



Can the Indian economy rebound from its COVID-19 crisis?

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India has been seeing a challenging growth narrative in the last ten years as well as more recently, but the country still has potential to transition to a knowledge-based economy with its key advantages: its position as a leader in knowledge and innovation, and a young, rapidly growing and educated population.

The economic news has been bleak just about everywhere this year, and it has been particularly bad for India. COVID-19 has taken a heavy toll on what was the world's fastest-growing major economy just a few years earlier.

But all is not lost. The global economy is expected to recover in 2021, and India is expected to see a strong rebound. Many investors underestimate India's long-term growth potential. It is interesting to note that over the last twenty years, MSCI India actually outperformed MSCI China in USD terms, although the latter has seen stronger returns over the last decade. Fig.1. and 2.

Over the longer term, the World Economic Forum believes India is a growing consumer market that few multinationals will be able to resist, with

consumption expected to grow to USD6 trillion by 2030¹. And its massive growth in online services, coupled with a strong, tech-savvy workforce also bodes well for future growth.

Despite India's undeniable challenges, the country may be approaching an inflection point, as a transition to a knowledge-based economy helps it return to strong growth.

FIRST, THE BAD NEWS

India has had the worst of both worlds this year. It not only felt the negative economic effects of a 14-week lockdown, but the lockdown failed to properly contain the pandemic. As of September, India has more than five million infections, and the numbers do not appear to be slowing. In fact, only the US has more cases².

And India's economy has taken a beating. The country's GDP fell by 23% in the second quarter and it is tipped to shrink by 9% this year — worse than any other large country on the continent — according to the Asian Development Bank³. Even before the pandemic hit, India's economic growth had slowed considerably from a few years earlier.

Fig 1: Performance of MSCI China vs MSCI India (September 2000 – September 2020)



Source: Bloomberg. Total returns in USD terms. 30 September 2020. Rebased to 100 as of end August 2000.

Fig 2: Performance of MSCI China vs MSCI India (September 2010 – September 2020)



Source: Bloomberg. Total returns in USD terms. 30 September 2020. Rebased to 100 as of end August 2010.

Small businesses, which is India's largest source of employment and a key driver of economic growth, have been severely affected. Sluggish growth among small businesses will also have an impact on consumption. The International Labour Organisation thinks COVID-19 could plunge as many as 400 million Indians deeper into poverty⁴.

THE ROAD AHEAD

The good news is that the pandemic won't last forever. The same ADB figures which tipped a 9% contraction this year predict 8% growth in 2021.

And there are already some green shoots.

Source: ⁴[https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/briefingnote/wcms_740877.pdf#page=\[6\]](https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/briefingnote/wcms_740877.pdf#page=[6])

The Purchasing Managers' Index (PMI) for manufacturing was recorded at 52 in the month of August — indicating expanding economic activity for the first time since April. And Maruti Suzuki, India's largest car maker sold 21.7% more cars in August 2020 than it did in the same month last year⁵. That said, the higher car sales could be due to pent-up demand following a six-month lockdown as well as a growing preference for private transportation as a result of the pandemic.

And while the Indian government's balance sheet has taken a hit, India's stimulus spending has lagged behind other countries, which means they may yet be able to pump-prime the economy back to growth.

But even with a post-pandemic bounce, India has a number of longer-term structural issues it needs to address.

The finance sector is in need of reform. The ratings agency S&P says India's banking sector will take time to recover and there were significant asset-quality issues in India prior to the onset of COVID-19, even as asset quality improved elsewhere⁶. Even so, there are some bright spots. Many underperforming smaller banks have been absorbed by more competitive rivals, and banking penetration is now almost universal.

Still, the banking sector (along with relatively high interest rates) has had an impact on corporate debt and underinvestment. One McKinsey survey found that 43% of India's long-term debt is held by companies that spend a predominant share of their earnings on debt service, while competition among small and medium-size companies is so fierce that many have little to reinvest⁷.

Over the short term, it is likely many businesses will be looking to rein in costs. That may involve new digital efficiencies, but it could also involve layoffs or attempts to restructure debt rather than new

borrowing for ambitious projects. But some canny investors are likely to do well, finding investment opportunities among businesses that need a quick cash injection or who have seen their values fall⁸.

Foreign Direct Investment inflows have been strong and investors from the US, Japan and other countries are very interested in moving manufacturing to India. This could be a major inflection point, if the government moves swiftly and decisively. The Indian economy can revive through a capex cycle driven by foreign investments.

IMPROVING FUNDAMENTALS

Over the longer term, the growth of internet services is likely to have a significant impact on India's economic future. More than half the world's population is now active on the internet, and about 12% of them are in India, more than in any other country except China. Much of this has been driven by the entrance of Reliance Jio, a low-cost operator which now has more than 300 million subscribers. The company's free voice calls and cheap data helped to double data usage in the space of a year.

Since Reliance Jio's entry into the market in 2016, Indians have had access to the world's cheapest data plans. It is clear that digital technology can generate enormous value, and the pandemic has accelerated the uptake of digital technologies.

Indian consumers have enthusiastically adopted delivery services, at-home entertainment, and digital applications regarding education, food, staples, shopping, communications, health, and fitness. In a research report, Morgan Stanley said 2020 will likely provide a tailwind to digital services, with competition heating up particularly in groceries⁹.

There is, however, plenty of room for growth. The same report said India's total online shopper base was about 30% of its internet population, compared

Source: ⁵<https://www.hindustantimes.com/business-news/current-state-of-indian-economy-the-good-the-bad-and-the-ugly/story-AmL0tZkWDGkJ5H1EA5G-J4N.html> ⁶<https://www.spglobal.com/ratings/en/research/articles/200923-global-banking-recovery-will-stretch-to-2023-and-beyond-11661040> ⁷<https://www.mckinsey.com/~media/McKinsey/Featured%20Insights/India/Five%20priorities%20for%20corporate%20India%20in%20the%20next%20normal%20after%20COVID%2019/Five-priorities-for-corporate-India-in-the-next-normal-after-COVID-19.pdf> ⁸<https://www.mckinsey.com/~media/McKinsey/Business%20Func-tions/M%20and%20A/Our%20insights/Indias%20post%20COVID%2019%20economic%20recovery%20The%20M%20and%20A%20imperative/Indias-post-COVID-19-economic-recovery-The-M-and-A-imperative-vf.pdf> ⁹https://economictimes.indiatimes.com/tech/internet/covid-19-to-accelerate-digital-adoption-in-india-jio-helped-spur-internet-usage-morgan-stanley/articleshow/76031939.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

with over 70% in the US and China. Morgan Stanley predicts India will have 914 million users by 2027 with 590 million online shoppers. As such, we are positive on the prospects of e-commerce delivery platforms in India as well as companies with subscription-based business models that offer entertainment and other services to households.

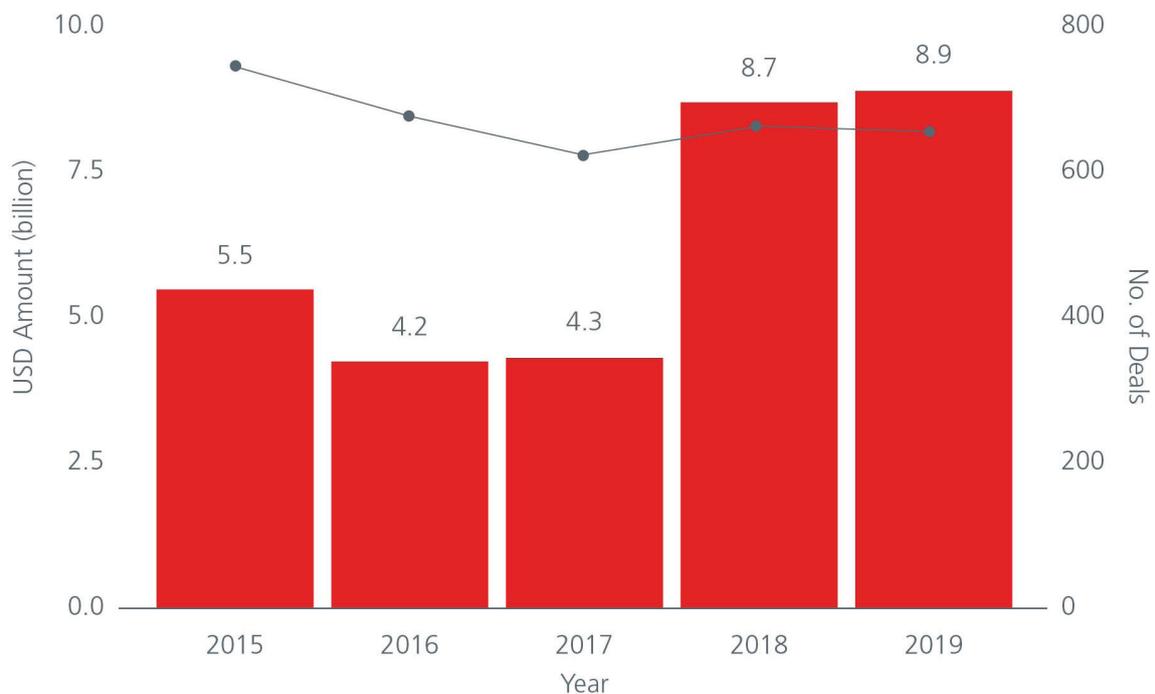
STARTUP PARADISE

India's digital leap has laid the foundation for its thriving startup ecosystem. According to the ADB, India has an estimated 26,000 startups, making it the third-largest startup ecosystem in the world¹⁰. And while the Indian government engaged in a high-profile push towards manufacturing with its "Make in India" campaign, it is the knowledge

economy and tech services that have really excelled in India. Even now among the listed companies in India, we are optimistic about India's software and services sector over the longer term.

Startup funding has taken a major hit this year. In fact, it is 29% lower than last year, according to one estimate¹¹. But over the longer term, growing spending power, better connectivity, access to new consumer markets and social media adoption is likely to see many companies grow. So too will India's strengths in human capital and ICT (Information and Communications Technology) services. In fact, between 2016 and late 2019, India saw consolidated inflows of over USD36 billion with 26 "unicorns" – startups valued over USD1 billion¹².

Fig 3: VC* investments into startups in India (2015 – 2019)



Source: Plotted based on data from Venture Intelligence. As of 24 December 2019. *VC is defined as Seed to Series F investments in companies less than 10 years old.

Source: ¹⁰<https://www.adb.org/sites/default/files/publication/612516/adbi-wp1145.pdf> ¹¹<https://www.livemint.com/companies/start-ups/startup-funding-down-29-in-first-half-of-2020-tracxn-11594216461904.html> ¹²<https://www.adb.org/sites/default/files/publication/612516/adbi-wp1145.pdf> ¹³<https://www.mckinsey.com/featured-insights/india/five-priorities-for-corporate-india-in-the-next-normal-after-covid-19> ¹⁴<https://www.mckinsey.com/~media/McKinsey/Business%20Functions/McKinsey%20Digital/Our%20Insights/Digital%20India%20Technology%20to%20transform%20a%20connected%20nation/MGI-Digital-India-Report-April-2019.pdf>

And the Indian market remains attractive to long-term investors. Some USD50 billion of foreign direct investment (FDI) equity flowed into India during the year that ended in March 2020, and several high-profile FDI investments have been announced in the past six weeks¹³.

Even so, to make the most of its advantages, India will have to enact policies to help its best prospects to gain a foothold. McKinsey believes that poor policies could hamper its best companies by as much as 50%¹⁴. Fig 4.

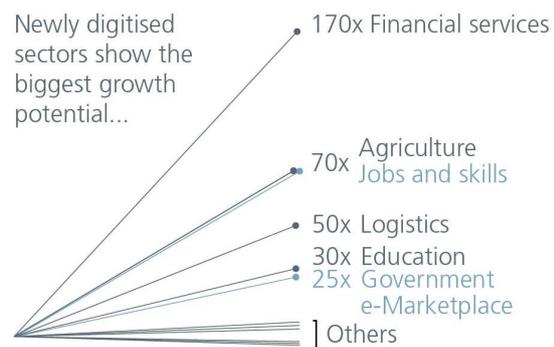
CAUTIOUS OPTIMISM

Decisive action to help India resume its high growth path is essential. The challenge is daunting. India's economy will need to grow at 8-8.5% every year to create jobs for the 90 million more workers who will be in search of non-farm work by 2030. The pandemic is a once-in-a-generation challenge to growth.

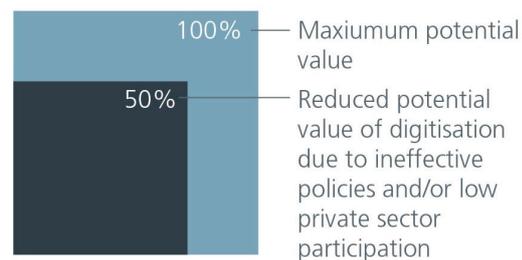
But India has a number of advantages. It has a young, increasingly educated population, a functioning democracy, respect for intellectual property and a stable currency. It is a leader in knowledge and innovation, which it has demonstrated through the success of the tech and pharmaceutical sectors.

The potential for growth is still huge, and although there will be challenges in the years ahead, there will be plenty of opportunities too.

Fig 4: Digital technologies can create significant economic value in India in 2025



...but India will need to seize the opportunity.



Source: McKinsey Global Institute. Digital India. Technology to transfer a connected nation. March 2019.

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