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The Indian economy catches up to pre-COVID levels; the growth outlook remains strong although with rising uncertainty

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- The Indian economy resumed on the path of recovery after a temporary disruption caused by the COVID second wave and associated lockdown/restrictions.

- In Q2 FY22, there was a robust sequential pick-up in the real GDP by 10.4% QoQ after registering a 16.9% QoQ decline in Q1 FY22 due to the impact of the second wave. This helped Q2 real GDP exceed its pre-COVID levels by 0.3% over Q2 FY20.

- On an annualized basis, growth numbers were mostly lower than the previous quarter, but that reflects the waning of the base effect.

- Real GDP growth moderated to 8.4% YoY in Q2 FY22 (slightly lower than our forecast of ~9% YoY) from 20.1% in Q1 FY22, and real GVA growth eased to 8.5% YoY from 18.8% over the same period.

- On the demand side, economic growth in Q2 was driven by private consumption, exports, and investment (thanks to government CAPEX).

- On the supply side, real GVA growth was driven by services and industry, while agriculture continued its good momentum.

- High-frequency indicators suggest a pick up in economic recovery in Q3 aided by progress on the vaccination front, a controlled COVID situation, and festival demand.

- The government's benign fiscal deficit position also leaves space to boost spending in the rest of FY22.

- Considering these factors, we maintain our real GDP growth projection of 10.5% YoY in FY22. However, we also note downside risks emanating from a possible resurgence in COVID cases (due to new variants) along with sustained inflationary pressures and supply-side bottlenecks.

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The economy registers a robust sequential recovery in Q2

The Indian economy resumed on the path of recovery after a temporary disruption caused by the COVID second wave and associated lockdown/restrictions. In Q2 FY22, there was a robust sequential pick-up in the real GDP by 10.4% QoQ after registering a 16.9% QoQ decline in Q1 FY22 due to the impact of the second wave. This helped Q2 real GDP surpass its pre-COVID levels by 0.3% over Q2 FY20. On an annualized basis, growth numbers were mostly lower compared to the previous quarter, but that reflects the waning of the base effect. Growth in Q2 was driven by private consumption, exports, and investment (led by government CAPEX). On the supply side, real GVA growth was driven by services and industry, while agriculture continued its good momentum. High-frequency indicators suggest a pick up in economic recovery in Q3 aided by progress on the vaccination front, controlled COVID situation, and festival demand. The government's benign fiscal deficit position also leaves space to boost spending in the rest of FY22. These factors continue to support our real GDP growth projection of 10.5% YoY in FY22. We see downside risks to our estimates emanating from a possible resurgence in COVID cases along with sustained inflationary pressures and supply-side bottlenecks.

India GDP estimates at constant prices

(Constant Prices)	% YoY						Q1 FY22 v/s	Q2 FY22 v/s
	Q1-FY21	Q2-FY21	Q3-FY21	Q4-FY21	Q1-FY22	Q2-FY22	Q1 FY20	Q2 FY20
Private Consumption	**-26.2**	**-11.2**	**-2.8**	**2.7**	**19.3**	**8.6**	**-11.9**	**-3.5**
Government Consumption	**12.7**	**-23.5**	**-1.0**	**28**	**-4.8**	**8.7**	**7.4**	**-16.8**
Gross Capital Formation	**-47.7**	**-8.0**	**3.0**	**14**	**56.7**	**17.2**	**-18.1**	**7.8**
Gross Fixed Capital Formation	-46.6	-8.6	2.6	11	55.3	11.0	-17.1	1.5
Exports	-21.8	-2.0	-3.5	9	39.1	19.6	8.7	17.2
Less Imports	-40.9	-17.9	-5.0	12	60.2	40.6	-5.3	15.5
Real GDP	**-24.4**	**-7.4**	**0.5**	**2**	**20.1**	**8.4**	**-9.2**	**0.3**
Real GDP Excluding Govt Exp	**-29.0**	**-5.2**	**0.6**	**-1**	**25.0**	**8.4**	**-11.3**	**2.7**

Source: MOSPI

Q2 FY22 real GDP surpasses the pre-pandemic level

On the expenditure side, real GDP growth moderated to 8.4% YoY in Q2 FY22 (slightly lower than our forecast of ~9% YoY) from 20.1% in Q1 FY22, due to the waning of the base effect. Nominal GDP growth was strong at 17.5% YoY, supported by real GDP growth as well as a higher deflator. Real GDP growth was led by private consumption, exports, and investment, contributing 4.7 percentage points (pp), 4.1 pp, and 3.4 pp, respectively, to the overall economic growth. While investment and exports surpassed their respective pre-COVID levels, private consumption is yet to catch up to its pre-pandemic level fully. Government consumption was favourable on the back of a low base from the previous year; however, it remained ~17% below the spending in Q2 FY20, as the government prioritized capital expenditure relative to revenue expenditure in the current year.

The government's focus on an investment-led growth strategy was reflected in the Gross Fixed Capital Formation (GFCF) that surpassed its pre-COVID levels by 1.5% over Q2 FY20 (after remaining 17.1% below its pre-COVID levels in Q1 FY22). Capital outlay by both the central and state governments (data for 22 states) remained robust during Q2 FY22 - increasing by ~52% YoY (vs 26.3% YoY in Q1 FY22) and 71.4% (vs 83.4% YoY in Q1 FY22). The government also nudged Central Public Sector Enterprises (CPSE) to pick up capital spending as they achieved 37% of their aggregate capital expenditure target in H1 FY22. Meanwhile, private investment demand is also likely to have picked up in the July-September quarter after facing a hit in Q1 FY22 due to the COVID second wave. As noted in our latest Economic Monitor report - the corporate sector started to show nascent signs of pick up in capital raising activities that appear to be translating to a turnaround in their fixed asset investments. Various business confidence surveys also portend towards buoyant optimism fueled by strong demand, which could indicate a further pick up in the private investment cycle. Nevertheless, headwinds in the form of persisting inflationary pressures and a fear of a resurgence in COVID cases persist and could upend tentative signs of revival of the private investment cycle.

As the base effect started to normalize, private consumption demand increased by 8.6% YoY (v/s 19.3% YoY in the previous quarter). While the sequential recovery was strong at ~9.2% QoQ (v/s its past 5-year trend of 0.2% QoQ in the September quarters), private consumption remained 3.5% below its pre-COVID level. This was broadly in line with the IIP weighted consumption index that stood 0.5% below its pre-COVID level, primarily due to a modest recovery in consumer durables that is a proxy for discretionary spending. While consumption demand - the key engine of Indian growth - remaining below its pre-COVID levels is concerning, high-frequency indicators for the Q3 FY22 period point towards robust spending buoyed by the festive period and pent-up demand. The pick-up in vaccine coverage and benign COVID situation has also resulted in a further easing of restrictions and a broader reopening of the economy that has boosted sentiments. Employment conditions also look steady with strong hiring activity and signs of a more well-rounded recovery, which portends well for a sustained demand ahead.

On the other hand, government consumption expenditure increased by 8.7% YoY, on the back of a favourable base (-23.5% YoY in Q2 FY21); nevertheless, it contributed ~1 pp to GDP growth in Q2 FY22. The central government revenue expenditure increased by 17.2% YoY in Q2 FY22, after a 2.4% contraction in Q1 FY22. On the other hand, state governments maintained their steady spending as the revenue expenditure (data for 22 states) increased by 13.2% YoY in Q2 FY22 vs 10.4% YoY in Q1 FY22. Meanwhile, the fiscal deficit continues to remain benign at only 36.3% of its budgeted estimate in the April-October period (this compares to 91.1% of the fiscal deficit BE getting exhausted on average in the past five years for the same period). As such, we expect overall government expenditure to remain robust in the remainder of the year that could get a further boost from stronger revenue collections, with only key concern coming from slow progress on the divestment program.

On the external front – exports continued to stand out in their performance, increasing by 19.6% YoY and 17.2% over its Q2 FY20 levels. Merchandise exports growth has been broad-based supported by strong external demand and registered a brisk ~55% YoY growth in April-October. With this pace, India is well on its way to achieving the government's target of $400 billion worth of exports in FY22. Meanwhile, in line with the recovery in domestic demand, imports also surged by 40.6% YoY in Q2 FY22 and stood 15.5% over its FY20 levels. The recovery in imports has also been broad-based, with core imports and imports of petroleum and gold products also increasing above their pre-COVID levels. Accordingly, with the current account deficit widening, net exports shaved off 4.4 pp from India's GDP in Q2 FY22 (vs -3.6 pp in Q1 FY22).

Industry and Services lead real GVA growth in Q2

Looking at the economy's supply side, real GVA rose by 8.5% YoY in Q2 FY22 compared to 18.8% YoY in the previous quarter, given a diminishing favourable base effect. However, there was a solid 7.9% QoQ sequential pick-up in real GVA in the September quarter, indicating a quick rebound from a 13% QoQ decline in the COVID second wave that impacted the June quarter. Aided by renewed economic recovery, real GVA in Q2 FY22 crossed its pre-pandemic level albeit marginally by 0.5% (vs previous quarter 7.8% below Q1 FY20 level). There was a broad-based improvement across sectors, led by services and industry segments with 5.8 pp and 2.1 pp contributions to overall GVA growth, respectively. The agricultural sector continued to register a robust performance, growing by 4.5% YoY in Q2, the same as the previous quarter, allaying fears of second wave impact on the sector's output. Accordingly, it maintained its contribution of ~0.6 pp to overall real GVA growth. With a strong start to rabi sowing and adequate reservoir levels, the sector's outlook remains bright.

India GVA estimates at constant prices

(Constant Prices)	% YoY						Q1 FY22 v/s	Q2 FY22 v/s
	Q1-FY21	Q2-FY21	Q3-FY21	Q4-FY21	Q1 FY22	Q2 FY22	Q1 FY20	Q2 FY20
Agriculture, Forestry & Fishing	**3.5**	**3.0**	**4.5**	**3.1**	**4.5**	**4.5**	**8.2**	**7.7**
Industry	**-35.8**	**-3.0**	**2.9**	**7.9**	**46.1**	**6.9**	**-6.2**	**3.7**
Mining & Quarrying	-17.2	-6.5	-4.4	-5.7	18.6	15.4	-1.8	7.9
Manufacturing	-36.0	-1.5	1.7	6.9	49.6	5.5	-4.2	3.9
Electricity and Other Utility Services	-9.9	2.3	7.3	9.1	14.3	8.9	3.0	11.4
Construction	-49.5	-7.2	6.5	14.5	68.3	7.5	-14.9	-0.3
Services	**-21.5**	**-11.4**	**-1.2**	**1.5**	**11.4**	**10.2**	**-12.5**	**-2.4**
Trade, Hotels, Transport, Communication etc	-48.1	-16.1	-7.9	-2.3	34.3	8.2	-30.2	-9.2
Financial, Real Estate & Professional Services	-5.0	-9.1	6.7	5.4	3.7	7.8	-1.5	-2.0
Public Administration, Defence and Other Service	-10.2	-9.2	-2.2	2.3	5.8	17.4	-5.0	6.6
Gross Value Added (at Basic Price)	**-22.4**	**-7.3**	**1.0**	**3.7**	**18.8**	**8.5**	**-7.8**	**0.5**
Core GVA	**-29.1**	**-8.6**	**0.7**	**4.1**	**25.2**	**7.5**	**-11.2**	**-1.7**

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

As the base effect waned, the industry's growth showed a marked decline on an annualized basis, from 46.1% YoY in Q1 FY22 to 6.9% YoY. However, the sector has shown solid growth, as seen by sequential pick up by 5.9% QoQ in Q2. The industry saw a turnaround from a contraction of 6.2% in Q1 FY22 to a growth of 3.7% in Q2 FY22 when compared to the respective quarters in FY20. All four major sub-sectors with the industry also showed a broadly similar picture, where on an annualized basis, growth numbers were lower than Q1 FY22 (as base effect diminished). To get a comparable picture without undue statistical base effect, we look at Q2 FY22 numbers compared to Q2 FY20. We note manufacturing and mining sectors coming out of contraction of 4.2% and 1.8% in Q1 FY22 (over Q1 FY20) to a healthy pace of growth of 3.9% and 7.9% in Q2 FY22 (over Q2 FY20), respectively. High-frequency indicators have shown recovery in the manufacturing sector, with the manufacturing PMI averaging 53.8 in Q2 FY22 vs 51.5 in the previous quarter. Compared to respective quarters of FY20, the construction sector inched closer to its pre-pandemic level, narrowing its contraction significantly from -14.9% in Q1 FY22 to -0.3% in Q2 FY22. The government's focus on CAPEX, especially on the roads, is possibly helping drive the sector's recovery. Meanwhile, the electricity extended its gains over its pre-pandemic level. The impact of extended monsoon and coal shortages at power plants on electricity output has possibly curtailed the growth to some extent.

High-frequency indicators have shown broadening of economic recovery to the services sector, including contact-intensive services, supported by progress on the vaccination front and controlled COVID situation. This was reflected in Q2 GVA data, as the catch-up in services sector growth, with strong sequential growth of 16.2% QoQ, driving the overall real GVA growth. Services sector growth was a strong 10.2% YoY in Q2 FY22 compared to 11.4% YoY in Q1 FY22 despite a less favourable base. This was driven by a sharp rise in the growth in the public administration, defence, and other services segment, which we see as a reflection of the rise in government spending at the center and states levels and likely growth in health services. Trade, hotels, transport, and communication segment saw its growth moderating on an annualized basis, but its strong recovery can be gauged from a narrowing contraction in Q2 FY22 to 9.2% (over Q2 FY20) from a decline of 30.2% (over Q1 FY20) the previous quarter. The financial, real estate, and professional services segments showed deterioration when compared to the pre-COVID level. With the progress on vaccination (83.7% of the adult population received at least one dose and 47.7% both doses so far) and controlled COVID situation (cases falling to the lowest level since May 20), we believe that growth in the services segment will gain traction and broaden further. The risk of COVID resurgence, especially in light of the new variant, could pose downside risks.

Overall, with the Indian economy returning to its pre-COVID levels in Q2 FY22, the H1 FY22 GDP growth stood at 13.7% YoY (this is over a base of 15.9% contraction in H1 FY21). As we progress to the second half of the fiscal year, we expect GDP to grow by ~8% YoY in H2 FY22 as the base effect normalizes (1.1% YoY in H2 FY21), and we continue to hold out our FY22 growth estimate at 10.5% YoY. We see downside risks to our estimates emanating from a possible resurgence in COVID cases (due to new variants) along with sustained inflationary pressures and supply-side bottlenecks.

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