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India - How is the world's fifth economy dealing with Covid?

Too early to say that India's growth story is over

Perhaps the biggest surprise from India's latest release of GDP data was the fact that growth of 3.1% YoY in the January-to-March quarter, well above consensus expectations of 1.6% (though in my view, a revision is likely). For the fiscal year as a whole (which ends on March 31), FY20 GDP was + 4.2% (from + 6.1% in FY19). The problem is that the lockdown started in India around March 20 (distorting only around 11% of the quarter), suggesting that the activity would have ben running at 89% of its potential pace in the whole quarter. According to this, 1Q20 growth should have been fixed at 3.61% yoy (well above the actual +3.1%). This is why some argue that behind the sharp slowdown lies an underlying weakness in the Indian economy. We believe that it is still too early to affirm such a thing, as not only domestic lockdown has affected the economy, also external (previous) lockdowns likely caused great distortion in India's activity. Looking ahead to 2Q20, a sharp drop of -7.5% QoQ is expected, and for FY2021 as a whole, the figure could be -5%.

Difficult to see a quick recovery. What thereafter?

The "red zones" of the country that are likely to make the slowest exit from lockdown account for more than 50% of the economy. Unemployment rate now stands at an estimated 25%, and many of those unemployed workers, including tens of millions of now-penniless rural migrants, could be reluctant to return immediately to their jobs in factories after fleeing the cities, often on foot. The pertinent question is what the monetary policy and RBI's rate cuts will achieve. Admittedly, liquidity injections and refinancing windows have so far failed to channel much credit to the real economy. But it is too early to conclude that these policies will fail. We have attended experiences in other countries (such as China), where liquidity and credit injections also took time to take off, and despite this we have seen favorable behavior of the economic aggregates afterwards. We will have to be patient to see if, as in other countries, this monetary facilitation gets its results. Maybe, my main concern after borrowers being offered a six-month repayment moratorium, is that another spike in NPLs could be around the corner. In my view this is the most worrying aspect, given the more precarious situation of banks in India. Could be a good opportunity to see if Modi's financial reform, (bankruptcy and insolvency law), helped to strengthen the banking system.

Fiscal. Modi's government decided against a populist fiscal splurge. This may save India from rating cuts.

Modi's government decided against a big fiscal spending to arrest the economic slowdown, relying on monetary policy to keep the economy afloat. This policy mix is good for bonds and credit conditions, while bad for the currency (an effect, which perhaps has been consciously sought to stimulate the external sector's contribution). The fiscal measures announced under the government's headline INR20trn stimulus package primarily took the form of loan guarantees and liquidity injections rather than direct fiscal spending, and could end up representing no more than 1% of GDP. This may save India from a credit derating—though a deep recession could hit government revenues hard. There has been no revision to the official deficit target of 3.5% in FY21. But with revenues collapsing, the actual headline deficit will likely exceed the 6.5%.

India is well-positioned to deal with an external shock

India is not as dependent on trade as its regional peers. With the basic balance back in positive territory and the RBI sitting on US$450bn of foreign exchange reserves, India is well-placed to ride out external shocks.

Bond market and Equities

The RBI has cut rates by 115bp so far this year and promised further cuts if inflation continues to decelerate. Inflation is likely to remain contained, allowing the RBI to deliver on its pledge. As a result, short-term bond yields continue to head lower (due to rate cuts INR8trn of liquidity infusions). Prospects are for bonds to perform well, not only due to outright debt monetization, but also because these bonds still offer high relative yields and positive real rates, and policymakers have relaxed limits on foreign participation, as well as explicitly stated its aim of getting its debt included in global bond indexes, which would lower funding costs.

Equities rebounded recently after their comparatively lackluster recovery. One piece of good news is that the sell-off this year has brought about a much-needed reset of valuations, with both price-to-earnings and price-to-book ratios now at multi-year lows. If India had a convincing plan to get back to structural nominal GDP growth of 10%, most foreign investors would be happy to consider paying a small premium to own Indian equities