AXIS BANK

India Economics

Outlook 2024: India resilient in a growth-challenged world

December 07, 2023

We expect upgrades to India's GDP forecasts, as continuing positive surprises force an upward reset in trend-growth assumptions. However, global headwinds are likely to intensify, as US growth in 2023 was boosted by unsustainable fiscal support. India's growth can therefore decelerate in FY25. The moderation in core inflation should persist, as GDP is still below the pre-pandemic path, but volatile food inflation is likely to keep headline above the mid-point of the target range. Slowing capital flows due to shrinking money supply in the US cut the sustainable current account deficit, but RBI has the reserves to keep INR volatility in check.

Exhibit 1: India macroeconomic projections

	FY22	FY23	FY24E	FY25F
GDP growth	9.1%	7.2%	7.0%	6.5%
Average CPI inflation	5.5%	6.7%	5.6%	4.8%
Current account deficit % GDP	1.2%	2.0%	1.4%	1.2%
BOP surplus USD bn	47.5	-8.5	-10.0	-15.0
Fiscal deficit (center+states)	10.4%	9.5%	8.9%	8.3%
Repo rate year-end %	4.0%	6.5%	6.5%	6.5%
USD/INR average	74.51	80.35	82.75	84.50
10y G-sec yield average	6.13%	7.32%	7.20%	6.80%

Source: Axis Bank Research

Domestic resilience likely to continue offsetting global headwinds

India's GDP growth is surprising positively despite several headwinds: fiscal consolidation, higher domestic interest rates, tightening liquidity conditions, and slowing exports of goods and services. We expect further 70/20bps upgrade to FY24/25 consensus forecasts, making India's growth revisions second only to the US's. We worry that the US's growth is supported by unsustainable fiscal support and is likely to disappoint with intensifying global headwinds, keeping us conservative on FY25 growth at 6.5%. We also expect trend-growth estimates for India to get revised to 7%+, as a cyclical recovery in capital formation (real-estate and corporate capex) throws light on the reasons for the 2012-19 slowdown.

Inflation to return to target gradually, limiting easing options

We expect the slow moderation in core inflation to persist, as the GDP gap vs the pre-pandemic path is narrowing but is still at 1.3 years of growth. The moderation in services inflation, reflecting slack in the labor force, is evidence of this trend. Fiscal discipline, building infrastructure, and a pick-up in capex also contribute over time. Core is currently annualizing well below the 4% target, though global factors (like gold) and strength in housing rents can push it up. The policy challenge though would come from volatility in food inflation, keeping inflation above the mid-point of the target for most of next year. Tight liquidity conditions, equivalent to a 25-30 bps rate hike, can ease once global risks fade. If the government sticks to 4.5% fiscal deficit in FY26, bond yields could ease too.

Index-inclusion and growing exports can offset slowing capital flows

A major challenge for India, as for all economies with current accounts in deficit (CAD), is the crowding out caused by a sustained high fiscal deficit in the US. Due to quantitative tightening, USD supply is likely to remain tight, but growing nominal GDP due to higher fiscal deficits keeps local USD demand elevated. Capital flows to India slowed to ~2% of GDP in the year-ended Sep-2023 and have fallen further since. This trend will only worsen till it cannot. Improving services exports can, by FY26, potentially nullify India's CAD, if growth remains near 7% and there are no large terms-of-trade shifts (like oil prices). The INR's abnormally low volatility, thus, is likely to persist.

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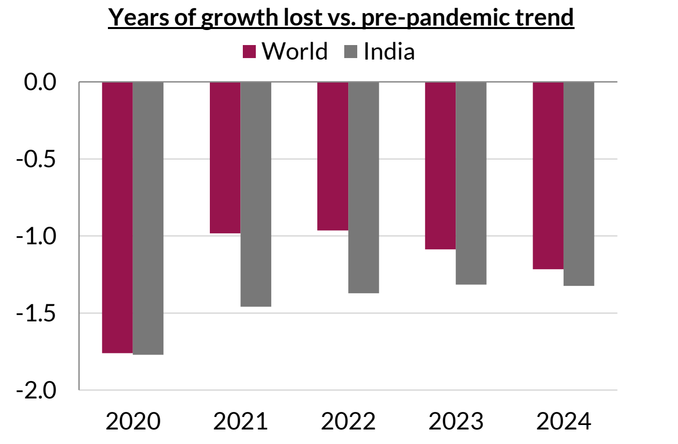
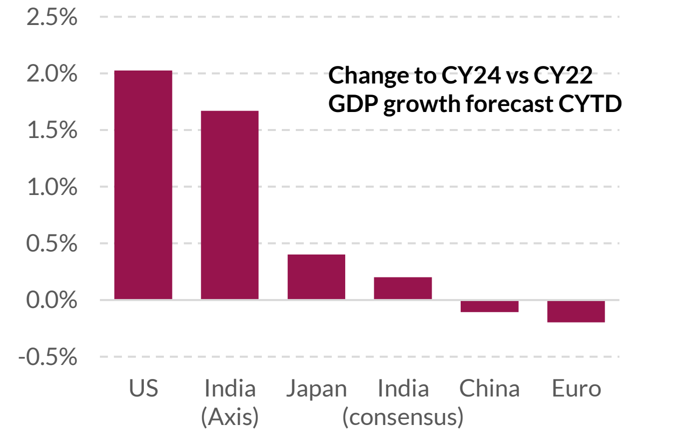
Focus charts

Exhibit 2: India catching up to pre-pandemic path, but not world



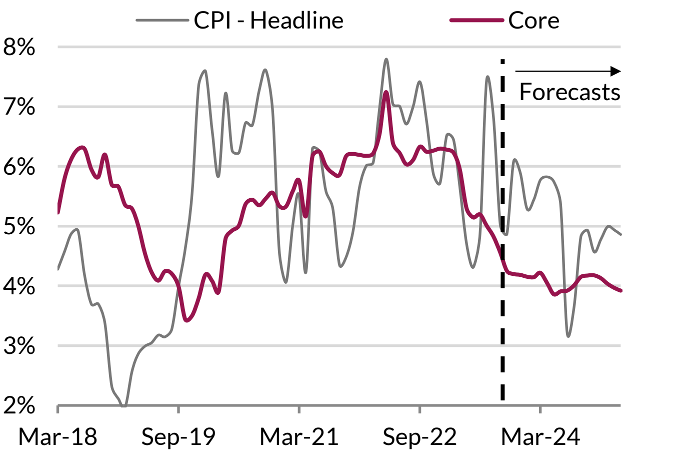
Source: CSO, IMF World Economic Outlook, Axis Bank Research

Exhibit 3: CY22-24 growth revisions since Jan-2023



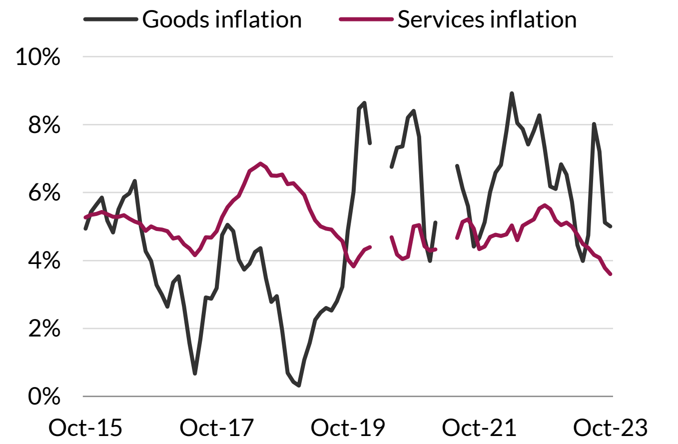
Source: IMF World Economic Outlook, CSO, Axis Bank Research

Exhibit 4: CPI inflation likely to return to target only haltingly



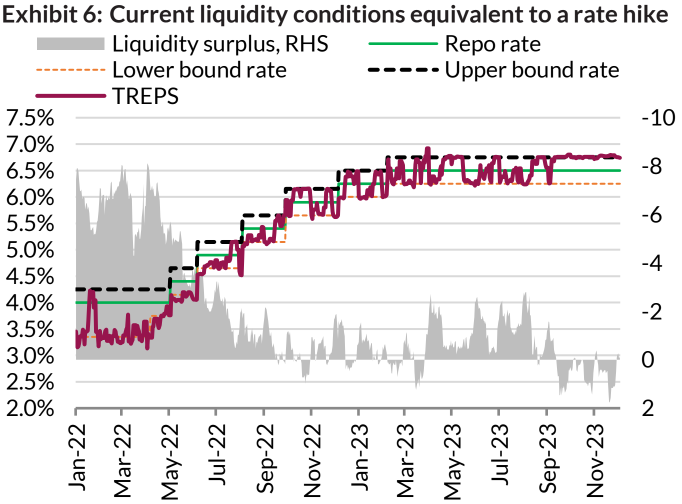
Source: MOSPI, Axis Bank Research

Exhibit 5: Services inflation lowest in nearly a decade



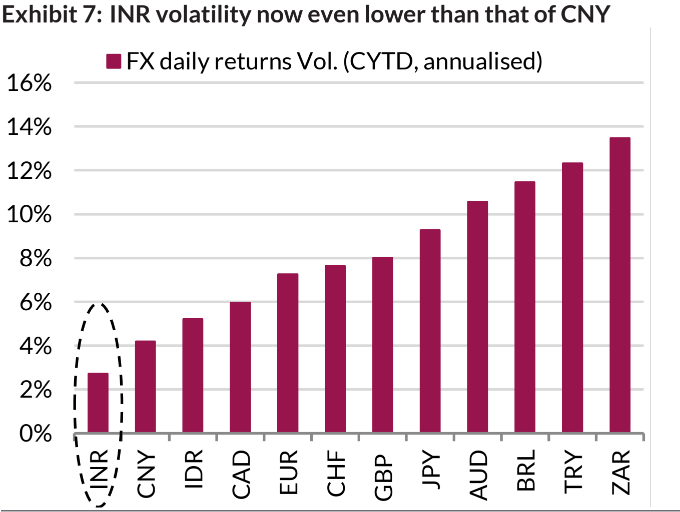
Source: MOSPI, Axis Bank Research

Exhibit 6: Current liquidity conditions equivalent to a rate hike



Source: Bloomberg, Axis Bank Research

Exhibit 7: INR volatility now even lower than that of CNY



Source: Refinitiv, Axis Capital

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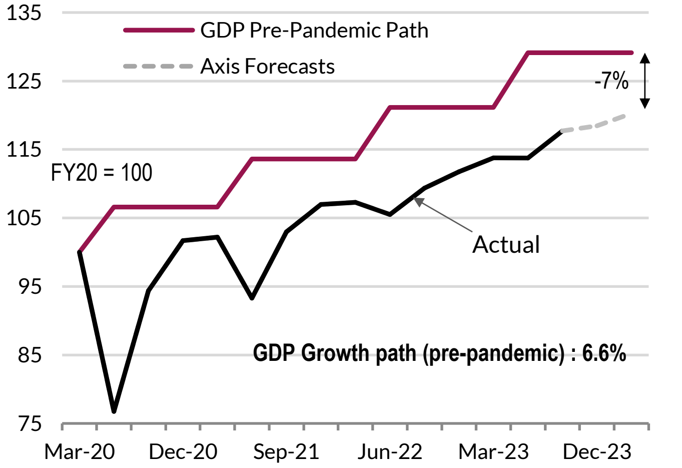
Domestic resilience likely to continue offsetting global headwinds

India's economic growth has surprised positively in the past few quarters despite the presence of local as well as global headwinds: continuing fiscal consolidation, higher domestic interest rates, tightening liquidity conditions, as well as slowing exports of goods and services.

Stronger-than-expected India growth narrowing gap vs the pre-pandemic trend

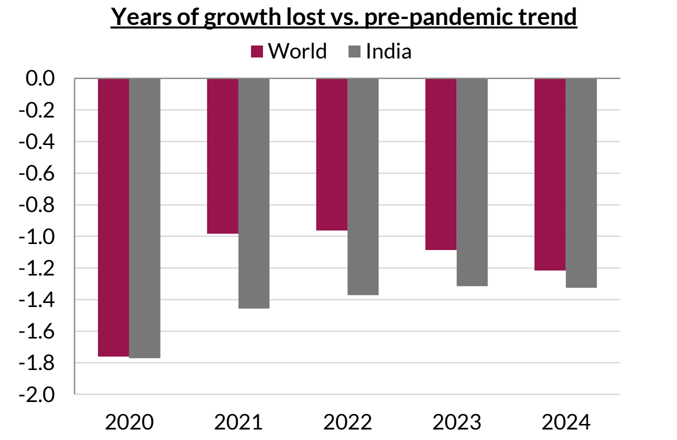
India's gap vs the pre-pandemic trend has now narrowed to 7% (Exhibit 8:) and in terms of the number of years of growth lost, it has caught up to the global average (Exhibit 9:). Importantly, while the gap vs the pre-pandemic trend, in terms of number of years of growth lost, has been expanding as such, that for India it has been narrowing. Given that this has been achieved despite continuing fiscal consolidation and monetary tightening in India, makes it more sustainable.

Exhibit 8: India GDP vs pre-pandemic path



Source: CSO, Axis Bank Research

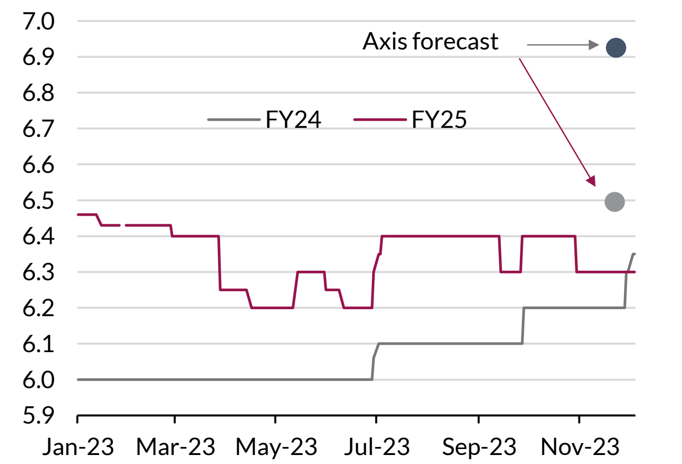
Exhibit 9: India catching up to pre-pandemic path,but not world



Source: CSO, IMF World Economic Outlook, Axis Bank Research

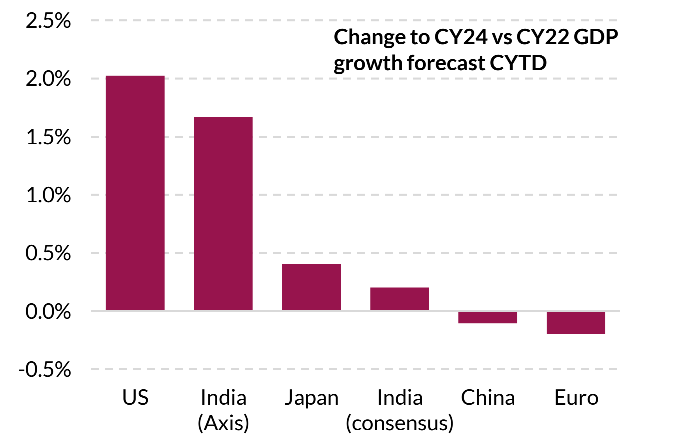
India's GDP growth for Q1 and Q2 in FY24 at 7.8% and 7.6%, respectively, was higher than expected and resulted in consensus upgrading the growth estimates for FY24 (Exhibit 10). Given that the consensus forecast of 6.35% in FY24 (Axis at 7%) still implies 5.1% growth in 2H (Axis: 6.3%), we expect upgrades to continue. We also expect FY25 growth forecasts to be upgraded. Since Jan-2023, revisions to consensus estimates for real GDP growth over two years (CY22-24 for others and FY23-25 for India) show that the US, Japan, and India have seen upgrades and the EU and China have seen downgrades (Exhibit 11).

Exhibit 10: Consensus has raised estimates, expect more



Source: CSO, Axis Bank Research

Exhibit 11: CY22-24 growth revisions since Jan-2023

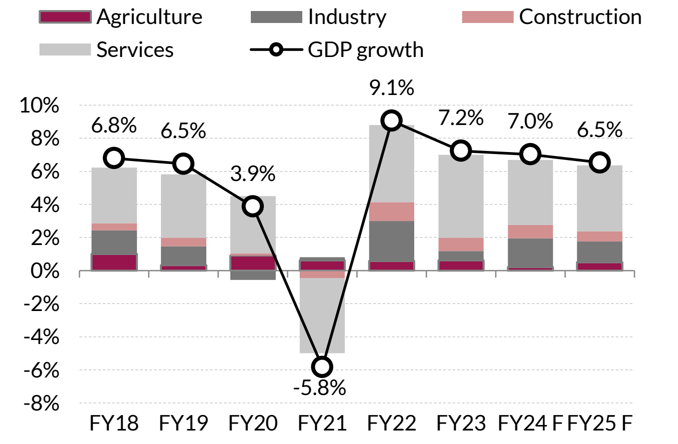


Source: IMF World Economic Outlook, CSO, Axis Bank Research

Growth supported by recovery in capital formation

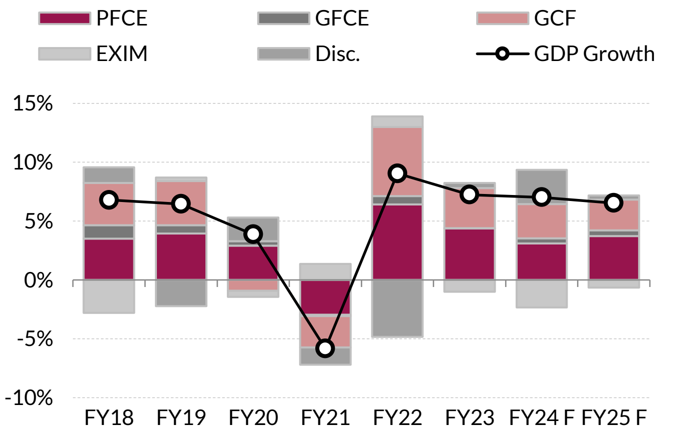
High-frequency demand trends for services in terms of credit growth, construction activity, trade travel and transportation, and others have been better-than-expected in the past few quarters. While top line growth for manufacturing has weakened, margins have expanded, supporting GVA growth. We expect 7.0% growth in FY24 and 6.5% in FY25 (Exhibit 12). The slowdown in growth is primarily due to a weaker global environment.

Exhibit 12: GVA growth driven by industry/construction



Source: CSO, Axis Bank Research

Exhibit 13: Both private and government consumption weak

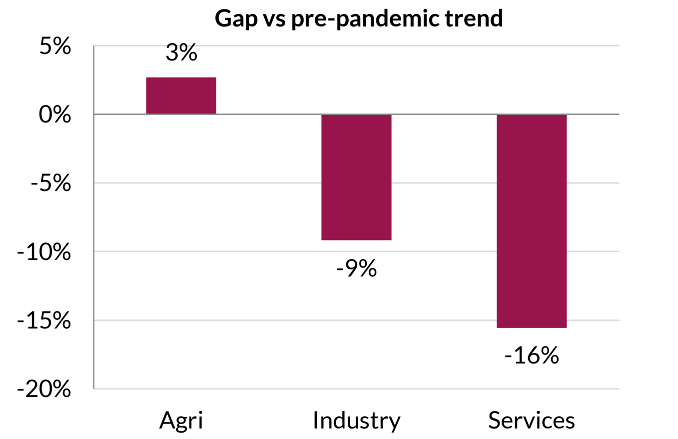


Source: CSO, Axis Bank Research

On the expenditure side, capital formation has been strong, while the rebound in consumption has been weaker. Private consumption (PFCE in Exhibit 13) has been weak, though we believe there are anomalies in measurement. Government spending (GFCE) in aggregate has been weak as well due to the inability of state governments to spend, which is visible in steadily elevated government cash balances with RBI. Domestic demand is doing better than global demand and net exports have been a drag on growth for at least the past two quarters (within net exports though higher value-added services exports are doing better).

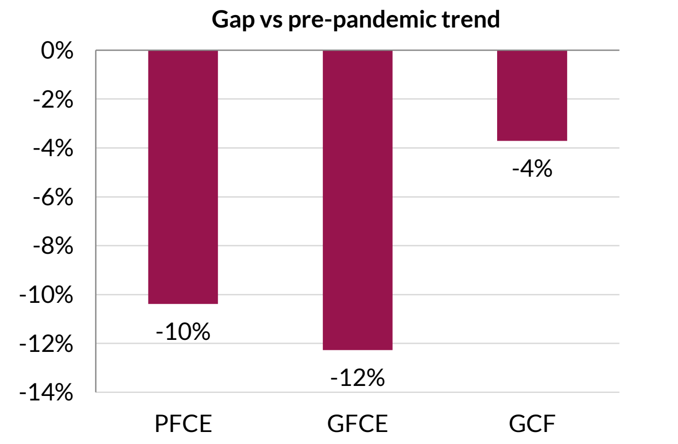
Versus the pre-pandemic trend, the gap is the largest in services and agricultural growth beats the trend (Exhibit 14). On the expenditure side, the shortfall versus trend is the largest in government spending and capital formation is closest to trend (Exhibit 15).

Exhibit 14: Services lagged pre-pandemic trend the most



Source: CSO, Axis Bank Research

Exhibit 15: Investments better than consumption vs trend

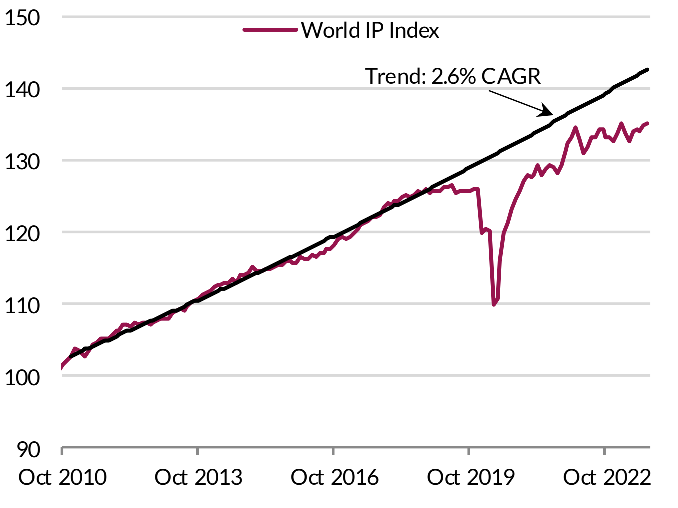


Source: CSO, Axis Bank Research

Global growth already a drag on activity, likely to worsen further

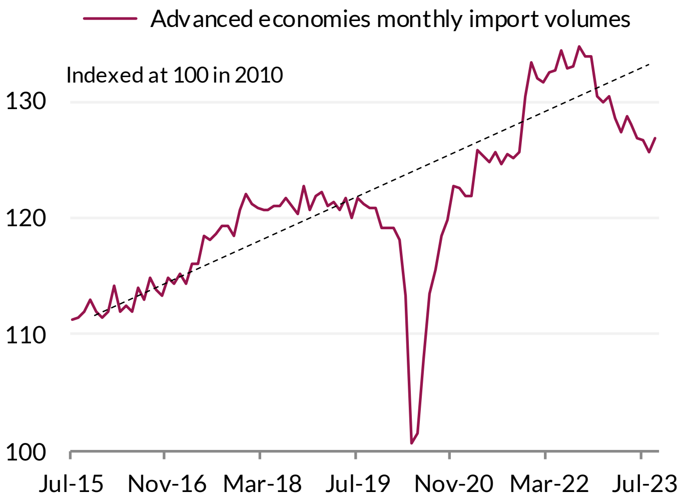
After the sharp post-Covid rebound, global growth has weakened as monetary conditions have tightened globally and some major economies have slowed their fiscal stimulus. Global Industrial Production (IP) is now moving away from trend, nearly flatlining in absolute terms (Exhibit 16). The primary driver is weak demand – except for the US, real retail sales are running well below the pre-pandemic trend. Import volumes in advanced economies are now back to 2021 levels and down nearly 8% from the peak (Exhibit 17).

Exhibit 16: Global IP diverging away from trend



Source: RBI, Axis Capital

Exhibit 17: Import volumes in AEs falling in absolute terms

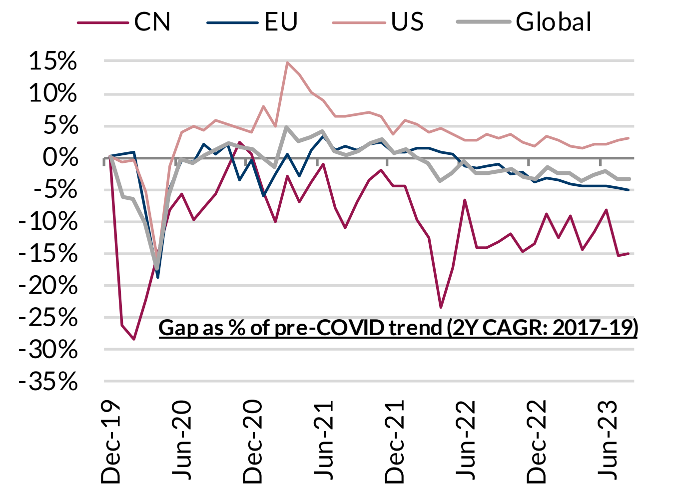


Source: RBI, Axis Capital

This weakness is despite US consumer demand remaining above the pre-pandemic trend, as Europe and China are seeing retail sales growth much below the pre-pandemic trend (Exhibit 18). Strength in the US has been supported by an unexpected sharp expansion in the fiscal deficit – for the fiscal year ended 30-Sep-2023, the deficit rose to USD 2 tn (adjusted for the student debt relief program cancellation by the Supreme Court which was booked as a reduction in spending) versus USD 1 tn in FY22 and similar amount budgeted initially (Exhibit 19).

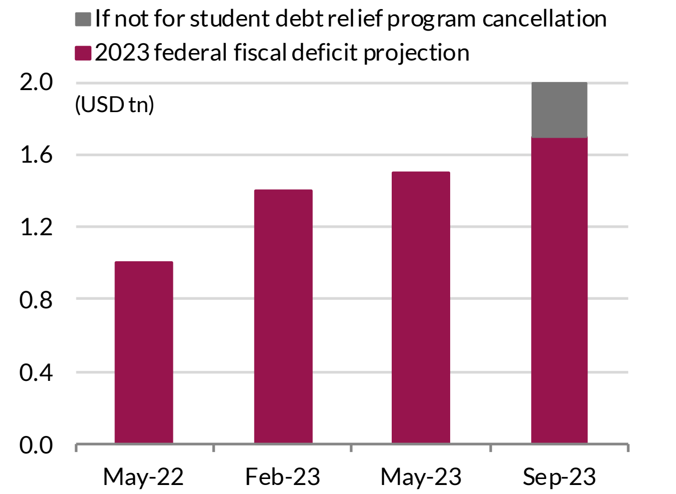
This has supported growth so far, and in our view, as the fiscal deficit stabilizes at this high level, implying no further stimulus, tightening monetary conditions are likely to trigger a recession.

Exhibit 18: Only US goods demand is above pre-pandemic trend



Source: RBI, Axis Capital

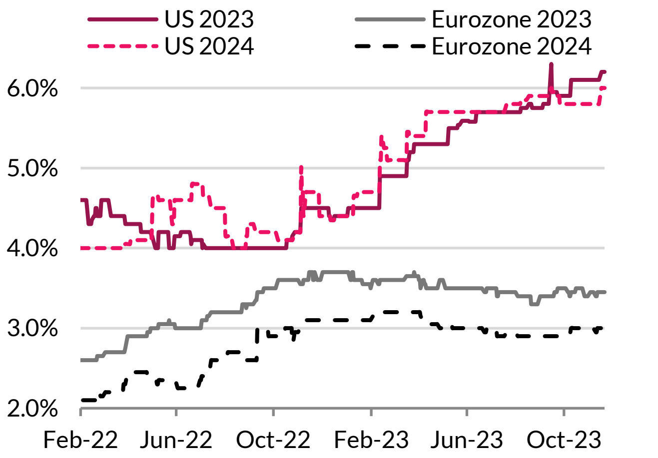
Exhibit 19: US fiscal deficit higher by ~USD 1 tn than projected



Source: RBI, Axis Capital

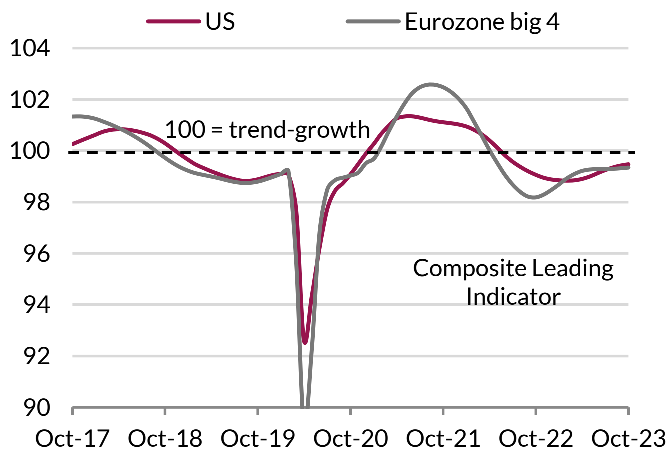
Fiscal surprises are limited to the US, and the EU may see further fiscal consolidation next year, which could be a further headwind for growth (Exhibit 20). Fiscal space for EMs is constrained by the tight dollar-funding market (more later in the report). Notably, OECD Leading Indicators (OECD CLI) for the US and Europe show below-trend growth going forward (Exhibit 21) .

Exhibit 20: Rising US fiscal deficit has supported demand



Source: Bloomberg, Axis Bank research

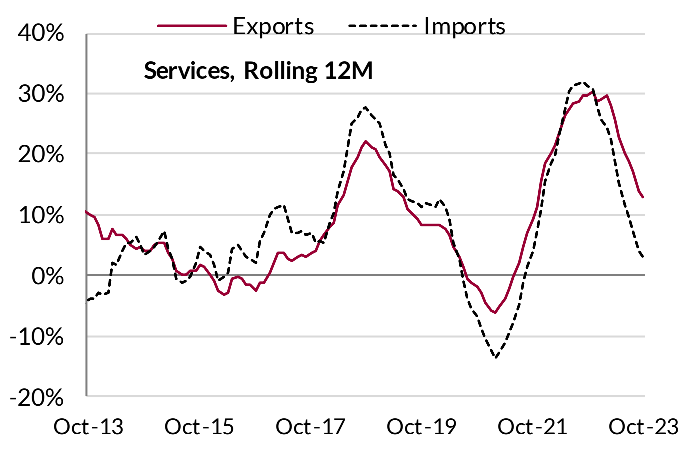
Exhibit 21: OECD Leading Indicators show sub-par growth



Source: OECD, Axis Bank research

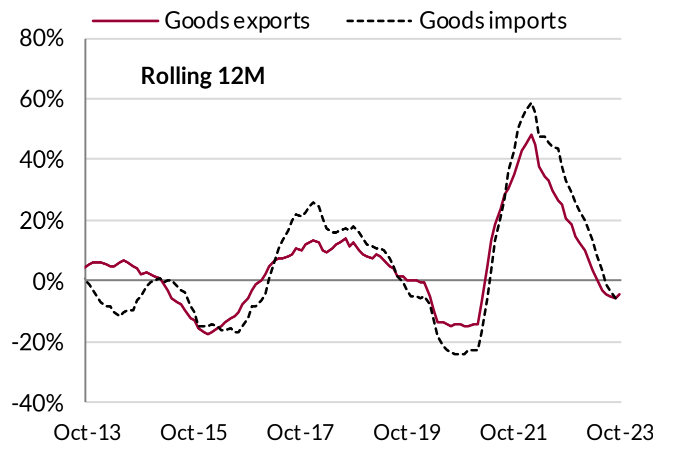
India's trade in services (Exhibit 22) and in goods (Exhibit 23) has slowed sharply from the peak. The growth gap between services exports and imports has widened, whereas in goods the trends are similar. This implies an expansion in India's net services surplus and in its goods trade deficit.

Exhibit 22: Services exports growth has slowed sharply



Source: RBI, Axis Capital

Exhibit 23: Goods imports and exports are both falling YoY

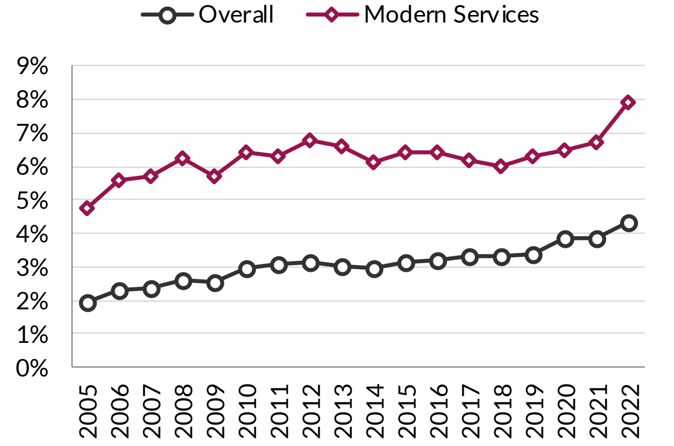


Source: RBI, Axis Capital

Going forward, share gains in both goods and services exports should support India's headline trade data. As explained in our note (link) on the structural drivers of India's share gains in global services exports, disaggregation of global services value-chains, rapid increase in global cross-border telecom bandwidth, and the surge in remote-working are adding to the demographic trends supporting growth in India's services exports to developed markets. India's share of modern services exports is now a remarkable 8% (Exhibit 24:).

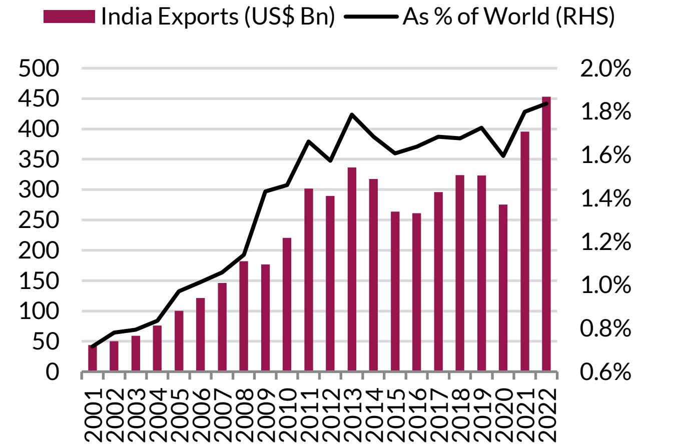
Similarly, improving competitive metrics, like in infrastructure and value-chain development in electronics, are likely to help India gain share of global goods exports, which had stagnated for nearly a decade (Exhibit 25). The value of exports has slowed in the recent months due to lower prices of oil and thence chemicals, growing global competition, as well as weaker volumes for large categories like apparel and textiles; however, India is seeing a rapid climb in electronics exports, where the government target of a 6x-7x growth in a few years seems achievable.

Exhibit 24: India's share of global goods exports to expand



Source: RBI, Axis Capital

Exhibit 25: India is gaining share of global services trade



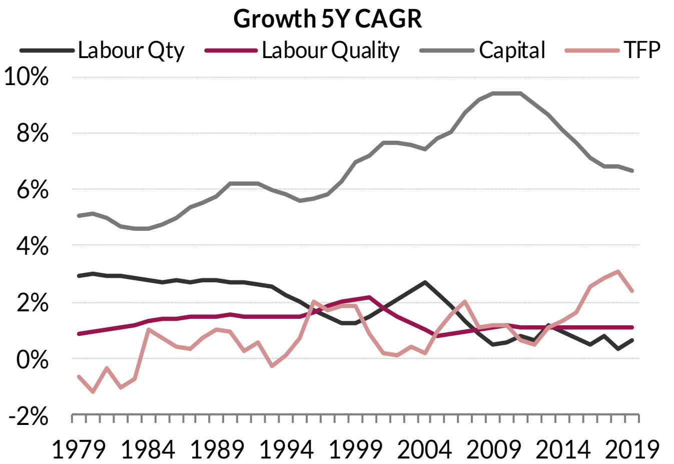
Source: RBI, Axis Capital

Trend growth estimates are likely to be upgraded again

Over the past decade, consensus estimates for India's trend growth rate declined from ~8% in 2007-12 to the current range of 6-6.5%. Covid cast new shadows on potential trend growth.

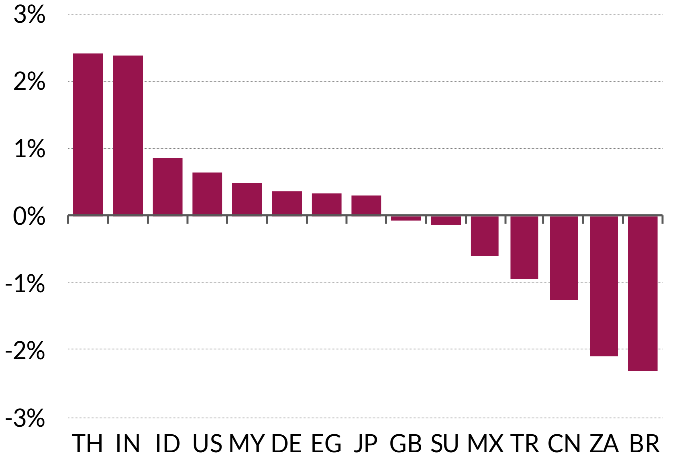
In our view, the growth decline was cyclical in nature, seen in the substantial drop in the five-year compounded growth rate for capital input between 2012-19 (Exhibit 26). India's growth till 2004 was driven largely by increasing labor quantity (working age population) and labor quality (higher educational attainment). The capex cycle that started in 2004 post the Electricity Act, start of the Golden Quadrilateral project, and development of ports and exports accompanied by a real estate boom, pushed the pace of annual capital input above 9%.

Exhibit 26: Slowing capital formation hurt growth 2012-19



Source: UC Davis, Axis Capital

Exhibit 27: India TFP growth 2014-19 among fastest globally



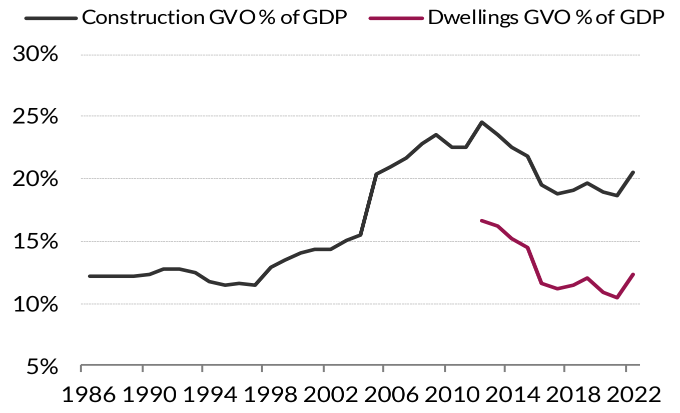
Source: UC Davis, Axis Capital

However, a deflating of the estate bubble turned the business cycle downwards, the five-year CAGR of capital formation fell to levels seen in the late 1990s.

The pace of change of labor input in India is relatively predictable, though over the medium term, changes in female labor force participation as well as hours worked can raise the pace. Total Factor Productivity (TFP) growth has been improving over the past decade, and was among the highest globally in the five years preceding the pandemic. We believe this can be sustained. 2-2.5% annual TFP growth in India is driven by substantial improvements in services – not just the accelerated shift to modern-trade and e-commerce, but also exports of high-value services.

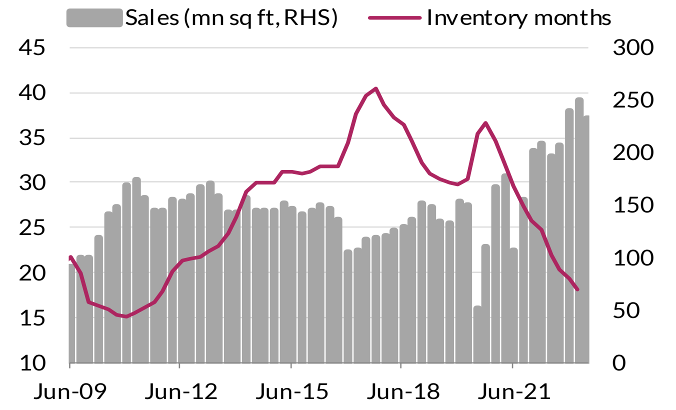
The real estate cycle has turned, as visible in the increase in the gross value of construction of dwellings as % of GDP (Exhibit 28) and falling inventories of developer-built housing, as sales volumes have picked up (Exhibit 29).

Exhibit 28: Dwelling construction can be larger part of GDP



Source: CSO, Axis Capital

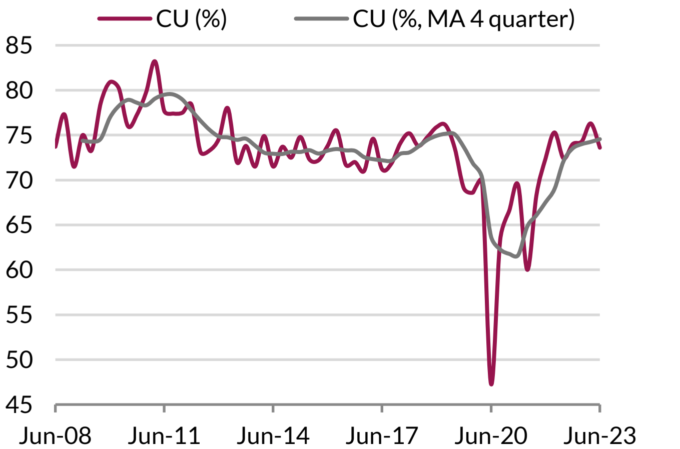
Exhibit 29: Housing inventories falling steadily



Source: PropEquity, Axis Capital

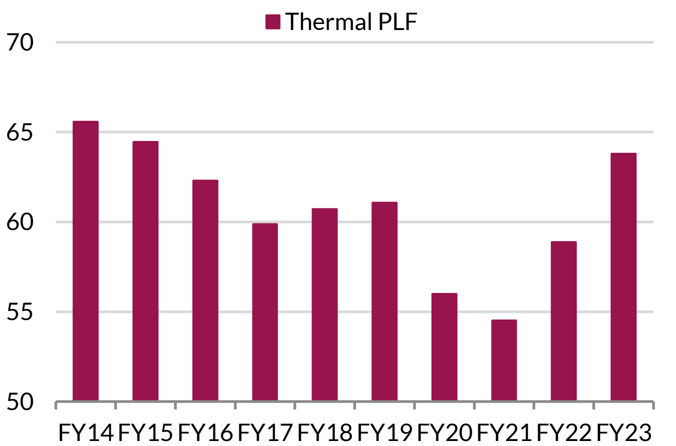
The corporate capex cycle is also turning after several years of deleveraging and cleaning-up of bad loans. As the twin balance sheet problem has been addressed and several years of under-investment has now started pushing utilization higher in several industries, more capital investment is likely going forward. In particular, the Covid disruptions are behind us (Exhibit 30).

Exhibit 30: Industrial capacity utilization now in mid-70s



Source: Capitaline, Axis Bank Research

Exhibit 31: Power PLFs rising; shortage in Oct-2023



Source: RBI, Axis Bank research

In sectors like thermal power generation, the average plant loan factor (PLF) is now reaching decade highs (Exhibit 31) and there was also power shortage for a short while in Oct-2023 (power demand tends to be volatile, so peak demand is 10-12% higher than average demand). The Axis Capital Utilities team estimates 80GW of new thermal power capacity needs to be commissioned by 2030 to obviate power cuts.

Investments in generating infrastructure on the renewable side are also likely to drive capex. As companies respond to the positive growth surprises (as described earlier in this section) and markets reward companies that are planning to add capacity, new expansion plans are likely to get chalked up. This cyclical recovery can support 4%+ growth in capital formation, driving 7%+ growth in GDP over the next few years.

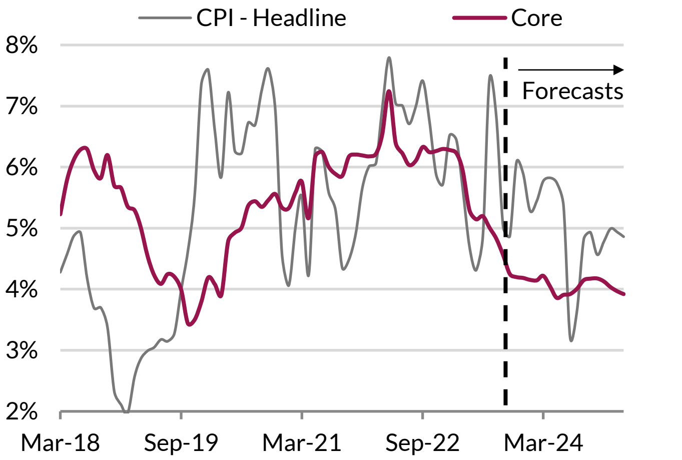
Inflation to return to target gradually, limiting easing options

We note two CPI inflation trends: (1) core inflation running at a below-target level on a sequential basis, and (2) headline to be sustained at more than 4% (Exhibit 32, 33). Strong growth conditions are likely to support inflation in the near to medium term, while a revival in capex checks core inflation. Hence, policy rates are unlikely to fall in CY24, though effective rates could be impacted by the improving fiscal balance and tight liquidity conditions.

Despite low core inflation, headline impacted by food shocks

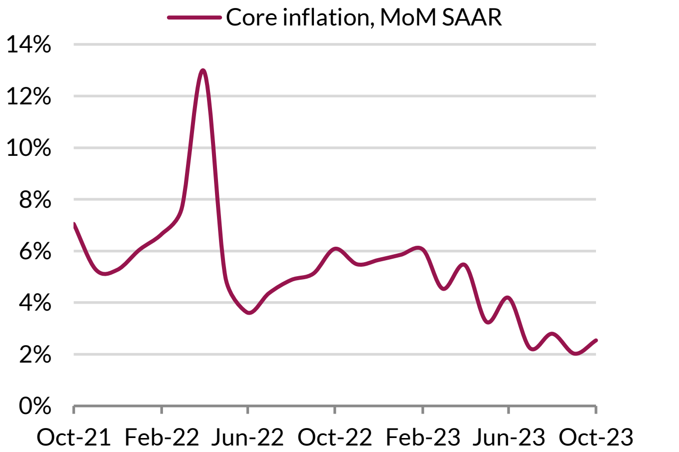
We expect the headline CPI inflation to remain volatile and above the mid-point of the target for the coming year (Exhibit 32). This is despite the core inflation drifting marginally lower from the current moderate levels which are already below pre-pandemic levels. On a seasonally adjusted MoM annualized basis, the core inflation is currently below 4% (Exhibit 33).

Exhibit 32: CPI inflation to return to target only haltingly



Source: MOSPI, Axis Bank Research

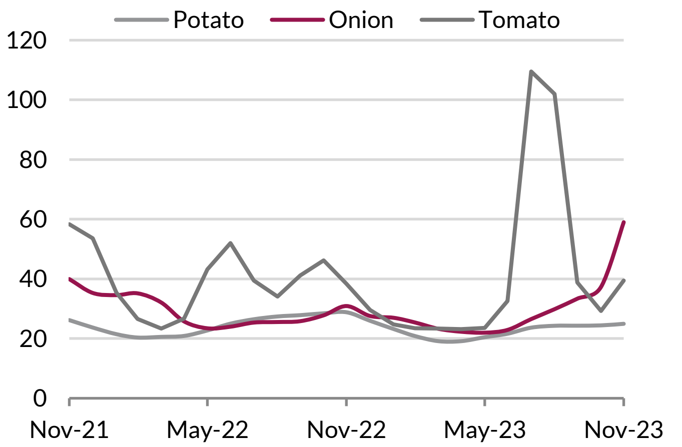
Exhibit 33: MoM SAAR of core inflation already below 4%



Source: MOSPI, Axis Bank Research

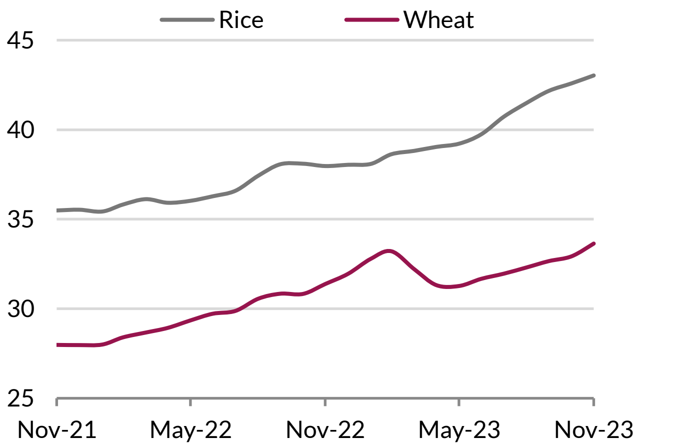
Meanwhile, food inflation is likely to remain volatile, with new supply shocks, compounded by the rising incidence of erratic monsoons, cyclonic disruptions, and hailstorms. While tomato prices fell in Sep and Oct, prices of cereals, pulses, and onion are rising (Exhibit 34). Despite export restrictions on wheat and rice, rising global prices have affected local prices (Exhibit 35). Such shocks increase the risk of entrenching inflation expectations.

Exhibit 34: Food pressure: Onion rising despite GoI supply



Source: DCA, Axis Bank Research

Exhibit 35: Global impact on cereals despite export controls

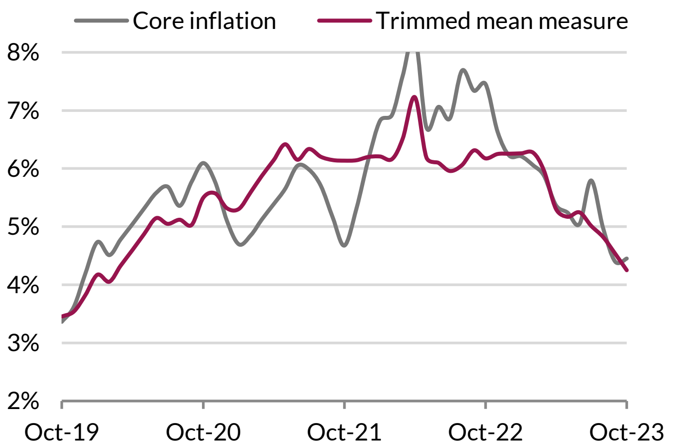


Source: DCA, Axis Bank Research

Some upside risks to core inflation going forward, but moderation to persist

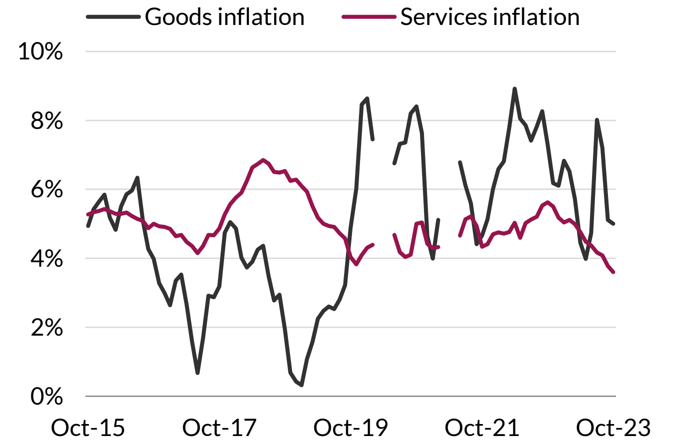
Both core inflation excluding petrol and diesel, as well as core inflation excluding petrol, diesel, gold, and silver have slowed meaningfully over the past year. While there is a good likelihood of global crude oil prices remaining well behaved in the face of a sharp increase in supply from the US, fiscal challenges in the US could mean a continued rebound in gold and precious metal prices.

Exhibit 36: Core lower with trimmed mean metrics as well



Source: MOSPI, Axis Bank Research

Exhibit 37: Services inflation lowest in nearly a decade

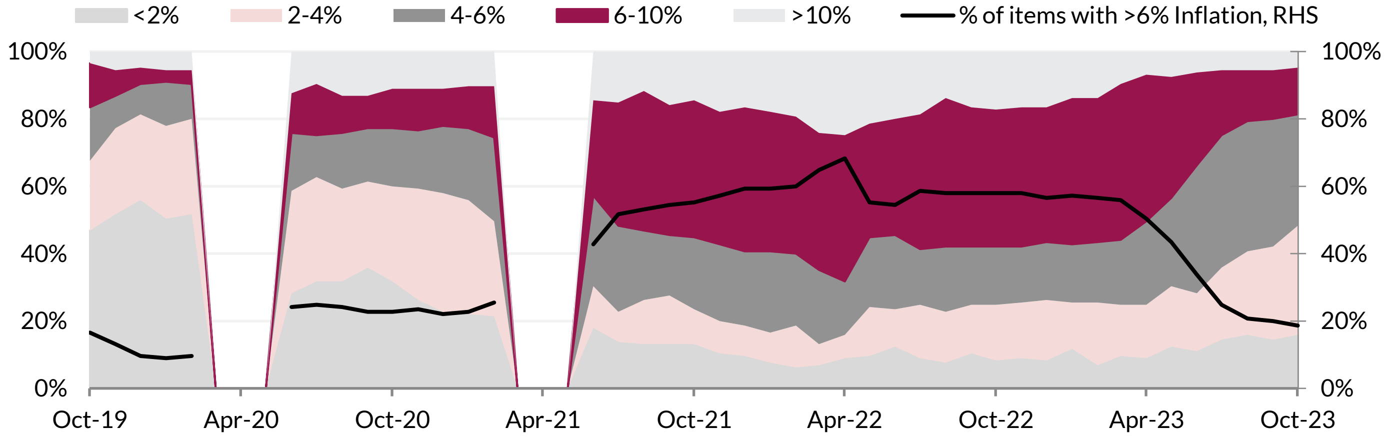


Source: DCA, Axis Bank Research

The trimmed mean has eased too (Exhibit 36), suggesting that the decline is broad-based. The number of sub-indices/categories reporting high inflation has been falling since the peak nearly two years back (Exhibit 38). The GDP is more than one year behind on the pre-pandemic trend, while fiscal and monetary tightening continues, suggesting that underlying inflationary pressures will remain limited. There can be some risk from rental inflation, as it slowly gets into the sample over six months (each house is sampled twice a year, so it takes some time for rent increases to show up fully in the CPI). At the higher end of India's workforce, due to the slowdown in services exports, wage pressures have eased meaningfully, while the placement season has been disappointing for graduating students. Even in the middle range of employment, perhaps best measured in services inflation, inflationary trends have eased (Exhibit 36).

Weak global demand also supports lower price pressures, with retail sales in major economies broadly unchanged from 2021 and supply-chain disruptions mostly behind us.

Exhibit 38: Decline in inflation has been broad-based, falling YoY for most categories

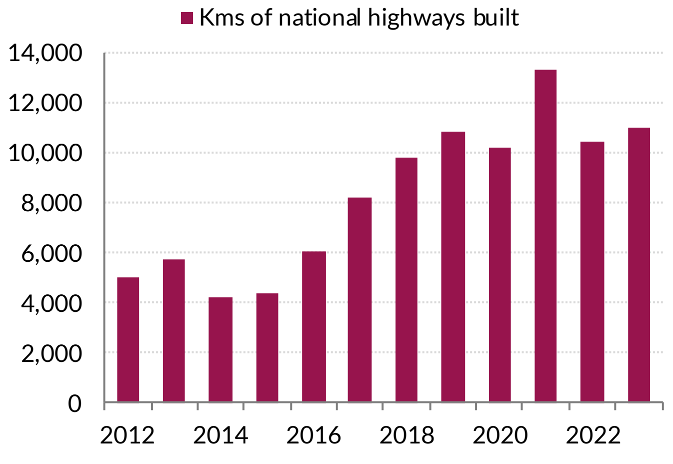


Source: MoSPI, Axis Bank

For sustained low inflation, healthy capex and fiscal discipline are essential

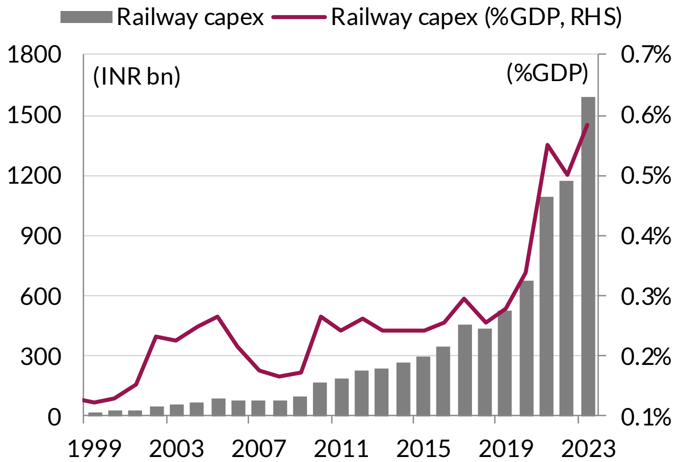
In addition to GDP, the measure of aggregate demand, being 7% below the pre-pandemic trend and thus indicating spare supply, significant investments made by the government in infrastructure over the past few years are also likely helping to keep inflation low. See, for example, the progress in roads (Exhibit 39) and railways (Exhibit 40). Going forward, if the state and central governments continue to focus on infrastructure, medium-term trends on inflation would remain benign despite a 7%+ GDP growth. While capex increases demand in the near term, the resultant increase in supply keeps medium/longer-term inflation in check.

Exhibit 39: Faster construction of national highways



Source: MoRTH, Axis Capital

Exhibit 40: Railway capex is now rising sharply as well

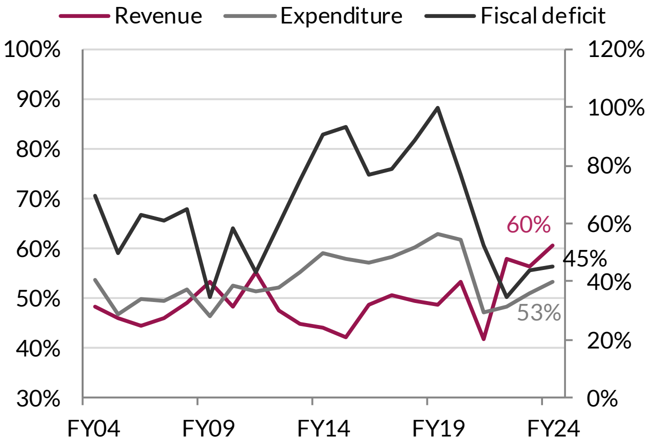


Source: CEIC, Budget documents, Axis Capital

Equally important is fiscal discipline, as the impact of higher policy rates on economic growth can be negated by higher fiscal deficit. As discussed in the first section of this report, the economy's growth momentum is despite fiscal as well as monetary consolidation. If it sticks to the fiscal deficit target of 4.5% of GDP by FY26, implying a reduction of 0.6% annually over the next two years, core inflation is likely to remain subdued.

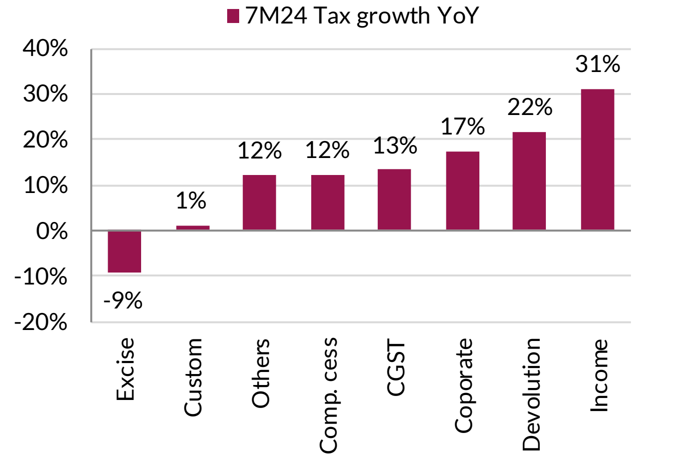
Even in FY24, while there was an expectation of front-loaded deficit given the upcoming general elections, we note that in the first seven months, the Centre has incurred only 45% of its FY deficit target (Exhibit 41), among the lowest in 15 years. Receipts over seven months are at 60% of budgeted revenues – a 20-year high. Direct tax collections have surprised positively (Exhibit 42), offsetting the fall in fuel excise (cut in May-2022).

Exhibit 41: 7M fiscal deficit lower than previous years



Source: CEIC, Axis Capital

Exhibit 42: Strong growth in direct taxes

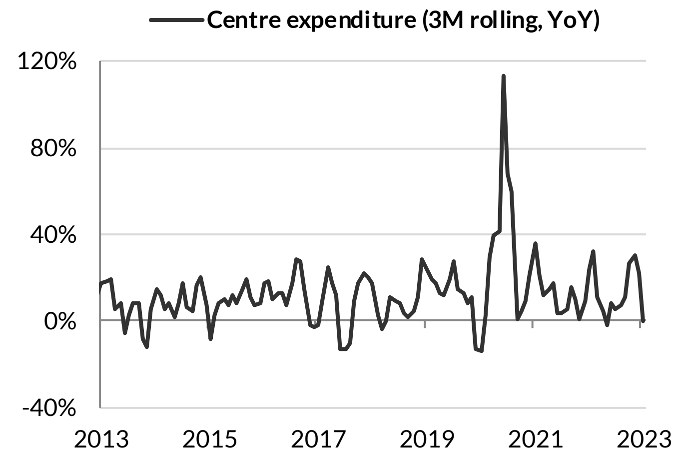


Source: CEIC, Axis Capital

The drop in excise on fuel and the rise in taxes that are in the sharable pool have meant that devolution to states has increased by 22% YoY as well.

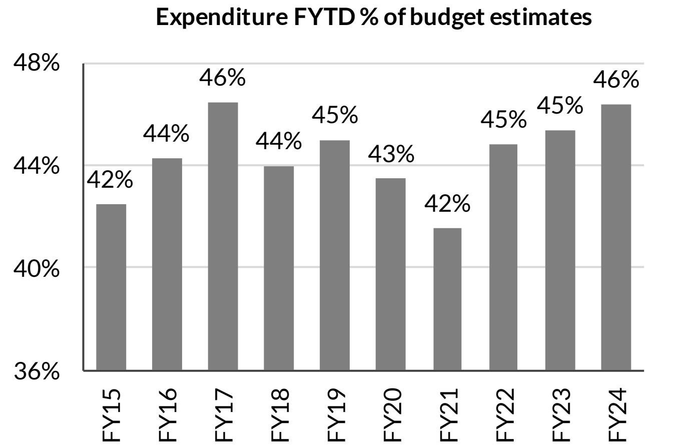
Given that the 3-month rolling YoY growth in central government spending is now close to zero already (Exhibit 43), there is no meaningful risk of a further slowdown in India in 2H necessitated by a forced sharp fiscal consolidation. While there was anticipation of front-loading of expenditure, expenditure growth at 8% FYTD is as per budget estimates. For 21 major states as well, 1H expenditure is 46% of FY budgeted estimates, which is not much higher than in prior years (Exhibit 44), reducing the risk of a slowdown.

Exhibit 43: Centre expenditure growth has slowed



Source: CEIC, Axis Capital

Exhibit 44: State spending in line with prior years



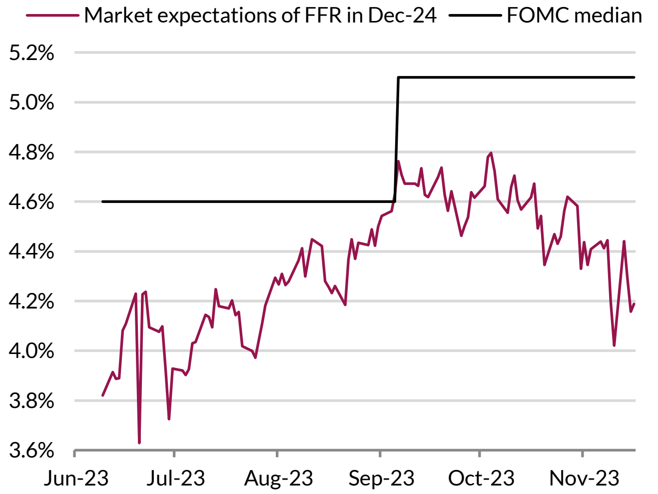
Source: CEIC, Axis Capital

Thus, we are of the view that the monetary policy does not have to counter the fiscal expansion, and therefore does not have to hike rates. On the other hand, current trends imply that inflation may not fall meaningfully below the 4% mid-point of range for the Monetary Policy Committee (MPC) in CY24. Even if the MPC desires to act preemptively, the conditions may not be favorable for it to cut, given the distortions in headline data due to food price shocks in the base and next year. We forecast an average inflation of 5.6% in FY24 and 4.8% in FY25 even though core inflation is seen being somewhat more benign.

As global rate cuts start next year, can there be some room for easing?

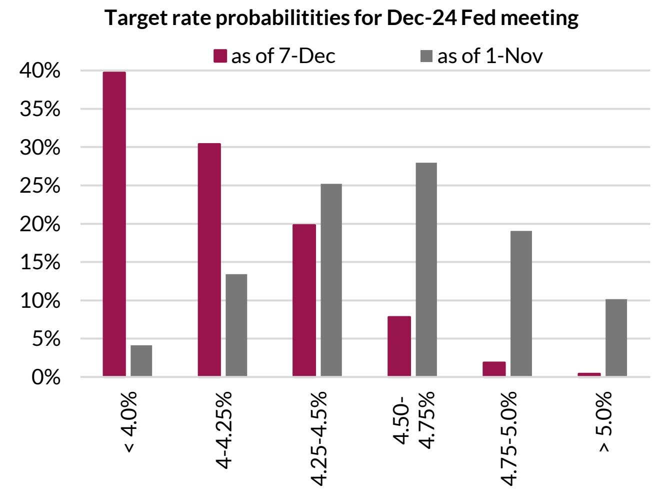
Over the past month, market expectations of Dec-2024 Fed Funds Rate (FFR) have fallen 60 bps (Exhibit 45). The markets now expect 5 rate cuts during 2024. Market-implied probability of a sub-4% rate (implying >6 cuts) has risen to 40% from just 4% and the probability of "zero rate cuts scenario" is now nearly zero (Exhibit 46). Fed's (FOMC) dot-plots in Sep-2023 signaled a median 5.1% rate as of end-2024 i.e. no rate-cuts scenario.

Exhibit 45: Markets dovish vs FOMC projections, again



Source: Bloomberg, Axis Bank Research

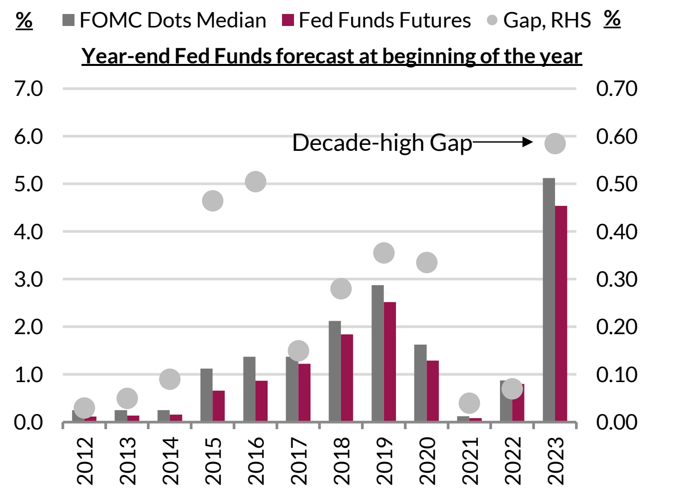
Exhibit 46: Probability distribution of market expectations



Source: Bloomberg, Axis Bank Research

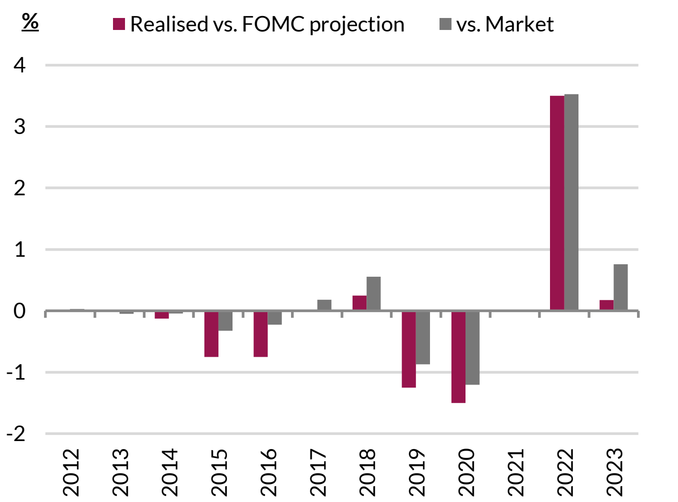
Every year since 2012, markets have been more dovish than the Fed when forecasting the one-year-ahead Fed Funds Rate (Exhibit 47). While forecasts might change in the 13-Dec Fed meeting, the 90 bps gap between current market implied FFR and the FOMC's Sep-2023 median forecast is the largest in more than a decade. The previous high was 60 bps in Dec-2022. In six of the past 12 years, the gap was less than 25 bps, and the 2019 outlook was disrupted by Covid. In the five years that remain, market forecasts were more accurate than the Fed's in three; the Fed won the forecasting battle in two – 2018 and 2023 (Exhibit 48).

Exhibit 47: Record gap between FOMC and market forecasts



Source: Bloomberg, Axis Bank Research

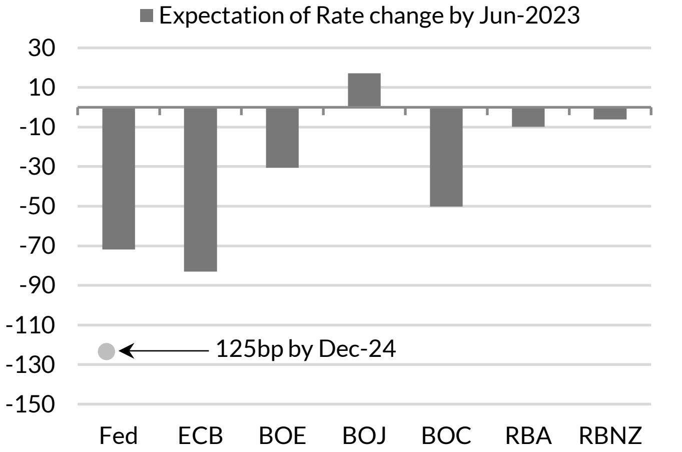
Exhibit 48: 2023 saw record gap between FOMC and market



Source: Bloomberg, Axis Bank Research

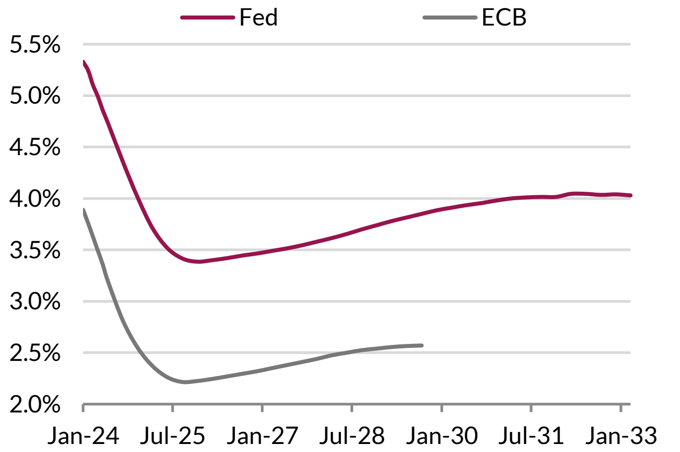
Market-implied policy rate expectations in Jun-2024 now show cuts in most major markets (Exhibit 49), with ECB expected to cut more than the Fed. While the resultant rates even after meaningful cuts are still well above the policy rates pre-Covid, can the RBI also ease? We do not see a direct link between the US/ EU policy rates and the RBI's repo rate, as each will be driven by domestic trends in growth and inflation.

Exhibit 49: Markets expect rate cuts in most markets by Jun



Source: Bloomberg, Axis Bank Research

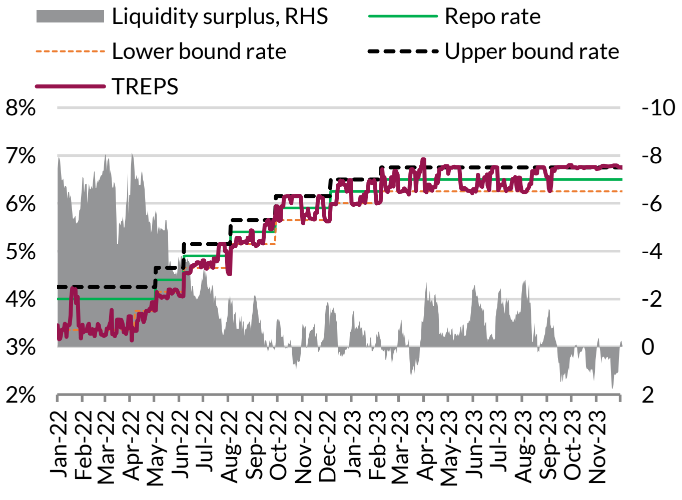
Exhibit 50: Policy rates should though be higher than in 2019



Source: Bloomberg, Axis Bank Research

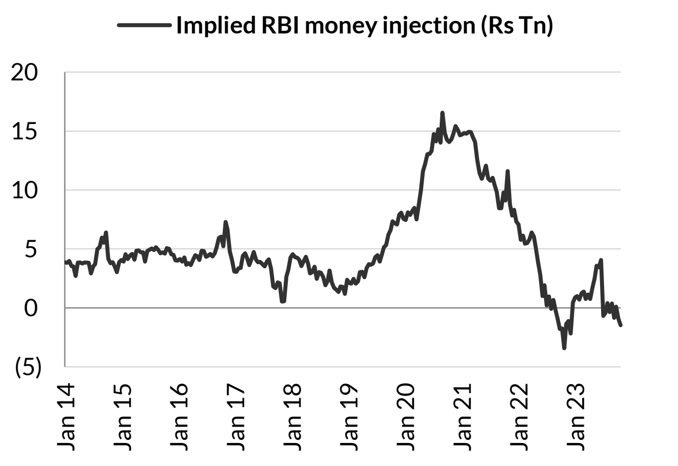
That said, monetary easing in the developed world, especially if followed by an increase in the quantity of dollars in the global system, can give comfort to the RBI towards easing liquidity conditions. The significant tightening of liquidity over the past year and a half has been equivalent to 25-30 bps rate hikes (Exhibit 51), as MSF is now the effective rate.

Exhibit 51: Current liquidity ➔ rates 25-30 bps higher



Source: Bloomberg, Axis Bank research

Exhibit 52: No effective money injection over 1.5 years

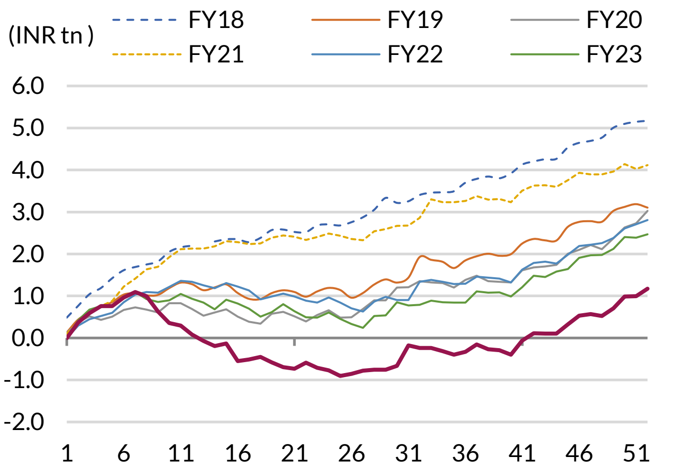


Source: MOSPI, Bloomberg, Axis Bank Research

Effective money injection by the RBI has been nearly zero in the last 18 months vs the Rs 5 tn+ it would inject over 12 months pre-Covid (Exhibit 52). We take this as the residual in M3 changes, which also get affected by banks' credit creation, a drain from growth in currency-in-circulation (CIC: this is still down FYTD; Exhibit 53), and changes in government cash balances (these have risen, but still lower YoY: Exhibit 54).

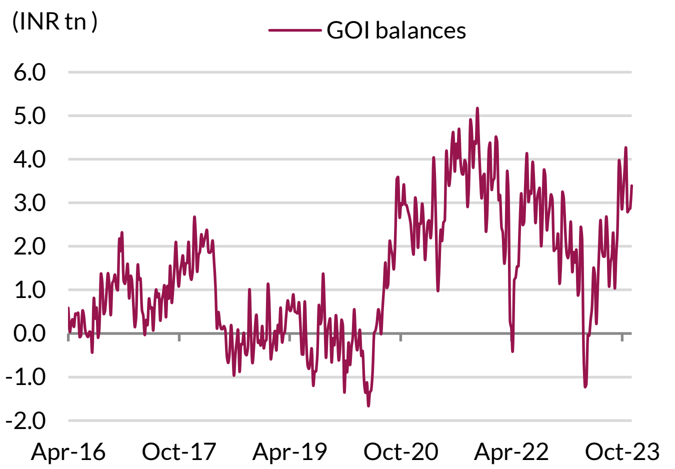
In our view, the RBI is keeping liquidity conditions tight to protect the economy and the currency from undue volatility given the financial risks brewing globally. Once global financing conditions ease, the RBI may inject liquidity, effectively driving a rate cut.

Exhibit 53: Demand for currency notes is negative FYTD



Source: Bloomberg, Axis Bank research

Exhibit 54: GoI balances held with the RBI are a liquidity drain



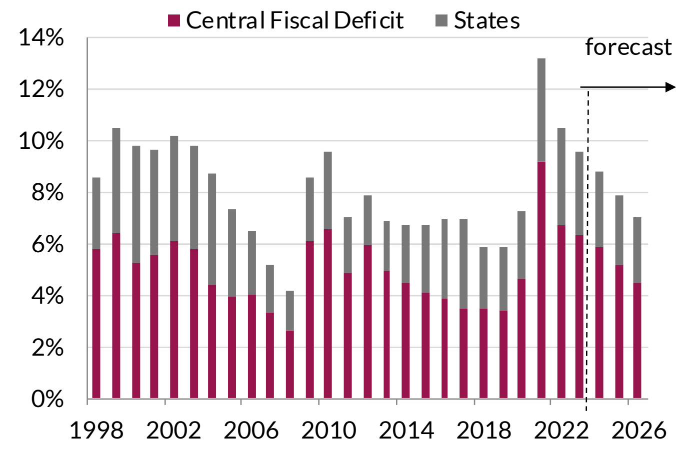
Source: MOSPI, Bloomberg, Axis Bank Research

CPI inflation is the driver of monetary policy, but WPI plays on fiscal issues too

The MPC mandate is linked to headline CPI, while WPI, which is far more sensitive to changes in imported commodity prices, has some forward-looking elements, affecting the GDP deflator.

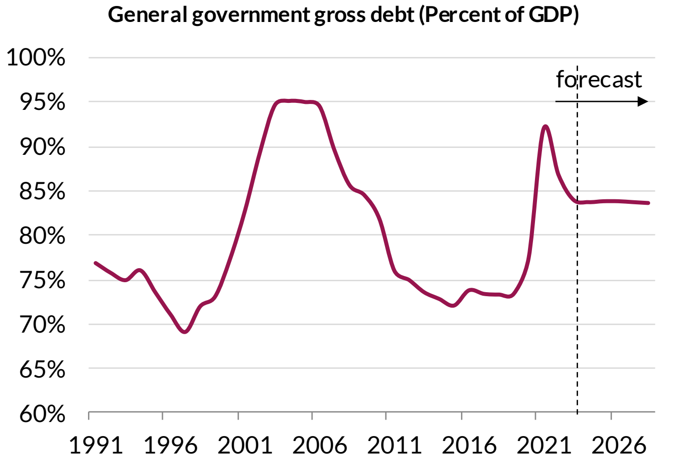
The GDP deflator also has a meaningful impact on debt sustainability – the debt-to-GDP ratio. Short bouts of high inflation have been associated with healthier sovereign balance sheets. FY11 is a notable example of this, as the debt ratio declined despite an elevated fiscal deficit. The government is committed to bringing down the central fiscal deficit to 4.5% of GDP by FY26, but for the debt-to-GDP ratio to fall below 70%, the nominal GDP growth needs to remain high.

Exhibit 55: Fiscal consolidation needs to continue (% of GDP)



Source: CEIC, RBI, Axis Capital

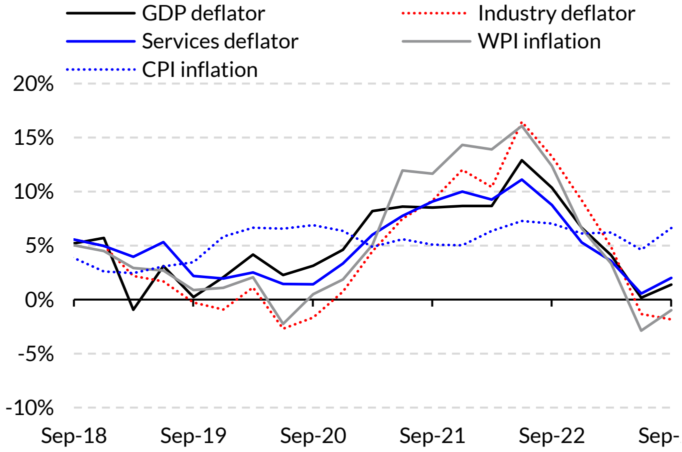
Exhibit 56: Government debt-to-GDP is still high



Source: IMF, RBI, Axis Capital

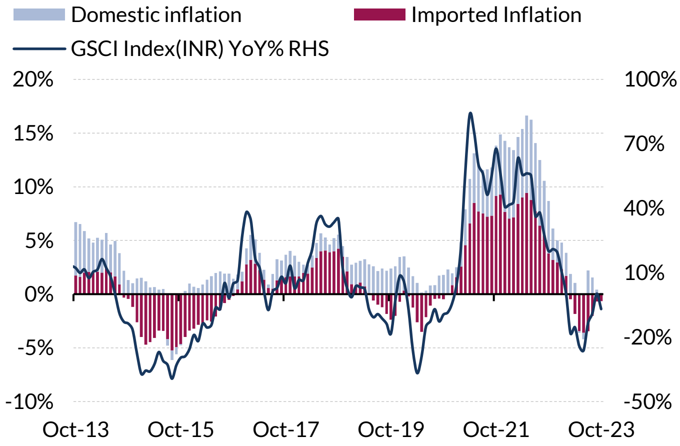
The GDP deflator generally lies below WPI and CPI inflation. The former tends to be more volatile, while CPI inflation is stabler given the influence of services inflation. In the long run, WPI inflation makes up around 60% of the variation in the GDP deflator, while CPI inflation makes up the remaining 40%. WPI matters more for industrial GVA, and CPI for services.

Exhibit 57: GDP deflator lies between WPI and CPI



Source: CSO, Axis Bank research

Exhibit 58: WPI sensitive to prices of imported commodities



Source: MOSPI, RBI, Bloomberg, Axis Bank Research

Going forward, while CPI inflation is expected to moderate at a sluggish pace as laid out above, WPI inflation might already have bottomed out. With higher volatility and fading of high base in commodity prices, WPI inflation is likely to rise back and support overall GDP deflator, boosting nominal growth and tax collections.

Longer-term rate trends likely to be positive if fiscal consolidation continues

If the 2024 general elections result in continuity in the leadership, we believe that the Centre will remain committed to the FY26 deficit target of 4.5%. If so, the supply of bonds would remain unchanged for nearly four years, even as its demand from banks, insurance and pension funds and mutual funds is likely to keep growing. This is in addition to the inflow from inclusion in global bond indices. This can also bring down long-term funding costs. If nominal GDP growth is sustained at a higher pace without forcing the CPI up, the debt-to-GDP ratio would also likely fall faster than currently expected.

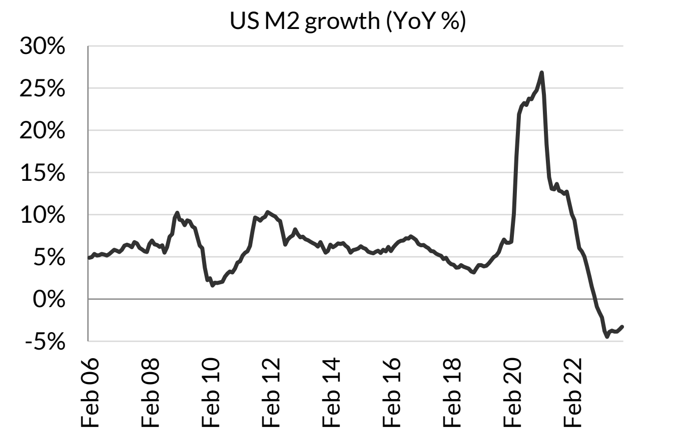
Index-inclusion and growing exports can offset slowing capital flows

The challenge for India, like peers with current account deficits, is its external balance owing to a crowding out led by the US's sustained high fiscal deficit – resulting in weak capital flows, while the current account deficit is pressured upwards by weak external and strong domestic growth.

Dollar shortage ex-US to continue to intensify till monetary easing restarts

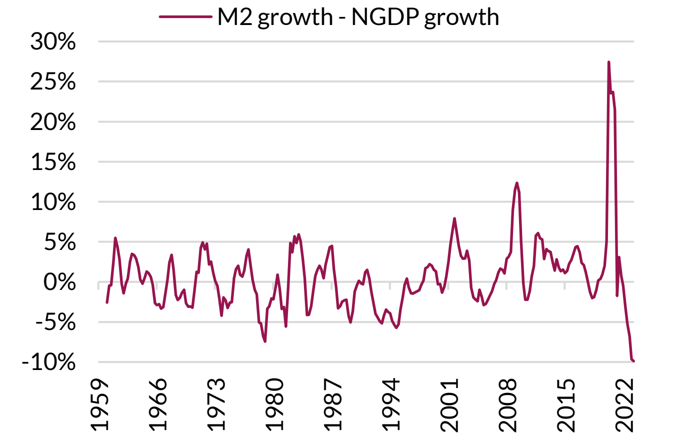
Due to quantitative tightening, money supply in the US is shrinking (Exhibit 59). With elevated fiscal spending keeping nominal GDP growth strong in the US, the gap between USD M2 growth and US nominal GDP growth is the worst since World War II (Exhibit 60). Money velocity is also likely to have risen given the increase in interest rates, but this suggests that availability of dollars outside the US is a growing challenge. This will likely worsen in the coming months/quarters, as M2 keeps shrinking and nominal GDP keeps growing.

Exhibit 59: Shrinking supply of USD (largely due to QT)



Source: CEIC, Axis Capital

Exhibit 60: US economy absorbing more dollars

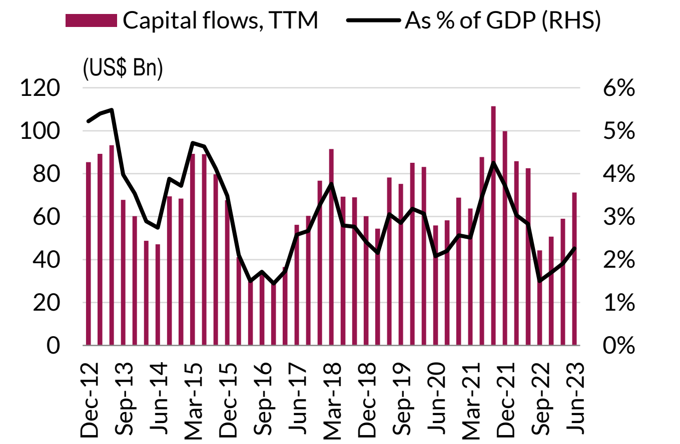


Source: CEIC, Axis Capital

Capital flows to India have slowed to ~2% of GDP, may fall further

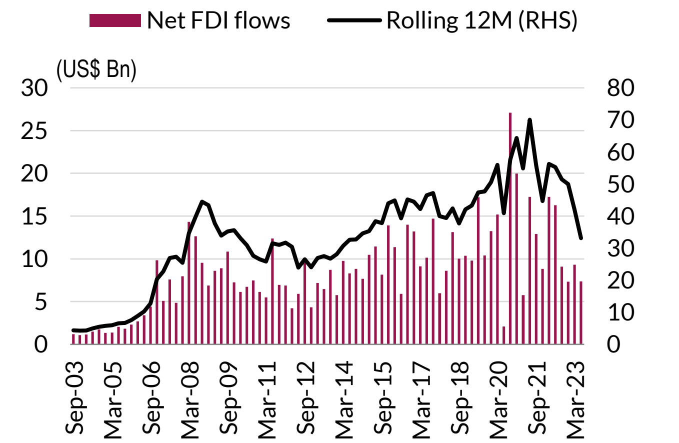
The current account deficit that India can sustain is determined by the quantum of capital flows. While 1H was supported by the surge in FPI flows after the US Fed temporarily grew its balance sheet after the banking system issues in Mar-2023 (Exhibit 61), the flows have weakened since then. Rolling 12-month net FDI, a major source of flows to India, has already slowed by USD 25 bn over a year and by USD 35 bn from the peak (Exhibit 62).

Exhibit 61: Capital inflows rose in 2Q'24, but slower since



Source: CEIC, Axis Capital

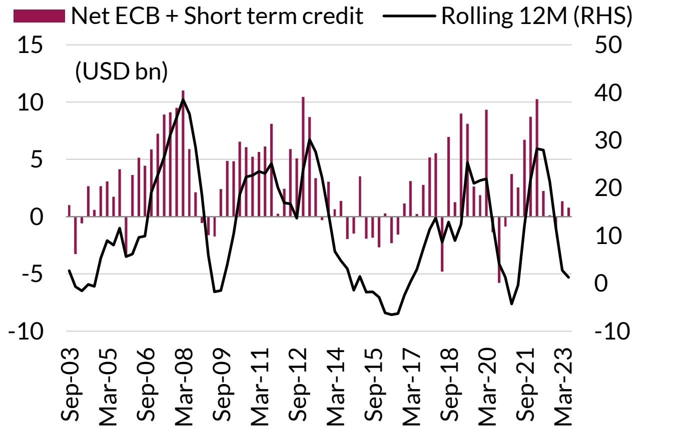
Exhibit 62: Net FDI inflows have slowed sharply



Source: CEIC, Axis Capital

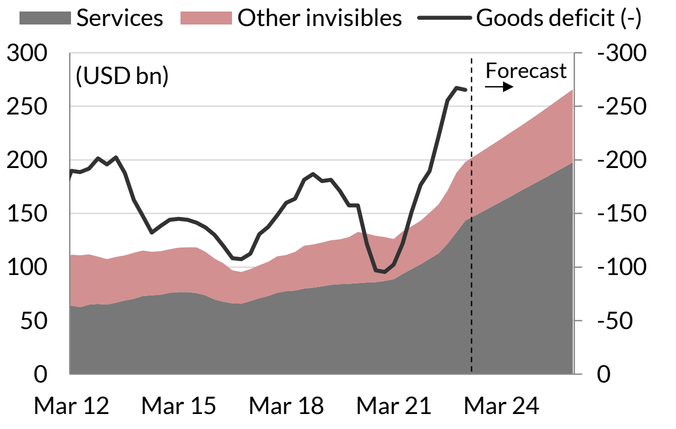
A meaningful part of India's CAD is also funded by credit – both the longer-term External Commercial Borrowings (ECB) and trade financing. While ECB has remained stable so far, shorter-term financing is seeing outflows, as firms are not willing to or not able to roll over short-term credit (Exhibit 63).

Exhibit 63: Net credit flows have also showed sharply too



Source: CEIC, Axis Capital

Exhibit 64: Services exports can offset high goods deficit



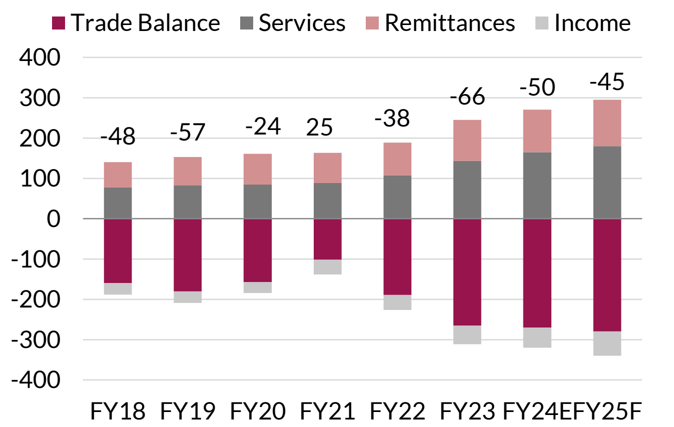
Source: CEIC, Axis Capital

Balance of Payments pressure offset by improving services exports

Though the adverse growth differential between India's resilient domestic economy and weakening global economy is likely to cyclically push up the CAD, we believe a structural improvement in India's services trade surplus can help keep the CAD in check. By FY26, we believe the services trade surplus can surpass the highest-ever goods trade deficit that India has ever incurred, implying that the current account can potentially be in surplus (Exhibit 64).

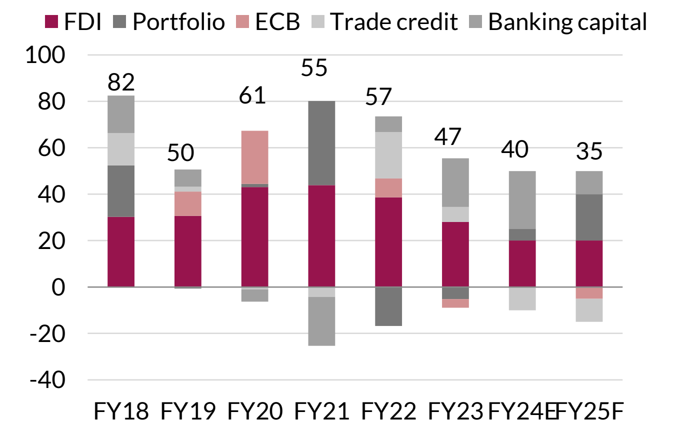
There are several sensitivities here, including the prices of commodities like oil and gold that can significantly affect India's terms-of-trade. To some extent, slowing global growth should also keep prices of the energy basket in check. Gold prices though may be uncorrelated and more dependent on the US fiscal and monetary policies going forward. We expect CAD to remain at 1-1.5% of GDP in the next two years (Exhibit 65).

Exhibit 65: India current account deficit to remain elevated...



Source: RBI, Axis Bank Research

Exhibit 66: ...while financial flows to remain constrained



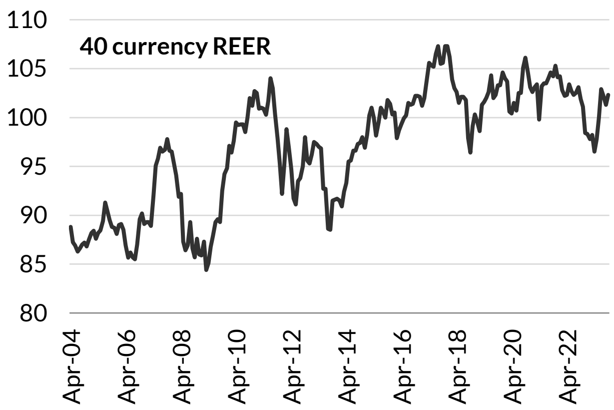
Source: RBI, Axis Bank Research

This should mean that capital flows fall to 1-1.5% of GDP (including 0.6% of GDP of inflows from bond index inclusion), as the US government and the US economy absorb the shrinking quantity of dollars available globally. The RBI can use its reserves to protect the INR from undue volatility.

INR volatility likely to remain in check

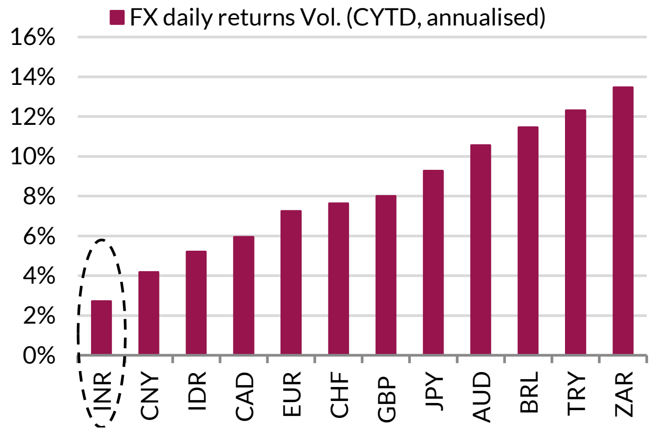
INR's Real Effective Exchange Rate (REER) has been remarkably stable over the past five years (Exhibit 67), as the RBI has dampened volatility.

Exhibit 67: REER range-bound in last 5 years



Source: CEIC, Axis Capital

Exhibit 68: INR volatility now even lower than that of CNY



Source: CEIC, Axis Capital

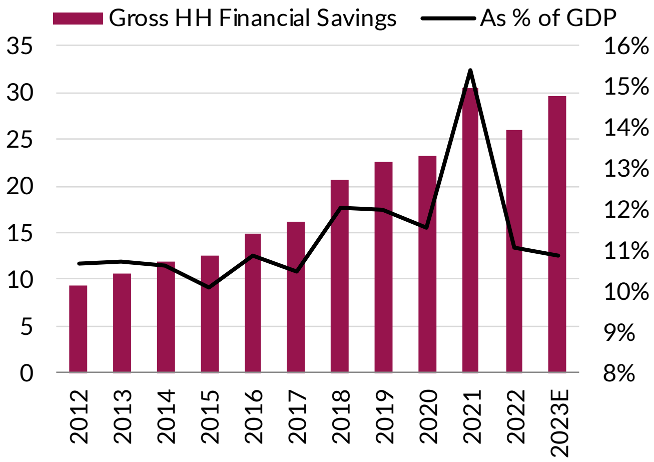
Such has been the extent of volatility management, that this year the INR has been less volatile against the USD than even against the CNY (Exhibit 68). There are risks that emerge from this level of stability as well – economic participants can get lulled into not hedging – but for now, we do not see this policy changing.

Domestic savings are growing too, though GDP acceleration may need inflows

Another perspective of external balance is the savings-investment gap. Strong medium-term growth in investments require financial savings, and if these are found to be insufficient, the current account deficit goes up ('investment + consumption' exceed production) and the economy needs foreign capital inflows to sustain its growth. For countries like India that run CAD, therefore, the availability of external capital can be a binding constraint.

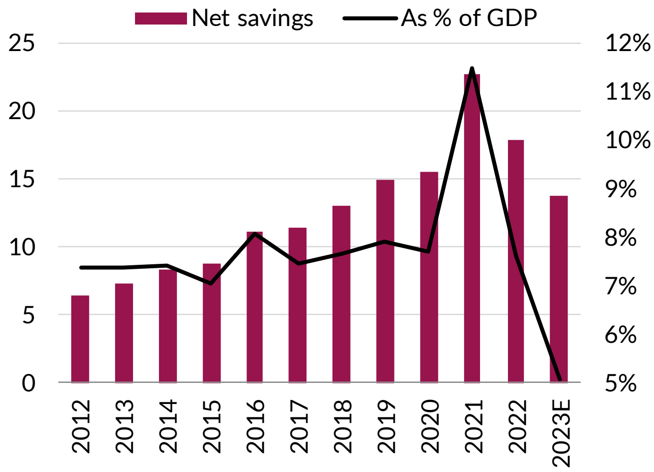
Can domestic savings pick up? Gross domestic savings in India come from households (individuals + MSMEs) and corporates, and are offset by dis-saving by the government (fiscal deficit). In FY22, gross household financial savings fell YoY (Exhibit 69). With household financial borrowings going up, net financial savings declined 21% YoY and fell below 8% of GDP (Exhibit 70). In FY23, this fell further below 6% of GDP.

Exhibit 69: Gross HH financial savings fell in FY22 (Rs tn)



Source: RBI, Axis Capital

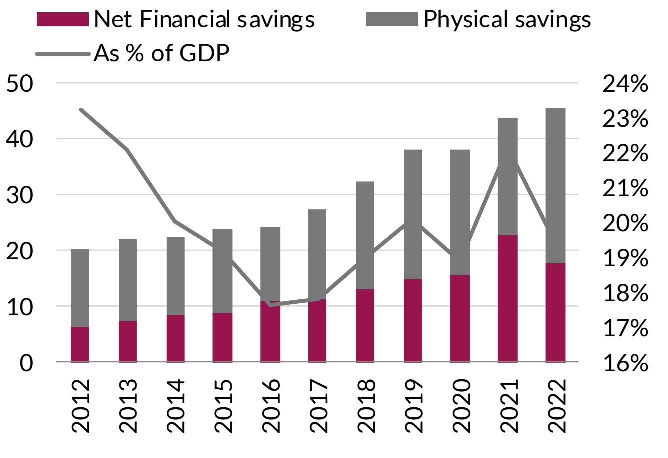
Exhibit 70: Net savings fell 21% YoY in FY22



Source: RBI, Axis Capital

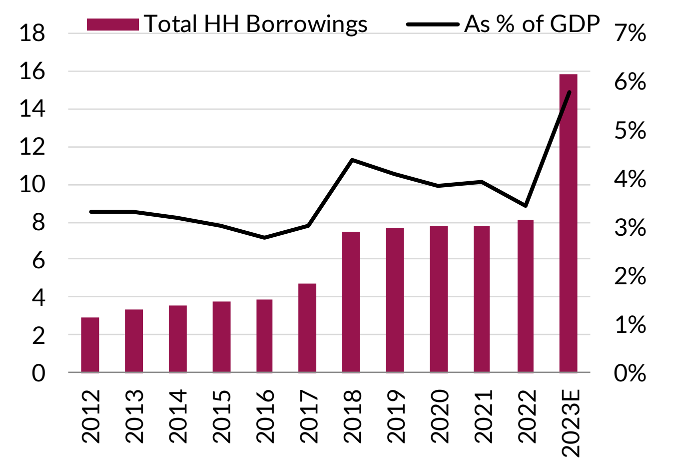
We do not see this as a structural problem. To start with, FY21 due to Covid restrictions saw a surge in savings; hence, the YoY decline once the economy opened and people got an opportunity to spend was expected. This trend likely continued in FY23. Equally importantly, overall savings did not fall in FY22. While financial savings did decline, they were offset by a rise in physical savings (Exhibit 71). As households invest in their own assets, physical savings rise – the rebound in dwelling construction discussed earlier in this report is a factor to be considered here. HH borrowings did not rise that much (Exhibit 72), but on a smaller base of financial savings, the impact on net financial savings appears to be larger.

Exhibit 71: Total savings were up, led by physical savings



Source: RBI, Axis Capital

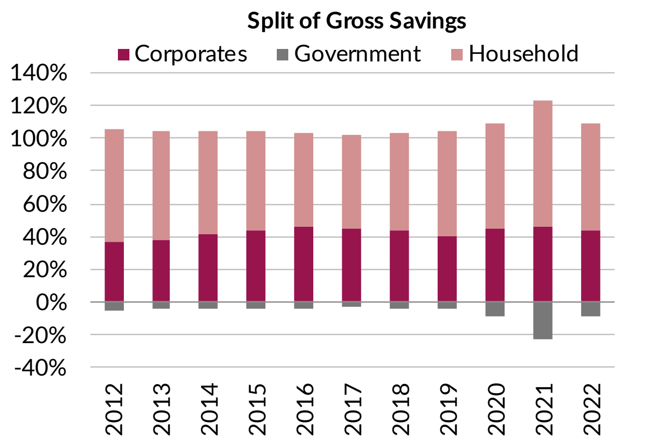
Exhibit 72: HH borrowings grew 4% YoY in FY22



Source: RBI, Axis Capital

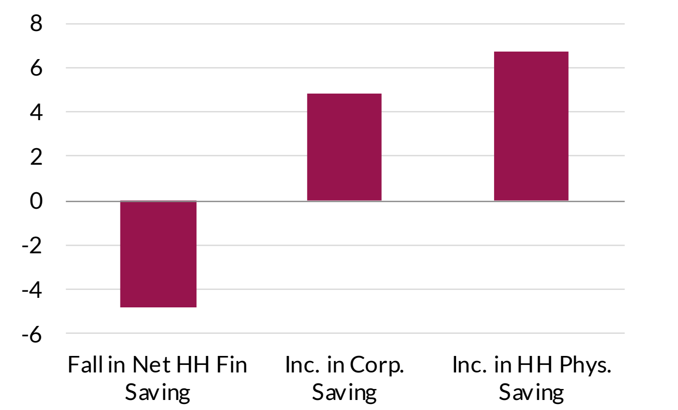
Perhaps more importantly, the total ability of an economy to fund its growth is best measured by the current account deficit. The rest is just a redistribution between the three major parts of the economy – households, corporates, and the government. Not surprisingly, the fall in household savings coincided with an increase in corporate savings (+18% YoY; Exhibit 74).

Exhibit 73: Gross savings split by HH, corporates, govt



Source: RBI, Axis Capital

Exhibit 74: In FY22, Fall in HH saving offset rise in corporates



Source: RBI, Axis Capital

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