Economics

DBS Focus

India's monetary policy to do much of the heavy lifting

Economics/Growth/Policy/Rates/India

DBS Group Research June 20, 2019

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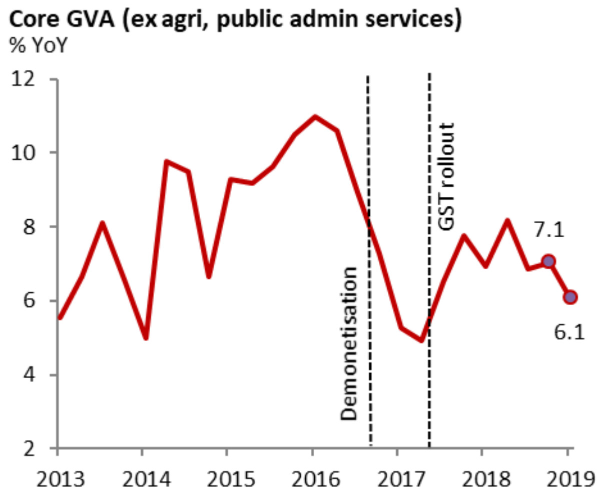
- *Subdued lead indicators and signals from our propriety GDP Nowcast model points to a soft start to FY20*
- *We revise down our FY20 GDP estimate modestly*
- *Monetary policy is expected to do much of the heavy lifting, given limited fiscal leeway*
- *Easing US yields, a dovish US Fed and cautious ECB, lower the hurdle for Asian central banks, including India, to embark on further easing*
- *We factor in 50bp more rate cuts in FY20*
- *Apart from policy easing, ensuring financial stability will be key*
- *Addressing non-banks' concerns is necessary on two counts*
- *INR bond yields have eased, along our expectations. More downside is likely*

Growth numbers out late-May confirmed concerns over a cyclical slowdown last year. GDP growth for the first quarter of 2019 (4Q FY19) slowed to a five-year low, slipping below 6%. This was accompanied by a downward revision in the FY19 growth to 6.8% vs the Central Statistical Agency's and our forecast at 7.0%. The breakdown had revealed a moderation in private consumption and capital formation trends, with the supply-side barometer for private sector activity i.e. core Gross Value Added (excluding agriculture and government services) slipped to 6.1% YoY in the March 2019 quarter vs 7.1% quarter before.

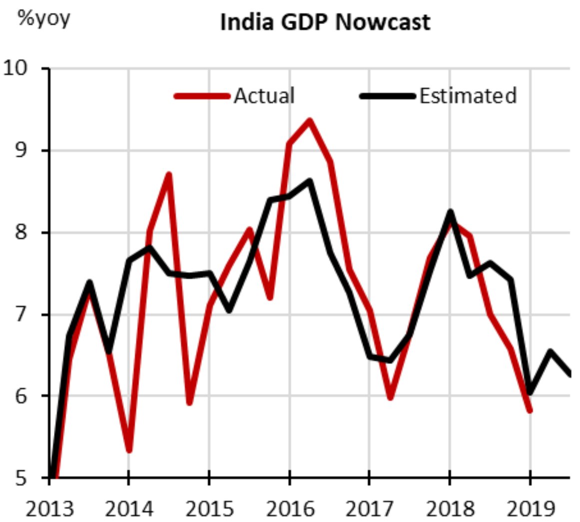


Source: CEIC, Data transformations are by DBS Group Research

Incoming data sets FY20 for a subdued start. Base effects are also adverse in the first half of the year. Election-related uncertainty and slower government spending also extended into the quarter. Consumption has moderated in urban and rural centres, according to lead indicators. Passenger car sales continue to fare poorly, while financial conditions got tighter (non-banks adding to mix). Rural wage growth is off lows but ex-base effects, the bounce is modest, which is also validated by a pullback in non-durables production output.

This likely spilled over to the investment cycle, also impacted by a pullback in public sector spending of the elections. Softer domestic demand is also visible in the non-oil non-gold import demand. Goods exports have fared better in INR terms, but could not skirt a wider trade deficit on higher oil and gold. **On the supply-side**, financial sector metrics are faring better but non-financial segments, particularly transportation and telecommunication, continue to lag.

The DBS GDP Nowcast model, which is our forward-looking proprietary model using statistically significant economic variables, points to moderation led by consumption and government spending.



Source: CEIC, Data transformations are by DBS Group Research

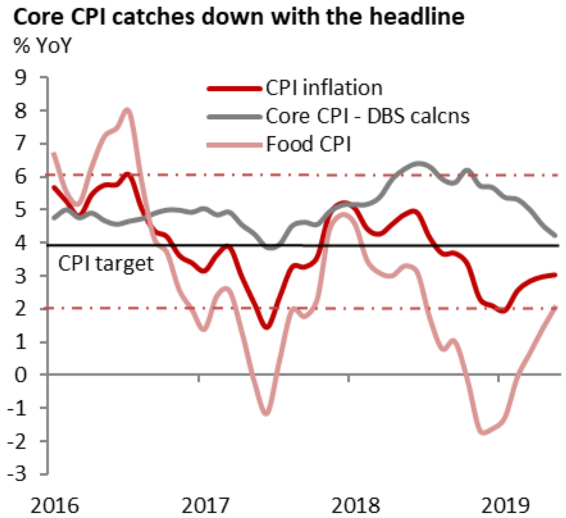
This will leave the FY20 in two halves. A weak first half, followed by a stabilisation in trends and return above 6% in second half of FY20, with weak base effects also of help. We observed in our post-election study had growth typically improves two-three quarters after the polls. Post-elections, government spending is likely to be revived, as focus remains on boosting infrastructure and reviving stalled projects. Expediting cases under the resolution and bankruptcy system will add latent private sector capacity back to the system.

Consumption is expected to get support from liquidity infusion which eases tight cash conditions, in addition to pro-farm measures including cash transfer, better procurement at MSP prices, stable farm export/import policies. Monsoon progress is under watch, particularly its geographical and spatial spread.

Trade outlook will remain challenging considering global demand slowdown and trade disputes. Add to this, the US' decision to withdraw preferential access to India's exports is an additional headwind. **Considering these factors, we revise down our real GDP forecast for FY20 to 6.8% YoY (vs 7% earlier) and GVA to 6.7% (vs 6.6% in FY19).**

Policy response to be led by monetary policy

Growth headwinds swiftly turn attention to the likely policy response. We expect monetary policy to do much of the heavy lifting, given limited fiscal leeway. At its early-June meeting, the RBI policy committee voted unanimously for a 25bp cut in the Repo rate, taking 2019 cuts to a cumulative 75bps. Policy stance was changed from 'neutral' to 'accommodative', opening the door to further easing. A negative output gap will keep demand-side inflationary risks in check, with core inflation catching down with headline CPI (core at 4.2% in May vs 6% average in October-December 2018). We expect inflation to remain sub-target this year (DBSf: 3.8% YoY vs 3.4% in FY19). As discussed here, in the face of slowing growth and sub-target inflation, the need to hanker over a wide real rate buffer has reduced.



Source: CEIC, DBS Group Research

Global cues have also played into the RBI's hands; easing US yields, a dovish US Fed and cautious ECB, lower the hurdle for the Asian central banks, including India, to embark on further easing. Oil prices have moderated from recent highs. Notably, the current bout of softening global yields is different from the last in 2012-2013, with regards to how India is placed. Back then, the rupee was under pressure, and inflation was in double-digits, making it a challenge for the central bank to loosen policy levers. This time around, the rupee is only marginally weaker on the year, while inflation is well below target. **Given this mix, we factor in another 50bp worth cuts in FY20, with the Repo rate to plateau at 5.25%.**

The fiscal room is, meanwhile, limited. Full-year Budget will be tabled on July 5, with slippage in the deficit target, if any, to be contained at -3.5% of GDP (our base case assumption is -3.4%). Gross borrowings were pegged at a record high in the interim budget, which spooked the markets. This will refrain the authorities from raising borrowings further, while any increase in spending/deficit target without commensurate jump in in borrowings will reignite worries over either the reliability of expenditure or an increase in off-balance sheet financing.

On liquidity, plans are afoot for a comprehensive review of the existing liquidity management framework by mid-July, likely factoring in the FY20 full-year budget and fiscal roadmap into question. Even as systemic liquidity conditions improve post-elections (seasonally favourable months), transmission is muted.

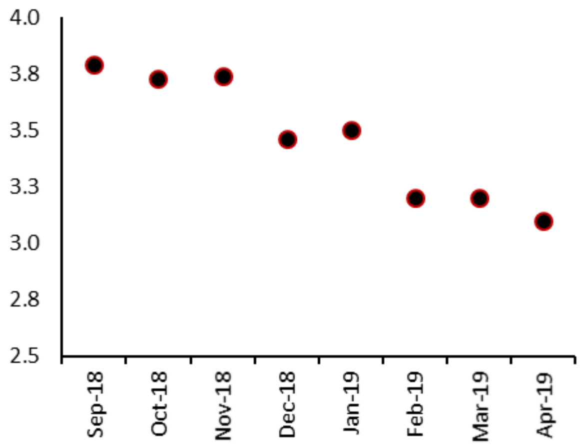
Apart from policy, financial stability will be a focus

Financial stability will be the central bank's key focus, as also ensuring transmission to the broad (and specific) sectors. Commercial banks are in a much better position now compared to three-four years back as most NPAs have been recognised, but the resolution process is in a state of work-in-progress. Banks' capital needs remain high to not only resolve cases but also to ensure growth impetus, as non-banks exercise tighter due diligence. Regulators and the key shareholders – the government – will be required to maintain tighter vigilance.

Addressing troubles facing non-bank finance companies (NBFCs), is a priority on two counts. Firstly, is the need to contain contagion risks. The sector has faced headwinds in the past nine months, with the latest rating downgrade and resultant surge in bond yields of a non-bank mortgage lender fuelling worries over the creditworthiness of weaker players in the sector. Respite is not in the offing as the RBI dismissed the need for a dedicated credit line to struggling entities, where problems are solvency driven, rather than due to a shortage of liquidity.

While an outright rescue package is not under consideration, piecemeal support has been underway to strengthen, stabilise and reduce the sector's regulatory arbitrage. Besides relaxing norms on non-banks to securitise their loans, a new operational liquidity framework is in the works for the entities to improve their asset-liability mix. Non-bank entities with more than INR50bn in assets had been asked to appoint a Chief Risk Officer to tighten risk management plans. NBFCs' borrowing costs are off highs in August-September 2018, there is a clear divergence between better and weak-rated institutions. Exposure to NBFCs has already put mutual funds under the pump, while the rest bide time - banks, provident funds, pension funds, insurance companies and retail investors. While the central bank's direct intervention comes with moral hazard risks, nonetheless regulators will need to shield the sector from any other credit events.

Mutual Funds exposure to NBFCs and HFCs
INR trn



Source: Mint (press), DBS Group Research

Secondly, tight financial conditions due to the NBFC crisis have aggravated the ongoing slowdown, with sectors most exposed i.e. auto, real estate, wholesale funding, infrastructure etc. are facing funding constraints. Looking ahead, we expect liquidity support be accompanied by stricter vigilance (correcting asset-liability mismatches).

With regard to markets, **along our expectations, INR sovereign bonds continue to extend gains, as positive catalysts fall into place** (see here). An empirical RBI staff study (December 2018) observed that the long-run pass-through from policy rate changes is almost complete in the case of shorter maturity securities, the pass-through is 20-30% for longer-term bonds. With a higher quantum of rate cuts on the cards, we hold out for further correction in the 10Y yields. Slippage in the rate-sensitive shorter tenors has meanwhile been sharper. From an elevated 6.8% in late-April, 2Y yields have tumbled to

6.2% this month, already meeting our quarter-end target. Sub-4% inflation spur expectations for further cuts. 6% beckons next as local and global conditions remain favourable.

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