# INDIA GROWTH PUZZLE - OCTOBER 2017

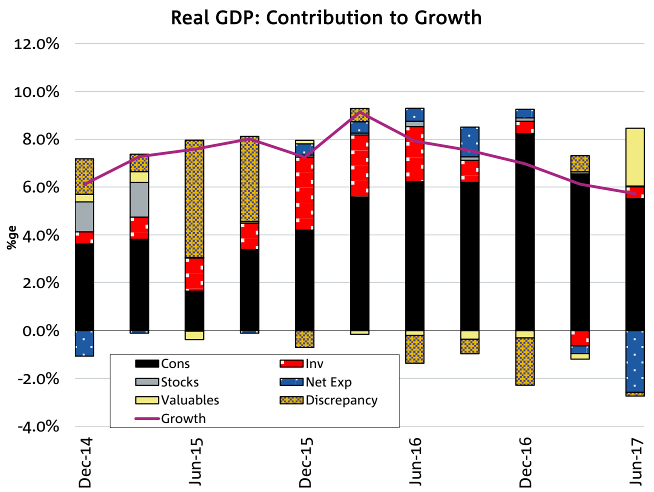
NAB Group Economics

The Indian economy has slowed considerably since the first half of 2016. The demonetisation program and the recently-implemented GST legislation were disruptive factors. They, nevertheless, do not account for the slowdown in its entirety. The Indian economy enjoyed windfall gains through lower oil prices, the effect of which has largely been eroded. Looking ahead, the economy is expected to gain traction as the impact of disruptive factors fades away. A focus on supply-side reforms will likely yield better results than pursing aggressive policies to lift demand.

## Recent slowdown

The Indian economy has eased sharply over the past year and a half. India is the 3rd largest economy in the world (on a Purchasing Power Parity basis), so a slowdown in India has implications for global growth. This paper aims to disentangle some of the factors underlying the slowing growth, and examines the outlook for the future.

**India GDP: By Expenditure**



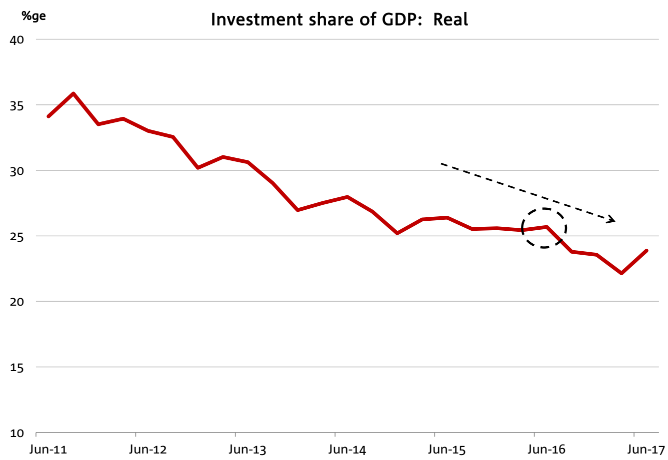

Source: NAB Economics/CEIC

From a recent peak of 9.1% yoy in March 2016, the Indian economy has decelerated to 5.7% yoy in June 2017, the slowest in 3 years. In fact, we look more closely at the data between December'16 and June '17, and compare it with the previous corresponding period, there are 2 aspects which clearly stand out:

- Lower contribution from investment spending
- Lower contribution from net exports

There has been a general downtrend in investment spending in India over the past 6-7 years. However, this has become more acute since June, 2016. The investment ratio to GDP reached a recent low in the March quarter, 2017, and still remains weak. The Indian Government launched its 'demonetisation' program on the 8th of November, where the old denomination Rs500 and Rs1, 000 notes ceased to be legal tender. This accounted for 86% of the value of notes in circulation, and it was not until March 2017 that enough new notes were put into the banking system.

**Declining investment share**

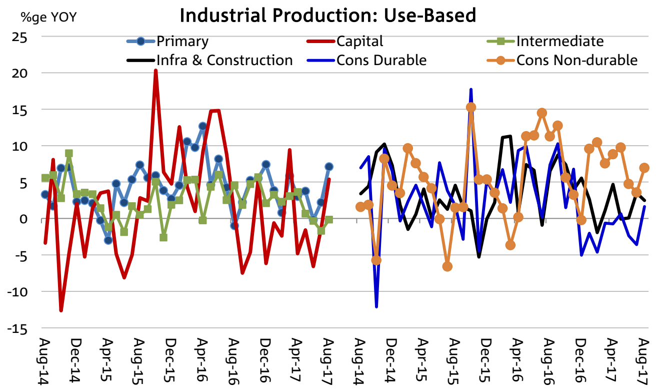



The *Industrial Outlook survey* conducted by the RBI during the October 2016-December 2016 period revealed that businesses were pessimistic about their profit margins and order books. It is unlikely that businesses would invest in a climate of low profitability and weak demand.

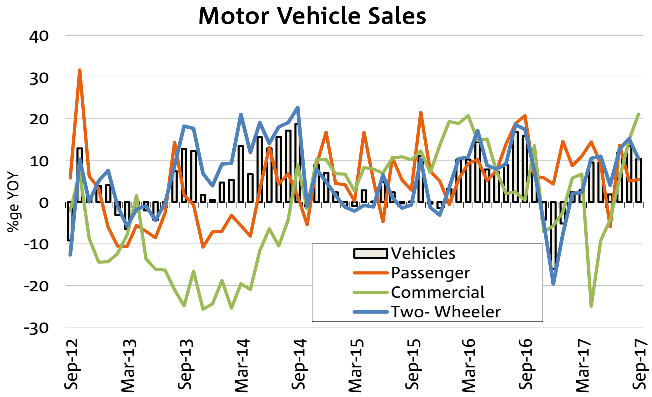
These trends are also borne out in higher frequency indicators such as industrial production. According to the IIP (by use), production of capital goods and durable goods consumption has been weak. Infrastructure activity has held up, largely due to

Government spending on roads and highways. However, the most recent set of data has been encouraging. Production of both capital goods and consumer non-durables recorded positive yoy growth in August. Furthermore, indicators for vehicle sales revealed a strong result for commercial vehicle sales in September, rising by 21.1% during the year to September, consolidating gains observed in July and August.

### IIP Use and Commercial vehicle sales

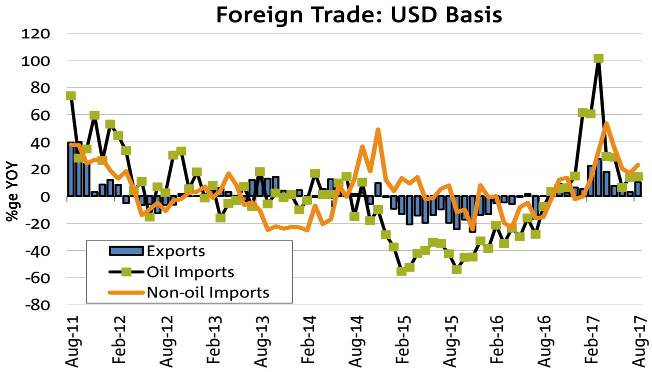



Source: CEIC




Turning to net exports, India has reaped a windfall gain from lower oil prices. This has helped compress the fiscal deficit and boost net export's contribution. In July, 2014 the benchmark West Texas Intermediate was around USD107/bl, but it slumped to USD26/bl in February, 2016. This can be seen in the merchandise trade data showing the sharp decline in the value of oil import purchases.

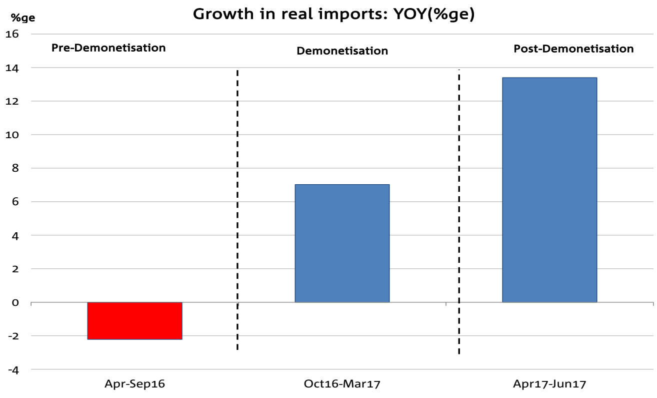
### India Merchandise Trade




Source: CEIC

This trend has largely reversed since late 2016 onwards. The data also points to other interesting trends. Export growth has been weak during the April to July period, but has picked up in August. Further, non-oil imports have also been strong.

### Recent growth in real imports

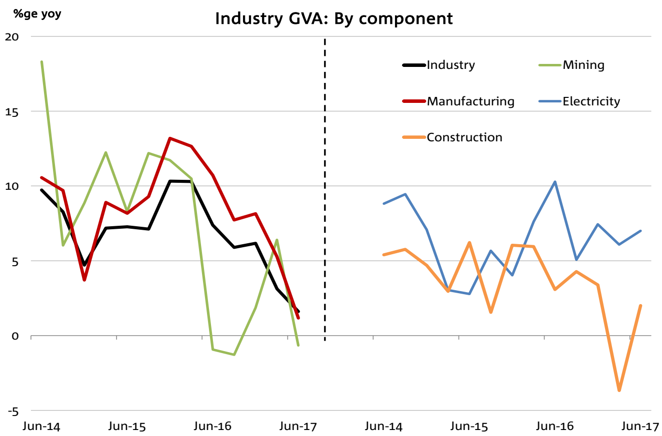



Typically, imports vary in line with incomes. However, this has not been the case recently in India. Real import growth gained momentum during October'16 to Mar'17 (the period directly impacted by demonetisation), and has accelerated further since. One possible explanation is the temporary disruption in domestic production networks due to demonetisation, which increased the reliance on imports. According to the RBI, there was an increase in imports of electric, construction and dairy machinery products.

## Industry GDP: A closer look

Looking at real activity by industry the slump in construction and manufacturing clearly stands out.

### Indian GDP by industry



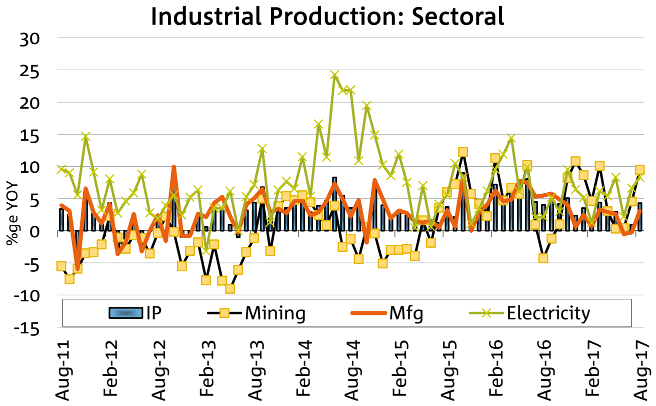

Source: CEIC

Mining was volatile, reflecting a sustained improvement in natural gas production, although weakness in crude oil and coal production took its toll in the June quarter of 2017. Electricity production was the best-performing sector.

The construction sector was likely hit badly hit by the demonetisation-induced cash crunch. As new notes began to surface, there was an upsurge in activity during the June quarter of 2017. Manufacturing, on the other hand, seems to have been hit by a double-whammy of both demonetisation and the GST – launched from July, 2017. The GST would have caused some uncertainty among manufacturing firms, something which they did not need given the challenges faced during demonetisation.

However, there appears to be some positive news with regards to manufacturing. In August, industrial production activity expanded 4.3% yoy, driven, in part, by a 3.1% rise in manufacturing activity. The August numbers for both industrial production and overall manufacturing were the highest since March, 2017.

### Industrial Production by sector




Source: CEIC

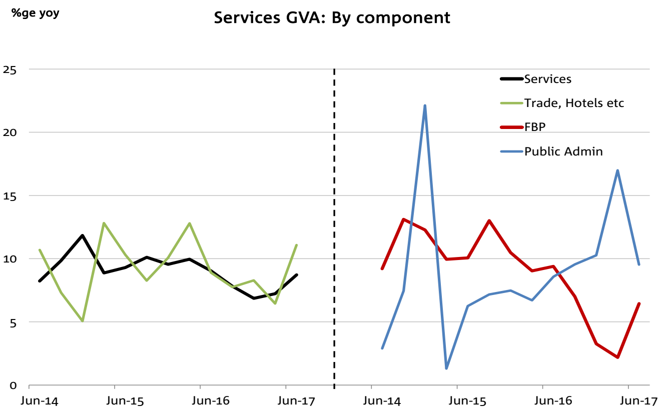
## Services GDP: A closer look

The services sector recorded a slowing in activity, but regained momentum in the June quarter, 2017. The slowdown in services has been comparatively modest, and it continues to remain the fastest growing sector of the Indian economy.

The overall numbers though don't tell the full picture. There remains considerable variation in performance among the sub-components of services. Services activity – in fact, GDP itself – was largely propped up by a surge in Government spending. India's growth performance would have been far weaker had it not been for Government-led spending. If we remove Government spending, yoy GDP would have be lower, on average, by 1.5% during the October'16 to June'17 period.

The trade and hospitality sector was negatively impacted by demonetisations, but has recovered since then. The Finance, Business and Property services sector seems to have borne the brunt of the decline, although it too has improved, albeit modestly, in the June quarter.

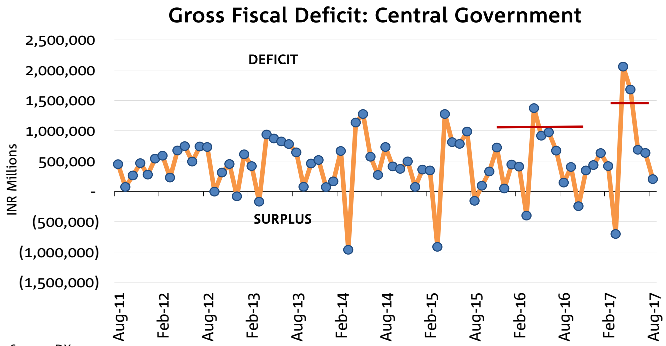
### Services Activity: by sector




Source: CEIC

There remains limited scope for further fiscal stimulus in the coming quarters, unless the Government decides to breach its 3.2% (ratio to GDP) deficit target. Spending during the April to August 2017 period has reached 96.1% of target: the corresponding figure for last year was 76.4%. Higher government spending - particularly on revenue and populist measures - can be inflationary and would necessitate higher interest rates, rendering them counterproductive. According to RBI calculations, an increase in the deficit ratio (to GDP) by 100bps would lead to a permanent 50bps increase in inflation.

### Fiscal deficit




Source: DX

### International tourism

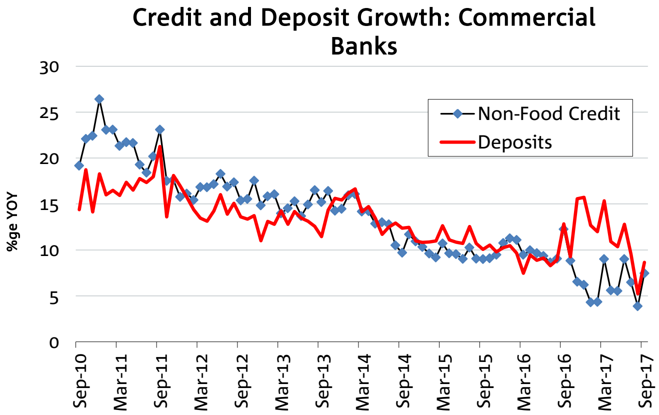

Source: CEIC

The trade and hospitality sector was hit hard by demonetisation, with the effect most pronounced in the March quarter. However, as the cash crisis dissipated towards late March /early April, conditions picked up, assisted by an improvement in international tourist arrivals and visitor spending.

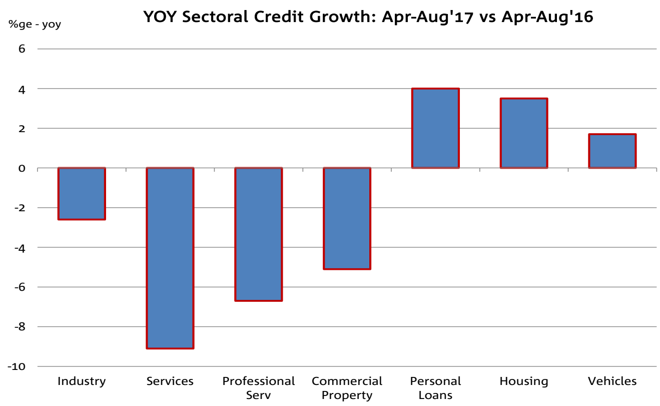
Conditions in the Finance, Business and Property services sector too were negatively impacted by demonetisation. This was most evident during the December 2016 and March 2017 quarters. In the real estate sector, the slowdown was evident in both commercial and residential sectors. According to Cushman and Wakefield, office space leasing was down 7% in the January to September, 2017 period compared to year-ago levels. In residential property, there was sluggish activity in terms of both sales and new project launches, although there remains anecdotal evidence that conditions in the affordable housing segment have started to pick up.

Besides real estate, consultancy services seems to have benefitted in the June quarter as firms prepared for the GST launch in July this year.

### Credit and deposit growth; Sector-wise credit




Source: CEIC




The onset of demonetisation led to a surge in deposit growth as customers rushed to meet the deadlines to deposit their now-defunct Rs500 and Rs1,000 notes. However, credit growth was very weak. Since then, credit growth has improved, and deposit growth has slowed down. Both credit and deposits are growing around the same pace currently. Despite the recent improvement in credit growth, it is still considerably weaker than 5 years ago. During the April to August 2017 period, credit to the services sector contracted by 9.1% yoy, including declines in sectors such as commercial property, shipping, trade and professional services. Credit to industry also shrunk by 2.6%. The one bright area was personal credit, with housing loans up 3.5%.

Factors such as demonetisation and the GST have exacerbated the slowdown in credit growth. However, there is more to the malaise of slow credit growth than merely demonetisation. The Indian banks (particularly Public Sector Banks) are saddled with a high share of non-performing loans. According to the RBI data, Gross Non performing loans in the Indian banking system are currently 9.6% of total assets, having risen from 9.2% in September, 2016. Despite this deterioration, the total share of stressed assets (non-performing and restructured) has fallen to 12.1%, c.f. 12.3% in September 2016.

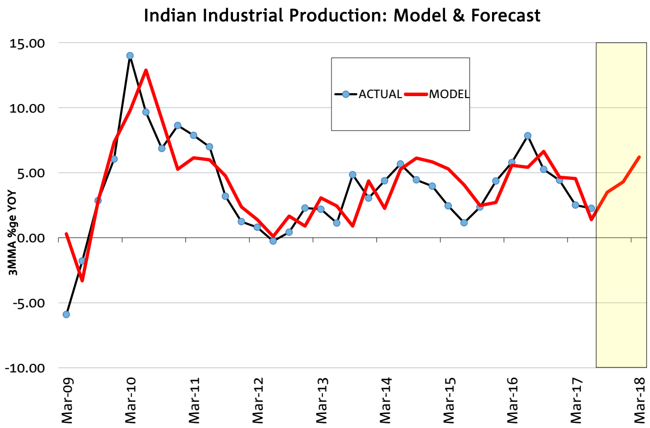
The Government and RBI are currently actively dealing with this issue. The Government created a tribunal to speed up bankruptcy and insolvency processes, and has given the RBI power to regulate bank non-performing assets. In June, the RBI had identified 12 large defaulters (which account for 25% of total Non-performing assets), against which bankruptcy proceedings were to commence. As per the new regulations, these proceedings have to be wound up in 6 months.

Given the considerable sums involved, the issue of non- performing loans will take both time and substantial amounts of capital to resolve.

## Outlook: Pickup expected

An improvement in activity is expected over the coming quarters.

### Inflation slowdown caused by prices insensitive to economic slack




Source: NAB Economics/CEIC

With the temporary factors such as demonetisation and GST implementation challenges expected to recede, the Indian economy should gain momentum. Econometric modelling by NAB Economics using a leading indicator approach suggests that industrial production activity is expected to expand by 6.2% yoy in the March quarter, 2018. In that regard, the recently released August 2017 results are encouraging. NAB Economics is forecasting a 6.8% outcome for real GDP in 2017, rising to 7.4% in 2018.

To ensure a durable recovery, supply side factors should be the primary focus. Speeding up project clearances, simplifying the taxation (including GST) regime, improving the ease of doing business – including cutting red tape, and continued progress in addressing banking sector stress will help bolster the country's growth potential. A focus on demand-boosting policies could ignite inflationary pressures, which might have to be curbed through interest rate rises, rendering them less effective.

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