India's Economic Outlook 2021–2023

- **Economic recovery is underway in India following damaging waves of COVID-19. Real GDP growth is expected to stabilize at around 7% y/y in 2022–2023, following an estimated 9% gain this year.**

- **Consumer and business sentiment is improving, supporting household spending and investment prospects, yet the evolving COVID-19 situation will remain the main factor impacting domestic demand momentum.**

- **Persistently high core inflation complicates the Reserve Bank of India's monetary policymaking at the time of nascent economic recovery. Inflationary pressures and financial stability considerations are expected to prompt the central bank to commence a cautious monetary normalization phase in the first half of 2022.**

ECONOMIC GROWTH OUTLOOK

India's economy is recovering on the back of an improved COVID-19 situation and a resultant easing of movement restrictions. In Q3-2021, the nation's real GDP expanded by 8.4% y/y (chart 1), supported by solid gains in domestic demand and recovering industrial activity. While output growth will likely weaken in the final quarter of the year as the favourable year-ago base effect fades away, we forecast India's real GDP gains to average 9.0% in 2021 as a whole. In 2022–2023, economic growth will likely stabilize at around 7% y/y, slightly above the country's current potential growth estimate of around 6%. Nevertheless, we note that the forecast is subject to significant uncertainties related to COVID-19 developments. The Indian economy's longer-term outlook is underpinned by favourable demographics and competitive labour costs. Meanwhile, pandemic-related scarring—such as educational disruptions and their impact on human capital as well as muted fixed capital investment—needs to be addressed and requires strong political will for continued reform implementation.

The evolving COVID-19 situation and the speed of India's vaccination program will be the key factors impacting the outlook for private spending. While consumer confidence has shown early signs of recovery (chart 2), Indian households remain rather cautious, which is reflected in muted spending indicators, such as vehicle sales. Nonetheless, sentiment should strengthen along with advancing vaccination levels, underpinning economic growth momentum into 2022; currently only 32% of the Indian population is fully vaccinated.

Improving business sentiment across the services and manufacturing sectors (chart 3), an accommodative policy backdrop, as well as the government's investment incentives and lending schemes will underpin the outlook for private sector business investment. Nevertheless, the pickup is expected to be gradual, in line with a cautious acceleration in commercial sector credit growth (chart 3). Reflecting implemented reforms in recent years, India has continued to attract foreign direct investment throughout the pandemic, and we expect the trend to continue over the foreseeable future.

Government spending remains growth-supportive even though fiscal space has narrowed significantly during the pandemic. Public outlays are targeted at healthcare, infrastructure, and education in order to improve India's long-term

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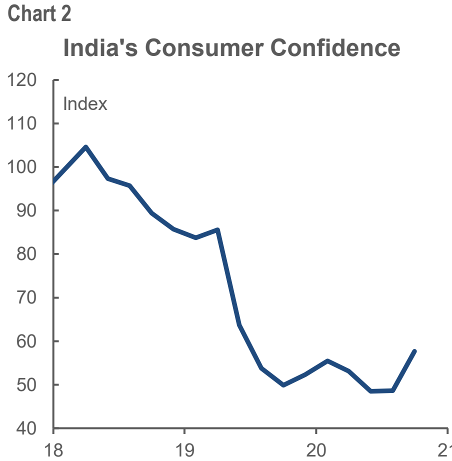
Chart 1

Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Reserve Bank of India, Bloomberg.

economic growth potential. According to the IMF, India's general government deficit reached 12.8% of GDP in Fiscal Year 2020–2021 (April–March), doubling from the pre-pandemic level. While the government is prioritizing the economy's recovery, it is simultaneously trying to show commitment to fiscal prudence over the medium-term in order to support investor confidence, in line with a recommendation by the IMF.

The external sector plays a smaller role in the domestically-driven Indian economy compared with the country's export-oriented regional peers. Regardless, Indian exporters are benefiting from strong global demand, particularly in the US and the European Union that together purchase over 30% of India's shipments abroad. At the same time, rebounding domestic demand and elevated oil prices are boosting India's imports. Accordingly, we assess that the external sector will remain a drag on real GDP growth over the coming quarters.

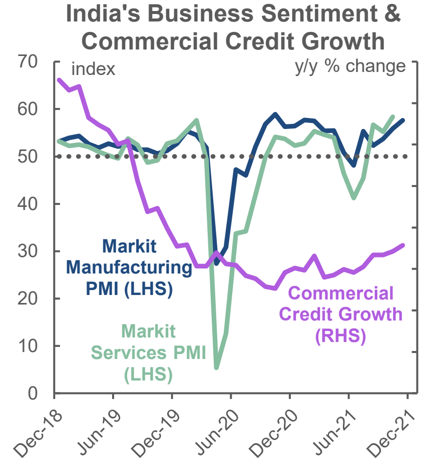
INFLATION, MONETARY POLICY, AND INDIAN RUPEE OUTLOOK

India's headline consumer price inflation dynamics have been volatile over recent months, while core inflation—CPI inflation excluding food and fuel—has remained persistently elevated (chart 4). Recently, weaker food price inflation has brought the headline rate down, with prices rising by 4.5% y/y in October, yet we assess that inflation will accelerate somewhat over the coming quarters. The upward pressures will be partially offset by the government's recent decision to reduce excise duties on petrol and diesel, bringing temporary relief to consumers. Headline inflation will likely reach 5.2% y/y by the end of 2021, pushed up by increased materials prices, high logistics costs, and rebounding domestic demand. In 2022–23, we expect price gains to remain elevated yet slightly below the upper ceiling of the Reserve Bank of India's (RBI) inflation target of 2%–6%. However, the forecast is subject to notable uncertainties that reflect food and commodity price movements as well as the Indian rupee outlook in the context of a monetary normalization bias in advanced economies.

The volatile and uncertain inflation dynamics are complicating the RBI's monetary policy conduct. The central bank maintains its "accommodative" policy stance and has pointed out that it would be continued as long as necessary to revive and sustain growth on a durable basis, while keeping inflation within the target. Indeed, the Indian economy needs supportive monetary conditions to underpin the nascent recovery, though persistent inflationary pressures are likely to keep the RBI's policymakers cautious. Accordingly, we expect the RBI to maintain the benchmark repurchase rate unchanged at 4.0% in the near-term; the policy rate was lowered by 115 basis points at the early stages of the pandemic. As many advanced and emerging market economies continue normalizing monetary policy over the coming months, Indian monetary authorities will likely start paying additional attention to financial market and exchange rate stability. Accordingly, we expect the RBI to commence a cautious monetary normalization phase by mid-2022, taking the benchmark repurchase rate from the current level of 4.0% to 4.75% by the end of 2022.

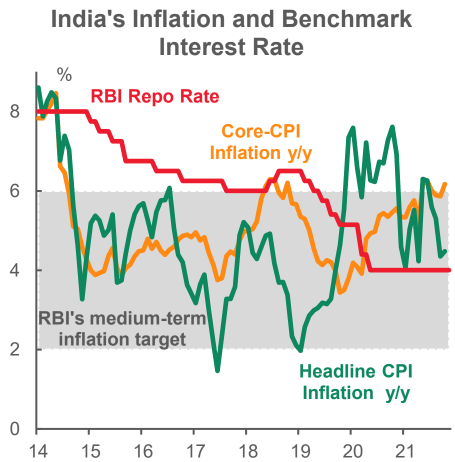
The Indian rupee (INR) has faced a gradual weakening bias against the US dollar (USD) in recent months (chart 5). We expect the value of the rupee to continue to reflect changes in global risk aversion amidst the evolving COVID-19 situation together with volatile appetite toward emerging market assets, shifting expectations regarding the US monetary policy normalization, as well as the prospects of India's current account balance swinging back into deficit amidst elevated oil prices and recuperating domestic demand. Simultaneously, high initial public offerings activity in India, a recovering economy, and manageable inflation outlook point to higher domestic real returns, supporting rupee-denominated assets. We expect USDINR to close the year at 74 before appreciating modestly to 72 by the end of 2022.

Chart 3



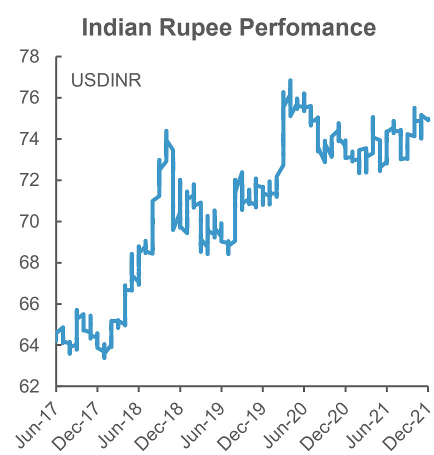
Sources: Scotiabank Economics, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

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