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Chartbook

Riders to the ride

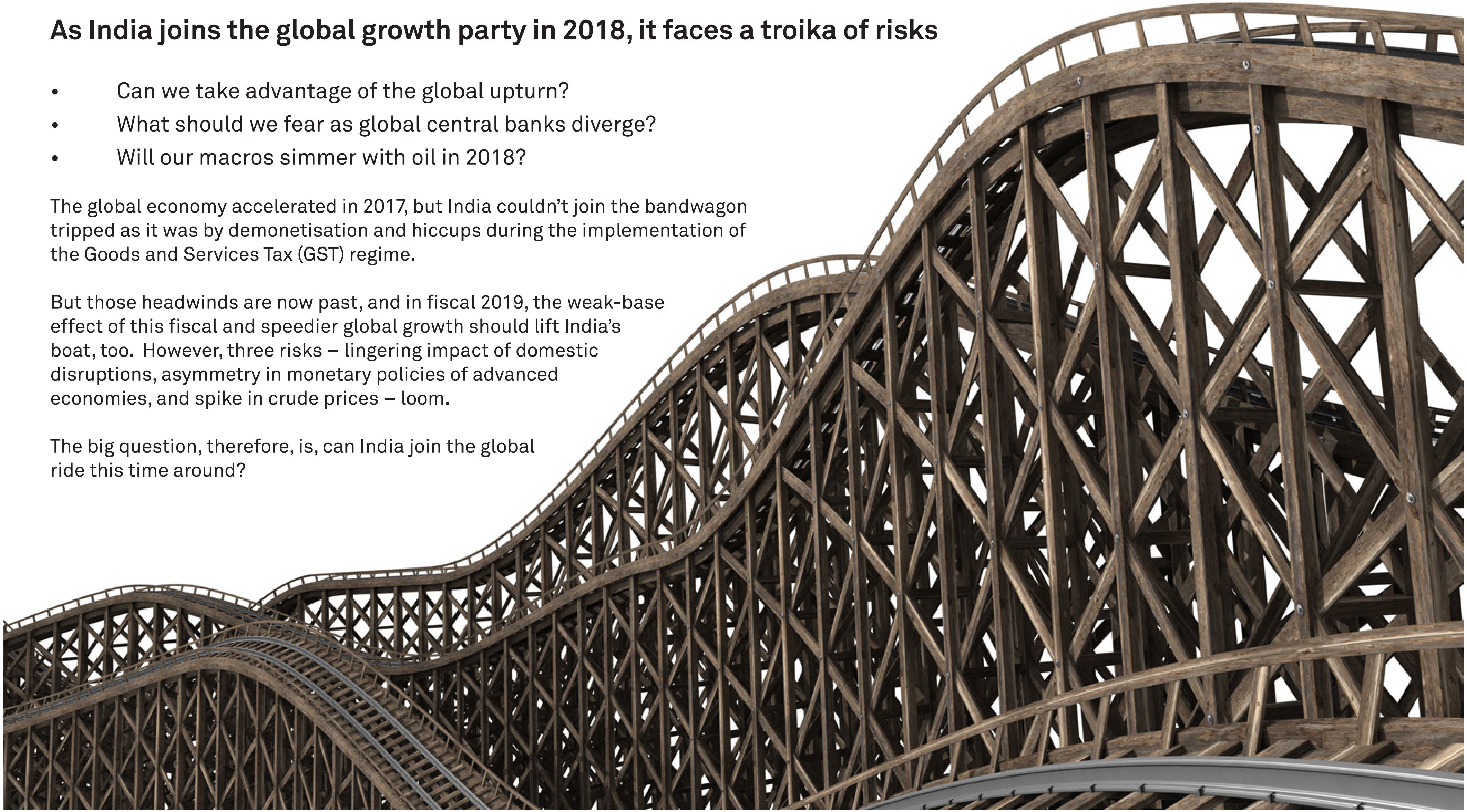
As India joins the global growth party in 2018, it faces a troika of risks

- Can we take advantage of the global upturn?
- What should we fear as global central banks diverge?
- Will our macros simmer with oil in 2018?

The global economy accelerated in 2017, but India couldn't join the bandwagon tripped as it was by demonetisation and hiccups during the implementation of the Goods and Services Tax (GST) regime.

But those headwinds are now past, and in fiscal 2019, the weak-base effect of this fiscal and speedier global growth should lift India's boat, too. However, three risks – lingering impact of domestic disruptions, asymmetry in monetary policies of advanced economies, and spike in crude prices – loom.

The big question, therefore, is, can India join the global ride this time around?



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1. The music is on…

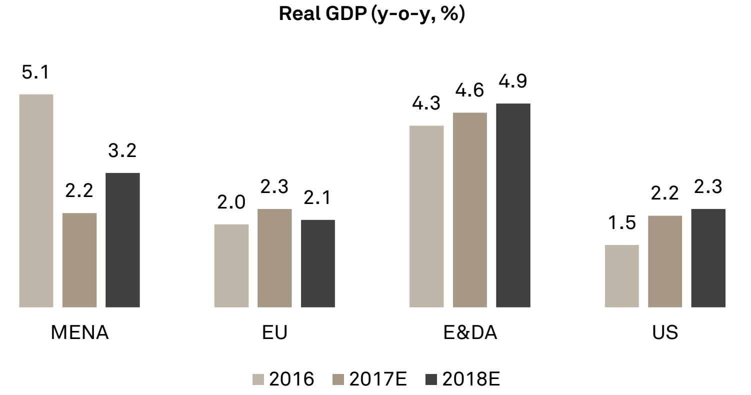
The global economy is dancing to synchronised beats, led by a cyclical upswing in Europe, China, Japan, the United States, and emerging Asia. Not surprisingly, the International Monetary Fund (IMF) expects[1] global growth to rise to 3.7% in 2018 after picking up by an estimated 50 basis points (bps) to 3.6% in 2017.

IMF expects global trade (goods and services, export plus imports) to only slightly moderate to 4% in 2018, from 4.2% in 2017, when it was 180 bps higher on-year. Volume of merchandise exports is estimated to have surged 200 bps to 4.2% in 2017, before it modestly eases to to 3.9% in 2018. Yet, the trade intensity of global growth (ratio of trade to GDP) continues to rise with trade growing faster than GDP growth. 2017 was the first year in six years when the trend reversed.

Despite the upswing, the contribution of trade to India's GDP growth this fiscal has been negative. Exports growth at 4.5% this fiscal is the same as the last, despite recovery in most of India's exports destinations (except Middle East and North Africa). On the other hand, growth in imports darted up 10%.

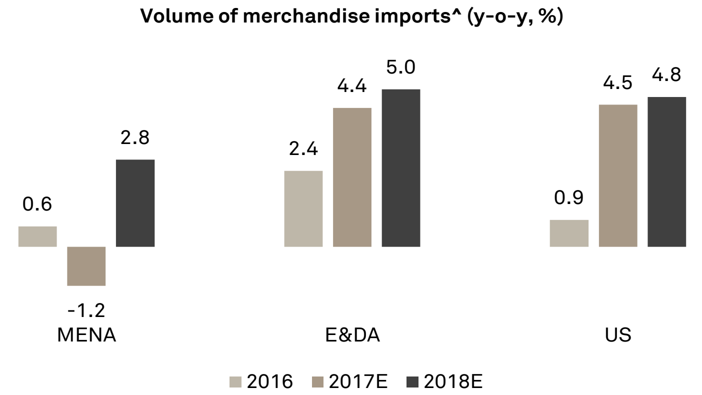
So how has the global recovery translated for India's major export destinations? Here's a closer look:

Economic recovery in key export destinations…



Note: Categorisation of countries as MENA, the EU and the E&DA is based on IMF classification; MENA: Middle East & North Africa, EU: European Union, E&DA: Emerging & Developing Asia, US: United States
Source: IMF, World Economic Outlook Database (2017)

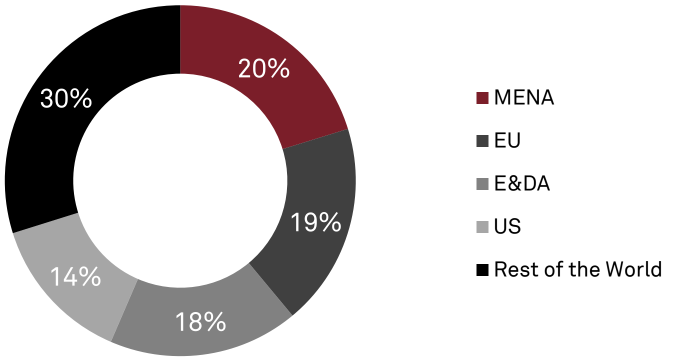
…accompanied by trade recovery



Note: ^ Volume of merchandise imports data was unavailable for the EU
Source: IMF, World Economic Outlook Database (2017)

[1] *The World Economic Outlook, October 2017*

Share of major export destinations in India's total exports



*Note: * Share in India's exports from fiscal 2013 to fiscal 2017*
Source: Ministry of Commerce & Industry, IMF

Economic and trade recovery in these regions, with firming prices in calendar 2017, led to a pick-up in the dollar value of exports. Commodities such as petroleum crude and products, base metals, machinery, and agri and allied activities gained the most.

India's key export destinations and principal commodities exported

	Exports growth		
	FY17	FY18 (Apr-Oct)	Key commodities exported#
MENA	-4.1%	-2.6%	Petroleum crude and products (0.1%), gems and jewellery (-21.9%), textiles and allied products (-2.4%), agri and allied products (7.8%), base metals (22.1%)
EU	5.8%	8.1%	Petroleum crude and products (-8.1%), textiles and allied products (2.4%), chemicals and related products (6.5%), machinery (25.8%), base metals (31.5%)
E&DA	13.5%	18.0%	Textiles and allied products (8.1%), chemicals and related products (18.5%), agri and allied products (16.9%), base metals (78.7%), transport equipment (-13.5%)
US	4.7%	7.9%	Gems and jewellery (-6.4%), textiles and allied products (3.1%), chemicals and related products (-4.9%), agri and allied products (37.1%), machinery (26.5%)

Note: #Top commodities exported to these regions (in dollars) from FY13 to FY17, numbers in parentheses denote growth in these commodities in FY18 (Apr-Oct)
Source: Ministry of Commerce & Industry, IMF

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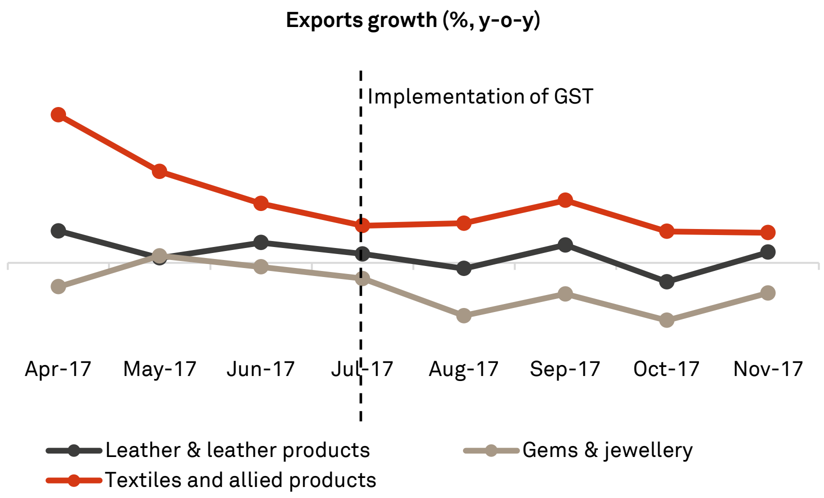
Among the labour-intensive sectors, while textiles and leather exports improved on account of the low-base of 2016, the gems and jewellery sector underperformed. Export growth in these labour-intensive sectors, which account for ~30% of India's total exports, was stymied owing to the twin domestic disruptions wrought by demonetisation and the goods and service tax (GST) implementation.

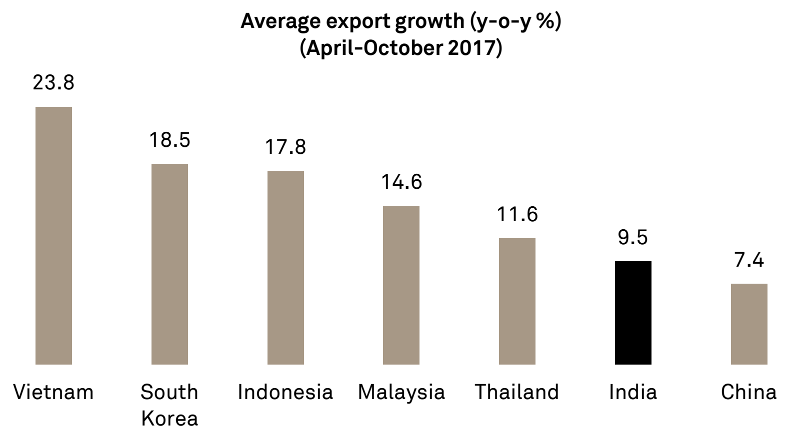
While India did not benefit much from the global recovery of 2017 because of domestic disruptions, many Asian peers did better. India's export growth during April-October 2017 at 9.5% appears sedate compared with Vietnam's 23.8%, South Korea's 18.4%, and Indonesia's 17.8%.

Impact of GST on exports of labour-intensive sectors



Source: CEIC, Ministry of Commerce

How India missed the exports recovery bus



Source: World Trade Organisation (WTO)

After India's underperformance in 2017, there is some good news ahead. Global growth momentum is expected to continue in 2018, coupled with a pick-up in import growth. The EU and the US are expected to have a strong broad-based cyclical recovery supported by consumption, investment and trade growth. The United Arab Emirates and Saudi Arabia are also expected to grow faster in 2018 with the easing of political turmoil in the region. The global growth, taken in conjunction with the continuing efforts at ironing out GST-led disruptions, should improve trade prospects for India in 2018. The labour-intensive sectors of gems and jewellery, textiles, and leather, which were most hit by the disruption, therefore can stand to gain in 2018.

However, if domestic disruptions continue, India could stand to miss the bus again in 2018 which can be a huge setback to domestic growth recovery.

Recent government initiatives to boost labour-intensive exports

In its mid-term review of the Foreign Trade Policy 2015-2020 in December 2017, the government announced numerous measures to promote exports of labour-intensive sectors and minimise damages inflicted on account of GST-related implementation hurdles. The measures include a 2% increase in incentive rates under the Merchandise Exports from India Scheme (MEIS) for labour-intensive sectors, including leather, textile and handlooms.

In addition, the GST rate for transfer/sale of duty credit scrips has been reduced from 12% to zero, and validity extended from 18 to 24 months. The policy also addresses the issue of working capital blockage of exporters due to upfront payment of GST on inputs. It enables exporters to source inputs or capital goods from domestic and foreign suppliers without upfront payment of GST. Merchant exporters can procure goods for export from domestic suppliers on payment of a nominal GST of 0.1%.

Looking to boost gems and jewelry exports by streamlining access to raw materials, the policy allows specified nominated agencies to import gold without payment of IGST.

If implemented in a timely manner, these steps will place India in a better positioned to reap the benefits of the global economic and trade recovery in 2018.

2. Global recovery is synchronised, but not monetary policies. What will that mean?

The global economy's synchronised and cyclical upturn is the strongest since the global financial crisis of 2007-08, with many advanced countries growing rapidly and above potential in the past two years. The outlook for 2018, too, is bright.

However, as growth goes up so does inflation, compelling central banks to sharpen focus on inflation control and tighten monetary policy.

In the global context, a tighter monetary policy could either imply raising interest rates or/and reducing/reversing the asset purchases by central banks. What then are the implications for emerging economies such as India which have seen abundant foreign capital inflows in the past few years fuelled by ample global liquidity?

Does this mean the days of low interest rates and abundant global liquidity are over?

This time, it's not so simple.

Though recovery in several advanced economies is synchronised, monetary policies are not. This is because of differences in the length/nature of recovery and differing inflation outcomes.

Recovery in the US is fairly mature as its economy has continued to expand for the past seven years. In contrast, the recovery in the EU and Japan is fairly young. They suffered a double-dip recession following the global financial crisis.

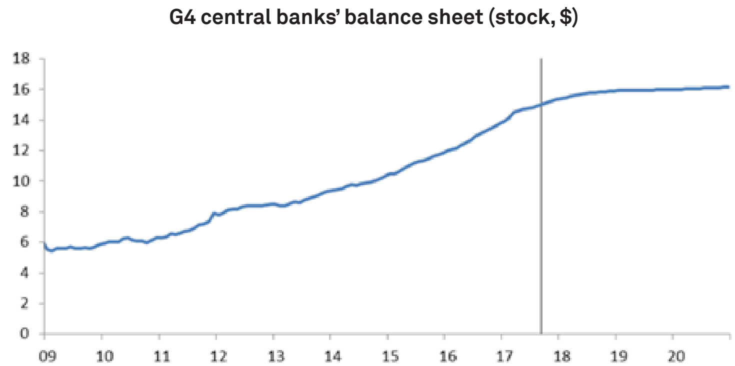
In general, low inflation, despite a pick-up in growth across advanced countries, means central banks will follow a cautious and calibrated approach to tightening.

Only two (the US Federal Reserve and Bank of England) of the four large central banks have raised their policy rates and are withdrawing liquidity. The others (European Central Bank and Bank of Japan) are still pumping in money, but in lesser magnitude. This implies global liquidity is continuing to expand and will do so for another 1-2 years.

Going forward too, implicit inflation expectations in the five-year bond yields show divergence in the US and the Eurozone. This suggests inflation could rise above the target in the US. But in the Eurozone, below-target inflation could keep interest rates low for an extended period.

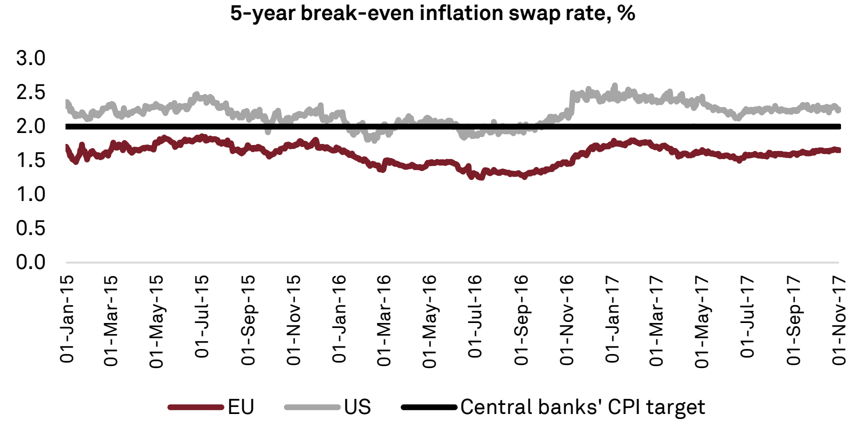
Consequently, interest rates in the Eurozone and Japan will remain lower for a longer period. S&P Global expects the ECB to announce a slowdown in asset purchases in the first half of 2018 with a view to unwinding completely by early 2019. The interest rates in Eurozone are, therefore, unlikely to rise before 2019.

Very gradual tightening by G4 central banks



Note: G4 refers to Bank of England, Bank of Japan, European Central Bank and US Federal Reserve
Source: S&P Global

Inflation expectations vary in US and Eurozone



Note: The breakeven inflation rate is a market-based measure of expected inflation. It is the difference between the yield of a nominal bond and an inflation- inked bond of the same maturity
Source: Federal Reserve, ECB, CRISIL, S&P Global

Unconventional monetary policies will continue to operate for a while, with implications on global liquidity. Broadly, there could be three reasons that could provoke global uncertainty leading to capital volatility:

First, divergence in monetary policies will mostly begin to play out in 2018 and is expected to continue for a while. The US economy, for instance, is now in the eighth year of an upturn and inflation is beginning to catch up. The Fed believes inflation (measured by the personal consumption expenditure [PCE] deflator) will cross the 2% target by end-2018. The Bank of Japan (BoJ) believes inflation will hit its target only by March 2020, while the ECB projects inflation in the EU is unlikely to even touch the target by 2020. Mysteriously, low inflation originates from the fact that though economies have seen faster growth in the recent past, in several economies, wage growth remains at all-time lows despite a fall in the unemployment rate.

Second, the dilemma of low consumer price (or PCE deflator) inflation but high asset inflation is also of concern since it could be concomitant to excessive risk-taking. For instance, during 2017, average inflation was 1.9% in the US, 1.7% in the Eurozone and 0.4% in Japan. In comparison, both oil and metal prices surged 24%. Global stock markets are at a record high while housing prices have also begun to move up. So far, central banks have maintained focus on consumer price index-linked (CPI) inflation or related targets. But the possibility of a bubble in asset prices could provoke prudential or regulatory actions by central banks in future.

Third, the risk of a possible 'late-cycle inflation' looms large. This refers to a condition wherein the incipient upside pressures on inflation stay hazy for long, but ultimately cause inflation to suddenly shoot up. The risk of such a condition is a sudden reaction by central banks to raise policy rates steeply. If all large central banks pursue this near-simultaneously, it could cause global interest rates to spiral and credit conditions to suddenly freeze.

Impact on India

The divergent monetary policies[2] and the consequent widening of the interest rate differential between the US and Europe will mean capital flowing into the US and further strengthening of the dollar. This has implications for capital flows into India, particularly foreign portfolio investments in bonds. Additionally, a stronger dollar can put pressure on local yields as global portfolios rebalance towards safe havens. How quickly that happens will depend on how swiftly the Fed tightens.

According to the IMF's latest Global Financial Stability report (October 2017), about $260 billion in portfolio inflows to emerging markets since 2010 can be attributed to the push of unconventional policies (such as quantitative easing) by the Federal Reserve. It further estimates that as Fed normalises

[2]US Fed announced rollback of historical QE; $10 billion each month (incrementing by $10 billion every quarter, till it hits $50 billion a month in October 2018. Raised Fed's funds rate 3 times (25 bps each) latest in December. S&P Global expects the European Central Bank to announce a slowdown in asset purchases in the first half of 2018 with a view to unwinding completely by early 2019. Bank Of Japan will also continue with QE

its monetary policy, it could reduce portfolio flows by $35 billion a year for the next two years. Countries that benefitted the most will see bigger reversals. The impact however, will also be determined by the resilience and growth outlook for economies.

The good news is India is expected to be much less impacted than other emerging markets because of favourable macros, proactive policies, low current account deficit (CAD), and last but not the least, foreign direct investment (FDI), which brings in significant stability to India's external funding requirements. The IMF estimates the cumulative impact of external factors on portfolios for India between 2017 and 2019 at -0.25% of GDP, compared with -1.45% for South Africa.

So tapering portfolio inflows would impact India less vis-à-vis its external financing needs compared with other emerging markets such as Malaysia, Poland, South Africa, and Turkey.

Many emerging economies dependent on high foreign capital inflows could face periods of shock as capital volatility rises due to uncertainties and flight to safety. And countries with high external borrowings could see their debt servicing costs rise as interest rates firm up.

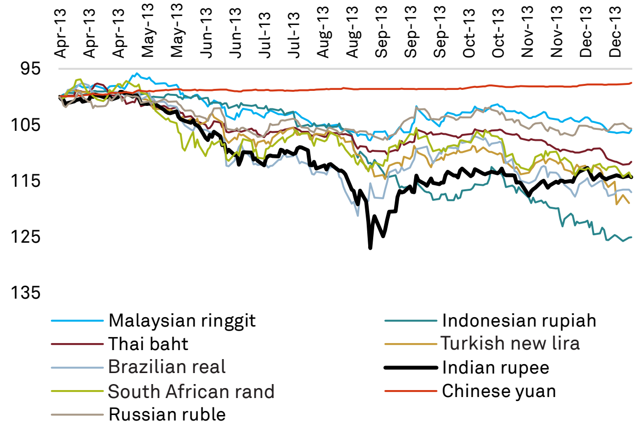
India, however, could stay relatively unscathed from these risks for two reasons:

First, the vulnerability of the Indian economy to external shocks has reduced significantly. Despite macros being under some strain, they are in the safe zone compared with 2013. Thus, the country is better prepared for capital shocks.

Second, India's short-term external debt at ~19% of total debt is low and CAD is healthy backed by FDI. Even if global interest rates firm up or global liquidity dries, India is unlikely to wobble much.

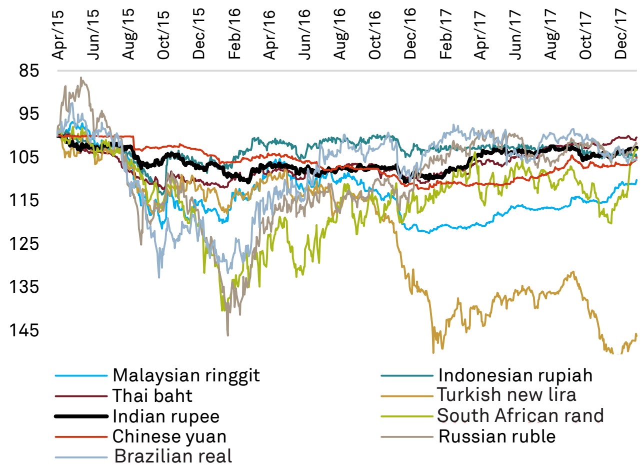
India's resilience then...

April 1, 2013 = 100, inverted scale



...and now

Currencies vs $
April 1 2015=100, inverted scale



Source: Reserve Bank of India, University of British Columbia, CRISIL

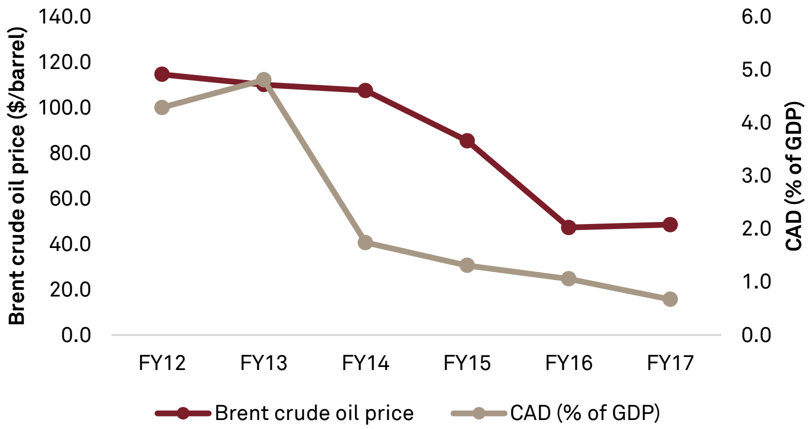
3. Will simmering oil singe macros?

Prices of Brent crude oil have been heating up, rising an average 16.4% on-year in this fiscal (April-December 2017), versus a 6.6% decline in the same period last fiscal. Prices crossed the $65-mark in December, a level not seen since May 2015. A continued rise in oil prices can damage India's macros through the following channels:

a. By exerting pressure on CAD

India is a net importer of oil, with crude and its products constituting 21.8% of the import basket and their share in exports much lower at 15%. The demand for international crude oil is relatively inelastic since India imports approximately 80% of its crude oil requirement.

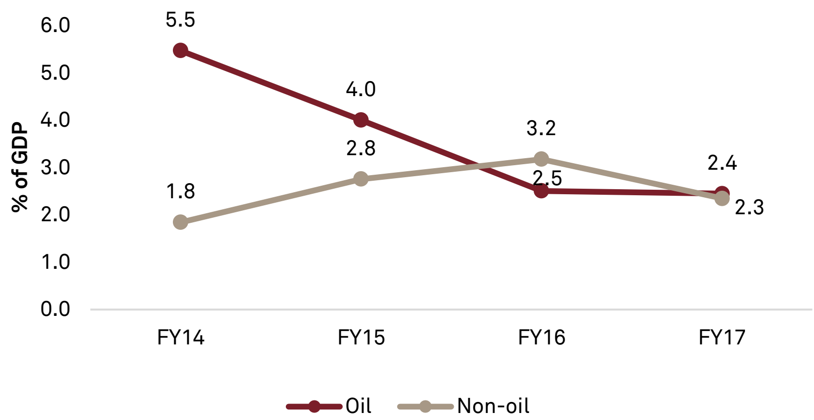
Fall in oil prices brought down CAD in past few years



Note: All figures are in US dollar terms
Source: US Energy Information Administration, RBI

Naturally, the fall in oil prices between fiscals 2014 and 2016 was instrumental in lowering the CAD. A drop in Brent crude oil price by $60 per barrel in this period led to the halving of the oil trade deficit to 2.5% of GDP in fiscal 2016, from 5.5% in fiscal 2014. The CAD fell despite the near doubling of the non-oil trade deficit during this period.

Despite rising non-oil trade deficit, CAD fell, as oil trade deficit halved



Note: All figures are in US dollar terms
Source: EIA, Ministry of Commerce

CRISIL Research expects Brent crude oil price to range $55-$60 per barrel in fiscal 2018, compared with $48.5 per barrel in the previous fiscal. Due to this and higher domestic consumption demand for imports, we expect the CAD to rise to 1.5% of GDP in fiscal 2018 from 0.7% of GDP in the previous fiscal. **A $10 per barrel further rise in oil prices from median forecast ($57.5 per barrel) can,** *ceteris paribus*, **push up CAD/GDP by about 60 basis points.**

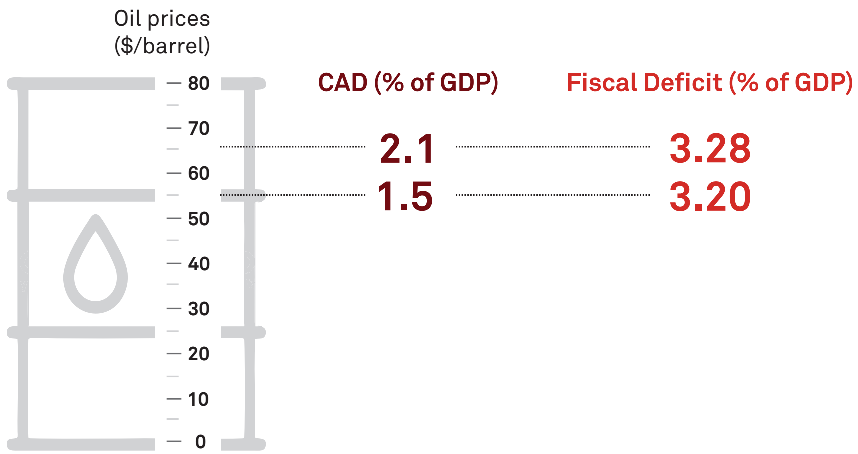
b. But the impact on fiscal deficit will be modest

Higher oil prices can strain the fiscal health of central and state governments through the following channels:

i. **Difficulty in raising tax rates on crude oil products:**
The centre collects excise tax on petrol and diesel from consumers - a flat rate charged per litre. While states levy a value-added tax (VAT), some charge an additional cess on these fuels. Taxes on fuels are outside the GST and form a significant component of state taxes. Lower oil prices in the past few years enabled the government to raise revenue by increasing excise duty with minimal impact on retail prices. These gains will not be extended if oil prices rise, and may even get eroded if government is compelled to cut these tax rates if high retail prices become unsustainable.

ii. **Higher subsidy outgo on petroleum products:**
With the government subsidising consumers on liquefied petroleum gas (LPG) and kerosene, the expenditure on these will increase with higher oil prices. However, some subsidies which were given before the oil price collapse, i.e., subsidies on petrol and diesel, no longer exist. This will limit the subsidy burden from reaching levels breached before 2014. The introduction of direct benefit transfer for giving the LPG subsidy, and the gradual rationalisation (through consumers who are voluntarily giving up the subsidy), will also help cap the subsidy burden. On the whole, with an effective oil price of at $55 per barrel[3] faced by the government on account of subsidies, the subsidy on LPG and kerosene is expected to be Rs 230-280 billion (0.14%-0.17% of GDP) in fiscal 2018, as per CRISIL Research estimates. **A $10 per barrel further increase in oil prices can increase subsidy burden by Rs 130 billion, which will, ceteris paribus, increase the fiscal deficit by 0.08% of GDP.**

Direct impact of oil prices on the twin deficits



Note: Impact of 10$ rise in oil prices is assuming other factors stay the same as in base forecast
Source: CRISIL Research

[3]*The subsidy burden faced by the government is on account of LPG (which trades at a discount relative to crude oil price), and kerosene (which trades at a premium). Since consumption of LPG is greater than kerosene, the effective price paid by the government for giving out oil-related subsidies is less than the actual crude oil price. $55 per barrel is consistent with $57.5 per barrel crude oil's price estimate*

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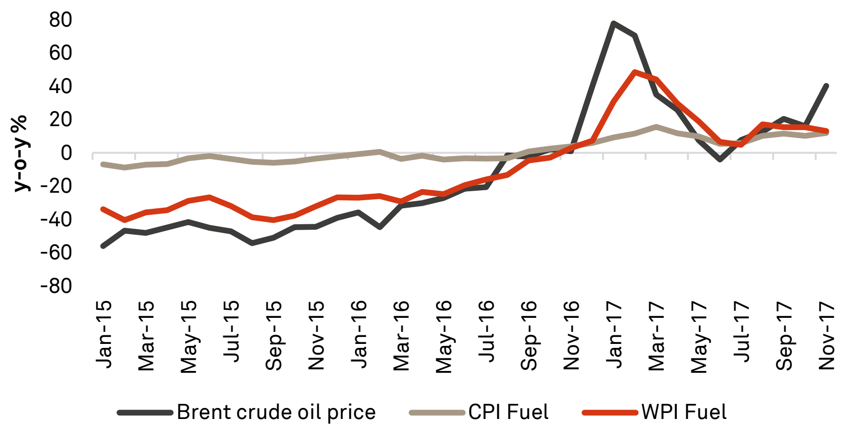
c. WPI inflation will be affected more than CPI

Rising oil prices will push up retail price inflation (as measured by Consumer Price Index [CPI]) as well as wholesale price inflation (indicated by wholesale price index [WPI]). The impact of oil price movements will be greater on WPI than CPI, because:

i. The WPI follows international price trends more closely than CPI
ii. Weight of fuel is higher in the WPI index (7.9% weight[4]) than in the CPI index (4.4% weight[5])
iii. At the consumer level, some fuel consumption (kerosene and LPG) are subsidised whereas there is negligible subsidy on the wholesale price. This could directly impact the costs and profitability of producers if the pricing power is low.
iv. Consumers have to pay taxes to central and state governments on petrol and diesel consumption, which is built in the retail prices.

WPI inflation tangoes crude oil prices better



Source: Office of Economic Advisor, Government of India; CSO; EIA

The benefits of low oil prices in the past few years did not completely reach final consumers. The average 30.5% on-year decline in crude prices between 2015 and 2016 had dragged down CPI inflation to a lesser extent than WPI. The contribution of the fuel component to CPI inflation was -0.1% during this period compared with the -1.9% contribution of fuel component to the WPI.

Fuel CPI inflation did not decline to the same extent as fuel WPI inflation for the following reasons:

i. Hikes in excise duty on petrol and diesel in 2015 and 2016.
ii. Deregulation of petrol in 2010, and diesel in 2014, enabling oil marketing companies to sell fuels at non-subsidised rates.
iii. Voluntary giving-up of LPG subsidy by approximately 11 million consumers.

With the rise in oil prices, retail inflation will receive an upward push from the following factors:

i. As petrol and diesel prices are now market-determined, oil marketing companies could pass on the higher crude oil prices to consumers, if they face profitability pressures.
ii. Implementation of "dynamic fuel pricing" of petrol and diesel – wherein their prices will be revised daily – will ensure retail fuel prices are in greater sync with international price movements.
iii. Impact of higher oil prices on other components of CPI, e.g., transport (having 6.3% weight in overall CPI), will further feed into retail inflation.

However, the government can reduce the impact of rising oil prices on consumer prices by cutting the excise duties on petrol and diesel. This will also help control the volatility in retail prices. When oil prices fell, the government's move to increase excise duties helped keep inflation stable. Likewise, modest cuts in excise duty in the event of a rapid rise in oil prices can help smoothen the impact on retail inflation. However, this could amount to pressures on the fisc, which is already under strain.

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[4]Fuel component of WPI inflation is measured by WPI mineral fuels index
[5]Fuel component of CPI is weighted average of LPG (excluding conveyance), Kerosene, Diesel (excluding conveyance), CPI Other Fuel, Petrol for vehicle, and Diesel for vehicle

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