MACRO PULSE

JULY 2021

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Acuite RATINGS & RESEARCH

From the desk of the Chief Analytical Officer

We are pleased to share with you the **seventh** edition of **Acuité Macro Pulse** (July 2021). We started this monthly publication on the economy from January 2021 to bring quality insights on an increasingly dynamic global and domestic economic landscape and we have already received encouraging feedback on its content.

The mood in the economy is clearly optimistic although tinged with a shade of caution. While there was a steady reduction in daily case loads and mortalities across Jun-21, it has largely plateaued in Jul-21 with relatively higher volume of infections still being reported from states such as Kerala and Maharashtra. Such a trajectory during a phase of unlocking of the economy and before the upcoming festival season, has kept alive the risks of the third wave. However, there has been a reasonably steady progress in the vaccination rate with around 27.5% of the country's population having already received the first dose by end of July-21. Although the daily vaccination print is still sub optimal, it is expected to pick up with increase of vaccine production by the existing players, sub-contracting arrangements for new vaccines and imports. We believe that a 60% run rate on vaccination by Dec-21 would not only mitigate the risks of new waves of the pandemic but also provide an impetus to the economic sentiments. Expectation of a pickup in vaccinations along with strong support from global economic growth to domestic exports and an accommodative policy backdrop (both monetary and fiscal) continue to underpin our FY22 GDP growth forecast of 10.0% albeit with some downside risk.

Inflation surely continues to be an overhang, but it is encouraging to see sequential inflation drivers respond to the calibrated unlock measures taken by the state governments since the beginning of Jun-21. Hopefully, a benign food inflation trajectory driven by a healthy kharif crop output will permit the central bank to continue with the accommodative monetary policy for another 3-4 months till demand side pressures build up.

The recovery in the economic landscape is also reinforced from the data collated on rating migration covering all CRAs (Source: Acuité Prime). The rate of upgrades rose at the sharpest pace in Q1FY22 since outbreak of the pandemic last year with corporates in several sectors performing better than expectations in FY21 and those in others already treading on a path of recovery. Importantly, the favourable monetary and fiscal policies have supported the liquidity position of the stressed businesses through measures like TLTRO and ECLGS. The credit ratio or upgrades over downgrades, have seen a steady rise since first quarter of last year. The gauge is at 2.08 in Q1FY22, meaning the proportion of upgrades is over two times higher than downgrades in the rating industry as compared to 0.36 times in Q1FY21. If the risks of further waves and the disruption thereof recede, such a trend may sustain throughout the current year.

Hope you continue to enjoy reading our report; we look forward to your valuable comments and suggestions.

Suman Chowdhury
Chief Analytical Officer

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Growth

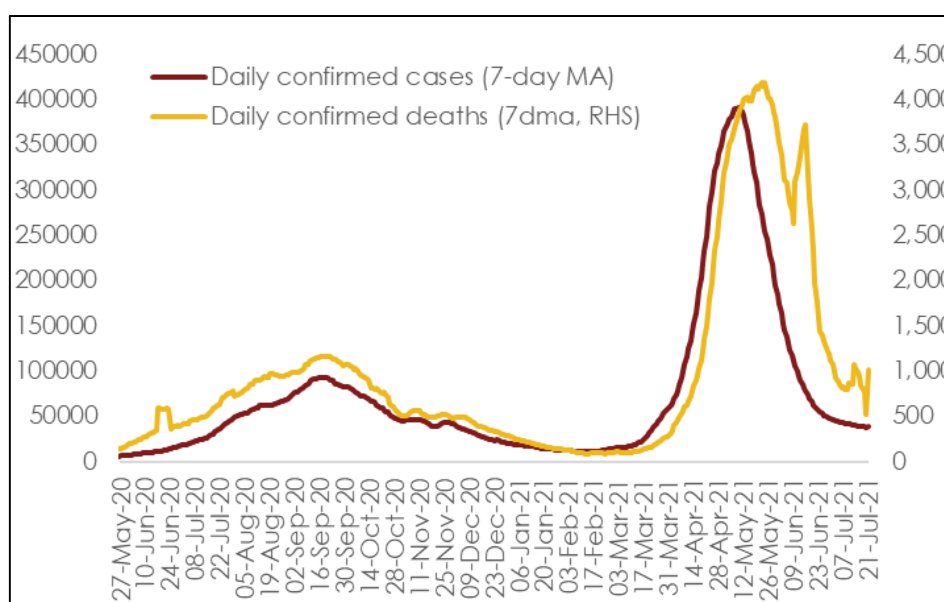
Cautious recovery

KEY TAKEAWAYS

- The decline in COVID infections along with gradual easing of lockdown restrictions, has allowed economic activity to recover in the months of Jun-21 and Jul-21.
- The same is validated by sequential improvement in high frequency data, with annualised readings continuing to find support in a low base from last year.
- After a strong spurt of recovery in Jun-21, some slowdown in momentum seen in first half of July, unsurprisingly as activity levels move gradually towards Feb-21 peak i.e., pre-second wave.
- A fresh rise in Covid infections in select states and districts however remains on close watch given the risks of a third wave.
- The other headwinds for growth are the uncertainty with respect to the pace of vaccinations and a lack of adequate progress in rainfall activity in Jul-21.
- Expectation of a pickup in vaccinations along with strong support from global economic growth to domestic exports and an accommodative policy backdrop (both monetary and fiscal) continue to underpin our FY22 GDP growth forecast of 10.0% with some downside risk.

The decline in Covid infections along with gradual easing of lockdown restrictions, has allowed economic activity to recover in the months of Jun-21 and Jul-21. While the number of Covid cases has slightly declined from around 47,000 in the beginning of July to around 42,000 in end July, the pace of decline has clearly slowed down and further, there has been a fresh spurt of new cases in states like Kerala. Encouragingly, however, vaccination progress continues to remain on course, albeit losing some steam since the peak of 6.2 mn doses/day in last week of Jun-21. As of July 20, 2021, average daily pace of vaccination for the month stands at close to 4 mn doses.

Chart 1: Daily confirmed new cases have stabilized at ~38k

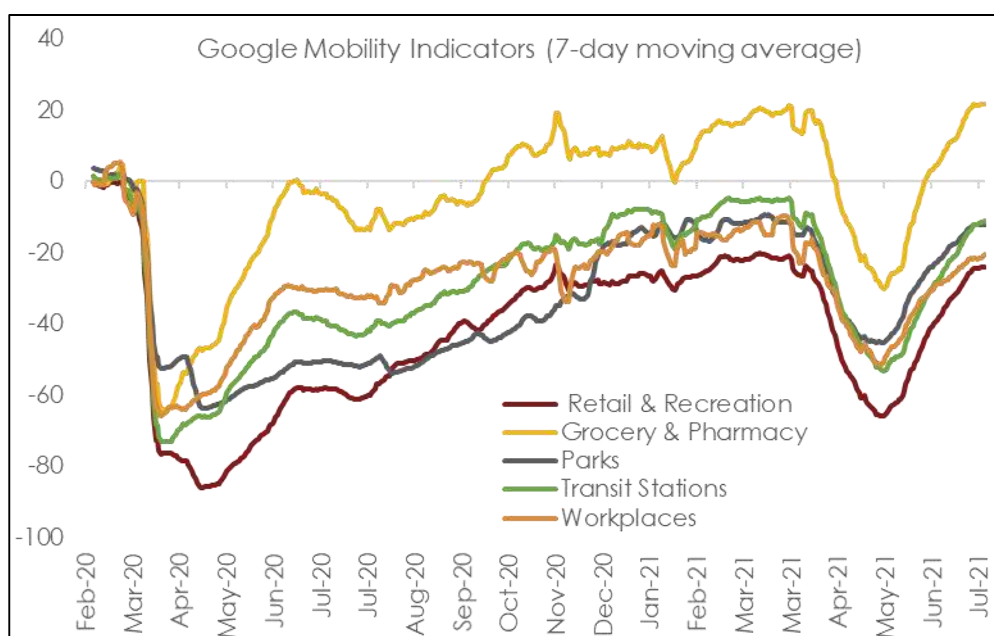


The incremental data for the month of Jun-21 broadly validates a sequential improvement in economic activity, with annualised readings continuing to find support in a low base from last year.

- IIP growth eased to 29.3%YoY in May-21 from a lofty 134.6% in Apr-21, broadly in line with market expectations. The moderation was a consequence of a waning favorable base from last year's stringent nationwide lockdown in Apr-20. The double-digit acceleration conceals a sizeable loss in sequential momentum of 8.0%MoM in May-21, reflecting the impact of state level lockdowns turning pervasive in the month. Barring the pandemic year of 2020, this is the first sequential contraction seen in the month of May in the 2011-12 based IIP series. With the gradual unlock measures across the states subsequent to the taper down of the intensity of the second wave, we foresee Jun-21 industrial production recording a healthy incremental improvement.
- E-way bills, capturing the underlying movement of goods in the country, have seen a sharp turnaround in Jun-21, posting a sequential growth of 36.8% compared to a contraction of 32.0% in May-21.
- Fuel consumption clocked an annualized growth of 1.5% in Jun-21. Although it is a modest growth significantly higher crude oil and retail fuel prices, but the demand growth has recovered from a contraction of 1.4% in May-21.

- Mobility indicators, as captured by Google Mobility, have risen across the board over Jun-Jul-21, with mobility associated with purpose of grocery & pharma exceeding Feb-21 peak (see chart).
- PMI indices moderated further in Jun-21, though the pace of deceleration eased compared to previous month. PMI manufacturing fell below the threshold of 50, coming in at a 11-month low of 48.1 vs. 50.8 in May-21. In similar vein, PMI services slipped to 41.2, to remain in contraction for the second consecutive month, compared to 46.4 in May-21. However, the latest data shows that the composite PMI for manufacturing has again recovered to 49.2 in Jul-21 and that in services at a relatively slower pace to 45.4.

Chart 1: Mobility has nearly recovered to near Feb-21 levels



After a spurt of recovery in Jun-21, some slowdown in growth momentum is being seen in H1 Jul-21, unsurprisingly as recovery gradually moves towards Feb-21 peak i.e., prior to pre-second Covid wave. The fresh rise in Covid infections in select states and districts however remains on close watch. While the threat of an impending third wave continues to loom, the latest nationwide serological survey conducted by the Indian Council of Medical Research (ICMR) indicating that up to two-thirds of the Indian population above the age of six have already been infected with the coronavirus, offers some hope on the reducing risks from the pandemic.

Outlook

After decelerating over Apr-May-21, high frequency lead indicators have moved into recovery mode over Jun-Jul-21. However, uncertainty with respect to slowdown in the pace of vaccinations and a non-uniform distribution in rainfall have risen lately.

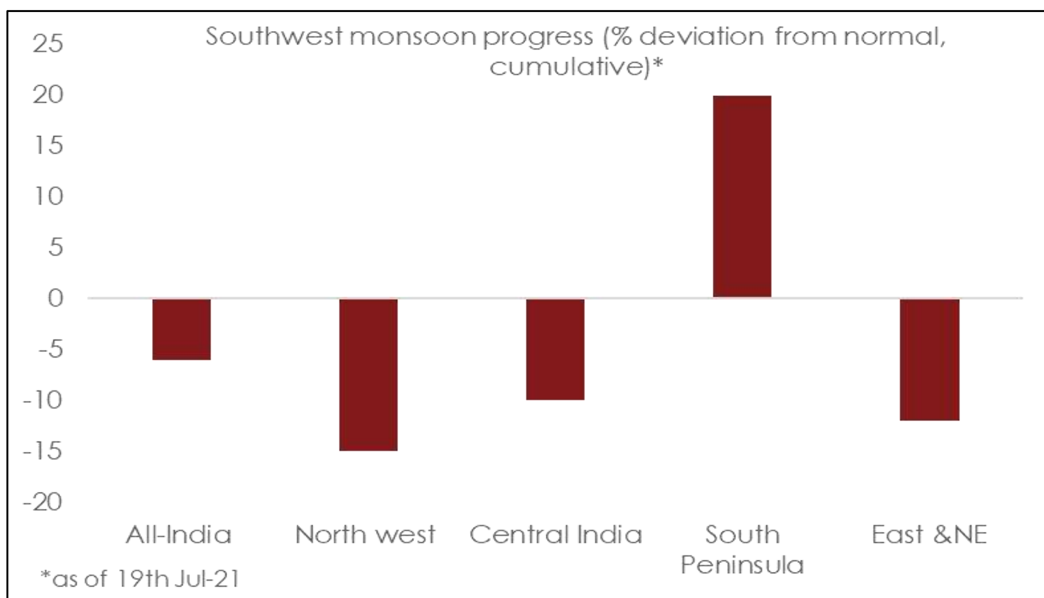
- With over 470 mn vaccine doses administered, India has inoculated close to 27.5% of its population with the first dose and around 8.0% with both the doses (as July 31, 2021). However, the pace of incremental vaccination has dipped

in Jul-21 after soaring to a record of 6.2 mn doses per day in the fourth week of Jun-21. Further, India continues to significantly lag some of the developed countries (US, Eurozone, UK, etc.) in vaccination progress as a percentage of the population. Having said so, we remain hopeful that with enhancement of domestic vaccine manufacturing capacity along with increased supply through imports, vaccination will speed up within the next 2-months.

- After remaining on "break" since last week of Jun-21, rainfall activity has shown a healthy pick up in H2 Jul-21, but not significant enough to make up for the season's cumulative loss. As of July 31, 2021 cumulative rainfall deficit for the season has come down 1% below LPA. While this has led to an improvement in sowing, the spatial distribution of rainfall will be important for crop productivity.

In addition to vaccinations allowing a stronger rebound in consumer sentiment and private demand, silver lining in the form of strong support from global economic growth to domestic exports and an accommodative policy backdrop (both monetary and fiscal) should further aid sequential recovery in growth. We continue to monitor these developments especially the fresh rise in Covid infections in select states, while sticking to our FY22 GDP growth forecast of 10.0% with some downside risk.

Chart 2: Barring South, rainfall activity had remained in deficit till third week of July



Inflation

Anxieties allayed

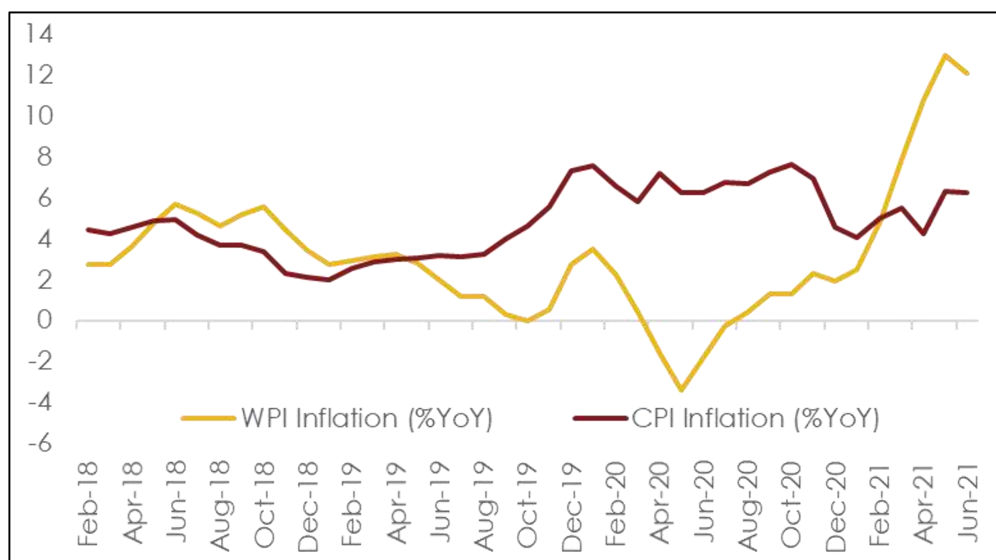
KEY TAKEAWAYS

- Inflation for both CPI and WPI indices for the month of Jun-21, surprised market expectations on the downside.
- This allayed market anxiety with respect to further build-up of price pressures.
- CPI inflation came in at 6.26%, little changed with respect to May-21 level of 6.30% but significantly below market consensus pegged at 6.6%.
- WPI inflation decelerated modestly from its record high level of 12.94% YoY in May-21 to 12.07% in Jun-21, vs. market consensus of 12.2%.
- It is encouraging to see sequential inflation drivers respond to the calibrated unlock measures taken by the state governments since the beginning of Jun-21. However, inflation risks have not abated.
- On close watch remain monsoon progress and global crude oil prices since they can change the expected inflation trajectory; also, the vaccination led build up in core price pressures in H2FY22 will be a monitorable.
- We hold on to our forecast of 5.5% average CPI inflation in FY22

Inflation for both CPI and WPI indices for the month of Jun-21, surprised market expectations on the downside, allaying market anxiety with respect to further build-up of price pressures.

- CPI inflation came in at 6.26%, little changed with respect to May-21 level of 6.30% but significantly below market consensus pegged at 6.6%.
- In similar vein, WPI inflation decelerated from its record high level of 12.94% YoY in May-21 to 12.07% in Jun-21, compared to market consensus of 12.2%.

Chart 1: WPI and CPI inflation both ease in Jun-21



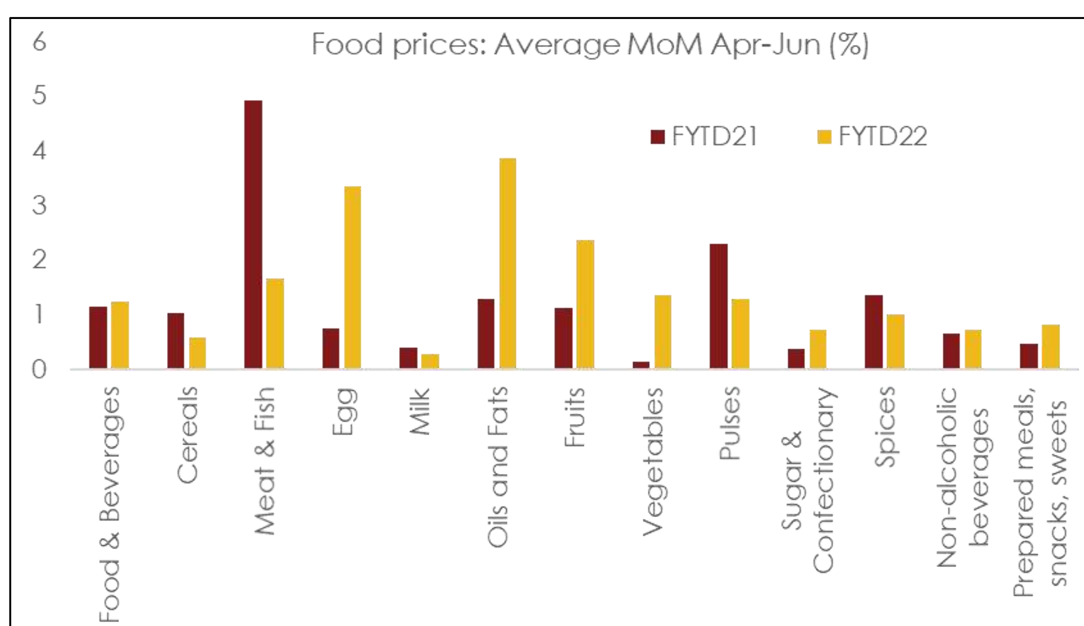
CPI inflation: Remains above 6.0%

- CPI inflation in Jun-21 remained above 6.0%, the upper threshold for policy tolerance for second consecutive month, while also exceeding MPC's Q1 FY22 forecast of 5.2% by 40 bps.
- On sequential basis, the headline index moved up by 0.56% MoM in Jun-21, lower than previous month's lockdown induced sharp jump of 1.65% MoM.
- While food inflation continued to register a sequential increase of 1.18% MoM, it is lower than previous month's print of 1.71% MoM. The relative moderation was led by Cereals, Meat & Fish, Milk, Oils & Fats, Fruits, Pulses, Sugar, Spices, and Non-Alcoholic Beverages. However, price pressures firmed up sequentially in case of Eggs, Vegetables, and Prepared Meals & Snacks. Gradual unlocking, expectation of an overall favourable monsoon outturn, and few supply side interventions by the government (easing imports while imposing stock holding limits for pulses, temporary reduction in excise duties on select edible oils, and free distribution of food grain under the PMGKY scheme) could keep price pressures at moderate levels in the coming months.
- Fuel and light prices registered a sober sequential increase of 0.31% MoM post the strong uptick of 2.44% MoM seen in the previous month. Sequential fall in electricity and LPG costs was seen to offset build-up of momentum in case of Kerosene, Diesel, Coke, and Charcoal. Despite the easing of incremental pressure, annualized inflation rate continued to climb. Considering the fuel

components in the Miscellaneous index, the consolidated fuel inflation stood at 15.2% YoY in Jun-21 which is the highest in the current series.

- Core index (CPI ex Food & Beverages and Fuel & Light indices) declined by 0.06% MoM, marking the first sequential fall in 4-years. This resulted in annualized core inflation moderating to 6.02% in Jun-21 from a 7-year high of 6.58% in May-21. Sequential easing was led by the seasonal drop in Housing index, sharp decline in Pan, Tobacco, and Intoxicants and Recreation Services, coupled with moderation in price pressures for indices of Clothing, Household Goods & Services, Health, and Personal Care & Effects. Barring the last, which was driven by a fall in price for gold and silver, most others benefited from the incremental unlocking in Jun-21 that helped to gradually restore supplies.

Chart 2: Food price pressures driven by oils & fats, Eggs and perishables in Q1 FY22



WPI inflation: Climbing slowly down the cliff

- The deceleration in headline WPI inflation notwithstanding, sequential momentum saw an increase of 0.75% MoM in Jun-21, up from 0.53% MoM in May-21.
- The sequential build-up in momentum was predominantly due to jump in price of fuel components. The consolidated fuel inflation saw a 2.79% MoM increase in Jun-21.
- Core WPI (Headline excluding food & beverages and fuel components) also depicted strong sequential momentum of 0.78% MoM, taking the annualized inflation in this category to a record level of 11.23% in Jun-21.
- In contrast, food & beverages inflation provided solace. Sequential momentum was subdued for second month in a row, with the index remaining unchanged in Jun-21 vis-à-vis May-21. This bodes well for CPI food & beverages inflation in the coming months.

Outlook

It is encouraging to see sequential inflation drivers respond to the calibrated unlock measures taken by the state governments since the beginning of Jun-21. However, inflation risks have clearly not abated.

- Monsoon in Jul-21 so far has not been able make good the shortfall seen since the third week of June although the extent of deficit has declined.
- India crude basket is up by 3.0% in Jul-21, over and above the 7.5% rise recorded in Jun-21. While crude prices have corrected with an OPEC+ deal coming through recently, upward bias in the near term amidst strengthening global growth recovery cannot be ruled out. Brent Crude Oil prices continue to hover around USD 70/bbl in early Aug-21.
- If the government is able to inoculate at least 60% of the population before the end of 2021 with a single dose of vaccine, then it could lead to an upbeat consumer sentiment (as seen in case of few developed economies currently) and fan demand side pressures in the near term. This may not allow core inflation to moderate from the current elevated levels.

Having said so, we do acknowledge that food carries the highest weight of 45.9% in CPI, and favourable seasonal factors (monsoon led) and supply interventions by the government could help offset some of the upside risks to headline inflation, as highlighted above. Additionally, while the likelihood of revenge spending and a temporary spurt in demand led pressures cannot be ruled out, it also needs to be juxtaposed with the sharp deterioration in output gap since the onset of Covid. As such, we continue to hold on to our forecast of 5.5% average CPI inflation in FY22 compared to the 7-year high level of 6.2% seen in FY21.

Government Finances

Slippage risks stacking up for FY22

KEY TAKEAWAYS

- India's central government fiscal deficit for the period Apr-May stood at 8.2% of budget estimates (BE) for FY22 compared to 25.6% over the corresponding period in FY21.
- The relatively lower accretion to fiscal deficit this year reflects better revenue collection and relatively slower pace of expenditure incurred during the first two months.
- The government sold its SUUTI shares in Axis Bank, thereby garnering Rs 40 bn in the month of May-21.
- Quality of spending continues to remain healthy with capital expenditure growth outpacing revenue expenditure growth.
- The budgeted expenditure in FY22 will overshoot on account of Covid relief packages, increase in fertilizer subsidy, higher outlay for vaccination and hike in DA/DR of government employees.
- However, tax revenue collection is likely to be on track while non-tax revenue levels have already been buoyed by RBI's dividend support.
- In order to minimize the risk to fiscal slippage, however it would be critical for the government to ensure that it meets the record high budgeted divestment target.

India's central government fiscal deficit for the period Apr-May stood at 8.2% of budget estimates (BE) for FY22 compared to 25.6% over the corresponding period in FY21. Prima facie, the relatively lower accretion to fiscal deficit this year reflects better revenue collection and relatively slower pace of expenditure incurred during the first two months. This trend has been further reinforced by the latest fiscal deficit for Jun-21, which stands at 18.2% of FY22BE vis-à-vis an unusually high 83.2% in Jun-20, the latter largely the fallout of the severe economic disruption brought by the pandemic.

Receipts: Buoyed by tax as well as non-tax revenues

Receipts have been buoyed from robust tax collections as well as non-tax revenue accretion.

- On FYTD basis (Apr-May), gross tax revenue collection clocked a robust growth of 147.9% YoY despite the onslaught from Covid's second wave. However, it's not just the annualized growth that looks better (aided by a favourable statistical base), but gross tax revenue has already clocked 14.1% of BE for the full year (vs. 6.2% in the corresponding period in FY21), thereby providing a strong starting point.
    - Barring service tax collection that contracted on annualized basis in Apr-May FY22, all other key tax sources recorded robust growth in collection, with particularly impressive growth seen in case of excise, customs, corporate tax, and GST.
    - It is important to note that incremental tax collections in some cases could show an adverse lagged impact of the strong resurgence in Covid infections during Apr-May FY22.
- Net tax revenue on FYTD basis (Apr-May) clocked a robust growth of 590.0% YoY compared to a contraction of 70.7% seen in the corresponding period in FY21 on account of support from gross tax collections and relatively lower tax devolution to states.

Non-tax revenue also recorded a strong annualized growth of 976.2% YoY in Apr-May FY22 compared to a contraction of 61.9% seen during the corresponding period in FY21. Notwithstanding the favourable statistical base support, the key reason for robust performance under this category stems from the significantly higher than budgeted dividend from the RBI, transferred in the month of May this year vis-à-vis August last year due to the synchronization of RBI's financial year with the GoI.

Non-debt capital receipts clocked a robust expansion of 478.8% YoY in Apr-May FY22 vis-à-vis a contraction of 72.9% seen in the corresponding period in FY21. The government sold its SUUTI shares in Axis Bank, thereby garnering Rs 40 bn in the month of May-21. While the robust growth rate reflects favourable statistical base effect from last year, overall disinvestment activity has been at a low key till Q1FY22.

Expenditure: Growth in capex continues to overtake that of revex

Total expenditure de-grew by 6.6% YoY in Apr-May FY22 vis-à-vis a meagre contraction of 0.2% seen in the corresponding period in FY21. On BE basis, this translates into 13.7% of the full year target vis-à-vis 14.6% seen in the corresponding period in FY21. We note a divergence between the pace of revenue and capital expenditure by the government:

- Revenue expenditure contracted by 9.1% YoY (14.2% of BE) during Apr-May FY22 vis-à-vis a modest contraction of 1.9% (14.8% of FY actuals) seen in the corresponding period in FY21. The slower momentum reflects the outsized impact of Covid relief work undertaken by the central government during the nationwide lockdown in Apr-20. With the central government extending some of the earlier programmes under Atma Nirbhar *Bharat* scheme from May-Jun 2021 onwards (along with DA/DR hikes to be paid from Jul-21 onwards), to provide relief from the second wave of COVID, revenue expenditure could pick up in the coming months.
- Encouragingly, capital expenditure growth expanded by 14.0% YoY (11.4% of BE) during Apr-May FY22 vis-à-vis an expansion of 15.7% (13.0% of FY21 actuals) seen in the corresponding period in FY21. Continued thrust on capex provides comfort and would be important for supporting the economy at a time when private sentiment could remain subdued, at least in the near term.

Outlook

After surprising pleasantly (compared to the revised estimates) in FY21, slippage risks to fiscal deficit have emerged in FY22 as highlighted in the June edition of *Acuite Macro Pulse*.

In addition to the additional spending asks getting accumulated (largely on account of COVID relief), the government recently hiked dearness allowance (DA) and dearness relief (DR) for its employees and pensioners to 28% from 17%. This is expected to cost about Rs 285 bn to the exchequer in addition to BE.

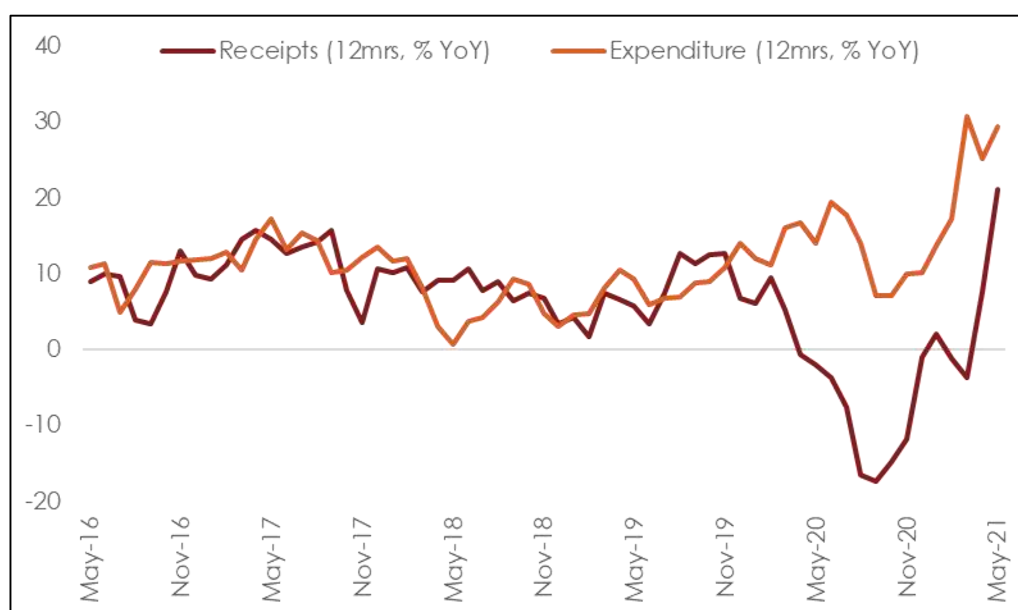
Cumulatively, we now see additional spending requirement of Rs 1.6-1.7 tn (0.7% of GDP) during FY22. While we acknowledge some upside risk to the headline fiscal deficit target of 6.8% of GDP, it is likely to be modest. Mitigating factors like higher than budgeted dividend income from the RBI, higher tax buoyancy, upside to budgeted nominal GDP, and introduction of spending curbs in Q2 FY22 on all ministries and departments (except health, agriculture, fertilisers, pharmaceuticals and food) could fully or partially compensate for overall fiscal slippage risks.

To conclude, while slippage risks have begun to stack up, the net impact could be modest at around 0.5%-1.0% of GDP. We would monitor the expenditure risks closely along with the realization of record high disinvestment target of Rs 1750 bn.

Table1: FYTD comparison of key drivers of fiscal deficit

Key Fiscal Variables (Cumulative Position as of Apr-May)				
	% of FY Actual/Target		%YoY	
	FY21	FY22	FY21	FY22
Revenue Receipts	2.7	19.6	-68.9	683.5
Net Tax	2.4	15.1	-70.7	590.0
Non-Tax	5.2	47.9	-61.9	976.2
Non-Debt Capital Receipts	1.4	2.6	-72.9	478.8
Total Receipts	**2.7**	**18.0**	**-69.0**	**679.8**
Revenue Expenditure	14.8	14.2	-1.9	-9.1
of which, Interest Payment	11.5	10.9	4.6	13.2
of which, Major Subsidies	9.8	18.6	-41.4	-7.1
Capital Expenditure	13.0	11.4	15.7	14.0
Total Expenditure	**14.6**	**13.7**	**-0.2**	**-6.6**
Fiscal Deficit	**15.3**	**5.2**	**-**	**-**

Chart 1: Growth in receipts showing a strong V-shaped recovery



Rates

Repricing of inflation risks

KEY TAKEAWAYS

- The 10Y g-sec yield finally appears to have bottomed out after dodging upside pressures for some time.
- From a near term macro perspective, the up move in yield reflects repricing of inflation risks.
- Combination of elevated input prices, Covid related disruptions, vaccination progress, and policy support led economic revival have resulted in an acceleration in inflation in most countries.
- This has started to result in readjustment in monetary policy expectations with respect to few central banks.
- Nevertheless, systemically important central banks, including the RBI, have so far treated the rise in inflation as 'transitory', while continuing to focus on supporting growth recovery.
- With progress on vaccination, we continue to expect the RBI to start the normalization of policy corridor from Dec-21 onwards, followed by an eventual hike in the benchmark repo rate in the first quarter of FY23.
- We continue to stick to our 10Y g-sec yield forecast of 6.15% by Sep-21 and 6.50% by Mar-22.

The 10Y g-sec yield finally appears to have bottomed out after dodging upside pressures for some time. Closing the month of May-21 at 6.02%, the benchmark yield inched up to 6.05% by end Jun-21 and has moved further up to 6.20% by end Jul-21. This is in sync with our near-term view of 10Y g-sec yield anchoring at around 6.15% by Sep-21 and further towards 6.50% by Mar-22.

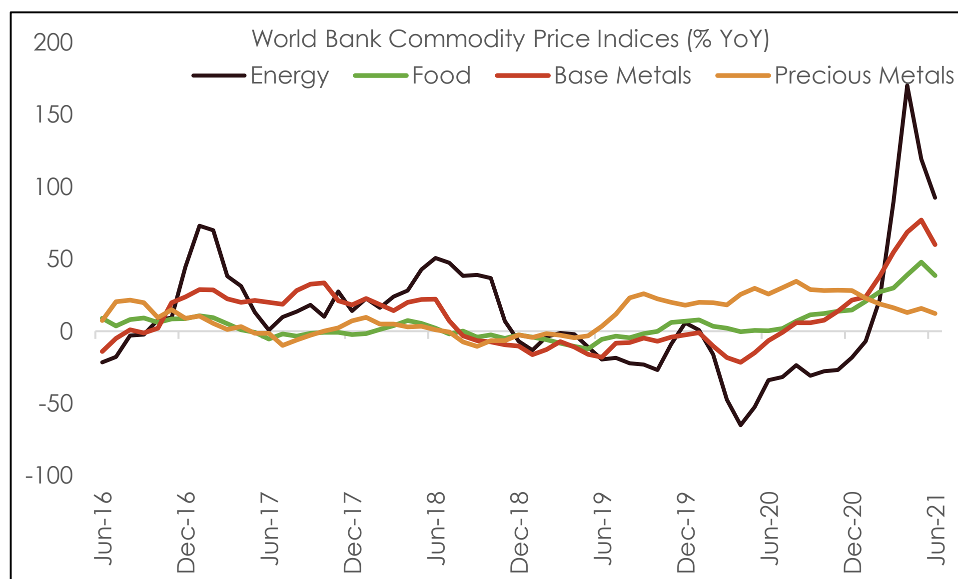
Repricing of inflation risks

From a near term macro perspective, the up move in yield reflects repricing of inflation risks as well as monetary policy expectations by investors. Recall, after remaining within the flexible inflation target band of 2-6% for five months, CPI inflation breached the upper threshold in May-21 with a print of 6.30%. Thereafter, it remained sticky at 6.26% in the month of Jun-21. Inflation risks have clearly risen amidst the recent sharp run up in international commodity prices. As of Jun-21, globally:

- Energy prices (including crude oil) are up by 93% YoY
- Base metal prices are up by 60% YoY
- Food prices are up by 39% YoY
- Precious metal prices are up by 12% YoY

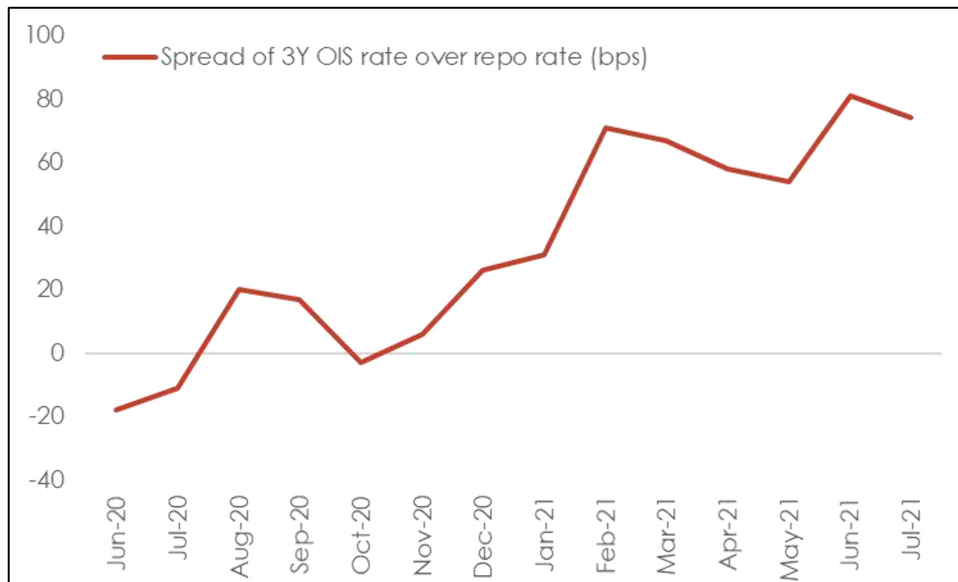
In the month of May-21, market participants were expecting CPI inflation to average close to 5.0% in FY22 (as per RBI's Survey of Professional Forecasters). With two consecutive 6.0%+ prints, there will undoubtedly be an upward drift in inflation expectation of market participants. We ourselves have marked our expected FY22 CPI inflation level up by 50 bps to 5.5%.

Chart 1: Sharp increase in input price inflation in recent months



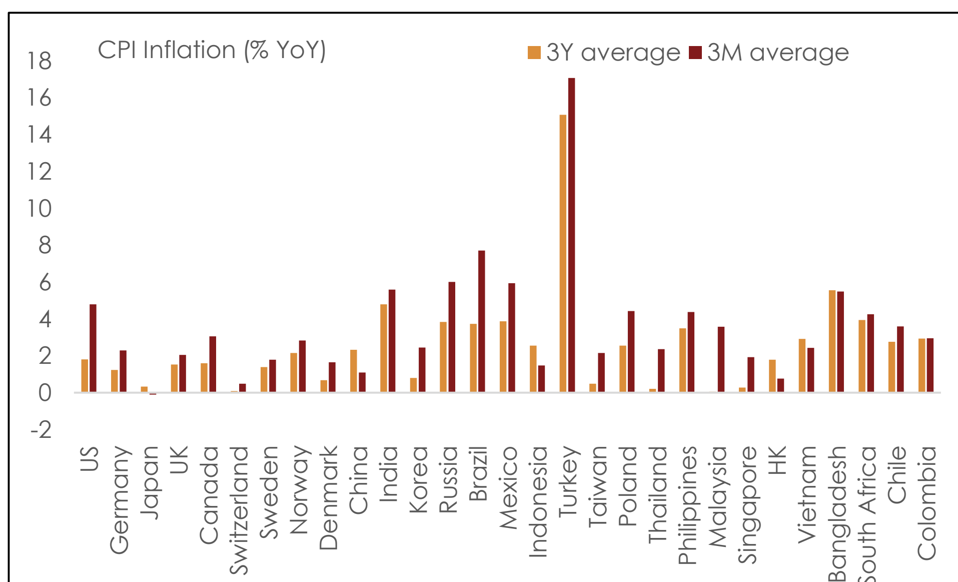
The repricing of inflation risk also permeated to market expectations with respect to normalization in monetary policy by the RBI. In this context, we would highlight the relatively sharp up-move in OIS rates in India since end May-21.

Chart 2: Swap rates have hardened in last 2-months



The repricing of inflation risks and thereby monetary policy expectations is something that also seems to be running across many countries. Among top developed economies barring Japan, CPI inflation in last 3-months has overshot its 3-year prior inflation by a fair margin. Similarly, within top emerging economies (excluding China), viz. Brazil, Malaysia, Russia, Thailand, Mexico, and Turkey, CPI inflation in last 3-months has overshot its 3-year prior inflation by a fair margin.

Chart 3: Recent inflation prints have been higher across key countries



Outlook

Despite repricing of inflation risks led by higher input prices and anticipation of strong V-shaped economic recovery, this has not yet resulted in a consensus around withdrawal of monetary accommodation at a global level. To be sure, few central banks have started to acknowledge the ongoing recovery along with inflation pressures in their own economies and have taken actions accordingly - Norges Bank, RBNZ, BoC, and BoK have given explicit guidance on monetary policy normalization in the near term (central banks in select EMs like Turkey, Brazil, and Russia have already resorted to interest rate tightening in 2021 to protect their respective currencies).

However, larger economies like the US, Eurozone, Japan, China, etc. have not shown any inclination for normalizing monetary policy in the near future despite recent high inflation prints.

- Most central banks, including the RBI, attribute recent burst of inflationary pressure to be transitory, which is expected to get normalized with increased unlocking of the economies
- Recently, the ECB tweaked its mandate to incorporate symmetric inflation deviation to make a valid case for somewhat higher inflation tolerance around the 2% target (similar to the US Fed)
- The PBoC on the other hand eased liquidity conditions by cutting reserve requirements by 50 bps to support financial conditions and economic recovery

We attribute this divergence to the underlying economic conditions existing prior to Covid, handling of the Covid situation by respective governments, and vaccination status and progress. We anticipate this economic divergence to have a bearing on exit strategies from the exceptionally accommodative policy setting in each country.

As far as India is concerned, we continue to expect FY22 to register a GDP growth of 10.0% with downside risks along with CPI inflation of 5.5%. In the latest RBI policy statement in early Aug-21, the central bank has reaffirmed its focus on supporting revival of growth in the near term via its accommodative policy stance.

We expect policy normalization to begin in a gradual fashion with comfort on vaccination, clarity on fiscal stance, and global rates setting. A small step towards that has already been taken by increasing the quantum of Variable Reverse Repo Rate (VRRR) auctions. The RBI could use the Dec-21 to Feb-22 window to restore the width of the LAF corridor to 25 bps from 65 bps currently. This will involve a 40 bps hike in the reverse repo rate to 3.75%, with repo rate remaining unchanged at 4.00%. The need for normalizing policy corridor would stem from

- Policy focus slowly getting back to inflation management as vaccine led herd immunity towards the end of FY22 could potentially stoke demand side pressures
- It would also help the central bank to start preparing domestic financial markets for taper prospects by systemically important central banks.

Thereafter, this is expected to be followed by a 25 bps hike in the repo rate in Apr-22.

Rupee

Global factors weighing

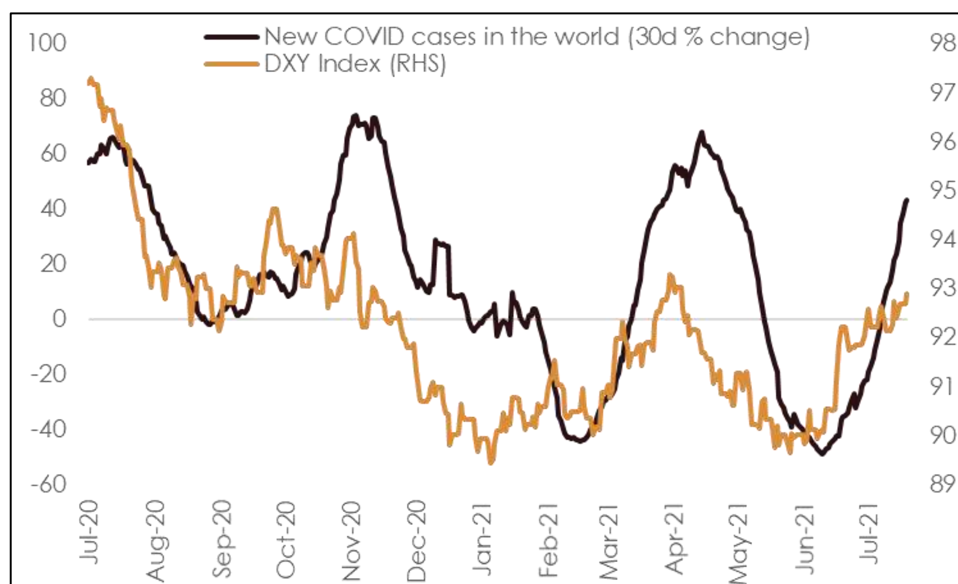
KEY TAKEAWAYS

- The Indian rupee has been gradually depreciating after closing at its strongest post pandemic level of 72.61 in May-21.
- The up move in USDINR has been riding on dollar strength for the last few weeks with triggers undergoing a shift from reflation to global risk aversion.
- We expect global risk aversion in currency markets to give way to reflation theme again as spread of vaccination attenuates severity of future waves of Covid.
- Domestically, the combination of gradual unlock, elevated commodity prices, and progress on vaccination would widen and normalize India's trade deficit.
- Meanwhile the relatively strong economic performance of US vis-à-vis other developed economies would create tailwinds for the USD and continue to reinforce the dollar's strength.
- We continue to expect USDINR to move up towards 75.0 by Sep-21, and further towards 77.0 by Mar-22

The Indian rupee has been gradually depreciating after closing at its strongest post pandemic level of 72.61 in May-21. The currency pair ended Jun-21 at 74.33 and has continued to trade closely in the 74.2-74.3 band in the last week of Jul-21.

The up move in USDINR has been riding on dollar strength for the last few weeks. While the underlying reason remains broadly unchanged, the triggers have changed in recent weeks. The month of Jun-21 saw the dollar index (DXY) move up by 2.7%, its strongest monthly change in nearly five years. This was predominantly a result of the reflation theme getting a shot in the arm post the elevated May-21 US inflation data and the Jun-21 FOMC outcome (for a brief, please refer to the Jun-21 edition of the Acuite Macro Pulse). However, in recent weeks, global risk aversion has come to the forefront, once again with Covid related concerns stoking uncertainty. Incremental infections have been rising in many countries (especially, in Europe) since the third week of Jun-21, with current daily global caseload almost 44% higher than its Jun-21 lows. This renewed concern on Covid has started spilling over to other asset classes, including currency markets, thereby triggering safe haven demand for CHF, JPY, and the USD in the last 3-4 weeks.

Chart 1: Recent rise in Covid concerns supporting safe haven demand for USD



Outlook

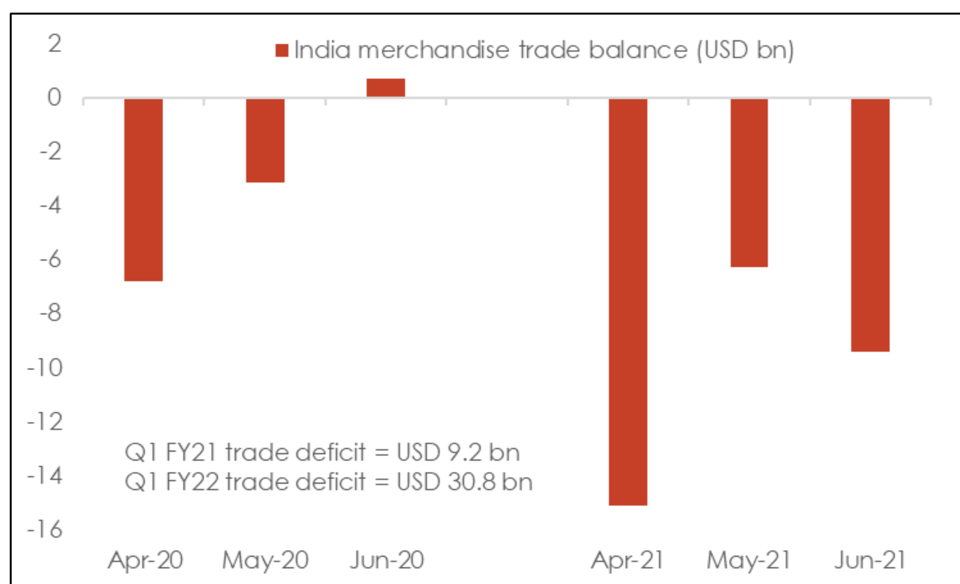
While we did not anticipate the recent rise in Covid infections in few countries resulting in a global risk aversion and supporting the dollar, the overall trajectory on rupee is turning out to be broadly along expected lines. As such, we stick to our USDINR call of 75.0 by Sep-21 and 77.0 by Mar-22.

In the near term, the anticipated gradual normalization of economic activity post the second wave of Covid will be one of the most important factors that would drive INR. We had highlighted in the May edition of the "Acuite Macro Pulse" the dampening impact of the severe resurgence of Covid in India on domestic demand. This resulted

in a substantial compression of the monthly merchandise trade deficit to USD 6.3 bn in May-21 from USD 15.1 bn in Apr-21. As states resorted to gradual unlocking thereafter, the merchandise trade deficit expanded somewhat to USD 9.4 bn in Jun-21. We believe there is scope for further widening of merchandise trade deficit in the coming months, as:

- There has been incremental progress on unlocking at state level, with visible impact on high frequency mobility indicators. The Google Mobility Indicator for Grocery & Pharmacy is currently not only at its highest level in the post pandemic period, but it has also surpassed its pre pandemic baseline level of activity. Further, there has been improvement seen in all other categories of mobility. Gradually improving mobility will result in recovery in domestic demand, thereby widening the merchandise trade deficit, *ceteris* paribus.
- Despite the recent correction, international commodity prices continue to remain elevated. This will continue to amplify the price impact on India's merchandise trade deficit in the coming months.
- Besides, the gradual progress on vaccination would also act as a medium-term factor for economic recovery, and thereby would lead to a wider trade deficit. India has so far (as of Juy-21 end) inoculated 27.5% of its total population with one dose of Covid vaccine. Going forward, with centralized procurement and augmentation in availability via higher throughput and liberalized imports, the likelihood of covering at least 60% of the total population before the end of 2021 appears plausible.

Chart 2: After getting compressed in May-21, India's merchandise trade deficit has started to expand



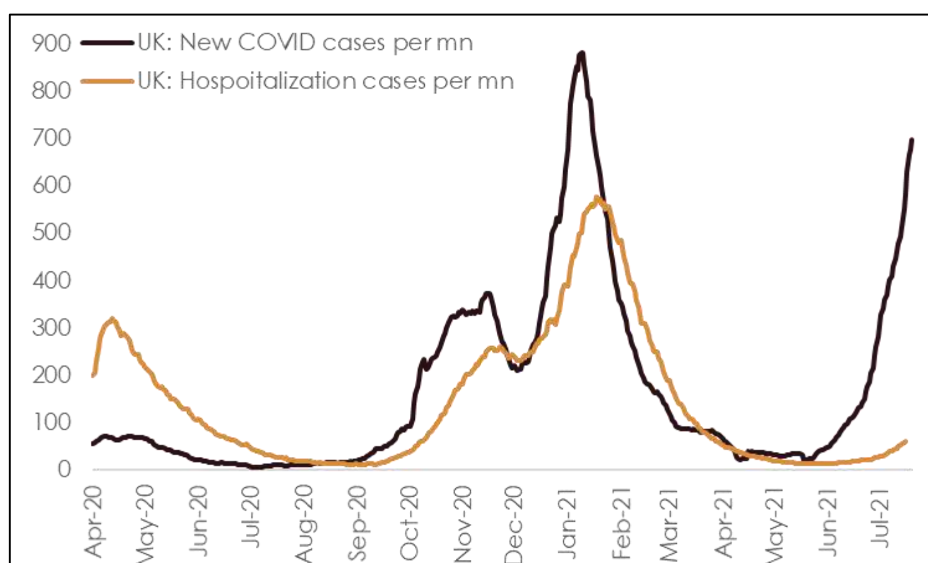
Hence, despite the temporary constriction of the merchandise trade deficit in May-Jun 2021, we continue to stick to our FY22 current account deficit forecast of USD 30 bn compared to a surplus of USD 24 bn in FY21. Even as current account balance

would move towards normalization, the accompanying balance of payments is likely to result in a moderation in surplus from USD 87 bn in FY21 to USD 44 bn in FY22. While per se healthy, the lower BoP surplus could potentially tend to increase INR's sensitivity to global FX volatility.

Meanwhile, the global FX backdrop will continue to be dictated by the reflationary theme, interspersed by bouts of Covid uncertainty. As highlighted in the rates section above, few central banks have already signaled their intent to start normalizing their respective monetary policies before the end of 2021. Importantly, the FOMC's sizeable upward revision to growth-inflation forecasts for 2021 along with the introduction of a cumulative 50 bps rate hike in 2023 (vis-à-vis none earlier) appears to be the first tentative step towards interest rate normalization in the US. Market participants have construed this as the first sign of FOMC members beginning to consider the possibility of tapering of its existing quantitative easing of USD 120 bn monthly asset purchase program. While the actual tapering could still be 2-3 quarters, adjustment in financial markets would in most likelihood lead the actual event. This will provide a supportive backdrop for the USD in the near term.

Having said so, we also note the recent spurt in the dollar index on account of Covid uncertainty led risk aversion in financial markets. We believe this to be short lived and gradually fade away (in favor of reflationary theme) as ongoing fast progress on vaccination front (at least in developed economies) is likely to attenuate the severity of future waves of reinfection. In this context, UK is a live example. With more than 68% of the population inoculated with at least one dose of vaccine, it went ahead with further unlocking earlier this month despite a strong resurgence in COVID infections. We believe the spread of vaccination not just provides a sense of economic comfort; it has also kept hospitalization rates under check so far. We believe countries with fairly large share of vaccinated population could move ahead on unlocking, thereby supporting our belief on the reflationary theme.

Chart 3: Despite substantial rise in new COVID infections in UK, hospitalization rates remain low on vaccine penetration



Global Overview

A Delta overhang

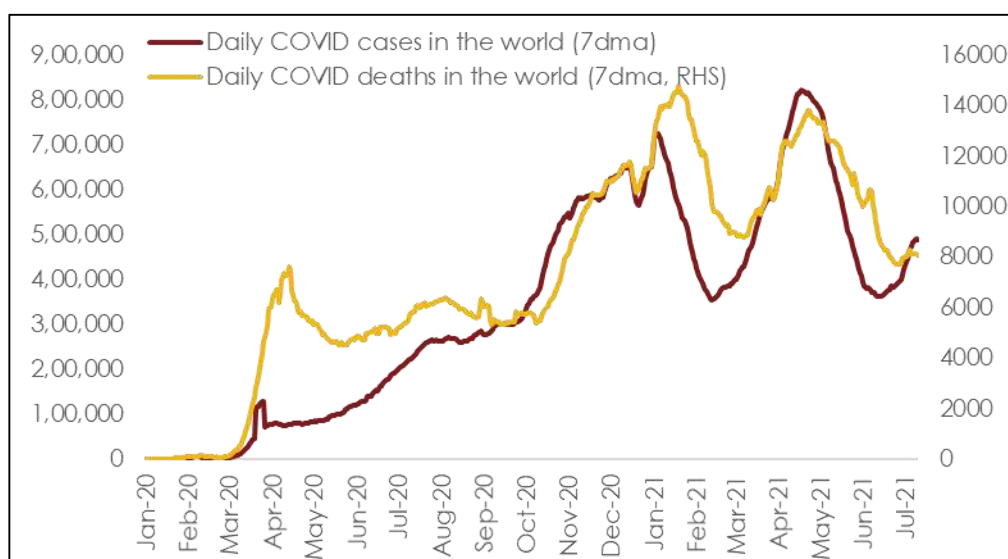
KEY TAKEAWAYS

- After bottoming out in first week of Jul-21, the total number of new Covid cases globally have once again started to rise with the Delta variant of the virus becoming the dominant strain of infections
- Despite this, with severity of cases and hospitalisation remaining low, gradual opening up of economies continues, with UK leading the way with a complete removal of restrictions
- As such, global growth recovery continues to tread forward cautiously with inflation running 'hot' in several countries as price pressures remain a consequence of higher energy prices and opening up of sectors after the pandemic.
- Following the shift from the Federal Reserve, some central banks have become active in discussions/ acting on taper strategies such as BoC, RBNZ, RBA and Norges Bank.
- Providing relief to global growth prospects, crude oil prices eased as the OPEC+ group reached a deal to raise oil production

Overview

After bottoming out in first week of Jul-21, the total number of new global Covid cases have once again started to rise with the Delta variant of the virus becoming the dominant strain of infections. In the fortnight between 6th and 19th Jul-21, global Covid cases rose by ~22% compared to 3.5% in the previous fortnight - with sharp increase recorded in Europe, SE Asia, Western Pacific and the Mediterranean. Only America, as a region, saw a decline in cases, led by South America. Against this backdrop, vaccination campaigns continue to gain ground with nearly 23.7% of world's population having received at least one shot. More importantly, several countries, notably in the European Union, have moved past the symbolic threshold of vaccinating >50% of their populations. This has allowed gradual progress on opening up of economies, with UK removing all Covid related restrictions on the 19th Jul-21 - being described as the 'Freedom Day'. The spread of the Delta variant remains under watch, but as long as hospitalization rates remain relatively low, it should be less detrimental to economic activity.

Chart 1: Progress on vaccine slow in Asia compared to EU and North America



Global growth recovery continues to tread forward cautiously. Global manufacturing PMI eased marginally in Jun-21 but reflect diverging dynamics. The index was stable in the US and recorded a tepid improvement in the Euro area. But, PMIs in UK, Japan, China and India were weaker with the index slipping below the threshold of 50 in India. Overall, the levels remain substantially high in developed economies but there is a loss of momentum off late. On the inflation front, the narrative of price pressures running 'hot' continues to gain steam further, as inflation in US and UK and Eurozone surprised on the upside. Price pressures remain a consequence of higher energy prices (from depressed levels last year) and opening up of sectors after the pandemic.

From a financial market's perspective, the minutes of Jun-21 meeting released by the Federal Reserve reset the tone yet again. Recall, the last meeting had indicated more members expecting a cumulative 50 bps hike in 2023, which market participants construed as the first sign of FOMC members beginning to consider the possibility of tapering. However, belying this assessment, the FOMC minutes were not as hawkish, with only limited support for beginning of taper in the near term. Nevertheless, following the shift by the Federal Reserve, some of the global central banks have

become active in discussions/acting on taper strategies as seen by the Bank of Canada, Reserve Bank of New Zealand, Reserve Bank of Australia and Norges Bank.

Providing relief to global growth prospects, crude oil prices eased as the OPEC+ group reached a deal to raise oil production, after expectations of short supplies sent prices to their highest level in nearly 3 years. It was decided that there will be an output increase of 400k bpd on a monthly basis initially beginning Aug-21; with the deal to increase production being extended up to Dec-22 from previous deadline of Apr-22. As from May-22, member states will be awarded higher production baselines, settling the objections held by UAE.

US

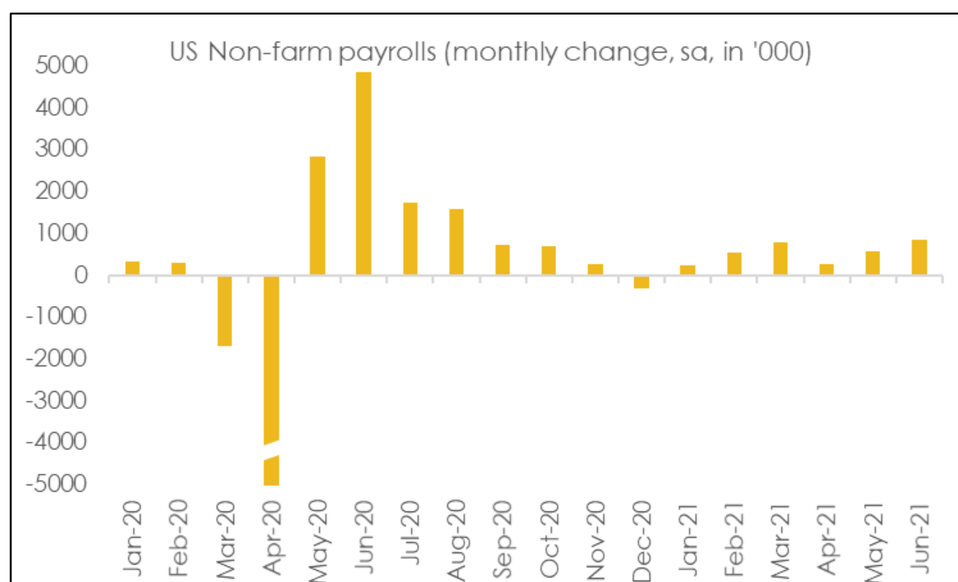
US economy continues to recover at a fast pace, driven by progress on vaccination and gradual opening up. Nearly, 56% of the population has been administered a single dose of the vaccine, while 48.6% has been administered both doses. The IMF raised its 2021 growth projection sharply to 7.0% from an earlier projection of 4.6% in Apr-21, due to a strong recovery from the Covid pandemic and on assumption that much of President Biden's infra and social spending plans will be implemented.

In incremental data, retail sales unexpectedly rose in Jun-21 by 0.6%MoM as demand for goods remained strong even as spending shifted in favor of services. In a validation of the buoyant consumer sentiment, Conference Board's consumer confidence index surged to its highest level in nearly 1-1/2 years, at 127.3 in Jun-21 as reopening of economy, and labour market optimism offset concerns of higher inflation. On the other hand, US factory output fell in Jun-21 by 0.1%MoM after accelerating 0.9% in May-21, owing to a moderation in automobile production amidst global semiconductor shortages. In similar vein, manufacturing output fell 0.1%MoM in Jun-21, with output excluding vehicles and parts rising by 0.4%.

Encouragingly, non-farm payrolls rose by 850k in Jun-21 (see chart), beating market expectations of a rise of 700k, led by strong hiring for Government jobs. However, unemployment rate ticked higher to 5.9% from 5.8% in May-21, indicating the rise in labour force to the tune of 150k in the month. Despite the ongoing recovery, employment deficit remains significant in the US economy estimated at more than 3 mn compared to its pre-pandemic levels.

CPI inflation rose by 0.9% MoM in Jun-21 (vs. 0.6% in May-21) to an annualized level of 5.4% (a 13-year high) led by supply constraints and a continued rebound in the costs of travel-related services (such as used cars and trucks' prices) from pandemic-depressed levels. Notwithstanding the rising CPI inflation readings, according to the minutes of the Federal Reserve's Jun-21 meeting, most policymakers agreed that the threshold to begin scaling back its monthly bond purchases had not yet been met. However, few members believed that the conditions to taper could arrive sooner rather than later amid an improving economic backdrop. This stance was also reiterated by Fed Chair Powell at his congressional testimony, saying that the US economic recovery still hasn't progressed enough to begin scaling back the central bank's massive monthly asset purchases. He further expects inflation to remain high in coming months before moderating, attributing the current upside as being more transitory in nature.

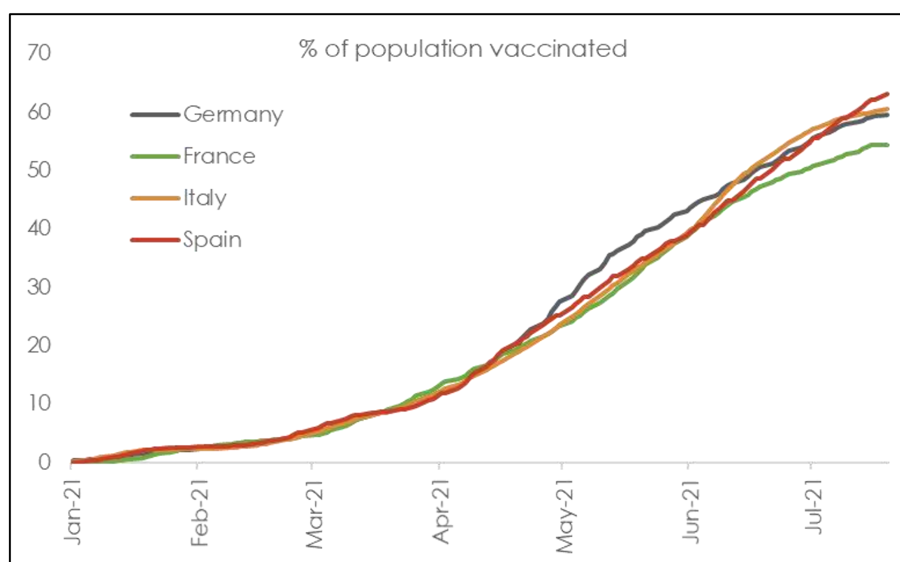
Chart 2: Non-farm payrolls continue to underpin labour market recovery in US



EUROZONE

In its strategic review earlier in the month, ECB raised its inflation target to 2.0% from 'below but close to 2%' previously; with the target being symmetric i.e., negative and positive deviations both being equally desirable. In addition, the ECB mentioned - 'when the economy is close to the lower bound (of interest rates, as it is currently), this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target'. Basis this review, a new policy path will be embarked upon from its next meeting scheduled on 22nd Jul-21.

Chart 3: Eurozone economies have seen a swift progress on vaccinations



Macroeconomic data as well as sentiment indicators for the region are continuing to recover with the opening up of the economies underway. The quick progress on vaccinations is likely to insulate the region from increased infections. The European Commission's economic sentiment indicator hit a 21-year high in Jun-21, with

confidence now above long period average in all sectors. Further, the Commission upgraded its Eurozone growth forecast to 4.8% in 2021 (vs. 4.3% previously), shrugging off growing worries about new Covid variants and the impact of supply bottlenecks on German industrial production; supported by reopening of economies in Q2-21 and hopes of a better tourist season.

HICP inflation remained unchanged at 1.9%YoY in Jun-21, with a narrow measure of core inflation much lower at 0.9%. However, goods inflation has seen a much faster pick up, rising from 0.4% in Apr-21 to 1.2% in Jun-21, reflecting producers' pass through of higher input costs to the consumers. In addition, services sector costs are also beginning to show signs of material pick-up. Meanwhile, the ECB remains largely sanguine, with staff inflation forecasts pegged at 1.5% for 2021 and 1.4% for 2022.

UK

Despite a rise in new daily cases owing to the Delta variant in the UK, the severity of cases and hospitalisations continue to remain much below previous waves of Covid infections. This has reinforced effectiveness of vaccines, with nearly 54% of the population being fully vaccinated and ~69% having received one shot (as of 19th Jul-21). Against this backdrop, the UK Prime Minster went ahead and lifted all Covid related restrictions on 19th Jul-21, being popularly described as the 'Freedom Day'. It remains to be seen whether the lifting off of restrictions will contribute to a continuation of strong growth in the Q3-21 or if Covid cases continue to rise, will it mean increased caution among consumers and slipping back into restrictions.

Most incoming macroeconomic data continues to indicate a strong rebound in economic activity in Q2, which should push GDP very close to pre-pandemic levels. GDP expanded by 0.8%MoM in May-21, albeit easing from 2.0% surge in Apr-21. The Bank of England (BoE) expects the economy to grow by 7.3% this year, the fastest since 1941. CPI inflation rose more than expected in Jun-21, to overshoot BoE's target, as it came in at 2.5% vs. 2.1% in May-21. Price pressures were broad based, seen in categories of food, fuel, second-hand cars, clothing and footwear as the economy bounced from the Covid induced lockdowns.

In its monetary policy last month, the BoE acknowledged that inflation would surpass 3.0% as the economy opens up, but indicated that the up move will be temporary and most MPC members favoured keeping stimulus intact. Members felt they should "lean strongly against downside risks to the outlook and ensure that the recovery was not undermined by a premature tightening in monetary conditions". Since then, some of the policy makers have signaled that stimulus measures may have to be trimmed back soon to keep inflation from increasing further. Meanwhile, Governor Bailey said the BoE would assess inflation data for things that could be temporary, before taking a call on raising rates and tightening the economy's money supply.

Japan

In its monthly update, Government of Japan kept its overall assessment of the economy unchanged from last month, retaining the view that economic conditions remain severe due to the impact of the pandemic.

From a growth perspective, a fresh state of emergency in Tokyo that will run through the Olympic Games until Aug-21 is expected to hurt growth in Q3-21. As such, the

Bank of Japan (BoJ) has downgraded the economy's growth forecast to 3.8% in the current fiscal year ending in Mar-22, from 4.0% projected in Apr-21. However, it revised growth for next fiscal year upwards by 30 bps to 2.7% on expectation that progress on vaccinations will allow consumption to revive. In its forward guidance the Bank indicated that "outlook is highly uncertain as domestic and overseas economies could be swayed by developments regarding the pandemic".

On the data front, Japan's services sector remained in contraction for the 17th consecutive month, with the PMI Index at 48.0 (vs. 46.5 previously). Further, the composite PMI Index, i.e., including manufacturing was at 48.9 in Jun-21, marking the second straight month of contraction. In some respite, confidence at Japanese manufacturers, as measured by the Tankan survey, rose for a fourth straight quarter due to a boost to exports. The headline index rose to +14 from +5 in Mar-21.

Japan's wholesale prices rose 5.1%YoY in May-21, to record the fastest pace of increase since 2008 fueled by rising commodity prices. But core CPI - the BOJ's preferred measure of inflation, rose just 0.1% in May-21 as weak domestic demand kept firms from passing on higher costs. As per BoJ, rising global commodity prices are likely to push up Japan's consumer inflation, though only for a temporary period, and to a smaller extent than in Western economies. In its quarterly projections, the BOJ revised up its core consumer inflation forecast to 0.6% from 0.1%.

China

GDP growth in Q2-21 came broadly in line with expectations at 7.9%YoY but lower than Q1 owing to the waning of a favorable base. On a QoQ basis, growth expanded by 1.3% compared to 0.4% in Q1, as regional lockdowns and mobility restrictions eased. Incoming data for Jun-21 continues to surprise upwards, with retail sales at 12.2%YoY and industrial production at 8.3%YoY.

In Q2, recurring Covid infections ensured that restrictions on economic activity and mobility remained in place in some form, though the impact on growth weakened. Recovery in growth has been largely driven by sectors of manufacturing, real estate and exports; with consumption recovery (especially in services) remaining on a backfoot. Recognizing this, Chinese Government has ramped up vaccination roll-out in Q2 although the efficacy of the vaccines used in China are reported to be lower than the vaccines used in the West.

After rising in recent months, producer price inflation (PPI) appears to have stabilized in Jun-21, as it dropped marginally to 8.8% from 9.0%YoY owing to steps taken by the Government to contain the surge in prices (such as release of metal reserve). Meanwhile, headline CPI inflation eased to 1.1% in Jun-21 from 1.3% in May-21, while core CPI inflation was stable at 0.9%YoY. This confirms the incomplete pass-through from higher cost prices into CPI, as of now. In a bid to support growth, the PBoC announced a 50 bps RRR cut effective 15th Jul-21, with an intent to provide some reprieve to corporates facing rising commodity prices. Offering guidance, the PBOC said "it would continue to implement a prudent monetary policy while keeping liquidity at a reasonable and ample level to create a suitable monetary and financial environment for China's high-quality development and supply-side structural reform"

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