India

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The economy and the country's public finances have stabilised while the banking sector has been improving gradually. Key to limiting several risks in the medium-term is to ramp up economic growth. This will require a more ambitious pace of economic reform from the popular government.

Country Risk Analysis

Summary and main conclusions

The economic recovery last year, driven by domestic demand, lifted the economy back to, or close to, its size prior to the pandemic. Still the level of GDP is far from where we expected it to be prior to the pandemic. Growth should slow slightly this year as positive base effects wane and some Covid related uncertainty continues to plague households and companies.

The government's fiscal response to the pandemic has been relatively muted. Lately, surprisingly strong revenues have helped to reduce the central government's budget deficit somewhat. Government debt which was high compared to peers already before the pandemic looks to be stabilizing at a new, higher level. This weighs on the sovereign's fiscal flexibility and risks crowding out lending to the private sector.

Despite a return to current account deficits, external balances remain strong, reducing country risk. The central bank has accumulated ample reserves over the past year, lifting them to new highs. External debt as a share of GDP remains moderate.

The banking sector has strengthened somewhat in the past year reflected in an improvement in most aggregate financial soundness indicators. Public support has contributed to rising profitability and capital adequacy while the share of non-performing loans has declined. Credit growth has been edging up, but is unlikely to take off in the near-term.

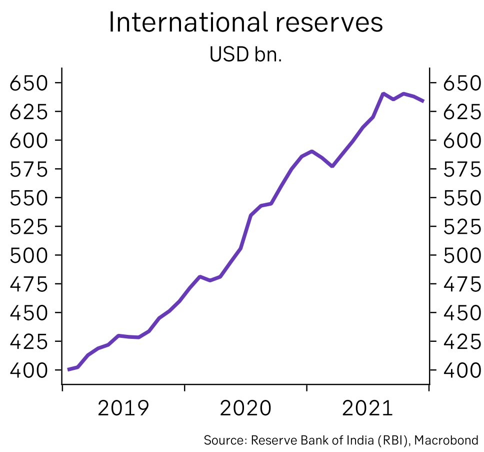
On the political front, state elections in several large states are expected to confirm the strong standing of the ruling BJP party and prime minister Modi. Relations with China and Pakistan remain tense with re-current border skirmishes. Meanwhile, ties with the US, Japan and Australia have been strengthened.

Recent economic developments

Growth rebounded in 2021. Following one of the deepest recessions in the world in 2020, the economy recovered in 2021, driven by domestic demand. Real GDP growth is expected to have reached 8.6% despite some deceleration towards the end of the year. This was naturally a consequence of the very weak previous year but would nonetheless be among the fastest growth rates in the world. Recovering demand and higher energy prices has caused inflation to edge up over the past year, but not as much as seen in advanced economies. Consumer prices rose 5.9% yoy in December. Meanwhile, unemployment has declined from its peak in 2020 to about 9%.

Rising trade deficit. Recovering domestic demand and higher oil prices led to a roughly doubling of the trade deficit in size in 2021. As a consequence, the current account shifted from an unusual surplus in 2020 to a small deficit (1.2% of GDP). At the same time, foreign direct investment (FDI) declined following a large increase in 2020. FDI's cover the current account deficit but are moderate as a share of GDP. Overall net capital flows were positive, possibly helped by the easing of restrictions on foreign ownership of corporate bonds. A continued recovery coupled with high oil prices should hold the current account in a moderate deficit in 2022 too.

Moderate external debt, ample reserves. External debt is moderate. This is a consequence of relatively high savings, enabling the country to finance its debt domestically. Foreign exchange buffers remain higher than average among peers. Despite the shift in the current account balance, reserves rose to about USD 638 bn at end-2021 boosted by net capital inflows and the IMF's SDR allocation (USD 17.8 bn). Hence, reserves are equivalent to roughly one year of prospective imports. India has a clean debt repayment record, contrary to many of its country risk peers.



Banking sector has strengthened. 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. Over the past year, however, aggregate financial soundness indicators have continued to improve. Government and central bank support have contributed to rising profitability and capital adequacy while the share of non-performing loans has declined, contrary to most expectations. The National Asset Reconstruction Company (bad bank) which is being set up may be able to help banks deal with a likely rise in impaired loans. Credit growth has been edging up since mid-2020 but most observers expect banks' balance sheets and risk aversion will make them reluctant to significantly step up new lending in the next few years.

Sovereign credit rating agencies keeping ratings unchanged. The major external sovereign credit rating agencies have all kept their ratings unchanged over the past year. One of the agencies maintain a negative outlook on the rating while another recently shifted the outlook from negative to stable. Their less gloomy outlook was based on a view that risks of a negative feed-back loop between the financial sector and the economy had receded.

Economic policies

Public finances remain strained. The pandemic continues to leave a significant imprint on public finances. The general government budget deficit merely edged down to 11.3% of GDP in FY21 (ending in March 2021) from 12.8%. Since then, government revenues have recovered, helped by improvements to the goods and services tax (GST), and recently rose above pre-pandemic levels. Still, prospects are bleak for any marked consolidation in the near-term. Fiscal flexibility suffers from a relatively rigid budget framework. This includes expenditures being structurally high, for example on public wages and subsidies. In addition, the high government debt has led to interest rate costs taking about one quarter of government revenues. This is higher than average among country risk peers. The current budget is based on a lower but realistic deficit but most economists advocate that policies should continue to be supportive in the near-term.

Deficits and debt are key credit weakness. Despite average nominal GDP growth well into double digits over the past decade, persistent fiscal deficits had yielded a high general government debt already before the corona related downturn. The downturn triggered a jump in the debt which subsequently remained at roughly 90% of GDP in mid-2021. Debt affordability has weakened. High indebtedness thus remains one of India's main credit weaknesses. Not only does this weigh on the sovereign's fiscal flexibility, the high debt is largely financed domestically which also risks crowding out lending to the private sector.

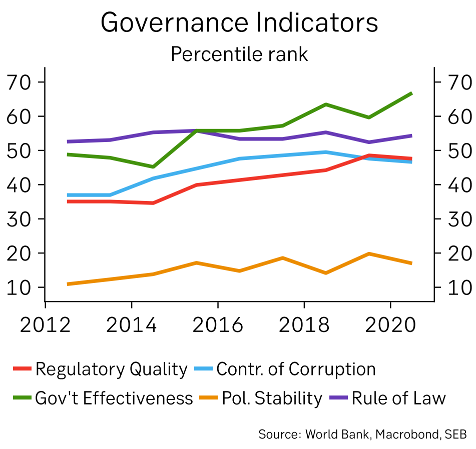
Mitigating factors. There are, however, a couple of factors mitigating sovereign risks attached to the high debt ratio. First, the debt stock is mostly in local currency and held by domestic investors. Capital markets are relatively closed and domestic banks are required to place a significant share of the deposit funding in government bonds. This makes debt easily financed. Second, average maturity is relatively long, making debt servicing less sensitive to interest rate volatility.

Normalisation of interest rates on the cards. Reserve Bank of India (RBI) kept policy rates unchanged during 2021. Although headline inflation remains within RBI's target range of 2-6%, the central bank is likely to start normalizing policy rates (currently negative in real terms) in the near-term.

Structural and institutional developments

Quality of governance broadly in line with peers. Most World Bank governance indicators are largely at par with country risk peers.

Low GDP per capita is a weakness. While high and relatively stable economic growth is a country risk positive, GDP per capita is still significantly lower than average among peers. This limits households' and the government's capacity to adjust to negative shocks. Broader human development indicators are also weaker than among peers.



Structural reforms – mixed performances. In its response to the downturn, the government included several structural measures aimed at improving the flexibility of labour laws, raising agriculture sector efficiency, strengthening the financial sector and raising infrastructure investments, among others. Despite trailing in its broader privatisation plan, the government concluded the long process of privatising Air India. Implementation of previously agreed reforms remains key, however, and uncertainty around this is high. This was reflected in the unexpected policy U-turn taken by the government in late 2021 when it repealed major agricultural laws that had triggered a year of protests.

Political and security situation

Government maintains strong standing. The results of upcoming state elections in four major states is expected to confirm a strong support for the Bharatiya Janata Party (BJP) which leads the country's coalition government. Economic policies are still relatively protectionist, reflected for example in India staying out of the RCEP which came into effect in January. However, the government has recently aired plans to strike new bilateral free trade agreements. It has also continued to foster Hindu nationalism which has reportedly become increasingly violent. We assume a moderate pace of economic reform in the years up to the elections in 2024.

Geopolitical risks. On the geopolitical front, the main risks are driven by the relations with neighbouring Pakistan and China. Meanwhile the country is improving its ties with mainly the US, but also with Australia and Japan. This has been manifested in the revival the so-called Quad (Quadrilateral Security Dialogue), a strategic security dialogue between India and these three countries.

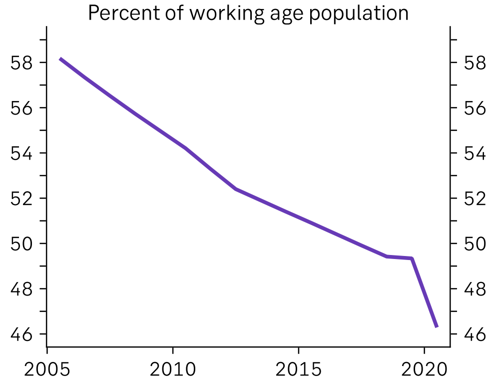
Outlook

Economic activity cooling slightly in near-term. Uncertainty around the outlook is high as the evolution of the pandemic is unpredictable. SEB expects GDP to expand 6.1% in 2022, down from an expected 8.6% in 2021, and about the same pace in 2023. Other observers such as the IMF and Oxford Economics are more positive in the near-term seeing real GDP growth staying at around 8% in 2022 before cooling in 2023.

Lower growth in long-term. Already before the pandemic, economists had revised down their estimates of potential GDP growth. Many forecasters have now lowered their projections further as the deep decline in the economy is expected to leave scars on its growth potential. Although the level of GDP is close to its pre-pandemic level, most estimates indicate that it will take several years, at best, before the economy returns to the pre-covid path. India's long-standing demographic advantage still stands but low labour force participation and reduced access to education will limit the contribution of labour input to production. SEB and observers such as the IMF expect growth to hover at about 6% in the longer run.

Labour force participation rate

Percent of working age population



Source: World Bank, Macrobond

Public finances to remain vulnerable. The budget proposal for the next fiscal year aims to boost investment, in particular in infrastructure, and targets a central government deficit of 6.4% of GDP (authorities' definition). Adding to this the states' deficits yield a general government deficit of at least 9.5% of GDP. The longer-term outlook for government indebtedness is uncertain. The government sets medium-term targets for budget deficits in accordance with the FRBM Act which was established to achieve medium-term fiscal consolidation. However, the Act has been amended several times and the path for reaching budget targets is somewhat unclear. The authorities' track record when it comes to fiscal consolidation is less than impressive. On the other hand, a favourable difference between growth and interest costs speaks in favour of a gradually declining debt. The IMF sees debt at 85% of GDP in 2026, well above pre-pandemic levels, and highlights the uncertainty related to the forecast.

Higher than expected government debt is a 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. Key to succeeding here, given the rigid budget structure, is that the pace of economic growth is kept up in the medium term. Beyond weighing on sovereign risk, higher government borrowing could also crowd out lending to the private sector and hence investments which are key to ramping up economic growth.

Bank health and credit growth could be weaker than expected. It is expected that a gradual strengthening of the banking sector will permit a gradual acceleration in new lending. This scenario is subject to downside risks. For example, the RBI in its most recent financial stability report forecasted that the NPL ratio of private banks would reach 8.1% by September 2022 in their main scenario, and 10.5% among state-owned banks. If this were to lead to a tightening of credit supply it would hold back economic activity more than expected.

External risks stemming from lower global demand and from geopolitics. 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. As to geopolitical risk, a rise in cross-border tensions could depress economic sentiment and activity, lead to disorderly migration and trigger financial market turbulence. Another external risk is higher than expected oil prices which would likely produce higher deficits on the current account and drive up inflation.

Natural hazard risks are high. India is, by some measures, classified as one of the top 10 countries in the world facing the risk of natural hazards with potentially severe economic consequences. The country is particularly exposed to drought and floodings, events that are likely to occur more frequently as a consequence of climate change. This poses economic and social risks.

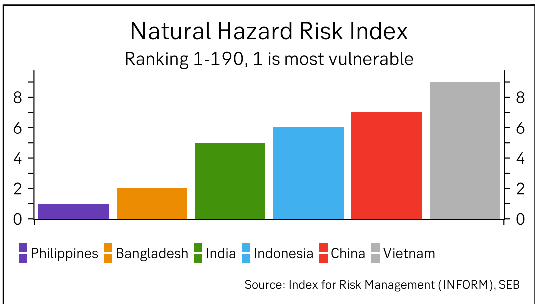
India: Key Economic Indicators

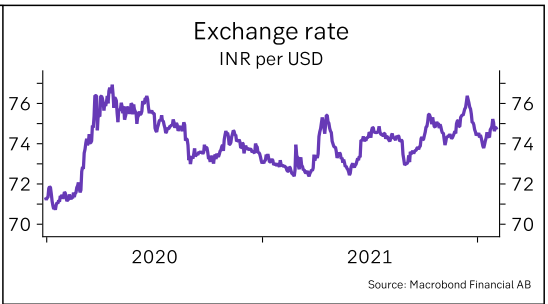
Macroeconomic	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
GDP (bn. USD)	2730	2830	2602	3030	3339	3719	4186	4716
GDP/capita (USD)	2015	2069	1883	2172	2371	2616	2919	3260
GDP (change)	7,3%	4,8%	-7,1%	8,6%	6,1%	6,2%	6,2%	6,2%
Investments/GDP	32%	33%	30%	33%	33%	33%	32%	32%
Government Finances*								
Budget balance/GDP	-6,4%	-7,4%	-13,1%	-11,3%	-9,7%	-8,8%	-8,3%	-8,1%
Govt debt/GDP	70%	73%	86%	91%	89%	88%	87%	86%
Interest rate costs/gov. revenues	23%	22%	26%	22%	26%	25%	25%	25%
Money & Prices								
CPI inflation	3,9%	3,7%	6,6%	5,2%	5,1%	4,8%	5,1%	5,2%
Stock market index	35401	38370	37873	53737	57028	55429	54463	53777
Interest rates	7,3%	6,7%	4,8%	3,8%	4,1%	4,4%	4,9%	5,4%
Exchange rate (USD)	68,4	70,4	74,1	73,9	74,8	74,2	74,2	74,4
Trade/GDP	42%	40%	38%	41%	40%	38%	36%	34%
Oil price (USD, Brent)	71	64	42	71	72	60	60	61
Balance of Payments (USD mn)								
Export of goods	507 610	516 732	470 112	568 666	605 340	645 473	685 393	724 960
Imports of goods	629 469	629 535	521 885	687 369	724 978	777 459	833 815	892 913
Other:	56 259	83 040	84 503	81 578	36 476	64 260	80 492	90 032
Current account	-65 600	-29 763	32 730	-37 125	-83 162	-67 726	-67 930	-77 921
(% of GDP)	-2,4	-1,1	1,3	-1,2	-2,5	-1,8	-1,6	-1,7
FDI,net	30 700	37 468	53 240	35 257	57 263	66 460	75 984	86 255
(% of GDP)	1,1	1,3	2,0	1,2	1,7	1,8	1,8	1,8
Trade balance	186 692	157 678	95 450	182 006	247 457	238 299	249 841	271 061
External Debt & Liquidity (USD bn)								
Reserves	374	432	549	596	613	649	705	765
months of imports	9	10	17	12	11	11	11	11
Total debt	521	564	564	599	636	676	721	770
o/w short term debt	104	107	104	109	115	122	130	139

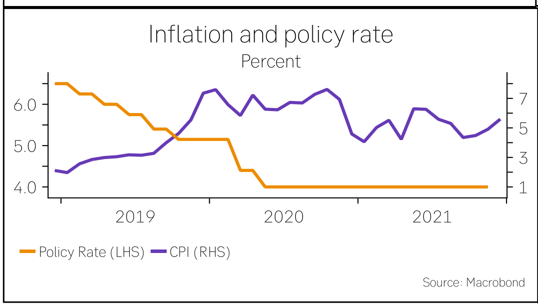
Sources: Oxford Economics, IMF and SEB estimates.
*General government on-budget transactions, fiscal year

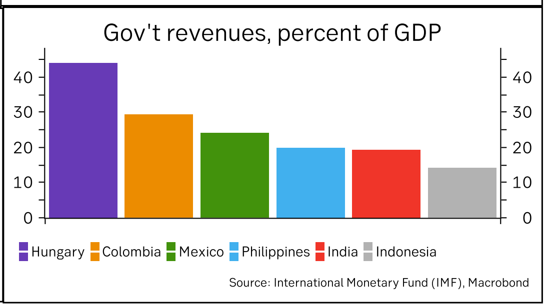
Rating history (end of year)				
Moody's	Baa2	Baa2	Baa3	Baa3
Fitch	BBB-	BBB-	BBB-	BBB-
S&P	BBB-	BBB-	BBB-	BBB-

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









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