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India's economy continues to outshine the global gloom despite a moderation in activity; a highly uncertain global environment poses risks

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- Based on the recent comments by US Federal Reserve (the Fed) chair, Jerome Powell, we expect the Fed to join the monetary tightening pause club in June.
- While inflation in most economies is now off its peak, it still remains at levels that are unprecedented in the modern central bank era of the past 30-35 years. As such, we believe it is premature to declare that the war on inflation is over.
- On balance, we remain cautious that the prevailing stance of monetary policy and financial conditions in much of the global economy – most notably the United States and Europe – will be sufficient to squash prevailing trends in underlying inflation rates.
- Absent further restraint from the bank credit channel or loosening in labour markets in the next few months, we believe that policy tightening will need to resume in select economies if underlying inflation rates are going to return to their target levels.
- Despite headwinds from external developments and some signs of growth moderation from some high-frequency data and the effects of unseasonal rains, the base case for India remains for a solid, albeit more moderate paced, economic expansion.
- On the supply side, industrial activity showed signs of moderation amidst the unseasonal rainfalls while the services sector continued to remain a bright spot. On the demand front, indicators for consumer demand were mixed.
- Our outlook for both the industrial and services sector remains upbeat given the strong fundamentals of the Indian economy, however, a spillover from slowing global growth in CY23 poses risks to the outlook beyond the immediate near term.
- Outlook for consumer demand is clouded with the risks from elevated services inflation, higher interest rates, uneven recovery in labour market conditions and uncertain weather conditions posing a threat to rural incomes.
- Labour market recovery is uneven – with job market showing marginal improvement, lagged recovery in services sector and continued disparity between urban and rural wages.
- Softening of the headline and core inflation in Mar-Apr bolsters our view that the RBI is likely to go for an extended pause on rates throughout FY24. However, if inflation (particularly core inflation) surprises on the upside dramatically, more hikes could be implemented.

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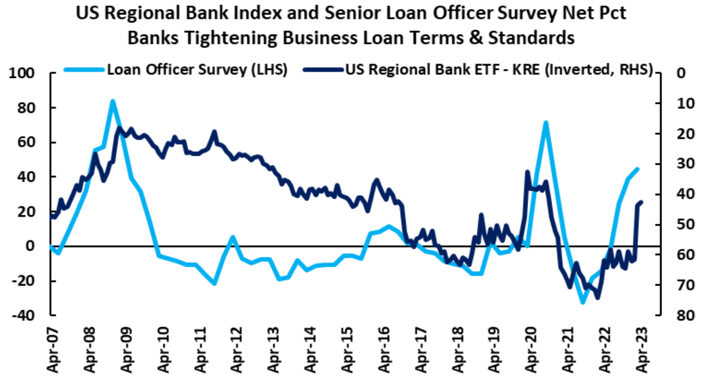
The Fed is set to join the monetary tightening pause club

As discussed in our prior monthly, central banks in multiple large economies have paused or are in the process of attempting to pause interest rate increases following the most pronounced period of monetary policy tightening in multiple decades. Based on recent comments from US Federal Reserve Chair Jay Powell, the US now seems highly likely to join the pausing club by holding interest rates steady in its June monetary policy meeting. Given the outsized role US monetary policy can have on global capital flows, foreign exchange movements, and US Dollar and non-US Dollar denominated debt instruments around the world, June's pause – if sustained – should have important global economic and financial implications (assuming the US govt resolves the pending deb ceiling matter in satisfactory manner).

Chair Powell's rationale guiding toward a June Fed pause aligned closely with the factors we highlighted last month that we expected to hear from central banks around the world as officials began to justify a halt or, in some cases, a slower pace of interest rate increases. Specifically, that monetary policy had become restrictive (to some unquantifiable degree); that in the United States – and most countries in the West – the pace of real economic growth had downshifted to a pace less likely to sustain the type of upward price pressures that took place in 2021/22; that restrictive supply chains are no longer a source of upward pressure on prices; that contemporaneous measures of wages and prices were off their peak and while still too high officials were cautiously optimistic of additional moderation ahead; and that dislocations in select banking systems likely were to reinforce all of these trends.

Significant tightening in credit noted in the past few months as a direct consequence of tightening monetary policy

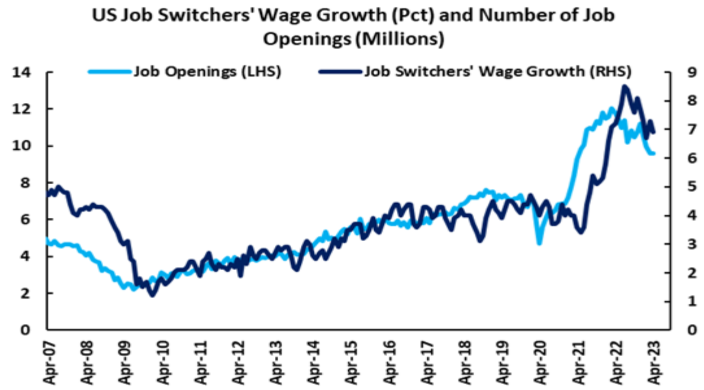


Source: Federal Reserve Board and S&P

Left unsaid in Chair Powell's and many other leading central bank officials from around the world's pause-related comments is a concern about over tightening monetary policy. To be sure, central banks in many countries have hiked interest rates at the fastest pace in 30+ years and the level of rates now is the highest in the past 15 to 20 years. In some locales, this interest rate policy has produced flare-ups in the financial system with attendant consequences for the cost and availability of credit (see above chart). Moreover, inflation is a lagging indicator, so policymakers genuinely have very little in the way of tangible metrics to evaluate today's policy setting(s) on 6-to-12-month forward inflation rates.

But inflation in many countries around the world still is at levels that are unprecedented in the modern central banking era of the past 30 to 35 years. Key inputs to the inflation process don't necessarily suggest additional upward pressure on core inflation rates from here on. At the same time, they do not suggest a sufficiently large disinflationary impulse that likely would lower underlying inflation rates back to target levels on a 12-to-18-month horizon (see chart). And there also is the pesky nature of services inflation, which as we have detailed previously has inflected higher and is less directly responsive to tighter monetary policy since the service sector of the economy is affected by interest rates less directly than the goods sector.

Improvement in labour market not sufficient enough to bring a large disinflationary impact



Sources: Atlanta Federal Reserve Bank and US Labour Department

On balance, we remain cautious that the prevailing stance of monetary policy and financial conditions in much of the global economy – most notably the United States and Europe – will be sufficient to squash prevailing trends in underlying inflation rates. Perhaps restraint from the bank credit channel will intensify over the summer, thereby tightening monetary and financial conditions further without any additional central bank measures beyond those currently signalled. But absent such a development and/or a visible and substantive loosening in labour markets in the next few months, we remain of the judgment that policy tightening will need to resume in select economies if underlying inflation rates are going to return to their target levels in the next 12-to-18 months.

Nonetheless, a multi-month, or longer, pause by the Fed – as now seems quite likely – should have notable implications for vast swaths of the global financial system and economy. For one, the absence of Fed interest rate hikes will provide other central banks space to slow or halt their monetary tightening. This especially will be the case for smaller to medium-sized countries and/or those whose domestic interest rates or exchange rates are particularly sensitive to increases in US interest rates. For another, the likelihood of a sudden stop situation in the US is incrementally lower with the Fed moving (for now) to the side lines. Finally, consistent with the US Dollar smile framework, the months ahead should involve a softer USD with favourable capital flow implications for emerging market economies with strong fundamentals, including India.

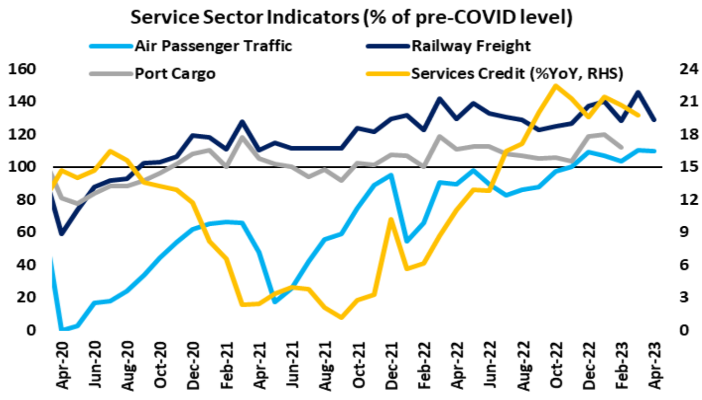
India's economic outlook remains resilient; downside risks to the outlook persist

India's economy remains resilient and relative to other large economies around the world a bright spot. Despite headwinds from external developments and some signs of growth moderation from some high-frequency data and the effects of unseasonal rains, the base case remains for a solid, albeit more moderate paced, economic expansion. We see moderation in both the supply and demand side of the economy. Notably, anytime the economy enters a cyclical moderation, risks to the downside increase to some degree and we are closely monitoring fundamentals and leading indicators for signs that such risks may be building.

On the supply side, industrial activity showed signs of moderation amidst the unseasonal rainfalls while the services sector continued to remain a bright spot.

The Index of Industrial Production (IIP) noted a muted growth of 1.1% YoY in March compared to 5.8% YoY in the prior month. Across segments, the sanguine growth in mining was offset by disappointing growth in manufacturing and a contraction in electricity generation reflecting the impact of unseasonal rainfall. Further, the high frequency data for April paints a mixed picture of the industrial sector. While manufacturing PMI and GST collections remained robust, other indicators like electricity generation and cargo movement showed signs of weakness. Going ahead, we expect the manufacturing sector and electricity sector to pick up amidst the easing of input cost pressures and rising temperatures.

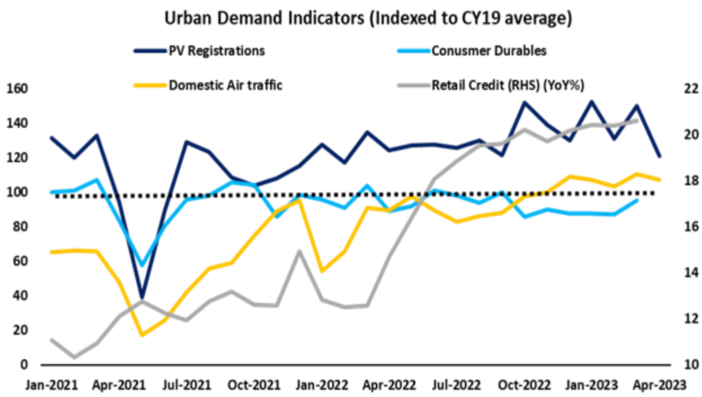
Services sector indicators remained buoyant



Source: CMIE

Meanwhile, the services PMI accelerated to its highest reading in the past 13 years as companies noted the fastest expansion in new orders and output despite the escalating price pressures. Other high-frequency data including domestic air passenger and services credit continue to register double-digit growth in April. Further, on the global front, despite the slowdown, the services sector continued to exhibit a stellar performance with services exports rising by 26% YoY in April. Going ahead, despite a slowdown in the IT sector, we expect other services like consulting, research, management, tourism etc. to provide support to the services sector. Accordingly, we remain optimistic about growth in the sector in the immediate future. That being said, we do not rule out the downside risks from the bleak economic outlook in advanced economies and the expected slowing of domestic demand.

Urban demand indicators paint a mixed picture



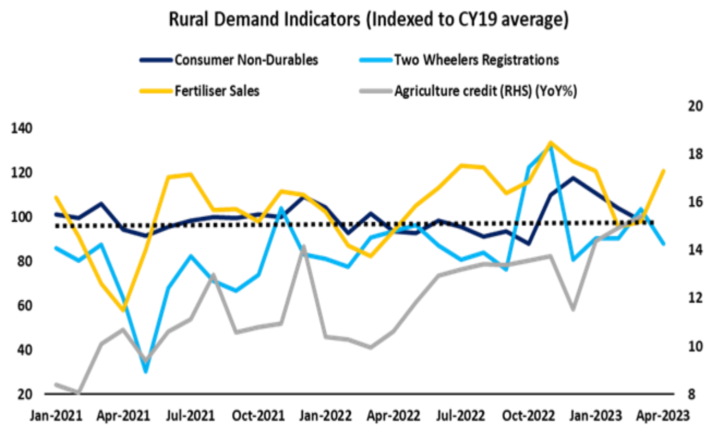
Source: CMIE

	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23
Industry indicators (% YoY)										
PMI Manufacturing *	53.7	55.5	54.0	53.9	55.1	57.8	55.4	55.3	56.4	57.2
Banks lending to Industry	1.7	7.3	7.5	9.5	12.6	8.7	8.7	7.0	5.7	
Industrial Production Index (IIP)	4.4	1.0	2.2	12.6	3.3	4.7	5.5	5.8	1.1	
IIP: Manufacturing	4.3	0.6	1.4	12.9	2.0	3.1	4.0	5.6	0.5	
IIP: Mining	8.6	2.6	3.9	7.8	5.2	10.0	8.8	4.8	6.8	
IIP: Electricity	0.9	2.8	6.1	16.4	11.6	10.4	12.7	8.2	-1.6	
Coal output	7.8	5.2	0.2	32.0	12.0	12.2	13.4	8.5	12.2	
Steel output	7.1	-0.6	4.1	3.3	7.7	6.2	10.8	11.6	8.8	
Cement output	11.3	14.2	8.9	19.7	12.5	9.5	4.6	7.5	-0.8	

*Source: CMIE; IHS Markit * PMI value above 50 indicates expansion over previous month while a value below 50 indicates contraction*

On the demand front high frequency indicators for consumer demand was a mixed bag. Among the urban demand indicators, sequential moderation was observed in petrol consumption, passenger vehicle sales (potentially due to BS VI Phase 2 norms leading to increase in prices) and consumer durables (impact of unseasonal rains along with change in consumption patterns from goods to services) while the growth remained robust in domestic air traffic and personal credit. The nascent signs of recovery in rural demand seem to be concentrated in the agriculture sector with tractor sales, diesel consumption, agriculture credit, and fertilizer sales remaining robust while other indicators like non-durables and two-wheeler registrations contracted. Going ahead, the outlook for consumer demand is clouded with the risks from elevated services inflation, higher interest rates, uneven recovery in labour market conditions (detail in focus box) and uncertain weather conditions posing a threat to rural incomes.

Recovery in rural demand indicators is likely concentrated in the agriculture sector

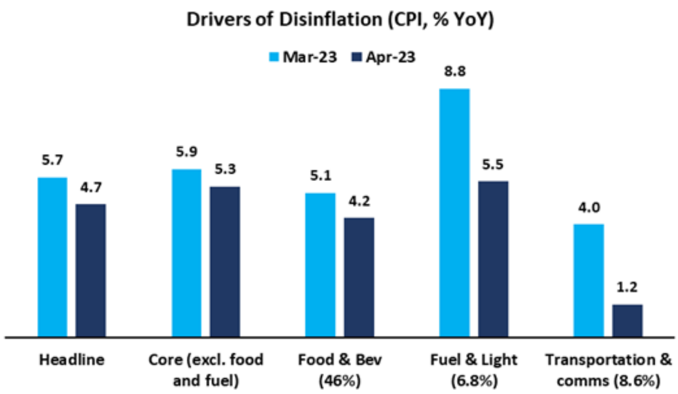


Source: CMIE

Inflation and Monetary Policy

Consumer price inflation further eased in April to 4.7% from 5.7% in March, printing comfortably below the RBI's upper tolerance threshold (6%) for a second consecutive month. The easing was primarily attributed to a favourable base effect and was led mainly by the food and beverages category, followed by fuel and light (electricity), and transportation and communications. Encouragingly, even core inflation (excluding the food and fuel group) eased significantly to 5.3% from 5.9% previously. Core inflation remained above 6% for six months before dipping below that level in March. The RBI had expressed concerns regarding the persistence of core inflation on many occasions and its softening over the past couple of months is likely to have given it the confidence of hitting a pause on the rate hike cycle in the April policy meeting. Accordingly, it is our expectation that the RBI is highly likely to keep monetary policy steady in the coming months.

While food remains the main driver of disinflation, fuel and transportation have also contributed



Source: CMIE; Note: Share of different components is noted in parentheses

In April, of the ~100bps softening, the food and beverages category contributed ~40bps while fuel and light and transportation and communications categories contributed ~20bps each. Food and beverages inflation eased to 4.2% from 5.1% previously, led by an easing in cereal and products and fruits inflation, while deflation in the oil and fats category intensified. The deflationary impact from lower vegetable prices (which was the main reason for disinflation seen through Sep-Dec 2022) waned further in April, despite a favourable base effect, reflecting that momentum is building in vegetable prices. Softening of price pressures in the fuel and light, and transportation and communication categories can be attributed to lower oil prices compared with a year ago (favourable base effect). Furthermore, the WPI inflation turned negative in April (-0.9% YoY) suggesting easing of input price pressures which could support easing of inflation in the core categories.

Looking ahead inflation is likely to stabilize as easing in the core categories is offset (or more than offset) by temporary spikes in food prices driven by seasonally high vegetable prices. Traditionally, vegetable prices spike in the summer months and remain high until the Kharif crops harvest in the months of September-October. Price pressures could be exacerbated by extreme weather conditions especially as some weather agencies have predicted El Niño conditions. Still, we expect headline inflation to remain within the RBI's tolerance range and core inflation to continue on a gradual disinflationary path. With inflation around 5% and policy rate of a 6.5%, the real interest rate is already higher than 1%, and is expected to remain at this level for the rest of FY24. In this context, we remain of the view that the central bank is likely to go for an extended pause on rates throughout FY24.

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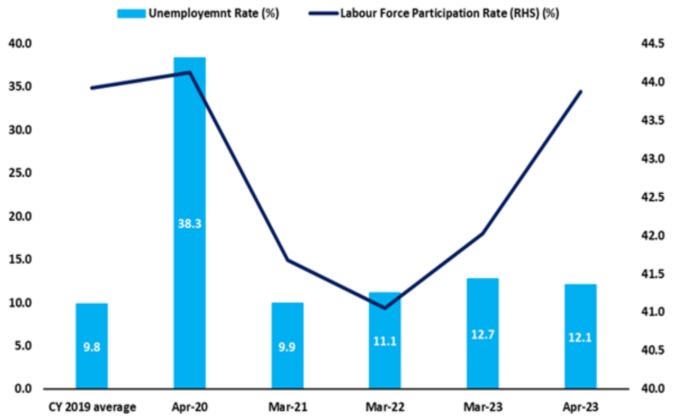
Focus section: Taking a closer look at the Indian labour market since the pandemic

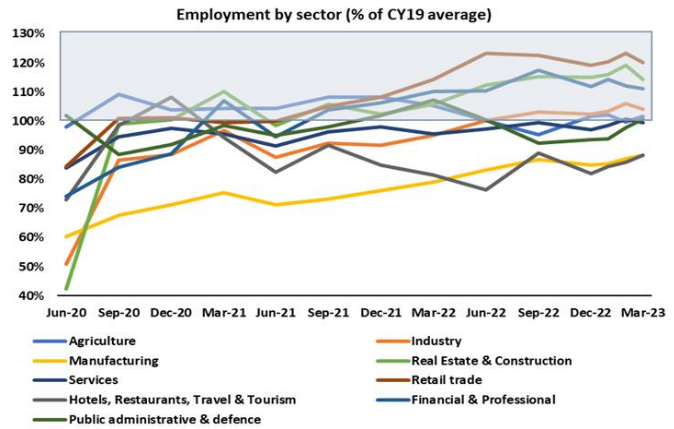
Three years on since the COVID pandemic's onset we take a close look at emerging labour market trends. The picture is nuanced, reflecting a combination of a cyclical recovery in aggregate jobs but a shifting mix of the types and locale of job growth underneath the surface. The data so far suggests marginal improvement in labour market with the total number of jobs remaining similar to pre-pandemic levels. Besides this, the divide between organized and unorganized sectors, contact intensive and non-contact intensive sectors, rural and urban sectors persist given divergent recoveries among different labour market sub-sections.

Job market shows marginal signs of improvement

At the height of the nationwide lockdown in April '20 around 120 million jobs were lost. Three years later, those job losses have been recovered but the recovery in the Indian economic growth has not lifted the level of total employment solidly beyond the pre-COVID peak as has been the case in many other economies. While FY24 started on a positive note with an exponential jump in the number of jobs, more data needs to be observed to call this improvement sustainable. Encouragingly, the number of people who had dropped from the labour force due to pandemic-induced job losses seems to be returning to the labour force with a broader labour force participation rate improving consistently since H2 FY23. While this rising labour force participation likely will result in a somewhat higher unemployment rate (unless job growth accelerates to match the pace of new entrants), more workers seeking employment should help to keep a cap on wage and salary trends with some favourable implications for inflation.



The employment in services sector is lagging the pre-pandemic levels particularly for contact intensive sectors - With the imposition of a country-wide lockdown, the industrial sector and services sector suffered steep job losses, while employment in the agricultural sector remained relatively unaffected potentially due to a reverse migration from urban areas to rural areas. Further, most of these migrant workers seemed to have found refuge in MNREGA or the agriculture sector. Accordingly, in CY21, the average number of people employed in agriculture rose to 106% of CY19 average levels (suggesting disguised unemployment) and declined to 101% in CY22 and 102% in CY23 (average till March) suggesting normalizing of labour force in agriculture.

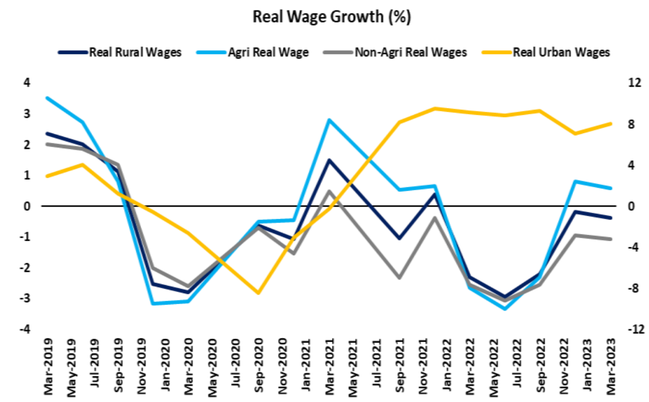


Meanwhile, the average number of people in the industrial sector which declined to 92% of pre-pandemic levels in CY21 seems to have recovered to its pre-pandemic levels (99% in CY22 and 104% in CY23) on the back of real estate and construction while manufacturing lags.

In contrast, employment in the services sector continues to lag its pre-pandemic levels with the average number of people in the services sector being at 97% of the pre-pandemic levels in CY22. This is despite what has been a very healthy recovery and expansion in the services sector. Consistent with the collapse in activity, contact intensive industries such as hotel/restaurant and travel/tourism suffered significant initial job losses; such employment levels remain far below their respective pre-COVID levels even after three years of the pandemic. The hiring data sourced from the Naukri JobSpeak (a proxy for formal employment) index further reaffirms that within the services sector, while there was an uptick observed in job listings for sectors like IT Software, Banking/Insurance etc. the hiring continues to trail pre-pandemic levels for the contact intensive sectors.

Quality of jobs has deteriorated compared to pre-pandemic levels - The quality of job revivals has also been sub-optimal. According to the latest Periodic Labour Force Survey (PLFS), the share of self-employed workers rose to 40% of the total workforce in Q3 FY23 compared to a 38% share in Q3 FY20. Data from CMIE suggests a similar trend for self-employed workers. We suspect that a portion of self-employed workers are "under employed" and earning less income from their self-employment than they would be if they were working as an employee. People employed as small traders & wage labourers, farmers, and home workers noted a faster recovery to pre-pandemic levels compared to the salaried individuals indicating a larger share of the workforce with lower wages and lesser to no job security.

Disparity between urban and rural job market persists - Lastly, on the wage front, the recent data indicates signs of nascent improvement in rural sector wages, however, the disparity between rural and urban wage growth continues to persist. Rural real wages (adjusted for inflation) are improving gradually with agriculture real wages turning positive recently while non-agriculture real wages are still in the negative territory. The real urban wage rates (proxied from the non-financial corporate results sourced from CMIE) however continued to remain in a positive trajectory since the beginning of FY22. The disparity between rural and urban wage growth could have led to rural demand lagging behind urban demand hitherto.



Source: CMIE; Note: The unemployment rate includes unemployed people who are willing to work but not actively looking for work. CPI rural is used to compute real rural wages and CPI urban is used to compute urban real wages.

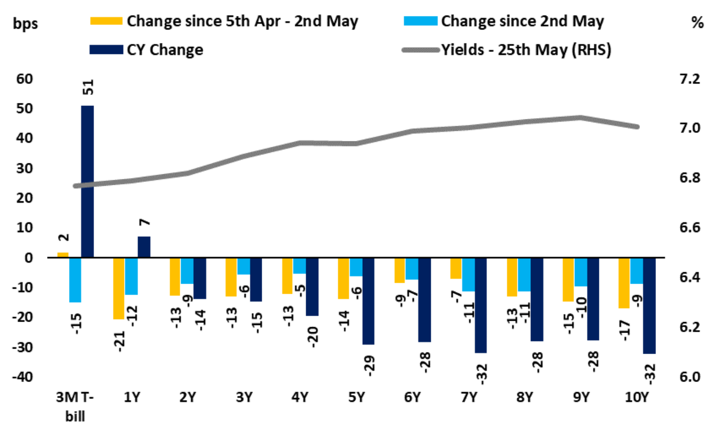
However, if inflation (particularly core inflation) surprises on the upside dramatically, more hikes could be implemented.

Market Update

In the first half of May, the short-term money market rate (overnight call money rate) rose to around 25-30bps above the repo rate owing to a liquidity crunch in the banking system caused by high credit demand and a larger amount of funds required by the banks due to 24*7 banking services. In the absence of variable rate repo auctions announced by the RBI, the average call money rate reached 6.8% on May 9. The announcement by the RBI on May 18 to conduct VRR auction for Rs 500 bn has eased the liquidity crunch and as of May 19, the call money rate was down to 6.2%. Liquidity conditions are likely to ease temporarily with the government's decision on May 19, to withdraw the largest denomination bank note of Rs 2000 from circulation over the next few months (it will remain valid for payments until September 30).

The bond market yields had already been on a downward trend in early April since the surprise decision by the RBI to hit a pause on the rate hike. In late April, strong demand for government bonds at an auction held on April 21 led to 10Y G-Sec yields correcting further by ~10bps (until May 2). Following that, on May 3 despite the 25-bps hike by the US Fed bond markets have continued to ease and for the first time in the past 12 months 10Y yield fell below 7% on May 12. This is likely due to a more neutral tone of the Fed Chair Powell's statement where he said that future rate decisions will be data dependent. Since then, the 10Y yield has hovered around 7%. Recently, the government's announcement to withdraw all Rs 2000 denomination bank notes from circulation is likely to result in an increase in banking system liquidity and a larger flow of funds into short-term debt instruments which could lead to easing of the shorter tenor bond yields.

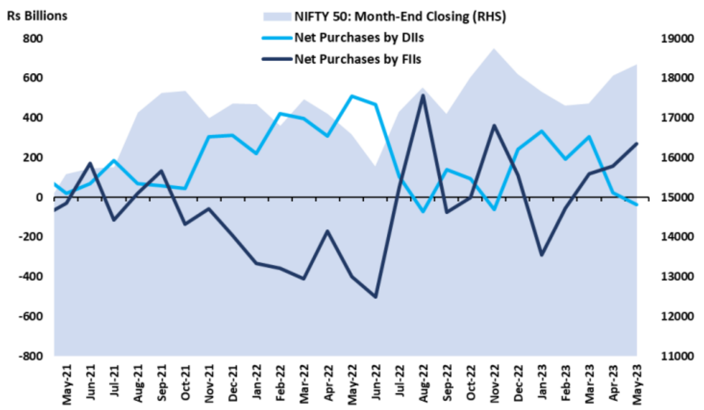
Yields have been easing, further softening ahead



Source: Bloomberg

The equity market gained impressively in April-May after closing relatively flat in March. The NIFTY and SENSEX gained by 4.1% MoM and 3.9% respectively as of May 23. The stock market strength is being led by buying from foreign investors who poured in ~Rs 268 bn in the equity market in the one month to May 23. Meanwhile, domestic investors have been net sellers with an outflow of ~Rs 37 bn. Reasons for FIIs remaining bullish on Indian equities are manifold including the US dollar weakness, lower treasury yields, strong Q4 FY23 corporate results particularly in the banking sector, and strong economic fundamentals and outlook for the country. External risks of volatility in the equity market exist. A delay in the US debt ceiling negotiations, and a possible downgrade of US Treasury bonds could trigger risk averseness among investors and capital flight from emerging markets such as India.

FIIs remained strong net buyers of equity



Source: CMIE; Note: Data for May-23 is until the 23rd

The exchange rate has hovered around the Rs 82/US$1 mark over the past two months. A general weakness in the US dollar since the regional bank crisis in the US in mid-March, and the resultant expectation of an impending pause to the Fed hiking cycle has positively impacted the local currency. Indeed, the DXY depreciated by more than 3% between mid-March and early-May. Meanwhile, the Indian rupee appreciated by merely 1%. The RBI's intervention in the market is clear given that the FX reserves went up by ~US$ 25 bn during the same time to reach US$ 595 bn by May 5. However, more recently the coverage around US debt ceiling negotiations has boosted the dollar owing to its safe-haven credentials and the fact that a successful raising of the debt ceiling will inherently provide stability to the US economy and its currency. Additionally, but separately the INR has also faced speculatory pressure over the past few days with unconfirmed reports of suspension of talks with Russia about the Rupee trade settlement mechanism. As of May 25, the exchange rate closed at Rs 82.7/US$1, ~1.0% weaker compared to a month ago.

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