India

Economic track record on the eve of elections

After nearly five years in power, Narendra Modi's track record is generally positive, even though the last year of his mandate was tough, with a slowdown in growth in Q3-2018/19. The main growth engines are household consumption, and more recently, private investment, thanks to a healthier corporate financial situation, with the exception of certain sectors. In full-year 2018, external accounts deteriorated slightly as a swelling current account deficit was not offset by foreign direct investment. A big challenge for the next government will be to create a more conducive environment for domestic and non-resident investment.

Robust growth in 2018 despite a slowdown in Q3-FY2018/19

In the third quarter of fiscal year 2018/2019 (October-December 2018), economic growth slowed to 6.6% year-on-year (y/y). This was in part due to a slowdown in government spending, while household consumption and investment continued going strong. Activity slowed in the primary sector but remained robust in the industry and the services sector. To stimulate growth, the Central Bank lowered its policy rates twice (in February and April 2019), taking advantage of mild inflationary pressures (+2.6% y/y in February 2019) and the end of US monetary policy tightening.

In calendar year 2018, economic growth rose to 7.4% (vs 6.9% in 2017), one of the highest growth rates in Asia. In comparison, growth was 5.2% in Indonesia, 6.2% in the Philippines, 6.6% in China and 7.1% in Vietnam. Despite India's solid performance, however, per capita income is still low at USD 2016.

Consolidation of corporate's financial situation

The situation of private non-financial companies has improved significantly. They are now in a more solid position than in 2011, when the corporate situation began to deteriorate.

Since 2014, Indian companies as a whole have been undergoing financial consolidation. The debt-to-GDP ratio fell by 5 percentage points to 57% in Q3 2018. According to central bank data, the interest charges of private listed non-financial companies have declined. They accounted for 22.3% of profits before tax in Q4 2018, down from more than 35% in 2014. Sales revenue growth has also accelerated strongly since year-end 2017, generating an increase in net earnings of nearly 25% in Q4 2018, despite an upturn in the total wage bill. As a result, profits before tax covered interest charges 4.5 times in Q4 2018, compared with only 2.8 times in 2014.

Yet in certain sectors the situation is still very fragile, notably in telecommunications and energy. According to Crédit Suisse [1], interest charges were higher than profits before tax for 96% of companies in the telecommunications sector and 58% of those in energy. The iron and steel sector had the highest concentration of loans at risk at the end of September 2018 [2] (34.2% of loans outstanding according to the central bank), but companies have managed to consolidate significantly their financial situation thanks to sales revenue growth and deleveraging. Profits before tax covered interest charges 11.7 times in Q3 2018, compared to 4.3 times in 2014.

Insufficient foreign direct investment

In 2018, for the first time since 2013, the balance of payments showed a deficit estimated at 0.2% of GDP (excluding changes in foreign exchange reserves). It can be attributed to a sharp increase in the current account deficit coupled with a decline in net capital inflows.

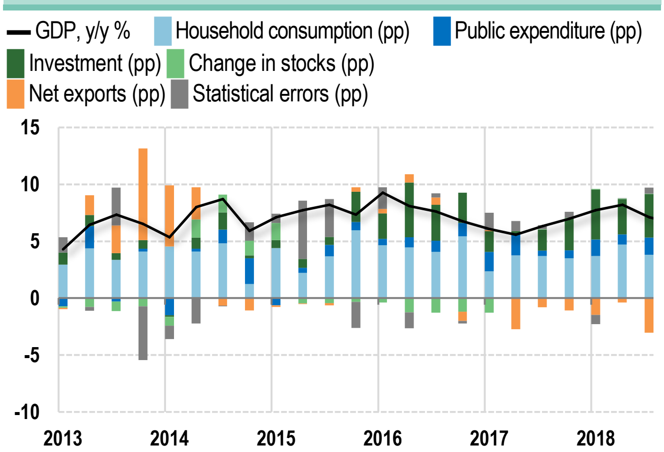
[1] *India Corporate Health Tracker*, February 2019.
[2] Sum of non-performing loans and restructured loans.

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth [(1)] (%)	7.2	7.4	7.6	7.8
Inflation [(1)] (CPI, year average, %)	3.6	3.4	3.3	4.1
Central Gov. Balance [(1)] / GDP (%)	-3.5	-3.3	-3.2	-3.0
Central Gov. Debt [(1)] / GDP (%)	46.9	46.1	45.7	45.2
Current account balance [(1)] / GDP (%)	-1.8	-2.4	-2.3	-2.1
External debt [(1)] / GDP (%)	20.4	19.4	19.2	19.1
Forex reserves (USD bn)	409	393	410	418
Forex reserves, in months of imports	11.5	9.1	9.3	9.5
Exchange rate USDINR (year end)	63.9	71.0	72.0	73.5

(1): Fiscal year from April 1st of year n to March 31st of year n+1
e: estimates and forecasts BNP Paribas Group Economic Research

2- Economic growth slowdown in Q3-FY2018/19



Source: CEIC

The current account deficit rose to 2.4% of GDP in 2018, a 0.9 point increase compared with 2017. The deterioration reflects the strong rise in the trade deficit, which rose 1.1 percentage points to 6.9% of GDP. Exports rose only 5.9% over the full year, while imports increased 12.1%, reflecting an upturn in investment and the oil bill.

At the same time, net capital inflows declined to only 2.2% of GDP in 2018 (from 3% of GDP in 2017). Net foreign direct investment (FDI) declined compared with the 2015-2016 peak, and represented 1.2% of GDP in 2018; this did no longer cover the current account deficit. As a result, the country is dependent on portfolio investment and thus exposed to international financial market volatility. Yet net portfolio investment outflows reached the equivalent of 0.4% of GDP in 2018. As net capital inflows were inadequate to cover the increase in the current account deficit, foreign exchange reserves declined by USD 20 bn and the rupee depreciated by 9% against the dollar in full-year 2018. Even so, foreign exchange reserves are still sufficient to cover the country's short-term external financing needs (1.3 times). Compared with 2013/14, corporates are also slightly less exposed to a revaluation of their debt thanks to the rupee's depreciation against the US dollar. The share of external debt denominated in USD accounted for only 45.9% of total debt at the end of 2018, compared with more than 63% five years earlier.

In Q1 2019, the balance of payments seemed to be healthier given the positive shift in the rupee and foreign reserves. In the first two months of the year, the trade deficit narrowed slightly thanks to the decline in imports.

One of the future government's objectives will be to stimulate further FDI in order to boost economic growth and reduce the country's dependence on volatile capital flows. Although the business climate has improved significantly during the Modi mandate, FDI flows are still mild and the stock of FDI accounted for only 14.3% of India's GDP at year-end 2018 (compared with 22.5% of GDP in Indonesia and 21.7% of GDP in China).

End of preferential tariffs with the United States?

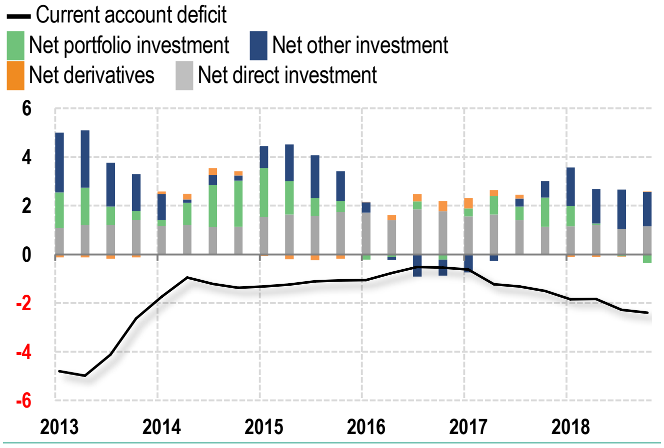
Since 1974, India has benefited from preferential tariffs for certain products exported to the United States under the framework of the Generalised System of Preferences (GSP), which aims to facilitate the development of emerging countries. President Trump announced that he might eliminate this advantage because sales of American products in India were heavily restricted, especially for medicines and basic necessities, such as milk.

Such a move would have only a moderate impact on India's economy. According to the US International Trade Commission, Indian exports to the United States as part of GSP amounted to USD 6.2 bn, 11.5% of exports to the United States, and the equivalent of 0.23% of GDP. These products include mechanical engineering, vehicles, iron and steel, chemicals and consumer goods.

Major challenges for the next government?

Between 11 April and 19 May, general elections will be held for the entire lower house of Parliament, and a new Prime Minister will be elected for the next five years.

3- Balance of payments (4-quarter sum, % of GDP)



Source: RBI

Although the Narendra Modi government's track record is generally positive, thanks notably to the introduction of the Goods and Services Tax (GST), the biometric coverage of the population (Aadhaar project) and a new corporate bankruptcy law, the next government will face several major challenges. Although per capita income has increased strongly in real terms (+6.8% a year on average over the past five years) and the poverty rate has declined, productive employment is still insufficient and informal employment is too high (81% of total employment according to the International Labour Organisation) to increase significantly the country's development.

The next government will have to create a more conducive environment for domestic and non-resident investment. These efforts must cover education (for all) and the labour market, by making it easier for women to find jobs, reducing hiring restrictions and lowering corporate costs in case of layoffs.

Johanna Melka
johanna.melka@bnpparibas.com