27 November 2024

India's Q2-FY25 Economic Growth Likely to Slow to a Six-Quarter Low; Elevated Inflation Delays Rate Cut Expectations to Q4

- US President-elect Donald Trump is expected to pursue a pro-growth policy agenda in his second term, with a focus on broad deregulation, tax reforms, and selective tariffs. This should keep the US growth on a solid trajectory and may boost the economy's long-term potential.
- Trump 2.0 is likely to adopt a nuanced tariff strategy, implementing selective and phased-in tariffs to manage inflation concerns, rather than broad-based tariffs. However, trade disruptions and periods of heightened uncertainty are likely.
- After a weak start to FY25, India's economic growth is projected to have slowed further in Q2. We expect real GDP growth to come at a six-quarter low of ~6.3% YoY in Q2 FY25.
- In Q2, signs of softer urban consumption, weaker external demand, and sluggish government spending were evident, while rural demand showed some pickup. Weather disruptions also dampened economic activity while contributing to inflation.
- India's real GDP growth for FY25 is expected to be around 6.7%, with a recovery in the second half, driven by the positive outlook for rural demand, an increase in government spending, and the fading of weather-related disruptions.
- Given a slower economic momentum, India needs a counter-cyclical policy response. Further, targeted supply-side interventions are needed to address inflationary pressures.
- The government's fiscal position leaves significant scope to boost spending in H2, though there is a risk of it missing the CAPEX target.
- Meanwhile, elevated inflation is constraining a counter-cyclical response by the monetary policy in the near-term. Headline inflation accelerated sharply to a 14-month high of 6.2% in October, driven by a sharp jump in vegetable prices.
- We now believe the earliest possibility for a policy rate cut is at the February meeting, with further delays possible if domestic inflation or global factors become adverse.

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Trump 2.0: Will deregulation, corporate tax cuts and an import tariff prove to be inflationary?

Donald Trump's election to a second (non-consecutive) term as US President will have sweeping implications for the world's biggest economy and – directly and indirectly – large swaths of the global economy. The Trump economic approach is a heterodox one, combining initiatives for robust private sector growth via a favourable tax regime and deregulation, preservation of social safety-net programs typically championed by the Democratic Party, select aggressive anti-trust enforcement, and trade intervention via tariffs. As with the first Trump Administration (Trump 1.0), the second Trump Administration (Trump 2.0) is poised to challenge existing, widely accepted economic norms. And, armed with a significantly better understanding of how government functions, Trump 2.0 has the capacity to enact potentially durable changes to the US and global economic policy.

Considerable analytical focus has been devoted to Trump 2.0's likely policy initiatives on the fiscal and international trade front. Such focus is a natural extension of Trump 1.0's policy pursuits plus those articulated by Mr. Trump during the presidential campaign. The conventional conclusions are that Trump 2.0 is likely to result in an initially faster US economic growth but with higher – perhaps considerably higher – US inflation due to widespread tariffs on US imports that both raise consumer prices directly and produce global production inefficiencies that (with a lag) increase further the cost of goods sold.

We find such analysis overly simplistic. To be sure, a fiscally driven aggregate demand boost with the economy at/close to full employment and/or immediate implementation of 10% to 20% tariffs on all imports would produce higher US consumer prices. But we do not see the Trump economic agenda unfolding in such a fashion; rather, the Trump 2.0 policy initiative is likely to be considerably more nuanced. Moreover, a key deciding factor of the presidential election was the cost of living – Trump 2.0 is not going to pursue policies at the start of its Administration that likely would worsen the cost of living issues further.

We are highly confident that Trump 2.0 will result in the broadest set of US import tariffs since the 1970s and possibly the 1930s but the precise composition and manner of implementation of those tariffs will matter greatly. Existing tariffs on select Chinese imports will remain and the duties charged may go up as soon as Mr. Trump is reinaugurated as President. The effect of such action is likely to be minimal, as the bulk of these tariffs have been in place since Trump 1.0 and trade flows and related goods production have adjusted accordingly. There also is a very good chance that aggressive tariffs will be wielded against Mexico (and to an extent Canada) early in Trump 2.0, in the event these countries are unwilling to assist in managing immigration pressures on the US border and/or the inflow of illegal narcotics.

More broadly, however, our assessment is that tariffs will not be a blunt force tool – i.e. implemented at a 20% immediate rate against all imports. At this point, it appears Trump 2.0 is not sure whether to implement broad tariffs under "economic emergency" provisions available to the President or whether to seek legislation, which, if enacted, would make the imposition of tariffs more durable since undoing them would require Congressional action with Presidential approval as opposed to just Presidential executive action. It will take time for the incoming economic team and President Trump to sort out its policy preferences on this front. Treasury Secretary nominee Scott Bessent has discussed the possibility of phasing in tariffs; such an outcome would allow producers and consumers to adjust production, consumption, expectations and the like over a period of time as opposed to immediately, thereby producing less economic disruption.

While a phased-in or surgical implementation of tariffs would minimize adverse effects on the US economy, any sort of broad-based tariff regime akin to what President Trump campaigned on – however implemented – will affect countries with large exports to the US. Certain industries such as, for instance, textiles are likely to experience only modest disruption since such industries already tend to be domiciled in the lowest or near lowest cost of production and the return on investment of producing such goods in the US is unattractive. However, it could be a different story for industries in the upper quartile of the value-add chain due to a mix of import duties and easier US regulations and – perhaps – lower US taxes and/or incentives to build domestic production.

None of this is to imply it will be smooth sailing on the international front. President Trump is unpredictable and, as seen in Trump 1.0, prone to staking out maximalist positions to try to obtain his desired outcomes. As a result, even if our broad assessment outlined above is generally correct, there will be periods of chaos, upheaval and the like. Sorting signals from noise during such periods always is challenging. But currently, we firmly believe the aforementioned framework is the best lens through which to view Trump 2.0's trade and tariff approach.

Away from tariffs, Trump 2.0 will pursue a decidedly pro-growth set of domestic economic policies. Whereas in Trump 1.0, a key component of Mr. Trump's pro-growth policies was a large reordering of the US tax code, we expect tax policy to play a secondary, albeit important, role in Trump 2.0. That partly reflects that additional tax cuts from the prevailing policy are likely to be targeted rather than broad and likely to focus more on increasing capital investment and thereby the economy's potential rate of growth.

We expect that an aggressive and exceptionally broad deregulation agenda will be at the heart of the domestic economic agenda. Deregulation of energy production to increase still further the US's leading position in global energy supply; deregulation of parts of the financial sector to try to ease the flow of capital to businesses, especially startups; rolling back of cumbersome permitting and paperwork; and a generally rah-rah "US is open for business" mindset. There also is the distinct possibility of a structural reworking of the Defence Department's spending on weapons and related infrastructure that holds the potential to have favourable long-run effects for emerging technologies and industries. To this point, President Trump is considering nominating an experienced venture capitalist to be Deputy Defense Secretary, which would be a first.

These pro-growth policies should keep the US domestic economy on the solid trajectory that has prevailed during the post-COVID era. The true measure of success of these pro-growth policies is less in the near-term growth rate – which also should be underpinned by continued favourable macro fundamentals – and more in whether they are able to boost US productivity and with it the pace of US potential economic growth. A similar policy mix in Trump 1.0 was in the process of doing just that when the COVID-19 shock hit. Success this time around – if realized – would be a positive for the world that helps to offset the negative effects of tariffs.

Q2 GDP Preview: India's economic growth projected to have fallen to 6.3% in Q2; FY25 GDP growth estimated at 6.7%

After a weak start to FY25, India's economic growth is projected to have slowed further in Q2. As per our estimates, real GDP growth is projected to have fallen to a six-quarter low of ~6.3% YoY in Q2 FY25 following 6.7% growth registered in Q1 FY25 when temporary disruptions—such as a heatwave and the general elections—had significantly impacted economic activity. Real GVA growth is estimated to be around 6.2% in Q2. While GDP growth and GVA growth are expected to remain relatively close, the gap between the two is anticipated to remain positive, supported by faster growth in net indirect taxes compared to the previous quarter.

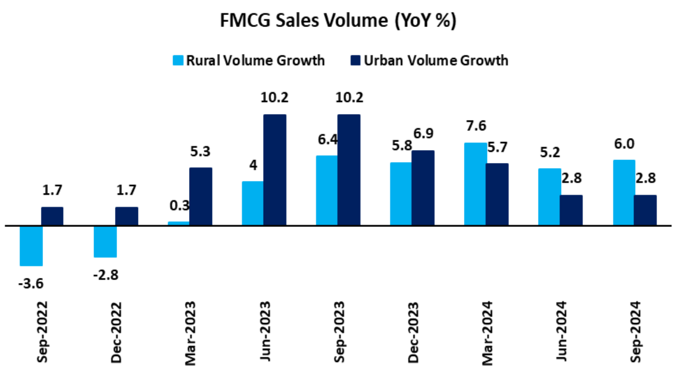
In Q2, signs of softer urban consumption, weaker external demand, and sluggish government spending were evident, while rural demand showed some pickup. Excess rainfall and an extended monsoon season have also dampened economic activity while contributing to inflation, particularly in food prices. Private investment showed improvement in Q2, although it was concentrated in select industries. Industrial activity slowed sharply while construction activity moderated, with cement production contracting and steel consumption growth easing. Services-related indicators displayed some resilience in Q2, with improvements seen in air and port traffic and government revenue expenditure (net of interest and subsidies). However, other indicators, such as banking credit and deposit growth, as well as the Services PMI, moderated in Q2 compared to Q1. Lower sales growth and margin pressures led to subdued corporate earnings reports, with manufacturing industries underperforming services industries.

For FY25, we revise India's real GDP growth forecast from 6.9%-7% to 6.7%, reflecting weaker-than-expected growth in H1, particularly in Q2. We expect a recovery in the second half of the year, driven by fading weather-related disruptions, and a positive outlook for rural demand. Additionally, government spending is likely to pick up. However, downside risks remain, primarily due to persistent domestic inflation pressures. Additionally, global factors, such as geopolitical tensions—particularly in the Middle East and the ongoing Russia-Ukraine conflict—along with heightened concerns about potential US tariff changes next year, could weigh on global demand, disrupt trade flows, and cause market volatility.

Demand conditions weakened in Q2; tentative signs of revival in early Q3

Domestic demand conditions weakened in Q2 FY25, driven by a cyclical slowdown, which was further exacerbated by weather-related disruptions. Structural factors such as sluggish households' income growth and the lack of a broader private investment revival continue to play a role. GST collections fell sharply to a 15-quarter low of 8.9% YoY in Q2, reflecting softening demand conditions.

Urban FMCG growth remains muted while rural counterparts saw some improvement



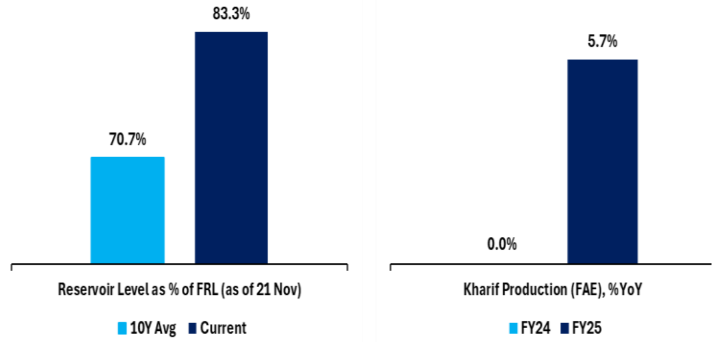
Source: Business Standard, NielsonIQ survey

Urban demand indicators showed weaker sales growth, while rural demand indicators were mixed. According to media reports, Nielson-IQ data indicated a decline in FMCG volume growth to 4.1% YoY in Q2 FY25, down from 8.6% in Q2 FY24, reflecting weaker consumer demand and ongoing challenges in the market. FMCG rural sales volume outpaced the urban counterparts for the third consecutive quarter. Banking retail credit continued to slow, with credit card usage showing continued moderation. Auto sales were disappointing, with passenger vehicle sales contracting by 1.3% in Q2, compared to a modest 3.4% growth in the previous quarter. This decline was primarily driven by weaker sales of passenger cars (a proxy for urban demand). Meanwhile, rural demand indicators, such as two-wheeler sales, grew at a slower pace compared to the previous quarter but remained in double digits, while tractor sales remained flat.

On the investment front, domestic CAPEX showed some sequential improvement, notably due to a rise in central government CAPEX (discussed later in the report) and new projects announced in Q2. According to CMIE, new capacity creation projects amounted to Rs 6.7 trillion (~77% from the private sector) in Q2 FY25, nearly doubling from Rs 2.2 trillion in the previous quarter and up 54% YoY. However, these new projects remain concentrated in just five sectors, which account for 82% of the new projects. Meanwhile, funds raised from the stock market continued at a robust pace. Having said that, a broader and sustained revival in investment seems unlikely in the near term, given the softer domestic conditions and heightened uncertainty about the global trade outlook. We continue to expect government CAPEX to drive investment activity in the near term.

Early high-frequency data for Q3 suggests some improvement, but the sustainability of this momentum will be key, particularly after the seasonal lift from festivals. There has been a broad-based pick-up in passenger vehicles, two-wheeler, and tractor sales in October, with vehicle registrations rising sharply during the festival season. Credit card usage also reportedly picked up during the festive period. GST collections and petroleum consumption also recovered in October, indicating a tentative revival in economic activity.

Recovery in private consumption in H2 expected to be driven by rural demand



Source: CMIE

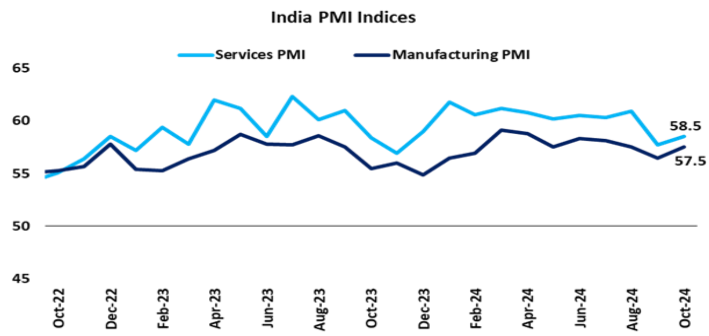
Anticipated recovery in private consumption in H2 is expected to be driven by rural demand. According to the first advance estimates for FY25, the kharif foodgrain output is estimated to rise by 5.7% over the final estimates of FY24. This, coupled with favourable conditions for rabi crops, supported by higher reservoir levels, is expected to boost rural income and demand. Urban demand, on the other hand, is likely to remain subdued, though it may improve incrementally due to expected easing in inflation and potential recovery in labour market conditions.

According to CMIE, the unemployment rate in rural areas rose in October, partly due to seasonal factors (the end of the kharif crop cycle). However, urban unemployment improved by ~60bps to 8.6% in October, with an increase in salaried employment. The PMI manufacturing and services indices also reported an increase in the pace of hiring in the organized sector, primarily in urban areas. The Naukri JobSpeak Index showed a strong 10% YoY growth in October, accelerating from 6% growth in September, indicating increased hiring in the organized sector. While these indicators suggest a tentative recovery in demand conditions and employment creation, it remains to be seen whether this trend will be sustained beyond the festival season. Although the expected fall in inflation should help improve purchasing power, the subdued growth in urban salaries and wages, as well as rural wage growth, remain a concern for a strong and sustained pickup in private consumption.

Industrial activity slid to a multi-quarter low in Q2, tentative signs of recovery in October

Industrial activity in Q2 FY25 slowed significantly, with the Index of Industrial Production (IIP) growth falling to an eight-quarter low of 2.6% YoY. This decline can be attributed to heavy rains, weaker demand, and the base effect. The mining, electricity, and manufacturing sectors all posted their lowest growth rates in eight, five, and seven quarters, respectively. Most use-based categories, except for capital and intermediate goods, saw weaker growth compared to the previous quarter, reaching multi-quarter lows.

PMI indices improved in October



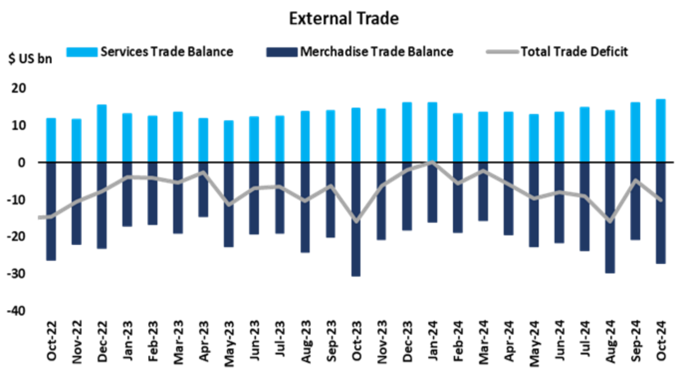
Source: S&P Global

However, there were tentative signs of a recovery in industrial activity in September. The IIP rebounded with a 3.1% YoY growth, recovering from a 0.1% contraction in August. The recovery was broad-based, with improvements across mining, electricity generation, and manufacturing. Furthermore, in early Q3, the PMI Manufacturing Index rose to 57.5 in October, up from September's eight-month low of 56.5, driven by domestic restocking ahead of the festive season and stronger export orders. Services-related indicators also showed improvement. The services PMI rose to 58.5 in October, up from a ten-month low in September, supported by robust demand and recovery in exports.

Exports show a sharp recovery in October after sluggish Q2

India's exports showed a sharp recovery in October following a sluggish pace in Q2. Merchandise exports grew robustly by 17.2% YoY in October, rebounding from a contraction of -3.9% YoY in Q2. Despite a 22.1% YoY decline in petroleum exports due to lower crude prices, non-oil exports surged by 25.6% YoY in October, driving overall export growth. Meanwhile, services exports grew by 21.3% YoY in October, while service imports increased by 26% YoY. Although the services trade balance improved, the merchandise trade deficit widened in October due to a rise in import growth. The trade outlook remains clouded by heightened uncertainties, particularly with the increased risk of the next US administration raising tariffs, potentially triggering retaliatory measures from impacted countries.

Trade deficit in October widened despite a sharp recovery in exports

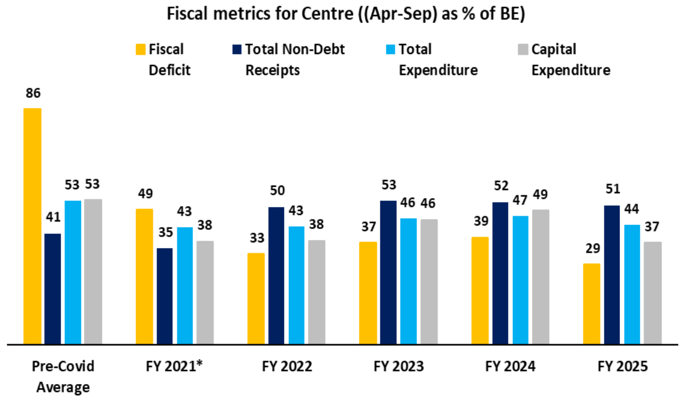


Source: CMIE

Need for counter-cyclical policy support amid slower economic growth in Q2

Given the expected slower economic growth in Q2, there is a need for counter-cyclical policy support from both fiscal and monetary policies, along with supply-side intervention to cool off inflationary pressures. After disruptions to central government spending during the national elections in Q1, government expenditure rose in Q2. However, the pace of spending remains slower than desired, considering the need to support the economy. While the central government's revenue and capital expenditure increased by 6% YoY and 10.3% YoY, respectively, in Q2, this was insufficient to offset weaker spending in the previous quarter. As a result, total government expenditure contracted by 0.4% YoY in H1 FY25, driven by a 15.4% YoY decline in CAPEX. To meet the full-year target, the government requires a ~52% YoY increase in CAPEX in H2 FY25. Given the current pace, the government is likely to miss its CAPEX target. Meanwhile, state governments also showed recovery in spending during Q2, but total expenditure across 20 states grew at a moderate pace of 8.1% in H1 FY25. Growth in revenue expenditure partly offset a steep 11.7% YoY decline in state CAPEX.

Contained fiscal deficit leaves the scope for stepped-up spending in H2



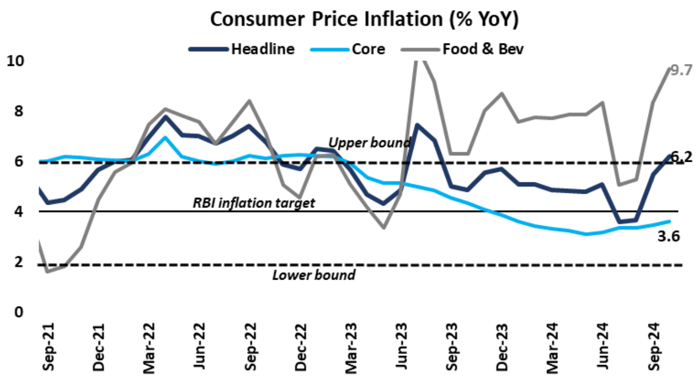
Source: CMIE; Note - * For FY21 calculation is based on Revised Estimates due to pandemic year

For the central government, strong non-tax revenues (boosted by a large dividend from the RBI), solid tax revenues, and tepid spending have helped narrow the fiscal deficit in the year to date. The fiscal deficit for H1 FY25 stood at 29.4% of the Budgeted Estimate (BE), down from 39% in the same period last year and significantly below the pre-pandemic five-year average of 86%. This provides the central government with significant fiscal space to increase spending in H2. There are early signs of increased government spending, as reflected in a sharp decline in cash balances in recent weeks, which should support broader economic activity. Additionally, media reports suggest that the central government is likely to release Rs 50,000 to 70,000 crore to states under its 'special assistance for capital investment' scheme in Q3, which would further aid the recovery of state CAPEX.

Jump in vegetable prices pushes the headline inflation above 6%

Headline inflation accelerated sharply to a 14-month high of 6.2% in October from 5.5% in the prior month, breaching the RBI's upper threshold of 6%. The uptick in inflation was driven by food inflation as core inflation despite rising continues to remain modest. Inflation in Q3 is likely to overshoot the RBI's projection of 4.8%.

Headline inflation crossed the 6% mark in October

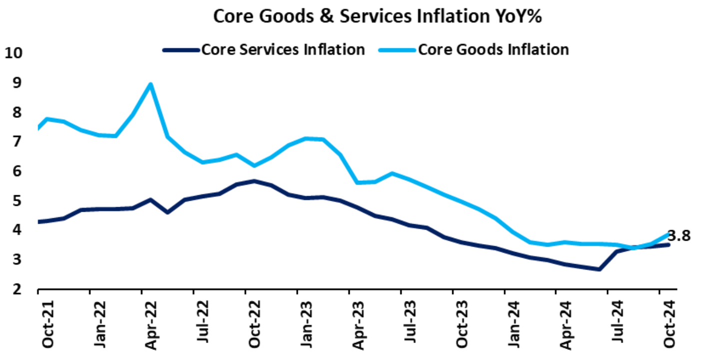


Source: CMIE

Food and beverages inflation quickened to a 15-month high of 9.7% up from 8.4% in September and contributed 4.4 percentage points to the headline print. This is primarily led by a sharp jump in vegetable prices which grew by 42% YoY (vs 36% in Sep) due to the impact of unseasonal rains. Indeed, excluding vegetables, food inflation is estimated at almost half at ~4.7%. In terms of contribution, cereals and edible oils also contributed to the elevated food inflation. Cereal inflation remained sticky at 6.9% (vs 6.8% in September). This could also be due to higher demand with the government removing the ban on rice exports. Meanwhile, edible oils inflation jumped to a nearly two-year high of 9.5% (vs 2.5% in September), due to the customs duty hike announced in mid-September and higher global prices. Positively, the vegetable price pressures are expected to recede going forward as fresh harvest arrives in the market. This is also being reflected in the daily prices which are showing a decline in vegetable prices in the first three weeks of November, however, cereals, pulses (except Tur), and edible oil prices showed a rise. While food prices should ease in the coming months from October's elevated levels, a more pronounced moderation is expected only by early next year.

Core inflation inched up to 3.7% in October, from 3.5% in September. This increase was primarily led by a rise in core goods inflation, which increased to 3.85% from 3.54% previously, largely due to higher gold and silver prices amidst the festive season demand. Meanwhile, core services' inflation remained flat at 3.5%. Core inflation appears to have bottomed out and is expected to pick up gradually as base effects fade and sequential price increases continue. Additionally, the PMI survey indicates that companies are passing on higher input costs to consumers, which should be further reflected in core inflation in the coming months.

Core inflation inched up led by gold & silver prices



Source: CMIE; DMI Calculations

An inflation spike in October pushes the expectations of a rate cut to Q4

Elevated inflation constrains countercyclical response by the monetary policy in the near-term. In our previous economic monthly, we had cautioned if the inflation remains elevated in October, the possibility of a policy rate cut in December is likely to be off the table despite a change in stance to neutral in the October policy meeting. We now believe the earliest possibility for a policy rate cut is at the February meeting, due to multiple reasons. Firstly, the inflation, especially in the food basket, has proven to be stickier. Given the RBI's concerns about second-order spillover from elevated food inflation, it is likely to be cautious. The RBI governor's comments in different forums in the past few weeks also indicated that the RBI is likely to wait and watch before the next policy move. Secondly, US President-elect Donald Trump's tariff plans, if implemented, could lead to disruption to global trade flows and fuel supply side pressures, thereby pushing up input price pressures to varying degrees. This would have a spillover impact on India even in the scenario that there is no direct imposition of higher tariffs on Indian exports. Further, Trump's likely reflationary policies have boosted the dollar and led to a rise in US Treasury yields, as markets reprice the US Fed rate outlook. This could make emerging economies' central banks, including India, cautious regarding easing their policies in the near term.

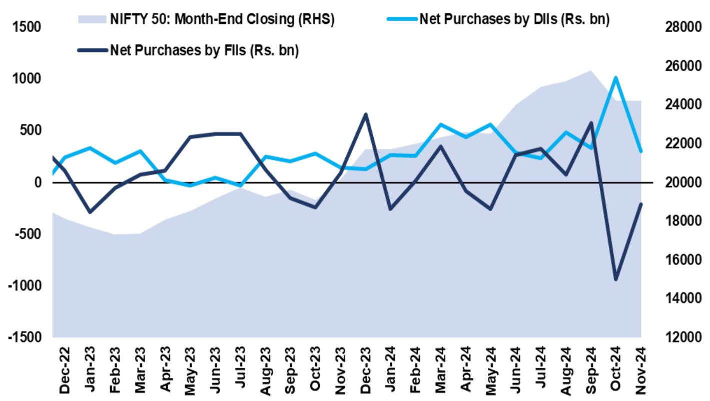
In its next policy meeting, we expect the RBI to remain on hold but raise its inflation projection and cut its economic growth projection for FY25. It is likely to remain optimistic about the economic growth outlook and will keep focus on managing inflation risks in the near-term. Given a heightened level of uncertainty, we don't rule out the domestic policy rate cut being delayed to early FY26 if domestic inflation and/or global factors turn adverse.

Market Update

Equity Market: Volatility in the Indian stock market continued in November. After a steep fall in October, the stock market saw continued pressures in the first half of

November, driven by disappointing Q2 corporate earnings, rising domestic inflationary pressures, and significant Foreign Portfolio Investor (FPIs) outflows with net outflows tracking at Rs. 211 billion in November so far. The waning support from Domestic Institutional Investors (DIIs) has further exacerbated market pressures. However, the markets have recovered in the past week on the back of positive cues from global markets, bargain hunting, and Maharashtra state election results (boosting expectations of reforms). Accordingly, as of November 25th, the Nifty 50 and Sensex were up by 0.1% and 0.9%, respectively, compared to October-end. The near-term outlook remains uncertain, with weaker earnings, geopolitical tensions, a strengthening dollar, rising US Treasury yields, and high domestic valuations posing challenges.

FPI outflows continued in November, but the intensity of selling seems to be reducing



Source: CMIE

Debt Market: The yields in the Indian bond market have been rising across the tenor since the second half of October. The larger-than-expected domestic inflation reading, coupled with increased US Treasury yields following Trump’s victory, has pushed benchmark 10-year Indian bond yields higher. However, following global cues, the 10-year bond yields eased in line with US bond yields. As of November 25, the Indian 10-year G-Sec bond yield is tracking closer to 6.82%, which could take cues from expectations of evolving domestic inflation and policy outlook, and to some extent from movement in the US treasury in the near-term. Meanwhile, in the overnight segment, tighter liquidity is causing the weighted call rate to hover above the policy rate at around 6.7%. This is possibly due to the RBI’s heavy intervention in the FX market and GST payments, which more than offset the decline in the government’s cash balance. We believe the RBI is likely to conduct liquidity fine-tuning to ensure overnight call rates are closer to the repo rate.

Currency Market: The strong US Dollar in October continued its momentum into November, and following Trump's victory, the US Dollar gained further strength. This led to the depreciation of most Asian currencies, with the Indian Rupee (INR) witnessing a relatively lesser decline of ~0.2% as of November 25th since October end. This smaller decline was due to RBI intervention aimed at cushioning the rupee from severe depreciation, as India’s foreign exchange reserves fell from US$682 billion on November 1st to US$657 billion by November 15th. While the RBI’s intervention prevents a sharper movement in the rupee, it also needs to balance the implications for export competitiveness which can come from a relatively larger depreciation of peers’ currencies. In fact, in real terms (REER), the Rupee is around 7% overvalued, indicating downward pressures in the currency are likely to continue. Moreover, the rupee is expected to trade with a depreciation bias due to the rising dollar strength, however a potential decline in crude oil prices, and continued intervention by the RBI will provide some support.

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