FICCI on US Rating Downgrade: The Rationale & Implications for India

New Delhi, August 8, 2011: The news is that Standard & Poor's (S&P) has downgraded US Economy's Long-Term Sovereign Credit Rating to AA+ from AAA with a negative outlook. According to S&P, this rating action is primarily driven by the perception that (a) the recently agreed debt ceiling plan envisaging $2.1 trillion spending cuts for the decade ending 2021 falls short of the S&P expectations ($4 trillion spending cuts to reaffirm US rating at AAA) and (b) recent data revisions of US GDP growth supports the contention that the economic recovery since 2008 has been more muted, contrary to earlier perceptions of a robust recovery.

Notwithstanding the rating downgrade, there is no denying of the fact that US fiscal position remains a cause for concern. FICCI estimates that the US budget deficit is currently running at over 9% of GDP, the third largest since Second World War. As the S&P estimates (see table 1), under the worst case scenario, US federal debt now at 74% GDP, will touch a staggering 101% of GDP by 2021.

Table 1:The anatomy of US deficit reduction proposals

	Current state	Simpson-Bowles	Domenici-Rivlin	S&P
Debt as a % of GDP	87% by 2020	60% by 2024	Below 60% by 2020	101% of GDP by 2021

Source: Congressional Budget Estimates (CBO), Economist & FICCI Research

Increase in debt levels act as a double-edged sword. Assuming taxes are to be raised to achieve debt sustainability, the distortionary impact lowers potential output. On the other hand, if the governments resort to discretionary cut in spending, this may have a contractionary impact. However, more crucially, as debt to GDP increases, there is a significant adverse impact on GDP growth (*research indicates that US GDP may decline by as much as 1.8% if debt levels were to cross 90% of GDP*)

Of more importance is the impact on the Indian economy because of this rating downgrade. FICCI believes that while the short-term impact would be more obvious in terms of market uncertainties, the long term impact may be more prolonged, but less obvious. However, the good thing is that the 2008 credit cycle has resulted in Indian industry emerging stronger and competitive in global business (for example, cost rationalization). On the downside, an uncertain global environment could however depress India's exposure to global markets (exports of goods & services, more than a quarter of India's GDP) and knock off percentage points from India's GDP growth.

There is a fear that investor moving out of US treasuries could move with commodities like crude oil, copper, iron ore etc which would result in a spiking of these prices. This could worsen the global inflationary scenario.

This apart, one positive fall out of the rating downgrade, FICCI feels could be the Indian market perception that a possible decline in crude prices may signal a pause in RBI rate hikes buoying investor sentiments. Additionally, the spreads between a US sovereign and Indian sovereign paper of comparable duration may decline, thus acting as an enabler to FII inflows into the country. This may have a sobering impact on the current account deficit, even though this may not be exactly desirable.

In conclusion, a mention must be made to the unchanged status of India's Foreign Currency Long-Term Sovereign Credit Rating by S&P at "BBB –" with a stable outlook (April 6, 2011). The reason for this rating outlook (Surprisingly, Iceland also enjoys a "BBB-"rating) as per the S&P is the fiscal position with debt GDP ratio at 71% of GDP in FY2012 (S&P estimates).

On the hindsight, consensus GDP projections for India's economy for FY2012 continue to be in the realm of near about 8%. This we feel, is principally a result of our high savings and investment rate and the buoyant domestic demand. Nevertheless, the need for a better fiscal management and accelerating structural reforms in India can hardly be over-emphasised.

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