# INDIA



## MANY RISKS THREATENING THE RECOVERY

**The economic recovery could be weakened by a second wave of Covid-19 and a fresh surge in inflation. With the government seeking to step up the pace of reforms to support growth over the medium term and improve the business environment, the number of protests against the moves is mounting, with protestors' ire directed particularly at the privatisations that the government is counting on to cut its budget deficit. In the banking sector, banks currently are able to deal with the expected rise in credit risk. Nevertheless, in order to support a resumption of lending growth, a new injection of capital into state-owned banks has already been planned, alongside the creation of a defeasance structure.**

### ECONOMIC RECOVERY WEAKENED BY RISING INFLATION AND A SECOND WAVE OF COVID-19

According to government estimates, real GDP for the 2020-21 fiscal year, that ended on 31 March 2021, contracted by 7.7% (having grown by 4.2% in the 2019-20 fiscal year). In the 2021-22 fiscal year, the central bank forecasts a recovery of 10.5%. But this recovery could be jeopardised either by a second wave of Covid-19 or by strong inflationary pressures.

Since March, the number of Covid-19 cases has increased significantly, particularly in the State of Maharashtra, which accounts for a substantial 14.5% of the total economy. On 4 April, the government therefore decided to impose a curfew in the State and to close 'non-essential' stores. Other States have already imposed new restrictions and further health measures may be introduced given that a very small share of the population has been vaccinated (2.9% had received a first vaccine dose by the end of March).

Meanwhile, there has been a resurgence in inflation (to 5% year-on-year in February, from 4.1% in January), due in particular to rising food prices and higher transport costs as the result of rising oil prices. This could also weaken the recovery, given that these two categories account for 39% and 8.6% respectively of the typical Indian household budget. Against a background of rising US long rates, the Indian central bank may therefore elect to tighten its monetary policy to tackle inflation and support the currency, even though inflation was still below its target of 4% +/- 2 points at the end of February.

### A BUDGET THAT DEPENDS ON PRIVATISATION RECEIPTS

The public finances are structurally fragile due to a narrow fiscal base and a continued high level of rigid expenditures, despite the reduction in government subsidies since 2014.

They have been further weakened by the economic crisis that followed the Covid-19 epidemic. According to the Finance Ministry, the government deficit could reach 9.5% of GDP for the 2020-21 fiscal year, with the general government deficit hitting 15% of GDP. Over the first ten months of 2020-21, the increase in the deficit came mainly from a rise in spending, particularly in the form of subsidies to the poorest households, which doubled their share of total spending to nearly 19%[1].

For the fiscal year that runs from 1 April 2021 to 31 March 2022, the Finance Ministry predicts that the government deficit will be reduced to 6.8% of GDP and the general government fiscal deficit to 11.0% of GDP.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth(1) (%) | 4.2 | -7.2 | 12.5 | 4.1 |
| Inflation (1) (CPI, year average, %) | 4.8 | 6.2 | 4.9 | 4.6 |
| General Gov. Balance(1) / GDP (%) | -7.3 | -14.8 | -11.0 | -9.5 |
| General Gov. Debt(1)/ GDP (%) | 72.2 | 89.8 | 90.0 | 91.5 |
| Current account balance(1) / GDP (%) | -0.9 | 0.3 | -0.9 | -1.7 |
| External debt(1)/ GDP (%) | 19.9 | 21.5 | 21.0 | 20.5 |
| Forex reserves (USD bn) | 457 | 542 | 590 | 620 |
| Forex reserves, in months of imports | 7.7 | 11.0 | 9.1 | 9.2 |

(1): Fiscal year from April 1st of year n to March 31st of year n+1

TABLE 1 — e: ESTIMATES & FORECASTS — SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**PRICES STARTED TO RISE AGAIN IN FEBRUARY**

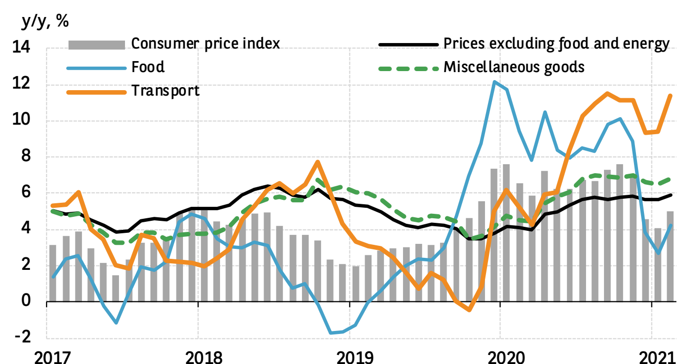
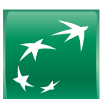



CHART 1 — SOURCE: RBI

The government plans to reduce its deficit by 18.5%, thanks to an increase in tax revenues as a result of an economic recovery and a sharp increase in revenue from the privatisation of state-owned companies (including two banks, an insurance company, electricity distribution companies, railways and the Air India airline). But the target for cash raised from privatisations (0.8% of GDP from an average of 0.4% over the past three years) looks particularly ambitious, given continued high levels of volatility in equity markets and the repeated waves of protest against the privatisations.

1 Part of the food subsidy spending in 2020-21 was accounted for by settlement of delayed payments by the government to the Food Corporation of India.



Total public spending is likely to remain stable (resulting in a two-point reduction in spending as a percentage of GDP). Indeed it could even increase as the government is planning to boost spending on health and infrastructure investment.

It would therefore seem that the government is prioritising support to the economic recovery over consolidation of the public finances, which remains somewhat theoretical. According to the ratings agency Fitch, government debt could thus climb above 90% of GDP in 2020-21 and stay at that level over the next five years. For the time being, there is little threat when it comes to refinancing debt. That said, the sharp rise in debt servicing costs (32% higher in 2020-21) is a source of concern, especially as government receipts remain extremely low. Interest payments are likely to hit more than 42.5% of government revenue in 2021-22, seven points higher than in 2019-20. Elsewhere, inflationary pressure could result in an increase in yields on long-term government bonds, which at the beginning of April remain contained at 6.2% (for 10-year bonds), in other words still below their level from before the Covid-19 crisis.

## BANKING SECTOR: THE GOVERNMENT ANNOUNCES THE CREATION OF A DEFEASANCE STRUCTURE

In its latest Financial Stability Report, published in January 2021, the central bank noted that the banking sector was in a more solid, albeit still fragile, position in Q3 2020 than it has been for the last five years. The share of non-performing loans was lower, at 7.5%, provision cover higher, at 72.4% of non-performing loans, and solvency ratios more comfortable, at 15.8%. Meanwhile, up until December 2020, banks continued to increase provisions in the expectation of an increase in non-performing loans, whilst not actually recording the loans as such. The deterioration in the quality of their assets will be recognised from the second quarter of 2021, as the Supreme Court confirmed (in March 2021) that the moratorium on repayments that was in force between March and August 2020 could not be extended beyond August 2020 and that regularisation of the situation should take place in March. Nevertheless, according to the ratings agencies and the central bank, banks should be in a position to cope with an increase in lending risk, even though the central bank estimates that the share of non-performing loans is likely to hit 13.5% in Q3 2021. The main source of concern lies more in their possible need to recapitalise to meet their solvency ratios, whilst also being able to expand credit supply at a time when they are having to increase provisions. Against this background, the government included in its budget for the year an injection of INR200 billion in additional capital (0.2% of GDP) for the state-owned banks, following on from a recapitalisation of a similar amount in the previous fiscal year. However, even these sums are far below the INR 1.9 trillion to INR2.2 trillion that ratings agency Moody's estimates is needed.

To help clean up bank balance sheets and support the recovery in bank lending, the government has announced the creation of a defeasance structure. For the time being, no details have been provided. The transfer of non-performing loans would free up capital, currently being used to bolster provisions for lending.

In addition, since May 2020 the government and the Reserve Bank of India have adopted policies to support households and companies, particularly small and medium-sized enterprises. Even so, despite the relaxation of monetary policy by the central bank, which has trimmed 130bp off average lending rates (policy rates were cut by 115bp between January 2020 and March 2021), the rate of growth remains modest.

BANK LENDING REMAINS SLUGGISH

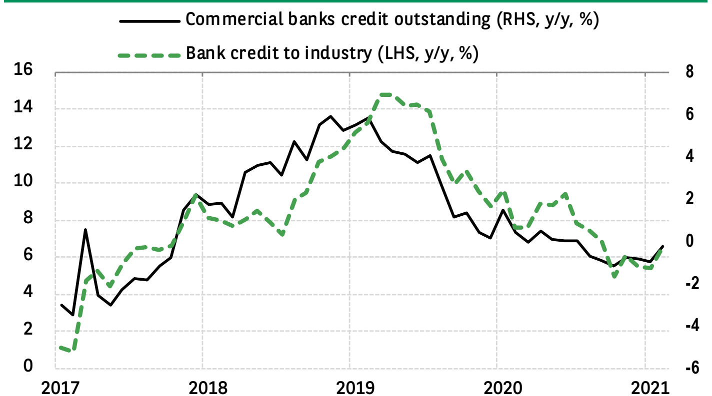



CHART 2 SOURCE: RBI

Excluding loans for the purchase of food, lending to households has decelerated, and lending to large companies has contracted due to a fall in their investment. These larger companies have not required financial support to get them through the crisis; although revenue fell sharply, profits increased due to the falls in labour costs and commodity prices over much of 2020.

Lending to medium-sized companies (18% of total lending) has stood out with extremely strong growth since September (up 19.1% year-on-year in January 2021), under the government-guaranteed Emergency Credit Line Guarantee Scheme, which was introduced on 23 May 2020 and closed on 31 March 2021. This scheme was specifically designed to address the financing needs of small and medium-sized businesses. According to the government, by the end of January 2021, INR 1.9 trillion in bank loans (excluding non-bank financial companies) have been made under this programme (36.6% of loans made over the year).

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