26 December 2024

Global Divergence in 2025; India's Outlook Faces Near-Term Headwinds, Policy Shift Key to Unlock Long-Term Growth Potential

DMI FINANCE

- The global economic landscape in 2025 is characterized by divergence across regions.
- The US is poised for continued strong growth, supported by favourable consumer and business finances, along with pro-growth policies of the next administration. Japan is expected to experience solid growth, benefiting from improving export competitiveness.
- In contrast, European economies will face a challenging 2025, given that much of the continent is struggling with low productivity and high inflation, accompanied by political turmoil in the two large economies of Germany and France. The UK may see improved prospects with easing monetary policy.
- Meanwhile, China's economic trajectory remains uncertain, heavily reliant on upcoming policy decisions.
- India's economic outlook faces near-term headwinds. A right policy response will be crucial in unlocking opportunities that can drive long-term growth.
- After a weak first half of FY25, marked by a sharp slowdown in Q2, we anticipate an economic recovery in the second half of the year, driven by a stronger rural demand, increased government capital expenditure, and moderating inflation.
- After a continued focus on supply-side reforms has created a business-friendly environment, there is a need for the policy focus to now shift towards stimulating demand. This could create a virtuous cycle of economic growth by incentivizing private investment, generating quality jobs, and boosting consumption demand.
- Additionally, India has an opportunity to position itself as a long-term destination for foreign investment amidst escalating global tensions, even though risks remain in the near term.
- In the December policy meeting, the RBI held the policy repo rate steady but reduced the Cash Reserve Ratio (CRR) by 50bps to alleviate liquidity pressures.
- We expect a shallow rate-cut cycle to begin in February 2025, driven by economic growth pressures and further moderation in inflation. Additional measures to support systemic liquidity are also anticipated.

Christopher Wiegand
Group Head - Economics & Data
christopher.wiegand@dmifinance.in

Pramod Chowdhary
Chief Economist
pramod.chowdhary1@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Yuva Simha
Economist
yuva.simha@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

Global Economy 2025: Uneven growth and uncertainties

The global economy enters calendar year 2025 on a differentiated footing and with increasingly diverse prospects depending on the country/geographical region. The United States is again poised to be a standout economic performer, extending its run of solid growth into the new year. Other, relatively large, advanced economies such as Japan and the UK are also likely to perform better in the coming year than in the prior 12 months. On the other hand, many European economies, particularly Germany and France, are facing potent headwinds that are likely to result in lacklustre economic performances. China, the world's second largest economy, is a major swing factor for the overall global economy in 2025. Either policymakers will turn recent rhetoric into substantive macro policies to reignite growth or the economy will remain sclerotic for a fourth consecutive year.

US and Japan are likely to witness solid economic growth in the upcoming year

The US economy enters 2025 as the most fundamentally sound economy in the world. Balance sheets for both the household and consumer sector remain in a favourable condition. Despite markedly higher interest rates (even with 100bps of Fed easing in the past three months), debt service burdens remain historically low due to a mix of long-term and fixed debt and strong income/profit growth. The rise in asset values also has strengthened consumer and business finances. President Trump's pending return to the White House and his pro-growth tax and regulatory plans has catapulted 'animal spirits' with positive implications for economic activity. Nonetheless, and as outlined in November's Economic Monthly Report, the year ahead will not be entirely smooth sailing. President Trump's tariff agenda and governing approach undoubtedly will result in periods of chaos and upheaval, and it will be important to separate the episodic bouts of chaos from the larger picture.

Japan is likely to experience relatively solid economic growth in the year ahead, recognizing that given its large export profile there will need to be adjustments by businesses and policymakers to the prospective US tariff regime. Japan seems finally to have escaped the perils of deflation and while it has a non-trivial long-term headwind in the form of demographics, it's domestic fundamentals are solid. Recent depreciation in the Japanese Yen has improved the competitiveness of Japanese exports, which will continue to benefit the economy in the coming year – even in a higher US tariff regime. The weak yen has also lifted substantially the value of foreign assets held by Japanese investors; such a development is an underrated dynamic, but a powerful one given that Japan's private sector is the largest net foreign creditor on earth.

Hope for UK; Europe still struggles; China's policy will determine the growth ahead

Prospects for the UK in 2025 appear the best they have been in the post-COVID era. The UK economy has been saddled by high and sticky inflation that resulted in a tight monetary policy. Moreover, with the UK private sector having an elevated share of floating rate debt, the Bank of England's (BOE) interest rate hikes have been particularly potent. The economy also has been burdened with public sector disfunction as the Tories cycled through three Prime Ministers in short order and limited confidence in the government, which spilled into diminished private sector economic activity. The recently elected Labour Government does not have any inspiring macro policy plans, but the simple changing of the political guard has been an incremental positive for the economy. And with the Bank of England's tightening efforts finally starting to produce a pathway to a more tolerable inflation backdrop, there is scope for lower interest rates in the period not too far ahead.

Europe – France and Germany, in particular – face a challenging 2025. Much of the continent remains saddled with low productivity, structural rigidities and the consequences of recent years' high inflation. France and Germany, Europe's two largest economies, are both facing political turmoil, which may not be resolved anytime soon. France's government is unstable as highlighted by the collapse of the latest government and inability to enact a budget and by President Macron's current efforts to form a new and effective government. Similarly, Germany is headed for elections in early 2025, as Chancellor Shultz's coalition government was unworkable. In Germany's case, the fractious nature of the current domestic political situation is likely to require another multi-party coalition post the election. This political disfunction in Europe's largest economies has undermined confidence and created vast policy uncertainty at a time when inflation has damaged fundamentals and the pace of economic growth, and major trading partners (China) are importing less due to their own sluggish economies.

Policymaking decisions by China's seniormost leaders in the first three months of the year will be pivotal in determining the Chinese economy's path in 2025 and beyond. Heavy public sector investment has fostered some narrow bright spots in China's economy – electric vehicles, artificial intelligence and an electronic payment related ecosystem. However, the broad economy is struggling mightily, as has been the case since H2 2021. Growth is weak – almost certainly far weaker than official statistics convey – risk appetite and entrepreneurial activity have collapsed, and social angst is climbing. Meanwhile, the property sector – which comprises 15 to 20% of the economy – is in terrible condition. Most property builders are bankrupt, leaving unfinished construction projects across the country and loans of questionable value across China's (official and unofficial) financial system. Moreover, property has been the dominant investable asset class for middle and upper-middle class households, so declining property values and severely impaired liquidity in the sector are a large overhang for Chinese households.

Chinese officials, at least the technocratic ones, seem to recognize the issues facing the economy, if not perhaps their scale and scope. Multiple policy trial balloons have been floated in the past six months with potential solutions for the myriad macro issues plaguing the economy. Some of these episodes have included sufficient detail as to make it appear that substantive policy responses would be forthcoming imminently but to no avail. At this point, the National People's Congress (NPC) in early March, increasingly, is becoming a near make or break for China's economic performance for the next couple of years. The NPC is the highest profile gathering of China's senior officials and is the natural time to announce formally new macro policies, especially given the sweeping nature of policies we judge necessary to combat the problems ailing China's economy.

India: Economic outlook faces near-term headwinds; policy response key to unlocking opportunities to lift long-term growth

The Indian economy faces near term headwinds as it enters 2025. In addition to subdued exports growth, sluggish households' income growth and the continued lack of a broad-based revival in private investment remain key concerns. After a weak first half of FY25, marked by a sharp slowdown in Q2, we expect economic growth to recover in the second half of the year. Real GDP growth dropped to 5.4% YoY in Q2 FY25, a seven-quarter low, down from 6.7% in Q1, despite the easing of temporary factors such as the general elections and the heatwave. The slowdown was driven by a weakness in private consumption and investment spending, with industrial activity decelerating, while the services sector continued to show resilience. The expected recovery in the second half of FY25 is likely to be driven by stronger rural demand, increased government capital expenditure (CAPEX), and moderating inflation. High-frequency data supports this outlook (as discussed in subsequent sections), though risks to our FY25 projection of 6.7% YoY real GDP growth persist. These risks stem from the fragile nature of the recovery, which remains vulnerable without a broader set of growth drivers, and also risks posed by global headwinds including US trade policy plans.

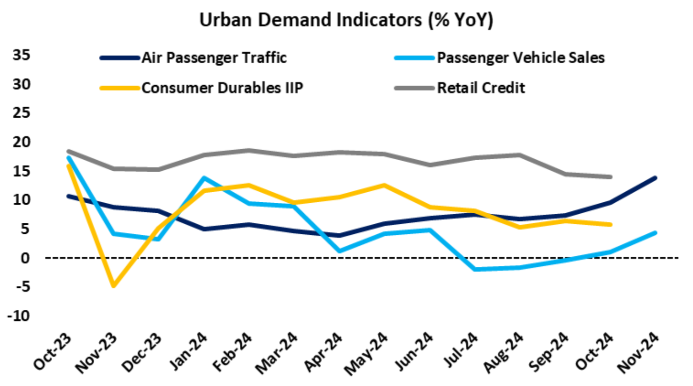
A stronger and more targeted policy response is essential to address short-term challenges and lay the foundation for a sustained and robust economic growth. Key areas of focus should include creating conditions that encourage private sector investment, capitalizing on emerging export opportunities driven by U.S. trade policies, and boosting households' purchasing power through targeted skill development programs and incentives for quality job creation. While years of supply-side reforms have improved the business environment, and corporate balance sheets have strengthened through deleveraging and banks have cleaned up overhang of NPAs from their books, the focus must now shift to stimulating demand. This could create a virtuous cycle of economic growth, by incentivising private investment, creating jobs, and thereby further lifting the consumption demand.

Looking ahead, government policy should prioritize demand-side measures, including strengthening the social security net, providing targeted income tax relief, and expanding support for skill development and quality job creation. Trade and investment policies must be agile in responding to emerging global trends and opportunities. India is well-positioned to benefit from shifts in global trade and investment patterns, particularly as the U.S. adjusts its trade strategies. While India's success in capitalizing on 'China+' strategies has been mixed, the country's large domestic market, ongoing supply-side reforms, government incentives, and strong diplomatic ties with the U.S. enhance its attractiveness for foreign investment. While trade disruptions will pose downside risks next year, the right policy mix could help India emerge as a key long-term investment destination.

Anticipated economic recovery seems on track in Q3

After a disappointing Q2 FY25, high-frequency economic data shows economic recovery in early Q3. In Q2, real private consumption growth slowed to 6.0% YoY from 7.4% in the previous quarter, likely due to softer urban demand while rural demand supported consumption. However, data released since then show that consumption has somewhat improved in the current quarter particularly in October, buoyed by the festive demand. Two-wheeler sales showed resilience, growing by 6.5%, suggesting stronger rural demand amid an above-normal monsoon. Tractor sales clocked double-digit growth in October and dipped in November. Consumer non-durables output also suggested recovery in October. However, urban consumption was uneven in early-Q3. Initial data from NielsenIQ for October shows overall FMCG growth at 4-5% (the urban market accounts for two-thirds of FMCG sales), which is disappointing in the context of the festival month. Retail credit growth and consumer durable output also showed further deceleration in October. Meanwhile, Passenger vehicle sales rose by 2.8% in October-November after contracting in Q2. Other indicators including air passenger traffic and petroleum consumption suggested some recovery in early Q3.

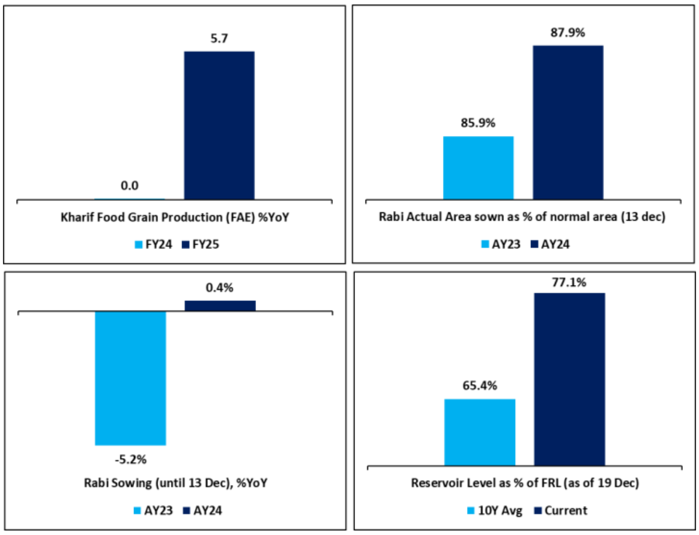
Urban demand indicators showed uneven growth in Oct-Nov despite festive season period



Source: CMIE

While we expect rural demand to support consumption growth in H2 FY25, urban consumption is likely to show uneven and sluggish growth owing to subdued urban wage growth and the continued impact of regulatory measures on retail credit. Based on corporate data sourced from CMIE, growth in employee costs of the non-financial sector fell to a 14-quarter low of 6.4% by the end of September '24. Meanwhile, prospects for rural demand remain positive. Real agricultural GVA jumped to a five-quarter high of 3.5% in Q2 and is expected to improve further, supported by healthy Kharif output and positive prospects of rabi sowing. Based on the first advance estimate Kharif foodgrain output is estimated to grow by an eight-year high of 5.7%. Meanwhile, rabi sowing is also tracking positively supported by healthy reservoir levels. All this augurs well for rural demand going forward.

Agriculture sector expected to support rural demand

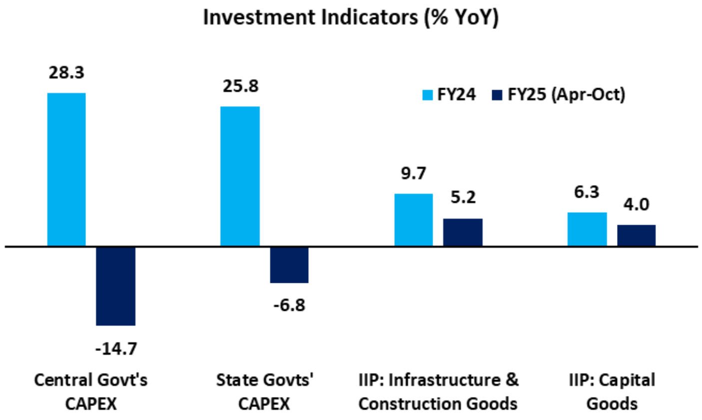


Source: CMIE

Government to drive investment spending in H2, though it will miss its CAPEX target

On the investment front, domestic CAPEX showed investment growth decelerated in Q2 owing to sluggish government capital spending despite the fading of the election related disruptions barring a few states. In fact, in the FYTD (Apr-Oct), the central government capital expenditure declined by 14.7% YoY while the state governments' capital spending was tracking 6.8% lower than last year.[1] The rebound in the government CAPEX is expected to drive overall investment in H2 FY25. That said, we believe the recovery in the central government CAPEX will not be enough to meet its budget estimate (BE). To meet the BE of Rs 11.1 lakh crore in FY25, the CAPEX has to increase by ~60% in the remaining five months of the current financial year – which seems highly unlikely given the historical trends. We expect the central government to miss the CAPEX target by around 8-10%.

Growth in investment related indicators has been weak in FY24 so far



Source: CMIE

In regard to private sector investments, we are yet to see signs of a broader revival in investment. As per data sourced from CMIE, new capacity creation projects rose by 54% YoY in Q2. However, these new projects remain concentrated in just five sectors, which account for 82% of the new projects. Funds raised by India Inc. from the stock market continued at a robust pace, which should provide some support to capacity expansion in coming quarters. However, 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.

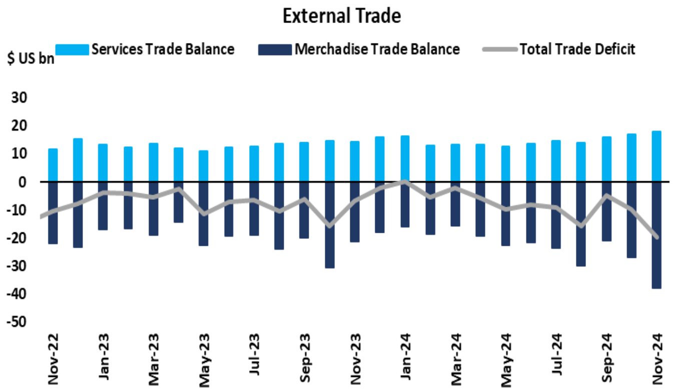
Trade deficit expected to weigh on growth in remainder of the year

Trade deficit widened to historical highs of US$ 37.8 bn in November due to a decline in exports and a jump in gold

[1] Data based on 20 states.

imports owing to festival related demand. In Q3 so far (October-November), the trade deficit widened to ~US$ 65 bn from ~US$ 52 bn in FY24 during the same time. This was led by higher gold and crude oil imports. Meanwhile, the growth in exports was relatively softer at 6.1% due to slowing global demand. On the other hand, services exports performed much better leading to an increase in services surplus from ~US$ 29 bn in October-November to ~US$ 35 bn in FY25 during the same time. The outlook for the trade remains clouded due to high uncertainty about impact of US trade policy plans.

Trade deficit widened in Q3 so far



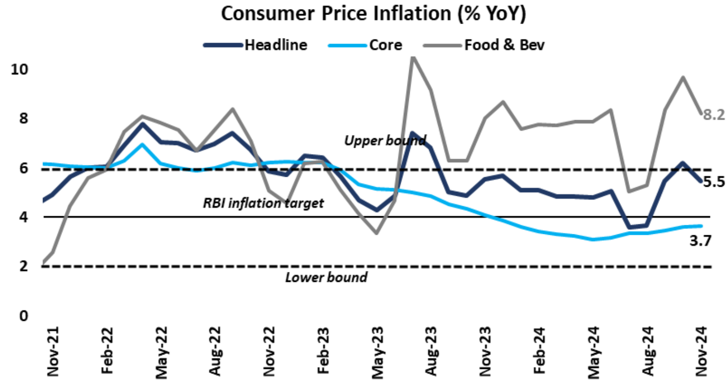
Source: CMIE

Inflation eases in November, further moderation expected going ahead.

Inflation pressures are likely to ease in 2025, though risks to outlook persist. In November, the headline CPI inflation eased to 5.5% YoY, down from a 14-month high of 6.2% YoY in October. This moderation was driven by a combination of a favourable base effect and a reduction in food inflation, particularly vegetables. Food & Beverage inflation moderated from 9.7% YoY in October to 8.2% YoY in November. This easing was largely due to the decline in vegetable prices, which contracted by 4.6% MoM after a significant rise of +8.2% MoM in the previous month. High-frequency data for December suggests a continued sequential decline in vegetable prices; however, it remains below the typical winter correction, and we may only see a substantial reduction in vegetable prices from early next year.

Positively, inflation in pulses fell below the critical 6% mark after nearly 18 months, with the outlook for pulses appearing promising given the healthy prospects of Rabi sowing. Apart from vegetables, cereals and edible oils were the main drivers of inflation. These are expected to remain sticky, due to potential spillovers from global prices and the continued pass-through effect from the import duty hike on edible oils, respectively.

Retail inflation eases in November led by food inflation



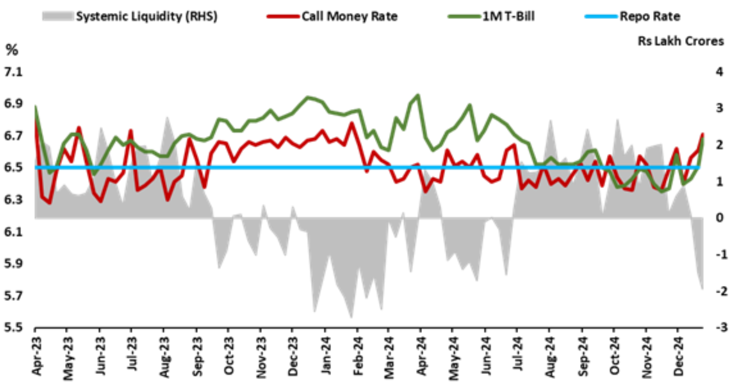
Source: CMIE

Core inflation remained largely unchanged at ~3.7% in November. Looking ahead, we maintain the view that core inflation has likely bottomed out and will gradually rise as the base effects fade and sequential price increases continue. Additionally, the PMI surveys indicate that companies, particularly in the services sector, are passing on higher input costs to consumers, which is expected to further pressure core inflation in the coming months. Further, US trade policies could pose risks to domestic inflation outlook.

Policy rate cut expected in February 2025; More liquidity enhancing measures likely

We expect a shallow policy rate cut cycle to begin from February '25 given economic growth pressures and further moderation in inflation. The composition of the Monetary Policy Committee is also shifting towards a more dovish side, with the new governor likely to adopt a balanced to dovish approach. Additionally, two members of the Committee already expressed support for a rate cut at the last meeting. We do note that expected rate cut cycle is likely to be shallow and may be tempered by external factors, such as US trade policy and geopolitical risks, as well as domestic issues like any surprise on inflation and exchange rate pressures.

Liquidity turned in deficit with overnight rates hovering above repo rate



Source: CMIE; Note: Data is reported based on weekly values apart from recent values i.e December 24th.

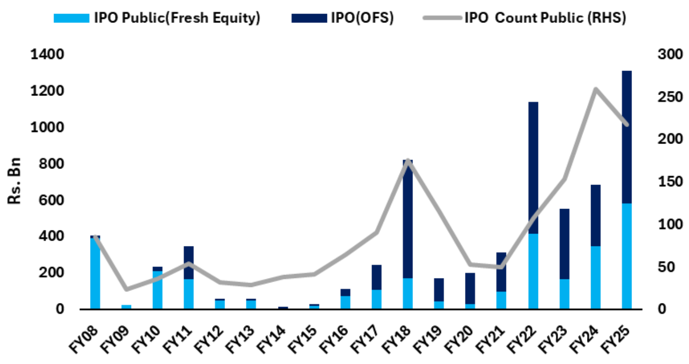
The RBI is likely to take additional measures to manage liquidity in 2025. In December so far (data till 24th), the average liquidity surplus has reduced to Rs. 0.3 lakh crore, down from Rs. 1.5 lakh core in October-November with liquidity dipping in deficit mode since the fortnight. This is due to the RBI's heavy intervention in the forex market, an increase in currency in circulation, and advanced tax payments by companies. In response to tightening liquidity, the overnight call rate has been tracking above the repo rate at around ~6.7% on December 24th. To ease the pressure on liquidity, the RBI announced a 50 bps CRR cut in the December meeting, which is estimated to infuse Rs 1.16 lakh crore in the banking system (please refer to [report] for details). We also expect the RBI to announce additional liquidity enhancing measures to align overnight call rates with the policy rate.

Market Update

Debt Market: After rising in November, the Indian government securities (G-Sec) 10-year yield moderated in the first week of December, reaching its lowest level in nearly three years at ~6.68%. This decline was driven by weaker-than-expected GDP data, expectations of liquidity-enhancing measures from the RBI, and falling US Treasury yields. However, the downward trend reversed as US Treasury yields rose ahead of the Fed December meeting. Although the Fed delivered the expected 25 bps rate cut, the hawkish tone of the policy indicated only two rate cuts in 2025 compared to four in the previous meeting, fuelling a rise in the US bond yields. Mirroring this trend, Indian bond yields also inched up, closing at ~6.78% on December 24th. However, with a slower pace of increase in Indian bond yields compared to treasury yields, the 10-year spread between the two have declined to the lowest levels in nearly two decades which could negatively impact foreign capital inflows.

Equity Market In the domestic equity market, Indian stocks shed only 0.3% in November, as selling pressures eased. Post some recovery in early Dec, markets have come under renewed pressures as investors adopted a cautious stance ahead of the US Fed meeting, potential tariffs from the incoming US administration, and concerns over stretched valuations in the Indian market. However, the hawkish tone of the Fed signalling fewer cuts in 2025 dented investor sentiment further and weighed on the equity market. Overall, the domestic equity markets likely managed positive returns by end of calendar year 2024 – rising by 9.2% so far (till 24th December) compared to 20% in the previous year. Robust performance of the stock market was also reflected in the significant participation in IPO issuances. Based on data available so far (till November), the total money raised in IPO in primary market stood at Rs. 578 bn compared to Rs. 346 bn.

Positive stock market sentiment led to a record high IPOs in current year



Source: CMIE; Note: Data for FY25 is till November.

Currency Market: In the currency market, the Indian rupee depreciated by 0.5% by the end of November, as most emerging markets faced pressure from a strengthening US dollar, driven by geopolitical headwinds and foreign capital outflows. The depreciation deepened in December with the dollar gaining further strength due to a hawkish Fed policy. The rupee breached the 85 level against the USD by the third week. Looking ahead, the rupee is expected to depreciate further, driven by a stronger dollar and the possibility of the RBI easing its foreign exchange intervention. Additionally, China's potential currency weakening, to counter possible US trade tariffs, could further pressure the rupee to avoid a loss in competitiveness. Rupee depreciation may also help alleviate the strain on India's foreign exchange reserves, which have fallen by ~US$ 38 billion over the past two months, likely due to the RBI's interventions in the forex market to manage currency volatility. Moreover, the rupee's depreciation could help reduce its overvaluation, which stood at 8.1% on the Real Effective Exchange Rate (REER) index basis as of November. In 2024 so far (data till 24th), the domestic currency has depreciated by 2.4% while the dollar index rose by 6.9% during the same period.

DMI FINANCE

DISCLAIMER

This research report/material (the "Report") is for the personal information of the authorised recipient(s) and is not for public distribution and should not be reproduced or redistributed to any other person or in any form without DMI's prior permission.

In the preparation of this Report, DMI has used information that is publicly available as well as data gathered from third party sources. Information gathered and material used in this Report is believed to have been obtained from reliable sources. DMI, however makes no warranty, representation or undertaking, whether expressed or implied, that such information is accurate, complete or up to date or current as of the date of reading of the Report, nor does it assume any legal liability, whether direct or indirect or responsibility for the accuracy, completeness, currency or usefulness of any information in this Report. Additionally, no third party will assume any direct or indirect liability. It is the responsibility of the user or recipient of this Report to make its/his/her own decisions or enquiries about the accuracy, currency, reliability and correctness of information found in this Report.

Any statement expressed as recommendation in this Report is general in nature and should be construed strictly as current opinion of DMI as of the date of the Report and may be subject to change from time to time without prior intimation or notice. The readers of this Report should carefully read, understand and investigate or enquire (either with or without professional advisors) into the risks arising out of or attached to taking any decisions based on the information or opinions contained in this Report. DMI or its officers, directors, personnel and employees, including persons involved in the preparation or issuance of this Report may have potential conflict of interest with respect to any recommendation and related information and opinions.

Neither DMI nor any of its officers, directors, personnel and employees shall be liable for any loss, claim, damage of whatsoever any nature, including but not limited to, direct, indirect, punitive, special, exemplary, consequential, as also any loss of profit in any way arising from the use of this Report or the information therein or reliance of opinions contained in this Report, in any manner.

No part of this Report may be duplicated or copied in whole or in part in any form and or redistributed without the prior written consent of DMI. Any reproduction, adaptation, distribution or dissemination of the information available in this Report for commercial purpose or use is strictly prohibited unless prior written authorization is obtained from DMI. The Report has been prepared in India and the Report shall be subject only to Indian laws. Any foreign reader(s) or foreign recipient(s) of this Report are requested to kindly take note of this fact. Any disputes relating to the Report shall be subject to jurisdiction of Republic of India only.