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# Economic growth slowed in Q3 owing to a normalizing base; growth was led by investment and services

- Real GDP growth moderated in Q3 FY23 to 4.4% YoY compared to 6.3% YoY in Q2 amidst the normalization of the base effect. The estimate was lower than the market expectations due to an upward revision in the base year.
- Nominal GDP growth slowed down to 11.2% YoY in Q3 FY23 from 17.2% YoY in Q2. The GDP deflator has continued to decline for the second consecutive quarter corroborating the moderation in inflation and further assuring that the worst of inflation has passed.
- Activity in Q3 was led by investment as private consumption slowed down. Meanwhile, government spending and net exports acted as drags on the overall pace of economic growth.
- From the supply side, real GVA grew by 4.6% YoY in Q3 FY23, higher than the real GDP growth suggesting a slowdown in net indirect tax growth.
- Growth in real GVA was led by services (mainly the contact-intensive sectors) as well as financial, real estate, and professional services. Meanwhile, even though manufacturing activity lagged, growth in the industrial sector improved led by construction. Agricultural activity remained robust reflecting a pick-up in non-crop activities.
- Going forward, we expect growth to be supported by a potential pick-up in investment activity buoyed by the government's push on capital expenditure and nascent signs of revival in private investment.
- However, we remain cautious about the outlook of consumer demand and the services sector due to rising interest rates, uneven labour market conditions and weaker external demand.
- Considering the above factors and the latest revisions in the data, our GDP projection for FY23 stands adjusted to 6.8% from 7.0% previously. Downside risks are posed by a slowing global growth environment owing to synchronized monetary policy tightening and heightened geopolitical uncertainty.

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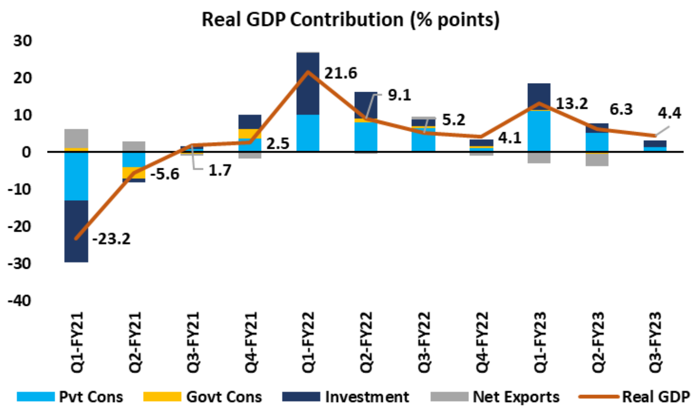
### Real GDP moderated to 4.4% in Q3 amidst the waning of the favourable base effect

India's real GDP growth moderated in Q3 FY23 to 4.4% YoY compared to 6.3% YoY and 13.2% YoY in Q2 FY23 and Q1 FY23 respectively, amidst the normalization of the base effect. The growth was in line with the RBI's estimate. Despite the moderation, real GDP inched up slightly to 111.6% of the pre-pandemic levels (Q3 FY20) from 109.4% in the preceding quarter. The estimate was lower than the market consensus due to the upward revision in the base year. Had the base remained unchanged, the real GDP would have grown by 5.1%. Nominal GDP growth slowed down to 11.2% YoY in Q3 FY23 from 17.2% YoY in Q2. The GDP deflator has continued to decline for the second consecutive quarter corroborating the moderation in inflation and further providing assurance that the worst of inflation has passed.

### Investment activity led the growth in real GDP followed by private demand; net exports were a drag




***Source: MOSPI***

Real GDP growth was driven by strong investment spending which grew by 5.4% YoY, although it slowed from 6.6% in the previous quarter. This was likely buoyed by the central government's capital expenditure push to support economic growth. Indeed, the central government continues to front-load capital expenditure which is currently tracking 25.1% higher YoY in FY23 (April-December) and stood at 67.3% of the FY23 Revised Estimates. However, the states have been lagging on this front with CAPEX increasing by only 2.8% during the same period (data for 19 states). Other investment-related indicators including the capital goods and infrastructure goods output (as per the IIP) have also improved in Q3. Announcements of new projects also increased significantly in the quarter ending December primarily led by the private sector. Furthermore, as per the RBI's survey seasonally adjusted capacity utilization increased by 20 bps to 74.5% in Q2 FY23. Additionally, the Union Budget for FY24 carried forward the government's stance of prioritizing investment-driven economic revival with CAPEX projected to rise to 3.3% of GDP in FY24 from its pre-pandemic average of 1.7% of GDP. All the above parameters are likely to bode well for a pickup in investment in the coming quarters though the increase in borrowing costs could weigh on broader investment activity.

### India's GDP estimates at a constant price

| (Constant Prices) | % YoY | | | Q2 FY23 v/s | Q3 FY23 v/s | FY23 (2nd |
|---|---|---|---|---|---|---|
| | Q1-FY23 | Q2-FY23 | Q3-FY23 | Q2 FY20 | Q3 FY20 | Adv. Est.) |
| Private Consumption | 20.0 | 8.8 | 2.1 | 15.2 | 14.8 | 7.3 |
| Government Consumption | 1.8 | -4.1 | -0.8 | -20.5 | 0.5 | 1.2 |
| Gross Capital Formation | 21.0 | 6.6 | 5.4 | 25.9 | 12.9 | 9.6 |
| Gross Fixed Capital Formation | 20.6 | 9.7 | 8.3 | 21.4 | 12.5 | 11.2 |
| Exports | 19.7 | 12.3 | 11.3 | 31.7 | 30.2 | 11.5 |
| Less Imports | 33.7 | 25.9 | 10.9 | 31.1 | 26.0 | 18.8 |
| Real GDP | 13.2 | 6.3 | 4.4 | 9.4 | 11.6 | 7.0 |
| Real GDP Excluding Govt Exp | 14.8 | 7.4 | 4.9 | 13.4 | 12.8 | 7.7 |

***Source: MOSPI***

Private consumption growth declined sharply from 8.8% YoY in Q2 to 2.1% in Q3 and contributed 1.3 pp to the real GDP growth. The moderation was driven by the waning of a favourable base effect and potential tapering-off of the pent-up demand. Nevertheless, the sequential growth in Q3 accelerated likely aided by the festive season demand. High-frequency data for the consumption demand continued to show optimism with improvement in urban demand indicators including passenger car sales, retail credit, domestic air traffic and petrol consumption in Q3. Even the proxies for rural demand including tractor sales, agriculture credit, two-wheeler registrations and rural wage rate etc. showed nascent signs of some improvement during the same period. The RBI's consumer confidence survey had also indicated improvement in consumer sentiment, with both the Current Situation Index (CSI) and the Future Expectation Index increasing by 1.3 pp to 84.8 and 116.2, respectively in January from the previous round in November. Going ahead, sustainable improvement in labour market conditions remains essential to support consumer demand which has been uneven hitherto. Labour market conditions were steady during the December quarter, with the (greater) unemployment rate at 11.6% marginally up from 11.0% in Q2 FY23, while labour force participation also inched up to 41.4% from 40.8% in the previous quarter. That being said, payroll indicators showed some signs of moderation with new additions to EPFO subscribers averaging at 8.4 lakhs in Q3 lower from 10.8 lakhs in Q2. As such, going ahead we remain cautious of consumption demand remaining robust amidst the rising interest rates and uneven labour market recovery.

Net exports continued to exert a drag on economic growth as they shaved off 0.2 pp from the real GDP growth, although they reduced from the previous quarter's drag of 3.4 pp. This was led by an uptick in the exports of the services which grew by a whopping 25% in Q3 while imports increased by only

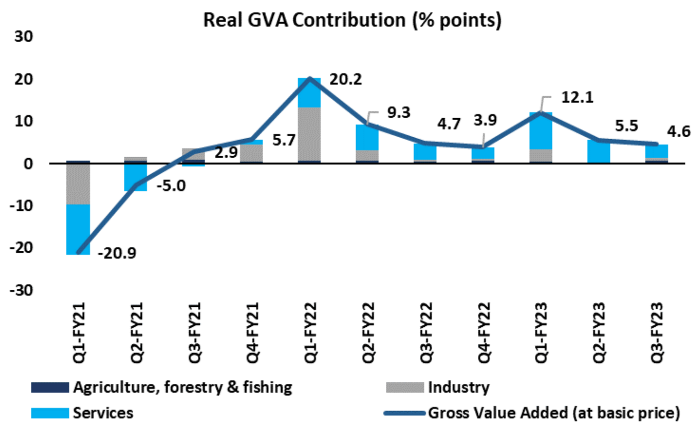
14%. Accordingly, the services surplus surged to $39 bn in Q3 compared to $27.8 bn in Q3 FY21. On the other hand, the drag from the merchandise trade has likely intensified as merchandise exports contracted in the December quarter for the first time in FY23 (by 2.1%) while imports continued to grow (6.2% YoY). With tightening monetary conditions taking a hold of key export markets like the US and the EU, the drag from net exports is likely to continue.

Lastly on the expenditure side, government consumption contracted by 0.8% YoY much lower than the contraction of 4.1% in the previous quarter. This was despite an increase of 15.7% YoY in central government revenue expenditure in Q3 suggesting curtailment by the states. The growth in revenue expenditure is expected to be softer as there has been a shift in the quality of government spending with an increased focus on capital expenditure that is driving investment demand, as noted above.

### Services sector lifted headline growth; manufacturing lagged while construction and agri remained strong

From the production side, real gross value added (GVA) grew by 4.6% YoY in Q3 FY23 (October-December 2022), slowing from 5.5% growth recorded in Q2 owing to the fading-off of the COVID-era favourable base effects. In terms of recovery from COVID, real GVA improved to ~113% of the pre-COVID levels, from 109.5% in Q2. The growth in real GVA was higher than the real GDP suggesting a slowdown in net indirect tax growth.

### A normalizing base led to slowing growth




*Source: MOSPI*

In terms of contribution, the services sector continued to lift growth led by the ongoing recovery in the contact-intensive sectors. Indeed, the trade, hotels, transportation and communications sub-sector grew at an impressive pace of 9.7% YoY supported by the festive and holiday season demand. In Q3, domestic air passenger traffic had crossed the pre-pandemic level for the first time while hotel occupancy rates continued to recover. Despite high-interest rates, the financial, real estate and professional services sub-sector remained resilient and grew by 5.8% YoY albeit slowing slightly from 7.1% in Q2. Public administration, defence and other services growth fell to merely 2.0% YoY from 5.6% in Q2 reflecting weak growth in state governments' revenue expenditures as central government revenue expenditure (ex-interest and subsidies) had improved in October-December 2022. Overall, at 6.2% YoY, the services sector remained the major driver of growth in Q3.

While the services sector continued to remain the bright spot, the industrial sector performance was mixed. Even though growth in the sector improved to 2.4% YoY (from a contraction in Q2), a second consecutive quarter of contraction in the manufacturing sector took the shine off from the industrial recovery. The manufacturing sector output was affected by higher interest rates and weaker external demand resulting in the manufacturing value added contracting by 1.1% YoY in Q3 (following a 3.6% YoY contraction in Q2). Nevertheless, with global commodity prices in Q3 coming-off of their multi-year highs and a slight recovery in exports, activity in the manufacturing sector has recovered a bit according to high-frequency indicators like the PMI and IIP for December-January.

The construction sector was the outperformer within the industry as growth in this sector accelerated to 8.4% YoY in Q3 from 5.8% in Q2. Indeed, IIP infrastructure and construction goods index growth had jumped to 7.3% YoY in Q3 (from 5.3% in Q2). Furthermore, cement production and steel consumption growth were strong in October-December. Mining and electricity and other utilities growth improved as well following the slowdown in Q2 caused by an extended monsoon and industrial slowdown which affected power demand.

### India's GVA estimates at constant price

| (Constant Prices) | % YoY | | | Q2 FY23 v/s | Q3 FY23 v/s | FY23 (2nd |
|---|---|---|---|---|---|---|
| | Q1-FY23 | Q2-FY23 | Q3-FY23 | Q2 FY20 | Q3 FY20 | Adv. Est.) |
| **Agriculture, Forestry & Fishing** | **2.5** | **2.4** | **3.7** | **12.7** | **11.7** | **3.3** |
| **Industry** | **9.6** | **-0.4** | **2.4** | **11.1** | **13.6** | **3.6** |
| Mining & Quarrying | 9.3 | -0.4 | 3.7 | -0.7 | 1.6 | 3.4 |
| Manufacturing | 6.4 | -3.6 | -1.1 | 11.9 | 12.9 | 0.6 |
| Electricity and Other Utility Services | 14.9 | 6.0 | 8.2 | 12.8 | 15.6 | 9.2 |
| Construction | 16.2 | 5.8 | 8.4 | 12.0 | 18.3 | 9.1 |
| **Services** | **16.3** | **9.4** | **6.2** | **8.1** | **12.6** | **9.4** |
| Trade, Hotels, Transport, Communication etc | 25.7 | 15.6 | 9.7 | 6.7 | 8.3 | 14.2 |
| Financial, Real Estate & Professional Services | 8.6 | 7.1 | 5.8 | 8.9 | 21.0 | 6.9 |
| Public Administration, Defence and Other Services | 21.3 | 5.6 | 2.0 | 8.5 | 7.3 | 7.1 |
| **Gross Value Added (at Basic Price)** | **12.1** | **5.5** | **4.6** | **9.5** | **12.7** | **6.6** |
| **Core GVA** | **12.6** | **6.0** | **5.4** | **9.2** | **14.1** | **7.3** |

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

Meanwhile, growth in the agriculture sector improved to 3.7% YoY (from a downwardly revised growth of 2.4% in Q2). The agriculture sector in FY23 to date has remained relatively resilient, especially considering that the Kharif sowing was slightly lower in 2022 compared to the prior year. The strong performance of the sector could reflect improvement in non-crop related activities including livestock etc. The downward revision in the estimated growth of the sector in FY23 to 3.3% from 3.5% previously (in the first advance estimates) is mainly due to an upward adjustment in the sector's growth in the past two years.

For the period immediately ahead, we expect momentum in all major sectors of the economy to remain strong. In January, both the manufacturing and services sector PMI remained in strong expansionary territory albeit moderating slightly from the 26-month and 6-month high readings respectively observed in December. Momentum in the construction sector is likely to be maintained as the government's focus remains on pushing CAPEX to support growth. Resilient cement production and steel consumption in December-January support this view. Tractor and fertilizer sales growth were in double digits in January suggesting good prospects ahead for the agriculture sector.

Looking further ahead, in FY24 sectors such as manufacturing and construction are likely to be supported by government schemes/policies like the Production-Linked Incentives, Gati Shakti and National Logistics Policy. As such we remain optimistic about these. Rabi sowing at the start of February was up 3.3% YoY, which should lead to higher production in the first half of FY24. However, we are cautious about the outlook for the services sector. As the push from the release of pent-up demand fades, momentum in the services sector is likely to slow in the absence of sustained improvement in the labour market conditions. Furthermore, a weaker global economy (courtesy of tighter monetary policies around the globe) is likely to impact services exports, particularly in the IT sector, which relies heavily on key export markets such as the US and the EU.

### Annual real GDP forecast remains unchanged at 7.0%

The National Statistical Office (NSO) also released the second advance estimates for the real GDP and GVA for FY23. As per the second advance estimate, FY23 real GVA growth is now pegged at 6.6% compared to 6.7% earlier. However, the projection for real GDP is unchanged at 7.0% for FY23. Even though the absolute figure is revised upwards, the revision in the base year (FY22 real GDP growth at 9.1% up from 8.7% earlier) has kept the FY23 estimate unchanged. Further, NSO projects the nominal GDP to grow by 15.9% YoY in FY23, reflecting a huge divergence in the real and nominal GDP. This is being led by the elevated inflationary pressures as indicated by the double-digit WPI, which averaged 11.0% (Apr '22-Jan '23). Given revisions in the latest data, our GDP projection now stands adjusted to 6.8% for FY23 from 7.0% earlier, with downside risks emanating from the global growth slowdown amidst the tightening of monetary policy conditions and geopolitical uncertainty.

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