India and the Credit Rating Agencies

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The recent downgrade of India as a sovereign borrower by the US-based Fitch has come close on the heels of similar downgrades and placing on "negative watch" by the other big two international credit rating agencies. In April, Standard and Poor's had lowered India's rating outlook from "stable" to "negative", and June it warned that India become the first "fallen angel" among the BRICS nations to get a sovereign credit rating below investment grade.

These moves have created hysteria in much of the media and near panic in official circles. The domestic financial press, being more susceptible to external perceptions than internal forces, is treating this as spelling doom for the Great Indian Growth Story. Some official spokespersons have tied themselves into knots by apparently agreeing with the substance of the analysis of these agencies, while disagreeing with the conclusions.

Others, including the Finance Minister himself, have tried to put a brave face on the matter, saying that these agencies have based their actions on "older data" which are no longer the correct indicators. Even so, Pranab Mukherjee declared that the government has "taken note" of the concerns raised by Fitch and others, and would take further "appropriate measures", in addition to those has said have already been taken (which include dubious policies like the fertiliser subsidy reform and capping subsidies as a per cent of GDP).

In fact, the likely domestic policy reactions to these downgrades are of much greater concern than actual analysis and prediction of these agencies, which are problematic at best. The international credit rating agencies have not exactly covered themselves with glory in the past few years, and in many countries there have been calls to regulate them and look for some ways to ensure greater accountability for the enormous power that they have to influence markets.

Throughout the global boom, and particularly in the US and some European countries, these rating agencies were consistently behind the curve, failing to point out what were really obvious problems and weaknesses in many of the institutions (public and private) to whom they gave Triple A investment status. The conflicts of interest involved in such behaviour are clear, but there has been no serious attempt at controlling them.

Nor is there any accountability or responsibility for their actions. When it became clear in the United States, for example, that much of their analysis and rating was plain wrong and downright misleading, and had led retail investors and pensions funds into putting their investments into completely risky and sometimes even fraudulent financial assets, these agencies blandly declared that they could not be held responsible since they were only offering "opinions". The fact that these "opinions" have huge influence on markets, also because in many countries certain types of investors like pension funds are forbidden from taking on any assets below investment grade, is apparently not their problem: they are just in the business of offering advice based on their own opinions.

There is more than irresponsibility at stake here. It has also become clear that these agencies behave in ways that not only affect their own business interests but are sometimes blatantly political, pushing for policies that would benefit finance and sometimes even in a politically partisan manner. It is no secret that the downgrade of US sovereign debt (which incidentally had the opposite effect of making it even more attractive in the financial markets!) just before the US Congress had a vote on allowing the fiscal deficit level to rise was designed to play into the hands of Republican opponents of the government.

In emerging markets, these credit rating agencies have played even more dangerous games, pushing for more financial liberalisation that is directly in their own interests, threatening downgrades if certain policies are not undertaken – all in the name of objective analysis to provide their "opinions". Yet a systematic study of these opinions would probably reveal how wrong they have been in so many instances, or how late they tend to be to come up with changes in their ratings, very much following the curve of market cycles rather than providing any useful projections for the future.

This is also the case for their analysis of the Indian economy, which appears to be either a bit slow to realise some basic facts, or heavily influenced by the desire to push for policies in the interest of global finance rather than the Indian economy. For example, Standard and Poor's based its recent assessment on the fact that the division of roles between a "politically powerful" Sonia Gandhi and "an appointed" Prime Minister had weakened the framework for making economic policy. But this supposedly destructive division has been in place since 2004, throughout the period of boom which the same agency has celebrated with its many earlier positive assessments.

Similarly, Fitch has cited "corruption" as a concern and a reason for the downgrade. But surely this is not something that has suddenly happened this year in India? Was there no such corruption two years ago, when Fitch was so bullish about India's prospects, especially compared to the rest of the world economy? If anything, more of the earlier scams in India are now being exposed, which makes current ones at least slightly less likely.

Fitch has also cited lack of "reforms" and gone on to argue that "India's medium to long-term growth potential will gradually deteriorate if further structural reforms are not hastened." This is an open push for reforms to benefit large corporate capital in finance and elsewhere, which is not at all the same thing as policy changes that will put the Indian economy on a sustainable and employment-generating growth path.

Indeed, that may be the crux of the problem. It is certainly true that the recent Indian success has been based in large part on the favourable perceptions of global capital, which generated capital inflows. But these inflows have not really been of the kind that generates more productive capacity and work along with access to new technologies and markets. Rather, financial inflows have dominated, and have contributed to a boom driven by consumer credit (including for real estate) and debt-driven high spending by corporations, generating growing current deficits in the process.

This is not a sustainable trajectory, nor has it provided better employment and living conditions for the bulk of the population. To ensure more stable and inclusive growth, the Indian economy needs to get on to a different path based on generating more productive employment that provides basic needs to all the population. This is not likely or even possible given the incentives created by the past pattern of capital inflows. If anything, such incentives actually militate against such a desirable change in strategy.

Thus, one of the adverse fallouts of this process has been the obsession with the GDP growth rate, regardless of the content of that growth. GDP can grow even when the "real economy: stagnates, if there is a boom in asset markets that generates real estate and construction activity and inflates financial sector GDP. But unfortunately, this obsession with growth has not just been within finance, but has also permeated industrialists, who should rather be concerned with their absolute profits and the size of their markets. And it has contaminated policy makers as well, as they focus single-mindedly on the quarterly GDP growth figures without looking at the composition of that growth and whether it is translating into higher employment and better material conditions for the bulk of the population.

In this context, it is evident that if the credit rating agencies had actually continued to be bullish on India, we would be getting further into the creation of an unsustainable bubble, the inevitable bursting of which would be even more painful. What is the point of getting lots of speculative inflows of hot money that do not translate into productive investment that creates employment? Why encourage the continuation of macroeconomic imbalances that are fundamentally undesirable?

So why should we bother about the "opinions" of these external credit rating agencies? Maybe we would all have been better off without the destabilising influence they have played and continue to play in India and in the rest of the world.

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