INDIA: UP AGAINST A WALL

The Covid-19 crisis did not spare India, and like many of the emerging economies, the country's economic and social situation has deteriorated sharply. Yet India's situation had already begun to deteriorate well before the onset of the pandemic, which only accentuated the country's weaknesses. The very sharp contraction in GDP triggered by the Covid-19 pandemic highlights the economy's structural vulnerabilities, especially the large number of workers without social protection. With the nationwide lockdown in April and May 2020, 75 million Indians fell below the poverty line, and there is reason to fear that the second wave could have a similar impact. In fiscal year (FY) 2021/2022, GDP growth should rebound vigorously, although forecasts are likely to be revised downwards due to the expected contraction in FY Q1 (the second quarter of the current calendar year), following the outbreak of the second wave of the pandemic. In the medium term, growth might fall short of 6% unless there is a significant easing of the structural constraints that are restricting the employment of regular workers and private investment. If growth does not exceed 6%, the government would have to face not only a possible downgrade of its sovereign rating by the rating agencies, but also increasing social risk.

Risks to the recovery

Impact of the Covid-19 crisis

During the fiscal year 2020/2021 (April 2020 to March 2021), India's GDP contracted 7.3% due to the Covid-19 pandemic. This was the country's first recession since fiscal year 1979/1980. As in the other emerging economies, growth rebounded as of mid-2020 and into the first months of 2021. But the recovery was cut short by a second wave of the pandemic. It is estimated that this second wave could cost the economy more than 2 percentage points (pp) of growth. Its impact, however, should be concentrated in FY Q1 2021/2022 (April-June 2021), and growth is expected to rebound again as of FY Q2.

An unprecedented recession

The Covid-19 pandemic had an especially big impact on India's economy. With the exception of the Philippines, the contraction was much worse than in the other Asian countries. The complete lockdown of the population for more than two months was very damaging for an economy that is highly dependent on domestic consumption.

All the components of demand declined with the exception of public expenditure. Private consumption, India's main growth engine (accounting for 59.4% of GDP on average over the past five years), contracted by 9.1%, and per capita household spending fell back to the level that prevailed three years earlier. At the same time, investment contracted by 10.8%. The decline in domestic demand triggered a sharp contraction in imports, although not enough to offset the downturn in exports. As a result, net exports made a negative contribution to growth.The contraction in economic activity was especially severe in the services sector (-4.6%) and to a lesser extent in industry (-2.1%). Agriculture was the only resilient sector (+0.5%).

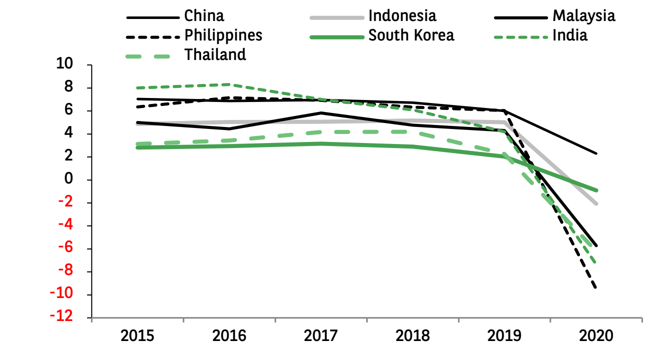
The severity of the recession can be attributed to the total lockdown of the population in a country characterised by a large number of low-income households (prior to the Covid-19 crisis, per capita GDP was only USD 2098 a year), the vast majority of which do not benefit from any social protections. International organisations estimate that between 78% and 90% of the active population works in the informal sector (the lower figure is from the International Labour Organization (ILO) and the higher figure is from the World Bank). According to the Center for the Study of Developing Societies (CSDS) and the Azim Premji University, 29% of urban workers (who were hit hardest by the pandemic) are day labourers without social protection, and who migrated from rural areas. Moreover, between 12 and 18 million of these migrants were forced to return to their home state following the outbreak of the Covid-19 crisis[1].

Although it certainly underestimates the amplitude of the shock, the unemployment rate peaked at 23.5% in April 2020, compared to 7.2% in January 2020.

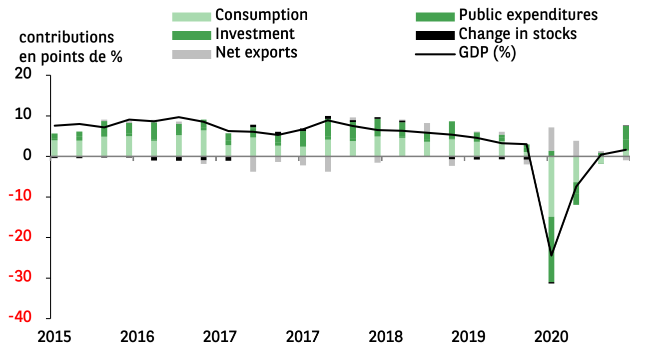
Under these conditions, the Pew Research Centre estimates that 75 million individuals fell below the poverty line last year, whereas the past 20 years of growth had lifted 248 million individuals out of poverty. The research centre also reports that 134 million individuals are now living on less than USD 2 a day. At year-end 2020, nearly

1 Amitabh Kundu, Research and Information System for Developing Countries.

GDP GROWTH IN INDIA AND THE OTHER ASIAN COUNTRIES



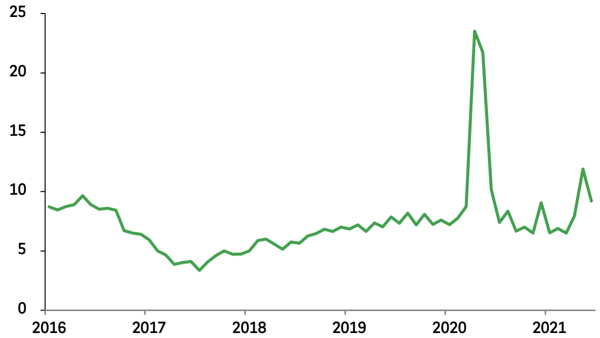
BREAKDOWN OF INDIA'S GDP GROWTH



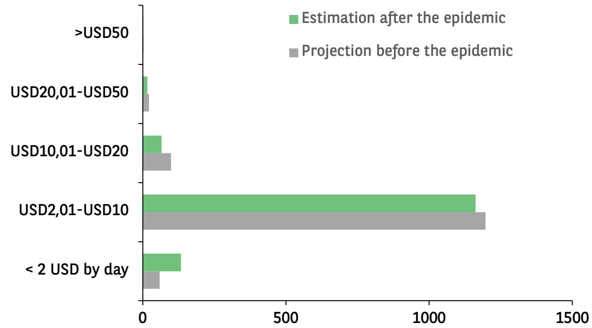
CHARTS 1A & 1B

SOURCE: CEIC, RBI

INDIA: UNEMPLOYMENT RATE



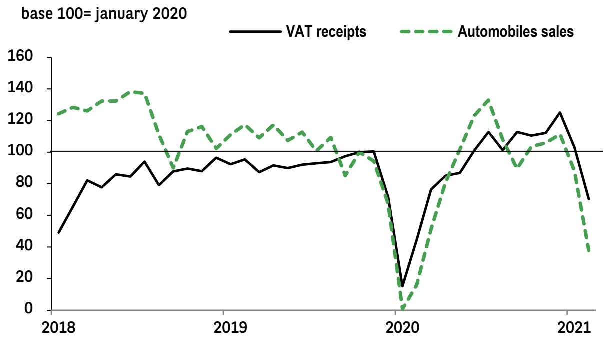
BREAKDOWN OF INDIA'S POPULATION BY REVENUE



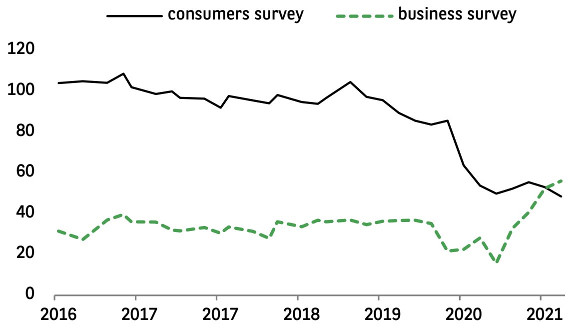
CHARTS 2A & 2B

SOURCE: CMIE, PEW RESEARCH CENTER

VAT REVENUES AND AUTOMOBILE SALES (100 = JANUARY 2020)



CONSUMER AND BUSINESS CONFIDENCE INDEXES



CHARTS 3A & 3B

SOURCE: RBI

1.16 billion individuals out of a total population of 1.3 billion, were living on the verge of poverty, with revenues ranging between USD 2 and USD 10 a day.

The recovery is threatened by a second wave of the pandemic

The ebbing of the first wave of the Covid-19 pandemic (April 2020) sparked a major economic rebound, and India swung back into growth as of fiscal Q3 (October to December 2020). The recovery was cut short in March 2021 by a second wave of the virus, which was much more virulent than the first but peaked in May. Although Narendra Modi's government did not reinstate another nationwide lockdown, numerous states – including the biggest economic powerhouses – opted for partial lockdowns that included shutting down all nonessential businesses.

According to economic indicators, there was a very sharp contraction in April 2021 that worsened in May 2021[2]. In comparison with March 2021, there was a very sharp downturn in the mobility of local residents[3], VAT revenues[4], sales of cars, two wheelers and tractors, demand for electrical power, and air and rail traffic, although they still held above the levels reported during the worst of the pandemic's first wave (April 2020). The unemployment rate rose significantly, to 12% at the end of May 2021, after falling back to only 6.5% in March, although this was still short of the peak in April 2020. The services sector seems to have been hit hardest, since factories were allowed to stay open in almost all of the states that imposed new restrictions. Household confidence indicators plummeted, falling to unprecedented levels in May 2021, even lower than those reported the previous year. Business confidence, in contrast, was resilient in May 2021, although it was lower than at the beginning of the year. The pandemic's second wave probably had an especially big impact on the financial situation of households since they had already been hit by a loss of revenue during the first wave[5].

2 June statistics are not available yet.
3 In April-May 2021, leisure travel was down 50% from pre-Covid levels (vs about -78% at the same time last year). Business travel was down 38% from pre-Covid levels (compared to -53% last year).
4 Although VAT revenues rose very strongly compared to the same period last year, they were down by an average of 32% in April and May compared to the peak of March 2021.
5 According to CMIE estimates, since the beginning of the pandemic, 97% of Indian households have reported a loss of income, which resulted not only in a decline in household consumption, but also in gold imports, which contracted sharply in 2020.

It is estimated that the second wave may have slashed GDP growth by more than 2 percentage points. In full fiscal year 2021/2022, the consensus forecast is now calling for growth to range between 8% and 10% (down from 11-12% before the second wave). Of course, as for all countries, the 2021 performance will be atypical, even if the figures are revised downwards. The big question is how strong will growth be after the fiscal year 2021/2022? This question is especially pertinent for India, since its growth had already slowed sharply even before the Covid-19 crisis.

Growth was slowing well before the Covid-19 crisis

GDP growth had already begun to slow in India well before the Covid-19 crisis. There were two phases to the slowdown: the first was observed after the 2009 financial crisis, and the second during the three fiscal years prior to the Covid-19 crisis.

GDP growth is also volatile because India is especially vulnerable to climate shocks due to its dependence on agricultural revenues. Household consumption is the main growth engine (57% of GDP), and since the majority of households live in rural areas (more than 65%) where half of the land is not irrigated, revenues are highly dependent on the monsoon. The quality of growth has also deteriorated over the past five years.

Analysis of the economic slowdown

According to the Conference Board's breakdown of growth, the economy slowed from 8.1% in 2004-2008 to 6.6% in 2011-2019 (excluding the 2009 crisis and its rebound in 2010) due to a decline in the contribution of capital and especially to a sharp decline in total factor productivity.

The accumulation of productive capital slowed. The investment rate declined by 7 percentage points to 28.8% between fiscal years 2007/2008 and 2019/2020. More importantly, the nature of investments has also changed. In fiscal years 2017-2019, the share of investment by private and state-owned companies declined significantly in favour of government and household investment. Companies cut back their investment in machinery and equipment, which dropped to the equivalent of only 5.7% of GDP in fiscal year 2018/2019.

The decline in total factor productivity reflects a loss of efficiency in the combined use of productive factors and/or a decline in technical progress, or simply a deterioration in the country's attractiveness[6]. Fundamentally speaking, the decline in total factor productivity reflects the structural constraints that are straining the country, handicapping foreign direct investment and restricting private productive investment: high corruption, insufficient infrastructure, restrictions on land acquisition, labour market rigidities, insufficient education, a low workforce participation rate for women, and the concentration of jobs in low value-added sectors. To make matters worse, the banking and financial sector is fragile and can barely support the economy, while the government has extremely little fiscal manoeuvring room to make the necessary investment expenditures.

The quality of growth deteriorates

In addition to the slowdown in GDP growth reported in recent years, there has also been a slight deterioration in the quality of growth. Labour market indicators have deteriorated and human development has slowed over the past five years. The economic crisis accelerated this deterioration, and the second wave could further strain a population that is already extremely vulnerable.

BREAKDOWN OF GROWTH BY PRODUCTION FACTORS

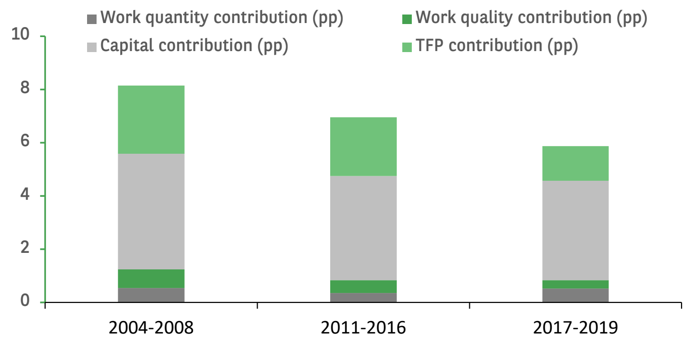


CHART 4

SOURCE: CONFERENCE BOARD

A sluggish labour market

In 2020, India's economy had to integrate more than 12 million new entrants to the labour market. According to the Center for Monitoring the Indian Economy (CMIE), India must create 16 million jobs by 2030 just to absorb all the new entrants. Looking at the employment rate, however, job creations have failed to cover job demand for several years.

According to estimates by the International Labour Organization (ILO), the employment rate (active workforce over the working-age population) was only 43% in 2020, which is far below the 57% threshold that the ILO considers to be acceptable. According to ILO estimates, this ratio has declined continuously after peaking at 52.7% in 2008.

At the same time, the labour market participation rate (employed population and jobseekers as a share of the working-age population) declined by more than 10 percentage points from a peak of 58% in 2005, to less than 46.3% in 2020 accord to the ILO (less than 42% according to CMIE). The labour force participation rate for women followed a similar downward trend, although it was already low fifteen years ago. According to the ILO, it was only 20.8% in 2019. According to this indicator, part of the population is completely excluded from the labour market. It is comprised notably of young people with no experience and no education.

Human development: little progress

In 2019, India ranked 131 out of 188 countries on the United Nations Human Development Index, outranking the other countries of the subcontinent, but lagging far behind those of the ASEAN-4. Moreover, although human development improved significantly in 1990-2010, advances have slowed sharply over the past five years, to an estimated 1.2% for the period 2010-2019, compared to 1.6% in 2000-2010. As a result, India gained only one place in the international ranking between 2015 and 2019.

To improve its human capital and increase the pace of job creations (especially for regular employment), it is imperative for the government reduce the structural constraints that are shackling the economy. Otherwise, this demographic advantage could be transformed into a real social risk.

6 Sector deformation of the economy is also an explanation of total factor productivity, but in India's case, as in most of the emerging economies, it makes a positive contribution, due mainly to the decline in the contribution of the agricultural sector in favour of other more productive sectors of the economy.

DECLINE IN THE LABOUR FORCE PARTICIPATION RATE

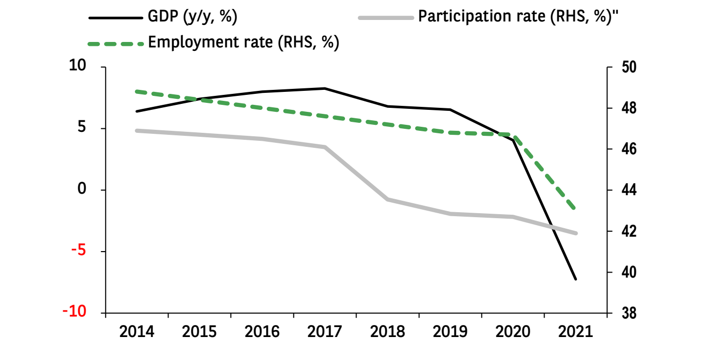


CHART 5 SOURCE: CEIC, ILO

BREAKDOWN OF EMPLOYMENT BY SECTOR

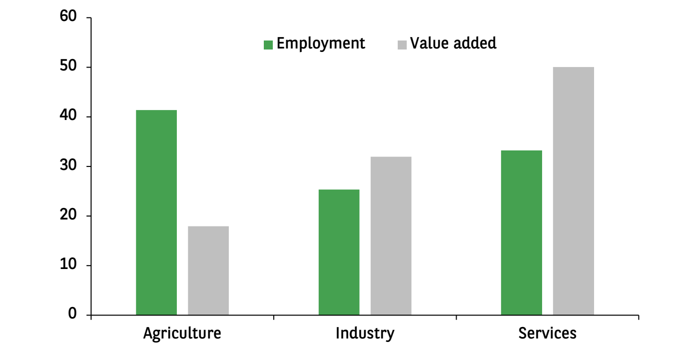


CHART 6 SOURCE: ILO

In the medium term, growth will barely exceed 6% due to structural constraints and the fragilities of the banking and financial system

Human capital: an untapped strength

Major structural constraints are restricting investment and job creations. Moreover, the business climate is still fragile, even though it is improving.

Over the past five years, although governance has improved slightly, India still lost five places, to 109 out of 211 countries, on the World Bank's 2020 worldwide governance ranking. It still lacks sufficient control over corruption (110th out of 209 countries according to the World Bank). According to Transparency International, corruption is still widespread, and India ranked 86th out of 183 countries in 2020 (8 places below its 2017 ranking).

The quality of infrastructure has also improved but is still lacking. Before the Covid-19 crisis, India ranked 70th out of 141 countries in the 2019 Global Competitiveness Report. Public infrastructure is still insufficient, notably access to electrical power.

Labour market rigidities are a major constraint for hiring "regular" workers. Instead, they favour the development of informal market. In the most recent competitiveness report, India scored only 44.4/100 in terms of labour market flexibility (compared to 64.4/100 for China).

The lack of skills in the workforce also places a big damper on the development of high value-added sectors. According to ILO statistics, 27.2% of the active population did not have any diplomas in 2018 (18.8% of men and 35.7% of women), and only 34% had the equivalent of a high school diploma. The average length of schooling was only 6.5 years. India has also failed to improve the quality of education over the past five years. The level of human capital development has regressed. The latest competitiveness report shows a sharp decline (-25%) in the number of diplomas in India over the past five years, the sharpest decline among the emerging countries.

Employment continues to be concentrated in agriculture (41.4% of the active population in 2019) even though the sector has a low weighting as a share of GDP (14.7% of value added). Inversely, the services sector (which contributes more than 55% to value added) only employs 33.2% of the active population. Manufacturing employment is also relatively moderate (12.1% of the active population) compared to the sector's weighting (17.5% of value added).

Large-scale reforms were adopted, but could be difficult to implement

Starting in 2019 and continuing through fall 2020, the Modi government adopted a series of major reforms to resolve structural constraints and to attempt to stimulate medium-term growth. These reforms cover corporate taxation, the labour market, agriculture and land acquisition. The big problem, however, lies in their implementation.

To stimulate both domestic and foreign investment, the government lowered the corporate tax rate at year-end 2019 from 30% to 22% (and from 25% to 15% for newly created companies in the manufacturing sector), bringing corporate taxation in line with the practices of the other Asian countries.

To reduce labour market rigidities, the lower chamber of Parliament (Lok Sabha) adopted four new labour codes, in August 2019 and then in September 2020, which are intended to replace the 29 existing codes[7]. The new laws aim to ease hiring and firing regulations in order to reduce the informal market's share of the economy. The government hopes this will facilitate formal employment, notably for companies with more than 100 employees, and the development of social protections. Employment in India is overly concentrated in small businesses with no social protections, due to the excessively tight regulations on hiring and firing workers in big corporations. According to the World Bank, if the new law is applied, 2.8 million workers would be able to leave the informal sector. In theory, these new labour market codes were to take effect on 1 April 2021, but in practice, their application has been postponed. They must first be validated by the states before they can be applied locally. At mid-June, the laws were still not in effect.

To increase productivity in the agricultural sector, the Modi government adopted three bills in September 2020. The state must allow farmers to sell their produce at prices they fix directly with their buyers, without government intermediation (this is already the case with the majority of farmers today). This reform aims to increase investment and productivity in the agricultural sector. Yet it was very poorly received by the agricultural world due to fears it could lead to the suppression of the minimum sales price (even though it is guaranteed by the government).

7 The wage code was adopted in August 2019 and the three other codes were adopted in September 2020 (the occupational safety, health and working conditions code, the industrial relations code, and the code on social security).

Lastly, to favour productive investment, especially in high value-added sectors, the government has repeatedly tried to ease restrictions on land acquisition for purposes other than agriculture. Despite numerous attempts at reform, the development of non-farm activities is still extremely regulated, enough to dissuade national and foreign companies from investing in India. More than 1200 laws govern land acquisition. Yet the most recent amendments adopted locally by the states of Gujarat and Karnataka are only marginal, and the reforms that were adopted do not seem to go far enough to alleviate the restrictions on the use of land for non-farm purposes. It is imperative to launch large-scale reforms at the national and local levels so that land acquisition is no longer a major obstacle hampering industrial investment projects.

In addition to these structural impediments, India's economic growth has also been held back in recent years by the fragility of the state-owned banks.

The fragility of India's banking and financial system is hampering growth

During the period 2016-2019, Indian banks sought to consolidate their financial situation by slowing the pace of loan distribution. Non-banking financial companies as a whole stepped in to provide additional financing for the economy by significantly increasing lending to niche sectors, including financing for households without regular revenues, small and very small enterprises, and real-estate financing (financing granted notably via the Housing Finance Companies).

Since September 2018, however, the share of lending provided by non-banking financial companies has diminished as their cost of financing increased following the bankruptcy of Infrastructure Leasing & Financial Services (IL&FS). At the same time, there was also a sharp slowdown in corporate investment.

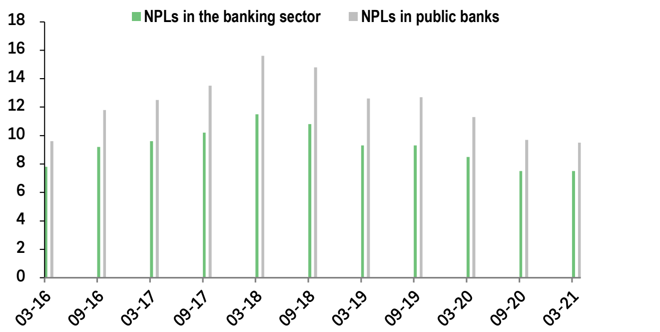
On the eve of the Covid-19 crisis, India's banks and non-banking financial companies were still in a fragile situation, and credit supply was not very abundant. The big question today is whether the banking and financing sector as a whole will be in a position to finance India's economic recovery in the short and medium term, once the Covid crisis is over.

<u>Commercial banks: more solid today than they were five years ago</u>

In the Financial Stability Report dated January 2021, the central bank described a banking sector that was in a much more solid situation in Q3 2020 than it was in the 5 previous years, even though it is still fragile. Although forecasts must still be revised to take into account the pandemic's second wave, so far the rating agencies esteem that the banking sector should be able to face up to higher credit risks and the deterioration in capital adequacy ratios due to the first and second waves of the pandemic. In contrast, the banks will have much higher needs for capital injections than the banking authorities initially expected. It will be imperative for the government to support the state-owned banks so that they can assume their role of providing economic support.

Starting in 2016, India's state-owned banks began consolidating their balance sheets. Their financial situation even strengthened after the first wave of the pandemic. The quality of bank assets was more solid in Q1 2021 than in 2018 (the non-performing loan ratio dropped to 7.5% from a peak of 11.5% in March 2018), provisions were higher (covering 68.9% of doubtful loans in March 2021, up from only 48.1% in March 2018), and solvency ratios were more comfortable (the capital adequacy ratio stood at 16% vs a low of 13.2% in March 2016). Even so,

NON-PERFORMING LOANS RATIO (%)



Note: stressed advances are defined as non performing assets + restructured standard advances.

CHART 7A SOURCE: RBI

PROVISION COVERAGE RATIOS (%)

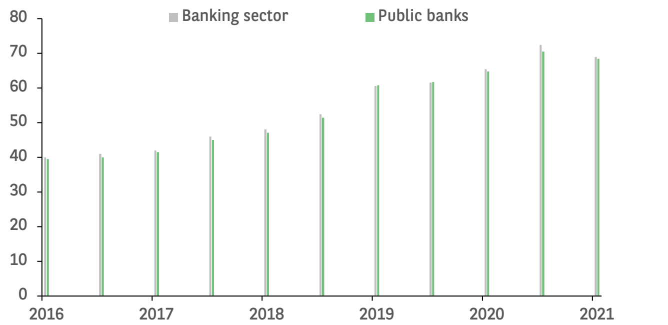


CHART 7B SOURCE: RBI

CAPITAL ADEQUACY RATIOS

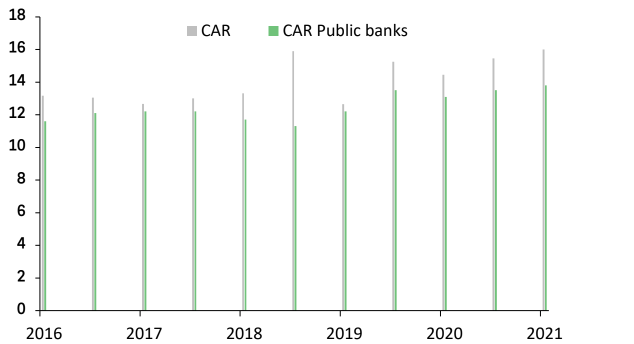


CHART 7C SOURCE: RBI

the disparity between banks is still high. State-owned banks are still the most fragile, with higher non-performing loan ratios (9.5%), lower provision coverage (68.4%) and much less comfortable capital adequacy ratios (13.8%). Moreover, the non-performing loan ratios do

BANK CREDIT (Y/Y, %)

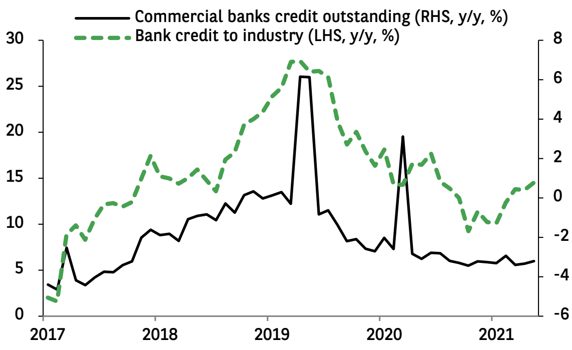


CHART 8

SOURCE: RBI

not yet show the impact of the recession, because the banks were allowed to delay the reporting of doubtful loans until March 2021.

To support the most vulnerable economic players, on 5 May the central bank governor authorised banks to restructure their loans to households and to small and medium-sized enterprises (for loans of less than RS 250 million) through 30 September 2021.

In its latest Financial Stability Report dated July 2021, India's central bank lowered its growth outlook for the current fiscal year to 9.5% due to the second wave of the pandemic. Even so, it esteems that there will only be a moderate deterioration in the quality of bank assets. According to the central bank, the non-performing loan ratio will increase by only 2.3 percentage points between March 2021 and March 2022. This would bring the non-performing loan ratio for the banking sector as a whole to 9.8% at March 2022 (12.5% for state-owned banks), which is slower than the pace that prevailed more than five years earlier.

At the same time, the central bank is forecasting a mild deterioration in bank capital adequacy ratios (from 16% to 15.5% by March 2022). It esteems that all state-owned banks will be able to comply with regulatory requirements by March 2022, thanks to capital injections announced by the government in February 2021 for a total of RS 200 bn (0.1% of GDP), after the same amount of capital was injected during the previous fiscal year. These projections also assume that the government will create a National Asset Reconstruction Company, a bad bank to facilitate the clean-up of the balance sheets of state-owned banks and public non-banking financial institutions. The transfer of non-performing loans would be comprised notably of housing loans with a value equal to or higher than RS 5 bn. Only state-owned banks and public non-banking financial institutions would be authorised to transfer non-performing loans with a provision ratio of nearly 100%, and they would recover 75% of the debt. The total amount of non-performing loans eligible to be transferred is estimated at RS 2000 bn. These transfers, the first of which are expected at the end of June (for a total of RS 890 bn), should free up capital for lending purposes that is currently tied up in provisions. This bad bank is to be financed through private funds (mainly from Indian banks) with a government guarantee of RS 310 bn (0.16% of GDP). In other words, the sector will largely bear the cost of this bail-in.

Bank lending was struggling to pick up prior to the second wave of the pandemic

Despite the central bank's easing of monetary policy in 2020, which reduced the average lending rate on new loans by 126 bp (key policy rates were cut by 115 bp between January 2020 and March 2021), on the whole, lending to industry picked up very mildly in the first months of 2021 (up 0.4% year-on-year in April 2021), after declining for five straight months, from October 2020 to February 2021.

Loans to major companies even contracted, reflecting their cutbacks in investment. Moreover, large companies could easily self-finance because even though sales contracted sharply, profits increased, thanks to a sharp downturn in labour costs and commodity prices for a large part of the year 2020.

In contrast, household lending (excluding food loans) accelerated rapidly in March and April (+12.6% y/y in April), at the same time as consumption rebounded. Lending to mid-sized companies (18% of lending) has grown extremely rapidly since September (+43.8% y/y in April), thanks to the Emergency Credit Line Guarantee Scheme set up between 23 May 2020 and 31 March 2021, which aimed to address the financing needs of small and mid-sized enterprises. According to the government, at the end of January 2021, this programme had distributed RS 1.9 trillion in bank loans (excluding non-banking financial companies), and accounted for 36.6% of loans granted during the year.

Non-banking financial companies are still solid, but vulnerable to market trends

On the eve of the Covid-19 crisis, loans outstanding granted by non-banking credit institutions still amounted to 11.6% of GDP (vs. 52.5% of GDP for banks).

Lending by non-banking financial companies slowed significantly during the Covid-19 crisis (+2.5% y/y in December 2020), but relatively less so than for banks. It is mainly short-term loans that increased as households encountered cash flow problems. At year-end 2020, the share of loans maturing in less than three months had increased by nearly 2 percentage points compared to the beginning of the crisis, to 11.5% of their loan portfolios. The share of long-term loans even declined, although they still account for 71.7% of total loans outstanding, reflecting a decline in corporate investment in a rather sluggish economic environment.

A priori, non-banking financing companies as a whole (including housing finance companies) are more vulnerable than banks to the Covid-19 shock due to the structure of their loan portfolios. In particular, part of the Indian population they finance has no bank accounts. Yet they have proven their ability to adapt and their resilience to shocks since 2018/19.

The industrial sector is still the main recipient of loans granted by non-banking financial companies as a whole (61.6%). Yet the share of consumer loans has increased to 24.5% in 2020, in keeping with automobile sales, due to the health crisis.

According to the central bank's latest report, the non-banking financing companies were in a satisfactory situation in December 2020. Like banks, however, these institutions were able to postpone the reporting of non-performing loans (which will only appear on Q1 2021 balance sheets). Yet the quality of their assets is more solid than for the banking sector (this was already the case prior to the Covid-19 crisis). Their doubtful loan ratio was only 5.3% at the end of December 2020, most of which was concentrated in services (9.4%) and, to a lesser extent, in agriculture (6.7%). The quality of consumer loans is still generally satisfactory, with a doubtful loan ratio of only 3.4% of loans outstanding at year-end 2020. All in all, the profitability of these non-banking financial institutions is generally satisfactory, with ROA of 1.9% and ROE of 10.2% at December 2020.

Even so, non-banking financial companies are still exposed to market financing. In December 2020, 46.4% of their financing was from bond and Treasury bill issues on the markets, and 30.3% from bank lending. Any increase in risk aversion, especially on the part of mutual funds (their main investors) would result in a sharp, irremediable increase in the cost of financing for these companies. During the Covid-19 crisis, the yield spread between 3-month issues of non-banking financial companies and government bond issues rose by more than 130 bp to a total of 230 bp in May 2020 for the least risky companies with an AAA rating, and an additional 100 bp for AA-rated companies. Thanks to the policy conducted by the monetary authorities, these tensions have since fallen sharply, and the cost of financing has dropped below pre-Covid levels. Yet the companies with the lowest credit ratings are still particularly vulnerable to any new risk aversion on the part of investors.

To conclude, based on the indicators available on the eve of the pandemic's second wave, banks and non-banking financial companies have the capacity to increase their credit supply and thus to support the economic recovery. But there is reason to fear that credit risks will rise sharply following the second wave of the pandemic, and that more capital will be needed for provisions to cover any potential losses. This risks squeezing the credit supply of banks, especially state-owned banks whose capital adequacy ratios are not as comfortable as for the private banks. In the past, the government has always stepped in to support the state-owned banks, injecting the capital necessary to support the banking sector when it was not in a position to raise funds on its own. Given the sharp deterioration in public finances, however, the government has little manoeuvring room to fund a bail out, which could strain the recovery of lending in the short and medium-term.

GOVERNMENT REVENUE GRADUALLY DECLINES (% GDP)

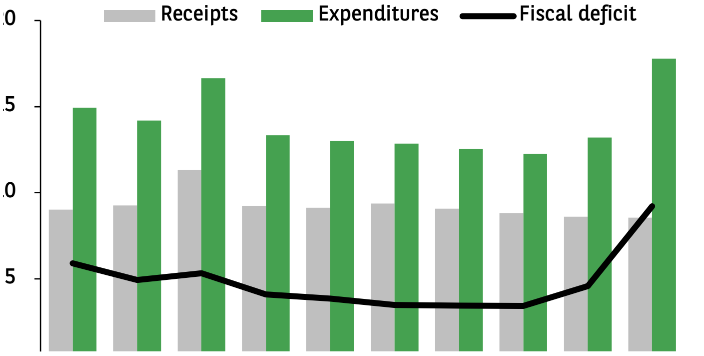


CHART 9 SOURCE: RBI

DEBT DYNAMICS (% GDP)

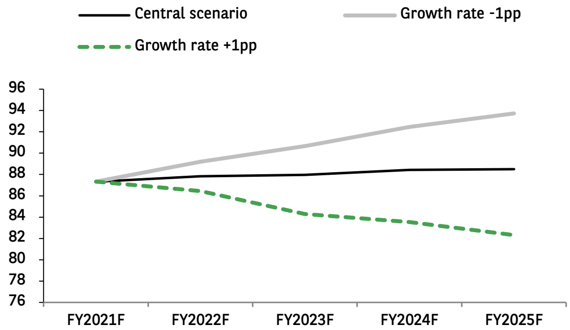


CHART 10 SOURCE: CEIC, BNP PARIBAS

Risks to public finances

So far, the evolution of India's public finances has been shaped primarily by economic growth and the primary balance, and less by interest rates. Yet as we have just seen, the risks to growth are particularly high as long as the adopted reforms are not implemented in an effective manner. Similarly, there are also high risks concerning the government's capacity to make a significant reduction in the primary deficit of all public administrations, because of a low fiscal base and the sharp increase in the weighting of incompressible expenditures.

Already weak, India's tax base has shrunk in recent years

India's public finances are structurally fragile due to a weak fiscal base and the high proportion of incompressible expenditures. Although public finances were consolidated over the five fiscal years 2015/2019, they began to deteriorate during fiscal year 2019/2020 and were further weakened by the economic crisis triggered by the Covid-19 pandemic.

After a gradual, 5-year decline, the central government deficit began swelling again in fiscal year 2019/2020 to 4.6% of GDP (up from 3.4% of GDP in FY 2018/2019), and the primary deficit rose to 1.6% of GDP. At the same time, the general government's primary deficit rose to an estimated 3.1% of GDP, compared to an average of only 1.7% of GDP over the previous five years.

Even before the Covid-19 shock, the central government's fiscal revenues had shrunk to only 8.6% of GDP (down from 9.4% in 2017/18), which is low compared to the other Asian countries[8]. Revenue declined notably because of major difficulties in implementing the single Goods and Services Tax (GST) nationwide in July 2017, which involved fiscal compensation to states to cover tax losses. The decline can also be attributed to the corporate tax cut in September 2019 (from 30% to 25.17%) to stimulate investment.

The Covid-19 shock had a massive impact on public finances. In FY 2020/2021, the central government's deficit doubled to 9.2% of GDP, while the general government's deficit may have exceeded 14% of GDP[9]. At the same time, government debt is estimated at more than 87% of GDP (up from 72.2% of GDP before the crisis).

The increase in the deficit is mainly due to a sharp increase in spending (+4.6 pp), notably household subsidies (+2 pp to 3.3% of GDP), which as a share of total spending doubled to more than 18% (38% of revenues). Interest expenses also rose sharply (+11.4%). They now account for more than 40% of government revenues (vs. an average of 34.5% over the previous five fiscal years), even though government revenues barely declined (-3.6%) thanks to higher customs duties.

8 Prior to the Covid-19 crisis, government revenue in Indonesia amounted to 12.4% of GDP, which is one of the lowest rates among the Asian countries, while Malaysia's came to 17.5% .
9 Public finance statistics for the states are reported with a big lag. We used IMF estimates based on budget projections.

Subsidies and interest payments together comprised nearly 38% of government spending, and more than 78% of revenues. The primary deficit swelled to 5.8% of GDP, after averaging only 0.7% of GDP during the previous five fiscal years.

In fiscal year 2021/2022 (1 April 2021 to 31 March 2022), the Minister of Finance intends to reduce the central government deficit to 6.8% of GDP and that of all public administrations to 11% of GDP. This would still bring the central government's primary deficit to 3.1% of GDP, which is much higher than pre-crisis levels. Moreover, when the budget outlook was published in February 2021, these forecasts already seemed optimistic, and may need to be revised upwards given the very sharp decline in VAT revenues reported in Q2 2020.

Looking beyond the current fiscal year, the government does not seem to be quite as determined to consolidate public finances as in the past. Stimulating growth in the short and medium term seems to be the top priority. Yet the government has very little manoeuvring room to support growth and face up to a new domestic or external shock without risking the deterioration of public finances, in which case the rating agencies would downgrade India's sovereign rating. A simulation of India's debt dynamics shows that if the general government's primary deficit is not brought back below the 3% threshold, then the public debt ratio will continue to deteriorate slightly, even if real growth holds at 6%.

Refinancing risks are still mild because the structure of the debt is not very risky

To date, the risks of refinancing India's debt are still small because the structure of its debt is not very risky and the government has access to abundant domestic savings.

The central government's debt has a long maturity (average of 11.3 years), is more than 94%-owned by residents, and the revaluation risk due to the rupee's depreciation is extremely low, since debt is almost exclusively denominated in the local currency (97%).

More than 93.5% of government debt is issued on the debt market. It is comprised mainly of fixed-term bond issues (62.6% of total debt) and, to a lesser extent, Treasury bills with a maturity ranging between 14 and 364 days (11.5% of government debt). Debt market issues are mainly held by banks (37.8%) and insurance companies (25.3%). The share of debt held by the central bank increased by 1 pp in fiscal year 2020/2021 to 16.2%. Over the next five years, the amount of debt reaching maturity is estimated at only 10.1% of GDP.

Since the beginning of 2021, the government's cost of financing has remained relatively stable (the 10-year rate was 6% in mid-June 2021). Yet the government is not sheltered from an increase in the cost of financing, even though the central bank's securities purchases have so far maintained bond yields at low levels. In contrast, the interest charge has risen sharply (due to the increase in debt) and is straining the government's capacity to fund investment spending. Moreover, if the government resorts to more financing from banks, which are already weak, it would erode their capacity to finance the private sector (crowding-out effect).

******

Narendra Modi's government is in a delicate situation. Public finances, which were already fragile prior to the Covid-19 crisis, have deteriorated sharply, and the outlook for medium-term growth is a source of concern. The rating agencies have placed a negative outlook on its sovereign rating. For the moment, government refinancing is not a major or imminent risk. Yet the debt servicing charge has risen sharply, limiting the government's capacity to invest, support the recovery and/or face up to a new shock. Under this environment, if the government fails to implement the reforms adopted in fall 2020, growth could be capped at 6%, while the employment rate continues to fall (job creations are falling short of demographic growth). Yet if GDP growth levels off below 6%, or if the government does not rapidly consolidate its public finances (the primary deficit of the government and all public administrations must be brought below 2.7% of GDP, which is even lower than pre-crisis levels), then the public debt trajectory would continue to diverge and the rating agencies would be likely to downgrade India's sovereign rating to "non-investment grade", further straining the government's capacity to support the economy. In the past, it has always been extremely problematic for India to implement reforms. And as the protests against the agricultural reforms suggest, this time will be no different, especially since Narendra Modi seems to have lost a bit of his shine based on the results of recent regional elections.

Completed on 5 July 2021

johanna.melka@bnpparibas.com

GENERAL GOVERNMENT DEBT DYNAMICS

	FY2019	FY2020	FY2021	FY2022e	FY2023e	FY2024e	FY2025e
Gross general government debt (% GDP)	70.3	72.2	87.3	87.8	88.0	88.4	88.5
General government's primary deficit (% GDP)	-1.1	-3.1	-9.3	-6.0	-4.0	-3.2	-2.8
Real GDP growth (%)	6.5	4.0	-7.3	8.3	6.4	5.7	6.1
Average nominal interest rate (%)	7.8	6.9	7.0	7.0	7.0	7.1	7.2
Inflation (%)	4.4	4.8	6.2	5.0	5.0	4.5	4.3

TABLE SOURCE: BNP PARIBAS

GROUP ECONOMIC RESEARCH

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

Jean-Luc Proutat US, UK - Head of economic projections, relationship with French network	+33 1 58 16 73 32	jean-luc.proutat@bnpparibas.com
Hélène Baudchon France - Labour markets	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Louis Boisset Japan - European Central Bank watch, Euro area global view	+33 1 57 43 02 91	louis.boisset@bnpparibas.com
Frédérique Cerisier Euro area (European gouvernance and public finances), Nordic countries	+33 1 43 16 95 52	frederique.cerisier@bnpparibas.com
Guillaume Derrien Italy, Spain, Portugal - International trade	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Raymond Van Der Putten Germany, Netherlands, Austria, Switzerland – Energy, climate	+33 1 42 98 53 99	raymond.vanderputten@bnpparibas.com
Tarik Rharrab Statistics	+33 1 43 16 95 56	tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Laure Baquero	+33 1 43 16 95 50	laure.baquero@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+33 1 40 14 30 77	thomas.humblot@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François Faure Head – Argentina	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam, South Africa	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Stéphane Colliac Turkey, Ukraine, Central European countries	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Sara Confalonieri Africa (Portuguese & English-speaking countries)	+33 1 42 98 43 86	sara.confalonieri@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot Korea, Thailand, Philippines, Mexico, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Johanna Melka India, South Asia, Russia, CIS	+33 1 58 16 05 84	johanna.melka@bnpparibas.com

CONTACT MEDIA

Michel Bernardini	+33 1 42 98 05 71	michel.bernardini@bnpparibas.com

GROUP ECONOMIC RESEARCH

CONJONCTURE
Structural or thematic topics.

EMERGING
Analyses and forecasts for a selection of emerging economies.

PERSPECTIVES
Analyses and forecasts with a focus on developed countries.

ECOFLASH
Data releases, major economic events.

ECOWEEK
Recent economic and policy developments, data comments, economic calendar, forecasts.

ECOTV
A monthly video with interviews of our economists.

ECOTV WEEK
A weekly video discussing the main event of the week.

MACROWAVES
Our economic podcast.

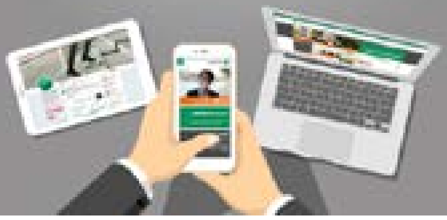
HOW TO RECEIVE OUR PUBLICATIONS

SUBSCRIBE ON OUR WEBSITE
see the Economic Research website

&

FOLLOW US ON LINKEDIN
see the Economic Research linkedin page

OR TWITTER
see the Economic Research Twitter page



Published by BNP PARIBAS Economic Research

Head office: 16 boulevard des Italiens – 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
Internet: www.group.bnpparibas.com - www.economic-research.bnpparibas.com

Head of publication : Jean Lemierre / Chief editor: William De Vijlder