Slowing Economy Demands One More Dose of Rate Cut

Brickwork Ratings, Mumbai, 02 December 2019: The release of the second quarter GDP estimate has confirmed the fears of continuing slowing down of Indian economy. The first quarter GDP estimate for the fiscal at 5% was the slowest seen in the last 6 years. The economic performance has slid further in the second quarter despite the policy initiatives taken by the government during the past few months and RBI’s continued accommodative stance. The GDP grew at a much lower rate of 4.55% in the second quarter, the lowest in last 26 quarters, despite favourable base effect. With this, the first half of 2019-20 GDP growth stands at 4.8%, plunging to the levels seen in March 2013.

A detailed analysis of sectoral performance shows that the first half of the current fiscal remained relatively weak with manufacturing sector showing contraction (-0.2%) and subdued construction sector activity (4.6%). IIP recorded one of the worst performances in the last 8 years with eight core sectors delivering negative growth in output in both September and October. RBI’s Industrial Outlook Survey of the Manufacturing Sector suggests further moderation with ‘The Business Assessment Index’ declining to 92.5 in Q2:2019-20 from 108.4 in Q1:2019-20. The survey also highlights slump in order inflows, output and employment conditions and lower optimism on availability of finance from internal accruals, bank finance and overseas sources. According to IHS Markit India Business Outlook, business confidence among private sector companies in India is down in October, with sentiment towards output, profitability and capital spending (capex) at their lowest levels since comparable data became available in late-2009. The composite Purchasing Managers’ Index which measures the performance of both manufacturing and services sectors further shrunk to 49.6 in October from the previous month’s 49.8. As per CMIE, new investment projects announced during Q1 2019-20 amounted to Rs 1,143 billion, 50% lower than the comparable period of 2018-19.

Regardless of bountiful monsoon, Agriculture output grew by just 2.1% in the second quarter of 2019-20, as prolonged monsoon and unseasonal rains damaged the crops in many regions. Much of the Q2 growth in GDP came in through rising Government Final Consumption Expenditure (GFCE). The share of GFCE in GDP (at current prices) rose to 13.9%, highest since March 2005. If we exclude GFCE, the Q2 GDP growth rate comes at 3.05% (y-o-y). On the other hand, the weak investment scenario is evident from the trailing Gross Fixed Capital Formation (GFCF)’s share at 29.7%, the lowest since June 2017.

It may be recalled that the GVA and GDP figures for the second quarter of 2018-19 was very low and therefore, the 4.5% growth for the Q2 2019-20 is indeed disappointing. Going forward, GDP for Q3 and Q4 will not have the advantage of the base effect also, hence the growth performance may continue to be subdued. The overall growth for Q3 and Q4 could be just about 5%. However, if the government undertakes important reforms, particularly fast tracks strategic disinvestment and spend the money on
infrastructure, undertakes PPP reforms on the lines recommended by the Kelkar Committee and creates conditions for the revival of investment climate, the overall growth can go up to 5% for the current fiscal. To sum up, while the risk factors to growth have become amplified, the positive factors have weakened.

**MPC Outlook**

Going by the present economic outlook, the economy demands further ease in monetary policy, though the signs of inflationary expectations intensified. Consumer Price Index (CPI) inflation, after remaining below 4% for last 15 months, picked up recently and moved beyond this level in October 2019. The major driver of inflation is food inflation. The prices of food articles, which were below 3% till August 2019, spiked to nearly 8% in October. Heavy rainfall and floods in different parts of the country have not only damaged crops but also disrupted the supply chain of commodities, leading to scarcity and price increases. On the other hand, sustained fall in crude oil prices helped easing domestic fuel prices, resulting in deflation in fuel item, moreover easing core inflation also provides some respite. The October inflation has already exceeded the MPC’s projections of 3.5-3.7% for H2:2019-20, and the month-on-month or sequential rise in inflation rate is relatively quicker than before.

Rising inflation and falling economic growth engulfed the fear of stagflation recently and the MPC is caught between the ‘rock and the hard place’ in deciding the policy rate. On top of it, the transmission of the rate cuts still remains a challenge and dismal bank credit growth portray weak demand. After the 25 bps rate cut in October policy review, major banks have reduced their marginal cost of lending rates (MCLR) by 5 to 10 bps, which is a positive sign. Yet, compared to 135 bps repo rate cut since February 2019, these banks have reduced their MCLR by just 30 to 50 bps during the same period. Though the cost of their deposits also has gone down, further reduction from the existing levels could face resistance from the savers.

The government and the central bank have taken a few policy initiatives to propel growth, but that will take some time to yield results. Given the underlying economic concerns and expected further downward revision in GDP growth, the MPC may continue to maintain the current accommodative monetary policy stance. Although the flexible inflation targeting framework has some more scope for rate cuts, the MPC may take a cautious stance in deciding the quantum of rate cuts, if the trend of increasing retail inflation continues. BWR feels that the RBI’s MPC will again lower its GDP projections for the current fiscal and go with 25 bps rate cut in its upcoming monetary policy review.
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