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India in ratings rut

Kunal Kumar Kundu

The recently released report by Moody's Investors Service, "India: 2005 Credit Analysis", has retained India's foreign currency rating at Baa3, which is investment grade, but has put the domestic currency rating two notches below at Ba2. While the outlook on the foreign currency rating is stable, mainly supported by growing foreign exchange reserves, lack of meaningful fiscal consolidation has prompted the rating agency to signal a negative outlook on the domestic currency rating. Fitch Ratings, another international rating agency, has expressed similar sentiments. Last month, Fitch concluded that it would not be able to upgrade India's sovereign rating purely because of concerns over the fiscal situation.

The reaction of credit rating agencies such as Moody's and Fitch comes amidst the government's poor performance on the fiscal management front. Some find the sharp change in Finance Minister P Chidambaram's stance on fiscal responsibility within eight months disconcerting. He now seems to have relaxed his position on the pace of reduction of deficit. In the United Progressive Alliance government's first budget in July 2004, the finance minister projected that he would get the revenue deficit down to 1.8% (of the gross domestic product) for 2005-06. In this year's budget, he projected a revenue deficit of 2.7% - a full 90 basis points more than what he said just eight months ago.

Moody's Investor Services and Standard & Poor's were quick to point out that the finance minister might have missed the boat on fiscal consolidation. They said he let go of an opportunity for faster fiscal consolidation during a time of higher growth, a process which may become infinitely more difficult in a climate of slow growth.

In this regard, the trend of revenue deficits (defined as the difference between revenue income and revenue expenditure) in India presents a gloomy picture. Since the turn of the century, revenue deficit as a percentage of fiscal deficit (sum of revenue and capital deficits) has been increasing, and touched an all-time high of 79.71% in 2003-04. This means the government uses close to four-fifths of its borrowings just to meet its own housekeeping expenses, leaving very little for capital (or productive) expenses.

While a conscious effort was made during the previous budget to reduce this to around 55%, the revised estimate shows that the figure in all probability will cross 61%. Thus, while the government promised to keep the deficit down, its housekeeping expenses exceeded its target by close to 12% - from Rs761.71 (US$17.5 billion) to Rs851.65 billion. The projected revenue deficit for 2005-06 is Rs953.12 billion, which is 2.7% of the gross domestic product (GDP) estimate for the fiscal year. In absolute terms, this represented an increase of close to 12%. If the revenue deficit is to be contained to 1.8% of GDP for 2005-06, it should have been Rs634.51 billion, or Rs317.77 billion less, virtually a third lower than the target.

Chidambaram, like his predecessors, has not been able to make much headway on the expenditure management front. Revenue expenditure, as projected in this year's budget, is up by a whopping 15.66%, from Rs3,860.69 billion in 2004-05 to Rs4,465.12 billion for 2005-06. At the same time, capital expenditure is down 43%, from Rs1,197.22 billion in 2004-05 to Rs678.32 billion for 2005-06. Thus very little capital formation is occurring in the country, with most of the money going into meeting daily expenses.

With too many commitments to make and too little leeway to meet them, the finance minister had to resort to the unthinkable - he held in abeyance for the year his promise to stick to his favorite FRBM (Fiscal

Responsibility and Budget Management) Act, which aims at reducing the revenue deficit to zero by 2008-09. This shift was not exactly the kind of thing that inspires confidence among rating agencies.

As a result, a lot - perhaps too much - has been left to be done in 2006-07 to 2008-09 to achieve the fiscal responsibility target. The revenue deficit needs to be brought down from the expected 2.7% for 2005-06 to nil in three years, or a 0.9% reduction every year after next year. So the revenue deficit needs to come down from Rs950 billion to zero in three years, or a reduction of about Rs300 billion per year. It doesn't take a rocket scientist, or an economist, to surmise that this is practically impossible, especially considering the past record. Revenue deficit in absolute terms has fallen only three times in the past 20 years, and only about Rs10 billion each time.

Moody's said that it was struck by the finance minister's failure to honor the FRBM Act. "I think the problem is that no one believes they will meet their targets. So, I think it would have been a statement of their seriousness of intent had they been able to stick to it," Kristin Lindow, lead sovereign analyst for India and a vice president of Moody's, told the media.

Furthermore, there is every possibility that the final revenue deficit figure for 2005-06 could be more than the one budgeted for. As we saw last year, there seems to be a chronic tendency to overestimate the amount of tax that can actually be collected. The estimate of the excise duty shows how overboard the government can go where revenue collection targets are concerned. For the financial year 2004-05, despite the resurgence in the manufacturing sector, estimated excise collections were almost 8% lower than the budget target.

"Surpassing the targets set by the FRBM would have boosted investors' confidence significantly as it would have reflected the government's ability to pursue a more aggressive front-loaded fiscal consolidation process," said Shelly Shetty, Fitch's analyst on India. Shetty said instead of doing that, the government used the "excuse of greater transfer of resources to states" to put on hold the deficit-reducing provisions of the FRBM. "This does little to improve credibility."

Kunal Kumar Kundu *is a senior economist with a leading bilateral chamber of commerce in India. He has a Masters in Economics from the University of Calcutta.*