INDIA

THE RECOVERY WILL BE SLOW

Between April and June 2020, India's economy contracted by nearly 24% compared to the same period last year. This unprecedented contraction can be attributed to the collapse of domestic demand. Although the economy has rebounded since June, it is still fragile and well below pre-crisis levels. The capacity of the central bank and the government to support the economy, which was already limited, has been further eroded by increasing prices and the drop-off in fiscal revenue. Public debt is expected to swell to 89% of GDP, and will strain the country's future development projects, especially given that government spending contributed to nearly 30% of economic growth last year.

AN UNPRECEDENTED ECONOMIC CONTRACTION

In the first quarter of FY 2021 (April-June 2020), India's real GDP contracted 23.9% year-on-year (y/y). With the exception of government spending, there was an unprecedented contraction in all components of domestic demand, triggered by the general lockdown of the population through 1 June. Household consumption, the main growth engine, declined 26.7% y/y. At the same time, investment fell by more than 47% y/y. Under these conditions, imports declined more sharply than exports, and net exports ended up making a positive contribution to growth. On the supply side, the contraction was especially severe in industry (down 33.8%), and to a lesser extent in services (down 24.3%), with a freeze on construction and transport activities as well as hotel and food services. As mild as it may have been, agriculture was the only sector to report positive growth (3.4% y/y).

The first economic indicators available for the second quarter of FY2020/21 confirm a rebound relative to the previous quarter, although activity is still a far cry from pre-crisis levels, prior to the outbreak of the coronavirus pandemic. Although industrial activity accelerated, the same cannot be said for services. In July, industrial production and merchandise transport both rebounded strongly compared to previous months, even though they were still in decline compared to the same period last year. The industrial production index rose to 118.1 after falling to a low of only 54 in April. Yet this is still more than 10.4% below the July 2019 figure, reflecting the persistently sharp contraction in capital goods and durable consumer goods (down 22.8% and 23.6% y/y, respectively). The rebound was especially strong for non-durable consumer goods.

This catching-up movement is expected to continue. In August, after four months of contraction, the PMI business sentiment index rose above 50, the threshold separating expansion from contraction. There were higher expectations for new (domestic) orders.

YET THE RECOVERY IS STILL FRAGILE

First, the services PMI rose compared to previous months, but the index was still at only 41.8 in August.

Second, bank lending to companies is still growing very moderately even though real interest rates are low (the average interest rate on new loans deflated for consumer price inflation was only 1.6% in August 2020, compared to 6.6% the previous year). New start-ups in Q2 2020 were down more than 88% compared to the year-end period. Moreover, foreign trade statistics for July show that capital goods imports amounted to only 62% of pre-Covid levels.

Third, the recovery in household consumption should remain gradual. In August, automobile sales were still down 4.7% y/y. Household confidence is still depressed, even though the latest survey data show that households are becoming more optimistic about the future.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth(1) (%)	6.1	4.2	-11.4	9.6
Inflation (1) (CPI, year average, %)	3.4	4.8	5.5	3.4
General Gov. Balance(1) / GDP (%)	-6.3	-7.3	-12.2	-8.5
General Gov. Debt(1)/ GDP (%)	69.9	72.2	88.7	87.1
Current account balance(1) / GDP (%)	-2.1	-0.8	0.0	-1.0
External debt(1)/ GDP (%)	20.0	19.9	20.0	20.0
Forex reserves (USD bn)	393	457	541	590
Forex reserves, in months of imports	6.5	7.7	11.0	9.1
Exchange rate USDINR (year end)	71.0	71.3	73.4	73.9

(1): Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATES AND FORECAST
TABLE 1
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

INDUSTRIAL PRODUCTION

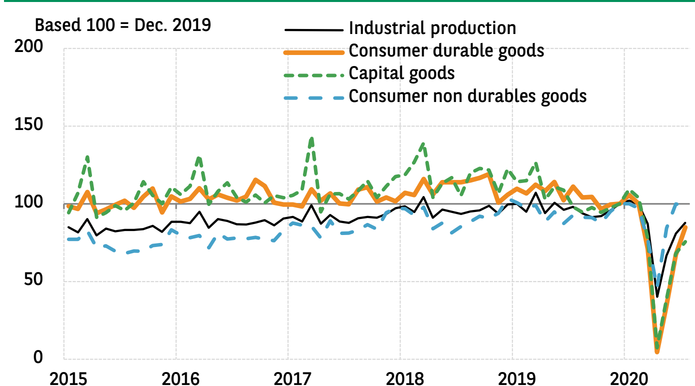

CHART 1
SOURCE: RBI

According to the Centre for Monitoring India's Economy (CMIE), the unemployment rate continued to decline, to 7.3% in mid-September, from a high of 23.5% in April, which suggests a rather rapid normalisation of the labour market. Yet this figure does not incorporate the informal market, which accounts for 80% of employment in India.

INFLATIONARY PRESSURES RISE SHARPLY

Despite the collapse of domestic demand, the July consumer price index rose to levels last seen in 2014. Prices rose 6.9% y/y, compared to only 3.1% the previous year. This acceleration is mainly due to higher food prices (which make up nearly 46% of the consumer basket of Indian households), especially for protein-rich foods. To a lesser extent, it can also be attributed to higher prices for transport (due to a gasoline tax increase), communications equipment and imported goods following the disruption of global supply chains. Yet even excluding food and energy prices, core inflation still rose to 5.9% y/y in July 2020, up from 4.3% a year earlier. Higher gold prices made a one-half point contribution to the increase in the core price index, excluding food and energy prices.

In the face of rapidly rising prices, the central bank halted its monetary easing. With its inflation target range of of 4% +/-2%, the central bank maintained its key rates unchanged at 4% following August's monetary policy committee meeting.

SEVERE EROSION OF PUBLIC FINANCES

In the first 4 months of FY 2020/21 (ending 31 March 2021), the government's fiscal deficit was 50% higher than in the same period last year, and accounted for 103.1% of the government's full-year target, which it set at 3.5% of GDP in February 2020. The very sharp erosion of public finances reflects the collapse of fiscal revenues (down 41.7%), which only reached 11% of the full-year target due to the contraction in economic growth. VAT revenues were down nearly 35%, while income tax revenues contracted by nearly 30%. At the same time, although spending was capped, it still rose 11.3% (35% of the full-year target). In FY 2020/21, the government deficit could swell to 8% of GDP (compared to 4.6% in 2019/20).

THE FISCAL SITUATION OF THE STATES HAS ALSO DETERIORATED SHARPLY

In August, the Minister of Finance announced that he will not be in a position to fully offset the loss of VAT revenues by the States, which they estimate at INR 3 trillion. The government attributes the shortfall essentially to the consequences of the Covid-19 pandemic (and not to the adoption of a single VAT rate in 2017). He announced that he would only pay out INR 650 billion to the states (via the luxury goods tax)[1]. To face up to the decline in VAT revenues (INR 2.35 bn), the government has asked the States to finance the shortfall in VAT revenues through debt issues (partially issued to the central bank at preferential rates), albeit without surpassing an amount equivalent to between 5.2% and 5.5% of GDP (depending on whether they partially or fully finance the financial loss), compared with 3% of GDP previously. On the eve of the opening of the GST Council, which brings the States and the government together to decide on the amount of compensation by 5 October 2020, ten States have already refused its two proposals. Moreover, regardless of the Council's outcome, at the end of FY 2020/21, the total general government deficit could amount to more than 12% of GDP, while the combined debt of the government and the States could approach 89% of GDP (vs 72.2% of GDP in FY 2019/20).

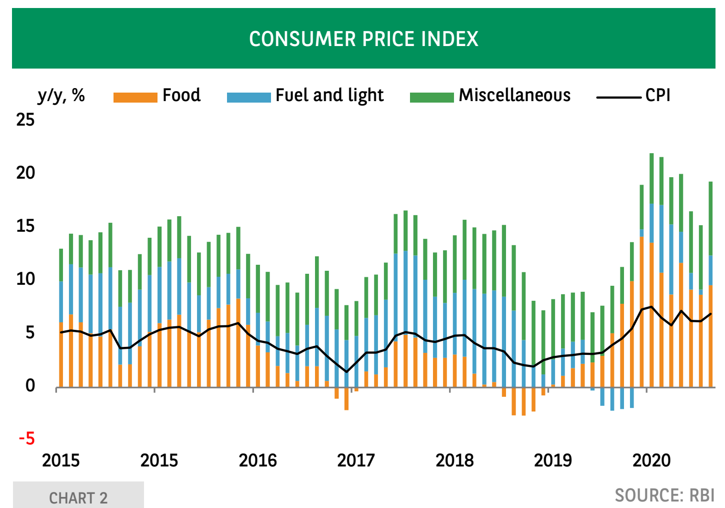

CHART 2
SOURCE: RBI

Looking beyond the risks of a deterioration in public finances and the downgrading of its sovereign rating (Moody's lowered India's sovereign rating by a notch last June, with a negative outlook), the government's tepid support for the economy is a source of concern for the recovery: last year, without a health crisis, government spending contributed nearly 30% to economic growth.

EXTERNAL ACCOUNTS ARE HOLDING UP WELL

India has consolidated its external accounts since the beginning of the year. As a net oil importer, India has benefited from the sharp drop in crude oil prices. Moreover, imports have contracted in conjunction with the erosion of domestic demand, offsetting the decline in exports.

In the first 5 months of FY 2020/21, the trade deficit narrowed by more than 72%. Over the period Avril to June 2020, the current account balance recorded a surplus equivalent to 3.9% of GDP.

The slight upturn in activity since June fuelled an acceleration in imports in July, which rose to 72% of pre-crisis levels. Yet consumer goods imports accelerated faster than imports of capital goods.

Despite a massive outflow of portfolio investment in March 2020, the exchange rate of the rupee against the US dollar was only 2.7% lower than at year-end 2019. Foreign reserves swelled to a high of USD 537 bn, nearly twice the country's short-term financing needs. For the moment, despite sluggish growth prospects, foreign direct investment continues to flood in.

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1 In 2017, the States agreed to adopt a single VAT rate for all States and to centralise VAT revenues through the central government. The Minister of Finance pledged to increase their VAT revenues by 14% each year thanks to tax revenues levied on luxury goods (through the end of FY 2022/23).