Economic growth in Q2 continues to be led by domestic demand and services sector as global outlook remains bleak

- Real GDP growth for Q2 FY23 came in at 6.3% YoY, in line with the RBI's expectation. On-target growth and recent moderation in inflation support our view of a smaller rate hike in the December meeting.
- Economic growth slowed from 13.5% YoY in Q1 FY23 mainly owing to the waning of a favourable base effect.
- Activity in Q2 was led by a continued recovery in private consumption and supported by investment. Meanwhile, government spending and net exports acted as drags on the overall pace of growth.
- From the supply side, real GVA grew by 5.6% YoY in Q2 FY23, down from 12.7% YoY in Q1 but stayed above its pre-pandemic levels.
- Growth in real GVA was led by services (mainly the contact intensive sectors) as well as financial, real estate and professional services. Industry exerted a drag on headline growth weighed down by weaker manufacturing and mining sector output. Meanwhile, the agriculture sector remained impressively resilient.
- Going forward, we expect growth to be supported by a continued recovery in private consumption led by services and festive demand, and resilient investment activity albeit with some moderating impact from a normalising base effect.
- Subdued government spending owing to fiscal constraints and negative net exports due to slackening external demand will continue to act as drags to headline rate of growth.
- Considering these factors, we retain our GDP growth projection for FY23 at 7%.
- Upside risks to our forecast include quicker than expected tapering of the monetary tightening by the RBI amid a quick deceleration in inflation, which would further support a revival in domestic demand. On the flip side, downside risks are posed by slowing global growth environment, volatile commodity prices as well as heightened geopolitical uncertainty.

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

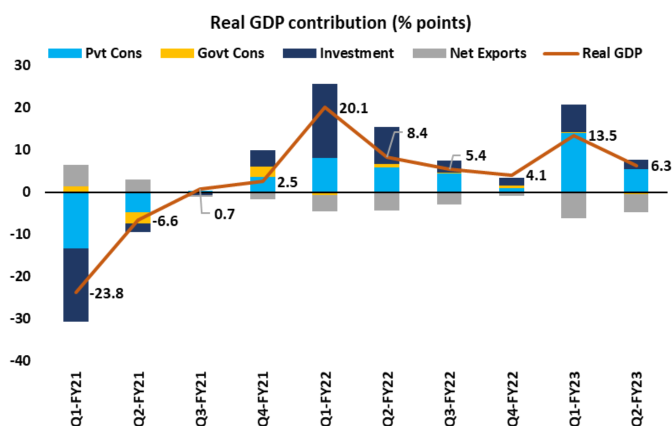
DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

DMI FINANCE

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

Real GDP in Q2 FY23 (July-September 2022) grew by 6.3% YoY, in line with the RBI's expectation, cementing our view of a smaller-than-50-basis-points hike in the December monetary policy meeting. Growth slowed from 13.5% YoY in Q1 owing to the waning of a favourable base effect, but still signaling a resilient recovery in economic conditions. Activity in Q2 was led by a continued recovery in private consumption and supported by investment. Meanwhile, government spending and net exports acted as drags on the overall pace of growth. The overall level of economic activity improved to 107.6% of pre-COVID level, up from 103.8% in Q1. Nominal GDP grew by 16.2% YoY in Q2 supported by a higher deflator.

Private consumption led the growth in real GDP



Source: MOSPI

Private consumption expenditure, which is the largest contributor to the aggregate demand grew by a strong 9.7% YoY, although down sharply from the previous quarter owing to the waning of a favourable base effect. Growth in this component was supported by a continued recovery in services activity as well as the boost provided ahead of the festive season. Indeed, in the first week of the festive season (between September 22 and 30th) online sales increased by 27% YoY according to a report by Redseer. Looking ahead, we expect private consumption recovery to continue as it will be further lifted in Q3 by the Diwali-related boost in demand. This is further reaffirmed by the improvement in the consumer confidence survey published by the RBI which saw the current situation index improving to 80.6 in the latest survey compared to 77.3 in July. Higher cost of credit could impede demand recovery but fading price pressures should cushion some of the negative impact. Sustainable improvement in labour market conditions which have been volatile hitherto are essential to support a continued recovery in the consumer sector.

Government consumption fell by 4.4% YoY as the government reined in expenditure to contain its fiscal deficit. Indeed, the government's revenue expenditure growth slowed to 3.1% YoY in Q2 from 8.8% in the previous quarter. Persistently high inflation is likely to have weighed on growth as well 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 remain unimpressive over the remaining quarters of the fiscal year. That said, the extension of the food security scheme until December and the payment of the recently announced dearness allowance are likely to prop up growth in revenue expenditure over the next few months. For economic recovery to sustain beyond the immediate future, other demand indicators will have to pick up.

Investment activity expanded in Q2 by 5.9% YoY showing impressive resilience even as high input costs and increasing cost of credit squeezed corporate profit margins. Indeed, net profits of the non-financial sector had reported a sharp contraction of 24% YoY in the quarter ending September. Value of new project completions was more or less flat sequentially. However, the government continued to push its infrastructure projects hard and as such the central government CAPEX grew by a handsome 42% YoY in Q2 FY23, which is likely the main reason that supported overall investment activity. Going ahead, private investment growth likely will strengthen in the period ahead supported by increased capacity utilization, improved credit ratios etc. should inflationary pressures ease up and monetary policy turn somewhat less hawkish. Additionally, while the state governments' capital expenditure has been tracking lower, the front-loading of the tax devolution by the centre could potentially help states to increase their capital spending in the remaining months of FY23. On the flip side, tepid global investor sentiment owing to slowing growth in systemically important economies could put a dampener on investment activity.

India's GDP estimates at constant price

(Constant Prices)	% YoY					Q2 FY23 v/s
	Q2-FY22	Q3-FY22	Q4-FY22	Q1-FY23	Q2-FY23	Q2 FY20
Private Consumption	**10.5**	**7.4**	**1.8**	**25.9**	**9.7**	**11.2**
Government Consumption	**8.9**	**3.0**	**4.8**	**1.3**	**-4.4**	**-19.7**
Gross Capital Formation	**26.8**	**8.4**	**5.2**	**19.3**	**5.9**	**26.1**
Gross Fixed Capital Formation	14.6	2.1	5.1	20.1	10.4	20.8
Exports	20.7	23.1	16.9	14.7	11.5	25.9
Less Imports	41.0	33.6	18.0	37.2	25.4	45.1
Real GDP	**8.4**	**5.4**	**4.1**	**13.5**	**6.3**	**7.6**
Real GDP Excluding Govt Exp	**8.4**	**5.6**	**4.0**	**15.3**	**7.5**	**11.3**

Source: MOSPI

Net exports drag on economic growth remained high in Q2 as resilient recovery in the domestic economy continued to

DMI FINANCE

support imports while intensification of the global growth slowdown affected exports. Indeed, export of goods and services grew by 11.5% YoY in July-September against the mammoth growth of 25.4% YoY in import of goods and services. Overall, the drag on headline growth remained high at 4.3pp, although it moderated from 6.2pp in Q1 mainly due to a normalizing base of comparison. 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 and in FY24.

Services sector led the rebound in Gross Value Added (GVA)

From the supply side of the economy, real GVA rose by 5.6% YoY slowing from 12.7% YoY in the preceding quarter, given a normalization of the base effect. Despite global disruptions including spillovers from the protracted Russia-Ukraine conflict, higher inflation globally and the corresponding monetary policy tightening adopted by major central banks somewhat hampering the pace of the economic recovery the real GVA managed to grow by 1.9% sequentially reversing the contraction of 7.2% in the previous quarter. Accordingly, the growth improved to~108% of the pre pandemic levels (corresponding quarter of FY20) from ~105% in Q1. In terms of contribution to overall GVA growth in Q2, the services sector led the overall growth, followed by the agriculture.

The growth in the agriculture sector remained impressive at 4.6% YoY in Q2 as compared to 4.5% YoY in the previous quarter. This is despite the lower Kharif acreage (0.8% lower compared to last year) as an uneven spatial distribution of rainfalls weighed on the sowing season. As per the government's first advance estimates of the Kharif season the food grain production is estimated to be 3.9% lower than the last season with rice being one of the most affected crops. The strong performance of the sector could reflect improvement in non-crop related activities including livestock etc. With a strong start to rabi sowing (7.2% higher than the last year as of 25 November), higher MSP announced for the rabi crops and adequate reservoir levels the outlook for the agriculture sector is optimistic.

With the waning of the base effect and the declining momentum noted in the manufacturing sector, activity in the industrial sector contracted by 0.8% YoY following 8.6% YoY growth in the previous quarter. Nonetheless, the output in the industrial sector managed to stay above its pre-pandemic levels. Among the major sub-sectors, the contraction was largely driven by the manufacturing sector which observed a decline of 4.3% YoY as the slackening external demand along with elevated input costs weighed on the activity in the sector. Even though we did expect growth in the manufacturing sector to moderate, the contraction however was rather surprising and contrasting to the other high frequency indicators like PMI manufacturing (average of 55.9 in Q2 vs 54.3 in Q1) and IIP which suggested resilience in the sector. Given consistent indications of resilient activity in the sector (strong PMI and corporate sales data) we expect growth to rebound in the remaining quarters of FY23. The mining sector also posted a contraction of 2.8% YoY as heavy rainfalls impacted the output. With a continued focus of the government on increasing capital spending, the construction sector grew by 6.6% YoY in Q2 and remained above its pre-pandemic levels. Moreover, the production of finished steel and cement continued to remain robust which bodes well for the construction activity going forward. Meanwhile, in tandem with the industrial slowdown affecting electricity requirements, extended monsoon and a diminishing favourable base effect the growth in electricity and other utility services moderated to 5.6% YoY from 14.7% YoY in Q1.

India's GVA estimates at constant prices

(Constant Prices)	% YoY					Q2 FY23 v/s
	Q2-FY22	Q3-FY22	Q4-FY22	Q1-FY23	Q2-FY23	Q2 FY20
Agriculture, Forestry & Fishing	**3.2**	**2.5**	**4.1**	**4.5**	**4.6**	**11.3**
Industry	**7.0**	**0.3**	**1.3**	**8.6**	**-0.8**	**6.7**
Mining & Quarrying	14.5	9.2	6.7	6.5	-2.8	2.5
Manufacturing	5.6	0.3	-0.2	4.8	-4.3	6.3
Electricity and Other Utility Services	8.5	3.7	4.5	14.7	5.6	10.9
Construction	8.1	-2.8	2.0	16.8	6.6	7.6
Services	**10.2**	**8.1**	**5.5**	**17.6**	**9.3**	**7.4**
Trade, Hotels, Transport, Communication etc	9.6	6.3	5.3	25.7	14.7	2.1
Financial, Real Estate & Professional Services	6.1	4.2	4.3	9.2	7.2	7.8
Public Administration, Defence and Other Services	19.4	16.7	7.7	26.3	6.5	14.3
Gross Value Added (at Basic Price)	**8.3**	**4.7**	**3.9**	**12.7**	**5.6**	**7.6**
Core GVA	**7.3**	**3.0**	**3.2**	**12.2**	**5.6**	**5.9**

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

Meanwhile, with the continued release of pent-up demand amidst receding concerns of the pandemic the services sector led the momentum in real GVA as it noted a robust expansion of 9.3% YoY in Q2 compared to 14.7% YoY in Q1 despite the unfavourable base effect and stayed above its pre-pandemic levels (~107%). The expansion of the services sector was led by a sanguine performance of the contact intensive sectors i.e., Trade, Hotels, Transport, Communication etc. which posted a double-digit growth of 14.7% YoY. High frequency indicators like domestic air passenger traffic and railway passenger traffic indicate a further pick-up in activity in the contact intensive sectors amidst the festive season. Meanwhile, the Financial, real estate & professional services also grew at a healthy pace of 7.2% YoY reflecting the improved credit and deposit growth in the banking system. Public administration, defence and other services registered a growth of 6.5% YoY. This was despite a contraction in the central government's revenue

expenditure (excluding interest and subsidies) potentially reflecting growth in other services like health, education etc. Going ahead, the outlook for the sector remains optimistic (as reflected in strong PMI readings) with the continued normalization of the consumption patterns. However, the rising services inflation could weigh on the growth momentum of the sector.

Overall, the latest national accounts data is in line with our expectations. In the rest of FY23, the government's thrust on CAPEX, and ongoing catch-up in the services sector are expected to support economic recovery. However, global global growth slowdown owing to tightening of financial conditions, volatile commodity prices, and spillovers from a heightened geopolitical uncertainty could weigh on the economic growth. We retain our projection of real GDP growth of 7% YoY in FY23.

DMI FINANCE

DISCLAIMER

This research report/material (the “Report”) is for the personal information of the authorised recipient(s) and is not for public distribution and should not be reproduced or redistributed to any other person or in any form without DMI’s prior permission.

In the preparation of this Report, DMI has used information that is publicly available as well as data gathered from third party sources. Information gathered and material used in this Report is believed to have been obtained from reliable sources. DMI, however makes no warranty, representation or undertaking, whether expressed or implied, that such information is accurate, complete or up to date or current as of the date of reading of the Report, nor does it assume any legal liability, whether direct or indirect or responsibility for the accuracy, completeness, currency or usefulness of any information in this Report. Additionally, no third party will assume any direct or indirect liability. It is the responsibility of the user or recipient of this Report to make its/his/her own decisions or enquiries about the accuracy, currency, reliability and correctness of information found in this Report.

Any statement expressed as recommendation in this Report is general in nature and should be construed strictly as current opinion of DMI as of the date of the Report and may be subject to change from time to time without prior intimation or notice. The readers of this Report should carefully read, understand and investigate or enquire (either with or without professional advisors) into the risks arising out of or attached to taking any decisions based on the information or opinions contained in this Report. DMI or its officers, directors, personnel and employees, including persons involved in the preparation or issuance of this Report may have potential conflict of interest with respect to any recommendation and related information and opinions.

Neither DMI nor any of its officers, directors, personnel and employees shall be liable for any loss, claim, damage of whatsoever any nature, including but not limited to, direct, indirect, punitive, special, exemplary, consequential, as also any loss of profit in any way arising from the use of this Report or the information therein or reliance of opinions contained in this Report, in any manner.

No part of this Report may be duplicated or copied in whole or in part in any form and or redistributed without the prior written consent of DMI. Any reproduction, adaptation, distribution or dissemination of the information available in this Report for commercial purpose or use is strictly prohibited unless prior written authorization is obtained from DMI. The Report has been prepared in India and the Report shall be subject only to Indian laws. Any foreign reader(s) or foreign recipient(s) of this Report are requested to kindly take note of this fact. Any disputes relating to the Report shall be subject to jurisdiction of Republic of India only.