25 July 2023

India's economic activity sustains momentum; positive fundamentals support the outlook, but risks persist

- Key economic trends in the world's largest economies (and economic regions) are becoming increasingly divergent after what can be best described as the most synchronous monetary policy tightening in decades (barring China).
- While on the one hand, the pace of real US economic activity appears to be on the verge of picking up, albeit from a below-trend pace, on the other hand, the economic growth picture in Europe has eroded substantially of late.
- In our judgement, two countries which can prove to be the largest risks to the global economy are currently the UK and China.
- Meanwhile, Indian economic growth has sustained momentum on the back of rising CAPEX by both central and state governments and sustained urban demand, particularly for services.
- Downside risks to the outlook for Indian economic growth persist in the form of a high probability of El Niño (associated with sub-par monsoon conditions), which could dampen rural consumption in the festive season ahead and a weakening external demand, which could hamper services exports which have remained unaffected hitherto.
- Meanwhile, the twin balance sheet issue which was characteristic of previous business cycle induced slowdowns in India does not seem to be a risk as of now.
- On the inflation front, the headline CPI inflation firmed up to 4.8% from 4.3% previously owing to a sharp rise in food prices, mainly that of vegetables due to seasonal shortages. Core inflation on the other hand remained sticky/flat in June.
- Going ahead, the uneven spatial distribution of the monsoon (which could further impact food prices) along with the waning of the favourable base effect is likely to lead to an upward bias in inflation.
- From a policy perspective, we expect the RBI to remain in a wait-and-watch mode in the remainder of FY24. It is likely to ignore the temporary increase in food prices which are better dealt with by government intervention.
- We expect the stance to remain focused on the withdrawal of accommodation for the upcoming policy with liquidity conditions remaining in surplus.

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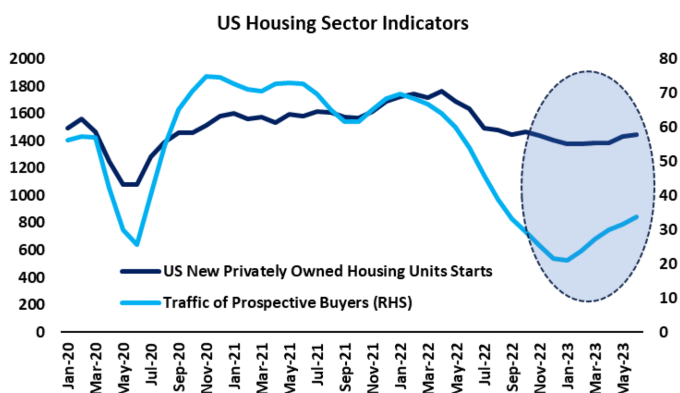
Trends diverging in key global economies

As the second half of 2023 gets underway, key economic trends in the world's largest economies (and economic regions) are becoming increasingly divergent. To be sure, the pace of economic growth in most countries has cooled from 2021 and 2022H1 and now is running at below trend rates, as high inflation has reduced real purchasing power and tighter monetary policy has taken hold. But the global economic backdrop is shifting toward asynchrony despite what has been the most synchronous (except for China) monetary tightening cycle in decades.

The United States has experienced in the past 12 to 15 months the most pronounced monetary policy tightening of any large economy, yet the pace of real US economic activity appears to be on the verge of picking up, albeit from a below-trend pace. The contraction in the housing sector appears to be ending and while housing is unlikely to be a spur to growth ahead given mortgage rates, it no longer being a notable drag will benefit the pace of growth. Meanwhile, the labour market remains sturdy with the unemployment rate holding a near five-decade low and sensitive leading indicators of hiring such as jobless claims on balance holding steady at low levels. With unemployment still so low, wage and income trends remain favourable. All told, we now are of the judgment that the US economy will outstrip expectations in 2023 H2, complicating potentially the Fed's desire to be done with hiking interest rates in the immediate future.

The US housing market drag appears to be bottoming



Source: Bloomberg

In Europe, central bank officials continue to signal that more interest rate increases lie ahead but the continent's growth picture has eroded substantially of late. Germany, Europe's biggest economy, is struggling with a combination of the highest (by far) interest rates in Europe since before the global financial crisis plus the tepid European and global manufacturing environment.

The economy we judge to be most exposed to a potentially deleterious outcome is the United Kingdom. British wage and price trends have proved the most resistant to central bank tightening of any major economy in the world. The most recent UK inflation reading at least arrested, for the moment, growing concerns that a full-fledged wage/price spiral was putting down roots. Nonetheless, UK wage growth remains exceptionally strong and is wildly inconsistent with a sustained moderation in core inflation from its prevailing, highly unacceptable, and debilitating rate.

Troublingly, the Bank of England, despite raising its policy rate by a larger-than-expected half a percentage point recently, does not seem to have a cogent blueprint for securing the conditions necessary for medium-term price stability. Given the open nature of the UK economy and the magnitude of capital flows in/out of the country owing to London's status as the second most important financial centre, we cannot rule out the possibility of a destabilizing drop in the British Pound that in turn sets off a negative feedback loop throughout the Isles. Assessing the likelihood of such an outcome with any precision is impossible but we view it, along with a policy error in China, as one of the largest risks in the global economy.

On that score, the Chinese economy is in its worst shape in decades. What should be a vigorous economic recovery following multiple years of China's stringent Zero COVID policy is anything but impressive. Instead, the economy is saddled with lacklustre aggregate demand, especially given the Zero COVID induced suppression of economic activity in 2021 and 2022, and major supply side headwinds. Forces as varied as China's two-year crackdown on its most successful technology companies (which now seems to be ending), household and business loss of confidence in economic policymaking resulting in depressed animal spirits, labour scarring from Zero COVID as highlighted in part by record high youth unemployment, guidance by policymakers to keep credit supply tight, ongoing problems in the property sector are all weighing on the Chinese economy. The result is a tepid aggregate demand, very weak manufacturing/industrial activity, and a risk that cascading property sector defaults by highly levered and bank financed developers could impair the banking system.

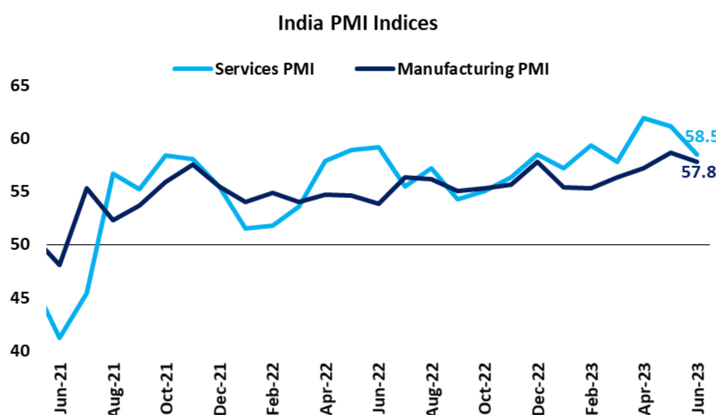
Despite this backdrop, policymakers to date have been hesitant to implement demand boosting programs and to seek to address supply side headwinds. This reticence likely reflects in part the government's greater focus on security over the economics of late. But it may also reflect the changing of macro-oriented personnel as part of President Xi's new term. Regardless, absent substantive demand and/or supply side measures in the period ahead, the Chinese economy is likely to remain lacklustre and be

a headwind to global trade and economically sensitive commodity prices over the balance of the year.

Indian economy sustains robust momentum; Downside risks persist

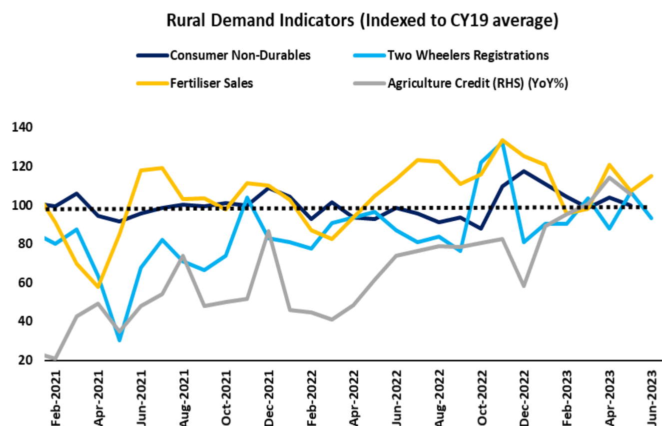
Over the course of the last month, Indian economic growth has sustained a robust momentum and stands in better shape relative to other economies. The lead indicators for the Indian economy continue to suggest buoyancy in economic activity on the back of the rising CAPEX by both central and state governments and sustained urban demand particularly for services due to a shift in the consumption pattern from goods and high services exports. Although some sequential moderation was observed in June for a few indicators including PMI indices, railway freight and high unemployment, we continue to hold our assessment of India being one of the fastest-growing economies in the world in FY24. In the following section, we focus on some of the most pertinent themes that will shape India's economic outlook in FY24.

Industrial and services sectors remained robust



Source: CMIE

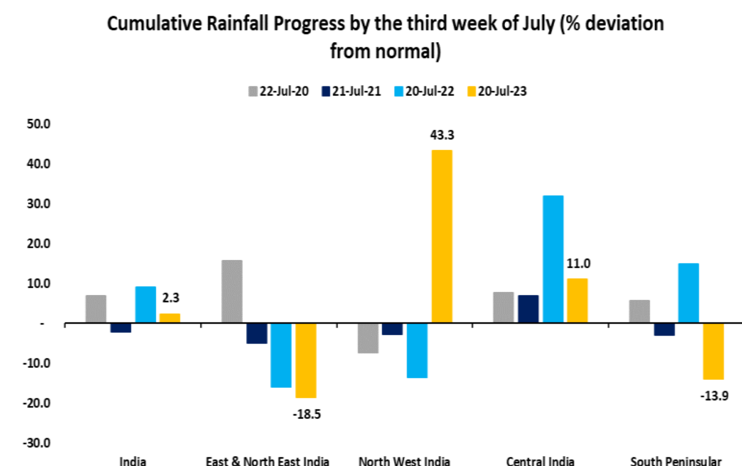
High probability of El Niño could impede the ongoing rural recovery



Source: CMIE

One of the immediate concerns surrounding Indian growth is the impact of the potential El Niño conditions (associated with the sub-par monsoon) on the rural economic outlook. A weak monsoon could dampen rural incomes, which have only started recovering recently, thereby impacting rural consumption. The high risk of El Niño comes on top of the delayed arrival of the southwest monsoon in the country. In June, the cumulative rainfall was 10% lower than normal. This weighed on sowing activity, with the actual area sown for all crops combined being 30% lower by the end of June compared with the same period a year ago. Delayed start to the sowing activity also impacted employment in the agriculture sector. Although, the rains have picked up in July with cumulative rainfall tracking in small excess as of the 20th, leading to improvement in sowing progress. However, it is still premature to conclude that the risk to agriculture has subsided. This is primarily due to the uneven spatial distribution of the rainfall with the northeast and southern peninsula regions recording large rainfall deficits while there is excess rainfall in the northwest and central regions of the country. In this context, should El Niño conditions intensify in the upcoming weeks, rural demand could turn out to be disappointing in the upcoming festive season.

Uneven spatial distribution of rainfall poses a risk to the rural sector



Source: CMIE

Slowing external economy poses a challenge to India's external sector

A sharp and synchronised tightening of monetary policy by central banks around the world coupled with elevated levels of inflation is weighing on the pace of economic growth in most advanced economies. Till now the weakening of the global growth had a limited impact on India's external sector with merchandise exports slowing down, while services exports continued to record a stellar performance. However, the data from the first quarter of FY24 indicates some bit of weakening in services trade. Overall, the services trade

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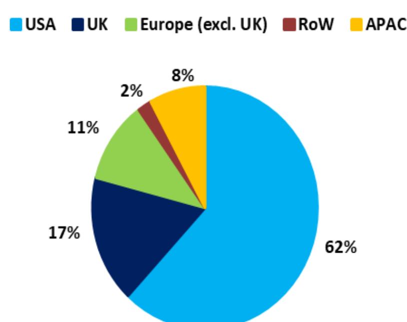
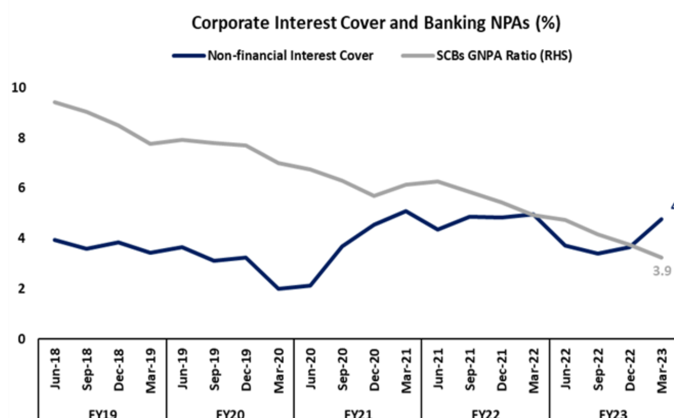
surplus moderated from US$ 40.5 bn in Q4 FY23 to US$ 35.2 bn in Q1 FY24. Among the sub-sectors, computer software services account for a major share in services trade and a majority of these go to the US and Europe. An intensification of a slowdown in these countries is likely to impact the services export even further, widening the drag of net exports on GDP.

Weakening of demand from the US and Europe is likely to impact the export of software services



Source: NASSCOM; Note: Data does not account for hardware

Robust Twin Balance Sheet working in India's favour



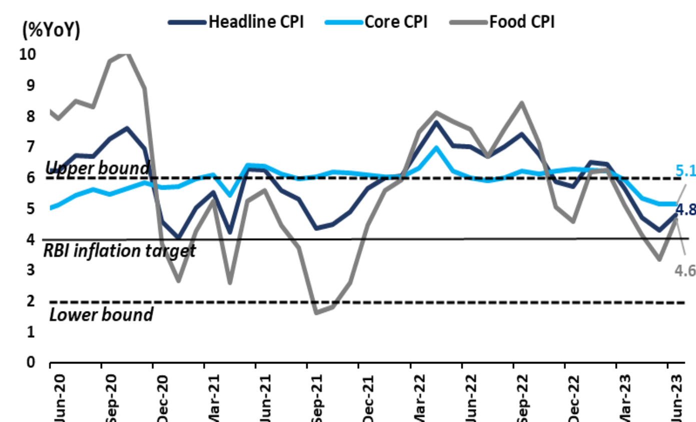
Source: CMIE; RBI

With Indian economic growth outpacing much of the world for the past 18 months, favourable global sentiment towards India is leading to a spurt of capital inflows in the country. The strengthening of both banking and corporate sector balance sheets has been an important factor supporting these capital inflows. As per the recent data sourced from the sample of ~3K companies, corporate profitability for Q4 FY23 improved from declining input costs and is likely to improve even further in Q1 FY24. In the banking industry, the gross NPA stands at a decadal low of 3.9% by the end of FY23, while capital buffers stand tall at 17.1% (CRAR) which is considerably above the minimum regulatory requirement. Overall, the twin balance sheet issue which was characteristic of previous business cycle induced slowdowns in India does not seem to be a risk as of now.

Inflation ticked up in June; RBI likely to remain in wait-and-watch mode

Consumer price inflation ticked up in June owing to a sharp rise in food prices, mainly that of vegetables due to seasonal shortages. Headline CPI inflation firmed up to 4.8% from 4.3% previously while food and beverages inflation quickened from 3.3% in May to 4.6% in June. Given adverse weather conditions and still considerable time between now and the Kharif season harvest (which eases shortages in key vegetables) inflation is likely to face an upward bias in the following few months. To correct the situation the government has taken supply side measures like temporarily banning rice exports and procuring and redistributing tomatoes in the regions of high consumption. Yet, on balance, seasonal food price pressures and the waning of the favourable base effect are likely to push overall inflation further up in Q2 FY24.

Headline inflation jumped in June courtesy of food prices; core inflation flat



Source: CMIE

Positively, core inflation (which strips out the volatile components of food and fuel) in June remained unchanged compared to May at 5.1%. Also, the wholesale price inflation (which tends to have a leading relationship with goods inflation) remained in the deflationary territory at -4.1% (from -3.5% in May) while services inflation eased to 5% (vs 5.2% in May). These developments are supportive of our view that while headline inflation is likely to spike from time to time owing to seasonal factors, core inflation should follow a path of gradual and orderly disinflation.

As a result, we remain of the view that the RBI will continue to hold rates at the current level throughout FY24 given its preference to bring inflation down to the target of 4% along with its unchanged CPI forecast of 5.2% for Q4 FY24. According to the minutes of the MPC meeting in June, comments from almost all members of the committee

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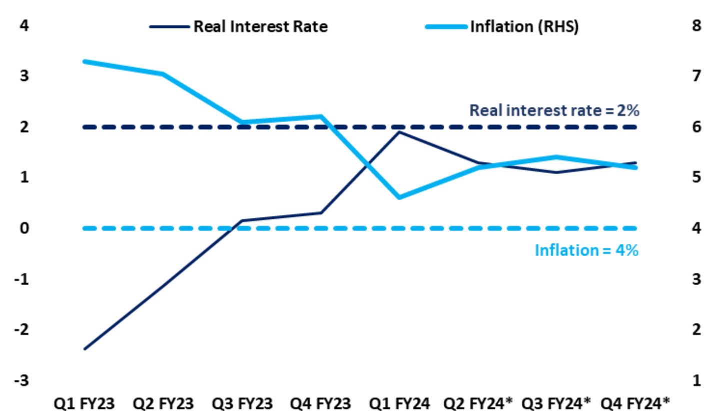
indicate a preference to remain vigilant on inflation. The experience from Australia and Canada – who both resumed monetary tightening after hinting the tightening cycle was over – likely made the RBI more cautious in its messaging to avoid prematurely declaring victory over inflation. However, we do not envisage further rate hikes in the current hiking cycle, even as inflation quickens in Q2 FY24, as the RBI is likely to ignore the temporary increase in food prices which are better dealt with government intervention. That said, a trigger for further rate hikes would be a sharp and durable increase in core inflation (which as of the time of writing seems like a very low probability risk).

At present, we judge the likelihood of any near-term monetary easing as quite low given that – 1) central banks in the advanced world still very much remain in tightening mode; 2) there are no signs yet of durable disinflation; and 3) outlook for global commodity prices remains uncertain which further clouds inflation outlook. Accordingly, the RBI is likely to remain in a wait and watch mode in FY24. The real interest rate (repo minus CPI inflation) in the remaining months of FY24 is likely to average a little above 1% based on a repo rate of 6.5% and the RBI's latest inflation projections. The RBI's previous rate cut decisions in the Inflation Targeting Regime have usually been preceded by a prolonged period of below 4% inflation and a real interest rate of 2% and above. As such a rate cut in FY24 seems unlikely as of now.

Real interest rate although positive, remains below 2%; inflation is still way above 4%



Source: CMIE, RBI; Note – Calculation of real interest rate for Q2 FY24 onward is based on repo rate of 6.5% and the RBI's latest inflation projections

Liquidity and stance

Surplus liquidity as measured by net absorption under the liquidity adjustment facility increased to Rs 1.7 lakh crore on average in July (data till 23rd) from Rs 1.3 lakh crore in June. This is likely due to an increase in bank deposits on account of withdrawal of the 2,000-rupee banknote, and a pickup in government spending. Given recent trends liquidity is likely to remain in surplus in the near future and the RBI is likely to maintain a stance of withdrawal of liquidity. This is supported by the recent multiple announcements of VRRR auctions by the central bank.

Market Update

- Domestic bond yields have mostly moved in tandem with the US bond yields over the past couple of weeks as events on the domestic front have unfolded mostly according to market expectations (be it the RBI policy decision or inflation releases). In the first week of July, yields on India 10Y g-sec rose reaching 7.16%, tracking higher yields in the US as better than expected jobs data raised expectations of the Fed remaining hawkish for longer. In the second week of July, yields eased (again tracking US yields) as a lower-than-expected inflation print in the US strengthened expectations of a pause after the July 26th Fed monetary policy meeting, reaching 7.07% on July 24th. In the period immediately ahead, we could see upward pressure on domestic yield return due to the expected firming of the inflation rate and heavy debt supply.
- The Indian equity market has gained sharply over the past few weeks as foreign investors continued to pour in funds. As on July 24th, both the NIFTY and SENSEX were up by more than 5% MoM. Strong FPI interest can be attributed to the strong earnings and robust health of the corporate sector as well as strong fundamentals of the Indian Economy vis-à-vis the rest of the world.
- The Indian Rupee has traded in the narrow range of 82-83 against the US dollar with the RBI intervening in the market to utilize the times of US dollar weakness to shore up its foreign exchange reserves. Indeed, since July 5, while the US dollar has weakened by 2.1%, the INR has remained more or less flat finding resistance around the 82 level. As of mid-July, India's foreign exchange reserves stood at US$609bn, equivalent to around 9 months' worth of imports.

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