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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 try to find out the possible impact of three global developments, viz. rising oil price, monetary policy normalization, and trade wars, on the Indian economy

This time, it's complex

The Indian economy is facing headwinds arising from the emerging global geopolitical and economic scenario. Oil, end of quantitative easing, and trade wars are the three perils that the world faces. While crude oil price surge is the least complex of the shocks, the other two shocks – monetary policy normalisation in most of the advanced economies and intensification of trade wars – take us to unchartered territory.

Elevated crude oil prices are has the most perceptible impact on current account deficit (CAD) and inflation. However, crude prices are expected to ease in 2019 on easing global demand and structural shift to non-conventional fuel alternatives, suggesting that its impact will be transitionary, unless oil prices stay elevated longer than expected, in which case the pressure on inflation and fiscal deficit can mount.

The retreat of the central banks of advanced economies – the United States (US) Fed and European Central Bank (ECB) from unconventional monetary policies can impact emerging markets such as India through interest rate changes and currency exchange rates. Research shows that US interest rate hikes plus quantitative tightening will have a greater impact on global financial conditions than the actions of the ECB and the Bank of Japan. Therefore, a faster-than-expected catch-up in inflation in the US can result in impulsive tightening, which would roil emerging markets.

Trade wars are intensifying and getting more complex. While US tariff walls with other economies are rising and facing retaliatory action, within Asia there has been an attempt to lower them for each other. The endgame of trade wars is hard to fathom, but they certainly have injected uncertainty into global policy direction and their impact will play out via trade, investment, supply chain disruption, and the confidence channel. The tariffs imposed by the US so far impact 5.7% of India's total exports to the country. The impact of the tariffs imposed thus far is rather limited with the tariffs on these commodities collectively working out to ~0.02% of India's gross domestic product (GDP) and 1.2% of India's CAD.

Money and Banking	Industrial Production	Inflation
The rate cycle reverses	Failing to hold momentum	Travelling further north, driven by fuel and core

MONEY AND BANKING

- Rising core and fuel inflation and weakening rupee forced the Reserve Bank of India (RBI) to raise its policy (repo) rate by 25 basis points (bps) on June 6, for the first time in 54 months. With this, the repo rate stands at 6.25%, the reverse repo at 6%, and the marginal standing facility rate at 6.5%
- Liquidity remains in surplus on the whole, albeit with some asymmetry
- While long-term interest rates continue to firm up, shorter end of the curve saw some easing
- In June, as per Basel-III requirements, the RBI increased the carve-out of the liquidity coverage ratio (LCR) from the statutory liquidity ratio (SLR) by two percentage of the net demand and time liabilities. This takes the total carve-out from the SLR to 13%
- CRISIL believes there is a possibility of another rate hike in the next monetary policy in August

INDUSTRIAL PRODUCTION

- The Index of Industrial Production (IIP) staged a steep drop from 4.8% in April to 3.2% in May
- IIP was dragged down by the manufacturing sector, where growth slipped to 2.8% from 5.3%
- Growth in IIP had picked up in April, but failed to hold momentum despite higher growth in mining and electricity sectors
- The core infrastructure index (comprising indices for coal, crude oil, natural gas, refinery products, fertilizers, steel, cement and electricity) also moderated to 3.6% growth in May, from 4.6% in April
- According to the use-based classification, all except primary goods saw growth decelerate
- Data for the first two months of Q1 fiscal 2019 suggest that industrial growth (at an average 4%) is somewhat higher than last year's Q1 (3% average for the corresponding period), but slower than Q4 fiscal 2018 (6.3% average)
- Going forward, some improvement in rural demand backed by normal monsoon, pick-up in exports and positive spillover of pay commission revision on overall consumption demand, will crank up industrial growth

INFLATION

- Consumer Price Index (CPI)-based inflation rose another 10 bps to 5% in June compared with May, which is more than thrice the 1.5% seen in the same month last year
- Though food inflation decelerated, what took the number higher was firming up of fuel and core inflation.
- Fuel inflation jumped to 8.5% in June, from 6.9% in May, amidst rising crude oil prices, while core inflation surged 10 bps to 6%
- Core inflation (CPI excluding food, fuel and light, petrol and diesel) rose to 6.0% in June, from 5.9% in May
- Wholesale Price Index (WPI)-based inflation jumped 140 bps to 5.8% from 4.4%, the highest level in 54 months. The surge is worrying because it's becoming broad-based
- CRISIL expects CPI inflation to perk up to 4.7% in fiscal 2019 from 3.6% a year before

Interest Rate	Rupee	Trade
Yields continue ascent on rate hike, tighter liquidity	Skidding for the fifth month as risk-off reigns	Trade deficit widens despite robust exports

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended June at 7.90%, 7 bps higher on-month
- The primary factors for the rise were the RBI rate hike dampening demand for bonds from banks and somewhat tighter domestic liquidity conditions
- 1- and 3-year G-sec yields have seen a sharper rise compared with the start of the year. This has flattened the yield curve slightly
- Moderation in crude oil prices and the RBI's open market operations curbed further rise in yields
- The US Federal Reserve's rate hike and tapering by the ECB also led to an anticipation of tighter financial conditions globally, causing foreign capital to flee
- CRISIL expects the 10-year G-Sec to remain under pressure and average at 7.7% by March 2019 compared with 7.62% in March 2018

RUPEE

- The rupee weakened against the dollar for the fifth consecutive month in June, and averaged 67.8
- A strengthening dollar and concerns about India's worsening current account balance weighed on the local currency
- Foreign portfolio investors fled to safe haven dollar assets as the trade spat between the US and its major trading partners, especially China, intensified
- The rupee will face pressure from CAD, which is steadily widening owing to rising oil and commodity prices and improving domestic consumption demand
- CRISIL expects the rupee to weaken to average 67 per dollar by March 2019 from 65 per dollar in March 2018

TRADE

- Merchandise exports grew in double digits for the second month on the trot in June, at 17.6% on-year, after 20.2% in May
- Import growth outpaced export growth, fueled by crude oil imports
- Trade deficit expanded to $16.6 billion, compared with $14.6 billion in May and $13 billion in June last year
- Services exports grew in double digits, 20.4%, for the tenth month in May
- Oil imports grew 56.6% in the month, with Brent crude oil prices averaging $74.4 per barrel, 60.5% higher on-year. Non-oil imports also gained pace, growing 11.2% in June compared with 6% the previous month
- CRISIL expects wider merchandise trade deficit to push CAD to 2.6% of GDP in fiscal 2019 from 1.9% of GDP in fiscal 2018. This will be driven by high import growth due to higher oil prices – expected to average $70-72 per barrel in 2018 compared with $54 per barrel the previous year
- While global recovery is expected to continue in 2018, escalation in trade wars can weaken the trade intensity of global growth – and that's a negative for India's export prospects

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