

# Are S&P and Fitch overreacting?

Cyclical ups and downs are no basis for an investment downgrade but it is time to address the deterioration in domestic macros

It is widely known that political roadblocks have held back economic reforms and the Indian economy is slowing down. Indeed, the Confederation of Indian Industry has appealed to the political leadership to converge on issues of national importance. That these factors should lead to a downgrade of India's credit rating, however, does not follow. A sovereign credit rating indicates a country's creditworthiness and the risk associated with investing in the country. It is apparent that despite the recent setbacks to economic growth, there is hardly any likelihood that India will default on its loan repayments. For one, the government's debt-to-GDP ratio has been fairly stable at 45 per cent and, second, its external liabilities constitute less than four per cent of its total outstanding debt. In fact, the recent rating actions by Standard and Poor's (S&P) and Fitch were initiated by the rating agencies themselves. It is no wonder, then, that the government has reacted negatively and rejected the reports.

It seems that in view of the turmoil in the euro zone, rating agencies are being extra careful about those countries that run relatively high deficits. It is important to note that most developing countries, including the Brics countries (Brazil, Russia, India, China and South Africa), are going through a period of economic slowdown that has resulted in increasing budget deficits.

The reports by S&P and Fitch do not dwell on the extent to which India's slowdown is due to negative developments in external conditions. I would attribute at least 80 per cent of the recent change in India's economic outlook to the slowdown in exports and sudden increase in risk aversion among portfolio investors resulting in large capital outflows. Whereas the impression generated by the



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***"The reports do not dwell on the extent to which India's slowdown is due to negative external conditions and wrongly suggest it is largely self-inflicted by policy makers"***

reports is that the downturn is largely self-inflicted by India's policy makers.

The S&P report's comments on how the separation of political power and executive leadership has been detrimental to economic policy-making are also off the mark. Such a system has worked well at times as is apparent from the excellent performance of the economy during the UPA-I regime. If the separation of power were a genuine handicap, then the agency should have downgraded the country much earlier in 2004 when this system was first put into place. The reason the government is finding it difficult to move forward with some economic reforms is that democratic processes can often be time consuming.

Despite these drawbacks, if one were to look at India's rating

as a broad indicator of the level of risk associated with investing in a country, I would think that the threat of a downgrade is not justified. India remains an attractive place to invest owing to its long-term growth potential. In fact, the data on foreign direct investment put out by the Reserve Bank of India show that inflows into India have actually increased from around \$35 billion in 2010-11 to \$47 billion in 2011-12. Despite the turmoil in financial markets and the outflow of capital led by portfolio investors, India has remained an attractive place to invest. External commercial borrowings by Indian companies have also remained robust during this period, indicating willingness of global banks to take on Indian debt.

Rating agencies have, historically, given little weight to the fact that developing countries are able to grow their GDP at a faster rate than they accumulate debt. The problems being faced by some of the developed countries are far more serious than those faced by India. Compared to the US, Japan and most European nations, India's debt as a percentage of GDP is lower, while its growth rate is higher. Yet all these countries have a higher rating compared to India.

A credit rating should not change according to cyclical ups and downs in an economy but should reflect structural changes. I do not see any deterioration in structural indicators like the saving and investment rates or labour productivity. The investment rate, which has moderated on account of the cyclical downturn, remains at a relatively high level of 35 per cent. Without the problems of an ageing population, India's saving rate is relatively high at over 30 per cent. A report throwing more light on such structural indicators would have been more interesting.