India

Analyst: Martin Carlens. Tel: +46-8-7639605. E-mail: martin.carlens@seb.se

The government, being constrained by a rigid budget structure and high debt, has provided a measured policy response to the economic slowdown largely brought on by the corona crisis. Still, public finances have deteriorated markedly. At the same time, external balances have strengthened. The ailing banking sector is limiting credit growth and its vulnerability continues to weigh on country risk.

Country Risk Analysis

Summary and main conclusions

Following an unprecedented contraction in real GDP in 2020, the economy is limping back, helped by a recovery in the manufacturing sector. Most forecasters have recently upped their expectations for a near-term recovery although its pace is highly uncertain. Risks to growth are mainly on the downside.

The fiscal response to the downturn has so far been smaller than among most emerging market peers. Still, deficits and debt ratios have deteriorated. The expected recovery in economic activity should lift government revenues which is imperative to stabilizing government finances, given the relatively rigid budget structure. We assume that this will help stabilize general government debt ratios, which currently are high.

External balances remain strong, reducing country risk. The central bank has accumulated ample reserves over the past year, lifting them to record highs. In addition, only a small share of government debt is denominated in foreign currency, and overall external debt as a share of GDP is moderate.

The banking sector, a long-standing credit weakness, has strengthened but still holds back credit supply in the economy and constitutes an important contingent liability for the government.

Some continued progress on structural reform has been made over the past year, despite the pandemic and despite the government's busy social and nationalistic agenda. On the political front, the BJP-led coalition government maintains strong public support, despite violent public protests towards the end of the year.

Country risk has risen in the past year, mainly as a consequence of weakening public finances and slower growth. Higher sovereign risk was reflected in a downgrade by one of the external credit rating agencies in 2020.

important your attention is drawn to the statement on the back cover of this report which affects your rights.

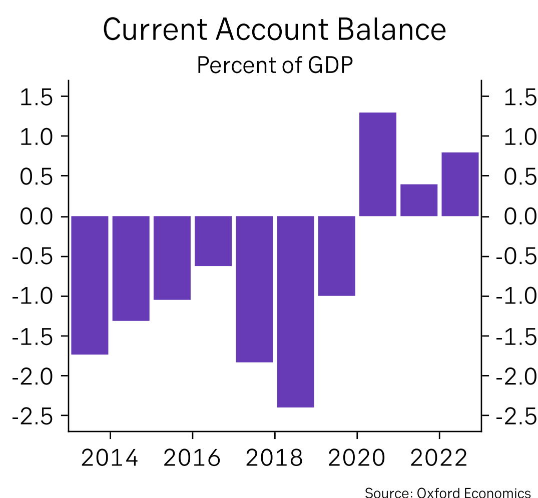
SEB

Recent economic developments

Activity has stabilized following unprecedented downturn. Economic growth had been slowing well ahead of the pandemic. Although the slowing was largely due to a cyclical cooling of domestic demand, structural issues such as a weak financial sector which was holding back new lending also contributed. When the pandemic hit, a collapse in domestic demand led to an unprecedented contraction in real GDP. Our house forecasters Oxford Economics expect it to have decreased by 7.7% in 2020. In the second half of the year, economic activity began to limp back helped mainly by a recovery in investments. On the supply side, the mending has been driven by an upturn in manufacturing.

Inflation resists economic slowdown. Despite the collapse in domestic demand, inflation rose last year. Higher food prices were the main driver, causing headline CPI to average 6.6% in 2020. Although this has left inflation above the central bank's 2-6% target range, expectations are that headline inflation should edge down in 2021.

Improving external balances limits country risk. Net trade is expected to have contributed positively to growth last year, largely due to an initial collapse in imports. By year-end, however, both import and export volumes were back to pre-pandemic levels. For the year as a whole, a shrinking trade deficit is expected to have lifted the current account from a small deficit well into a surplus. Meanwhile foreign direct investment (FDI), increased significantly compared to 2019, contrary to the drop seen across most of the world. Still, net FDI remain moderate as a share of GDP.



External debt is moderate hovering around 20% of GDP over the past few years. This is a consequence of relatively high savings, enabling the country to finance its debt domestically. Less than 4% of government debt is denominated in foreign currency. In addition, FX buffers are higher than average among peers. The strengthening of the current account has helped increase reserves to a record high USD 586 bn at end-2020. This is equivalent to roughly 11 months of prospective imports. India has a clean debt repayment record, contrary to many of its country risk peers.

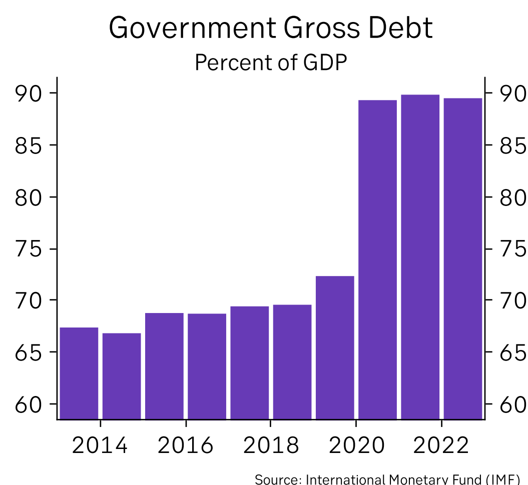
Economic policies

Public finances deteriorated sharply. Over the past 10 years, the general government deficit has been close to 8% of GDP on average, leaving little room for fiscal spending in response to the downturn. The extent of India's fiscal response has been smaller than in most large emerging market economies. Still, the downturn's impact on public finances in 2020 is likely to have been large. VAT as well as income tax revenues collapsed, leading to a large undershoot of budget targets and a general government deficit in the order of 12% of GDP (FY20-21).

Structurally high expenditures and limited revenues. Apart from an already high budget deficit, the room for fiscal manoeuvre is limited by a relatively inflexible budget framework. Expenditures are structurally high, including on public wages

and subsidies, and revenues are low due low incomes and a narrow tax base. Equally important, a high government debt has led to interest rate costs taking 23% of government revenues, according to Moody's. This is much higher than average among country risk peers.

Public debt and deficits are key credit weakness. Persistent fiscal deficits have yielded a general government debt in the order of 70% of GDP in the past few years. This is despite average nominal GDP growth well into double digits over the past decade. It thus remains one of India's main credit weaknesses. A couple of factors mitigate the risks attached to the high debt ratio. First, the debt stock is mostly in local currency and held by domestic investors. Capital markets are relatively closed and domestic banks are required to place a significant share of the deposit funding in government bonds. This makes debt easily financed. The minor share of foreign denominated debt also shields the government from external re-financing and exchange rate risk. Second, average maturity is relatively long, making debt servicing less sensitive to interest rate volatility.



Banking sector has strengthened but still holds back credit and constitutes contingent liability. Given the limited domestic bond market, banks and non-bank financial institutions remain a key channel for capital allocation in the economy. The dire state of the financial sector, leading to low lending, has thus held back economic activity in the past few years. The sector also constitutes a significant contingent liability for the government as public sector banks stand for roughly 70% of total assets.

The recapitalization of state-owned banks and continued resolution of non-performing loans (NPL) has improved the resilience of the sector compared to three years ago. For example, the share of NPLs have declined steadily through Q3 2020. Going forward, the recently proposed asset reconstruction company to resolve legacy problem loans may aid to speed up recovery and resolution of lenders. This being said, vulnerability indicators are likely to show a broad weakening in the wake of the economic slowdown. Although the state-owned banks are in a less troublesome financial position than a couple of years ago, most observers see a need for additional capital injections in the near-term to meet capital requirements.

Structural and institutional developments

Historically high growth has enabled some catching up in incomes, from low levels. High and relatively stable economic growth in the decade preceding the pandemic has helped lift the level of GDP per capita, despite India's growing population. At the same time the level of incomes remains significantly lower than average among peers. This is a credit weakness. Human development indicators are also weaker than among peers.

Incremental steps on structural reforms. Over the past year, the government to some extent has used the sense of urgency to push for progress on various structural reforms aimed at improving longer-term growth prospects. Measures have included

changes to regulations of the agriculture sector and to labour market laws. Further steps have also been taken to raise the limits on FDI in certain sectors. This being said, uncertainty surrounding the government's ability to implement already agreed reforms remains high.

One credit rating agency cut sovereign rating. In mid-2020, one of the major rating agencies cut their sovereign rating one notch and maintained a negative outlook. They argued that the government was facing rising challenges to mitigate risks related to "a sustained period of relatively low growth, significant further deterioration in the general government fiscal position and ongoing stress in the financial system". Another rating agency introduced a negative outlook on the sovereign.

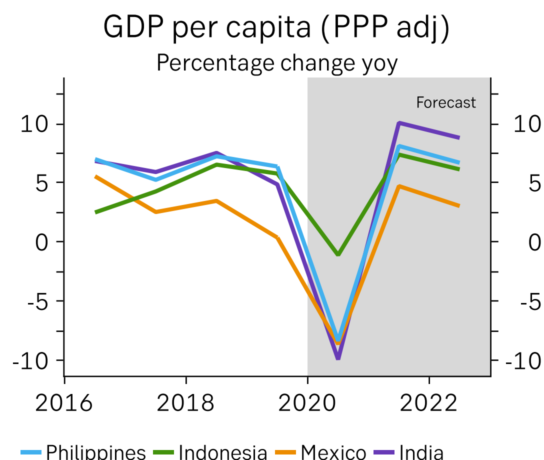
Political and security situation

Popular government maintains focus on social, nationalistic issues. The Bharatiya Janata Party (BJP)-led coalition government maintains strong public support. Prime minister Modi's second term has been marked by a strong focus on the social and nationalistic agenda. With the outset of the pandemic, the government has stepped-up its so called "self-reliance campaign" which some argue is a re-packaging of the previous "make in India", and others see as yet another step towards increased protectionism. It is also planning to raise import tariffs further. Some observers expect that since the government is preparing for state elections in two important states in 2021, the appetite for embarking on new possibly painful economic reforms may be low in the near-term.

On foreign security, the country's relations with China reached a long-time low following violent stand-offs at the border in mid-2020. In addition, the government has tightened regulations on FDI from neighbouring countries (in practice targeted at China according to some observers) and introduced trade barriers on Chinese imports. This has driven India to a closer relationship with allies such as the US.

Outlook

Near-term jump in annual growth. The recovery that started in the second half of 2020 is likely to lose some momentum in 2021. Nevertheless, following an expected contraction of about 7% in 2020, our house forecasters Oxford Economics expect real GDP to grow by 8.8 % in calendar year 2021. The government and IMF economists expect growth in the next *fiscal year* (starting in April) to accelerate to more than 11%. Such a recovery would also imply an acceleration in GDP per capita growth. Needless to say, these forecasts are attached with an unusually high degree of uncertainty due to the development of the pandemic.



Source: International Monetary Fund (IMF), Macrobond, SEB

Longer road to full recovery. The pandemic has led to a deep decline in the size of the Indian economy. In addition, the mechanical jump in GDP growth expected in 2021 is likely to be followed by more moderate growth rates than previously expected. Already before the pandemic, most economists had revised down their estimates of potential GDP growth. On the other hand, India's long-standing demographic advantage still stands. Its population is projected to grow for yet three decades and should overtake China's by 2027 (UNDESA forecast).

Fiscal consolidation postponed. The budget proposal for the coming year includes a *central* government deficit of 6.8% of GDP (compared to -9.5% in the current FY). Adding state deficits, yields an expected general government deficit/GDP well into double digits. Although implying higher than expected deficits, many observers appreciated that the budget provides ample room for productivity increasing investments. This should support growth in the medium-term. The budget also implies that government debt, which probably rose towards 90% of GDP in 2020, is unlikely to decline materially in the next few years. The IMF sees debt at 83% of GDP in 2023. A year ago, the forecast was 66%.

A failure to stabilize government debt is an important risk. With public finances being a key country risk weakness, a failure to stabilize government debt ratios would be one of the main risks to our main scenario going ahead. For example, if the pace of growth fails to pick up, debt metrics could worsen given the rigid budget structure. Similarly, mutually reinforcing downside risks from stresses in the economy and the financial system could lead to an even more prolonged erosion in fiscal strength than we currently project.

Higher fiscal deficits and higher debt/GDP could make it more difficult to roll-over maturing debt at a reasonable cost. Higher government borrowing could also crowd out lending to the private sector, and hence investments which are key to ramping up economic growth.

Deteriorating health of banks could hamper credit and slow growth. The central bank recently forecasted that the NPL ratio could reach 13.5% by September 2021, even under a scenario based on a strong economic rebound. Indeed, several analysts have noted risks of a broad worsening of credit quality when the regulatory forbearance is tightened. If this were to lead to a tightening of credit supply it would hold back economic activity more than expected.

Rising social and political risk could delay recovery. Governments across the world are struggling to address the issues of social and income inequalities that have risen during the pandemic. In Asia, some analysts have singled out India as particularly vulnerable to rising social and political risks in the wake of the pandemic. This in turn could weigh on the economic recovery and have negative credit implications.

External risks stemming from lower global growth and trade. Uncertainty surrounding the pace of recovery in external demand is high. Hence, although India is a relatively closed economy, another risk to our main macro scenario is a slower than expected global economic recovery. Another external risk is higher than expected oil prices which would likely produce higher deficits on the current account and drive up inflation.

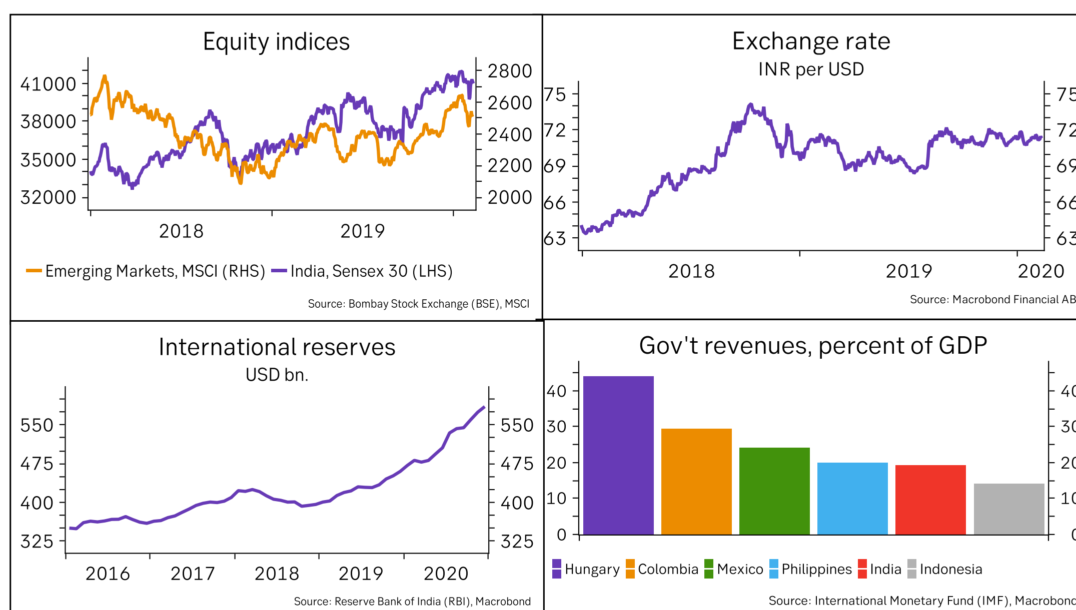
India: Key Economic Indicators

Macroeconomic	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
GDP (bn. USD)	2227	2554	2721	2835	2571	3093	3659	4013
GDP/capita (USD)	1679	1905	2009	2072	1861	2217	2598	2823
GDP (change)	9,0%	6,6%	6,8%	4,9%	-7,4%	8,8%	5,8%	6,6%
Investments/GDP	31%	30%	32%	31%	28%	27%	26%	26%
Government Finances								
Budget balance/GDP*	-7,1%	-6,4%	-6,2%	-8,2%	-13,1%	-10,9%	-10,0%	-9,6%
Govt debt/GDP*	69%	69%	70%	73%	86%	83%	83%	83%
Money & Prices								
CPI inflation	5,0%	3,3%	4,0%	3,7%	6,8%	4,6%	4,6%	4,6%
Stock market index	26361	30923	35401	38370	37873	47988	49092	49522
Interest rates	7,2%	6,5%	7,3%	6,7%	4,8%	3,7%	3,8%	4,4%
Exchange rate (USD)	67,2	65,1	68,4	70,4	74,1	71,9	69,3	70,6
Trade/GDP	41%	40%	42%	39%	38%	35%	31%	30%
Oil price (Brent)	$44	$54	$71	$64	$42	$51	$55	$58
Balance of Payments (USD mn)								
Export of goods	436 626	458 574	507 614	514 729	475 446	513 070	541 905	568 700
Imports of goods	486 195	551 090	629 098	598 228	496 748	575 466	605 191	640 105
Other:	37 456	53 469	55 884	53 736	70 602	89 896	92 286	90 955
Current account	-12 113	-39 047	-65 600	-29 763	49 300	27 500	29 000	19 550
(% of GDP)	-0,5	-1,5	-2,4	-1,0	1,9	0,9	0,8	0,5
FDI,net	39 412	28 876	30 700	37 468	41 938	28 595	37 202	48 725
(% of GDP)	1,8	1,1	1,1	1,3	1,6	0,9	1,0	1,2
Trade balance	107 475	148 135	186 692	157 678	93 370	120 541	118 944	137 695
External Debt & Liquidity (USD bn)								
Reserves	340	389	374	432	544	619	676	734
months of imports	8	7	7	8	10	11	12	13
Total debt	456	513	521	564	566	599	636	676
o/w short term debt	84	98	104	107	106	112	118	125

Sources: Oxford Economics, IMF and SEB estimates.
*)General government on-budget transactions, fiscal year

Rating history (end of year)					
Moody's	Baa3	Baa3	Baa3	Baa2	Baa3
Fitch	BBB-	BBB-	BBB-	BBB-	BBB-
S&P	BBB-	BBB-	BBB-	BBB-	BBB-

Type of government:	Parliamentary Democracy
Next elections	Legislative elections: 2024, Presidential elections: 2022
Other:	
Latest PC deal	None
Latest IMF arrangements	1993/SBA



Disclaimer

Confidentiality Notice

The information in this document has been compiled by Skandinaviska Enskilda Banken AB (publ) (“SEB”).

Opinions contained in this report represent the bank’s present opinion only and are subject to change without notice. All information contained in this report has been compiled in good faith from sources believed to be reliable. However, no representation or warranty, expressed or implied, is made with respect to the completeness or accuracy of its contents and the information is not to be relied upon as authoritative. Anyone considering taking actions based upon the content of this document is urged to base his or her investment decisions upon such investigations as he or she deems necessary. This document is being provided as information only, and no specific actions are being solicited as a result of it; to the extent permitted by law, no liability whatsoever is accepted for any direct or consequential loss arising from use of this document or its contents.

SEB is a public company incorporated in Stockholm, Sweden, with limited liability. It is a participant at major Nordic and other European Regulated Markets and Multilateral Trading Facilities (as well as some non-European equivalent markets) for trading in financial instruments, such as markets operated by NASDAQ OMX, NYSE Euronext, London Stock Exchange, Deutsche Börse, Swiss Exchanges, Turquoise and Chi-X. SEB is authorized and regulated by Finansinspektionen in Sweden; it is authorized and subject to limited regulation by the Financial Services Authority for the conduct of designated investment business in the UK, and is subject to the provisions of relevant regulators in all other jurisdictions where SEB conducts operations.

Skandinaviska Enskilda Banken AB. All rights reserved.