Global Macro Research - Insight

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India's economy: a global bright spot

The country will continue to outperform other major economies in 2024, as near-term momentum shows no sign of waning. While easing core inflation supports our view for a cutting cycle from June, the economy's resilience raises risks of a prolonged pause.

Key Takeaways

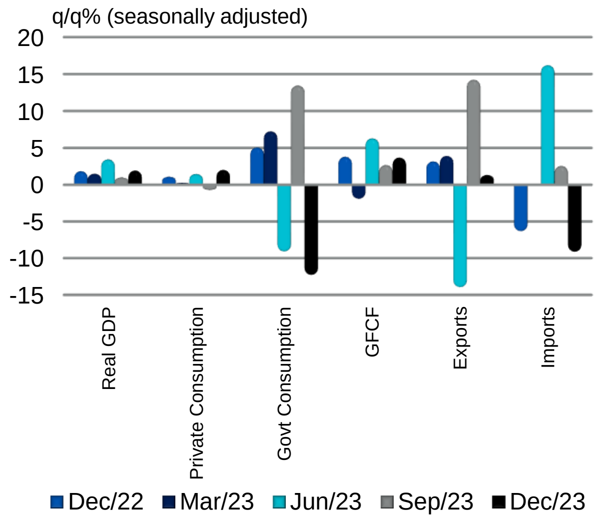
- India's economy is showing limited signs of slowing as indicators point to a pick-up in activity at the turn of the year, after very rapid growth through 2023.
- Q4 GDP showed the economy continues to surprise to the upside and we have adjusted our 2024 forecast from 5.8% to 6.3% to reflect the strong momentum.
- Despite the booming economy, core inflation has continued to moderate and, while uncertainty remains around food inflation, we expect headline inflation to ease by mid-year, creating scope for monetary easing.
- Moreover, fiscal consolidation will put the onus on the Reserve Bank of India to support private sector activity and, as such, we continue to pencil in the first cut for June.
- However, monetary conditions do not appear particularly tight and, with strong growth likely to persist into Q1, the extent to which policymakers will cut has shrunk in our view. We now see 75bps of cuts in 2024, with the policy rate settling at 5.75%.
- There are also growing risks of a 'no landing' scenario in India given the economy's resilience. A pick-up in domestic demand could reverse the progress in core disinflation and dissuade policymakers from providing further support for the economy.

India's moment to shine

India's economy continues to grow apace and should retain its place as one of the bright spots in the global economy in 2024. The Q4 2023 GDP release revealed activity surged 2% quarter over quarter (seasonally adjusted terms), taking growth to 8.4% year over year, far above consensus expectations of 6.6%. Overall, the economy expanded an impressive 7.7% in 2023, above our expectations of 7.3%.

The main drivers of the Q4 expansion were a rebound in household consumption and a third consecutive quarter of acceleration in fixed investment growth (3.7% quarter-over-quarter), as well as a sharp reduction in imports (down 9.1%). From a sectoral perspective, while GVA growth proved slower (6.5% year over year), services and construction activity proved resilient, indicating underlying economic strength.

Figure 1: Strong fixed investment and a net exports boost drive the economy's expansion



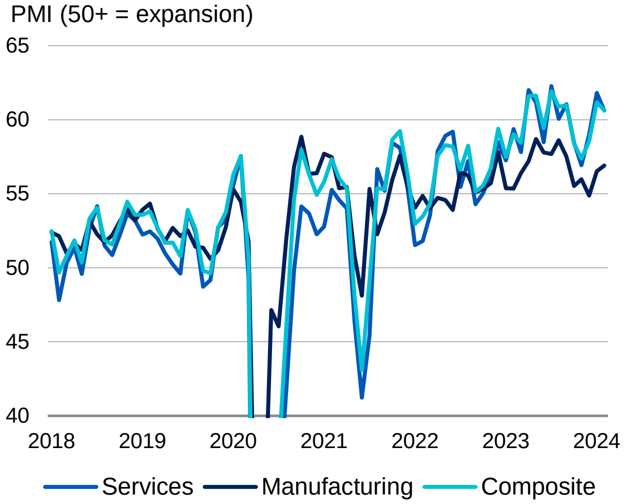
Source: Haver, abrdn, March 2024

Survey data also suggest the economy has performed well in 2024 so far.

Purchasing Managers' Indices (PMIs) indicate activity has accelerated, with the composite index up 2pts in the year to February to its highest level since September (see Figure 1). Driving this rise has been a surge in services output, following a lull in Q4.

Manufacturing has also improved in early 2024, benefitting from strong new orders, both domestically and externally.

Figure 2: PMIs point to an acceleration of activity in Q1

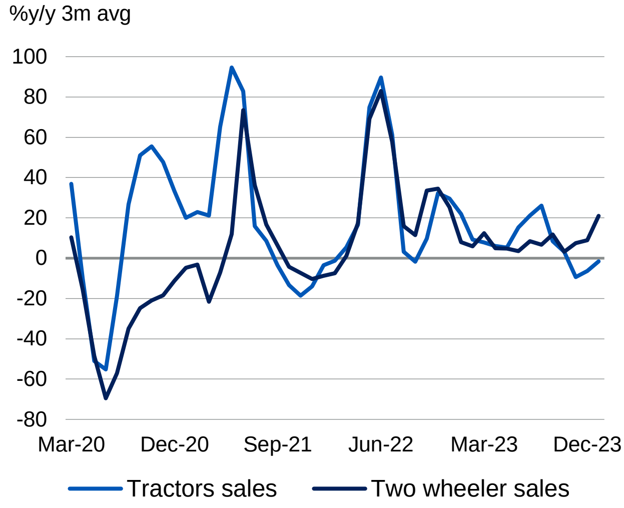


Source: Haver, abrdn, March 2024

Underpinning the strength of PMI readings is the continued improvement in consumer confidence. In January, the Reserve Bank of India (RBI)'s bi-monthly consumer confidence survey showed a further improvement in both current and future expectations, maintaining the recovery path since the pandemic shock.

Hard data add to the feel-good narrative surrounding India's economy. Credit growth has been outpacing the economic expansion, with service sector loans up 23% year over year and personal lending rising 29%. Vehicle sales are also showing an upturn in activity (see Figure 3).

Figure 3: Upturn in vehicle sales



Source: Haver, abrdn, March 2024

There are also signs of further strength in capital expenditure and construction activity. Imports of machinery, cranes and railway equipment are all surpassing pre-pandemic demand. Relatedly, construction borrowing picked up in 2023, growing 11% year over year in December. This, alongside the government's budgeted increase of 11% for capital expenditure in the FY2024/25, should mean the strong performance of fixed investment continues.

All this has led us to revise our growth forecast to 6.3% in 2024, from 5.8% previously. While still strong, it will mark a slowdown from 2023. The fiscal impulse is set to cool over the coming quarters and there remain some pockets of weakness on the consumer front. More specifically, the government announced a smaller-than-expected budget deficit for FY2024/25, forecasting it to narrow 0.7ppt to 5.1% of GDP. And there remain challenges in the agricultural sector implying some balance sheet weakness among lower income households that will take time to recover.

The softest of landings

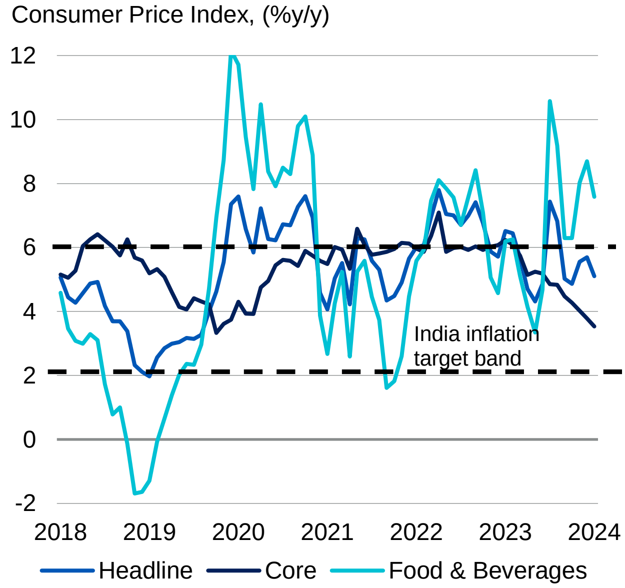
Despite the strength of economic activity, inflation has receded over the past year, and we expect it to cool further over the course of 2024. Core inflation has all but returned to target-consistent levels, pointing to a likely 'soft landing' for the Indian economy following the spike in inflation in 2022 and the subsequent RBI hiking cycle.

Our preferred measure for underlying inflation – a three-month average of month-over-month core inflation, annualised – shows a run rate of 3.1%, down from 6.4% a year earlier (and lower than the 3.5% year-over-year rate of core).

In fact, it is food inflation that held headline CPI back from returning to the 4% target midpoint.

El Niño-related disruptions to weather patterns and geopolitical shocks have resulted in large swings in food prices, which India is particularly vulnerable to given its relatively high weighting to food and beverages in its consumer price basket (46%).

Figure 4: Core inflation continues to recede



Source: Haver, abrdn, March 2024

Over the past 12 months, food inflation has contributed on average 3.1ppts to monthly headline inflation prints, requiring inflation in other goods and services to run far below target-consistent rates to hit the target mid-point.

The issue of food price volatility was apparent in the RBI's household inflation expectations survey, which showed an increase in three-month inflation expectations, with most survey respondents citing food prices as part of their reasoning. It should be noted that inflation expectations have been slow to recede, yet this has not been reflected in core inflation readings.

While uncertainty over food production remains, there are signs of some price pressures easing – the spike in tomato and onion prices has since moderated – and the production of both rice and foodgrains has been expanding. Ultimately, the path for food prices will remain unclear until the monsoon season, which runs from June to September.

RBI not in a rush but cuts still likely in 2024

Overall, we believe the economy's strength and considerations around the timing of the Fed's rate cutting cycle mean that the RBI is unlikely to loosen monetary conditions until mid-year.

Indeed, the RBI maintained its policy rate at 6.5% at its February meeting and remained "focused on the withdrawal of accommodation" as had been the case since it paused in April 2023.

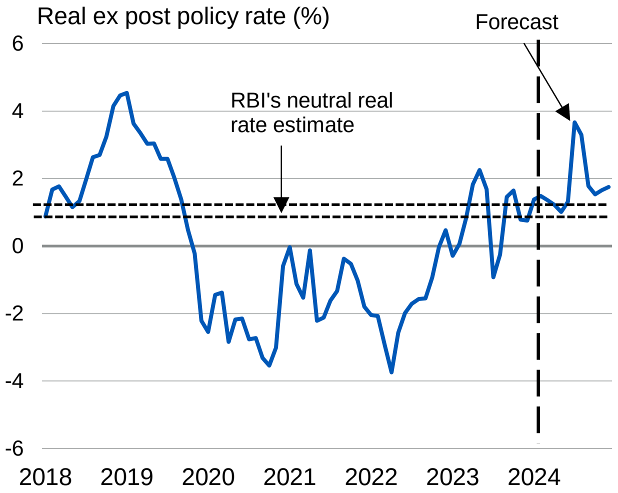
However, there was a dissenter; Professor Jayanth R. Varma, who called for a 25bps cut. This was the first time such a cut had been voted for since the RBI paused its hikes in April 2023. Varma has been the most dovish member of the Committee, repeatedly pointing to the risks of overtightening.

Yet, with the economy and credit growth booming and bank surveys signalling strong demand and an easing of lending conditions, monetary conditions do not appear significantly restrictive and the risks of overtightening seem slim.

The RBI's own assessment of the neutral real policy rate has it in a range of 0.8-1.0%, implying the real ex-post policy rate was only briefly in restrictive territory in Q2 2023 and has since swung around the neutral range.

We do expect it to shift above the neutral estimate over the course of 2024 as headline inflation moderates, but, as bank lending surveys show, the pass-through to activity may still take time to unfold and there is a reasonable chance that the impulse from prior tightening has largely run its course.

Figure 5: RBI's own assessment will signal scope for cuts in 2024



Source: Haver, abrdn, March 2024

Given the economy's resilience, the timing of the RBI's first cut is unclear. While we maintain our call for June, the probability is increasingly tilting towards a move in Q3. Using the real ex-post policy rate as a gauge, we think the RBI can still use falling headline inflation, less supportive fiscal policy and rate cuts by other major central banks as a rationale to ease (see Figure 5).

We see the RBI cutting 25bps in June and a combined 75bps before the end of 2024, taking the policy rate to 5.75% (50bps above our prior forecast).

Indeed, as the government pulls back, policymakers are hopeful that the private sector will ramp up investment to support the economy. As part of this, we think the RBI's pro-growth tilt will spur it to ease credit conditions to ensure investment activity continues to expand.

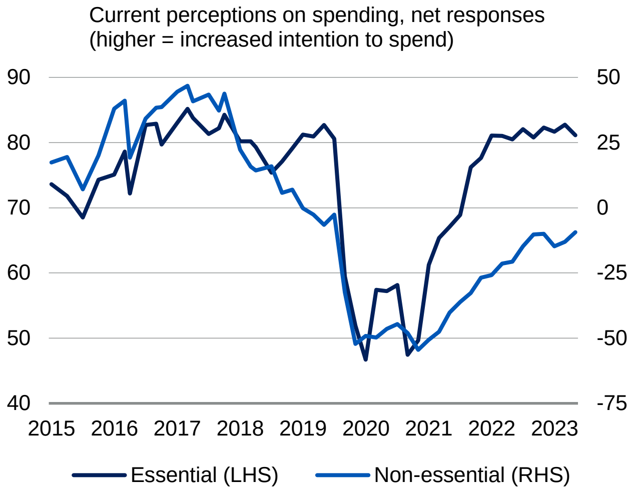
'No landing' risks

There is a possibility that India's economy does not slow in coming months and quarters. The downtrend in core inflation could imply India is (at least momentarily) benefiting from resurgent supply.

And were households to grow more confident, demand-side price pressures could pick up over the course of 2024.

Indeed, consumer surveys show that spending may currently be more tilted towards essentials, particularly higher food prices, and less on non-essentials (see Figure 6). If food prices fall, there is a possibility that consumers grow more confident and ramp up demand for core goods and services.

Figure 6: Consumer demand could surprise higher



Source: Haver, abrdn, March 2024

A pick-up in core inflation would reduce the rationale for cuts and, given the heavy tilt to household consumption, any strength would see the economy growing at a healthy clip. This could result in the RBI delaying or forgoing policy cuts.

In such a scenario, policymakers could accelerate fiscal consolidation and seek to cool consumer lending to ensure India's economy avoids overheating. As such, the probability of further rate hikes is low.

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