Comparative analysis of India's sovereign rating assigned by various International rating agencies

Saswati Mohanty
Swapnalok Towers, Film city road, Malad (East), Mumbai-400097, MS, India

Abstract

1. ABSTRACT

Sovereign credit rating is an assessment of the credit worthiness of a country and impacts its ability to raise financing from the global capital markets. With a good rating, the cost of credit or the interest offered by any country becomes lower, and vice versa, for a low rating. Sovereign ratings are assigned by an independent rating agency, with the most prominent and credible ones being – Moody's, Fitch and Standard & Poor's (S&P). India witnessed a slew of rating actions from these rating agencies in June 2020, as discussed below:

- Moody's downgraded India's sovereign rating to Baa3, whilst retaining its 'Negative' outlook;
- S&P reaffirmed the rating and outlook at BBB-/Stable;
- Fitch revised the outlook to Negative while retaining the rating at BBB-;

This means that all the three rating agencies have kept India's sovereign rating at the bottom of the investment grade, with two rating agencies keeping the outlook as 'negative' – meaning that there is a chance of rating being downgraded further to the non-investment grade,which may impact India's ability to raise capital from the international market.

In the aforesaid context, this study analyses the rationale behind individual rating agency's approach towards India sovereign rating based on their own frameworks and finds that GDP growth rate, per capita GDP, consolidated deficit (aggregation of fiscal and current account deficits), and debt to GDP ratio are the critical parameters, on which India should focus on to maintain or upgrade the sovereign ratingin the future.

KEYWORDS: Sovereign credit rating, debt to GDP ratio, GDP growth rate, per capita GDP,fiscal deficit, current account deficit

2. BACKGROUND

Relevance of sovereign credit rating

Sovereign credit rating is an assessment of the credit worthiness of a country and impacts its ability to raise financing from the global capital markets. Sovereign credit rating is assessed by independent rating agencies and provide an independent and impartial opinion of the credit worthiness of sovereign's indebtedness. Sovereign rating affects the country's ability to tap international capital market to raise funding. It has got immense importance for developing and less developed countries, as they are in the path of development and continuously need funds for various investment activities from the global capital markets to supplement their domestic resources.

The developing countries need capital to grow on a continuous basis and tap the global capital markets to supplement their domestic resources – accordingly, a strong credit rating helps these countries to raise capital at competitive rates and diversify their funding base. With a good rating, the cost of credit or the interest offered by any country becomes lower, and vice versa, for a low rating.

Global investors rely on sovereign credit ratings to calibrate their risk appetite for any country, thus impacting its financing flexibility. Sovereign ratings impact the quantum of funding available and the cost (i.e., interest rate) associated with such funding. With a better rating, the cost of credit goes down and the quantum of funding available goes up. If the funds raised are deployed for developmental projects giving better returns than the cost of funding, then the GDP growth improves, which may result in the sovereign's ability to better service the debt raised – and this also results in an improved sovereign rating, resulting in virtuous cycle. However, in a similar manner, vicious credit cycle, comprising of lower GDP growth and weaker debt servicing may impair sovereign rating. Whilst better rated countries attract debt investment at a very low interest rate, e.g., US, Canada, Germany, France, etc. Weakerrated countries raise funding at a higher cost, viz., South Africa.

Global rating agencies

There are many credit rating agencies in the world, though Standard & Poor (S&P), Moody's and Fitch are the biggest and most credible ones and handle approximately ~95% of rating business in the world. All of these three agencies use different methodologies for assigning ratings to different sovereign entity.

Grade	S&P	Moody's	Fitch
Investment grade	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
Speculative grade	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
	B+	B1	B+
	B	B2	B
	B-	B3	B-
	CCC+	Caa1	CCC+
	CCC	Caa2	CCC

Rating categories

Every credit rating agency has got their own notations for the rating, as seen in the adjoining table. Their ratings are divided into two grades: 'Investment' grade and 'Speculative or non-Investment' grade. In case of Investment grade, there is less possibility of the issuer to default in contrast to Speculative grade, so generally the rate of interest offered by the issuer is less and vice-versa. A higher level of rating would imply lower risk, allowing the country to borrow at low rates as opposed to one with lower rating.

Sovereign ratings have three outlooks connected with the rating given by the rating agencies. They are: Positive, Negative and Stable. Positive outlook means that the rating has a possibility of up gradation in the near future, whereas Negative outlook means the rating has a possibility of down gradation, and Stable means that rating will remain its position for some period of time. In the same manner, ratings are also done for short-term and long-term loans. Rating given for credit of period less than one year are called short-term credit rating and for more than one year is called long-term rating.

The Negative outlook in the sovereign rating, more particularly, in the bottom-most of Investment grade rating (i.e., BBB- by S&P/Fitch and Baa3 by Moody's) may be an important economic concern, which means if proper, immediate and consolidated plan is not executed to revive the economy, then the rating could soon be downgraded to a Speculative and non-Investment grade and will have several implications on the economy. For example, with respect to India, the economic impact of the Covid19 pandemic lockdown is indeed severe in the near term, two of the three rating agencies (e.g., Moody's and Fitch) have put India sovereign on 'Negative' outlook, meaning that there is a ~33% probability that the sovereign ratings may be downgraded to Ba1/BB+ in the next two years.

Any rating downgrade to non-investment grade (i.e., Ba1/BB+) may force the global investing community to re-calibrate their asset/fund allocation materially and this may impact on the capital/currency markets, especially, the bond markets.

3. REVIEW OF LITERATURE

A study by Emilian Constantin Miricescu(2015), on 25 developed and emerging European countries for the period 2001-2013 found that, the sovereign rating has a strong negative influence on bonds interest rate. The relationship becomes strong in times of economic crisis and weak during economic growth.Another study is done by Chaudhry Abdulla Imran Sahi, Abid Rasheed (2017), shows that bond yields of Pakistan has negative correlation with sovereign credit rating, inflation rate and current account balances. Country risk has got significant positive impact on bond yield. Luitel andVanpee(2018), on the financial market of the low-income countries find out that the sovereign rating strongly affects the FDI and portfolio investment. When rating is better government gets more fund investment from outside, so they require less funds from the banks. So, banks give more and more loans to private investors. Sovereign credit rating has got a positive impact on the financial market of the country. The study of Mellios(2006), on the determinants of sovereign credit ratings finds that, ratings areprimarily influenced by percapita income, government income, real exchange rate changes, inflation rate and default history. Another study is done by Otaviano Canuto, Sanket Mohapatra, and Dilip Ratha(2011), on the shadow sovereign ratings for 52 unrated countries which are not taken by the three main rating agencies. With the help of the linear regression model the study finds that, out of 52 unrated countries, 07 can be in the investment grade, 10 are likely to be in the BB grade, 20 in the B grade and 10 are likely to be in the CCC grade.

Based on the above literature, in this study, we discuss about the ratings given and the different criteria taken into consideration for the period 2004-2020, by the three rating agencies to change India's rating and the ways forward to upgrade the rating.

4. SOVEREIGN RATING ASSESSMENT CRITERIA OF RATING AGENCIES: FRAMEWORK REVIEW OF S&P, FITCH, AND MOODY'S

- **S&P:** S&P's sovereign rating parameters include broadly five pillars with multitude of parameters associated with each of the pillars, e.g., 1) institutional assessment (e.g., effectiveness, stability, and predictability of policymaking, sovereign debt payment culture, external security risks, etc.), 2) economic assessment (e.g., GDP per capita, projected GDP growth, economic diversity, etc.), 3) external assessment (e.g., balance of payment situation, external indebtedness, etc.), 4) fiscal assessment (e.g., fiscal flexibility, long-term fiscal trends, Debt/GDP, debt structure and funding access, and potential risks associated with contingent liabilities, etc.), and 5) monetary assessment (e.g., exchange rate regime, and monetary policy credibility, etc.).
- **Moody's:** Moody's sovereign rating assessment is based on the consideration of 4 rating factors: 1) economic strength (e.g., size of the economy, per capita GDP, etc.), 2) institutions and governance strength (e.g., quality of institutions, policy effectiveness, etc.), 3) fiscal strength (e.g., Government debt/GDP, debt/revenue, debt trend, interest payments/revenue, etc.), and 4) susceptibility to event risk (e.g., political/geo-political risk, balance of payments situation, financial sector risk, etc.). Some of these factors comprise sub-factors and metrics as well.
- **Fitch:** Fitch's approach to sovereign rating analysis is an assessment of the following 4 analytical pillars, which form the creditworthiness of the sovereign: 1) structural features (e.g., GDP per capita, political stability, financial sector risks, sovereign debt servicing history, etc.), 2) macro-economic performance, policies and prospects (e.g., GDP growth levels, inflation, etc.), 3) public finances (e.g., Debt/GDP, interest/revenues, fiscal balance, foreign currency debt, etc.), 4) external finance (e.g., FX reserves, current account deficit, etc.).

5. INDIA SOVEREIGN RATING ACTIONS (2020): S&P, FITCH, AND MOODY'S

India witnessed a slew of rating actions from international credit rating agencies in June 2020. Moody's downgraded India's sovereign rating (though aligning with S&P and Fitch)to Baa3, whilst retaining its Negative outlook. This was followed by S&P reaffirming the rating and outlook at BBB-/Stable, whilst Fitch revised the outlook to Negative while retaining the rating at BBB-. The historical movement of sovereign ratings is exhibited in the table below.

	Jan, 2004	Jan, 2007	Feb, 2009	Mar, 2010	Apr, 2012	Jun, 2012	Jun, 2013	Sep, 2014	Apr, 2015	Nov, 2017	Nov, 2019	June, 2020
S&P		BBB-stable	BBB-negative	BBB-stable	BBB-negative			BBB-stable				BBB-stable
Fitch						BBB-negative	BBB-stable					BBB-negative
Moody's	Baa3 Stable								Baa3 positive	Baa2 stable	Baa2 negative	Baa3 negative

A brief analysis of the rating actions undertaken by these global rating agencies is provided in the section below.

6. ANALYSIS OF INDIA SOVEREIGN RATING ACTIONS

For our analysis, basis the rating agency commentary, we have taken a view that the qualitative parameters used by the rating agencies have remained broadly in an acceptable range, so as not to impact the sovereign rating materially. Accordingly, we have focused on the key economic parameters of the India sovereign for our analysis, as depicted in the table below.

Year	GDP/capita (INR)	Real GDP growth rate (%)	Debt/GDP (%)	Fiscal balance/GDP (%)	Current Account balance/GDP (%)
2004-05	50,325	7.90	38.8	-2.3	-0.22
2005-06	53,478	7.92	39.9	-2.5	-0.74
2006-07	56,964	8.06	41.3	-2.2	-0.69
2007-08	60,466	7.66	42.7	-1.8	-0.92
2008-09	61,468	3.09	46.5	-4.8	-1.80
2009-10	65,394	7.86	47.6	-5.5	-2.35
2010-11	69,994	8.50	48.9	-4.5	-2.65
2011-12	71,609	5.24	53.5	-5.9	-4.30
2012-13	74,599	5.46	56.7	-5.3	-5.21
2013-14	78,348	6.39	59.8	-5.1	-1.91
2014-15	83,091	7.41	60.9	-4.9	-1.55
2015-16	88,616	8.00	62.4	-4.7	-1.26
2016-17	94,751	8.26	62.0	-4.4	-0.79
2017-18	100,268	7.04	64.5	-4.5	-2.38
2018-19	105,361	6.12	67.2	-4.5	-2.86
2019-20	108,620	4.18	70.4	-4.8	-1.18
2020-21 (P)^	103,927	-8.00	90.6	-12.5	0.3

* Source: RBI's database

^ Projected by various rating agencies

MOODY'S

Moody's was the first rating agency to upgrade India sovereign rating to an investment grade (Baa3) in 2004, taking note of the expected strong GDP growth rates during the years 2004-2008, with acceptable fiscal and current account balance. During the 2012-14 era, when the GDP growth rate declined and the combined deficit (fiscal and current account combined) were much higher than the thresholds (or historical data), Moody's did not make any amendments to its rating, may be viewing that it's a cyclical/transitory impact and no structural changes have happened.With a pro-reforms NDA government coming to power, Moody'schanged the outlook to Positive in April 2015, may be factoring in higher growth rates, driven by reforms. This was followed up by a rating upgrade to Baa2/Stable in November 2017, on the backdrop of improving GDP growth rates, acceptable fiscal/current account balance, and promulgation of GST and other structural reform measures. However, with the growth levels coming down and worsening of fiscal position, the rating was put under Negative outlook in November 2019, followed by a downgrade (to Baa3/negative) in June 2020, as depicted/rationalized in the table below.

Rationale for change in outlook from Baa2/Stable to Baa2/Negative (Nov'19)	Rationale for downgrading the rating from Baa2 to Baa3 (Jun'20)	What can lead to a further downgrade (from Baa3 to Ba1)
• Slowdown in economic growth (GDP growth of ~5% during Sep'19 quarter) from Moody's earlier expected levels of 6.6%+/11%+ on a real/nominal basis • Its belief that the slowdown is 'structural' and will be prolonged in nature due to 'lower effectiveness' in kick-starting the economy via various stimulus/ policy measures • Funding/liquidity issues of the NBFC sector, which has percolated down to retail businesses, auto players, housing sector and heavy industries • Prospects of further reforms to support business investment and growth, and significantly broaden the narrow tax base, have diminished	• Weak implementation of economic reforms since 2017 • Relatively low (@6%) economic growth over a sustained period from the previous ~8% assumption – this is on account of subdued private sector capex cycle, stress in the financial sector and reforms not yielding results • Significant deterioration in the fiscal position of governments (central and state) with higher Debt/GDP levels of	• Dominant, mutually-reinforcing, downside risks from deeper stresses in the economy and financial system that could lead to a more severe and prolonged erosion in fiscal strength than Moody's currently projects

• Expected increase in debt burden and widening of fiscal deficit (expected to rise to 3.7% during FY2020 by Moody's), following GoI's stimulus measures	~84% (30% more than Baa median) • Rising stress in India's financial sector	

S&P

S&P was the last global rating agency to upgrade India to Investment grade (BBB-/Stable) in January 2007 taking note of the strong GDP growth rates during 2004-2007 and expectations of higher growth rates under benign global conditions. However, post the Global Financial Crisis (2008) and with the increasing macro-economic and financial risks, S&P changes the outlook from BBB-/Stable to BBB-/Negative. However, with an improvement in the GDP growth rates during FY2009-10 and the expectation that fiscal deficit will improve going ahead, S&P changed the outlook to Stable (from Negative) in March 2010. S&P again changed the outlook to Negative during April 2012 on account of declining growth levels, increasing fiscal and current account deficits. With the change in government, stabilization of fiscal deficit and improvement in the current account parameter, S&P changed the outlook back to Stable in September 2014 and have not made any amendments to its rating since then. The rating remained the same in June 2020, when the other two rating agencies have downgraded India sovereign rating, implying that S&P is more tolerant and optimistic of Indian financial position, and considers that the deterioration in the fiscal parameters in FY2020-21 is unavoidable due to the pandemic, and with proper fiscal policy, India will revert to its pre-pandemic growth trajectory. The rationale for the rating actions (during 2020) is discussed in the table below.

Rationale for maintaining the rating at BBB- (Jun'20)	Rationale for maintaining the outlook at stable (Jun'20)	What can lead to a downgrade (from BBB- to BB+) or negative outlook
• Ratings on India reflect the country's above-average real GDP growth, sound external profile, and evolving monetary settings. • India's strong democratic institutions promote policy stability and compromise, and also underpin the ratings.	• Stable outlook reflects S&P's expectation that India's economy will recover following the containment of the COVID-19 pandemic, and the country will maintain its sound net external position. • Stable outlook also assumes that the government's fiscal deficit will recede markedly following a multi-year high in FY2021.	• India's GDP growth fails to meaningfully recover from FY2021 onwards, and its trend growth rate falls towards the average of its peers. • Net general government deficits materially exceed S&P's forecasts, signifying a weakening of India's institutional capacity to maintain sustainable public finances

FITCH

Fitch had maintained the India sovereign rating throughout 2003-08 period and after the Global Financial Crisis (2008). However, it changed the rating outlook in June 2012 (to BBB-/Negative) due to the declining GDP and higher fiscal and current account deficits. However, with the expected improvement in these parameters, it reverted to Stable outlook in June 2013. However, with a decline in the growth rates and expected weakening of fiscal balance, Fitch changed the rating outlook to Negative in June 2020, with the rationale discussed in the table below.

Rationale for maintaining the rating at BBB- (Jun'20)	Rationale for negative migration in outlook (Jun'20)	What can lead to a downgrade (from BBB- to BB+)
• The relatively closed nature of India's capital markets, with limited foreign portfolio inflows, supports the authorities' ability to finance wider fiscal deficits domestically. • RBI has also built up its foreign-exchange reserve buffers in recent months to US$ 502 billion by 5 June 2020, covering around nine months of current account payments, higher than the 'BBB' median of five months • GoI has announced structural reforms as part of its response to the pandemic to strengthen GDP growth over the medium term, which, if successful, could improve India's fiscal position	• The coronavirus pandemic has significantly weakened India's growth outlook for this year and exposed the challenges associated with a high public-debt burden. • Expected incremental fiscal spending of up to 1% of GDP (over and above current stimulus package of 10% of GDP), albeit fiscal cost being 1%. • Historically weak implementation of fiscal rules stipulated in the Fiscal Responsibility and Budget Management Act. • Medium-term GDP growth outlook may be negatively affected by renewed asset-quality challenges in banks and liquidity issues in non-banking financial companies (NBFC). • Heavy onus on public-sector banks to bail out the affected sectors and extend impaired-loan recognition, heightening solvency risks if not met by adequate and timely	• A structurally weaker real GDP growth outlook, for instance due to continued financial-sector weakness or reform implementation that is lacking. • Failure to reduce the fiscal deficit after the pandemic recedes, and to put the general government debt/GDP ratio on a downward trajectory.

	capital support from GoI.	

7. CONCLUSION

A comparative study on the India's sovereign rating movements during the period 2004-2020 is done based on the rating actions of the three global rating agencies, e.g., Fitch, Moody's, S&P. After analyzing the commentary for the rating actions undertaken, the study finds that 4-5 critical economic parametershave been the constant features for change in the rating action – apart from the structural reform measures of the government in 2016-18 (e.g., GST, bankruptcy law, etc.). During the last review in June 2020, the concerns of the rating agencies for the change in outlook are well articulated as follows:

- Fiscal deficit remains the weakest link within the overall macro-economic parameters
- Stronger medium-term growth is needed to obviate the impact of weak fiscal though it is hard to come by at the current juncture
- Financial sector will continue to be under pressure and will be bearing the brunt of rescuing the real sector under the Covid-19 stimulus plan

The negative outlook, implies a possibility of further downgrade which, if it happens, will take the rating below investment grade. Whilst the impact of the economic slowdown sharply aggravated by the Covid-19 lockdown is indeed severe in the near term, we believe that the global rating agencies may take cognizance of India's resilience through past economic crises since the 1990s, its adequate foreign currency reserves and its institutional and regulatory framework that has strengthened over the past two decades. A near-to-medium term disruption in the growth as well as the fiscal trajectory precipitated by the Covid19 crisis is foreseeable but will also need to be looked at on a relative basis vis-a-vis peers who have similar vulnerabilities.

From the point of view of the government, it would be instructive to examine the concerns raised by the rating agencies and address them effectively. The government may need to prepare a medium-term fiscal consolidation roadmap to inspire confidence in markets. It may also consider undertaking various pro-reform measures so as to improve the medium-term growth levels, as it will mitigate the impact of higher Debt/GDP and improve fiscal position (via buoyant tax revenues).

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