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India economic forecast: Could there be light at the end of this tunnel?

December 2020

Contents

Second-quarter GDP data reveals interesting conundrums

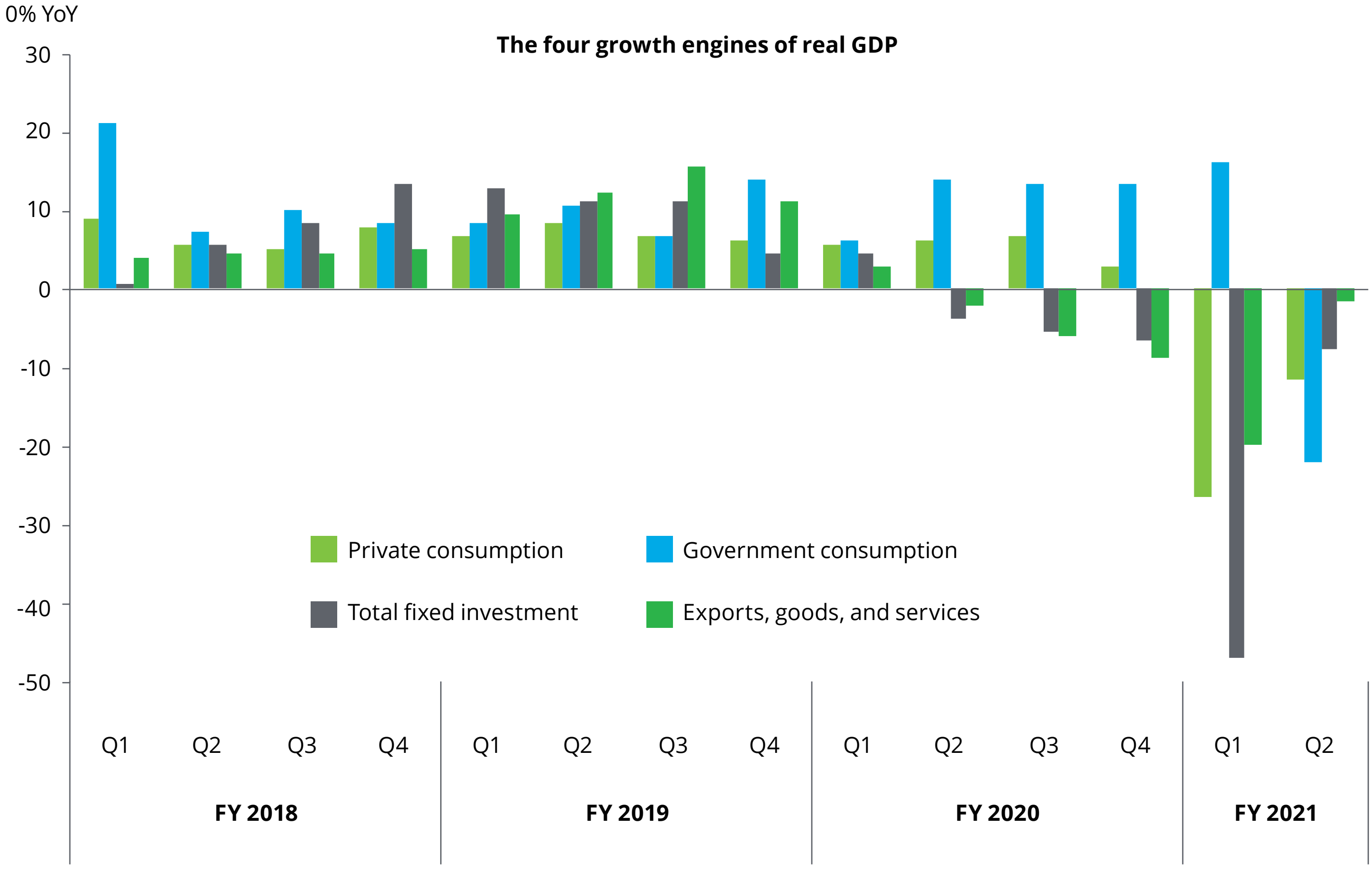
COVID-19 has weighed down on economic growth in the first two quarters of FY2021, which is no surprise. India was amongst the few countries that went into a nation-wide lockdown post the pandemic, and after that, the economy unlocked in phases during these two quarters. Mobility restrictions and social distancing led to unparalleled supply-chain disruptions and consumer demand fallout (figure 1). What is encouraging is that after a year over year (YoY) decline of 23.9 percent in Q1 FY2021, the economy contracted by 7.5 percent in Q2. This is because the recovery in Q2 turned out to be stronger than what was anticipated by a majority of market analysts.

Nevertheless, several downside risks persist, and it will be important to charter the probable medium-term growth outlook for the economy. We project growth that may rebound in double digits in FY2022 after a contraction in FY2021. However, GDP levels may continue to remain below projected levels at pre-pandemic growth rates during our forecast horizon.

Coming to the analysis of the second quarter GDP, the contraction may have turned out to be better than market expectations. However the devil lies in the details. On the demand side, the quarter saw its first sharp contraction of 22.2 percent in government spending (consumption + investments) since Q4 FY2015, which is counterintuitive, given rising government spending since the pandemic. Private domestic demand contracted, but not as much as in Q1. Private consumer spending dropped by −11.3 percent and gross fixed capital investment by −7.3 percent. The falling volume of global trade reduced exports by −1.5 percent, but the decline was significantly lower than the previous five quarters. Falling domestic demand and oil prices led imports to contract (−17.2 percent) faster than exports. Therefore, net exports added to the GDP.

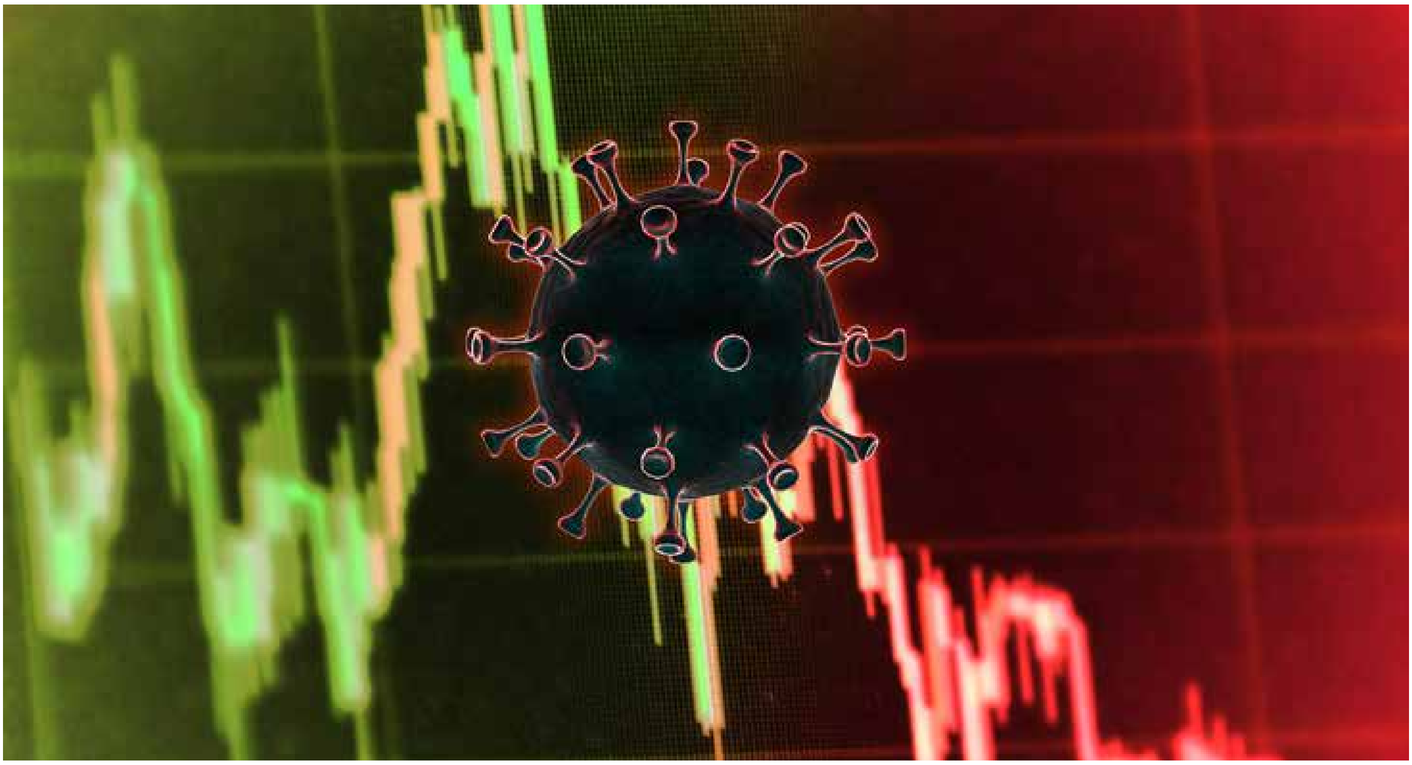
On the industry side, manufacturing and agriculture sectors reported marginal but positive growth. The manufacturing sector grew by 0.6 percent, while the agricultural sector maintained its growth momentum at 3.4 percent. The services sector, which contributes 55 percent of the GDP contracted by −11.4 percent. As expected, the “trade, hotels, transport, communication, and services related to broadcasting” were the hardest-hit services sub-sectors that contracted by −15.6 percent. That said, the “financial, real estate, and professional services” sub-sectors contracted by −8.1 percent, which was higher than the contraction in Q1. This suggests a lagged impact of the pandemic on the financial sector, even as remote working due to intermittent lockdowns continued to impact professional services. The “public administration, defence, and other services” also registered a higher decline of −12.2 percent than in Q1.

Figure 1. With GDP contracting for two consecutive quarters, India is technically in recession



Source: Center for monitoring Indian economy, Deloitte Research, December 2020,

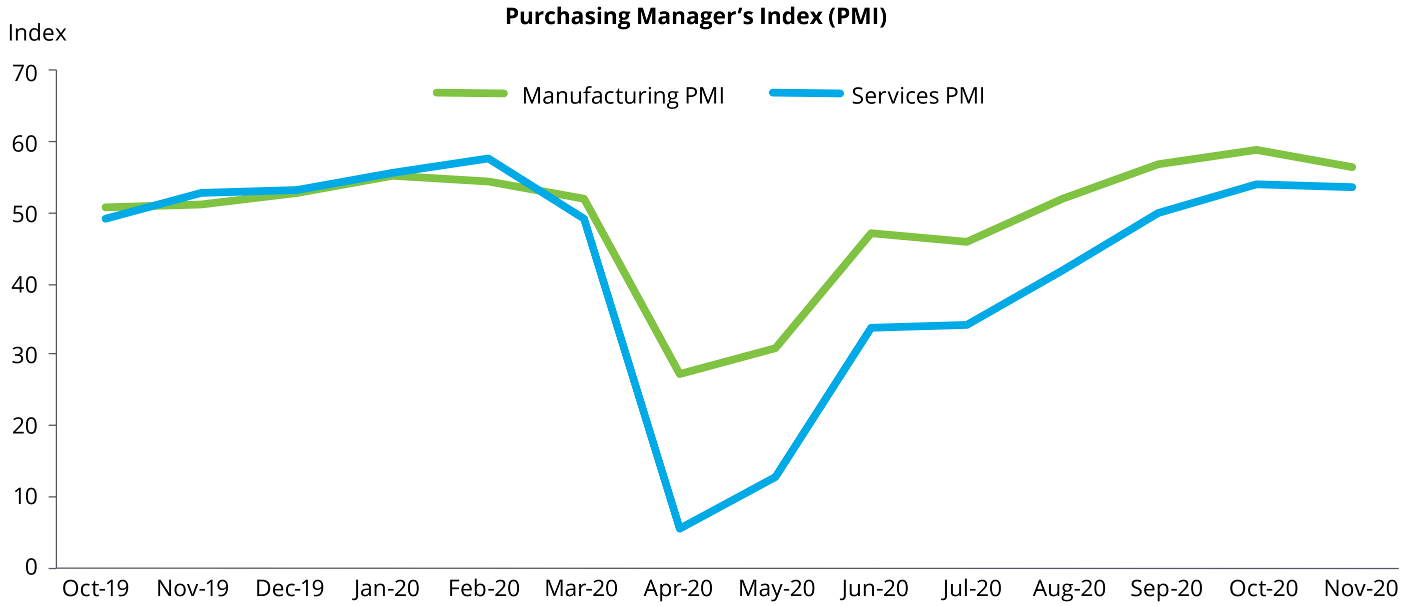
With such a large contraction in the first half of the fiscal year, expecting a contraction for this entire fiscal year relative to the previous is discernible. The concerning question is if the economy is on the path to recovery. Since the quarterly GDP data is released with a two-month lag, we should look at these numbers in the rear-view mirror, keeping in perspective what recent high-frequency data is implying and we do have both good and bad news.



The good and the bad...

The good news is that high-frequency data suggests that economic activity has been picking up pace lately. Since September, restrictions on inter-state movements were lifted to ensure mobility of goods, thereby easing supply-side pressures. This is also reflected in the industrial activity pick-up. The Purchasing Managers' Indices (PMI) for both industry and services suggest expansion (above 50; figure 2). Stronger car sales, rising finished steel production and diesel consumption, and higher goods and services tax revenue collections suggest that even though economic activities are still below pre-COVID-19 levels, pent-up demand and festivities have added to buoyancy in economic activity.

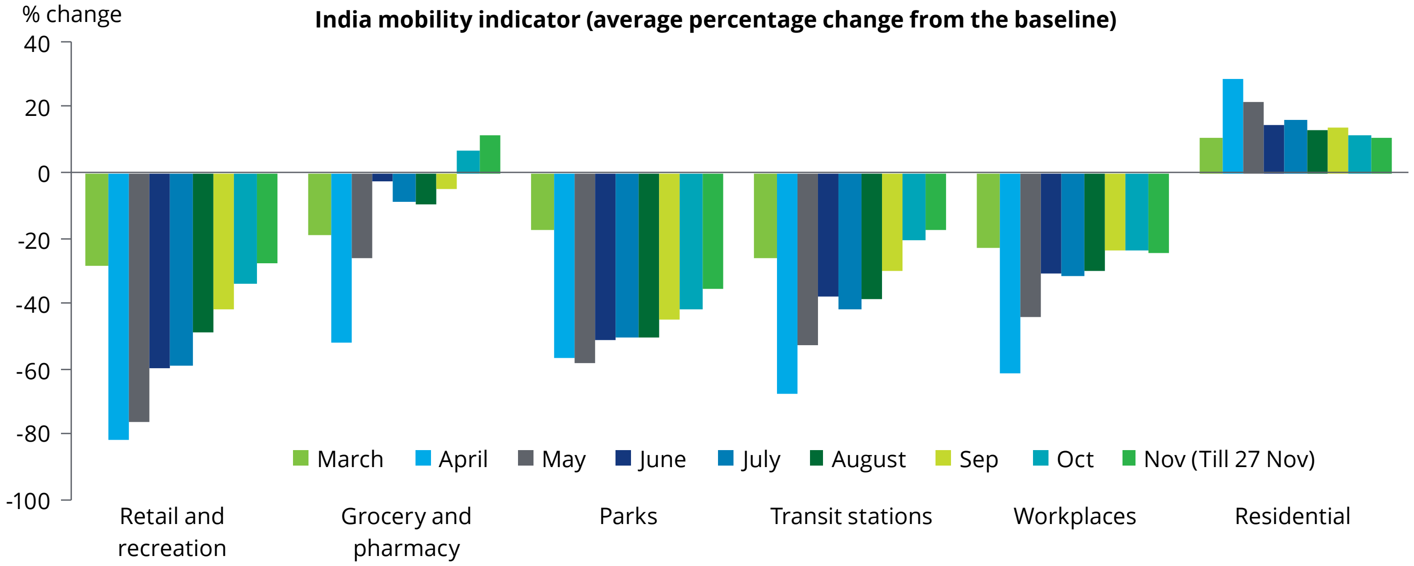
Figure 2. Economic activity is resuming, buoyed by pent-up demand and festival-related spending



Source: Center for monitoring Indian economy, Deloitte Research, December 2020,

The *bad news* is that significant uncertainties linger on demand sustainability. People's movement remains restricted due to fewer flights and trains plying across states. The google mobility index suggests that mobility in residential areas improved relative to February, but people have been avoiding parks, recreational areas, and transit stations as they are worried about falling sick (figure 3). Evidently, high infection rates and health-related anxieties are keeping consumers from spending on travel, entertainment, and leisure.

Figure 3. Mobility is improving around residential places and for essential needs only

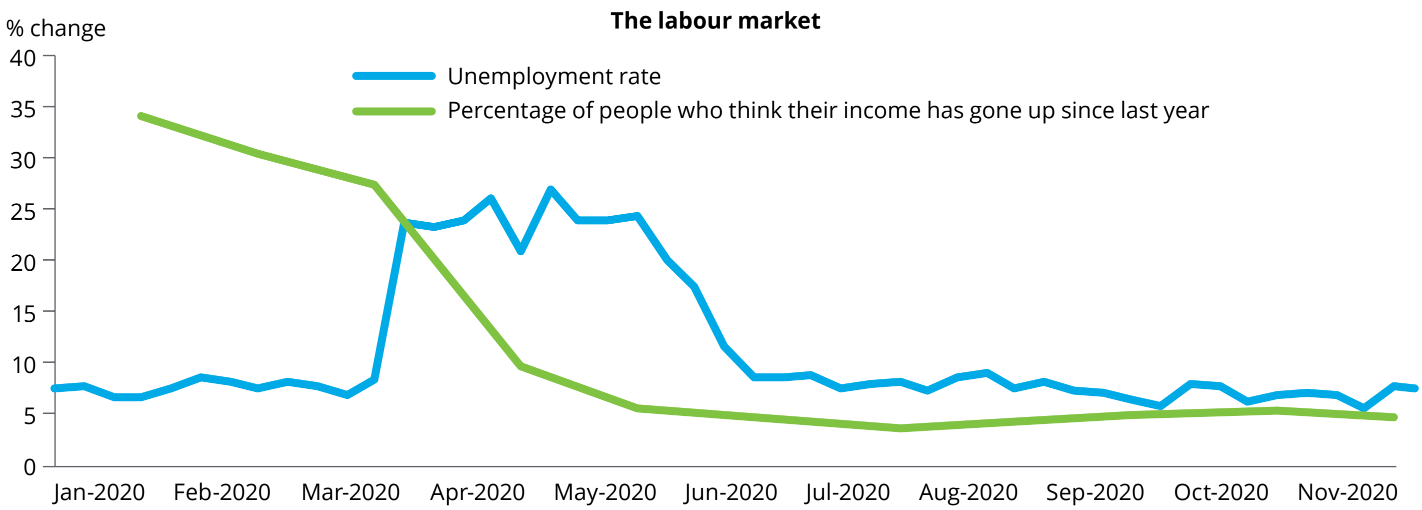


Note: The baseline is the movement in February which is set to 0.

Source: Center for monitoring Indian economy, Deloitte Research, December 2020,

The purchasing power of consumers has been impacted as well. The extent of a falling unemployment rate since April and May, as seen in figure 4, is desirable. However, concluding that we are *"well into the usual"* about the labour market should be taken with a pinch of salt. Labour force participation has been on a decline, indicating that a large segment of the working population is now out of the labour market and discouraged from looking for jobs. The number of people who feel wealthier, compared with last year, has declined sharply. In other words, the negative wealth effect could be impacting their ability to spend more.

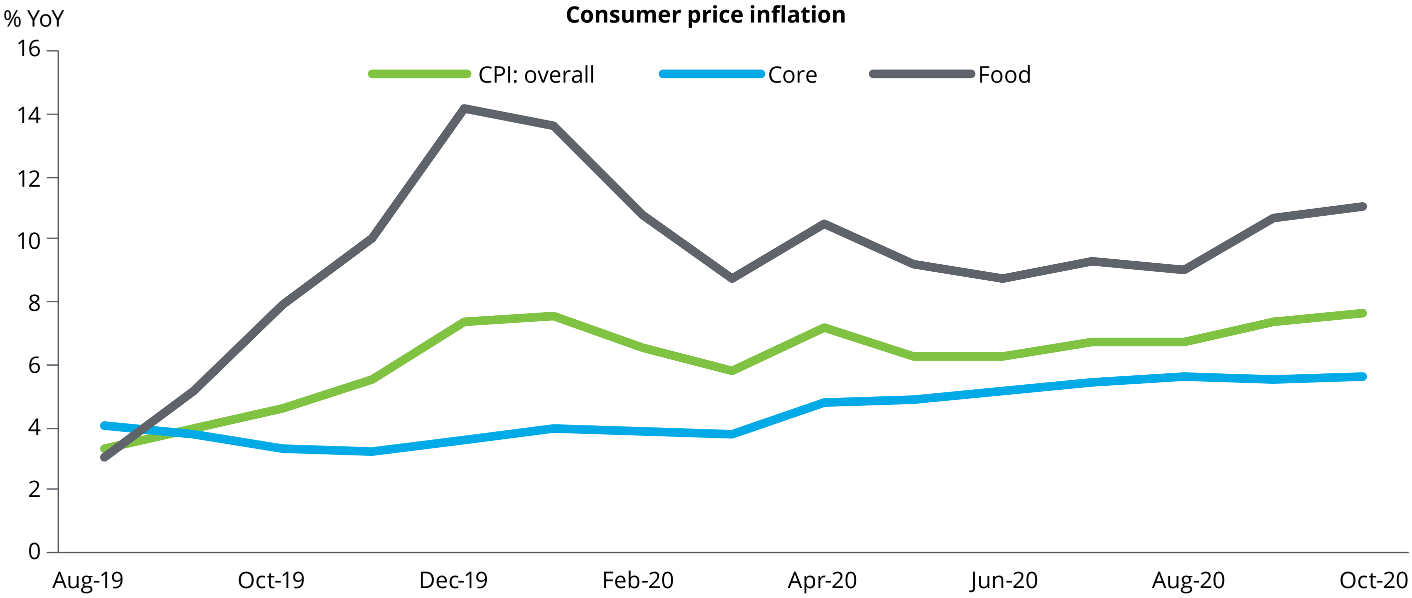
Figure 4. Labour market remains weak



Source: Center for monitoring Indian economy, Deloitte Research, December 2020,

Besides, inflation has remained persistently high, even if one excludes the prices of food and fuel (figure 5). High inflation expectations and transport disruptions are keeping prices high. While one might expect food prices to decline with easing supply-side disruptions, sticky core prices may impact demand for essential products, which is already low.

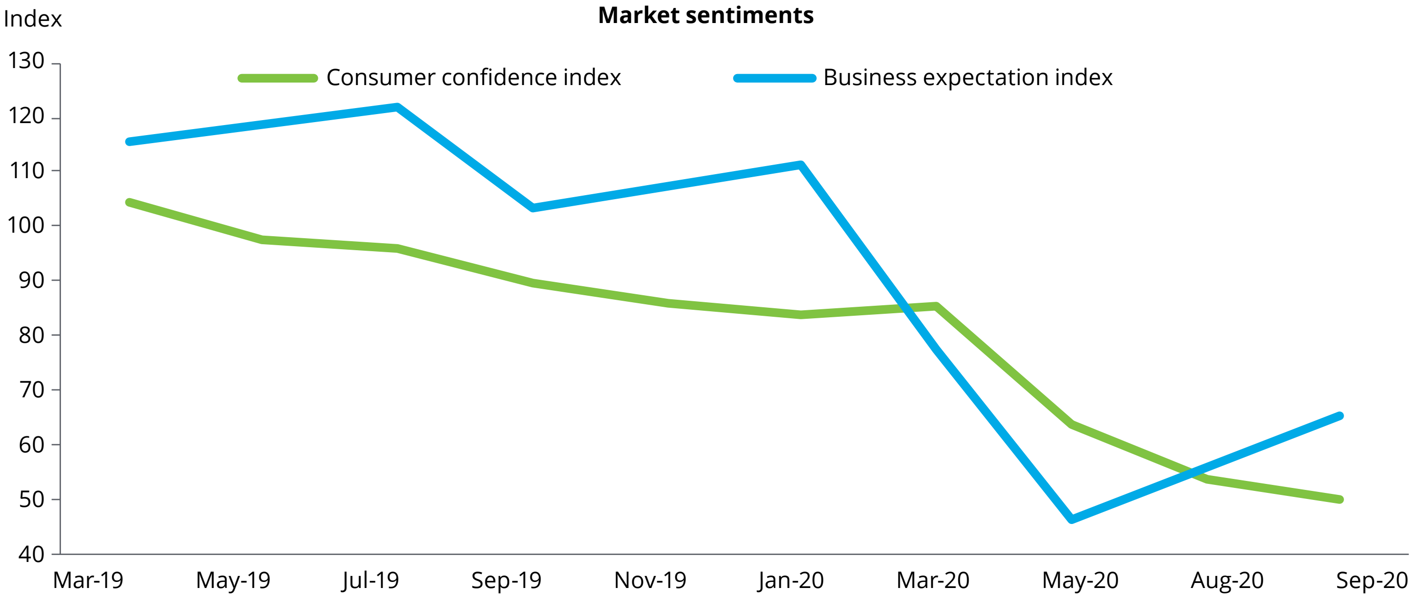
Figure 5. Prices have remained sticky downwards



Source: Center for monitoring Indian economy, Deloitte Research, December 2020,

Optimism amongst businesses after the easing of movement restrictions, and the anxiety of consumers about health and finance are aptly reflected in their respective diverging sentiments in figure 6. While the business expectation index has improved since September after a steep decline post the onset of the pandemic, the consumer confidence index shows no signs of recovery.

Figure 6. Consumer confidence remains weak while business expectations improve



Source: Center for monitoring Indian economy, Deloitte Research, December 2020,

…but, not so ugly

If high inflation persists, the RBI may decide not to reduce policy rates in the next few months. This could hurt businesses, especially small and medium enterprises and those in the informal sector that continue to face high borrowing interest rates on working capital. With consumer spending accounting for close to 60 percent of the GDP, poor consumer confidence and low income and wealth may lead to lower consumer spending. Low demand does not bode well for business confidence and capital investment.

Could these bad signals imply an uglier economic outlook? Not necessarily.

One of the biggest challenges to the low demand and supply equilibrium that we are witnessing, is the high levels of infection and fear amongst consumers of falling sick. Fortunately, there exist drugs that reduce the recovery time or prevent the disease from developing into criticality in a majority of the cases. Recently, encouraging news about several vaccines and their high effectiveness suggest that there is possibly light at the end of this tunnel, and that we may have an end date to the pandemic, even if it may not be immediate. These are likely to have a positive impact on consumer confidence going forward.

Mobility restrictions, social distancing, and low income have translated into higher savings amongst consumers across all income classes. Demand for discretionary goods, which is also highly elastic in nature, has remained low for a while. Once infections come down significantly and people are confident about moving out, pent-up demand for discretionary goods will also pick up rapidly, especially amongst the top 10 income percentile of the population. To catch up with the rising demand for discretionary goods, businesses will be compelled to increase investments and hire quickly. This is because prolonged low investments (for over six quarters or more) would have affected capacity constraints and inventory levels.

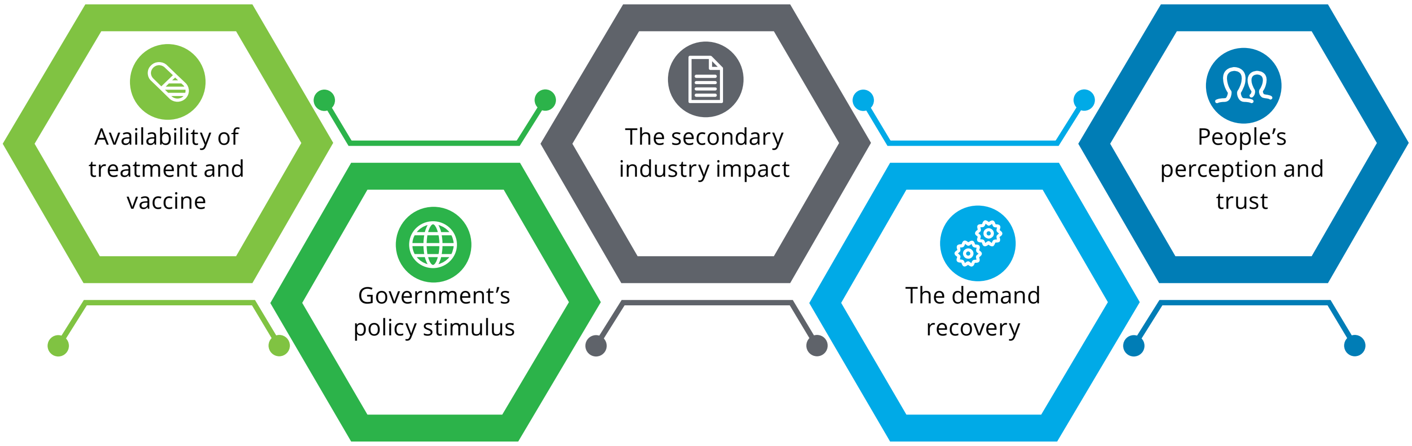
Lastly, stimulus measures and reforms announced by the government and liquidity measures by the RBI may prop up industrial activity and demand. The nature of the measures and reforms announced is such that their impact could come to the fore with a certain lag and even coincide with the time when infection rates are significantly low and consumers are out to spend, thereby boosting the recovery process further.

What is common about all the above suppositions is that the arguments hinge on reduced infections and increased mobility. In short, there is likely to be pain in the short term, but the outlook in the medium term may improve significantly.

The outlook – what lies ahead

Based on recent data and signals, we decided to update our projections for the medium term. We had released our last publication on scenarios in July. We continue to assume that five factors (as explained in our July publication)[ii] will most likely shape the path to recovery, as listed in figure 7.

Figure 7. The five factors that will determine the pace of the economic rebound



Source: Deloitte Research, December 2020

We foresee three scenarios panning out in the future, ranging from optimism to extreme pessimism.

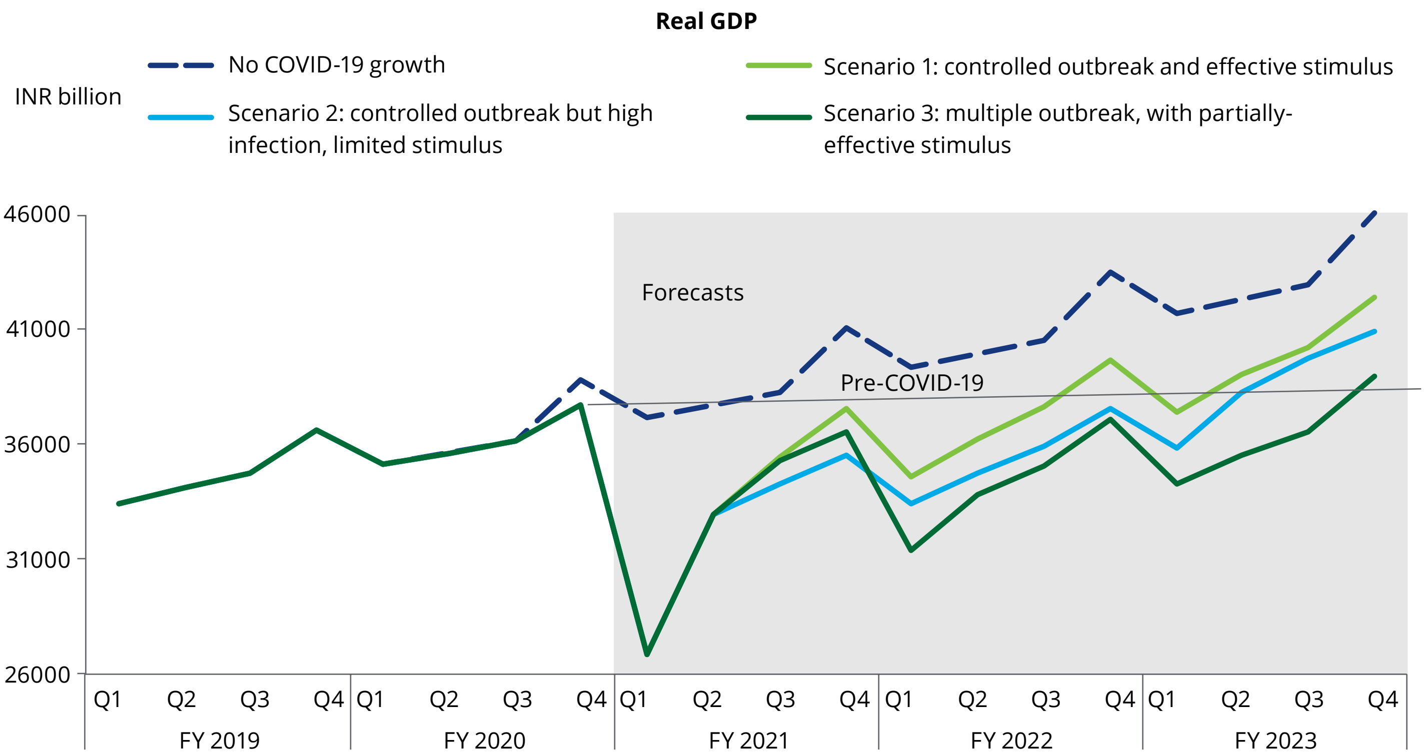
Scenario 1 is where the economy rebounds strongly in FY2022, as we expect several effective vaccines to be out and available. The regional spurts in infection may also start tapering from June 2021. Total active infection cases begin to come down reasonably by August and there are no further outbreaks. The stimulus and reforms come into play with ripple effects across sectors. We expect the economy to reach pre-crisis levels by Q3 FY2022 (Oct-Dec 2021) and revive at a sustainable pace thereafter.

Scenario 2 is where regional infections, especially in urban cities, continue to be high and lockdowns keep getting intensive. A vaccine is not available to the population till the end of 2021, while people remain sceptical of the vaccine effectiveness. The government is limited by its resources, and capital expenditure and infrastructure spend take a hit. Reforms take more time to impact. We expect the economy to reach pre-crisis levels in early FY2023.

Scenario 3 is the most pessimistic prediction where the economy suffers several outbreaks and reinfections leading to a second major lockdown in March 2021. Vaccines largely remain ineffective, besides being unavailable. Government resources are majorly directed towards saving lives and livelihood. India barely reaches pre-COVID-19 levels at the end of our forecast period, which is till FY2023.

Figure 8 compares GDP levels under the three scenarios. After a contraction in FY2021, the economy strongly bounces back in FY2022 under Scenario 1 and 2. This is because of the low-base effect in FY2021 and also because Milton Friedman's plucking theory plays out.[iii] The theory suggests that recessions are negative events that pull the economy down and after it, the economy bounces back up. The pace of the rebound is proportional to the depth of the recession. Even under Scenario 3, where the economy continues to reel under infection in FY2022, the year manages to grow modestly.

Figure 8. GDP projections under the three scenarios suggest output to remain below pre-COVID-19 GDP levels



	FY 2020	FY 2021	FY 2022	FY 2023
Scenario 1		-8.3	11.7	7.5
Scenario 2	4.2	-10.6	9.5	9.4
Scenario 3		-9.1	4.5	5.8

Source: Deloitte Research, December 2020

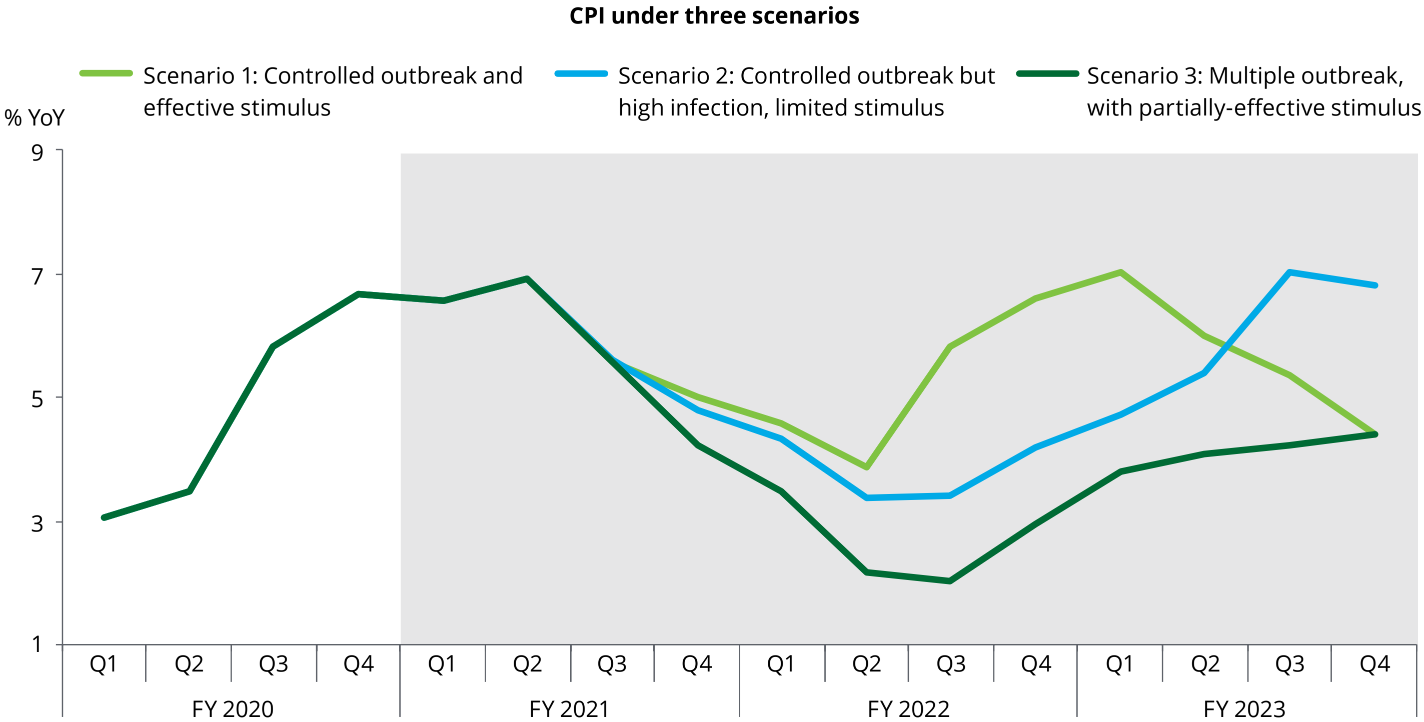
The rebound in FY2022 is the strongest and quickest in Scenario 1. Quick access to several alternative vaccines to the vulnerable segments of the population will likely break the infection chain faster. Not only will reduced infection improve consumer confidence, the buoyancy impact of government spending could also coincide with the economic recovery in FY2022 in this scenario. However, we also expect some delay in private spending due to crowding out because of which, growth momentum would slack in the following year. Under Scenario 2, private spending picks up momentum faster, as soon as infection rates fall, because low government spending compels private investments to meet the gap. The economy sees significant growth for several quarters in Scenario 2, albeit a bit deferred relative to Scenario 1.

That said, stronger growth rates in FY2022 could be deceptive. Despite a quicker rebound even in Scenario 1, the output levels remain below the pre-pandemic GDP levels. Assuming that there is a higher likelihood of Scenario 1 or 2, we expect growth to range between 9.5 percent to 11.7 percent in FY2022.

Prices are expected to ease till mid-2021 because of low demand and low supply equilibrium but rise quickly as soon as infection rates are under control. This is because demand overshoots supply in a very short time span in Scenario 1 and 2 (figure 9), though inflation is lagged by a few quarters in scenario 2. Prolonged low investments leading to capacity constraints and reduced inventories fail to meet a strong rebound in durable goods, leading to stronger core prices.

Scenario 3 is our highly pessimistic outlook of the economy and we do not expect it to materialise. This is a scenario where low demand and low supply equilibrium result in low growth and prices throughout our forecast period.

Figure 9. Prices rise faster as demand outpaces supply under Scenario 1 and 2

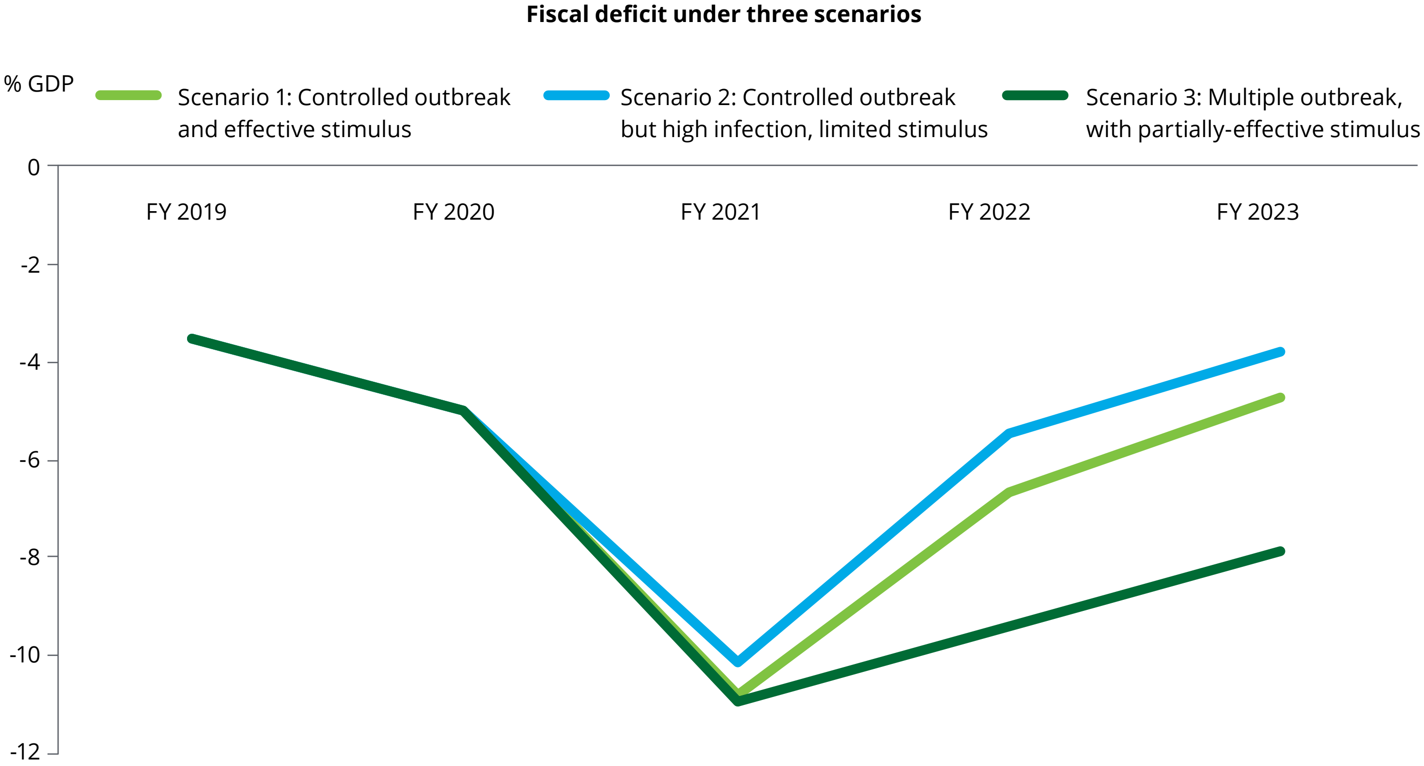


	FY 2020	FY 2021	FY 2022	FY 2023
Scenario 1	4.8	6.0	5.2	5.7
Scenario 2		6.0	3.8	6.0
Scenario 3		5.8	2.7	4.1

Source: Deloitte Research, December 2020

The fiscal deficit worsens in the initial years because of low growth leading to lower tax revenues and higher government spending. A stronger rebound in Scenario 1 helps the government to improve its fiscal and debt situation in the years ahead, while the economy gets trapped in high deficit and high debt under Scenario 3. The government is in the best position to consolidate in the medium term under Scenario 2 (figure 10).

Figure 10. The fiscal deficit is expected to be high in FY2021 due to low growth and high government spending



Source: Deloitte Research, December 2020

Undoubtedly, there lie uncertainties in the path to recovery. These scenario projections are ways to anticipate probable outcomes and keep our eyes on the road ahead, as we look at the past two quarters' GDP numbers in the rear-view mirror. Recent developments, such as low fatality rates in India and the possibility of the release of several vaccines give us hope of a stronger and faster rebound. Even though we may lose a couple of years of high growth to the pandemic, we prefer to be an optimist at this time point of time and view the glass as half full.

[i] CMIE database

[ii] Rumki Majumdar, "COVID-19: Indian economic forecast amidst uncertainties, Deloitte India", July 2020, https://www2.deloitte.com/in/en/pages/about-deloitte/articles/indian-economic-forecast-amid-covid.html

[iii] Noah Smith, “Milton Friedman Got Another Big Idea Right”, Bloomberg, November 4, 2019 https://www.bloomberg.com/opinion/articles/2019-11-04/milton-friedman-s-plucking-theory-of-recessions-looks-right

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