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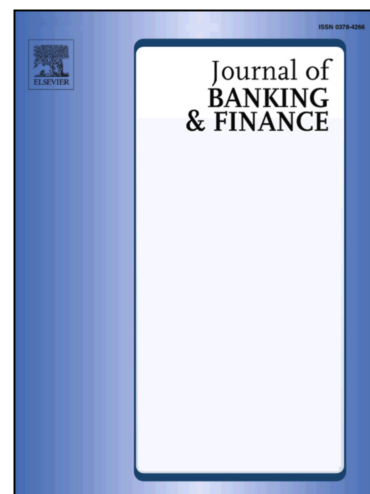

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Modelling the U.S. sovereign credit rating

Vito Polito* and Mike Wickens†‡

May 18, 2014

Abstract

This paper proposes a new methodology for generating sovereign credit ratings. These are determined by mapping the probability that the debt-GDP ratio might exceed a maximum debt limit at some point in the future into a credit rating. The debt limit can be either ad hoc or based on the financial ability of a government to change fiscal policy in the future to meet its outstanding obligations. When applied to quarterly U.S. data from 1970 to 2011, two clear instances are found in which the U.S. sovereign credit rating would have been downgraded on this basis: during the 1970s oil crisis and in the aftermath of the Lehman collapse in 2008. This result is robust to several alternative views on the maximum borrowing capacity of the U.S. economy.

JEL Classification: E62, H30, H60

Keywords: Credit risk, Sovereign risk, fiscal limits, default probability

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