The tunnel just got longer, but you can still see the light

June 2021

The GDP data released by the government for the January–March quarter of FY2020–21 signaled a sliver of good news—a recovery was on its way before the second wave hit us. It is also an assurance that the economic fundamentals were probably strong and the economy will likely steer itself back after we tide through this wave. However, with the extended and strict lockdowns enforced by a majority of the states in the April–June quarter, the strong recovery that we were so confident about may be harder to come by.[i] As mobility restrictions continue to hurt the economy, we might be losing a good part of our output this quarter.

The spike in infections has made us go back to the drawing board and revisit our outlook. Even as we gradually make our way out of the devastating storm that hit us, the impact on this quarter has been enormous and set back the potential recovery of several industries. The lopsided industry growth we discussed at the beginning of the year may further accentuate.[ii] A few industries will see a relatively quicker rebound, while for others it may be delayed further.

We have made a few broad assumptions and created two scenarios. The baseline scenario, of which we see a higher probability, is where the situation improves quickly. As there is low visibility on the way things will pan out over the next few months, we have provided a range of forecast numbers. The other scenario is more pessimistic; however, we do not associate much likelihood with it.

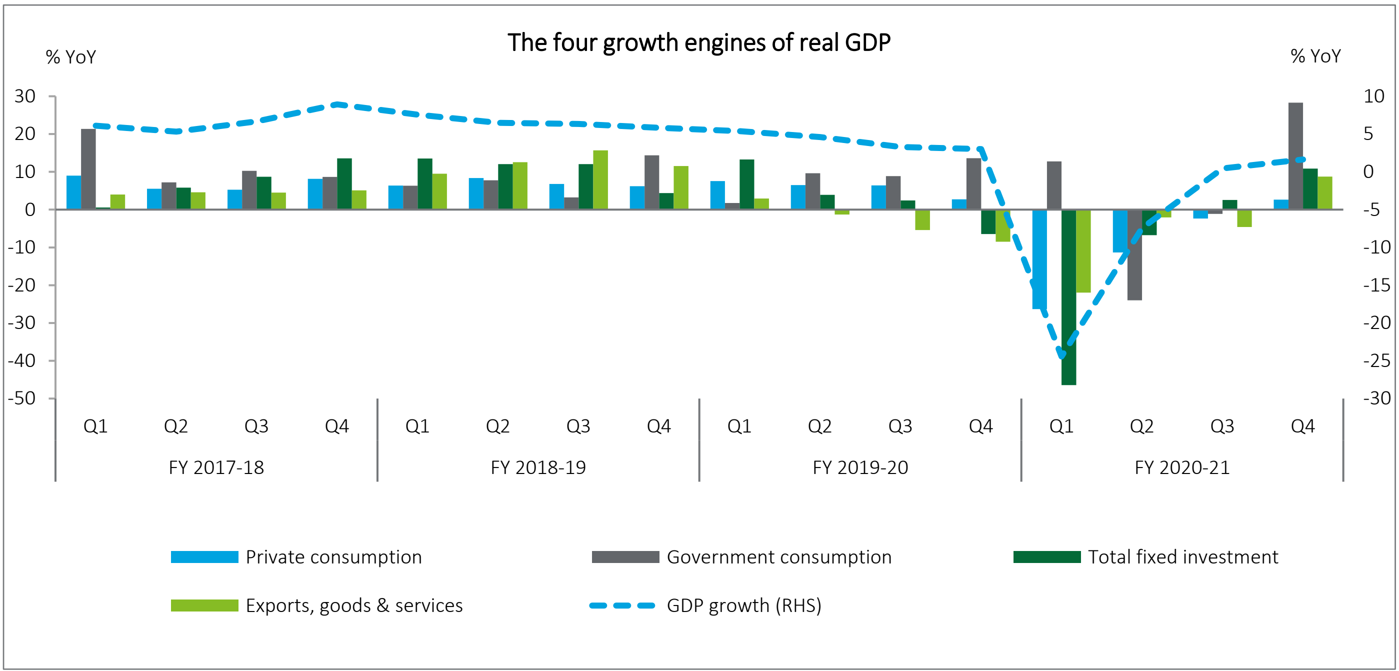
In the baseline, we expect growth to range between 8.8 percent and 10.4 percent during FY2021–22. Economic activity will likely pick up rapidly in the second half, while its pace will probably get pushed by a couple of quarters and flow into the next fiscal year (FY2022–23). Growth in the following year will be strong; with a significant portion of the population having been vaccinated, successive waves may have a minimal economic impact. Pent-up demand amongst the population segment that has saved for long will come in full throttle. However, inflation may come roaring back after a subdued period due to global factors as well as the impending domestic recovery.

The momentum before the interruption

The government's massive spending was a big boost to growth in the January—March quarter of FY2020–21. However, private investment and exports also did exceptionally well. Goods exports saw a significant rise, driven by increasing engineering goods, chemical products, and pharmaceutical exports. While the low-base effect played an important role, improving business sentiments during this period and a strong recovery amongst industrial nations also provided the desired boost. Consumption spending gained some traction during this quarter but not enough, suggesting a hesitancy to spend because of health and financial anxieties.

On the industry side, real gross value added increased by 3.2 percent in Q4 FY2020–21. Manufacturing and construction did exceptionally well, although the latter was mostly driven by government infrastructure activities, while private construction remained low. The services sector grew modestly with performance in the "trade, hotels, transport, communication, and services related to broadcasting sector" weighing on overall services growth. The good news is that the "financing, insurance, real estate, and business services sector" did well. Healthy profits, equity performance, and sustained investor interest across financial institutions led to a strong rebound in the industry until the second wave. Strong demand for services exports and a rapid technology ramp up helped business services rebound quickly.

Figure 1. Growth in Q4 FY2020-21 signals that a recovery was on its way



Sources: Center for Monitoring Indian Economy, Haver Analytics, May 2021

A setback, but not swept away by the second wave

Evidently, the growth path varied across industries. While a few did well through the pandemic, a few rebounded immediately after mobility restrictions were eased last year. Meanwhile, those that required social contact continued to struggle (figure 2).

Despite the momentary setback, the second wave will likely accentuate the lopsided recovery amongst industries.

Manufacturing and construction

These sectors drove India's recovery in the past two quarters. The bounce back will be equally strong in the coming months with easing movement restrictions, pent-up and festive demand, and revival of several government infrastructure projects. For instance, highway construction grew by 74 percent year on year in April–May of FY2021–22, suggesting the government-backed construction industry to probably be the least affected by the lockdown.[iii] However, low credit to the real estate sector, labour shortages, and delayed under-construction projects may keep private construction subdued.[iv]

Technology and telecommunication services

The sector performed well until the onset of the second wave. Since the current wave has been more India-centric, while the rest of the world economy is reviving strongly, an unequal impact on the supply side in the short term has stressed the offshore service delivery model of MNCs and service providers. In the consumer technology market, businesses providing tech support to the education, finance, health, and food sectors did well and will continue to do so.

The telecom industry appears to be cautiously optimistic. Growth in broadband connectivity, expanding digital services ecosystem in the wake of the pandemic, and the Production Linked Incentive (PLI) scheme for the sector may boost domestic production and increase investment as the global shortage of electronics are rippling through industries disrupting the tech supply chain worldwide.

Financial services

The impact of defaults and low retail business was well provisioned for by banks. Private Equity (PE) and Venture Capital (VC) investors also continued to invest in the sector, expecting a robust performance. Restructured accounts were performing reasonably well until recently. The second wave may impact the credit quality of loan books and deteriorate the non-performing asset situation. Higher unemployment may increase loan defaults and put pressure on lenders' margins. Poor retail and MSME performances may add to the stress further with a lag. Banks will likely push for credit growth to improve margins even though personal loan demand and retail finance may slow down.

Retail industry for non-essentials and automotive

Non-essentials such as clothing and footwear saw a partial recovery until the second wave, as online sales helped brick-and-mortar players survive the pandemic. Post the second wave, consumers are consciously spending more on essential and health-related products, while precautionary savings have gone up. Wide-reaching infection in rural and suburban areas and rising oil prices have had a broad-based impact on demand.

We expect spending on large-ticket items to remain low and gain traction during the festive season. The auto-sector recovery may be restrained due to supply-chain disruptions (owing to the temporary shutdown of manufacturing plants) and deferred demand for several vehicle segments.

Figure 2. The sector-wise performance suggests a lop-sided recovery

Sectors that have done well during the pandemic
- Essentials in retail
- Tech sectors in cross-section with food, financial sector, health, education

Sectors that witness a rebound before second wave
- Manufacturing and construction
- Banking
- Electricity (in residential, industry, agriculture)
- Infrastructure construction

Sectors that continued to struggle before the second wave
- Hospitality and tourism
- Private construction and real estate
- Electricity (commercial sector)
- Mining

Most impacted sectors post the second wave
- Hospitality and tourism
- Non-essential retail
- Automotive
- Private construction and real estate

Source: Deloitte research

The economic projections: What lies ahead

Recovery trends across industries give us sufficient reasons to remain cautiously optimistic in our baseline scenario. We have provided a range of forecasts for the baseline considering that we are still not out of the woods and uncertainties regarding the pandemic persist, even though infection rates seem to have peaked already. Assumptions for the baseline are detailed in sidebar1. If, however, the pandemic prolongs and successive waves have an amplified economic impact, things could look much worse, as suggested in our pessimistic scenario.

SIDEBAR1: Assumptions around the baseline

Scenario 1 (baseline): Recurring but contained impact of the COVID-19 waves defer economic rebound momentarily

Indian economy

- The second wave (April 2021–June 2021) has a sizeable economic impact, but a third wave (November 2021–January 2022) will have a marginal to no significant impact. Successful vaccine rollout helps in progressively diminishing the economic and health impact of each successive infection wave.
- Rural demand is marginally weaker because of the rapid infection spread to rural India.
- Job losses are limited to informal and semi-formal sectors.
- Mobility restrictions and reallocation of government spending towards health support and infrastructure delay the implementation of government reforms and infrastructure schemes.
- Financial sector health remains steady with lower systemic financial risks on the economy
- RBI's support to banks improves credit growth, but sector lending differs (industry lending remains low)

World economy

- Global demand improves with increased mobility across borders by early 2022
- Speculations about the US Fed monetary policy result in market volatility
- Global commodity prices, including oil prices, rise with increased global activities, pressuring the domestic currency, inflation, and the current account balance

Scenario 2 (pessimistic): Recurring and acute impact of the COVID-19 waves result in a long and painful recovery

Indian economy

- Consecutive waves significantly impact the economy and health
- Vaccine rollouts remain largely ineffective in controlling the infection as "escape mutations" drive new resurgence
- Rural demand buckles under the weight of infection spread, resulting in aversion to spending and increased precautionary savings
- Widespread job losses are seen across industries, especially in the services sectors
- Mobility restrictions, inability to raise funds, and reallocation of government spending towards health support and infrastructure significantly delay implementation of government reforms and infrastructure schemes and lead to a higher fiscal deficit.
- Financial sector health worsens with rising NPAs in banks and corporate defaults resulting in macroprudential systemic financial risks to the economy
- RBI steps in rather frequently by easing monetary policy and liquidity, but its effectiveness is limited because of low credit appetite

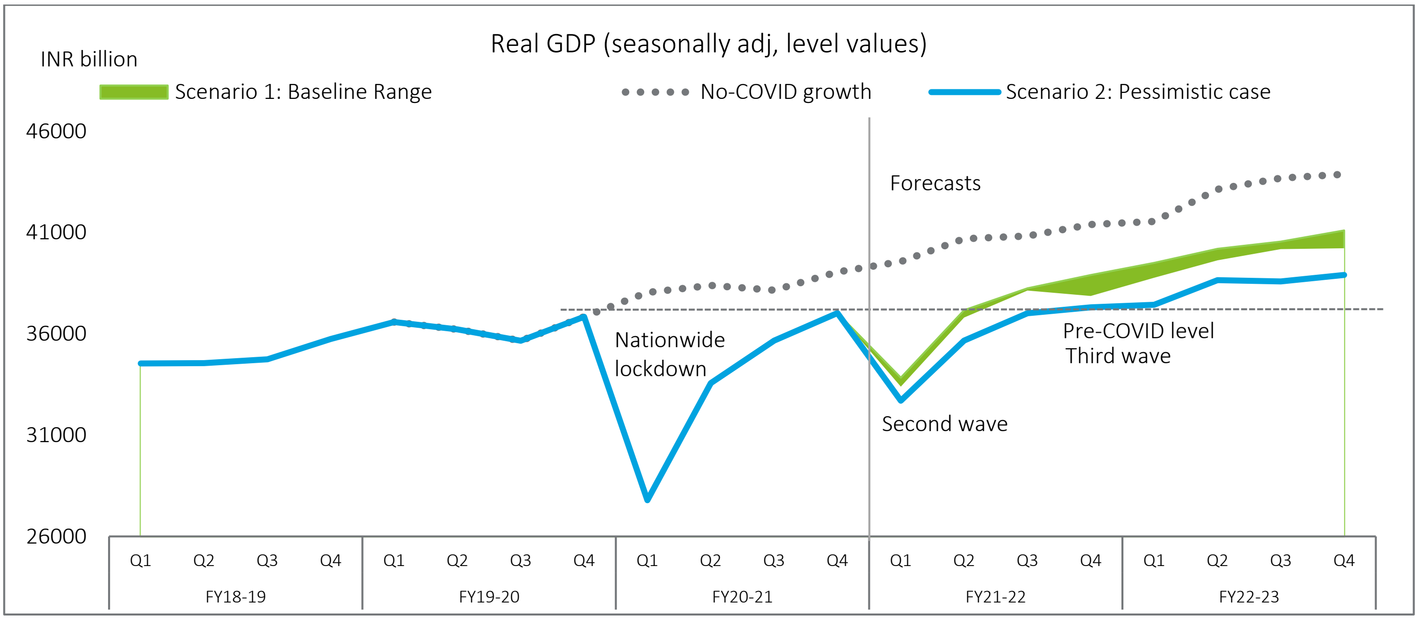
World economy

- The ebb and flow of the infection results in a lopsided global economic recovery with US and China driving the recovery
- Global commodity prices, including oil prices, result in higher inflation and depreciation of the currency
- The US Fed's taper tantrums and sooner-than-expected change in the monetary policy stance amongst industrial countries lead to a global liquidity freeze and capital outflows from emerging nations

Growth: According to our highly likely baseline scenario, we expect economic activity to pick up rapidly in the second half. The pace of the recovery may get pushed by a couple of quarters and flow into the next fiscal year; however, we expect growth to range between 8.8 and 10.4 percent (Figure 3). Growth in the following year is likely to be strong and may exceed 8.5 percent. This is because, by the next year, a significant proportion of the population will have been vaccinated—enough to break the infection chain. Successive waves are unlikely to have a significant economic impact, aiding in the pent-up demand accelerating. Under the alternate scenario, where the economy continues to reel under successive infection waves, the economy grows modestly over the next couple of years.

That said, stronger growth rates in FY2021–22 could be deceptive. Despite a quicker rebound even in Scenario 1, the output levels remain much below pre-pandemic GDP levels.

Figure 3. GDP levels remain far below the potential GDP (at non-COVID scenario levels)

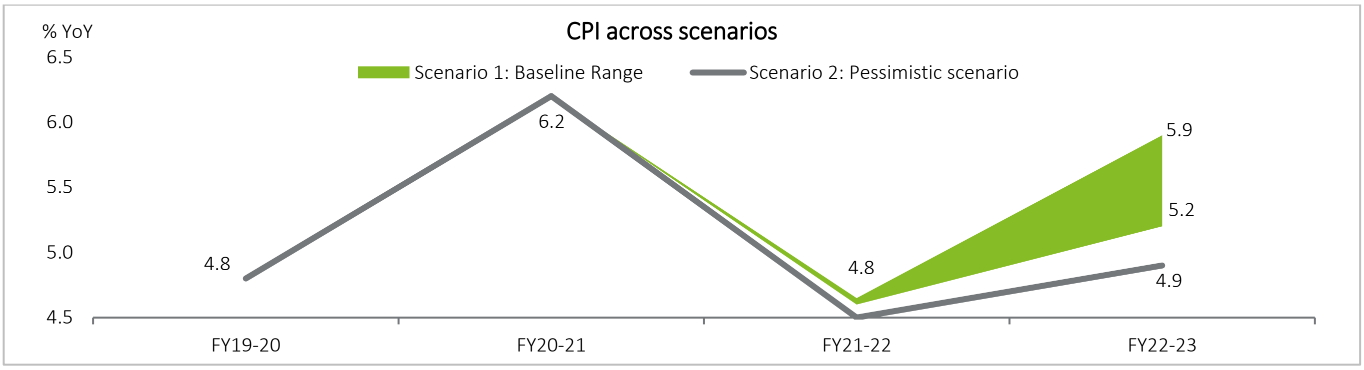


			Scenario 1: Baseline Range				Scenario 2: Worse case		
			Quarterly and annual projections						
	FY19-20	Q1			5.4	4.0			
		Q2			4.6				
		Q3			3.3				
		Q4			3.0				
Nation-wide lockdown	FY20-21	Q1			-24.4	-7.3			
		Q2			-7.4				
		Q3			0.5				
		Q4			1.6				
2nd wave	FY21-22	Q1	21.8	10.4	20.2	8.9	17.7	6.3	Forecast
		Q2	10.7		9.6		6.3		
3rd wave		Q3	7.2		6.9		3.8		
		Q4	5.1		2.3		0.8		
	FY22-23	Q1	16.8	8.8	16.1	8.5	14.5	7.5	
		Q2	8.1		7.7		8.4		
		Q3	6.0		5.3		4.3		
		Q4	5.7		6.2		4.3		

Prices: We expect inflation to be range-bound for the next few months due to the low demand-supply situation and base effect (Figure 4). However, there will be upward price pressures emanating from the following:

- Rising commodity prices, such as crude oil, iron, and steel, raising transport and production costs
- Higher shipping charges leading to global inflation that may seep in through imports
- Pent-up demand rising faster than supply as the economy recovers. As capital spending and investments were low over the past few years, these will reflect in supply constraints, limiting the ability to ramp up supply once demand fires up, resulting in demand-push inflation

Figure 4. High inflation risks persist



Source: Centre for Monitoring Indian economy; Deloitte research

The implications are likely to be two-pronged:

- For the RBI, it would mean that policy rates may not ease much, even though an accommodative monetary policy stance may continue for long. With rising prices, there may be pressure on the RBI to raise rates. The RBI will have a tough balancing act in the coming quarters.
- For the industry, rising prices will lead to higher production costs. Producers will have a difficult task ahead of them, deciding on whether or not to pass the rising costs onto the consumers by increasing prices, thereby, denting the demand recovery.

Private investment: Uncertainties regarding demand and low business confidence will weigh on private investments, while big investment decisions around capital expenditure will likely be on the back burner for some time. However, spending will increase rapidly as soon as pent-up demand picks up and prices for products will increase.

Fiscal deficit: While the primary focus of the government will be on spending on health care, MSMEs, and infrastructure, the resurgence of cases will likely see a reallocation of funds towards supporting lives and livelihood. There might be a reduction in capital spending in certain infrastructure categories, implying that a larger deficit may have lower multiplier effects on jobs, income, and asset creation in the economy than previously assumed. This could result in higher anxiety amongst investors and possibly lead to rising yields.

Domestic currency: The currency will likely remain weak during the forecast period against major currencies for several reasons. The global economy may rebound faster than the domestic economy. A higher fiscal deficit and resurgence of infection waves may unnerve investors, who may then prefer to shore up money in safer havens. Finally, any directional changes in the monetary policy stance by central banks in industrial countries could also squeeze global liquidity and reverse capital flows. A depreciated currency, however, will aid in greater competitiveness and increase services export revenue.

In short, the end of the tunnel may seem farther, but the light remains visible. The path to recovery has been delayed, but we have to patiently build our resilience until we finally emerge from this tunnel. The good news is that the economic fundamentals are strong and once we are out of the pandemic, the economy will be back on the recovery path that we were witnessing a quarter earlier. The bad news is that the lopsided growth may leave a scar on the economy for longer.

[i] Rumki Majumdar, India: The year that was and will be, *Deloitte*, April 2021, https://www2.deloitte.com/in/en/pages/pages/about-deloitte/articles/recovery-amid-a-rising-state-of-dichotomy.html

[ii] Rumki Majumdar, India: Recovery amid a rising state of dichotomy, *Deloitte*, January 2021, https://www2.deloitte.com/global/en/insights/economy/asia-pacific/india-economic-outlook-01-2021.html

[iii] Tweet by the Ministry of Road Transport and Highways, June 4, 2021, https://twitter.com/MORTHIndia/status/1400832846923649024?ref_src=twsrc%5Etfw

[iv] RBI credit lending data, https://www.livemint.com/companies/news/pandemic-worsens-liquidity-woes-of-india-s-realty-sector-11623177592086.html

Deloitte.