24 February 2023

The Indian economy remains resilient; outlook less rosy due to a mix of international and domestic factors

- Despite outsized increases in interest rates across the world, inflation remains above the central banks' comfort levels. Particularly, services inflation has accelerated meaningfully higher for the first time in decades, which can be attributed to a continued strength in the labour market.
- Accordingly, it appears that interest rate hikes will persist beyond that currently anticipated as inflation is likely to stay elevated above desired levels for longer. We assess these risks to be the greatest in the United States.
- Moving ahead, the central banks are likely to continue focus on "calibrated" tightening given that real interest rates generally have been lifted from a solidly negative territory to somewhat positive.
- High-frequency data for the Indian economy suggest sustained momentum, however, the outlook is becoming more two-sided due to a mix of international and domestic factors.
- We are cautious about demand remaining robust in FY24 due to a weaker global economy and uneven recovery in employment.
- The Union Budget for FY24 carried forward the theme of prioritizing investment-driven economic growth revival and fiscal consolidation. Tax slabs under the new regime have been rationalised. PLI and duty cuts will provide manufacturing push.
- For FY24, the government has set a budget deficit target of 5.9% of GDP, implying a fiscal consolidation of 0.5 percentage points over FY23 RE.
- Meanwhile, the RBI stepped down the pace of its rate hike to 25-bps in February. However, the tone was assessed to be cautiously hawkish with no change in stance and continued discomfort around the persistence of core inflation at elevated levels.
- Core inflation remained above the RBI's upper threshold of 6% at 6.2% (unchanged since November). Additionally, headline CPI for January surprised on the upside accelerating sharply to 6.5% up from 5.7% in December due to a surge in food prices.
- With the core inflation remaining persistent at elevated levels the possibility of another rate hike in the April RBI meeting has gone up. Furthermore, the stance is likely to be unchanged (focus on withdrawal of accommodation) as the real repo rate continues to remain below pre-pandemic levels.

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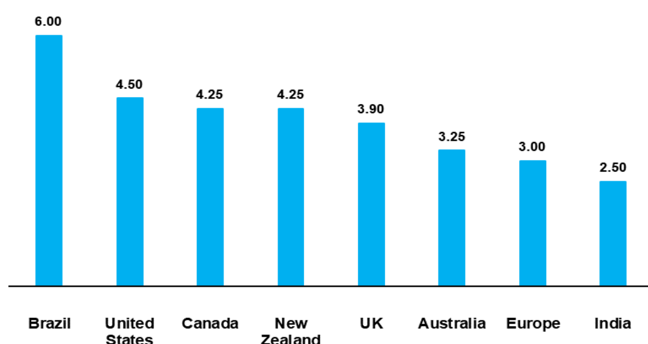
Despite significant tightening, inflation remains above the central banks' comfort levels

Despite outsized interest rate increases in percentage terms in the past 12 to 18 months by G20 countries around the world, there is little tangible evidence that the generational overshoot in inflation rates is on the verge of being snuffed out. Moreover, there only are scattered small-scale signs of financial stress and market dysfunction that typically characterize periods of monetary tightening and – importantly – which typically presage material and sustained economic weakening be it in economic growth, employment, and/or inflation. Accordingly, it increasingly appears likely that interest rate hikes will persist beyond the currently anticipated and/or that inflation will stay elevated above desired levels for longer with these risks probably greatest in the United States.

As highlighted in the chart below, many of the largest economies in the world have undertaken substantial interest rate hikes in a compressed period. Indeed, in the world's largest economic regions, the magnitude of rate increases is the largest in more than 40 years. And further rate hikes lie ahead given the nexus of current and prospective inflation notably above desired levels and – for many countries – tight to very tight labour markets with accompanying elevated nominal wage trends.

Central banks have undertaken substantial rate hikes in a short period of time



Source: Bloomberg; Rate hikes have been computed since December 2021

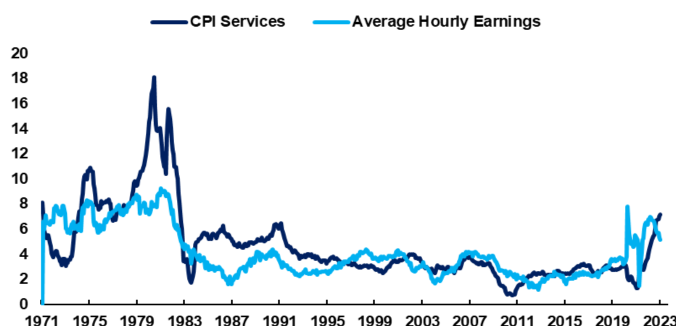
To be sure, inflation rates around the world have moderated somewhat from their respective peak rates of increase in Q2 and Q3 of CY22 and incrementally labour market conditions have loosened from their hottest levels, as judged by a series of indicators such as quits, job openings, number of employment offers received by job seekers, percentage increase in compensation for job switchers and the like. But price pressures are proving relatively resistant – recognizing inflationary trends are a lagging indicator – to the downshift in economic growth experienced to date plus tighter monetary policy and financial conditions.

Ongoing stickiness in prices likely is a by-product of various factors. Atypically, monetary tightening around the world is taking place very early in the business cycle given that the COVID-induced recession that befell the world ended in 2020H2 and monetary tightening in most G20 economies began less than 18 months later. Economies in the early stages of a business cycle tend to have few(er) imbalances and as such tighter policy does not have the same effect as in later parts of the business cycle when macro imbalances have had time to develop.

Separately, but significantly, the current cycle is the first in decades where services sector inflation has accelerated meaningfully higher. Higher interest rates most directly affect interest-sensitive sectors of the economy such as property and more directly affect the most cyclical parts of the economy such as manufacturing and affect least directly the services sector. On this score, sizable interest rate increases have cooled substantially both residential and commercial real estate activity in many parts of the world, and real-time manufacturing indicators such as purchasing managers' indexes (PMIs) are consistent with a manufacturing sector that is stagnant to somewhat contracting.

However, services sectors across the world are not responding in the similar fashion to the various degrees of interest rate increases and tightening financial conditions. This almost certainly is due to a continued strength in labour markets given the tight historical linkage between labour market compensation and services sector inflation.

Historical relationship between labour market compensation and services inflation is strong



Source: Bloomberg

A central issue for the outlook is how will policymakers deal with this dynamic. Will they observe the weakening in interest rate sensitive areas and manufacturing as the (typical) leading edge of a tighter monetary policy induced slowdown and seek to pause rate hikes soon? Will they soldier on so long as spot inflation rates remain well above

desired levels even though inflation trends respond with a lag to policy, economic and financial developments? Will they continue to tighten policy but in the event the services sector remains resistant to such tightening conclude that interest rates are an ineffective tool to achieve a weaker services sector without causing immense economic and financial damage elsewhere? There are no definitive answers to these questions. We suspect strongly that there will be variation across economies and regions, reflecting idiosyncratic factors, policymaker judgments and likely misjudgements, and – in some countries – political realities and pressures.

Countries with a higher share of floating rate debt to be more cautious in hiking; US to set the tone

In seeking to assess which countries' central banks are likely to be more responsive to monetary tightening's visible effects on interest-sensitive and highly cyclical sectors of the economy and thereby pause tightening even if inflation rates improve only slightly from prevailing levels, we have sorted countries by private debt burdens, allocation of floating and fixed rate among that debt, and for floating rate debt the frequency of resets and implications, if any, on payment amortization. Countries such as the UK, Canada, Australia and New Zealand score very high by this analytical filter given their large stocks of floating-rate debt – especially consumer debt, including for housing – and rapid adjustment of interest costs in response to changes in their respective policy interest rates.

The United States, on the other hand, lies at the bottom of this analytical filter, owing to fixed-rate term financing being the dominant form of borrowing on both consumers' and businesses' balance sheets. This is particularly the case for residential real estate where consumers locked in 30-year mortgages in recent years with rates of 2½% to 3¾%.

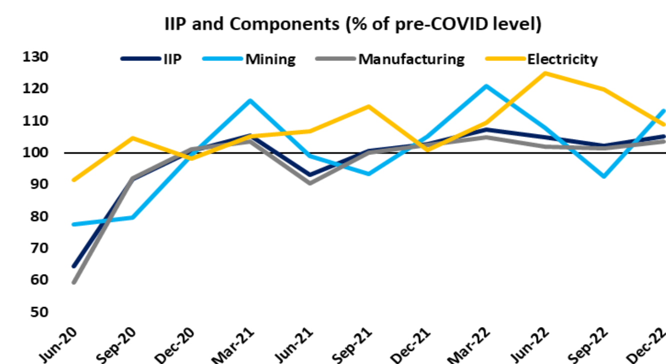
Chances are good that nearly all central banks currently in tightening mode will hike rates further. Regardless of the scope of tightening that lies ahead in most economies, the recent approach of central bankers trying to calibrate carefully additional tightening from here likely will remain the modus operandi given that real interest rates generally have been lifted from solidly negative territory to somewhat positive in the past 6 to 18 months.

With the US wage and price trends proving particularly resistant to both economic moderation and monetary tightening to date, the possibility that the Federal Reserve ultimately has to increase its policy interest rate to close to 6% (from 4.75% currently) is rising. Recent comments by Fed Chair Jerome Powell make it clear that he would like to be able to pause tightening soon; however, key economic indicators since he made those remarks have not been supportive of that notion. Given the US and the Fed's dominant role in affecting interest rates in many parts of the world and also exchange rates, interest rate increases that bring the US monetary policy rate toward 6% could force other countries – particularly emerging economies – to keep hiking their domestic interest rates even if such a decision is not in their best interests.

India's economy resilient in Q3 FY23; near-term outlook remains positive

The Indian economy remained a global standout as 2022 concluded and 2023 began, but the outlook is becoming more two-sided due to a mix of international and domestic factors. The industrial sector (as measured by the index of industrial production or IIP) grew by 2.4% YoY in the quarter ending December (Q3 FY23), accelerating from 1.6% in the previous quarter, on the back of strong growth in the mining and electricity sectors even as growth in the manufacturing sector slowed. Sequentially though, manufacturing production continued to increase and reached 103.5% of its pre-COVID levels in Q3 (from 101.4% in Q2) while the overall IIP reached ~105% compared with 102% previously. This improvement was corroborated by an improvement in the business assessment index of the RBI's Industrial Outlook Survey to 108.6 in Q3 from 106.7 in Q2. Construction activity is likely to have remained robust as the IIP infrastructure and construction goods index growth jumped to 7.3% YoY in Q3 (from 5.3% in Q2). Furthermore, cement production and steel consumption growth were strong in October-December.

IIP reached 105% of pre-COVID levels in Q3 compared with 102% in Q2 FY23

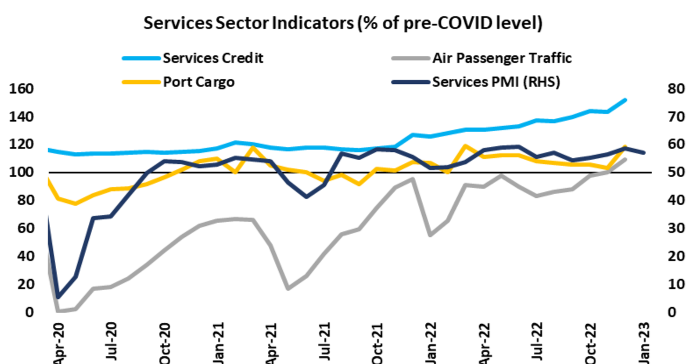


Source: CMIE

Services indicators as well showed an improvement in activity in Q3 FY23. Services PMI increased to an average of 56.7 in October-December, from 55.7 in the previous quarter and has remained in the expansionary territory since August 2021. Domestic air passenger traffic crossed its pre-pandemic levels for the first time in November-December. Services sector credit has remained one of the main drivers of credit growth. Furthermore, results from the RBI's

Services and Infrastructure Outlook Survey suggest that the business situation improved vastly in Q3 FY23. In the agriculture sector, growth in Q3 is likely to have been resilient with the Kharif sowing at 102% of the normal area sown, however, sowing was slightly lower when compared on an annual basis. Tractor sales improved 7.2% YoY in the quarter reflecting increased harvesting activity.

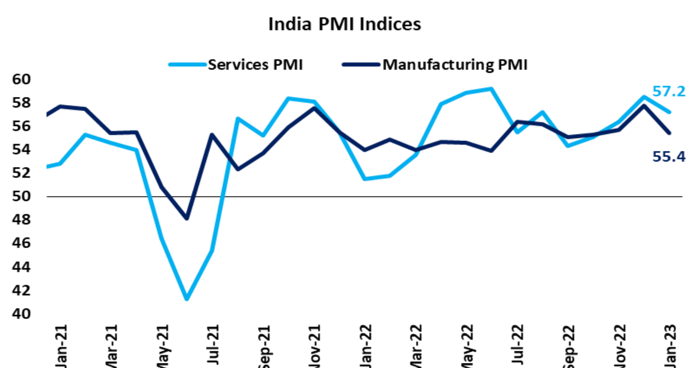
Services sector recovery remained strong in Q3



Source: CMIE; S&P Global

Moreover, the PMI – a key leading indicator – for both the manufacturing and services sector remained in strong expansionary territory in its latest reading albeit moderating slightly from the 26-month and 6-month high readings respectively observed in December. While both sectors continue to see an increase in new work/orders, weak external demand is affecting the growth. According to RBI surveys, cost pressures arising out of the higher cost of financing, wages, and raw materials are likely to persist at least until Q2 FY24, which could affect profit margins in these sectors and make the outlook less rosy. Yet, in FY24 sectors such as manufacturing and construction are likely to be supported by government schemes/policies like the production-linked incentives, Gati Shakti and National Logistics Policy. As such we remain optimistic about these. Rabi sowing at the start of February was up 3.3% YoY suggesting good prospects ahead for the agriculture sector. We are however more cautious about the outlook for the services sector and consumer demand.

Domestic PMI indices stayed robust in January



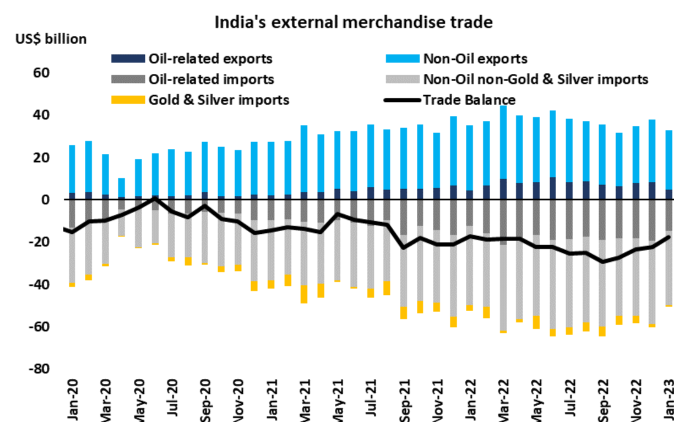
Source: S&P Global

Uneven recovery in employment and a weaker global economy to hold back growth

Demand indicators continued to point towards sustained momentum supported by the release of pent-up demand, especially in the contact intensive sectors. While we expect this to continue for the period immediately ahead, we are more cautious about demand remaining robust in FY24. For one, the ongoing unevenness in the labour market is a key factor for our more cautious outlook for consumer demand and the services sector broadly. Despite an improvement in the greater unemployment rate in January to 10.2% from an average of 11.6% in the December quarter, employment in sectors like manufacturing, travel and tourism, and hotels and restaurants still trail their pre-COVID levels. Sustainable improvement in labour market conditions remains essential to support continued recovery in the consumer sector.

Second, the international sector is softening as tighter monetary policies take hold; key export markets such as the US, and the EU are experiencing the greatest degree of monetary tightening as policymakers seek to lower inflationary pressures. In the calendar year 2022, average exports in the first half were ~US$ 39.6 billion, while in the second half, they were roughly 10% lower, falling to US$ 35.9 billion. Most of this decline came from the non-volatile non-oil component of exports. Meanwhile, imports have increased owing to a relatively strong domestic economy requiring higher energy and industrial imports. Average merchandise imports in H1 2022 were ~US$ 59.2 billion, which increased to ~US$ 61.3 billion in H2. In January, exports contracted by 6.6% YoY while imports contracted by 3.6% YoY resulting in a narrowing of the trade deficit to a 12-month low. This was largely led by a decline in non-oil non-gold imports led by lower capital goods imports, chemicals, and ores and minerals. Given that high frequency indicators suggest sustained domestic momentum, the lower imports could be a result of seasonal factors and lower prices of industrial raw materials. Overall, for the period April 2022 – January 2023, the merchandise trade deficit stood at US$ 232.9 billion, significantly wider than the deficit of US$ 153.8 bn during the same period a year ago. India's strong services exports (courtesy of the IT sector) have traditionally helped in offsetting a large part of the deficit on the trade account. Indeed, India's services exports grew by 31.9% YoY to US$ 272 bn over April 2022 – January 2023, whereas services imports grew by 27.2% YoY to US$ 151 bn. Services trade account surplus for the period April-December stood at US$ 121 bn compared with US$ 87.6 bn during the same period a year ago.

External trade dragged GDP in H2 2022; pressure likely to remain owing to weaker external demand



Source: CMIE

Disinflation trend breaks as food prices spiked in January; elevated core inflation remains a cause of concern for policy

The RBI met in February 2023 and continued to sound cautiously hawkish even though it stepped down the quantum of the rate hike from 35 bps to 25 bps. However, the decision to increase the policy rate was not unanimous with two members dissenting in the favour of no repo rate hike at all. In the February monetary policy meeting, the RBI reiterated its previous policy remarks (December) on breaking the persistence of core inflation and containing second-round effects. Considering the uncertainty around the inflation trajectory and external financial conditions, the RBI did not provide any future policy guidance and retained the flexibility to respond if the inflation outlook were to worsen.

Incidentally, the headline inflation print for the month of January surprised on the upside accelerating sharply to 6.5% up from 5.7% in December. The uptick in inflation was led by a combination of a surge in food prices and an unfavourable base effect. As such, the food & beverages inflation jumped to its 3-month high of 6.2% up from 4.6% in the previous month on the back of a surge in the cereal inflation to 16.1% from 13.8% in December and a pick-up in the prices of protein products (i.e., meat, eggs etc.). The latest uptick in cereal inflation is rather hard to explain as such a drastic sequential momentum wasn't noted even during the peak of global supply disruption during the Russia-Ukraine war. Additionally, there seems to be a discrepancy in the overall cereal index with the weighted sum of the sub-components, showing a slower rise in cereal inflation (14% YoY) compared to the reported overall index. Nonetheless, the government has already intervened by offloading the central pool of wheat stocks in the market to ease the price pressures. Hence, we view this spike to be more transitory in nature. Meanwhile, vegetable prices continued their seasonal correction.

Headline inflation accelerated on the back of uptick in food prices

CPI Inflation, YoY%												
Sub-groups	Weights	Pre-COVID average*	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23
CPI (headline)	100.0	4.2	7.8	7.0	7.0	6.7	7.0	7.4	6.8	5.9	5.7	6.5
CPI-Urban		4.2	7.1	7.1	6.9	6.5	6.7	7.3	6.5	5.7	5.4	6.0
CPI- Rural		4.3	8.4	7.1	7.1	6.8	7.2	7.6	7.0	6.1	6.1	6.9
Core-CPI	54.1	4.8	7.0	6.2	6.0	5.9	6.0	6.2	6.1	6.2	6.2	6.2
Food and beverages	45.9	3.7	8.1	7.8	7.6	6.7	7.6	8.4	7.0	5.1	4.6	6.19
Pan, tobacco and intoxicants	2.4	6.7	2.7	1.2	1.8	1.8	1.7	2.0	1.9	2.0	2.6	3.1
Clothing & footwear	6.5	4.3	9.9	8.9	9.5	9.9	9.9	10.2	10.2	9.8	9.6	9.1
Housing	10.1	5.6	3.5	3.7	3.9	3.9	4.1	4.6	4.6	4.6	4.5	4.6
Fuel & light	6.8	4.4	10.8	9.5	10.1	11.8	10.8	10.4	9.9	10.6	11.0	10.8
Household goods and services	3.8	4.5	8.0	6.8	7.5	7.4	7.5	7.7	7.6	7.7	7.4	7.3
Health	5.9	5.5	7.2	5.4	5.5	5.4	5.4	5.5	5.7	5.8	6.2	6.4
Transport and communication	8.6	2.8	10.9	9.5	6.9	5.6	5.2	5.4	4.6	5.3	4.9	4.5
Recreation and amusement	1.7	4.6	7.3	6.0	7.0	7.1	6.9	6.3	6.1	5.4	5.2	5.1
Education, stationery etc.	4.5	5.6	4.1	4.2	4.5	5.0	5.5	5.7	5.8	5.8	5.9	5.8
Personal care and effects	3.9	4.8	8.6	6.2	6.7	6.0	7.0	6.8	7.0	7.0	8.1	9.6

Source: CMIE

On the other hand, core inflation remained sticky in January at 6.2%, unchanged since November remaining a cause of policy concern for the RBI. Core inflation in the latest month was underpinned by an acceleration in prices of health, household items, personal care, etc. potentially stemming from a resilient demand and an increase in gold prices. Looking ahead, while government intervention along with a robust Rabi crop is likely to provide a breather to food inflation, the core inflation is expected to remain sticky as the economic recovery progresses.

From the policy standpoint, the RBI is likely to remain steadfast in its resolve to break the persistence of the core inflation and contain the second-round impact. With core inflation remaining persistent at elevated levels the possibility of another rate hike in the April RBI meeting has gone up. Further, the decision on the stance is likely to be unchanged as the real repo rate continues to remain below pre-pandemic levels. In the September policy, the governor highlighted that monetary policy had moved from neutral to accommodative in June 2019. During that time the real policy rate was around ~2% and liquidity conditions were in deficit. Using the RBI's latest inflation (5.7% for Q4 FY23) estimate and assuming an even higher policy rate of 6.75%, the real policy rate will still be lower than pre-pandemic levels at the end of Q4 FY23. Additionally, the liquidity conditions are likely to normalize heading into April.

Market Update

Indian bond markets experienced a volatile start to the new calendar year. After declining for two consecutive months, the benchmark 10-year yield rose in January to an average of 7.34% from 7.28% in December. The hardening of the long-term yields was led by a combination of factors including an increase in US treasury yield following an unexpected hawkish tweak in Japan's policy, a rise in Brent

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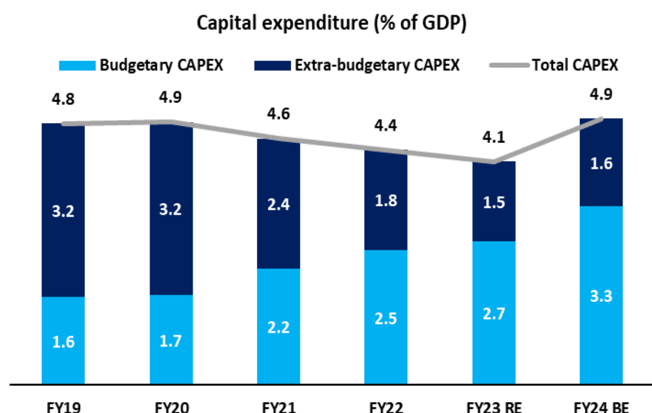
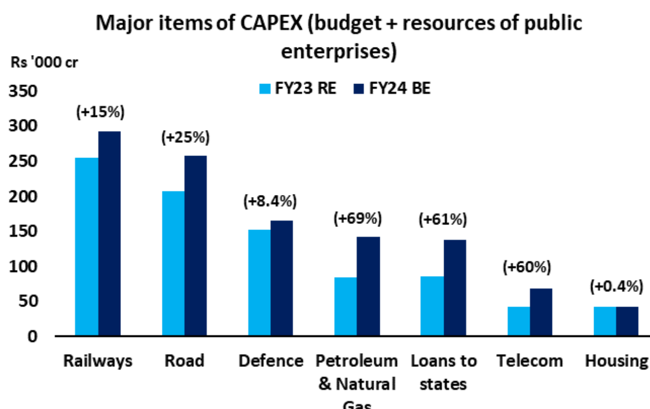
Budget FY24 major themes: Focus on CAPEX-driven economic growth revival and fiscal consolidation; reduction in extra-budgetary CAPEX; dichotomy of lower tax rate without deductions; and PLI push

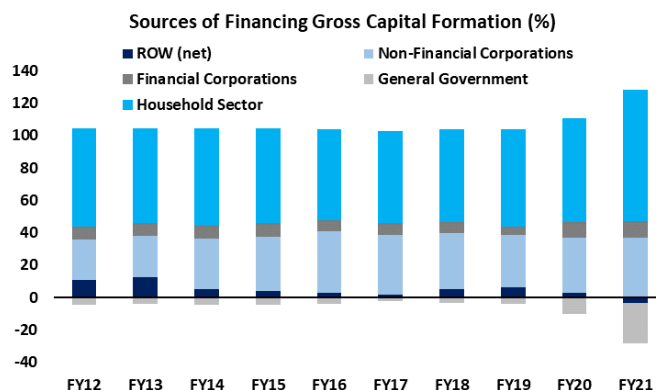




Recognizing the need to nurture the ongoing economic recovery, the FY24 budget continued to build on the previous budget's theme of increasing capital expenditure without sacrificing fiscal consolidation. For FY24, the government has set a fiscal deficit target of 5.9% of GDP, implying a fiscal consolidation of 0.5% of GDP and putting itself on track to attain a fiscal deficit target of 4.5% of GDP by FY26. Indeed, the government has budgeted capital expenditure at over 33.4% for FY24 over FY23 BE (which also includes the Rs 1.3 lakh crore interest free loans to the state governments). In recent years, capital expenditure has received a strong thrust and has accelerated from its five-year pre-COVID average of 1.7% of GDP to 2.7% of GDP in FY23 RE and budgeted at 3.3% of GDP in FY24, its highest ever since FY05. However, during the same time, extra-budgetary CAPEX (investment by public enterprises) has reduced from 3.2% of GDP in FY20 to 1.5% of GDP in FY23 RE and is budgeted to improve slightly to 1.6% in FY24. Even the slight increase in the latest budget is on the back of an increase in off-budgetary support to the Food Corporation of India (without this the extra-budgetary CAPEX would be even lower at 1.1% of GDP in FY24). That said, total CAPEX (budget + off-budget) is projected to increase by ~32% YoY, accelerating from 9.6% growth last year, which should support recovery. The ongoing economic revival through infrastructure and job creation could potentially spur private sector investment if demand conditions remain conducive.

New tax rate to support consumption; but investment likely to be hit

The government also decided to rationalize the tax slabs under the new income tax regime and raised the tax rebate limit to Rs 7 lakh. The move is aimed at providing some tax relief to individuals and put more money in the hands of the public to support consumption recovery. The government's decision to keep the tax slabs unchanged in the old tax regime suggests that it wants more people to opt for the new tax regime (without deductions) to reduce the tax compliance burden and streamline the tax system. The exchequer expects a revenue loss of ~Rs 37k crore due to the changes in the personal tax.



The flipside of putting more money into the hands of people to boost consumption but not allowing for deductions is that investment activity will take a hit. Indeed, households are the largest financers of gross capital formation accounting for around 2/3rds of total investment in the economy (pre-COVID). Demand for tax saving mutual funds, insurance products and other long-term savings instruments will hence be affected and could in turn have an offsetting impact on GDP from the rise in consumption.

PLI Focus; custom duty reduction to help ramp up local manufacturing

The government's production linked incentive (PLI) scheme, launched in 2020, has been successful especially in the electronics, auto and pharmaceutical sectors. To further push local manufacturing, attract investment and create jobs, the FY24 budget has increased allocation for PLI to Rs 8.1k crores from Rs 4.8k crores in FY23 RE, with the largest allocations to electronics, food processing, pharmaceuticals and automobiles and auto components. Furthermore, excise duty exemptions/reductions have been provided on certain inputs for sectors like green mobility, electronics, electricals, chemicals and petrochemicals, and metals, which will further support domestic manufacturing.

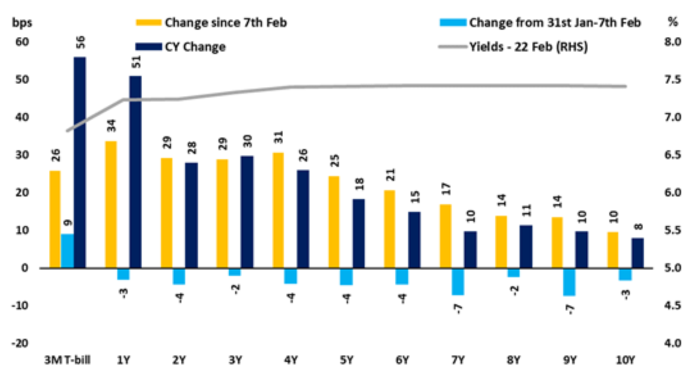
Production linked incentive scheme allocation (Rs. Crores)

Sector	FY23 RE	FY24
Electronics	2,203	4,645
Food processing	801	1,530
Pharmaceuticals	1,663	1,200
Automobiles and Auto Components	11	604
White Goods, ACs, LED lights	4	65
Drone	40	33
Textiles	8	5
Advanced Chemistry Cell Battery Storage	1	1
Telecom	90	-
Total	**4,820**	**8,083**

Source: Union Budget Documents

prices (US$82/bbl in December to US$85/bbl) and an expectation of a higher market borrowing announcement in budget FY24. Bond market took a breather following the Budget FY24 on February 1, wherein the government announced lower-than-expected market borrowings for FY24. Consequently, the Indian 10Y yields eased by ~7 bps at the end of the trading session on February 1. However, the yields hardened again in the subsequent week tracking the rise in US treasury yields as the stronger economic data cemented views of Fed remaining hawkish for longer. The uptrend in the yields continued in subsequent days with 10-year yields inching up to 7.41% (data as of February 22) from 7.31% on February 7th. The hardening of yields was driven by the continued hawkish tone of the RBI governor in the latest policy meeting, acceleration in the domestic inflation print which has increased bets of another rate hike in the April policy meeting and a rise in global yields. Additionally, the RBI devolved a bulk of 10-year bond on primary dealers at an auction which added pressure to the long-term yields. Looking ahead the near-term outlook is likely to be guided by the movement in US treasury yields and the oil prices as the government borrowing program for the current year is scheduled to end on February 24.

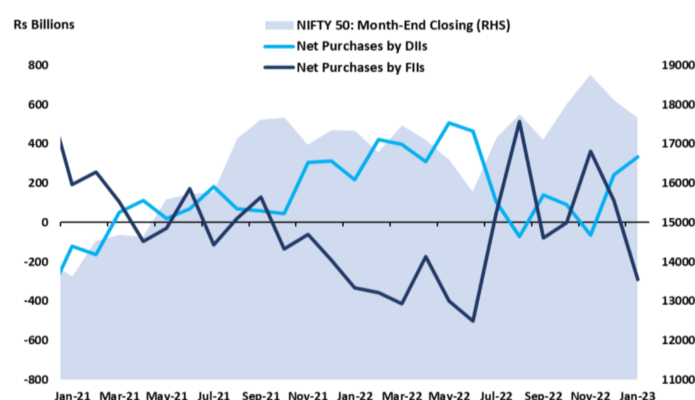
Higher US yields and a more hawkish RBI caused the yields to jump in Jan-Feb



Source: Bloomberg; Investing.com; Note: Data till February 22nd

Indian equity markets continued to remain under pressure for the second consecutive month in January as both the benchmark indices – NIFTY and SENSEX were down by 2.4% and 2.1%, following a decline of 3.5% and 3.6% in December, respectively amidst capital outflow by foreign investors, reopening of the Chinese economy and a decline of Adani's stock following the release of the Hindenburg report which made a series of allegations against the business conglomerate. Domestic investors continued to support India's equity flows with Domestic Institutional Investors investing ~Rs 334 billion in January offsetting the withdrawal by Foreign Institutional Investors to the tune of ~Rs 228 billion (the largest capital outflow since June 2022). Following the budget announcement, the index climbed up by ~1% as the budget doubled down on capital spending and infrastructure development supporting economic growth. However, the gains post the budget announcement were wiped out on account of the continued volatility in the stock prices of the Adani group. Since then, equity markets have remained volatile with the NIFTY declining by 0.4% (data as of February 22). Given the uncertainty surrounding the global front, we will expect the volatility to continue with bouts of corrections.

Foreign investors pulled out capital in January amidst bouts of global markets volatility



Source: CMIE

The Indian Rupee has been oscillating back and forth against the US Dollar. The rupee gained in January, offsetting December losses, but has since weakened again against the dollar in February. The USD/INR appreciated by 0.8% in January to trade at 81.8 levels on average vs 82.5 in December. In January, a relatively weaker dollar amidst a less hawkish stance by the Fed (the dollar index declined by 1.7%) and a relatively benign trade deficit (one year low of US$ 17.7 bn) supported the domestic currency. Moving into February, the greenback gained back its strength as the strong US economic data stoked fears of continued rate hikes by the Fed and interest rates remaining "higher for longer". Consequently, the dollar index increased by 2.4% (data as of 22 Feb) from the end of the prior month, while the domestic currency depreciated by 1.1% during the same time. The depreciation was in line with the other emerging market economies. Going ahead, with risk aversion in the global markets and the rising US dollar, we could see some depreciatory bias in the domestic currency, however, any move beyond 83 is likely to be limited by the RBI intervention. The same is being reaffirmed with the forex reserves noting the largest weekly decline in 11 months to US$ 567 bn (data as of Feb 10th) from US$ 575 bn in the prior week.

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