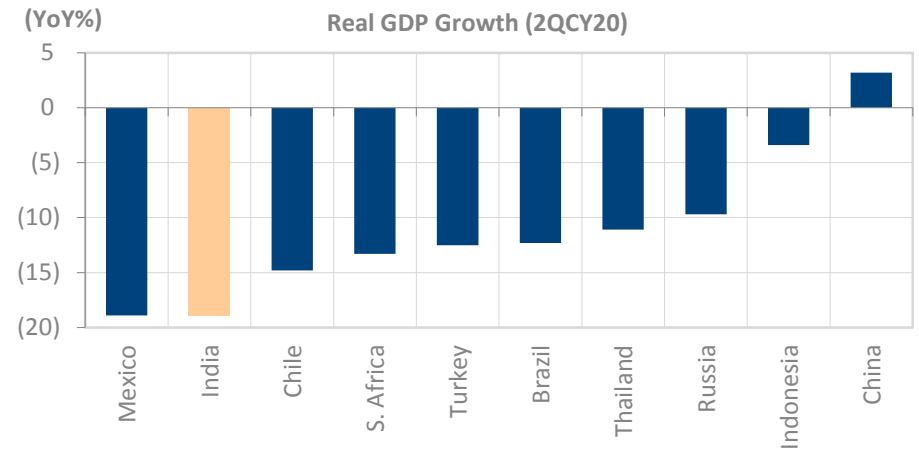


MPC caught between low growth and high inflation

The government has been unable to further ease lockdown restrictions due to steady rise in Covid cases. This along with weak demand dragged the recovery momentum in July. The optimistic consensus expectations of sharp recovery in growth are not backed by early trends and hence growth estimates are likely to be cut. Inflation, on the other hand, has stayed above the MPC target range for last 7 months and the transmission of rate cuts announced so far has been weak. The risk aversion among lenders and an expected spike in the NPAs would also be a drag on transmission. The MPC will have to deal with this dual challenge of high inflation and weak growth in its upcoming policy meet on August 6, 2020.

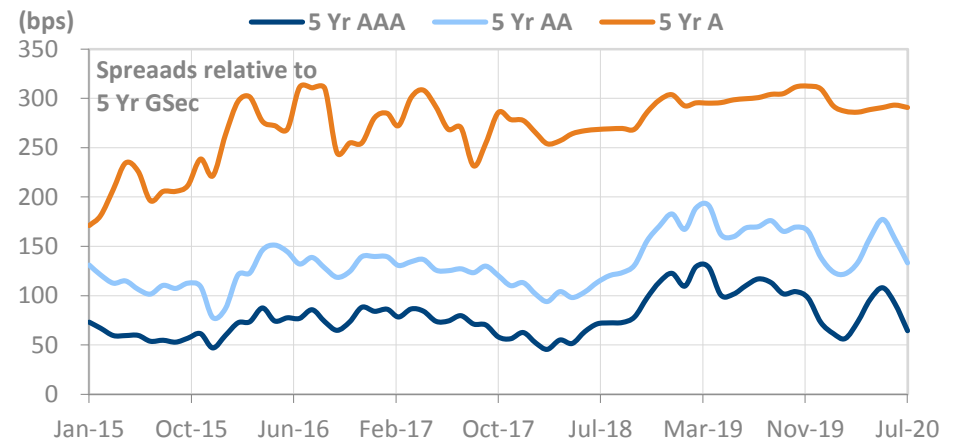
- State Governments have been forced to maintain stringent lockdown as the pace of increase in Covid cases is not moderating. The stringency of lockdown in India is broadly similar to countries with large number of active cases.
- After a sharp rebound until June, the pace of recovery has slowed down in July, due to restrictions on businesses and weak demand.
- Employment rate is now near pre-Covid level aided by pick up in agriculture and daily wage jobs. However, the salaried jobs haven't recovered from the lows of April.
- India is expected to report sharpest contraction in GDP growth in 2QCY20 among peer EMs. While the consensus also implies steep economic recovery over next 3 quarters, the early trends do not support this optimism and growth estimates could be downgraded.
- The MPC faces a tough combination of uptrend in inflation and weakening growth. While policy rates have been cut by 250bps since Feb 2019, banks have passed on only a fraction of this to new borrowers. Slower pace of transmission to existing borrowers further blunts the policy rate cut impact. Although weak credit growth and surplus liquidity aid decline in lending rates, risk aversion among lenders and the expected spike in NPAs would be a drag on transmission. On balance, while MPC is likely to ease rates further, lending rate cuts could continue to lag policy rate cuts.

Contraction of Indian economy in 2QCY20 is expected to be sharpest among EMs



Source: Bloomberg, IIFL Research

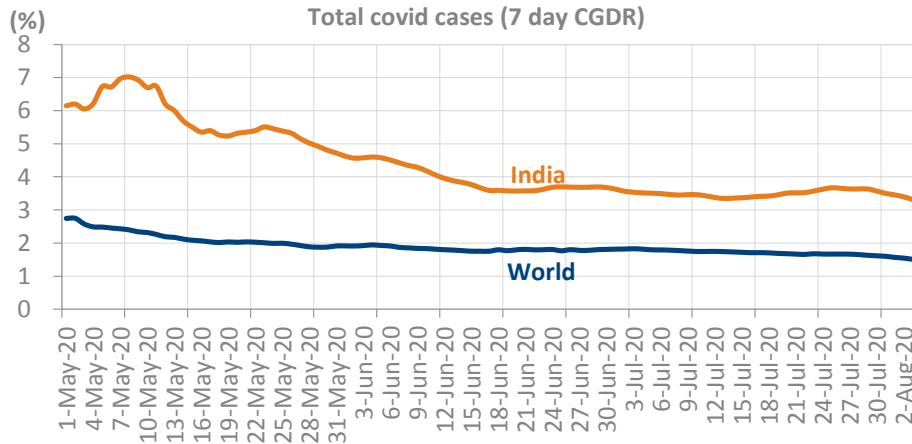
Spreads on lower rated bonds are near 5-year highs while spreads on higher rated bonds are closer to 5-year lows



Source: Bloomberg, IIFL Research. **Note:** Based on monthly average of yields

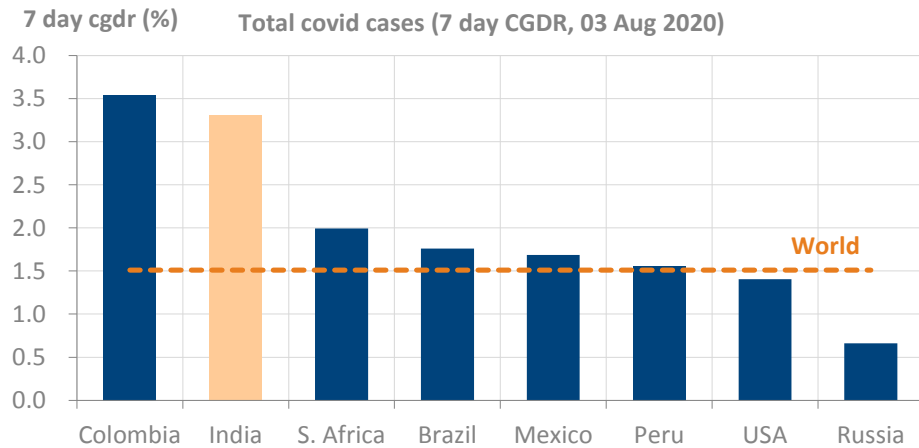
Stringent lockdown persists

Figure 1: The pace of rise in Covid cases did not moderate in July



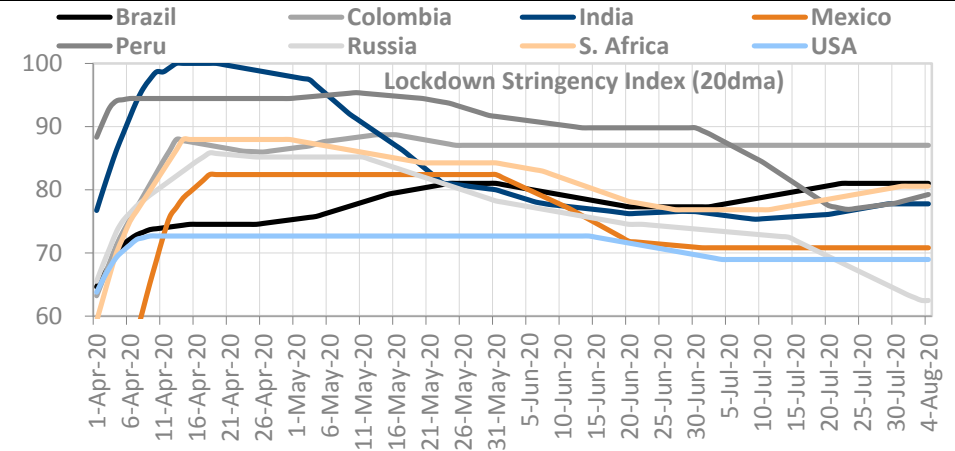
Source: <https://ourworldindata.org/>, IIFL Research

Figure 2: Covid cases in India are rising at a faster pace compared with other countries



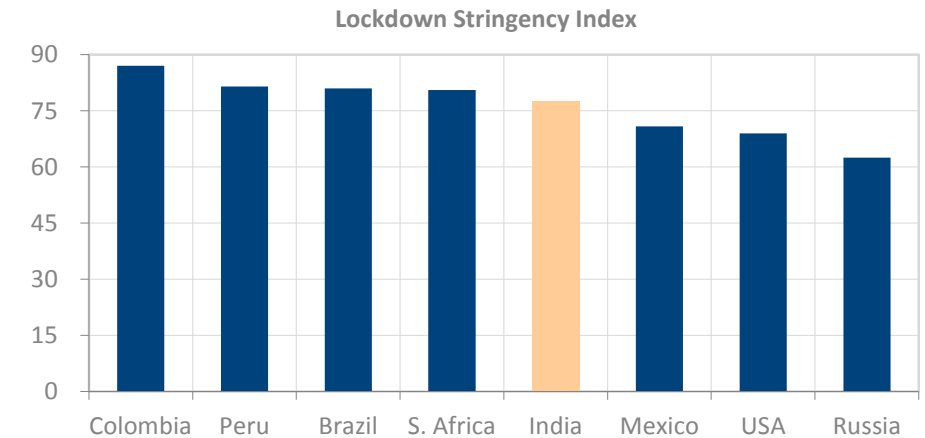
Source: <https://ourworldindata.org/>, IIFL Research. **Note:** The selected countries account for nearly two-thirds of active and total Covid cases.

Figure 3: The lockdown stringency hasn't eased in India after some relaxations in May and June



Source: University of Oxford Coronavirus Government Response Tracker, IIFL Research **Note:** The selected countries account for nearly two-thirds of active and total Covid cases.

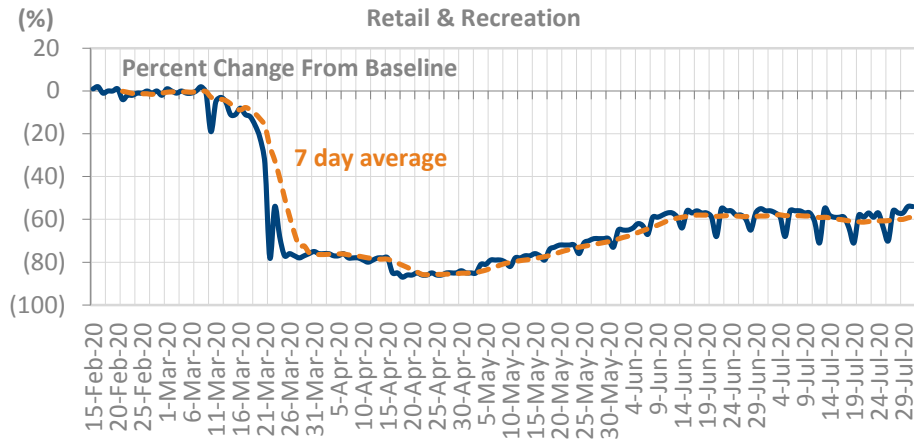
Figure 4: India's lockdown stringency is broadly similar to countries with high number of active cases



Source: University of Oxford Coronavirus Government Response Tracker, IIFL Research **Note:** The selected countries account for nearly two-thirds of active and total Covid cases.

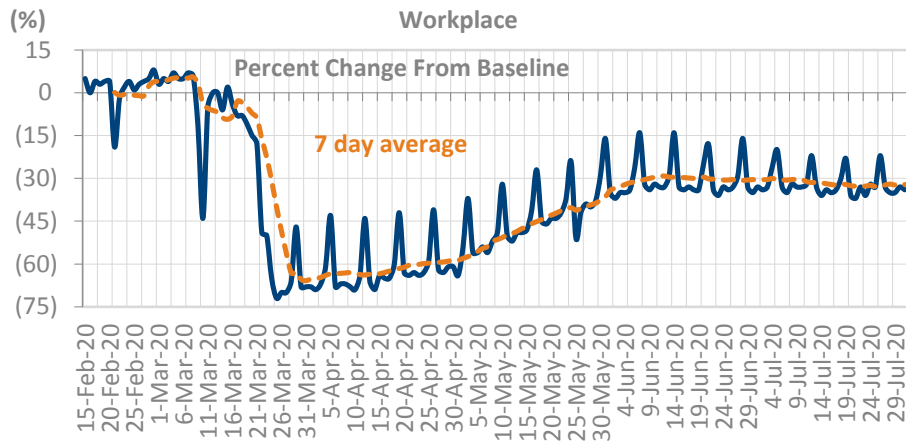
Plateauing mobility

Figure 5: Retail and recreation activity has stabilized at 60% below pre-covid levels



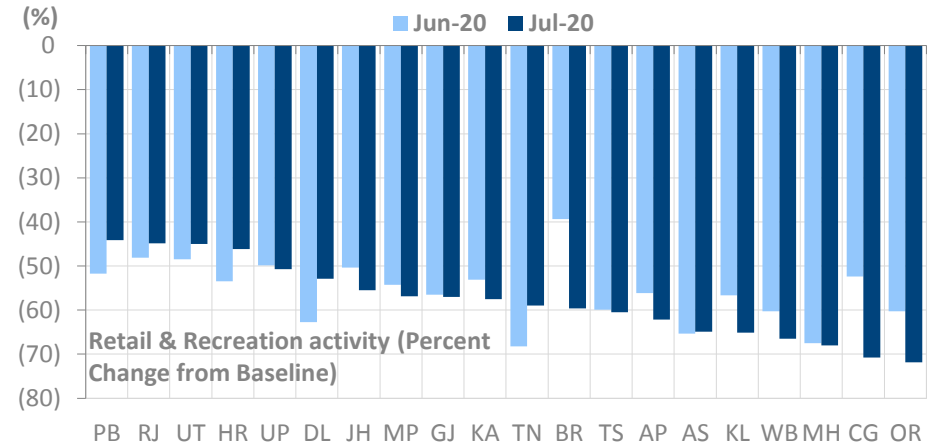
Sources: Google mobility report, IIFL Research.

Figure 6: Workplace activity has actually declined slightly in July



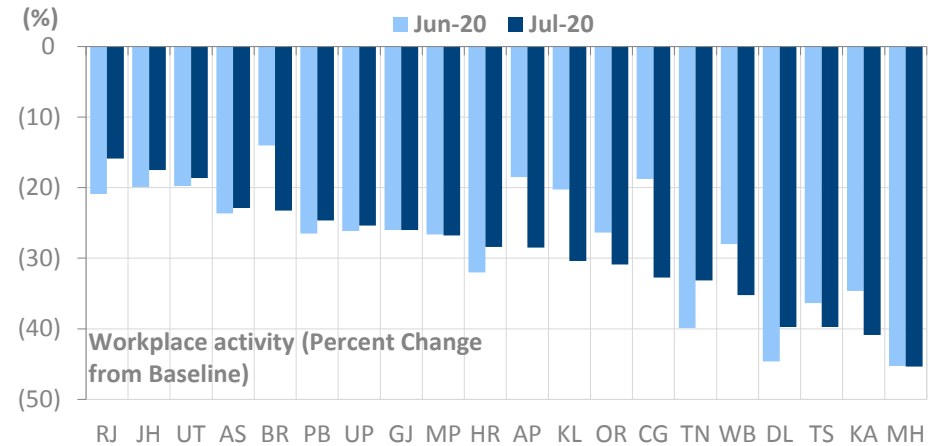
Sources: Google mobility report, IIFL Research.

Figure 7: Retail & recreation activity has actually dropped in many states



Sources: Google mobility report, IIFL Research. Based on average of last week of June and July 2020

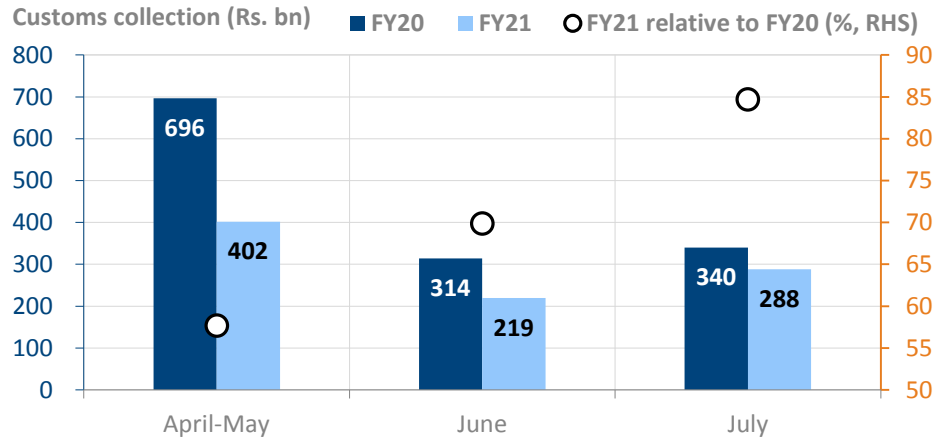
Figure 8: Workplace activity has improved in very few states



Sources: Google mobility report, IIFL Research. Based on average of last week of June and July 2020.

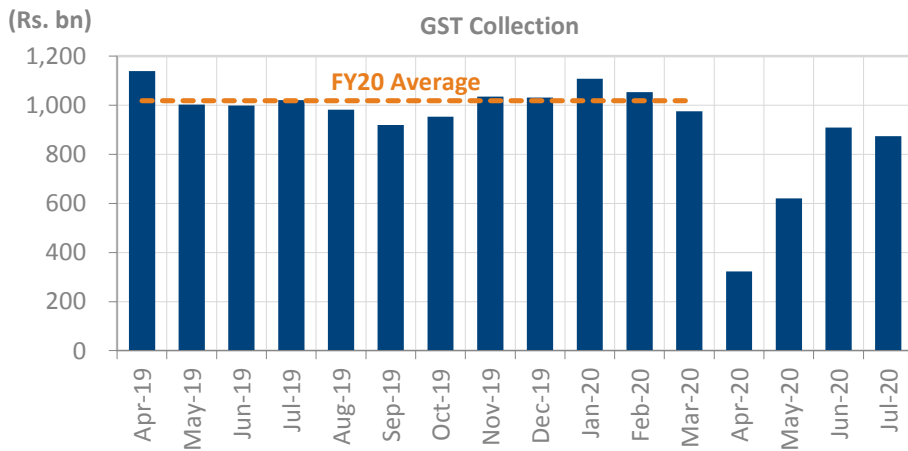
Economic activity stagnating below pre-covid levels

Figure 9: Customs collection in July-20 improved to ~85% of July-19 levels...



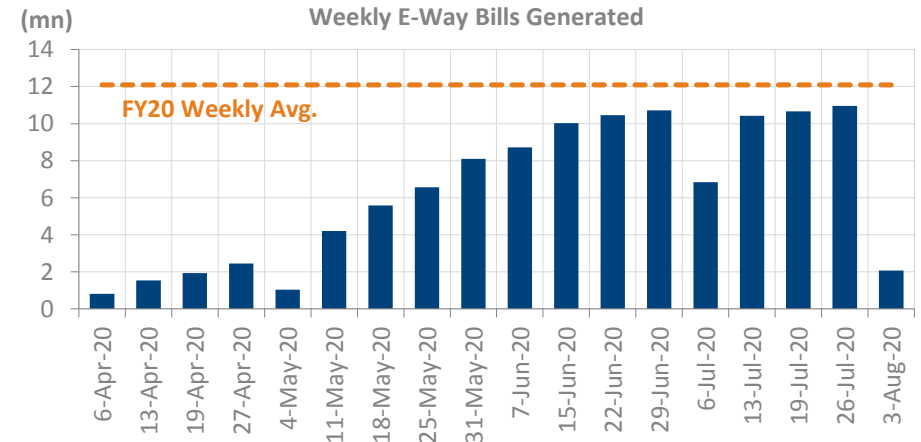
Source: CBEC, IIFL Research. *Includes only locations with Electronic Data Interchange (EDI)

Figure 10: GST collections moderated in July



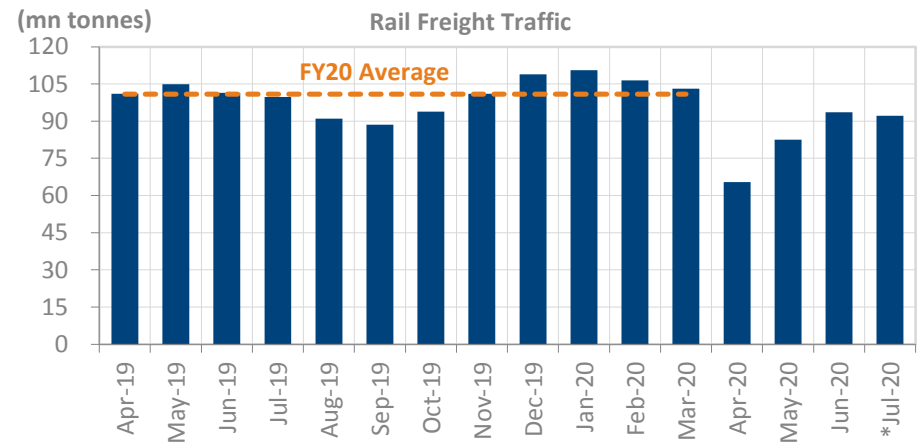
Source: PIB, IIFL Research

Figure 11: E-way bills generation has not improved in July



Source: CEIC, IIFL Research. Avg bills generated in FY20 calculated using total E-way bills generated in FY20 divided by 52.

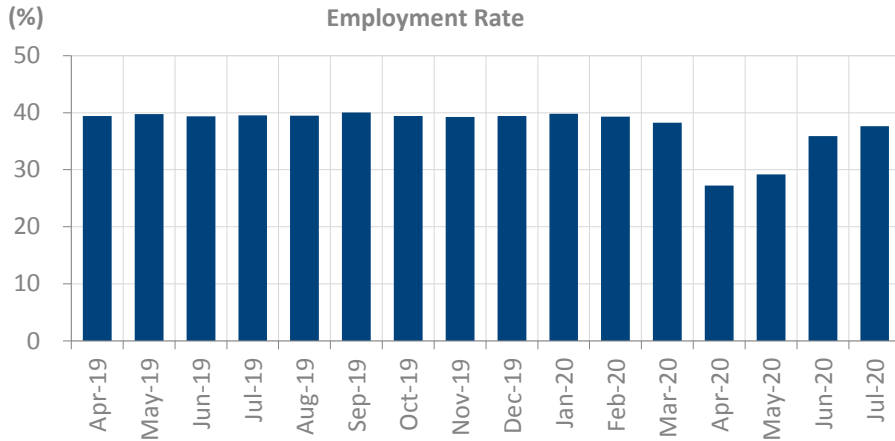
Figure 12: Rail freight traffic has stagnated ~10% below FY20 average



Source: PPAC, PIB, IIFL Research. **Note:** *July data extrapolated based on traffic of 20 days in July

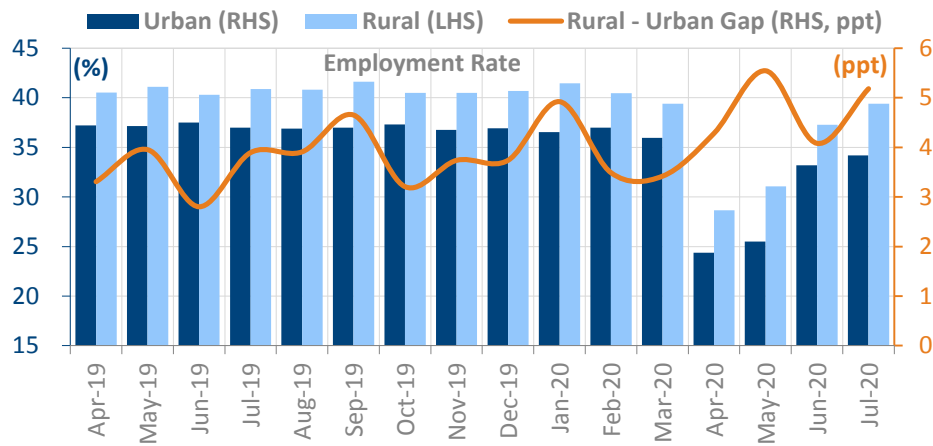
Farm and daily wage jobs drive improvement in employment

Figure 13: Employment rate has nearly recovered to pre-Covid levels



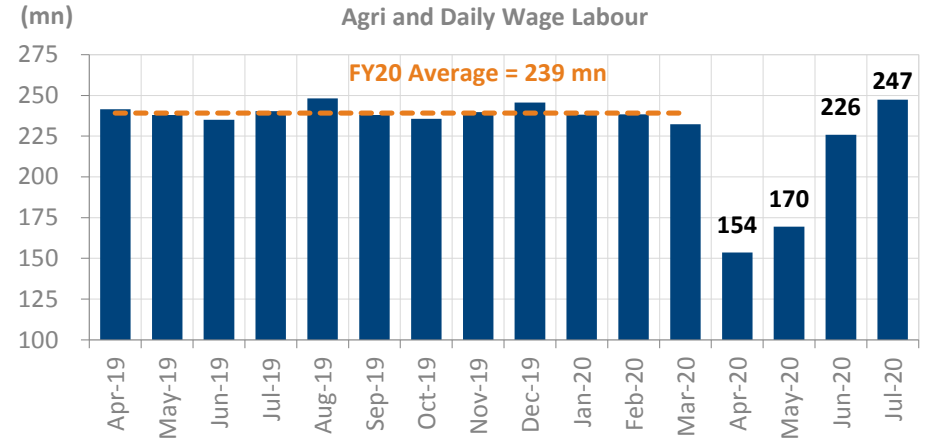
Source: CMIE., IIFL Research

Figure 14: However the gap between rural and urban employment has widened...



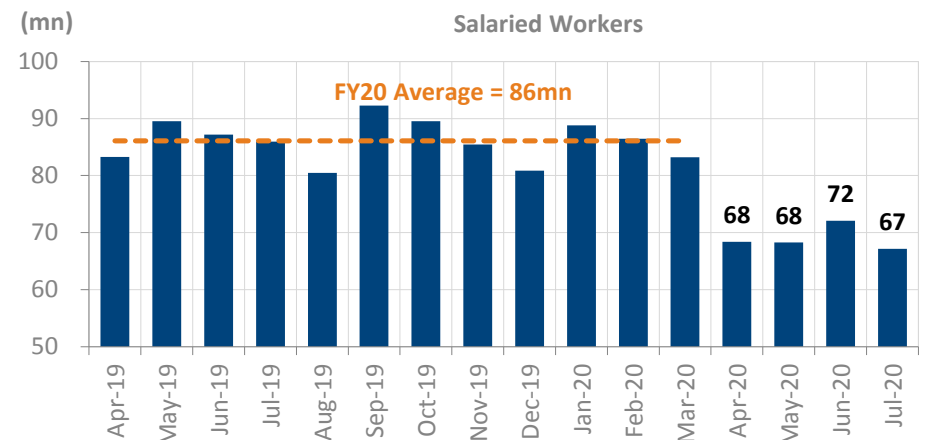
Source: CMIE., IIFL Research

Figure 15: ...as agri and daily wage jobs drove the recovery...



Source: CMIE., IIFL Research

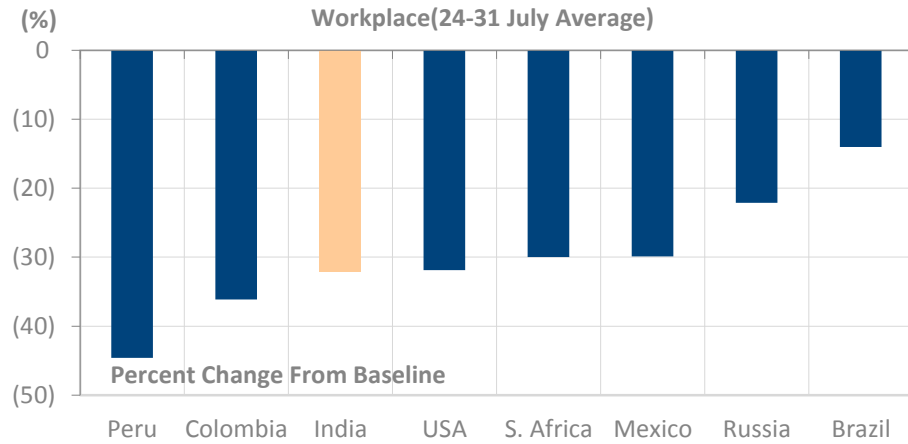
Figure 16: ...However salaried jobs remain near the lows of April



Source: CMIE., IIFL Research

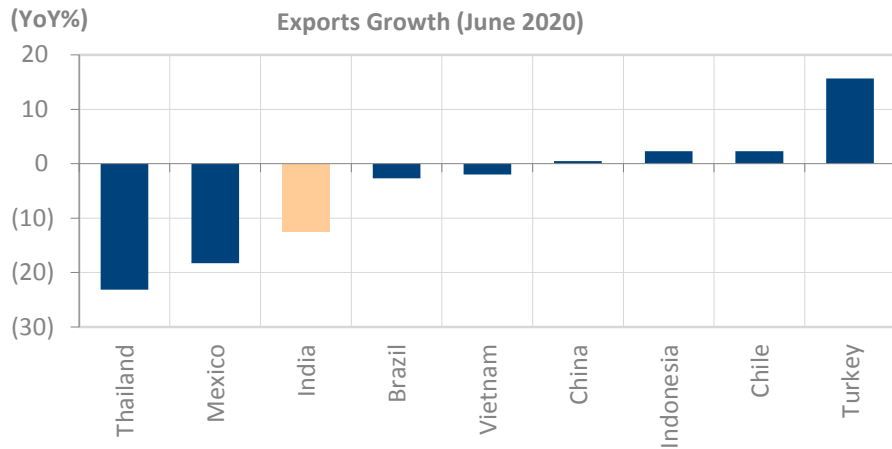
Expectations of sharp rebound for India

Figure 17: Among countries with large number of active cases only Russia and Brazil have higher workplace activity relative to India



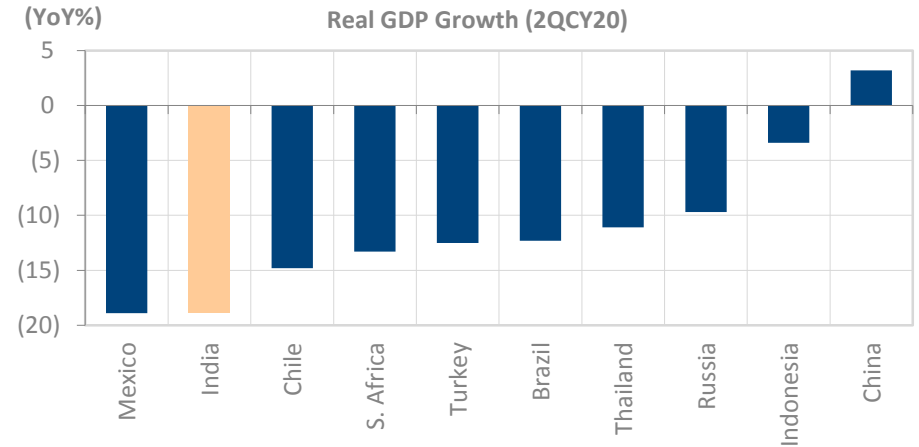
Source: Google Mobility Report, IIFL Research.

Figure 18: Recovery of exports from India has been weaker than several EMs



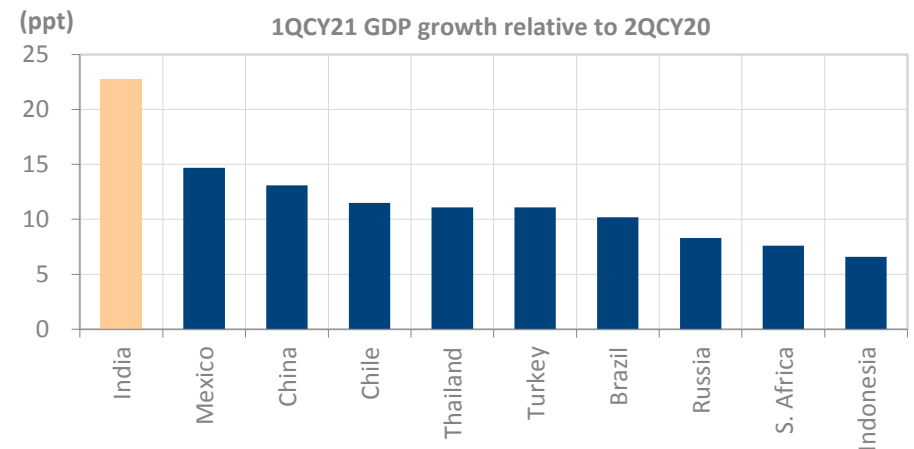
Source: WTO, Media releases, IIFL Research. Peer EMs based on countries that have data on June 2020 exports

Figure 19: Contraction of Indian economy in 2QCY20 is expected to be the most severe among EMs ...



Source: Bloomberg, IIFL Research.

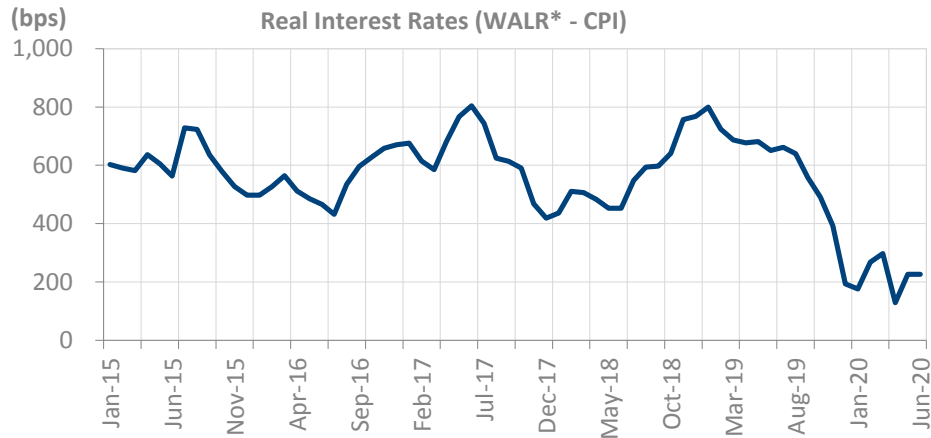
Figure 20: ...However the consensus is also implying a sharp rebound over the next three quarters.



Source: Bloomberg, IIFL Research

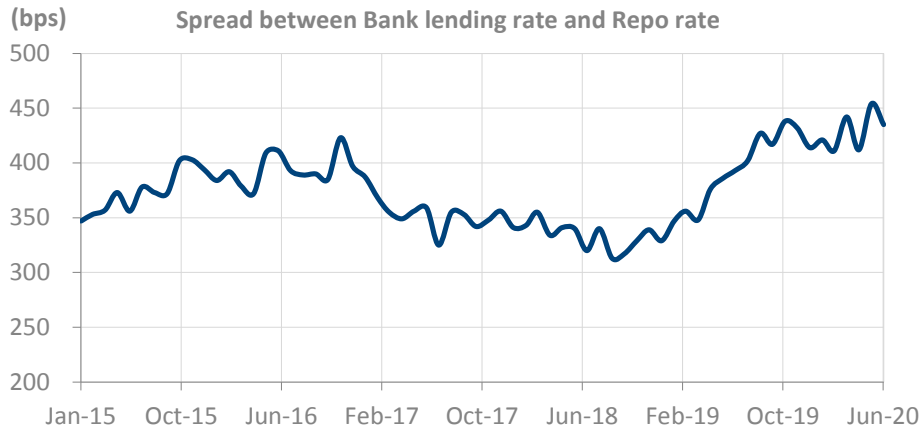
Transmission remains weak

Figure 21: Real lending rates have moderated with spike in inflation in last few months



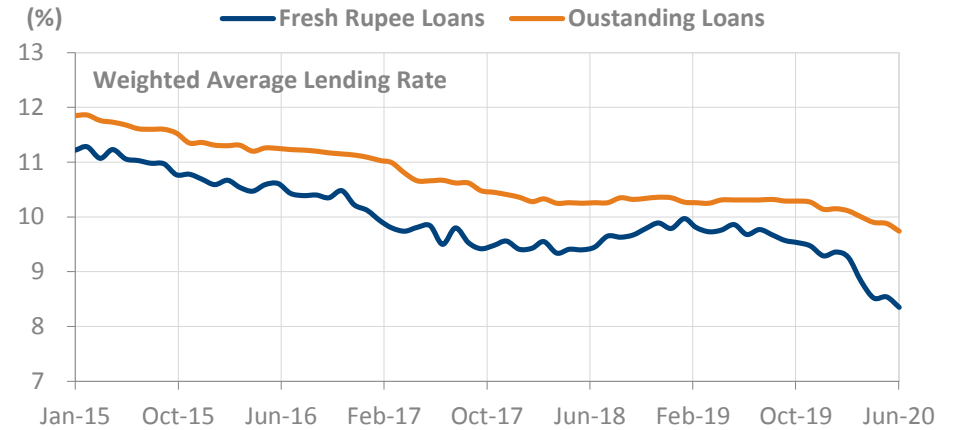
Source: CEIC, IIFL Research **Note:** *Weighted Average Lending Rate on fresh INR loans

Figure 22: Spreads between Repo rate and bank lending rate remain at elevated levels



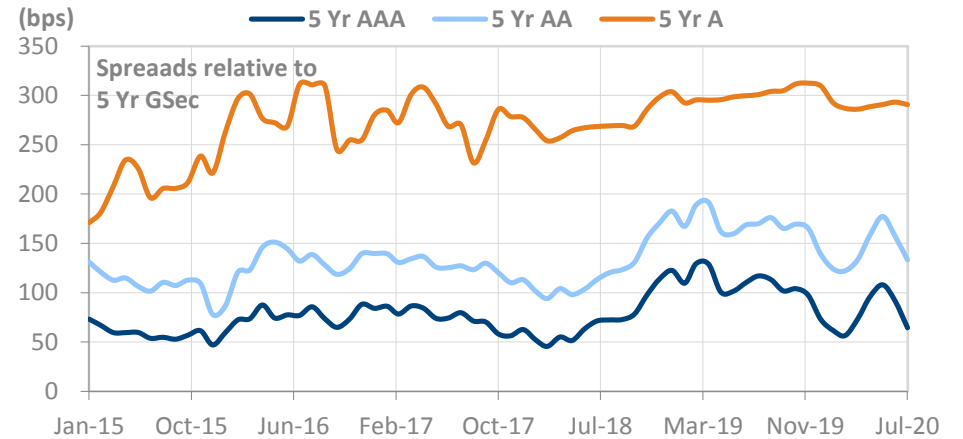
Source: CEIC, RBI, IIFL Research. **Note:** Weighted average lending rate on fresh rupee loans

Figure 23: Transmission of rate cuts is slower for existing borrowers



Source: RBI, IIFL Research.

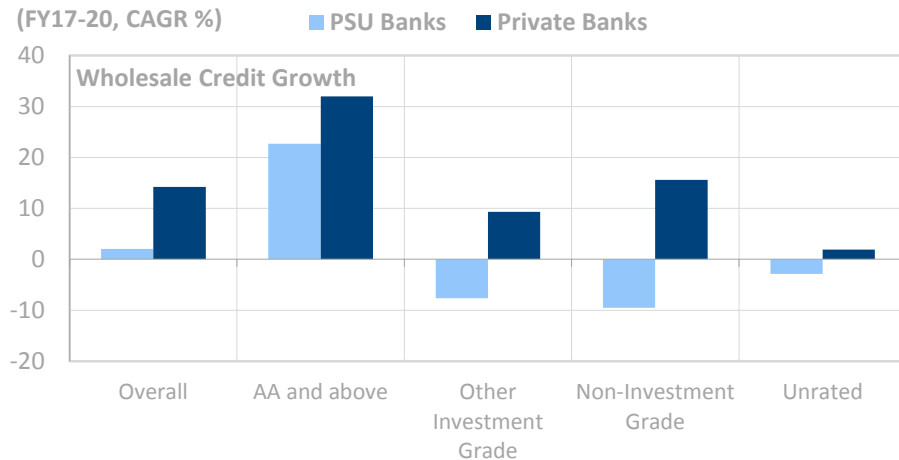
Figure 24: Spreads on lower rated bonds are near 5-year highs while spreads on higher rated bonds are closer to 5-year lows



Source: Bloomberg, IIFL Research. **Note:** Based on monthly average of yields

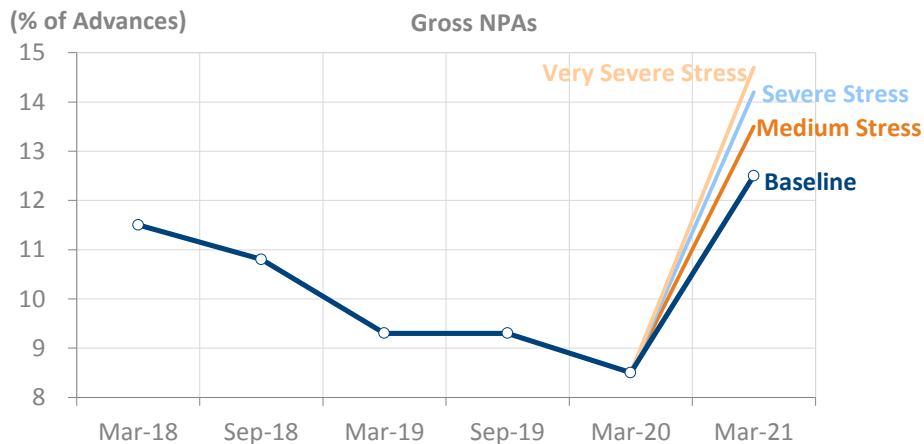
Risk aversion and NPA burden could impede transmission

Figure 25: PSU bank lending to higher rated borrowers reflects the risk aversion among PSU bankers



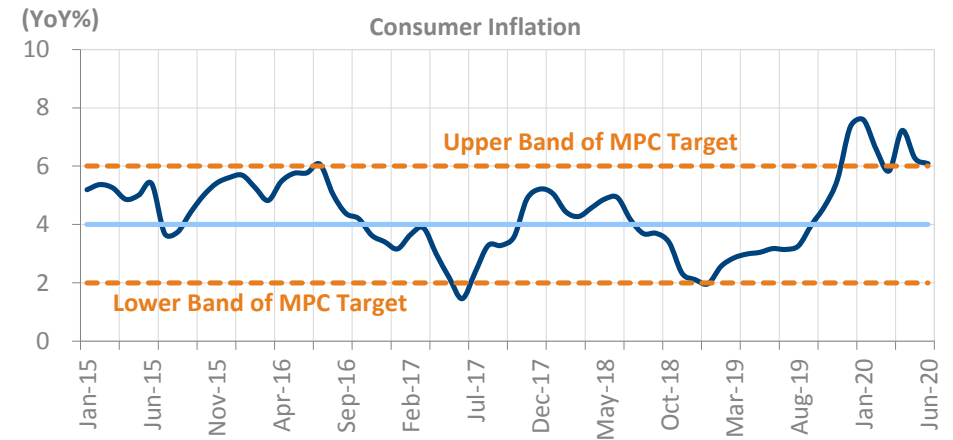
Source: CEIC, RBI, IIFL Research.

Figure 26: Bank NPAs are projected to jump by ~4-6ppt of advances



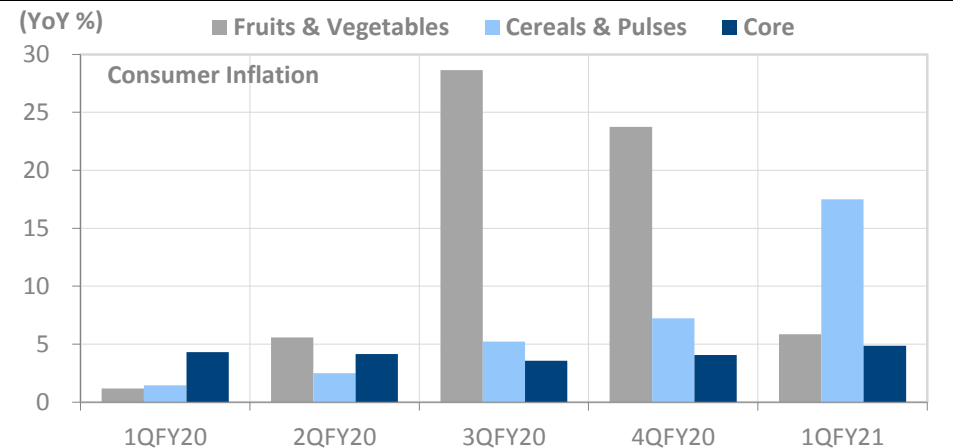
Source: RBI, IIFL Research.

Figure 27: CPI has been above the upper band of MPC target range since Dec-19



Source: CEIC, IIFL Research.

Figure 28: The stickier components of food and core inflation are driving the acceleration in inflation



Source: CEIC, IIFL Research.

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