INDIA

CONSTRAINED GROWTH IN THE SHORT AND MEDIUM TERM

Economic growth is still vulnerable to another epidemic wave as less than 50% of the population was fully vaccinated at the end of December 2021. Activity has already been losing momentum since December, and it could be curbed even further by the new epidemic wave that swept the country in January at a time when labour market conditions are still deteriorated. Inflation is another risk factor looming over the recovery. Not only does it reduce household purchasing power, but it could also convince the monetary authorities to raise policy rates. Under this scenario, enterprises that were already reticent to increase investment due to the prevailing climate of uncertainty would further postpone investment projects, even though their financial situation has improved significantly and banks are well positioned to increase credit supply. In the longer term, the halting of agricultural reform and the impact of the crisis on human development are factors that will crimp the country's growth potential.

A FRAGILE RECOVERY AT A TIME OF INFLATION AND A DETERIORATED LABOUR MARKET

In Q3 2021, real GDP rose above the pre-pandemic level of Q3 2019. Yet after rebounding strongly following the second pandemic wave, the recovery seems to have stalled in November. Demand for electricity, sales of tractors and automobiles, and basic industrial production have all slowed compared to September and October. This slowdown drove up the unemployment rate by 0.9 percentage points to 7.9% in December 2021.

Employment statistics are also alarming. Since the second wave of the pandemic ended, the employment rate has held relatively stable despite the growth rebound. In November, the employment rate was only 37.3%, or 2.5 percentage points below the pre-crisis level. Although the unemployment rate has fallen in recent months, the main job creations were in rural areas, where wages are lower than for urban jobs.

The first half of 2022 should be marked by another economic slowdown, especially in the services sector, since the pandemic is picking up again. The government has already announced new measures to limit the spread of the pandemic; at the end of December 2021, only 44% of the population had been fully vaccinated.

Inflation is the other risk factor threatening growth. Inflation accelerated again in October 2021 and rose to 5.6% in December. Although prices are not rising as fast as the monetary authorities' inflation target (4% +/- 2pp), the central bank could still raise its key rates over the course of 2022, in keeping with the tightening of US monetary policy. This risks further straining the recovery of private investment.

The IMF lowered its medium-term growth forecast from 7.3% to 6%. The pandemic is expected to have a lasting impact on capital accumulation (with the decline in private investment) as well as on the volume and quality of employment (more poverty and a lower level of education, with numerous labour market participants leaving the labour market). International institutions also fear that the banking and financial sectors are not in a position to support the recovery. Yet the banks' strong resilience to the crisis (including state-owned banks) is reassuring. The situation of certain non-banking financial companies (NBFC), in contrast, is more disturbing.

LARGE COMPANIES ARE HEALTHIER THAN BEFORE THE CRISIS

Despite the recession, Indian companies have consolidated their balance sheets. In 2020, they benefited from a sharp drop in wage costs. For listed companies, profits have surged to levels unseen since fiscal year 2015.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth(1) (%)	4.2	-7.2	8.9	8.7	6.0
Inflation (1) (CPI, year average, %)	4.8	6.1	5.4	5.7	5.0
General Gov. Balance(1) / GDP (%)	-7.3	-13.7	-10.6	-9.0	-8.5
General Gov. Debt(1)/ GDP (%)	73.7	84.2	83.9	81.9	81.8
Current account balance(1) / GDP (%)	-0.9	0.9	-1.8	-2.7	-1.3
External debt(1)/ GDP (%)	19.9	21.6	20.0	20.4	20.6
Forex reserves (USD bn)	457	580	633	670	695
Forex reserves, in months of imports	7.7	11.0	9.1	9.2	9.0

TABLE 1

(1) Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INFLATION

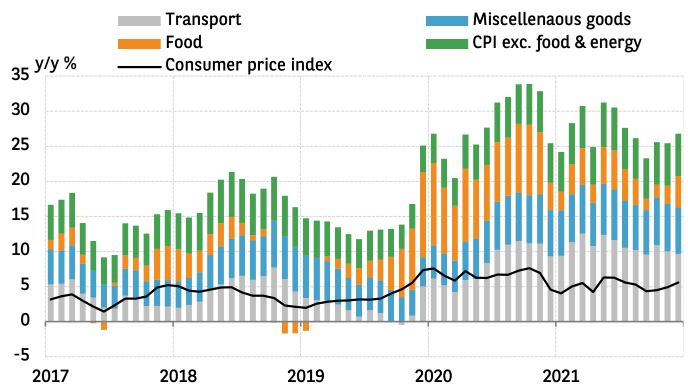

CHART 1

SOURCE: BNP PARIBAS

In a lacklustre economic environment marred by high uncertainty, companies stepped up debt reduction, a process underway since 2018. In Q2 2021, pre-tax profit was 5.3 times higher than the interest charge, the highest ratio since 2010. Yet despite favourable monetary conditions (the average interest rate on new loans declined by more than 120 basis points between end 2019 and end 2021), enterprises are reticent to invest. Production capacity utilisation rates are still below the long-term average.

BANKING SECTOR: CREDIT RISK SEEMS TO BE UNDER CONTROL

In its most recent financial stability report released in late December 2021, the Reserve Bank of India (RBI) confirmed that the banking sector continued to consolidate between March and September 2021. Although this analysis is still biased by government measures to support the most fragile households and enterprises, which were introduced in March 2020 and will run through March 2022, the banking sector should be in a position to face up to the expected increase in credit risk once economic agents no longer benefit from state-backed loans.

On the whole, asset quality, solvency and profitability of the banking sector (including the most fragile state-owned banks) have improved since 2018, and the Covid-19 crisis has not hampered the sector's consolidation.

The non-performing loan ratio for the banking sector as a whole declined to 6.9% in September 2021 from 8.5% in March 2020. Moreover, although asset quality of state-owned banks is much more fragile compared to private banks, it has been improving. Their average non-performing loan ratio declined from 11.3% in March 2020 to 8.8% in September 2021.

In the construction sector, loan quality is still mediocre, although it has improved slightly since March 2020. According to the central bank, 20% of loans to this sector are still considered non-performing. In industry and services, in contrast, the situation has consolidated, and in agriculture, it is still relatively stable. The quality of household loans has deteriorated: the non-performing loan ratio increased by 0.4 pp to 2.5% between March and September 2021. The most risky household loans are for automobiles and real estate. The impact on the banking sector as a whole, however, is still mild, because household loans account for only 10.5% of all bank loans outstanding.

According to the central bank's forecast, loan quality is expected to deteriorate between March and September 2022. The non-performing loan ratio could rise by 1.2 percentage points to 8.1% (+1.7 pp for state-owned banks). Meanwhile, non-performing loan provisions are still insufficient. In September 2021, the provision coverage ratio for risky assets was only 68.1% for the banking sector as a whole, and 66.5% for the state-owned banks.

Capital adequacy ratios improved between March and September 2021 thanks to the government's capital injections into the most fragile state-owned banks and capital increases by the private banks as well as by the more solid state-owned banks. For the banking sector as a whole, the Capital Adequacy Ratio (CAR) rose to 16.6% in September 2021 (vs. 16.3% in March 2021). Moreover, although the RBI expects the CAR to fall slightly to 15.4% by September 2022, all banks should be in a position to comply with the regulatory requirement of 9%, even in the event of an especially severe shock (last year they were not prepared to do so).

Lastly, bank profitability seems to have improved significantly, albeit from very low levels. In September 2021, banks reported a Return on Assets (ROA) and Return on Equity (ROE) of 0.8% and 9.2%, respectively. State-owned banks that failed to generate a profit in March 2020 were able to report an ROA and ROE of 0.5% and 7.7%, respectively, in September 2021.

Bank lending has rebounded since July. Loan growth has returned to levels not seen since mid-2019, even though it is still extremely low (+3.5% on average over the past three months for industrial loans). The recent rebound has been especially strong for loans to small and very small enterprises.

NON-PERFORMING LOANS IN THE BANKING SECTOR

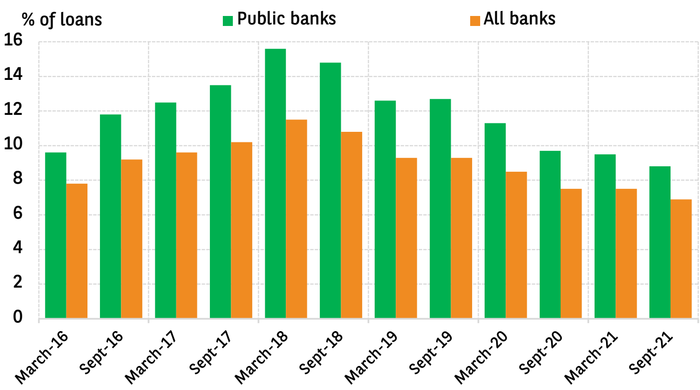

CHART 2

SOURCE: RBI

NON-BANKING FINANCIAL COMPANIES: WIDE DISPARITIES

Non-banking financial companies (NBFC) are still in a fragile financial situation. On the whole, their situation has improved slightly since March 2020, although there are still wide disparities between NBFCs.

According to the RBI, NBFCs produced loans equivalent to 12.6% of GDP in September 2021 (vs. 76.3% of GDP for bank loans). The quality of NBFC banking assets deteriorated slightly between March and September 2021, even though it is more solid than in March 2020. In September 2021, the non-performing loan ratio was 6.5% of total loans outstanding (+0.1 pp relative to March 2021). The non-performing loan ratio was 11.5% for farm loans, 11% for loans to services, and 7.9% for industry loans (40% of loans produced by NBFCs).

On the whole, their capital adequacy ratios are still comfortable. They averaged 26.3% in September 2021 (vs. 23.7% in March 2020). But of the 191 NBFCs analysed by the RBI, 10 NBFCs (whose assets accounted for 4.6% of total NBFC assets) did not comply with the regulatory requirement of 15% (in March 2021, only 7 NBFCs did not reach the regulatory target).

AGRICULTURAL REFORM IS ABANDONED

In fall 2020, Narendra Modi's government adopted several major reforms to stimulate medium-term growth. Among them was an agricultural reform programme. This reform aimed to increase productivity in a sector that employs a big share of the active population. Last November, however, faced with fierce opposition from farmers, the government finally decided to withdraw the reform. Abandoning the reform could enable Modi's party to win more seats in the regional elections to be held in Uttar Pradesh in the first part of 2022. Yet it raises doubts about the government's capacity to carry out vital reforms.

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