

# India

## A big victory for Modi in the midst of a tougher economic environment

*Narendra Modi won a major victory in the general elections, further bolstering his legitimacy. His party won a strong majority in the lower house of parliament and could go on to clinch a majority in the upper house by late 2020 as well, if it manages to maintain power in the upcoming State legislative elections. The country's economic situation was not very favourable for the Prime Minister as his first mandate came to an end. Economic growth slowed sharply in the last quarter of fiscal year 2018-19 and prospects have been revised downwards. The government must accelerate the reform process in order to increase the pace of job creations and encourage foreign investment.*

### ■ Economic growth slows sharply

In the fourth quarter of fiscal year 2018/19 (ended 31 March 2019), India's economy reported the sharpest slowdown in the past five years. Growth slowed to only 5.8% year-on-year (y/y) compared to 7.2% in the year-earlier period. This slowdown can be blamed only partially on unfavourable base effects. It is essentially due to the sharp slowdown in investment in a less favourable economic and financial environment. After five consecutive quarters of growth of more than 10%, investment increased only 3.6% y/y, even though production capacity utilisation rates are still high.

Household consumption also slowed, albeit by only 1 percentage point (pp) compared to the previous quarter, to 7.2% y/y. Although exports of goods and services also slowed mildly, to 10.6% y/y, net exports continued to make a negative contribution to GDP growth. Business is still buoyant in the services sector, but slowed sharply in manufacturing and construction, while agriculture contracted.

The first economic indicators available so far do not suggest a strong rebound in the first quarter of 2019/2020 (April-June 2019). On the whole, although industrial output accelerated slightly in April and business confidence indicators picked up in May, other indicators tend to dampen this good news. Investment is unlikely to accelerate given the ongoing decline in capital goods production and imports. Output of consumer durables also remained extremely weak, and automobile sales contracted in April for the sixth consecutive month. Lastly, based on the slowdown in cement and steel output in April, activity in the construction sector did not rebound either.

Economic growth faces major risks. The central bank has lowered its 2019 outlook by 0.2 percentage points to 7%. To stimulate activity, the central bank has made three 25bp key rate cuts since the beginning of the year, trimming the repo rate to 5.75%. Moreover, although inflationary pressures have increased slightly since the beginning of 2019 (+3% y/y in May), inflation is still below the central bank's target of 4%. So far, monetary easing has lowered the average interest rate on new loan production by only 21 bps. The liquidity constraints of non-banking financial companies (NBFC) could also begin to squeeze investment.

To boost economic growth sustainably and stimulate job creations (which averaged only 6 million a year during Modi's first mandate, even though the active population increased by 8 million a year on average), the new government must increase the general skills level of the population and develop infrastructure. Although the fiscal

### 1- Forecasts

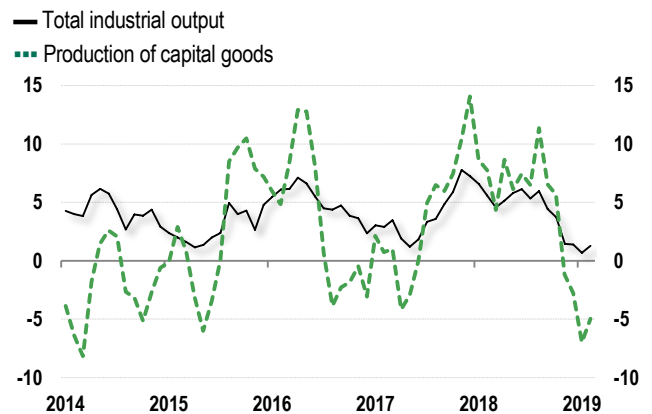
	2017	2018e	2019e	2020e
Real GDP growth <sup>(1)</sup> (%)	7.2	6.8	7.1	7.3
Inflation <sup>(1)</sup> (CPI, year average, %)	3.6	3.4	3.5	4.2
Central Gov. Balance <sup>(1)</sup> / GDP (%)	-3.5	-3.4	-3.4	-3.2
Central Gov. Debt <sup>(1)</sup> / GDP (%)	45.6	44.6	44.2	43.8
Current account balance <sup>(1)</sup> / GDP (%)	-1.8	-2.1	-2.0	-2.2
External debt <sup>(1)</sup> / GDP (%)	20.0	20.0	20.1	20.8
Forex reserves (USD bn)	409	393	440	465
Forex reserves, in months of imports	11.5	9.1	9.4	9.3
Ex change rate USDINR (year end)	63.9	71.0	73.5	76.5

(1): fiscal year from April 1<sup>st</sup> of year n to March 31<sup>st</sup> of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

### 2- Industrial output

y/y, 3-month moving average



Source: CEIC

deficit has declined sharply, the fiscal base is still too shallow to allow major expenditures.

### ■ Slowdown in lending by non-banking financial companies

The slowdown in investment can be attributed in part to the slowdown in lending by non-banking financial companies, and the increase in their cost of financing, which they carried over to the cost of credit. Despite the acceleration in bank lending since April



2018 (in conjunction with the consolidation of banks' financial situation), total lending growth slowed by 1 percentage point over the year to 10% y/y in April.

Since September 2018, the growth rate of NBFC lending has slowed sharply, to 13% y/y in Q4 2018/2019, from 24% in the year-earlier period. This trend reflects the financial troubles these institutions encountered following the default of *Infrastructure Leasing & Financial Services*. In May 2019, the central bank underscored the importance of these institutions in the financing of part of the economy<sup>1</sup> and encouraged banks to offset at least part of the sharp decline in financing via mutual funds and Treasury bill issues. The share of bank lending granted to NBFC increased by 1.4 pp over the past twelve months to 7.3% in April.

At the end of March 2019, the central bank esteemed that the financial situation of NBFCs was still solid on the whole, although it has deteriorated over the past 12 months. Non-performing loans (NPLs) accounted for 6.6% of loans outstanding (compared to 5.8% in the year-earlier period) and their capital adequacy ratio was 19.3%. In comparison, these ratios were not as healthy for the banking sector as a whole, even though they have improved significantly since March 2018: the non-performing loan ratio for banks was still 9.3%<sup>2</sup> and the capital adequacy ratio was 14.2%. To consolidate the situation of NBFC and reduce liquidity risk, the central bank decided to reinforce its regulations. Previously, NBFC had to comply with prudential regulations in terms of equity and provisions for risky assets. Starting in April 2020, they will also have to comply with liquidity ratios.

### ■ Public finances in 2019: revenue drops sharply

In fiscal year 2018/2019 (ended 31 March 2019), the government managed to reduce the fiscal and primary deficits by 0.1 and 0.3 percentage points of GDP, respectively. The fiscal deficit slipped to 3.4% of GDP, the lowest level since 2008. Yet this strong performance must be kept in perspective. As a share of GDP, government revenue declined by 0.3 pp compared to the previous year and accounted for only 8.8% of GDP (0.4 pp short of the Finance Minister's target in February), the worst performance ever recorded. This relative decline can be attributed almost exclusively to the reduction in tariffs resulting from the slowdown in world trade, while direct levies (notably on companies) increased (reflecting the improvement in corporate financial health). The revenue shortfall compared to the government's target is mainly due to disappointing VAT revenues, which though higher, accounted for only 2.4% of GDP, 1 pp short of target (already revised downwards in February 2019).

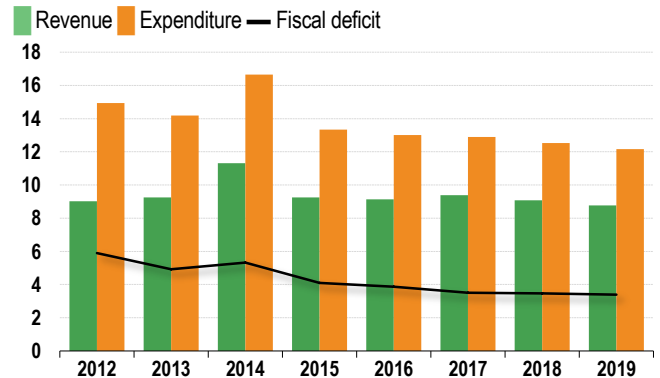
To reduce the fiscal deficit, the government had to cut back expenditure (excluding interest) for the fifth consecutive year, which came to only 9.1% of GDP, 1.5pp less than five years earlier. Although investment spending is still insufficient and below target, it nonetheless increased 0.1 pp to 1.6% of GDP.

<sup>1</sup> NBFC lending as a share of total lending was estimated at 14.8% in March 2019.

<sup>2</sup> For state-owned banks, the NPL ratio was still 12% in March 2019.

## 3- Public finances

% GDP



Source: Treasury, CEIC

Looking beyond the mixed performance of the fiscal deficit, the government debt ratio continued to decline to 47.9% of GDP. At the same time, however, State debt continued to rise according to Finance Ministry estimates, limiting the decline in the public debt, which is still holding at 67.3% of GDP.

### ■ Narendra Modi wins a very comfortable victory

The Bharatiya Janata Party (BJP), Narendra Modi's party, won an even more comfortable victory in the general elections of April-May 2019 than it did five years earlier. The BJP won 303 of the 542 seats in the lower house of parliament (up from 268 prior to the elections). The National Democratic Alliance (NDA), the coalition party, now holds 65.9% of the seats. The big question is whether the NDA will be able to win a majority in the upper house as well in order to implement new reforms (especially those concerning land ownership). Currently, the NDA holds only 34.7% of the seats. However, by the end of 2020, 43 seats are up for grab in States currently governed by the NDA. Narendra Modi could obtain a parliamentary majority within the next 18 months if his party stays in power in these States (following legislative elections to be held in the months ahead, notably in October in Maharashtra).

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