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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 focus on the price and production dynamics of pulses

Stabilizing the pulse rate

Prices of pulses, which had been on a boil for long, worrying the government and consumers, have cooled this year. Overall food inflation fell to -0.9% in the first quarter (Q1) of fiscal 2018 from 7.3% a year ago. The steepest drop in the food basket has been in pulses, followed by vegetables. The latter slumped 230 basis points (bps) on-year to -13.1% in Q1, while pulses inflation is down 500 bps to -19%. However, with vegetables shedding some of the base effect-led relief, and given seasonal pressures, vegetable prices skyrocketed in July. Pulses inflation, however, continued to dip, substantiating our contention that the price of pulses surges every two-three years. Our study, 'Every third year, pulses catch price-fire' had highlighted this in November 2015.

Pulses follow what the economists refer to as the 'cobweb phenomenon', where output responds to prices with a lag. Production decisions, taken on the basis of prices experienced in the preceding period, create a cyclical pattern in pulses, which gets amplified by weather because these crops are largely rain-fed. This phenomenon can be attributed to a number of factors, including pricing policies, import policies, production decisions, and the weather. The cobweb pattern typically prevails when no price smoothing (or assuring) mechanisms are in place.

In fiscal 2017, bumper production and a sharp decline in prices did bring relief to the consumer, but not to the farmer. That's because input costs grew steadily, while output prices fell sharply, negating the benefit of higher production. Our analysis shows that falling prices had a detrimental effect on the profitability of growers. Profit margins for all pulses, except gram, fell an average 8% on-year in fiscal 2017.

The policy focus with regards to pulses, therefore, should not only be on improving production but also on price-smoothening measures. Increasing irrigation coverage and development of markets are long-term remedies. In the near term, however, efforts should focus on effective use of price stabilization fund and ironing out of inefficiencies in the futures market.

Monetary Policy	Industrial Production	Inflation
Down comes the repo	IIP shrivels on GST jitters	Inflation reverses trend on higher food prices

MONETARY POLICY

- The Monetary Policy Committee (MPC) in its review on August 2, announced a 25 bps reduction in the policy rates (repo rate is down to 6%, the reverse repo rate to 5.75%, and marginal standing facility rate to 6.25%). Four out of six members were in favor of the decision, while one voted for a 50 bps cut and another for status quo
- The MPC maintained its neutral monetary policy stance, but is now more comfortable with the inflation trajectory since several upside risks have reduced or not materialized
- Liquidity conditions stayed in the surplus zone, facilitating swifter transmission of interest rate cuts across instruments
- Bank credit growth shows a small recovery
- In fiscal 2018, we expect banking credit to grow at 8-10% supported by an improvement in economic growth and domestic demand, while the deposits growth will remain strong at 9-11%. Given the abundant liquidity and rather tepid credit demand, banks are likely to further bring down interest rates over the next few months

INDUSTRIAL PRODUCTION

- Industrial activity, as measured by the new series of the Index of Industrial Production (IIP), shrank for the first time in four years to -0.1% on-year in June, compared with 2.8% in May
- While a high-base effect was partly to blame, much of the damage is expected to have come from destocking of goods ahead of the transition to the Goods and Services Tax (GST)
- A sharp slowdown in inflation based on the Wholesale Price Index (WPI) in June may also have contributed to the decline, considering the new IIP series (2011-12) has more value-based components compared with the older one
- Manufacturing activity declined by 0.41%, whereas mining and electricity were mildly positive
- According to the use-based classification, there was a decline in all the categories save for infrastructure & construction goods and consumer non-durables, which grew 0.6% and 4.9%, respectively. The sharpest decline was in the capital goods category, at -6.8%

INFLATION

- Both Consumer Price Index (CPI) and Wholesale Price Index (WPI) based inflation reversed the downtrend and nosed up in July on higher food prices
- Food inflation continued to dip, clocking -0.3% compared with -2.1% in June, but the fall was arrested by a waning out of the low-base effect and a seasonal uptick in vegetables inflation
- Fuel inflation stayed benign on lower global crude oil prices and a stable rupee
- Core inflation as measured by the WPI dipped on weak manufacturer's pricing power, where the same measure in CPI edged up reflecting the impact of GST implementation on prices
- CRISIL Core Inflation Indicator (CCII), which excludes the volatile food articles, metals and fuel prices, eased 30 bps on-month to 1.2% in July

Interest rate	Rupee	Trade
Rate-cut hopes, GST set bonds afire	Foreign investors pump it in, lift rupee	Growth in exports slows further

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended July at 6.47%, down 4 bps on-month
- Expectation of rate cut by the Reserve Bank of India and continuous foreign institutional investor purchases helped lower yields
- The continuing high systemic liquidity also lowered yields
- Yield on the one-year G-sec settled at 6.28%, down 13 bps on-month
- Corporate bond yields fell in tandem with yields on the 10-year paper moving down 16 bps on-month to 7.14% by July-end
- CRISIL expects the 10-year G-sec yield to settle ~6.7% by March 2018

RUPEE

- Rupee closed at 64.1 per dollar in July, 1% stronger on-month
- The rupee's run has been powered by a multiplicity of factors, primarily the strengthening macroeconomic fundamentals of the Indian economy
- Domestic factors such as low inflation and current account deficit (CAD) and prudent fiscal-monetary policies reduced India's external vulnerability and strengthened the rupee
- Gains were boosted by foreign portfolio inflows, which have been positive despite the Fed rate hike in June and falling domestic bond yields
- Rupee as well as other emerging market currencies were also boosted by the weakening of the dollar for the sixth month in a row
- CRISIL expects rupee to settle at 65.5 per dollar by March 2018, compared with 65.9 in March 2017

TRADE

- After starting 2017 on a strong footing, India's exports slowed down since April 2017. While import growth has also been falling since May, it remains far higher than export growth
- Export growth slowed further in July to 3.9% on-year from 4.4% in the previous month
- Import growth also slowed to 15.4% July compared with 19% in the previous month
- Trade deficit widened to $11.4 billion in July from $7.8 billion in the same month last year
- Non-oil export growth slowed to a one-year low of 1.8% in July from 4.5% in the previous month, whereas non-oil import growth reduced to 15.5% in July from 21.2% in the previous month
- The trend of imports growing faster than exports is expected to continue this fiscal, as domestic demand strengthens further on account of normal monsoon and payouts to government employees as per the Seventh Pay Commission recommendations
- We expect India's current account deficit to rise a bit to 1% of GDP in fiscal 2018 from 0.7% in fiscal 2017, owing to a wider trade deficit

Source: CRISIL Research

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