dun & bradstreet
GROWING RELATIONSHIPS THROUGH DATA

D&B ECONOMY OBSERVER

Issue 135
August 2019

Contents

Research Team
Dr. Arun Singh
Dipshikha Biswas
Raj Kiran
Sharika Dhar

View from the top

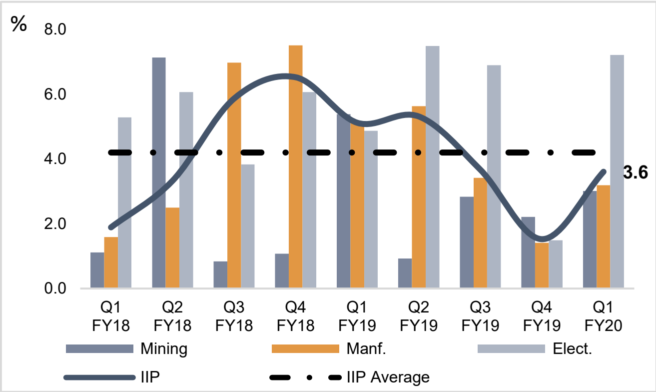
Given the continued weakening of the global economic activity and increasing concerns on multiple issues on the domestic front, one question is openly asked again and again: Is India's growth headed for a further slowdown that will last longer than earlier expected? Taking a stock of the various ongoing and emerging challenges, globally and domestically, it is highly likely that the answer is yes.

Globally, the economic activity continues to worsen with slowdown in growth and risk of recession impacting countries such as China, US, Germany and Britain. Argentina has already entered recession. The trade wars and protectionism are impacting business investment, their optimism and trade flows across the world, worsening a global slowdown that was already underway. The consequent rise in risk aversion has led to pulling back of financial flows. Global flows of foreign direct investment fell by 13% in 2018, to their lowest level since the financial crisis. It was the third consecutive annual decline. The contagion effects are expected to impact India.

Domestically, even if there are cyclical impediments to growth, there are issues at the sectoral level and differ across sectors from autos to real estate, construction, power, telecom, banking and finance apart from agriculture which makes the task of the government somewhat difficult to address. How deep are the structural issues and how fast the sectors can come out of it will determine the extent of slowdown and the pace of revival. Firstly, there is no quick fix solution at the sectoral level and secondly, it will take time for the sectoral issues to get resolved. Looking at a sectoral level, most of the sectors such as auto, telecom, power, NBFCs and agriculture are facing supply side or market-oriented issues which do not have short term solutions. In such a scenario to what extent can the government's fiscal stimulus or RBI's monetary stimulus address both the demand and supply dynamics? Incomplete pass through and transmission lags in the monetary policy renders the RBI's initiatives ineffective in the short run. Secondly, consider this, if the government puts money in the hands of people it can boost demand. However, without providing for gainful employment opportunities, correcting the skewed distribution of income and lessening the dependence of ~60% of the population on the vagaries of the monsoon, it would not push the consumption bandwagon, rather result in fiscal profligacy.

Even when India was growing at a higher rate (7.2%) with low inflation (3.6%), the economy recorded a high unemployment rate. Data shows that around 2 out of 10 young people (15-29 years) in the labour force were unemployed during FY18. Not only unemployment was higher, income distribution remained skewed. A little more than 67% of the households (surveyed) at the all India level had average monthly earnings up to Rs 10,000 in FY16. A minimum wage bill which will try to address the low level of income cannot be a fixture as even though it can increase the affordability of the people, through a wage cost spiral it might also increase the minimum price level of goods. India will need to generate not only more jobs, but also high paying jobs with a sound social security system for health, education and old-age, so that it can unleash the potential demand of its huge population, especially, the young people in the labour force.

IIP growth rate in Q1 FY20, lower than average of last 8 quarters

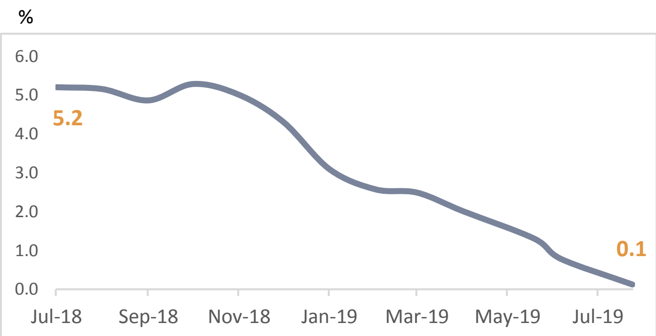


Source: MOSPI

Real Sector

- Slowdown in both mining and manufacturing contributed to a subdued IIP growth of 2% (y-o-y) in Jun 19, lowest in 4 months.
- Output of mining rose by 1.6%, a 3-month low; manufacturing grew by 1.2%, slowest in 4 months. Electricity generation grew by 8.2%, an 8-month high.
- Output of capital goods declined by 6.5% and consumer durables declined by 5.5%, lowest since Nov 17. Output of infrastructure/construction goods contracted (1.8%), 1st time in 25 months.
- Output of primary goods rose by 0.5%, lowest in 6 months; consumer non-durables and intermediate goods grew by 7.8% & 12.4% respectively.
- Core industries output rose by ~0.2% in Jun19, lowest since May 15. Cement output fell by 1.5%, lowest in 24 months; fertilizer output rose by 1.5% post contraction for 2 months.
- Fiscal deficit was at 61.4% of the full year target by Q1 FY20.
- In Apr-Jul 2019, domestic sales for passenger vehicles declined by 21.6%-lowermost in 19 years. Commercial vehicles declined by 13.6% (y-o-y).

Persistent moderation in Core WPI inflation indicates weak demand

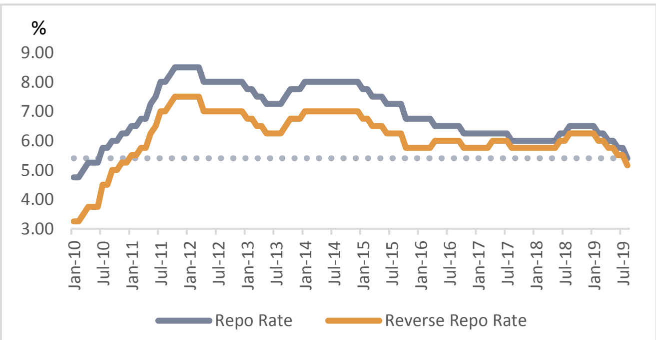


Source: Ministry of Commerce & Industry

Price Scenario

- CPI inflation marginally dipped to 3.1% in Jul 19 led by easing of food inflation and disinflation in the fuel group.
- Vegetables inflation softened to 2.8%, lowest in 4 months, inflation in pulses surged to 6.8%, highest since Oct 16. Inflation in fuel & light group contracted by 0.4%, 1st time in FY12 series.
- WPI inflation was 1.1%, a steep 25-month low due to declining moderation in major sub-groups.
- Inflation in food articles eased to 6.2%. Inflation in cereals & pulses remained elevated while vegetables inflation was 10.7%, lowest in 5 months.
- Inflation in fruits surged to 15.4%, highest since May 18.
- Inflation in raw cotton softened to 1.1%, lowest since Jun 18. Crude petrol prices contracted by 15%, lowest since May 16. Inflation in manufactured products was 0.3%, lowest since Jul 16.
- Core WPI inflation was 0.1% lowest in 33 months; Core CPI inched up to 4.3%, highest in 3 months.

Repo rate is the lowest in over 9 years

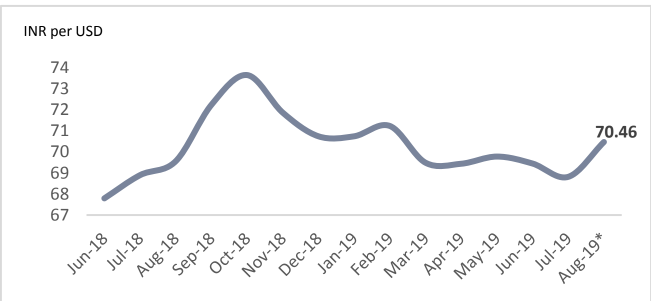


Source: RBI

Money & Finance

- The RBI in its 3rd Bi-monthly Monetary Policy Statement for FY20 decided to reduce the policy repo rate by 35 basis points to 5.40% from 5.75%, marking the 4th consecutive repo cut since Feb 19. Consequently, the reverse repo rate under the Liquidity Adjustment Facility (LAF) stands adjusted at 5.15%.
- Bank credit grew by 12.2% (y-o-y) as on the week ended July 19, 2019 compared to 12.4% (y-o-y) as on the week ended July 20, 2018. Aggregate deposits grew by 10.6% compared to 8.1% during the same period.
- Bank credit to iron & steel industry continued to contract for the 14th consecutive month and stood at -11.4% in Jun 19. Bank credit to construction industry moderated to 6.7% in Jun 19, lowest since Mar 18.
- Net investments in mutual funds stood at Rs 678.8 bn in Jul 19, highest since Jan 19. The equities segment witnessed net inflows of Rs 150.8 bn, highest since Nov 18.
- The RBI in its liquidity operations absorbed Rs 25.6 tn in Jul 19, highest since Apr 17.

Rupee on a downward trajectory vs US$ after 12-month high in Jul 19



Source: RBI

* August data till 14th Aug 2019

External Sector

- India's merchandise exports rose by 2.2% (y-o-y) to US$ 26.3 bn, while imports contracted by 10.4% to US$ 38.8 bn and the trade deficit narrowed to US$ 13.4 bn, lowest since Apr 19.
- Oil imports declined by 22.1% (y-o-y%) in Jul 19 to US$ 9.6 bn. Global brent prices were valued at $64 per bbl, decreasing by 14% in Jul 19 over Jul 18.
- Services receipts rose to US$ 18.6 bn in Jul 19, registering a growth of 9.96% (y-o-y) while payments rose to US$ 11.8 bn rising by 14.2% and the services trade balance was US$ 6.8 bn.
- Foreign exchange reserves were valued at US$ 430 bn in week-ended Aug 9, 2019. Gold reserves were valued at US$ 27 bn, highest since week ended March 1, 2013.
- FII outflows in Jul 19 was US$ 433.6 mn, after inflows since Feb 19. Outflows in equity were US$ 1.8 bn and outflows in debt were US$ 1.4 bn.

Dun & Bradstreet's Macro Economic Forecasts			
Variables	Forecast	Latest Period	D&B's Comments
I.I.P Growth	2.5% - 3.0% Jul-19	1.96% Jun-19	Lackluster growth in the Index of Industrial Production (IIP) is expected to prevail during the year as the various manufacturing sectors are facing multiple challenges which will take time to get resolved. Fiscal stimulus planned by government and the policy rate cuts by the RBI along with other initiatives are likely to offer some respite to the corporates. However, a comprehensive/wide ranging reform package will be required to address the various issues at the sectoral level.
Real GVA Growth	Q1 FY20(F) 6.3%	Q4 FY19(P) 5.7%	
Inflation W.P.I	1.1% - 1.3% Aug-19	1.08% Jul-19	Lower economic activity along with subdued demand conditions and low commodity prices globally are likely to keep inflation benign. Two factors, lower agriculture production and flood in many districts in India have the potential to impart some inflationary pressures.
Inflation C.P.I (Combined)	3.2% - 3.4% Aug-19	3.15% Jul-19	
15-91 days T-Bills	5.5% - 5.7% Aug-19	5.68% Jul-19	Lowering of policy rate by the RBI, low crude oil prices, foreign fund outflows in the debt market and low or negative yields globally will continue to keep the yields low. At the same time, increased likelihood of a fiscal stimulus package has raised concerns of additional borrowing by the government.
10-year G-Sec Yield	6.4% - 6.6% Aug-19	6.60% Jul-19	
Bank Credit*	10.5% - 11.0% Aug-19	12.16% Jul-19	
Exchange Rate INR v/s US$	71.0- 71.2 Aug-19	68.81 Jul-19	Strengthening of dollar despite Fed rate cut amidst increase in risk averseness over concerns about US-China trade negotiations and fear of an Argentina credit default and FII outflows from Indian markets will continue to weigh upon the rupee.
All figures are monthly average			
* Refers to End Period; *Jul data: Week ended Jul 19,2019*			

Effectiveness of Monetary Policy Transmission in India

Globally, countries have shifted from monetary policy tightening (2016 to early 2019) to monetary policy easing since March 2019 as per the Global Monetary Tracker which compiles monetary policy trend of 54 countries. As per theory, reduction in interest rates increases borrowing and stimulates consumption, leading to economic growth. Much however depends on how effectively, with respect to time and quantum, the monetary transmission mechanism works. In India, the RBI has been ahead of the curve in monetary policy easing, reducing the repo rate by 110 bps since Feb 19 as inflation has remained within the target range since Aug 2018. This has been the steepest rate cut since 2000, with the exceptions in 2008-09, i.e. during Lehman crisis. The urgency indicates that the RBI wants commercial borrowings to increase. The pass through of the policy rate cut to the commercial interest rates will enable corporates to borrow at lower rates.

There has been a reduction in the lag in transmission of policy rate to the commercial rates in the recent period compared to the earlier decade. According to a study by the RBI, transmission of policy rate to bank credit usually took about seven months during 2001 to 2011. This has come down to an average of four to six months. During Feb-Jun 2019, when the RBI reduced repo rate by 75 bps, there was a pass-through of 29 bps in a period of about two months.

However, there have been instances of incomplete pass-through and longer period of transmission. Some of the reasons behind the inflexibility of the interest rates which prevailed a decade ago still exists today. In FY02, sharp reduction in repo rate was not reflected in bank lending rates despite measures such as lowering interest rates on small savings schemes and reduction in CRR. The reasons for downward inflexibility in transmission were high average cost of deposits, limited flexibility to reduce interest rates in the short-run, relatively high non-performing assets (NPAs), non-interest operating expenses and procedural bottlenecks in recovery of dues by banks and large borrowing by the government. Close to a decade later, some of the issues still prevail. As per research, the major reasons behind weak transmissions are: (i) Maturity mismatch and interest rate risk for deposits and loans; (ii) rigidity in saving deposit interest rates; (iii) competition from other financial saving instruments; and (iv) deterioration in the health of the banking sector. Out of the four, three issues have been discussed below:

1) Rigidity in savings deposit interest rate – 58% of the total deposits are term deposits and 77% of the term deposits are for 1 yr and above and most of the term deposits have fixed interest rate which means transmission is effective only for fresh deposits. Besides banks have no incentive to decrease the deposit rate with the decrease in repo due to high operating expenses of savings accounts and already stressed balance sheets. **How can this be fixed?** Linking repo rate with deposit rate can address the issue and some banks are currently moving towards this system. High dependency on bank deposits for lending has resulted into interest-rate stickiness. Banks can move over to a variable interest rate structure on longer term deposits. Banks also need to look at other sources to fund lending such as issuance of debentures/commercial papers and borrowings from the capital market.

2) **Deterioration in the health of the banking sector** - Effective monetary transmission is impeded by weak balance sheets due to low loss-absorption capacity to deal with problem loans. Increased cost of funds and liquidity crunch due to high NPAs impact bank's profitability, further impacting transmission. **How can this be fixed?** Initiatives like IBC, NBFC regulations, PCA framework for PSU banks along with increased liquidity in the system has given a chance to banks to recover and transmit the benefit to its customers.

3) **Competition from other financial saving instruments:** With an increased risk appetite, financial literacy, good performance of stock markets and well-structured products, households are diverting a part of their savings to risky assets like mutual funds. Risk free instruments including public provident fund, national savings certificate, etc. competing with banks. Despite quarterly review of interest rates, movement in small savings rate has remained highly inflexible. There is an increased reliance of public sector enterprises from National Small Savings Fund to meet their expenditure for various social schemes of the government, the re-payment of which is done by the government. Here, it becomes less imperative for the government to reduce the small savings rate. **How can this be fixed?** In Apr 2016, the government decided to revise small savings rates quarterly, aligning them with the government bond yields of previous quarter. However, even as the G-sec yields have been falling since Aug 2018, interest rate on national savings schemes has increased during Oct 2018 to Mar 2019. Recently, the government has reduced the interest rate on national savings schemes only by 10 bps for Jul-Sep 2019. To strengthen monetary transmission, the government needs to pro-actively peg the small savings rate with the G-sec bond yields.

India is a developing market taking proactive measures to create a robust financial infrastructure. Enabling effective monetary transmission would not only increase credibility of the Central Bank but also help in strengthening the financial structure.

Monetary Transmission on select Lending and Deposit Rates

Data in bps

Period	Policy Rate (Bank/Repo)	Lending Rate (PLR/Base Rate/MCLR)	WALR (fresh loans)	WALR (outstanding loans)	Term Deposit Rate-Max	Avg. TDR/WATDR
Feb 98-Apr 00	-400	-225	na	na	-200	-200
Feb 98-Feb 99	-200	-100	na	na	-50	-75
Mar 99- Apr-00	-200	-125	na	na	-150	-125
Jan 01-Dec 2003	-400	-150	na	na	-425	-387.5
Jan 01-Dec 02	-250	-100	na	na	-325	-287.5
Jan 03- Dec 03	-150	-50	na	na	-100	-100
Jan 2015- Jul 2017	-175	-85	-142	-123	-210	-186
Jan 2015-Mar 2016	-125	-62.5	-98	-74	-110	-91
Apr 16- Oct 16*	-50	-2.5	1	-5	-60	-35
Nov 16- Jul 17*	0	-20	-68	-53	-20	-63
Feb 2019- Jul 2019	-75	-17.5	-29	5	-60	-66

Note: Monetary instruments differ based on the time period. Bank rate, Prime Lending Rate (PLR), and Average Term deposit rate (Avg TDR) are considered for Feb 98-Apr-00. PLR and Avg TDR are considered for Jan 01-Dec 03. Base rate is considered for Jan 15- Jul 17. MCLR- Marginal Cost of Funds based Lending Rate; WALR- Weighted Average Lending Rate; WATDR- Weighted Average Term Deposit Rate

Source: RBI

Please send your feedback to Dr Arun Singh, Chief Economist.
Dun & Bradstreet Information Services India Pvt. Ltd., ICC Chambers, Saki Vihar Road, Powai, Mumbai 400 072. CIN - U74140MH1997PTC107813
Tel: 91-22-4941 6666 | Email: SinghArun@DNB.com | www.dnb.co.in