STRONG GROWTH, BUT INDIA CANNOT REPLACE CHINA

Indian economic growth slowed in the first quarter of the current fiscal year and leading indicators suggest that it will stand at 6.9% over the fiscal year as a whole (vs. 8.2% last year). There are a number of risks to GDP growth, but they remain moderate. Apart from rising inflationary pressures, which could delay the expected monetary easing in December, the slowdown in foreign demand is the main risk. Weakening Chinese demand, in particular, may hinder the development of India's manufacturing sector, which is already undersized due to competition from Chinese consumer and capital goods at increasingly competitive prices. While India's growth is the highest among emerging countries, it clearly cannot supplant China as the engine of global growth. Instead, thanks to its growing population, it can provide opportunities for international companies. We are already seeing significant changes in household consumption patterns, with a shift towards durable consumer goods.

GROWTH SLOWS DOWN BUT REMAINS STRONG

In the first quarter of the fiscal year (FY) 2024/2025 (April-June 2024), economic growth stood at 6.7% year-on-year (y/y), down 1.1 points on the January-March figure, as a result of a decline in net taxes and lower public spending. Nevertheless, household consumption rebounded (boosted by easing inflationary pressures) and total investment remained solid. Net exports contributed positively to growth for the second consecutive quarter as a result of slowing imports.

Even though economic activity indicators for the second quarter confirm that growth is continuing to slow down, the growth outlook for the entire FY2024/2025 is still favourable. Despite slowing from last year (and from the average of 7.4% during the 2014-2019 period), growth is expected to stand at 6.9%, the highest level among emerging countries. Household consumption (57.2% of GDP on average over the past five years) should remain steady thanks to rural household demand rebounding (due to a favourable monsoon). On the other hand, investment momentum is likely to wane. Although the financial position of companies has strengthened in recent years and production capacity utilisation rates remain above their long-term average, business lending has slowed. Real interest rates on new loans have increased by 490 basis points (bps) since mid-2022. In addition, data published by the Ministry of Finance suggest that public investment fell over the first five months of the current fiscal year (-13% y/y), compared to the same period last year. The government would need to increase its investment very significantly over the rest of the year (+41%) in order to achieve its target of increasing public investment to 3.4% of GDP.

Exports have also started to contract (from July onwards) and no improvement is expected by the end of the year. Changes in external demand pose a risk to short-term growth, despite India being less vulnerable to the external environment than other Asian countries, in view of its limited integration into global trade. Due to the structure of its trade relations and the sources of its foreign investment, India is more exposed to a slowdown in the United States than in China (its exports to the United States and China account for 17.6% and 3.8% of its exports, respectively). However, competition from Chinese consumer and capital goods at increasingly competitive prices could not only hinder the development of India's manufacturing sector, which is already not large enough to meet employment needs, but could also increase the dependence of India's economy on its big neighbour. In addition, the inclusion of sovereign bonds in emerging market indices (since June 2024 in the JP Morgan index and from September 2025 for the FTSE Russell EMGBI) could increase the country's vulnerability to an external financial shock. However, this risk will be partially mitigated by a maximum cap of 6% of the total debt on ownership of government bonds by foreigners.

In the medium term, growth is expected to remain at between 6.5% and 7% thanks to buoyant services and the tax incentive programmes adopted by the government since 2020, which should benefit the manufacturing sector.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, % (1)	9.7	7.0	8.2	6.9	6.7
Inflation, CPI, year average, % (1)	5.5	6.7	5.4	4.7	4.3
General gov. balance / GDP, % (1)	-9.5	-9.6	-8.5	-7.9	-7.5
General gov. debt / GDP, % (1)	85.2	84.8	82.5	83.9	83.7
Current account balance / GDP, % (1)	-1.2	-2.0	-0.7	-1.1	-1.2
External debt / GDP, % (1)	19.7	18.4	18.7	19.0	18.5
Forex reserves, USD bn	618	562	623	678	721
Forex reserves, in months of imports	7.9	6.7	8.6	8.1	8.5

(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: ECONOMIC SLOWDOWN

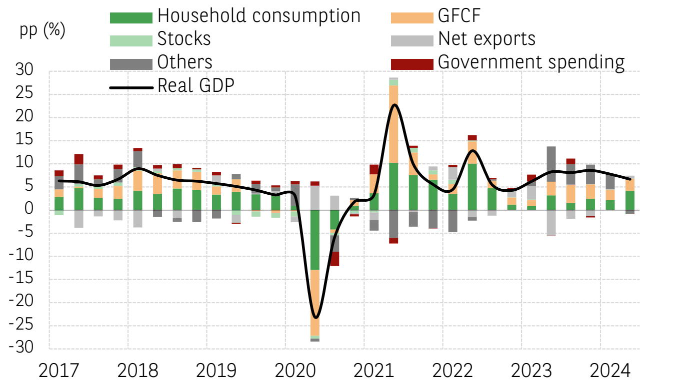

CHART 1 SOURCE: CEIC, BNP PARIBAS

LIMITED EFFECT OF THE UPCOMING MONETARY EASING

Inflation accelerated significantly in October (+6.2% y/y), due to unfavourable base effects and the sharp rise in food prices (+10.9%). Inflationary pressures are expected to slow in Q1 2025 thanks to the good harvests, but risks remain on the upside due to highly volatile food prices. Over the entire fiscal year, inflation is expected to stand at 4.7% (with a target of 4% +/- 2 pp), which should enable the Reserve Bank of India (RBI) to make a first rate cut by the first quarter of 2025. However, the timing and scale of its monetary easing hinge on the U.S. Federal Reserve's approach to this. As things stand, a cumulative cut in RBI key interest rates of 75 bps is the most likely scenario (the "neutral" real repo rate would be between 1.4% and 1.9%, according to the RBI), but an easing of just 50 bps (in total) cannot be ruled out. Either way, even a cut of 75 bps would not put downward pressure on the rupee, as the rate spread with the United States would be bigger than it is currently (assuming that the Fed cuts its rates to 3.25%-3.5% by mid-2025).

However, the effect of such monetary easing will be limited, as monetary policy is still not fully transmitting to the economy. The hike in key interest rates (+250 bps between mid-2022 and early 2023) has led to an increase in interest rates on new loans of just 169 bps. In addition, recent changes in the composition of household savings (shifting away from bank deposits and towards savings products with better interest rates) are distorting things even further. Liquidity pressures have increased and banks could be less inclined to make more credit available.

PUBLIC FINANCES: LIMITED ROOM FOR MANOEUVRE

Public finances are still the weak spot in the economy. Debt remains high (nearly 84% of GDP) and, even though the refinancing risk is low, the government has little fiscal room for manoeuvre to support growth and meet the country's very substantial equipment and infrastructure needs. Although the deficit of the government and all administrations is falling, it is still close to 8% of GDP, and the interest paid on the debt is absorbing nearly 38% of budget revenue. However, since 2021/2022, the government has chosen to slow down the pace of its fiscal consolidation so that it can increase its investment spending.

INDIA IS NOT CHINA…

India is currently in no position to supplant China as the engine of global growth. Over the past five years (excluding the pandemic period), its contribution to global growth has been less than half of China's. It has neither the industrial capacity nor the income to become an economic power to rival China. However, its domestic market, although still small, is growing.

India's contribution to global trade is low (1.9% of global goods exports and 4.5% of services exports, whereas Chinese exports accounted for 14.5% of global goods exports and 5% of services exports in 2023) and its imports are still small. It is the seventh largest importer in the world (2.9% of total global imports), far behind the United States, China and Germany.

Although its primary energy consumption has increased by 51% over the last ten years, it is still much lower than China's (22.7% of China's consumption), according to the latest data from the Statistical Review of World Energy. This is because its manufacturing sector is still small (17.3% of GDP) and investment,

INDIA: CPI AND MONETARY POLICY

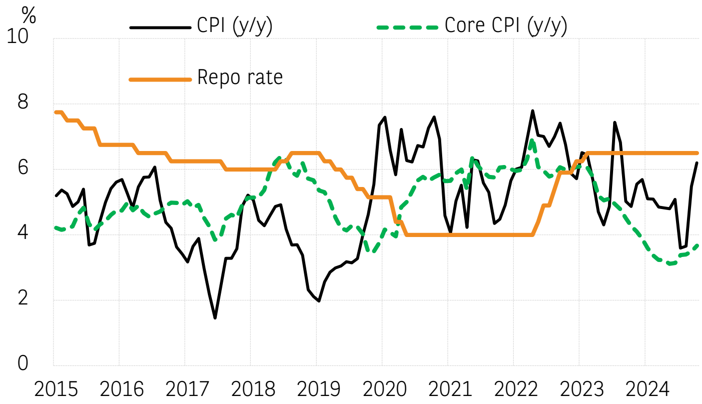

CHART 2 SOURCE: CEIC, RBI

particularly in industry, infrastructure and real estate, which are energy-consuming sectors, remains modest. India's current energy consumption is comparable to China's twenty years ago. Therefore, unless India successfully manages to develop its industry very rapidly and step up its urbanisation, it currently seems unlikely that the country will become as big a consumer of commodities as China over the next ten years. Even if its primary energy consumption doubled (as has been the case in Vietnam over the past ten years, alongside the development of its industry), it would still be less than half of China's current consumption.

Indian household consumption cannot be likened to China's (3.2 times lower), as its level of GDP per capita at PPP is still 2.5 times lower. However, it is by no means small (nearly USD 2.2 billion in 2023), and is similar to Japan's (which was down 4.2% in 2023). It has increased by an annual average of 5.7% in volume terms over the past ten years. This reflects the population growth (+1% per year), but also the emergence of an upper-middle class. According to Euromonitor, 119 million Indians (11% of the population over the age of 15) had an annual income of more than USD 5,000 in 2023 (compared to 37 million in 2010), with 40 million earning an income of more than USD 10,000 per year. In addition, according to data from the World Inequality Database, 1% of the adult Indian population (more than 9 million Indians) had an average annual income of over USD 60,000 in 2022. As a result, India is seeing the emergence of a population with the income to purchase capital goods and vehicles.

The latest survey on household consumption patterns reflects this rising purchasing power. The portion of the consumer basket for non-food items has increased by nearly nine percentage points in twenty years to account for nearly 61% of their consumer basket, while durable consumer goods (such as cars) accounted for 7.2% of urban household purchases in 2022/2023 (compared to 5.6% ten years earlier). The development potential of the car market is reflected in the foreign direct investment trends. Alongside construction, chemicals and renewables, it receives some of the highest levels of FDI among India's industrial sectors.

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