Economics

DBS Flash

India: Rising inflation to constrain policy room

Economics/Growth/Fiscal/Rates/India

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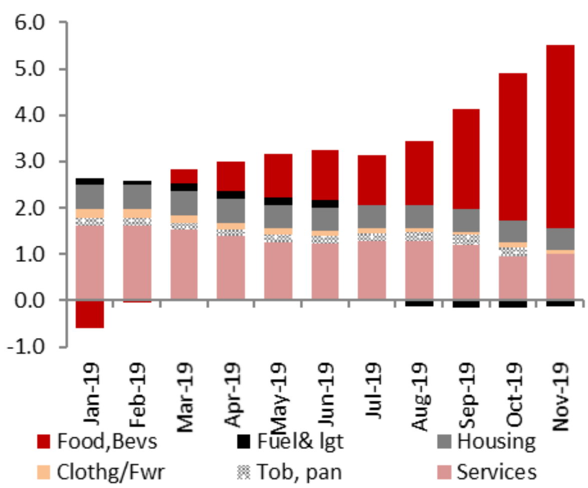
- *Latest data points to a build-up in inflation pressure, while growth moderates in 4Q*
- *November inflation was in breach of the 4% inflation target for a second successive month*
- *October industrial production points to a softer start to 4Q growth*
- *As the RBI pauses, baton passes to the government*
- ***Implications for forecasts**: Inflation is likely to stay high for the next six months before tapering. Rates to be on hold during this period*
- ***Implications for markets**: Long-end bond yields likely to remain elevated due to inflation and fiscal pressures*

November inflation extends climb

November CPI inflation accelerated to 5.5% YoY, in breach of the 4% target (mid-point of 2-6% range) for the second consecutive month and near three-year highs. Core remained subdued yet steady at 3.5% YoY.

Food inflation is punching above its weight, driven by prolonged supply disruptions on poor weather and a late withdrawal of monsoons. The food and beverages component rose 8.7% vs 7% month before. Vegetables (concentrated in 2-3 staple varieties) accounted for two-third of the jump, accompanied by a slight increase in protein and pulses. Contribution of non-food components remain low but further decline was stalled by transport and personal care effects (including gold).

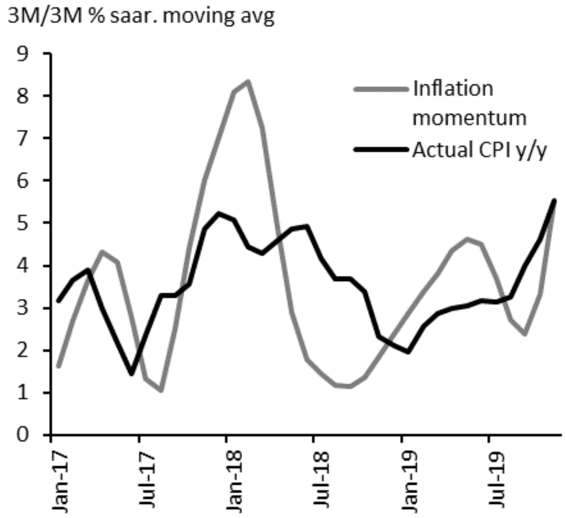
Food accounts for bulk of the headline jump



Source: CEIC, DBS

Core and core-core (excluding gold) inflation stayed weak, pointing to sub-par demand, in turn suppressing pricing power of industries.

Our inflation momentum indicator (3M/3M% saar moving average) points to quickening in price pressures in the coming months.



Source: CEIC, data transformations is by DBS

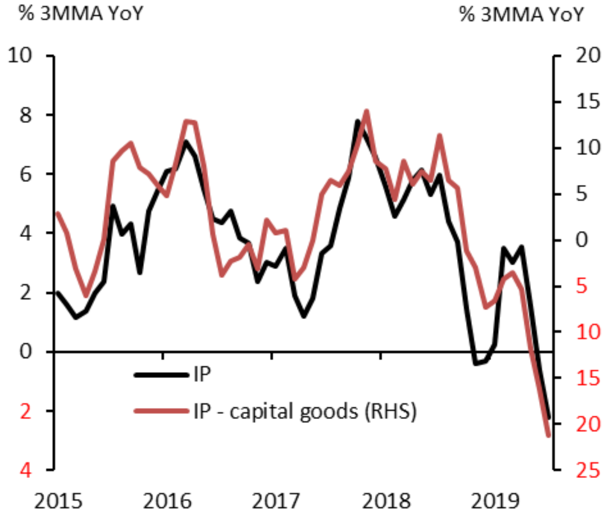
Factoring in the likelihood of supply-driven elevated food costs and upcoming telecom price increases, headline inflation is poised to head to 6% over the next two months (peak likely in Jan20 due to low base in Jan19 when inflation was at 2% YoY). We also note an uptick in the global FAO food index, which would essentially percolate through imports and rise in price expectations. To add, favourable base effects from a fall in global fuel prices will also dissipate into early next year.

Prints are likely to stay close to or above-target into early FY21, before tapering. Beyond the near-term stabilisation (at weak levels) in core, base effects to see the indicator inch higher into FY21.

Subdued IIP reinforces a negative output gap

Marking a third month of contraction, industrial production in October declined -3.8% YoY vs -4.3% month before. This marks the weakest three-month run for the IIP in the current series. Considering the seasonality effect from last year's Diwali which fell in November 2018 (vs October this year), October and November IIP were expected to stay sombre, aggravated by unfavourable base effects.

Drags on the headline were broad-based – electricity (-12% YoY), capital goods (-22%), infra & construction (-9%) and consumer durables (-18%). These reinforce protracted weakness in investment and consumption related sectors in the past four quarters. Core industries index, auto numbers and PMIs point to weak activity even as inventory levels ease at the margin.



Source: CEIC, DBS

There might be relief on few counts in 1Q, helping to arrest a sharper contraction in the headline IIP – base effects are likely to turn favourable providing a fillip to few sectors, end of monsoon should allow utilities and mining activity to resume and a sharp increase in intermediate goods in October (if sustained) would bode well for manufacturing output.

The IIP data puts 4Q19 (3QFY20) GDP on a weak footing, notwithstanding, festive related demand. Our GDP Nowcast model points to growth running below 4.5% at last count, which if materialised will imply downside risks to our FY20's growth forecast at 5%.

Policy outlook: from monetary to fiscal

The Reserve Bank of India monetary policy committee (MPC) paused on rates in December, surprising consensus for an 25bps cut. This leaves the repo rate at 5.15% after five consecutive rate cuts this year.

The MPC raised inflation forecasts and lowered growth. CPI inflation is now seen at 4.7-5.1% in 2HFY20 (vs 3.5-3.7% earlier) and 3.8-4.0% in 1HFY21. Real GDP growth for FY20 was cut by a sharp 1.1% to 5.0%, which reflects a recovery in 2HFY20 to 4.9-5.5%. First half of FY21 is seen at 5.9-6.3%, likely assuming a return to above 6% in the year.

Key takeaways for the policy guidance were:

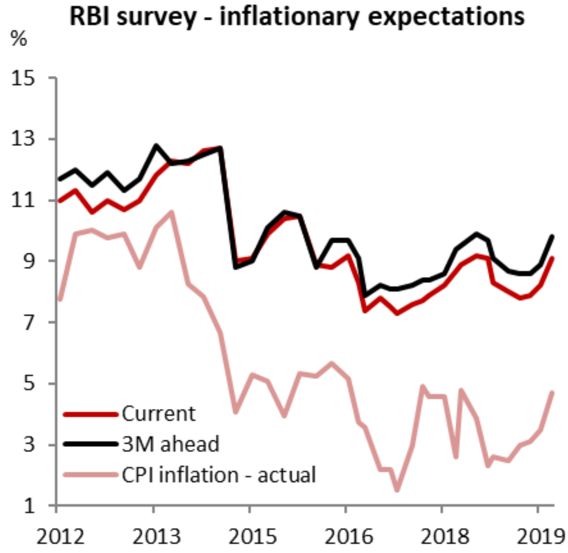
- The RBI expects food inflation to stay elevated in the coming months, whilst also ringing a word of caution on the wider (protein etc.) trend. Even as core inflation slipped to a series low in October and stayed weak in November, the recent rise in telecom prices is expected to add upward pressure.

-The MPC noted room for more lagged transmission, drawing confidence from a) lower bond yields and money market instruments; b) 49bps correction in the 1Y marginal cost of funds based lending rate (MCLR) vs 135bps in the repo rate; c) banks linking their lending rates to the benchmark rate.

-Uptick in households inflation expectations in the latest survey – both 3M and 1Y – was likely a concern for the authorities (see chart in next column).

-The MPC maintained an overall 'accommodative bias as long as it is necessary to revive growth', while ensuring that inflation remains within the target.

RBI survey - inflationary expectations



Source: RBI, DBS

Our take: Ahead of the December policy review, we had expected policymakers to look past the supply-driven nature of the recent surge in headline inflation and benign core (pointing to sub-par demand) to convince the MPC for a 25bps cut this month.

This bias was reflected in the RBI's move to cut growth projections sharply (by 1.1% between two rate reviews) whilst simultaneously raising inflation forecasts. But official guidance reinforced that movements in the headline CPI will remain the overarching target. Juxtaposing our expectations for inflation to remain above target (peak in January 2020) at least for the next six months, the RBI is likely to stay on hold, before contemplating room for cuts (if any) into FY21. **Between now and then, their bias will also be influenced by**: a) evolving inflation and growth dynamics; b) February's Budget where we expect a modest slippage in deficit targets; c) extent of policy transmission; d) liquidity and credit growth.

Onus to spur growth shifts to the government

Since the government signaled fiscal consolidation in the full-year Budget, growth conditions have deteriorated. Weak growth has impacted revenue growth, compounding worries over an already weak run-rate for tax revenues. Gross tax revenue has fallen further to 1.2% YoY between April-October vs 17% budgeted pace, primarily on lower indirect tax collections. Centre's GST collections is ~40% short of the budgeted estimate in first eight months of FY20. Speculation is that these weak collections might push the GST Council to consider increases in certain tax rates to improve revenues, which will, however, be negative for consumption.

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. Partial payments from telecom operators might also provide some cushion to the math.

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.

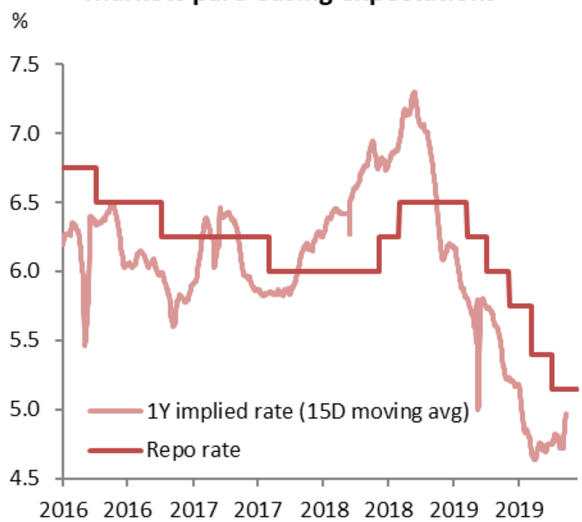
As it stands, fiscal costs of the corporate tax reduction (likely to be smaller than earlier anticipated as not all firms are willing to forego exemptions to avail the new corporate tax rate) coupled with below budgeted run-rate of direct and indirect taxes point to a miss in the FY20 deficit target. Nominal GDP run-rate 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. Fiscal consolidation might be delayed in FY21, with a higher deficit target of -3.4%. Given weak growth dynamics, some extent of slippage can be justified by the FRBM escape clause (permits up to 0.5% of GDP miss). At the margin, higher inflation will help raise the nominal GDP run-rate.

Market implications

Since the December review, the INR sovereign bond yield curve has seen shorter tenor yields off lows, accompanied by a sharper rise in longer-dated yields. Markets have priced out expectations for further cuts by the RBI.

Markets pare easing expectations



Source: Bloomberg, DBS

10Y yields (generic) are up >30bps since 5 December as markets push out rate cut expectations in view of the sharp bounce in inflation readings.

Add to this market chatter that the government might settle for a modest fiscal slippage in FY20 (DBSf: -3.6% of GDP vs -3.3% budgeted) is being construed as a sign of additional borrowings in 1Q20, worrying investors. FPIs have trimmed their exposure in debt for the second consecutive month in December (month-to-date). Recent cautious comments from S&P on risks to ratings from a prolonged slowdown also weighed on sentiments.

For the INR bond yield curve, steepening pressures may give way to gradual flattening pressures. While short-term INR yields (<1Y) are likely to stay anchored, downside to 10Y yields look limited. Speculation has risen on non-mainstream policy action to lower long-term borrowing costs. There are a few ways to do this – outright buying of securities, doing a Twist (selling short term securities while simultaneously buying longer term ones) or keeping liquidity flush. If the RBI starts to lean in this direction, extending duration would be more attractive.

At this juncture, odds of an off-cycle or out-of-the-box move to lower yields appears unlikely. Open market operations by the central bank and stronger treasury demand from domestic banks (in midst of a slowing credit cycle) might help to slow, but not reverse, the rise in 10Y yields in the run-up to the February's Budget.

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