India

Mixed performance for the end of Narendra Modi's mandate

India's economic growth slowed between July and September 2018, hard hit by the increase in the oil bill. The sharp decline in oil prices since October will ease pressures, at least temporarily, on public finances and the balance of payments, and in turn on the Indian rupee (INR), which depreciated by 9% against the dollar in 2018. In a less favourable economic environment, Narendra Modi's BJP party lost its hold on three states during recent legislative elections.

Growth slows but prospects remain upbeat

In fiscal Q2 2018/19 (July-September 2018), India's GDP growth slowed to 7.2% year-on-year (y/y). The slowdown is mainly due to the negative contribution of net exports to growth, which was induced by a sharp rise in imports (oil and capital goods). Domestic demand was still dynamic even though it slowed slightly from the previous quarter. Household consumption was lifted by the easing of inflationary pressures (even though the decline in agricultural prices strained household revenues in rural areas). Investment growth remained buoyant for the third consecutive quarter (+12.5% y/y) due to the increase in government spending on infrastructure, an upturn in bank lending and the increase in production capacity utilisation rates in the manufacturing sector.

Against all expectations, the sharp rise in fuel prices was more than offset by the decline in food prices (-2.6% y/y in November), which still account for a very big share of the total consumption basket of Indian households (39%). Consequently, the increase in the general price index was limited to 2.3% y/y at the end of November, which is much lower than the target set by the monetary authorities (4% +/- 2 percentage points).

Despite the upturn in lending (+13% y/y), India's central bank decided to maintain its key rates at 6.5% at the December monetary policy committee meeting at a time of less volatility for the rupee (INR). Even so, interest rates on new loan production increased slightly in the third quarter (+20bp), reflecting the tightening of monetary policy in June and August.

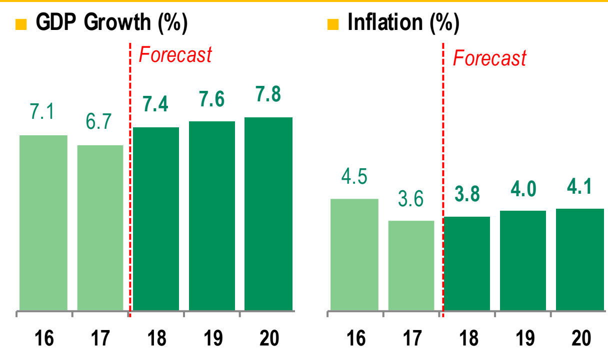
Growth prospects are still looking upbeat. For full-year 2018/19, growth is expected to near 7.4% before gradually accelerating over the next two years, despite the slowdown in foreign demand. Robust domestic demand will drive growth. The banking sector clean-up will favour a rebound in private investment in industry, even though interest rates are expected to continue rising slightly.

Central government budget overruns in the first 7 months of the fiscal year

After five years of fiscal consolidation, the central government should not meet its deficit reduction target for the second consecutive year (from 3.5% of GDP in 2017/2018 to 3.3% of GDP in 2018/2019). Fiscal revenues, and VAT revenues in particular, will fall far short of the government's targets.

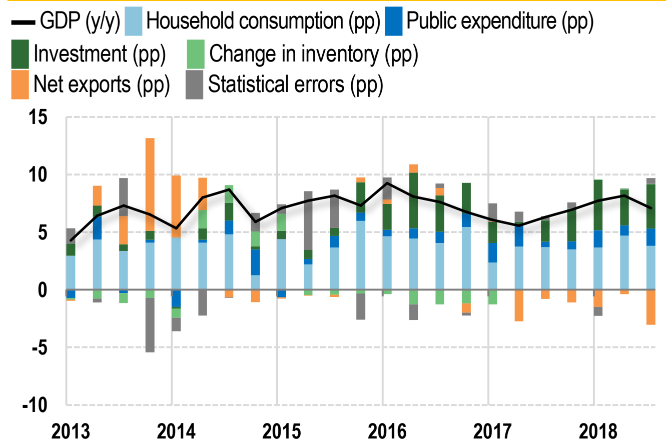
In the first 7 months of fiscal year 2018/2019, which will end on 31 March 2019, the fiscal deficit reached 104% of the annual target.

1- Growth and inflation



Source: National accounts, BNP Paribas.
Fiscal year from April 1st of year n to 31 March of year n+1

2- Economic slowdown in Q2-FY19



Source: CEIC

The government did not want to exceed 75% of its target during this period to avoid having to revise downwards the expenditures planned for the second half of the fiscal year. During the same period last year, the deficit amounted to 96% of its full-year target. The budget overrun is mainly due to revenues, which fell short of targets. Although fiscal revenues were up 8.2% compared to the previous year, they accounted for only 45.7% of the target in the first 7 months of this year, compared to 48.1% last year and an average of 50% over the past three years. Although VAT revenues increased significantly, they were still far below the finance ministry's forecast (35% of the full-year target).

In the first 7 months of the fiscal year, public spending was relatively in line with fiscal targets: it amounted to only 59.6% of full-year spending, slightly less than the previous year despite the increase in the cost of gasoline price subsidies (+7.2%). One positive point is that investment spending, which is vital for supporting medium-term growth, increased by nearly 9% compared to the same period last year and amounted to 58.9% of the full-year target.

Even so, it will be hard for the government to meet its 0.2 point deficit reduction target without significantly cutting back investment spending in the second part of the fiscal year. The decline in oil prices since mid-October should nonetheless help reduce gasoline subsidies and the shortfall in import taxes[1].

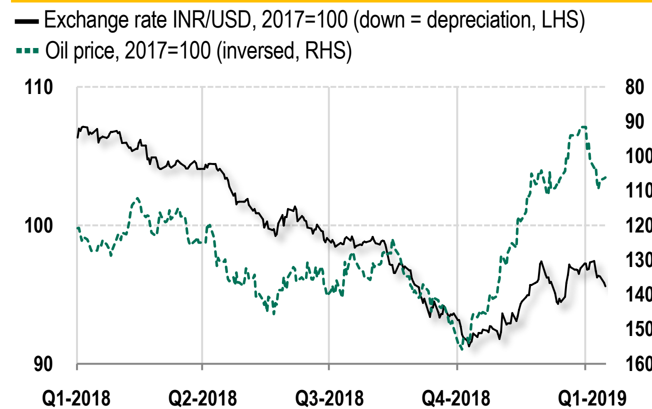
Contrary to the central government, the states managed to limit their fiscal deficit in the first half of the current fiscal year, which accounted for 35% of the full-year target of 2.6% of GDP (vs. 3.1% of GDP in 2017/18)[2]. This strong performance, like the one last year, mainly reflects the increase in revenues induced by central government transfers to offset the loss of revenues following the introduction of VAT. Unlike the central government, however, the states will concentrate most of their spending in the fiscal second half. Moreover, following changes of government after the 11 December elections, three states (Madhya Pradesh, Rajasthan and Chhattisgarh) announced additional spending measures. The new governors (members of the Congress Party) decided to cancel certain loans taken out by farmers (as was already the case in seven other states) and to increase the minimum selling prices of certain crops in addition to those announced by the Modi government last summer. For some states, such as Madhya Pradesh, the cost of loan cancellation can account for as much as 20% of their budget, and will thus have to be spread out over several years. Although there is only limited risk of budget overruns by the states, debt cancellations, like those benefiting public electrical utilities, are not favourable for implementing good governance and management of the country's credit risks.

Despite the risk of budget overruns, in October the IMF forecast a decline in the public debt to GDP ratio. Over the past five years, this ratio has risen by more than two percentage points according to the central bank, and remains much higher than the ratio for the other Asian countries (68.9% of GDP in March 2018 according to the central bank). A simple levelling off seems more probable.

State-owned banks: the situation stabilises

The situation of banks has stopped deteriorating but remains very fragile. In Q2 2018/2019, the doubtful loan ratio declined for the first time since mid-2014 to 10.8% (14.8% for state-owned banks). Although the provisioning rate is still far too low, it rose to 52.4% in September, up from 48.1% in March 2018. At the same time, solvency ratios deteriorated slightly. In order for the most fragile banks to meet the target ratio of 9% at 31 March 2019, the government announced that it would inject an additional INR 410 bn by the end of the fiscal year. Given their financial difficulties, the state-owned banks only managed to raise INR 240 bn of the needed INR 580 bn. Government support will amount to INR 1060 bn in fiscal year 2018/19. The central bank also announced that it would postpone by one year the 0.625% increase in the Capital Conservation Buffer to 2.5%.

3- Appreciation of the rupee (INR) and the decline in oil prices



Source: CEIC

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[1] To limit the impact of higher oil prices on purchasing power, in October the government lowered its import taxes on petroleum-based products and asked local governments to reduce the VAT rate on these products. Moody's estimates that the fiscal cost will be small (0.05% of GDP by the end of the current fiscal year).

[2] Monthly Bulletin of the Reserve Bank of India, December 2018