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Economic Round-up: December 2022

As 2022 ends economic challenges stand ready for major global economies. Persistently high inflation, elevated borrowing costs and resurgence in Covid-19 infections in China are some of the key risks to global growth. Further, as major central banks (US Fed and ECB) have indicated to keep the rates high this year as well, there is no respite in sight. Economies are bracing for a technical recession, which in case of India will impact our exports, rates, foreign inflows and currency. However, strength in our domestic demand and government spending is likely to prevent any major economic slowdown. A dominant question this year will be, when central banks will pause.

Global growth: 2023 is off to a shaky start as major global economies are beginning to show signs of stress owing tight monetary policies. While in the US, housing sector, retail sales, industrial activity are under strain, in Europe inflation continues to bite and weak demand is hampering production business. Risks to global growth are also emanating from China, as it witnesses economic slowdown due to surge in Covid-19 infections amidst low vaccination rates. As global economy heads towards a possible economic recession, a key question for the investors will be when major central banks will pause.

Global Central Banks: So far, both US Fed and ECB have indicated that rate hikes could continue well into the current year as well, until inflation is substantially brought down. In case of BoE, there appears a split as to when to pause, considering the bank has already hiked rates 9 times since Dec'21. Recently, in Dec'22, US Fed, ECB, and BoE had slowed their pace of hike in benchmark rates by incorporating 50bps increase, compared with 75bps rise in their previous meetings. BoJ also shocked the markets in Dec'22 as it widened the 10Y bond yield target range from -0.25% to +0.25% to -0.5% to +0.5%.

Key macro data releases: With data on the fiscal state of the government coming in till Nov'22, fiscal deficit has reached 58.9% of the targeted level, compared with 46.2% during the same period last year. Capex remains the bright spot, with spending spearing ahead and revenue expenditure also at par with last year. On the income side, net revenue witnessed marginal slowdown on account of moderation in both direct and indirect tax receipts.

On the industrial production side, core sector output expanded by 5.4% in Nov'22 compared with a growth of 0.9% in Oct'22. This was on the back of improvement in coal, fertilizers, steel and cement output. Double digit growth in steel and cement has lifted hopes of robust growth in construction sector.

CPI inflation eased much more than expected to 5.9% in Nov'22 (12-month low), (our estimate 6%) from 6.8% in Oct'22. This was the first time in FY23 that inflation was below RBI's upper threshold of 6%. Food inflation moderated to an 11-month low at 4.7% in Nov'22 compared with 7% in Oct'22. This could almost entirely be explained by a decline in vegetable inflation, due to seasonal factors. Some moderation was also visible in fruits. Other items in the food basket however continued to show underlying price pressures. Core CPI (excl. food and fuel) edged up to 6% in Nov'22 from 5.9% in Oct'22. Barring amusement and recreation, clothing and footwear and housing, all other components of core inflation showed acceleration. Maximum traction was seen in transport and communication and pan, tobacco and intoxicants.

Global developments

Key issues in 2023

As CY22 came to a close, US economic data showed mixed impact of Fed rate hikes so far. While housing market, retail sales, industrial production, and PMIs are witnessing signs of stress, on the other hand, labour market conditions continue to remain tight, inflation is slowing and consumer sentiment is seen to be improving.

Existing home sales in the US fell by (-) 7.7% in Nov'22, lowest since May'20 (during the time of pandemic), however when compared with pre-pandemic period it is lowest since Nov'10. Elevated mortgage rates (30Y fixed mortgage rate averaging 6.8% in Nov'22, levels last seen in early 2000s) are adding to the woes of the buyers. NAR's pending home sales index also dropped sharply with sales down for the 6th consecutive month in Nov'22 (-4% MoM). Barring the pandemic period, this is the lowest level since the index was launched in CY01. Apart from this, manufacturing activity is also showing signs of lull with headline industrial production down by (-) 0.2% in Nov'22 and manufacturing down by (-) 0.6%. Softening capital spending in the wake of higher borrowing costs was cited as the key reason. Even consumers are beginning to feel the pinch with savings rate running at near record low and retail sales dropping by (-) 0.6% in Nov'22, following 1.3% increase in Oct'22. Excluding volatile components (gasoline and autos), sales were down by (-) 0.2%. However, Fed in last meeting conveyed that it intends to keep rates higher for longer period, until inflation is substantially brought under control. The current stance takes into account the view that labour market still remains tight and wage pressures (avg hourly wage estimated to rise by +5% in Dec'22) persist. Continuing jobless claims have moved only marginally above the historic low of 1.7-1.8mn mark. Lay-offs are mainly seen in the tech sector so far.

In Eurozone (EZ), inflation will continue to remain the dominant theme this New Year as well. While EZ's headline CPI has eased to 10% in Nov'22 from 10.6% in Oct'22, ECB still estimates that upward pressures remain. The current slowdown was mainly owing to dip in energy and services inflation. However, food inflation, pent-up demand, depreciation of the Euro, rising wages, and residue supply-bottlenecks issues, are expected to keep CPI at elevated levels this year. Amidst this, higher borrowing costs is already denting economic growth. Retail sales in Oct'22 were weaker (-1.8% MoM) than anticipated (-1.7%), and also lower than Sep'22 print (-0.8%). Contraction in industrial production too accelerated with activity falling by (-) 2% (MoM) in Oct'22 (est.: -1.5%), following 0.8% decline in Sep'22. Manufacturing PMIs for Dec'22 also indicate that activity remains in contraction (47.8 in Dec'22 versus 47.1 in Nov'22), although its pace has eased. Despite this, ECB in its last meeting had indicated that it plans to hike rates further to control inflation. Analyst are predicting a technical recession in Eurozone in H1CY23.

Another eminent risk in CY23 will emerge from China, where stringent Covid-19 restrictions had impacted activity in the latter part of Q4CY22. Following widespread protests in the country, these restrictions have recently been loosened. However, as a result of this, Covid-19 cases in the country have surged significantly. This has even led to re-imposition of travel restrictions (US, Italy, Spain) on passengers coming from China. On the other hand, economic impact of re-opening the economy is still unclear. Official PMI data indicates that both manufacturing (47.8 in Dec'22 versus est.: 47 and 48 in Nov'22) and non-manufacturing (41.6 in Dec'22 versus est.: 45 and 46.7 in Nov'22) activity had taken a hit in Dec'22 and came in below expectations as well. Reports indicate that businesses (including construction) are dealing with staffing problem, while services sector is impacted by rapid spread of infections and low vaccination rates (although rates have seen gradual pick in the past few weeks). However the PMI data should be used as indication, rather than an actual trend of economic activity, as the real impact of re-opening will be visible only when government releases its actual data. Up till Nov'22, industrial production was down by (-) 2.2% versus est.: +3.6% and +5% in Oct'22. Retail sales fell by (-) 5.9% (est.: -3.7%), followed by (-) 0.5% decline in Oct'22. Even FAI slowed to 5.3% (est.: 5.6%) during Jan-Nov'22 period from 5.8% during Jan-Oct'22.

RBI

RBI's Dec'22 policy announcement was in line with expectation. A rate hike of 35bps materialized and the stance of withdrawal of accommodation has been retained. However, cautiousness prevailed with regard to anchoring of inflation expectations and the policy tone reflected need to be mindful of future inflationary shocks even though inflation forecast was unchanged at 6.7% for FY23. On liquidity management, RBI is expected to be 'nimble and flexible' in its approach. Going forward we expect, some comfort to CPI print emanating from favourable base. Even Rabi crop would get relief from good North East monsoon and adequate reservoir levels. However, wariness should prevail with regard to reversal of seasonality decline in tomato and potato prices. Demand pressure still persists as visible in resilient services activity which will tend to push up prices. Thus, our CPI forecast for FY23 stands a tad higher at 6.8% compared to RBI's estimate of 6.7% while our growth projection stand in line with RBI forecast. We expect terminal repo at 6.5% with another 25bps hike in its Feb'23 policy and thereafter a pause.

Global central bank decisions

In line with market expectations, US Fed raised its key policy rate by 50bps to reach a level (4.25-4.5%) highest in ~15 years. While the pace of rate hike was slower than 75bps increase in its Nov'22 meeting, the central bank indicated that rates are expected to remain elevated during CY23 as well. No reductions can be expected until CY24. It is expected that rates will continue to rise till a target range of 5-5.25%, followed by cut in rates to ~4.1% by CY24 and 3.1% by CY25. Prevalence of higher rates in CY23 also implies greater risk to economic outlook in the year.

ECB too increased its policy rate by 50bps in its Dec'22 meeting and stated that rates will rise further as outlook for inflation has been revised upward. Inflation is estimated to average at 8.4% in CY22, before declining to 6.3% in CY23, to 3.4% in CY24 and to 2.3% in CY25. ECB President has already indicated at hiking rates by 150bps over the course of Bank's next 3 meetings. Market participants are now expecting deposit rate to peak at 3% by Jul'23 (currently at 2%), versus 2.75% expected earlier. Tighter monetary policy is also expected to dent growth, with central bank expected Eurozone GDP to rise by 3.4% in CY22, before slowing to 0.5% in CY23. CY24 onwards growth is expected to pick up again (1.9%).

Bank of England also continues to maintain tight monetary policy conditions and hiked rates by 50bps in its Dec'22 meeting, albeit slightly lower than 75bps increase in Nov'22. The bank expects inflation to remain high for a considerable period of time, led by global prices and pressure on wages. Both higher rates and inflation is also expected to dent economic growth. UK GDP is expected to decline by -0.1% in Q4CY22, versus 0.1% increase expected in Nov'22.

BoJ made a surprise move in it Dec'22 meeting, and increased its target yield band to -0.5% to +0.5% from -0.25% to +0.25%. Although the change in target range was more to smoothen the bond market functioning than to indicate change of monetary policy direction. Following this decision, 10Y bond yields have gained ~21bps, while Yen has depreciated by ~3%.

Special studies

How did the IPO market perform in CY22?

While the size of the IPO market remained small in CYTD22 so far at ~Rs 55,000 crore versus Rs 1.2 lakh crore. In CYTD22, while Sensex has risen by 7.6% on an average, the returns on IPOs averaged 17.7%. Overall, IPOs issued had been concentrated in 3 major sectors (contributing to 56% of the total issuance)-edible oil, insurance and hospital & healthcare services. While edible oil industry performed very well on the stock market, insurance industry (LIC) had taken a hit, while returns in healthcare services industry were modest at best.

While in CY21, the dominant industries remained e-commerce, auto, chemicals, insurance and finance (investment), in CYTD22, industries such edible oil, hospital & healthcare services, and insurance dominated the IPO space. These 3 alone contributed to 56% of the total issuances in CYTD22.

In CYTD22, 12 industries witnessed big ticket (>1,000 crore) IPOs, of which insurance sector (LIC) was the biggest with an issue size of ~Rs 21,000 crore. This was followed by industries such edible oil (~Rs 7,000 crore), hospital & healthcare services (~Rs 3,200 crore), textile (~Rs 3,100 crore) and courier services (~Rs 3,000 crore), amongst others.

Amongst 12 big ticket issuances, 5 were listed a discounted price, averaging -5.3%. LIC (-8.6%) and Rainbow children's Medicare (-6.6%) were listed at a discount of even more than average. On the other hand, 7 companies were listed at a premium, averaging 13.5%. Amongst these, Patanjali foods (30.8%), Global Health (18.5%), and Campus Activewear (21.6%) recorded a premium above average.

Out of a total of 84 companies (versus 99 last year), 17% companies listed at a discount, 6% companies were listed at the same price as the issue price, while 77% companies listed at a premium.

As of Dec'22 (18 Dec), out of these 84 companies, 32% of the companies are trading (last price) at a discount (compared with issue price), while 68% of them are still trading at a premium.

Overall, these companies have recorded an average return (last versus list price) of 17.7% in CYTD22, versus 7.6% gains made by Sensex.

Amongst the 84 companies, 12 (versus 33 last year) were those which had an issue size of over Rs 1,000 crore (big ticket companies). These companies gave an average return of 5.8% at the time of listing (compared with issue price). As of Dec'22, these companies have given an average return of 33.1% (compared with list price).

Out of the 12 big ticket companies, most gains were made by stocks of Adani Wilmar, Rainbow Children's Medicare, Patanjali Foods, Vedant Fashions, Pradeep Phosphates and Five Star Business, averaging return of 65.3%.

On the other hand, LIC and Delhivery were the only ones currently trading at a discount (compared with list price), averaging -24%.

Overall, taking into account all the companies (sample of 84 companies) which issued IPOs in CYTD22, while the size of issuance was Rs 55,492 crore, this valuation rose to Rs 57,624 crore (+3.8% from issuance) at the time of listing, and was trading at even higher valuation of Rs 65,325 crore (+13.4% from listing) as of Dec'22. This implies, investors made gains of Rs 8-10k crore over the year by investing in the IPO market.

Impact of inflation on consumption/production

Global economy has been witnessing upheavals due to uncertainty posed by factors such as the Russia-Ukraine conflict which resulted in supply constraints thus hampering global value chains. These have in turn pushed global prices to a new high in CY22. India has not been unaffected to these waves. Some products faced the brunt of high inflation with people restricting the purchase. However for others, the pent up demand phenomenon helped to retain growth in production. The study attempted to understand if inflation has any association with lower consumption (production as proxy where data no available) levels or it insulated from it completely.

The impact of global inflation was seen on the domestic front too with WPI print accelerating to as high as 16.6% in May'22 (all time high in the current series). It moderated since then to 8.4% in Oct'22 (5.8% in Nov'22) led by factors such as RBI's rate hike cycle, dip in vegetable inflation amongst others. Different categories of products were used to see if their growth was evenly impacted during the Apr-Oct'22 period vis- a- vis inflation.

Higher Inflation effecting growth

- Under consumption, higher inflation for fertilizer did have an impact on sales. Elevated global prices pushed fertilizer prices higher. This was on the back of economic sanctions imposed earlier in the year and disruptions caused under the route of Black Sea. Furthermore, supply constraints from China (suspension of exports) all pushed the prices higher. Fertilizer sales have fallen as a result of the same down by (-) 5.5% from 3.3% last year.
- Steel prices registered a moderation, nevertheless they continued to remain elevated with double digit (at 15.8% for Apr-Oct'22). Furthermore, Government of India in May'22 had also imposed export duty, the same has been lifted off in Nov'22.
- Under production, for goods under the consumer non-durable categories such as butter, ghee, cakes, butter and chocolates the production level registered a moderation with uptick in inflation. A similar scenario was witnessed with, tea and coffee production too.
- For consumer durable products such as linen, carpets, towels, footwear and jewellery have all seen lower production level in CYTD22 compared with the previous year on account of much high inflation during the same period.
- Apart from these goods, production of cement have also eased with acceleration in inflation. The cement sector in CYTD22 was negatively impacted by elevated commodity prices. As a result, inflation for cement products edged up by 9.6% in Apr-Oct'22 from 3.1% in Apr-Oct'21, thus pulling down cement production to 8.8% from 34.9% in Apr-Oct'21.

For FY22 (Apr-Oct'21), across categories both production and sales growth was higher on the back of higher base along with pent up demand. As a result, in that year both production and consumption growth was expected to dip. However for certain products, high inflation did have some impact on growth. In addition to higher inflation rate, other factors such as incessant rains and falling consumer sentiment especially towards certain categories of consumer durable goods also had some association with moderation in sales growth. Also evidently, some of the slowdown was visible across the discretionary products with higher priced items sometimes facing the brunt of the same. However, other products remain insulated despite higher inflation.

Is there a scope for lowering corporate tax rate further?

In Sep'19, the Union Government in a surprise move slashed corporate tax rate on both existing and new domestic manufacturing units. This was done to incentivize domestic production amidst a loss in economic momentum. Subject to the condition that no other incentive or exemption is availed by a domestic company, it can pay a tax rate of 22%, which implies an effective tax rate of 25.17%. Similarly, to attract fresh investments, tax rate for new domestic companies (incorporated after 1 Oct 2019) was also reduced to 15% (effective tax rate of 17.01%).

With the Budget coming up, suggestions and demands have been put forward to lower the corporate tax rate further to spur investment and production. This comes against the backdrop of emerging signs of deceleration in the economy. Firms have been grappling with higher input costs, which still have not been fully passed on the consumers. There have also been early signs that the pent-up demand narrative is slowly fading. Even on the global front, there have been increased expectations of a global recession.

For the aggregate sample (2,576 companies), we saw that the effective tax rate has declined from 27.6% in FY18 and FY19, to 22.8% in FY20 as the reduced corporate tax became effective from this year. Since then, there has been some further moderation in the effective tax rate which continues to hover around ~22%. It was interesting to note that this is below the effective tax rate of 25.17% specified by the government.

Majority of companies (44.1%) had an effective tax rate between 25-30%. This is consistent with the government notified effective tax rate. Furthermore, around 20% companies had a lower tax rate of between 20-25%, and another 17% had an effective tax rate of below 20%. The divergence between firms with respect to the effective tax rate is due to the extent of exemptions/subsidies taken by the particular business. However, there were companies which had a higher tax rate of above 30%. Most of these were concentrated in the finance, capital goods, chemicals and textiles sector.

On a disaggregated level, for companies with turnover less than Rs 5 crore (micro), the effective tax rate has been very low in almost all the years. Interestingly, while the effective tax rate for these firms averaged around 14% between FY18-FY20, it actually increased to 15.2% in FY21. In Fy22, this dropped sharply to 12.1%.

For firms with net sales between Rs 5-50 crores, the effective tax rate had shown variation. While it reduced to 18.9% in FY20 from 22.2% in FY19, it edged up significantly in FY21 to 25.4%. It did decline to 21.3% in FY22, but has remained above average. For medium enterprises (turnover between Rs 50-250 crores), while the effective tax rate declined from 22.9% in FY18 to 18.4% in FY20, it edged up to 21.9% in the year thereafter and remained elevated at 21.8% even in FY22. For the large companies (annual turnover exceeding Rs 250 crores), which accounted for more than 40% of the total sample, the effective tax rate was relatively higher. However, the tax rate has shown significant moderation. From 28% in FY18, it declined to 23% in FY20. It has remained at 22.1% in the period thereafter.

Furthermore, the effective tax rate in India is lower than several other Emerging Economies such as Brazil and Argentina, and even some advanced economies such as Australia and France. Apart from this, fiscal cost for the government will also be a significant deterrent, particularly since the government is likely to focus on fiscal consolidation.

‘T’ has not been the season of much gain

CY22 had been a tumultuous year. It started off on a shaky note with Ukraine Russia war, which impacted commodity prices. Inflation for major economies peaked. This led central banks globally to turn the tables. From ultra-low rates seen in the preceding two years to support the economy from Covid-19 induced slowdown; central banks shifted the gear to control inflation. Thus, central banks globally remained hawkish, raising policy rates. This coupled with Covid-19 related restrictions in China, impinged on the global growth fundamentals. Concerns of recession also emanated in Eurozone, UK. Even in the US, worries persisted over ‘hard landing’.

In this environment it is interesting to see how various asset classes have fared over the year in terms of nominal returns. We had conducted a short exercise to see how in this uncertain environment returns fared across different asset classes. The first fortnight of December for 2021 and 2022 had been averaged to calculate the annual returns.

‘T is not the season to cheer’ as can be seen from the returns of major asset classes. If inflation which is averaging around 6.5-7% is also buffered in, the real returns would look even less impressive.

Amongst major ones, sharp drop in returns was seen for crypto with Bitcoin. The hype over Bitcoin has now been obscured with investors thinking twice before investing in them. This has been on account of regulatory concerns over security issues. Further, collapse of FTX, which used to be the fourth largest crypto exchange in the world along with the uncertain global environment and wobblier macro fundamentals, also led to falling returns in this segment. It fell as sharply as 72.8%.

The best return came from natural gas due to the war effect. This is also on account of major economies intention to shift away from oil and coal. Thus many had resorted to natural gas instead of coal for production of electricity. Apart from this, even supply issues concerning supplies from Russia also led to soaring natural gas prices and hence higher returns. Taking positions in the futures segment would have opened this door though admittedly this was not what could have been expected.

Oil remained volatile throughout the year with annualized average daily volatility rising to 46.3 % in CYTD22 from 32.2% in CY21. Further in CYTD22, oil traded in the range of US$ 76.1-128/bbl, against CY21’s range of US$ 51.1-86.4/bbl. Return on oil thus edged up to 9.8% (on point to point basis) as most of the economies started running at full capacity post Covid. The return looks low compared to the peak prices witnessed in the interim period with the $ 125/barrel mark being touched.

The third best return came from currency and investments in the dollar would have given a return of around 8%. With the dollar strengthening for most of the months, the rupee went down in a scaled manner and was higher than the average of 3-4% which was witnessed in the past.

Equity market gave a relatively satisfactory return of 7.6%. In real terms however once adjusted for inflation would come down further to just about 1%. However, sectoral indices showed variation.

Conventional avenues were not favourable for savers which when adjusted for inflation gave negative returns. Among investment options, Bank deposits >1 year, gave a return of 5.3%, higher than return on 364 days T-Bill which gave a return of 4.2%. Currently the situation has reversed completely, return on Bank deposits >1 year are running at 6.7% whereas for 364 days T-Bill it is 6.9%. This is because liquidity conditions have driven the T-Bill rates while bank deposit rates have moved up in specific maturity brackets. Notably, return on government bonds have been just 1.5%.

Housing gave a return of 4.5%, with maximum return increasing for cities such as Kochi (11.1%), Kolkata (8.4%) and Delhi (8.3%). However, for other metros such as Bangalore (3.6%), Mumbai (3%) and Chennai (1.8%), it remained below the All India level. Even on a rising rate cycle, the return from housing is expected to be stable in the medium to near term as these are long interest cycle loans which get balanced out during the tenure.

Rising policy rate impacted return on government securities as rising rates caused fall in prices and hence the total returns index showed minimal returns.

Gold continued to give virtually nil returns to rising DXY and even in the coming year. With the dollar declining in value of late, there can be an upside to gold in 2023.

What is the real interest rate?

When conjecturing the direction of central bank policy rate, we all know that inflation is important as they have a mandate to target this variable. The question then arises as to when should central banks draw the line and pause with rate changes. In this context the concept of real interest rates is spoken of where markets try and guess the real interest rate that central banks may be having at the back of the mind. In this note, we looked at real policy rates across different countries to gauge if there is any pattern that can be observed.

Some observations here stated below:

- In case of India we are in the positive zone when it comes to real repo rate.
- Asian countries have tended to have positive real rates as seen in case of China, Saudi Arabia, while Brazil and Mexico in Latin America are in a similar state.
- The euro area, UK and USA are at the other level where inflation is just too high real rates are negative and will remain so until inflation comes down as central banks are unlikely to hike their rates beyond another 50-100 bps in the coming months and would wait for the rate hikes to have their impact on inflation. USA has witnessed a downward movement in inflation which makes it possible to pause after a while. For Euro area inflation is still at 10% which offers scope for further aggression. The same holds for UK.

Supplementary grants announced by government and fiscal impact

Central government had recently presented the first batch of supplementary grants. The net cash outgo was pegged at Rs 3.26 lakh crore which is ~1.2-1.3% of the GDP. While a bulk of additional spending is for fertilizer and food subsidy, other important heads also include compensation to OMCs, rural development, railways and roads. We don’t expect this is to have a significant impact on the targeted fiscal deficit ratio (6.4%) which may move up by 0.2-0.3% of GDP as there are other forces at work that will counter this impact which includes buoyant revenue collections and expected increase in nominal GDP.

Out of the net cash outgo of Rs 3.26 lakh crore,

- Rs 1.09 lakh crore is on account of higher fertilizer subsidy bill, which was incurred owing to higher input prices following the outbreak of the Russia-Ukraine war.

- Additional Rs 80,348 cr in on account of extension of PM-Garib Kalyan Anna Yojna (PMGKAY).
- To cover for the losses made by Oil Marketing Companies (OMCs) owing to domestic LPG operations and PM-Ujjwala Yojna, Ministry of Petroleum is set to incur additional Rs ~25,000 crore.
- Apart from this, ministry of rural development has estimated an extra Rs ~45,000 cr spending under National Employee Guarantee Fund (NEGF)/MG-NREGA/PM-Awas Yojna-Rural.
- Ministry of Railways is estimated to spend Rs 12,000 crore as capital outlay, while Ministry of road transport & highways will spend an extra Rs ~18,000 crore. Nearly Rs 10,000 crore will be used of meeting resource gap of J&K and Puducherry.

The increase in total expenditure of Rs 3.26 lakh crore will result in total size of the budget going up to Rs 42.7 lakh crore assuming nothing else changes. The fiscal deficit under ceteris paribus conditions will increase from Rs 16.6 to Rs 19.9 lakh crore. The budget was premised on the GDP in nominal terms to be Rs 258 lakh crore. However, based on the developments during the year which is characterized by high inflation we expect the GDP to increase to Rs 275-280 lakh crore. With no other change in the budgetary numbers the fiscal deficit ratio would be between 7-7.1%.

However, we need to realize that the dynamics of the budgetary numbers have changed during the year on the revenue side too.

- On the income side, direct tax collections through income and corporation tax would be higher by around Rs 45-50,000 crore assuming corporate profits improve. (There might be downside risks to corporate tax collections if companies continue making lower profits/losses in Q3 and Q4 as well. Our study on corporate results for Q2FY23 showed 18.5% drop in PBT for a sample of 1,519 non-BFSI/IT companies).
- Within indirect taxes, a net increase of around Rs 47,000 crore may be expected with GST and customs clocking higher revenue and excise coming down by around Rs 30-35,000 crore.
- Further, within non-tax revenues, the budgeted amount of Rs 2.70 lakh crore can be exceeded by between Rs 35-45,000 crore with better dividend being paid by PSUs including banks and revenue from economic services including communication coming in higher.
- Disinvestment proceeds are however expected to be lower by around Rs 25,000 crore at Rs 40,000 crore, down from BE of Rs 65,000 crore.
- Taking all these into account net revenue of the government will provide a support of Rs 1.17 lakh crore.
- We thus expect fiscal deficit ratio to come at ~6.6-6.7% of GDP in FY23 assuming that none of the other expenses are lowered and the budget size is at Rs 42.71 lakh crore. If there are cuts invoked by any ministry, the fiscal deficit will only improve.

Is credit growth impacted by repo rate changes?

With ceteris paribus assumption we had looked at movement in WALR on outstanding loans and the corresponding credit growth for the last 7 years (FY15-22). Ideally a lower interest rate regime should boost credit demand as it lowers borrowing cost. But does this mean that easy money makes every segment borrow more? Probably not, as borrowing is normally linked with state of demand in various segments and capacity utilization rates, which in turn are linked with the overall state of the economy.

Interestingly in this time period, the interest rate cycle had been in the downward direction with an about turn only in FY23 when RBI has started raising the repo rate since May 2022 (repo rate was also raised in 2018-19). There have however been phases of volatility in credit demand which is explained by faltering growth conditions due to pandemic induced slowdown. In fact, data shows the credit cycle moved more closely with the corresponding growth cycle rather than WALR.

On sectoral basis, credit growth in industry largely remains unaffected by falling interest rates as the uptick in credit growth is not significant. In fact government schemes such as ECLGS have been more successful in boosting credit for these sectors than a lower interest rate regime. For other sectors such as services, NBFC credit demand has moved in tandem with WALR. Within the personal loan segment, credit off take has generally been high and stable over the period studied.

- In the 7 years period ending FY22, WALR has fallen by 310 bps before increasing in FY23 when the RBI started increasing the repo rate. On an average, the fall in WALR has been around 44bps in each year with FY19 being one where it remained virtually unchanged. FY21 was the pandemic period, where fall in WALR was the sharpest on record (by 82bps).
- Theory suggests that credit demand is likely to pick up in a falling interest regime as both consumption and investment picks up, on account of lower borrowing cost. In 4 out of the 8 years analyzed credit growth has improved with fall in interest rates. However, in FY17, FY20 and FY21, credit growth faltered despite a favourable lower interest rate. In FY23, even though rates went up, growth in credit has been sharp. If we juxtapose the GVA growth rate (excl. Agri and public admin and defence at constant prices) we will see that in all these years, growth has been volatile in the downward direction. Hence it has impacted the credit demand in the economy. FY17 faced the brunt of demonetization; FY20 was on account of contagion impact of US-China tariff war and also beginning of Covid-19 induced slowdown which had spillover effects in FY21 as well.
- Between FY15-22, credit growth averaged ~9.1% with the highest growth visible in FY19 at 13.4% and lowest growth visible in the pandemic period at 5.5%.
- In case of services, a clear picture is not obtained with changing interest rates especially when they increase as in FY23 (YTD).
- For sectors such as housing, auto, credit card outstanding, especially the consumer driven segment; the relation between lower borrowing cost and credit demand has fared relatively better. But even in rising rate scenarios, growth in credit has not been dampened.

Impact of monetary policy on rates

A nagging issue when conducting monetary policy is to ascertain whether or not the transmission mechanism is effective. This is important because if the central bank keeps raising or lowering the control rates, and interest rates on deposits and advances do not follow suit with adequate responses, then the efficacy gets affected and purpose may not be achieved.

2022 had been the year when almost all central banks have started raising their policy rates in a bid to control inflation which has received a boost post the Ukraine war where disruptions have contributed to the acceleration in price movement. In this brief study, we had analysed monetary policy actions of global central banks in CYTD22 and their impact on domestic lending rates and sovereign bond yields.

Data indicated that countries such as US, Canada, Australia, Mexico, S.Africa have relatively more effective transmission mechanisms, i.e. lending rates have changed almost in portion to change key policy rates. Government Debt market is seen to be more responsive in case of countries like France, Germany, Brazil, Australia and UK. In case of India, transmission into increase in both lending and G-Sec rates seems to be slower relative to the other countries studied. However, debt market interest yields have risen more (than lending rates) in proportion to policy rates

Argentina, Turkey and Russia were considered as outliers for the purpose of the study as extraordinarily high inflationary conditions, domestic political developments and outbreak of war impacted policy decisions in these countries.

Elsewhere, in terms of change in lending rate and 10Y yields, divergent trend was observed in most economies.

- While countries like Brazil, US, Mexico, Australia, S. Africa, Canada, had near perfect transmission mechanism for bank lending rates, their corresponding 10Y yields had not reacted as much to change in policy rates. One of the reason can be that 10Y yields also react to expectations of future changes in policy rates and how the overall economy is expected to perform.
- In case of European economies, transmission into bank lending rates was most visible in UK, followed by Germany, Italy and France. Response in UK also appeared to be relatively good at 80%. Hence, bond markets in Europe seem to have fully priced in the impact of monetary policy rate hikes.
- Amongst the Asian economies, S. Korea began tightening much earlier than countries like India and Indonesia. As a result, transmission into lending rates and bond market reaction was much better than India and Indonesia. While Indonesia began hiking only in Aug’22, movement is lending rates is already visible from Oct’22.
- In case of India, it ranks toward the lower end of the spectrum in both transmission into lending rate and bond market reaction.

Key policy developments

- The Central government has decided to provide free foodgrains to ~81.35 crore beneficiaries under the National Food Security Act (NFSA) for one year from January 1, 2023. The Centre will spend more than Rs 2 lakh crore in this period as food subsidy under NFSA and other welfare schemes. 5 kg food grains per person to Priority Households (PHH) beneficiaries and 35 kg per household to Antyodaya Anna Yojana (AAY) beneficiaries (poorest of the poor) will be provided free of cost for next one year. This scheme subsumes the Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY) scheme.
- The MSP for fair average quality of milling copra has been fixed at Rs. 10,860/- per quintal and for ball copra at Rs. 11,750/- per quintal for 2023 season. This is an increase of Rs. 270/- per quintal for milling copra and Rs. 750/- per quintal for ball copra over the previous season. This would ensure a margin of 51.82% for milling copra and 64.26% for ball copra over the all India weighted average cost of production.

Data Releases

Currency outlook: Focus on Fed

In 2022, INR depreciated by 10.1% led by a rally in dollar. DXY index gained by 8.2%. This is turn was due to Fed's aggressive monetary policy tightening. In 2022, Fed raised policy rates by a cumulative 425bps. While other global central banks also raised rates, they lagged the Fed and hence saw their currencies lose value against the dollar. India too did not remain immune. Further complicating the narrative was India's weakening domestic fundamentals such as high inflation, surging trade and CAD deficits as well as softening foreign inflows. However, we remain optimistic that the worst may be over for the INR and it may appreciate to 80-83/$ in 2023. In saying so, risks do remain as a sharper than anticipated global slowdown may spur a fresh rally in the dollar.

Bond Market Round-up

In Dec'22, bond yields globally changed direction and went for an upswing as Federal Reserve now expects a higher terminal rate at 5.1%. Even ECB officials hinted at peak inflation might not be way past us. These moves impacted yield trajectory. On domestic front, RBI's policy remained in line with market expectation, thus 10Y yield did not exhibit much volatility. However, with ending of calendar year and a review of the yield situation compared to previous year, brings some interesting conclusion. In CY22, sovereign 10Y yield globally as well as in India noticed considerable upward movement. Tightening policy environment amidst inflation, resulted in the same. For India, what has been a stark contrast compared to CY21 is that there has been a significant flattening of the yield curve, with rise in yield of short term papers. The short term papers were indeed more responsive to policy rate change by RBI. The gap between short and long end paper fell to 74bps in Dec'22 compared to 298bps in Dec'21. The liquidity dynamics also changed considerably. On an average, liquidity surplus fell to Rs 3.1lakh crore in CY22 compared to Rs 6.3lakh crore in CY21. Even the drivers of liquidity noticed a shift. With rising credit deposit gap, forex depletion and constrained space for OMO (on account of rising rate cycle), liquidity surplus in the system went down. Going forward, we expect slight deficit in liquidity is going to be the new normal. The outlook for yields remain heavily contingent on the upcoming borrowing calendar of FY24. No additional borrowing in Q4 has comforted domestic yield in Dec'22. We expect fiscal deficit ratio to come down slightly to 5.5-6 % in FY24. This would support the yield. Our outlook for the next 30days is at 7.3-7.4%.

Core industries

India's eight core sector output expanded by 5.4% in Nov'22 compared with a growth of 0.9% in Oct'22. This was on the back of improvement in coal (12.3% vs 3.7%), fertilizers (6.4% vs 5.4%) steel (10.8% vs 6.5%) and cement output (28.6% vs contraction of 4.3% in Oct'22). Double digit growth in steel and cement has lifted hopes of robust growth in construction sector. On a cumulative basis, growth in eight core sector has moderated by 8% in Apr-Nov'22 against 13.9% last year.

Central government finances

Central government's fiscal data shows that on FYTD basis (Apr-Nov) fiscal deficit reached 58.9% of the targeted level versus 45.6% as of Oct'22 and 46.2% as of FYTD22. In terms of spending, capex spending by the government continues to be the bright spot, with 59.6% of the budgeted target utilized as of Nov'22 (FYTD basis) compared with 54.6% spent as of Oct'22. Revenue spending remains at par (62.5% as of Nov'22) with last year (61.5% as of Nov'21). On the income side, government has seen 15.5% jump in gross tax revenues uptil Nov'22, down from 18% growth recorded till Oct'22. Indirect tax collections have witnessed a greater slowdown (8.5% as of Nov'22 versus 11% as of Oct'22), compared with direct tax collections (23.9% versus 25.9%). Within direct taxes, income tax collections are relatively more steady (26.7% versus 27.7%) in comparison to corporate tax receipts (21.1% versus 24.1%). Within indirect taxes, the softening was mainly on account of continued contraction in union excise collections (-20.9% versus -18.8%). Overall, centre's net revenue moderated, as it was up by 4.8% compared with 7.1% as of Oct'22. Going forward, we can expect revenue spending to pick up pace (subsidy disbursements), and we continue to estimate marginal slippage of 0.2-0.3% in fiscal deficit ratio.

CAD widens

India's current account deficit surged to a more than 9-year high of 4.4% in Q2FY23 (US$ 36.4bn) from 2.2% of GDP in Q1 (US$ 18.2bn). This was led by a widening trade deficit which in turn was due to a sequential decline in exports, while imports remained buoyant. Invisible receipts were higher led by software receipts and remittances. Surplus in capital account dipped to US$ 6.9bn from US$ 22.2bn in Q1FY23, led by a dip in FDI flows and banking capital outflows. As a result, forex reserves noted a depletion of US$ 30.4bn in Q2FY23 as against an accretion of US$ 4.7bn in Q1FY23. We believe that CAD is likely to have peaked in Q2FY23 and will see a moderation going forward, led by easing global commodity prices. However, slowing global growth will be detrimental for both goods and services exports. We expect CAD of 3.3% of GDP in FY23.

CPI inflation moderates

CPI inflation eased much more than expected to 5.9% in Nov'22 (12-month low), (our estimate 6%) from 6.8% in Oct'22. This was the first time in FY23 that inflation was below RBI's upper threshold of 6%. Food inflation moderated to an 11-month low at 4.7% in Nov'22 compared with 7% in Oct'22. This could almost entirely be explained by a decline in vegetable inflation (decline of 8.1% in Nov'22 compared with an increase of 7.8% in Oct'22), due to seasonal factors. Some moderation was also visible in fruits (2.6% versus 5.2% in Oct'22). Other items in the food basket however continued to show underlying price pressures. Cereals inflation inched up by 13% to its highest since Sep'13, from an already elevated level of 12.1%. Prices of eggs which had been declining since Apr'22, inched up sharply by 4.9% in Nov'22. Other commodities such as meat and fish and milk and milk products showed upward momentum. Fuel and light inflation inched up sharply to 10.6% in Nov'22 from 9.9% in Oct'22. This is even though global oil prices are now below US$ 80/bbl, as prices have not been lowered at the consumer end.

Core CPI (excl. food and fuel) edged up to 6% in Nov'22 from 5.9% in Oct'22. Barring amusement and recreation, clothing and footwear and housing, all other components of core inflation showed acceleration. Maximum traction was seen in transport and communication (5.3% in Nov'22 from 4.6% in Oct'22) and pan, tobacco and intoxicants (2% versus 1.9% in Oct'22). High prices may have deterred consumption of amusement and recreation services by individuals. Inflation in this category eased to 5.4% in Nov'22 from 6.1% in Oct'22.

WPI begins to cool

Headline WPI moderated to a 21-month low of 5.8% (BoB est.: 6.8%) in Nov'22 from 8.4% in Oct'22. Food inflation in Nov'22 softened to almost 2-year low of 2.2% from 6.5% in Oct'22. This was led by contraction in fruits and vegetable inflation (-13.8% compared with 11% in Oct'22). Vegetable prices declined by 20.1% against an increase of 17.6%, tomato prices nose-dived to 32-month low of -52.5% compared with an increase of 5.3% in Oct'22 due to supply glut. Potato prices eased further by 13.8% in Nov'22 (45% in Oct'22). Fruit prices slipped in to contraction after a period of 15 months down by 1.1% (+0.2% in Oct'22). Protein based items such as egg, milk and fish too edged lower by 2.3% in Nov'22 against 4% in Oct'22. However, milk prices inched up 6% in Nov'22 (5.5% in Oct'22). Cereal inflation (12.8% from 12% in Oct'22) was pushed up led by higher wheat prices (18.1% from 16.2% in Oct'22). Prices of pulses also moved up a tad bit by 0.6% (0.4% in Oct'22). Global food prices remained steady in Nov'22 compared with last month.

Fuel and power inflation in Nov'22 eased to 17.4% from 23.2% in Oct'22, owing sharp drop in electricity index (9.5% in Nov'22 versus 20.5% in Oct'22), followed by moderation in mineral oil index (23.8% versus 29.1%). Coal price index also eased to 3% from 4.2% in Oct'22. The dip in mineral oil index was in line with the trend seen in international oil prices, which has eased to 12.4% (YoY) in Nov'22. In absolute terms, oil prices averaged US$ 91/bbl in Nov'22 versus US$ 94/bbl in Oct'22. Within mineral oil, the slowdown was broad-based, with prices of LPG, Furnace oil index declining the most. Prices of kerosene and petrol also eased significantly.

Core inflation moderated for the seventh consecutive month in Nov'22 to 3.5% from 4.7% in Oct'22. Manufactured products inflation was also down at 3.6% in Nov'22 from 4.4% in Oct'22. Of the 22 commodity sub-indices, 15 indices rose at a slower pace in Nov'22 than Oct'22 led by textiles, basic metals, chemicals, paper products, motor vehicles, computer and electronic products. Within basic metals, prices continued to fall for major commodities, albeit at a slower pace, indicating some pressure might be beginning to build up. For instance, prices of copper contracted by -6.3% in Nov'22 versus -6.5% in Oct22, while that of aluminium fell by -9% versus -10.1% in the previous month. Even on international level, prices of some commodities have declined at a slower pace, as reflected in World Bank's pink sheet. Prices of aluminum (-10.8% in Nov'22 versus -23.1% in Oct'22), copper (-17.3% versus -22.2%), lead (-9.9% versus -14.7%) and Zinc (-11.2% versus -11.7%) are such examples.

IIP growth eased

IIP growth fell by 4% in Oct'22 compared with an increase of 3.5% in Sep'22. This was a much sharper fall than both consensus (estimated 1% decline) and our estimates (increase of 0.5%) and also marked the biggest pace of decline in industrial output since Aug'20. This was led by a sharp decline in manufacturing output which fell by 5.6% in Oct'22 versus 2.2% increase in Sep'22. Out of the 23 sub-groups within manufacturing, output in 19 industries declined. Within this, output of wearing apparel (37.1%), electrical equipment (33.2%), leather (24.3%) and pharma products (21.4%) declined the most. Electricity output too moderated markedly to 1.2% in Oct'22 versus 11.6% in Sep'22. Even mining output decelerated to 2.5% from 5.2% in Sep'22. Compared with the levels seen in 2019 (pre-pandemic period), IIP growth was up by 4.5% in Oct'22 versus 9% in Sep'22.

Within use-based, output of both consumer durables (15.3%) and non-durables (13.4%) registered double-digit decline. Further, while capital goods output declined by 2.3% (from 11.4% in Sep'22), even intermediate goods output was 2.8% lower. Sharp slowdown was also visible in the output of primary goods (2% in Oct'22 versus 9.5% in Sep'22) and infrastructure and construction goods (1% versus 7.7% in Sep'22).

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