MACRO PULSE

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Contents

Growth 3
Inflation 8
Government Finances 13
Rates 18
Rupee 23
Global Overview 28

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Growth

Strong sequential economic recovery in store

KEY TAKEAWAYS

- The NSO has projected FY21 GDP to contract by 7.7% - this would the most severe contraction that the economy has faced in last seven decades
- However, prospects for the economy have improved with gradual easing of lockdown restrictions, supportive policy environment, global recovery, and pent-up demand
- As such, the implied GDP growth for H2 FY21 is projected at -0.1% YoY vis-à-vis a massive contraction of 15.7% seen in H1 FY21
- With most lead indicators corroborating a V-shaped recovery, we believe the sentiment would get a further boost from prompt roll-out of COVID vaccine in many countries, including India
- As such, we expect FY22 GDP to show a record expansion of 11%

Prospects for India's FY21 economic growth have improved gradually in the last few months. To be sure, the economy would still face a recession, in fact the worst in the last seven decades. However, consensus expectation (as per RBI's Survey of Professional Forecasters) of the severity of recession has improved somewhat from a peak of 9.1% contraction in FY21 GDP in Sep-20 to a contraction of 7.7% - now anchored by the release of the first advance estimate of FY21 GDP from the National Statistical Office in Jan-20.

So, how will the economy round up in FY21?
The Indian economy had a rough start this year with government authorities imposing one of the most stringent lockdown restrictions (compared to other parts of the world) to contain the spread of COVID due to which GDP in Q1 FY21 faced a massive contraction of 23.9% YoY. Thereafter, with gradual tapering of lockdown restrictions (the so called 'unlock' phase is still underway), economic activity started to respond favorably amidst anecdotal evidence of pent-up demand and inventory restocking. As such, GDP contraction eased considerably to 7.5% YoY in Q2 FY21.

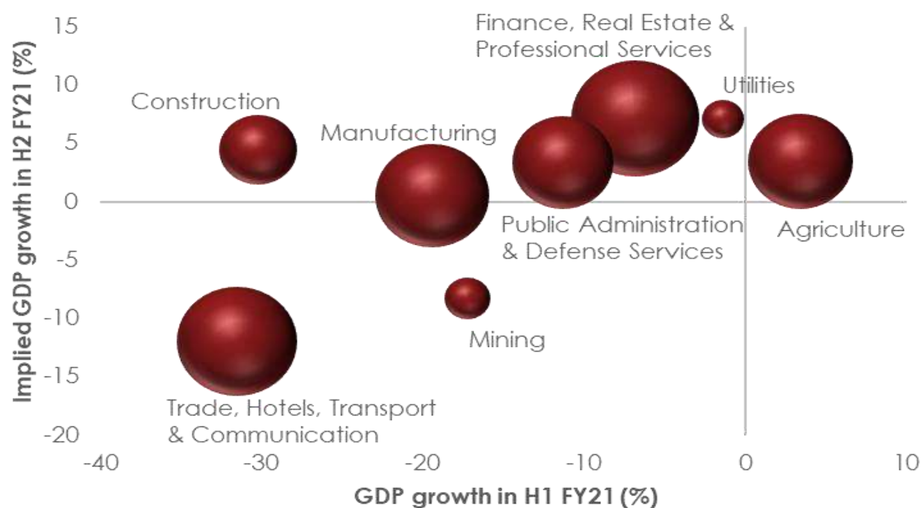
Going forward, GDP is expected to post a mild contraction of 0.1% in H2 FY21 (implied from NSO's first advance estimate of full year GDP) vis-à-vis a contraction of 15.7% seen in H1 FY21. While the improvement in H2 over H1 is expected to be broad based, government consumption is projected to take the lead with 17.0% YoY expansion.

Table 1: Key highlights of India's GDP

(In % YoY)	FY20	FY21	H1 FY21	H2 FY21
GDP	**4.2**	**-7.7**	**-15.7**	**-0.1**
Private Consumption	5.3	-9.5	-18.9	-0.6
Government Consumption	11.8	5.8	-3.9	17.0
Gross Fixed Capital Formation	-2.8	-14.5	-28.1	-0.8
Exports	-3.6	-8.3	-10.7	-5.8
(less) Imports	-6.8	-20.5	-29.1	-11.3

Similarly, from a sectoral perspective, the sequential improvement in H2 FY21 GVA over H1 is expected to be broad based and is projected to be led by Utilities (7.1% YoY), Finance, Real Estate & Professional Services (7.1% YoY), Construction (4.4% YoY), Agriculture (3.4%), Public Administration, Defense & Other Services (3.3% YoY). The Manufacturing sector in the meanwhile is projected to eke out a modest expansion of 0.5% YoY in H2 FY21.

Chart 1: Shift in sector wise growth of FY21 GVA



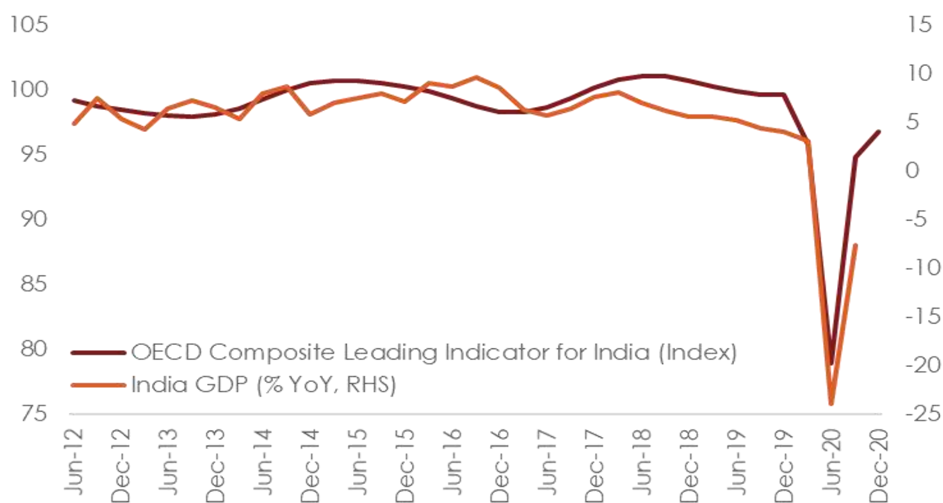
Note: Size of the bubble denotes share in FY20 GVA

High frequency signals corroborate sequential improvement in activity

Economic recovery that commenced from Q2 FY21, appears to have gathered further momentum in Q3 with progress on unlock, festive led and pent-up demand support, and global economic recovery from subdued levels. We see improvement in the following key areas during Q3 FY21:

- Strong rural demand in the backdrop of monsoon support, government's rural spending push, and relatively less COVID penetration. This is getting manifested in healthy performance in case of production of fertilizers, 2-wheeler sales, tractor sales, consumer non-durables, etc.

Chart 2: Leading indicators pointing towards further sharp recovery



- Overall, business optimism has picked up (as per surveys conducted by the RBI, CMIE, and Markit) on the back of increased levels of mobility, improvement in economic activity, and continued support from monetary and fiscal policies with respect to accommodative regulatory dispensations and favorable conditions for cost and availability of capital.
- However, we also note that urban consumer sentiment has lot of room to catch up due to relatively higher COVID penetration, possibility of income losses, record high retail fuel prices, etc. In addition, risk aversion in the banking system continues to prevail as manifested in sluggish credit growth despite record low lending rates – concerns over the possibility of rapid deterioration in asset quality (as per RBI's stress tests, banks' GNPA ratio may increase from 7.5% in Sep-20 to 13.5% by Sep-21 under the baseline scenario) could continue to keep caution intact.

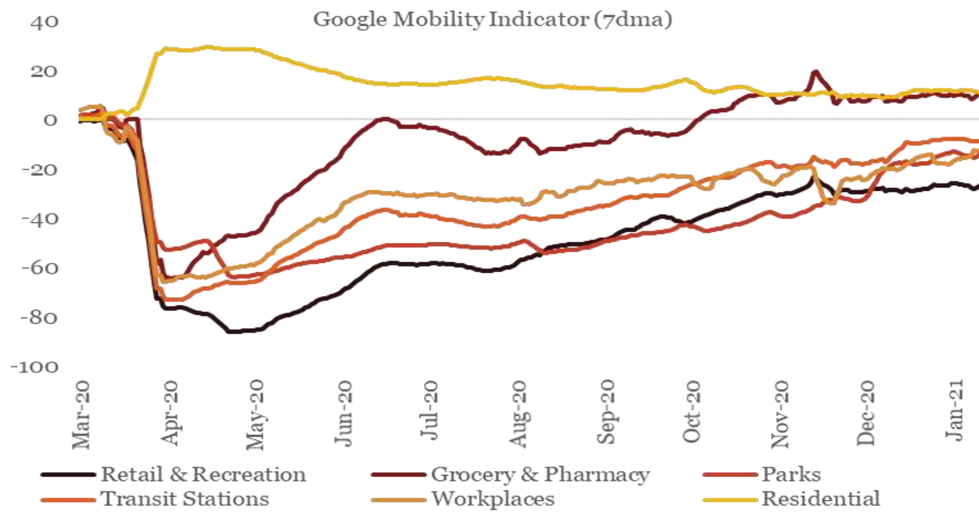
Outlook

Going into FY22, we take comfort from few notable developments.

- As per the latest update from the World Bank, global economy is projected to show a sharp expansion by 4.0% in 2021 vis-à-vis a contraction of 4.3% in 2020. This will have a positive spillover on Indian economy through the channels of external trade and financial market sentiment.
- Key countries in the world have kickstarted their COVID vaccination drive. This would eventually offset the risk from the virulent mutation led sudden spurt in COVID infections in Europe/ US. In case of India, the DGCI has granted restricted emergency use authorization to two vaccines (Covishield and Covaxin), with vaccinations commencing from Jan 16, 2021. With vaccination coverage expected to get better in the coming quarters, this we believe would not only lead to complete unlock of the economy, but at the same time, it would also boost consumer and business confidence.

Hence, we expect GDP to post a V-shaped recovery in FY22 with a record high growth print of 11.0%. This anticipated recovery would be front loaded as H1 FY22 would benefit from a significantly favorable base effect.

Chart 2: Mobility indicators are getting close to their pre pandemic levels



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Inflation

Food CPI provides near term comfort

KEY TAKEAWAYS

- CPI inflation remained elevated through much of FY21 on the back of cost-push inflation, hike in fuel taxes and prices of select services
- The latest Dec-20 print saw CPI inflation ease to a 15-month low of 4.59%, offering the much-needed comfort, led by food prices primarily.
- In contrast, WPI inflation moderated sharply in FY21, reflecting the impact of COVID disruptions and collapse in global crude oil prices.
- For FY22, we expect CPI inflation to average close to 5.0%, a significant softening from likely FY21 average of close to 6.0%
- We expect RBI to maintain a status quo on rates in the foreseeable future but continue to drain out excess liquidity from the system – a move that remains largely consistent with its accommodative stance.

From an inflation perspective, FY21 was a challenging year for India. Post the pandemic outbreak, belying expectations of a softening amidst a sharp correction in demand, CPI inflation continued to rise relentlessly. On hindsight, the production gyrations, rise in producer mark ups amidst reduced competition, hike in taxes on petroleum products and alcohol, along with sharper disruptions in availability of some services appear to have had a greater impact on keeping inflation high from the supply side.

As such, on a FYTD21 basis (Apr-Dec), average CPI inflation stands at 6.6% compared to 4.1% over the same period in FY20. Among the key drivers, were Food; Pan, Tobacco & Intoxicants and Miscellaneous categories. Core inflation, i.e., headline excluding Food and Fuel, averaged at 5.5% compared to 4.0% in Apr-Dec FY20, also having seen a consistent buildup over the last 2 quarters.

	FY20	H1 FY21	Q3 FY21
CPI headline	4.76	6.73	6.38
Food	6.05	8.89	7.62
Pan, Tobacco & Intoxicants	4.16	9.31	10.59
Clothing & footwear	1.62	3.02	3.32
Housing	4.53	3.39	3.22
Fuel & Light	1.37	2.27	2.25
Misc.	4.43	6.33	6.83
Core Inflation	4.03	5.38	5.75

Dec-20 CPI finally provides reprieve

For the first time in FY21, CPI inflation eased considerably in Dec-20 CPI to a 15-month low of 4.59% compared to 6.93% a month ago, bringing the much-needed respite as the monthly print reverted to RBI's inflation targeting band of 4% +/-2%.

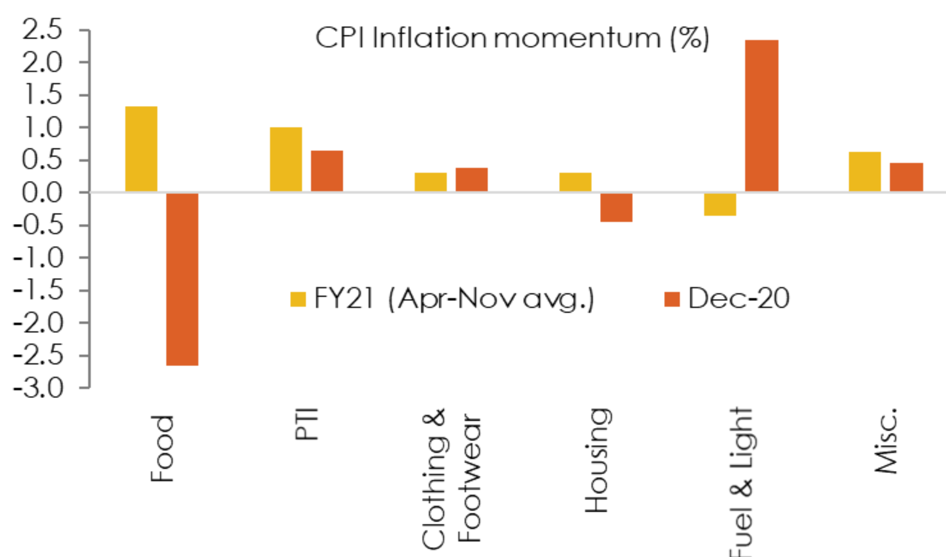
- While a favorable base effect supported, the sequential correction in prices in Dec-20 was led by food and housing categories. Food prices corrected by a sharp 2.7%MoM, single-handedly driven by vegetables (-15.7%MoM). This drove annualized food inflation to 16-month low of 3.9% compared to 8.9% a month ago.
- On the other hand, Housing index contracted by 0.4%MoM, in line with the seasonal contraction seen in the month of December (and June). This should be seen as a one-off and Jan-20 onwards the momentum will once again turn positive.

Among other components, capping the inflation downfall was the sharp upward adjustment in **Fuel and light prices**, which rose by 2.4%MoM in Dec-20. Among the sub-components, price pressures were seen across the board led by LPG, diesel, kerosene, coal and charcoal, reflecting to some extent the cumulative ~20% increase in India Crude Basket over the months of Nov-Dec-20.

In comparison, sequential momentum in other components, namely – Pan, tobacco & intoxicants, Clothing & footwear and Miscellaneous remained muted, either marginally below or in line the FYTD average run rate (see chart1).

Core inflation, i.e. Headline ex. Food and Fuel, reflecting underlying demand conditions in the economy, softened marginally to 5.65%YoY in Dec-20 from 5.85% in Nov-20.

Chart1: Dec-20 vs. average FYTD21 (Apr-Nov) momentum



WPI Inflation: Muted

In contrast, WPI inflation moderated sharply in FY21, reflecting the impact of COVID disruptions and collapse in global crude oil prices (see chart 2). After plunging to a trough of -3.37%YoY in May-20, WPI prices have been slow to recover. On an average, so far in FY21 (Apr-Dec), WPI stands at -0.18% compared to 1.56% over the same period in FY20.

Rural inflation slips below urban counterpart

After moving almost in tandem and in fact reining above the urban inflation over Sep-Nov-20, rural CPI inflation eased substantially below its counterpart in Dec-20 after a hiatus of nearly a year. This was largely a manifestation of disproportionately higher share of food in rural CPI basket and the concomitant sharp decline recorded in food prices in the month.

Chart2: CPI and WPI diverged through much of FY21

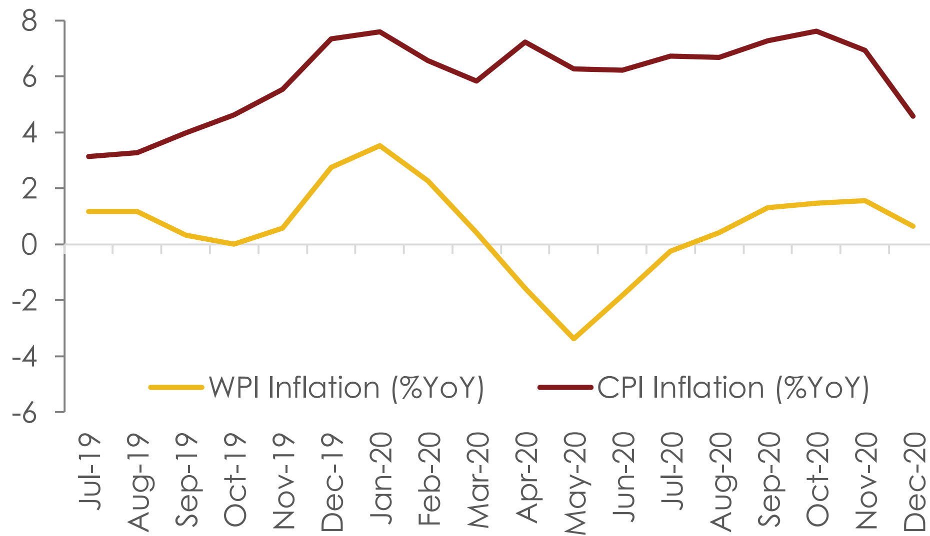
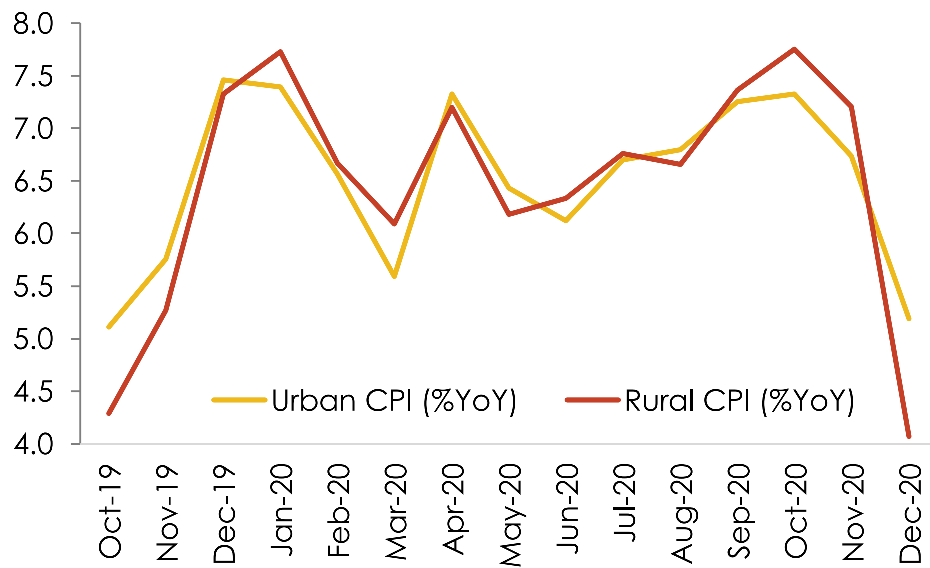


Chart3: Rural CPI inflation eases significantly below Urban in Dec-20



Inflation targeting: Resetting the inflation band?

One area that has been subject of intense debate recently, is with respect to RBI's inflation targeting regime, given that the current mandate of maintaining CPI inflation within the 4% +/-2% range is slated for review by Mar-21. Recall, India had officially adopted flexible inflation targeting (FIT) in Jun-16 to place price stability as the primary objective of the monetary policy.

The recent comfort drawn from Dec-20 inflation print (and trajectory in Q4 FY21) should provide solace to the RBI as well as the Government – to continue to retain the current mandate as is. In a recent paper, RBI in fact argued that given that the trend inflation in India has steadily declined to 4.1-4.3%, maintaining the inflation mid-point target at 4.0% seemed appropriate.

Outlook

- Dec-20 CPI inflation print offered the much-needed course correction to the inflation trajectory. We expect this downward adjustment to persist into the last quarter of FY21 amidst a salubrious impact on food prices from winter seasonality, Kharif output, good progress on Rabi sowing, along with a positive statistical base. On non-food prices, however we remain watchful of the pass-through of the rise in global commodity prices of oil and other industrial metals, along with demand-side pressures as a vaccine-led economic recovery gradually gains impetus.
- For FY22, we expect CPI inflation to average close to 5.0%, a significant moderation versus likely FY21 average of close to 6.0%.

Government Finances

An exceptional year

KEY TAKEAWAYS

- The surge in fiscal deficit to 135% of BE over FYTD21 (Apr-Nov) reflects the lockdown's impact on tax revenues amidst higher expenditure commitment of the Government in a bid to mitigate impact of the pandemic.
- Gross tax revenues have contracted by 12.6%, led by weakness on both direct and indirect taxes, with the exception of excise duty collections (owing to hike in taxes on petroleum product)
- Disinvestments have been a laggard this year, despite the lofty budgeted target of Rs 2.1 lakh Cr
- Total expenditure growth enters positive territory owing to a pick in spending in the month of Nov-20, which augurs well to support a backloaded growth recovery in H2
- For the current fiscal year, we expect the Centre's fiscal deficit to GDP to rise to 7.0% against the budgeted 3.5%.

Fiscal deficit for FYTD21 (Apr-Nov) stood at 135.1% of Budgeted Estimates (BE) compared to 114.8% over the same period last year. The surge in fiscal deficit run-rate this year reflects the impact of lockdown on tax revenues amidst higher expenditure commitment from the Government in a bid to mitigate the impact of the pandemic.

Revenues: Momentum improving but a gaping shortfall vs BE continues

Gross tax revenues, on FYTD21 basis, have contracted by 12.6% compared to +0.8% over the corresponding period in FY20. The weakness has been led by –
Direct taxes – Both, corporate and income tax collections have recorded a contraction, of 35.7% and 12.3% respectively.
Indirect taxes –GST and customs duty collections are trailing at -16.5% and -18.8% respectively. Only excise duty collections have recorded a strong growth of 47.7% owing to the steep hike in taxes on petroleum products effected in May-20.

However, on a sequential basis, tax collections have shown signs of improvement off late, in line with 'unlocking' and improving growth momentum of the economy. This has been expectedly led by indirect taxes of excise, customs and GST. GST collections have not only clocked above Rs 1lakh Cr over three consecutive months from Oct-Dec-20, but Dec-20 collections have in fact soared to a record high on account of festive and pent-up demand (also aided by improved tax administration, see chart1). On net basis, tax revenues in FYTD21 have recorded a slower contraction at 8.3% compared to +2.6% in FYTD20, owing to delay in required tax devolution to the states.

Non-tax revenues, (comprising of Interest receipts, Dividends and profits, External Grants etc.) on an annualized basis have recorded a sharp contraction of 46.6%, amounting to only 32% of BE, versus comparable growth of 67.8% and 74% of BE over Apr-Nov FY20.

Similar weakness is seen in collection of Non-debt capital receipts, with the key component of disinvestments being a laggard so far in FY21. Against a target of Rs 2.1 lakh Cr set in the Budget, Government has been able to raise a total of Rs 15220 cr via OFS, buybacks and IPOs so far in FY21. Despite equity markets remaining buoyant, the poor performance of PSEs shares as well as delays caused due to pandemic have weighed on disinvestment traction. With little time left for executing a big-ticket disinvestment such as Air India or BPCL in this fiscal year, a gaping shortfall versus BE is unavoidable.

Chart1: GST collections in Dec-20 at a record high

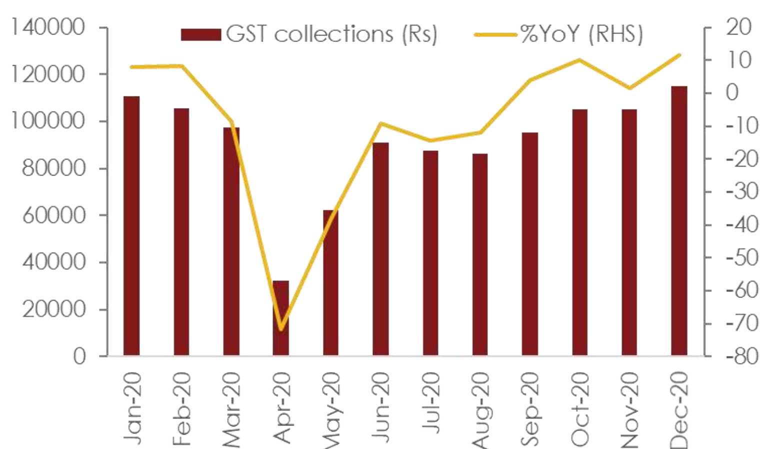


Table 1: Performance of revenues in FYTD21

Performance of Revenues				
Apr-Nov	**% of BE**		**%YoY**	
	FY20	**FY21**	**FY20**	**FY21**
Tax Revenues (gross)	58.4	42.3	0.8	-12.6
Direct Taxes				
Corporate Tax	51.8	27.3	-0.9	-35.7
Income Tax	55.8	36.8	7	-12.3
Indirect Taxes				
CGST	66.5	42.3	10.5	-25.3
Compensation Cess	65.5	46	0	-18.8
Customs	69.6	45.7	-12.5	-17
Excise duties	69.6	73.5	-3.8	47.7
Non-tax revenues	71.3	32.3	67.8	-46.6
Non-debt capital receipts	42.3	8.1	10.4	-37.5

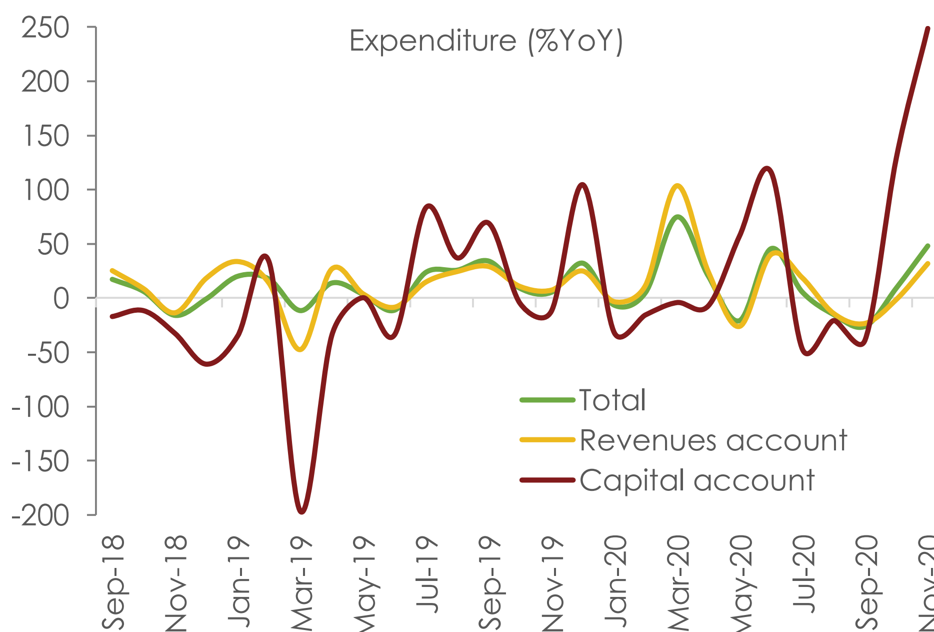
Expenditure: Nov-20 sees a thrust up

Total expenditure, on FYTD basis, has recorded a growth of 4.7%YoY compared to 12.8% over the same period in FY20. On BE basis, this translates into 62.7% compared to 65.3% over Apr-Nov FY20. Segregating expenditure by purpose -

- Revenue expenditure, which are directed towards meeting day-to-day expenses of the Government, have seen a muted growth of 3.7%YoY so far in FY21 compared to 13.0% over the same period in FY20. This slow increase in revenue expenditure is a function of subsidy payouts being subdued so far.
- Encouragingly, capital expenditure has expanded by 12.8%YoY so far in FYTD21, higher than FYTD20 growth of 11.7%.

The growth in expenditure on a FYTD basis, has been driven single-handedly by the rise in government spending in the month of Nov-20 (see chart2). Prior to that, i.e., on Apr-Oct basis, growth in total revenue growth was a meagre 0.4%YoY and capital expenditure was in contraction. It appears, that Government is revving up expenditure in the second half of the year in a bid to support the nascent recovery that is taking shape, perhaps an outcome of comfort drawn from the pick-up in GST collections.

Chart2: Sharp uptick in capital expenditure seen in Nov-20



Outlook

Having borne the brunt on both the fronts – i.e., loss of revenues and the need to incur higher spending, Government's fiscal position in FY21 is stretched to say the least. As the fiscal year draws to a close, some recovery in revenues is visible albeit not enough to compensate for the significant losses over Q1 and Q2. On the expenditure side, while the Government did commit to several fiscal packages including PM Garib Kalyan Yojana, followed by three variants of *Atmanirbhar* Scheme among others, but the cumulative fiscal stimulus remains underwhelming in comparison to peers. Further, monthly data did not show any significant traction in spending up till the month of Oct-20. The pick-up in Nov-20, in that sense augurs well, and the pace of spending if sustained will help support the backloaded anticipated growth recovery in FY21.

For the current fiscal year, we expect the Centre's fiscal deficit to rise to 7.0% against the budgeted 3.5%. Looking ahead, while some consolidation in fiscal deficit is expected and in fact should be aimed at, the Budget FY22 will have the tough ask to deliver on imparting extraordinary growth impulses to support consumption and investment recovery while adhering to some degree of fiscal consolidation.

Rates

Slow normalization

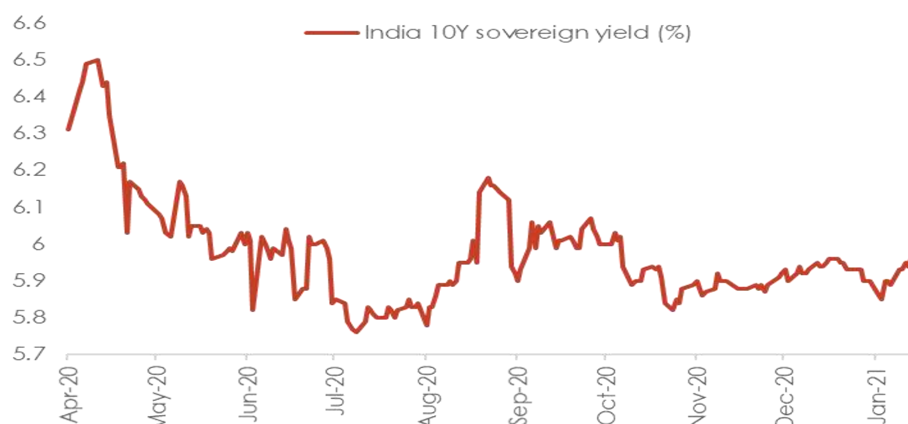
KEY TAKEAWAYS

- The RBI is expected to continue with its accommodative monetary policy through the remaining part of FY21 as well as for a major part of FY22 to ensure economic recovery is sustainable
- With growth conditions likely to stabilize in the next 2-4 quarters, we expect the central bank to start normalizing monetary policy by raising repo rate by 25 bps in Feb-22
- As a prelude to interest rate normalization, the RBI is also expected to calibrate liquidity conditions by curbing the current state of liquidity glut
- The benign global rates backdrop is likely to continue in calendar year 2021
- We expect India's 10Y sovereign yield to rise moderately from 5.85% in Mar-21 to 6.20% by Mar-22

The Indian 10-year sovereign yield has traded between 5.76-6.50% in FY21 so far. Major phase of the upside in yields was front loaded, especially in the month of Apr-20. To recall, this was the period when risk-off sentiment was at its peak owing to unknown risks from COVID and hence global financial markets, including domestic markets, were in a state of heightened risk aversion.

Since that short period of extreme turbulence, global financial markets, including domestic markets have stabilized on the back of unprecedented support from policymakers. From a monetary policy perspective, of the 37 central banks that the Bank of International Settlements tracks, 31 eased their monetary policy rate by a median cut of 125 bps between Feb-Nov 2020. Four developed regions' central banks (ECB, BoJ, SNB, and Riksbank) did not opt for direct monetary easing as the policy rate in these economies was already at the zero bound before COVID got declared as a global pandemic by the WHO in Mar-20. In addition, many central banks also resorted to stabilizing domestic financial conditions in their economy by way of macro-prudential easing and provision of short term (repo) and long term (quantitative easing) liquidity.

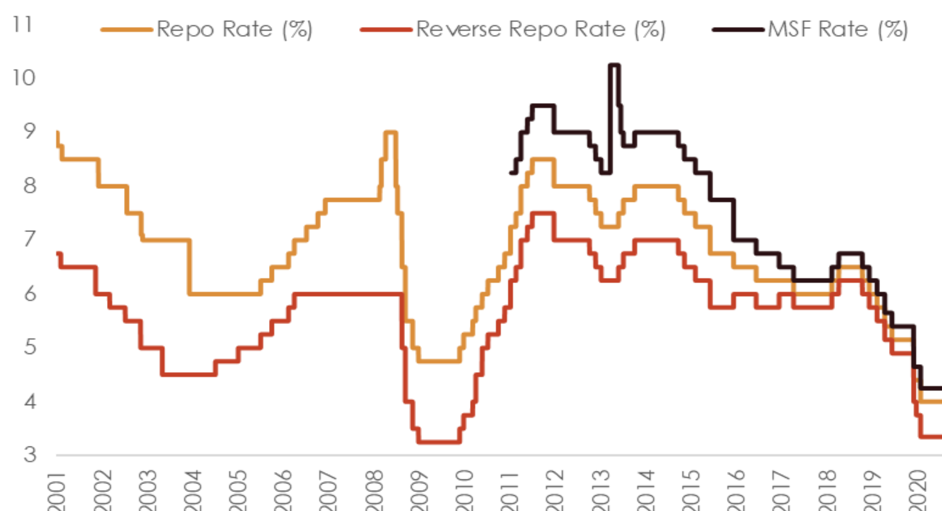
Chart 1: Post Apr-20, the 10Y sovereign yield has traded in a narrow band



While the benign global rates backdrop helped India, the RBI per se has also played an instrumental role in anchoring long-term rates despite the onerous (but unavoidable in the COVID context) supply pressure from fiscal slippage and persistence of inflation above the threshold for tolerance (pegged at 6% as per the flexible inflation targeting framework). To mitigate the economic and financial impact of COVID, the RBI:

- Reduced repo rate and reverse repo rate by 115 bps and 155 bps respectively
- Provided direct liquidity through CRR reduction of 100 bps (for a period of one year)
- Provided indirect liquidity via FX intervention and bond purchases (OMOs/ Operation Twist)
- Eased various regulatory and supervisory guidelines to support COVID related disruptions

Chart 2: The repo rate is currently at an all-time low of 4.00%



The MPC says

The monetary policy committee of the RBI has been on pause since their last move of 40 bps cut in repo and reverse repo rates in May-20. Since then, CPI inflation remaining north of 6% (barring the recent reading of 4.59% print for Dec-20), created a credibility hurdle for the central bank. Nevertheless, we believe the RBI has eased policy rates substantially (with repo rate at all time low) – the real repo rate stands at -2.5% between Apr-Dec FY21 vis-à-vis 0.7% in FY20 and 2.9% in FY19.

In recent meetings, the MPC has emphasized upon the need to maintain accommodative monetary policy stance as long as necessary – at least during FY21 and also in FY22 to support durable economic recovery.

Since CPI inflation averaged lower at 6.4% in Q3 FY21 vis-à-vis RBI's projection of 6.8%, there is relief to be drawn. This should ease some bit of pressure off the MPC with the likelihood of a prolonged pause getting stronger with expectation of moderation in inflation to 5.0% in FY22 from estimated 6.0% in FY21. Nevertheless, we expect the central bank to start normalizing monetary policy and expect a 25 bps hike in repo rate in Feb-22 policy review, somewhat ahead of the expected tapering of current quantitative easing by the US Fed. This back-ended approach should provide ample time for economic recovery, aided by the prompt vaccine roll-out, to get entrenched.

Outlook

With FY21 coming to a close, we expect the 10Y g-sec yield to trade close to 5.85% by Mar-21 on account of the above mentioned factors (although the announcement of the FY22 Union Budget on Feb 1st will also be an important event for the bond market).

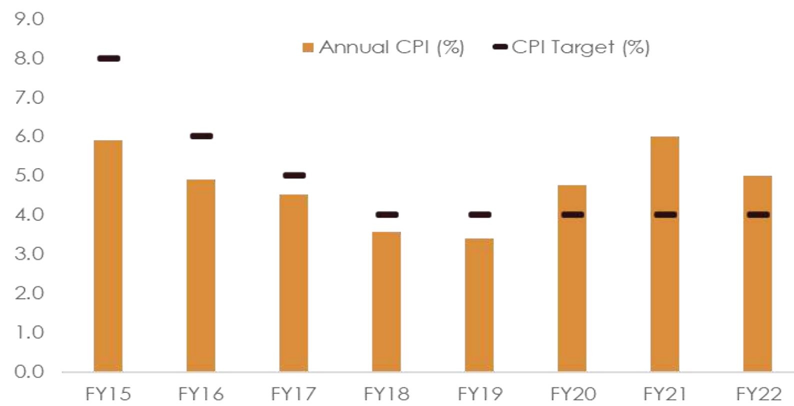
Going into FY22, we expect two fundamental factors to show sequential improvement, albeit with riders:

- Although CPI inflation is expected to moderate to 5%, it would continue to remain above the 4% target for the third consecutive year. While the former would provide comfort, the later could trigger the beginning of policy normalization once growth conditions stabilize. As a prelude to interest rate normalization, we note that the RBI has already initiated the first leg of liquidity calibration through the variable rate term reverse repo (VRRR) auction on Jan 15th worth Rs 2 tn. Going forward, we expect liquidity calibration to proceed further via the roll back of temporary 100 bps CRR relaxation in end Mar-21 (this relief measure was announced in the wake of COVID uncertainty in Mar-20). We believe the central bank would rely on both frictional tools (like the VRRR auction and SDF) and permanent tools (like CRR and MSS) to calibrate liquidity conditions depending upon the overall BoP outturn.
- The general government fiscal deficit is expected to improve towards 9.0% of GDP (Centre: 5.5%; States: 3.5%) in FY22 from an estimated level of 12.0% (Centre: 7.0%; States: 5.0%) in FY21. While this would provide comfort, the size of the deficit would continue to remain above pre pandemic levels, thereby requiring continued RBI support to clear the supply pressure.
- On the global front, while we expect the accommodative monetary policy stance along with aggressive balance sheet expansion by systemically important central banks to continue, US yields could carry a minor upside bias on account of further anticipated deterioration in fiscal deficit. We note that the 10-year US sovereign yield has already hardened by 24 bps prior to the US Presidential election day in Nov.

Taking all the above into account, we expect the Indian 10-year sovereign yield to increase towards 6.00% by Sep-21 and further towards 6.20% by Mar-22.

- Upside risk to this view emerges from a swift reversal in dollar sentiment, monsoon failure leading to high inflation, and faster as well as stronger than anticipated economic recovery.
- Downside risk to this view emerges from slower than anticipated economic recovery and a strong disinflationary push towards the 4% target, which would then obviate the need for any interest rate normalization in FY22.

Chart 3: CPI inflation is expected to remain above target for three years in a row



Rupee

Controlled appreciation

KEY TAKEAWAYS

- Although INR has appreciated in FY21 so far, it has emerged as one of the underperformers among its peers
- The anticipated backdrop of weak USD sentiment should continue to support EM currencies, including INR
- We expect India to post record BoP surplus of USD 105 bn in FY21, followed by a healthy surplus of USD 55 bn in FY22
- FX intervention from the central bank is likely to continue in its active form as the RBI could continue to bolster insurance against global risk aversion
- We expect controlled appreciation in the currency to play out with INR at 73.0 in Mar-20 to 71.0 by Mar-21

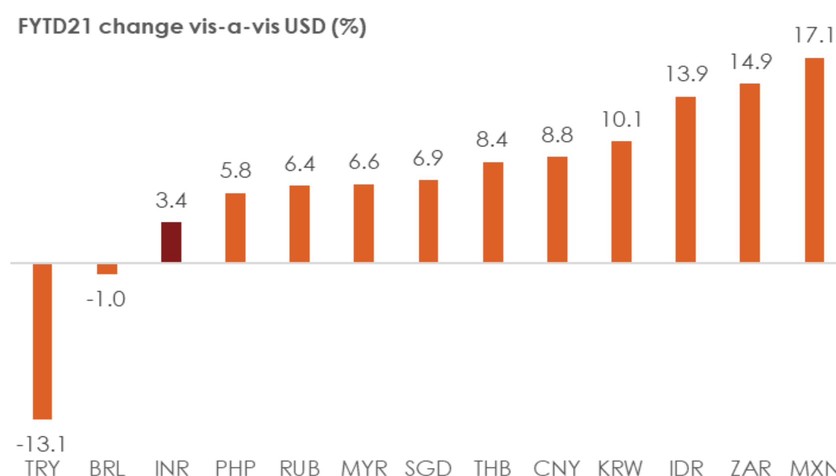
The Indian rupee has gained by 3.4% in FY21 so far – if the trend holds in the near term, then FY21 would end up with an appreciation in the currency after a gap of four years. Having said so, we note that on FYTD basis INR has been a laggard compared to other emerging market currencies, and in fact the worst performer after TRY and BRL.

What's driving INR strength?

INR has strengthened from its FY21 low of 76.94 in Apr-20 to 73.11 in Jan-21 so far. This has happened at a time when India's merchandise trade balance has been gradually worsening. After posting a rare surplus of USD 0.7 bn in Jun-20 (driven by the Great Global Lockdown that shrunk domestic demand for imports while keeping commodity prices extremely soft), the merchandise trade balance has reverted to the usual deficit territory, with the print for Dec-20 coming at USD 15.4 bn – as against the monthly average deficit of USD 13.4 bn seen in FY20.

There are two key factors working towards INR strength:

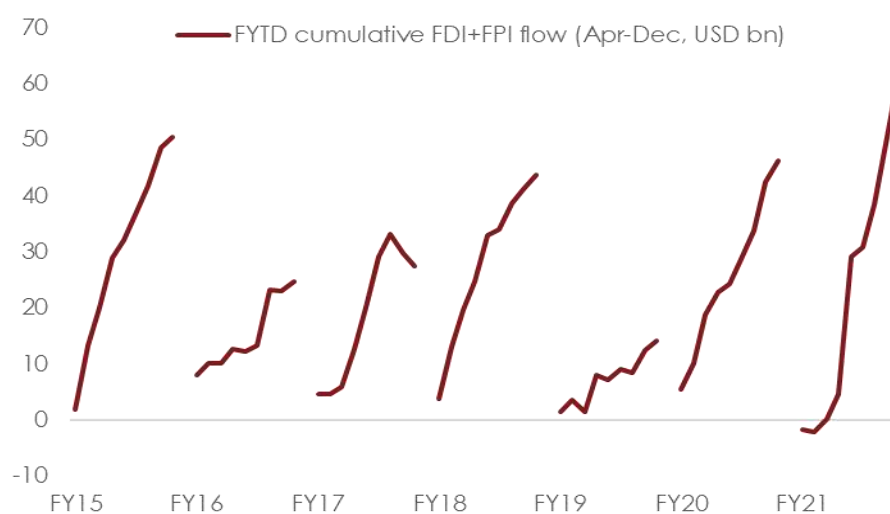
Chart 1: INR has been a laggard among EM peers on FYTD basis



- Dollar weakness: The dollar index (DXY) has slipped by 8.4% in FY21 so far. Weakness in the USD has been broad based - except for TRY and BRL, all other major DM and EM currencies, including the INR, posted gains vis-à-vis the USD in FY21 so far. The USD seems to be weighed down by a multitude of factors. Exceptionally strong reflationary policies followed by the US policymakers have manifested in record amount of monetary and quantitative easing along with a substantial increase in the fiscal deficit. The strong forward guidance from the Federal Reserve on the likelihood of accommodative policy stance persisting until 2022 along with the fresh bout of fiscal stimulus package worth USD 1.9 tn under the new administration under President Biden is likely to keep the dollar under pressure in the near to medium term.

- Robust capital inflows: The combination of global liquidity push and domestic pull (low real rates along with growth and reforms potential) factors is resulting in substantial capital inflows into the country. Between Apr-Oct FY21, India received USD 27.5 bn of Net FDI inflow – this is the highest amount of direct investment inflow ever received in the first seven months of any financial year. In case of portfolio flows, the country received Net FPI inflow of USD 28.6 bn between Apr-Dec FY21, the highest three-quarter cumulative inflow since FY15.

Chart 2: Foreign investment inflows in FY21 so far creating a new high



Note: For FY21, FDI figures for Nov and Dec are projected numbers

Why is INR lagging vis-à-vis most of its peers?

While INR has shown moderate appreciation in FY21 so far, it also stands out as one of the worst performers among EM currencies. The underperformance in case of INR stems from:

- Heavy FX purchases by the RBI: The central bank purchased USD 58 bn of spot foreign currency surplus in the first eight months of FY21. FX reserve data thereafter indicates further mop up to the extent of approximately USD 20 bn between the months of Nov-Dec. Such active pace of FX intervention has moderated the gains in INR. However, this has also attracted the attention of US Treasury, which as of Dec-20 has put India under the watchlist for currency manipulation.

- While India's current account is expected to post a rare surplus in FY21, thereby exaggerating the BoP surplus, the overall fiscal situation has worsened in the aftermath of COVID. Although almost every country in the world would see a worsening of their fiscal balance on account of the economic shock and COVID related support, the pre-existing fiscal conditions for India were not

encouraging with general government deficit being one of the highest among peers. This got exacerbated further due to the onslaught of COVID. We expect the general government fiscal deficit to increase to 12.0% GDP in FY21 vis-à-vis the previous 3-year average of 6.3%.

Outlook

The above mentioned factors could result in controlled appreciation in INR in the remaining months of FY21. As such, we expect USDINR at 73.0 by end Mar-20.

For FY22, while the backdrop of the anticipated weakness in dollar is likely to persist on account of relatively strong reflationary policies in the US, the domestic impulses could get incrementally favorable.

- India could turn out to be one of the front runners of the global V-shaped recovery with a strong double-digit expansion in GDP. Compared to World Bank's forecast of expansion in World GDP by 3.8-4.0% over calendar years 2021-2022, we expect India to post a substantial outperformance with a GDP growth of 11.0% in FY22.
- Inflation pressure is expected to moderate towards 5.0% from the estimated 6.2% in FY21.
- This should help moderate the pressure on overall fiscal position, with likelihood of general government deficit consolidating by 300 bps to 9.0% of GDP in FY22.

With improvement in growth prospects and hardening of global commodity prices, India is also likely to revert to the usual current account deficit position. We expect current account balance to post a deficit of USD 30 bn in FY22 vis-à-vis a surplus of USD 32 bn in FY21. Despite the deficit outturn on current account, India's financial and capital account are expected to remain healthy, thereby generating a BoP surplus of USD 55 bn in FY22 vis-à-vis a surplus of USD 105 bn in FY21.

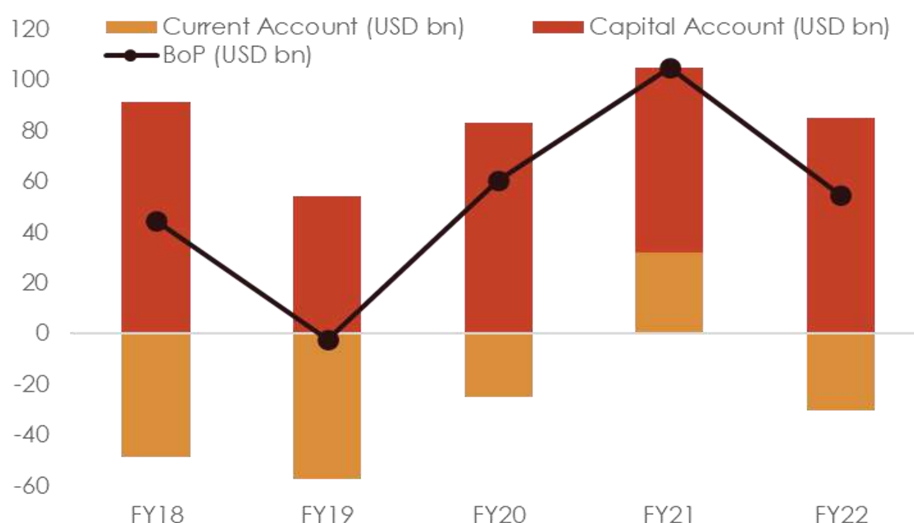
This macro backdrop would continue to favor INR in our opinion. However, the RBI is once again likely to be a key player in the FX market with active net buy side intervention. The premise for this got corroborated by the Governor Das's recent speech (*Towards a Stable Financial System*: Nani Palkhivala Memorial Lecture, January 16, 2021), wherein he highlighted (in italics below – emphasis is ours) that:

"Sustained accretion to foreign exchange reserves has improved reserve adequacy in terms of conventional metrics such as (i) cover for imports (18.4 months) and (ii) reserves to short-term debt in terms of residual maturity (236 per cent). ***Sound external sector indicators augur well for limiting the impact of spillovers of possible global shocks and financial stability concerns as investors and markets are credibly assured of the buffer against potential contagion****. While abundant capital inflows have been largely driven by accommodative global liquidity conditions and India's optimistic medium-term growth outlook, domestic financial markets must remain prepared for sudden stops and reversals, should the global risk aversion factors take hold. Under uncertain global economic environment, EMEs typically remain at the receiving end.*

In order to mitigate global spillovers, they have no recourse but to build their own forex reserve buffers, even though at the cost of being included in currency manipulators list or monitoring list of the US Treasury*. I feel that this aspect needs greater understanding on both sides so that EMEs can actively use policy tools to overcome the capital flow related challenges."*

As such, while we expect INR to appreciate once again in FY22, the pace would get interspersed by central bank's actions in the FX market resulting in INR's underperformance vis-à-vis peers. We expect USDINR at 72.0 by Sep-21 and 71.0 by Mar-22. Risk to this view stems from an appreciation in the dollar, which could potentially impart a depreciation bias to INR.

Chart 3: India is expected to generate strong consecutive BoP surpluses



Note: FY21 and FY22 are forecasts

Global Overview

A hopeful start to 2021

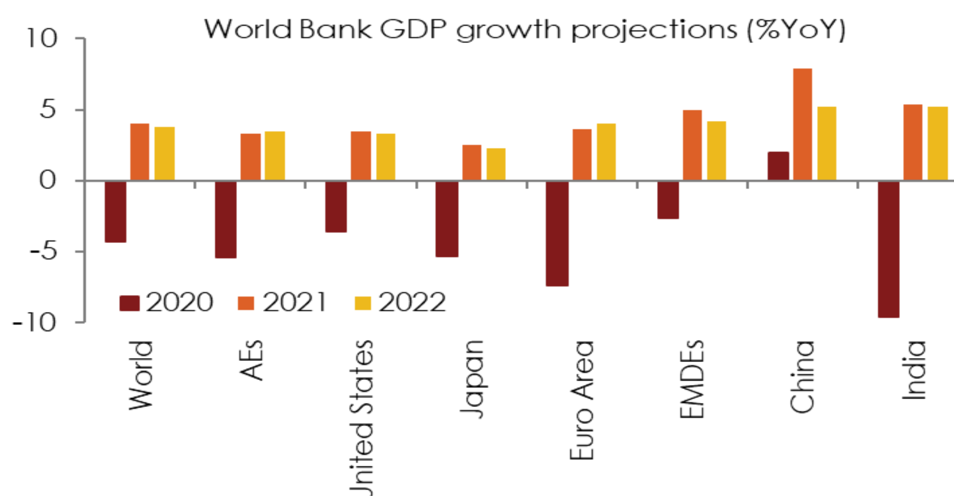
KEY TAKEAWAYS

- The promising news on several vaccines has raised hopes that the end to the pandemic is finally in sight.
- As such, despite softer economic indicators and increasing global COVID infections investor sentiment remains largely buoyed.
- From an economic standpoint, the global economy is emerging from one of its deepest recessions and a subdued recovery is gradually take shape.
- World Bank, in its recently released Global Economic Prospects, expects global economic output to expand by 4.0% in 2021 but still remain more than 5% below pre-pandemic projections.
- Emergence of inflation is also a theme expected to see a comeback especially in the developed markets. Commodity prices have already begun to rise, led by crude oil and industrial metals.
- Risks to pace of recovery stem from a slower than anticipated pace of mass production, distribution and administration of the vaccine.

While the outbreak and containment of COVID dominated the narrative in 2020, the pandemic is expected to continue to remain the flavour in 2021 as well, albeit from a different perspective. The promising news on several vaccines has raised hopes that the end to the pandemic is finally in sight. As such, despite softer economic indicators and increasing global COVID infections, especially in the US and Europe, the enthusiasm of a soon to be available vaccine has kept investor sentiments largely buoyed. The final month of year 2020 also managed to overcome two event risks. One, after months of discussions, US finally passed a new stimulus bill. Second, in the nick of time, a trade deal between EU and the UK with respect to the prolonged Brexit was agreed to. Adding to this, key global central banks committed to continue to provide liquidity to the markets, and this is likely to keep the party going a bit longer.

From an economic standpoint, the global economy is emerging from one of its deepest recessions and a subdued recovery is gradually take shape. As the vaccine rollout gains momentum, the rebound in labour markets and consumer spending will be critical growth drivers in 2021. A complete unlock will also allow a faster resurgence in services, demand for which has remained bottled up this year. World Bank, in its recently released Global Economic Prospects, expects global economic output to expand by 4.0% in 2021 (see chart) but still remain more than 5% below pre-pandemic projections. Global growth is projected to moderate to 3.8% in 2022, weighed down by the pandemic's lasting damage or 'economic scarring' to potential growth.

Advanced economies are projected to recover, with growth reaching 3.3% and 3.5% in 2021 and 2022, respectively, on the back of pandemic containment aided by widespread vaccination and sustained monetary policy accommodation, which is expected to more than offset the partial unwinding of fiscal support. On the other hand, World Bank envisions the aggregate EMDE (Emerging market & developing economies) growth to firm to 5.0% in 2021 (led by China's rebound) but then to moderate to 4.2% in 2022. Excluding China, the recovery across EMDEs is anticipated to be more muted, averaging 3.5% in 2021-22, as the pandemic's lingering effects continue to weigh on consumption and investment.



Apart from the pace of activity recovery, emergence of inflation is also a theme expected to see a comeback especially in the developed markets. Commodity prices have already begun to rise, led by crude oil and industrial metals in anticipation of a faster economic recovery taking shape globally. More recently, on account of concerns over renewed lockdowns hitting demand, Saudi Arabia has offered to make voluntary cuts in its oil output in Feb-20 in a bid to persuade OPEC+ producers to hold output steady.

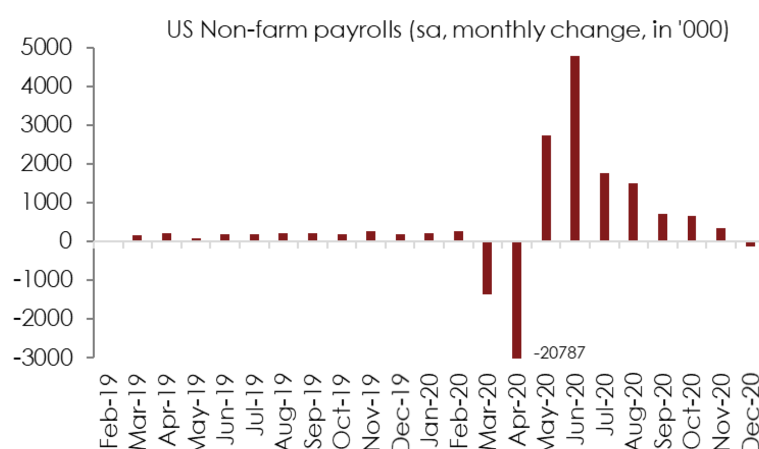
From the perspective of risk, while a sharp rise in commodity prices is definitely one, the bigger risk to global recovery comes from the challenges associated with mass production, distribution and administration of the vaccine. A slower than anticipated pace of inoculation, will come with risk of additional waves of virus, some form of containment measures along with social distancing norms remaining a reality, thereby weighing on the speed of recovery in 2021.

USA

The start to the new year has not been all rosy. The resurgence in COVID infections continues unabated. On the data front, as per Non-farm payrolls, the economy shed 140k jobs in Dec-20, the first loss since Apr-20 which was the peak of the pandemic (see chart). In addition, the pace of vaccine rollout continues at a pace slower than envisaged. Having started vaccinating "at-risk" groups and the elderly, so far 31.1 mn vaccinations have been distributed of which, only 12.2 mn have been administered.

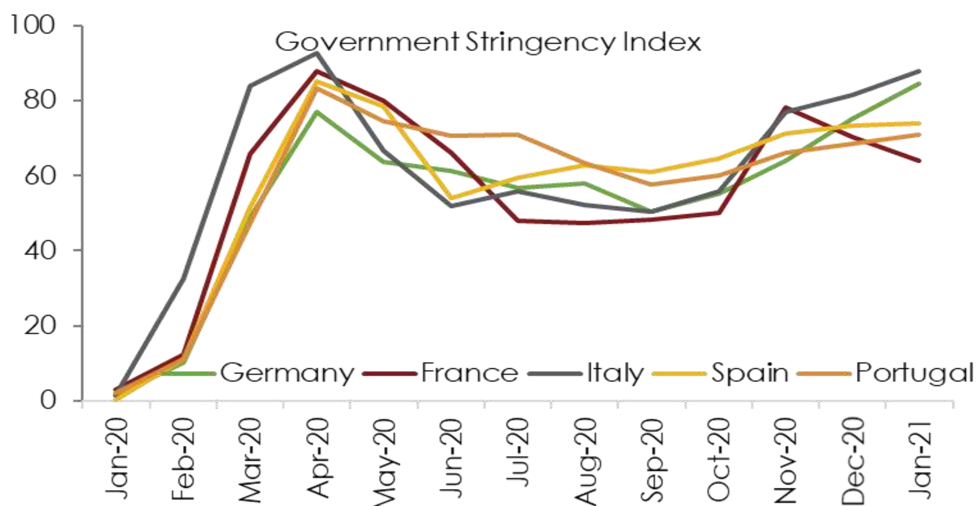
From a political perspective, the so-called "Blue Wave" which arrived in the wake of the two Democrat Georgia senate seats, augurs well from the perspective of facilitation of reforms and a more benign trade policy that should support growth recovery. Add to this, the Government's USD 900 bn of fiscal stimulus last month, which includes funds directed towards small business, consumers and unemployment benefits among others, and the commitment from Fed to continue to support the growth recovery remains comforting.

Hopes of additional fiscal stimulus have yet again gained centre-stage with Joe Biden, ahead of his inauguration as US president proposed a USD 1.9 tn coronavirus relief program, aimed at bolstering vaccine, testing efforts and other health programs, funds for state and local governments along with affected families via direct payments and unemployment insurance.



Eurozone

After a strong quarterly GDP growth in Q3 (12.5%QoQ), the Eurozone economy is likely to witness a double-dip recession in the winter amidst the lockdowns and widespread restrictions imposed on economic activity as a second wave of the virus hit (see chart). However, incoming data from the region shows, that while manufacturing continues to display some degree of strength (PMI at 55.2 in Dec-20 vs. 53.8 in Nov-20) but judging by the mobility data consumption (and services) was probably weaker and is likely to drive GDP contraction in Q4.



Reflecting this, the European Commission expects the eurozone economy to contract by 7.4% in 2020, before growing by 4.1% in 2021. Growth in 2021 will be supported by the strong fiscal policy response and gradual improvement in domestic and external demand. Consumer spending is expected to be slow to recover as containment measures could well last up till the end of Q1-21.

Acknowledging the downside to growth, in its Dec-20 policy, the European Central Bank (ECB) decided to recalibrate its monetary policy instruments but not ease its current stance. The two main measures announced were (1) An extending/expanding of the Pandemic Emergency Purchase Programme (PEPP) by another EUR 500bn to a total package of EUR1,850bn until Mar-22 and (2) Another three liquidity operations (TLTRO) with an extension of the 50 bps TLTRO rate discount until Jun-22, subject to lending performance. In its policy minutes released recently, the ECB articulated that "*the second wave of the pandemic would not make the crisis deeper as a whole but would make it more drawn out than previously anticipated*". Clearly, amidst the evolving macros, the central bank is expected to remain very accommodative this year.

China

China is expected to be a key driver of the global economic recovery in 2021. The rebound in China in 2020 from the pandemic has been quite strong, as validated by the full year GDP growth of 2.3% (the only major economy in expansion this year) and exceptionally robust Q4 GDP growth of 6.5%. However, growth recovery still remains

incomplete amidst external demand that is still to catch up to pre-pandemic levels, small manufacturers facing production hurdles and travel bans continuing. A faster recovery in imports however suggests the pick-up in household consumption is gradually taking shape, and will continue to bolster the recovery in 2021.

Having said so, growth upside in 2021 is likely to be capped by tighter financial conditions to curb possible financial risks, likely appreciation of the yuan and fiscal consolidation and monetary tightening as growth recovery stabilizes.

UK

UK is expected to see a double dip recession, led by the services sector while manufacturing remains relatively more resilient; akin to the Eurozone. The UK economy shrank for the first time in six months in Nov-20, by 2.6% versus +0.6% Oct-20, to mark the first contraction since April's lockdown. The GDP contraction reflects a four-week lockdown in England that began on 5th Nov-20 and tight restrictions in the rest of the UK. The announcement of the third national lockdown, earlier this year amidst a new variant of the coronavirus, means that the economy will continue to shrink even in Q1 2021. After the recent lockdown, Britain offered an additional support package worth USD 6.2 bn to businesses to soften the impact.

Looking ahead, the UK economy is expected to revert to growth in 2021 given the positive vaccine related developments, which is ahead of many other countries. However, recovery is expected to be shallow as it will also face adjustments with respect to UK-EU trade deal, which will delay the full recovery from the pandemic.

Japan

Since late 2020, the number of COVID infections and accompanying deaths have been on the rise in Japan. Amidst news of a new strain of virus detected, the Government suspended the travel subsidy and introduced a temporary ban on non-resident foreign nationals from coming to Japan. More recently, a state of emergency has been implemented in Tokyo and 10 other prefectures through 7th Feb-20. On the data front, while some forward-looking indicators (such as Tankan survey, core orders) have continued to remain strong, other real-time indicators are showing initial signs of weakness (IIP growth stalled in Nov-20, manufacturing PMI came in at threshold level of 50). The third wave of virus exposes the services sector to renewed weakness in the near term, as the chances are high that many Japanese will go into self-quarantine.

At the last meeting, Bank of Japan (BoJ) decided to prolong the corporate lending program (launched in May-20, aimed at providing credit to small and medium enterprises) for another six months. More recently, the Government has also offered emergency funds to select services sectors amidst the new restrictions imposed. While early days yet, the continued rise in virus infections could weigh on the pace of recovery in Q1.

About Acuité Ratings & Research Limited:

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Investor Outreach:

Rituparna Roy Deputy Vice President Ph: + 91-7506948108 rituparna.roy@acuite.in	Gaurav Ketkar Manager Ph: +91-8452815872 gaurav.ketkar@acuite.in

Analytical Contacts:

Suman Chowdhury Chief Analytical Officer Ph: + 91-9930831560 suman.chowdhury@acuite.in	Karan Mehrishi Lead Economist Ph: +91-9910810569 karan.mehrishi@acuite.in

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