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Policy measures support growth in India but add to macro imbalances

After a full year of recovery from the twin shocks of de-monetization and GST (goods and services tax) roll-out, the Indian economy started to face significant headwinds over H2 2018. The latest print show that growth slowed from a two year high of 8.2% y/y in Q2 2018 to 7.1% y/y in Q3. Sequentially, the deceleration was even more pronounced with annualized growth shifting from 7.8% to 3.3% during the same period. Importantly, three-month average industrial production growth, a key gauge for activity in India, has materially weakened recently. Of particular concern for economic officials in India is the combination of higher uncertainty in international financial markets, slower domestic consumption growth, more stressed conditions in the agricultural sector and softer global demand.

Within this backdrop, the Indian authorities have decided to loosen both monetary and fiscal policies in recent weeks. In the latest meeting of the Reserve Bank of India's Monetary Policy Committee (RBI MPC), policy rates were cut by 25 basis points (bps) and the official stance changed from "calibrated tightening" to "neutral." On the fiscal side, the F2020 interim budget point to a pause in fiscal consolidation as central government deficits are projected to be flat at 3.4% of GDP versus a previous expectation of deficit reduction to 3.1% of GDP.

Looser policies are indeed expected to create an impulse and be growth supportive. However, there is a cap for policy stimuli as additional easing can reinforce existing imbalances, producing inflation and widening the twin deficits, which could ultimately undermine macroeconomic stability and long-term growth. Our analysis delves into the three reasons why policy space to support growth is limited for India over the coming quarters.

First, concerns over growth in India appear overstated as key business surveys are holding up well and gross fixed capital formation delivers two digit growth. The business expectation index, which provides a single snapshot of business outlook in every quarter based on nine indicators, has improved both in Q4 2018 and Q1 2019, hovering deep into positive territory. Moreover, the negative sentiment prevalent in Q3 2018 (triple challenge of tightening global financial conditions, FX pressures and higher oil prices) has partially reverted.

Second, capacity utilization has improved and the output gap has closed over recent quarters, pressuring core inflation (excludes food and energy). While the government targets headline inflation, the difference between headline inflation and core inflation is exceptionally high, as the former runs at 2.0% while the latter runs at 5.6%. The direction for convergence is still not clear. The RBI MPC pointed that '*while inflation excluding food and fuel remains elevated, the recent unusual pick-up in the prices of health and education could be a one-off phenomenon*.' However, ever since the implementation of the inflation-targeting regime produced more moderate inflation and anchored inflation expectations, core inflation has dominated headline inflation, i.e., headline inflation tended to converge towards core inflation. Should core inflation dominate again, headline inflation would overshoot beyond the 4.0% target and close to the 6.0% upper limit of the inflation band, restricting any space for further easing and likely pushing for a policy reversal.

Real GDP growth in India
(quarterly, y/y, %)

Sources: Haver Analytics, QNB Economics analysis

Third, despite central government efforts to deliver fiscal consolidation, fiscal space is limited as the total public sector borrowing as a percentage of

GDP is high and has been broadly flat at around 8.2% over the last five years. Central government consolidation has been offset by higher deficits from Indian local states and additional off-balance sheet borrowing and borrowing from public sector enterprises. In this sense, the interim budget does not bode well for fiscal sustainability and for the gradual rebalancing of the Indian economy. While additional transfers to low-income farmers is a positive development, it should replace less efficient subsidies and welfare programs, as there is no space for new unfunded liabilities. The public sector investment-savings gap has to be reduced if India is to produce a private investment boom without widening the still sizable current account deficit.

All in all, India's growth remains robust and the country is expected to deliver some of the best growth performances globally. However, excessive stimuli can add to existing macroeconomic imbalances and contribute to undermine macroeconomic stability and long-term growth.

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