Economics

# India chart book

# Volatility overshadows growth

Group Research

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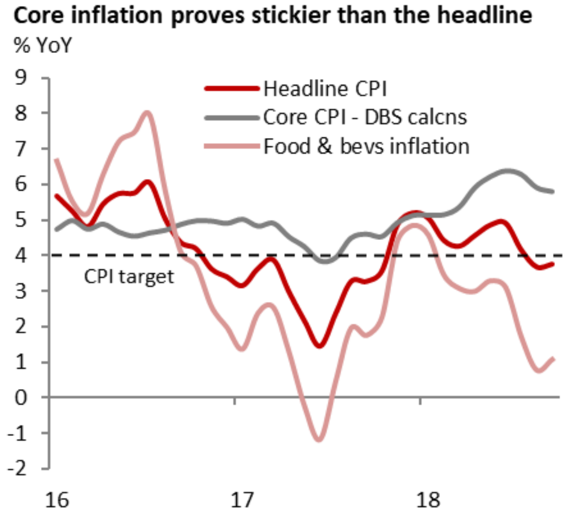
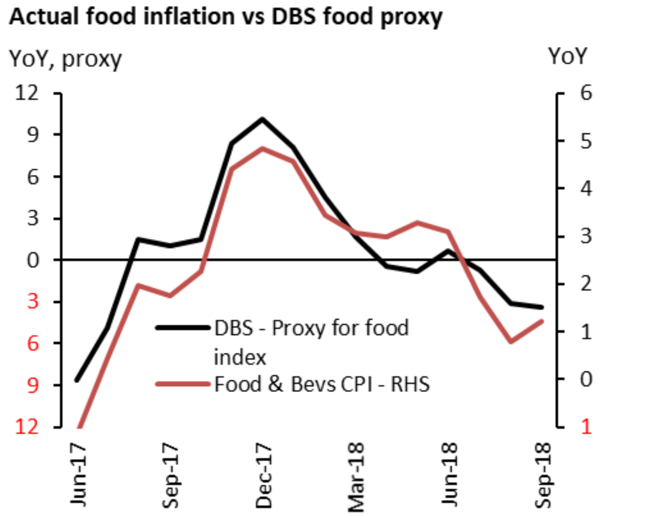
- *Benign food inflation gave the RBI space to keep rates on hold this month. We revise down our CPI forecast a notch. Guidance suggests policy remains centered on the inflation mandate and is not targeted at currency management.*
- *Inflation might not be a concern (besides core), but currency and oil prices are unknowns. We retain the possibility that weak global cues might need to be defended by one-two hikes in rest of FY19.*
- *Rising rates and dollar, China-US trade friction, high oil prices and geopolitical unease have resulted in a broader sell-off. Indian equities which had, erstwhile, been resilient to rising yields, have narrowed this year's gains.*
- *There have been a mix of liquidity boosting steps and intervention by the RBI. The government is talking up the rupee, backed by import curbs to contain the current account deficit at 3% of GDP and emphasizing on fiscal consolidation.*
- *A non-resident deposit/ bonds scheme is under consideration. Its success in calming markets will hinge on an improvement in the external environment, akin to 2013.*
- *Growth momentum has been resilient yet far. The trend is likely to face speedbumps in H2 FY19 but will still be amongst the fastest in the region. Base effects, moderation in government spending, tighter financial conditions and a wider trade miss might slow growth to 7-7.5% by end-FY19. CAD is seen at -2.7% of GDP, with any miss in the fiscal deficit to be contained at -3.4-3.5%.*
- *We look for the USDINR to head towards 75.0 factoring in our base case of at least four hikes by the US Fed over the year, which will be dollar and rates positive. OMOs have supported domestic bonds, but concern over borrowings and cautious banks/ FPIs, might leave 10Y yields back up at 8.1-8.2% by end-year.*

Core inflation continues to outpace headline CPI on higher contribution by services (transport)



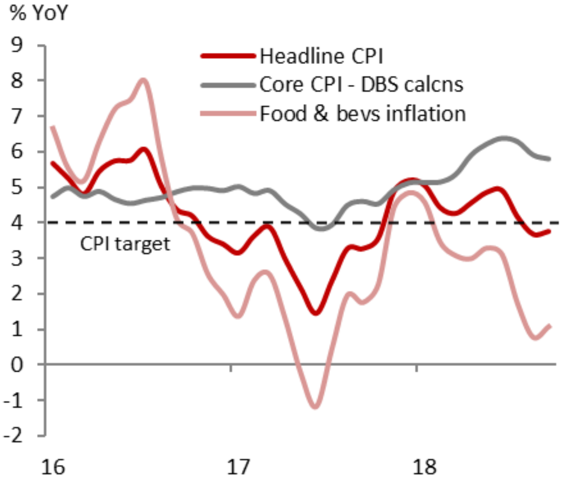

Our in-house proxy for food prices tracks food CPI inflation closely.



## Inflation outlook

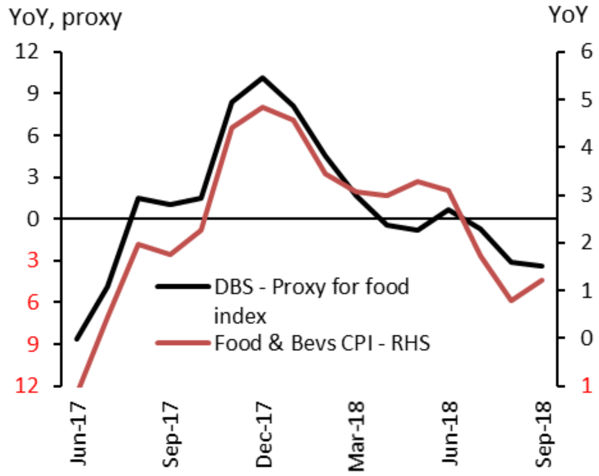
September CPI inflation stayed below the 4% target for a second consecutive month, along our expectations. Core inflation continues to outpace the headline and remains elevated at 5.8% YoY.

**Core inflation proves stickier than the headline**



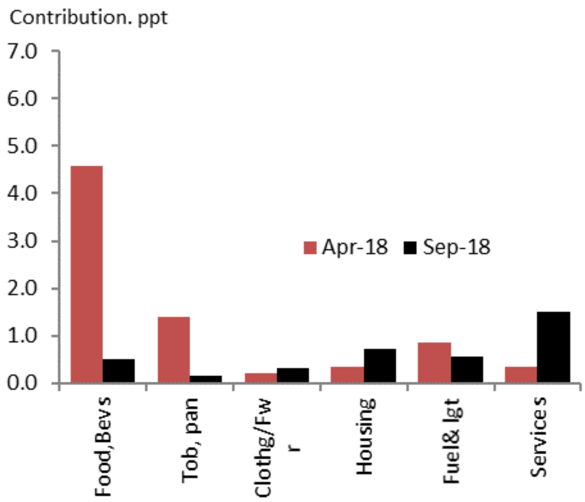

Our in-house proxy for food inflation tracks changes in the official food CPI inflation closely, which off late signals a bottoming out in store.

**Actual food inflation vs DBS food proxy**




Contribution of CPI sub-components has seen services (via higher transport costs) punch higher than its weight vs the dominant food inflation. This has fed into core pressures. Nonetheless, YTD benign trend (largely due to slow food) prods us to lower our CPI inflation estimate to 4.4% YoY vs 4.7% earlier.

**Main CPI sub-head -non-food adds more than food**




Real rates (i.e. 1Y INR Tbill yield – CPI) are also near the two-year average, providing ample cushion. In view of global risks, the rupee and INR rates will require a higher risk premium to reflect further RBI policy tightening risks, rising crude prices and likelihood of higher uncertainty ahead of upcoming state elections.

**Real interest rate****

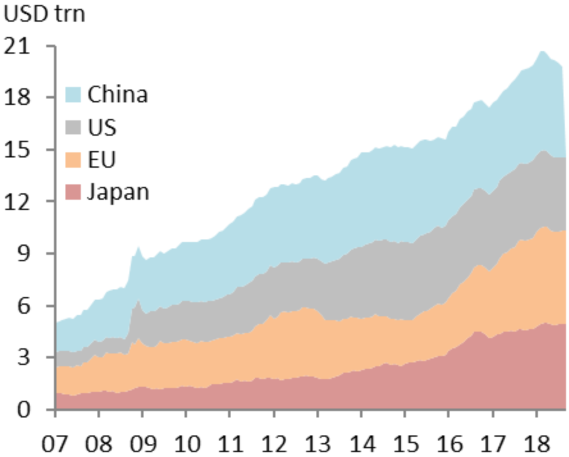

* CPI Industl workers used as proxy until Jan12; **1Y Tbill yield- CPI

## Financial markets

Taking a step back, G3 economies and China have, cumulatively, expanded their balance sheets by ~90% in the past decade. Over the next few years, with the US leading the way, policy is likely to be normalised, making liquidity scarce and flows headed back to the developed markets.

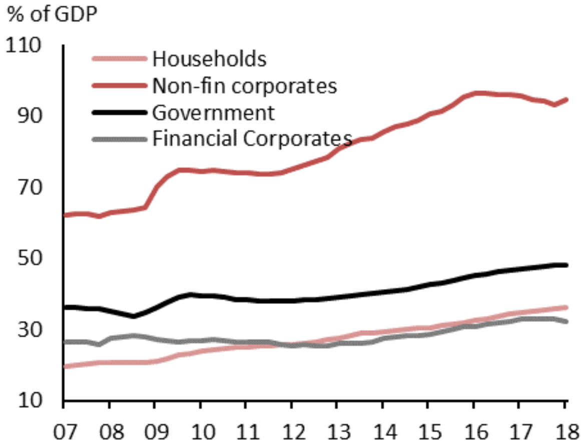
This will not only put EM economies, that have built leverage owing to low rates, in a tough spot, but also trigger a reversal in high-yield seeking foreign flows.

**Central bank balance sheets - G3 and China**




Source: CEIC, FT, DBS

**Debt levels amongst 30 EM economies are up**

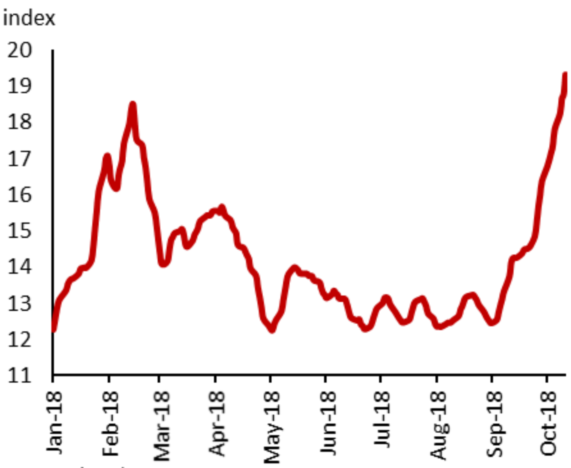



Source: IIF, DBS Group Research

High volatility has pushed up India's VIX gauge.

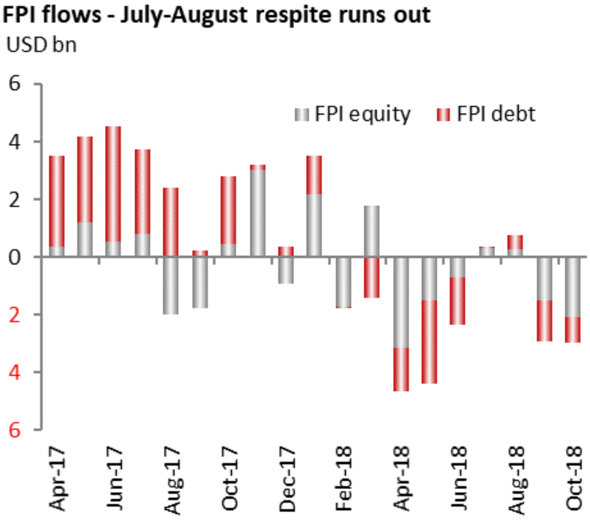
On 2018 year-to-date basis, foreign portfolio investors are net sellers of USD3.7bn Indian equities and USD8bn debt. This has close to reversed 40% of 2017 inflows, as global allocation shifts back to the developed markets.

**India VIX - NSE volatility index**

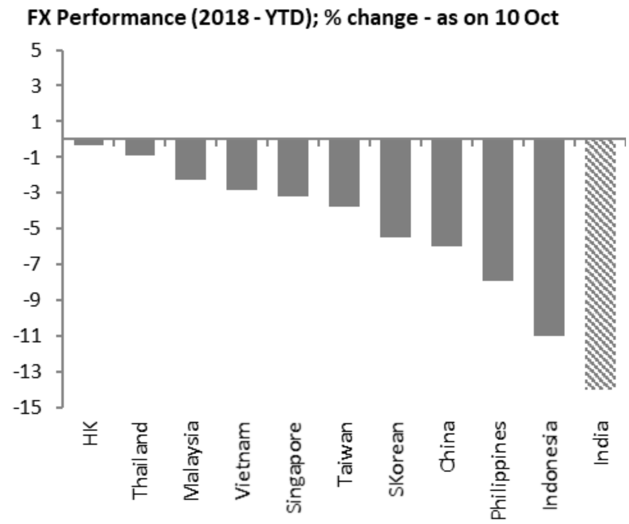



Source: Bloomberg, DBS

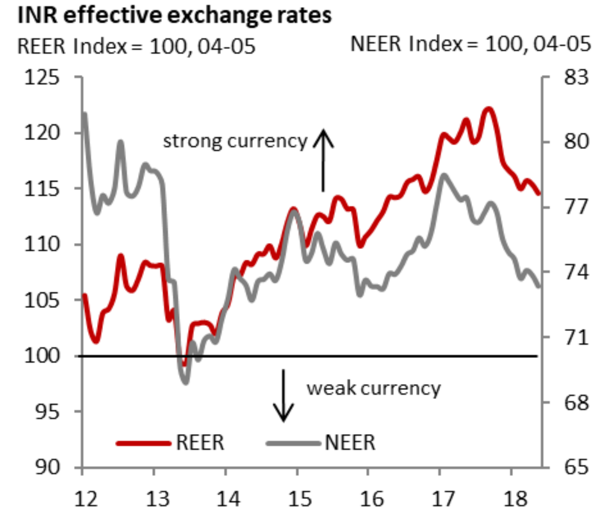
**FPI flows - July-August respite runs out**



Against the USD, the rupee remains the worst performing currency in the Asia-10 pack. INR forwards suggest further depreciation is in store, owing to negative global cues. A non-resident deposit/ bonds scheme is under consideration. Its success in calming markets will hinge on an improvement in the external environment, akin to 2013.

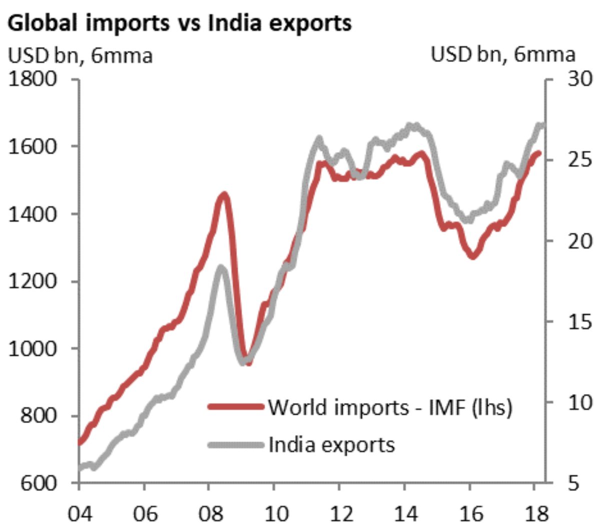



Our INR forecasts signal a depreciating bias could persist on dollar strength and risk-off jitters. On real effective exchange rate basis, INR is still above the neutral 100-mark (down 7% since December 2017).

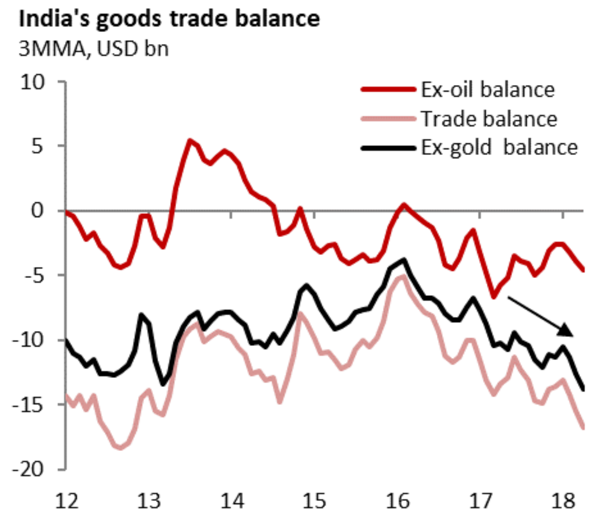



## External balance deteriorates

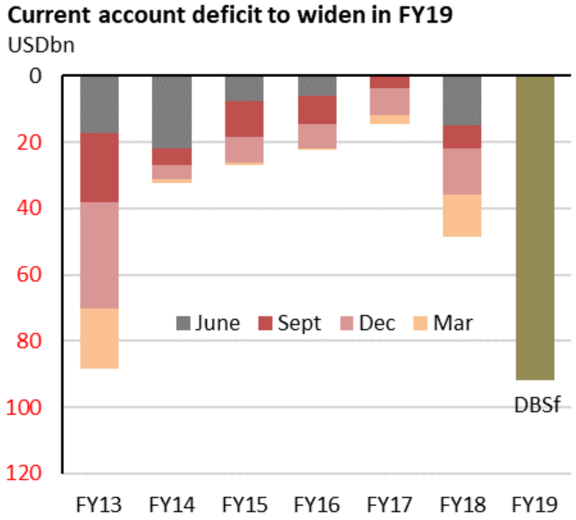
India's exports are more tightly correlated with global demand, rather than a cheaper rupee. A tougher trading environment is unfortunately in the offing, in midst of US-China trade disputes and protectionist overtures by the rest. This limits the room for global trade to expand meaningfully in 2019.



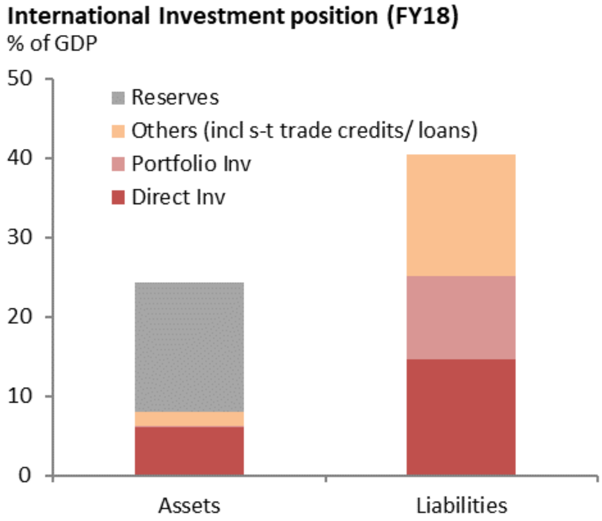

Recent tariffs were targeted at less than 10% of imports, while key categories of oil, gold and consumer electronics (~cumulatively 35-40% of total), which are primarily responsible for widening the FY18 deficit, are still out of scrutiny.



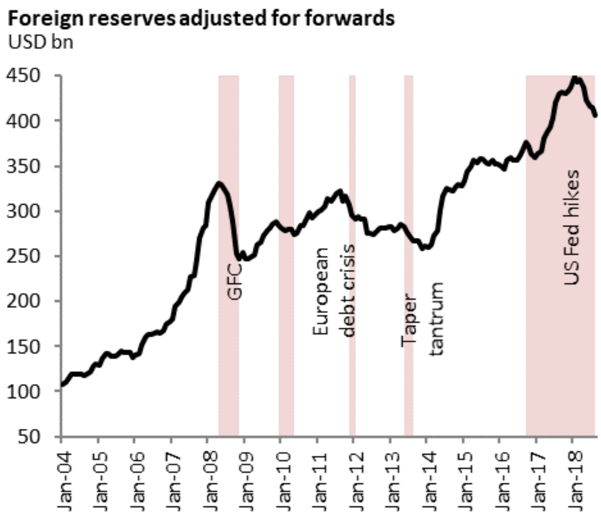
Current account deficit is likely to widen on higher oil and non-oil imports. We estimate FY19 CAD at -2.7% of GDP (USD75bn), with a likelihood a rise to ~3% year after if oil prices stay high and demand elasticity remains weak.



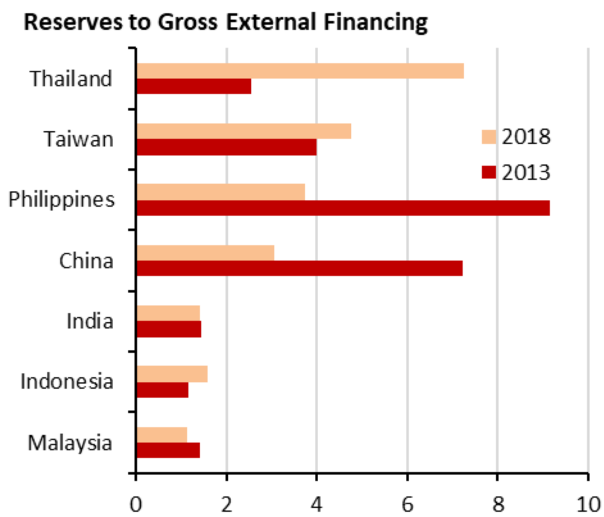

The International investment position (IIP) remains in deficit, with FX reserves making up the biggest chunk of assets, whilst liabilities rise on portfolio and trade credits.




A challenging global environment has compelled the RBI to intervene aggressively this year to contain INR depreciation. Besides spot, intervention also occurred in the forwards markets, to ensure minimal disruption to liquidity conditions.



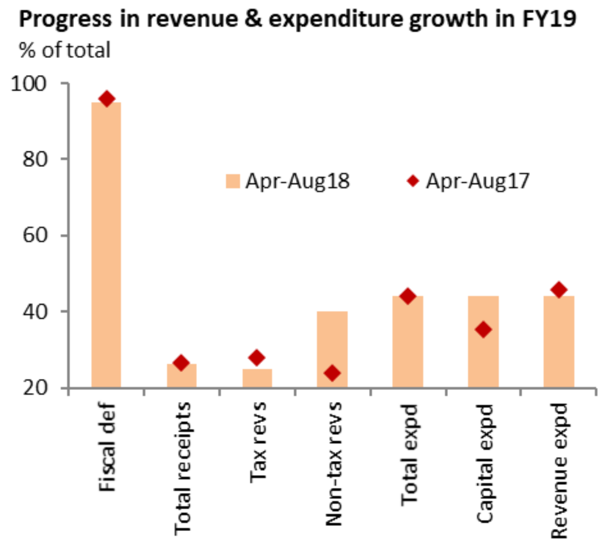

Higher reserves vs 2013 have also been accompanied by higher financing needs (short-term residual maturity and CAD), keeping the ratio nearly unchanged in 2018.

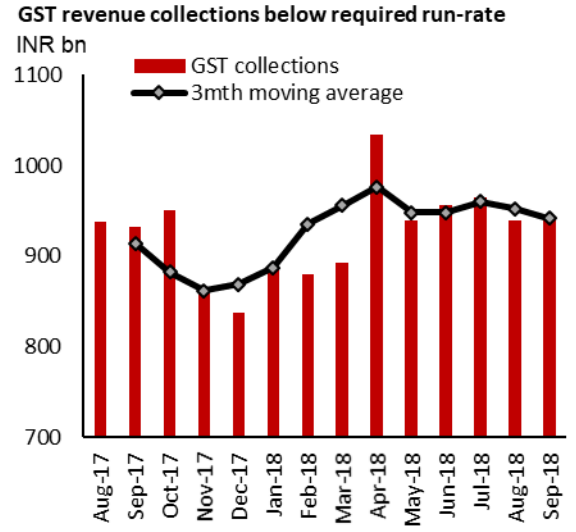


## Fiscal developments

Year-to-date progress has seen the fiscal deficit near 95% in 1HFY19. Expenditure and revenues largely track last year's progress, with non-taxes being propped up by fuel excise collections. Capital expenditure is also being front-loaded.

GST revenue collections are modestly below target. Centre's GST run-rate in H1FY19 is ~INR30bn below target, with a consistent shortfall to increase the gap. Uncertainty over the division of IGST is another overhang. Weaker revenues and need to maintain expenditure might result in a small miss in the FY19 fiscal deficit at –3.4-3.5% of GDP (vs targeted -3.3%).

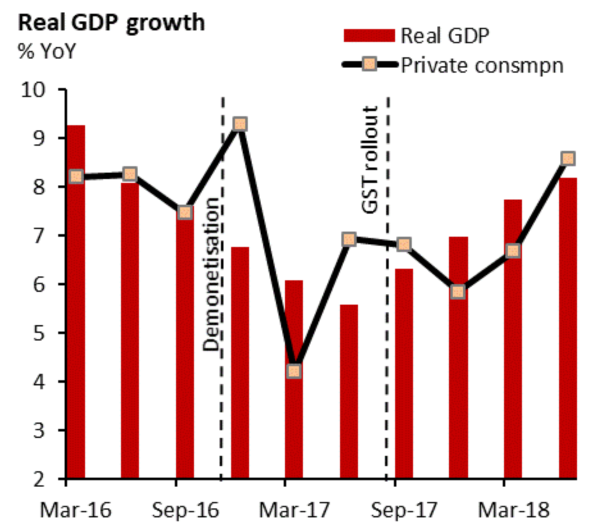


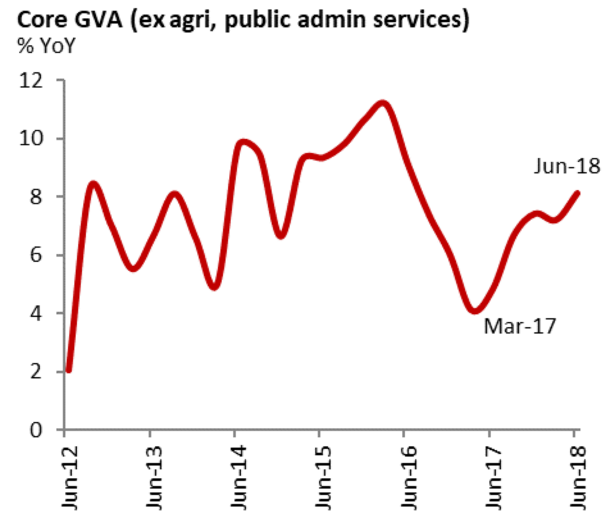




## Growth outlook

GDP growth started the FY on a high of 8.2% YoY. Base effects, moderation in government spending and tighter financial conditions along with a wider trade miss are likely to slow growth to 7-7.5% by end-FY19.

On the supply end, encouragingly, core GVA i.e. excluding farm and public admin services has continued to improve in recent quarters.



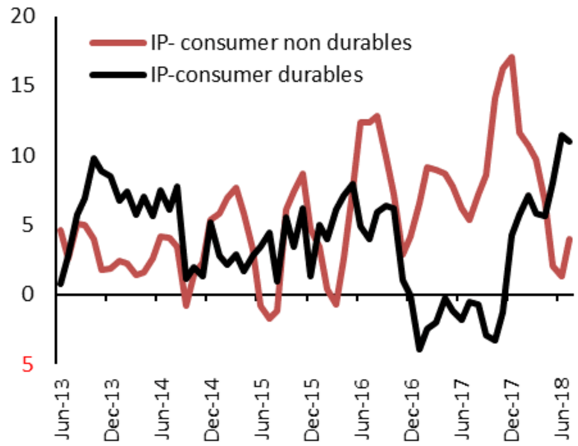



Consumption growth is likely to be the main contributor to growth, primarily urban and non-farm spending (proxy durables production) as rural incomes continue to underwhelm.

Capacity utilisation rates have stabilised in recent quarters, just as investment growth gets off its back. Public capex spending has improved, while the private sector continues to focus on deleveraging and improving its capital structure.

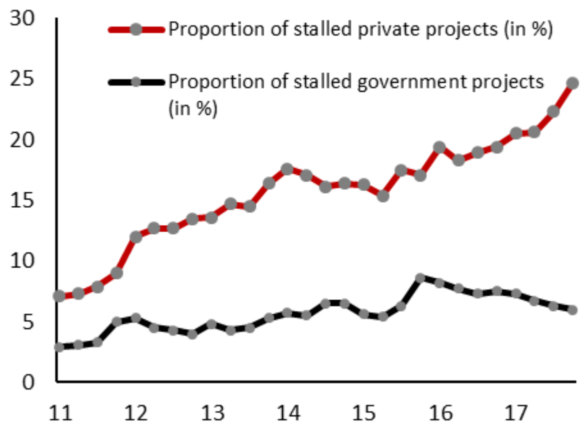
**Industrial production - durables vs non-durables**

% 3MMA YoY




**Stalling rate of private sector projects still high**

%



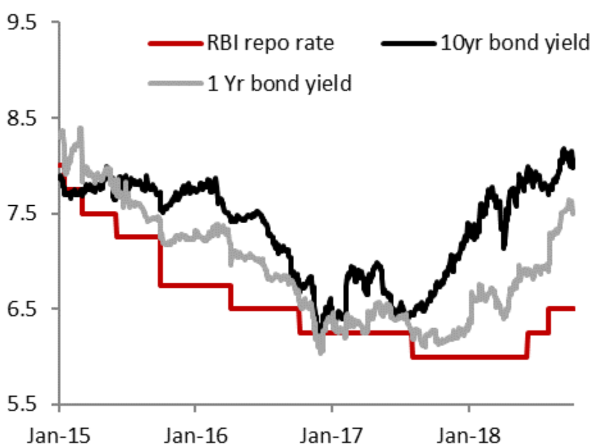

Source: CMIE, DBS

Despite the central bank's status quo, financial conditions have tightened. Short- and long-term bond yields have risen by 80-100bp since the start of the year. Commercial papers rates are up, whilst corporate bond issuances are down nearly 35-40% to the comparable period last year.

Non-bank entities continue to be bogged down by asset-liability mismatch and liquidity concerns. While part of the credit demand might shift to the banks, higher borrowing costs and difficulties in access of funding from mutual funds (due to redemptions) is likely to slow loan growth (see here).

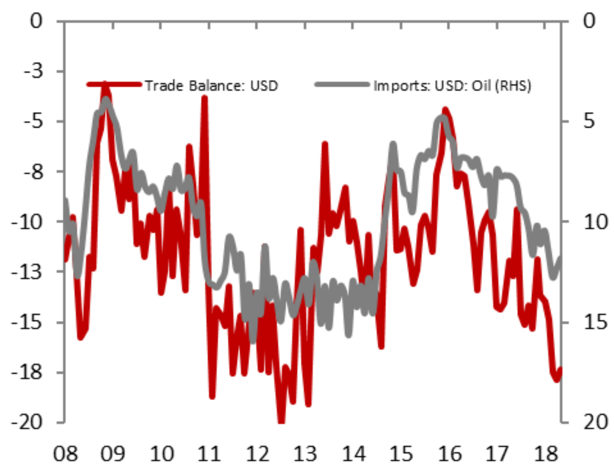
**Tighter financing conditions despite RBI no-move**

% pa, repo




**Total trade deficit vs oil imports**

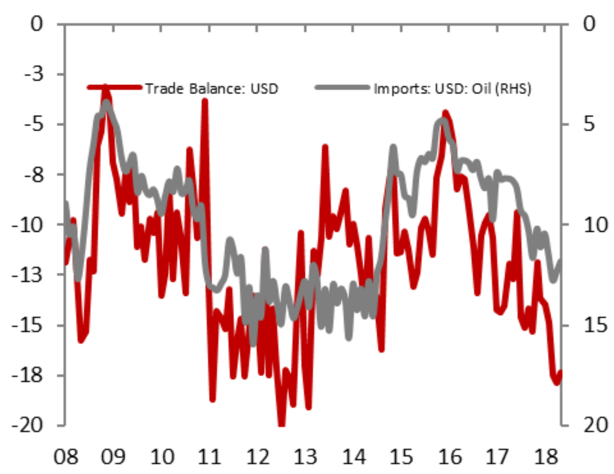
USDbn USDbn



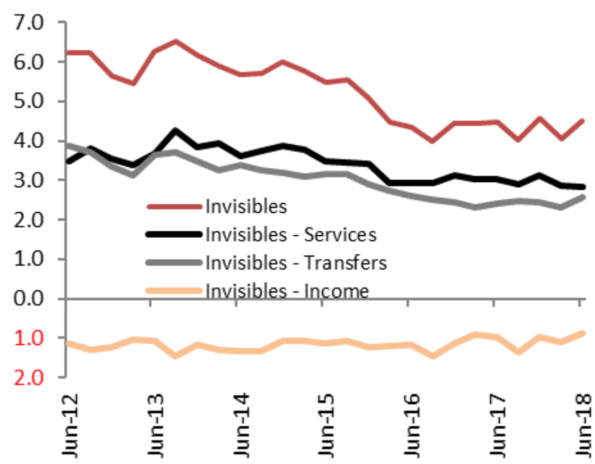
Surge in oil imports will keep the pressure on the net goods trade balance, in turn burdening the current account deficit.

Service sector earnings have moderated, with downside risks on the rise in midst of rising trade protectionism, and tighter labour movements, despite a weaker rupee.

**Total trade deficit vs oil imports**



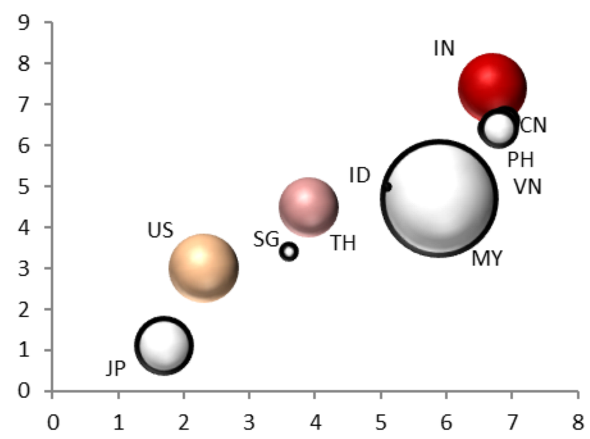

**Earnings from invisibles, under BOP, moderate**




Beyond a firm H1, growth is likely to hit a speed-bump in H2 on base effects and aforementioned factors. Despite that, full-year growth will average a relatively strong 7.4% YoY. Compared to Asia-10, India stands out amongst a handful that will expand at a faster pace in 2018 vs year before.

**Growth outlook - G3 and the region**

Yaxis = 2017; Xaxis = 2018, % YoY, hollow spheres = scale of moderation likely and vice-a-versa



## Forecasts on major indicators

| | GDP (YoY) | | | | CPI inflation (YoY) | | | |
|---|---|---|---|---|---|---|---|---|
| | 2016* | 2017 | 2018 | 2019f | 2016* | 2017 | 2018 | 2019f |
| **Annual change (%)** | 8.0 | 7.1 | 6.7 | 7.4 | 4.9 | 4.5 | 3.6 | 4.4 |

*end March; fiscal year

| Exchange rate and interest rates forecasts | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | 1Q18 | 2Q18 | 3Q18f | 4Q18f | 1Q19f | 2Q19f | 3Q19f | 4Q19f |
| **USD/INR** | **eop** | 65.2 | 68.5 | 72.5 | 73.0 | 73.5 | 74.0 | 74.5 | 75.0 |
| **Repo rate** | **(%, eop)** | 6.00 | 6.25 | 6.50 | 6.75 | 7.00 | 7.25 | 7.50 | 7.50 |
| **Government bond yields** | **2Y (%, eop)** | 6.85 | 7.54 | 7.84 | 7.85 | 7.85 | 7.85 | 7.85 | 7.85 |
| | **10Y (%, eop)** | 7.40 | 7.90 | 8.02 | 8.10 | 8.20 | 8.30 | 8.40 | 8.50 |
| | **10Y-2Y (bps)** | 55 | 36 | 18 | 5 | 15 | 25 | 35 | 45 |

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**Sources**: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).