

# ISAS Insights

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## Clouded Sunshine Over India's Economy

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India's local-currency bond yields are at 8.21 per cent, an all-time high. Yields rise if there is increase in supply of Government paper, indicating that Government is borrowing more—a sign of fiscal stress. Inflation risks and monetary stance affect yields, with lower inflation indicating higher bond prices and lower yields. In Asia, yields on Indonesian paper used to be very high, but are now around 6 per cent, based on better macro-economic management, a greater openness to the foreign exchange markets and lower inflation. Moody's now rates Indonesia as investment grade, S&P one notch below. By contrast, ratings for Indian debt have been falling over the last year.

India's bad run with the rating agencies started in 2009, soon after the new Government (United Progressive Alliance, UPA-2) was sworn in. S&P downgraded India to BBB minus with a negative outlook. The argument was that the Indian Government had initiated several policies prior to the elections that put the fiscal position under stress. Moody's was more positive, giving India a Baa3 rating, on the argument that India's diversified economic structure and its strengths had to be factored in. Moody's was confident the India's formal institutions and institutional mechanisms would be capable of enacting corrective policies and regulations to overcome the fiscal stress.

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In 2010, S&P improved India's outlook to stable from negative, while still keeping the rating at BBB minus. It pointed out that the fiscal position had improved and that some efforts at fiscal consolidation had been made. It continued to express concern over high government borrowings and inflationary pressures. Moody's continued with Baa3 and a stable outlook, taking note of the healthy external indicators, India's sharp recovery from the Global Financial Crisis and fiscal reforms that had happened in the interregnum.

S&P's worries about India continued in 2011. While keeping the rating and outlook unchanged, serious concerns were expressed about inflation and the growing fiscal deficit and the inaction on the part of Government to address the growing burden of public debt. Moody's continued to be optimistic about the capabilities of the Indian economy to overcome fiscal difficulties, but pointed to persistent inflationary pressures and domestic policy paralysis. Moody's predicted that India's growth would exhibit a persistent downward trend over the next two periods, but was still hopeful that India would pull through on the strengths of its vibrant private sector.

By 2012, the comments were becoming far more strident. S&P downgraded India to a negative outlook at BBB minus. They warned that ratings may be downgraded again if external position continued to worsen and if fiscal reforms continued to be sluggish. S&P commented adversely on the retrospective taxation proposals, noting that this would affect investments. Moody's, without changing their ratings, pointed out that there were several negative trends in the economy including slowing investment and poor business confidence.

### **Lack of Fiscal Prudence**

Over the three years, the rating agencies have been quite unhappy with the developments in the Indian economy, in particular the lack of fiscal prudence, the inflationary pressures and the lack of business confidence. It is clear that, with little or nothing being done on governance, market expectations are that there would be further downgrades. This could even take Indian paper to junk-bond status, severely impacting on the ability to raise capital overseas. Without external capital, India's growth story would be seriously hampered.

It is interesting to note that during August 2012, several public sector banks and even ICICI have raised funds overseas. These have been three- to five-year debt papers, raised in Singapore and elsewhere, and have been of the order of a billion dollars each. The investment markets have subscribed to these papers without demur, and the coupon rates have ranged between 4.00 per cent and 4.5 per cent, which is not at all unfavourable, given the above credit rating story. Simultaneously, the financial (equity) markets have been buoyant, with institutional inflow of

close to 2.75 billion dollars (US) in August 2012 alone. These numbers help analyse the current developments in the Indian economy.

First, it is clear that Government has been able to make little progress in improving its image. It has not been possible to transact any business in the ongoing Parliament session as the principal opposition party – the Bharatiya Janata Party (BJP) – has been stalling the proceedings, demanding the resignation of Prime Minister Manmohan Singh, alleging that he is responsible for the loss in allocation of coal mining blocks to private sector companies. The complaint is that, instead of auctioning these blocks and thus maximising revenues to the Government, they were parcelled out to applicants in a non-transparent manner at very low prices. There is claimed to be evidence that one such allocation was made to the close relative of a sitting minister.

In the face of these complaints, there has been little progress in any governance-related activity. The promises of reduction of subsidies, increases in diesel and gas prices, and efforts to control the fiscal deficit, have taken a backseat to political expediency. The latest GDP figures indicate growth of around 5.5 per cent, an eight-year low. Government borrowings have exceeded budgetary targets for the period, and tax collections are likely to be affected by the slowdown. The report on the power blackout that occurred in late July 2012, plunging large parts of the country into darkness, indicates that it was due to reckless overdrawing from the grid by some of the states. The power utilities in these states are incurring huge losses and are unable to buy power from the market. As they are short of funds, rather than buying power from the market, they resorted to overdrawing from the grid, an approach that gives them some leeway in payment and settlement of dues. The fiscal condition of states is also poor.

### **RBI is a Single Sane Voice**

From all points of view, India is staring at a serious fiscal situation. The Reserve Bank of India (RBI), a single sane voice in this chaos, has been repeatedly pointing to the need to rein in public debt – arguing also that monetary and fiscal policies need to go hand in hand. At a recent appearance before a Parliamentary Standing Committee, the RBI Governor, D Subbarao, openly differed with the Government on monetary easing, arguing that action now lay in the hands of the Government through fiscal correction.

The supply of Government paper is considerable at this point in time, and coupled with poor outlook by the rating agencies, it is not surprising that yields have gone up significantly.

On the other hand, market behaviour appears to be driven by some opposing arguments. Developed-market funds need to be invested in the emerging markets for annual gains before

Christmas; and even among the emerging markets, India is one of the few countries with a transparent financial architecture that is performing at around six per cent. Company balance sheets continue to show healthy profits, and though margins have been squeezed by increased input costs, volumes are continuing to rise — a clear indicator that consumption spending has not decreased. Interestingly, there is evidence from bank balance sheets that savings are on the decline — perhaps due to inflation as well, but consumption has not dropped. Especially, demand for real estate and gold remains very high, as savers consider these to be a better hedge against inflation. Thus, while investment and capital formation appears to be low, consumption spend continues. As India goes into the busy festival season of Diwali and Christmas, this would keep cash registers rolling.

### **A New Look at Some Budget Moves**

Investors are also likely to see announcements by the Finance Minister, P Chidambaram, and the Securities regulator as positive. On 1 September 2012, a committee that was set up to examine some of the draconian legislation introduced in the budget has suggested postponement of the measures by three years. Mauritius has been a source of investment funds into India for many years, and there has always been a suspicion that some of the funds are laundered funds of Indian entities. The proposed GAAR (General Anti-Avoidance Rules) would have changed all that. Now that the committee has proposed postponement of these provisions by three years, it would be business as usual. Markets are likely to react extremely favourably to these announcements.

The acceptance of overseas debt paper put out by banks and other corporate entities at reasonable rates is an acceptance of the fact that the business environment and the public policy environment are currently out of synchronisation; and while little can be expected from Government policy, it does not mean that business will come to a stop. If this argument is to be extended further, then one would be looking at a sharp rally in financial markets in the next couple of months. However, rather than a sector-specific or a broad-based rally, it is likely that investors would carefully pick stocks that perform well, would steer away from balance sheets that have governance concerns and focus on those that are performers and have a good, ethical management record.

The proof of this hypothesis is likely to be visible within the next few weeks – with bullish tendencies seen in the markets, select stocks rising fast, and with the visual media generally talking up the Indian economy. The real worry is that this euphoria is likely to be short-lived. There is no evidence that capital investment has restarted. On the contrary, banks continue to sit on huge debts of incomplete infrastructure projects. Large corporate are sitting on huge cash

balances that they are reluctant to invest in India. There is little clarity in Government policy, especially on fiscal reforms.

Unless these fundamental issues are tackled, the sunshine period may well be short. And actually, that is what the credit rating agencies are getting worried about.

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