INDIA

A BALANCING ACT

In India, economic growth is holding up thanks in particular to slowing inflation and early signs of an improvement in the labour market. Public finances, which consolidated slightly during the fiscal year 2022/2023, remain much more fragile than five years ago. The government is favouring growth over fiscal consolidation. Capital expenditure continues to increase, even though room for manoeuvre is shrinking due to the high and rising interest payments on government debt. The sharp rise in public investment has improved the quality of infrastructure, which should attract a little more foreign investment. Despite its non-involvement in the conflict in Ukraine, but primarily concerned with its own interests, India is seeking to move closer to the United States and Europe in order to counterbalance China, while maintaining its relations with Russia, its main energy and arms supplier.

ACTIVITY SLOWING BUT RESILIENT

India once again held up well to the global economic slowdown. Over fiscal year (FY) 2022/2023 as a whole, which ended on 31 March, economic growth reached 7.2%. In Q4 of the fiscal year (January-March 2023), it slowed to 6% y/y, which was much faster than expected. The outlook for FY2023/2024 is less favourable. According to the central bank (Reserve Bank of India, RBI), real GDP growth is expected to stand at 6.5%. These forecasts seem optimistic because the risks to growth are significant.

Over the first two months of the current fiscal year, economic activity continued to slow, both for companies and rural households. Industrial production slowed to 3.9% in April y/y compared to 5.4% in Q1 2023, and electricity demand has contracted over the last three months. Although domestic demand (60% of GDP) remains solid, it is weakening, as evidenced by the drop in tractor purchases by rural households and the slowdown in loans to households. Besides, although vehicle sales increased significantly in May, this can mainly be explained by the expected end of subsidies on 1st June; sales should then fall in the very short term.

However, it is worth mentioning two favourable developments, although they are yet to be confirmed: first, the slowdown in inflationary pressure and second, the rise in the employment rate.

In May 2023, the rise in prices stood at 4.3% y/y, close to the RBI's target of 2% +/- 2 percentage points (pp). At the same time, core inflation (excluding energy and food) was moderate at 5% y/y (a level not seen since mid-2020), leading the RBI to leave its key policy rates unchanged at 6.5% in June, a new status quo for the Monetary Policy Committee. The RBI is expected to reduce rates by Q1 2024 at the latest. However, inflationary risks remain high, particularly due to the *El Niño* meteorological phenomenon. At the end of June, total rainfall was 19% less than normal seasonal rainfall. It is estimated that a potential drought may have an impact of 25 to 30 basis points on economic growth (downwards) and on inflation (upwards).

The labour market is showing some signs of improvement. Up slightly since June 2022, the employment rate rose significantly in May (+2 pp to 38.6%), returning to levels prevailing before the Covid-19 pandemic. Admittedly, the unemployment rate remains high (7.7% in May), but this reflects the return of workers who had been forced to leave their jobs following the Covid-19 crisis. In the absence of any clear resumption of employment, the rise in the employment rate shows at least an uptick in confidence among the working-age population.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, % (1)	-6.6	8.7	7.2	6.1	6.5
Inflation, CPI, year average, % (1)	6.1	5.5	6.7	5.5	4.4
General Gov. Balance / GDP, % (1)	-13.9	-10.4	-9.9	-8.9	-8.1
General Gov. Debt / GDP, % (1)	89.4	84.1	83.4	83.5	83.4
Current account balance / GDP, % (1)	0.9	-1.2	-2.3	-2.0	-1.8
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

(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

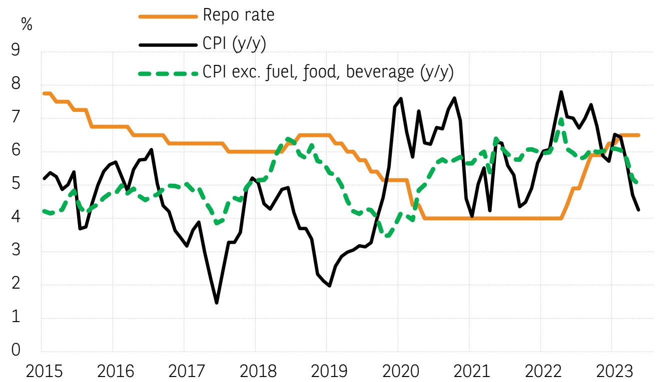

CHART 1 SOURCE: CEIC, RBI

PUBLIC FINANCES: FRAGILE CONSOLIDATION

Public finances in India are structurally fragile. Fiscal revenues are still extremely low (9% of GDP in FY2022/2023). Compared to GDP, they have not increased since the implementation of the Goods and Services Tax (GST) in July 2017. Moreover, the high burden of interest payments on government debt, which have risen sharply since the Covid-19 pandemic, constitutes a major constraint. However, the debt refinancing risk remains moderate, because government debt is denominated in rupees and held primarily by domestic creditors.

Over FY2022/2023, in line with the Ministry of Finance target, the government's fiscal deficit fell by 0.4 pp to 6.4% of GDP. This slight consolidation was made possible by the general decline in spending, which offset the contraction in revenues caused by the drop in customs duties on oil products (adopted to contain inflation) and the reduction in dividends received (caused by the drop in profits in line with the increase in production costs).

However, the fiscal deficit remained well above the level prevailing before the Covid-19 pandemic (3.8% of GDP on average over the 2015/16 and 2019/20 fiscal years). This slow consolidation reflects the government's new strategy, which aims to stimulate economic activity while also containing the fiscal deficit slippage. As a result, despite the high level of subsidies (which increased sharply with the Covid-19 pandemic) and the increase in interest payments (which reached 37.8% of government revenues over FY2022/2023), the government increased its capital expenditures, which reached 2.7% of GDP over the past year (+180% in five years).

According to the preliminary estimates of the Ministry of Finance, the consolidated public deficit (central government and States) should reach 9.9% of GDP, i.e., a 0.5-point reduction over a year. Central government debt should be slightly down, at 83.4% of GDP.

For FY2023/2024 the government forecasts a fall in the fiscal deficit by 0.5 pp to 5.9% of GDP. This consolidation should be made possible by the drop in subsidies (-0.8 points of GDP), in particular on food products (these subsidies were increased during the Covid-19 pandemic) and on fertilisers (subsidies were implemented as a result of the conflict in Ukraine). By doing this, subsidies should return to levels seen before the 2019/2020 pandemic crisis. Funds released would be used to further increase capital expenditure (+0.6 bp to 3.3% of GDP) and cover the expected increase in interest charges on debt (+0.3 points of GDP), which should reach 3.6% of GDP. By FY2025/2026, the government aims to reduce the fiscal deficit to 4.5% of GDP (a level still higher than that seen before the crisis).

INDIA ON THE INTERNATIONAL STAGE: BETWEEN STRATEGY AND OPPORTUNISM

India has always sought to adopt a neutral stance on the international scene. Its strategy is guided solely by the defence of its economic, social and cultural interests. This is particularly the case since Narendra Modi came to power in 2014; his governments have built on their political, economic and military relationships, to strengthen the country's autonomy, particularly in terms of defence. The country has been part of the Quadrilateral Security Dialogue (The Quad) with the US, Japan and Australia since 2020.

China remains its primary trading partner (13.8% of imports in 2022). This trade dependence on the Asian giant is common to most Asian countries. Unlike other South Asian countries, Chinese investment in India is extremely low. Meanwhile, India also boosted trade agreements in Asia in 2022 and resumed its trade negotiations with the European Union in summer 2022.

Beyond trade, in recent years India has wanted to strengthen its role as a major powerhouse in Asia, so as to counterbalance the growing influence of China. We should reiterate that cross-border tensions between the two countries remain marked, as evidenced by the confrontations in December 2022. Not having the financial and technological capabilities of its big neighbour, India has gradually moved closer to the United States.

Due to its neutrality but also its historical dependence on Russian military equipment and technology, India (like China and Pakistan) has not condemned Russia's invasion of Ukraine. On the contrary, it is seeking to take advantage of sanctions against Russia to import oil at a discount price. By doing this, Russia has become its primary oil supplier, ahead of countries in the Middle East. Furthermore, even though India has sought to diversify its arms supply sources, Russia was still its primary supplier in 2022 (45% of arms purchased abroad over the period 2018-2022), well ahead of the United States (11%).

INDIA: SLOW CONSOLIDATION OF PUBLIC FINANCES

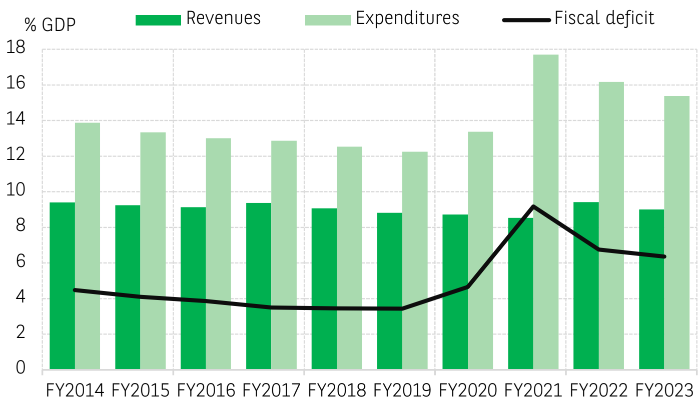

CHART 2 SOURCE: CEIC, MOF

THE BUSINESS ENVIRONMENT IS IMPROVING BUT GOVERNANCE IS NOT

Since 2019, an increasing number of reforms have been adopted to promote investment. In addition to lower corporate income tax rates in 2019 and the adoption, from 2020, of financial incentive programmes (Production Linked Incentive Scheme, PLI) for companies in labour-intensive sectors, the government has significantly increased investment in infrastructure. As a result, total miles of motorway and electricity production capacity increased by 27% and 22% respectively in five years. In addition, digitisation of the economy has thrived. In 2021, 46.3% of the population had access to the Internet, i.e., almost 17 pp more than before the Covid-19 pandemic. At the same time, administrative constraints on companies have been eased. Although still significant, the time taken to start a business, carry out real estate construction and the costs incurred by administrative procedures have decreased.

Conversely, the quality of governance has not improved in the last five years. India was ranked 112th out of 213 countries in 2022 according to the World Bank (i.e., 5 places lower than in 2017). Despite the government's attempts at prevention, corruption remains prevalent, as evidenced by India's downgrading from 80th in 2019 to 85th in 2022 by Transparency International. In terms of the rule of law, India's ranking has also fallen since 2019. The country was ranked 102nd in 2022 compared to 95th in 2018. Growing impairments of freedom of expression and worship are regularly reported by international non-governmental organisations. According to the latest report on democracy in the world published by the University of Gothenburg, democracy has deteriorated in the country and India is considered an "electoral autocracy".

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