Weaknesses in its financial system could put downward pressure on India's economic recovery

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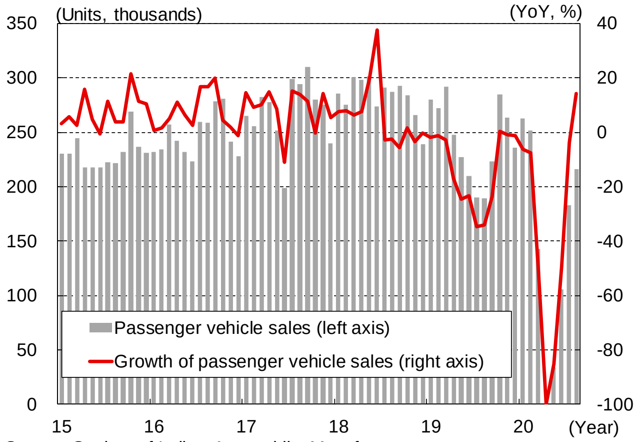
India's real GDP growth rate for the April-June quarter recorded its largest slump since records began (-23.9% YoY) on the back of a nationwide lockdown. However, the economy started to recover afterwards as various restrictions on travel and movement were eased in stages. Passenger vehicle sales reveal the number of units sold has continued to rise since bottoming out in April when they dropped to zero due to store closures. In August, vehicle sales hit double-digit growth of 14.2% YoY owing to the low level of sales the previous year which was the result of consumers refraining from purchasing cars ahead of the introduction of new emissions regulations and a downturn in sales finance (Chart 1).

That being said, the future of the economy is still extremely uncertain. The number of COVID-19 cases in India is the second highest in the world in terms of the cumulative total and it is difficult to say that India has succeeded in controlling the spread of infection. Looking ahead, it will be important to keep an eye on the high level of downside risks to the economy, as well as weaknesses in the financial system. India's ratio of non-performing loans to gross loans rose swiftly due to stricter guidelines for some banks published by the Reserve Bank of India (RBI) since FY2015. As a result, India now has a much higher level of non-performing loans compared with other Asian countries (Chart 2). In its Financial Stability Report published in late July, the RBI said that while the ratio of non-performing loans has improved a little and fell to 8.5% in March 2020, its baseline scenario for the ratio in March 2021 is 12.5% (the real GDP rate forecast for FY2020 is -4.4% YoY) and this may escalate to 14.7% (real GDP rate forecast of -7.2% YoY) in a very severely stressed scenario – close to the highest level on records.

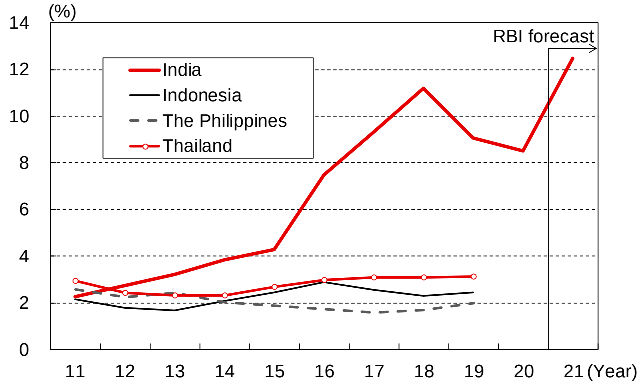
Even before the COVID-19 pandemic, the reluctance of banks to lend to businesses and individuals that started with the collapse of large non-banking financial companies in FY2018, and the aforementioned large decline in the number of vehicle sales this reluctance led to, is fresh in peoples' memories. In addition, in March, the government took measures that included prohibiting new loans and investment and placing temporary restrictions on withdrawals from a large private bank in order to address the deterioration of financial institutions' finances and maintain the stability of the financial system. In the case that India's financial pipes become clogged further, there is also the risk that, coupled with a worsening of the COVID-19 situation, there will be a rise in downside risks to the economy. It will be important to keep an eye on this situation going forwards.

Chart 1: Number of Passenger Vehicle Sales in India



Source: Society of Indian Automobile Manufacturers,
MUFG Bank Economic Research Office

Chart 2: Ratio of Non-Performing Loans to Gross Loans in Asian Countries



Note: India's non-performing ratio data is as of end March.
Forecast for 2021 is forecast of Reserve Bank of India's baseline
Source: IMF, MUFG Bank Economic Research Office

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