Research

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Ring, fence

How fit is India to fend off 1-2-3 punches?

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Executive summary

In January this year, we highlighted a troika of looming global risks, with implications for India. Two of these – asymmetry in monetary policies in advanced economies and elevated oil prices – have since manifested. The third – trade wars – has moved from rhetoric to action.

In this sequel, we examine how these risks have advanced and assess how prepared India is to brave them.

The chinks are showing already.

Since the start of 2018, foreign investors in India have fled debt and equities. Trade deficit has swelled and precipitated a fall in the rupee. All this, tangoing with the trend in other emerging markets.

The impact of external shocks depends on their magnitude and the economy's ability to face it. While the oil price shock is a known devil with perceptible impact on current account deficit (CAD) and inflation, we are still struggling to get a hold on the other two, which do not have much precedence.

The most prominent and inevitable risk of these shocks is on CAD and its financing. Since India is a net importer of oil, higher oil prices straightaway fuel the merchandise trade deficit. Besides, the trade wars (by pulling exports and/or pushing up the import bill) could widen the non-oil trade deficit which is already at levels higher than in fiscal 2013, when the CAD was at its peak.

The rupee inevitably gets swept by the next wave of risks. If CAD were to balloon, the rupee would face depreciation pressure. To boot, it could display high volatility given the triangulation effect of elevated crude oil prices, trade wars, and increased dollar demand, while monetary policy normalisation in advanced economies could stoke capital outflows from India. However, we expect the rupee to stabilise towards the end of this fiscal to average 67 per dollar in March 2019 compared with 65 in March 2018.

Consumer price index (CPI) inflation has been witnessing some pressure from rising crude oil prices but the pass through is still incomplete. We'll have to wait and watch how second-round effects enter headline inflation in coming months.

Overall, gauging the impact of these shocks is not very straightforward as these transmit through multiple channels, and over an extended period of time. Besides, most of these shocks are evolving, which makes it all the more difficult to decipher how they will pan out.

Though most of India's macro parameters have seen some strain lately, they also appear resilient when compared with the 2013 'taper tantrum', and in better shape than other emerging markets to negotiate the latest onslaught of global risks.

The worrying part, though, is that the quantum and complexity of these shocks are greater.

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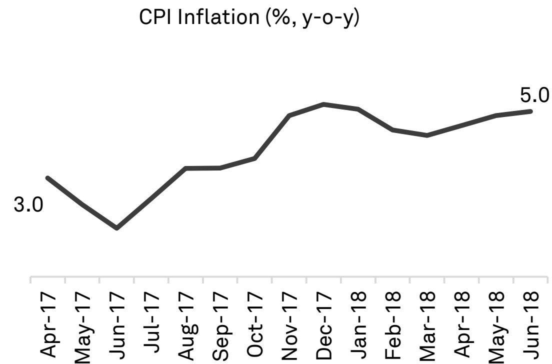
The matrix reloaded

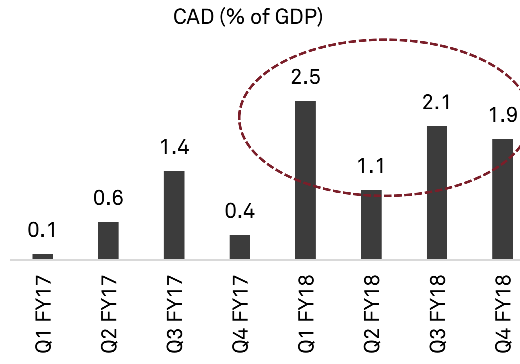
Macros at large

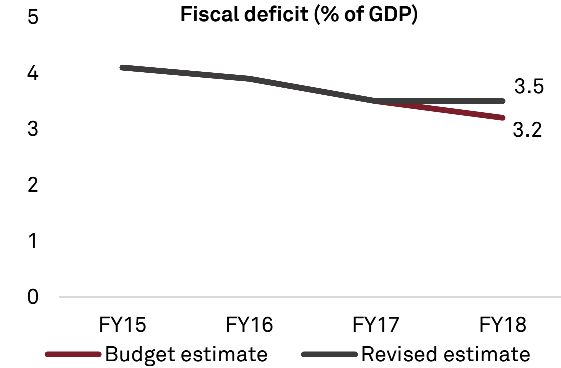
- India's headline economic indicators are relaying some not-so-good news at present.
- CAD slid from 0.1% beginning fiscal 2017 to 1.9% end fiscal 2018, plumbing 2.5% in between.
- Fiscal deficit target of 3.2% was breached last fiscal, and revised upward for this year.
- Inflation has been marching up in the past few months. The Reserve Bank of India in June 2018 raised its inflation forecast and hiked policy rate after a gap of four-and-a-half years.
- All this has quickly translated into a weakening rupee against the US dollar. It depreciated 7.9% on average from January to July 2018, as result of foreign capital flight from the Indian equity and debt markets and appreciation of the US dollar index[1] (up 5.8% since January 2018).
- A worsening rupee makes our imports costlier and adds to domestic inflation.

[1] Dollar index is the weighted average of the foreign exchange value of the US dollar against the currencies of a broad group of major US trading partners

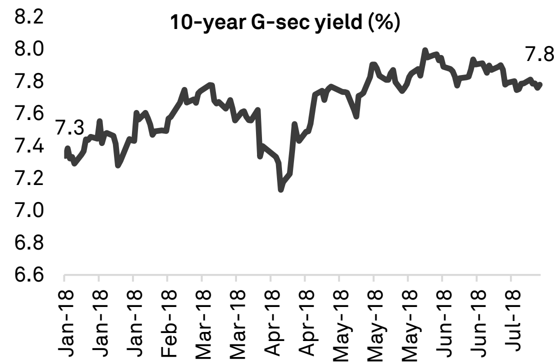
Macro misbehaviour…

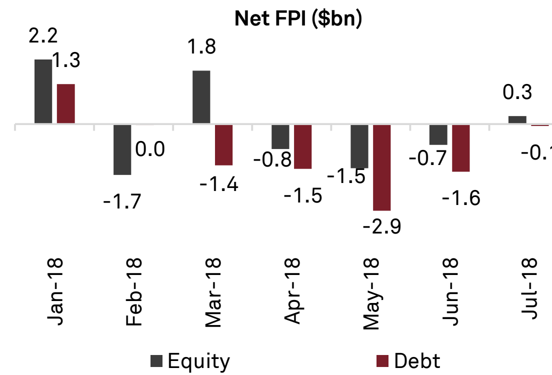


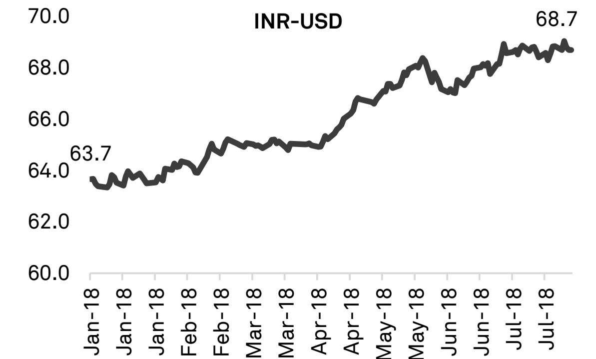




… makes for fickle financials







Source: NSDL, RBI, CCIL

How well can India take the punches now?

The potential impact of an external shock on a country can be gauged by assessing the quantum of its short-term liabilities, its ability to finance them from its own resources, and its overall macroeconomic health.

We find that while risks/ shocks have risen, India is better poised to face them compared with the past and other emerging market peers.

The three components of vulnerability

Extent of liabilities

There are two kinds of short-term external liabilities: CAD and short-term external debt.

Of these, CAD has seen the most significant jump to 1.9% of GDP in fiscal 2018 from 0.6% in fiscal 2017. With rising oil prices, it is expected to climb to 2.6% in fiscal 2019.

That said, CAD remains significantly below the levels it reached before the taper tantrum. In fiscal 2013 – the year preceding the taper tantrum - CAD had reached 4.8% of GDP, which dented investor sentiment and spurred capital flight.

On the other side, short-term external debt has remained broadly stable over the past few years. The share of debt with maturity of up to one year (known as short-term debt (original maturity)) in total external debt had peaked in fiscal 2013 and has descended since (see appendix). The share of long-term debt obligations due in one-year (known as short-term debt (residual maturity)) in total debt, too, has remained stable.

Ability to finance liabilities

The stability in short-term debt obligations has been accompanied by India's improving ability to service it. An indicator for debt sustainability is the debt service ratio – which is the ratio of gross debt service payments[2] to current account receipts[3]. This debt service ratio has fallen in fiscals 2017 and 2018 owing to recovery in export earnings relative to the past few years and a marginal fall in gross debt service payments (see appendix for long-term trend in this indicator).

[2] Including both principal and interest rate payments to non-resident creditors
[3] Net of official transfers

In addition, foreign exchange reserves held by the Reserve Bank of India are more than sufficient to finance the overall set of liabilities. As shown in the table below, the ratio of foreign exchange reserves to the sum of short-term debt (residual maturity) and CAD stands above one.[4] This means foreign exchange reserves are in excess of liabilities arising from CAD and short-term debt obligations (including long-term debt repayments due in one year). Even if we look at reserves relative to the International Monetary Fund's (IMF's) Assessing Reserve Adequacy (ARA) metric for emerging markets (which includes additional indicators reflecting potential drains on balance of payments[5]), the ratio remains well above one – meaning reserves are greater than the benchmark prescribed by the IMF.

Macroeconomic health

India's macroeconomic parameters may not be on tops, but they are still much healthier than in fiscal 2013. With reining in of inflation, the growth inflation mix has been improving. The combined fiscal deficit also looks healthier as the centre has made some headway on the fiscal consolidation path. Though this combined fiscal deficit has started slipping since fiscal 2017, and might continue to be under pressure, it is expected to stay lower than in fiscal 2013.

[4] This is the extension of reserves coverage rule proposed by Alan Greenspan and Pablo Guidotti

[5] This metric gives a benchmark for emerging markets based on the following indicators: (i) export income to reflect the potential loss from a drop in external demand or a term of trade shock; (ii) broad money to capture potential residents' capital flight through the liquidation of their highly liquid domestic assets; (iii) short-term debt to reflect debt rollover risks, and (iv) other liabilities to reflect other portfolio outflows

In terms of vulnerability, India is in a much better place now than in fiscal 2013

	Indicator	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19P
External liabilities	CAD (% of GDP)	2.8	2.7	4.3	4.8	1.7	1.3	1.1	0.7	1.9	2.6*
	Short-term external debt (% to total external debt): Original maturity	20.1	20.4	21.7	23.6	20.5	18	17.2	18.7	19.3	NA
	Short-term external debt (% to total external debt): Residual maturity	41.2	40.6	40.9	42.1	39.7	38.5	42.7	41.6	42.0	NA
Ability to finance external liabilities	Debt service ratio	5.8	4.4	6	5.9	5.9	7.6	8.8	8.3	7.5	NA
	Reserves/(short-term debt + CAD)	1.9	1.7	1.3	1.1	1.5	1.6	1.6	1.8	1.6	NA
	Reserves/ IMF EM ARA metric	2	1.7	1.6	1.4	1.4	1.5	1.6	1.6	1.6	1.5#
Domestic macroeconomic health	GDP growth (% y-o-y)	8.5	10.3	6.6	5.5	6.4	7.4	8.2	7.1	6.7	7.5*
	CPI inflation (% y-o-y)	12.3	10.5	8.4	9.9	9.4	6	4.9	4.5	3.6	4.7*
	Fiscal deficit (% of GDP) - combined	9.5	6.8	7.9	6.9	6.7	6.7	7	7	6.6**	5.9^
	-Centre	6.5	4.8	5.9	4.9	4.5	4.1	3.9	3.5	3.5**	3.3^
	-States	2.9	2.1	1.9	2	2.2	2.6	3.1	3.5	3.1**	2.6^
	Government debt (% of GDP)	70.6	65.6	65.3	65.2	66.8	66.7	68.6	67.4	NA	NA

Note: P: projection; *CRISIL Forecast; #IMF Forecast; **Revised estimates; ^Budget estimates

Source: RBI, Ministry of Finance, IMF, CSO, CRISIL

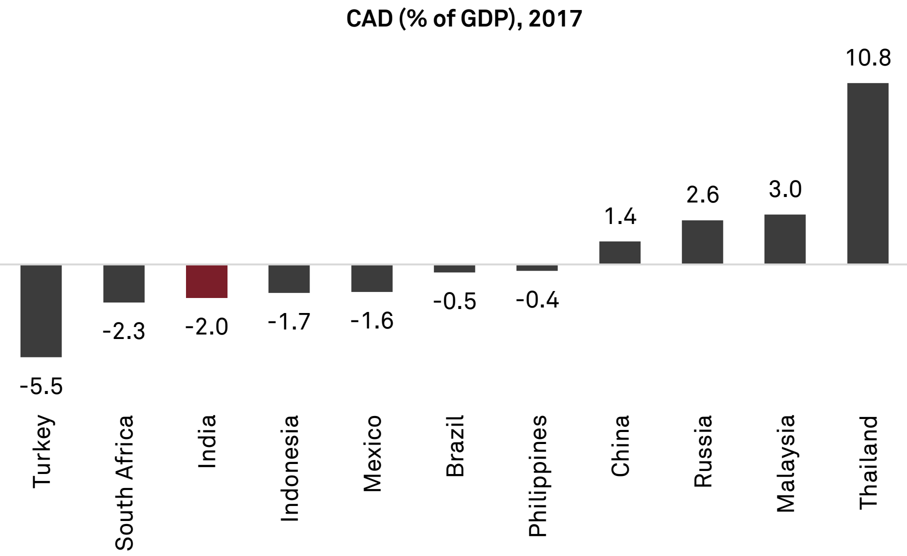
How India stacks up against other emerging markets

Here, we compare India with 10 other emerging market peers on key vulnerability indicators. While India runs a higher current account deficit than most, adequate reserves are a good offset. We also have one of the lowest inflation risks among these emerging markets.

Turkey and South Africa appear to be the most vulnerable of the lot, while Thailand and Russia seem to be the best placed. Interestingly, despite Russia ranking well, its currency has been the worst performing, as a result of sanctions and other adverse political developments.

Third-largest CAD

India runs the third-largest CAD among the selected emerging markets. The only countries worse off are Turkey and South Africa. In contrast, China, Malaysia, and Thailand run current account surpluses. It is no surprise, then, that currencies of these economies have appreciated against the US dollar in the current risk-off scenario.

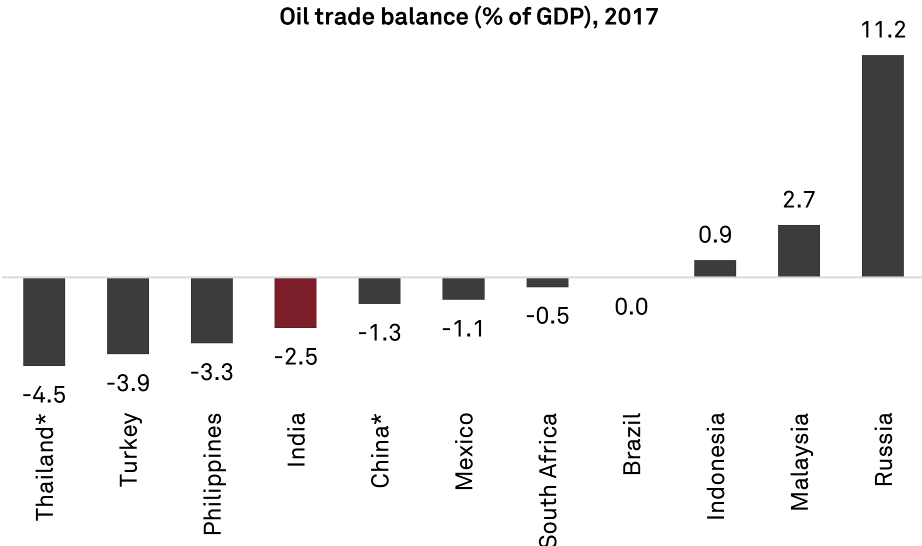


Note: Numbers are for calendar year 2017

Source: IMF

Fourth-widest oil trade deficit

The primary driver of India's high CAD is oil, where we have the fourth-widest deficit as a percentage of GDP among the selected emerging markets. Besides India, Thailand, Turkey, and Philippines are expected to be impacted the most by the sharp rise in oil prices. However, despite having the highest oil trade deficit, Thailand runs a current account surplus, which indicates that its non-oil export earnings offset the deficit on oil trade. Among 11 emerging markets, three run an oil trade surplus.



Note: Numbers are for calendar year 2017;*data for 2016

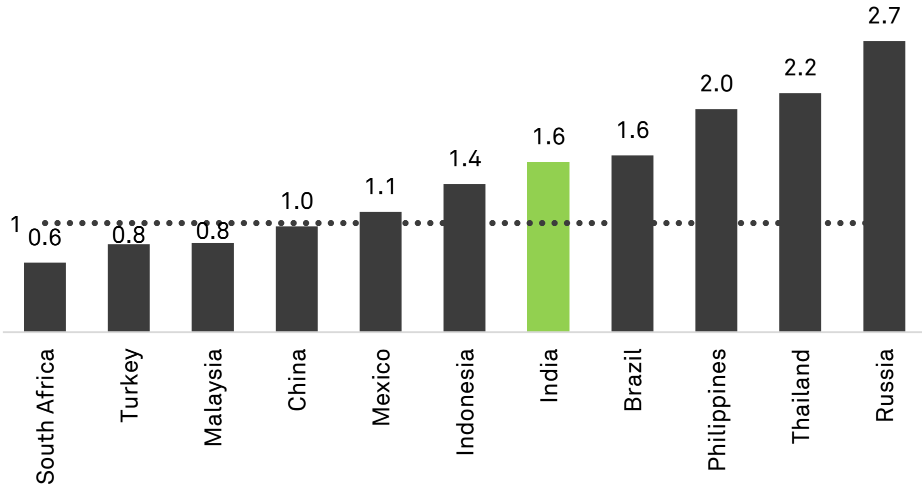
Source: UN Comtrade, IMF, CRISIL

Fifth-highest reserves

Seven out of eleven emerging markets have adequate reserves, as per the IMF's ARA benchmark for emerging markets. India figures in this list. However, Russia, Thailand and Brazil have larger reserves as a proportion of the ARA requirement.

Among countries running current account deficits, Turkey and South Africa do not have adequate reserves to finance their deficit.

Reserves relative to IMF's ARA benchmark, 2017

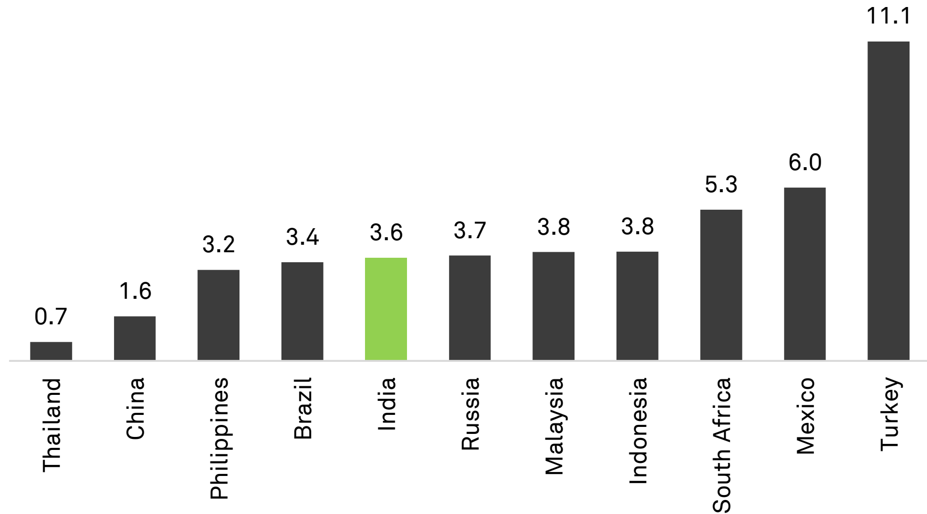


Source: IMF estimates

Fifth-lowest inflation

India has the fifth-lowest inflation. Thailand and China have the lowest, while the outlier is Turkey, which has double-digit inflation.

Headline annual inflation, 2017



Source: IMF

External shocks and impulses

Oil price surge: been there, done that

The oil shock is the least complex of the global shocks India is facing, but has had the most perceptible impact on CAD and inflation.

Brent crude oil prices surged 50% on-year in the first quarter of fiscal 2019 to $70 per barrel on average, fuelled by supply cuts by the Organization of the Petroleum Exporting Countries, rising geopolitical tensions in the Middle East, and production disruptions in Venezuela.

Rising oil prices will have a direct upward impact on India's CAD, given its huge oil import dependence. *Ceteris paribus*, every $10 rise in oil price per barrel can jack up CAD by 40-50 basis points (bps).

The impact on headline consumer inflation is likely to be limited as fuel is assigned a lower weight in the Consumer Price Index (CPI). Despite that, higher market linkages bring about immediate impact of the rising prices on inflation. So, the first-round impact on the CPI is inevitable. It is, however, the second-round effects (through seepage into other categories) that worry monetary policymakers.

But since the adoption of inflation targeting, it is believed that the transmission of fuel price hikes to generalised inflation has weakened. This incomplete pass-through, therefore, somewhat limits the impact of rising oil prices on inflation.

On the fiscal front, deregulation of petrol and diesel and the asymmetry in the government's excise duty policy (i.e. hiking the duty on petroleum products when oil prices were falling and not cutting it when the price is rising) has provided a cushion to the government. Hence, the subsidy burden does not necessarily rise when oil prices start firming up. A $10 increase in price could push up the fiscal deficit by ~8 bps as a percentage of GDP.

Rising oil prices can also weigh on growth. The Economic Survey (2016-17) estimated that a $10 per barrel increase in oil price can pare growth by 20-30 bps.

This suggests India's macros – barring CAD – are relatively resilient to a crude oil prices shock, provided it is transitory. We take comfort in the fact that most forecasters expect crude oil to soften from next year on easing global demand and structural shift to non-conventional fuel alternatives. However, if crude oil prices stay elevated longer than expected, the pressures on inflation and fiscal deficit can mount.

Monetary policies: clear and present danger

Most of the major advanced economies have initiated 'liftoff' of extremely accommodative monetary policies they had put in place post 2008 financial crisis. The withdrawal involves central banks' tapering asset purchases, raising policy rates, and eventually shrinking the balance sheet via asset sales – all referred to as normalisation. The roll-back of quantitative easing will lead to an uncharted territory, since such a policy action has no precedence.

All this is made more complex by the fact that advanced countries central banks are at different stages of monetary policy normalisation, depending on the varying pace of recovery and inflation pressures they are experiencing. The US is at a much-advanced stage of balance sheet reduction, whereas the European Central Bank (ECB) continues to purchase assets (at tapered volume) and the Bank of Japan is easing. In such a scenario, it becomes difficult to assess the cumulative impact on global financial conditions.

The retreat of the central banks of the advanced economies from unconventional monetary policies can impact emerging markets through the currency and investment channels. Rising interest rates in an advanced economy reduce its interest differential with emerging market securities, which, if coupled with rising macroeconomic vulnerabilities in oil-dependent emerging markets such as India, can lead to capital flight from these economies.

Major economies normalising monetary policies

For now, rising interest rate in the US is already attracting foreign capital to the economy, which is boosting the dollar's strength. The rupee is inadvertently facing the brunt of capital flight at a time when CAD is widening.

While the process of monetary policy normalisation is still evolving, emerging markets, including India, must keep an eye peeled for triggers that could hasten the speed of this process. Two such signposts are critical:

Fed's actions have greater spillover effect versus other major central banks

Monetary policy actions of the US Fed have a greater impact on emerging market economies compared with other major central banks such as the ECB[6]. This is because the US dollar is the most widely used international currency. For instance, in 2014, dollar credit extended outside the US was ~$7 trillion, while euro credit was almost half at $3.9 trillion[7]. Going by this, the US Fed's monetary-policy tightening will have a greater impact on other economies compared with continued accommodative stance of the ECB and other major central banks. India needs to be particularly cautious because nearly half of its external debt is dollar-denominated. So, sharper Fed rate hikes and steeper weakening of domestic currencies in emerging markets can balloon the debt repayments burden.

Policy response error leads to faster-than-expected rate hikes

Until 2017, inflation was benign and inexplicably low, globally. But it started picking up in response to surging oil prices. Another factor keeping inflation under control was wage rigidity, which is now changing. A large part of the rise in inflation is also being led by core components, suggesting demand-side pressures are kicking in. In the US, the core measure has touched the US Fed's target rate. Other pressures on inflation arise from the possibility of widening twin deficits — CAD, led by restrictions on imports which could make them costlier, and fiscal deficit, led by government spending and tax cuts — in

[6] Rey (2015). International Channels of Transmission of Monetary Policy and the Mundellian Trilemma. IMF
[7] McCauley, Mc Guire and Sushko (2015). Global dollar credit: links to US monetary policy and leverage, BIS WP 483

coming years. A faster-than-expected catch-up in inflation in the US can result in impulsive tightening, which would roil emerging markets.

Trade wars: no endgame in sight

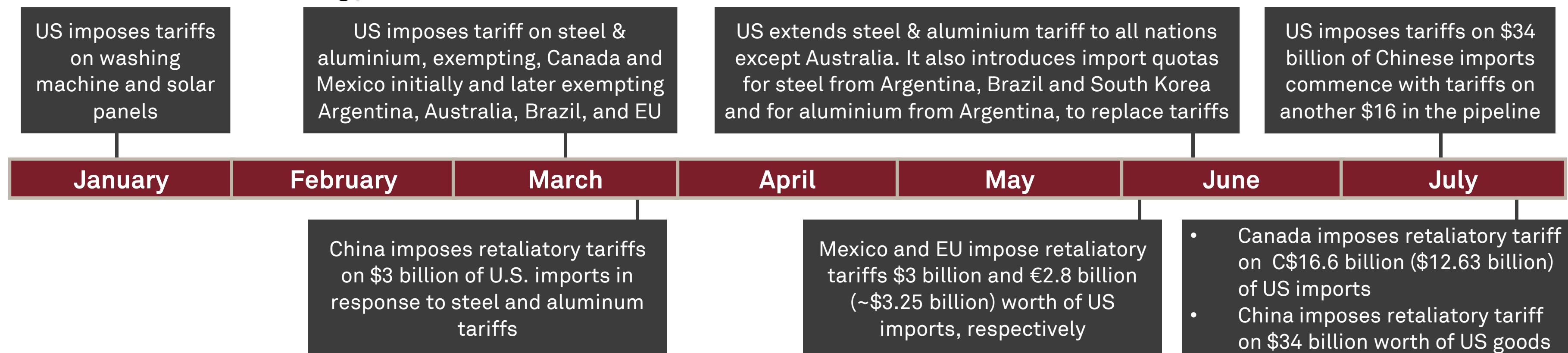
The third shock that has gripped the global economy is the unleashing of trade wars. Given that the tariff wars are playing out in a tit-for-tat fashion, and trade negotiations between countries are still underway, it is difficult to ascertain the final impact of this shock on an economy. For instance, while the US has hiked tariffs on Indian imports, China has reduced them. India, too, has proposed to reciprocate in both cases. There is also a possibility of the countries switching their trade partners.

In the short run, it may be difficult to replace existing suppliers and hence the tariff hikes could prove to be inflationary. Equally important is the uncertainty on account of such trade wars, which could prompt corporates to postpone their long-term investment decisions.

The other impact is likely on India's exports, which is still trying to recover from GST-related glitches. The size of non-oil trade deficit is quite large at present. Between fiscals 2017 and 2018, though oil contributed to a wider trade deficit, non-oil trade deficit played as big a role. In fiscal 2018, non-oil trade deficit stood at 55% of total trade deficit, compared with 46% in fiscal 2013, when the CAD was at its peak. This suggests that if the ongoing trade developments were to impact exports and make imports costlier, this part of trade deficit will add to the pressure coming from higher oil prices.

The tariffs imposed by the US government have so far impacted 5.7% of India's merchandise exports to that country (0.9% of India's total merchandise exports). The tariffs on these commodities collectively work out to ~0.02% of India's GDP and 1.2% of India's CAD.

Timeline of US tariff war with its trading partners in 2018



The table below shows the commodity-wise impact for India. It turns out that the total impact of these tariff hikes for India is rather limited.

US tariff walls on India

Commodity	Tariff rate	Share in India's exports to the US^
Washing machines	20%	0.01%
Solar panels	30%	0.1%
Steel	25%	4.1%*
Aluminium	10%	1.4%
Total		***5.7%***

Note: ^Based on India's exports data for fiscal 2018; * including iron and its articles

Source: United States Trade Representative, Ministry of Commerce and Industry, CRISIL

In its latest Union Budget 2018-19, India unilaterally announced import duty hikes on ~40 categories of goods, including certain electronics (cell phones, smart watches), automobile parts and footwear. Import tariffs doubled in most categories. Not surprisingly, a recently released World Trade Organisation report showed that, among G20 countries, India has initiated far more measures considered to be 'trade restricting' compared with the past year.

In response to its trade fight with the US and to strengthen its defence, China agreed to reduce tariffs on a number of products from five Asian countries. While in principle this may look like a good development with regard to India's burgeoning trade deficit with China, it is important to note that China applies a lot of non-tariff barriers on Indian exports – such as pharmaceutical and agricultural products. Hence, we will have to wait and watch to see the actual impact of such tariff reductions.

The endgame of trade wars is hard to fathom, but they certainly have injected uncertainty into global policy direction. Moreover, their impact will play out via trade, investment, supply chain disruptions, and last but not least, the investor confidence channel.

Conclusion

Going forward, while the risks from rising crude oil prices could ease, those from asymmetric monetary policies and trade protectionism could persist.

All these create a 'risk off' scenario.

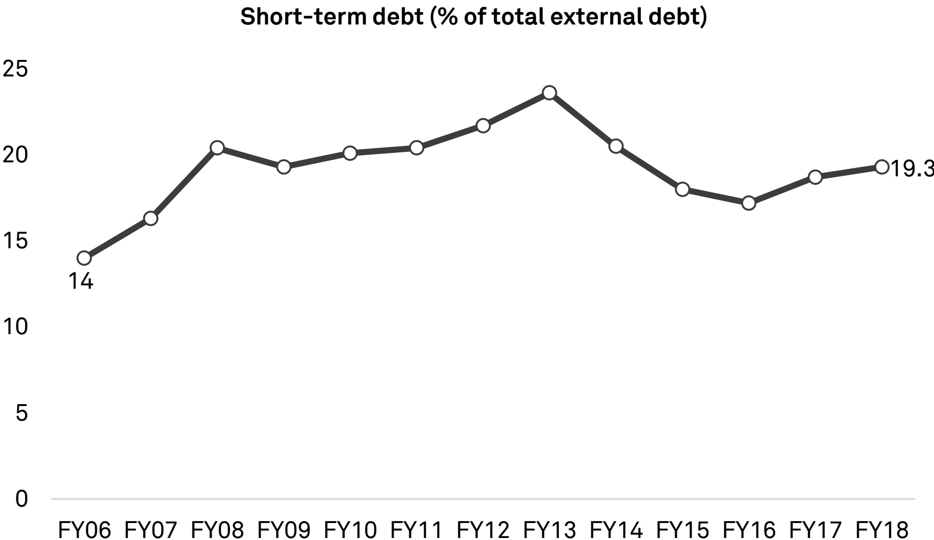
Reading the impact of these shocks is not easy as they transmit through multiple channels and over an extended period of time. Besides, most of these shocks are still evolving, which makes it all the more difficult to decipher their final effects.

Yet, compared with 2013, India is way more resilient and looks better prepared vis-à-vis its own past and other emerging markets. But this is no time for complacence. India would do good to keep an ear to the ground on the following risks:

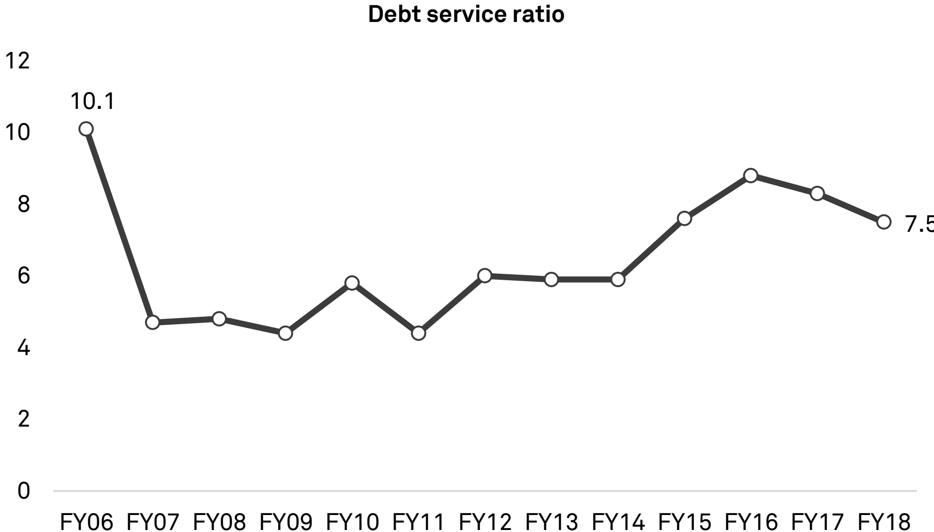
- Sustained surge in oil prices stemming from geopolitical tensions, especially between the US and Iran
- Escalation of tariff-war between the US and its major trading partners
- Policy response error of central banks in the process of normalising their monetary policy, especially the US Fed. A faster-than-expected catch-up in inflation in these economies can result in impulsive tightening, which would roil emerging markets. The uncertainty about the global economic environment can cause the banks to err and raise policy rates too soon or too late, with serious repercussions for capital movement.

Appendix

India's short-term external debt is at sub-2013 levels



Debt service ratio has remained benign



Source: Ministry of Finance

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