ECOWRAP

भारतीय स्टेट बैंक
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'Be the Bank of Choice for a Transforming India'

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MARKETS AWAIT NEXT STEPS

The Government rightly announced its intent to spur the market sentiments. This is perhaps also the first time that the Government has taken the lead in thwarting the turbulence in foreign exchange market, even as the RBI is focussed on managing exchange rate volatility. This is possibly a reflection of the fact that as an inflation targeting central bank, RBI may be concerned about the exchange rate only to the extent it feeds into inflation. The markets may not have understood this nuance and thus were expecting more from the RBI also. This may be one of the reasons for the rupee to have depreciated post the measures.

We believe, though the measures are heartily welcome in the long term, but in short term the efficacy of these measures will largely depend on rupee stability. For example, for Masala Bond our estimates indicate that for a assumed rate of even 8.35% and annual rupee depreciation of 3%, the spread for the investor is 109 bps may shrink further if rupee further depreciates. Thus masala bonds would be successful only in the event of rupee gaining stability.

So what could be the next steps or continued steps?

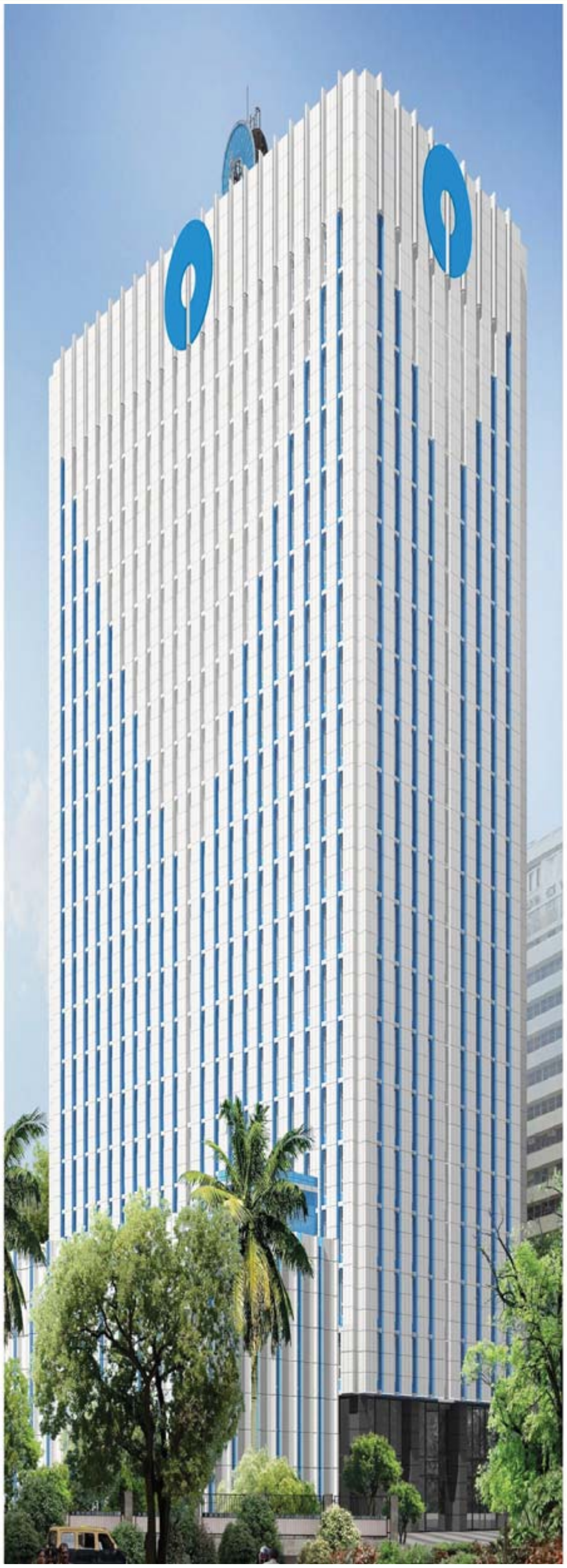
First, in the interregnum, RBI could sell at least an additional $25 billion from its reserves to support the rupee, based on our historical analysis of RBI intervention patterns since 1990s. Coupled with this, RBI should monitor NDR market more closely.

Second, issuing an NRI bond could be a less preferred option. Though in short term, an NRI bond will ease some pain, but considering the increasing trend of residual short term (42% of total external debt) and the higher interest cost this time to compensate for risk premia, the costs could outpace benefits.

Third, as an immediate measure, oil companies must be asked to purchase all their USD requirements directly from RBI through a single bank as in 2013.

Fourth, manufactured goods imports from China (96% of total imports from China), of which electronics form a primary component. Domestic manufacturing of mobile phones & other electronic products needs to be promoted and the Government must seriously consider import curbs.

Fifth, and most importantly, announce export incentivisation measures. For example, we must bring back the policy of promoting SEZs. We must ensure a dedicated window specifically for exporters refunds within a defined TAT. We must also quickly announce a holistic Agri Export Policy. It is surprising that we imported pulses even in FY18, when pulse prices were crashing !



MEASURES TAKEN BY GOVERNMENT TO CURB CAD AND STABILIZE RUPEE

- The Government announced a couple of measures to control the rupee. Accordingly, the Government has decided (i) to permit manufacturing entities to raise $50 million upto 1 year vs earlier 3 years, (ii) Masala bonds issued in FY19 exempted from withholding tax, (iii) Removal of exposure limit for FPI to a single group at 20%, (iv) Indian banks be allowed to market make and warehouse masala bonds to increase liquidity, and (v) Mandatory ECB hedging conditions for the infrastructure loans will be reviewed.
- The steps taken by the Government underlines its intent to spur the market sentiments, but the rupee dollar rate has depreciated post the measures. There may be 2 reasons for this.
- First, this is also the first time that the Government has taken the lead in thwarting the turbulence in foreign exchange market, even as the RBI is focussed on managing exchange rate volatility. This is possibly a reflection of the fact that as an inflation targeting central bank, RBI may be concerned about the exchange rate only to the extent it feeds inflation. The markets may not have understood this nuance and thus were expecting more from the RBI also.
- Second, the above measures look like typical capital control liberalisation measures which have historically worked less in case of global dollar shortage scenarios, as is being witnessed currently. For example, we believe that to permit manufacturing entities to raise $50 million upto 1 year vs earlier 3 years is an excellent measure in long-term but in the short term foreign investor may not buy into the emerging market risks.

MASALA BOND

- Let us take the example of Masala Bond. In mid-year 2016, the first Masala Bonds (also known as Synthetic INR Notes) were kicked off with HDFC's Rs.1500 cr issuance (3 yr 1 month tenor) yielding 8.33% pa (all in annualised yield). The USD / INR was Rs.67.14. With passing of more than two years since its issue the rupee has depreciated about 3.18% p.a. The Government has now indicated doing away with the withholding tax. The borrower thus has to take a call on the domestic interest rate vis-a-vis rupee dollar volatility.
- Today, in the present situation, with rupee depreciating by about 10% since April 2018, from an investors perspective, the yield on these bonds will be largely dependent on hedging in NDF market where currency analysts expect rupee to depreciate. The current global environment may not make this option lucrative for foreign investors to invest in India considering expected rise in US interest rates. The FII / FPI Investment up to September 2018 (Calendar Year) is in the negative.
- Recent reports of RBI appear to corroborate such trend with no Masala Bonds being floated since April 2018 except for one issuance of Dewan Housing.
- Our estimates indicate that for an assumed rate of even 8.35% and annual rupee depreciation of 3%, the spread for the investor is 109 bps which may shrink further if either the offer yield is brought down or rupee further depreciates. This re-confirms the fact that masala bonds would be successful only in the event of rupee gaining stability. Being an unhedged instrument from the issuer perspective, the pricing of the bond *(the investors will demand a currency risk premium on the coupon and hence borrowing cost for Indian corporates through this route may end up slightly higher)* is extremely critical and the subscription depends on the spread available to the investor who bears the exchange rate risk.

What Does the Masala Bond Investor Get in an Unhedged Case?

	Scenario 1	Scenario 2	Scenario 3
10 Yr Gsec rate as on 14 09 2018	8.13%		
SBI 3 Yr MCLR 14 09 2018	8.65%		
Bajaj Finance Ltd, 3 Yr 7 Days, AAA Bond 30 08 2018	8.65%		
Bond Coupon 3 Yr assumed	8.65%	8.50%	8.35%
Tenor	3 Years	3 Years	3 Years
USD / INR at the time of investment as on 14-09-2018	72	72	72
Investor gets after 3 years	92.35	91.96	91.58
Rupee Depreciated (assumed) pa	3%	3%	3%
Value after INR Dep after 3 Yrs / Stop Loss	78.68	78.68	78.68
Net Effective Yield pa for Investor without hedging	5.49	5.34	5.19
Libor 3 Yr rate (Swap) 14 09 2018 (i)	3.00	3.00	3.00
Risk Premium say, (ii)	1.10	1.10	1.10
Effective rate (i) + (ii)	4.10	4.10	4.10
Spread	1.39	1.24	1.09

Source: SBI Research; While Scenario 1 assumes SBI MCLR as the Pricing; Scenario 2 and Scenario 3 assumes a lower pricing

- One of the other options suggested is removal of exposure limit of 20% of FPI corporate bond portfolio to a single corporate group, company and related entities and 50% of any issue of corporate bonds will be reviewed. This is with regard to FPI investment in debt. It is pertinent to note that Foreign Investment Utilisation Limit as on 14th September 2018 was 76.66% i.e. Rs. 204441 cr out of upper limit of Rs.266700 cr. The corresponding figure for 14th September 2017 was 99.20% i.e. Rs.242369 cr out of upper limit of Rs.244323 cr. The existing upper limit of Rs. 266700 cr would stand increased to Rs. 289100 cr from October 2018.
- The above figure clearly says that the interest of the FIIs is itself waning and merely increasing the limit may not be of much help.

POSSIBLE MEASURES TO STABILISE RUPEE: WHAT COULD BE THE NEXT STEPS?

1. IMMEDIATE RBI INTERVENTION

- As an immediate measure RBI can aggressively intervene and supply the dollars in the market (both spot and forward) as it has huge FX reserves. However, given that the current disturbance in foreign exchange market are largely a byproduct of global headwinds, the question is how much can RBI use its foreign exchange coffer with reserves now below $400 bn? To understand this, we did a simple estimate to find out what was the extent of RBI intervention in previous periods relative to reserves. During the period of Jun'08 to May'09, when rupee depreciated by 13%, RBI sold dollars worth $43 billion, though the FX reserves at that time were $312 billion. Even during 90s, when the total Forex Reserve was less than $40 billion, RBI intervened in the market by selling 8-9% of total reserve to counter falling rupee. So, we believe in the present scenario, RBI could go up to its tolerance limit of 10% (a crude proxy of the average ratio over all periods) by selling at least an additional $25 billion in the forex market.

RBI Intervention at the time of Rupee Depreciation

Period	Depreciation in Rupee (in %)	RBI Intervention (Sale of Dollars) in $ Bn	Stock of FX reserves at the start of intervention in $ Bn	RBI Intervention as % of FX Reserves Stock
Apr-18 to Jul-18	5.0	16.3	420.5	3.9%
May-13 to Sep-13	16.0	14.3	287.8	5.0%
Sep-11 to Feb-13	11.0	23.6	311.4	7.6%
Jun-08 to May-09	13.0	43.3	312.1	13.9%
May-04 to Aug-04	2.5	2.6	119.3	2.2%
May-00 to Oct-00	5.0	3.6	37.2	9.7%
Oct-95 to Feb-96	6.0	1.68	22.2	7.6%

Source: RBI; SBI Research

2. NRI BONDS ONLY A LIMITED OPTION

- The markets are agog with rumour that Government may consider launching of NRI bond to arrest the fall of the rupee. In 2013, the RBI raised foreign currency deposits (FCNR-B) through a subsidised scheme to shore up its reserves. Though in short term, an NRI bond will ease some pain, but considering the increasing trend of residual short term external debt which had already touched $222 billion in March'18 (42% to total external debt), it will have a significant impact on the debt. Also at the time of maturity, it will further put pressure on the rupee like it happened in FCNR-B bonds. If we consider that RBI may still use this option and mobilise an amount of $ 35 billion through this route, the short term external debt to total debt ratio may further increase to 46%, which should be avoided.

3. MUST GO FOR DIRECT DOLLAR PURCHASE FROM RBI BY OIL COMPANIES

- Currently oil companies are purchasing USD requirements for oil imports. USD buying by oil companies, during times of little FPI inflows / outflows creates significant depreciation pressure on Rupee.
- We suggest that oil companies may be asked to purchase all their USD requirements directly from RBI through a single bank, an arrangement that was used in 2013 as well. Further, oil companies may also be asked to borrow USD for import payments directly from foreign branches of Indian Banks. These funds may be borrowed for longer term instead of the very short term funds borrowed currently.

4. MEDIUM-TERM MEASURES FOR IMPORT CONTROL

- In India's import basket petroleum, crude and products, electronic goods, electrical and non-electrical machinery and gold are the major components which occupy more than 50% share. Amongst these, share of electronic goods has increased from 8% in FY15 to 12.3% currently. The share of gold has remained almost constant at around 8%.

Growth of Imports (% YoY)	FY15	FY16	FY17	FY18	Apr-18	May-18	Jun-18	Jul-18	Aug-18
Total Imports	**-0.7**	**-15.2**	**1.1**	**19.8**	**4.6**	**14.9**	**21.3**	**28.8**	**25.4**
Petroleum, Crude & products	-15.9	-40.3	4.8	25.8	41.5	49.5	56.6	57.4	51.6
Electronic goods	15.5	9.3	5.1	23.5	-6.4	19.9	14.3	26.4	22.5
Machinery, electrical & non-electrical	1.9	4.0	-3.6	19.0	9.1	30.9	32.8	30.6	46.2
Gold	19.5	-7.7	-13.4	21.9	-33.1	-29.8	-2.8	40.9	92.6
% Share of above 4 in total imports	**53.2**	**48.5**	**48.2**	**49.7**	**50.6**	**53.3**	**52.5**	**53.9**	**55.0**
Petroleum, Crude & products	31.0	21.8	22.6	23.7	26.3	26.4	28.7	28.2	26.2
Electronic goods	8.4	10.8	11.2	11.5	10.5	11.5	11.0	11.7	12.3
Machinery, electrical & non-electrical	6.2	7.6	7.2	7.2	7.3	7.4	7.4	7.2	8.5
Gold	7.7	8.4	7.2	7.3	6.5	8.0	5.4	6.8	8.0

Source: SBI Research

- Machinery, electrical and non-electrical also form a major share in India's import basket (7% in FY18 from 6% in FY15). This fiscal their growth has exceeded 30% every month. Focus has to be in building capacity in this area, otherwise these will keep on adding to our import bill.
- In our import basket, petroleum imports are inelastic followed by electrical and non-electrical machinery. Gold imports since stable or rather declining, the controllable area remaining is only Electronic Imports.
- Manufactured goods form the major import from China (96% of total imports from China), of which electronics form a primary component, though the share has reduced still it is substantial. Domestic manufacturing of mobile phones & other electronic products needs to be promoted, with some incentives such as 10-year tax breaks.

Imports from China (USD million)

	Electronics	% share of Electronics imports in Total imports from China
Jun-17	2464	40
Jul-17	2427	40
Aug-17	2823	43
Sep-17	3276	47
Oct-17	2441	41
Nov-17	2750	44
Dec-17	2849	42
Jan-18	2610	38
Feb-18	2345	38
Mar-18	2771	41
Apr-18	1518	31
May-18	1922	31
Jun-18	1974	31
Jul-18	1947	32

Source: SBI Research

5. EXPORT PROMOTION MEASURES A MUST

It is absolutely crucial to promote exports as a long term strategy as controlling imports is only a short term solution.

A. SEPARATE WINDOW FOR EXPORTERS' GST REFUNDS

- The Central Board of Indirect Taxes and Customs (CBIC) was periodically organising its special fortnight drive in order to fast track clearance of pending GST refunds of exporters, but the Federation of Indian Export Organisations (FIEO) is claiming that refund clearance has slowed down and saying that over Rs 20,000 crore GST refunds are stuck. A separate window and dedicated refund cells for exporters will be helpful.
- Recently CBIC has organised the third tranche of its special fortnight drive from July 16 and in the previous last two fortnights, it had cleared Rs 5,401 crore and Rs 7,635 crore refunds stuck with regard to Integrated GST (IGST) paid and input tax credit (ITC) claims. Till Jun'18 the Government had claimed that it cleared pending GST refunds to the tune of Rs 38,062 crore.

B. ANNOUNCE AN EXPORT PROMOTION POLICY FOR AGRICULTURE

- There is a huge scope for exports of processed agricultural products, but for that we need effective cold chains. The government needs to put in money to push infrastructure if agri exports have to be increased. Improvement in warehousing infrastructure would also counter inflation concerns due to seasonal factors such as poor monsoon rains.
- India's warehousing capacity for perishables is disproportionately concentrated in a few regions. Almost 50% of cold-storage capacity is concentrated in the states of Uttar Pradesh and Punjab. Post-harvest losses of agricultural commodities is estimated to be about Rs 40,000 crore annually.
- India's agricultural trade surplus could increase significantly if it cuts down on imports of pulses and edible oils. Pulses alone made up for close to 13% of the value of India's total imports of agriculture and allied products in 2017-18.

C. PROMOTING SEZ MUST BE RELOOKED INTO

- SEZ as a concept must be reviewed again. Promoted SEZs should be built near Ports. All Infrastructure and Logistic issues should be addressed to create world class facilities. The original tax incentives provided to boost SEZs should be brought back.
    - China's manufacturing success in the past few decades largely depends upon success in SEZs. In July 1979, the Standing Committee of the National People's Congress passed the SEZ law, which opened China to the world. The rules governing these SEZs were made favourable to foreign investment and policies were targeted and tailored to attract it. Money began flowing in heavily.

- There were two other aspects of the success of China's SEZ policy: proper state attention to the development of infrastructure and the creation of efficient administrative machinery.
- Indian SEZs have failed to catch the fancy of international investors for reasons ranging from lack of infrastructure support to legislative complexities including those pertaining to the labour market and land acquisition.
- The SEZs are supposed to be self-sufficient, so that they can deliver products at internationally competitive rate for export market. In absence of cost efficiency, the zones were not able to deliver. Further, the world economy growth rates have moderated and the commitment to be export positive could not be worked. Also the ports need to be well connected to the manufacturing hubs.
- SEZs could be made Manufacturing hubs for exports in India.

Comparison of SEZ policies: China & India

Factor	China	India
Size	Mostly mega-SEZs. Typically running into hundreds of hectares. Some even thousands	Considerably smaller in scale Even ten hectares qualifies
Location	Located mostly near coasts to facilitate maritime trade	No such strategic location specific planning. Land acquired anywhere
Labour laws	Relaxed in the SEZs	Relatively less flexible
Source/nature of investment	Largely FDI-driven	Not FDI driven
Tax holidays	Exists	Exists Arguably on a greater scale
Infrastructure	Superior connectivity, mainly through ports	Port infrastructure shoddy. In addition, land acquired anywhere without provision of suitable railway/road links
Non-resident nationals	Non-resident Chinese in Hong Kong and Taiwan well tapped	Lack of such geographically favourable condition. Inability to tap NRI funds fully

Source: SBI Research

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ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management, corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

DISCLAIMER

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