

## In case you missed it: Goldilocks returns

Positive signs on the trade front, a surprisingly dovish Federal Reserve and another solid month for US jobs gave risk assets a boost this week, capping the best January for US stocks in 30 years. Goldilocks is well and truly here. But the bears are lurking.

### In this bundle



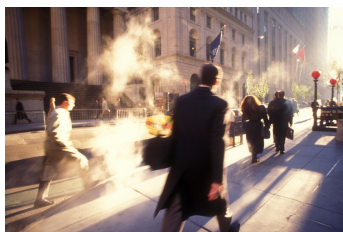
#### United States

##### **Federal Reserve: Prudent patience**

No change from the Federal Reserve as they emphasise they are in no hurry to raise interest rates. But if the data warrants it, and we think it will, they...

By James Knightley

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##### **US jobs report: Stronger than ever**

The main message is that strong employment growth is resulting in higher pay and this is attracting more people back to the labour market. The Fed is on...

By James Knightley

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##### **US-China trade talks: No solution in sight**

The US and China meet tomorrow in an attempt to cut a trade deal. But chances are that protectionism will get worse before it gets better. US demands are...

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##### **Eurozone: No bounce back in GDP**

GDP growth of just 0.2% quarter-on-quarter in the final quarter of 2018 confirms the slow growth environment that the eurozone has slipped into and there...

By Bert Colijn



## India

### **India: Bracing for yet another turbulent year**

Markets are bracing for intensified political risk as a general election looms in May. Losses by Modi's incumbent party in recent state elections...



### **What the Venezuelan oil sanctions mean for supply**

The US has imposed sanctions on Venezuelan state-owned oil company PDVSA, effectively bringing US purchases of Venezuelan oil to an end. The announcement...

By Warren Patterson

# Federal Reserve: Prudent patience

No change from the Federal Reserve as they emphasise they are in no hurry to raise interest rates. But if the data warrants it, and we think it will, they are prepared to tighten policy further later in the year



Source: iStock

## The Fed is in no hurry

The Federal Reserve has unanimously voted in favour of leaving the Fed funds target range at 2.25-2.5% and the clear message in the accompanying statement is that the Fed is on pause for some time to come. The key sentence was “the committee will be patient as it determines what future adjustments to the target rate” may be required. The statement also dropped the description that “some further gradual increases” in interest rates will be needed and have removed any reference to the balance of risks.

Certainly the unsettling effects of recent financial market volatility, trade uncertainty and the government shutdown give them clear reasons to adopt a wait-and-see stance. With inflation pressures described as “muted”, helped by the plunge in fuel costs, it looks as though it could be for quite a protracted period. Nonetheless, the economy is in decent shape with the jobs market described as “strong” and economic activity “solid”.

Back in December, the Federal Reserve indicated that it would slow the pace of rate hikes this year to probably two from the four 25bp moves seen in 2018. This still seems sensible to us, but the dovish tone in today’s FOMC statement hints at downside risks to this view. The US does face more economic headwinds this year: The lagged effects of higher interest rates, the strong dollar, the

fading support from 2018's fiscal stimulus and trade tensions at a time of weakening global activity all suggest that the US economy will experience slower growth in 2019.

But, there are clear positives too with a strong jobs market, rising pay, plunging energy costs boosting real incomes and a recovery in equities supporting sentiment. We also expect core inflation to continue grinding higher, rising above 2.5% by the early summer. As Jerome Powell stated in the press conference, they are data dependent and if the data warrants it, they will hike again.

## The perfect combination - equities up, gasoline prices down...



Source: Bloomberg, ING

## A bias to hikes

In terms of the timing of the policy moves the government shutdown argues for caution in the near-term. It has been economically disruptive with the latest “polar vortex” potentially adding to the downside risks for 1Q GDP. There will also be questions over the quality of the data released for December and January given significant numbers of statisticians were furloughed. As such the Federal Reserve is unlikely to feel confident responding either way to these data, which offers further support to a wait-and-see stance

Taking it all together we are unlikely to see an interest rate rise in the first quarter, but we still think there is a decent chance of a move in June. If the strength of the US jobs market persists and wages keep rising the consumer side should help support growth and generate a little more inflation. Furthermore, if we can get some progress on US/China/EU trade relations that could help lift spirits, boosting business optimism, investment spending and the outlook for trade. So while the Fed is right to be patient for now, we still think they have more work to do.

## Alternative options

We have to acknowledge the Federal Reserve does have other tools that it could use to adjust the monetary policy stance. Fed Governor Lael Brainard has suggested that raising countercyclical buffers is one way that could be used to tighten monetary conditions whilst also shoring up financial risks. However, this seems to have little broad support at this time, especially with the Fed in wait-and-see mode.

However, the more likely alternative appears to be that the Fed could accelerate (or

decelerate) sales of its longer-dated Treasury holdings with the Fed commenting in a separate note that it is "prepared to adjust" balance sheet normalisation (both in size and composition) after agreeing to maintain the \$50bn roll off per month. A potential inverted yield curve in the US is a challenge for the banking system since banks have long-dated assets and short-term liabilities and this environment would deter lending. Selling longer-dated Treasuries would re-steepen the curve, thereby putting up borrowing costs but taking some of the pressure off the financial system. However, with Fed Chair Jerome Powell saying it won't be used as an "active" tool, the Fed funds target rate will remain the main driver of policy.

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Article | 1 February 2019

## US jobs report: Stronger than ever

The main message is that strong employment growth is resulting in higher pay and this is attracting more people back to the labour market. The Fed is on pause, but the case for rate hikes will persist

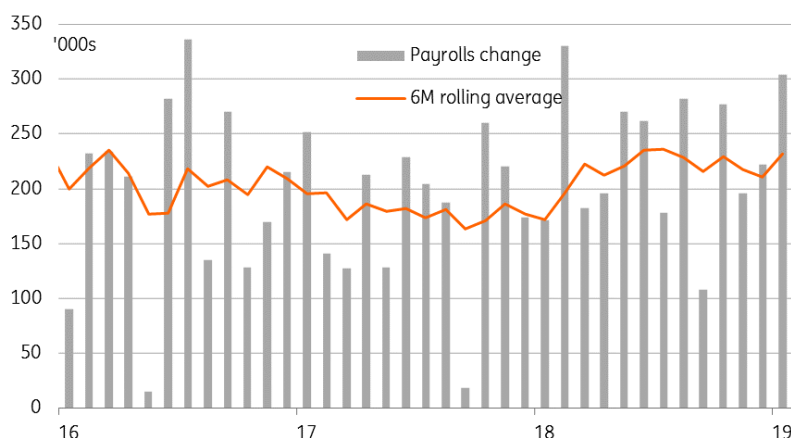


Source: iStock

### Firms still hiring

This is another really strong jobs report with non-farm payrolls rising 304,000 in January. This was above even the most optimistic forecast in the Bloomberg survey and suggests that the US economy is in great shape with businesses desperate for workers. Admittedly some of this strength stems from a 90,000 downward revision to December 2018's initially reported payrolls figure, but it suggests that the US economy hasn't been adversely impacted by the government shutdown in any meaningful way.

## US employment growth remains robust



Source: Bloomberg, ING

## Competition for labour is pushing up pay

Pay was a little disappointing, rising just 0.1% month-on-month – the weakest growth rate since February last year and below the 0.3% consensus – which seems odd given the fact other surveys suggest businesses are struggling to hire workers and pay is going up. Indeed the National Federation of Independent Businesses earlier reported that over a third of small businesses have vacancies that they cannot fill, with plans to raise worker compensation at all-time highs. Furthermore, the January Beige Book published by the Federal Reserve reported that “wages grew throughout the country... across skill levels, and numerous Districts highlighted rising entry-level wages as firms sought to attract and retain workers and as new minimum wage laws came into effect”. The annual rate of wage growth is still 3.2% year-on-year, in line with expectations, and if we get a 0.3% MoM reading next month, annual wage growth could hit 3.5%. Wage growth for production and non-supervisory workers is already there.

## People coming back to the jobs market...

This acceleration in wages is apparently attracting workers who had left the labour force back into the market. The worker participation rate rose to 63.2%, which is the highest reading since August 2013. As such, the fact that the unemployment rate rose to 4% shouldn't be too much of a concern. Firms clearly need workers and this increase in labour supply will be absorbed as long as they have the right skills.

## The case for Fed rate hikes persists

Job creation will likely slow in 2019, but this is as much due to a lack of suitable workers and firms not able to fill vacancies (despite rising labour supply) as it is to economic headwinds for the US. With worker pay on the rise and employees feeling secure in their jobs, consumer spending will likely remain firm while adding to inflation pressures in the economy. Fed Chair Jerome Powell talked of economic and market crosscurrents, justifying a pause from the Federal Reserve, but if we can get better news on US-China trade relations, that will lift some of the global gloom. We continue to believe that strong fundamentals should be enough to convince the Federal Reserve to raise interest rates once more in the summer.

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Article | 29 January 2019

## US-China trade talks: No solution in sight

The US and China meet tomorrow in an attempt to cut a trade deal. But chances are that protectionism will get worse before it gets better. US demands are too ambitious for quick fixes. The negative effects of higher tariffs are starting to kick in and economic growth will not provide much support to world trade either. Trade growth will drop to 1.3% in 2019



Source: Shutterstock

### US-China trade talks: little chance for a deal before the 1 March deadline

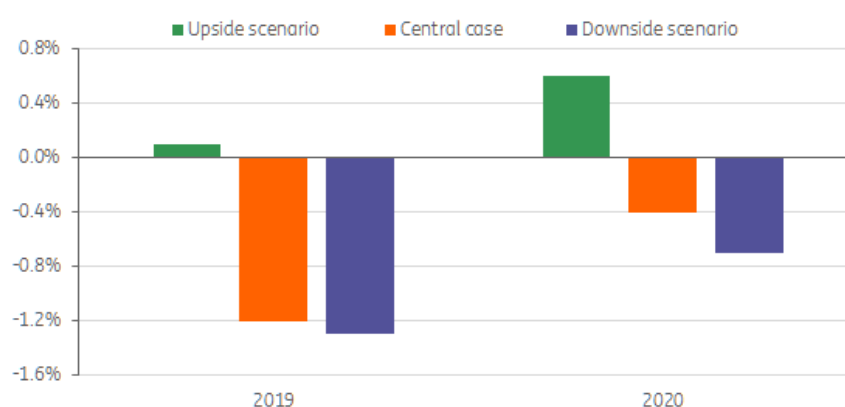
US-China talks resumed on 7 January in Beijing with both sides positive about the prospects for a deal, continuing the constructive tone that had taken hold since the American and Chinese leaders agreed to a ceasefire at the beginning of December. But as we expected back then (see [Don't cry victory yet](#)), optimism has since faded. Although China has recently made some advances towards the US, the American [wish list](#) is very ambitious and wide-ranging. Alongside a much lower bilateral trade deficit, US negotiators are increasingly insisting on fundamental changes in China's industrial policy 'Made in China 2025'. More transparent foreign exchange operations and the value of the renminbi are on the list as well.

We don't foresee a deal on all these issues being agreed before the deadline on 1 March. Just last week, US Commerce Secretary Wilbur Ross said the two sides were "miles and miles away from a resolution".

- So, in our *base case*, we expect the US to turn the heat on China by increasing tariffs on \$200 billion of Chinese imports to 25% in 2Q from the 10% rate imposed in September.
- In a *downside risk scenario*, the US expands tariffs further in 3Q to Chinese imports which have not yet been hit by higher tariffs (around \$260 billion worth of imports).
- On the other hand, an *upside risk scenario* could see Presidents Jinping and Trump reach a deal. China has already announced various policy aims of market-based reform and a rebalancing of its economy. So one route to a solution might involve China “announcing” a timetable of implementation (as seen in the [2018 announcement](#) on liberalising the exchange rate and foreign investment regime) and agreeing to strengthen enforcement, with sanctions to be imposed in the case of no compliance. In this upside risk scenario, all tariff hikes from both sides thus far would be undone. That delivers a positive impulse of 0.6 percentage points for trade in 2019 (chart 1).

We think it is almost impossible to reach such a deal before 1 March. So, if the upside risk scenario happens at all, it would happen later (3Q we assume) after the US increases pressure in 2Q.

### Chart 1: Effect of tariffs on world trade, three scenarios



Source: ING

### US-EU talks: the threat of auto tariffs

Aside from the US-China trade tensions, there is the imminent threat of tariff increases on US imports of cars and parts, some 3% of world trade. The US Department for Commerce has been conducting an investigation into the national security implications of importing cars and parts using the same procedure that led to the introduction of steel and aluminium tariffs in 2018.

Whether the report-to be published on 17 February at the latest- will find a national security threat is still unconfirmed, but it seems likely. President Trump will then have the option to raise tariffs.

Tariff increases on cars and parts are of particular concern to the EU, piling the pressure on the trade talks that are officially yet to begin. The US and EU have been engaged in talks since the summer, but not formal trade negotiations. On the EU side, member states need to agree on a mandate for the European Commission’s trade negotiators. The EU’s negotiating mandate is likely to be limited to reducing tariffs on industrial goods and trying to harmonise standards (technical, health and safety) for products to be sold within the EU.

The [US negotiating objectives](#) go much further than the agreed talks about tariffs on industrial goods and product standards, raising issues that proved to be deal-breakers for TTIP, including improving market access for US agricultural goods (chlorinated chicken etc). The gap between the US objectives and the mandate that the EU negotiators will bring to the talks may be too large for a deal to be done. **So, in our base case, we expect US import tariffs on autos to be raised during the second half of 2019 without exempting the EU.**

## WTO dispute settlement on borrowed time

In the meantime, various countries have filed complaints at the WTO about protectionist measures taken in 2018, like the tariff increases on steel and aluminium. But the WTO's appeals court is on borrowed time and may be unable to hear appeals in 2019. The court will fall below the minimum number of judges as soon as a dispute involving one or more of the judges' countries of nationality (China, India and the US) is referred to the court.

What's more, two of the judges will reach the end of their terms in December with little prospect of having these terms extended, or of new appointees taking their place. The US has refused to appoint new judges since 2016 in protest against previous rulings. It argues that the court is changing the rules of international trade to the disadvantage of WTO members, without allowing them a say.

Trade faces an uncertain future without this court. If the court is unable to hear appeals, any actions that have broken the international trade rules will stay in place, continuing to damage international trade, and setting precedents for further tariff increases.

## Trade growth: higher tariffs are starting to bite

World trade growth slowed in 2018. We expect global goods trade to end 2018 with a year-on-year growth rate of 3.2%, considerably lower than the strong growth of 4.7% in 2017. Trade growth has increasingly been suppressed by the effects of the trade war. The conflict has made its presence felt through different channels.

Firstly at the firm and industry level. The direct effect of tariff hikes on the aggregate level of trade has thus far been limited partly because quite a few American companies that need intermediates from China successfully requested [tariff exemptions](#) for imports of thousands of products. Nevertheless, for some bilateral trade flows and for trade performance at the industry level, significant effects are visible. China's imports of soybeans, for example, are still some [40% lower](#) than this time last year.

It is also important to realise that many products that are hit by tariff hikes are intermediate products. If they become more expensive, prices of other products can rise as well.

Secondly, and probably of significant importance, tariff increases are playing a role in declining business confidence and putting a brake on investment growth.

## Underlying trade growth

But more has been at play than the effects of the trade war. Moderation of trade growth in 2018 is in part a return to the 'normal' rate of growth after 2017 when trade growth outpaced by far the growth of world GDP and the growth of global industrial production. The slowdown of industrial

production growth itself also put a brake on trade growth in 2018.

- Underlying this is the fact that growth in the economy generates less world trade than in the fifteen years running up to the crisis when the rate of trade growth was almost twice that of real GDP. Structural changes in the world economy are responsible for this. Emerging economies are increasingly consumption- rather than export and investment-driven, and therefore less import-intensive. These economies consume more of what they produce, rather than exporting it.
- Secondly, as we have stressed in earlier notes (see for example [Trade nowhere close to its heyday](#)), global value chains are not the driver of trade growth that they once were. Flows of foreign direct investment (FDI) and other indicators suggest that value chains are no longer expanding at their pre-crisis rates. The global value of greenfield FDI picked up slightly in 2018 relative to 2017 but remains at a lower level than pre-crisis (Chart 2). Differences in labour costs have become less pronounced across countries, partly thanks to automation. This is one of the reasons for the decreasing incentive of offshoring.
- Third, due to the changes in these underlying drivers, China's contribution to world trade growth, worth around 1.5 percentage point each year from 2000-2010, but falling to less than half of that in 2011-2017, is likely to shrink further. China is pursuing a policy of self-sufficiency and rebalancing away from exports and investments towards consumption, which implies less growth of imports and exports.

The effects of longer-term initiatives like 'Made in China 2025' and especially the 'Belt and Road Initiative' may be somewhat offsetting in their effects on world trade, with the former aimed at moving China's position within value chains towards higher value-added activities, and the latter [facilitating international trade](#). In the near term, however, it is the slowdown in China's growth which will dominate other factors to drive weaker growth in world trade.

## Chart 2: World wide cross border greenfield investment flows, (2003-2018)



Source: ING calculations, data from FDintelligence and IHS-Markit

Data in constant 2017 USD. Nominal greenfield FDI is sourced from FDintelligence and deflated with dollar based 'investment deflators' from IHS - Markit. If no deflator was available, average Local Currency Unit based 'investment deflators' of peer countries were used in combination with the country specific exchange rate to transform the greenfield FDI flows to constant dollars. In specific cases of hyperinflation or socio-economic unrest (eg. Venezuela, Syria, and South Sudan), assets are assumed to be fully dollar denominated. For these countries, FDI flows have not been adjusted.

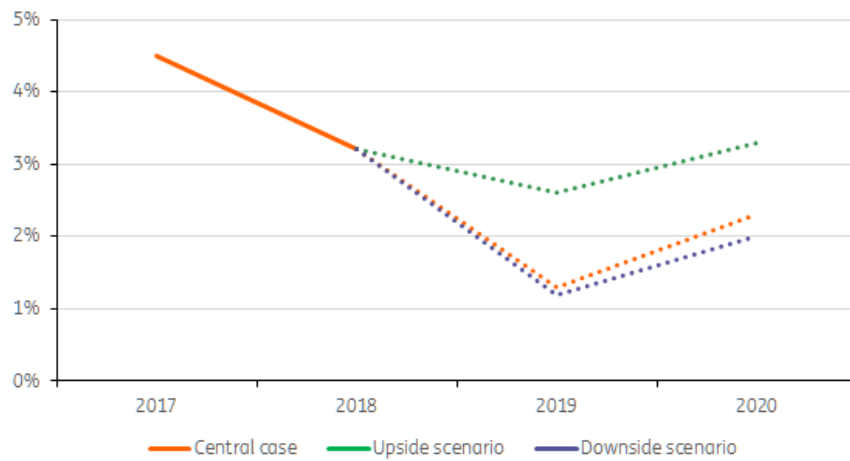
## Trade outlook for 2019 and 2020

The outlook for global growth in 2019 and 2020 is rather gloomy with a growth figure of 1.3% this year and 2.3% next year. Due to a further moderation of production growth, support for trade from the economy this year will be only a little over half the support given in 2018, according to our model.

Add to this the negative effect of the trade war on trade growth, which will be almost three times as large as last year, and the collapse of trade growth is largely explained. After 2020, trade volume growth should recover again towards its 2011-17 average of 2.7%, if tariffs are not increased further.

Our upside and downside scenarios imply different paths for trade growth. The trade conflict might come to an end or escalate further than we currently expect. In the downside scenario, trade growth is close to 1%, while in the upward risk scenario, trade growth is about twice as high, stressing the fact that in 2019 the effects of the trade dispute really make a difference (Chart 3).

### Chart 3: World trade growth 2017-2020, three scenarios



Source: ING

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Snap | 31 January 2019

## Eurozone: No bounce back in GDP

GDP growth of just 0.2% quarter-on-quarter in the final quarter of 2018 confirms the slow growth environment that the eurozone has slipped into and there does not seem to be an easy way out as downside risks persist in early 2019



Source: Shutterstock

Hopes of a swift bounce back after the poor third quarter had already faded towards the end of the year, but the 0.2% growth in GDP remains disappointing nevertheless. After hopes of 2.5% growth at the beginning of the year, 2018 annual growth has turned out to be only 1.8%. The end of the year was marked by a disappointing recovery in auto production in Germany, downside risks further impacting confidence and yellow vest protests in France. The persistence in the growth decline indicates that there is more to it than one-offs with downside risks persisting early in 2019 as well.

Italy saw growth decline by -0.2% in Q4, therefore entering a technical recession and adding to worries about the stability of the third largest eurozone economy. More positive was France where despite the impact from the yellow vest protests, GDP growth held up at 0.3%. A much more severe impact had been indicated by the PMI, which had plummeted into negative territory in December. Exports increased significantly in France, offsetting stalling consumption growth. Germany also avoided a technical recession in Q4 judging from the annual growth figure for 2018 and Spain saw a slight acceleration of growth to 0.7%.

For the ECB, the weak growth rate means that the current staff projections of 1.7% growth for 2019 will be a tall order. Given the weakness in surveys about eurozone growth in January as well, it is likely that the 2019 growth forecast will see a substantial downgrade in March when the new staff projections are released. With this, the almost philosophical debate in the governing council of where we are and where we are going may take a more pessimistic turn that will please the doves...

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# India: Bracing for yet another turbulent year

Markets are bracing for intensified political risk as a general election looms in May. Losses by Modi's incumbent party in recent state elections raise the prospect of an indecisive vote and a coalition government. Re-pricing for this will exert upward pressure on government bond yields and the USD/INR exchange rate



Source: Shutterstock

## 2%

### Month-to-date INR depreciation

Signals a start to another turbulent year

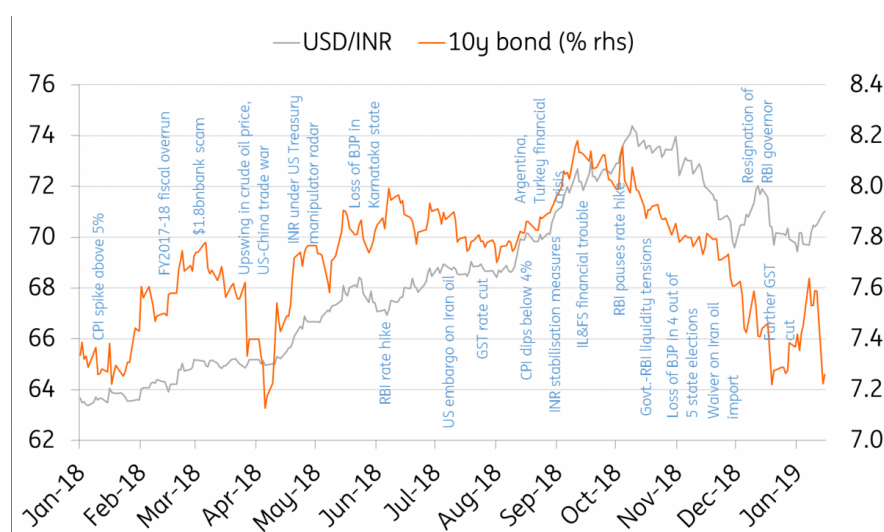
## A tumultuous 2018

The economy ended 2018 on a mixed note. Growth continued to grind lower as reflected by the slowdown in exports and industrial output towards the end of the year, while inflation dipped to the lowest in 18 months on persistently low food and energy prices. But core inflation remained high, feeding into rising inflation expectations. Public finances and external payments remained on weakening trends owing to high oil imports and election-related spending.

The conflict between the Reserve Bank of India (RBI), the central bank, and the government over the issue of the RBI sparing more of its reserves to fund a wider fiscal gap rocked markets in the last quarter. The rift ended with the resignation of Governor Urjit Patel in early December. Just as this paved the way for a stepped-up liquidity injection into the financial system under new governor Shaktikanta Das, the fiscal floodgates opened with further cuts in the Goods and Services Tax and extra-budgetary support measures for farmers.

Global market volatility spiked towards the end of 2018 but local markets enjoyed a brief respite from lower oil prices. The government bond market had its best quarter in four years in the final quarter of 2018. Yet a rally in the Indian rupee (INR) in November with a more than 6% monthly appreciation against the US dollar was short-lived and the currency returned to being Asia's worst-performer in December. 2018's annual depreciation of 8.5% was the most since 2013.

### What made 2018 a turbulent year?



Source: Bloomberg, ING

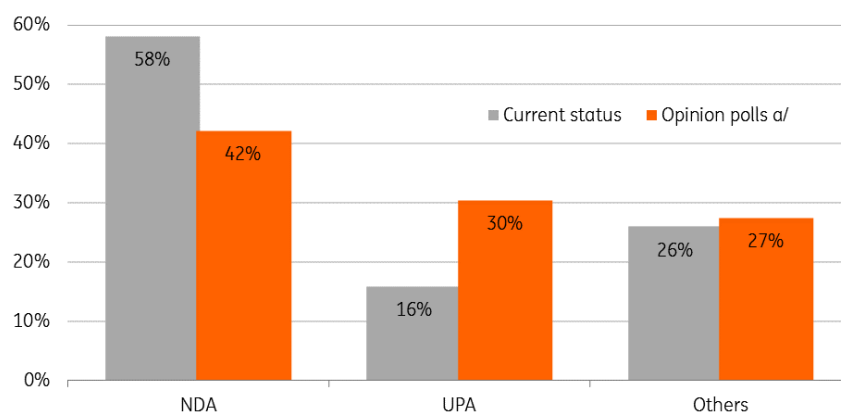
### Politics overshadows economy in 2019

A general election is scheduled for May this year and the environment will likely become murky as we get closer to polling day. With his popularity falling, Prime Minister Modi has reason to be concerned. The losses of Modi's Bhartiya Janata Party (BJP) in recent state assembly and other by-elections have significantly diminished the prospects of a clear win for the party, while the opposition, led by the Congress Party, is consolidating its position.

We think it will be too close to call. Something similar to last year's assembly election in Karnataka state, in which the BJP came out as the winner and yet couldn't form a government, could be imagined at the national level. Even if the BJP retains its majority, with a slim margin over the opposition, the likelihood of the Congress-led coalition forming a new government cannot be ruled out. The opinion polls have been predicting such an outcome.

If indeed the poll predictions as laid out in the following figure become a reality, a 16 percentage point loss of parliamentary seats of Modi's National Democratic Alliance (NDA) in favour of the Congress-led United Progressive Alliance (UPA) represents a significant shift in the political landscape – not good news for the markets.

## Lok Sabha (Lower House) party positioning - current and expected



a/ Average of five major opinion polls held in December 2018 and January 2019.

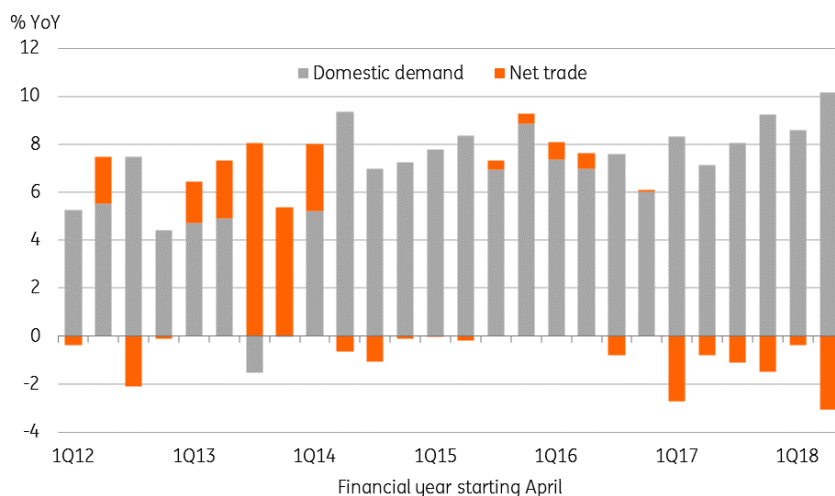
Source: Wikipedia, ING

## The real economy is stuttering

An early estimate by the National Statistics Office puts GDP growth in the current financial year ending in March 2019 (FY2019) at 7.2%, in line with consensus and up from 6.7% in FY2018, a year that was marred by the effects of demonetisation and the chaotic GST implementation. Growth peaked above 8% in the first quarter of the year but slowed to 7.1% in the subsequent quarter. The latest economic data is pointing to a further drift below 7%. Hence, the 7.2% official estimate remains at downside risk - not good news for PM Modi before the elections although the final figure isn't expected to be out until after the elections.

It's hard to imagine fresh stimulus, both monetary and fiscal, helping growth in time for the vote in May. While the economy may still benefit from stimulus in the end, the external headwinds (the US-China trade war, the downturn in technology cycle, slowing global growth, and rising oil prices) are likely to prevail throughout FY2020. We expect this to nudge India's GDP growth below 7% in the upcoming year. However, a significant hit to GDP growth will likely be prevented by strong domestic demand on the back of the government's populist spending measures.

## Domestic demand-driven growth



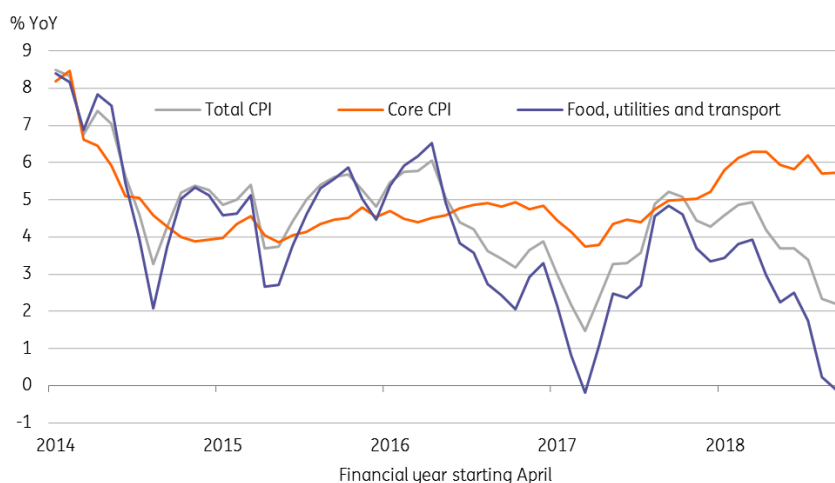
Source: CEIC, ING

## Elevated inflation expectations

Meanwhile, absent significant supply-side shocks to food or fuel prices, the inflation outlook looks to be benign through mid-2019, beyond which high base effects will wear off to pull the year-on-year inflation rate higher. While the demand-pull price pressure from ample liquidity and election cash handouts could exert upward pressure on prices, it also depends on the extent the extra cash is recycled back into the economy amid prevailing uncertainty.

After all, loose fiscal policy is inflationary and it tends to fuel inflation expectations. High core inflation hovering close to a 6% rate so far in FY2019 reflects elevated expectations. New RBI Governor Das has admitted that the wide gap between the headline and core CPI measures is a policy challenge.

## High core consumer price inflation



Source: CEIC, ING

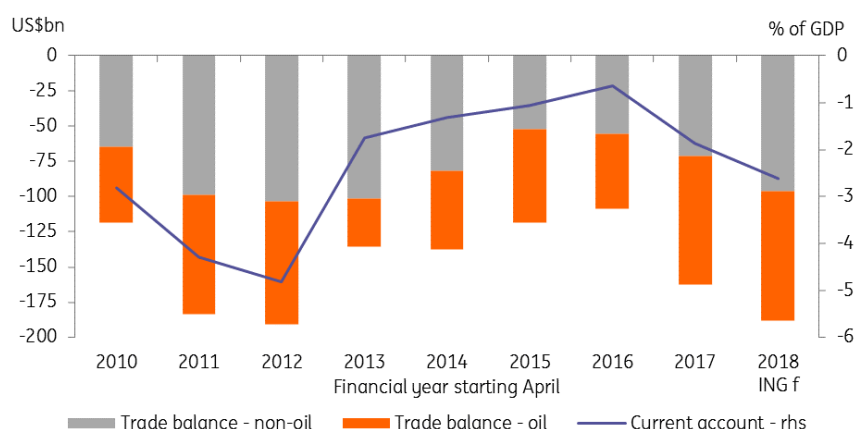
## Deteriorating external payments

The widening trade and current account deficits will persist as drags on India's GDP growth. Almost half of the widening of the trade deficit is coming from the oil trade. Global crude prices resumed their upward march in December and are expected to remain on that trend this year as OPEC+ streamlines supplies to support prices. This means that the upward pressure on the trade deficit will persist. Moreover, a further hit from the end of the waiver of US sanctions on oil imports from Iran in March this year could make matters worse.

Besides oil, firmer domestic demand will keep overall imports strong, while export growth falters due to slower global growth. We expect these factors to push the current account deficit higher to about 3% of GDP in FY2020, the highest in seven years, from an estimated 2.6% for the current year, which is up from 1.9% in the last year.

Meanwhile, political uncertainty could have foreign investors treating Indian markets cautiously. Net foreign portfolio flows swung from a brief inflow toward the end of 2018 to an outflow starting 2019. This does not just reflect the politics. The troubles at non-bank finance companies are far from over with media reports of another infrastructure lender defaulting on its debt due this month. We see no near-term respite from negative foreign investor sentiment.

## Oil pressures trade and current deficits higher



Source: CEIC, ING

## Loose macro policies are inflationary

The government's drive to boost growth has shifted economic policies into an expansionary mode. Last October the RBI moved its policy stance to 'calibrated tightening' citing sustained inflation risks. The events since, especially after the resignation of Urjit Patel, have clearly shifted the bias towards easing. New RBI governor Das is likely to endorse the shift to a 'neutral' stance at the next meeting on 7 February. We have recently downgraded our RBI policy forecasts from two rate hikes this year to no more hikes. However, with the sustained pressure from the government to ease, we won't be surprised if the central bank decides to cut rates in February.

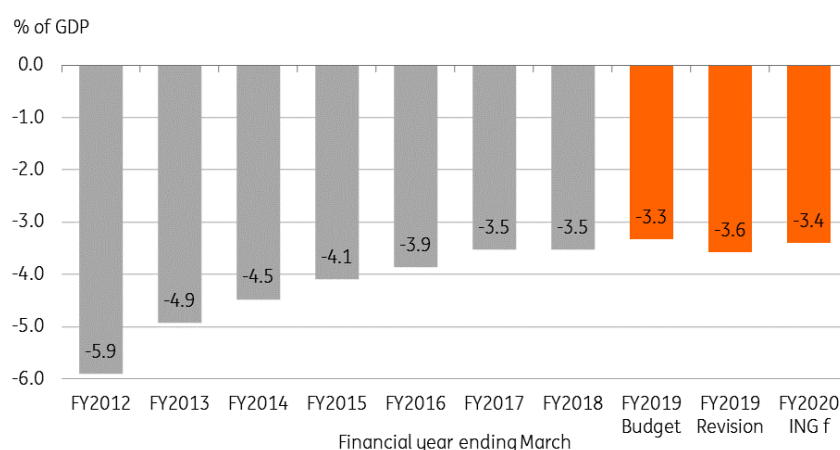
Before the RBI meeting, the interim finance minister Piyush Goyal is due to present the FY2020 budget to the parliament on Friday, 1 February (Finance Minister Jaitley is reportedly on medical leave). Growth will outweigh fiscal discipline as the Modi administration pushes for a second term. As such, after an overshoot of the deficit in the last financial year and more likely again in the

current year, hopes of any fiscal consolidation receiving prominence in evolving macro policy are largely misplaced.

We see the revised budget for current FY2019 producing a deficit equivalent to 3.6% of GDP, well above the government's initial projection of 3.3% (consensus 3.5%). Our forecast for FY2020 deficit is 3.4%. In the event of the incumbent government staying in power or the Congress-led coalition taking over, fiscal policy will likely remain overly loose, with the deficit likely to remain well above the 3% comfort level.

We consider such fiscal-monetary policy mix exceptionally expansionary. Although the economy is expected to slow, it's not likely to crash. A nearly 7% India's growth puts it among the ranks of the world's fastest-growing economies, which argues against stimulatory policies. Moreover, such a policy mix will further add to inflation, which is already under pressure from high oil prices and the weak currency.

## Derailed consolidation of public finances - fiscal deficit



Source: CEIC, ING

## The markets at the receiving end of it all

Loose financial policies are good for the people – make hay while the sun shines. But the financial markets continue to be at the receiving end of it all.

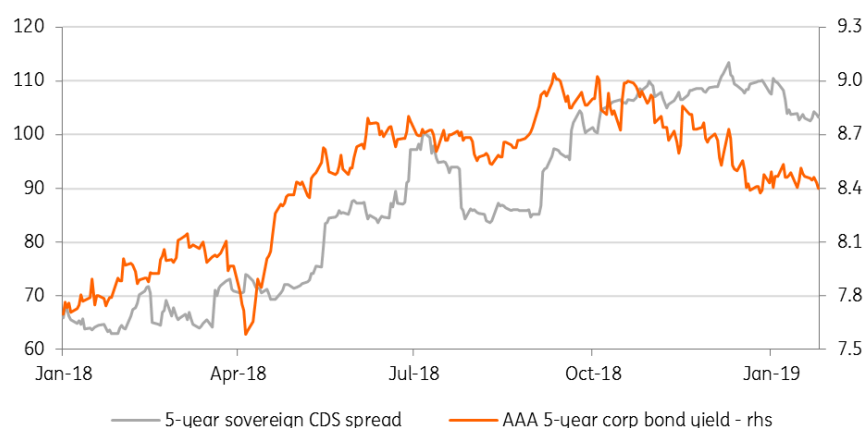
Weakening fiscal and external payments and uncertainty about future policy directives to mend this state of affairs suggest that local financial assets will remain under steady weakening pressure. Government bonds may be enjoying the comfort of low inflation currently but the increase in public debt issuance to plug a wider deficit is likely to re-exert upward pressure on yields. The AAA-rated corporate bond yields, as well as sovereign default spreads, have risen sharply over the last year and we anticipate no let up in these trends. All it will take is a single negative nudge from rating agencies.

Relatively strong growth performance may keep any negative rating action at bay. But it also depends on how rating agencies view the government's progress in consolidating its finances. Moody's, S&P and Fitch all have a stable outlook on India's long-term foreign currency debt ratings.

The INR's 8.4% depreciation in 2018 was the worst in half a decade. 2019 isn't off to a good start

either with a 2% month-to-date depreciation against the USD being the steepest among regional economies. We see the USD/INR rate re-testing 33 within the current quarter.

## Rising risk premium



Source: Bloomberg, ING

## The economy at glance - ING forecasts

India (FY starting April)	FY2015	FY2016	FY2017	FY2018 f	FY2019 f	FY2020 f
Real GDP (% YoY)	8.2	7.1	6.7	7.1	6.8	7.2
CPI (% YoY)	4.9	4.5	3.6	3.5	4.5	5.0
Fiscal balance (% of GDP)	-3.9	-3.5	-3.5	-3.6	-3.4	-3.2
Public debt (% of GDP)	70.0	69.5	71.2	72.5	72.0	71.0
Current account (% of GDP)	-1.1	-0.6	-1.9	-2.6	-3.1	-2.9
FX reserves (mth of imports)	10.2	10.6	10.2	8.3	7.9	7.8
External debt (% of GDP)	182.1	168.2	171.4	160.0	162.2	175.5
RBI repo rate (% eop)	6.75	6.25	6.00	6.50	6.50	6.50
3M T-bill rate (% eop)	7.27	5.82	6.09	6.75	6.90	6.90
10Y govt. bond yield (% eop)	7.47	6.68	7.40	7.60	7.80	7.80
INR per USD (eop)	66.33	64.84	65.18	72.50	68.00	65.00

Sources: Bloomberg, CEIC, ING forecasts

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Snap | 29 January 2019

## What the Venezuelan oil sanctions mean for supply

The US has imposed sanctions on Venezuelan state-owned oil company PDVSA, effectively bringing US purchases of Venezuelan oil to an end. The announcement has had little impact on price, with expectations growing in recent days that such action would be taken. Furthermore, Venezuela will likely increase sales to buyers outside of the US



Source: Shutterstock

### What was decided?

The US Treasury announced yesterday that it is imposing sanctions on Venezuelan state-owned oil company PDVSA, which would effectively close the US as a market for Venezuelan crude oil. Volumes currently being shipped will be exempt from sanctions whilst Venezuela will be allowed to sell oil to US refiners, however payments will have to go to a blocked account so that proceeds cannot be remitted to Venezuela.

The sanctions also prohibit the sale of diluents to PDVSA- usually blended with the heavier crude oil that Venezuela exports. The US exports around 120Mbbls/d of lighter oils to Venezuela for this purpose. Furthermore, US companies currently transacting/engaged with Venezuela have been given three months to wind down operations. Whilst Venezuelan refiner Citgo, currently operating in the US will be allowed to operate as normal but is not allowed to remit funds to Venezuela.



## What is the impact on oil supply?

EIA data shows that the US imported on average 514Mbbbls/d of Venezuelan crude oil over 2018. This supply is key for a number of refiners in the US Gulf Coast, who blend it with domestic light oil, making an optimum blend for US refineries. These refiners can switch to other origins for heavier crude oil though it may be fairly difficult for the time being.

The obvious choice for the industry would be to turn increasingly to Canadian oil. However, as a result of mandated production cuts in Alberta, the additional supply from Canada is likely to be limited. The other issue is logistics- the reason Canadian oil producers cut output was due to a lack of takeaway capacity and this is an issue that is likely to linger for quite some time.

Refiners could also turn increasingly to the Middle East for heavy crude oil supply. However under the current OPEC+ deal, members are likely to cut output of heavier crude oil first, given the discount at which it trades to lighter grades. Mexico is another supplier of heavier crude to US refiners but Mexican output has trended lower in recent years, which has also meant that exports of crude oil to the US have trended lower.

Venezuela can turn to its next biggest buyers to increase purchases- China and India, which both took, on average, around 300Mbbbls/d over the course of 2018. However for China, much of the exports go towards debt repayment, and so for PDVSA, this does little to help generate cash.

## More downside to Venezuelan output?

Venezuelan oil output has been in decline for several years now, with a lack of investment in oil fields seeing production fall from close to 2.4MMbbbls/d in late 2015 to around 1.2MMbbbls/d currently. Given that US oil service companies will have to wind down dealings with PDVSA, this suggests the potential for a more rapid decline in Venezuelan crude oil output moving forward.

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