25 August 2023

India's growth in Q1 likely held up; agriculture sector growth is critical for the near-term outlook. Slowing global growth remains a continuing risk.

- Two main themes are likely to dominate the global economic outlook over the balance of 2023 – inflation rates throughout much of the world continuing to be too high for central banks to declare their inflation-fighting efforts to be over and the risk of a Chinese economic mishap.
- Chinese economic fundamentals are in their worst shape in decades. Factors like crackdown on technology companies, handling of the COVID situation, labour scarring from multiple years of stringent COVID restrictions and property sector woes have soured household and business sentiment.
- While a sustained weakness in China probably will reduce select global commodity prices – with some beneficial effects for headline inflation around the globe – sustained economic weakness in the world's second-largest economy will have adverse implications for much of the global economy, particularly countries in Asia.
- GDP growth in Q1 is expected to have remained strong with manufacturing, construction and agriculture remaining strong while services growth seems to have moderated slightly. From the expenditure side, investment likely was the main driver of growth with net exports contribution remaining positive.
- In Q2, there have been some signs of a slowing consumption growth. Uncertain weather conditions, which could affect agricultural growth and rural propensity to consume in the upcoming festive season, pose the greatest risk to economic growth in the near term.
- Beyond the immediate near-term, we assess a slowing global economy, which could lead to a moderation of capital flows into the country and temper demand for Indian goods and services, to be the central risk to the country's economic outlook.
- A spike in food prices led to a surge in headline inflation in July. Although food price inflation is likely to moderate by August-September, the risk from El Niño continues to pose a concern. On a positive note, core inflation, WPI and services inflation all continued to ease, indicating that the underlying disinflationary trend persists.
- From a policy perspective, we expect the RBI to look past the transient surge in food prices. No further rate hikes are expected unless core inflation surprises on the upside and remains elevated on a durable basis. The possibility of a rate cut in FY24 seems bleak given that inflation is expected to remain above 5% until Q1 FY25.

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Global Economy: Inflation and China's outlook to dominate the economic scene in 2023

Two main themes are likely to dominate the global economic outlook over the balance of 2023 – inflation rates throughout much of the world continuing to be too high for central banks to declare their inflation-fighting efforts to be over and the risk of a Chinese economic mishap.

The former has been front and centre for the global economy for the past 18-21 months as elevated inflation rates turned out "not to be transitory" to borrow a phrase from Federal Reserve Chairman, Jerome Powell. The latter is a rapidly rising risk, as China's post-COVID economic bounce petered out remarkably quickly and the country's array of economic challenges seems to be coalescing at once with Chinese economic policymakers either not recognizing the need for a forceful response or electing not to respond.

The Chinese economy is in its worst shape in decades

Chinese economic fundamentals are in their worst shape in decades. What should be a vigorous economic recovery following multiple years of China's stringent Zero-COVID policy is anything but impressive. Instead of rising consumer demand for goods and services and strong business demand for labour, aggregate demand in the Mainland is lacklustre and firms are husbanding resources.

This demand weakness appears to be the by-product of various factors. Both consumers and businesses have lost confidence in the economic outlook, and as it appears, economic policymaking. We do not believe this to be the result of a singular development. Rather, it likely is a function of a combination of the multi-year crackdown on technology companies, the 180-degree turn in late 2022 from COVID being a near death sentence to it being largely harmless (and the population seeing that officials' multi-year scare tactics regarding COVID were just that), and the ongoing, highly visible prioritization of the Chinese Communist Party's (CCP) interests above economic interests, a perception shift from the past 25 years.

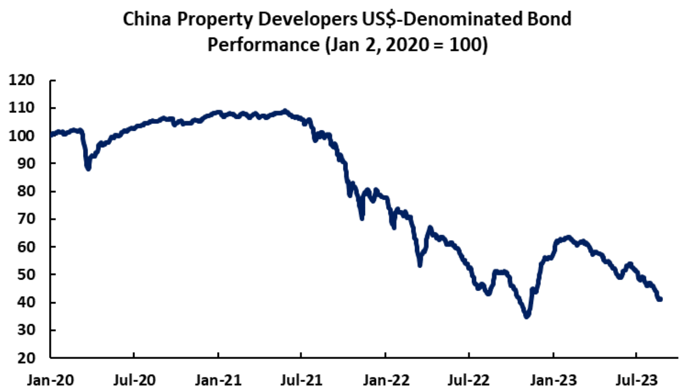
The ensuing collapse in household and business animal spirits also is being accompanied by other drags on aggregate demand. Labour scarring from multiple years of stringent COVID restrictions likely is affecting productivity adversely. While in the past 10 days, policymakers have reduced interest rates slightly and boosted liquidity provisions, overall credit policy remains tight.

Unemployment rate is much higher than levels seen pre-COVID

Source: Bloomberg

Separate but related to all these headwinds, the property sector is in freefall, raising the spectre of not only significantly slower economic growth ahead but also the possibility – even if still a tail risk – of financial contagion across a wide swath of the domestic financial system. Recent weeks have brought a highly visible technical default in one of – if not the most – important property developers.[1] Prior to the technical default, this company and other property developers' considerable troubles in completing developments – due to a combination of financial constraints plus COVID restrictions on activity – had soured deeply prospective homebuyers' attitudes. Moreover, the nature of residential development in China where a homebuyer makes a downpayment with a developer in the early stages of construction has trapped a significant amount of middle-class consumers' capital in unfinished residential construction, damaging confidence further and many household balance sheets.

Property sector seems to be in a freefall



Source: Bloomberg

[1] The developer has until early September to cure the missed interest payments to prevent the technical default from becoming a proper default.

As a result, the scores of hung property developments throughout the country are a huge headwind to homebuyer attitudes. The absence of new buyers, in turn, strains property developers' finances. This increases the difficulty of completing projects due to financing constraints and further elevates the risk of credit defaults by developers.

The prospective scope of financial knock-on effects from this downward cascade is unknown given the opacity of the financial system but the risk could be quite large. On this score, the recent announcement by one of the ten largest Chinese trust companies that it is unable to pay interest or meet redemptions on a variety of its trust products could be the tip of the proverbial iceberg. Trust companies are large lenders to property developers and if the aforementioned very large property developer ends up not curing its technical default, the ripple effects through the trust industry stand a good chance of being sizable.

To date, Chinese policymakers have failed to unleash measures to counter these various contractionary forces. In July, policymakers talked about the need for a more transparent regulatory regime, renewed business confidence, and some support for the property sector and other sectors of the economy. But that talk largely has been just that. Actual policy measures have been peripheral to the economy's central challenges and woefully insufficient to the task at hand.

The next two to three weeks are – in our judgment – very important, as downward pressures stemming from the aforementioned financial strains potentially build further. Should there be no additional tangible efforts to support the property sector, aggregate demand in general and/or a plan to deal with the possible failure of segments of the trust (and asset management) industry, downside risks likely will continue to build.

While sustained weakness in China probably will reduce select global commodity prices – with some beneficial effects for headline inflation around the globe – sustained economic weakness, or worse, in the world's second-largest economy will have adverse implications for much of the global economy, particularly countries in Asia.

Indian Economy: GDP growth in Q1 is expected to have remained strong; data out on Aug 31

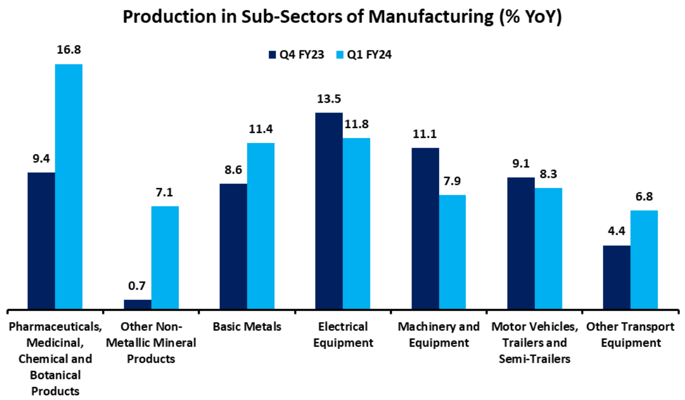
The Indian economy remains resilient and continues to perform well in absolute terms and relative to the bulk of the global economy. Macro fundamentals remain generally favourable, owing to a mix of solid balance sheets – especially in the banking and corporate sector – decent consumer spending fundamentals, and what appears to be a peaking in core inflation, which likely is helping real income expectations. Meanwhile, the public sector remains strongly committed to its various CAPEX programs, which also are helping to buoy growth.

The upcoming GDP report (due in a week's time) should underscore this dynamic. We assess the pace of economic activity in India likely to have improved in Q1 FY24 (Apr-Jun 2023) from the 6.1% growth seen in the prior quarter. According to the RBI's latest survey of professional forecasters on macroeconomic indicators, median growth in Q1 FY24 is expected to be 7.5% YoY.

Manufacturing, construction, and agriculture likely were the main drivers of growth

Activity in the manufacturing sector continued to gather pace in the quarter ended in June as evidenced by the acceleration in IIP growth to 4.7% from 3.9% previously. Improvement was seen both in consumer and investment segment manufacturing. Even though activity in the June quarter typically slows due to seasonal and weather-related factors, the sequential moderation in the manufacturing sector production was much milder compared to the usual trend. Sectors that led manufacturing growth in Q1 include pharmaceuticals, metals, electrical equipment, automobiles, machinery, and transport equipment.

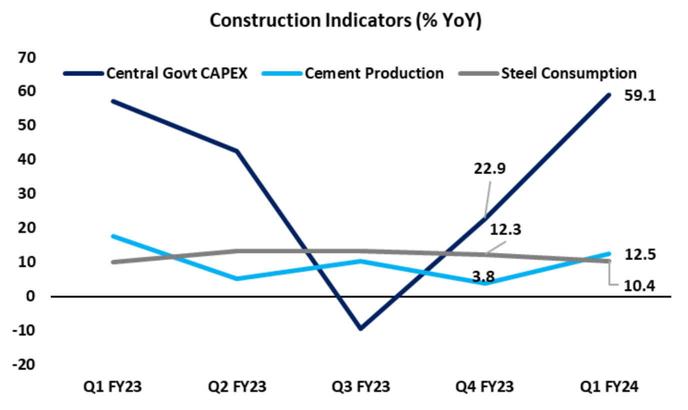
Sub-sectors showing green shoots in Manufacturing



Source: CMIE

The construction sector continues to do the heavy lifting on supporting economic growth given the government's unwavering commitment towards infrastructure development by pushing CAPEX. Indeed, the growth of central government CAPEX in Q1 jumped to a whopping 59% YoY on top of an already impressive growth in the corresponding quarter of the last three years. In fact, the amount spent on CAPEX in Apr-Jun 2023 was around 4.5 times of what was spent in the corresponding quarter of FY20 (pre-COVID). CAPEX implementation by the states in this FY is even more impressive than the central government with growth tracking at ~100% YoY for Q1 (for the 19 states for which data is available at the time of writing). Continued strong growth of cement production and steel consumption supports the view that the pace of growth of the construction sector remains robust.

Indicators of construction remained strong in Q1



Source: CMIE

We expect growth in the agriculture sector to have remained strong in Q1 owing to higher sowing of Rabi crops (higher by 3.3% YoY) and a higher increase in MSP for most of the crops compared with last year. According to the advance estimates of agricultural production for 2022-23, for the rabi season, foodgrain production is expected to be higher by 9.9% YoY, with cereals higher by 11.2% and pulses by 0.8%.

Services growth seems to have slowed in Q1

Meanwhile, growth in the services sector seems to have slowed slightly from the rate of growth seen in Q4 FY23, partly owing to the normalisation of the favourable base effect. The slowdown in the trade and transportation sub-sector is visible in indicators like domestic air passenger movement, commercial vehicle sales, GST E-way bills generation, services exports, etc. Hotel occupancy rates have gone down in the June quarter. In the financial sector, bank profitability is likely to have narrowed owing to the narrowing of the bank spread with the increase in deposit rates because of tight liquidity. Meanwhile, insurance premium growth improved. Nevertheless, sentiment in the services sector remained very positive as the PMI averaged higher than 60 for the quarter, compared with 58 in January-March.

Consumption indicators mixed but leaning towards improvement

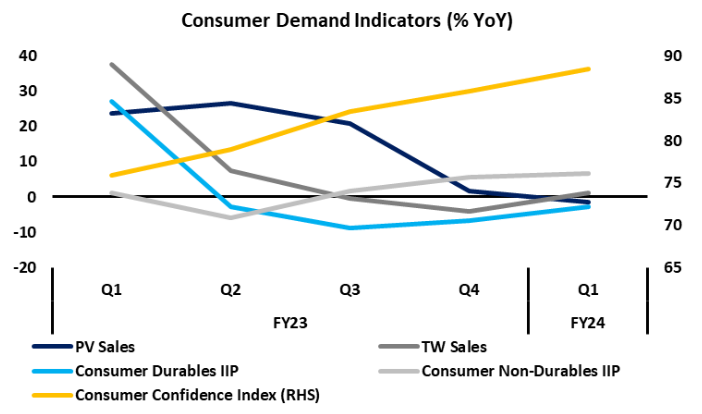
From the expenditure side, indicators of consumption in Q1 FY24 were mixed but on balance seem to be leaning towards improvement, when compared with the previous quarter. Signalling improvement in the rural demand, two-wheeler sales and consumer non-durables production improved, meanwhile, passenger car sales and consumer durables production remained in the red indicating weakness in urban demand. Strength in rural demand was likely underpinned by a healthy Rabi season harvest which would have boosted rural incomes. Higher unemployment in the urban regions, losing steam of pent-up demand for services and high cost of credit are likely to have affected urban consumption.

High-frequency indicators suggest a mild moderation in growth in the transport, trade, and financial sector

Services Indicators (% YoY)	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
Domestic Air Passengers	206.2	64.1	18.5	52.2	19.1
Air Cargo Traffic	9.8	1.4	-8.1	-0.8	-0.4
Railway Freight	11.8	8.4	3.2	3.8	1.1
Port Cargo Traffic	9.3	12.8	5.1		0.9
CV Sales	100.4	34.4	11.5	7.1	-5.1
GST E-way Bills	45.6	20.1	17.2	18.1	15.8
Services Exports	35.4	30.2	24.5	22.8	6.1
Life Insurance First year Premium	39.7	36.6	19.1	-7.0	-0.9
Bank Spread (%)	3.7	3.8	3.8	3.6	3.4
Services PMI	58.7	55.7	56.7	58.1	60.6

Source: CMIE, RBI, S&P Global

Rural consumption likely improved while urban consumption slowed



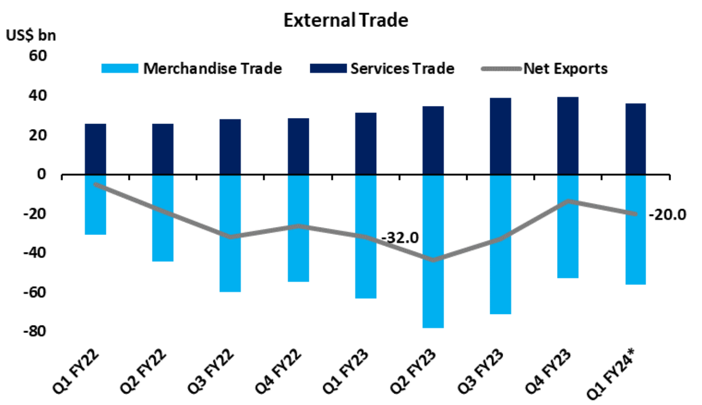
Source: CMIE

Investment likely remained the main driver of growth

As was the case in H2 FY23, we expect investment to have remained the major driver of growth in Q1 FY24. To reiterate, central and state governments' push on CAPEX is the main reason behind strong investment growth over the past few quarters. Additionally, a revival of demand in the housing/real estate sector has supported overall investment activity post-pandemic. Indeed, the share of dwellings, other buildings and structures in overall fixed investment increased to a six-year high in FY22. Improvement in Knight Frank's Real Estate Current Sentiment score to a five-quarter high in Apr-Jun 2023 indicates that this trend has likely continued in FY24. Acceleration in the growth of infrastructure and construction goods production further points to strong investment activity in the June quarter.

While net exports remained in the red in April-June, their contribution to GDP growth is likely to have remained positive owing to a very large deficit in the corresponding quarter in FY23. In value terms, the net trade deficit (goods and services) narrowed to ~US$20 billion in Q1 FY24, compared with a deficit of around US$32 billion in Q1 FY23. While lower energy and non-energy commodity prices have helped in narrowing the merchandise trade deficit (on a YoY basis), India's services sector surplus has swollen owing to continuing strong demand for its IT-BPM services from developed countries.

Net exports likely remained a positive contributor to growth in Q1

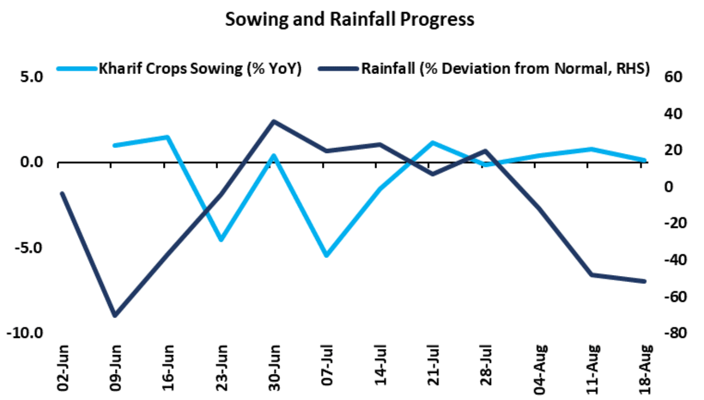


Source: CMIE; Note: Q1 FY24* based on monthly releases of trade figures

With Q2 FY24 halfway through, early indicators of economic activity suggest some signs of a slowdown in consumption. High-frequency indicators like auto sales and petroleum consumption have moderated. Employment has shrunk while a jump in inflation led by food prices is likely to have some detrimental impact as well on consumption. Regarding rural consumption, there has been an improvement in Kharif crop sowing due to the increase in rainfall during July and August. Still, the temporal and spatial distribution of rainfall has been uneven which has affected sowing in many parts of the country. While rainfall in June was in deficit overall, the month of July saw heavy rainfall that led to floods in many parts of the country and has been followed by a lull in rainfall activity since the beginning of August. According to CMIE, two-thirds of the geographical area of the country has received deficient showers from August 1-18. This is expected to take a toll on the late planting of the kharif crop. As such, uncertain weather conditions, which could affect agricultural growth and rural propensity to consume in the upcoming festive season, pose the greatest risk to economic growth in the near term.

We do not expect the outlook for investment to change throughout FY24. Public sector push to CAPEX, positive sentiment in the real estate sector, increasing capacity utilisation of manufacturing companies, and robust twin balance sheets of banks and corporates, are likely to keep conditions favourable on that front. Beyond the immediate near-term risk to agriculture and the rural economy, we assess a slowing global economy, which could lead to a moderation of capital flows into the country and temper demand for Indian goods and services, to be the central risk to the country's economic outlook.

Near-term risk to agriculture and rural economy persists; could affect consumption



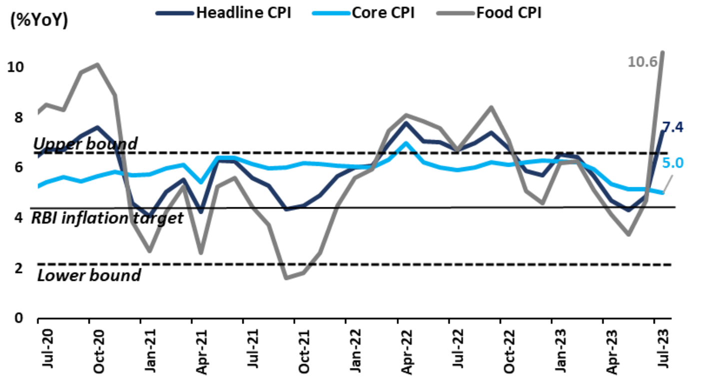
Source: CMIE

Transient food price pressures led to a surge in headline Inflation in July; monetary policy is expected to remain cautiously hawkish

Headline inflation surged sharply to a fifteen-month high of 7.4% in the month of July from 4.9% in the previous month. Inflation has printed above the central bank's upper threshold of 6% after four consecutive months of staying below it. This jump in prices was led by the acceleration in food inflation. Indeed, food and beverages inflation quickened to almost a three-year high of 10.6% up from 4.7% in June particularly on the back of rising prices of vegetables – predominantly tomatoes. Positively, daily tomato prices have started to ease recently with the improvement in supply. Apart from the vegetable prices, inflation also edged up slightly in cereals, meat, fruits, pulses etc. Looking ahead, with the arrival of fresh stock of tomatoes by the end of August, an increase in import of pulses, government steps like imposition of export duty on onions etc., we could see some respite in the food prices. However, the risk from El Niño continues to pose a concern with the cumulative rainfall tracking at 7% lower than the long-term average as of August 23.

Encouragingly, the core inflation softened from 5.1% in June to 5.0% in July owing to a softer pick up in prices of all the categories barring recreation and amusement. Finer details reveal that moderation was observed in both goods and services inflation. Further, the WPI inflation continued to remain in the deflationary territory, although the pace of decline moderated to 1.4% in July from 4.1% in the previous month – which could aid further softening of the goods inflation. Overall, we remain optimistic about underlying price pressures remaining on a disinflationary path.

Headline inflation breached the RBI's upper tolerance due to a pick-up in food prices



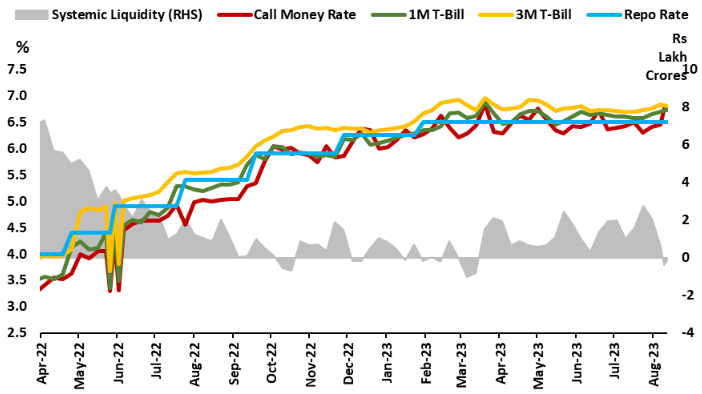
Source: CMIE; Food CPI includes food and beverages

Amidst the backdrop of a build-up in inflationary pressures in the food basket and resilient domestic economic conditions, the MPC met in August and remained in a wait-and-watch mode as it held the policy rate steady at 6.5%. The governor recognized the acceleration of price pressures in June and expected further pick-up in July-August led by a seasonal spike in vegetable prices. Consequently, the RBI revised its inflation trajectory upwards for Q2 FY24 to 6.2% from 5.2% earlier. With a sharper than expected inflation print in July, average inflation in Q2 could very well be higher than 6.2%. On balance, we now expect inflation in FY24 to be in the range of 5.5%-5.8% (compared with the RBI's projection of 5.4%).

On monetary policy, the RBI is likely to look past the transient surge in food prices (as mentioned by the governor in his statement). We believe that only a sharp and durable rise in core inflation could force the RBI to resume rate hikes again although we assign a very small probability to such an event. With inflation remaining much above the target of 4% for FY24, we do not anticipate any rate cuts in the rest of FY24. As mentioned in our India Economic Monitor for July 2023, the RBI's previous rate cut decisions in the Inflation Targeting Regime were usually preceded by a prolonged period of below 4% inflation and a real interest rate of 2% or above. Given that the RBI expects inflation to remain higher than 5% until Q1 FY25, neither of these conditions is likely to be met in our current forecast period.

Post the announcement of a temporary requirement for the banks to maintain an incremental CRR (Cash reserve Ratio) of 10% on the increase in NDTL between May 19 and July 28, the systemic liquidity slipped into deficit mode for the first time in five months (data as of August 23). This has led to a hardening of the overnight rates with the weighted average call rate increasing to 6.77% on August 23 from 6.4% (a day before the policy announcement). Going ahead, the focus of the liquidity operations is likely to remain on keeping the overnight rates closer to the policy rates.

Short-term rates have increased due to the RBI's measure to address the liquidity overhang



Source: CMIE; Note: Data till August 23

Market Update

- Bond Market: Domestic bond yield continued to rise following the firming up of the US treasury yields, rising oil prices and a jump in domestic inflation. With domestic inflation printing above the RBI's upper threshold and the stronger treasury yields following the hawkish Fed minutes, the 10-year yield surged to 7.22% as of August 22 compared with 7.12% at the beginning of July. It settled back to 7.19% as of August 23. The upward bias in yields is likely to continue in the coming few weeks with stronger US economic data keeping the hopes of another rate hike alive.
- Equity Market: After scaling their fresh high in the first half of July, the risk-off sentiment due to the sovereign rating downgrade of the US by Fitch and weak global cues led to the correction of the market. Consequently, the pace of the FII inflows in the Indian equity markets moderated in the first half of August but picked up thereafter. Overall, as of August 23, NIFTY and SENSEX were down by 1.2% and 1.4% MoM respectively.
- Currency Market: In July, the domestic currency remained stable as the USD/INR pair traded at 82.2, similar to the level observed in June. However, with the return of the risk aversion coupled with the rising global crude oil prices and strong US economic data leading to an uptick in treasury yields, the rupee depreciated by 0.5% while the dollar gained 1.5% during the same time (data till August 23). While we expect the depreciatory pressures to continue in the near future, the RBI is expected to contain the volatility.

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