Economics

DBS Focus

India: Growth to slow before turning the corner

Economics/Growth/Policy/Fiscal/India

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- *Lead growth indicators remain soft. DBS GDP Nowcast suggests that the weak patch extended to 3Q19*
- *This has brought forth questions on the nature of the slowdown*
- *Cyclical concerns are underscored by the still-tight financial conditions and wide term premiums*
- *Key pillars face balance sheet worries, which poses a structural drag*
- *Encouragingly, counter response via monetary and financial sector support is underway*
- *An accommodative monetary policy and focus on transmission have helped*
- *Initial support through demand channels will provide short-term boost, which when followed by long-term focused reforms will help return growth to potential*
- *Modest fiscal slippage in FY20 and slower consolidation in FY21 is expected*

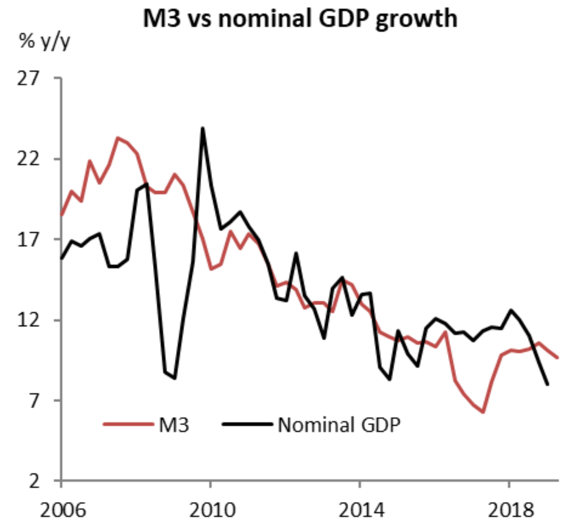
India is in midst of a growth slowdown, with recovery likely to set in the coming quarters. Even as global growth has lost momentum, idiosyncratic domestic factors have contributed to a sharper deceleration in India. Lead growth indicators for 3Q19 remain soft, with the DBS GDP Nowcast model pointing to further slowdown vs April-June 2019 quarter's 5% YoY.

In our recent conversations with corporates and business practitioners, the question over the nature of slowdown - structural or cyclical, supply or demand driven - rose multiple times. This classification aids in determining the type and extent of support that the authorities are likely to provide to reverse the tide. Signs that the policy push is growth-supportive is encouraging. Dovish rate cuts, income support scheme and corporate tax cuts have set the ball rolling, with more measures likely to be unveiled in the coming quarters. **We outline the likely causes behind the deceleration in activity, followed by counter measures to support growth.**

Cyclical troubles

We view this slowdown as part cyclical and part structural. **Cyclical concerns are underscored by the tight financial conditions and wide term premiums**. Monetary aggregates highlight underlying concerns on 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 loan-to-deposit rate is high owing to slow deposit creation.

Monthly data highlight that the trend continues. On the back of a slump in the April-June nominal GDP growth, M3 growth has also slowed from 10.6% in 1Q19 to sub-10% by 3Q. This coupled with wide term premium (gap between 10Y risk-free sovereign yield and the repo rate, 10Y GSec to corporate bond yields) show that borrowing costs are yet to come down meaningfully. Reinforcing the concern over a negative credit impulse was evident in RBI's data which showed a plunge in the flow of financial resources to the commercial sector.



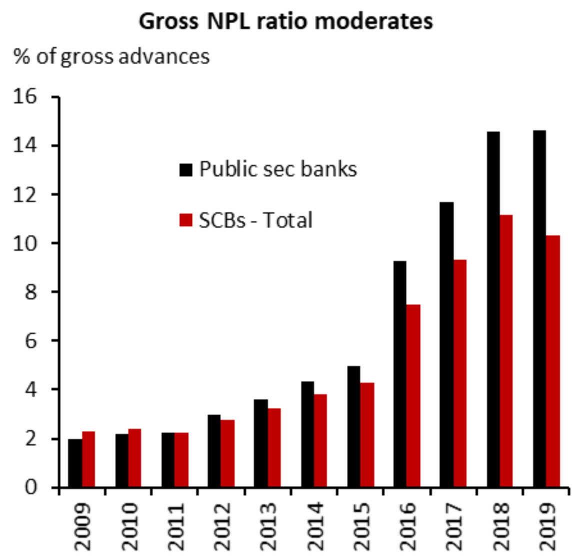
Source: CEIC, DBS

Encouragingly, these cyclical constraints are being addressed. The RBI reaffirmed its dovish leaning through 135bps cuts this year, with room for another 50bps cuts within FY20. The central bank has moved beyond moral suasion to ask banks to peg part of their loan book to external benchmarks and hence better reflect rate movements. Despite the liquidity panel proposing a small deficit balance, the RBI has maintained conducive conditions to facilitate transmission. This has helped pull corporate bond yields, particularly the shorter-end drift lower. Entering the seasonally unfavourable 2HFY, any liquidity deficits are likely to be met by support via repos, OMOs to keep yields stable. We discuss more measures later in the note.

Balance sheet worries is a structural drag as well as a supply constraint

Balance sheet worries facing the four key four pillars of growth, is a structural drag. The extent of pressure varies, while efforts to deleverage is underway on most fronts.

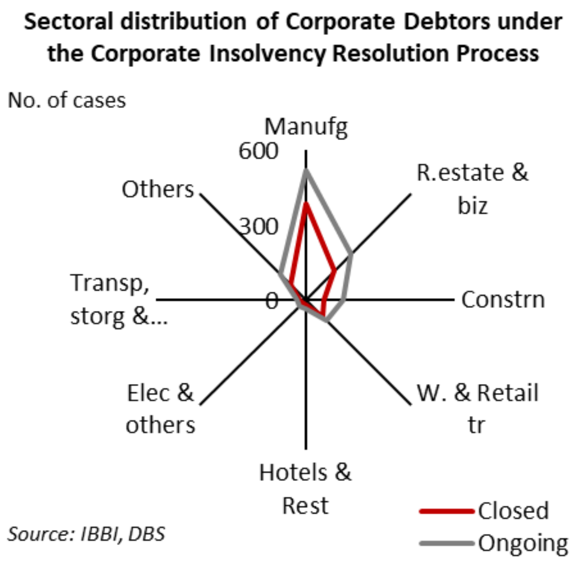
Financial institutions: Following a sharp increase in the banks' non-performing loans since 2015's asset quality review, the ratio has moderated in recent quarters.



Source: CEIC, DBS

A sharper reduction in the ratio is, however, deterred by a) slow progress of resolution cases under the new mechanism of Insolvency and

Bankruptcy process (see chart); b) increase in banks' exposure to the non-banking sector, which face funding risks; c) remnant pressure from sectoral slowdown, e.g. metals, infrastructure, power, mining etc. Provisioning and capital buffer demands remain high, with few institutions also hurt by governance issues

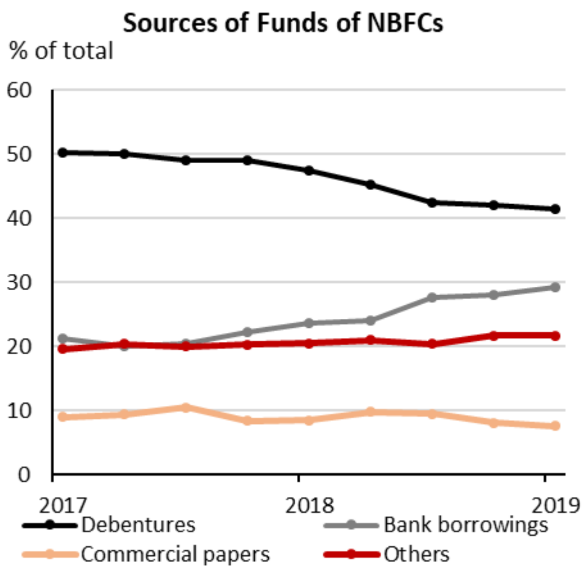


Source: IBBI, DBS

In a bid to consolidate the sector, number of public sector banks have been merged, narrowing the number to 12 from over 20 earlier. This is a positive move to achieve economies of scale, but in the near-term will consume banks' management bandwidth to ensure a smooth transition.

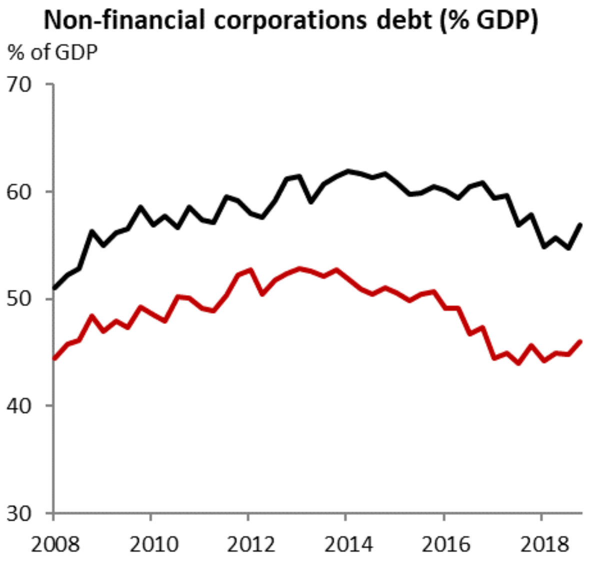
NPAs of NBFCs is comparatively lower at 6% of overall loans, but face risks of a rise in the coming quarters. Asset-quality of certain non-banks (particularly those with wholesale-oriented loan books) face scrutiny, following which the RBI has tightened its liquidity vigilance. Tighter funding conditions faced by NBFCs has seen them rely increasingly on banks, debt markets and offshore borrowings, as domestic players (mutual funds etc.) grow warier and borrowing costs for the stressed names remain high.

An industry wide asset quality review is not on the cards for NBFCs, but efforts are underway to ring fence the weaker names, to ensure any liquidity crisis does not turn into an insolvency issue or pose systemic risks**.** Housing finance companies have been brought under the central bank to streamline regulatory oversight. More recently, liquidity norms for NBFCs were announced to improve their asset liability management framework and help early detection of any funding squeeze. These measures are intended to place a cap on the negative ALM mismatches over specific liquidity buckets, while also necessitating the need for liquidity coverage ratios (LCRs). External commercial borrowings provisions have been eased to provide an avenue for NBFCs to raise funds.



Source: RBI, DBS

Corporates**:** At an aggregate level, debt levels of non-financial corporations' debt as a % of GDP has moderated in the past two years.

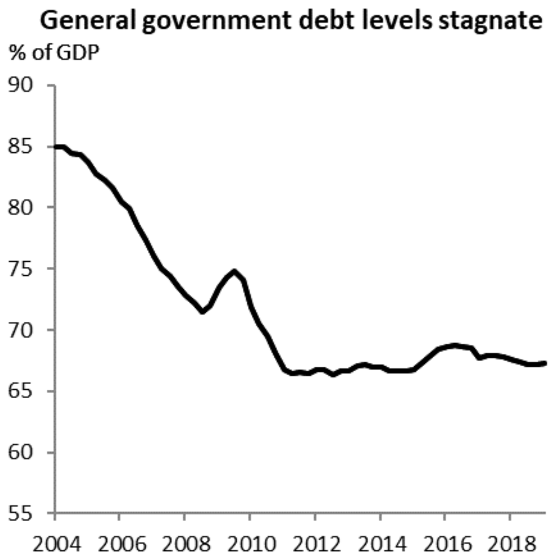


Source: BIS credit statistics, DBS

Granular data suggests firms are not completely out of the woods. Disconnect between the benchmark equity index and corporate sales performance has continued. Interest coverage ratio is off lows as borrowing costs have begun to recede but is still below pre-2010 levels. Forward-looking RBI business sentiment surveys have weakened, with a correction in the capacity utilisation rates. Companies credit profile in 1HFY20 was the weakest in three years according to Crisil, with slowing growth adding to the outlook risks. New project announcements by the private sector remain subdued.

There are nonetheless some encouraging signs as the decline in gross fixed asset investments has bottomed out and started edging back towards 30% of GDP. Borrowing costs are also easing following RBI's cuts and transmission playing catch-up. The corporate tax reduction is expected to result in net savings for the corporates, helping them to either utilise funds to deleverage further or pass it on via product cost cuts to the end-consumer.

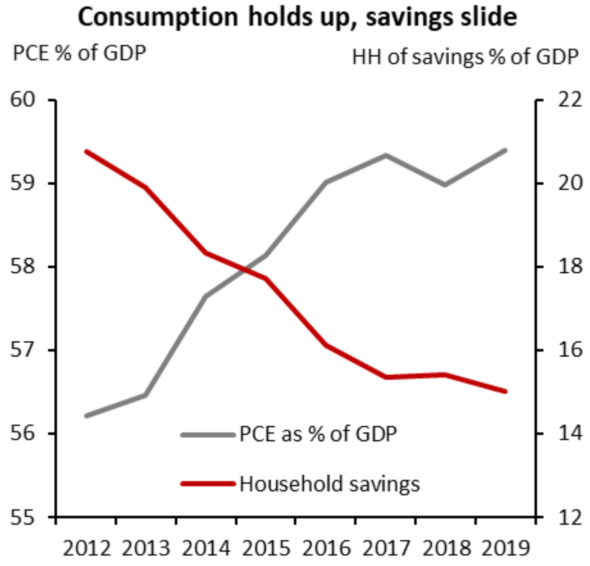
Government: The fiscal math is under scrutiny, particularly as the revenue slowdown poses a risk poses fiscal slippage risks. Gross tax revenues rose 1.5% YoY in first six months of FY20, slowest since FY10 and way below the budgeted 17%. Much of this underperformance is driven by lower indirect tax collection as well as, corporate (8-9% YoY) and income tax receipts (~3%) also moderating in 1Q-2QFY20. This will further increase the reliance on borrowings, which already runs at a high of ~8% of GDP, comprising of centre, state and public sector borrowings. This equals households' net financial savings, in effect reigniting the 'crowding out' for the private sector.



Source: BIS credit statistics, DBS

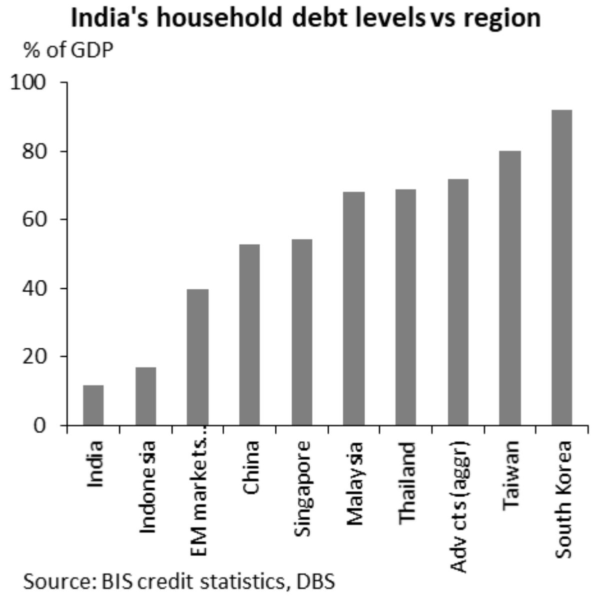
General government debt as a % of GDP has been sticky around 70% of GDP in recent years. Consolidation in the centre's fiscal deficits in the past four years have prevented an increase in the overall debt levels. However, the slower pace of correction in the centre's deficit in FY20-21 coupled with prospects of weak revenues suggest that meeting the medium-term goals of lowering the debt to 60% of GDP stands delayed. States missed their deficit target last year and is likely this year as well as power sector debt and higher pay commission commitments adds to their spending needs. We expect modest fiscal slippage in FY20 (to -3.6% of GDP) and slower consolidation in FY21 is expected (closer to -3.4-3.5 % of GDP).

Households**:** While corporate and bank balance sheets were under stress since 2013-2014, consumption spending emerged as a key support for growth. Consumption held up despite weak income growth, suggesting two likely support factors a) households dipped into savings to finance demand – this is backed by data showing a sustained deceleration in the overall savings rate, led by households; b) higher leverage to sustain consumption. Non-banks stepped in to fill the void left by banks' easing credit growth after 2013-2014. Further, banks' retail loan growth has grown by double-digits in the past 3-4 years.

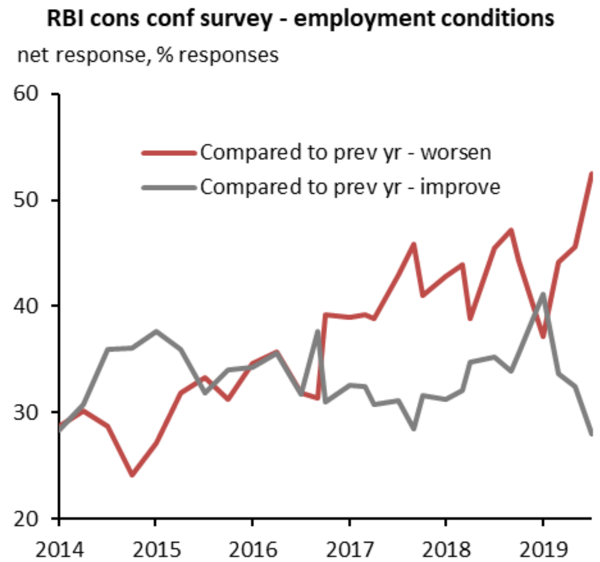


Source: CEIC, DBS; years - in fiscal years

As a result, household debt as a % of GDP has been gradually rising. **Clearly, India's household debt levels are amongst the lowest compared to the advanced countries and many Asian counterparts.** But is slightly high compared to its own past. With banks and non-banks in balance sheet correction mode, due diligence has been tightened and institutions are warier of undertaking fresh exposure. Households' on their part have also turned more cautious, as signalled by the central bank's recent consumer sentiment indices.



Source: BIS credit statistics, DBS



Source: RBI, CEIC, DBS

Near-term support measures (income support schemes, likely personal income tax cut etc.)

will help short-term consumption, with a sustained acceleration to require confidence in jobs and income creation.

Support measures are underway, and more is likely

As a reflection that reforms are headed in the right direction, India was amongst the top ten countries which have improved the most in the World Bank's Ease of Doing Business ranking, for three consecutive years. India climbed from 77 last year to 63 amongst 190 countries considered in the 2020 edition of the report. To revive growth, efforts are required with a short-term lens and another set of medium-term initiatives, which will provide a stronger foundation for growth to thrive.

As a near-term priority:

-After years of running a tight ship, the RBI has overtaken its regional peers to lower the repo rate by 135bps this year. We expect 50bps more by end-FY20, with assurances of lower for longer to continue even as inflation is back up to the 4% target on seasonal/ transient trends.

-Expedite transmission of an easy monetary policy. RBI has moved beyond moral suasion to ask banks to peg part of their loan book to external benchmarks. Besides preparing borrowers of the oncoming regime of floating rates, depositors also need to be prepped for lower returns. Streamlining national small saving schemes and post office savings (etc.) to a similar benchmark as bank deposits will also narrow the arbitrage, and hence support banks' deposit mobilisation.

-Need to strengthen the financial system/fragilities and fix trust deficit: Sufficient transparency between market players and regulators, which will allow market instruments to price these risks fairly and adequately. In the near-term, this could include liquidity support for mutual funds to defreeze them as a funding source for NBFCs, refinance window for illiquid assets and contain banks' exposure to non-banks. Review of NBFCs/HFCs books to gain a clearer picture of debt burden and kickstart resolution.

-Short-term boost to consumption by better price realisation for the rural sector. Expedite movement of excess/ surplus producing states to ones where there is a shortage or consider resumption in exports. Ensuring MSPs are prevailing price will provide an income boost for farmers.

Medium-term emphasis to run the growth marathon:

-To enhance asset quality concerns, creation of e a centralised body to manage asset distressed sales might be reassessed. This could be in the shape of a private asset management company, akin to agencies created in Thailand, Korea, Malaysia etc in wake of the Asian financial crisis. This will minimise the number of stakeholders involved, make the process transparent, unburden banks and non-banks balance sheets and provide relatively fair value to the projects stuck in various phases of resolution. In case of over-recovery in a said case, the difference can be divided by the agency with the financial creditors. This will, concurrently, allow the NCLT and IBC frameworks to strengthen, as the current resolution pace is running way below potential.

-Improving revenues and better GST compliance: Pursue expansion in the tax base post-GST, which will also help provide a fillip to overall tax collections. Asset monetisation and privatisation, whilst one-off, will provide relief to revenues and prevent cutback in growth-oriented spending objectives. A contentious but crucial part in expanding the tax base is to consider inclusion of agricultural incomes. It will also help to bite the bullet to recognise off-balance sheet borrowings and deferred payments in a phased manner to improve credibility.

-Infrastructure focus remains paramount, with moves to step up rewarding projects expected to improve after a slow start to the year.

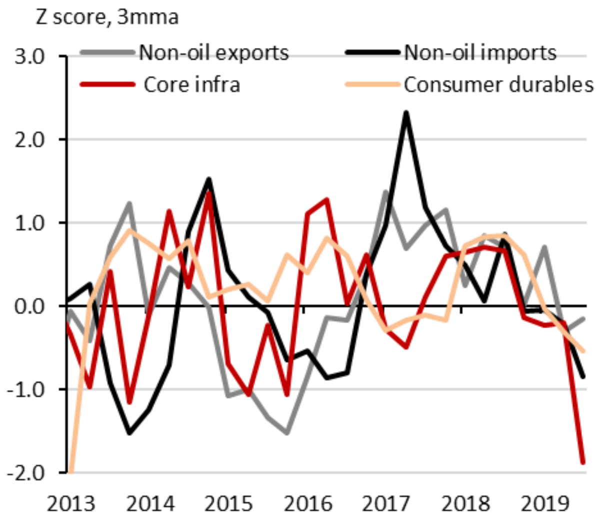
-Plans to merge labour laws into four main codes was an important move. Next step of consultations, besides unions, must include employees formal, informal and new gig economy to address structural constraints. Minimum wage increases to be standardised and reinforced. This can be supplemented by a more robust employment registry which will provide updated statistics on job creation and employment.

-Education, tertiary training, skill developments and good quality institutions will provide a productive workforce and fix the supply problem. This will need to be matched with adequate job creation, by attracting global and domestic manufacturing companies, and asset-generating opportunities for non-farm workforce, e.g. infrastructure and rural construction, amongst others.

Further moderation, before turnaround

Real GDP decelerated from 8% in 1Q18 to 5% in 2Q19 (first quarter FY20). Our proprietary DBS Nowcast model and momentum indicators point to further slowdown in 3Q19 (i.e. 2QFY20) vs 2Q's 5% led by lower consumption demand and investments, even as government spending resumes after elections.

India: production and trade



Source: CEIC, data transformation is by DBS

After the mid fiscal year slump, we expect a gradual improvement in the momentum towards late in the fiscal year and into 2021, helped also by base effects and lagged impact of measures undertaken. A broad pullback in near-term growth trend, however, prods us to revise down our GDP forecasts for this year and next. We expect the output gap to stay negative, with GDP growth below 6% this year and closer to 6% in FY21.

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