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Chapter 3 - Does India's Sovereign Credit Rating reflect its fundamentals? No!

INTRODUCTION

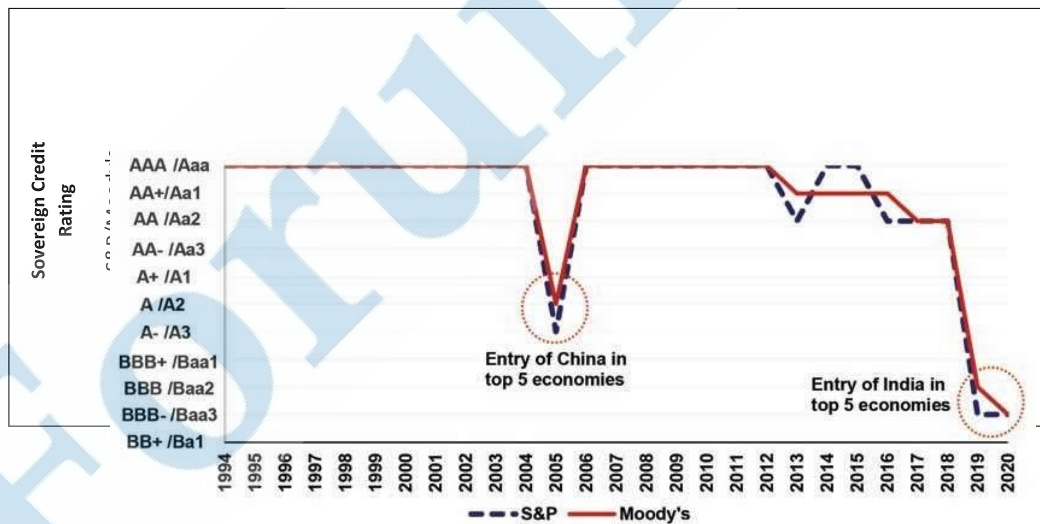
- In the history of sovergein credit ratings , never before the fifth largest economy in the world has been rated as the lowest rung of the investment grade (BBB-/Baa3).
- Reflecting the economic size and thereby the ability to repay debt, the fifth largest economy has been predominantly rated AAA.
- However, China and India are the only exceptions to this rule – China was rated A-/A2 in 2005 and now India is rated BBB-/Baa3.

This chapter covers this debatable issue of sovereign credit of India by external auditors. Do the fundamentals that supposedly drive sovereign credit ratings rationalise this historical anomaly? In this chapter, the Survey asks this important question and answers a resounding No!

THE BIAS AGAINST EMERGING GIANTS IN SOVEREIGN CREDIT RATINGS

Figure 1 shows that the sovereign credit rating of the fifth largest economy (current US$) by two credit ratings agencies (CRAs) declined steeply in 2005 following China's entry into the top five economies. Similarly, the sovereign credit rating of the fifth largest economy (current US$) by two CRAs declined steeply in 2019 following India's entry into the top five economies.

Figure 1: Sovereign Credit Rating of Fifth Largest Economy (Current US $)



Source: Bloomberg and World Bank

INDIA'S SOVEREIGN CREDIT RATINGS

- Currently, India is rated **investment grade** by three major CRAs – S&P, Moody's and Fitch. India's sovereign credit ratings upgrades have mainly been witnessed in the second half of 2000s, in recognition of higher economic growth prospects and strengthened fundamentals of the Indian economy.

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- Further, during most of the 1990s and mid 2000s, India's sovereign credit rating was **speculative grade**. India's credit rating was upgraded to investment grade by Moody's in 2004, Fitch in 2006 and S&P in 2007. Notably, Indian economy grew at an average rate of over six per cent, and at approximately eight per cent in several years during this period. Hence, during most of the decade of 1990 and early 2000's, India's high rate of economic growth co-existed with a sovereign credit rating of **"speculative grade".**

DOES INDIA'S SOVEREIGN CREDIT RATING REFLECT ITS FUNDAMENTALS? NO!

- There is a large academic literature that highlights bias and subjectivity in sovereign credit ratings, especially against countries with lower ratings.
- Do the fundamentals that supposedly drive sovereign credit ratings rationalise this historical anomaly of India's low ratings? Answer is a resounding No!

HAVE INDIA'S SOVEREIGN CREDIT RATINGS REFLECTED ITS FUNDAMENTALS IN THE PAST? NO!

- India's negative outlier status w.r.t. its sovereign credit ratings vis-à-vis performance on several parameters remains true not only now but also during the last two decades.
- India has consistently been rated below expectation as compared to its performance on various parameters during the period 2000-20.
- Within its sovereign credit ratings cohort, India has consistently been rated much below expectation for its level of GDP growth rate during the period 2000-20.

DOES INDIA'S SOVEREIGN CREDIT RATING REFLECT ITS WILLINGNESS AND ABILITY TO PAY? NO!

Credit ratings map the probability of default and therefore reflect the willingness and ability of borrower to meet its obligations. India's willingness to pay is unquestionably demonstrated through its zero sovereign default history. Within India's sovereign credit ratings cohort, India is rated much below expectation for its number of sovereign defaults since 1990 (which is zero for India), making it a negative outlier.

- India is again a negative outlier, rated below expectation for the numbers of years since last sovereign default (which is zero for India) within its sovereign credit ratings cohort. Unlike several of its cohort countries, India has never defaulted during the period.
- India's ability to pay can be gauged not only by the extremely low foreign currency denominated debt of the sovereign but also by the comfortable size of its foreign exchange reserves that can pay for the short term debt of the private sector as well as the entire stock of India's sovereign and non-sovereign external debt.
- India's sovereign external debt as per cent of GDP stood at a mere four per cent as of September 2020 (DEA). Moreover, 54 per cent of India's sovereign external foreign currency denominated debt was owed to multilaterals and IMF as of end-March 2020 (DEA), which is not expected to impact credit rating assessments. Since India does not have full capital account convertibility, the private sector has to repay its foreign currency denominated debt by exchanging rupees through the forex reserves.
- India's non- government short term-debt as per cent of forex reserves stood at 19 per cent as of September 2020 (DEA). India's forex reserves stood at US$ 584.24 as of January 15, 2021 (RBI), greater than India's total external debt (sovereign and non-sovereign) of US$ 556.2 bn as of September 2020 (DEA).
- In corporate finance parlance, therefore, India resembles a firm that has negative debt,

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whose probability of default is zero by definition.

- Despite this compelling statistic, India is an inexplicable negative outlier in its ratings cohort. Within countries with partial capital account convertibility in India's sovereign credit ratings cohort, India has consistently been rated much below expectation for its level of short-term external debt (per cent of reserves) during the period 2000-20, emerging as a negative outlier.
- Similarly, India has consistently been a negative outlier, rated below expectation for its level of reserves adequacy ratio within its sovereign credit ratings cohort during 2000-20,
- India's sovereign foreign denominated debt is met through India's forex reserves. Since India has partial capital account convertibility, this implies that private foreign denominated debt also needs to be met by either private export earnings or India's forex reserves.
- Given private export earnings, India's large forex reserves are in fact an underestimation of its ability to repay its short-term obligations. Yet India's sovereign credit rating is BBB-/Baa3, failing to capture this high ability to pay debt obligations!

EFFECT OF SOVEREIGN CREDIT RATING CHANGES ON SELECT INDICATORS

- Changes in sovereign credit ratings can affect economies. From 1998 till date, India has witnessed four instances of a sovereign credit ratings downgrade and seven instances of a sovereign credit ratings upgrade.
- As ratings do not capture India's fundamentals, it comes as no surprise that past episodes of sovereign credit rating changes for India have not had major adverse impact on select indicators such as Sensex return, foreign exchange rate and yield on government securities.

Short-Term Effect of India's Sovereign Credit Rating Downgrades

- There is correlations between a credit ratings downgrade and Sensex return as well as exchange rate (INR/USD), averaged across downgrade episodes from 1998-2018. It may be seen from various data that during the rating downgrade, Sensex return, on average, fell by around one per cent over the previous day, and recovered to grow at 0.38 per cent over the next two weeks.
- Exchange rate (INR/USD), on average, appreciated by around 0.01 per cent over the previous day, and appreciated by 0.01 per cent over the next two weeks.

Medium-Term Effect of India's Sovereign Credit Rating Downgrades

- There are correlations between a credit ratings downgrade and Sensex return, exchange rate (INR/USD) and G-Sec yields (5 year and 10 year) and spread in the medium term, averaged across downgrade episodes from 1998-2018.
- It may be seen that during ratings downgrade, Sensex return, on average, fell by around four per cent over the previous month, and recovered to grow at 0.5 per cent over the next six months. Figure 34
- During ratings downgrade, exchange rate (INR/USD), on average, depreciated by around one per cent over the previous month and depreciated by 0.2 per cent over the next six months.
- During ratings downgrade, yield on G-Sec (5 years), on average, fell by 1.4 per cent over the previous month, and grew at 0.1 per cent over the next six months. Yield on G-Sec (10 year), on average, fell by 3.3 per cent over the previous month, and declined by 0.29 per cent over the next six months. Spread (RHS), on average, fell by 22 per cent over the previous month, and grew at one per cent over the next six months

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Long-Term Effect of India's Sovereign Credit Rating Downgrades

- There are correlations between a credit ratings downgrade and Sensex return, exchange rate (INR/USD) and FPI (Equity and Debt) in the long term, averaged across downgrade episodes from 1998-2018.
- It may be seen that: (i) that during the year of ratings downgrade, on average, Sensex return rose by around 34 per cent over the previous year, and grew at 26 per cent the next year.
  (ii) During the year of ratings downgrade, on average, exchange rate (INR/USD) depreciated by around nine per cent over the previous year, and depreciated by two per cent the next year.
  (iii) During the year of the rating downgrade, on average, FPI Equity fell by 67 per cent over the previous year, and fell by 759 per cent in the next year. Average FPI Debt too followed a similar pattern, declining by 289 per cent, on average, during the year of rating downgrades, and declining by 114 per cent in the next year.

MACROECONOMIC INDICATORS AS DETERMINANTS OF SOVEREIGN CREDIT RATING CHANGES

- Past episodes of rating changes have no or weak correlation with macroeconomic indicators. However , there is no clear pattern between changes in GDP growth and sovereign credit rating changes
- India's Fiscal Deficit (as per cent of GDP) for Central and State Governments in relation to sovereign credit ratings changes during 1998-2020: All sovereign credit ratings upgrades occurred in years that witnessed lower fiscal deficit as compared to the previous year.
- India's general government debt (as per cent of GDP) in relation to sovereign credit ratings changes during 1998-2019: Most sovereign credit rating upgrades occurred in years that witnessed higher or similar level of general government debt (as per cent of GDP) as the previous year.
- India's overall debt (as per cent of GDP) in relation to sovereign credit ratings changes during 1998-2019: Most credit ratings upgrades occurred in years that witnessed higher overall debt as compared to the previous year.
- India's consumer price inflation (annual per cent change) in relation to sovereign credit ratings changes during 1998-2020: The pattern of correlation between inflation and changes in sovereign credit ratings is not clear.
- India's current account deficit (as per cent of GDP) in relation to sovereign credit ratings changes during the period 1998-20: The pattern of correlation between sovereign credit rating changes and current account deficit is not clear.

It may be seen that during years of India's sovereign credit rating changes, the average performance of macroeconomic indicators was better than or similar to the previous year. The average performance of macroeconomic indicators further improved or was similar in the year after the sovereign credit rating change

POLICY IMPLICATIONS

- The Survey questioned whether India's sovereign credit ratings reflect its fundamentals, and found evidence of a systemic under-assessment of India's fundamentals as reflected in its low ratings over a period of at least two decades.
- India's fiscal policy must, therefore, not remain beholden to such a noisy/biased measure of India's fundamentals and should instead reflect **Gurudev Rabindranath Thakur's** sentiment of a mind without fear. In other words, India's fiscal policy should be guided by considerations of

growth and development rather than be restrained by biased and subjective sovereign credit ratings.

- While sovereign credit ratings do not reflect the Indian economy's fundamentals, noisy, opaque and biased credit ratings damage FPI flows. Sovereign credit ratings methodology must be amended to reflect economies' ability and willingness to pay their debt obligations by becoming more transparent and less subjective. Developing economies must come together to address this bias and subjectivity inherent in sovereign credit ratings methodology to prevent exacerbation of crises in future.

The pro-cyclical nature of credit ratings and its potential adverse impact on economies, especially low-rated developing economies must be expeditiously addressed. India has already raised the issue of pro-cyclicality of credit ratings in G-20. In response, the Financial Stability Board (FSB) is now focusing on assessing the pro-cyclicality of credit rating downgrades