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Geopolitical tensions pose downside risks to the economic outlook

DMI FINANCE

- The Russia-Ukraine war poses a stagflationary shock to the global economic outlook while accentuating volatility in the financial markets across the world.
- The OECD estimates that global growth could be reduced by over 1 percentage point (pp), and global inflation raised by ~2.5 pp in the first full year after the start of the conflict.
- The Indian economy continues to recover from the temporary disruption caused by the third wave, with real GDP projected to be around 8.8% YoY in FY22.
- However, the FY23 outlook is clouded by the ongoing geopolitical tensions and the consequent impact on commodity prices, especially crude oil, given India's high import dependence.
- Economic growth is projected to be around 7.7% in FY23, with downside risks posed by higher commodity prices.
- If crude oil prices remain elevated, averaging ~$125/bbl in FY23, economic growth could fall sharply to around 6.7%, and the current account deficit may widen to ~3.5% of GDP (versus 2.3% in the base case) in FY23.
- The government has some fiscal space to absorb the higher global energy price; however, if prices remain elevated, the FY23 budget deficit target of 6.4% of GDP is likely to be missed without expenditure rationalization.
- High oil prices will also pose challenges to the RBI's dovish leaning. A $10 per barrel rise in oil price is estimated to raise CPI inflation by 49 bps if the government passes the impact of the oil price rise on to consumers.
- The potential for at least a partial pass-through will further push up the already high inflation, which has been persisting above the RBI's upper threshold of 6% for a second consecutive month in February.
- The upcoming policy meeting in early April will give more clarity on how the oil price shock is likely to change the RBI's policy guidance.
- Recent comments by the RBI Governor do suggest that the central bank may not rush to raise policy rates even if the ongoing oil price shock leads to a temporary jump in inflation, advocating supply-side measures to control the same.

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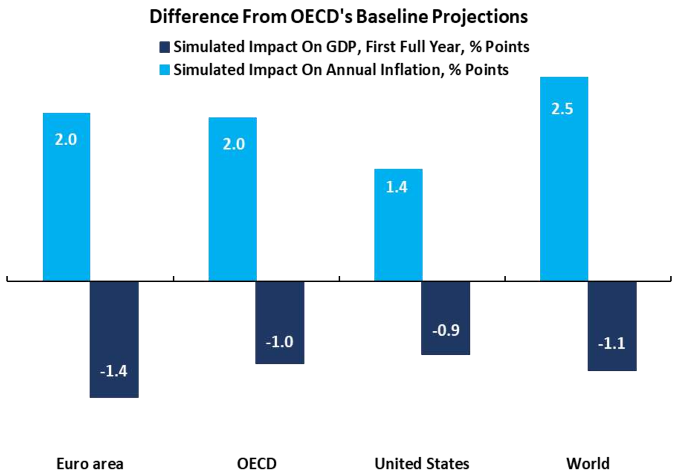
Geopolitical tensions pose a stagflationary shock to the global economy

The Russia-Ukraine war poses downside risks to the global economic growth and upward inflation pressures. This comes at a time when the global economic activity was starting to recover from the fallout of the Omicron wave. The global composite PMI recovered from its 18-month low of 51.1 in January to 53.4 in February as the pace of expansion picked up in both manufacturing and services sectors and business optimism soared to a near-record high. A decline in global daily new cases from ~ 34 lakhs per day (January 24) to ~18 lakh cases per day by March 19 helped economic recovery.

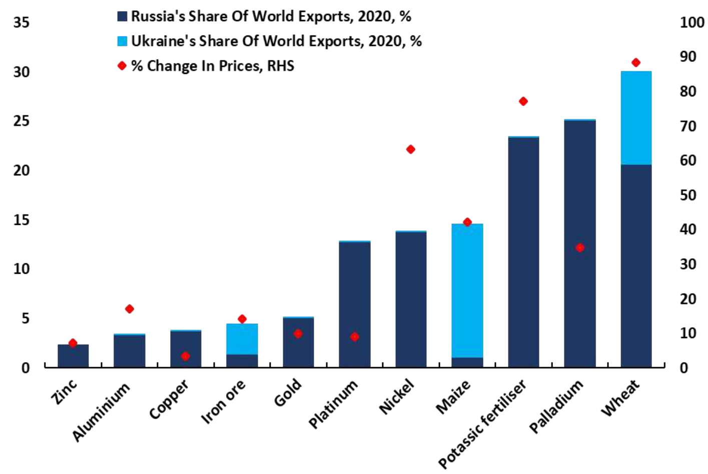
OECD's simulations suggest potentially a sizeable hit to global growth and higher prices if the conflict persists



Source: OECD calculations using the NiGEM global economic model.

The Russia-Ukraine conflict has disrupted ongoing economic recovery and led to a negative supply shock for the global economy. This comes on the back of existing supply-side issues primarily driven by the COVID pandemic, with the Global Supply Chain Pressure Index (GSCPI) remaining at elevated levels despite some easing in Jan-Feb 2022. In the near term, the effects of the war are likely to operate through multiple channels and would change as the conflict, and associated talks, evolve. Russia and Ukraine together account for only about 2% of global GDP at market prices, but they are large producers and exporters of several food items, minerals, and energy. Consequently, the war (and sanctions imposed by western countries on Russia) has raised concerns about commodity supply disruptions leading to a sharp jump in several commodity prices since the last week of February. These developments will weigh on the ongoing economic recovery and add to already high inflationary pressures. The volatility in financial markets has also risen, with equity markets correcting sharply, while US treasuries and dollar gained on safe-haven demand in late February-early March. While markets have recovered in the past few days and some commodity prices retreated from the elevated levels, volatility could persist for several months. The range of possibilities for how the conflict might ultimately be resolved remains very high, thereby accentuating uncertainty over the global economic outlook. As per the OECD, before the start of the conflict, the global recovery from the pandemic was expected to continue with projected global GDP growth of 4.5% in 2022 and 3.2% in 2023, helped by progress with global vaccination efforts and supportive macroeconomic policies in the major economies. Post the onset of the conflict, OECD estimated that global growth could be reduced by over 1 percentage point, and global inflation raised by close to 2½ percentage points in the first full year after the start of the conflict, under the assumption that the commodity and financial market shocks seen in the first two weeks of the conflict persist for at least one year. This is a large stagflationary shock to the global economy. Besides geopolitical tensions, the recent surge in cases in China, Hong Kong, and some western countries also suggest that the evolving COVID situation will continue to pose downside risks to the global economy.

Russia and Ukraine are large producers and exporters of many commodities; prices rose on concerns of supply disruptions



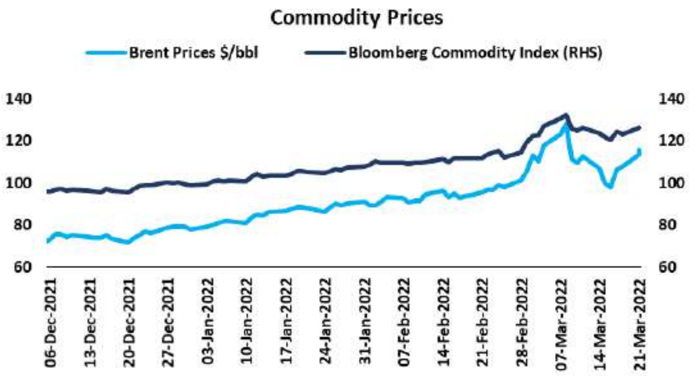
Source: OECD. Note: For fertilizer, the % increase denotes the difference between the monthly price for January and the monthly price for February. For all other items, it denotes the difference between the average price for January 2022 and the average price for the period from February 24 to March 14, 2022.

Given the high uncertainty over the economic costs of the conflict, policymakers face significant challenges as they move ahead to withdraw the stimulus provided after the onset of the pandemic. One of the key concerns surrounding the war is the surging international commodity prices, especially elevated global crude oil and natural gas prices since the beginning of the war. The price of Brent crude has risen by ~18% from an average of $ 94/bbl in February to ~$111 (average till March 21) in March. The global food prices are also increasing, as noted in the food price index surging by 5.7% MoM in February. 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 is likely to accentuate inflationary pressures for food, energy, and manufactured goods, making matters more complicated for the central banks worldwide, which are facing the double whammy of increasing inflation and slowing growth. The US recorded a multi-decadal highest inflation print of 7.9% YoY in February on the back of rising gasoline, food, and housing prices. With surging inflation prints, the US Fed embarked on its interest rate hike cycle as it announced a 25-bps rate hike to a target range of 0.25% to 0.5%, the first increase since 2018, and indicated six more rate hikes in the rest of the year. The committee revised the 2022 growth projection to 2.8% from 4% earlier and inflation to 4.3% from 2.6%. It indicated that the US economy is strong enough to withstand rate hikes and the potential impact of the Russia-Ukraine war. However, the US bond market is pricing in a higher recession risk, with the inversion between 5 and 10-year yields and a flattening trend between 2 and 10-year yields. Meanwhile, the European Central Bank announced that its Pandemic Emergency Purchases Programme (PEPP) would end on schedule by March'22, and net purchases under the Asset Purchase Programme (APP) could end by Q3-2022 if the medium-term inflation outlook does not weaken. Central banks of New Zealand, Canada, Mexico, and Russia raised their respective policy rates during Feb-Mar '22. On the other hand, the People's Bank of China paused after two consecutive months of easing. China's stock market saw heightened volatility amidst several headwinds, including COVID lockdowns, regulatory scrutiny, ADR delisting concerns, and geopolitical tensions. Coordinated policy measures seem to have helped China's stock market stage a recovery in the past few days, though it remains to be seen if the recovery would sustain in the face of several headwinds. China's National People's Congress announced its growth target of around 5.5% for 2022 – the lowest in 30 years – from last year's 6.1% amidst a rise in COVID cases despite strict zero-COVID strategy leading to repeated lockdowns adding to pressures from property crisis and geopolitical tensions.

High commodity prices pose downside risks to India's economic recovery

The Indian economy continues to recover from a temporary disruption caused by the third wave. However, the FY23 outlook is clouded by the ongoing geopolitical tensions and the consequent impact on commodity prices, especially crude oil (80%-85% dependence on imports) and edible oil (with imports meeting ~55% of domestic requirement), for which India has high import dependence. The recent uptick in COVID cases in some Asian countries, especially China, has also raised concerns about the possibility of a fourth wave. While India looks better prepared to face any new COVID wave thanks to the progress on the vaccination front, higher commodity prices pose downside risks to economic growth and are likely to weigh on the fiscal position, current account, and inflation outlook, as discussed in subsequent sections.

Geopolitical tensions led to a sharp jump in commodity prices

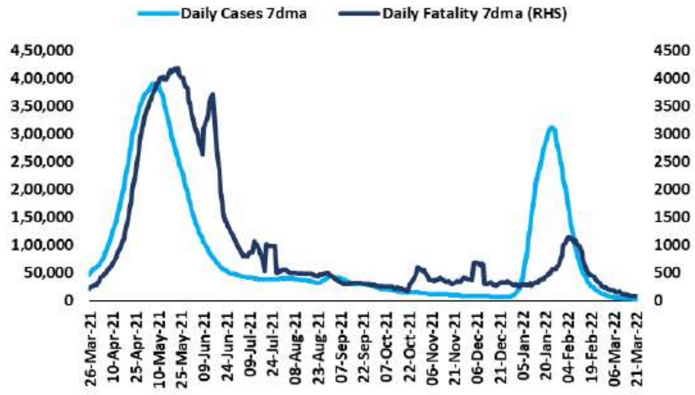


Source: Bloomberg

Economic recovery gained some traction in February with the third wave abating; geopolitical tensions could disrupt the ongoing recovery

With the third wave further abating, India's daily new cases have been on a downward trajectory after witnessing a peak in the last week of January. The daily new cases (7dma) have fallen further from ~45K in mid-February to ~2.1K as of March 21, while the daily positivity rate (7dma) has dropped from 3.3% to 0.4%. With daily recoveries exceeding the daily new cases, the active caseload has come down to a mere ~24K as of March 21 – among the lowest levels since the onset of the pandemic. Meanwhile, the daily fatalities (7-dma) have also reduced to roughly 81 compared to more than 600 deaths in mid-February. On the vaccination front, India has crossed another milestone with over 181 crores of doses being administered as of March 21, inoculating over 95% of the eligible population with at least one dose and 80.6% of the population with both the doses. Further, the vaccination pace is likely to see a renewed push with the government kick-starting vaccination for the 12-15 age cohort from March 16 and announcing precautionary doses for everyone above the age of 60. High vaccination coverage is expected to provide resilience in the face of a fourth wave, provided vaccines remain effective against the emerging variants.

New cases and fatalities came down to very low levels



Source: CMIE

With the impact of the third wave being muted, the industrial sector performance largely remained steady, as reported by the high-frequency indicators. However, rising commodity prices could hinder the recovery going ahead. In January 2022, the Index of Industrial Production (IIP) noted an expansion of 1.3% YoY compared to a ten-month low of 0.7% YoY in December, supported by the base effect. Despite the third wave, the growth remains unchanged on a sequential basis, with the IIP standing at 106% of its pre-COVID levels for the second consecutive month. While mining and electricity noted growth on a sequential basis of 3.7% MoM and 1.9% MoM, respectively, the manufacturing sector witnessed a contraction of 0.9% MoM. As per the lead indicator, the PMI manufacturing stayed in the expansionary zone for the 8th consecutive month in February and noted marginal improvement from 54.0 in January to 54.9 in February, led by expansion in new orders and production. The business confidence also touched a four-month high as demand conditions remained supportive amidst declining cases and relaxations in restrictions. Meanwhile, other high-frequency indicators remained somewhat mixed, with GST collections crossing the Rs 1.3 lakh crore mark for the second consecutive month in February though moderating sequentially (4% MoM decline v/s 6% MoM increase in January). The issuance of e-way bills slowed but remained robust in February. Cement production noted growth in January, reflecting signs of a revival in the construction sector which had posted a contraction in Q3 FY22. On the agricultural front, rabi crop output is projected to grow 1.5% in FY22 and reach a record-high of 162.5 million tons which bodes well for agriculture growth.

The services sector activity noted recovery in February with a decline in cases and the lifting of the associated restrictions. The PMI for the services sector stood at 51.8 in February compared to 51.5 in January as the companies noted a modest increase in new business and output driven by the domestic demand. Bank credit to services sector remained robust, posting growth of 7.3% YoY in January led by the credit to trade (12.0% YoY), credit to NBFCs (10.7% YoY), and credit to tourism, hotels & restaurants (10.3% YoY), reflecting a broadening of recovery. Domestic air traffic jumped by ~20% MoM on a sequential basis (v/s ~43% contraction in January), indicating a quick recovery from the third wave. Further, the resumption of international flights from March 27 will boost the recovery of the tourism and travel industry. Meanwhile, the other high-frequency indicators like freight traffic, port traffic, and steel consumption declined sequentially, potentially reflecting the impact of the COVID third wave. Going ahead, the services sector recovery is expected to gain traction as the COVID cases remain contained though its pace might be tampered with due to risks emanating from the Russia-Ukraine conflict.

On the demand side – consumption-related indicators were mixed. The IIP consumption index (weighted average of consumer durables and consumer non-durable) noted sequential moderation in January, growing by 3.6% MoM (v/s expansion of 9.8% MoM in December); however, the index managed to stay above its pre-COVID levels for the second consecutive month (100.4% of 2019 CY average). Global semiconductor shortages and the rising cost of vehicles and fuel continue to weigh on the automobile industry. Retail sales for passenger vehicles, two-wheelers, and three-wheelers combined moderated sequentially by 4.6% MoM, while wholesale dispatches declined by 5.6% MoM in February. Tractor sales have also declined, reflecting the lackluster rural demand. Moreover, with disruption to the production and supply of palladium (used in catalytic converters for cars) and inert gases (such as argon and neon, used in the production of semiconductors) due to the Russia-Ukraine war, the automobile industry is likely to continue to face supply constraints in the coming quarters.

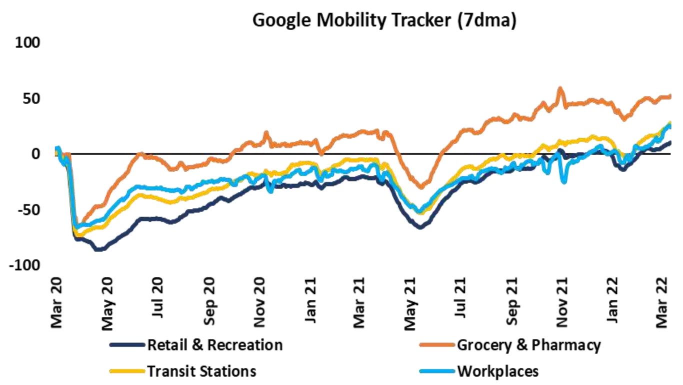
High-frequency consumption indicators paint a mixed picture

Consumption Indicators, Index Averaged to 2019										
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Jan-22	Feb-22
Google Mobility - Grocery & Pharmacy	-52.0	-2.5	-4.9	9.5	18.5	3.2	32.7	47.5	36.8	48.3
Google Mobility - Retail & Recreation	-81.5	-59.8	-41.9	-27.5	-22.1	-40.4	-13.0	2.0	-9.2	3.3
Petrol Consumption	5.4	12.6	13.6	15.0	15.2	13.3	14.4	15.6	13.7	14.1
Personal Loans	108.1	107.9	112.8	117.1	127.7	120.7	126.4	133.8		
Passenger Vehicle Sales	9.8	65.4	102.3	131.3	135.7	90.8	110.9	118.3	120.7	110.2
Two Wheeler sales	23.4	58.5	76.0	105.4	88.7	68.4	67.3	84.5	74.9	72.3
Tractor Sales	8.7	124.9	145.7	144.5	117.3	83.9	68.8	86.5	67.3	63.9
Domestic air passenger traffic	0.0	8.5	16.9	31.4	33.5	13.0	29.6	30.4		
IIP: Consumer Durables	4.4	63.0	104.0	100.7	107.2	80.7	105.6	98.0	96.6	
IIP: Non-Consumer Durables	49.0	99.5	99.4	108.6	106.0	95.6	99.3	108.5	103.1	

Source: CMIE, Google Mobility Reports

Meanwhile, the labor force participation recovered, but this pushed up the greater unemployment rate from 9.7% in January to 11.5% in February. The deterioration in the unemployment rate was concentrated in rural areas, while urban areas noted an improvement in the unemployment rate (9.3% v/s 11.1% in Jan). This was further supported by the hiring trends in the organized sector as the Naukri index registered a growth of ~31% YoY and continued to stay above the pre-COVID level for a second consecutive month. What comes as a sign of relief is also the job gains in the services sector, reversing the employment lost the previous month on account of the third wave, even though the industrial and agricultural sectors noted job losses in February. Going ahead, a sustained increase in consumption demand necessitates a durable recovery in the employment conditions, which has been volatile hitherto. Encouragingly, the retail credit continued to sustain its double-digit growth on an annualized basis and improved sequentially, with credit increasing by 3.0% MoM, building on the gains of 3.4% MoM in December. Further, daily mobility (7dma) around retail & recreation and groceries & pharmacies rose to 4.4% and 47.9% above the baseline respectively by the end of February and further to 10.7% and 52.9% respectively in March (data till March 17), indicating a pickup in the consumption activity.

Rising mobility suggest a pickup in economic activity

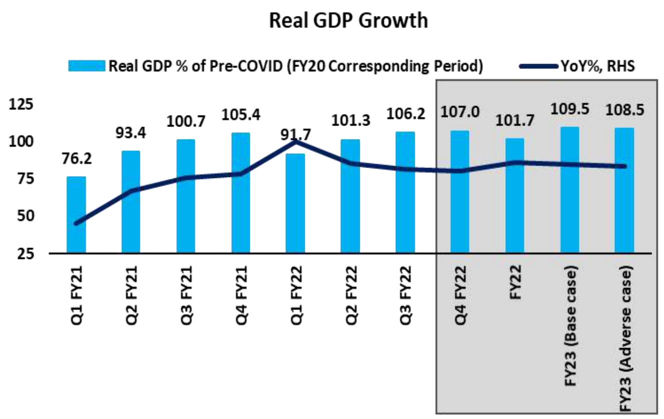


Source: Google Mobility Reports

On the investment activity front, the data suggest tentative signs of revival in private investment. As per the investment-related indicators of IIP data, capital goods output noted marginal sequential moderation of 0.3% MoM in January, while infrastructure/constructions goods noted an uptick of 2.7% MoM. Moreover, supporting the nascent signs of revival in investment activity is the improved credit to the large industries. The credit to large industries grew by 0.5% YoY in January and noted a sequential growth of 2.0% MoM (v/s 1.9% MoM in December), and capital raising in the equity market continued.

With respect to the external sector, exports remained resilient, buoyed by robust external demand. India's merchandise export grew by 25% YoY in February and stood ~46% higher than last year's level (Apr-Feb) and ~28% above pre-COVID levels for the same period led by the exports of engineering goods, petroleum, and chemical products. Meanwhile, the increased bill for petroleum and crude oil (growth of 69% YoY) pushed up the imports by ~36% YoY in February, widening the trade deficit to $20.8 bn compared to $17.9 bn in the prior month. The revival of domestic demand, the recent increase in crude oil prices, and slower global growth will likely widen the trade balance in Q4 FY22 and FY23.

Higher oil prices pose downside risks to economic growth



Source: CMIE; Note: Shaded area represents projections. FY23 Base case assumes oil prices averaging at $ 95/bbl while adverse case assumes oil prices averaging at $ 125/bbl

Overall, economic recovery is likely to continue in Q4-FY22 but at a slower pace than in the prior quarter. This follows slower than expected economic growth in Q3 FY22. Real GDP growth moderated to 5.4% YoY in Q3 FY22 from 8.5% in Q2 FY22, and real GVA growth eased to 4.7% YoY from 8.4% over the same period, partly due to the waning of the low base effect from last year. On a sequential basis, the economic growth slowed to 6.4% in Q3 v/s 10.4% in Q2 but jumped to 106% of the pre-COVID level (Q3 FY20) as all the subcomponents were estimated above their pre-COVID levels. On the demand side, real GDP growth was driven by private consumption (aided by festival demand) and exports, while investment and government spending were disappointing, and imports acted as a drag. On the supply side, real GVA growth was driven by services, while agriculture and industry segments noted slower than expected momentum. As per the second advance estimate, the NSO projects FY22 real GDP to grow by 8.9% YoY in FY22 compared to its earlier estimate of 9.2% YoY, partly due to a revision in the FY21 GDP number. With the ebbing of the third wave, the economic recovery gained traction, as discussed above; however, global headwinds could weigh on the pace of economic recovery. We expect economic growth to be around 4.4% YoY in Q4 FY22 and 8.8% YoY for FY22, with downside risks posed by geopolitical tensions.

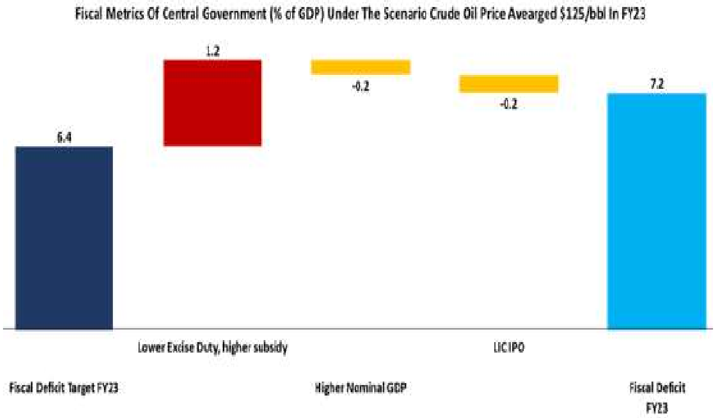
The FY23 economic outlook marred by geopolitical tensions

The ongoing military conflict between Russia and Ukraine has led to increased volatility in the financial markets across the globe. With the global supply disruptions worsening due to the ongoing war, the international commodity prices have surged further, with crude oil prices averaging ~$111 (data till March 21), even touching highs of ~$139/bbl intraday in early March. Given India's high dependence on imported crude oil, rising Brent prices could significantly impact the country's economic recovery. A $10 per barrel (sustained) rise in oil price is estimated to reduce India's real GDP (annual) growth by ~0.2-0.3 percentage points. In the baseline scenario, we assume that Russia's energy exports are disrupted, leading to elevated oil prices in the near term. However, in H2-FY23, the alternate sources of oil supply come through (Iran-nuclear deal, OPEC+ supply response to the current scenario, and release of strategic petroleum reserves), and geopolitical tensions ease eventually leading to a moderation in the oil prices, with the oil prices averaging $95/bbl for FY23. Under this base case, economic growth is projected to be around 7.7% YoY in FY23 (with downside risks). However, growth could slip sharply to around 6.7% if the prices remain elevated, averaging around $125/bbl in FY23. Fiscal and monetary policies remain supportive of economic growth revival in this highly uncertain environment. However, in the following two sections, we discuss how high energy prices amidst the Russia-Ukraine conflict could eat policy space through lower revenues, higher subsidies, and inflationary pressures. The recent development of India buying Russia's crude oil at a discounted price may partly lower the impact from the global price shock, though it remains unclear how much quantity is being planned to be imported from Russia in the coming year.

The government's fiscal position continues to remain favorable in FY22; most of the impact of rising oil prices will be seen in FY23

In FY22, the budget deficit is expected to be around the revised target of 6.9% of GDP despite the likely postponement of the LIC IPO and potential implications from higher commodity prices. This is because revenues collections and projected nominal GDP are likely to be higher than revised estimates, and there is a possibility of underspending. Further, fuel price shock has been absorbed by oil companies instead of the government directly so far in Q4-FY22. The government's fiscal position also remained benign, driven by higher revenue collections and lower expenditures. In the fiscal year (Apr-Jan), the central government's fiscal position remained contained as the fiscal deficit stood at just 59% of its revised estimates, which is an all-time low as per the RBI estimate. This is aided by higher revenue collections, with net tax revenues touching an all-time high of 87.7% of RE in the April-Jan period. Also, the government met 75% of the revised expenditure estimates (v/s 82% of the budgeted estimates during FY16-20). The total CAPEX stood at 73% of its revised target compared to an average trend of 82% of its BE target in the past years on average until January (FY16-FY20). As a result, the government has the space to increase the capital expenditure by 157% YoY in Feb and March, which may not be achieved fully. Consequent underspending and given space of 0.2% of GDP due to a higher than budgeted nominal GDP growth (of 17.6% v/s 19.6% as per NSO), the government will comfortably meet the revised fiscal target of 6.9% of GDP for FY22 despite not meeting the revised divestment target (due to LIC IPO postponement to FY23) and some absorption of the fuel price shock (with the dividend from OMCs likely to be hit).

Elevated oil price, if persisting, will lead to large fiscal slippage in FY23



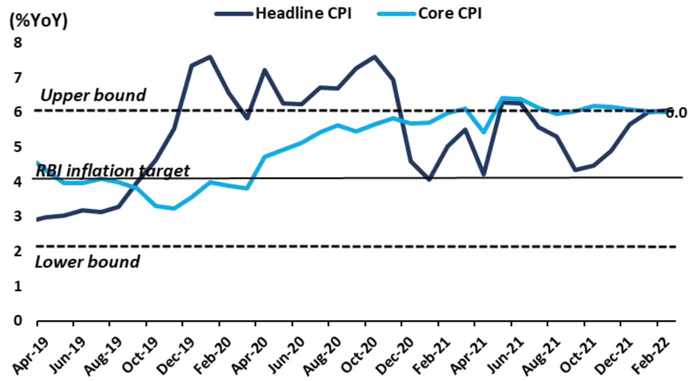
Source: Budget documents, authors' calculations

For FY23, the government has set a fiscal deficit target of 6.4% of GDP. Geopolitical tensions and resultant higher fuel and fertilizer prices are expected to weigh on fiscal arithmetic. A $10 per barrel (sustained) rise in oil price is estimated to widen the fiscal deficit by around 43bps of GDP (if the govt absorbs the price rise fully). After cutting excise duty by Rs5/lt and Rs10/lt on petrol and diesel in Nov '21, the govt has not changed the excise duty. Domestic retail oil and diesel prices have been raised only by Rs1.6/lt in 2022 till March 23, after keeping the prices unchanged since Nov '21. This is despite a ~Rs21/lt rise in the Indian basket oil price since Dec '21 (till early March). Oil marketing companies are absorbing the higher fuel prices for now. In the scenario oil prices remain elevated in FY23, averaging $125/bbl, and the government absorbs half of the price rise and raises fertilizer subsidy, fiscal slippage could be around ~1.2% of GDP. However, the projected higher than budgeted nominal growth (of 11.1% vs projected 13.6%YoY) and postponement of the LIC IPO to FY23 could partly offset the eventual fiscal spillage to ~0.8% of GDP. There is high uncertainty on the exact impact given evolving global prices situation and unknowns of how much the impact the government will absorb on its account. Overall, the government has some fiscal space to absorb the higher global energy price; however, if prices remain elevated, the budget deficit target is likely to be missed without expenditure rationalization. Any fiscal slippage will translate into higher than budgeted borrowing and put pressure on yields.

High energy prices to test the RBI's dovish leaning

Higher commodity prices will also accentuate challenges faced by the RBI in managing multiple goals. Before the start of the war, the RBI faced the challenge of starting the policy normalization process to ward off inflationary pressures while supporting economic recovery and managing the government's large borrowing program. In the last meeting, it maintained a dovish policy stance, prioritizing growth revival over inflationary pressures. It banked on its optimistic inflation projection (of 4.5% YoY in FY23) for a smooth and gradual exit from the pandemic period stimulus. Given underlying inflationary pressures, we believe that inflation is likely to average around 5.4% YoY in FY23 as a pass-through of input costs to final consumers pickup with demand recovery.

Headline inflation stays above the RBI's upper threshold for a second consecutive month in February



Source: CMIE

In February 2022, the retail headline inflation print again came above the RBI's upper threshold, at an eight-month high of 6.07% YoY compared to 6.01% YoY in the prior month. The headline inflation averaged 6.04% YoY in the last two months compared to the RBI's projection of 5.7% YoY for Q4 FY22. A sharp rise in global energy prices in February-March has added to upward pressures for inflation. The signs of surging commodity prices are already being witnessed in the latest WPI print for February, which reversed its declining path and rose to 13.1% YoY in February. Pass-through of higher global energy prices to consumers has not happened so far as the pump prices have been kept largely unchanged. If the elevated global oil prices persist in the coming months, the retail prices will eventually follow the lead unless the government announces a reduction in excise duty.

Given increasing price pressures and the headwinds from the Russia-Ukraine conflict, the RBI thus has a tough job in the upcoming policy meeting in April. It may revisit its growth and inflation projections to account for the latest development. In the recent speech, Deputy Governor Michael Patra signaled that it would not be unreasonable to treat the current fallout between Russia and Ukraine as largely supply shock at this stage. The RBI Governor also assured ample liquidity to support ongoing economic recovery, indicating that the RBI will not rush to tighten monetary policy even if the supply shock causes a temporary jump in inflation. This stance is likely to face strong pressures from the projected rate hikes by the US Fed, existing input costs built-up, and elevated global energy prices. A $10 per barrel (sustained) rise in oil price is estimated to (on average) have a direct impact of 24 bps and an indirect impact of 26 bps on CPI inflation if the govt passes the oil price rise on to consumers. In our base case (with an average oil price of $ 95/bbl and the government absorbing half of the oil price shock), we already see inflation at 5.4% (with upside risks) compared to RBI's projection of 4.5% in FY23. In one scenario, if oil prices increase to $125/bbl on average in FY23 (and the govt absorbs half of the price shock), inflation would cross the RBI's upper threshold, averaging ~6.5% YoY. This could compel the central bank to bring forward the policy rate hike to H1-FY23 (from presently expected H2-FY23) and hike the rates cumulatively by at least 75bps in FY23 (compared to 50bps presently anticipated). This might be complicated by another consideration, i.e. possibility of fiscal slippage and the need for the central bank's support to prevent a jump in yields.

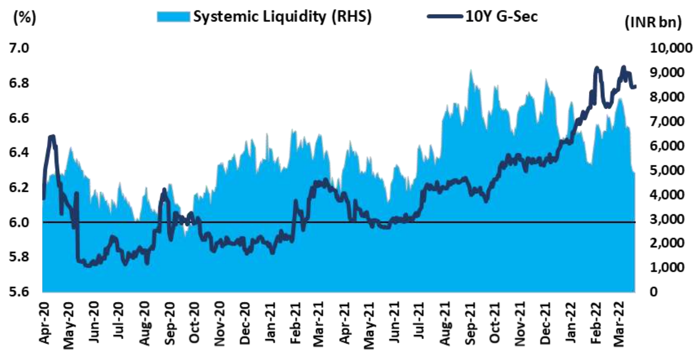
The RBI will also have to manage likely pressures on the currency as higher commodity prices, including oil, will widen the current account deficit (CAD). A $ 10/bbl increase in crude oil prices is estimated to widen the CAD by ~40 bps of GDP. In the base case scenario with oil prices averaging ~$ 95/bbl, the CAD is expected to increase from an estimated 1.6% of GDP in FY22 to 2.3% of GDP in FY23 (with upward risks). Additionally, if oil prices averaged $125/bbl, it could rise to ~3.6% of the GDP. This would put pressure on the rupee even though part of the deficit is likely to be financed by FDIs and external borrowings. However, the war chest of

$622 billion (as of March 11) forex reserves provides the RBI with enough flexibility to intervene in the currency markets.

Market Update

Indian bond market remained highly volatile in February and early March on account of a combination of factors, including higher government borrowings announced in the budget, inflationary pressures, policy normalization by major central banks, delay in India's inclusion in global bond indices, and surging commodity prices due to the ongoing geopolitical tensions. With the announcement of a higher than anticipated government borrowings program for FY23, 10-year benchmark G-sec yield soared to 6.89% by February 3, before cooling off to 6.66% by February 18 as the RBI's dovish stance in the last meeting and the cancellation of the auctions (for February 18) citing the government's comfortable cash position for FY22 provided some relief to the market. However, with Russia's invasion of Ukraine, the global crude oil prices rallied, adding pressure on the bond yields. Accordingly, the bond yields averaged 6.76% in February, compared to 6.61% in the previous month. Moving into March, as the Russian-Ukraine conflict intensified, building further pressure on the crude oil prices, the bond yields inched up further. However, the bond market reacted positively to the news of a tentative peace plan being hatched out between Russia and Ukraine, leading to softening of the crude oil prices. As such, the bond yields eased by ~6 bps to 6.78% on March 21 from an average of 6.84% (average of March with data till March 14). However, the crude oil prices have flared up again (after trading below $ 100/bbl on 15-16 March) to ~$110-$120/bbl, leading to bond yields edging up.

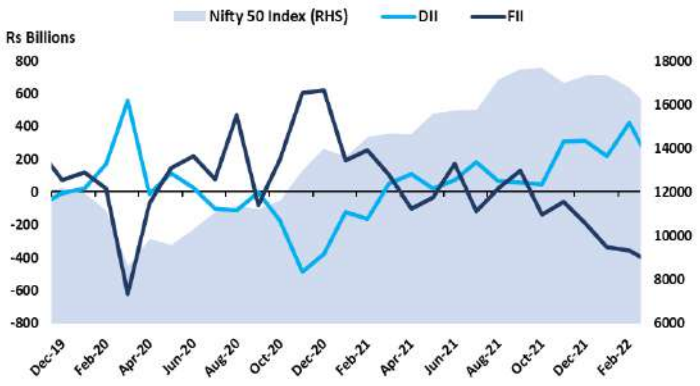
Bond yields recorded volatility, cooling off from highs of early March to inch up again



Source: CMIE, Bloomberg

Indian equity markets went through a major sell-off in February, eroding all the gains of the preceding two months. Global risk-off sentiment amidst geopolitical events and elevated commodity prices drove the markets down. Accordingly, both the benchmark indices – NIFTY50 and SENSEX declined by 3.1% MoM and 3.0% MoM, respectively, in February. Amidst the broader market, the MidCap and SmallCap underperformed the benchmark index, dropping by 5.1% and 8.8%, respectively, in February. While the exodus of the foreign investors continued for the fifth consecutive month, withdrawing ~Rs 355 billion in February, the domestic investors (who invested ~Rs 420 billion in Indian markets) continue to show confidence in India's economic outlook. In line with the global indices, the Indian equity markets surged recently, with both the indices (NIFTY50 and SENSEX) noting gains of 1.9% (data till March 17), drawing confidence from the positive global cues arising from softening of the crude oil prices. With ongoing uncertainty on the global front, we expect volatility to continue in Indian equity markets.

Foreign portfolio investors' exodus continued for the fifth consecutive month



Source: CMIE

The Indian Rupee came under pressure against the dollar as the USD/INR pair depreciated by 0.8% in February to trade at 74.9 levels on average v/s 74.4 in the previous month, amidst outflows in FPIs and widening of the trade deficit as crude oil prices rose sharply. With the Russia Ukraine tensions escalating and oil price touching the highest level since the global financial crisis of 2008 in early March, the rupee fell to an all-time low of 76.92 (intraday crossing 77) on March 7, 2022. However, it recovered some lost ground since, recording an average depreciation of 1.7% (data till March 21). Recovery was noteworthy as it came despite the Fed announcing a rate hike. Easing in the oil prices and the RBI's heavy intervention (indicated by a $9.6 billion drop in its FX reserves to $622 billion by March 11) supported the recovery. We expect the RBI to continue to use its significant FX reserves to curtail sharp currency volatility.

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