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Economic Round-up: March 2023

Global growth is showing signs of slowdown as mixed economic data is being reported from the US and China. While in the US labour market is beginning to show the impact of elevated rates, in China, recovery is losing momentum as is visible from official PMI readings. Even in Europe, manufacturing sector continues to suffer at the hands of weak global demand. Further, cracks that had appeared in the global financial system (due to SVB, Credit Suisse) will also put pressure on global central banks to slowdown/stop their tightening cycle. There is now a greater chance of Fed hitting a pause button from its next policy meeting in view of flattering labour market. Even BoE is likely to pause soon, while RBA has already put a stop to its rate hike spree. On the positive side, inflationary pressures have begun to cool off, leaving consumers with a higher purchasing power, which in turn may support domestic demand. Housing sector is also seeing revival in US and China.

Global growth: Economic activity is showing signs of slowdown in the US (manufacturing PMI, job openings, factory orders, retail sales), while it seems to be improving in China, albeit at a slower pace (industrial productions, real estate, FAI, retail sales). In Eurozone, while manufacturing sector still reels under the pressure of weakness in export demand, services activity is seen picking up pace. Sharp drop in energy prices in Europe has led to decline in headline CPI and leaving consumers with higher purchasing power. However, stickiness in core inflation is still worrisome and can dent consumer demand. However, the economic outlook is not as bleak as earlier anticipated and both Germany and UK expecting to avoid recession this year.

Global Central Banks: Despite turmoil in the financial markets (led by SVB and Credit Suisse), major global central banks opted for continued rate hikes. US Fed and BoE raised their key policy rates by 25bps, while ECB announced a 50bps hike. Major central banks (Fed, ECB, BoE, BoJ, Bank of Canada, & Swiss National Bank) also announced joint liquidity operations to address liquidity concerns. According to the statement, frequency of 7-day maturity operations, under the existing US dollar swap lines, will be increased from weekly to daily. Going ahead, while ECB has vowed to maintain its hawkish stance, investors are split in case of BoE and US Fed. While in case of BoE there is a 50-50 chance that it may opt for a pause, in case of Fed, the likelihood currently stands at 59%, owing to slowdown in growth. BoJ and PBOC on the other hand will maintain loose monetary policy for now.

Key macro data releases: On the industrial production side, core sector growth slowed down by 6% in Feb'23 after growing by 8.9% in Jan'23 on the back of broad-based moderation. Cumulatively, for the year, infrastructure index eased to 7.8% in FYTD23 (Apr-Feb'23) compared with a growth of 11.1% in the previous year. Production of crude oil, coal, natural gas and refinery and electricity fell.

CPI inflation data edged down modestly to 6.4% in Feb'23 after moving up to 6.5% in Jan'23. For the second-month in a row, CPI data came in above RBI's upper tolerance band. Food inflation virtually remained steady at 5.9% in Feb'23. Stickiness of core inflation persists (6.1% in Feb'23 as well). Amongst major items of core, housing inflation rose to near 3-year high, followed by health (10-month high). However, inflation in personal care and effects and transport and communication witnessed some moderation inFeb'23.

Global developments

Jitters in financial markets

Earlier in Mar'23, shockwaves were sent through global financial markets as news of regional bank failures in the US broke out. Silicon Valley Bank (SVB) was at the heart of the crisis. This was mainly owing to its excessive reliance on deposits from start-ups in order to support its lending growth. As liquidity dried up, start-ups withdrew their deposits and the bank had to sell its securities at a loss to raise fresh capital. To stem the crisis and avoid broad contagion, regulators stepped in. The UK arm of SVB was bought by HSBC—a deal brokered by BoE and UK Treasury. In the US, the bank was seized by Federal Deposit Insurance Corporation (FDIC). In addition to this, markets were further jolted by the news of trouble in Credit Suisse, a major Swiss Bank. To avoid a major financial sector crisis, it was acquired by UBS Group. Central banks also announced joint liquidity operation to ease investor concern.

Following the financial sector shocks, US macro data is pointing towards a slowdown in the economy. Latest ISM manufacturing PMI for Mar'23 fell to 46.3 from 47.7 in Feb'23. This was driven by dip in new orders index (mainly export orders), inventories and employment index. Factory orders for Feb'23 fell by (-) 0.7% versus est.: -0.5%, but at a slower pace compared to (-) 2.1% decline in Jan'23. US retail sales in Feb'23 also declined by (-) 0.4% on MoM basis. Job openings (JOLTS data) fell below 10mn (9.9mn in Feb'23; est.: 10.4mn) for the first time since May'21. Following the release of these data points, likelihood of Fed hitting a pause button has increased. On the other hand, as Fed has slowed the pace of rate hikes, housing sector is seeing some revival with US pending home sales rising by 0.8% to its highest level since Aug'22.

In Eurozone (EZ), economic activity is showing signs of improvement, with composite output index up at 53.7 in Mar'23 (highest since May'22) versus 52.0 in Feb'23. This was on the back of acceleration (10-month high) in services activity (55.0 versus 52.7), while manufacturing activity still continues to reel under pressure (49.6 from 49.9 in Feb'23). Services activity was seen picking up across major EU economies (Germany and France) on the back of revival in consumer demand and new export business. On other hand, stress in manufacturing sector was also broad-based owing to dip in new orders, mainly export business. On the inflation front, significant easing was witnessed as headline CPI index eased to 6.9% in Mar'23 from 8.5% in Feb'23. The cooling-off was driven by dip in energy cost-backed by fall in international oil prices and government subsidies. However a key concern-stickiness in core inflation remains. Core CPI rose to a new high of 5.7% in Mar'23 from 5.6% in Feb'23. Food (15.4% versus 15%), services (5% versus 4.8%) inflation also remains on the higher side. Supported by drastic decline in energy prices, business climate has improved with the Ifo index up at 93.3 points from 91.1 points in Feb'23. Recently, the Ifo institute also released its upgraded forecast for the German economy and now expects it to avoid recession in CY23 (+0.3% versus -0.4% expected earlier).

In case of China, reopening of the economy showed mixed results. The official manufacturing PMI, after reaching a decade high of 52.6 in Feb'23, eased to 51.9 in Mar'23 owing to volatile global financial conditions. On the other hand, the official non-manufacturing PMI jumped to a 10-year high of 58.2 in Mar'23 from 56.3 in Feb'23. This on account of revival in construction activity and consumer spending. Retail sales in Jan-Feb'23 rose by 3.5%, in line with market expectations and significantly up from (-) 1.8% decline in Dec'22 and 0.2% increase in CY22. Industrial production in the same period (Jan-Feb'23) rebounded less sharply and was up by 2.4% from 1.3% in Dec'22. Fixed Asset Investment (FAI) a gauge of investment in the economy, too rose, by 5.5% from 5.1% in CY22. Property sector is seems to be exiting from the painful period as real estate investment during Jan-Feb'23

period fell by (-) 5.7% compared with (-) 12.2% decline in Dec'22. Even home sales fell at a slower pace of (-) 3.6% during the same period, compared with (-) 24% drop in CY22.

Global central bank decisions

Despite the market turmoil, US Fed increased its key policy rate by 25bps in its Mar'23 policy meeting, taking the cumulative hike to 450bps. However, with signs of slowdown in economic activity, it is now expected that Fed end its tightening rate cycle and will go for a pause in its next policy meeting. The last meeting, a summary of economic projections and dot plot was also released. The Fed now expects GDP growth to slow down further to 0.4% in CY23 versus 0.5% growth projected earlier. On the other hand, PCE inflation index is estimated to rise by 3.3% from 3.1% projected earlier. Yet, the dot plot indicates that majority of the MPC members are of the view that aggressive rate action is not need. Currently, chances of Fed opting for a pause have increased to 59% from 43% earlier, on the back of weaker than estimated economic latest economic data.

In case of BoE, in line with market expectations the central bank too raised its rates by 25bps, taking the cumulative hike to 350bps. While the central bank reaffirmed that it expects inflation to fall significantly in Q2CY23, the unexpected jump in CPI for Feb'23 (10.4% versus 10.1% in Jan'23) has again split the markets between more rate hikes by BoE or a pause. While given the volatility in financial markets and the impact of higher rates calls for a pause, stickiness in core inflation may push BoE to hike rates more till Sep'23.

ECB on the other hand, continued hiking rates by 50bps and has reiterated its hawkish tone, indicating more rate hikes in the coming months. This is despite easing of headline inflation, on account of sharp dip in energy prices. A key concern that remains is stickiness in core CPI.

A major central bank which has recently announced a pause is the Reserve Bank of Australia (RBA), breaking the spree of 10 continuous rate hikes so far. The central bank has conveyed that it will observe the impact of existing rate hikes and then take a call on future rate decision. It also cautioned that the current pause does not imply the end rate tightening cycle.

In case of Asia, both Japan and China continue to maintain loose monetary policies. BoJ has further clarified that the exit strategy from current monetary policy stimulus cannot be discussed as of now as the inflation is yet to fall within bank's targeted range on a sustainable basis. In fact in order to keep its 10Y yields within the targeted range, BoJ has also announced increase in range of its planned bond buying in Q2CY23. It will now buy ¥ 100bn to ¥ 500bn of 10Y-25Y bonds per operations, compared with ¥ 200bn to ¥ 400bn range set for Q1.

PBOC also surprised markets by announcing unexpected cut in CRR (-25bps) for all most all banks (except those which already have a reserve ratio of 5%). the weighted average RRR for financial institutions now stands at 7.6%. This along easing restrictions for property sector, China is trying to give growth a push following the reopening of the economy from its stringent Covid-19 lockdown measures.

Special studies

Cost of Borrowing-Small Savings

In the wake of rising interest rates scenario, Government has followed suit by jacking up the rates on small savings schemes for Q11FY24. The increase across components have been in the range of 10-70bps in line with expectation. A status quo position has been maintained for PPF rates at 7.1%. Deposits contributes the bulk of the savings deposits with a share of 69.4%. Recently, Centre had pegged Rs 8.88 Lakh crore of the gross issuance calendar for H1FY24. As per our calculation (*Bank of Baroda Study: Centre has finely managed its H1FY24 calendar*), the average interest cost is projected at 7.29%-7.35%. Against this, the study attempted to estimate the cost of borrowings and average interest cost based on newly revised rates for small savings.

Small savings rate hiked

Government of India has revised the small savings scheme for Q1FY24 from Q4FY23. With the revision, there has been increase in interest rates across the board with only one exception.

- Time deposits have been raised by 20bps for 1year deposits to 6.8% from 6.6% previously.
- For 2 year (6.9% vs 6.8%) and 3 year (7% vs 6.9%) deposits, the rates are now higher by 10bps. Time deposits for 5-year duration have been raised by 50bps to 7.5% for Q1FY24. Recurring deposits for 5-year tenure have been elevated to 6.2% mark from 5.8% previously.
- Interest rates under the Monthly income scheme have been pushed up by 7.4%, it holds a sizeable share in total savings.
- The highest rate of increase (70bps) has been registered for the National Saving certificate at 7.7% compared with 7% rate in Q4FY23.
- Kisan Vikas Patra scheme will now be attracting much higher rates of 7.5% as against 7.2%.
- Under the Sukanya Samridhi Scheme, rates have been increased by 40bps to 8% from 7.6% in Q4FY23.
- However, the exemption to these rising interest rates have been for Public Provident Fund wherein the rates are steady at 7.1%.

Structure of Small Savings

In order to understand the structure of small savings better, it is important to notice the share of each of components. This is based upon RBI's data for Feb'22 on components wise break up of small savings. Deposits have the highest share in total savings comprising about 69.4%, followed by saving certificates at 23% and Public provident Fund at 7.6%

Cost of Borrowing

Recently the government had also announced the borrowing calendar for H1FY24, which has been estimated at Rs 8.88 lakh crore for H1 (57.6% of total borrowing). In our Note (https://www.bankofbaroda.in/-/media/project/bob/countrywebsites/india/economic-scenario/data-releases/borrowing-calendar-h1fy24--31-19.pdf) on the same, it has been projected the average interest cost of Centre on these securities at 7.29%-7.35% for first half of borrowing programme.

For the year 2023-24, Government has budgeted Rs 6.48 lakh crore as receipts for small savings. After deducting the repayments, the net securities against small savings have been earmarked at Rs 4.74 lakh crore. By calculating the component wise borrowing costs and using the revised interest rates; it has been estimated the overall interest payment for government with the revision has inched up to 6.75% from 6.47% (based on old rates). In absolute terms the interest cost would rise from Rs 41,917 crore to Rs 43,731 crore (new rate). But this would be lower than the market borrowings cost which is placed at 7.29-35% based on our estimates.

In case however, we exclude savings deposits from the lendable pool then the average cost of borrowing is expected to be much higher at 6.95% (old rate) and 7.28% (new rates). In absolute terms the cost will be higher from Rs 45,041 crore to Rs 47,211 crore (new rate). However, this scenario is more theoretical as banks include CASA when reckoning overall lending and the same principle applies here.

External sector review

India's external sector is ending FY23 on a much more strong footing than what was expected at the start of the year. While surging commodity prices led to burgeoning external deficits during the first half of the year increasing risks to global growth, the consequent correction in commodity prices has helped the external sector in H2FY23. After surging to a 37-quarter high of 4.4% of GDP, CAD is expected to moderate going forward. A stronger than expected moderation in merchandise deficit and resilient services exports have lent considerable support to India's CAD. We expect CAD in a comfortable range of 2.4%-2.5% in FY23, and even lower in FY24 (1.9%-2.2%). This should support INR. However, concerns remain on the capital account side with FDI, FPI and ECB inflows expected to be lower.

Merchandise trade performance

India's export and growth contracted at a faster pace of 8.8% in Feb'23 compared with a decline of 6.6% in Jan'23. Even imports dipped by 8.2% in Feb'23, after falling 3.6% in Jan'23. The sharper pace of decline in imports vis-à-vis exports led to a further narrowing of trade deficit to US$ 17.4bn in Feb'23 from US$ 17.7bn in Jan'23, and US$ 18.7bn in Feb'22.

In FYTD23 (Apr'22-Feb'23), exports have increased by 6.8%, compared with a growth of 47.1% in the same period last year. It must be noted that the impressive growth in FYTD23 came on a low base in FY21, due to the disruptions caused by the pandemic. Even so, India's export growth has lost momentum in the last few months amidst a decline in external demand. Table 1, gives the commodity wise breakup of exports for the top 10 commodities. These account for about 78% of total exports this years

Engineering goods which account for about 24% of India's exports (FYTD23), have declined by 4.5% this year. This is mainly on account of weak demand from key markets such as China, EU and US. Slowdown in iron and steel exports due to government's decision to levy an export duty on certain iron and steel products between May-Nov'22, also impacted exports of engineering goods. A sharp contraction was also visible in exports of rice which declined by 28.9% this year. Lower domestic production and higher prices which forced the government to put a ban on exports of broker rice as well imposition of a 20% export duty, contributed to lower exports. Exports of plastics and gems and jewellery were also lower in FYTD23 on a YoY basis.

In FYTD23 (Apr'22-Feb'23), India's imports rose by 18.9% building on a 59.2% increase in the same period last year. This can be explained by higher commodity prices due to the Russia-Ukraine war, as well as increased domestic consumption due to pent-up demand.

In terms of commodity wise composition of imports, the top 10 import items account for over 77% of total imports. Almost all import items have seen an increase in FYTD23 in value terms. Gold has been the only exception. In fact, compared with US$ 45bn in FYT22, gold imports have declined to US$ 31.7bn this year. In volume terms, gold imports have declined sharply by 26% (Apr-Jan'23). Despite lower global prices, the domestic price of gold was higher due to a significant depreciation in INR, which weighed on demand. Gold prices in India increased by around 9% in FYTD23.

Oil is the most significant item in the import basket, accounting for close to 30% of total imports. Oil imports have increased sharply by 38.1% in FYTD23, amidst an increase in oil prices. Oil prices have increased by 26% in FYTD23. Another import item which showed a sharp increase this year is coal. Higher global prices as well as increased demand from domestic industries following easing Covid-19 restrictions impacted demand. Despite the government's hopes of reducing dependence on imported coal, higher domestic energy needs and low domestic production, have necessitated the need for importing coal.

Services trade in FYTD23

India's services exports have performed very well this year. Despite the moderation in global economy, services exports have risen by 30.5% this year (Apr-Feb'23). On the other hand, services imports have increased by 24.6% in the same period. As a result, India's services balance has increased to US$ 133bn compared with US$ 95.9bn in the same period last year. This is positive for India's external position as it will help to fund the huge merchandise deficit.

FDI flows in FYTD23

On the capital account side, foreign inflows are an important source of funding the current account deficit. For this, India relies on FDI, FPI and ECB inflows, amongst others. FDI inflows (equity) into India stand at US$ 41.9bn in FYTD23 (Apr-Jan'23), lower than US$ 50.3bn in the same period last year. However, the total FDI inflows (which also includes reinvested earnings and other capital) has increased to US$ 61.5bn between Apr-Jan'23, compared with US$ 45.9bn in the same period last year.

Disaggregated data from Department of Policy and Promotion (DIPP) which gives data till Dec'22, shows that equity inflows into automobile industry and computer software and hardware, have declined sharply in FYTD23. These together account for over 25% of total FDI inflows. On the other hand, inflows into services and trading which account for about 29% of total FDI inflows, have increased in the same period.

FPI flows in FYTD23

Apart from FDI, FPI inflows also help in bridging the financing gap on the external side. However, while FDI inflows are much more stable and productive, FPI flows tend to be more volatile. In FYTD23, FPI inflows have remained largely negative. In fact, in 7 out of the 11 months (excluding Mar'23), FPIs have been negative driven by a global risk-off sentiment and synchronized monetary policy tightening. Total outflows from India stand at US$ 5.2bn so far (data up to 24 Mar 2023), almost entirely driven by outflows from the equity segment.

ECB inflows

Apart from FDI and FPI, ECBs too play an important role in India's Balance of Payments. However, there has been a slowdown in ECB approvals by RBI in recent months. In fact, ECB approvals in FYTD23 have been lower at US$ 21.2bn compared with US$ 30.9bn in the same period last year. This is due to higher global interest rates, as well as volatility in exchange rate have weighed.

Current account deficit

India's current account deficit (CAD), swelled to 4.4% of GDP in Q2FY23. This was driven by a sharp pickup in merchandise trade deficit due to higher commodity prices as well as pent-up demand. However, we do believe that the worst is over. In recent months, merchandise trade deficit has moderated. While exports have been impacted due to weak external demand, imports have dipped by much more due to lower global commodity prices, as well as weakening domestic demand. Hence, we expect CAD to moderate to 2.2% of GDP in Q3FY23. Higher than expected moderation in imports as well as continued strength in services imports suggest that CAD may shrink further to 0.8%-1% of GDP in Q4FY23. Overall for FY23, CAD is estimated at ~2.4%-2.5% of GDP, versus ~3% estimated earlier. For FY24, CAD is expected in the range of 1.9%-2.2% of GDP.

The glitter of gold

The rupee value of gold touched its record high of Rs 59,233/10gm on 20 Mar 2023 while crossing the Rs 60,000 mark in its intra-day trading. However, some correction was noticed subsequently (eyeing UBS decision to buy Credit Suisse and also Fed policy). In this context, it was interesting to evaluate the factors that have driven gold prices historically. Movement of dollar holds the key. In general, an appreciating dollar puts downward pressure on gold ceteris paribus. In the current context, with dried up liquidity and ongoing banking crisis, DXY is unlikely to trade with an appreciating bias. The Fed has kept its statement cautious indicating that decisions will be data driven. This indeed would push up gold demand with the safe haven factor coming into play. We expect an upside to gold price to persist and touching the US$ 2,000/troy ounce might be likely. All in all, as an asset class, inclination may continue to be towards the 'good old gold'. The shimmer of gold might further pinch the core inflation number going forward.

How Gold prices fared historically:

- We tracked gold prices since 2006 to see the trend in prices both in Re and US$ terms. It was interesting to note that barring three period especially CY13, CY14 and CY15, gold prices have generally been on an uptrend. Ultra-low US Fed rate (0-0.25%) coupled with stable domestic growth during period in the region of 6.4-7.4% drove investors 'risk on' sentiment.
- Notably, years of geopolitical tension and economic crisis had a direct impact on gold prices. For example, post the global financial crisis of CY08, gold prices in Re terms shot up by 31%, whereas in US$ terms it increased by 25%. Also in CY12, post the political turmoil in Egypt, Libya, Yemen, and Bahrain, gold price in Re terms rose by 31% whereas in US$ terms, it increased by 28%. Further post Covid-19 situation, gold prices skyrocketed. In Re terms, the price increased by 33.4% and in US$ terms, the increase was 27%.
- In CYTD23 (till 21 Mar'20), again the uptrend was clearly visible. From an average of Rs 50,964/10gm in CY22, the price increased to Rs 56,904/10gm. In dollar terms similar increase is visible as this is the base number that gets converted in rupee terms. Uncertainty with regard to global growth conditions, ongoing banking crisis and its contagion effect, increased the safe haven demand for gold, which is explained in detail in the next section.

Factors driving gold price:

Demand dynamics: Gold demand firmed up especially the holdings of global central banks increased. Its share in total gold demand rose from 11% in CY21 to 24% in CY22. As per World Gold Council report, major buying

was from Turkey and China. Notably, in CY22, PBOC (central bank of China) reported its first ever increase in gold reserves, a phenomenon last seen in Sep'19. Hedging against inflationary risk and geopolitical uncertainty may be cited as primary reasons towards increased holdings.

Uncertainty with regard to macro fundamentals globally: CY22 and CYTD23 have been a phases of volatility in growth prospects. Rising inflation dilemma grappled central banks globally. Synchronized slowdown was observed for major economies such as US (real GDP, YoY moderated to 2.1 in CY22% from 5.9% in CY21), Eurozone (real GDP, YoY moderated to 3.5% in CY22% from 5.3% in CY21), Japan (2.3% from 1.1%) and China (3% from 8.4%). Inflation through major part of CY22 remained above targeted levels for major advanced economies. Financial conditions remained tighter with Fed, ECB, BoE rolling back major stimulus undertaken during the Covid-19 period and also hiking rates by 475, 350bps and 375bps respectively in the current cycle. This was translated into higher borrowing costs globally. These have increased safe haven demand for gold.

Dollar and Gold: As an asset class, gold prices exhibit a negative relationship with movement of DXY. Ceteris paribus, since gold is denominated in dollar, any increase in dollar theoretically makes gold less attractive as investment leading to a decline in demand. On most of the occasions, we have seen this negative relationship has hold true. In fact in the longer series, since 2000 onwards, the correlation coefficient between DXY and gold price was -0.28. For a short term series since 2022, the correlation coefficient was -0.76.

Exchange traded funds driving demand for Gold: As seen in Fig 2, the outflow on gold ETF has been reduced significantly in CY22. From outflow of 189 tonnes, it was reduced to 110tonnes. Even in India, the funds mobilized through gold ETFs are on an uptrend. Rise in gold price would further attract inflows in this segment going forward. In simple terms, gold ETFs are basically units denoting physical gold which may be in paper or dematerialized form. This is significant because in India there are several options of dealing in gold such as spot trading, gold bonds and futures market where one can derive benefits that flow from gold as an investment.

Outlook on Gold:

The recent upsurge in gold is a risk-off sentiment and inclination towards safe haven demand. The crossing of Rs 60,000/10gm mark for gold was following the Credit Suisse debacle. The news of UBS buying Credit Suisse has heightened volatility in the market. In fact for the past week, the apprehension of banking failure post SVB, First Republic Bank crisis, has caused preference for gold. Both in rupee and dollar terms, gold have gained by above 6% itself in the past 1 week (since 13 Mar).

Dollar to hold cues: a lot will depend on how the dollar moves. A stronger dollar will work against gold. The Fed has raised the rates once again yesterday and it is still uncertain as to whether there would be a pause subsequently. This may help to retain attractiveness of gold as an investment option.

Physical Demand for gold to continue: Demand from India, China is likely to continue. In China, some economic indicators such as retail sales, fixed assets are holding up well. Also monetary stimulus will encourage demand. In case of India macros are relatively well placed compared to global counterparts. Apart from this, in the coming months, seasonal demand for gold would persist. Resilient agriculture sector would also push rural demand for gold higher. In other words, the good old gold would persist and favoured as a major asset class which in turn will put upside risk to its price.

Impact of rising Gold prices on India's macro:

CPI to be watched: Gold has 1.08% weight in the overall CPI basket, which is small when looked at. But within core, much of the movement in Personal Care and Effects inflation (3.9% weight in overall CPI), is attributed to

the volatility in the gold prices in the past few months. So the shimmer of gold might bite further on the already sticky core inflation.

Pressure might be on imports: Gold has a share of around 5% in India's overall import basket. In FYTD23, gold imports in value terms has moderated to US$ 31.7bn. However, with rising gold prices trade deficit might (currently in FYTD23 at US$ 247.5bn compared to US$ 172.5 in FYTD22) widen especially, in a scenario where exports are already under pressure.

Splitting the petrol pie

Volatility in oil prices raises the question on the redistribution of the revenue to different stakeholders including suppliers, Oil marketing companies (OMCs), Centre and States as prices move in different directions. In simple words, who will bear the burden or enjoy the fruits, in tune with rise/fall in international crude prices. In this short exercise, we had charted out this distribution for certain time periods since Apr'20. The pricing of fuel products in India is still controlled even though the overt subsidy has been phased out. While the consumer has been paying higher prices at most times, after a point there is a tendency to freeze the same. When this happens there is redistribution across the stakeholders.

Components of Petrol and Diesel price build up:

- To arrive at the retail price of petrol, various components were added. This comprised the base price which is a combination of the exogenously determined supplier's price and the component charged by the OMC. To this was added the freight cost, excise duty of the Centre, the dealer commission and state VAT. For the purpose of this exercise, the price in Delhi was considered.
- The movement in international oil price of crude and the final consumer price of petrol is reflected in the pass through across components.
- Apr'20 and Jun'22 were chosen as these time points demarcated the low and high of international oil price in the chosen time period (Apr'20-till date). It was seen that with increase in international crude prices from Rs 13.4/lt to Rs 58.8/lt, the base price, or the price charged by OMCs rose to Rs 57.1/lt from Rs 28/lt in the same period.
- Other than the volatility in base price of OMCs, other components especially the centre's tax underwent some degree of change. From Rs 23/lt in Apr'20, the excise duty went down to Rs 19.9/lt, to protect consumers from rising oil prices. States' tax on the other hand went up to Rs 15.7 in Jun'22 from Rs 14.8/lt in Apr'20.
- With oil prices significantly coming down lately, the buildup components have remained unchanged and the base price charged by OMCs has been retained at the same level. The pricing of petrol and diesel is on the basis of 15-day rolling average of international price.

Who would benefit with volatility in international oil prices?

- In this exercise, we considered different time points, where oil prices exhibited maximum change and tried to see the impact in terms of share of different stake holders in the petrol pie. A similar result holds for diesel as well, with no anomaly in trend between the two.
- For the period May'20 to Dec'20, when international oil prices went up from US$ 32/bbl to US$ US$ 50/bbl, the share of OMC's in the retail price of petrol have only increased from 3.5% to 4.9%. Centre's

share on the other hand, has gone down from 46.3% to 39.7%. Notably, this is not because of excise duty cuts, but on account of increase in retail price, which has expanded the denominator. States' share in the retail price have remained stable at 23.1%. VAT has increased in absolute terms by Rs 2.7/lt in the same period. Miscellaneous share has risen to 4.9% from 5.4%, due to increase in both freight and dealer commission.

- Between Dec'20 to Jun'21, when international oil prices went up from US$ 50/bbl to US$ 72/bbl, OMCs share fell to 3.5% from 4.9%. Centre's share continued to go down from 39.7% to 34.4%. States' share was retained at 23.1%, due to Rs 2.9/lt increase in VAT. Miscellaneous component was more or less in line at 4.3% in Jun'21 against 4.9% seen in Dec'20. Oil suppliers' share rose to 34.7% from 27.5%.
- For the period Jun'21 to Mar'22, when international oil price increased from US$ 73/bbl to US$ 98/bbl, share of OMCs in retail price continued falling to 1% from 3.5%. Oil suppliers' share went up from 34.7% to 49.3%. Centre's share again fell to 29.2% from 34.4%, on account of Rs 5/lt cut in excise duty. States' share fell to 16.2% from 23.1%, due to Rs 6.6/lt cut in VAT. Notably this is the only period in our analysis where States VAT cut was observed.
- Between Mar'22 to Jun'22, when international oil price reached its high of US$ 119.8/bbl in our period of analysis, OMC's share in retail price went down to -1.8% from 1%. The negative share is on account of higher converted international crude price (taking into account the spot exchange rate and spot international crude price as on date) compared to the base price charged by OMCs. Oil suppliers' share increased to 60.8% in Jun'22 from 49.3% in Mar'22. Centre's share went down to 20.6% from 29.2%, following Rs 8/lt cut on excise duty in petrol. States' share was retained at 16.2%, with 21paise increase in VAT during the same period.

It's often a matter of conjecture on how the oil burden is distributed when prices move up or sown. This is so as the supplier's price is fixed exogenously and there is little control over this element. While taxes are decided at the centre and state levels, their responses have been measured and calibrated. The centre has lowered the excise duty rate twice, while different states have followed varied tax structures depending on the fiscal space that is available. Needless to say, the onus of adjustment is on either the OMC or retail customer on an ongoing basis. However, once it was decided to peg the retail price, the onus has shifted to the OMC. Hence while the retail consumer may say that with global crude oil price coming down, there has been no change in the final price paid, the OMCs would justify their gain on grounds of having absorbed the higher cost earlier when the price of crude increased.

Even in the past, when oil prices were hovering around US$ 75-80/bbl, the share of OMCs in retail price of petrol ranged between 6-12%. Currently at US$ 75/bbl, the share of OMC is at 19.1%. We believe, this is unlikely to change, instead some increase in share of OMCs might be visible with fall in oil prices in the near term, to recoup the earlier losses.

Is investment taking place?

A question often asked is as to whether or not the investment cycle has resumed in India. There are proxies used to denote whether or not companies are investing. Growth in bank credit or issuances in the debt market are good indicators on the funding side. But, at the end of the day we should see assets in the form of machinery or buildings coming up. Construction is another indication of investment being made, which is largely under the domain of the government which funds such activity. One way of figuring this out is to see how companies have

invested in fixed assets. Here, the balance sheets of companies can be used to ascertain if their stock of gross fixed assets plus capital work in progress has increased over time. Information on assets is available for year ending September 2022 and the analysis here looked at year on year growth rates for increase in GFA (including capital work in progress). The sample used was quite comprehensive as it covered over 3700 companies.

The sample 3,771 companies showed the progress in GFA which witnessed an increase from Rs 31.76 lakh crore as of September 2018 to Rs 36.34 lakh crore in September 2022, with the value remaining virtually stagnant as of September 2020. The CAGR for this period was 3.4%. On an annual basis however, there appeared to be some traction with growth for September 2021 being 3.5% and September 2022 being 4.9%.

Which industries make big investments?

While all companies need to invest to expand production, there has tended to be concentration in certain sectors. The chart below shows that companies in the infrastructure sector accounted for 50% of total GFA of the sample companies. The three sectors, crude oil (24.2%), Power (16.7%) and telecom (10.9%) led the pack followed by iron and steel with 9.9%. Therefore whenever one is to gauge the investment climate it would be essential to see what these Big-4 industries are doing in terms of expansion. The auto sector is the fifth largest sector that has potential to push the needle with a share of 4.8%. Presently there have been problems first on the supply side due to availability of semi-conductors during this period; and on the demand side due to growth slowing down due to high inflation which has come in the way of purchasing power.

ECB Profile

ECBs have been a very useful source of funding for Indian corporates. Given that global interest rates tend to be lower than those prevailing in India, there is a distinct advantage for companies. There is of course the currency risk which is involved when such a decision is taken as often hedging the debt service component can make it less attractive. There has however been an increase in such loans and the purpose here is to examine some aspects of these borrowings reckoned so far this year against the background of how these inflows have increased over time.

ECB registrations

The pattern is one where there was a decline during 2012-17 after which it increased to peak at $ 52.9bn in 2019-20. However, subsequently there was a decline and in the first 10 months of the current financial year was just $ 21.5bn compared with $ 32.5bn during the same period of FY22. Three factors have contributed to this tendency in FY23. **First,** global interest rates have increased with the Fed raising rates several times to 4.50-4.75%. **Second,** the rupee has been volatile with a decline of around 7.5% till February end. **Third,** the pace of investment has also slowed down leading to lower demand for funds by industry. This can also be seen in terms of slowdown in growth in credit.

The major takeaway is that it is possible for the economy to raise over $ 50bn from this market if conditions are favourable. Given that India gets around $ 80-85bn as FDI, this amount is quite significant in terms of managing the balance of payments. In this period the share of ECBs in total external debt has been more or less stable though has increased from 33% to 36%.

What has been the purpose of such borrowings?

The table below gives the purpose of raising ECBs. Interestingly a third of the total is being raised for on-lending purposes while nearly 14% is for new projects and another 11.5% for capital goods. Almost 13.7% is being used

for refinancing loans (both rupee and ECB) while 10.3% is for local sourcing of capital goods. Quite clearly almost half of the ECBs are being used for financial purposes (refinance and on-lending) and are not directly linked with physical goods. Around 25% is for direct investment purposes.

Where are ECBs sourced from?

Almost 62% of the total approvals are loans from commercial banks which can be both branches of Indian banks overseas as well as foreign banks. The capital market is not favored much with the share being just 6.2%. The credit rating of the economy would play a role here and given that it is BBB (-), would mean higher borrowing costs for companies. Foreign collaborations including equity investors had a share of 19.4%

Which industries have been borrowing though this route?

The financial services segment led with share of nearly 37%, followed by coke and refinery products with 11%. Hence two sectors accounted for almost half of total ECBs. Telecom had share of 8.5% and electricity, gas, 6.7%. Interestingly, all the leading sectors are those in the infrastructure space where the cost of borrowing tends to be lower than when procured from domestic sources.

As India moves towards attaining the goal of achieving the $5 trillion economy, there would be need for the investment rate to increase. For this to materialize companies would have to look at various alternative modes of financing. The ECB route looks attractive and would be explored more by corporates in the coming years. As we come to the end of the present interest rate cycle, the movement would now be downwards, probably from 2024 onwards. This would make such funding relatively cheaper though the currency risk would have to also be buffered in. As these registrations have crossed the $ 50bn, there is scope to progressively increase the quantum towards the $ 70-75bn mark to keep pace with the rising demand for funds.

Is South-Asia on the brink of a crisis?

The recent economic crisis in Pakistan is vividly reminiscent of a similar crisis in Sri Lanka just last year. Even more alarming is the fact that many of India's neighbours are facing a similar set of economic challenges. Apart from Pakistan and Sri Lanka, even Bangladesh and to a lesser extent Nepal have been grappling with increased economic instability in recent times, in the form of weak external buffers and high domestic inflation. In fact, the similarities are eerie. The dual shock of the Covid-19 pandemic and the Russia-Ukraine war brought the external vulnerabilities of these countries to the fore, which was compounded by short-sighted, and sometimes politically motivated government policies. Consequently, several of these countries are now scrambling for forex resources to 1) fund imports, 2) boost forex reserves, and 3) avoid debt default. All of these countries are in advance stages of talk with the IMF for securing the same.

Pakistan's economic crisis: Years in making?

The economy has been suffering with ballooning of trade deficit and rising import bills, while exports remain stagnant. Foreign exchange reserves have shrunk. Pakistan largely imports commodities for its domestic consumption. ADB back in Feb'22 had noted that Pakistan had the lowest trade to GDP ratio in the World, a valid cause of concern. PKR has crashed and had been trading at 283/dollar. A large number of industries have halted production and even supply chain movement has stopped. Floods added a bigger blow to this ongoing economic meltdown with the destruction of cotton crop-biggest commodity that the country exports.

Geo-political background: The crisis in Pakistan is attributed to multiple factors starting with the political inability to break off from the group of powerful vested interest groups. The country also lacked political will and gave

undue privileges to a few elite group in the form of tax breaks and access to easier capital. Heightened polarization, coupled with political instability and catastrophic floods in 2022 added to an already precarious economic situation. This, in addition to piling up of debt and short sightedness of policy makers and accelerating inflation has pushed Pakistan on the brink of the worst economic crisis that it has ever seen.

Devastating floods added to the burden: The economic crisis in Pakistan had been brewing prior to the flooding calamity. The disastrous floods in CY22, complicated the economic woes. The country received 190% of its normal rainfall in the months of Jul and Aug'22. There were some areas (such as Baluchistan and Sindh) which received as much as 450% more than normal rains. It had a ravaging impact across the country with over 4mn acres of agriculture land, 13,000 km of highway and 2mn homes damaged as a result.

The estimated cost of rehabilitation and reconstruction stands to the tune of US$ 16.3bn as per the World Bank. These exclude the requirement of new investment and measures needed to support the economy and making it resilient to future climate shocks. According to Brookings, the recovery needs are estimated at 1.6 times of the budgeted national development expenditure. As per estimates, the floods directly resulted in the loss of 2.2% of GDP in FY22. Agriculture sector suffered the biggest decline of 0.9%. There was a widespread destruction of food crops as well as cash crops such as cotton, which forced the country to rely on imports, thus pushing it into a balance of payment crisis.

Balance of payment crisis: Foreign exchange reserves with Pakistan's central bank have fallen sharply in the last few months. From about US$ 17.3bn at the end of Jun'21, forex reserves declined to just US$ 9.8bn at the end of Jun'22 and further to US$ 3.1bn by Jan'23, which is estimated to cover less than 3-weeks' worth of imports. While there has been some upward momentum lately, foreign exchange reserves continue to hover around precarious levels. As has been mentioned earlier, the devastating floods of 2022 played a significant role in this. Textile exports form an important source of employment as well as dollar inflows into the country. Pakistan's trade deficit swelled to US$ 39.7bn at the end of fiscal year ending Jun'22. Concomitantly, remittances inflows dried up. As per reports, remittances accounted for ~9% of Pakistan's GDP in 2022, and are also a major source of foreign exchange. In the period Jul'22-Jan'23, remittances have fallen by 11% on a YoY basis to US$ 16bn.

Exchange rate in a free-fall: Pakistan had also been spending its forex reserves to keep its currency from depreciating. To fulfill the IMF conditions to move towards a market-based exchange rate, Pakistan allowed the removal of unofficial caps on the exchange rate. This was aimed at removing the distortions in the market and bring parity between the different rates (official rate, rates by foreign exchange companies and the black market rate). The rapid depreciation of the exchange rate is further fuelling inflation.

Inflation at multi-decade high: Inflation in Pakistan hit the double digit mark in 2022, accelerating to 19.7% compared with 8.9% last year. Price pressures have intensified further with inflation jumping to a five-decade high of 31.5% in Feb'23 owing to higher prices of food and energy commodities. This has prompted the State Bank of Pakistan to hike policy rates by 300bps to 20%; highest policy rate in 27 years. There are expectations of further rate hikes, as inflation is likely to remain elevated.

Economic meltdown: Barring FY20, when the country witnessed negative growth of 0.9% on account of Covid-19 crisis, Pakistan's economy had been growing at a healthy pace. Growth rebounded in FY21 to 5.7% and then to 6% in FY22. However, with the current economic downturn, the economy is expected to grow at a much more subdued pace. IMF in the World Economic Outlook has projected Pakistan's economy to slow down to 2% in the current fiscal year. Next year, the economy is expected to rebound by 4.4%. World Bank has also pegged Pakistan's growth to slow down to 1.7% in the current fiscal.

Response from International community: Pakistan is looking at securing funding to strengthen its forex reserves. One of the key avenues for this is through safeguarding IMF loan, which will help it to fill the financing gap. In 2019, Pakistan signed a US$ 6bn loan programme with the IMF which was further expanded to US$ 6.5bn, based on fulfilment of certain conditions. Pakistan received a US$ 1.2bn tranche in Aug'22 and is now desperately trying to secure the next tranche of US$ 1bn. However, IMF has been steadfast in ensuring that the conditions of the agreement are being met before disbursing the next tranche

Way out: Some experts have made suggestions and corrective approach to counter the impact of the crisis in the following ways: The government can collect ~PKR 100bn by taxing provinces on property, land and agricultural income; Another suggestion has also been made to levy levying a special emergency tax on vehicles; Further, electricity tariff on residential properties can also be increased to mobilize revenue; Out of the total defense budget, non-combat defense budget can be trimmed down; Additionally, downsizing the federal government or by moving divisions that manage subjects that have been transferred to provincial governments can also bring in more resources; State land to be sold via public auction mandatorily only and ban to be put in place on any land allotments; Formation of a privatization programme.

Bangladesh: An all too familiar story?

A similar situation is evolving in Bangladesh as well. Fueled by an increase in global commodity prices due to the Russia-Ukraine war, imports have risen. This has led to a depletion in foreign exchange reserves, depreciation of the exchange rate and double-digits inflation. It must be noted that Bangladesh is an import driven economy which relies heavily on import of fuel as well as many essential items. In fact, Bangladesh imports more than 95% of its energy. On the other hand, its export basket is heavily skewed towards textiles, particularly of ready-made garments (RMG), which depends on external demand conditions which have tended to be volatile. Worsening the current account dynamics, remittances which are an important source of funding for the CAD have also fallen in recent months. Just like Pakistan, availability of better exchange rate at the black market has pushed expatriates towards these channels. Even in the capital account, reduction in foreign direct investment (FDI) flows have further exacerbated the misbalance in the balance of payments, putting Bangladesh in a capricious situation.

However, the government has been proactive in managing the impending crisis. To protect the declining reserves, the government put a ban on non-essential imports and reduced the supply of dollars to commercial banks. Following in the footsteps of the crisis struck Sri Lanka and Pakistan, Bangladesh became the third South-Asian nation to seek help from IMF. However, unlike Sri Lanka and Pakistan, Bangladesh did not sought a "bailout package", but a "stabilization package" and successfully secured it. In Jan'23, IMF approved a US$ 4.7bn loan programme for Bangladesh. One of the factors working in favour of Bangladesh is that its external debt commitments are much more comfortable when compared with Sri Lanka and Pakistan. At around 12% of GDP, Bangladesh's external debt to GDP ratio is well within the IMF mandate of 40%.

Is Nepal headed the same way?

Nepal too faces the same problems. Apart from depleting foreign exchange reserves, depreciating currency and soaring inflation, the country also faces a severe liquidity and banking crisis. In the aftermath of the Covid-19 crisis, while credit growth improved, deposit growth lagged behind. This led to a shortage of loanable fund with the banks. On the other hand, asset quality of banks deteriorated, due to a decline in the repayment capacity of borrowers amidst higher lending rates and rising leverage. As a result, several banks were merged.

Further, remittances which account for about 25% of Nepal's GDP have been impacted ever since the Covid-19 pandemic. The state of government finances too is not rosy. Government revenue generation has trailed its expenditure, as most of it is import based. However, as per the latest IMF assessment, the conditions in Nepal have improved. Credit growth has moderated on the back of rate hikes by the Nepal Rastra Bank. Inflation too has softened. Further, with improving global growth, remittances receipts have rebounded leading to easing pressures on the external front and a stabilization of forex reserves.

Sri Lanka: Out of the woods?

Sri Lanka was amongst the first South-Asian country to show signs of economic stress as it grappled with sky-high inflation and grossly inadequate forex reserves which led to shortage of basic essentials such as food, medicines and fuels. As we had discussed earlier, a combination of adverse external shocks in the form of the Covid-19 pandemic, along with ill planned policies by the government were the key contributors of pushing the economy to the brink of collapse. This ultimately culminated in the country defaulting on its debt obligations in Apr'22.

Since then, the government has continued to make efforts to secure funding from external sources including the IMF. It is currently awaiting the approval of a US$ 2.9bn bailout package from IMF and is working on meeting the conditions set out in the agreement. Some of these condition which are already being met include: increase in taxes and power tariffs, raising policy rates to control inflation and moving toward a market-determined exchange rates. It is to be noted that IMF has set out similar conditions for Pakistan as well. The country has also received considerable support from the global community. So far, India has provided about US$ 4bn to Sri Lanka as assistance. It has also received financing assurances from Paris club of creditors as well as Saudi Arabia and China, which will help secure the IMF package.

Disinvestment potential

In the previous fiscal year (FY23), we noticed that disinvestment receipts had been running much behind the revised target also. Compared with FY23RE of Rs 50,000 crore, government had garnered only Rs 31,000 crore as of Jan'23. In this brief analysis we looked at the potential resources that can be collected through disinvestment working on the premise that the government continues to hold 51% share in all the PSUs including those in the financial sector. This will indicate the maximum amount that can be raised without any change in ideology of government ownership at current market prices. However, as this theoretical scenario does not take into account strategic and non-strategic sectors/companies, the numbers stated below should be read with caution.

Current disinvestment target and status

Every year government announces a disinvestment targets in its annual budget presentation. For instance, for FY23, initially budgetary target was set at Rs 65,000 crore which later brought down to Rs 50,000 crore. For FY24, the target has been set at Rs 51,000 crore. In FY23, government collected Rs 35,294 crore in disinvestment receipts and a bulk of it came from LIC's IPO (Rs 20,516 crore), thus missing the revised target also for FY23.

Potential kitty

The list of companies chosen for disinvestment each year is strategically determined, based on government's overall governance agenda (minimum government, maximum governance), the extent to which the sectors are critical and market conditions. In this note, we undertook a hypothetical exercise to determine what can be the potential size of disinvestment receipts if government was to divest its stake in all PSEs, PSBs and insurance

companies up to 49% thus retaining control with 51% shareholding. The data had been taken from the website of Department of Investment and Public Asset Management (DIPAM). The market capitalisation along with the current shareholding of the government was based on the closing price of 8 Mar 2023 as specified on the website.

Non-Bank PSEs

Amongst the 53 PSEs under the ambit of the central government which are listed, maximum dilution (above 35%) is possible in 10 companies, namely: KIOC ltd, Scooters India Ltd, HMT Ltd., ITI Ltd., ST trading corporation, Fertilizers and chemicals Travancore Ltd, MMTC Ltd., Andrew Yule and Company Ltd, ITDC and SJVN Ltd. However, the revenue earned from these will be limited (Rs 24,929 crore) as their current market capitalisation is low. On the other hand, maximum revenue potential (based on current M-cap) exists from dilution in companies, such as Hindustan Aeronautics Limited, Coal India, ONGC and Indian Railways Finance Corporation which can potentially raise around Rs 75,000 crore.

Financial Institutions

Amongst the 16 banks and other financial institutions, we excluded LIC (as stake sale has already taken place and there are indications that there may not be any further sale in the near future) and IDBI Bank (GOI's share is already lower than 51%) from our analysis. Amongst the remaining 14 entities, maximum dilution (above 40%) can be made in Punjab & Sind Bank, Indian Overseas Bank, UCO Bank, Central Bank of India and Bank of Maharashtra. The revenue earned from dilution of stake in these can amount to Rs 62,471 crore (based on their current M-Cap). Other major PSBs which have high market capitalisation, can give the government over Rs 1 lakh crore of revenue if stake in those banks is lowered to 51%. Banks and insurance companies have potential of around Rs 1.8 lakh crore of disinvestment without affecting the public nature of the enterprise.

Concluding remarks

The above analysis shows that potential kitty for disinvestment receipts if government decides to bring down the stake in all PSEs, PSBs, other financial institutions to 51%, would be at ~Rs 3.5 lakh crore. Of this, Rs 1.7 lakh core can come from PSEs and Rs 1.8 lakh crore from financial institutions. However, as the stake of the government comes down there would also be lower dividend inflows from these enterprises. Currently, dividend earned from all PSEs (bank and non-bank) stands at Rs 50,000 crore. At the present level of the Sensex, total market capitalization of government holdings in these enterprises (PSEs and FIs) is around Rs 17 lakh crore. Bringing down the stake to 51% across the board would be releasing around Rs 3.5 lakh crore. This implies that the dividend yield stands at around 3.0%.

State Borrowings in FYTD23

Actual state borrowing for FYTD23 (as of 28 Feb 2023) cumulatively was way behind the actual target for the year. Amongst different tenors, securities with tenor of more than 10 and 15 years are a much preferred alternative than the securities with tenor less than 10 years. In the recent months, cost of raising funds had also become expensive, with states having to pay more for their market borrowing. The 10Y G-sec yield had edged upwards following global cues. RBI too is likely to continue with the monetary tightening if inflation doesn't cool off in the near term.

Actual versus Planned Borrowing

- In FYTD23 (till 28 Feb 2023), states borrowed Rs 6.19 lakh crore, at par with the amount raised last year during the same period. This was 62% of the total supply (Rs 10 lakh crore) announced for the whole year.
- Notably, states borrowed much higher this year (Rs 6.19 lakh crore) than last year (Rs 6.14 lakh crore) for the same period. States raised the maximum amount in the month of Feb'23 in FYTD23, to the tune of Rs 84,220 crore.
- Amongst states, Maharashtra, Uttar Pradesh and Madhya Pradesh are far off from their borrowing target for FY23. Actual borrowing for Tamil Nadu has only reached the half way mark at Rs 73,000 crore against a planned borrowing of Rs 1.4 lakh crore.
- Also states like West Bengal and Uttarakhand are not expected to meet their planned target in FY23.
- States such as Andhra Pradesh, Haryana, and Himachal Pradesh are relatively closer to their mark.
- There are also states that have already exceeded their planned target. These include, Assam, Meghalaya and Jammu & Kashmir.

Average Cost

The average cost amongst states have registered marginal difference. The weighted average yield for state bonds had risen, resulting in states having to pay more towards their market borrowing. Notably, the highest cost was been borne by states like Rajasthan, West Bengal, Telangana and Goa with weighted average yield at 7.76%, while the lowest is at 7.47% for Meghalaya. On the other hand, the weighted average yield for the 10Y paper for all states was at 7.68%. In comparison, the 10Y G-sec for FYTD23 has averaged around 7.32% (31st Mar 2022 to 28 Feb 2023).

The 10Y yields did harden this year on the back of the global cues with aggressive tightening by global central banks. Fed is expected to continue to keep rates elevated for a while. On the domestic front, higher inflation continues to remain a cause of concern.

Tenor

In particular, the 10 Years securities account for 30.1% share followed by securities maturing in over 15 years with a share of 29.5%. States such as Rajasthan, Punjab, Telangana and Tamil Nadu are prime examples of the same. On the other hand, states such as Haryana and Maharashtra have preferred 6Y, 7Y and 8Y papers. Andhra Pradesh is an exception which prefers 6Y, 7Y and also 18Y as well as 20Y papers.

Data Releases

Currency outlook: Further downside for INR likely

Driven by a weakness in DXY, global currencies appreciated. Volatility remained high amidst turmoil in global banking system and Fed policy meet. INR appreciated by 0.7% in Mar'23 amidst promising global as well as, domestic fundamentals. In FY23, INR depreciated by 7.7%, after depreciating by 3.5% in FY21. Increased expectations of a rate cut by Fed in the second half of CY23, will keep DXY under pressure. On the domestic side, a moderation in imports has kept trade deficit in check. Lower oil prices also bode well for the external sector outlook. Further, while merchandise exports have slipped, services exports have shown resilience suggesting that CAD is likely to remain in a comfortable range. While the stage looks set for a runaway appreciation in INR, we believe that the RBI is likely to maintain the exchange rate in the close range of 82-83/$, as has been the trend in recent past, as external demand remains weak.

Bond Market Round-up

Global bond yields fell sharply in Mar'23 following the banking crisis. The Fed's recent policy gave a slight dovish hint. This led US 10Y yield fell by 45bps on MoM basis. Other major global yields followed suit. India's 10Y yield fell by only 12bps. The yield on long end papers have remained broadly stable. What stands out in the yield picture is the flattening of India's yield curve. If we compare the 31 Mar 2023 yield curve with 31 Mar 2022, there is a sharp contrast. The current borrowing plan have finely managed issuances with major concentration towards the long end segment. Despite this, we expect the flattening of yield curve to continue. Liquidity deficit would further aggravate in Apr'23 with Rs 61,131crore maturity of TLTROs. Increased currency demand in the election year, fairly robust credit demand will also impact flows. Thus correction in short end papers is unlikely in near term. However, long end curve would get comfort from slightly softening inflation print in Mar'23 due to falling vegetable prices and favourable base. Discomfort to short end curve would further aggravate if the 25bps rate hike is materialised by RBI in the coming policy.

Core industries

India's eight core industries slowed down by 6% in Feb'23 after growing by 8.9% in Jan'23 on the back of broad-based moderation. Cumulatively, for the year, infrastructure index has eased to 7.8% this year (Apr-Feb'23) compared with a growth of 11.1% in the last year. Crude oil production contracted further to (-) 4.9% after declining by (-) 1.1% in Jan'23. Output of Coal, natural gas and refinery also took some beating and edged down by 8.5% (13.4% in Jan'23), 3.2% (5.3% in Jan'23) and 3.3% (4.5% in Jan'23) respectively. Electricity output too registered a much slower growth of 7.6% compared with 12.7% in Jan'23. With seasonal change, demand is likely to pick-up in the coming months. However, on the positive side, fertilizer output has registered an improvement, clocking a healthy growth of 22.2% in Feb'23 (17.9% in Jan'23). Cement production too advanced further expanding by 7.3% against 4.6% growth in Jan'23. Going forward, IIP growth is expected at 4.5% in Feb'23 on YoY basis from 5.2% in Mar'23.

Central government finances

Central government's fiscal data shows that on FYTD basis (Apr'22-Feb'23) fiscal deficit reached 82.8% of the targeted level versus 67.8% as of Jan'23 and 82.7% as of FYTD22. In terms of spending, capex spending by the government continues to be the bright spot, with 81.1% of the budgeted target utilized as of Feb'23 (FYTD basis) compared with 78.3% spent as of Jan'23. Revenue spending remains at par (83.9% as of Feb'23) with last year. On the income side, government has seen 12% increase in gross tax revenues till Feb'23, slightly down from 12.6% in Jan'23. Both indirect tax collections (8% as of Feb'23 versus 8.5% as of Jan'23) and direct tax collections slowed (16.2% versus 16.8%). Within direct taxes, both income tax and corporate tax collections have eased. However, centre's net revenue gathered momentum, as it was up by 10.6% compared with 4.4% as of Jan'23.

Borrowing calendar: Centre has finely managed its H1FY24 calendar

Centre has come up with its H1FY24 borrowing calendar. The borrowing plan for H1 is pegged at Rs 8.88 lakh crore which is 57.6% of overall borrowing plan of FY24. This share is lower than the long run average of 60.8%. Maturity wise concentration is skewed towards longer end securities, especially between 10-40 year papers. This is likely to keep yield of the longer tenor papers stable.

Post the borrowing calendar announcement, the 10Y benchmark paper's yield has been broadly stable at 7.32% (previous close: 7.29%). Even the yield on 30Y and 40Y paper is trading at 7.4%, only 4bps up from its previous trading session. Going forward, we expect that India's yield curve is likely to have a flattening bias. Short end papers, especially the 182 days and 364 days T-Bill rates are still quite elevated. Call rates are also nearing the MSF rate. Further, strain on liquidity is likely to continue due to year-end target meeting of various ministries. We don't foresee much volatility on the long end curve.

Based on our calculation, average interest cost of the Centre on all these securities translates to around 7.29-7.35% for the first half borrowing programme.

CPI remains above RBI's upper band

CPI inflation data edged down modestly to 6.4% in Feb'23 after moving up to 6.5% in Jan'23. For the second-month in a row, CPI data came in above RBI's upper tolerance band. Food inflation virtually remained steady at 5.9% in Feb'23. Stickiness of core inflation persists.

CPI food index continued to remain elevated at 5.95% in Feb'23 against 6% in Jan'23, on YoY basis. Amongst major food items, sharpest pace of increase was led by fruit prices which moved up to 6-month high at 6.4% in Feb'23 from 3% in Jan'23. Cereals continued to clock double digit inflation (highest in this series). Even milk prices also rose 8-year high in Feb'23. Pace of disinflation in vegetable prices went down. Notably, 5 out of 12 broad group of food and beverage noticed inflation above 6%.

Core CPI (excl. food and fuel) remained sticky at 6.1% in Feb'23 as well. Amongst major items of core, housing inflation accelerated to more than 3-year high to 4.8% in Feb'23 from 4.6% in Jan'23. Health inflation also rose to 10-month high at 6.5% in Feb'23 from 6.4%. However, some comfort has been seen with lower prices of gold contributing towards personal care and effect inflation going down to 9.4% from 9.6% in Jan'23. Transport and communication and education have also registered moderation. Amongst the 8 major broad group of core inflation, 4 of the items have remained above 6%.

WPI cools down further

Headline WPI moderated to 25-month low of 3.9% in Feb'23 (BoB est.: 4.1%) from 4.7% in Jan'23. Food inflation eased only a tad to 2.8% in Feb'23 from 2.9% in Jan'23. Amongst these, inflation eased in food grains (11.8% versus 13%), eggs, meat & fish (1.5% versus 2.2%) and spices (12.5% versus 16.1%). Within food grains, cereal inflation moderated (13.9% versus 15.5%) on account of wheat (18.5% versus 23.6%). However, paddy inflation continued to inch up (8.6% versus 7.2%). Inflation in pulses was also seen ticking up in Feb'23 (2.6% versus 2.4%). At the international level, World Bank's pink sheet data shows that global paddy prices have begun to moderate in Feb'23 (15% versus 18% in Jan'23) and wheat prices are seen contracting (-3% versus 0%). Domestically, in case of vegetables, contraction in prices was slower (-21.5% versus -26.5%), while in case of fruits, pressure is seeing building up with inflation at 7% in Feb'23 versus 4.1% in Jan'23. Within vegetables, while inflation in potato and onion fell even more sharply in Feb'23, inflation in tomato is seeing an uptick (-13.5% versus -40.4%). Even milk inflation rose to 10.3% from 9%.

Fuel and power inflation in Feb'23 eased to 23-month low of 14.8% from 15.2% in Jan'23, owing to slowdown in the mineral oil index (15.8% versus 17.9%). On the other hand, inflation in coal and electricity index inched up. While coal inflation rose to 3.4% in Feb'23 from 2.6% in Jan'23, electricity index was up at 19.7% versus 16.6%. Mineral oil index tracked the trend in international crude prices, which slipped sharply in Feb'23 (-11.3%) compared with -1.8% decline in Jan'23.

Core inflation slowed for the tenth consecutive month in Feb'23 to 2.1% from 2.8% in Jan'23. Manufactured products inflation moderated considerably to 1.9% from 3% in Jan'23. Of the 22 commodity sub-indices, 13 indices rose at a slower pace in Feb'23 than Jan'23 led by basic metals, chemicals, textiles, computer and electronic products and electronic equipment. Within basic metals, prices of aluminum decelerated at a faster pace (-6.5% versus -5.2%), while it deceleration remained unchanged in case of zinc (-0.9%). Contraction eased a tad in case of lead (-1.8% versus -1.9%), while prices for copper noted an increase (1.1% versus -2.5%). On international level, as reflected in World Bank's pink sheet, prices of aluminum (-25.6% versus -16.8%), Zinc (-13.4% versus -8%), lead (-8.9% versus -5.6%) and copper (-10.1% versus -7.6%) continue to decline sharply.

IIP growth moderates

IIP growth edged upwards to 5.2% in Jan'23 compared with a growth of 4.7% in Dec'22. This was above our estimate of a 5.1% increase. This was led by manufacturing output rising to 3.7% in Jan'23 from 3.1% in Dec'22. Manufacturing sector gained momentum with over 14 out of 23 sub-industries registering improvement. Bulk of this gain was accounted by production of electrical equipment (13.6% versus -0.8%), beverages (13.4% versus 3.3%) and food products (8.3% versus 1.2%). Manufacture of coke (5.1% versus 2.1%) and chemicals (4.2% versus 2%) continued to clock higher growth. Slower pace of contraction was also noticed in manufacture of computers (-29.6% against -37%) and leather products (-0.4% against -11.4%). On the other hand, manufacture of wood products (-12.6%) and wearing apparel (-22.3%) disappointed. Production of pharma goods decelerated down to 9.2% (16% in Dec'22).

Electricity production accelerated to 12.7% against a growth of 10.4% in Dec'22. Moderation was seen in mining production at 8.8% against 10% in Dec'22. On a FYTD basis, IIP growth stands at 5.4%.

Within use-based, capital goods output accelerated to 4-month high to 11% in Jan'23 compared with a growth of 7.8% in Dec'22, led by government push. Primary goods output also improved to 7-month high to 9.6% from

8.4%. Intermediate and infra goods output eased down by 0.1% and 8.1% respectively. Output of consumer non-durable goods also registered moderation at 6.2% (7.6% in Dec'22) noting concerns over rural demand. On other hand, consumer durable goods output contracted at a much slower pace of (-) 7.5% in Dec'22 (-11% in Dec'22) signaling some pickup in domestic demand.

Concerns over global economic slowdown and elevated inflation remains tantamount to India's growth story too. Exports have been sharply hit as a result of the lackluster demand and is likely to remain worrisome in the coming months. This as result would also hit manufacturing growth, going ahead. Weakness in this sector was also witnessed as manufacturing PMI slowed down to 4-month low of 55.3 in Feb'23. Against the above backdrop, we expect IIP growth to be much lower than anticipated in H2FY24.

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