Global Research
& Analytics

CRISIL
An S&P Global Company

INDIAN ECONOMY

CRISIL Insights

November 2016

Through the monthly CRISIL Insights Indian Economy series, we offer incisive analysis of macroeconomic parameters of the country. In this issue, we look at the impact of demonetisation on GDP growth.

Demonetisation queues, Q3-Q4 cues

What a tumultuous month November has been. The mind-space of economists over the last few days has been hijacked by demonetisation and its aftermath. In a sudden move, the Narendra Modi government announced the demonetisation of Rs 500 and Rs 1000 currency notes. The short-term impact of this is playing out and has been quite disruptive as the system was not prepared for sudden withdrawal of these high denomination notes, which account for the 86% of currency in circulation.

The bold move by the government, in addition to reducing the menace of counterfeit currency, has macroeconomic consequences as well. It will hurt private consumption, the key engine of growth at this juncture, and therefore GDP growth. The adverse impact on GDP will be concentrated in the third and fourth quarters, and should peter off after that. It will also put further downward pressure on inflation which has been lower than expected in the last two months. Bond yields will come down and interest rate transmission will improve.

So far, so good.

A number of players in the unorganised sector, who use cash as a key medium of transactions, are being inconvenienced. The real estate sector, where deals involve cash, will also be adversely impacted. These are transitory issues and should get resolved over time. But, the reduced upside risk to inflation and rising risk to growth, due to demonetisation, raises the odds in favour of a rate cut in the December monetary policy.

Another issue is India's declining current account deficit (CAD), which has given a lot of comfort on the external vulnerability front over the last 2-3 years.

CAD fell nearly $66 billion in fiscal 2016, down from its peak in 2013. The narrowing was almost entirely caused by a sharp fall in the goods trade deficit. The good luck from this factor, however, ends in 2016. From calendar 2017, most commodity prices are forecast to start rising, which means that the trade deficit will swell.

DEMONETISATION	Industrial Production	Inflation
Significant structural benefits on the cards	Mild upturn in IIP	A positive direction for CPI

DEMONETISATION

- The government's stunning move to demonetise Rs 500 and Rs 1,000 currency notes by replacing the former and discontinuing the latter – and announcing a new Rs 2,000 note -- will have a transitory impact on GDP growth in the short term, but will spell significant structural benefits over the long term.

- Millions of small enterprises in the unorganised sector that use cash to transact will be inconvenienced for a while. Cash-dependent, consumption-led sectors will also feel the pinch, while investment demand will be tempered in the short term. Over the long term, however, the move could change the face of the Indian economy, improve the government's fiscal position and tax compliance. The size of the cash economy will shrink, as will black money generation avenues, because of better cash-flow trails. Inflation would tread down as demand slows in the short term, but the impact over the long-term would be neutral.

INDUSTRIAL PRODUCTION

- After two consecutive months of negative growth, IIP was up at 0.7% on-year in September. The improvement was on account of manufacturing sector, which was mildly up at 0.9% in September as opposed to -0.2% in August. Twelve of the twenty-two industry groups in the manufacturing sector displayed positive growth in September over the same month last year.

- Within manufacturing, consumer-oriented sectors led the improvement, registering a growth of 3.6% in September, compared to -1.2% in August. Investment-related sectors, on the other hand, displayed poor performance (-0.8% growth in September compared to 0.5% in August). The key consumer-oriented sectors that drove the growth were food product & beverages (6.4%), textiles (4.1% growth), motor vehicles (3.8%) and rubber & plastic products (4.3%). According to use-based classification of IIP, consumer goods drove the overall improvement in IIP, growing 6% in September, up from 0.7% in August.

INFLATION

- Inflation moderated further to 4.2%, a one year low, in October from 4.3% in September. This was driven by a drop in food inflation to 3.3% (drop of 60 bps) - especially in vegetables, fruits and pulses, while core inflation edged up to 5.1%. Fuel and light inflation (including petrol and diesel) also picked up 30bps in October, driven by higher petrol and diesel inflation. The positive impact of a favourable monsoon this year is reflecting in lower food prices. Further, the recent demonetisation measure, we believe, will curb demand and put downward pressures on inflation in the short run.

- Going ahead, we expect inflation to trend lower and average 4.8% in the second half of fiscal 2017, because of lower consumption due to demonetisation and good monsoons resulting in higher food supply. Overall, we expect inflation to average 5% in fiscal 2017.

CRISIL
An S&P Global Company

Interest Rate	Rupee	Trade
Rate cut pares yields	Hold steady despite dollar outflows	Exports show sharp upturn

INTEREST RATE

- Yields declined for the fourth month on the trot in October, pushed down by the central bank's policy rate cut, softer consumer price index-linked inflation, and increase in the foreign portfolio investor (FPI) investment limit in government securities (G-secs). Yield on the 7.59% 2026 G-sec ended at 6.89%, down 7 basis points (bps) on-month. The 10-year G-sec yield had last fallen below 7% in July 2009. On average, yields drifted lower by 19 bps to 6.85% even as one-year yields ended at 6.50%, down 14 bps on-month.

- With the central bank aiming for near-neutral levels, liquidity has continued to expand. It was in excess for the third straight month in October. However, the surplus was much lower than in September owing to $6 billion of the total $20 billion flowing out of foreign currency non-resident deposits.

RUPEE

- Global market participants went on a hiatus in October as uncertainty over the outcome of the upcoming US Presidential election trumped robust India macros, resulting in moderate outflow of foreign capital. Uneasiness over the redemption from foreign currency non-resident deposit accounts and the strengthening dollar also weakened the rupee.

- On average, the rupee was stable at 66.7 per dollar, but fell 0.3% at month-end. While the rupee has gained some lost ground over the past few months, its value remains 2.6% weaker on-year. The currency remained tightly range-bound at 66.5-66.9 per dollar.

- Subdued foreign investors extracted $1.5 billion net from the Indian markets – $900 million from debt and $640 million from equities. However, so far this year, foreign inflows have overall been healthy, attracted by domestic indicators and facilitated by global liquidity. Net portfolio investment totalled $6.9 billion from April to October compared with $720 million in the corresponding period a year ago.

TRADE

- India's merchandise exports picked up significantly in October, rising 9.59% on-year, led by improvement in shipment of two on India's largest export commodities – engineering goods and gems & jewellery. On the whole, non-petroleum exports in October 2016 stood at $20.80 billion compared to $18.92 billion in October 2015, showing a rise of 9.9%.

- Imports too displayed some improvement during the month. Hitherto in negative territory, import growth in October stood at 8.1% on-year, with rising oil prices pushing up oil imports. At $7.14 billion, India's oil imports in October 2016 rose 4% over the same month last year. Non-oil imports too grew 9.3% in the month. Consequently, the trade deficit in October increased to $10.16 billion from $9.69 billion in the year ago period. Cumulatively for Apr-October 2016 period, though, trade deficit is still lower at $35.6 billion compared to $50.3 billion during the same period last year.

Source: CRISIL Research

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

CRISIL is majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Global Research & Analytics (GR&A)

CRISIL Global Research & Analytics (GR&A) is the world's largest and top-ranked provider of high-end research and analytics services. We are the world's largest provider of equity and credit research services. We are also the foremost provider of end-to-end risk and analytics services to trading and risk management functions at world's leading financial institutions and corporations. We offer corporate strategy, competitive intelligence and key account management support to corporations globally. We operate from research centers in Argentina, China, India and Poland, working with our clients across several time zones and in multiple languages. We are proud to be an organization that has the vision to proactively invest in its people and get them future-ready. We are committed to delivering cutting-edge analysis, opinions, and solutions. This underscores our proposition of "Making Markets Function Better".

CRISIL Privacy Notice

CRISIL respects your privacy. We use your contact information, such as your name, address, and email id, to fulfil your request and service your account and to provide you with additional information from CRISIL and other parts of S&P Global Inc. and its subsidiaries (collectively, the "Company") you may find of interest.
For further information, or to let us know your preferences with respect to receiving marketing materials, please visit http://www.crisil.com/privacy. You can view the Company's Customer Privacy at https://www.spglobal.com/privacy.

Last updated: April 2016

Disclaimer

CRISIL has taken due care and caution in preparing this report. Information has been obtained by CRISIL from sources which it considers reliable. However, CRISIL does not guarantee the accuracy, adequacy or completeness of any information, and is not responsible for any errors in transmission; and especially states that it has no financial liability whatsoever to the subscribers / users/ transmitters/ distributors of this report.

Argentina | China | Hong Kong | India | Poland | Singapore | 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

CRISIL
A S&P Global Company