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INDIA UPDATE

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SHIFTING ECONOMIC POLICIES CREATE HEADWINDS FOR GROWTH; RISING INFLATION TO PRECLUDE FURTHER POLICY RATE CUTS

Demonetization failed to control "black money" and slowed growth in 2016 and early 2017

Indian growth is disappointing in 2017. The second quarter of the calendar year's 5.7 percent year-over-year real GDP growth was the weakest since the first quarter of 2014, when India was buffeted by spillovers from the US taper tantrum. India's real GDP growth lagged China's throughout the first half of 2017. Its slowdown came as little surprise after the Indian government in mid-November 2016 announced it was withdrawing higher-value banknotes from circulation. The government mandated that all physical currency be exchanged at bank branches for newly issued banknotes by month-end or become worthless. As a strategy to uncover corrupt officials' ill-gotten wealth (called "black money" in India), demonetization was a failure: Holders of 99 percent of physical currency exchanged it for new banknotes, with most corrupt officials apparently evading checks on exchanging "black money" for new currency as skillfully as they evaded India's other checks on corruption. But if demonetization's impact on corruption was slight, its collateral damage to economic growth were anything but: Businesses held out until customers obtained new currency before making sales, sharply slowing the economy.

The Goods and Services Tax will slow growth in late 2017 & 2018

Equally jarring policy changes continued in the first half of 2017, when the government announced the replacement more than half a dozen central and state-level taxes with a national goods and services tax (GST) effective July 1st. While the GST simplifies the taxes it replaces and reduces what previously amounted to effective tariffs on trade between India's states, it is still complex: the government continues to tinker with the rates applicable to different categories of economic activity, and the GST imposes new compliance requirements on businesses. While tax collection data is so far spotty, the GST likely will amount to an effective tax increase by broadening the base of economic activity subject to taxes: Gross tax revenues jumped 22.3 percent from a year earlier in July 2017, the month the GST was introduced. This tax hike seems

CHART 1: GROWTH HAS SLOWED AND ITS QUALITY DETERIORATED AFTER DEMONETIZATION IN LATE 2016

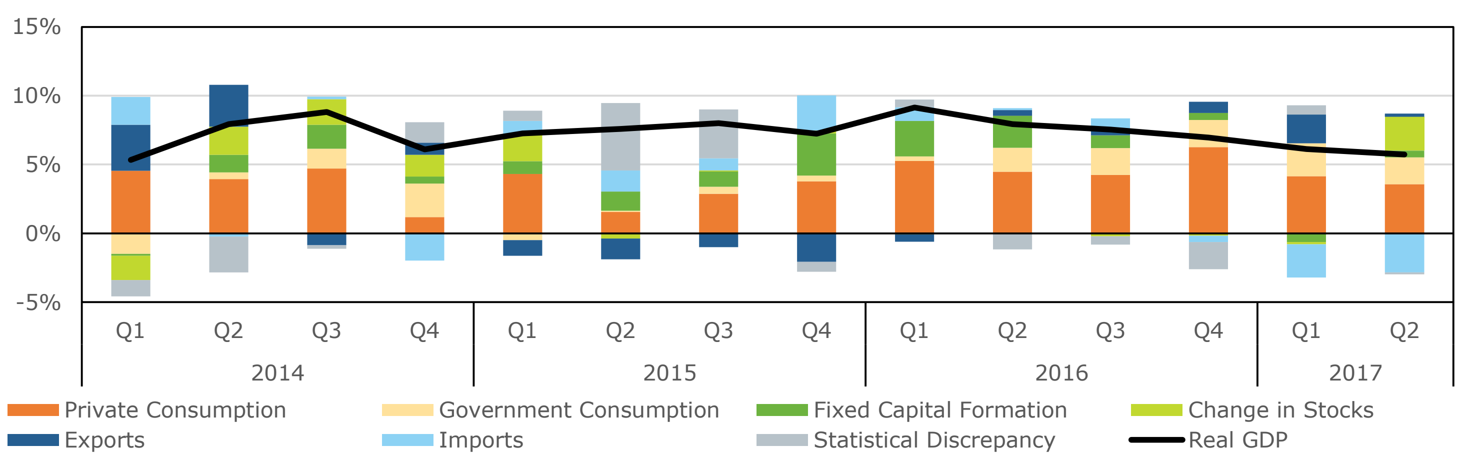

Chart sources: CSO, CEIC, The PNC Financial Services Group appropriate since India's general government fiscal deficit was 6 to 7 percent of GDP in calendar-year 2016 according to the IMF, and since India's general government revenues, at about 20 percent of GDP, are well below the 30 percent average of emerging and developing economies. But the tax hike will nevertheless prolong 2016 and early 2017's headwinds to growth. Real GDP growth will likely slow to 5.3 percent in the second half of calendar-year 2017, with softer demand for consumer durable goods from small business owners reinforcing the ongoing weakness of capital spending, before picking up to 6.5 percent growth in 2018. Inflation will likely accelerate as growth slows. As businesses that had not in the past paid taxes begin to pay GST, they will raise prices, partially passing the tax on to their customers, and raising producer and consumer prices. Stabilizing energy and food prices will also lift CPI inflation, which is likely to accelerate to more than 5 percent by the second half of 2018 from a low of 1.5 percent in June 2017, when prices of food (two fifths of the CPI basket) fell 2.1 percent in year-ago terms.

Inflation will likely turn higher

The prospect of faster inflation limits the Reserve Bank of India's (RBI's) latitude to support growth with more interest rate cuts. The RBI successfully transitioned to an inflation targeting policy regime under former Governor Raghuram Rajan, who led the RBI from 2013 to 2016. In its new policy framework, the RBI announces a target for CPI inflation over the medium term, meaning a one to two-year time horizon, currently set at the midpoint of a two to six percent range in year-ago terms. The policy has been extremely successful: Riding the tailwinds of the drop in global commodity prices that began in mid-2014, the RBI held core CPI (excluding volatile food, fuel and electric costs) to 3.7-5.5 percent between September 2014 and August 2017. This success allowed the RBI to cut its policy repo rate from 8.0 percent in December 2014 to 6.0 percent at its October 2017 monetary policy decision. Going forward, a confluence of upward shocks to inflation is set to lift both headline and core CPI to the top half of the RBI's target range, if not over it, by mid-2018. As inflation rises, the RBI will likely have to raise the policy repo rate by 0.5-1.5 percentage points to 6.5 to 7.5 percent by year-end 2018.

The Reserve Bank of India's next move is likely to be a hike

A turning point for Indian monetary policy could mean a turning point for India's exchange rate as well. Counterintuitively, higher policy rates will probably slow capital inflows. India's capital controls limit short-term investment inflows through money markets, the sort of capital flows that chase rising interest rates in countries with open financial markets. By contrast, rate hikes are likely to discourage the types of international capital inflows India's government permits: Momentum-following investors could cut exposures to Indian government bonds as interest rates rise and bond prices fall, and rate hikes could make Indian stocks less attractive by raising interest expense for publicly-traded companies. This turning point in Indian policy rates comes when India's rupee is quite expensive: In July 2017, it was about 7 percent overvalued relative to its historical trend against currencies of India's trading partners according to the Bank for International Settlements. After averaging under 64 per dollar in August 2017, the rupee could depreciate to close 2018 at 70.4 if it reverts to its long-term trend and if tighter US monetary policy causes the dollar to appreciate modestly (See Chart 2).

Downside risks to the rupee as Indian policy rates rise

CHART 2: RUPEE LIKELY TO DEPRECIATE AS MONETARY POLICY CYCLE REACHES A TURNING POINT

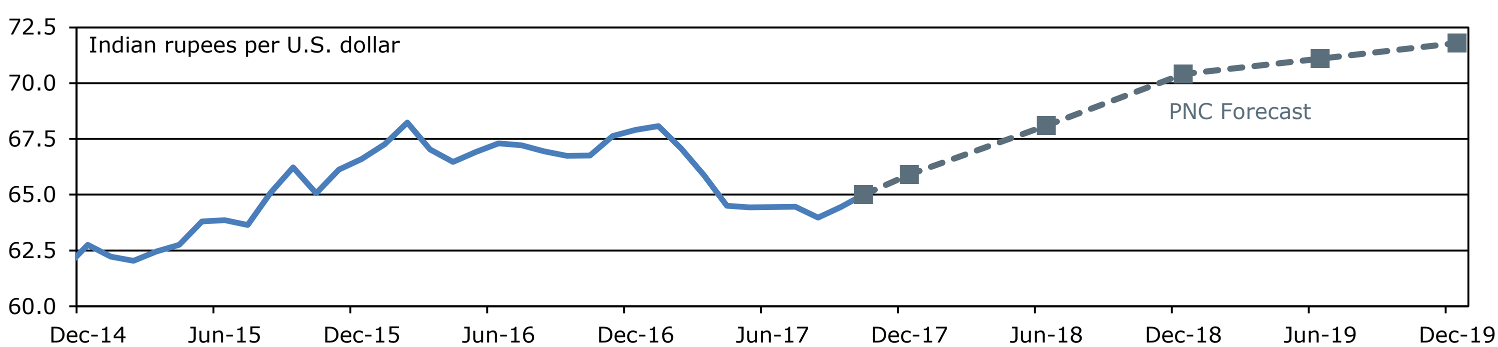

Chart sources: Reserve Bank of India, CEIC, The PNC Financial Services Group

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