India’s Economic Outlook: Selected Financial Sector Issues

Singapore Seminar Series
STI/RRO/IIMPACT Event

May 12, 4:00—6:00 PM
Roadmap

• India’s macro-financial setting and India’s banking sector

• Changing structure of India’s financial system

• Linkages and supporting reforms

• Takeaways
Macroeconomic and financial setting and India’s banking sector
India’s increasing global role

- Most populous country in 2023
- Third largest economy
- 15% of global growth in 2023
- G-20 Presidency in 2023

Figure 1.1. India’s Share of Global GDP (Percent)

2. Share of Global GDP in Purchasing Power Parity, 2021

Sources: World Economic Outlook database; and IMF staff calculations.
High economic growth, reforms, and shocks

• Annual average growth at 6.6 percent during 1991-2019
• Over 400 million people lifted out of poverty in the last 15 years
• Adverse external shocks (GFC, COVID-19, etc.)
• Adverse domestic shocks (e.g. 2018 NBFC crisis)
• Positive domestic reforms (e.g. flexible inflation targeting)
Near-term growth outlook positive but service sector not generating enough jobs
Inflation and the fiscal deficit have been a challenge.

**Consumer Price Index**
(In percent, year-on-year)

**Government Balance**
(In percent of GDP)

Sources: CEIC CDMNext; and IMF staff calculations.
Sources: Ministry of Finance; Reserve Bank of India; and IMF staff estimates.
External position has strengthened

**Current Account Balance 1/**
(In percent of GDP)

**Reserves**

Sources: Haver Analytics; and IMF staff calculations.

1/ Data is presented in calendar year format, where 2020Q4 = Dec-20.
The financial sector appears sound and credit is recovering.
Growth and financial sector development

- Further financial sector deepening needed to support growth
  - Healthy financial sector critical
    - Efficient credit allocation
    - Financial sector stability and economic stability

**Figure 1.3. Financial Deepening**
(Credit to GDP, percent)

Note: EMDE-Asia (ex. India) includes average of Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, Indonesia, Japan, Malaysia, Maldives, Micronesia, Mongolia, Myanmar, Nepal, Papua New Guinea, Philippines, Solomon Islands, Sri Lanka, Timor-Leste, Tonga, Vanuatu, and Vietnam. 2019 does not include Micronesia, Sri Lanka, and Tonga. 2020 does not include Cambodia, Micronesia, Papua New Guinea, Sri Lanka, and Tonga. avg = average; EMDE = emerging market and developing economies.
Public sector banks still dominate

- Public sector banks 60 percent of bank assets
- 22 domestic private banks and 46 foreign banks
- Some 100,000 regional rural banks and urban and rural cooperatives
- Productivity of public sector banks’ dependent firms lower
- Need for continued reforms (resolution of bad debt, improved governance, privatization, etc.)
Changing structure of India’s financial system
Growing importance of non-banking financial companies (NBFC)

- Sharp rise in NBFC
  - e.g. Micro, small, and medium enterprises have benefited
  - Regulatory arbitrage
- Default of systemically important NBFCs in 2018
  - Spillovers into banking sector
  - Adverse impact on economy and feedback loop
- NBFC regulatory reform
  - Large NBFC (capital, provisioning, regulatory convergence, etc.)
  - Non-systematic NBFC less onerous
- Reform areas
  - e.g. diversification of NBFC funding sources; limits on bank borrowing

![Figure 1.4. Financial Intermediaries (Share of nominal GDP)](chart)

Sources: Reserve Bank of India; Haver Analytics; Statista; and IMF staff calculations.
Increased reliance on market-based financing

- From a low base, market-based financing more important
- Prospect of global indices inclusion
- Bond market development (competition and increased access to long-term financing, better risk management, lending to innovative sectors)
- Reform areas:
  - Better creditor rights
  - Market and rating infrastructure
  - Broaden investor base, etc.
Leveraging digitalization to foster financial inclusion

- India’s effort in fostering financial inclusion leveraging digitalization—spectacular
- In 2011 only 35 percent access to bank accounts
- Three-pronged approach (India stack)
  - Biometrical digital identification (Aadhar)
  - Debit cards linked to Aadhar
  - United Payment Interface (connecting various platforms)
- Residual obstacles (e.g. financial and digital literacy)
Green finance: India’s Environment, Social, and Government (ESG) market

- Vulnerable to climate change with large economic/social costs
- Climate events can undermine financial sector stability
- India’s commitment to reduce carbon intensity; carbon neutrality by 2070
- ESG market surged but still small (2 percent of total bond issuance)
- Reform areas (e.g.):
  - Availability of data for financial sector stakeholders to assess financial sector risks
  - Securities and Exchange Board of India likely to address issues related to discloses

Sources: Bloomberg; and authors’ calculations.
Note: AUM = assets under management; ESG = environmental, social, and governance;
Linkages and supporting reforms
Capital flows: trends, risks, and new investor base

- Capital inflows beneficial
- Current account deficit of 2.5 percent financeable
- India’s gradual capital account liberalization (FDI, equity)
- Gradual easing of restrictions on debt flows
- Portfolio flows more volatile (GFC, taper tantrum, COVID-19)
- Capital flow cycles shorter and greater volatility
- Reforms areas: strengthening of policy frameworks, e.g. medium-term fiscal framework, communication

Sources: CEIC; Haver Analytics; and IMF staff calculations.
Addressing corporate sector vulnerabilities

- Prior to COVID-19, corporate sector deleveraging
- Micro-firm profits persistently low
- Stress testing the corporate sector can identify risks for the financial sector and evaluate policies
- In severe adverse scenario, capital of public sector banks below regulatory requirement
- Authorities’ relief measures and monetary policy easing during COVID-19 effective

Figure 9.11. The Impact of Corporate Stress on Bank Balance Sheets by Bank Type
(Percent)
Debt resolution frameworks

- Resolving over indebtedness of corporates allows financial system to allocate resources efficiently
- Insolvency and Bankrupcty Code in 2016 milestone
- Resolution frameworks (in-and out-of-court, and hybrid)
- Reform areas:
  - Encourage out-of-court processes
  - In-court restructings timelines too ambitious, need for additional resources
  - Staffing and capacity development

Figure 10.5. Duration of Ongoing Liquidations (As of June 2022)

Source: Insolvency and Bankruptcy Board of India.
Monetary policy communication

- Institutional reforms that reduce market volatility makes financial markets more attractive for savers/investors
- Monetary policy communication important
- RBI’s flexible inflation targeting (2016) has improved anchoring of inflation expectations
- RBI’s forward guidance moderated uncertainty and supported assets prices during pandemic
- Reform areas: refining tools (e.g. forward-looking communication about economic outlook and RBI’s policy reaction function)
Takeaways

• Increased global economic importance
• India has recovered well from the pandemic and appears to be entering a period of macroeconomic stability—albeit not without risks
• Long-term outlook positive: catch-up and demographic dividend
• Long run potential can be enhanced— additional investment will be key
• Financial sector critical to allocate resources efficiently
• Public banks to continue to dominate, but non-banking financial companies, capital markets, leveraging digital finance, and the ESG market have changed the system.
Key reform areas:

• Reducing the share of public banks and strengthened PSB governance
• NBFC important role but more funding diversification and reduced bank-linkages
• Corporate bond and ESG market further development (e.g. broaden investor base and ESG data)
• Continued digitalization to foster financial inclusion; digital and financial literacy critical

Supporting reforms:

• Continued gradual capital account liberalization can bring benefits but key is to strengthen frameworks (medium-term fiscal frameworks, etc.)
• Improving debt resolution frameworks (latest draft bill encouraging; resources and capacity development critical)
• Continued institutional reforms that reduce market volatility. Building on the success in monetary policy communication, further refining tools (e.g. on economic outlook and policy reaction function)
Excerpt languages

QR code and link to the excerpts

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THANK YOU