Sovereign Rating Methodology: Feedback Report

Scope Ratings would like to thank market participants who provided feedback on its revised sovereign rating methodology, which was published on 14 December 2023. This report addresses comments received on a confidential basis during the call for comments period, which ended on 14 January 2024.

1.1. Comment on the use of purchasing power parity for assessing GDP/ capita

While theoretically a useful tool to determine the relative value of currencies, using it for GDP per capita is problematic given difficulties of calculation and estimation, but also because it would introduce an unwarranted positive bias towards less-developed countries.

- **Scope's answer:**

There are circumstances for which GDP per capita using market exchange rates is better than purchasing power parity (PPP) and vice versa. Any significant comparison of prices across countries must consider a wide range of goods and services. This is not straight-forward because of the large amount of data that must be collated and underlying complexities of the comparison process. Overall, market exchange rates are a better choice if one is dealing with financial flows, that is, money flows transacting across international borders. Conversely, GDP per capita by PPP is a superior metric if one is considering and comparing well-being and standards of living across countries.

First, under our sovereign rating methodology, we adopt GDP per capita as income per capita serves as a useful proxy of the economic and financial wealth of the resident sector and the degree of high-value added activities in the economy. With the objective to measure well-being, adjusting the metric for PPP allows for the correct comparability of the levels of buying power associated with a given per capita income level across countries and currencies.

Second, GDP per capita by PPP allows our Quantitative Model (QM) to better capture the role of income disparities within the institutional development of countries. Research displays a close correlation between GDP per capita (in USD terms) and indicators of institutional quality, but this relationship is generally non-linear: rises in GDP per capita link to more meaningful advancements of institutional quality at lower thresholds of GDP per capita. This non-linearity of the relationship between GDP per capita and institutional quality is partly addressed by adoption of the PPP adjustment, which corrects a part of the large gap between market and PPP-based rates for emerging market and developing economies.

Third, PPP exchange rates are comparatively stable. By contrast, GDP per capita assuming market rates can be comparatively unstable, resulting in more meaningful swings in metrics of income per capita even when underlying living standards have not shifted dramatically.

Moreover, while market-based exchange rates are especially relevant for internationally traded goods, non-traded goods and services are cheaper in low-income as compared to in high-income economies. If such differences in the prices of non-traded goods across economies are not accounted for, this would underestimate the buying power of consumers in low-income economies and, thus their general welfare and level of credit strength.

Finally, we updated our model to fixed thresholds from previously dynamic ones to enhance our accounting of sovereign credit risk. GDP per capita using market exchange rates may prove inconsistent with fixed thresholds over time, as underlying inflation elevates GDP per capita progressively in USD terms. As such, keeping GDP per capita using market exchanges with fixed thresholds would result in inflation increasing the indicative credit rating of sovereigns year after year even when inflation ought not point to strengthened credit scores. This distortionary effect grows with the passage of time. By adjusting GDP per capita based on PPP in constant international dollars, this removes this distortionary effect and allows for the correct specification of GDP per capita under our model following the adoption of fixed thresholds.

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1.2. Comment on mapping table

Mapping 'no score' from the quantitative model to an indicative rating of 'd', as suggested by the mapping table in Figure 9, may contradict the stated practice per paragraph 1.1.6 of not assigning ratings when data is lacking in coverage or quality.

- **Scope's answer:**

We do not rate a sovereign if data is lacking in coverage or quality, or if issues place the utility of the data into question. For the avoidance of doubt, we clarify that the lowest indicative rating determined by the quantitative model is indeed 'c', not 'd'. In case of 'no score', we therefore do not have an indicative rating of 'd', but in fact not enough information to start the rating process.

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