INDIA

BANKS AND COMPANIES STRONGER THAN IN 2019

In 2022, economic growth slowed but was still buoyant. The outlook for 2023/2024 is favourable even though real GDP growth should slow by around 1 percentage point. In the short term, the main risks are linked to rising prices, which could force the Central Bank to tighten its monetary policy further. The occurrence of the El Niño phenomenon is also a potentially negative factor. Despite the slowdown in growth and the rise in interest rates (48% of loans are at a variable rate), banks and companies remain much stronger than at the end of 2019. In its latest stress tests, the Central Bank reaffirmed that, despite the deteriorating economic and financial environment, public banks would not need any capital injection to meet capital requirements.

INCREASING RISKS TO GROWTH

In 2022, economic growth slowed to 6.7% compared to 8.9% in 2021. Domestic demand remained strong, although it decelerated. The contribution of net exports was negative. Over the January-March 2023 period, real GDP should increase by around 5% year-on-year (YoY) and by 7% in the fiscal year (FY) 2022/2023 ending on 31 March 2023.

In FY 2023/2024, economic growth should slow to 6%. All components of demand are expected to decelerate due to the rise in interest rates, the residual effects of inflation on household purchasing power and the global slowdown. In the short term, the main risks are linked to a sharper than expected rise in prices (induced in particular by higher crude oil prices). In addition, weather forecasts point to the increased risk of *El Niño* during the monsoon, with the consequent negative impact on agricultural production and inflationary pressures.

Prices rose by 6.7% in 2022, compared to 5.1% in 2021. Excluding energy and food, price rises reached 6.1%. Although it slowed at the end of the year, inflation rebounded in the first few months of 2023, reaching 6.4% YoY in February. Against this backdrop of inflation and tensions over the rupee, the Indian Central Bank (Reserve Bank of India, RBI) raised its key rates by 250 basis points (bps) between April 2022 and April 2023. The transmission of monetary policy has so far been partial. The weighted average lending rate for new loans only increased by 100 bps.

THE BANKING SECTOR WILL SUPPORT ECONOMIC ACTIVITY

The banking sector is now much stronger than it was before the COVID-19 epidemic, but also compared to the situation that prevailed five years ago. Although credit risks may increase in the next few quarters due to the lifting in March 2023 of the latest guarantees provided to micro-, small and medium-sized enterprises (in the framework of "restructuring schemes"), the slowdown in economic activity and the increase in interest rates (48% of loans are at a variable rate). In addition, despite monetary tightening, banks and non-bank financial companies did not reduce their credit supply, which increased by 12.6% over 2022 (compared to 6.6% in 2021). According to rating agencies, SMEs would be the most vulnerable to the monetary tightening. However, an increase in the non-performing loan ratio is not RBI's preferred scenario, and should this occur, it would remain modest and Indian banks would be able to cope, without any new injection of capital by the government.

The latest report on financial stability confirmed the continuation of banking sector consolidation between March and September 2022. The quality of assets improved, profitability increased and liquidity and sol-

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, % (1)	-6.6	8.7	7.0	6.0	6.3
Inflation, CPI, year average, % (1)	6.1	5.5	6.7	5.5	4.4
General Gov. Balance / GDP, % (1)	-13.9	-10.2	-10.0	-9.0	-8.1
General Gov. Debt / GDP, % (1)	89.4	84.1	83.5	83.7	83.5
Current account balance / GDP, % (1)	0.9	-1.2	-3.5	-2.8	-2.8
External debt / GDP, % (1)	21.5	19.5	19.6	19.8	19.9
Forex reserves, USD bn	579	618	562	550	570
Forex reserves, in months of imports	9.0	7.9	6.7	6.2	6.1

TABLE 1

(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDIA: CPI AND INTEREST RATES

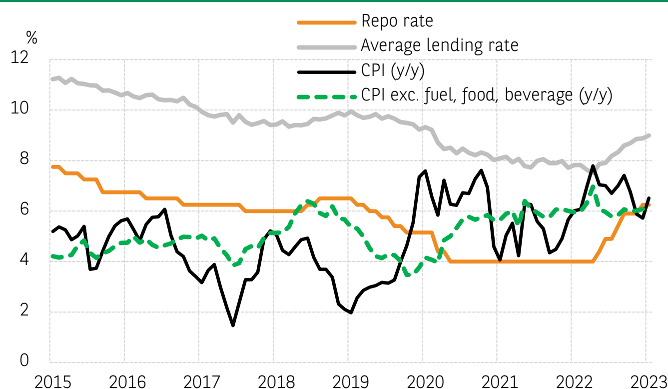

CHART 1

SOURCE: RBI, BNP PARIBAS

vency ratios remained above regulatory standards, although they decreased in conjunction with the sharp rise in credit. However, relative to GDP, the amount of outstanding bank credit (excluding credit to financial companies and the government) has decreased by 0.3 pp over the last twelve months, standing at 50.2% of GDP at the end of 2022.

In September 2022, the non-performing loan (NPL) ratio stood at 5%, down 1.9 pp compared to the same period a year earlier. Furthermore, even though public banks remained more fragile than private banks, their NPL ratios also improved significantly. At the end of September,

NPLs reached only 6.5% of their total loans (compared to 8.8% in September 2021). The drop was particularly marked in industry and in particular in the metals sector, where the ratio was only 6.5% in September 2022 (compared to 44.5% five years earlier). The construction sector remains the most fragile sector. Its NPL ratio was still as high as 18.3% in September 2022. Nevertheless, the risks for the banking sector remain under control, since loans to the construction sector only accounted for 3.4% of total credits.

Micro-, small and medium-sized enterprises (MSME) remain the most fragile actors. Although falling over the last twelve months, the NPL ratio was still 7.7% in September 2022. At that time, 5.2% of lending was still being restructured as part of the programme put in place during the COVID-19 outbreak.

Furthermore, although provisions are still insufficient across the banking sector as a whole, they covered 71.5% of risky assets in September 2022 compared with 68.1% a year earlier.

In conjunction with the rise in bank lending, liquidity in the banking sector has declined over the past twelve months, but remains comfortable. The liquidity coverage ratio stood at 135.6% in September 2022 (141.2% for public banks).

Solvency ratios are down 0.7 pp compared to March 2022, but remain sufficiently comfortable at 16% across the banking sector. The downturn, which can be explained by the very sharp acceleration in bank lending, can be seen for all public, private and foreign banks. However, it has been much more pronounced for foreign banks. Nevertheless, the capital adequacy ratio of public banks (14.5%) remained slightly higher than the level recorded in September 2021 and well above regulatory requirements.

Finally, bank profits consolidated thanks to the slight increase in their net interest margin (+20 bps between September 2021 and September 2022). Their Return on Assets and Return on Equity stood at 1% and 11.2% respectively in September 2022.

In the short term, apart from a worsening in the macroeconomic environment (inflation, growth) proving more significant than expected, two risks are weighing on the banking sector: i) a deterioration in the financial situation of MSMEs due to the rise in interest rates; and ii) a drop in the valuation of banks' asset portfolio due to the monetary tightening, even though government bond yields have remained relatively stable since the beginning of 2023 after having increased by more than 80 bps in 2022. At the end of September 2022, government securities accounted for 51% of banks' total assets.

NON-BANK FINANCIAL COMPANIES ARE STILL FRAGILE

Non-bank financial companies as a whole (including housing finance companies) remain an important source of financing for the Indian economy. In the FY2021/2022, they accounted for 12.4% of total credit. However, they remain structurally more fragile than banks because first, they are financed entirely by borrowing (unlike banks with a deposit base) and second, they finance the actors most vulnerable to a slowdown in economic activity. Apart from lending to small companies in the industrial sector (37.5% of total lending), households are the ones benefiting the most from lending granted by non-bank financial companies (29.5% of total lending). Although their situation has consolidated, particularly since IL&FS went bankrupt in 2019, some non-bank financial companies are still fragile, as evidenced by the latest RBI stress test results.

INDIA: NON-PERFORMING LOANS IN THE BANKING SECTOR

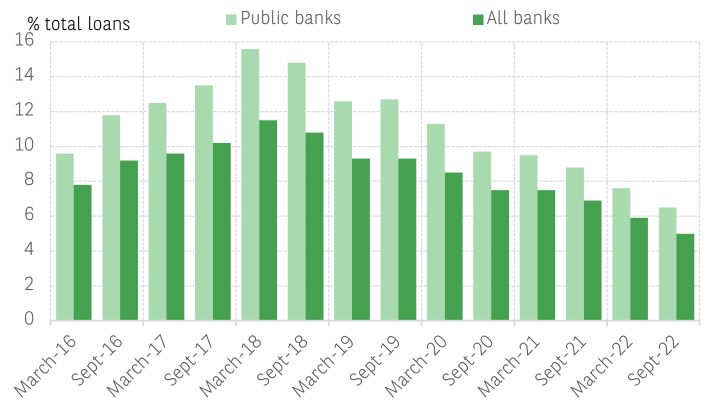

CHART 2 SOURCE: RBI, BNP PARIBAS

Over the past twelve months, the quality of their assets has generally improved. The NPL ratio fell by 1.4 pp, reaching 5.1% in September 2022. At the same time, although falling, their capital adequacy ratio reached an average of 27.4% while their return per asset was 2.5%. However, according to the latest RBI stress tests, nine out of one hundred and fifty-two companies analysed (these nine representing 4.7% of lending granted) would see their solvency ratio drop below the regulatory threshold of 15% during 2023, and thirteen would be affected in the event of a severe shock (recession, inflation above 10%). This would lead to a rise in NPL ratios from 1.8 pp to 6.9% and reduce the average capital adequacy ratio of non-bank financial companies as a whole to 22.6%.

THE FINANCIAL SITUATION OF HOUSEHOLDS AND BUSINESSES IS STILL STRONGER THAN BEFORE THE PANDEMIC CRISIS

Private sector debt (excluding financial companies) reached 87.7% of GDP in Q3 2022. Although still above its pre-crisis level, household debt has declined significantly over the past twelve months. It reached 35.5% of GDP in September 2022 compared to a high of 40.7% of GDP in March 2021, according to the Bank for International Settlements (BIS). Household debt is mostly made up of bank loans (79.6% of the total) and, to a lesser extent, loans taken out with non-bank financial companies and loans from housing finance companies (which make up 9.4% and 9.7% of their total debt, respectively).

Non-financial corporate debt remains modest. According to the RBI, it reached 52.2% of GDP in Q3 2022, which is 2.3 points lower than the level prevailing at the end of 2019. In terms of financial situation, companies are much more comfortable than just before the COVID-19 outbreak. However, this financial situation has deteriorated since Q3 2022 with the slowdown in sales and the increase in interest charges on debt (+18.5% YoY in Q4 2022), which has led to a drop in profits (-15.3% YoY in Q4 2022). As of Q4 2022, pre-tax profits covered 4.6 times their interest costs.

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