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Rating the global rebalancing

Why are Italy and Spain, on the brink of fiscal disaster, rated notches above India? This bias has to be urgently corrected, to reflect the real risk profile of the developed world and to enable high growth in developing economies

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The world needs an economic rebalancing. For a decade or more before the financial crisis, the global economy was driven by the consumption of the developed world. However, this excessive consumption was funded through government and individual debt, aided by market exuberance—an ideal recipe for financial crises, and it did. The composition of GDP (C + I + G+X-M) of the developed world was dominated by C + G (coupled with current account deficit) while in the developing world, the lion's share came from I + X (exports) that generated current account surplus. Simply put, the rich countries consumed too much and others too little. The savings in the developing world that resulted from consuming too little funded the consumption binge of the developed world.

Now, with little room for C and G in the developed world, coupled with de-leveraging of consumers and sovereigns, we have a problem. The developing countries, on the other hand, are evolving but need to change their model from investments and exports to consumption.

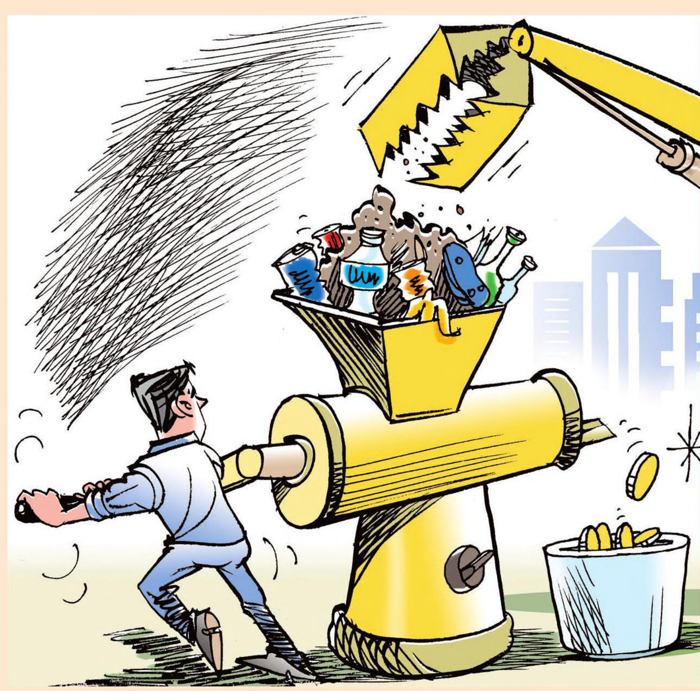
That's easier said than done. The world will need changes in the relative prices of goods, credit and currencies, which will determine international trade in terms of the type of goods consumed, production location and the resultant flow of capital and credit to countries.

While the world has avoided a disaster, we haven't arrived at a sustainable solution. Monetary easing and financial gymnastics won't work much longer. We run the risk of a blow-out in the current crisis. Thus, the obvious question is what does a sustainable solution to the global problem entail? Effective rebalancing would mean realignment in both financial variables as well as the reallocation of resources. This has to go hand in hand with the fundamental changes in the structure of production of goods and services.

In this new order, the US needs to see a significant decline in its current account deficit on the back of a cheaper dollar. In essence, it needs to consume less internally, and sell more to the world. Countries on the periphery of the eurozone also need to reduce their current account deficits and work towards building surpluses. This could happen on the back of a declining euro or perhaps selective exit by countries from the European currency union. Germany will be the exception but must learn to live with reduced current account surpluses, especially versus the other member countries of the union. Europe thus needs to see both internal and external rebalancing.

To facilitate this, both the euro and the dollar (and related currencies, like the pound sterling) need to see significant corrections against the currencies of the emerging economies, which will be the demand base in this rebalanced world. The Chinese yuan, for instance, needs to appreciate against both the euro and the dollar, as do other developing-world currencies like the rupee. Thus, current depreciation pressures notwithstanding, the long-term value of the rupee is headed northward. However, currency realignment alone will not ensure global rebalancing. There are other conditions required.

First, commodity prices have to reflect the demand-supply balance, not the froth created by excess liquidity. With the global economy slowing down, (likely to grow at 3% in 2012 and 2013), it is difficult to understand why oil prices are still above $90 a barrel. However, the price of any natural resource is determined by its marginal cost of extraction. For instance, oil extraction from most difficult sources, like shale or tar sands, is $60-70/barrel. A similar argument holds for other commodities whose markets have become completely 'financialised' with prices riding the liquidity wave rather than reflecting the 'fundamentals'.



Second, ratings and the price of credit must reflect reality. While credit rating agencies threaten to downgrade India to a sub-investment grade, their stance perhaps stems from their historical bias against developing markets. It's indeed ironic that Italy and Spain, which are on the brink of fiscal disaster, are rated BBB+ by Standard and Poor's—a good two notches above India. This bias has to be corrected to enable high growth in developing economies through ample and appropriately priced liquidity.

The first step in moving to such a changed paradigm for the pricing of credit is to accept the entrenched positions that have led to this history of credit mispricing. For one, bank and institutional portfolios have humongous holdings of developed-country bonds. This is predicated on the assumption that developed country bonds have only interest risk and no credit risk. Any radical revision of ratings, however desirable, is likely to upset this fragile equilibrium that the developed world is desperately clinging on to.

The irrational faith of rating agencies in the ability of developed economies to avoid default has meant that, despite the 2008 meltdown, ratings of both sovereign governments in the West and companies and institutions within these economies haven't been adjusted to reflect the risk of default. Italy and Spain again are examples where rating agencies have turned a blind eye to the prospect of sovereign default. French and German banks, saddled with large amounts of sovereign debt of these teetering economies, continue to enjoy ratings that are fairly respectable investment grade. Similar is the case with large American banks that have hefty portfolios of mortgage bonds which remain beaten down.

One reason why banks and financial institutions get away with the impression of possessing a robust balance sheet is because significant chunks of their securities portfolio are not marked to market. Besides, there are exposures through off-balance sheet 'shadow banking' vehicles. A deeper assessment of the market value of their investments is likely to present a far bleaker picture of their financial health.

In short, for a more accurate pricing of credit that would support global rebalancing, these issues have to be recognised and tackled with a sense of urgency. Ratings of the developed world have to be cut substantially to reflect their risk profile, and those of the emerging world upgraded.

It is also imperative to restore the natural flow of capital and resources. Two things need to be recognised here. Credit growth in the developed world, particularly to the SME segment, remains weak. Central banks in the West might be creating liquidity but this is either flowing back to the central bank as excess reserves parked by banks or into financial markets. This is not restricted to developed markets alone. The excessive caution that global investors and rating agencies have adopted towards emerging markets is impeding the natural flow of capital from the low-growth, low-yielding developed world to the relatively high-growth, high-yielding developing world. Small and mid-size companies that are the real engines of growth in emerging markets are the worst affected, since they figure towards the bottom of the risk hierarchy.

For a sustainable solution to the growth conundrum faced by the global economy, this natural flow of resources must be restored. SMEs in Asia and Latin America need to have aggressive investment to ramp up growth. If this natural flow is restored, it would not only spur much-needed growth but also address issues of excessive depreciation of emerging market currencies and associated problems like high inflation.

However, the need for reallocation of resources is not confined to debt and credit markets. Take the case of equities. Emerging markets account for approximately 35% of global output but only 10% of global market capitalisation. In their portfolio allocation decisions, FIIs must move from weighing portfolios in line with market capitalisation to weighing in line with GDP. This will cut down volatility, risk spreads and equity premiums. Besides ensuring an optimal allocation of resources, this should also reduce the merry-go-round of periodic flights to safe dollar assets that yield a pittance and the breakdown of the risk-return dynamics it entails. It's ironic to see pension funds, which are meant to offer safe but reasonable rates of return to investors, actually yield negative real returns in their chase for the safety of US Treasury bonds.

More realistic ratings, restoring the natural flow of resources in consonance with relative yield potentials of economies and more rational portfolio allocation will reflect in employment, investment, exchange and interest rates, which, in turn, will affect consumers, companies, investors and governments and finally lead to the rebalancing of the world on a sustainable basis. All of us know what's to be done, but are constrained by fears of crisis, political upheaval and human suffering. This fear is an integral part of the human psyche and is understandable. However, we can't miss the woods for the trees and require a roadmap. The least painful would be for finance to lead the way through global portfolio, capital and credit rebalancing to reflect changed realities.

As for India, we have to ensure we do what finance minister Pranab Mukherjee has pleaded for. Given that fractured mandates are likely to remain an integral feature of Indian politics, it's best we learn how to deal with each other when it's most important.

GDP = Private consumption + Gross investment + Government spending + (Exports - Imports)

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