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ECONOMIC RECOVERY IN THE ADVANCED COUNTRIES: LESSONS FROM THE PAST

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The Covid-19 crisis has deeply affected our economies. Although the rebound observed in recent months seems to have been confirmed, uncertainty persists over their capacity to fully recover. This article will look at how the G7 economies reacted during post-recession phases in the past, in terms of GDP, private consumption and investment. How quickly did GDP in these economies catch up with pre-crisis levels and trends? What were the most dynamic components of aggregated demand during recovery phases? Given the specific characteristics of the Covid-19 crisis, can it really be compared with previous shocks? These are some of the questions that we will discuss in this article while highlighting current sector disparities.

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INDIA: UP AGAINST A WALL

Johanna Melka

The Covid-19 crisis did not spare India, and like many of the emerging economies, the country's economic and social situation has deteriorated sharply. Yet India's situation had already begun to deteriorate well before the onset of the pandemic, which only accentuated the country's weaknesses. The very sharp contraction in GDP triggered by the Covid-19 pandemic highlights the economy's structural vulnerabilities, especially the large number of workers without social protection. With the nationwide lockdown in April and May 2020, 75 million Indians fell below the poverty line, and there is reason to fear that the second wave could have a similar impact. In fiscal year (FY) 2021/2022, GDP growth should rebound vigorously, although forecasts are likely to be revised downwards due to the expected contraction in FY Q1 (the second quarter of the current calendar year), following the outbreak of the second wave of the pandemic. In the medium term, growth might fall short of 6% unless there is a significant easing of the structural constraints that are restricting the employment of regular workers and private investment. If growth does not exceed 6%, the government would have to face not only a possible downgrade of its sovereign rating by the rating agencies, but also increasing social risk.

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The Covid-19 crisis has deeply affected our economies. Although the rebound observed in recent months seems to have been confirmed, uncertainty persists over their capacity to fully recover. This article will look at how the G7 economies reacted during post-recession phases in the past, in terms of GDP, private consumption and investment. How quickly did GDP in these economies catch up with pre-crisis levels and trends? What were the most dynamic components of aggregated demand during recovery phases? Given the specific characteristics of the Covid-19 crisis, can it really be compared with previous shocks? These are some of the questions that we will discuss in this article while highlighting current sector disparities.

The Covid-19 crisis is different from past crises. It combines a triple shock – a supply shock, a demand shock and an uncertainty shock – and its long-term consequences are still partly unknown. In the G7 countries (United States, Japan, Germany, UK, France, Italy and Canada), GDP in volume plummeted by nearly 6% in 2020, a much sharper contraction than the 3.6% decline reported during the 2009 recession. The gradual lifting of health restrictions, the acceleration of vaccination campaigns in most countries, and public policy support – both fiscal and monetary – should bolster the economic rebound in the second half of 2021.

We are still left with the question of whether the crisis will leave any lasting scars on these economies. The size of any scars will depend on several factors, especially public policy decisions. So far, the governments of the advanced economies have opted to intervene rapidly and massively to support economic agents, with measures geared towards households and companies. These interventions were mainly designed to limit the destruction of productive capital that may have occurred through a wave of bankruptcies or a significant surge in unemployment, especially long-term unemployment. So far, the gamble seems to have paid off fairly well, although some disparities can be seen between countries. In the European Union, for example, most of the negative shock of the Covid-19 crisis was absorbed through short-time working schemes and similar furlough measures, which significantly softened the impact on the labour market. The unemployment rate rose from 6.4% in March 2020 to 7.8% in August, before slipping back to 7.3% in March 2021. In the United States, in contrast, the fluctuations were much more abrupt. After reaching a pre-crisis low of about 3.5%, the US unemployment rate reached a peak to nearly 15% at the height of the pandemic. Since then, it has fallen back to about 6% of the active population.

One of the main questions now facing analysts and decision makers is the rebound capacity of these economies once all the health restrictions have been lifted. When will GDP, private consumption and investment return to pre-Covid levels in the advanced economies? When will they return to the levels they would have reached if the Covid crisis had never occurred (see box 1)? Has the crisis eroded the long-term growth potential of these economies? If yes, then by how much? Although we present these questions here in macroeconomic terms, they also raise numerous questions about changes in labour market conditions, the effectiveness of public policy support measures, and the sustainability of public finances in the different countries. If an economy rapidly closes the gap created by the crisis, then the consequences for the real economy will be smaller and not as lasting. Inversely, if the economy is slow to recover and remains weak, it will take longer for the labour market to return to normal. In this case, public support would still be necessary, raising the question of the sustainability of public debt.

In the second part of this article, we will try to get an idea of post-Covid macroeconomic trends in the months ahead by analysing the behaviour of the G7 economies during the exit phases of past recessions. We looked at recessions in which average growth was negative for a full year, which differs from the standard definition based on two consecutive quarters of contracting GDP. We observed the impact of these crises on

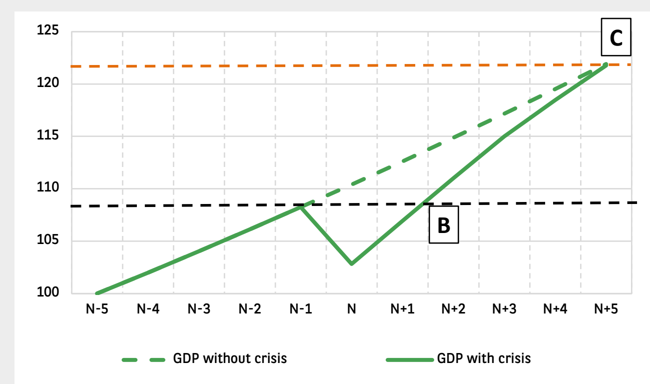
POTENTIAL POST-CRISIS SCENARIO

The big question is whether the negative shock of the Covid-19 crisis will have a lasting impact on the G7 economies. Has it eroded their long-term growth potential?

This question is illustrated in chart 1, which simulates the dynamics of GDP growth before and after a crisis. In the chart, GDP is represented by the green line. The dotted green line represents GDP growth if the crisis had not occurred (scenario 1). Under this scenario, GDP would continue to grow without interruption at a pace close to its long-term potential.

In our second scenario, the crisis intervenes in year N, at point A on the chart. Thanks to the automatic post-crisis rebound, GDP returns to the pre-crisis level (represented by the horizontal black dotted line), at point B on our chart. GDP returns to point B more or less rapidly depending on the size of the post-crisis rebound. At point B, GDP has returned to the pre-crisis level, but it is still far below point C, which is the point it would have reached without the crisis. In our example, growth does not return to point C until 5 years after the shock (N+5 on our chart). As we will see later in this article, if the crisis structurally weakens the economy, it is also possible that GDP will never return to point C.

ILLUSTRATION OF A POST-CRISIS ECONOMIC REBOUND:



BOX 1 CHART 1 SOURCE: BNP PARIBAS

the G7 economies and the speed at which they recovered based on the analysis of traditional macroeconomic variables: GDP, potential GDP, private consumption, total investment and exports of goods & services. Our sample comprises the G7 countries (US, Japan, Germany, UK, France, Italy and Canada) and we analysed about past 25 recessions. We looked not only at recessions that hit all of the G7 economies, but also took into account more localised recessions. We examined the oil shocks of 1974 and 1980; the subprime crisis of 2008-2009; the recessions of the early 1990s in the US, the UK and Canada, at a time of rising interest rates; the European Monetary System crisis of 1992-1993, which impacted several Eurozone member countries; the 1980 recession in the UK; the 2002-2003 recession in Germany due to the euro's appreciation and the slowdown in world trade; and the recessions in Japan in the late 1980s (bursting of the equity and housing market bubbles) and late 1990s (Asian crisis).

A crisis can have lasting consequences

In the vast majority of cases, economic and/or financial crises have a lasting impact on a country's growth momentum. The immediate impact of the crisis and the scars it leaves on the economy largely depend on three factors: the nature of the shock, the differentiated impact on sectors, and whether or not it includes a banking and financial crisis. The key factor is the nature of the shock, i.e. whether it comprises a supply shock, a demand shock or a combination of the two. A supply shock without a demand shock is likely to have a smaller economic impact that does not last as long. In terms of sector disparities, a shock can be concentrated more in the manufacturing sector (through the collapse of global trade, for example) or in the services sector (as was the case during the Covid crisis, which we will return to later in this article). Lastly, destabilisation of the banking and financial sector can have lasting effects at the macroeconomic level, notably by undermining the dynamics of bank lending, which in turn strains aggregated demand.

Recessions and slower growth

Table 1 shows the average GDP growth rates for the G7 countries that prevailed during the five years before and after recessions.

Based on our sample and methodology (using the average growth rates 5 years before and after the crisis), table 1 shows that average growth declined in 80% of the cases after a recession (see charts 2-5). For our selection, average growth (unweighted) contracted by about 1 point. In only certain cases, this post-recession economic slowdown can be seen as the normal reaction of an economy after a period of sharp acceleration in growth and major risk taking. In this case, the recession corrects the excesses that had built up before the outbreak of the crisis. Yet an economic and financial crisis can also have a negative impact on growth and/or on the level of productivity, notably via the destruction of productive capital, which in turn reduces medium-term growth. Note that independently of the negative effects of a crisis, most mature economies are experiencing a structural slowdown in productivity gains. Among recent recessions, one of the most striking examples is the subprime crisis of 2008-2009, which had an especially lasting impact on the dynamics of the G7 economies. Economic literature is filled with documentation on the long-term effects of financial and banking crises, and the 2009 crisis in particular[1]. Most of these crises are associated with a sharp drop-off in production and employment. They can have a lasting impact on the dynamics of productivity gains, inequalities and

AVERAGE GDP GROWTH RATES 5 YEARS BEFORE AND AFTER A RECESSION

	Average growth of final private consumption 5 years before	Years of recession	Average growth of final private consumption 5 years after	Delta «after the recession» vs «before the recession»
Japan	7.7	1974	4.6	↘
	3.9	1993	1.4	↘
	1.9	1998/1999	1.3	↘
	1.0	2008/2009	1.1	↗
United Kingdom	5.0	1974/1975	2.5	↘
	2.5	1980/1981	3.6	↗
	4.8	1991	3.1	↘
	2.6	2008/2009	1.6	↘
United States	5.0	1974/1975	3.2	↘
	2.4	1982	4.7	↗
	3.2	2008/2009	1.9	↘
Italy	4.0	1975	4.6	↗
	2.9	1993	2.2	↘
	1.1	2008/2009	-1.0	↘
		2012/2013	1.1	↗
Germany	3.4	1975	3.4	↘
	2.4	1982	2.5	↗
	3.4	1993	1.3	↘
	1.5	2002/2003	0.6	↘
	0.6	2009	1.1	↗
France	4.7	1975	3.3	↘
	2.2	1993	2.0	↘
	1.9	2009	0.7	↘
Canada	2.2	1982	3.7	↗
	3.2	1991	2.3	↘
	3.7	2009	2.6	↘

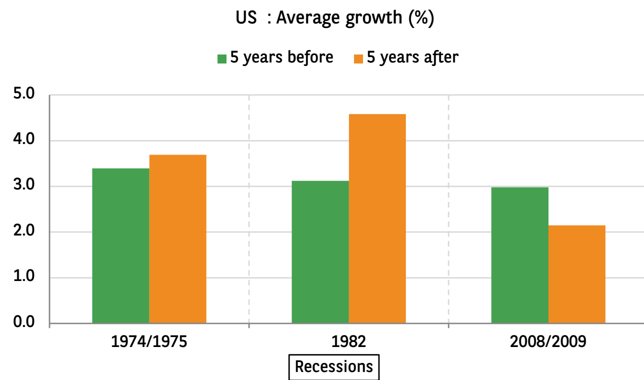
Note: For Italy, since the 2012 recession followed closely on the 2009 crisis, we compare Italy's 5-year average growth rate before the 2009 crisis with the 5-year average after the 2012 crisis.

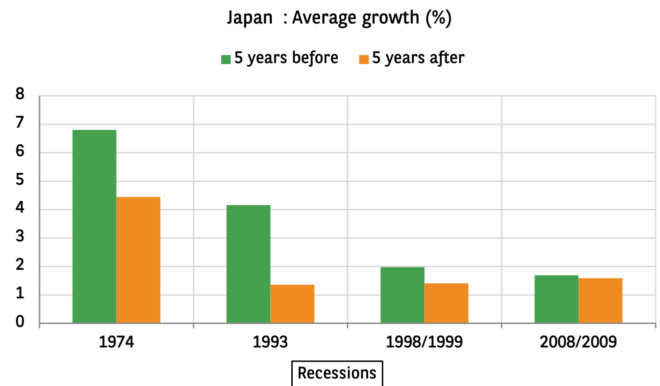
TABLE 1 SOURCE: WORLD BANK, BNP PARIBAS

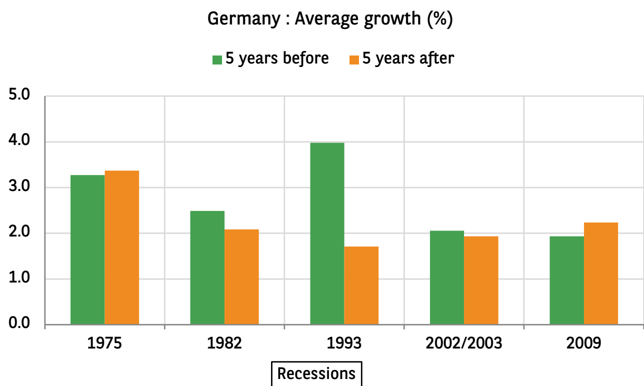
the public finance situation of a given country (we will come back to the 2009 crisis later in this article). They can also weaken potential growth rates and the standard of living of the local population. For Eurozone member states, the 2008-2009 crisis was rapidly followed by the sovereign debt crisis, which continued to have a severe impact on these economies. Some countries in our selection, like Italy, were hit

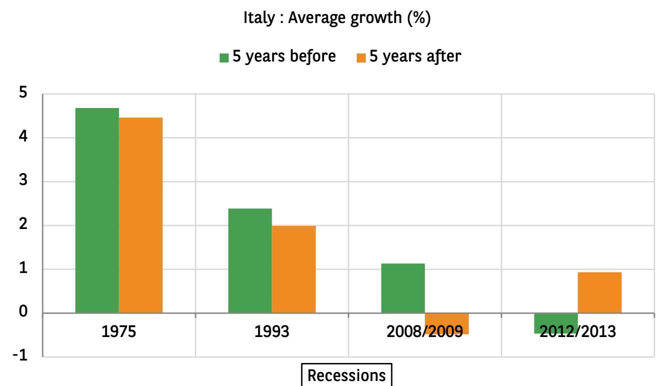
1 C.M. Reinhart & K.S. Rogoff, *The aftermath of financial crises*, NBER January 2009; W. Chen et al., *Lasting effects: The global economic recovery 10 years after the crisis*, IMF Blog, October 2018; E. Debauche & al., *The crisis: what lasting effects on growth, employment and public finances?*, Revue d'économie financière, 2011

AVERAGE GDP GROWTH RATES 5 YEARS BEFORE AND AFTER RECESSIONS









CHARTS 2-5

SOURCE: WORLD BANK, BNP PARIBAS

by two consecutive severe recessions that had a lasting impact on the country's productivity and public finances[2]. Inversely, Germany was the only big Eurozone economy in which growth increased after the 2009 crisis, fuelled by strong domestic demand.

In this environment, GDP can return more or less rapidly to the pre-crisis level, as well as to the level that it would have reached if the crisis had not occurred (for further explanation, see box 1 and chart 1). It all depends on the vigour of the post-crisis economic rebound and on the economic growth that prevails in the years thereafter. Except for specific cases, GDP in the countries in our selection returned relatively quickly to pre-crisis levels or higher, regardless of the size of the shock. This is an important point because it suggests that the shortfall in GDP due to a recession is rapidly erased in the years following the shock. Table 2 shows that GDP often returns to the pre-crisis level during the year following the crisis. The 2008-2009 crisis is a notable exception. For our selection of countries with the exception of Canada, it took longer for GDP to return to the pre-crisis level. As to Italy, two back-to-back crises – the subprime crisis and the eurozone sovereign debt crisis – had a long-lasting impact on economic growth, and it took 6 years before GDP returned to the pre-crisis level.

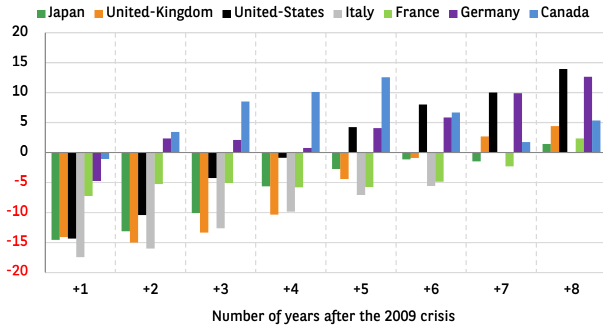
Investment: the weak link of economic recoveries

An economic crisis tends to have a more severe and lasting impact on total investment than on the other components of demand, namely private consumption and exports of goods and services. In post-crisis periods, consumption and exports do not slow down as much as investment (the 5-year unweighted average was down 1.5 points for consumption, 1.8 points for exports and about 2.5 points for investment). At the same time, it takes much longer for investment to catch up to pre-recession levels than consumption or exports. For the countries in our selection, chart 6 highlights the relatively slow pace of investment after the 2009 crisis.

Several factors explain these differences. In the midst of and following an economic or financial crisis, private investment is likely to be hampered by the high level of uncertainty, which delays its recovery and in turn hinders the economic rebound[3]. Over the longer term, these dynamics can erode the country's productive capital and growth potential. As to public investment, after recessions, governments are often determined to rapidly restore their public finances. An excessively sharp fiscal consolidation can further undermine growth momentum.

2 OFCE, *Italy: escaping the high-debt and low-growth trap, Policy Brief,* May 2019.
3 *"Business investment in EU countries", Occasional Paper Series*, ECB, October 2018

INVESTMENT SHORTFALL FOLLOWING THE 2009 CRISIS (%)



In Canada, 4 years after the 2008/2009 crisis, the level of overall investment was 10% higher than the pre-crisis level. In France, in contrast, 6 years after the crisis, investment was still about 5% short of the pre-crisis level.

CHART 6 SOURCE: WORLD BANK, BNP PARIBAS

This was the case in the aftermath of the Eurozone sovereign debt crisis[4]. Inversely, household consumption, which tends to return more rapidly to the pre-crisis level as we pointed out above, is supported by several factors, including automatic stabilisers (higher unemployment benefits, for example), the downward rigidity of nominal wages, and the big share of constraint expenditures.

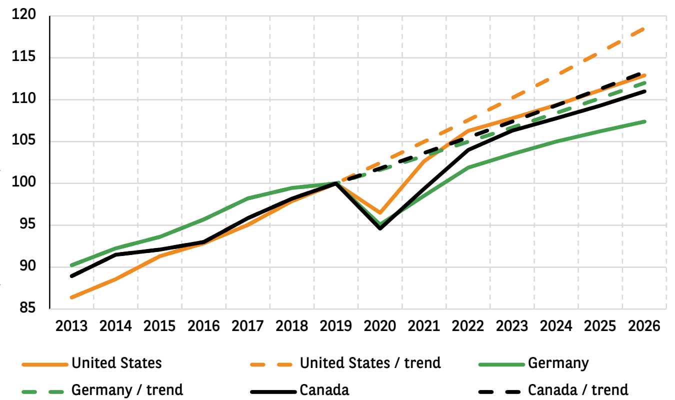
Covid-19: the specific characteristics of the health crisis

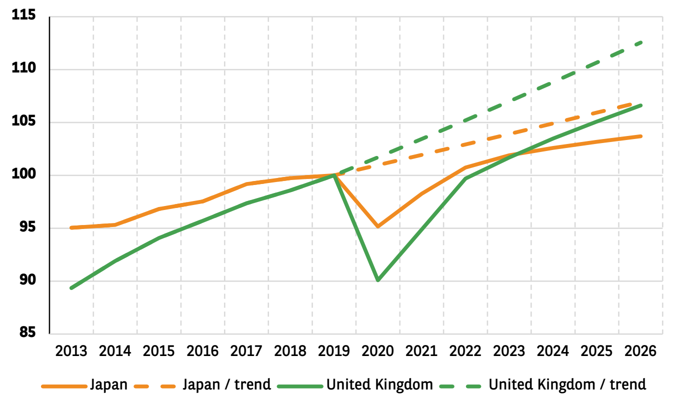
As we pointed out earlier in this article, the Covid-19 crisis, like many crises, should lead to a decline in the potential output of the G7 countries, notably those in the Eurozone. So far, the G7 have largely limited the destruction of productive capital (which occurs through corporate bankruptcies and surging unemployment) thanks to massive interventions by national governments. But their potential growth has eroded throughout the crisis due to the decline in the number of hours worked per employee. At the macroeconomic level, the Eurozone's potential output in 2022 is still likely to be about 3% below the trajectory expected in projections carried out prior to the crisis, according to the European Central Bank (ECB)[5].

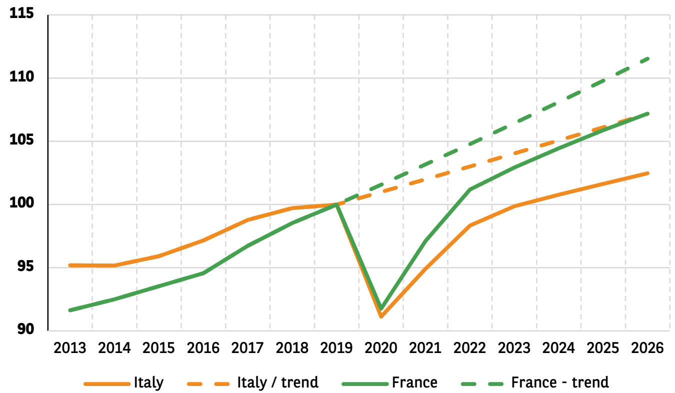
Yet the vigour of the economic recovery, which continues to surprise many observers, should enable GDP to rapidly return to pre-crisis levels in most of the G7 economies. By next year, the majority of G7 countries will have returned to the 2019 level. According to the latest projections by the International Monetary Fund (IMF), in contrast, GDP in the G7 countries is likely to remain far short of the pre-crisis trend (measured in this article as the average growth rate five years before the crisis) (see charts 7a-c). The United States stands apart on this point, since US GDP has virtually returned already to the pre-crisis trend, buoyed by the major fiscal impulse implemented, although growth should taper off again once the cyclical rebound is over.

Yet the pandemic's medium-term impact on the G7 economies is still uncertain. Key issues include the withdrawal of fiscal support and theNtargeting of the hardest hit sectors.

OBSERVED AND EXPECTED GDP AND THE PRE-CRISIS TREND (100 = 2019)







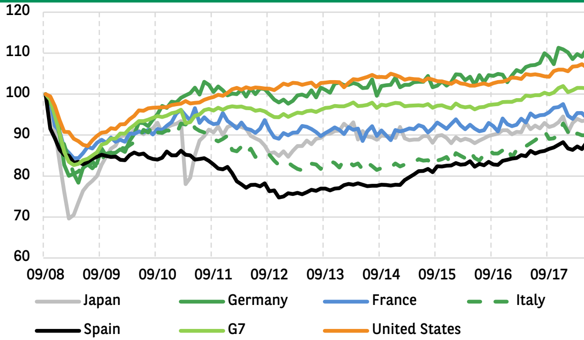
CHARTS 7A, 7B & 7C SOURCE: WEO FMI, BNP PARIBAS

From a macroeconomic perspective, the G7 economies are rebounding strongly, but sectoral situations are much more mixed.

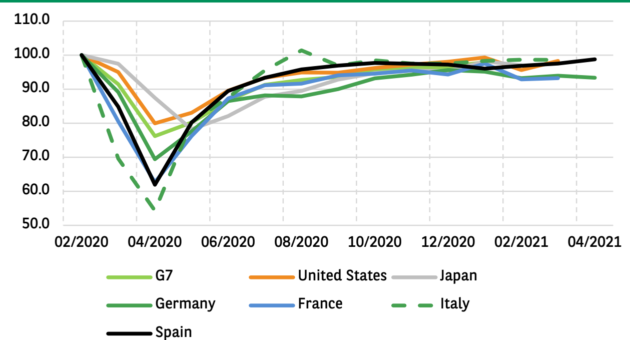
4 A.Bénassy-Quéré et al., *Which fiscal union for the euro area?*, CAE, February 2016

5 P. Lopez-Garcia, *The impact of Covid-19 on potential output in the euro area*, ECB Economic Bulletin, Box 2, November 2020

MANUFACTURING OUTPUT DURING THE COVID-19 CRISIS (100 = FEBRUARY 2020)



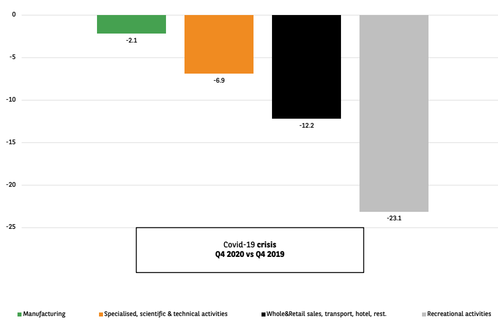
MANUFACTURING OUTPUT DURING THE SUBPRIME CRISIS (100 = SEPT. 2008)



CHARTS 8A & 8B

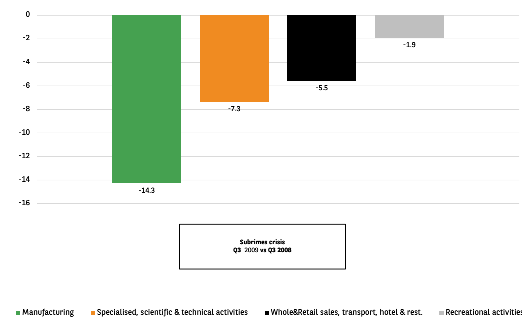
SOURCE: NATIONAL SOURCES, REFINITIV, BNP PARIBAS

EUROZONE: LOSS OF BUSINESS BY SECTOR ONE YEAR AFTER THE COVID-19 CRISIS (%)



During the Covid-19 crisis, manufacturing value added in the eurozone was only about 2% below the pre-crisis level of Q4 2019.

EUROZONE: LOSS OF BUSINESS BY SECTOR ONE YEAR AFTER THE SUBPRIME CRISIS (%)



Following the subprime crisis, manufacturing value added in the eurozone in Q3 2009 was about 14% below the level of Q3 2008.

CHARTS 9 & 10

SOURCE: EUROSTAT, BNP PARIBAS

Covid-19: a massive shock on the tradeable services sector

We must begin by pointing out that the manufacturing and services sectors are not two distinct entities. Corporate activities are becoming increasingly complex and diversified. Industrial companies also have own account services production[6]. The industrial production process implies a large number of services activities, such as R&D, marketing and accounting. For simplicity's sake, this article will maintain the traditional distinction between the two sectors in the database that we use. All countries have implemented health measures to curb the pandemic, and these measures have impacted all segments of the economy. Yet this macroeconomic picture tends to mask major sector disparities. Business was especially hard hit in tradeable services. Moreover, these services will only gradually recover from the loss of business.

Uncertainty about the pandemic brought private consumption to a standstill as certain businesses were shut down and borders were closed, social distancing measures were introduced, and consumers were afraid to enter enclosed spaces. Consequently, it will take some time before activity fully recovers in tradeable services. Of course, manufacturing industry was also hard hit by the health crisis, but to a much lesser extent. Industry has benefited from the very strong rebound in global trade in recent months, and volumes already rose last winter above pre-crisis levels[7].

Looking at sector disparities, a striking comparison can be made between the current Covid-19 crisis and the subprime crisis of 2008-2009. The Covid-19 shock has had a bigger impact on services, while the great financial crisis had a much bigger impact on manufacturing. During the earlier crisis, it took three years for global merchandise trade to return to pre-crisis levels. Charts 8a and 8b show manufacturing output in the G7 countries during the Covid-19 crisis and 2008 subprime crisis, respectively. Despite differences in momentum between countries, on the whole we can see that there was a much more abrupt drop-off in manufacturing output during the Covid-19 shock than during the 2008 crisis. The rebound was also much stronger, and production rapidly returned to pre-crisis levels. Following the 2008 crisis, in contrast, the rebound in manufacturing output was much more gradual. Some eurozone members, especially the southern countries like Italy and Spain, were hit by a double shock as the sovereign debt crisis followed

6 M. Crozet & E. Milet, *Is industry becoming less industrial?*, CEPII letter, February 2014
7 G. Derrien, *World trade in goods reaches new heights*, EcoFlash, BNP Paribas, May 2021

close on the heels of the 2008 crisis. Inversely, certain G7 countries like the United States and Germany pulled through much better.

In charts 9 and 10, the shortfall in activity one year after the onset of the crisis (measured by the value added in real terms) highlights the differences in the sector impact between the Covid-19 crisis and the subprime crisis, respectively. In the manufacturing sector, activity rebounded rapidly after spring 2020 and has almost completely closed the gap, whereas in 2009, there was still a big shortfall a year after the crisis began. Inversely, recreational activities were relatively spared by the subprime crisis, whereas they are largely bearing the brunt of the Covid-19 crisis.

The speed at which this service category recovers will depend on the savings behaviour of consumers. Households have accumulated additional savings during the crisis. In the end, renewed confidence and a decline in household savings, notably precautionary savings, will drive the recovery of the services hit hardest by the pandemic.

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Given the very specific nature of the Covid-19 shock, it is not easy to draw comparisons between the current crisis and past economic and financial crises. Nonetheless, an analysis of past shocks provides some answers to questions raised by the Covid-19 crisis. Although it did not trigger a banking sector crisis, the belated rebound in the confidence of economic agents, especially companies in the sectors hit hardest by the crisis, could strain investment momentum and thus the overall economic recovery. Today there are still many uncertainties concerning the evolution of the pandemic, given the growing alarm about the Delta variant and the surge in new cases despite the acceleration in vaccination campaigns. Yet the G7 economies have shown proof of a strong capacity to adapt in the face of health restrictions. The digitalisation process has even accelerated in certain segments of the economy, notably via online sales, which suggests that the loss of productivity could be limited. In the end, we cannot grasp the overall consequences of this crisis until the pandemic has been brought fully under control.

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HOW MANY YEARS DOES THE GDP NEED TO RETURN TO ITS PRE-CRISIS LEVEL?

Country	Year	GDP level
Japan	1974	+1
	1993	+1
	1998/1999	+1
	2008/2009	+4
United States	1974/1975	+1
	1982	+1
	2008/2009	+2
Germany	1975	+1
	1982	+1
	1993	+1
	2002/2003	+1
	2009	+2
United Kingdom	1974/1975	+2
	1980/1981	+2
	1991	+2
	2008/2009	+3
Italy	1975	+1
	1993	+1
	2008/2009	-
	2012/2013	+6
France	1975	+1
	1993	+1
	2009	+2
Canada	1982	+2
	1991	+2
	2009	+1

TABLE 2

SOURCE: WORLD BANK, BNP PARIBAS

INDIA: UP AGAINST A WALL

The Covid-19 crisis did not spare India, and like many of the emerging economies, the country's economic and social situation has deteriorated sharply. Yet India's situation had already begun to deteriorate well before the onset of the pandemic, which only accentuated the country's weaknesses. The very sharp contraction in GDP triggered by the Covid-19 pandemic highlights the economy's structural vulnerabilities, especially the large number of workers without social protection. With the nationwide lockdown in April and May 2020, 75 million Indians fell below the poverty line, and there is reason to fear that the second wave could have a similar impact. In fiscal year (FY) 2021/2022, GDP growth should rebound vigorously, although forecasts are likely to be revised downwards due to the expected contraction in FY Q1 (the second quarter of the current calendar year), following the outbreak of the second wave of the pandemic. In the medium term, growth might fall short of 6% unless there is a significant easing of the structural constraints that are restricting the employment of regular workers and private investment. If growth does not exceed 6%, the government would have to face not only a possible downgrade of its sovereign rating by the rating agencies, but also increasing social risk.

Risks to the recovery

Impact of the Covid-19 crisis

During the fiscal year 2020/2021 (April 2020 to March 2021), India's GDP contracted 7.3% due to the Covid-19 pandemic. This was the country's first recession since fiscal year 1979/1980. As in the other emerging economies, growth rebounded as of mid-2020 and into the first months of 2021. But the recovery was cut short by a second wave of the pandemic. It is estimated that this second wave could cost the economy more than 2 percentage points (pp) of growth. Its impact, however, should be concentrated in FY Q1 2021/2022 (April-June 2021), and growth is expected to rebound again as of FY Q2.

An unprecedented recession

The Covid-19 pandemic had an especially big impact on India's economy. With the exception of the Philippines, the contraction was much worse than in the other Asian countries. The complete lockdown of the population for more than two months was very damaging for an economy that is highly dependent on domestic consumption.

All the components of demand declined with the exception of public expenditure. Private consumption, India's main growth engine (accounting for 59.4% of GDP on average over the past five years), contracted by 9.1%, and per capita household spending fell back to the level that prevailed three years earlier. At the same time, investment contracted by 10.8%. The decline in domestic demand triggered a sharp contraction in imports, although not enough to offset the downturn in exports. As a result, net exports made a negative contribution to growth.The contraction in economic activity was especially severe in the services sector (-4.6%) and to a lesser extent in industry (-2.1%). Agriculture was the only resilient sector (+0.5%).

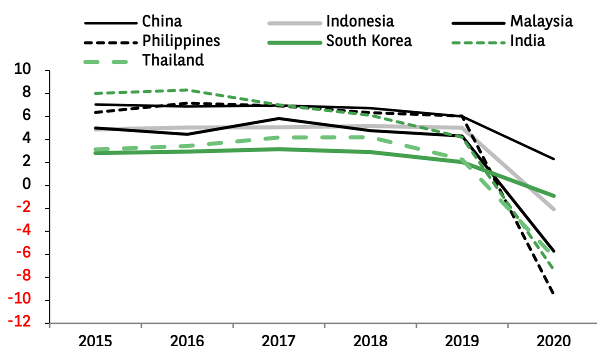
The severity of the recession can be attributed to the total lockdown of the population in a country characterised by a large number of low-income households (prior to the Covid-19 crisis, per capita GDP was only USD 2098 a year), the vast majority of which do not benefit from any social protections. International organisations estimate that between 78% and 90% of the active population works in the informal sector (the lower figure is from the International Labour Organization (ILO) and the higher figure is from the World Bank). According to the Center for the Study of Developing Societies (CSDS) and the Azim Premji University, 29% of urban workers (who were hit hardest by the pandemic) are day labourers without social protection, and who migrated from rural areas. Moreover, between 12 and 18 million of these migrants were forced to return to their home state following the outbreak of the Covid-19 crisis[1].

Although it certainly underestimates the amplitude of the shock, the unemployment rate peaked at 23.5% in April 2020, compared to 7.2% in January 2020.

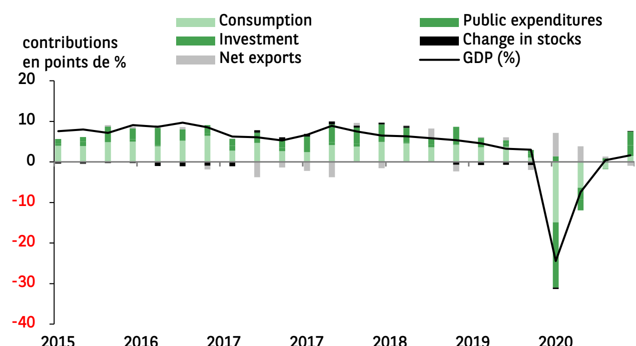
Under these conditions, the Pew Research Centre estimates that 75 million individuals fell below the poverty line last year, whereas the past 20 years of growth had lifted 248 million individuals out of poverty. The research centre also reports that 134 million individuals are now living on less than USD 2 a day. At year-end 2020, nearly

1 Amitabh Kundu, Research and Information System for Developing Countries.

GDP GROWTH IN INDIA AND THE OTHER ASIAN COUNTRIES



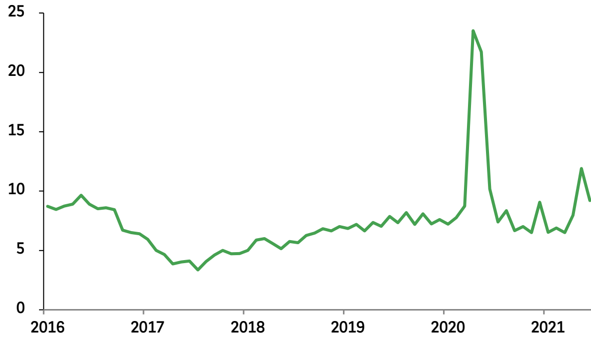
BREAKDOWN OF INDIA'S GDP GROWTH



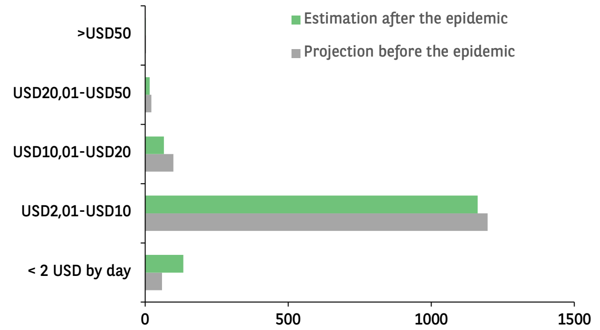
CHARTS 1A & 1B

SOURCE: CEIC, RBI

INDIA: UNEMPLOYMENT RATE



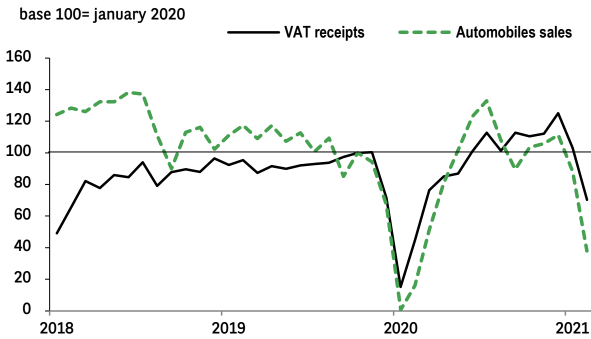
BREAKDOWN OF INDIA'S POPULATION BY REVENUE



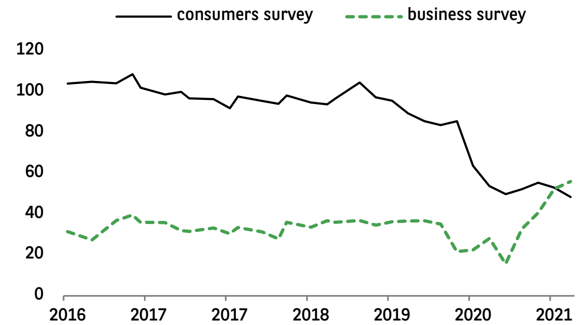
CHARTS 2A & 2B

SOURCE: CMIE, PEW RESEARCH CENTER

VAT REVENUES AND AUTOMOBILE SALES (100 = JANUARY 2020)



CONSUMER AND BUSINESS CONFIDENCE INDEXES



CHARTS 3A & 3B

SOURCE: RBI

1.16 billion individuals out of a total population of 1.3 billion, were living on the verge of poverty, with revenues ranging between USD 2 and USD 10 a day.

The recovery is threatened by a second wave of the pandemic

The ebbing of the first wave of the Covid-19 pandemic (April 2020) sparked a major economic rebound, and India swung back into growth as of fiscal Q3 (October to December 2020). The recovery was cut short in March 2021 by a second wave of the virus, which was much more virulent than the first but peaked in May. Although Narendra Modi's government did not reinstate another nationwide lockdown, numerous states – including the biggest economic powerhouses – opted for partial lockdowns that included shutting down all nonessential businesses.

According to economic indicators, there was a very sharp contraction in April 2021 that worsened in May 2021[2]. In comparison with March 2021, there was a very sharp downturn in the mobility of local residents[3], VAT revenues[4], sales of cars, two wheelers and tractors, demand for electrical power, and air and rail traffic, although they still held above the levels reported during the worst of the pandemic's first wave (April 2020). The unemployment rate rose significantly, to 12% at the end of May 2021, after falling back to only 6.5% in March, although this was still short of the peak in April 2020. The services sector seems to have been hit hardest, since factories were allowed to stay open in almost all of the states that imposed new restrictions. Household confidence indicators plummeted, falling to unprecedented levels in May 2021, even lower than those reported the previous year. Business confidence, in contrast, was resilient in May 2021, although it was lower than at the beginning of the year. The pandemic's second wave probably had an especially big impact on the financial situation of households since they had already been hit by a loss of revenue during the first wave[5].

2 June statistics are not available yet.
3 In April-May 2021, leisure travel was down 50% from pre-Covid levels (vs about -78% at the same time last year). Business travel was down 38% from pre-Covid levels (compared to -53% last year).
4 Although VAT revenues rose very strongly compared to the same period last year, they were down by an average of 32% in April and May compared to the peak of March 2021.
5 According to CMIE estimates, since the beginning of the pandemic, 97% of Indian households have reported a loss of income, which resulted not only in a decline in household consumption, but also in gold imports, which contracted sharply in 2020.

It is estimated that the second wave may have slashed GDP growth by more than 2 percentage points. In full fiscal year 2021/2022, the consensus forecast is now calling for growth to range between 8% and 10% (down from 11-12% before the second wave). Of course, as for all countries, the 2021 performance will be atypical, even if the figures are revised downwards. The big question is how strong will growth be after the fiscal year 2021/2022? This question is especially pertinent for India, since its growth had already slowed sharply even before the Covid-19 crisis.

Growth was slowing well before the Covid-19 crisis

GDP growth had already begun to slow in India well before the Covid-19 crisis. There were two phases to the slowdown: the first was observed after the 2009 financial crisis, and the second during the three fiscal years prior to the Covid-19 crisis.

GDP growth is also volatile because India is especially vulnerable to climate shocks due to its dependence on agricultural revenues. Household consumption is the main growth engine (57% of GDP), and since the majority of households live in rural areas (more than 65%) where half of the land is not irrigated, revenues are highly dependent on the monsoon. The quality of growth has also deteriorated over the past five years.

Analysis of the economic slowdown

According to the Conference Board's breakdown of growth, the economy slowed from 8.1% in 2004-2008 to 6.6% in 2011-2019 (excluding the 2009 crisis and its rebound in 2010) due to a decline in the contribution of capital and especially to a sharp decline in total factor productivity.

The accumulation of productive capital slowed. The investment rate declined by 7 percentage points to 28.8% between fiscal years 2007/2008 and 2019/2020. More importantly, the nature of investments has also changed. In fiscal years 2017-2019, the share of investment by private and state-owned companies declined significantly in favour of government and household investment. Companies cut back their investment in machinery and equipment, which dropped to the equivalent of only 5.7% of GDP in fiscal year 2018/2019.

The decline in total factor productivity reflects a loss of efficiency in the combined use of productive factors and/or a decline in technical progress, or simply a deterioration in the country's attractiveness[6]. Fundamentally speaking, the decline in total factor productivity reflects the structural constraints that are straining the country, handicapping foreign direct investment and restricting private productive investment: high corruption, insufficient infrastructure, restrictions on land acquisition, labour market rigidities, insufficient education, a low workforce participation rate for women, and the concentration of jobs in low value-added sectors. To make matters worse, the banking and financial sector is fragile and can barely support the economy, while the government has extremely little fiscal manoeuvring room to make the necessary investment expenditures.

The quality of growth deteriorates

In addition to the slowdown in GDP growth reported in recent years, there has also been a slight deterioration in the quality of growth. Labour market indicators have deteriorated and human development has slowed over the past five years. The economic crisis accelerated this deterioration, and the second wave could further strain a population that is already extremely vulnerable.

BREAKDOWN OF GROWTH BY PRODUCTION FACTORS

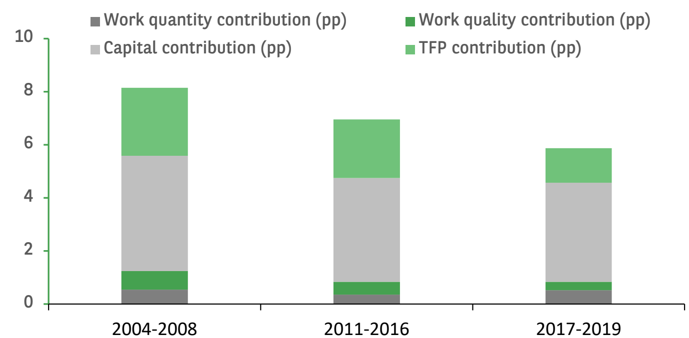


CHART 4 SOURCE: CONFERENCE BOARD

A sluggish labour market

In 2020, India's economy had to integrate more than 12 million new entrants to the labour market. According to the Center for Monitoring the Indian Economy (CMIE), India must create 16 million jobs by 2030 just to absorb all the new entrants. Looking at the employment rate, however, job creations have failed to cover job demand for several years.

According to estimates by the International Labour Organization (ILO), the employment rate (active workforce over the working-age population) was only 43% in 2020, which is far below the 57% threshold that the ILO considers to be acceptable. According to ILO estimates, this ratio has declined continuously after peaking at 52.7% in 2008.

At the same time, the labour market participation rate (employed population and jobseekers as a share of the working-age population) declined by more than 10 percentage points from a peak of 58% in 2005, to less than 46.3% in 2020 accord to the ILO (less than 42% according to CMIE). The labour force participation rate for women followed a similar downward trend, although it was already low fifteen years ago. According to the ILO, it was only 20.8% in 2019. According to this indicator, part of the population is completely excluded from the labour market. It is comprised notably of young people with no experience and no education.

Human development: little progress

In 2019, India ranked 131 out of 188 countries on the United Nations Human Development Index, outranking the other countries of the subcontinent, but lagging far behind those of the ASEAN-4. Moreover, although human development improved significantly in 1990-2010, advances have slowed sharply over the past five years, to an estimated 1.2% for the period 2010-2019, compared to 1.6% in 2000-2010. As a result, India gained only one place in the international ranking between 2015 and 2019.

To improve its human capital and increase the pace of job creations (especially for regular employment), it is imperative for the government reduce the structural constraints that are shackling the economy. Otherwise, this demographic advantage could be transformed into a real social risk.

6 Sector deformation of the economy is also an explanation of total factor productivity, but in India's case, as in most of the emerging economies, it makes a positive contribution, due mainly to the decline in the contribution of the agricultural sector in favour of other more productive sectors of the economy.

DECLINE IN THE LABOUR FORCE PARTICIPATION RATE

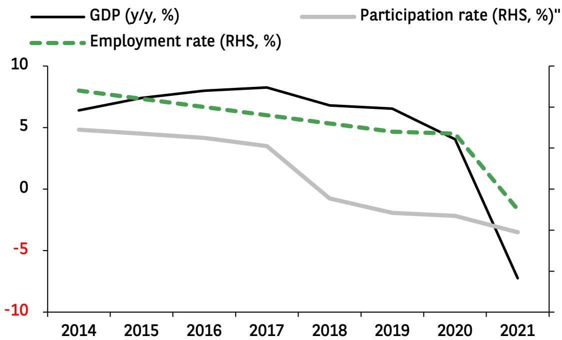


CHART 5 SOURCE: CEIC, ILO

BREAKDOWN OF EMPLOYMENT BY SECTOR

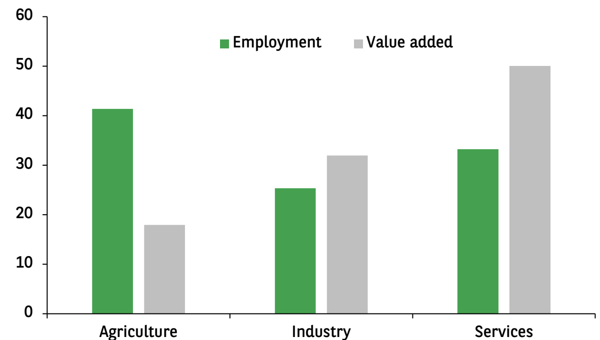


CHART 6 SOURCE: ILO

In the medium term, growth will barely exceed 6% due to structural constraints and the fragilities of the banking and financial system

Human capital: an untapped strength

Major structural constraints are restricting investment and job creations. Moreover, the business climate is still fragile, even though it is improving.

Over the past five years, although governance has improved slightly, India still lost five places, to 109 out of 211 countries, on the World Bank's 2020 worldwide governance ranking. It still lacks sufficient control over corruption (110th out of 209 countries according to the World Bank). According to Transparency International, corruption is still widespread, and India ranked 86th out of 183 countries in 2020 (8 places below its 2017 ranking).

The quality of infrastructure has also improved but is still lacking. Before the Covid-19 crisis, India ranked 70th out of 141 countries in the 2019 Global Competitiveness Report. Public infrastructure is still insufficient, notably access to electrical power.

Labour market rigidities are a major constraint for hiring "regular" workers. Instead, they favour the development of informal market. In the most recent competitiveness report, India scored only 44.4/100 in terms of labour market flexibility (compared to 64.4/100 for China).

The lack of skills in the workforce also places a big damper on the development of high value-added sectors. According to ILO statistics, 27.2% of the active population did not have any diplomas in 2018 (18.8% of men and 35.7% of women), and only 34% had the equivalent of a high school diploma. The average length of schooling was only 6.5 years. India has also failed to improve the quality of education over the past five years. The level of human capital development has regressed. The latest competitiveness report shows a sharp decline (-25%) in the number of diplomas in India over the past five years, the sharpest decline among the emerging countries.

Employment continues to be concentrated in agriculture (41.4% of the active population in 2019) even though the sector has a low weighting as a share of GDP (14.7% of value added). Inversely, the services sector (which contributes more than 55% to value added) only employs 33.2% of the active population. Manufacturing employment is also relatively moderate (12.1% of the active population) compared to the sector's weighting (17.5% of value added).

Large-scale reforms were adopted, but could be difficult to implement

Starting in 2019 and continuing through fall 2020, the Modi government adopted a series of major reforms to resolve structural constraints and to attempt to stimulate medium-term growth. These reforms cover corporate taxation, the labour market, agriculture and land acquisition. The big problem, however, lies in their implementation.

To stimulate both domestic and foreign investment, the government lowered the corporate tax rate at year-end 2019 from 30% to 22% (and from 25% to 15% for newly created companies in the manufacturing sector), bringing corporate taxation in line with the practices of the other Asian countries.

To reduce labour market rigidities, the lower chamber of Parliament (Lok Sabha) adopted four new labour codes, in August 2019 and then in September 2020, which are intended to replace the 29 existing codes[7]. The new laws aim to ease hiring and firing regulations in order to reduce the informal market's share of the economy. The government hopes this will facilitate formal employment, notably for companies with more than 100 employees, and the development of social protections. Employment in India is overly concentrated in small businesses with no social protections, due to the excessively tight regulations on hiring and firing workers in big corporations. According to the World Bank, if the new law is applied, 2.8 million workers would be able to leave the informal sector. In theory, these new labour market codes were to take effect on 1 April 2021, but in practice, their application has been postponed. They must first be validated by the states before they can be applied locally. At mid-June, the laws were still not in effect.

To increase productivity in the agricultural sector, the Modi government adopted three bills in September 2020. The state must allow farmers to sell their produce at prices they fix directly with their buyers, without government intermediation (this is already the case with the majority of farmers today). This reform aims to increase investment and productivity in the agricultural sector. Yet it was very poorly received by the agricultural world due to fears it could lead to the suppression of the minimum sales price (even though it is guaranteed by the government).

7 The wage code was adopted in August 2019 and the three other codes were adopted in September 2020 (the occupational safety, health and working conditions code, the industrial relations code, and the code on social security).

Lastly, to favour productive investment, especially in high value-added sectors, the government has repeatedly tried to ease restrictions on land acquisition for purposes other than agriculture. Despite numerous attempts at reform, the development of non-farm activities is still extremely regulated, enough to dissuade national and foreign companies from investing in India. More than 1200 laws govern land acquisition. Yet the most recent amendments adopted locally by the states of Gujarat and Karnataka are only marginal, and the reforms that were adopted do not seem to go far enough to alleviate the restrictions on the use of land for non-farm purposes. It is imperative to launch large-scale reforms at the national and local levels so that land acquisition is no longer a major obstacle hampering industrial investment projects.

In addition to these structural impediments, India's economic growth has also been held back in recent years by the fragility of the state-owned banks.

The fragility of India's banking and financial system is hampering growth

During the period 2016-2019, Indian banks sought to consolidate their financial situation by slowing the pace of loan distribution. Non-banking financial companies as a whole stepped in to provide additional financing for the economy by significantly increasing lending to niche sectors, including financing for households without regular revenues, small and very small enterprises, and real-estate financing (financing granted notably via the Housing Finance Companies).

Since September 2018, however, the share of lending provided by non-banking financial companies has diminished as their cost of financing increased following the bankruptcy of Infrastructure Leasing & Financial Services (IL&FS). At the same time, there was also a sharp slowdown in corporate investment.

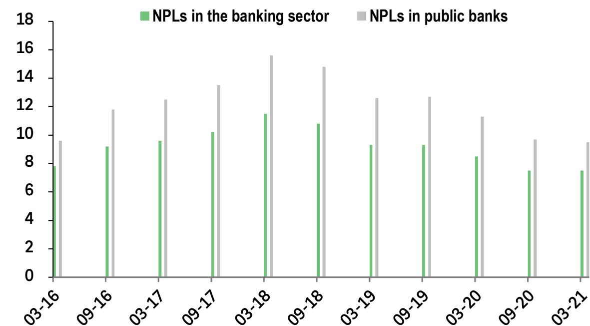
On the eve of the Covid-19 crisis, India's banks and non-banking financial companies were still in a fragile situation, and credit supply was not very abundant. The big question today is whether the banking and financing sector as a whole will be in a position to finance India's economic recovery in the short and medium term, once the Covid crisis is over.

Commercial banks: more solid today than they were five years ago

In the Financial Stability Report dated January 2021, the central bank described a banking sector that was in a much more solid situation in Q3 2020 than it was in the 5 previous years, even though it is still fragile. Although forecasts must still be revised to take into account the pandemic's second wave, so far the rating agencies esteem that the banking sector should be able to face up to higher credit risks and the deterioration in capital adequacy ratios due to the first and second waves of the pandemic. In contrast, the banks will have much higher needs for capital injections than the banking authorities initially expected. It will be imperative for the government to support the state-owned banks so that they can assume their role of providing economic support.

Starting in 2016, India's state-owned banks began consolidating their balance sheets. Their financial situation even strengthened after the first wave of the pandemic. The quality of bank assets was more solid in Q1 2021 than in 2018 (the non-performing loan ratio dropped to 7.5% from a peak of 11.5% in March 2018), provisions were higher (covering 68.9% of doubtful loans in March 2021, up from only 48.1% in March 2018), and solvency ratios were more comfortable (the capital adequacy ratio stood at 16% vs a low of 13.2% in March 2016). Even so, the disparity between banks is still high. State-owned banks are still the most fragile, with higher non-performing loan ratios (9.5%), lower provision coverage (68.4%) and much less comfortable capital adequacy ratios (13.8%). Moreover, the non-performing loan ratios do

NON-PERFORMING LOANS RATIO (%)



Note: stressed advances are defined as non performing assets + restructured standard advances.

CHART 7A SOURCE: RBI

PROVISION COVERAGE RATIOS (%)

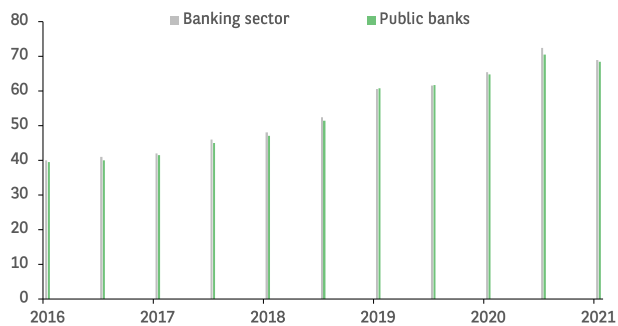


CHART 7B SOURCE: RBI

CAPITAL ADEQUACY RATIOS

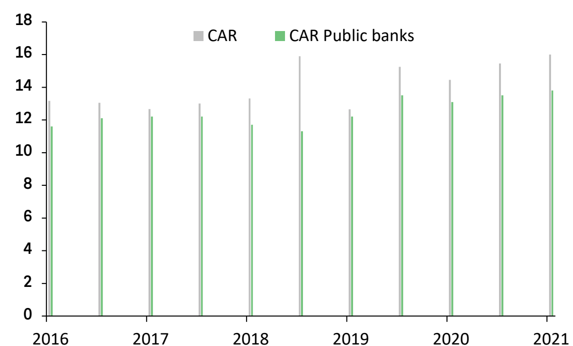


CHART 7C SOURCE: RBI

BANK CREDIT (Y/Y, %)

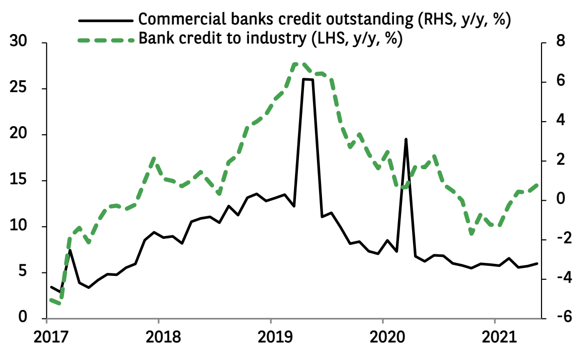


CHART 8 SOURCE: RBI

not yet show the impact of the recession, because the banks were allowed to delay the reporting of doubtful loans until March 2021.

To support the most vulnerable economic players, on 5 May the central bank governor authorised banks to restructure their loans to households and to small and medium-sized enterprises (for loans of less than RS 250 million) through 30 September 2021.

In its latest Financial Stability Report dated July 2021, India's central bank lowered its growth outlook for the current fiscal year to 9.5% due to the second wave of the pandemic. Even so, it esteems that there will only be a moderate deterioration in the quality of bank assets. According to the central bank, the non-performing loan ratio will increase by only 2.3 percentage points between March 2021 and March 2022. This would bring the non-performing loan ratio for the banking sector as a whole to 9.8% at March 2022 (12.5% for state-owned banks), which is slower than the pace that prevailed more than five years earlier.

At the same time, the central bank is forecasting a mild deterioration in bank capital adequacy ratios (from 16% to 15.5% by March 2022). It esteems that all state-owned banks will be able to comply with regulatory requirements by March 2022, thanks to capital injections announced by the government in February 2021 for a total of RS 200 bn (0.1% of GDP), after the same amount of capital was injected during the previous fiscal year. These projections also assume that the government will create a National Asset Reconstruction Company, a bad bank to facilitate the clean-up of the balance sheets of state-owned banks and public non-banking financial institutions. The transfer of non-performing loans would be comprised notably of housing loans with a value equal to or higher than RS 5 bn. Only state-owned banks and public non-banking financial institutions would be authorised to transfer non-performing loans with a provision ratio of nearly 100%, and they would recover 75% of the debt. The total amount of non-performing loans eligible to be transferred is estimated at RS 2000 bn. These transfers, the first of which are expected at the end of June (for a total of RS 890 bn), should free up capital for lending purposes that is currently tied up in provisions. This bad bank is to be financed through private funds (mainly from Indian banks) with a government guarantee of RS 310 bn (0.16% of GDP). In other words, the sector will largely bear the cost of this bail-in.

Bank lending was struggling to pick up prior to the second wave of the pandemic

Despite the central bank's easing of monetary policy in 2020, which reduced the average lending rate on new loans by 126 bp (key policy rates were cut by 115 bp between January 2020 and March 2021), on the whole, lending to industry picked up very mildly in the first months of 2021 (up 0.4% year-on-year in April 2021), after declining for five straight months, from October 2020 to February 2021.

Loans to major companies even contracted, reflecting their cutbacks in investment. Moreover, large companies could easily self-finance because even though sales contracted sharply, profits increased, thanks to a sharp downturn in labour costs and commodity prices for a large part of the year 2020.

In contrast, household lending (excluding food loans) accelerated rapidly in March and April (+12.6% y/y in April), at the same time as consumption rebounded. Lending to mid-sized companies (18% of lending) has grown extremely rapidly since September (+43.8% y/y in April), thanks to the Emergency Credit Line Guarantee Scheme set up between 23 May 2020 and 31 March 2021, which aimed to address the financing needs of small and mid-sized enterprises. According to the government, at the end of January 2021, this programme had distributed RS 1.9 trillion in bank loans (excluding non-banking financial companies), and accounted for 36.6% of loans granted during the year.

Non-banking financial companies are still solid, but vulnerable to market trends

On the eve of the Covid-19 crisis, loans outstanding granted by non-banking credit institutions still amounted to 11.6% of GDP (vs. 52.5% of GDP for banks).

Lending by non-banking financial companies slowed significantly during the Covid-19 crisis (+2.5% y/y in December 2020), but relatively less so than for banks. It is mainly short-term loans that increased as households encountered cash flow problems. At year-end 2020, the share of loans maturing in less than three months had increased by nearly 2 percentage points compared to the beginning of the crisis, to 11.5% of their loan portfolios. The share of long-term loans even declined, although they still account for 71.7% of total loans outstanding, reflecting a decline in corporate investment in a rather sluggish economic environment.

A priori, non-banking financing companies as a whole (including housing finance companies) are more vulnerable than banks to the Covid-19 shock due to the structure of their loan portfolios. In particular, part of the Indian population they finance has no bank accounts. Yet they have proven their ability to adapt and their resilience to shocks since 2018/19.

The industrial sector is still the main recipient of loans granted by non-banking financial companies as a whole (61.6%). Yet the share of consumer loans has increased to 24.5% in 2020, in keeping with automobile sales, due to the health crisis.

According to the central bank's latest report, the non-banking financing companies were in a satisfactory situation in December 2020. Like banks, however, these institutions were able to postpone the reporting of non-performing loans (which will only appear on Q1 2021 balance sheets). Yet the quality of their assets is more solid than for the banking sector (this was already the case prior to the Covid-19 crisis). Their doubtful loan ratio was only 5.3% at the end of December 2020, most of which was concentrated in services (9.4%) and, to a lesser extent, in agriculture (6.7%). The quality of consumer loans is still

generally satisfactory, with a doubtful loan ratio of only 3.4% of loans outstanding at year-end 2020. All in all, the profitability of these non-banking financial institutions is generally satisfactory, with ROA of 1.9% and ROE of 10.2% at December 2020.

Even so, non-banking financial companies are still exposed to market financing. In December 2020, 46.4% of their financing was from bond and Treasury bill issues on the markets, and 30.3% from bank lending. Any increase in risk aversion, especially on the part of mutual funds (their main investors) would result in a sharp, irremediable increase in the cost of financing for these companies. During the Covid-19 crisis, the yield spread between 3-month issues of non-banking financial companies and government bond issues rose by more than 130 bp to a total of 230 bp in May 2020 for the least risky companies with an AAA rating, and an additional 100 bp for AA-rated companies. Thanks to the policy conducted by the monetary authorities, these tensions have since fallen sharply, and the cost of financing has dropped below pre-Covid levels. Yet the companies with the lowest credit ratings are still particularly vulnerable to any new risk aversion on the part of investors.

To conclude, based on the indicators available on the eve of the pandemic's second wave, banks and non-banking financial companies have the capacity to increase their credit supply and thus to support the economic recovery. But there is reason to fear that credit risks will rise sharply following the second wave of the pandemic, and that more capital will be needed for provisions to cover any potential losses. This risks squeezing the credit supply of banks, especially state-owned banks whose capital adequacy ratios are not as comfortable as for the private banks. In the past, the government has always stepped in to support the state-owned banks, injecting the capital necessary to support the banking sector when it was not in a position to raise funds on its own. Given the sharp deterioration in public finances, however, the government has little manoeuvring room to fund a bail out, which could strain the recovery of lending in the short and medium-term.

Risks to public finances

So far, the evolution of India's public finances has been shaped primarily by economic growth and the primary balance, and less by interest rates. Yet as we have just seen, the risks to growth are particularly high as long as the adopted reforms are not implemented in an effective manner. Similarly, there are also high risks concerning the government's capacity to make a significant reduction in the primary deficit of all public administrations, because of a low fiscal base and the sharp increase in the weighting of incompressible expenditures.

Already weak, India's tax base has shrunk in recent years

India's public finances are structurally fragile due to a weak fiscal base and the high proportion of incompressible expenditures. Although public finances were consolidated over the five fiscal years 2015/2019, they began to deteriorate during fiscal year 2019/2020 and were further weakened by the economic crisis triggered by the Covid-19 pandemic.

After a gradual, 5-year decline, the central government deficit began swelling again in fiscal year 2019/2020 to 4.6% of GDP (up from 3.4% of GDP in FY 2018/2019), and the primary deficit rose to 1.6% of GDP. At the same time, the general government's primary deficit rose to an estimated 3.1% of GDP, compared to an average of only 1.7% of GDP over the previous five years.

GOVERNMENT REVENUE GRADUALLY DECLINES (% GDP)

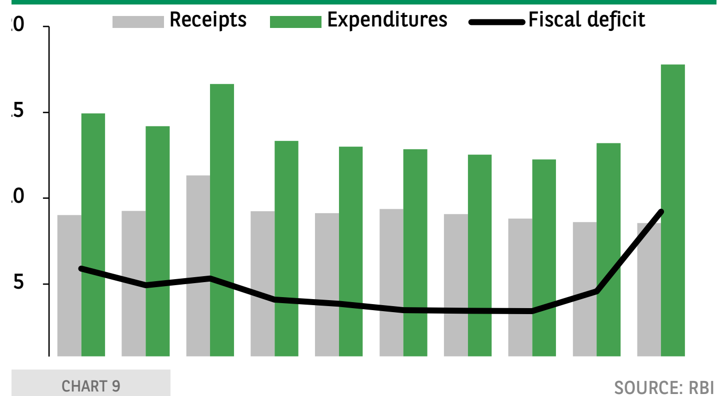


CHART 9 SOURCE: RBI

DEBT DYNAMICS (% GDP)

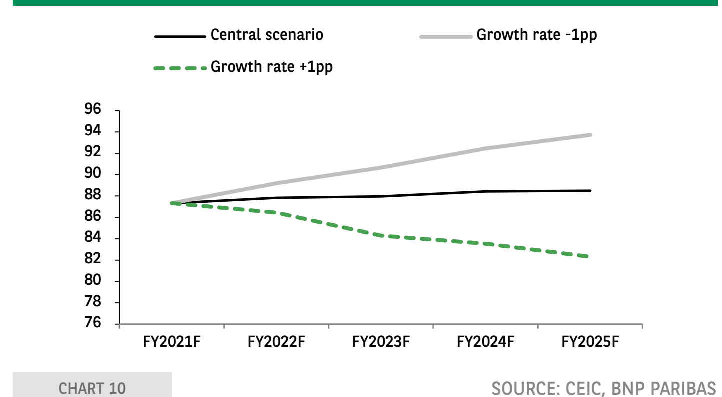


CHART 10 SOURCE: CEIC, BNP PARIBAS

Even before the Covid-19 shock, the central government's fiscal revenues had shrunk to only 8.6% of GDP (down from 9.4% in 2017/18), which is low compared to the other Asian countries[8]. Revenue declined notably because of major difficulties in implementing the single Goods and Services Tax (GST) nationwide in July 2017, which involved fiscal compensation to states to cover tax losses. The decline can also be attributed to the corporate tax cut in September 2019 (from 30% to 25.17%) to stimulate investment.

The Covid-19 shock had a massive impact on public finances. In FY 2020/2021, the central government's deficit doubled to 9.2% of GDP, while the general government's deficit may have exceeded 14% of GDP[9]. At the same time, government debt is estimated at more than 87% of GDP (up from 72.2% of GDP before the crisis).

The increase in the deficit is mainly due to a sharp increase in spending (+4.6 pp), notably household subsidies (+2 pp to 3.3% of GDP), which as a share of total spending doubled to more than 18% (38% of revenues). Interest expenses also rose sharply (+11.4%). They now account for more than 40% of government revenues (vs. an average of 34.5% over the previous five fiscal years), even though government revenues barely declined (-3.6%) thanks to higher customs duties.

8 Prior to the Covid-19 crisis, government revenue in Indonesia amounted to 12.4% of GDP, which is one of the lowest rates among the Asian countries, while Malaysia's came to 17.5% .
9 Public finance statistics for the states are reported with a big lag. We used IMF estimates based on budget projections.

Subsidies and interest payments together comprised nearly 38% of government spending, and more than 78% of revenues. The primary deficit swelled to 5.8% of GDP, after averaging only 0.7% of GDP during the previous five fiscal years.

In fiscal year 2021/2022 (1 April 2021 to 31 March 2022), the Minister of Finance intends to reduce the central government deficit to 6.8% of GDP and that of all public administrations to 11% of GDP. This would still bring the central government's primary deficit to 3.1% of GDP, which is much higher than pre-crisis levels. Moreover, when the budget outlook was published in February 2021, these forecasts already seemed optimistic, and may need to be revised upwards given the very sharp decline in VAT revenues reported in Q2 2020.

Looking beyond the current fiscal year, the government does not seem to be quite as determined to consolidate public finances as in the past. Stimulating growth in the short and medium term seems to be the top priority. Yet the government has very little manoeuvring room to support growth and face up to a new domestic or external shock without risking the deterioration of public finances, in which case the rating agencies would downgrade India's sovereign rating. A simulation of India's debt dynamics shows that if the general government's primary deficit is not brought back below the 3% threshold, then the public debt ratio will continue to deteriorate slightly, even if real growth holds at 6%.

Refinancing risks are still mild because the structure of the debt is not very risky

To date, the risks of refinancing India's debt are still small because the structure of its debt is not very risky and the government has access to abundant domestic savings.

The central government's debt has a long maturity (average of 11.3 years), is more than 94%-owned by residents, and the revaluation risk due to the rupee's depreciation is extremely low, since debt is almost exclusively denominated in the local currency (97%).

More than 93.5% of government debt is issued on the debt market. It is comprised mainly of fixed-term bond issues (62.6% of total debt) and, to a lesser extent, Treasury bills with a maturity ranging between 14 and 364 days (11.5% of government debt). Debt market issues are mainly held by banks (37.8%) and insurance companies (25.3%). The share of debt held by the central bank increased by 1 pp in fiscal year 2020/2021 to 16.2%. Over the next five years, the amount of debt reaching maturity is estimated at only 10.1% of GDP.

Since the beginning of 2021, the government's cost of financing has remained relatively stable (the 10-year rate was 6% in mid-June 2021). Yet the government is not sheltered from an increase in the cost of financing, even though the central bank's securities purchases have so far maintained bond yields at low levels. In contrast, the interest charge has risen sharply (due to the increase in debt) and is straining the government's capacity to fund investment spending. Moreover, if the government resorts to more financing from banks, which are already weak, it would erode their capacity to finance the private sector (crowding-out effect).

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Narendra Modi's government is in a delicate situation. Public finances, which were already fragile prior to the Covid-19 crisis, have deteriorated sharply, and the outlook for medium-term growth is a source of concern. The rating agencies have placed a negative outlook on its sovereign rating. For the moment, government refinancing is not a major or imminent risk. Yet the debt servicing charge has risen sharply, limiting the government's capacity to invest, support the recovery and/or face up to a new shock. Under this environment, if the government fails to implement the reforms adopted in fall 2020, growth could be capped at 6%, while the employment rate continues to fall (job creations are falling short of demographic growth). Yet if GDP growth levels off below 6%, or if the government does not rapidly consolidate its public finances (the primary deficit of the government and all public administrations must be brought below 2.7% of GDP, which is even lower than pre-crisis levels), then the public debt trajectory would continue to diverge and the rating agencies would be likely to downgrade India's sovereign rating to "non-investment grade", further straining the government's capacity to support the economy. In the past, it has always been extremely problematic for India to implement reforms. And as the protests against the agricultural reforms suggest, this time will be no different, especially since Narendra Modi seems to have lost a bit of his shine based on the results of recent regional elections.

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GENERAL GOVERNMENT DEBT DYNAMICS

	FY2019	FY2020	FY2021	FY2022e	FY2023e	FY2024e	FY2025e
Gross general government debt (% GDP)	70.3	72.2	87.3	87.8	88.0	88.4	88.5
General government's primary deficit (% GDP)	-1.1	-3.1	-9.3	-6.0	-4.0	-3.2	-2.8
Real GDP growth (%)	6.5	4.0	-7.3	8.3	6.4	5.7	6.1
Average nominal interest rate (%)	7.8	6.9	7.0	7.0	7.0	7.1	7.2
Inflation (%)	4.4	4.8	6.2	5.0	5.0	4.5	4.3

TABLE SOURCE: BNP PARIBAS

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