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Can COVID-19 cause structural damages to Indian economy?

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With the spreading of COVID-19 virus global financial markets have reacted strongly with a fear of a global pandemic on March 2020.

Employment plunged, and real GDP. fell to historic lows. Almost all of that, however, reflected the direct effects of the pandemic, which forced much of the economy into lockdown.

There was a loss of confidence in the equity markets with ***Nifty Bank*** down by ***16.7%***, ***Nifty50*** down by ***13%*** and ***Sensex*** down by ***13.15%***(March 23rd, 2020).

Investors quickly turned their focus to commodities like gold to hedge the risks of volatility during these uncertain times with gold hitting all-time high recently indicating that the economy would be on a path of recession.

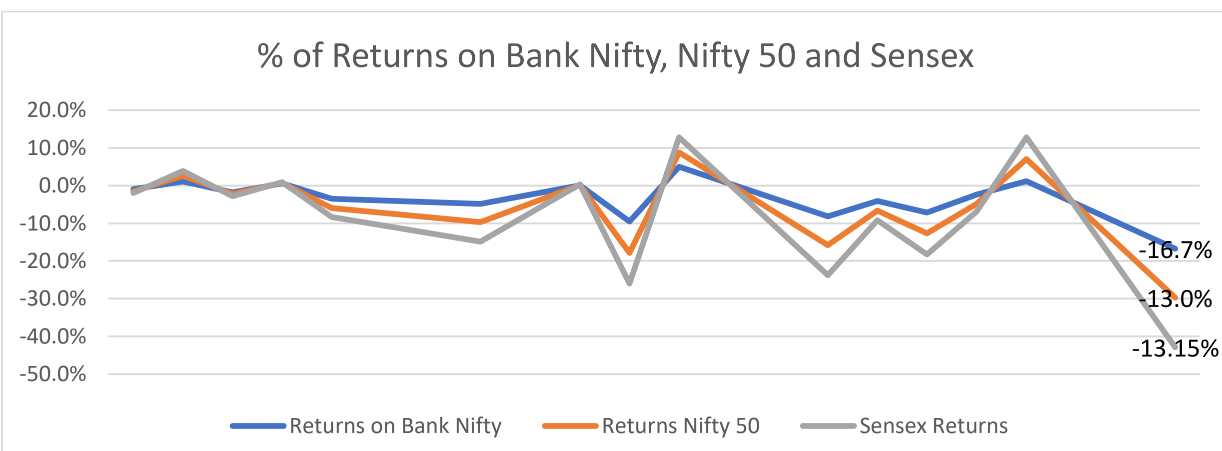

Fig1: Returns on Bank Nifty, Nifty 50 and Sensex ***Source: Yahoo Finance***

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But as per the graph below economy seems to be on a recovery path indicating a ***"V"- shape recovery*** indicating the classic real economy shock, a displacement of output, but growth eventually rebounds, and the annual growth rates could fully absorb the shock.

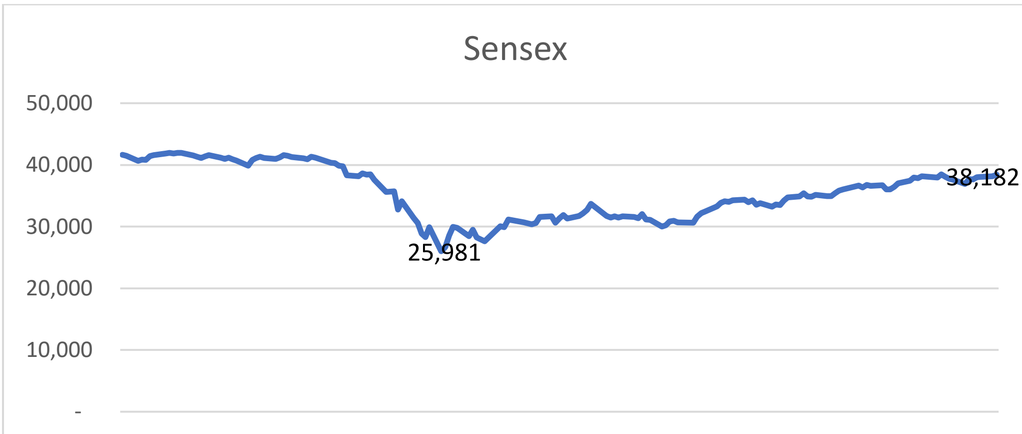

Fig 2: Sensex YTD (2020) ***Source: Yahoo Finance***

Also, it is worth looking back at history to place potential impact path of COVID-19 empirically. In fact, V- shape recovery patternduring epidemic such as SARS was observed.

Considering the fact that a year and two before the global pandemic, India has been trying to recover from the catastrophic turmoil caused by ***IL&FS*** (India's leading infrastructure finance company) as IFLS has defaulted on the payments to the lenders resulting in a panic across the financial market and have jeopardized hundreds of investors, banks and mutual funds associated with IL&FS and recently with the ***Yes Bank crisis.***

The recovery trend of the ***Bank Nifty Index*** shows completely a different picture about banking and finance sector – A ***"L"- Shape recovery***, indicating ***significant structural complications*** in an economy which might take a very long time to recover but history cautions us against drawing a conclusion between financial market sell-off and real economy.

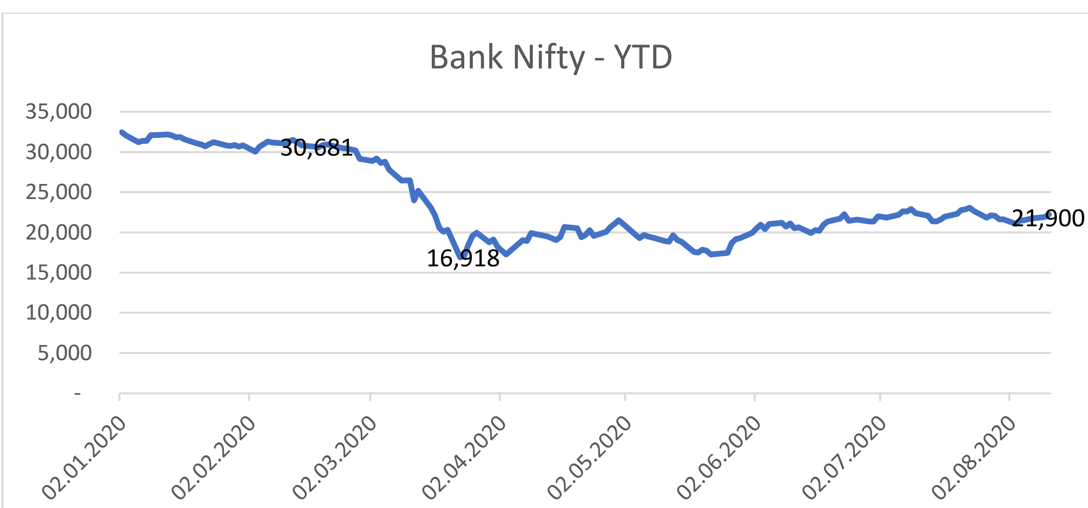

Fig 3: Bank Nifty YTD (2020) ***Source: Yahoo Finance***

Also, there has been a significant ***slow down in the in commercial bank year-on-year (YoY)credit growth*** along with a ***slowdown in the aggregate deposits***.

In March 2019 the bank credit growth was 13.1% and has been steadily falling and has reached a level of 6.4% on March 2020.

Aggregate deposits have reached a growth rate of 9.50% followed by a 10% growth rate previous quarter.***Slowing credit growth*** is one of the most critical challenges for the banking industry and there is a need to focus on prudent lending by the banks as it affects their profitability. Though RBI has taken necessary steps like reducing repo rates, bank need to start focusing on credit off take and credit flow.

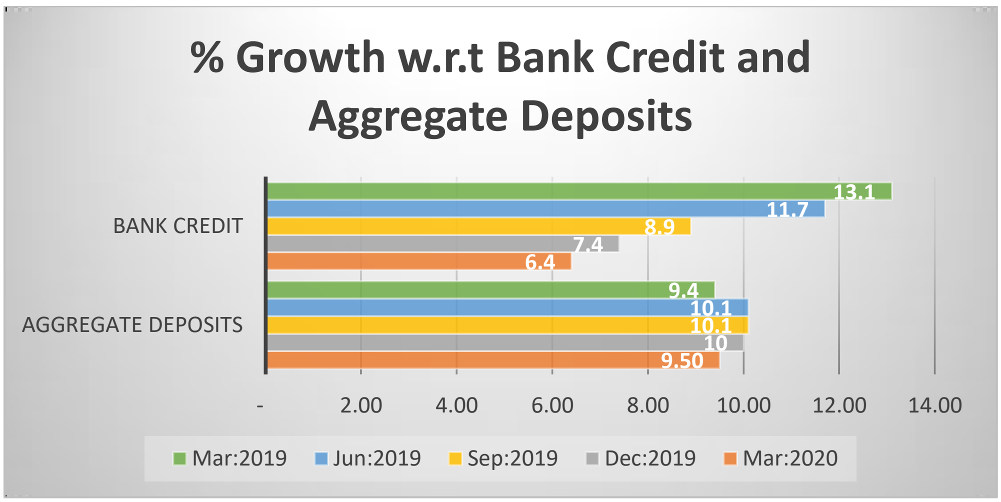

Fig 3: Bank credit and Aggregate Deposit GrowthSource: RBI

These falling growth rates of bank credit and aggregate deposits pose as a serious threat to the Indian Economy especially during times of volatility.

Falling growth rates and aggregate deposits across commercial banks suggest adrop-in consumer spending and confidence which would in turn cause steep declines in industrial output and employment as failing companies lay off workers. Millions of workers lost their regular incomesleading to reduced spending which in turn would cause millions to lose their jobs. Sustained consumer spending must be maintained to keep the economy afloat.

Moreover, with policy rates being so low, savers experience a negative real rate with high expectations of inflation over an extended period.Savers started shifting investments to real assets like gold and flew away from financial assets like deposits.

As per Consumer Confidence Survey, almost ***78%*** of the total respondents feel the ***economic situation has worsened***during June and July 2020. Despite the negative perception about the current scenario, almost 44.3% feel the economic situation will improve one year from now.

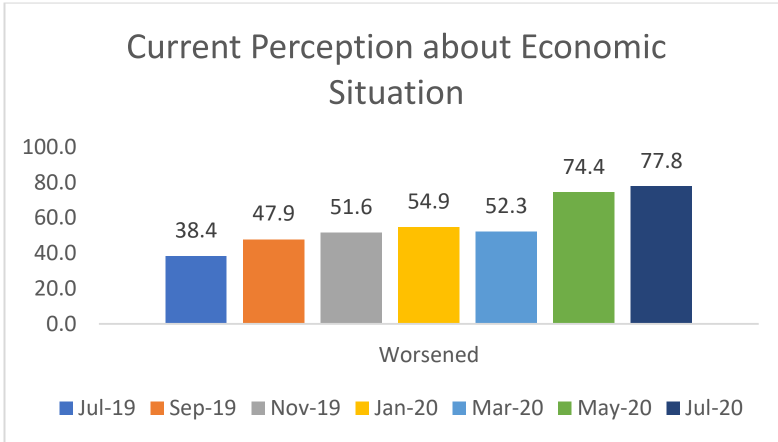

Fig 4: Perception about current situationSource: RBI

Perceptions and expecations on Income decreased among the respondents in the consumer confidence survey has been increasing at an expotential rate

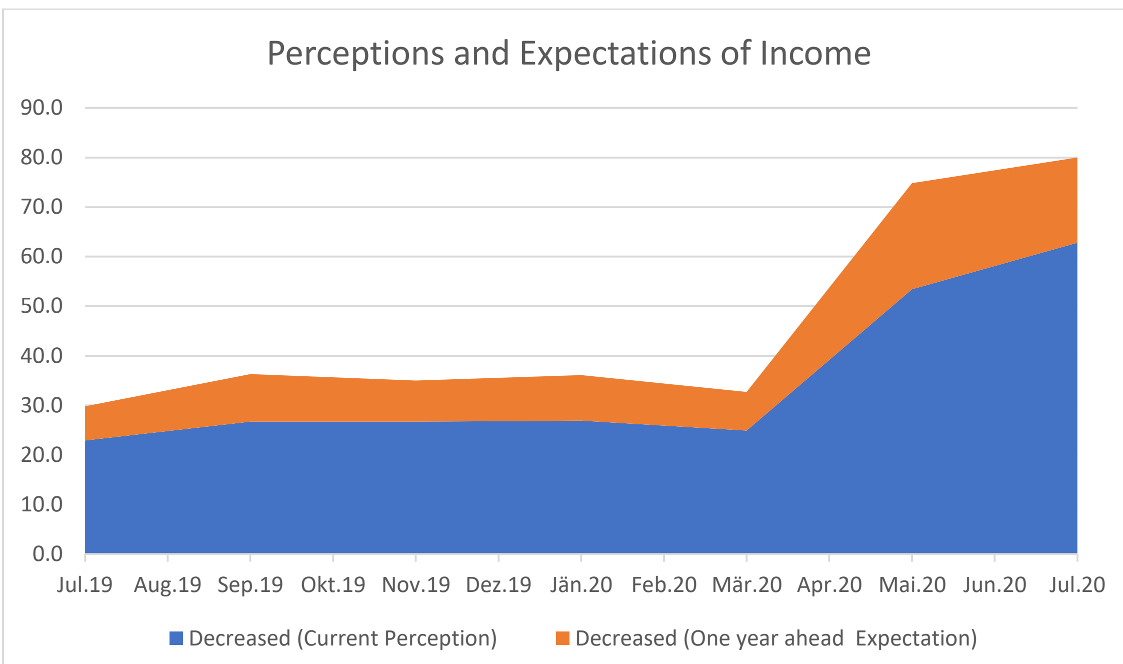

Fig 5: Perception and Expectation of incomeSource: RBI

Yet the perception for consumer spending has been on the negative side. The % of respondents having a perception of decreased spending has been increasing for both current scenario as well as a year from now.

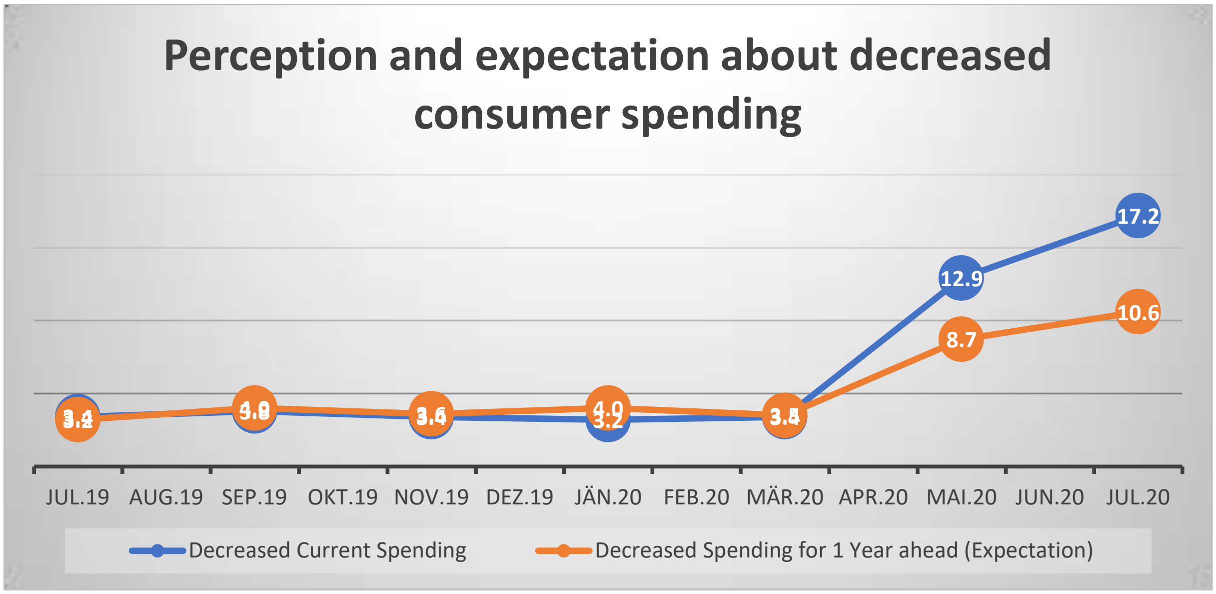

Fig 6: Perception about decreased consumer spendingSource: RBI

As the consumer spending perception and expectationsdampened and unsold goods began to pile up, factory production slowed down. Nonetheless, stock prices continued to rise, and by the fall of that year Sensex may reach to stratospheric levels that could not be justified by expected future earnings.

With Sensex rebounding, drawing straightline conclusions for the real economy may not be a right indicator. Neverthless financial markets are recession indicators, history shows that bear markets and recessions should not be automatically conflated.

Whether an emerging economy like India can avoid recession or not, the path back to growth under COVID-19 will depend on a range of drivers such as the degree to which the demand will be delayed.

If issues like Consumer spending are left unadressed, it could lead to a significant structural damage (the economies supply side) leading to a L-shaped economic recovery and having a significant impact on the growth. Whereas COVID-19 appears to be a potentially potent to hit directly on consumer confidence, keeping consumers at home, weary of discretionary spendings and perhaps pessimistics about longer term.

Focusing on the consumer signals and restoring confidence must be the primary concern as of now for better sustainable growth of the economy.

Bibliography

[1] RBI’s Households’ Inflation Expectations Survey

[2] RBI’s Consumer Confidence Survey

[3] Great Depression - History