Economics

DBS Focus

India 2023 Outlook: Strategic opportunity

Economics/Growth/India

DBS Group Research | December 1, 2022

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	FY21 **2020**	*FY22* **2021**	*FY23* **2022f**	*FY24* **2023f**
Growth (y/y %)	-6.6	8.7	7.0	5.8
Inflation (y/y %)	6.2	5.5	6.8	5.2
Currency, vs USD eop	73.5	75.8	81.7	80.6
Policy rate, % eop	4.0	4.0	6.5	6.25
10-year yield, % eop	6.2	7.5	7.5	7.4

Structural shifts

- *India's economy is the fifth largest in the world, surpassing UK*
- *Global shifts provide the opportunity to expand its economic heft*

Economic outlook

- *Domestic sector strength is likely to partly offset unfavourable externals*
- *As pent-up demand passes, growth and inflation are likely to moderate*
- *Rate hike cycle is at the last leg*
- *We expect macro stability to sustain, tracking a gradual consolidation path*
- *FX reserve accumulation a priority*
- *Direction of commodity prices is a key wildcard*

Currency

- *USD/INR to consolidate within 80-84 in 2023-2024*
- *We do not consider the INR an over-valued currency*

INR Rates

- *Recent rally and sharp flattening in INR OIS curve suggest that markets are pricing for the approaching end of RBI's hike cycle.*
- *Tight liquidity and heavy bond supply are expected to persist in 2023.*

ECONOMICS (Radhika Rao)

India's economy overtook the United Kingdom to become the fifth largest in the world on nominal GDP (US dollars), besides retaining its third spot on Purchasing Power Parity (PPP) basis. This marks a fast climb from the ninth position a decade ago. India is presented with a strategic opportunity to expand its economic heft to assume a greater role in the world arena as well as amongst the investment community. Besides the inherent domestic momentum, global forces, marked by volatile geopolitics, supply chain dislocations, trade skirmishes, climate change and challenging demographics, provide the ignition to lift the economy towards its goal of $5trn nominal GDP from estimated $3.4trn this year.

India continues to climb the ladder (nominal GDP, current prices, US$)

Ranking	2000	2005	2010	2015	2020	2022
1	*US*	*US*	*US*	*US*	*US*	*US*
2	*Japan*	*Japan*	*China*	*China*	*China*	*China*
3	*Germany*	*Germany*	*Japan*	*Japan*	*Japan*	*Japan*
4	*UK*	*UK*	*Germany*	*Germany*	*Germany*	*Germany*
5	*France*	*China*	*France*	*UK*	*UK*	***India***
6	*China*	*France*	*UK*	*France*	***India***	*UK*
7	*Italy*	*Italy*	*Brazil*	***India***	*France*	*France*
8	*Canada*	*Canada*	*Italy*	*Italy*	*Italy*	*Canada*
9	*Mexico*	*Spain*	***India***	*Brazil*	*Canada*	*Russia*
10	*Brazil*	*Korea*	*Canada*	*Canada*	*Korea*	*Italy*
11	*Spain*	*Brazil*	*Russia*	*Korea*	*Russia*	*Iran*
12	*Korea*	*Mexico*	*Spain*	*Russia*	*Brazil*	*Brazil*
13	***India***	***India***	*Australia*	*Australia*	*Australia*	*S. Korea*

Source: World Bank, IMF, DBS

Three levers will be key in this regard and have already been set into motion.

- **Manufacturing push and supply chain rejig**

Government's policies have increasingly been tailored towards supporting and expanding the economy's manufacturing footprint, as a source of improving trend growth and employment (see our reports *Understanding India: Growing footprint in electronics* and *Understanding India: Manufacturing push – a reset*)

Globally, trade conflicts and protectionist policies have highlighted fragilities of existing global value chains, magnified by the pandemic. **Firms have added resilience and reliability to their matrix of priorities when sourcing supplies and suppliers, in effect widening the net for fresh new potential sources**. This has provided a good opportunity for India to capitalise on the window to attract part of these capacities.

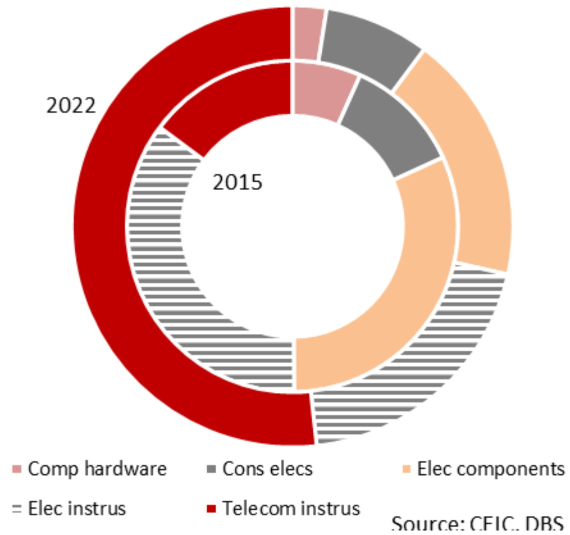
For instance, Foxconn, Apple's main iPhone assembler, has been shifting more of its manufacturing capabilities to India, including part production of iPhone 14 handsets, to be sold domestically and for exports. China's strict Covid rules and delayed reopening is also expected to be a catalyst for major firms to diversify to India, besides selected ASEAN economies. Reports suggest suppliers might move few sections of Airpods and Beats headphone production to India. Low labour costs and large surplus labour are other useful parameters for the economy to be viewed as a viable alternative for the China+1 strategy. Re-shoring and friend-shoring have become a part of the lexicon.

This also helps the economy to also lower reliance on imported imports for intermediate and raw material supplies, including manufacturing inputs, which also exposes firms to the consequent vulnerability on domestic supply-chains. This has prompted authorities to beef up domestic production capabilities for selected sectors. This is necessary to rebalance growth and be more manufacturing-led, helped by relatively competitive base salaries vs most production-intensive countries in the region, according to the recent JETRO survey.

Amongst various supportive measures, corporate tax rate cuts and more recently, fiscal incentives via the Production Linked Incentive (PLI) scheme (sector-specific) have been a key draw for domestic and global manufacturers, worth investments across automotive, electronics, speciality chemicals, etc. This complements the firm FDI trend, totaling $39bn (gross) in first half of FY23, but easing from year before.

Considerable groundwork has been completed on bilateral FTAs, with closer ties with the Gulf Cooperation Council (GCC) countries, UK, EU, and Canada on the cards in 2023, after agreements with UAE and Australia (parliament ratified in late-Nov) were completed.

Electronic exports - segments % share 9M2015 vs 9M2022



Source: CEIC, DBS

A wider manufacturing base is also broadening the export mix, led by high value products in the past two years compared to the previous five years. Besides Covid-driven segments (e.g., pharma, services etc.), exports of engineering, project goods, electronics etc. have increased. Manufacturing goods which make two-thirds of the total rose 37%yoy in FY22, driven largely by engineering goods, chemicals, pharma, plastic, textiles, and related products. Electronics is a small part of overall shipments (<5%), but jumped 41%yoy last year, punching above its weight. Higher presence of finished goods, besides push from PLI, and commodity price gains contributed to this outperformance. **We expect this push to continue to support real growth in the medium-term as well as attract manufacturers keen to diversify/ complement their presence in the region.**

On the international arena**, India is due to take over the G20 Presidency for 2023**, providing a platform to not only host global partners over strategic topics but also revitalise bilateral trade, investment, and sustainability discussions on the sidelines.

- **Digital architecture**

India's digital architecture has strengthened significantly in the past five-six years, including the universe of finance, payment systems, nationwide identification framework, distribution of welfare schemes, healthcare official data stack intended to solve social/ inclusion needs, and logistics, besides others. This has been supported by a sharp rise in mobile phone subscribers (~700mn) and increasing internet penetration.

To some extent, the digital/tech infrastructure has also helped to overcome gaps in physical infra, for instance through proliferation of e-commerce players (last mile delivery) and start-ups. Number of start-ups[1] are estimated to be over 72k by mid-2022 spread over 50 sectors, with the count of unicorns at near 70, according to the Hurun Global Unicorn index.

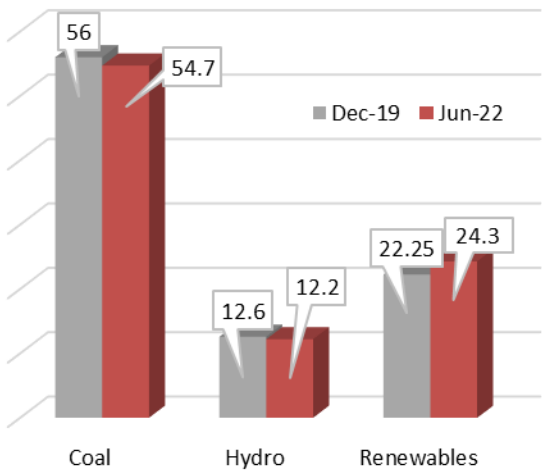
Developments include:

a) Digital national identification i.e., Aadhar, which is the world's largest biometric identification system, enrolling over 1.3bn residents and supporting 1.5-2.0mn monthly authentication transactions (dashboard)
b) Surge in electronic, mobile, and contactless payment mechanisms, notable amongst which is Unified Payments Interface (UPI) to facilitate real time transactions and transfers. This interface processed over 48mn transactions last year, largest in the world and 7x the combined volume of major economies, according to ACI Worldwide[2]
c) E-governance, includes the government's efforts to improve direct delivery of welfare schemes to the intended beneficiaries
d) Increasing use of the FASTag mechanism i.e., a RFID tag to make toll payments directly from customers linked prepaid or savings/current account, which has improved efficiency on national highways
e) Establishment of India Stack which is a set of APIs (Application Programming Interface) developed by the government and private sector players, helping to launch several flagship initiatives
f) Telemedicine and consultation have improved the efficiency of the healthcare system, accelerated by the pandemic

- **Energy transition**

India has committed to lowering its emission intensity and increase non-fossil capacity to 500GW by 2030. Maintaining strong growth while making this shift presents a challenging yet crucial opportunity to establish a decarbonised recovery path. Encouragingly, renewable installed capacity has already reached two-thirds of the initial target set in 2015. To move towards the net-zero target by 2070, incremental steps will be necessary in the short-term, including disincentivising fresh investments into fossil sources, retrofit energy-intensive industries as well as the power sector, new capital investments to have inbuilt green accreditations and balance the fiscal/ economic fallout. s

Installed capacity (% share)



Source: CEA, DBS

Financing requirements are significant at least $25-30bn per year over this decade, which is likely to be achieved via a close coordination between private and public sector players, through a combination of debt financing, equity investments and buy-in of long-term creditors. As the climate change and sustainability agenda

[1] Times of India

[2] ACI Worldwide press release

assumes more importance, high-carbon economies are likely to come under increasing scrutiny. A transition towards an equitable, sustainable, and employment-centric recovery is the need of the hour – for now and years ahead (see Chartbook: India's Green Transition - renewable energy thrust)

Trend growth

Growth drivers in 2022 have largely evolved along India Outlook 2022: Shifting to a higher gear, crucially as the Covid situation remained under control.

These key pillars of medium-term growth, in addition to catalysts like increasing public sector expenditure on physical infrastructure, other supply-side reforms (GST and better tax compliance, bankruptcy court, bad bank etc.), and favourable demographics are expected to set the economy on a virtuous cycle of recovery. For instance, widespread adoption of real-time payments is estimated to have unlocked ~0.56% of the country's GDP [2]. An increase in manufacturing sector as % of GDP from 18% to 19% handle of GDP can add 0.5-0.6% of the headline GVA. Besides a salutary impact on labour/ capital inputs, contribution via total factor productivity is likely to gradually return to pre-2018 contribution levels. We expect growth to stabilise around 5.8-6.0% over the next five years.

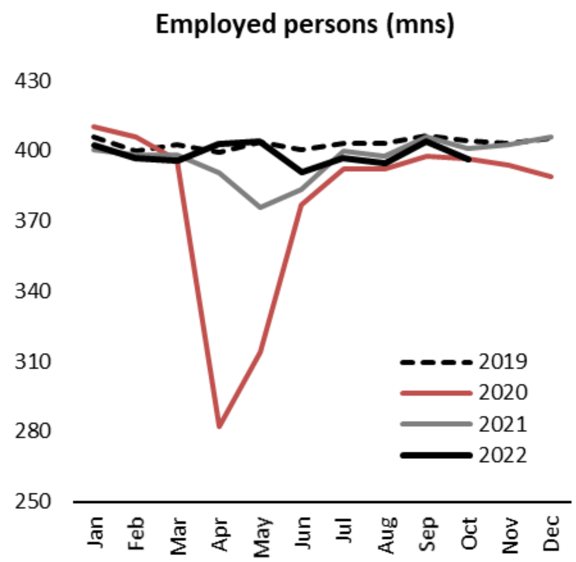
Macro environment for the year ahead

India stayed on track with its reopening in 2022, benefiting from significant vaccination coverage and low fatality rates from the subsequent Covid sub-variants. This allowed for the economy to emerge amongst the regional outperformers on growth and financial markets action.

Growth

- *Domestic demand to trump exports in supporting growth*

Consumption is expected to normalise after the trend improved in 2022 on reopening boost, service sector pick-up, rise in job creation and pre festive buoyancy. Lagged impact of these tailwinds coupled with better employment generation is likely to backstop household spending, while easing inflation benefits real purchasing power in 2023. With urban employment on the mend, non-farm rural sector is likely to benefit from backward linkages as well as higher allocations towards the rural employment scheme i.e., MNREGA at the upcoming Budget.



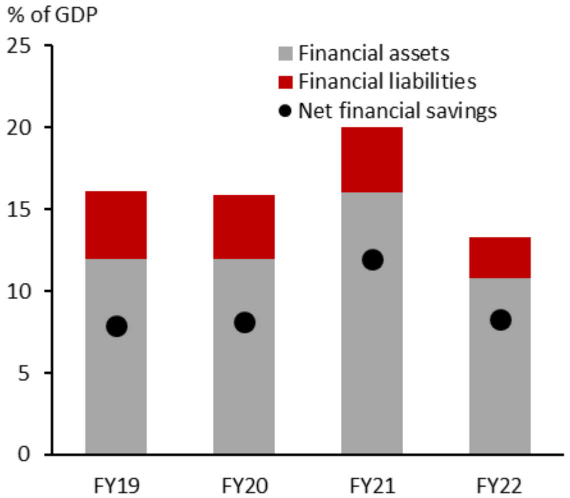
Source: CMIE, DBS

As a counter, some moderation in demand is expected vs FY23:

a) passage of reopening demand;

b) run-up in household savings in FY21 has largely run its course, with the trend back towards normal (pre-pandemic) levels, tracking the pullback in households' financial assets on the back of a reduction in bank deposits. This coincides with a sharp pickup in retail credit, with personal loans registering the fastest rise amongst the major segments for good part of 2022. Housing loans make up more than half of the personal loans, followed by vehicle credit, whilst unsecured loans (credit card outstanding) make up ~5% of total outstanding. With moderation in financial savings, higher credit uptake might be channelled to finance excess spending needs;

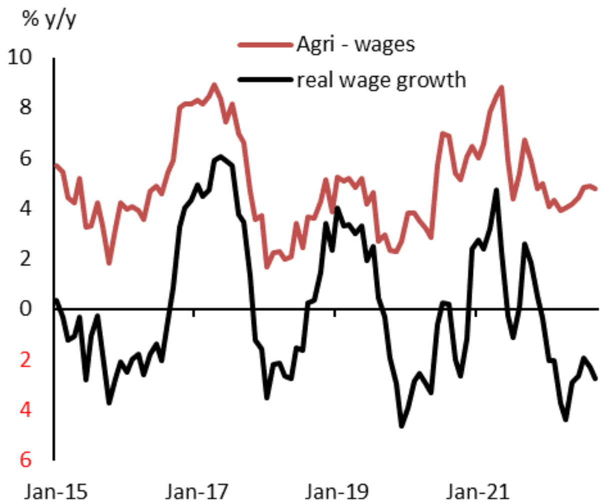
Household financial savings (as % of GDP)



Source: RBI, DBS

c) Farm sector performance meanwhile remains exposed to the weather vagaries (subject to climate change and related disturbances including floods, drought, swings in monsoon etc.), notwithstanding a consistent increase in the proportion of gross irrigated land. Real rural wage growth (adjusted for inflation) remains in red, with easing inflation in 2023 likely to provide a brief respite before attention turns to the strength in kharif crop sowing. In the near-term, encouragingly, area under rabi cultivation expanded by 7.2% as of 17 Nov, raising hope for this season's crop coverage to exceed record acreage witnessed in the 2021-22 season.

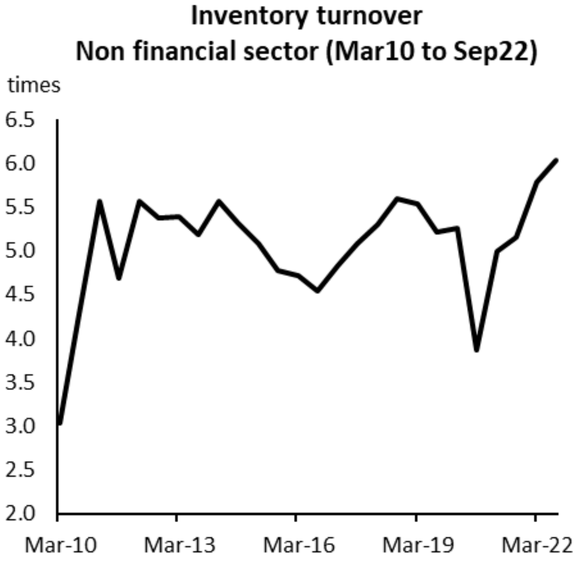
Agri rural wages - nominal and real



CEIC, DBS

- *Government capex spending to lead the growth cart*

Industrial activity improved this year, reflected in higher capacity utilisation rates, as well as strong pick up in capital and construction output, electricity generation, cargo traffic etc. Pre-festive restocking demand was also the other catalyst for trend improvement. For the non-financial sector, inventory turnover has been steadily improving from 2H21, implying the number of times a company has to restock their inventory per year. Meanwhile, there is some relief on rising input prices, as the recent survey IIM Ahmedabad's Business Inflation Expectations Survey (BIES) registered signs of moderation in cost pressures faced by firms – shifting from very significant cost increase (over 6-10%) to moderate cost increase (3.1% to 6%).

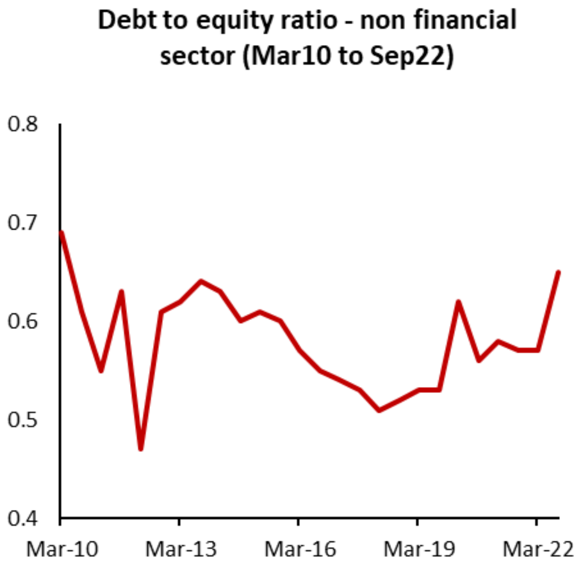


Source: CMIE, DBS

Momentum might moderate at the margin as restocking demand slows and visibility on the demand pipeline eases, not helped by uncertainty in the export markets.

Firms deleveraged through the pandemic, helped by a lift in profits due to accelerated formalisation and better market share, which allowed companies to pare their debt and strengthen balance sheets. With the lift in borrowings in recent months, the scale of deleveraging is likely to slow down. High inflation has also taken a bite, with robust sales from non-finance companies in the Sep22 quarter accompanied by a moderation in profits owing to sharp increase in input costs, and inability of a complete pass-through.

While the private sector (households and corporates) dominates capital formation, the government is also expected to play a bigger role for the capex cycle, which has already been set into motion via higher spending into infrastructure and logistics, including flagship programs like the National Infra Pipeline and National Logistics Policy. Share of capex in the spending mix is the highest in over 13years. Year-to-date centre's capex disbursements (49.5% yoy in 1HFY23) is higher than current expenditure, channeled into roads & highways, railways as well as shipping sectors. Despite higher subsidy outgo, strong tax revenue windfall has allowed the centre to support higher capex allocations, with states also expected to play a constructive role.



Source: CMIE, DBS

Direction of the FY24 Budget in February will be key. **Inferring from the authorities' preference for supply side push towards infrastructure and manufacturing, we expect a pro-growth slant.** This would provide impetus to private sector investments, as leverage levels have corrected, margins could find relief from easing input price pressures, and government's structural policies take root, as a counter to the cloudy global outlook.

- *Goods and service exports face a challenging outlook*

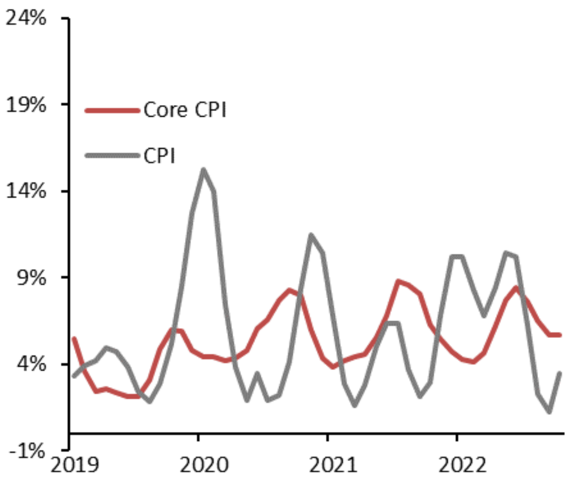
Global growth is expected to slow markedly in US, Europe, UK, and China. As we discuss in [India's evolving trade dynamics](), nominal goods exports carries a strong positive correlation with the demand-side driver i.e., global imports, with a slowdown in the latter to weigh on trade performance, with some tail-end impact on private investment cycle as well. Same is true of service exports as well (60% information technology and software focused). Lagged impact of (global and domestic) monetary policy tightening, as well as less conducive liquidity conditions are likely to be reflect next year.

Overall, we maintain our FY23 growth projection at 7% yoy and are mindful of a passage of pent-up demand domestically besides, a more challenging external environment next year. We trim FY24 growth forecast to 5.8% yoy vs 6% held previously, with base effects in the past three years rendering headline prints to be volatile.

Inflation and policy direction

Retail inflation prints peaked in Sep22 and have since begun to ease, helped by favourable base effects. Undercurrents of sticky food inflation is expected to subside on the back of harvest arrivals in Nov, with high-frequency numbers pointing to a pullback in perishables even as cereals retain momentum. Incremental imported price pressures have ebbed as global crude prices are off highs. Core inflation segments, meanwhile, are likely to be slow to correct given the catch-up in service sector pressures and lagged pass through of input price adjustments. In the short-term, November inflation is expected to ease to 6.4-6.6% from 6.8% in Oct. Headline inflation will stay above the 2-6% target band in rest of FY23, before slipping to 5-6% range in FY24. For the year, our inflation forecast for FY23 is at 6.8%, followed by 5.2% in FY24.

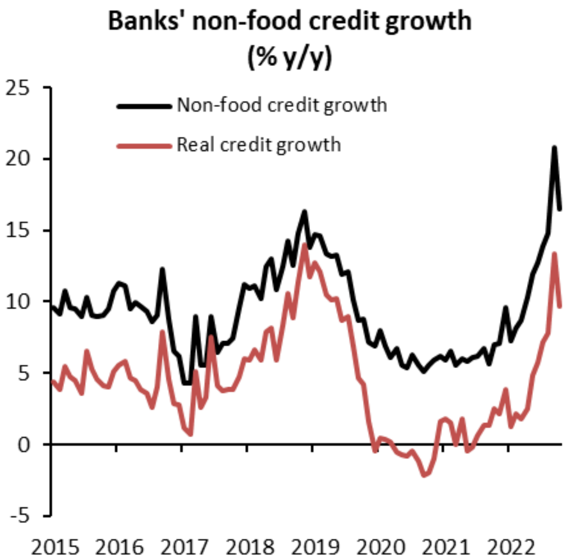
Inflation momentum (3M/3M % annualised)



Source: CEIC, data transformations are by DBS

Three consecutive quarters (1Q22-3Q22) of inflation averaging above the 2-6% target band necessitated the RBI policy committee to write to the government. Minutes of the Oct22 meeting highlighted a divergence in views amongst the committee members on the course of action ahead, along the lines of growth, inflation, and financial stability. Even as inflation is past its peak, headline and core prints are still elevated, necessitating the RBI to continue with the rate hike cycle. We expect the RBI to undertake a cumulative 60bp hikes by Feb23 in this cycle. Apart from inflation, rupee stability is also in focus for the authorities.

Credit growth has witnessed a sharp revival in the past ten months, rising to a decade high of in Oct22 on a broad-based pickup, led by retail, working capital demand and substitution effects (capital markets to banks), besides likely added buoyancy on festive demand. With deposit growth lagging this upturn (800-900bp below loan growth), liquidity has tightened. Borrowing costs are up, including the marginal cost of fund-based lending rate (MCLR) of the largest public sector bank has risen from 7.0% to 7.95% for the 1Y tenor since Dec21, while benchmark-linked rates will be adjusted up following the 190bp increase in repo rate. Incremental credit to deposit ratio has surpassed 100%, standing at ~114% as of Nov 4.



Source: CEIC, DBS

Pressure to raise deposit rates further is likely to build, to prompt banks to lower reliance on bulk deposits. Strong growth in credit growth is encouraging, with incremental lift here on likely to face speedbumps by way of an aggressive rate hiking cycle, slower deposit growth and passage of seasonal drivers, with an eye also on the durability of broader economic momentum to sustain this demand.

Fiscal health

In midst of the pandemic, additional spending needs and adverse economic impact on revenues, pushed fiscal deficits sharply higher. The centre's fiscal deficit jumped from -4.7% of GDP in FY20 to peak at -9.2% in FY21 and is thereafter expected to return to -6.4% in FY23. Strong revenue, particularly from taxes (direct up 24% in first half of FY22), has been a key tailwind to consolidation efforts, on the back of hastened formalisation and windfall from excise fuel taxes. This helped to offset a bigger subsidy bill and an increase in capex allocations.

Authorities are expected to lower the centre's deficit to -4.6% of GDP by FY26 from Budgeted -6.4% this year, necessitating additional revenue generation measures and lower discretionary spending. Better than budgeted nominal GDP growth has also been a cushion to the fiscal math but is likely to dissipate from next year. **We expect the upcoming FY24 Budget to peg the deficit at -5.8% to -6% of GDP**, accompanied by higher direct and indirect collection assumptions, disinvestment, and dividends. States' fiscal strain has also risen, with deficits shooting up to -3.8% of GDP in FY21, before likely easing to -2.5-2.7% this year.

External balances

We expect broader macro stability to prevail with a deterioration in current account balances to ease in 2023 and fiscal deficit to consolidate. Regional trade data is pointing towards a slowdown, with India's exports declining in Oct22. A wide negative on the goods trade account, offset only partly by service trade receipts, and accompanied by a sharp rise in the imported commodity bill, is likely to push the current account deficit to ~$120bn, -3.4% of GDP. Under the financial account, FDI inflows (~40% of total capital flows) are expected to remain resilient but will be more than negated by net portfolio outflows. This is likely to push FY23 BOP to a deficit (-$55bn) after three successive years of surplus.

In FY24, slower exports but a sharper moderation in imports is expected to narrow the FY24 CAD to -2.7% of GDP, accompanied by a ~$35bn balance of payments deficit. Foreign reserves stock was rundown on account of FX intervention and valuation effects. US dollar consolidation and easing pressure on the rupee should stabilise the prevailing stock. A revival in portfolio and investment inflows is likely to see the authorities keen to rebuild buffers rather than allow for INR appreciation. Our inhouse vulnerability indicator i.e., gross external financing ratio for India points to slightly stronger buffers than the 2013 taper tantrum.

Risks

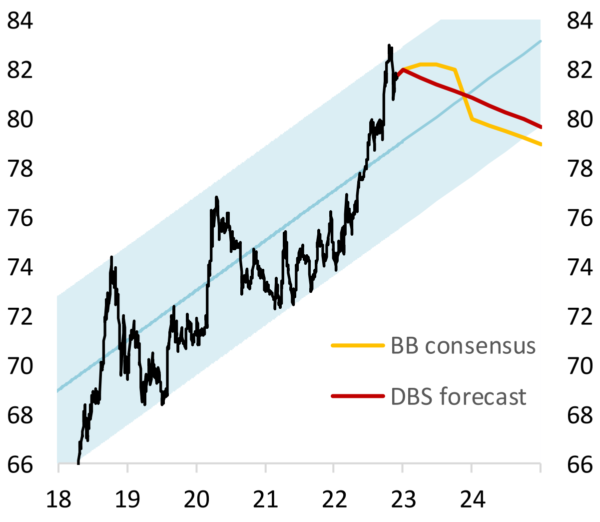
Our base case assumptions are for a challenging growth environment next year, characterised by soft-landing in the US, slow improvement in China's growth and contraction in the Eurozone. These will impact India's growth through the export and investment channels, with higher weightage of domestic growth engines expected to tilt the balance towards relative growth outperformance.

Risks to our scenario stem from a sharp and synchronised slowdown amongst the global economies on the back of this year's overt policy tightening moves, which might negate India's domestic growth impulses and lead to a steeper pullback. Energy commodity price direction is a wildcard if price action deviates significantly from our oil analysts' forecasts of $85-90/bl in 2023.

INR STRATEGY (Philip Wee)

We see USD/INR consolidating between 80 and 84 over the next two years. USD/INR likely peaked at a record high of 83 on 19 October, at the top of its price channel. **USD/INR will be slow in returning to the lower half of its price channel.** First, the central bank (RBI) will want to replenish its war chest. After falling USD109bn to USD525bn in the first ten months, foreign reserves recovered to USD545bn by 11 November. Second, the global economy will slow in 2023 and India's export growth has turned negative amidst record trade deficits. India will need to balance between supporting growth and returning inflation into its 2-6% target while guarding against complacency regarding the USD and the Fed. We project the RBI and Fed policy rates peaking at 6.50% and 5% respectively in 1Q23.

USD/INR outlook

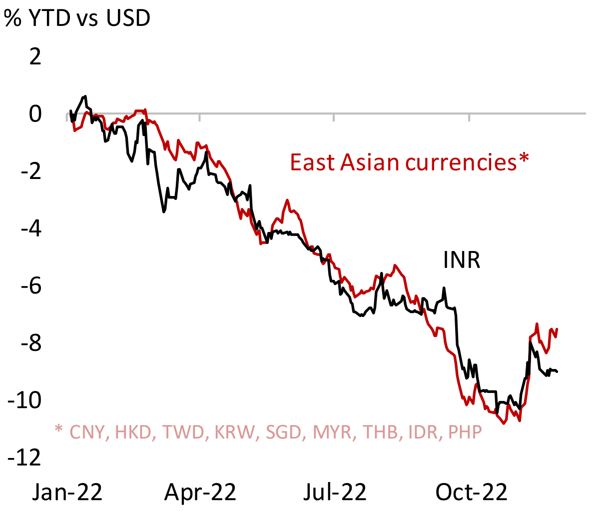


Sources: DBS Research, Bloomberg data

We do not consider the INR as an over-valued currency. During the USD's surge in 2022, RBI kept the INR aligned with the depreciation in the Asia ex-Japan currencies on an indexed basis via currency interventions and positive interest rate differential against the US. The

Bombay Sensex also hit a record high of 62,448 on 25 November. In June-September, RBI delivered three 50 bps hikes to 5.90%.

RBI keeps INR close to East Asian peers



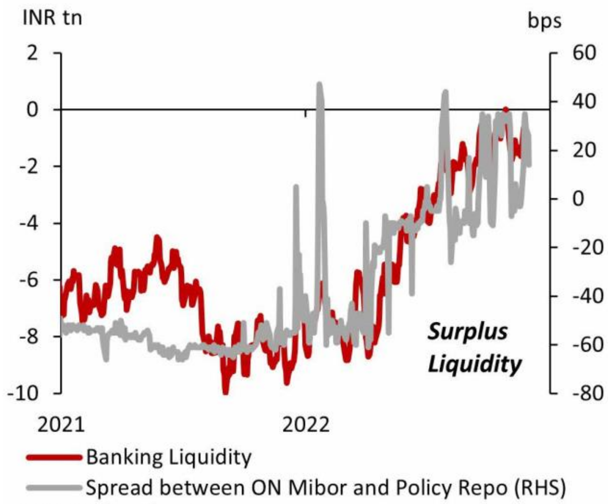
Sources: DBS Research, Bloomberg data

RATES STRATEGY (Duncan Tan)

Recent rally and sharp flattening in INR OIS curve suggest that markets are pricing for the approaching end of RBI's hike cycle. Policy repo rate is currently priced to peak at around 6.50% by 1Q23, which is in line with our forecast. However, with inflation proving to be sticky, the risks are skewed towards a higher peak in policy repo rate in 2023, rather than lower. 1Y-5Y OIS curve is also inverted, pointing to expectations for some rate cuts to happen as soon as 4Q23.

Banking liquidity, while still in small surplus, is sufficiently tight that we are seeing temporary periods where money market rates (overnight call, repo) deviate away from the policy repo rate and towards the Marginal Standing Facility rate (upper bound of Liquidity Adjustment Facility corridor). More of such episodes are likely to repeat in 2023.

Tighter liquidity and higher MIBOR



Source: Bloomberg

Market's focus is shifting to the budget in February and its associated financing needs. Fiscal consolidation could be rather limited due to 2024 being an election year, and thus, we expect GSec supply is to remain relatively heavy in 2023. With tighter liquidity weighing on demand from banks, market absorption of the heavy supply could be challenging. RBI could potentially restart OMO Purchases to support banks' bond demand and also inject durable liquidity to avoid overtightening of liquidity.

We forecast US growth to slow in 2023, likely tilted toward second half of the year. In that scenario, attendant risk-averse sentiments could see high-yielders like India GSecs initially underperform, especially if there are large equity outflows. However, GSec bonds could subsequently recover if oil prices also fall alongside the slowdown in US growth (lower oil prices have a positive impact on India's inflation, external and fiscal).

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