21 September 2021

Indian economy set to grow by double digits in FY22 as economic recovery gains further traction

- The pace of global economic growth appears to be moderating in the backdrop of a resurgence in the delta variant cases.
- India's COVID cases resumed their decline following a temporary spike led by Kerala.
- The pace of vaccination continues to accelerate, with daily inoculations averaging ~74 lakhs in the first half of September up from the full month average of 43 lakhs and 63 lakhs in July and August, respectively.
- The impact of the second COVID wave weighed on India's GDP print for Q1 FY22 as it contracted by 16.9% QoQ. However, this was much lower compared to the 29.7% QoQ contraction during Q1 FY21.
- High-frequency indicators in Q2 FY22 continue to gain traction and point towards a return to their respective pre-COVID levels.
- The government's fiscal position remains comfortable amid muted revenue expenditure and buoyant tax collections so far, providing it space to increase fiscal spending in the remainder of the year.
- Export performance remains stellar at record highs in FY22 so far, buoyed by reforms undertaken by the government and a strong global recovery.
- Based on the evolving economic data, robust export performance, and higher government spending anticipated in the remainder of the year, we revise our real GDP growth forecast higher to 10.5% YoY for FY22 (from 9.9% YoY previously).
- To sustain growth over the medium term, a revival of investment demand will be crucial. With increased focus on capital expenditure by both central and state governments, we expect the government to lead the investment cycle and eventually crowd in private sector participation.
- Based on our statistical analysis, capacity utilization, exports, interest rates, and economic policy uncertainty index are key determinants of investment demand in India and are likely to drive the private investment cycle.
- Given the surge in systemic liquidity, we expect the RBI to announce additional measures to manage liquidity conditions. However, in terms of the policy normalization, we expect the first pivot in the form of a change in accommodative policy stance to occur in the Dec'21/Feb'22 meeting.

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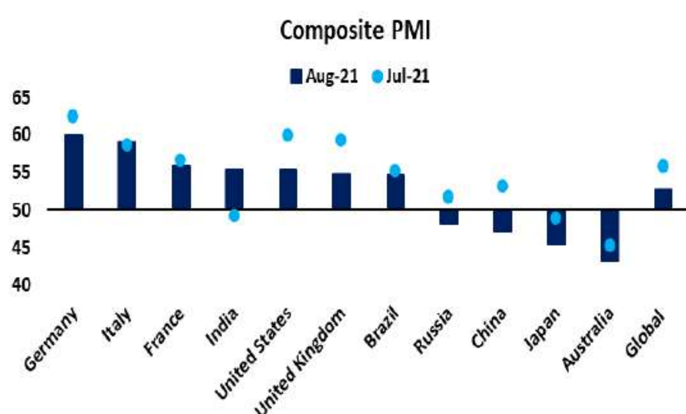
Global growth outlook moderates on the backdrop of new COVID wave

After remaining upbeat during the first half of the year, the pace of global economic growth appears to be moderating as economies inch closer towards normalcy - in varying trajectories. The resurgence of the delta variant across regions has also impinged on the recovery as certain countries bring back restrictions. High-frequency indicators such as the composite PMI have managed to stay in the expansionary zone; however, the pace of growth eased to 52.7 in August from 55.8 in July, contributed by both manufacturing and services sectors. The moderation in PMI prints is primarily centered in Asian economies, which have reported a relatively lower vaccination pace compared to advanced economies and are accentuating the divergence in economic recovery. Incoming data from various countries highlight the unequal growth trajectories that are also evident within the advanced and emerging economy cohorts. Growth in China moderated on account of multiple factors such as the surge in COVID cases that restricted mobility during July-August, the government crackdown on big tech companies, and floods. Early GDP estimates for the UK highlight that the economy registered a mere 0.1% growth in monthly GDP for July compared to 1% in the month of June, reflecting the fallout of a rise in COVID cases on economic momentum. The US noted weak job data during August, possibly reflecting the impact of the delta variant. In contrast, the Eurozone reported an expansion of 2.2% QoQ in Q2CY21, against a 0.3% contraction in the prior quarter. On the aggregate, according to the provisional estimates of the Organisation for Economic Co-operation and Development (OECD) released in August, the GDP growth of the OECD area fared below its pre-pandemic levels in Q2CY21 despite registering a strong growth rate of 1.6% QoQ (vs 0.6% in the prior quarter).

PMI survey shows the global economy lost momentum in August



Source: IHS Markit

With economic recovery showing nascent signs of moderation in various countries, central banks have expressed caution in reversing the ultra-accommodative stance in the near term. During the Jackson Hole meeting, the Federal Reserve Chair provided a dovish guidance as he reiterated the Fed's commitment to keeping monetary policy accommodative and policy rates lower even as tapering of bond purchases is expected to commence in 2021 itself. The Fed chair noted there was a slack in labour markets, and inflationary pressures were largely seen as transient. Meanwhile, in line with the inconsistency in the economic recovery and rising inflationary pressures, the policy normalization process has begun in some countries like South Korea, Brazil, Chile, Hungary, etc.

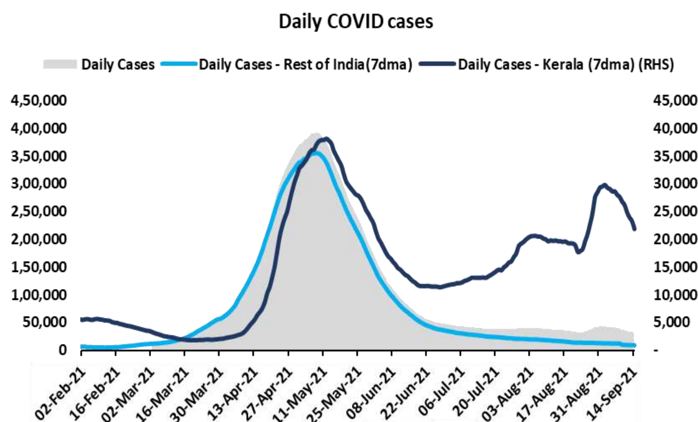
The divergence in the growth-inflation dynamics across countries can be balanced with a more equal vaccination across countries. In addition to supporting the growth recovery by reviving activity levels, control over the spread of the virus will also enable better policy support through lower inflations as supply-side disruptions are corrected. Currently, Asia as a whole has managed to inoculate 48% of the population with at least a single dose, whereas advanced countries like the US and the UK have inoculated 63% and 71% of their respective population with at least one dose (data as of September 14). As such, a faster vaccine drive supported by more equal access to vaccines should be undertaken across the globe to curb the delta variant.

India's COVID situation remains benign; the pace of vaccination accelerates further

India's COVID situation has remained benign following the curbing of the second wave that peaked in early May this year. Daily COVID cases continue to ease and have fallen below the 30,000 mark (7 day moving average [7dma]) as of September 15, 2021 – its lowest since mid-March 2021. Kerala, which has been driving the bulk of India's daily case count since early August, noted a decline in cases from ~30K (7dma) in early September to ~20K (7dma) as of September 15, 2021. Meanwhile, cases in the rest of India also continued to ease and are currently being reported at less than 10K (7dma) daily cases. While there has been an overall decline in cases, the share of concentration in Kerala has increased; it currently contributes ~70% of India's total daily cases vs a ~50% share at the beginning of August. This resonates with the positivity rate of Kerala that remains elevated at 16.5% (and over 20% for certain districts such as Wayanad), compared to 2% at an all-India level. However, the severity of the cases remains low, with India reporting less than 500 daily deaths for 14 consecutive days in September and a daily case fatality rate of 1%. Encouragingly, Kerala's fatality rate remains even lower at 0.6% as of September 14, 2021. Other COVID metrics also

remain benign, with India's active caseload constrained at 3.5 lakhs as daily recoveries continue to exceed daily cases. Nevertheless, caution is warranted especially ahead of the upcoming festive season that could result in a spike in cases and a possible third wave.

India's COVID situation continues to improve



Source: Covid19india.org

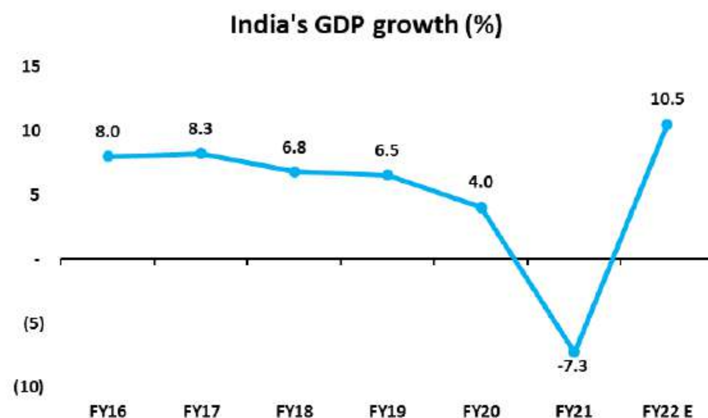
Even as the spread of cases remains in check, enhancing the immunity of the population continues to garner prime focus. The pace of vaccination continues to accelerate, with daily inoculations averaging ~74 lakhs in the first half of September compared to the full month average of 43 lakhs and 63 lakhs in July and August, respectively. Accordingly, India has administered over 76 crores of doses so far and, as a result, inoculated over 62% of the adult population with at least a single dose and ~20% of the adult population with both doses. States such as Goa and Himachal Pradesh lead the vaccination drive and have already inoculated their entire adult population with at least a single dose. In contrast, the more populous states such as Uttar Pradesh, Bihar, Jharkhand, and West Bengal trail the vaccination drive and need to step up the efforts.

Meanwhile, the supply situation remains conducive, with the Serum Institute of India (SII) reported to have produced ~15 crore doses in August that is more than double the production levels of SII during April. According to the SII, it will be able to ramp up its production to 20 crore doses by September itself, which is almost double its production plan submitted to the center in May. If the estimated production levels by SII are sustained for the remaining months, and the previously stipulated supply pipelines for Covaxin and Sputnik are maintained, India will be able to support the inoculation of more than 90% of the adult population by the end of December 2021. This is notwithstanding the additional vaccine supplies in the pipeline both from foreign and domestic producers that are in various stages of trials and could bolster the supply situation even further in the coming months.

India expected to report double digits growth in FY22 as the economic recovery picks up pace

India's growth recovery continues to advance as we put behind the impact of the second COVID wave. The calibrated reopening of the economy buttressed by better adaptation to the evolving pandemic, higher vaccination rates, containment of daily cases, etc. have reaped robust year-over-year growth rates across economic indicators as they tread closer to their pre-COVID output levels. This was reflected in the Q1 FY22 GDP print that noted its highest ever quarterly growth print at 20.1% YoY (close to our estimates of 19.8% YoY). However, this was not without the scars from the second COVID wave that resulted in a 16.9% QoQ contraction in Q1 FY22 (much higher than the 3% seasonal contraction seen in past years during Q1 of each fiscal year) and pushed the economy ~9.2% below its pre-COVID levels. Nevertheless, the impact of the second COVID wave was largely limited to the months of April and May, with a turnaround evident from June onwards. As we progress, the evolving high-frequency indicators in July-August (as noted below) point towards a continued recovery and indicate a return to their respective pre-COVID levels and surpass in some instances. We expect this to reflect in the Q2 FY22 GDP numbers that are likely to reveal its return to the pre-COVID output levels.

India expected to report double-digit growth in FY22



Source: CMIE; FY22 numbers are DMI estimates

The agricultural sector that has led the recovery since the beginning of the pandemic continues to power through. After delayed progress in the sowing of Kharif crops until July, the pace of sowing improved over August, and the actual area sown surpassed its normal area for the first time this season in September, rising to 102.2% as on September 10, 2021. This helped narrow the gap from last year's area sown to -0.9% compared to -54.9% below last year's level as of July 2, 2021, due to deficient monsoons in July and August. However, rainfall levels also appear to be reviving in September, with the cumulative deviation of rainfall from its long period average easing from -9.2% until August to -5.8%

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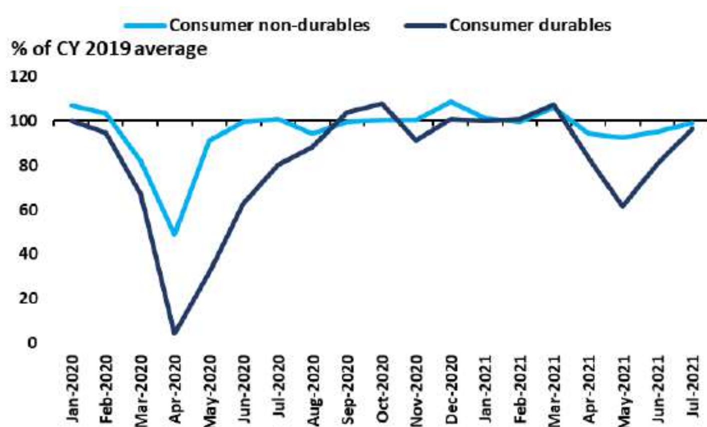
until September 10, 2021. Other indicators such as fertilizer sales, tractor sales also remained robust compared to FY20 levels, although they remained below the previous year's levels.

The industrial activity also continued to gather momentum. The Index of Industrial Production (IIP) caught up to its pre-COVID levels in July (100.7% of CY2019 average) as it noted a 7.2% sequential increase, building on the back of a 5.7% MoM increase in June. The recovery was led by electricity and manufacturing that witnessed a sequential increase of 9.2% and 8.2% respectively in July, while mining production continued to contract 0.9% MoM due to the seasonal impact of monsoons. Meanwhile, electricity generation increased by 17.1% YoY in August vs 7.1% YoY in July and reached 116% of its pre-COVID levels (vs 111% in July). Manufacturing PMI in August continued to remain in the expansionary territory at 52.3, although its pace of growth eased compared to 55.3 in July. The second consecutive month of expansion was seen across improved sales and demand, new orders, new export orders, stock building efforts, etc., although elevated price pressures curbed the pace of growth and also paused hiring efforts.

In the services sector, the recovery became more broad-based. The PMI services rebounded sharply into expansion territory to an 18-month high at 56.7 in August (vs 45.4 in July). The receding effect of the pandemic resulted in the reopening of several establishments in the services sector that boosted production levels and was matched by improving demand and new orders. E-way bill collections and GST collections continued to note a robust pace of growth at 33.3% YoY, and 29.6% YoY in August (vs 32.7% YoY and 33.1% YoY in July) as the movement of goods and general activity resumed. Domestic air passenger traffic increased by 62.4% sequentially and 136% YoY in July. Cargo traffic at major ports increased by 6.7% YoY in July. Meanwhile, Rail freight traffic continued to increase robustly in August by 17% YoY (vs 18.4% YoY in July).

Consumption demand notes a broad-based recovery



Source: CMIE

On the demand side – consumption demand also continued to note a more well-rounded recovery. The IIP consumption index (weighted average of consumer durables and consumer non-durables) increased for the second consecutive month on a sequential basis by 9.7% in July (after an 11.9% MoM increase in June) and rose to 97.8% of its pre-COVID levels. This was largely driven by a rebound in consumer durables that increased by 19.5% MoM in July (following a 31.2% MoM increase in June), reflecting a return of more discretionary consumption. In contrast, consumer non-durables that can be seen as a proxy for essential goods have remained broadly steady at ~99% of their pre-COVID levels in July. Meanwhile, other lead indicators for August continue to point towards a continued pick-up in consumption demand. Retail sales for passenger vehicles increased to 155% of the pre-COVID levels, albeit supply-side issues due to shortages of semi-conductors can pose a near-term challenge for recovery in this segment. In contrast, two-wheeler sales noted a modest recovery of 3% MoM in August and stood at 86% of the pre-COVID levels reflecting price pressures and a relatively strained financial position for consumers at the bottom of the pyramid.

On the government side, overall spending by the central government has remained modest so far this year at -4.7% YoY (April-July), with the revenue expenditure lower by even more at -7% YoY in this fiscal. Meanwhile, total receipts of the government have remained buoyant at 193% YoY (April-July), supported by the economic recovery, formalization of the economy, and strong tax collection efforts. Accordingly, the government has managed to limit its fiscal deficit to just 21% of its budgeted estimates until July – its lowest in more than the past five years. As such, the fiscal position of the government remains favourable at this time. The government cash balance also remains elevated at nearly Rs 4 lakh crore as on August 27, 2021, which can easily fuel increased spending in the coming months. As such, we expect higher government support in the remainder of the year and do not rule out the possibility of total spending by the government exceeding its budgeted estimates (supported by higher than budgeted revenue receipts).

On the external sector front, Indian exports continue to note a stellar performance. Exports have been buoyed by the reforms undertaken by the government along with the strong global recovery so far and stand ~68% higher compared to last year's levels (April-July) and ~23% above pre-COVID levels for the same period. According to the IMF, Global trade volumes are also expected to increase by 9.7% in 2021 and 7% in 2022, and we expect India to ride the upcoming globalization drive. During the hyper-globalization period from the early 2000s till the global financial crisis, Indian exports increased at a CAGR (compounded annualized growth rate) of ~22% for nearly a decade (FY01-FY09). This

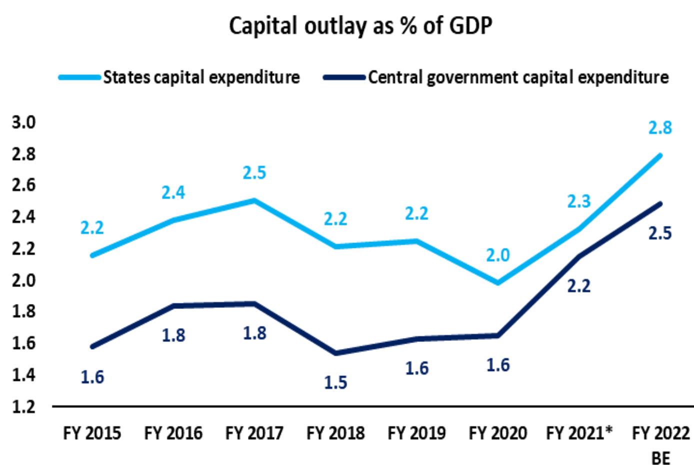
also drove the investment cycle and saw investment share in GDP increase from 26% to ~35% during the period. As such, the expected robust performance of exports in the current year is likely to contribute not only to India's overall growth but also have spillover effects on India's investment cycle.

Based on the evolving economic data, robust export performance, and stronger government spending anticipated in the remainder of the year, we revise our GDP forecast higher to 10.5% YoY for FY22 (from 9.9% YoY previously).

Investment demand holds the potential to be the engine of durable growth for India in the medium term

As India transcends its objective of returning to its pre-COVID output levels – the focus turns to the growth trajectory from here on. In the following section, we emphasize investment demand as the engine of durable growth for India in the medium term. While private consumption demand continues to recover driven by pent-up demand and improving sentiments, its sustainability may face headwinds, given the concerns of an unequal recovery among consumers along with a poor quality of job recovery. Exports are set to ride the global growth wave and buoy India's growth. However, this also remains susceptible to the fading fiscal, and monetary impulses across advanced economies as they move closer towards normalization and inflation concerns solidify. In this light, we see investment demand as the key driver of "durable" growth for India through its channel of higher investments, generating more employment, leading to higher wages/disposable income, and eventually driving higher consumption demand.

Central and state governments have increased focus towards capital expenditure



Source: CMIE; * states capital expenditure figures for FY21 are revised estimates and actuals for central government. Data for states is the sum of 27 states and UTs

The Indian government has already moved its focus towards an investment-led growth strategy, as is evident in its shift towards higher capital outlay. The transition has been apparent in the increased capital spending noted since H2 FY21 (75% YoY vs -11.6% YoY in H1 FY21), which has continued in the new fiscal year so far (~15% YoY in April-July). State governments have also followed suit, increasing their capital expenditure by ~91% YoY in the months April-July FY22 (based on data available for 19 states). Moreover, both center and state governments have budgeted ambitious capital expenditure targets at 2.5% of GDP and 2.8% of GDP, respectively, for FY22. If achieved, these would be their highest capital expenditure as % of GDP in the past seven years at the least. Meanwhile, on the private investment side, the offtake has been relatively muted with the perpetual uncertainty from the pandemic stalling fresh investment projects. While there is no hard data available on a quarterly basis to distinguish the shares of public and private investment – indicators such as low-capacity utilization rates (less than 70% in Q4 FY21), muted bank credit to industries (~2% below March 2020 levels as of July 2021), negative sentiments as per the business assessment index of the RBI in Q1 FY22, declining fixed asset to total asset ratio for private corporates, etc. indicate a laggard recovery for private investment.

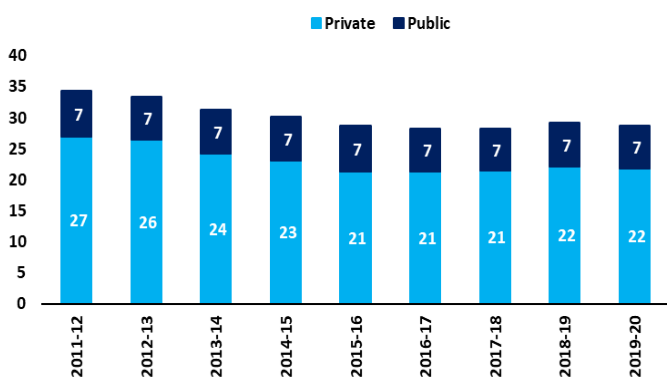
To better understand the key drivers of investment demand in India, we have conducted an econometric analysis. Typically, investment behaviour is a determinant of demand conditions, cost & availability of funds, and investment sentiments, among other factors. Based on our analysis, we have identified variables for each of these determinants and find a statistically significant relation (up to 10% level of significance) of Gross Fixed Capital Formation (a proxy for investment demand and our dependent variable) with capacity utilization (demand condition), exports (a proxy for external demand), India 10Y benchmark yields with lag up to 3 quarters (cost of funds) and economic policy uncertainty index with a lag of 1 quarter (investment sentiments). We also find the business expectations index of the RBI's Industrial Outlook Survey to have a correct sign and improve the explanatory variance share of the model (R-square of 75%), although it is not statistically significant.

Drawing an inference from our model, we expect a conducive investment environment in the form of low-interest rates, robust exports growth, and low economic policy uncertainty that are likely to revive private investment demand ahead. Other variables such as capacity utilization rates and business expectations are also expected to improve going ahead; however, they remain susceptible to the possibility of a third wave. A resurgence in cases could limit economic activity in general and continue to breed business uncertainty, thereby inhibiting recovery of private

investment demand, even as the policy environment remains supportive. As such, efforts towards curbing another wave through higher vaccination rates, social distancing norms ahead of the festive season, etc. play a crucial role in a strong revival of private investment demand.

This garners more attention, especially since the slowdown of investment growth in recent years (investment demand share of GDP declined from 34.3% in FY12 to 28.8% in FY20) can be attributed to the fall in private investment participation. Private sector participation (including households) that comprises the bulk of investment demand at more than 75% - saw its share in India's GDP declined from 27% in FY12 to ~22% in FY20. Meanwhile, public investment (comprising the remainder share of ~25% of investment demand) has seen its share in GDP remain broadly steady at ~7% over the same period. However, with the government's participation in investment demand expected to increase ahead in line with its capital outlay targets (as noted above), a crowding in of private investments could also take place. The government is also attempting to drive privatization of various sectors, introduce reforms such as PLI schemes for various sectors, create a more business-friendly environment (improve ease of doing business), etc., that could revive the animal spirits of the private sector and lead to strong investment-led growth.

Share of investment demand in India's GDP decline with falling private sector participation

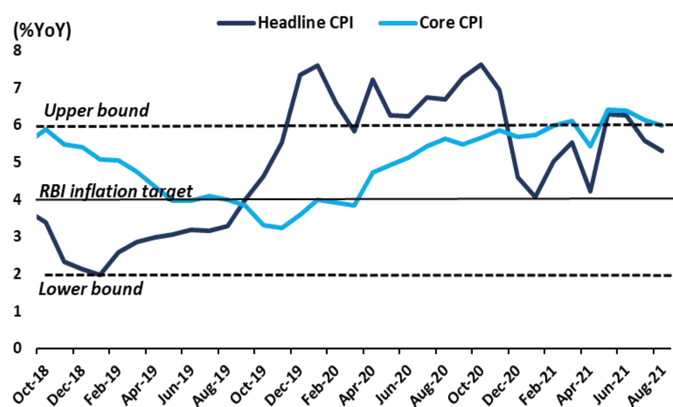


Source: CMIE; Note: private sector constitutes – private financial & non-financial corporations and households; public sector constitutes – public financial & non-financial corporations and general government

RBI continues to maintain dovish stance; likely to announce further measures to contain surplus liquidity

In the aftermath of COVID-19, the RBI has been injecting abundant liquidity in the system to contain the adverse impact of the pandemic on the economy. Since February 2020, the RBI has announced liquidity measures amounting to Rs 17.2 lakh crore. Consequently, the systemic liquidity has reached elevated levels of Rs ~8.5 lakh crore in September (approx. 5.4% of Net demand and time liabilities as of September 10), and the cost of borrowings has come down significantly across financial segments. However, as we inch closer towards normalcy, discussion on the winding up of monetary policy support has picked up. This was reflected in the minutes of the latest MPC meeting that brought to the fore a dissent among the MPC, as one of the members voted against the accommodative stance and advocated a hike in the reverse repo rates. Concerns about the persistence of inflation pressures and anchoring inflation expectations have also increased. Nonetheless, the balance of the MPC continues to lean towards maintaining its accommodative stance and prioritizing growth over inflation concerns.

Headline CPI eases, providing comfort to RBI's accommodative stance



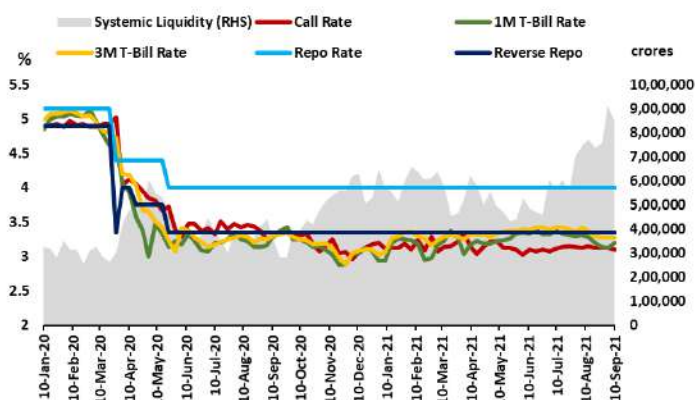
Source: CMIE

Giving comfort to RBI is the moderation in the CPI print that came in at 5.3% YoY in August (vs 5.59% YoY in July) and continued to ease for the third consecutive month. The softening of inflation print went beyond a favourable base effect from last year as the sequential momentum eased from 0.7% MoM in July to 0.2% MoM in August. The decline was primarily led by moderation in food prices which deflated by 0.1% MoM in August compared to an increase of 1.0% MoM in July. Meanwhile, core inflation remained sticky at ~6% YoY in August (vs 6.1% YoY in July), although its momentum eased marginally to 0.4% MoM compared to 0.6% MoM in July. This likely reflects the easing of supply-side bottlenecks as the economy reopens further and provides more support to the argument of inflation pressures being transient. Going ahead, we expect inflation prints to remain benign, supported by a favourable base effect (until November), moderating food prices on the back of improving progress on Kharif sowing activity and further easing of supply-side constraints. This is likely to provide more policy space to the RBI and maintain its accommodative stance in the coming months. We continue to expect a change in accommodative policy stance at the end of Q3 FY22/early

Q4 FY22 (in Dec'21/Feb'22 meeting) that could come in the form of a reverse repo rate hike. We expect the first repo rate hike only to take place in the next fiscal year (FY23).

In the interim, the RBI has already announced measures to address the extraordinary surge in systemic liquidity. The RBI has increased its fortnightly Variable Rate Reverse Repo (VRRR) auction amount from Rs 2 lakh crore to Rs 4 lakh crore in a calibrated manner over August-September. Notwithstanding the augmented size of VRRR, short term rates drifted lower as renewed capital inflows and liquidity injecting operations through G-SAP purchases kept liquidity conditions elevated. Accordingly, money market rates such as the call rate, 1month T-bill, 3month T-bill continue to trade below the reverse repo rate of 3.35% (25 bps, 15 bps, and 7 bps, respectively as of September 10). We believe the RBI is likely to augment its VRRR amount further and also use alternative policy tools to manage liquidity conditions and steer market rates towards the Liquidity Adjustment Facility (LAF) corridor. However, we do not see this as a change in stance yet and expect the accommodative support to continue. In fact, the absorption of systemic liquidity is likely to be more challenging given the expected increase in government spending in the coming months, along with robust capital flows that would warrant RBI's intervention in the forex market. Lastly, we draw comfort in the way the RBI has been pro-active since the beginning of the pandemic and offered pre-emptive support that has largely surprised market participants positively. In a recent interview, the RBI governor reinstated that *"all our actions will be calibrated, they will be well-timed, they will be cautious and there will be no sudden shocks to the market"*.

Short term rates remain below reverse repo rates despite increased VRRR auction amount



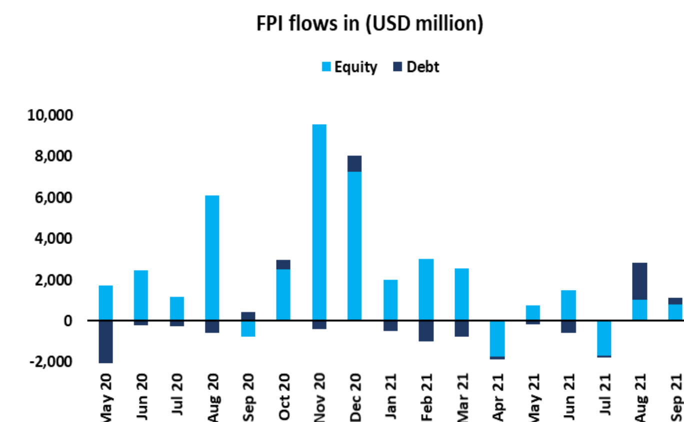
Source: CMIE

Market Section

Indian Bond markets traded in a narrow range in August. Yields on the 10-year benchmark G-sec hovered around the 6.2% threshold as it averaged 6.23% in August, marginally higher compared to 6.17% in the previous month. The moderating CPI print in July 2021 and continued support of RBI in terms of fresh G-SAP auctions of Rs 50,000 crore and regular open market operations (OMOs) during August kept yields in check. However, Indian debt markets witnessed windfall gains towards the end of August as foreign portfolio investors injected $1.8 billion in the Indian debt market (95% of which was received in the last week of August) after a seven-month hiatus. Consequently, yields on the 10-year benchmark G-sec fell by ~10bps from 6.26% on August 27 to 6.16% on September 3 before inching up marginally. Early indication in September also points towards a continuation of foreign flows (~$300 million until September 14) that are likely to meet the growing supply. Meanwhile, mutual funds also continued to invest in Indian debt markets, parking $2.8 billion after $2.6 billion in July. Going ahead, the expectation of lower inflation prints and continued policy support from the RBI is likely to keep yields in check.

Indian equity markets extended their upward momentum in August, with both the indices – NIFTY and SENSEX – soaring to record highs. The NIFTY 50 and SENSEX recorded gains of 8.7% MoM and 9.4% MoM, respectively, in August. The Indian equity market continues to outperform its peers as the MSCI EM index recorded gains of 2.4% in the same period. Equity indices were supported by the recovery in the Indian economy, as evident in the strong corporate earnings results for Q1 FY22, gradual improvement in COVID cases, and accelerated vaccination drive. Foreign Portfolio Investors (FPIs) turned net buyers of equities in August to the tune of $1 billion after withdrawing $1.7 billion in the previous month. Moreover, despite the record highs, the valuations of the indices improved with the Price-to-Earnings (P/E) ratio of the NIFTY 50 index reducing from 27 in July 2021 to 26.3 August 2021. The equity market continues to report fresh highs entering into September, supported by the ongoing optimism over economic recovery.

Foreign investors pour capital into the Indian debt market after seven months of capital withdrawal



Source: CMIE; Note – data for September 21 is until September 14

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The Indian rupee appreciated in August after two consecutive months of depreciation. The Indian currency appreciated by 0.5% MoM against the US dollar to average 74.1 in August compared to 74.5 in July, supported by increasing FPI inflows and softening in crude oil prices. The pick-up in momentum of economic recovery post abatement of the second COVID wave and absence of the RBI's intervention also supported the appreciation of the domestic currency. In line with its emerging market peers, the appreciation in the Indian rupee was also guided by the dovish policy comments by the Fed chair during the Jackson Hole symposium in the last week of August. Moving into September, the Indian rupee has further strengthened on account of a weaker dollar following weaker jobs market data in the United States. The dollar index has deteriorated by 0.4% during September so far. Going ahead, we expect some downward pressures on the rupee amidst volatile crude oil prices. However, robust capital inflows in tandem with the improving economy should cap any major downside risks.

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