Box A

The Recent Economic Slowdown in India

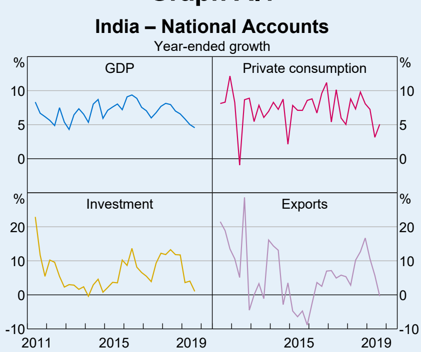
Economic growth in India has slowed significantly in recent quarters. Year-ended GDP growth has fallen from 8.1 per cent in the March quarter of 2018 to 4.5 per cent in the September quarter of 2019. The slowdown has been broad-based across the expenditure components of GDP – consumption, investment and export growth have all slowed notably (Graph A.1). Growth in the agricultural and industrial sectors has weakened considerably although services sector growth has remained relatively steady.

India is Australia's fifth largest export destination. The value of Australian exports to India has grown by an average annual rate of 17 per cent since 2014. Education services and coking coal are Australia's main exports to India, accounting for more than 70 per cent of 2018/19 exports. Growth in these exports has been closely tied to India's long-term economic development. Rising incomes in India have contributed to increased demand for Australia's education exports, and urban construction and infrastructure investment have increased demand for steel, and thus coking coal. While education exports continued to grow in 2018/19, weakness in the industrial sector and the extended monsoon season weighed on export volumes of coking coal in mid 2019 (Graph A.2).

The slowdown reflects a range of economic, policy and financial factors

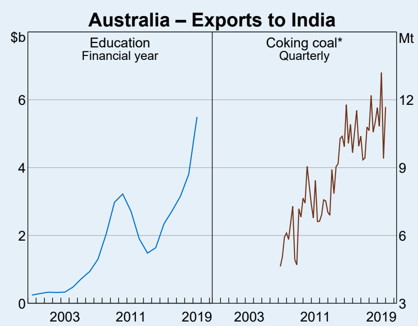
The slowdown in India reflects a number of developments over the past 18 months. A series of factors resulted in slower growth of private and public consumption in mid 2018. The Reserve Bank of India (RBI) increased interest rates in response to rising core inflation. Around the same time, the government implemented various reform policies, including the introduction of a goods and services tax and compulsory insurance requirements for owners of cars. While these reforms are expected to have longer-term benefits, in the short term they have weighed

Graph A.1



Sources: CEIC Data; RBA

Graph A.2



* Seasonally adjusted by the RBA

Sources: ABS; RBA

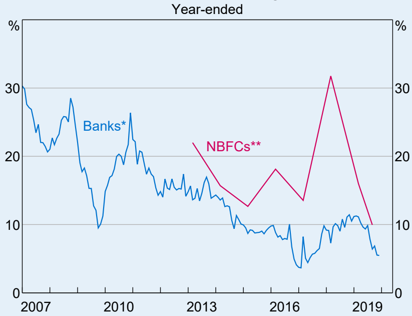
on small business activity and car purchases. Oil prices also increased sharply, which contributed to weaker consumption, placed downward pressure on corporate profit margins, and lowered petroleum excise revenues. Growth in government expenditure declined as the government sought to meet its fiscal deficit targets.

More recently, a tighter supply of credit has contributed to the economic slowdown, particularly the sharp reduction in investment growth in 2019. This followed an acceleration of credit growth in 2017, a sizeable share of which was provided by non-bank financial companies (NBFCs) that received a surge in funding following the demonetisation process in 2016.[1] Investor sentiment towards NBFCs soured in late 2018 after a high-profile NBFC, Infrastructure Leasing & Financial Services (IL&FS), defaulted on some of its short-term debt obligations. As a result, funding costs for NBFCs rose and lending by NBFCs slowed materially (Graph A.3). NBFCs provide around a fifth of total lending in India, so this deceleration in credit growth has had a material effect on overall lending activity.[2]

Graph A.3

India – Credit Growth by Lender

Year-ended



* Non-food credit; excludes lending to non-banking financial companies

** 2019 data are provisional

Sources: CEIC Data; RBA; RBI

Lending growth has also slowed at public and private sector banks. At public sector banks, there has been a sustained rise in non-performing loans and restructured loans, which has placed pressure on their profitability and capital positions. Regulatory attention around corporate governance has increased for both public and private sector banks given incidences of poor practices. These factors have reduced the ability and willingness of banks to supply credit.

In recent quarters, additional factors have contributed to the prolonged nature of the slowdown. Global policy uncertainty and weak external demand contributed to a contraction in exports through 2019. Both business and consumer confidence have fallen noticeably. Most recently, very heavy rainfall at the end of an extended monsoon disrupted both agricultural production and construction activity.

The authorities have responded, but there are few signs of a turnaround to date

The Indian Government has announced a range of measures to support economic activity. Most significantly, the government reduced the corporate tax rate from 30 per cent to 22 per cent and lowered the tax rate for new manufacturing firms from 25 per cent to 15 per cent. In addition, the recent budget provides for income tax cuts aimed at stimulating consumption. The government has also announced plans to invest heavily in infrastructure over the next five years and has pursued more targeted measures to support growth as well. For example, a ban on government purchases of new vehicles was lifted in an effort to support the auto sector.

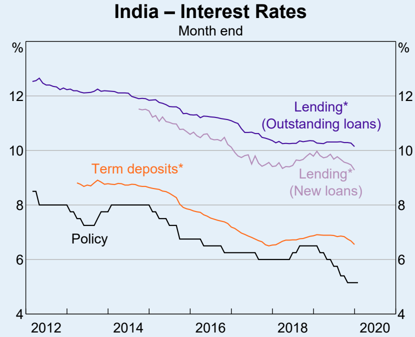
Steps have been taken to strengthen the banking sector and support the flow of credit to the real economy and between banks and NBFCs. Capital has been injected into public sector banks, limits on the exposure of banks to NBFCs have been relaxed and the RBI has permitted some bank lending to NBFCs to count towards 'priority sector' lending requirements. Authorities have also intervened directly in NBFCs: the government took control of IL&FS in 2018 and, in late 2019, the RBI removed the management of another NBFC and initiated insolvency resolution.

Monetary policy has also responded to the slowdown, with the RBI reducing its policy rate by 135 basis points in 2019. However, in contrast to the tightening cycle in mid 2018, pass-through to the retail banking sector has been muted so far. Lending rates on the stock of outstanding loans have been largely unchanged and term deposit rates have fallen only by around 35 basis points (Graph A.4). The lack of pass-through to lending rates reflects rigidity in deposit rates (and thus funding costs) because of competition for deposits between the banking sector and government-administered small savings schemes. These are deposit products offered by the government directly to the public. The government has left interest rates on these schemes unchanged in recent quarters, limiting the ability of banks to reduce their deposit rates.

The RBI has taken steps to improve the pass-through of monetary policy. For example, towards the end of 2019, the RBI announced that lending rates for all new floating-rate small business and personal loans issued by banks should be linked to external benchmarks, such as market interest rates. Pass-through to these market interest rates has been more complete over the past year. In addition, lending rates must now be reset at least once a quarter (previously this typically occurred only once a year). This reform is intended to improve transparency around loan pricing and to increase the extent to which lending rates are influenced by policy rates. The RBI expects GDP growth to begin to turn around in coming quarters as the stimulus measures implemented by the government and the RBI gain traction. Encouraging developments in recent months include improvements in car sales, air passenger traffic and capital expenditure. So far, however, any turnaround appears modest. ✠

Graph A.4

India – Interest Rates



* Weighted average rates of scheduled commercial banks

Source: RBI

Endnotes

[1] In 2016, the government of India withdrew the legal tender status of the country's two highest denomination banknotes. This resulted in a notable rise in the assets under management of mutual funds. In turn, mutual funds invested in debentures and commercial paper, including that issued by NBFCs.

[2] For more detail on non-bank lenders in India, see Reserve Bank of Australia (2019), 'Box A: Risks in Non-bank Lending in India', *Financial Stability Review*, April, viewed 21 January. Available at <https://www.rba.gov.au/publications/fsr/2019/apr/box-a.html>