WOULD ACTIONS BY A FUTURE AUSTRALIAN GOVERNMENT TO STOP THE ADANI CARMICHAEL MINE FROM PROCEEDING CONSTITUTE AN INCREASE IN AUSTRALIAN 'SOVEREIGN RISK'?

Paper prepared for the Australian Conservation Foundation

by

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This paper has been prepared at the request of the Australian Conservation Foundation to explain the concept of 'sovereign risk' as used by international financial institutions and investors; and whether actions by a future Australian Government to prevent the Carmichael coal mine in the Galilee Basin in Central Queensland as proposed by Adani Mining from proceeding, would constitute a form of 'sovereign risk', or would detract from Australia's sovereign risk rating.

What is 'sovereign risk'?

The term 'sovereign risk', as used by rating agencies and in financial markets more generally, carries a very precise meaning. It refers to "the probability that a government defaults on its debt" (Peter and Grandes 2005: 7) or "the risk that the sovereign declares to be unable to fulfil its repayment obligations in foreign currency which leads to the sovereign's default on liabilities in foreign currency" (Karmann and Maltritz 2003).

Thus for example, Standard and Poor's, one of the three major global rating agencies, stresses that "sovereign ratings … pertain to a sovereign's ability and willingness to service financial obligations to nonofficial (commercial) creditors" (S&P Global 2017).

'Sovereign risk' is a particular type of 'country risk', to which international investors may be exposed as a result of investing in a country other than the one in which they are domiciled (Scholtens 2004: 7).

For investors in assets other than government debt (such as listed or unlisted equities, property, joint ventures in other businesses, or wholly-owned subsidiaries) two particularly important forms of 'country risk' arising from possible government actions are the risk of expropriation or nationalization of their assets (with or without any or adequate compensation); and the risk of being unable to repatriate dividends, profits or capital as a result of regulation (such as exchange controls). Because these directly relate to actions by a government which may detract from investors' ability to access the returns on their investment, or the investment itself, they are sometimes included under the heading of 'sovereign risk'.

Banks with international exposures (arising from loans to foreign residents, investments in securities issued in foreign jurisdictions, or business operations in foreign countries) routinely undertake 'country risk assessments' intended to assist in identifying and managing the risks associated with these exposures. These assessments are typically based on an evaluation of a country's macro-economic conditions and prospects (usually with a particular emphasis on its balance of payments and international financial position); the stability of its financial system; the state of its public finances; and an assessment of its political stability. Similar assessments are often undertaken by large multinational companies.

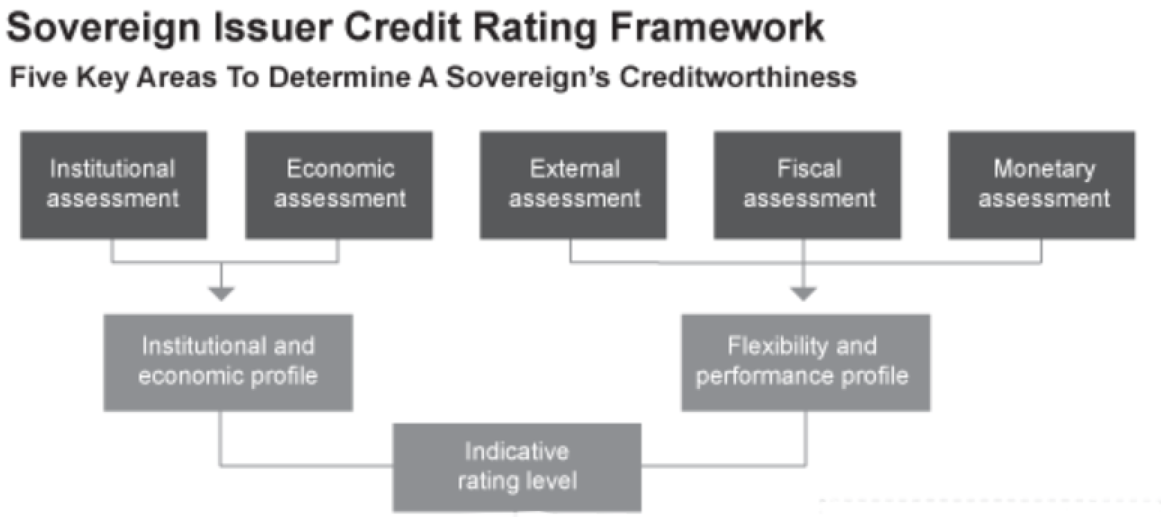
Over the past decade or so, the term 'sovereign risk' has become more widely applied to refer to almost any change in government policy which might adversely impact foreign investors (or even a single foreign investor) in a particular country (McCrann 2013; McKenzie 2014).

However, this is a considerably broader and looser use of the phrase 'sovereign risk' than is common in financial markets or among institutional investors.

How do rating agencies consider political factors in assessing 'sovereign risk'?

As noted earlier, the sovereign risk ratings issued by international rating agencies are intended to indicate the probability that a sovereign government will be unwilling or unable to meet its financial obligations to non-official creditors.

The following chart summarizes the criteria used by S&P in determining its sovereign credit ratings.



Source: S&P Global (2017).

- The *institutional assessment* reflects S&P's assessment of how a government's institutions and policymaking affect a sovereign's credit fundamentals by delivering sustainable public finances, promoting balanced economic growth, and responding to economic or political shocks. This includes the transparency and accountability of data, processes, and institutions; a sovereign's debt repayment culture; and potential external and domestic security risks.
- The *economic assessment* reflects S&P's view of a country's income levels (as measured by per capita GDP), growth prospects and economic diversity and volatility (all of which affects its government's ability to service debt).
- The *external assessment* reflects the status of the country's currency in international transactions, its external liquidity (its capacity to generate foreign exchange to meet its external financial obligations), and its international financial position (its residents' assets and liabilities vis-à-vis the rest of the world).
- The *fiscal assessment* reflects the sustainability of the government's finances and its debt burden, including an assessment of its fiscal flexibility, long-term trends and vulnerabilities, debt structure, access to funding and contingent liabilities (for example, in the event of a banking crisis).

- The *monetary assessment* is an evaluation of the central bank's or monetary authority's ability to fulfil its mandate while sustaining a balanced economy and attenuating any major economic or financial shocks. It includes an assessment of the exchange rate regime, the credibility of monetary policy, and the depth and diversification of the country's financial system and capital markets.

Moody's sovereign risk rating framework is based on four essentially similar criteria:

- *Economic strength*, incorporating real GDP growth, the volatility of GDP growth, the level of nominal GDP in US$ and of per capita GDP, the country's WEF Global Competitiveness Ranking, and an assessment of credit growth.
- *Institutional strength*, based on indices of government effectiveness, corruption and the 'rule of law', inflation and inflation volatility, and track record of default.
- *Fiscal strength*, including measures of government debt and interest payments relative to GDP and government revenue, the trend in debt over the past four years, the relative importance of foreign vs domestic currency debt, and financial assets relative to debt.
- *Susceptibility to event risk*, including assessments of political risk, the stability of the banking system, government's access to finance, and the country's balance of payments and international investment position (Moody's Investors Service 2016).

Clearly, the stability, predictability and transparency of a country's political system and institutions does have some influence on its sovereign credit rating. As S&P notes,

> "Effective policymaking and stable political institutions enable governments to address periods of economic distress and take measures to correct imbalances. This helps sustain long-term growth prospects and limit the risk of sharp deterioration of a sovereign's creditworthiness. Stable and well-established institutions generally ensure a certain degree of predictability in the general direction of policymaking, even when political power shifts between competing parties, with resulting policy changes" (S&P Global 2017).

The focus of the assessment of a country's political and policy-making institutions is on whether they help support a government's ability to meet its financial obligations.

Among the specific factors which S&P considers under this heading are "actual or potential challenges to political institutions, possibly involving domestic conflict, from popular demands for increased political or economic participation, or from significant challenges to the legitimacy of institutions on ethnic, religious, or political grounds"; and "the cohesiveness of civil society, as evidenced by social mobility, social inclusion, prevalence of civic organizations, degree of social order, and capacity of political institutions to respond to societal priorities" (S&P Global 2017).

There is nothing in this which suggests that a country's sovereign rating would be adversely affected by a change in government policy affecting a particular foreign investment proposal, such as a coal mine.

Moodys' assessment of 'political risk' appears to be more narrowly focussed than S&P's. It assesses domestic political risk using per capita GDP (as "a proxy for the potential for low-income related social unrest"), and the World Bank's Voice and Accountability Index, which "captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media", and is a component of the World Bank's Worldwide Governance Index (World Bank 2018). Moody's notes that it "may adjust the score to reflect our forward-looking view of domestic political risk based on the country's specific situation".

Again, there is nothing in this description which suggests that a country's sovereign rating would be adversely affected by a change in government policy pertaining to a particular foreign investment proposal.

Finally, it is worth noting that the rating agencies' evaluation of 'political risks' are undertaken on a *relative* basis – that is, how a given country compares on the various criteria used to determine political risks with other countries – rather than against some *absolute* scale.

Rating agencies recognize that, in most countries, governments 'come and go', whether as the result of democratic elections or by other processes (indeed, governments which remain in power for extended periods through undemocratic means tend to have relatively low sovereign ratings) – and that when governments change, at least some government policies also change. They recognize that incumbent governments can change policies, in response to changing economic or other circumstances, or in response to political pressures. Such changes are unlikely to affect a country's sovereign rating unless they in some way prompt a re-assessment of that country's willingness or ability to meet its financial commitments, relative to those of other countries.

Australia's sovereign rating

Australia was originally given a AAA rating by Moodys in October 1974, and by S&P in June 1975. It was downgraded one notch by Moodys in September 1986, and by S&P in December of that year; and again by Moodys in August 1989 and by S&P in October 1989. Fitch's first rating of Australia, in January 1996, was AA, two notches down from an AAA rating. S&P upgraded Australia one notch (to AA+) in May 1999, and restored the AAA rating in February 2003. Moody's upgraded Australia from AA2 to AAA in October 2002. Fitch upgraded Australia to AA+ in February 2003, and to AAA in November 2011.

Since then, Australia has been one of only ten countries to be rated AAA by all three of the principal international credit rating agencies (the other nine are Canada, Denmark, Germany, Luxembourg, Netherlands, Norway, Singapore, Sweden and Switzerland).

Australia is however the only one of these ten countries whose AAA rating is not regarded as 'stable' by all three agencies.

Since June 2016, S&P has had Australia's AAA rating on 'negative watch', reflecting "risks to the government's fiscal consolidation plan and risks to financial stability, economic outlook, and fiscal performance, should home prices fall abruptly with negative consequences for financial stability" (S&P Global 2018). S&P considers Australia's economy to be "highly vulnerable to any major shift in offshore capital flows" and that "Australia's international investment position remains a major weakness in the sovereign credit profile", as "a result of decades of sizeable current account deficits, financed by external borrowing".

Nonetheless, S&P also notes that "Australia is a wealthy, diversified, and resilient economy", which derives in part from "derives from strong institutional settings and decades of economic reform". Importantly, in the context of this report, they also observe that "Institutions are stable and provide checks and balances to power, there is strong respect for the rule of law, and a free flow of information and open public debate of policy issues" (S&P Global 2018).

It is worth noting that Australia's sovereign debt rating has *not* been affected by previous government policy decisions, based on environmental grounds, to prevent particular projects from proceeding or which may have affected the returns from particular investment proposals. Among those decisions are:

- the ending of sand mining (by an American company) in 1977, after the Fraser Government used its powers over mineral exports to force the company to cease operations;
- the introduction by the Western Australian Government in 2006 of a policy requiring that all new gas developments in that state supply the equivalent of 15% of their LNG exports to the domestic gas market;
- State Government bans on uranium mining (in New South Wales, Victoria, Queensland and Western Australia);
- Western Australian government restrictions on coal mining in the Margaret River region;
- State and Territory Government restrictions or bans on coal seam gas exploration and development, and/or on hydraulic fracturing ('fracking') for gas; and
- State Government restrictions on logging in native forests in Western Australia, New South Wales, Victoria and Tasmania.

Not only have these decisions had no bearing on Australia's sovereign credit rating (even though some of them have adversely affected the relevant foreign investors): nor have they had any impact on the credit ratings of any State or Territory Governments.

Nor has Australia's sovereign rating, or the credit ratings of individual states and territories, ever been affected in any way by changes in government policies regarding the taxation of resources projects – including:

- the significant increases in the crude oil levy imposed by the Fraser Government in the late 1970s;
- the expropriation of private coal royalty rights by the Wran Government in New South Wales in the early 1980s;

- the introduction of the Petroleum Royalties Rent Tax by the Hawke Government in the late 1980s;
- the proposed introduction of the Resources Super Profits Tax, and the subsequent introduction of the Mineral Resources Rent Tax, by the Rudd and Gillard Governments in 2010; and
- substantial increases in iron ore royalties imposed by the Western Australian Government in 2011.

The reason that none of these decisions have had any impact on Australia's sovereign credit rating, or the ratings of State and Territory Governments, is because they have not been perceived to have had any adverse impact on the ability or willingness of those governments to meet their financial commitments (and indeed in some cases may have been perceived as, at least at the margin, enhancing their ability to meet those commitments by strengthening their fiscal position).

Australia's ability to attract foreign investment

Australia needs to attract foreign investment in order to finance its persistent current account deficits – which in turn reflect the persistent shortfall between domestic saving and domestic investment – but it has had very little difficulty doing so.

Australia has attracted almost A$2 trillion in foreign investment (of all types) since 1989 (ABS 2018), of which almost $830bn has been in the form of foreign direct investment (that is, investment by foreign companies in their wholly- or largely-owned Australian branches or subsidiaries). Australia has attracted almost $380bn of foreign investment into its mining industry since 2007 (most of it in the form of equity).

The total stock of (gross) foreign investment in Australia stood at over $3.3 trillion at the end of 2017, equivalent to 185% of GDP (up from 120% of GDP at the end of 2000). Of this amount, over $900bn (equivalent to 50% of GDP, up from 34% of GDP at the end of 2000) was in the form of foreign direct investment (including $644bn of foreign direct equity investment); while a further $586bn (33% of GDP, up from 23% at the end of 2000) was in the form of portfolio equity investment (including investment by foreign institutional investors).

Data compiled by the United Nations Conference on Trade and Development indicates that between 2000 and 2016, foreign direct investment inflows into Australia amounted to US$520bn, the 13th highest in the world (exceeded only by the US, China, the UK, Hong Kong, Brazil, Germany, Canada, the Netherlands, Singapore, the British Virgin Islands, Spain and Belgium), and ahead of much larger economies such as France, India, Italy, Korea and Japan (UNCTAD 2017, Annex Table 1).

Australia's stock of inward foreign direct investment at the end of 2016 was equivalent to 45.8% of GDP according to UNCTAD data, higher than most other middle-sized or large advanced economies except for the Netherlands (103.9%) and Canada (62.5%); and above the UK (45.5%), Spain (45.2%), the US (34.4%), France (28.3%), Germany (22.2%), Italy (18.7%) or Japan (3.8%) (UNCTAD 2017, Annex Table 7).

The same data shows that the stock of inward foreign direct investment in Australia increased by 15.2 pc points of GDP between 2000 and 2017. Among 'advanced' economies this was less than most small European economies, Singapore, Hong Kong and Israel, as well as Canada and the UK (in both of which the stock of inward FDI rose by 18.7 pc points of GDP between 2000 and 2017); but it was larger than for any of France (14.9 pc points), the US (7.4 pc points), Japan (2.8 pc points), Germany (-1.8 pc points) or New Zealand (-6.0 pc points).

It is perhaps notable that Australia's ability to attract foreign investment does not seem to have been hampered by the decline in Australia's rankings on surveys of international competitiveness over this period. For example, Australia's overall rank in the Global Competitiveness Index compiled by the World Economic Forum has slipped from 16th in 2006-07 to 21st in 2017-18 (Schwab and Sala-i-Martin 2017). This largely reflects deteriorating perceptions (on the part of executives) of the quality of Australia's institutions and infrastructure, and of the efficiency of goods and labour markets, and consistently low assessments of the 'sophistication' and innovation capacity of Australian business.

There is no evidence that Australia's ability to attract foreign investment, either in general or more specifically into the resources sector, has been adversely affected by any of the environmental or taxation policy decisions referred to in the previous section.

What impact might a decision to prevent the Adani Carmichael coal project from proceeding have on Australia's sovereign rating or ability to attract foreign investment?

The foregoing discussion has sought to show that Australia's sovereign debt rating, like that of other countries, is determined by the ratings agencies' assessment of the Australian Government's willingness and ability to service and repay its debt; and that this assessment is relative to the willingness and ability of other sovereign governments to repay and service their debts.

It has sought to show that, while the rating agencies take into account a variety of economic, financial, institutional, and political factors in arriving at their assessments, they do not seek to 'pass judgement' on individual government policy decisions, except to the extent that they have some bearing on a government's willingness and ability to meet its financial commitments. It has argued that neither Australia's sovereign rating, nor the ratings of State and Territory Governments, have ever been affected by environmental policy decisions which those governments have taken, notwithstanding that in some instances they have had an adverse impact on foreign investors.

The foregoing discussion has also suggested that while banks, institutional investors and multi-national companies' assessments of 'country risk' consider a broader range of risks than those associated with government debt-servicing, the factors which go into those assessments are essentially similar to those used by credit rating agencies – although they are supplemented by consideration of factors specific to those institutions or companies.

Finally, the foregoing discussion has also indicated that Australia has had little difficulty attracting substantial volumes of foreign investment, notwithstanding that on several occasions the Australian Government, or State or Territory Governments, have taken decisions on environmental policy grounds, or with regard to taxation arrangements, which have in some instances disadvantaged particular foreign investors.

There is absolutely no reason to think that Australia's sovereign credit rating would be in any way affected if a future Australian Government were to prevent the Adani Carmichael coal mine from going ahead on environmental grounds (such as concern over its possible impact on the Great Barrier Reef).

Nor is it likely that any such decision would prompt international banks to downgrade their assessment of Australia's 'country risk', given that Australian banks have themselves been reluctant to lend to the Carmichael mine (Robertson 2017; Stevens 2017), a position also taken by many foreign banks (Griffiths et al 2017). Government actions preventing a project from proceeding which banks did not want to finance themselves is not a source of additional 'country risk'.

On the other hand, it is probable that any such action by a future Australian Government could prompt international coal mining companies to re-evaluate Australia's attractiveness as an investment destination.

But any such assessment would, of necessity, consider Australia's attractiveness as an investment destination *relative* to other countries with significant coal reserves or export potential.

The largest coal exporters, after Australia, are – Indonesia, Russia, the US, Colombia, South Africa, Canada, the Netherlands, North Korea, Mongolia, China, Poland, the Philippines, Kazakhstan and the Czech Republic (Workman 2018).

It's very difficult to imagine any of these countries, with the possible exceptions of the US and Canada, becoming 'more attractive' destinations for investment by multi-national coal companies simply because a future Australian Government stopped the proposed Carmichael mine from proceeding on environmental grounds.

And any such evaluation would also recognize that both the US and Canadian federal and state or provincial governments have from time to time stopped coal-related projects from going ahead on environmental grounds.

For example in April 2009 the US Environmental Protection Agency withdrew a permit previously issued by the same agency under the Bush Administration for a coal-fired power station on Navajo land in New Mexico (*The Economist* 2009). This year, Canadian company Kinder Morgan suspended the expansion of its Trans Mountain oil pipeline (from Edmonton in Alberta to Burnaby in British Columbia as a result of "continued actions in opposition to the project" by the British Columbia provincial government (Ferreras and Mertz 2018). In response, the Canadian Energy Pipeline Association asserted that the uncertainties created by this decision would "undermine Canada's ability to attract capital to grow the economy and provide jobs for Canadians" (Healing 2018).

There is in fact no evidence to date that Canada's "ability to attract capital" has been adversely affected by this decision – and certainly there has been no effect on Canada's sovereign credit rating, or the Canadian currency.

It is quite possible that investment in energy projects could, at the margin, be deflected from Canada to the United States – but any such investment decisions would also need to be cognisant of the possibility that the regulatory environment for energy projects in the US could change abruptly depending on the outcome of future Congressional or Presidential elections (as occurred after the 2008 elections, and again in the opposite direction after the 2012 elections).

From an Australian perspective, however, the key point is that any decision by a future Australian Government to prevent the Adani Carmichael mine from proceeding would not be setting any international precedents.

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