INDIA

SLIGHT IMPROVEMENT

India's economic and financial situation has consolidated slightly since the summer. After contracting sharply in Q2 following the spread of the Covid-19 pandemic, economic activity rebounded strongly in Q3. Even so, at end-September, only 20% of the population was fully vaccinated, which means the country is not sheltered from a third wave of the pandemic. Growth prospects are still looking good for the rest of the year. Household consumption will benefit from falling inflation and higher government spending. Business leaders are still confident, even though they are taking a cautious approach to investment plans. Borrowing rates are low, and the banking sector, though still fragile, is doing better than it was three years ago. In the first five months of the fiscal year (April-August 2021), fiscal revenues increased sharply, and the government could lower its target for the fiscal deficit this year, from 6.8% of GDP to 6.2%. The debt-to-GDP ratio should decline, at least this year, reducing the risk of a sovereign downgrade by the rating agencies.

Q3 GROWTH IS POISED TO REBOUND

Adjusted for seasonal variations, Q2 2021 GDP contracted by more than 12.7% compared to the previous quarter according to our estimates. This contraction is due to lockdown measures introduced to halt the spread of the Covid-19 pandemic. Even so, the decline in GDP is a far cry from the one reported at the same time last year. By June, activity indicators had already rebounded, and this improvement was confirmed in the survey results for July-August. In August, however, activity was still far below the levels that prevailed in Q1 2021, and the recovery seems to be running out of steam. Households are much less optimistic than business leaders, and they are having a hard time regaining morale. Although inflation is falling, it is still high (5.3% in August 2021). The unemployment rate is higher than the level that prevailed before the second wave of the pandemic (7.5% at the end of September 2021) and employment continues to contract. It declined to only 34.6%, compared to a pre-crisis level of nearly 40%. Moreover, even though companies are consolidating their financial situation, private investment is still weak based on bank lending trends and the production of capital goods. In the first seven months of the calendar year, the value of investment projects was still lower than in 2020, even though interest rates fell to a low point in Q2 2021 (the average interest rate on new loan production in rupees was 7.8%, down from the pre-crisis level of 9.3%). Meanwhile, energy shortages and the steep rise in energy prices could threaten India's economic recovery.

The country is still vulnerable to a new wave of the pandemic since less than 20% of the population had been fully vaccinated at the end of September 2021. In the second half of the current fiscal year, growth should get a boost from higher government spending, ongoing export momentum and the upturn in services, in keeping with vaccine distribution and the slowdown in inflation. By year-end 2021, vaccination coverage could reach 40% of the population.

PUBLIC FINANCES CONSOLIDATE SLIGHTLY

Public finances are still fragile but they consolidated slightly in the first five months of fiscal year 2021/2022, reducing the risk of a sovereign downgrade by the rating agencies.

In FY 2020/2021, public finances deteriorated sharply due to increased spending at a time when revenues remained extremely limited. The government deficit swelled to 9.2% of GDP, from an average of only 3.8% of GDP during the previous five years. We estimate that the general government's fiscal deficit could have increased to 13.7% of GDP. Similarly, the public debt is likely to have accounted for more than 88% of GDP in FY2020/2021 (up from 72% of GDP the previous year).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth(1) (%)	4.2	-7.2	7.0	11.2
Inflation (1) (CPI, year average, %)	4.8	6.1	5.4	4.5
General Gov. Balance(1) / GDP (%)	-7.3	-13.7	-10.8	-9.0
General Gov. Debt(1)/ GDP (%)	72.2	88.3	87.2	86.3
Current account balance(1) / GDP (%)	-0.9	0.9	-1.4	-1.7
External debt(1)/ GDP (%)	19.9	21.6	20.8	20.4
Forex reserves (USD bn)	457	542	585	615
Forex reserves, in months of imports	7.7	11.0	9.1	9.2

TABLE 1

(1): FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ACTIVITY INDICATORS

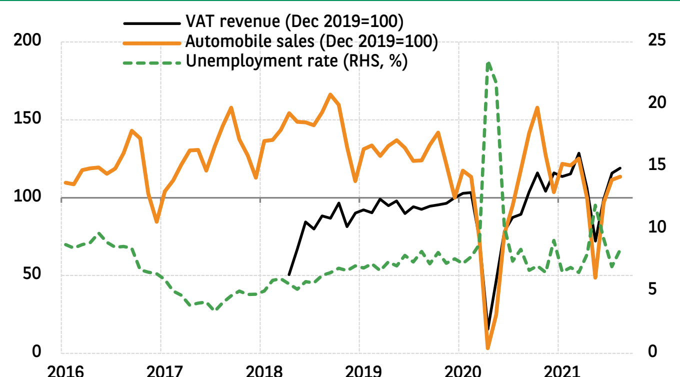

CHART 1

SOURCE: CEIC

Although government financing is not problematic given its low risk profile (financing in domestic currency, at a fixed rate, and with a long maturity), Fitch has placed a negative outlook on the sovereign rating based on its feeble tax base (government revenues have declined regularly since FY 2017/2018 and amounted to only 8.6% of GDP before the crisis) and the sharp increase in interest (40% of revenues last year) at the same time as its debt swelled.

In FY 2021/2022, the government plans to reduce the deficit to 6.8% of GDP. With nominal growth estimated at 14.4%, the debt-to-GDP ratio should improve, assuming the government manages to reach its target.

Public finances were solid in the first five months of FY 2021/2022, which is encouraging. For the first time since FY 2011/2012, only 31% of the planned full-year deficit was reached during this period. This strong performance can be attributed to a very big increase in revenues (+130% compared to the same period in 2019), which accounted for 42.4% of the full-year target (compared to an average of 29% over the previous five years), reflecting a sharp increase in taxes (notably VAT revenues). In contrast, the proceeds from divestments are once again expected to fall far short of the authorities' target. The biggest uncertainty is the pace of revenues over the rest of the year. The positive results in the first months of FY 2021/2022 seem to correspond to late payments that should have been collected during the previous year. If the improvement is due to a sustainable increase in the fiscal base, however, government revenues could reach 9.9% of GDP over the full year, which would be the highest level since FY 2013/2014.

Spending amounted to only 22.8% of the full-year target. The good news is that the share of capital investment increased. Moreover, even though the government announced economic support programmes to offset the second wave of the pandemic, direct budget costs will remain low (0.2% of GDP).

Lastly, the authorities' target of reducing the deficit to 6.8% of GDP seems to be within reach. It could even be revised downwards to 6.2% of GDP. Moreover, the government is not having any financing troubles. The Ministry of Finance estimates that 55% of net debt issues will be directly underwritten by the central bank, which held more than 17% of the debt in June 2021, compared to only 14% in the year-earlier period. The share of debt held by foreign investors is still extremely small (6%). Moreover, in the first half of the current fiscal year, the government did not encounter any difficulties in issuing bonds on the market. It borrowed at an average rate of only 6.2%, with an average maturity of 16.7 years.

A FRAGILE BUT RESILIENT BANKING SECTOR

In July 2021, the Reserve Bank of India (RBI) confirmed the banking sector's strong resilience to the Covid-19 crisis. Although still fragile, the sector is more solid than it was three years ago.

The quality of assets has improved over the course of FY 2020/2021. In March 2021, doubtful loans amounted to "only" 7.5% of all banking sector loans, down from a peak of 11.5% in March 2018. The government adopted four state-backed lending programmes for small and mid-sized companies as well as for the sectors in the greatest difficulty between May 2020 and June 2021. The Emergency Credit Line Guarantee Scheme helped increase the rise in credit risk. According to Fitch, these loans account for more than 10% of banking sector loans outstanding (nearly 5% of GDP). Yet whereas the quality of assets was consolidated in agriculture, industry and services, it deteriorated slightly for personal loans, even though some of the credit risk was still contained (2.1% for all personal loans). Jewellery and construction are still the sectors with the highest concentration of loans at risk.

Although the non-performing loan coverage ratio is still low, it was nonetheless 68.9% in March 2021, and the capital adequacy ratio (CAR) was satisfactory at 16%.

PUBLIC FINANCES

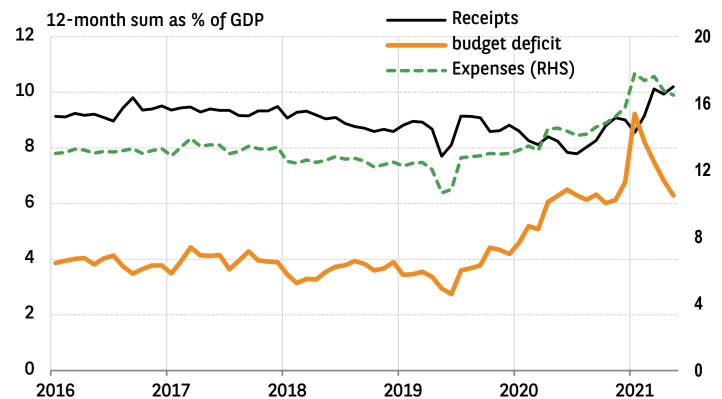

CHART 2

SOURCE: MOF, CEIC

Moreover, although the state-owned banks are in a much more fragile situation than the private banks, in July the central bank estimated that they were still in a position to face up to higher credit risks. In its central scenario (full-year growth of 9.5% in the current fiscal year), RBI expects the non-performing loan ratio to deteriorate from 7.5% in March 2021 to 9.8% in March 2022. However the CAR is expected to hold at a sufficient level (15.5%) to comply with regulatory requirements. Even in a worse-case scenario (growth of only 0.9%), all banks – including the state-owned banks – would comply with the regulatory ratio of 9%.

The biggest concern is the banks' capacity to increase credit supply. For the past two years, credit growth has slowed sharply (+6.1% y/y in July 2021), especially in industry (+1% y/y in July). Loans to individuals is the only category that continued to report strong growth (+11.2% y/y). To enable banks to support the recovery, in February 2021 the government announced the creation of the National Asset Reconstruction Company Ltd (NACL), a "bad" bank. Initially planned for June, its start-up was delayed. Moreover in September, the RBI estimated that the transfer of the first part of the non-performing assets of state-owned banks and public non-banking financial companies, for an amount of INR 900 bn (out of a planned total of INR 2 trillion: 1.8% of loans outstanding, or 0.9% of GDP) would not occur before year-end 2021.

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