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Moody's upgrades India to highest sovereign rating post liberalization

Further upgrades from Moody's unlikely, but other agencies could follow suit

- **Moody's upgraded India's sovereign credit rating to Baa2 from Baa3, the highest rating that the country has received from the global ratings agency post liberalization. Outlook on the rating is also changed to stable from positive. Notably, Moody's has upgraded India's rating after nearly 14 years (last in January 2004).**
- **The ratings agency attributed the upgrade to a host of economic and institutional reforms (such as GST, better monetary policy framework, bank recapitalization, demonetization and DBT), which are expected to drive a gradual improvement in India's fiscal metrics. India's real GDP growth is also expected to improve from 6.7% in FY18 to 7.5% in FY19, and then remain high in the ensuing years.**
- **Although the upgrade has no impact on the country's fundamentals, it is a sentiment booster and largely reflects the governments' past and ongoing actions.**
- **Moody's clarified that further upgrades will depend on a *material* improvement in fiscal metrics, along with a *strong and durable recovery* of the investment cycle. On the contrary, a material deterioration in fiscal metrics/health of the banking system could prompt a downgrade. Overall, we do not expect any further rating change from Moody's in the near future; however, an upgrade from other rating agencies (Standard & Poor's and Fitch) is long due, in our view.**

Moody's – one of the three major global ratings agencies – upgraded the Government of India's local and foreign currency issuer ratings by one notch to Baa2 from Baa3. The outlook on the rating was also changed to stable from positive. The global ratings agency has upgraded India's rating after nearly 14 years (last in January 2004; Exhibit 1). This is India's highest credit rating by Moody's post liberalization.

Reasons for the upgrade

Moody's took note of the Indian government's wide range of economic and institutional reforms, such as the GST (would promote productivity by removing barriers to inter-state trade), improvement in the monetary policy framework, measures to address the overhang of non-performing loans (NPL) in the banking system, demonetization, and Aadhar and the Direct Benefit Transfer (DBT) system for targeted delivery of benefits. The rating agency expects India's GDP growth to accelerate to 7.5% in FY19 from 6.7% in FY18; it sees "similarly robust levels" of growth in the ensuing years. Moody's also highlighted that India has stronger long-term growth potential than most other Baa-rated sovereigns.

Exhibit 1: Movements in India's ratings by three major rating agencies

Standard & Poor's (S&P)		Fitch		Moody's	
Rating	**Date**	**Rating**	**Date**	**Rating**	**Date**
BB+	7-Dec-92	BB+	8-Mar-00	Ba2 (Lowest)	28-Jul-99
BB ↓ (Lowest)	22-Oct-98	BB ↓ (Lowest)	21-Nov-01	Ba1 ↑	3-Feb-03
BB+ ↑	2-Feb-05	BB+ ↑	21-Jan-04	Baa3 ↑	22-Jan-04
BBB- ↑ (Highest)	30-Jan-07	BBB- ↑ (Highest)	1-Aug-06	Baa2 ↑ (Highest)	16-Nov-17

The table doesn't include change in ratings' outlook

Source: Bloomberg, MOSL

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Moody's also stressed that the government's steps to increase formalization in the economy (to broaden the tax base) and promote expenditure efficiency (rationalizing government schemes and better targeted delivery using DBT) would lead to a gradual improvement in India's fiscal metrics. Moody's expects India's debt-to-GDP ratio to rise by ~1pp to 69% in FY18 and remain stable thereafter in the subsequent years, before falling gradually as nominal GDP growth continues and revenue-broadening and expenditure efficiency-enhancing measures take effect.

What does the ratings upgrade mean?

Theoretically, a sovereign credit rating upgrade implies that the risks associated with a sovereign default have subsided, leading to a decline in the risk free rate (i.e. government bond yields). A lower risk free rate, in turn, would lead to a decline in borrowing costs for corporates. The 10-year G-sec yield, which had increased by 30bp over the last 30 days, reacted favorably, opening 10bp lower at 6.96% post the ratings upgrade announcement, but lost the gains during the course of the day and closed at ~7.05%, similar to 7.06% on the previous day. The INR also appreciated 0.5% against the US dollar during the day.

Overall, we believe that the ratings upgrade is a sentiment booster and largely reflects the government's past and ongoing actions. The development, however, has no impact on fundamentals of the country.

Don't expect another upgrade from Moody's; other agencies could follow suit, though

"*The rating could face upward pressure if there were to be a material strengthening in fiscal metrics, combined with a strong and durable recovery of the investment cycle, probably supported by significant economic and institutional reforms. In particular, greater expectation of a sizeable and sustained reduction in the general government debt burden, through increased government revenues combined with a reduction in expenditures, would put positive pressure on the rating.*", says Moody's press release.

Since neither a sharp decline in general government debt nor a strong revival in investments is on the anvil, we do not expect another upgrade from Moody's in the near future. However, since other rating agencies have not taken any rating action for more than a decade, we believe the time is ripe for them to revisit India's sovereign ratings *(Exhibit 1)*. This makes us believe that the other two agencies could soon follow suit with a rating upgrade.

N O T E S

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