26 April 2023

India's growth remains on track; incomplete consumer demand, uncertain weather and external headwinds weigh on the outlook

- Central banks around the world are now in the process of pausing rate increases or intending to be able to pause rate increases with some already having paused. However, it is premature to conclude that the end of the global rate hike cycle is imminent given the inflation backdrop still prevailing today.
- Despite a softer global growth environment, India's economy is likely to have remained resilient in the January-March quarter. Consumer goods demand recovery has been mixed while services demand recovery remains robust.
- We believe that consumer demand in the near term likely will remain resilient. However, factors like incomplete labour market recovery, unpredictable weather conditions, higher inflation and consequently higher interest rates pose risks to the outlook beyond the near term.
- Investment activity is likely to have remained strong in Q4 albeit with some slowdown. We are hopeful that it will remain robust in FY24 owing to the continued push by the government for infrastructure development. The increase in private sector investment announcements bodes well for the future investment outlook.
- Despite an expected improvement in export growth owing to the success of some PLI schemes (electronics, automotive, chemical sectors, etc.), external trade is likely to remain a drag on overall growth in FY24, given India's heavy dependence on imports for oil, machinery, electronics, and industrial raw materials.
- Outlook ahead will also depend crucially on the agriculture sector performance, which will have bearing on the rural demand as well as the path of inflation over FY24. Unfortunately, at this juncture, it is not possible to have clear visibility as to the potential macro effects.
- Defying the market expectations of a 25-bps hike, the RBI in the latest policy meet decided to leave the repo rate unchanged at 6.5%. However, the governor emphasised that it was a pause and not a pivot, not ruling out further rate hikes if the situation so warrants.
- Inflation cooled in March, after remaining above the RBI's upper threshold of 6% for two months. Looking ahead, we expect inflation to ease, supported by a favourable base effect. However, weather conditions and a resurgence of oil prices could cause inflation to rise again.
- From the policy perspective, we remain of the view that the RBI will opt for an extended pause on rates throughout FY24, provided durable disinflation continues. However, further rate hikes could be triggered if inflation surprises dramatically on the upside.

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Desire to pause tightening is emerging with some central banks already having paused…

Following the swift pace of monetary tightening in many of the world's largest economies in the past 9 to 18 months, central banks around the world are now in the process of pausing rate increases or intending to be able to pause rate increases. Central banks in some large economies – India, Australia, Canada – refrained from hiking interest rates at their most recent central bank policy meeting. Other major central banks – such as those in the United States, United Kingdom, Europe – have hinted at a desire to take a pause from hiking rates at each policy meeting in the not-too-distant future.

Australia, Canada, and India have paused hikes

	Policy Rate (%)						Cumulative Hikes since Jan 2022 (bps)	Inflation (deviation from target)
	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23		
US	4.00	4.50	4.50	4.75	5.00	5.00	475	5.0 (+3.0)
China	3.65	3.65	3.65	3.65	3.65	3.65	-5	0.7 (-2.3)
EU	2.00	2.50	2.50	3.00	3.50	3.50	350	6.9 (+4.9)
Japan	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0	3.2 (+1.2)
UK	3.00	3.50	3.50	4.00	4.25	4.25	400	10.1 (+8.1)
Australia	2.85	3.10	3.10	3.35	3.60	3.60	350	6.8 (+4.3)
Canada	3.75	4.25	4.50	4.50	4.50	4.50	425	4.3 (+2.3)
India	5.90	6.25	6.25	6.50	6.50	6.50	250	5.7 (+1.7)

Source: US Federal Reserve, People's Bank of China, European Central Bank, Bank of Japan, Bank of England, Reserve Bank of Australia, Bank of Canada, Reserve Bank of India; Note: Latest available monthly inflation data.

The pause or desire to pause interest rate increases reflects multiple factors, some of which central bankers view as the direct and desired by-product of their aggressive monetary tightening campaign of the past 9 to 18 months.

First, the pace of real economic growth (except China which is a unique case due to its long-lasting and recently ended Zero-COVID policy) had moderated from the robust, generally well above trend growth rates of 2021 and part of 2022. The degree of moderation in growth varies substantially across countries with growth in India, for instance, moderating considerably less than growth in the US or Canada. Moreover, on both an inter- and intra-country basis, the moderation in growth is hardly distributed evenly across sectors. The most cyclically sensitive sectors such as housing, and other big-ticket purchases, and also manufacturing have cooled significantly, more so than services-related parts of the economy. Nonetheless, the moderation in the overall pace of aggregate demand nearly everywhere is providing monetary policymakers increasing confidence that demand-driven pressures on resources – be they goods, services, labour – have peaked on an economy-wide basis.

Second, supply disruptions have abated. Such disruptions took many forms in recent years. Nearly every country had some degree of supply disruption in the labour market, owing to employer/employee mismatch due to the fractured nature of economic reopening due to COVID and select workers being unwilling to work due to health concerns. Those disruptions have vanished, judging by prime age labour force participation rates being back near their pre-pandemic levels, wage growth in the past six months no longer accelerating to the upside and various industry reports. Separately but related, China's abandonment of its Zero-COVID policy has been key in alleviating numerous production bottlenecks in the global supply chain. Together, abating supply disruptions and shortages are also providing monetary policymakers confidence that the worst of this cycle's price pressures likely is in the past.

Third, relative prices of labour (wages and income) and goods and services (finished prices) have moderated from their peak rates of increase. On the inflation front, this is the case for both headline and core (ex-food and energy) price indexes. While inflation measures remain far too high currently for even the most optimistic monetary policy official to declare confidently that inflation stability has been restored and/or that the underlying inflation rate will be back to its desired target rate in the next 12 to 15 months, such measures have eased from the highs and are lagging indicators. It is this lagging nature combined with the moderation in economic growth and normalized supply side that is leading policymakers to conclude that a pause is, or is on the verge of being, appropriate monetary policy.

Fourth, there is an expectation – one that we share, at least directionally – that recent financial sector turbulence in the United States and Europe will result in a more challenging credit environment that will have the de facto effect of additional interest rate increases beyond those delivered by the central bank. On this score, there are some early signals that this is indeed the case. In the United States, there has been a reallocation of bank deposits from smaller and mid-sized banks to money market accounts, the big New York City banks and to some extent the largest regional banks, while in Canada and the UK, bank credit is pulling back.

…However, it is premature to conclude that the end of the global rate hike cycle is imminent

We are less confident that the aforementioned developments alone – that is, absent additional monetary tightening – will prove to be sufficient to squash prevailing inflationary trends in much of the global economy. Central banks have lifted policy interest rates to elevated levels in

many countries by the standards of the past 15 to 20 years and inflation is a lagging indicator so taking some time to evaluate the monetary policy's effect on the key inputs to inflation and inflation itself may very well be prudent in select circumstances.

But the prevailing global monetary tightening campaign has some important nuances versus the bulk of tightening campaigns in the past 30 to 35 years since the current policy tightening is taking place quite early in a new business expansion. Such a stage of the business cycle typically has few(er) imbalances – in both the real economy and the financial economy – than later in the cycle when balance sheets tend to have become more levered, cash flow more challenged and misallocation of capital more prevalent. Fewer imbalances imply sturdier economic underpinnings, which in turn likely means interest rates need to be higher to achieve the desired policy effect.

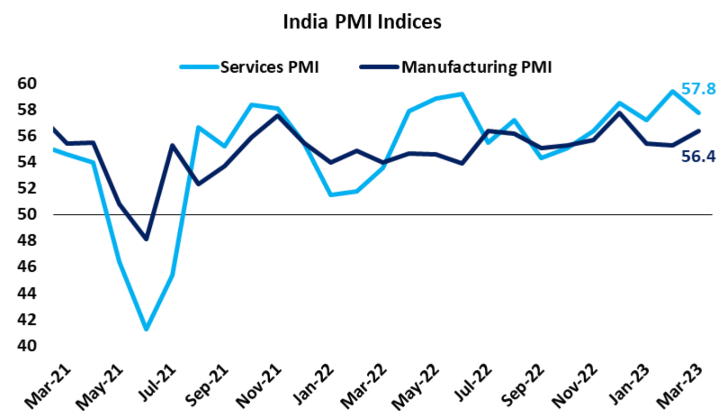
Moreover, the current cycle is the first in multiple decades where the rate of services inflation has inflected meaningfully higher. The services sector is affected indirectly by higher interest rates and thereby tends to respond when rates reach a quite elevated level vis-à-vis underlying macro-conditions. At present, there only are fleeting signs of broad services sector weakening in many economies, which is not to imply conditions won't weaken but rather that additional tightening in conditions likely still is necessary.

As a result, it is our judgement that it is premature to conclude that the end of the global rate hiking cycle is imminent. Additional central banks may signal either explicitly or implicitly that they intend to pause monetary tightening later this quarter. But unless labour markets start in relatively short order to loosen visibly, thereby providing a clear signal of less spending power for the services sector, we suspect that pauses in many countries will prove to be short lived or an unattainable hope given the inflation backdrop still prevailing today.

Despite a softer global growth environment, India's economy is likely to have remained resilient in the January-March quarter

Amidst a slowing global economy, the Indian economy continues to exhibit resilience despite some slowness noted in few of the high frequency indicators. We remain optimistic about domestic growth in both absolute terms and vis-à-vis peer economies. Forward-looking data such as RBI surveys for infrastructure and the services sector remain in highly optimistic territory, consistent with continued solid economic growth in the near term. Potential downside risks to India's outlook include protracted geopolitical tensions, uncertain weather conditions and resurgent global financial market volatility.

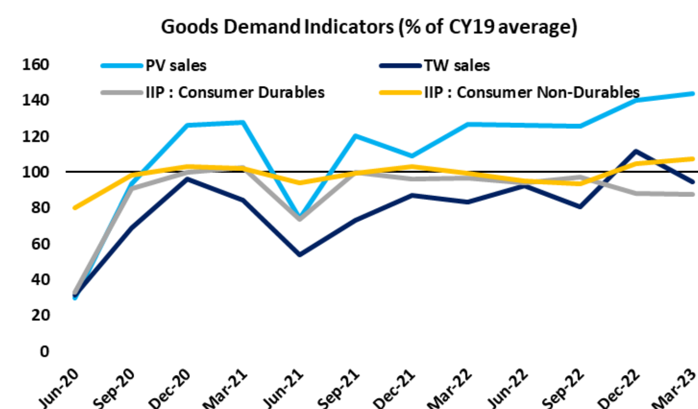
PMIs have remained in the highly optimistic territory



Source: S&P Global

Consumer demand indicators in Q4 FY23 presented a mixed picture although overall assessment still leans towards improvement. Passenger vehicle and two-wheeler sales continued to grow handsomely which is a positive indication for both urban and rural demand. Meanwhile, consumer durables contracted potentially reflecting the shift in consumption pattern from goods to services and also potentially the effect of RBI policy tightening. However, the non-durables (proxy for rural demand) have improved reflecting nascent signs of recovery in rural demand. Overall, as per the use-based classification of the IIP, the consumption related indicators continue to lag the investment related indicators suggesting that consumer demand for goods is yet to fully recover.

Consumer demand for goods has been mixed



Source: CMIE; Note: Mar-23 quarter data for IIP is based on Jan-Feb average

However, services demand indicators have remained strong. Domestic air passenger traffic growth has picked up sharply in Q4 FY23 and remains above pre-pandemic levels. Furthermore, demand appears to be robust for trade services, as commercial vehicle sales (a proxy for consumer spending on trade services) in Q4 surpassed their pre-pandemic levels for the first time. Continued strong growth in GST E-Way bills also bodes well for demand for trade

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Services Demand Indicators												
	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Domestic Air Passengers ^	6.4	25.0	53.4	65.9	30.1	52.2	86.3	70.3	92.3	85.7	102.2	107.0
CV Sales ^	17.3	45.2	65.6	79.0	44.1	68.0	71.8	86.9	89.4	90.1	95.6	110.1
GST E-way Bills *	-46.1	-0.4	15.1	27.9	97.9	27.5	10.8	9.2	45.6	20.1	17.2	18.1
Non-food credit *	6.0	5.1	6.6	5.5	4.9	6.8	8.3	8.7	13.7	15.7	15.3	15.9
Bank Deposits *	9.6	10.5	10.8	11.4	9.8	9.4	12.1	8.9	8.6	12.5	9.2	9.6
Life Insurance First year Premium ^	73.8	112.8	99.2	130.5	78.9	118.6	109.6	163.1	110.2	162.0	130.5	110.5

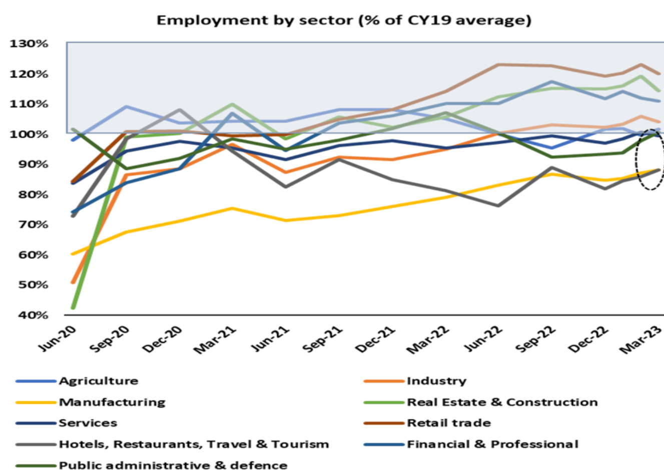
*Source: CMIE; Note: ^ % of CY19 average. * % YoY change. Credit and deposit data is until Feb-23*

services. As far as financial services are concerned, growth in bank credit, a pickup in deposits growth, and growth in life and non-life insurance premium (annually) are indicative of robust demand for banking and insurance services.

Given the performance of the above mix of indicators, we believe that consumer demand in the immediate near term likely will remain resilient. This view is reaffirmed by the future expectations index of the RBI consumer confidence survey remaining in an optimistic territory in its latest round.

Nonetheless, the outlook is not without risks beyond the near term. First, an incomplete recovery of the labour market is bound to inhibit the growth of consumer demand beyond a certain point. Indeed, employment in sectors such as manufacturing and hospitality is still lagging pre-COVID levels by ~12% even though overall employment levels have recovered to pre-COVID levels. Second, despite recent improvement in rural demand it continues to lag urban demand and will be impacted further if weather conditions turn unfavourable. Currently, there are mixed views about the normalcy of monsoon. While the Indian Meteorological Department (IMD) expects a normal monsoon this year, some other agencies have predicted a below normal monsoon owing to a strong probability of El Niño conditions developing over the second half of the monsoon season. And finally, high inflation and consequently higher interest rates are likely to continue to trickle down and impact consumption over the next financial year.

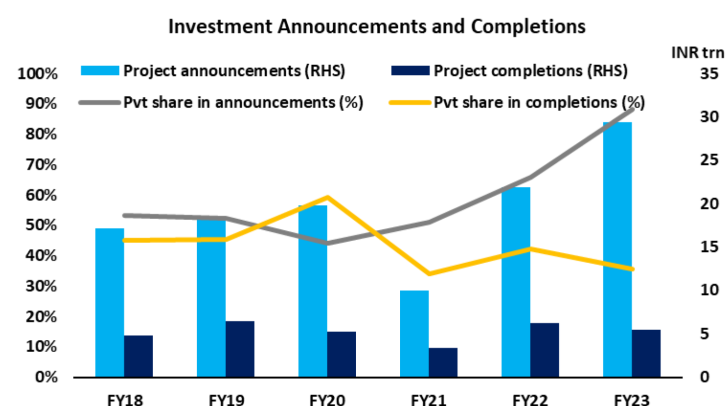
Incomplete employment recovery in select sectors is one of the key risks to robustness of consumer demand



Source: CMIE

Investment was the main driver of growth in Q3 and is likely to have remained so in Q4 albeit with some slowdown. This is mostly driven by government CAPEX, as private investment remains subdued. Indeed, according to the revised estimates for FY23, government CAPEX is estimated to have grown by 18.5% YoY in Q4 FY23, and by 22.8% YoY for the full year. As such cement production and steel consumption continued to grow at a robust pace in Q4. The weak investment activity in the private sector was confirmed by CMIE's CAPEX data. In Q4, the private sector's share of the total investment projects completed was merely 31%, with the government sector accounting for the rest. For FY23, the private sector accounted for 36% of total investment projects completed. This is in comparison to a pre-COVID three-year average of 50%. Non-oil and non-gold-and-silver imports also slowed in Q4, contracting by 4.5% YoY in Q4 pointing to slowing investment in machinery and equipment.

Private sector completions are low, but announcements picked up



Source: CMIE

Still, we are hopeful that investment activity will remain strong in FY24. With an ambitious CAPEX target for a third year in a row, the government is expected to remain steadfast in its plans to push infrastructure development in FY24 to support economic growth. Production of capital and infrastructure and construction goods has remained resilient indicating continued demand for CAPEX-related equipment. Moreover, government-led infrastructure projects have the capacity to boost the economy's medium- to long-term productive capacity, thereby proving both short- and medium-term positive economic effects. While private

investment has failed to pick up meaningfully until now, a 35% increase in investment announcements in FY23, with the private sector accounting for almost 90% of these, bodes well for future investment outlook. According to the RBI, capacity utilisation at manufacturing firms in Q3 FY23 was at 74.3% (above its long-run average of 73.7% for a second consecutive quarter), which again is a positive sign for investment growth in FY24.

With a moderating global economic backdrop, net trade continues to be a drag on headline economic growth although the degree of drag likely moderated in Q4. The latest data show a narrower merchandise trade deficit, while the services trade surplus continued to widen. Looking ahead, progress on PLI-schemes especially in the electronics, automotive and chemical industries is expected to support export growth over FY24. Meanwhile, dependence on imports for oil, machinery, electronics, and industrial raw materials is likely to keep the import bill elevated. Overall, we expect the drag from trade on headline growth to remain as demand for imports (owing to strong domestic growth prospects) is likely to outstrip demand for exports (owing to slower global growth).

Weather-related risks for agriculture sector are high

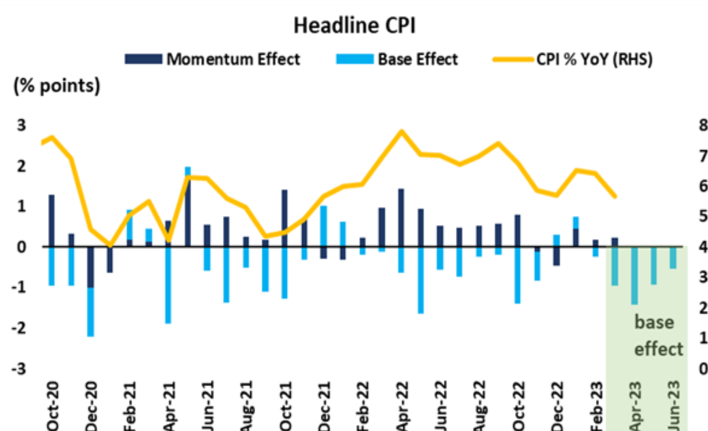
Outlook ahead will also depend crucially on the agriculture sector performance, which will have bearing on the rural demand as well as the path of inflation over FY24. Unexpected rains during late March have raised concerns about crop damage and Rabi crop output being affected. This could impact rural incomes and further inhibit rural consumption recovery. Lower agricultural output could also lead to a return in food price pressures which were responsible for the spike in inflation in January-February (food inflation moderated sharply in March). Looking ahead (as already mentioned before) risks to this sector will remain owing to unpredictable monsoon conditions, which is the main determinant of the success of the Kharif agricultural season. This is an area we are monitoring closely although, unfortunately, at this juncture it is not possible to have clear visibility as to the potential macro effects.

The MPC decided to take a pause after six consecutive rate hikes leaving the repo rate unchanged at 6.5%

Defying the market expectations of a 25-bps hike, the RBI in the latest policy meet decided to press a pause leaving the repo rate unchanged at 6.5%. The decision to pause was driven by the rising financial stability concerns on the global front amidst the failure of multiple regional banks in the US, tightening of the financial condition and the desire to assess the cumulative impact of past rate hikes on the growth and inflation outlook. Interestingly enough, the decision to take a pause was unanimous compared to the last meeting (in February) where in only two members were in the favour of a pause. However, the governor stated that the pause was only for this meeting and RBI remains ready to act if the situation warrants, not ruling out further rate hikes if required. The MPC also decided by a majority of 5 out of 6 members to remain "focused on the withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth", providing the RBI with the policy space to act if inflation does not decline on a durable basis.

The April policy meeting provided additional insights behind the "wait-and-watch" approach adopted by the central bank in its latest meeting. Firstly, the MPC is of the view that there is a need to assess the cumulative impact of the previous rate hikes. The weighted average call rate is already up by 320 bps in response to a 250-bps hike in the repo rate, the effect of which is yet to be fully realised. Secondly, some members noted although India's growth remains resilient there are nascent signs of moderation in high-frequency indicators including non-oil, non-gold imports, bank credit growth etc. In this context Dr. Ashima Goyal highlighted that the impact of monetary policy tightening on output is 2-3 times greater than that on inflation. Thirdly, as per Dr. Rajiv Ranjan some softening in the core CPI has been observed in February with month-on-month seasonally adjusted annualised rate (SAAR) slowing down to 5% (from 6% in December 2022). This could have provided the RBI with some policy space to opt for a pause in the last meeting. Lastly, a few members also discussed the real interest rate and were of the view that real interest rates are appropriate to bring down inflation progressively to its target of 4%. Further, the real interest rates are expected to increase further based on the inflation projections of the RBI, hence no policy action may be required by the MPC.

Inflation falls below 6% threshold in March; base effect likely to support inflation in next few months



Source: CMIE

However, the members also cautioned on the upside risk to inflation largely emanating from the supply side shocks

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including the recent announcement by the OPEC+ group to cut oil production leading to an increase in oil prices and weak monsoon which could lead to a spike in food prices again. Hence, as per the central bank the war against inflation is not yet over, and declaring an end to the monetary policy tightening would be premature.

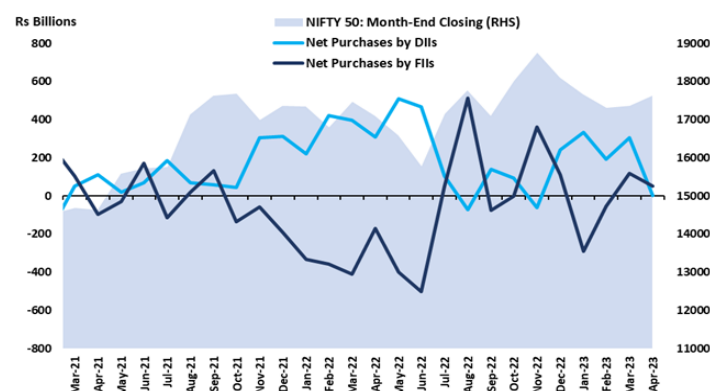
Giving some comfort to the RBI's latest decision, the recent inflation print does indicate a moderation in price pressures though it is primarily driven by the base effect which is expected to be favourable for the next few months. After remaining above the RBI's upper threshold of 6% for two consecutive months, the headline inflation eased to 5.7% in March. This was its lowest reading in the past 15 months. The moderation in headline CPI is primarily led by the softening of food & beverages inflation (to 5.1% YoY from 6.3% YoY in the prior month) supported by lower vegetable prices. Meanwhile, encouragingly core inflation also eased to 5.9% (from 6.2% previously) on the back of moderation in all components barring health and housing. Going ahead, we expect inflation to ease, supported by a favourable base effect, however the risks from the possibility of El Nino conditions and resurgence of oil prices following the production cut announcement by the OPEC+ remain. From the policy perspective, the recent decline in inflation does strengthen our baseline view of RBI opting for an extended pause throughout FY24. However, further rate hikes could be triggered if inflation surprises dramatically on the upside.

Market Performance

Indian equity markets largely remained flat in March after three consecutive months of decline as the benchmark indices – NIFTY50 was up by 0.3%, while SENSEX increased by a mere 0.05%. Despite the spillovers from the banking turmoil in the US and Europe, the equity markets in India managed to close in green as the losses in the first three weeks of March were offset in the last week. While domestic investors continued to support the market (with net inflows of Rs 192 bn), the foreign institutional investors turned net buyers to the tune of Rs 118 bn after two months of a selling streak. Overall, Indian equity markets have remained resilient compared to their counterparts amidst the financial market volatility. The upward momentum noted in the last week of March continued in first half of April with the NIFTY50 index posting gains of 1.5% (data as of 21st April) on the back of sustained FII inflows and the optimism on the Indian economic growth. However, the market continues to remain volatile amidst the mixed corporate earnings results in Q4 FY23 and global uncertainty.

In the foreign exchange market, the Indian rupee strengthened a bit against the US dollar in March-April but continued to remain volatile on most days amidst the rising uncertainty in the global financial market. The USD/INR appreciated marginally by 0.3% in March to average 82.3 compared to an average of 82.6 in the previous month amidst the return of foreign investors in Indian equity markets and falling global crude oil prices. Indeed, the average crude oil prices have retreated below the US$80 mark for the first time since the onset of the war to ~US $79/bbl in March from ~US $84/bbl in February. Moving into April, the domestic currency continued to gain strength on the back of the weakening dollar as a series of weak economic data fueled the expectation of a pause in the rate hike cycle and sustained capital inflows from foreign investors as the risk-on sentiment returned. However, the gains of the rupee were limited due to the resurgence of Brent prices as the OPEC+ group announced a surprise cut in oil production starting May. As such, the Indian currency on average appreciated marginally by 0.3% in April (data till 21st April) while the dollar index declined by 1.8% during the same time. Looking ahead, the softening dollar index, sustained FIIs inflows, and lower current account deficit is likely to provide appreciatory bias to the rupee; however we do not rule out the downside risks from rising oil prices and resurgence of risk-off sentiment if the uncertainty at the global front heightens.

Equity markets remained flat in March; FIIs flows continue despite global financial market volatility



Source: CMIE

Bond markets observed some easing of pressure over the past month. The yields declined in the second half of March tracking the decline in the US treasury yields because of the regional banking crisis. Additionally, the coincidental decline in oil prices also provided some respite to the bond market. Accordingly, the 10-year yield dropped from its three-month peak of 7.43% on 8th March to 7.31% at the end of March. However, the shorter end of the curve continued to remain under pressure with the tightening of the liquidity conditions and an expectation of a rate hike by the RBI. As such, the average 2-year benchmark yields rose by ~12 bps to 7.24% in March. With sharper increases in short term rates the 10-year-2-year spread narrowed from 24 bps in February to 12 bps in March. In April, the 10-year yields declined even more dramatically to 7.2% (7 bps decline from the previous

closing) on 7th April following an unexpected pause in the RBI meeting. Since then, the yields have largely remained range bound with positive factors including lower inflation and expectation of continued pause by the RBI being counterbalanced with the rising yields due to hawkish remarks of FOMC members and rising crude oil prices.

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