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Ratings downgrade, an overreaction

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Fitch and S&P have been harsh on India. But steps to restore investor confidence must be taken soon.

The outlook for the Indian economy would not only depend on how the sovereign debt crisis in Europe plays out in 2012, but also on how our government would handle the policy inertia that is eroding business confidence domestically and internationally.

And there is a general perception that the lack of political consensus on reforms would be a stumbling block, which would come in the way of reviving the economy and restoring it to the path of growth. It is under these circumstances that the rating agencies, Standard & Poor's (S&P) and Fitch have downgraded India's sovereign rating.

S&P has further hardened its negative stance in its report entitled 'Will India be the First BRIC fallen angel?' wherein it has warned that, if the situation does not improve, India could slide into junk bond status.

Indeed, a further downgrade would not only significantly impact foreign investment inflows but also push up cost of borrowings from abroad, denting income, employment and growth.

But is such a downgrade acceptable?

SOUND FUNDAMENTALS

According to S&P, the concerns range from the ballooning fiscal and current account deficit to the growing political vacuum which could lead to protectionist policies.

Our banking system is among the most stable in the world.

Fitch has cited the faltering reforms agenda and similar reasons for heightened risks to India's medium and long-term growth potential. But do these concerns warrant a downgrade?

Is India's ability to service its debt in doubt? Have rating agencies overlooked the inherent strengths and resilience of the Indian economy?

There is no denying the fact that the global macro-economic environment has had a deleterious impact on our economic growth. Our GDP growth has declined to 6.5 per cent during 2011-12, against 8.4 per cent achieved in the previous year. Similarly, our high fiscal deficit, burgeoning subsidy bill, and increasing current account deficit driving down the value of the rupee, rising inflation, among others, are cause for concern.

But this does not mean that India's macro-economic credentials have been severely dented.

India has emerged as the third-largest economy globally and has improved its global ranking in per capita income. And the falling growth trends in India extend to other large countries such as China, South Africa and Brazil as well.

Our high savings and investment rates, a stable banking system, strong domestic consumption demand accruing from rising per capita incomes in rural and urban areas, and a reservoir of educated manpower, allude to the inherent resilience of our economy to absorb external and domestic shocks.

Foreign investors still consider India as an attractive business destination and have pumped in $46.8 billion as foreign direct investment in 2011-12, against $34.8 billion in 2010-11.

Our exports have also breached the target of $300 billion for 2011-12 despite global odds. Besides, external commercial borrowings by Indian companies are also rising, indicating the confidence of lending agencies in the Indian economy.

Our external debt as a percentage of GDP is among the lowest in the world. Even when it comes to total debt, both external and internal, our country is better off than many advanced countries.

All this shows that India does not come in the category of nations that would default on their external obligations.

PRIORITISE REFORMS

But it is equally true that ratings are undertaken in a dynamic setting and are subject to change, once it is perceived that the economic activity is regaining momentum and the government is serious about reforms.

A clutch of reforms in a few strategic areas, to begin with, would go a long way to dispel investor pessimism and demonstrate that India means business.

CII believes that the government would do well to work towards effecting fiscal consolidation by augmenting revenue and curtailing unproductive expenditure, extending price decontrol to diesel, opening up FDI in multi-brand retail, pensions and insurance, implementing GST, effecting monetary easing by cutting CRR and policy rates by 100 basis points, fast-tracking infrastructure projects, addressing problems of land acquisition, providing fiscal stimulus to investments and easing supply-side bottlenecks in agriculture.

Fitch has said that India can be downgraded further in the next 12-24 months if corrective measures are not taken.

Such warnings, along with declining macro-economic indicators, should serve as a wake-up call to gear up and take remedial measures to reinvigorate the economy and bring it back to the 9 per cent growth trajectory.

The realisation of our latent growth potential would depend crucially on the government's determination to take the right decisions at the right time, which would kick-start investment in our economy.

Given the strong resilience and inherent growth potential of Indian economy, the Government and political parties could seize this opportunity to prove that India is a growth story that cannot be overlooked.

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