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INDIA UPDATE

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Tale of Two Recoveries: Upbeat Economic Prospects Contrast With a Slow Emergence from the Health Crisis

The agricultural sector has remained resilient during the pandemic

India's economy has begun to recover from its fastest contraction on record. Real GDP plunged 24.4% in the second quarter of 2020 in year-over-year terms amid lockdown measures, financial turmoil, and plunging world trade. The Reserve Bank of India (RBI) provisionally sees an 8.0% contraction of real GDP in the April 2020 to March 2021 fiscal year (FY 2021); this would be the sharpest yearly contraction on record. Contact-intensive industries were hit extremely hard; the trade, hotel, transport and communication sector is projected to shrink 18.0%. Rural India was an exception to this historic contraction—agricultural output grew 3.0% year-over-year in FY 2021 (See Chart 1). The agricultural sector comprises about 15% of GDP and employed 45% of working Indians pre-downturn, a share that rose in FY 2021 as laid-off urbanites returned to family farms.

The policy response to the crisis was aggressive. The government passed four rounds of fiscal stimulus in 2020 totaling almost 10% of GDP, and another 17% of GDP is planned in the FY 2022 budget. The budget increases public capex 26% from FY 2021, funds the restructuring of defaulted debt to boost credit growth, and increases health expenditures 137%. For its part, the Reserve Bank of India (RBI) cut its policy repo rate 1.15 percentage points to 4.0%, launched a QE-like program of lending to commercial banks, loosened liquidity rules for banks, and encouraged forbearance of loans to distressed borrowers. With the recovery underway in early 2021, the RBI has begun to unwind crisis era policies, returning required bank reserves to the pre-crisis level.

Proposed financial sector reforms will improve liquidity conditions

The latest economic indicators suggest that the substantial fiscal stimulus passed in the last year has effectively restored some parts of the economy to pre-pandemic levels. Industrial output rose in year-ago terms in three of the five months through January, and was above the pre-pandemic level in January; imports rose for three straight months through February; and activity in the manufacturing and services sectors is improving. High-frequency indicators for power demand, air traffic, and retail improved notably between January and March.

PNC expects the RBI to hold its monetary stance steady at its April decision due to an improving economic outlook and expectations for higher inflation; the central bank's survey of household inflation expectations showed one-year ahead inflation expectations of 10% in January, up from 8%

CHART 1: THE AGRICULTURAL SECTOR REMAINED RESILIENT AS OTHER SECTORS SHRUNK

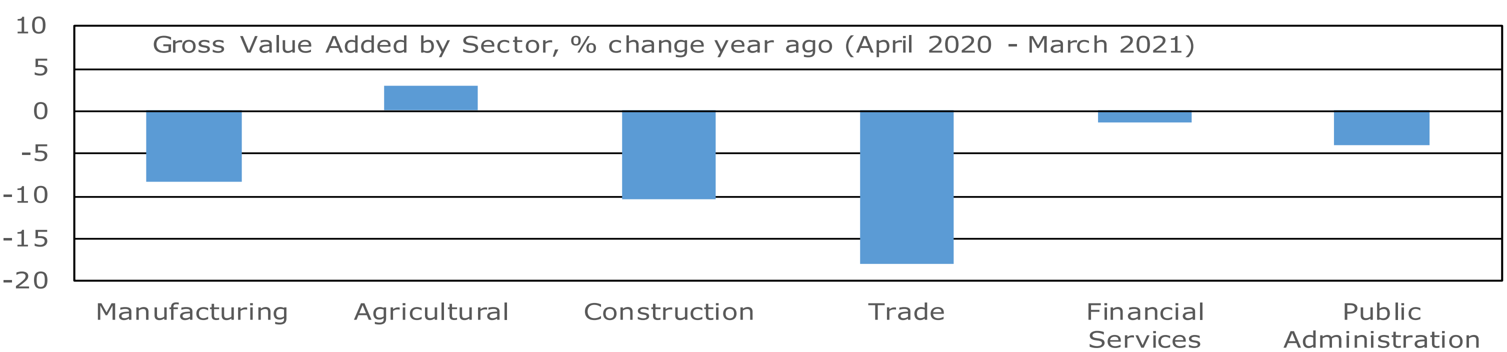

Chart source: Central Statistics Office, Government of India

Firmer inflationary pressures are likely to persist in the near-term

to 9% in surveys conducted before the pandemic. CPI inflation exceeded the upper band of the RBI's 2% to 6% target range in seven of the past ten months, pushed higher by fuel-tax hikes in March and May 2020; core inflation (excluding food and energy) has been above 5.0% since July 2020. Both overall and core inflation are likely to pick up in the short term because of comparisons to early 2020, and remain elevated through the rest of 2021 and 2022. PNC expects the RBI to start raising interest rates in the second half of 2021 in reaction to higher commodity prices, although rate hikes could be delayed if the government reverses the 2020 fuel-tax hikes. A brighter economic outlook, fiscal deficits to fund the crisis response, and spillover from higher advanced economy interest rates have pushed Indian government bond yields up even as a resurgence of coronavirus cases began in February.

Real GDP growth likely around 7% in fiscal year 2022, but risks to the downside

Economic growth in the non-agricultural sector has been uneven and will likely remain lumpy in FY 2022 due to rising coronavirus cases and the slow pace of vaccinations. Service-sector activity has improved since its May 2020 trough but remains below pre-pandemic levels; renewed restrictions on business in many cities and states will keep economic activity in the high-contact service sector soft in the near-term. Industrial production will improve as the global economic recovery supports demand for Indian exports, though rising oil prices will weigh on manufacturers' margins. The pandemic will linger longer in India than in developed countries—India started its vaccination drive in January with an ambitious plan to vaccinate about a quarter of the population by July, but early progress has been very slow. Agricultural output will remain resilient in the near-term; winter sowing was solid and an expected normal monsoon season (June to September) is a positive. Improved consumer demand, continued growth in the agricultural sector, stronger capex and exports should foster an economic recovery in FY 2022. PNC expects real GDP growth of around 7% over the year, although the balance of risks is to the downside. The passage of labor and agricultural reforms by the Indian Parliament in September could boost potential economic growth in the medium- to long-term if implemented successfully, notably by eliminating the government's fiscal burden related to buying and subsidizing staple grains.

Downside risks to the rupee as commodity prices increase

After ending 2020 as one of the weakest Asian currencies, the rupee is off to a solid start in 2021, gaining 1.8% against the dollar in the first quarter. PNC forecasts for the rupee to lose some momentum (See Chart 2) by the end of the year as inflationary pressures, higher crude oil prices (India is a net oil importer) and decreased risk-on sentiment weigh on the currency. If U.S. government bond yields rise as rapidly in the rest of 2021 as they did in the first quarter, the rupee could be weaker than forecasted, although the RBI would likely intervene in exchange rate markets to limit its depreciation.

CHART 2: RUPEE TO LOSE SOME MOMENTUM DUE TO RISING COMMODITY PRICES AND DECREASED RISK-ON SENTIMENT

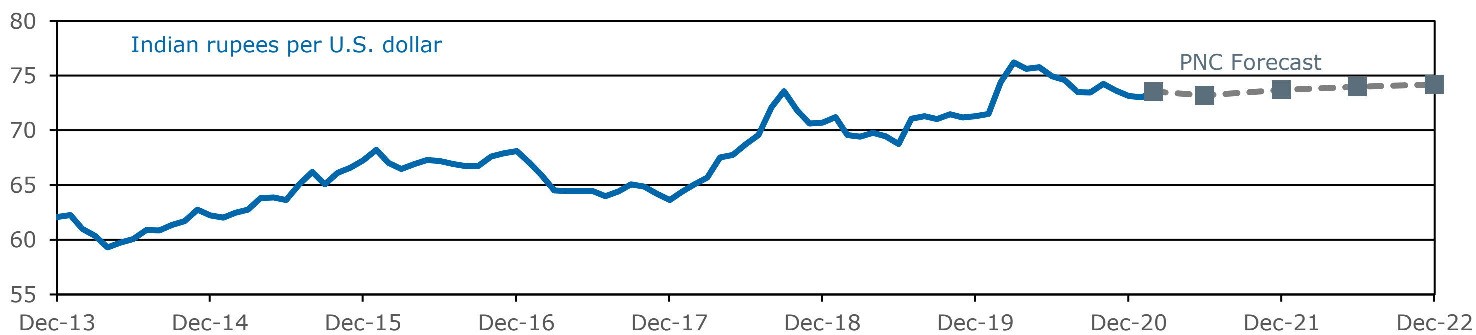

Chart sources: Bloomberg, The PNC Financial Services Group

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