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 analyze if state-level spending is aligned to the requirements and also look at the role of state governments in the recent uptick in investments

States of spending

High and rising inequality, large gaps in health and education outcomes, and the need to create rural infrastructure imply the government's role in the economy has become more prominent, particularly in areas the private sector has shied of. At the same time, given the limited resources at its disposal, the government must ensure its spending is in appropriate areas, effective, and efficient.

States are playing an increasingly important role in India's investment spending, accounting for 65% of the overall government spending, with larger shares in social sectors and capital formation. It is observed that the central government's capital spending through its budget is coming down and the public investments in the economy are increasingly becoming dependent on state governments and the internal and extra budgetary resources of the public-sector entities.

During fiscals 2016-2018, of the 18 non-special category states, five states – Uttar Pradesh, Bihar, Karnataka, Telangana and Maharashtra – accounted for almost half the capex done by the states. Interestingly, of these, Uttar Pradesh, Bihar and Telangana, had the highest proportion of capex in the state spending.

But what about spending priorities of the states in other critical areas such as health, education, irrigation, housing, social security, urban and rural development? States like Uttar Pradesh, Punjab, Madhya Pradesh and Bihar are not directing their funds to areas they lag in, whereas Chhattisgarh, Gujarat, Haryana and Telangana have fared better in prioritizing their spending.

In nearly all major states, most of the spending is concentrated on education: ~15% of total spend on average at an all-state level. Some states like Andhra Pradesh, Bihar and Chhattisgarh are spending much more (~19% of their total spending). This ties well with requirements since these states rank low on education. But states like Kerala, Karnataka and Haryana, which rank relatively high on education levels, are also spending over 15% on education. Thus, they need to shift focus to other sectors. These state economies might in fact benefit more if funds are oriented towards other areas such as irrigation or roads.

A common feature observed across states is the lack of adequate attention on key areas such as health, irrigation and housing. Housing attracts merely 1% of state spending on average, while 2% is spent on urban development and 4-5% on the rest.

Money and Banking	Industrial Production	Inflation
Divergent rates	Low base steadies IIP	Second straight fall

MONEY AND BANKING

- Policy rate hikes by the RBI in August have started transmitting into higher deposit and lending rates
- The double-digit run-up in banking credit continues, with growth printing at 12.9% on-year as of August 17, up from 12.4% in the previous month
- While the central bank kept its stance neutral, CRISIL believes the Monetary Policy Committee (MPC) can hike repo rate once more, if higher-than-anticipated upside risks to inflation materialize. These include pressures from crude oil, stronger demand conditions, and food prices. Upcoming domestic and global data will determine the MPC's decision
- CRISIL expects banking credit growth to remain at 11-12% this fiscal, supported by improved economic growth, increase in working capital requirement due to rise in commodity prices, and resolution of big-ticket stressed assets. Deposit growth should also brighten as banks continue to increase their deposit rates in sync
- The next monetary policy review decision is on October 4. We expect the MPC to keep the policy rates on hold in this review

INDUSTRIAL PRODUCTION

- The Index of Industrial Production (IIP) rose 6.6% on-year in July, from 6.9% growth in June, • led by healthy growth in manufacturing and electricity sectors. In terms of the end use, the IIP performance was driven by robust growth in infrastructure & construction goods and consumer goods
- IIP logged steady growth for the second consecutive month partly on account of a low base of last year when industrial activity was hit due to implementation of the Goods and Services Tax (GST). Slowdown in core sector growth however capped the growth in overall IIP
- Going forward, some improvement in rural demand backed by normal monsoon, rationalization of GST rates, pick-up in exports and positive spillover of Pay Commission revision (for central and state government employees) on overall consumption demand will crank up industrial growth
- Accordingly, capacity utilization of manufacturers is expected to pick up in some select sectors where consumer-oriented demand and government spending will support. Still, overall utilization rates will not be significant enough to support a broad-based lift in private sector investment this fiscal

INFLATION

- Consumer Price Index (CPI)-based inflation softened for the second consecutive month, falling 50 basis points (bps) to 3.7% in August, compared with 4.2% in July
- Wholesale Price Index (WPI)-based inflation also fell 60 bps to 4.5% in August, due to softening food inflation and base effect
- Core inflation fell for the third consecutive month – to 5.4% in August from 5.5% in July – aided
- Sharp decline in food inflation coupled with a high base of last year (when inflation had got a lift on account of implementation of the GST)
- For fiscal 2019, CRISIL expects CPI inflation to rise to 4.8% from the 3.6% average seen in fiscal 2018

Interest Rate	Rupee	Trade
Double whammy	Entering the 70s	Exports pacy, imports slow

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended August at 7.95%, 18 bps higher on-month
- Rising oil prices were the primary factor behind higher yields. Rate hike by the RBI also did not have a significant impact. On the contrary, bond yields fell immediately following the announcement as the maintenance of neutral stance calmed investors
- Expectation of higher government borrowing in the second half, and rising interest rates in the United States (US), which are widening the interest rate differential with India, are adding to bond market woes
- CRISIL expects the 10-year G-sec to remain under pressure and average at 7.8% by March 2019 compared with 7.62% in March 2018

RUPEE

- Rupee breached the psychological 70/$ level in August, closing the month at 70.9/$, on rising current account deficit (CAD), crisis in Turkey, and stronger dollar
- The dollar index strengthened as rising global uncertainties and anticipation of a steady Fed fund rate hike increased appetite for US bonds
- The Turkey crisis dragged down currencies of most emerging market economies, especially those with a weak current account balance
- CRISIL expects the rupee to average 68.5/$ in March 2019, compared with 65/$ in March 2018. While the rupee has depreciated sharply in recent months, past trends indicate a tendency for the rupee to revert to its mean values

TRADE

- Merchandise exports grew 19.2% on-year in August, compared with 16.1% in the previous month. This is the fourth consecutive month of double-digit export growth
- Petroleum products and engineering goods were the top contributors to export growth
- Services exports expanded 33.2% on-year in July, the ninth consecutive month of double-digit growth. Weaker rupee and strong global economy are enabling broad-based recovery in exports
- However, stronger imports are offsetting export gains. Merchandise imports grew 25.4% on-year in August, compared with 28% in the previous month. Oil and gold were the key factors behind the numbers
- With a slight moderation in import growth, the trade deficit reduced $0.4 billion on-month to $17.4 billion in August, but was still $4.7 billion higher on-year
- So far this fiscal (April-August 2018), exports have grown an average 15.9% on-year, and imports 18.2%. Despite a pickup in export growth, the trade deficit is at a five-year high due to pressure from oil imports
- Going forward, export growth can also face risks from weaker global trade growth owing to escalating trade wars

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