Economics & Strategy

DBS Focus

India outlook 2020: Slow climb to recovery

Economics/growth/FX/rates/equity

Group Research

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Radhika Rao
Economist

Philip Wee
FX strategist

Eugene Leow
Rates strategist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

India forecasts (in fiscal years)

	2018*	2019	2020F	2021F
Growth, yoy%, ave	7.1	6.8	5.0	5.8
Inflation, yoy%, ave	3.6	3.4	3.9	4.2
Core inflation, yoy%, ave	4.7	5.8	3.8	4.4
Currency, vs USD, eop	65.1	69.2	72.0	73.5
10-year yield, %, eop	7.6	7.4	6.7	7.0

*Fiscal year ending March; 2018 = FY18 i.e. YE Mar18

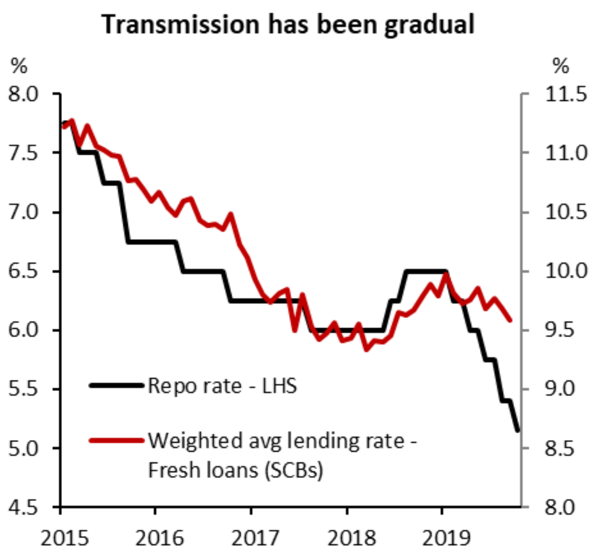
- *Growth deceleration and financial sector stress have dominated India's narrative this year*
- *We expect growth to bottom out in late 2019 and gradually inch up.*
- *Inflation is seen at below target in FY20, a shade above in FY21*
- *More rate cuts are likely, with the RBI at the last leg of its policy easing*
- *We expect to see some slippage in FY20 and FY21 fiscal deficit targets*
- *Sub-2% of GDP current account deficits are expected*
- *Record high FX reserves provide a buffer and vulnerability ratios are comfortable*
- *Political stability is bolstered by the ruling coalition's improving count in the Upper House*
- *FX: INR's depreciation bias has returned*
- *Rates: Bull steepening in the INR curve is starting to look stretched*

Economics

This year's narrative on the Indian economy was dominated by a sharp deceleration in economic activity and persistent financial sector stress. Growth eased from 8% YoY in March 2018 quarter to a likely sub-5% in 3Q and 4Q19. Idiosyncratic domestic factors have played a key role in pulling down growth.

This slowdown is driven by an interplay of factors. This is part cyclical and part structural, which points to the likelihood of a slow climb to recovery in 2020.

Cyclical concerns are underscored by the tight financial conditions despite an aggressive rate easing cycle this year. Liquidity premia, credit risk premia as well as term premia (spreads between Repo rate and 10Y GSec is at a multi-year high of 140bp) are elevated, hindering efficient policy transmission.

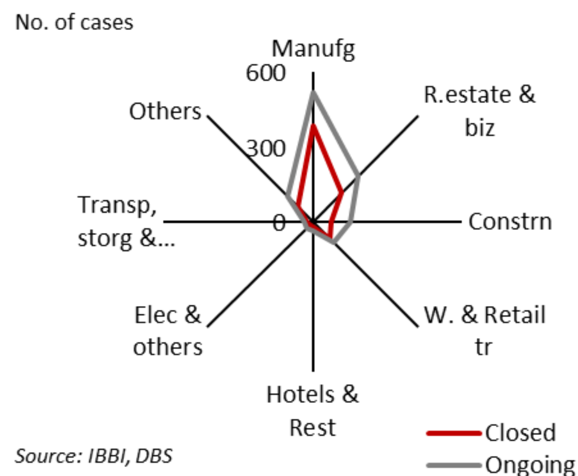


Source: CEIC, DBS

Banking liquidity has been in surplus for over four months, but weaker credit risk appetite has hurt its availability to the real sector, including real estate, small and medium scale enterprises, weaker non-banks, amongst others. Concurrently, monetary aggregates highlight underlying concerns on growth as M3 growth continues to trail nominal GDP growth. Shortage of risk capital, from the angle of cost of funds and supply has restrained economic activity.

Balance sheet worries facing the four key four pillars of growth, is a structural drag. Cross-synergies between these segments, which led a supply issue to magnify prevailing weakness in demand.

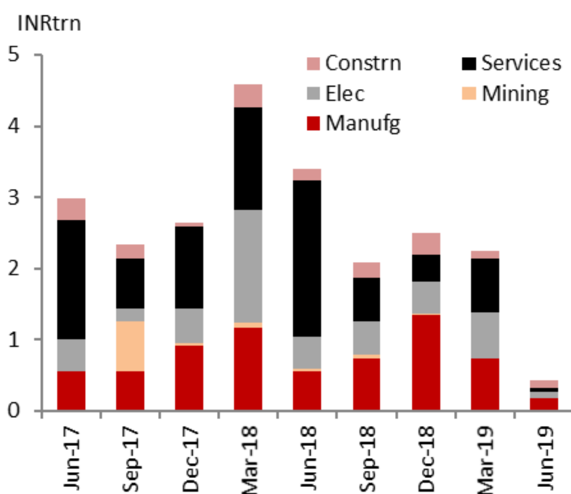
Financial institutions: Following a sharp increase in the banks' non-performing loans since 2015's asset quality review, the ratio peaked last year and has eased to 10.3% as of March 2019. Pace of improvement has been moderate due to a) slow progress of resolution cases under the new mechanism of Insolvency 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

NPAs of NBFCs are lower at 6% of overall loans but faces 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. An industry wide asset quality review is not on the cards for NBFCs, but as more cases of liquidity and solvency worries emerge, the authorities might outline the systemically key institutions and increase their oversight on these, to ensure these don't pose systemic risks.

Corporates: Non-financial corporations' debt as a % of GDP has moderated in the past two years. Granular data suggests firms are not completely out of the woods, however, with sentiments sliding in the past year. Interest coverage ratio is off lows as borrowing costs have begun to recede but is still below pre-2010 levels. New investments projects have slipped to a 15year low in 1HFY20 according to the CMIE data. Investment spending as a % of GDP fell in past five successive years before stabilizing at lows in the past two quarters due to higher public sector spending.



Source: Livemint, CMIE, DBS

Public finance: The fiscal math is under scrutiny, as slower revenue growth poses a risk not only the centre's coffers but also its contribution to the states' receipts. This will further increase the reliance on borrowings, which already runs at around 8% of GDP (comprising of centre, state, and the public sector). This equals households' net financial savings, in effect reigniting the 'crowding out' for the private sector due to a lower investable surplus. These factors have kept general government levels at 70% of GDP, a strong 10% above the required FRBM run rate.

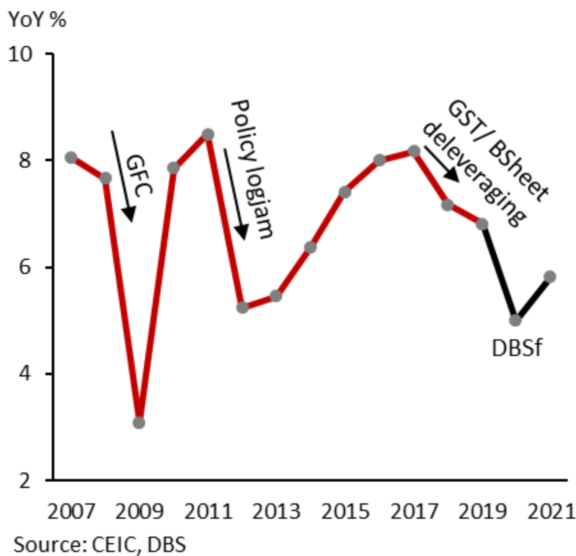
Households: While corporate and bank balance sheets have been under stress since 2013-2014, consumption spending emerged as a key support for growth: due to a) spending was being compensated by eroding savings; b) higher growth in retail and personal loans. India's household debt levels are lower than advanced countries and many Asian counterparts, but levels are rising compared to its own historical trend. Uncertainty over incomes, an easing savings rate and tighter vigilance by non-banks have pushed consumers to delay discretionary spending.

Apart from soft farm wage growth, linkages between rural sector activity and credit extended by non-banks and banks have added to the slowdown. Manufacturing sector makes up about a fifth of rural output, 10% by construction, and 40% by the farm sector. Slower credit disbursements by NBFCs to the real estate sector, for instance, has impinged on the sector's ability to absorb non-farm employment, in turn putting pressure on incomes. This has added to already negative mood in confidence indies.

Outlook

Our GDP Nowcast model suggests growth ended 2019 on a somber note. With more high-frequency indicators surprising on the downside, we dial down our FY20 real GDP growth to 5% YoY (prev 5.5%), with the likelihood of two quarters of sub-5% growth and inching up past 5% in 1H20. Favourable base effects, easier monetary conditions could support demand and while global conditions stabilize at lows. FY21 GDP growth is pegged at 5.8% YoY. Demand-supportive measures are expected in February's Budget, which should help growth in the short-term. Resumption of government spending coupled by inventory restocking is expected to help production, while non-financial sectors underpin services output.

Growth: trough before upturn

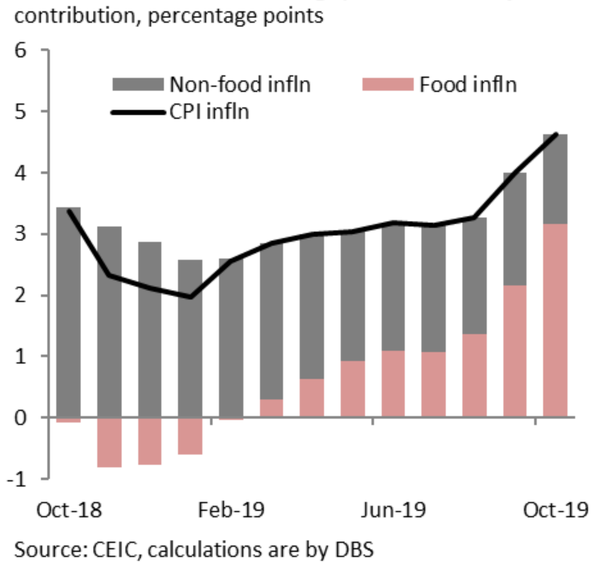


Source: CEIC, DBS

Inflation dynamics – near-term overshoot, back to target in FY21

April-October 2019 CPI inflation averaged 3.5%, keeping below the mid-point of the RBI target i.e. 4%. Supply-disruptions and a late monsoon withdrawal has, however, driven monthly inflation numbers past the 4% target.

Food CPI off the trough, non-food slips



Source: CEIC, calculations are by DBS

Staple vegetables have risen by 20% YoY in Sept-Oct, vs 4.6% in the prior five months, driving food inflation and in turn the headline. Food (and bevs) segment rose 6.9%, strongest since mid-2016, vs 4.7% month before. Contribution of non-food components, by contrast, continued to shrink, with core inflation (non-food, non-fuel) slipping to 3.5%, a new low for the series, with the latter also reflective of prevailing weak demand conditions.

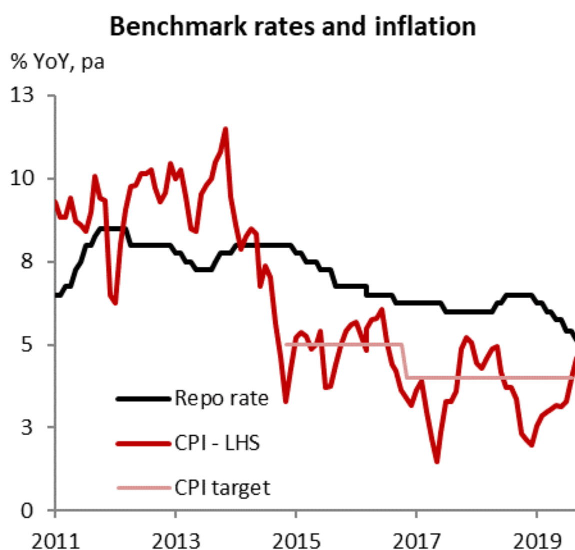
As supply conditions ease and the government raises imports to plug the staples shortfall, we expect headline inflation to taper over the next 6 months, during which low base effects will also keep inflation elevated (to recall January 2019 inflation stood at 2% YoY). Into FY21, trends are expected to moderate. Prevailing short-term spike prods us to revise up our FY20 inflation to 3.9% YoY (prev 3.6%) and FY21 to 4.2% (vs prev 3.8%).

Three-pronged support: monetary, fiscal and macro policies

We remain hopeful of three-pronged support – monetary, fiscal and macro policies.

Firstly, monetary policy. Rate cuts were the key source of policy support in 2019 with a cumulative 135bps cuts, most in the region and taking the repo rate to 5.15%.

Firming up of recent inflation numbers does put the central bank in a bind. While we are at the last leg of easing: a) unlike past episodes where supply shocks could lead to generalized price pressures, the present phase of weak consumption and soft confidence surveys lower the risks of a broader pickup in prices. This could give policymakers the confidence to ease without worrying over broader rise in inflation; b) full-year inflation is still below the 4% target.



Source: CEIC, DBS

A pause on rates at this juncture could reverse part of the transmission that has occurred through the bond markets, making it an uphill task to convince banks/ markets to pass on previous rate cuts. With the output gap in negative, dovish policy will stay its course. We hold out for another 50bps of cuts in FY20, divided between December 2019 and March 2020 quarters.

Next is fiscal policy. Since the government signaled fiscal consolidation in the full-year FY20 Budget in FY20, growth conditions have deteriorated. Weak growth has impacted revenue growth, compounding worries over an already weaker run-rate for tax revenues. Gross tax collections made 37% YoY in first six months of FY20 vs 43% last year. GST collections are running below target, suggesting a shortfall in indirect tax collections as well.

To bridge the gap, reliance on non-tax revenues particularly privatization and strategic sale of state's stake sales has risen. Encouragingly, the government recently approved strategic sale of five public sector companies. Stakes in three of these units could raise an estimated INR840bn, helping to meet or even surpass the budgeted INR1.05trn (0.5% of GDP) target. An additional ~0.3% of GDP boost to revenues owing to RBI dividend payouts, could help cover part of the shortfall.

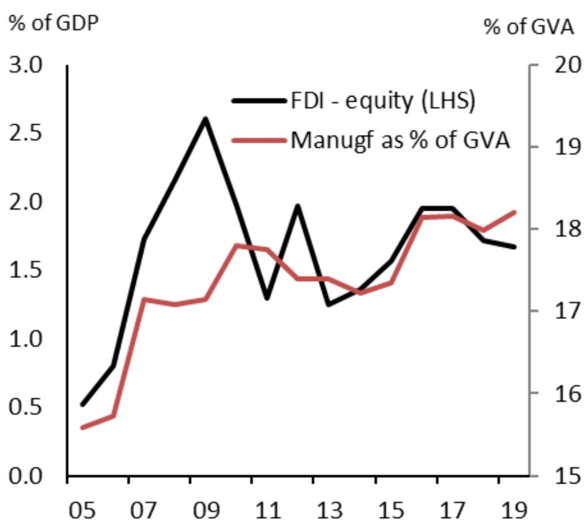
Revenue expenditure is running at 14% vs the budgeted 22% in 1HFY20, with the slower disbursements of the farmers income support scheme as identification of beneficiaries remains an uphill task also due to outdated land records. Capital expenditure, which makes a smaller part of total expenditure, is running at a reasonable pace – a bright spot for growth.

As it stands, fiscal costs of the corporate tax reduction (likely to be smaller than earlier anticipated as not all firms are willing to forego exemptions to avail the new corporate tax rate) coupled with below budgeted run-rate of direct and indirect taxes point to an at least 0.2-0.3%

of GDP miss in the FY20 deficit target. Nominal GDP is also below the assumed 12% YoY this year. **We expect the FY20 fiscal deficit to be revised to -3.6% of GDP vs budgeted -3.3%.**

For FY21, February 2020 Budget assumes importance. We expect short-term measures to spur demand, including personal income tax changes, expansion in rural schemes, sectoral support etc. We expect fiscal consolidation to be delayed in FY21 and target raised to -3.4%. Reasonable and realistic economic assumptions will see markets take a small slippage in their stride. Given weak growth dynamics, some extent of slippage is justified (under the FRBM escape clause) as well.

Lastly, macro policies will also be important to draw in foreign capital – investments and portfolio flows. The sovereign offshore bond issuance is not on the cards. Emphasis instead will be on improving the investment environment and expediting approvals. Gross FDI in FY20 and FY21 is likely to remains at ~USD60-65bn, including reinvestments and fresh equity.

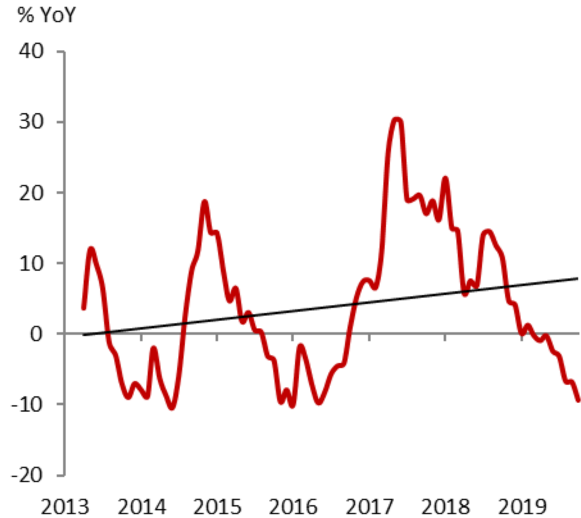


Source: CEIC, DBS

Work on improving hard and soft infrastructure, expediting dispute resolution, clarity on contractual obligations etc. will be important aspects for investors. Year-to-date equity and debt FPIs total USD10bn, vs net outflows last year. Assuming a conducive global environment amid flush liquidity and yield-hungry investors, we expect FY21 portfolio flows to also stay supportive.

External balances

Current account dynamics are favourable. Trade deficits have narrowed in the past three months as lackluster exports are accompanied by sharp slowdown in non-oil, non-gold imports demand; latter reflecting weak investment and consumption demand locally.



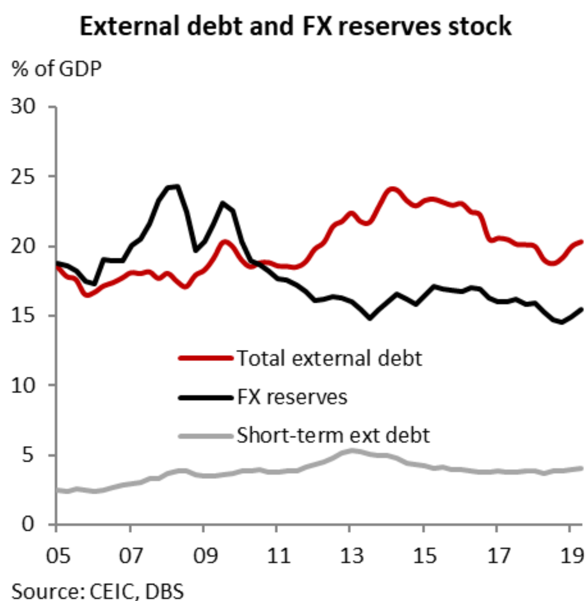
Source: CEIC, DBS

We expect FY20 current account deficit to narrow to -1.4% of GDP this year and -1.8% in FY21, keeping within the comfortable threshold of sub-2%, assuming steady oil prices.

Assumptions on the financial flows hinge on the capital and investment flows outlook. We remain sanguine on these fronts, which is likely to leave the FY20 balance of payments with a

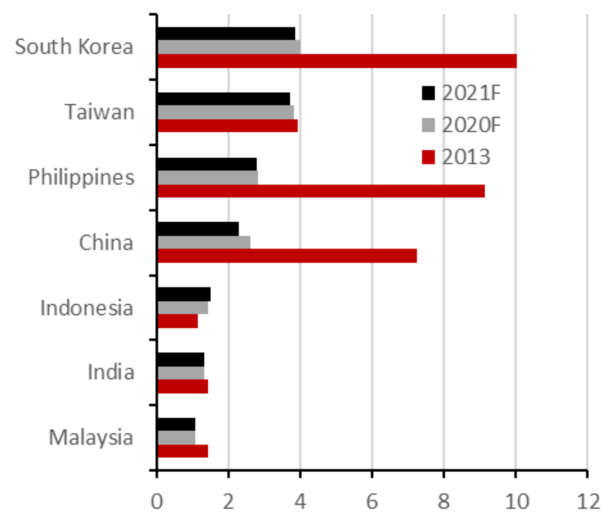
small surplus after two years of deficits. Basic BOP, however, is poised to slip into red.

External vulnerability indicators are on the mend, helped by the central bank's reserves accumulation. Total reserves stood at a record high of USD440bn by late-October, with imports coverage at a healthy 11x months. Total external debt has risen to a record high of USD557bn due to a sharp increase in external commercial borrowings. While long-term external debt is nearly equal to the total FX reserves, the closely watched short-term debt (due within a year) is at 0.3x of the reserves stock. On residual maturity basis (i.e. portion of total debt that is due within the year), short-term debt makes about 56% of total reserves as of June 2019 vs 57% in March 2019.



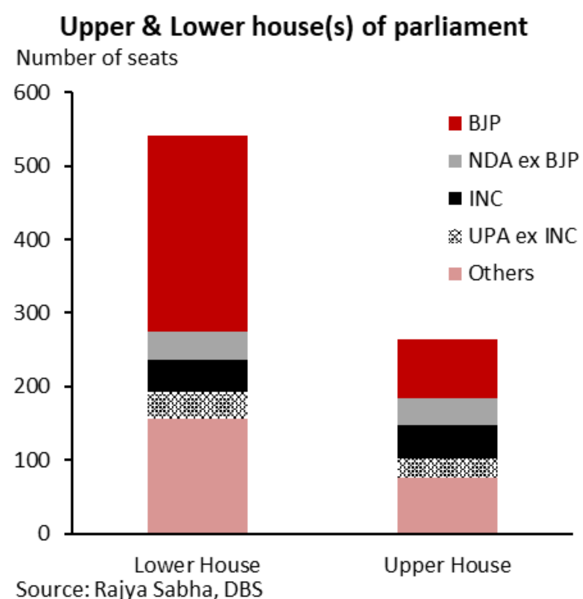
Source: CEIC, DBS

Based on our analysis of the gross external financing requirement ratio (short term debt plus current account vs reserves), India besides Indonesia, remain exposed to stress if funding conditions unexpectedly tighten in 2020.



Political stability and reform agenda

Following big-ticket reforms in the first term, we expect smoothening its implementation to be in focus in the first part of the government's second term, including simplifying the GST mechanism, strengthening the banking/ non-bank sector and tightening the bankruptcy law.



Source: Rajya Sabha, DBS

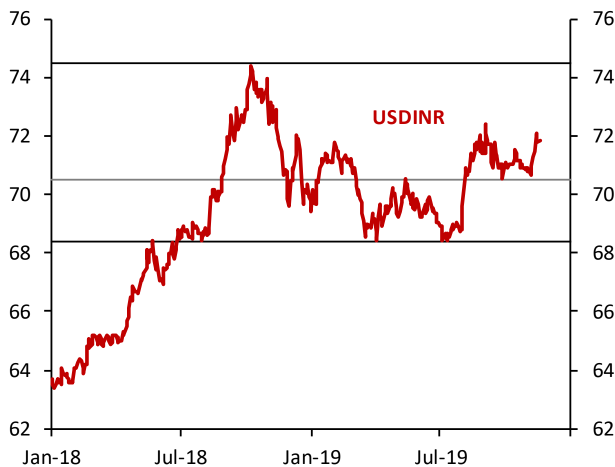
Near-term priority would be to shore up growth, initially by boosting demand by fiscal means and thereafter by addressing structural constraints. In 2H19, a sharp cut in corporate

tax several piecemeal sectoral meas`ures, were the highlights. The May 2019 elections saw the ruling party extend its support base in the Lower House. The Upper house math is also expected to shift in favour of the ruling coalition.

FX: INR's depreciation bias has returned

We look for the Indian rupee to hold a 68.5-74.5 range with a weak bias. The Reserve Bank of India is expected to further lower rates by another 50bps by March 2020 after the total 110bps delivered since February. Conversely, the Fed is likely to have completed its mid-adjustment cycle after its third cut in October.

Indian rupee to stay weak past 70 vs USD

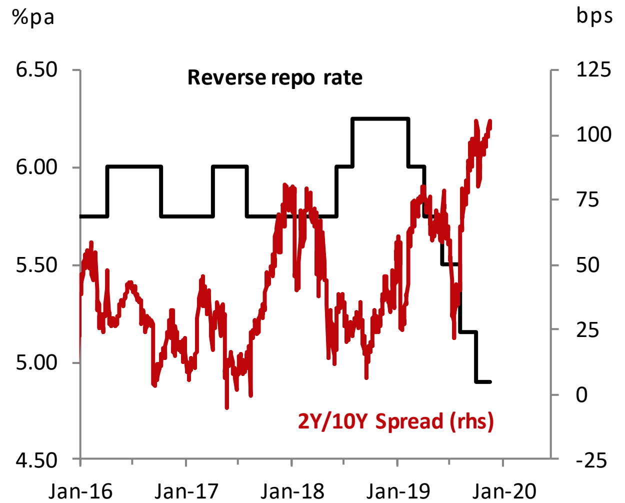


Sources: DBS Research, Bloomberg data

Rates: Steepening into flattening

India govvies will hold up relatively well in early 2020 but are somewhat concerned about fiscal issues over a longer horizon. The Reserve Bank of India (RBI) has been on an aggressive easing spree but we suspect that room to cut rates has become more limited into FY21. As such, the bull steepening in the INR curve is starting to look stretched. Notably, the 2Y/10Y spread (98bps, 2.5 SD away from the five-year average) is steep by recent standards and we think that short-term rates may be resistant to heading much lower even as they are anchored by low policy rates.

The India curve is steep by historical standards



Source: Bloomberg

Thus far, longer-term rates have borne the brunt of budgetary worries. Shorter-term rates have done well as low inflation is supportive of easy monetary policy. However, these dynamics could change over the coming quarters. The interplay between inflation and fiscal worries will be critical to watch for and we see two ways curve flattening can play out. In the benign scenario, inflation expectations fall, and fiscal worries ease, allowing longer-term INR rates to decline. In a more challenging scenario, fiscal and inflation worries pick up with the underperformance now concentrated in the front of the INR curve.

Group Research

Economics & Macro Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying, CFA
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India, & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

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

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