Preparing for sustainable growth

Amidst a challenging and uncertain global economic backdrop, where geopolitical uncertainty and trade tensions have taken center stage, India's relative global appeal remains intact, albeit in the medium term.

India is fundamentally well positioned, with its core strength residing in the increase in the share of working-age population along with the recent reset in the corporate tax rate, which has boosted the country's global competitiveness.

However, near-term concerns have emerged with Q1 FY20 GDP growth slipping to a 25-quarter low of 5% and a widening of the negative output gap for FY20. Not only do the leading indicators of urban and rural consumption, along with that of investment, paint a dismal picture, but also uncertainty about global demand is taking its toll on India's exports. The anemic growth of all major growth drivers is clouding fiscal consolidation prospects with fisc coming under pressure from various stimulus measures announced in the last three months against a background of a slowing economy.

Despite fiscal consolidation pressure coming to the fore, the government is cognizant of the growing need to bolster the economy. Its efforts to revive the animal spirits in an ailing economy range from implementing demand-side measures, like the PM-KISAN scheme in the FY20 union budget and the increase in dearness allowance for central government employees, to promoting supply-side measures, like targeted micro steps for sectors such as auto; micro, small and medium enterprises (MSMEs); affordable housing and non-banking financial companies (NBFCs)/housing finance companies (HFCs). According to our estimate, after adding the budgetary allocation for PM-KISAN, the net fiscal stimulus for FY20 comes to ~US$26 billion (0.9% of GDP). The fiscal impact of all the non-budgeted measures comes to ~US$15.4 billion (0.5% of GDP) on a net basis.

The big-ticket reduction in corporate tax is a major fiscal policy lever adopted by the government that has not only resulted in improved market sentiment — as seen by the outperformance of the Indian equity market relative to most of its peers since the announcement of the corporate tax cut —but has also led to price cuts by a few companies (especially in the auto space). Even as the effective corporate tax rate has been brought down for existing companies, the effective tax rate of 17% for new manufacturing setups incorporated post 1 October 2019 is a win-win situation. This could potentially help companies (in search of new production facilities) consider India as an investment option in the face of the ongoing trade war.

Among such measures, the government's cash transfer program further catalyzes the near-term growth momentum. Total cash-based transfers have increased from 0.1% of GDP in FY14 to 1.1% in FY19. This is likely to touch 1.4% in FY20. We also note a structural shift in the pace of bank-based transactions post-demonetization. The government's emphasis on the Digital India drive, the liberalization of the e-commerce sector and steadily growing income levels are expected to support online consumption in India. This is likely to improve economic efficiency in the longer run.

All these measures, coupled with the accommodative stance of monetary policy, are likely to provide a leg up to economic growth in the next six to eight quarters. Following the cumulative 135 bps reduction in the repo rate since February 2019, bank lending rates have also started to respond in the same direction. Provision of surplus liquidity in the banking system would further aid transmission, as there is normally a two- to three-quarter lag between policy rate and economic variables.

Besides the government measures, the Reserve Bank of India (RBI) has also undertaken steps to support sentiment and growth via boosting primary liquidity in the market, providing record high transfers to the government, the introduction of external benchmarks for improving policy transmissions, relaxation of external commercial borrowings (ECB) requirements and relaxing the prompt corrective action (PCA) framework.

However, the sharp, negative surprise in the Q1 FY20 GDP print gave rise to expectation of a severe downturn in economic growth momentum, leading us to mark down our FY20 GDP growth forecast to 6% with downside risk. We do not expect any near-term impact on GDP growth from the current set of measures outlined above. However, the near-term revival in sentiment is likely to be palpable, which in turn should arrest the current downside risks.

Over the next six to eight quarters, the impact is likely to play out as the tax multiplier kicks in.

According to our estimate, the corporate tax rate cut will eventually bring about higher growth in the medium term via a multiplier of ~1. The boost to bottom line for companies is likely to manifest in the form of (i) higher capex, (ii) higher payment to shareholders and/or (iii) payment of past debt. Similar expansion is likely to be experienced via the PM-KISAN rollout, which also has a multiplier of ~1. This is likely to boost investments and consumption in the economy over the medium term.

The favorable monsoon outturn in 2019, with the south-west monsoon ending with a surplus of 10% (vis-à-vis the long period average [LPA]) in contrast to the forecast of a deficit of 4%, is likely to aid rural consumption. The recent spurt seen in food-price inflation is likely to be transient, and we expect it to be offset by the arrival of kharif produce and better prospects for rabi sowing, led by surplus rainfall and adequate water reserves.

With consumer price index (CPI) inflation projected to remain below 4% (averaging at 3.5% in FY20 as compared with 3.4% in FY19) for the third year in a row, and the monetary policy reaction function of the RBI becoming more sensitive to a negative output gap, expectation of further monetary easing remains on the table. The overnight index swaps (OIS) market expects about 45 bps of incremental monetary easing from the RBI over the next year. We expect the RBI to deliver another 25–40 bps in the remainder of FY20, before getting into a prolonged pause.

Foreign investment inflows have started to improve on the back of a stable exchange rate, positive election outcome, gradual economic liberalization and anticipated monetary policy easing in the USA in the coming quarters. Recent relaxation of foreign direct investment (FDI) norms for single-brand retail, digital media, coal mining and contract manufacturing bodes well for further traction. The easing of ECB norms since December 2018, coupled with low US dollar rates, has led to a jump in ECB flows.

With pickup in foreign investment flows amidst a moderating trade deficit on account of lower export and import demand, volatility in the Indian rupee (INR) is likely to remain limited. However, uncertainty over oil prices and global trade tensions (that could morph into a currency war) are likely to keep the INR on a tensed turf, although we expect the INR to trade in the range of 69–73 over the course of next year. Over the longer term, increasing growth premium and inflation stability would be supportive of the currency.

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