as isolated announcements, but as part of a broader process through which financing conditions may tighten over time.

The main channels considered include a higher sovereign risk premium, more limited or more costly access to external financing, reduced room for refinancing, rising debt service pressures, and, where relevant, exchange-rate depreciation or reserve depletion. The relative importance of these channels varies across cases depending on the monetary and exchange-rate regime. Under floating regimes, stress may be transmitted more visibly through currency weakness and a higher domestic-currency burden of external debt; under dollarization or hard pegs, it is more likely to appear through foreign-currency liquidity constraints, reserve losses, and tighter financing conditions.

This stage is particularly important for understanding how sovereign ratings can become part of a cumulative process of financial constraint in developing economies. Even where the short-term market response is limited, a downgrade or negative outlook may still validate adverse market perceptions, increase the future cost of funding, and narrow the policy space available to governments already facing fiscal and external vulnerability.

## Case Selection and Country Case Classification

The case selection is purposive rather than statistical. The objective is not to construct a representative sample of all sovereign rating events, but to assemble a set of cases that captures variation across regions, monetary regimes, and forms of sovereign stress while preserving a common analytical structure. The sample therefore includes Argentina, Belize, Colombia, Ecuador, Indonesia, the Maldives, Pakistan, Sri Lanka, and Zambia. Each case is assigned a primary driver classification based on a close reading of the sequence linking the trigger event, the CRA narrative, the pillars of sovereign assessment most directly affected, and the channels through which stress is transmitted to financing conditions and external debt servicing.

In each case, the assigned driver should be understood as the dominant organizing mechanism of the episode rather than as an exclusive explanation. Several cases combine overlapping sources of vulnerability, but the classification focuses on the exogenous event that most clearly structures the CRA narrative, the short-term market response, and the medium-term transmission of stress into borrowing costs and external debt service. Within each broader driver category, specific subcategories may be identified in order to capture the immediate form through which stress is expressed in a given country. Thus, debt restructuring cases may also involve proximate triggers such as political shocks, external financing shocks, or pandemic-related disruptions; climate event cases may differ according to the scale and macroeconomic effects of the disaster; and public spending adjustment cases may take the form of subsidy reform or expenditure contraction, changes in fiscal discipline levers likely acting as, or broader disputes over fiscal credibility. These subcategories do not replace the primary classification, but help to specify the concrete mechanism through which sovereign stress is activated, interpreted by CRAs, and transmitted into tighter financing conditions.

The first group of cases is classified under the debt restructuring driver. This includes Argentina, Belize, Ecuador, Sri Lanka, and Zambia, where the core of the episode revolved around default, distressed exchange, missed payments, or the formal restructuring of sovereign obligations. In these cases, sovereign stress was mediated primarily through the redefinition of repayment capacity, repayment terms, and creditor relations.

The second group is classified under the climate event driver. Pakistan is the clearest case in this category, since the 2022 floods functioned as the proximate shock that transformed pre-existing macroeconomic and external fragilities into a more acute episode of sovereign stress. In this case, the climate shock most clearly structured the downgrade narrative, the worsening in financing conditions, and the subsequent transmission of stress into debt-servicing pressures.

The third group is classified under the public spending adjustment driver. This includes the Maldives, Colombia, and Indonesia, where the central issue was not sovereign restructuring but the interaction between fiscal anchors, expenditure choices, subsidy reform, reserve rebuilding, policy credibility, and market confidence. In these cases, the relevant episodes were organized around the management of fiscal adjustment, the credibility of macroeconomic policy, and the extent to which sovereign risk was shaped by government decisions over public spending priorities and the broader policy framework.

This classification makes it possible to compare CRA behaviour across three distinct mechanisms of sovereign stress: debt restructuring, climate shock, and adjustment through fiscal policy and public expenditure. At the same time, the framework remains flexible enough to recognize that several episodes combine more than one source of vulnerability. The purpose of the classification is therefore analytical rather than mechanical: it identifies the driver that most clearly structures the downgrade narrative, the short-term market reaction, and the medium-term transmission channels in each case.

## Case Study Analysis

The following cases have been examined to show that the episodes cannot be understood solely in terms of domestic macroeconomic deterioration or country-specific policy decisions, but rather should be seen in the context of the international monetary system within which developing economies face unequal and unstable access to liquidity and external financing, and lack of policy space on the monetary level. Under these conditions, “original sin” remains a defining constraint, since many sovereigns continue to rely on borrowing in foreign currency and are therefore acutely exposed to shifts in market sentiment and refinancing conditions. In this setting, rating actions contribute to a self-fulfilling prophecy in which adverse assessments validate market pressure, raise borrowing costs, weaken access to external finance, and thereby help produce the very fragilities they are said to measure.



# Argentina

<b>Driver Classification:</b>	Debt Restructuring / Political Shock
<b>Rating Agencies Covered:</b>	S&P / Moody's / Fitch
<b>Date:</b>	August–September 2019

## Case Study Analysis

In Argentina, the events of August and September 2019 constitute one of the clearest examples of how a political and electoral shock can rapidly develop into a sovereign stress episode, a loss of market access and, ultimately, a reframing of the debt profile as a case of default or distressed exchange. Following the outcome of the 11 August PASO primary elections,[1] S&P and Fitch downgraded the sovereign on 16 August, arguing that the abrupt shift in policy expectations and the tightening of financing conditions had materially increased the likelihood of default (S&P Global Ratings, 2019b; Fitch Ratings, 2019a). S&P stated explicitly in its report that the negative outlook reflected uncertainty amid highly complex economic and financial market dynamics, further exacerbated by the timing of the electoral calendar (S&P Global Ratings, 2019b).

The situation escalated on 28 August, when the Minister of Finance announced an extension of maturities on short-term instruments issued under domestic law, together with the government's intention to renegotiate maturities with private creditors and the International Monetary Fund (IMF), presenting the measure as a reprofiling aimed at preserving debt-servicing capacity (Reuters, 2019b). However, the rating agencies interpreted this liability management operation as a credit event: S&P lowered the rating to SD (Selective Default) on 29 August (S&P Global Ratings, 2019c), Fitch downgraded it to RD (Restricted Default) on 30 August (Fitch Ratings, 2019b), and Moody's cut it to Caa2 while signalling the possibility of a further downgrade, emphasizing the expectation of investor losses (Reuters, 2019d).

The rating agencies did not cause the entire deterioration, but they did formally classify it under the technical definition of default. In other words, the market had already begun to reprice Argentine debt after the PASO primaries, but the intervention of S&P, Moody's and Fitch transformed a liquidity and rollover crisis into a formal signal of a credit event, reinforcing the closure of external financing and further narrowing the scope for economic policy manoeuvre.

## Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (GDP annual growth, %)-	2.2-	9.9	10.24	.0	-1.6	-1.7	5.5*
<b>Inflation</b> (CPI, %) <sup>5</sup>	3.8	36.1	50.94	3.0	211.4	117.83	1.5**
<b>Fiscal balance</b> (% GDP)	-4.5	-8.3	-4.5	-4.0	-5.1	0.3	0.0*
<b>Current account</b> (% GDP)-	0.8-	0.91	.3	0.5-	3.2	-1.0	-0.4*
<b>Reserves</b> (USD bn)	44.8	39.43	9.7	49.11	0.11	6.63	6.3*
<b>Debt</b> (% GDP) <sup>8</sup>	8.0	102.8	80.6	74.4	155.4	85.3	73.1*

Source: Authors' calculations based on official Argentine and IMF sources, supplemented by Reuters reporting for the 2019 CPI figure

\*Projected/programme figures. \*\*Observed year-end figure.

## Driver Event Narrative

The Argentine episode can be classified as a debt restructuring episode accompanied by a political shock, as the immediate trigger was not simply a deterioration in the public finances, but rather the interaction between a political shock, the loss of market access and the government's decision to reprofile maturities. The 11 August PASO primaries abruptly altered expectations regarding programme continuity, the government's payment strategy and its relationship with creditors. For this reason, even before the formal announcement of the reprofiling, Fitch and S&P had already downgraded the sovereign on 16 August, explicitly linking the electoral outcome to tighter financial conditions and a higher likelihood of default (S&P Global Ratings, 2019b; Fitch Ratings, 2019a).

When, on 28 August, the Minister announced an extension of maturities on short-term debt and the intention to renegotiate the maturities of sovereign bonds, as well as the agreement with the IMF, the government sought to present the measure as a liquidity operation aimed at preserving debt-servicing capacity (Reuters, 2019b). However, the rating agencies interpreted the decision as a unilateral alteration of the original terms of the debt. In this shift, the narrative moved from financing stress to a credit event, and the boundary between liability management and selective default all but disappeared (S&P Global Ratings, 2019c; Fitch Ratings, 2019b; Reuters, 2019d).

Daily data show that the market had already begun to price in a crisis before the announcements of 28–30 August. Taking 12 August, the first trading day after the 11 August PASO primaries, as the reference date, the USD T-spread rose from 1,261.8 basis points (bps) in t0 to 1,662.0 in t+1 and 3,285.1 in t+15; the one-year probability of default

increased from 39.9 per cent to 72.5 per cent over the same horizon; and the 7-day LELIQ rate[2] climbed from 55.1 per cent to 67.4 per cent.

Although the repricing of sovereign risk began with the political shock rather than with the formal downgrades by the agencies, the subsequent actions of the CRAs acted as amplification mechanisms. In the window surrounding the government's announcement, the T-spread increased from 2,815.1 to 2,975.5 bps in the next available observation, while the probability of default rose from 49.1 per cent to 65.1 per cent. In the rating agency window, the spread rose again from 2,975.5 to 3,181.4 bps, and the probability of default from 65.1 per cent to 72.8 per cent. By contrast, the LELIQ rate showed little immediate reaction and increased only with a lag, reaching 76.0 per cent by t+10.

In econometric terms, between 1 August and 15 October 2019, the correlation in levels between the T-spread and the one-year probability of default was 0.94, while the correlation in first differences was 0.60. By contrast, the correlation with the LELIQ rate was 0.79 in levels, but virtually zero in daily changes.[3] From this perspective, the appropriate interpretation is not one of a pure causal effect running from the rating action to the market, but rather one of endogeneity with an amplifying effect: both the market and the rating agencies were responding to the same shock, yet the rating actions reinforced the closure of financing conditions.

## Event Windows

GOVERNMENT ANNOUNCEMENT (t0 = 28-Aug 2019)							
VARIABLE	t0	t+1	t+5t	+10t	+15	t+30	Maximum variation in 30 observations
USD sovereign spread (T-spread, bps)	2915.1	2975.53	216.3	2889.2	2924.4	2994.91	8.30%
1Y default probability (%)	49.16	5.1	71.36	46	2.47	1.85	7.90%
7-day LELIQ rate (%)	67.46	7.4	67.57	67	3.86	2.12	2.40%
ARS/USD exchange rate	57.54	58.155	5.87	55.8	56.04	57.526	.70%
CREDIT RATING AGENCIES' ACTIONS (t0 = 29-Aug-2019)							
VARIABLE	t0	t+1	t+5t	+10t	+15	t+30	Maximum variation in 30 observations
USD sovereign spread (T-spread, bps)	2975.5	3181.43	073.2	2868.5	2937.5	2869.11	8.30%
1Y default probability (%)	65.17	2.8	69.16	1.76	2.56	9.22	6.00%
7-day LELIQ rate (%)	67.46	7.4	67.57	67	1.16	0.82	5.10%
ARS/USD exchange rate	58.15	58.825	5.75	55.81	56.07	57.656	.70%

Source: Calculations using the Cbonds dataset. t0 is the first available observation on the event date; t+1, t+5, t+10, t+15 and t+30 denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between t0 and t+30, relative to the minimum level in that window.

The exchange rate did not move substantially between the government's announcement and the rating downgrades, but its depreciation became more pronounced over the following weeks, once the central bank ceased actively defending the peso. As a result, international reserves fell from USD 61.2 billion in July 2019 to USD 47.8 billion in August, USD 42.4 billion in September, and USD 36.9 billion in October. Monthly inflation rose from 2.2 per cent in July to 4.0 per cent in August and 5.9 per cent in September. According to Reuters, the central bank spent almost USD 1 billion in reserves within a matter of days to support the peso, before the reintroduction of capital controls in early September (Reuters, 2019e).

The Argentine case displays a sequence characteristic of peripheral economies, in which a political shock triggers a sharp rise in sovereign spreads, and this pressure is then transmitted into exchange-rate volatility which, when met by intervention from the monetary authority, is reflected in a loss of international reserves. This process ultimately led to the re-establishment of foreign exchange controls.

From the perspective of monetary hierarchy, this dynamic reflects a structural vulnerability associated with the subordinate position of the domestic currency within the international monetary system. In economies such as Argentina, where the domestic currency does not function as a reserve asset and external stability remains persistently dependent on access to foreign exchange, political shocks tend to translate rapidly into financial penalties, impaired market access, and heightened pressure on external liquidity.

### Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
17/07/25	Caa1 (Stable)						
24/01/25	Caa3 (Positive)						
27/09/22	Ca (Stable)						
28/09/20	Ca (Stable)						
03/04/20	Ca (Stable)						
30/08/19	Caa2 (Under review)						
12/07/19	B2 (Negative)						
29/11/17	B2 (Stable)						
06/03/17	B3 (Positive)						

S&P							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
17/12/25	CCC+ (Stable)	17/12/25	CCC+	07/09/20	C	17/12/25	C
15/03/24	CCC (Stable)	15/03/24	CCC	07/04/20	SD	15/03/24	C
29/03/23	CCC- (Negative)	13/03/24	SD	30/12/19	C	13/03/24	SD
16/11/22	CCC+ (Negative)	13/06/23	CCC-	20/12/19	D	13/06/23	C
07/09/20	CCC+ (Stable)	08/06/23	SD	30/08/19	C	08/06/23	SD
07/04/20S	D	14/03/23	CCC-	06/05/16	B	14/03/23	C
07/01/20	CCC- (Negative)	09/03/23	SD			09/03/23	SD
30/12/19	CC (Negative)	09/03/23	CCC-			09/01/23	C
20/12/19S	D	09/01/23	SD			06/01/23	SD
30/08/19	CCC- (Negative)	16/11/22	CCC-			07/09/20	C
16/08/19B	- (Negative)	07/09/20	CCC+			21/01/20	SD
12/11/18B	(Stable)	21/01/20	SD			30/08/19	C
30/10/17B	+ (Stable)	07/01/20	CCC-			03/02/16	B
04/04/17B	(Stable)	20/12/19	CC			10/09/13	C
06/05/16B	- (Stable)	30/08/19	CCC-			13/09/10	B
30/07/14S	D	16/08/19	B-				
29/11/17	CCC- (Negative)	12/11/18	B				
10/09/13	CCC+ (Negative)	30/10/17	B+				

FITCH							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
24/03/23C		26/10/22	CCC-	17/04/20	C		
26/10/22	CCC-	10/09/20	CCC	07/04/20	C		
10/09/20	CCC	17/04/20	RD	06/04/20	RD		
26/05/20R	D	07/04/20	RD	23/01/20	C		
17/04/20C		23/01/20	RD	23/12/19	C		
07/04/20C	C	23/12/19	CC	20/12/19	RD		
06/04/20R	D	20/12/19	CC	03/09/19	C		
23/01/20C	C	03/09/19	CC	03/08/19	RD		
23/12/19C	C	30/08/19	RD	16/08/19	C		
20/12/19R	D	16/08/19	CCC	14/05/19	B		
03/09/19C	C	14/05/19	B	07/11/18	B		
30/08/19R	D	07/11/18	B	04/05/18	B		
16/08/19	CCC	04/05/18	B				
14/05/19B							
07/11/18B							
04/05/18B	(Stable)						
07/11/17B	(Positive)						

Source: [datosmacro.com](https://datosmacro.com)

### **CRAs' Response: Methodology-Consistent vs Discretionary/Bias**

During this episode, the three agencies activated their respective frameworks of distressed exchange or selective default, as the sovereign's decision entailed a unilateral extension of maturities and a higher likelihood of losses for bondholders. In their view, this justified a move to SD, RD and Cad2, respectively. Moreover, the earlier statements issued on 16 August had already incorporated the political shock and the tightening of financing conditions as factors weakening the sovereign's creditworthiness.

However, the fact that this response can be accommodated within the agencies' methodology does not remove the problem of bias and discretion. In Argentina, the agencies were not merely observing a quantitative deterioration; they were also judging the credibility of the policy framework in a context of political transition, electoral uncertainty and extreme dependence on external financing.

This is where the amplifying bias becomes visible. In a peripheral economy marked by strong de facto dollarization of portfolios, high spreads and limited market access, a downgrade does not merely describe risk; it also contributes to producing it. Causality in this sense is not linear, but circular. The sovereign reprofiles because it has lost market access, yet the formal downgrade helps to make that loss of access even deeper and more persistent.

### **Transmission Channels and Implications on External Debt Service Costs**

The exchange-rate channel was one of the most immediate and powerful mechanisms through which the Argentine shock affected debt-servicing conditions. According to the Banco Central de la República Argentina (BCRA), the country's central bank, the peso depreciated by 22.8 per cent on the first business day after the PASO primaries and weakened further to ARS 59.1 per US dollar by the end of August, implying a cumulative depreciation of 30.1 per cent relative to 9 August (Banco Central de la República Argentina [BCRA], 2019).

Reuters likewise reported that, by early September, the peso had already lost 28 per cent of its value since the 11 August primary election, even after official intervention and before the new exchange controls temporarily stabilized the official rate (Reuters, 2019c). In practical terms, this meant that the sovereign shock was not confined to bond prices and country-risk indicators; it rapidly spilled over into the foreign-exchange market, where the loss of confidence translated into a sharp increase in the domestic-currency cost of servicing foreign-currency liabilities.

This transmission channel mattered because exchange-rate depreciation directly worsened debt dynamics in a highly dollarized and externally constrained economy. The IMF later stressed that, despite foreign-exchange interventions beyond programme provisions, the peso continued to depreciate, thereby raising inflation and increasing the peso value of public debt (International Monetary Fund [IMF], 2021). The BCRA itself acknowledged that the depreciation after the primaries interrupted the previous disinflation trend, while inflation accelerated to 5.9 per cent in September, reflecting a rapid pass-through from the exchange rate to domestic prices (BCRA, 2019).

At the same time, the defence of the currency entailed a significant loss of reserves: the BCRA reported that international reserves had fallen by USD 18.35 billion between the Friday before the primaries and 8 October, while Reuters noted that the central bank sold nearly USD 1 billion in the second half of the final week of August alone in order to support the peso (BCRA, 2019; Reuters, 2019e). The broader implication is that exchange-rate depreciation did not merely accompany the crisis; it amplified it by increasing the domestic burden of external debt, worsening inflation, and forcing the authorities to spend scarce reserves before reimposing exchange controls.



## Ecuador

**Driver Classification:**

Debt Restructuring / External-Financing Shock

**Rating Agencies Covered:**

S&amp;P / Moody's / Fitch

**Date:**

April–August 2020

### Case Study Analysis

In 2020, the rating agencies treated the Ecuadorian case as an episode of debt distress accelerated by an external liquidity shock. The combination of the pandemic, the collapse in oil prices and the loss of market access led the government to launch, on 8 April, a consent solicitation aimed at deferring payments and creating liquidity space while negotiating a broader restructuring (World Bank, 2020; Economic Commission for Latin America and the Caribbean, 2021). Fitch downgraded Ecuador to CC on 24 March, then to C on 9 April and to RD on 20 April, while S&P moved from CCC-/C with negative CreditWatch on 25 March to SD/SD on 13 April. Following the completion of the debt exchange at the end of August 2020, both Fitch and S&P upgraded the sovereign risk back to B-, reflecting the fact that the transaction had eased the immediate default risk, even though it did not remove Ecuador's underlying structural fragility (Fitch Ratings, 2020b, 2020a, 2020c, 2020d; S&P Global Ratings, 2020d, 2020e, 2020c).

## Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (GDP annual growth, %)-	0.1-	9.29	9.45	.9	2.0-	2.0	
<b>Inflation</b> (CPI, %)-	0.1-	0.91	.9	3.71	.4	0.51	.9*
<b>Fiscal balance</b> (% GDP)-	3.5-	7.1-	1.7-	0.2-	3.7-	1.3-	1.2*
<b>Current account</b> (% GDP)-	0.12	.7	2.92	.4	1.95	.7	6.0*
<b>Reserves</b> (USD bn)	3.47	.2	7.98	.5	4.56	.9	9.8*
<b>Debt</b> (% GDP)	53.46	5.9	58.6	55.4	51.2	49.9	50.3*

Source: Authors' calculations based on official Argentine and IMF sources, supplemented by Reuters reporting for the 2019 CPI figure

\*Projected/programme figures. \*\*Observed year-end figure.

## Driver Event Narrative

The 2020 episode in Ecuador shows how an external shock can quickly turn into a restructuring episode. The trigger was not a single fiscal announcement, but the convergence of three factors: the COVID-19 shock, the collapse in oil prices and the loss of access to market financing. The Ministry of Economy and Finance acknowledged that gross financing needs for 2020 to 2024 had more than doubled relative to December 2019 and that market access was no longer a viable source of funding for Ecuador. Within that context, the debt operation was presented as a way of gaining breathing space, easing immediate liquidity pressures, reducing refinancing risks and aligning the strategy with the IMF's debt sustainability framework (Ministry of Economy and Finance of the Republic of Ecuador, 2020; World Bank, 2020; Economic Commission for Latin America and the Caribbean, 2021).

The institutional sequence then moved very quickly. On 8 April 2020, the government launched the consent solicitation. On 17 April, it announced that holders of nearly USD 20 billion in bonds had agreed to defer interest payments until August. The official timetable also made clear that 24 April marked the end of the grace period, after which Ecuador would face a legal default if the consent solicitation was not successful. In other words, the government was not only preparing a broader restructuring, but also trying to avoid a disorderly default in the very short term while securing multilateral support and negotiating with private creditors.

The rating agencies translated that sequence into a narrative of imminent default. Fitch first pointed to a deterioration in Ecuador's capacity and willingness to pay, moving from CC to C and then to RD as the authorities announced their intention to renegotiate commercial liabilities and make use of the grace period. S&P followed a similar path, placing Ecuador at CCC-/C with negative CreditWatch on 25 March and then lowering it to SD/SD on 13 April. The central point is that the agencies did not interpret the operation as an orderly liability management strategy, but as confirmation that default or distressed exchange had already become the baseline scenario (Fitch Ratings, 2020b, 2020a, 2020c; S&P Global Ratings, 2020d, 2020e).

It is not possible to construct a standard event window for Ecuador. This is due not merely to a data limitation, but to a structural feature of the case itself. As a dollarized economy, Ecuador lacks a domestic currency and does not operate an independent monetary policy, which removes two of the main channels through which rating announcements are usually tracked at high frequency: exchange-rate adjustment and the interaction between sovereign stress and monetary policy. At the same time, the available information does not permit the consistent reconstruction of a domestic sovereign yield curve for the period under review, making it difficult to observe movements in term premia across maturities around the key rating dates. For that reason, the analysis focuses instead on the sequence linking the downgrade to tighter financing conditions, weaker rollover capacity, and the deterioration of external debt-servicing conditions within a fully dollarized monetary regime.

The subsequent normalization confirms that the main driver of the episode was restructuring under conditions of acute external financing stress. By early August 2020, Ecuador reported that it had secured support for the restructuring of USD 17.4 billion in bonds. S&P later noted that the distressed debt exchange had been completed at the end of August, extending maturities and reducing both face value and interest payments. In the first days of September, both S&P and Fitch upgraded the sovereign back to B-. This did not mean that Ecuador's vulnerabilities had disappeared, only that it had moved from default or selective default into a post-restructuring phase with slightly greater financial breathing space.

### Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
26/01/25C	aa1 (Stable)						
13/06/25C	aa3 (Stable)						
27/02/23C	aa3 (Stable)						
26/02/21C	aa3 (Stable)						
03/04/20C	aa3 (Negative)						
06/02/20C	aa1 (Stable)						
12/12/18	B3 (Negative)						

S&P							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
20/08/25B	- (Stable)						
11/01/24B	- (Negative)						
01/09/20B	- (Stable)	20/08/25	B-				
13/04/20S	D	11/01/24	B-				
24/03/20	CCC-	01/09/20	B-				

FITCH							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
03/09/20B	-(Stable)			03/09/20	B		
20/04/20R	D			20/04/20	C		
09/04/20C				09/04/20	C		
24/03/20C	C			24/03/20	C		
19/03/20	CCC			19/03/20	C		
21/08/19B	-			21/08/19	B		
10/01/19B	-			10/01/19	B		
17/08/18B	-(Stable)			17/08/19	B		

Source: [datosmacro.com](https://datosmacro.com)

### CRA's Response: Methodology-Consistent vs Discretionary/Bias

From a methodological perspective, the actions of the rating agencies can be presented as broadly consistent with their stated frameworks. Fitch argued that the fall in oil prices, the loss of market access and the government's decision to renegotiate its liabilities had materially increased the risk of default. S&P adopted a similar view, framing the case as one in which default or distressed exchange had become highly likely in the short term. In terms of sovereign assessment, the episode activated at least three dimensions at once: the fiscal pillar, because financing needs widened abruptly; the external pillar, because Ecuador remained dependent on dollar funding in a context of closed market access; and the institutional pillar, because the authorities' ability to manage an orderly restructuring came under severe pressure.

Even so, the fact that the agencies' response can be accommodated within their methodology does not remove the broader design problem. The Ecuadorian case shows that the rating does not operate only as an ex-post measure of distress, but also as a judgement about what constitutes an acceptable sovereign response under extreme stress. The government stated explicitly that the consent solicitation was intended to provide temporary relief in the face of the health emergency and the oil shock, while preserving cooperation with the IMF and other multilateral funders. Yet the agencies treated the deferral as confirmation that a default event had effectively become the baseline scenario. In that sense, the methodology captures the formal alteration in payment terms but leaves in the background the structural asymmetry of a dollarized economy without a lender of last resort in its own currency and with no effective access to market financing.

This is where the amplifying bias becomes most visible. In a peripheral and dollarized economy, the language of probable default or selective default does not merely

describe an existing fragility; it also contributes to tightening the conditions under which restructuring must be negotiated. The IMF itself noted that, given the debt operation already under way, Ecuador had effectively lost market access and would have to rely on multilateral and bilateral financing during 2020. Under those conditions, the downgrade ceases to be a neutral signal and becomes part of the same mechanism that restricts sovereign room for manoeuvre.

### **Transmission Channels and Implications on External Debt Service Costs**

In Ecuador, dollarization removes the possibility of absorbing shocks through exchange-rate adjustment. Without that buffer, the need for dollar liquidity becomes far more visible. The limited policy instruments available in a dollarized economy, combined with restricted access to financing, tend to deepen fiscal and external strains when capital flows reverse. In that context, the downgrade is transmitted less through exchange-rate pass-through than through the inability to refinance on reasonable terms and the need to preserve cash in dollars in order to sustain priority payments.

The transmission channel operates through the sovereign premium, bond pricing and the formal classification of credit events. The CRAs framed the consent solicitation as evidence that default or distressed exchange had become imminent. Fitch downgraded Ecuador to C after stating that some form of sovereign default was now likely, while S&P moved the sovereign to SD/SD on the expectation of missed interest payments and a distressed exchange. In this sense, the rating does not merely reflect risk; it also reclassifies the contractual and regulatory environment surrounding sovereign credit, raising the cost of bridge financing and increasing the shadow cost of external debt service even before new coupon payments are due. The sovereign therefore ends up paying more not only in financial terms, but also through the concessions required to restore sustainability.

In its official communication to investors, the Ministry of Economy and Finance made clear that market access was no longer a viable funding option for Ecuador and linked the worsening in financing conditions to a broader rise in risk premia across the high-yield segment. These conditions increased the intertemporal cost of debt service, because commercial rollover had effectively been blocked and the payment profile in dollars became critically dependent on available cash and external liquidity. As a result, the opportunity cost of allocating resources to coupon payments rather than priority spending increased sharply, reinforcing the need to restructure in order to obtain immediate relief and reduce refinancing risk.



## Sri Lanka

<b>Driver Classification:</b>	Debt Restructuring / Political Shock
<b>Rating Agencies Covered:</b>	S&P / Moody's / Fitch
<b>Date:</b>	April 2022 – 2023

### Background

In April 2022, Sri Lanka defaulted on its external debt for the first time, marking a critical juncture in the country's economic trajectory. The default occurred in the context of a severe balance-of-payments crisis, rapidly declining foreign exchange reserves, and acute political instability. Notably, Sri Lanka was ineligible for assistance under the G20 Common Framework for Debt Treatments, established in November 2020 to coordinate debt restructuring for low-income countries. This exclusion compelled Sri Lanka to rely on creditor-driven restructuring processes. Consequently, the country's debt treatment diverged from the principles articulated in the Addis Ababa Action Agenda, which emphasizes shared responsibility between creditors and debtors and advocates for restructuring approaches that preserve fiscal space for sustainable development. Instead, Sri Lanka's restructuring imposed a disproportionate adjustment burden on domestic institutions and citizens, raising concerns regarding both distributive equity and long-term development outcomes.

Sri Lanka's experience also illustrates the broader and increasingly influential role of CRAs, whose assessments extend beyond the evaluation of default risk to shape policy incentives and macroeconomic trajectories. In December 2024, Fitch upgraded Sri Lanka's Long-Term Foreign Currency Issuer Default Rating (IDR) from RD to CCC+, citing the successful completion of a foreign debt exchange with a 98 per cent participation rate, the conclusion of domestic debt optimization in September 2023, and emerging signs of macroeconomic stabilization. Fitch also upgraded the Local Currency IDR to CCC+, aligning it with the foreign currency rating on the basis of reduced default risks on domestic obligations. While these upgrades signalled improved investor confidence, they also implicitly validated the macro-fiscal consolidation and austerity measures embedded in Sri Lanka's 48-month IMF Extended Fund Facility (EFF),<sup>[4]</sup> initiated in March 2023. In this way, CRA signals not only influence market perceptions but also shape domestic policy choices, often reinforcing priorities that privilege fiscal consolidation and creditor repayment over developmental and social expenditures.

## Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (real GDP, %)-	0.3-	0.52	.7	-12.44	.3	5.4	5.4
<b>Inflation</b> (CPI, %) <sup>3</sup>	.1	-4.8	3.54	7.70	.6	2.7	2.7
<b>Fiscal balance</b> (% GDP)	-9	-10.7-	11.7-	10.2	-8.3	-6.8	
<b>Current account</b> (% GDP)-	2.1-	1.4-	3.7-	1.91	.7	1.2	
<b>Reserves</b> (USD bn)	7642	56643	1391	898	4392	61226	838
<b>Debt burden</b> (Public sector gross debt, % GDP)	81.9	96.6	100	114.21	04.2	96.1	

Source: Calculations based on Cbonds data

The key indicators in the above table reflect the economy's expansion or contraction over time, notably highlighting severe downturns during 2020 and 2022 due to external shocks and internal challenges. Inflation rates, measured by the Consumer Price Index (CPI), indicate the level of price stability, with a dramatic surge in 2022 signalling hyperinflationary pressures. The fiscal stance, represented by the central government's budget balance as a percentage of GDP, illustrates the degree of fiscal deficits, which widened notably during the crisis years, implying increased government borrowing and debt accumulation.

The current account balance relative to GDP captures external trade and income flows, fluctuating with external shocks and economic adjustments. Reserves quantify the country's foreign currency stockpile to meet external obligations, with a significant depletion in 2022 highlighting external vulnerabilities. Lastly, the public debt burden, expressed as a percentage of GDP, underscores the escalating debt levels that threaten fiscal sustainability, with a peak in 2022 reflecting mounting debt-servicing pressures amid economic turmoil.

## Case of Restructuring

A central consequence of Sri Lanka's debt crisis and restructuring has been a substantial contraction of fiscal space for sustainable development. The March 2023 bailout agreement between the IMF and the government of Sri Lanka, led by President Ranil Wickremesinghe, provided financial assistance of less than USD 3 billion over a four-year period to address the country's balance-of-payments crisis. As a precondition for the loan, the IMF required Sri Lanka to restructure both its external and domestic public debt, including obligations to private international lenders, bilateral creditors, and domestic financial institutions such as the country's central bank, commercial banks, and pension funds. The restructuring framework aimed to limit losses for foreign creditors to an approximate 30 per cent haircut, while reducing the government's interest burden by approximately 0.5 percentage point of GDP annually through adjustments

to domestically held sovereign bonds. In particular, interest rates on government bonds held by major pension funds were to be reduced from over 20 per cent to 12 per cent, and subsequently to 9 per cent from 2025 until maturity, with pension fund returns also subject to a 30 per cent tax. Additional IMF conditions included a transition to a market-determined exchange rate, which contributed to currency depreciation and higher import prices, as well as fiscal consolidation measures such as increasing the value-added tax (VAT) to 15 per cent. Another important aspect of the conditionalities imposed included the restructuring of state-owned enterprise debts (as seen with Ceylon Petroleum Corporation). These reforms directly affect a wide range of stakeholders, including foreign creditors, domestic banks, pension funds, corporations, and wage-earning households, particularly workers whose retirement savings are invested in these funds (Ghosh & Ruwanpura, 2023).

According to the Central Bank of Sri Lanka's Economic Review 2024, total government expenditure amounted to LKR 6,131 billion. Of this, nearly half, LKR 2,690 billion (44 per cent), was allocated to interest payments. Recurrent expenditures further constrained fiscal flexibility, with salaries and wages totalling LKR 1,066 billion and pensions and welfare transfers amounting to LKR 1,234 billion. In contrast, only LKR 791 billion (13 per cent) was devoted to capital investment. This expenditure composition reflects a significant development constraint, as debt-servicing obligations have crowded out spending on critical sectors such as infrastructure, education, healthcare, and climate adaptation, thereby undermining progress towards the Sustainable Development Goals (SDGs) (Central Bank of Sri Lanka, 2024).

On the revenue side, Sri Lanka's fiscal adjustment has relied heavily on consumption-based taxation. VAT and excise duties together generated over LKR 2,181 billion, more than half of total government revenue, while income taxes contributed a comparatively modest LKR 1,026 billion. The regressive incidence of consumption taxes places a disproportionate burden on low-income households, exacerbating income inequality and directly conflicting with the objectives of SDG 10 (Reduced Inequality) and SDG 1 (No Poverty). In aggregate, the fiscal structure reveals a pattern in which debt service dominates expenditure, consumption taxes underpin revenue mobilization, and continued borrowing remains necessary to close financing gaps (Central Bank of Sri Lanka, 2024).

### **Driver Event Narrative**

The April 2022 default can be categorized as the debt restructuring driver that led to the credit rating agencies' downgrading. In this specific case, Fitch downgraded Sri Lanka's foreign currency bonds issued on international markets to C from CC. The Long-Term Local Currency IDR was affirmed at CCC and the Country Ceiling at B- (Fitch Ratings, 2022a). Moody's downgraded Sri Lanka's long-term foreign currency issuer and senior unsecured debt ratings to Ca from Caa2 on 18 April 2022, while keeping its outlook at stable. The decision to downgrade, according to Moody's, was driven by the authorities' announcement of suspension of external public debt repayments, which would lead to a series of defaults with the first coupon payments for the government's international bonds coming due on 18 April (The Morning, 2022). S&P lowered Sri Lanka's foreign currency rating to CC from CCC, citing the economic crisis in the country and rising external funding pressures.

## Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
23/12/24C	aa1 (Stable)						
28/11/24C	a (Under review)						
18/04/22C	a (Stable)						
28/10/21C	aa2 (Stable)						
19/07/21C	aa1 (Under review)						
28/09/20C	aa1 (Stable)						
17/04/20	B2 (Under review)						
20/11/18	B2 (Stable)						
26/07/18	B1 (Negative)						

S&P							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
19/09/25	CCC+ (Stable)						
25/04/22S	D						
13/04/22	CC (Negative)						
12/01/22	CCC (Negative)						
11/12/20	CCC+ (Stable)	25/09/23	CCC+				
20/05/20B	- (Stable)	19/09/23	SD				
14/01/20(	Negative)	21/07/23	CC				
04/12/18B	(Negative)	13/04/22	CCC-				

FITCH							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
19/05/22R	D	27/11/20	CCC				
13/04/22C		24/04/20B	-	27/11/20	C		
17/12/21C	C	18/12/19B		24/04/20	B		
27/11/20	CCC	27/09/19B		18/12/19	B		
24/04/20B	- (Negative)	03/12/18B		27/09/19	B		
18/12/19B		06/02/18B	+	03/12/18	B		
27/09/19B		09/02/17B	+	06/02/18	B		
03/12/18B		22/07/16B	+	09/02/17	B		
06/02/18B	+ (Stable)	29/02/16B	+	22/07/16	B		

Source: macrobonds.com

Moody's assessment of Sri Lanka highlighted the country's critically low foreign exchange reserves at approximately USD 1.7 billion at the end of March 2022, which covered only about one month of imports and had been depleted despite bilateral aid from India and China. The downgrade reflected governance weaknesses, macroeconomic fragility, and substantial external funding pressures, exacerbated by rising global energy and food prices, which increased the import bill and external financing needs. Although Moody's maintained a stable outlook, it noted that without decisive fiscal reforms and IMF support, private sector creditor losses could surpass the levels implied by the previous Caa2 rating, with losses potentially ranging between 35 per cent and 65 per cent. The assessment underscored Sri Lanka's precarious external position, structural debt sustainability issues, and the likelihood of material creditor losses amid a challenging political and economic environment that hampered swift policy response and recovery efforts (The Morning, 2022). Hence, what we see in the case of Sri Lanka is the sovereign debt trap that entangles developing countries within the global financial system, with the country's debt crisis linked to risky borrowing and issuing of high-interest sovereign bonds to foreign creditors since the early 2010s.

After the government's April 2022 announcement of suspension of repayments, the credit rating agencies immediately raised the USD sovereign spread, from about 12–14 bps to approximately 24.76 bps, with fluctuations around 23.20–27.81 bps over the following 30 days. This sharp widening, almost doubling in the initial period, reflected an increased perception of default risk or broader market concerns about Sri Lanka's sovereign creditworthiness following the restructuring announcement. Similarly, the 10-year yield increased markedly (from 17.19 per cent to peaks around 30.64 per cent), aligning with the higher spreads and indicating a more negative outlook on credit risk.

The Sri Lankan rupee modestly depreciated over time, with a maximum variation of about 8.53 in the LKR/USD exchange rate, signalling some market volatility but not extreme currency instability, despite increased credit risk perceptions. The sovereign interest rates (likely reflecting domestic policy rates) remained unchanged initially, then increased somewhat but showed no variation over the 30-day window, implying the primary concern was external credit risk rather than domestic monetary policy actions.

As mentioned above, at t0 (12 April 2022), the CRAs responded with an immediate increase in perceived risk (spread up to ~24.76 bps). Over subsequent days and weeks, the spread fluctuated but remained elevated relative to pre-event levels. This suggests that the agencies reacted swiftly to the debt restructuring but exhibited some stabilization afterward, possibly reflecting processing of debt restructuring developments, market sentiment, and emerging data. The maximum variation indicates that market perceptions, as measured by spreads, experienced considerable volatility, reaching nearly 20 bps in the month following the event. This volatility is typical during and immediately after restructuring events, reflecting the uncertainty and adjustment of market expectations.

## Event Windows

GOVERNMENT ANNOUNCEMENT (t0 = 02- April-2022)							
VARIABLE <sup>t</sup>	0	t+1	t+5 <sup>t</sup>	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	14.811	5.55	17.47	23.64	27.812	3.56	87.75
Exchange rate (LKR/USD)	296.76	296.75	311.75	318.89	326.893	49.161	7.66
Sovereign 10Y yield (YTM, %)	17.19	17.942	0.02	26.42	30.642	6.52	78.23
Policy rate	6.50	6.50	6.50	13.501	3.50	13.501	07.69
CREDIT RATING AGENCIES' ACTIONS (t0 = 12- April-2022)							
VARIABLE <sup>t</sup>	0	t+1	t+5 <sup>t</sup>	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	24.762	6.64	27.81	26.97	24.732	3.20	19.84
Exchange rate (LKR/USD)	319.16	321.91	326.89	336.74	346.393	45.988	.53
Sovereign 10Y yield (YTM, %)	27.48	29.343	0.64	29.87	27.572	6.05	17.62
Policy rate	13.50	13.501	3.50	13.501	3.50	13.500	.00

Source: Calculations using the Cbonds dataset.  $t_0$  is the first available observation on the event date;  $t+1$ ,  $t+5$ ,  $t+10$ ,  $t+15$  and  $t+30$  denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between  $t_0$  and  $t+30$ , relative to the minimum level in that window.

### CRAs' Response: Methodology-Consistent vs Discretionary/Bias

Fitch's ratings are guided by its Sovereign Rating Model (SRM), which employs 18 variables based on historical data and forecasts, and by the Qualitative Overlay (QO), which reflects qualitative factors not fully captured quantitatively. This indicates a formalized, systematic approach intended to ensure consistency across different assessments. However, the practice of not applying the SRM and QO for ratings in the CCC range or below, and instead relying solely on rating definitions, introduces a degree of discretion. The C rating of Sri Lanka and the decision to downgrade due to a default-like process appeared to be influenced by current events and subjective judgement about the country's willingness and ability to service debt (Fitch Ratings, 2022a).

S&P's response would appear to be more methodology-consistent as it stated that the losses were likely to exceed levels consistent with the previous Caa2 rating because of Sri Lanka's very low foreign exchange reserves adequacy and significant debt sustainability challenges. A Ca rating was consistent with losses between 35 per cent and 65 per cent,

in line with a relatively wide range of precedents by defaulting sovereigns coinciding with its assessment variables (The Morning, 2022).

According to a report published post-restructuring, Fitch upgraded Sri Lanka's foreign currency debt rating to CCC+ from RD, and Moody's to Caa1 from Ca. Key actions cited in this regard included debt relief (e.g., principal haircuts up to 27 per cent, debt service reductions, maturity extensions), demonstrating macroeconomic reform progress, such as fiscal stabilization, ending monetary financing, and creating buffers for future debt service payments. Also credited was the development of a credible macroeconomic reform plan supported by the IMF, which aimed to rebuild fiscal and external buffers by 2028, hence improving the outlook for creditworthiness (Mahinda Siriwardana, 2025).

### **Transmission Channels and Implications on External Debt Service Costs**

In the short term, Sri Lanka's debt restructuring and the associated IMF programme reduced immediate external debt service pressures by delaying repayments and lowering coupon payments on international sovereign bonds (ISBs). The restructuring of approximately USD 12.55 billion in ISBs involved a principal haircut of about 27 per cent, maturity extensions, and a roughly 33 per cent reduction in coupon rates to around 4.3 per cent. As a result, the country obtained significant near-term repayment relief, with no foreign-currency bond maturities until 2029, and lower interest payments in the early years of the new bond structure. These measures temporarily improved liquidity conditions and helped stabilize Sri Lanka's external position following the 2022 default, when reserves had fallen to critical levels and sovereign spreads and yields spiked sharply. In addition, the restructuring reduced market uncertainty and allowed credit rating agencies such as Fitch and Moody's to upgrade Sri Lanka's rating from default levels once the exchange was completed, improving investor confidence and partially restoring access to external financing.

Despite these short-term benefits, the restructuring generates important long-term implications for Sri Lanka's external debt-servicing burden. Although coupon reductions and maturity extensions provide temporary relief, external debt-servicing obligations are expected to rise again once repayment begins after the grace period, particularly after 2028–29, when amortization of the new bonds commences. The restructuring structure includes macro-linked bonds and governance-linked bonds, which may increase interest payments if economic performance exceeds baseline projections, thereby linking debt service costs to macroeconomic outcomes. Moreover, the IMF's Debt Sustainability Analysis (DSA) framework aims to restore Sri Lanka's access to international capital markets by 2027, potentially exposing the country again to high-interest borrowing through international sovereign bonds. This dynamic creates a risk that future external debt servicing could remain elevated, especially if export growth and foreign-exchange earnings do not expand sufficiently to meet repayment obligations. Consequently, while the restructuring alleviates immediate liquidity stress, it does not fully eliminate long-term vulnerabilities, and Sri Lanka may continue to face structural constraints on fiscal space, as a large share of government revenue will remain committed to servicing external debt rather than financing development priorities.



## Belize

<b>Driver Classification:</b>	Debt Restructuring / Liability Management (Blue Bond)
<b>Rating Agencies Covered:</b>	S&P
<b>Date:</b>	August 2020 – November 2021

### Background

Between 2020 and 2021, Belize moved from an episode of debt distress and selective default to a more orderly exit through a liability management operation that culminated in the Blue Bond transaction.[5]

In 2020, S&P had downgraded the sovereign to CC/C and later to SD/SD over the restructuring of the Superbond,[6] treating the payment relief strategy as a selective default event (S&P Global Ratings, 2020c, 2020d). In September 2021, the government announced an agreement in principle with a bondholder committee to launch a cash tender offer and consent solicitation aimed at retiring the 2034 bond (Government of Belize, 2021). Once the exchange and repurchase were completed, S&P upgraded the sovereign to B- in November 2021 and assigned a stable outlook (S&P Global Ratings, 2021).

In terms of financing conditions, the episode shows how the loss of market access can turn external debt service into an immediate liquidity constraint, while the exit from selective default depended crucially on credit enhancement through official backing and political risk insurance, which reduced refinancing risk and helped to anchor expectations (S&P Global Ratings, 2021; US International Development Finance Corporation, 2021).

### Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (GDP annual growth, %)1	.9	-13.5	22.47	.0	4.78	.2	6.1*
<b>Inflation</b> (CPI, %)0	.2	0.44	.9	6.7	3.72	.6	0.3*
<b>Fiscal balance</b> (% GDP)	-2.7	-9.0	-1.7	-0.8	-2.1	-2.1	
<b>Current account</b> (% GDP)-	7.7-	6.2	-6.5	-8.3	-0.6	-1.5	
<b>Reserves</b> (USD bn)	0.30	.3	0.40	.5	0.50	.5	
<b>Debt</b> (% GDP)5	5.47	1.1	55.34	7.94	6.6	42.6	

Source: Authors' calculations based on official Belize sources: Statistical Institute of Belize (Gross Domestic Product and Consumer Price Index datasets/releases) for GDP growth and inflation, and Central Bank of Belize, Major Economic Indicators (2001–2024) for fiscal balance, current account, foreign reserves, and government debt. For 2024 GDP, the SIB reports that annual output "increased ... by 8.2% compared to the Annual GDP of 2023".

\*For 2025, the SIB reports 0.3% year-end inflation and the latest available annual GDP growth observation used here is 2025Q3.

## Driver Event Narrative

Belize entered the pandemic with pre-existing fiscal and external vulnerabilities. The shock caused by COVID-19 led to a deep contraction in 2020 and brought the sustainability of the Superbond to the centre of the sovereign risk debate, given its weight within Belize's external debt profile. In that setting, the government moved towards a restructuring strategy that S&P interpreted as a selective default event. In June 2020, S&P lowered the sovereign to CC/C, and on 12 August 2020, it downgraded the foreign currency rating to SD/SD, framing the episode as one of funding stress followed by debt restructuring within the logic of selective default (S&P Global Ratings, 2020c, 2020d).

The turning point came on 3 September 2021, when the government of Belize announced an agreement in principle with a committee of bondholders to structure a cash tender offer and consent solicitation aimed at retiring the 2034 bond, conditional on the closing of the Blue Bond financing arrangement (Government of Belize, 2021). The strategy worked as a credibility device because it transformed a distressed liability into an instrument backed by stronger guarantees and therefore perceived as significantly safer by the market.

The process was completed on 9 November 2021, when S&P raised the long-term foreign currency rating to B- from SD and assigned a stable outlook, signalling Belize's exit from the selective default episode and its transition into a post-restructuring phase (S&P Global Ratings, 2021).

## Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
15/10/24	Caa1 (Stable)						
16/11/22	Caa2 (Stable)						
24/11/20	Caa3 (Stable)						
12/05/20	Caa1 (Negative)	15/10/24	Caa1 (Negative)				
05/03/19	B3 (Stable)	16/11/22	B3 (Stable)				
11/04/17	B3 (Stable)	24/11/20	B3 (Stable)				

Source: [datosmacro.com](https://datosmacro.com)

S&P							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
09/11/21	B- (Stable)						
24/05/21	SD						
25/02/21	CC (Negative)						
21/08/20	CCC+ (Stable)						
12/08/20	SD						
30/06/20	CC						
16/04/20	CCC (Negative)	09/11/21	B-	09/11/21	B		
23/03/17	B- (Stable)	25/02/21	CC	24/05/21	SD		
17/03/17	SD	21/08/20	CCC+	21/08/20	C		

Source: [datosmacro.com](https://datosmacro.com)

### CRAs' Response: Methodology-Consistent vs Discretionary/Bias

From the perspective of S&P's methodology, the response can be read as consistent with its own framework. The initial downgrade reflected the treatment of the debt operation as a selective default event, while the subsequent upgrade followed once the transaction had been completed and the immediate payment stress removed. In that sense, the episode was shaped mainly by the fiscal and external pillars, since the core issue was not short-term macroeconomic performance as such, but the sovereign's ability to manage external obligations under acute financing pressure.

Even so, the case also reveals an important source of bias. Belize's exit from selective default depended less on an endogenous strengthening of fundamentals than on an institutional repackaging of risk. The operation took the form of a buyback financed through a climate-labelled structure and supported by guarantees that altered the pricing, risk profile and market eligibility of the sovereign obligation. In that sense, although S&P's response was methodologically consistent on its own terms, it also validated, as an improvement in credit quality, something that rested heavily on credit enhancement and on the support of the broader external financial architecture. The result is to reinforce the centre-periphery asymmetry in the way sovereign crises are resolved.

improvement in credit quality, something that rested heavily on credit enhancement and on the support of the broader external financial architecture. The result is to reinforce the centre-periphery asymmetry in the way sovereign crises are resolved.

## Transmission Channels and Implications on External Debt Service Costs

In Belize, the absence of any meaningful exchange rate movement during the 2020–21 episode is consistent with the hard peg of the Belize dollar to the US dollar, which functions as the main nominal anchor. Throughout the period, the exchange rate remained effectively stable at around BZD 2 per US dollar. This suggests that the adjustment was not transmitted through depreciation or through an inflationary pass-through, but rather through the channels that are more typical of economies operating under a fixed exchange rate regime, especially pressures on foreign currency liquidity. In that setting, the key constraint lies in preserving external liquidity and maintaining reserve adequacy rather than in managing exchange rate volatility.

In economies with an exchange rate anchor, the absence of nominal exchange rate movement does not imply the absence of financial stress. On the contrary, it often indicates that the tension has been displaced to other parts of the adjustment mechanism. In this case, the pressure was expressed mainly through sovereign asset prices, tighter external financing conditions and a higher dependence on refinancing capacity. Debt servicing therefore became increasingly tied to the availability of foreign currency liquidity and to the sovereign's ability to renegotiate its obligations on viable terms.

Even before the restructuring episode, concerns had already been raised about debt sustainability and the risks that high debt levels posed to the exchange rate anchor and reserve adequacy. Once the rating agencies classified the process as selective default, these vulnerabilities became more acute, since market access deteriorated further, rollover became less likely and the cost of external debt service became increasingly dependent on cash flow and on the terms that could be secured through renegotiation. In that sense, the rating did not simply reflect an underlying stress event but also contributed to tightening the conditions under which the restructuring had to take place.

The exit phase in 2021 altered the cost of debt service through a liability management operation. The government announced a cash tender offer together with a consent solicitation aimed at retiring the 2034 bond under the Blue Bond structure, and S&P upgraded the sovereign once the transaction had been completed (Government of Belize, 2021; S&P Global Ratings, 2021).

The effect on debt service operated on two levels. First, the repurchase reduced refinancing risk and smoothed the payment profile over the short and medium term. Second, the insurance component and the broader official support surrounding the transaction compressed the sovereign premium relative to a purely private restructuring scenario, lowering the expected cost of future financing and, with it, the projected burden of debt service.



## Zambia

<b>Driver Classification:</b>	Debt Restructuring / Pandemic Shock
<b>Rating Agencies Covered:</b>	Fitch / S&P
<b>Date:</b>	April – November 2020

### Background

Zambia was the first African country to default on its sovereign debt during the COVID-19 era, suspending payments on its Eurobonds<sup>[7]</sup> in November 2020. According to data from the IMF, Zambia is among over 50 low- and lower-middle-income countries that are now allocating more funds to external debt service than to public health or education. It underwent multiple credit rating downgrades in 2020 (Fitch Ratings, 2020). The default triggered its entry into the G20 Common Framework for Debt Treatments, a mechanism aimed at coordinating debt relief among official and private creditors. Zambia's request was not for debt cancellation but rather a restructuring to manage unsustainable debt levels exacerbated by the pandemic and a decline in copper revenues. In response, Fitch downgraded Zambia's Long-Term Foreign Currency Issuer Default Rating to RD, and the country was assigned SD ratings by other agencies. Despite Zambia's signing a USD 1.3 billion IMF programme in 2022 and securing a restructuring deal with bilateral creditors (including China and members of the Paris Club) in mid-2023, credit rating agencies have been slow to revise its ratings upward. The agencies maintain a cautious outlook, often citing concerns about implementation risks and future political instability.

In 2024, Zambia reached a significant milestone by securing a deal with private bondholders that included a 20 per cent nominal haircut and a stretched repayment schedule. However, even after these positive developments, Zambia's sovereign ratings remained near default levels. This punitive stance persisted despite IMF forecasts that, with the restructuring finalized, Zambia's debt trajectory would become sustainable.

The downgrades had direct and negative consequences. Zambia was effectively shut out of international capital markets, forcing it to rely heavily on domestic borrowing. This increased domestic interest rates and crowded out private sector investment. The prolonged low ratings also discouraged foreign investment and kept borrowing costs elevated, counteracting the very debt relief efforts the restructuring was intended to achieve.

## Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (real GDP, %)1	.4	-2.8	6.25	.2	5.44		5.4
<b>Inflation</b> (core inflation rate, %)2	3.6-	14.7	-36.2-	2.4-	4.2-	17.5	
<b>Fiscal stance</b> (CG balance, % GDP)-	1.1-	5.35	.2	0.6	2.52	.2	
<b>Current account</b> (% GDP)0	.6	12.11	1.93	.8	-3	-1	-0.85
<b>Reserves</b> (USD bn)	1.42	1.18	2.77	3.033	.314	.295	.3
<b>Debt burden</b> (Public sector gross debt, % GDP)	91.9	80.1	71.5	56.4	73.7	69.6	69.8
<b>Foreign direct investment</b> (change in USD mn)	125.3	-168.3-	353.1-	1190	-46.5	86.9-	73.8
<b>Capital flows</b> (change in USD mn)		204.82	700	288.8-	758-	1030	-472.5
<b>Policy rate</b>	11.5	89		91	11	4	14.25

Source: Calculations based on [TradingEconomics.com](https://tradingeconomics.com)

The economic indicators reflect the broader context of Zambia's sovereign debt crisis and subsequent restructuring process. The sharp contraction in GDP in 2020 (-2.8 per cent), widening fiscal deficit (-5.3 per cent of GDP), and declining reserves coincided with Zambia's default on its Eurobonds during the COVID-19 pandemic, which triggered credit rating downgrades and entry into the G20 Common Framework for Debt Treatments. Following the crisis, the economy experienced a recovery from 2021 onwards, supported by fiscal consolidation and the USD 1.3 billion IMF programme agreed in 2022. This is reflected in improved fiscal balances, rising reserves, and a significant reduction in public debt from 91.9 per cent of GDP in 2019 to 56.4 per cent in 2022 before stabilizing at around 70 per cent.

However, despite progress in restructuring agreements with bilateral creditors in 2023 and private bondholders in 2024, external financing conditions remained fragile. Volatile foreign direct investment, negative capital flows in later years, and a sharp increase in the policy rate to 14.25 per cent by 2025 suggest continued investor caution and restricted access to international capital markets. The shift from large current account surpluses in 2020–21 to deficits after 2023 also reflects evolving external pressures. Overall, the data illustrate a gradual macroeconomic stabilization following the default, but with persistent vulnerabilities linked to debt restructuring, investor confidence, and external financing constraints.

### Driver Event Narrative

Zambia's case sheds light on the debt default event coupled with the pandemic shock in 2020. Before November 2020, Zambia had been through episodes of downgrading between 2015 and 2018, owing to accumulation of external debt, high fiscal deficits and pressure on foreign exchange reserves (Bank of Zambia, n.d.). The government of Zambia had to raise both the monetary policy ratio and the statutory reserve ratio, to reduce high demand pressures in the foreign exchange market which were fuelling high inflation.

Zambia's 2020 default on a USD 42.5 million Eurobond repayment amid the fallout from the COVID-19 pandemic resulted in immediate downgrading by Fitch and Moody's. The crisis was framed as being due to failure of fiscal discipline; other reasons included the country's overdependence on raw copper exports and exposure to global price swings.

On 24 September 2020, Fitch had downgraded Zambia's Long-Term Foreign Currency IDR from CC to C, including all senior unsecured foreign currency bonds, following the government's consent solicitation on 22 September requesting a six-month suspension of debt service payments on three global bonds due between October 2020 and March 2021 (Fitch Ratings, 2020). Fitch viewed this as initiating a default-like process or potential distressed debt exchange (DDE), reflecting Zambia's constrained external liquidity, worsened by the COVID-19 pandemic, and the high risk of missed payments. The downgrade also incorporated governance and institutional factors, with Zambia assigned an ESG Relevance Score of 5 for Political Stability, Rule of Law, Institutional Quality, Control of Corruption, and Creditor Rights, highlighting the importance of willingness to service debt. Positive rating action would require withdrawal of the consent solicitation and timely coupon payments, while negative outcomes would follow payment suspension or failure to meet debt obligations, with both fiscal and institutional credibility highlighted as key drivers of sovereign risk (Fitch Ratings, 2020). Simultaneously, S&P downgraded Zambia to CCC- with a negative outlook (indicating substantial risk under Speculative Grade) on 26 September 2020, and to SD on 22 October 2020.

The event windows below show the short-term market response to Zambia's sovereign default announcement on 13 November 2020 and the subsequent credit rating downgrades on 18 November 2020. Over a 30-day window, the USD sovereign spread exhibited minimal variation, rising only 0.19 bps after the default and 0.36 bps following the rating actions, indicating that investors had largely anticipated these events or had already priced in the associated credit risk. The Zambian kwacha showed modest depreciation, with the ZMW/USD exchange rate increasing 0.68 and 0.75 points over the respective windows, reflecting slightly higher currency risk but overall stability. Meanwhile, the 10-year sovereign yield and the policy rate remained unchanged throughout both windows, suggesting that long-term borrowing costs and monetary policy expectations were unaffected by the announcements. Overall, these results imply that the market reaction to Zambia's default and credit rating actions was muted, with only minor adjustments in currency and spreads, highlighting the pre-emptive pricing of sovereign risk and limited short-term volatility in key financial indicators.

However, looking at the medium- to long-term reactions, the kwacha depreciated sharply in response to the macroeconomic shocks and uncertainties stemming from debt distress and negotiations. The data shows a 64 per cent depreciation from ZMW 12.9 to over ZMW 21.1 per US dollar by end-2020, coinciding with the onset of the pandemic and the default. During the debt negotiations, particularly when foreign investor sentiment turned adverse amid uncertainties about domestic debt restructuring and renewed access to markets, the kwacha likely experienced increased volatility or further depreciation, as seen through the exchange rate reactions to key events and the withdrawal of foreign investors from the domestic debt market. Moreover, Zambia's Eurobond spreads widened significantly in reaction to the key events related to the debt negotiations, including discussions with private creditors and the formation of the Official Creditors Committee (OCC). The evolution of spreads showed sharp increases during periods of uncertainty, such as when the negotiations faced delays or when there was

speculation about the inclusion or exclusion of domestic-law debt or non-resident holders. For example, during the period leading up to the July 2022 agreement with creditors, spreads rose markedly, reflecting increased risk premia demanded by investors.

## Event Windows

EVENT OCCURRENCE (t0 = 13- November-2020)							
VARIABLE <sup>t</sup>	0	t+1	t+5 <sup>t</sup>	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	32.10	32.103	2.14	32.163	2.16	32.11	0.19
Exchange rate (ZMW/USD)	20.892	0.89	20.90	20.96	20.98	21.03	0.68
Sovereign 10Y yield (YTM, %)	33.003	3.00	33.003	3.00	33.003	3.00	0.00
Policy rate	8.00	8.00	8.00	8.00	8.00	8.00	0.00
CREDIT RATING AGENCIES' ACTIONS (t0 = 18- November-2020)							
VARIABLE <sup>t</sup>	0	t+1	t+5 <sup>t</sup>	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	32.133	2.17	32.153	2.16	32.09	32.05	0.36
Exchange rate (ZMW/USD)	20.962	0.96	20.96	20.99	21.00	21.11	0.75
Sovereign 10Y yield (YTM, %)	33.003	3.00	33.003	3.00	33.003	3.00	0.00
Policy rate	8.00	8.00	8.00	8.80	0.00	8.00	0.00

Source: Calculations using the Cbonds dataset.  $t_0$  is the first available observation on the event date;  $t+1$ ,  $t+5$ ,  $t+10$ ,  $t+15$  and  $t+30$  denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between  $t_0$  and  $t+30$ , relative to the minimum level in that window.

In summary, immediate market reactions reflected increased risk perception, with widened spreads and likely higher yields, and significant currency depreciation and volatility, driven by fears of default, uncertainties in the restructuring process, and political developments affecting investor confidence.

## Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
21/11/25	CCC+ (Stable)						
21/10/20	SD						
21/02/20	CCC (Negative)						
23/08/19	CCC+ (Stable)						
22/02/19	(Negative)	18/02/22	CCC+				
24/08/18	B- (Stable)	25/09/20	CCC-				

FITCH							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
18/11/25	B-						
18/11/20	RD			18/11/20	RD		
24/09/20	C	16/04/20	CC	16/04/20	C		
16/04/20	CC	20/12/19	CCC	20/12/19	C		
20/12/19	CCC	27/06/19	CCC	27/06/19	C		
27/06/19	CCC	11/10/18	B-	11/10/18	B		
11/10/18	B-	26/07/18	B	26/07/18	B		

### CRAs' Response: Methodology-Consistent vs Discretionary/Bias

It is important to contextualize the ratings of 2020, given Zambia's debt trajectory that was marked by a series of downgrades even prior to the COVID-19 pandemic. After maintaining a credit rating of B throughout most of the first half of the 2010s, the country's outlook deteriorated in 2016, leading to multiple downgrades in 2018 that brought its rating to CCC before the pandemic struck in 2020. The depreciation of the kwacha in 2019 exacerbated the debt burden by increasing interest payments, pushing debt levels towards unsustainability. The onset of COVID-19 in 2020 hit an already weakened economy, which had grown by only 1.4 per cent in 2019. The pandemic intensified economic decline, resulting in a contraction of 2.8 per cent in 2020, the country's first recession since 1998. This resulted in macroeconomic deterioration culminating in

Zambia's external debt service default, with the fiscal deficit ballooning from 9.4 per cent in 2015 to 14.5 per cent in 2020. From 2016 to 2020, arrears primarily accumulated in VAT refunds and payments to road contractors stemming from fiscal challenges such as higher expenditure relative to revenues, driven by increased debt service obligations, subsidy overruns, COVID expenditure, currency depreciation, and slower growth. In addition, the unpaid arrears had further compromised liquidity and solvency for service providers, as government-held capital dried up (Mbewe et al., 2020; Grigorian & Bhayana, 2024).

The debt situation worsened due to structural issues and repayment obligations. Zambia issued Eurobonds with bullet repayment structures in 2012, 2014, and 2015, intensifying medium-term sustainability risks. By 2020, the country had defaulted on a USD 42.5 million coupon payment. External debt surged from USD 1.96 billion (18.9 per cent of GDP) in 2011 to USD 12.7 billion (over 540 per cent of GDP) in 2020. The debt-to-GDP ratio rose sharply from 60.6 per cent in 2016 to 120 per cent in 2019, with interest payments increasing from 3.4 per cent of GDP to 6 per cent over the same period. Heavy reliance on non-concessional external debt, which comprised over half of the external debt by 2019, further strained finances. Zambia's application for the Debt Service Suspension Initiative (DSSI) [8] in 2020 was met with demands to suspend payments to private bondholders, worsening default risks. This ultimately led to Zambia's default on all three Eurobonds, which were accelerated, leading to interest arrears and ongoing negotiations with creditors (Mbewe et al., 2020).

The Zambian experience underlines a broader concern with the credit rating agencies who have treated the restructuring process as a sign of insolvency rather than a tool for restoring sustainability. This approach undermines the objectives of the Common Framework and risks deterring other countries from engaging in timely restructuring efforts. From the methodological aspect, there are plausible arguments for the internal consistency of the agencies' fiscal assumptions based on the pillars of debt sustainability, fiscal policies, external vulnerabilities and institutional capacity. These criteria are consistent with standard assessment frameworks, focusing on indicators such as high debt-to-GDP ratios, default risks, and limited fiscal space.

Within these frameworks, the ratings can be justified by Zambia's substantial debt stock, rising debt service costs, and vulnerability to external shocks, especially given the external debt's sharp increase from 18.9 per cent of GDP in 2011 to over 540 per cent of GDP by 2020, alongside accumulating arrears (Grigorian & Bhayana, 2024). However, there is evidence suggesting potential bias or discretion, especially in the timing of downgrades or the emphasis on specific indicators, such as the default on Eurobonds, which could reflect a reactive stance.

Moreover, the default itself curtailed Zambia's external borrowing capacity and prompted the use of international debt relief mechanisms, creating a feedback loop that affects policy credibility and investor confidence, further undermining the credibility and increasing borrowing costs that would result in deterring long-term investment.

### Transmission Channels and Implications on External Debt Service Costs

In Zambia's case, the immediate market response to the sovereign default and credit rating downgrades in 2020 was relatively muted, as evidenced by the minimal variation in 30-day sovereign spreads, which rose by only 0.19 bps, indicating that investors had largely anticipated default-related risks or had already priced them in prior to the official events. Despite this, the country experienced a sharp depreciation of the kwacha, which depreciated approximately 64 per cent from ZMW 12.9 to over ZMW 21.1 per US dollar by year's end. This substantial currency depreciation increased the local-currency value of Zambia's external debt, which mostly consisted of foreign-currency liabilities. The resulting pass-through effect meant that the effective debt burden in local-currency terms surged, intensifying the pressure on Zambia's external debt service costs and fiscal stability.

The widened sovereign spreads and elevated bond yields during the crisis further exemplified heightened risk perception among investors. Spreads increased markedly during negotiations with creditors, especially around key restructuring milestones, reflecting increased risk premia demanded by the market. Concurrently, the exchange rate's increased volatility and depreciation amplified external debt-servicing costs, creating a compounding effect that undermined fiscal space and worsened macroeconomic stability. The government's fiscal and monetary responses, including policy rate hikes and currency interventions, aimed to mitigate these pressures but often contributed to deeper economic contraction and financial distress. The figures indicate that these external pressures, initially triggered by the default, propagated through currency and market channels, creating a feedback loop of increasing debt costs and macroeconomic fragility.

Over the medium to longer term, these transmission channels manifested in persistent elevated external debt service costs and constrained access to international capital markets. Despite initial debt restructuring efforts, Zambia's external-debt-to-GDP ratio remained high, and external financing conditions stayed fragile, as shown by negative capital flows and declining foreign direct investment. The continued depreciation and elevated spreads signalled ongoing investor caution, reinforcing the cycle of high borrowing costs and debt accumulation. The figures underscore how currency depreciation, market risk premia, and external liquidity pressures interacted dynamically, serving as channels through which the sovereign default increased Zambia's external debt service costs, ultimately constraining fiscal policy and prolonging economic recovery.



## Pakistan

<b>Driver Classification:</b>	Climate Event
<b>Rating Agencies Covered:</b>	S&P / Moody's / Fitch
<b>Date:</b>	October 2022 – February 2023

### Background

Pakistan has gone through 25 loan programmes till date (IMF, 2025), as national public debt exceeded PKR 80 trillion or approximately 70 per cent of GDP as of mid-2025. Amid fiscal deficits, high inflation, and a persistent need for external financing, largely from the IMF and bilateral partners like China, national foreign exchange reserves have been oscillating while over half of the government revenue has been spent on servicing debt repayments.

### Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (real GDP, %) <sup>2</sup>	.4	4.44	.6	7.32	.4	2	3.7
<b>Inflation</b> (CPI EOP, %)	12.68		12.3	13.2	24.54	.1	5.6
<b>Fiscal stance</b> (CG balance, % GDP) <sup>3</sup>	7.9-	7.1-	6.1-	5.3-	7.8-	6.8	-71
<b>Current account</b> (% GDP) <sup>4</sup>	4.8-	1.7-	0.8-	4.7-	1-	0.6	-0.45
<b>Reserves</b> (USD bn)	17.92	02	4	10.8	12.7	15.9	20.7
<b>Debt burden</b> (Public sector gross debt, % GDP)	86.1	76.6	71.47	8	75.2	70.8	

*Calculations based on Trading Economics, Ministry of Finance reports, and Cbonds.*

Pakistan's economic growth was volatile between 2019 and 2025, peaking at 7.3 per cent in 2022 before slowing and moderately recovering to 3.7 per cent in 2025. Inflation fluctuated significantly, rising sharply to 24.5 per cent in 2023 before stabilizing at around 4 - 6 per cent in 2024–25. The fiscal balance remained persistently negative, indicating continued government deficits, while the current account deficit gradually narrowed over time. Meanwhile, international reserves declined sharply in 2022 but recovered steadily, and public debt as a share of GDP generally trended downwards. The COVID-19 pandemic and the devastating floods in 2022 exacerbated the fiscal shortfall by increasing spending needs, which reportedly led to insufficient fiscal space to respond

to economy wide-shocks (Public Expenditure Review, 2023). Moreover, Pakistan's high debt-to-GDP ratio had spiked to 78% at the end of fiscal year (FY) 2022 which further stagnated at around 70.8% by 2025 (Finance Division, 2025).

### Driver Event Narrative

Pakistan's case can be categorized as a climate event on top of the pandemic shock. It has witnessed consistent heatwaves of above 45°C, followed by monsoons and floods that wreaked havoc in 2022. Its climate vulnerability score has averaged around 0.5, which makes it one of the top 10 most climate-vulnerable countries. While Pakistan's greenhouse gas output is a mere 0.3 per cent, it suffers a disproportionate amount of damage from climate disasters, with heavy tolls on economic, social and infrastructure stability (Islam, 2023). Pakistan has ranked highest in the Climate Risk Index (CRI) ratings because of its high relative economic losses as well as the number of affected people in absolute and relative terms. Climate-related threats have grown more severe in Pakistan in the past few years and the country is expected to experience "unusual extreme events" (Germanwatch, 2025).

The 2022 floods submerged one-third of the country, affecting 33 million people. They claimed the lives of 1,730 people, with nearly 8 million displaced, and killed 1.16 million heads of livestock, alongside the destruction of infrastructure including schools, bridges, roads, health facilities, and community-service buildings (Pakistan Economic Survey 2023; Fitch Solutions, 2022). The damage was estimated at USD 14.9 billion, the loss to the GDP at USD 15.2 billion, and the total needs of rehabilitation at USD 16.3 billion. The sectors that suffered the most included housing, agriculture, food, livestock, fisheries, and transportation and communications (Pakistan Economic Survey, 2025). Six months after the floods, approximately 4.5 million people were still living in or near inundated areas, while around 2.5 million lacked access to safe drinking water. An estimated 1.1 million individuals risk deteriorating from acute food and livelihood insecurity (IPC Phase 3) into emergency conditions (IPC Phase 4) due to inadequate assistance. Malaria outbreaks have been reported in at least 12 districts across Sindh and Balochistan. More than 7 million women and children require urgent nutritional support, and roughly 3.5 million children, particularly girls, face a heightened risk of permanently dropping out of school. Meanwhile, the Pakistan Floods Response Plan remains only 36 percent funded despite being more than halfway through its nine-month timeline, and substantial portions of the infrastructure damaged or destroyed by the floods have yet to be rebuilt (Government of Pakistan-Finance Division, 2025).

The floods were seen as having weakened the country's liquidity and funding conditions, which led to credit rating downgrades by the Big Three agencies (Tan, 2025). The downgrades also had an impact on the country's public utility agencies, with the water and power authority being downgraded to CCC- as a response to the sovereign rating action.

## Event Windows

EVENT OCCURRENCE (t0 = 1 June-2022)							
VARIABLE <sup>t</sup>	0	t+1	t+5 <sup>t</sup>	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	1,260.00	1,300.87	1,288.25	1,276.63	1,344.121	,814.324	3.99
Exchange rate (PKR/USD)	197.666363	197.47368	197.692062	01.90928	208.87660	204.623845	.77
Sovereign 10Y yield (YTM, %)	11.9650	11.9650	11.96501	1.9650	11.96501	1.9650	0.00
CREDIT RATING AGENCIES' ACTIONS (t0 = 21 November 2022)							
VARIABLE <sup>t</sup>	0	t+1	t+5 <sup>t</sup>	+10	t+15	t+30	Maximum variation in 30 days
USD sovereign spread (T-spread, bps)	4,073.74	4,199.92	4,011.27	4,330.75	3,637.00	2,936.27	47.49
Exchange rate (PKR/USD)	221.15000	221.15000	220.51300	220.43200	221.52	22.450	.92
Sovereign 10Y yield (YTM, %)	11.9650	11.9650	11.9650	11.96501	1.9650	12.8460	7.36

Source: Calculations using the Cbonds dataset.  $t_0$  is the first available observation on the event date;  $t+1$ ,  $t+5$ ,  $t+10$ ,  $t+15$  and  $t+30$  denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between  $t_0$  and  $t+30$ , relative to the minimum level in that window.

The table vividly demonstrates how specific external events and credit rating actions can influence key sovereign risk indicators such as the USD sovereign spread, exchange rate, and long-term yield over different time horizons. Following the floods occurring at  $t_0$ , on 1 June 2022, the sovereign spread shows a modest increase of approximately 44 bps within 30 days, reflecting a slight rise in perceived country risk linked to the growth in public debt and external vulnerabilities as highlighted in the Pakistani government's public debt report (Ministry of Finance, 2022). The report noted a significant escalation in Pakistan's external debt, driven by currency depreciation, rising interest costs, and increased external borrowings, all of which can elevate investor concerns and contribute to wider spreads and higher yields. The exchange rate remained relatively stable in the short term, aligning with the report's mention of currency depreciation (around 39 per cent) primarily impacting the stock of external debt. The small fluctuation in the exchange rate demonstrated market sensitivity to external factors but also suggested some resilience amid debt-servicing pressures.

Post-credit rating actions by Fitch on 21 October 2022, the data shows a more pronounced impact: the sovereign spread expanded by roughly 47.5 bps within 30 days, indicating increased risk perception after the rating downgrade or review, which the report correlated with heightened external debt-servicing costs and increased global interest rates. The sovereign 10-year yield's rise to approximately 12.85 per cent reflected investor

concerns over Pakistan's debt sustainability amidst rising interest expenses and external vulnerabilities, particularly the increase in interest payments and external debt profile. The minimal movement in the PKR/USD exchange rate suggested that currency stability was maintained temporarily, but the wider spreads and yields indicated a deteriorating risk environment, consistent with the discussion of elevated external debt levels, currency depreciation, and increased interest costs highlighted in the report (Ministry of Finance, 2022). Collectively, the figures in the table depict how external shocks and credit assessments directly influence sovereign risk metrics.

**Figure 4. Transmission Channel: The Impact of Currency Hierarchy and External Vulnerabilities on Sovereign Debt Dynamics**



Source: [cbonds.com](https://cbonds.com)

Figure 4 shows Pakistan's bond yields over time from January 2019 to January 2026, highlighting the key fluctuations in the country's borrowing costs. Notably, there is a significant upward movement in yields beginning around mid-2022, and continuing into 2023, suggesting that market investors perceive higher risks associated with Pakistan's debt, likely influenced by credit rating downgrades amongst other economic challenges. The elevated yields made borrowing more expensive, affecting government financing and debt servicing. While there were some periods of stabilization, the overall trend indicates rising borrowing costs, which would hinder fiscal flexibility and economic growth. By devising a clear picture of Pakistan's fiscal health, it is evident that challenges remain in inflation rates and rising expenditures, particularly due to increases in the cost of debt servicing, especially on foreign-currency-denominated debt—leading to higher markup payments, along with the lingering effects of past floods (Government of Pakistan, Finance Division, 2024).

## Sovereign Rating Trajectory

Following the floods in June 2022 which continued until October 2022, Moody's downgraded Pakistan from B3 (Negative) to Caa1 (Negative). It was followed by S&P and Fitch, which downgraded Pakistan's rating from CCC+ to CCC- in February 2023 before upgrading it again to CCC (already reflecting high external funding risks and high medium-term financing requirements) in July (Kiani, 2023).

MOODY'S							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
13/08/25	Caa1 (Stable)						
28/08/24	Caa2 (Positive)						
28/02/23	Caa3 (Stable)						
06/10/23	Caa1 (Negative)						
02/06/22	B3 (Negative)						
08/08/20	B3 (Stable)						
14/05/20	B3 (Under review)						
02/12/19	B3 (Stable)						
20/06/18	B3 (Negative)						

S&P							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
24/07/25	B- (Stable)						
22/12/22	CCC+ (Stable)	24/07/25	B-				
28/07/22	B- (Negative)	22/12/22	CCC+				
04/02/19	B- (Stable)	28/07/22	B-	24/07/25	B2	4/07/25	B

FITCH							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
14/02/23	CCC-	14/02/23	CCC-				
21/10/22	CCC+	21/10/22	CCC+	21/10/22	C		
13/01/20	B-	13/01/20	B-	13/01/20	B		
14/06/19	B-	14/06/19	B-	14/06/19	B		
14/12/18	B-	14/12/18	B-	14/12/19	B		
25/01/18	B (Negative)	25/01/18	B	25/01/18	B2	1/10/22	C

Source: [Datosmacros.com](https://www.datosmacros.com)

Moody's further downgraded Pakistan's rating to Caa3 in February 2023, alluding to a negative outlook (Moody's Ratings, 2024). The downgrade was driven by Moody's assessment of Pakistan's increasingly fragile liquidity and external position, with the country's foreign exchange reserves having fallen to extremely low levels, inadequate to cover import needs and external debt obligations over the immediate and medium term. Moody's suggested that a further downgrade would be likely "if Pakistan were to default on its debt obligations to private-sector creditors and the expected losses to creditors as a result of any restructuring were larger than consistent with a Caa3 rating".

Fitch upgraded Pakistan for the first time in three years from a "substantial default risk" nation to "highly speculative" with a limited margin of safety albeit with a stable outlook in April 2025. This upgrading offered Pakistan a window to access slightly lower interest rates. The finance minister described the rating upgrade as a testimony that there was a permanency in Pakistan's macroeconomic stability and that the country was on a firm path of structural reforms needed to "move towards sustainable inclusive growth without gold rush" (The Express Tribune, 2025).

For a highly debt-distressed and climate-vulnerable country, a credit rating downgrade could perpetuate a cycle of austerity in response to the external shock of climate catastrophes. The increasing debt burden and interest costs contribute to a negative outlook and potential credit rating downgrades, which further raise sovereign yields due to perceived higher risk. This combined with the elevated debt service obligations strains fiscal balances, heightening concerns among rating agencies about the country's ability to meet its debt obligations efficiently even as its social expenditure programmes are underfunded, as clearly evident in Table 2, which shows how spending on health, education and social security in Pakistan had been cut to make space for disaster relief. Consolidated development spending in Pakistan stood at 2.5 per cent of GDP in FY22, of which the Federal Government contributed about 84 per cent. These levels were lower than those of regional peers (Pakistan Expenditure Review, 2023).

**Table 2**

YEAR	SOCIAL SECURITY & WELFARE (PKR mn)	% OF BUDGET EXPENDITURE	NATURAL CALAMITIES & DISASTERS (PKR mn)	% OF BUDGET EXPENDITURE	EDUCATION (PKR mn)	% OF BUDGET EXPENDITURE	HEALTH (PKR mn)	% OF BUDGET EXPENDITURE
2018-19	173,443	5.60	20,933	0.70	868,022	28.10	421,778	13.70
2019-20	280,258	7.40	72,353	1.90	901,013	23.90	505,411	13.40
2020-21	225,278	5.30	89,138	2.10	802,226	18.90	586,270	13.80
2021-22	418,591	6.50	130,043	2.00	1,101,654	17.10	919,418	14.30
2022-23	610,036	6.20	393,940	4.00	1,251,055	12.70	843,179	8.60

Source: Calculations based on Pakistan Economic Survey (2022–23)

### **CRA's Response: Methodology-Consistent vs Discretionary/Bias**

When downgrading Pakistan's credit rating to CCC+, Fitch had pointed to the country's deteriorating external liquidity, declining foreign exchange reserves and high external debt pressures, describing them as "critical". This reflected the agency's criteria which prioritize macroeconomic stability, debt sustainability and external balances. At the same time, Fitch also mentioned the policy risks that could undermine Pakistan's IMF programme and external funding outlook, further reiterating the importance of maintaining fiscal and economic reforms (Fitch Ratings, 2022b).

Since then, Pakistan has made progress in narrowing its budget deficits and implementing structural reforms that support its IMF programme performance and funding availability (The Express Tribune, 2025). Pakistan remains under fiscal discipline and a tight fiscal stance which has entailed, among others, removal and targeting of subsidies, as nearly USD 31 billion in concessionary capital was tied up with the continuation of the IMF programme. Moreover, the finance minister has revealed that almost 90 per cent of the pledges made by the international community at a donor conference in Geneva were in the form of "project loans" that were to be rolled out over the next three years (Brookings, 2023). All this demonstrates a typical CRA influence on market perception and behaviour, possibly reinforcing policy trajectories of austerity measures shaped by methodological biases and market-driven discretion.

### **Transmission Channels and Implications on External Debt Service Costs**

Pakistan's downgrading in 2022 reflected an unfavourable situation where the "widespread floods" were expected to undermine its efforts to rein in twin fiscal and current account deficits (Fitch Ratings, 2022b). Furthermore, foreign exchange reserves were under severe pressure, falling every week since the disbursement of USD 1.2 billion from the IMF in the week to 2 September, upon the completion of the 7th and 8th reviews of Pakistan's Extended Fund Facility (EFF) with the IMF. As part of the fiscal consolidation package under the EFF, austerity measures were carried out. Moreover, high inflation which spiked in July–September during the floods brought about monetary tightening, which saw the policy rate go up by 800 bps by December 2022 and set at 22 per cent during FY 2024, during the post-flood adjustment phase.

While it is difficult to capture all the effects of downgrades, the case still shows the effect on interest rates, the exchange rate, and sovereign T-spreads. During the first nine months of FY23, there was a significant increase in external public debt repayments, which contributed to capital outflows. Specifically, the external debt repayments amounted to USD 11,400 million, compared with USD 8,139 million in the same period in the previous year. A significant portion of the increase in external debt, approximately USD 470 million, was attributable to exchange rate fluctuations. As mentioned above, other, indirect transmission channels included public spending cuts. A World Bank report showed a decline of approximately 20% in some sectors of development expenditure, with a likely slowdown in climate-specific development spending in the near term, especially given the broader emphasis on austerity and expenditure rationalization (World Bank, 2023a).

In summary, the transmission mechanism operates through a process where climate vulnerability increases perceived default risk, leading to downgrades, which in turn escalate borrowing costs, constrain fiscal and investment capacity, and ultimately threaten debt sustainability and economic stability.



## Maldives

<b>Driver Classification:</b>	Climate Event / Debt Distress
<b>Rating Agencies Covered:</b>	Moody's / Fitch
<b>Date:</b>	October 2021 – 2022

### Background

The Maldives is a small island developing state (SIDS) whose sovereign credit profile is deeply shaped by structural exposure to climate change and external shocks. Extreme climate vulnerability, stemming from sea-level rise, coastal erosion, and increasing frequency and intensity of climate-related disasters, has become a salient factor in assessments of the country's macroeconomic stability and long-term debt sustainability. For SIDS such as Palau and the Maldives, tourism accounts for 58–65 per cent of GDP (International Institute for Environment and Development, 2024).

The Maldives' situation depicts a vulnerable economy heavily affected by external shocks, notably the COVID-19 pandemic, with high inflation, substantial fiscal deficits, large current account deficits, and elevated public debt levels. Its debt-to-GDP ratio exceeds 100 per cent, making it one of the debt-distressed SIDS. While there are signs of recovery, the persistent vulnerabilities and high inflation pose risks to debt sustainability and economic stability.

The Maldives experienced severe economic disruptions between 2019 and 2025, marked by a sharp contraction of -34.2 per cent in real GDP in 2020 due to the COVID-19 pandemic, followed by a robust rebound in 2021. Despite this recovery, the country faced persistent macroeconomic vulnerabilities, including hyperinflation, with inflation rates exceeding 97 percentage points from 2019 through 2021 and rising above 107 percentage points by 2024 and 2025, indicating ongoing price stability challenges. The fiscal deficit worsened significantly in 2020, reaching -23.7 per cent of GDP, and despite improvement in subsequent years, it remained high, reflecting strained public finances.

The current account deficit also widened dramatically during 2020 to -35.8 per cent of GDP, signalling a substantial external imbalance and reliance on external financing. External reserves showed signs of recovery after hitting a low in 2023, increasing in 2024 and 2025, but still reflect fragility. Public debt surged from 41.4 per cent of GDP in 2019 to a peak of 86.9 per cent in 2020, before declining and then rising again, underscoring the country's increased borrowing during crisis periods. Overall, the Maldives' economic indicators reveal a fragile recovery marred by high inflation, external vulnerabilities, and significant debt burden, all compounded by its exposure to climate risks.

### CRA's Response: Methodology-Consistent vs Discretionary/Bias

When downgrading Pakistan's credit rating to CCC+, Fitch had pointed to the country's deteriorating external liquidity, declining foreign exchange reserves and high external debt pressures, describing them as "critical". This reflected the agency's criteria which prioritize macroeconomic stability, debt sustainability and external balances. At the same time, Fitch also mentioned the policy risks that could undermine Pakistan's IMF programme and external funding outlook, further reiterating the importance of maintaining fiscal and economic reforms (Fitch Ratings, 2022b).

Since then, Pakistan has made progress in narrowing its budget deficits and implementing structural reforms that support its IMF programme performance and funding availability (The Express Tribune, 2025). Pakistan remains under fiscal discipline and a tight fiscal stance which has entailed, among others, removal and targeting of subsidies, as nearly USD 31 billion in concessionary capital was tied up with the continuation of the IMF programme. Moreover, the finance minister has revealed that almost 90 per cent of the pledges made by the international community at a donor conference in Geneva were in the form of "project loans" that were to be rolled out over the next three years (Brookings, 2023). All this demonstrates a typical CRA influence on market perception and behaviour, possibly reinforcing policy trajectories of austerity measures shaped by methodological biases and market-driven discretion.

### Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (real GDP, %) <sup>7</sup>	.8	-8.1	13.26	.4	5.62	3	8.6
<b>Inflation</b> (CPI percentage points, %)	97.2	98.5	97.2	100.5	102.5	107.5	107.9
<b>Fiscal stance</b> (CG balance, % GDP)-	6.5-	23.7-	14.2-	11.6-	102.5-	12.5	
<b>Current account</b> (% GDP)-	25.9-	35.8-	8.7-	16.9-	10.6-	18.7	
<b>Reserves</b> (MVR mn)	744.1	975.3	781.8	823.4-	21.3	673.2	983.8
<b>Debt burden</b> (Public sector gross debt, % GDP)	41.4	86.9	64.1	57.2	588.6	62.4	

Source: Cbonds

The debt sustainability metrics for the Maldives remain highly adverse. General government debt is projected to rise to 117.6 per cent of GDP in 2026, up from an estimated 109.4 per cent in 2023, more than double the projected median level for B-category peer countries. These dynamics reflect a combination of high financing needs, elevated borrowing costs, and structural constraints on revenue mobilization. In response, the authorities have signalled plans for fiscal consolidation, including subsidy reforms that were reportedly postponed to late 2024 and are expected to generate fiscal savings of approximately 3 per cent of GDP on average over 2024–26. However, such consolidation efforts pose significant political, economic and social challenges, particularly given their potential impacts on vulnerable groups and the government's

parallel objectives of expanding infrastructure and strengthening climate resilience. The tension between fiscal adjustment and development priorities is especially pronounced in climate-vulnerable contexts, where large-scale public investment is essential for long-term adaptation and growth (Buhr et al., 2018; Beirne et al., 2021; Bharadwaj et al., 2024).

### **Driver Event Narrative**

Recent downgrades of the Maldives' Issuer Default Ratings (IDRs) have been driven primarily by worsening external financing and liquidity indicators. Credit rating agencies have emphasized declining foreign exchange reserve buffers, rising external public debt, and increasing rollover risks associated with large upcoming external debt service obligations. These pressures are combined with the challenges of maintaining the currency peg to the US dollar, which further constrains policy flexibility and heightens vulnerability to external shocks. Fitch in 2020 downgraded the Maldives to CCC from B+ (Fitch Ratings, 2020e). The downgrades were driven by a ~20 per cent drop in foreign reserves and rising debt service obligations for 2025 and 2026 (Government of the Maldives, n.d.). In this case, CRAs have highlighted heightened stress in external financing conditions, including reduced creditor support and increased difficulty in securing external funding on affordable terms. Taken together, these factors have materially weakened the Maldives' external position, reinforcing negative rating actions and raising concerns regarding the authorities' capacity to meet near- and medium-term external obligations.

### **Sovereign Rating Trajectory**

The Maldives has experienced a sustained deterioration in its sovereign ratings over the years from 2019–20 following the pandemic shock, climate vulnerability and debt distress, underscoring growing concerns regarding fiscal sustainability, external financing constraints, and climate-related vulnerabilities. These ratings placed the Maldives among the most distressed sovereigns in its peer group, with direct implications for borrowing costs and market access (Fitch Ratings, 2020e).

FITCH							
LONG-TERM RATINGS				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
29/08/24	CC						
29/10/21	B- (Stable)	29/10/21B	-	29/10/21	B		
05/11/20	CCC	05/11/20	CCC	05/11/20	C	29/10/21	B
30/03/20	B (Negative)	30/03/20B		30/03/20	B	05/11/20	C
08/05/19	B+	08/05/19B	+	08/05/19	B	30/03/20	B
15/05/18	B+ (Stable)	15/05/18B	+	15/05/18	B	08/05/19	B
15/05/17	B+ (Stable)	15/05/17B	+	15/05/17	B	15/05/18	B

MOODY'S							
LONG-TERM RATINGS				SHORT-TERM RATING			
27/11/25	Caa2 (Stable)						
11/09/24	Caa2 (Risky)						
	Caa1						

The downgrade of the Maldives' IDR to CCC by Fitch reflected expectations of intensified and prolonged external liquidity pressures stemming from the COVID-19 pandemic and increased debt levels due to debt-funded infrastructure spending. The country experienced an economic contraction of 34.2 per cent in 2020, surpassing the declines seen during the 2009 global financial crisis and the 2004 tsunami, primarily driven by a near-complete halt in tourism, its main revenue source, and limited fiscal capacity to counteract these shocks despite relief measures.

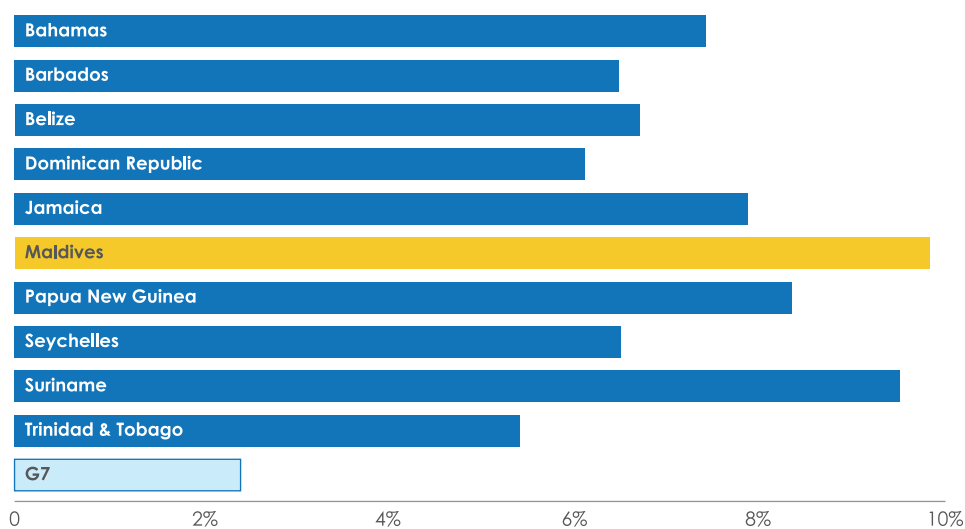
Public debt surged to 110.7 per cent of GDP, and fiscal deficit widened significantly to 21.7 per cent by the fiscal year of 2020, with tourism-dependent revenues plummeting by nearly 40 per cent. The country's external financing options have also become more constrained, with pressing debt service obligations totalling USD 494 million between late 2020 and mid-2022, including repayments on outstanding bonds and government-guaranteed debt, further challenging sovereign resilience amid ongoing external and economic strains (Fitch Ratings, 2020e).

### CRA's Response: Methodology-Consistent vs Discretionary/Bias

Climate risk constitutes a central factor in the Maldives' sovereign risk assessment. Credit rating agencies increasingly incorporate exposure to climate-related disasters and long-term environmental risks into their evaluations of sovereign creditworthiness. For the Maldives, acute climate exposure has contributed to higher perceived default risk and, consequently, elevated borrowing costs.

The Maldives currently faces borrowing costs on international bond markets in the range of 9 to 12 per cent, substantially above the average for SIDS and far above rates faced by advanced economies. In 2023, the average cost of borrowing for SIDS on international bond markets was approximately 7.05 per cent, compared with 2.09 percent for G7 countries (Figure 5).

**Figure 5. Individual SIDS' Cost of Capital vs the G7**



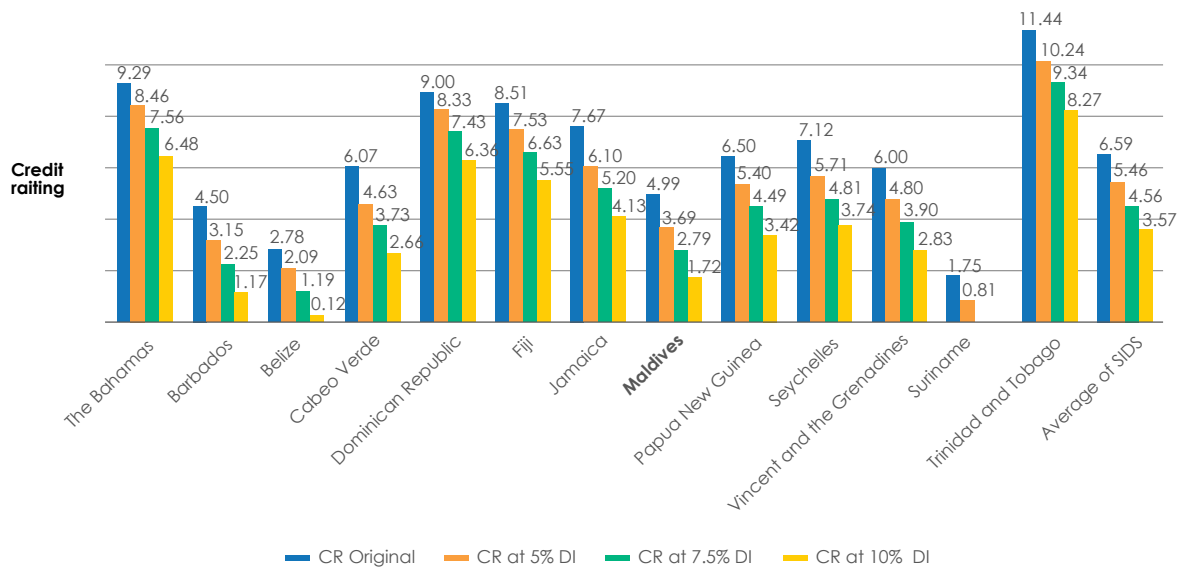
Source: ODI Global Policy Brief.

These differentials reflect both structural vulnerabilities and the risk premia associated with climate exposure, narrow economic bases, and limited fiscal buffers. Elevated interest rates further exacerbate debt sustainability challenges by increasing debt-servicing burdens and reducing fiscal space for productive and resilience-enhancing investment.

The Maldives' experience also reflects broader systemic challenges faced by SIDS within global credit rating and sovereign debt markets. A recent UN Department of Economic and Social Affairs (UNDESA) study found that during the COVID-19 pandemic, emerging market and developing economies experienced a cumulative 125 rating notches of downgrades, while advanced economies, despite larger fiscal expansions and faster debt accumulation, were downgraded by only six notches. This asymmetry underscores structural biases in rating practices that disadvantage smaller, more vulnerable economies. SIDS are among the most highly indebted country groupings globally.

A further structural constraint is the small size and limited liquidity of SIDS debt markets, which reduce incentives for credit rating agencies and investors to develop specialized expertise. The relatively high fixed costs of acquiring country-specific knowledge contribute to informational asymmetries, market inefficiencies, and potentially inflated risk premia, thereby increasing borrowing costs for SIDS. Adding on to this point, the International Institute for Environment and Development (2024) projected changes in credit ratings scores under different disaster intensity scenarios (Figure 6), examining how natural disasters and climate change impact the fiscal positions of SIDS and showing a noticeable decline in the credit ratings of all the countries.

**Figure 6. Projected Sovereign Credit Ratings of SIDS for Different Disaster Intensity**



Source: International Institute for Environment and Development (2024)

Another important consideration is the lack of integration of disaster preparedness in the credit assessments of SIDS. An analysis of the relationship between the index of lack of disaster preparedness and credit ratings found a weak association between both variables (Table 3).

**Table 3. Mapping Driver Events to CRA Assessments and Rating Narratives**

COUNTRY	CREDIT RATING SCORE 2021	LACK OF DISASTER-PREPAREDNESS INDEX
Suriname	1.75	19.5
Belize	2.78	28.05
Barbados	4.50	9.50
The Maldives	4.99	13.76
Saint Vincent and the Grenadines	6.00	9.36
Cabo Verde	6.07	5.7
Papua New Guinea	6.50	48.91
Seychelles	7.12	8.96
Jamaica	7.67	19.44
Fiji	8.51	11.31
Dominican Republic	9.00	30.15
The Bahamas	9.29	10.88
Trinidad and Tobago	11.44	10.56

Source: INFORM Report 2021 (Thow et al. 2021)

This lack of integration means that countries like the Maldives may be undervalued or misclassified relative to their true risk profiles, hampering their ability to leverage financial support for resilience investments.

### Transmission Channels and Implications on External Debt Service Costs

The interaction between high debt servicing and limited access to concessional finance creates a binding constraint on development and climate adaptation in the Maldives and other SIDS. To remain economically and physically viable, these countries need to invest heavily in human capital, resilient infrastructure, energy systems, and food security. However, debt-servicing obligations already exceed available climate and development finance flows by a substantial margin.

Between 2016 and 2020, SIDS collectively received USD 9.42 billion in development and climate finance to support resilience-building, while paying USD 26.6 billion to external creditors. Limited access to concessional finance forces many SIDS to rely on commercial borrowing, which, given weak credit ratings, entails prohibitively high costs. Research by

the Resilient and Sustainable Island Initiative (RESI) estimates that if 10 SIDS issuing USD-denominated bonds between 2003 and 2023 had borrowed at G7 interest rates, they would have saved approximately USD 34 billion, equivalent to 78 per cent of total development assistance received over the same period (International Institute for Environment and Development, 2024).

The Maldivian case highlights the self-reinforcing cycle linking climate vulnerability, adverse credit ratings, high borrowing costs, and constrained fiscal space. Climate risk increases perceived sovereign risk, which raises borrowing costs and weakens debt sustainability, thereby reducing the capacity to invest in climate resilience and development. This dynamic not only undermines progress towards sustainable development but also raises critical questions about the appropriateness of current sovereign risk assessment frameworks for climate-vulnerable states. More systematic integration of concessional climate finance, debt relief mechanisms, and climate-adjusted rating methodologies may be required to prevent climate exposure from becoming a structural driver of persistent debt distress among SIDS.



## Colombia

<b>Driver Classification:</b>	Public Spending Adjustments
<b>Rating Agencies Covered:</b>	S&P / Moody's
<b>Date:</b>	June 2025

### Background

In June 2025, S&P and Moody's downgraded Colombia's sovereign rating. S&P lowered the long-term foreign currency rating from BB+ to BB and assigned a negative outlook, while Moody's cut the sovereign from Baa2 to Baa3, its final investment-grade notch (S&P Global Ratings, 2025; Moody's Ratings, 2025).

Both agencies justified their decisions by pointing to a sustained weakening in Colombia's fiscal position. In their view, the deterioration in fiscal outcomes had undermined investor confidence, increased the debt burden and raised interest costs. S&P also argued that the combination of large fiscal deficits and weak economic performance had made the country more vulnerable to external shocks.

In its report, S&P emphasized limited fiscal flexibility, a high debt burden, a weak external position and moderate income levels as key constraints on the sovereign profile. It also linked the recent deterioration to expansionary primary spending, rising interest payments and revenues that fell short of expectations, all of which contributed to missed fiscal targets and persistently large deficits from 2024 onwards (S&P Global Ratings, 2025).

The negative outlook reflected not only the possibility of a further downgrade over the following 18 months but also growing concern about the predictability of fiscal policy. That concern intensified after the government moved to suspend the fiscal rule,[9] a decision widely interpreted as confirmation of a worsening fiscal trajectory (Reuters, 2025a; Reuters, 2025b).

### Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (GDP annual growth, %)	3.2	-7.2	10.8	7.3	0.8	1.5	2.6
<b>Inflation</b> (CPI, %)	3.8	1.6	5.6	13.1	9.3	5.2	5.1
<b>Fiscal stance</b> (% GDP)	-2.5	-7.8	-7.1	-5.3	-4.3	-6.7	
<b>Current account</b> (% GDP)	-4.6	-3.4	-5.6	-6.0	-2.3	-1.7	-2.4
<b>Reserves</b> (USD bn)	53.2	59.0	58.6	57.3	-59.6	62.5	66.3
<b>Debt</b> (% GDP)	48.4	60.5	60.9	58.5	54.4	56.4	

*Source: Authors' calculations based on official Colombian sources. GDP growth and CPI inflation data are taken from Banco de la República's Boletín de Indicadores Económicos, based on DANE data. Fiscal balance and debt data correspond to Gobierno Nacional Central series reported in the same source. Current account data come from Banco de la República balance-of-payments statistics, and reserves refer to yearend net international reserves. For 2025, annual fiscal balance and debt data were not yet available in final form, so those cells are left blank.*

### Driver Event Narrative

The June 2025 episode illustrates how a fiscal event, in this case the activation of the escape clause and the suspension of the fiscal rule announced by the government, can be transformed by the rating agencies into a disciplinary mechanism that reshapes market perceptions and policy constraints. The episode can be classified as a public spending adjustment driver, since it placed the state under suspicion of fiscal weakening. From this perspective, the agencies were not reacting only to the scale of the fiscal slippage, but also to the political decision to preserve room for manoeuvre rather than adhere immediately to the existing fiscal anchor.

At the time of the announcement on 10 June 2025, the immediate movement in the USD sovereign T-spread and the USD/COP exchange rate was limited. The rating agencies,

however, interpreted the announcement as evidence of institutional and fiscal deterioration and soon translated that assessment into a formal change in Colombia's sovereign ratings. Moody's downgraded the sovereign to Baa3, while S&P lowered the long-term foreign currency rating to BB and assigned a negative outlook, linking the decision to weaker fiscal outcomes, rising debt and interest burdens, and the suspension of the fiscal rule as a sign of a less predictable policy framework.

The logic underpinning these decisions is that stronger fiscal discipline implies lower sovereign risk. Yet this view leaves aside the possibility that the spread and exchange rate channels may operate in the opposite direction, by increasing the domestic-currency cost of debt service, weakening the public balance sheet and making fiscal adjustment more costly both socially and politically. In that sense, even when a downgrade produces visible short-term signals in risk premia or the exchange rate, its more significant effects may emerge only over the medium term, particularly in peripheral economies that depend on access to dollar liquidity and external financing on competitive terms.

From that perspective, the downgrades by Moody's and S&P affected not only the fiscal pillar but also the institutional one. This matters because institutional credibility tends to be more persistent than any single macroeconomic indicator. What is at stake is not simply the measurement of fiscal performance, but a broader judgement about what constitutes an appropriate policy response and when deviation from the rule is considered legitimate. At that point, the question of bias becomes difficult to avoid, since the agency no longer acts merely as an observer of repayment capacity, but also as an arbiter of acceptable policy conduct.

The subsequent behaviour of spreads and the exchange rate reinforces this criticism, because the market response appeared more muted than the severity of the rating signal might suggest. Around the date of the agencies' action on 26 June 2025, the T-spread stood at 349.8 bps, and it rose only to 354.3 the following day, while the COP/USD exchange rate moved from 4,042 to 4,098. A few days later, the spread had compressed to around 324 bps by t+5.

This suggests, first, that the market had already incorporated part of the deterioration before the downgrade and, second, that the agencies' action did not necessarily reveal new information. Rather, it may have operated as a mechanism whose force is greater in the periphery, where some investors and mandates respond mechanically to rating changes. Even when the price effect is not permanent, the downgrade still functions as an event that heightens volatility and conditions future access to financing.

## Event Windows

GOVERNMENT ANNOUNCEMENT (t0 = 10-June-2025)							
VARIABLE	t0	t+1	t+5	t+10	t+15	t+30	Maximum variation in 30 observations
USD sovereign spread (T-spread, bps)	348.8	351.8	343.6	352.6	342.9	316.5	12.4%
Exchange rate (COP/USD)	4207.4	4181.8	4101.3	4077.7	4059.7	4074.0	
	4	8	3	7	7	0	3.7%
Sovereign 10Y yield (YTM, %)	12.7	12.8	12.5	12.3	12.2	11.8	11.2%
CREDIT RATING AGENCIES' ACTIONS (t0 = 26-June-2025)							
VARIABLE	t0	t+1	t+5	t+10	t+15	t+30	Maximum variation in 30 observations
USD sovereign spread (T-spread, bps)	349.8	354.3	324.0	328.1	323.9	312.1	13.5%
Exchange rate (COP/USD)	4042.4	4098.3	3985.4	3997.4	4021.9	4047.3	
	4	3	4	4	9	3	5.1%
Sovereign 10Y yield (YTM, %)	12.2	12.3	12.2	12.1	11.5	11.8	6.5%

Calculations using Cbonds dataset.  $t_0$  is the first available observation on the event date;  $t+1$ ,  $t+5$ ,  $t+10$ ,  $t+15$ , and  $t+30$  denote the 1st/5th/10th/15th/30th subsequent available observations in the series (typically business days, so they are not calendar-day horizons). The "maximum variation" column reports the variation between minimum and maximum levels observed between  $t_0$  and  $t+30$ .

In this case, the most important channel is not the immediate movement in spreads or the exchange rate, but the way in which the rating agencies internalize the adjustment itself. The logic resembles a self-fulfilling prophecy: the agency downgrades the sovereign on the assumption that fiscal space has narrowed, yet the downgrade itself contributes to narrowing that space even further.

When the driver is public spending adjustment, the outcome can easily become excessive, because consolidation is then required under tighter financial conditions. This raises the social and political cost of adjustment and increases the likelihood of conflict, thereby reinforcing the same institutional judgement that the agency uses to justify the downgrade.

## Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
26/06/25	Baa3 (Stable)	26/06/25	Baa3				
27/06/24	Baa2 (Negative)	27/06/24	Baa2				
08/06/23	Baa2 (Stable)	08/06/23	Baa2				
06/10/21	Baa2 (Stable)	06/10/21	Baa2				
03/12/20	Baa2 (Negative)						
23/05/19	Baa2 (Stable)						
22/02/18	Baa2 (Negative)						

S&P							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
26/06/25	BB (Negative)						
18/01/24	BB+ (Negative)						
19/05/21	BB+ (Stable)						
26/03/20	BBB- (Negative)						

FITCH							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
01/07/21	BB+ (Stable)	01/07/21	BB+				
01/04/20	BBB- (Negative)	01/04/20	BBB-	01/07/21	B		
20/11/19	BBB	20/11/19	BBB	01/04/20	F3		
23/05/19	BBB	23/05/19	BBB	20/11/19	F2		
14/11/18	BBB	14/11/18	BBB	23/05/19	F2		
09/05/18	BBB (Stable)	09/05/18	BBB	14/11/18	F2		

Source: [datosmacro.com](https://datosmacro.com)

### **CRAs' Response: Methodology-Consistent vs Discretionary/Bias**

The actions taken by Moody's and S&P were explicitly grounded in the fiscal pillar, yet they quickly took on the character of an institutional judgement. In practice, the perceived weakening of the policy framework associated with the suspension of the fiscal rule came to outweigh the size of the deficit or the projected debt path. In that sense, the agencies activated two assessments at once, fiscal and institutional, while the economic, external and monetary dimensions were treated largely through their transmission effects. The downgrade was therefore not presented as a marginal adjustment in macroeconomic indicators, but as a broader verdict on credibility and on the state's capacity to sustain fiscal discipline.

From a methodological point of view, there are plausible arguments for internal consistency if one accepts the agencies' underlying assumptions. If the fiscal balance deteriorates and the credibility of the anchor weakens, then a reassessment of sovereign risk may follow, since fiscal room for manoeuvre narrows and uncertainty over the path of consolidation increases. Even so, the Colombian case still reveals the possibility of overreaction, particularly when the downgrade arrives in an environment already marked by high spreads and fragile financing conditions. In such circumstances, the rating action can tighten conditions precisely when fiscal policy requires flexibility in order to avoid adverse feedback effects (IMF, 2025b). This means that methodological consistency, even if granted, does not remove the broader problem of design, amplification and the coexistence of multiple forms of bias.

The language used by the agencies also tends to treat government announcements as evidence of structural weakening. In this setting, the rating functions less as a neutral measure and more as an evaluative judgement, in which credibility comes close to meaning adherence to the rule, while budgetary deliberation is recast as a source of risk. This bias is especially consequential in peripheral economies, because it transforms distributive and political disputes over public spending into variables that, once penalized, push policy towards a narrow repertoire of acceptable responses. The underlying problem, then, is not simply that downgrades may reflect risk, but that they can become part of the very mechanism that helps to produce the risk they claim to measure (Ministerio de Hacienda y Crédito Público, 2025).

### **Transmission Channels and Implications on External Debt Service Costs**

In the medium term, the effects are more likely to appear through monetary and financial transmission channels, where the rating acts less as an isolated shock than as a signal that amplifies pre-existing vulnerabilities. In the fiscal and exchange rate environment, episodes of volatility can place pressure on the central bank to react not only to observed variables, but also to shifting expectations. This is a familiar pattern in peripheral economies, where the exchange rate plays a central role in macroeconomic adjustment because of the structural dependence on external finance.

In Colombia, the medium- and longer-term effects of the rating agencies' actions on observable variables remain difficult to assess, since less than a year has passed since the downgrade. Even so, some expected transmission mechanisms can already be identified.

The first is the sovereign risk premium in US dollars. In principle, a downgrade or negative outlook should translate into a persistent increase in the risk premium and, with it, higher costs of issuing or refinancing debt in foreign currency. Yet, when the episode is examined using daily data, the effect associated with the agencies' announcement appears to be concentrated in very short-term volatility rather than in a sustained upward shift in spreads. In the  $t_0$ -to- $t+30$  window around 26 June 2025, the sovereign T-spread shows an immediate peak at  $t+1$ , but ends the one-month horizon below its initial level, suggesting that the downgrade was traded more as a validation of information already priced in by the market.

A similar pattern appears in the exchange rate. Around the agencies' announcement on 26 June 2025, the COP/USD moved up in the very short term and then reversed, closing the  $t_0$ -to- $t+30$  horizon at broadly the same level as on the day of the event. In that sense, the tension seems to have been transitory and visible mainly in slightly higher volatility, rather than in a lasting exchange rate shift. At the same time, other forces affecting the peso were also at work, particularly in a context of broader US dollar weakness, which makes it difficult to isolate the precise effect of the downgrade alone on the exchange rate. If depreciation were to persist long enough to feed into prices, interest payments, the fiscal position and debt dynamics, a monetary response would normally become more likely. In this episode, however, the central bank, Banco de la República, did not move towards an additional tightening cycle, suggesting that the downgrade did not generate a sufficiently strong pass-through to force a more restrictive monetary stance (Banco de la República, 2025b; IMF, 2025b).



## Indonesia

<b>Driver Classification:</b>	Public Spending Adjustments
<b>Rating Agencies Covered:</b>	Moody's / Fitch
<b>Date:</b>	October 2022 – February 2023

### Background

In March 2025, the investment bank Goldman Sachs downgraded Indonesian assets, citing "rising fiscal risks" from President Prabowo Subianto's government initiatives. Despite maintaining the credit rating at the same high level since 2017, Fitch warned that

a substantial increase in fiscal deficits could trigger a downgrade. The risks are centred around worries over fiscal health after Prabowo announced government measures including budget reallocation for the free meals programme, creation of a sovereign wealth fund and expansion of the housing policy for low-income families. Goldman Sachs stated that “long-end bonds will come under pressure amid rising fiscal risks and a potentially heavier bond supply” (Bloomberg News, 2025).

## Economic Conditions

INDICATOR	2019	2020	2021	2022	2023	2024	2025
<b>Growth</b> (real GDP, %)	4.97	-2.19	5.03	5.01	5.04	5.02	5.39
<b>Inflation</b> (CPI, %)	3.02	1.6	1.56	3.36	1.8	2.26	2.38
<b>Fiscal stance</b> (CG balance, % GDP)	-2.2	-6.5	-4.65	-2.35	-1.65	-2.3	-2.92
<b>Current account</b> (% GDP)	-2.7	-0.4	0.3	1	-0.2	-0.6	-0.1
<b>Reserves</b> (USD bn)	129.2	135.9	144.9	137.23	146.4	155.7	156.47
<b>Debt burden</b> (Public sector gross debt, % GDP)	30.6	39.7	41.1	39.7	39.2	38.8	

Source: *cbonds.com*

The table shows Indonesia's resilient economic situation characterized by steady real GDP growth, which ranged from 4.97 per cent to 5.39 per cent from 2019 to 2025, indicating sustained economic expansion despite global uncertainties. Inflation remains relatively low and stable, fluctuating between 1.56 per cent and 3.36 per cent, supporting price stability. The fiscal stance shows a gradual widening of the central government deficit, with the deficit-to-GDP ratio increasing slightly from -2.2 per cent in 2019 to an estimated -2.92 per cent in 2025, reflecting ongoing fiscal challenges but within manageable levels. The current account transitions from a deficit of -2.7 per cent of GDP in 2019 to near balance in 2024 and 2025, suggesting improved external stability. Foreign reserves have generally increased, reaching approximately USD 156.5 billion in 2025, aiding external resilience. Additionally, the public sector gross debt remains at manageable levels, fluctuating around 30–41 per cent of GDP, indicating Indonesia's continued capacity to service its debt without significant stress, despite some increases during the period. Hence, the overall picture shows Indonesia maintaining a stable macroeconomic environment with somewhat steady growth, controlled inflation, manageable debt levels and improving external balances.

A Bloomberg News (2025) report indicated that there is limited potential for outperformance in fixed income which will likely be under pressure due to rising fiscal risks and increased bond issuance. Meanwhile, yields on dollar-denominated Indonesian

bonds issued by PT Pertamina and PT Perusahaan Listrik Negara have widened slightly, reflecting growing concerns over government finances. The Indonesian stock market also experienced declines, with the Jakarta Composite Index dropping around 1 per cent, driven by weaker corporate earnings and tighter banking system liquidity. Additionally, an unusual delay in Indonesia's January 2025 budget data heightened fears about the country's fiscal health following the recent policy steps by Prabowo, adding to the overall cautious outlook on Indonesia's economic stability (Bloomberg News, 2025).

During 2025, Fitch and Moody's had kept ratings stable but their reports had made it notably clear that the country's future ratings would heavily depend on fiscal discipline, stronger tax revenue and managing global economic risks; hence an upgrade would require a tax ratio increase, budget deficit decrease and successful structural economic reforms, while a possible downgrade would be due to an economic growth slowdown, widening fiscal deficit and worsening geopolitical tensions (Primantoro, 2025). Therefore, the announcement of the government policy measures would have raised the spectre of rating downgrades.

### **Driver Event Narrative**

The fiscal event occurred in January 2025 with the announcement of the free nutritious meals programme and the energy subsidy policy. In addition, 80,000 Red and White Village Cooperatives were to be established with funds ranging between IDR 350 trillion and IDR 400 trillion. Subsequently, amidst the credit rating downgrade threats, the national nutrition agency acknowledged challenges in covering the costs of the free meal programme; it ended up slashing the cost per lunch box by a third to around IDR 10,000 (USD 0.60). The year's phased rollout from three million to 17.5 million recipients would incur an estimated cost of between USD 4.3 billion and USD 28 billion (Arshali et al., 2025).

Although the government did move ahead with the implementation of these budgetary measures, Moody's and Fitch believed the situation was still manageable because of the government's manageable debt burden and its ongoing efforts to expand the size and competitiveness of the manufacturing and commodity sectors. However, the threat of aggressive US trade restrictions loomed; further, if countries like Indonesia did not implement fiscal consolidation, they were seen to face limitations in cutting interest rates, making the debt burden high and causing exchange rate and capital flow pressures. Therefore, the focus was very much on retaining the medium-term fiscal burden and recommendations to raise tax revenues and give up on the "fiscal populism" agenda (Primantoro, 2025).

The CRAs' assessments centred on challenges to fiscal sustainability, which was seen as being under threat if the government continued to execute the social programmes and increase public spending. However, the agencies did not react immediately, keeping the ratings outlook stable until only recently in February 2026.

The event window in response to the government announcements shows that the markets remained steady and there was very limited fluctuation in risk premia, exchange rates and yields, demonstrating market confidence. The spread remained nearly unchanged, starting at 2.41 bps and shifting only marginally to a high of 2.59 bps over 30 days, with a maximum variation of only 7.95 bps. This indicates that the perceived risk of Indonesia's sovereign debt did not increase significantly, reflecting market confidence in the country's fiscal health and economic prospects. Additionally, the exchange rate remained quite stable, moving slightly from IDR 16,237 per USD to around IDR 16,330, with just a IDR 1.21 variation over 30 days. Such minimal fluctuation suggests a resilient external position, possibly supported by stable foreign exchange reserves and effective currency management, showing no immediate stress in the currency market.

Moreover, the yield showed only a slight upward trend, from 7.04 per cent to a maximum of 7.16 per cent, before decreasing to 6.91 per cent. This pattern indicates minor initial concerns, likely due to new developments or external shocks, but the subsequent decline signals regained investor confidence and perceived stability in Indonesia's debt outlook. Lastly and importantly, the policy rate remained steady initially at 6.00 per cent, then was lowered to 5.75 per cent, with a maximum 30-day variation of 4.35 per cent. The rate cut reflects an accommodative monetary stance, aimed at supporting growth, maintaining low inflation, or responding to external conditions, while signalling confidence in the economy's resilience. Hence, the question of bias becomes unavoidable as a CRA downgrade would be more of a self-fulfilling prophecy that may have real impacts on fiscal sustainability configuring investors and market mandates.

## Event Window

GOVERNMENT ANNOUNCEMENT (t0 = 6-January 2025)							
VARIABLE	t0	t+1	t+5	t+10	t+15	t+30	Maximum variation in 30 observations
USD sovereign spread (T-spread, bps)	2.41	2.43	2.40	2.59	2.51	2.49	7.95
Exchange rate (IDR/USD)	16237.00	16268.00	16360.80	16330.80	16164.90	16330.10	1.21
Sovereign 10Y yield (YT, %)	7.039	7.1190	7.1620	7.1570	7.1070	6.9120	3.62
Policy rate	6.00	6.00	6.00	5.75	5.75	5.75	4.35

Source: Calculations using the Cbonds dataset.  $t_0$  is the first available observation on the event date;  $t+1$ ,  $t+5$ ,  $t+10$ ,  $t+15$  and  $t+30$  denote the 1st, 5th, 10th, 15th and 30th subsequent available observations in the series, so they represent trading/business observations rather than calendar-day horizons. Maximum variation is computed as the distance between the minimum and maximum levels observed between  $t_0$  and  $t+30$ , relative to the minimum level in that window.

## Sovereign Rating Trajectory

MOODY'S							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
05/02/26	(Negative)						
26/04/24	Baa2 (Stable)						
10/02/22	Baa2 (Stable)						
10/10/20	Baa2 (Stable)						
13/04/18	Baa2 (Stable)						

S&P							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
27/04/22	BBB (Stable)						
17/04/20	(Negative)						
31/05/19	BBB (Stable)						

FITCH							
LONG-TERM RATING				SHORT-TERM RATING			
FOREIGN CURRENCY		LOCAL CURRENCY		FOREIGN CURRENCY		LOCAL CURRENCY	
Date	Rating	Date	Rating	Date	Rating	Date	Rating
		24/01/20	BBB	24/01/20	F2		
		14/03/19	BBB	14/03/19	F2		
		02/09/18	BBB	02/09/18	F2		
24/01/20	BBB	20/12/17	BBB	20/12/17	F2		
14/03/19	BBB	19/07/17	BBB-	19/07/17	F3		
02/09/18	BBB (Stable)	21/12/16	BBB-	21/12/16	F3		

### **CRA's Response: Methodology-Consistent vs Discretionary/Bias**

Before Moody's issued a ratings outlook cut to negative in February 2026, it had been announced that Indonesia's 2025 Q4 GDP was projected to grow 5.67 per cent year-on-year, up from 5.12 per cent in Q2 and slightly above the previous 5.5 per cent forecast, driven by new government stimulus including food assistance and temporary construction work. In this regard, Finance Minister Purbaya Yudhi Sadewa expected the rupiah, which had weakened around 3 per cent year-to-date, to strengthen as foreign investors respond to accelerating growth. The January–September fiscal deficit reached 1.56 per cent of GDP, higher than the 1.1 per cent for the same period in 2024, with the 2025 full-year deficit projected at 2.78 per cent; revenues fell 7.2 per cent to IDR 1,863.3 trillion and expenditures totalled IDR 2,234.8 trillion, slightly below 2024 levels. To manage the deficit, Indonesia planned to issue its first dim sum bonds in yuan. Although investor concerns about central bank independence and fiscal prudence persisted after the departure of Sri Mulyani Indrawati as finance minister, the government framed the budget as adaptive and credible, balancing short-term stimulus with medium-term fiscal sustainability amid social pressures from rising inequality and limited job opportunities (Reuters, 2025c).

In February 2026, Moody's cut Indonesia's credit rating outlook from stable to negative while maintaining its Baa2 investment-grade rating, citing concerns about policy predictability and governance risks. The move followed investor uncertainty and a USD 80 billion market sell-off triggered by transparency concerns raised by MSCI (Morgan Stanley Capital International). Despite the outlook change, the government maintains ambitions to raise economic growth from around 5 per cent to 8 per cent through large-scale programmes such as free meals, rural cooperatives, and public services, supported by investment through the sovereign wealth fund Danantara Indonesia. Officials, including chief economic minister Airlangga Hartarto and central bank governor Perry Warjiyo, argue that Indonesia's economic fundamentals and financial system remain strong. However, Moody's warned that a future downgrade could occur if fiscal policy becomes significantly more expansionary without revenue reforms, if capital outflows weaken the external position, or if the financial health of state-owned enterprises deteriorates (Reuters, 2026).

The Indonesian government says the revised rating outlook does not reflect fundamental economic weakness but stems from misunderstanding about the recent financing reforms. It highlighted a fiscal deficit ceiling of 3 per cent of GDP and a debt ratio below 40 per cent of GDP, with about 70 per cent of public debt denominated in rupiah, which helps reduce exchange rate risks. Indonesia's economy recorded strong growth in 2025, outperforming several major economies including China, Saudi Arabia, and the European Union. Inflation remained within the target range of 2.5 per cent  $\pm$  1 per cent, reaching 2.92 per cent in December 2025 and 3.55 per cent in January 2026. Additionally, Indonesia's foreign exchange reserves totalled USD 156.5 billion at the end of 2025, covering more than six months of imports, which exceeds international adequacy standards and supports financial stability (Pratama, 2026).

Indonesia's case suggests that while CRAs do consider fundamental economic indicators such as GDP growth, fiscal balance, debt ratios, and foreign reserves, indicating a structured methodological approach, there is also evidence of discretionary bias influenced by external market sentiment and transient shocks. The outlook downgrade to negative despite robust

economic performance, including high quarterly growth rates, stable inflation, and ample foreign reserves, indicates that market fears, investor perceptions, and external concerns such as MSCI transparency issues are significantly impacting the ratings. The agencies' references to policy predictability and governance risks, rather than purely macroeconomic fundamentals, point towards subjective judgments that can amplify narrative biases. The shift in outlook, coupled with market reactions and external uncertainties, reveals potential procyclicality and bias where ratings may disproportionately reflect short-term market emotions rather than long-term stability. Consequently, Indonesia's rating reassessment appears to be a blend of methodologically grounded evaluation and discretionary influences, raising questions about the consistency and neutrality of CRA assessments in dynamic market conditions.

### **Transmission Channels and Implications on External Debt Service Costs**

The transmission of CRA signals to Indonesia's external debt-servicing costs operates mainly through sovereign risk premia, exchange rate dynamics, and investor portfolio adjustments. Following fiscal policy announcements and the subsequent negative outlook revision, market indicators showed only limited stress. The USD sovereign spread increased marginally from 2.41 bps to 2.59 bps, while the 10-year sovereign yield rose from 7.04 per cent to 7.16 per cent before declining to 6.91 per cent, suggesting temporary concerns but a recovery in investor confidence. The rupiah moved only slightly from IDR 16,237 to around IDR 16,330 per USD, indicating minimal currency pressure. These modest changes imply that external borrowing costs have not increased significantly in the short term. Structural factors help mitigate risk, including foreign exchange reserves of about USD 156.5 billion and a public debt ratio below 40 per cent of GDP, with roughly 70 per cent of debt denominated in rupiah, which reduces exposure to currency fluctuations.

Although some expected transmission mechanisms can be identified, it is still early to establish and assess the medium- and long-term effects of the rating agencies' actions on observable variables since the downgrading happened only in February 2026 and the previous reactions were mostly in the case of warnings from the rating agencies.

# Summary of Country Case Studies

COUNTRY	DRIVER EVENT	EVIDENCE	KEY FINDINGS
Sri Lanka	Debt Distress & Restructuring	S&P moved bonds to SD in the context of default/restructuring dynamics.  Fitch downgraded Sri Lanka to RD after a default on foreign-currency bonds.	<ul style="list-style-type: none"> <li>• Default 2022 → severe FX crisis, IMF programme → austerity + consumption-tax-driven revenue</li> <li>• Fitch upgraded to CCC+ after debt exchange success; priorities shifted to debt repayments</li> <li>• Public investment crowded out (only 13 per cent of total spending) → fiscal space eroded</li> </ul>
Zambia	Debt Distress & Restructuring	Fitch rating actions around Zambia's default/restructuring episode (incl. default-related downgrades). Missed Eurobond coupon/default and subsequent CRA default classifications (Fitch RD; S&P SD).	<ul style="list-style-type: none"> <li>• First African COVID-era default 2020 → RD/SD rating, shut out of capital markets</li> <li>• Even after the 2023 restructuring + IMF programme, rating improvement is minimal</li> <li>• CRAs treated restructuring as an insolvency indicator, prolonging exclusion</li> <li>• Sovereign default triggered complex feedback loops – e.g. currency depreciation and risk premia – thereby deepening macro-financial fragility</li> </ul>
Argentina	Debt Distress & Restructuring	Fitch downgraded Argentina to C, explicitly stating a distressed debt exchange process had begun. Fitch later moved to RD after failure to pay interest within the grace period.	<ul style="list-style-type: none"> <li>• Default 2019 → sovereign stress + market access loss + capital controls</li> <li>• CRAs downgraded to SD/RD → crisis formalized → financing conditions tightened</li> <li>• Peso collapse + reserve loss → inflation surge + higher FX debt burden</li> <li>• Debt spike + persistent deficits → constrained fiscal space + investment crowding-out</li> </ul>
Ecuador	Debt Distress & Restructuring	Fitch downgraded Ecuador to RD in connection with the government's liability-management operation. Fitch also flagged probable default dynamics during the 2020 episode.	<ul style="list-style-type: none"> <li>• External shock 2020 (COVID + oil price collapse) → liquidity crisis + loss of market access</li> <li>• Consent solicitation/deferral → CRAs downgraded to SD/RD → default/distressed exchange formalized</li> <li>• Successful debt exchange (Aug 2020) → temporary relief → ratings upgraded back to B-</li> <li>• Dollarization constraint → no FX adjustment → reliance on external financing + constrained fiscal space</li> </ul>

COUNTRY	DRIVER EVENT	EVIDENCE	KEY FINDINGS
Belize	Debt Distress & Restructuring	S&P lowered Belize to SD in 2020 amid restructuring/default characterization. S&P had earlier lowered Belize to CC in expectation of debt restructuring.	<ul style="list-style-type: none"> <li>Debt distress 2020 → restructuring of Superbond → SD classification</li> <li>Loss of market access → external liquidity constraint under fixed exchange rate (no FX adjustment)</li> <li>Blue Bond operation (2021) → debt buyback + credit enhancement → reduced refinancing risk</li> <li>Post-restructuring upgrade to B- → improved financing conditions but reliance on external support</li> </ul>
Pakistan	Climate Event	Fitch downgrade actions in 2022–23 reflected acute credit stress; the climate channel is commonly linked to the 2022 floods weakening liquidity/funding conditions. Moody's downgrade emphasized fragile liquidity/external position (the macro channel through which floods can bite).	<ul style="list-style-type: none"> <li>Devastating 2022 floods + heatwaves → 33M displaced, 1.16M livestock killed, inflation 35 per cent</li> <li>Moody's &amp; Fitch downgraded to Caa3/CCC- citing liquidity crisis, FX reserve depletion + political instability</li> <li>IMF bailout linked to strict fiscal adjustments → later upgrade after reforms and bailout access</li> </ul>
Maldives	Climate Event	Moody's highlighted very high exposure to environmental risks via its ESG Credit Impact framing for Maldives. Fitch noted elevated external/fiscal vulnerabilities and high default risk (context consistent with SIDS fragility).	<ul style="list-style-type: none"> <li>Repeated downgrades → currently Caa2/CCC+ due to FX reserves + external debt stress</li> <li>Climate risk + tourism exposure → borrowing costs extremely high (9–12 per cent)</li> <li>Debt projected to exceed 117 per cent of GDP by 2026 → fiscal tightening + subsidy reform delays</li> </ul>
Indonesia	Public Spending Adjustments	Fitch explicitly discussed a credible fiscal consolidation path and continuing consolidation in 2022. S&P also referred to rapid fiscal consolidation in its Indonesia rating narrative.	<ul style="list-style-type: none"> <li>Fitch warned that deficit expansion could trigger a downgrade despite a high-grade history</li> <li>Nutrition programme costs scaled back; health funding cut to meet fiscal targets</li> <li>Illustrates ratings influencing domestic expenditure compression</li> </ul>
Colombia	Public Spending Adjustments	Reuters reported rating actions tied to fiscal weakening, deficit slippage, and fiscal rule concerns. Fitch's later downgrade rationale pointed to persistent large fiscal deficits, reinforcing the fiscal-stress channel.	<ul style="list-style-type: none"> <li>Fiscal deterioration 2025 → suspension of fiscal rule → weakened policy credibility</li> <li>CRA's downgraded (BB / Baa3) → loss of investment-grade edge + negative outlook</li> <li>Limited immediate market reaction → downgrade largely validated pre-priced risks</li> <li>Higher risk premia over time → tighter fiscal space + more costly public spending adjustment</li> </ul>

# Conclusions

Through nine comprehensive national case studies from across the developing world, this analytical paper illustrates the influential hand of the Big Three CRAs – Moody's, Fitch and S&P – in shaping the dynamics of sovereign macro-financial conditions. In both Sri Lanka and Zambia, sovereign debt defaults triggered increases in risk premia and currency depreciations, exacerbating already protracted macro-financial fragility, while IMF loan conditions mandating regressive taxation and budget cuts eroded already scarce fiscal space. In particular, debt restructuring was treated as an insolvency indicator in Zambia. In Argentina, rating agencies' treatment of debt distress in combination with a perfect storm involving the peso's collapse, foreign reserve declines, inflation surge and persistent deficits not only constrained fiscal space but, importantly, crowded out investment.

The driver of climate shocks led to an acute rating downgrade for Pakistan immediately after the 2022 floods which displaced 33 million people, hiked inflation to 35 per cent, depleted foreign exchange reserves, squeezed liquidity and led to political instability. In the Maldives, repeated downgrades cited climate risk, among other variables, which has played a part in maintaining high borrowing costs of 9 to 12 per cent.

In both Indonesia and Colombia, fiscal expansion resulted in immediate warnings. Public spending for a school nutrition programme across Indonesia triggered warnings of a rating downgrade despite decades of low fiscal deficits averaging 1.5 per cent of GDP. Subsequently, the nutrition programme was scaled back and health funding cut to meet fiscal targets. In Colombia, the suspension of the legal rule upholding fiscal discipline led to the loss of investment-grade edge and a negative rating outlook. A vicious cycle generates higher risk premia, tighter fiscal space and austerity measures with attendant social impacts.

The empirical findings of this report clearly demonstrate the punitive, procyclical and narrowly framed logics of CRAs in their practices and methods for developing countries. The specific driver events across the Global South, including debt distress and restructuring, political shocks, climate disasters, external-financing stress, and public spending adjustments, reveal recurring mechanisms through which CRAs convert episodes of uncertainty into tighter financing conditions. Although the sovereign contexts differ significantly, the macro-financial effects illustrate common elements, such as the widening of sovereign spreads, exchange rate depreciations and diminished foreign exchange reserves, refinancing risks, and stronger incentives for governments to prioritize fiscal adjustment over development expenditure. The comparative evidence suggests that rating actions do not merely mirror deteriorating fundamentals. Rather, they frequently validate and amplify market stress, reinforcing a cycle in which adverse shocks are translated into higher borrowing costs and narrower policy space for economic and social development objectives.

Improving sovereign financing conditions in the Global South requires a transformation in the production of sovereign risk assessments. As long as the dominant ratings architecture remains concentrated, developing countries will continue to confront a system that systematically overprices vulnerability and underestimates long-term development potential. In this sense, proposals such as the African Credit Rating Agency and a Multilateral Credit Rating Agency should be understood as strategic interventions in the global financial architecture aimed at correcting persistent asymmetries and providing independent and regional institutional alternatives in the context of a monopoly condition and geographical concentration of the Big Three rating agencies.

## A Two-Pronged Approach: Reforming CRAs As Well As Creating New Regional and Multilateral Rating Agencies

The central question of how to address the methodological bias, flaws and implications of CRAs has given rise to a complex debate marked by distinct views. One perspective is that rating methodologies can be reformed to increase legitimacy as well as confidence in their accuracy, integrity and potential to safeguard global financial stability. An opposing argument is that CRAs cannot be reformed in light of a broad range of factors such as the lack of accountability, procyclical financial markets and entrenched market power, among other reasons. One key perspective is that ratings are, by essence, opinions, not certifications, and thereby are unable to accurately anticipate crises and attendant debt default risks. This rationale stresses that the way forward should be to reduce the reliance of financial markets on CRAs. Initiatives that reflect this stance include the G20-endorsed Financial Stability Board view published in 2010 as well as the provisions of the Dodd-Frank Act and European Union regulations. And yet a third way forward is the creation of independent and new rating agencies on the regional level, such as the newly established African Credit Rating Agency and the Multilateral Credit Rating Agency outlined below by guest contributors.

## Revamping CRA Methodology

In alignment with the first camp of corrective reforms addressed to CRAs, and with an emphasis on but not limited to the Big Three agencies, a wide range of recommendations have been in circulation over the decades. They include, for example:

- Employing a long-term (30-40-year) trajectory of economic and social development on which to base ratings, rather than the 5-10-year trajectory used by current rating methodologies;
- Decreasing the weight placed on GDP per capita as well as expanding growth-based criteria to the potential for higher growth and convergence;
- Distinguishing between liquidity risk and long-term risk in rating methodology;
- Increasing transparency, particularly to reduce subjective biases that proliferate in the absence of accurate access to national data;
- Assessing debt-to-GDP ratios according to the 30-40-year scenario, rather than the 5-10-year scenario as is currently done;
- National financial sustainability should be integrated into long-term sovereign ratings for the objective of limiting the procyclical nature of ratings;

- Productive use of sovereign debt should be incorporated (for example, capital assets, including infrastructure and social development, that are being financed by sovereign borrowing);
- Prioritize the maturity structure of the debt, as long-term debt is inherently less risky than short-term debt as it avoids the risk of rollovers;
- Minimize subjective assessments, such as national political stability, which reflect inherent biases towards developed countries and do not reflect economic fundamentals;
- Consideration of the adequacy of national credit risk management systems in place; and
- Incorporation of regional monetary arrangements that help ensure sovereign liquidity.

### **Strategic Vision and Institutional Framework for the African Credit Rating Agency**

*(Dr. Patrick Ndzana Olomo, Head of Economic Policy and Sustainable Development, African Union Commission)*

The African Union has formally recognized the structural implications that external credit rating assessments can have on sovereign debt sustainability, fiscal space, and long-term development trajectories across African economies. Empirical evidence from the continent demonstrates that rating actions often amplify exogenous shocks, deepen procyclicality, and increase borrowing costs precisely at moments when countercyclical public financing is most needed. This dynamic has direct consequences for infrastructure investment, climate adaptation financing, and the achievement of development priorities. It is within this broader context that the African Union Heads of State and Government have decided to establish an African Credit Rating Agency (AfCRA) as a strategic continental response.

The vision of the AfCRA is to establish a technically rigorous, independent, and internationally credible institution capable of providing sovereign and sub-sovereign credit assessments grounded in a nuanced understanding of African economic structures, vulnerability profiles, and structural transformation pathways. Its objective is not to challenge the existence of established global agencies, but to complement the global rating architecture by reducing information asymmetries, improving risk differentiation, and strengthening analytical transparency. In doing so, the AfCRA aims to contribute to more accurate pricing of African sovereign risk and help mitigate contagion effects that frequently treat diverse economies as a homogeneous asset class.

A central pillar of the AfCRA will be institutional independence. Established as a private-sector-led and -driven institution, the AfCRA governance arrangements will guarantee the operational autonomy of rating committees, shield analytical processes from political influence, and embed strict conflict-of-interest safeguards. A professionally qualified and majority-independent board, transparent appointment procedures, and external audit and peer review mechanisms are essential to building market confidence. Methodological transparency will be comprehensive, including public disclosure of rating criteria, model assumptions, stress-testing frameworks, and clearly defined triggers for upgrades and downgrades.

From an analytical perspective, the AfCRA will integrate conventional fiscal, monetary, and external sustainability indicators with forward-looking metrics reflecting climate exposure, natural capital, demographic dynamics, structural reform trajectories, and regional integration under the African Continental Free Trade Area. Particular attention will be given to the interaction between climate vulnerability and debt sustainability, ensuring that temporary external shocks do not automatically translate into disproportionate and persistent rating penalties. At the same time, analytical discipline will remain uncompromised, with clear assessments of liquidity risks, debt management capacity, and institutional effectiveness.

A phased implementation strategy will enhance the AfCRA's credibility. The initial phase will focus on establishing a robust legal and regulatory framework aligned with international standards, recruiting experienced analysts with global expertise, and publishing detailed sovereign methodologies. Subsequent phases will expand coverage to sub-sovereign entities, development finance institutions, and thematic instruments such as green and sustainability-linked bonds. Financial sustainability will rely on diversified revenue streams in order to safeguard analytical autonomy and avoid excessive dependence on rated entities. If successfully implemented, the AfCRA will contribute to improved risk differentiation among African sovereigns, reduced contagion-driven volatility, stronger domestic capital markets, and more stable financing conditions for development-oriented public investment. Ultimately, its legitimacy will be rooted in technical excellence, methodological clarity, institutional independence, and recognition by global institutional investors as a credible and disciplined component of the international sovereign rating ecosystem.

## A Multilateral Credit Rating Agency: A Proposal

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A Multilateral Credit Rating Agency (MCRA) situated within the United Nations has the potential to act as a counterweight to the collective power of private CRAs. An MCRA would have two key objectives: improve credit risk assessments for sovereigns, and advance the UN's Sustainable Development Goals (SDGs) (Pérez Caldentay and Villarreal, 2023). The MCRA's functions include due diligence, development of forward-looking approaches (ensuring standardization), assessing the satisfaction of societies' basic needs (as represented by the SDGs), assisting sovereigns to target expenditures more effectively, and facilitating stakeholder engagement. Furthermore, the MCRA can catalogue and disseminate experiences with the rating industry and its products, as well as the effectiveness of innovations and regulatory changes.

A range of financing solutions for supporting EMDEs during rough patches are presented. They include GDP-linked bonds, income-linked bonds, state contingent bonds, disaster- and hurricane-linked clauses and so on (Pérez Caldentay and Villarreal, 2023). The MCRA can collate and validate the experiences of these instruments. In these ways, the MCRA would serve the global public good. Systematic analyses of industrial configuration can also include the presence of other overlooked aspects, particularly important for EMDEs. Two aspects are small and medium-sized enterprises (SMEs) and the informal sector. Analysis of stages of development, particularly with respect to infrastructure, socioeconomic factors, and goals of macroeconomic policies, and trends associated with long-term dynamics can help unlock the mystery of whether bias is present in the ratings methods. Long-term dynamics, such as climate change and inequality, evolve slowly, and can be treated as constant under the 3-to-5-year time horizon associated with traditional ratings.

While noting the benefits of an MCRA, the UN Development Programme has expressed concern as to whether its introduction would amount to a structural shift in a space characterized by the strong presence of the market mechanism and could possibly generate inefficiencies (UNDP, 2023). One of the MCRA's key goals, again, is to improve the assessment of sovereign creditworthiness so that resource allocation is rendered more efficient. The MCRA would not be implementing or imposing its own method of assessment onto stakeholders. It would be facilitating the emergence of solutions that can be adapted as needed. This includes a complementary rating scheme with a longer-term horizon; it can be implemented with the use of fan charts and scenario analysis.

It would be beneficial for the MCRA to acquire NRSRO (Nationally Recognized Statistical Rating Organization) status from the US government to enable its innovations for regulatory purposes. The MCRA should be rolled out in a piecemeal fashion to enable adjustments and contain costs as it grows over time. It

is also recommended that the MCRA be placed in a unit within the UN that supports EMDEs, such as CEPAL/ECLAC, UNDESA, UNDP or UNCTAD, to enhance communication and maximize knowledge transfer. This would acknowledge the importance of the MCRA to EMDEs and their experiences with sovereign debt and debt-servicing burdens. The MCRA can avoid strong influence by the CRAs (“regulatory capture”) with its divisional structure, engagement with diffuse interests and experts with diverse and independent opinions, and involvement of the press. Improvements in evaluations of creditworthiness facilitate stability and investment in productive activities as investors will have confidence in the efficient allocation and effectiveness of their investments. The MCRA refinements will also support improvements in the SDGs and socioeconomic outcomes for people, generally. The MCRA can potentially be dovetailed with public credit rating agencies at the national or regional levels, with a methodology that explicitly captures the influence of cyclical behaviour associated with market economies, whether advanced or developing (see Schroeder 2013, 2015).

The MCRA has a challenging mandate to support improvements in sovereign credit risk assessment, locate ways to moderate sovereign risk, and facilitate achievement of the SDGs. It needs to do these while recognizing the elephant in the room, i.e., climate change. The MCRA needs to pilot new methods of credit risk assessment and for achieving debt sustainability. The new paths cannot simply adjust or provide minor updates to the methods of the private rating agencies. Simply generating modest changes or adjustment would risk their absorption by the agencies into their own methods and make the MCRA’s approaches redundant and the agency itself unnecessary. The basis of the MCRA must be such that it will be daunting for the private rating agencies to replicate. Ultimately, the MCRA would have a unique role, edge, and design for supporting sovereigns in the 21st century.

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# Endnotes

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<sup>[1]</sup> PASO: Open, Simultaneous, and Mandatory Primary Elections (Primarias Abiertas, Simultáneas y Obligatorias), Argentina's nationwide primary election mechanism through which parties and coalitions select their candidates. Because participation is compulsory and the vote is open to the broader electorate, PASO results often serve as an early signal of electoral strength ahead of the general election and can therefore have a significant effect on market expectations.

<sup>[2]</sup> LELIQ refers to Letras de Liquidez, short-term central bank securities denominated in Argentine pesos and used to absorb excess liquidity from banks, playing a key role in the transmission of monetary policy.

<sup>[3]</sup> Correlation coefficients were computed from the Cbonds dataset by matching the daily series for the USD-T spread, the 1-year default probability, and the 7-day LELIQ rate over the period from 1 August to 15 October 2019. Pairwise Pearson correlations were estimated both in levels and in first differences using only exact common-date observations. This exercise is descriptive and intended to capture co-movements around the event window; it does not identify causal effects in a strict econometric sense.

<sup>[4]</sup> The IMF's Extended Fund Facility provides financial assistance to countries facing serious medium-term balance-of-payments problems because of structural weaknesses that require time to address.

<sup>[5]</sup> Belize's "Blue Bond" was a debt-for-nature swap structured to repurchase and retire the 2034 "Superbond" and replace it with financing with better terms, linking debt service relief to marine conservation commitments. In financial terms, the transaction was supported by a credit enhancement scheme through political risk insurance granted by the US International Development Finance Corporation (DFC), which raised the perceived quality of the instrument and contributed to reducing the risk of refinancing and the expected cost of the external service (S&P Global Ratings, 2021; US International Development Finance Corporation, 2021).

<sup>[6]</sup> The "Superbond" was the name given to Belize's international sovereign bond which, after successive restructurings, was consolidated into a single instrument (mainly the Belize Government International Bond 2034), becoming the country's most relevant commercial external liability and the focus of negotiations in 2020–21, including the operation that culminated in the Blue Bond (Government of Belize, 2021; S&P Global Ratings, 2020c, 2020d, 2021).

<sup>[7]</sup> A type of bond denominated in a foreign currency, most likely to be the USD.

<sup>[8]</sup> It includes monitoring spending, enhancing public debt transparency and ensuring prudent borrowing. The DSSI borrowers are committed to use freed-up space resources to increase social, health, or economic spending in response to the crises (World Bank).

<sup>[9]</sup> The fiscal rule, established in 2011 by Latin America's fourth-largest economy, imposes limits on government spending and debt to ensure the long-term sustainability of public finances and macroeconomic stability.



