21 October 2021

The Indian economy's Goldilocks phase faces external headwinds; strong external accounts position to help avoid a repeat of a 2013 'taper-tantrum'

- India's domestic economic conditions continue to improve, aided by a contained COVID situation and accelerated vaccination pace.
- High-frequency data shows a Goldilocks phase as economic recovery is broadening while CPI inflation remains on a downward trajectory.
- In contrast, the external environment is starting to deteriorate given moderation in the pace of global economic activity and rise in volatility in global markets amidst supply chain disruptions, rise in energy prices, inflationary pressures, and uncertainty over the pace of the US policy normalization.
- The US Fed is expected to announce the tapering of its bond purchases before the end of 2021, raising concerns about a repeat of the 2013 "taper-tantrum" and the ensued tightening of financial conditions in emerging markets, including India.
- In this context, we revisit India's economic and market conditions to reassess potential implications for the economy after first reviewing these in our March '21 report.
- We reiterate our assessment that India is not immune to global market volatility. However, its improved macro-economic fundamentals and a strong external account position (the fourth largest foreign exchange reserves globally and a current account surplus) provide policymakers with the flexibility to manage policy response in a non-disruptive manner and curtail volatility during global market events.
- Given India's high dependence on oil imports, we see any sustained increase in global energy prices as a key upside risk to domestic inflation and the RBI's present gradual policy normalization approach.
- We presently expect the RBI to raise the reverse repo rate in the Dec '21/Feb '22 meeting, while the repo rate is likely to be hiked in H1-FY23.
- In the event of upside risks to inflation, the RBI might have to recalibrate its gradual policy normalization approach even though it is likely to try to limit the impact on economic recovery, partly with the help of the government's supply-side interventions.

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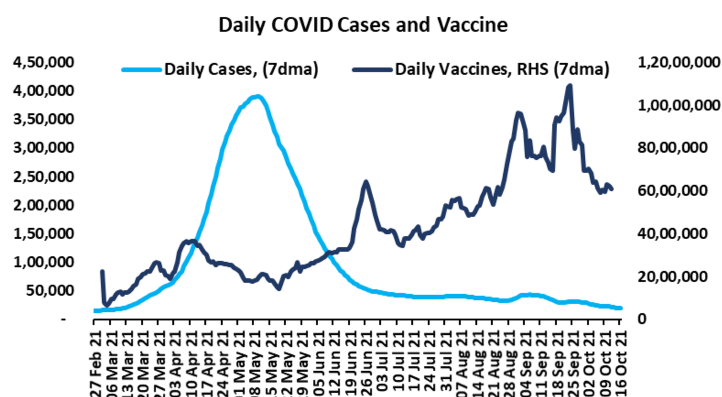
India's improving domestic economic conditions face external headwinds

India's domestic economic conditions continue to improve, aided by a contained COVID situation and accelerated vaccination pace. Incoming economic data shows a Goldilocks phase with economic activity picking up while CPI inflation easing. In contrast, the external environment is starting to deteriorate with data showing moderation in the pace of global economic activity and rise in volatility in global markets amidst supply chain disruptions, rise in energy prices, inflationary pressures, and uncertainty over the pace of the US monetary policy normalization. In this report, we provide an update on India's economic environment and revisit possible implications of the US's bond program tapering on India.

India: the COVID situation continues to improve; pick up in vaccination pace bolsters economy's prospects

India's COVID situation has continued to moderate since its second wave peaked in early May. The 7-dma (day moving average) of daily cases fell below the 20K mark on October 9, for the first time in over 200 days and improved further to ~16K by mid-October. The daily cases have been easing gradually, thanks to the improvement witnessed in Kerala, where cases dropped from ~30K (7-dma) at the beginning of September to ~9K as of October 16. Further, the active caseload also continued to decline and stood at less than 2 lakh cases (October 16) as daily recoveries continued to outpace the daily cases. Encouragingly the easing in cases is being accompanied by improvement in fatalities, which have remained under 500 since the beginning of September. Moreover, the daily positivity rate (7-dma) has also eased to below 2% by the first week of October; however, it remains elevated at double-digits in certain pockets, such as Kerala and in some of the North-Eastern states.

COVID cases remain contained; vaccination pace higher than in Q1 FY22



Source: CMIE

Meanwhile, India's vaccination pace has accelerated significantly, with daily inoculations averaging ~81 lakhs in September and ~54 lakhs in the first half of October compared to the monthly averages of 43 lakhs and 63 lakhs in July and August, respectively. Accordingly, India has administered over 97 crores of doses by October 17, as a result, inoculated ~74% of the adult population with at least a single dose and ~30% of the adult population with both doses. However, regional differences continue to persist as more populous states like Uttar Pradesh, Bihar, Jharkhand, and West Bengal, trail the vaccination drive. Meanwhile, the recent pace of vaccination moderated in October as 7-dma daily vaccine doses declined from ~70 lakh doses by the end of September to ~42 lakh doses by October 16. With over 70% of the population having received the first dose, the trend is not surprising as the future course of vaccination is likely to be driven by the administration of the second dose. Given that over 88% of the doses administered are by Covishield, the future pace of vaccination is expected to be slower due to the mandatory waiting period of 12-16 weeks between the first and the second dose.

India: High-frequency data indicate a Goldilocks phase as the economic recovery broadens while inflation eases

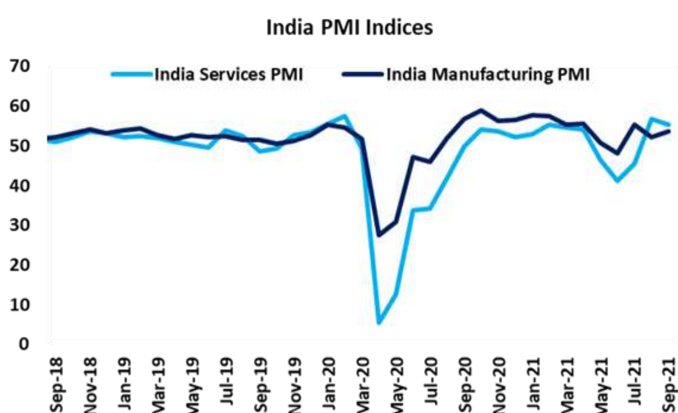
A contained COVID situation and accelerated vaccination pace aid the continued normalization of economic activities and the broadening of economic recovery. The incoming data for lead economic indicators suggest that the Indian economy has likely surpassed its pre-pandemic levels in Q2 FY22. We expect economic growth to be around 9% YoY in Q2 FY22, putting real GDP above the pre-COVID level. High-frequency indicators suggest a continuation of recovery into Q3.

The agricultural sector that has led the recovery since the beginning of the pandemic continues to power through. The sowing of Kharif crops ended at 0.2% higher than last year, allaying fears of impact from the slower pace in July-August. Prospects for rabi crops are also bright given normal monsoon and total live storage in 130 important reservoirs of ~80.4% of the full reservoir level. This should support the continued robust performance of the sector and boost rural demand. Meanwhile, other indicators such as fertilizer sales and tractor sales remained robust compared to FY20 levels.

With industrial activity gaining further traction, the Index of Industrial Production (IIP) remained above its pre-COVID levels (taken as CY2019 average) in August at 100.5%, led by robust electricity production at 119.6%, while manufacturing output remained closer to the pre-COVID level at 98.8%. However, the mining sector lagged at 95.8% due to the impact of an extended monsoon season. On a

sequential basis, the IIP index momentum registered a marginal decline of 0.2% MoM, following solid gains of 7.2% MoM in the previous month, as the contraction in mining and manufacturing offset the expansion in electricity. The lead indicator for September, the PMI manufacturing index, suggests continued recovery, with the index rising to 53.7 compared to 52.3 in August, driven by improvement in output and new orders. Reaffirming the expectation of further expansion in the industrial sector, the RBI's Business Expectation Index also surged from 124.1 in Q2 FY22 to 135.7 in Q3 FY22. However, electricity generation for September declined by 1.69% YoY, possibly reflecting near-term coal supply challenges. An extended monsoon season, flooding of some coal mines, and surge in global coal prices have led to a shortage of coal stocks at several power plants in the past few weeks, even as electricity consumption continues to remain high in line with economic recovery and the festival season demand. This has caused power cuts in some cities. Given large coal stocks with Coal India and expected pick-up in coal production with the end of the monsoon season, coal dispatches to power plants are likely to rise, helping replenish inventories in the coming weeks. This should ensure that India will escape any major power crisis and related disruption to economic activity in the country.

The manufacturing and services PMI indices continue to expand, driven by strong demand prospects



Source: IHS Markit

Encouragingly the services sector indicators show a broadening of the recovery, with contact-intensive services picking up. The RBI expectation index of the services sector suggests that the rebound seen in Q2 FY22 is likely to be carried forward as companies anticipate improved demand conditions for the rest of the fiscal year. In September, the PMI also managed to stay in the expansionary zone; however, it moderated slightly to 55.2 from 56.7 in August. The expansion was primarily supported by improved domestic customer footfall amidst the easing of COVID restrictions and increased marketing efforts supporting new business inflows. Travel restrictions continued to weigh on international demand for Indian services. With the government permitting foreign tourists' arrival from October 15 by chartered flights and November 15 for regular flights, we could see a boost to the tourism sector. Domestic travel is also expected to pick up supported by "revenge spending", the festival demand, and the government allowing 100% capacity in domestic flights. Other services related indicators such as domestic air passenger traffic and rail freight showed robust growth rates.

Broad-base recovery in industrial and services sectors in Q2 FY22

Industrial and Services Sector Indicators, Index averaged to 2019								
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Aug-21	Sep-21
Industrial Sector								
PMI Manufacturing	27.4	47.2	56.8	56.4	55.4	48.1	52.3	53.7
IIP	41.4	82.7	95.1	105.3	111.6	94.0	100.5	
IIP: Manufacturing	32.0	81.3	96.0	105.5	108.8	91.9	98.8	
IIP: Mining	72.7	79.1	80.8	108.2	128.3	97.4	95.8	
IIP: Electricity	79.6	99.0	105.5	100.1	114.1	107.2	119.6	
Coal output	79.5	79.9	80.9	119.7	161.1	85.9	90.7	
Steel output	17.3	78.8	96.6	110.1	112.9	98.5	102.0	
Cement output	15.2	93.3	85.9	100.1	123.6	100.3	100.7	
Services Sector								
PMI Services	5.4	33.7	49.8	52.3	54.6	41.2	56.7	55.2
Banks' lending to services sector	110.5	109.1	111.2	111.3	114.3	112.3	113.3	
Rail freight	58.9	87.5	102.3	119.5	127.5	111.2	111.2	111.4
Airline cargo traffic	16.8	57.0	83.5	90.0	98.7	82.9	92.4	
Railways traffic passengers	-1.1	0.6	5.7	27.2	45.4	20.4	36.8	
Passenger domestic air traffic	0.0	16.5	32.9	61.0	65.0	25.3	55.9	59.0

Source: CMIE, IHS Markit; Note: PMI indices are shown as actual levels

Recovery on the demand side also firmed up in September, as evident in several high-frequency indicators. With a majority of the states easing COVID related restrictions amidst declining cases, Google grocery and pharmacy mobility (on a 7-dma basis) surpassed its baseline levels in mid-June and stood 31% above baseline by September end. Personal credit continues to post strong 12.1% YoY average growth during April-August '21 compared to average 9.5% YoY growth in Q4 FY21. Other demand indicators such as consumer durables and nondurables, petrol consumption, tractor sales, two-wheeler sales posted robust growth, with some indicators surpassing their pre-pandemic levels. However, other indicators like passenger car sales declined in September due to supply-side constraints as the shortage of semiconductors continues to pose a challenge. Nonetheless, with optimism surrounding economic recovery, the consumer confidence published by the RBI also improved with the current situation index increasing substantially from 48.6 in July to 57.7 in September and future index expectation rising from 104 to 107 during the same period.

Adding to the positive news is the recovery in the job market, strengthening the future consumption outlook. As per the

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CMIE, the greater unemployment rate declined from 11.5% in August to 9.9% in September, the lowest rate observed since the onset of the second COVID wave. Further, there are early signs of improving job quality as the largest job gains were visible for the salaried employees (69 lakh jobs), followed by small traders and wage laborers (56 lakh jobs). Looking at the sectoral distribution, the industrial sector saw job gains supported by an increase of jobs in real estate & construction (56 lakh jobs), potentially reflecting the result of an increased push on the Capex spending by the center.

Demand indicators firmed up further in August-September

Consumption Indicators, Index averaged to 2019								
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Aug-21	Sep-21
Google mobility - retail & recreation	-81.5	-59.8	-41.9	-27.5	-22.1	-40.4	-16.3	-13.0
Google mobility - grocery & pharmacy	-52.0	-2.5	-4.9	9.5	18.5	3.2	29.8	32.7
Unemployment rate	23.5	10.2	6.7	9.1	6.5	9.2	8.3	6.9
Petrol consumption	51.9	88.9	83.7	101.6	103.1	87.7	88.0	88.1
Personal loans	108.7	108.4	112.0	116.0	123.9	121.3	126.0	
Passenger car sales	1.4	38.3	97.1	95.5	95.5	81.6	73.5	52.1
Two wheeler sales	2.5	66.0	119.2	81.5	101.0	76.4	92.8	102.8
Tractor sales	18.6	147.2	173.4	107.1	142.1	179.8	97.7	156.9
IIP: Consumer durables	4.4	63.0	104.0	100.7	107.2	80.6	95.4	
IIP: Non-consumer durables	49.0	99.5	99.4	108.6	106.0	95.2	99.3	

Source: CMIE; Note: Mobility and Unemployment indicators are shown as actual levels

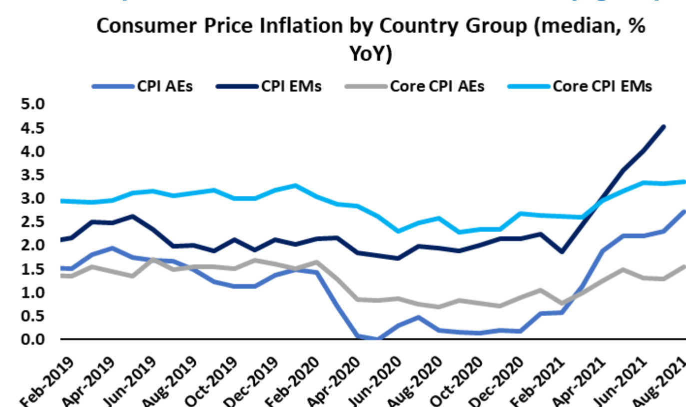
Despite strong recovery witnessed in high-frequency indicators, investment demand indicators have been mixed with new projects' announcements, as per the CMIE, falling by 57.1% QoQ in Q2 FY22, registering a 68% fall for the government sector and a 55% QoQ drop for the private sector. However, other high-frequency indicators such as capital goods imports, steel and cement consumption, and IIP capital goods productions are indicating a recovery. 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. The total government expenditure for the month of August grew by 40.7% YoY after contracting by 23% YoY in July, on the back of rising capital expenditure as it increased by 92% YoY. Strong revenue collections at (114% YoY for April-August) alongside the current fiscal space with fiscal deficit at only 31% of Budget Estimate [BE] (April-August) vs the past five-year average of 79% of BE during the same period provide space for the government to increase its expenditure for rest of the fiscal. The central government also lifted spending curbs on different departments, indicating an intent to push up the expenditure in the remainder of FY22, which should boost the economy.

Aggregate demand continues to get a boost from exports. The exports demand accelerated and stood steady at 125% of its pre-pandemic levels (on the base of FY20) in September, with cumulative exports in H1 FY22 reaching close to the halfway mark of the target of $400 billion exports for the full year. On a quarterly basis, the exports increased by 38% YoY in the quarter ending September and stood 31% above the pre-pandemic levels (corresponding quarter of FY20), while imports registered a much higher increase of 63% YoY and stood 25% above their pre-pandemic levels, reflecting a revival of domestic demand and stocking for select items ahead of the festival season. While Indian exports could continue to benefit from solid external demand (WTO revised its projection for the global merchandise trade growth in 2021 to 10.8% YoY from 8.0% earlier) in the near-term, sustaining the exports growth into next year could face challenges amidst signs of global growth losing momentum.

Revisiting India's readiness to withstand a possible "taper-tantrum"

In early 2021, the improving global economic outlook had caused the market to reprice the prospects of a pull-back in policy support by major central banks, primarily the US Fed, leading to a rise in financial markets volatility and raising concerns about a repeat of the "2013 taper-tantrum (pegged as "taper-tantrum" 2.0 covered in our March'21 report). The process of policy normalization was delayed by the new COVID waves in India (in April-May) and globally (in June-August), providing relief to global financial markets. With the resumption of economic recovery as COVID cases ebbed and the vaccination pace picked up, major central banks are again at crossroads, evaluating the timing and the pace of exit from ultra-loose monetary policies. The task of many central banks has been complicated by the rising inflationary pressures and the recent surge in energy prices.

Inflation pressures have risen across country groups



Source: IMF; AEs = advanced economies; CPI = consumer price index; EMs = emerging market economies

Pandemic-driven disruptions to supply chains, alongside the release of pent-up demand and the rebound in commodity prices, have already caused consumer price inflation to increase rapidly in several countries. Central banks must strike a balance between preventing inflation from becoming entrenched beyond temporary spikes while ensuring that policy stimulus is not withdrawn in haste when economic recovery is still fragile, and uncertainty is high. To head off price pressures, some major emerging economies, including Brazil, Chile, Hungary, Russia, and Turkey, have already begun normalizing monetary policy. Central banks of some AEs such as Iceland, Czech Republic, South Korea, and Norway have also raised their policy rates in 2021 so far. Meanwhile, major advanced economies such as the US, the UK, and Eurozone continue to keep policy rates unchanged, attributing the recent rise in respective domestic inflation to transitory factors, but have either begun (ECB and Bank of Canada) or indicated the start of tapering (the US Fed) in the coming months. As per the Fed's policy meeting minutes, the US central bank could start the process of tapering of bond purchases in either mid-November or mid-December and conclude around the middle of next year.

Given the taper guidance by the US Fed, global markets volatility has increased, with bonds yields rising and currencies coming under pressure. In this light, we revisit the possibility of 2013 like "taper tantrum" and its implications for India (please refer to the box on the right-hand side for the 2013 "taper tantrum" episode). ***Our analysis continues to show that India is not immune to "taper-tantrum" driven global market volatility. However, policy buffers in terms of large foreign exchange reserves and improved external accounts position compared to 2013 provide room to manage the policy response in a non-disruptive manner and curtail volatility, unlike during the 2013 taper-tantrum. We also note that elevated global energy prices, in addition to broad commodity prices, and the risk of further increase given demand-supply imbalances could pose upside risks to domestic inflation. A faster than presently projected inflation may force the RBI to reconsider its gradual policy normalization approach. We discuss these points in the following sections.***

First, our March '21 economic monitor report outlined India's enhanced macro-economic and external account stability in FY21 compared to that during the taper tantrum episode of 2013, when India was pegged among the 'fragile five' economies. In FY22, India's fundamentals have further strengthened, and they continue to fare much better than its emerging market peers. As outlined in the table on the next page, India outperforms its peers in three out of five metrics (growth, foreign exchange reserve, and external debt stock as a % of GNI). On inflation, while India ranks third, the average inflation (5.3% April-September), along with the forecast for FY22, is likely to remain within the tolerance

Box: "Taper-Tantrum-2013"- An unforgettable summer

In response to the 2008-09 Global Financial Crisis, major central banks had cut rates to an all-time low and launched unconventional assets purchase programs. The resultant comfortable global monetary conditions transmitted to emerging economies in the form of capital inflows, with India receiving more than $28 billion annually on average in the FY10-FY13 period. The sudden and significant change in global monetary and financial conditions followed the US Federal Reserve's taper talk. On May 22, 2013, Federal Reserve Chairman Ben Bernanke first spoke of the possibility of the Fed tapering its bonds purchases. This had a sharp negative impact on financial conditions of emerging markets, including India. During May 22-August 30, 2013, India witnessed sustained outflows of foreign capital; the Rupee depreciated sharply, bond spreads increased, and equity prices fell.

Effect of taper tantrum on Emerging Economies (April-August 2013)

	Exchange rate depreciation (%)	% change in stock prices	% change in reserves
Brazil	19.2	-10.6	-3.1
Indonesia	12.3	-16.7	-14.1
India	22.1	-7.7	-7.0
Turkey	13.7	-22.8	-4.6
South Africa	14.6	11.1	-5.4

Source: Bloomberg; Calculated from end April 2013 to end August 2013; exchange rate is vs the US Dollar

India's vulnerability to external shocks was exacerbated by its relatively weak macro and mainly external accounts positions, including high current account deficit, relatively low FX reserves, high inflation, and elevated fiscal deficit. This led to India's classification among the 'fragile five' economies during that period. Even within this group, India had the largest exchange rate depreciation and the second largest decline in reserves. "Facing risks of currency turmoil due to the taper-tantrum, the RBI judged that spillovers could endanger financial stability and growth and gave priority to stabilization of the rupee in the conduct of monetary policy (RBI, 2014)". Accordingly, an unconventional policy response had to be deployed. Liquidity operations ensured that money market rates were tightened, FX reserves were augmented by overseas borrowings and swaps, and gold imports were restricted. These measures helped stabilize the rupee in the ensuing months. However, inflation pressures persisted, warranting a more conventional monetary policy response in the form of policy rate increases in Sep-Oct 2013 even as the unconventional measures began to be wound down.

band of RBI (4% +/-2%). This contrasts with the double-digit inflation in FY13. On the current account, India slipped one rank compared to our March '21 report, as the revival in domestic demand led to higher imports. However, India reports a current account surplus in Q1 FY22, buoyed by robust exports, compared to a high deficit in FY13. India has also registered a decline in external debt % of GDP while significantly boosting FX reserves compared to FY13. Overall, India's solid macro-economic fundamentals and external metrics continue to provide a robust line of defense against a possible further rise in global markets volatility as the US Fed starts to taper its bond purchase program.

India holds a much stronger external account position compared to the 2013 taper-tantrum period

External vulnerability - Peer comparison										
	Current Account as % GDP*		Foreign Exchange reserves (USD bn)^		External Debt stocks as % GNI		CPI % YoY#		Growth % YoY**	
	FY13	FY22	FY13	FY22	CY13	CY19	FY13	FY22	FY13	FY22 E
Brazil	-3.3	-1.3	366	339	19.8	31.8	5.6	8.7	1.9	5.2
Indonesia	-2.3	-0.1	98	130	29.8	37.0	4.2	1.5	6.0	3.2
India	-4.7	0.9	293	637	23.3	19.7	10.0	5.3	5.5	9.5
Turkey	-6.0	-3.7	104	68	41.1	58.9	8.1	18.2	4.8	9.0
South Africa	-4.6	4.6	41	44	39.3	55.0	5.6	4.8	2.2	5.0
India Rank	**4**	**2**	**2**	**1**	**2**	**1**	**5**	**3**	**2**	**1**

Source: Bloomberg, World Bank, and IMF; Note – 1) Rank for external debt as a % of Gross National Income (GNI) and Consumer Price Index (CPI) is measured in descending order (the lowest number is the best rank); the rest of the indicators are ranked in ascending order (highest number is the best rank), 2) FY refers to a fiscal year (April-March), and CY refers to a calendar year (January-December)

**** FY22 is for April-June 2021 period for all countries; FY13 is an average of four quarters***

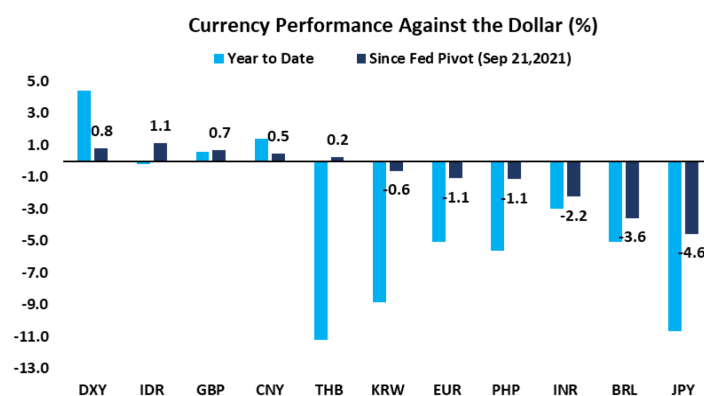
^ FY13 data is as of end-March 2013, and FY22 data is as of end-Sep 2021 for all countries

 # FY13 data is based on monthly averages; FY22 data is the average of April 2021-September 2021

***** For all countries (except India), growth for FY13 pertains to CY12, and FY22 estimates are based on CY21 estimates from IMF; for India, it is for FY22.***

Second, in the March '21 report, we had argued that the Indian Rupee looked less vulnerable, given a strong external accounts position, to external shocks than in FY13 when it had fallen by ~22% during April-August 2013. The Rupee has come under pressure recently as the dollar strengthened following the US Fed's September policy meeting and bouts of risk aversion. The rise in oil prices has further weighed on the domestic currency, given India's continued high dependence on oil imports. Moreover, the RBI's stance has been relatively dovish (in line with easing domestic inflation) compared to the tightening/tapering of bond purchase programs by central banks in advanced and EM countries, adding to pressure on the INR. Despite recent pressures, the Indian Rupee has outperformed some of its peers, depreciating by only ~3% on a year-to-date basis (since the end of 2020). This reflects the solid external accounts position (large FX reserves of ~$637 billion and continued current account surplus of ~1% of GDP in Q1 FY22) along with continued foreign capital flows driven by a positive outlook for the economy. A depreciating bias against the rupee may continue in the near term, given elevated crude oil prices and dollar strength. However, the firepower of the RBI in terms of its FX reserve stock is likely to curtail excessive depreciation pressures and prevent the need for disorderly policy actions.

Indian Rupee depreciates in line with other currencies since the US Fed's pivot



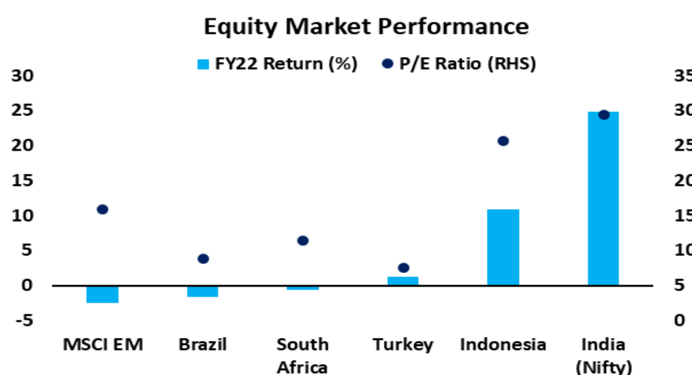
Source: Bloomberg; currency performance is calculated until October 15, 2021

Third, capital outflows from the equity markets continue to be a possibility during a global "risk-off" sentiment period, especially as the US Fed starts to taper its bond purchase program. However, India's relatively better economic prospects should continue to prevent market correction of levels seen during the 2013 taper-tantrum. Indian equity markets have consecutively breached record highs and rallied by nearly 25% in this fiscal year so far (which was on the back of a 71% rally in FY21), outperforming its major emerging-economy peers. Meanwhile, the valuations seem to have stretched, with India's P/E ratios surpassing that of most of its emerging market peers and poses a risk of a market correction. However, earnings have also kept pace, resulting in the P/E ratio (Nifty) improving from its peak of more than 36 during February 2021 to ~29 as of October 15, 2021. The IMF has also retained India's growth at 9.5% YoY in FY22 and 8.5% YoY for FY23 in its latest outlook that stands above other major economies. As such, the risk of a sharp and prolonged correction is likely to be limited compared to 2013, given the relatively strong fundaments of the Indian economy at present.

There has also been a slight shift in the composition of investors in equity markets in the current fiscal year. Foreign portfolio investors that injected a record capital inflow of more than $37 billion in FY21 have noted a deceleration in its pace of capital injection as they have parked only an

additional $1 billion of capital so far this fiscal (April-September). Meanwhile, the ongoing rally has been fueled by domestic investors, in contrast to the past year. This is reflected in the net capital inflow of equity mutual funds that have continued for the seventh consecutive month in September, while retail participation in stock market holdings stands at its highest ever. While foreign investors are well invested in Indian equity markets, there is a domestic investor exuberance as well, solidifying the confidence in the Indian economy and also balancing the risk from FPI withdrawal.

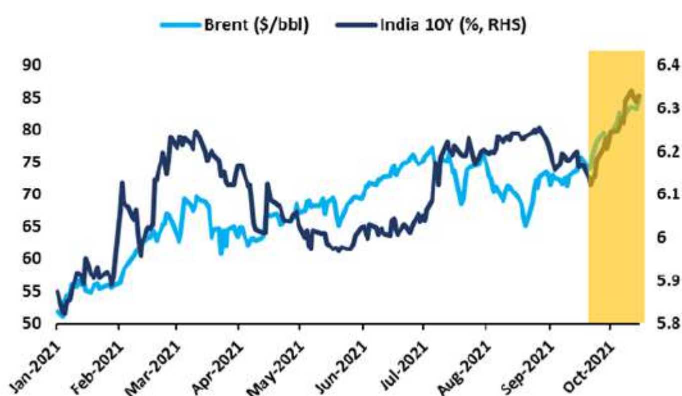
Indian equities outperform other emerging market peers, supported by earnings growth



Source: Bloomberg, FY22 returns, and P/E ratio are as of October 15, 2021

Fourth, in our March '21 report, we had noted that domestic yields could increase in tandem with US bond yields. But we had assessed that domestic factors could be a relatively larger driver of bond prices than global ones compared to 2013. We had also noted risks posed by higher global energy prices. Over the past month, domestic policy steps, rise in global energy prices, and the US Fed taper guidance have all taken place around the same time, making it difficult to differentiate between the primary driver of the recent rise in domestic yields.

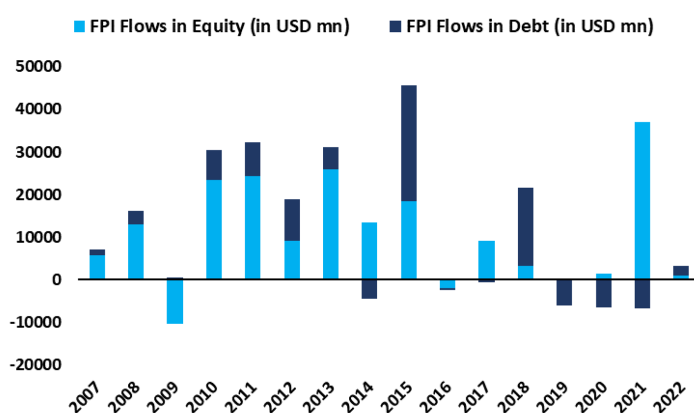
Rising oil prices weigh on bond yields



Source: Bloomberg

Since the US Fed's September policy announcement, the US 10Y bond yield has increased by ~27 basis points, whereas India's 10-year G-Sec yield increased by ~20 basis points during this period. Additionally, the RBI suspended the G-Sec acquisition program (G-SAP) in its October policy meeting, which weighed on domestic yields. Notably, there has also been a flare-up in global oil prices, with Brent prices rising by over 18.5% since the start of September, pushing domestic yields up.

FPI flows in equity markets slow in FY22; debt flows see a reversal in trend since past three years



Source: CMIE; above are based on fiscal years

Despite these developments, the rise in Indian 10-Year G-Sec yield was less than that in the US yield. The Indian bond market was supported by an improving fiscal position (compared to the budget targets) and RBI's commitment to ensure orderly evolution of yields. Further, foreign portfolio investors have seen a sudden reversal in trend, with FPIs investing over $3.3 billion of capital in August and September 2021. Despite recent inflows, the debt utilization limits for the government and corporate bonds remain low at ~26% and ~22% respectively, as of the end of September 2021 (compared to ~95.6% and 45% of limits utilized by FPI's in government and corporate papers respectively in April 2013). Around $32 billion of capital is invested by foreign investors in Indian debt markets, which is just ~5% of the total FX reserves held by the RBI. Moreover, the recent influx in the capital can also be accorded to a more durable flow of capital given the increased prospects of India's sovereign bonds inclusion in global bond indices that are less likely to reverse in the short term. This entails a relatively lower scope of a reversal of capital flows on a larger scale. As such, the transmission channel for global volatility through foreign capital flows in/out of the bond market has remained weak in FY22 compared to FY13. Given the expected domestic policy normalization, elevated energy prices, and the US Fed taper plans, we expect the Indian 10-year G-sec yield to trade in the range of 6.20-6.45% in the near term. As the RBI moves ahead with the

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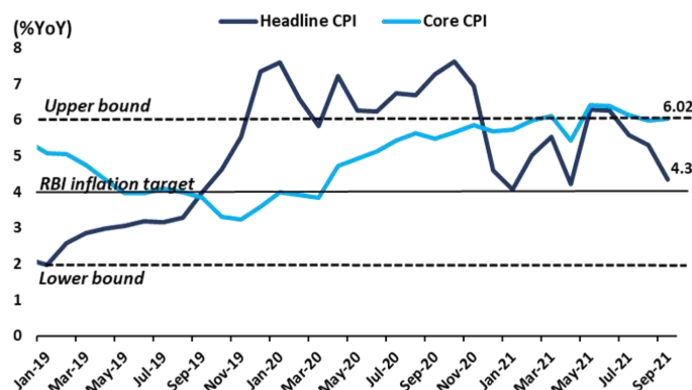
policy normalization in H2 FY22 in line with economic recovery, the direction for domestic rates is likely to remain upward. The RBI has kept the door open for restarting GSAP and other interventions to prevent disorderly movements in the yields.

The RBI continues to remain accommodative; steps up liquidity normalization efforts ahead of policy normalization

The domestic monetary policy stance could also be affected due to spillover from global commodity prices, especially crude oil prices. After several measures last year in response to the COVID shock, the RBI continues to lean towards maintaining policy support to nurture economic recovery. The RBI has also adopted a gradual approach to policy normalization, wherein there is a continuous bias towards supporting economic growth revival. Given the liquidity overhang in the system, the RBI is gradually adjusting the liquidity position with evolving macro-conditions before it moves ahead with the policy normalization in the second half of FY22. To adjust liquidity, the RBI announced suspension of secondary market G-Sec Acquisition Programme (GSAP) operations and increased the quantum of fortnightly variable reverse repo (VRRR) operations from Rs 4 lakh crore to Rs 6 lakh crore in a calibrated manner (over October-December) in its October policy meeting. The RBI will also consider complementing the 14-day VRRR auctions with 28-day VRRR auctions in a similar calibrated fashion, depending on the liquidity conditions. The RBI Governor emphasized that the VRRR auctions are primarily a tool for rebalancing liquidity and should not be interpreted as a reversal of the accommodative policy stance. He assured that the RBI would ensure adequate liquidity to support the process of economic recovery and to support the market in ensuring an orderly completion of the government's borrowing programme. Given the abundance of liquidity, we view liquidity normalization as a pre-condition to the policy normalization process. We presently expect the RBI to raise the reverse repo rate in the Dec '21/Feb '22 meeting, while the repo rate hike is likely to be in H1-FY23.

Giving comfort to the RBI is the moderation in the CPI inflation that came in at 5.3% YoY in August and eased further to 4.3% in September compared to 5.6% YoY in July, thanks to the base effect and moderation in food inflation. Core Inflation, however, has remained sticky around 6% YoY. 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. Factoring in recent lower inflation prints and projected further easing in price pressures, the RBI lowered its headline CPI inflation forecasts to 5.3% YoY for FY22 from 5.7% YoY earlier. However, as demand recovery continues and gets an additional boost during festival season, we see risks of pass-through of cost built-up to consumers, which could eat into the expected benefit from lower food inflation and base effect. Meanwhile, rising global energy prices are also increasing the cost pressures.

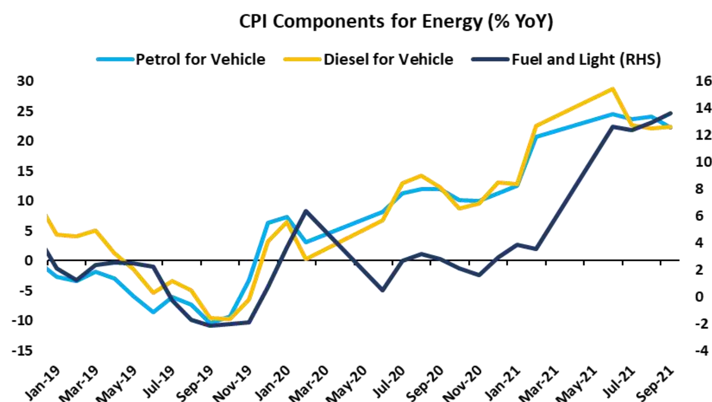
Headline CPI inflation well within RBI inflation target range; even as core inflation remains sticky



Source: CMIE; RBI

Given India's high dependence on oil imports, we see global energy prices as a key risk to domestic inflation and the RBI's present gradual policy normalization approach. The possibility of the government absorbing part of the oil price increase through tax cuts has not materialized so far. Brent prices have increased by more than 18.5% since the beginning of September and are almost 100% higher than the previous year's levels. The steady increase in oil prices since last year is reflected in the energy components of the CPI basket that stood at their record highs in September. Inflation for Fuel & light, petrol, and diesel for vehicles stood at 13.6%, 22.3%, and 22.4% respectively in September and together contributed ~145 basis points to the headline CPI print on a YoY basis.

Energy components in CPI surge to record highs



Source: CMIE

The RBI, in its October Monetary Policy Report, had outlined the baseline assumptions for its Inflation and growth projections, wherein the price of crude oil (Indian Basket) has been assumed at $75/barrel in H2 FY22. According to the RBI, a 10% increase in the Indian crude basket (above its baseline) would increase inflation by 30 basis points, while economic growth is estimated to be impacted by 20 basis points compared to its baseline projections. The Indian crude oil basket was already trading ~11% above the baseline assumption as of mid-October, which could push inflationary pressures.

Besides crude oil prices, supply bottlenecks and input shortages persist with the pandemic, as reflected in higher input prices. The Wholesale price index (WPI) of India, which better captures this, remained elevated at 10.7% YoY in September (and continued to see double-digit growth for the sixth consecutive month) driven by the increase in manufactured products (11.4% YoY) along with the sharp increase in its energy components (24.8% YoY) that has a higher weight relative to the CPI basket. Moreover, commodity prices that remain elevated could also permeate into these components. The World Bank's Base Metal Index stands ~46% YoY higher in September 2021. According to our estimates, a 10% global base metal price rise could increase headline CPI by ~6 bps (assuming a pass-through of 20 bps from non-food manufacturing Wholesale Price Index to CPI core). This could further put upward pressure on core inflation that already remains sticky at ~6% YoY in September 2021, especially as manufacturers are more likely to pass on higher prices now with the improvement in demand conditions.

The above factors pose upside risks to the inflation trajectory that could disrupt India's present Goldilocks situation and consume the space available with the RBI in terms of the CPI remaining within its target band. We see a risk that the inflation outturn might exceed RBI's projection of 5.3% for FY22 and push the RBI to reconsider its gradual approach to policy normalization. Even in this scenario, the RBI is likely to try to ensure non-disruptive policy actions even as timing/pace of policy normalization might be recalibrated to evolving inflation risks. We do see the possibility of fiscal and supply-side actions by the government, in addition, to several measures already taken to help limit the upside risks to inflation.

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