INDIA

DETERIORATION DESPITE SUSTAINED GROWTH

In Q2 2023, Indian economic growth remained solid. But since the summer, the situation has deteriorated slightly. In addition to the contraction in exports, rural demand is slowing. Inflation has rebounded and downward pressures on the rupee have increased slightly due to the sharp slowdown in capital inflows. External accounts are expected to remain under pressure until the end of the year. The sharp rise in oil prices and a below-normal monsoon are weighing on the trade deficit and fuelling inflationary pressures. In addition, the narrowing yield spread between Indian and US government bonds is limiting portfolio investment. So far, the banking sector has weathered the rise in interest rates well. Credit risks have receded, even though the private sector is highly exposed to an interest rate shock. Finally, the financial position of public banks has strengthened.

GROWTH STILL ROBUST IN Q2 2023

In the second quarter of the calendar year (first quarter of the fiscal year 2023/2024), Indian economic growth remained robust (+7.8% y/y). It was supported by the dynamism of domestic demand as exports contracted in conjunction with the global economic slowdown.

Although slightly slowing, the pace of growth in investments remained solid (+8% y/y). After deteriorating slightly in 2022, due to higher interest charges and production costs, the financial position of listed companies improved in the first half of 2023. The increase in their net profits offset the increase in their interest burden. At the end of June 2023, their EBIT (earning before interest and tax) covered 5.2 times the interest payments on their debt (compared with 4.9 times a year earlier). Under these conditions, the increase in production capacity utilisation rates in Q1 2023 (to 76.3% compared with a long-term average of 74.3%) argues in favour of an increase in private investment over the remainder of 2023, albeit at a slower pace than in previous quarters given the downside risks to global growth and monetary tightening. Weighted average interest rates on new loans have risen by 126bps over the past twelve months (+210bps in real terms). However, at the end of July, the pace of growth in business loans remained robust (+13.7% y/y compared with an average of 9.7% over 2022).

Government investment, too, remained buoyant in the first four months of the 2023/2024 fiscal year (up 51.9% on the same period last year). Over the year as a whole, the government is forecasting an increase in capital expenditures from 0.6pp to 3.3% of GDP.

Although business confidence remains particularly positive, consumer confidence seems to have started to turn around after an uninterrupted rise since Q3 2021. According to the Reserve Bank of India (RBI), urban and rural wages have fallen in recent months. In addition, rural households fear that winter crops will be smaller than in previous years. At the end of September, the last month of the monsoon, the rainfall deficit compared with normal was still estimated at 5.6%.

STRONG REBOUND IN INFLATIONARY PRESSURES

After several months of slowdown, inflation has rebounded over the last two months. Consumer prices rose by an average of 7.1% year-on-year (y/y) in July and August 2023, after slowing to 4.3% in May 2023. This rise reflects the pressure on food prices, and more specifically on vegetable prices (+26.1% y/y). To contain this increase (45.9% of household consumer goods), the government decided at the end of July to ban exports of non-basmati rice (as it had done in September 2022 on broken rice) and imposed additional taxes on parboiled rice exports.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, % (1)	-5.8	9.1	7.2	6.1	6.0
Inflation, CPI, year average, % (1)	6.1	5.5	6.7	5.9	5.0
General Gov. Balance / GDP, % (1)	-13.9	-9.6	-9.2	-9.0	-8.1
General Gov. Debt / GDP, % (1)	89.3	84.8	83.6	83.9	83.5
Current account balance / GDP, % (1)	0.9	-1.2	-2.0	-1.7	-1.8
External debt / GDP, % (1)	21.4	19.7	18.4	18.7	19.0
Forex reserves, USD bn	579	618	562	515	537
Forex reserves, in months of imports	9.0	7.9	6.7	7.2	8.2

(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDIA: CPI AND INTEREST RATES

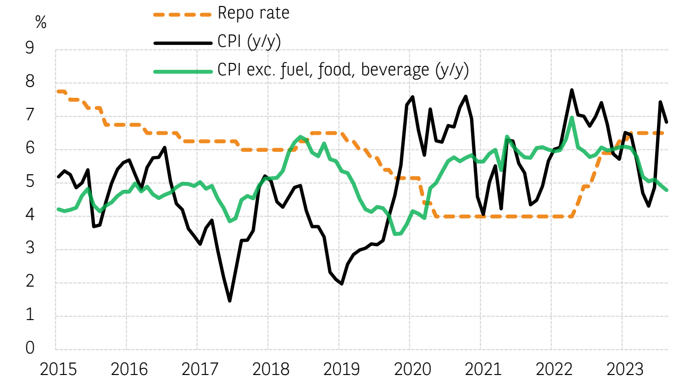

CHART 1 SOURCE: CEIC, RBI

To date, this rise in food inflation has not spread to core inflation (prices excluding food and energy), which has continued to decelerate, although it remains high (+4.8% y/y in August).

However, due to the rebound in inflationary pressures, the RBI is in an uncomfortable position. Indeed, the rise in prices excedeed the target of 4% +/- 2pp, even though economic activity is showing signs of slowing and downward pressure on the rupee remains strong. Furthermore, given the pressure on food prices and the rise in international oil prices, inflationary risks remain on the upside.

SLIGHT DETERIORATION IN EXTERNAL ACCOUNTS

In the first half of 2023, the current account deficit fell by 0.8pp of GDP compared with the previous six months, to just 0.6% of GDP, compared with 2.3% for the whole of 2022.

However, this consolidation, reflecting the fall in the trade deficit brought about by the contraction in the price of imported raw materials, is unlikely to last. According to data from the Indian Ministry of Trade, the trade deficit increased significantly in July and August compared with the previous quarter. Exports lagged, while imports accelerated again. The economic slowdown in the United States, India's largest trading partner (17.7% of its exports in 2022), partly explains this deterioration. Exports to the US fell 9.7% in the first half of 2023 compared with the same period last year.

In addition, the recent rise in oil prices is likely to further widen the trade deficit, even though in H1 2023 34.2% of oil came from Russia and was imported at a price a third lower than Brent.

At the same time, net capital inflows, which were already modest over 2022 as a whole, have slowed significantly since July, according to data published by the Institute of International Finance (IIF). This movement can be explained by the scissor effect between the fall in yields on 10-year Indian government bonds and the rise in 10--year US government bond yields. Downward pressure on the rupee has increased slightly over the past three months. Interventions by the RBI to contain the depreciation of its currency have been limited and foreign exchange reserves, although down since mid-July (USD -16.7 bn), remain very comfortable. They stood at USD 523 bn at the end of September, equivalent to 1.7 times the country's short-term external financing needs. The country's net external debt accounts for only 10.8% of GDP.

The main risks to external accounts and growth are persistently high oil prices and an increase in capital outflows. These two phenomena weigh on the rupee and exacerbate inflationary pressures.

A MORE ROBUST BANKING SECTOR

Over the past five years, the Indian banking sector has strengthened significantly. Private sector debt has been fairly stable at 90% of GDP since the end of 2021 (household and non-financial corporate debt was estimated in Q4 2022 at 36.4% and 53.6% of GDP respectively by the Bank for International Settlements).

Asset quality has improved and solvency ratios have strengthened. Public banks, while still more fragile than private banks, are now strong enough to cope with a macroeconomic shock without any additional capital injection. In particular, strengthening their position has enabled them to increase their credit offer. Although still modest, the outstanding credit granted by commercial banks increased by 2.6pp in a year to 53.3% of GDP in July 2023.

In the banking sector as a whole, the non-performing loan (NPL) ratio has fallen by two percentage points (pp) over the past twelve months to just 3.9%. In public banks alone, NPLs accounted for 5.2% of total loans compared with 15.6% five years earlier. It is in the agricultural sector that loans remain the most fragile. According to the RBI, risky assets accounted for 8% of loans in March 2023. This ratio was 6.8% in industry, 5.1% in services and 2.9% for loans to households. In industry, the most fragile sectors are construction and jewellery. Even though provisions remain modest, they now cover 74% of NPLs (compared with 48.1% five years earlier).

INDIA: RISING TRADE DEFICIT

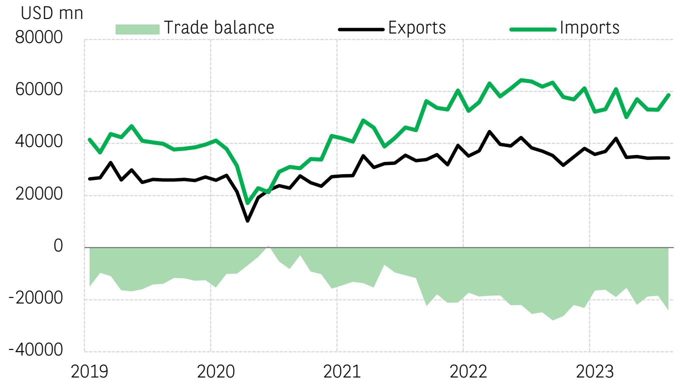

CHART 2 SOURCE: CEIC, RBI

At the same time, solvency ratios have improved. At the end of March 2023, the Capital Adequacy Ratio (CAR) was 17.1% in the banking sector as a whole and 15.5% in public banks.

The main risk is the high level of loans at flexible rate. According to the RBI, 72% of loans granted by the 14 largest commercial banks (which hold 81% of total banking assets) are at flexible rates. This type of loan constitutes 79.4% of loans in agriculture, 82.3% in industry, 76.3% in services and 60.2% for loans to individuals (excluding consumer goods). Mortgages (51.3% of loans to households, or 16.4% of bank loans) are the most vulnerable to an increase in interest rates, as 94.8% of them are granted at flexible rates.

In addition, the transmission of monetary policy to the real economy increased significantly over the last period of monetary tightening compared with previous periods. Over the period from April 2022 to July 2023, the rise in key rates (+250 bp) resulted in an increase in weighted average rates on new loans of 193 bp.

The property market is also showing signs of a slowdown in some states, as evidenced by lower sales prices in the major cities of Gujarat, West Bengal and Rajasthan. However, credit risks in the real estate sector are partially limited by regulatory constraints. Thus, the amount of the mortgage loan (for any purchase of a property worth more than INR 3 million) must not exceed 80% of the value of the property purchased (90% for loans of less than INR 30 million).

Johanna MELKA
johanna.melka@bnpparibas.com