Global Research & Analytics

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INDIAN ECONOMY

# CRISIL Insights

June 2018

Through the monthly CRISIL Insights Indian Economy series, we offer incisive analysis of macroeconomic parameters of the country. In this issue, we examine how India's vulnerability has changed in the past five years and how it compares with other emerging markets

## Of shocks and vulnerabilities

While the Indian economy is recovering from the twin shocks of demonetization and Goods and Services Tax implementation, exogenous temblors have started to manifest. More recently, some of the key macros – current account deficit (CAD), inflation, fiscal deficit and bond yields – have been stressed. Over the past few months, capital flows into emerging markets have tapered and, in some cases, even seen outflows – India has seen outflows both in debt and equity. External shocks such as rising oil prices, tightening by the United States Federal Reserve, and geopolitical uncertainties – coupled with weakening of some of the domestic macroeconomic indicators – are driving this trend.

Although oil is the dominant risk at this juncture, asymmetric monetary policies in advanced countries and noticeable tilt towards protectionist trade policies are potential global shocks lurking. All these create a 'risk off' scenario.

So, are we heading towards a 2013-like situation when the 'taper tantrum' was enough to roil the rupee? Unlikely, because India is way too resilient today than then, despite some of the macroeconomic parameters worsening.

Received wisdom says although all emerging markets are impacted by the 'risk off' scenario, the ones with poor macroeconomic fundamentals get hit the most. In 2013, with its high twin deficits, India was part of the ignominious 'Fragile Five' (Turkey, Brazil, India, South Africa and Indonesia) and was hit by capital outflows following the announcement by the Fed that it is likely to cull asset purchases.

With a significant improvement in its macroeconomic parameters since fiscal 2015 and foreign exchange reserves at $412 billion, India is today outside the group. Eight out of 11 emerging market currencies analyzed have depreciated against the dollar this year. The rupee has been the fifth-worst performing currency.

Net-net, while risks have risen, India looks better prepared compared with both its own past and other emerging markets.

| Money and Banking | Industrial Production | Inflation |
|---|---|---|
| Pre-emptive strike | IIP logs a rebound | Inflation further up on higher fuel and core |

MONEY AND BANKING

- Pre-empting simmering crude prices and a wobbly rupee from having a deeper inflationary impact, the Reserve Bank of India (RBI) raised the policy rate after a four-and-a-half-year gap
- After maintaining the status quo since the last cut in August 2017, the Monetary Policy Committee hiked rates by 25 basis points (bps)
- With this, the repo rate stands at 6.25%, the reverse repo at 6%, and the marginal standing facility rate at 6.5%
- Liquidity in the banking system was fairly in surplus mode in May, although there was some reduction from April. Despite surplus liquidity conditions, market interest rates have continued to flare up
- The double-digit run-up in banking credit continued, with growth printing at 12.1% in May. However, it is still not broad-based and industrial credit growth remains anemic
- Deposits growth has, however, slowed down to 7.1% as on May 11, as the impact of demonetization wears off
- CRISIL believes there is a possibility of another rate hike if crude prices stay at current levels

INDUSTRIAL PRODUCTION

- After sudden deceleration in March, the Index of Industrial Production (IIP) grew 4.9% on-year in April, marginally up from 4.6% in March, supported by a low base
- Growth in April was supported by manufacturing, which rose 5.2% (compared with 4.7% in March) and a 5.1% growth (3.1% in March) in mining
- Output of India's eight major industries supported overall IIP growth, accelerating to 4.7% in April from 4.4% in March
- Electricity sector growth, on the other hand, slowed down to 2.1% from 5.9%
- According to the use-based classification, capital goods sector registered the highest growth at 13.0%, though mostly helped by a weak base

INFLATION

- Consumer Price Index (CPI)-based inflation marched higher to 4.9% in May from 4.6% in April
- Fuel was the main driver of overall inflation, jumping up over 100 bps, while core inflation, which had added to the central bank's woes last month, crept 20 bps north, nearly touching 6%
- The pick-up was also led by food inflation, which rose 30 bps after having declined for 4 months in a row
- Wholesale Price Index (WPI)-based inflation jumped to 4.4% in May, from 3.2% in April, the highest level in 14 months. Fuel inflation was the main driver, while similar to the trend in CPI, core WPI inflation also crept higher
- CRISIL expects inflationary conditions to firm up going forward. With improving domestic demand conditions, manufacturers will pass on higher input costs to consumers, which will show up in core inflation

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| Interest Rate | Rupee | Trade |
|---|---|---|
| Yields surge as players dump bonds | Oil slick, rising dollar trips rupee | Oil greases trade growth numbers |

INTEREST RATE

- The market was uncomfortably hot for debt investors in the month of May, with yields touching a multi-year high of 7.9%
- Yield on the 10-year government security (G-sec) ended May at 7.83%, up 6 bps from April-end
- Lack of demand for bonds, both by foreign as well as domestic players, and expectation of a rate hike by the RBI owing to increasing inflationary pressures, continued to put upward pressure on yields
- Other factors such as rising oil prices, which can have inflationary and fiscal implications for the government, are also pushing yields up
- With a delayed fiscal consolidation glide path, rising oil prices (which lead to inflationary pressures), and tightening liquidity, yields on the 10-year G-sec continue to remain under pressure
- CRISIL expects the 10-year G-sec yield to settle at 7.6-7.7% by March 2019, compared with 7.62% in March 2018

RUPEE

- Rupee averaged 67.5 per dollar in May, 2.9% weaker on-month and 4.8% weaker on-year
- Rapid rise in oil prices, massive foreign capital outflow and an appreciation in dollar are the main reasons behind the weakness
- Rising CAD, coupled with the fact that capital inflows needed to finance the gap are declining, is exerting pressure on the rupee
- Currencies of other emerging and advanced economies also suffered owing to the dollar's gain
- CRISIL expects the rupee to weaken to 66.5 per dollar by March 2019 from 65 in March 2018
- Foreign capital inflows also face risks from a further reduction in global liquidity and any escalation in geopolitical risks

TRADE

- Merchandise export growth shot up to 20.2% on-year in May compared with 5.2% in April. Imports grew at a slower 14.8%, though significantly higher than 4.6% in April
- The revival was largely due to the 'oil effect' – as oil exports doubled on-year, and imports grew 49.5% due to a sharp rise in prices. Excluding oil, too, growth in exports was higher than imports
- Despite relatively slower imports, trade deficit widened $780 million on-year to $14.6 billion. It must be noted that growth in imports was over a high base of 33.8% in May last fiscal
- CRISIL expects trade deficit to widen further this fiscal as the sharp rise in oil prices poses significant upside risks for imports
- Due to a wider merchandise trade deficit, we expect India's CAD to widen to 2.5% of GDP in fiscal 2019 from 1.9% of GDP in fiscal 2018

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