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Favourable base and services sector recovery drive double-digit growth in Q1 FY23; Global developments pose downside risks to the outlook

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- Real GDP growth for Q1 FY23 came at 13.5% YoY, close to our estimate of 13.8%, buoyed by a favourable base effect.
- Economic growth in Q1 was led by private consumption and investment, while net exports dragged down overall growth.
- In terms of pre-COVID levels, the level of economic activity moderated to 103.8% (compared with Q1 FY20) from 106.7% in Q4 FY22 (vs Q4 FY20), reflecting the impact of a higher inflationary environment, tighter monetary policy, and increased geopolitical uncertainty on economic activity.
- From the supply side, real GVA grew by 12.7% YoY in Q1 FY23 compared to 3.9% YoY in Q4 FY22, aided by the favourable base effect.
- The GVA growth was led by services and industry segments reflecting the normalization of economic activity. Agricultural sector growth showed resilience despite the impact of the heat wave.
- The real GVA managed to stay above the pre-pandemic levels (compared to Q1 FY20) at 105% in Q1 FY23 but decelerated from the ~110% level in the previous quarter.
- In the rest of FY23, a contained COVID situation, higher vaccination coverage, government's CAPEX, and ongoing catch-up in the services sector are expected to support economic recovery.
- However, global growth slowdown, high commodity prices, domestic inflationary pressures, and monetary policy tightening by the RBI will weigh on India's economic recovery.
- We retain our projection of real GDP growth of 7% YoY in FY23, though see downside primarily emanating from global developments.

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Private consumption recovery strong; investment resilient while net exports dragged GDP growth

Real GDP growth for Q1 FY23 came at 13.5% YoY, close to our estimate of 13.8%, buoyed by a favourable base effect. In terms of contribution, growth in Q1 was led by private consumption (14.0 percentage points (pp)) and investment (6.7pp), while net exports' drag (negative 6.2pp) on headline growth intensified. In terms of pre-COVID levels, the level of economic activity moderated to 103.8% (compared with Q1 FY20) from 106.7% in Q4 FY22 (vs Q4 FY20), reflecting the impact of a higher inflationary environment, tighter monetary policy and increased geopolitical uncertainty on economic activity. In nominal terms, GDP growth jumped to 26.7% YoY in the June quarter, up from the 14.9% growth recorded in the March quarter, reflecting the impact of high inflation.

Private consumption grew by a whopping 25.9% YoY, accelerating sharply from the 1.8% growth recorded in Q4 FY22, owing to a favourable base effect and recovery in spending on services. In terms of recovery from COVID-19, the level of private consumption expenditure continued to improve and reached ~110% of pre-COVID levels in the June quarter, up from 108.3% in the March quarter. The latest data is especially impressive when seen in the context of multi-year-high inflation and tightening financial conditions over the past few months. Indeed, private consumption growth surprised on the upside as high-frequency indicators like employment growth and consumer durable and non-durable goods indices of the IIP were mixed. Nevertheless, the recovery was corroborated by improvements in other indicators like contact-intensive services, retail credit, and employment growth in the formal sector. In Q1 FY23, retail credit growth accelerated to 18.1% YoY compared with 12.6% in March, pointing to increased demand for credit in the consumer segment. While developments in the labour market have been mixed, the formal sector job recovery remained strong, with the Naukri JobSpeak Index averaging around 125% of pre-COVID levels in April-June. Looking ahead, prospects for private consumption seem to be improving. Consumer sentiment continued to improve in Q1 FY23 and into July, according to the latest RBI survey, which bodes well for continued recovery in consumer demand. The approaching festival season and a controlled COVID-19 situation should also help provide a boost to overall demand. Persistently high inflation and tightening financial conditions will exert a drag on private consumption recovery. Beyond the immediate future, a sustainable improvement in labour market conditions will remain a key prerequisite for consumer demand recovery.

Meanwhile, real government consumption spending grew by just 1.3% YoY, down from the 4.8% growth recorded in the last quarter of FY22. Compared with the pre-COVID level (Q1 FY20), real government consumption in Q1 FY23 was still ~10% higher but declined compared with Q4 FY22, when it was ~35% higher. Revenue expenditure of the government grew by 8.8% YoY in the first quarter of FY23, much higher than the budgetary targets for the full year, reflecting front loading of expenditure to support the economy. Still, a higher inflationary environment deflated growth in real terms. In line with the conservative revenue expenditure target of the government for FY23, we believe that contribution of government consumption expenditure to headline growth will further wane over the remaining quarters of the fiscal year. For economic recovery to sustain beyond the immediate future, other demand indicators will have to pick up.

India's GDP estimates at constant price

(Constant Prices)	% YoY					Q1 FY23 v/s
	Q1-FY22	Q2-FY22	Q3-FY22	Q4-FY22	Q1-FY23	Q1 FY20
Private Consumption	**14.4**	**10.5**	**7.4**	**1.8**	**25.9**	**9.9**
Government Consumption	**-4.8**	**8.9**	**3.0**	**4.8**	**1.3**	**9.6**
Gross Capital Formation	**72.3**	**26.8**	**8.4**	**5.2**	**19.3**	**6.4**
Gross Fixed Capital Formation	62.5	14.6	2.1	5.1	20.1	6.7
Exports	40.8	20.7	23.1	16.9	14.7	20.2
Less Imports	61.1	41.0	33.6	18.0	37.2	30.3
Discrepancies	-37.6	-108.1	58.4	344.1	-75.0	-81.7
Real GDP	**20.1**	**8.4**	**5.4**	**4.1**	**13.5**	**3.8**
Real GDP Excluding Govt Exp	**24.8**	**8.4**	**5.6**	**4.0**	**15.3**	**3.2**

Source: MOSPI

Real gross capital formation growth shot up to 19.3% YoY in Q1 FY23, from 5.2% in the previous quarter, boosted by the low base impact of Q1 FY22. As a proportion of pre-COVID spending, investment fell to ~106% in the June quarter from 118% in the preceding quarter. The government continues to lead in driving investment, as its CAPEX grew by an astounding rate of 57% YoY in April-June. The government will remain a major driver of investment in FY23, as reflected in the high CAPEX outlays budgeted for the current financial year. As for the private investment, there were tentative signs of revival in Q1, but a higher price environment and uneven demand recovery have held back broader capital spending revival. Higher new project announcements (25% YoY in Q1), deleveraged balance sheets of the corporates, and a capacity utilization rate of ~75% among manufacturing firms mean that conditions for private investment revival seem ripe. However, higher input costs squeezing profit margins and elevated economic uncertainty might have prompted the companies to delay their investment plans. Given the expected boost to consumer demand from the upcoming festival season, there is potential for investment recovery to gather pace over the next few months. However, a higher inflationary environment and tighter financial conditions might continue to act as dampeners on investment growth in FY23.

Net exports' drag on headline growth intensified in Q1 as ongoing domestic recovery and a higher commodity price environment led to elevated imports, while the global economic slowdown impacted export growth. Net exports had a negative contribution of 6.2pp to India's economic growth in Q1, much higher than the negative 1.0pp in Q4 FY22. Given the resilient domestic economy and slowing global growth, net exports will likely remain a major drag on headline growth in the remaining quarters of FY23.

Besides a favourable base effect, the services sector led the rebound in Gross Value Added (GVA)

Looking at the supply side of the economy, the real GVA rose by 12.7% YoY in Q1 FY23 compared to 3.9% YoY in Q4 FY22, aided by the favourable base effect as Q1 FY22 was impacted by the second COVID wave. However, on a sequential basis, the growth of the real GVA contracted by 7.2% QoQ following an expansion of 5.2% in the prior quarter. Despite sequential moderation, the real GVA managed to stay above the pre-pandemic levels (compared to Q1 FY20) at 105% but decelerated from the ~110% level in the previous quarter. Across sectors, the growth was led by services and industry segments, with 9.4 pp and 2.7 pp contributions to overall GVA growth, respectively. The agricultural sector continued its upward trajectory, recording a growth of 4.5% YoY during the same period. However, the sequential contraction was larger at 13.3% in Q1 FY23 compared to the pre-COVID trend of 10.4% (average of FY16-FY20) due to the heat wave across the country, which impacted the yield and quality of crop production adversely. Additionally, the elevated level of fertilizer prices could have weighed on the sector's performance. In the current quarter, even though the monsoon picked up the pace recently, leading to the progress of the Kharif sowing, the outlook for the agriculture sector remains marred with uncertainty associated with the uneven spatial distribution of rains.

Aided by the base effect, the growth in the industrial sector accelerated to 8.6% YoY in Q1 FY23 after posting a modest growth of 1.3% in Q4 FY22. However, on a sequential basis, the sector contracted by 12.6%, much larger than the pre-COVID trend of 2.1% contraction (average of FY16-FY20), potentially reflecting the impact of elevated input cost pressures on the profit margins of the sector. Among major sub-sectors, the growth in the industrial sector was led by construction which grew by 16.8% YoY. The sequential slump, however, in the construction sector was also visible in the decline in highway construction for Q1 FY23. Going ahead, the construction activity is likely to pick up in the coming months amidst the government's thrust on capital spending to support the economy's growth. The manufacturing sector expanded by 4.8% YoY in Q1 FY23 after a contraction of 0.2% in the prior quarter, led by the favourable base effect. On a sequential basis, the sector noted a contraction, broadly in line with the decline in IIP-Manufacturing output and squeezing profit margins reported by listed manufacturing companies. On a positive note, there are tentative signs of a pick-up in the manufacturing sector as reflected in the acceleration of PMI manufacturing to its eight-month high of 56.4 in July, supported by the improved demand conditions domestically even as the export orders growth slowed. Additionally, if the recent moderation in commodity prices is to be sustained, the manufacturing activity is likely to gain momentum. Meanwhile, electricity and other utility services rose by 14.7% YoY and was the only major industrial sub-sector posting a sequential uptick in Q1 FY23. However, the growth is expected to normalize in the current quarter in tandem with the seasonal impact of the monsoon. In comparison, the mining sector registered a growth of 6.5% YoY with a sequential contraction of 13.7% QoQ in the first quarter of the fiscal year. The growth in the mining sector is likely to be muted in Q2, reflecting the monsoon-related seasonal impact.

India's GVA estimates at constant price

(Constant Prices)	% YoY					Q1 FY23 v/s
	Q1-FY22	Q2-FY22	Q3-FY22	Q4-FY22	Q1-FY23	Q1 FY20
Agriculture, Forestry & Fishing	**2.2**	**3.2**	**2.5**	**4.1**	**4.5**	**9.9**
Industry	**46.6**	**7.0**	**0.3**	**1.3**	**8.6**	**5.5**
Mining & Quarrying	18.0	14.5	9.2	6.7	6.5	3.3
Manufacturing	49.0	5.6	0.3	-0.2	4.8	7.0
Electricity and Other Utility Services	13.8	8.5	3.7	4.5	14.7	11.2
Construction	71.3	8.1	-2.8	2.0	16.8	1.2
Services	**10.5**	**10.2**	**8.1**	**5.5**	**17.6**	**3.0**
Trade, Hotels, Transport, Communication etc	34.3	9.6	6.3	5.3	25.7	-15.5
Financial, Real Estate & Professional Services	2.3	6.1	4.2	4.3	9.2	10.5
Public Administration, Defence and Other Services	6.2	19.4	16.7	7.7	26.3	18.9
Gross Value Added (at Basic Price)	**18.1**	**8.3**	**4.7**	**3.9**	**12.7**	**4.7**
Core GVA	**24.6**	**7.3**	**3.0**	**3.2**	**12.2**	**1.4**

Source: MOSPI; Note – Core GVA is GVA excluding agriculture, forestry & fishing and public administration, defence, and other services

As expected, the growth in the first quarter of FY23 was led by the services sector, which registered a strong growth of 17.6%, aided by a pick-up in the public administration & other services and contact-intensive services amidst the broadening of the vaccination coverage. The public administration, defence, and other services posted an impressive growth of 26.3% YoY in Q1 FY23 (7.7% in Q4 FY23), supported by growth in public administration and recovery in the other services (health, education etc.) segment. Meanwhile, growth in the contact-intensive sectors, i.e., Trade, hotels, transport, communication, etc. accelerated sharply by 25.7% YoY in Q1 FY23 with a continued normalization of consumption pattern due to containment of the COVID situation. However, the output continues to remain below the pre-COVID levels reflecting the incomplete recovery of the sector. Nonetheless, incoming data for high-frequency indicators, including the domestic travel and credit to contact intensive sector (i.e., Tourism, hotels & Restaurants) bodes well for the continued momentum in the sector in July. Financial services grew by 9.2% YoY in Q1 FY23 and remained the only services sub-sector to note a sequential pick-up (24% QoQ). Going ahead, the pace of the services sector is expected to hold up from the continued release of the pent-up demand; however, the catch-up of services inflation might impinge on the growth momentum of the sector.

Overall, the latest national accounts data is in line with our expectations (of 13.8% YoY growth for Q1 FY23). In the rest of FY23, a contained COVID situation, higher vaccination coverage, government's CAPEX, and ongoing catch-up in the services sector are expected to support economic recovery. However, global growth slowdown, high commodity prices, domestic inflationary pressures, and monetary policy tightening by the RBI will weigh on India's economic recovery. We retain our projection of real GDP growth of 7% YoY in FY23, though see downside primarily emanating from global developments.

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