India: Facing up to a new wave

Recent growth figures have been positive, but the easy period following economic reopening has now passed, and the development of a new Covid wave threatens both growth and India's sovereign ratings

Source: Shutterstock

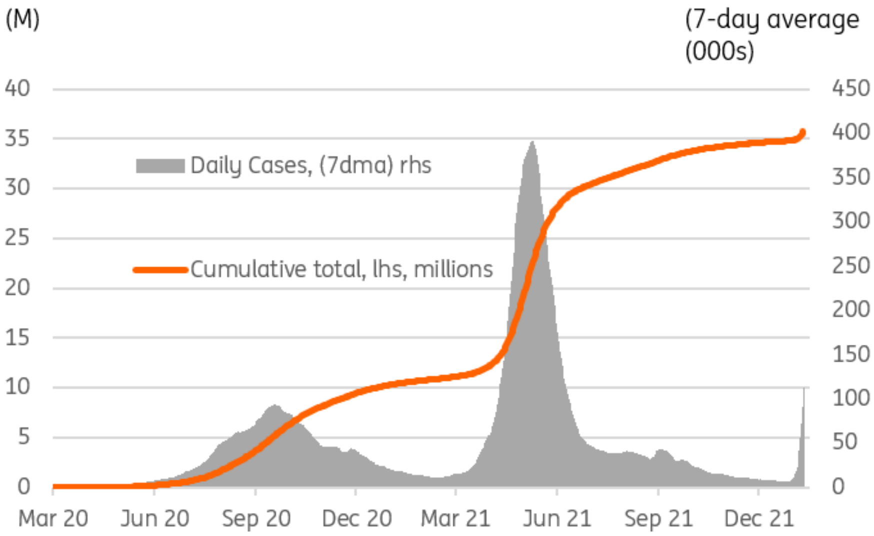
India and Covid-19 – not a "good" pandemic

India has not had a "good" pandemic (of course, no one really has). At its worst during April / May of 2021, the daily confirmed case total neared 400,000 and daily death rates approached 5,000. In fairness, the scale of these numbers is exaggerated by the large size of India's population, though confirmed cases may also not capture the full extent of the pandemic, with measures of "excess mortality" in 2020 and 2021 suggesting both cases and deaths due to Covid may have been substantially under-reported.

Strict lockdowns were implemented after the Delta variant started to spread and although this had the desired impact of reducing the spread of the virus, it resulted in a substantial slowdown in economic activity. This 2021 slowdown came on top of the full-year 2020 decline in GDP of 7%, the second-worst in the APAC region after the Philippines.

And despite being one of the world's largest producers of vaccines, India's vaccine rollout has been quite slow relative to many of its APAC neighbours. Even now, only just over 60% of the population has had any vaccination, with just 44% fully vaccinated.

India 7-day daily moving average and cumulative total Covid cases

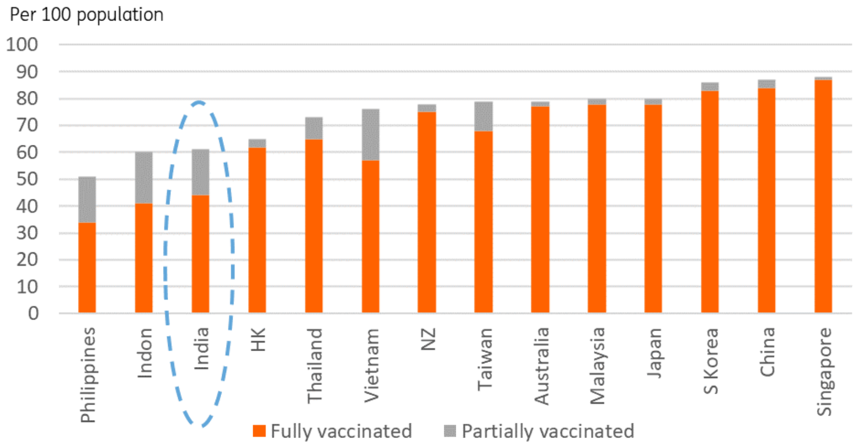


Source: Our World in Data

These are higher vaccination rates than Indonesia or the Philippines, and progress is ongoing. But these percentages lag most of the rest of the region and could be a problem if the Omicron variant takes hold, possibly requiring a return to movement restrictions for the population and a further associated slump in economic activity. We would not rule this out by any means given how easily this variant appears to spread even within heavily vaccinated economies in regions like Europe. India's 7-day average daily case numbers have picked up to 40,000 with the latest daily tally at more than 100,000. A week ago, it was less than 10,000. These figures are rapidly climbing and the daily rate may be several times higher by the time this note goes to print. As we learned last time, it takes only two weeks from being fully in control to being in full crisis mode.

What potentially compounds the modest vaccination rates, is the almost total reliance on traditional vaccines such as Covaxin and Covishield – essentially the AstraZeneca vaccine. Whilst these have been shown to be effective at protecting against the original Covid and subsequent variants, mRNA vaccines seem to have stronger protective properties against Omicron (and even then, heavily reduced). So India joins Indonesia and perhaps the Philippines in the region as being potentially at greater risk from an outbreak of Omicron than other countries in Asia-Pacific in terms of both the likely rate of spread and the severity of symptoms.

Asia vaccinations by dose



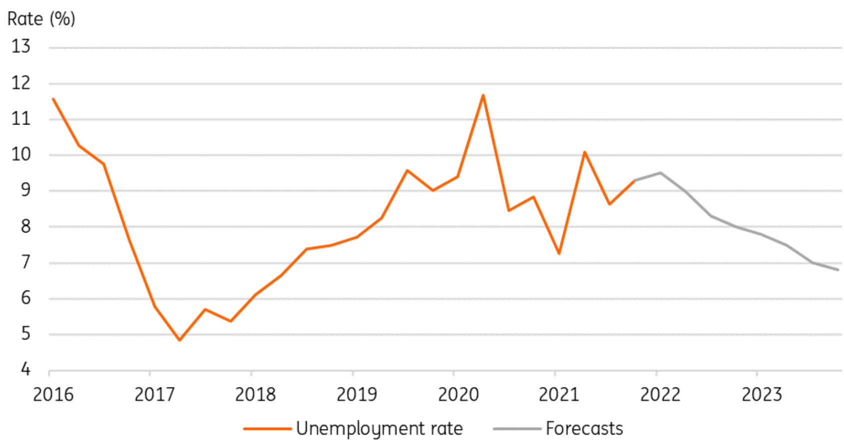
Source: Our World in Data

Economic growth – not as good as you'd think

Thanks to the 2021 Covid wave, what should have been a bounce-back year for India turned out to be far weaker than originally expected. 2Q21 GDP declined by 16.9% quarter-on-quarter as the Delta variant wreaked havoc on the nation. 3Q21 GDP only recovered some of this lost ground, rising 10.4% QoQ. The unemployment rate (urban) has declined from its peak of about 12% in 2020 to around 9% now. And if we don't see another bad Covid wave, unemployment should continue to decline through 2022 and 2023, approaching 6-7% by end-2023, and helping to support consumer spending.

But while the current rates of Indian economic growth and labour market developments are clearly encouraging, there is a degree of "rose-tinting" to some analysis of the current economic situation. In terms of absolute levels of economic activity, India is close to or has just achieved pre-Covid levels – depending on your preference for seasonally adjusted data or not. But this achievement still leaves India's GDP substantially lower than it would have been absent the pandemic.

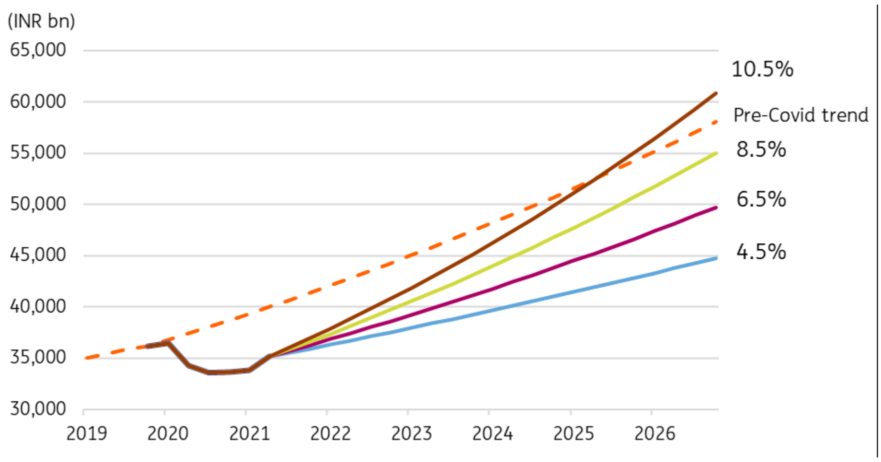
Urban unemployment rate (%)



Source: CEIC

In the chart below, we show the historical performance of India's GDP and then extrapolate at different rates to show what will be needed for India to return to its pre-Covid path. The chart shows that the decline in India's economic activity has been so severe that it will require a growth rate of around 10.5% per annum over the coming years to bring India back to its pre-Covid path any time soon. That seems unduly optimistic to us, even if there is a near-term bounce. At about 8.5%, there will also be convergence back to the prior trend, though it will take place very slowly, and not occur until well into the next decade.

India - recovering lost GDP will be tough



Source: CEIC, ING

Growing quickly is sometimes easier following a sharp decline. But not always. For example, businesses that go bust during a prolonged and severe shock like the Covid-19 pandemic will not always spring back to life as soon as reopening occurs. Labour force participation that gets displaced does not always return, and interrupted education/training may never be picked up again at the point of departure. Add to that, the depressing effects on growth of substantial additional quantities of government, household, and corporate debt, and not only may the prior path of GDP never be re-attained, but potential growth rates after an initial bounce may prove to be slower, not faster than previously.

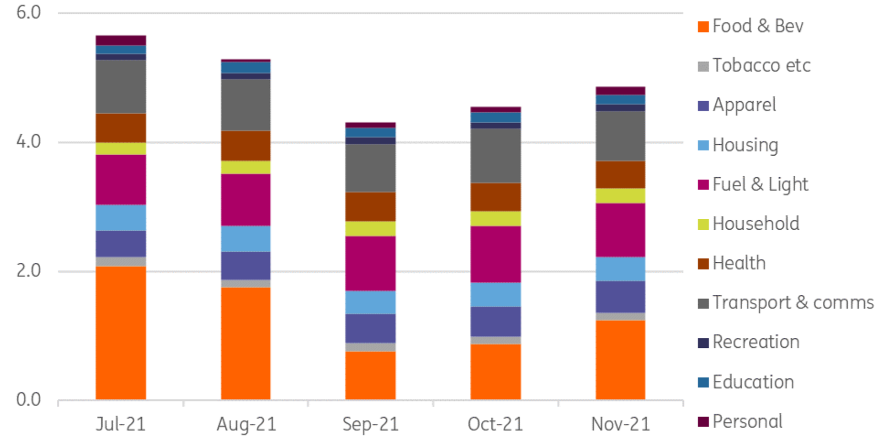
There is certainly a chance that India follows this gloomier path, and optimism over currently encouraging service sector and manufacturing PMI indices miss this point and focus a bit more than could be sensible on the immediate pace of recovery. 2021 GDP could register growth of approximately 8% thanks to the easy comparison with 2020, but in 2022 and 2023, we see growth slowing back below 8% (calendar, not fiscal year basis) making any return to a pre-Covid path quite protracted.

In short, it is the level of activity in India, not the rate of growth viewed against some abnormally depressed base that really matters. PMIs can be useful, but there is a limit to the utility of simple directional indicators.

Inflation – staying higher for longer

Despite this slightly downbeat view on economic growth, the inflation outlook for India isn't particularly benign. Our forecast for headline CPI inflation rises steadily through to the release of January inflation, and that is even with an assumption of some very benign month-on-month CPI estimates over the coming months. Recent declines in global crude oil prices will certainly help in the near-term, though oil is heading up again, so we aren't taking that for granted. Some other commodity prices and also seasonal food increases don't seem to have made it fully through to the most recent CPI releases even though key vegetable prices have moderated more recently. There could still be a pipeline of higher input prices on the way.

Contribution to YoY CPI Inflation by component



Source: CEIC, ING

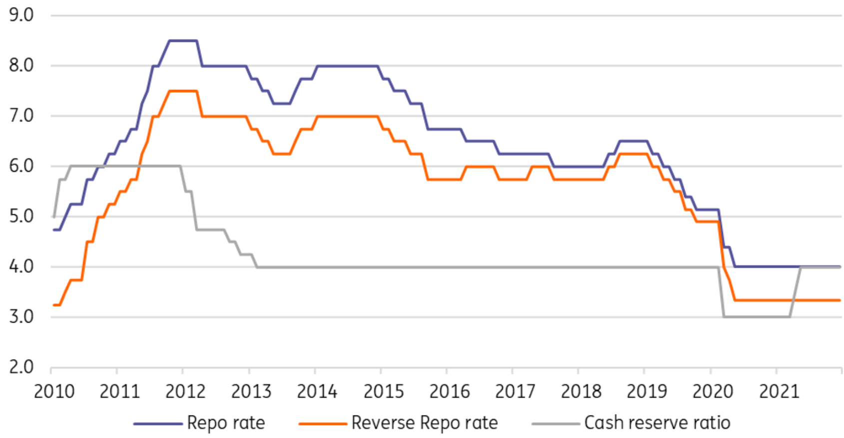
Even with the better outlook for crude oil, the headline inflation rate will likely rise just above 6% - the upper limit of the Reserve Bank of India's (RBI) inflation target, centred on 4%.

Inflation is then likely to settle in a range between 5% and 6% until after the April CPI figure is released mid-year when it should begin to move back towards the RBI's central target of 4%.

RBI policy and bank lending

Like most other forecasters, we anticipate the RBI's tolerance of this rising inflation tide to be finite, and we look for an increase in the policy repo rate from its current rate of 4.0%. We had been confidently looking for this to occur as early as 1Q22, but the most recent RBI rate meeting made no hint at all that policy would be changed any time soon. There was also no change to the reverse repo rate which forms a "floor" for policy rates.

RBI Policy rates



Source: CEIC, ING

The corridor for repo rates and the reverse repo had widened during the pandemic to assist liquidity provision. Now that the emergency period has passed, there is an argument for restoring the corridor to its pre-pandemic width of 25bp, especially now that T-bill yields have risen into the corridor having traded slightly lower at times in 2021.

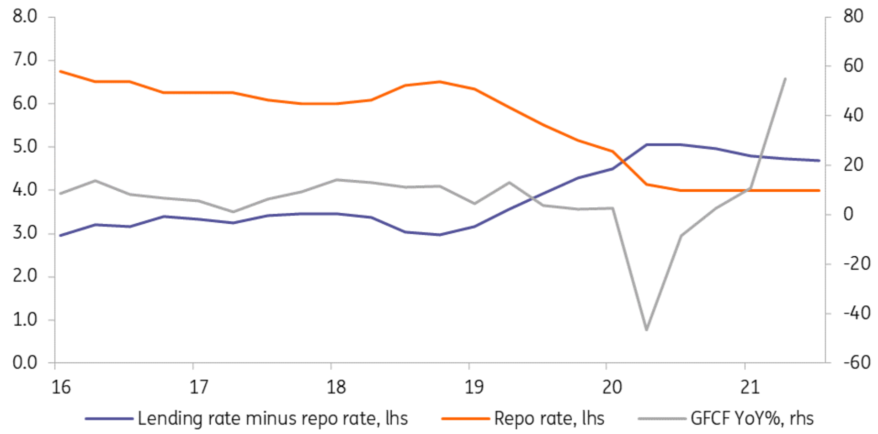
We look for policy rates to end 2022 at 4.6%. Though this will only take real policy rates from being outright negative (as they are currently) to around zero. If there is a risk to these numbers, it is that inflation proves stickier and requires a higher nominal and real interest rate to squeeze it out.

Despite the RBI's aggressive easing during the pandemic, lending rates from banks have not fallen nearly as much and banks have widened their interest margins. That's good for bank profitability but probably not for the prospects for capital investment.

Gross fixed capital formation growth is off the charts right now, entirely due to favourable base effects. Pre-pandemic business investment growth ran at an average annual rate of about 6%. That seems a plausible goal post-pandemic but may require banks to absorb some margin compression as policy rates rise. This should be possible if lending volumes increase.

In 2021, annual commercial bank credit growth was steady at about 6%. If history is any guide, it will need to grow faster than this to equip a 6% annual growth rate in business investment.

Lending rates and Gross Fixed Capital Formation



Source: CEIC, ING

Rating outlook and fiscal deficit

Rating agencies have been unusually clear about what they need to see from India for it to avoid a rating downgrade. Currently, India is at BBB- and a negative outlook from Fitch, BBB- stable outlook from S&P and Baa3 stable from Moody's.

All three main rating agencies rate India's foreign currency sovereign debt as investment grade, but at the lowest rung. And with Fitch maintaining its negative outlook, India may lose its investment-grade credit rating from them in 2022 if hit by any new shocks to growth.

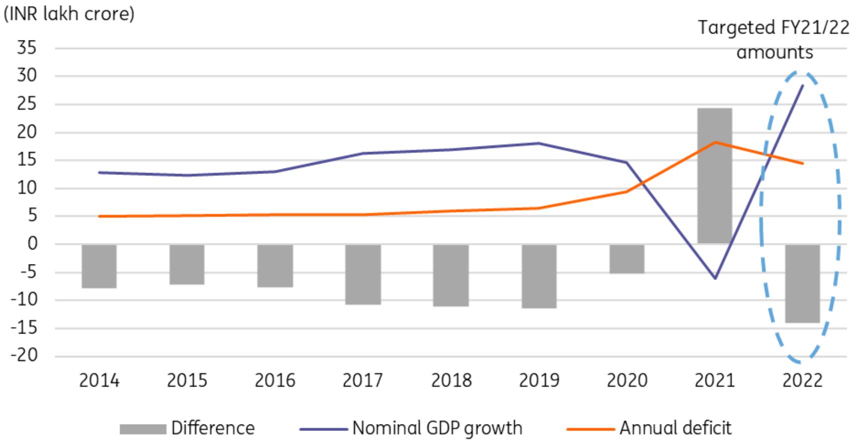
The key metric for any downgrade is very simple - India's fiscal position. Like most economies during the pandemic, India's fiscal deficit worsened considerably as tax revenues slumped and government spending shot up to offset the crashing economy.

India's gross public debt as a percentage of GDP increased to 89.61% of GDP in 2021 (OECD estimates) and is expected to push up to 90.6% in 2022 before heading lower. Interest payments form the single largest component of government expenditure, estimated at INR 809701 crore - more than twice as much as defence (INR 347088 crore), or pensions (INR 189328 crore) and account for more than 23% of total government expenditure.

There are a variety of risks to the fiscal outlook. The 2021/22 budget outlook assumes a 14.4% nominal growth rate. Implicit within this is a real GDP growth rate that will not substantially dip below 10% assuming inflation runs somewhere around the middle of the RBI's 4% +/- 2% target. Rising debt-service costs are another risk given the global backdrop of tightening policies in the US and elsewhere. Yields on 10Y Indian government bonds have increased by about 60bp since the beginning of last year and the balance of risks is that they move higher still. Revenues will also need to come in as predicted, and expenditures should not creep above budgeted amounts – slippage on fiscal targets is not uncommon in even the most prudent economy.

From an estimated deficit of 9.5% of GDP in 2020/21, the deficit is budgeted to decline to 6.8% in 2021/22. That said, running the monthly deficit numbers for fiscal-year 2021/2022, they look on track, and the latest figures for October suggested that the deficit may even come in below the government's 6.8% target. Still, deficit figures are prone to big monthly anomalies, especially towards the end of the fiscal year, and we also really have to factor in some future impact from the Omicron variant. As a result, it will be very difficult to declare "mission accomplished" until full fiscal-year figures are in, and then the process begins again to deliver another year of debt-consolidating deficits (basically anything where the deficit as a percentage of GDP is less than the nominal GDP growth rate).

Deficit additions and nominal GDP growth

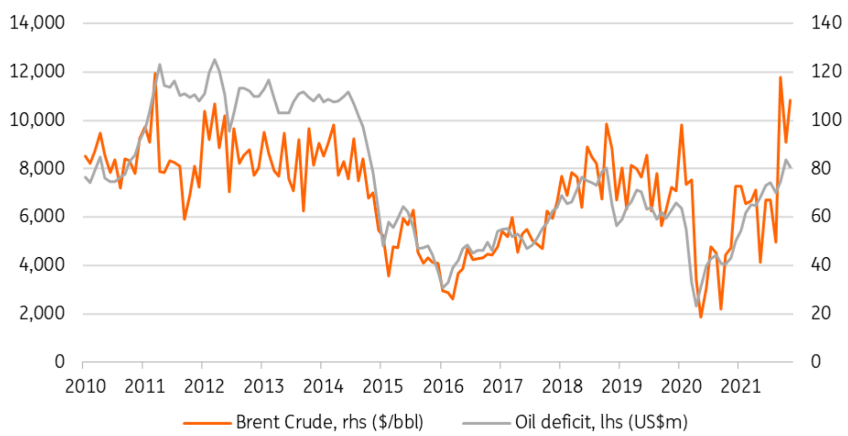


Source: CEIC, ING

Trade – fading boost to balance from pandemic

The sharp drop in domestic demand in India during 2020 due to the pandemic led to the trade deficit shrinking and briefly reaching a small surplus in June 2020. This brief foray into surplus was also helped by a temporary dip in crude oil prices. Oil accounts for about 50% of the Indian trade deficit. And a $10 decline in crude prices is enough to reduce the overall deficit by about $1bn per month.

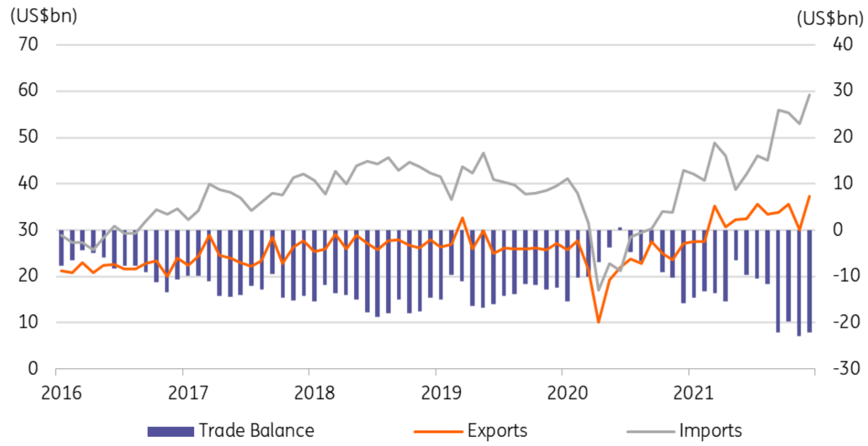
India's trade deficit and Brent crude prices



Source: CEIC, ING

Monthly deficit figures are running at about -$20bn currently. Both export and import growth is good, and the recent decline in crude oil prices was certainly helpful. But the ongoing recovery will likely shift the balance of trade more in favour of imports, and we forecast the trade deficit further increasing in both $bn terms and as a percentage of nominal GDP.

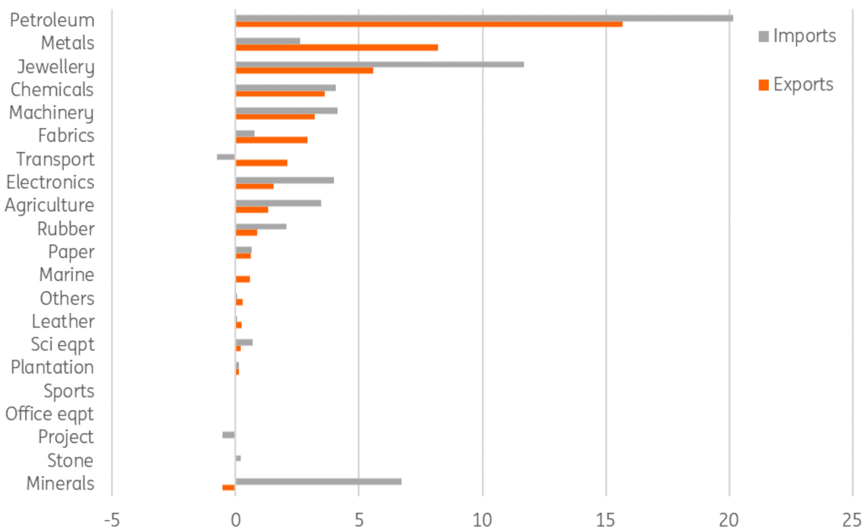
India trade and trade deficit



Source: CEIC, ING

In terms of the composition of Indian trade, most of the year-on-year growth in exports is accounted for by contributions from five main sub-categories. The principal contributor is petroleum, which mainly reflects high current crude and product prices. It is also more than replicated in the import category, so doesn't imply a positive net effect (in fact the contrary). Besides petroleum-based exports, metals, jewellery, chemicals, and machinery dominate India's export growth. Almost the same five sub-categories make up the bulk of India's import growth too, except that minerals imports replace metals exports. There are also stronger exports of fabrics than imports and slightly stronger imports of electronics than exports.

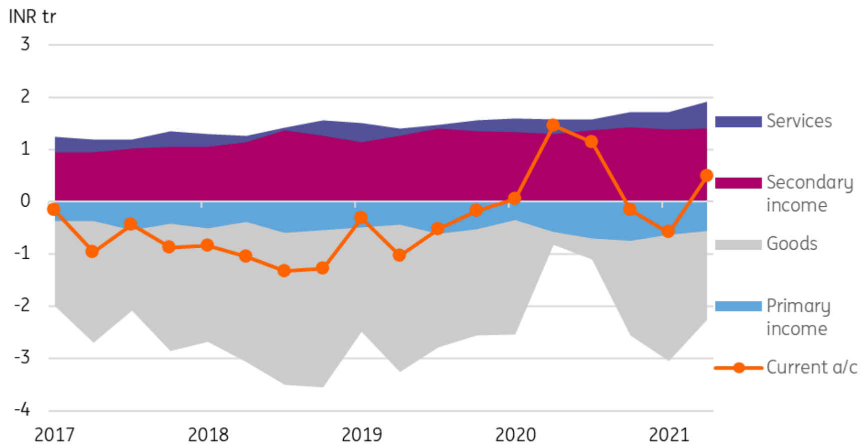
Contribution to export growth by component



Source: CEIC, ING

While there are encouraging signs of growth in India's balance of trade in services, it is the goods side that still dominates and where most of India's current account volatility stems from. Secondary income, mainly from worker remittances provides a solid boost, but primary incomes on direct and portfolio investments are a persistent drain and will most likely become more so following the surge in IPOs in the last few years, even if this does provide a short-term boost through the capital account.

India current account balance



Source: CEIC, ING

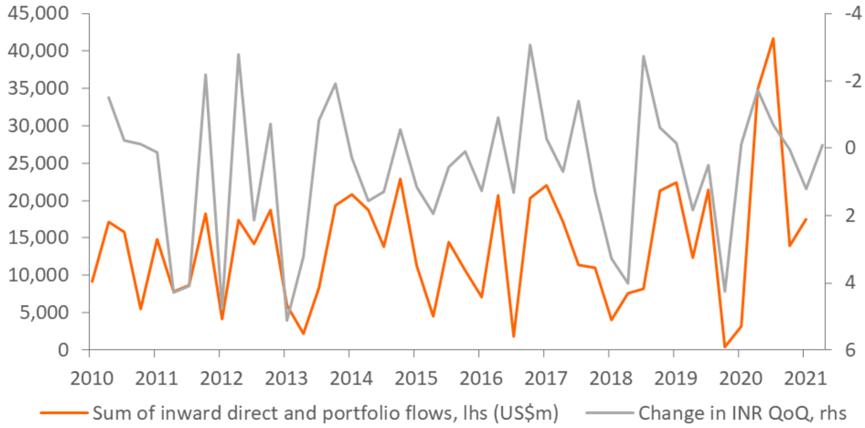
Capital flows and INR

In 2021, a pipeline of IPOs attracted inflows of portfolio capital which helped buoy the Indian rupee relative to some of its other Asian peers, bearing in mind that most currencies in the region have weakened to some extent versus a stronger dollar.

How this pans out in 2022 depends on your outlook. An optimistic view is that having demonstrated the IPO model, 2022 will deliver more of the same, and the INR will remain supported. But an alternative view, and the one we tend to favour, is that the recent flop in the PayTM IPO and some others suggests that the pipeline of such deals in 2022 will find the going tougher. Investors may not be willing to subscribe to new offers where there is no track record of profitability, or where there is doubt about the direction of shares immediately following issuance. Even savvy investors playing the greater-fool theory need to know that there is sufficient demand to enable early flipping of issues to pay off.

The background for equity markets in general in 2022 might also be a more difficult one. Both local and global interest rates look as if they will be on the rise, and perhaps quite a bit more than had been expected several months ago given the high rates of inflation in economies like the US and Europe. Earnings growth will not be as easy to achieve as it was in 2021 in the absence of helpful base effects or technical bounces. And the sentiment of foreign investors to emerging market stocks may be more challenged than it has been of late.

INR and capital flows



Source: CEIC, ING

Capital account convertibility – coming…slowly

An important speech by Deputy Governor Rabi Sankar in October provided some clues as to the future for Indian capital account convertibility. The first point to note is that since it started to embark on capital account liberalisation back in 1990, the journey has been a cautious one, and has not always gone in a straight line. But India is not likely to back-pedal on capital account convertibility. Sequencing of the liberalisation has proceeded along lines from theoretically less risky to more risky capital flows.

For example, the market for Foreign Direct Investment is now largely unrestricted except for some sectors such as real estate and strategic sectors. In this, there are few differences from more developed markets. Equity markets have also been de-restricted as the recent IPO boom demonstrates. Debt markets have always been regarded as inherently more footloose and hence riskier, so deregulation here has started gradually for government securities. But as Deputy Governor Rabi Sankar notes, there is an effort to liberalise portfolio investments further via the "Fully Accessible Route", under which, over time, there would be virtually unfettered access for foreign investors into government securities.

Of course, coupled with an inflation target, capital account liberalisation could imply greater volatility in FX and debt markets. So, one of the mollifying policies that seems to be being pursued is to get India included in key global bond indices - possibly this year. India remains the last major emerging market economy to be included in such indices since China was included two years ago. Once this is achieved, investors will tend to be much less footloose, whereas currently, they may need an excuse to have any exposure at all.

Until such time, and assuming that our core EUR/USD forecasts are in the right ballpark, then some weakening of the INR vs the USD seems probable over 2022. We see year-end 2022 USD/INR at 76.0, though this should return to 74.0 by the end of 2023. Entry into a global bond index has been estimated to result in inflows of up to $40bn into Indian debt securities. Not only would this result in the INR rallying sharply once it looks imminent, but it would also likely flatten the slope of the government yield curve with spillover benefits into corporate debt securities also likely.

Conclusion – It's looking better, but watch those Covid-19 numbers

2022 is going to be an important year for India. The outlook for growth is tentatively positive but is maybe not as solid as some directional indicators suggest and may well be severely tested again by the Omicron Covid variant. And this is also where the biggest threat from a credit downgrade most likely lurks. Weaker than expected growth in the face of a new Covid wave would undermine what currently looks to be good progress on deficit reduction with little scope for offsetting policy responses. A trickier external environment with the US Federal Reserve taking an increasingly hawkish stance could also provide further challenges, and it is notable that the INR showed signs of weakness towards the end of the year. But the inclusion of India into global bond indices this year could provide a very positive offset.

India summary table

	1Q22	2Q22	3Q22	4Q22	2021	2022	2023
GDP (YoY%)	1.1	15.0	7.3	6.9	7.4	7.3	8.0
CPI (YoY%)	5.7	4.8	5.0	4.6	5.1	5.0	4.7
Unemployment rate (Urban eop)	9.5	9.0	8.3	8.0	9.3	8.0	6.8
Residential real estate YoY%	2.4	3.9	4.9	4.6	2.2	3.9	3.8
Fiscal Balance %GDP (fiscal year ending)					9.5	6.3	5.5
Gross debt/ GDP (%)					89.6	90.6	88.8
Current a/c balance (% GDP)					1.0	-0.8	-1.2
7-day repo rate (eop)	4.0	4.2	4.4	4.6	4.0	4.6	5.0
10Y yields (eop)	6.6	6.7	6.8	6.8	6.4	6.8	7.3
USDINR (eop)	75.0	76.0	76.8	76.0	74.3	76.0	74.0

Source: ING

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