Economics

DBS Flash

India: Tempering growth expectations

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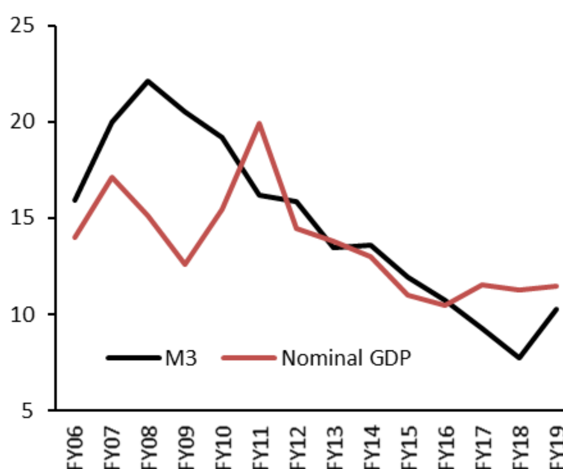
- *India's growth outlook has dimmed*
- *Monetary aggregates highlight underlying concerns over growth, as tighter financial conditions, weak rural sector/ consumption, and uncertain global demand surface as drags*
- *Three tailwinds might help stabilise growth in second half of the year, along with favourable base effects*
- *Burden falls on monetary stimulus (and liquidity) to support growth, while fiscal math remains constrained*
- ***Implication for our forecasts**: Taking cues for GDP Nowcast model, we revise our growth estimates for FY19 and FY20 to 7.0%, with downside risks*
- ***Implication for investors**: A return to policy stimulus will be negative for rates but supportive of the rupee and equity markets, if the global environment remains conducive*

India's outlook is under scrutiny as world looks for growth. Since 4Q18, the narrative has been dominated by downside risks to growth facing the G3 economies (ex-US), and China. Of late, sentiment indicators are showing signs of stabilisation at weak levels, but hard data is yet to reflect a decisive turnaround.

The International Monetary Fund, Asian Development Bank and at home, the Reserve Bank of India have all trimmed their growth projections for India for FY19 and FY20. These revisions leave growth in the 7.2-7.5% range. Our in-house GDP Nowcast model also points to softening in momentum into FY20.

Monetary aggregates highlight underlying concerns over growth. On annual basis, broad money i.e. M3 growth has trailed nominal GDP growth, pointing to tightness in monetary conditions. Theoretically, if money supply growth is slower than nominal GDP, there is room to loosen policy levers without worrying overtly over inflation or asset prices. In the current cycle, credit growth has picked up, but the concurrent elevated loan-to-deposit rate reflects lack of money creation. This in turn, has added to the rigidity in deposit rates, and hurting the appetite for banks to lower lending rates.



Source: CEIC, DBS Group Research

In the current growth cycle

On the ground, high-frequency data suggest that weakness in consumption and subdued exports is spilling over into investment and production. A case in point was weak February industrial production, as output rose 0.1% YoY from a downwardly revised 1.4% (vs 1.7% prior) in the month before. The breakdown saw a sharp correction in capital and intermediate goods output, along with slower growth in durables. This follows earlier

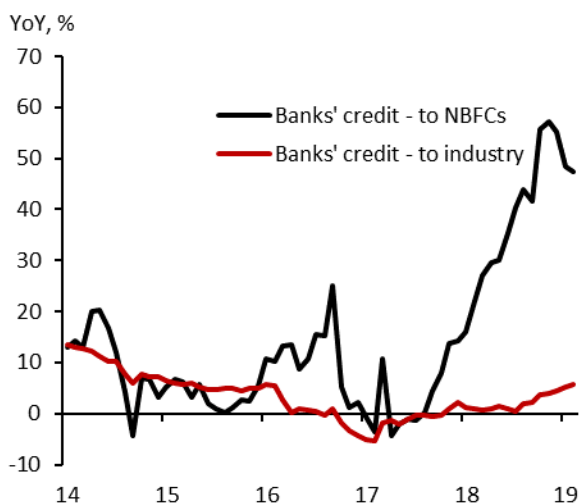
Refer to important disclosures at the end of this report.

indications of easing coal and electricity growth. PMI readings are holding in the expansionary territory above 50, but its track record in gauging underlying manufacturing momentum has been mixed.

Key pockets of sub-par activity are:

a) *consumption sector:* visible in a slump in passenger vehicle sales including cars, two-wheeler and tractor sales, which cumulatively finished FY19 at 6.7% YoY vs FY18's 15.6%. Diesel consumption has been moderate, barring a spike in February, with the recent spurt in global oil prices expected to curb demand. Rural wage growth are off lows but not back to strong levels

b) *tight financial conditions*: global volatility prompted the RBI to keep rates on a tight leash last year, along with a liquidity crunch amongst non-bank sectors. Impact of these factors is showing with a lag, especially on sectors previously served by non-banks, which includes commercial real estate sector, wholesale segments (e.g. infra), retail auto etc. Under financial services, banks have stepped up credit expansion but bulk of this is directed to retail lending or non-banks. Lending to medium and small enterprises, and the broader industrial sector has slowed. Funding costs for lower-rated enterprises and sectors with higher risk-weighting remains high, in turn restraining working capital needs and delaying investment decision.



Source: CEIC, DBS Group Research

c) *challenging global demand backdrop*: regional exports have fared poorly since 4Q18, hurt by the double whammy of cyclical slowdown in electronics coupled with trade disputes hurt global demand. Some of those concerns have been allayed by a recent bounce in PMIs, less negative exports growth in the region and upside surprise in China's 1Q19 GDP. The diversified nature of India's exports helped in FY19's rise in 9% vs 10.5% year before but might be a challenge to sustain if global demand weakens. Another indicator of domestic demand, non-oil non-gold purchases have weakened owing to lower machinery, engineering goods, electronics, transport equipment and minerals.

d) *deceleration in public spending:* Spending is routinely scaled back in the final quarter of the year to meet targets. Looming elections also lower the likelihood of frontloading expenditure at the start of FY20 (barring the first tranche of the direct income transfer for farmers). Add to this, CMIE data signals a sharp slowdown in new investment announcements in the March 2019 quarter, with an increase in the stalled projects as a percentage of total implemented.

Counterweights to partly stabilise growth

While the above weigh on growth, three factors might emerge as tailwinds in 2H19, which are expected to stabilise the momentum. Firstly, our pre-election study (see here) shows that on average, growth slows a quarter before the elections, but rises three quarters after, as election-related uncertainty eases, private sector investments return, and the government resumes capex spending plans. Lagged impact of any consumption-boosting measures also boosts spending. An increase in fiscal deficit target for FY20 raised the headroom for spending, but with riders as aggressive revenue projections and higher reliance on borrowings will prod the government to stay within the red line of -3.5% of GDP (FY20 budgeted estimate -3.4%). States are also an important source of support at the grassroot level, as their revenue expenditure grew an average 15% YoY in the past five years to FY19 vs the centre's 9%.

Secondly, ongoing monetary easing is timely (-50bp cut yet far in 2019), as markets eye transmission of rate cuts to banks' lending rates and bond markets. Select banks have lowered their lending rates by a notch, but rigidity in deposit rates has emerged as a hurdle (see here). To expedite pass-through to banks and debt markets, liquidity measures will also be necessary. The RBI has shown its hand via the swap route in March and April, with open market operations likely to be tapped in the second half of the year, which is also a seasonally weak

period for liquidity. We look for further easing in rates. In April, downward revisions in economic projections coupled with remarks that the 'the output gap remains negative' and the need for 'domestic growth impulses' suggest that the door remains open for further policy easing. We expect another rate cut, with June as our base case. An argument for the cut to be delayed to August is equally strong if the RBI sees reason in factoring in the full-year budget due in July and awaits a clearer picture on monsoon developments (see here).

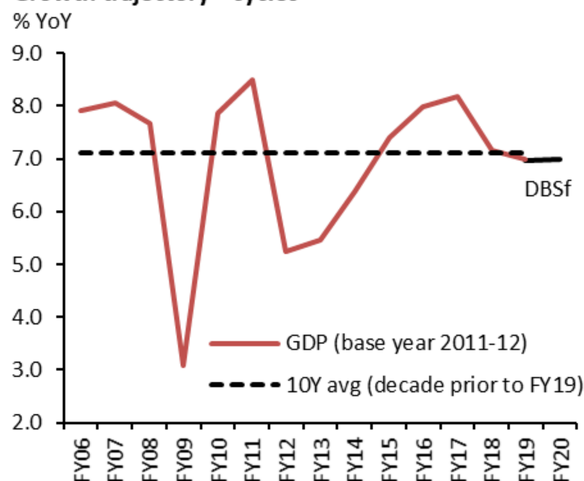
Thirdly, regardless of which party assumes power post-elections (our base case is for the incumbent to return for a second term), the immediate economic priority will be to address the weak farm demand quotient, improve job creation and boost consumption. Policies are likely to shift from a consumer bias (pro-inflation) to producer bias (protecting incomes). Finally, at the margin base effects will buoy readings in second half of the fiscal year.

Factoring in headwinds and offsetting factors, **we lower our growth forecasts to 7.0% YoY for FY19 and FY20 (vs 7.4% earlier), with downside risks.** March 2019 and June 2019 growth will mark the trough with real GDP at 6.2-6.5% YoY, weighed by adverse base effects. Second half of FY19 is likely to see growth return to above 7.0% as base effects turn favourable and cyclical tailwinds resurface.

Downside risks to our growth forecasts stem from a hesitant central bank. Monetary stimulus (and liquidity boost) is necessary to jumpstart the transmission process, just as the fiscal room is limited. While the intention to preserve policy space is prudent, real rate cushion of over 200bps is enough justification to lower rates further. There is also debate over how the central bank and the banking sector view liquidity, which has resulted in differing views over the need to take more supportive steps. For the RBI, rupee liquidity is focused on the Weighted Average Call Rate (WACR), which has been relatively stable and close to the benchmark Repo rate, thus signalling to the authorities that liquidity remains ample. By contrast, for banks, the squeeze from insufficient/ mismatched maturity of deposit growth, legacy issues and competition from alternative deposit instruments, at a time when regulations have tightened, keep funding costs elevated. Hence, an efficient transmission mechanism will require a common ground on liquidity needs, which might require a re-assessment of the central bank's preference for a neutral-to-deficit balance on most days.

Cyclical vs potential growth trends

Back to growth, apart from the cyclical swings, there is a clear need for potential growth to improve. Various studies – RBI [1] and World Bank [2], utilising the production function and statistical filters, estimate potential growth in the range of 7-7.2%. annual GDP in the past decade has been oscillating around this growth level, peaking above 8% in FY16-FY17 and a trough around 5.5% five years prior.



Source: RBI, DBS Group Research

The structural need to raise potential growth to provide for the economy's rising employment needs, higher savings rate and in turn, boost investment capacity through domestic resources, should remain a priority.

Notes:
[1] RBI Working paper series; 05/2016
[2] World Bank, India Development Update, March 2018

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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