US Downgrade - World Going South: What Happens Now?

Guest Column

India has a great story and we must build and execute our future carefully

BY ADITYA PURI

First, let's all be on the same page. The US downgrade was not only valid but overdue because of highly-leveraged customers, overborrowed government and a political system that is not working. The comments from Washington reflect the pain of a superpower in transition to a normal country It would have been more responsible if they had acknowledged their problems and drawn a plan for fixing them.

Similarly, the way some American business leaders have reacted to the suggestion that the US government might not be able to service dollar debt lacks proper analysis and is based on misplaced hubris. Yes, the US can print dollar to repay debt. But then, the value of the dollar as well as rating goes down further. If this is the strategy that the US is likely to follow, then it should state it clearly so that investors would take appropriate action before the US paper money becomes worthless. We may mention that such an attitude from a country with the world's reserve currency would be irresponsible.

The US is recovering from a crisis and not a recession; so, it is imperative that they understand that fixing consumer sentiments, over leveraged household balance sheets, high unemployment, asset bubbles and a high deficit takes time. This is reflected in the US banks requiring five years to fix their leverage, bad balance sheet quality and mismatched funding in terms of Basle III.

We must recognise that US accounts for 23% of the world's GDP in nominal terms and thus any slowdown there will affect global growth. With the US and euro in trouble, the world growth will slow down substantially and therefore, markets will be repriced lower. The US downgrade should primarily impact the cost of US sovereign, corporate and retail borrowing and stocks. The impact on financial variables in other parts of the world will work largely through heightened global risk perception that will spread contagion. We will need to see how financial markets and governments react over the next few weeks and for a while irrational volatility will grip markets.

But there are reasons to believe that the panic this time around will not be like 2008. Comparisons with 2008 are incorrect because people were swimming in the dark in a crisis situation. Now, most people know what needs to be done. They may not find it palatable and may therefore take sub-optimal decisions but consequences are known.

While the downgrade by S&P is a wake up call on the state of its finances, the fall in US debt and equities will be cushioned because: A) the US has 43% weightage in MSCI index compelling fund managers to hold a significant fraction of their portfolio in US stocks. B) If two out of three agencies have AAA rating, then investors can treat as AAA — a pressure on other agencies not to downgrade. C) Tier-I investments need only A rating and most large institutional investors are mandated to hold tier-I bonds and not AAA bonds.

THE NEAR TERM PROSPECTS FOR THE DEVELOPING WORLD

Let's face facts. In a risk-averse environment appetite for emerging market risks reduce. This will impact the cost and availability of international funding. Exchange rates will be volatile in the short run and will, instead of fundamentals, be driven by flows based on risk perception. Access to equity markets will also be an issue.

Growth across the world will slow down and this is bound to impact on growth rates in emerging markets. India will also be affected through a decline in exports and a decline in domestic consumption consequent to sentiment, inflation and rising interest rates. But, there is a silver lining: gains from a decline in crude and commodity prices may be more than we lose by a slowing global economy. Besides, the RBI and the government preferred a growth of 7.5-8% to tame inflation. A global slowdown may help us achieve this without resorting to many more interest hikes.

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The biggest risk on the horizon seems to be the prospect of the US Fed resorting to QE3 — a massive bond buy-back programme to inject liquidity This will drive up commodity prices and inflation in emerging markets. This will leave economies like India and China with low growth but high inflation.

Thus, going forward, we must realise that: A) Regulators/governments globally are coming to terms with the fact that maintaining economic growth levels through increasing debt financing (deficit) is not sustainable specifically with the need to deleverage the financial sector and reduce risky lending to prepare for the next crisis (which may come before we solve this one). So, we must accept a lower, sustainable growth which is prudently funded. We need to ensure maximum results from our financial inclusion initiatives as we have limited fiscal deficit cushion. We cannot have two India. Financial inclusion is an economic, social and political necessity. However, we need to ensure sustainability for the underprivileged, the country and bank balance sheets. India's goal of inclusive growth in a sustained manner can only be met by policies that create livelihoods and not by subsidies. The US experiment with Fannie Mae and Freddie Mac which backed mortgage lending to completely unviable households in hindsight was avoidable.

We also must accept the need for a strong financial sector which can intermediate effectively to promote growth while balancing risk and reward. Banks will need access to capital which is going to be scarce and will demand returns.

B) The developing world that was not decimated by the financial crisis needs to ensure that they are not subjected to same medicine as the developed world.

C) QE2 has not been a success. Clearly, creating liquidity cannot substitute for the weakness in private consumption caused by asset loss, high unemployment and uncertainty. What excess liquidity does is that banks pass on money to consumers leading to asset bubbles and leverage.

D) Going forward, capital will be scarce and decisions will not be made on the basis of themes or trends but on the basis of fundamentals. It is important governments, banks and companies realise this. India has a great story. We must build and execute our future carefully.

(The author is MD, HDFC Bank. Views are personal)