23 February 2024

India's economic growth remains on track amidst continued disinflation; risks from volatile food prices persist

- Interest rates in much of the world are likely to be headed lower in 2024 but the continued economic resilience and hotter than expected inflation print suggest that the timeline for easier monetary policy is likely to be later than and less pronounced than currently anticipated.
- Based on inflation data, the bulk of disinflation around the world is achieved through weaker consumer goods prices, while services inflation has likely remained too high for broad inflation to return to desired levels.
- Therefore, central banks globally will look for tangible signposts suggesting services inflation is likely to moderate on a durable basis before commencing the policy loosening.
- High-frequency indicators for the domestic economy suggest growth remained strong owing to sustained urban demand and robust growth in the services sector. Meanwhile, a slight slowness in the industrial sector and a weak agriculture sector are likely to weigh on the GDP growth in Q3.
- While the data for January suggest that the economic momentum continued, we remain cautious of the volatile labour market and any escalation in geopolitical tensions.
- Headline inflation moderated to a three-month low of 5.1% in January from 5.7% in December, aided by the favourable base effect and softening of food inflation. Meanwhile, core inflation continues its downward trajectory driven by a broad-based improvement in goods and services inflation.
- Elevated food inflationary pressures along with continued easing in the core inflation suggest while underlying price pressures are receding, the risks to the inflation outlook from volatile food prices remain very much alive. Meanwhile, growth has remained on solid footing. Against this backdrop, we do not expect the central bank to cut rates before Q2 FY25.

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Given still higher than desired rates of inflation monetary policy loosening is likely to be later than currently anticipated

Data and events from these first nearly two months of 2024 have highlighted that the pathway toward easier monetary policies and lower interest rates throughout the global economy will be uneven. We wrote in our January monthly that we expected interest rates in many of the world's largest economies to head somewhat lower in 2024 but that heightened expectations for a rapid and pronounced decline in rates are unlikely to materialize. Continued economic resilience and/or hotter than anticipated inflation readings so far this year have reinforced that judgment.

The outlook for economic growth is differentiated across the world's biggest economies. Economic growth in the United States remains the standout in the constellation of the world's largest economies. Growth in 2023 topped three percent and more importantly, leading indicators suggest little in the way of moderation in the period ahead for the pace of US economic activity. Other large economies such as Japan, the UK, and Europe are not on anywhere near as strong a footing as the US but in many cases are starting to see glimmers of improvement in the most cyclically sensitive parts of their respective economies now that interest rates have crested. China, meanwhile, remains quite weak, saddled with massive overinvestment in the property sector and no plan for resolving the sector's overinvestment and over-indebtedness, depressed animal spirits, constantly shifting business sector rules and regulations, and heretofore woefully insufficient countercyclical policy efforts.

Despite vastly different economic speeds, the largest economies in the world (minus China) generally still experience higher than desired rates of inflation. It is this dynamic that forms the foundation of our judgment that the timeline for easier monetary policy is likely to be later than and less pronounced than currently anticipated.

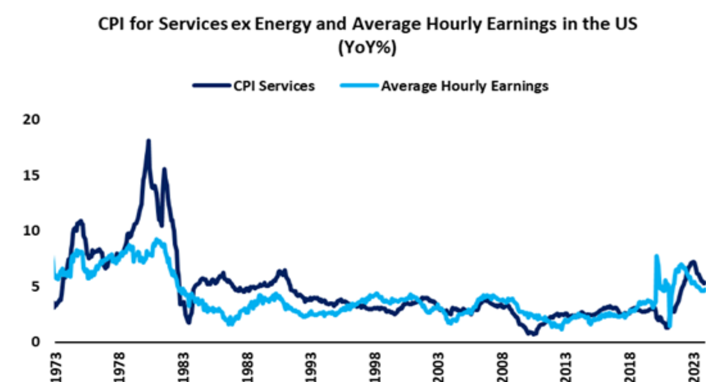
To be sure, price pressures – especially those for so-called core prices that exclude food and energy costs – have moderated by a good-sized amount in the past 18 to 24 months. Nonetheless, we continue to conclude that upside risks to the trend rate of inflation – core and/or headline depending on a country's inflation target – are too high for central banks to begin easing monetary policy in the near term. Indeed, year-to-year inflation metrics, which are admittedly backward looking, remain solidly above desired levels in every major economy; more timely six-month annualized percentage change measures generally also are above desired levels.

Goods inflation could increase in the period ahead; services inflation is yet to moderate further to achieve the last mile of disinflation

The composition of the disinflation that has taken place also is a reason for caution. To date, the bulk of disinflation around the world has been due to pronounced disinflation and in some instances deflation – in the prices of consumer goods. Weakness in consumer goods prices is a natural by-product of the steep hike in global interest rates and to some extent better functioning supply chains, which were disrupted markedly due to COVID. However, with interest rates having (seemingly) peaked and surveys hinting at pent up demand in interest rate sensitive sectors such as housing, it may be that currently, very low consumer goods inflation rates will rise in the period ahead.

Services inflation likely remains too high for broad inflation (core and/or headline) to return to desired levels. One of the unique aspects of the current cycle is that services inflation rates have peaked higher, breaking out of the multi-decade range that had persisted. With services constituting an increasingly large share of overall economic activity in major economies and less directly influenced by interest rates, services prices have experienced considerably less moderation than the price of goods. Given a strong linkage between nominal labour compensation and services sector inflation, it remains our judgment that some weakening in labour market conditions, which in turn moderates compensation growth, is probably necessary for services inflation to moderate by the needed 1 to 2½ percentage points depending on the economy to achieve the so-called last mile of disinflation back to target.

Historical relationship between labour market compensation and services inflation is strong



Source: Bloomberg

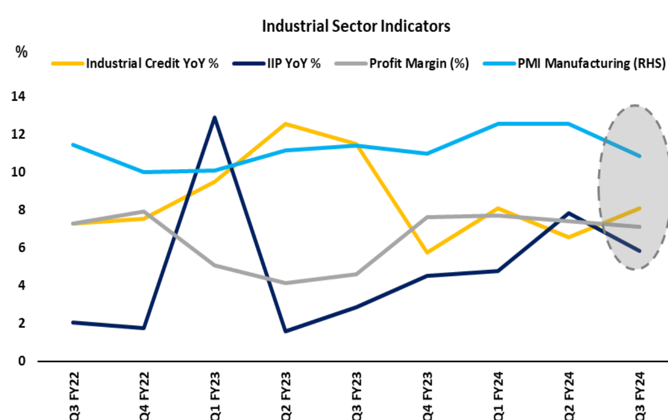
Such a process need not be complete for the door to open for lower interest rates; rather, there need to be tangible signposts that the process is underway, and the process seems likely to persist. Further reductions in job hopping, a sustained rise in layoff announcements and stalling out in

broad economic growth measures all are potential key inputs to providing central bank officials with the confidence that the "last mile" on services inflation is likely proceeding in the desired direction. In many countries, we expect such an outcome will materialize, but that summer is the prospective timeline for tangible signs starting to emerge and not the period immediately ahead.

Indian economy continues to outperform the bulk of the other economies; with expectations of a more moderate pace of expansion for the remainder of FY24

The Indian economy continues to exhibit resilience relative to the rest of the world. Despite some moderation observed in select high-frequency indicators, the base case remains for a solid, albeit more moderate paced, economic expansion in H2 FY24, owing to sustained urban demand and robust growth in the services sector. Meanwhile, some bit of slowing in the industrial sector and agriculture sector is likely to weigh on the GDP growth in Q3. We continue to monitor closely volatile labour market indicators, as a sustained weakening in the labour market would challenge the economy's favourable outlook, as would an escalation in geopolitical tensions.

Industrial sector growth to moderate slightly in Q3 but remains solid



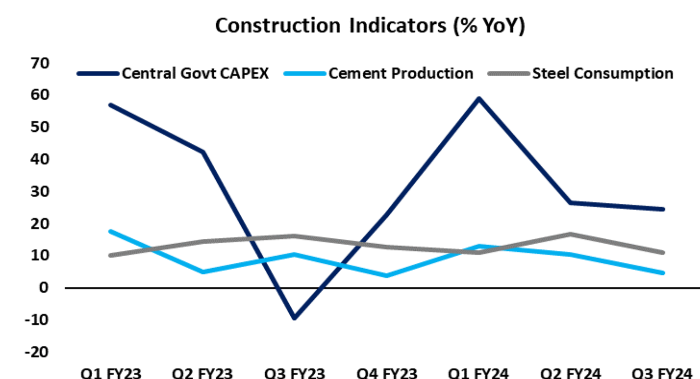
Source: CMIE; S&P Global

Activity in the industrial sector has likely held its ground in Q3 FY24 despite a slight moderation. The index of industrial production (IIP) grew by 3.8% in December after an (unsurprising) festival induced slowdown observed in November (2.4%). An uptick in the manufacturing sector primarily supported this. With that, the growth of IIP in Q3 stood at 5.8%, which was lower than the 7.8% growth observed in the previous quarter – mainly on account of the unfavourable base effect. Nonetheless, it is much higher than the 5.3% growth seen in FY23. Other high frequency indicators for industrial sector indicators point towards sustained momentum including expansionary PMI manufacturing (despite a sequential blip), industrial credit,

and sustained elevated profit margins of the manufacturing companies in Q3.

The growth in the industrial sector continues to be supported by the construction/infrastructure related goods given the government's commitment towards infrastructure development by pushing CAPEX. Accordingly, the growth of central government CAPEX continues to remain elevated at nearly 25% in Q3, a similar rapid pace of expansion to the prior quarter. CAPEX implementation by the states[1] also remained impressive with growth tracking in double digits (17%) in Q3. The continued strong growth of steel consumption supports the view that the pace of growth in construction remains strong. However, cement production growth has slowed in Q3.

Construction activity continues to be supported by government capital spending



Source: CMIE

Services sector indicators continue to suggest a positive momentum

Services Indicators (% YoY)	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Domestic Air Passengers	206.2	64.1	18.5	52.2	19.1	23.0	9.1
Air Cargo Traffic	9.8	1.5	-7.9	-0.8	-0.4	1.7	10.2
Railway Freight	11.8	8.4	3.2	3.8	1.1	4.8	6.4
Port Cargo Traffic	9.3	13.0	5.3	12.8	0.9	2.9	10.0
CV Sales	100.4	34.7	11.3	7.1	-5.1	4.2	3.1
GST E-way Bills	45.6	20.1	17.2	18.1	15.8	15.0	17.1
Services Exports	35.4	30.2	24.5	22.8	5.9	4.2	5.1
Life Insurance First Year Premium	39.7	36.6	19.1	-7.0	-0.9	-21.2	5.4
Non-food Credit*	13.8	15.7	15.3	15.4	16.3	15.3	15.8
Services PMI*	58.7	55.7	56.7	58.1	60.6	61.1	58.1

Source: CMIE, S&P Global; * Bank credit is excluding HDF merger, Services PMI is based on an average of the months.

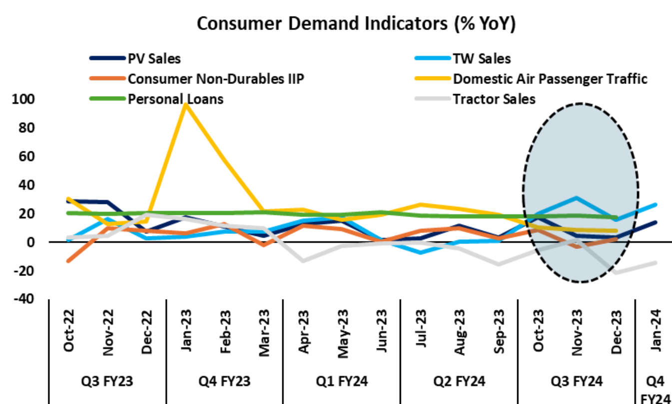
High-frequency indicators in the services sector point towards a positive momentum continuing in Q3 generally. Most of the indicators barring CV sales and domestic air passenger in the trade and transportation sub-sector

[1] Based on data of 24 states.

suggest activity gathered further momentum in the quarter ending December. The financial sector also likely remained strong reflected in improvement in insurance premiums and double-digit credit growth in the banking sector.

With Q4 FY24 halfway through, early indicators of economic activity suggest momentum has likely sustained. PMI – a key leading indicator – for both the manufacturing and services sector observed a four-month and a five-month high reading in January. Additionally, the forward-looking survey from the RBI also suggests a positive outlook for both sectors in Q4 FY24, albeit the optimism was a shade lower for the industrial sector compared to the prior round of surveys. While the companies expect the input cost pressures to persist in the current quarter (Q4), they are optimistic about the selling prices and consequently the profit margins. Favourable profit expectations are a key lifeblood to continued business expansion and, as such, bode well.

Consumption indicators mixed but leaning towards improvement

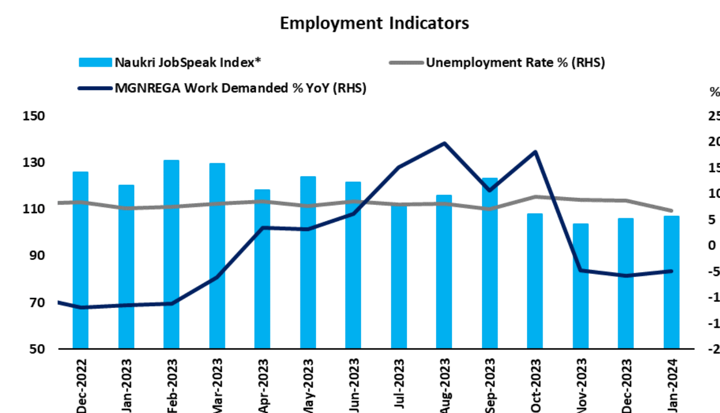


Source: CMIE

From the expenditure side, the growth in Q3 has likely been supported by the consumption expenditure mainly driven by the sustained urban demand reflected in strong growth in domestic air passengers, PV sales and retail credit etc. Meanwhile, rural demand indicators were a mixed bag suggesting rural demand continued to trail urban demand. The indicators which showed improvement include two-wheeler sales and moderating demand in the (Mahatma Gandhi National Rural Employment Guarantee Act) MNREGA scheme while tractor sales, consumer non-durables output etc. remained weak. The early indicators for January lean towards positive with auto sales, two-wheeler sales, toll collections etc. remaining strong. Meanwhile, tractor sales continued to remain in the negative territory in January.

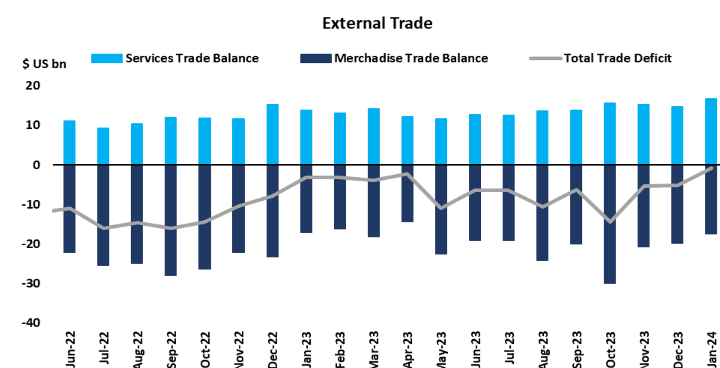
As highlighted in our previous monthly reports, one of the major factors which could inhibit the growth of consumption is the volatile recovery in the labour market. The unemployment rate inched up in Q3 to 9% from 7.6% in the prior quarter, reflecting continued stress in the labour market. In Jan '24, while the unemployment rate improved significantly to a 16-month low of 6.8%, it came on the back of a massive drop in the labour force. Although this is mostly a seasonal trend due to the conclusion of the Rabi sowing, what remains a cause of concern is the extent of decline in the labour force which was much larger (~14 mn) compared to an average of ~5 mn in the post-pandemic period (2021-2023). To gauge a better picture of the labour market, we also looked at the additional indicators including the Naukri JobSpeak Index, and the employment demanded under the MNREGA scheme. While the Naukri index continued to deteriorate in January reflecting weakness in the white collar hiring, the work demanded under the MNREGA scheme has dropped which somewhat reflects improvement in the rural labour market. Overall, the data on this front was mixed and needs to be monitored closely.

Employment Indicators suggest weakness in the labour market



Source: CMIE; * Naukri JobSpeak index is indexed to the 2019 calendar year average

After widening in Q3, the trade deficit is expected to narrow in Q4 based on early indicators



Source: CMIE

Lastly, on the external front the, drag from the external sector is expected to continue in Q3 with the merchandise trade

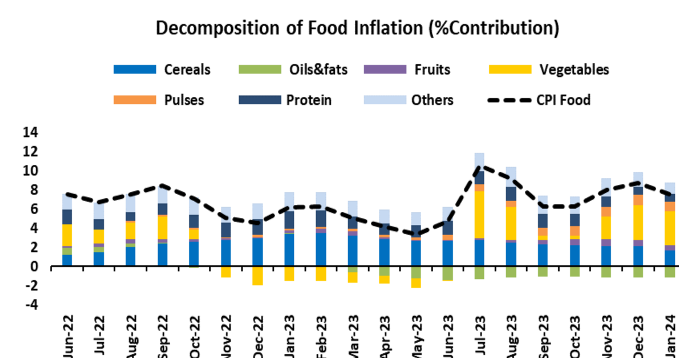
deficit widening to US $70.5 bn from US $63.2 bn in Q2. However, the robust services surplus (US $42 in Q3 vs US $40 in Q2) is likely to contain some widening of the Current Account deficit in the December quarter. Looking ahead, the deficit tends to narrow in the last quarter of the fiscal year. The data from January confirms the same with the merchandise trade deficit narrowing to a nine-month low of US $17.5 bn led by a larger sequential decline in imports compared to exports. The sequential decline in imports could be a sign of slowing consumption growth (needs to be watched) along with moderation in commodity prices. Meanwhile, the sequential deceleration in exports could be a result of the tensions surfacing in the Red Sea on top of the weak global demand. On the other hand, the services surplus remained robust in January owing to continuing strong demand for software and professional services.

Disinflationary trend in the core is intact, but we remain watchful of food inflation

Headline inflation moderated to a three-month low of 5.1% in January from 5.7% in December, aided by the favourable base effect. Food & Beverage inflation eased to 7.6% in January from 8.7% in the previous month but continued to remain elevated. Within the food category, the easing was led by cereals and fruits, while inflation continued to persist in categories like vegetables (27.0%), pulses (19.5%) and spices (16.4%). Though vegetable prices typically fall significantly in the winter months, the seasonal correction in Dec and Jan has been much less, keeping the annualised print much higher than the levels observed historically. A similar pattern is being observed in daily prices for the first week of February as well – which have risen on account of an uptick in tomatoes. Meanwhile, the cereal prices are showing some signs of moderation, due to the increased quantum of wheat sales by the government under the open market sale scheme (OMSS). Indeed, the sale of wheat has almost doubled in the previous three months (Nov-Jan) compared to the Aug-Oct period. Along with the supply-side intervention, the improved Rabi sowing for the cereals (+1.2% YoY) also augurs well for the food inflation. Lastly, there are no signs of easing in the prices of pulses (based on daily data) and the outlook also remains uncertain with Rabi sowing for pulses tracking much lower than the previous year's levels (-3.7% YoY).

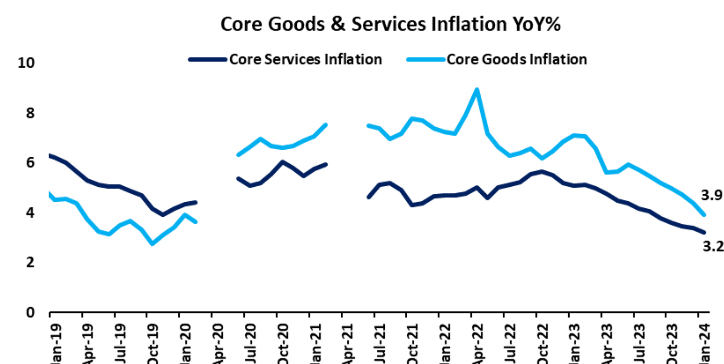
Core inflation on the other hand remained on its downward trajectory, printing at the lowest level (3.6%) noted in the post-pandemic period and underscoring that for a good-sized portion of the domestic economy supply and demand are broadly in balance. Details of the core components reveal that the improvement is largely broad-based across the services and the goods inflation. Core services inflation has declined to 3.2% from 3.4% in December bringing the FYTD average to 3.9% compared to 5.2% in FY23. The easing in services inflation is led by housing, healthcare, recreation, and personal care & effects while there was a slight uptick in education. Core goods inflation printed below 4% for the first time since the pandemic, bringing the FYTD average to 5.2%, down from 6.9% in FY23. This is being supported by softer input prices reflected in the WPI (Wholesale Price Index – Manufactured Goods) remaining in the deflationary territory for the most part of the current fiscal year.

Inflation in some categories of food like vegetables and pulses continues to remain elevated



Source: CMIE; Note: Protein includes eggs, meat and milk.

Core goods and services inflation continues to moderate in January



Source: CMIE; MoSPI

Monetary policy easing not expected before Q2 FY25

From the policy perspective, the latest inflation reading should not have any material implications. Still, elevated food inflationary pressures along with continued easing in the core inflation suggest while underlying price pressures are receding, the risks to the inflation outlook from volatile food prices remain very much alive. Even the Feb policy meeting stressed the need to remain actively disinflationary to prevent generalization of the food price pressures. Further, the growth has also remained solid which has provided space for the RBI to prioritize inflation over growth. Against this backdrop and the RBI's emphasis on aligning

the headline inflation to the target of 4% on a durable basis, we remain of the view that there will be no rate cuts before Q2 FY25. With the US Fed not expected to cut until at least May or June(at the earliest), the RBI opting for a rate cut earlier than that seems highly unlikely and potentially counterproductive. Meanwhile, the central bank will continue to manage the evolving liquidity conditions through two-way fine-tuning operations to keep overnight call rates closer to the policy rate.

Market Update

- **Equity Market**: Indian equity markets were volatile in January owing to the subdued performance of large-cap companies and lack of positive global cues amidst hawkish Fed remarks. This affected investor sentiment negatively. Indeed, the Foreign Institutional Investors (FII's) turned net sellers pulling out Rs 257 bn from the Indian equity market. However, domestic investors continued to support the market thereby keeping the equity indices at a broadly similar level as seen in December. While volatility continued in February, the moderation in the domestic inflation and broadly favourable macro fundamentals aided the investor sentiment. Overall, NIFTY50 was up by 2.3% by February 22nd.

- **Bond Market:** Domestic bond yields cooled off across the maturity spectrum in February after remaining at around 7.2% for the most of January. This was led by multiple factors including the announcement of lower-than-expected market borrowings in the interim budget, lower domestic inflation print, and increased foreign capital inflow in the debt market which offset the impact of the recent uptick in the US treasury yields following the release of inflation data which was above the market estimates. On average, the 10-year benchmark yield softened to 7.08% in February (data till the 22nd). Looking ahead, the movement in the US treasury yield is expected to weigh on the otherwise favourable debt market.

- **Currency Market:** The domestic currency appreciated slightly to trade at an average of 83.11 (USD/INR) in January compared to 83.26 (USD/INR) in December potentially on the back of rising foreign capital inflow in the debt market ahead of India's inclusion in the JP Morgan Index and the central bank intervention, negating the impact of rising crude oil prices and strengthening dollar index. Moving into February the rupee traded in a narrow range (82.9-83.1), as the positive factors including a favourable interim budget, lower trade deficit, and sustained foreign flows in debt segment were offset by a rally in the dollar index following the release of the inflation data. Looking ahead, the foreign investor's interest in the Indian debt market and the recent announcement of India's increased representation in the MSCI Emerging Market Index could help support the rupee. However, any sharp appreciation is unlikely as the central bank will intervene to prevent excessive volatility in the USD/INR pair.

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