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Sonal Badhan
Economist

Economic Round-up: May 2024

Markit global manufacturing PMI rose to 22-month high of 50.9 in May'24 from 50.3 in Apr'24. The index stood in the expansionary zone for the 4th consecutive month in a row, and was supported by solid activity in US, China, and UK. Contraction in Eurozone and Japan eased. Overall, output, new orders (including export orders) improved. Both input and output prices also inched up at a faster pace. Recently IMF revised China's GDP forecast for CY24 upward (from 4.6% earlier to 5%), following signs of revival in the economy and announcement of government measures to stimulate growth. However, manufacturing and services sector are again showing signs of slowdown in May'24, thus suggesting uneven recovery. In the US too, in Q2CY24 (till May'24) labour market is beginning to normalise, consumer spending is weakening and confidence surveys show that participants are excepting a recession in the next 12 months. As a result, probability of a rate cut by Fed in Sep'24 has increased. ECB is set cut rates this month. Timing of BoE is yet to be determined, but at least 2 rate cuts are priced in for this year. RBI, in view of solid domestic growth is expected to keep rates on hold till Oct'24. General election results indicate 3rd third term for NDA government, resulting into policy continuity at the centre.

Global growth: Slowdown in global growth momentum was visible in Apr/May'24 period. In the US, labour market seems to be normalising (increase in jobless claims, decline in job openings), cracks in consumer spending are appearing and ISM manufacturing PMI is showing contraction in activity. In China, after reporting robust growth in Apr'24, larger manufacturing firms are again noting some distress (official PMI). Retail sales and property sector growth continues to remain lethargic. Impact of stimuli measures announced by the government to revive growth will have to be seen in the coming months. In Eurozone, manufacturing activity continues to contract, but the pace has slowed, hinting at some stabilization. Market survey results show growing optimism that conditions will improve as ECB begins to lower rates.

Global Central Banks: In May'24, US Fed, ECB, and BoE, kept their respective rates on hold. Fed officials have reiterated on multiple occasions that bringing inflation down to targeted range remains a key priority. Further, weakness in labour market is also being closely tracked. As a result, atleast one rate cut is now expected by Fed in Sep'24. In case of BoE, markets are pricing in a rate cut in Aug'24 as inflation is inching closer to 2% mark. ECB is expected to be the 1st major central bank to cut rates in Jun'24 meeting. In contrast, BoJ is expected to hike rates in Jul'24, as inflation is appearing to re-accelerate.

Key macro data releases: The latest data on **GDP** shows that Indian economy rose by 8.2% in FY24 after expanding by 7.2% FY23. Higher than anticipated GDP was on the back of strong growth led by industrial (9.5% from 2.1% in FY23). **RBI declared a record Rs. 2.11 lakh crores surplus transfer to the government** in FY25, compared with Rs. 87,416 crores in FY24. The higher than anticipated surplus can be attributed to higher interest income led by an increase in both global as well as domestic yields. There were also revaluation gains on forex reserves unlike in 2022. **CPI inflation** came in at 4.8% in Apr'24, on YoY basis, higher than our estimate of 4.7%. Food inflation inched up to 8.7% in Apr'24 from 8.5% in Mar'24. **Core CPI** (excl. food and fuel) was stable at 3.2%.

Global developments

Global growth: Engines of growth in US losing steam

Second estimates for US GDP growth in Q1CY24 suggest that growth was even lower than what was estimated earlier. Q1 print was revised lower from 1.6% (1st advanced estimates) to 1.3% now, and is also down from 3.4% in Q4CY23. The downward revision was led by lower than previously estimated growth in consumer spending (2% in Q1 versus 3.3% in Q4), private inventory investment, and federal government spending. On the positive side, upward revisions were made to state & local government spending, residential and non-residential fixed investment, and exports. Now at the start of Q2CY24 (Apr'24), consumer spending has noted even more significant moderation, with real spending (adjusted for inflation) down by (-) 0.1% versus 0.4% increase in Mar'24. Spending on goods has fallen by (-) 0.4%, following 0.9% increase in Mar'24, while that on services eased to 0.1% from 0.2% in the previous month. Further, labour market is also showing some strains with initial jobless claims for week ending 25 May 2024 rising by 3k to 219k (est.: 218k). The 4-week moving average for continuing claims also inched up, by 5.75k to reach 1.79mn. In addition to this, 30Y fixed mortgage rate has also creeped up from 6.99% in Apr'24 to 7.06% in May'24. It had averaged 6.75% in Q1CY24. This is expected to dent real estate sector growth in Q2, thus further slowing the economy down. Conference Board consumer confidence survey results also indicate that consumers are expecting a recession in the next 12 months. US ISM manufacturing index shows that activity contracted in May'24 (48.7), from Apr'24 (49.2), dragged by slowdown in new orders (excluding export orders) and production. Employment improved. Input price index moderated. Noting these conditions, at least one rate cut is now expected from Fed this year.

Manufacturing conditions in the Eurozone seem to have stabilized. Markit PMI index rose to 47.3 in May'24—highest since Mar'23, and up from 45.7 in Apr'24. This is the 3rd consecutive month when activity has contracted at a slower pace, supported by new orders and exports. Business confidence also improved in May'24. Country-wise, while smaller economies like Greece, Netherland and Spain noted remarkable improvement, activity in major economies like Germany and France still remain lacklustre, but prospects seem to be improving. France's manufacturing index rose to 46.4 in May'24 (highest since Feb) from 45.3 in Apr'24. Business confidence sub-index jumped to 27-month high in May'24 (highest since Feb'22) in case of both France and Germany. In Germany, overall PMI index rose to 4-month high of 45.4 from 42.5 in Apr'24, led by improved demand from US and China. Backlog of work was down and inventories also noted depletion. The Germany Ifo business climate index also reports similar trend. While the overall index remained unchanged in May'24 at 89.3, the expectations index inched up from 89.7 in Apr'24 to 90.4 in May'24.

IMF has recently upgraded China's GDP forecast for CY24 to 5% from 4.6% earlier. This was based on better than expected growth in Q1CY24 (5.3% versus est.: 4.6%; 5.2% in Q4CY23) and announcement of government measures to revive growth. However, in May'24, the economic momentum seems to be slowing, with official manufacturing PMI plunging back into contraction (49.5), down 0.9 points from Apr'24 (50.4), dragged by weak new order and in particular export orders. This could be partly due to new tariffs announced by the US on China. Non-manufacturing PMI remained broadly unchanged at 51.1 in May'24. In Apr'24, industrial output had accelerated by 6.7% (est.: 5.5%), up from 4.5% rise in Mar'24. However, domestic consumption remains weak with retail sales rising by 2.3% (slowest pace since Dec'22), lower than est.: 3.8% and 3.1% increase in Mar'24. Property pain too remains. New home prices in Apr'24, fell at the fastest pace in 9 years. Government has recently announced measures to clear inventories. Local government will be buying some flats to spur demand.

RBI

MPC members, in the Jun'24 policy meeting are expected to hold rates, by keeping repo rate unchanged at 6.5%, SDF at 6.25% and MSF and bank rate at 6.75%. No change in stance is also expected, as RBI will keep liquidity tight to keep short-term rate higher and support INR. Liquidity deficit may ease as elections come to an end government spending will see a pick up in the coming months. Further, upward revision to RBI's GDP forecast for FY25 can be expected. CPI forecasts may not change as of now.

Global central bank decisions

US Fed had kept its policy rates unchanged at 5.25-5.5% for the 6th consecutive time in Apr-May'24 meeting. Now, given the stickiness in retail inflation (3.4% in Apr'24 versus 3.5% in Mar'24) and even Fed's closely tracked PCE price index (2.7% in Apr'24, unchanged from Mar'24), Fed is expected to hold rates in its Jun'24 meeting as well. In the upcoming policy, Fed will also announce an update on its economic projections. Currently, CME FedWatchTool is predicting ~51% chance of 25bps rate cut in Sep'24 meeting.

Bank of England (BoE) left its policy rate unchanged at 5.25%—at 16 year high, in its May'24 meet. The decision was not unanimous. 7 out of 9 members opted for a pause, while 2 members (Deputy Governor Dave and external member Dhingra) voted for a 25bps cut. Last meeting had paved way for rate cuts in CY24, as inflation is inching closer to 2% target market. Although, following an upside surprise in inflation for Apr'24 (2.3% versus est.: 2.1%; 3.2% in Mar'24), possibility of a rate cut in Jun'24 and Aug'24 has dwindled. However, markets are still pricing in at least 2 rate cuts this year.

Amongst the major central banks, **ECB** is expected to cut rates first in its Jun'24 meeting tomorrow, after keeping the rates unchanged in the May'24 meeting. Despite the higher than expected inflation print for May'24 (2.6% versus est.: 2.5%), the central bank is set to announce 25bps rate cut. This is keeping in view, slowdown in economic activity in major economies of the bloc (Germany and France) due to elevated borrowing costs. Despite the cut, real interest rates will still remain positive, thus the monetary policy will be less restrictive instead of loosening.

BoJ in line with market expectation, kept its monetary policy rates unchanged in its Apr'24 meeting and reaffirmed that it will continue to maintain ultra-loose policy till inflation doesn't rise to its targeted level on a durable basis. Latest data for Japan shows that there is a recovery in retail sales (1.2% in Apr'24 versus est.: 0.6% and -0.2% in Mar'24) and rebound in inflation (Tokyo inflation—leading indicator of nationwide CPI—was up by 2.2% in May'24 from 1.8% in Apr'24). Recently, BoJ Governor Kazuo Ueda stated in the parliament that "If our economic and price outlook, or risks, change, that will also be reason to change the level of interest rates". Analysts are thus pricing a rate hike in Jul'24. No change is expected in Jun'24 meeting.

Special studies

Capital formation in corporate sector in FY24

At the level of the economy, capital formation has shown some positive trends. In FY24, gross fixed capital formation ratio was 30.8% from 30.7% in FY23. In nominal terms growth was 9.9%. Against this background, the growth in gross fixed assets in the corporate sector can be positioned. Gross fixed assets includes also capital-work-in-progress. The suggestion from a set of 2165 companies is that there was a marginal slowdown in growth of GFA to 5.6% in FY24 from 5.9% in FY23. For this sample, GFA for FY24 was Rs 34.09 lakh crore.

The main drivers of capital formation in the corporate sector:

Of the 36 sectors, half of them accounted for 94% of total assets. The top 5 industries accounted for 64% of assets. Hence, the main thrust to growth is provided by crude oil, power, iron and steel, banking, and auto sectors. The first three are capital intensive sectors which are also related to the infrastructure development process in the country.

Interestingly 50% of the 26 industry groups witnessed a decline in growth in GFA in FY24. Of the top 18 industries which dominate overall GFA (as seen in the chart), 11 witnessed slowdown in growth. This explains why there was a marginal slowdown in overall growth in GFA for the sample companies.

Significant declines in growth rates could be seen in oil, chemicals, textiles, gas transmission. Growth in case of power has been negative in both the years which does indicate that there is not much of capacity expansion within this sample (renewables are not covered in this sample). The decline in growth rate for oil is also indicative of a similar phenomenon. In case of textiles, overall slowdown in the readymade garments segment (-14.2%) due to lower exports could be the factor driving this tendency in investment. The chemicals segment too witnessed de-growth of 1.7% in FY24.

Media, consumer durables, and realty are other segments that have witnessed a decline in growth rates. This goes along with the narrative of relatively lower consumer spending which gets reflected in surplus capacity in case of consumer durables. Going by the IIP, growth for durables were 0.6% and 3.6% in the last 2 years following a sharp rise of 12.4% in FY22.

Sharp increases in growth were observed in case of capital goods, the diversified group of companies, mining, business services, and diamonds and jewellery. This can be corroborated with steady growth in production of capital goods (as per IIP) which was 6.2% in FY24. The same held for mining which was up by 7.5% and hence higher growth in assets can be linked to stable production trends.

Concluding remarks: The results of the sample companies can be taken to be indicative of capital formation activity in the corporate sector. Growth has slowed down for certain in FY24 and more importantly the performance has been selective and linked with sectors that have done well in terms of production. This also fits in with the picture at the macro level where gross fixed capital formation has remained virtually unchanged.

State finances in FY24

The provisional accounts of 25 states for the year FY24 show some interesting trends:

- Most states have fiscal deficits (as per provisional estimates) much lower than what they had projected at the beginning of the year, which indicates that prudence is the path followed by them. Alternatively they may have targeted a higher amount and internally decided to spend and borrow lower amounts.
- Capex budgeted for was also much higher than what was achieved for the majority of states. This is indicative of the fact that either the absorptive capacity was limited or there were issues in implementing these projects. On an average 84% was the achievement rate.

We look at the deviations of provisional figures of fiscal deficit for FY24 from the budgeted amounts for 24 states. Sikkim is excluded as it was budgeted to have a surplus but had an equivalent deficit thus skewing the deviation number.

Only 3 states, besides Sikkim, had fiscal deficits which exceeded the targeted amount and included Bihar, Mizoram and Andhra Pradesh. Among the larger states Gujarat, Maharashtra, Odisha, Tamil Nadu and UP had over 30% deviation from budgeted amounts.

These 25 states had budgeted a capex programme of Rs 8.37 lakh crore for the year. The provisional amount spent was Rs 7.02 lakh crore which is 84% of the target (Table 1). Uttar Pradesh, Telangana, Bihar and Sikkim were the 4 states to spend the budgeted amount or go beyond the target. 7 states with almost Rs 50,000 cr or above of planned capex accounted for 58% of total budgeted spending. A factor that would have contributed to the shortfall could be the practice of some states waiting till the end of the year to balance the fiscal deficit and cutting back on capex, which is a discretionary expenditure to meet their targets. This could have lowered the actual capex implemented. Alternatively there may not have been enough projects to implement given the time involved in awarding projects which has caused this shortfall.

Tax revenue: Total tax revenue for these 25 states was Rs 29.56 lakh crore. The share of GST was around 31.6% followed by 21.8% for State excise and sales tax. Stamps and registration had share of 7.4%. Together these internal taxes which can be called own tax revenue was 60.8%. The balance was mainly states' share in union taxes. The own tax revenue distribution across states is interesting.

- Telangana had the highest share of own tax revenue in total tax revenue at 82%.
- States with ratios of between 70-80% were Haryana (79%), Karnataka (78%), Kerala (77%), Maharashtra (73%) and Tamil Nadu (71%).
- Andhra Pradesh and Gujarat had ratios above sample average at 68% and 62% respectively.
- Uttar Pradesh and Punjab had ratios at around the average of 61%.
- The remaining 16 states had greater dependence on transfers from union tax collections as internal generation was limited.

Within states' own tax revenue, GST was the most important component at 31.6% for all states put together. Here too there are patterns in terms of share of GST in total taxes across state.

- Karnataka, Mizoram and Haryana had ratios of about 41%.
- States with ratios above average but less than 40% were Kerala, Maharashtra, Bihar, Nagaland and Sikkim with 38-39% each followed by Telangana, UP, Gujarat with 33-35%.

Sales tax and excise duties are initiatives of states which levy these taxes mainly on liquor, tobacco and fuel. The states which had a ratio of well above 21.8% were Andhra Pradesh, Haryana, Karnataka, Kerala, Tamil Nadu, Telangana and Kerala. Punjab and Rajasthan had ratios of 23%.

The message that comes out is that the higher consuming states end up paying higher taxes like GST and sales tax/excise duty. Those where consumption capacity is constrained have to depend progressively on more transfers from the Union taxes as directed by the Finance Commission. In the context of consumption, the table below gives the per capita GST payments made in different states for FY24. The population numbers for states are lagged using extrapolated data on NSDP. The purpose here is to only provide an illustration on the consumption patterns in states on the basis of per capita GST tax paid.

The points that emerge here are:

- The three smaller states of Sikkim, Nagaland and Mizoram had paid the highest per capita GST in FY24.
- Among the larger states Karnataka, Telangana, Kerala, Haryana and Maharashtra had an average per capita GST of above Rs 10,000.
- Andhra Pradesh, Gujarat, Tamil Nadu, Uttarakhand and Himachal Pradesh had per capita GST of above the average of the states considered here.
- 11 states had less than average per capita GST payments which is reflective of lower levels of consumption. States like Bihar, Rajasthan, MP, and West Bengal among others had less than Rs 5000 per capita GST.

The distribution of per capita GST across states is a reflection of consumption taking place in the country. This is not even. Relatively larger states like West Bengal, MP and Rajasthan have substantially lower ratios than the average of all states.

In conclusion it may be said that states have more than adhered to the fiscal deficit targets for FY24. This has also meant that they were cautious while spending which may have affected their capex as the average achievement ratio was 84%. Only 4 states met their targets.

On the revenue side, an examination of tax income shows that GST, sales & excise and stamps and registration receipts accounted for around 61% of the total for all states. There was variation however in states based on their consumption orientation. This comes out from the shares of GST and sales/excise collections in tax revenue. The per capita GST paid by states varies considerably across states and also points to the varied consumption patterns

RBI dividend at record high

RBI declared a record Rs. 2.11 lakh crores surplus transfer to the government in FY25, compared with Rs. 87,416 crores in FY24. This was also much higher than both the budgeted (Rs. 1.02 lakh crores, including dividend from banks and FIs) and street estimates of ~Rs. 1 lakh crores surplus. The higher than anticipated surplus can be attributed to higher interest income led by an increase in both global as well as domestic yields. There were also revaluation gains on forex reserves unlike in 2022. The higher surplus will have a positive impact on government finances. This is positive in terms of maintaining the targeted fiscal deficit. Thus, the additional Rs 1 lakh crore gives government the headroom to either cut back on its gross borrowing from the market, putting lesser pressure on domestic yields, or to increase its thrust towards capex. The main budget post elections will throw better light on the same. Overall, this is likely to have a positive impact on government yields. We expect 10Y yield to go below 7% in the coming months. Frontloading by FPIs due to inclusion in the global bond index will further lend support.

What has led to record high surplus: conjectures?

RBI has transferred a record high dividend to the government for accounting year 2023-24. This is far higher than budgeted amount of Rs 1.02 lakh crore for FY25. This Rs 1.02 lakh crore is also inclusive of Dividend transfer of Nationalised Banks & Financial Institutions. Thus, from RBI itself a windfall gain has been received. This level of high transfer of surplus was last witnessed in 2018-19. A result of such unexpected increase could be higher interest income from foreign securities, exchange gain/loss from foreign exchange transactions. The other part of in "other income" may be due to some rebalancing of provisions no longer required due to write-back of excess risk provision from Contingency Fund.

Impact:

- The higher than budgeted dividend transfer by RBI bodes well for India's fiscal dynamics and will provide a boost to the government's effort towards fiscal consolidation. It must be noted the in the interim budget the government had set a target of bringing down fiscal deficit target to 5.1% of GDP in FY25 from 5.8% of GDP in FY24.
- Government can hence reduce its dependence on market borrowings which are currently budgeted at Rs 14.13 lakh crores (gross) and help lower borrowing costs. Lower than expected borrowings by the government will have a softening impact on yields. The impact has already been felt in the G-sec market with yield on the new benchmark 10Y yield to below 7%, falling by ~ 5bps and we expect a softening momentum in yields going forward. With bond-index related FPI inflows also expected to surge in Q2 FY25, we may see benchmark 10Y yield falling to as low as 6.75% assuming RBI invokes rate cuts in the second half.
- The government can also choose to deploy the additional resources for higher spending, preferably for capital expenditure. Incidentally, the government had already increased its capital expenditure to Rs 11.1 lakh crores or 3.4% of GDP in FY25.
- Apart from this, the bumper dividend pay-out is also likely to ease reliance on government's disinvestment program, on which the progress has been slow in the last few years.

How different sectors fared in terms of capital formation

When talking about the investment demand of Indian economy, the first data point which comes to our mind is the gross fixed capital formation, which basically speaks about additions to fixed assets such as machinery and equipment. Added to this, the increase in stocks of inventories give us an overall picture. National Account statistics 2024 gave us an idea about the same regarding different sectors. Two angles are explored here: 1) how shares of Gross Capital Formation (GCF) across sectors have emerged over a ten year period and 2) how productivity of capital (under certain assumptions) has moved.

Few highlights of the same are:

- The sectors whose shares have moderated in overall capital formation are the ones whose productivity has increased. Thus, necessarily moderation in share in total is not bad, it should be looked from the perspective of deployment of existing capital and the inherent nature of industries, whether it is capital intensive or not and the lagged input-output dynamics.
- Another thing which comes out from the study is that Gross Value Added for the sectors are not showing much momentum. This means that the movement in capital formation is driving overall productivity ratios. Notably, productivity looked in the study is partial productivity and is the ratio of GVA to gross capital formation.
- The input-output dynamics show that manufacturing is still under pressure as both share of GVA and capital have moderated. There remains scope for higher capital utilisation.
- Real estate shows improvement in terms of improvement in share of GVA.

How have shares moved?: Two quinquennium are looked at for the purpose of our analysis one ranging from FY14-FY18 and another FY19-FY23. The purpose of looking at the same is to even out odd years.

- Sector wise, real estate and other services, manufacturing, transport, storage, communication & services related to broadcasting, trade, repair, hotels and restaurants and public administration and defence are the top sectors having the maximum share (68.3%) in overall capital formation.
- Between two quinquennium's, share of manufacturing in capital formation has fallen. The major jolt was faced during pandemic (2019-20) where share of manufacturing in GCF fell to its lowest of 16%. Post which, it recovered to 18.3% in 2021-22, but again witnessed deceleration in 2022-23. Despite this, the current share has surpassed its pre-pandemic level, which hints at some recovery of the sector at a crawling pace.
- Mining and quarrying is witnessing some moderation on account of slowing export growth.
- Forward linkage from real estate was also visible in construction sector whose share also increased in the two quinquennium.
- The share of public administration and defence also improved, attributable to increased government spending.

Productivity of capital: Next, we look at the partial productivity of capital by calculating how much output will be produced with per unit of capital. Here it is defined as Gross Value Added per unit of Gross capital formation which includes both gross additions to fixed assets (i.e., fixed capital formation) and increase in stocks of inventories.

- For the two quinquennium's under consideration, average productivity of capital has broadly remained unchanged.
- Among major sectors, productivity has improved for sectors such as real estate, mining and quarrying and for utility services. However, for sectors such as trade, hotels etc. manufacturing and public administration and defence the productivity remained unchanged in the current quinquennium. For construction and agriculture, forestry, and fishing, it has fallen the most.
- Notably, for financial sector, the productivity is elevated as it is a less capital-intensive sector. Even excluding financial services, the productivity ratios doesn't alter much.

Sectoral analysis:

- For manufacturing, productivity flattened. This explains that firms are gradually utilising their existing capacity. However, one interesting shift that has been noticed is that the ratio for manufacturing sector has fallen since 2018-19 (pre-Covid-19). This shows that albeit some improvement in productivity, there is further scope for improvement in existing capacity. As per RBI data, capacity utilisation rate of 76.3 observed in 2022-23 is still lower than the highs of 83.2 observed in 2011.
- Trade, repair, hotels, and restaurants has remained flat in terms productivity of capital. This is on account of fall in the productivity of capital of Hotels & restaurants. Especially, with low occupancy rate, the productivity has been severely impacted during Covid-19 period, where the ratio hit its lowest of 0.97. However, in 2022-23, it recovered from its low at 1, despite lower than 2.67 seen in 2018-19. Thus, still the productivity of this sub segment is yet to reach its pre pandemic level.
- For real estate, ownership of dwelling & professional services, the increase in productivity ratio may be attributable to positive home buyer sentiments, stable growth in per capital income and supportive policies. Notably, post Covid-19, the productivity in this sector has maintained its momentum.
- For Construction productivity of capital is still less aligned. Ideally it should have picked up in line with the improvement in productivity of real estate, ownership of dwelling & professional services. Thus, there is further scope for improvement in this sector.
- For Transportation, the ratio has fallen primarily driven by Air transport. The deceleration in productivity also coincided with the period when some airlines were grappling higher capital cost and liquidity issues.

Summary: So, what can be concluded putting the pieces of puzzle of output and capital formation of different sectors. We have identified certain sectors based on whether the share of GVA has increased at a faster pace than GCF or not. Few things come out clearly:

- For capital intensive sectors such as manufacturing and construction, margin of improvement remains. For manufacturing, share of both output and capital has moderated.
- For construction on the periphery shares in GCF have improved but share in GVA have fallen impacting productivity ratio. This may be due to the inherent nature of the sector of deployment of additional capital.
- Sectors such as real estate have been able to increase output with efficient deployment of capital.

A likely surge in FPI Flow (Debt)

The inclusion of Indian government bonds in the Bloomberg and JP Morgan global bond indices has excellent implications for Indian market and the economy as a whole, raising its standing amongst its global peers. The optimism surrounding growing prospects of economy, coupled with lower inflation, stable currency and stability in reforms remains favorable and reflects optimism towards India's growth potential. This serves as a strong background for potential investors and opens new sources of investment avenues for domestic capital, given there is availability of funds. This is touted to be the shining moment for Indian economy.

Indian economy remains a favored place for investment as has been reflected by strong FPI flows in the past few months. After China and Brazil, India's government bond market is the third largest amongst emerging economies. The foreign ownership stands at a mere 2%, much lower when compared to other emerging economies. Back in

Sep’23, it was announced that starting from 28 Jun 2024, JP Morgan will include India in its Government Bond Index-Emerging markets. The GBI EM GD (Global diversified Index) comprises of fund from across the globe with the AUM totaling to US$ 213bn. India is assigned a weightage of total 10% in the index. With this weightage, India is expected to garner total inflows close to US$ 30bn in FY25. There will be an investment in over 23 Indian government bonds with the notional value to the tune of US$ 330bn. In addition to this, Indian securities are also expected to be included in the Bloomberg EM local currency government Index. The index could possibly include 34 Indian securities. This is likely to happen by Jan’25 with an initial weightage of 10%. With this, India’s rupee will become the third largest currency, component wise after China’s renminbi and South Korean won. Overall, we expect this will bring in combined (equity and debt) FII flow to the tune of US$ 40-45bn.

Global market trends and macro updates have influenced the global movement of FPI flows. The news of inclusion of India in the government bond index has driven FII flows higher across segments including, in the debt segment. There has been a steady increase starting from Oct’23 (Fig1), with FII flows in the debt segment at US$ 0.8bn and climbing to US$ 2.7bn, highest level in over 5-years. Secondly, the sector wise data under the sovereign segment (Fig 2) has noticed a gradual increase in investment scaling as high as US$ 29bn in Mar’24, signaling greater demand and sharp uptick since Oct’23 given the announcement of inclusion of India in the global bond indexes. This is based on the following factors:

- India’s economy remains on strong footing with the economy expected to clock 7.6% in FY24 according to government estimates. For FY25, RBI expects the economy to register a growth of 7%. Even other global agencies have forecasted India to grow at a healthy pace of 6.8% (IMF) with the possible upward revision and 6.6% (World Bank) for FY25.
- Strong optimism surrounding India’s growth story, signs of traction in domestic demand, supported by benign oil prices. Additionally, robust capital markets coupled with returns and conducive environment will attract more FII flows in to the country.

FPI inflows in the debt segment have started increasing from November right up to March. In April the decline can be attributed to market expectations of the Fed deferring the decision on rate cuts beyond June. This means that interest rates will remain high for longer in the US markets.
AUC under sovereign bonds had increased to an all-time high of $ 28.8bn in March 2024. Until September 2023, it had remained range bound at $ 18-19bn.

However, there has been some moderation lately and the reasons for this include: 1) Uncertainty over interest rate movement by global central banks; 2) Uneven growth in global economies with divergence in global central banks actions. According to OCED, US is expected to witness slowdown, with growth forecasted at 2.6% in CY24, followed by 1.8% growth projected in CY25. China’s economy is projected to grow at a much slower pace from 4.9% to 4.5% in CY24 and CY25 respectively. On the other hand, Japan is projected to rebound and register a growth of 0.5% and 1.1% for the same period. Europe is likely to witness some recovery, with a growth of 4.9% (CY24) and 4.5% (CY25); 3) Escalated geo-political tensions continues to remain a cause of concern with elevated risk of higher inflation.

Prospects for gold loan business

India is the second largest consumer of gold in the world. Since 2019 (pre-pandemic), gold consumption has increased by 10% (till CY23). The prospect for domestic gold demand is brighter on account of cultural affinity, long held traditions and as a safe-haven asset class and amidst growing geopolitical uncertainties. From the point of view of households there has also been a tendency to leverage their gold assets to borrow from institutions to finance consumption against gold as collateral. Thus, it opens more opportunities for both Banks and NBFCs for expanding the loan book of gold.

- Our study shows that while NBFCs have a higher share of gold loans, when compared with banks, there has been a deceleration lately.
- Banks' funding against gold has increased effectively in the past two years.
- There has also been an increase in the ratio of incremental gold loans to imports (though it needs to be said upfront that loans sought against gold would not necessarily be from the current purchases but from the existing stock of the metal based jewelry).

How have international gold prices moved?: The sharp upswing in international gold price was only visible since FY20 which accelerated due to Covid-19 induced shock. Prior to this phase, favourable global interest rates, stable global growth and a rather stable dollar had muted gold demand, thus keeping international gold price range bound. The Covid-19 episode alone led gold price to shoot up to US$ 1,825/troy ounce in FY21 from US$ 1,263/troy ounce visible in FY19, an increase of 44.5%. Post Covid-19 there not much downward correction in gold price. A part of the reason was the Russia Ukraine war with other factors being surge in global inflation resulting in restrictive monetary policy regimes. Hence gold as an asset class became a preferred choice of investors as an effective hedge.

Domestic gold demand: Gold imports in volume terms have picked up considerably (exception has been FY17) during the period FY14 to FY19, increasing from 662 ton to 983 ton. This was supported by firm private consumption demand recording average growth rate of 7% during the same period. Gold imports in FY17 showed moderation partly due to a higher import duty that was imposed to contain the current account deficit (CAD).

However, the Covid-19 led shock has resulted in considerable moderation in gold imports. From 983 ton in FY19, gold imports moderated to 651 ton in FY21. This is in sharp contrast to the prices data in Figure 1 which showed a considerable uptick, thus giving some signal that domestic demand must also have been buoyant during the same period. However, this is not reflected in the data. A likely explanation could be the slowdown in private consumption demand (PFCE fell by -0.4% between FY19-21).

Post FY21, gold imports were volatile. FY22 witnessed some upward correction with resumption in economic activity. FY23 showed moderation due to an increase in gold import duty by 4.25%. However, some turnaround was visible lately, albeit the level is still lower than the high of FY19. Thus, there is no clear one-to-one relation between import demand in India and international price of gold as several regulatory factors come into play while gauging the demand side.

Upward pressure in gold prices to remain

- **Volatile dollar:** Generally international gold price and Dollar movement should be a mirror image of each other as seen in Figure 3. As an asset class, gold prices exhibit a negative relationship with the movement of DXY. Ceteris paribus, since gold is denominated in dollars, any increase in the dollar theoretically makes gold less attractive as investment, leading to a decline in demand. The long run correlation (Since 2000) between Gold price and DXY translates to -0.17. Going forward, one rate cut by Fed is priced in as reflected in the CME Fed watch tool data, possibly in Sep'24. Thus, DXY may have a softening bias, hence theoretically gold demand should pick up and prices should notice an uptrend in the near term.
- **Geopolitical conflict:** Gold demand is likely to persist in the near term from a possible continuation of Israel-Hamas conflict. Apart from this, the likely impact in terms of spike in energy prices as crude prices bears the initial brunt in such cases; might also pose upside risks to inflation. Thus, gold may prove to be the desired choice amongst major asset class. Apart from this, it is an election year for major economies, thus safe-haven demand for gold remains.
- **Central banks are increasing their gold reserves:** Over the years, central banks' holding has picked up. From a low of 7% seen in CY20, the share has improved significantly to 26% at present. As per World Gold Council report, Central Bank of Turkey was the largest buyer, followed by People's Bank of China and Reserve Bank of India. This may be on account of attaching greater weight to gold's value in crisis response, diversification of portfolio and credibility on account of store-of-value. This pace is likely to continue in CY24 as well.
- **Demand from ETFs:** There have been consistent outflows in the ETF segment. 2023 level was quite significant. The outflow may be attributable to cashing out of gold back into positive yielding bonds as highlighted in 'Gold Demand trends' report of World Gold Council. However, some momentum was visible in Q12024, where the pace of outflow slowed. For India, ETFs saw positive Q1 inflows, and two new funds were launched during the quarter.
- **Retail appetite changing:** Post Covid-19 with resumption of economic activity and usual seasonal phenomenon such as marriage, holding gold as prestige especially as a mark of wealth and prosperity, the retail demand has picked pace. In overall gold demand, the share of jewellery fabrication has significantly increased to 48.6% in Q1CY24 from 36% seen in CY20, Notably, it is getting back to pre-pandemic level of 49.4%.

The financialization of gold: Simultaneously it has been observed that households have been leveraging their gold assets to secure funds from the financial system. In FY21, there has been considerable jump in loan against gold jewellery by 72.9%. There was moderation in FY22 witnessed more due to the elevated base. Post FY22, the growth rate has been in double-digits, albeit some softening in FY24, on account of increased diligence.
For all the years (except FY22, strong unfavourable base for SCBs) growth rate of SCBs outpaced NBFCs, albeit the outstanding credit under loan against gold jewellery being far higher in actual terms for NBFCs than SCBs. Since FY20, CAGR for SCBs have also been far sharper than for NBFCs despite discounting the last 6months data for NBFCs due to unavailability of information.

How Gold loan portfolio has moved: The two primary lenders, i.e. SCBs and NBFCs have witnessed an interesting change in shares of loans against gold jewellery. Data for NBFCs lending against gold before FY20 is not available for comparison. SCBs share in gold loan has witnessed increase whereas NBFCs have shown some degree of loss of momentum of late. The same is reflected in the growth rates as well, as seen in the previous section. Next, we tried to look at the incremental gold loans to imports. The data shows that it was high at 4.22 in FY20. It came down to 3.12 in FY21 and since then has been lower than 1. Given that the ratio was as high as 4.22 in FY20 it can be concluded that there is considerable potential to harness this route to grow the retail book. SCBs have reached its FY20 levels whereas NBFCs are lagging.

Way Forward: As per major market consensus, gold price is likely to be in the range of US$ 2000-2300/troy ounce. World Bank projects international gold prices at US$ 2,100/troy ounce for CY24 and US$ 2,050/troy ounce in CY25. It further highlights that elevated geopolitical tensions and policy uncertainty would strengthen demand in CY24. Further, the report pointed out that the reserves management strategies of several EMDE central banks would also keep demand for gold higher. This in turn may prompt lenders to offer a higher loan amount against the same quantity of gold, thus resulting in a higher LTV ratio. This leaves more scope for further expansion of the gold loan portfolio and as visible in the data Banks should take it as an opportune moment to garner higher market share with the rapidly ongoing financialization of gold.

Data Releases

Currency outlook

In May'24, INR has traded in the range of 83.10/$-83.53/$. The elections outcome and expectations of Fed commentary impacted currency movements. The key focus remains on crude price movements which will be supplemented by debt inflows. Given the strong external fundamentals and unchanged stance from the Fed we expect INR to trade in the range of 83.0-83.50/$, with an appreciating bias for the year.

Bond Market Round-up

Global yields were mixed in May'24 amidst a changing narrative on the future course of global monetary policy. US 10Y yield eased as soft macro data has once again reignited expectations of a Fed rate cut in Sep'24. On the other hand, rate cuts by ECB and BoE are facing hurdles from a resurgence in inflation in the respective regions. On the domestic front, India's new benchmark security has shown a considerable degree of softening bias in May'24 and eased below the 7% mark. RBI's bumper surplus, FPI inflows and an outlook upgrade by S&P were the primary drivers of the exuberance seen in the government bond markets in May'24. Going forward, we expect India's 10Y yield to remain in the range of 6.95%-7.05% in Jun'24, led by lower US yields and further FPI investment in debt securities ahead of index inclusion.

GDP growth soared in FY24

Indian economy rose by 8.2% in FY24 after expanding by 7.2% FY23. Higher than anticipated GDP was on the back of strong growth led by industrial (9.5% from 2.1% in FY23). With gradual improvement in global economic outlook, exports are expected to register stronger growth. GVA growth is expected at 7% led by broad based improvement across sectors. Revival in agriculture sector on the back of normal monsoon, political stability and lowering of rates in H2 will provide impetus to growth story. Based on the above, we expect the Indian economy to clock a growth rate of 7.3-7.4% in FY25, with downside risk emanating from geopolitical uncertainties.

WPI inflation accelerating

WPI inflation accelerated at the fastest pace in 13 months, as it rose by 1.3% in Apr'24 from 0.5% in Mar'24. This was due to jump in both food and fuel inflation. Food inflation rose by 5.5%, on account to steep increase in vegetable prices. Within this, basic items like onions, tomato and potato have seen build-up in prices. Apart from this, food grain inflation remains relatively sticky. Paddy prices are exerting pressure, while wheat prices have noted some moderation. Separately, elevated international oil prices have had an impact on domestic fuel inflation, which rebounded to 1.4% from (-) 0.8% in Mar'24. ATF, Kerosene prices were the most impacted. Increased prices of other commodities on an international level, have also led to inching up of manufactured inflation, driven by basic metals. Prices of Aluminium and Copper have registered a steep jump in Apr'24. Commodity prices have seen a revival on hopes of increased demand from China. Going forward, 'higher for longer' rate scenario in the US, and demand revival in China will drive the international commodity prices. Domestically, heat wave conditions will decide the trajectory of food inflation.

CPI inflation

CPI inflation came in at 4.8% in Apr'24, on YoY basis, higher than our estimate of 4.7%. Food inflation inched up to 8.7% in Apr'24 from 8.5% in Mar'24. Within food, 6 out of 12 broad categories have remained above 6% with inflation in vegetables and pulses remaining at double digit of 27.8% and 16.8% respectively in Apr'24. The sequential picture gives a better picture of the evolution of food inflation. Food inflation has risen by 0.7% in Apr'24 on MoM basis compared to 0.2% in Mar'24. On a seasonally adjusted basis, food inflation went up by 0.3%, so some of the upside rise was attributable to seasonal phenomenon as well. Pressure points were across the board ranging from cereals, meat and fish, oils and fats, fruits, vegetables, pulses, and sugar.

Core CPI (excl. food and fuel) was stable at 3.2%. Core inflation was stable, on YoY basis. Apart from personal care and effects (due to elevated price of gold, 7.9% increase MoM), sub-categories of core showed moderation. However, here sequential picture also gave a better clarity. Sequentially core inflation picked up to 0.6% from 0.1% in Mar'24. The momentum came from housing which rose by 1% from -0.2% in Mar'24, on MoM basis, which is a seasonal trend. Apart from this, clothing, household goods and services, education and personal care and effects also noticed considerable momentum. Thus, some build-up in core cannot be ruled out in the medium term. We expect core to remain around 4% in Q1FY25.

Growth in Industrial Production

IIP growth moderated to 4.9% in Mar'24 from 5.6% in Feb'24, led by improvement in manufacturing and electricity output. Within manufacturing, improvement was visible across sectors including wearing apparel and pharma products. Within use-based classification, capital, and consumer non-durable output outshined, signalling steam in the economic engines. However, concerns from global economy continues on account of uncertainty on interest rate outlook by Central Banks and ongoing geo-political tensions remains a concern. On domestic front, the current heatwave conditions continue to pose challenges with water reservoir level much lower than last season. However, IMD has projected above normal monsoon which holds key for the kharif crops. Moreover, the likelihood of political stability and strong domestic fundamentals are key positive for the economy.

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For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
sonal.badhan@bankofbaroda.com