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Junk debt - or a rubbish rating?

By Kunal Kumar Kundu

BANGALORE - United States-based rating firm Standard & Poor's downgraded its outlook for India's sovereign debt from stable to negative on February 24, while retaining the country's BBB- rating - the lowest investment grade. In essence, India's sovereign debt is just a step away from being declared junk. Not only does that indicate that the economy is in a perilous state - it drives up the cost of borrowing.

The last time India was downgraded to junk was in 1991. Are we saying that India is currently on the edge of the precipice and is about to hurtle down the abyss, as it did then, when, if memory serves me right, inflation ruled at 16.7% in August 1991. India's foreign currency assets were worth a measly US$1.1 billion on June 30, 1991, just good enough to cover the country's import bill for a fortnight.

That year, the government leased 20 tonnes of gold to the State Bank of India (SBI) for sale abroad, with an option to repurchase it after six months. The government also asked the Reserve Bank of India (RBI) in July 1991, to ship 47 tonnes of gold to the Bank of England to raise $600 million.

Agreed, India's current fiscal situation is a cause for concern. This is purported to be the background for the current downgrade, along with external vulnerability, given the rising current account deficit. But before we go into the depth of the issue, it is important remember that in the interim, during 2001-2004, there was a strong debate on same issue, when global rating agencies downgraded India in view of a rising fiscal deficit.

In January 2004, Professor Nouriel Roubini (RGE Monitor) and Richard Hemming (senior advisor at the Fiscal Affairs Department of the International Monetary Fund) in their paper "A Balance Sheet Crisis in India?", drawing on their and India's experience of the previous crisis in 1991, concluded by highlighting several vulnerabilities that India was on the verge of another crisis. In retrospect, however, these risks never materialized. India recorded 8%-plus annual gross domestic product (GDP) growth for the next few years thereafter and everything was under control.

Now, the specter of a high deficit is again looming large. India's estimated fiscal deficit for the financial year 2008-09 is 6%, and if one takes into account the state government deficits, the total fiscal deficit should be in the region on 9% to 10%. However, the uptick in the deficit has as much to do with rising expenditure as it has to do with falling revenues as growth momentum slows, following the contagion effect of the global crisis.

It is important to note that the fiscal deficit rose despite a sharp fall in private spending. Hence the rise in the fiscal deficit has not been caused by private spending. Even the external (im)balance that is of concern to the rating agency has a lot to do with the global financial crisis. In fact, with domestic demand shrinking and commodity prices falling (and unlikely to improve much even next year or the next given the general recessionary trend), India's external balance will be much under control going forward.

Given the demand contraction (both domestic and external), India will be lucky to record even 6% GDP growth in 2008-09. It is not expected to be much better than 6.5% even by 2009-10. Thereafter, India will record much higher GDP growth. Clearly the fiscal vulnerability that is being talked about is more cyclical than structural and hence is a lesser cause for worry.

Seemingly, for the rating agency economists, these are issues not important enough to dwell on, and hence they have decided to sound alarm bells by simply going by the macro-indicators and their past experience, failing to take congniscance of the fact that the business environment changes and a much more holistic view needs to be taken.

In the case of India, 1991 was different. Since then, India has seen many structural changes and, as an economy, the country is in a much better shape. Because of prudent practices, India has managed to avoid the financial contagion that many developed economies, with their cutting-edge policies and regulations, have fallen into.

A major part of the blame for the implosion of the global financial market has to do to with the credit rating agencies themselves, for their miserable failure to predict a crisis that was possibly one of the most predictable ever to hit the global financial system. Agencies that pour their energies into studying company data day in and day out could not predict the collapse of the US housing bubble, despite every data indicating that big trouble was brewing. Not only that, they went ahead and boldly gave a high investment grade rating to various structured products that abounded with junk, leading to the problem being exacerbated.

A scorecard released recently by Credit Suisse detailing the vulnerability of various countries repays study. (Click here for table.)

Country Vulnerability Scorecard

Ranking	Country	2009 current account bal / GDP	2009 Govt debt / GDP	Pvt sector credit / GDP	Bank loans / deposits	Net ext assets / GDP	Net short term ext debt / GDP	Banking assets / GDP	2008 imports & exports / GDP	S&P Credit Rating	CDS spreads
1	Iceland	-6%	122%	435%	204%	-184%	248%	1002%	103%	BBB-	1,000
2	Bulgaria	-18%	18%	71%	130%	-72%	5%	na	144%	BBB	665
3	Lithuania	-15%	17%	62%	150%	-48%	6%	na	132%	BBB+	790
4	Estonia	-5%	4%	96%	190%	-67%	26%	na	147%	A	675
7	Latvia	-6%	10%	30%	254%	-68%	38%	na	108%	BBB-	950
8	Romania	-11%	13%	35%	122%	-39%	-1%	na	84%	BB+	745
12	Hungary	-4%	69%	63%	119%	-93%	-14%	38%	160%	BBB	530
13	Poland	-5%	44%	45%	115%	-45%	1%	52%	86%	A-	380
14	Ukraine	-4%	22%	63%	150%	-17%	-10%	na	92%	B	0

Source: Credit Suisse Global Equity Strategy

Credit Suisse ranked countries with regard to their vulnerability by taking into account various factors, the lowest ranking being more vulnerable. The table highlights the ratings given to the East European countries. As we all know, this region has the ability to have a severe impact on even the developed European economies. The S&P rating column shows that only one East European country, Latvia, had a BBB- rating similar to that of India. All others have higher rating than that of India, at times substantially higher.

Yet consider that fact that Hungary, Ukraine and Romania have already gone to the International Monetary Fund (IMF) for a bailout. In contrast, India is talking of making contributions to the IMF's coffers to finance these bailouts. India's ranking is 25, that is, it is a country considered to be much less vulnerable than others. More importantly, consider Iceland, now a poster boy of doom because of its reckless policies. Iceland was rated similarly to India. Clearly, S&P even failed to predict Iceland's tremendous fall from grace.

Given the current situation, Keynesianism - with government spending seeking to take up the slump in the private sector - is the way out of the present crisis for most countries. Given the contraction in domestic demand, India needs to do the same.

Similarly for the US. The forecast fiscal deficit for the US in the current year is higher than that of even India. It is quite likely that, if S&P or another such rating agencies were handed the relevant data for the US without the information to which country it referred, the sovereign rating that would result for the world's biggest economy could well be "junk".

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