Executive Summary

- Over the last year, India’s economy has struggled to gain traction, highlighted by a wide GDP miss in Q1-2019. Leading indicators of economic activity have been underwhelming and proved to be indicative of a further slowdown in Q2. The weakening economy and a drier-than-expected monsoon season has already led us to revise down our GDP forecast significantly, and we view further growth downgrades as likely.
- In response to the growth slowdown, the Reserve Bank of India (RBI) has cut its policy interest rates multiple times this year, including a larger-than-expected rate cut in August. That said, we still believe the RBI has policy space to lower rates, and see at least one more rate cut this year.
- Political risk was elevated ahead of the general election for Prime Minister earlier this year. While Narendra Modi’s re-election eased some of that risk, we believe his policy agenda is consistent with a weaker rupee. Recent decisions by Modi have also renewed geopolitical risk tied to relations with Pakistan, which have the potential to weigh on the economy and the currency.

India’s Economy Isn’t So Hot

India has been one of the fasting growing economies in the world for quite some time now. However, over the past year, India’s economy has started to decelerate, with GDP growth slowing significantly since the middle of 2018. The slowdown was very evident in Q1, with GDP growth downshifting to 5.8% year-over-year, a notable deceleration from 6.6% in Q4-2018. The deceleration in Q1 can likely be attributed to uncertainty surrounding the general election earlier this year. Due to the uncertainty around the re-election of Narendra Modi, investment growth in Q1 slowed to 3.6% year-over-year, down from 11.7% in Q4-2018. In addition, private consumption growth fell to a little over 7% year-over-year, down from close to 8.5% in Q4-2018. The slowdown in consumption and investment growth more than offset the increase in government spending, with the increase in government expenditures largely due to Modi’s efforts to gather additional support from Indian constituents ahead of the election.

Despite Modi winning the election and some political risk being alleviated, we believe the slowdown in India’s economy is likely to persist. Over the course of 2018 and into 2019, leading and coincident indicators of activity have deteriorated. After a sharp slowdown late in 2018 and a modest recovery early this year, industrial output decelerated once again in June, slowing to 2.0% year-over-year. Another primary indicator of activity we track is passenger vehicle sales. Passenger vehicle sales is used as a proxy for retail sales in India and is a good leading indicator of consumer activity. Over the course of this year, passenger vehicle sales have plummeted, contracting sharply in 2019 (Figure 1 on next page). As of July, on a three-month average basis, passenger vehicle sales have contracted 23% year-over-year, even sharper than the largest decline seen during the Great Recession in 2008. This suggests to us that consumer activity may continue to slow and that the economy could remain relatively subdued in the short-term.
These leading indicators proved to be indicative of a further deceleration in India’s economy in Q2. Today’s release of second quarter growth was again quite dismal, with data indicating India’s GDP slowed to 5.0% year-over-year. While the headline print is concerning, the underlying components are alarming as well. Investment growth was relatively flat; however, exports decelerated to 5.7% year-over-year, down from 10.6% in Q1.

In addition to weak economic activity, there have been reports that India’s monsoon season has not been as robust (or “rainy”) relative to prior years. The agriculture and farming industry represents a sizeable share of India’s economy, close to 15% of gross value added. Given the sector’s significance to the health of India’s economy, there is a substantial amount of importance on a successful monsoon season (generally viewed as from late May to early October), one where a sufficient amount of rainfall occurs throughout the country. While August was a strong month for rainfall, in aggregate, rainfall in India has been below the longer-term average, or “normal” rainfall for the monsoon season. Through mid-August, India has had 599 mm of rainfall, while normal monsoon season typically brings about 616 mm. While the difference seems negligible, there has been a noticeable impact on the amount of crops sown in India so far this year. Through mid-August, farmers have sown 4.2% less of India’s main crops relative to last year, which could result in a further deceleration in the overall economy (as well as a potential increase in food prices).

<table>
<thead>
<tr>
<th>Sowing Progress of Major Indian Crops</th>
<th>Area Sown Measured in Hectares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2018-2019</td>
</tr>
<tr>
<td>Rice</td>
<td>338.4</td>
</tr>
<tr>
<td>Pulses</td>
<td>125.3</td>
</tr>
<tr>
<td>Cereals</td>
<td>159.9</td>
</tr>
<tr>
<td>Oilseeds</td>
<td>164.9</td>
</tr>
<tr>
<td>Sugar</td>
<td>55.5</td>
</tr>
<tr>
<td>Jute &amp; Mesta</td>
<td>7.2</td>
</tr>
<tr>
<td>Cotton</td>
<td>115.2</td>
</tr>
<tr>
<td>Total</td>
<td>966.4</td>
</tr>
</tbody>
</table>

Source: CEIC and Wells Fargo Securities
We have been cognizant of India’s deceleration for some time now and have downgraded our GDP forecasts for both 2019 and 2020 multiple times. In August last year, our 2019 GDP forecast was 7.8%; however, following the deterioration in activity indicators and a weak monsoon season, our 2019 forecast now stands at just 6.2% (Figure 2). Following weaker-than-expected growth in Q2, it is very likely that our GDP forecast will get revised lower again.

**Figure 2**

India 2019 Annual GDP Forecast

<table>
<thead>
<tr>
<th>Month</th>
<th>GDP Forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug-18</td>
<td>7.8%</td>
</tr>
<tr>
<td>Oct-18</td>
<td>7.8%</td>
</tr>
<tr>
<td>Dec-18</td>
<td>7.8%</td>
</tr>
<tr>
<td>Feb-19</td>
<td>7.8%</td>
</tr>
<tr>
<td>Apr-19</td>
<td>7.8%</td>
</tr>
<tr>
<td>Jun-19</td>
<td>7.8%</td>
</tr>
<tr>
<td>Aug-19</td>
<td>6.2%</td>
</tr>
</tbody>
</table>

**Figure 3**

India Cash Transfers to Government

<table>
<thead>
<tr>
<th>Year</th>
<th>Trillions of Rupees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>0.5</td>
</tr>
<tr>
<td>2015</td>
<td>0.5</td>
</tr>
<tr>
<td>2016</td>
<td>1.0</td>
</tr>
<tr>
<td>2017</td>
<td>0.5</td>
</tr>
<tr>
<td>2018</td>
<td>1.0</td>
</tr>
<tr>
<td>2019</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India and Wells Fargo Securities

**Reserve Bank of India: Easing, and...Independent?**

The Reserve Bank of India (RBI) has also been focused on the slowdown in the economy and has embarked on a prolonged easing cycle. So far in 2019, the RBI has cut its main policy rate four times for a cumulative reduction of 105 bps. Notably, the RBI opted to reduce its main repurchase rate 35 bps in early August, a more aggressive cut than the 25 bps markets had expected, in order to support the economy. Our assessment is that the RBI has additional room to cut policy rates further, as inflation hovers around the lower end of the central bank’s target range, and real interest rates are still relatively high. We believe the RBI will pursue at least one more interest rate cut this year, likely at its next meeting in October, and continue to ease into 2020.

Concern over the independence of India’s central bank became more apparent in October 2018, when deputy governor of the RBI, Viral Acharya, resigned from his post over concerns the government was trying to meddle in monetary policy and exert more control over the central bank’s regulations. Upon resigning, Acharya gave a speech that resulted in elevated awareness by market participants that the independence of the RBI was coming under pressure.

“Governments that do not respect central bank independence will sooner or later incur the wrath of financial markets, ignite economic fire and come to rue the day they undermined an important regulatory institution”.

While Acharya’s resignation and comments themselves did not result in a large selloff in Indian financial markets, the resignation of RBI governor, Urjit Patel, brought his comments to life. Patel shared the same independence concerns as Acharya, and left the RBI when PM Modi increased pressure on the central bank to transfer its cash reserves to the government in an effort to support the economy through increased fiscal spending ahead of elections. On the day of Patel’s resignation, the rupee depreciated over 2% during that day.

Just this week, these concerns have increased, as the RBI transferred a record 1.76 trillion rupees ($24.5B) to the central government (Figure 3). While RBI disbursements to the government are not uncommon, the size and timing of the transfer is unusual. With the economy decelerating, it is possible that pressure was placed on the RBI to disburse additional funds, and we view the outsized transfer of the RBI’s cash reserves as a possible indicator of a deterioration in the central
bank’s independence. These funds will likely be used by the government to support the economy. We also believe the independence of the RBI may continue to be questioned by markets over time.

**India-Pakistan Tensions Rising Again**

Tensions between India and Pakistan have been in place for a long time; however, recent decisions by the Modi administration may have escalated this strained relationship even further. Following the independence of India and Pakistan from Britain in 1947, the Kashmir region opted to remain independent from both nations. However, Kashmir was eventually ceded to India, with India controlling the majority of the region. Kashmir opting to join India generated historical tensions between India and Pakistan, and to this day, is a source of stress between the two countries, and despite a ceasefire being in place, often results in military conflict. Subsequent to the initial 1947 arrangement there have been some changes, and for the last few decades influence on Kashmir has been divided between three countries—India, Pakistan and China.

In addition, when Kashmir agreed to join India in 1947, it did so under the condition that it would be granted autonomy. This autonomy was granted and protected by Article 370 of the Indian Constitution, which effectively gave Kashmir the right to self-govern and make its own laws. In early August, PM Modi revoked Article 370, citing national security concerns, sparking outrage from Pakistani authorities. Along with revoking Article 370, Modi will create two separate territories—Jammu and Kashmir (J&K) and Ladakh—and effectively eliminate Kashmir’s autonomy. Opposition political parties in India have described the move as an attack on Indian democracy, while Pakistani authorities claim the decision directly infringes on Pakistan’s sovereignty.

In response, Pakistan has officially downgraded diplomatic relations and has suspended its bilateral trading relationship with India. Pakistan Prime Minister, Imran Khan, also announced he would file a formal protest with the United Nations Security Council, and has rejected President Trump and other world leaders’ offers to help mediate and de-escalate the situation. While the India-Pakistan trade relationship is small, with India sending less than 1% of total exports to Pakistan, we believe there is potential for this situation to escalate to a point where India’s economy could be impacted. As of now, we expect aggressive rhetoric between the two countries to continue and tensions to remain high; however, military conflict cannot be ruled out. India and Pakistan have already engaged in an armed skirmish in February of this year, and existing tensions regarding Kashmir have been prevalent for a long period of time, which means the likelihood of another military confrontation is higher than usual. In this scenario, the economy would likely experience significant disruptions and decelerate quicker than we currently forecast.