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 focus on the role of capital productivity, defined by ICOR.

Parsing productivity

What do trends in efficiency of investment portend for future growth?

Investment freeze has remained a stubborn bugbear in India's current growth downturn. But, an equally important – yet less scrutinized factor is – the productivity of investment. Growth can come from an increase in investment. Or, it can come from ratcheting up its productivity. The incremental capital output ratio (ICOR)[1] is a crude but useful measure that explains the relationship between fixed investment and growth over periods of time. As a rule, ICOR is not to be assessed annually. This is because the ratio is prone to a high degree of volatility. Besides, a lumpy investment in a given year is unlikely to yield growth in the same year, making it look less productive. Therefore, we look at the average ICOR over a five-year period.

Efficiency of fixed capital investment as measured by ICOR saw a sustained improvement over the last decade. It declined to average 4.5 in fiscals 2015-2019 from 5.5 in fiscals 2010-2014, implying incremental growth exceeded incremental investment. In short, capital productivity improved. This can be explained by two factors:

- **Benefits of previous investments:** This accompanied moderation in fixed investment growth and pick-up in gross domestic product (GDP) growth, supported by a consumption impulse. The sharp surge in growth led to over-investment in the post Global Financial Crisis period. As growth slowed, capacities remained unutilized, and ICOR stayed high during the second term of the United Progressive Alliance government. But, as demand picked up (reflected in sharp and sustained rise in private consumption demand), capacity utilization improved, leading to a fall in ICOR.
- **Investment in low gestation period projects in the past five years:** Within fixed investment, there is a clear shift from lumpy investments to those with faster turnaround time in returns and growth. This was seen in sectors such as auto, among industrial sectors. Within infrastructure, faster investment growth was seen in sectors such as urban infrastructure and roads, backed by government's policy orientation.

Going forward, the impact of investments made over the last few years in infrastructure, especially roads, highways, metro, and other transport sectors, is likely to start yielding returns and improve the efficiency of invested capital. An overall improvement in the ease of doing business is possible if systemic reforms initiated, such as implementation of the Goods and Services Tax and the Insolvency and Bankruptcy Code, are pursued.

[1]Measured by fixed investment required to produce an additional unit of output. As per the Harrod-Domar model, the analysis of ICOR assumes no diminishing return to capital, no lag between investment and production and full capacity utilization - which overlook the rigidities and flexibilities of the real world. However, there still exists merit in evaluating this ratio, which indicates efficiency of investment in the economy.

Global Research & Analytics

Money and Banking	Industrial Production	Inflation
Liquidity in surplus	Slip before mild uptick	Northward march

MONEY AND BANKING

- Interest rates, both at the short and long end of the curve, moved down after the Reserve Bank of India (RBI) announced an accommodative stance
- CRISIL Research expects the twin impacts of past rate cuts and the change in monetary policy stance to catalyze monetary policy transmission
- Liquidity turned surplus in June - for the first time since October 2018 – as currency in circulation was stable and the RBI upped open market operation purchases
- Scheduled commercial banks continued to post double-digit growth, albeit the pace slowed a bit with credit growth of 12% as on June 28, compared with 12.7% in May-end
- CRISIL Research expects banking credit to grow 13-14% this fiscal, compared with ~12.2% in fiscal 2019 and ~7.4% in fiscal 2018, driven by strong retail credit growth, higher disbursements to NBFCs, and resolution of big-ticket stressed assets
- Deposit growth is expected to be 11-12%, partly due to higher share in subscriptions to debt issuances versus mutual funds

INDUSTRIAL PRODUCTION

- Index of Industrial Production (IIP) slipped a notch in May at 3.1%, compared with 4.3% in April. The deceleration was led by mining and manufacturing, even as electricity held its turf
- As per use-based classification, almost all categories other than consumer non-durables saw slower growth
- Growth in core infrastructure sector output also slowed in May, led by coal, crude oil and refinery products, while sectors such as steel, cement and electricity lent support
- Despite slower growth, the average for the fiscal stands at 3.7%, hinting at a possible mild recovery in growth
- The pick-up, if sustained, bodes well for the manufacturing sector, which has been grappling with large capacity overhangs and sub-optimal utilization due to subdued demand
- The second half of fiscal 2020 is expected to see some improvement, supported by softer interest rates, some pick-up in rural demand led by normal monsoon and the government's minimum income support scheme (PM-Kisan). While government spending is gradually taking a backseat, capacity utilization may improve with the expected consumption pick-up

INFLATION

- Consumer Price Index (CPI)-linked inflation rose for the fifth consecutive month in June to 3.18%, up 13 basis points (bps) from 3.05% in May. It remains comfortably below the RBI's medium-term target of 4%
- Food inflation continued to climb up, and even core inflation firmed up after slowing down in the previous three months
- Wholesale Price Index (WPI)-based inflation declined sharply to 2.02% in June – down from 2.45% in May – lowest in 23 months. The decline was broad-based and was led by fuel inflation which turned negative, for the first time since October 2016
- Thus, not only does CPI inflation remain benign, but also the WPI inflation continues to edge down. Together, these indicate low inflationary pressures in the economy
- CRISIL forecasts CPI inflation to average 3.8% in fiscal 2020, up from 3.4% last fiscal

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Interest Rate	Rupee	Trade
Yields on skid row	Mild clawback	Pervasive decline in trade

INTEREST RATE

- Yield on the 10-year government security (G-sec) averaged 6.94% in June, 35 basis points lower on-month and 95 bps lower on-year. The RBI's third straight rate cut, along with a rise in its open market purchases of G-secs, softened yields
- The RBI ramped up its open market purchases of G-secs to Rs 275.1 billion in June compared with Rs 250 billion in the previous month
- Lower crude oil prices and interest rates in the United States (US) lent further support
- Consequently, foreign portfolio investor (FPI) inflows to the debt market rose to $1.2 billion (net) in June compared with $0.2 billion in the previous month
- CRISIL expects the 10-year G-sec yield to settle at 7-7.3% by the end of the fiscal compared with 7.5% in fiscal 2019-end

RUPEE

- Rupee averaged 69.4/$ in June, gaining 0.5% on-month. Modest FPI and weakness in the US dollar amid dovish US Fed stance aided the rupee
- The dollar index fell 0.4% on-month as investors exited the US bond market amid anticipation of a Fed rate cut
- In the emerging market economies, most currencies appreciated against the weaker greenback
- Softening of crude oil prices to a 4-month low is also likely to have supported the rupee
- In the first quarter of fiscal 2019, rupee depreciated 3.8% compared to the same quarter a year ago, mostly on the back of a stronger dollar
- Rupee is expected to weaken in fiscal 2020 as risks from higher current account deficit (CAD), volatile oil prices and tariff war mounts, but anticipated Fed rate cut will check further depreciation
- CRISIL expects the rupee to average 71/$ by March 2020, compared with 69.5/$ in March 2019

TRADE

- Both exports and imports saw a broad-based decline. Trade deficit stood at $15.3 billion, $80 million lower on-month and $1.3 billion lower on-year
- Merchandise exports declined 9.7% on-year in June, after growing 3.9% previous month
- Imports also declined 9.1% compared with 4.3% growth in May
- While decline in exports is a fallout of slowing global trade and GDP growth, imports are weakening due to subdued domestic demand
- Risks to export growth are materializing as escalating trade tension between US and China is hurting global trade and investment flows. While trade diversion of goods hit by US-China tariffs can boost export by India, sustaining growth in those sectors will require improved competitiveness
- Meanwhile, falling core imports have capped the rise in CAD. That said, India remains vulnerable to a sharp rise in oil prices, whose movement has been quite volatile of late
- CRISIL expects India's CAD to average 2.2% of GDP in fiscal 2020 compared with 2.1% of GDP in fiscal 2019

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