INDIA

STRUCTURAL REFORMS INSTEAD OF FISCAL SUPPORT

The economy has rebounded strongly since July, driven by the recovery in industry, which then spread to the services sector starting in October. Although the recovery still seems to be fragile, the central bank has raised its growth forecast for fiscal year 2020/2021 to -7.5%. Fiscal year 2021/2022 is expected to see a major automatic rebound in growth. Lacking the means to support growth through a fiscal stimulus package, the government has set out to create a more propitious environment for investment that would enable medium-term growth to return to a pace of about 7%. The latest reforms are working in this direction. Yet passing reform measures does not guarantee that they will be implemented, much less that they will be successful.

A FRAGILE REBOUND

In the second quarter (July-September 2020) of the fiscal year that will end on 31 March 2021 (FY2020/2021), India's GDP growth contracted "only" 7.5% year-on-year (y/y), after contracting 23.9% y/y in the previous quarter. Business accelerated in agriculture (+1.4% y/y) and to a lesser extent in industry (+0.6% y/y), but continued to contract in services (-11.4% y/y). At the end of September 2020, economic activity was still 9% short of the figure reported for full-year 2019/2020.

At the beginning of fiscal Q3, the recovery began to expand into the services sector. Activity accelerated rapidly in industry in October 2020, even though November's industrial production was still 6% below the year-end 2019 level. Demand for electrical power rose above the 2019 level. The unemployment rate continued to decline to 6.5%, after peaking at 23.5% last April. Lastly, VAT revenues increased by nearly 15% compared to the same period last year, after several months of decline.

November indicators suggest, however, that the recovery is still fragile, for both households and corporates, even though India has not yet been hit by a second wave of Covid-19. Although business confidence indexes in both industry and the services sector have held above the 50 threshold (which indicates economic expansion), they declined slightly in services. Bank credit to industry also contracted for the second consecutive month (-0.7% y/y).

The household confidence index rebounded slightly in November 2020 but remains far below pre-crisis levels. The unemployment rate is now close to the level that prevailed in late 2019, but the labour market participation rate is still 2 points below pre-crisis levels. Employment is still sluggish in the construction, hotel & restaurant, tourism and textile sectors. Lastly, there seems to be a dichotomy between urban and rural household consumption. Motor vehicle sales (cars and two wheelers) declined in November after rising for two months. In rural areas, in contrast, household consumption seems to be robust, as illustrated by the sharp increase in tractor sales, buoyed by a bumper harvest and an increase in rural wages (between 8% and 10%) as part of the Mahatma Gandhi National Rural Employment Generation Act.

In full-year 2020/2021, the IMF and the World Bank are forecasting a contraction of about 10% of GDP. The World Bank fears a sharp increase in the poverty rate because 90% of workers do not benefit from sufficient social protections.

Fiscal year 2021/22 should see a major, automatic rebound in growth. Household consumption is expected to accelerate, bolstered by the winding down of the pandemic and efforts to vaccinate the population, which should begin in mid-January. Business is also expected to rebound progressively among small and mid-sized enterprises. Although we cannot exclude the risk of a new wave of the virus, it does not seem likely that the government would impose a lockdown as strict as the one in March-April 2020.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth(1) (%)	4.2	-11.4	11.6	5.0
Inflation (1) (CPI, year average, %)	4.8	5.8	4.3	3.8
General Gov. Balance(1) / GDP (%)	-7.3	-13.2	-11.0	-9.0
General Gov. Debt(1)/ GDP (%)	72.2	89.8	90.1	90.3
Current account balance(1) / GDP (%)	-0.9	0.3	-0.9	-2.0
External debt(1)/ GDP (%)	19.9	21.5	21.0	20.5
Forex reserves (USD bn)	457	541	590	620
Forex reserves, in months of imports	7.7	11.0	9.1	9.2
Exchange rate USDINR (year end)	71.3	73.1	73.4	73.9

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

INDUSTRIAL OUTPUT

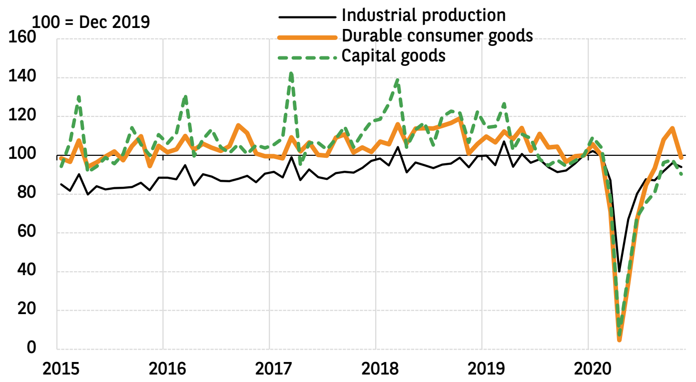

CHART 1

SOURCE: CEIC

MEASURES TO STIMULATE MEDIUM-TERM GROWTH

India's economy should be in a position to absorb the shock of 2020/2021. Though fragile, the banking and financial sector should be able to support the expected increase in non-performing loans, even though the government may have to make more capital injections. Although the fiscal deficit is rising, refinancing risks are still mild.

Looking beyond 2021, in contrast, the situation could deteriorate if GDP growth fails to exceed 5%, at a time when fiscal leeway will still be tight.

This is why the N. Modi government has been striving to correct the slowdown in growth since 2019. It is still working towards its goal of becoming an industrial power. Consequently, although it cannot set up a fiscal programme to stimulate growth in the short term, the government has adopted new reforms to stimulate medium-term growth.

The reforms adopted in 2019 and pursued through fall 2020 aim to create a more favourable environment for private investment (both domestic and non-resident) and employment, especially jobs in the formal sector. Declining investment was one of the factors behind the slowdown in growth reported in recent years. The investment ratio had dropped to only 26.9% before the Covid-19 crisis, compared to 35.8% in 2008.

To stimulate domestic and foreign investment, the government lowered the corporate tax rate in late 2019 from 30% to 22% (and from 25% to 15% for newly created manufacturing companies). Aligning its corporate tax rates with those practised in the other Asian countries was a positive move.

The government also adopted major legislation to ease the restrictions hampering the labour market and to encourage the creation of jobs in the formal sector. This allows companies to develop more labour-intensive activities, much like the model that China followed in the 1980s and 90s, and to increase their participation in global trade through labour-intensive assembly work using low-skilled workers.

To increase productivity in the agricultural sector, the Modi government passed three bills in September 2020. The government would allow farmers to sell their crops at prices they set with their buyers, without using the government as an intermediary (this is now the case for the majority of farmers). This reform aims to increase investment and productivity in the agricultural sector. Yet it was very poorly received by the agricultural world, which feared the elimination of minimum sales prices (which are nonetheless guaranteed by the government). After several months of protests, the Supreme Court announced on January 12 the suspension of these three bills in order to find a compromise between the government and the farmers.

Lastly, the government announced that it intends to privatise all state-owned companies in so-called non-strategic sectors, which includes rail transport and electrical power companies.

If all of these reforms were implemented successfully, they could have a positive impact on medium-term growth. Yet adopting reforms has always been problematic in India, as illustrated by the mixed results of the introduction of the Goods and Services Tax (GST) in 2017.

BANKING SECTOR: SUPPORTING THE RECOVERY WILL NOT BE EASY

After several years of consolidation, India's banking sector now seems to be better positioned to handle a crisis than it was three years ago. On the other hand, it might not be solid enough to stimulate the recovery.

Between March and the end of August 2020, the banks granted a 6-month moratorium on debt payments. No loans were recorded as non-performing loans. In Q3-2020, despite the contraction in economic activity, the non-performing loan ratio continued to decline to 7.5%, from a high of 11.5% in Q1 2018. The banking sector did not begin to feel the impact of the Covid-19 crisis until Q4 2020. In November, the rating agency S&P estimated that the doubtful loan ratio could increase by 2 to 3 percentage points to 10-11% by the end of fiscal year 2020/2021. In its most recent report on financial stability, the central bank estimated that the NPL ratio could reach 13.5% by September 2021 (16.2% among state-owned banks), even under a scenario based on a strong rebound in growth (from 0% y/y in H2 2020/2021 to 14.2% y/y in H1 2021/2022).

NON-PERFORMING LOANS ARE STILL LIMITED

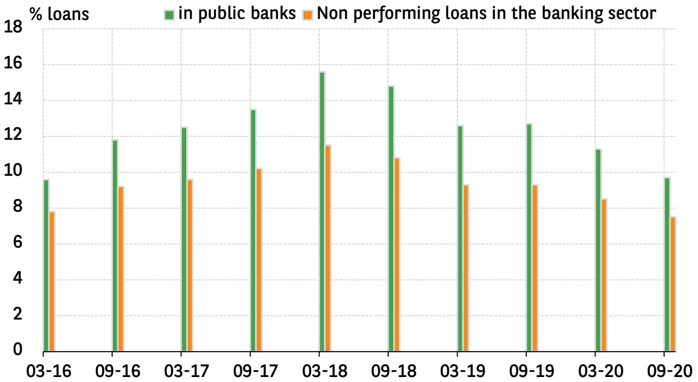

CHART 2 SOURCE: RBI

Indian banks are better capitalised than they were three years ago. In Q3 2020, provisions covered 72.4% of doubtful loans, and the solvency ratio for the banking sector as a whole was 15.8%. Yet the state-owned banks are still much more fragile than the private banks (their ratio was 13.5%). According to the central bank, without capital injections, four banks will not be able to meet their equity capital requirements by September 2021.

The central bank considers that the overall solvency ratio could decline by 1.6 percentage points to 14% by September 2021. At the end of August 2020, Moody's estimated that the state-owned banks would need new capital injections of between INR 1.9 trillion and INR 2.2 trillion (1% of FY2020 GDP) over the next two years to maintain a provisioning coverage ratio of 70% and to meet their equity capital requirements. The state-owned banks are in a more comfortable financial situation than they were a few years ago, and the big state-owned banks have already launched moves to raise capital. They could still benefit from government support, which already injected INR 2.8 trillion between 2016/2017 and 2019/2020. Yet certain banks might be much less inclined to increase their credit offer as long as their financial position has not been consolidated, as was the case in 2017-2018.

Completed on 11 January 2021

Johanna MELKA
johanna.melka@bnpparibas.com