Acuite
RATINGS & RESEARCH

Macro Pulse Report

February 2023

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Acuité RATINGS & RESEARCH

From the desk of the CAO

Greetings from Acuité Ratings & Research!

This is the **twenty sixth** edition of **Acuité Macro Pulse (AMP)**, our monthly commentary on the global and the domestic economy. As the uncertainties in the global and the domestic economic landscape continue to increase and the linkages become more complex, AMP is one of those publications which sincerely endeavours to unravel those complexities.

Perhaps, there has been no such point in the past three decades except during the global financial crisis in 2008 when the global economy and markets have witnessed turbulence and volatility in such scale as in early March. Global headwinds had started quite some time (actually 3 years) back with the rise of the Covid pandemic in Mar-20 and its domination throughout CY20 and CY21, closely followed by the geo-political crisis in Ukraine in CY22 and the global inflationary pressures that triggered co-ordinated monetary tightening thereafter all over the world. While the pandemic appears to have lost its sting, the conflict in Ukraine has continued to persist for over a year now, keeping the global economy vulnerable to a further escalation of the crisis. The global inflation pandemic which has its roots in the supply chain crisis as well as in the excessively liberal fiscal and monetary policies worldwide induced by the Covid pandemic and the Ukraine war, refuses to subside in a hurry despite strong doses of rate hikes and quantitative tightening by all the key central banks in the world except that of Japan and China. The side effects of the strong doses administered in the respective economies, however, have started to be visible. The sharp i.e almost 5% hike in the interest rates in US and the consequent drop in bond prices have already impacted the banking sector particularly those with higher ALM risks. The Federal Reserve has to come to the rescue of the distressed banks and provide backstop insurance to all the outstanding deposits. Nevertheless, the contagion risks clearly exist and has already shown its impact in Europe, where a vulnerable Credit Suisse had to be hastily merged with UBS. While it is still a far cry from the GFC of 2008, market participants have already termed it as a "mini banking crisis".

Clearly, such a treacherous and murky global economic landscape doesn't promise an auspicious start to the new fiscal 2024. One aspect which is apparent though is that the theme of "higher for longer" is set to play out for both retail inflation and interest rates. Despite the turbulence in the banking sector, three major central banks – Fed, ECB and BoE have already hiked rates in the current month and have not provided any clear indication that they are over with such hikes. In our view, the stance is unlikely to be different at this stage in the case of RBI MPC when they convene in early April. Not just the headline CPI inflation which saw a fresh spurt to around 6.5% in Jan-Feb'23 due to a cereal induced fresh bout of food inflation but core inflation also continues to be well entrenched at 6%+ levels. Not to speak about the "risk-off" theme in the global markets which increases the vulnerabilities on the currency front. In our opinion, a 25 bps hike in April is on the cards and it may be also a challenge for the MPC to announce a "pause" given the current environment.

Such persistent headwinds notwithstanding, the steady momentum in domestic economic momentum is encouraging. The latest print of **Acuité Macroeconomic Performance index (AMEP index)** in Feb-23, translates into a YoY growth of 5.9% and 2.0% MoM. We can still aim for a GDP growth of 6% in the coming fiscal if weather Gods are supportive.

Cheers,

Suman Chowdhury
Chief Analytical Officer

Growth

FY24 growth: Pulls and pressures

KEY TAKEAWAYS

- The overall state of the Indian economy continues to remain healthy, though several lead indicators have seen pace of growth coming off marginally at the start of the year in the background of increased global headwinds through the ongoing banking crisis in US and Europe.
- Nevertheless, optimism can be drawn from the possibility of a milder global economic slowdown or a "soft landing" anticipated in 2023. Adding to the momentum, closer home, Union Budget for FY24 reinforced Government's commitment towards capital investments, via an outlay of Rs 10 tn in FY24.
- For FY24, risks to domestic growth emanate from the impending slowdown in global demand and trade, along with a moderation in urban consumption as pent-up demand wanes and transmission of cumulative past rate hikes transpires with a lag.
- There is yet no clear sign of an uptick in the private sector investment cycle amidst heightened global uncertainties.
- Recovery in rural consumption and continued focus of the Government on capex should prove supportive of growth, but not enough to offset the global headwinds.
- Additionally, risks are emerging on the stability of the monsoon in the current year, given the forecast of "El Nino"; needless to say, any adverse weather conditions during the kharif season will have an impact on agricultural output.
- As such, we continue to hold on to our view of GDP growth moderating to 6.0% in FY24 from 7.0% (NSO's estimate) in FY23.

The overall state of the Indian economy continues to remain healthy, though several lead indicators have seen pace of growth coming off marginally at the start of the year. The global environment has turned further uncertain and turbulent with the failure of regional US banks and the merger of Credit Suisse with UBS in Europe. Nevertheless, optimism can be drawn from the possibility of a milder global economic slowdown anticipated now in 2023. The IMF, in its Jan-23 World Economic Outlook upgraded 2023 GDP growth by 20 bps to 2.9% - to mark the first upward revision to growth in past one year. Adding to momentum, closer home, Union Budget has reinforced Government's commitment towards capital investments, via an outlay of Rs 10 tn in FY24, translating into 3.3% of GDP – a two decade high.

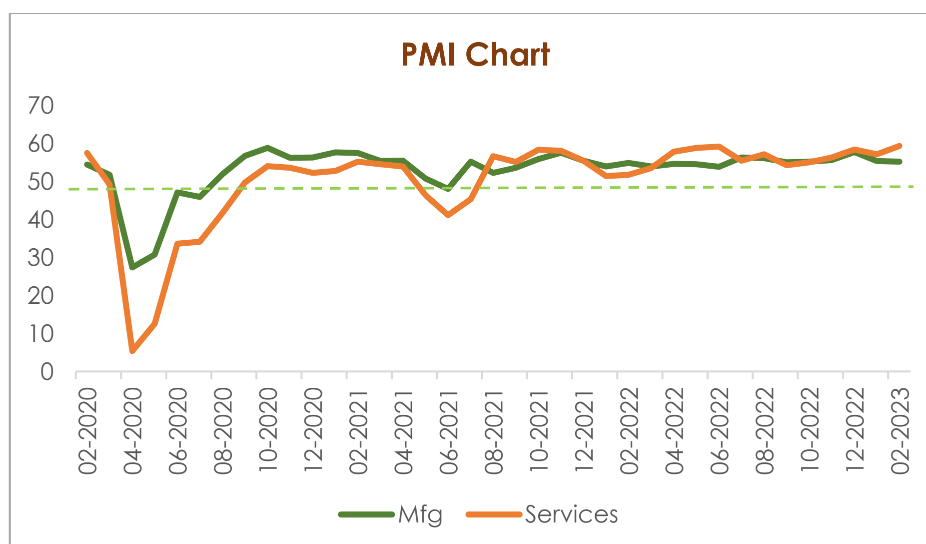
Recent data releases

After remaining resilient over the month of Nov-22 and Dec-22, with many high frequency lead indicators touching new peaks, incremental data for Jan-23 has seen a marginal loss of momentum across most indicators of domestic economic activity. While overall, state of economy continues to remain healthy, the sizeable sequential dip in exports in Jan-23 and Feb-23 is a harbinger of the impact of an impending slowdown in trade volumes in the wake of slowing global demand anticipated in 2023.

- India's GDP growth decelerated sharply to 4.4% YoY in Q3 FY23 from 6.3% YoY in Q2, performing weaker than market expectations which were closer to 5%. The downward slide in headline growth was primarily due to waning of favorable statistical base effect, the contraction in the manufacturing and the export sectors along with the lack of strength in domestic consumption demand. Sequentially, we note that the GDP expanded by a robust 3.5% QoQ, better than the pre pandemic average (over a 5-year period) of 2.1% QoQ observed in Q3. Services activity continues to outperform industrial activity and the run-rate for investment growth remains healthy, supported by capex-oriented government spending.
- The trajectory of **Acuité Macroeconomic Performance index (AMEP index)** in Feb-23 highlights that domestic demand has remained largely resilient in the current fiscal despite the increased global headwinds. The index print, adjusted for the shorter duration of the month of February, stood at 127.3 which translates into a YoY growth of 5.9% and 2.0% MoM. A moderate upward momentum in the index is visible after the sluggishness in the past few months although its sustainability will need to be seen going forward.
- India's industrial activity rose to 5.2% YoY in Jan-23 from 4.7% in Dec-22, marginally beating market consensus. Sequential momentum in IIP was moderately strong at 0.8% MoM in Jan-23, building on the 5.7% MoM expansion recorded in the previous month, and broadly in line with the average expansion of 0.7% MoM usually seen in the month of January.
- Gross GST revenue collections in Jan-23 (i.e., for transactions in Dec-22) rose to the second highest level on record of Rs 1.56 Lakh Cr compared to Rs 1.49 Lakh Cr in Dec-22. However, it has seen a sequential drop again to Rs 1.50 Lakh Cr in Feb-23 which still translates into an annualized growth of 12.4%.

- Headline PMI manufacturing index slipped to a 4-month low of 55.3 in Feb-23 from more than a 2-year high of 57.8 in Dec-22 owing to slower increase in sales and output.
- On the other hand, Services PMI rose sharply to 59.4 in Feb-23 after slightly slipping to 57.2 in Jan-23. New businesses continued to rise led by domestic order, as international orders saw a marginal fall.
- As such, Composite PMI Output Index fell slightly from near 11-year highs of 59.4 in De-22 to 59.0 in Feb-23, but remained well above its long-run average (54.1)
- E-way bills generated eased from a record peak of 8.4 Cr in Dec-22 to 8.2 Cr in both Jan-23 and Feb-23.
- Merchandise exports moderated to a 3-month low of USD 33.9 bn in Feb-23 from USD 38.1 bn in Dec-22. On an annualised basis, exports contracted by 2.0%YoY in Feb-23. Sequential moderation in exports for the last two months was predominantly on account of Machinery Items, Chemicals, Agri & Allied Products, and Electronic Goods.
- Credit growth of scheduled commercial banks continued to remain robust, clocking a growth of 15.5%YoY in the fortnight ending Feb 24, 2023 compared to 9.1% as of Feb-22.

Chart 1: Both Manufacturing and Services PMI display resilience



Outlook

Economic factors that have shaped the recovery in FY23 include strength in urban consumption in the festive season, strong pace of Government expenditure along with a moderation in non-food retail inflation.

Looking ahead, despite global growth outcomes likely to fair better than anticipated a few months ago, the world economy nevertheless is poised for a slowdown. The impact of moderation in trade volume growth to 2.4% in 2023 from 5.4% in 2022 (IMF estimates) is likely to have an impact of India's exports. Growth of merchandise goods, driven by manufacturing goods, is already on a downtrend over the last 3-4 months.

Strength in monthly net services exports consistently between USD 13-15 bn over the last three months, offer comfort.

Among other drivers of growth, pace of private capex recovery could remain somewhat sluggish and uneven amidst global uncertainties. Urban consumption, which is still performing relatively better, is likely to show fatigue (especially for goods) as pent-up demand wanes and transmission of cumulative past rate hikes by RBI is completed. Some cushion may come from rural demand amidst improvement in cash flows post Rabi season unless it is offset by adverse weather conditions. The uptick in Q3 FY23 production and sales of tractors is a good lead indicator for the same.

Anticipated recovery in rural consumption and strength in Government capex notwithstanding, we continue to anticipate GDP growth to moderate to 6.0% in FY24 from 7.0% (NSO's estimate) in FY23.

Chart 2: Recent improvement in tractor sales bodes well for a broader rural recovery

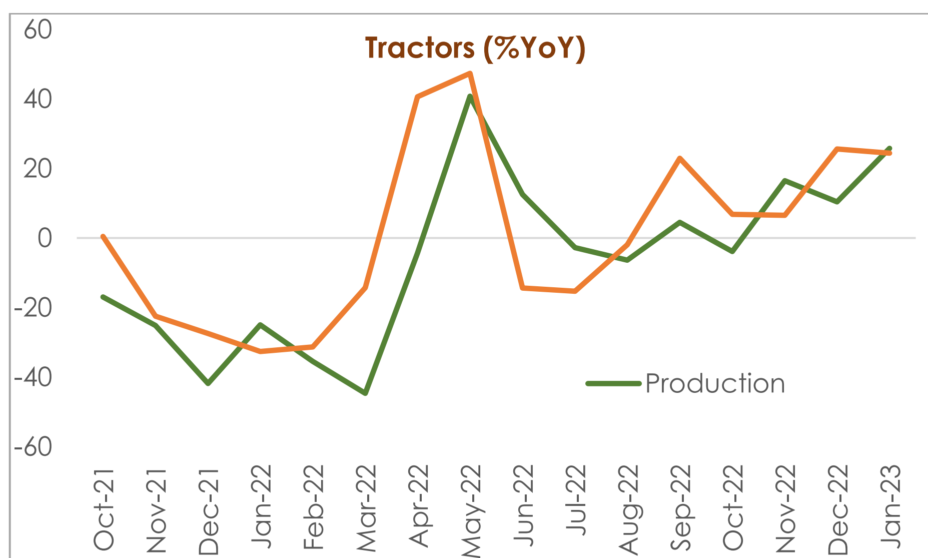
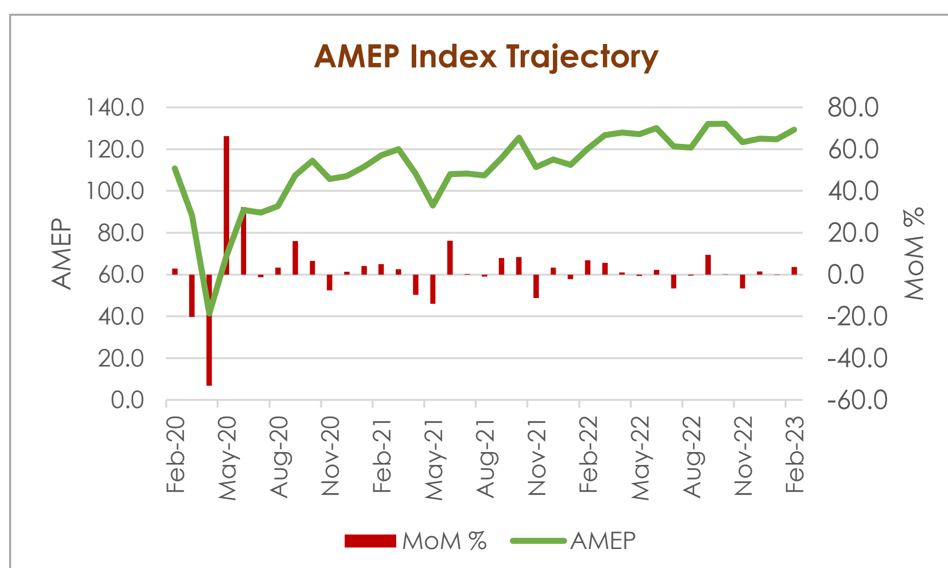


Chart 3: AMEP Index continues to reflect economic resilience



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Inflation

Uncomfortable trend reversal in retail print

KEY TAKEAWAYS

- India's inflation at retail and wholesale level diverged in Jan-23 and Feb-23. While the CPI print rising to 6.52% YoY (3-month high) and marginally moderated to 6.44% YoY in Feb-23, WPI continued to ease to 4.73% YoY and 3.85% YoY(25-month low) respectively in these two months.
- Notwithstanding the divergence at headline level, both inflation metrics depicted a rising sequential momentum. While CPI rose by 0.46% on MoM basis, WPI posted a relatively smaller increase of 0.13% MoM in Jan-23. Further, a sequential momentum of similar magnitude seen in Feb-23 as well- WPI rose by 0.20%MoM while CPI posted a relatively smaller increase of 0.17%MoM.
- The upside in CPI inflation in Jan-23 was led predominantly by heavy-weight Food and Beverages index, which rose by 0.45% MoM to defy the series average contraction of 0.76% MoM usually seen in January. However, the F&B index fell slightly by 0.06% MoM in Feb-23.
- Concerns on core CPI inflation continue to persist, with strong momentum seen in both goods and services pushing core inflation to match headline inflation in Jan-Feb'23.
- The strong upside surprise in the CPI print of the last two months could potentially result in Q4 FY23 inflation coming in above 6.0%, significantly higher than RBI's estimate of 5.7%.
- Looking ahead, in the base scenario, lower commodity prices (food and non-food) vis-à-vis average levels in 2022 in the absence of any significant weather factors and moderation in domestic growth impulses are likely to allow non-core inflation to gradually moderate in FY24.
- However, taking on board the likelihood of core inflation facing downward rigidity as it displays higher persistence, we continue to maintain our FY24 CPI inflation forecast of 5.3%.

Overview

India's inflation at retail and wholesale level diverged in Jan-23 with the CPI print rising to 6.52% YoY (3-month high) and WPI easing to 4.73% YoY. A similar trend has been seen in Feb-23 with a print of 6.44% YoY for CPI and 3.85% YoY (25-month low) for WPI respectively. More importantly:

- Notwithstanding the divergence at headline level, both inflation metrics depicted a rising sequential momentum– while CPI rose by 0.46% on MoM basis in Jan-23, it moderated to 0.17% in Feb-23; for WPI, it was 0.13% and 0.20% MoM respectively.

Key highlights of CPI inflation

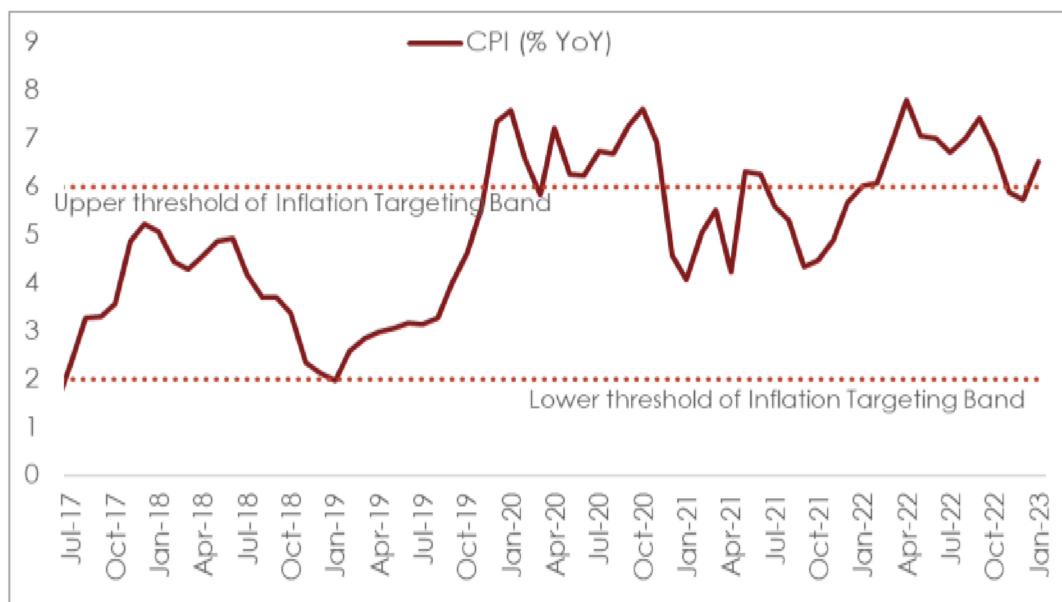
- CPI inflation for the month of Jan-23 and Feb-23 surprised market expectations that has been expecting a progressive moderation of the headline print, by a wide margin.
- The upside in Jan-23 was led predominantly by heavy-weight Food and Beverages index, which rose by 0.45% MoM in Jan-23 to defy the series average contraction of 0.76%MoM usually seen in January but as a relief, it contracted slightly by 0.06% in Feb-23. Within food, the upturn was led by Cereals (2.72% MoM in Jan-23 and 0.75% MoM in Feb-23), Spices (1.56% MoM and 0.53%) and Milk (0.58% and 0.92%). On the other hand, price pressures were seen sequentially easing in the case of Vegetables (-3.75% and -2.53%), Edible Oils (-0.69% and -1.71%), and Sugar (-0.57% and -0.58%).
- At a broader level, acceleration in food inflation was driven by non-perishables, which rose to over a 9-year high of 9.5% YoY in Jan-23, with prices of Spices, Cereals, Milk, and Eggs continuing to march ahead at an elevated pace. However, with good rabi sowing and a normal monsoon in the base scenario, upside risk to food inflation could get neutralized.
- The jump in CPI was also led by the sub-indices of Housing (0.82% MoM in Jan-23 and 0.81% in Feb-23) and Miscellaneous (0.47% and 0.41%). Within Miscellaneous index, the upsurge was led by Personal Care and Effects (10-month high of 1.59% MoM followed by 0.73% MoM in Feb-23), Health (0.66% and 0.60%), and Household Goods and Services (0.46% MoM in both the months). On an annualized basis, this pushed core inflation (CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) to 6.5% YoY in Jan-23/Feb-23 from 6.3% YoY in Dec-22.
- Consolidated fuel prices remained unchanged on both sequential (0.0% MoM) as well as annualized basis (8.5% YoY).

Key highlights of WPI inflation

- WPI inflation moderated to 4.73% YoY in Jan-23 and 3.85% YoY from 4.95%YoY in Dec-22 on account of favorable statistical base, even as the index rose sequentially.
- The incremental gain in Jan-23/Feb-23 was led predominantly by the Consolidated Food & Beverages index that rose by 0.59% MoM.
- As a comfort, the Consolidated Fuel index declined by 1.34% MoM in Jan-23.

- Core WPI (WPI ex indices of Primary: Food, Mfg: Food, Mfg: Beverages, Fuel & Power, and Primary: Crude Petroleum & Natural Gas) moderated to a 27-month low of 2.14% YoY in Feb-23 from 2.80% YoY in Jan-23 and 3.15% YoY in Dec-22.

Chart 1: CPI inflation once again breached RBI's band in Jan-23 and Feb-23



Outlook

The jump in Jan-23 CPI inflation and its persistence in Feb-23 has been a huge negative surprise. At 6.4%-6.5%YoY, it not only reversed the moderation seen in retail inflation over the months of Nov-22 and Dec-22, but once again breached RBI's tolerance band. It is likely that the Jan-23 print pushes Q4 FY23 CPI inflation well above 6.0%, higher than RBI's projection of 5.7%. In addition, it could potentially result in full year inflation averaging at 6.7%, i.e., 20 bps higher than our's and RBI's estimate of 6.5%.

While the food price pressures were broad-based in the last two months, there is a silver lining, given the slight sequential contraction in Feb-23. Juxtaposed with lower global food prices vis-à-vis average levels in 2022, moderation in domestic growth impulses, assumption of a normal monsoon in CY23, and a healthy rabi output (cultivation ended with 3.3% increase in acreage over the previous sowing season), food price pressures can likely ease in FY24. Having said so, we will remain watchful of strength and distribution of Southwest monsoon, amidst early signs of a possible El Nino phenomenon developing in later summer months of 2023.

Global commodity prices continue to remain ranged, with CRB index averaging at 294 in Feb-23 vs. 296 in Dec-22 and may have dropped further in Mar-23, despite milder slowdown anticipated in global growth and opening up of China. Expectation of slowdown in global growth could continue to keep most commodity prices at a somewhat lower level in 2023 vis-à-vis 2022.

Taking the outlook on food and fuel (non-core) on board, along with expectation of core inflation facing downward rigidity, we continue to maintain our FY24 CPI inflation forecast of 5.3% in the base scenario.

Chart 2: Significant WPI inflation moderation, only slight drop for CPI inflation

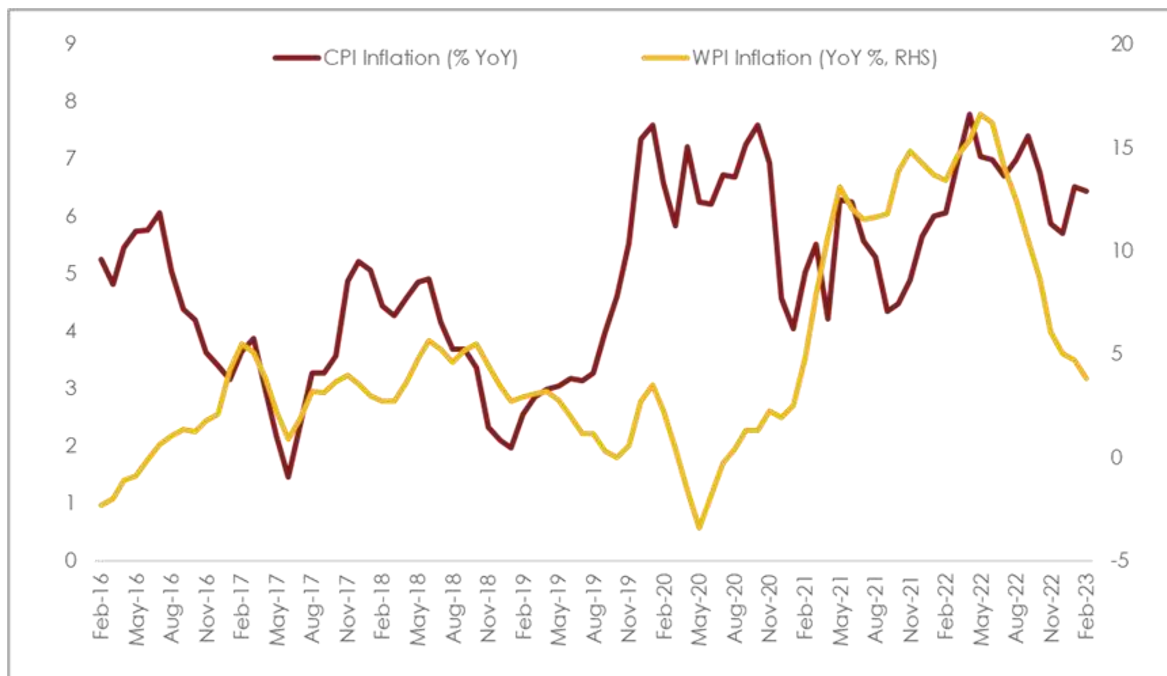
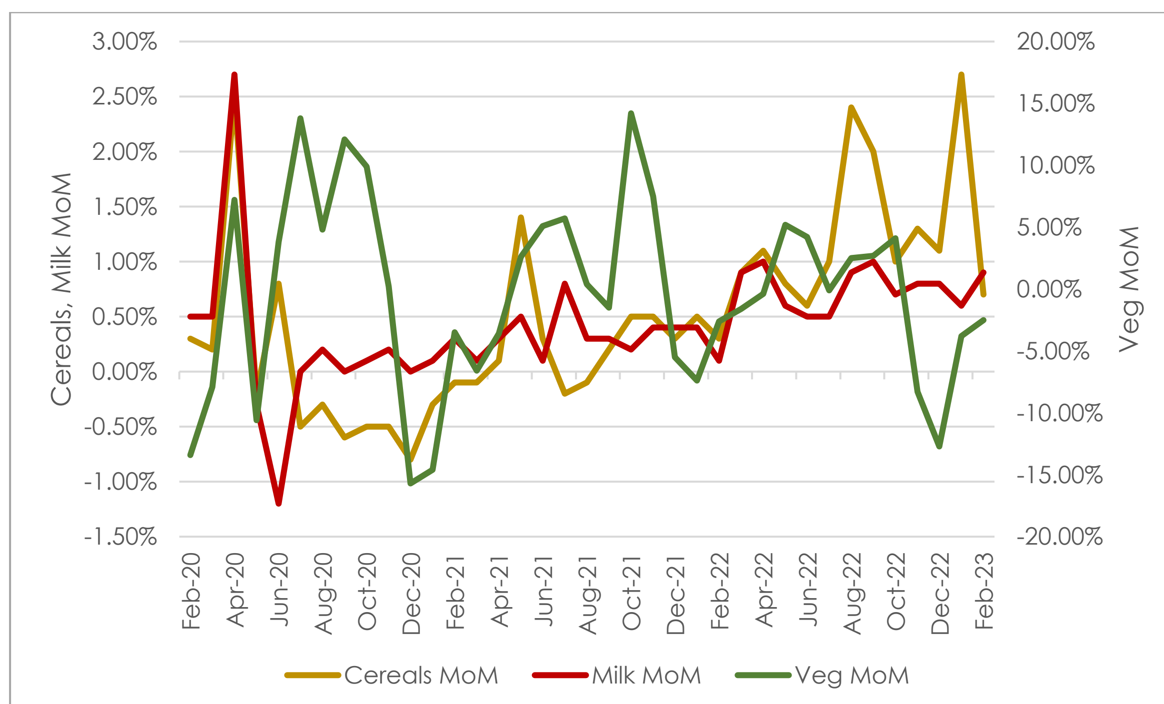


Chart 3: Categories shaping food inflation



Government Finances

FY23 deficit target retained

KEY TAKEAWAYS

- As per revised estimates and in line with expectations, the central government retained its FY23 fiscal deficit target at 6.4% of GDP in the Union Budget.
- Healthy tax buoyancy and higher than budgeted nominal GDP base is expected to help the government offset the overall slippage in FY23 expenditure.
- With respect to funding, FY23 saw provision for additional funding via T-Bills (Rs 500 bn), other receipts (Rs 429 bn), small savings (Rs 135 bn), and external loan (Rs 46 bn).
- Latest fiscal information reveals that central government fiscal deficit for the period Apr-Jan stood at 67.8% of RE for FY23, higher than the level of 59.1% of actuals in the corresponding period in FY22.
- The FYTD fiscal theme continues to rest upon strong tax collections and prioritization of capital over revenue expenditure.
- For FY24, the Union Budget has lowered the target for fiscal deficit to 5.9% of GDP and as part of the fiscal consolidation measures, aims to bring the levels below 4.5% by FY26.
- Prima facie, the budget arithmetic appears credible with reasonable assumptions on receipts, expenditure, and nominal GDP. Encouragingly, the thrust on capex saw an increase with continued emphasis on railways, roads, and defence.
- Overall, we expect the headline fiscal deficit target for FY24 to be met with risks appearing neutral at this stage.

The Finance Minister presented the FY24 Union Budget on the usual Feb 1, 2023. As expected widely, the Budget retained its fiscal deficit target for FY23 at 6.4% of GDP. For FY24, the Budget displayed a fine balance between fiscal retreat and increased thrust on quality of growth. Continuing on its path of moderate fiscal consolidation, the FM announced a 50-bps reduction in fiscal deficit ratio to 5.9% in FY24 (for a detailed discussion, please refer to our note on FY24 Union Budget https://www.acuite.in/pdf/Union_Budget_Feb-2023.pdf). Compression in FY24 fiscal deficit is expected to be driven by reduction in revenue expenditure ratio (primarily on account of lower subsidy bill) and a marginal increase in non-tax revenue ratio.

Focusing on the current year, incremental information reveals that central government fiscal deficit for the period Apr-Jan stood at 67.8% of revised estimates (RE) for FY23, higher than the level of 59.1% of actuals in the corresponding period in FY22. The relatively higher accretion to fiscal deficit this year reflects moderation in the pace of realization of receipts even as expenditure disbursal remains somewhat higher than last year's momentum.

Receipts: Both tax and non-tax revenues providing support

At a cumulative level, total receipts in the first ten months of FY23 have started to trail last year's momentum.

- On FYTD (Apr-Jan) basis, gross revenue receipts clocked 81.7% of RE, slightly lower than 84.8% of actuals in the corresponding period in FY22.
    - Although cumulative tax collection momentum remains strong, there has been some moderation in momentum of late. Annualized growth in gross tax collection moderated from 22.4% in Q1 FY23 to 13.7% in Q2, followed by a further drop to 4.5% in Q3.
    - The impressive momentum in GST revenue collection continues to persist with total monthly collections averaging at Rs 1.50 tn during Apr-Feb FY23 vis-à-vis Rs 1.21 tn average seen in the corresponding period in FY22.

Non-tax revenue collections accelerated to 88.2% of RE during Apr-Jan FY23 from 83.6% of actuals in the corresponding period in FY22. Pick-up in dividend pay-out from PSEs along with support from telecom spectrum revenue in the current year has managed to offset the drag on account of lower dividend transfer from the RBI in the current year.

Non-debt capital receipts clocked 68.5% of RE during Apr-Jan FY23, lower than the level of 83.1% of actuals in the corresponding period in FY22. The government realized a moderate Rs 27 bn from IRCTC OFS in Dec-22 but at an overall basis, the pace of disinvestment has been particularly low in the current fiscal.

Expenditure: Superior quality of spending being maintained

On FYTD (Apr-Jan) basis, total expenditure disbursal stood at 75.7% of RE, higher than 74.0% of actuals in the corresponding period in FY22.

- Capital expenditure clocked 78.3% of BE during Apr-Jan FY23 vis-à-vis 74.5% of actuals in the corresponding period in FY22. Bulk of this was incurred on defence, railways and urban housing. In addition, to facilitate capex by states,

the FY23 Union Budget had made provision for disbursing Rs 1.1 tn as interest-free loans to states with attached conditionalities for targeted spending. In this context, we note that loans disbursed under central government's capex grew by a whopping 106.0% YoY during Apr-Dec FY23 vis-à-vis a contraction of 60.6% in the corresponding period in FY22.

- Revenue expenditure too firmed up to 75.1% of RE during Apr-Jan FY23 from 74.0% of actuals in the corresponding period in FY22.
    - Interest payments and subsidies have accounted for 44.3% of revex disbursals in 9-months of this fiscal.
    - Excluding interest payments and subsidies, revex grew by a modest pace of 0.4% YoY during Apr-Dec FY23.

Outlook

As highlighted in our last month's edition of Acuite Macro Pulse, despite the prevalence of fiscal headwinds, the central government has used available levers (including buoyant tax collections) to ensure adherence to FY23 fiscal deficit target of 6.4% of GDP.

The RE for FY23 outlined by the Finance Minister in the Union Budget document is expected to be met. Few notable highlights from the same include:

- Increase in target for gross tax revenue by Rs 2.85 tn compared to BE, with bulk of the upward revision coming from higher collections from corporate tax, income tax, and GST, even as collection from customs and excise duty saw a minor downward revision.
- Non-tax revenue saw a minor downward revision of Rs 79 bn on account of lower realization from dividends and profits.
- Target for divestment got pruned to Rs 500 bn from Rs 650 bn in BE.
- Total expenditure got revised up by Rs 2.42 tn in account of higher outlay for revex. Meanwhile, allocation for capex saw a minor downward revision by Rs 220 bn.
- In value terms, the RE for fiscal deficit got revised up by Rs 981 bn. However, the fiscal deficit ratio remained unchanged at 6.4% of GDP on account of the higher than Nominal GDP vis-à-vis BE (as per NSO's first advance estimate, the Nominal GDP is projected to grow by 15.4% in FY23, significantly higher than the initial budgeted assumption of 11.1% - this generated additional fiscal buffer of ~30 bps).
- With respect to funding, FY23 saw provision for additional funding via T-Bills (Rs 500 bn), other receipts (Rs 429 bn), small savings (Rs 135 bn), and external loan (Rs 46 bn).

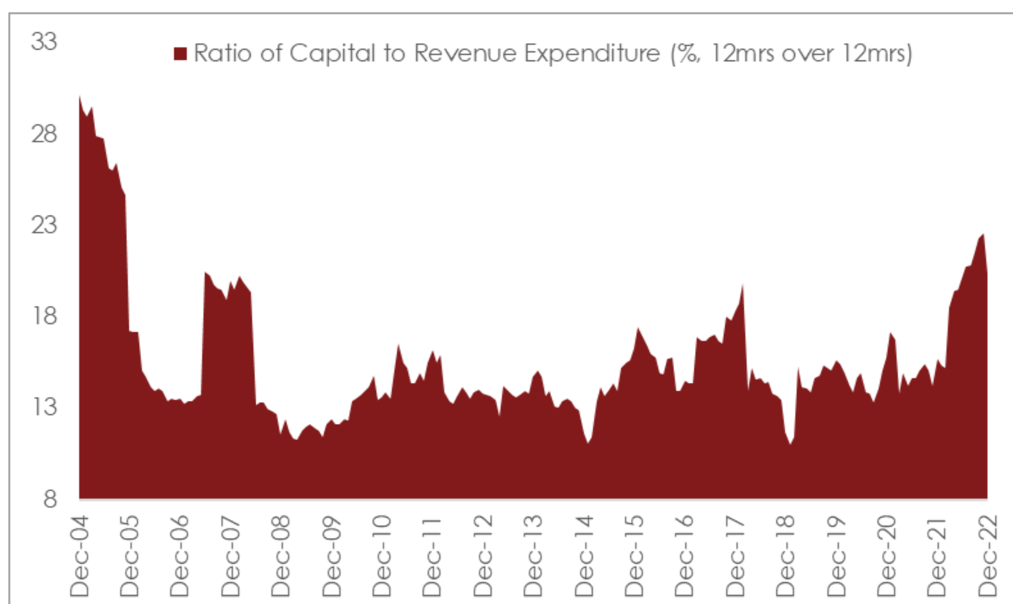
As for the FY24 outlook, the budget arithmetic appears credible with reasonable growth assumptions for Nominal GDP (10.5%) and gross tax collections (10.4%). The disinvestment target is not lofty (at Rs 510 bn) and could be achieved if traction is maintained through the year. Total expenditure is budgeted for a moderate growth of 7.5% as revex is slated for a subdued expansion by 1.2% (on account of savings generated from cut in subsidy budget). Encouragingly, the government doubled down on its focus for capex, which saw the total outlay increasing by 37.4% (with continued emphasis on railways, roads, and defence).

Overall, we expect the headline fiscal deficit target of 5.9% of GDP for FY24 to be met with risks appearing neutral at this stage.

Table1: Comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position, Apr-Dec)				
	% of FY Actual/Target		%YoY	
	FY22	FY23	FY22	FY23
Revenue Receipts	79.9	75.4	59.2	2.1
Net Tax	81.0	74.6	53.1	5.6
Non-Tax	74.5	81.9	105.6	-17.4
Non-Debt Capital Receipts	72.6	66.0	-14.0	93.6
Total Receipts	79.8	75.0	57.1	3.6
Revenue Expenditure	66.5	67.3	8.0	9.3
of which, Interest Payment	70.3	72.4	19.8	20.3
of which, Major Subsidies	62.7	67.2	19.4	29.2
Capital Expenditure	66.1	67.3	26.8	25.1
Total Expenditure	66.4	67.3	10.6	11.8
Fiscal Deficit	**47.9**	**56.6**	**-**	**-**

Chart 1: Quality of fiscal spending has been the best since FY05



Rates

Monetary policy back in focus

KEY TAKEAWAYS

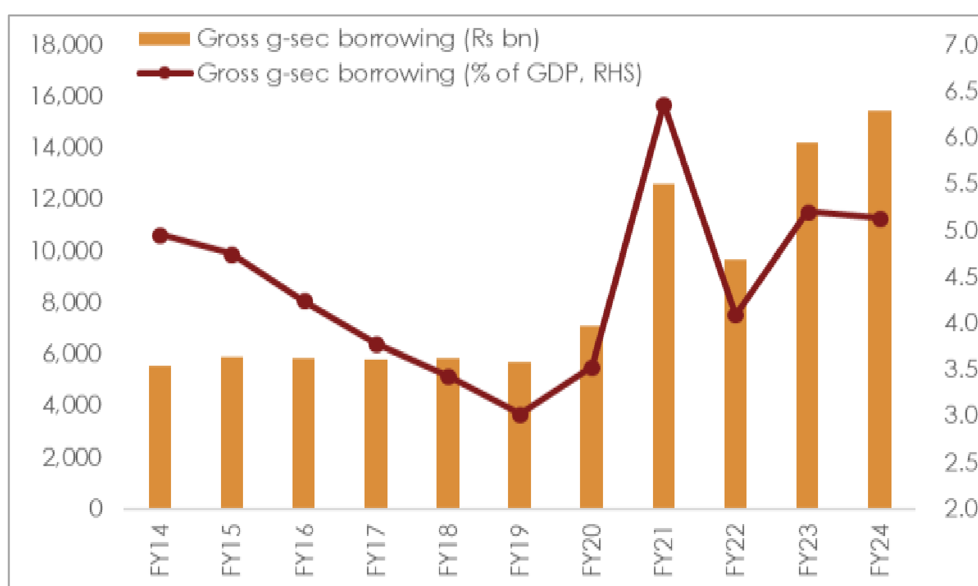
- FY24 Union Budget provided comfort to bond market through the combination of credible fiscal arithmetic, maintenance of gradual fiscal glidepath and a downward surprise in borrowing target.
- However, the respite has been short lived as the specter of record high quantum of gross borrowing, higher inflation for a longer period and proposed changes in tax that make bond investments less attractive to investors , is weighing upon market sentiment.
- More importantly, fading of extreme pessimism on global growth is creating some elbow room for central banks to squeeze in additional monetary tightening although the emergence of a banking crisis in US may help to moderate the latter.
- We continue to maintain our call of 25 bps repo rate hike in Apr-23. However, with likelihood of Q4 FY23 CPI inflation not just exceeding RBI's forecast of 5.7%, but also going past the policy comfort threshold of 6%, the MPC could retain its current stance for policy flexibility.
- We expect 10Y g-sec yield to remain close to 7.4-7.5% in the near term and gradually drift lower towards 7.00% by Mar-24.

In Jan-23 edition of the Acuite Macro Pulse report, we had highlighted that market participants would focus on the signals from the FY24 Union Budget for near term cues in the backdrop of early and tentative signs of comfort on global and domestic inflation.

The fiscal policy outline presented in the FY24 Union Budget was broadly in line with market expectations with the central government seeking to narrow its fiscal deficit by 50 bps to 5.9% of GDP. In order to do so, the central government has budgeted for a gross borrowing target of Rs 15.43 tn in FY24. While this is going to be a record high borrowing target in value terms, as ratio to GDP, it is marginally lower at 5.1% vis-à-vis 5.2% in FY23. More importantly, it is also lower compared to market expectations, which were close to Rs 16 tn as per various surveys, ahead of the presentation of the Union Budget.

The combination of credible fiscal arithmetic, maintenance of gradual fiscal glidepath, and downward surprise in borrowing target comforted bond market sentiment with yield on the 10Y g-sec easing by 7 bps to 7.27% (its lowest level since the middle of Dec-22) on the day of the presentation of FY24 Union Budget.

Chart 1: While FY24 borrowing target saw a jump, it is slightly down as GDP ratio



While the 10Y g-sec yield moved up thereafter to 7.45% levels, it has subsided back to the levels that existed prior to the presentation of FY24 Union Budget.

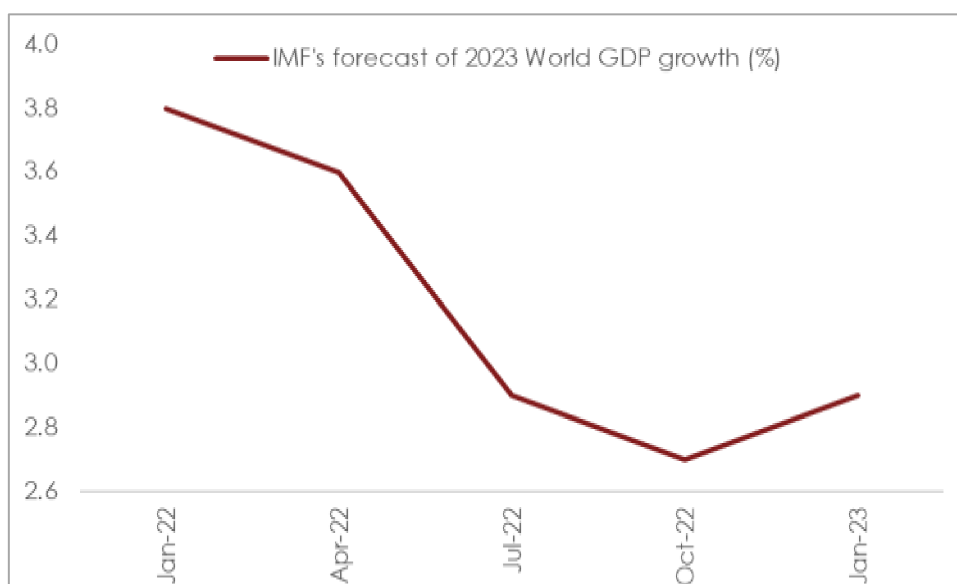
So, what really changed in the interim?

One could argue that while the FY24 borrowing target has come lower than street expectations, the sheer quantum of borrowing would eventually weigh upon sentiment and the positive bond market reaction immediately post the presentation of the FY24 Union Budget can be classified as knee jerk. Moreover, the proposed imposition of tax on insurance products indirectly linked to long dated bonds could weaken the strong appetite (seen in FY23 so far) from such institutional investors.

While that's indeed the case, a prominent concern currently gripping market sentiment is the renewed uncertainty on inflation in tandem with reassessment of extreme downside risks to global economic growth.

Post the easing of Zero Covid policy in China, the IMF revised up its forecast for 2023 World GDP growth by 20 bps to 2.9% - this is the first instance of upward revision in last four reviews. The recent strong spell of US economic data has muted the recession risks, with soft landing scenario now emerging as a base case for 2023 for most market participants.

<u>Chart 2: Extreme pessimism on global growth has started to fade</u>



The fading of hard landing scenarios is generating elbow room for central banks to persist with the 'higher for longer' positioning of monetary policy rate.

- Market participants are now pricing 50 bps of incremental rate hike from the US Fed in the coming months after the latest 25 bps hike in Mar-23. While there was an expectation in some quarters of a larger 50 bps hike in March, it perhaps got moderated due to the sudden emergence of the banking crisis in US which necessitated a rescue from the Fed and the Government.

In case of Indian economy, the overall narrative on growth continues to remain supportive despite expectation of easing of momentum (RBI expects GDP growth to moderate to 6.4% in FY24 from 7.0% in FY23 while its survey of professional forecasters points towards the median likelihood of GDP growth moderating to 6.0% in FY24 from 6.9% in FY23). Below mentioned excerpts from RBI's Feb-23 monthly bulletin summarizes the current mood on growth succinctly:

"In India, domestic consumption and investment stand to benefit from stronger prospects for agricultural and allied activities, strengthening business and consumer confidence, and strong credit growth. Supply responses and cost conditions are poised to improve even though inflation witnessed a rebound in January. The Union

Budget 2023-24's emphasis on capital expenditure is expected to crowd-in private investment, strengthen job creation and demand, and raise India's potential growth."

While such optimistic outlook from the central bank underscores the resilience of the domestic economy, it is also likely to allow the MPC to continue focusing on inflation management without any binding trade-offs on growth sacrifice.

- In this context, we note that there is now a live risk of CPI inflation in Q4 FY23 not just exceeding RBI's forecast of 5.7%, but also going past the policy comfort threshold of 6%.
- While stable crude oil prices and expectation of a healthy rabi output could keep near term inflation risks somewhat under check, early signals of development of El Nino weather conditions (usually associated with rainfall deficiency) towards Jul-23 could pose a potential risk for overall inflation.
- Meanwhile, core inflation – the centerpiece of MPC's concerns, continues to remain elevated above 6% levels for nine months in a row.

As such, we maintain our call of another 25 bps rate hike in the next policy review in Apr-23. While there is a case for a pause thereafter to assess recent rate hikes and allow the impact of gradual tightening of liquidity conditions to unfold, the MPC could retain its stance (i.e., withdrawal of accommodation) for sake of policy flexibility amidst the unsettled debate on US Fed's terminal rate, additional uncertainty due to the banking crisis in US and Europe as well as persistence of stickiness in domestic core inflation.

From bond market perspective, uncertainty around the projected disinflationary path (both global and domestic) and record high gross borrowing from the central government in FY24 would keep overall sentiment cautious. As such, we stick to our upper range of near term forecast at 7.50% for Mar-23.

Going forward, the anticipation of moderation in inflation (despite prevalence of some near term weather related risks) would help lower long-term yields over a longer horizon. As such, we expect 10Y g-sec yield to gradually moderate towards 7.00% levels by Mar-24. However, this may be preceded by a pivot in the monetary policy stance towards the end of next fiscal but the heightened uncertainty in the global environment is making it difficult to predict a reasonable time frame for the latter.

Rupee

Shifting undercurrents

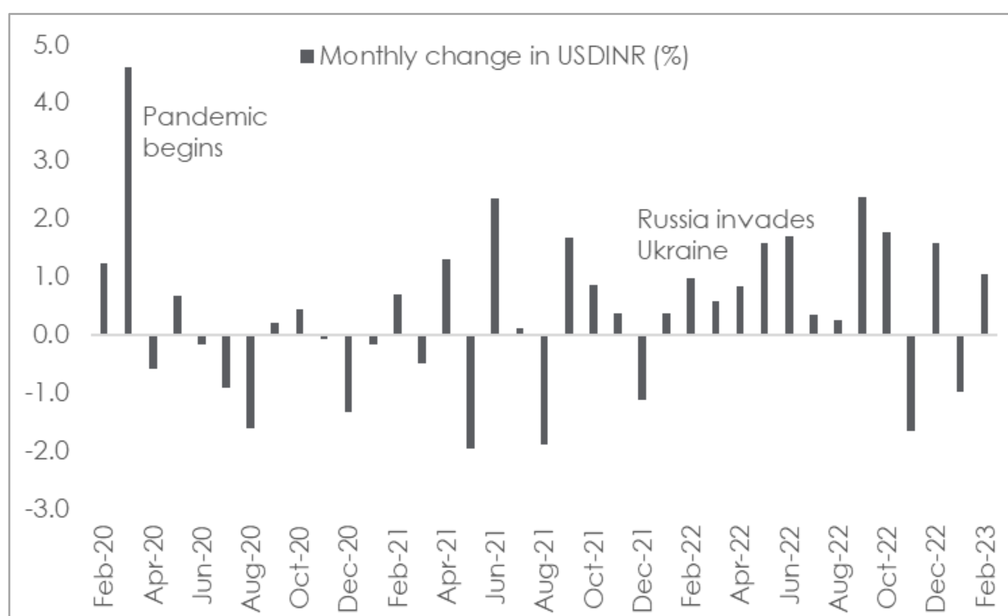
KEY TAKEAWAYS

- The INR has continued to remain relatively stable in the band of Rs 81-83 over Jan-Feb'23 without any sharp movements.
- While the pressure on INR post the Russia-Ukraine war continues to persist, the headwinds have weakened considerably in recent months.
- Heightened concerns on the current account and BoP deficit are giving way to moderate concerns, which are comfortably manageable in a usual business cycle.
- Repricing of near-term rate hikes by the US Fed along with pricing out of rate cuts by end 2023 could be supportive of the USD in the short term; however a repeat of 2022 type secular rally in USD seems unlikely.
- Amidst risk of a narrower deficit on India's current account and BoP, we revise lower our USDINR forecast for Mar-23 to 83 from 84 earlier.
- Going forward, INR could find stability amidst expectation of further improvement in the BoP position and likelihood of a Fed pivot towards the end of FY24.

After closing the month of Jan-23 at a level of 81.92, the Indian rupee depreciated further to 82.8 against the US dollar by end Feb-23. The month of Feb-23 is important for two occasions, viz. 3-years of post-pandemic world and 1-year of Russia-Ukraine war.

- In the 36 months of post pandemic space, INR weakened for a total of 23 months, i.e., ~64% of the time. Cumulative depreciation for INR during this period stands at 14.6%, implying an average depreciation of ~0.4% per month.
- In the 12 months of Russia-Ukraine war, INR depreciated for a total of 7 months, i.e., ~58% of the time. Cumulative depreciation for INR during this period stands at 11.0%, implying an average depreciation of ~0.9% per month.

Chart 1: Russia-Ukraine war has had a greater impact on INR than the pandemic



Clearly, the Russia-Ukraine war has had more than twice the impact on INR compared to the pandemic, and that too in a shorter time span (the difference would be stark if one restricts the pandemic period to just 24 months instead of 36 months).

There are two key reasons why INR suffered much more in the post Russia-Ukraine period than the post pandemic period:

- Global commodity prices, which had started to recover as countries were gradually coming out of Covid restrictions, got a shot in the arm with flaring up of the geopolitical crisis (indeed the Reuters CRB Index gained by 22.0% in 2022 after increasing by 38.5% in 2021) that involved two key commodity producers.
    - This exposed the vulnerability of many net importing countries. Indeed, India's current account balance that posted an average surplus of 0.3% of GDP between Jun-20 and Dec-21 quarters, turned into an average deficit of 2.7% during Mar22 and Sep-22 quarters (with peak deficit recorded at 4.4% in Sep-22 quarter). It should be noted that for India, while commodity prices played a crucial role in expansion of the current

account deficit in recent quarters, the role of pent-up demand in pushing imports higher cannot be under emphasized.

- Russia-Ukraine war also destabilized global risk appetite in financial markets with negative returns in equities and bonds in most countries. From FX market perspective, the USD found favor in safe haven demand. The DXY index which lost 1.5% in the first two years of the pandemic (2020 and 2021), gained 7.8% in the year after that (in 2022) on account of the war. Its should be noted that safe haven demand was not the sole factor behind the USD rally. The flare up in commodities and fast paced normalization of economic activity in the US prompted the Federal Reserve to undertake the most accelerated pace of monetary tightening seen in last four decades – almost 5% over the last one year, with other central banks lagging in monetary tightening. Consequently, the USD enjoyed a high carry advantage.

From INR perspective, it is important to keep this distinction in mind. As we move towards the end of FY23 and look forward to FY24, it is important to note that the currency drivers are undergoing a change.

- On the services front, trade surplus in Feb-23 is estimated to have risen to USD 14.6 bn compared to USD 13.8 bn in Jan-23. Services exports is estimated to have risen to USD 29.2 bn last month, clocking a growth of 36.8% YoY on annualised basis and 4.0% MoM on sequential basis.
- Amidst the buoyancy in services exports led by IT/ITeS sector, on net basis, India's monthly trade balance (goods and services) was in a marginal deficit of USD 2.8 bn in Feb-23, with the cumulative trade deficit over Apr-Feb FY23 standing at USD 114.6 bn.
- Extreme concerns over India's current account deficit are gradually easing. This is on account of (i) the anticipated slowdown in domestic growth (we expect GDP growth to moderate to 6.0% in FY24 from NSO's estimate of 7.0% in FY23), and (ii) gradual easing of supply chain disruptions in last one year that has helped in moderating commodity prices (on monthly average basis, Reuters CRB index is down by ~12% in Feb-23 compared to its post Russia-Ukraine war peak in Jun-22). Incidentally, for crude oil, the fall has been much more at ~29% in the corresponding period with the lower trade deficit further supported by the increased purchase of crude from Russia. It is noteworthy that commodity prices have remained range-bound despite China easing its Zero Covid policy in last 2-months.

Chart 2: Global supply chain disruptions have eased considerably in last one year

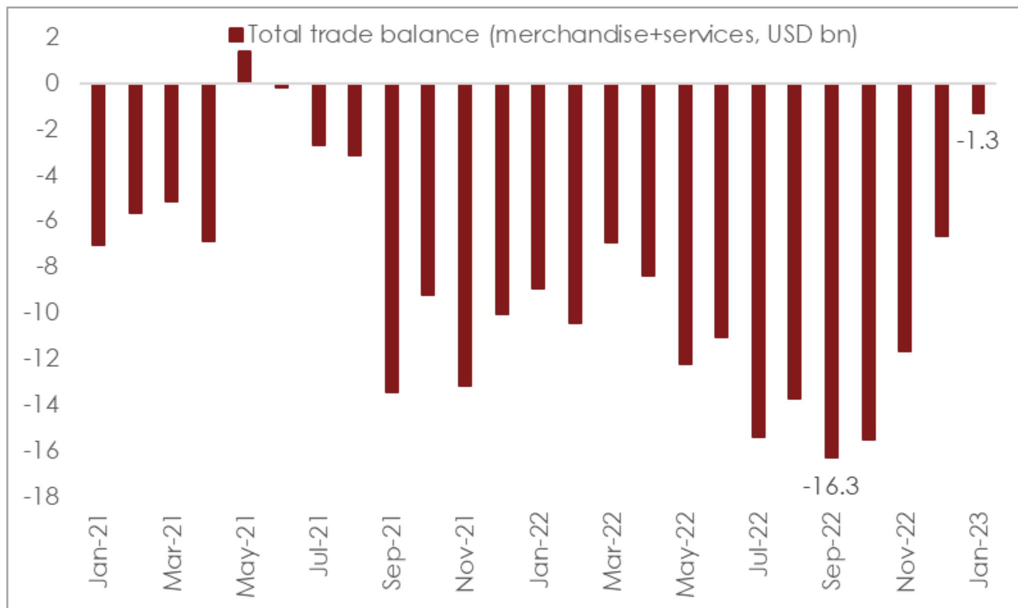
- While we maintain our forecast for India's FY23 current account deficit at 3.1% of GDP (the same as the median value from RBI's Feb-23 survey of professional forecasters), we see a risk of a narrower deficit due to lower than anticipated commodity prices along with continued strength in services exports.
- This in turn will result in the likelihood of a lower than anticipated BoP deficit in FY23 (our current forecast stands at USD -38 bn), with bulk of the deficit already having accrued in H1 FY23.

- With respect to global FX sentiment, we acknowledge the likelihood of inflation concerns staying alive, which in turn could continue to prompt key central banks to delay their anticipated pivot in monetary policy, while persisting with their monetary tightening in the interim.
    - Repricing in of rate hikes in the near term for Federal Reserve and pricing out of rate cuts for end 2023 will continue to provide tailwinds to the USD, at least in the near term. Having said so, we do not expect the carry advantage to have an outsized impact on the USD (like it did in 2022), as it could be moderated because of similar rate actions by other key central banks, esp. the ECB (market participants currently price in additional 100-125 bps rate hike in 2023).

From INR perspective, reasons for expecting incremental weakness continue to persist. However, as argued above, the headwinds are weakening on account of fading of excessive BoP deficit risks along with an absence of an encore of the USD strength. As such, USD-INR is expected to remain below 83.0 in end Mar-23.

Going forward, INR could find stability amidst expectation of further improvement in the BoP position and likelihood of a Fed pivot towards the end of FY24.

Chart 3: India's total trade deficit has narrowed significantly from its peak in Sep-22



Global Overview

Murky and treacherous environment

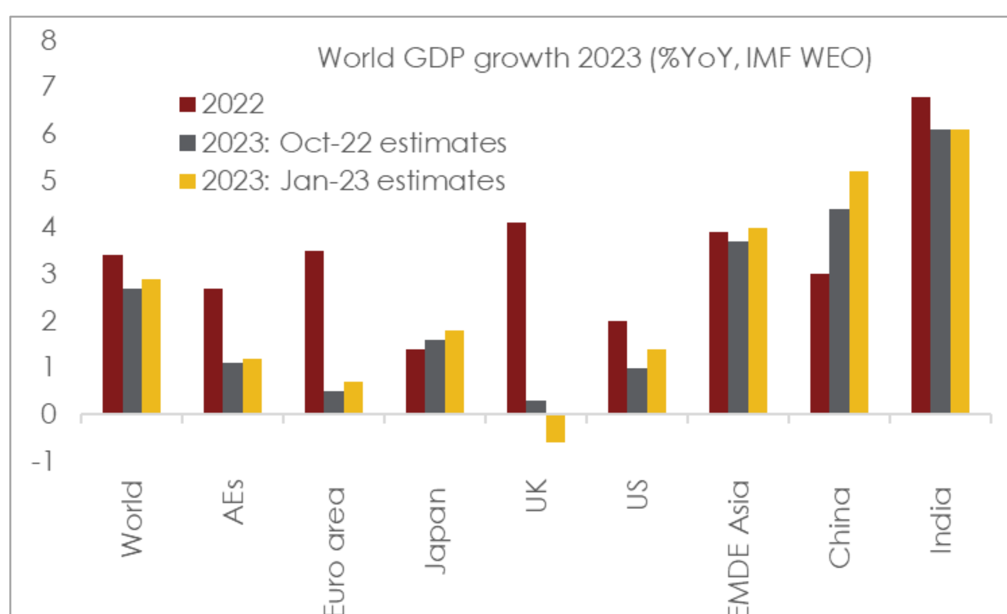
KEY TAKEAWAYS

- Global growth expectations for 2023 are on a mend. Amidst the removal of the zero Covid policy and the restrictions in China, a less severe winter in Europe and lower energy prices, IMF for the first time in a year raised its growth forecast.
- Global GDP for 2023 is now expected to expand by 2.9%, an upward revision of 20 bps compared to Oct-22 update.
- Capturing the improvement in growth momentum, JPMorgan Global Composite PMI index showed marginal improvement in the last two months, following 10 months of consecutive decline, rising from 49.8 points in Jan-23 to 52,1 points in Feb-23.
- The pace of recovery in the US has in particular caught most economic observers off-guard. While markets were buoyed by the decline in headline CPI inflation from 6.5%YoY in Dec-22 to 6.0% in Feb-23, the strong sequential momentum (on both headline and core) punctured the fervour somewhat. Moreover, there was a jump in Non-farm Payrolls (NFP) by 311K in Feb-23 – significantly higher than the market expectations along with relatively steady retail sales with only 0.4% decline in Feb-23 after a 3.2% MoM rise in Jan-23. On the flipside however, the failure of a few regional banks and the consequent crisis may have a bearing on the US economy going forward.
- To be objective, while some forward-looking indicators do point towards an impending slowdown, or even perhaps a recession; the latest set of incremental data reinforces the theme on rates "higher for longer".

Global overview

Global growth expectations for 2023 are on a mend despite fresh headwinds in the form of a stress in the banking sector. Amidst removal of restrictions in China, a less severe winter in Europe and lower energy prices, the IMF for the first time in a year raised its growth forecast. Global GDP for 2023 is now expected to expand by 2.9% - an upward revision of 20 bps compared to the Oct-22 update. While this still would be a slowdown compared to an expansion of 3.4% in 2022, IMF expects growth to bottom out this year before accelerating to 3.1% in 2024. While risks of a recession have reduced, IMF does call for balance of risks being titled on the downside amidst still simmering Ukraine-Russia war and tighter financial conditions globally. The international agency also estimates CPI inflation slowing to 6.6% this year, 0.1% higher versus Oct-22 estimate, though moderating from 8.8% in 2022.

Chart 1: MF World Economic Outlook upgraded 2023 global GDP growth by 20 bps



Capturing the improvement in growth momentum, JPMorgan Global Composite PMI index showed modest improvement in the last two months, following 10 months of consecutive decline, rising from 49.8 points in Jan-23 to 52,1 points in Feb-23. Majority of countries recorded an increase, with the index rebounding in United States and China compared to the previous month, with continued recovery in the Eurozone, particularly in Germany, Spain and Austria. PMI index passed the 50-point mark in Canada, France, Ireland, Italy and Hong Kong.

The pace of recovery in the US has however caught most economic observers off-guard. Up to end of Jan-23, the economy was poised for a "soft-landing" i.e., a speedy disinflation without a recession. However, come Feb-23 and the incoming barrage of economic data exceeding market expectations by a wide margin, the notion of "soft-landing" has given way to "no-landing". While markets were buoyed by the decline in headline CPI inflation from 6.5%YoY in Dec-22 to 6.0% in Feb-23, the sequential momentum (on both headline and core) punctured the fervour somewhat. Moreover, there was a jump in Non-farm Payrolls (NFP) by 311K in Feb-23

– significantly higher than the market expectations along with relatively steady retail sales with only 0.4% decline in Feb-23 after a 3.2% MoM rise in Jan-23. One camp of observers is now even looking at 'no-landing' scenario for the US economy. On the flipside however, the failure of a few regional banks and the consequent crisis have convoluted the US economic outlook.

To be objective, while some forward-looking indicators do point towards an impending slowdown, or even perhaps a recession; the latest set of incremental data means one thing clearly – globally, interest rates are likely to remain higher for longer albeit the pace of increases have subsided. Despite the emergence of a stress in some parts of the global banking sector, Fed along with the ECB and BoE have raised rates in the month of Mar-23.

Indeed, markets are now looking at rate hikes by Fed to continue beyond the 25 bps already effected in Mar-23, possibly a 25 bps hike each in May-23 and Jun-23. This would take the terminal rate to 5.25-5.50% range. Another change in market expectations that the robust economic data has led to is that quantum of rate cuts expected in 2023 down to 25bps from 50 bps earlier. This finally reduces the divergence in rates outlook between the Fed and market participants.

US economy

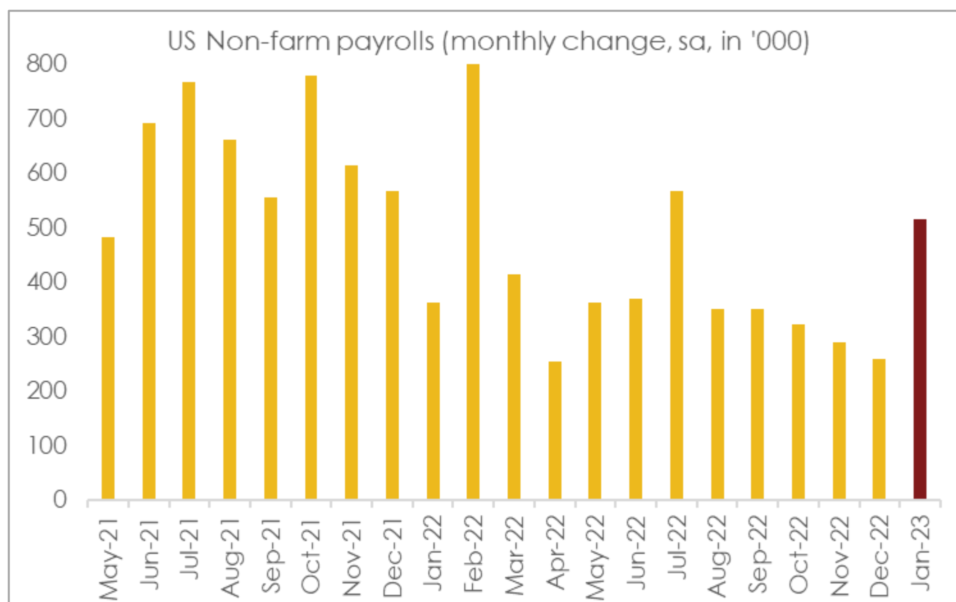
Three key data points released in Feb/Mar-23 are having a strong bearing on economic assessment of the US economy -

- **Sticky Inflation:** US headline CPI inflation continued to descend lower to 6.0% in Feb-23 from 6.4%YoY in Jan-23 and 6.5% in Dec-22, however the MoM gain (at were higher than expected. Excluding volatile food and energy, Core CPI increased 0.5%MoM and 5.5%YoY in Feb-23, still high levels vis-à-vis Fed's expectations.

- **Exceptional labour market strength:** Jan-23 saw 504K addition to non-farm payrolls followed by 311K; the unemployment rate dropped to a 53-year low at 3.4% in Jan-23 before climbing back slightly to 3.6% in Feb-23.

- **Strong consumption**: Retail sales surged 3.2%MoM in Jan-23 to beat consensus estimates of a 2.0% expansion by a wide margin, marking the fourth biggest MoM rise in over 20 years. However, it fell slightly by 0.4% MoM in Feb-23, still highlighting the strength of economic activity in US.

Chart 2: US non-farm payrolls at +517k in Jan-23 surprised considerably on the upside



In other data, manufacturing production has witnessed a stagnation in the last two months declining slightly by 1.0% in Feb-23. In addition, reviving demand for cars, furniture, appliances, restaurants along with a relatively warmer weather has supported economic activity overall, at the start of the year.

The stickiness in inflation along with better data on economic activity has fuelled expectations among market participants that Fed may need to push rates higher for longer. Expectation of rate hike continuing beyond Mar-23 has emerged as the base case, with markets pricing in further rate hike in May-23 and even Jun-23. In addition, rate cuts from 2023 timeline are shifting to 2024. Unsurprisingly, Fed Chairman Powell recently warned that Fed's path to getting US inflation lower in 2023 is "probably going to be bumpy". Amidst such a scenario, the failure of a few regional banks in USA and the stress in Credit Suisse leading to its merger with UBS in Europe, has further convoluted the growth outlook.

UK

Inflation in UK receded for the third consecutive month in Jan-23, with the headline print coming in lower than expected at 10.1%YoY compared to 10.5% in Dec-22. However, it unexpectedly edged higher again in Feb-23 at 10.4%. The largest upward contributions to the headline rate came from cost of food (18%, the highest since August 1977 vs 16.7%), mainly vegetables due to shortages of salad produce and other vegetables, amid bad weather in southern Europe and Africa, and the impact of higher electricity prices

Excluding those more volatile components, core CPI actually increased to 6.2% YoY in Feb-23 from 5.8% in Jan-23. Given headline inflation still remains much above BoE's target of 2.0%, the central bank raised its policy rate by 50 bps to 4.0% in its Feb-23 policy and further to 4.25% in Mar-23, thereby signalling further tightening in the offing.

Incremental data on economic activity remains mixed, though some indicators have surprised considerably on the upside. Retail sales grew by 1.2% in Feb-23 after a 0.9% gain in Jan-23 following a 1.2% drop in Dec-22, aided by moderating fuel costs and discounts. Further, wage growth (measured as 3m moving average) rose by 6.7%YoY in Jan-23, up from 6.5% in Dec-22 and above expectations. On the other hand, real GDP in Q3 is estimated to have fallen by 0.2%QoQ in Dec-22, while growth in Q4 has remained flat vis-à-vis previous quarter to narrowly miss a widely anticipated contraction. For the year, GDP growth stands at 4.1%. Looking ahead, UK economy which is yet to attain its pre-pandemic level, is projected by IMF to contract by 1.6% in 2023 in sharp contrast to US and EU, both of which are expected to grow. Tighter fiscal and monetary policies and financial conditions and still-high energy retail prices are likely to weigh on household budgets.

Investors expect quarter-point rate hike, probably at the BoE's next meeting in May, pushing up sterling moderately against the dollar. But many economists said the central bank might have already reached the end of its tightening cycle.

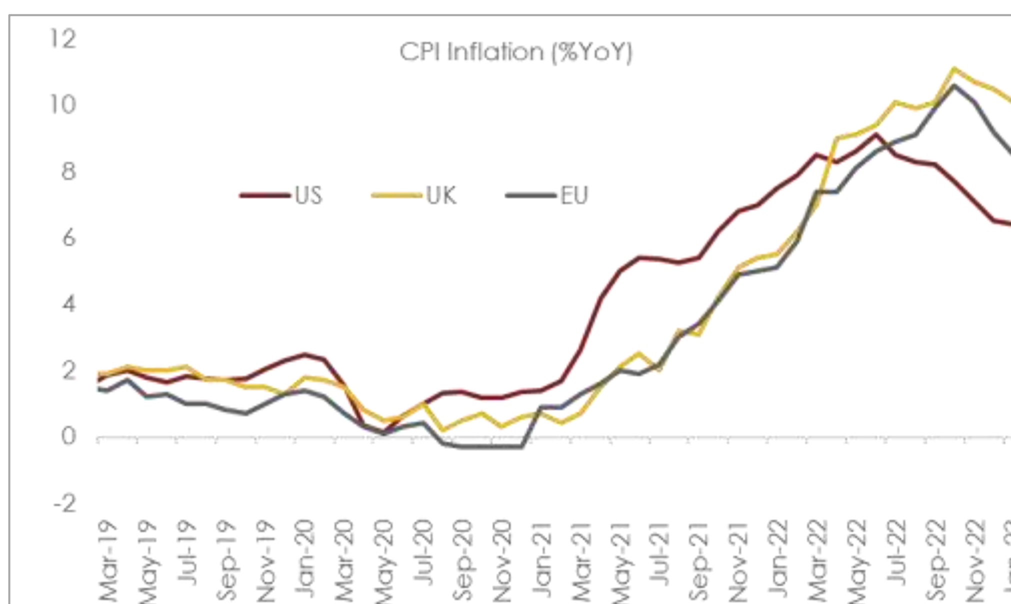
Eurozone

Eurozone economy has fared better than expected, managing to avoid a contraction in Q4-22 with GDP growing modestly by 1.8% YoY. While most economies stagnated, Germany and Italy recorded marginal contractions while France and Spain eked out small momentum. Support to the economy has come from relatively milder winter and lower price of global natural gas and oil. In other data, the European Commission's Consumer Confidence indicator for Feb-23 rose by 1.7 points to -19 - to mark the highest level in past year. Consumer sentiment continues to draw support from the strength in labour markets, with the Eurozone unemployment rate falling to a record low of 6.6% in Dec-22 and inching very slightly to 6.7% in Jan-23.

Adding to the positive data, Eurozone inflation eased for the third consecutive month in Jan-23, to 8.5% and stayed at the same level in Feb-23 from 9.2% in Dec-23. Yet again, energy remained the biggest driver, rising by 17.2%YoY though down from 25.5% in Dec-22. Food costs rose marginally from 13.8%YoY in Dec-22 to 14.1% in Jan-23. Stripping both these volatile components, core inflation stood at 5.2% in Jan-23 i.e., the same level as previous month.

In its Mar-23 meeting, ECB hiked rates by another 50 bps over the 50 bps already effected in Feb-23 to bring the deposit rate to 3.0% and refinancing rate to 3.5%. More recently, Fabio Panetta, an executive Board member with the ECB commented that ECB must shift to smaller rate increases soon or risk stamping out growth. ECB, since Jul-22, has raised policy rate by 300 bps. The sharp tightening seen over the last three quarters is likely to have a material impact on 2023 growth, with IMF projecting region's growth in 2023 slowing to 0.7%YoY from 3.5% in 2022.

Chart 3: Inflation has peaked, though the pace of sequential moderation is slower



JAPAN

Japan's growth trajectory was uneven in 2022, oscillating between expansion and contraction. For Q4-22, GDP was stagnant, albeit lower than expected. While private consumption recorded a 0.5%QoQ expansion, business spending fell by an equal magnitude. Growth in Japan is expected to be marginally better in 2023, with IMF pegging growth forecast at 1.8% compared to 1.4% of 2022. The bigger macro challenge will be on the inflation front, which in the Japanese economy is trending higher. As of Feb-23, headline CPI subsided to 3.3%YoY from a high of 4.3%YoY with core-inflation also lower at 3.1% vs 4.2% in the previous month. A combination of moderate growth and increased inflation pressures, adds to Bank of Japan's dilemma of when to begin tightening of monetary policy. The new incoming BoJ Governor Kazua Ueda (to begin his tenure in Apr-23) will have to watch evolving domestic economic dynamics closely to enable BoJ to move away from easy monetary policy as and when considered necessary.

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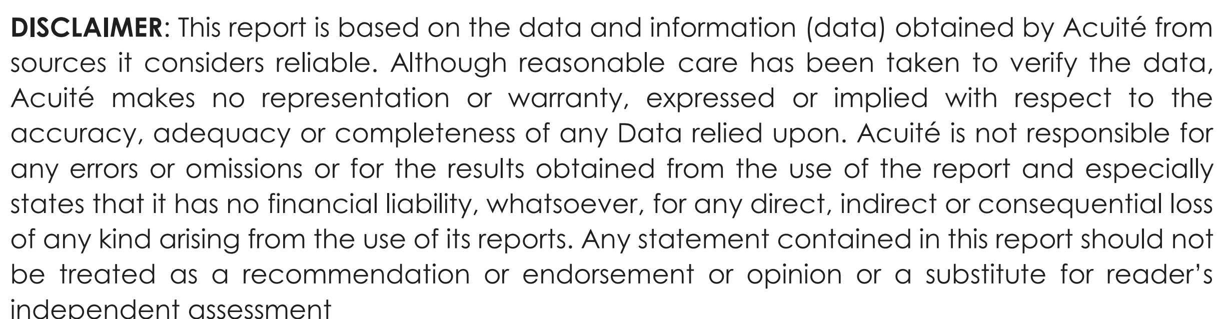
Media Contact:

Sahban Kohari Ph: + 91-9890318722 sahban@eminenceonline.in

Analytical Contacts:

Suman Chowdhury Chief Analytical Officer Ph: + 91-9930831560 suman.chowdhury@acuite.in	Prosenjit Ghosh Chief Operating Officer – Subsidiaries Ph: +91-9920656299 prosenjit.ghosh@acuite.in



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