Research

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Pivoting with the Fed

Data since the Global Financial Crisis suggest India did not quiver every time the US Fed moved, except when its own fundamentals were shaky. There's no reason why it would be any different the next time.

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Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Ltd.
dharmakirti.joshi@crisil.com

Pankhuri Tandon
Junior Economist, CRISIL Ltd.
pankhuri.tandon@crisil.com

Executive summary

In this insight, we analyse how sensitive India is to changes in monetary policies of other economies, in particular the US.

This study is done against the backdrop of changes in economic thinking regarding the influence of monetary policies on global financial cycles. Recent cross-country evidence has shown that the monetary policies of advanced economies, especially the US, affect not only capital flows to emerging markets and their exchange rates, but also asset prices, credit growth and leverage in these economies. The impact has amplified after the 2008 crisis, when major central banks adopted unconventional monetary policies. In this insight, we study this evidence specific to India.

We find that the impact on India has not been as widespread as what cross-country evidence has shown. The variables most affected by US monetary policy stance were short-term capital flows, India's overseas borrowing, and credit spreads. However, rupee movements, long term capital flows, domestic monetary policy, government securities, and domestic credit growth did not follow much the changing US policy for most of the period post 2008.

In fact, rupee depreciation was lower, foreign direct investment higher, and domestic rates lower when the US Federal Reserve (Fed) tightened its stance post 2013.

However, significant exceptions to these trends were the years 2013 and 2018, when most of these variables were adversely affected by US monetary tightening.

We find that the extent of impact has depended on domestic vulnerability. India's vulnerability was reducing for most of the period when the Fed was tightening monetary policy. This reduced the adverse impact of tightening global financial conditions on India during that time.

The importance of domestic vulnerability is also underscored in our experience in the years 2013 and 2018, when India got adversely impacted by the US Fed's monetary policies. India was highly vulnerable these years, which allowed the adverse impact to get transmitted to the economy.

Viewing from this lens, how is the external environment expected to affect India in near term?

Global monetary environment is expected to remain benign at least till next year. However, there is also significant geopolitical uncertainty, which is affecting risk appetite. India's own vulnerability has also shown some sign of weakness of late with slowing GDP growth and rising fiscal stress.

This could result in volatile foreign capital inflows, especially of short-term nature like FPIs. In such a scenario, it is critical for India to maintain macroeconomic prudence and improve fundamentals.

Introduction

About a year ago, Indian financial markets were stung by steep rupee depreciation as rising interest rates in the US drove out capital. In contrast, the US Fed has cut rates thrice this year, bringing stability in the rupee.

This is a telling example of how monetary policies of major advanced economies impact us. In particular, ever since the 2008 global financial crisis, the US Fed, European Central Bank (ECB), and Bank of Japan (BoJ) have taken monetary policy into uncharted waters, cutting interest rates to all-time lows, and purchasing assets at an unprecedented rate.

A growing body of economic research shows that such unconventional monetary policies have impacted emerging markets in ways not captured by traditional economic models. Not just capital flows and currency movements, but asset prices, leverage, and credit growth, too, in emerging economies, have danced to their tunes. The impact has been in both directions -- while interest rate cuts have helped bring a big chunk of capital to emerging markets, policy normalisation by major central banks has played havoc on capital inflows, currency, and crept into domestic monetary policies of emerging economies.

How vulnerable has India been? In this Insight, we empirically examine how monetary policies of advanced economies, especially the US Fed, have driven India's financial metrics. For this, we divide the post 2008 timeline into two buckets for comparison: an 'easing period,' when the Fed rolled out unconventional monetary policy between 2009 and 2012; and the 'tightening period' corresponding to normalisation, between 2013 and 2018.

Lessons from this experience help us foresee the impact of changes in external environment in the future. In what follows, we analyse the near-term outlook on global financial conditions, and identify the opportunities and risks in the current scenario.

Twist and taper: global monetary policy cycles since the 2008 crisis

US Fed and the easing cycle

After the outbreak of the 2008 global financial crisis, the US Fed first initiated monetary policy easing by sharply cutting rates at a quick pace. By December 2008, the Fed's policy rate hit the zero lower bound. To boost the economy further, it undertook massive asset purchases under its quantitative easing (QE) programme. The Fed continued to ramp up QE until 2012.

The tapering

In May 2013, Fed governor Ben Bernanke shook markets by hinting that it may start tapering the quantum of purchases, if the economy improved. While it was not an official announcement, the sudden change perceived in Fed's tone hit risk appetite and unleashed the 'taper tantrum'. The tapering of purchases began in December 2013 and eventually ended in October 2014. The Fed also began reducing its balance sheet by stopping to reinvest in its purchased securities from October 2017. Meanwhile, it started raising the Fed funds rate from December 2015.

And easing again

After raising rates eight times since then, the Fed reverted to cut its policy rate thrice in 2019. It has also resumed increasing its balance sheet. However, as noted by S&P Global, this operation is different from QE, and meant only for preventing unwanted tightening of monetary conditions.

The ECB follows

ECB started QE much later in January 2015. It ended asset purchases in December 2018, but has resumed purchases from November 2019. Its policy rate, which it had hiked in the peak of crisis in 2011, has been negative since June 2014. The deposit rate was cut by a further 10 basis points (bps) to -0.50% in September 2019.

How BoJ did it, a little differently

The BoJ, which was the first to have experimented with QE in 2001, resumed it after the financial crisis in December 2008. It went further, with quantitative and qualitative easing and yield-curve control. BoJ has maintained its highly accommodative stance until now. It has also maintained negative interest rates since the crisis.

2019, the year of synchronised easing

This year has seen synchronised easing by central banks across. Following the US Fed, most central banks have cut rates. These include Asian economies (India, Indonesia, Thailand, South Korea, Malaysia, and the Philippines) and other emerging-market peers, such as Russia and South Africa.

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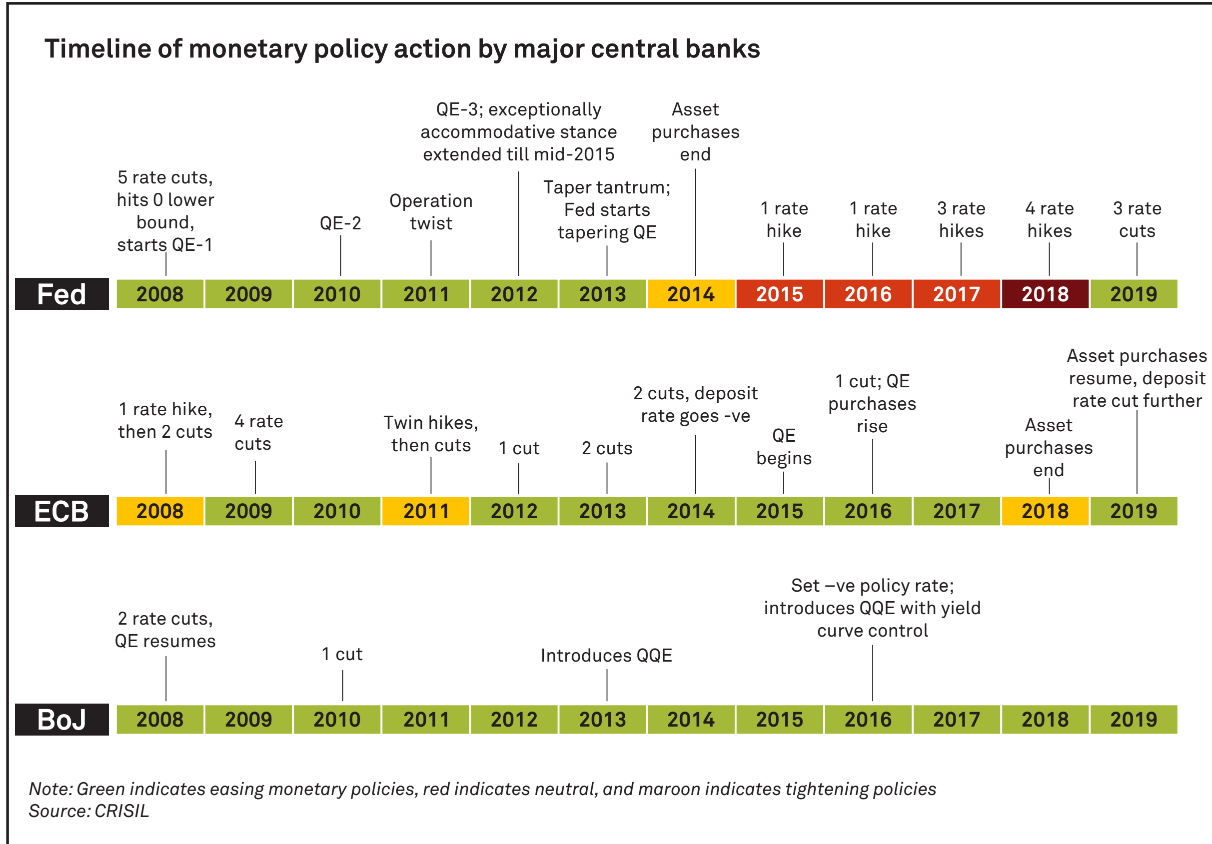
Timeline of monetary policy action by major central banks



Note: Green indicates easing monetary policies, red indicates neutral, and maroon indicates tightening policies
Source: CRISIL

How global monetary policies impact us

What recent research says

Basic economic theory suggests that monetary policy actions of other economies can impact the domestic economy through altering capital flows. For instance, a rate cut by the US Fed can lead investors to chase higher-yielding assets in other economies. The rise in capital flows to recipient economies leads to appreciation in their currency. If the exchange rate is fixed, rise in capital flows forces central bank of the recipient country to either absorb excess capital flows or cut its policy rate as well. This is essentially the “Mundell’s trilemma” or the “impossible trinity”, which says that an economy cannot have control over capital flows, monetary policy independence, and fixed exchange rate all at once. Mundell’s trilemma suggests that a flexible exchange rate can absorb any impact of global monetary policy spillovers and help domestic monetary policy maintain independence.

However, new research post 2008 crisis has found that the unconventional monetary policies of advanced economies have impacted other economies in many more ways than captured in Mundell’s trilemma.

The rise of global financial cycles

Helene Rey (2018)[1] has found the US monetary policy to be a significant driver of ‘global financial cycles’. In global financial cycles, capital flows, credit growth, risky asset prices and leverage tend to co-move across countries. As a result, US monetary policy influences not only capital flows to other economies, but also credit creation, asset prices and corporate spreads in those economies – including the ones having flexible exchange rates.

The ensuing booms and busts

Raghuram Rajan (2019)[2] has said that monetary easing by advanced economies can fuel unsustainable credit and investment booms in emerging markets. He says, *“Easy monetary policy is transmitted to receiving countries via capital flows, currency appreciation, a rise in borrowing, and an increase in prices of financial and real assets. All this gets reversed when central banks tighten – which leads to increasing financial fragility.”* Phases of abundant liquidity can incentivise firms to rely more on debt financing. This results in higher vulnerability when monetary tightening by advanced economies leads to tightening of global financial conditions. However, he also stresses that not all kinds of foreign capital are bad – durable capital like FDI can help foster growth in emerging market economies, which are typically short of risk capital.

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[1] *Helene Rey (2018). National Monetary Authorities and the Global Financial Cycle. The sixteenth L.K. Jha Memorial lecture, published by RBI.*
[2] *Raghuram Rajan (2019). Rising Tide. IMF Finance & Development Magazine, June 2019.*

Capital flows and economic development

Arvind Subramanian and Dani Rodrik (2019)[3] have compared the experiences of China – closed to capital flows (especially short-term capital) until recently; and Argentina – which is now imposing capital controls after years of free capital account. While Argentina has been trapped in a series of financial crisis driven by capital volatility, China, sheltered from volatile capital, has been able to prevent rapid currency appreciation and grow its exports. The authors have shown that nearly every major emerging market crisis has been preceded or accompanied by surges in capital flows. Hence, there is a need to maintain prudential capital controls.

Impact on India

A Reserve Bank of India (RBI) paper (2016),[4] however, argues that India did not get significantly affected by US monetary policy. In particular, domestic monetary policy, and its transmission to money and credit markets were not affected in the period of study considered till 2015.

India's experience - what data suggests

Here, we analyse the impact of unconventional monetary policies on India in the past 10 years, to test whether India's financial indicators moved in sync with findings of recent economic research, as previously set out.

For this, we classify the past 10 years into two periods: 'easing' and 'tightening,' and compare the movement of indicators in these periods. Given that the Fed is an important driver of global financial conditions[5], 2008 to 2012 (i.e. fiscals 2009 to 2013) can be classified as the 'easing period', when US was easing monetary policy, while 2013 to 2018 (i.e., fiscals 2014 to 2019), the 'tightening period' (*see Box: "Twist and taper: global monetary policy cycles since the 2008 crisis"*)[6].

a. Foreign capital flows

i. Foreign portfolio investments (FPI) – global developments matter

FPI inflows have been volatile, and their movements have closely followed changes in monetary policies in major advanced economies.

FPI flows were consistently robust between fiscals 2010 and 2013, when the Fed continued to pump in liquidity through three phases of QE. This is despite the worsening of domestic macroeconomic parameters in fiscals 2012 and 2013, which increased India's vulnerability and put the country in the 'fragile 5' category. However, FPIs experienced a sharp drop during the 'taper tantrum' period in fiscal 2014 and have been volatile since then.

On average, FPI flows have been lower in the tightening period between fiscals 2014 and 2019, compared with the preceding easing period.

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[3]*Arvind Subramanian and Dani Rodrik (2019). The Puzzling Lure of Financial Globalisation. Project Syndicate.*
[4]*Michael Patra, Sitikantha Pattanaik, Joice John, Harendra Behera (2016). Monetary Policy Transmission in India: Do Global Spillovers Matter? RBI Occasional Papers.*
[5]*A number of studies have shown that US monetary policy has become a major driver of global financial cycles, including by Jorda, Schularick,Taylor and Ward (2018). Global Financial Cycles and Risk Premiums. Federal Reserve Bank of San Francisco Working Paper.*
[6]*It must be noted that fiscal 2014 has been taken under the tightening period despite the Fed taper starting only from December 2013. The reason is that 'taper tantrum', which followed the mere hint of tapering by Fed governor in May 2013 hit risk appetite and put a stress on financial conditions, particularly on emerging markets, such as India.*

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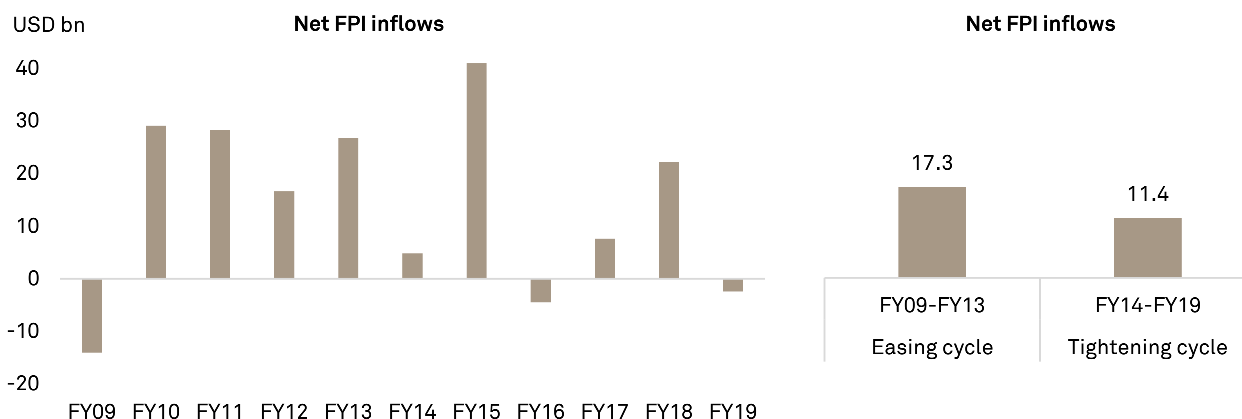
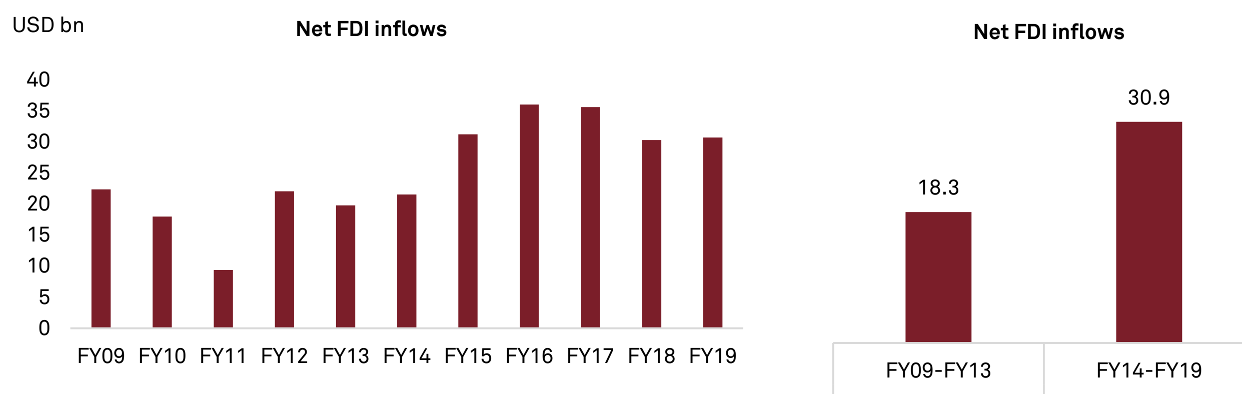


Note: Dates denote fiscal years; eg. FY09 refers to fiscal 2009
Source: RBI, CRISIL

ii. FDI – flowing on fundamentals, rather than global financial cycles

Foreign Direct Investment (FDI) has significantly risen since fiscal 2015, even as the Fed began normalising monetary policy. Overall, India saw higher FDI inflows in the tightening period, compared with the easing period. The quantum of FDI has also been higher than the FPI inflows, on average. This is good since FDIs are a more durable form of investments than FPIs.

FDI flows have been driven more by domestic economic and regulatory environment than by global monetary conditions. Higher FDI during the tightening period can be explained by the improving domestic growth prospects and other macroeconomic fundamentals. On average, India's GDP grew 7.3% between fiscals 2014 and 2019, compared with 6% between fiscals 2009 and 2013 *(see box "India's vulnerability over the years")*. Moreover, as the Indian economy started slowing down from fiscal 2018, FDI inflows also moderated, but remained higher than pre-fiscal 2014 levels. Easing regulations have also helped attract these inflows.



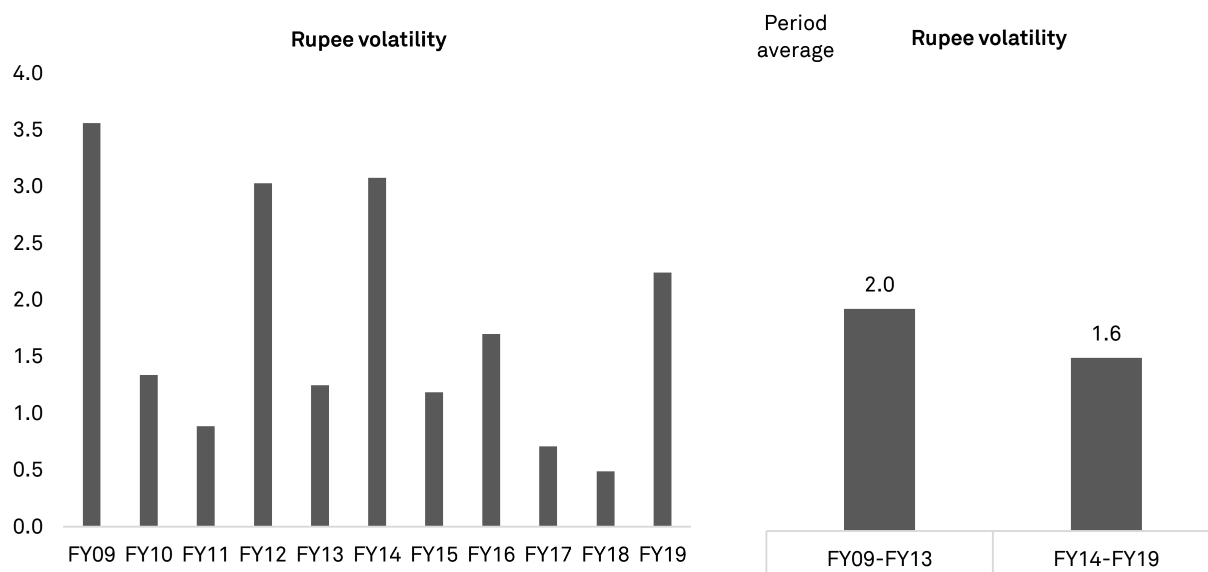
Source: RBI, CRISIL

b. Rupee - function of external shocks and domestic vulnerability

The rupee's movement has been influenced by global monetary policies and India's vulnerability on the trade account. In general, the currency's volatility has declined over time.

Rupee volatility peaked in fiscal 2009 – in the immediate aftermath of the global financial crisis, when there was a flight to safety. This was followed by fiscals 2012 (when ECB hiked rates twice) and 2014 (when taper tantrum roiled the markets). However, when QE actually reversed, particularly by the Fed, the rupee's volatility was much lower. The only exception was fiscal 2019, when volatility rose significantly.

The importance of CAD: India's current account deficit (CAD) was the main driver of these trends. From a peak of 4.3% of GDP in fiscal 2013, CAD reduced to 1.8% in fiscal 2018. On average, CAD stood at 1.4% of GDP between fiscals 2014 and 2019, compared with 3.4% of GDP between fiscals 2009 and 2013. That said, CAD's worsening to 2.1% of GDP in fiscal 2019 reflected in weakening of the rupee *(see Box: India's vulnerability over the years for further details).*



Note: Volatility is measured by standard deviation
Source: RBI, CRISIL

Rupee also depreciated to a lesser degree against the US dollar in the tightening period compared with the easing period, as CAD reduced and overall capital flows improved. Moreover, if we look at the real effective exchange rate (REER), which measures the inflation-adjusted value of the rupee against currencies of its 36 major trading partners, it has been on a rising (i.e., appreciating) trend since fiscal 2015.

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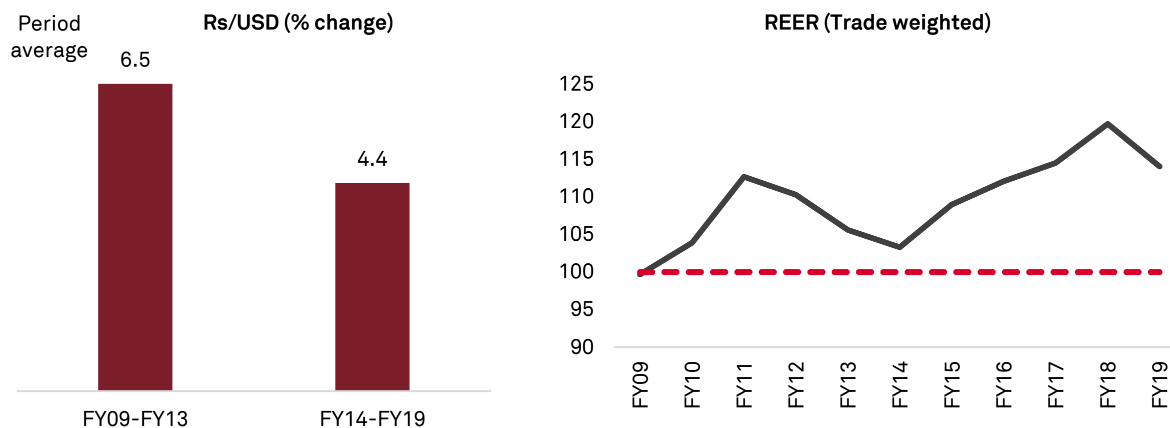
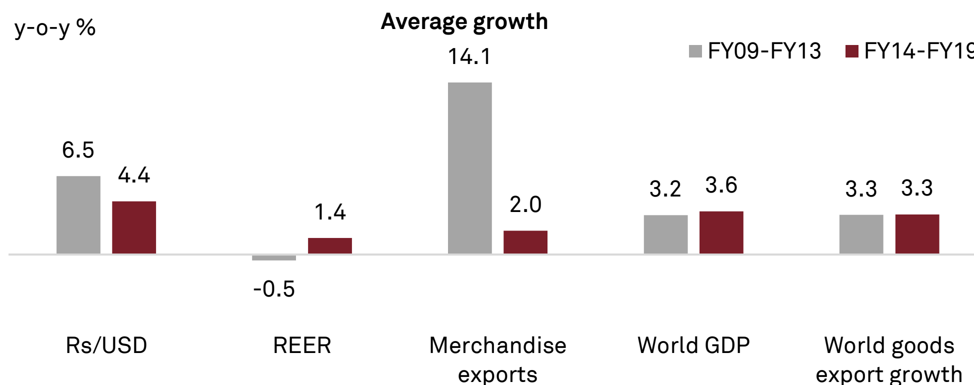


Note : a positive % change in Rs/$ implies depreciation of rupee; while a positive % change in REER implies appreciation
Source: RBI, CRISIL

Rupee's play on exports: On the flipside, appreciating rupee also contributed to slower export growth to some extent. After fiscal 2014, when the rupee appreciated in real terms, exports growth slowed despite world GDP growth improving slightly between fiscals 2014 and 2019 compared with the preceding five-year period. However, several other factors were also at play in dragging exports during this period, including falling trade intensity of global growth, and initial glitches in Goods and Services Tax implementation.



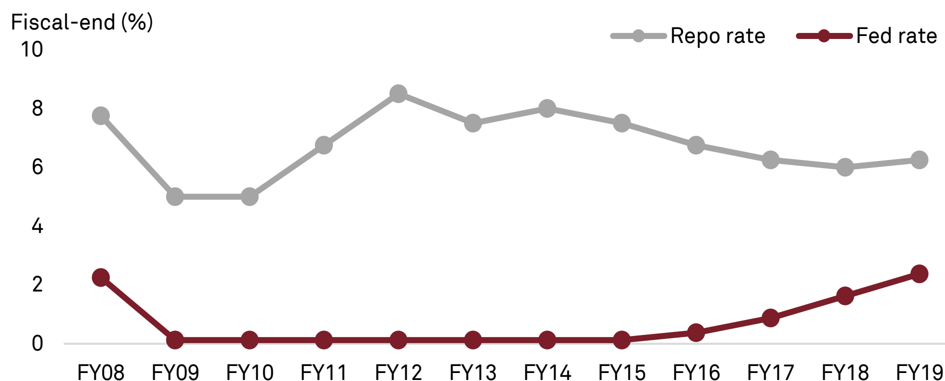
Source: International Monetary Fund, RBI, CRISIL

c. RBI policy – mostly driven by domestic factors

Domestic monetary policy has not always followed policies of global central banks. The RBI followed the Fed in sharply cutting its policy rate immediately after the crisis to cushion the economy. However, during the rest of the easing period, while the Fed funds rate stayed at the 0% lower bound, the RBI raised rates. Moreover, when the Fed started hiking rates since 2015, the repo rate was on a downward trend. The only exception was fiscal 2019, when the RBI followed the Fed in raising rates.

Domestic economic health has driven RBI's decisions. Between fiscals 2009 and 2013, the RBI raised rates to tackle double digit inflation and higher crude oil prices. After that, domestic inflation and crude oil prices fell, giving RBI room to cut rates. However, in fiscal 2019, despite domestic inflation staying low, the RBI raised rates to tackle the sharp rise in crude oil prices and depreciation of the rupee.

Not much in common: Policy rates of RBI and Fed



Source: RBI, US Federal Reserve, CRISIL

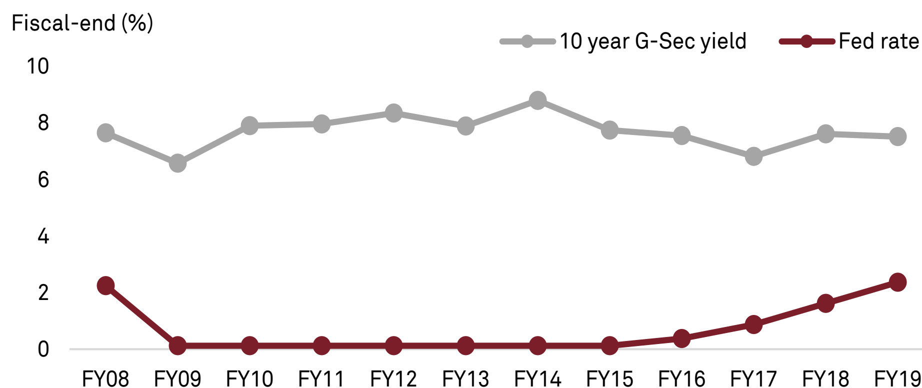
d. Domestic bond yields - unaffected, credit spreads – affected

As a proxy for asset prices, we analyse the movement of 10 year government security (G-Sec) yields. Rising yields would mean falling prices, and vice-versa.

Benchmark yields were not significantly affected by US monetary policy. In fact, G-Sec yields rose in the easing period and fell in the tightening period. In other words, bond prices fell in the easing period and rose in the tightening period.

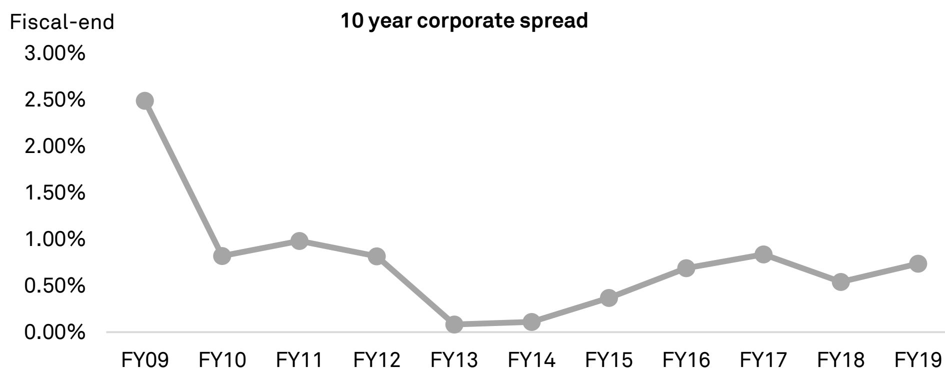
Movements in repo rate and crude oil prices were the bigger drivers of G-Sec yields compared with US policy.

Crosswired: 10-year yields and Fed rate



Source: Clearing Corporation of India Ltd, US Federal Reserve, CRISIL

However, risk indicators such as corporate bond spreads have moved in sync with global monetary cycles. If we analyse the difference between 10-year AAA-rated corporate benchmark and 10 year G-sec yields, the spread fell in the easing period, but started rising in the tightening period.

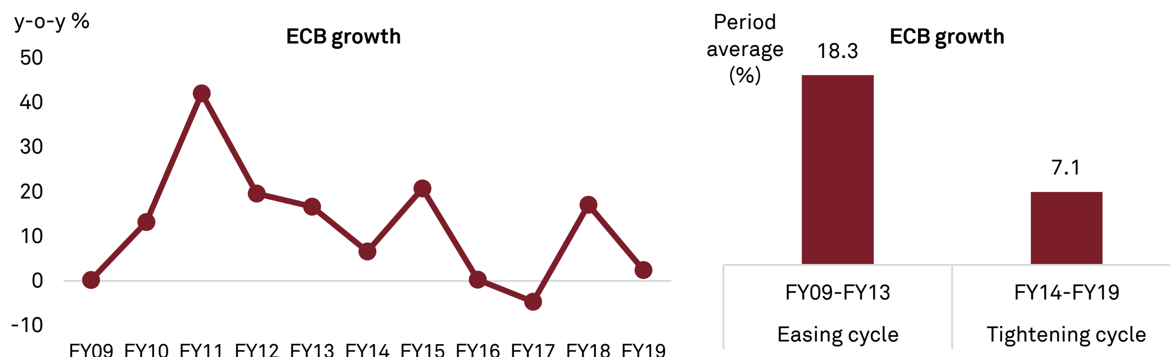


Source: Clearing Corporation of India Limited, CRISIL

e. Corporate borrowing from abroad – up on easing, down on tightening

External commercial borrowings (ECBs) had clearly risen during the easing period and fallen in the tightening period.

As mentioned, while Fed rate remained close to the 0% lower bound, domestic interest rates rose in the easing period, driven by RBI's rate hikes. The widening interest rate differential drove corporates to borrow from overseas markets. ECBs have again been rising in fiscal 2020, as Fed resumed its easing.

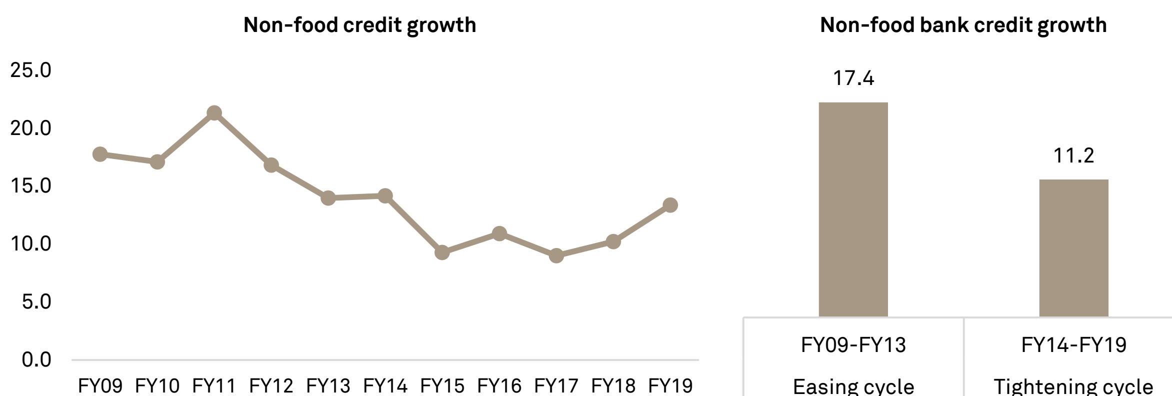


Source: RBI, CRISIL

f. Domestic credit growth – falling all the way

Domestic bank credit growth has been on a falling trend in both easing and tightening periods.

Falling credit is largely a fallout of domestic woes, especially the scale of non-performing assets (NPAs) manifesting in this period. Global monetary policy has had little say. Even in fiscal 2020, which saw a synchronised monetary easing by RBI as well as other central banks, bank non-food credit growth fell to 8.3% on-year as on October 2019.



Source: RBI, CRISIL

The data trends show that while India benefited from the easing cycle, mostly in terms of FPI flows, the losses in the tightening cycle were far less, because India's economic fundamentals were turning stronger then. This helped attract more durable FDIs, and capped depreciation in the rupee.

However, a significant exception was 2018, which saw a reversal in these trends.

That brings us to the next part of this Insight.

India's vulnerability over the years

India's vulnerability to external shocks can broadly be gauged through three parameters:

a. **External liabilities:** This is indicated by the CAD and external debt. Of these, CAD and short-term external debt are short-term liabilities.

b. **Ability to service external liabilities:** This is done by comparing external liabilities with foreign exchange reserves and export receipts. If the ratio of our foreign exchange reserves to our short-term external liabilities is greater than one, the reserves are deemed adequate to cover any short-term external risks. The International Monetary Fund (IMF) has also devised a broader metric to cover a broad set of risks (known as the IMF Assessing Reserve Adequacy for emerging markets i.e. IMF EM ARA metric). The ratio of our foreign exchange reserves to this metric must also be greater than one, for them to be deemed adequate. We also look at the debt-service ratio, which is the ratio of our debt-service payments to our export receipts.

c. **Macroeconomic health:** This is indicated by GDP growth, inflation, and fiscal deficit.

The table below plots these indicators since the 2008 crisis. It broadly shows that our vulnerability peaked in fiscal 2013, after which it has been on a declining trend. Overall, vulnerability was higher in the easing period compared with the tightening period.

Vulnerability again deteriorated in fiscal 2019, driven by widening CAD and slowing GDP growth.

	Indicator	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
External liabilities	*CAD (% of GDP)*	2.3	2.9	2.7	4.3	4.8	1.7	1.3	1.1	0.6	1.8	2.1
	External debt (% of GDP)	18.7	19.4	19.0	19.8	22.4	24.0	23.3	23.1	20.6	20.0	20.0
	-Short-term external debt (% of GDP)	3.6	3.9	3.9	4.3	5.3	4.9	4.2	4.0	3.8	3.9	4.0
Ability to finance external liabilities	*Debt service ratio*	4.4	5.8	4.4	6	5.9	5.9	7.6	8.8	8.3	7.5	6.4
	Reserves/(short-term debt + CAD)	3.5	3.1	2.7	1.9	1.6	2.5	3.0	3.4	3.6	2.8	2.5
	Reserves/ IMF EM ARA metric	2.1	2.0	1.7	1.6	1.4	1.4	1.5	1.6	1.6	1.6	1.5
Domestic macroeconomic health	*GDP growth (% y-o-y)*	3.1	7.9	8.5	5.2	5.5	6.4	7.4	8.0	8.2	7.2	6.8
	CPI inflation (% y-o-y)	9.1	12.4	10.4	8.4	9.9	9.4	5.9	4.9	4.5	3.6	3.4
	Fiscal deficit (% of GDP) - Combined	8.5	9.5	7.0	7.8	6.9	6.7	6.7	6.9	6.9	6.4	5.8
	-Centre	6.1	6.6	4.9	5.9	4.9	4.5	4.1	3.9	3.5	3.5	3.4
	-States	2.4	3.0	2.1	1.9	2.0	2.2	2.6	3.1	3.5	3.0	2.6*
	Government debt (% of GDP)	74.5	72.5	67.5	69.6	69.1	68.5	67.8	69.9	69.0	69.8	69.8

Note: Colours indicate the degree of vulnerability: with green indicating low, yellow medium and red high vulnerability
*Short-term debt is based on original maturity; *States' FY19 fiscal deficit is the budget estimate given by RBI*
Source: RBI, IMF, Ministry of Statistics, Controller of General Accounts, CRISIL

Why 2018 was different

The last calendar year saw a significant impact of external developments on India's financial conditions. Global financial conditions tightened considerably as the Fed accelerated the pace of rate hikes (four rate hikes in 2018 after three hikes the previous year), while continuing to reduce its balance sheet size. Rising US-China trade tensions further weakened investor appetite, hurting capital flows to the emerging markets, including India.

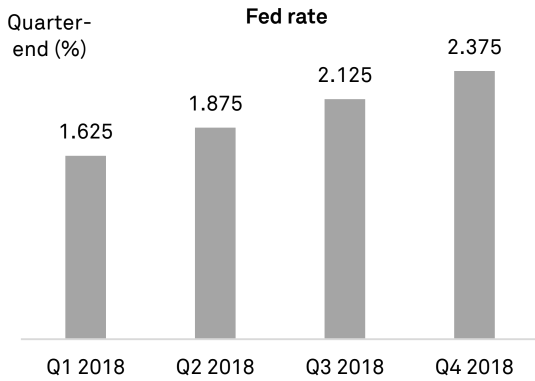
While external financing conditions were tightening, India's vulnerability to external shocks was rising. In particular, India's CAD widened to a five-year high because of a rise in crude oil prices, leading the rupee to depreciate 11% in 2018, the highest rate since the 2013 taper tantrum. Domestic monetary policy also followed the Fed's policy stance. Even though the consumer price index (CPI)-based inflation remained within the RBI's target range of 2-6%, the central bank raised the repo rate twice in 2018, and even changed its stance to calibrated tightening in October 2018. In its October policy statement, the RBI said: *"The MPC notes that global headwinds in the form of escalating trade tensions, volatile and rising oil prices, and tightening of global financial conditions pose substantial risks to the growth and inflation outlook. It is, therefore, imperative to further strengthen domestic macroeconomic fundamentals."*

Other Asian peers like Indonesia and Thailand also followed the Fed by raising their policy rates during this period.

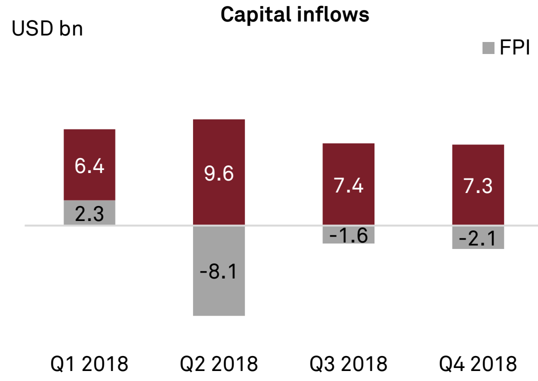
Hence, the 2018 experience proved:

- Adverse external developments can be easily transmitted to the domestic economy, if the country's economic health is weak.
- The resilience of the Indian economy during the tightening cycle lasted only until vulnerabilities, such as CAD, remained low – and that, thanks to favourable crude prices.

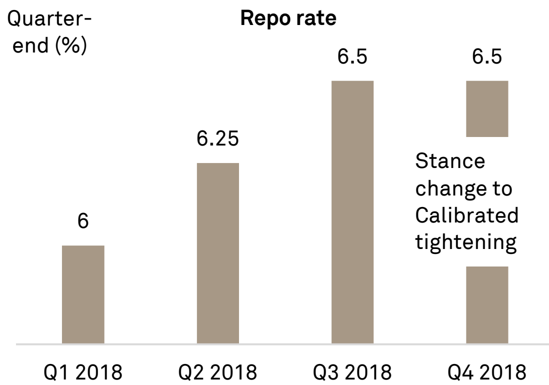
Four rate hikes by Fed in 2018...



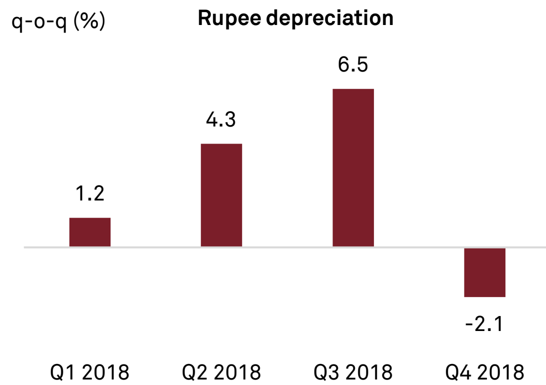
....led to a fall in India's capital inflows



...tightening domestic monetary policy



...and sharp depreciation in the rupee



Note: US Fed rate in the chart refers to the mid-point of target range; rupee depreciation has been taken over quarter-end (last month's average)
Source: RBI, US Federal Reserve, CRISIL

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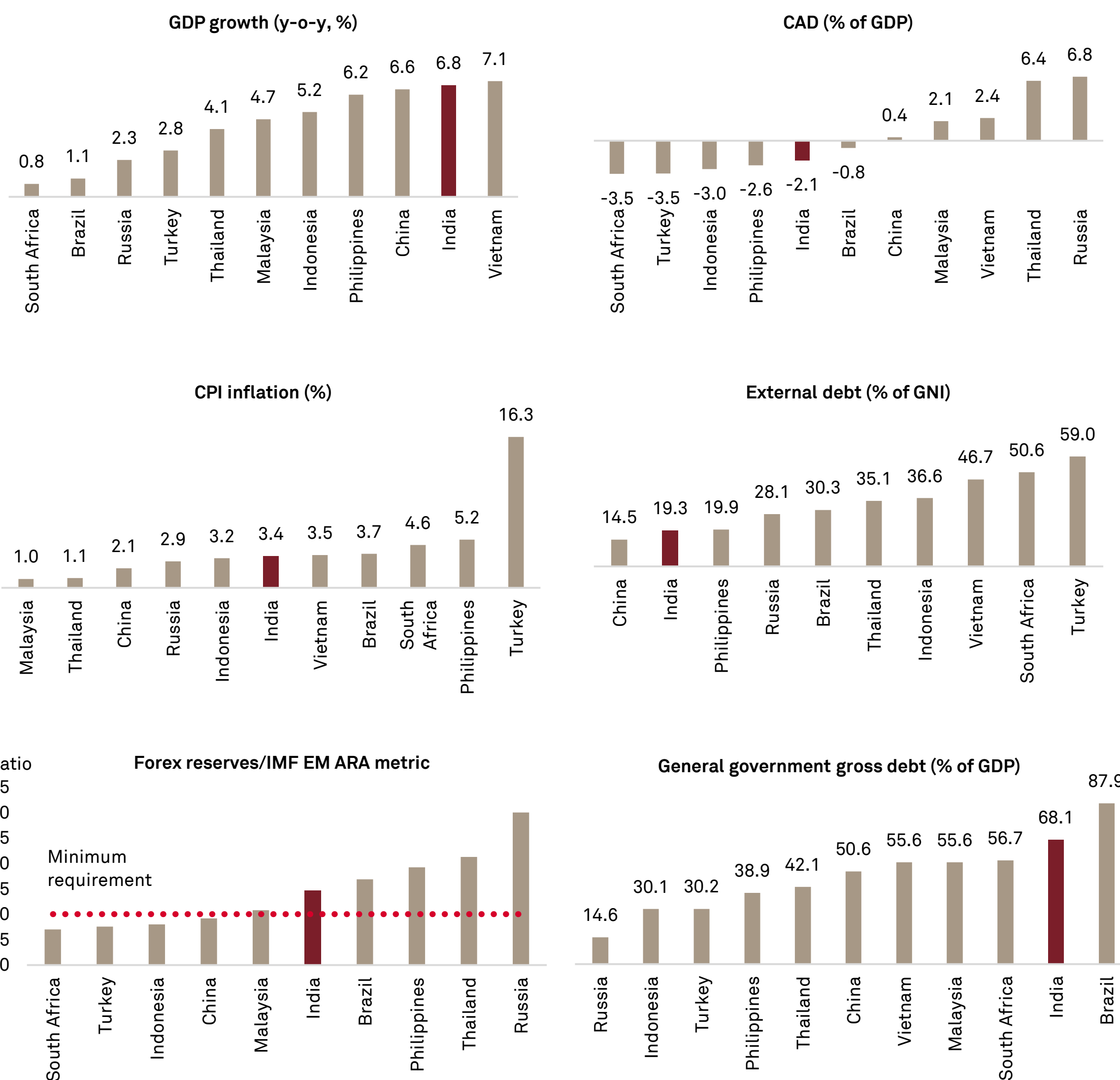
How India's vulnerability compares with other emerging markets

India fares well compared with most other emerging markets in terms of most vulnerability indicators. In particular, as in 2018 (calendar year), India had the second highest GDP growth and second lowest proportion of external debt among select emerging markets. However, the one indicator where it ranked among the worst was government debt as a proportion of GDP.

Key vulnerability indicators in 2018



Note: Data is for calendar 2018; reserves data for Vietnam not available
Source: IMF, CRISIL

How central banks are perched, and the implications for India

Calendar 2019 has seen a return of easing financial conditions, driven by synchronised monetary easing by most central banks. While the Fed started the year on a 'patient' note, rising downside risks to growth from US-China trade tensions compelled it to cut rates thrice this year. The Fed rate now stands at 1.50-1.75%. It has also started increasing its balance sheet to prevent tightening of monetary conditions. In addition, the European Central Bank (ECB) cut its deposit rate by 10 bps to -0.50% in September and has resumed net asset purchases of €20 billion per month from November. BoJ remains steady on QE and negative interest rates. However, in their latest meetings in December, both the Fed and the ECB kept rates unchanged.

Going forward, S&P Global expects the fed rate to stay unchanged through 2020. S&P also believes that the ECB can cut rate by another 10 bps in 2020 if data fails to show more signs of improvement in growth. It is unlikely to end quantitative easing before 2021 or raise rates before 2022.

The benign global interest rate environment bodes well for the Indian markets. If we go by the experience of the previous easing cycle, India could expect significant capital inflows. Lower crude oil prices are also expected to support the fundamentals. CRISIL Research expects the Brent crude oil prices to range in $60-63 per barrel in 2020, compared with $63.8 per barrel in 2019 so far[7].

Watch out for

a. **Slowing global growth**
   In the earlier easing cycle, the global economy saw a gradual improvement in growth, which led to higher risk appetite that brought capital flows into the emerging markets. But now, global growth is on a downtrend, driven by major economies such as the US, China and EU. India's GDP growth is also slowing.

b. **High uncertainty**
   The main drag on global growth this year has been the US-China trade war. As the world's two largest economies ratcheted up tariffs on each other, global trade flows were disrupted and investments delayed further. While the two countries seem to have reached a partial trade deal and halted further rise in tariffs in December, several issues, particularly related to technology remain unresolved. Uncertainty regarding resolution of such issues, and their impact on global economy, remains high.

   These factors are dampening investors' risk appetite and preventing them from investing in the emerging markets despite the monetary easing. Moreover, investors are flocking to safer havens, such as US Treasuries and gold. Bonds have rallied, even though a significant chunk of them are yielding negative returns.

[7] *Until December 9, 2019*

c. Rising domestic vulnerability

India's vulnerability to external shocks has recently shown signs of weakening. While fiscal 2019 saw vulnerability rise primarily on account of rising CAD, risks in fiscal 2020 are arising out of other economic fundamentals. In fact, we expect CAD to reduce to 1.4% of GDP in fiscal 2020 from 2.1% of GDP in fiscal 2019.

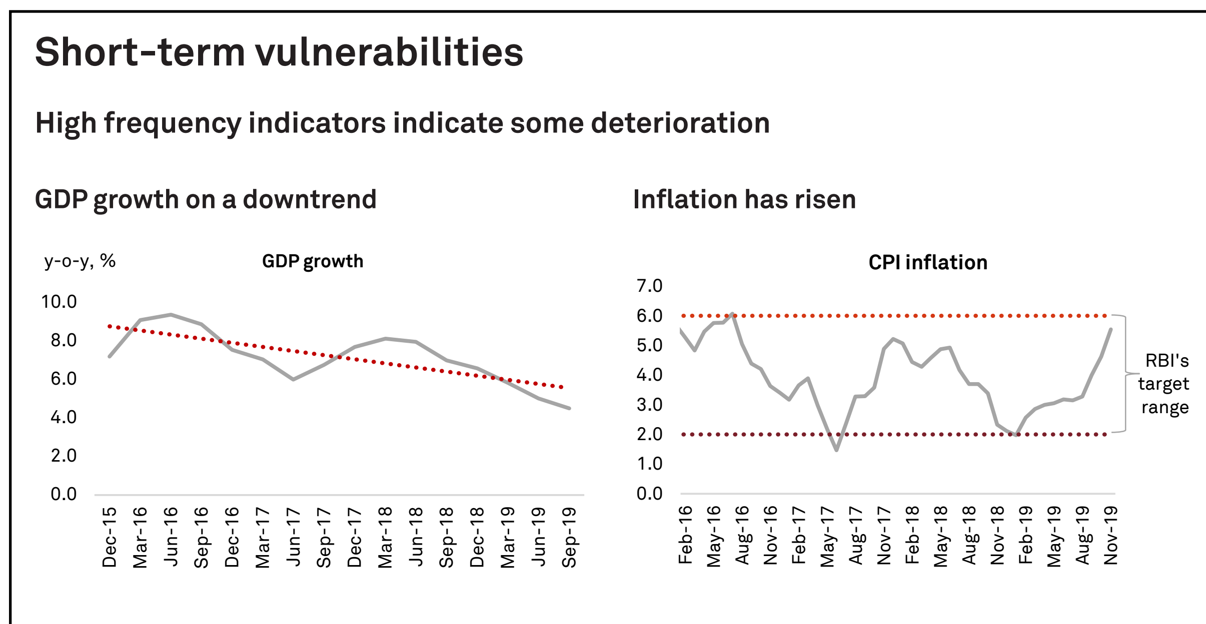
The major worry this year is slowing GDP growth. At 4.5%, GDP growth in the second quarter of fiscal 2020 was the lowest in 26 quarters. Growth in the first half of this fiscal averaged 4.8%, significantly below 7.5% seen in the same period previous year. Stress in the financial sector, after crisis faced by non-banking financial companies, played a major role in the slowdown.

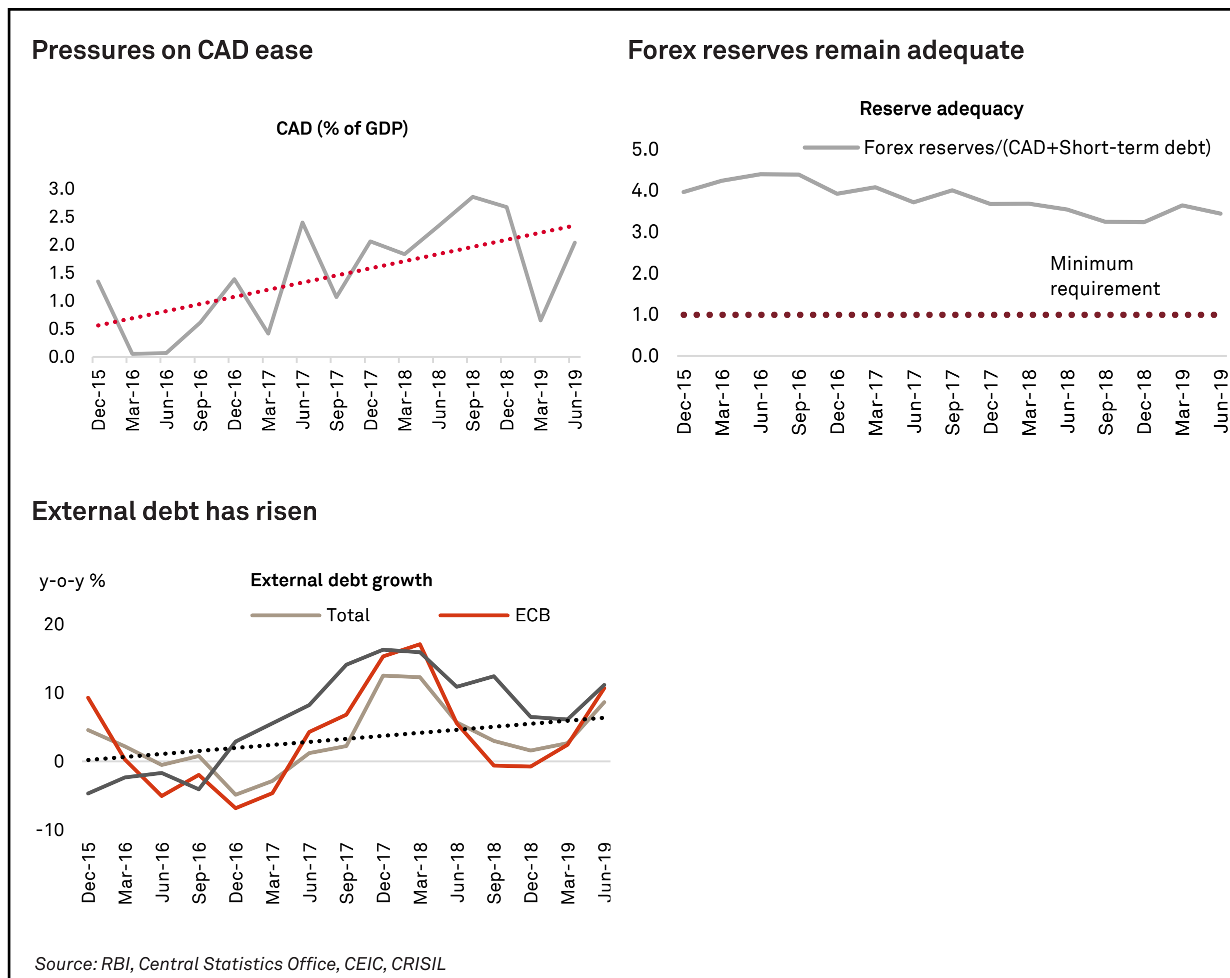
On the fiscal front, while the government has targeted to reduce the fiscal deficit to 3.3% of GDP in fiscal 2020 from 3.4% in fiscal 2019, concerns have risen from slowing tax collections and GDP growth.

Inflation has also been rising primarily on account of surge in vegetable prices. Rising global food prices are further adding pressure. However, low core and fuel inflation are limiting the upside.

However, pressures have eased on the current account as lower crude oil prices and subdued domestic demand have led to a sharp reduction in imports. Foreign exchange reserves also remain adequate.

In the current environment, amid mounting risks and slowing growth, capital flows, especially of short-term nature such as FPIs, are likely to be volatile. Therefore, maintaining macroeconomic prudence and reducing external vulnerability are critical. We saw in 2013, how the high and rising twin deficits (current account and fiscal) created a huge volatility in the Indian currency. As vulnerability deteriorated again in 2018, the sell-off in the emerging markets led to a sharper-than-expected weakening of the rupee.





Source: RBI, Central Statistics Office, CEIC, CRISIL

Conclusion

The impact of global monetary policies on the Indian economy has been limited to a few financial parameters for brief periods of time. The extent of impact has depended on India's vulnerability to external shocks. Domestic vulnerability was lower during the stretch of tightening monetary policy by the Fed, compared with the easing period. This cushioned India from adverse spillovers of contractionary global financial conditions post 2015. However, 2018 served to remind us how easily external shocks could transmit, if domestic vulnerability deepens.

Going forward, while global monetary conditions are expected to remain benign, the global economic environment is in a flux. India's own vulnerability has shown some signs of weakness. Under these circumstances, it should be wary of depending too much on short-term capital, and instead, seize opportunities to attract more durable capital to aid growth.

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Argentina | China | Hong Kong | **India** | Poland | Singapore | UAE | UK | USA
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 /lifeatcrisil

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