HSBC Global Research

22 November 2021

India Economics Comment

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Economics

India

Four burning questions

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- We tackle four burning questions; rural demand will depend, to a large extent, on the recovery of the real estate sector
- The rich have spent more on imported goods, but a pivot to services could enhance ‘trickle-down’
- Potential growth will rise back up if ongoing reforms are successfully implemented; as inflation crosses 6% at year-end, RBI policy normalization will gather pace

We have been getting four questions repeatedly over the last few weeks. Here are our answers.

1. Is rural growth dependable?

Rural demand was a source of stability through much of the pandemic period. Rains were normal and rural activity was largely exempt from lockdowns. But things seem to have changed over the last few months. A large consumer company highlighted that rural demand has weakened. The production of consumer non-durables has slowed since May as has the production of some rural-focused consumer durables such as two-wheelers.

What’s going on? We find that a bunch of reasons have converged. **One**, NREGA outlays have been growing at a negative clip since May (-11.3% y-o-y), though in absolute terms they remain higher than the pre-pandemic period. **Two**, monsoon rains have been volatile over the last few months. **Three**, agricultural exports, which had risen at the start of the year, have moderated since. **Four**, construction wages have been weaker since May, partly led by volatile rains hurting activity. **Five**, rural inflation has been on the rise since May, hurting real purchasing power. Putting all of this together, real rural wages have slowed.

So, what next? High energy prices pose a risk to the real purchasing power of rural Indians. But a lot will depend on activity levels. And here, construction activity will play a key role, in our view.

Over the last two decades, rural Indians have diversified into non-agricultural activities, particularly construction (both urban construction, led by commuting rural labourers, as well as rural).

Real estate makes up 70% of construction. There is reason to believe that residential real estate is likely to be a buoyant sector, led by the desire to improve houses after long periods of lockdown, low mortgage rates, and financial gains, especially at the top of the pyramid. Latest data shows an uptick in demand, but further increases will be key (see chart 2).

Government capex is another driver of construction activity. Strong tax revenues of the central government, and the easing of logistical disruptions could lead to higher capex. State capex has also held on well so far. Of 16 states, 13 have achieved a higher proportion of budgeted capex by September, compared to the same time last year. Frontloaded devolution of revenues by the central government to the states in November, and gains from higher oil VAT revenues can help further.

Bottom line: Construction activity, we believe, will hold the key to rural demand.

2. If the rich are spending, is it trickling down?

There is enough data to show that inequality has risen though the pandemic period. But there is also a sense that as the rich spend, it will trickle down to the rest. Is that happening yet?

True that some data looks buoyant. Retail sales in the recent festive period were higher than pre-pandemic levels. But this was not reflected in domestic production. In fact, the production of consumer durables is the weakest link in the Industrial Production data.

What does this mean? We believe that the rich have been spending, but more so on imported goods. Even as **domestic production remains 6% below normal, imports of consumer goods is 32% above normal** (see chart 3). This, we believe, has diluted the trickle-down from the top to the rest.

Will trickle-down improve? Yes, it could gain traction for two reasons. One, as vaccination rates rise, demand is pivoting from goods to services (see chart 4). Most services are domestically produced, and the gains could trickle down more than they do for goods. Two, if real estate demand rises from here on, the demand for labour and material could be another source of trickle-down.

Bottom line: The trickle down from the top to the bottom of the pyramid has been arguably soft, but can pick up as demand pivots to services and if construction activity improves

3. What will drive growth in 2022?

The pivot to services is likely to lead recovery over the next few months. Our services tracker remains 20% below pre-pandemic levels, and there is significant scope for catch-up. But what will drive growth once pent-up goods and services demand normalizes? We believe growth over the next few years will be a **face-off between the scars the pandemic leaves behind and some new growth drivers that have emerged.** Let us explain.

The economic cost of inequality is the most visible scar that the pandemic is likely to leave behind. 80% of India's labour force is informal. About half of them, i.e. the non-agricultural informal labourers, have faced the brunt of the pandemic. The loss in their incomes could hurt future demand and thereby the growth prospects of the formal sector.

To offset that, three new drivers have emerged over the pandemic period. **One**, high skill exports (such as IT services, autos, pharmaceuticals, mobile phones and specific machinery), have gained global market share over the last few years. Unfortunately, low-skill exports haven't risen as impressively. **Two**, the start-up tech eco-system is growing rapidly, attracting large financial inflows. In fact, 50% of India's FDI is now digital versus 20% a few years ago. This sector has many positives such as nurturing an entrepreneurial culture, creating jobs and capex. But while fast growing, it remains a small share of GDP. **Three**, the government has pursued some important reforms through the pandemic period such as the asset monetization programme, the creation of a bad bank, and expansion of the Production Linked Incentive scheme. But for each of them, implementation will be key.

Bottom line: India's 'potential' growth is likely to dip (from 6% at the eve of the pandemic to c5.5% after), but could rise back up if ongoing reforms are implemented well. We expect 'actual' GDP growth at 8.4% in FY22 and 6.4% in FY23.

4. How high can inflation climb?

All thermal energy sources combined have a 6% weight in the CPI basket, and when transport fares are included, it adds up to 8%. The current rise in energy prices (assuming oil remains at current levels until March 2022) can add about 1ppt to CPI inflation (see table 1). But with some inflation indices like electricity responding more slowly to high global prices, the 1ppt rise could feed into the data over time (see chart 5).

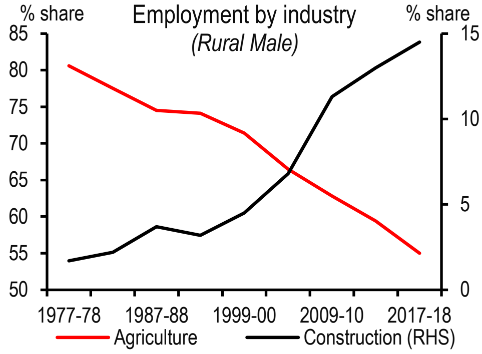
More pass-through by manufacturers who are seeing a big fall in margins can also add to inflation. Indeed, PMI Manufacturing margins are at a seven-year low. And a rise in pent-up services demand, where price pressures can't be traded away as easily as in the case of goods demand is also likely to weigh on inflation.

The RBI has already embarked on a gradual normalization path. We expect it to raise the reverse repo rate over the December and February meetings.

Bottom line: As the base normalizes in December, and oil prices remain elevated at current levels, CPI inflation could average above 6% (the RBI's upper tolerance limit) for 6 months.

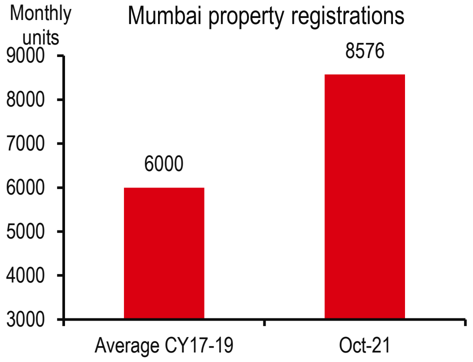
This is an abridged version of a report by the same title published on 22-Nov-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Chart 1: Construction-based employment in rural India is on the rise



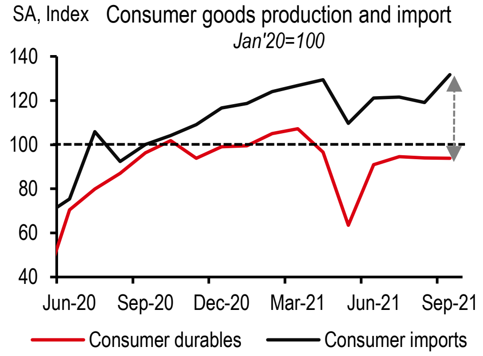
Source: NSSO, HSBC

Chart 2: The residential real estate sector has bounced back from the second wave



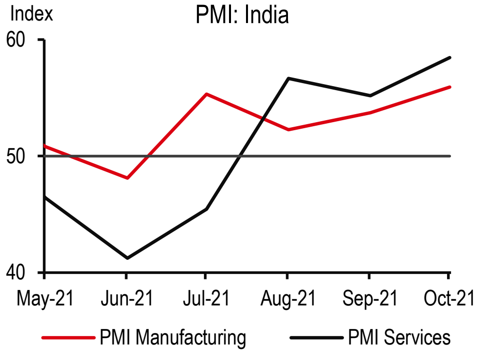
Source: TOI, HSBC

Chart 3: The rich have been spending, but arguably more on imported goods



Source: CEIC, HSBC. Consumer imports include agriculture & allied products, leather items, electronic goods, textile articles, etc.

Chart 4: Demand is pivoting from goods to services



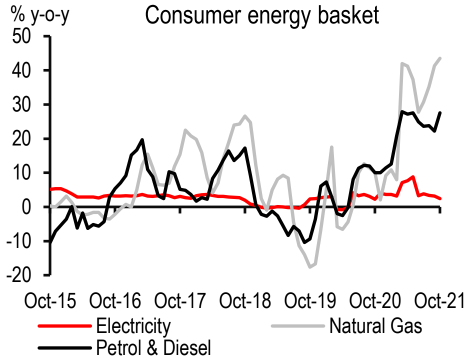
Source: IHS Markit, HSBC

Table 1: High energy prices could add 1ppt to CPI inflation …

Category	Weight in CPI (%)	Impact on inflation (ppt)
Petrol & Diesel	2.3	0.5
Coal & Electricity	2.3	0.2
Natural Gas	1.3	0.3
Conveyance	2.4	0.2
Gross impact		**1.2**
Excise duty cut		-0.3
Net impact		**1.0**

Source: HSBC estimates

Chart 5: … but the full impact will only show up over time as some indices (like electricity) respond slowly to global prices



Source: CEIC, HSBC

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