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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. we focus on how inflation will increasingly influence India's monetary policy landscape

Pricking the inflation balloon

The Reserve Bank of India (RBI) has succeeded in restraining inflation in the comfort zone over the past four years. As a result, consumer price index-linked (CPI) inflation averaged 4.6% in the first 11 months of this fiscal. Inflation declined sharply following demonetisation. But this has failed to satisfy the RBI. Not only did it stay pat on rates in its February monetary policy review meeting, but it also changed the policy guidance to 'neutral' from 'accommodative'. In February, CPI inflation rose to 3.7% on the back of higher food and fuel inflation, while core inflation stayed sticky around 5%, further deepening RBI's concerns.

We estimate inflation will rise to 5% on average in fiscal 2018. While this is still within the (4 ± 2)% range set by the government, it is higher than the 4% central value that the RBI is targeting over the medium run. Inflation could very well rise as there is an expected upside from fuel inflation even as core inflation remains stubborn despite weak domestic demand/excess capacity.

Typically, the most straightforward policy approach to lower inflation is to adopt a tighter monetary policy supplemented by a tight fiscal policy, which calls for fiscal-monetary coordination. Such coordination is lacking in some ways. Since 2015, the monetary policy has been easing (repo rate was cut by 175 basis points or bps), while the fiscal policy was tightening (fiscal deficit was reduced from over 4% of GDP in fiscal 2014 to 3.5% this fiscal). Close coordination between fiscal and monetary policy is critical to maintain financial stability, the absence of which can lead to higher-than-desired interest rates, pressures on exchange rates, and rising inflation, all of which can impact growth and the effectiveness of the policies.

Thus, we believe the monetary-fiscal policy mix will have to adjust such that both become tighter to control inflation. But fiscal policy will have to assume a bigger role – consolidation will have to be accompanied by significant reorientation of spending towards agriculture, health, education, and infrastructure where supply constraints are worrying and are the real reason for stubborn inflation. A tighter monetary policy will not be able to hold back demand for long in these sectors.

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Monetary Policy	Industrial Production	Inflation	Interest Rate
Now to speed up interest rate transmission	IIP climbs despite DeMo, though still weak	Inflation bumps up on higher fuel and food inflation; core stays sticky	Yields lift-off on Mint Road stance switch

MONETARY POLICY

- The Monetary Policy Committee on February 8 kept the policy repo rate unchanged at 6.25%, and moved its stance from 'accommodative' to 'neutral'. That could very well mark the end of the current rate cut cycle, which began in January 2015 – at least in the near term
- A 'neutral' stance gives the RBI the flexibility to move in either direction of the interest rate cycle as macro conditions permit. The shift reflects the central bank's decision to exert caution on the inflation front in its journey towards the medium-term inflation target of 4%
- Focus hereon will be on interest rate transmission, which has been swift in the bond market, but sluggish in bank lending rates
- Liquidity in the banking system surges as the deadline for exchange / deposit of old bank notes approaches

INDUSTRIAL PRODUCTION

- Index of Industrial Production (IIP) expanded 2.7% on-year in January, after contracting by 0.1% (estimated earlier at 0.4%) in December
- According to the use-based classification, basic goods led the IIP growth, rising 5.3% in January. There was some contribution by capital goods, too, which grew 10.7%
- The growth, however, is also in part due to a favourable base effect as industrial activity had declined 1.6% in the same month last year
- Cumulatively, IIP has grown a meagre 0.6% during April 2016-January 2017, compared with 2.7% in the year-ago period

INFLATION

- In February, both the measures of inflation - wholesale price inflation (WPI) and consumer price inflation (CPI) - shot up by 130 basis points (bps) and 50 bps respectively over the January number. Higher food and fuel inflation were to blame
- Food inflation bumped up as it shed off its base effect, while fuel inflation rose on the back of higher global oil prices and a weaker rupee
- But a sticky core is at the helm of the RBI concerns as persistent stickiness in core can keep overall inflation from falling further. The RBI's medium term inflation target is set at 4%

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended February at 6.87%, up 46 bps on-month
- In its third monetary policy review meeting since its formation in September 2016, the Monetary Policy Committee on February 8 stayed put on rates. This was despite excess liquidity in the system and contrary to the consensus expectation of a policy rate cut.
- The RBI's unexpected move to hold policy rates and change in its monetary policy stance from 'accommodative' to 'neutral' led yields to shoot up
- CRISIL expects the 10-year G-sec yield to settle around 6.8% by March-end 2017 and rise modestly to settle around 6.9% by the end of fiscal 2018

Rupee

Rupee rallies as FIIs go shopping

Trade

Global tailwinds nudge India's export recovery

RUPEE

- After four months of shying away from India's shores, foreign institutional investors (FIIs) returned with $2.4 billion net inflows in February, pumping in $1.5 billion in equities and $0.9 billion in debt
- Rupee gained an average 1.5% on-month in February on favourable domestic and global cues
- The government's fiscal deficit target – 3.5% of gross domestic product in fiscal 2017 and 3.2% in the next – set in last month's budget, encouraged market players
- In addition, the RBI refrained from cutting the repo rate in February and changed its policy stance from "accommodative" to "neutral". The prudent fiscal and monetary outlook coupled with slowing inflation and steady growth improved investor sentiment
- Resurgent capital inflows by foreign portfolio investors strengthened the rupee even as weakness in the dollar helped the Indian currency. The dollar index, measuring the currency's value against a basket of the currencies of six major trading partners, fell an average 1.5% on-month
- Other emerging market currencies also rose against the dollar

TRADE

- Exports grew 17.5% in February, the first double-digit growth since 2014. Although a weak base effect helped, exports were still 11.4%2 higher than in January, reflecting the effect of a strengthening global economy on India's merchandise trade
- On the other side, imports climbed 21.8% on-year in February, fuelled by oil and gold. An upswing in domestic consumption demand post demonetisation helped drive up import growth. Core imports (consumption goods excluding oil and gold) also grew at a robust 14.2%
- However, investment goods' imports declined 24.8%, which reflects the continued lack of investment appetite in the economy
- In fiscal 2017 so far, exports have grown 2.9%, while imports have fallen 2.2%. With the narrowing trade deficit, we expect current account deficit (CAD) to reduce to 0.9% of GDP in fiscal 2017, from 1.1% in previous fiscal
- Further improvement in the next fiscal will depend on sustained growth in global demand. Economic conditions in US and Europe (India's largest export markets) have perked up. However, there is a risk of growing trade protectionism in these economies. On the other side, continued buoyancy in oil prices is likely to widen the trade deficit, through higher import growth. Owing to these factors, we expect CAD to widen to 1.3% of GDP in fiscal 2018

Source: CRISIL Research

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CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com

/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited

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