India Economic Outlook

Lower rates, liquidity to drive cyclical recovery

August 2019

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INDIA ECONOMIC OUTLOOK

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Lower rates, liquidity to drive cyclical recovery

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The downturn in global and domestic economy is mirrored in India's consumption, investment and export slowdown. A growth revival requires lower interest rates and liquidity. Transmission of RBI's rate cuts has started and PSB recap and liquidity for MSMEs and NBFCs will ensure a cyclical recovery in FY21. The global backdrop of lower oil prices favours dip in interest rates and inflation and a stable INR. Depreciation of Yuan remains a key risk. We see headroom for another 40bps rate cut by RBI in FY20 to support 7% GDP growth in FY21.

Investment and consumption slowdown: Consumption demand, the driving force behind India's growth, has exhibited lukewarm growth since Q3FY19 following a drop in discretionary buying. Investment demand too has decelerated due to lower aggregate demand, global slowdown and scarce credit.

Reviving the growth engine: RBI has reduced the repo rate by 110bps to 5.4% in CYTD19 and now provided ample liquidity at Rs 1.5tn (Aug'19). But transmission has been slow. With external benchmarking of loans this will improve and reduce loan EMIs, leaving a greater portion of incomes for consumption or savings/investments. This apart, Rs 100tn of investment is planned in the five years by the Centre to revive growth.

Reforms to lift growth to 7%: The Centre's revenue receipts rose 6.4% in Q1FY20. Indirect tax revenues were up 4%. A slowdown implies limited upside for revenue receipts. While fiscal stimulus may revive consumption in the near term, reforms such as improving 'ease of doing business', changes in the IBC Act, liquidity provision for NBFCs/ MSMEs, privatisation and PSB recap (Rs 700bn), Jalan committee surplus and excess provision transfer (Rs 1.76tn) are enablers that will revive growth to 7% in FY21 in our view.

Global backdrop favourable: Low global interest rates and oil prices set a favourable backdrop for India. Digitisation of the global economy opens up opportunities for India's digital ecosystem. Services exports, though decelerating, are holding up much better as the global services economy is outperforming the manufacturing economy

INR stable, yields to fall: Lower oil prices are a boon for the INR. FPI outflows typically do not last for more than 3-6 months. Another 40bps rate cut by RBI and lower domestic yields could kickstart growth, as was the case in 2003/2009.

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FY20 OUTLOOK

We expect India's economic growth to slacken to 6.5% in FY20 from 6.8% in FY19 as the rural demand slump dampens domestic consumption, a weak capex cycle saps investment demand, and the global downturn mounts pressure on exports. That said, the outlook brightens for FY21 as the RBI's dovish monetary stance, together with the government's economic measures and thrust on roads, power, infrastructure and housing development, could lend wings to a GDP growth recovery at 7%.

FY20 outlook: Bumpy ride yet hope simmers

After bottoming out in FY20, growth to accelerate in FY21

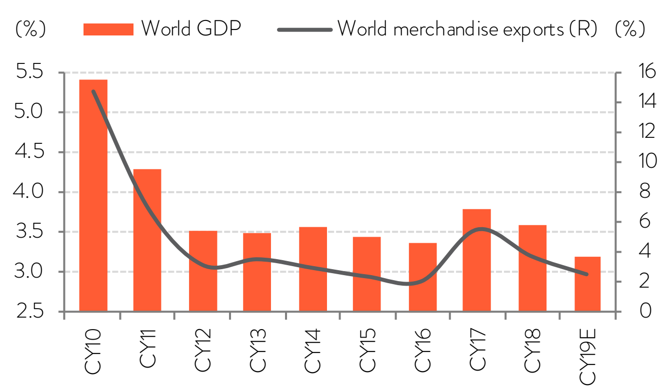
India's economy lost steam from H2FY19 onwards due to a mix of domestic and global factors that weakened GDP growth to 6.8% in FY19 from 7.2% in FY18. Anaemic rural consumption has been a key trigger of the slowdown. In addition, credit rationing in the wake of liquidity troubles at large NBFCs and HFCs also weighed on domestic demand. US-China trade war has impacted exports.

Recent economic data has not been encouraging either –

- Non-oil non-gold imports, a barometer of domestic demand, have fallen 5% YoY in Q1FY20 compared with an increase of 5.4% in FY19.
- Domestic auto volumes (passenger car) have skidded (-) 23% in Q1FY20 compared with 2% increase seen in FY20.
- Investment demand which was showing signs of revival also decelerated in Q4FY19. The year started on a lukewarm note due to lower capex by Centre. New private project announcements have also dropped off.

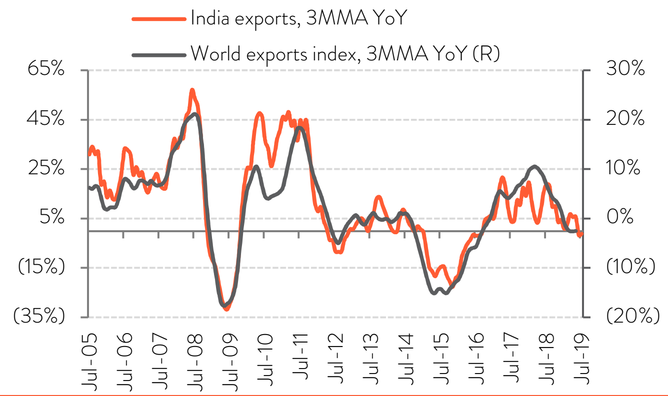
Globally, disruptive factors such as US-China trade war, financial volatility, slowdown in global demand along with waning effects of US fiscal stimulus have taken a toll on exports.

FIG 1 – GLOBAL GROWTH AND EXPORTS TO DECELERATE FURTHER



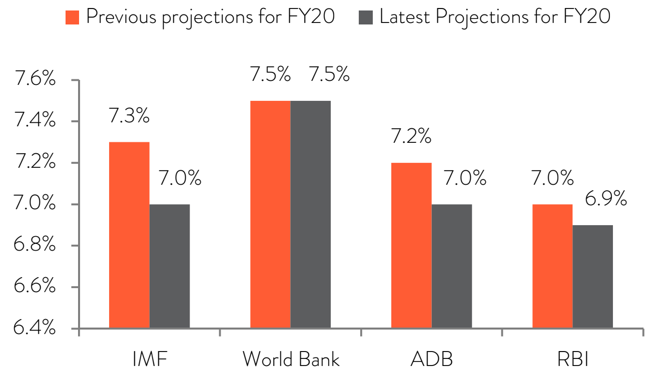
Source: CEIC, Bank of Baroda Research

FIG 2 – INDIA'S EXPORTS ALSO EXPECTED TO REMAIN WEAK



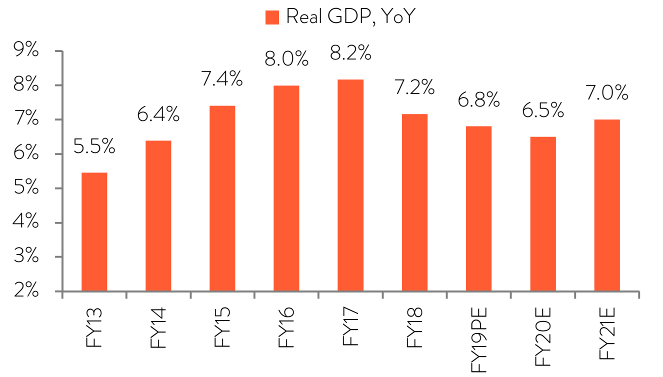
Source: CEIC, Bank of Baroda Research

FIG 3 – MAJOR AGENCIES HAVE DOWNGRADED INDIA'S GROWTH FOR FY20



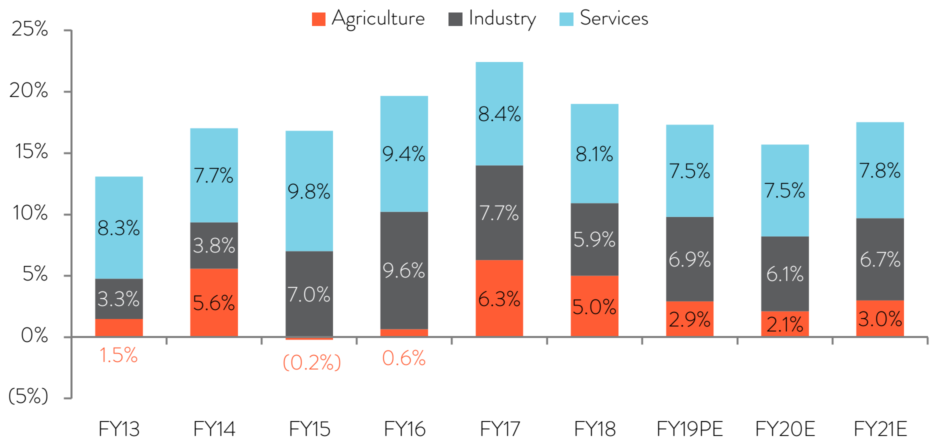
Source: Respective reports of IMF, WB, ADB & RBI

FIG 4 – WE EXPECT REAL GDP GROWTH TO SLOW TO 6.5% IN FY20…



Source: CEIC, Bank of Baroda Research| PE –Provisional Estimate | E – Bank of Baroda Estimates

FIG 5 – …AS INDUSTRY AND AGRICULTURE GROWTH WEAKENS



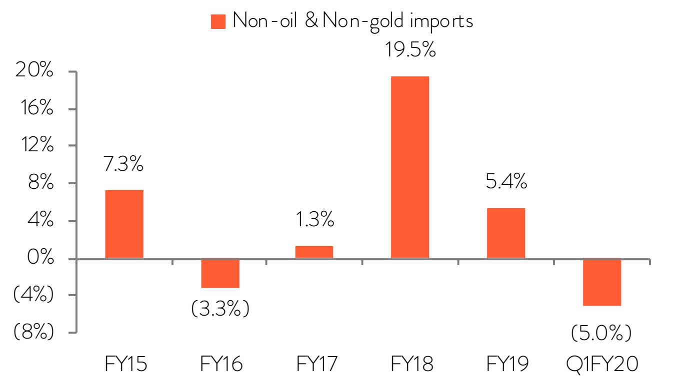
Source: CEIC, Bank of Baroda Research | PE –Provisional Estimate | E – Bank of Baroda Estimates

FIG 6 – GDP GROWTH TO REBOUND TO 7% IN FY21

Sectoral growth rate at constant prices (%)	Share	FY16	FY17	FY18	FY19PE	FY20E	FY21E
Agriculture	14.4	**0.6**	**6.3**	**5.0**	**2.9**	**2.1**	**3.0**
Industry	31.3	**9.6**	**7.7**	**5.9**	**6.9**	**6.1**	**6.7**
Mining & Quarrying	2.9	10.1	9.5	5.1	1.3	4.5	2.5
Manufacturing	18.0	13.1	7.9	5.9	6.9	5.5	6.8
Electricity, gas, water supply and other utility services	2.2	4.7	10.0	8.6	7.0	7.0	7.0
Construction	8.2	3.6	6.1	5.6	8.7	7.6	8.0
Services	54.3	**9.4**	**8.4**	**8.1**	**7.5**	**7.5**	**7.8**
Trade, hotels, transport, communication & services related to broadcasting	19.1	10.2	7.7	7.8	6.9	6.8	7.4
Financial, real estate & professional services	22.1	10.7	8.7	6.2	7.4	7.5	7.5
Public administration and defence	13.1	6.1	9.2	11.9	8.6	8.5	9.0
GVA at basic price	100	**8.0**	**7.9**	**6.9**	**6.6**	**6.3**	**6.8**
GDP	-	**8.0**	**8.2**	**7.2**	**6.8**	**6.5**	**7.0**

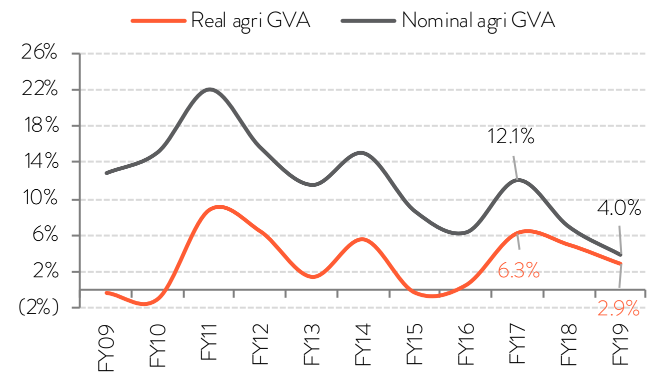
Source: CEIC, Bank of Baroda Research | PE –Provisional Estimate | E – Bank of Baroda Estimates

FIG 7 – NON-OIL NON-GOLD IMPORTS CONTINUE TO DISAPPOINT



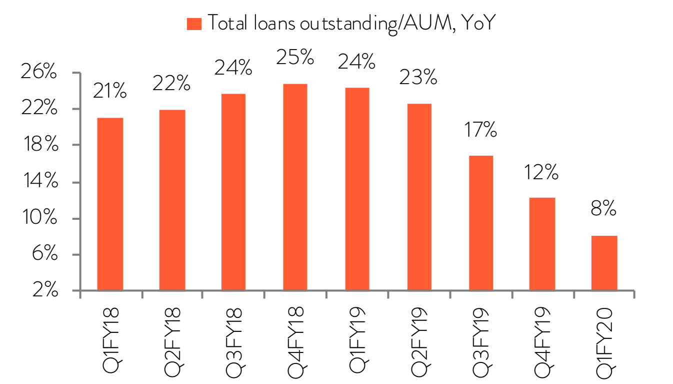
Source: CEIC, Bank of Baroda Research

FIG 8 – DROP IN AGRI GVA



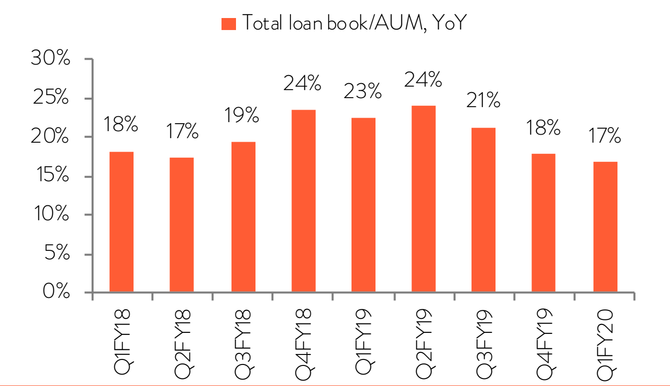
Source: CEIC, Bank of Baroda Research

FIG 9 – SLOWDOWN IN HFCs CONTINUES IN Q1FY20



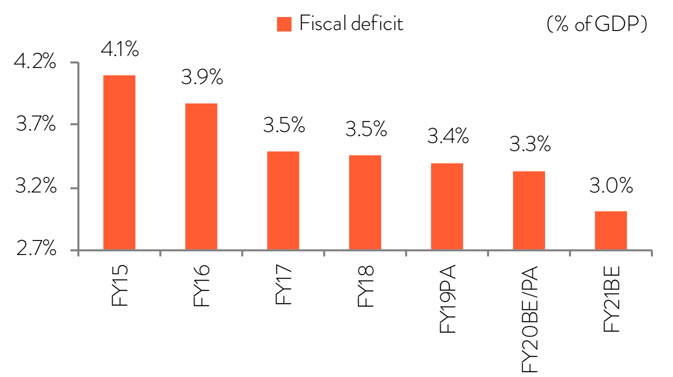
Source: HDFC, India Bulls Housing Finance, LIC, PNB Housing Finance, DHFL | Note: DHFL data till Q4FY19

FIG 10 – SIMILAR TREND IN NBFCs



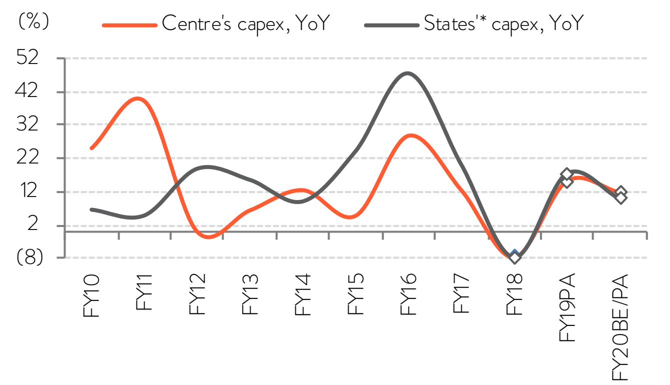
Source: Bajaj Finance, Shriram Transport Finance, Sundaram Finance, Mannapuram Finance, Mahindra Finance, Cholamandalam Inv & Finance

FIG 11 – CENTRE ON THE PATH OF FISCAL CONSOLIDATION



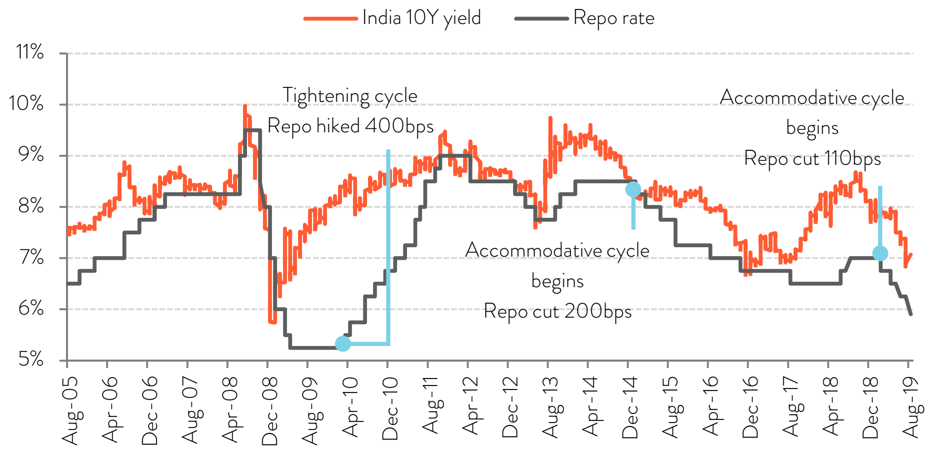
Source: Budget documents, Bank of Baroda Research | BE – Budget Estimates, PA – Provisional Actuals

FIG 12 – CENTRE AND STATE CAPEX SPENDING



Source: Budget documents, Bank of Baroda Research | Note: FY19PA – Provisional Actuals for Centre using CGA data and Revised Estimates for states | *Includes UP, Karnataka, Bihar, Odisha, Kerala, Tamil Nadu, Chhattisgarh, Rajasthan, Punjab, Haryana, Gujarat, W. Bengal, Maharashtra, AP and Telangana

FIG 13 – POLICY RATE AND 10Y YIELD ON A DOWNWARD TRAJECTORY



Source: Bloomberg, Bank of Baroda Research I Aug'19 10Y yield is as on 21 Aug 2019.

Rate cuts, reforms to spark recovery in FY21

In our view, lower interest rates could offer a way out of the current downcycle by easing the consumer loan burden (EMIs) and bringing down real interest rates in the economy – in turn opening up space for aggregate demand to increase. We see room for RBI to cut policy rates by another 40bps to 5% this year as inflation remains in check.

Structural factors such as lower oil prices (already down 13.7% in FYTD20) and high global & domestic food stocks will work in favour to keep inflation below RBI's target of 4%. An unconventional rate-cut cycle has already set in with the current MPC decision to cut rates by 35bps instead of the usual 25bps. More could follow suit depending upon the evolution of economic data.

Other economic measures of the government such as upfront release of Rs 700bn capital to PSBs, providing Rs 200bn additional liquidity support to HFCs, clearing of pending GST refunds of MSMEs within 30days, ensuring future returns to be sorted within 60days and withdrawal of enhanced surcharge on long/ short term capital gains, will support growth in the near term. Apart from this, reforms were also initiated towards easing tax compliance through faceless scrutiny, reduction in GST returns and addressing complaints through a centralised system.

Along with these, government's efforts towards increasing the flow of credit, in particular, to NBFCs (first loss of 10% to be borne by the government for additional disbursement of Rs 1tn) will also help in turning around the economy. So would the recent amendment to the Insolvency and Bankruptcy Act, privatisation of Air India and rapid digitisation of the economy. Reforms and structural trends should help take growth back to 7% in FY21, in our view.

CONSUMPTION

Domestic consumption, which until recently was the primary driver of India's growth, has slowed sharply amid rural distress, scarce market liquidity and low consumer optimism. While key indicators of consumption suggest further pain, we believe recently announced measures such as the government's direct income support scheme (PM-Kisan) and higher crop prices, together with a recent monsoon revival, would support the ailing consumption sector.

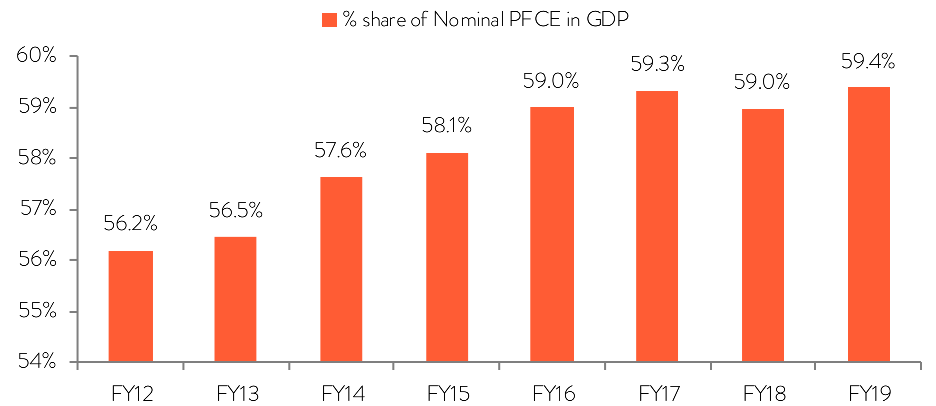
Consumption: India's growth engine slows

Decline in private and public demand

Consumption demand has been a key driver of India's growth since FY12. The share of private consumption in GDP has risen from 56.2% in FY12 to 59.4% in FY19. Within this, the share of services consumed has expanded to 49% of private final consumption expenditure (PFCE) compared with 47% of PFCE in FY12. FMCG goods in PFCE have however fallen to 40% from 43% earlier. Durable goods which were seem to be doing better are now showing signs of slowdown.

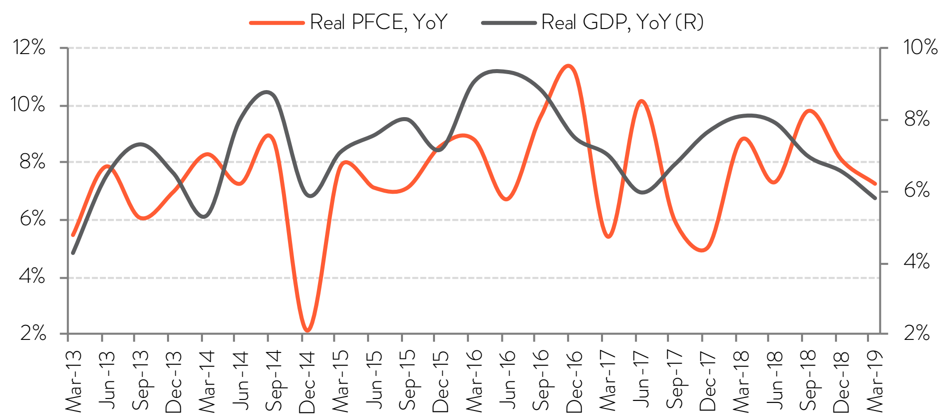
We have observed a marked slowdown in India's demand environment since Nov'18. Private consumption growth has decelerated from a high of 9.8% in Q2FY19 to 7.2% in Q4FY19. While the government did try to pick up some of the slack in the fourth quarter, full-year government consumption also slowed to 9.3% from 15.4% in FY18. This can be attributed to the paltry 6.8% increase in indirect taxes in FY19 vs. the 14.3% rise in FY18, due to a reduction in tax incidence on a number of goods and services under GST.

FIG 14 – SHARE OF PFCE IN GDP HAS RISEN…



Source: CEIC, Bank of Baroda Research

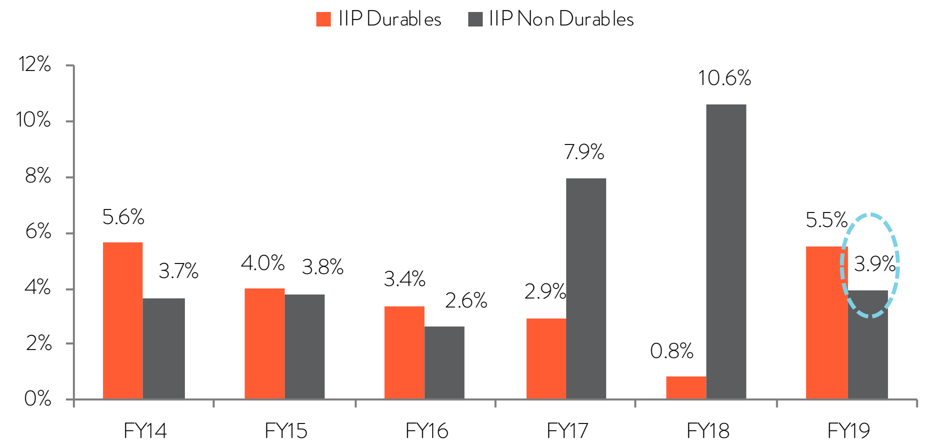
FIG 15 – …BUT REAL PFCE HAS BEGUN TO DECELERATE



Source: CEIC, Bank of Baroda Research

Non-durables hardest hit

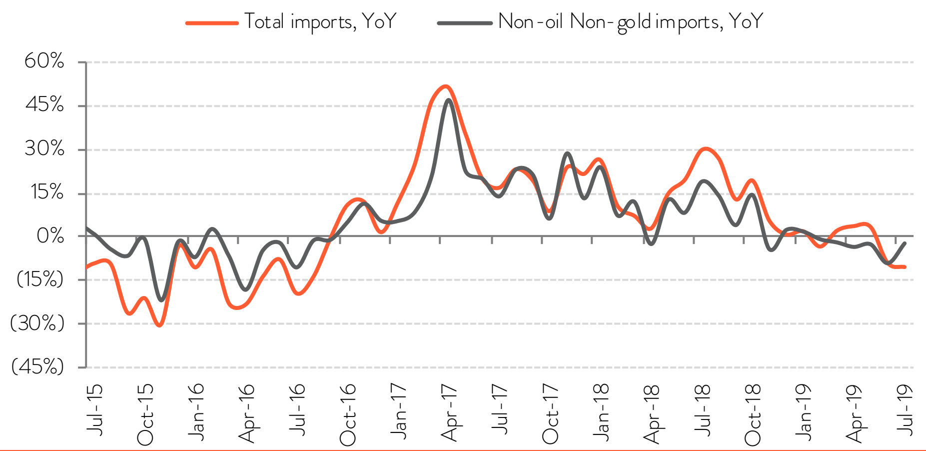
FIG 16 – GROWTH SLOWDOWN EVIDENT IN NON-DURABLE GOODS



Source: CEIC, Bank of Baroda Research

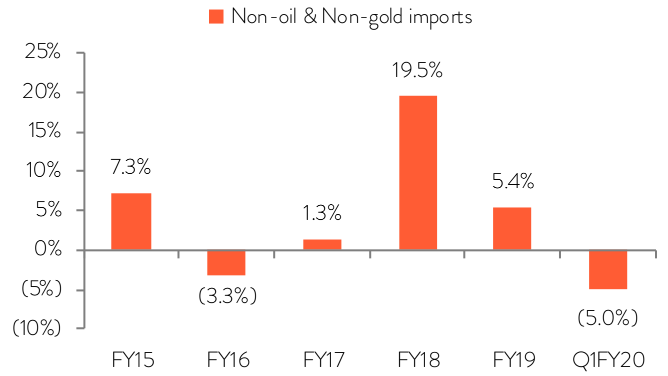
During H2FY19, growth in non-oil non-gold and electronic imports dipped to 1.4% and 3.2% YoY respectively compared with increases of 9.3% and 14.7% YoY in H1FY19. Full-year figures show a deceleration to 5.0% and 8.5% in FY19 for these two import categories from 19.5% and 23.2% in FY18 respectively. Non-oil non-gold imports saw further deterioration in Q1FY20, declining 5% YoY. A downturn is also visible in passenger car sales and air passenger travel – the latter being afflicted by both soft demand and a reduction in capacity.

FIG 17 – SLOWDOWN SET IN FROM NOV'18



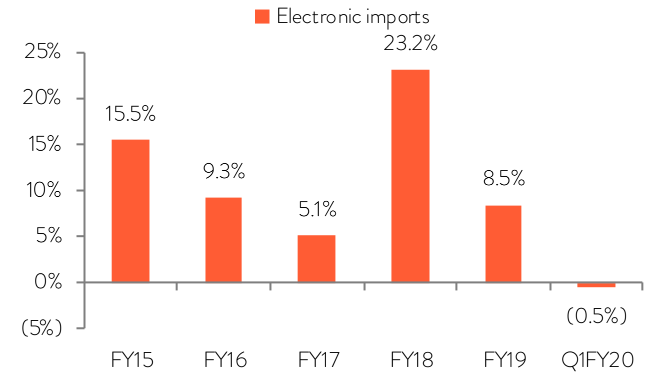
Source: CEIC, Bank of Baroda Research

FIG 18 – NON-OIL NON-GOLD IMPORTS SHOW SHARP DECLINE IN GROWTH



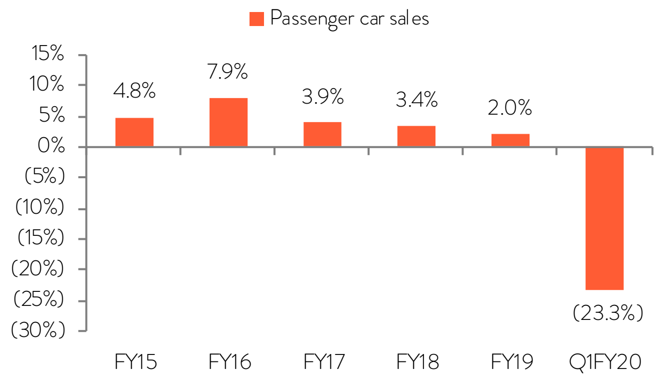
Source: CEIC, Bank of Baroda Research

FIG 19 – ELECTRONIC IMPORTS HAVE PLUMMETED AS WELL



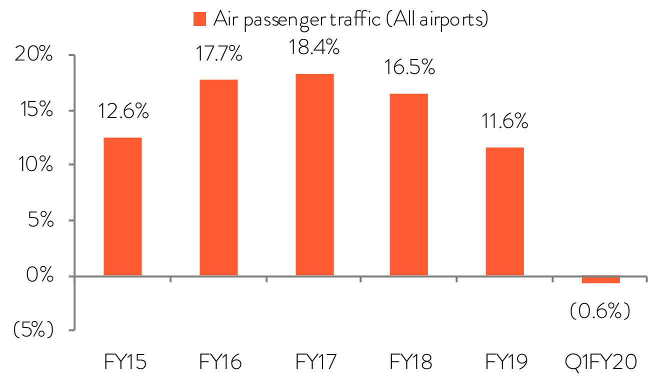
Source: CEIC, Bank of Baroda Research

FIG 20 – SIMILAR TREND IN PASSENGER CAR SALES…



Source: CEIC, Bank of Baroda Research

FIG 21 – … AND AIR PASSENGER GROWTH

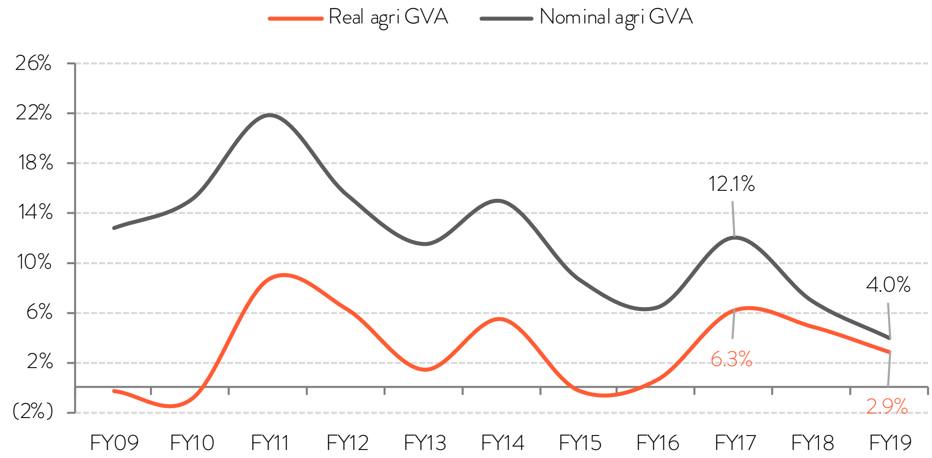


Source: CEIC, Bank of Baroda Research

Rural distress behind flagging demand

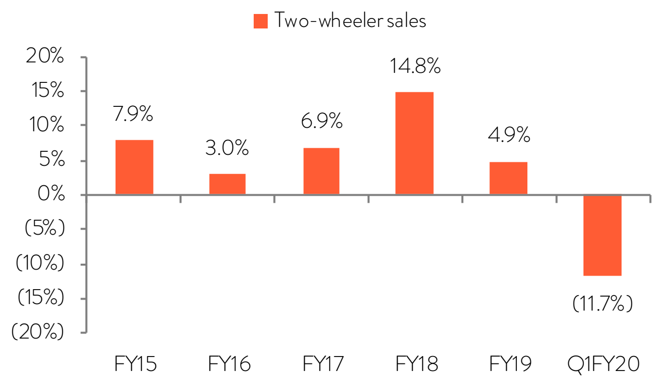
Agriculture which constitutes 39% of rural GDP grew by only 2.9% in FY19 vs. 5% in FY18 and 6.3% in FY17. In Q4FY19, growth declined to 0.1% YoY. In nominal terms, the agriculture sector grew just 4.0% in FY19 compared with 12.1% in FY17 and 7% in FY18. Lower agriculture income has stifled rural demand, clearly visible in the deceleration of two-wheeler and tractor sales growth to 4.9% and 10.2% respectively in FY19 from 14.8% and 20.5% in FY18. The trend has even continued in Q1FY20.

FIG 22 – AGRICULTURE SECTOR GROWTH MUTED



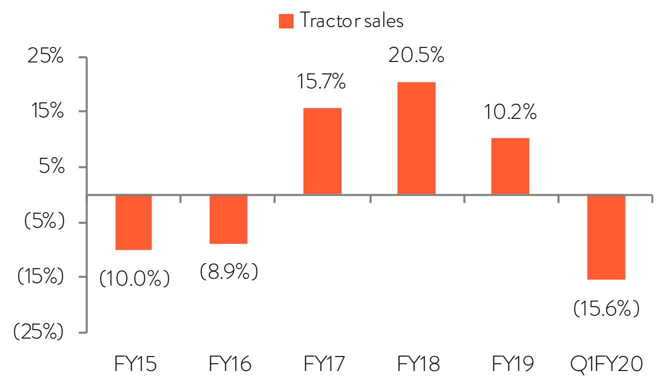
Source: CEIC, Bank of Baroda Research

FIG 23 – TWO-WHEELER SALES DECLINE SHARPLY



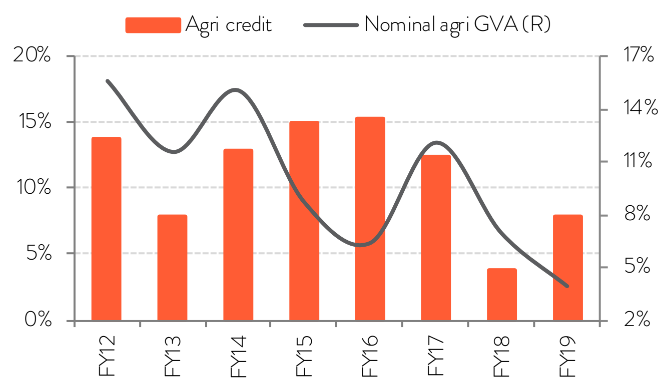
Source: CEIC, Bank of Baroda Research

FIG 24 – TRACTOR SALES ALSO FOLLOWING SUIT



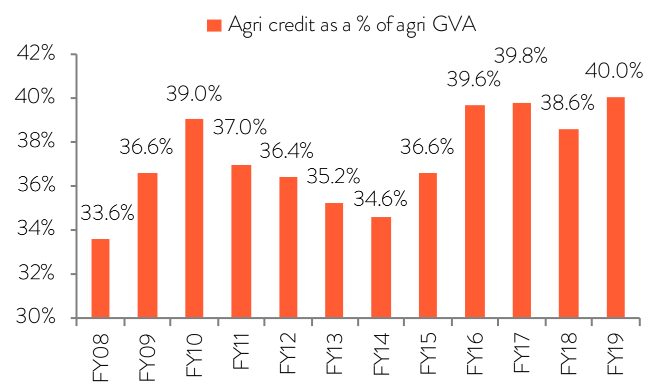
Source: CEIC, Bank of Baroda Research

FIG 25 – AGRI CREDIT SHOWING SOME SIGNS OF REVIVAL



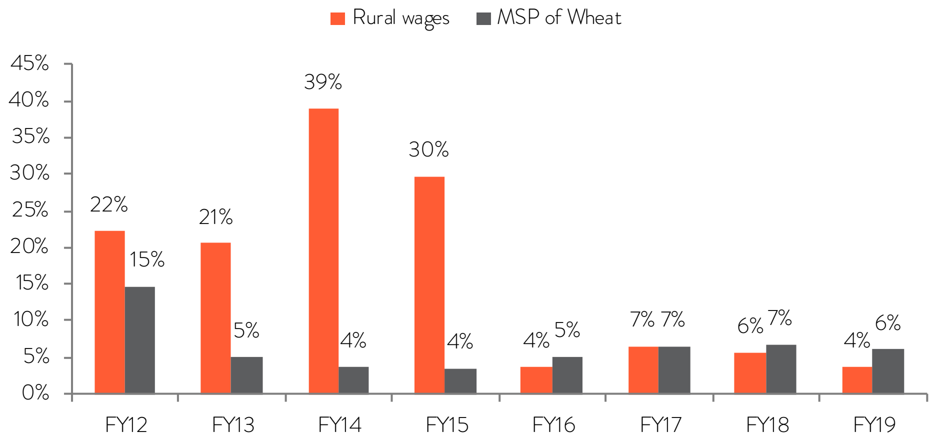
Source: CEIC, Bank of Baroda Research

FIG 26 – AGRI CREDIT GROWING FASTER THAN AGRI GVA



Source: RBI, Bank of Baroda Research

FIG 27 – RURAL WAGE GROWTH STAGNANT

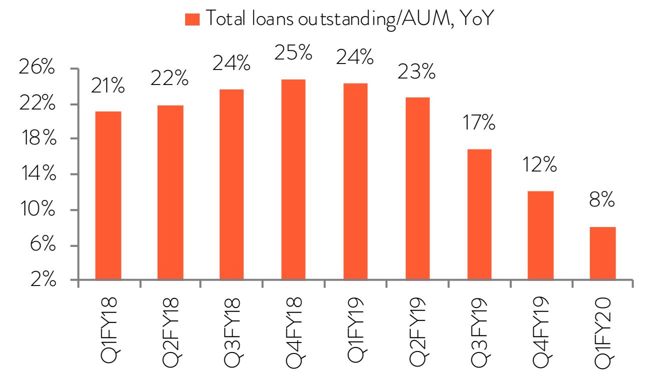


Source: CEIC, Bank of Baroda Research | Note: Average rural wages

NBFC liquidity crisis another key impediment

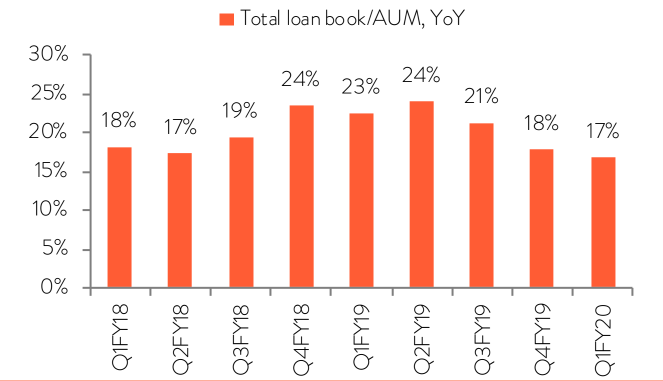
Apart from rural distress, another important reason for the consumption slowdown was the NBFC liquidity crunch sparked by the IL&FS imbroglio in H2FY19. This crisis curbed credit availability in the economy, in turn depressing demand. AUM growth for both HFCs and NBFCs declined to 8% and 17% YoY respectively in Q1FY20 from 24% and 23% in Q1FY19. Banks stepped up lending to fill in the gap.

FIG 28 – SLOWDOWN IN HFCs…



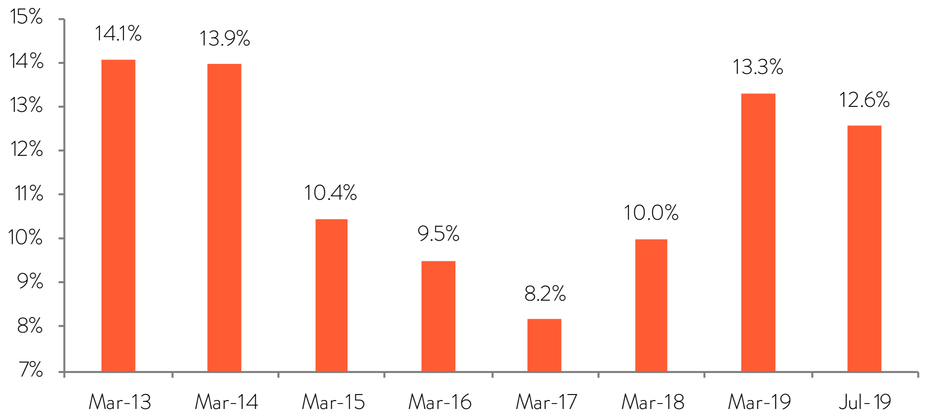
Source: HDFC, India Bulls Housing Finance, LIC, PNB Housing Finance, DHFL| Note: DHFL data till Q4FY19

FIG 29 – …AS WELL AS NBFCs



Source: Bajaj Finance, Shriram Transport Finance, Sundaram Finance, Mannapuram Finance, Mahindra Finance, Cholamandalam Inv & Finance

FIG 30 – COMMERCIAL BANK LENDING



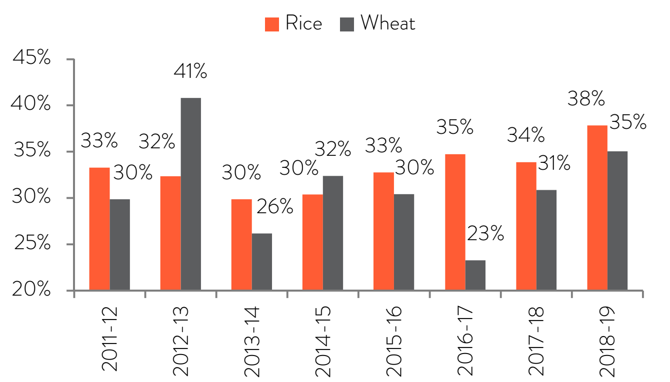
Source: CEIC, Bank of Baroda Research

Policy measures to encourage rural spending

Union Budget FY20 saw the finance minister roll out a number of measures to tide over stress in the rural sector –

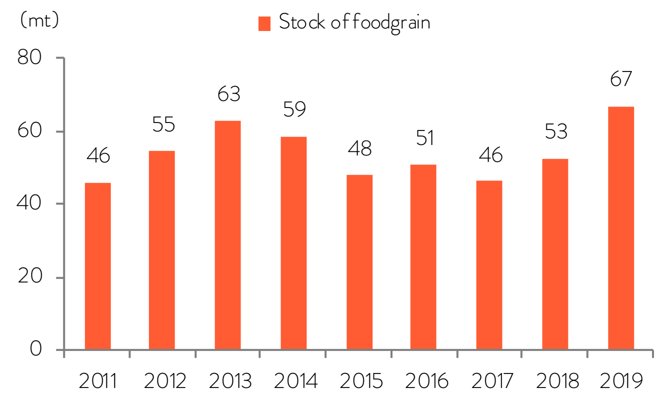
- The government has stepped up food procurement, as reflected in the sharp increase in foodgrain stock to 67mn tonnes in 2019 from 46mn tonnes in 2017, with a special focus on wheat.

FIG 31 – PROCUREMENT AS A PERCENTAGE OF CROP PRODUCTION ON THE RISE…



Source: Department of Food and Public Administration, Bank of Baroda Research | Note: 2018-19 data for rice procurement till Jul'19

FIG 32 – …DRIVING UP FOODGRAIN STOCK IN CENTRAL GOVERNMENT POOL



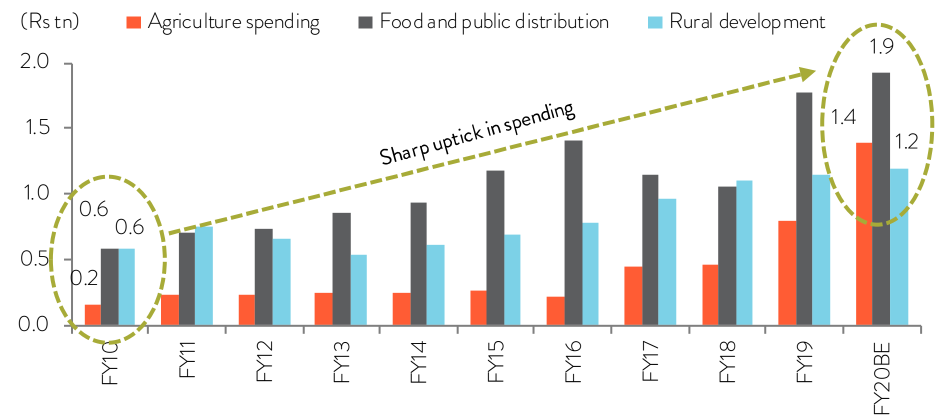
Source: FCI | Note: Monthly figures for March each year. Also, up to 01-Sep-13, unmilled paddy was included with rice. It has been added post 2014 to maintain parity.

- In FY19, the government announced its flagship income support scheme 'Pradhan Mantri Kisan Saman Nidhi' or PM-KISAN, where a sum of Rs 6,000 is given to every farmer annually in three equal instalments of Rs 2,000 each. PM-KISAN has already been implemented from 1 Dec 2018 with an outlay of Rs 200bn (0.1% of GDP) for FY19. The outlay for FY20 has been raised to Rs 870bn from Rs 750bn budgeted earlier as the programme will now cover all farmers (>145mn beneficiaries).

Similar schemes in different states include Rythu Bandhu in Telangana and Kalia in Odisha where assistance is provided on a per acre basis.

- The government has also allocated Rs 600bn in FY19 for the National Employment Guarantee Fund (MNREGA).
- The budget allocated to the rural sector has increased sharply over the years. Agriculture spending has more than doubled from Rs 0.6tn in FY10 to Rs 1.4tn in FY20. Farm loan waivers by state governments are estimated at Rs 2.6tn which is likely to further aid rural consumption.

FIG 33 – BUDGET ALLOCATED TO AGRICULTURE HAS INCREASED SUBSTANTIALLY OVER THE YEARS



Source: CEIC, Bank of Baroda Research | Note: BE – Budget Estimates

FIG 34 – LOAN WAIVERS AIMED AT EASING RURAL DISTRESS

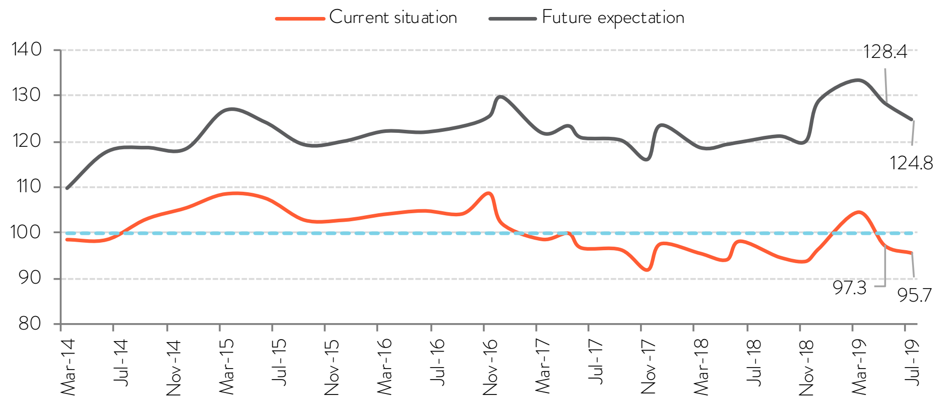
States (Rs bn)	Loan waivers announced/ implemented	Total bank credit to agriculture as of Jan'19
Karnataka	422	1,131
Madhya Pradesh	410	645
Rajasthan	460	798
Andhra Pradesh	240	-
Tamil Nadu	58	-
Telangana	170	-
Maharashtra	305	968
Punjab	100	740
Uttar Pradesh	364	1,438
Chhattisgarh	61	-
Assam	6	-
All India	-	12,686
Total to date	**2,595**	**-**

Source: Newspaper Reports

Risks to consumption revival

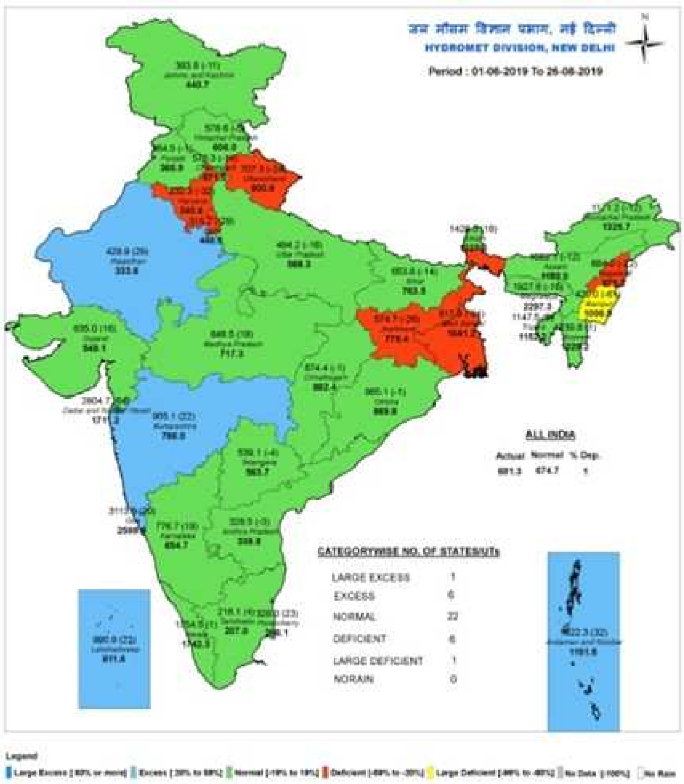
Policy measures aside, monsoon has had a period of low rainfall and then excess rainfall. This will impact sowing and productivity in the near-term. But adequate water storage will be positive for Rabi crops. Waning consumer optimism due to a deterioration in sentiments on the economic situation and employment is another concern. According to the latest RBI survey, consumer confidence in India dropped in July, with the current situation index falling to 124.8.3 from 128.4 in May and the future expectations gauge down to 95.7 in July from 97.3.

FIG 35 – CONSUMER CONFIDENCE WEAKENING



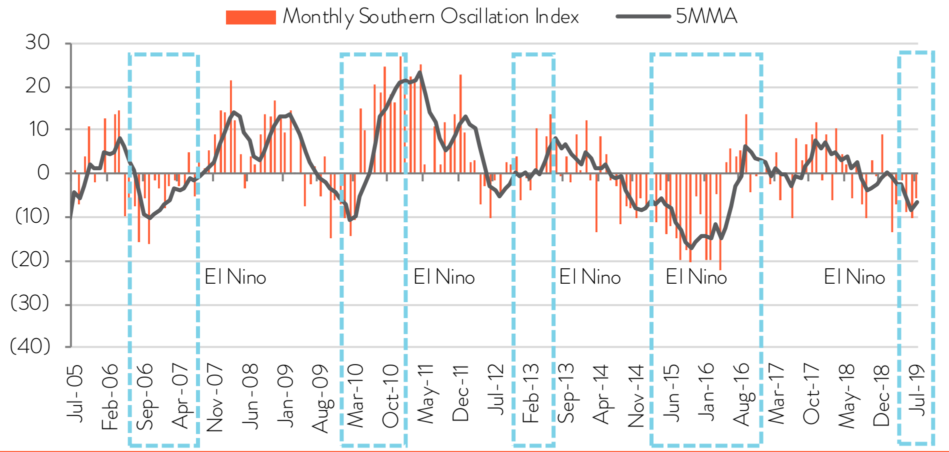
Source: CEIC, Bank of Baroda Research

FIG 36 – SOUTHWEST MONSOON IS NOW ABOVE NORMAL



Source: IMD, Bank of Baroda Research

FIG 37 – EL NINO HAS TURNED OUT TO BE WEAKER THAN ANTICIPATED



Source: Bureau of Meteorology, Australian Government

INVESTMENT

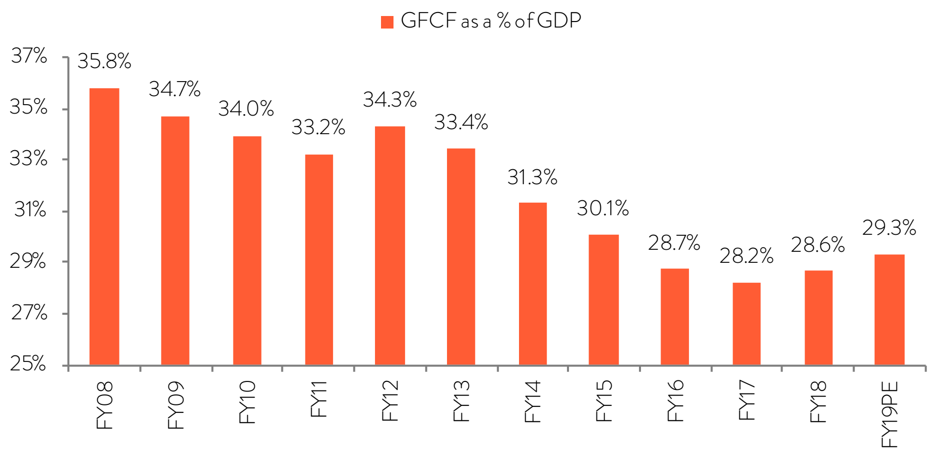
Investment demand is exhibiting a downcycle amid muted capex by the Centre, sluggish new project announcements from the private sector and subdued residential investment. The liquidity crisis has further exacerbated matters. But with the government's focus on moving towards a US$ 5tn economy, infrastructure is likely to get a substantive boost, especially roads, power and housing. Government has indicated it will invest upto Rs 100tn in 5 years, which would revive the capex cycle and stimulate demand in the economy in the near term.

Investment: On a downcycle

Fair degree of moderation since FY08

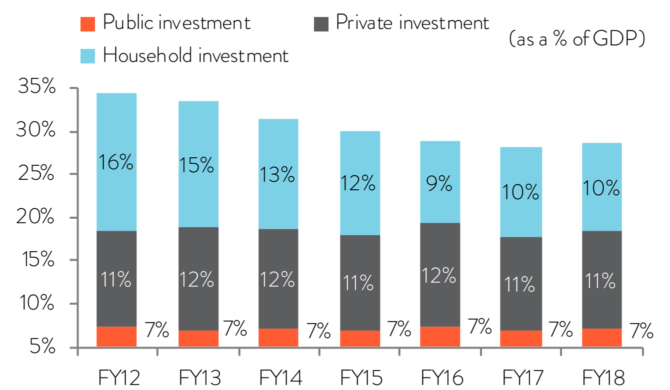
From a high of 35.8% in FY08, India's investment rate (GFCF/GDP) has been falling steadily, hitting a low of 28.2% in FY17 before inching up slightly to 29.3% in FY19. The downcycle has been led by low household real estate investment, which saw its share in GDP shrink from 13% in FY09 to 10% in FY18. Muted residential investment demand in conjunction with structural factors such as a large basket of incomplete/stalled projects has meant stable housing prices. The NBFC liquidity crisis in H2FY19 has further curtailed residential investment.

FIG 38 – INVESTMENT DEMAND TO GDP RATIO DECLINING SINCE FY08…



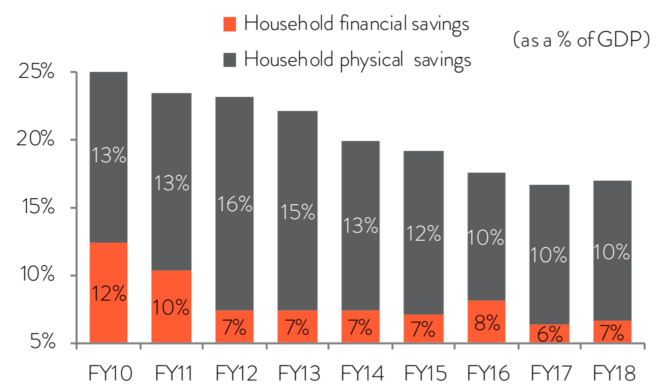
Source: CEIC, Bank of Baroda Research | Note: PE - Provisional Estimate, GFCF – Gross fixed capital formation

FIG 39 – …LED BY MUTED HOUSEHOLD INVESTMENT…



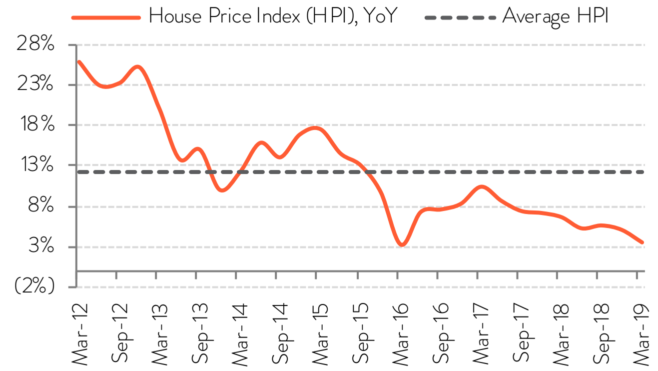
Source: CEIC, Bank of Baroda Research

FIG 40 – …ON ACCOUNT OF LOWER PHYSICAL SAVINGS



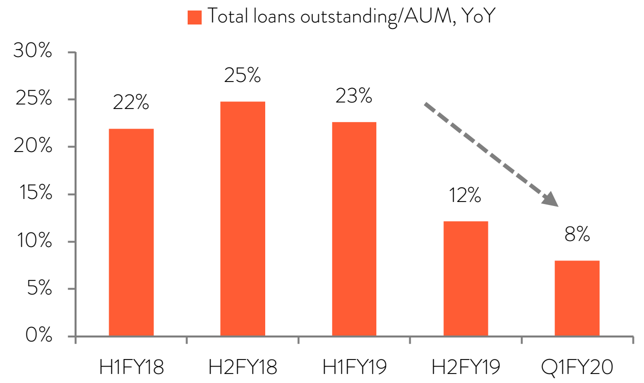
Source: CEIC, Bank of Baroda Research

FIG 41 – HOUSING PRICES THUS REMAINED MUTED; DEMONETISATION EXACERBATED MATTERS…



Source: CEIC, Bank of Baroda Research

FIG 42 – …AS DID LIQUIDITY ISSUES FACED BY HFCs IN H2FY19



Source: Bajaj Finance, STFS, Sundaram, Mannapuram, M&M Finance, Cholamandalam, Bank of Baroda Research | Note: DHFL data as of Q4FY19

While residential investment remained muted, private corporate sector and government investment demand has perked up over the last three years. Since FY17, gross fixed capital formation (GFCF) has averaged an increase of 9.3% p.a. vs. 3.9% over FY13-FY16, led by complementary public and private investment. However, investment demand seems to have hit a rough patch in Q4FY19.

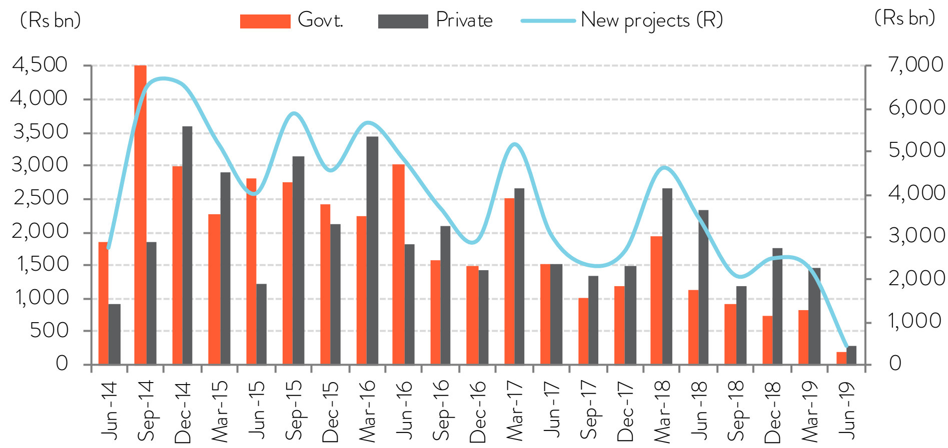
FY19 hit by muted government capex and liquidity issues

At 3.6% YoY, investment demand in Q4FY19 grew at its slowest pace since Q1FY18. This can be explained by:

- Deceleration in credit disbursal by HFCs – from 23% YoY in Sep'18 to 12% YoY in Mar'19 on account of asset liability management (ALM) issues faced by certain lenders, and
- Steep drop in new project announcements for the last four quarters (Fig 43) –on account of a slowdown in new projects by the private sector and a pullback in government capex over Oct'18-Feb'19 to meet the fiscal deficit target. States did spend through FY19 but started FY20 on a softer note.

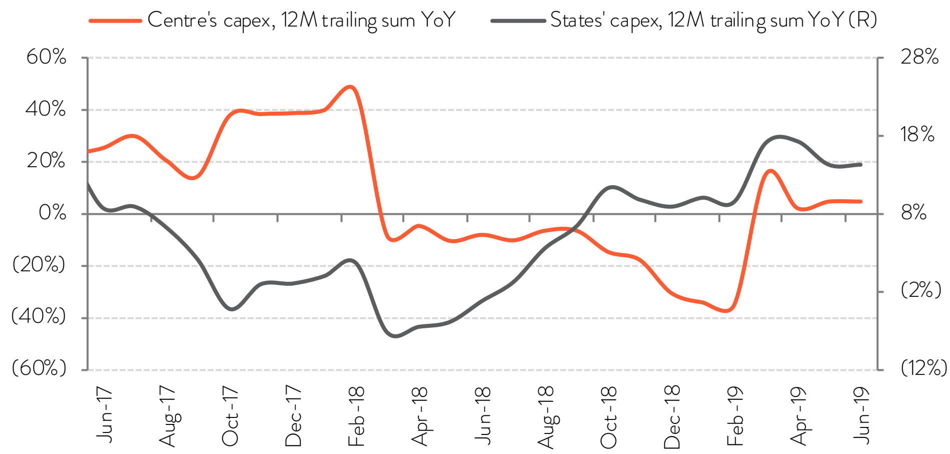
The central government's capex pullback coincided with a slowdown observed in both capital goods production and imports.

FIG 43 – DECLINE IN PRIVATE CAPEX ANNOUNCEMENTS AFFECTED NEW PROJECTS



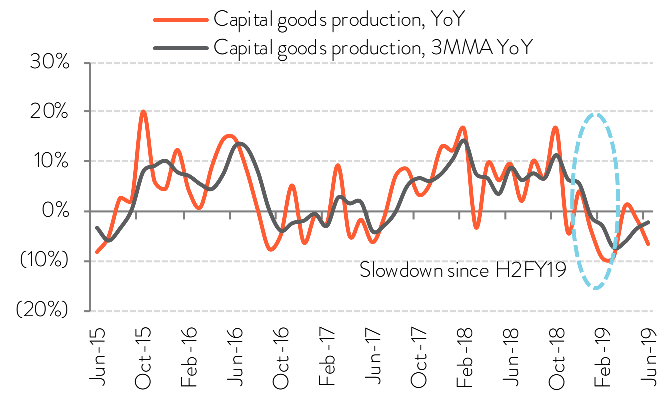
Source: CMIE, Bank of Baroda Research

FIG 44 – CENTRE'S CAPEX PLUMMETED IN H2FY19 AND IS STILL MUTED



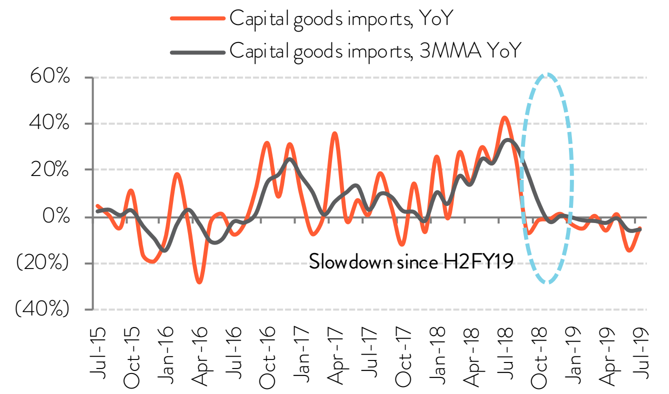
Source: CEIC, Bank of Baroda Research | Note: All states excluding N.E states, Bihar, Goa, Jharkhand, Karnataka and Uttarakhand

FIG 45 – LOWER CAPEX AFFECTED CAPITAL GOODS PRODUCTION IN H2FY19, A PERSISTING TREND



Source: CEIC, Bank of Baroda Research

FIG 46 – CAPITAL GOODS IMPORTS ALSO DROPPED PRECIPITOUSLY



Source: CEIC, Bank of Baroda Research

Government changing gears to stimulate investment

The finance ministry's 2019 Economic Survey reiterated the need to kickstart India's investment cycle. To this end, the government has proposed a capital outlay of Rs 100tn in the next five years led by infrastructure spending (8% of GDP p.a.) on roads, railways, airports, inland waterways and affordable housing. Of this, Rs 25tn is being targeted toward rural India alone to ensure better quality roads, irrigation and drinking water.

To finance this ambitious plan, a Credit Guarantee Enhancement Corporation will be set up. Some of the key government schemes that could see large investments are:

- **Housing for all** (providing a 'pucca' house to every family by 2022), renewable energy, education, health, piped water connections to every household, and coverage of 50 cities with metro networks in the next five years. Under Pradhan Mantri Awas Yojana – Gramin (PMAY-G), a total of 15.4mn rural homes have been constructed during the last five years. In the second phase spanning 2019-22, 19.5mn additional houses are proposed to be provided to eligible beneficiaries.

- **Make in India:** The government's 'Make in India' initiative aims to develop the country into a manufacturing hub. Recent hikes in custom duties on a number of items such as gold, PVC, auto parts, synthetic rubbers and engineering goods support this programme. To encourage foreign investment, 100% FDI has been permitted for insurance intermediaries, local sourcing norms for single-brand retail have been eased, and the opening up of FDI in aviation, media and insurance is being examined.

- **Improving connectivity:** The government aims to connect 100% of villages with rural roads and construct 60,000km of national highways in the next five years. Completion of Bharatmala phase-1 and the launch of phase-2 to develop state road connectivity is also in the works. Other five-year targets are to modernise 400 railway stations, double the number of functional airports to more than 200, and achieve a 100% increase in port capacity.

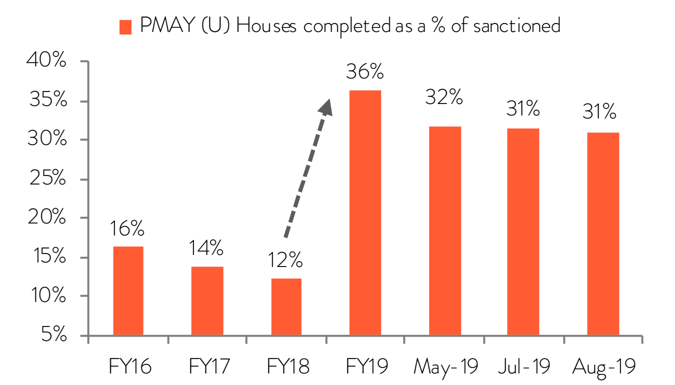
  The outlay for connectivity scheme Pradhan Mantri Gram Sadak Yojana (PMGSY) has already been enhanced by 22.6% with its completion date advanced from 2019 to 2022. Under phase-3, over 125,000km of roads are to be upgraded with an investment of Rs 803bn over five years.

- **Incentivising solar power and EVs:** The government has announced incentives to promote electric vehicles (EV) in the country by reducing customs duties on EVs and also providing tax benefits to consumers. To promote renewable energy, it has encouraged the use of solar stoves and battery chargers.

- Upcoming initiatives such as **Pragati (proactive governance and timely implementation)** are likely to boost the completion rate of projects. Under this programme, major projects will be debottlenecked on a regular basis through video conferencing with officials.
- **PSB recapitalisation:** The Rs 700bn recap announced in the FY20 budget and the recent announcement of upfront release of the same is expected to ensure that public sector banks (PSB) have enough capital to support growth.
- **Deepening of bond markets:** To create a conducive environment for long term financing, it has been proposed to establish an organisation for credit enhancement to infrastructure and housing projects. Further, requirement of Debenture Redemption Reserve (DRR) in respect of listed companies, NBFCs and for HFCs has also been removed.

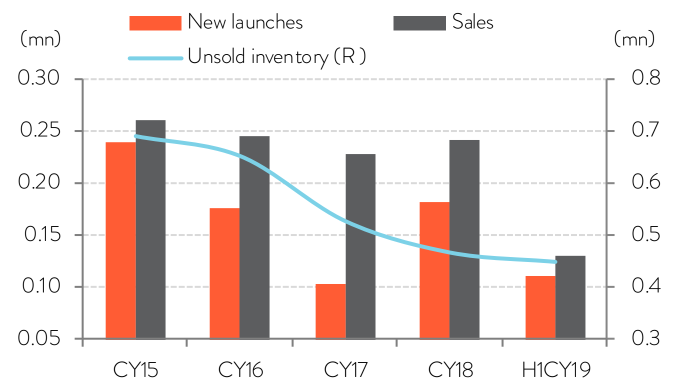
Some bright spots

FIG 47 – AFFORDABLE HOUSING PICKING UP PACE



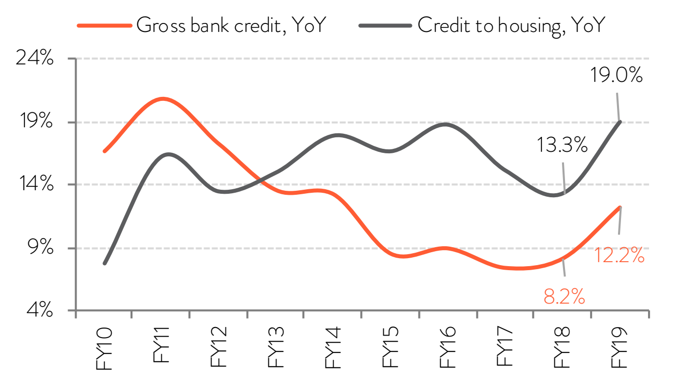
Source: MOHUA, Bank of Baroda Research | Note: PAMAY (U) – Pradhan Mantri Awas Yojana (Urban), Data as on 13 Aug 2019

FIG 48 – UNSOLD HOUSING INVENTORY DECLINING



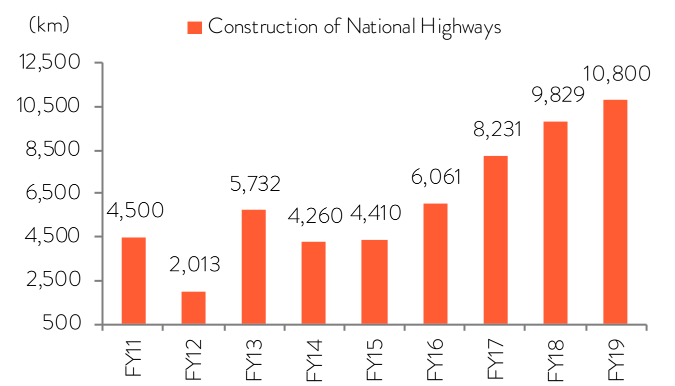
Source: Knight Frank, Bank of Baroda Research

FIG 49 – CREDIT TO HOUSING SECTOR RISING



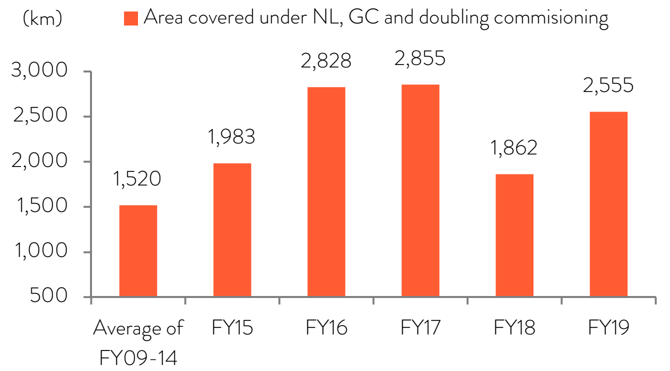
Source: CEIC, Bank of Baroda Research | Note: Current growth rate of gross bank credit is 11.1%, housing is 18.9% as on Jun'19

FIG 50 – HIGHWAY CONSTRUCTION GATHERING PACE



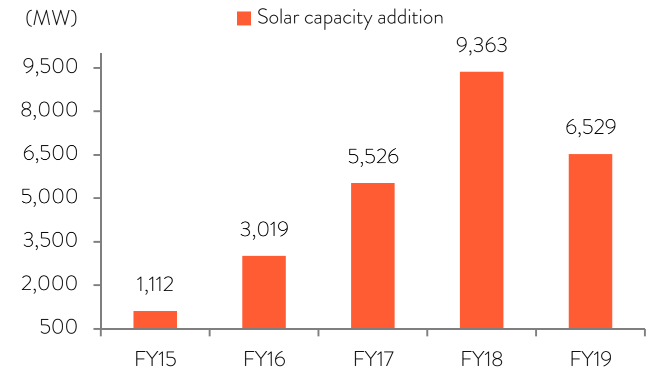
Source: MORTH, Bank of Baroda Research

FIG 51 – RAILWAY CONSTRUCTION ON AN UPTREND



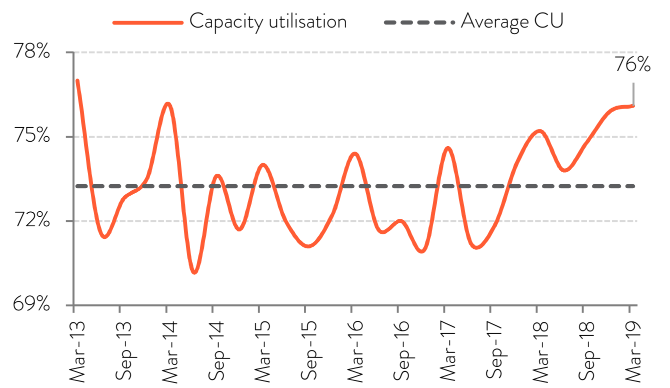
Source: Ministry of Railways, Bank of Baroda Research | Note: NL – New Lines; GC – Gauge Conversion. FY19 figure corresponds to new lines as reported by media

FIG 52 – CAPACITY EXPANSION AT SOLAR PLANTS



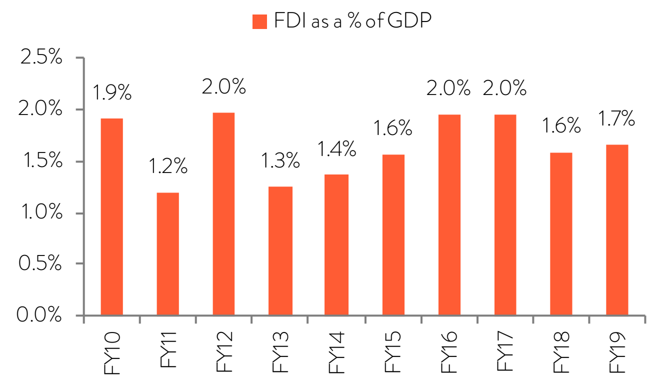
Source: Ministry of New and Renewable Energy, Bank of Baroda Research | Note: FY19 figure as reported by media

FIG 53 – INDUSTRYWIDE CAPACITY UTILISATION FAR ABOVE AVERAGE



Source: CEIC, Bank of Baroda Research

FIG 54 – FDI AS A PERCENTAGE OF GDP REMAINS STABLE



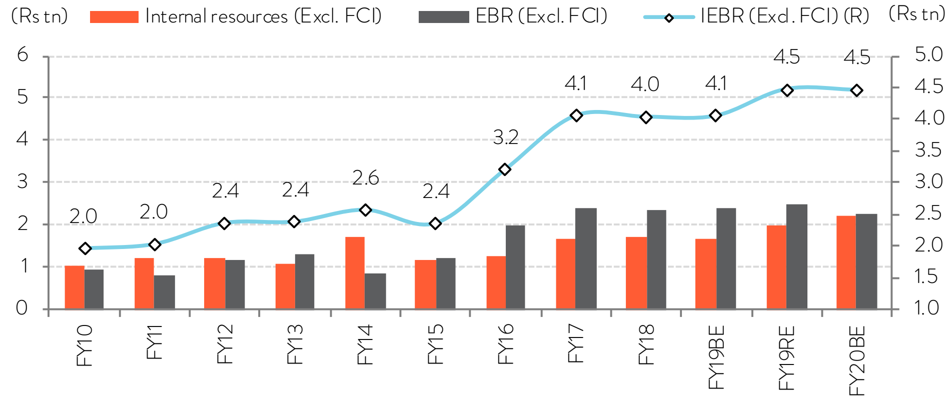
Source: CEIC, Bank of Baroda Research

Off-budget financing supplements capital spend

Despite muted capital spending by the government, investment demand is being stimulated through internal and extra budgetary resources (IEBR). Borrowings through EBR (extra budgetary resources) which include raising money via bonds, debentures and external commercial borrowings have been increasing at a faster pace since FY17, and as per revised estimates (RE) are projected to increase to Rs 4.1tn in FY19 as against Rs 3.1tn in FY18.

In FY20, however, EBR is expected to moderate to Rs 3.2tn given that it will be supplemented by internal budgetary resources (arising out of profit earnings of enterprises) at Rs 2.2tn compared to Rs 2tn in FY19RE.

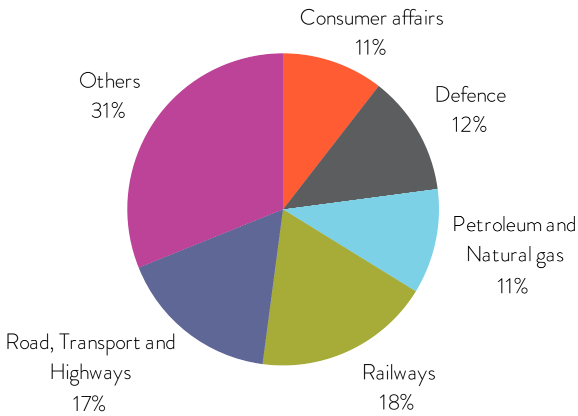
FIG 55 – RESOURCES RAISED THROUGH IEBR AUGMENTING CAPEX SPEND



Source: Union Budget, Bank of Baroda Research | Note: BE – Budget Estimates, RE – Revised Estimates

Ministry-wise, the highest share of capex (gross budgetary support + IEBR) is projected to be towards infrastructure creation, with railways, road, transport and highways comprising 35% of the outlay in FY20 (Fig 56). This is in consonance with the Union Budget's thrust towards promoting investments in these sectors. As such, ongoing concerted efforts toward public-private partnership should help revive the capex cycle in the near term and bring investment demand back on track.

FIG 56 – MINISTRY-WISE SHARE IN OVERALL CAPEX (GBS+IEBR)



Source: Union Budget, Bank of Baroda Research | Note: GBS- Gross Budgetary Support, IEBR-Internal and Extra Budgetary Resources

FIG 57 – ALLOCATION MINISTRY-WISE (GBS AND IEBR)

Ministries (Rs bn)	Share (%)	FY19RE GBS	FY19RE IEBR	FY20BE GBS	FY20BE IEBR
Consumer Affairs	10	14	1,643	14	905
Defence	12	985	0	1,082	0
Petroleum	11	20	944	17	936
Railways	18	531	858	658	941
Roads	17	686	620	721	750
Others	31	931	2,060	894	1,844
Total	**100**	**3,166**	**6,126**	**3,386**	**5,376**

Source: Union Budget, Bank of Baroda Research | Note: GBS- Gross Budgetary Support, IEBR-Internal and Extra Budgetary Resources

PUBLIC FINANCE

Indicators of central and state government finances suggest that fiscal consolidation is underway, led by the central government. The Centre's revenue targets for FY20 look ambitious and likely shortfalls in collection would exert pressure on its spending. State governments could step in to bridge the gap as they appear to have the legroom for expansionary fiscal policy, as seen in FY19.

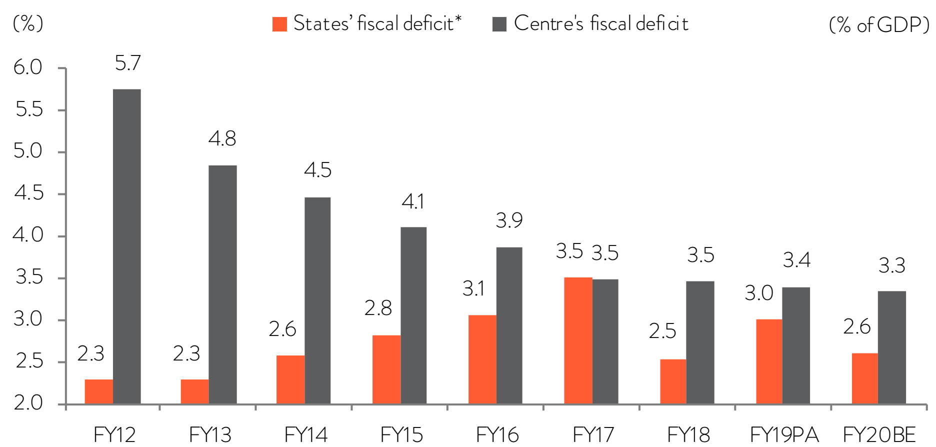
Public finance: Fiscal consolidation underway

Centre's fiscal deficit improving

From a peak of 8% in FY12, the combined fiscal deficit of the Centre and states has come down to 6.4% of GDP in FY19. This was made possible by a reduction in the Centre's fiscal deficit from a high of 5.7% in FY12 to 3.4% of GDP in FY19 (provisional actuals) as expenditure slowed. However, states have made up for the lower spend by centre. Central government spending increased at 8.1% CAGR over FY14-FY19 vs. 16.1% CAGR by states.

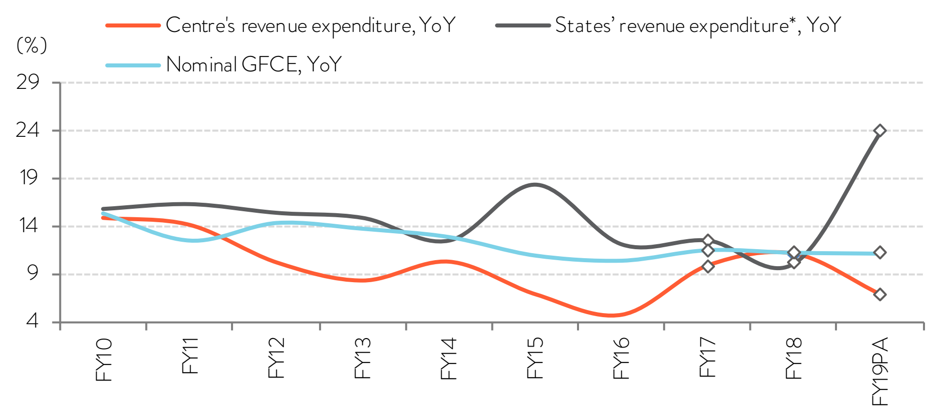
Apart from prudent expenditure management, fiscal consolidation over the years has been aided by relatively buoyant direct tax collections, in particular from personal income tax. Over the last three years, income tax receipts have increased at a 17.1% CAGR and corporate tax collections have grown at 13.6%.

FIG 58 – OVERALL FISCAL DEFICIT CONSOLIDATION LED BY CENTRE



Source: CEIC, Budget documents, RBI, Bank of Baroda Research | Note: PA – Provisional Actuals for Centre using CGA data and Revised Estimates for states, BE – Budget Estimates | *Includes UP, Karnataka, Bihar, Odisha, Kerala, Tamil Nadu, Chhattisgarh, Rajasthan, Punjab, Haryana, Gujarat, W. Bengal, Maharashtra, AP, Telangana

FIG 59 – STATE* SPENDING HELPED CUSHION GDP GROWTH IN FY19



Source: CEIC, Budget documents, RBI, Bank of Baroda Research | Note: PA – Provisional Actuals for Centre using CGA data and Revised Estimates for states | *Includes UP, Karnataka, Bihar, Odisha, Kerala, Tamil Nadu, Chhattisgarh, Rajasthan, Punjab, Haryana, Gujarat, W. Bengal, Maharashtra, AP and Telangana

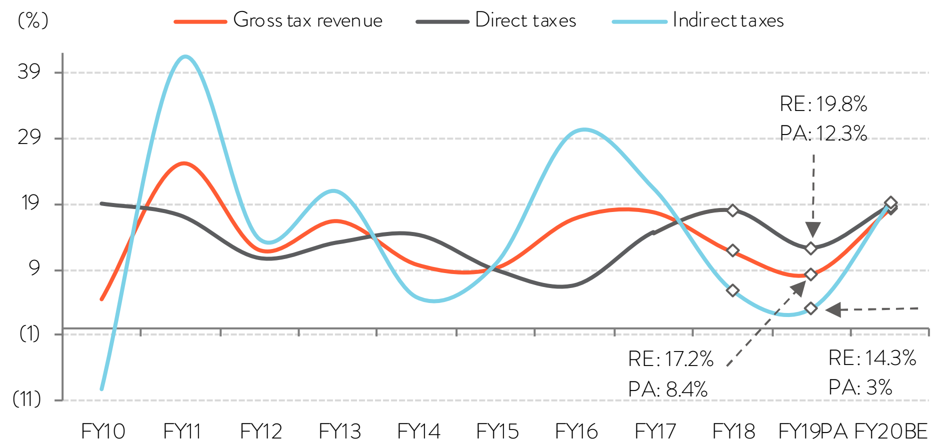
FY19 tax collections miss estimates

Income tax receipts rose just 7.2% as per FY19 provisional figures (18.1% in FY18), whereas corporate tax collections remained buoyant, growing 16.2% (17.8% in FY18). Indirect tax collections too have been muted due to a reduction in tax incidence for a number of goods and services under GST as well as the ongoing consumption downturn.

GST revenues increased only 3% in FY19 (provisional) as against 5.8% in FY18, driven by below-anticipated CGST and IGST collections. Excise revenue was depleted by cuts in petrol and diesel duties. Compared with revised budget estimates, CGST revenue fell short by Rs 464bn and IGST by Rs 211bn. This shortfall was only marginally compensated for by Rs 51bn of excess collection as GST cess.

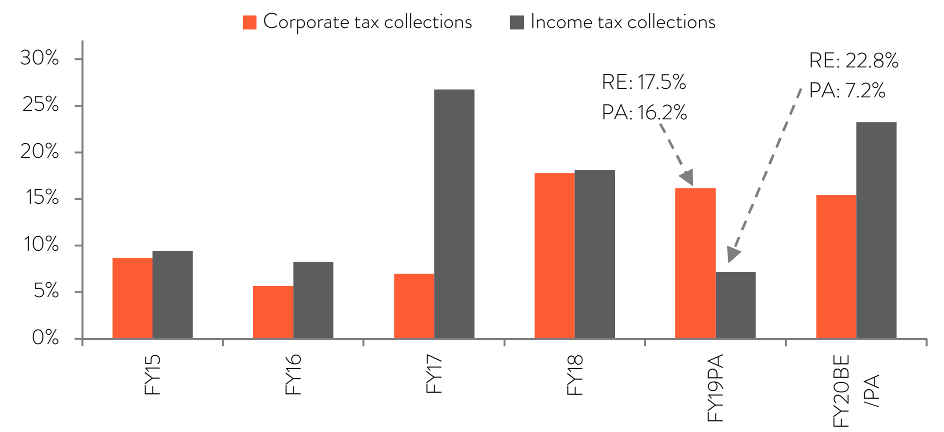
Taken together, both direct and indirect taxes for FY19 have missed revised estimates by Rs 1.7tn. The Centre's net revenue collections have increased by only 8.9% in FY19 (provisional) compared with the projected increase of 20.5%.

FIG 60 – CENTRE'S TAX REVENUE GROWTH DIPS IN FY19; EXPECTED TO RECOVER IN FY20



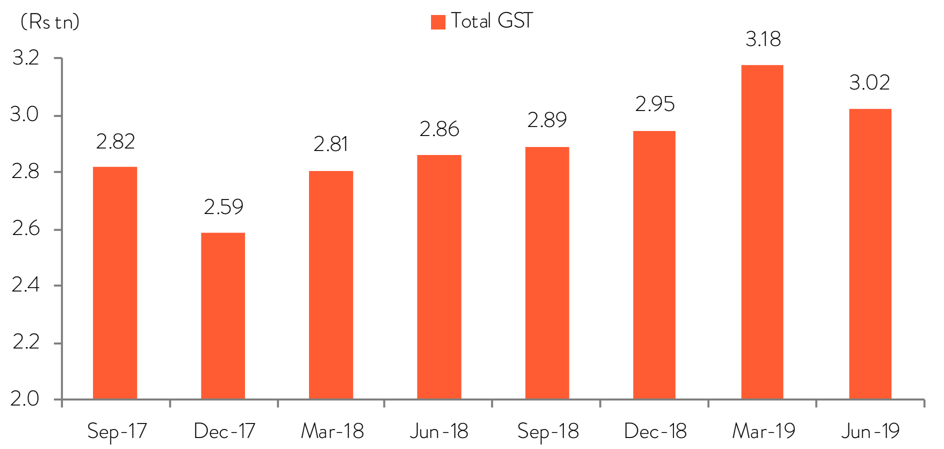
Source: CEIC, Budget documents, RBI, Bank of Baroda Research | Note: PA – Provisional Actuals for Centre using CGA data, BE – Budget Estimates, RE – Revised Estimates

FIG 61 – LOW INCOME TAX COLLECTIONS DRIVE DIRECT TAXES DOWN IN FY19; TARGET FOR FY20 ALSO A TOUGH ASK



Source: CEIC, Budget documents, RBI, Bank of Baroda Research | Note: PA – Provisional Actuals for Centre using CGA data, BE – Budget Estimates, PA- Provisional Actuals

FIG 62 – GST COLLECTIONS INCREASED JUST 3% IN FY19; Q1FY20 COLLECTIONS ALSO MUTED



Source: CEIC, Bank of Baroda Research

Capital expenditure exhibits rising trend

On the expenditure front, we note a decline from 14.6% CAGR over FY08-FY13 to 8.1% over FY14-FY19. This was driven by lower revenue spending, which eased from 15.9% to 7.9% over the same period. However, the Centre's capital spending was not compromised, rising from a 7.1% CAGR over FY08-FY13 to 10.1% over FY14-FY19.

FY20 tax revenue targets ambitious, RBI's dividend a support

To continue down the fiscal consolidation path and contain the deficit at 3% of GDP next year, the government has initiated the following steps:

- Raised cess on individuals earning income above Rs 20mn and Rs 50mn
- Hiked cess and infrastructure tax on petrol and diesel by Rs 2/litre
- Hiked customs duties on a variety of products (from 10% to 12.5% on gold and other precious metals; from 0% to 5% on imported books) and imposed a nominal basic excise duty on tobacco products and crude.

These revenue mobilisation measures will add almost Rs 500bn to the kitty. But even adjusting for this income, FY20 revenue targets in certain segments look rather high. For instance, based on provisional direct tax collections in FY19, an increase of 18.6% will be required in FY20 to meet budgeted targets. Within this, while corporate tax collections are expected to meet the FY20BE target, income tax collections are a worry. After rising by 7.2% in FY19, income tax collections will have to climb 20.4% in FY20, even after adjusting for Rs 130bn of additional revenue collected from surcharge on individuals earning more than Rs 20mn.

In the case of indirect taxes, a 13.5% jump in collections will be required vs. 4.7% in FY19 (provisional). This is after adjusting for Rs 320bn of additional revenues from excise duties and Rs 50bn from higher custom duties. CGST collections, at the current monthly run-rate (Apr-Jun'19), are estimated to fall only marginally short of the budget estimate and can be partly compensated via excess collections under IGST.

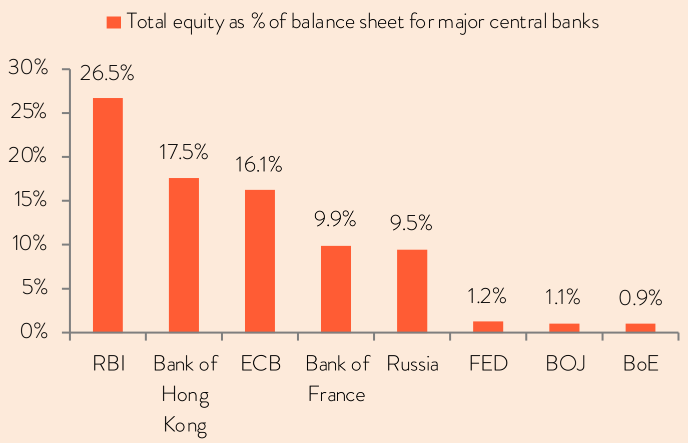
Higher non-tax revenue growth, led by 5G auctions and RBI dividends, will help bridge the gap in tax revenue collections. As per recommendation of Jalan Committee (as illustrated on Page 31), RBI's Central Board has decided to transfer Rs 1.76tn to the government comprising Rs 1.23tn surplus and Rs 526bn of excess provisions (5.5% of balance sheet) identified as per ECF. This is nearly twice the amount estimated in the FY20 Budget (~Rs 900bn). Out of Rs 1.76tn, Rs 280bn has been transferred as interim dividend by RBI in Feb'19.

In case of telecom auctions, the government earns 25% upfront payment in the ongoing fiscal year and the balance is spread over the next few years. Disinvestments are another source of income, where the target for FY20 has been increased to Rs 1,050bn.

Drawing on RBI's surplus reserves

In FY19, a committee headed by former RBI governor Bimal Jalan was instituted to study the central bank's economic capital framework and determine the quantum of surplus reserves that could be transferred to the government. The committee has recommended that realised gains can be distributed while unrealised gains cannot be (Rs 7tn as on 31 Jun'18). Realised gains have been referred as Contingent Risk Buffer and recommended at 5.5% to 6.5% of RBI's balance sheet. The surplus distribution policy will target only realised equity in the range of 6.5-5.5% and net surplus thereafter to be distributed.

FIG 63 – RBI HAS HIGHEST SHARE OF CAPITAL RESERVES AMONG MAJOR CENTRAL BANKS



Source: CEIC, Bloomberg, RBI, Bank of Baroda Research

FIG 64 – PRIOR RECOMMENDATIONS ON RESERVES

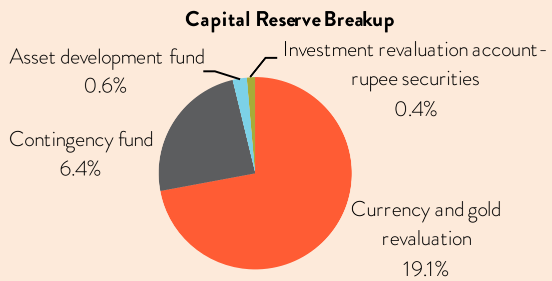
Committee	Recommendation
V Subrahmanyam (1997)	12% of total assets as contingency reserve
Usha Thorat (2004)	18% of total assets as total reserves (CGRA, contingency reserves, asset development reserve)
Y H Malegam (2013)	Adequate amount of profits should be transferred each year to contingency reserve
Economic Survey (2015-16)	16% of total assets

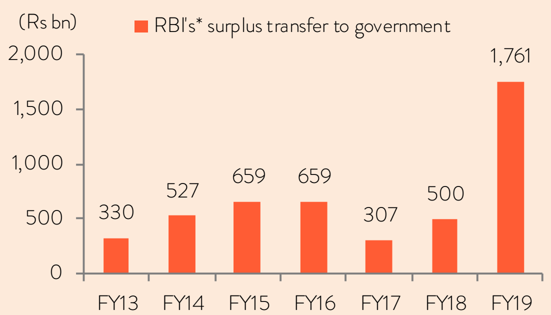
Source: RBI, Economic Survey, Bank of Baroda Research

FIG 65 – RBI'S BALANCE SHEET COMPONENTS

(Rs bn)	2014-15	2015-16	2016-17	2017-18
Contingency Fund	2,216.1	2,201.8	2,282.1	2,321.1
Asset Development fund	217.6	227.6	228.1	228.1
Investment Revaluation Account -Rupee securities	32.1	524.1	570.9	132.9
Currency and Gold Revaluation	5,591.9	6,374.8	5,299.5	6,916.4
Capital Reserves	8,057.8	9,328.3	8,380.5	9,598.5
Balance Sheet	28,891.6	32,430.1	33,040.9	36,175.9
Capital Reserves to Balance Sheet (%)	**28.0**	**28.8**	**25.4**	**26.5**

FIG 66 –RBI'S SURPLUS TRANSFER & BREAKUP OF RBI CAPITAL RESERVES





Source: CEIC, Bloomberg, RBI, Bank of Baroda Research | *Refers to RBI accounting year Jul-Jun

Expenditure growth to remain range-bound

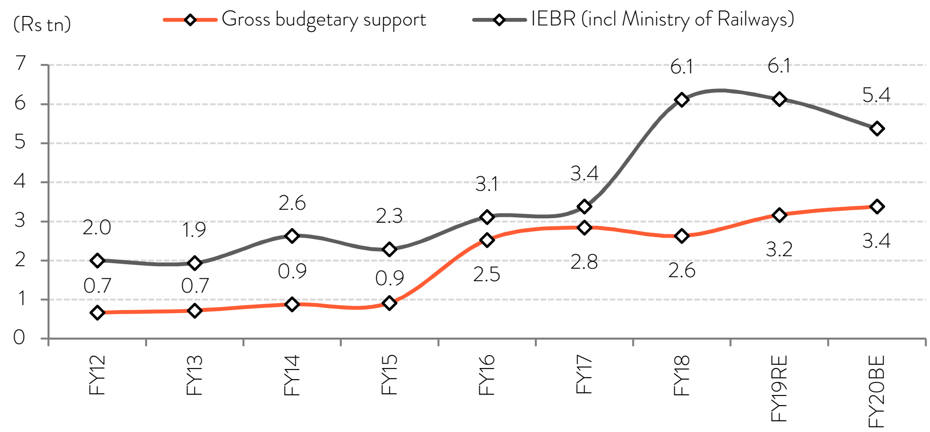
On the expenditure front, headline expenditure is budgeted to rise 20.5% in FY20 (vs. 7.9% in FY19 provisional), led by revenue spending growth of 21.9% (6.9%). On the other hand, capex growth (through budgetary support) is estimated to be lower at 11.8% vs. 15.1% in FY19. Capex through IEBR is also set to moderate to 12.2% after surging 28.5% in FY19. A major part of the easing can be explained by lower spends by Food Corp of India (FCI). Of the total IEBR, internal budgetary resources are estimated to grow 10.9% in FY20BE vs. 17% in FY19. In case of EBR, roads and railways will see a major jump in this year (Fig 67).

FIG 67 – MINISTRY-WISE INTERNAL AND EXTERNAL BUDGETARY RESOURCES (IEBR)

(Rs bn)	2016-17RE	2017-18RE	2018-19RE	2019-20BE
Consumer affairs, food and public distribution (FCI)	1	721	1,643	905
Petroleum	1,047	874	944	936
Railways	746	800	858	941
Roads	593	593	620	750
Others	1,677	1,781	2,060	1,844
Total	**4,064**	**4,769**	**6,126**	**5,376**
Total (ex-FCI)	**4,063**	**4,048**	**4,483**	**4,472**

Source: Budget documents, Bank of Baroda Research | Note: BE – Budget Estimates, RE – Revised Estimates

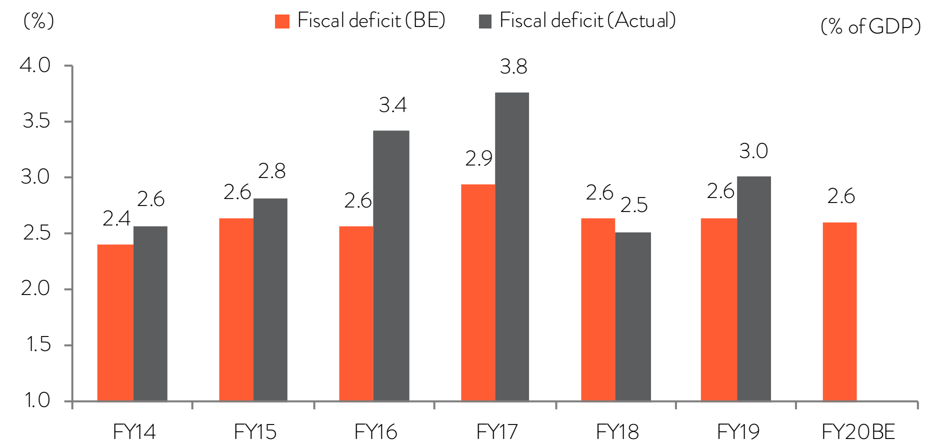
FIG 68 – CENTRE TO SUPPORT CAPEX VIA IEBR



Source: CEIC, Budget documents, RBI, Bank of Baroda Research | Note: BE – Budget Estimates, RE – Revised Estimates

Thus, states may have to step up spending to bridge the gap left by the Centre. Notably, states had cut their fiscal deficit in FY18 which resulted in a modest decline in revenue spending and a steep fall in capex. This was reversed in FY19 when capital spends increased and fiscal deficits expanded. While states have projected fiscal consolidation in FY20BE, we believe they have room to maintain deficits at the same levels as last year and thus ensure continued capital spending in the economy.

FIG 69 – FISCAL DEFICIT OF STATES* HAS HISTORICALLY BEEN HIGHER THAN BUDGETED



Source: CEIC, Budget documents, RBI, Bank of Baroda Research | *Includes UP, Karnataka, Bihar, Odisha, Kerala, Tamil Nadu, Chhattisgarh, Rajasthan, Punjab, Haryana, Gujarat, W. Bengal, Maharashtra, AP and Telangana

FIG 70 – CENTRE'S FISCAL ESTIMATES

(Rs bn)	FY17	FY18	FY19RE	FY19PA	FY20BE	Increase (%)		
						FY19PA	FY20BE	FY20BE/PA
Tax revenue								
Corporation tax	4,849	5,712	6,710	6,636	7,660	16.2	14.2	15.4
Taxes on income	3,646	4,308	5,290	4,617	5,690	7.2	7.6	23.3
Indirect taxes	8,620	9,123	10,428	9,550	11,192	4.7	7.3	17.2
Total - Tax revenue	**17,158**	**19,189**	**22,482**	**20,802**	**24,612**	**8.4**	**9.5**	**18.3**
Less: State's share	6,080	6,730	7,369	7,615	8,091	13.1	9.8	6.3
Centre's tax revenue	11,014	12,425	14,844	13,170	16,496	6.0	11.1	25.3
Total non-tax revenue	**2,728**	**1,927**	**2,453**	**2,462**	**3,132**	**27.7**	**27.7**	**27.2**
Centre's revenue (net)	**13,742**	**14,352**	**17,297**	**15,632**	**19,628**	**8.9**	**13.5**	**25.6**
Capital receipts								
o/w Internal debt market borrowing	4,082	4,507	4,227	4,227	4,731	(6.2)	11.9	11.9
o/w Disinvestment	477	1,000	800	850	1,050	(15.0)	31.3	23.5
Total receipts	**19,752**	**21,420**	**24,572**	**22,907**	**27,863**	**6.9**	**13.4**	**21.6**
Expenditure								
Total expenditure	**19,752**	**21,419**	**24,572**	**23,114**	**27,864**	**7.9**	**13.4**	**20.5**
Revenue	16,906	18,788	21,406	20,085	24,478	6.9	14.3	21.9
Capital	2,846	2,631	3,166	3,030	3,386	15.1	6.9	11.8
Revenue deficit	3,164	4,436	4,109	4,453	4,850	0.4	18.0	8.9
Fiscal deficit	**5,356**	**5,911**	**6,344**	**6,454**	**7,038**	**9.2**	**10.9**	**9.0**
% of GDP	**3.5**	**3.5**	**3.4**	**3.4**	**3.3**	-	-	-

Source: Budget Documents, Bank of Baroda Research | Note: BE – Budget Estimates, RE – Revised Estimates, PA – Provisional Actuals

FIG 71 – STATES' FISCAL ESTIMATES

(% YoY)	States*				
	FY16	FY17	FY18	FY19RE	FY20BE
Capital expenditure	47.7	20.2	(7.8)	17.5	9.9
Revenue expenditure	12.2	12.6	10.2	24.0	8.4
Total expenditure	**18.9**	**14.4**	**5.7**	**22.6**	**8.7**
State's own tax	18.7	11.7	12.8	18.2	11.8
State's own non tax revenue	3.8	7.8	6.7	48.1	3.2
Total revenue receipts	**14.8**	**10.8**	**11.4**	**24.8**	**9.6**
Total capital receipts	**45.0**	**30.1**	**(11.3)**	**17.0**	**9.6**
Total receipts	**20.9**	**15.5**	**5.1**	**23.0**	**9.6**
Ratios					
Fiscal deficit/GDP	**3.4**	**3.8**	**2.5**	**3.0**	**2.6**
Revenue deficit/GDP	0.2	0.5	0.3	0.3	0.1
Own tax revenue/Revenue receipts	76.3	77.0	77.9	73.8	75.3

Source: Budget documents, RBI | *Includes Uttar Pradesh, Karnataka, Bihar, Odisha, Kerala, Tamil Nadu, Chhattisgarh, Rajasthan, Punjab, Haryana, Gujarat, W. Bengal, Maharashtra, Andhra Pradesh and Telangana | Note: BE – Budget Estimates, RE – Revised Estimates

EXTERNAL SECTOR

India's exports grew 8.6% in FY19 vs. 10% in FY18 due to a deceleration in global growth, tariff wars and lower commodity prices. Non-oil non-gold imports also faltered amid low domestic consumption. With the global downturn deepening, merchandise exports are unlikely to pick up in FY20. Imports too will be constrained by softer domestic demand and moderate crude prices. As such, services exports may be the only silver lining with software service receipts remaining buoyant.

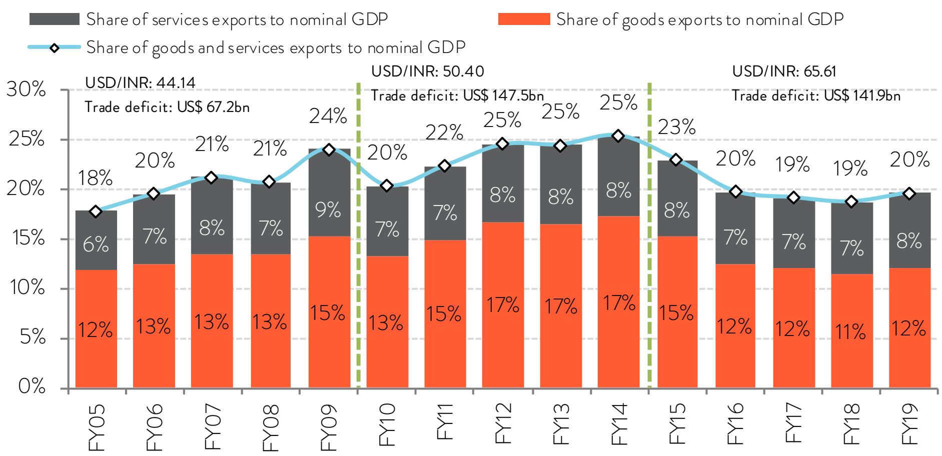
External trade: Struggling amid global downturn

Exports continue to weaken

From a peak of 25% in FY14, the share of exports (goods and services) in India's GDP fell to 19% in FY17 and has improved slightly to 20% now. The decline from peak levels has been led by sluggish merchandise exports whose share in GDP slipped from 17% in FY14 to 12% in FY19. On the other hand, services contribution has remained stable during this period.

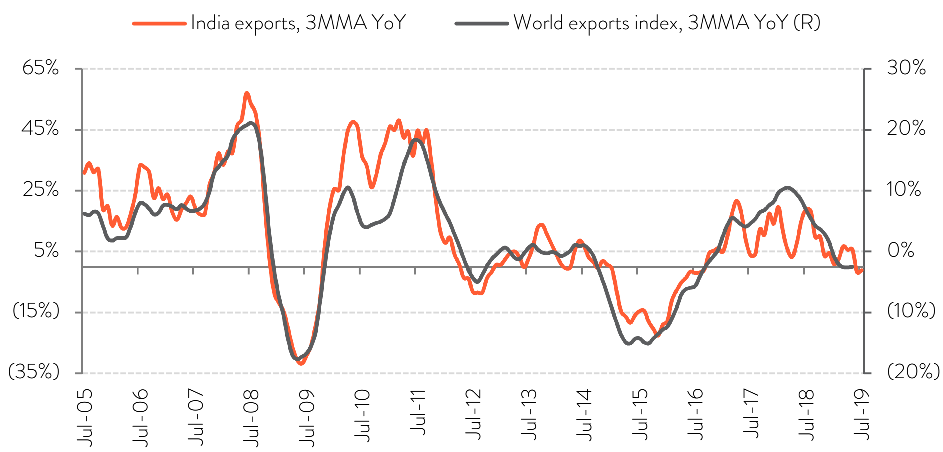
The decline in India's exports closely mirrors the slowdown globally. Worldwide export growth slipped to 3.7% in CY18 from 5.5% in CY17 as global economic growth ebbed to 3.6% from 3.8%. With a much sharper decline expected in global growth to 3.2% in CY19, global trade volumes are likely to remain muted.

FIG 72 – EXPORTS OF GOODS AND SERVICES FELL TO 20% OF GDP IN FY19 DUE TO LOWER MERCHANDISE EXPORTS



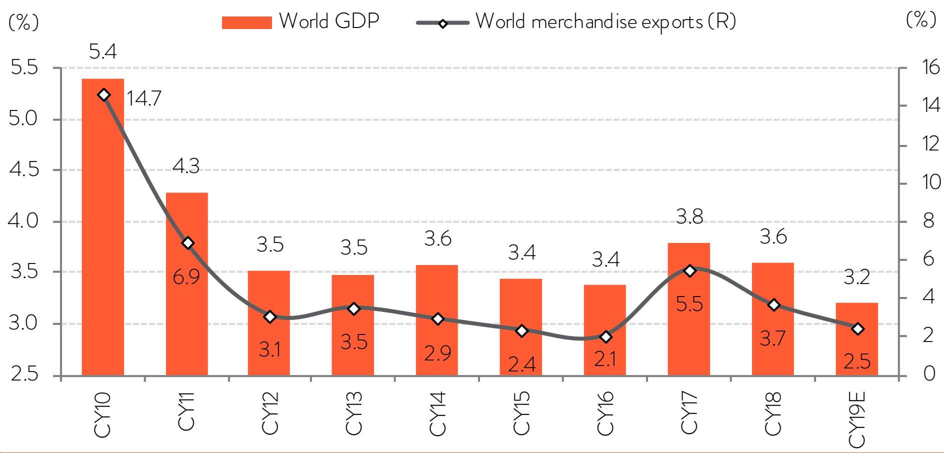
Source: CEIC, Bank of Baroda Research

FIG 73 – INDIA'S MERCHANDISE EXPORTS FALLING IN LINE WITH GLOBAL EXPORTS



Source: CEIC, Bank of Baroda Research, CPB Netherlands Bureau for Economic Policy Analysis

FIG 74 – GLOBAL EXPORTS LOSING MOMENTUM AMID SOFT ECONOMIC GROWTH



Source: IMF World Economic Outlook Update July 2019, Bank of Baroda Research

Merchandise exports the hardest hit

India's merchandise exports have registered a steep decline amid the global downturn, from 10% in FY18 to 8.6% in FY19. Between Apr-Jul'19, exports have further declined by 1%. Exports to Europe and Asia Pacific (ex-China), which accounted for ~48% of India's merchandise exports in FY19, have slowed the most. On the other hand, exports to China continued to grow at 25% in FY19.

In FY20, demand in Euro Zone is expected to deteriorate further. Growth in export-oriented Asian economies such as Thailand, Korea and Singapore is also likely to suffer due to the US-China trade war and attendant supply chain disruptions.

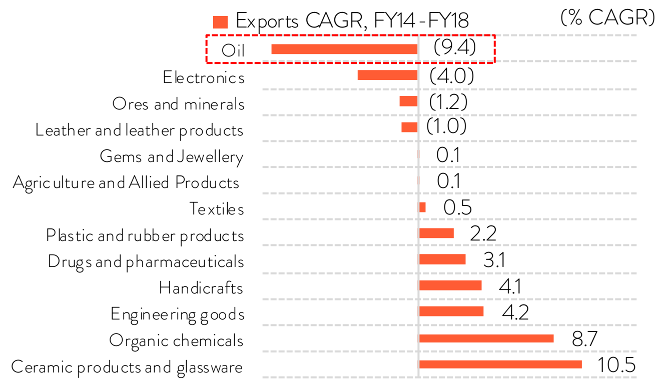
FIG 75 – INDIA'S EXPORTS TO ASIA AND EUROPE SLOWED THE MOST

Region (% YoY)	% Share FY19	FY14	FY15	FY16	FY17	FY18	FY19	Q1FY20
Middle East	24.4	1.1	0.9	(20.1)	(2.4)	0.7	10.3	0.3
Americas	21.1	1.5	8.9	(10.6)	4.1	14.3	9.6	13.5
Asia and Pacific (Ex. China)	28.1	3.3	2.6	(14.9)	12.5	12.8	4.1	(8.5)
China	5.1	9.3	(19.5)	(24.5)	12.9	31.1	25.4	4.0
Europe	19.7	4.1	(3.4)	(10.6)	5.8	13.1	6.6	(0.6)
Other	1.0	107.3	(57.7)	(20.4)	(0.5)	(26.4)	26.6	(1.3)

Source: CEIC, Bank of Baroda Research

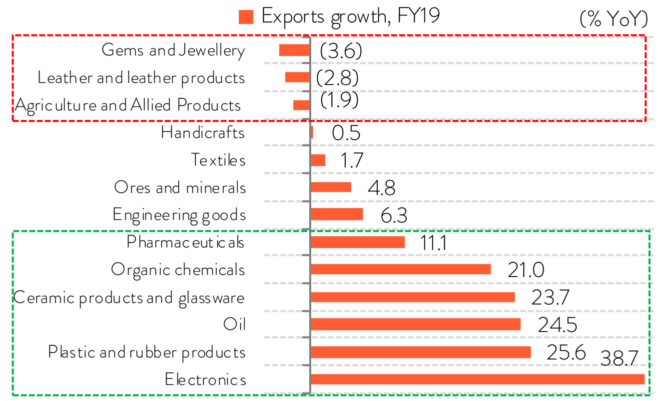
While exports of certain goods increased in FY19, viz. electronics (39%), plastics (26%) and organic chemicals (21%), others such as gems and jewellery, leather and agriculture goods showed a decline. The slowdown has been marked by both, a reduction in commodity prices and a sharp deceleration in volumes as measured by cargo traffic growth in H2FY19. On the other hand, oil exports increased by 24.5% in FY19 vs. a drop of 9.4% CAGR between FY14-FY18 mainly due to higher oil prices.

FIG 76 – OIL EXPORTS DECLINED OVER FY14-FY18…



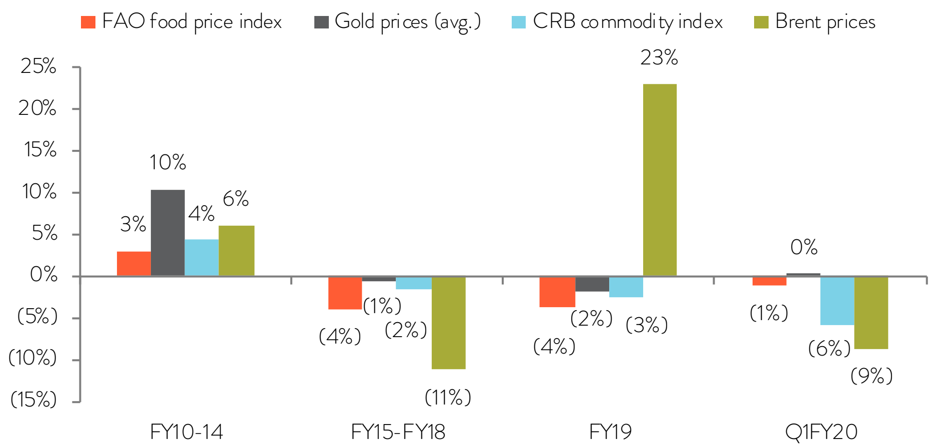
Source: CEIC, Bank of Baroda Research

FIG 77 – …BUT INCREASED 24.5% IN FY19



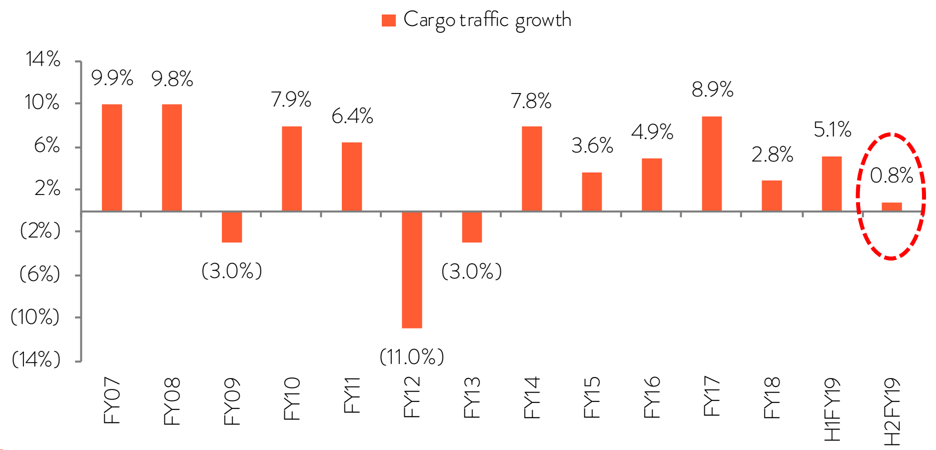
Source: CEIC, Bank of Baroda Research

FIG 78 – BARRING OIL, ALL COMMODITY PRICES MODERATED IN FY19



Source: Bloomberg, Bank of Baroda Research

FIG 79 – EXPORT VOLUME GROWTH NOSEDIVED IN H2FY19

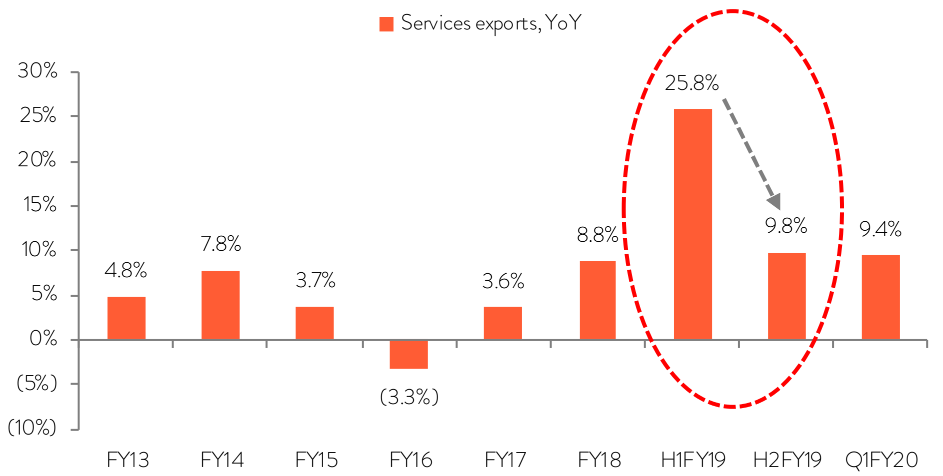


Source: CEIC, Bank of Baroda Research

Services exports losing momentum

As with merchandise exports, services exports also saw a deceleration in H2FY19. After rising 26% in H1FY19, growth stumbled to 9.8% in H2.

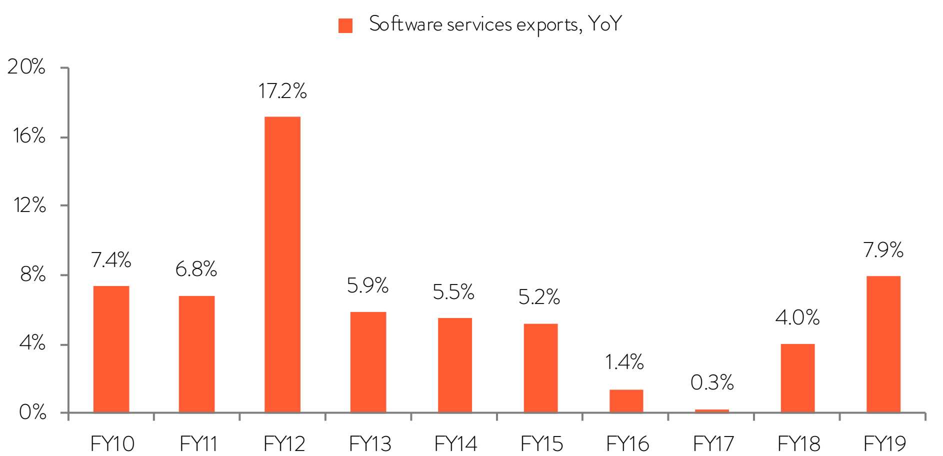
FIG 80 – SERVICES EXPORTS PLUNGED IN H2FY19



Source: CEIC, Bank of Baroda Research

Software services have been a key driver of India's services exports. In fact, software service exports have risen by 7.9% in FY19 compared with 4% in FY18. India's software exports are concentrated in the US (55%) and Europe (26%). While growth in the Eurozone is expected to slow considerably in CY19, US demand may hold up. Hence, on the whole, the outlook for services exports looks brighter than that for the merchandise segment.

FIG 81 – EXPORTS OF SOFTWARE SERVICES SHOWING AN UPTICK



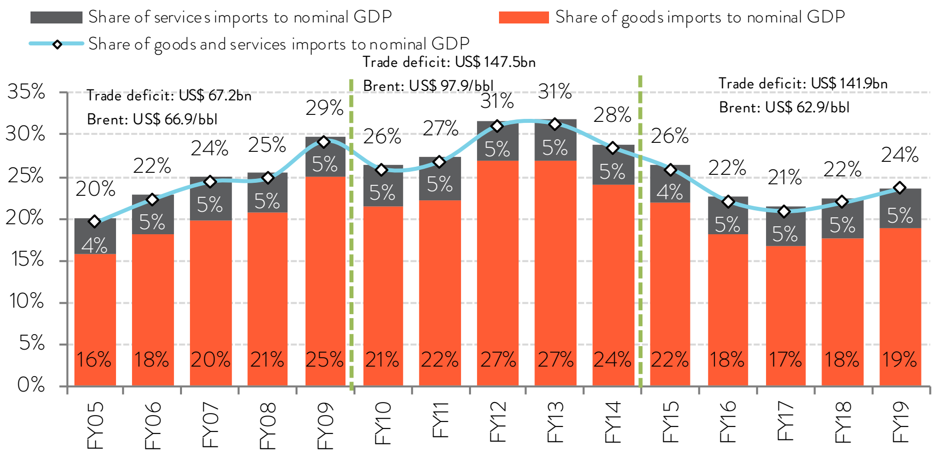
Source: CEIC, Bank of Baroda Research

Imports faltering as well

From a peak of 31% in FY13, the share of imports (goods and services) in GDP fell to 21% in FY17 led by a lower percentage of goods imported, primarily oil. In FY19, imports rose to 24% of GDP on the back of higher oil imports (5% of GDP). The oil deficit also ballooned to US$ 93bn from a low of US$ 56bn in FY17 due to higher oil prices (+23% in FY19) as import volumes grew just 1.3%.

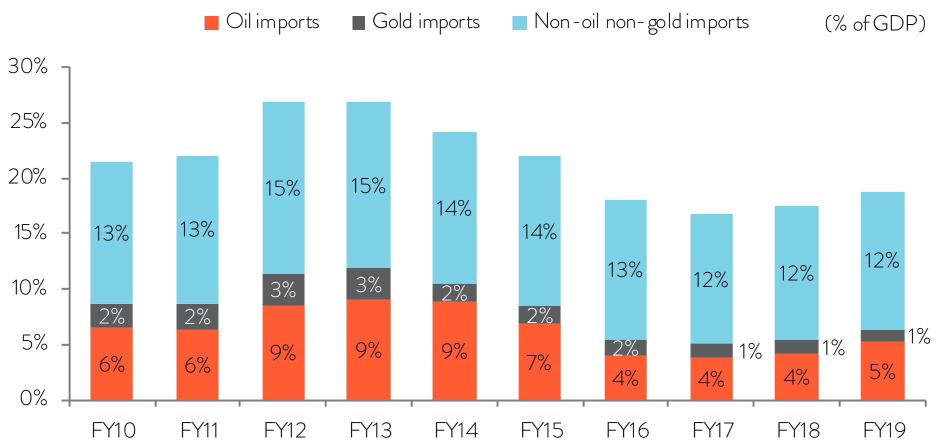
The growth in non-oil non-gold imports has declined during FY19 due to lower domestic consumption. Imports of electronic and capital goods have been falling since Nov'18 while agriculture imports have been heading south since Oct'17. Gold is the only commodity showing an increased intake.

FIG 82 – SHARE OF IMPORTS IN GDP AT 24% IN FY19 FROM 20% IN FY05



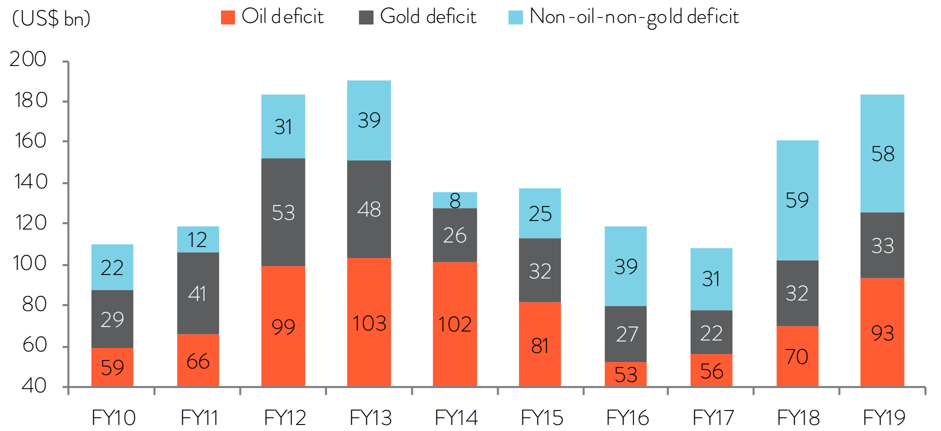
Source: CEIC, Bank of Baroda Research

FIG 83 – OIL IMPORTS INCREASED TO 5% OF GDP IN FY19 LED BY HIGHER PRICES



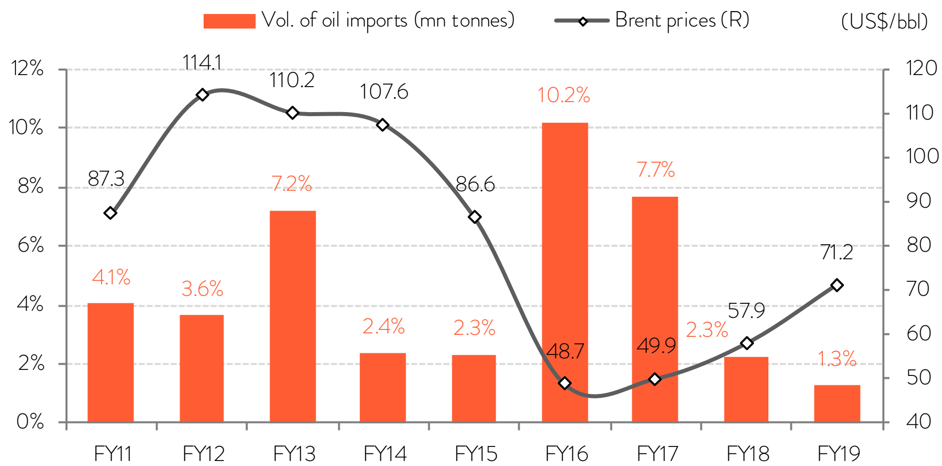
Source: CEIC, Bank of Baroda Research

FIG 84 – OIL DEFICIT BALLOONED IN FY19



Source: Bloomberg, CEIC, Bank of Baroda Research

FIG 85 – VOLUME OF OIL IMPORTS FALLING AS OIL PRICES INCREASE



Source: CEIC, Bank of Baroda Research

Trade outlook muted

With a slowing world economy and escalating tariff war between the US and China, we expect global trade and hence India's exports to remain lacklustre in CY19. Depressed commodity prices will be another limiting factor. Already in Q1FY20, exports have fallen 1.8% and we see no respite ahead.

Imports are also likely to soften further, in particular non-oil non-gold intake, because of subdued domestic demand. Non-oil non-gold imports have fallen 4.3% over Apr-Jul'19. Further, with oil prices at US$ 65/bbl in FY20 compared with US$ 71/bbl in FY19, oil imports will amount to only US$ 136bn vs. US$ 146bn if oil were to average at US$ 70/bbl in FY20. Services exports led by software services may, however, offer some support.

FIG 86 – SLOWING GLOBAL GROWTH TO HURT EXPORTS

Real GDP (% YoY)	CY14-CY17	CY18	CY19E
World	3.6	3.6	3.2
Advanced economies	2.1	2.2	1.9
Euro area	2.0	1.9	1.3
Japan	1.0	0.8	0.9
US	2.3	2.9	2.6
Emerging Market and Developing Economies	4.6	4.5	4.1
China	6.9	6.6	6.2
India	7.4	6.8	6.5*

Source: World Economic Outlook July 2019, IMF | *Bank of Baroda estimate | Note: Data for India is for Apr-Mar financial year

CURRENCY

The recent breach of the psychological 7/US$ mark for the Chinese Yuan (CNY) has put incremental pressure on the INR. While the CNY has depreciated by 3.7% in Aug'19, the INR also declined by 4.5%. Despite this, benign oil prices are the biggest underlying support for the rupee. While equity outflows have led to some currency volatility, we believe FDI inflows and low oil prices could keep the USD/INR rate at 70-72/$ in FY20.

Currency: Depreciation pressure on INR

FIG 87 – INR OUTLOOK

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20E Oil@65	FY20E Oil@70
USD/INR	47.92	54.40	60.47	61.15	65.46	67.07	64.46	69.89	70-72	72-74
Oil prices (US$/bbl)	114.1	110.2	107.6	86.6	48.7	49.9	57.9	71.2	65.0	70.0
CAD as % of GDP	4.2	4.7	1.7	1.5	1.0	0.6	1.9	2.1	1.9	2.1
FII inflows (US$ bn)	19.1	31.0	9.5	45.1	(1.6)	7.2	22.2	(0.6)	10.0	8.0
FX reserves (US$ bn) (accretion/depletion)	(12.8)	3.9	15.6	61.4	18.1	21.6	43.6	(3.3)	15.1	8.1

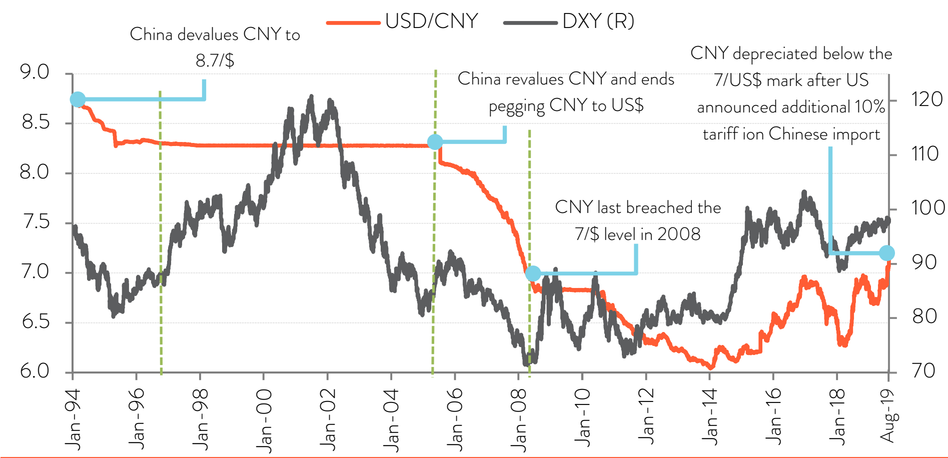
Source: Bloomberg, CEIC Bank of Baroda Research | E – Bank of Baroda estimate

Yuan weakening as trade tensions worsen

Apart from its detrimental impact on exports, the ongoing tariff war between the US and China is also weighing on the INR. The CNY has depreciated significantly by 5.8% since May'19, after the US imposed tariffs on US$ 250bn worth of Chinese imports. More recently, the US upped the ante by announcing a 10% tariff on another US$ 300bn worth of Chinese goods, which pushed the CNY below 7/$, an 11-year low. This in turn has put pressure on EM currencies including the INR.

With the constant back and forth between US and China on the trade dispute, the outlook on CNY remains marred in uncertainty. Any further depreciation in the Yuan remains a key risk for the INR going forward.

FIG 88 – CNY HAS DEPRECIATED AGAINST THE USD



Source: Bloomberg, Bank of Baroda Research | As on 26 Aug 2019

FIG 89 – CURRENCY CROSS-CORRELATION MATRIX

USD/INR	JPY	CNY	IDR	PHP	KRW	THB	MYR	RUB	BRL	TWD	ZAR	TRY
1-month	(0.87)	0.97	0.91	0.97	0.91	(0.56)	0.94	0.91	0.96	0.83	0.93	0.20
3-month	(0.63)	0.94	0.55	0.79	0.81	0.02	0.78	0.84	0.86	0.63	0.89	(0.02)
1-year	0.50	0.30	0.78	0.81	(0.39)	0.61	0.30	0.51	(0.01)	(0.28)	0.22	0.09
5-year	(0.28)	0.73	0.83	0.70	0.47	(0.08)	0.55	0.65	0.80	0.18	0.71	0.80

Source: Bloomberg, Bank of Baroda Research | As on 26 Aug 2019

Lower oil price a key support

India's current account deficit (CAD) and rupee movement are closely linked. The events of 2013 serve as a case in point – in FY12 and FY13, India's CAD had ballooned to 4.2% (US$ 78bn) and 4.7% (US$ 88bn) of GDP respectively. FDI and FPI inflows stood at only 50% and 53% of CAD in these two years. The rest had to be made up either via loans or by drawing down existing reserves. This unsustainably high deficit precipitated a steep 14% drop in the INR against the USD in a span of five months between May'13 and Sep'13, before some recovery once CAD was recalibrated to a more sustainable level of 1.7% of GDP in FY14.

India's external account came under pressure once again in FY19 when higher oil prices saw CAD swell to 2.1% of GDP (US$ 57.3bn) from 1.9% (US$ 48.7bn) in FY18. However, oil prices have softened recently to below US$ 65/bbl vs. US$ 71/bbl in FY19, implying that CAD is likely to narrow to 1.9% of GDP in FY20 (assuming oil at US$ 65/bbl in our base case) – which bodes well for the rupee.

FIG 90 – OIL PRICE SENSITIVITY

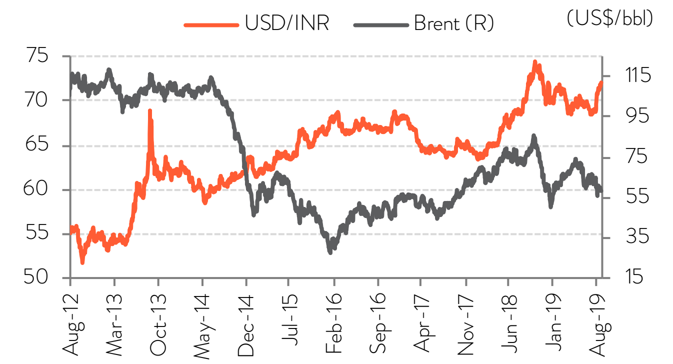
(US$ bn)	FY16	FY17	FY18	FY19	2020E Oil@65	2020E Oil@70
Oil prices (US$/bbl)	**48.7**	**49.9**	**57.9**	**71.2**	**65**	**70**
USD/INR	**65.46**	**67.07**	**64.46**	**69.89**	**70-72**	**72-74**
Current account	**(22.1)**	**(14.3)**	**(48.7)**	**(57.3)**	**(57.4)**	**(62.4)**
CAD/GDP (%)	**(1.0)**	**(0.6)**	**(1.9)**	**(2.1)**	**(1.9)**	**(2.1)**
Trade balance	(130.0)	(112.4)	(160.0)	(180.3)	(181.6)	(189.1)
- Merchandise exports	266.4	280.2	309	337.2	346.0	348.3
- Merchandise imports	396.4	392.6	469	517.5	527.6	537.4
--Oil imports	82.9	86.8	108.6	140.8	135.8	145.6
--Non-oil imports	313.5	305.8	360.4	376.7	391.8	391.8
- Net Services	69.7	68.3	77.6	81.9	84.0	84.0
--Software	71.5	70.8	72.2	77.7	80.0	80.0
Transfers	62.6	56	62.4	69.9	70.0	72.5
Other invisibles	(24.4)	(26.3)	(28.7)	(28.9)	(29.9)	(29.9)
Capital account	**41.2**	**36.3**	**91.4**	**54.4**	**72.5**	**70.5**
% of GDP	**2.0**	**1.6**	**3.6**	**2.0**	**2.4**	**2.4**
Foreign investments	31.9	43.2	52.4	30.1	43.0	41.0

(US$ bn)	FY16	FY17	FY18	FY19	2020E Oil@65	2020E Oil@70
- FDI	36	35.6	30.3	30.7	33.0	33.0
- FII	(4.1)	7.6	22.1	(0.6)	10.0	8.0
Banking capital	10.6	(16.6)	16.2	7.4	10.0	10.0
Short-term credit	(1.6)	6.5	13.9	2.0	5.0	5.0
ECBs	(4.5)	(6.1)	(0.2)	10.4	10.0	10.0
External assistance	1.5	2.0	2.9	3.4	3.5	3.5
Other capital account items	3.3	7.6	6.1	1.1	1.0	1.0
E&O	(1.1)	(0.5)	0.9	(0.5)	0.0	0.0
Overall balance	18.1	21.6	43.6	(3.3)	15.1	8.1

Source: CEIC, Bank of Baroda Research

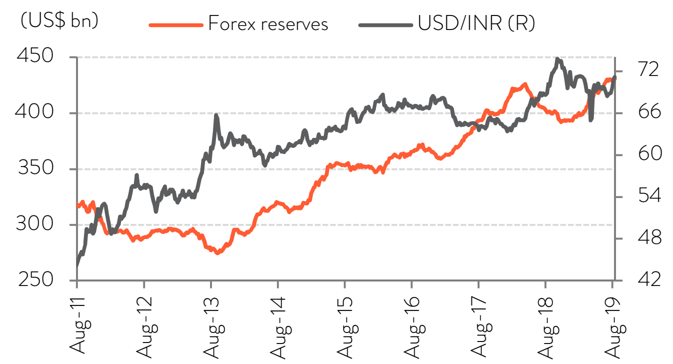
While we expect oil prices to remain benign, recent geopolitical tensions in the Middle East and accompanying price volatility are key risks to our currency outlook. Should oil prices rise to US$ 80/bbl levels, India's trade deficit will surge to US$ 204bn or 6.9% of GDP in FY20 from US$ 180bn (6.7% of GDP) in FY19. This will cause a shortfall of US$ 12.4bn in US dollar supply which will be met through depletion of forex reserves, proving detrimental for the INR.

FIG 91 – LOWER OIL PRICES SUPPORT INR



Source: Bloomberg, Bank of Baroda Research | As on 26 Aug 2019

FIG 92 – INR DEPRECIATES AS PRESSURE ON FOREX RESERVES INTENSIFIES



Source: CEIC, Bloomberg, Bank of Baroda Research | As on 16 Aug 2019

Debt inflows to counterbalance equity outflows

Historically, FPI outflows have proven to be the most immediate and important driver of currency depreciation. This is illustrated in the following episodes:

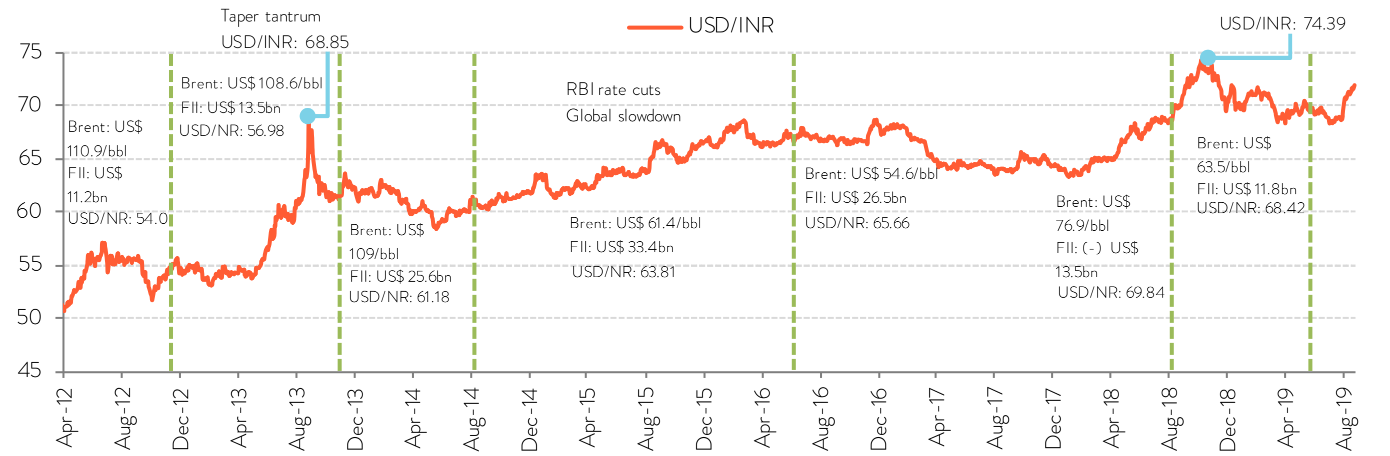
- In FY09, the INR depreciated by 13% after FPI outflows of US$ 10.2bn triggered by the collapse of Lehman Brothers and the ensuing global financial crisis.
- During Jun'13-Sep'13, cumulative FPI outflows were US$ 11.8bn, driven by the taper tantrum when the US Fed signalled the beginning of the end for quantitative easing. As a result, the INR dropped nearly 14% against the USD

(to 68.85/$) in a span of four months in 2013, before recovering once the RBI successfully raised foreign capital through FCNR (B) deposits.

- In FY17, FPI outflows of US$ 11.3bn in the third quarter preceded a 2% decline in the INR.
- In FY19 as well, FPI outflows were concentrated between Apr'18 and Oct'18 at US$ 16.6bn, contributing to a 12% depreciation in INR. Since then, a resumption of inflows has kept the rupee stable.

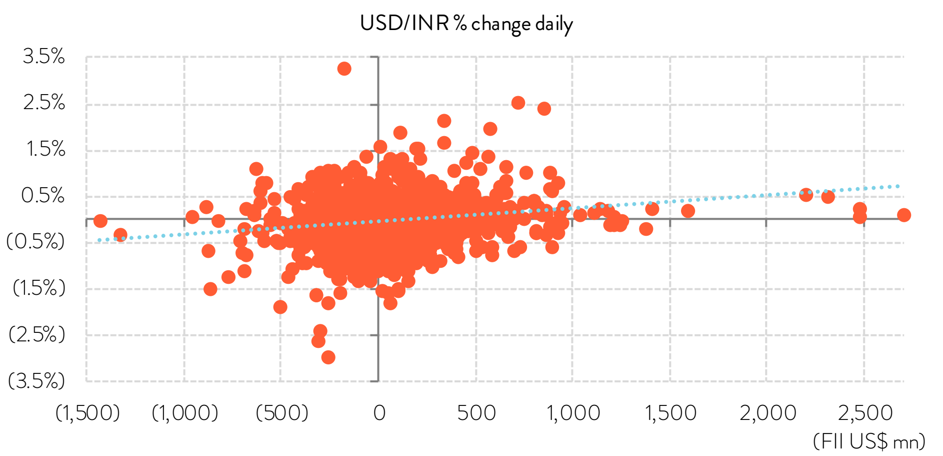
Other factors also play a role in the INR's trajectory, but the immediate decline in value of the currency coincides with FPI outflows. This is because the impact of other variables such as oil prices, food inflation and fiscal deficit plays out through equity and debt market inflows/outflows which in turn affect the INR with a lag. For instance, a US$ 10/bbl increase in oil price is likely to push up retail inflation by 60-70bps (direct and indirect impact). This implies higher yields and hence reduced FPI positions in India, which then triggers INR depreciation.

FIG 93 – RUPEE MOVEMENT



Source: Bloomberg, Bank of Baroda Research | As on 26 Aug 2019

FIG 94 – FII OUTFLOWS EXERT DEPRECIATION PRESSURE ON INR

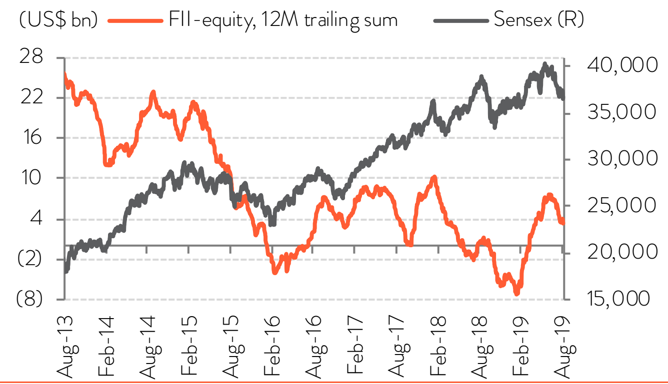


Source: Bloomberg, CEIC, Bank of Baroda Research | As on 26 Aug 2019

In FY19, FII outflows from India totalled US$ 6.3bn, concentrated largely in the debt segment. In equities, FII inflows in Q4FY19 at US$ 6.8bn helped offset outflows of US$ 6.7bn over Apr-Dec'18. This trend continued in Q1FY20 with inflows of US$ 4.5bn in equities, while debt attracted just US$ 884mn.

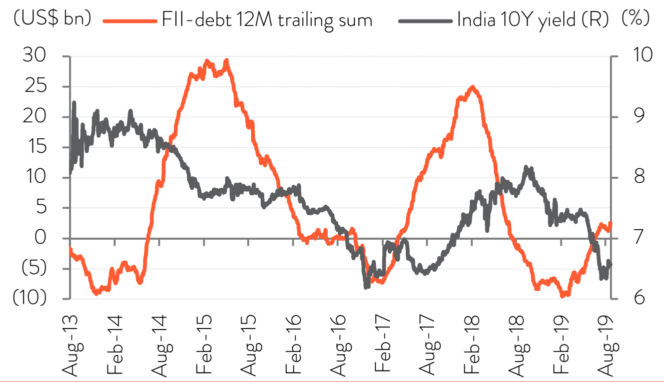
However, there has been a reversal since Q1 as a hike in FPI surcharge in the FY20 Budget coincided with the domestic growth slowdown, prompting FIIs to pull out US$ 3.3bn from the domestic equity market since Jul'19. On the other hand, debt inflows have picked up to US$ 2bn, partly mitigating the impact of the equity exodus. We expect debt inflows to continue at the same pace. Equity outflows may also abate as the government has now rolled back the FPI surcharge and SEBI has also eased norms for these investors.

FIG 95 – FII-EQUITY FLOWS HAVE DECELERATED SINCE JUL'19



Source: Bloomberg, CEIC, Bank of Baroda Research | As on 23 Aug 2019

FIG 96 – DEBT INFLOWS HAVE PICKED UP



Source: Bloomberg, CEIC, Bank of Baroda Research | As on 23 Aug 2019

INFLATION

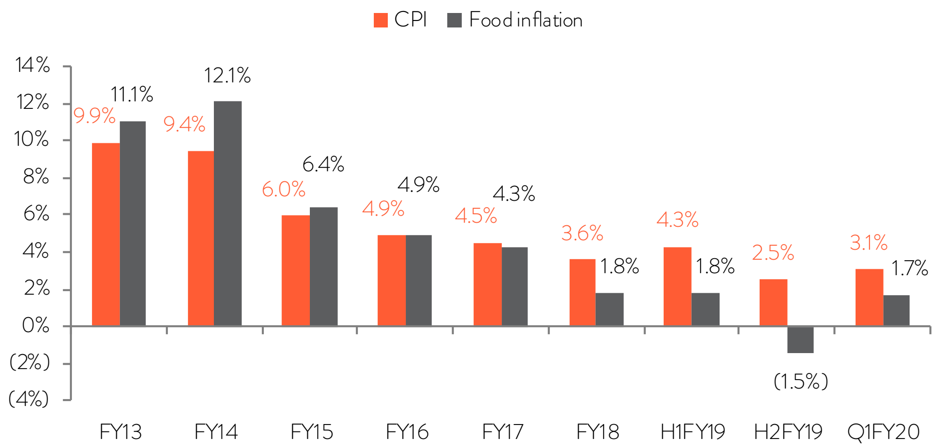
After a print of 3.4% in FY19, we expect headline CPI at 3.3%/3.5% in FY20/FY21. Food inflation is likely to inch up steadily, particularly in the second half of the year due to a low base effect and scattered monsoon progress. But with oil prices expected to hold close to current levels, inflation in the fuel, light, transport and communication categories should moderate. We also forecast a 160bps drop in core inflation to 4.2% as poor consumption demand erodes pricing power.

Inflation: Holding within MPC's 4% target

CPI cooled off in H2FY19

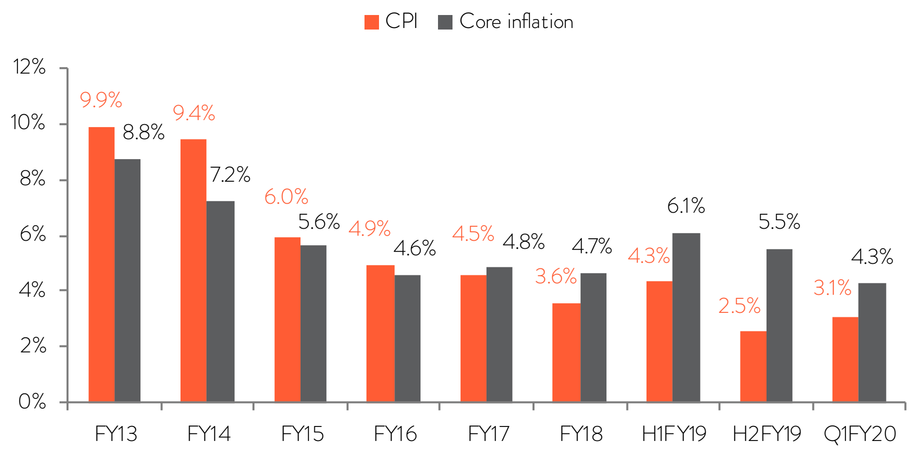
India's inflation rate has moderated considerably in H2FY19 following a 1.5% decline in food inflation (up 1.8% in H1), closing FY19 at 3.4%. Vegetables, pulses and sugar prices have eased the most. Cereals also edged down despite a generous increase in MSPs last year. With large food stocks (domestic and global), food prices are unlikely to pick up much in the near-to-medium term. Core inflation, on the other hand, has remained high through FY19 (5.8%), rising to 6.1% in H1 before cooling off to 5.5% in H2.

FIG 97 – RETAIL INFLATION MODERATED IN H2FY19, LED BY FOOD BUT IS INCHING UP LATELY



Source: CEIC, Bank of Baroda Research | Note: In Jul'19, CPI was at 3.2%, CFPI inched up to 2.4%

FIG 98 – CORE INFLATION REMAINED HIGH THROUGH FY19 BUT HAS MODERATED OFF LATE



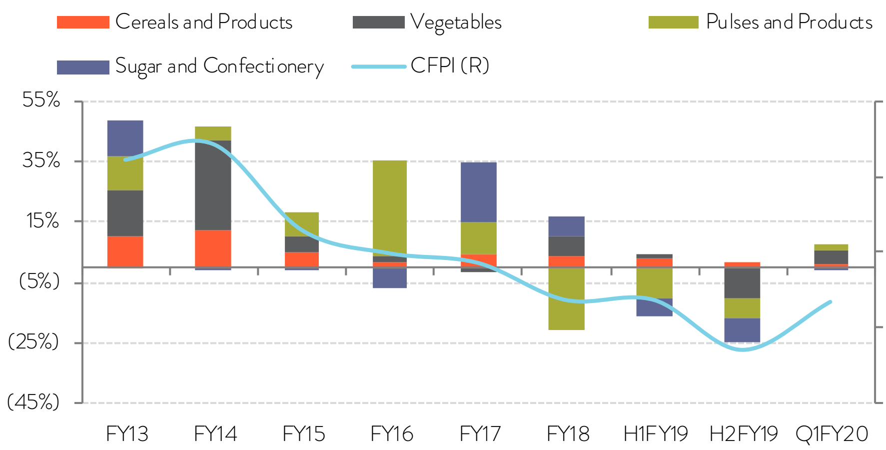
Source: CEIC, Bank of Baroda Research | Note: In Jul'19, Core CPI was at 4.2%

Deflation in food prices

A combination of factors contributed to the decline in food inflation in FY19, namely: (1) deflation in prices of vegetables (–4.4%), pulses (–8.2%) and sugar (–7%); (2) a favourable global food price cycle, stable foodgrain production (283mn tonnes in FY19) and rising grain stock (81mt in Jun'19 vs. 69mt in Jun'18); (3) muted rural wages as MGNREGA allocation stagnated (0.3% of GDP) and the focus shifted to direct income transfers; and (4) falling agri exports to GDP, resulting in surplus supply in the domestic market.

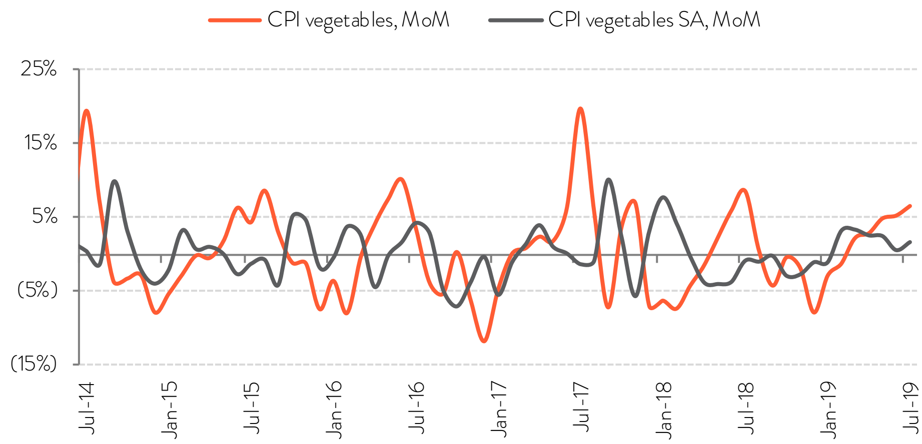
Vegetable prices dropped 4.4% in FY19. Pulses (–8.2% vs.–20% in FY18) and sugar (–7% vs. +6%) fell the most

FIG 99 – MODERATION IN VEGETABLE PRICES DRAGGED FOOD INTO DEFLATION IN H2FY19, SLIGHT UPTICK IS VISIBLE CURRENTLY



Source: CEIC, Bank of Baroda Research | Note: In Jul'19 vegetable inflation was at 2.8%, pulses inflation rose to 6.8%

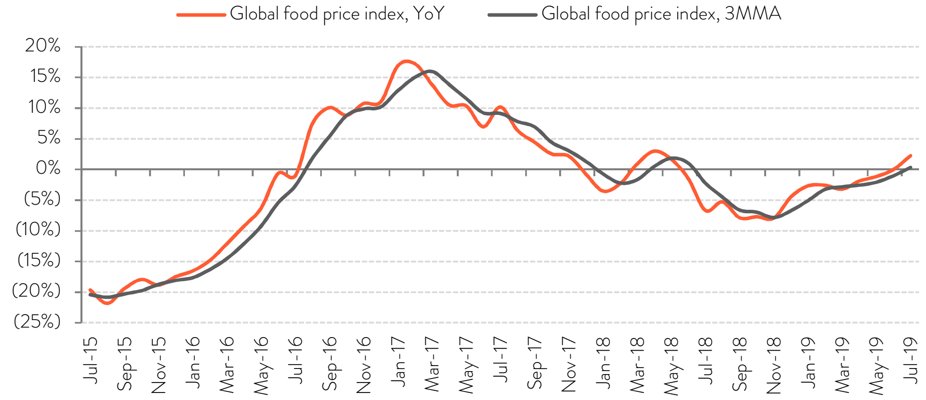
FIG 100 – SEASONALITY-ADJUSTED VEGETABLE PRICES INCHING DOWN, REFLECTING RECEDING SEASONAL IMPACT



Source: CEIC, Bank of Baroda Research

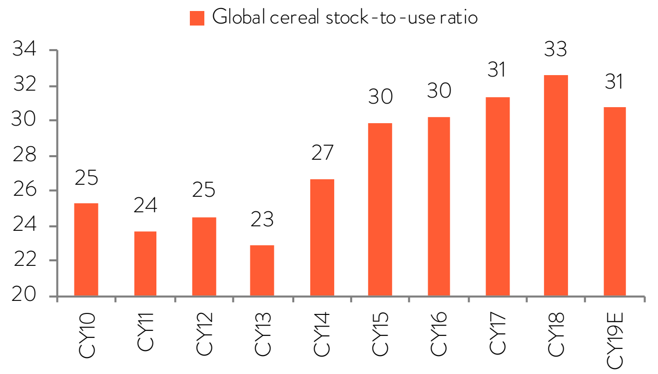
Food prices remain muted globally

FIG 101 – FAVOURABLE GLOBAL FOOD PRICE CYCLE



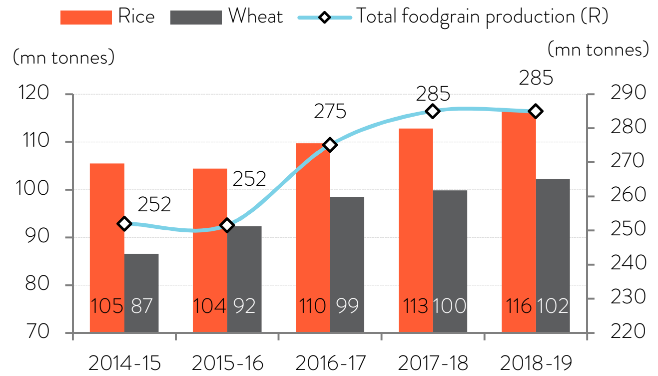
Source: FAO, Bank of Baroda Research

FIG 102 – HIGHER STOCK OF CEREAL GLOBALLY CONTAINED DOMESTIC PRICES



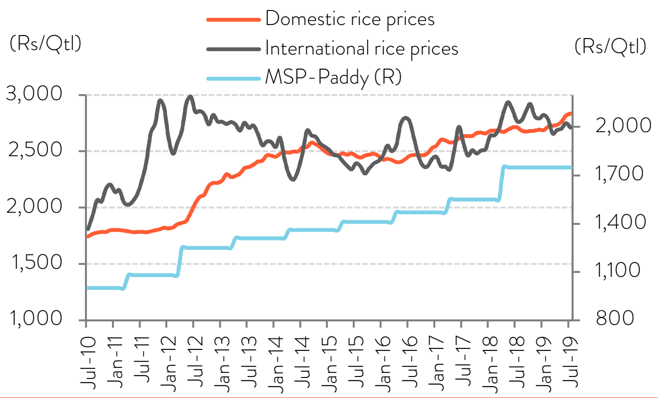
Source: FAO, Bank of Baroda Research

FIG 103 – INDIA'S FOODGRAIN PRODUCTION HAS REMAINED STABLE AS WELL



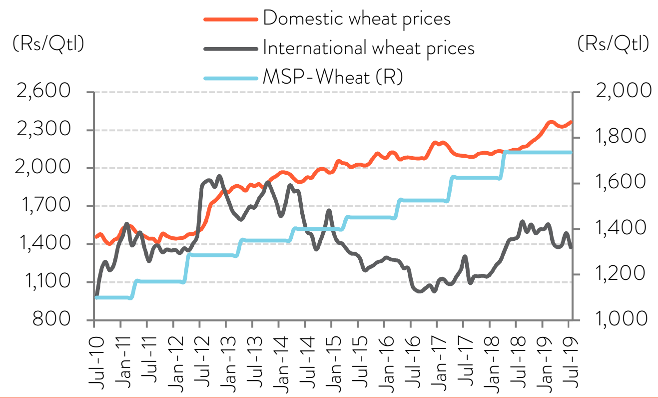
Source: Ministry of Agriculture and Farmers Welfare, Bank of Baroda Research, 2018-19: | Note: 4th Advance Estimate, Years represent agriculture years

FIG 104 – DOMESTIC & INTERNATIONAL PRICES OF RICE WERE ALIGNED…



Source: CEIC, World Bank, Bank of Baroda Research

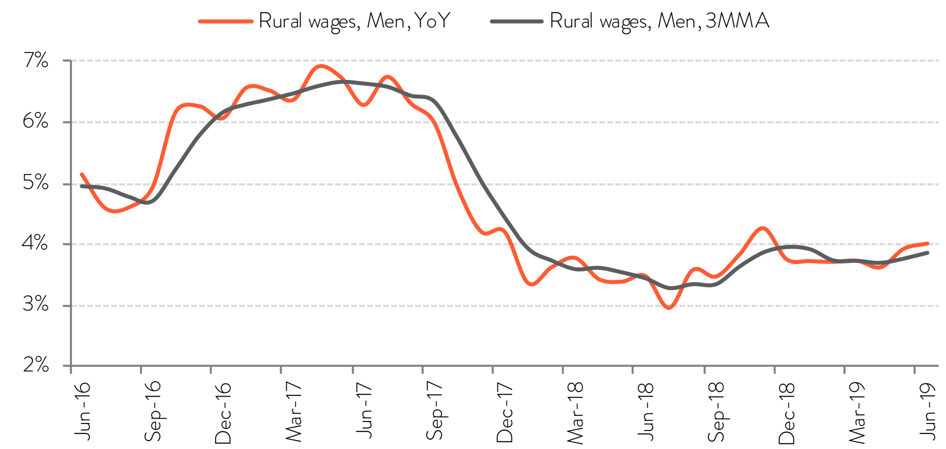
FIG 105 – …BUT DOMESTIC WHEAT PRICES TRENDED HIGHER, LIMITING PRICE HIKES



Source: CEIC, World Bank, Bank of Baroda Research

Allocation to rural jobs scheme MGNREGA flat at 0.3% of GDP over the last few years and per-day wage stagnant

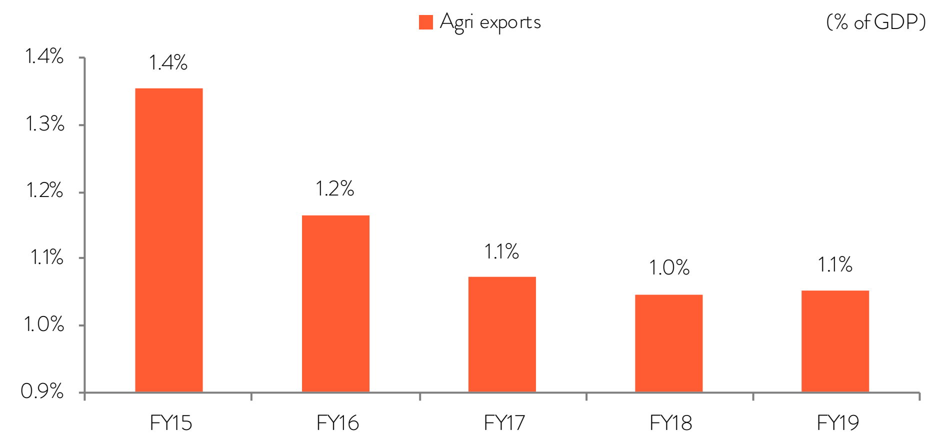
FIG 106 – MUTED RURAL WAGES LED TO LOWER CONSUMPTION



Source: CEIC, Bank of Baroda Research

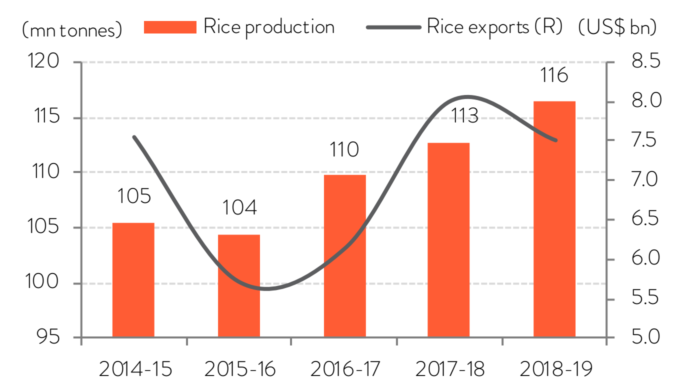
Domestic production of major cereals (wheat, rice) shot up in FY19 while exports declined, creating a supply surplus and hence pricing pressure

FIG 107 – AGRI EXPORTS TO GDP RATIO HAS FALLEN SINCE FY15



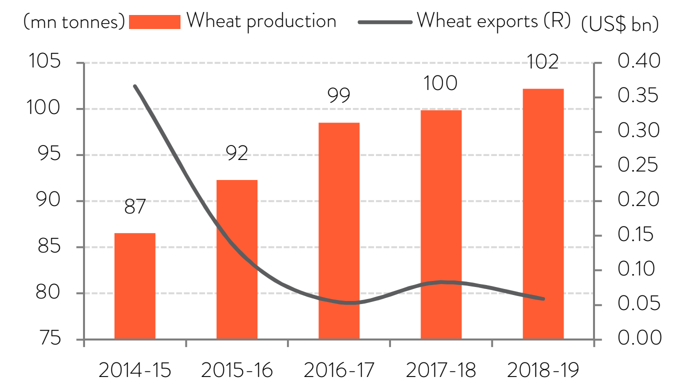
Source: CEIC, Bank of Baroda Research

FIG 108 – DOMESTIC PRODUCTION OF RICE RISING BUT EXPORTS ARE FALLING...



Source: Ministry of Agriculture and Farmers Welfare, CEIC, Bank of Baroda Research | Note: Years represent agriculture season

FIG 109 – ...SIMILAR TREND FOR WHEAT, LEAVING THE DOMESTIC MARKET IN SURPLUS

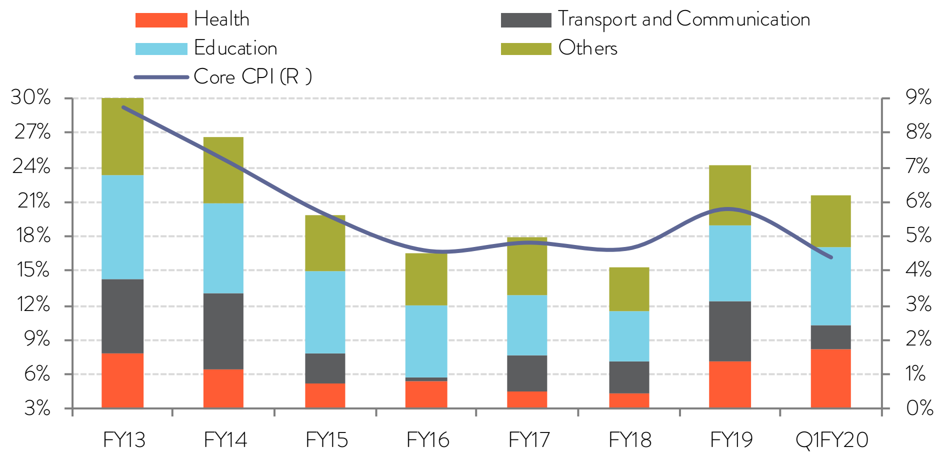


Source: Ministry of Agriculture and Farmers Welfare, CEIC, Bank of Baroda Research | Note: Years represent agriculture season

Core sticky through FY19 but moderating of late

Core inflation has come off from 6.1% in H1FY19 to 5.5% in H2FY19 and 4.2% in Q1FY20 as the housing component stabilised. Housing inflation had risen by 6.8% in FY19 due to the Pay Commission related hike in HRA. Other major components that saw significant increases in FY19 were healthcare (7.1% in FY19 vs. 4.4% in FY18), transport and communication (5.2% vs. 2.7%), and education (6.6% vs. 4.5%). These three groups comprise 19% weightage in the CPI. However, the pace of inflation in all these indices has started to ease from Q4FY19 and should continue to moderate.

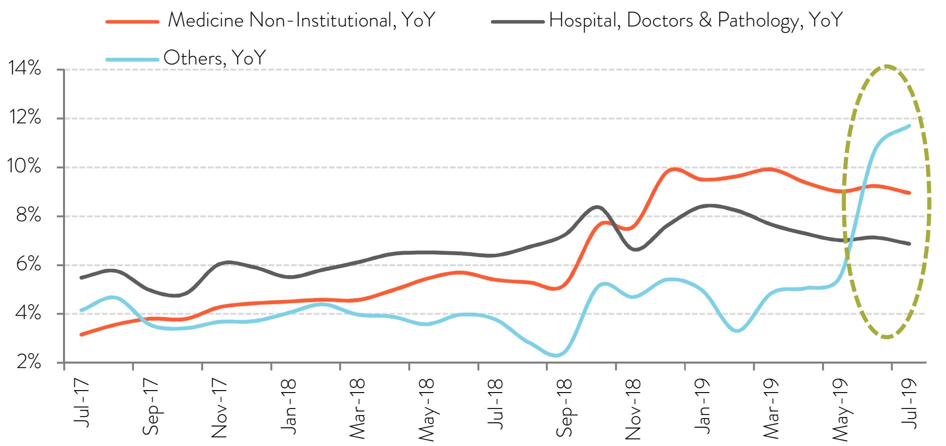
FIG 110 – HEALTH AND EDUCATION SAW SIGNIFICANT INCREASES IN FY19



Source: CEIC, Bank of Baroda Research

FIG 111 – HEALTHCARE: HIGHER COST OF MEDICINES LED TO ELEVATED INFLATION, BUT IS MODERATING LATELY

Inflation in healthcare peaked in Mar'19 and has been moderating since then



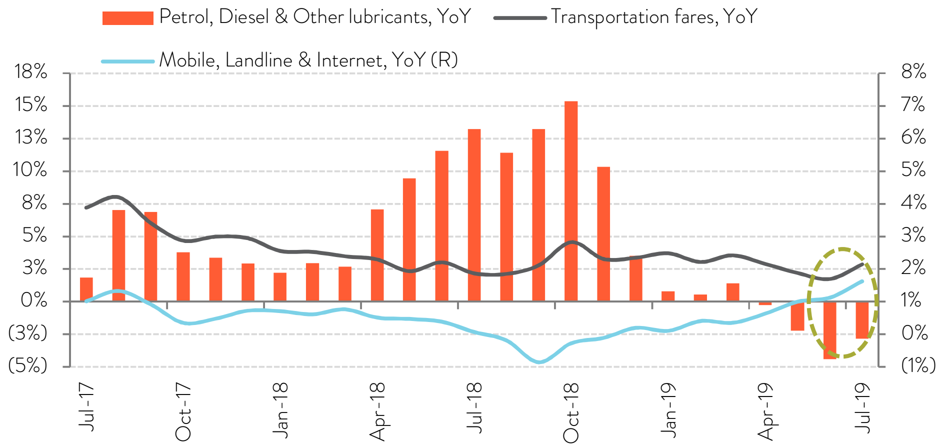
Source: CEIC, Bank of Baroda Research

Global oil prices rose ~18% in H1FY19 but fell 17% in H2, leading to lower inflation in the latter part of the year.

In Q1FY20, oil prices are down by (-) 3% and currently further lower at US$ 59/bbl.

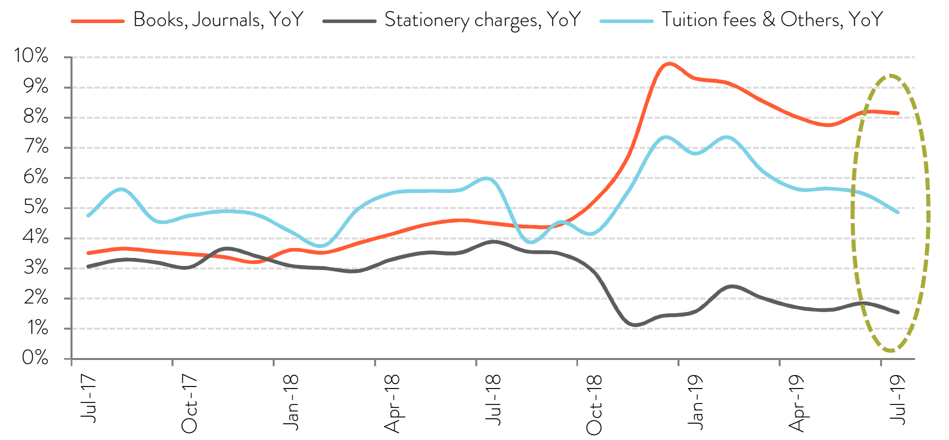
CPI sensitivity to a US$ 10/bbl change in oil price is ~70bps

FIG 112 – TRANSPORT & COMMUNICATION: HIT BY VOLATILE FUEL PRICES



Source: CEIC, Bank of Baroda Research | Note: Jul'19 rise in petrol and diesel prices is due to increase in excise duty

FIG 113 – EDUCATION: HIGHER TUITION FEES, BOOK & JOURNAL PRICES DROVE INFLATION UP, BUT EDGING DOWN OF LATE

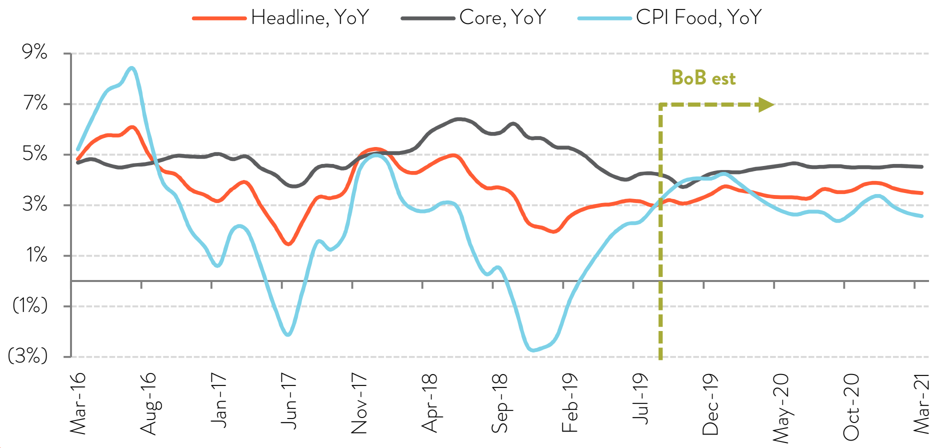


Source: CEIC, Bank of Baroda Research

Expect CPI to remain benign in FY20

We expect headline CPI to be at 3.3%/3.5% in FY20/FY21 vs. 3.4% in FY19. Food inflation is likely to inch up steadily, in particular during H2FY20 due to the low base of last year. Below-normal monsoon in the initial period and then excess rainfall later has hindered sowing of certain crops, which in turn will drive up prices. On the other hand, oil prices appear to have stabilised at current levels and hence the fuel, light, transport and communication categories should see lower inflation. We expect core inflation to come off to 4.2% in FY20 as lower consumption implies lower pricing power.

FIG 114 – HEADLINE CPI EXPECTED TO BE AT 3.3%/3.5% IN FY20/FY21



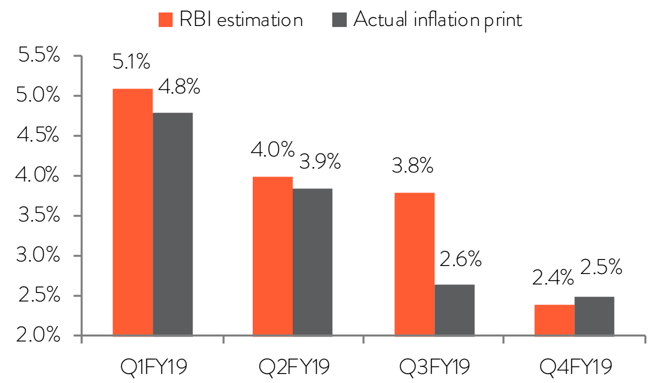
Source: CEIC, Bank of Baroda Research

FIG 115 – TRAJECTORY OF INFLATION IN FY20E

(BOB Estimates) (%)	CPI	Core	CFPI
FY20E			
Q1FY20	3.1	4.2	1.7
Q2FY20E	3.1	4.2	2.9
Q3FY20E	3.2	4.0	4.0
Q4FY20E	3.6	4.3	3.8
FY21E			
Q1FY21E	3.3	4.6	2.8
Q2FY21E	3.5	4.5	2.6
Q3FY21E	3.7	4.4	3.1
Q4FY21E	3.5	4.5	2.7

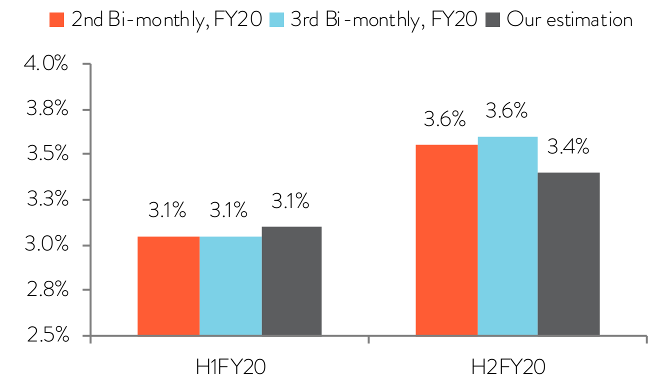
Source: Bank of Baroda Research

FIG 116 – ACTUAL INFLATION THROUGH FY19 HAS UNDERSHOT RBI'S TRAJECTORY

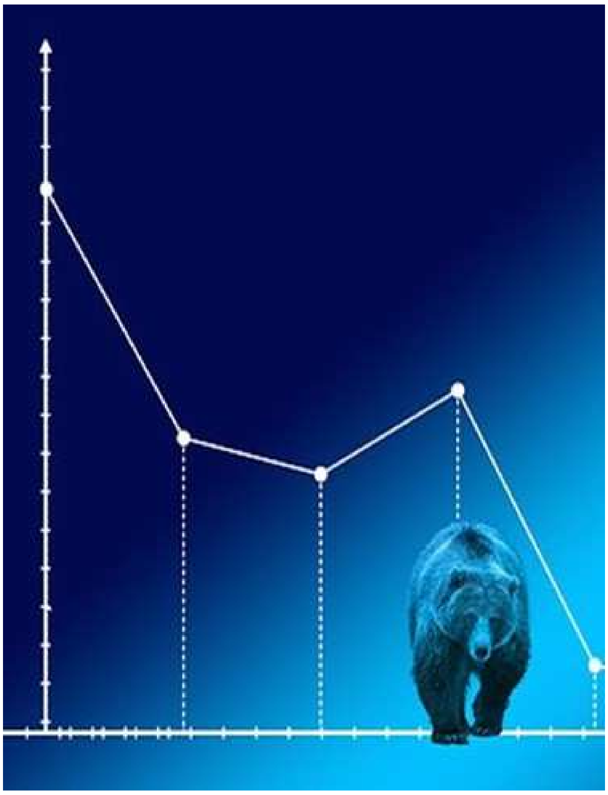


Source: MPR and RBI policy document, Bank of Baroda Research

FIG 117 – RBI HAS RETAINED ITS INFLATION FORECAST FOR FY20 AT 3.3%



Source: RBI policy document, Bank of Baroda Research



INTEREST RATES

RBI's monetary accommodation initiatives are likely to continue at an urgent pace amid efforts to revive the economy. The central bank has slashed the repo rate by 110bps in the current cycle, and we anticipate another 40bps cut this year to prop up growth. This in turn would contain the 10Y yield at benign sub-6% levels in FY20 (assuming oil at US$ 65/bbl). Overall, we expect a sustained dovish policy stance to support a return to 7% GDP growth in FY21.

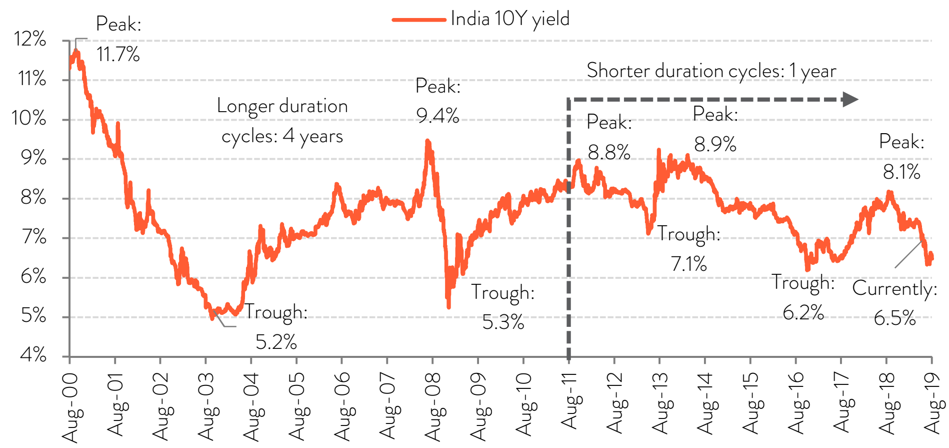
Interest rates: Expect 40bps cut in repo

Yields: A volatile trajectory

India's 10Y yield peaked at 8.1% in Oct'18, coinciding with oil prices breaching US$ 80/bbl following US sanctions on Iran. Since then, oil has fallen and so have global and domestic yields. Indian yields did react negatively to a few domestic events such as above-estimated borrowing in H2FY19 and high gross borrowing in FY20BE (Rs 7.1tn, 24% higher than FY19).

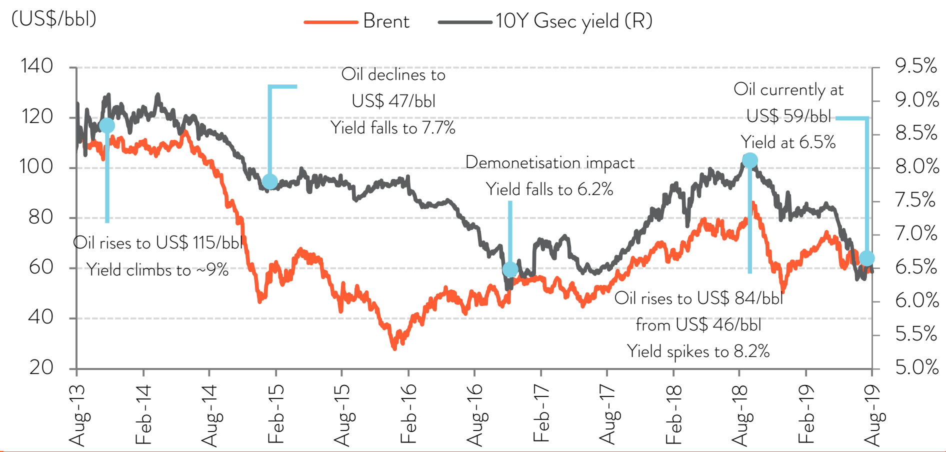
On the positive side, RBI has reduced policy rates by 110bps in the last four consecutive MPC meetings and also revised its stance from tightening to neutral and then to accommodative within a span of three monetary policy meetings. Liquidity with banks has moved from deficit to surplus and RBI continues to inject durable liquidity into the economy, supporting a more benign outlook on yields.

FIG 118 – 10Y YIELD PEAK AND TROUGH CYCLE



Source: Bloomberg, Bank of Baroda Research | Note: Data as on 26 Aug 2019

FIG 119 – OIL PRICES AND 10Y YIELD EXHIBITING PERFECT CORRELATION



Source: Bloomberg, Bank of Baroda Research | Note: Data as on 26 Aug 2019

Current macro favours steady decline in yields

The outlook on Indian yields is fairly benign if one looks at historical peaks and troughs. The lowest points in the 10Y interest rate cycle are 5% in 2003 followed by 5.2% in 2009. We believe the current macroeconomic backdrop favours a steady decline in yields below 6% in FY20 for the reasons outlined below.

Global downturn and accommodative policies

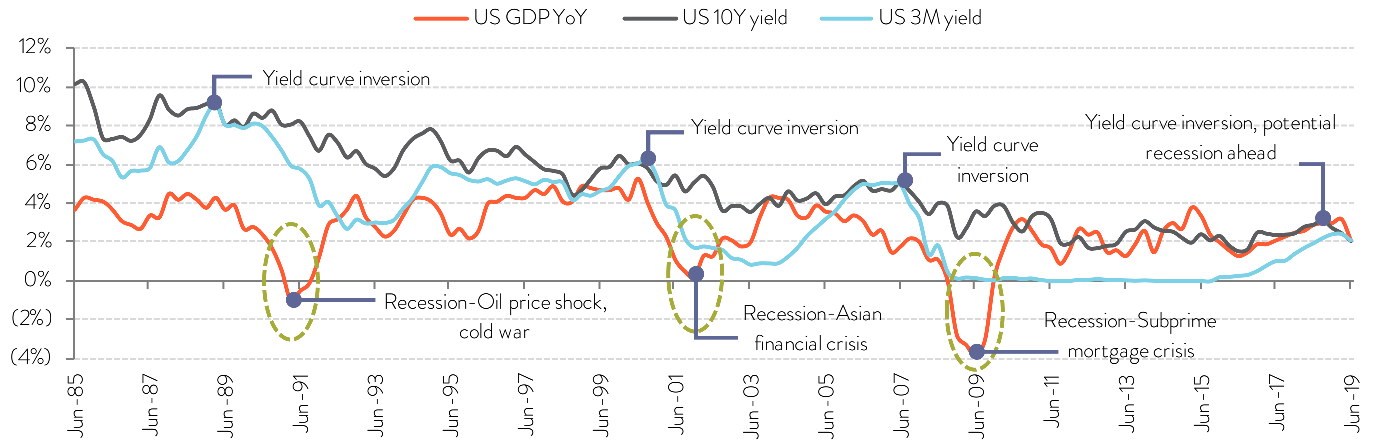
The global economy is decelerating and central banks the world over are reducing policy rates as they turn more accommodative. The US yield curve has inverted which is a sign of slowing growth. Global crude prices have started to ease and commodity prices too are declining. Amid the downturn, the 10Y sovereign yield of all major economies has declined in CYTD19.

FIG 120 – POLICY RATES SIGNAL ACCOMMODATIVE STANCE IN CYTD19

Country (%)	Current policy rate	CY18	CYTD19	Direction of policy rate in CYTD19
Germany	0	0	0	-
UK	0.75	25	0	-
Japan	(0.1)	0	0	-
China	4.35	0	0	-
Brazil	1.75	75	0	-
US	2.25	100	(25)	⬇
Mexico	8.00	100	(25)	⬇
Korea	1.5	25	(25)	⬇
Thailand	1.50	25	(25)	⬇
Malaysia	3	25	(25)	⬇
Australia	1	0	(50)	⬇
Russia	7.25	0	(50)	⬇
Indonesia	5.50	175	(50)	⬇
Philippines	4.25	175	(50)	⬇
India	5.40	50	(110)	⬇

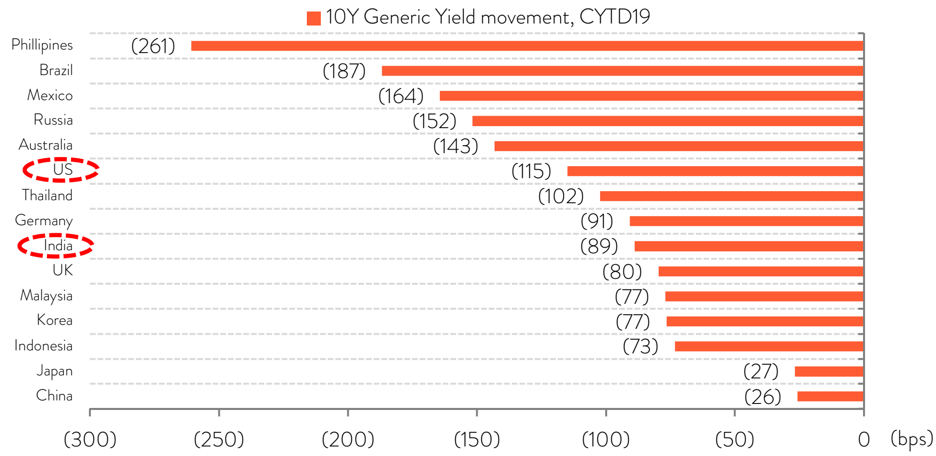
Source: Bloomberg, Bank of Baroda Research | Note: Policy change in bps

FIG 121 – US YIELD CURVE INVERSION PORTENDS A RECESSION



Source: Bloomberg, Bank of Baroda Research | Note: Yield curve inversion is seen post Fed policy in Jul'19, as on 26 Aug, US 10Y yield: 1.52%, US 3M yield: 1.95%

FIG 122 – 10Y YIELD OF ALL ECONOMIES DECLINED IN CYTD19

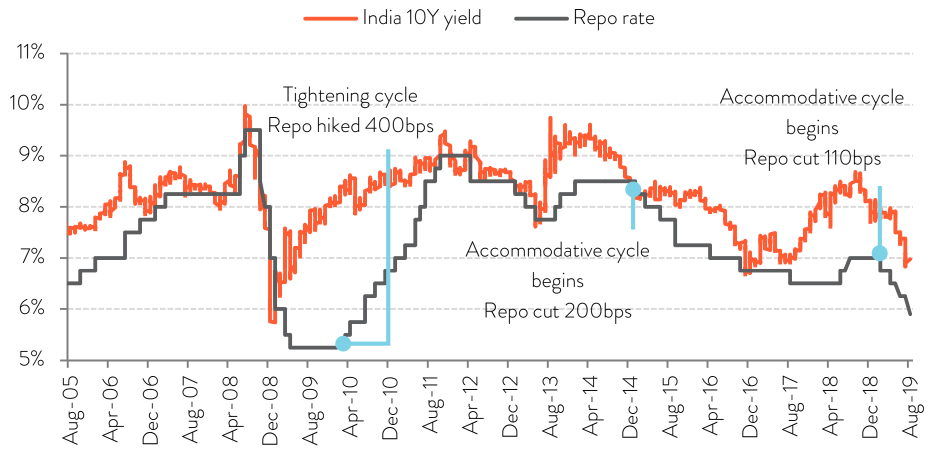


Source: Bloomberg, Bank of Baroda Research | Note: Data as on 26 Aug 2019

Room for more rate cuts

We see room for more rate cuts by RBI – as much as 40bps in FY20 – as real interest rates remain high and growth continues to stutter. Given the current global slowdown and domestic fiscal stance of paring the deficit to 3%, we believe monetary stimulus will be required. Historical data suggests an economic revival when the 10Y yield has fallen to as low as 5.2%/5.3%, as domestic mortgage and other loans get repriced, leading to higher consumption/savings and thus a virtuous growth cycle.

FIG 123 – TRANSMISSION OF POLICY DECISION INTO 10Y YIELD

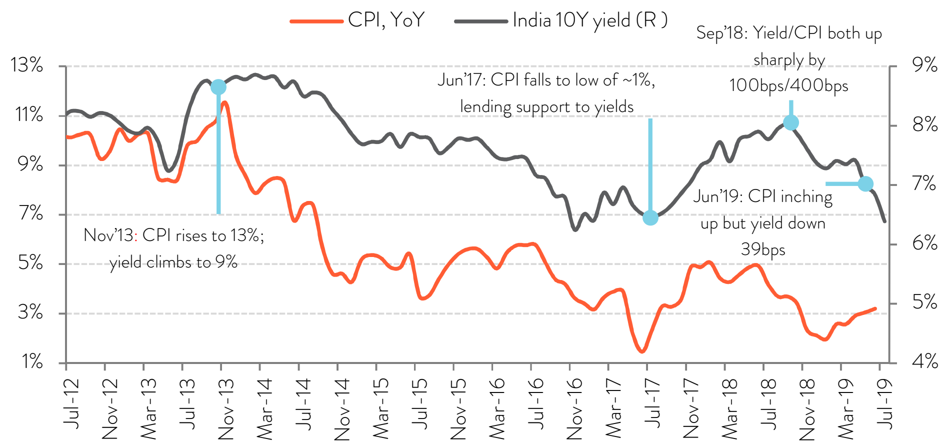


Source: Bloomberg, CEIC, Bank of Baroda Research | Note: Data as on 26 Aug 2019

Inflation in check

With inflation expected to stay below RBI's target of 4% in FY20 and FY21, the central bank has the leeway to cut rates by another 40bps this fiscal.

FIG 124 – INDIA 10Y YIELD AND INFLATION TRAJECTORY



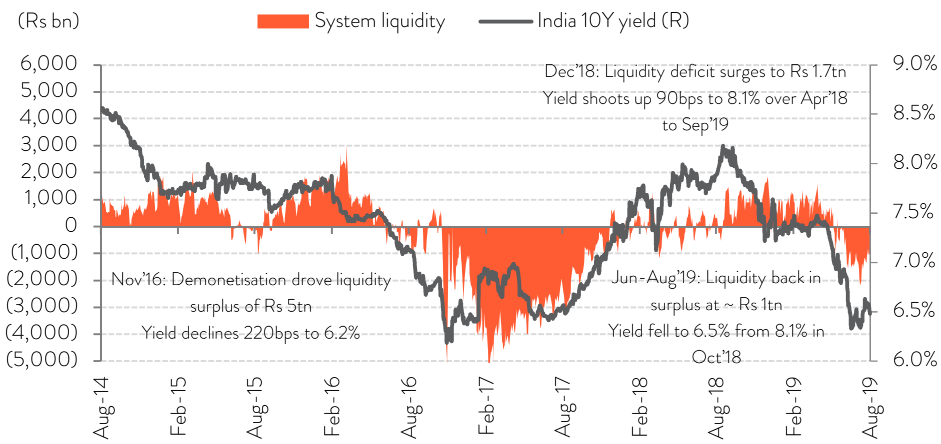
Source: CEIC, Bank of Baroda Research

Liquidity swings from deficit to surplus

Monetary policy transmission is more effective in a liquidity-surplus scenario. In Dec'18, India's liquidity deficit had increased to Rs 1.1tn fuelled by FPI outflows of US$ 14bn over Apr-Dec'18 and the credit-deposit wedge in the banking system. While credit growth increased to 15% in Dec'18, deposit growth was only 9%, increasing banking system reliance on RBI. At the same time, RBI sold dollars worth US$ 26.5bn (Apr-Nov'18), leading to tight liquidity.

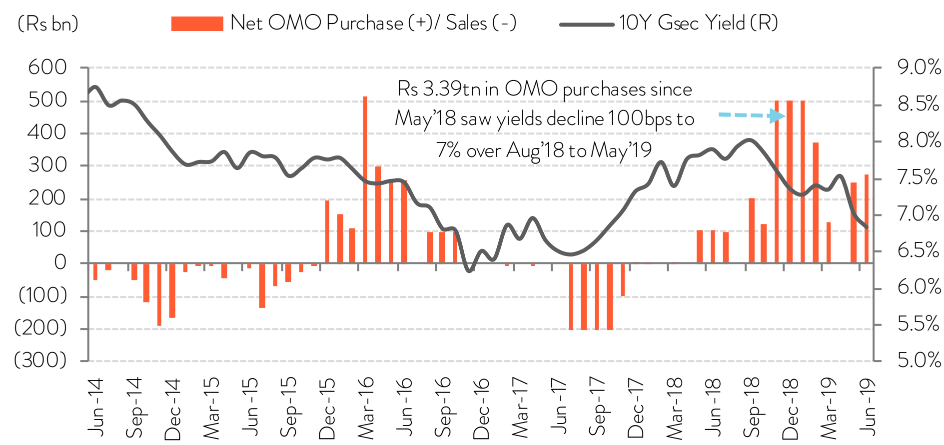
However, the central bank's durable liquidity measures have provided the necessary comfort. It conducted open market operation (OMO) purchases worth Rs 2.99tn in FY19 and Rs 525bn in FYTD20, as well as a US$ 10bn swap for a tenor of three years. This has turned system liquidity into a surplus of Rs 1.3tn on average in Jul-Aug'19(till date), a phenomenon last observed in Jun'18.

FIG 125 – SURPLUS LIQUIDITY IN THE SYSTEM LOWERING 10Y YIELD...



Source: Bloomberg, CEIC, Bank of Baroda Research | Note: Data as on 26 Aug 2019

FIG 126 – ...LED BY OMO PURCHASES WORTH RS 3.4TN SINCE MAY'18



Source: Bloomberg, CEIC, Bank of Baroda Research

Decoding the future OMO trajectory

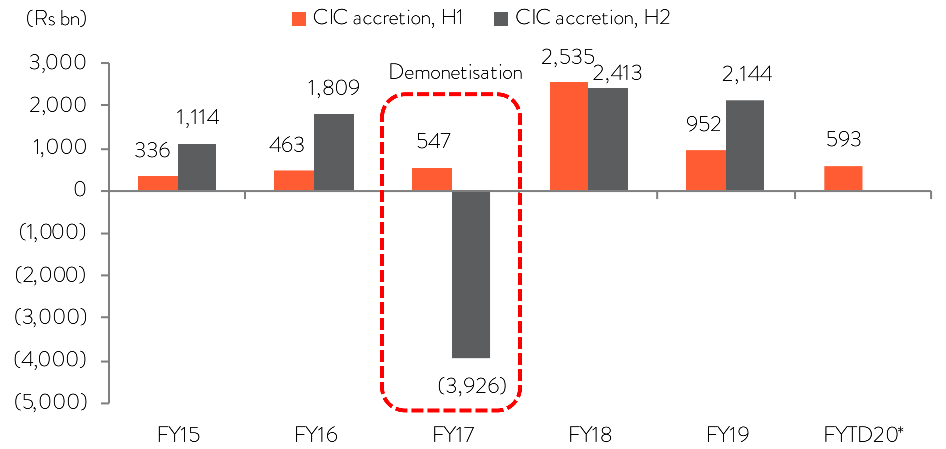
OMO purchases are dependent on various factors:

Currency in circulation (CIC)

CIC accretion is taking place at a far slower pace in FYTD20 (Rs 593bn) compared to the same period in previous years (Rs 952bn). Currency demand generally picks up in the second half (Fig 127). We expect CIC accretion at

~Rs 2tn-2.3tn in FY20, though the pace could reduce if domestic demand remains weak, limiting the need for OMO purchases.

FIG 127 – CIC ACCRETION AT A FAR SLOWER PACE IN FYTD20



Source: CEIC, Bank of Baroda Research | Note: Data for FYTD20 as on 16 Aug 2019

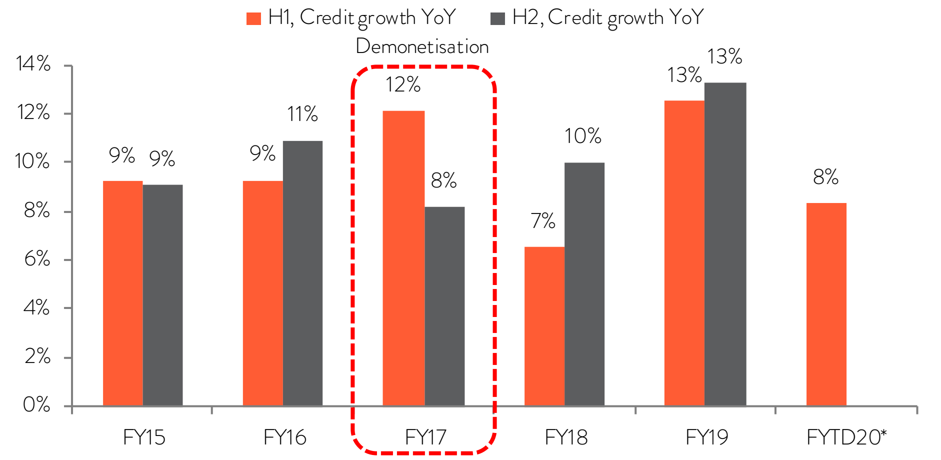
Liquidity situation

Currently, the central bank's focus seems to have shifted from neutral liquidity to a surplus situation (~Rs 1.3tn on average in Jul-Aug'19 to date). Our baseline assumption is that a Rs 700bn-800bn surplus will be the new normal, which amounts to ~0.5% of NDTL (Rs 146tn in FY20E). However, if RBI resorts to more term repo for liquidity infusion, the OMO requirement might be lower in the remaining half of FYTD20.

Credit-deposit wedge

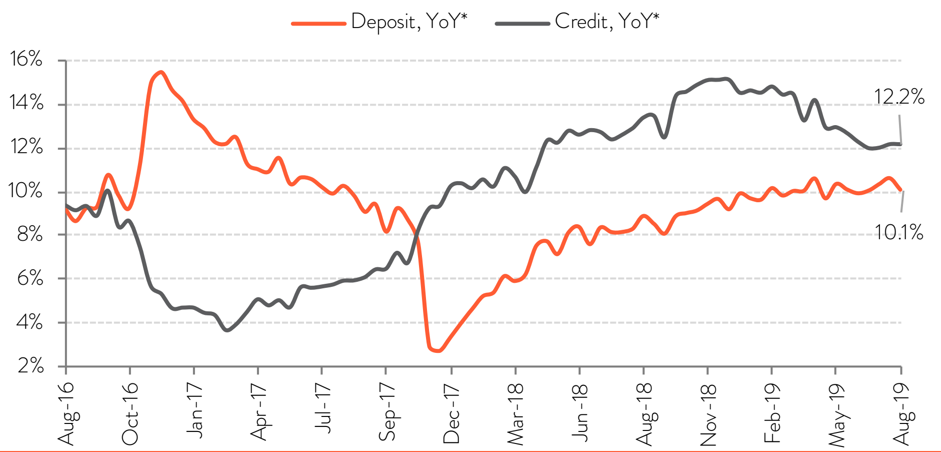
Credit demand generally picks up in the second half. This might widen the credit-deposit gap from the current 200bps. Estimated credit growth of 13% and deposit growth of 10% in FY20 implies that RBI may have to pump in additional liquidity of Rs 500bn-800bn (OMO purchases) on the assumption of CRR and SLR at 4% and 19% respectively.

FIG 128 – CREDIT DEMAND IS HIGHER IN H2



Source: CEIC, Bank of Baroda Research | *Fortnight as on 02 Aug 2019

FIG 129 – CREDIT-DEPOSIT WEDGE ~200BPS IN AUG'19



Source: CEIC, Bank of Baroda Research | *Fortnight as on 02 Aug 2019

FIG 130 – CREDIT, DEPOSIT AND INVESTMENT TREND

(Rs tn)	FY15	FY16	FY17	FY18	FY19
Credit	**65.4**	**72.5**	**78.4**	**86.3**	**97.7**
Abs change	5.4	7.1	5.9	7.8	11.4
% YoY	9.0	10.9	8.2	10.0	13.3
Deposit	**85.3**	**93.3**	**107.6**	**114.3**	**125.7**
Abs change	8.3	7.9	14.3	6.7	11.5
% YoY	10.7	9.3	15.3	6.2	10.0
Investment	**24.9**	**26.3**	**30.3**	**33.2**	**33.8**
Abs change	2.8	1.3	4.1	2.9	0.6
% YoY	12.6	5.4	15.4	9.5	1.9
CD ratio	**76.6**	**77.7**	**72.9**	**75.5**	**77.7**
Incremental CD ratio	**0.66**	**0.90**	**0.41**	**1.17**	**1.00**

Source: CEIC, Bank of Baroda Research

FII inflows

Lower oil prices bode well for India's external balances. With oil prices at US$ 65/bbl, we estimate India's CAD at 1.9% in FY20 (US$ 57.4bn). This will be financed through surplus in the capital account – stable FDI inflows (US$ 33bn in FY20) and a pickup in FII inflows (US$ 10bn). As a result, the BoP surplus in FY20 is estimated at US$ 15.1bn. This will help keep the INR in the range of 70-72/$ in FY20. Thus, for balance sheet adjustment, OMO purchase of another Rs 500bn-800bn seems feasible.

FIG 131 – RBI's BALANCE SHEET

(Rs bn)	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20E
Total Notes Issued	14,732	17,077	15,063	19,120	21,635	23,218
Capital & Reserves	67	67	67	67	67	67
Deposits	5,187	5,065	8,963	6,526	7455	8228
-Bank	3,947	4,294	5,042	5,071	6,095	6,705
Other Liabilities and Provisions	8,905	10,220	8,947	10,463	11,309	12,101
Total Liabilities	**28,892**	**32,430**	**33,041**	**36,176**	**40,467**	**43,614**
Gold Coins & Rupee Coins	1,218	1,393	1,324	1,450	1,612	1,692
Investments – Foreign	21,359	23,064	23,687	26,351	27,854	29,247
Investment – Domestic	5,185	7,033	7,558	6,297	9,838	11,412
Loans and Advances	802	520	173	1,639	692	769
Other Assets*	327	419	300	440	471	494
Total Assets	**28,892**	**32,430**	**33,041**	**36,176**	**40,467**	**43,614**

Source: RBI, Bank of Baroda Research | *Includes investments in subsidiaries | E – Bank of Baroda Estimates, Years represent RBI's Jun-Jul calendar year

FIG 132 – INTERRELATION BETWEEN CIC ACCRETION, OMO PURCHASE AND FX INFLOWS

FY	CIC accretion (US$ bn)	Net FX intervention, cash (US$ bn)	FII inflows (US$ bn)	Fx accretion (US$ bn)	Net OMO purchase (Rs bn)
FY12	1,144	(20.1)	18.9	(13.6)	1,342
FY13	1,217	(2.6)	31.0	(0.3)	1,461
FY14	1,101	9.0	8.9	16.7	520
FY15	1,472	54.8	45.7	41.0	(627)
FY16	2,152	10.2	(2.5)	18.8	623
FY17	(3,282)	12.4	7.6	10.2	1,105
FY18	4,941	33.7	22.5	53.1	(888)
FY19	2,136	(15.4)	(4.0)	(14.1)	2,860
FY20E	1,796	9.9*	3.1#	14.3**	500-800

Source: RBI, CEIC, Bank of Baroda Research | RM – Reserve Money, E – Bank of Baroda Estimates | *Actual data: Apr-Jun'19, **Actual data till 16 Aug 2019, # Actual data till 23 Aug 2019

Market rates falling; overseas borrowing to further depress rates

Term deposit rates as well as weighted average lending rates have gone down in FYTD20, in sharp contrast to the trend seen in FY19.

FIG 133 – MAJOR RATES ARE FALLING

Tenure (%)	Post office term deposits	Bank term deposits*	Change in FYTD20 (bps)	
			Post Office deposits	Bank Term deposits
1Y	6.9	6.70	(10)	(10)
2Y	6.9	6.50	(10)	(30)
3Y	6.9	6.25	(10)	(55)
5Y	7.7	6.25	(10)	(60)
NSC (5Y)	7.9	-	(10)	-

Source: Bloomberg, Bank of Baroda Research | *SBI

As announced in Union Budget 2019-20, the Centre is expected to issue 10-15% of overall gross borrowing of Rs 7.1tn in the overseas market and in foreign currency. This could reduce the burden on domestic issuances by ~US$ 10bn, which along with fiscal discipline at the Centre, will further push down rates.

FIG 134 – QUARTERLY DATA ON CENTRAL GOVERNMENT BORROWING

(Rs bn)	FY15	FY16	FY17	FY18	FY19	FY20 (actual)	FY20 (planned)
Q1	1,830	1,740	1,500	1,680	1,320	2,040	2,210
Q2	1,570	1,630	1,910	1,890	1,440	1190*	2,210
Q3	1,430	1,640	1,610	1,640	1,270	-	-
Q4	1,090	840	800	670	1,680	-	-
Total	**5,920**	**5,850**	**5,820**	**5,880**	**5,710**	**-**	**7,100**

Source: Bloomberg | *Till 16 Aug 2019

Rate cuts key to recovery in FY21

In our view, lower interest rates hold the key to a domestic revival by way of stimulating consumption demand, reviving the credit and capex cycle, and kickstarting a virtuous cycle of growth by steadying the dynamics of savings and investment. In the wake of RBI's persistent stimulus through rate cuts totalling 110bps in the last four policy meeting and its enhanced focus on improving NBFC liquidity, the credit cycle should remain robust.

Moreover, the government-led stimulus through PPPs (via the EBR route) to finance infrastructure, higher MSPs to improve farm income and recent economic measures would also have the desired impact on growth. In our view, the current slowdown appears to be more cyclical in nature, in line with the global downturn. We anticipate a recovery in FY21 aided by structural reforms, with GDP growth estimated to bottom out at 6.5% in FY20 before rebounding to 7% in FY21.

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