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MARKETS DISCOUNT RATING DOWNGRADE: CONSUMPTION TRAITS POST COVID REVEAL PREFERENCE FOR LOCAL BRANDS

Issue No. 18, FY20

Date: 2 JUN 2020

India has been downgraded by Moody's to Baa3 with a negative outlook on the pretext of prolonged period of slower growth, rising debt, weakening of debt affordability and stress in financial system. However, India has not been alone to witness rating downgrade. **So far around 21 emerging and developing countries have registered either a rating and/ or outlook downgrade by the agency**. **This does not come as a total surprise as emerging markets are always more susceptible to rating downgrades compared to developed economies in times of stress even if some of them have very low debt to GDP ratio, also clearly evident from history. Apart from sovereign rating downgrade, Moody's has taken rating actions on 11 Indian banks.**

Pertinently, among all the different criteria used by credit rating agencies perhaps growth considerations always take center stag and if historical trends are to be believed, even takes primacy over fiscal sustainability. There are instances where fiscal situation has deteriorated but the rating has been indeed upgraded. Also, it can be seen that countries which were downgraded earlier bounced back soon which resulted in their upgrade after that.

Though rising debt is mentioned as one of the reasons for rating downgrade by Moody's, we believe sustainability of debt is more crucial issue and currently our debt is at sustainable level. The rating action is no reflection on the ability of the Government of India to service its debt obligations. The sovereign external debt comprises around 20% of the total external debt. The current level of foreign exchange reserves are sufficient to meet any debt obligations. The downgrade by Moody's is unlikely to result in any immediate repercussions on exchange rates and bond spreads immediately on India offshore bonds. We are in unprecedented times and there have been a host of sovereign downgrades already. However, we need to be careful that we remain in investment grade and continue to give growth a big push through policy measures.

Furthermore, it seems that the downgrade was not completely unexpected. This is clearly visible in the data that market is not yet impacted by the rating downgrade. BSE Sensex and NSE Nifty rose and even Rupee appreciated against the US Dollar.

Australian politician Jay Weatherill once said, "***We may very well be faced with the choice of retaining the AAA credit rating or abandoning some of our key infrastructure projects, which are about jobs for the future. I will choose jobs in that equation every time***". **We believe the time is such that every country should think and work in that direction and focus on growth as the mantra for future policy action.**

RATING DOWNGRADE

- Moody's has downgraded India by one notch to Baa3 from Baa2, with a negative outlook. Prolonged period of slower growth, rising debt, weakening of debt affordability and stress in financial system have been cited as the reasons for the downgrade.
- Historical ratings reveal that India has only witnessed one and two net ratings upgrades by S&P and Moody's respectively, since 1992. In case of Fitch there was one net upgrade since 2000, while there has been no change in net ratings by DBRS Morningstar since 2007.
- **India has not been the only country which has witnessed rating downgrade. So far around 21 countries belonging to emerging and developing countries group have registered either a rating and/ or outlook downgrade by the agency**. When we look at the latest available macro economic indicators of these countries some of the them (Nicaragua, Hong Kong and Botswana) have positive current account balance. Botswana, Zambia and Ethiopia have good fundamentals (the first two low debt to GDP ratio and Ethiopia high growth) when compared to other countries, still Moody's changed their outlook to negative or downgraded recently.
- **This shows that emerging markets are more susceptible to rating downgrades in times of stress even if some of them have very low debt to GDP ratio**. Pertinently, among all the different criteria used by credit rating agencies perhaps growth considerations always take center stage, and if historical trends are to be believed, even takes primacy over fiscal sustainability.
- There are instances where fiscal situation has deteriorated but the rating has been indeed upgraded. For instance Malaysia in 1999 and Indonesia in 2003. Also, it can be seen that countries which were downgraded earlier bounced back soon which resulted in their upgrade after that.
- **We thus believe that the future policy action should focus on only growth so that we remain in investment grade.**

Sovereign Rating of India: Changes since 1992

Rating Agency	Rating in 1992	Current Rating	Net Rating Upgrade
Standard & Poor's	BB+	BBB-	1
Moody's	Ba2	Baa3	2
Fitch Ratings	BB+ (in 2000)	BBB-	1
DBRS	BBB (in 2007)	BBB	0

Source: SBI Research, Net Rating Upgrade~ Rating Upgrade-Downgrade

Rating/Outlook Downgrade by Moody's this year

Country	Current Rating	GDP Growth	Gov Debt to GDP	CAD to GDP	Date
Argentina	Ca	-2.2	71.9	-0.8	04-04-2020
Belize	Ca11	1.6	82.1	-7.8	12-05-2020
Bolivia	B1	2.2	57.7	-3.5	10-03-2020
Botswana	A2	0.2	14.1	2.1	30-05-2020
Costarica	B2	2.1	-	-2.5	10-02-2020
Ecuador	Caa3	0.1	53.4	-0.1	03-04-2020
Ethiopia	B2	9.0	-	-5.3	05-07-2020
Hongkong	Aa3	-1.2	42.4	6.1	20-01-2020
India	Baa3	4.2	50.3	-2.1	01-06-2020
Kenya	B2	5.4	62.1	-5.8	08-05-2020
Lebanon	Ca	-1.9	154.9	-24.3	21-02-2020
Maldives	B3	0.4	73.1	-26.1	21-05-2020
Mauritius	Baa1	3.8	58.7	-5.7	02-04-2020
Mexico	Baa1	-0.3	47.5	-0.3	18-04-2020
Namibia	Ba2	-0.8	49.2	-4.5	23-05-2020
Nicaragua	B3	-4.2	33.6	5.7	14-02-2020
Oman	Ba2	1.8	47.5	-5.5	30-03-2020
Romania	Baa3	4.1	35.4	-4.6	25-04-2020
South Africa	Ba1	0.2	62.2	-3.0	27-03-2020
Suriname	B3	1.9	43.5	-3.3	14-04-2020
Zambia	Ca	3.7	20.8	-1.3	06-04-2020

Source: IMF, Bloomberg, CEIC

DEBT DYNAMICS

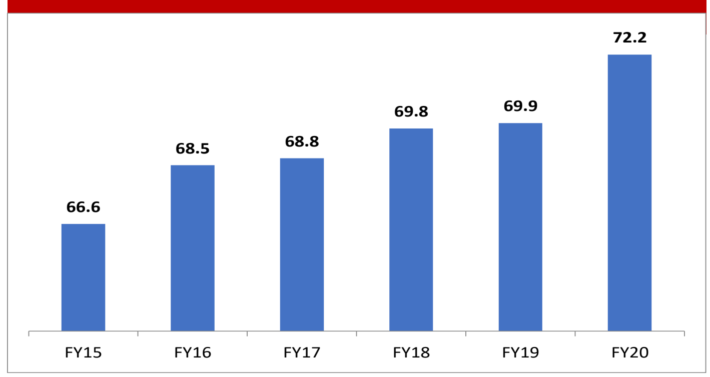
- Moody's has stated that India's total debt-to-GDP ratio was 30 percentage points higher than the 'Baa median' and is expected to reach 84% of GDP this year from 72.2% in FY20. Even if it should stabilise at that point, it is unlikely to fall materially thereafter.
- However, the rating action is no reflection on the ability of the Government of India to service its debt obligations. The sovereign external debt comprises around 20% of the total external debt. The current level of foreign exchange reserves are sufficient to meet any debt obligations. Further the RBI has formalized the $75 billion dollar SWAP with Bank of Japan to tide over any extreme unforeseen event 2019. On the internal debt, since most of the debt is domestically owned, the debt servicing of the same is not an issue. India has one of the lower debt to GDP ratio at in comparison many high rated sovereigns, which shows rating has no connection to the world of logic and common sense. For example, **as Economist magazine concludes** " *A challenge will be to get sovereign ratings right as public finances come under heavy strain. What, for instance, to make of America's Treasury borrowing a record $3trn this quarter" And what would justify cutting Italy's rating to junk?"*
- The Economist magazine continues to say "*More fertile area for reform concerns over-reliance on ratings. They are hardwired into all manner of regulations and investment mandates, often in a mechanistic way that discourages investors from doing their own homework. They help determine everything from banks' capital requirements to what mutual funds are allowed to buy. A study in 2018 found that references to ratings in American bond funds' investment mandates had actually increased since 2010.*"
- We believe that sustainability of debt is crucial issue given the fact that nominal GDP growth this fiscal is expected to be zero or sub-zero. Research suggests that the critical factor determining a country's maximum sustainable debt level is the difference between its future nominal interest and growth rates. This interest-growth differential determines the rate at which a country's Government debt rises relative to its output, sometimes termed the "natural" debt dynamics. A higher interest-growth differential means that a country must raise larger surpluses in order to stabilize its debt-GDP ratio.
- In India the quarterly average interest-growth differential (for the period of FY13 to FY20) was -4.4% with differential rising continuously since Q1 FY19. In Advanced Economies also, average risk-free interest -growth differentials since 1960 is usually less than zero. The average annual interest-growth differential in six advanced economies has been -1.7% since 1880 and -0.8% since 1960.
- In the current situation in India both the key interest rate and GDP are expected to fall further. Our nominal GDP growth is likely to contract and based on this our interest-growth differential may turn positive also. Further, if interest rates are higher than expected, then the cost of rolling over a given debt increases. There have been studies which show that if the difference between interest rate and nominal growth rate is negative then there is no level of debt which is unsustainable, i.e. the Government can borrow easily.
- The Government should only think of such interest-growth differential and not slippage in fiscal deficit. **Even a downgrade with decent GDP growth is far better situation compared to the downgrade with negative growth and manageable fiscal deficit.**

S&P Foreign Currency LT Rating Change

Country	Year	Cash Surplus/ Deficit (% of GDP)	GDP growth	Rating change
Indonesia	2003	-1.7	4.8	Upgrade (CCC+ to B- in May' 2003 and B in Oct' 2003)
	2007	-1.0	6.4	No change
	2009	-1.7	4.7	No Change, followed by upgrade in 2010 (BB- to BB+ in 2010)
US	2009	-10.3	-2.8	No Change
	2010	-10.1	2.5	No Change
Germany	1995	-7.9	1.5	No Change
Malaysia	1998	-0.8	-7.4	Downgrade (BBB to BBB- in Sep' 1998)
	1999	-3.8	6.1	Upgrade (BBB- to BBB in Nov' 1999)
	2002	-4.9	5.4	Upgrade (BBB to BBB+ in Oct' 2002)
Thailand	2003	1.5	7.2	Upgrade (BBB- to BBB in Oct' 2003)
	2009	-3.0	-0.7	No Change
	2012	-2.2	7.3	No Change

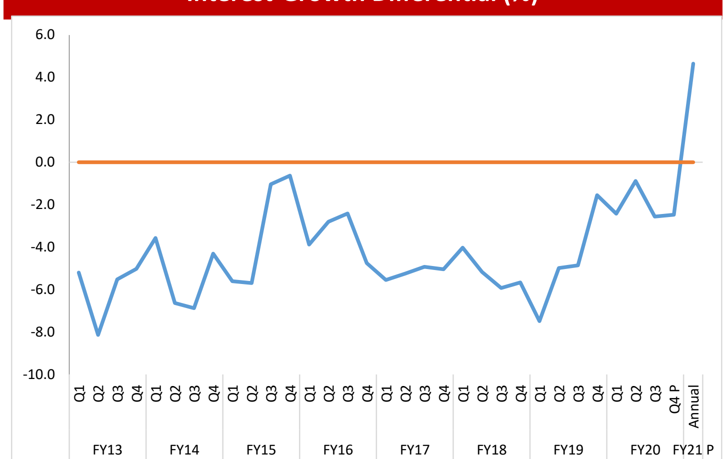
Source: SBI Research, World Bank, WEO, Bloomberg

Combined Domestic Liabilities of Centre & States (% of GDP)



Source: SBI Research

Interest-Growth Differential (%)



Source: SBI Research

DOWNGRADE WAS ALREADY ANTICIPATED BY THE MARKET

- As 20 countries were already downgraded or outlook turned negative before India, it was widely anticipated that India's rating would also be downgraded. This is clearly visible in the data that market is not yet impacted by the rating downgrade. BSE Sensex and NSE Nifty rose and even Rupee appreciated against the US Dollar.

INCREASED PREFERENCE FOR LOCAL BRANDS?

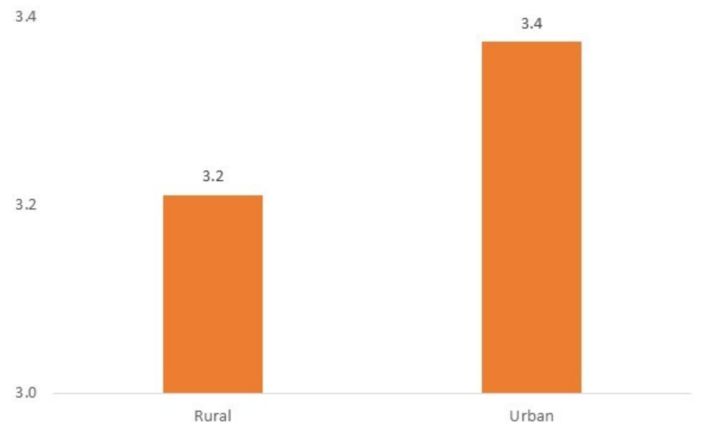
- The decline in private final consumption expenditure (PFCE) in FY20 was clearly visible in both current and constant prices. For FY20 as a whole the PFCE dropped by 300 bps in the current prices.
- To find out the consumption loss during the lockdown period of 2-months, we have estimated that urban consumption has declined much faster than rural areas. This may be due to the more containment zones in the urban areas.
- In the last 2-months, The investment demand as captured in the Gross Fixed Capital Formation (GFCF) has also contracted sharply in real terms. The investment demand for FY20 has dropped by whopping -12.6% which does not augur well for the growth revival in the near term. Since COVID related lockdown was only in the end of FY20, the decline suggests full year trend which will become more pronounced in Q1 FY21.
- **In fact our research shows that health, safety and quality assurance will significantly determine consumption into the future. Another major change which is being observed is the increased preference for local brands and cutting back discretionary consumption**. All these will have material impact on consumption in FY21.

Market Reaction Post Rating Downgrade

Variable	Yesterday's Closing price	Today's Price at 2 PM	Change
BSE Sensex	33304	33849	545 points
NSE NIFTY	9826	9980	154 points
10 Yr G Sec	5.78	5.76	-2 bps
Rs/$	75.55	75.36	-19 bps
NDF	78.53	78.31	-22 bps

Source: Bloomberg; SBI Research

Consumption Loss *(% to GDP) under PFCE during Apr-May



Source: SBI Research ,*Approximates based on loss in non-essential consumption in Apr-May

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