INDIA UPDATE

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FRAGILE DEMAND KEEPS INDIA IN A GROWTH SLUMP AS RBI PAUSES EASING CYCLE

Slower growth to continue in 2020, with a slightly faster second half of the year

India is still projected to be the second-fastest growing large economy in 2020

India's economy hit a rough patch in 2019. Real GDP growth is projected to grow 5.0 percent year-over-year in the fiscal year running April 2019 to March 2020, the slowest pace since 2009, when GDP growth was 3.1 percent. Slowing domestic demand, a shrinking manufacturing sector and falling global demand for Indian exports share the blame for 2019's weakness. Private final consumption expenditure growth slowed from 9.9 percent year-over-year in the third quarter of 2018 to 5.1 percent year-over-year in the third quarter of 2019, and nominal GDP growth was its slowest in ten years, 8.0 percent, in the second quarter of the year. Passenger vehicle sales—an indicator of urban demand—plummeted 13.8 percent in 2019, the worst drop on record, according to the Society of Indian Automobile Manufacturers; tractor sales—an indicator of rural demand—rose 2.4 percent year-over-year in December 2019 after ten consecutive months of declines, according to the Tractor Manufacturers Association. PNC expects below-trend growth to continue in the first half of 2020, with a mild back-loaded acceleration in economic growth in the second half of 2020; Reserve Bank of India interest rate cuts in 2019, and additional cuts in 2020, will support a recovery to trend. PNC forecasts real GDP growth of 5.5 percent in the fiscal year of 2019, rising to 6.5 percent in 2020. Despite slower recent growth, India is still projected to be the second-fastest growing large economy through early 2021, lagging only slightly behind China. Risks to India's outlook remain tilted to the downside; even so, India should outperform most emerging economies in 2020 against a backdrop of slow global growth.

The Reserve Bank of India (RBI) cut its benchmark repo policy rate at five consecutive monetary policy meetings between February and October 2019, reducing it by a cumulative 1.35 percentage points to 5.15 percent, to cushion the slowdown. At its December and February rate decisions, the Monetary Policy Committee held the benchmark repo rate steady due to December's uptick in inflation. Total CPI inflation accelerated to 7.4 percent in the month, the highest in over five years, and breached the 6 percent upper bound of the RBI's 2 to 6 percent target range. A supply-side surge in onion prices caused food prices to surge 12.2 percent. Core inflation, excluding volatile

CHART 1: AFTER FIVE CONSECUTIVE CUTS, RBI KEPT THE REPO RATE STEADY AS INFLATION BREACHED THE TARGET

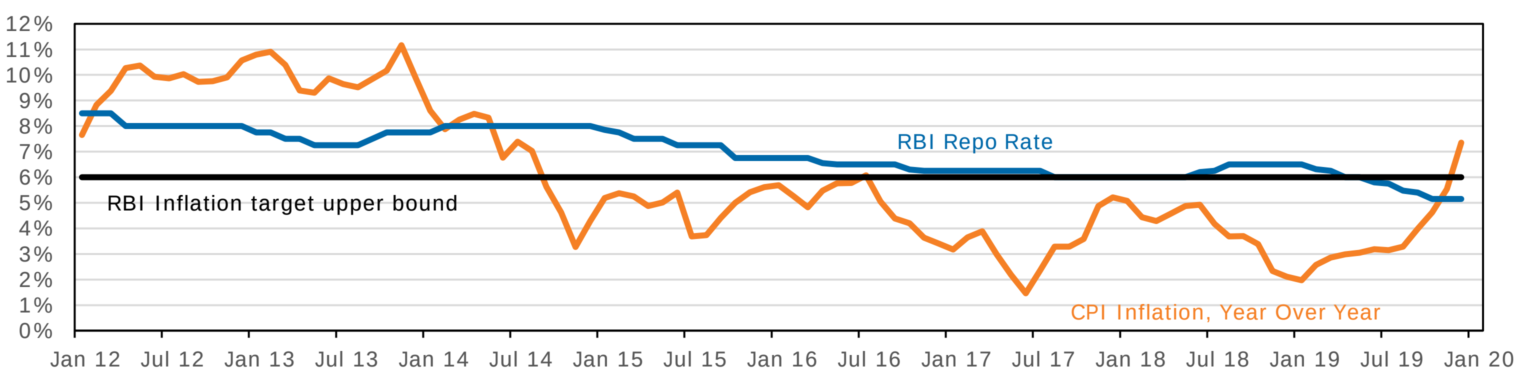

Chart sources: Bloomberg, The PNC Financial Services Group

Core inflation trended lower in 2019 and is currently near the record-low

food and energy prices, slowed in 2019 and, at 3.5 percent in December, was close to the record low of 3.4 percent. PNC forecasts the RBI to hold the repo rate steady until food inflation cools, then reduce it by 25 basis points to 4.9 percent by year-end 2020.

Expansionary fiscal policy will also support Indian growth in 2020. In September 2019 Prime Minister Narendra Modi's government cut corporate tax rates from 33 percent to 22 percent. The tax cut, equivalent to 0.7 percent of GDP, will support growth in capital expenditures and attract more foreign direct investment. The annual budget, released by Indian Ministry of Finance in February 2020, also contains a range of tax reforms that will potentially attract foreign investment; tax exemptions to interest, dividend and capital gains income are granted to sovereign wealth funds of foreign governments as long as the investments are held for at least three years. However, India's already strained fiscal health and high public debt for an emerging market (the IMF forecasts the general government debt to reach 68.5 percent of GDP in 2020) will put upward pressure on inflation in 2021. India's fiscal deficit target in the current 2019-2020 fiscal year was revised up to 3.8 percent from the Ministry of Finance's initial target of 3.3 percent set in July 2019 partly driven by lower government revenues from the corporate tax cut.

Financial sector vulnerabilities continue to pose important downside risks; a series of defaults and insolvency issues affecting non-banking financial companies in 2018 and 2019 have constricted credit supply. The non-performing loans ratio increased to 9.1 in 2019 from 3.3 five years ago. Total credit flows from banks and non-banks from April to mid-September 2019 dropped 88 percent from the same period a year earlier, despite the RBI lowering its policy repo rate 0.85 percentage point over that period. Year-over-year growth in the stock of bank credit in the Indian banking system has been slowing since 2018 and was most recently 5.1 percent in the third quarter of 2019, down from 9.9 percent in the third quarter of 2018. Financial sector vulnerabilities, large fiscal deficits, and large foreign borrowing needs are limiting the financial system's ability to transmit monetary stimulus to the real economy.

Downside risks to the rupee as the global economy slows

Slower Indian growth, trade frictions and a decelerating global economy make the rupee likely to depreciate further against the dollar in the first half of 2020. PNC forecasts the rupee to depreciate by 4.0 percent to ₹74.0 per dollar by mid-year, then recover to ₹72.0 by year-end 2020 as growth stabilizes and the drag from the coronavirus outbreak abates. Relatively low policy interest rates in the United States and negative interest rates in Europe and Japan will continue to fuel investment inflows into emerging economies like India, where the 10-year bond yield of more than 6 percent exceeds domestic inflation. These tailwinds will eventually offset the near-term negatives for the Indian economy and rupee.

CHART 2: RUPEE TO DEPRECIATE THROUGH MID-YEAR, BUT A RECOVERY IS LIKELY IN THE SECOND HALF OF 2020

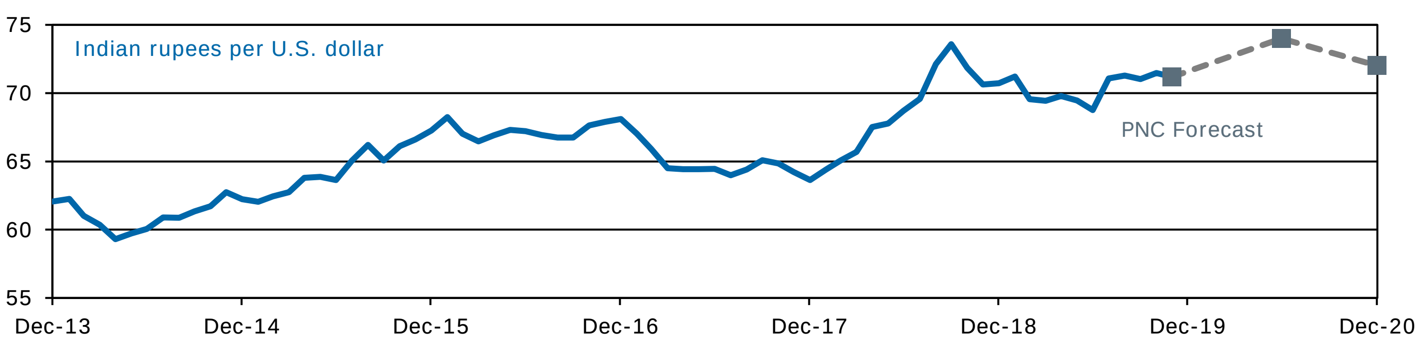

Chart sources: Reserve Bank of India, The PNC Financial Services Group

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