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Global Economic Outlook

- **US Federal Reserve hikes interest rate to tame inflation:** US Federal Reserve increased the federal funds rate, its key short term interest rate, by 75 basis points to 3-3.25%. Federal funds rate is the interest rate at which commercial banks in the US lend their excess reserves to each other on an overnight basis. One basis point is one-hundredth of a percentage.
- The rate hike showed the Fed's commitment to fighting inflation. The gap between prices and wages is attributable to a sharp increase in the profit share of national income. There have been shortages of a wide variety of items due to the pandemic shutdowns, the war in Ukraine and a fire at a huge semiconductor factory in Japan.
- **U.S. bond funds see biggest weekly outflow in four weeks:** U.S. bond funds witnessed huge outflows in the last week as caution over the pace and length of U.S. interest rate increases crept in ahead of the Federal Reserve's policy decision.
- According to Refinitiv Lipper data, U.S. bond funds recorded outflows worth $7.33 billion in their biggest weekly net selling since August 24.
- **U.S. labour market resilient as recession signals grow stronger**: Fed Chair Jerome Powell told that "there's only modest evidence that the labour market is cooling off," describing it as continuing "to be out of balance."
- Economists say companies are hoarding workers after experiencing difficulties in hiring in the past year as the COVID-19 pandemic forced some people out of the workforce, in part because of prolonged illness caused by the virus.
- There were 11.2 million job openings at the end of July, with two jobs for every unemployed person.
- **OPEC+ supply shortfall now stands at 3.5% of global oil demand:** OPEC+ is now producing below its targets by a record 3.58 million barrels per day - about 3.5% of global demand - highlighting underlying tight supply in the oil market, even as recession fears drag oil prices lower.
- Oil prices rose this week to above $92, partly supported by news of the OPEC+ shortfall, but were headed for a fourth monthly decline ahead of an expected further U.S. interest rate hike which may curb economic growth and fuel demand.
- Two main factors have been derailing OPEC+'s ability to hit its production targets: a chronic problem with underinvestment among certain members such as Nigeria and Angola, and, more recently, the impact of Western sanctions on Russian output.
- **Euro zone likely entering recession as price rises hit demand:** A downturn in business activity across the euro zone deepened in September, according to a survey which showed the economy was likely entering a recession as consumers rein in spending amid a cost of living crisis.
- Manufacturers were particularly hard hit by high energy costs after Russia's invasion of Ukraine sent gas prices rocketing, while the bloc's dominant services industry suffered as consumers stayed at home to save money.
- S&P Global's flash Composite Purchasing Managers' Index (PMI), seen as a good gauge of overall economic health, fell to 48.2 in September from 48.9 in August.

Domestic Outlook

- **Eco activity still below pre-pandemic level; RBI to slow down on rate cuts till next year: ADB**
- With economic activity still to reach pre-pandemic levels, the RBI may slow down the pace of rate hikes until next year to quell soaring inflation while supporting growth, the Asian Development Bank (ADB) says in its latest report.
- The Manila-based multilateral funding agency has raised the inflation forecast for the current fiscal year ending in March 2023 to 6.7 per cent from its earlier projection of 5.8 per cent. For the next fiscal year too, the forecast has been revised upwards to 5.8 per cent from 5 per cent earlier.
- The report says the Reserve Bank of India (RBI) is expected to increase policy rates even though economic activity is still below the pre-pandemic trend and inflation continues to be driven more by domestic supply conditions than international factors.
- The RBI may, however, consider slowing the pace of policy rate hikes until next year because economic activity, although increasing, remains below the pre-pandemic trend. At the same time, allowing the exchange rate to serve as an automatic stabilizer will help improve the balance of payments position.
- High inflation due to elevated oil and commodity prices will likely require continued tightening monetary policy to ensure that inflation expectations do not get entrenched, which would likely hinder economic growth in the short run.
- ADB has cut India's GDP growth forecast for the current fiscal to 7 per cent from 7.2 per cent, on the assumption that global demand will remain sluggish and oil prices will remain elevated.
- For next fiscal, ADB expects the Indian economy to grow by 7.2 per cent as against 8 per cent it had projected earlier.
- Nevertheless, the economy is expected to grow strongly over the forecast horizon, with investment playing a catalytic role. Private consumption will be affected by higher inflation eroding consumer purchasing power

Prepared by M Dileep Chandra, AM
Editorial team: Dr. K.J. Satyasai (CGM), Dr. Vinod Kumar (GM) and Smt. Balwinder Kaur (DGM)
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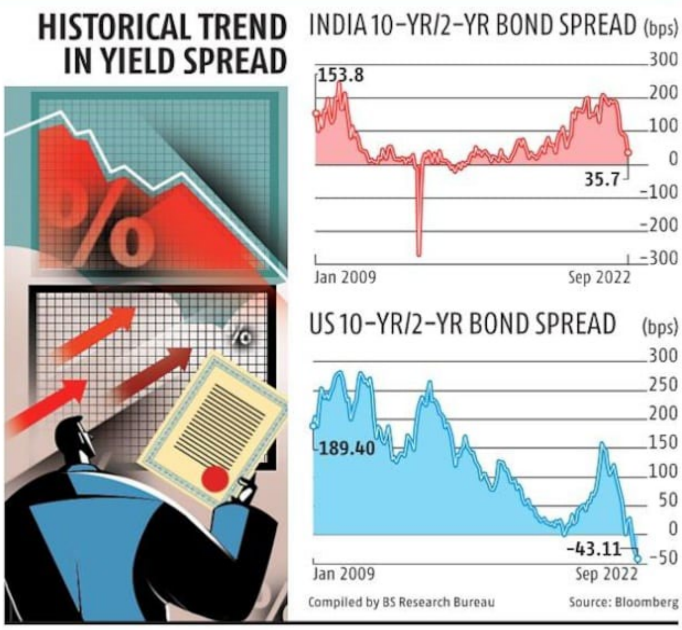
even though consumer confidence continues to improve. Sticky core inflation will adversely impact spending over the next 2 years if wages fail to adjust.

- On the rupee, ADB said the RBI has been active in preventing it from depreciating further, resulting in the biggest drawdown of foreign exchange reserves since the 2008-09 global financial crisis.
- The rupee depreciated from ₹ 74.3 to the US dollar in January 2022 to ₹80 in July. It fell further below ₹81 this week.
- To minimise the loss of reserves, future interventions should be aimed at reducing wide short-term exchange rate swings rather than stabilising the rate, thereby allowing it to reflect underlying market conditions and remain an automatic stabiliser.

Interest Rate Outlook

- **India, US 10-year yield spread at its lowest in 12 years:** The benchmark interest in India is now lagging behind the US – the world's biggest economy - by a wide margin.
- The yield on the 10-year US Treasury bill is up 90 basis points (bps) since the end of July this year, while it is nearly unchanged during the period. As a result, the yield spread between India and the US 10-year Treasury bills has declined 376 bps - its lowest level since 2010.
- Most of the decline in spreads between India and the US occurred in the past two years as the RBI has run an accommodative monetary policy, compared to its peers in the advanced economies.
- Such a low spread raises the risk of a sudden spurt in bond yields in India or a further depreciation in the Indian rupee, or both.
- **Narrowing bond yields signal liquidity squeeze in the markets:** Financial markets are signalling the liquidity tightening and a slowdown in the economy, as shown by a sharp rise in yields on short-term bonds, resulting in the spread between those and the rates on long-term bonds narrowing.
- The spread between the yield on the 10-year government of India and two-year bonds declined to a 38-month low of 36 basis points last week compared to 83 basis points at the close of last month and 200 basis points at the end of December last year.
- According to the data from Clearing Corporation of India (CCIL), the yield spread between the shortest-tenure (91 days) and the longest-tenured (40 years) bonds declined to 197 basis points last week from 260 basis points at the end of August and 341 basis points at the end of December last year.
- The result has been the zero-coupon yield curve flattening, which signals deterioration in liquidity conditions and a growth slowdown in the economy in the coming months.
- Liquidity has tightened in the financial market in the last few days with a sharp decline in the surplus available with the Reserve Bank of India. This is forcing borrowers to pay higher interest (or yield) to raise money by issuing short-term instruments.
- The decline in liquidity has been attributed to factors such as reduction in foreign exchange reserves, advance tax payments by companies, and much faster growth in bank credit than in deposits.
- Bond yields in India are following developments in the United States, where the yield curve is inverted at a three-month now.
- Yields on short-term bonds in the US are now higher than those on long-term bonds, which is most often the case in normal economic conditions. The yield on the two-year US government bond is now 3.97 per cent while the 10-year US government bond yields 3.54 per cent.
- This inversion has been accompanied with a slowdown in GDP growth in the US and a high probability of a recession later this year or the first half of this year.



Source: Bloomberg

Weekly Benchmark Bond Yield Movement (%)					
Date	**19-Sep**	**20-Sep**	**21-Sep**	**22-Sep**	**23-Sep**
USA 10 years	3.50	3.57	3.53	3.71	3.70
India 10 years	7.25	7.30	7.25	7.35	7.43
India 5 years	7.20	7.23	7.19	7.29	7.37
India 3 months	5.74	5.78	5.88	5.85	5.90

Source: CMIE, worldgovernmentbonds.com

- The yield on the government benchmark 10-year bond for the period (26-30 Sep 2022) is expected to be in the range 7.35% to 7.50%.