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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 examine trade data to assess the impact of demonetization and GST

Examining India's trade performance in light of recent reforms

The Narendra Modi government has initiated a number of structural reforms in recent months. While these reforms are expected to benefit the economy in the medium to long run, they have created some short-term disruptions. Some of these were evident in India's trade performance. India's current account deficit (CAD) increased sharply to $14.3 billion, or 2.4% of GDP, in the first quarter of fiscal 2018. This is the highest deficit in four years. The culprit was merchandise trade deficit, which surged to $41.2 billion, compared with $23.8 billion in the first quarter of fiscal 2017.

India's exports put forth a modest growth of 4% in April-August 2017 in rupee terms. While India's exports have benefitted from stronger global trade growth in the first half of 2017, growth has been much lower than other major Asian economies such as China, Vietnam and Indonesia. In addition, strengthening of rupee and demonetization-led disruption appear to have contributed to the weak performance of Indian exports. Higher value of rupee relative to other currencies makes Indian exports more expensive in the international market, thereby decreasing their demand. The Goods and Services Tax (GST), too, created transitory headwinds for exporters as the delay in refunds choked liquidity.

Imports, on the other hand, shot up by 23% in April-August 2017. While the high import growth is partly a result of low-base effect, it is also the result of reversal of key trends, which had kept imports subdued in the past few years. Consumption continues to be the key driver of domestic demand, leading to a rise in consumption-related imports. Imports of industrial and investment-related goods have also increased, though at a slower pace than consumption-related imports. Oil imports, not included in either of the above two categories, too saw a reversal in trend from April to August 2017 mainly because of rising Brent crude prices. Strengthening of rupee also contributed to the increase in the import bill. A part of surge in imports could also be due to the slowdown in domestic production on account of disruptions in local supply chain, first due to demonetization and then due to the rollout of GST.

For India's trade balance to improve, exports need to post a sustained growth in the remaining months of fiscal 2018. Additionally, improvement in trade balance is contingent upon the pace of global economic recovery, valuation of rupee, and import appetite.

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Monetary Policy	Industrial Production	Inflation
Standing pat on the repo rate	IIP shows a sharp, broad-based upturn in August	Food brings relief to inflation

MONETARY POLICY

- The Monetary Policy Committee (MPC) of the Reserve Bank of India kept its policy rates unchanged in its October meeting, with repo rate at 6%, the reverse repo rate at 5.75%, and marginal standing facility rate at 6.25%
- The MPC maintained its neutral monetary policy stance, but remains concerned on the inflation front
- The MPC sharply cut its gross value added growth forecast to 6.7% from 7.3% estimated earlier
- Liquidity stayed in the surplus zone in September, even as advance tax outflows from the system brought the levels somewhat down compared to August
- Bank credit growth at ~6.5% has shown some signs of a recovery from the after-effects of demonetization
- Deposit growth, though strong at 9.4%, is lower than the peak of 15.3% in December 2016, as the impact of demonetization is tapering off
- CRISIL expects the MPC to cut policy rates if risks to growth rise and inflation undershoots the MPC's forecast

INDUSTRIAL PRODUCTION

- The Index of Industrial Production (IIP) grew 4.3% on-year in August, after a meagre 0.94% in July and a negative growth in June
- The turnaround in IIP was broad-based, barring mining which got a 'base effect' boost
- The sharp upturn in IIP may be indicative of restocking exercise before the commencement of festive season in the economy
- According to the use-based classification, capital goods displayed a positive growth (5.4%) – after four consecutive monthly declines – albeit on the back of a low base
- Infrastructure and construction goods grew by a healthy 2.5%, suggesting some revival in the construction space
- Consumer goods, too, displayed healthy growth with both the durables and non-durables growing positively - by 1.6% and 6.9%, respectively

INFLATION

- Consumer price index (CPI)-based inflation for September was unchanged at 3.3% from August, while wholesale price inflation fell to 2.6% from 3.2%
- Food inflation fell in September, reversing a two-month trend. This year's near-normal monsoon suggests agriculture production growth is likely to follow trend. This, coupled with last year's bumper crop, will keep food inflation in check
- Fuel inflation, calculated by adding petrol, diesel, fuel and light components, rose to 6.4% from 6.1% in August
- Core inflation (CPI excluding food, fuel and light, petrol and diesel) rose slightly to 4.4% from 4.3% in August
- GST rates for most services are higher than the erstwhile service tax rate and are likely to have pushed up prices
- CRISIL expects CPI to average 4% in fiscal 2018 (down from 4.5% in fiscal 2017)

Interest Rate	Rupee	Trade
Fiscal concerns harden yields	Macro woes trip rupee	Strong recovery in exports

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended September at 6.66%, up 13 basis points (bps) on-month
- Expectations of higher borrowing by the government to support growth propped up yields Rising CPI-linked inflation, 3.36% in August from 2.36%, also kept hopes of an RBI rate cut at bay. Both reasons combined to harden yields
- On the global front, ongoing tensions in the Korean peninsula, rise in US benchmark Treasury yields (10-year US Treasury yield rose to 21 bps to 2.33% at September-end), and the Federal Reserve's announcement of balance sheet normalization also weighed on gilts
- As a result, foreign portfolio investors ratcheted down their net purchase on Indian debt to $0.2 billion in September from $2.4 billion in August
- Oil prices too saw a sharp spike, with Brent simmering to $56.2/barrel in September from $51.7/barrel. Rising crude prices when inflation in India has started picking up too weighed on the sentiments, pushing the yields up
- CRISIL expects the 10-year G-sec yield to settle ~6.7% by March 2018

RUPEE

- Rupee closed September at 65.4 per dollar, 2.1% weaker on-month
- Disappointing progress of the domestic economy and adverse global geopolitical developments led to foreign portfolio outflows
- Rupee weakened even as dollar index remained weak, and most other major emerging market currencies gained on an average during the month
- Rupee is likely to remain under pressure in fiscal 2018 from higher CAD, as import growth is expected to be stronger than export growth. CRISIL expects the rupee to settle at an average 65.5 per dollar by March 2018, compared with 65.9 in March 2017

TRADE

- Exports outperformed imports for the first time in fiscal 2018, with the merchandise exports strengthening 25.7% (in dollar terms) on-year in September from 10.3% in August, while imports slowed to 18.1% from 21% in the previous month
- Export recovery was broad-based with most of the principal commodities registering higher on-year growth relative to the previous month
- The mild slowdown in imports was mainly due to a decline in gold imports and deceleration in industrial and investment-related goods imports
- However, import growth is likely to remain high this fiscal due to improving consumption demand. While higher global GDP and trade growth this year will support India's exports, the latter could stand to lose from a stronger rupee
- Owing to a wider trade deficit, CRISIL expects CAD to increase to 1.5% of GDP in fiscal 2018 from 0.7% of GDP in fiscal 2017

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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