India's investment versus consumption debate

Economics
India

Setting the record straight

- In contrast to the dominant narrative, we find that investment is being led *more* by private real estate demand than public capex
- A host of evidence suggests that consumption is stronger than GDP data suggests, even if not equitably across groups
- Core inflation could remain low, led by external dynamics, but with scant evidence that financial conditions are tight, the RBI can stay put for now

There's a dominant narrative on the Indian economy. It goes something like this: GDP growth is robust, led by strong public investment, and early signs that the private sector is choosing investment over consumption. In fact, even consumer staples are weak. Strong investment means potential growth has risen, keeping core inflation muted. **Sounds convincing, but doesn't meet the smell test.** Historically, investment has never climbed sustainably (+ 10% y-o-y) while consumption is weak (+ 3.8% y-o-y). Shouldn't higher consumption kick in first, bringing the confidence to invest? In French revolution parlance, is it true that the Indian economy is eating cake while not being able to afford bread?

What's driving investment? The government is raising capex meaningfully, but PSUs are cutting back, leaving the overall public investment ratio below pre-pandemic levels. Instead, it is private investment that has risen, led by 'dwellings & structures'. This chimes well with the rise in house sales and housing loan growth. But the other important component of investment – 'machinery & equipment' – remains weak, and it would be premature to call the start of a new investment cycle, at least at this point.

Is consumption that weak? There are several reasons to believe that consumption growth is not as slow as GDP data suggests. Consumer goods imports, personal services, and non-housing personal loans have been rising quickly. We believe the private consumption data will be revised up in subsequent GDP revisions. While investment growth could still be higher than consumption growth, the wedge between them would likely turn out to be narrower (2ppt instead of 6ppt), implying that overall growth is better balanced between consumption and investment than widely believed.

Having said that, we are not claiming that consumption growth is equitable. Top-of-the-pyramid consumption growth is exceeding bottom-of-the-pyramid, even though data over the last two months suggests that incomes at the lower end have improved.

So why is core inflation falling? It is hard to confirm if potential growth has risen post the pandemic. Instead, the reasons we believe core inflation has fallen are imported disinflation (with China's export prices tumbling), softer input prices (allowing producers to cut output prices while maintaining margins), and India's two-speed economy (leaving service inflation depressed). Yet, with scant evidence that financial conditions are tight, we believe the RBI will leave policy rates unchanged for now.

Bread or cake?

There's a dominant narrative on the Indian economy. It goes something like this:

GDP growth is strong, led by investment growing 10% y-o-y as per GDP data, and much of this is led by public investment. On the other hand, private consumption is weak, growing at a paltry clip of 3.8% y-o-y[1]. Consumer non-durables production is a case in point, only 4% higher than pre-pandemic levels. Households and corporates are choosing investment over consumption, which has raised India's potential growth, and is also keeping core inflation muted.

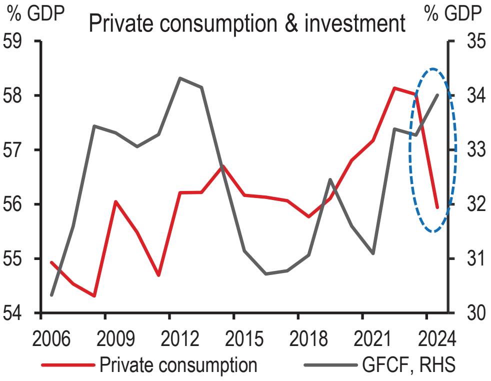
Sounds convincing, but it doesn't meet the smell test. Historically, investment has never climbed sustainably as a percentage of GDP while consumption falls (see chart 1). After all, it is the same exuberance that drives both. And in the pecking order of growth, higher consumption typically kicks in first, giving confidence to investors, who, over time, add to capacity by investing.

And, the process of investment should lead to the remuneration of either labourers (in the build-out of roads and buildings), or owners of capital, who, in turn, can spend. Sure, one can argue that the marginal propensity to consume is higher for labourers than for owners of capital, but, still, as we document further below, the outperformance of investment over consumption has never been that large.

In French revolution parlance, is it really true that the Indian economy is eating cake while not being able to afford bread?

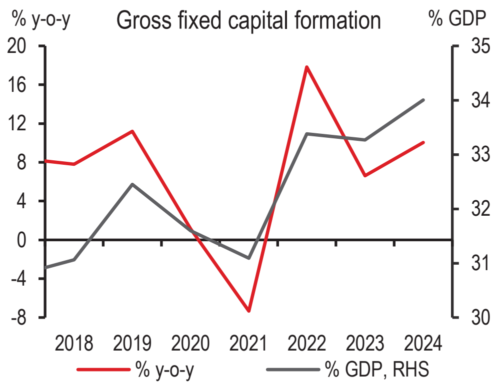
What's going on? Let's dig deeper.

Chart 1: Never before has investment risen sustainably, while consumption falls



Source: CEIC, HSBC

Chart 2: Investment is rising



Source: CEIC, HSBC

What's driving investment?

Investment has indeed risen across various cuts of the data (see chart 2). The investment rate is higher than pre-pandemic levels (forecast at 34% of GDP in FY24 versus 32% in FY19), although a touch lower than the peak of FY12 (34.3% of GDP). But what's the main driver of this spurt?

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[1] 10% and 3.8% are our forecasts for FY24

Exports?

If indeed, consumption demand is weak, what's stoking investment? Perhaps external demand is strong? And, indeed, India's export ratio is higher than pre-pandemic levels.

But a closer scrutiny suggests that 85% of the rise is led by higher services exports, rather than higher goods exports[2].

We have written extensively in the past about the dramatic rise in professional services exports, with over 1600 MNCs setting up global capability centres (GCCs) in India, from where they produce and export services ranging from legal, accounting, HR, to business development, R&D and design.

Impressive, indeed. But professional services exports are generally not particularly capital intensive, so can't really explain the investment rise[3]. In fact, if anything, they depend on highly skilled labour (like engineers), whose consumption spending should rise.

Public sector?

Next, you may suggest that public capex is pushing up India's investment rate. And, indeed, central government has ramped up capital spending since FY19 (the last pre-pandemic year), and the states joined in the efforts in FY24 (see chart 5). Combined, the two have raised capex by about 2% of GDP over this period.

But, alongside, public sector enterprises (PSEs) have lowered their capex thrust over this time, blunting the overall public sector capex push (see chart 6). In fact, overall public sector capex is no higher than pre-pandemic levels.

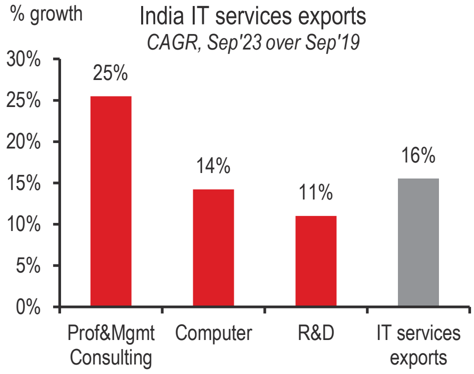
That then leaves the private sector. Is it really the private players pushing investment higher?

Bottom line: Investment has been growing rapidly. The public investment ratio has risen over the last year, led by higher government capex. But PSUs have cut back sharply, leaving overall investment rates below pre-pandemic levels.

Chart 3: Services exports are rising sharply…

Source: CEIC, HSBC

Chart 4: …led by professional services

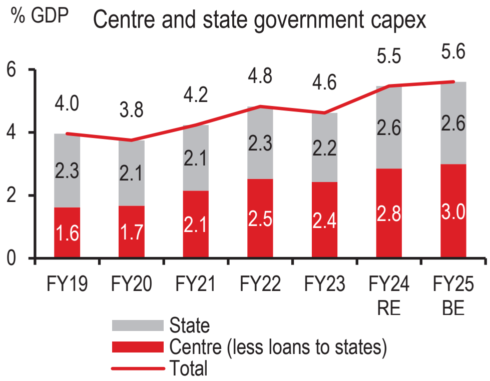


Source: CEIC, HSBC

2 India's exports to GDP ratio has risen by 2.4% of GDP between end-2019 and end-2023. Of this, c85% comes from higher services exports.

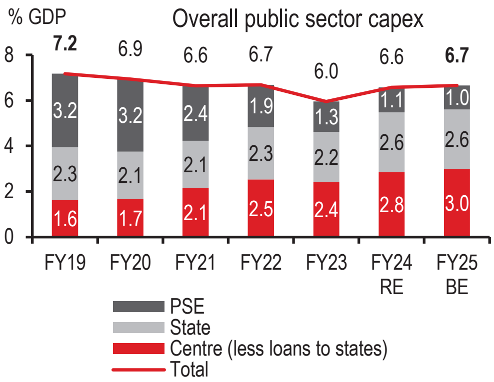
3 It is only over time, when current commercial real estate spare capacity is exhausted, that they may lead to new real estate activity

Chart 5: Central and state government capex has risen…



Source: RBI, India budget documents, HSBC. Note: RE: Revised estimates, BE: Budget estimates. Note: State capex for FY24 and FY25 are HSBC estimates

Chart 6: …but PSE capex has fallen over the same period, blunting the capex thrust



Source: RBI, India budget documents, HSBC. Note: State capex for FY24 and FY25 are HSBC estimates

The private sector's investing – selectively

We analyse a detailed breakdown of investment, across private and public corporates, households and general government, which, while the data ends in FY23, gives a good sense of trends, which likely continued into FY24.

We find that both private corporate and household investment is higher now compared to FY19 (the last pre-pandemic year), and, in fact, the overall private sector capex ramp-up is higher than the overall public sector one (see chart 7).

This leads to the next question. Is this the start of a new private sector led capex cycle, for which we have been waiting for over a decade?

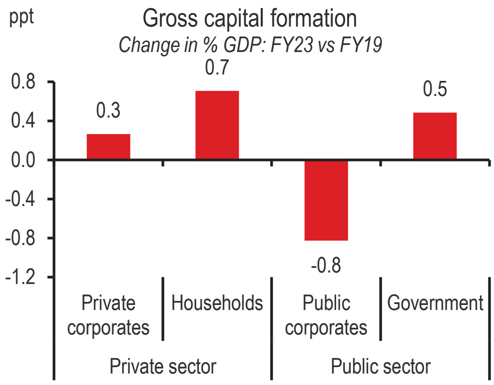
We think not. Or, at least, not yet. Breaking down private capex further shows that, compared to FY19, the entire rise is coming from 'dwellings, buildings and structures', which is reflective of real estate and infrastructure (see chart 8). This chimes well with the strong growth we see in house sales (see chart 9) and housing loan growth (+16.7% y-o-y in nominal terms).

But 'machinery and equipment' investment, is not rising. In fact, it is weaker than FY19 levels.

To be sure that this is a new investment cycle, we believe immediate production capacity – reflected by machinery and equipment – should rise. After all, it makes up 40% of India's investment pie (see pie chart 10).

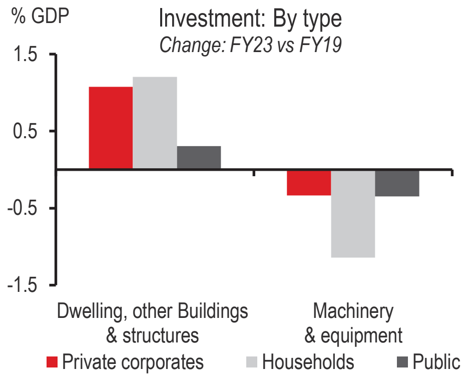
Bottom line: It is private capex that has prompted the investment spurt, led by 'dwellings and structures'. This chimes well with the strong growth we see in house sales and housing loan growth. But the other important component of investment – 'machinery and equipment' – has fallen, and it would be premature to call the start of a new investment cycle, at least at this point.

Chart 7: Private sector capex has risen faster than public sector…



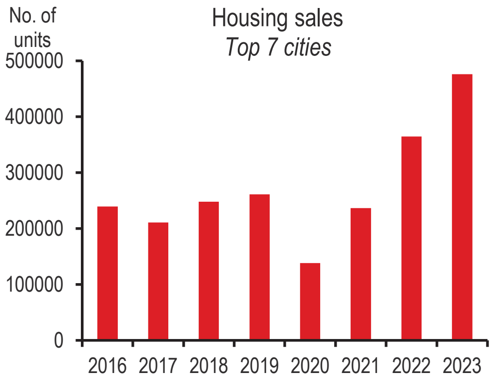
Source: CEIC, HSBC

Chart 8: …and it's coming from higher 'dwellings, buildings & structures' build-out…



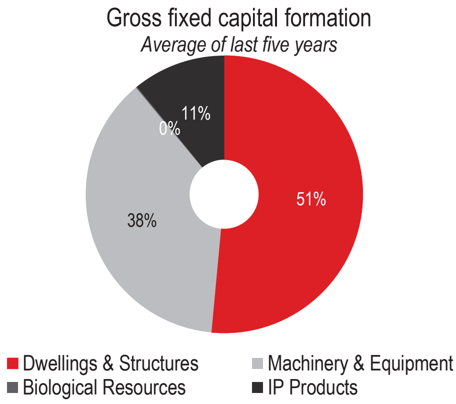
Source: CEIC, HSBC

Chart 9: …which chimes well with strong growth in housing sales



Source: Anarock annual reports, HSBC

Chart 10: Machinery & equipment is an important part of the investment pie



Source: CEIC, HSBC

Consumption conundrum

Next, we move to consumption. It has been slowing however we slice the data (see chart 11). The consumption-GDP ratio is lower than pre-pandemic levels (forecast at 55.9% of GDP in FY24 versus 56.1% in FY19). Furthermore, it grew at a paltry 3.5% in the December quarter, less than a third of investment growth.

Can this be true? We have already discussed above that investment and consumption growth do not tend to diverge so sharply. After all, they are driven by the same exuberance/confidence in the economy.

There are several reasons to believe that consumption growth is not as slow as GDP data suggests.

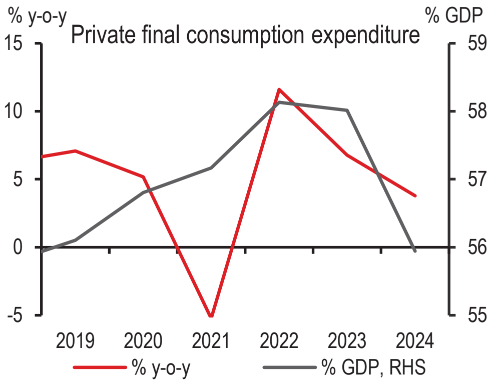
One, real consumer goods imports have been on the rise (see chart 12) and are now 30% higher than pre-pandemic levels. To put this in context, infrastructure and construction goods production is 25% higher than pre-pandemic levels.

Two, the latest GDP data shows that public and personal services grew at 7.5% y-o-y in real terms, December. Of this, public services growth was weak (government consumption declined 3.2% y-o-y), implying that private services demand grew quite rapidly.

Three, non-housing personal loans, part of which fund consumption, are growing rapidly (+19.8% y-o-y), and even faster than the growth in housing loans (16.7% y-o-y, see chart 13).

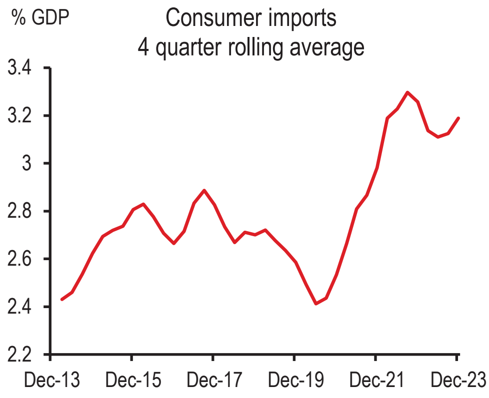
Bottom line: We believe GDP data is underestimating private consumption. Consumer imports, personal services and non-mortgage growth have all been rising faster than nominal GDP growth.

Chart 11: Consumption has slowed across various cuts of the data



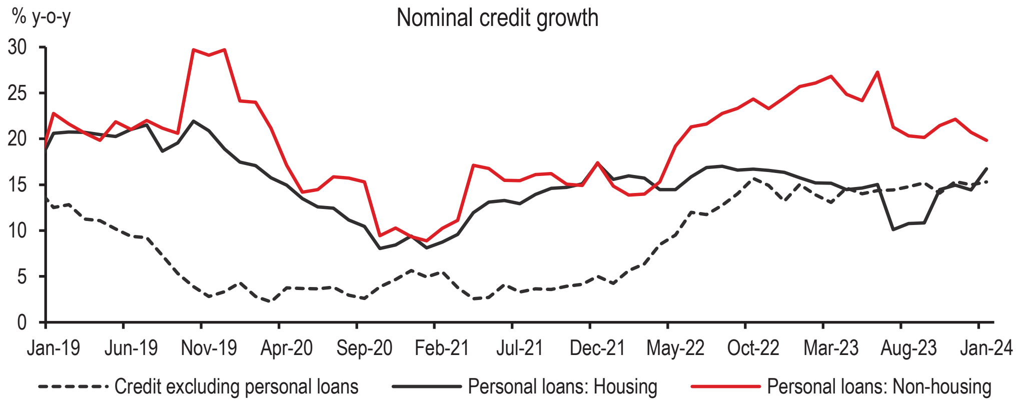
Source: CEIC, HSBC

Chart 12: Consumer goods imports have been on the rise



Source: CEIC, HSBC

Chart 13: Non-housing personal loans are growing rapidly



Source: CEIC, HSBC.

Consumption growth to be revised up, investment down

In fact, we believe that, in subsequent revisions, consumption growth will be revised up.

Does that mean that GDP growth will be revised up? Not necessarily, as we believe there will be some redistribution, from investment to consumption. Let us explain.

The same GDP investment data is available in two documents from the government. One of them is the GDP data release, which we get every quarter.

The other comes later, and tries to adjust the GDP investment data to ensure that the savings-investment macro identity holds (whereby: saving – investment = current account balance).

For the identity to hold, an adjustment is often made, by introducing an 'errors and omissions' entry under investment. For FY23, 'errors and omissions' was a large -1% of GDP (INR2.2trn), which we believe implies that, in the GDP data release, investment was overestimated by 1% of GDP.

If this same amount is taken away from investment and parked as private consumption in FY24, investment growth could still be higher than consumption growth, but the wedge between them would be narrower (from investment growth running 6ppt higher than consumption growth, to 2ppt higher than consumption growth), and in line with the long-term average. Overall economic growth would be better balanced between consumption and investment.

Bottom line: We believe private consumption will be revised up in subsequent GDP revisions. While investment growth could still be higher than consumption growth, the wedge between them would likely turn out to be narrower than is reflected in the GDP data currently, implying that overall economic growth is better balanced between consumption and investment than is widely believed.

Is consumption equitable?

While we believe consumption growth is not as weak as reflected in GDP data, and expect upward revisions, **we are not implying that consumption growth is equitable**.

We do believe that top-of-the-pyramid demand is far more robust than bottom-of-the pyramid, as reflected by strong real consumer *durable* goods imports (30% above pre-pandemic levels) coexisting with weak *non-durable* goods production (4% above pre-pandemic levels). And with passenger vehicle sales (54% above pre-pandemic levels) outnumbering two-wheeler sales (16% above pre-pandemic levels).

Indeed, rural India has been grappling with climate-change related disruption in rains and food production, and small firms suffered disproportionately more than large firms during the pandemic and commodity prices shock of the past few years.

Having said that, very recent data suggests that **things maybe improving for the informal sector**:

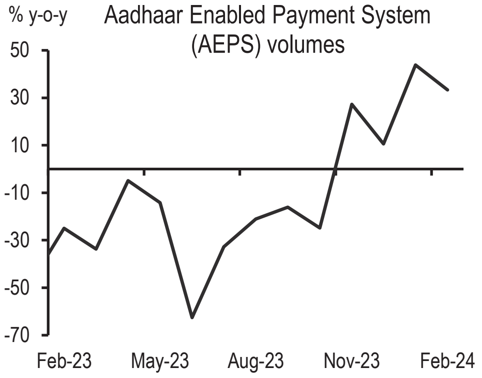
One, some hurt by weak farm production found alternate employment and income in construction work. Indeed, remittances from urban to rural India rose recently, as did cash balances in rural accounts (see charts 14 and 15).

Two, with lockdowns ending and input prices falling, small firms are also regaining business. The wedge between large and small firm profitability has narrowed somewhat (see chart 16). And small firms have been able to remunerate their employees better (see chart 17).

Indeed, we had seen that the domestic production of consumer goods was falling between May and November 2023. Over the last two months, that has begun to tick back up (see chart 18). This may be a trend worth watching.

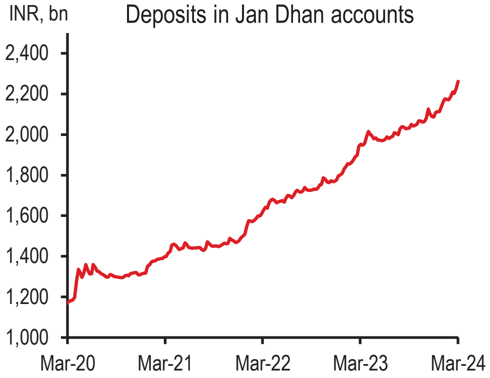
Bottom line: There are signs of a K-shaped recovery. Having said that, data over the last two months suggests that incomes at the bottom of the pyramid may have improved.

Chart 14: Remittances from urban to rural India have risen



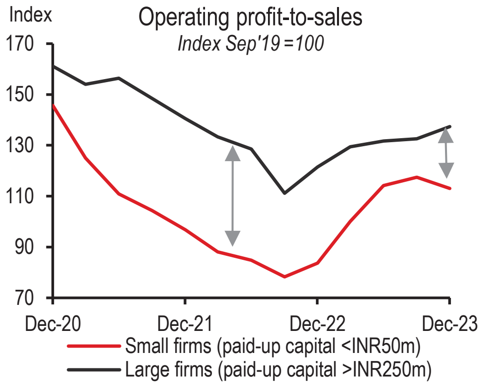
Source: CEIC, HSBC

Chart 15: Cash balances in rural accounts have also increased



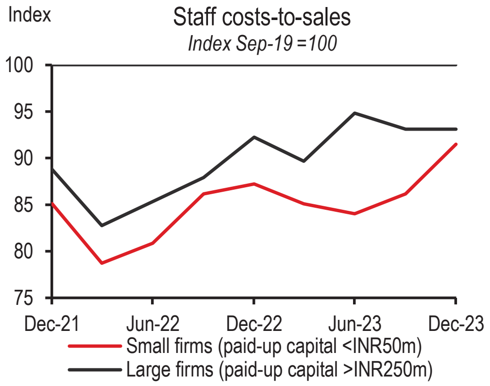
Source: CEIC, HSBC

Chart 16: Wedge between large and small firm profitability has narrowed a shade



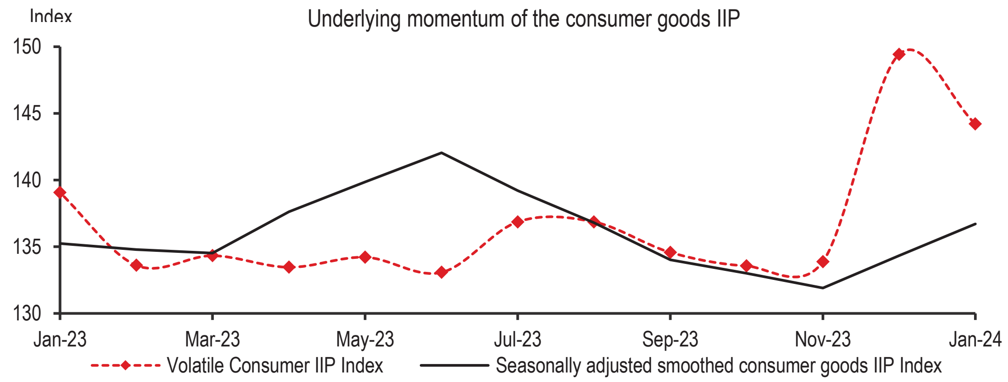
Source: RBI, CEIC, HSBC

Chart 17: Small firms are remunerating their employees better than before



Source: RBI, CEIC, HSBC

Chart 18: Domestic production of consumer goods has begun to tick back up



Source: CEIC, HSBC. Note: The original index is very volatile. To read through the noise, we first seasonally adjust the series and then take a 3-month moving average

Core inflation conundrum

Core inflation has fallen rapidly in India (see chart 19). The dominant narrative puts it down to investment rising, leading to potential growth rising, thereby increasing the slack.

As discussed above, our analysis implies the investment increase is not yet broad based. And potential growth doesn't need to rise for a slack to emerge. In fact, the latest December quarter data shows that GDP remains 4% below the pre-pandemic trend.

Instead, we believe falling core inflation has to do with the following – two externally determined, and one domestically determined developments:

Imported disinflation. Here, it's worth highlighting the dynamics from China. Wage cost increases in China have been muted, export prices have tumbled, and export volumes have risen. Meanwhile, India's imports, particularly of consumer goods, have steadily risen. We believe India is importing some of this disinflation.

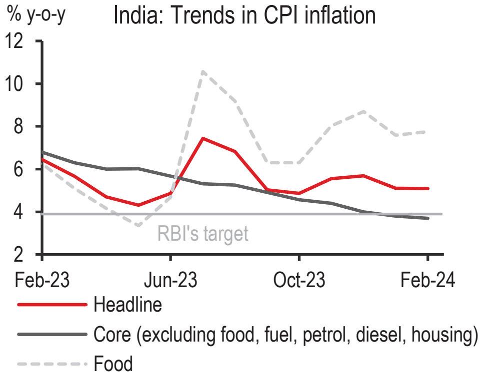
Falling input prices. Oil prices fell 14% y-o-y in FY24. Other commodity prices softened as well. Falling input prices gave manufacturers an opportunity to cut output prices while holding on to profit margins (see chart 22).

Two-speed economy. As we have discussed at length, 'new' India is rising rapidly, while 'old' India is growing at a slower pace. This can be seen particularly in the softer rise in the price of services (see chart 23), which the bottom-of-the-pyramid households tend to consume more of, when incomes rise.

Even if input prices rise, and if India's bottom-of-the-pyramid recovers, we think falling import prices will keep a lid on core inflation over the next several months.

Bottom line: Core inflation has fallen, led by imported disinflation (as China's export prices tumbled and export volumes soared), softer input prices (allowing producers to cut output prices while maintaining margins), and India's two-speed economy (service prices will likely rise when household incomes at the bottom-of-the-pyramid increase).

Chart 19: India's core inflation has fallen rapidly to below 4% y-o-y



Source: CEIC, HSBC

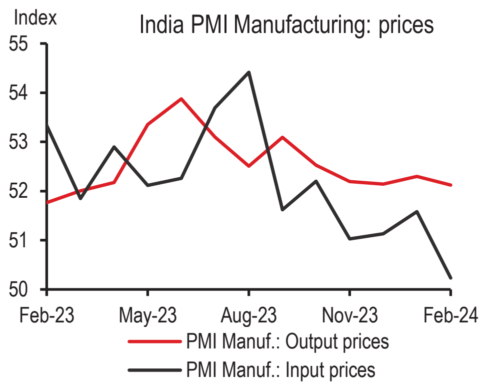
Chart 20: China's export prices have tumbled…

Source: CPB, HSBC

Chart 21: …while export volumes have risen

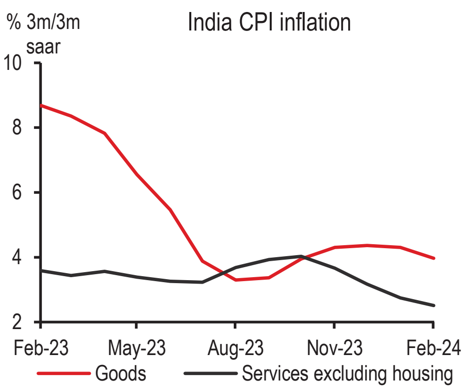
Source: CPB, HSBC

Chart 22: Input prices have fallen in India



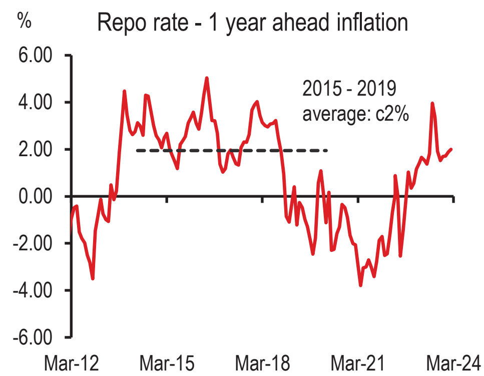
Source: S&P Global PMI, HSBC

Chart 23: Prices of services have seen a softer rise



Source: CEIC, HSBC

Chart 24: When inflation last averaged 4%, real rates were at 2%



Source: CEIC, HSBC. FY24 real rates are based on HSBC 1 year ahead inflation forecasts

What does this mean for rate cuts?

Tight monetary policy has served the central bank well during a period of heightened global volatility. Whether that should change immediately, from a Taylor rule perspective, depends on:

Growth slack … it's complicated
As discussed above, GDP is 4% below the pre-pandemic trend. As such, it is possible for core inflation to fall (given the slack), and yet for GDP growth prints to be high (as GDP climbs back to the pre-pandemic trend levels). It is worth reiterating that softer core inflation doesn't necessarily mean higher potential growth.

Things are further complicated as there seems to be a 'new' India that is growing more rapidly than 'old' India, and it is in the latter where the slack seems to exist. But if trends over the last two months continue, old India could gradually recover, closing the slack.

Neutral rates… it's not directly observable
In the period right before the pandemic, headline inflation had averaged 4%. During this period, real rates were around 2% (see chart 24). A RBI study in 2022 indicated that real neutral rates may have halved over the pandemic period, though it is also possible that they have risen since.

While uncertainties on where neutral rates truly lie remain, it is worth noting that real rates at present (at about 2%) do not seem to be restrictive. Credit is growing at 16%, higher than nominal GDP growth of 10%.

And, if indeed potential growth has risen, or is likely to rise, it would mean the economy's neutral rate levels should only rise.

Inflation … it's not at target
Core inflation has come down, but headline inflation is still above target (5.1% versus 4% target). Moreover, we believe inflation will move higher in 2H (4.2% in 1H versus 4.8% in 2HFY25).

So, if the growth slack is closing, neutral rates may rise over time, and inflation is not yet at target levels, but growth is buoyant, and oil prices have risen recently, it may be a good idea for the RBI to stay on hold for now.

Already, liquidity has eased somewhat, as reflected in softer overnight rates. And as the government spends at March-end, liquidity could ease further. Against this backdrop, we do not think the RBI will be in a hurry to change its stance[4] or cut the repo rate.

We expect a shallow rate cutting cycle (of 50bp starting in June, taking the repo rate to 6% by end-2024), and that **to only start once the Fed starts cutting rates**.

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[4] The RBI aligned its 'hawkish' stance with still-incomplete transmission and inflation ruling above its 4% target

Disclosure appendix

Additional disclosures

1 This report is dated as at 20 March 2024.

2 All market data included in this report are dated as at close 19 March 2024, unless a different date and/or a specific time of day is indicated in the report.

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Expiry: End of Quarter