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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 look at why the new GDP series has generated a lot of heated debate.

GDP: The signal and the noise

Gross domestic product (GDP) is easily the most important and widely used summary indicator of the health of an economy. Whether it is a good indicator of economic well-being, though, has been open to debate.

As Nobel Laureate Joseph Stiglitz noted, in many cases, GDP statistics seem to suggest that the economy is doing far better than most citizens' own perceptions.

This was indeed the case in 2015 when the new GDP series released by Central Statistical Office showed high and accelerating growth. A refrain heard widely was, "It does not feel like 7-7.5% growth."

The new series entails a change in the base year to 2011-12 besides the use of a revised methodology and new databases for GDP computation. It relies on value-based indicators as against volume-based indicators in the previous series.

We believe the debate on GDP has generated more light than heat so far, with many commentators taking a 'my way or the highway' approach.

We find that the sharp fall in inflation measured by the GDP deflator, the wedge between Consumer Price Index (CPI) and Wholesale Price Index (WPI), lack of appropriate deflator for some sectors, and the change in methodology are behind concerns the new series has generated.

To be fair, the disconnect with ground level data is not uniform - it is more prominent in the manufacturing sector, which now uses the new and improved method.

The WPI-based deflator, used for computing the real value added from nominal, also pushes up real GDP, given that WPI has been in deflation zone for almost a year. Indeed, the disconnect of indicators such as credit growth and corporate topline growth narrows when we compare these nominal variables with nominal GDP.

In our opinion, some of the disconnect can be explained technically and will disappear as the wedge between CPI and WPI reduces and the toplines of corporates start improving.

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Monetary Policy	Industrial Production	Inflation
Next rate cut could be in October	IIP grows positively for second consecutive month	Inflation jumps up in July

MONETARY POLICY

- As expected, Reserve Bank of India (RBI), in its monetary policy review on August 9, kept the repo rate unchanged at 6.5%. While the central bank believes a good monsoon will curb rising inflation, it emphasised that sticky core inflation and implementation of the Seventh Pay Commission recommendations, especially the increase in HRA, could pose a challenge. RBI retained its March 2017 inflation target with upside risks.
- Since the last monetary policy meeting, higher food prices and sticky services inflation have meant that June CPI inflation touched a 22-month high of 5.8%. We believe this surge to be a blip, and adequate monsoon will pull it back. Overall, we expect inflation to average 5%, GDP to grow at 7.9% and RBI to deliver another rate cut of 25 basis points this fiscal.

INDUSTRIAL PRODUCTION

- The Index of industrial production (IIP) grew 2.1% on-year in June 2016, up from 1.1% in the previous month. Not only is it the second consecutive month of positive growth but also the highest so far this year. That said, the pace of growth still remains low.
- Improvement was seen across the board. Manufacturing sector - the mainstay of IIP with ~75% weightage -grew positively for the second straight month by 0.9%, 30 bps up from its last reading. Eighteen of the twenty-two industry groups in the manufacturing sector grew positively in June from the same month last year.
- The positive growth in manufacturing was led primarily by the consumer-oriented sectors (3.5% growth) whereas industrial and investment oriented sectors grew negatively (-0.7%) in June, displaying continuously weak momentum. According to use-based classification, the fall in the capital goods category intensified in June (-16.5%) from May (-12.3%) even as all other categories displayed improvement.

INFLATION

- Inflation rose for the fourth consecutive month to 6.1% - a 23-month high - in July on the back of rising food inflation and an unfavourable base effect. While food inflation increased to 8.4% (+60 bps), core inflation remained contained at 5.1%. Moreover, categories with inflation higher than 6% accounted for only 23% weight, comprised by food items majorly. Therefore, CRISIL Research believes that the increase in the consumer price index-linked (CPI) inflation is transitory. A normal monsoon, as forecast by the India Meteorological Department (IMD), and proactive steps taken by the government to manage food supply will rein in food inflation this fiscal. Latest data suggests rainfall is 3% above normal so far, which has helped raise reservoir levels and supported sowing. Sown area coverage so far is higher by 43.6 lakh hectare than normal as on August 5, with substantial progress in pulses. Therefore, we believe it will take 1-2 months for the benefit of the rains to wash away the rise in food prices.

Interest Rate	Rupee	Trade
FII rush, liquidity slash yields	Global liquidity, local macros strengthen rupee	Twist in the exports recovery script

INTEREST RATE

- Yields were subdued by global and local factors in July, falling in an almost straight line. The 7.59% 2026 government security (G-sec) ended at 7.16%, down 29 basis points (bps) on-month while, on average, yields slipped 19 bps to 7.30% during the month. Staying consistently below 7%, the yield on the 1-year G-sec ended at 6.84% sliding 13 bps on-month.
- Liquidity has steadily improved since the beginning of this fiscal, with the Reserve Bank of India injecting close to Rs 805 billion through open market debt purchases and the government increasing its spending. June's liquidity deficit became a surplus in July. As a result, the net average daily operation changed from injection of Rs 413 billion in June to absorption of Rs 49.9 billion in July through the central bank's liquidity adjustment facility - or the sum of net repo, net term repo, and marginal standing facility.

RUPEE

- After weakening for two straight months, the rupee appreciated by a marginal 0.1% on average in July. It ended the month at 67.2 per dollar compared with 67.6 in June-end. The initial volatility over Brexit settled somewhat, but the uncertain recovery in most advanced economies drove accommodative central banks forward on the easing course. While the Japanese government joined hands with its central bank to unveil focussed stimulus packages, the Bank of England cut its policy rate by 25 basis points on August 4.
- With global markets flush with liquidity, funds found their way to emerging markets, especially India, given that its macros are more favourable than those of peers. In addition, better domestic growth prospects buttressed by a good monsoon, approval of the Seventh Pay Commission recommendations which will raise the salaries and pensions of government employees, and the much-awaited passage of the Goods and Services Tax (GST) bill placed India's economy in a sweet spot.

TRADE

- Export growth slipped back into negative territory in July, tanking 6.8% on-year, belying hopes of a sustained recovery. Of particular concern was a 4.5% drop in non-oil exports, which had grown at an average 1.8% in the previous two months.
- However, trade deficit narrowed to $7.8 billion – down $5.3 billion on-year and $0.4 billion on-month – as the slide in imports was sharper, at 19%. Despite the dip in July, exports so far this fiscal have seen some revival compared with last year. Imports, by contrast, have seen a steeper decline.
- CRISIL expects export growth to remain tepid through 2016 given that global growth forecasts continue to edge lower. For yet another year, lower import bill (muted oil imports due to benign crude oil prices and weak gold imports given domestic policy restrictions) will anchor India's current account deficit (CAD). CRISIL, accordingly, expects CAD to rise slightly in fiscal 2017, to 1.3% of GDP from 1.1% in fiscal 2016.

Source: CRISIL Research

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