
Viewpoint: India's rating upgrade

November 17, 2017

Moody's Investor Service has upgraded India's foreign as well as the local currency long term rating by a notch from Baa3 to Baa2 on November 16, 2017. The short-term local currency rating has also been upgraded from P-3 to P-2.

The decision to upgrade India's ratings, at this point, underpins Moody's expectations that India's progress on the economic and institutional reforms will enhance its growth potential and gradually contribute in reducing the government's debt burden over medium term. This decision also shows Moody's belief that notwithstanding the present burden of high debt, the reform measures presently in place and those underway will help reduce the risk of a sharp increase in debt even during periods of downside.

According to Moody's, these reform measures are helping improve the business climate, enhance productivity, stimulate both foreign and domestic investments and push the objective of strong and sustainable economic growth.

Some of the notable reforms initiated by the government in recent past include:

- (a) Goods & Services Tax (GST): addressing productivity and removing barriers to trade
- (b) Monetary Policy Committee (MPC) framework: aimed to bring about greater degree of transparency in monetary policy decisions, including decisions on interest rates
- (c) Banking sector reforms: addressing key concerns, such as, the NPL (non-performing loans) issue through the launch of Insolvency and Bankruptcy Code (IBC) and the decision to re-capitalize Public Sector (PSU) banks
- (d) Demonetization: aimed at reducing the influence of informal economy
- (e) Direct Benefit Transfer (DBT): an attempt to change the mechanism of transferring government subsidies directly to the beneficiaries by using 'biometric technology'

However, while there are improvements in the economic fundamentals, the bond yields, nevertheless, have moved north over the past couple of quarters in the wake of:

- Neutral monetary stance maintained by the RBI and its hawkish undertone in the monetary policy commentary
- Talks pertaining to fiscal consolidation; especially in the aftermath of disruptions caused by GST implementation; raising concerns over government being able to achieve the fiscal deficit target of 3.20% of GDP for FY18
- Continued Open Market Operations (OMO) (G-sec sale) by the RBI to suck out durable liquidity from the system

Having said that, considering this recent development of India's rating upgrade, we expect the bond prices to appreciate over near to medium term as:

- The yields are attractive. The 10-year benchmark is trading at 97 bps above the repo rate. The last 5-year average is 57 bps. A mean reversion is a logical move
- Credit rating upgrade underscores the reform measures of the government
- The foreign inflows are expected to increase as India moves one more rung into the investment rating scale
- Rupee to remain largely stable with short stretches of appreciating bias based on portfolio and FDI inflows
- Benign inflation environment to continue. The average headline CPI to remain below the neutral 4%
- Rating upgrade to maintain pressure on the government to maintain its path to fiscal consolidation

In view of current developments, investors are encouraged to remain invested in the short term and duration funds as the market looks forward to price-in the much-awaited credit rating upgrade.

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