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ECONOMY OBSERVER

JANUARY 2023

The Central Bank is likely to pause its rate hike cycle in February – Dun & Bradstreet India

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> The high and sticky core retail inflation raises concerns even as the headline inflation eases below the Central Bank's target. The US Federal Reserve is yet to indicate the end of its policy tightening cycle, and this will weigh upon the Central Bank's decision on policy rate when it meets in February 2023. We expect that the central bank might pause its rate hike cycle in its February meeting and assess the impact of previous rate hikes. Even as India's growth remained resilient so far, the weakening of external demand that supported its growth momentum during the first half of the current fiscal year is likely to wane. Domestic demand too might remain lukewarm. Dun and Bradstreet's pan India survey shows that optimism amongst businesses for volume of sales, a proxy for demand, in Q1 2023 has fallen to its lowest level since Q3 2021

Real Economy

Dun & Bradstreet India expects industrial production to have declined in December 2022 as the domestic festive driven demand wanes and exports continue to weaken amidst slowing global trade. Dun & Bradstreet expects the Index of Industrial Production (IIP) to have grown by (-1.0%) - (-0.5%) during December 2022.

Price Scenario

Even though both wholesale and retail inflation continue to ease, the sticky nature of core inflation warrants cautiousness. Core inflation now hovers around double-digit levels rising to the highest level since January 2012, since the data is available. Dun & Bradstreet expects both wholesale and retail inflation to ease further before picking up, albeit moderately, when the impact of the low food prices from the fresh arrivals in winter fades away. Dun & Bradstreet expects Consumer Price Inflation (CPI) to be in the range of 5.6% - 5.8% and Wholesale Price Inflation (WPI) to be around 4.3% - 4.5%, respectively in January 2023.

Money & Finance

The broadly stable oil prices, fall in US Treasury yields, slowdown in US inflation rate, and easing of overall inflationary pressures, barring the core inflation, has raised hopes that the Central Bank is coming close to a pause in its policy tightening cycle. This is positive for the bond market as the yield curve appears to have flattened by December 2022. Nonetheless, uncertainty amongst foreign investors in the debt market will continue to exert upward pressure on yields. As liquidity progressively tightens, the short end of the curve will remain high. On the other end, the government's market borrowing target to be announced in the upcoming Union Budget will impact the 10-year yield. Dun & Bradstreet expects the 15-91-day Treasury Bills yield to remain at around 6.4% -6.5% and 10-year G-Sec yield to be 7.4% -7.45% for January 2023

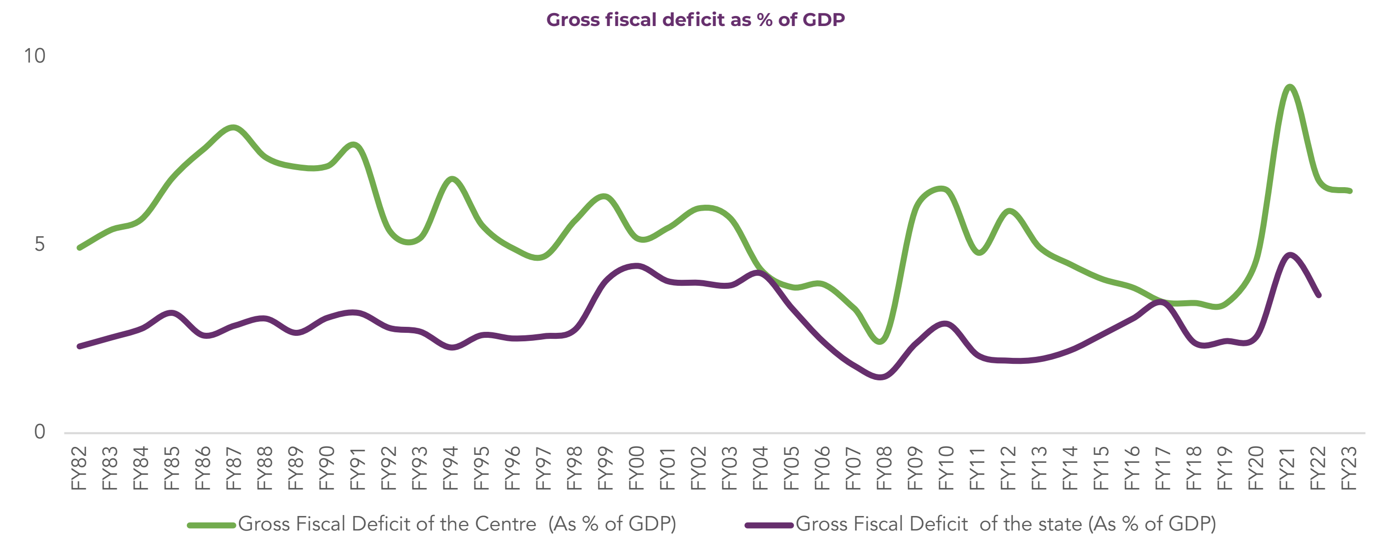
External Sector

Better-than-expected inflation data for US is likely to provide a short-term reprieve for the rupee versus the dollar. The likelihood of the Federal Reserve slowing down on its rate hikes is prompting investors to swap the dollar for riskier asset classes supporting the rupee. It is to be noted that although the return of foreign portfolio investors to the equity market bodes well for the rupee, the support might be temporary. Domestically, a lower-than-expected inflation and reduced pressures on imported inflation as global commodity prices cool-off will help rupee to gain some strength. Dun & Bradstreet expects the rupee to appreciate to 81.9 per US$ during January 2023.

D&B's Economy Observer Forecast

Variables	Forecast	Latest Period	Previous period
IIP Growth	(-1.0) % - (-0.5) % Dec-22	7.1% Nov-22	-4.0% Oct-22
Inflation WPI	4.3% - 4.5% Jan-23	4.95% Dec-22	5.85% Nov-22
CPI (Combined)	5.6% - 5.8% Jan-23	5.72% Dec-22	5.68% Nov-22
Exchange Rate (INR/US$)	81.9 Jan-23	82.46 Dec-22	81.81 Nov-22
15-91 day's T-Bills	6.4% - 6.5% Jan-23	6.39% Dec-22	6.46% Nov-22
10 year G-Sec yield	7.4% - 7.45% Jan-23	7.31% Dec-22	7.36% Nov-22
Bank Credit	14.5% - 15.0% Jan-23	12.9% Dec-22	15.61% Nov-22

Expectations for Union Budget 2023-24: Priorities for growth



BE: Budget estimates, RE: Revised estimates; For State, data for FY21 is RE, FY22 is BE; For Centre, data for FY22 is RE and FY23 is BE
Source: RBI and Union Budget

After three years of multiple, complex and disparate set of challenges ranging from pandemic, war, rising protectionism, high inflation to supply chain disruptions, the world economy is now entering into fourth year with heightened risk of slipping into recession. This has made policy making a difficult choice for governments across the globe. With this background, Union Budget 2023-24 is extremely important especially, as this is going to be last full budget before general elections in 2024. The Government has to manage the fine balance between fiscal prudence while ensuring productive expenditure, announcing growth promoting measures, creating jobs, supporting troubled MSMEs, providing social support to masses, focusing on green energy and continue the infrastructure push. Importantly, there is a need to create appropriate support mechanism in the event of significant global slowdown while managing fiscal challenges. Thus, while there will be many priorities for government in this Budget, few are important to mention.

Thrust on self-reliant India to create more jobs

When countries are moving towards diversifying their supply chains, India should strongly focus on creating opportunities to attract investor's interest. We expect the government to extend the PLI schemes to new sectors such as electricity storage systems, solar cells and modules, aircraft including UAVs, AI, robotics and automation etc. Besides, accelerating efforts towards one district one product (OPOP) scheme and linking this to create export hubs and developing organised market for traditional products would create growth centres, promoting self -reliance, thereby supporting the rural economy. This would also help in creating jobs.

Support to troubled MSMEs – the biggest job creator

Even as MSMEs are yet to recover from the twin shocks – Covid-19 pandemic and the Russia-Ukraine crisis – they have been hit by a third shock, monetary tightening. Rising interest rates and elevated input costs are hurting their investment plan and bottom-line growth, respectively. On the other hand, the cost-of-living crisis continues to weigh on consumer confidence and demand for goods and services, hurting their top-line growth. In this context, government should continue to provide support to MSMEs.

Given that interest rates are increasing rapidly, support under Interest Equalization Scheme should be restored to 5% for manufacturer MSMEs and to 3% for merchant exporters. The scheme should also be extended to the services sector. Exporters should be provided automatic enhancement in credit limit by 25% without the need of collateral. Further, the pre-shipment credit in foreign currency should have a ceiling of London Interbank Offer Rate (LIBOR) +200 basis points

Since 2018, import tariffs for several product categories have been raised. All such protection should be accompanied with a 'sunset' clause and the government should gradually phase out of import tariff. This will improve the competitiveness of domestic MSMEs. Interlinking of Foreign Trade Policy with Foreign Direct Investment and industrial policies will play a significant role in increasing India's share of high value-added technology-intensive exports. The One District One Product concept needs to be supported by sufficient infrastructure by the District Industries Centers. The government should also facilitate cross border e-commerce and provide the same benefits as applicable to conventional exports. A target should be set to increase the share of e-commerce retail exports to 10% of merchandise exports by 2027.

The Remission of Duties and Taxes on Export Products (RoDTEP) scheme should be expanded to cover the remaining sectors (specifically the remaining chapters of HS code). There should also be no capping on the rates so as to effectively eliminate the incidence of taxes including embedded taxes, not refunded through GST and other mechanism. RoDTEP should also be extended to Export Oriented Units (EOUs), Special Economic Zone (SEZ), and Advance/ Duty Free Import Authorization holders.

Focus on climate change and energy transition for sustainable growth

Given the commitment to achieve net zero by 2070 at the COP27 summit in 2022, the government can initiate a discussion of imposing a green tax in the Union Budget. This would send out a positive signal to the global investors especially in the developed markets. On the other hand, the government can also formulate incentives to lure global and domestic investors for green financing, especially, in infrastructure which will also establish India's credibility in its efforts towards achieving its climate change target. There could be renewed focus to increase the pace of energy transition in the Budget.

Support to masses impacted by three years of crisis

Incentivizing savings of households to brace for an extended period of slowdown such as providing tax incentives for savings in pension and insurance or increasing the threshold under Section 80C, in turn would mobilize resources for infrastructure spending.

Given the challenges in food and fertilizer that the world witnessed due to the geo-political crisis, the budget might place emphasis on these two areas as well. In the agriculture sector, incentives for investing in post-harvest material handling and processing, improved farming practices associated with organic farming and adopting sustainable agricultural practices to lower carbon emissions could be the focus areas.

Farmers in 2021 as well as 2022 had suffered huge losses owing to the skyrocketing fertilizer prices driven by the Russia Ukraine war. Given India's dependence on imports for fertilizers and the huge subsidies that had to be given to farmers in 2023, more reforms are required in the sector. The government could formulate appropriate incentives for using conventional fertilizers with viable bio-fertilizers, encourage practices that rationalize use of fertilizers and promote best practices and newer technologies.

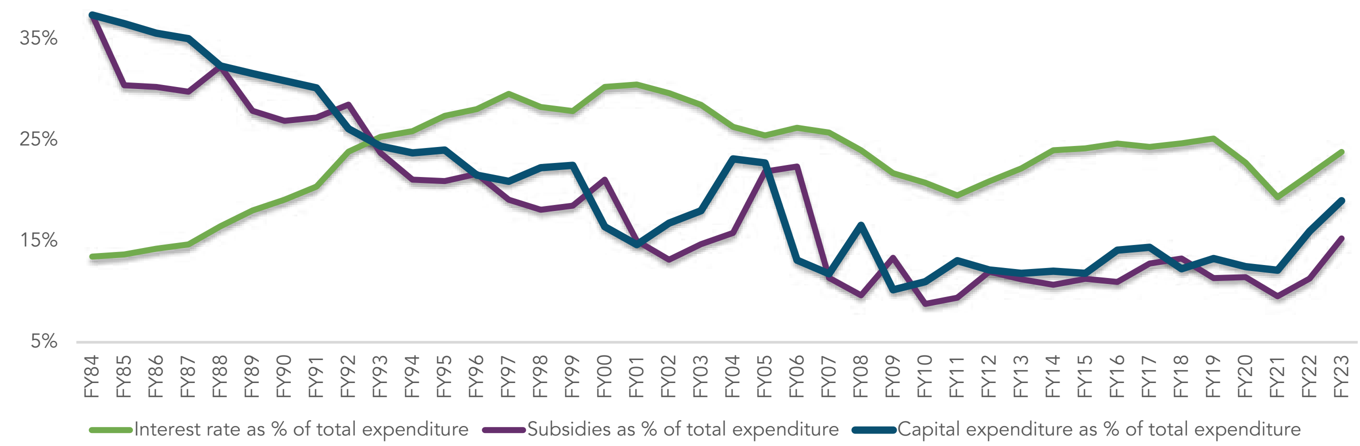
Quality of infrastructure spending given fiscal consolidation

To commit to more capex amidst fiscal consolidation would require the government to identify and rationalize some of the non-priority spending. We expect Centre to continue to allocate long-term capex funds for states. While the government had announced Rs 1 trillion, 50-year, interest-free capex loans to states in the last Union Budget, it is important to nudge states to increase their capital spending. While 20% of the above fund was linked to state reforms, the government could similarly earmark a section of the fund allocated in 2023-24 towards spending on green infrastructure.

Given the heightened uncertainty and the myriad of external shocks that the economy is facing currently, ensuring macroeconomic stability would be critical. To ensure macroeconomic stability and bring the growth rate back to the pre-pandemic growth path, adhering to the fiscal deficit target and staying on the glide path will be imperative. However, it would be crucial to maintain fiscal prudence without constricting growth as global risks persist. We thus expect the government not only to announce some concrete measures to brace the economy from the imminent global slowdown but also to lay down the blueprint of its growth strategy for this decade. The right policy decisions could curve a turning point for the economy at this time.

Out of every Rs 100 allocated for expenditure, government spends around Rs 35 on interest payment and subsidies and allocates less than Rs 20 for capital expenditure

Share of interest payments, subsidies and capital expenditure in total expenditure of the Central Government



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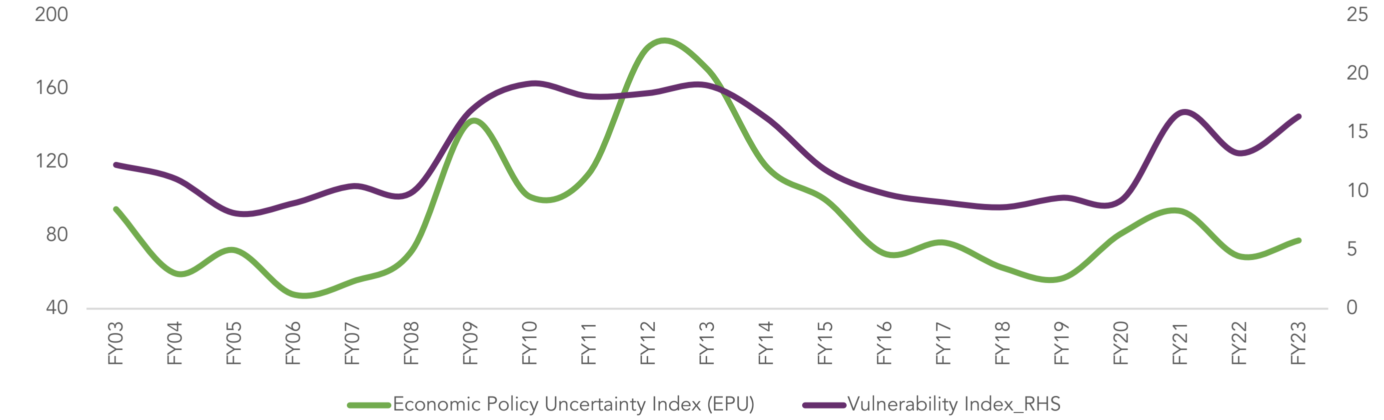
Source: RBI and Union Budget

As a pecentage of GDP, India allocated around 3.4% of its GDP for interest payments and 2.1% on subsidies, more than 2.5% that it allocated towards capital expenditure in FY22 (RE)

- In FY23, fertiliser subsidy has doubled as the government tried to insulate the farmers from the sharp spike in global prices
- Given India's dependence on imports for fertilizers and the huge subsidies that had to be given to farmers in 2022, more reforms are required in the sector
- The impact of the rate hike cycle will inflate the interest costs of both the Central and state government
- The centre's interest payment which was budgeted to be at round 3.6% of GDP in FY23 will increase in FY23, but will be more pronounced in FY24 constricting the capital expenditure and raising the debt servicing costs to much higher levels in the short to medium term
- The combined total liabilities of Centre & States as a % of GDP which was slightly more than 89% in the last two years is thus expected to increase in the uocoming fiscal year

Policy and macroeconomic uncertainty increased in FY23 after falling in FY22

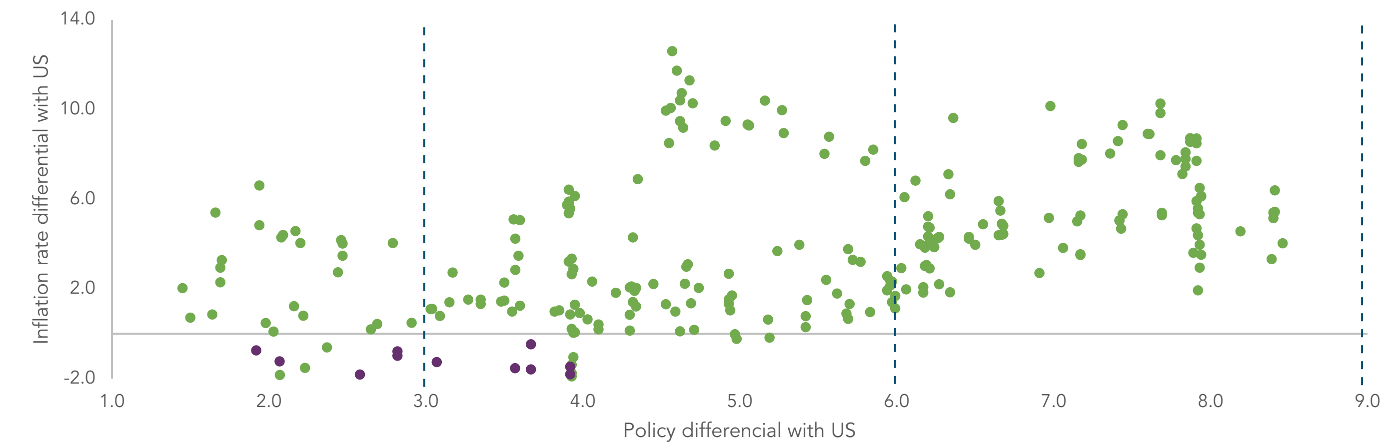


Vulnerability index: Sum of Fiscal deficit to GDP, current account deficit to GDP and inflation rate
Vulnerability index value for FY23 are estimates and EPU for FY23 are the average of 1st 3 quarters
Source: Haver Analytics, MOSPI, RBI

By end of 2022, economic policy uncertainty index rose to a level higher than end of 2020, barring Q4 FY22, when uncertainty remained high owing to the Russia Ukraine war

- Unlike generic economic uncertainty, which cannot be controlled, policymakers can reduce economic policy uncertainty. Hence the announcements in the forthcoming Union Budget would be crucial to alleviate the uncertainty prevailing amongst investors, businesses and households
- Economic policy uncertainty correlates strongly with the macroeconomic environment and can be used as a leading indicator for economic stability as measured by the vulnerablity index which is the sum of fiscal deficit to GDP, current account deficit to GDP and inflation rate
- The vulnerability index in FY23 (estimated), is expected to rise to the highest level since FY14, except for the pandemic year of FY21, indicating that the government should adhere to the fiscal deficit target, provide support to boost export growth and continue to take measures to alleviate supply side pressures to inflation
- We expect the Government to meet its fiscal deficit target of 6.4%, current account to widen above 3.0% of GDP and inflation to average above the Central Bank's target of 6% in FY23

India's policy rate gap with the US narrows to the lowest level since 2006 while inflation gap with US turns negative since September 2021



Source: Haver Analytics

Following the US Fed rate hike by 425 bps point the Reserve bank of India has hiked the policy repo rate cumulatively by 225 bps in 2022. With this, the policy gap with the US has narrowed down to the lowest level since 2006. This has supported FII inflows into the equity market

- Higher policy differential with the US impact capital flows to India, put downward pressure on rupee and lead to higher imported inflation
- India's policy rate gap with the US has been the highest when the policy repo rate remained at 8% and above during 2002, 2008, 2011, 2012 and 2014
- As the US FED hiked the interest rates to the highest level in 15 years to battle against inflation which rose to a 40 year high, and the global commodity process skyrocketed, rupee deprecated by close to 10% against the dollar in 2022
- Inflation in India rose to 7.79% in April 2022, highest in 8 years, and stayed above Central Bank's target level for 10 months till Oct 2022 before moderating to below 6%
- Contrary to historical trends, the inflation rate differential with the US has been negative as the US ran a higher inflation than India since September 2021

Economic Survey

Department of Economic Affairs (DEA) will release an annual document on 31st January 2023 on the overall performance of the economy in FY23 and brief out the challenges that lie ahead along with laying the vision of the government to achieve them

Union Budget

The Central Government will present its annual financial statement of revenues & expenditures that for FY24 along with various initiatives to support the economy given the various downside risks to growth

RBI monetary Policy

After hiking the interest rate by 35 bps to 6.25% in December 2022, the February MPC meeting outcome is likely to indicate when the Central Bank's tightening cycle will end

Second Advanced Estimates of National Income

With the economy estimated to grow by 7% in FY23, as per the first advanced estimates, the National Statistical Office is expected to release second Advanced Estimates of National Income on 28 February that will state the performance of Indian Economy with the revised benchmark estimates and additional data available

US FOMC meeting (Federal Open Market Committee Schedule)

Following aggressive rate hikes of 75 basis points for four consecutive periods and 50 basis point hile in December, watch out for the stance taken by the US Fed as US inflation cooled off in December

IMF World Economic Outlook (WEO)

Watch out for the IMF WEO to understand which economies are likely to be in recession, which economies will continue to experience protracted slowdown and which economies will grow strongly amidst the various economic headwinds

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