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2021 has begun on a strong positive note with mass-vaccination drives and announcement of the Union Budget amidst falling COVID-19 cases in India. However, despite the pervasive optimism, a second wave of infections and new mutations of the virus observed in global economies has led to heightened uncertainty and could plausibly threaten the progress of the recovery in the economy.

The Road Ahead

CARE Ratings OUTLOOK FOR FY22

The year 2020 witnessed unmatched turmoil with the COVID-19 virus and the resultant pandemic induced lockdowns that emerged as the biggest challenge to economic growth in more than a century. In order to alleviate the adverse implications of the health crisis, Governments and central banks across the world responded unprecedentedly and this included measures ranging from lowering key policy rates to cash transfers to loan guarantees. How have the Indian policy-makers stood up to the "once in a century" challenge and have the policy actions borne fruits for various segments of the economy?

How India fared last year

India's response to the pandemic was more unique compared with global economies as it focused on a mixture of demand and supply-side policy measures while concentrating on ramping up the fiscal spending after the commencement of the unlock process in the economy. Additionally, a favorable monetary policy ensured abundant banking system liquidity and the temporary forbearance relief provided an immediate support to the debtors. After individuals faced palpable hardships throughout the lockdowns in 2020, there have been incipient green shoots reflected by various high frequency indicators during the fag end of the year.2021 has begun on a strong positive note with mass-vaccination drives and announcement of the Union Budget amidst falling COVID-19 cases in India. However, despite the pervasive optimism, a second wave of infections and new mutations of the virus observed in global economies has led to heightened uncertainty and could plausibly threaten the progress of the recovery in the economy.

COVID-19 and the pandemic induced lockdown have had far-reaching implications on the Indian economy, which even prior to the health crisis was constrained with myriad of challenges. The economy registered a record contraction of 23.9% in Q1-FY21 and recovered marginally with a negative growth of 7.5% in Q2-FY21. The improvement in the GDP demonstrates the resilience in the economic recovery process, albeit partially. The signs of recovery in the economy have further strengthened since November 2020 onwards with the number of normalizing sectors expanding. A sustained resurgence in various high frequency indicators such as power demand, E-way bills, GST collections, steel consumption coupled with improvement in capacity utilization in the manufacturing sector, revival in consumer confidence and upbeat business sentiments and corporate earnings cumulatively reflect a faster than expected economic resurgence. Nonetheless, India's economy is estimated to contract by 7.7% in FY21 with a steep decline of 15.7% in the first half of the fiscal while a modest fall of 0.1% in the second half.

Sectoral analysis shows that agriculture growth has been steady, and it has been a silver lining despite the challenges while contact-based services, manufacturing and construction have been the hardest hit sectors and showing gradual recovery. There have been a number of forecasts released by various government and international institutions, projecting a sharp "V-shaped recovery" for the Indian economy in the forthcoming fiscal. The Economic Survey 2020-21 estimates a robust double-digit growth of 11% in FY22, albeit over a lower base with rekindling of consumption and investment demand amidst mega-vaccination drive. The International Monetary Fund (IMF) has projected the economy to grow by 11.5% and reclaim the status of the fastest growing economy. The RBI too has estimated growth on similar lines at 10.5% in FY22 supported by sustained improvement in financial resources and strong impetus provided by the Union Budget towards the revival of key sectors. We are relatively less bullish at 10%, which is still a double-digit number. Cumulatively, all estimates highlight the economy's strong vigor to comeback amidst lingering impediments.

Government response to pandemic

In the backdrop of the health crisis, the year has been a challenging for the Government finances with shortfall in revenue collections owing to limited economic activities and additional expenditure requirements to mitigate the fallout of the pandemic on various sections of the economy. The Government has been both proactive and calibrated in its approach and has designed a combination of relief, credit and reform measures best suited for the evolving situation of the economy. The unique path followed was combining immediate measures with medium term policy responses so as to lay the foundations for future growth too. This is in contrast to the front-loaded large stimulus announced a number of global economies. Pursuant to the three economic stimulus announcements which accounted for around 9% of the GDP and relaxation of restrictions, the focus was re-oriented towards the highly anticipated Budget with expectations of supporting the recovery and preserving the solvency of business and households.

Was the Union Budget able to match the expectations?

Indeed, it was a landmark budget with the priority for the Government unequivocally on "Growth" and crucial expenditure targeted towards capex and health. The Budget has supplemented its infrastructure focus plans with innovative financing tools which include raising resources from monetization of government owned assets and a thrust to privatization. The Budget has been iced with some far-reaching reforms announced in terms of disinvestment which is now to be read as privatization and the asset monetization of PSUs. This should unleash a lot of activity in the market s- both equity and debt and we can see a boost for InvIts and Reits this year.

The financial sector keeps firing

The financial sector of the economy also managed the unprecedented shock of the COVID-19 with relatively sound capital and liquidity buffers coupled with congenial financial interventions by the RBI. The central bank reduced policy rates by 115 bps since March 2020 and enhanced liquidity support via various conventional and unconventional measures like Open Market Operations (OMOs), Long Term Repo Operations (LTRO), Targeted Long Term Repo Operations (TLTRO) for specific sectors. These unconventional measures have led to a surge in corporate bond issuances aggregating Rs 5.8 lakh crs during April-December 2020 compared with Rs 4.6 lakh crs in the corresponding period last year. Despite the conducive financial environment, financial flows have remained constrained on account of subdued credit growth by both banks and non-banking financial corporations. Commercial paper issuances during the 9-month period have also been lower by almost 30% than the same period last year. The Financial Stability Report (FSR) released by the RBI highlights the improvement in the asset quality till September 2020.

CARE Ratings' Modified Credit Ratio (MCR) also has seen a marginal uptick in Q3-FY21 which reflects improved credit quality. Nonetheless, the FSR points out that the pandemic threatens to result in balance sheet impairments and capital shortfalls. Various macro stress tests indicate that the gross non-performing assets (GNPAs) ratio could spike to 13.5% in September 2021 under the baseline scenario and could escalate to 14.8% under a severe stress scenario. It is to be noted that the banking sector have been reporting relatively better asset quality during the current fiscal owing to the forbearance relief provided by the Supreme Court announcement while the RBI in its projections is likely to have factored in the roll-back of the relief measures. The task ahead for the RBI will be to restore economic growth and livelihoods by ensuring comfortable liquidity and gradual roll-back of already announced liquidity measures, without jeopardizing its core objective of financial stability.

The crux will be private investment and household spending

The pandemic led economic shock resulted in sharp deceleration in both consumption and investment in the economy. Private consumption is estimated to decline by around 9.5% in FY21 while the investment rate is estimated to dwindle to multi-year lows of 24.2% during the fiscal. While consumption has been affected by lower confidence, loss of income, fear of contagion; private investment has remained tepid chiefly on account of heightened uncertainty regarding post-pandemic economic prospects. As government spending on capital expenditure accounts for around 2-2.5% of GDP, the recovery and the growth prospects going forward hinges on the revival in the private capex cycle. A turnaround in both consumption and investment - which are the pillars of the economy - is imperative for sustained recovery and growth prospects of the economy.

Concomitantly, it imperative for private sector entities to raise funds from the equity and bond markets coupled with term lending supported by the banking system to meet the investment requirements. The recent proposal in the Union Budget in formation of a development financial institution with an overall lending portfolio of Rs 5 lakh crs in the next 3 years will provide a major boost to infrastructure financing. Additionally, India has remained a preferred investment destination in FY21 as FDI inflows have been robust which reflects better economic recovery prospects in the economy. Further easing of relaxations by the government in various sectors will provide additional fillip to foreign investment in the economy.

> "As a credit rating agency, the upgrades and downgrades would be important as the economy reverts to normal as do the regulatory forbearance gets diluted over time. Typically, any recovery in the economy will lead to an improvement in the modified credit ratio (MCR) which is the ratio of number of upgrades plus retentions to number of downgrades plus retentions. This has been coming down and been less than 1 in FY21 and it may be expected to get gently reversed as the economy recovers."

How does FY22 stack up?

Various sectors in the economy have been affected to different degrees and the recovery across sectors has been unequal. On one hand there has been resilience seen in the agriculture, pharmaceuticals and technology sectors while recovery in manufacturing, auto, powerhas been faster than expected. However, contact-intensive services sectors like tourism, recreation, aviation continue to grapple with the challenges of the pandemic. So the two questions in the context of the recovery are how fast will we see a revival in the services segment (especially the contact intensive ones) and whether the faster the expected recovery seen in the industrial sector will be sustained?

For the first question, the recovery in the services sectors is likely to be uneven with some sub-segments likely to outshine the others. Sectors like information and technology, telecom will continue to shine in the next year with companies seeing robust orders and shift to a more digital set-up. The pick-up in the hospitality industry (including media and entertainment) will be contingent on the swiftness of the mass-vaccination drive and the progress of further relaxations by the Government. Although we will get more clarity on these aspects in the next couple of months, we can expect these sectors to commence its upward movement only by the second half of FY22. In case of the aviation sector, the outlook looks relatively somber as travel has been restricted to essentials while international travel is likely to be contingent upon the management of the pandemic in various countries which are witnessing second and third waves of the infections.

In terms of the industrial sectors things could show mixed picture in terms of industry –specific sectors and consumer-specific sectors. The former which includes cement, steel, power, construction could register a much faster recovery supported by government led infrastructure push. The latter, which includes auto, FMCG, consumer durables, textiles could see a more gradual pace of recovery and be linked with job creation. Also, with lower infections in the rural segment than urban, recovery is likely to be swifter in the former.

The RBI will have a critical role to play in the way in which the economy evolves. With a rather large government borrowing programme this year already announced and an expected upsurge in state government debt with some relaxation being provided on the fiscal deficit ratios, we can expect stress in liquidity especially so if private sector demand for credit picks up. The RBI will have to persevere with more OMOs and TLTROs to stabilize liquidity and hence government bond yields. This indication has already been given by the central bank.

Banks have had a relatively challenging time this year confronting low demand for credit, surfeit of liquidity, lower interest rates, threat of rising NPAs, moratorium, restructuring of loans, credit guarantee for SME loans, etc. It will be back to normal albeit in a gradual manner this year and hopefully the system has already buffered for this change. Their reaction to credit demand will be interesting as growth of 10-11% in GDP, howsoever statistical it may be, will bring about an increase in demand for credit. This is where they have to tread carefully in cherry picking their customers.

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In conclusion

After a sharp decline in the GDP of the country, a sharp and resilient V-shaped recovery in 2021 looks inevitable. Despite the optimism, we need to be cautious as India is likely to touch the Rs 220 trillion economy ($3 trillion) mark by the end of FY22, a number which was budgeted for in the previous Budget. Following the recovery, the important question is whether the economy will be able to sustain the economy growth trajectory post FY22? A combination of supply-side reforms, easing regulations, push to infrastructure investments, boost to manufacturing through performance linked incentives, comfortable financial conditions, increase in discretionary spending and recovery in services sectors subsequent to the roll-out of the vaccine strengthens the optimism towards faster growth in the coming years and achieving the $5trillion economy at a brisk pace.

Ajay Mahajan is the Managing Director & CEO of CARE Ratings Ltd. He is a widely experienced financial services expert with 30 years in banking and capital market businesses. He worked in organizations like Bank of America where he started his career in 1990 and went on to become MD & Country Head of Global Markets Group. Here he also led the initiative of building the first 100% foreign owned NBFC in the country to do primary dealership and credit fixed income. Thereafter, Ajay joined YES BANK in a top management role to build out multiple functions like Financial Markets, Investment Management, Financial Institutions and International Banking. Ajay moved thereafter to UBS in 2008 to build their India franchise from scratch, another deeply entrepreneurial role. In three years of joining UBS had most credit, Financial Markets, Debt Capital Markets and Retail Products in India. Ajay's last assignment was a 7 year long stint in IDFC Group which he joined in 2013 to play a hugely transformative role to lead the conversion of their Infrastructure financing business to a multi-product, multi-segment wholesale banking business comprising Corporate Credit, SME Credit, Financial Markets, Government Banking, Financial Institutions and International Banking. Besides, this role required building teams, systems, processes and cutting-edge technologies to support the wholesale bank's growth. Ajay was one of the founding members of FIMMDA, the financial markets SRO in India and headed product development committee and several other initiatives for market development. He also held the Vice Chairman role at FIMMDA. While at this role, he was also entrusted with heading a sub-committee, a part of Jaspal Bindra Committee constituted in 2001, under the aegis of RBI to work on development of the financial markets and derivatives markets in India. Ajay holds a Bachelor of Engineering in Electrical & Electronics Engineering from BITS Pilani, and an MBA from FMS (where he was a Gold medalist) and is also CFA Charter holder from CFA Institute, USA.