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Economic landscape improves in 2021; new themes emerge in a post-COVID world

- The global economic landscape has turned more favourable, aided by additional fiscal stimulus, continued monetary policy support, and the ongoing vaccination drive.

- The inoculation drive is currently underway in more than 87 countries, with more than 193 million doses administered globally. The advent of new vaccines is likely to expedite the current pace of vaccination.

- India's COVID situation remains benign, with new cases being restricted to a smaller number of regions. The vaccination drive progresses steadily in comparison to global standards, however, remains short of its target.

- Meanwhile, economic recovery was still underway in January, with further signs of broadening of recovery. A new set of government relaxations in February are likely to propel economic activity further.

- Considering traction in economic recovery and a larger-than-expected fiscal stimulus unveiled in the budget, we revise real GDP projection for FY21 to -6.7% YoY from -7.8% YoY previously and a growth of 12.4% YoY in FY22, up from an earlier forecast of 9.9% YoY.

- While the broader economy is on a V-shaped recovery path, a K-shaped recovery is evident among companies (by size) and households with a growing disparity between the more affluent and lower-income segments.

- The Union Budget for FY 2021-22 prioritized economic growth revival over fiscal consolidation, with a clear shift in spending strategy from relief and income support measures to more growth-inducing and productive spending.

- The central bank assured a calibrated approach to liquidity normalization and support to ensure orderly completion of the government's elevated borrowing program in FY22. Drop in inflation provides the central bank flexibility to continue with an accommodative policy stance into FY22.

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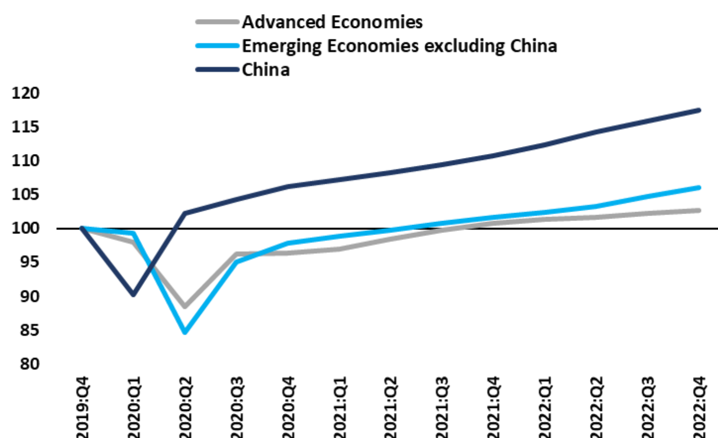
Global economic outlook on a rebound path with clear disparity

The global economic landscape has turned more favourable since setting foot into 2021. The additional fiscal stimulus rolled out in December (primarily in developed nations), continued ultra-loose monetary policy, and the vaccination drive underway across the globe, have all set a promising backdrop for the current year. This is evident in reflation trade with increasing commodity prices, higher treasury yields, rising trade volumes, and general economic activity. The International Monetary Fund (IMF) has also revised its global growth forecasts upwards to 5.5% YoY in 2021 (compared to 5.2% YoY previously), following a contraction of 3.5% YoY (compared to 2.6% YoY earlier) in its latest report. However, certain contact-intensive sectors of the economy continue to reel under the strains brought on by the pandemic. According to the global sector Purchasing Managers' Index (PMI) survey for January - sectors such as tourism & recreation, transportation, construction, and telecom services continued to contract, although at a slower pace. A disparity is also evident between advanced and emerging economies in terms of their expected recovery path that varies based on their policy support and vaccine availability. The divergence also extends among advanced economies based on their behavioural, public health, social and economic responses to the virus. As such, the IMF expects the US and Japan to reach their end-2019 activity levels in the second half of 2021, while this recovery target is not achieved even into 2022 for the UK and the Euro region.

IMF forecasts divergent recovery for advanced and emerging economies (Index, 2019: Q4 = 100)

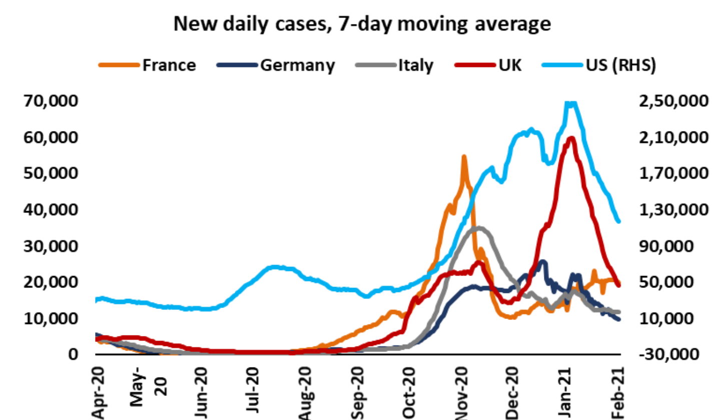


Source: IMF WEO, January 2021

The 'trump card' in the pack remains vaccination progress – which is a significant factor in how soon herd immunity is achieved and normalcy is restored across the globe. The vaccination drive is currently underway in 87 countries, with more than 193 million vaccine doses being administered. However, this constitutes only ~2.5% of the world population and factors in a single dose as opposed to the two doses required for immunity. Based on self-stipulated targets - countries are far behind their vaccine timelines, and according to the current pace - ~6.5 million people being vaccinated daily - it could take several years before herd immunity is achieved (~75% of the population). Nevertheless, the pace of inoculations has been increasing steadily, with countries stepping up their vaccination capabilities and improving logistical efficacy. The arrival of new variants of vaccines in the market (some with a single dose requirement) is likely to expedite the process.

Meanwhile, the recent resurgence of the virus in some advanced countries appears to have abated – with daily cases across the globe falling to less than 4 lakhs at present from its peak of ~7.4 lakh fresh cases around the start of the year. The sustained drop suggests that governments are possibly becoming more adept at handling the containment of the virus with faster reaction functions. This provides more time for vaccine rollout to progress simultaneously. However, caution needs to be exercised, given the risk of another wave of the virus (including due to virus mutation) could derail the recovery process.

COVID-19 cases witness sharp fall across the globe



Source: Our World in Data

India's COVID situation continues to improve; provides space for an unencumbered vaccination drive

India's COVID situation continued to remain benign. Fresh cases declined to less than 11,500 (7dma) as of February 11, 2021, with more than 70% of daily cases concentrated in two states (Kerala and Maharashtra), while the rest of the country showed a significantly low emergence of new cases (less than 1,000). Active cases also continued to decline and stood at less than ~1.4 lakhs as daily recoveries continued to exceed daily cases, bringing the active caseload to 1.3% of overall cases (one of the lowest caseloads globally). As such, the recovery rate stood at 97.2%, among the highest globally. Positivity rate and death rate also remained at their respective lows of 1.9% and 1.43%, far lower than global standards. A part of the

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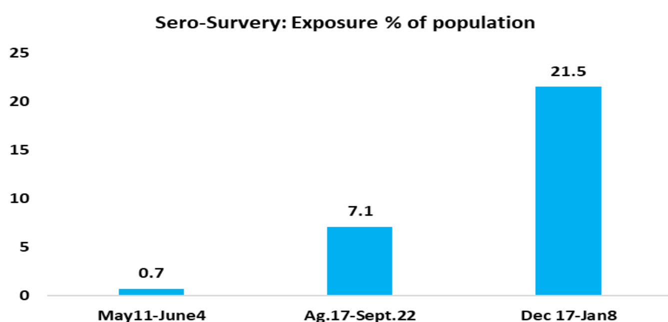
success in the country's contained virus situation could be attributed to the process of natural herd immunity build-up. The third nation-wide Sero-survey showed an overall seroprevalence in 21.5% of the population, including in 31.7% of urban slums, 26.2% of urban non-slums, and 19.1% of rural areas. This is three times the exposure found in the second round of the survey in August-September. Even then, a large portion of the population remains vulnerable, which underscores the necessity of the vaccination drive.

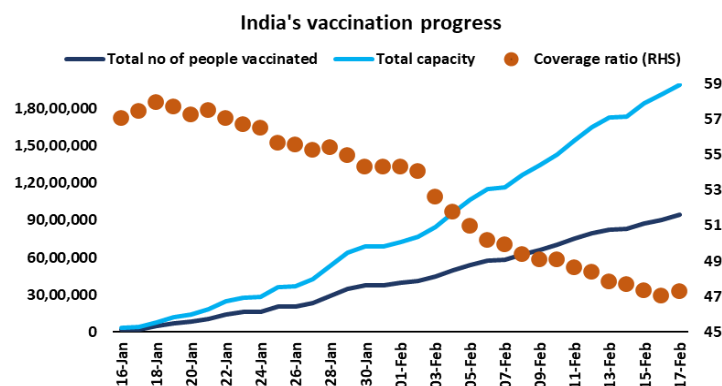
Seroprevalence jumps three-fold in India



Source: PIB, ICMR

Meanwhile, India's vaccination drive, currently the fourth-highest in the world in terms of the number of vaccine doses being administered, progresses unabated. However, factoring in India's population size, only ~0.6% of the population has been vaccinated (single dose) at present, and the objective of achieving herd immunity remains a distant goal. India's coverage ratio remains poor at less than 50%, indicating apprehension about vaccines' safety and a certain degree of negligence given the virus' controlled spread at present. Considering India's target of inoculating 30 crore individuals (by the end of August 2021), more than 26 lakh beneficiaries will have to be vaccinated daily v/s ~4 lakh daily beneficiaries being vaccinated currently. As such, India will have to significantly ramp up its inoculation speed given its large population by involving the private sector and expanding the coverage from priority population groups to wider segments.

Vaccination progresses amid low participation



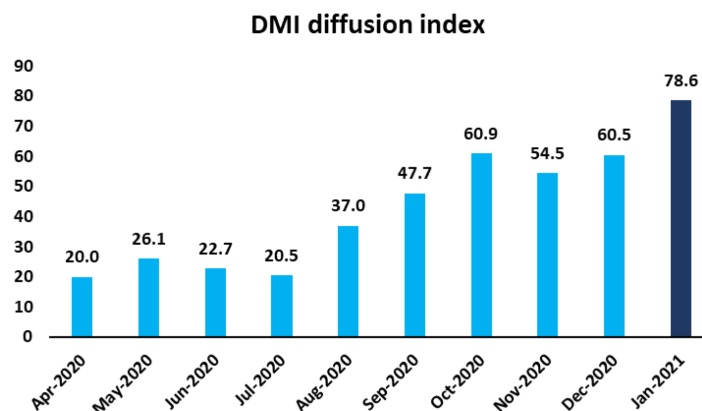
Source: Ministry of Health and Family Welfare, PIB

India treads the path of economic recovery

India's economic recovery continues to gain traction buoyed by the benign COVID situation, ongoing vaccination drive, and the recent spurt in government spending. This is reaffirmed in evolving high-frequency data that portends towards further broadening of economic recovery. Based on our Diffusion Index – more than 60% of the indicators that we track stood above pre-COVID levels in December 2020 compared to ~55% in November 2020. This appears to have improved to more than 75% based on a smaller sample of data available for January 2021 so far (1/3rd of the total set of variables that we track).

We expect this to improve further moving into February as data is likely to reflect a relaxation of restrictions on places such as cinema halls, swimming pools, exhibitions halls, etc. that are allowed to operate at a higher capacity along with complete removal of restrictions on inter and intra-state movement of goods and people in the country. Early indications from Google's mobility data already suggest an improvement with mobility improving to less than 9% below the baseline (in the first 12 days of the month) after being stuck around ~12% below baseline levels for the past two months. This could provide a fillip to select segments of the economy such as tourism, transport, and construction that are still reeling from virus-induced inhibitions.

Economic recovery broadens as per Diffusion Index



Source: DMI Finance; Our Diffusion Index shows the % of indicators showing above/equal growth to pre-COVID levels (taken as January-December 2019 average); January 2021 data is based on 1/3rd of the data.

High-frequency data suggests that the outlook for industries has improved. The manufacturing PMI index value increased to 57.7 in January sharply in the expansion territory and above the 56.4 print in December. The Index of Industrial Production (IIP) moved back to reflect an expansion of 1% YoY in December, following a contraction of 2.1% YoY in November, driven by the manufacturing sector, which grew by 1.6% YoY. On a two-digit level of classification, 9 out of 23 sectors showed growth versus 5

out of 23 in the previous month, indicating broad-based recovery. The IIP electricity component continued to sustain its growth in December while mining contracted, although on the back of an unfavourable base. According to the Reserve Bank of India's (RBI) Order Books, Inventories, and Capacity Utilisation Survey, the manufacturing sector's capacity utilization rate improved to 63.3% in Q2 FY21 from its low of 47.3% in the previous quarter.

The agriculture sector's outperformance continues with the sowing progress of Rabi crops (area sown under Rabi crops was 2.8% higher as of January 29, 2021, compared to the same period last year), supported by high reservoir levels. Agriculture credit also increased by 9.4% YoY in December 2020, its fastest pace in 3 years.

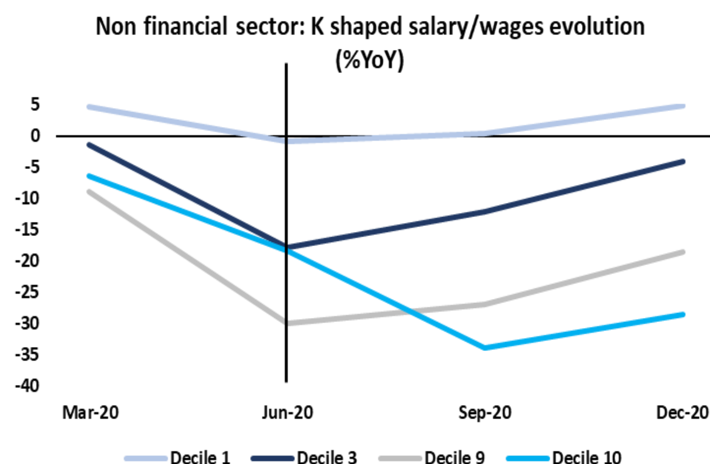
Meanwhile, service sector recovery is gaining traction. The services PMI index value inched marginally higher to 52.8 in January versus 52.3 in the previous month. Lead indicators such as E-way bill registrations, rail freight traffic, and automobile sales continued to grow. Air passenger traffic continued to operate ~43% below the previous year's levels in December, although it has improved sequentially. While certain contact intensive segments of the services sector still operate below pre-COVID levels, they hold the potential for a considerable rebound as restrictions are being lifted further. As per the revised budget estimate for FY21 (covered in detail under the fiscal section of this report), higher-than-previously-expected government spending should also boost the public administration segment and thereby overall services sector recovery. Considering the traction in economic recovery and a larger-than-expected fiscal stimulus unveiled in the budget, we revise real GDP projection for FY21 to -6.7% YoY from -7.8% YoY previously and a growth of 12.4% YoY in FY22, up from an earlier forecast of 9.9% YoY. We expect the economy to register 0.7% YoY growth in Q3 FY21, exiting two consecutive quarters of contraction.

Different facets of K-shaped recovery raise doubts over the sustainability of consumption demand over medium-term

Even as the broader economy remains on the path of V-shaped recovery, there are signs of a rise in inequality, outlaying concerns of K-shaped recovery. This is important as a sustainable economic recovery in the medium-term would, in part, hinge on a more balanced process. Private consumption demand has been the primary driver of growth for India (~57% share of GDP), and given its immediate manifestation in the economy - it ascertains the bulk of recovery going ahead in the near term. Real private consumption contraction eased to 11.3% YoY in Q2 FY21 compared to the steep fall to 26.7% YoY in Q1 FY21, supported by pent-up demand.

A closer look at the data suggests that consumption recovery is primarily led by pent-up and fresh festive demand in Q3 from the richer and relatively more unaffected segments of the population. A wider disparity between the more affluent and lower-income segments of the population has emerged in the post-COVID world – resulting in a K-shaped recovery. Employment conditions indicate that the poor/unorganized/less educated have been more severely impacted compared to the richer/organized/educated sections. The stress in the rural sector was already evident in the spike in demand for work by households under Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) scheme - that had increased to ~90% YoY at its peak in October 2020 and remains high at ~40% YoY in January 2021. However, according to the CMIE consumer pyramid household survey (CPHS), employment for salaried employees increased to 1.6% in January 2021 compared to end-2019 levels, while employment for small traders & wage labourers declined by 5% for the same period.

K-shaped recovery: Salary and wages recover faster for larger firms



Source: CMIE

Even within the organized sector, larger firms have been better able to brace the COVID storm and recover better compared to smaller firms. Based on a sample of ~300 firms in the non-financial sector, sales for the top two decile firms have increased by 2.5% YoY on average in Q3 FY21 after contracting by ~41% YoY on average in Q1 FY21. This contrasts with the bottom two decile firms that continue to witness a contraction in their net sales by more than 50% YoY on average in Q3 FY21 after contracting by nearly 70% in Q1 FY21. These implications have transpired in employment conditions with larger firms witnessing an improvement in their salary and wages in Q3 FY21 (salary

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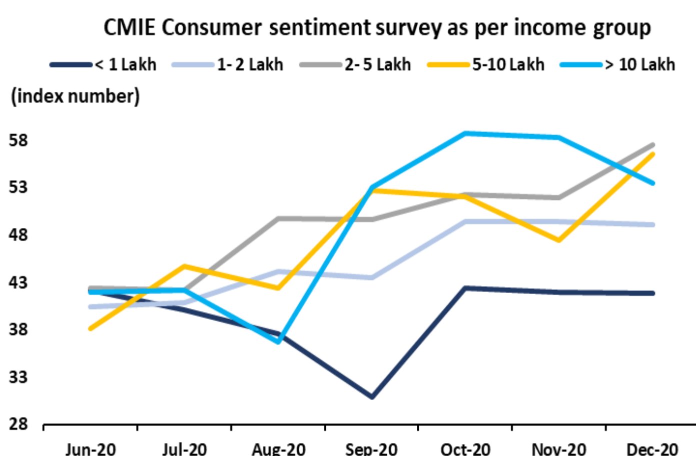
costs for the top decile firms increased by 4.8% YoY after contracting in Q1 FY21), while smaller firms continue to cut employee costs into Q3 FY21 (salary costs remain ~18-30% below previous year's levels for the bottom decile firms).

Moreover, CMIE's index of consumer survey (ICS) further indicates that the low-income earning segment of the population (earning less than Rs 1 lakh per annum) noted a deterioration in their survey score by 31 points between June 2020 and September 2020, while the higher income earning segment (earning more than Rs 10 lakhs per annum) noted an improvement of 53 points in the same period. While this disparity has narrowed moving into December, the divergence persists, raising doubts on how long the more affluent segment can continue driving consumer demand ahead.

Consumer sentiments reflect K-shaped recovery



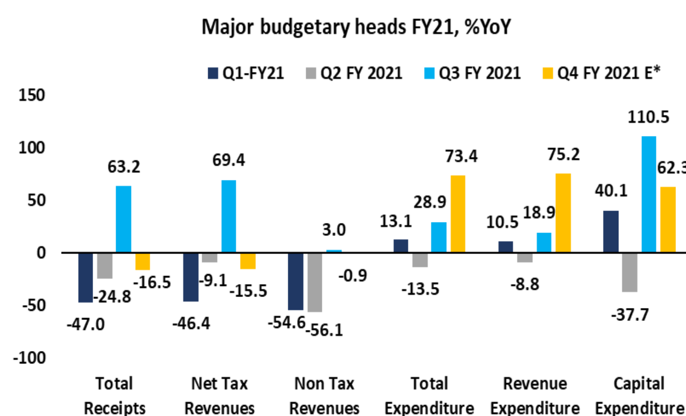
Source: CMIE

Considering the above disparity, government support was warranted for the marginalized segments of the population. However, there has been a visible pullback in support for the more stressed segments, as seen in a reduction in MGNREGA allocation, along with an absence of spending on measures for sectors like travel & hospitality, restaurants, etc. that continue to witness laggard recovery. The government is banking on investment-led spending to trickle down and create jobs, a process that could take time. Accordingly, while recovery is underway; and we expect consumption to improve sharply from the first quarter's troughs, reverting to its earlier pace of growth that drove the bulk of India's GDP might be a challenge. In this respect, the government's drive towards boosting investment demand will have to be actualized to create more jobs and thereby support consumption recovery.

Fiscal stimulus to complement private recovery ahead

As the private sector braces itself and attempts to emerge out of the pandemic-stricken year - the central government doubled down on its support, timing it with the recovery of the broader economy to boost growth. Government spending maintained a strong pace in December along with a shift towards capital expenditure, consistent with the trend seen in October and November, respectively. This is expected to increase further as outlined in the Union Budget unveiled earlier this month. Based on the revised estimates for FY21, government spending has scope to rise significantly by ~73% YoY in Q4 FY21, after adjusting for the shift in the Food Corporation India (FCI) bill, with revenue expenditure and capital expenditure having room to rise by 75% YoY and 62% YoY, respectively (refer to the chart below). If the government can utilize the bulk of this, it will help narrow GDP contraction in FY21 than what is presently anticipated.

Government expenditure likely to increase further



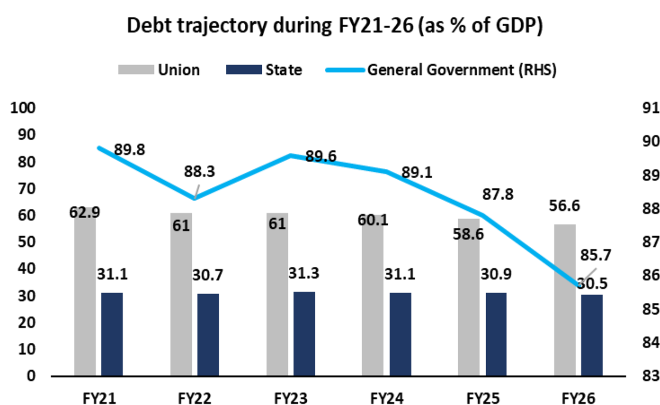
Source: CGA, CMIE. Note: *estimate based on annual budgeted numbers

For the next fiscal year, the government has proposed to raise total spending significantly to 15.6% of GDP in FY22, up from 13.2% of GDP in FY20. There is also an improvement in the quality of spending with a shift from committed spending and income support measures to more growth-inducing and productive spending now. While capital expenditure has been budgeted to rise by 26.2% in FY22 v/s FY21 Revised Estimate (RE), revenue expenditure is expected to contract by 2.7% in FY22 v/s FY21 (reflecting the unwinding of COVID-related support measures). As such, the capital to revenue expenditure ratio increased to 18.9% - its highest in more than a decade. To finance higher spending, the government has given itself a long rope by revising the deficit for FY21 to 9.5% of GDP from the budgeted estimate of 3.5% of GDP and is proposing a deficit of 6.8% of GDP for FY22. Revised estimates for total receipts have also been pegged conservatively, as such leaving the possibility of a positive surprise (Please refer to our budget report - *India's budget doubles down on driving growth* for more details).

Despite higher deficits, the government is banking on the revival of economic growth with the help of a counter-cyclical policy to achieve debt sustainability. This will require

the execution of stated infrastructure investment plans. After estimating a deficit of 6.8% of GDP in FY22, the government targets bringing down the deficit further to 4.5% of GDP by FY26. This varies from the Fifteenth Finance Commission's estimates which recommended the fiscal glide path to reduce to 4% of GDP by FY26 in its base case while reducing to 4.5% of GDP if economic recovery is slower than expected. For states, the Commission expects the deficit to reduce to 3% by FY26 (at the upper limit of the specified range), as such providing a consolidated fiscal glide path for the total fiscal deficit to reach ~6.8% of GDP by FY26. The Commission has also laid out a debt trajectory with the public debt to GDP ratio to continue to serve as a medium-term anchor for India's fiscal policy. Acknowledging the upward pressure on both the Centre and states' fiscal and debt positions, the Commission has allowed flexibility and space, keeping in mind a positive interest growth differential in the next two-three years. As such, the fiscal glide path begins from FY23 and moves to 85.7% eventually in the terminal year (refer to the chart below). However, debt sustainability is contingent on the translation of the ambitious government drive into actual growth. If growth fails to rise on a sustained basis meaningfully, the debt level could remain high and a rating downgrade risk could arise.

Debt consolidation recommended by Finance Commission



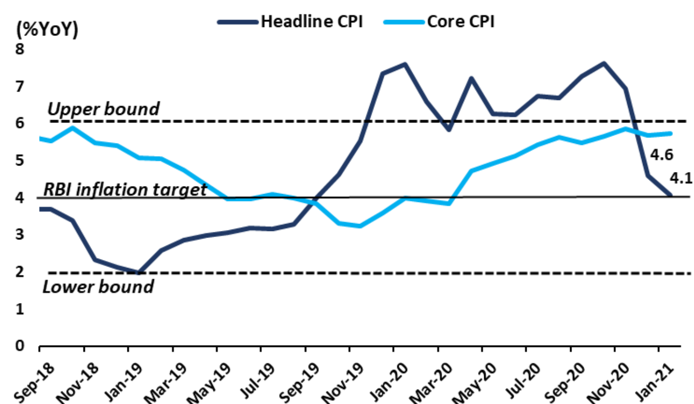
Source: Fifteenth Finance Commission

RBI's path to get tricky as it embarks on policy normalization

With economic recovery gaining traction and the fiscal policy expected to take over the lead role in driving stimulus ahead - the focus has been on RBI's exit strategy (from the emergency measures rolled out in response to the pandemic, including the massive liquidity injection). In the latest policy meet, the RBI governor maintained a delicate balance of ensuring continued accommodative support to the economy while at the same time setting the stage for gradual policy normalization - in line with our expectations. As such, the RBI decided *"to continue with the accommodative stance of monetary policy as long as necessary"* while keeping policy rates unchanged. The governor assured that the policy normalization process would be gradual and conducted in a calibrated manner, ensuring ample liquidity in the system. Cash reserve ratio (CRR) normalization was introduced in a calibrated two-phase format with a 50-basis point increase to 3.5% to be brought into effect on March 27, 2021, and the remaining 50-basis points increase to be brought into effect on May 22, 2021. To allay concerns regarding the government's sizeable gross borrowing in FY22, the governor assured that the central bank would ensure orderly completion of the market borrowing program in a non-disruptive manner. In this regard, the RBI allowed retail investor participation in the G-sec market and extended dispensation of enhanced held to maturity limit of 22% of net demand and time liabilities up to March 31, 2023, to include securities acquired between April 1, 2021, and March 31, 2022.

However, striking this balance is likely to become more challenging as economic revival gains momentum in FY22. This is captured in the upward revision of RBI's growth forecasts (revised upwards to 26.2-8.3% YoY in H1 FY22 from 21.9-6.5% YoY earlier) and the tweaking of its inflation forecast marginally higher (5.2%-5% YoY from 5.2%-4.6% YoY earlier) in H1 FY22. Nevertheless, RBI's balance of support continues to be skewed towards growth revival. Given the growth-inflation dynamic, we believe that the central bank will maintain a long pause on policy rates, at least till the third quarter of FY22. The interim will ensure gradual normalization of liquidity while limiting volatility through Open Market Operations (OMOs)/Operation Twist etc.

Inflation eases within RBI's target range



Source: RBI

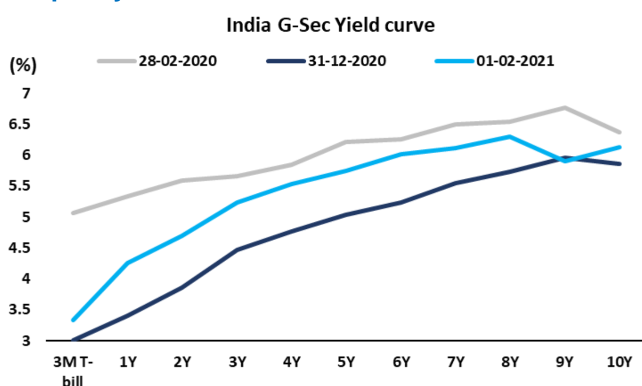
Since the last policy meeting, Consumer Price Index (CPI) inflation has fallen sharply to 4.6% YoY and 4.1% YoY in December 2020 and January 2021, respectively, after breaching the upper tolerance threshold of 4% (+2%/-2%) policy band for six consecutive months (June-November 2020). This was supported by a favourable base effect and

sharp correction in vegetable prices. The favourable base effect is likely to keep food inflation low for a few months ahead, along with fresh food arrivals and active supply management, providing space in the interim for continued expansionary policies to remain. However, core inflation is expected to firm up ahead with an escalation in cost-push pressures, on the back of rising industrial raw material and input prices and a sharp increase in core inflation could eat up space during an extended period of accommodative support.

Market update

After benign conditions until January 2021, Indian bond markets reacted negatively to the higher-than-expected budget deficits, additional borrowing in FY21, and elevated borrowing in FY22. Benchmark 10Y G-sec yield spiked to 6.15% from around 5.9% before the budget. Market participants were also disappointed with the absence of any concrete measures such as the release of an OMO calendar. However, bond yields have corrected recently, with the RBI springing into action through the announcement of open and special market operations. The RBI will have to actively support bond markets going into the next year as well given the projected high debt supply. This is pertinent, especially considering the continued lack of support from foreign investors. After recording positive flows of $554 million in December, Foreign Portfolio Investors (FPIs) pulled back again in January 2021 to the tune of $342 million. This trend has continued into February based on daily reported flows.

Yield curve shifts upwards on large borrowing program and policy normalization

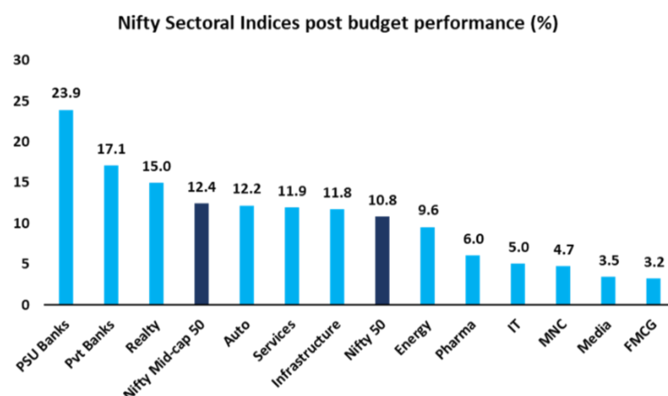


Source: Bloomberg; 3M T-bill refers to three-month Treasury Bill

On the other hand, equity markets received a massive impetus after the announcement of the Union Budget. The NIFTY50 index has rallied by nearly 11% since the budget (with an intra-day gain of 4.7% on budget day - February 1, 2021), after pre-budget jitters led the index to shed around 2.5% in January 2021. Broad-based gains were felt across sectors, with Public Sector Undertaking (PSU) banks leading post-budget gains, followed by private banks and the realty sector.

Meanwhile, foreign portfolio investments continued to flow into equity markets, albeit at a slower pace in January 2021 ($2.65 billion) v/s record flows in November 2020 ($8.1 billion) and December 2020 ($8.4 billion), respectively. Pre-budget jitters led to a pullback by FPIs; however, this was quickly reversed following budget announcements that witnessed a net inflow of nearly $1 billion in four days (February 1-4). Going ahead, combined fiscal and monetary stimulus are likely to favour equity markets. However, the current valuations remain elevated, notwithstanding the sound quarterly performance for corporates, with the P/E ratio for the NIFTY50 index at record highs of ~42. Thus, market volatility can rise intermittently.

Equity markets jump to record highs



Source: CMIE; returns calculated over January 29-February 10, 2021

The Indian Rupee registered gains for the second consecutive month as it appreciated by 0.7% in January 2021 v/s the previous month. After trading at a range of 73-74 since December 2020, the Rupee broke the floor and traded below the 73 handle, towards the end of January 2021. A culmination of continued FPI flows, improving COVID and economic scenario, along with the release of an expansionary budget, resulted in strong demand for the domestic currency. RBI's intervention also eased in December 2020 and January 2021 relative to those seen during October and November last year, allowing more room for the Rupee to gain. This was despite a strong Dollar index that strengthened in January and in the early days of February. We continue to maintain an appreciating bias for the Rupee as the macro backdrop remains conducive. However, this remains contingent on the scale of intervention by the RBI going forward. Increasing oil prices also pose a potential risk to our view as demand improves with the reopening of economic activity. However, any sudden volatility is expected to be contained by the RBI's record arsenal of Forex reserves.

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