Global Research & Analytics

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INDIAN ECONOMY

CRISIL Insights

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Through the monthly CRISIL Insights Indian Economy series, we offer incisive analysis of macroeconomic parameters of the country. In this issue, we take a closer look at the countries, commodities, and factors contributing to the widening of the trade deficit

On the blink - Signal turning amber on trade

After a benign few years, India's twin-deficit challenge appears to be re-surfacing. The fiscal deficit slipped by 30 basis points (bps) from the budget target in current fiscal year, and the current account deficit (CAD) is on an upward trajectory. Though not a cause for alarm as yet, it does warrant close monitoring.

India's CAD is s expected to be 1.9% of gross domestic product (GDP) in fiscal 2018, up from 0.7% in fiscal 2017 and 1.2% in fiscal 2016. We estimate CAD at 2.5% of GDP in fiscal 2019 - the upper bound of the perceived safe limit.

The global environment has been a mixed blessing. Global growth and trade have revived but so have oil prices. Additionally, the protectionist winds threaten to blow away trade recovery. Among India's top export markets, the United States (US), Germany, and the United Kingdom (UK) have the highest number of restrictive policies that affect India. India too has responded by raising import tariffs on a few items.

Crude oil price increase, clearly, is one of the key factors behind rising CAD as the bulk of our demand is met via imports. We estimate that a $10 rise in crude oil prices could push up CAD/GDP by 60 bps. But, the reasons for our rising external imbalance extend beyond oil and protectionism.

- Shrinking trade surplus with India's major export destinations, including the European Union, the US (which are currently witnessing a strong cyclical upturn), and the United Arab Emirates, has contributed to the widening trade deficit. Part of the reason for this is demonetisation-related transitory disruption and Goods and Services Tax (GST)-related glitches faced by exporters.
- The rupee has appreciated against major trading partners in real terms. Although exchange rate is not a dominant determinant of trade, its appreciation encourages imports and discourages exports.
- In fiscal 2018, private consumption slowed yet imports rose sharply. Also, import growth was broad-based, with all these categories witnessing an acceleration. The proximate reasons for this are domestic production disruptions amid slowing consumption and GDP growth. In electronic items which are witnessing a sharp increase in domestic demand are largely imported.
- Agricultural trade surplus has shrunk from $20 billion in fiscal 2014 to below $5 billion in fiscal 2018. Collapse of demand and prices in crops such as guar gum and cereals tamped down agricultural trade surplus.
- As pointed out in our earlier studies, India is losing out to more competitive markets such as Bangladesh and Vietnam in garments exports.

Some of the above constraints to trade are transitory in nature, the others such as falling competitiveness are structural and will require concerted policy effort.

Money and Banking	Industrial Production	Inflation
Rates claw up on liquidity crimp, fiscal fret	Strong start for IIP in 2018	Inflation down on lower food

MONEY AND BANKING

- The Reserve Bank of India's (RBI), Monetary Policy Committee (MPC) maintained its neutral monetary policy stance in February, but flagged the inflation trajectory, which has risen of late
- Liquidity in the banking system, surplus since demonetization, is gradually moving towards neutrality, pushing up market rates
- System liquidity entered the deficit zone on an average basis in February, requiring the RBI to infuse funds; higher currency in circulation, an increase in bank credit growth, and a sharp rise in the government's cash balances constrained liquidity into the deficit territory
- Credit growth rose to 10.7% as of mid-February 2018, up from 4.4% a year ago
- CRISIL Research expects the repo rate to remain unchanged over the next six months unless significant upside risks to the MPC's inflation forecast materialize
- We forecast banking credit will grow 9-10% in fiscal 2019, supported by improving domestic demand conditions and higher capital inflow into public sector banks, which will create room to push credit. Deposits will likely increase 6-7%

INDUSTRIAL PRODUCTION

- Industrial activity improved for the third consecutive month in January. Index of Industrial Production (IIP) growth stood at 7.5% on-year in January compared with 7.1% growth in December
- Manufacturing sector (the largest contributor to IIP) was once again the key contributor to this growth. It grew 8.7% in January, versus 8.5% in December
- This signals that the industry is bouncing back from GST-related glitches and could be on track to reap the benefits of domestic and global growth recovery
- Electricity growth was also impressive at 7.6% (4.4%)
- According to the use-based classification, infrastructure and construction goods displayed strong buoyancy, growing by a healthy 6.8%

INFLATION

- Consumer Price Index (CPI)-based inflation slid to 4.4% in February from 5.1% in January, marking the second consecutive month of decline
- Food inflation fell nearly 150 bps on-month, while core inflation was flat
- Inflation in housing – the category that had rapidly been pushing up core inflation for the last 7-8 months – was stable at a high 8.3% for the month
- In this fiscal to date, CPI inflation averaged at 3.5%, a sharp slide from 4.6% for the same period in fiscal 2017. Most of the fall in inflation is on account of lower food and core inflation
- Wholesale Price Index (WPI)-based inflation eased for the third straight month in February, dropping to 2.5% from 2.8%
- We expect CPI inflation to perk up to ~4.6% next fiscal. The pick-up will be due to rising consumption demand, impact of house rent allowance revisions on housing inflation, and higher global crude oil prices

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Interest Rate	Rupee	Trade
Yields continue northward march	Rupee slips on domestic and global cues	Recovery in exports drops pace

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended February at 7.73%, up 30 bps on-month
- Yields edged higher on inflation and fiscal slippage concerns, amidst tightening liquidity and lower demand from banks
- Corporate bond yields rose in tandem, with yield on the 10-year paper moving up 39 bps on-month to 8.25% by February-end
- CRISIL expects the 10-year G-sec yield to settle at 7.6-7.7% by March 2019

RUPEE

- Rupee executed a U-turn in February, tumbling 1.2% on-month in February to 64.4 per dollar
- The very factors buoying the currency in the previous three months – weakening dollar and net capital inflows by foreign portfolio investors – reversed their course, as the Indian economy faced adverse domestic and global headwinds
- The rupee will face pressure from the CAD, which has begun to widen with rising oil and commodity prices and improving domestic consumption demand
- Foreign capital inflows, needed to finance the CAD, face risks from tighter global liquidity (due to the US Fed withdrawing the quantitative easing program) and unfavorable global financial developments (such as correction in global stock markets and rise in US treasury yields)
- The US dollar, whose weakness was a major factor behind the rupee's appreciation in fiscal 2018, can strengthen with Fed rate hikes, continued rise in US treasury yields, and improved economic growth
- Due to these factors, CRISIL expects the rupee to weaken to 66.5 per dollar by next fiscal-end from ~65 by this fiscal-end

TRADE

- Merchandise export growth halved to 4.5% on-year in February from 9.1% in January, marking the third straight month of falling export growth
- Imports still outpaced exports, but slowed significantly to 10.4% from 26.1%. Consequently, trade deficit narrowed to $12 billion from $16.3 billion. But it's still $2.5 billion higher on-year
- In fiscal 2018 so far (April 2017 - February 2018), merchandise trade deficit widened to $51 billion compared with the corresponding period in the previous fiscal. Imports have grown an average 23% on-year, more than twice the 10.6% growth in exports
- While strengthening global growth is expected to support export growth in the near term, persisting glitches in GST can weaken the recovery. However, import growth will stay robust owing to rising oil prices and improving domestic consumption demand
- Owing to a wider merchandise trade deficit, CRISIL expects the CAD to widen to 2.5% of GDP in fiscal 2019 from an estimated 1.9% this fiscal

Source: CRISIL Research

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