INDIA

NEW HEADWINDS

The international economic and financial environment is not helpful for the Indian economy. Although India produces and exports wheat, it will suffer from surging commodity prices. Slowing growth is likely to hamper the government's announced fiscal consolidation. The government will be forced to increase fertiliser subsidies sharply if it wants to contain the increase in domestic food prices, which make up almost 46% of consumer spending. India will not be able to avoid a significant deterioration in its current account deficit driven by higher oil prices and downward pressure on the rupee, especially if recent portfolio investment outflows continue. The results of the recent regional elections should ensure a degree of political stability at least until the 2024 general election.

GROWTH ALREADY SLOWING BEFORE THE CONFLICT IN UKRAINE

In the third quarter of fiscal year 2021/22 (September-December 2021), India's economic growth flagged. Real GDP growth was only 5.4% y/y as opposed to 8.5% in the previous quarter. In calendar 2021, although growth rebounded by 8.1% relative to 2020, the increase compared with 2019 was a modest 1%.

Growth forecasts for the full fiscal year (ended 31 March 2022) remain favourable, but have been downgraded because of the international geopolitical situation and rising commodity prices. Economic indicators for early 2022 also remain mixed. It appears that growth began to slow well before the conflict in Ukraine.

Consumer spending remains particularly fragile. Since November 2021, automobile sales have been lower than pre-Covid levels. The labour market is struggling to regain its pre-pandemic impetus. In mid-April, the unemployment rate was 7.8% as opposed to 7.3% in 2019, and the employment rate was only 37.6% in January versus almost 40% in 2019. In addition, despite slowing domestic demand, inflationary pressure has remained significant. In February, inflation was 6.1% y/y, even though not all of the increase in oil prices filtered through to consumers in the form of higher petrol prices. Slower growth in domestic demand is confirmed by a slight decrease in VAT receipts in January and February compared with the previous months, although they were well above pre-Covid levels.

In February, industrial production slowed significantly relative to January, as did the pace of bank lending, although the latter remained faster it was than before the pandemic. Business confidence indices remain strong, with PMIs still showing an acceleration in demand, although they have fallen slightly from their November 2021 highs.

LIMITED DIRECT IMPACT FROM THE CONFLICT IN UKRAINE…

The conflict in Ukraine will have a limited direct impact on India's economy, because India's trade with Russia and Ukraine is extremely modest. Its exports to those two countries make up only 1% of its total exports, and imports from them account for only 1.7% of the total.

… BUT MULTIPLE INDIRECT RISKS

However, there are significant economic risks. India is facing two external shocks, one from rising US interest rates and the other from rising commodity prices. Fortunately, India's external accounts are solid and it should be able to cope with the deterioration in its balance of payments. Its foreign exchange reserves are now much more comfortable than they were in 2013. They equal 20.1% of GDP – just over twice India's short-term borrowing requirement – as opposed to 16.2% at the end of 2012 (one times the borrowing requirement).

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, % (1)	4.2	-7.2	8.9	7.3	6.0
Inflation, CPI, year average, % (1)	4.8	6.1	5.5	6.7	5.5
General Gov. Balance / GDP, % (1)	-7.3	-13.7	-10.6	-9.3	-8.5
General Gov. Debt / GDP, % (1)	73.7	84.0	83.6	82.5	82.4
Current account balance / GDP, % (1)	-0.9	0.9	-1.5	-3.6	-2.1
External debt / GDP, % (1)	19.9	21.6	19.7	19.4	18.7
Forex reserves, USD bn	457	580	633	650	675
Forex reserves, in months of imports	7.7	11.0	9.1	8.8	8.9

TABLE 1

(1) Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CONSUMER PRICE INDEX

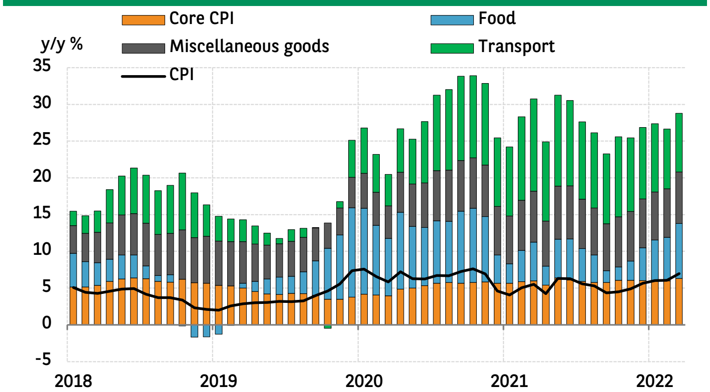

CHART 1

SOURCE : CEIC

Higher US interest rates could result in major capital outflows and cause the rupee to weaken, particularly if India's central bank (the RBI) maintains its loose monetary policy. Between December and February, net portfolio investment outflows attributable to foreign investors amounted to 1.5% of GDP annualised, whereas portfolio inflows totalled 1.2% in the whole of 2021. However, the rupee remained relatively stable (down 1.6% between December and February) due to central bank intervention in the forex market.

The sharp rise in commodity prices resulting from the conflict in Ukraine and sanctions against Russia represents a greater risk.

As regards food supplies, Ukraine is India's biggest foreign supplier of cereals (34.3% of imports) and oils (15.8%), and India imports most of its fertiliser from Russia (61%). However, sharply higher cereal prices should have a modest impact, because India's cereals imports are limited (except for maize). India produces and exports both wheat and rice. Conversely, it is a major consumer and importer of animal and vegetable oils. In March 2022, domestic food oil prices rose by almost 30%, pushing up retail price inflation by 12 basis points (bp). Finally and most importantly, India imports fertilisers, the price of which is closely correlated with gas prices. Higher fertiliser prices could drive up food prices further in the next few months, unless the government significantly increases subsidies.

India also imports a large amount of metals, particularly precious metals, and above all mineral fuels. Metals accounted for 12.3% of its imports in 2019 and mineral fuels 31.9%. The rise in energy prices (up 54.9% in the first three months of 2022) and precious metals prices (up 9.3%) is likely to widen India's current account deficit and lead to greater inflationary pressure.

In the three months from December to February, India's trade deficit in petroleum products was almost 30% higher than the annual average in 2019.

According to RBI estimates, a 10% rise in the crude oil price reduces growth by 0.2 points, increases inflation by 0.3 points and increases the current account deficit as a proportion of GDP by 0.4 points if it were passed on in full to the real economy.

To contain the impact of higher oil prices on real consumer incomes, however, the government could decide to cut taxes or increase subsidies. Taxes make up almost 50% of the petrol price paid by Indian consumers. By the end of March, the government had not announced any measures to support its economy. However, anticipating higher oil costs, it sharply increased crude oil purchases from Russia in February and March, at a heavily discounted price (USD 30 below the Brent crude price, excluding transport and insurance). However, those purchases (13 million barrels in two months, as opposed to 16 million in the whole of 2021) remain marginal compared with India's needs, since its oil imports totalled 4.9 million barrels per day in 2021.

As a result, assuming that international commodity prices remain high, the boost to inflation in 2022/23 could reach 1.5 points, and the current account deficit/GDP ratio could be 2 points higher.

BUDGET AT RISK FOR FISCAL YEAR 2022/2023

The budget presented in February for the 2022/23 fiscal year ending 31 March 2023 is expansionary. The government is preferring to support growth rather than shore up its public finances. In particular, it is planning a 24.5% increase in public investment.

As a result, the government is expecting a modest reduction in its budget deficit (excluding the deficit of India's states) from 6.9% of GDP (revised budget for 2021/22) to 6.5%. However, that budget now looks optimistic. It was prepared before the conflict in Ukraine and includes a 27% reduction in subsidies (equal to 0.7 points of GDP) compared with the revised 2021/22 budget. Subsidies were to be cut on fuel oil, fertiliser and food in 2022/23, although they would still have remained higher than pre-Covid levels.

However, upward pressure on commodity prices and the downside risk to growth will probably force the government to increase its expenditure on subsidies, hampering the announced fiscal consolidation.

INDUSTRIAL OUTPUT

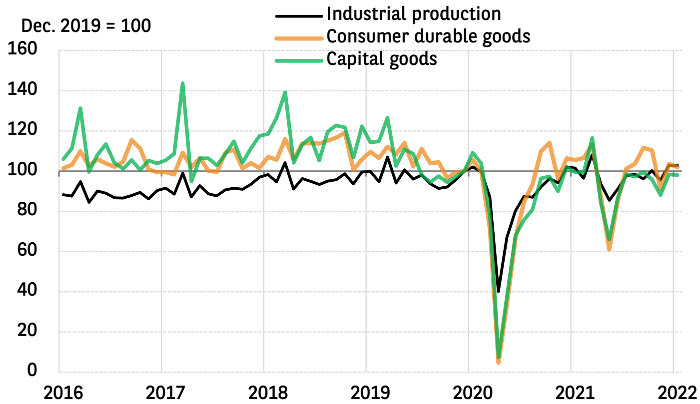

CHART 2

SOURCE : CEIC

THE BJP'S VICTORY IN THE REGIONAL ELECTIONS

Narendra Modi's party, the BJP, maintained control over four of the five Indian states that held regional elections in February and March. Its victory in Uttar Pradesh (UP) is a good sign for the prime minister since it is India's most populous state and a good indicator of how the 2024 general election will go. However, the BJP's position in UP is less comfortable than it was 2017, since it won 251 seats there as opposed to 312 five years earlier.

The BJP also lost control of Punjab, finishing behind the Aam Admi Party (AAP), which won its first ever state. In Gujarat and Himachal Pradesh states, which the BJP currently controls, elections will take place in late 2022.

Overall, these election results should ensure a degree of political stability until the next general election and possibly beyond.

Writing completed on 11 April 2022

Johanna Melka
johanna.melka@bnpparibas.com