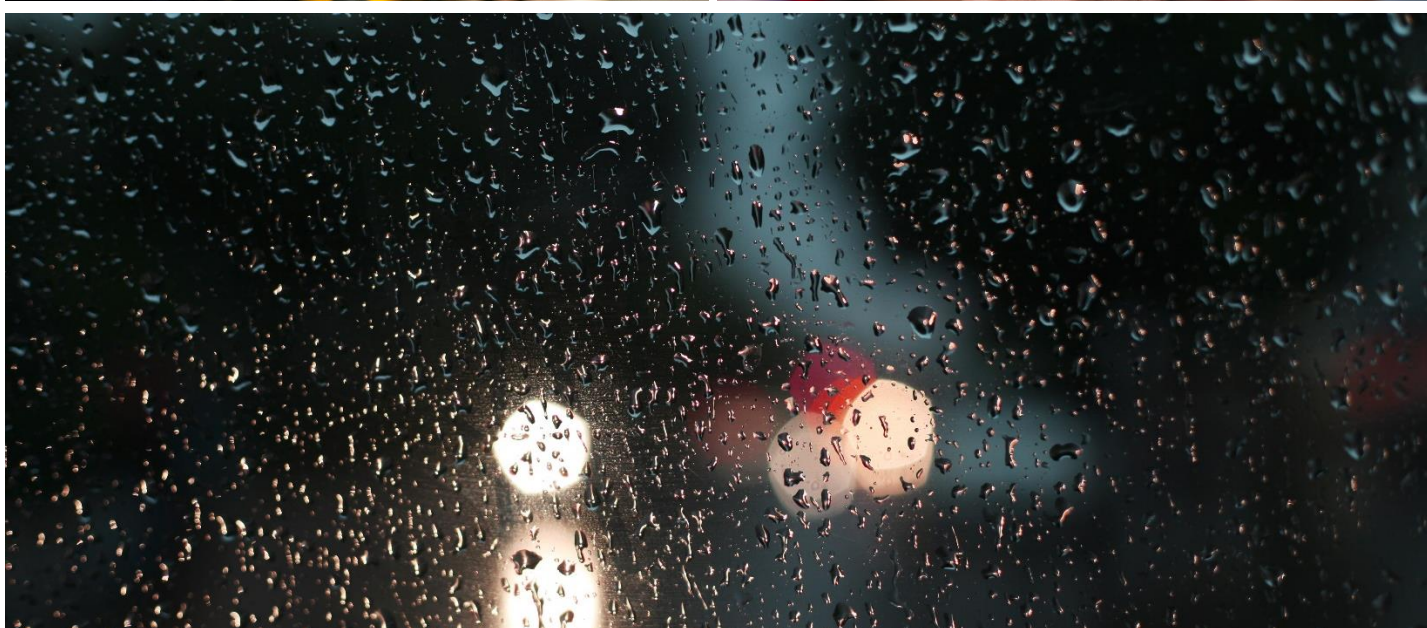


India outlook FY20

January 2019



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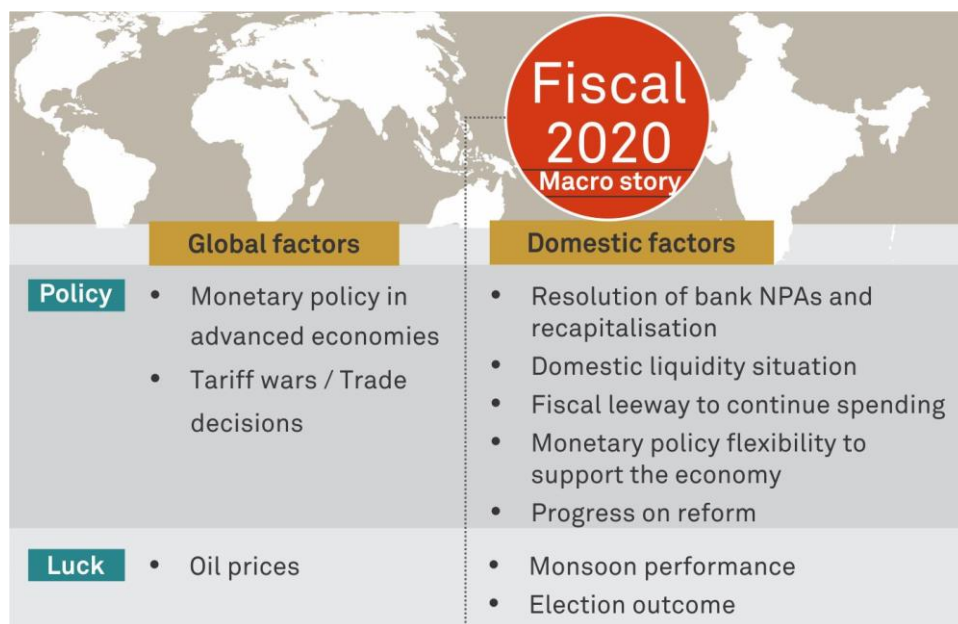
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India's growth outlook for fiscal 2020 will essentially have domestic drivers. The key drivers are expected to be private consumption and investment. With weak global environment, India will have to lean on domestic factors. With the government pursuing a fiscal consolidation path, the pickup in growth is expected to be only gradual. A change in the growth mix is on cards, with private sector likely to take over the baton from the government.

What luck and policy to shape economic outcome



Source: CRISIL

So unlike fiscal 2019, the push will have to come from private consumption and investments, as the government's hands are tied in the fiscal sense.

India outlook, a year from here

	FY18	FY19F	FY20F
GDP (y-o-y %)	6.7	7.2*	7.3
CPI inflation (% , average)	3.6	3.7	4.5
10 year G-sec yield (% , March)	7.6	7.7	7.5
Current account deficit (% of GDP)	1.9	2.6	2.4
Rs per \$ (March)	65.0	71.0	72.0

Note: *advance estimates by CSO

Source: CSO, RBI, CRISIL

In a tremulous world, how do India's metrics look?

GDP growth could see a modest uptick to 7.3% in fiscal 2020

Fiscal 2019 was a year of recovery from demonetisation and the initial disruption caused by the Goods and Service Tax implementation. The economy has so far fired mainly on the public investment cylinder, and is estimated to grow at 7.2%. Private consumption has disappointed. Exports, however, have performed well, presenting a buoy to the manufacturing sector.

In fiscal 2020, CRISIL expects GDP to grow 7.3% on following assumptions:

- Normal rains
- Oil prices lower than 2018
- A stable political outcome

With the government likely to stick to a fiscal consolidation path, the pick-up in growth is expected to be only gradual. A change in the growth mix is on cards, with private sector likely to take over the baton from the government.

GDP growth influencers

	FY17	FY18	FY19	FY20
Consumption				
1. Private / household consumption				
1.a. Income growth / Income push				
(i) Farm income				
(ii) Non-farm income				
(iii) Pay Commission revisions				
1.b. Inflation for consumers / Input prices for manufacturers				
(i) Food				
(ii) Fuel and commodity				
1.c. Interest rate environment				
2. Government consumption				
Investment				
1. Private / corporate				
(i) Capacity utilisation				
(ii) Deleveraging				
2. Government				
Exports				
1. Global growth				
2. Trade environment				

Source: CRISIL

Favourable	Unfavourable	Neutral
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To reiterate, the drivers are expected to be private consumption and investment.

Private consumption

Although it has slackened of late, private consumption growth next fiscal is likely to find support from softer interest rates and improvement in farm realisations, as food inflation moves up. Plus, the lower base effect will help. Private consumption growth has only been falling over the last 4 years.

Investments

Overall investments rebounded in fiscal 2019 with fixed investments growing 12.2%, up from 7.6% in fiscal 2018. Moreover, the investment ratio (investment/GDP) is estimated to have surged to 32.9% after wallowing at 30-31% in the past 4-5 years. The pick-up might have brought with it a healthy change in the investment spending mix, though official data on this will only be available in early 2020. Spending (by the Centre and the states) on construction of rural roads, highways, and affordable housing drove public investments, but private investment looked up only in select sectors such as auto, cement and steel, where capacity utilisation increased.

For fiscal 2020, sustaining the momentum in overall investments will be a tough task without support from private investments. With continuously improving capacity utilisation and the end of the de-leveraging phase for corporates, conditions are ripe for a revival of private corporate investments. A stable political outcome will facilitate this.

Exports

Some worries show up here. In fiscal 2019, exports performed well, growing 12.1%, led by a low base, easing of constraints posed by GST implementation and lingering tailwind of global trade revival in 2017. The spur was also reflected in the sharp pick-up in manufacturing GDP growth to 8.3% compared with 5.7% in fiscal 2018. But gains on the external front were offset with imports rising faster than exports.

However, going forward, export growth faces risks of weakening global trade growth owing to escalating trade wars. But it could also benefit from bilateral trade wars, especially between United States and China. In the recent past, India's exports to China have actually risen for those products on which China has imposed tariffs on US.

Variations to the base case forecast

These assumptions hold for a base case forecast of 7.3% GDP growth in fiscal 2020. At this juncture risks are tilted somewhat to the downside than upside to this forecast.

The downside emanates from the following:

(1) Monsoon risk: Our base case assumption is of a fourth consecutive year of normal monsoon. The past 15 years have seen two such periods of four consecutive normal rainfall years – 2005 to 2008 and 2010 to 2013 – that yielded healthy average agriculture growth of 3.6% and 5.5%, respectively. But the National Oceanic Atmospheric Administration of United States (US) is forecasting an El Niño¹ event in 2019. India faced two consecutive El Niño events in 2014 and 2015 with agriculture GDP growth dropping to near zero. Now, when farmer incomes have been dropping, a weak rainfall, if manifests, could add to the rural pain.

(2) Political risk: If the general elections this year were to yield a fractured mandate and derail/delay the process of reforms, the implications on sentiments, investments and growth could be adverse.

¹ The condition, which typically occurs at irregular intervals of three to five years, weakens the Asian monsoon, often causing drought in north-west and central India and heavy rainfall (or even floods) in north-east.

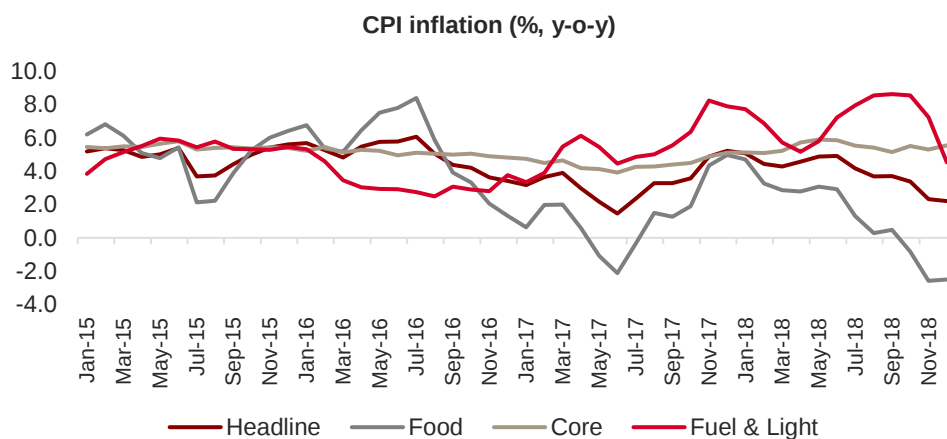
(3) Oil prices: In the base case, global crude oil prices are expected to soften to settle around \$60-65 average per barrel in fiscal 2020 compared with \$68-72 average per barrel in fiscal 2019 as overall global demand slows. However, some price pressure could be felt in response to the recently announced supply cuts by the Organisation of Petroleum Exporting Countries (OPEC). If oil prices were to spike and stay high through the fiscal, India's manufacturers could face input price pressures. And with consumption seeing only a gradual revival, pass-through of these higher costs on to prices could be difficult therefore squeezing margins.

(4) Much weaker global outlook: For now, the deceleration in global growth is gradual. However, if the slowdown is much faster and deeper than is being currently expected, global demand and trade growth could severely slowdown, creating adverse consequences for India's exports.

Inflation to rise in fiscal 2020

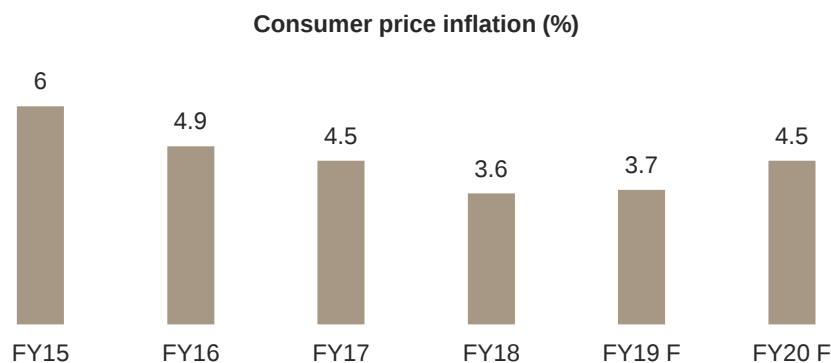
In all likelihood, fiscal 2019 would be the second consecutive year of sub-4% consumer price index (CPI)-based inflation. From an average 4.5% in fiscal 2017, CPI inflation fell to 3.6% in fiscal 2018. We estimate it at 3.7% for fiscal 2019, given the continuous and sharp decline in food prices and slowdown in global crude oil prices compared with a few months ago.

How the components have moved



Source: CSO, CRISIL

Poised for an uptick in fiscal 2020



Source: CSO, CRISIL

However, some of these factors may change in fiscal 2020:

- **Food inflation** has remained subdued for long, with key categories such as vegetables, pulses, and sugar witnessing fall in prices for many months now. This has been leading the decline in the headline number so far. But the situation could likely reverse if monsoon fails or is inadequate next fiscal (given early warnings of El Niño). Fiscal 2020 might also see an upturn in pulses prices as they seem to follow a cobweb phenomenon² with prices rising every third year. According to World Bank's latest projections, global food prices, which were almost stable in calendar 2018, are expected to rise by 1.5% in 2019. This is likely to have bearing on domestic food prices, too.

Also, if the government's procurement machinery becomes responsive enough to address the farm stress, food prices could get pushed towards announced higher minimum support prices.

- **Core inflation**, which has about 54% weight in overall CPI, is another factor to watch out for, as it continues to remain sticky. Even as housing inflation has been trending down – as the one-time statistical impact of the Pay Commission-related house rent allowance hike is waning off - other categories such as *health, education, recreation and amusement, and transport and communication* continue to witness high (5% +) inflation. This limits the downside to overall inflation. Factors such as implementation of Pay Commission hikes by more states and populist measures such as farm loan waivers can add to the upside for core inflation or keep it elevated.
- **Fuel (petrol & diesel) inflation** is likely to remain soft. Global crude oil prices have come off their recent peak in October 2018, and are unlikely to rebound this year, given the slowdown in global growth prospects. Lower crude oil prices can translate to lower fuel inflation for India provided excise duties are not hiked. However, it is important to note that the weight of petrol & diesel in overall CPI basket is quite low (2.3%), and hence, its impact on overall inflation is limited.

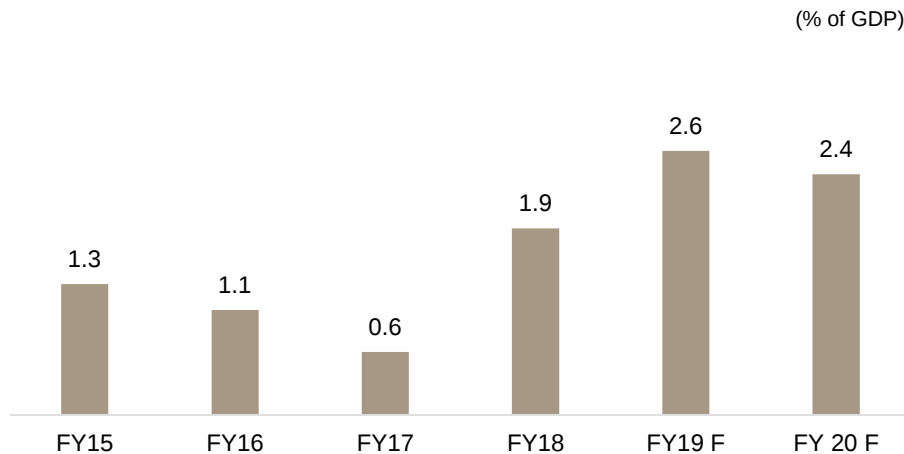
The above considered, CRISIL projects CPI inflation in fiscal 2020 at a higher 4.5%

Current account deficit to ease

We expect current account deficit (CAD) to reduce to 2.4% of GDP in fiscal 2020 from 2.6% of GDP in fiscal 2019. Import growth is expected to slow down, driven by lower oil prices relative to fiscal 2019. However, export growth is also expected to slow on account of lower global GDP growth (especially in advanced economies and China, which are India's top export destinations), and weakening global trade growth on account of escalating trade wars.

² Depending on the elasticity of the demand and the supply curve, the fluctuations in prices and production would perpetually continue, or converge to or diverge from the equilibrium, thus creating a cobweb like pattern around the two curves. If the demand and supply curves have similar elasticity, then the prices and production would continuously fluctuate. If the demand curve is relatively more elastic than the supply curve, the fluctuations may eventually converge to an equilibrium. However, if the demand curve is relatively inelastic compared with the supply curve, the fluctuations may diverge away from the equilibrium.

CAD to moderate



Note: F=forecast

Source: Reserve Bank of India, CRISIL

Rupee to remain in a flux

We expect the rupee to remain volatile and settle at 72/\$ on average by March 2020 compared with an estimate of 71/\$ by March 2019. Low crude oil prices and slowing pace of monetary policy normalisation in the US will support the rupee, so we see only a modest weakening. Low crude oil prices keep external vulnerability (as measured by CAD) under check and slower policy rate hikes by the US Federal Reserve reduce the interest rate arbitrage. But given that India runs a CAD, rupee remains exposed to volatility emanating from oil, tariff wars, and monetary policy surprises from the advanced countries.

Volatile rupee



Source: Reserve Bank of India, CRISIL

Interest rates to soften

Domestic interest rates, which had risen last year, are expected to soften in fiscal 2020. With inflation under control, softer crude oil prices relative to last year, we believe the Monetary Policy Committee would change its stance to neutral from calibrated tightening and could cut the repo rate by at least 25 bps (from 6.50% currently). This will help soften benchmark bond yields.

However, fiscal health remains a key risk. We assume central government's fiscal deficit to be 3.3% of GDP in fiscal 2020. Any slippage will put upward pressure on bond yields.

On the global front, slower pace of rate hikes in the US will support domestic yields. S&P Global expects the Fed to raise rates only twice in 2019 by 25 bps each (compared with three hikes of 25 bps each projected earlier), following four rate hikes in 2018. Lower crude oil prices, and its positive impact on India's macros - current account deficit, inflation and fiscal health - can further help investor sentiment.

Due to these factors, we expect the 10-year government security (G-sec) yield to average at 7.5% by March 2020 compared with 7.7% in March 2019.

Factors that will shape interest rate outlook

		FY17	FY18	FY19	FY20
Domestic factors	Repo rate				
	Inflation				
	Fiscal deficit				
	CAD				
Global factors	Oil prices				
	US interest rates				

Source: CRISIL

Favourable Unfavourable Neutral

Global trends that matter

1. Growth is coming down from a high

The 'synchronous' music has more or less stopped, with recent growth projections signalling quite the reverse in 2019. Growth in most major economies is set to moderate. According to S&P Global, global growth is expected to slow to 3.6% in 2019, compared with a six-year high of 3.8% in 2018.

The US is expected to lead the way down, as both waning fiscal stimulus and cumulative effect of ongoing monetary policy normalisation will drag growth. China's expansion will continue to moderate amid anticipated policy easing, as ongoing trade tensions impact business and investor confidence negatively. Europe will slow, too.

Moreover, risks are tilted to the downside. They include uncertainty about trade wars and pace of interest rate normalisation by the US Federal Reserve.

What's in it for India: Slowing global demand and trade will hurt India's exports growth in 2019. India's exports already missed the bus in 2017, when growth was booming all around, owing to the twin domestic disruptions wrought by demonetisation and the Goods and Service Tax (GST) implementation. In 2018, volatility in crude oil prices, which peaked to a four-year high of \$84 per barrel during the year, and US tariffs on steel and aluminium, further weakened net exports growth.

Global growth in most major economies to moderate in 2019

Region/ Country	Share in India's export (%)		Real GDP growth (% , y-o-y)			
	Fiscal 2017-18	2015	2016	2017	2018F	2019F
United States of America	15.8	2.9	1.6	2.2	2.9	2.3
Eurozone (Euro Area-19)	10.4	2.0	1.9	2.5	1.9	1.6
United Kingdom	3.2	2.3	1.8	1.7	1.3	1.3
Japan	1.6	1.4	1.0	1.7	0.9	1.1
China	4.4	6.9	6.7	6.9	6.5	6.2
World (S&P Global)	-	3.5	3.2	3.7	3.8	3.6
World (IMF)	-	3.4	3.3	3.8	3.7	3.5

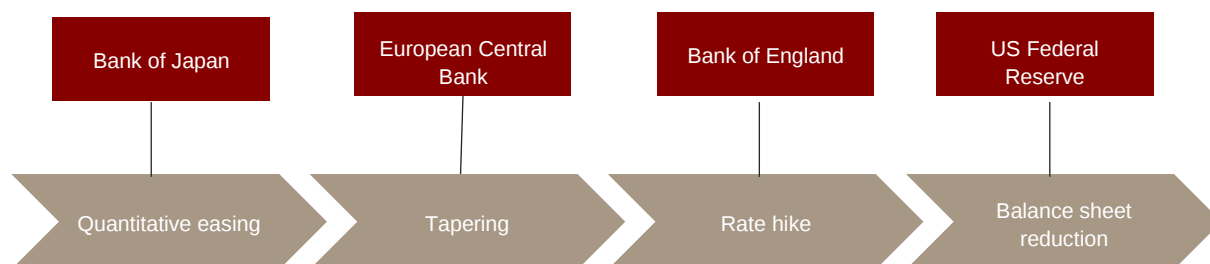
Source: CRISIL, S&P Global, International Monetary Fund (IMF) (January 2019)

2. Monetary policies – asymmetric and normalising

Advanced economies are 'normalising', or winding back their extremely accommodative monetary policies unfurled in the wake of the 2008 global financial crisis. Of the four major central banks, the US Federal Reserve, European Central Bank, and the Bank of England have initiated policy normalisation, while the Bank of Japan is continuing with quantitative and qualitative easing.

Typically, such monetary policy normalisation involves central banks' tapering of asset purchases, raising policy rates, and eventually shrinking the size of their balance sheet to the normal level by rolling off maturing assets.

Major advanced economies aren't 'going back' in the same way



Source: S&P Global, CRISIL

In 2018, rising US interest rates meant bond market sell off in emerging markets. This led to a sharp weakening of currencies in countries that run a current account deficit. India was no exception.

What's in it for India: While the slower-than-expected US Federal funds rate hike may favour foreign capital inflows into India, a pick-up in the policy rates in Europe may chip off some of the gains. But this is unlikely to materialise before the end of 2019. Moreover, US monetary policy actions have a greater impact on emerging market economies compared with the ECB.³ Overall, India will stand to gain from the slowing pace of US Fed rate hikes, in terms of capital flows (see *Box below*).

3. The 'twist' depends on oil

Being the largest import item, oil has a significant impact on India's CAD, and indirect impact on inflation and fiscal deficit. The following table indicates how India's CAD could change with different levels of crude oil prices.

As crude oil prices rose to four-year highs in 2018, CAD sniffed 3% of GDP, the highest since the 'taper tantrum' period. India's vulnerability to crude oil price changes also made it one of the worst victims of capital flight among emerging markets. This caused a sharp depreciation in the rupee.

However, since November, crude oil prices have fallen sharply, despite additional cuts announced by the OPEC, reflecting weakening global demand conditions.

Going forward, slower global GDP and trade growth will weigh on demand and keep crude oil prices lower than last year.

Crude impact on CAD

Crude oil price (\$/barrel)	CAD (% of GDP)	
50	1.8	
60	2.3	
62.5	2.4	→ CRISIL forecast for fiscal 2020
70	2.7	
80	3.1	

Note: The CAD forecast assumes that other factors remain the same, as in our baseline forecast for fiscal 2020

Source: CRISIL

³ Rey (2015), *International Channels of Transmission of Monetary Policy and the Mundellian Trilemma*. IMF

Key developments in the US

- *Slowing US growth*: S&P global expects US to slow to 2.3% in 2019 from 2.9% in 2018
- *Slowing pace of monetary policy normalisation*: In its December 2018 monetary policy meeting, the Federal Open Market Committee signalled a slower pace of policy rate hikes in 2019 and 2020, compared with September projections
- *China-US trade war “truce”*: US has delayed increasing tariffs on \$200 billion worth of Chinese goods to 25% from 10% pending a 90-day negotiation period until March 1, 2019

...and how they translate for India

- Slower growth in the US will adversely impact India through the export channel, since it accounts for the largest share of India's export earnings. About 16% of India's exports go to the US, compared with 10% to Euro-area, 9% to United Arab Emirates, and 4% to China
- Export growth can also be affected by escalating trade war between US and China. While the negotiations between the two economies are still on, investors are postponing their long-term investment decisions, given persisting uncertainty. This will weigh on global GDP growth. In addition, protectionist measures will weaken trade intensity, further reducing India's scope for growing its exports
- Interestingly trade war seems to have boosted India's exports to China. In fiscal 2019 so far (April-November), India's exports to China has grown 41% on-year, compared with 11.8% growth to US and 8% to the Euro-area. Exports have, especially, increased in cotton and petroleum, on which China has been intending to impose tariffs on US. If this trend continues, it can help India reduce its massive trade deficit with China
- On the upside, a dovish monetary policy in the US would ease the pressure on rupee and interest rate, as foreign capital that exited emerging market economies on the back of steady US rate hikes in US and rising US treasury yields returns.

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