MOODY'S CREDIT RATINGS - ECONOMY

NEWS: Recently, Moody's downgraded the U.S. credit rating—a move that, while met with a calm market response, signals a subtle decline in global confidence in America's fiscal leadership.

- It is the latest downgrade of the three major rating agencies to lower the federal government's credit, Standard & Poor's downgraded federal debt in 2011 and Fitch Ratings followed in 2023.
- A downgrade in the rating indicates that the risk of default of the instrument is higher than what was earlier predicted.

WHAT'S IN THE NEWS?

What are Credit Ratings?

- **Definition**: A credit rating is a formal assessment of a borrower's ability and willingness to repay debt, issued by agencies such as Moody's, Standard & Poor's (S&P), or Fitch Ratings.
- **Purpose**: It reflects the creditworthiness of an entity (country, company, or instrument) and guides investors on the risk of default associated with lending to or investing in that entity.
- **Rating Spectrum**:
    - **High Rating (e.g., AAA)**: Indicates extremely low credit risk; the borrower is highly likely to repay.
    - **Low Rating (e.g., BB or below)**: Indicates speculative or high-risk borrowers with potential to default.
- **Disclaimer**: Credit ratings are not investment advice; they do not recommend whether to buy, hold, or sell a security.

Types of Credit Ratings

- **Sovereign Rating**: Assesses a **nation's ability and willingness** to repay debt obligations. It influences global investor confidence and determines the cost of foreign borrowing for the government.
- **Corporate Rating**: Measures the **financial health and creditworthiness of private firms**. It is crucial for businesses trying to raise funds through bonds or loans.
- **Bond Rating**: Evaluates the **risk of default on a specific debt instrument** or bond issue, helping investors price the bond's risk premium.

Evaluation Process of Credit Rating Agencies (CRAs)

- **In-depth Analysis**: CRAs conduct comprehensive evaluations based on financial statements, industry dynamics, and broader macroeconomic, regulatory, and political contexts.
- **Agency-Specific Methodologies**: Different CRAs apply **varied criteria and weightages** to factors such as earnings stability, governance, leverage, and liquidity.
- **Common Rating Criteria**:
    - **Operational Efficiency**: Capacity of the issuer to manage operations cost-effectively.
    - **Financial Strength**: Profitability, leverage ratios, cash flows.
    - **Managerial Competence**: Quality of leadership, strategic decisions, and governance.
    - **Debt Repayment History**: Track record in servicing past debt obligations.

Reasons Behind Downgrade in U.S. Credit Ratings (Moody's Analysis)

- **High Debt-to-GDP Ratio**:
    - U.S. debt has exceeded 120% of GDP—a critical threshold suggesting reduced repayment capacity.
- **Chronic Fiscal Slippage**:
    - Persistent budget deficits due to emergency spending post-2008 (financial crisis, COVID-19 stimulus, etc.).
- **Political Gridlock**:
    - Partisan divides have caused repeated debt ceiling standoffs and government shutdown threats, undermining fiscal discipline.
- **Erosion of Institutional Trust**:
    - Moody's downgrade reflects global concerns about the weakening credibility and long-term fiscal sustainability of U.S. governance.

Global Implications of U.S. Credit Downgrade

- **Erosion of Dollar Dominance**:
    - Central banks are increasingly **diversifying their foreign reserves** away from the U.S. dollar into gold, euros, or digital assets due to uncertainty.

- **Pressure on Emerging Markets**:
    - **Higher U.S. Treasury yields** post-downgrade could prompt capital outflows from developing countries and raise their cost of external borrowing.
- **Historical Lessons – Taper Tantrum (2013)**:
    - Sudden U.S. monetary tightening previously caused financial instability and capital flight from countries like India, Brazil, and South Africa.
- **Broader Surveillance of Sovereign Debt**:
    - Even **developed economies** (e.g., Germany with 62.5% debt-to-GDP, Canada at 110.8%) are facing enhanced global scrutiny on fiscal prudence.

India's Fiscal Challenges

- **High Public Debt**:
    - India's general government debt is projected at **~80% of GDP by 2025**, well above the prudent level for emerging economies (~60%).
- **Limited Fiscal Space**:
    - Elevated debt constrains the government's ability to respond to crises or invest in key sectors like infrastructure and health without widening fiscal deficits.
- **Populist Expenditures**:
    - Election-related freebies (loan waivers, free electricity, etc.) often drain public funds without long-term productivity gains.
- **Structural Weaknesses**:
    - **Low Tax-to-GDP Ratio (~11%)**: Far below the OECD average of 34%, due to a narrow tax base, evasion, and weak enforcement.
    - **Judicial Delays in IBC**: Slow resolution of bankruptcy cases under the Insolvency and Bankruptcy Code undermines credit discipline and deters investment.
    - **Underinvestment in Key Sectors**: Infrastructure still lags in terms of **logistics, education quality, and public health**, limiting inclusive growth.

Implications of High Fiscal Deficit in India

- **Crowding Out of Private Sector**:

- Government borrowing reduces loanable funds available for private firms, **raising interest rates** and **dampening private investment** (currently ~20–22% of GDP).

- **Distorted Lending Patterns**:
    - Banks prioritize government securities to meet **Statutory Liquidity Ratio (SLR)**, limiting affordable credit to MSMEs and startups.
- **Interest Burden**:
    - Over **25% of central government expenditure** goes toward servicing debt interest, reducing resources for social sector spending.
- **Stagnation Risk**:
    - Persistent fiscal stress can limit future growth potential, crowd out innovation, and create inflationary pressures.

Way Forward for India

- **Promoting Fiscal Discipline**:
    - Avoid unsustainable populism; shift focus towards **productive expenditure**, such as infrastructure, skilling, and innovation.
    - Rationalize subsidies and improve public service delivery mechanisms to ensure **better fiscal efficiency**.
- **Tax Reform and Compliance**:
    - **Broaden the tax base**, use data analytics for better compliance, and reduce tax leakages through digitization.
- **Prioritize Capital Over Revenue Expenditure**:
    - Capital expenditure (roads, railways, digital infrastructure) offers **higher growth multipliers** than subsidies or administrative expenses.
- **Export and Trade Diversification**:
    - Boost competitiveness in manufacturing and services exports.
    - Strengthen regional and bilateral Free Trade Agreements (FTAs) to reduce dependence on select markets.
- **Enhancing Credit Market Depth**:
    - Improve insolvency mechanisms and encourage private capital by reducing procedural and judicial delays.

Source: https://economictimes.indiatimes.com/markets/stocks/news/aswath-damodaran-explains-3-reasons-why-moodys-ratings-downgrade-of-the-u-s-didnt-impact-market/articleshow/121594174.cms?from=mdr