26 June 2023

India's growth is resilient in the face of a global economic slowdown; outlook remains positive, but risks persist

- The global economy has proved to be impressively resilient in the face of the dampening effects of elevated inflation and rapid and large and, in some cases, unprecedented monetary policy tightening.
- That said, underlying (i.e., core) rates of inflation in many parts of the global economy have proved far stickier than government policymakers had anticipated. Sticky underlying inflation rates – especially in major economic areas such as the United States and Europe – are in our judgment the biggest risk to the global economy over the next 12 to 18 months.
- We expect central banks will need to reluctantly press on with the hikes in 2023 (and possibly into 2024); an alternative scenario (where central banks pause prematurely) could be worse with resurgent inflationary pressures returning in 2024 and at that point, the level of interest rates required to squash inflation likely would be multiple percentage points above prevailing rates.
- India's growth has been impressive when seen in the context of the prevailing global economic slowdown. Overall FY23 growth printed at 7.2%. While we expect the pace of growth to moderate in FY24, India is likely to remain the fastest growing major economy in the world.
- Private consumption growth slowed in H2 FY23 owing to a normalising base effect, a high inflationary environment and an increase in the cost of financing. While there are nascent signs of demand picking up, the risks to the outlook remain tilted to the downside.
- In FY23, the government's CAPEX push drove investment growth, a story which is likely to remain unchanged in FY24. Positive sentiment on real estate/housing is also likely to aid investment.
- From the supply side, services sector activity remains very strong. Manufacturing sector activity indicators have also continued to improve into April-May. Seasonal weather disturbances could affect activity in the electricity, construction, and agriculture sectors.
- In June, the RBI voted to keep the policy interest rate and stance unchanged at 6.50% and "focussing on withdrawal of accommodation" respectively. We retain our view of the RBI keeping the policy rate unchanged in the current year unless inflation and more importantly core inflation surprises on the upside (in a durable fashion).

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The global economy has proved to be impressively resilient…

With the midpoint of the calendar year 2023 just ahead, the global economy can be best characterized as one of impressive resiliency. Across the bulk of the developed and developing world, the pace of real economic activity has held up quite well in the face of the dampening effects of elevated inflation and rapid and large and, in some cases, unprecedented monetary policy tightening.

Amongst the G20 and many of the world's largest developing countries, there is hardly any sign of an imminent economic contraction. To be sure, the pace of growth in most countries has cooled, as high inflation has reduced real purchasing power and higher interest rates have taken hold. But economic expansion continues apace, holding down unemployment and helping to prevent – at least so far – the type of negative feedback loop that typically presages recession from taking hold.

Economic resiliency in the face of high inflation and rapid monetary tightening likely is a by-product of various factors. For one, every economy around the world is in the early stages – as measured by time – of a new economic expansion given the synchronized global recession caused by COVID and government officials' decisions to enact public health measures that collapsed economic activity. One natural by-product of this development is that economies typically have fewer imbalances this early in a new business cycle. On the real economic side, it is unusual for major inventory misalignments to have accumulated that result in steep and rapid cutbacks in production and employment and it tends to be too short a duration of time for capital investment to be seriously misallocated. In short, the more elongated a business cycle, the greater the opportunity for economic imbalances to have developed; the reverse applies too and is the current dynamic.

Historic government policy actions in 2020 that persisted in most cases until some point in 2022 also have helped to fortify the financial side of many economies against higher interest rates. Term funding was available at historically low interest rates and spreads and depending on the economy, businesses and/or households locked in multi-year (and in some cases such as US homeowners, multi-decade) financing at rock bottom interest rates. With such term funding in place, large swaths of the global economy are yet to be affected directly by the central bank-driven move up in market interest rates, as there has been little to no need to access new financing.

…but so has core inflation

The upshot of these trends – at least as of this writing – is that underlying (i.e., core) rates of inflation in many parts of the global economy have proved far stickier than government policymakers and/or consensus forecasters had anticipated. Sticky underlying inflation rates – especially in major economic areas such as the United States and Europe – are in our judgment the biggest risk to the global economy over the next 12 to 18 months.

Despite signalling by most central banks that they remain fully committed to restoring inflation rates to desired levels in the period ahead, we are skeptical that such an outcome will unfold seamlessly and in a straight line. This judgment reflects in part our assessment that a good-sized amount of loosening in labour market conditions will be required to reduce inflation given the rapid rate of services inflation[1] and the prospective hit to labour income necessary to lower the trend in such prices. It also reflects what we believe to be a misjudgment by multiple central banks of the degree of the monetary and financial restraint that is in place. On this score, financial assets have been rallying of late and are back near levels of a year ago. Meanwhile, real interest rates are only somewhat positive whereas in prior periods when inflation was as high as it is currently, considerably higher real interest rates proved necessary to squash inflation.

We expect central banks will need to reluctantly press on with the hikes; an alternative scenario could be worse

We envision two possible paths for inflation and in turn monetary policy, interest rates and economic growth.

The first is that central banks – however reluctantly – continue to tighten policy as required over the balance of 2023 and, if necessary, into 2024 to ensure that unacceptably high inflation rates begin to turn down with more vigour than experienced to date. This may or may not ultimately require proper recessions in select countries. But, at a minimum, it likely requires economic growth slower than current for the next 12 to 18 months and interest rates higher than current.

The second is that the central banks that are inclined to be done with monetary tightening go on an extended policy pause – one that lasts on balance for the remainder of 2023 and perhaps even the early part of 2024. Yet, in this second scenario, the policy pause(s) turn out to have been premature and policymakers are confronted in 2024 with some mix of re-accelerating economic growth, strengthening labour market conditions, firming inflation and are prodded into having to resume their interest rate hiking campaigns. In

[1] See April 2023 India Economic Monitor

such a scenario, unfortunately, inflation will have become even stickier than at present and the level of interest rates required to squash inflation at that point likely would be multiple percentage points above prevailing rates. The ensuing recession(s) would be deep and potentially lengthy and the knock-on effects on other economies would be sizable.

We lean toward the first scenario described here being the ultimate outcome. And, of course, this is by far the desired of the two possibilities we outline. Central banks have spent decades establishing their low, stable inflation bona fides and there is robust institutional acceptance of the damage that persistently high inflation rates cause for all parts of an economy. But the second scenario cannot be ruled out entirely given the misjudgements most policymakers have made about inflation in the past couple of years.

India's growth is impressive when seen in a global context

Economic growth in India continues to remain strong in the context of a global economic slowdown and recessionary concerns. In Q4 FY23 economic growth surprised on the upside at 6.1% YoY driven by not only the strong investment activity and services sector recovery but also the impressive turnaround in industrial activity (mainly manufacturing) and net exports (whose contribution to headline growth turned positive). Overall, FY23 real growth printed at 7.2% YoY. While we expect the pace of growth to moderate in FY24, India is likely to remain the fastest growing major economy in the world.

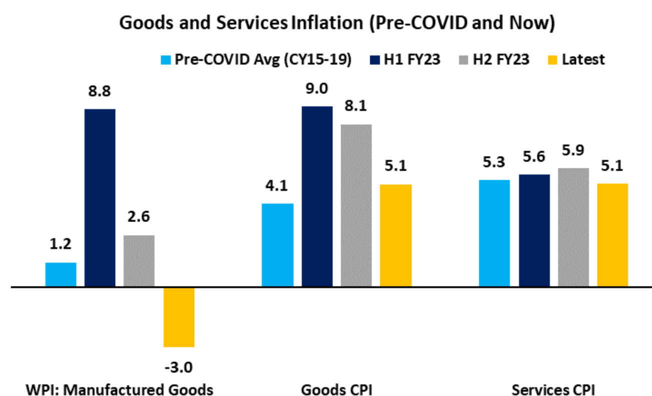
High inflation has stifled consumer demand

Private consumption growth slowed (to 2.5% YoY) in the second half of FY23 (from 13.6% YoY in H1 FY23) but as discussed below seems poised to pick up in the period ahead. While this was partly attributed to a normalizing base effect, even in level terms, private consumption reached 115% of the pre-COVID level in Q2 FY23 and has stayed flat ever since (pre-COVID trends suggest private consumption generally increases in Q3 and Q4). The slowdown in private consumption in the second half of FY23 can be attributed to the waning effect of pent-up demand but also a rapid rise in the cost of credit as well as a jump in inflation, especially that for services. According to our calculations, services inflation in H2 FY23 averaged 5.9% compared with 5.6% in H1. While goods inflation was lower in H2 compared with H1, it was still quite high at 8.1%.

Nascent signs of recovery are visible, but risks remain

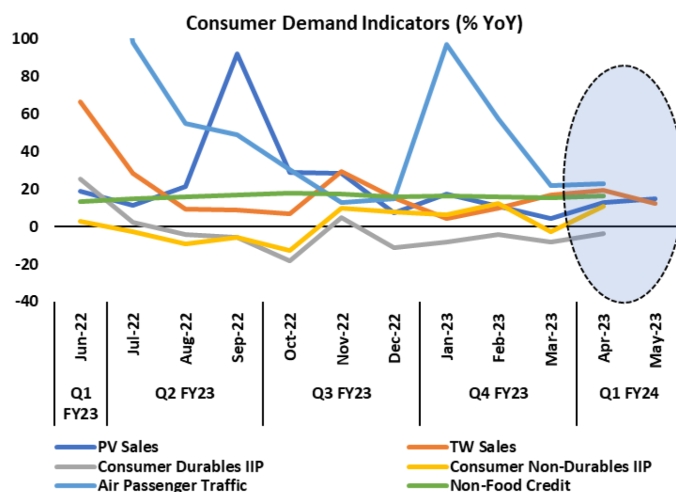
High-frequency demand indicators for both goods and services (like passenger vehicle sales, two-wheeler sales, consumer indices of IIP, air passenger traffic, etc.) show a pickup in growth (or narrowing of contraction). The recent moderation in inflation, strong Rabi sowing (up by 3.3% YoY) and production estimates (SAE up by 6.2% YoY), improvement in wage growth in the corporate sector and nascent signs of improvement in rural wages (see May monthly) bodes well for a pickup in private consumption in FY24. However, risks to the outlook are tilted to the downside from a normalizing demand for services, El Niño impact on the agriculture sector and consequently rural incomes, and a high cost of credit.

Services inflation peaked in H2 FY23



Source: CMIE; DMI Calculations

Early signs of demand pick up?



Source: CMIE

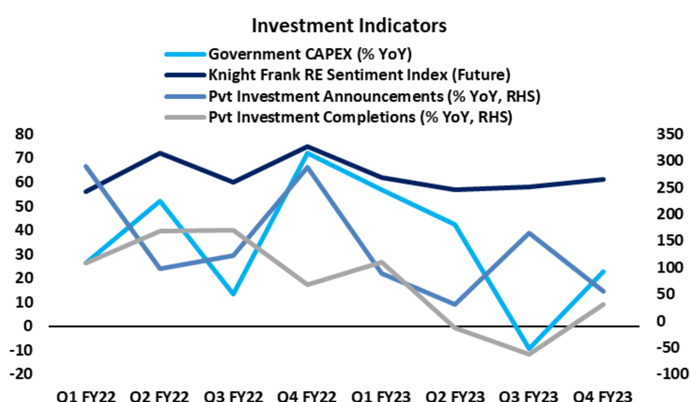
Govt CAPEX push drove investment in FY23, story likely unchanged for FY24

Investment became the main driver of growth in H2 FY23 punching a higher score in headline growth than private consumption as a high cost of credit, fading of pent-up demand and inflation inhibited consumer demand. Investment activity in the past two financial years was driven by a very sharp increase in government capital expenditure given the government's focus on infrastructure development, logistics improvement and overall betterment in the business

environment. Additionally, a revival of demand in the housing/real estate sector has supported overall investment activity post-pandemic in FY22 and likely in FY23. Indeed, the share of dwellings, other buildings and structures in overall fixed investment increased to a six-year high in FY22. Meanwhile, private investment fell by 14% YoY and remains more than 20% below its CY19 level, as per CMIE. High raw material costs, the increasing cost of financing and a highly uncertain global growth environment have held back private investment growth.

There is some anecdotal evidence of plans of greater private sector investment spending in construction-related sectors like steel and cement manufacturing, however, these anecdotes are scattered and too small in scale to suggest a broad-based pickup in private sector investment. Positively though, private sector investment announcements have increased by 195% and 26% in FY22 and FY23 respectively, pointing to early signs of a revival in private sector investment, however, it is doubtful that these will materialize in FY24 given the recent slowdown in consumer demand and the global recessionary fears. The government push on CAPEX (central government target: 37% growth over FY23 RE; state governments target: ~20% growth over FY23 RE[2]) is likely to sustain continued growth in investment in FY24. Positive sentiment on real estate/housing is also likely to aid investment.

Govt-led CAPEX and housing likely investment drivers in FY24; private investment outlook uncertain



Source: CMIE, Knight Frank Real Estate Sentiment Index

Drag from net exports likely to reduce

External trade is likely to be a mixed bag. On the one hand, the slowing global economy is likely to negatively impact the country's exports, while on the other hand continued improvement in export items like electronic goods, pharmaceuticals, etc. will have a positive impact. India's services exports of IT, professional and consultancy services also will be vulnerable to the global economic slowdown, although these have remained surprisingly resilient until now, potentially due to cost advantages vis-à-vis those in advanced economies. Given the moderation in the pace of consumption, a low commodity price environment and absent private investment, imports are likely to fall by a larger margin. On balance, export and import dynamics are not central to the broad Indian economic outlook.

Despite the slowdown in exports, pharma and electronics exports increased

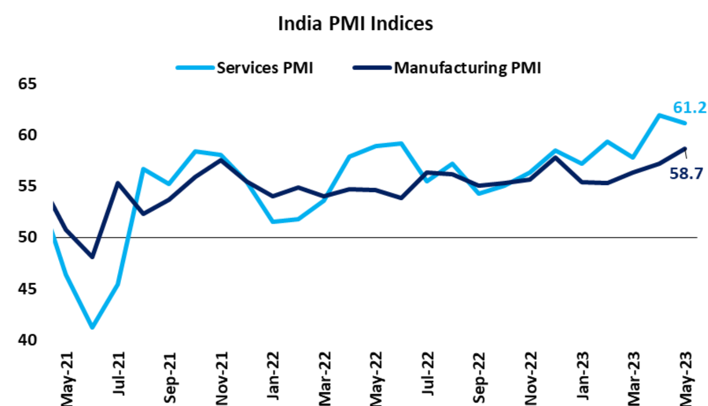
Major Imports by Commodities			
US Dollar (Mn)	Apr-May 2022	Apr-May 2023	Change
All commodities	**1,19,182**	**1,06,990**	**-12,192**
Petroleum, crude & products	34,234	30,794	-3,439
Non-POL	84,948	76,195	-8,753
Vegetable oil	3,433	2,218	-1,215
Coal, coke & briquettes, etc.	10,330	8,001	-2,329
Organic & inorganic chemicals	6,632	4,906	-1,725
Pearls, precious & semi-precious stones	5,342	3,986	-1,355
Machinery, electrical & non-electrical	6,710	8,069	1,358
Iron & steel	3,093	3,532	439
Electronic goods	12,461	13,112	651
Gold & silver	8,339	4,847	-3,492

Source: CMIE

Services is strong but industry is mixed; high inflation and weather disturbances pose risks to the outlook

From the supply side of the economy, activity in the services sector in Q1 FY24 continues to expand at a rapid pace as is suggested by the overwhelmingly high PMI readings for April-May. Continued strong external demand for Indian services, as highlighted above, has supported the sector. Service sector businesses are dealing with high input costs and competitive pressures, and as such overall business confidence in May came down a bit but remained high from a historical point of view.

Services PMI second highest in 13 years; manufacturing highest since October 2020



Source: S&P Global

[2] For 29 states and UTs

Meanwhile, manufacturing activity continues to improve as evidenced by the rebound in the latest IIP and PMI data; indeed, the most recent manufacturing PMI was the strongest since October 2020. Despite this positive signal, recent anecdotal evidence suggests that production for consumer goods might slow over the next few months before picking up over the festive season (September-November). Construction activity has remained buoyant given strong cement production and steel consumption data (for April-May) although weather-related disturbances may cloud the trend in the period immediately ahead. Electricity production has been impacted due to unseasonal rains and lower temperatures which has tempered energy demand.

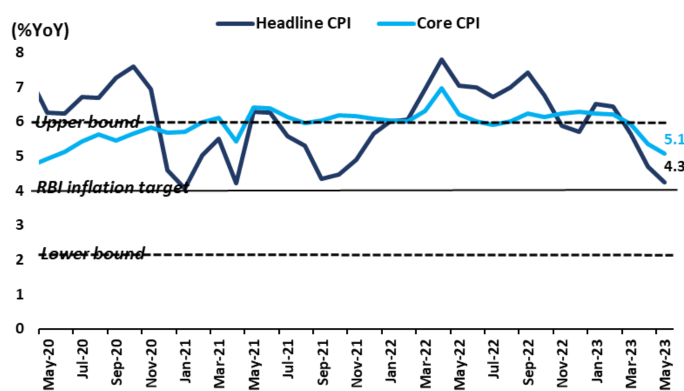
Fortunes for the agriculture sector will depend highly on the progress and distribution of the southwestern monsoon. On the one hand, the IMD has forecasted rainfall during the monsoon season at 96% of the long period average. On the other hand, numerous weather agencies have predicted a high chance of El Niño conditions this year which could lead to a large rainfall deficit and reduced agricultural production. Thus far and positively, the overall area sowed for Kharif crops was up by 1.5% YoY as of June 16th.

RBI maintained the status quo on policy rates; expected to remain on pause

In June, the MPC unanimously voted to keep the policy interest rate unchanged at 6.50% while 5 out of 6 members voted to keep the stance unchanged to withdrawal of accommodation to ensure inflation progressively aligns with the target. Even though the central bank maintained a status quo on key policy rates, the tone of the statement was largely perceived to be hawkish with a slight change in the language of the stance from “to ensure that inflation remains within the target going forward while supporting growth" to “to ensure that inflation progressively aligns with the target, while supporting growth” providing an impression of keeping the key policy interest rate higher for longer. Continued uncertainties globally i.e., the resumption of interest rate hikes by the central banks of Australia and Canada following the policy pause may have been a reason that RBI does not want to declare victory over inflation prematurely. From the policy standpoint, we retain our view of the RBI keeping the interest rates unchanged in the current year unless inflation and more importantly core inflation surprises on the upside (in a durable fashion).

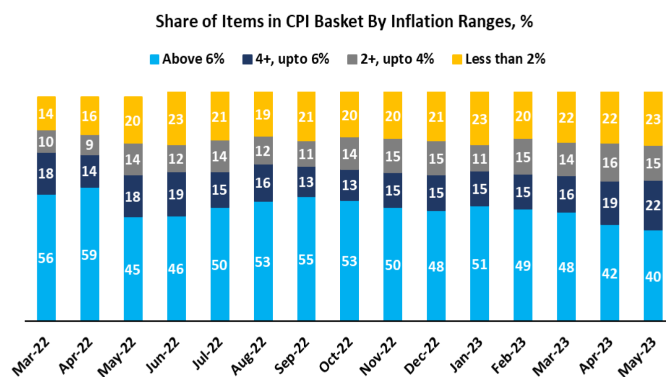
CPI headline inflation moderated further from 4.7% in April to 4.3% in May. This marks a 25-month low. Headline inflation has printed below the central bank’s upper threshold of 6% for the third consecutive month and is tracking close to the RBI’s estimate of 4.6% for Q1 FY24. Furthermore, component-level details reveal that the fall in headline inflation was largely broad-based. Food and beverages inflation decelerated sharply to 3.3% from 4.2% previously on account of continued easing in prices of edible oils, vegetables and meat and fish. Meanwhile, the prices of milk products, cereals and pulses remained elevated. Encouragingly, core inflation eased in May to 5.1% from 5.3% previously on the back of moderation in all categories barring personal care and effects reflecting the impact of a pick-up in gold prices. Based on details of the 299 items in the CPI basket, the share of items with inflation above 6% has declined to 40% in May from over 50% in the last six months of 2022.

Headline inflation moderated to 4.3% in May supported by a favourable base effect



Source: CMIE

Broad-based decline in inflation in May



Source: CMIE

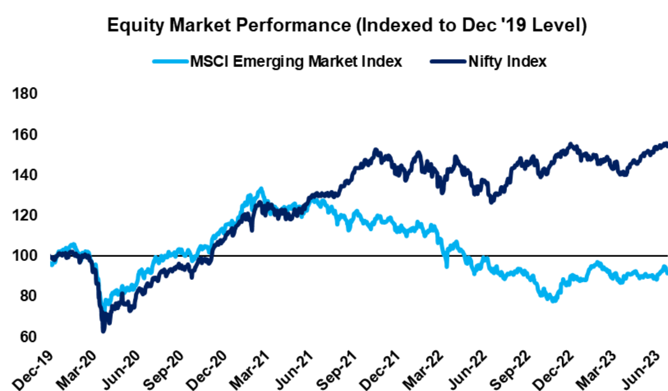
Despite these favourable developments, the “all clear” has not yet been reached regarding inflationary risks. Firstly, the base effect is expected to fade in the next few months pushing up inflation. Secondly, the risk from the adverse weather conditions (increased probability of El Niño associated with poor monsoon) continues to persist which is likely to negatively impact food prices. However, on the positive side, the WPI index observed a deflation of 3.5% in May (vs 0.9% in April) suggesting an easing of the input cost pressures which augurs positively for retail inflation. Additionally, the RBI’s latest survey suggests that the household expectation of prices three-months and one-year

period ahead has moderated by 10 bps each. Overall, we expect inflation to be in the vicinity of 5% for FY24 with risks tilted to the upside.

Market Update

The Indian equity markets continued their upward roll in May as both the indices – NIFTY and SENSEX – registered gains of 2.6% and 2.5% respectively. Amidst a broader market pickup, the BSE Mid-cap and BSE Small-cap overperformed the benchmark by increasing 6.3% and 5.6%, respectively, in May. The positive momentum is due to various factors including optimism around growth, strong corporate earnings, receding domestic inflation, and persistent buying on the part of foreign investors. Indeed, the FII's have pumped Rs 438 bn into Indian equities in May, the highest in CY23 so far. The upward rally continued in June with the benchmark indices inching closer to a record high in the week of 19th June on the back of positive global cues. However, the market observed some volatility in the week amidst Fed Chair Jerome Powell's testimony and a delayed monsoon. Overall, the domestic equity market continues to be resilient (up by 3.1% since the beginning of CY23) compared to the emerging markets with the Indian benchmark tracking over 50% higher than the pre-pandemic levels.

Indian equity markets remain resilient



Source: Bloomberg, Investing; Note: Data till 23rd June

Bond yields have been easing across the maturity spectrum in the past few weeks. The 10-year benchmark yields have declined by ~18 bps from an average of 7.19% in April to 7.02% in May while 1-year yields have declined by 8 bps during the same time. A downward movement in yields was observed despite the uptick in the US treasury yields driven by a strengthening domestic macroeconomic outlook, easing inflation, declining oil prices, and improving liquidity conditions (owing to a withdrawal of the Rs. 2,000 banknotes). In June, the bond yields continued to ease before the RBI policy meeting on June 8th where the cautiously hawkish stance by the MPC led to a marginal uptick in the yields. Accordingly, the 10-year yields inched up by 4 bps to 7.02% on the day of the policy. Since then, the bond yields have remained under pressure with 10-year yields reaching 7.07% by June 23rd as the negative impulses from the hawkish Fed comments hinting at more rate hikes in 2023 and a surge in supply of state government bonds outweighed the positive impulses from easing inflation and softening crude oil prices. Going ahead, while the near-term movement in the yields is expected to be flat, the bouts of volatility on account of global cues cannot be eliminated.

In the foreign exchange market, the domestic currency remained range bound in May as it oscillated between 82-83 levels against the US Dollar. On average the USD/INR traded at 82.3 in May noting a mild depreciation of 0.4% compared to the preceding month. The depreciation was led by a resurgence in the US dollar's strength amidst the successful debt-ceiling negotiations and a hawkish Fed. Accordingly, the dollar index appreciated by 1.0% on an average in May. The downward movement in the rupee was somewhat limited due to softer crude oil prices, sustained foreign inflows and the RBI intervention in the foreign exchange market to prevent sharp volatility in the domestic currency. Indeed, the RBI's forex reserves declined by $ 6.8 bn (compared to the beginning of May) to $ 589 bn on May 26. Moving into June, the rupee has somewhat strengthened amidst the weakening of the dollar (as the risk-on sentiment returns after the successful completion of debt-ceiling negotiations), softening of the crude prices and robust GDP print of Q4 FY23 offsetting the impact of the hawkish pause by the Fed. Accordingly, while the dollar depreciated by 1.4% till 23rd June (from May-end), the domestic currency appreciated by 0.9%. Going ahead, the movement in the currency market is likely to be range bound with periods of sharp correction being utilized by the RBI to build up its forex kitty.

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