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India: Growth returns, but challenges remain

Policy is supportive but COVID-19 and geopolitics weigh on the country's outlook

Shirley Shen,
Economist (Non-China Asia)
Macro Research – Core Investments

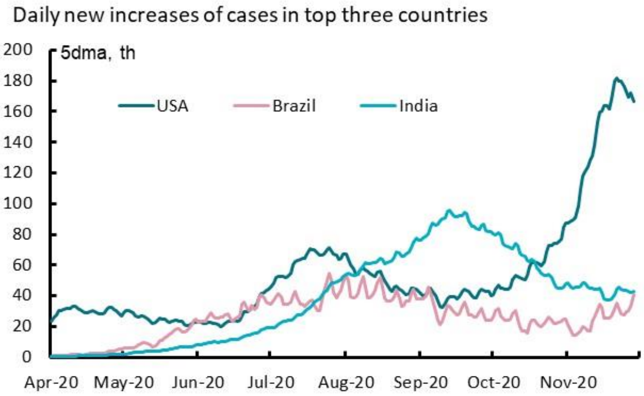
Key points

- The Indian economy has been severely impacted by the pandemic. But recent counts of daily increases suggest India has passed its first peak of COVID-19 cases
- Real GDP growth has improved sharply from -24% year-on-year in the June-quarter to -7.5% in the September-quarter, but near-term challenges remain
- Sluggish domestic and external environments will likely serve as key drags on Indian growth. We expect growth to contract by 9% in FY21 before rebounding to 8% in FY22
- Near-term risk surrounds the ongoing containment of the pandemic, which could weigh on domestic demand on the back of virus fears and income uncertainty
- Geopolitical conflict remains tense, with India imposing economic sanctions against China. Under the current situation, these could exacerbate domestic condition

India passed its first peak of COVID-19 cases

2020 will be an unforgettable year as the sudden shock of the COVID-19 pandemic has caused sizeable and long-lasting disruptions to the global economy. India was no exception. In fact, with many countries now seeing easing infection rates, India's daily COVID-19 cases appears to have also passed its first peak (Exhibit 1). However, the number of active cases remains elevated and India still has the second-largest number of cases globally, behind the US.

Exhibit 1: Daily rises in COVID-19 cases have peaked



Source: WHO, Worldmetrics, and AXA IM Research, Dec 2020

As of now, the number of cumulative coronavirus cases has surpassed 9.5 million, more than double that of less than three months ago. The total recorded COVID-19 related deaths have now crossed 130,000, but the fatality rate has been falling since August to 1.5% and continues to remain much lower than the global average of 3.2%, according to official figures. In addition, the daily growth rate of cases has also fallen below 1%, the fifth highest globally.

The government continues to significantly ramp up its testing infrastructure and is now carrying out one million tests a day. In addition, as recent Google Mobility indices suggest, activities have been gradually normalising since the end of the more than two-month-long nationwide lockdown in June. Notably, grocery and pharmacy mobility indices are already back to pre-pandemic levels. On 1 September, unlock 4.0 was announced, easing guidelines even further. Railway freight, passenger vehicle sales, petrol demand and manufacturing Purchasing Managers' Indices (PMI) have all signalled a rebound following the easing of these restrictions.

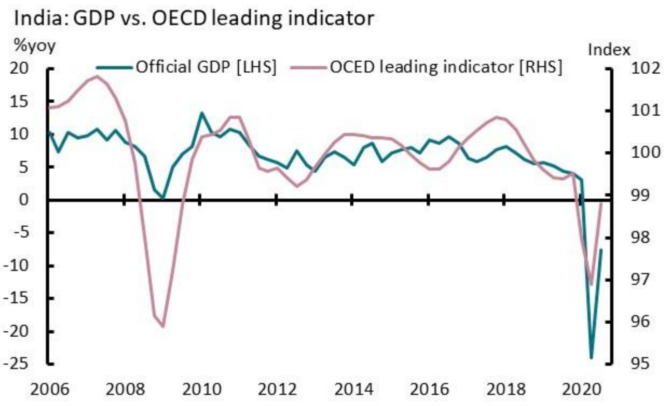
Overall challenges remain in terms of battling the pandemic, and the risk of a second wave of the virus lingers. However, given the economic costs of the nationwide restrictions, the unlocking process will continue to take place slowly.

Near-term economic challenges, but long-term outperformance

While Indian economic activity has gained some traction recently, the record spread of the outbreak, lingering local movement restrictions, rising uncertainty and the already-slowing domestic economy even prior to the onset of the pandemic, lead us to expect that the post-virus recovery will be very gradual.

With target GDP growth in excess of 8%, the actual growth rate had already slowed to 4.1% year-on-year (yoy) by the end of 2019. This year, the global pandemic has delivered a crushing blow to the Indian economy, reducing growth to -24% by mid-2020 (Exhibit 2). Not only was this the worst contraction on record, but it was also the deepest globally, reflecting the highly domestic-oriented nature of the economy, leaving it more susceptible to the pandemic. Although growth in the July-to-September quarter marked a significant improvement to -7.5%, the outlook for India remains challenging. Going forward, we expect the sluggish domestic and external environment to serve as key drags on Indian growth, which is projected to contract by 9% in FY21 before rebounding to 8% in FY22.

Exhibit 2: Sharp growth deceleration due to COVID-19

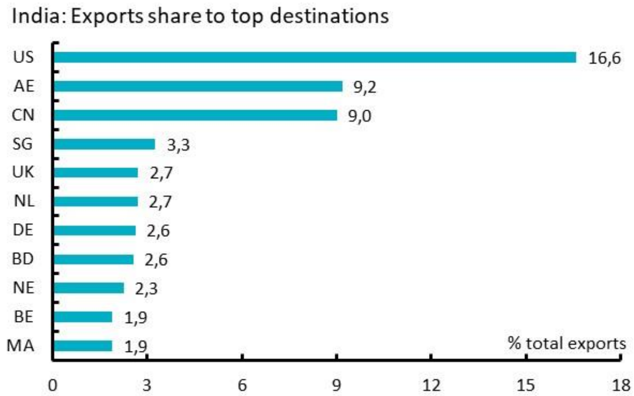


Source: CEIC, OECD, and AXA IM Research, Dec 2020

The unprecedented nationwide lockdown in India significantly disrupted domestic economic activity. Of the top five states that have contributed nearly 75% of coronavirus cases in India, three of them (Maharashtra, Tamil Nadu and Delhi) contribute close to 40% of the country's GDP. As the lockdown has been progressively eased, economic activity has started to regain momentum, with broad-based improvement across high-frequency indicators such as electricity consumption, electronic waybills, Goods and Services Tax (GST) collections, rail freight and auto sales. The manufacturing PMI also rebounded strongly to 58.9 in October, marking the highest reading since October 2007. Meanwhile, labour market conditions also reflect signs of improvement with a falling unemployment rate, though it is yet to catch up with pre-pandemic levels.

Externally, both exports and imports experienced the sharpest declines, contracting by around 60% on an annual basis in April. The slowdown was broad-based, both on a country as well as product level. However, the easing of pandemic-related restrictions globally has resulted in some slight recovery of export growth in recent months. The new export orders component of the PMI saw an obvious rebound from the April lows, rising smartly in November to 54.8, signalling expansion. Going into year-end, we expect export growth to maintain a slow-paced recovery on the back of improving demand from China and developed markets. However, the still-accelerating spread of coronavirus cases globally will limit the pace of the recovery.

Exhibit 3: Sluggish exports to key destinations



Source: CEIC, and AXA IM Research, Dec 2020

Despite the weakening macroeconomic momentum, headline inflation has remained elevated, suggesting a large pandemic-led supply-shock. Going forward, inflation is likely to slowly soften due to easing pandemic related supply effects, the base effect and soothing food prices supported by related policy measures. Even so, the figure will likely remain elevated, averaging around 5% to 5.5% for the remainder of FY21. Risks will also be skewed to the upside driven by a robust growth recovery. Since the lockdown, the Reserve Bank of India has lowered its policy rate by 115 basis points (bps) to 4%, with the latest cut delivered in May. The official policy statement acknowledged the severe damage to economic activities based on the trend in high-frequency data. On balance, we believe the dovish stance remains, and as inflation starts to soften, we expect another 50bps of cuts by end-FY21.

Fiscal policy has also been supportive. In May, Prime Minister Narendra Modi announced a special economic package called 'Atmanirbhar Bharat' (Self-reliant India), totalling around 10% of GDP. Although the headline stimulus seemed impressive, a breakdown suggests that liquidity support and credit guarantee measures accounted for almost three-quarters of the total. Direct fiscal support was only 10% of the package, roughly 1% of GDP. Going forwards, fiscal slippage is likely to continue as revenues remain under pressure and expenditure keeps rising. On the last day of June, Modi announced an extension of the free food grains scheme for qualified households for an extra five months, taking the food grains-based support bill to 0.8% of GDP from 0.3% of GDP. As of now, the government's fiscal stimulus so far is tracking at around of 1.4% GDP.

Nevertheless, India's economy is likely to achieve a strong recovery following the deep contraction this fiscal year - we forecast real GDP growth of 8% in FY22. The economy is progressively opening up and supply-side constraints are easing incrementally. In addition, India's long-term outperformance highlights its resilience. The wide range of structural trends, including ongoing labour supply growth and competitive unit labour costs, all work in its favour. A more favourable corporate tax regime, which is particularly supportive of manufacturing firms, should reinforce growth, alongside additional fiscal and monetary easing.

However, in the near-term, the bigger challenge in India lies within domestic demand, which remains weak as virus fears and income uncertainty are set to weigh on economic activity. Moreover, risks will continue to surround the ongoing containment of the virus as activity recovers, particularly in an economy which faces substantial hurdles to delivering mass inoculation in 2021. India could face a second and even a third wave of the outbreak next year.

Long-term obstacles and political challenges

While the near-term challenges could hinder a strong recovery, India also faces a range of longer-term challenges. These include global financial stability (such as corporate insolvency and bankruptcy issues given India's high indebtedness), institutional issues including - but not limited to - corruption, ineffective tax systems, lagged economic development compared to other emerging markets in Asia, trade war risks and geopolitical concerns. All these elements could create additional burdens preventing India from achieving its full potential recovery path.

Initially, Prime Minister Modi embarked on strong growth-enhancing measures. After taking office, he ended an era of socialist-style planning by abolishing the Planning Commission and introduced the India Reform Association, through which he began to introduce more market-oriented measures. Not only has he implemented demonetisation and GST reform, Modi also ushered in economic reforms and launched a "Made in India" campaign to encourage companies to manufacture products domestically. By 2019, India stood as the world's ninth largest recipient of foreign direct investment. In addition, the continuous focus on sanitation and infrastructure projects improved the lives of many villagers, which combined with the improvement of power facilities has pushed India's GDP to an astonishing average of 7% during Modi's tenure.

In 2019's general election, the Bharatiya Janata Party-led National Democratic Alliance swept to victory by winning more than 350 seats. In the first year of Modi's second term, the government has taken several key political decisions. More recently, locust plagues – which can have devastating impacts on agriculture, representing 16% of the Indian economy - as well as military border conflicts have disrupted India's economy. The conservative budget has been criticised, and setbacks in stimulating investment and exports suggest that Modi is finding it difficult sustaining his second 'economic miracle'.

On the geopolitical front, tensions between India and China re-emerged in early 2020. In February, India introduced a tariff policy restricting the import of Chinese goods. Later, the government launched the "Indian goods – our pride" campaign against China-manufactured products, before implementing 100% customs clearance checks on Chinese goods and banning more than 200 Chinese mobile phone applications, including TikTok and WeChat. Taken together, Modi's actions appear in reaction to China's own "Made in China" policies.

However, tensions between India and China have not been limited to trade. Renewed border tension in the Himalayan mountain range began in June and the conflict seems to have only exacerbated as both sides appear to dig in for a long winter. Both India and China are strengthening their armed forces and infrastructures in conflict areas to cope with escalating tension, as well as to prepare themselves for the upcoming severe winter season. However, with limited armaments and winter supplies, India is unlikely to endure large-scale military conflict in the coming months.

On the other hand, India continues to enact economic boycotts against China. In addition to its withdrawal from the new Regional Comprehensive Economic Partnership agreement (RCEP), India has also prohibited Chinese companies from participating in key investment areas such as road construction projects. Like all protectionism, this has had a domestic cost for India, with Indian companies, constrained by the pandemic, unable to fulfil cancelled imports. Under the current circumstances, these boycotts will likely exacerbate domestic conditions further.

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