# Macro Pulse Report

January 2023

# Contents

## From the desk of the CAO

Greetings from Acuité Ratings & Research! I am happy to release the **twenty fifth** edition of **Acuité Macro Pulse**, our monthly health-check on the global and the domestic economy. I would also like to share another good news with you – Acuité has been certified as a **"Great Place To Work"** for the second year in a row which strengthens our aspiration to transform the company into one of best knowledge organisations in India.

In early February, there were two key domestic economic events – **Union Budget FY24** and the **RBI MPC** Meeting. While our analysis of these events has been published separately and is available on our website, let me share a larger perspective of what we take away from them. The budget didn't throw any surprises – it continued to reinforce the fiscal narratives of higher capital expenditure with increased focus on sustainability and higher adoption of digital technology in almost every sphere of the economy that will drive both growth and productivity gains, both critical to reach the milestone of US 5 tn nominal GDP. There was also the intent to revert to fiscal consolidation that was on display although the targets have been kept realistic – a 50 bps reduction in fiscal deficit in FY24 and another 150 bps over the next two years. What was noteworthy was the relative lack of populist measures despite the impending state and central elections.

As regards the takeaways from MPC, the 25 bps hike to bring the repo rate to 6.50% was a given but what was not expected by the market, was the tone of hawkishness in the statement that suggested more hikes may be on the way. The stance was also retained at "withdrawal of accommodation" to stress on the fact that more work needs to be done on the inflation front. This was subsequently validated in the latest CPI inflation print which gave a somewhat shock to the market by rising again to 6.5% in Jan-23 after coming below 6% in the previous two months. The central bank's concerns are not only on food inflation that continues to shape the inflation figure but also on core inflation which has remained well above 6% since the start of the current fiscal, highlighting the deep rooted nature of the problem.

While inflation is likely to see a gradual downtrend across the world assuming of course no fresh adverse events, the central banks across the world including in India are unlikely to drop guard easily given their experience over the last two years. It is likely that the monetary stance will continue to be in a "mini hike – pause" mode for an extended period to ensure that inflation doesn't evolve into a chronic ailment for the global economy.

India is not likely to be different with RBI likely to watch the core inflation print closely before going for the "pause' button. This increases the likelihood of the repo rate climbing further to 6.75%/7.00% over the next few quarters if inflation continues to play a cat and mouse game. This will translate into a few more hikes in lending and deposit rates with banks lagging behind in monetary transmission.

On the positive side, the growth momentum is visible in the domestic economy despite the slowing effect of the global developments and we believe that a GDP growth of 6.0% is quite realistic for FY24.

Your feedback will help us to improve the contents of the publication. So, please don't hesitate to drop in a line. Happy reading,

Suman Chowdhury
Chief Analytical Officer

# Growth

## Slower but steady in FY24

**KEY TAKEAWAYS**

- The Indian economy has managed to withstand the headwinds rather well over the last several months amidst a tough global environment.
- Domestic growth impulses have gained strength, as urban consumption continues to push demand for both goods and services with derivative support accruing from the government capex cycle which has got a further boost from the Union Budget 2023. Private investments remain somewhat confined, unsurprisingly in an environment of heightened global uncertainty although the higher credit growth reflects the start of a trickle.
- The breadth of domestic economic activity should continue to find support in a healthy rabi harvest and improved rural demand, the strength in services sector exports, pent up demand in the travel and the tourism sector along with central government's consistent focus on pushing capital expenditure.
- Nevertheless, growing risks to growth outlook emanate from the impending slowdown in global demand in 2023, with Dec-22 domestic export growth contraction of 12.2%YoY – i.e., the steepest contraction in 2 years, serving as a harbinger of tougher times ahead. Further, the continuing rise in interest rates and a relatively tighter liquidity environment may have a lagged impact on demand.
- Taking all these factors into account, we continue to hold our GDP growth forecast at 7.0% for FY23 but anticipate the trajectory to slip to 6.0% in FY24 which would still place India as one of the highest growth economies.

The Indian economy has managed to withstand the headwinds rather well over the last several months amidst a tough global environment - the geopolitical uncertainty that continues to simmer, a synchronized and an aggressive monetary policy rate tightening cycle and the slowing momentum in global growth.

Domestic growth impulses have gained strength, as urban consumption continues to push demand for both goods and services with derivative support coming from central government capital expenditure which is pegged at Rs 7.5 Lakh Cr in FY23 and Rs 10.0 lakh Cr in FY24. Private investments remain somewhat confined, unsurprisingly in an environment of heightened global uncertainty although there are signs of green shoots due to the incentives such as PLI being provided by the government. Growing risks to growth outlook emanate from the impending slowdown in global demand in 2023, with Dec-22 domestic export growth contraction of 12.2%YoY – i.e., the steepest contraction in 2 years, serving as a harbinger of tougher times ahead.

**FY23 First advance estimate**

As per First Advance Estimates of National Income released by National Statistical Organisation (NSO), India's real GDP and GVA growth for FY23 are projected at 7.0% and 6.7% respectively. The projected GDP growth stands a tad higher than RBI's though it matches with our estimate.

- FY23 estimated growth marks a deceleration vis-à-vis 8.7% and 8.1% of real GDP and GVA growth clocked in FY22 – a year marked by onset of post pandemic recovery and strongly supported by a favourable base.
- Nominal GDP for FY23, which becomes a critical input for budget arithmetic, is estimated at Rs 273.1 Lakh Cr – translating into annualised growth of 15.4% compared to 19.4% in FY22. Against the budgeted growth of 11.1%, this growth upside gives the Government an added fiscal headroom of nearly Rs 95000 Cr in FY23 (or 30 bps cushion to FY23 fiscal deficit to GDP ratio of 6.4%).
- With H1 FY23 GDP growth estimated at 10.7%YoY, the First Advance Estimates imply a growth of 4.5% in H2 FY23. This marks a sharp slowdown – an outcome primarily of winding down of favourable statistical base, even as incremental quarterly growth momentum remained resilient in Q3 FY23 amidst reopening dynamics and festive season support.

**Recent data releases**

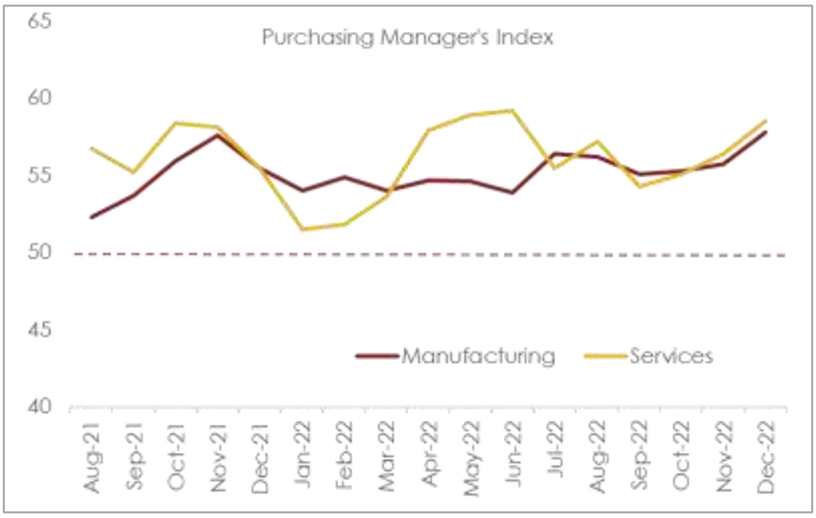
Looking at the latest data releases, high frequency indicators suggest that domestic economic activity remained broadly resilient over the months of Nov-22 and Dec-22, though the steep contraction in exports can be seen as a red flag.

- While **Acuité Macroeconomic Performance index (AMEP index)** has witnessed a moderation from a high of 131.7 in Sep-22 to 123.3 in Dec-22, it has recorded a growth of 7.2%YoY and 0.7%MoM respectively. The higher figures printed in Sep-22 and Oct-22 had been a reflection of heightened economic activity before or during the festive season which is typically difficult to sustain in the subsequent months. On a cumulative basis for the first nine months of the fiscal

(Apr-Dec'22), the average AMEP index has risen by 14.4% as compared to the corresponding period of the previous fiscal which was partly impacted due to the lockdown from the second Covid wave.

- India's growth print in industrial index of production (IIP) moderated to 4.3%YoY in Dec- 2022 after touching a five-month high of 7.3%YoY in Nov-22, in line with market consensus pegged at 4.5%YoY. However, the sequential momentum was strong at 5.3%MoM in Dec-22, building on the 6.3%MoM expansion recorded in the previous month and broadly in line with the average expansion of 6.7%MoM usually seen in the month of December. This reflects a gradual recovery in industrial activity after a sluggish H1FY23.
- Headline manufacturing PMI rose to a 22-month high of 57.8 in Dec-22 from 55.7 in Nov-22, led by a strong increase in new orders and output. However, it has seen a subsequent drop to 55.4 in Jan-23, it has been higher than 55 since Sep-22.
- Services PMI rose to the highest level in 6 months coming in at 58.5 in Dec-22 from 56.4 in Nov-22, driven by an increase in new businesses. At a granular level, growth was driven by sectors of finance and insurance. Subsequently, it has slightly moderated to 57.2 in Jan-23.
- As such, the Composite PMI Output Index sped from 56.7 in Nov-22 to 59.4 in Dec-22 to mark the quickest pace of sequential growth in 11 years but it came down to 57.5 in the previous month.
- Gross GST revenue collections in Dec-22 (i.e., for transactions in Nov-22) rose marginally to Rs 1.49 Lakh Cr compared to Rs 1.46 Lakh Cr in Nov-22 and further to Rs 1.56 Lakh Cr, with the annualized growth registering an improvement to 12.7%.
- E-way bills rose yet again in Dec-22, to 8.4 Cr from 8.1 Cr in Nov-22 but it has again dipped to 8.2 Cr in Jan-23.
- Merchandise exports slipped to USD 32.9 bn from USD 34.5 bn in Dec-22 and USD 34.8 bn in Nov-22. After posting a modest growth of 9.6%YoY in Nov-22, exports contracted both in the months of Dec-22 and Jan-23.

**Chart 1: Buoyancy in PMI in H2FY23, slight dip in Jan-23**



**Outlook**

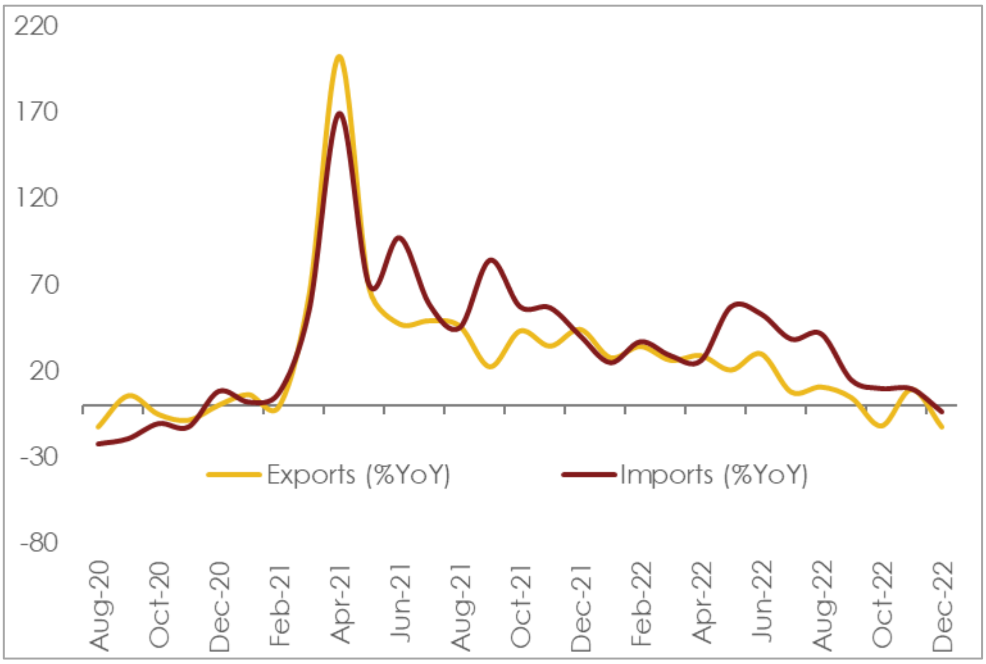
Resilience in economic activity continues to get underpinned by the supportive undercurrent visible across most proxy indicators such as PMI, Core output, E-way bills generated among others, broadly over the months of Dec-22 and Jan-23. Encouragingly, the pace of growth has endured beyond the festive season. The breadth of economic activity continues to find support in healthy rabi sowing, moderating retail inflation, strength in services sector exports along with central government's focus on capex.

Having said so, we acknowledge escalating downside risks from external side amidst weakening of growth impulses due to tightening of global financial conditions and still heightened geopolitical uncertainty. In its latest update to the Global Economic Prospects report, the World Bank slashed its growth forecast for 2023 and 2024 to 1.7% and 2.7% - this marks a sharp loss of momentum against the growth estimates of 3.0% in 2023 and 2024 provided in June 2022. The latest export data for Jan-23 which marks the steepest fall in nearly 2 years, can be seen as a harbinger of tougher times ahead. Within exports, manufacturing exports remain a weak point, with growth remaining in contraction since Oct-22.

Among other drivers of growth, pace of private capex recovery could remain somewhat sluggish given escalating global headwinds and slowing urban consumption on the back of rapid pace of monetary tightening undertaken by the RBI since Apr-22. This would mean a moderation of growth impulses as we move into FY24.

Taking these factors into account, **we continue to hold on to our GDP growth outlook at 7% for FY23 and anticipate growth slipping to 6.0% in FY24.**

**Chart 2: Export in Dec-22, marked the steepest pace of decline in more than 2 years**



# Inflation

## It’s too early to declare victory

**KEY TAKEAWAYS**

- India’s inflation at retail and wholesale level diverged in Jan-23 with the CPI print unexpectedly rising to 6.52% YoY (3-month high) while WPI eased slightly to 4.73% YoY (24-month low).
- What is noteworthy is the reversal of the declining trend on a sequential basis with a positive growth MoM in both inflation indices.
- While easing food prices had helped both WPI and CPI inflation drift lower over months of Nov-Dec-22, it was observed that some components in the food index (esp. non-perishable items) have actually been responsible for a sharp increase in Jan-23.
- Concerns on core CPI inflation continue to persist, with the print holding steady at 6.3% over the last three months given the strong momentum seen particularly in the services inflation.
- The strong upside surprise in Jan-23 CPI print could potentially result in Q4 FY23 inflation coming in close to 6.0%, higher than RBI’s estimate of 5.6%. In addition, it could potentially result in full year inflation averaging at 6.7%, i.e., 20 bps higher than Acuite and RBI’s estimate of 6.5%.
- Although we continue to expect FY24 CPI inflation to moderate to 5.3% (on account of moderate relief from commodity prices and impact of lower growth momentum), likelihood of a breach of inflation targeting band again in Q4 FY23 will continue to keep RBI’s MPC vigilant.
- As such, we maintain our call of a 25 bps rate hike in the Apr-23 policy review. Thereafter, the MPC may choose to leave the door open for incremental rate hikes by turning data dependent.

**Overview**

India's inflation at retail and wholesale level diverged in Jan-23 with the CPI print reversing its downward trend and rising to 6.52% YoY (3-month high) while WPI slightly eased to 4.73% YoY (24-month low). More importantly:

- Notwithstanding the divergence at headline level, both inflation metrics depicted a rising sequential momentum, albeit with a significant difference in magnitude – while CPI rose by a significant 0.46% on MoM basis, WPI posted a relatively smaller increase of 0.13% MoM over the previous month.
- After remaining below the policy target band of 2-6% for two successive months in Nov-22 and Dec-22, CPI inflation shot above the target in Jan-23.

**Key highlights of CPI inflation**

- The increase in CPI index marks the steepest sequential momentum seen in the month of January compared to the series average of -0.17% MoM before the latest print. Typically, the headline inflation witnesses a seasonal sequential decline in the month of January due to the benign prices of perishable food items.
- Food and Beverages index rose unexpectedly by 0.45% MoM in Jan-23 vs. the series average of -0.76% MoM usually seen in January. The upturn was led by Cereals (2.60% MoM), Eggs (2.26% MoM), Spices (1.56% MoM), and Meat & Fish (0.81% MoM). On the other hand, price pressures were seen easing in case of Vegetables (-3.75% MoM), Edible Oils (-0.64% MoM), and Sugar (-0.57% MoM).
- 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 healthy rabi sowing and a normal monsoon assumed in CY23 along with expected steps from government to cool down any spurt in food prices, upside risk to food inflation could get neutralized.
- The jump in CPI was also driven by the sub-indices of Housing (0.82% MoM) and Miscellaneous (0.47% MoM). Within Miscellaneous index, the upsurge was led by Personal Care and Effects (10-month high of 1.59% MoM), Health (0.66% MoM), and Household Goods and Services (0.44% MoM). On annualized basis, this pushed core inflation further(CPI ex indices of Food & Beverages, Fuel & Light, and petrol and diesel items within Miscellaneous) to 6.5% YoY in Jan-23 from 6.3% YoY in Dec-22. Clearly, heightened core inflation is one of the key concerns of policy makers at this stage.
- 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 from 4.95%YoY in Dec-22 on account of favorable statistical base, even as the index rose sequentially, marking its largest monthly rise in 3-months.

- The incremental gain in Jan-23 was led predominantly by the Consolidated Food & Beverages index that rose by 0.59% MoM. Offering comfort, the Consolidated Fuel index declined by 1.34% MoM.
- 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 2.62% YoY in Jan-23 from 3.15% YoY in Dec-22.

**Outlook**

While favourable statistical base effect helped WPI inflation drift lower in Jan-23, both inflation indices registered a sequential rise driven by surging prices of food and services at wholesale and retail levels. Having said so, the divergence in inflation at retail and wholesale level continues to persist, and in fact widened in Jan-23. Although WPI inflation continued its descent, CPI inflation rose to a 3-month high of 6.52% YoY. The divergence between them manifests (i) relatively strong linkage of WPI basket to softening global commodity prices, and (ii) dominance of services (non-tradables) in Core CPI basket. While the former has been on a correction path since mid-2022, pick-up in services activity has enabled an acceleration in prices and has been responsible for a stickiness in core CPI inflation.

However, there is also silver lining. Juxtaposed with lower commodity prices vis-à-vis average levels in 2022, expected moderation in domestic growth impulses, assumption of a normal monsoon in CY23, and a healthy rabi sowing (cultivation ended with 3.3% increase in acreage over the previous sowing season), one is hopeful of food price pressure easing, allowing for a gradual downward trajectory in CPI inflation In FY24. As such, we maintain our FY24 CPI inflation projection of 5.3%.

However, the steep upward surprise in Jan-23 CPI inflation data could push Q4 FY23 CPI inflation towards 6.0%, higher than RBI's projection of 5.6%. In addition, it could potentially result in full year inflation averaging at 6.7%, i.e., 20 bps higher than Acuite and RBI's estimate of 6.5%.

From monetary policy perspective, the likelihood of a breach of inflation targeting band in Q4 FY23 would continue to impart a sense of vigil and hawkishness in RBI MPC. As such, we maintain our call of a 25 bps rate hike in the Apr-23 policy review. It is also likely that we need to wait longer for the much awaited change in stance in monetary policy from "withdrawal of accommodation" to "neutral". After April, the MPC could choose to leave the door open for incremental rate hikes by turning data dependent.

**Chart 1: CPI and WPI inflation depicted a divergent trend at headline level in Jan-23**

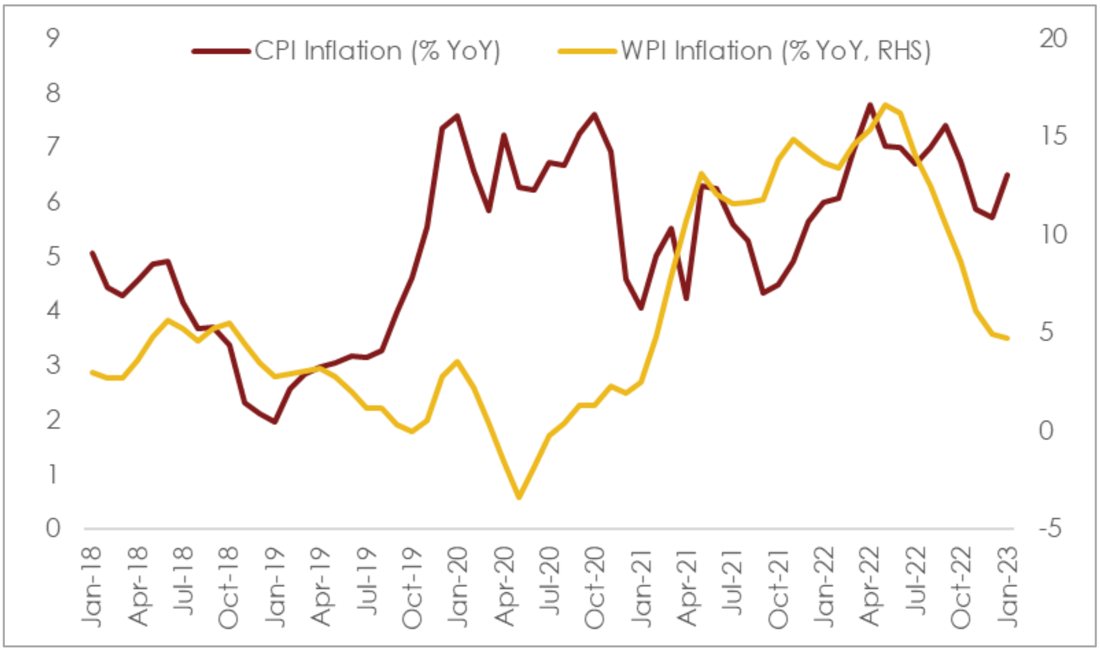
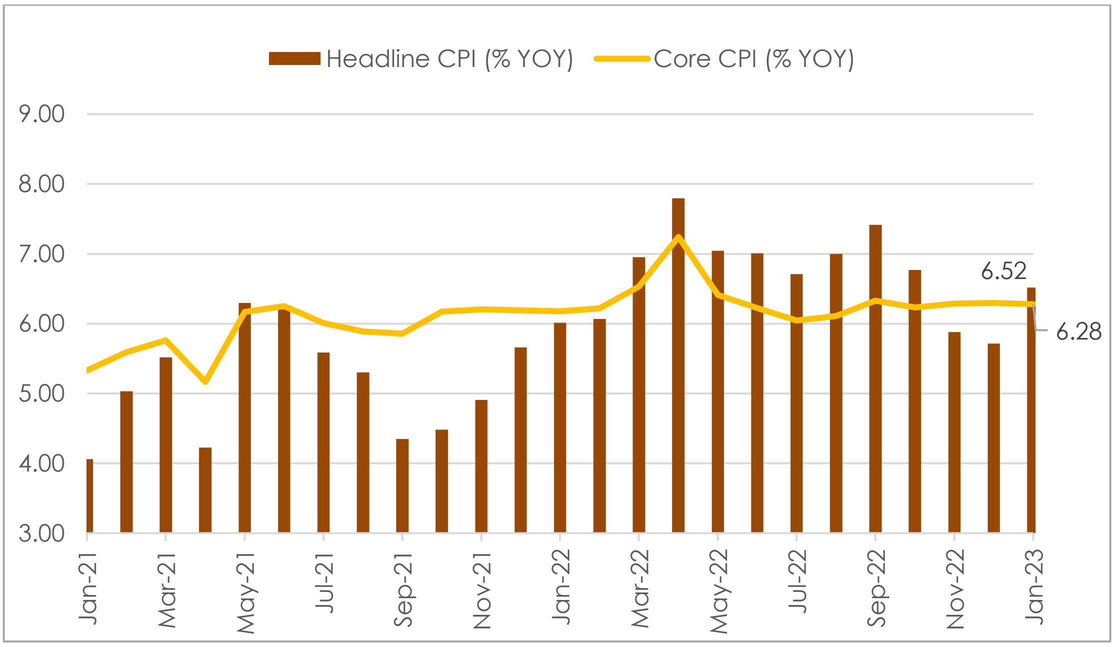



**Chart 2: All not well on the inflation front**



# Government Finances

## Focus on quality of expenditure

**KEY TAKEAWAYS**

- India's central government fiscal deficit for the period Apr-Dec stood at 59.8% of budget estimates (BE) for FY23, higher than the level of 47.9% of actuals in the corresponding period in FY22.
- The FYTD fiscal theme continues to rest upon strong receipt collections and prioritization of capex over revex.
- Fiscal headwinds continue to persist in the form of additional subsidy burden, cut in excise duty and customs on select items to provide relief from inflation, deferment of big-ticket divestment, and lower than budgeted dividend transfer by the RBI.
- Nevertheless, we continue to believe that the central government has buffers that would enable it to attain the budgeted target on account of persistence of tax buoyancy, upward adjustments in some of the indirect tax rates, expenditure saving and rationalization, and higher than budgeted Nominal GDP base.
- Union Budget 2023 has pegged the fiscal deficit target for FY24 at 5.9% of GDP, 50 bps down from 6.4% in FY23, reverting to the fiscal consolidate mode post pandemic.
- Capital expenditure, green energy, agriculture, and adoption of digital technology emerge as focus areas. Improvement in the quality of expenditure and fiscal transparency also remain on radar, besides credible arithmetic.
- Central government's capital spending is expected to rise to a two decade high of 3.3% of GDP in FY24, providing a strong impetus to growth and job creation. With revenue expenditure set to grow marginally by 1.2% in FY24 amidst savings on food and fertilizer subsidies, the quality of spending is expected to improve further.

India's central government fiscal deficit for the period Apr-Dec stood at 59.8% of budget estimates (BE) for FY23, higher than the level of 47.9% of actuals in the corresponding period in FY22. While both receipts and expenses have been outperforming last year's pace, the higher accretion to FYTD fiscal deficit this year is on account of relatively faster pace of expenditure disbursal vis-à-vis budget estimates.

**Receipts: Both tax and non-tax revenues providing support**

Total receipts in the nine months of FY23 continue to be buoyed by strong tax collections.

- On FYTD (Apr-Dec) basis, net tax revenue clocked 80.4% of BE compared to 81% of actuals in the corresponding period in FY22, indicating a very similar pattern.
    - Momentum so far is supported by healthy collections under income tax, corporate tax, and GST. The impressive momentum in GST revenue continues to persist with total monthly collections averaging at Rs 1.50 Lakh Cr during Apr-Jan FY23 compared to the anticipated monthly run rate of Rs 1.35-1.40 tn for meeting the BE. While the mid-year hike in GST rates for select goods and services and the festive heavy H2 FY23 are seen to be key enablers, moderation in imports could weigh upon the momentum in the coming months.
    - Meanwhile, collections from excise and customs have been relatively lower, reflecting the relaxation in duties on select import items (including retail fuel) to provide relief from elevated inflation.

Non-tax revenue collections accelerated to 79.5% of BE during Apr-Dec FY23 vs. 74.4% of actuals in the corresponding period in FY22. Pick-up in dividend pay-out from PSEs along with support from telecom spectrum revenue has managed to offset the drag on account of lower dividend transfer from the RBI this year.

Non-debt capital receipts clocked 69.5% of BE during Apr-dec FY23, similar to the levels of 72.7% of actuals in the corresponding period in FY22. After a gap of 4-months, Nov-22 saw government realizing Rs 38 bn from sale of Axis Bank shares held by SUUTI. However, no big ticket disinvestment is expected in the current year after that of LIC in May-22.

**Expenditure: Quality of spending gets a further leg-up**

On FYTD (Apr-Dec) basis, total expenditure disbursal stood at 71.4% of BE, higher than 66.4% of actuals in the corresponding period in FY22.

- Momentum continues to be led by capital expenditure that clocked 65.4% of BE during Apr-Dec FY23 vis-à-vis 66.1% 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 Lakh Cr 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 have more than doubled during Apr-Dec FY23.
- Revenue expenditure too firmed up to 72.9% of BE during Apr-Dec FY23 from 66.5% of actuals in the corresponding period in FY22.

- Interest payments and subsidies have accounted for 42.4% of revex disbursals in the first 8 months of this fiscal.
- Excluding interest payments and subsidies, revex grew by a modest pace of 3.7% YoY during Apr-Nov FY23.

**Other key highlights**

Recently, the government made two key announcements:

- The FY23 Union Budget had made provision for seminal issuance of Sovereign Green Bonds (SGBs) as a part of overall borrowing. Accordingly, Rs 160 bn was proposed to be issued in Q4 FY23 in 5 and 10-year maturities and the proceeds would be used in public sector infrastructure projects. The first tranche of SGBs have been issued in Jan-23. While FY24 Union Budget hasn't made any specific provision for issuance of SGBs, the market expects fresh issuances of Rs 150-160 bn in the next fiscal.
- The government will provide free foodgrains under the National Food Security Act for a period of 1-year, starting from Jan 1, 2023. This will replace the Pradhan Mantri Garib Kalyan Ann Yojana (PMGKAY) (the post pandemic free foodgrain program) with effect from Dec 31, 2022. We believe this timely announcement would not just help in prudent management of foodgrain buffer stocks, but it will also reduce the FY24 food subsidy bill by approximately Rs 1 trillion (Lakh Cr), thereby generating additional fiscal space for developmental expenditure.

**Outlook**

As highlighted in our last month's edition of Acuite Macro Pulse, fiscal headwinds continue to persist in the form of additional subsidy burden (primarily on account of extension of PM Garib Kalyan Anna Yojana and adverse spill over of Russia-Ukraine war on prices of fertilizers and crude oil), cut in excise duty and customs on select items to provide relief from inflation, deferment of big-ticket BPCL divestment, and lower than budgeted dividend/surplus transfer by the RBI.

However, we continue to believe that the central government would be able to scrape through and attain the budgeted fiscal deficit target of 6.4% of GDP which has also been validated in the Union Budget FY24.

**Union Budget FY24**

The FY24 Union Budget displayed a fine balance between fiscal consolidation and the need to preserve growth impulses. Continuing its path of fiscal consolidation for the third consecutive year, the Budget announced a 50 bps reduction in fiscal deficit to GDP ratio from 6.4% in FY23 to 5.9% in FY24. The impetus on capex since FY21 has been sustained along with a fresh digital push and thrust on the green economy with a vision to drive productivity and efficiency gains over the medium term. In addition, the recalibration in personal income tax slabs and raising of income tax rebate threshold to Rs 7 lakh under the new tax regime will not only be a relief for the salaried class and pensioners but also serve as a consumption support. Overall, it appears to be a budget for everyone - intending to push the domestic growth levers of the economy, viz. consumption and investment. We will cover the budget in greater detail in our next Macro Pulse. Meanwhile, you can also refer to our publication on the budget here: https://www.acuite.in/pdf/Union_Budget_Feb-2023.pdf

**Chart 1: Central government remains committed towards gradual fiscal consolidation**

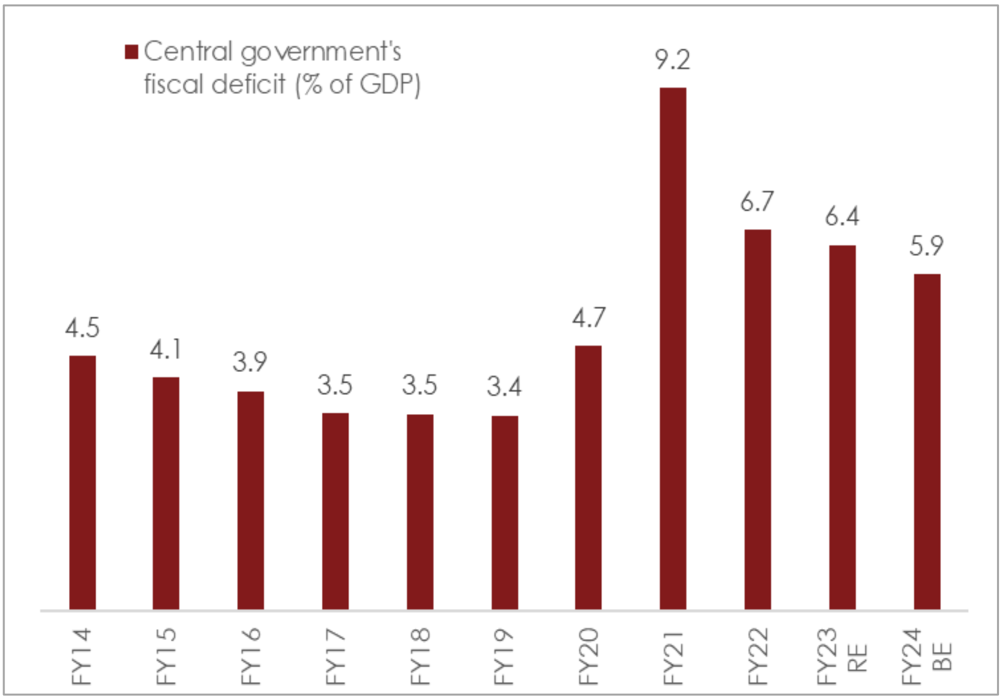



**Table1: Comparison of key drivers of fiscal deficit**

| Key Fiscal Variables (Cumulative Position, Apr-Nov) | | | | |
|---|---|---|---|---|
| | % of FY Actual/Target | | %YoY | |
| | FY22 | FY23 | FY22 | FY23 |
| Revenue Receipts | 62.6 | 64.6 | 67.1 | 4.8 |
| Net Tax | 62.4 | 63.3 | 64.9 | 7.9 |
| Non-Tax | 64.1 | 73.5 | 79.5 | -11.1 |
| Non-Debt Capital Receipts | 52.8 | 52.3 | 14.1 | 100.4 |
| **Total Receipts** | **62.5** | **64.1** | **66.0** | **6.2** |
| | | | | |
| Revenue Expenditure | 56.3 | 62.5 | 8.2 | 10.8 |
| of which, Interest Payment | 57.3 | 58.0 | 20.4 | 18.1 |
| of which, Major Subsidies | 53.2 | 94.7 | 14.1 | 30.6 |
| Capital Expenditure | 46.2 | 59.6 | 13.5 | 63.4 |
| **Total Expenditure** | **54.7** | **61.9** | **8.8** | **17.7** |
| | | | | |
| **Fiscal Deficit** | **43.8** | **58.9** | **-** | **-** |

# Rates

## Moderate upside on the cards

**KEY TAKEAWAYS**

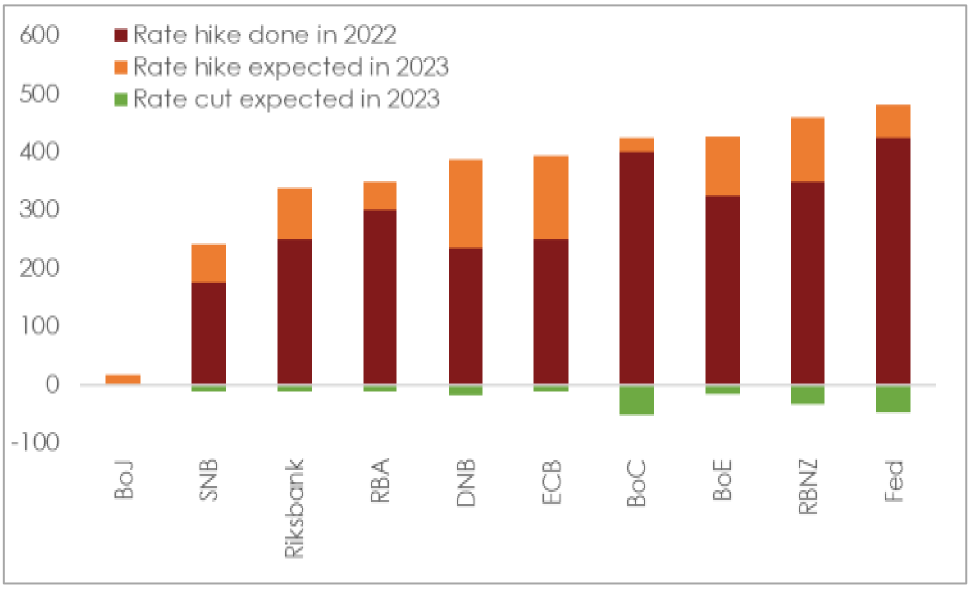
- Over the last 3-months, inflation has begun to descend from peak levels across most economies in the world.
- The upshot from this development has been a step down in monetary policy aggression by most central banks despite the persistence of monetary tightening.
- Current market pricing suggests a softening of residual rate hike expectations from key central banks.
- In line with consensus expectations, the Monetary Policy Committee of the RBI raised repo rate by 25 bps to 6.50% in its scheduled policy meeting on 8th Feb-23. This takes the cumulative hike in repo rate to 250 bps since May-22.
- Although average inflation forecast for FY23 saw a downward revision to 6.5% and for Q4FY23 to 5.6%, the central bank highlighted that core inflation continues to remain sticky around 6% levels.
- Despite 2 out of 6 MPC members voting for a pause in policy tightening, the remaining 4 members continue to sound collectively hawkish. The policy stance remained unchanged with the MPC continuing to be "focused on withdrawal of accommodation".
- We expect the RBI to persist with monetary tightening given the persistence in core inflation at elevated levels. This leaves the door open for yet another 25 bps hike in Apr-23 with shift in stance becoming data dependent.
- We continue to maintain our 10Y g-sec yield call in the 7.10-7.50% range for the near term.

Over the last 3-months, inflation has begun to descend from peak levels seen around mid-2022 across most countries in the world. Moderation in commodity prices since then, ongoing gradual easing of global supply chain disruptions, and lagged impact of monetary policy tightening is beginning to have the desired impact on inflation (which is also enjoying a favorable statistical base in most cases).

As highlighted in the Dec-22 edition of "Acuite Macro Pulse" report, although success in taming inflation is still far away (as inflation continues to persist much above policy targets in several countries), these are indeed encouraging signs. The upshot from this development has been a step down in monetary policy aggression by most central banks despite the persistence of monetary tightening.

Current market pricing suggests a softening in residual rate hike expectations from key central banks (for e.g., while the dot plot from Dec-22 Fed policy review suggests incremental 75 bps of rate hike in 2023, market participants are expecting a lower quantum of 50 bps). In fact, market expectations are depicting a strong pivot in late 2023, with likelihood of the beginning of a rate cut cycle for key central banks (for Canada and US, nearly 51 bps and 47 bps of rate cut is currently priced in respectively).

**Chart 1: Markets expect monetary policy pivot to manifest in late 2023**

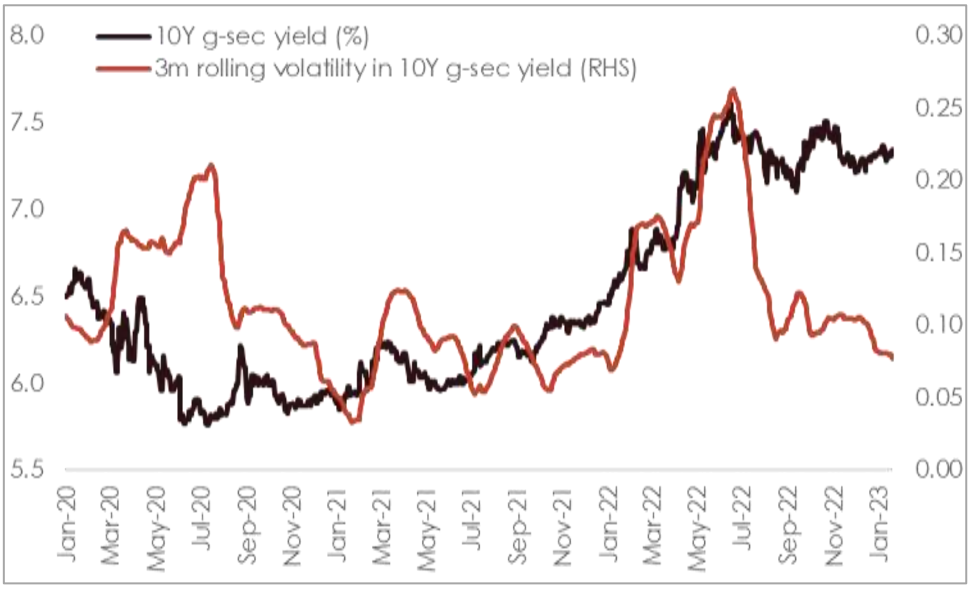



Notwithstanding this broadly comforting global rates backdrop, domestic g-sec yields have traded with a mild upward bias in recent weeks.

- Compared to its Dec-22 lows, the 10Y g-sec yield is up by 14 bps currently.
- After closing the month of Dec-22 at 7.32%, India's 10Y g-sec yield is currently trading close to 7.35%.

Despite this mild upward bias, we note that volatility in 10Y g-sec yield has been moderating and is currently at its lowest level (on 3-month rolling basis for standard deviation) in FY23 so far.

## Chart 2: Volatility in 10Y g-sec yield moderated with rangebound movement




After a bottom of 7.2% near end Nov-22, there has been a moderate upside of yields of 15-18 bps. While CPI inflation printed under 6% in Nov-Dec 2022 after remaining above the policy threshold for ten consecutive months, it has again seen a spurt in Jan-23. WPI inflation in the meantime has exhibited fast paced deceleration – the recent annualized print of 4.73% in Jan-23 stood at a 23-month low. In addition, near term drivers (like improvement in rabi sowing and moderation in price of India Crude Basket compared to recent months) provide a supportive backdrop for the inflation trajectory despite the volatility in food prices.

This has coincided with a dilution in RBI's monetary policy aggression, similar to the trend observed in case of other key central banks. In the last policy review in Feb-23, two MPC members voted for no rate hike vs. the consensus decision of 25 bps hike (which was a step down from 35 bps rate hike in the Dec-22 meeting). In addition, two out of six members preferred a neutral stance, i.e., in contrast to the 'withdrawal of accommodation' policy stance adopted by the consensus.

While we continue to expect the RBI to persist with monetary tightening to guard against generalization of core inflation pressures into a wage-price spiral, we believe:

- After a hike of 25 bps in Apr-23, MPC could opt for a pause for impact assessment.
- The stance may change to "neutral" only after core inflation witnesses a sustained decline to below 5%.

With this backdrop, the mild upside in g-sec yields is somewhat perplexing. We can nevertheless ascribe the following reasons for the same, which we believe would be non-durable in impact:

- BoJ's unexpected raising of cap on 10Y JGBs (to 0.50% from 0.25% earlier) triggered a short sell in global fixed income market towards the end of 2022. However, with the BoJ reiterating that this does not tantamount to a rate hike and maintaining status quo in its Jan-23 policy review, normalcy is getting restored.

- With pressure on INR switching from depreciation to appreciation, the RBI nature of FX intervention has also shifted from being a net seller of dollars to a net buyer of dollars in recent months. To partially sterilize the impact of this intervention on liquidity, the central bank has sold Rs 107 bn worth g-secs since Nov-22. We do not expect the trend to continue in any meaningful and durable manner as seasonal pick-up in cash in circulation and overall expectation of BoP deficit is already working to reduce the money market liquidity surplus.

**Outlook**

The FY24 Union Budget offers relief to the bond market as the announced gross borrowing target of Rs 15.4 trillion is lower than the consensus estimate of close to Rs 16 trillion. Since the headline fiscal arithmetic appears credible, there is no prima facie reason to expect the need for additional borrowing at this stage.

The 10Y g-sec yields continue to remain soft and the budget has given a rationale for that softness. This is in line with our view of bond yields remaining range bound (7.10-7.50% on the 10Y) until Mar-23. However, with global monetary tightening almost running its course (while the US Fed is expected to pause in Mar-23, we anticipate the RBI to deliver its final rate hike of 25 bps in Feb-23 and opt for a pause thereafter), bond yields could drift lower in FY24.

Having said so, the moderation is unlikely to be swift as (i) overall supply pressure on account of gross borrowing remains elevated, and (ii) ballooning interest burden (at 3.6% of GDP in FY24) on account of mounting debt levels would make achieving fiscal deficit target of "under 4.5% of GDP by FY26" a challenging task. This would require doubling down of policy effort to shed fiscal flab, aggressive implementation of monetization strategy, and enhancing tax coverage and compliance.

# Rupee

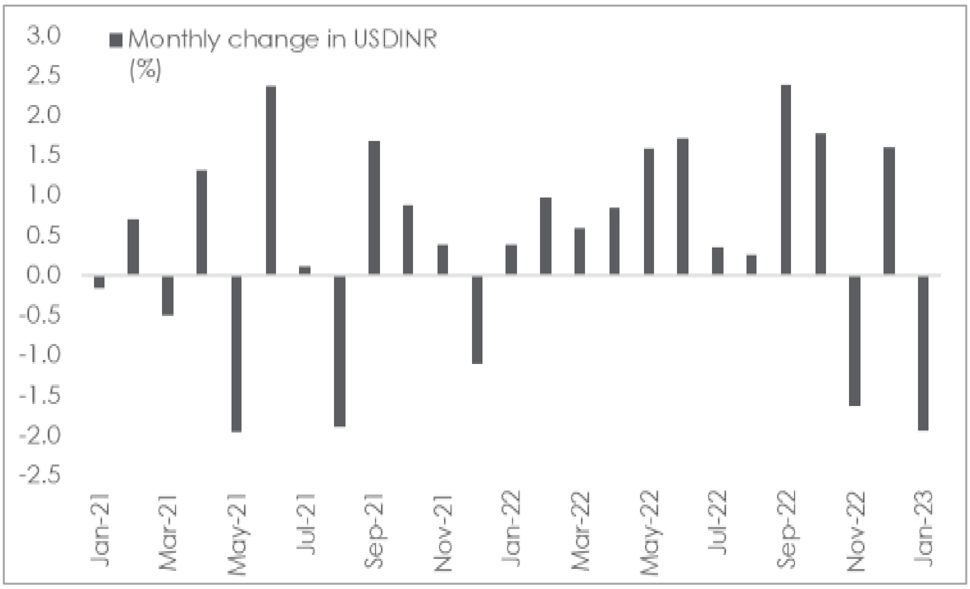
## Likely to remain range bound

**KEY TAKEAWAYS**

- After closing the month of Dec-22 at a level of 82.72, the Indian rupee has exhibited some volatility in the band Rs 81-83.
- We continue to expect a soft landing for the global economy and see pricing in of early reversal of monetary policy stance across the key economies as untenable. This along with the gradual QT should be supportive of the USD.
- Meanwhile, expectation of BoP deficit could continue to weigh upon INR.
- While we continue to expect mild weakness in rupee, there is a downside risk to our Mar-23 USD-INR call of 84.

After closing the month of Dec-22 at a level of 82.72, the Indian rupee has exhibited some volatility in the band Rs 81-83.

**Chart 1: INR continues to exhibit volatility**




The rupee witnessed a significant appreciation in Jan-23 but the trend has been reversed in Feb-23 with the currency back to the almost one year high levels of 83.

DXY Index had dropped by over 10% compared to its big figure level of 114 seen in Sep-22, with the month of Jan-23 marking its fourth consecutive monthly fall. However, this has got partly reversed in the current month with the DXY moving up from almost 101 to 104. While the global market was earlier pricing in the possibility of a recession like scenario forcing the Fed to do a U-turn on its intent to keep monetary policy rate 'higher for longer' to tame inflationary pressures, the latest data prints and communication seem to suggest otherwise.

Easing of Covid restrictions in China in our opinion would reduce the tail risks for the global economy in 2023 and provide support to commodity prices on the margin. This would reduce the likelihood of a hard landing scenario for the global economy, thereby raising the chances of the Fed staying on course. In addition, the Fed will reduce its balance sheet by a further USD 1.1 tn in 2023, way ahead of any other major central bank, a gradual mop up of dollar liquidity would continue to support the USD.

An additional factor weighing upon the USD has been the issue of US Treasury's debt ceiling. Lack of political consensus on increasing the debt limit in time (before Jun-23) could potentially open up the possibility of a default by the US government, which would weigh upon the USD. While we don't see any easy resolution on this topic (given the dominance of Republicans in the House), political negotiations with respect to spending could be drawn out in the coming months.

From INR perspective, reasons for expecting a mild weakness continue to persist:

- Notwithstanding some moderation in India's merchandise trade deficit in last 3-months, the overall level of deficit continues to remain elevated (at an average level of USD 24.3 bn per month in FY23 so far vs. USD 15.9 bn in FY22).
- While we recently lowered our estimate of FY23 BoP to USD -38 bn from USD -60 bn projected earlier, it nevertheless remains in a deficit territory.
- Foreign investment flows are showing signs of moderation.
    - For the first time in 29-months, FDI flow had turned negative with Nov-22 recording a net direct investment outflow of USD 2.4 bn.
    - The month of Jan-23 has seen a net portfolio outflow of over USD 3.0 bn – the worst outcome in last 7-months.

**Chart 2: Despite some moderation, India merchandise trade deficit remain elevated**

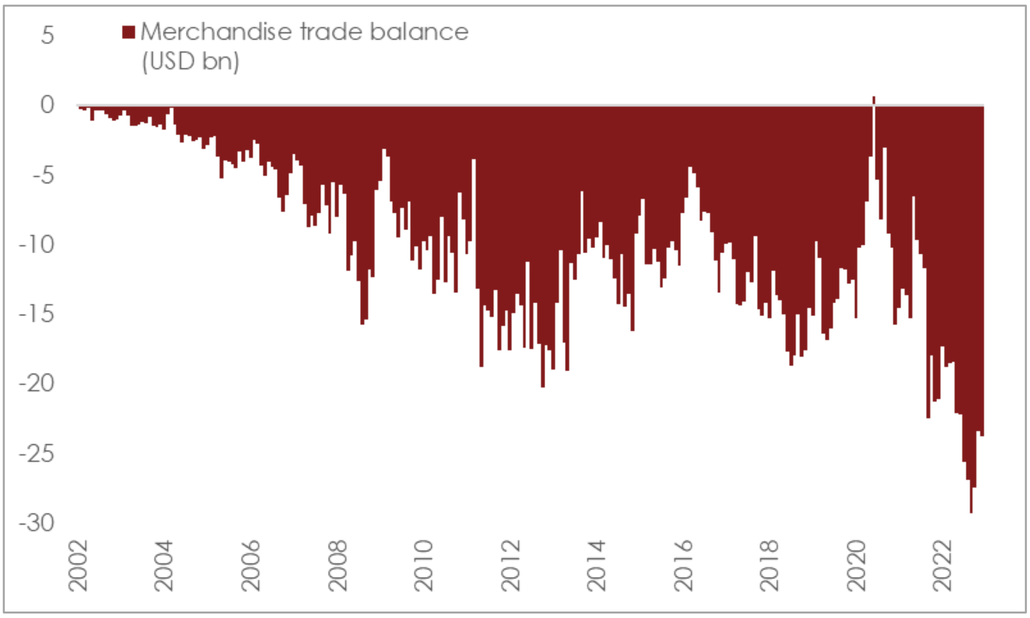
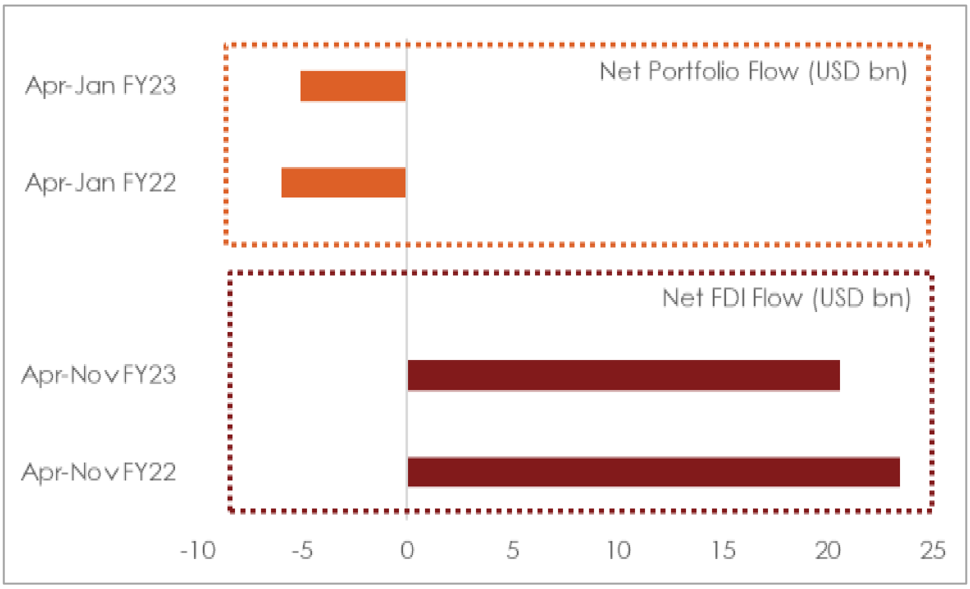


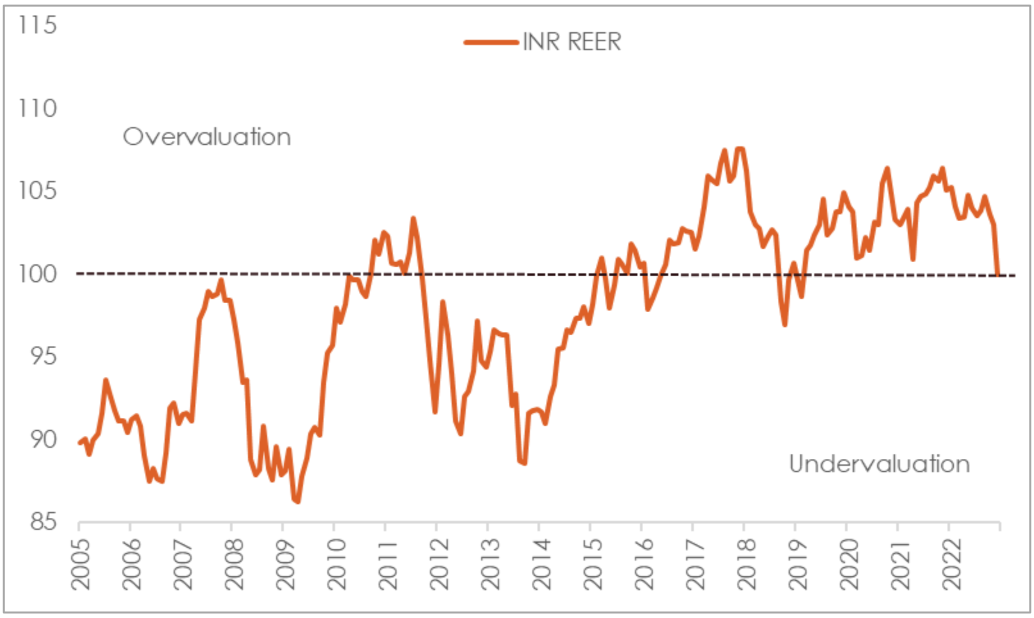

**Chart 3: Foreign investment flows continue to trail last year's performance**



As such, we expect mild weakness in rupee to continue. However, we acknowledge that there is a possibility of a downside risk to our Mar-23 USDINR call of 84.

- The dollar weakness theme has receded for now, with the US Fed indicating its 'higher for longer' stance emphatically in the upcoming policy review on Feb 1, 2023.
- Rupee's underperformance in recent months vis-à-vis its trading partners has narrowed its REER based overvaluation considerably. As of Dec-22, the REER index stood at 100, its lowest level in last 46-months.

**Chart 4: Rupee's REER index has fallen to a 46-month low**



# Global Overview

## Balancing growth-inflation impulses

**KEY TAKEAWAYS**

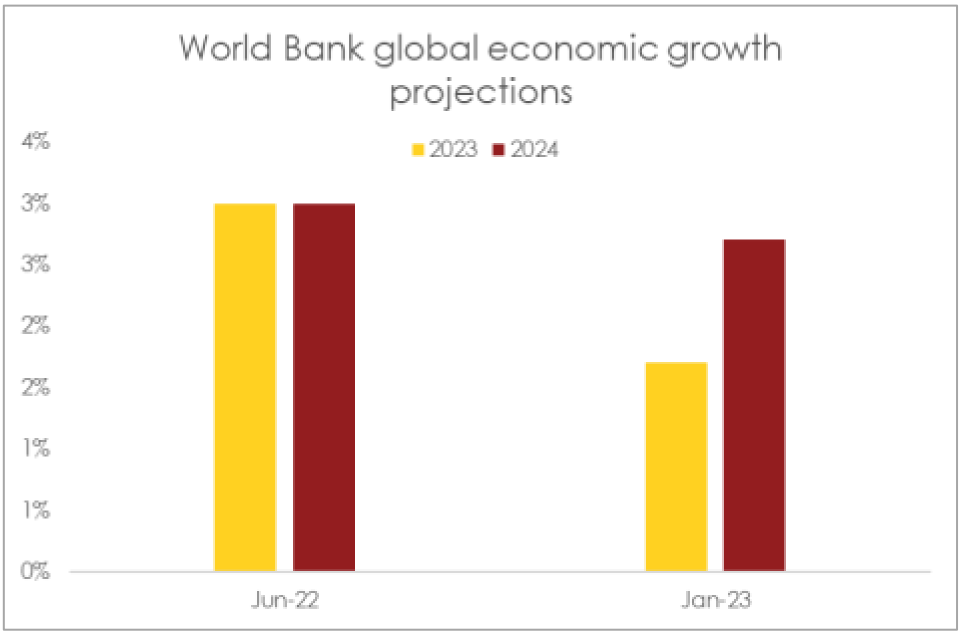
- As the calendar 2023 proceeds to the second month, it is perhaps apropos to define last year as intensely challenging on the economic front with complexities arising from geopolitical tensions along with aggressive and synchronized rate tightening in a bid to lower inflation to tolerable levels.
- This impending slowdown was captured in the JPMorgan Global Composite PMI in December which remained flattish at 48.2 in Dec-22 from November's 29-month low of 48.0, and still lingers below the 50 benchmark that separates expansion from contraction.
- In its latest report prepared at the start of the year, World Bank indicated a sharp, long-lasting slowdown. The challenges that the global economy is facing are immense and weakening economic indicators point to further challenges ahead.
- Looking into 2023, it is expected to be a year of weaker growth outcomes. The tightening of financial conditions will unleash its full impact, pushing some economies into a recession. But the year will also likely see lower inflation and a near-end to rate hikes.

**Global overview**

As 2023 commences, it is perhaps apropos to define last year as intensely challenging on the economic front with complexities arising from geopolitical tensions along with an aggressive and synchronized rate tightening in a bid to lower inflation to tolerable levels. These factors persist into 2023 and are likely to weaken growth outcomes as monetary policy tightening unleashes its full impact, pushing some economies into a recession. The nascent signs of this impending slowdown were captured in the JP Morgan Global Composite PMI which remained flattish at 48.2 in Dec-22 from a 29-month low of 48.0 in Nov-22, and still lingers below the 50 mark that separates expansion from contraction. Although signalling a slight easing in the pace of contraction, the reading was still among the weakest registered over the past 15 years.

In its latest World Economic Prospects report, World Bank predicts a sharper and long-lasting slowdown, with global growth projection for 2023 reduced to 1.7% from 3.0% expected just six months ago. The sharp downturn in growth is expected to be widespread, with forecasts in 2023 revised down for 95% of advanced economies and nearly 70% of emerging market and developing economies.

**<u>Chart 1: World Bank trims global growth prospects for 2023 and 2024</u>**




2023 will also likely see lower inflation and a near-end to rate hikes as early signs of easing inflation have emerged in EMEs such as India, Brazil Russia, and Thailand. US CPI inflation too softened to a 14-month low of 6.5%YoY in Dec-22 from 7.1%YoY in Nov-22. UK inflation marginally eased to 10.5%YoY in Dec-22 from 10.7% in Nov-22 and inflation retreated to single-digit territory in Eurozone to stand at 9.2%YoY in Dec-22 from 10.1%YoY in Nov-22. This indicates inflation having peaked amid easing global commodity prices, even as core inflation across major economies remains stubbornly elevated on account of persistent pressure in services inflation.

While there is a consensus on a likely slowdown in growth in 2023, there still seems to be a fair degree of divergence on whether advanced economies will slip into a recession or not. Despite hiking rates aggressively through last year, labour markets in most advanced economies have proven to be resilient. In US, non-farm payrolls saw an addition of 223k in Dec-22, yet again beating consensus estimates of 200k along with a reduction in unemployment rate to 3.5%. Against these pockets of strengths, it remains to be seen if economic resilience can continue for longer than being anticipated, well into 2023.

Given these growth-inflation dynamics, central bankers are likely to dial down on their pace of rate hikes and assess the impact of past cumulative hikes on the economy. As growth slowdown increasingly becomes more palpable with some economies slipping into a recession in 2023, terminal rates may well be in near sight perhaps hitting a peak in H1-23.

**US**

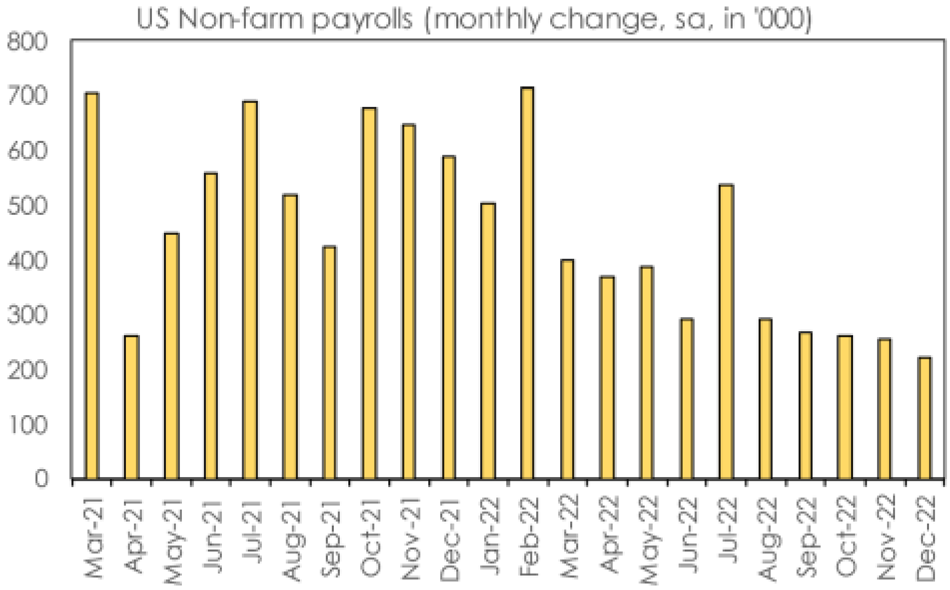
The U.S. ended 2022 with a moderation in CPI inflation suggesting the economy has started to move the way the Federal Reserve had hoped for. CPI index contracted by 0.1%MoM in Dec-22, marking the first sequential contraction recorded since May 2020. On annualized basis, this translated into inflation easing to a 14-month low of 6.5%YoY in Dec-22 from 7.1%YoY in Nov-22. Energy prices weighed on the overall index, as gasoline prices slipped sequentially by 9.2%MoM. In addition, the transport component of the CPI index recorded its 6th consecutive month of sequential decline at 2.5%MoM in Dec-22. Core CPI, which excludes food and energy, also moderated to 5.7%YoY in Dec-22 from 6.0%YoY in Nov-22. On the heels of CPI, headline PPI prices also rose less than expected in Dec-22, with PPI inflation easing to 6.2%YoY in Dec-22 from 7.3%YoY in Nov-22.

On the activity side, holiday shopping season turned out to be weaker than expected with retail sales (which capture consumer purchases of goods) plummeting more than expected by 1.1%MoM in Dec-22, the sharpest drop in 12-months. This marked the second consecutive monthly moderation in retail sales, pulled down by decline in purchases of motor vehicle, furniture, and dining out. Still elevated goods prices along with rising interest rates are undercutting leveraged consumption of goods. This slowdown in demand for goods does not bode well for manufacturers as validated by industrial production falling by 0.7%MoM in Dec-22, to mark the biggest decline in last 1 year and the sixth negative print in last 8 months. Manufacturing activity remains on a weak turf amidst waning global growth backdrop, rising interest rates and a stronger dollar.

On the other hand, the labour market surprised on the upside in Dec-22, as the unemployment rate fell back to a pre-pandemic low of 3.5% in Dec-22 from 3.7% in Nov-22. Non-farm payrolls exceeded expectations too with 223,000 jobs added in Dec-22 led by service-oriented sectors of Leisure and hospitality, Health care and social assistance among others. Nonetheless, this was still the lowest monthly jobs increase since Jan 2021. The most crucial detail coming in from the labour market report was easing wage growth, which grew at 4.6%YoY in Dec-22, to mark the slowest annual pace in 16 months.

On the monetary policy front, minutes of the FOMC meeting held in Dec-22 suggest that the Fed's hawkish leaning remains very much intact at this point as officials warned against a premature easing until a sustained decline in inflation is achieved. But Federal Reserve Board members also acknowledged they had made "*significant progress*" over the past year in raising rates enough to bring inflation down. As a result, they recognize the need to balance the fight against rising prices with the risks of a slowing economy and "*potentially placing the largest burdens on the most vulnerable groups*" through higher-than-necessary unemployment. This, along with the moderating spending and easing inflation have led to expectations of Fed going somewhat slower on rate hikes (and in magnitude too) in the next meeting to be held of 31st Jan-1st Feb.

**Chart 2: US non-farm payrolls trend lower, but continue to surprise on the upside**




On balance, recent economic indicators support resilience in the US economy so far in Q4, though headwinds from still elevated inflation, tightening monetary policy and heightened global uncertainty remain in place. Despite the moderation in the headline inflation, the FOMC will not immediately end to the rate hiking cycle, but more like slow the pace of tightening to 'take stock' of the impact of cumulative past hikes on the economy.

**UK**

The most encouraging macroeconomic development in the UK, was the relief on consumer inflation in Dec-22 which eased to 10.5%YoY from 10.7% in Nov-22, in line with market expectations. At a granular level, the moderation continued to be driven by price reduction of motor fuels, along with clothing and footwear, and recreation and culture. The largest, partially offsetting upward effect came from food and non-alcoholic beverages which registered the highest inflation in 45-years of 16.9%YoY in Dec-22 due to rising prices of eggs, milk and cheese. Inflation for services such as restaurants and hotels also saw an upside along with energy costs (electricity, gas and other fuel categories). While the government has announced an energy price cap for all households for a period of at least six months since Oct-22, higher wholesale energy prices are still being partly passed on to consumers.

Looking ahead, incremental softness in commodity prices and some moderation in domestic demand are likely to gradually help ease price pressures. BoE Governor Andrew Bailey said that the moderation in consumer prices marked "*the beginning of a sign that a corner has been turned*" and that inflation could fall rapidly this year but indicated that persistent labour market pressures and stubbornly elevated services inflation meant it was too soon for the BoE to let down its guard.

According to estimates released by the Office for National Statistics (ONS), GDP registered an unexpected growth of 0.1% MoM in Nov-22 from 0.5% in Oct-22, defying market expectations of a 0.2% contraction. The services sector grew by 0.2% sequentially, while construction remained broadly flat, and industrial production decreased by 0.2%. However, the economy remains on a weakening path with GDP growth declining by 0.3% in Q3 2022(down from the preliminary estimate of a fall of 0.2%) owing to disruptions to business activities due to Queen Elizabeth's funeral in Sep-22.

Despite the looming risk of a recession and hopes that inflation has passed its peak, UK finance minister Jeremy Hunt acknowledged the possibility of a "slimmed down" spring budget with no immediate tax cuts. In his recent statement, Hunt suggested "We must not do anything that risks permanently embedding high prices into our economy, which will only prolong the pain for everyone."

**Eurozone**

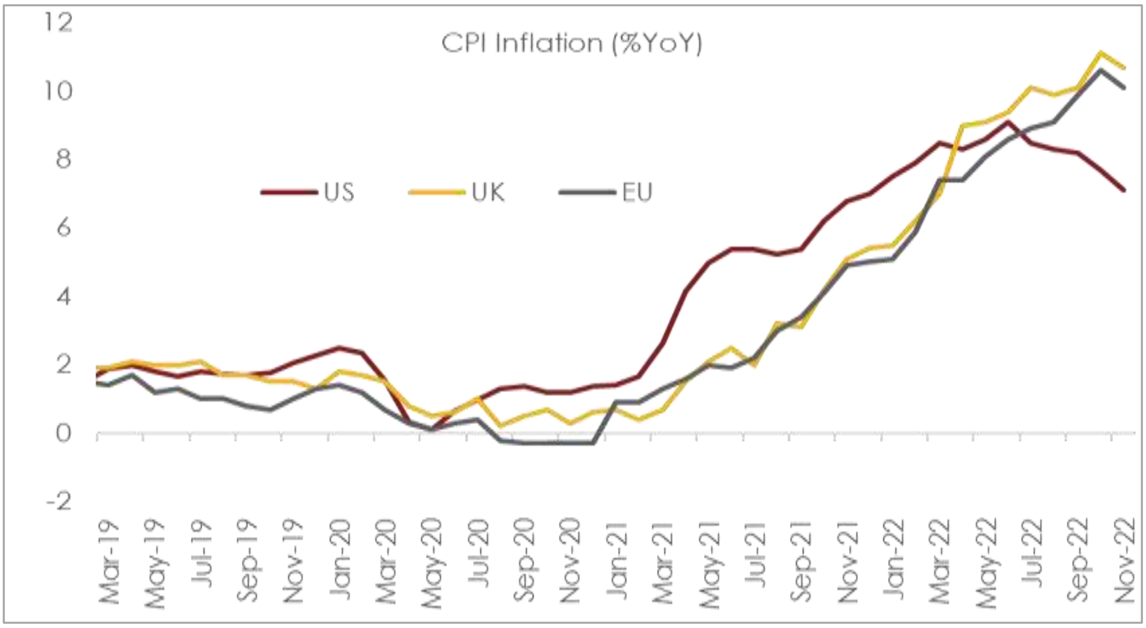
In Eurozone, inflation retreated to single-digit territory and stood at 9.2%YoY in Dec-22 from 10.1%YoY in Nov-22, in line with an earlier preliminary estimate. The decline in headline inflation was led by lower energy price inflation, while inflation in food, alcohol & tobacco, non-energy industrial goods, and services continued to trend up. On a geographical basis, inflation in 19 countries was above the eurozone average in Dec-22, while 7 countries joined Spain with below-average inflation. Since Nov-22, annual inflation slowed in 22 member states, with inflation remaining stable in 2 and rising in 3. The lowest annual rates of inflation were registered in Spain (5.5%), Luxembourg (6.2%), and France (6.7%) while the highest annual rates were recorded in Hungary (25%), Latvia (20.7 %), and Lithuania (20%). Despite the moderation in the headline inflation, core inflation, continued to rise to a new record of 5.2%YoY in Dec-22 from 5.0% in Nov-22. Although headline inflation in Eurozone is on a downward trajectory, ECB President Christine Lagarde warned that consumer prices remain "way too high." She added that monetary policy tightening would continue "until such time when we have moved into restrictive territory for long enough so that we can return inflation to 2% in a timely manner". The ECB's latest projections released in Dec-22 indicate inflation above the ECB's 2% target through 2025, justifying the sharpest and most aggressive rate hiking cycle on record of 250 bps in slightly more than 4 months.

The downturn in Eurozone business activity has likely passed its trough as the composite PMI for the region rose to a 5-month high of 49.3 in Dec-22 from 47.8 in Nov-22. This marked the seventh month of composite PMI below the 50-mark that separates growth from contraction, the longest streak of downturn since Jun-13.

Another positive surprise was the upturn in the European Commission's Economic Sentiment Indicator which rose to 95.8 in Dec-22 from 94.0 in Nov-22. On the consumer side, euro zone retail sales rose 0.8%MoM, beating market expectations, on account of higher fuel sales at petrol stations.

The broad-based improvement in business activity and inflation trajectory will likely give some comfort to policymakers at the European Central Bank who have been tightening monetary policy to contain inflation running considerably above their target. Recessionary fears continue to linger, but the economy seems to have gathered pace, suggesting that the recession ahead perhaps may be shallower than previously thought.

**Chart 3: Inflation has peaked in G3 economies, with Dec-22 print sharply lower**




**JAPAN**

Japan's core inflation, which excludes volatile fresh food but includes oil costs, hit a fresh 41-year high of 4.0%YoY in Dec-22 from 3.7% in Nov-22, exceeding the Bank of Japan's 2% target for the ninth consecutive month. The updraft in inflation was driven by higher energy prices, along with processed food prices which grew at the fastest pace since 1976. Core inflation excluding energy also hit 3% for the first time since 1991, reflecting the entrenched inflationary price pressures beyond oil and gas.

At its first Monetary Policy Meeting of 2023, Japan's central bank maintained its ultra-loose monetary policy stance, defying market expectations that it would phase out its massive stimulus programme amid mounting inflationary pressures. Following a surprise move in Dec-22 to double the yield band, the BOJ kept intact its yield curve control (YCC) targets in its Jan-23 meeting, setting them at -0.1% for short-term interest rates and around 0% for the 10-year yield. The central bank defended the status-quo as price of services (particularly labour costs) has grown by a modest 0.8%YoY in Dec-22, compared to a 7.1%YoY gain in goods prices. The BOJ also slashed its economic growth projections for the next two fiscal years by 20 bps and 40 bps respectively to 1.7% and 1.1%, amid worries of slowing global demand weighing on the export-reliant Japanese economy. BOJ Governor Haruhiko Kuroda, however, said the BOJ projected wages to rise at "quite a fast pace," as corporate profits are at record highs, the job market is tightening and the economy is seen expanding above potential for three straight years.

Looking ahead, Japanese government's proposed stimulus package, designed to absorb some burden of higher energy costs for households and firms, should help support the economy in the coming quarters. Still, the elevated levels of consumer prices add to concerns that the central bank may have underestimated the strength of inflation momentum.

**About Acuité Ratings & Research Limited:**

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