The Neoliberal Trap

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With general elections just a year away the Manmohan Singh government finds itself trapped. There is little it can do to revive the economy or spend on welfare to appease the electorate, since it fears that such measures would increase the deficit on its budget and provoke a downgrade of its sovereign rating. Since all major rating agencies place India on the lowest investment grade, any downgrade would push it below investment grade or into junk status. The resulting macroeconomic policy freeze is, however, neither stabilizing the economy nor winning favour with the rating agencies. The economy is still on low-growth mode, consumer price inflation remains high and the current account deficit on the balance of payments widens ominously.

In the event, despite the government's best efforts, rating agency Standard & Poor's (S&P) has in May chosen to stay with it lowest-investment grade (BBB-) sovereign rating for India, with a negative outlook. In April last year, soon after it became clear that India's high growth story was at an end, S&P had kept India in the lowest-investment grade category, but lowered its outlook to negative from stable. This indicated that there was a likelihood that India could be downgraded to below investment grade or junk status.

In its 2012 assessment revising its outlook for India the rating agency said: "India's investment and economic growth have slowed, and its current-account deficit has widened. We are revising the outlook on the long-term ratings on India to negative to reflect at least a one-in-three likelihood of a downgrade." S&P had then declared that it could revise its rating or outlook anytime over the next 24 months, with chances of an improvement if the government takes action to "reduce structural fiscal deficits and to improve its investment climate."

Now a little more than a year later the agency has once again held that its "negative outlook signals at least a one-in-three likelihood of a downgrade within the next 12 months." Further, it has threatened that it "may lower the rating" if it finds that "slower government reforms than we (it) currently expect would not lead economic growth to recover to levels experienced earlier this decade."

When the April 2012 outlook downgrade occurred, the then Finance Minister Pranab Mukherjee received the news with outward calm, saying there is no need to panic and that India's growth story is intact with GDP expansion projected at 7 per cent in 2012-13. In fact, sections in government were critical of the S&P assessment, quoting Moody's decision to hold India stable, even if at the lowest investment grade. Behind this outward complacence or even aggression, however, there were signs that the government was responding to S&P. Despite political opposition, it launched another round of reform in September last year, starting with the symbolically important decision to permit foreign direct investment in multi-brand retail. That effort has continued since. In fact, Finance Mnister Chidambaram was on a road show to attract foreign investors with promises of major concessions when the recent S&P ratings reaffirmation occurred.

But what was remarkable was the shape of Budget 2013. If there was a standout feature of that Budget, it was that Finance Minister Chidambaram seemed to have been overwhelmed by a desire to record a declining fiscal deficit in his books. To realise that he slashed expenditures during the final months of financial year 2012-13 to deliver on the revised fiscal deficit target of 5.2 per cent of GDP. He also combined optimistic estimates of increases in receipts with substantially curtailed budgeted expenditures to deliver a 4.8 per cent fiscal deficit to GDP figure for 2013-14. The net result was that in the last full Budget under UPA II, aggregate expenditures were reined in, welfare spending was cut and subsidies were slashed. With growth at 5 per cent, that reflected poor economic sense. It was, of course, politically foolish as well.

Clearly this was not a desired direction in policy even for a government committed to reform. Hence, many speculated that the driving force seemed to be a desire to appease the rating agencies. If so, these measures have not paid off. Neither is S&P impressed with the latest round of reforms, nor is it convinced by the government's promise to bring its fiscal deficit down to the 3 per cent it targets. In fact, the threat of a possible downgrade over the next 12 months seems to be geared to pressurising the government not to resort to increased deficit-based spending in the run up to the elections. Yet, it wants growth to return to levels experienced earlier this decade. Ensuring higher growth while cutting government spending is what countries in Europe have realised is impossible.

When faced with impossible demands the best the government could do is to tell the rating agencies that it refuses to listen. In any case the rating agencies themselves are a discredited lot after the global crisis. In fact, earlier this year, the Department of Justice of the US government—represented by the United States attorney general and supported by attorneys general from 16 states—filed civil fraud charges against Standard & Poor's. The charge is that between September 2004 and October 2007, S&P "knowingly and with the intent to defraud, devised, participated in, and executed a scheme to defraud investors" in mortgage-related securities. The DoJ's case is based on 40 "collateralised debt obligations"—toxic securities—created at the height of the US mortgage bubble. These bonds went bust, resulting in losses to investors. The DoJ not only claims that S&P knew this could happen when it gave them high ratings or left them unrevised, but also that it misinformed investors by arguing that its ratings "were objective, independent, uninfluenced by any conflicts of interest."

There is no need for a sovereign to fear an agency thus charged by the government of the country in which it is headquartered. Yet all the Finance Ministry has done in response to the S&P assessment is to express its disappointment and argue that the assessment ignores major improvements in the Indian economic environment. That amounts to feeble protest rather than a rejection of the assessment. Clearly the government fears the likes of S&P.

The reason for this is not fear of the agency itself but of the financial investors who may take its assessment seriously. Despite the fact that the ratings agencies stand discredited after the global crisis many still turn to them for assessments of their potential investment targets. Moreover, in many instances those with fiduciary responsibilities (such as managers of pension funds) are required to invest only in products rates as investment grade by the ratings agencies. So if India is downgraded to junk status it can have a negative effect on foreign investment inflows. Given the fact that the stock market is to a substantial extent driven by such inflows, a reduction can result in a fall in equity prices, which could in turn encourage existing investors to exit. The result can be a market collapse and investor exodus. That is bad news in itself for a country that, according to figures from the Securities and Exchange Board of India, has accumulated foreign investments in its equity and debt markets of more than $175 billion.

It is even worse for a country that currently records a current account deficit placed at 6.7 per cent of GDP in the last quarter of 2012. Finance Minister P. Chidambaram underlined the government's perception when he noted in his budget speech: "This year, and perhaps next year too, we have to find over USD 75 billion to finance the current account deficit. There are only three ways before us: FDI, FII or External Commercial Borrowing. That is why I have been at pains to state over and over again that India, at the present juncture, does not have the choice between welcoming and spurning foreign investment. If I may be frank, foreign investment is an imperative." It is a short step from here to the argument that the ratings agencies have to be appeased.

But appeasing the raters is no easy task. It requires unwarranted reform, which is difficult to push fast enough in a parliamentary democracy with contending parties. Even when some parties in opposition are themselves in favour of neoliberal reform, they are unlikely to support the government when legislation is required. Appeasement requires incentivising private investors, which implies opting for a low taxation regime. Despite low taxes, the fiscal deficit has to be reined in, which requires lower expenditures. And despite lower government expenditures, the growth story has to be kept going, which is near impossible.

In the circumstances the government seems to have only two options. One is to protest, however, feebly, that a negative outlook is unwarranted and hold that a downgrade is, therefore, unlikely. The second is to hope that the S&P assessment would not affect investor sentiment. As of now it has not. With the world awash with cheap liquidity, most emerging markets are experiencing a surge in capital inflows. India too has till mid-May received net foreign institutional investor inflows alone of $18.5 billion in 2013, as compared with $12.1 billion during the corresponding period in 2012. The government is presenting this as evidence that S&P has got it wrong.

The problem is that with growth slowing, inflation high and the current account deficit uncomfortably wide, economic uncertainty is on the rise. Foreign capital inflows are high, despite that uncertainty, because of global factors. But economic circumstances and the government's paralysis may soon result in an uncertain political environment as well. Then foreign finance may give S&P the signal it needs to downgrade India to junk status. The original sin was to open doors to speculative inflows and accumulate a large stock of such capital. The power of the rating agencies is merely a reflection of the economic vulnerability that policy resulted in. The government is stuck in the neoliberal trap it set for itself.

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