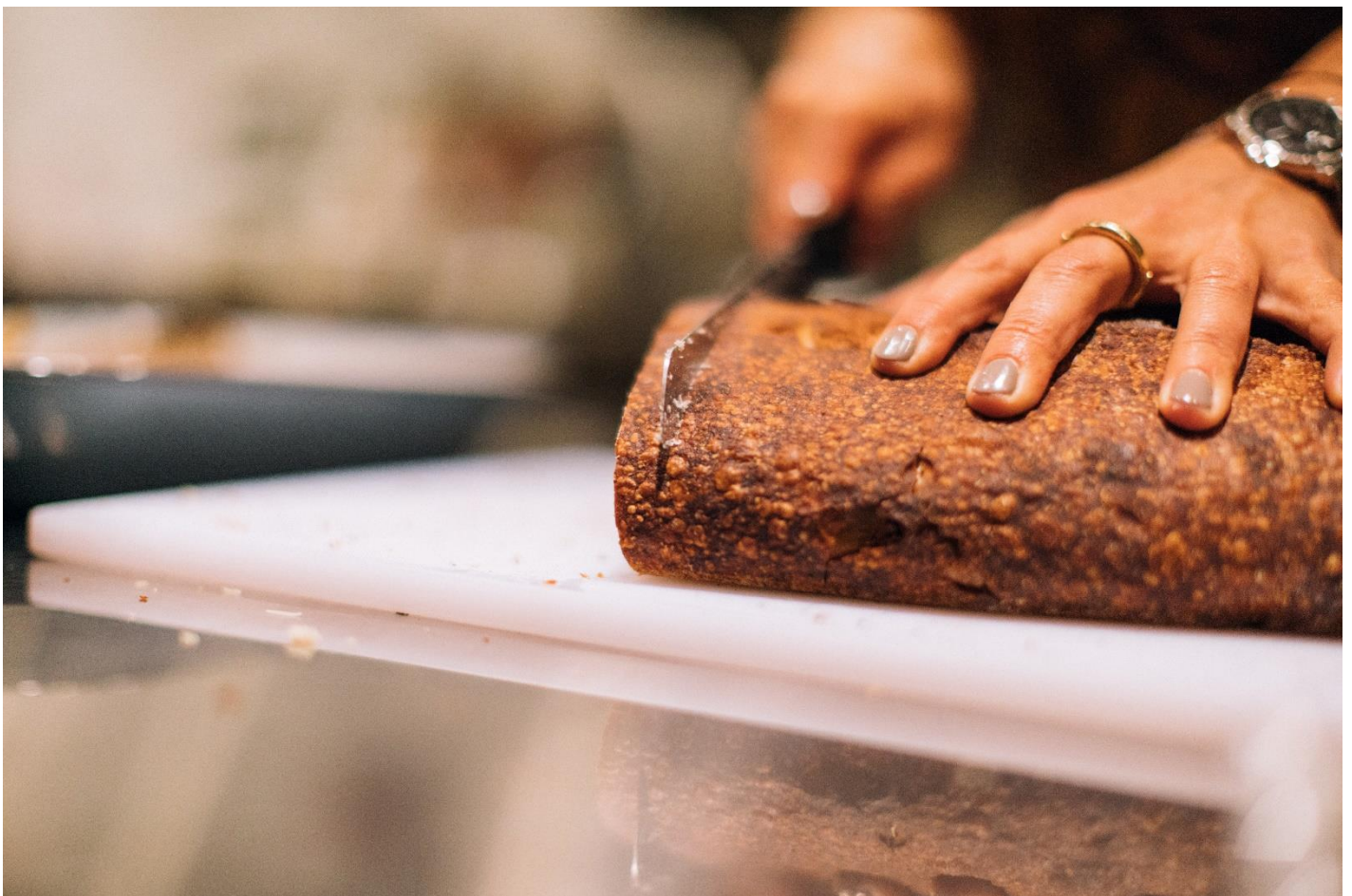


# Trimming India GDP forecast by 10 bps

Downward bias from forecasts of lower global trade and growth

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## India will still grow faster than the trend rate

For fiscal 2019, we are lowering our GDP growth forecast by 10 basis points (bps) to 7.4% from 7.5% estimated earlier. Forecasts of lower global trade and GDP growth has created a downward bias to growth in emerging economies.

Globally, growth started losing steam earlier this year with second-quarter GDP data for most economies coming below consensus and also lower than the first quarter. Amid escalating trade wars, rising input costs from rising oil and commodity prices also were a drag on growth.

With this in sight, the International Monetary Fund (IMF) revised down its global GDP growth estimate to 3.7% in 2018 from 3.9% earlier. The global trade growth estimate was pulled down to 4.2% for 2018 from 4.8%. The growth forecast for emerging economies was revised down to 4.7% from 4.9%.

As the trade intensity of growth declines, India's exports, which saw a revival in early part of 2018, could likely see slower growth. The upturn so far in exports was being led by a low base, easing of constraints posed by GST implementation and lingering impact of global trade revival in 2017.

Despite the downward revision, at 7.4%, India's growth in fiscal 2019 will be faster than both, the 6.7% seen in fiscal 2018 and the trend rate of growth. The long-term average growth rate seen in the last thirteen years – as per the recently released GDP back series data – is 6.9% (*see box for further details on the back series*).

For the rest of this fiscal, growth will find support from private consumption, driven by continued government spending on construction activities (rural roads, affordable housing and MGNREGS projects), benign inflation, and revision in government salaries at the state level. In addition, there is a weak-base effect in play.

Despite some pick-up in capacity utilisation rates for a few sectors such as auto, cement and steel, private investment has remained sluggish with most corporates preferring to deleverage rather than take up hefty investments. Investment growth, therefore, is only firing on one cylinder – government spending – through the public sector, and higher capital spending by states.

The forecast has a downward bias given that global growth prospects are turning weaker than estimated earlier. Also, if liquidity issues persist in the financial system, demand could get further dented.

### Drivers of growth

	Q4FY18	Q1FY19	Q2FY19
GDP	7.7	8.2	7.1
Private consumption	6.7	8.6	7.0
Government consumption	16.9	7.6	12.7
Investment	14.4	10.0	12.5
Exports	3.6	12.7	13.4
Imports	10.9	12.5	25.6

## What Q2 GDP data tells us

GDP growth in Q2 slipped to 7.1% from 8.2% in Q1. While slowdown in private consumption was the big drag, investment growth accelerated. Government spending also grew faster, as did exports, but the gains were offset by a sharp surge in imports.

The worry, though, is the slowdown in private consumption. Most of the demand pick-up this year was expected to come from rural consumers as they benefited from improved farm incomes (due to good monsoons and higher MSP) and non-farm incomes (due to government spending on construction activity).

But data suggests some strain. Agriculture growth slowed in Q2 compared with Q1, though it is still growing above trend. But alarm bells are ringing on farmer income. Nominal growth in agriculture GDP fell to 2.8% in Q2, which is lower than the real growth rate of 3.8%, indicating a fall in farmer realisations. Meanwhile, construction growth also slowed in Q2, suggesting that non-farm incomes, too, are growing at a slower pace.

Meanwhile, tighter liquidity conditions in the non-bank space that may have hampered consumer demand could also be behind slower private consumption growth. Q2 saw investment growth accelerate to 12.5% in Q2 from 10% in Q1. The sharp pick-up in investments in first half (H1) of this fiscal comes on a low base, but is also likely to be helped by a mild pick-up in private investment as capacity utilisation rates rise in select sectors. Investment growth, therefore, largely continues to be driven by government spending. In Q2, government spending rose 12.7% compared with 7.6% in Q1.

Growth in exports was slightly higher at 13.4% in Q2 compared with 12.7% in Q1. In H1 this fiscal, overall export growth at 13.1% was much higher than 6.3% in H1 of last fiscal. But a sharp surge in imports has shaved off some of these gains. Imports rose 25.6% in Q2 compared with 12.5% in Q1.

For the second half of fiscal 2019, growth is expected to slow down further dragged by lower global trade and growth prospects that could hurt our exports.

## CPI inflation to average 4.6% in fiscal 2019

Consumer price index (CPI)-based inflation has remained below the Reserve Bank of India's (RBI) medium-term target of 4.0% in the last three months, reaching a 13-month low of 3.31% in October 2018. This is largely attributed to food inflation, which has been unusually subdued in the past few months, with the latest print being negative. This is surprising because it comes on a weak base of last year, when food prices fell after demonetisation. Since food has the highest weight (~40.0%) in CPI, low food inflation is compensating for high core and fuel inflation and keeping overall inflation low.

With mandi prices of most kharif crops trailing the announced higher minimum support prices (MSPs) and healthy output, food prices may continue to remain subdued. The sharp fall in international crude oil prices (Brent is currently ~\$60 per barrel, significantly lower than the \$80 seen in October) and cut in excise duties on fuel by the government would help in bringing down fuel inflation.

With global growth slower than expected – especially in China, the world's largest commodity importer – oil prices could be capped. Of course, geopolitical issues have the potential to alter this math. However, fuel inflation has a much lower weight in overall CPI inflation. With a downward revision in GDP growth, demand pressures on inflation will subside further, which means core inflation could soften going ahead. Accordingly, CRISIL has revised down its inflation call for fiscal 2019 by 20 bps to 4.6% from 4.8% earlier.

## 10-year G-sec yield to settle at 7.9% by March 2019

Benchmark yields have witnessed substantial volatility this fiscal. After crossing 8% for the first time in four years, yield on 10-year government security (G-sec) has fallen by more than 50 basis points from the peak reached in September, in tandem with movement in oil prices. The RBI's open market purchases, along with a cut in central government's market borrowing program for the rest of this fiscal, has further helped address excess supply of G-secs.

Nevertheless, risks of a sudden rise in oil prices on current account deficit and fiscal slippage persist, which could exert upward pressure on yields. In addition, tightening bias in monetary policy can push up yields. With a change in the RBI's policy stance from neutral to calibrated tightening, we believe it can hike the repo rate by another 25 bps this fiscal. Further, the US Federal Reserve is expected to raise its policy rate one more time in 2018 (making total four rate hikes in 2018), and thrice in 2019, according to S&P Global. With rising risks to global growth, the recent Fed minutes hinted at a slower pace of rate hikes which augurs well for government bond yields.

On balance, we expect the 10-year G-sec yield to settle at 7.9% by the end of fiscal 2019.

## CAD to average 2.6% of GDP

We expect the current account deficit (CAD) to widen to 2.6% of GDP in this fiscal from 1.9% of GDP in fiscal 2018, driven by a wider merchandise trade deficit. In this fiscal so far (April-October 2018), merchandise trade deficit has been \$113 billion, \$22 billion higher than in the same period last year due to faster growth in imports (17% average growth April-October 2018) compared with exports (13.6%). If the recent decline in oil prices sustains, import growth will soften, but growth in exports still faces headwinds from weaker global trade growth owing to escalating trade wars.

## 50% chance of 71/\$ by March 2019

The rupee has fallen sharply against the US dollar this fiscal, losing nearly 7.8% on-year fiscal so far (April to November), as global headwinds multiplied and the current account deficit (CAD) widened. Sharper foreign portfolio investment (FPI) outflow – around \$15 billion net-outflow fiscal so far – and strengthening dollar (8.4% appreciation in dollar index<sup>1</sup> seen between April and November) have also been weighing on the rupee.

However, the rupee has been showing signs of recovery during the last month. After hitting an all-time low of 74.4/\$ in October, the currency recovered sharply in November, averaging 71.9/\$. **We believe rupee to stay around this strengthened level and average 71/\$.** This is our base case, with 50% probability of occurrence. Easing crude oil prices, waivers on US sanctions for India's oil imports from Iran, and currency swap deal with Japan will continue to support to the rupee.

However, there is a 15% probability of the rupee settling at 74/\$, and a 35% probability of it appreciating to our previous forecast of 68.5/\$. Risks, which were tilted to the downside in October, have corrected somewhat after the steep fall in crude oil prices.

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<sup>1</sup> The dollar index (trade-weighted) measures the value of US dollar against a basket of currencies of its major trading partners

## The GDP back series saga

On November 28, 2018, India's Central Statistics Office (CSO) released the 'Back series: 2004-05 to 2011-12' of GDP with 2011-12 as the base year. This was a much-awaited data release since the new GDP series on the 2011-12 base was unveiled in January 2015. This now allows for meaningful study of historic growth rates under the new series. Currently, data goes back to 2004-05 but the CSO will also shortly release the entire historic series, perhaps dating back to the 1950s.

### What led to downward revision in GDP in the new series?

Broadly, for the overlapping years (fiscals 2006 to 2014), overall GDP growth is lower than the old series by an average 80 basis points. The highest that the GDP growth has touched as per this series is 8.5% in fiscal 2011 against 10.3% recorded by the old series. From the demand side, the new base series leads to significantly lower growth rates in private and government consumption, based on trends seen by newer sets of proxies.

From the supply side, growth in gross value added (GVA) is 100 bps lower in the new series compared with the old. Growth was estimated to be slightly lower in trade, hotels, transport and communication and about 430 bps lower in financing, insurance real estate and business services. Growth is estimated higher in community, social and personal services.

Comparing the two series for overlapping years also throws up some interesting results:

<b>Average growth (%)</b> <b>Fiscals 2006 to 2014</b>	<b>2011-12</b> <b>base year series</b>	<b>2004-05</b> <b>base year series</b>
<b>Real GDP</b>	<b>6.7</b>	<b>7.5</b>
<b>Demand-side components</b>		
Private consumption	6.2	7.7
Government consumption	6.8	7.7
Gross fixed capital formation	9.7	9.0
Exports of goods and services	12.4	12.3
Imports of goods and services	13.1	13.9
<b>Supply-side components</b>		
Agriculture	3.8	4.0
Industry	6.9	6.9
<i>o/w Manufacturing</i>	7.9	7.4
<i>Construction</i>	7.8	7.2
Services	7.6	9.1
Trade, hotels, transport and communication	7.7	8.6
Financing, insurance, real estate and business services	7.4	11.7
Community, social and personal services	8.9	6.8

Source: CSO, CRISIL

### Nominal versus real growth – what a difference inflation makes

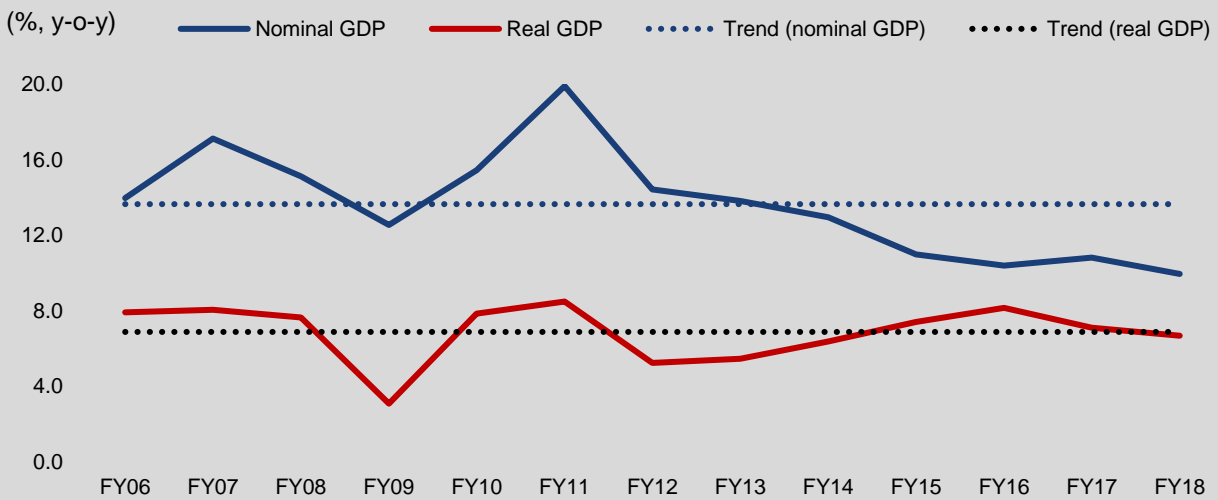
The updated data pegs the average real GDP growth in the four years ending fiscal 2018 at 7.3%, or 40 bps higher than the ~6.9 % in the preceding nine years.

But nominal GDP growth paints a different picture. It averaged 10.5% in the past four years, or 500 bps lower than the trend growth of 15.5% in the previous nine years.

This partly explains lower credit growth, corporate revenues and tax collections in the past four years compared with the earlier period. The difference in real and nominal GDP growth is explained by inflation, which has fallen significantly in the past four years.

Therefore, nominal micro-level micro indicators should be compared with nominal and not real GDP numbers.

#### Real vs nominal GDP growth rates



Source: CSO, CRISIL

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