India

Gloomy prospects

India's real GDP growth remains far below its long-term potential, and economic indicators do not suggest a significant turnaround in the short term. The government has little manoeuvring room to stimulate the economy. In the first eight months of the fiscal year, the budget deficit already amounted to 115% of the full-year target, and the central bank must deal with rising inflationary pressures, which are hampering its monetary easing policy (which is not very effective anyway). The prospects of materially lower economic growth has led the rating agency Moody's to downgrade its outlook to negative. Yet it is the financing of the economy as a whole that is at stake.

Growth falls far short of potential

In the second quarter of the current fiscal year (July-September 2019), India's GDP growth slowed sharply to only 4.5% year-on-year (y/y). This brings growth in the first half of 2019/20 (fiscal year ending 31 March 2020) to 4.8%, down from 5.4% in the year-earlier period. This is the sharpest slowdown since 2013, even though conditions are much more favourable now than in the past. In the first six months of the fiscal year, inflationary pressures were under tight control (+3.3% vs +11.3% in 2013/14) and the monetary authorities cut the key rate by 135 basis points (bp), even though the move was only very partially carried over to interest rates on new loans. Oil prices are also much lower than in 2013 (-43%) and international investors have shown confidence in the new Modi government. Yet despite government and central bank measures, growth has been hard hit by the sharp slowdown in household consumption (the main growth engine) and investment, albeit to a lesser extent. Although net exports continue to make a positive contribution to growth (due to the decline in imports), exports contracted in the current fiscal Q2. Lastly, Q3 economic indicators do not suggest a strong rebound in activity in the short term. In October, power generation and coal production contracted for the third consecutive month. In manufacturing, production capacity utilisation rates have dropped to the lowest level since 2013, and production of capital goods and consumer goods have declined by 21.9% and 18% y/y, respectively.

Scant means to boost growth in the short term

The monetary and fiscal manoeuvring room to stimulate growth is extremely limited.

The big problem for the monetary authorities is that the monetary policy transmission channel is not working well. Moreover, the rise in inflationary pressures since September (+5.5% y/y in November 2019, compared to a target of 4% give or take 2 percentage points) is now limiting its policy to stimulate growth. Citing price increases, the monetary policy committee opted to keep key rates unchanged at its most recent meeting in December. The authorities must also support the financing of non-banking financial companies, the main source of the big surge in lending since 2017.

Using fiscal policy to stimulate growth is also heavily restricted by the risk of deficit slippage in the current year and fears that its sovereign rating would be downgraded by the international rating agencies. In the first eight months of the fiscal year (April to November), the fiscal deficit already amounted to 115% of the full-year target. Even though the government frequently reports a surplus in the fourth-quarter of the fiscal year, it will not suffice to reach the government's deficit target of 3.3% of GDP.

Faced with these constraints, the government adopted other strong measures, including a significant cut in the corporate tax rate, the privatisation of four major state-owned companies and labour market reform. Although these measures are major advances, they will not stimulate growth in the short term. Corporate investment will

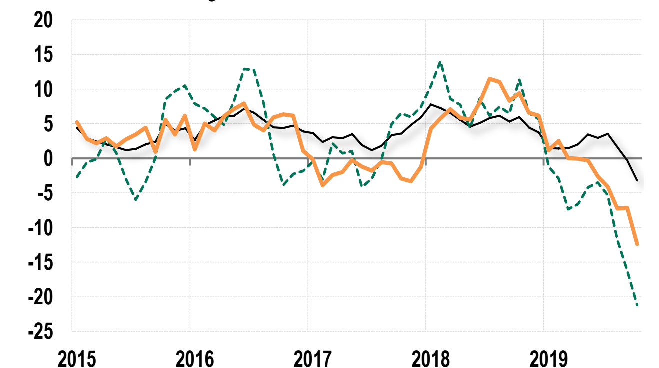
1-Forecasts

	2018	2019e	2020e	2021e
Real GDP growth[1] (%)	6.8	4.8	5.5	6.0
Inflation [1] (CPI, year average, %)	3.4	4.3	4.5	4.5
General Gov. Balance[1] / GDP (%)	-6.3	-7.2	-6.9	-6.7
General Gov. Debt[1]/ GDP (%)	69.8	70.7	70.8	70.6
Current account balance[1] / GDP (%)	-2.1	-2.1	-2.2	-2.4
External debt[1]/ GDP (%)	20.0	19.9	20.0	20.0
Forex reserves (USD bn)	393	457	493	530
Forex reserves, in months of imports	9.1	9.4	9.6	9.8
Exchange rate USDINR (year end)	71.0	71.3	73.5	73.9

(1): Fiscal year from April 1st of year n to March 31st of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output



Source: CEIC

continue to hinge on a recovery in household consumption, which in turn depends on a significant improvement in lending conditions, notably for non-banking financial companies.

Faced with this environment, growth forecasts have been revised sharply downwards for the next two fiscal years. Growth could fall below 6% after averaging 7.5% over the past five years. A lasting slowdown in growth would not only hamper job creations, which already fail to cover new entrants to the job market, it would also strain the consolidation of public finances, Indian companies (underway since 2014) and the banking sector. As things currently stand, fears of materially lower economic growth led the rating agency Moody's to downgrade India's sovereign rating to a negative outlook.

What are the risks in terms of debt sustainability?

Public debt could exceed 70% of GDP as of fiscal year 2019/20. For the moment, however, refinancing risks still seem to be limited.

At year-end 2018/19, public debt already amounted to 69.8% of GDP (i.e. 285% of the annual revenues of the central and state governments), a 2.8-point increase compared to 2013/14, even though the fiscal deficit of all public administrations declined (to 6.3% of GDP in 2018/19 from 7.5% in 2013/14). This increase reflects the increase in "off budget" expenditure, notably by the States.

As part of its public finance consolidation programme, the government is aiming to reduce the public debt ratio to only 60% of GDP by 2024/25. Yet this target does not seem feasible in the light of current growth prospects.

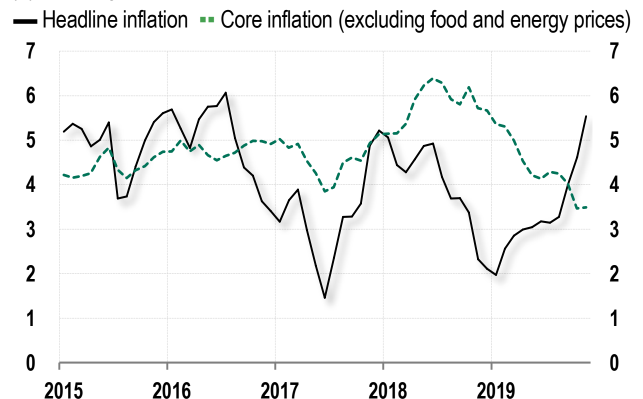
If growth were to hold below 6% on average through 2022/23, the public debt ratio would exceed 70% of GDP over the next three years, assuming the government manages to hold the primary deficit below the threshold of 2% of GDP (1.4% of GDP in 2018/19).

Yet even though India's public debt is among the highest in the emerging countries, its structure is not very risky and refinancing risks are limited. India's debt has long maturities (averaging 10 years), is held mainly by residents (more than 96%) and is denominated in the local currency (97%). Yet the government still has major financing needs that are straining growth. The IMF estimated its needs at 11.4% of GDP in 2019. Moreover, for fiscal year 2018/19, interest payments amounted to 5.3% of GDP, the equivalent of 21.7% of total revenue. Although refinancing risks are limited, any increase in government financing needs could squeeze out financing for the rest of the economy. Banks are the main buyers of public debt securities (39.1%) and financing has been lastingly reduced for non-financial companies.

Banking and financial sector: downturn in the housing market creates new risks

Faced with the sharp increase in the cost of financing, due notably to outflows from mutual funds following the bankruptcy of IL&FS in September 2018, loans granted by non-banking financial companies (NBFC) have dropped off sharply since Q3 2019 (-36% y/y). On the whole, the NBFC still boast a solid financial position, which is much better than for the state-owned banks. Although the share of doubtful loans was rising in Q3 2019, it was still limited to 6.3% of loans outstanding, and the solvency ratio was 19.5% (well above the regulatory threshold of 15%). The central bank has also adopted a regulation that requires NBFC to comply with a liquidity ratio of 100% as of December 2020. The main risk, other than a severe and lasting slowdown in economic growth, is a downturn in the housing sector. The exposure of NBFC as a whole is not very high (6% of loans outstanding), but this is not the case for *Housing Financing Companies* (HFC) specialising in mortgage loans for the real estate sector. Commercial banks, which are still very fragile, are also highly exposed to the real-estate sector (22.5% of lending) which is in the midst of a downturn. In 2018/19, new housing starts contracted for the third consecutive year. Sales reported by listed real-estate companies contracted by 27.8% in Q3 2019, and house prices continued to slow (+2.8% y/y in Q3 2019).

3- Rising inflationary pressures



Source : RBI

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