25 January 2023

Indian economy continues to outperform but outlook uncertain; Government support critical to sustaining growth in FY24

DMI FINANCE

- December marked yet another month of cooling global economic activity as high inflation and tighter global financial conditions continued to blunt consumer demand and business activity.
- There has been some improvement in inflation while the labour markets have remained strong. Against this backdrop, the central banks now seem to be moving on from “catch-up” tightening to “calibrated” tightening involving smaller rate increases.
- High-frequency data for the Indian economy suggest continued resilience, however, the external sector and weak private investment continue to be a drag on domestic activity. We are more cautious about the demand for services remaining robust in 2023 as global growth slows.
- A look at the data for 2022 indicates that capital spending announcements continue to be plentiful and led by the private sector, but completions remain skewed toward the public sector. With the lack of enthusiasm in the private sector, we expect the government to continue to lead CAPEX growth.
- For FY23, we expect the government to meet its fiscal deficit target of 6.4% supported by a higher nominal growth than assumed in the budget, even though there will be some slippage in absolute terms.
- Looking ahead, we expect the government to set the fiscal deficit target in the range of 5.9-6.0% of GDP for FY24, thereby continuing its fiscal consolidation path.
- Headline inflation eased in December (to 5.7%) led by a seasonal decline in vegetable prices. However, core inflation remained sticky at 6.2% YoY, remaining a cause of policy concern.
- With elevated levels of core inflation and the domestic economy being resilient, we expect the RBI to deliver another rate hike before pausing to break the persistence of the elevated core inflation.
- We continue to advocate a terminal rate of 6.5%-6.6%, however recent moderation in the headline inflation has increased the likelihood of a smaller hike of 25 bps in the upcoming meeting in February.

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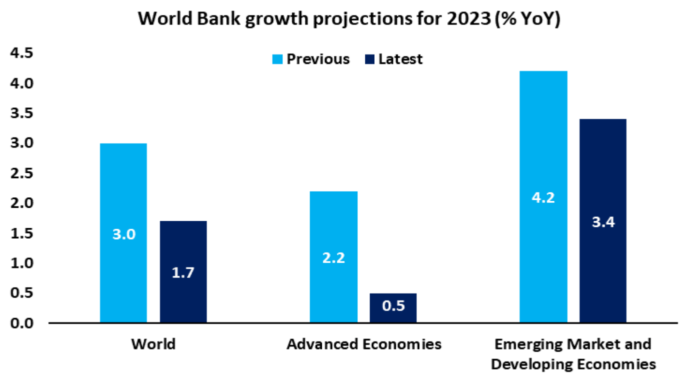
Global economy continued to cool in December

December marked yet another month of cooling global economic activity as high inflation and tighter global financial conditions continued to blunt consumer demand and business activity. The degree of cooling in economic activity continues to vary by region and country in response to idiosyncratic factors and the degree of monetary policy tightening. With many central banks likely to continue to tighten monetary policy in early 2023, the global economy will likely remain sluggish for at least the next couple of quarters. According to the World Bank, global growth is estimated to have slowed to 2.9% in 2022 (from 5.9% in 2021) and is forecast to further slow to 1.7% in 2023.

The World Bank revised its global growth forecast for 2023 downwards to 1.7%



Source: The World Bank, Projections as per Global Economic Prospects reports of June '22 and January '23

Timely data on global economic activity – the composite PMI – underscore the degree of variation in differing regions and countries. In Europe, economic weakness is showing some signs of moderation both for the Continent as a whole and the biggest economies individually. Importantly, the worst-case economic outcomes feared by some for Europe this winter have not come to pass, as the Ukraine-Russia conflict has remained geographically contained and energy prices -- aided by a seasonally warm winter – have not skyrocketed as feared. The US slowing trend, on the other hand, seems to be intensifying given the latest PMI figures and other data showing weakness in consumer spending near the turn of the year.

Performance across the major emerging markets similarly varied. While India notched up the strongest expansion for a decade and continues to be a global standout, Russia, Brazil and mainland China all reported falling levels of business activity. Although of the three, China likely will experience a rebound in 2023H1 as it moves on from its Zero-COVID policy.

The combination of tighter financial conditions, supply chain improvements and relief in (many) commodity costs has begun to bring down inflation rates across the globe, but inflation rates still are higher than the levels tolerable to central banks, especially in the developed world. For instance, headline inflation in the US eased to 6.5% in December, down from a peak of 9.1% in June 2022. Nonetheless, it remains 4.5 percentage points (pp) higher than the Federal Reserve's medium-term target rate of inflation of 2%. In the EU and UK, this delta was even higher at 7-9 pp above the target.

PMIs improved but remained in the red in December

Composite PMI (Value > 50 indicates expansion from previous month; <50 indicates contraction; 50 is no change)									
	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22
Global	51.2	51.3	53.5	50.8	49.3	49.6	49.0	48.0	48.2
US	56.0	53.6	52.3	47.5	44.6	49.5	48.2	46.4	45.0
China	37.2	42.2	55.3	54.0	53.0	48.5	48.3	47.0	48.3
Eurozone	55.8	54.8	52.0	49.9	48.9	48.1	47.3	47.8	49.3
Japan	51.1	52.3	53.0	50.2	49.4	51.0	51.8	48.9	49.7
Germany	54.3	53.7	51.3	48.1	46.9	45.7	45.1	46.3	49.0
UK	58.2	53.1	53.7	52.1	49.6	49.1	48.2	48.2	49.0
India	57.6	58.3	58.2	56.6	58.2	55.1	55.5	56.7	59.4

Source: S&P Global

There has been some improvement in inflation around the world, but it still exceeds central banks' tolerance levels. However, labour markets around the globe have remained remarkably strong, which is probably offsetting to some degree the impact of rate hikes on economies. According to the global composite PMI, staffing levels have risen for the twenty-eighth consecutive month, although the pace of job creation globally appears to be flatlining. The US, euro area, Japan and India were among the regions to raise workforce numbers. China, the UK, Brazil and Russia were among those to register declines. History suggests that in the absence of some loosening in labour market conditions from prevailing levels, it will be very difficult for core inflation – particularly the prices of services – to fall to levels consistent with central banks' inflation objectives.

Inflation continues to ease but is still far above targets

	Policy Rate (%)										Cumulative hikes since Jan 2022 (bps)	Inflation (deviation from target)
	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23		
US	0.50	1.00	1.75	2.50	2.50	3.25	3.25	4.00	4.50	4.50	425	6.5 (+4.5)
China	2.85	2.85	2.85	2.85	2.75	2.75	2.75	2.75	2.75	2.75	-10	1.8 (-1.2)
EU	0.00	0.00	0.00	0.50	0.50	1.25	2.00	2.00	2.50	2.50	250	9.2 (+7.2)
Japan	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0	4.0 (+2.0)
UK	0.75	1.00	1.25	1.25	1.75	2.25	2.25	3.00	3.50	3.50	325	10.5 (+8.5)
India	4.00	4.40	4.90	4.90	5.40	5.90	5.90	5.90	6.25	6.25	225	5.7 (+1.7)

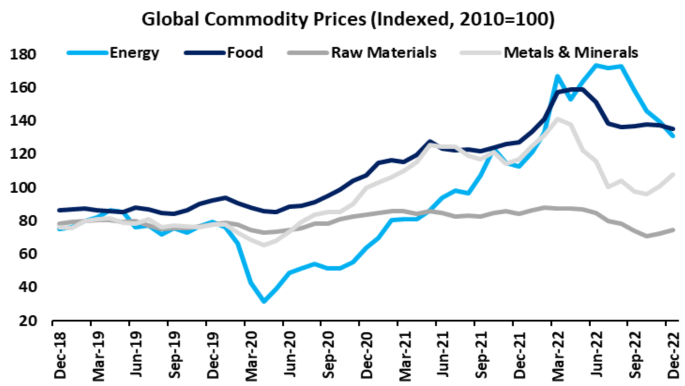
Source: US Federal Reserve, People's Bank of China, European Central Bank, Bank of Japan, Bank of England, Reserve Bank of India

On that score, major global central banks now seem to be moving on from "catch-up" tightening, where they sought to correct being massively late to increase interest rates, to “calibrated” tightening. This new phase likely will involve a quarter, or half a percentage point rate increases each meeting but, importantly, will continue until underlying inflation trends are sustainably lower than prevailing currently. Furthermore, central banks will need clearer signs of the labour market and demand weakness before considering a pause to ongoing monetary tightening.

China, however, remains an outlier on this front. In the past two months, China has terminated its strictest-in-the-world Zero-COVID policy and has begun to prioritize economic recovery as underscored by various policy proclamations. Although there is no immediate-term policy bazooka coming like the one introduced in the aftermath of the 2008 financial crisis, policy support is beginning to be introduced and may be targeted to sectors most in need, such as real estate. We expect that easier monetary and credit conditions will be an integral part of that policy support, but it may be the middle of 2023 before Chinese demand begins to respond meaningfully.

Against this backdrop, oil prices have continued their recent easing. In December, oil prices fell by around 11% MoM on weak global demand as well as fears of a global economic recession. Oil prices have remained low despite China dropping the Zero-COVID policy and expected pick-up from demand from that country. Meanwhile, global food prices eased further in December by 1.5% MoM but risks of food prices spiking again will remain high with La Nina forecasted to return for a third straight year and with cereal supply uncertainty from Ukraine for as long as the conflict continues. Metal prices increased for the second consecutive month in December by 6.6% MoM but remained far lower than the levels seen in 2021 and earlier this year.

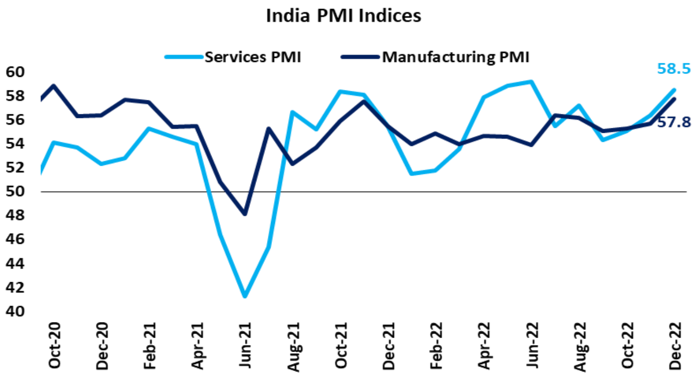
Commodity markets remained cool in December; pressure expected to return with China re-opening



Source: The World Bank

Looking ahead, we expect global commodity prices to rise again with the reopening of China and the associated release of pent-up demand, even while we recognize that the timing of a spike in pent-up Chinese demand is very hard to ascertain. As noted earlier, our best assessment is that a vigorous pickup in Chinese demand still is a few months away, as the latest wave of infection runs its course and policy levers begin to be pressed with greater vigour.

The Indian Economy continued to outperform in Q3 FY23, but the outlook is more uncertain



Source: S&P Global

The Indian economy remained a global standout as 2022 concluded and 2023 began, but the outlook is becoming more two-sided due to a mix of international and domestic factors.

For the period immediately ahead, the economy is likely to continue to perform well. The composite PMI just hit its highest level in over 11 years and retail sales have solid forward momentum. Indeed, consumer auto sales grew by a strong 29% YoY in the quarter ending in December as festive offers attracted buyers. According to RedSeer, e-commerce players in 2022 recorded sales worth around double that recorded in 2019 during the festival season. Improving consumer sentiment suggests that in the near-term consumers remain inclined to sustain their recent solid spending trend.

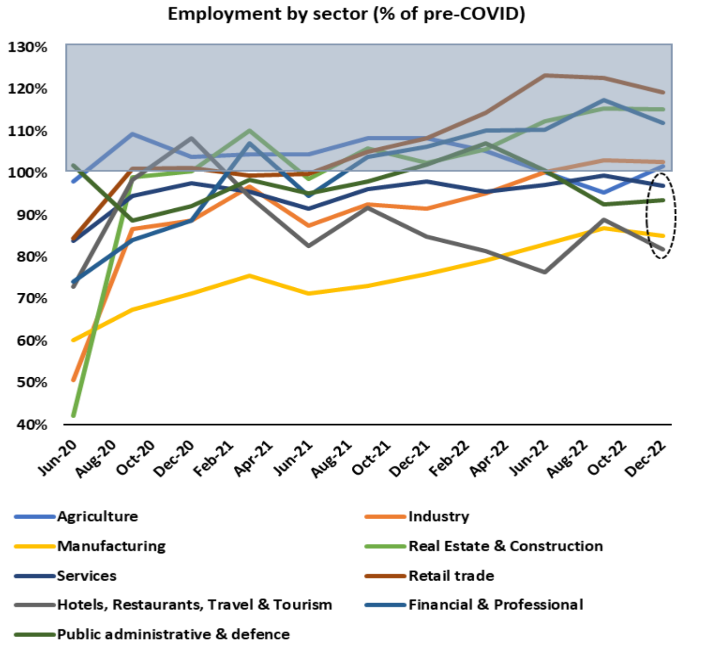
Meanwhile, leading indicators for the manufacturing and service sectors are at 26 and 6-month highs, respectively. Both sectors continued to see an increase in new work and production and – consistent with this strength – demand expectations remain strong over the next 12 months and are likely to continue to support business confidence.

In the industrial sector, particularly, we remain optimistic about manufacturing and construction which will be supported by the government’s schemes/policies like the production-linked incentives, Gati Shakti and National Logistics Policy. Prospects for the agriculture sector also appear bright in the near future with area sowed under rabi crops up by 3.5% YoY (until mid-January) and reservoir levels much above the 10-year average. High prices of wheat, the most important rabi crop by volume, should support healthy growth in agricultural incomes, and in turn the rural demand recovery.

However, for the services sector, we are more cautious about demand remaining robust in 2023. For one, the international sector is softening as discussed earlier as tighter monetary policies take hold; key export markets such as the US, and EU are experiencing the greatest degree of monetary tightening as policymakers seek to lower inflationary pressures.

Ongoing unevenness in the labour market is a key factor for our more cautious outlook for consumer demand and the services sector broadly. The greater unemployment rate in December remained high at 11.6%, a level that is much higher than the pre-COVID average. While a higher unemployment rate can be partly attributed to a strong expansion in the labour force (102% of pre-COVID levels by December), sectors like travel and tourism, manufacturing, public administration and defence, hotels and restaurants continue to lag in employment recovery. Sustainable improvement in labour market conditions remains essential to support continued recovery in the consumer sector and such a development will take on greater importance as international weakness affects the export sector.

Unevenness in the labour market recovery is a key factor curbing consumer demand



Source: CMIE; Note: Pre-COVID refers to CY19 average

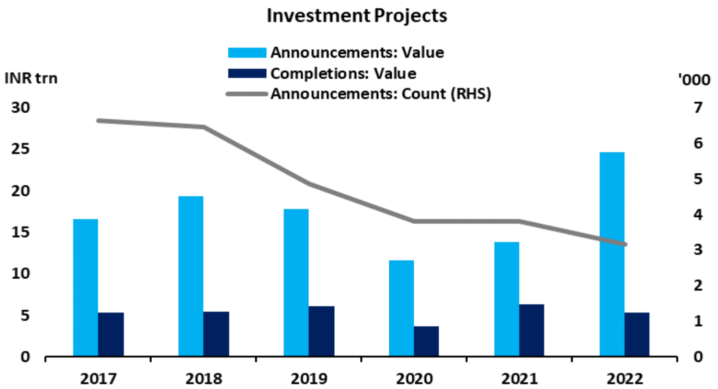
The private CAPEX cycle is yet to pick up

A look at the data for 2022 indicates that capital spending announcements continue to be plentiful and led by the private sector, but completions remain skewed toward public sector spending rather than private sector outlays.

Investment announcements in the quarter ending December 2022 increased to ~Rs 6.3 trillion, up 51% YoY compared with the previous quarter's figure of Rs 4.4 trillion. A large portion (~93%) of these announcements was made by the private sector. Still, many of the private CAPEX investment announcements in 2022 were a result of government concessions and PLI schemes in a select few industries.

According to CMIE, of the Rs 19.7 trillion worth of new investment proposals in 2022 (information as of January 2nd), Rs 3.97 trillion is in 6 large semiconductor projects, which is a result of the government's India Semiconductor Mission initiative. The next biggest project announcements were green hydrogen and ammonia renewable energy plants, which were made in response to the Green Hydrogen / Green Ammonia Policy announced by the Prime Minister on August 15, 2021. Furthermore, while the announcement of new investment projects in value terms has increased sharply in 2022, the number of projects has gone down. Put differently, the base of such investment projects is relatively narrow. Consider: only 3.2k new investment proposals were made in 2022 whereas, in the pandemic hit 2020 and 2021, 3.8k proposals were made in a year. Back in 2017 and 2018, nearly 6.5k new investment projects were announced. The large reliance on government incentives and the low number of investments in 2022 suggests that while private investments have picked up, they lack the animal spirits that are necessary to turn the uptick into an investment tide.

Investment announcements increased in 2022 but completions and project counts reduced



Source: CMIE, data as of January 22nd

The slowing down of project completions is yet another sign of the lack of enthusiasm in the private sector to kick-start the investment cycle in India. In 2022, the private sector completed projects worth Rs 1.9 trillion (likely to increase as more information flows in). However, this was just 35% of total investment projects completed, with the government accounting for the lion's share. Not only is the amount of investment projects completed in 2022 lower than the previous year's Rs 2.5 trillion, but it is also lower than the average ~Rs 3 trillion worth of private investment projects completed in the three years before COVID-19 (2017-19).

Focus Section: Fiscal deficit target likely to be contained with marginal slippage in absolute terms; FY24 Budget to focus on fiscal consolidation and capital expenditure to support growth

	Fiscal Metrics					as % of GDP					%YoY				
INR lakh crores	FY21 A	FY22 BE	FY22 RE	FY23 BE	FY23 E	FY21 A	FY22 BE	FY22 RE	FY23 BE	FY23 E	FY21 A	FY22 BE	FY22 RE	FY23 BE over FY22 RE	FY23 E over FY22 RE
Revenue Receipts	16.34	17.88	20.79	22.04	24.19	8.3	8.0	8.8	8.5	8.9	-3.0	9.5	27.2	6.0	16.3
Net Tax Revenues	14.26	15.45	17.65	19.35	21.89	7.2	6.9	7.5	7.5	8.0	5.1	8.4	23.8	9.6	24.0
Gross Tax Revenues	20.27	22.17	25.16	27.58	31.10	10.2	9.9	10.6	10.7	11.4	0.8	9.4	24.1	9.6	23.6
Non Tax Revenues	2.08	2.43	3.14	2.70	2.30	1.0	1.1	1.3	1.0	0.8	-36.5	17.0	51.1	-14.1	-26.8
Non Debt Capital Receipts	0.58	1.88	1.00	0.79	0.54	0.3	0.8	0.4	0.3	0.2	-16.0	226.2	73.5	-20.7	-45.7
Total Receipts	**16.92**	**19.76**	**21.79**	**22.84**	**24.73**	**8.5**	**8.9**	**9.2**	**8.9**	**9.1**	**-3.5**	16.8	28.8	4.8	13.5
Total Expenditure	**35.10**	**34.83**	**37.70**	**39.45**	**42.24**	**17.7**	**15.6**	**15.9**	**15.3**	**15.5**	**30.7**	-0.8	7.4	4.6	12.0
Revenue Expenditure	30.84	29.29	31.67	31.95	34.43	15.6	13.1	13.4	12.4	12.6	31.2	-5.0	2.7	0.9	8.7
Capital Expenditure	4.26	5.54	6.03	7.50	7.81	2.2	2.5	2.5	2.9	2.9	27.0	30.0	41.4	24.5	29.6
Fiscal Deficit	**18.18**	**15.07**	**15.91**	**16.61**	**17.51**	**9.2**	**6.8**	**6.7**	**6.4**	**6.4**					
Fiscal Deficit % of GDP	**9.2**	**6.8**	**6.7**	**6.4**	**6.4**										

Note: E- Estimates; BE - Budget Estimates; RE - Revised Estimates; A - Actuals;

The central government's fiscal position continued to remain contained as of November 2022, guided by robust revenue collections. The fiscal deficit stood at just 59% of its Budgeted Estimates (BE), compared to its pre-COVID-five-year trend (FY16-20)- where over 100% of the deficit target was exhausted during the same time. This has provided the central government with the flexibility to carry out additional expenditure (it announced an additional expenditure involving a net cash outgo of Rs 3.26 lakh crore in the first supplementary demand for grants in FY23) in the remaining year without deviating from its deficit targets.

The finance minister is scheduled to unveil the budget for the next fiscal year - FY24 and release the revised fiscal numbers for the current fiscal year on February 1. We expect the government to maintain its fiscal deficit target for FY23 at 6.4% of GDP, thereby continuing on its fiscal consolidation path by narrowing the deficit from 6.8% of GDP in FY22 and 9.2% of GDP in FY21. On the revenue side, total receipts are tracking ~64% of the BE (April-November) and are likely to exceed the budget estimates by ~Rs 1.89 lakh crore buoyed by robust tax collections. Net tax revenues are likely to overshoot the budget targets due to strong growth in direct taxes and GST collections. However, the increased tax revenue is being offset with the lower dividend by the RBI (~Rs 30K crore vs BE of ~Rs 74K crore) due to higher interest costs to maintain liquidity adjustment facility (LAF) operations, lower divestment proceeds (~ Rs 31K crore vs BE of Rs 65K crore) and higher expenditure. On the expenditure front, the pace of government spending is higher compared to last year and is currently tracking at 62% of BE. Revenue expenditure is estimated to exceed the BE by ~Rs 2.5 lakh crores on account of higher food subsidy (extension of free food grain program (PMGKAY)) and fertilizer subsidy (due to rise in energy prices). Meanwhile, the capital expenditure is only slightly higher than BE based on the first supplementary demand for grants. With that, while in absolute terms fiscal slippage is expected at ~ Rs 90K crore, the higher nominal GDP growth for FY23 (15.4% as per MOSPI's first advanced estimates) will support the deficit target of 6.4% for FY23. However, there are upside risks to our estimates as we have not accounted for additional potential compensation to OMCs for under-recoveries already sustained (losses incurred by freezing fuel prices).

The budget for FY24 will be the last full budget before the general elections of 2024 and will be presented against the backdrop of slowing growth and tighter financial conditions. With this, the government is expected to deal with the dual objective of supporting growth along with fiscal prudence. For FY24, we expect the government to set the fiscal deficit target in the range of 5.9-6.0% of GDP. To achieve the same, the government is expected to rely on expenditure rationalization through a decrease in subsidy expenditure as growth in tax revenue is likely to moderate with slowing nominal growth. Along these lines, the government has already scrapped the free food grain program by integrating it under the national food security act (NFSA) for one year, which is likely to reduce the additional food subsidy. With no additional disruptions in the global supply chain and a fall in global commodity prices, the fertilizer subsidy is also expected to come down in FY24. Meanwhile, the rural welfare scheme will continue to be in focus with rural demand remaining lacklustre in FY23.

Capital spending, on the other hand, is expected to be one of the key themes amidst a volatile global environment and no meaningful pick-up in domestic private investment so far. In FY23 the centre also launched a scheme to provide interest-free loans to states to boost capital spending by the states. With state Capex currently lagging, we anticipate the scheme to be extended in FY24. The government is likely to continue the support provided to the MSMEs in the form of an extended emergency credit guarantee scheme. Additionally, with the global economic slowdown weighing on exports we expect the budget to announce additional measures to support exports. Overall, the government is expected to support the nascent CAPEX revival while sticking to the fiscal consolidation path.

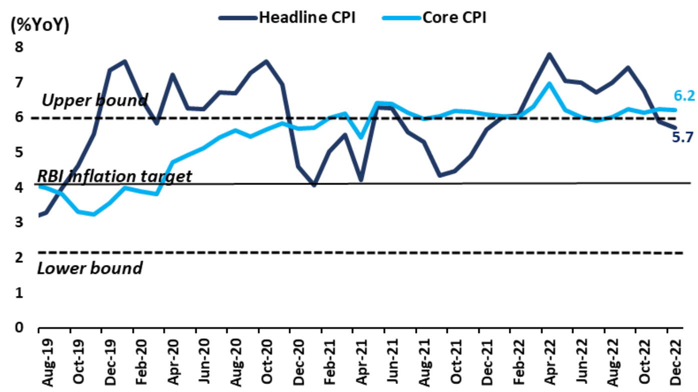
Headline CPI printed below RBI's upper band of 6%; Terminal rate to be around 6.5-6.6%

In December, the CPI headline inflation softened further to 5.7% YoY compared to 5.9% YoY in the previous month, printing below the RBI's upper threshold of 6% for the second consecutive month. This is welcome news. The moderation came despite the unfavourable base effect of 30 bps from the last year. With this the average for Q3 FY23 stands at 6.1% YoY, significantly lower than the RBI's projection of 6.6% YoY. Easing headline print was led by a slowing in food prices, particularly vegetables which more than offset increases in other categories of food including cereals, milk, eggs, and meat etc.

Despite the welcome easing in headline prices, core inflation remained sticky at 6.2% YoY, remaining a cause of policy concern. Core inflation in the latest month was underpinned by an acceleration in prices of health, household items, personal care, etc. potentially stemming from resilient services demand and an increase in gold prices.

WPI inflation, on the other hand, eased to its 22-month low of 5.0% in December from 5.8% in November led again by food prices. Further, the manufacturing WPI eased to 3.4% in December from 3.6% in the preceding month. Both developments imply a potential easing of the pass-through of input cost pressures by the producers. Going forward, we expect headline inflation to moderate further driven by a continued decline in food prices and easing of input cost pressures. However, core inflation is expected to remain sticky at elevated levels.

Lower food inflation leads to a decline in headline inflation in December



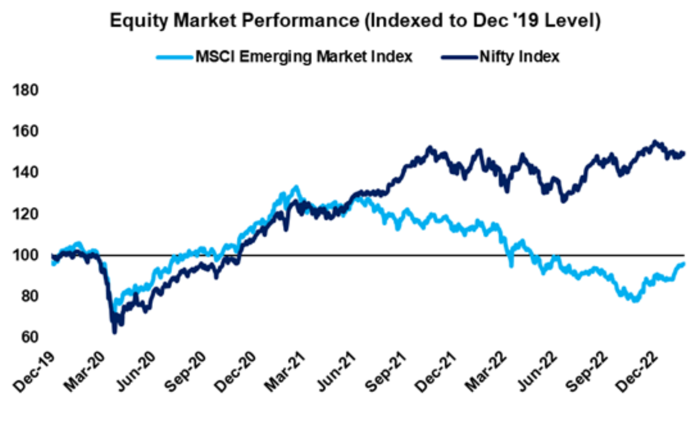
Source: CMIE

From the monetary policy perspective, the RBI is unlikely to take comfort from the decline in headline inflation which is caused by the seasonal decline in vegetable prices. Additionally, with high-frequency indicators suggesting a still resilient domestic economy both here and now, and in the period immediately ahead, we expect the RBI to deliver another rate hike before pausing to break the persistence of the elevated core inflation. We continue to advocate a terminal rate of 6.5%-6.6%, however, moderation in the headline rate of inflation has increased the likelihood of a smaller hike of 25 bps (instead of 35 bps) in the upcoming monetary policy meeting in February.

Market Update

Indian equity markets went through a major sell-off in December, wiping out almost all the gains of the previous month. The equity market was likely affected by the sharp increase in COVID cases in China raising concerns over its spread to the neighbouring countries, subsequently affecting mobility and business activity. Furthermore, the release of strong GDP data (Q3 CY23) for the US economy accentuated fears of a hawkish stance by the Federal Reserve (the Fed) rendering volatility to the market. Accordingly, both the benchmark indices – NIFTY50 and SENSEX declined by 3.5% MoM and 3.6% MoM respectively in December. However, in 2022 the Indian equity markets were ahead of emerging markets. Overall, the Indian equity market index (NIFTY) was higher by ~50% compared to pre-COVID levels (December 2019 average), outperforming other emerging markets (MSCI EM index at ~12% lower than pre-COVID levels). Moving into January equity markets remained highly volatile amid the release of FOMC minutes, anticipation of a slower policy hike by the Fed and outflows by foreign institutional investors. We do not expect any sharp corrections in markets on account of the foreign outflows as domestic investors continue to provide support to the market. However, the volatility is likely to continue amid global uncertainty.

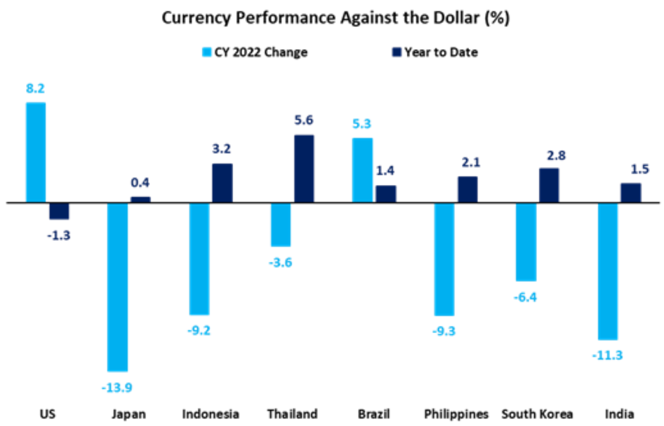
Indian equity markets overperformed peers in the calendar year 2022



Source: Bloomberg; CMIE; Note: Data till January 23rd

Indian Bond markets traded in a narrow range in December since the RBI policy meeting where the RBI announced a repo rate hike of 35 bps. Yields on the 10-year benchmark G-sec hovered around the 7.3% threshold as it averaged 7.28% in December, marginally lower compared to 7.33% in the previous month. Meanwhile, slightly less softening was seen at the shorter end of the curve leading to a narrowing of the 10y-1y spread from 49 bps in November to 47 bps in December. This was led by a combination of positive factors including easing of domestic inflation, and a decline in oil prices from an average of ~US$91/bbl in November to an average of ~US$81/bbl in December. Moving into January, the benchmark 10-year yields surged to an average of 7.33% (data till 23rd January) again as the positive impulses from the moderation in domestic inflation are offset by an increase in Brent prices owing to the removal of the restrictions in China (~US$88/bbl by January 23rd from ~US$78/bbl on January 4th) and shift in the focus of the investors' worries over the announcement of higher borrowing program in the budget. Hence, we expect the yields to remain range bound before the announcement of the Union Budget for FY24.

With a decline in the dollar index, other currencies have been appreciating since the beginning of 2023



Source: Bloomberg; Investing.com; Note: Data for 2023 till January 23rd. US represents change in Dollar Index

In the foreign exchange market, the Indian Rupee came under pressure against the dollar as the USD/INR pair depreciated by 0.9% to an average of 82.52 in December compared to 81.78 in the preceding month. Foreign capital outflows (combined equity and debt market), hawkish comments by the US Fed governor, and elevated levels of current account deficit have contributed to the weakening of the domestic currency. Overall, the domestic currency has depreciated to the tune of ~11% in the year 2022 in line with other emerging market economies led by the strengthening of the greenback, capital outflows by foreign investors, and widening of the current account deficit. FIIs pulled out capital to the tune of ~US$19 bn from the Indian markets. Since the beginning of 2023, the Indian rupee has appreciated by 1.5% (data as of January 23rd) on the back of the weaker dollar (dollar index declined by 1.3%) as investors anticipate softer rate hikes by the Fed. The recent appreciation in the last week is also led by renewed optimism among foreign investors and debt inflows worth US$1 bn in EXIM bank. Overall, we expect the rupee to remain at similar levels with any move below 81 levels likely to be utilized by the RBI to build up their capital buffers. Going ahead, the near-term outlook will be guided by the union budget and upcoming policy meetings by the Fed and RBI.

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