

India Macro Update – No Smooth Sailing Ahead

India's economy has been the worst-affected by Covid-19 but has also been the fastest to recover from the slump. However, the second wave of the pandemic paves the way for a bumpy ride again this year, while structural bottlenecks will continue to hold back India's economic potential for years to come



Source: Shutterstock

Risks shifting from growth to inflation

India's economy has been hit by the Covid-19 pandemic more than any other economy in Asia. Yet it's also been the fastest one to recover from the slump.

GDP crashed by a hefty -24% year-on-year in 1Q FY2020 (April-June 2020) as a nationwide lockdown slammed the brakes on the economy. The gradual reopening revived activity and the GDP contraction moderated to -7.3% YoY over the next quarter. The negative growth streak ended earlier than most other Asian economies with a small 0.4% YoY rise in 3Q FY2020, thanks to firming domestic spending.

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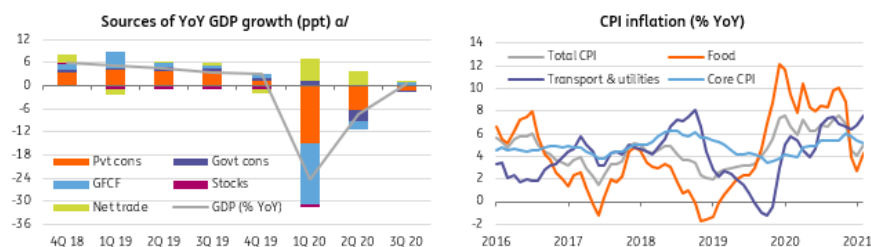
Domestic demand suffered a significant blow from the pandemic. The mass migration of labourers at the height of lockdown and a spike in the jobless rate dented private consumption, while weak business confidence weighed on investment. The much-hyped Covid-19 stimulus, equivalent to 10% of GDP was barely visible in government consumption given that a large chunk of it was long-term spending for infrastructure development and structural reforms. Meanwhile, weak global demand weighed on exports. Imports suffered a much bigger hit than exports as a result of the crash in domestic demand. This made net trade the only positive contributor to GDP growth.

From the supply-side, services have been the biggest drag on GDP, accounting for almost two-thirds of the -9.7% fall in gross value added in the first three quarters of FY2020. Manufacturing made up the rest of the GDP fall. The agrarian economy was surprisingly unscathed despite several natural disasters, including flooding and cyclones, as well as the prolonged farmers' strike against the government's marketing reforms for their produce.

Rising food and fuel prices suggest that the inflation risk is far from over.

Weak domestic demand failed to contain upward pressure on consumer prices. CPI inflation exceeded the Reserve Bank of India's 2%-6% policy target for almost the entire year in 2020. It retraced back towards the middle of the target range in December and January but resumed the upward march in February on the back of rising food and fuel prices, which suggests that the inflation risk is far from over. No wonder then that the Reserve Bank of India is leading the monetary policy normalisation in Asia, being the first central bank in the region to tighten via a 50-basis-point hike in the cash reserve ratio for commercial banks at its last meeting in February.

Growth and inflation dynamics



Source: CEIC, ING Bank

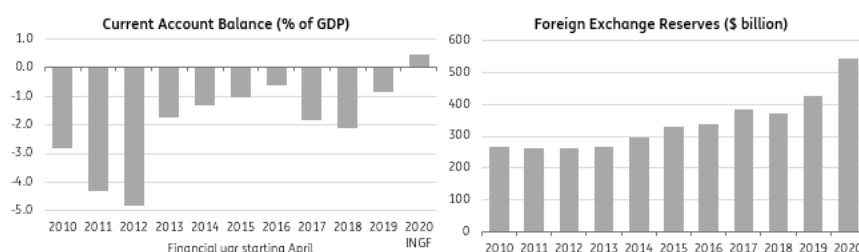
a/ Bars may not stack up to total GDP growth due to statistical discrepancy.
Quarters are on financial year (April to March) basis.

Favourable external payments

Meanwhile, India's external payments last year were better than they've been in quite some time. Indeed, exports were under pressure from weak global demand and continued global trade tensions. But imports suffered more on account of weak domestic demand and lower global oil prices. This explains a positive swing in the current account balance back to surplus after decades of deficits. Our estimate of the annual current account surplus equivalent to 0.4% of GDP in FY2020 follows a deficit of -1% of GDP in the previous year.

As the record stimulus and surge in liquidity around the world found their way into risky assets, the RBI took advantage of resurgent capital inflows and the resultant appreciation of the Indian rupee (INR) to stockpile foreign exchange reserves. A record annual increase of \$115 billion boosted outstanding FX reserves to US\$542 billion in 2020, covering 18 months of imports and five times the short-term external debt.

2020 the best year for external payments in many years



Source: CEIC, ING Bank

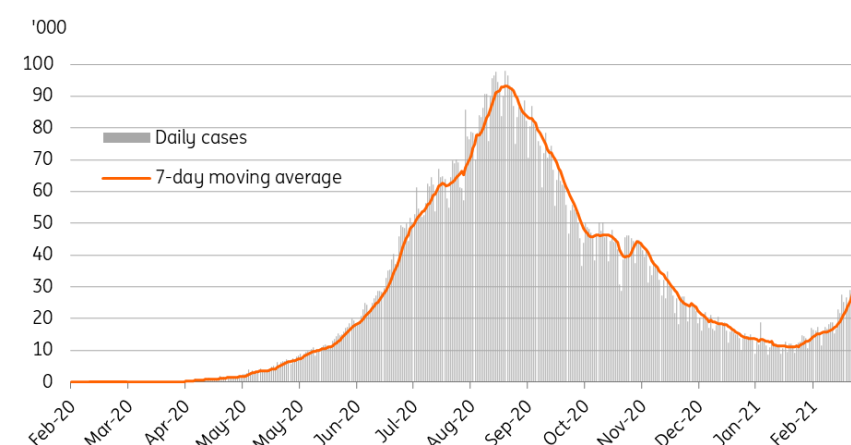
Yet weak investor sentiment

The large stock of reserves also serves as a buffer for the RBI, allowing it to support the INR in the event of an exodus of capital during global risk-off moves, like the one seen recently. However, a key side-effect of such a policy is the wrath of the US Treasury. The persistent one-sided intervention and a significant bilateral goods trade surplus with the USA led the Treasury to bring India onto its watchlist of currency manipulators in the latest report released in mid-December. That said, the INR's 2.3% of depreciation against the USD in 2020 was the steepest among Asian currencies.

Growth overtaking fiscal austerity was the right policy response in dealing with the global pandemic.

Weak public finances and the domestic financial system remain the key factors weighing on investor sentiment. Of course, spending growth rather than fiscal austerity was the right policy response in dealing with the global pandemic though the spending surge and revenue shortfall widened the budget deficit to an estimated 9.5% of GDP in FY2020. As the cyclical downturn compounded the economy's structural problems, the global rating agencies wasted no time in putting India's investment-grade sovereign rating under watch for a possible downgrade. Moody's and Fitch downgraded their Baa3/BBB rating outlooks from 'stable' to 'negative' in June last year.

Covid-19 infections - the second wave is here



Source: Worldometers, ING Bank

Number of infections as of 21 March 2021.

No smooth sailing ahead

Even though India has improved in the global rankings in terms of total Covid-19 cases so far (now third in the world from second), the number of daily new cases has started to grow and some major cities are facing renewed lockdowns. This is beginning to undermine the economic recovery.

Although the low base year effect should sustain GDP growth on an upward path in the next couple of quarters, the balance of risks remains tilted to the downside. The latest data on industrial output, with a -1.6% YoY output contraction in January proves the point. Our growth forecast for the current quarter is +2.7% YoY, bringing the annual GDP contraction to -7.0% in the fiscal year ending in March 2021, which is among the steepest in the region.

Just as the passage of rising global oil prices to domestic fuel prices is going to pressure inflation higher...

Economic policies should remain supportive of the recovery. The Budget for FY2021 aims for a V-shaped economic rebound next year to 11% GDP growth from a record -7.7% contraction in FY2020 – both the projections are part of the government's annual Economic Survey for FY2020. We remain sceptical of such a robust recovery outlook, though we aren't far from anticipating it either with our FY2021 growth view of 9.2%.

Rising food and fuel prices suggest that inflation risk is resurfacing again. Headline CPI inflation advanced to 5.0% YoY in February from 4.1% in the previous month, underscoring this risk. The pass-through of rising global oil prices to domestic fuel prices and then onto the broader CPI basket will continue to pressure headline inflation higher over the course of FY2021. We see inflation staying close to the top end of the RBI's 2%-6% policy target zone, if not exceeding it. This underpins our forecast of 5.8% average inflation in the next fiscal year.

... it's also going to weaken the external payments via a widening trade deficit.

External payments are expected to see some reversal in FY2021 from the strong position enjoyed in the previous year. A dominant driver here is rising oil prices pushing imports higher and still-anaemic external demand keeping exports subdued. The associated widening of the trade and current account deficits will be a key drag on GDP growth. We see the current account balance swinging back to a deficit of close to 1% of GDP in FY2021 from a one-off surplus in FY2020. Hopefully, the US-China trade and technology war turns out to be less of a drag on sentiment under the new Biden administration, and India gets some favourable treatment as a key US ally on this front.

Key economic indicators and ING forecasts

India (FY starting April)	FY2018	FY2019	FY2020 f	FY2021 f	FY2022 f
Real GDP (% YoY)	6.5	4.0	-7.0	9.2	6.4
CPI (% YoY)	3.4	4.8	6.3	5.8	5.3
Fiscal balance (% of GDP)	-3.4	-4.6	-9.5	-6.8	-5.3
Public debt (% of GDP)	69.6	72.3	95.0	93.0	91.0
Current account (% of GDP)	-2.1	-0.9	0.4	-0.8	-1.7
FX reserves (US\$ bn)	385	442	558	585	610
External debt (% of GDP)	20.1	19.4	23.0	22.0	20.5
RBI repo rate (% eop)	6.25	4.40	4.00	4.25	4.50
3M T-bill rate (% eop)	6.14	4.23	3.30	3.65	3.90
10Y govt. bond yield (% eop)	7.35	6.14	6.30	6.80	7.10
INR per USD (eop)	69.17	75.39	73.00	72.80	72.00

Source: CEIC, ING Bank

Accommodative policies prevail

Clearly, growth continues to be the main goal of macroeconomic policies coming into 2021 even as the government aims to trim down the fiscal deficit and the RBI has recently signalled an end to its monetary easing albeit with a continued accommodative bias.

In some display of fiscal tightening, the government is aiming to narrow the deficit from a record 9.5% of GDP estimate for FY2020 to 6.8% in FY2021. However, with the little-changed spending budget of INR 34.8 trillion for FY2021 all hopes of a lower deficit rest on recouping the revenue loss suffered in the last year, which in turn depends on the economy staging a strong V-shaped bounce. Moreover, the revenue receipts are projected to grow by 15% in the next fiscal year, which against 13.9% of nominal GDP growth implied by the official budget projections appears to be a bit of a bold assumption. As such, weak public finances will continue to be a key overhang on government bonds throughout 2021, and probably even beyond.

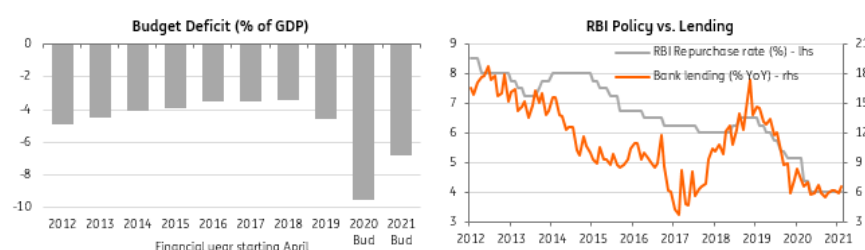
The transmission of rising global bond yields to domestic yields

complicates the RBI's policymaking.

The transmission of rising global bond yields to domestic yields complicates the RBI's policymaking. Since late 2019 the central bank has been engaged in keeping bond yields low in order to facilitate the government's rising market borrowings for financing the wider budget deficit. The pump-priming of the local financial system with liquidity injections via 'operation twist' and targeted repo auctions was successful in keeping yields low, though this was countered by weak investor confidence and subdued bank lending growth.

As such, the financial system continues to be flooded with excess liquidity that's potentially inflationary as well. This underpins the RBI's decision in February to keep the main policy interest rates unchanged but raise the cash reserve ratio for banks. Even though this signals the end of the easing cycle, we don't think a policy rate hike is on the table anytime soon.

Fiscal and monetary policies



Source: CEIC, ING Bank

Markets on bumpy ride too

Indian financial markets have not escaped the global risk-off sentiment recently. Local currency bond yields followed their US counterparts higher, complicating the RBI's task of keeping a lid on borrowing costs for the government as it taps the market for more funds to plug the budget gap. The 10-year government bond yield is up by more than 40bp year-to-date to 6.22% from its end-2020 level. Rising inflation and supply overhang should sustain the upward pressure ahead.

We are sceptical of the INR maintaining its year-to-date outperformance over the rest of the year.

Surprisingly enough, the INR has been doing relatively well so far this year despite being whipsawed in the recent risk-off bout. In fact, it has shifted to be an Asian outperformer year-to-date from an underperformer over the last few years. However, the current negative economic backdrop leaves us sceptical that the currency can maintain such performance going forward. Our end-2021 USD/INR forecast remains at 73.00 (spot 72.60).

Political risk may intensify as several Indian states head to the

polls this year.

Political uncertainty should be on the rise amid a number of state elections scheduled this year. The National Democratic Alliance, the ruling coalition led by Prime Minister Narendra Modi's Bhartiya Janata Party, is currently governing two of five states that are heading to the polls in April-May 2021. The Legislative Assembly elections in the state of Bihar held late last year was a vote of confidence in the Modi administration. Similar outcomes in forthcoming state elections should be market-friendly, though it is difficult to predict the course of Indian politics during the ongoing economic discontent against the government's chaotic handling of the pandemic.

Reforms, reforms, reforms

The Covid-19 outbreak has come as a significant setback for the Indian economy, putting the brakes on its ascent over the last half a decade. With some permanent downward shocks to consumer and investment demand, reclaiming the previous heights is going to be an extremely slow process, in our view.

Despite significant liberalisation and opening of the economy to foreign competition since the 1990s, various structural hurdles continue to hold back India's rapid growth potential. Among the prominent structural issues are the country's small manufacturing and export base, large unorganised sector, insufficient infrastructure, impediments to land and labour reforms, perennially weak public finances, twin-deficits (budget and current account), weak financial system, high level of non-performing assets of public sector banks, and the red tape and corruption above all.

The systemic excesses caused by unprecedented fiscal and monetary stimulus could worsen the perennial bad debt problem faced by public sector banks.

Adding to these issues now are the systemic excesses caused by unprecedented fiscal and monetary stimulus -- for example, a surge in liquidity and lower interest rates fuelling bank lending and with it, the risk of accelerating bad loans. Moving towards a sustainable green economy is yet another structural challenge that the authorities will have to put up with.

Moreover, the onus of furthering the economic reform agenda is almost entirely on the public sector. As such, most of the Covid-19 fiscal stimulus, worth 10% of GDP, was directed towards long-term structural reforms of critical sectors including coal, mining, power distribution, atomic energy, aviation, and space. And, like everywhere in the region, investment in sustainability or green initiatives was largely missing in all this.

Financial sector stability matters a lot for investor confidence in the economy. Abrupt policy changes, like the demonetisation in late 2016, haphazard implementation of the goods and services tax in mid-2018, and the shadow banking crisis since late 2018 are not helpful and some of these could be avoided. The shadow banking jitters are now turning into another structural headache, which together with rising non-performing loans of public sector banks, continues to

prevent the central bank from reaching its monetary goal of boosting growth without stoking inflation.

Long delays in implementing infrastructure projects, frequent cost overruns, land acquisition problems, the difficulty of harnessing private investment, etc. are well-known for holding back infrastructure development. So are weak public finances and high public sector debt crowding out private investment; unfriendly labour laws hindering private and foreign direct investments; and relatively high income-tax rates depressing consumer spending.

Without significant structural reforms, India will remain a low-middle income country in the years ahead.

Without significant structural reforms, India will remain a low-middle income country -- the per capita gross national income (GNI per capita) of about \$2,000 is near the low-end of the World Bank's \$1,000-12,000 range for middle-income countries. The FY2021 Budget initiatives of boosting healthcare and the 'future ready' rail and road infrastructure, production-linked incentives for key sectors, the boost to spending for clean cities and clean water programme, and recapitalisation of public sector banks are welcome measures to speed up the reform agenda. But these are just announcements so far. Concrete steps to have these moving forward will be a real game-changer.