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Headwinds to the economic outlook rise, driven by spillovers from ongoing geopolitical tensions

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- The Ukraine-Russia conflict has caused a severe stagflation shock to the world economy, complicating policy trade-offs for central banks by accentuating inflationary pressures across the globe and weakening the global growth outlook.
- As a result, the IMF cut global economic growth projections to 3.6% in 2022, down by 0.8 percentage points compared to the January forecast.
- It raised inflation projections to 5.7% for advanced economies and 8.7% for emerging market and developing economies for 2022 — 1.8 and 2.8 percentage points higher than forecasts made in January.
- Deterioration in the global economic environment and high commodity prices pose downside risks to India's economic recovery.
- The recent rise in COVID cases in some major cities has added to the list of headwinds, though higher vaccination levels should help limit the potential impact.
- High global commodity prices are expected to add to rising domestic inflation, weighing on demand recovery by curtailing purchasing power and forcing the central bank to hasten the policy normalization.
- In its first meeting of FY23, the RBI kept key policy rates and the accommodative stance unchanged but embarked on the policy normalization.
- The central bank revised the forward guidance, focusing on withdrawal from ultra-accommodation and prioritizing containing inflation over economic growth revival.
- In March, CPI inflation accelerated to a 17-month high of 6.95% YoY, remaining above the RBI's upper threshold for a third straight month.
- Looking closely at 299 items within the CPI basket, the share of items with inflation above 6% has gone up to 56% by March '22 from 32% in Feb '21.
- With the building of inflationary pressures, the RBI is now expected to front-load rate hikes starting in the June meeting, with at least 75 bps cumulative rate hikes in FY23.
- If inflation does not materially ease after the expected peak in Q1-FY23, the RBI will be forced to tighten monetary policy more than presently anticipated.

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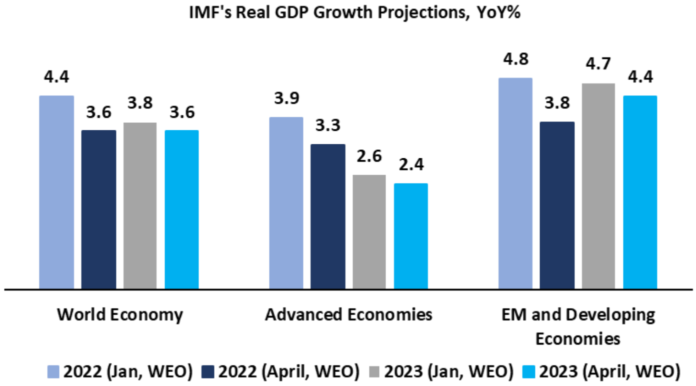
The Ukraine-Russia conflict pushes the global economic recovery off-track

The Ukraine-Russia conflict has caused a severe stagflation shock to the global economy. Ongoing conflict and associated disruption to world trade are keeping global commodity prices at elevated levels, fueling already high inflationary pressures across the globe, accelerating the pace of withdrawal of monetary accommodation by major central banks, and weakening the global growth outlook. High-frequency data indicates that global economic activity lost traction in March due to geopolitical tensions. The JPMorgan Global Composite Output Index posted 52.7 in March, down from 53.5 in February, with output growth slowing for the manufacturing and service sectors. The IMF has also downgraded global economic growth projections for 2022 and 2023 by 0.8 and 0.2 percentage points compared to the January forecast respectively, to 3.6% in 2022 and 2023. The downgrades were primarily driven by the war's direct impacts on Russia and Ukraine and global spillovers.

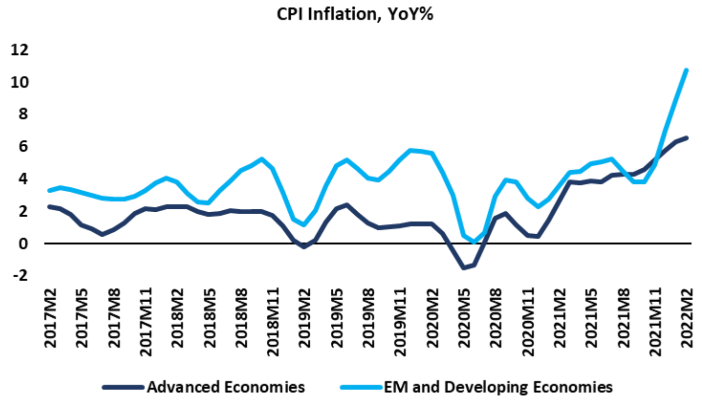
IMF cuts global economic growth forecasts sharply



Source: IMF, Projections as per World Economic Outlook reports of January and April 2022.

Given the stagflationary shock induced by the war, policy trade-offs have become more challenging for central banks across the globe as they have to step up efforts to prevent high inflation from becoming entrenched despite weakening economic growth. The war has accentuated inflationary pressures, which had been rising even before the war due to supply-demand imbalances and policy support during the pandemic. Russia and Ukraine together account for a significant share of global exports of wheat, corn, potassic fertilizer, platinum, gas & oil, palladium, etc. As a result, the war has accentuated inflationary pressures for food, energy, and manufactured goods. The repeated lockdowns in China would also cause new bottlenecks in global supply chains, feeding into global inflationary pressures. As per the IMF, inflation is projected at 5.7% in advanced economies and 8.7% in emerging market and developing economies for 2022 — 1.8 and 2.8 percentage points higher than forecasts made in January. In the US, nearly 40-year high inflation is leading to markets pricing in aggressive rate hikes by the US Fed, with the likelihood of a 50bps rate increase in the next meeting. A faster pace of monetary tightening by major central banks and geopolitical developments are causing increased financial markets volatility, especially for emerging economies.

Inflation continues to heat up across the major economic groups



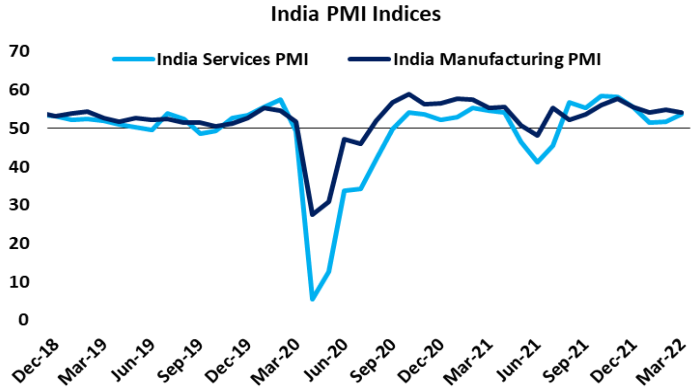
Source: IMF

Some of the factors contributing to high inflation have been largely beyond the control of central banks, with prices of energy and food driven by global supply shocks caused by the war in Ukraine. Accordingly, supply-side intervention would be needed in conjunction with monetary tightening to contain inflationary pressures. In this direction, the US announced the release of ~180 million barrels of oil from its stockpile to cool crude prices. Additionally, the International Energy Agency's 31 member nations announced the release of 120 million barrels from their emergency oil reserves, including 60 million barrels from the announced drawdown from US stockpiles. These measures, coupled with a weakening global economic outlook, led to an easing in Brent oil prices from highs of ~$140/bbl in early March to ~ $110 by 20 April amidst continued volatility. The outlook for commodity prices will continue to hinge on geopolitical developments.

India's economic outlook faces rising headwinds driven by geopolitical developments

Deterioration in the global economic environment and high commodity prices pose headwinds to India's ongoing economic recovery, which was showing tentative signs of traction with the ebbing of the third COVID wave. High-frequency data suggest a mixed picture with continued robust exports performance and incrementally favourable conditions for private investment revival aided by the government's thrust on CAPEX, offset by an uneven recovery in private consumption, high uncertainties, and rising inflation. High global commodity prices are expected to add to rising domestic inflation, which could weigh on demand recovery by curtailing purchasing power and forcing the central bank to tighten monetary policy faster than anticipated. On the supply side, service-related indicators show signs of broadening economic recovery, and the agriculture outlook remains positive, while industrial sector data indicate a weakening momentum. The recent rise in COVID cases in some major cities has added to the list of headwinds, which could throw a spanner in the services sector recovery. Daily new cases have gone up from around 1K (7-dma) in the first week of April to ~1.4K by 19 April. These factors pose downside risks to our projection of 7.7% YoY real GDP growth in FY23. Higher vaccination levels (83% of the eligible population received both doses) should help limit the potential impact of any new COVID wave.

PMI survey reflects a moderation in the manufacturing sector while the services sector notes a sharp pickup



Source: CMIE

Industrial activity momentum weakened in Feb-March due to rising input cost pressures and global supply chain disruptions. The Index of Industrial Production (IIP) grew by a modest 1.7% YoY in February, driven by a favourable base effect. On a sequential basis, the index recorded a steep contraction of 4.7% MoM (v/s 0.1% MoM expansion in January). The slowdown was led by manufacturing which declined by 5.5% MoM, followed by electricity (2.9% MoM) and mining (1.2% MoM). The early indicators for March suggest a mixed picture for the industrial activity. E-way bills (10% YoY/13% MoM) and GST collections (15% YoY/7% MoM) showed robust growth in March. The electricity generation noted a strong pick of 19% MoM after contracting by 3% MoM in the prior month. However, PMI for the manufacturing sector indicates moderation in the industrial activity, with the index dropping marginally from 54.9 in February to 54.0 in March as companies noted building inflationary pressures as a major cause of concern. Going ahead, we expect the industrial growth to remain affected because of elevated global commodity prices and supply chain disruptions amidst the ongoing war and COVID related lockdowns in China. Even the RBI's Business Expectation Index moderated slightly from 137.8 in Q4 FY22 to 134.7 in Q1 FY23 but continued to remain in expansionary territory. Potential disruption to electricity supply due to low coal stocks at power plants might also weigh on industrial activity.

Supported by the ebbing of the third COVID wave and higher vaccination levels, the services sector activity gained traction in recent months. The services PMI noted its fastest expansion in 2022 so far, as the index jumped from 51.8 in February to 53.6 in March. Meanwhile, the other indicators for the services sector also suggest a robust activity, with national electronic toll collection rising by 13% MoM in value terms (v/s 1% MoM in February). Rail freight and port traffic noted a strong sequential pickup. Domestic air passenger traffic grew by ~39% MoM in March. The aviation sector is likely to get a boost from the government's decision to resume scheduled commercial international passenger services from 27 March. Further, the bank credit to services picked up sequentially, led by the contact intensive sectors reflecting the broadening of the economic recovery.

On the agricultural front, the outlook for the sector remains bright, with higher rabi sowing, projection of a normal monsoon, and adequate reservoir levels. The rising wheat prices globally amidst the conflict provide a silver lining for India's Agri exports, especially wheat (which is estimated to be a record 111.32 million tons output). Accordingly, India could export a record 10 million tons of wheat in FY23. Egypt, one of the largest importers of wheat, has already approved India as one of its suppliers and is likely to import at least one million tons of wheat. However, high fertilizer prices could pose challenges ahead of the Kharif sowing season. We expect the government to help alleviate some input pressures through higher fertilizer subsidies in FY23.

From a private consumption demand perspective, the high-frequency indicators suggest an uneven recovery. There are some tentative signs of demand recovery in March after remaining tepid in the preceding month on account of uncertainty surrounding the third wave and escalating geopolitical tensions. Its sustainability remains doubtful at this point, given uneven labour market conditions and rising inflationary pressures. Consumption demand remained under pressure in February as both IIP consumer durables and non-durables noted sequential contraction for the second consecutive month, with both indicators now below their respective pre-COVID levels (please refer to the table below). On the other hand, retail credit continued its upward growth trajectory as it increased by 4.0% MoM in February. Moving into March, the high-frequency indicators point towards a revival in consumption demand as the third wave and the corresponding restrictions subsided. Google mobility for retail & recreation and grocery & pharmacy continued to stay above the pre-pandemic levels in March and early April though the pace of sequential improvement slowed. Indicators such as passenger vehicle sales/registrations, two-wheeler registrations, petrol consumption, etc. noted sequential improvement in March, reflecting the uptick in consumption activity. The consumer confidence survey exudes improved sentiments, with the current situation index increasing from 64.4 in January 2022 to 71.7 in March and the future expectations index rising from 103.3 in January to 115.2 in March (value above 100 level shows optimism and below indicates pessimism). The Naukri index, an indicator of hiring trends in the organized sector, stood at 123% of the pre-COVID levels in March 2022, supported by broad-based hiring across industries. However, on a sequential basis, the Naukri index declined by 7.9% MoM, reflecting some caution in hiring given increased uncertainty due to global geopolitical developments. More comprehensive labor market data from CMIE showed a disappointing picture, indicating an uneven recovery. The greater unemployment rate fell from 11.5% in February to 11.1% in March, but it was due to a decline in the labour force, whereas the employment level fell by ~1.4 mn in March '22, taking the total jobs lost since the beginning of 2022 to ~10.2 mn. A sustainable recovery in jobs conditions remains critical for a durable consumption recovery.

High-Frequency indicators suggest an uneven recovery in demand

Consumption Indicators, Index Averaged to 2019										
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Feb-22	Mar-22
Google Mobility - Grocery & Pharmacy	-52.0	-2.5	-4.9	9.5	18.5	3.2	32.7	47.5	48.3	48.0
Google Mobility - Retail & Recreation	-81.5	-59.8	-41.9	-27.5	-22.1	-40.4	-13.0	2.0	3.3	7.5
Personal Loans	108.1	107.9	112.8	117.1	129.7	120.7	126.4	133.8	143.3	
Passenger Vehicle Sales	9.8	65.4	102.3	131.3	135.7	90.8	110.9	118.3	111.5	127.6
Two Wheeler sales	23.4	58.5	76.0	105.4	88.7	68.4	67.3	84.5	72.3	85.2
Tractor Sales	8.7	124.9	145.7	144.5	117.3	83.9	68.8	86.5	63.9	88.0
Domestic air passenger traffic	0.0	8.5	16.9	31.4	33.5	13.0	29.6	47.9	33.1	46.0
IIP: Consumer Durables	4.4	63.0	104.0	100.7	107.2	80.7	105.6	98.0	92.5	
IIP: Non-Consumer Durables	49.0	99.5	99.4	108.6	106.0	95.6	99.3	108.5	94.1	

Source: CMIE, Google Mobility Reports

On the investment activity front, corporates' improved credit profile and rising capacity utilization bode well for the private investment revival; however, ongoing heightened uncertainty, rising input costs, and uneven consumption recovery may delay the broader investment pickup. As per CMIE data, new investment projects announced increased by 50% QoQ to Rs 5.2 lakh crore in Q4 FY22, higher than the pre-pandemic quarterly (in CY2019) average of Rs 4.4 lakh crores , which bodes well for the investment activity in the country. Infrastructure credit also remained robust as it grew by ~12% YoY in February. Thanks to deleveraging and robust earnings, the corporate credit profile has posted a strong performance in FY22, indicating improved balance sheet strength to absorb shocks and undertake fresh investments in FY23. According to CareEdge Ratings, the credit ratio (share of upgrades to downgrades) clocked a decadal high at 2.64 times in the H2-FY22, pointing towards a "positive" outlook. Further, rising capacity utilization should incentivize companies to step-up investment. The capacity utilization for the manufacturing sector reached the pre-pandemic levels, improving from 68.3% in Q2 FY22 to 72.4% in Q3 FY22, although it was below the long-period average. However, ongoing geopolitical tensions and elevated input costs (as reflected in WPI inflation of 14.6% YoY in March) may delay the broader revival in private investment. The government will continue to take the lead in driving the investment in FY23.

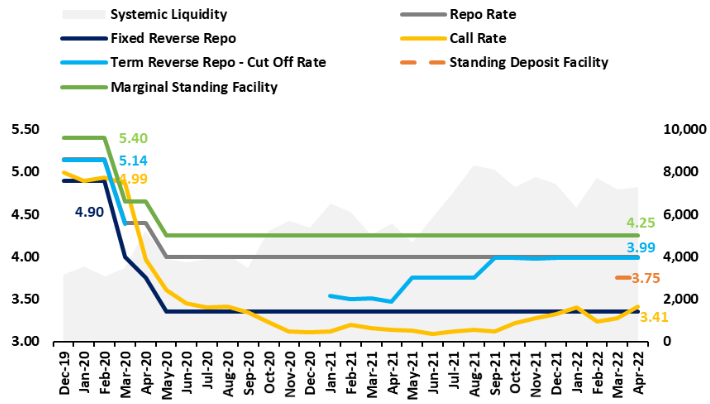
On the fiscal front, the government spending pace was disappointing in February while revenue collections continued to show a strong performance. In February, the government spending slowed to 11.0% YoY, down from 21.6% YoY in January. The expenditure was led by the revenue expenditure, which rose by 12.7% YoY in February, while growth in CAPEX remained muted at 0.8% YoY (19.8% YoY April '21-February '22). Despite the government prioritizing CAPEX-led growth, the center is likely to miss the FY22 CAPEX target, with the center meeting only 80.5% of its revised target compared to the average trend of 90.8% of the BE being met in the past years on average until February (FY16-FY20). Meanwhile, the total government receipts stood at 83.9% of revised estimates, which is higher than the previous trend average of ~76.5% until February (FY16-20). As per the early estimates, gross tax receipts grew by 34% YoY in FY22, exceeding the revised estimate by nearly Rs 1.9 trillion. This, coupled with likely savings on the expenditure account, should help the government overachieve the FY22 budget deficit target of 6.9% of GDP, despite postponing the LIC IPO to FY23.

Meanwhile, aggregate demand remains supported by exports which maintained their robust growth, noting an increase of 14.5% YoY in March and reaching a record-high of $420 billion in FY22. This was supported by broad-based exports performance, with engineering goods, chemicals, petroleum products, pharmaceuticals, cotton yarn/fabrics, and rice being the best-performing goods categories. Meanwhile, imports also kept pace with the exports as they clocked a growth of 24% YoY in March and reached an all-time high of $612 bn for FY22, led by petroleum products. Overall, India's merchandise trade deficit rose by 87% to ~$ 192 bn, which will widen the current account deficit and act as a drag on economic growth. In FY23, a weakening global growth outlook is likely to weigh on exports' performance, even as there will be new opportunities for some items like wheat, steel, etc. due to geopolitical developments, and the government plans to promote electronic manufacturing and increase global value chain participation through the Production Linked Incentive scheme.

The RBI embarks on formal policy normalization as inflation takes the front seat

As indicated in our last monthly report, high commodity prices and rising inflationary pressures could eat into policy space in FY23. In its first meeting of FY23, the RBI kept key policy rates and the accommodative stance unchanged, in line with expectations. However, it started the policy normalization, prioritizing containing inflation over economic growth revival. It revised the forward guidance indicating a focus on withdrawal from ultra-accommodation. To reinstate the pre-COVID liquidity management framework, the RBI decided to restore the width of the LAF (Liquidity Adjustment Facility) corridor to its pre-pandemic configuration of 50 bps. To operationalize this, the RBI introduced the Standing Deposit Facility (SDF) – an additional tool for absorbing liquidity without any collateral- with an interest rate of 3.75% as the floor of the LAF corridor. The RBI assured that it would engage in a gradual and calibrated withdrawal of the liquidity over a multi-year time frame beginning this year while reiterating its commitment to ensuring the availability of adequate liquidity to meet the productive requirements of the economy.

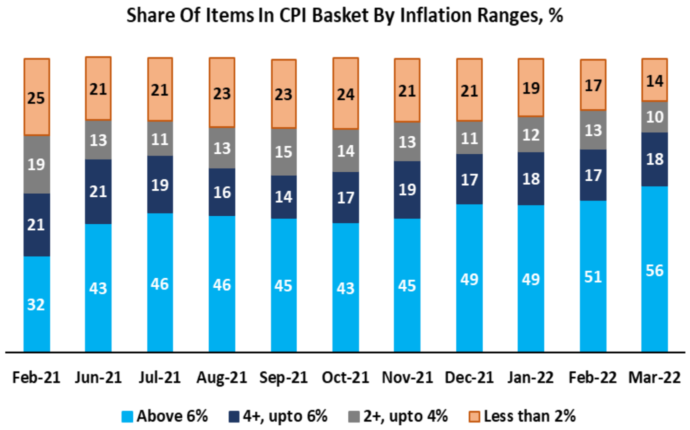
RBI introduced SDF as the floor of the LAF corridor



Source: CMIE; Note: Data for April is based on 15 April.

The RBI's plan to withdraw liquidity in a gradual manner will face a huge challenge from the building up of inflationary pressures. Ongoing geopolitical tensions, higher global commodity prices, and persistent supply chain disruptions have imparted upside risks to the inflation trajectory, which was already showing signs of an upturn. There are also signs that the inflation pressures are becoming broad-based. Looking closely at 299 items within the CPI basket, the share of items with inflation above 6% has gone up to 56% by March '22 from 45% in Sep '21 and 32% in Feb '21. Meanwhile, the share of items with inflation below 2% fell to 14% from 23% and 25% over the same period. In the April meeting, the RBI revised the FY23 projections for inflation to 5.7% YoY compared to the earlier estimate of 4.5% YoY, assuming the oil price at $100/bbl. It expects inflation to peak in Q1 FY23 at 6.3% YoY before gliding towards 5.1% YoY by Q4 FY23. There is considerable uncertainty about the inflation outlook, with its trajectory critically dependent on the evolving geopolitical situation (and associated implications for global commodity prices) and monsoon.

High inflation is becoming broad-based



Source: CMIE, shares may not total 100% due to the unavailability of data for some items

The latest inflation print indicates that inflationary pressures are likely to rise in the H1-FY23. In March, India's CPI inflation accelerated to a 17-month high of 6.95% YoY, led by food prices and core inflation, remaining above the RBI's upper threshold for a third straight month. Among the nine sub-groups noted in the table below, all except the housing and pan/tobacco categories reported inflation higher than their respective pre-COVID averages. Inflation in the urban areas rose to above 6%, while it shot up sharply to 7.6% in the rural areas. Core inflation firmed up from 6.0% YoY in February to 6.3% YoY in March, on the back of the rise in personal care, clothing & footwear, and household items. The food and beverages inflation quickened to 7.5% YoY in March, led by a sharp rise in prices of oil & fats, followed by vegetable prices and meat & fish, whereas prices of eggs and pulses witnessed some moderation. Fuel inflation eased but remained above its pre-COVID average.

Inflation for most major sub-groups running above pre-COVID averages

CPI Inflation, YoY%								
Sub-groups	Weights	Pre-COVID average*	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22
CPI (headline)	100.0	4.24	4.48	4.91	5.66	6.01	6.07	6.95
CPI-Urban		4.20	5.04	5.54	5.90	5.91	5.75	6.12
CPI- Rural		4.28	4.07	4.29	5.36	6.12	6.38	7.66
Core-CPI	54.1	4.75	6.24	6.21	6.12	6.01	6.02	6.33
Food and beverages	45.9	3.69	1.82	2.60	4.47	5.58	5.93	7.47
Pan, tobacco and intoxicants	2.4	6.68	4.27	4.05	3.16	2.45	2.39	2.98
Clothing & footwear	6.5	4.25	7.53	7.94	8.30	8.78	8.86	9.40
Housing	10.1	5.57	3.54	3.66	3.61	3.52	3.57	3.38
Fuel & light	6.8	4.37	14.35	13.35	10.95	9.32	8.73	7.52
Miscellaneous	28.3	4.44	6.83	6.75	6.65	6.55	6.58	7.02

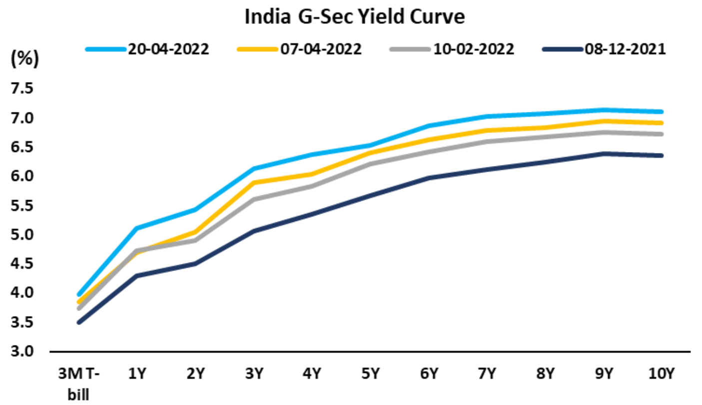
Source: CMIE, Pre-COVID average is for FY16-FY20 period

The full impact of the hike in domestic fuel prices (of ~Rs 10 per litre since mid-March) will be felt in April. Food inflation is likely to be supported by the current momentum and base effect. Housing and services inflations are likely to pick up with the normalization of activity. We also believe pass-through of the input costs to final consumers will pick up, putting pressure on inflation. Considering a higher than previously anticipated momentum in prices, we project the FY23 inflation of ~6.0% (with upside risks), up from the earlier forecast of 5.4% and higher than RBI's revised projection of 5.7%. This will feed into higher household inflation expectations, which are already high and showed a pickup in the latest round of the survey, with three months and one year ahead inflation expectations rising by 10 bps each to 10.7% and 10.8%, respectively, compared to the previous round. Considering these factors, we expect the RBI to change its stance to "neutral" from "accommodative" in the June meeting. With inflation likely to average ~6.8-7% in Q1, much higher than the RBI's projection of 6.3% for the quarter, we now expect the RBI to front-load rate hikes starting in the June meeting compared to an earlier expectation of Q2-FY23. We expect the central bank to deliver at least 75 bps cumulative rate hikes in FY23. If inflation does not materially ease after the expected peak in Q1-FY23, the RBI will be forced to tighten monetary policy even more than presently anticipated.

Market Update

Bond markets came under pressure in April after seeing some relief in the second half of March. As crude oil prices fell from their early March highs, the 10-year G-Sec yield eased from the high of 6.89% in the first week of March to 6.78% in the following two weeks. However, yields hardened again with the rise in oil prices and a hike in the US Fed's policy rate, indicating a faster pace of policy tightening in the future. Overall, the 10-yr G-Sec yield rose by 7bps by March-end compared to February end. In April, yields rose post the release of the borrowing calendar. Some market participants expected the government to announce a somewhat lower borrowing given the potential for cash carry-forward from FY22. But the G-Sec borrowing calendar sticks to the script, with H1FY23 gross borrowing projected at 59% of full-year FY23 issuance. Yields rose further across the curve post the RBI meeting and a higher than expected CPI inflation. Markets were hoping for explicit guidance from the RBI about its likely support to absorb the government's record FY23 market borrowing of Rs 14.95 lakh crore (~Rs 14.3 lakh crore after adjusting for switch operations). However, the central bank did not offer details on how it plans to manage the government's borrowing programme. The RBI's decision to enhance the limit under the Held to Maturity category from 22% to 23% of NDTL (Net Demand and Time Liabilities) failed to cheer the bond markets. Higher than expected inflation also weighed on the bond markets. Since one day before the April policy meeting, yields have risen across the G-Sec yield curve - 13bps for 3M t-bills, 37bps for 2yr, 13bps for 5-yr, and 19bps for 10yr G-Sec (data as of 20 April). We expect the RBI to intervene to support the government borrowing programme through operation twists/OMOs to prevent a sharp rise in yields, though its interventions are likely to be less than last year, given the plan to withdraw liquidity and focus on containing inflation.

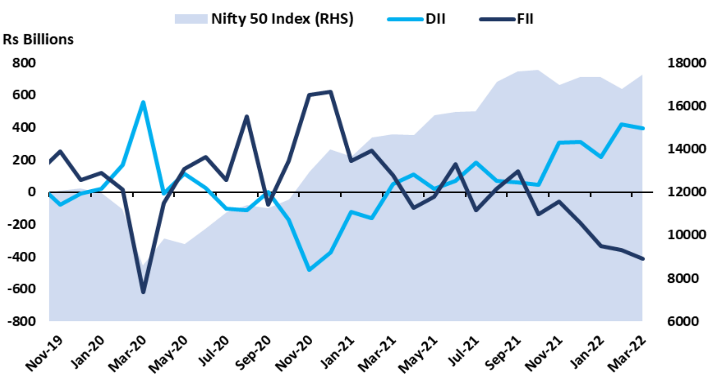
Yields have risen across the G-Sec yield curve following the RBI's meeting



Source: Bloomberg; Investing

Indian equity markets rebounded in March, recovering the losses suffered in the previous two months despite the intensification of the Russia-Ukraine war. Accordingly, the benchmark indices – NIFTY50 and SENSEX gained 4.0% MoM and 4.1% MoM, respectively, in March. The domestic buyers supported the equity markets as the capital flight continued on the part of the foreign institutional investors. As such, the foreign investors pulled out Rs 411 billion from the equity markets, while the domestic institutional investors (DII) invested Rs 397 billion in March. The stock market came under renewed pressure in April, with the Nifty 50 Index down by 1.9% in April (till the 20th) due to disappointing corporate earnings and selling by foreign investors.

Foreign investors continue to pull out capital amidst rising global headwinds in March



Source: CMIE

In the foreign exchange market, the Indian Rupee remained under pressure against the dollar as the USD/INR pair depreciated by 1.6% to an average of 76.20 in March compared to 74.9 in the preceding month. Sustained foreign capital outflows, a strong US Dollar amidst safe-haven demand and the Fed's hawkish stance, and elevated oil prices leading to a widening trade deficit have contributed to the weakening of the domestic currency. As a result, the RBI's intervention in the foreign exchange market was stepped-up to support the INR. The RBI announced two USD-INR sell-buy swaps in the last two months (one done in March and another to be conducted on 26 April) worth $10 bn, besides intermittent interventions. The forex reserves have declined as the RBI continues to support the INR. The country's forex reserves dropped by ~$30 bn in 2022 to $604 bn (as of 8 April). Going ahead, we expect pressures on the INR to continue until the tensions between Russia and Ukraine subside. However, RBI's likely intervention should limit the currency's excessive movements.

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