The pandemic will cost India its ascent over the last half decade

The pandemic has pushed the Indian economy off the cliff. The fall is so bad that it will cost the ascent India made over half a decade. With long-lasting wounds and bruises, the climb back will be painfully slow. So, where is the country headed? Certainly, nowhere near prime minister Narendra Modi's $5 trillion vision in the near-term

Passengers come out from local trains in Kolkata, India wearing facemasks as a mandatory prevention measure against Covid-19 after the railway station was closed for nearly 8 months

Source: Shutterstock

Key takeaways

- **Covid-19:** India remains Asia's epicentre of the pandemic, as total infections look set to surpass the 10-million mark by mid-December.
- **Growth:** The worst of India's current slump may be over but recovery will be slow. The five most affected Indian states make up for about 40% of the country's GDP, which will hold back growth from a strong rebound.
- **External sector:** A silver-lining is a healthy external payments position, thanks partly to weak domestic demand and low global oil prices. But that won't be enough to move the sovereign from the negative rating watch.
- **Inflation:** CPI has bucked the regional low inflation trend as upward price pressure from supply disruptions and pro-cyclical policies outweigh weak demand due to the

high unemployment with the trend to continue going into 2021.

- **Monetary policy:** Central bank policy interest rates are at record lows and the Reserve Bank of India continues to pump liquidity to keep the economy afloat. With all efforts failing to stimulate lending, any additional policy support is likely to be in vain.
- **Fiscal policy:** Over 10% of GDP stimulus package is spending-lite, mainly focusing on structural reforms. Yet, the budget deficit is going to be through the roof in the current fiscal year and will remain elevated in the near term.
- **Politics**: Increased political anxiety amidst a number of state elections in 2021 could prove to be an added whammy for the economy and local markets.
- **Markets:** The RBI's drive to keep market yields and government borrowing costs low has paid off. The currency is benefiting from a broader emerging market rally.

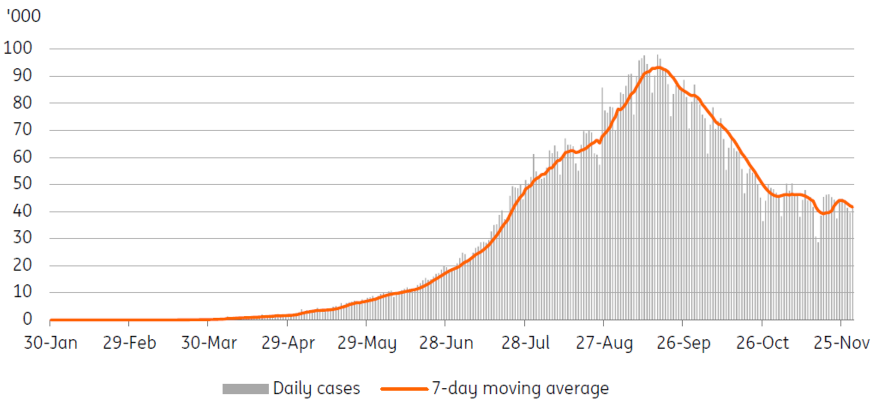
The fight against Covid-19 continues

India is the world's second-most-populous country, and living up to its name, it has become the country with the second-highest number of Covid-19 cases in the world after the USA, with total cases crossing the 9-million mark recently. The seven-day daily average new cases is currently close to 42,000 and the 10-million mark appears to be around the corner, most likely to be reached by mid-December. So far, more than 137,000 fatalities have been recorded but the official figures remain debatable. The reality could be much worse than what these numbers suggest.

While the infection curve has yet to flatten, the second wave has dampened the prospects of the pandemic being brought under control any time soon with the festive season of Diwali and recent state elections in Bihar as recent key inflection points, sending some regions back into lockdowns and curfews to curb the spread.

The mass labour migration as the first lockdown was announced, surge in joblessness and supply chain disruptions weighed on the recovery from the huge crash induced by the initial closure of the economy, and the second wave of lockdowns are now threatening to delay the recovery further.

Covid-19 - the second wave is here



Source: Worldometers, ING

Data as of 29 November 2020.

-15.7%

GDP contraction in 1H20

Year-on-year

An economy off the cliff

The Indian economy started battling the pandemic from a position of weakness.

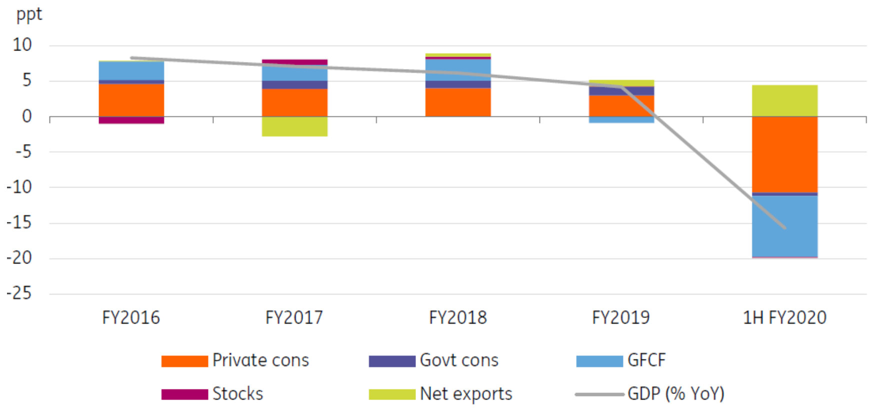
GDP growth has been on a downward drift over the last few years and crashed by a hefty -25% quarter-on-quarter seasonally adjusted rate in the April-June quarter - the first quarter of the financial year which started in April 2020 (FY20), as the nationwide lockdown slammed the brakes on the economy. The gradual easing revived activity, and GDP bounced back by 21% QoQ in 2Q20. Even then, the -15.7% year-on-year contraction in the first half of FY20 was the worst ever and also the steepest in Asia.

The slump is broad-based on both the demand and the supply sides of the economy and almost every GDP component has been hit hard

The slump is broad-based on both the demand and the supply sides of the economy and almost every GDP component has been hit hard, but private consumption and investment have suffered the largest blows. The much-hyped 10% Covid-19 stimulus was nowhere to be seen, instead, government consumption fell by 22% YoY in 2Q20. To be fair, the stimulus wasn't mean to show up anyways, as much of it was of a long-term nature. Exports also suffered from weak global demand, though weak domestic demand dented imports more, leaving net trade as the sole positive contributor to GDP growth in 1H20.

From the supply-side, services were the biggest drag on GDP, explaining almost two-thirds of the -15.7% contraction, while manufacturing made up for the rest. The agrarian economy remained surprisingly unscathed and managed some growth despite several natural disasters, including flooding and cyclones.

Explaining the record GDP plunge



Source: CEIC, ING

Bars may not stack up to total GDP growth due to statistical discrepancy.

Not out of the woods just yet

Like elsewhere in Asia, the worst of India's slump is certainly behind it, however, a large part of the economy continues to be reeling.

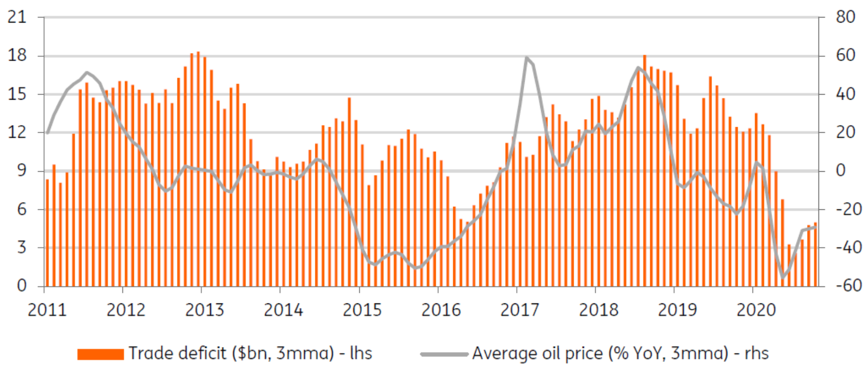
The five most affected Indian states at the time of writing are Maharashtra, Karnataka, Andhra Pradesh, Tamil Nadu and Kerala – in that order, which coincidentally make up about 40% of the country's GDP and economic activity in some of these and other states remain partially stalled. In Maharashtra, home to the financial capital Mumbai and with the biggest share in total GDP i.e. 14%, the existing lockdown has now been extended until 31 December 2020.

India's exports plummetted by a whopping 17% YoY in the first 10 months of 2020 – the steepest in Asia and unfortunately it lacks the export support that some of its Asian neighbours have recently started enjoying. The decision to stay out of the Regional Comprehensive Economic Partnership (RCEP) trade deal will also deprive the country of any potential benefits of this intra-regional free trade, although there might not but much to reap here given the existing bilateral trade agreements, which partly reduces incremental benefits. Therefore, the small share of exports in GDP and low exposure to China insulate it from the risk of any trade or technology war.

> *Without a material improvement in the underlying economic fundamentals, it's going to be a tough path for the INR going into 2021*

Meanwhile, weak domestic demand and subdued global oil prices should sustain weak imports and narrower trade deficit trends well into 2021. The current account posted a record surplus of $20 billion in 1Q20, which with a huge stockpile of foreign exchange reserves of over $500 billion, the external payments position should continue to be comfortable. However, this hasn't prevented international credit rating agencies from cutting India's sovereign rating outlook on the grounds of slow growth and deteriorating public finances. In turn, the negative rating overhang has been an added whammy to a beleaguered Indian rupee, sustaining it as an Asian underperformer, the status it has held over the last few years. Without a material improvement in the underlying economic fundamentals, it's going to be a tough path for the INR going into 2021 as well.

Lower oil price, narrower trade deficit



Source: CEIC, ING

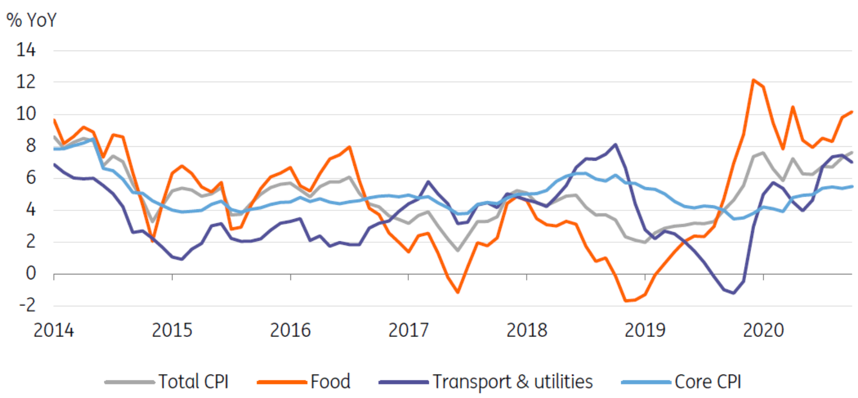
Rising inflation

The demand destruction due to Covid-19 drove CPI inflation lower in much of Asia.

But not in India, where it has almost doubled this year. The supply disruption during lockdowns and panic buying pushed consumer prices higher, which meant inflation crossed the central bank's 6% policy limit in every month this year except one through to October. Latest data for October puts inflation at 7.6% YoY, bringing the year-to-date FY20 average to 6.9% as against 3.5% over the same period of FY19.

High food and transport prices have been the main problems. Lower global oil prices might have been a godsend from the trade perspective but the transmission of these to domestic prices was pared by pro-cyclical policy such as administrative hikes in retail prices of petrol and diesel. Even as high unemployment and weak consumer confidence continue to play its parts in suppressing demand, the upward price pressure are unlikely to abate anytime soon.

What's driving inflation higher?



Source: CEIC, ING

What more can the Reserve Bank of India do?

Policy interest rates at record lows, the banking system is swamped with liquidity and there is commitment to support augmented government borrowing to fund the budget deficit.

The prevailing fiscal policy constraints in helping the economy turn the tide saw the central bank taking the lead in providing stimulus during the pandemic. A significant portion of the 10.5% (GDP equivalent) "total stimulus package" was, in fact, made up of monetary measures.

Besides conventional measures, including a total of 115 basis points of policy interest rate cuts and 100 bps of cut to banks' cash reserve requirement from March to May, the RBI also resorted to unconventional policy measures in its drive to support financial system liquidity. However, the central bank's unconventional easing measures were far from outright quantitative easing or direct deficit financing.

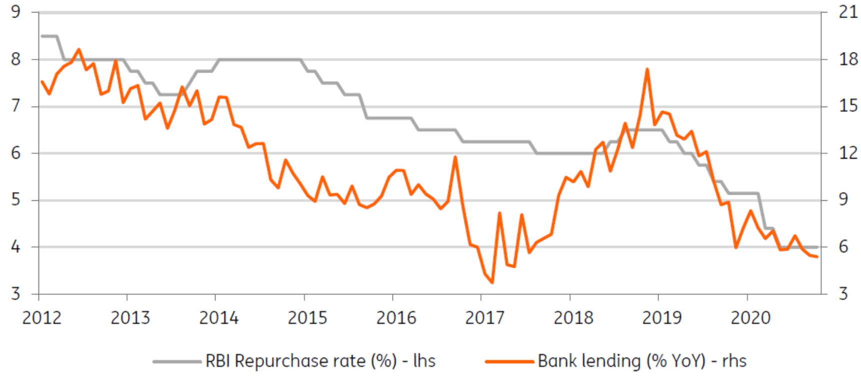
> *The monetary policy guidance in October emphasised the need to see through temporary inflation pressures and also maintain the accommodative stance at least during the current financial year and into the next. - RBI Governor Shaktikanta Das*

Rising inflation forced the RBI to pause the rate cut cycle at the August meeting, leaving the repurchase rate at 4.00% and reverse repo rate at 3.35%, there is no change to the accommodative policy stance, however, which the central bank has noted to remain "as long as it is necessary to revive growth and mitigate the impact of Covid-19 on the economy while ensuring that inflation remains within the target going forward". Nor is there any let-up in the RBI's liquidity boosting operations. The central bank announced more steps towards this in the last policy meeting in October.

While the banking system is flooded with liquidity, high inflation has pushed real interest rates into negative territory. India's real rates are the most negative in Asia but there are no buyers for cheap funds and bank lending growth continues to slow, which suggests, additional stimulus won't be of much use, as confidence needs to return first.

Exploring the depth of Asia's unconventional central bank easing

Aggressive easing failed to stimulate loan demand



Source: CEIC, ING

Fiscal stimulus only looks big

In response to the crisis, the Indian government tried to match its macro-policy response with its Asian peers but the stimulus – more than 10% of GDP was more hype than reality. The real (on-budget) spending was meagre and concentrated on structural reforms of critical sectors including coal, mining, power distribution, atomic energy, aviation, and space. The reforms will be beneficial for the economy over the longer-term, but not instantly. And, like everywhere in the region, the investment in sustainability was largely missing in all this, with barely any emphasis on green initiatives or meeting any of the near-term environmental goals.

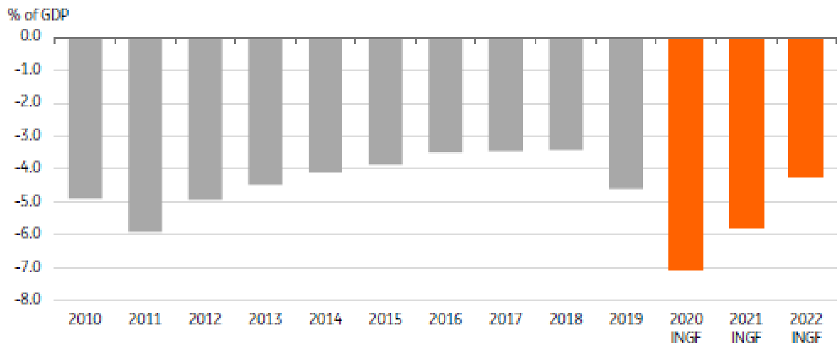
Our deficit forecasts for the next fiscal year is 5.8%

The government's budget deficit is going to be through the roof in the current fiscal year, wiping out any consolidation over the last few years. The cumulative deficit in the first seven months of the current fiscal year was up 45% YoY and reached 120% of the original budget goal set for the entire year. This comes as revenue took a big hit with a 24% YoY plunge and spending were steady at the year-ago level. We are looking for the full-year deficit of 7.1% of GDP, up from 4.6% in the last year and double the official target of 3.5% for this year.

While it's premature to think about any fiscal consolidation in the next year, the insufficient stimulus is going to hold back recovery and keep the fiscal deficit as a proportion of GDP elevated. Our deficit forecasts for the next fiscal year is 5.8%.

Asia's lamentable green response to Covid-19

Derailed public finances - fiscal deficit as a percentage of GDP



Source: CEIC, ING

Where is stimulus going?

Total Stimulus 10.5% of GDP: On Budget 2.9%, Monetary 7.5%, Green 0.5%

Stimulus measures	Rs bn	Stimulus measures	Rs bn
Micro, small, and medium enterprises	**5,946**	**Migrant workers, vendors, and farmers**	**3,100**
Collateral free loans	3,000	Food supply for migrant workers	35
Subordinate debt provision	200	National portable ration card	-
Equity infusion fund	600	Rental housing for migrant workers	-
EPF support for 3 months	25	Interest subvention of 2%	15
Cut in statutory EPF contribution	68	Credit facility for street vendors	50
Special liquidity scheme for investment in NBFCs	300	Housing subsidy for middle-income group	700
Partial credit guarantee for NBFCs	450	CAMPA funds for tribal employment	60
Liquidity injection for power distribution cos	900	Working capital facility for farmers	300
TDS reduction	500	Concessional credit to farmers	2,000
Farming, marine, and dairy infrastructure	**1,500**	**Structural reforms of 8 critical sectors**	**81**
Fund for farm gate infrastructure	1,000	Enhancing coal production	-
Micro food scheme	100	Enhancing private invest in mining	-
Marine and inland fishery	200	Indigenisation of defence production	-
Vaccination of livestock	133	Promoting PPP in aviation	-
Dairy infrastructure	150	Privatisation of power distribution cos	-
Herbal and medicinal plantation	40	Viability gap fund for social infrastructure	81
Bee keeping	5	Boosting PPP in in space sector	-
Operation greens	5	Atomic energy development with PPP	-
Other government measures	**2,328**	**Monetary stimulus – RBI measures**	**8,016**
Rural development scheme (MGNREGS)	400	TLTRO - two auctions of 500bn each	1,500
Enhancing online education	-	100bp CRR cut to 3%	1,370
Exemption of Covid-related debt from IBC	-	Increase MSF from 2% of SLR to 3%	1,370
Increase in borrowing limit for states	-	Financing window for NBFCs	500
Decriminalising companies act	-	Variable repo operation	1,760
Others previously announced (PMGKP)	1,928	Others	1,516

Source: Ministry of Finance, Reserve Bank of India, and newswires

Political anxiety

Increased political uncertainty amidst a number of state elections next year may well be an overhang on markets. The National Democratic Alliance, the ruling coalition led by Prime Minister Narendra Modi's Bhartiya Janata Party, is currently governing two of five states as the country heads to the polls in April-May 2021.

The recent Legislative Assembly elections in the state of Bihar 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.

Underperforming markets

The central bank's drive to keep market yields and government borrowing costs low has paid off.

'Operation Twist' (selling short-term bonds and buying long-term ones), targeted repo operations, special financing window for non-bank finance companies – all helped to mitigate the upward pressure on yields from a record government borrowing issuance. Helping this further was the government's decision to leave its borrowing plan for 2H20 unchanged at the original target of INR 4.34 trillion as against market expectations of about 20% increase over that. The total borrowing for the year is earmarked to be INR 12 trillion.

> *The central bank's drive to keep market yields and government borrowing costs low has paid off*

However, the bond market appears to be in limbo in a sense that the RBI has been defying investor demands for higher yields to compensate for a supply glut as well as high inflation. The central bank rejected all bids in four consecutive 10-year government bond auctions since August. Clearly, the RBI has gained an upper hand as excess liquidity finds its way into some investment channels and government bonds still remain a safer bet in an uncertain economic environment. The benchmark 10-year yield has been firm in a narrow 5.8-6.0% trading range over the last three months. That said, we expect the latest inflation spike to reassert an upward bias on yields moving into 2021.

Meanwhile, weak growth outlook and worsening public finances have fuelled sovereign downgrade risk. Moody's and S&P have spared no time in placing India's Baa3/BBB- rating under negative watch in June. While the INR has been under pressure from all sides, it isn't entirely ignored by investors in the ongoing emerging market rally. Even so, the INR is still Asia's weakest currency this year with a 3.6% year-to-date depreciation and there are no strong reasons to expect it to move up the ranks over the next year.

As the worst year in the country's history comes towards an end, India's economic situation doesn't look very promising.

> *Even though we forecast over 7% GDP growth next year, India's economic situation doesn't look very promising*

The continued Covid-19 spread, lack of additional macro-policy support and persistently weak economic confidence suggest it's going to remain behind the curve in Asia's post-Covid bounce back. Externally, geopolitics, the trade and tech war will be continuous headwinds to the recovery and escalating tensions on the border with China could yet be another dampener. And with several state elections lined up next year, the domestic political risk cannot be ruled out either.

That said, we forecast over 7% GDP growth next year. But that is likely to be a transitory bounce from the favourable base effect rather than underlying economic strength.

Key economic indicators and ING forecasts

India (FY starting April)	FY18	FY19	FY20F	FY21F	FY22F
Real GDP (% YoY)	6.1	4.2	-10.8	7.5	5.6
CPI (% YoY)	3.4	4.8	6.8	5.5	4.9
Fiscal balance (% of GDP)	-3.4	-4.6	-7.1	-5.8	-4.2
Public debt (% of GDP)	69.6	72.3	83.0	78.9	75.5
Current account (% of GDP)	-2.1	-0.9	1.7	0.8	0.3
FX reserves (US$ bn)	385	442	540	563	580
External debt (% of GDP)	20.0	19.5	23.0	22.0	21.0
RBI repo rate (%, eop)	6.25	4.40	4.00	4.00	4.00
3M T-bill rate (%, eop)	6.14	4.23	3.20	3.40	3.60
10Y govt. bond yield (%, eop)	7.35	6.14	6.20	6.60	6.90
INR per USD (eop)	69.17	75.39	74.60	73.30	73.00

Source: CEIC, ING forecasts

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