Election muddies India's outlook

Government pressure shifts RBI stance towards easing

by Prakash Sakpal in Singapore

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The Indian economy ended 2018 on a mixed note. Growth continued to grind lower, as reflected by the slowdown in exports and industrial output towards the end of the year. At the same time, inflation dipped to its lowest level in 18 months in the light of persistently low food and energy prices.

The conflict between the government and the Reserve Bank of India rocked markets in the last quarter, after Delhi asked the central bank to spare more of its reserves to fund a wider fiscal gap. The rift ended with the resignation of Governor Urjit Patel on 10 December. Just as this paved the way for a liquidity injection under new Governor Shaktikanta Das, the fiscal floodgates opened with extra-budgetary support for farmers and further cuts to the Goods and Services Tax.

A general election is scheduled for May and conditions will probably become murky as polling day approaches. Prime Minister Narendra Modi's popularity is falling, and the losses of his Bharatiya Janata Party in recent state assembly and other by-elections have dimmed prospects for a clear win. Meanwhile Modi's opponents, led by the Congress Party, are consolidating their position.

The general election is too close to call. The results of the 2018 assembly election in Karnataka state, in which the BJP came out as the winner and yet couldn't form a government, could be repeated at the national level. Even if the BJP win a slim majority, the likelihood of a Congress-led coalition forming a new government cannot be ruled out. Opinion polls have been predicting such an outcome. If the forecasts become reality, a 16 percentage point loss of parliamentary seats of Modi's National Democratic Alliance in favour of the Congress-led United Progressive Alliance will engender a marked shift in the political landscape.

An early estimate by the national statistics office puts GDP growth in the financial year ending in March 2019 at 7.2%. That reflects the consensus and is up from the 6.7% measured in 2018, a year marred by the effects of demonetisation and the chaotic implementation of the Goods and Services Tax. Growth peaked above 8% in the first quarter of the year but slowed to 7.1% in the subsequent quarter. The latest data point to a drift below 7%. Hence, the 7.2% official estimate remains at downside risk – bad news for Modi before the elections, although the final figure is not expected to be released until after the elections.

It is hard to imagine fresh stimulus, both monetary and fiscal, helping growth in time for the May vote. While the economy may still benefit from stimulus in the long term, external headwinds (the US-China trade war, the downturn in the technology cycle, slowing global growth, rising oil prices) are likely to prevail throughout as far as 2020. We expect this to push India's GDP growth below 7% in the upcoming year. However, strong domestic demand on the back of the government's populist spending measures is likely to prevent a significant decline in GDP growth.

Political uncertainty will cause foreign investors to treat India cautiously. Net foreign portfolio flows swung from a brief inflow towards the end of 2018 to an outflow at the start of this year. This does not just reflect the politics. The troubles at non-bank finance companies persist, with reports of infrastructure lenders defaulting on debt. We see no near-term respite from negative foreign investor sentiment.

The government's drive to boost growth has shifted economic policies into an expansionary mode. Last October the RBI moved its policy stance to 'calibrated tightening', citing sustained inflation risks. The events since, especially after Patel's resignation, have shifted the bias towards easing. New RBI Governor Das is likely to endorse the shift to a 'neutral' stance at the next meeting on 7 February. At ING, we have recently downgraded our RBI policy forecasts from two rate rises this year to no more increases. However, with the sustained pressure from the government, we would not be surprised if the central bank opts to cut rates in February.

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