MACRO PULSE

DECEMBER 2021

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Acuité RATINGS & RESEARCH

From the desk of the Chief Analytical Officer

We are happy to inform you that we have completed **one year** of publication of our **Acuité Macro Pulse** with the release of this **twelfth edition (Dec 2021)**. This monthly commentary on the Indian and the global economy has caught the attention of investors, bankers and policy makers for its sharp perspectives and its extensive coverage on a wide range of economic indicators.

Needless to say, 2022 hasn't really started on a good note with the continuing threat of the pandemic driven by the new variant, Omicron. By the first week of Jan-22, the daily global case load has already surpassed 2 million on a weekly average basis and India has also started to follow the rising graph with daily cases set to touch 200,000. Encouragingly, the incidence of hospitalitizaion and mortalities continue to be low and though it is a bit premature to discount the risks from Omicron, we believe that the duration of the third wave will be significantly less as compared to the previous ones. This expectation is also reinforced by the significant vaccination coverage with aggregate vaccine doses administered exceeding 1.5 bn which makes India the second largest nation after China in terms of the scale of vaccination; further it is estimated that more than 60% of the population has received at least one dose of the vaccine by the third quarter end of FY22.

Indian economy has so far displayed resilience in the face of rising headwinds to global and domestic growth; our **proprietary AMEP index** has remained intact in Q3 FY22 (averaged at 118 in Oct-Nov'21 vs. 110.3 in Q2 FY22). However, we remain cautious of the new risks emerging from the rapid spread of the new strain along with the persistent challenges from global supply chain disruptions, elevated commodity prices and the threat of a global growth slowdown in the early part of 2022. While our earlier expectations for Q4 GDP was around 6.2%, this may witness a drop of up to 50 bps due to the impact of the fresh surge. Nevertheless, we believe that the economic impact of the third wave will be relatively lower as compared to the previous surges going by the current data on hospitalization and mortalities. For the whole of FY22, we hold on to our growth estimate of 10.0% for now albeit with increased downside risks that will depend on the way the third wave plays out over the next 1-2 months. What is particularly notable is that the credit ratio i.e. upgrades vs downgrades for the whole CRA industry in the nine months of the current fiscal has continued to remain strong at 2.67 times as against 0.86 times in the corresponding period of the previous year, reflecting the confidence in the medium term revival in the economy.

While the MPC continued to signal the continuity of the accommodative policy in Dec-21, it is evident that domestic interest rates are on its way up and it is clearly reflecting in both short term and long term bond yields. The acceleration in the monetary normalization in the developed economies, liquidity calibration by RBI and the expected inflationary pressures have led to the rate tightening; on similar lines, the rupee is also likely to remain volatile. What will be keenly awaited now is the Union Budget and the narrative it sets for the economy.

Take Care and Cheers,

Suman Chowdhury
Chief Analytical Officer

Growth

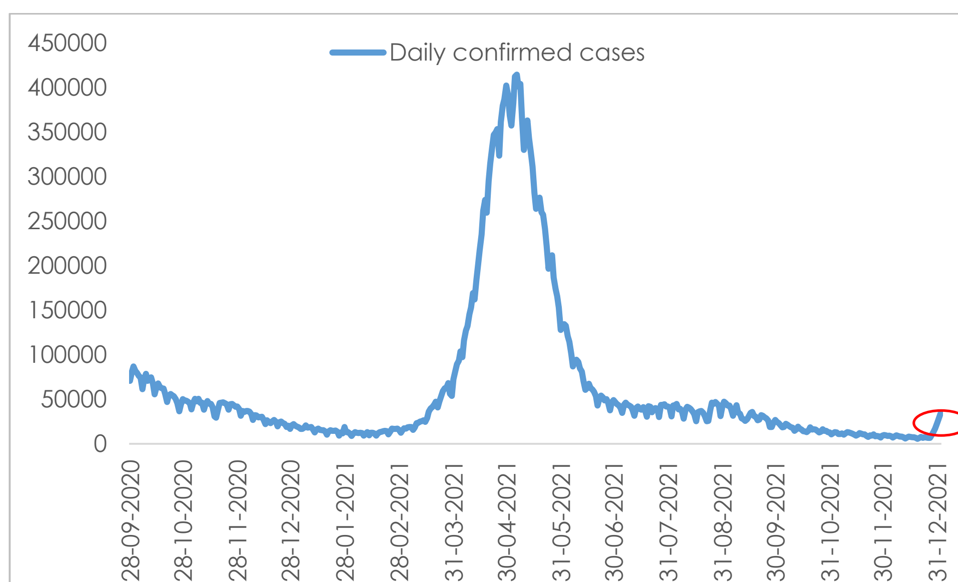
Supportive in Q3FY22, rising headwinds

KEY TAKEAWAYS

- Domestic growth momentum continued to remain intact in Q3FY22. Despite headwinds to global growth mounting in the wake of new Omicron strain, supply chain disruptions and elevated inflation, Indian economy has so far displayed resilience.
- This has been enabled by unlocking of the economy particularly the contact intensive sectors and healthy progress in the pace of vaccinations. In Dec-21, vaccination clocked a daily pace of more than 7 mn as against 5.9 mn over Oct-Nov'21 and by the end of the quarter, 1.45 billion doses have been administered and 61% of the population have received at least one dose of the vaccine.
- As such, most high frequency indicators have continued to incrementally record a pick-up in Dec-21, shrugging off the post festive seasonal dip seen in Nov-21.
- However, the recent spike in Covid infections in some states could again lead to localized restrictions thereby slowing the pace of economic recovery.
- Going forward, we remain mindful of risks from global supply chain disruptions, still elevated commodity prices and slowdown in global growth. While another wave of Covid does remain a distinct possibility, its severity and the economic impact is expected to be much lower.
- We hold on to our FY22 growth estimate of 10.0% with downside risks.

Economic momentum had lost some steam in Nov-21 as pent up and festive demand consumption dropped its intensity. This was manifested in our proprietary AMEP index which fell to 111.0 in Nov-21 from a post pandemic peak of 124.9 in Oct-21. Nevertheless, overall domestic growth momentum had remained intact in Q3FY22. Despite rising headwinds to global growth in the wake of new Omicron strain, persistent supply chain disruptions and elevated inflation, Indian economy has so far displayed resilience. This has been enabled by steady progress in the pace of vaccinations clocking more than 7 mn doses per day in Dec-21 as against 5.9 mn over Oct-Nov'21. The aggregate vaccine doses administered stood at 1.45 bn as on Dec end in India which makes it the second largest nation after China in terms of the scale of vaccination; further it is estimated that 60.7% of the population has received at least one dose of the vaccine by the quarter end. As such, most high frequency indicators have continued to incrementally record a pick-up in Dec-21, shrugging off the post festive seasonal dip in Nov-21. However, Covid cases in a few states and particularly a few metros have started to rise over the last few weeks, increasing the likelihood of a third Covid wave. This may prompt state governments to impose lockdown like restrictions which could slower the pace of economic recovery.

Chart 1: COVID infections have recently started recording an uptick

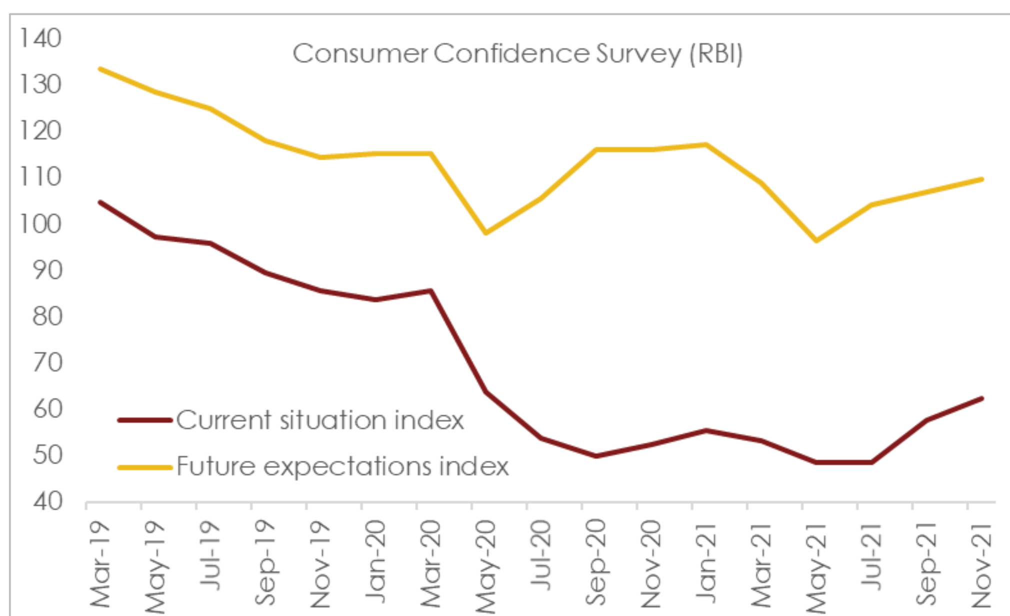


High frequency lead indicators: A granular look at recovery

- India's industrial production posted a mild downtick to 3.2% YoY in Oct-21 from 3.3% in Sep-21 (revised up from 3.1%). Despite the moderation in headline IIP growth, which was accompanied by a negative surprise vis-à-vis market expectations, sequentially the index rose by 4.3% MoM in Oct-21 vis-à-vis an expansion of 1.1% seen on average basis in the month of October (2012-2019). In fact, a cursory observation suggests that in general, the sequential momentum in IIP post the second wave of infections during Apr-May FY22 has been outpacing its pre COVID trend.

- PMI manufacturing soared to a 10-month high in Nov-21, coming in at 57.6 vs. 55.9 in Oct-21, led by improved input purchases owing to strengthening demand and improving market conditions. PMI services eased from a near 10-1/2 year high of 58.4 in Oct-21, albeit marginally to 58.1 in Nov-21 continuing to underscore recovery in contact intensive sectors.
- E-way bills generated eased from a record high of 73.5 mn in Oct-21 to 61.1 mn in Nov-21, owing to post Diwali fatigue. Nevertheless, E-way bills have bounced back in Dec-21 and the latest data from GSTN indicates that there has been a recovery to 71.6 mn e-way bills in Dec-21.
- As such, total GST collections in Nov-21 crossed Rs 1.3 tn mark for the second consecutive month to clock the second highest level since the introduction of the tax regime.
- NONG (Non-oil-non-gold) imports, a key indicator of domestic demand, saw a marginal downside to USD 34.0 bn in Nov-21 from its record high of USD 35.8 bn in Oct-21.
- Consumer confidence, as per RBI's latest round improved further to 62.3 in Nov-21 from 57.7 in Sep-21 round.

Chart 2: Albeit still low, consumer confidence remains on recovery path



Outlook

It is heartening to note the continued pace of the growth momentum till the end of Q3 FY22. While there were concerns of the momentum possibly easing due to the end of the festive season, visible moderation in export momentum and the rise of the Omicron variant globally, economic activity has been able to broadly shrug off these concerns so far. Personal mobility as measured by Google has continued to surpass the baseline (as of Mar-20) for key categories of Retail and recreation and Workplaces, which are typically the slowest to revive.

Meanwhile, the drag from global supply chain disruptions in case of energy and semiconductors is likely to persist in the near term, although the peak concern appears to be behind us. As such, production in domestic auto sector, along with others such as electronics and white goods could continue to remain under some pressure. Global commodity prices including crude oil continue to remain elevated and volatile, impacting input prices and margins. Baltic Dry Index has eased by 60% since it's Oct-21 peak but stands around 80% higher on an annualized basis.

If the threat from the new variant of Covid doesn't intensify further in the coming months, then sequential momentum in industrial production could still find support from:

- **Progress on vaccination:** As on Dec-21 end, India has inoculated 61% of its population with single dose and fully vaccinated around 40%. This should continue to provide a strong boost to consumer sentiment and demand recovery, particularly the unlocking of pent-up demand.
- **Strong government spending:** As of Nov-21, central government's cumulative expenditure touched 59.6% of FY22 budget estimates (8.8% YoY) vis-à-vis 54.3% of actuals (4.7% YoY) in the corresponding period in FY21. Revenue expenditure is now likely to get disbursed at a higher pace in H2 FY22 to meet budgetary targets as well as demand for unallocated items (like Covid related expense, fertilizer subsidy, wage hikes, MGNREGS enhancement, etc.). Meanwhile, govt capital expenditure is stable with Apr-Nov FY22 growth at 13.5% YoY vis-à-vis 12.8% seen in the corresponding period in FY21.
- **Continued monetary policy support:** The RBI reiterated its growth supportive stance in Dec-21 policy review until the recovery becomes durable, strong, and inclusive. The risks related to the new Covid variant, Omicron appear to have delayed the process of the interest rate normalization in India, as of now.

Taking all the above factors into consideration, we continue to retain our FY22 GDP growth forecast at 10.0% but with higher downside risks than earlier. While the possibility of another wave of Covid has increased significantly, we believe that the economic impact could be much lower on account of the vaccine penetration and the likelihood of limited lockdowns.

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Inflation

Material upside risks

KEY TAKEAWAYS

- Nov-21 had seen both inflation metrics i.e., on retail and wholesale price accelerate. While CPI surprised on the downside a bit vis-à-vis market expectations, WPI inflation soared to yet another record high.
- The recent comfort on headline CPI inflation is proving to be transient, with passthrough from WPI to CPI inflation likely to keep core CPI elevated, already northward of 6.0% over Oct-Nov'21.
- On CPI inflation outlook, food inflation is expected to provide comfort owing to expectation of a record Kharif output, healthy traction of acreage under Rabi crops along with policy interventions in case of edible oils and pulses. Typical winter seasonality has also kicked in for vegetable prices in Dec-21.
- However, upward price pressures from strengthening demand, yet-to-reflect hike in telecom tariffs, along with the incremental supply disruptions from the fresh Covid wave remain on watch.
- For FY22, we continue to expect average CPI inflation to print at 5.5% with material upside risks, though moderately lower vis-à-vis the 7-year high level of 6.2% in FY21.

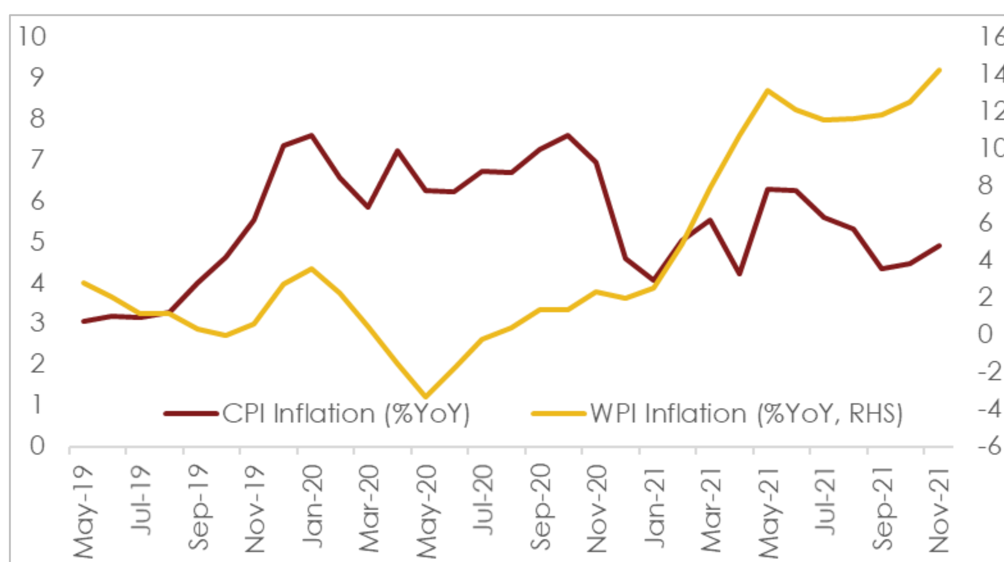
Overview

Nov-21 saw both inflation metrics i.e., on retail and wholesale price accelerate. While CPI surprised slightly on the downside vis-à-vis market expectations, WPI inflation soared to yet another record high. The comfort on headline CPI inflation is proving to be transient as we had highlighted in our last edition of Acuité Macro Pulse. In addition, the passthrough from WPI to CPI inflation is likely to keep core CPI elevated, already northward of 6.0% over Oct-Nov-21.

CPI inflation: Key highlights

- India's CPI inflation rose to 4.91% YoY in Nov-21 from 4.48% in Oct-21, coming in below market expectations which was in the range of 5-5.10%. After bottoming out in Sep-21 at 4.35%, this marks the second consecutive month of upside.
- Despite a reduction in sequential price pressures versus previous month, the upside in headline print underlined the unfavorable base at play. To put this in perspective, incrementally CPI index rose by 0.73% MoM in Nov-21 i.e., nearly half the pace of 1.41% seen in Oct-21.

Chart 1: Both WPI and CPI accelerated in Nov-21



- Providing respite, fuel prices' index contracted by 18 bps sequentially to record its first contraction in 15 months. This was driven by moderation in price of electricity (-3.2% MoM) along with Diesel, Charcoal and Dung Cake, which more than offset the strong uptick in low-weighted Kerosene prices (13.49% MoM). As such, fuel inflation eased from Oct-21's record high of 14.35% YoY to 13.35% in Nov-21.
- In similar vein, fuel items in the miscellaneous index (i.e., Petrol and Diesel) registered a sizeable decline in momentum – reflecting a more direct impact of the cut in excise tax and/or VAT by the government. This led to a month-

over-month contraction in 'Transport and Communication' sub-category within Miscellaneous by 58 bps.

- Food prices retained their elevated momentum at 1.19% MoM, though lower vs. 2.26% in Oct-21. Upside pressures were led by vegetables prices which reeled under the impact of unseasonal rains along with Eggs and index heavy weight Cereals. However, capping the upside, edible oils recorded a contraction along with Meat & fish prices, to provide succor. Annualized food inflation rose marginally to 2.60% from 1.82% in Oct-21.
- Among other movers, category of clothing and footwear posted a strong momentum of 0.91% MoM – underscoring the ability of producers to charge higher price for goods amidst the ramp-up in festive demand.
- Core inflation (i.e., CPI ex Food & Beverages and Fuel & Light indices) increased by 0.37% MoM in Nov-21 vs. 0.69% MoM in Oct-21. Despite the moderation in sequential momentum, annualised core inflation rose a tad to remain above the 6.0% handle for the second consecutive month (see table below).

Table1: Key highlights of CPI inflation

CPI sub-components				
	%MoM		%YoY	
	Oct-21	Nov-21	Oct-21	Nov-21
CPI headline	**1.41**	**0.73**	**4.48**	**4.91**
Food	2.26	1.19	1.82	2.60
Pan, Tobacco & Intoxicants	0.31	0.10	4.27	4.05
Clothing & footwear	0.61	0.91	7.53	7.94
Housing	0.93	0.37	3.54	3.66
Fuel & Light	0.98	-0.18	14.35	13.35
Misc.	0.63	0.25	6.83	6.75
Core Inflation	**0.69**	**0.37**	**6.17**	**6.21**

WPI inflation

- WPI inflation soared to a record high of 14.23% YoY in Nov-21 from 12.54% in Oct-21. Sequentially prices rose by a strong 2.73% - to mark the fastest pace of monthly increase on the series.
- Price pressures were led by categories of food (driven by vegetables and eggs) and fuel incrementally in the month of Nov-21.
- Despite a marginal downside in India Crude Basket in the month of Nov-21 (by 1.8%MoM in USD terms), delayed pass-through of past increase in crude oil saw price pressures across the fuel sub-components. This was led by Bitumen, Kerosene, LPG, Petrol among others.

Outlook

On CPI inflation outlook, food inflation is expected to continue to remain the biggest source of comfort, as –

- Government pegs Kharif foodgrain output at a record 150.5 MT

- Traction of acreage under Rabi crops remains healthy, clocking an annualized growth of 2.4% as on the last week of Dec-21, over the corresponding period in 2020.
- Policy interventions in case of edible oils and pulses continue to cap prices
- The typical winter seasonality is also gathering pace as seen in vegetable prices, down 6.5% sequentially so far in Dec-21 (up to 20th Dec-21).
- The second order impact of reduction in excise/VAT duties on petrol and diesel along with Omicron concern led correction in global commodity prices, should provide additional comfort.

Having said so, several 'known-knowns' and 'known-unknowns' inflationary risks remain on the anvil.

- The impact of upward adjustment in telecom tariffs in Dec-21 is yet to get reflected.
- Continued progress on vaccinations, recovery in personal mobility along with a combination of pent-up or revenge demand could keep core inflation elevated.
- Several sectors such as autos, electronics, consumer durables, textiles among others are seeing pass-through of higher inputs costs in a calibrated manner, which could continue into 2022 along with still persistent supply disruptions.
- The spread of Omicron runs the risk of re-imposition of state-level restrictions. Though we believe that the impact of lockdowns if any, on economic activity is expected to be limited, it could nevertheless induce short term supply disruptions and in turn fuel inflationary pressures.

From perspective of CPI trajectory, we expect subsequent inflation readings to trend higher amidst the waning of a favorable base. Beginning Dec-21, CPI inflation is expected to remain in the 5.5%-6.0% band until the end of the fiscal year. Overall, we continue to maintain our FY22 average CPI inflation forecast at 5.5% with material upside risks (from factors outlined above).

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Government Finances

Wiggle room for fisc still exists

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-Nov'21 stood at 46.2% of budget estimates (BE) for FY22 compared to 59.0% of actuals in the corresponding period of FY21.
- The relatively lower accretion to fiscal deficit this year continues to reflect strong revenue collection (barring disinvestments), even as expenditure disbursal momentum showed signs of pick-up.
- Basis the second supplementary demand for grants, there is now a likelihood of additional spending (on net basis) requirement of about Rs 3.2 tn.
- Despite the expenditure slippage, the government could still meet the headline fiscal deficit ratio target of 6.8% of GDP in FY22 on account of positive surprise in tax and non-tax revenue collections, besides getting some room for adjustment from the higher than budgeted growth in FY22 Nominal GDP (led by higher inflation).
- Having said so, fiscal risks on account of substantial shortfall in disinvestment revenue and a potential Omicron led fresh wave in India need to be watched closely.

India's central government fiscal deficit for the period Apr-Nov stood at 46.2% of budget estimates (BE) for FY22 compared to 59.0% of actuals in the corresponding period of FY21. The relatively lower accretion to fiscal deficit this year continues to reflect strong revenue collection (barring disinvestments), even as expenditure disbursal momentum showed signs of pick-up.

Receipts: Powering ahead

Total receipts have been buoyed by robust tax as well as non-tax revenue accretion.

On FYTD basis (Apr-Nov), gross tax revenue collection clocked a robust growth of 50.3% YoY compared to a contraction of 12.6% seen in the corresponding period in FY21. However, it's not just the annualized growth that looks better (which is strongly aided by a favourable statistical base) – in fact, gross tax revenue has already clocked 69.8% of BE for the full year (vs. 50.7% of actuals in the corresponding period in FY21), thereby concluding first eight months of the fiscal year on a strong note. Further, vis-à-vis 2-years ago period (to avoid the pandemic related statistical distortion), gross tax revenue still clocked a healthy growth of 31.3% during Apr-Nov FY22 vs. the corresponding pre pandemic period in FY20.

- While strong momentum in tax collection is broad based, it is being powered by robust growth in customs (reflecting pickup in imports) and corporate tax (reflecting healthy earnings performance). We also note that total GST collections have stayed above Rs 1.30 tn for two consecutive months over Oct-Nov 2021.
- The excise duty cut announced by the central government last month on petroleum products to provide relief to consumers is estimated to have a minor impact of Rs 230-250 bn (~0.1% of GDP) of foregone revenue for the remainder of FY22 and hence will not materially alter overall tax collection.

Net tax revenue on FYTD basis (Apr-Nov) clocked a robust growth of 64.9% YoY vs. a contraction of 8.3% seen in the corresponding period in FY21 on account of support from gross tax collections and relatively lower tax devolution to states.

Non-tax revenue too recorded a strong annualized growth of 79.5% YoY in Apr-NovFY22 compared to a contraction of 46.6% seen during the corresponding period in FY21. Notwithstanding the favourable statistical base support, the key reason for robust performance under this category stems from a significantly higher than budgeted dividend from the RBI.

Aided by favourable statistical base, non-debt capital receipts clocked a healthy expansion of 14.1% YoY in Apr-Nov FY22 vs. a contraction of 46.6% seen in the corresponding period in FY21. In Oct-21, the government garnered Rs 2.1 bn via 0.4% divestment of its residual stake in IPCL.

Expenditure: Disbursals pick up further momentum

Total expenditure disbursal picked up momentum after remaining subdued in the initial months of the fiscal year. During Apr-Nov FY22, expenditure clocked a growth of 8.8% YoY compared to an expansion of 4.7% in the corresponding period in FY21.

On BE basis, this translates into 59.6% of the full year target vis-à-vis 54.3% seen in the corresponding period in FY21. Few observations:

- While headline revenue expenditure expanded by 8.2% YoY (61.5% of FY22 BE) during Apr-Novt FY22 vis-à-vis an expansion of 3.7% (47.4% of FY21 actuals) seen in the corresponding period in FY21, bulk of the growth is led by interest payments and subsidies. Excluding these, revenue expenditure stood at a subdued level of 2.8% YoY during Apr-Nov FY22 vs 4.9% in the corresponding period in FY21. However, with easing of restrictions on government spending from Sep-21 onwards, we expect the pace of revenue spending to gather momentum in H2 FY22.
- Thrust on investment continues with capital expenditure clocking a growth of 13.5% YoY (49.4% of FY22 BE) during Apr-Nov FY22 vis-à-vis of 12.8% (56.8% of FY21 actuals) seen in the corresponding period in FY21. Growth in capital expenditure was led by the Ministry of Road Transport and Highways, which exhausted nearly 70% of its FY22 BE as of Nov-21. Continued thrust on public capex provides comfort and would be important for supporting the economy at a time when private sentiment continues to remain subdued, at least in the near term.

Outlook

Supported by buoyant tax collections and higher than budgeted non-tax revenues, central government's fiscal position appears comfortable compared to the previous fiscal despite suffering from a temporary setback on account of the second wave of Covid in the initial months of the fiscal year.

However, we had highlighted in the November edition of 'Acuité Macro Pulse' report that additional expenditure items are stacking up. We had estimated that a combination of vaccination cost, Covid relief programme, hike in DA/DR allowance, higher fertilizer subsidy outgo, and a potential top-up of the MGNREGS budget would entail an additional spending of about Rs 2.3 tn. However, there is now a likelihood of actual increase in spending (net basis) to be close to Rs 3.2 tn. The higher than estimated spending includes impact from extension of PMGKY scheme to Mar-22 from Nov-21 along with Rs 620 bn for capital infusion in Air India Assets Holding Company for re-payment of past government guaranteed borrowing and past dues/liabilities of Air India.

Despite the higher than anticipated net spending outgo, the government could still meet the headline fiscal deficit ratio target of 6.8% of GDP in FY22 on account of significant positive surprise in tax and non-tax revenue collection so far. Significantly higher than budgeted growth in FY22 Nominal GDP (led by higher inflation) could also provide room for adjustment.

Having said so, there are few risks that need monitoring:

- The government has so far achieved only about 7% of its FY22 divestment target of Rs 1750 bn. Bridging this yawning gap in the remaining 3-months appears to be a daunting task amidst signals of scaling back of monetary accommodation by key central banks as this could potentially impart some volatility to equity markets.

- The rapid spread of Omicron variant of the coronavirus in India is a significant risk factor in Q4FY22. Although we are of the opinion that any fresh wave would be significantly less in severity, it can lead to further increase in government expenditure for health which could in turn have fiscal implications.

Table1: FYTD (Apr-Nov) comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position as of Apr-Nov)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	49.8	76.0	-17.3	67.1
Net Tax	48.3	73.5	-8.3	64.9
Non-Tax	59.7	91.8	-46.6	79.5
Non-Debt Capital Receipts	31.5	11.0	-37.5	14.1
Total Receipts	49.2	69.8	-17.9	66.0
Revenue Expenditure	54.0	61.5	3.67	8.15
Capital Expenditure	56.8	49.4	12.77	13.47
Total Expenditure	54.3	59.6	4.74	8.83
Fiscal Deficit	**59.0**	**46.2**	**-**	**-**

Rates

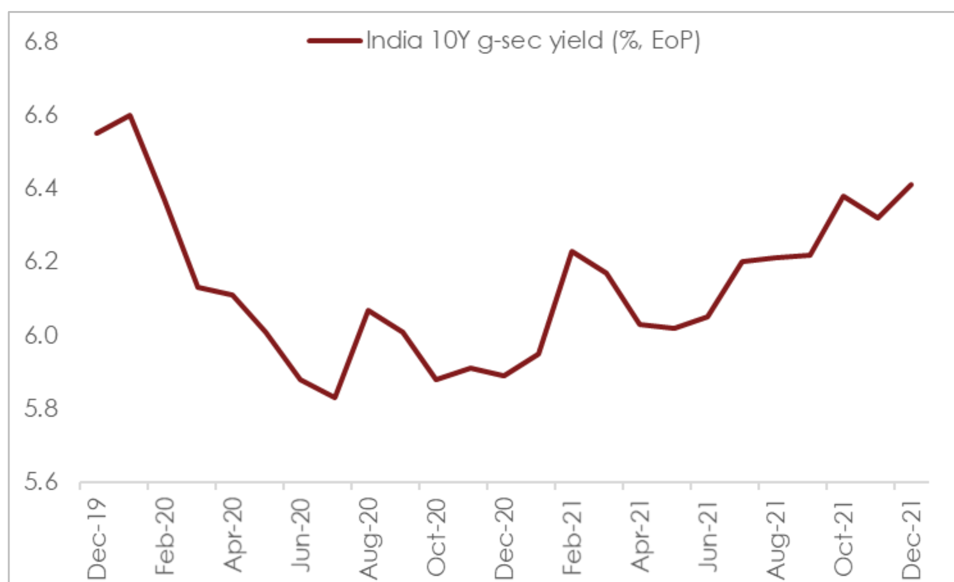
Hardening bias despite RBI's status quo

KEY TAKEAWAYS

- India's 10Y g-sec yield moderated towards 6.32% in Nov-21 from 6.38% in Oct-21 but rose thereafter to 6.47% levels in Dec-21, its highest since the start of the pandemic in mid Apr-20.
- Government policy interventions to ease off inflationary pressures along with RBI's maintenance of status quo on reverse repo rate supported market sentiment to some extent.
- However, pipeline inflation risks are building up as seen from the core inflation levels, with likelihood of its manifestation in CPI inflation in the coming quarters.
- Systemically important central banks like the US Fed and the BoE have made a hawkish pivot in Dec-21 in a bid to scale back pandemic era monetary accommodation and expedite policy normalization.
- We expect RBI to make some progress on interest rate normalization in Feb-22 or on Apr-22 after a slightly prolonged wait-and-watch phase.
- We continue to expect 10Y g-sec yield to remain around 6.50% by Mar-22.

India's 10Y g-sec yield moderated towards 6.32% in Nov-21 from 6.38% in Oct-21. However, bonds once again came under some pressure in the month of Dec-21, with the 10Y g-sec yield trading close to 6.47%, its highest level since the start of the pandemic in mid Apr-20.

Chart 1: 10Y g-sec yield is almost at a post pandemic high



Support factors played a role, but…

Over the course of last two months, bonds enjoyed limited support from the following factors:

- To provide relief from record high retail fuel prices, the central government reduced excise duty on petrol and diesel by Rs 5 and Rs 10 per litre respectively in the first week of Nov-21. This was complemented subsequently by reduction of the respective VAT rates (by different magnitude) on petrol and diesel by around 27 state governments. Further, with a view to restraining the rise in global crude oil prices, India released 5 mn barrels of crude oil from its strategic petroleum reserves, in parallel and in consultation with other major global energy consumers including the US, China, Japan and Korea.
    - As per our estimates, the reduction in retail fuel taxes provided a little over 30 bps of downward impulse to CPI inflation in Nov-21 (part of the impact will also spill over to Dec-21).
    - The coordinated geo-strategic intervention in the oil market is symbolic in our opinion and is unlikely to cause any sustained impact on prices.
- Triggered by the uncertainty from Omicron, going into the Dec-21 monetary policy review, the market consensus had drifted towards expecting a status quo on reverse repo rate. However, a certain section of the market expected a minor upward adjustment in the reverse repo rate to signal the formal

commencement of interest rate normalization, following the gradual calibration of liquidity surplus by the RBI.

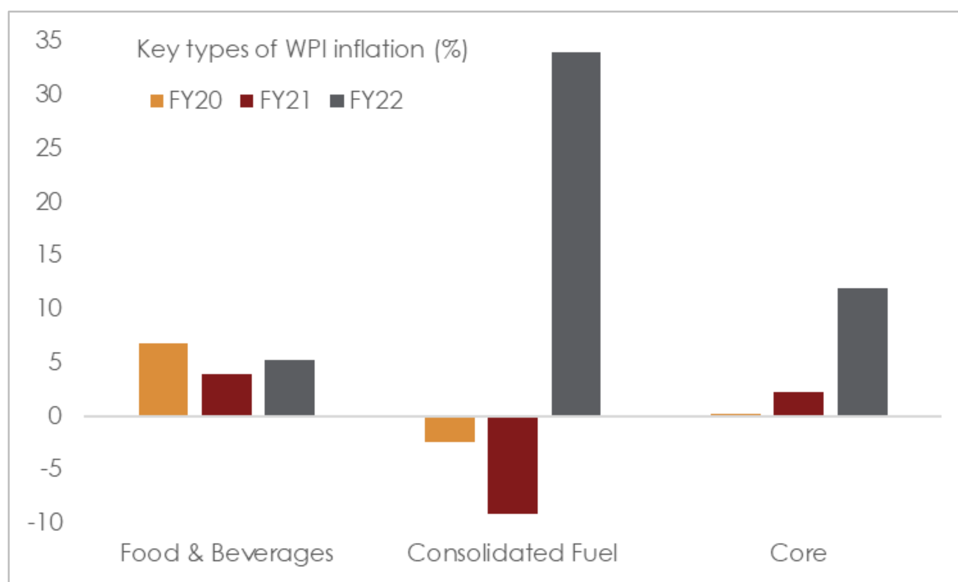
- The RBI has chosen to maintain reverse repo rate unchanged at 3.35% to ensure that India's ongoing economic recovery becomes "durable, strong, and inclusive" while downside risks from global spillovers (a potential resurgence in Covid, persistent supply disruptions, and divergence in monetary policy trajectories) get mitigated.

…ended up having a short shelf life

While the above-mentioned factors provided some support, it ended up being transitory as yields started moving up in Dec-21 due to emergence of offsetting factors.

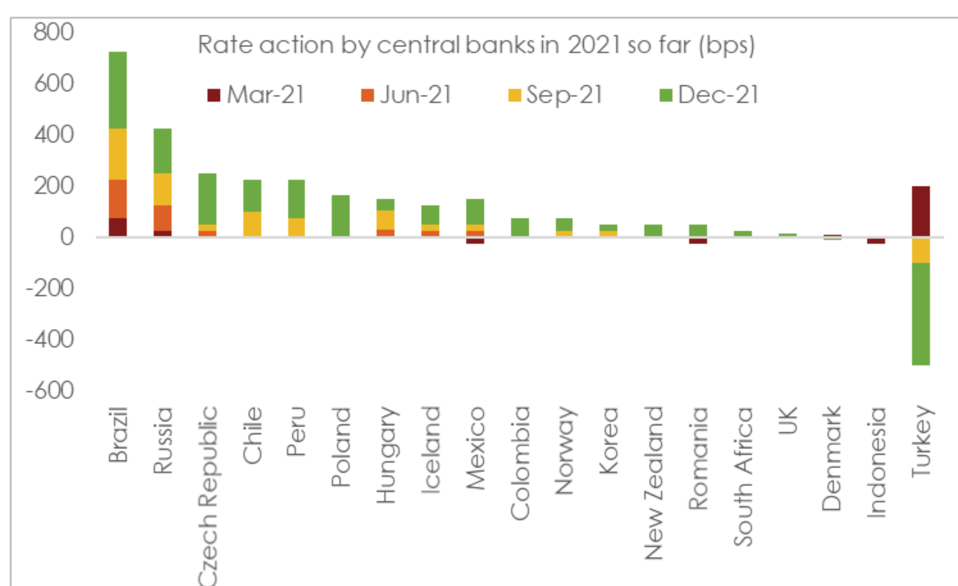
- **Emergence of inflation risks**
  Notwithstanding the substantial cut in petroleum taxes, inflation risks continue to be tilted to the upside. WPI inflation printed at 14.23% YoY in Nov-21, the highest in three decades. The accompanying core wholesale rate of inflation has been in double digits for seven consecutive months now. While the manifestation on overall retail inflation has so far been moderate, sharp and persistent build-up of input price inflation is gradually getting passed on depending upon pricing power in each sector. In this context, the ongoing upward price adjustments in FMCG space (besides others) and the sharp escalation in telecom tariffs from Dec-21 are noteworthy.

Chart 2: Fuel and manufacturing wholesale inflation depicting elevated pressure



- **<u>The turn in global monetary policy</u>**
  Central banks across many countries have started to scale back pandemic era monetary accommodation. Among developed countries, the US Fed and the BoE are major central banks who initiated their monetary policy normalization with a rather hawkish pivot in Dec-21 (refer Global Overview section below for details) in a bid to start refocusing on inflation management. Meanwhile, several EM central banks appear to be ahead in terms of policy normalization, prompted by inflation concerns and financial market stability. The year 2022 is likely to see more central banks join the normalization bandwagon, especially with the US Fed now projecting three round of rate hikes.

<u>Chart 3: Interest rate normalization by central banks gather momentum in Q4-21</u>



Outlook

Although the RBI, like most EM Asian central banks has resisted formal monetary policy normalization, the recent hawkish pivot from the Fed and the BoE could potentially change that going into 2022. Expectation of improvement in sequential domestic growth along with continued emphasis on recalibration of liquidity surplus will keep alive the likelihood of a token hike in the reverse repo in Feb-22 policy review. While any significant deterioration in domestic growth outlook on account of Omicron can reinforce the 'wait and watch' approach of RBI, market participants may continue to price in policy normalization. This will continue to provide some hardening bias to the 10Y g-sec yield, anchoring it near our target of 6.50% by Mar-22. Having said so, expectation with respect to India's inclusion in the global bond indices next year could limit any runaway pressure on yields.

Rupee

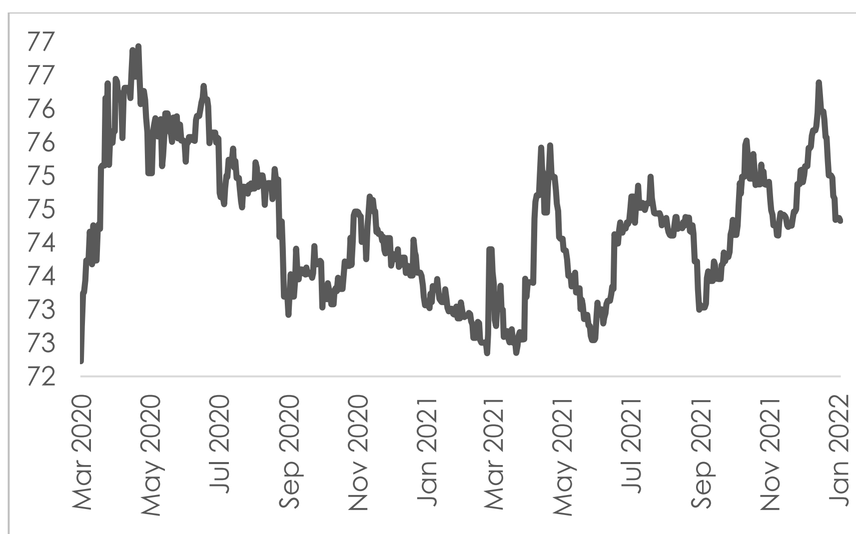
A post pandemic low

KEY TAKEAWAYS

- Indian rupee has been on a tumultuous ride since the beginning of the calendar 2021, witnessing significant volatility in the band of 72.4-76.0/USD.
- From maintaining an appreciating bias in the early months of 2021 amidst record high foreign inflows, the INR has been losing ground past couple of months.
- While INR started 2022 on a positive note there had been a sharp interim surge where the rupee almost touched 76.0/USD-the weakest level in nearly 2 years led by both domestic and global factors.
- Going forward, we continue to remain USD bulls on the back of constructive outlook on US growth, extremely elevated inflation, and the recent hawkish pivot displayed by the Federal Reserve in favor of monetary policy normalization.
- Domestically, improvement in demand and progress on vaccination is seen to be putting pressure on India's merchandise trade deficit.
- We expect BoP surplus to moderate in FY22 to USD 32 bn (after (after adjusting for the USD 17.9 bn worth SDR allocation from the IMF made in Aug-21) from USD 87 bn in FY21.
- We continue to expect USDINR to move up towards 76-77 levels by Mar-22.
- The key factors set to drive the INR in 2022: (i) spread and virulence of Omicron, and (ii) likelihood of India's inclusion in the global bond indices.

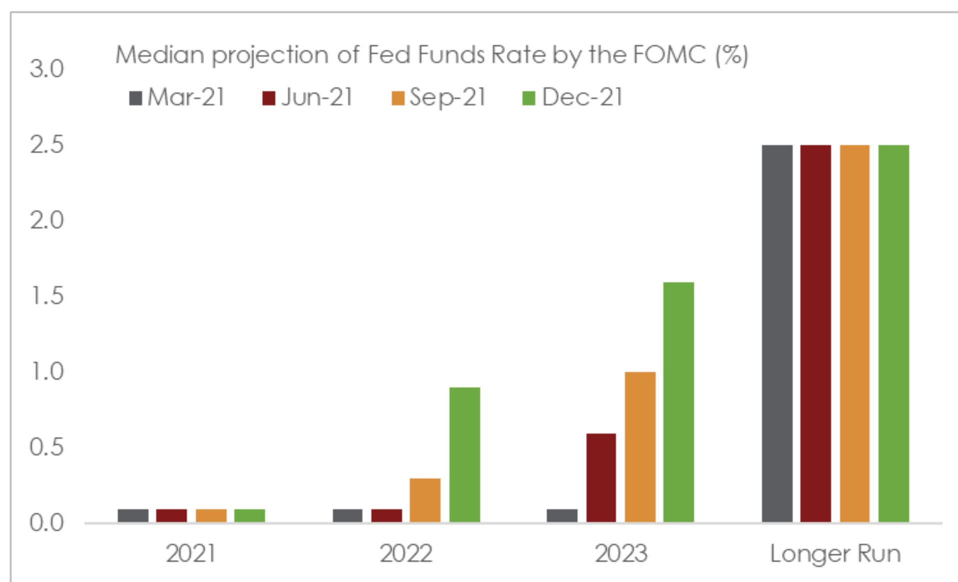
Indian rupee has been on a tumultuous ride since the beginning of the calendar 2021, witnessing significant volatility in the band of 72.4-76.0/USD. From maintaining an appreciating bias in the early months of 2021 amidst record high foreign inflows, the INR has been losing ground past couple of months. While INR started 2022 on a positive note there had been a sharp interim surge where the rupee almost touched 76.0/USD in Dec-21-the weakest level in nearly 2 years led by both domestic and global factors.

Chart 1: INR touched a near two-year high level in Dec-21



On the global front, continued strength in the US dollar amid a sharp hawkish tilt by the Federal Reserve primarily driven by inflationary pressures perceived to be more 'permanent' than earlier expected, has been one of the factors weighing on INR. In the recent FOMC meeting in Dec-21, Fed has not only announced its intent to accelerate the ongoing taper (by doubling the pace of monthly bond purchase tapering from USD 15 bn per month to USD 30 bn per month), but more importantly, it now projects three round of rate hikes in 2022, up from just one projected in the Sep-21 policy review. The projection of three rate hikes by the latest dot plot practically eliminates any major gap between end of taper and beginning of policy rate normalization as rate hikes can potentially now happen every quarter post the conclusion of the taper program in Mar-22. Going forward, we continue to believe in the strength of the dollar. Our optimism on USD stems from the economic outperformance of the US economy (averaged over 2021 and 2022, the IMF expects US GDP to grow by 5.6%, thereby making it one of the strongest growth centres among DMs).

Chart 2: Dec-21 FOMC saw a sharp hawkish pivot in favor of policy rate normalization



Domestically with increasing mobility, pent-up demand has started to get unlocked. This in addition to high global commodity prices, has kept demand for imports at elevated levels, thereby weighing upon the merchandise trade deficit. The surge in merchandise imports to a record high average level of USD 55 bn in the last three months could weigh on FY22 current account deficit (CAD). As such, we revise our CAD forecast higher at USD 46 bn in FY22 from USD 38 bn previously.

On capital account, Q3 FY22 saw a surge in FPI outflows to the extent of USD 6.5 bn, which could continue into Q4 FY22 as key global central banks begin to normalize monetary policy amidst enduring inflation at elevated levels. Hence, our FY22 BoP surplus projection now stands adjusted lower to USD 32 bn from USD 50 bn (after adjusting for the USD 17.9 bn worth SDR allocation from the IMF made in Aug-21).

Going forward, we continue to expect INR to face steady depreciation pressures. We believe that there is a material likelihood that USD/INR pair will touch the level of 76-77 by Mar-22. Having said so, the intensity of adjustment is likely to be less severe vis-à-vis the 2013 'Taper Tantrum' episode on account of relatively better domestic macros (especially expectations with respect to medium term growth and inflation) and strong FX Reserve Cover (~USD 636 bn currently that corresponds to about 13-14 months of import cover) which provides stronger ammunition to the central bank for providing support to INR, as and when required.
Additionally, the following factors could reduce the extent of weakness in INR and provide downside risk to USDINR forecast:

- Renewed COVID risks triggered by Omicron is likely to impart some downside pressure to global commodity prices.
- India's inclusion in global bond indices is likely to happen next year. An event like this could create new source of foreign inflow, thereby altering the currency dynamics.

Acuite
RATINGS & RESEARCH

Global Overview

Omicron clouds 2022 outlook

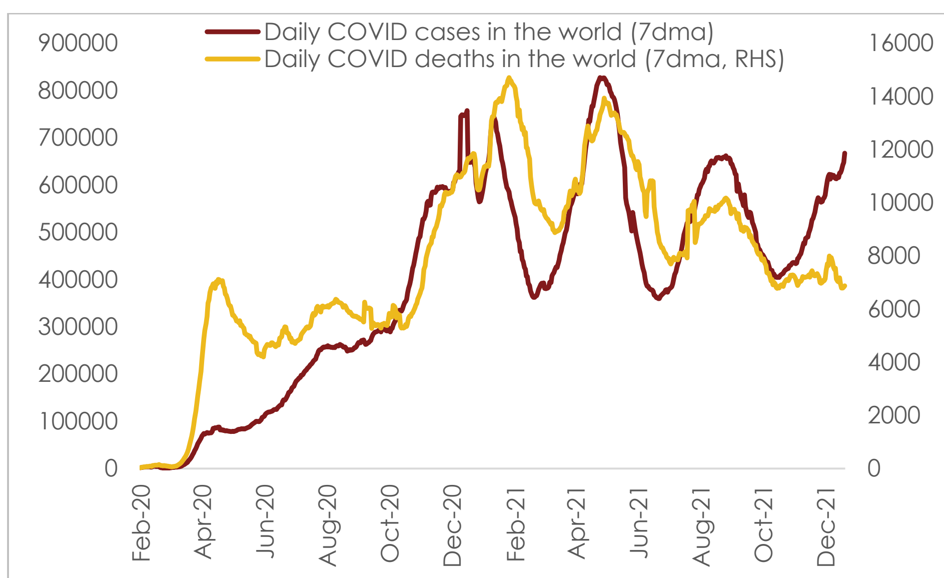
KEY TAKEAWAYS

- New Covid cases are on an uptrend globally, triggering a fresh wave. While the initial rise in cases was concentrated in Europe, subsequently infections have picked up across various geographical regions especially Africa with the emergence of the Omicron variant which has thereafter spread to the UK and the USA quite extensively.
- Despite growing infections and possible downside to growth, persistently high inflation has pushed central banks to abandon the dovish stance as 2021 drew to an end.
- The Fed announced a speeding up of the taper pace, with asset purchases now expected to conclude in Mar-22 rather than Jun-22; along with a steeper path of rate hikes over 2022-23.
- The Bank of England (BoE) went a step ahead to become world's first major central bank to raise interest rates since the onset of pandemic.
- The emergence of the Omicron variant has added a fresh element of uncertainty to the strength of global recovery heading into 2022, amidst possible upside to inflation.

Global Overview

New Covid cases once again are on an uptrend globally. While the initial rise in cases was concentrated in Europe, subsequently cases have picked up across various geographical regions partly driven by the new Omicron variant. As on Dec 31, 2021, the 7 DMA of daily global cases has more than doubled to 1.32 million from 0.57 million as on Nov-21 end and has further increased beyond 2.0 million in early Jan-22. On a region wise basis, the biggest jump is seen in Africa where the number of cases has soared with the emergence of the Omicron variant. This is followed by Europe and the American region (i.e., North and South) In contrast, infections have fallen in the regions of SE Asia and Mediterranean. On a positive note, in comparison to the pace of rise in global infections, Covid related deaths have remained quite low since mid-Oct-21 and have trended lower on a 7DMA basis of late (see chart).

Chart 1: Covid infections have spiked globally, deaths have remained low so far



* Chart data till third week of Dec-21

Against this backdrop, the effectiveness of vaccine against the Omicron variant has come under question. While conclusive results are still awaited on this front, initial data however does reinforce that a third dose or a booster shot could help boost immune response against the Omicron variant.

Despite growing infections and possible downside risks to growth, soaring inflation has pushed central banks to abandon the dovish stance as 2021 drew to an end. The Fed announced an acceleration of the taper pace, with asset purchases now expected to conclude in Mar-22 rather than in Jun-22. With its revised quarterly inflation projections (see Table1), FOMC has also signalled a significantly steeper path of rate hikes in the coming two years when compared to Sep-21. It now expects three 25 bps rate hikes each in 2022 and 2023, and further two hikes of a cumulative 50 bps in 2024.

The Bank of England (BoE) went a step ahead to become world's first major central bank to raise interest rates since the pandemic. The nine-member MPC voted 8-1 to raise the Bank Rate to 0.25% from 0.10%, with Governor Andrew Bailey saying that the Bank needed to tackle strong inflationary pressures building in the economy. On the

other hand, the European Central Bank (ECB) confirmed it would end its emergency bond purchase program in Mar-22, but simultaneously also signalled its plans to continue with its regular asset purchase program for at least several months thereafter in a continued support to economy.

US

At its Dec-21 FOMC meeting, the Committee decided it would double the pace of asset purchase tapering. To be specific, the pace of monthly buying of Treasury and MBS (Mortgage-Backed Securities) stands reduced by USD 20 bn and USD 10 bn respectively, beginning Jan-22. At this pace, purchases stand to be concluded by Mar-22 instead of Jun-22.

The change of taper pace in less than six weeks since the initial announcement has been led by favourable developments of -1) continued tightening of labour market and 2) acceleration in inflation way past Fed's target. To put this in perspective, inflation was up 6.8% YoY in Nov-21, its highest level since Jun-82. While rising energy prices contributed to the upside, but stripping out energy and food costs i.e., core inflation too rose by 4.9% YoY – a record high. In a major departure from its past stance, the Committee no longer characterized the current inflation drivers as "transitory"; in line with Chairman Powell's testimony to Congress in late Nov-21. Instead, the Committee was of the opinion that the pandemic related imbalances in the economy have been slow to wane and in turn are contributing to "elevated inflation levels". While the emergence of the Omicron variant could possibly weigh on economic activity in the near term, it also could potentially worsen the current bout of inflation.

The other key changes were with respect to Committee's Summary of Economic Projections, especially for the year 2022 and beyond. The upward adjustment in core PCE inflation for both 2022 and 2023 (see table1) reinforces two points – one, that inflation is unlikely to ease quickly and second, inflation is likely to remain above target for an extended period. In comparison, the unemployment rate is expected to ease to 3.5% by end of 2022 – reflecting near achievement of 'maximum employment' goal. Based on median projection, FOMC members now pencil in three 25 bps hikes in 2022 in comparison to being evenly split between no hike and one hike as of Sep-21. This is expected to be followed by 75 bps of hike in 2023 followed by another 50 bps in 2024.

On macroeconomic front, incremental real activity data has been mixed. US retail sales grew by less than expected at 0.3% MoM led by weakness in electronics and department store sales. Separately, Non-farm payrolls increased by less than half of the consensus estimate in Nov-21, at 210k. On a positive note, the previous two months payrolls were revised up by 82k along with a stronger drop in unemployment rate from 4.6% to 4.2%. Additionally, ISM manufacturing index rose to 61.1 and indicated some preliminary signs that supply constraints may be beginning to ease. ISM services index too catapulted to 69.1 surpassing an all-time high level achieved last month.

Table: Economic Projections of FOMC members (median)

	As of Sep-21				As of Dec-21			
Variable	**2021**	**2022**	**2023**	**2024**	**2021**	**2022**	**2023**	**2024**
Change in real GDP	5.9	3.8	2.5	2	5.5	4.0	2.2	2
Unemployment rate	4.8	3.8	3.5	3.5	4.3	3.5	3.5	3.5
PCE inflation	4.2	2.2	2.2	2.1	5.3	2.6	2.3	2.1
Core PCE inflation	3.7	2.3	2.2	2.1	4.4	2.7	2.3	2.1

EUROZONE

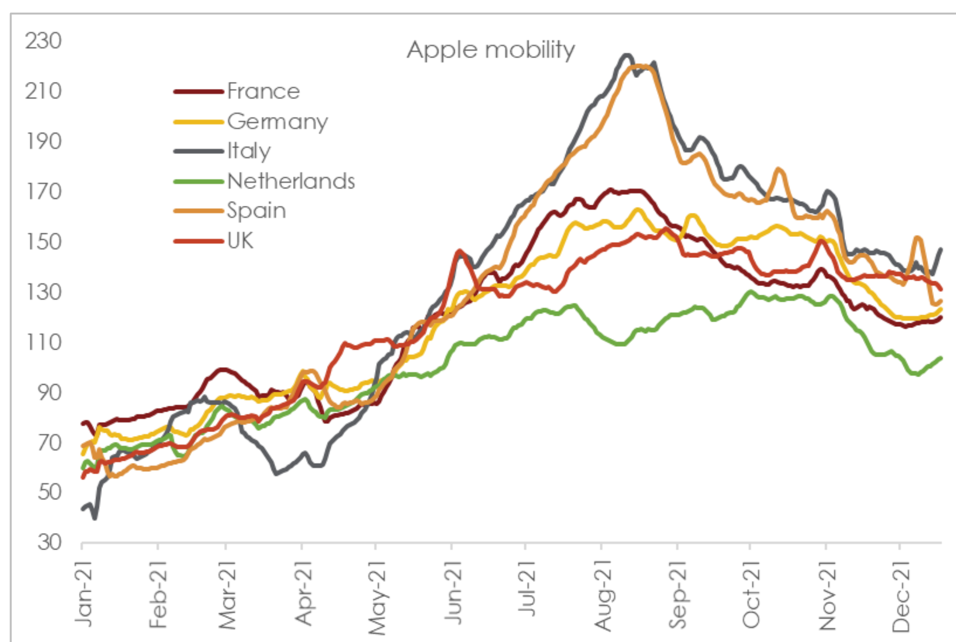
The recent data points to economic activity in Eurozone undergoing a slowdown amidst fresh wave of infections and elevated inflation. However, the moderation has been led more by the services sector, amidst renewed restrictions while manufacturing sector has performed relatively better with supply bottlenecks showing early signs of waning.

As such, the Services Purchasing Managers' Index (PMI) for the region slipped to 53.3 in Dec-21 (as per flash estimates), after posting at 59.9 points in Nov-21. The differences between countries were marked. The slowdown was mainly driven by Germany, for which the PMI score fell below 50 to 48.4 for the first time in eight months. In comparison, France saw growth continue at a fast pace, which should help keep the economic impact of the fourth wave modest in 4Q. Separately, industrial production expanded by 1.1% MoM in Oct-21, to clock an annualised growth of 3.3%. This marked the first sequential uptick after two months of contraction. On inflation front, preliminary estimate for HICP inflation in the Eurozone jumped to 4.9% YoY in Nov-21 up from 4.1% in Oct-21, with core inflation rising to 2.6% YoY vs. 2.1% previously. At a granular level, energy prices were the dominant driver, up 27.4% on an annualised basis, along with services inflation.

In comparison to its peers, ECB adopted a more measured approach in its Dec-21 policy, signalling only a gradual shift to a less accommodative monetary policy. The ECB reaffirmed the end to purchases under the Pandemic Emergency Purchase Program (PEPP) program by Mar-22; while stating that Q1-2022 purchases would be conducted at a slower pace than the previous quarter. Post the completion of PEPP purchases, the ECB said it would quicken the pace of its regular Asset Purchase Program (APP) from the current EUR 20 bn per month to gradually taper overall bond purchases. In addition, the central bank went a step ahead and extended the reinvestment horizon for its PEPP holdings until at least the end of 2024 and said net purchases under the PEPP program could be resumed if necessary to counter negative shocks related to the pandemic.

In its updated economic projections, ECB forecasts CPI inflation at 2.6% for 2021 and 3.2% for 2022 (vs. 2.2% and 1.7% earlier), but projected inflation slowing to 1.8% for 2023 and 2024. With respect to GDP growth, the ECB lowered its forecast by 40 bps for 2022 to 4.2% but raised its forecast for 2023 to 2.9% vs. 2.1% earlier. Objectively, the prospect of inflation returning below the 2% target over the medium term allows the ECB to gradually taper its bond purchases during 2022.

Chart 2: Mobility declined sharply in Eurozone amidst outbreak of fresh infections



UK

Economic recovery has been dealt a fresh blow with the arrival of the Omicron variant. Economic activity had already begun to lose momentum in Oct-21 ahead of a rise in infections, as GDP expanded by a mere 0.1%MoM against an expectation of 0.4% amidst weakness in the industrial sector. In other incremental economic indicators, PMI measure for economic output fell from 57.6 in Nov-21 to 53.2 in Dec-21. Accompanying the slowdown in growth, UK consumer price inflation surged to 5.1% in Nov-21 i.e., the highest level in more than a decade.

Against this easing growth momentum, the Bank of England surprised some section of the market, by announcing a 15 bps hike in policy interest rate to 0.25% - to become the first G7 central bank to do so in the current cycle. In its accompanying statement, BoE cited an already tight labour market that continues to tighten, amidst signs of inflation "persistence". In terms of guidance, the BoE hinted that moderate tightening may be needed overtime, albeit at a gradual pace. BoE Governor Andrew Bailey insisted that the Bank needed to tackle inflationary pressures building in the economy. Though the central bank did acknowledge the Omicron variant posing downside risks to activity in early 2022, the balance of its effects on demand and supply, and hence on medium-term global inflationary pressures, is unclear. In similar vein, BoE Chief economist more recently commented that "I think it is also important to keep in mind that omicron-related risk is probably two-sided, at least as it is reflected in our core objective, our ambition in terms of the inflation outlook over the medium term".

In terms of its economic assessment, the central bank acknowledged downside risks to growth from Omicron variant. The Bank expects consumer price inflation to remain around 5% through the majority of the winter period, and to peak at around 6% in Apr-22, with further upside predominantly due to lagged impact on utility bills of rise in wholesale gas prices.

CHINA

The Chinese economy moderated further in Nov-21, weighed down by the repeated outbreak of infections along with worsening of property market slump. In terms of incremental data, investment growth eased to 5.2% on a YTD basis as of Nov-21 from 6.1% upto end of Oct-21. The slowdown was led by a contraction in the automobile sector, amidst shortages of semiconductors which also weighed on industrial output. As such, industrial production clocked a growth of 3.8% YoY compared to 3.5% in Oct-21. Further, annualised retail sales growth weakened to 3.9%, missing forecasts of 4.7% expansion by a fair margin. The drag was driven by weakness in restaurant and catering sub-sectors, as people stayed at home amidst renewed restrictions amidst Government's "zero-COVID" approach.

On the monetary policy front, in a bid to support the flailing growth, the PBoC cut the RRR for the second time this year, by 50 bps effective 15th Dec-21 (announced on Dec 6, 21), estimated to release 1.2 tn Yuan. This has been followed by a cut in its main interest rate for the first time in 20 months. As such, the 1-year loan prime rate (LPR) stands 5 bps lower at 3.8% - first reduction since Apr-20, i.e., since the onset of the pandemic.

Looking ahead, various growth forecasts for China are pegging growth in the vicinity of 5.0% in 2022 amidst continued stress in the real estate sector, weakening exports and domestic consumption. At the end of the three-day annual Central Economic Work Conference held over 8-10 Dec-21, the conference directed government departments at all levels to "take responsibility for stabilizing the macroeconomy" heading into 2022.

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