DISILLUSION

India should report an unprecedented contraction in real GDP this year. The big question is how strong will it rebound thereafter? The rating agencies have begun to doubt whether India will return to its potential growth rate in the years ahead because its economic slowdown began much earlier than the Covid-19 crisis. India's slowdown dates back at least to 2018, and could even be an extension of the 2009 financial crisis. Since 2014, real GDP growth seems to have been driven solely by positive external shocks, creating the illusion of robust growth. Yet the banking sector is still much too fragile to restore GDP to the growth rates of the past.

FRAGILE GROWTH SINCE 2018, OR MAYBE EVEN 2009

In fiscal year 2019/20, ended 31 March 2020 (FY2020), India reported real GDP growth of only 4.2%, its weakest performance since the global financial crisis of 2009, and far below its potential growth rate, estimated at 7.3%. In Q4 2019/20 (January to March 2020), real GDP rose only 3.1% compared to the year-earlier period. All components of growth slowed sharply or contracted. This sharp slowdown only partially reflects the impact of the coronavirus pandemic on economic activity.

The current slowdown began well before the coronavirus crisis. It can be traced back to September 2018 and the bankruptcy of two subsidiaries of the non-banking financial company Infrastructure Leasing & Financial Services (IL&FS). Since then, economic activity has gradually slowed, corporate profits have fallen and the unemployment rate has risen.

The IL&FS bankruptcy triggered a sharp drop in lending by non-banking financial companies (NBFC) and housing finance companies (HFC), whose weight in financing the economy had increased sharply since 2014 (especially for households, real estate companies and SME). The NBFC and HFC had stepped in for the ailing state-owned banks. Starting in 2018, mutual funds, the main source of financing for the NBFC, sharply reduced their exposure to the most vulnerable ones, generating a sharp increase in their financing costs and a liquidity squeeze.

The decline in non-banking lending since September 2018 has been a major handicap for a whole section of the economy, notably the construction and real estate sectors. The number of residential real-estate projects declined by 85% in the year 2019-20, and sales prices for residential assets contracted by 2.7% y/y in Q4 2019. Micro, small and medium enterprises (MSME), which play an essential economic role (29% of GDP and 48% of exports), were granted only a third of the loans they requested in full-year 2019.

The economic slowdown has intensified since September 2019. Household consumption slowed with the increase in the unemployment rate, and corporate investment contracted (-2.8% in full-year 2019/2020) as earnings declined and financing became more difficult. Lastly, like in the rest of Asia, exports also contracted, reflecting trade tensions between China and the United States.

According to certain economists[1], the economic slowdown observed since 2018 is actually an extension of the financial crisis of 2009. The fragile financial situation of banks and companies can be traced back to 2009, and has hampered investment, competitiveness and India's exports. A series of positive external shocks since 2014-15 has helped boost growth (especially the sharp drop in commodity prices and the increase in non-banking lending since 2014), creating the illusion of robust growth.

1 Arvind Subramanian and Josh Felman (2019)

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth(1) (%)	6.1	4.2	-4.7	8.3
Inflation (1) (CPI, year average, %)	3.4	4.7	3.5	4.4
General Gov. Balance(1) / GDP (%)	-6.3	-7.3	-11.5	-8.5
General Gov. Debt(1)/ GDP (%)	69.9	72.2	84.9	83.7
Current account balance(1) / GDP (%)	-2.1	-0.8	-0.1	-1.0

TABLE 1

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

INDUSTRIAL PRODUCTION

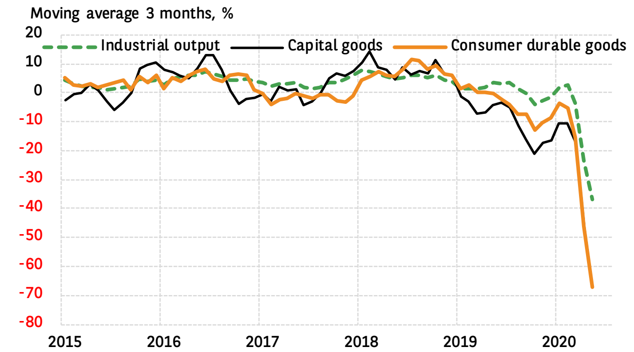

CHART 1

SOURCE: RBI

The Covid-19 crisis, in contrast, has directly impacted an economy whose economic fundamentals were already weakened, with little fiscal and monetary policy leeway to deal with the crisis. For the first time since fiscal year 1979-80, India will not be spared recession, which was not anticipated at the beginning of the pandemic.

AN UNPRECEDENTED CONTRACTION IN ECONOMIC ACTIVITY

In June, the IMF revised downwards its growth outlook for India. It now expects real GDP to contract by 4.5% in fiscal year 2020-21 (whereas in April it was forecasting a sharp slowdown to +1.9%), before rebounding by only 6% in 2021/22. The 10-week lockdown of the population has had an unprecedented impact on economic growth. Moreover, even though general lockdown restrictions have been lifted since 1 June, several states were forced to maintain shelter-in-place measures in certain cities and districts due to the spread of the virus. At the end of June, the number of new coronavirus cases was still rising by 4% a day.

The lockdown triggered an unprecedented contraction in economic activity. In April-May, industrial output plunged by 46% on average compared to the same period last year (after contracting more than 18% y/y in March), with an especially sharp drop in capital goods production. Survey results of business leaders in industry and services alike confirm that economic activity contracted sharply for the third consecutive month at the end of June.

Since the general lockdown ended on 1 June, economic activity has rebounded slightly. The industrial business confidence index rebounded to 47.2 in June, but this is still well below the 50 threshold that separates contraction from expansion. The unemployment rate fell back by more than 15 percentage points to 8% in mid-July after a high in April-May. Lastly, after plummeting in April, electrical power consumption has begun rising again. Looking beyond the Covid-19 pandemic, meteorological services are also forecasting a good monsoon this year, which should boost the revenues of rural households.

A BIG SHOCK FOR A FRAGILE BANKING SECTOR

India's banking sector is fragile, especially the state-owned banks, although the March 2020 rescue of Yes Bank by the government and the central bank is a good reminder that some private banks are vulnerable, too.

The quality of bank assets has generally improved since 2018, but the banks are still fragile with insufficient provisions. According to the IMF, the ratio of non-performing loans net of provisions to capital was 41% at year-end 2019. At the end of September 2019, the non-performing loan ratio for the banking sector as a whole was 9.2%, although it was 12.7% for state-owned banks (vs 3.9% for private banks). Despite the Insolvency and Bankruptcy Code adopted in 2016, debt restructuring periods are still long (394 days on average), even though they have been shortened considerably.

At the end of March 2020, equity capital was generally sufficient to meet capital adequacy requirements thanks to the government's massive capital injections over the past two years[2] (the capital adequacy ratio was 15.3%). Yet the situation still differs widely between state-owned banks, and some may need further capital injections in the months ahead.

Liquidity is also insufficient: liquid assets covered only 22.9% of short-term commitments at year-end 2019. Corporate profitability is also extremely low, with ROA and ROE of only 0.2% and 2.7%, respectively, in 2019.

The economic crisis triggered by the Covid-19 pandemic will drive up credit risk by 220 basis points (bp) according to S&P estimates last May, but it could rise much higher given the expected economic contraction. Moreover, companies were already seeing their financial situation begin to deteriorate in 2019. At the end of the year, the central bank estimated that the most fragile economic sectors in terms of credit risk were construction, metalworking, infrastructure and mining.

Excluding companies and workers in the transport, construction, tourism, food services and retail sectors, the economic agents with the highest exposure to the lockdown were households and small businesses (which account for 27% and 5% of banking lending, respectively), including micro-enterprises and SME. The 3-month suspension of loan payments only partially alleviated the pressure on these borrowers. Moreover, even though banks are the main lenders to mid-sized companies, it is the NBFC who have the highest exposure to the most fragile borrowers.

The banks and the NBFC will have to deal with rising credit risks at a time when they are already fragile. Although lending institutions will continue to benefit from government support, they will become more selective in granting loans, which is bound to place a damper on the recovery.

PURCHASING MANAGERS INDEX (PMI)

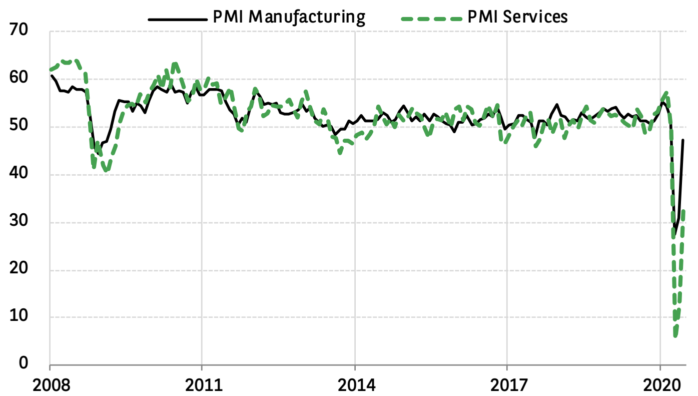

CHART 2

SOURCE : RBI

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2 Over the past two fiscal years, the government has injected INR 2826 bn (the equivalent of 1.4% of GDP) to recapitalise the most fragile state-owned banks.