MORE TURBULENCE

The second wave of the pandemic seems to have passed after new cases peaked in May. Economic activity is unlikely to contract as much as it did last year, and the decline should be limited to the second quarter. Yet the second wave is estimated to have cost more than 2 percentage points of GDP, and it comes at a time when households are still struggling to recover from the impact of the first wave. In 2020, 75 million people dropped below the poverty line. Moreover, the rebound expected this year might not suffice to stabilise the public debt ratio, which could lead the rating agencies to downgrade India's sovereign rating. In this very uncertain environment, the rupee is not benefitting from the strength of India's external accounts.

ECONOMIC ACTIVITY CONTRACTED IN Q1 2021/2022

The second wave of the pandemic that swept India starting in March 2021 has triggered a sharp decline in activity. All indicators declined sharply in April (industrial output, VAT revenue, automobile and tractor sales, road traffic and employment rate) and these trends worsened in May. The pandemic did not spare a single region, but the ten hardest hit regions together account for 60% of India's GDP.

Despite its severity, the economic contraction should be much weaker than in 2020. Lockdowns were still highly localised, and many states decided not to shut down their factories. Economic activity is unlikely to contract by more than 10% in Q1 FY2021/2022 compared to the previous quarter (vs. a 25.9% contraction in the same period last year). Moreover, the economy should rebound gradually as of Q2 FY2021/2022, unless the country is hit by a third wave of the pandemic (only 4.2% of the population had received two doses of the vaccine at the end of June). Since mid-June, activity has rebounded slightly as health restrictions are lifted. The unemployment rate peaked at 13% in early June, compared to more than 23% at the height of the crisis in April 2020, and dropped back to 9.2% at the end of June. Similarly, household confidence indexes have begun to pick up slightly, especially those for rural households. According to the India Meteorological Department, the monsoon should be favourable this year, boosting the recovery in rural areas.

Yet a sharp rise in inflationary pressures could strain the recovery. In May, prices rose 6.3% year-on-year (y/y), reflecting a sharp increase in food and energy prices, and to a lesser extent, the constraints on supply chains and the rise in consumer goods in general. Excluding energy and food items, prices rose 7.2% y/y in May, the biggest increase since 2014. At the monetary policy committee meeting in June, the central bank held its key rates at 4%, and reiterated that it would continue to pursue an accommodating monetary policy as long as the recovery had not been confirmed, even though inflation had surpassed its target rate of 4%, plus or minus 2 percentage points. Consequently, India's central bank is likely to maintain its key policy rates unchanged through the end of the year.

For full fiscal year 2021/2022, economists revised downwards the consensus growth forecast by more than 2 percentage points to a range of between 8% and 10%, from 11% and 12%, previously. The World Bank is forecasting GDP growth of 8.3% this year and 7.5% in FY2022/2023.

SOCIAL RISKS ARE ON THE RISE

According to the Centre for Monitoring Indian Economy (CMIE), since the beginning of the Covid-19 pandemic in March 2020, 97% of households have reported a decline in purchasing power due to job losses, a situation that was accentuated by rising consumer prices. In 2020, according to the Pew Research Center, an estimated 75 million Indians dropped below the poverty line (defined as revenue of less than USD 2 a day). This brings the total to 134 million people, whereas it took 20 years to lift 248 million people out of poverty according to the World Bank. At the same time, the number of people living off daily revenue of between USD 2 and USD 10 increased to a total of 1.13 billion at year-end 2020.

The CMIE estimates that the second wave has already resulted in 25.3 million job losses at the end of May 2021 (including 15 million job losses in the month of May alone), mainly day workers who do not

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth(1) (%)	4.2	-7.2	8.4	9.4
Inflation (1) (CPI, year average, %)	4.8	6.1	5.0	5.0
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	0.9	-0.6	-1.7
External debt(1)/ GDP (%)	19.9	21.6	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

ECONOMIC INDICATORS

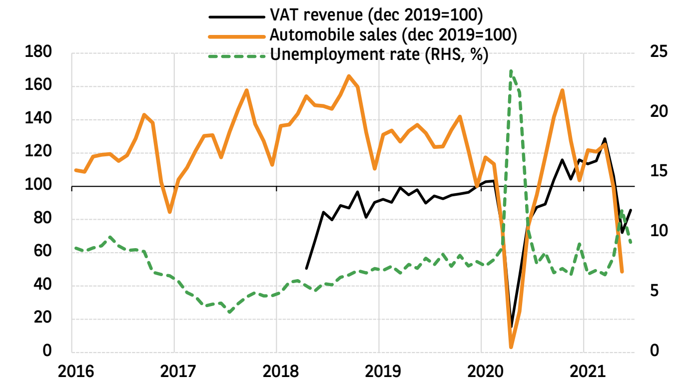

CHART 1 SOURCE: RBI, CMIE

benefit from any social protections. Yet unlike "regular" workers, those employed in the informal sector will find work more rapidly once the lockdown measures are lifted.

GREATER PRESSURES ON PUBLIC FINANCES

Already fragile before the Covid-19 crisis, India's public finances have deteriorated significantly in fiscal year 2020/2021 as public spending has increased sharply. The government deficit rose to 9.2% of GDP and debt (excluding the states' debt) swelled by more than 9 percentage points to 55.4% of GDP in the first three quarters of fiscal year 2020/2021. It is estimated that the deficit and debt of all public administrations could reach 14% of GDP and more than 87% of GDP in fiscal year 2020/2021.

In the FY2021/2022 budget bill presented in February 2021, the government decided to stimulate the recovery at the risk of further deteriorating public finances. It was forecasting a deficit of 6.8% of GDP, up from an average of 3.8% of GDP in the five years preceding the Covid-19 crisis. Although this is more than 2 percentage points lower than in fiscal year 2020/2021, the budget called for much higher spending (15.6% of GDP) than during the pre-Covid period. The government's outlook called for a primary deficit of 3.1% of GDP, which is also much higher than pre-crisis levels (0.7% of GDP on average in the five previous years).

With the second wave of the pandemic, there were increasing calls for a much vaster fiscal support package, even though fiscal revenues plummeted in April 2021 after new lockdown measures were implemented and the economy contracted. Yet the government has very little manoeuvring room. India's sovereign rating already has a negative outlook and the rating agencies could downgrade India to "non-investment grade" if the debt/GDP ratio were to deteriorate any further. According to our projections, the debt-to-GDP ratio would not be stabilised if growth were to fall below 9%.

SOLID EXTERNAL ACCOUNTS

There was a strong consolidation of India's external accounts in 2020. Despite an unfavourable domestic and international environment, India is still attractive for foreign investment.

In calendar year 2020, the current account balance showed an unprecedented surplus of 1.3% of GDP. This consolidation is mainly due to a nearly 2-point decline in the trade deficit. Imports contracted sharply due to declining domestic demand, which more than sufficed to offset the decline in exports.

At the same time, foreign direct investment (FDI) flows swelled by more than 27% to 2.5% of GDP (vs. an average of 1.8% of GDP over the five previous years). According to UNCTAD, India was the fifth largest recipient of FDI in 2020. FDI inflows were mainly driven by mergers and acquisitions, and concentrated primarily in information & communications technology, healthcare, infrastructure and energy.

Although portfolio investment declined compared to 2019, notably due to major capital outflows in Q1 2020, investment nonetheless accelerated rapidly in Q3 and Q4 2020. In full-year 2020, the net surplus came to 0.6% of GDP.

BALANCE OF PAYMENTS

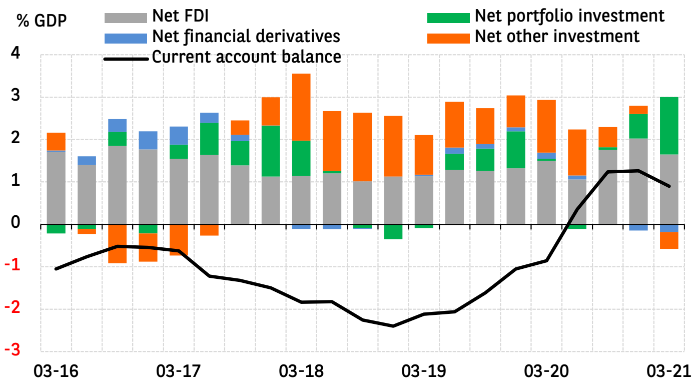

CHART 2

SOURCE: RBI

All in all, the balance of payments (excluding variations in foreign reserves) showed a surplus of 3.9% of GDP in 2020 (vs 2% in 2019).

In the first five months of the calendar year, the trade deficit rose significantly compared to the same period last year, although this seems to reflect a normalisation of the situation more than a real deterioration. Moreover, foreign direct investment remained solid (in the first four months). In contrast, portfolio investment showed a deficit in April similar in size to the one reported the previous year (once again due to the pandemic's spread and the economic contraction), which put downside pressure on the rupee.

Even so, India's external position is still solid. Foreign reserves peaked at USD 564 bn in mid-June 2021, the equivalent of 10.6 months of imports, and cover 1.8 times the country's short-term financing needs. External debt is still holding below the threshold of 22% of GDP.

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