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INDIA

Economy

Outlook CY21

- The Covid pandemic was a classic black swan event for the global economy. It spread rapidly throughout the world, causing severe health and economic hardships. Many countries fought hard to bring the spread of infections under control, but success was short-lived. Large parts of the developed world witnessed a second wave of the pandemic and had to take stringent measures to contain it.
- Covid took a toll on Indian economy as well – the country recorded a technical recession during the year after its GDP contracted in two consecutive quarters. However, Indian economy is recovering faster than expected and the momentum is likely to continue in coming quarters.
- We expect the Indian economy to contract 7.5% in FY21 and grow 8.5% in FY22. We expect the economy to post positive growth in all quarters of CY21, starting with a modest growth of ~0.8% YoY in Q4FY21 (Q1CY21) and increasing sharply to ~20% in Q1FY22 (Q2CY21) due to low base effect and sequential momentum.
- We expect inflation to remain elevated in early CY21 due to supply-side constraints. As per our forecasts, CPI inflation is likely to average 6% in Q4FY21 (Q1CY21) and 5.6% in Q1FY22 (Q2CY21). However, we expect inflation to ease and decline to ~4.3% towards the end of CY21.
- Given the expected inflation trajectory, we expect the MPC to hold rates till Q2FY22 (Q3CY21). The RBI may continue to take other measures to keep financial conditions easy to support recovery.
- The IMF expects global growth at -4.4% in CY20 and 5.2% in CY21. In line with contraction in global growth, global trade is expected to contract 10% in CY20 and grow 8% in CY21. Given the weak global trade backdrop, we expect India's exports to decline 11% YoY in FY21 and increase 13% in FY22. Imports, on the other hand, are expected to decline by as much as 25% in FY21 due to weak domestic economy and low commodity prices. In FY22, we expect imports to grow 22% due to low base effect, recovery in domestic economy and uptick in commodity prices. In CY21, we expect the INR to trade in a range of 73-75/USD with an appreciation bias.

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Headline inflation likely to fall below 5% by end-CY21

Headline retail inflation has consistently remained above the MPC's comfort level of 6% since Dec'19, barring the sole exception of Mar'20. During the first eight months of FY21, headline CPI averaged 6.9% while core inflation averaged 5.6%. The RBI decided to consider Apr-May'20 as break in inflation series due to price data collection issues soon after the onset of Covid. Hence, although CPI inflation has exceeded 6% for more than three quarters, the break in series will imply the MPC's mandate of keeping inflation between 2-6% will not be considered breached.

We expect inflation to remain high in the near future, mainly due to high food prices. Table 1 below shows our quarterly expected inflation trajectory through FY22.

Table 1: Expected trajectory of CPI inflation

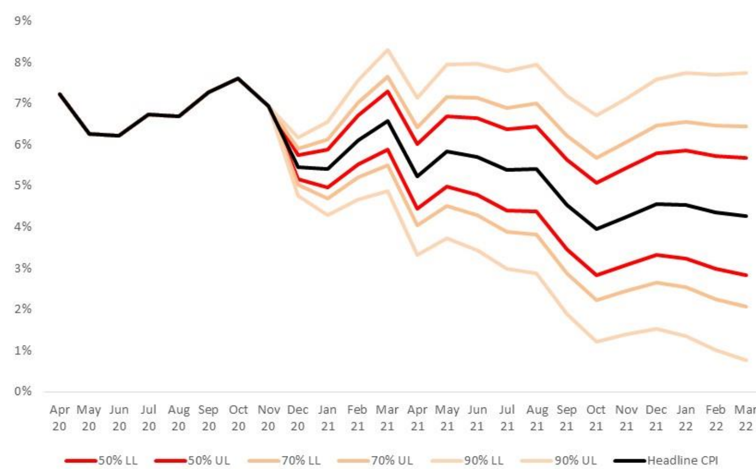
	FY21E					FY22E				
	Q1	Q2	Q3(E)	Q4(E)	Full yr (E)	Q1(E)	Q2(E)	Q3(E)	Q4(E)	Full yr(E)
Headline CPI inflation										
Actual CPI inflation	6.6%	6.9%	-	-	-	-	-	-	-	-
Headline CPI (I-Sec)	-	-	6.7%	6.0%	6.5%	5.6%	5.1%	4.3%	4.4%	4.8%
MPC forecast	-	-	6.8%	5.8%	6.5%	4.6% to 5.2%		-	-	-
RBI Professional Forecasters' Survey (Dec 2020)	-	-	6.6%	5.4%	6.3%	5.0%	4.5%	-	-	4.5%
Core CPI inflation										
Actual Core inflation	5.0%	5.6%	-	-	-	-	-	-	-	-
Core (I-Sec)	-	-	5.7%	6.0%	5.6%	5.2%	4.7%	4.7%	4.6%	4.8%
RBI Professional Forecasters' Survey (Dec 2020)	-	-	5.4%	5.3%	5.3%	4.8%	4.3%	-	-	4.2%

Source: Mospi, I-Sec research

Among non-food items, we expect to see price pressures in some services such as healthcare, transport and personal care costs. Overall, in Jan-Mar'21 we expect core inflation to remain above 5%, but eventually settle in the range of 4.6-4.7% in the remaining three quarters of the year.

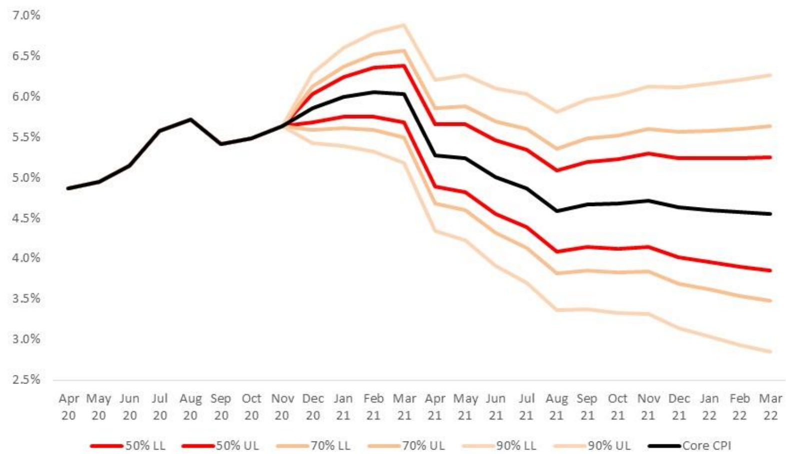
Below, we give our expected headline and core inflation trajectory till Mar'22:

Chart A: Expected headline inflation trajectory



Source: Mospi, I-Sec research. Dark red lines indicate 50% confidence interval, pink lines indicate 70% confidence interval, and light pink lines indicate 90% confidence interval.

Chart B: Expected core inflation trajectory

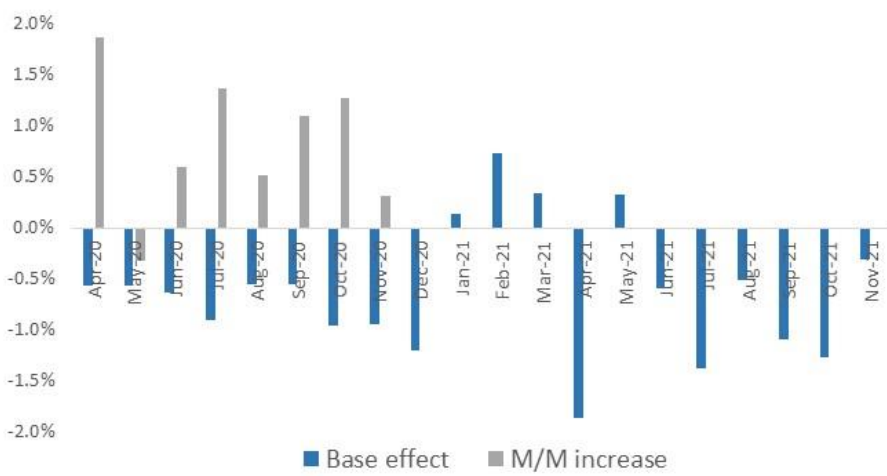


Source: Mospi, I-Sec research. Dark red lines indicate 50% confidence interval, pink lines indicate 70% confidence interval, and light pink lines indicate 90% confidence interval.

Our forecasts imply that actual inflation is likely to exceed MPC's projections

Table 1 shows that we expect CPI inflation to average 6.7% in Q3FY21 and 6% in Q4FY21 respectively. This indicates that our inflation forecast is marginally higher than the MPC's forecast of 5.8% in Q4FY21. Also, in H1FY22, we expect inflation to average ~5.3%, a tad higher than the upper bound of MPC's forecast of 5.2%.

Chart C: CPI base effect



Source: Mospi, I-Sec research

MPC may not find room for rate cut till Q3CY21

As a consequence of high inflation, we do not believe the MPC will find room for rate cut at least till Q3CY21. In our opinion, the possibility of inflation outturns surprising on the lower side is low. In fact, we believe there is an upside risk to our forecasts and actual outturns could turn out to be higher.

Growth rebounding faster than expected…

The Q2FY21 GDP growth data surprised on the higher side. Real GDP contracted 7.5% YoY in Q2FY21, sharply up from the 23.9% contraction recorded in the preceding quarter, mainly due to better than expected performance by manufacturing, trade and construction sectors. Our analysis of financial performance of listed manufacturing companies showed that companies cut costs aggressively in the second quarter. Hence, although the volume of their production declined, steeper cut in expenditure led to improvement in gross value-added. The analysis further showed that most of the cost reduction came from lower input prices rather than lower employee expenses. Also, the data showed inventory build-up in certain sectors such as metals, textiles and food manufacturing.

This has implications for growth in the coming quarters. Since lower input prices drove expenditure cut in Q2FY21 and not lower employee expenses, private consumption may not take a big hit in the coming quarters. Also, commodity prices have started increasing, indicating the positive performance by manufacturing sector may not sustain for long. Moreover, growth in sectors that recorded inventory build-up in Q2FY21 may face headwinds later in the year.

Three of the four components of industry – mining, manufacturing, and electricity – have very low contact intensity of final consumption and also production process. Hence, we believe the performance of these sectors is likely to be relatively more resilient to the spread of Covid and the resultant restrictions. Construction activity, on the other hand, may remain subdued due to relatively higher contact intensity of production process and weak demand.

Overall, we expect industry to record growth of -10% in FY21. The rebound in FY22 is expected to be robust – we expect industry to record a growth of 10.5%.

When it comes to the services sector, some components such as travel, leisure, entertainment, and hospitality are likely to remain under pressure until mass vaccination is carried out. However, other sectors such as trade could see traction due to pent-up demand. Overall, we expect services sector to record growth of -9% in FY21 and bounce back to 9.2% in FY22.

It should be noted that these projections have wide bands of uncertainty due to a number of moving factors, most important of them being the spread of Covid in India and abroad.

Table 2: India growth projections

% YoY	FY21 (E)	FY22 (E)
Agriculture	3.6%	3.2%
Industry	-10%	10.5%
Services	-9%	9.1%
Real GDP	-7.5	8.5

Source: Mospi, I-Sec research

India’s imports likely to contract twice as fast as exports in FY21

Covid took a heavy toll on global trade as demand for imported goods shrunk and production in export-oriented factories halted. Moreover, restriction on physical movement of goods (except some items) acted as a strong headwind. According to the IMF’s World Economic Outlook (Oct’20), global growth is projected at -4.4% in CY20 and 5.2% in CY21. Hence, the IMF estimates that after the contraction in CY20 and recovery in CY21, the global economy will be 0.6% above its level in CY19. Over the medium term (post-CY21), the Fund estimates global growth to trend at ~3.5%.

In line with contraction in global growth, global trade is expected to contract 10% in CY20. The current crisis has hit contact-intensive sectors more than the manufacturing sector. The former tend to be relatively less trade-intensive than the latter. Hence, the expected decline in global trade is not proportionate to the expected decline in global output.

In CY21, global trade is expected to grow 8% and by >4% in the subsequent years.

Given the weak global trade backdrop, India’s exports are expected to decline 11% YoY in FY21. However, in FY22 exports are expected to recoup the contraction and grow 13%, in line with global trade and output recovery. Imports, on the other hand, are expected to decline by as much as 25% in FY21 due to weak domestic economy and low commodity prices. In FY22, we expect imports to grow 22% due to low base effect, recovery in domestic economy and uptick in commodity prices.

In Sep’20, the RBI signalled that it was willing to let the INR appreciate in order to contain inflation. However, given the large inflow of foreign money in India’s capital markets, the central bank is facing a tough task of managing liquidity and aligning market rates with policy rates. In CY21, we expect the INR to trade in a range of 73-75/USD with an appreciation bias.

Government finances stretched, focus will be on Budget FY22

The severe impact of Covid on government finances became clear quite early into the pandemic. As of Oct’20, the government has received only 34% of its budgeted revenue receipts, but spent 56% of its budgeted revenue expenditure and 48% of budgeted capital expenditure. Hence, in the 7MFY21, the government has reached 120% of its full-year fiscal deficit target. State government finances are even more stretched due to GST revenue shortfall.

Table 3: Snapshot of Central government finances, Oct’20

(Rs bn)	BE-FY21	Actuals till Oct 20	% of actuals to BE, FY21	% of actuals to BE, FY20
Revenue Receipts	20209	6919	34.2%	46.2%
Tax Revenue (net)	16359	5757	35.2%	41.4%
Non-Tax Revenue	3850	1162	30.2%	71.6%
Non-Debt Capital Receipts	2249	164	7.3%	22.4%
Total Receipts	22458	7083	31.5%	44.9%
Revenue Expenditure	26302	14640	55.7%	59.4%
Capital Expenditure	4120	1973	47.9%	59.5%
Total Expenditure	30422	16614	54.6%	59.4%
Fiscal Deficit	7963	9531	119.7%	102.4%

Source: CGA, I-Sec research

We expect Budget FY22 to have higher allocation towards healthcare (reflecting the cost of vaccinating large sections of the population), focus on employment generating and asset creating sectors, thrust on capital expenditure and present a fiscal glide path.

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