24 March 2023

Indian economic activity remains strong in February; outlook uncertain due to a combination of international and domestic factors

- The impact of monetary policy tightening has started to appear in the financial sector - with the collapse of multiple regional banks in the US, the takeover of Credit Suisse by UBS, worsening cost of capital for financial institutions globally, and emerging reports of weakening in credit performance in institutions most directly exposed to higher interest rates.
- Central banks (particularly in western countries) now face a policy dilemma of securing price stability vs financial stability. Although, we do expect the central banks to continue to increase interest rates to combat price pressures which are far too elevated, the hikes going forward are likely to be more cautious.
- The Indian economy continues to hold up reasonably well despite growth moderating to 4.4% YoY in Q3 FY23 supported by investment activity and continued revival in the services sector.
- High-frequency indicators suggest resilience in economic activity; however, the outlook remains uncertain due to a mix of domestic and global factors including uneven recovery in private consumption, patchy private investment, and the weaker external sector.
- The central government's fiscal position remains contained in the first ten months of FY23 with the fiscal deficit reaching 67.8% of the Revised Estimate. We do see some risk of minor slippage from the second batch of supplementary demand of grants.
- In February, India's headline CPI remained at elevated levels (6.4%), only slightly lower than the previous month's 6.5% due to elevated food prices. Meanwhile, core inflation also remains sticky at 6.2%.
- In our view, easing of core inflation to below 6% will be seen as an important signpost towards decisive and durable moderation in inflation closer to the target of 4% in the medium term by the Monetary Policy Committee (MPC). As such we expect the MPC to raise rates again in its next policy meeting in April.

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Cracks emerge in the financial sector; economic growth to be hit further

The past couple of weeks have brought the first visible signs that the most pronounced global monetary tightening cycle in decades is beginning to take effect with implications for the macroeconomic outlook. Heretofore, there had been only scattered small-scale signs of financial stress and/or market dysfunction globally. However, the collapse of multiple regional banks in the United States, the Swiss government's facilitated takeover of Credit Suisse (CS) by UBS, the worsening cost of capital for financial institutions globally, and emerging reports of weakening in credit performance in institutions most directly exposed to higher interest rates all are consistent with a policy backdrop that is finally beginning to bite.

The cost of capital for the financial sector, be it debt or equity, is likely to be more adverse for some period, which in turn is likely to affect adversely the cost and supply of capital to the real economy. Concerns about the stickiness of uninsured deposits in the United States likely will lead nearly all banks to be more cautious in growing their loan and securities books. The Swiss government's decision to wipe out entirely CS's AT1 (additional tier 1) bonds – a specific type of bank debt that is a cornerstone of European banks' capital structure – is likely to increase funding costs for banks in Europe and the UK even with regulators in both countries making forceful statements that the CS outcome was not applicable in their respective regions. Banks in the US and Europe/UK have the biggest global footprints, are in the two biggest economic regions and have the capacity to influence sentiment toward the sector globally.

Without fail, a higher cost of capital for financial intermediaries translates to a higher cost of capital (and often reduced access to capital) for users of capital, i.e., businesses and households that comprise the real economy. While our confidence in such a directional conclusion is extremely elevated, the rough, much less precise, magnitude of this effect is nearly impossible to ascertain. The current environment is not the same as 2007-08 nor is that period even remotely applicable; moreover, policymakers have reacted rapidly and forcefully. Nonetheless, history is clear that a more challenging funding environment for financial intermediaries translates to a more challenging financing environment for borrowers and – in time – a softer economic growth environment.

Central banks now face the dilemma of securing price stability vs financial stability

There never is an opportune time for a financial sector flare up and the current environment is a particularly terrible time given prevailing rates of underlying inflation throughout much of the global economy. While the near certain tougher credit environment will be a headwind to economic growth, inflation rates are so far away from desired/acceptable levels in many countries and key inputs to the inflation process – such as employment conditions in many western countries – are so strong that central bankers cannot be confident that financial sector-induced credit tightening on its own will be sufficient to temper price pressures to the degree the policymakers desire.

Despite the quickest tightening cycle in decades, inflation remains far away from desired levels

	Policy Rate (%)						Cumulative Hikes since Jan 2022 (bps)	Inflation (deviation from target)
	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23		
US	3.25	4.00	4.50	4.50	4.75	5.00	475	6.0 (+4.0)
China	3.65	3.65	3.65	3.65	3.65	3.65	-5	1.0 (-2.0)
EU	2.00	2.00	2.50	2.50	2.50	3.00	300	8.5 (+6.5)
Japan	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0	3.3 (+1.3)
UK	2.25	3.00	3.50	3.50	4.00	4.25	400	10.4 (+8.4)
India	5.90	5.90	6.25	6.25	6.50	6.50	250	6.4 (+2.4)

Source:* *US Federal Reserve, People's Bank of China, European Central Bank, Bank of Japan, Bank of England, Reserve Bank of India

There may be no worse dilemma for a central bank than trying to secure price stability at a time of financial instability, whatever the degree of financial instability. But that is what many central banks around the world now face.

Conditional on financial sector turbulence not worsening from here, we expect that most central banks will continue to increase interest rates in the period immediately ahead to combat price pressures that remain far too elevated. But these will be very cautious interest rate hikes with policymakers stressing that they are aware of the need to balance price stability and financial stability and that they will be monitoring financial and economic conditions acutely – code for they have no idea themselves what policy action beyond the very near term ultimately might be taken. In this context, the Fed raised the policy rate by 25 bps to 4.75-5.0% in its latest meeting and changed the forward guidance language from "*ongoing increases in the target range*" to "*some additional policy firming may be appropriate*" signalling that the policy peak is perhaps nearby. The Fed chair noted that the recent events in the banking system are likely to result in tightening of lending conditions, which will have a similar impact as further hikes implying that the current banking crisis is to some extent doing the job which the Fed wanted to do. This strengthens the case that future policy actions would be more cautious and data dependent.

On balance, the combination of still higher policy interest rates – whatever the ultimate scope – plus the near certainty of a more challenging bank financing environment tilt to the

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downside the risks around economic growth over the remainder of 2023. As noted earlier, having confidence in the magnitude of this headwind is impossible at this point but the directional tilt is clear. Inflation is a lagging indicator so chances are good that it may remain near prevailing levels for many months, potentially creating the impression that a stagflationary environment is emerging.

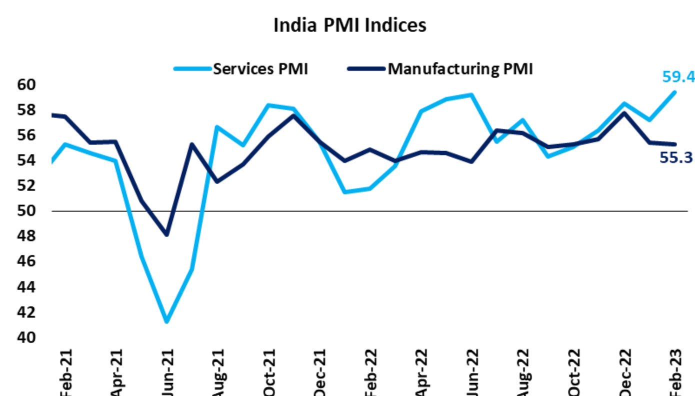
As such, the macro environment ahead is going to be one of the most uncertain ones in quite some time with various conflicting signals. Fortunately, there are no major imbalances in most of the world's major economies – unlike 1999-2000 or 2007-08 – and the policy response to the financial sector's troubles has been rapid and large. These dynamics in turn should forestall a rapid and destabilizing economic descent. But the prospects of a recession in many places of the world have gone up and the prospective timetable for such an outcome has been pulled forward.

India's economic growth holds momentum despite pockets of softness

The Indian economy continues to hold up reasonably well in both absolute terms and relative to other large economies around the world. India's growth did moderate in Q3 FY23 with the pace of activity advancing by 4.4% in Q3 (from 6.3% in Q2), in part due to the waning of the base effect. The growth in the previous quarter was supported by investment activity potentially buoyed by the government's CAPEX push as private consumption growth slowed due to the base effect. On the supply side, while normalizing consumption pattern supported the continued revival of the services sector, industrial sector performance in Q2 was dragged down by the second consecutive quarter of contraction in manufacturing activity amidst the elevated input cost pressures.

Encouragingly, the industrial activity seems to have stabilized in Jan-Feb after slowing down in the holiday-heavy festive season (Oct-Nov). The index of industrial production observed a robust growth of 5.2% YoY in January (second highest reading since July '22) and expanded sequentially for the third consecutive month. In terms of the composition, the growth was supported by electricity and mining, while the momentum in the manufacturing sector has been sluggish amidst the continued weakness in the external sector demand. Nonetheless, as per the lead indicator, the PMI manufacturing in February stayed in the expansionary zone despite multiple headwinds, led by expansion in new orders and output largely driven by domestic demand as international orders remained subdued. Meanwhile, other high-frequency indicators like GST collection, e-way bills, credit to large industries, etc. remained buoyant. However, with the world fearing snowballing of the US banking crisis, especially in light of the recent financial events, the extent of the global demand slowdown remains a key uncertainty for the industrial sector outlook.

Domestic PMI indices stayed robust in February



Source: S&P Global; index value above 50 indicates expansion

Supported by the recovery in the contact-intensive sector (which bore the maximum brunt of the pandemic) and the resilient banking sector, the services sector led the growth in Q3 FY23. High-frequency data suggest that momentum in the services part of the economy continues to hold up. In February, the services PMI reached its highest reading ever in the past 12 years as companies reported that demand resilience and competitive pricing policies underpinned the joint best upturn in sales. Looking ahead, while the incoming high-frequency data remains strong and suggests a positive outlook for the services sector (partly on account of the low base), the risk from easing of domestic demand as pent-up demand fades and external slowdown impinging on growth remains.

Demand conditions remained buoyant; outlook is uncertain due to a host of factors

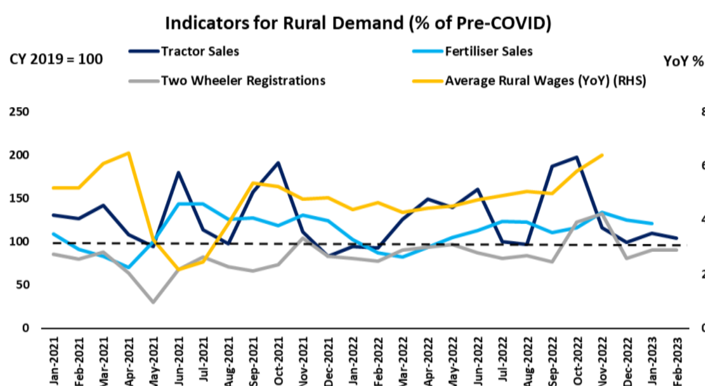
Incoming data for aggregate demand indicators continue to reflect resilience amidst the multiple headwinds. However, looking ahead the outlook is more uncertain due to a mix of domestic and global factors.

Firstly, the risk for the growth outlook ahead lies in the uneven recovery in private consumption. Urban demand has shown consistent signs of improvement with robust momentum in high-frequency indicators like passenger vehicle sales, domestic air traffic, personal credit, etc. Meanwhile, there are nascent signs of improvement in the proxies for rural demand indicators like consumer non-durables, two-wheeler registrations, tractor sales, diesel consumption etc. (which had been lagging urban demand) owing to strong Rabi sowing providing some comfort that demand conditions are likely to remain conducive, at least in the immediate near term. However, the outlook is less promising in the second half of CY23 with the risk of uneven

rains affecting the Rabi crop output and El Niño conditions (associated with sub-par monsoon) hitting India in 2023.

Furthermore, as we have flagged previously, an uneven recovery in the labour market, with employment in sectors such as manufacturing and hospitality still lagging pre-COVID levels, is likely to hold back private consumption recovery, once the boost from pent-up demand fizzles out.

Rural demand shows signs of steady improvement

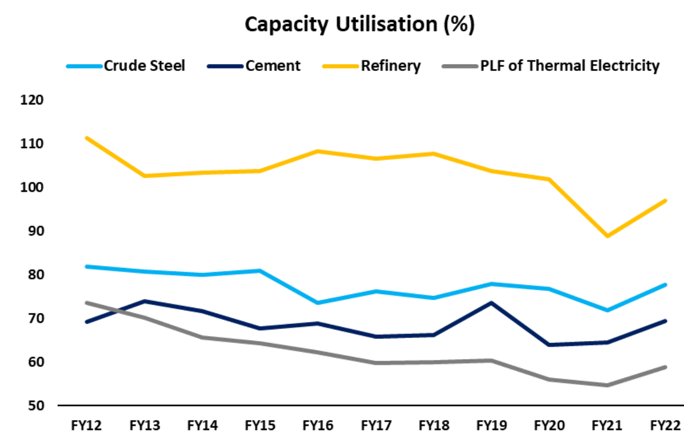


Source: CMIE

Secondly, private investment has remained weak. While investment activity was the leading driver of economic growth in the prior quarter it was likely buoyed by the government's continued focus on CAPEX as the signs of pick up in private sector investment have been patchy up till now. This could be due to low capacity utilisation (CU) in the private sector. According to a CMIE study, the CU for the four capital-intensive sectors where the private sector has substantial investment, has remained low. For conventional power generation, the plant load factor (a measure of CU) is much lower than a decade ago. For refineries, the CU dropped to 97% in FY22 which is significant given refineries generally report over 100% of CU, while for crude steel CU is down to 77.8% in FY22 (from 81. 8% in FY12). On the other hand, the CU for the cement industry stood at similar levels despite a significant increase in capacities reflecting unutilised capacities in the industry. Hence, for these large industries, there is no significant reason to consider big investment decisions at present.

Lastly, the external sector held back growth in the last quarter and recent developments in major economic regions outside India suggest that the trend likely will persist. Importantly, however, the extent of the drag came down significantly compared to Q2, thanks to the resilient services export. Turning to recent data, the merchandise trade deficit narrowed in Jan-Feb (compared to the previous quarter) in line with the seasonal pattern. Overall, the trade deficit narrowed by 6.4% YoY to US$33.8bn YoY in the first two months of CY23 with imports witnessing a larger contraction than exports owing to the cooling of the commodity prices. Whether the current narrowing of the merchandise trade deficit is a one-off event or if it sustains is yet to be seen. But at present, we remain of the view that a weaker global economy is likely to exert a drag on domestic growth.

Lower capacity utilization remains a challenge for meaningful pickup in private investment



Source: CMIE; Above four industries account for 30% of the total net fixed assets of all non-finance companies in CMIE's database

The spillover from slower global growth will not only be felt through weaker exports but also through weaker capital flows to the country. Indeed, gross inward foreign direct investment (FDI) moderated to US$ 61.5 billion during FY23 (April-January) from US$ 70.5 billion a year ago. A rise in global risk-off sentiment, despite India's bright growth prospects, is likely to hurt foreign investment flows into the country in FY24.

The central government fiscal deficit remains contained; additional grants likely to create minor slippage

The central government fiscal deficit widened to 67.8% of the Revised Estimates (RE) in the first ten months of FY23 (Apr-Jan) which was slightly higher compared to the last year (58.9% of RE) as the expenditure growth exceeded the revenue growth. Nonetheless, the fiscal deficit continued to be much lower than the five-year pre-pandemic average (117% for FY16-20). In terms of composition, the capital expenditure of the government has grown impressively by 29% YoY (Apr-Jan), while growth in revenue expenditure so far has been rather modest (9.7% YoY), reflecting improvement in the quality of the government's expenditure.

Cash outgo proposed under the second supplementary demand for grants

Purpose	Expenditure (in crores)		
	Revenue	Capital	Total
Fertilzer Subsidy	36,325		36,325
Defence Pensions	33,718		33,718
GST compensation	33,506		33,506
Universal Service Obligation Fund (Telecom Sector)	25,000		25,000
Others	15,828	3,755	19,583
Total	1,44,378	3,755	1,48,133

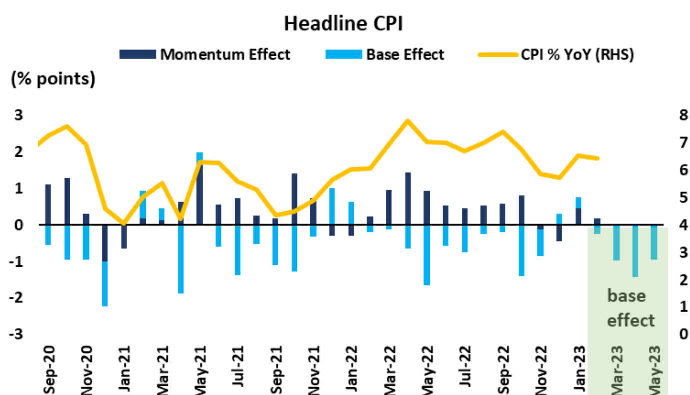
Source: Department of Economic Affairs

For the current fiscal year, the central government has sought parliamentary approval for the second batch of supplementary demand of grants worth Rs 2.7 lakh crores involving a net cash outgo of roughly Rs 1.48 lakh crores. The bulk of the additional spending is concentrated in fertiliser subsidies, defence pensions, the telecom sector and GST compensation. The additional expenditure is likely to be met by the savings under other heads, but we do see the risk of minor slippage in the fiscal deficit target for FY23.

Inflation refuses to budge in February; another rate hike is likely in April

In February, consumer prices increased in excess of 6% (the RBI's upper tolerance threshold) for a second consecutive month as high food prices (particularly cereal) kept headline inflation elevated. CPI rose by 6.4% YoY, only slightly lower than the 6.5% recorded in January while food and beverages inflation accelerated to 6.3% (up from 6.2% previously). Within food, the cereal inflation rose to 16.7% in Feb (up from 16.3% in Jan). While there was a discrepancy in the overall cereal index against the weighted sum of sub-components in January (the latter showing a softer rise) the same was not true for the latest month implying that the rise is not probably linked to a data quality issue. The increase could have been the result of the discontinuation of free food grains under the PMGKAY scheme leading to higher demand. Nonetheless, in response to high cereal prices, the government has already intervened by offloading additional wheat in the market from the FCI's (Food Corporation of India) stocks. This has led to an 8-10% drop in retail prices of wheat and wheat flour in the month leading up to mid-March, which is likely to show up in a slower inflation print for March. A favourable base effect and falling WPI inflation are also likely to support an easing in price pressures over the next few months.

Inflation above 6%; easing likely ahead



Source: CMIE

While the spike in headline inflation seen over the past couple of months is expected to be temporary, the RBI is likely to focus more on core inflation which continues to remain sticky above 6% (6.2% in February). Core inflation remains elevated as a result of continued high inflation in the clothing and footwear, transportation, household goods and services, health, and personal care and effects categories. As mentioned in the statement of the RBI governor and the individual statements of a majority of MPC members, persistently high core inflation and containment of second round effects remain major policy concerns. In our view, easing of core inflation to below 6% will be seen as an important signpost towards decisive and durable moderation in inflation closer to the target of 4% in the medium term by the MPC. As such we expect the MPC to raise rates again in its next policy meeting in April, especially since both the Fed and ECB – the locales of recent financial sector turbulence – have continued to hike interest rates in the past week.

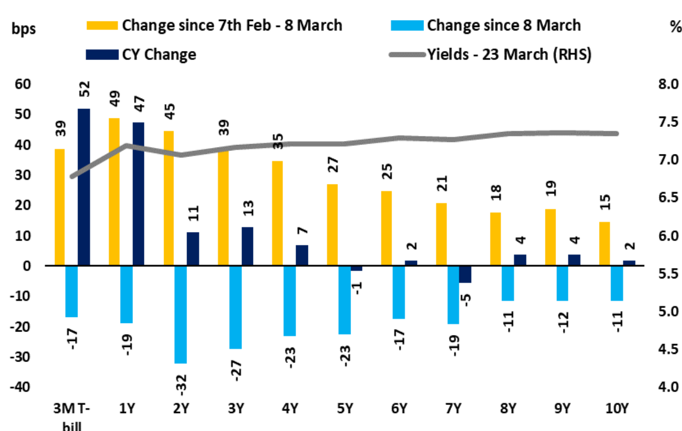
Market Update

Bond markets remained volatile in February – March tracking volatility in the global markets. Strong economic data in the US and persistently high inflation had prompted comments from Fed Chair Jerome Powell about the terminal rate needing to be higher than previously anticipated and the possibility of increasing the pace of rate hikes. Higher than anticipated domestic inflation in January had also contributed to harder yields until early March. India's 10Y G-sec yield reached 7.46% on March 8 compared with 7.34% one month ago. However, the collapse of two regional banks in the US, Silicon Valley Bank and subsequently Signature Bank, in the second week of March, led to a softening of yields as investors rushed to the safety of American debt. Indian government bond yields remained in check even as inflation data for February came in hotter than expected strengthening the case for another rate hike by the RBI in April. Between March 8-23, US 10Y treasury yields declined by 58bps while the same for the Indian counterpart declined by 11bps. Bond yields in the US slid following the Fed's policy decision on March 22, as the Fed chair delivered a somewhat dovish statement signalling that the policy peak is perhaps nearby. US 2Y yield has fallen by 35 bps since the meeting. In the near term, movement in the bond yields will track global yields. Looking ahead, low oil prices, an expected easing in the rate of inflation and a resilient domestic economy should keep yields under check.

Indian equity markets remained under pressure in February as the continued fallout from the Adani crisis coupled with the risk-off sentiment due to the expectation of quicker interest rate hikes in the US affected investor sentiment. The NIFTY fell by 2% through February while the SENSEX fell by 1%. This happened even as domestic institutional investors invested Rs 192 billion in the equity market, more than offsetting the outflow of Rs 53 billion by foreign institutional investors. The equity market indices improved in the first week of March owing to positive global cues. However, the

sentiment soon turned sour as the failure of the Silicon Valley Bank and soon after that of the Signature Bank in the US spooked investors. Quick action by the US and European regulators and the sale of CS to UBS have calmed the markets as of the time of writing but investors are likely to remain cautious over the coming weeks. The NIFTY was down by 1.3% in March (till 23rd) while the SENSEX was weaker by 1.8%. In the near term, the outlook for the equity markets remains uncertain and will be guided by global market developments. Over the medium term, healthy corporate balance sheets and good economic prospects for the country should ensure support for Indian equities.

Bond market volatility – before and after SVB collapse



Source: Investing.com, Bloomberg; Data till 23rd March

The Indian rupee depreciated by 0.9% in February in line with the strengthening of the US Dollar as strong economic data, persistently high inflation and subsequently the Fed chair's comments raised the speculations of a 50-bps hike by the bank in March. The drop in the foreign exchange reserves in February to ~ US$561 bn from US$576 bn (end January) likely reflects some intervention in the currency markets by the RBI to prevent the exchange rate from breaching the 83-level. In the first week of March, the rupee appreciated slightly in line with the return of FIIs but as the investor sentiment turned weak following the SVB and Signature Bank collapse, FIIs turned negative again and the exchange rate gains were erased. Still, quick action by the regulators in the US and Europe did well to curb excess volatility in the market. In March (as of the 23rd), the rupee averaged 82.3 against the US Dollar, compared with 82.6 in February. In terms of the real effective exchange rate, the rupee depreciated to below 100 (fair value) to 99.6 in January (from being around 4% overvalued at the start of Q3 FY23) correcting the imbalances and easing depreciatory pressure on the currency. Plus, the fall in oil prices (to below US$75/bbl by mid-March from ~84 at the start of March) is likely to provide support to the rupee. Given the highly precarious financial conditions globally, we do not rule out bouts of volatility in the currency markets. Ongoing risk aversion could create some depreciatory bias for the rupee in the near term, although the RBI is likely to curb any excess volatility in the exchange rate.

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