27 September 2023

India's economy remains strong, but pockets of softness persist; amid elevated global economic uncertainty, risks are tilted to the downside.

- 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 a weak Chinese economy.
- Core inflation in select economies has somewhat moderated in the past couple of months but central banks are not likely to relax their hawkish monetary policy tilt in CY23.
- Chinese policymakers have announced some measures including marginal loosening in the monetary policy and liquidity, but we do not believe this is enough for a larger pick-up in consumer demand. More pronounced pro-growth policy support may not materialize until after the 2024 Chinese New Year Holiday.
- Domestically, the real GDP growth accelerated to 7.8% in the first quarter of the current fiscal supported by a favourable base effect, a pick-up in private consumption which was lacklustre in the H2 FY23, continued strength in the CAPEX spending, services and construction activities.
- Leading high-frequency indicators from both the demand and supply side of the economy, suggest continued strength in economic activity, although select pockets of softness persist.
- Downside risks persist in the form of continued sub-par monsoon levels, weakening external demand and renewed surge in global crude oil prices on account of recent supply cuts announcement. Based on evolving conditions, the GDP print for FY24 could be lower than the RBI's estimate of 6.5%.
- Headline inflation moderated slightly in August at 6.8% but remained above the RBI's upper threshold. Encouragingly, the core inflation has continued to moderate since the start of the year.
- For the outlook ahead, while we expect overall food price inflation to correct further in the coming months, mainly owing to normalizing supply and prices of vegetables, there are certain items for which prices are likely to remain elevated for longer posing an upside risk to inflation.
- From the policy perspective, we believe that a sharp and durable rise in core inflation would be required to force the RBI to resume rate hikes again, which given broad inflation dynamics outlined above seems to be an unlikely scenario.

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

The two main themes we highlighted in our August monthly report – central banks' inability to declare their inflation-fighting efforts to be complete and a very weak Chinese economy – remain solidly intact and are likely to remain the two dominant macroeconomic themes for the remainder of 2023 and early 2024.

Since mid-August, China's economic policymakers seem to have a somewhat better appreciation for the challenges facing the mainland's economy and its financial system but – in our judgment – still do not grasp the magnitude of these challenges. Officials in recent weeks have announced a variety of small-scale measures designed to put a floor under the property market and consumer spending. For instance, there has been both a shift in rhetoric toward residential real estate – one that is more friendly toward housing as an investment, not just a residence – and a relaxation in property regulations to try to boost home buying, which has had some marginally positive effect in Tier 1 cities such as Shanghai and Shenzhen. Likewise, on the consumer demand front, there have been some targeted initiatives that appear to have halted the ongoing deceleration in consumer outlay growth.

However, these and other recent policy initiatives such as the marginal loosening in monetary policy via both the interest rate and liquidity channel are pale in comparison to the scale of the headwinds facing the Chinese economy. The property sector needs not just to cease being in freefall; rather, it urgently needs both a vigorous boost to homebuying attitudes and demand plus a structural plan to keep systemically important property development companies in business. Consumer and business attitudes need to be buoyed via renewed confidence in the outlook, support for incomes (e.g., tax cuts), lower interest rates, and the like. And overall macro policy needs to become much more pro-growth and aligned with the economy's reality as opposed to the reality Chinese policymakers are trying to project.

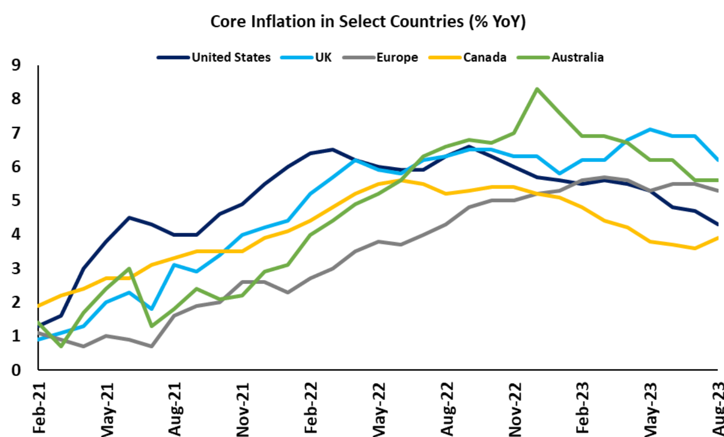
We remain highly sceptical that a more pronounced set of pro-growth policies are coming in the period ahead until/unless the economy weakens further. Even then, we are of the judgment that policymakers will be cautious. Greater policy support may not materialize until after the 2024 Chinese New Year Holiday.

A weak Chinese economy may have some favourable effects on inflation globally given its status as the second-largest economy in the world, but these effects are small and insufficient to alter the domestically driven inflationary pressures that continue to persist in many of the world's largest economies. Accordingly, central banks in many of the world's largest economies continue to maintain a so-called hawkish policy bias, i.e., judging the risks tilted toward still higher policy interest rates/tighter monetary policy (such as through quantitative tightening or less generous liquidity provisions).

Such a scenario has been our central judgment for much of calendar 2023. This judgment has been based on our assessment that fundamental underpinnings in many economies were stronger and more resistant to higher interest rates than in past cycles where monetary tightening was occurring many years into the business cycle at a time when macro imbalances had accumulated and that absent labour market weakening, services inflation likely would persist at too high rates for central banks' comfort.

While core inflation rates have moderated and likely will moderate somewhat further between now and the year end, we retain our judgment that most of the world's largest and most important central banks will not relax that hawkish monetary policy tilt in calendar 2023.

Core inflation has moderated in select economies, however the stance likely to remain hawkish in 2023



Source: Bloomberg

Nonetheless, the likelihood of additional interest rate hikes this year is the lowest it has been since the global monetary tightening cycle began roughly two years ago. Multiple factors account for this. First, core inflation rates are moderating; they still are too high in many large economies, but they are – at least for now – moving in the desired direction. Second, monetary policy has shifted from being the loosest in the post-WWII era to something that likely is neutral or some (unknown) degree of restrictive. Generally, when western central banks lift their nominal policy interest rate to close to or above the rate of inflation – as is the case in multiple countries now particularly the United States, inflationary pressures historically have moderated. The degree of additional inflation moderation is up for debate but

with ex-ante and/or ex-post real interest rates positive (or at least not deeply negative), the urgency that characterized much of this global policy tightening cycle has diminished.

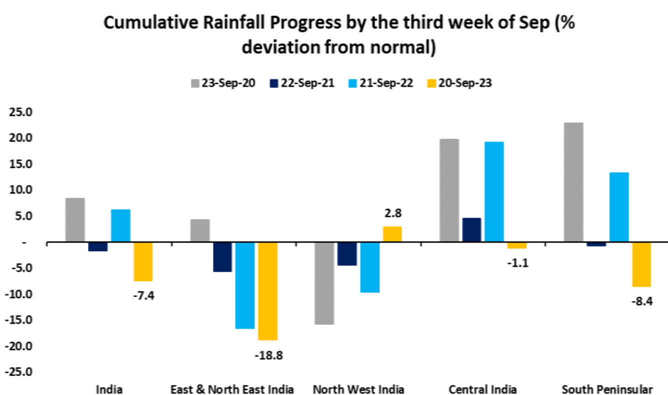
Of the world's largest economies, the United States and the United Kingdom are most likely to tighten monetary policy somewhat further from here in the next three to four months. In the US, Federal Reserve Chairman Jerome Powell seemingly would prefer (hope) to be done with interest rate increases. Nonetheless, he made it crystal clear at last week's Fed meeting that if he and his colleagues conclude that additional rate hikes were needed to ensure the return and maintenance of price stability in the world's most important economy, such action would be taken.

Indian economy sustains robust momentum; Downside risks persist

Economic activity in India has remained upbeat despite challenging global landscape. Real GDP growth accelerated to 7.8% in the first quarter of the current fiscal supported by a favourable base effect, a pick-up in private consumption which was lacklustre in H2 FY23, continued strength in the CAPEX spending, services, and construction activities. Encouragingly, the manufacturing sector also maintained positive momentum buoyed by the favourable demand conditions and moderating input prices which likely supported the profit margin. Leading high-frequency indicators from both the demand and supply side of the economy, including PMI surveys, IIP growth and PV car registrations, non-durables production and domestic air passenger traffic, etc. suggest continued strength in economic activity, although select pockets of softness persist.

Despite moderation in a couple of indicators, the base case remains for a solid, albeit more moderate paced, economic expansion. The following section covers some of the existing risks (covered in the July monthly monitor) as well some of the emerging challenges for the domestic economy.

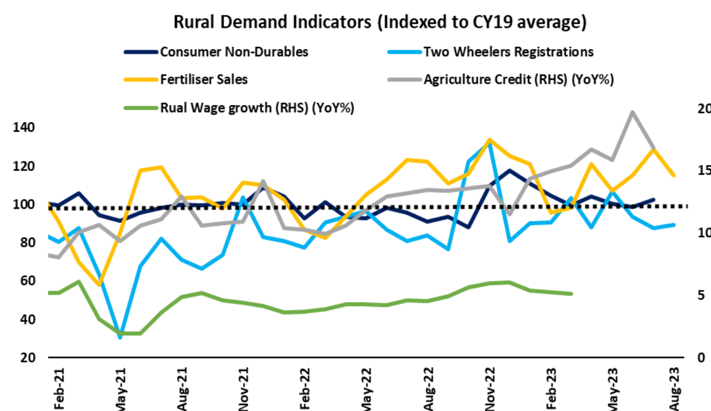
EL Nino remains a threat to the domestic rural recovery



Source: CMIE

As we have mentioned in our prior reports, one of the immediate challenges to growth continues to be the sub-par monsoon rainfall. The impact of the EL Nino conditions is becoming increasingly apparent with the rainfall deficit tracking at 7.4% as of September 20th. While the overall Kharif sowing has recovered to previous year levels, the impact of the rainfall on the output may dampen the rural incomes and thereby the consumption. Further, the ongoing adverse weather conditions could also hamper the upcoming winter sowing season, as due to deficient rainfall the reservoir levels are tracking below their decadal averages – which are crucial for the winter crop. Even though the impact of poor monsoon has not been observed on rural demand indicators yet, which are in fact showing tentative signs of improvement in the last two months, the risk cannot be overlooked. The true extent of the damage to the rural sector could very well be visible during the festive season. Apart from the weather-related risks, household demand could also suffer in upcoming months due to still elevated inflationary pressures more pronounced in the food category.

Erratic weather conditions could threaten the ongoing rural demand recovery

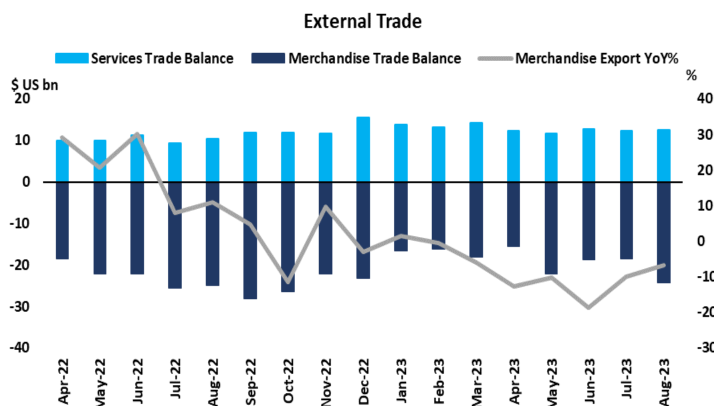


Source: CMIE

The persistence of the global slowdown as visible in continued contraction in the Global Manufacturing PMI remains a threat to domestic economic growth. In the first quarter of FY24, as a result of slowing external demand, net exports contracted by 7.7% and shaved off 4.6 pp from the growth number. A similar trend is being seen in the trade-related indicators for July-August. The merchandise trade deficit widened to a monthly average of US $21.3 bn from US $18.8 bn in the previous quarter owing to an increase in imports vis-à-vis exports. On the other hand, the services surplus, which has been providing a cushion to the merchandise deficit has remained stable during the same time. Overall, with the deepening of the slowdown particularly for China (where we have already seen a drop in

share of exports from 5% in FY22 to 3.4% in FY23), the health of external sector could suffer further.

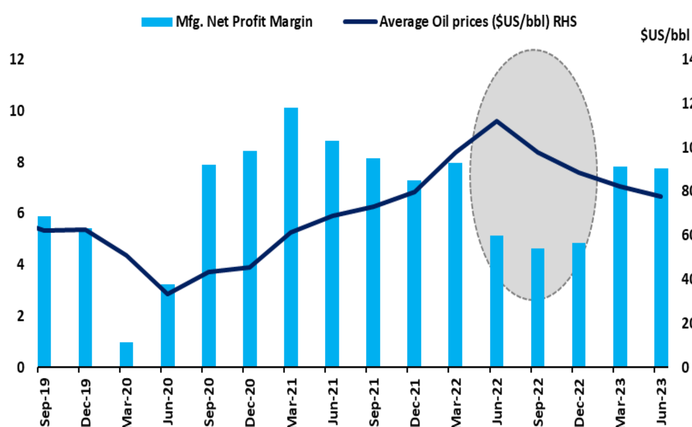
Trade deficit widened in August due to slowing external demand



Source: CMIE

Lastly, another emerging challenge facing the Indian economy could be the renewed surge in crude oil prices. The global crude oil prices have rallied to reach their 10-month high in September – trading around ~$93-$94/bbl on the back of the supply cuts announced by Saudi Arabia and Russia. Surging oil prices, especially if sustained at prevailing or higher levels, will put pressure on the current account deficit – which is already struggling due to falling exports. Further, the rising oil prices could also push up the already elevated inflation and keep the interest rates at higher level. Additionally, if the oil prices sustain the elevated levels, it could potentially dent the profit margins of the manufacturing sector which have just started recovering only recently - affecting the growth of the domestic economy.

Manufacturing profit margins could get squeezed with the increase in oil prices



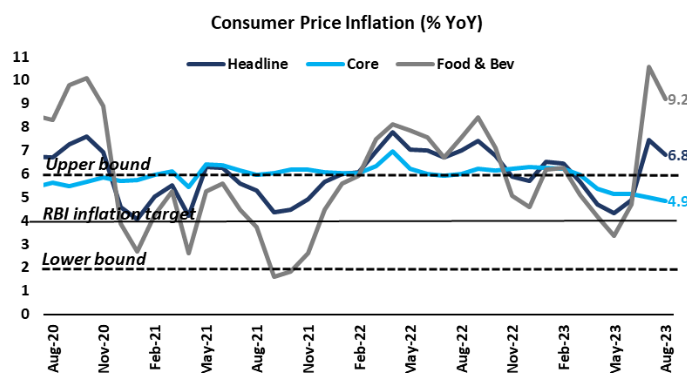
Source: CMIE: Bloomberg

Overall, based on evolving conditions, the GDP print for FY24 could be lower than the RBI's estimate of 6.5%.

Inflation eased slightly in August; further easing likely. Food price risks could persist but underlying disinflationary trend is intact; RBI to remain on pause

After breaching the 7% level in July, consumer price inflation moderated slightly in August, coming in at 6.8%. While this is still higher than the RBI's 4% target by almost 3 percent, it supports our view that the food-driven recent spike in inflation is likely to be temporary. Food and beverage inflation in August was still quite elevated at 9.2% although it came down from the reading of 10.6% in July. Very importantly, core inflation has continued to moderate since the start of this year which gives confidence that barring the volatile prices of food and fuel being passed through to core prices, underlying price pressures continue to ease.

Headline inflation remained above the RBI's upper threshold of 6%



Source: CMIE

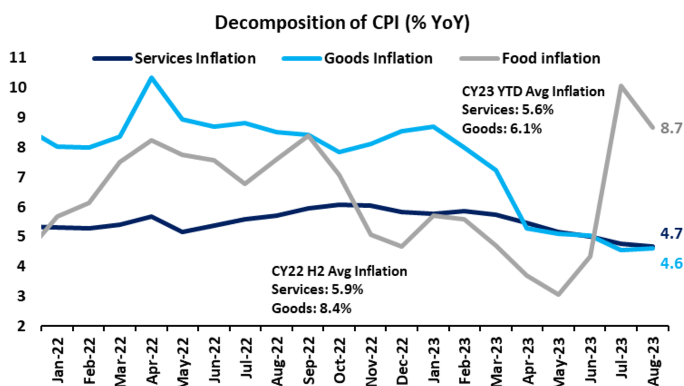
While we expect overall food price inflation to correct further in the coming months, mainly owing to normalizing supply and prices of vegetables, there are certain items for which prices are likely to remain elevated for longer. These include categories like meat and fish, pulses, oils, and spices which have contributed to the rise in food inflation over the past couple of months. Lower sowing for pulses and oilseeds in the ongoing Kharif agricultural season poses a risk that high inflation in these categories could persist for longer.

The impact of elevated food prices is visible in the wholesale price inflation as well. WPI food inflation spiked in July-August causing the extent of deflation in wholesale prices to temper. Nevertheless, manufactured goods prices have remained in the deflationary territory. Moreover, decomposition of CPI reveals that the services inflation broadly continued to follow a disinflationary path in August.

We remain of the view that the RBI will look through the food-driven recent spike in inflation. Continuation of disinflation in core CPI, moderation in services inflation and deflation in manufactured goods gives confidence that underlying price pressures are receding. Moreover, monetary policy is tighter than it was given the RBI's actions during the past year.

As such, we expect the policy rate to remain on hold. We believe that a sharp and durable rise in core inflation would be required to force the RBI to resume rate hikes again, which, given the broad inflation dynamics outlined above seems to be an unlikely scenario.

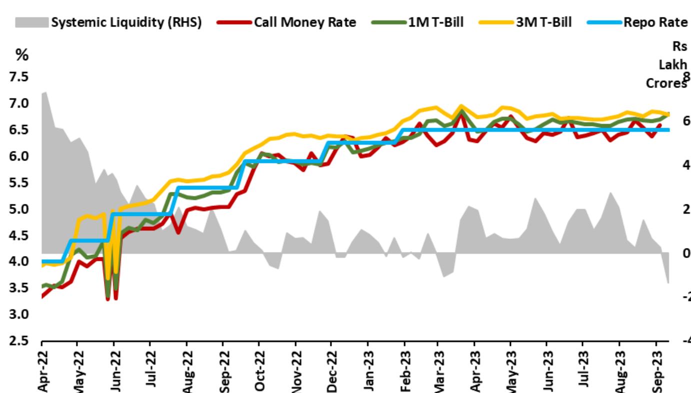
Year to date average goods and services inflation is much lower than H2 CY22



Source: CMIE; DMI Calculations

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 previous reports, 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.

Banking system liquidity deficit at its widest in four years



Source: CMIE; Note: Data till September 22nd

Surplus liquidity in the system jumped towards the end of August, likely owing to a pickup in government spending. However, it again dipped into deficit from the middle of September as advance tax payments and GST remittances drained liquidity. As such the weighted average call rate has remained 20-30 bps above the repo rate over the past week at ~6.8%. Banking liquidity deficit widened to Rs 1.6 lakh crore, a four year high, as on September 21st. Still the RBI continued to hold VRRR auctions. Another reason that could be weighing on liquidity is the RBI's intervention in foreign currency markets as the dollar index strengthened to its highest since March, as markets come to the realization that the bar is quite high for the Fed to consider reducing interest rates anytime soon.

Even though the RBI began unwinding of the temporary requirement for the scheduled commercial banks to maintain an incremental CRR in a phased manner beginning from September 9th returned some liquidity to the market, overall banking system liquidity remains in the red. It is likely to improve towards end of September as government spending kicks in. The inclusion of Indian Government Bonds in the JP Morgan EM index could help in improving liquidity from the foreign channel. The RBI could announce VRR auctions to correct the liquidity situation especially considering the higher liquidity needs of the festive season, but the focus of two-way operations will remain on keeping the overnight call money rate closer to the repo rate.

Market Update

- Bond Market: Pressure on Indian bond yields persisted in August, as an increase in bond yields in the US, higher domestic headline inflation and an increase in crude oil prices all weighed on sentiment. The G-sec 10Y yield averaged 7.19% in August, compared with 7.11% in July. Since mid-September, bond yields have eased slightly owing to the moderation in inflation for August. Further, the inclusion of Indian Government Bonds in JP Morgan's EM index is likely to help cap bond yields. Yet persistently high global economic uncertainty, higher yields in the US, increase in oil prices and the government's huge borrowing needs are likely to keep exerting upward pressure on bond yields.

- Equity Market: Indian equity markets ended weaker in August following five consecutive months of growth. The slight bit of correction in August is attributed to higher domestic inflation, more hawkish tone from the Fed and lower net sales growth of the corporates, all of which negatively impacted sentiment. Indeed, foreign portfolio inflows in August fell to a four-month low and overall NIFTY closed 2.5% lower MoM at the end of August. In September, the equity market scaled fresh highs even as FIIs remained net sellers, but domestic institutional investors continued to pump in money. Favourable domestic economic prospects have supported the rally in the equity market. Despite some correction in the past few sessions, on

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average, in the month to date (26th Sep) equity markets have gained by ~2%.

- Currency Market: The rupee has remained under pressure owing to a strengthening US dollar. The Fed's ongoing hawkish stance coupled with persistently high global economic uncertainty has provided strength to the dollar. In August, the US dollar on average appreciated 1.7% while the INR depreciated by 0.8%. The rupee has remained remarkably resilient, which can be attributed to the RBI's intervention in the foreign currency markets as well as positive domestic economic fundamentals. In September to date (26th), the US dollar has gained by 1.9% while the rupee has lost 0.3% of its value. Since the start of August India's foreign exchange reserves have declined by ~US$10 billion, but still stand strong at ~US$593 billion.

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