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Global central banks to ease policy in 2024; Indian economic activity remains solid; RBI to keep liquidity tight to keep inflation in check

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- Global central banks are increasingly signalling that they see the battle against inflation as nearly over and that their policy bias is shifting toward lowering rates in 2024 to try to ensure continued economic expansion.
- The pace of policy normalization by some central banks, notably the US Fed and the Bank of Canada, seems to be abrupt given the still elevated core inflation and the asymmetric risks that persistently elevated inflation poses to medium-term economic performance.
- While we share the qualitative judgement that interest rates are headed lower in 2024, the move across central banks will be asynchronous, irregular, and will begin later than forward interest rate markets currently predict.
- Indian economic growth was solid in Q2 FY24 as real GDP grew by 7.6% YoY, buoyed by investment and government consumption as private consumption slowed and the drag from the external sector continued.
- High-frequency indicators for October-November suggest a strong start to Q3 FY24. We expect consumption growth to have improved in Q3, driven by festive season demand, while investment activity is likely to have remained strong.
- Meanwhile, external trade likely continued to exert a drag on GDP growth. Downside risks to the outlook persist from the weaker agricultural output and elevated food inflation dampening the consumption growth, and slowing global demand.
- Consumer price inflation accelerated in November to a three-month high of 5.6% YoY led by a pickup in food prices along with the adverse base effect. Meanwhile, core inflation continues its downward trajectory with some data puzzles surrounding the housing inflation component which we expect to correct in the coming months.
- From the policy standpoint, the RBI is expected to look past the transient surge in inflation owing to food prices and is expected to maintain the status quo in the next policy meeting. Moreover, the inflation is expected to remain above 5% till Q1 FY25 as per the central bank's latest projections. Hence, a change in stance at this juncture seems unlikely.
- The focus of the policy meeting will remain on keeping liquidity tight to prevent the generalization of price pressures.

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Policy bias seen shifting toward lowering rates in 2024

Interest rates throughout much of the global economy are headed lower in 2024, although the extent and pace of decline are highly uncertain. Two years on from the start of the most pronounced monetary tightening the global economy had experienced in decades, central banks' policy is in the process of pivoting. Explicitly – such as via forward interest rate guidance – and/or implicitly – such as via economic forecasts – central banks increasingly are signalling that they see the battle against inflation as nearly over and that their policy bias is shifting toward lowering rates in 2024 to try to ensure continued economic expansion.

The speed of this policy pivot by some central banks – most notably the US Federal Reserve (the Fed) and the Bank of Canada (BOC) – has been abrupt. For instance, in early December, Fed Chair Jerome Powell in public remarks emphasized that US interest rates were likely to remain elevated for some time, as core inflation was expected to persist at high levels in the period ahead. Roughly two weeks later at the Fed's December policy meeting, US officials debuted a new policy statement hinting at a more balanced risk assessment toward inflation, projected 75 bps of rate cuts in 2024, and the Chair himself during his press conference endorsed wholeheartedly that interest rates were likely to decline in 2024. To be sure, there were caveats about continued favourable progress on inflation, but that continued favourable progress often was characterised as close to a fait accompli.

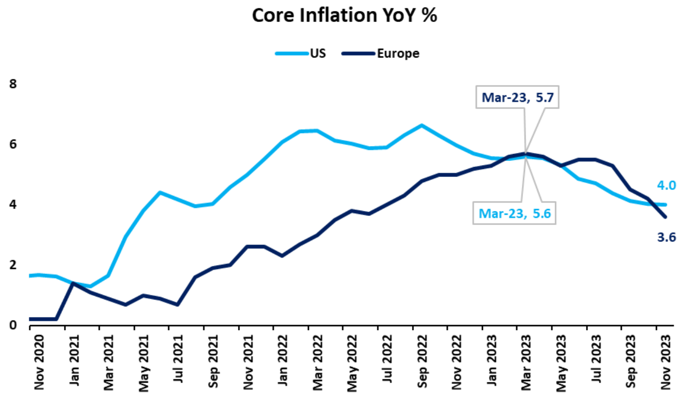
Other large central banks such as the European Central Bank (ECB) have not spoken openly about the prospect of lower interest rates in 2024 ala the Fed/BOC but their latest economic forecasts signal a reasonably high probability of lower rates in the year ahead. ECB officials project a second consecutive calendar year of solidly below-trend GDP growth (0.8% in 2024) at a time when core inflation has moderated by 200 bps since spring to 3.6% in November. The Bank of England (BOE) in its public comments has been resolute about interest rates staying 'higher for longer' but the latest inflation data in the UK show inflation moderating in a manner somewhat similar to the European Continent. Indeed, the UK's core inflation on a year-on-year basis also has cooled by 200 bps since spring, including a 60 bps deceleration in November versus October.

Pace of disinflation over H2 CY23 has been impressive and quicker than expected

Twelve-month trailing inflation rates in the mid-3% range or thereabouts are not uncommon in many major economies and represent a marked improvement from year-on-year inflation rates in the 5-6% range at the start of 2023. Such rates of core inflation still are too high and given the asymmetric risks that persistently elevated inflation poses to medium-term economic performance, we are surprised at the magnitude of the policy guidance pivot by select central banks. Moreover, the limited disinflation in services sector inflation and the ongoing run-rate of services sector inflation throughout much of the world is a reason for scepticism that recent months' pace of disinflation will continue apace in the months immediately ahead.

Nonetheless, the degree of disinflation in the past six months has been impressive, far outstripping what both we and the consensus envisioned, and many monetary policymakers seem increasingly convinced that core inflation will continue to moderate in 2024 with monetary policy adjusting accordingly.

Core inflation in the US and Europe has moderated more than 200 bps from their respective peaks



Source: Bloomberg

While interest rates are likely headed lower in the year ahead in many economies, we are quite confident that the move will be asynchronous, irregular and will begin later than forward interest rate markets currently predict.

- **Asynchronous:** In the past four years, the pace of economic activity – including inflation developments – has become less synchronous across major economies than in the 20 years prior to the COVID-19 shock. This reflects a combination of factors, including disparate domestic economic responses to the initial COVID shock and inflation's surge, differences in exposure to fractured global supply chains, and an economy's flexibility and dynamism. As a result, business cycles are not as tightly correlated across economies as they were, which should result in interest rate cycles that also are less correlated.
- **Irregular:** The overarching pattern of monetary easing cycles in the past 25 years has been for rates to decline steadily and by more than generally anticipated. However, those periods were characterised by inflation

rates lower than prevailing currently and labour markets less tight than prevailing currently. As a result, there was a limited risk of an "inflation mistake" from lower interest rates. Such is not the situation at present. Accordingly, interest rate reductions will be more about trying to fine-tune monetary policy. This in turn is likely to result in policymakers trying to feel their way along so that policy is neither too tight – thereby risking recession – nor too easy – thereby risking a reacceleration in price pressures. Such calibration is challenging in the best of times, even more so with inflation at prevailing rates.

- **Later Start Date:** In our assessment, few, if any, central banks will begin lowering interest rates as soon as March 2024, which is the timeline currently priced in to forward interest rate markets. Even with confidence rising among central bankers that inflation will continue to moderate toward desired/targeted levels, spot inflation still is solidly above such levels and policymakers are, by their nature, cautious. Rate reductions as soon as March also likely would – at a minimum – validate market pricing of 125 bps to 150 bps of cuts in most advanced economies and – potentially – lead markets to price in even more rate reductions. Absent a recessionary macro setting, fundamentals do not support such a rapid and sizable decline in rates.

Economic developments in recent years have been unexpected, to say the least. From the public health induced sudden stop in global economic activity nearly four years ago to (in some countries) the most pronounced pro-growth economic policy on record to the breakdown in global supply chains and disruptions to domestic labour markets to the rapid surge in inflation and the (eventual) rapid tightening in monetary policy, the unexpected has been the norm.

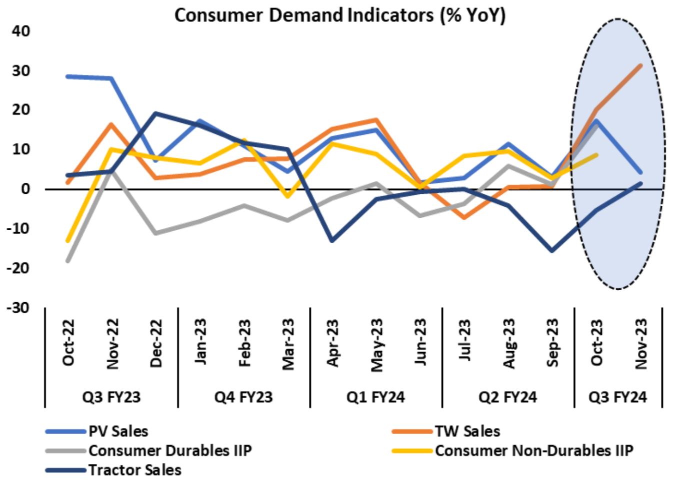
As calendar year 2024 is poised to begin, the widespread expectation is that interest rates will decline throughout much of the global economy. We share that qualitative judgment but are confident that the mid-1990s to 2020 experience of rapid declines in interest rates, once the rate cycle has commenced, is not the appropriate analog for the year ahead. This cycle likely will be more circuitous rather than a straight line and the to-date stickiness in service sector inflation is a potential buffer to lower rates.

India's economy outperformed expectations in Q2; outlook positive for the remainder of FY24

India's economy remains on a favourable overall trajectory despite the mix of challenging international macro developments. Indian economic growth was solid in July-September 2023 (Q2 FY24) as it grew by 7.6% YoY, way above market estimates, which predicted growth to come in at 6.8% (consensus estimate). Activity in Q2 was primarily led by investment and government consumption as private consumption slowed and the drag from the external sector continued. The continued strong pace of growth underscores the resilience of the domestic economy in the face of slowing global economic growth.

Private consumption growth slowed to 3.1% YoY in Q2 from 6% in the prior quarter owing to the waning of the favourable base effect. Growth in this component was supported by the continued strong urban demand while the rural demand slowed due to the uneven monsoon. Early signals from indicators of consumer demand generally point to an improvement in the pace of private consumption in Q3 FY24 buoyed by the festive season. Automobile sales in October-November were strong as the festive season and related offers boosted demand. Two-wheeler sales growth was much more impressive, suggesting some improvement in rural demand. Even tractor sales showed growth in November after remaining in the red for the previous seven consecutive months. IIP consumer durables and non-durables growth also jumped in October, although this is partly owing to an unfavourable base effect due to a shift in the festive month. Usually, IIP growth suffers around Diwali as a loss in the number of working days impacts overall production. November-December IIP data would give a more complete picture of whether the improvement in consumer demand indicators has been sustained, or whether October was just a one-off positive data point.

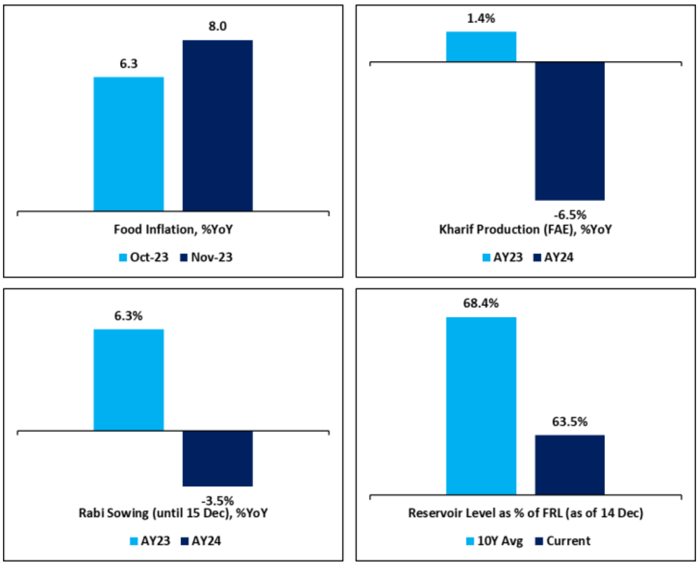
Oct-Nov data points to an improvement in the pace of consumption…



Source: CMIE

While we expect consumption growth to have improved in Q3, risks to consumption growth are posed by a resurgence in food inflation in November driven by the seasonal spike in vegetable prices. Although we expect such pressures to be temporary, there is a risk that persistently high food inflation could spill over into other categories and dampen overall consumption growth. Additionally, the underwhelming performance of the agricultural sector could exert a further drag on consumption. Kharif crop production (foodgrains plus oilseeds) is estimated to be lower by ~6.5% YoY. As of the latest data, Rabi sowing is tracking ~3.5% lower (as of December 15th). Lower agricultural production could adversely affect rural incomes and thereby consumption.

…but elevated food price inflation and poor agriculture performance pose risks to consumption



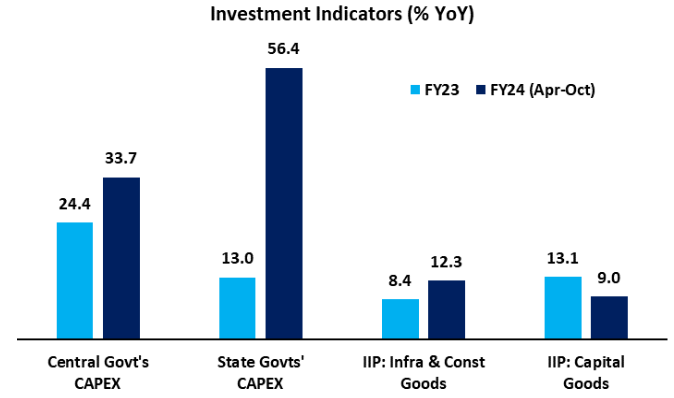
Source: CMIE; Note: FAE - First Advance Estimate, AY - Agricultural Year as notified by the govt, FRL - Full Reservoir Level. AY24 Kharif production is based on first advance estimates.

Investment activity remains buoyant supported by government CAPEX and the Real Estate Sector

Investment was the main driver of GDP growth in Q2, and we expect it to remain strong in H2 FY24. CAPEX has been a key driver of economic growth in recent years and we expect that investment outlays – especially those by the central and state governments – will continue to do the heavy lifting in this regard. In the first seven months of the FY24, central government capital expenditure grew by ~34% YoY while the state governments' capex increased by ~56%. As the general elections approach, it will be in the governments' interest to deliver flagship infrastructure projects, which will ensure that focus on CAPEX remains. That said, some tempering in the rate of growth could be seen in H2 FY24 as both states and the central government had frontloaded CAPEX in H1. Furthermore, the continuing strong demand in the real estate sector is likely to support investment as well. In Q2 FY24, housing unit sales in the top seven metropolitan cities grew by 36% YoY to ~1.2 lakh units, according to a report by Anarock Property Consultants. Early indicators of investment activity for Q3 point to a resilient pace of investment growth.

Although private investment has failed to pick up meaningfully until now, conditions for a private sector investment revival are ripe given healthy corporate profits and balance sheets, high capacity utilization, and healthy FII flows into the Indian capital markets. In the medium term, private investment will need to pick up if investment momentum is to be sustained. A weak global growth environment, elevated cost of credit and still high rate of inflation (although the disinflationary trend seems to be intact) could inhibit investment growth beyond the immediate near term.

Investment activity has picked up in FY24, but mostly public sector-driven

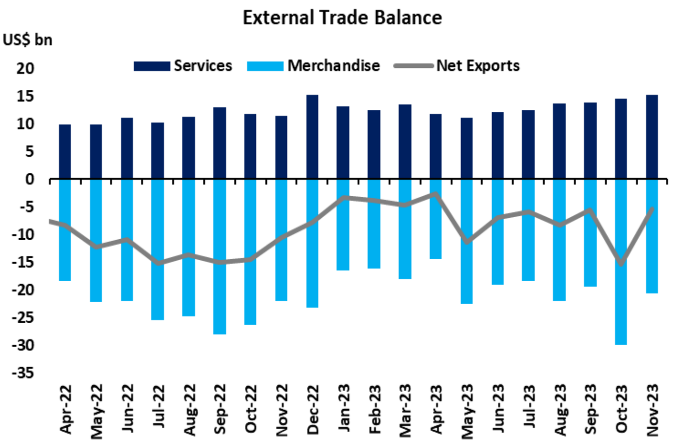


Source: CMIE

External trade will remain a drag on growth

Lower oil prices along with healthy growth in services exports have helped improve India's net trade balance. Indeed, in the first 8 months of FY24 (the latest available data is until Nov 2023), the net goods and services trade deficit narrowed to ~US$ 60 billion, compared with ~US$ 100 billion during the same period one year ago. However, we expect net exports to remain a drag on GDP growth in the remainder of FY24. India has benefited from a lower commodity price environment over the past couple of quarters which has allowed narrowing of the trade deficit in nominal terms. But in real terms, the trade deficit continues to widen and pull GDP growth down.

Trade deficit in nominal terms has narrowed in FY24



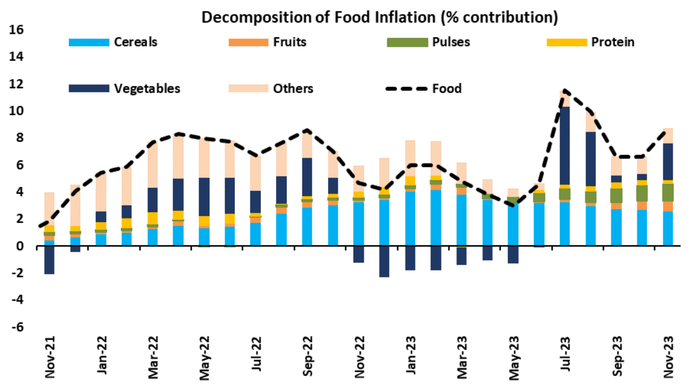
Source: CMIE

Overall, we expect GDP growth in India to remain solid in the remainder of the fiscal year albeit with some moderation in the rate of growth. Growth will be underpinned by continued government push on infrastructure-led development and investment and resilient consumer demand. Given the country's dependence on imports for its energy and infrastructure development needs, external trade is likely to remain a drag on headline growth for the foreseeable future.

Headline inflation printed to a three-month high owing to volatile food prices

In line with our expectations, headline inflation accelerated to a three-month high of 5.6% in November from 4.9% in October. It averaged 5.2% YoY in the last two months, sitting below the RBI's forecast of 5.6% for Q3 FY24. The rise in headline inflation is primarily led by a pickup in food prices along with an adverse base effect. Food & beverage inflation quickened to 8.0% in November up from 6.3% in October due to a resurgence in the vegetable price along with the persistence of broad-based pressures in other food items. More than half of the food basket - by weight - continues to record inflation above 6% led by cereals (10.3%), vegetables (17.7%), fruits (11.0%), spices (21.5%) and pulses (20.2%).

Food inflation quickened due to vegetable prices while pressures remained in other components



Source: CMIE; Note: Protein includes Meat, Fish and Egg. Other categories include spices, sugar etc.

Looking ahead, vegetable prices are tracking lower, (predominantly onion which has led to a pick-up in Nov) in the first two weeks of December due to improved supply, however, the extent of seasonal moderation is less than what has been observed in the past. Furthermore, the prices of cereals and pulses are also showing some moderation. However, upside risks to food inflation from lower reservoir levels (potentially impacting Rabi sowing and production) and the extent of the drop in Kharif grains production need to be watched. Based on the first advance estimates, the Kharif foodgrain output is estimated to be 4.6% below last year's level. If the final production remains closer to the current projection, it will exert upward pressure on food prices.

Core inflation, on the other hand, continues to decline for a fifth consecutive month to 4.1 % in November, posting yet another lowest level in the post-pandemic period. The only component which currently is tracking above the 6% threshold is the personal care and effects (7.8%) – where the decline in other sub-components was offset by the rising gold prices. Another component in core inflation that requires special mention is the housing inflation which has continued to moderate, despite the private surveys suggesting continued strong demand. This could potentially be corrected in the upcoming months and could weigh on the core services inflation. Having said that, core inflation should still track closer to the target of 4% for the remainder of the fiscal year.

Core inflation posted its lowest level since the onset of the pandemic

CPI Inflation, YoY%									
Sub-groups	Weights	Pre-COVID average*	Apr-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23
CPI (headline)	100.0	4.2	4.7	4.9	7.4	6.8	5.0	4.9	5.6
CPI-Urban		4.2	4.9	5.0	7.2	6.6	4.7	4.6	5.3
CPI- Rural		4.3	4.7	4.8	7.6	7.0	5.3	5.1	5.8
Core-CPI	54.1	4.8	5.3	5.1	5.0	4.9	4.5	4.3	4.1
Food and beverages	45.9	3.7	4.2	4.7	10.6	9.2	6.3	6.3	8.0
Pan, tobacco and intoxicants	2.4	6.7	3.5	3.7	3.9	4.1	3.9	3.9	3.8
Clothing & footwear	6.5	4.3	7.5	6.1	5.6	5.2	4.6	4.3	3.9
Housing	10.1	5.6	4.9	4.6	4.5	4.4	4.0	3.8	3.6
Fuel & light	6.8	4.4	5.5	3.9	3.7	4.3	-0.1	-0.4	-0.8
Household goods and services	3.8	4.5	6.5	5.6	5.2	4.7	4.3	3.9	3.6
Health	5.9	5.5	6.3	6.2	6.2	6.2	5.9	5.9	5.5
Transport and communication	8.6	2.8	1.2	2.5	2.5	2.5	2.3	2.0	2.1
Recreation and amusement	1.7	4.6	3.8	3.6	3.7	3.6	3.4	3.3	3.1
Education, stationery etc.	4.5	5.6	5.7	6.0	5.5	5.5	5.3	5.1	5.0
Personal care and effects	3.9	4.8	9.0	9.0	8.9	8.1	8.5	7.8	7.8

*Source: CMIE; *Pre-COVID refers to FY16-FY20*

Monetary policy implications

From the policy standpoint, the continued moderation in core inflation suggests there is no spill over from food inflation to core components. Hence, **the RBI is expected to look past the transient surge in inflation owing to food prices and is expected to maintain the status quo in the next policy meeting**. Moreover, as per the latest projections of the central bank, inflation is expected to remain above 5% till Q1 FY25. Hence, a change in stance at this juncture seems unlikely as it would create room for financial loosening and would be counterproductive to the RBI's battle against inflation. Moreover, the RBI does not have the long-term inflation fighting credibility that the other large global central banks have, so any shift in policy guidance likely requires a lower headline and core inflation than currently persist, especially given India's economic growth prospects.

The focus of the policy meeting will remain on keeping liquidity tight to prevent the generalization of price pressures. While the central bank in its October monetary policy meeting had hinted at the use of Open Market Operation (OMO) sales (auction route) to keep liquidity tight, the need for such an action has not arisen yet as the liquidity has remained tight due to currency leakage, foreign exchange intervention by the RBI and an increase in government cash balances. Furthermore, the usage of the tool seems unlikely in the immediate near-term as the liquidity is already tracking in deficit. In fact, the central bank conducted the Variable Repo Rate (VRR) auction on December 15th worth Rs 1 trillion to infuse liquidity in the banking system. Nevertheless, the chances for OMO sales remain alive should the system liquidity improve over the next few months on the back of a pick-up in the government spending in Q4 and potential foreign capital inflows in the debt market ahead of India's integration into the JP Morgan EM Bond Index beginning next year.

Market Update

- **Equity Market:** The Indian equity market extended its upward rally for the second consecutive month in November – as NIFTY50 gained 5.5% on the back of renewed optimism among foreign investors about the domestic economy. As such, the FII inflows in the domestic equity stood at Rs 90 bn. The upward momentum continued in December as the benchmark indices scaled fresh highs (5.6% gain till Dec 21st) buoyed by multiple factors including robust GDP print for Q2, the outcome in favour of the ruling party in the recently concluded state elections, continued moderation in domestic core inflation along with the dovish commentary in the Fed's last meeting (suggesting multiple rate cuts in 2024).

- **Bond Market:** After surging briefly in October, the domestic bond yields moderated in the past few weeks, tracking the decline in US treasury yields and global crude oil prices as events on the domestic front have unfolded largely in line with market expectations. Indeed, the 10-year G-sec yield declined to 7.28% by the end of November from 7.36% at the beginning of the month. In December with the RBI maintaining the status quo on the policy rates and US treasury yields declining further following the dovish Fed commentary, domestic yields have softened further. As such, the 10-year G-sec yields moderated further to 7.20% the day after the Fed policy announcement. Since then, the yields have continued to trade below 7.2% as the market awaits fresh triggers.

- **Currency Market:** In the foreign exchange market, the Indian Rupee remained under pressure against the dollar as the USD/INR depreciated further its weakest monthly average of 83.3 in November compared to 83.2 in the preceding month. The increased dollar demand by importers weighed on the domestic currency, while declining crude oil prices and falling dollar strength may have provided some support. Further, the sharp depreciation in the rupee has been arrested due to the central bank's intervention in the FX market. Moving in December, the domestic currency traded at an average of 83.4 up until the Fed meeting as a rise in the dollar weighed on the currency. However, after the dovish commentary of the latest Fed meeting, the dollar has somewhat retreated (depreciation of 1.9% between Dec 12-21st) providing some support to the domestic currency. Moving ahead, the rupee is expected to trade with some depreciation bias amidst volatile crude oil prices and choppy foreign capital inflows.

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