Ecowrap

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Q2 GDP AT 4.2%, FY20 AT 5.0%: WE SHOULD RIDE THE LONG WINTER!

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We expect Q2GDP growth at 4.2%. Our acceleration rate for 33 leading indicators at 85% in October 2018 is down to just 17% in September 2019, with such decline gaining traction from March 2019. Even IIP growth number for Sep'19 was –4.3%, which is quite alarming. **We are revising our GDP forecast for FY20 to 5% from 6.1% earlier**. **We expect growth rate to pick up pace in FY21 to 6.2%**. **We also expect revisions to GDP data as in the past, but that is likely in February 2020 as is the custom.** In FY17, Q1 GDP figure was revised upwards from 7.1% in every revision and finally settled at 9.2%.

We however believe this growth rate in FY20 should be looked through the prism of **synchronized global slowdown (countries have witnessed 22-716 basis point decline between June'18 and Jun'19, and India cannot be isolated!**). India **is also significantly lower in Economic Uncertainty Index when compared globally**! We also believe that Moody's change in outlook from stable to negative will not have any significant impact as rating actions are always a laggard indicator and the markets this time have categorically given a thumbs down to such.

We now expect larger rate cuts from RBI in December policy. However such rate cut is unlikely to lead to any immediate material revival, rather it might result in potential financial instability as debt financed consumption against an increasing household leverage had not worked in countries and India cannot be an exception. The contemporary issue for macroeconomists is to focus on assuring adequate aggregate demand and the role of fiscal policy in this context is of paramount importance. Much of the reluctance about use of fiscal policy in India currently appears from the fact that the monetary policy space is still adequate. This we believe could be counterproductive. In essence, markets are not unduly worried about fiscal deficit and await clarity from Government on the extent of fiscal slippage in current fiscal. Such an announcement could in fact be good for the markets!

Against such growth slowdown, it is imperative that India adheres to no negative policy surprises in sectors like Telecom, Power and NBFCs. For example, it is imperative that a lasting solution is worked out for the NBFC sector that has been much delayed now. We believe that given the crisis of confidence in the financial markets**,** provision of central bank liquidity for NBFCs is necessary to ensure the stability of the financial system. With every passing day the risk increases that the not so better rated NBFCs in their quest to achieve the capital ratio could do it through deleveraging and reduction of their assets, thus prolonging the credit crunch. It is reminiscent of the back loading of mega bank recapitalisation that was unveiled only in 2017. **What is thus needed is a credible frontloading of backstop** against good quality assets which can be used quickly to absorb potential losses, for NBFCs if they materialise. Similarly, the woes of the telecom sector need to be addressed so that new investors are encouraged to set up new networks in the country. Simultaneously, it is perplexing that a growing economy is witnessing a contraction in power demand with Discoms buying less power for reasons well known. Average PLF of thermal plants dipped to all time low of 48.9% in Oct. Renewables generation declined by 6.4% despite 15% increase in installed capacity.

Separately, there is a perception in the market domain that de-risking the financial system has brought down the money multiplier in recent period, and that has purely to do with a slow growth in money supply in recent times. **However, it is not entirely correct**. **The creation of money supply is largely endogenous in Indian context, catering purely to low money demand. Our research shows that the increase in digital transactions post 2016 also played a critical role in the decline in money multiplier,** which has changed the composition of financial saving of households away from currency to some extent. In particular, there has been a substitution from currency and much of it has gravitated towards digital mode of payments.

GDP MAY GROW AT 4.2% IN Q2FY20

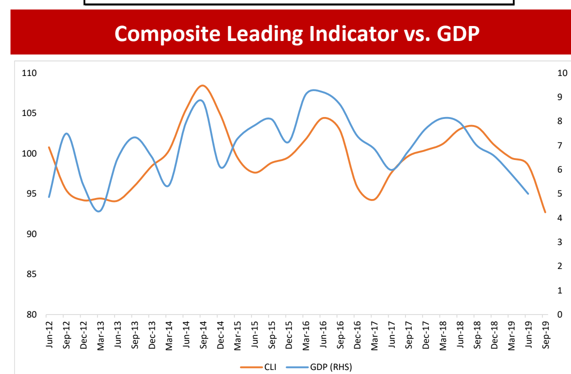
- Based on our composite leading indicator suggests GDP growth to slowdown further from 5.0% in Q1 of FY20 to 4.2% on account of low automobile sales, deceleration in air traffic movements, flattening of core sector growth and declining investment in construction and infrastructure. Our 33 high frequency leading indicators reveal an acceleration rate which was 65% in Q1 FY19 declined sharply to 27% in Q2 FY20.
- Besides that, Skymet also reported that the country as a whole received 110% of the long period average (LPA) of 89 cm of rainfall during the four-month-long southwest monsoon period, making it to the above normal category. Among meteorological divisions, Central India and Southern Peninsula received the maximum rainfall of 129% and 116% of their LPA, respectively. Excess monsoon rains and the floods caused by them had affected Kharif crops in many States, including MP, Maharashtra, Gujarat, Karnataka and Punjab. While 40 to 50% of soyabean crop has been hit in Madhya Pradesh, which is the biggest producer of the oilseed, 30 to 40% of groundnut and up to 30% of cotton crops have been affected in Gujarat. As these states are major agrarian States, so this could have a negative impact on agricultural growth.
- Considering all these domestic parameters along with global downturn, we now foresee a GDP growth at 5% in current fiscal.

Mapping of Leading Indicators with GDP Growth

Year	Quarter	% of indicators showing acceleration	GDP Growth (%)
FY18	Q1	59	6.0
	Q2	66	6.8
	Q3	64	7.7
	Q4	73	8.1
FY19	Q1	65	8.0
	Q2	63	7.0
	Q3	63	6.6
	Q4	47	5.8
FY20	Q1	35	5.0
	Q2 P	**27**	**4.2**

Source: SBI Research

Composite Leading Indicator vs. GDP



Source: SBI Research

WE MUST CORRECT SECTORAL MISALLOCATION OF RESOURCES RATHER THAN USING MONETARY AND FISCAL POLICY AS POLICY TOOLS

- We believe, that the steps taken by the Government should take time to permeate through the system. We also believe that rate cuts is unlikely to lead to any material revival, rater it could result in potential financial instability as debt financed consumption against an increasing household leverage had not worked in countries and India cannot be an exception.
- The alternative to targeting fiscal deficit is that like most advanced economies and several emerging market economies, India should target a structural deficit, which serves as an automatic counter-cyclical stabilizer.

MISINTERPRETING GROWTH SLOWDOWN AS A BY-PRODUCT OF BANK LENDING: INCREASING DIGITIZATION RESUTING IN DECLINE IN MONEY MULTIPLIER

- There is a perception in the market domain that de-risking the financial system has brought down the money multiplier in recent period, and that has purely to do with a slow growth in money supply in recent times. However, it is not entirely correct. The creation of money supply is largely endogenous in Indian context, catering purely to low money demand.
- Interestingly, if we look the monthly trend of money multiplier, it is showing a declining trend post demonetization (there has a marginal increase recently though). The increase in digital transactions also played a critical role in the decline in money multiplier, which has changed the composition of financial saving of households away from currency to some extent. In particular, there has been a substitution from currency and much of it has gravitated towards digital mode of payments.
- For example, increase in use of digital payments such as e-wallet, debit card and credit card at PoS and UPI has changed the composition of both reserve money as well as monetary base and further impacted central bank's control power of money supply. Empirical literature suggests that in China during 1990 to 2010 there is robust evidence that electronic money had a negative impact on M0 but a positive impact on M3. In addition, the central bank's abilities to control money supply can be affected by the wide application of electronic money.
- In a similar vein we carried out an empirical analysis for the post-demonetization period to understand the impact of digital transactions (DT) on M0, M3 and money multiplier (MM) and results suggest that increase in digital transaction (sum of credit/Debit cards usage at PoS, PPI, Mobile banking) has a negative impact on M0 and money multiplier. This is quite consistent with the theory as people prefer to hold less cash in hand as they do more and more digital transactions. However, at the same time if the deposits with bank goes up and hence there is positive relationship between M3 and digital transactions.

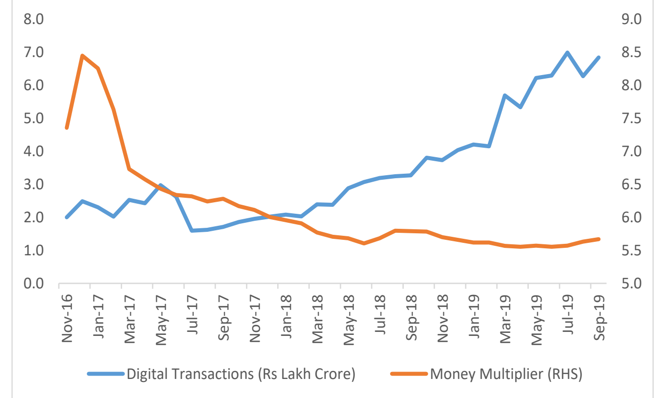
REVISION IN QUARTERLY GDP DATA

- Advance estimates of quarterly GDP data are of crucial importance for policymaking and business planning. Advance numbers are based on high frequency real time indicators while detailed information arrived at a significant lag. In India, GDP data are revised six times and there are instances where quarterly GDP figure has been changed more than four times. In FY17, Q1 GDP figure was revised upwards in every revision and finally settled at 9.2%. Similarly, Q1 of FY18 was revised from 5.7% to 6.0%. So, we could say that Q1 of FY19, which came out as 5.0% might be revised further.

MONETARY POLICY NOT ENOUGH IN CURRENT CIRCUMSTANCES

- Under the current macro environment, monetary policy seems to be less effective than fiscal policy as low interest rate does not guarantee for rise in demand for investment as it is the "future expectation" that drives investment decision rather than cost. So we believe, monetary policy should never be the primary macro policy driver in any economy rather it should be a complementary one.

Movement of Money Multiplier with Digital Transactions



Source: SBI Research

Regression Results

$$M0 = -0.0422(DT); \quad p-value: 0.0000$$

$$M3 = 0.0177(DT); \quad p-value: 0.0000$$

$$MM = -0.0015(DT); \quad p-value: 0.0000$$

Period: Nov'16 to Sep'19
DT: Digital Transactions; MM: Money Multiplier

Weekly Increase in Currency in Circulation on Diwali

Year	Amount(Rs Billion)
2009	153.04
2010	244.42
2011	99.19
2012	226.75
2013	190.03
2014	190.29
2015	402.95
2016	184.92
2017	281.67
2018	494.20
2019	308.71

Source: SBI Research

Revisions in GDP -Growth rates (%)

	1st Estmate	1st Revision	2nd Revision	3rd revision	4th Revision
Q1 GDP -Growth					
2016-17	7.1 (31Aug16)	7.2 (28Feb17)	7.9 (31May17)	8.1 (28Feb18)	9.2 (28Feb19)
2017-18	5.7 (31aug17)	5.6 (31May18)	6. 0 (28Feb19)	-	-
2018-19	8.2 (31Aug18)	8.0 (28Feb19)	-	-	-
2019-20	5(30Aug19)	-	-	-	-
Q2 GDP -Growth					
2016-17	7.3 (30Nov16)	7.4 (28Feb17)	7.5 (31May17)	7.6 (28Feb18)	8.7 (28Feb19)
2017-18	6.3 (30Nov17)	6.5 (28Feb18)	6.3 (31May18)	6.8 (28Feb19)	-
2018-19	7.1 (30Nov18)	7.0 (28Feb19)	-	-	-
2019-20	-	-	-	-	-

Slow Down in Major Countries during Past 1 year

Country	Jun-18	Jun-19	Decline in GDP growth in (bps)
Australia	3.2	1.2	-199
China	6.7	6.2	-50
India	8.0	5.0	-294
Indonesia	5.3	5.1	-22
Japan	1.5	1.0	-55
Turkey	5.6	-1.5	-716
Spain	2.4	1.8	-67
Russia	2.2	0.9	-130
Italy	1.0	0.01	-103
Germany	2.5	0.03	-247
US	3.0	2.3	-66

Source: SBI Research

- The contemporary issue for macroeconomists is to focus on assuring adequate aggregate demand. We believe it is incorrect for central bankers to suggest that they have this challenge under control - or that with their current toolkit they will be able to get it under control. Fiscal policy needs to be a major focus, especially given what low or negative interest rates mean for the sustainability of deficits.
- The high inflation and high interest rates of the 1970s generated a revolution in macroeconomic thinking, policy and institutions. The low inflation, low interest rates and stagnation of the last decade has been longer and more serious and deserves at least an equal response.

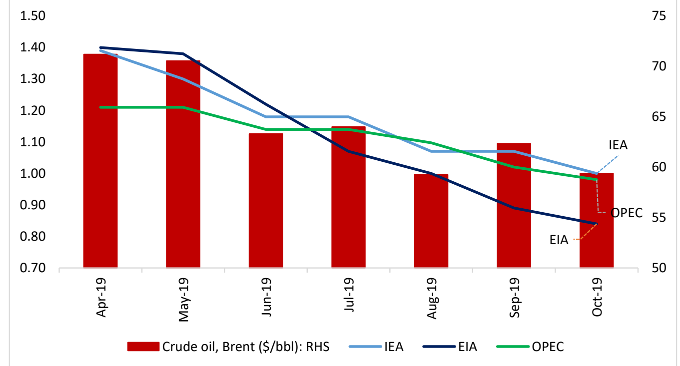
CONSUMPTION DECLINE

- The economic slowdown is not just restricted to Indian economy, but has rather spread like contagion from our Western and Eastern counterparts. What started as US-China Trade war has moved to Europe and South East nations are also not untouched. The declining vehicle sales internationally and the overall industry slowdown is resulting in moderation of global GDP growth to 3.2% in 2019 compared to the 3.8% in 2017.
- World oil markets have undergone a U-turn, switching from supply-side risks like OPEC's production cuts or U.S. sanctions against producers Iran and Venezuela to concerns of slowing consumption amid fears of a global recession. According to the Oct'19 Commodity Markets Outlook, growth in oil demand is now 1 million barrels per day—the weakest growth rate since 2012. Since Apr'19, the crude oil demand has decreased by more than 23% and is in line with crude prices. We expect Brent crude oil prices to be around $60/bbl in 2019 and are projected to weaken further in 2020 as rising oil supply output from non-OPEC countries in 2020, could cause oil prices to fall further if there is not enough demand to absorb the extra supply.
- In India also the private final consumption expenditure has slumped to 3.1% in Q1 FY20, the weakest level since Q3 FY15.

GDP GROWTH TO REVIVE IN NEXT TWO QUARTER ONWARDS

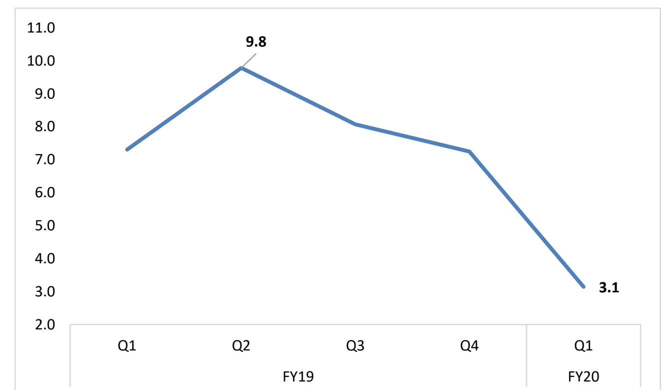
- Our projection shows annual real GDP growth for FY20 and FY21 will be 5% and 6.2% with nominal growth to be 9.0% and 10.6% during the same period. GDP deflator to be around 3.9% and 4.4 % for FY20 and FY21.
- We however believe this growth rate in FY20 should be looked through the prism of synchronized global slowdown (countries have witnessed 22 -716 bps point decline between June'18 and Jun'19, and India cannot be an isolation!). India is also significantly lower in Economic Uncertainty Index as compared globally! We also believe that Moody's change in outlook from stable to negative will not have any significant impact as rating actions are always a laggard indicator and the markets this time has categorically given a thumbs up to such.
- The Government is doing the correct thing in addressing sector specific problems. NBFC, Telecom, Roads, Power and Real Estate are sectors that require specific attention and there must not be any negative sector specific policy surprises in the current uncertain environment! It is primarily only through such that we can come out of this slump and fiscal policy could only act as a supplement.

Global Oil Consumption, Berrels per day (in million)



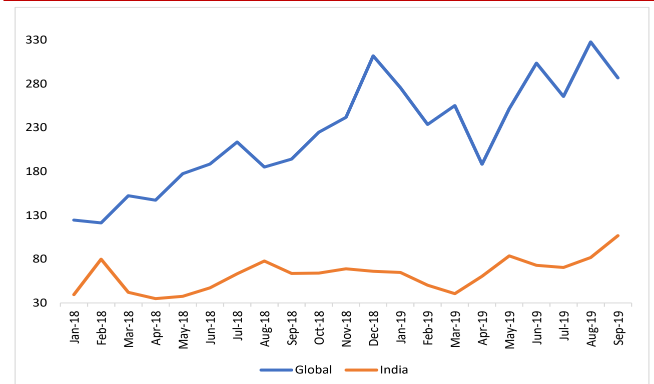
Source: SBI Research

Decline in PFCF (at constant prices, % YoY)



Source: SBI Research

Economic Policy Uncertainty index



Source: SBI Research

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Contact Details:
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point
Mumbai - 400021
Email: soumya.ghosh@sbi.co.in
gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya