FM targeted liquidity issues; sustained upturn in market will take time

The biggest concern for the Indian government in providing substantial fiscal stimulus seems to be the fear of a downgrade of sovereign rating to a junk category given our high debt-to-GDP and low tax-to GDP-ratios. On the other hand, not providing any significant or effective stimulus will do more harm than good amid the Covid-19 pandemic. If these issues are not addressed, India's structural growth potential will be impacted. It is paramount for our 'nominal' GDP growth rate to accelerate quickly in the next couple of years in order to keep the debt/GDP ratio in check.

The government has thus far announced relief measures in a calculated manner, to limit the direct impact on our fiscal deficit in the current year and to provide maximum liquidity and growth support, to weather this crisis. Tuesday's announcement on the micro, small and medium enterprises (MSME) sector, which employs around 110 million people and contributes 30 per cent and 40 per cent to our GDP and exports respectively, was encouraging. The biggest announcement of Rs 3 trillion (3 per cent of overall system loans) collateral free loans to MSME as this can accelerate loan growth once the demand returns and help push back the non-performing asset (NPA) accretion by 12 months.

On the other hand, for the government, this guarantee is largely fiscal-neutral in the current year. We note that the default rates in the MSME sector is slightly higher and could worsen further given lack of demand amid the challenging macro environment. The current default rate is close to low double-digit levels, and it is skewed more for public sector banks given their relatively weak underwriting standards compared to the private players. Overall, the announcement is positive for banks and non-bank finance companies (NBFCs) with high exposure to MSMEs. The liquidity support measures for the NBFCs and housing finance companies (HFCs) with full and partial government guarantees is a step in the right direction. This will help to address some of the pressing concerns of the sector in the near term. That said, we continue to remain cautious on the sector, as we believe the segment will see more downside in the near-to-medium term and the improvement is expected only after a few quarters.

The other major announcement was clearing the dues of distribution companies (DISCOMs) worth Rs 900 billion via liquidity infusion by Power Finance Corporation (PFC) and Rural Electrification Corporation (REC). While this is not a reform, this will help clear the pending dues of power-generating and transmission companies, and will help to improve their liquidity position. Overall, Tuesday's announcements were targeted toward easing liquidity issues and the fiscal impact of these measures in the current financial year is expected to be limited. Out of the total Rs 20 trillion figure that the PM mentioned, already around Rs 13 trillion has been accounted for so far, as per our calculations. The announcement of further details of the remaining Rs 7 trillion and its funding mechanism, over the next couple of days, will determine the actual effectiveness of this entire package and its impact on India’s credit metrics and various asset classes.

Hence, we expect the financial markets to behave in a measured manner, given the cautious environment and weakening sentiments. Reforms in land, labor and legal systems are the main structural issues that the finance minister is expected to address in the next few days, and we believe these are the important announcements that can potentially improve structural appeal for foreign investments in India. While these measures can help to arrest the steep fall in growth and partially restrict the cascading effect of the recession, a sustained upturn in the broad-based equity market will depend on return of consumer spending and improvement in employment opportunities, which we believe, will take some more time. Hence, investors should adopt a conservative approach and be well diversified in their asset allocation strategy until the pandemic is convincingly brought under control.