21 January 2022

India's economic recovery slows amidst rising headwinds; Near-term outlook clouded with uncertainty from the third wave

- The global economic outlook remains beset by rising headwinds at the start of the year. While the new COVID variant is being considered to be less severe, certain countries have imposed COVID related restrictions, which cloud the near-term global economic outlook.

- After containing the second wave, India is witnessing its third COVID wave with a sharp increase in daily cases. Encouragingly, hospitalization and fatality rate remain low supported by the rapid vaccine coverage that has been extended to the age group of 15-18 years.

- The Indian economic recovery appears to have eased moving into November and December relative to the robust expansion seen during the festive period of October. We expect Q3 FY22 GDP to grow by 6.5% YoY.

- Going ahead, we expect the momentum to moderate further given the restrictions imposed in response to the third COVID wave and impact Q4 FY22 GDP growth by ~60 basis points.

- With the moderation in momentum observed in Q3 FY22 and the expected impact of COVID restrictions in Q4 FY22, we revise our annual growth forecast for FY22 to 9.3% YoY (with downside risks) from 10.5% YoY earlier.

- Government spending remained sluggish in October and November with a contraction in capital expenditure. Government spending is likely to pick up in the coming months with its favourable fiscal position.

- We expect the government to maintain its fiscal deficit target of 6.8% of GDP in FY22. We see downside risks if the LIC IPO were to shift to next fiscal year.

- Going ahead, we expect the government to continue on its path of fiscal consolidation and set a fiscal deficit target in the range of 6-6.3% of GDP in FY23. We expect the government to continue to prioritize its investment led growth strategy ahead.

- Inflation inched higher in December, as the favourable base effect waned, with risks skewed to the upside. However, inflation is likely to remain within the tolerance band of the RBI in Q4 FY22 and provide space to remain accommodative in the near-term.

- We see an increased possibility of the RBI further delaying its policy normalisation to Q1 FY23 given the intensification of the third wave. In the event of a delay, we expect the RBI to continue rebalancing liquidity using its fine-tuning operations and maintain its flexibility amidst the rising uncertainty.

Pramod Chowdhary
Chief Economist
pramod.chowdhary@dmifinance.in

Ashray Ohri
Economist
ashray.ohri@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

www.dmifinance.in

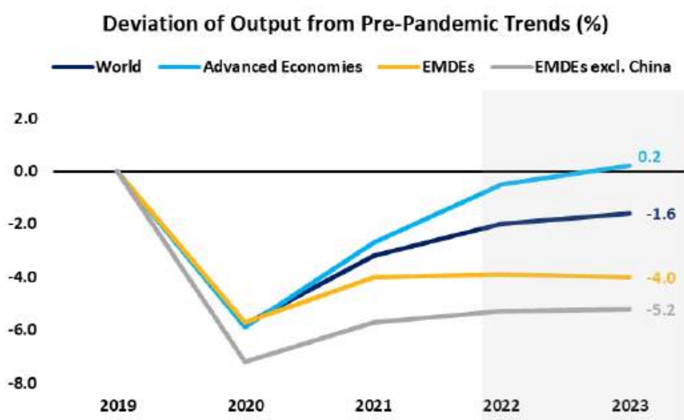
+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

Global economic outlook for the new year beset with older, stronger headwinds

As we set foot into another year, we carry forward the mixed bag of proceeds from the previous one. Even as the global economic activity treads higher, headwinds to the economic recovery have strengthened further. The key risk continues in the form of a new COVID wave (Omicron variant) that towers over the previous waves in terms of its transmissibility, with close to 30 lakh daily cases being reported across the globe (more than three times the previous peak seen in April 2021). However, the silver lining remains its low severity, with the case fatality rate of the new variant at less than 0.4% at present. Nevertheless, countries across the world are resorting to some form of restrictions and containment measures, even though they remain less severe compared to the measures in the previous waves and are weighing on the ongoing recovery. The World Bank recently revised its global growth forecasts downwards by 20 basis points to 4.1% YoY for 2022 (following an estimated 5.5% growth for 2021), owing to the resurgence of the pandemic and its associated disruptions, along with the waning of policy support. Thereafter the World Bank expects global growth to moderate further to 3.2% in 2023. Implicit in the moderation is the uneven impact of the pandemic – which sees advanced economies catching up to their pre-pandemic trend by 2023 due to better vaccine coverage, fiscal cushion, and a stronger return of the investment cycle, while emerging markets and developing economies, on the other hand, are likely to remain ~4% below their pre-pandemic trends. In fact, excluding China, the group is likely to be ~5.2% below its pre-pandemic trends by 2023, as the scarring from the pandemic, exacerbated by a poorer vaccine coverage, and lower fiscal support are likely to weigh on the recovery.

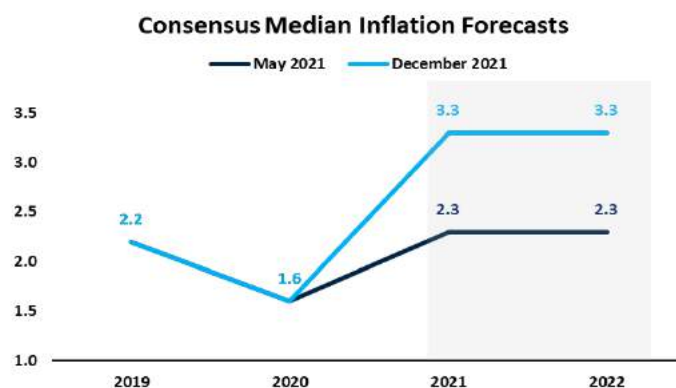
Uneven recovery to the pre-pandemic path among country groups



Source: World Bank; Note – Shaded area reflects forecasts

Even as the impact from the new wave is likely to cut through the global recovery process disproportionately, other headwinds such as rising commodity prices, inflation pressures, and persisting supply side disruptions are likely to impede global economic recovery at least in the near-term. While some moderation in the supply side bottlenecks was noted in December (as seen in the Baltic Dry Index and vendor delivery times and input costs of global PMI surveys), the advent of the new variant is likely to disrupt the nascent improvement again. The median inflation forecasts according to global consensus across economies has increased by 100 basis points to 3.3% for both 2021 and 2022, from 2.3% in the previous release in May 2021 as the demand-supply mismatch pushes prices higher. Responding to the sharp spike in inflation expectations several central banks across the globe have turned more hawkish. The Fed chair announced that the Fed could start shrinking its balance sheet this year itself given the stronger position of the economy, and market participants anticipate more than 3 hikes by the Fed in 2022. Meanwhile, other central banks of economies such as England, Poland, Russia, etc have already started hiking interest rates. Accordingly, financial conditions across the globe have tightened and are likely to further impede the recovery process. Financial market volatility, especially among emerging economies, could further strain the recovery as interest rates reprice and capital outflows take place.

Global Inflation forecasts have picked up across economies



Source: World Bank; Note – Shaded area reflects forecasts

In addition to the low severity of the Omicron variant, there is some added optimism regarding a tentatively shorter cycle of transmission compared to the previous waves. Countries such as the United Kingdom and South Africa that were the primary targets of the new wave are observing early signs of peaking (with cases peaking in less than 4 weeks since its precipitous rise). Countries appear to be operating under this base case for now. However, until a clear tapering of cases is visible across nations, the near-term outlook for the global economy remains uncertain.

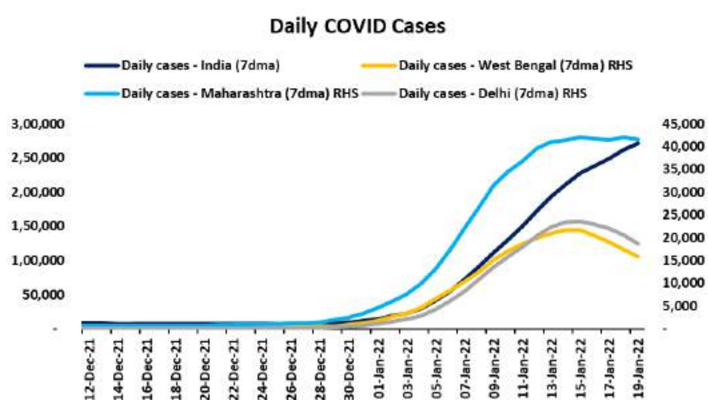
India also plagued with the third wave of the virus

With the emergence of the Omicron variant, India witnessed the third wave of the virus starting end of December. Before

DMI FINANCE

the onset of the third wave, India's daily cases (7dma) were declining gradually from 11.3K in mid-November to 6.6K on December 25. Since then, the daily cases (7dma) have surged to 2.7 lakhs as of January 19, potentially reflecting the higher transmissibility of the variant. The daily positivity rate (7dma) has increased from under 1% to more than 16.2% during the same period. Meanwhile, with the daily active cases outpacing daily recoveries, the active caseload has increased from 1.3 lakhs in mid-November to 19.2 lakhs as of January 19. However, the lower hospitalizations and fatality rate remains the silver lining of the current COVID wave. The fatality rate (7dma) has declined from 3.0% in mid-November to 0.1% at present. While all the states have started witnessing an increase in cases, over 50% of the cases are concentrated in Maharashtra, Karnataka, Delhi, Tamil Nadu, and Kerala. However, tentative signs of peaking out in Delhi, West Bengal, and Maharashtra provide some comfort to the current third wave. Furthermore, the current vaccination pace has also gained momentum with the onset of the vaccination drive for the 15-18 age group and precautionary dose for frontline workers and people aged above 60 years. The daily vaccination pace has increased from 55 lakh doses in mid-November to 72 lakh doses as of January 19. With India having administered over 159 crores of vaccine doses as of January 19, India has managed to inoculate 94% of the adult population with at least a single dose and 71% of the adult population with both doses.

Tentative signs of tapering of cases in few states



Source: CMIE

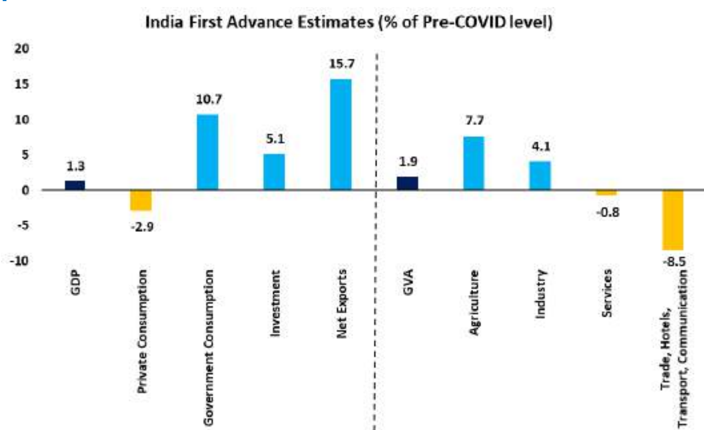
Indian economic recovery loses traction amidst rising headwinds

India's economic recovery continues to proceed, albeit at a slower pace, consistent with the global scenario. India's first advance estimate for the full fiscal year was released by the MOSPI earlier this month, stipulating the growth at 9.2% YoY in FY22. The estimate stands slightly lower than the RBI's forecast (as well as ours), however, it puts India's output back above pre-COVID levels by 1.3% after a contraction of 7.3% YoY in FY21. The recovery (from pre-COVID levels) is estimated to be led by net exports (15.7%), government consumption demand (10.7%), and investment demand (2.6%), while private consumption is estimated to remain below its pre-COVID levels by 2.9% in FY22. From the supply side, the gross value added is expected to surpass its pre-COVID levels by 1.9% in FY22, led by the agriculture sector (7.7%), industry (4.1%), while services remain ~0.8% below pre-COVID levels. Although all sub-components of services have recovered back above the pre-COVID levels, the contact intensive trade, hotels, transport, communication, etc. component remains ~8.5% below pre-COVID levels, highlighting the prolonged stress induced by the pandemic.

The Indian economy caught up to its pre-COVID levels by Q2 FY22, however, the traction thereafter has been interrupted by rising headwinds. The robust festive activity noted during October 2021 (as mentioned in our previous economic monitor report) has been followed by a relatively tepid pace of expansion in the months of November and December, possibly reflecting the waning of pent-up demand. Fiscal support has also been tepid so far in October and November and while we expect a pick-up in government spending in the coming months, the high base from the previous year during the same period is likely to curtail any sizeable, annualized growth rates. In addition, we expect the growth momentum to get further impacted in the final quarter of the fiscal year as states across the country reimpose restrictions to combat the Omicron variant. Around 26 states and union territories have imposed night curfews and/or weekend curfews, along with other containment measures of varying degrees. This is reflected in the Oxford Stringency Index of India that has jumped to ~71.8 since January 3rd, from an average of 42.4 and 51 in November and December respectively (although this is lower than the restrictions during the second wave in May when the index surged to ~82 levels). Consequently, mobility levels have been impacted with the transit station and grocery & pharmacy mobility dropping by ~10ppt and ~9ppt respectively to 3.8% and 38.5% above their baseline levels in H1 Jan 2022 (v/s December 2021), while residential mobility has picked up. Workplace mobility along with retail and recreation mobility that had recovered above their baseline levels for the first time in December 2021 (since March 2020) have fallen back below their baseline levels in the first half of January. Other ultra-high frequency indicators such as electricity consumption also indicate a tapering in pace of growth. Accordingly, based on the early indications, we expect Q4 FY22 GDP growth to be impacted by ~60 basis points, assuming cases peak and restrictions start to ease by around the mid of February. We expect the impact to be lower than the previous waves, given better adaptability, higher vaccine coverage, and milder restrictions in place so far. ***Given the slowing traction in economic recovery***

observed in Q3 FY22 along with the expected disruptions from the Omicron variant in Q4 FY22, we revise our growth forecast for FY22 lower to 9.3% YoY from 10.5% YoY earlier. Moreover, the near-term outlook remains clouded given the uncertainty around the Omicron variant and we see downside risks to our growth projection under a more lasting third wave. For Q3 FY22 we expect GDP to increase by 6.5% YoY.

India's First Advance Estimates indicate output above pre-COVID levels



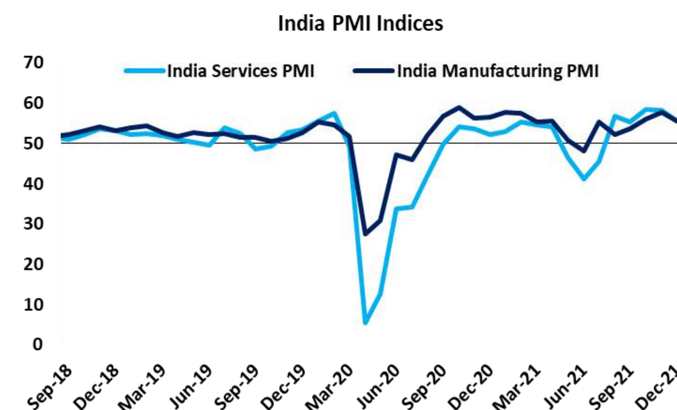
Source: MOSPI

High-frequency data shows a tapering in momentum in Q3 FY22 following the strong start in October

The robust traction in economic activity noted during the festive period in October has been followed by a relatively sluggish pace of recovery in the months of November and December. On the agricultural front, the sector performance remained solid, buoyed by the ongoing rabi sowing and good reservoir conditions. As of January 14, the sowing of Rabi crops was ~1.2% higher than the previous year and was ~6.3% above India's normal rabi acreage, primarily driven by oilseeds. The current live storage in 130 important reservoirs stood at ~70% of the full reservoir level, which was ~12.5% above its decadal average (as of January 13th) and continues to bode well for the sowing season. Moreover, strong agriculture credit along with robust fertilizer sales also pointed towards a positive outlook for the sector. Fertilizer sales increased by 5.3% YoY in December after noting a 3.2% YoY increase in November. Meanwhile, agriculture credit increased by 10.4% YoY in November compared to its past five-year trend of 9% during this period.

In the industrial sector, high frequency indicators pointed towards a waning of the pace of recovery. The Index of Industrial Production (IIP) growth eased to 1.4% in November from 4% in October and fell below its pre-COVID levels by 1.5%. Both manufacturing and electricity production noted a moderation in growth to 0.9% YoY and 2.1% YoY respectively (v/s 3.1% YoY for both in October) and saw their output fall below their pre-COVID levels to 98.4% and 93.7% respectively in November (from 103.3% and 106% in October). There was a broad-based slow down with only 5 of the 23 sub-manufacturing classifications remaining above their pre-COVID levels in November compared to 10 sub manufacturing industries in October that had output above their pre-COVID levels. Mining activity remained resilient as it stood at 103.3% of its pre-COVID levels and noted a sequential expansion of 1.9% MoM. Early signals from other high-frequency indicators point to a continued moderation in momentum in December. The manufacturing PMI eased to 55.5 in December from a ten-month high of 57.6 in November as companies noted a loss in momentum despite strong growth of new work and production. Rising headwinds in the form of input cost pressures continued uncertainty of the pandemic, and supply bottlenecks dampened business sentiments. However, early daily data for electricity generation points towards a marginal uptick of 2.7% YoY on average in December v/s 2.4% average growth in November. Overall, while we expect the recovery in the industry to continue, we believe its pace is likely to be tempered by input cost pressures, supply-side constraints, and disruptions from the most recent COVID wave.

PMI indices suggest a sustained recovery in manufacturing and services albeit at a slower pace



Source: IHS Markit

The service sector indicators indicated a mixed recovery in November and December, after a strong festive month in October. The services PMI remained robust at 55.5 in December (above its long-run average of 53.9), however, it moderated from its previous two months. Service companies reported strong growth of sales and business activity although the rate of expansion moderated along with building price pressures and subdued sentiment due to concerns around another COVID wave. Other high-frequency indicators such as E-way bills and railway freight traffic continued to report robust year-on-year growths, although they saw their pace moderate in November and December respectively. Port traffic noted a contraction of 0.2% in November reflecting the global container shortages

and shipping hurdles. In the aviation sector, both passenger and cargo traffic continued to recover although passenger traffic remained ~12% below its pre-pandemic levels in November, while cargo handled fell to 10% below pre-COVID levels in November (after increasing to 105.5% in October). Encouragingly, credit to the service sector noted a pickup to 3.6% YoY in November, its fastest pace of growth since February 2021. However, going ahead, the incomplete recovery in the service sector could get further hampered by the rising pandemic induced restrictions across the nation.

Early data for November and December suggest slower recovery after the festive period

Consumption Indicators, Index Averaged to 2019										
	Apr-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Oct-21	Nov-21	Dec-21
Google Mobility - Grocery & Pharmacy	-52.0	-2.5	-4.9	9.5	18.5	3.2	32.7	42.8	47.4	47.5
Google Mobility - Retail & Recreation	-81.5	-59.8	-41.9	-27.5	-22.1	-40.4	-13.0	-4.9	-0.4	2.0
Petrol Consumption	51.9	88.9	83.7	101.6	103.1	87.7	87.9	98.3	94.8	102.0
Personal Loans	108.1	107.9	112.8	115.4	123.3	120.7	126.4	128.0	129.3	
Passenger Vehicle Sales	9.8	65.4	102.3	131.3	134.1	90.7	110.9	105.7	110.1	117.9
Two Wheeler sales	23.4	58.5	76.0	105.4	88.3	68.4	67.3	73.3	105.4	84.5
Tractor Sales	8.7	124.9	145.7	144.5	117.3	83.4	68.5	68.1	72.7	86.2
Domestic air passenger traffic	0.0	16.7	33.5	62.0	65.9	25.8	59.1	74.9	89.0	
IIP: Consumer Durables	4.4	63.0	104.0	100.7	107.2	80.7	102.0	104.0	86.0	
IIP: Non-Consumer Durables	49.0	99.5	99.4	108.6	106.0	95.6	99.6	101.2	101.4	

Source: CMIE, Google mobility reports; CY 2019 refers to Jan' 19-Dec'19

From a demand perspective, high-frequency indicators suggested a mixed recovery. Consumption demand indicators remained under pressure with the IIP consumer durables contracting for the third consecutive month on an annualized basis in November, even as consumer non-durables held steady. Compared to pre-covid levels consumer durables fell to 85% of the 2019 average, reflecting the strain in discretionary spending, while consumer non-durables stood at 101.4 % of its pre-COVID levels. Global supply disruptions permeated into the auto sector demand with retail sales of passenger vehicles contracting for the third consecutive month in December (-10.2% YoY vs -17.9% YoY in November). Meanwhile, retail sales for two wheelers and tractor sales contracted more sharply by 19.9% YoY and 40.3% YoY in December respectively, reflecting lackluster rural demand. In contrast, petrol and diesel consumption posted a growth of 4.1% YoY and 1.6% YoY respectively in December, after contracting in the previous month, possibly buoyed by the reduced excise duty, and remained above their pre-COVID levels. Google mobility levels also continued to increase moving into December. All sub-components of mobility moved above their baseline levels in December, with mobility for grocery and pharmacy rising to 47.5% above their baseline levels. Retail & recreation and workplace mobility increased above their baseline levels for the first time on average in December 2021 since the release of the data in February 2020. Retail credit on the other hand continues to remain robust at 11.6% YoY in November, driving overall credit in India. However, consumption demand could remain under pressure if economic activity remained inhibited due to stricter restrictions in response to the pandemic.

With respect to investment demand, our investment index based on the IIP use-based classification (weighted average of capital and infrastructure goods), increased at a modest pace of 1.6% YoY in November v/s 4.2% YoY in October. The IIP infrastructure/construction goods noted a steady growth of 3.8% YoY in November, however, capital goods contracted for the second consecutive month (-3.7% YoY in November). Credit to infrastructure remained healthy at 8.9% YoY and 8.6% YoY in October and November – their highest pace of growth since July 2019. Encouragingly, the new investment projects announced along with investment projects completed for Q3 FY22 increased by 67.8% YoY and 74.1% YoY respectively, according to CMIE data. However, capital expenditure by the central government remained tepid in October (-24.1% YoY) and November (-53.5% YoY), after a strong expansion in the first half of the fiscal year, although state capital expenditure remained robust. Even as investment indicators show continued signs of recovery, they remain below their pre-COVID levels. Accordingly, with the private investment cycle yet to kickstart in a sustained manner, the government will have to spearhead the investment cycle in the interim.

On the external sector, Indian exports continued to maintain their stellar growth, as exports increased to a record high of $37.8 billion in December and clocked a growth of ~39% YoY v/s 34% YoY in November. Accordingly, in the fiscal year so far (April-December), exports stand ~51% YoY higher on track to meet the fiscal year target of $400 billion. Exports have been boosted by both petroleum products (158% YoY FYTD) and non-petroleum products (40.5% YoY FYTD), aided by government incentives and schemes to make Indian manufactured products competitive at a global scale. Meanwhile, Indian imports also kept pace with exports as they increased to their highest ever at ~$59.5 billion in December, clocking a growth of 38.5% YoY vs 56.4% in November. Indian imports have also been increasing steadily with the recovery in domestic demand along with rising commodity prices. Imports of petroleum products increased by 67.9% YoY in December while the non-oil-non-gold component that is a proxy for core demand increased by ~34% YoY in December. Accordingly, with the robust export performance, the trade deficit remained broadly steady in December at ~$21.7 billion and stood ~38% YoY higher compared to 107% YoY increase in the previous month. Nevertheless, on a fiscal year-to-date basis, the

merchandise trade deficit stands ~124% YoY higher (April-December) and is likely to weigh on India's GDP relative to last year.

Government spending expected to pick up in coming months buoyed by higher revenue collections; fiscal deficit target likely to be maintained with downside risks

The central governments' fiscal position continued to remain benign as of November 2021, guided by the robust revenue collections along with a slightly tepid pace of spending by the government. The fiscal deficit stood at just 46% of its budgeted estimates (BE), compared to its past 5-year trend (FY16-20)- where over 100% of the deficit target has been exhausted in the first eight months of each fiscal year. This has provided ample space to the government to carry out additional expenditure (the central government has announced expenditure to the tune of Rs 3.23 lakh crore [1.4% of GDP] in the first and second supplementary demand for grants in FY2022) in the remainder of the year while also possibly meeting its deficit targets for the current fiscal year. The pace of spending by the government remains relatively slow, having met ~60% of its BE by November, compared to the past five-year average of 66% during this period.

The finance minister is scheduled to unveil the budget for the next fiscal year - FY23 and release the revised fiscal numbers for the current fiscal year. We expect the government to maintain its fiscal deficit target for FY22 at 6.8% of GDP, thereby continuing its fiscal consolidation from 9.5% of GDP in FY21. The robust revenue receipts that stand ~66% higher YoY so far (April-November), buoyed by both gross tax collections (50% YoY) and non-tax revenues (80% YoY), is likely to exceed its budgeted target by ~Rs 3 lakh crore in FY22, according to our estimates. We see this getting offset with a shortfall of ~Rs 65,000 crore from the disinvestment target (assuming the LIC IPO goes through by March 2022) and higher expenditure to the tune of Rs 3 lakh crore (assuming some shortfall in achieving the capital spending target). Moreover, the first advance estimate by the MOSPI - stipulates a nominal GDP growth of 17.6% YoY for FY22, which is higher than the GDP growth considered for the budgeted estimate and provides ~Rs 63,000 crores of additional space (0.3% of GDP) towards a higher fiscal deficit. Accordingly, on balance we see the government hold on to its deficit target for FY22. However, we see downside risks if the LIC IPO were to be shifted to the next fiscal year, which is estimated to garner funds of ~Rs 1 lakh crore, in which case the government could miss its deficit target by ~0.3-0.4% of GDP. Under this scenario, we would expect the government to rationalize expenditures and push for higher dividends from public sector units to partially reduce the slippage.

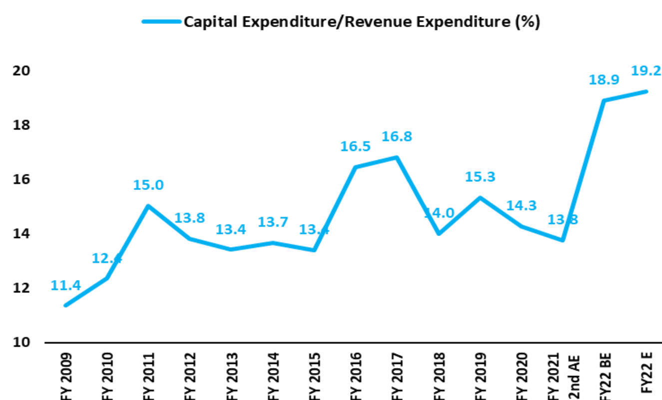
Nevertheless, the strong collections on the revenue front have enabled the government to undertake higher expenditure. If the government is able to achieve the additional ~Rs 3 lakh crore (extra spending in the supplementary demand for grants) over the budgeted target, it would entail higher spending to the tune of 7.3% YoY in the remainder of the year (December-March) and will be the highest government spending at 16.3% of GDP in more than 15 years (barring FY21). Implicit in this is the transition towards a more capital focused spending by the government, with capital expenditure contributing ~2.6% of GDP in FY22. Going ahead, we expect the government to continue its investment led growth strategy. We see a strong focus towards infrastructure building in the economy, which has a high growth multiplier and would be critical in the absence of strong private investment activity so far. According to media reports, a large chunk of this could be channeled towards the transport sector with a ~30% hike in the budget allocation for the ministry of road and transport highways (MORTH). The transport sector has comprised ~1/5th of the total capital expenditure of the central government in recent years and has also seen higher efficiency (for FY22 ~68% of the capital budget estimate for the MORTH has been achieved until November v/s ~49% of capital expenditure target being met overall). Alongside this, we expect the government to continue focusing on its

Fiscal metrics for FY22						as % of GDP					%YoY				
INR bn	FY 2020 A	FY 2021 BE	FY 2021 RE	FY 2022 BE	FY 2022 E	FY 2020 A	FY 2021 BE	FY 2021 RE	FY 2022 BE	FY 2022 E	FY 2020 A	FY 2021 BE	FY 2021 RE	FY22 BE over FY21 RE	FY22 E over FY21 RE
Revenue Receipts	16,841	20,209	15,552	17,884	20,887	8.3	9.0	8.0	8.0	9.0	8.4	3.0	-7.7	15.0	34.3
Net Tax Revenues	13,569	16,359	13,445	15,454	17,787	6.7	7.3	6.9	6.9	7.7	3.0	-0.8	-0.9	14.9	32.3
Gross Tax Revenues	20,101	24,230	19,003	22,171	25,504	9.9	10.8	9.8	9.9	11.0	-3.4	-1.6	-5.5	16.7	34.2
Non Tax Revenues	3,272	3,850	2,107	2,430	3,100	1.6	1.7	1.1	1.1	1.3	38.8	22.9	-35.6	15.4	47.2
Non Debt Capital Receipts	686	2,250	465	1,880	1,250	0.3	1.0	0.2	0.8	0.5	-39.2	87.7	-32.2	304.3	168.8
Total receipts	**17,527**	**22,459**	**16,017**	**19,764**	**22,137**	**8.6**	**10.0**	**8.2**	**8.9**	**9.5**	**5.2**	**7.8**	**-8.6**	**23.4**	**38.2**
Total Expenditure	**26,863**	**30,422**	**34,503**	**34,832**	**37,962**	**13.2**	**13.5**	**17.7**	**15.6**	**16.4**	**16.0**	**9.2**	**28.4**	**1.0**	**10.0**
Revenue Expenditure	23,506	26,301	30,111	29,290	31,834	11.6	11.7	15.5	13.1	13.7	17.1	7.5	28.1	-2.7	5.7
Capital Expenditure	3,357	4,121	4,392	5,542	6,127	1.7	1.8	2.3	2.5	2.6	9.1	21.7	30.8	26.2	39.5
Fiscal Deficit	**9,337**	**7,963**	**18,487**	**15,068**	**15,825**	**4.6**	**3.5**	**9.5**	**6.8**	**6.8**					
Fiscal Deficit % of GDP	**4.6**	**3.5**	**9.5**	**6.8**	**6.8**										

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

flagships measures under Make in India and Atmanirbhar Bharat such as the Production Linked Incentive (PLI) scheme to boost manufacturing performance in India. A greater focus towards enhancing social infrastructure is also expected in the budget with higher allocation for health/medical and education infrastructure. Moreover, renewable energy remains a key focus area of the government and we could see policy measures and incentives to augment investments in this segment.

Share of capital expenditure in overall expenditure notes a sharp increase in recent years



Source: CMIE, India Budget documents

Even as capital focused spending garners traction, we expect the share of revenue spending to moderate in comparison. The capital to revenue expenditure ratio is already expected to increase to 19.2% in FY22, its highest in over a decade and we could see this increase further as government pulls back support and subsidies (government expenditure on food, fertilizer, and petroleum subsidies increased to its highest ever at ~3.3% of GDP in FY21 and is expected to be at 2.3% of GDP v/s 1.5% of GDP in FY22 as per budget estimates) as we hopefully put behind the pandemic behind us. However, we expect the government to continue focusing on some welfare measures with an aim to provide relief to the rural sector that remains impacted by the pandemic. Accordingly, we could see measures targeted towards creating rural jobs and boosting rural income such as higher allocation to the MGNREGA (that could comprise of higher wages), a wider ambit of MSP crops, and a further boost to agriculture credit. The government is also likely to extend the incentives towards affordable housing as it falls short of its target of housing for all by 2022. The budget could also entail some measures to boost consumption demand through boosting the disposable income, by providing relief to taxpayers through raising standard deductions.

Going ahead, we expect the government to continue on its fiscal consolidation path as it has set aside a fiscal deficit target of 4.5% by FY26. For FY23 we expect the government to set the fiscal deficit target in the range of 6-6.3% of GDP. As the pace of nominal growth tapers going ahead, we expect the pace of government spending to also be curtailed. Accordingly, higher revenue collections by the government will be required to stick to the fiscal glide path without compensating for the government expenditure support in the post covid recovery. While the government can continue to rely on its asset monetization path, this channel has consistently missed its targets widely in the past two years. The rising accumulation of some big-ticket divestments such as LIC, BPCL, IDBI Bank, could result in a one-time windfall gain for the government. However, a more sustained source of income could be realized through a higher tax buoyancy. India's gross tax to GDP ratio, even after the robust collections this year, is expected to stand at 11% of GDP, which stands lower compared to international standards. According to the world bank – India's tax revenue to GDP ratio stood at ~12% compared to the global tax to GDP ratio of ~14.9% in 2018. As such we see more scope of augmenting India's tax efficiency. The government has already undertaken actions towards simplifying tax filings, and compliance in the past budgets, and we expect more measures towards this front in the budget. While we may also see a selective increase in GST rates of some products, we would expect some benefits or exemptions on the direct tax front to boost private spending. On the whole, a strong

Expectations from the FY2023 Budget	
Consumption	Higher allocation of MGNREGA and other measures to boost rural income. Food grain subsidy under PM-GKAY. Extending incentives under affordable housing and providing push for housing for all scheme.
Social capital/ Healthcare	Higher allocation towards Medical/healthcare and education infrastructure. Additional allocation towards vaccination for children and booster shots. Provide incentives to private sector to modernise and scale up health care facilities and equipment
Infrastructure	Continued focus on capital led Infrastructure spending under the foundation schemes of the government such as National Infrastructure Investment Pipeline (NIIP) and Gati Shakti. Higher allocation towards transport sectors (MORTH and NHAI) with dedicated spending on projects like Bharatmala, Sagar Mala, high speed rail, etc. Adequate allocation for production linked scheme (PLI) and expansion to more sectors.
Financial sector	Policy initiatives to give impetus and incentives for innovations and greater adoption of technology in banking sector. Continuation of impending privatisation of IDBI Bank and two PSBs. Regulation of cryptocurrencies.
Farm/Rural Sector	Schemes to raise productivity in the agriculture sector. MSP Hike along with wider ambit of crops under MSP. Increase in agriculture credit target along with other schemes to increase farmer income
Bond issuance	Inclusion of Government of India (GoI) securities in global bond indices
Revenues measures	Boost tax buoyancy through higher digitisation and counter-measures for tax evasion. Continued reliance on a sizeable divestment and asset monetisation target.
Renewable Energy	At the COP26 summit - PM Modi announced that the country will install 500 GW of non-fossil energy capacity and meet 50% of energy requirement from renewable sources by 2030. The renewable energy segment remains one of the key focus areas of the government and we could see policy measures and incentives to boost investment, financing under this segment(augment PLI allocation for manufacturing of solar modules, etc)

DMI FINANCE

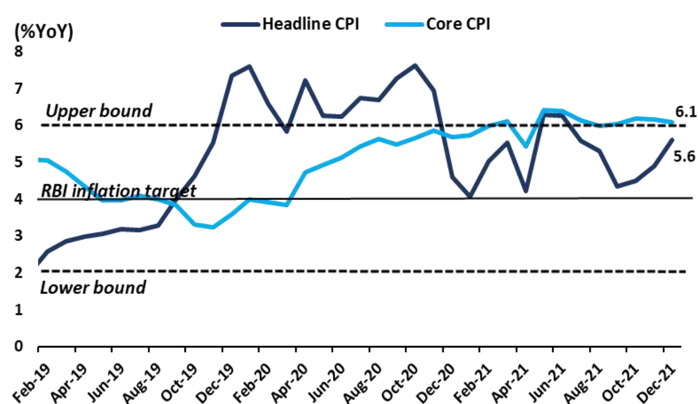
revenue streamlining is required by the government to ensure the dual objective of supporting the economic recovery along with the fiscal consolidation path.

RBI in wait and watch mode amidst economic uncertainty during third COVID wave

Amidst the rising headwinds to domestic growth and the uncertainty of the Omicron variant, the RBI deferred the process of policy normalization in the December meeting and kept key policy rates unchanged. However, the RBI continued to seamlessly manage liquidity, transitioning from the fixed rate reverse repo to the variable rate reverse repo window through higher auctions and across tenors. As per the preannounced calendar, the RBI conducted two VRRR auctions of 14-day tenor in December amounting to Rs 6.5 lakh crore on December 17 and Rs 7.5 lakh crore on December 31, in effect absorbing the entire systemic liquidity through this window (systemic liquidity averaged Rs 7.3 lakh crore in December). Augmenting the 14-day VRRR auctions, the RBI also conducted other fine-tuning operations ranging between 3-7 days maturity and 28-day VRRR to rebalance the liquidity. Carrying this forward into the new year - the RBI conducted a 14-day VRRR auction of Rs 5 lakh crore as of January 14, combined with 6 other finetuning operations ranging between 3-7 days maturity until January 18. Accordingly, short-term rates have continued to creep up. Among the overnight rates, while the weighted average call rate has stayed closer to the reverse repo rate, triparty and market repo rates have inched higher as of January 14. Other money market rates such as term money, 3-month T-bill, CP, and CD have also stayed elevated. Going ahead, we see further pressure on short-term rates as the RBI treads closer towards its path of policy normalization. Following the December policy meeting, we had anticipated a hike in the reverse repo rate in the upcoming February monetary policy meeting. However, with the onset of the third COVID wave, we see an increased possibility of the process of policy normalization getting further delayed to Q1 FY23. In the event of a delay, we expect the RBI to continue rebalancing liquidity using its fine-tuning operations of short-term maturity and maintaining its flexibility amidst the rising uncertainty.

In December, the CPI headline inflation accelerated to a five-month high of 5.6% YoY compared to 4.9% YoY in the previous month led by the waning of the favorable base effect. With this the average for Q3 FY22 stands at 5.0% YoY, marginally lower than the RBI's projection of 5.1% YoY. The recent surge in prices is led by acceleration in food prices and elevated levels of core CPI. Food inflation escalated from 1.9% YoY in November to 4.0% YoY led by an increase in prices of cereals, milk products, etc., as the favourable base effect waned. On the other hand, the core inflation persisted at 6.0% YoY remaining a cause of concern driven by an increase in prices of clothing and footwear, household items, personal care, etc. However, on a sequential basis, the momentum of headline inflation eased from 0.7% MoM in November to a deflation of 0.4% in December led by the correction in food prices. WPI inflation, on the other hand, eased marginally in December to 13.6% from 14.2% in November. Nonetheless, it stayed in double-digits for the ninth consecutive month reflecting the elevated supply-side pressures. While price pressures persist with upside risks in the form of rising input costs and supply side disruptions, inflation is expected to remain within the tolerance band of the RBI in the near-term. As such we see space for the central bank to potentially delay the process of policy normalization amidst the flaring up of cases.

Inflation inched higher with the waning of the favourable base effect; remains within the upper bound of RBI target



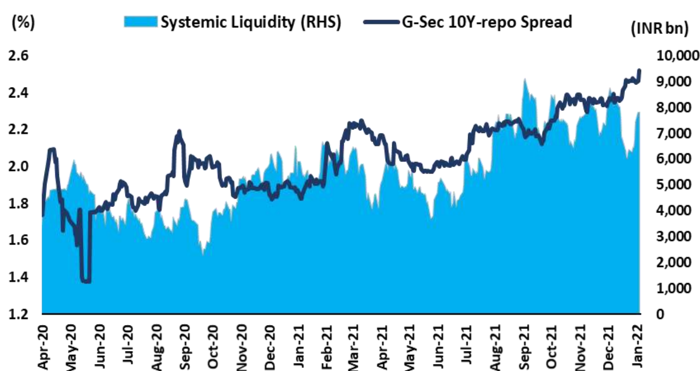
Source: CMIE

Market Section

Indian bond markets continued to remain under pressure in December as most major central banks engendered the withdrawal of their ultra-loose monetary policy stimulus. The RBI also continued on its path of liquidity normalisation even as it delayed its policy normalisation process. The yields on the Indian 10Y G-sec rose to 6.41% on average in December (v/s 6.33% and 6.35% on average in October and November, respectively), taking the quarterly average of yields to 6.37% vs 6.03% and 6.19% in Q1 and Q2 FY22, respectively. This was broadly consistent with the increase in the US 10-year yields that increased by 21 basis points on average in Q3 FY22. Accordingly, capital outflows from FPIs to the tune of ~1.6 billion into Indian debt markets were noted in Q3 FY22 that partially offset the inflows of ~3.2 billion in Q2 FY22. Moreover, elevated oil prices (Brent averaged ~$80/bbl in the December 2021 quarter that was ~8.8% higher on a QoQ basis) have further weighed on domestic yields, which have increased to their highest levels in nearly two years. Meanwhile, the continued absorption of systemic liquidity by the RBI (Rs 7.3 lakh crore on average in

December 2021 vs 7.9 lakh crore in September 2021) along with its management through higher VRRR auctions have gradually moved interest rates higher across the curve. Shorter tenor rates have increased more notably in Q3 FY22 vs Q2 FY22 - with the 1 year and 2-year yields increasing by 37 basis points and 26 basis points respectively on average, while the 10-year yield has increased by 17 basis points on average. Accordingly, the yield curve has flattened with the 10Y-1Yspread reducing by 20 basis points on average in Q3 FY22. Going ahead, we see the pressure on the short-term rates to be relatively higher as we expect a further flattening of the curve. The RBI policy and the financial budget are two major events that are to take place during the first week of February and will have a crucial bearing on the Indian debt markets.

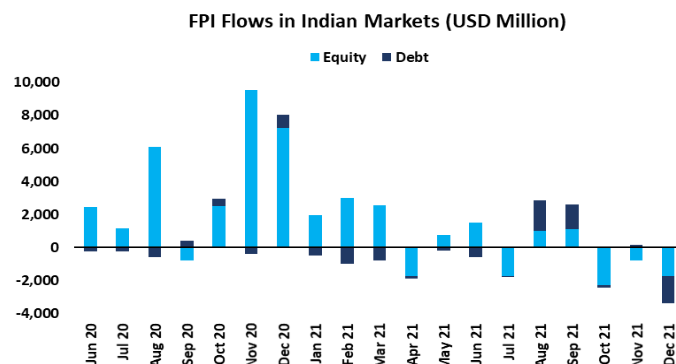
Bond yields increase to the highest levels in two years on the back of liquidity normalization and high oil prices



Source: CMIE, Bloomberg

Indian equity markets rebounded in December, paring losses from the previous month as Indian benchmark indices - NIFTY and SENSEX increased by 2.2% and 2.1% respectively after contracting by 3.9% and 3.8% respectively in November. However, the recovery was partial as Indian indices ended the quarter (Q3 FY22) lower by 1.5% compared to Q2 FY22. Rising headwinds from the risk-off sentiment of the Omicron variant, along with a faster than anticipated normalization of the US Fed policy, continued to result in foreign capital outflows. FPIs withdrew another $1.7 billion from Indian equity markets in December, taking the total outflows in Q3 FY22 to ~$4.8 billion (v/s inflows of $446 million in Q2 FY22). However, domestic investors continued to plough capital in equity markets, with Mutual Funds investing another ~$2.4 billion in December ($6.8 billion in Q3 FY22), its tenth straight month of net inflow. A large part of the rally has been supported by higher participation by retail investors who have increased their shareholding in the companies listed in the National Stock exchange from 6.4% in December 2019 to 7.1% in September 2021 (in value terms). The momentum appears to continue moving into the new year despite the headwinds in the form of rising COVID cases and inflationary pressures. Foreign portfolio investors also seem to have returned ($163 bn inflows based on data until January 13, 2022) in the new year. Indian indices have increased by more than 5% in the new year (as of January 17), with the NIFTY and SENSEX trading near record highs.

Foreign investors continue to pull out capital from Indian markets amidst rising headwinds



Source: CMIE

The Indian Rupee came under pressure in December as it depreciated by 1.2% against the dollar – averaging ~75.4 v/s 74.5 level in November. The domestic currency depreciated by a similar magnitude of 1.2% on a quarterly basis in the final quarter of the calendar year as capital outflows by FPIs persisted for the third consecutive month in December (~$3.3 billion in December and ~$6.4 billion in Q3 FY22 from both debt and equity markets) on the back of a more hawkish than anticipated Fed policy. This was further accentuated by the risk-off sentiment from the resurgence of a new COVID wave across the world. Elevated oil prices along with a burgeoning trade deficit for India (trade deficit increased to a record high of $60.9 billion in Q3 FY22) further weighed on the domestic currency, which depreciated over the 76 handle in mid-December. However, India's performance has been in line with other emerging market peers and better compared to some other currencies such as the Philippines, Brazil, Thailand, etc. that have noted a more sizeable depreciation against the dollar. Moving into the new year the macro-economic backdrop has become more detrimental, with market participants expecting an even more hawkish stance by the Fed in 2022 along with Brent prices scaling to fresh highs in more than 7 years. Amidst this, there has been some support by a halt in the persisting capital outflows by FPIs and modest inflows to the tune of ~280 million until mid-January. RBI intervention has also increased sizeably, with the RBI estimated to have sold dollars to the tune of ~148 billion in the period between 10th-31st December 2021. Accordingly, the rupee has appreciated by ~1.6% on average until mid-January compared to December. However, we could see continuing pressure in the remainder of the year as a more hawkish Fed policy, along with higher commodity prices, weigh on the rupee.

DMI FINANCE

DISCLAIMER

This research report/material (the “Report”) is for the personal information of the authorised recipient(s) and is not for public distribution and should not be reproduced or redistributed to any other person or in any form without DMI’s prior permission.

In the preparation of this Report, DMI has used information that is publicly available as well as data gathered from third party sources. Information gathered and material used in this Report is believed to have been obtained from reliable sources. DMI, however makes no warranty, representation or undertaking, whether expressed or implied, that such information is accurate, complete or up to date or current as of the date of reading of the Report, nor does it assume any legal liability, whether direct or indirect or responsibility for the accuracy, completeness, currency or usefulness of any information in this Report. Additionally, no third party will assume any direct or indirect liability. It is the responsibility of the user or recipient of this Report to make its/his/her own decisions or enquiries about the accuracy, currency, reliability and correctness of information found in this Report.

Any statement expressed as recommendation in this Report is general in nature and should be construed strictly as current opinion of DMI as of the date of the Report and may be subject to change from time to time without prior intimation or notice. The readers of this Report should carefully read, understand and investigate or enquire (either with or without professional advisors) into the risks arising out of or attached to taking any decisions based on the information or opinions contained in this Report. DMI or its officers, directors, personnel and employees, including persons involved in the preparation or issuance of this Report may have potential conflict of interest with respect to any recommendation and related information and opinions.

Neither DMI nor any of its officers, directors, personnel and employees shall be liable for any loss, claim, damage of whatsoever any nature, including but not limited to, direct, indirect, punitive, special, exemplary, consequential, as also any loss of profit in any way arising from the use of this Report or the information therein or reliance of opinions contained in this Report, in any manner.

No part of this Report may be duplicated or copied in whole or in part in any form and or redistributed without the prior written consent of DMI. Any reproduction, adaptation, distribution or dissemination of the information available in this Report for commercial purpose or use is strictly prohibited unless prior written authorization is obtained from DMI. The Report has been prepared in India and the Report shall be subject only to Indian laws. Any foreign reader(s) or foreign recipient(s) of this Report are requested to kindly take note of this fact. Any disputes relating to the Report shall be subject to jurisdiction of Republic of India only.