India: Moody's upgrade comes at the right time

The local markets cheered Moody's surprise upgrade of India's sovereign debt rating

Baa2

India's sovereign rating

From Baa3 (Moody's)

In a surprise move, Moody's upgraded India's sovereign rating by one notch to Baa2 from Baa3 with stable outlook, citing ongoing progress on economic and financial sector reforms boosting the country's long-term growth potential and thereby reducing the risk of a sharp rise in the public debt burden. The first sovereign rating upgrade in 14 years puts Moody's assessment of India's creditworthiness a notch above S&P's and Fitch's, both currently having a stable outlook on their BBB- ratings.

We think the announcement in October by the Indian government of INR 2.11tr (US$32bn) recapitalisation plan for public sector banks, to which Moody's was quick to respond with its positive views, may have triggered the upgrade. S&P and Fitch also applauded the recapitalisation plan as long-term positive for the economy but they fell short of overlooking the risk of likely fiscal slippages as growth took a hit from demonetisation late last year. We do not think S&P and Fitch will rush to follow Moody's with an upgrade, not at least until they see some evidence of fiscal consolidation in the budget for FY2018/19 (April-March), not due until February 2018. That's when we could as well see some loosening in the fiscal policy in the run-up to general elections in 2019.

Moody's upgrade comes as a surprise as India's strong economic fundamentals are currently undermined by a cyclical downturn, which Moody's view as transitory. It's also a move at the right time for financial markets which have been battered since September by a spate of bad news of weak real activity growth, rising oil prices pressuring inflation, and fiscal slippages as the public spending gears to support growth. And indeed markets cheered the move with all three main asset classes – stocks, government bonds and the INR – posting strong gains.

It will take a continued flow of good economic news to sustain the current positive market sentiment in the period ahead. The 2QFY17/18 GDP report due November 30 will be key (ING forecast: 6.4%, consensus: 6.6%). We think the RBI will remain cautious on inflation as global oil price edges higher, while weak INR and fiscal slippages complicate policymaking. We forecast an on-hold RBI through 2018. We reiterate the forecast of end-2017 USD/INR of 65.20 and 65.0-65.5 trading range for 2018.