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Economic growth momentum eased in Q3 FY22; global headwinds pose risk to ongoing economic recovery

- Economic recovery continued in Q3 FY22 but at a slower pace than expected.
- Real GDP growth moderated to 5.4% YoY in Q3 FY22 (compared to our estimate of ~6.5% YoY) from 8.5% in Q2 FY22, and real GVA growth eased to 4.7% YoY from 8.4% over the same period.
- With continued normalization of the base effect, economic growth slowed on a sequential basis; however, the economy registered a solid pickup compared to its pre-COVID level.
- Accordingly, Q3 FY22 real GDP jumped to 106% of the pre-COVID level (Q2 FY20), up from 101.3% in the previous quarter.
- On the demand side, real GDP growth in Q3 FY22 was driven by private consumption (aided by festival demand) and exports, while investment and government spending were disappointing.
- On the supply side, real GVA growth was driven by services, which noted marked improvement with the broadening of the economic recovery. Meanwhile, agriculture and industry segments noted slower than expected momentum.
- As per the second advance estimate, the NSO projects FY22 real GDP to grow by 8.9% YoY in FY22 compared to its earlier estimate of 9.2% YoY, partly due to a revision in the FY21 GDP number.
- With the ebbing of the third wave, we expect the economic recovery to gain traction in the coming months; however, global headwinds could weigh on the pace of economic recovery.
- Given the revisions in base year number and a lower-than-expected Q3 growth number, we now see FY22 real GDP growth at 8.8% YoY compared to our earlier projection of 9.3% YoY.
- Fiscal and monetary policies remain supportive of economic growth revival in this highly uncertain environment, though high energy prices amidst the Russia-Ukraine conflict could eat policy space through higher subsidy and inflationary pressures.

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Economic growth continued in Q3 but at a slower pace; the second advance estimate pegs FY22 GDP growth at 8.9%

Economic recovery continued in Q3 FY22 but at a slower pace than expected. With continued normalization of the base effect, economic growth slowed on a sequential basis; however, the economy registered a solid pickup compared to its pre-COVID level. On the demand side, real GDP growth was driven by private consumption (aided by festival demand) and exports, while investment and government spending were disappointing. On the supply side, real GVA growth was driven by services, while agriculture and industry segments noted slower than expected momentum. As per the second advance estimate, the NSO projects FY22 real GDP to grow by 8.9% YoY in FY22 compared to its earlier estimate of 9.2% YoY, partly due to a revision in the FY21 GDP number. With the ebbing of the third wave, we expect the economic recovery to gain traction; however, global headwinds could weigh on the pace of economic recovery. Fiscal and monetary policies remain supportive of economic growth revival in this highly uncertain environment, though high energy prices (with Brent oil prices ~$100/bbl) amidst the Russia-Ukraine conflict could eat policy space through higher subsidy and inflationary pressures. Given the revisions in base year number and a lower-than-expected Q3 growth number, we now see FY22 real GDP growth at 8.8% YoY (with downside risks) compared to our earlier projection of 9.3% YoY.

Private consumption and exports drive real GDP growth in Q3 even as government spending and investment disappoint

On the expenditure side, Q3 FY22 real GDP growth came at 5.4% YoY, lower than our estimate of ~6.5% YoY. With continued normalization of the base effect, economic growth slowed on a sequential basis; however, the economy registered a solid pickup compared to its pre-COVID level. Accordingly, Q3 FY22 real GDP jumped to 106% of the pre-COVID level (Q2 FY20), up from 101.3% in the previous quarter. Nominal GDP growth was strong at 15.7% YoY in Q3, bolstered by a higher deflator. Inflation remained elevated during the quarter, with WPI inflation averaging 14.1% in the third quarter of the current financial year, keeping the deflator high (10.5% YoY).

Real GDP growth in Q3 FY22 was driven by private consumption (aided by festival demand) and exports, while investment and government spending disappointed. As the base effect continues to normalize, private consumption growth moderated to 7% YoY in Q3 from 10.2% YoY in the prior quarter. However, there was a continued strong sequential pick up in private consumption spending, growing by 14.5% QoQ in the December quarter, similar to the level in the prior quarter (by 15.9% QoQ) aided by festival demand and vaccination coverage. Accordingly, private consumption reached 107.6% of its pre-COVID level in Q3 FY22 compared to 101.1% in Q2. Supporting this increase has been robust retail credit growth which grew by 14.3% YoY in December compared to 11.6% YoY in November. The RBI's consumer confidence had also indicated improvement in consumer sentiment, with the Current Situation Index increasing marginally in January to 63.7 from 62.3 in November 2021 even though the Future Expectations Index noted moderation but continued to stay in optimistic territory. Sustained improvement in labor markets conditions is needed for consumption recovery to gain traction beyond the pent-up demand. Labour markets conditions were steady during the December quarter, with the (greater) unemployment rate at ~11% in Q3 FY22 marginally up from ~10.4% in Q2 FY22, while labour force participation remained around 41.9%, similar to the previous quarter level. After some jobs losses during January due to the third COVID wave, labour markets conditions seem to be on the mend, boosting the outlook for recovery in private consumption. Potential higher energy prices and continued high consumer inflation could weigh on purchasing power, tapering the pace of consumption recovery.

India GDP estimates at constant prices

(Constant Prices)	% YoY						Q2 FY22 v/s	Q3 FY22 v/s
	Q2-FY21	Q3-FY21	Q4-FY21	Q1-FY22	Q2-FY22	Q3-FY22	Q2 FY20	Q3 FY20
Private Consumption	**-8.3**	**0.6**	**2.7**	**14.2**	**10.2**	**7.0**	**1.1**	**7.6**
Government Consumption	**-22.9**	**-0.3**	**28**	**-4.4**	**9.3**	**3.4**	**-15.8**	**3.1**
Gross Capital Formation	**-6.1**	**-1.9**	**14**	**72.3**	**26.8**	**8.3**	**19.1**	**6.3**
Gross Fixed Capital Formation	-4.5	-0.6	11	62.5	14.6	2.0	9.5	1.4
Exports	-6.4	-8.6	9	40.4	20.5	20.9	12.7	10.5
Less Imports	-17.9	-5.2	12	60.7	40.7	32.6	15.5	25.8
Real GDP	**-6.6**	**0.7**	**1.6**	**20.3**	**8.5**	**5.4**	**1.3**	**6.2**
Real GDP Excluding Govt Exp	**-4.5**	**0.9**	**-1.1**	**25.0**	**8.4**	**5.6**	**3.6**	**6.5**

Source: MOSPI

Government spending contribution to Q3 real GDP growth was modest. As expected, the Government consumption growth slipped sharply to 3.4% YoY in Q3 FY22 from 9.3% in the previous quarter. Revenue expenditure growth averaged 11.4% YoY in the quarter, down from 17.2% in Q2 FY22, partly thanks to the base effect. This coupled with inflationary pressures (weighing on inflation-adjusted real growth), led to slower growth in govt consumption on an annualized basis. However, the sequential growth improved in the quarter, helping govt consumption reach 103% of its pre-COVID level of Q3 FY20, up from 84% (of Q2 FY20 level) in the prior quarter.

Investment slowed more than expected in the December quarter, with growth sharply down from 26.8% YoY in Q2 FY22 to 8.3% YoY in Q3, noting sequential contraction by 8.2% QoQ compared to a growth of 22.7% QoQ in Q2. Despite the government's focus on an investment-led growth strategy, a slower pace of central government CAPEX, with growth falling sharply to 13.4% YoY in Q3 from ~52% YoY in Q2, weighed on the investment growth. Slower investment growth in the quarter possibly also reflects that private investment was sluggish despite some tentative signs of revival. There are tentative signs of revival in credit demand by large industries, with credit to large industries that notched a growth of 1.3% YoY, its highest since July 2020. Further, companies continue to tap alternate sources of funding as well. Companies have raised a record Rs 1.05 lakh crore through IPOs during the current financial year till the end of December, more than the total of Rs 0.70 lakh crore raised in the previous three years. More IPOs are lined up for Q4 FY22. Moreover, capacity utilization (CU) for the manufacturing sector recovered to 68.3% in Q2 FY22 after the waning of the second wave, which had caused plummeting of CU to 60.0% in the previous quarter. As manufacturing companies maintained a broadly similar level of inventories in Q1 and Q2, improvement in sales led to a sequential decline in the inventory to sales ratio by 18 percentage points to 60.5% in Q2 FY22. We expect govt CAPEX to pick up in the remainder of FY22, which could rise by the potential for central govt CAPEX to rise by ~82% in Q4 FY22 as per the revised FY22 budget estimates. The Union Budget for FY23 carried forward the government's stance of prioritizing investment-driven economic growth revival with CAPEX projected to rise to 2.9% of GDP in FY23 from its pre-COVID average of 1.7% of GDP. These bode well for a pickup in investment in coming quarters though elevated global uncertainties could delay a broader recovery in the investment.

On the external trade front, exports continued their robust growth, increasing by 20.9% YoY, reaching 110.5% of Q3 FY20 levels. Merchandise exports growth has been broad-based supported by strong external demand and registered a brisk ~41% YoY growth in the December quarter. With this pace, India remains on the way to achieving the government's target of $400 billion worth of exports in FY22. With the ongoing recovery in domestic demand and higher commodity prices, imports growth also remained strong, at 50% YoY in Q3 FY22, and stood at ~143% of its Q3 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, net exports shaved off 3.2 pp from India's GDP in Q3 FY22 (vs -4.4 pp in Q2 FY22). Moving ahead, the surging global commodity prices amidst rising geopolitical tensions could weigh on the trade balance in the rest of FY22 and into FY23. Policy normalization by major central banks is also likely to create volatility in global financial markets, weighing on the pace of economic recovery. These external headwinds coupled with domestic uncertainty related to future COVID variants continue to pose risks to a continued robust exports growth.

The services sector lead real GVA growth as economic recovery broadens. Industry posts sluggish growth

On the supply side of the economy, the real GVA expanded by 4.7% YoY in Q3 FY22 compared to an expansion of 8.4% YoY in Q2 FY22 as the favorable base continues to taper off. With the extension of the economic recovery in Q3 buoyed by the vaccination progress and the festive season, the real GVA grew by 6.1% QoQ compared to 8.6% QoQ in Q2 FY22 and remained ~107% of its pre-pandemic levels (compared to the corresponding quarter of FY20). The agricultural sector continued its growth trajectory; however, it posted modest growth of 2.6% YoY against the 3.7% YoY in the prior quarter. With the Kharif crops being only marginally higher in FY23 as the total production output is estimated to grow by 2% YoY to 153.5 million tons and the flooding caused in some parts of the country, the performance of the agricultural sector was impacted in Q3. Nonetheless, the agriculture sector continued to be resilient as the growth stayed at 107% of its pre-COVID level. Further, rabi crop output is estimated to have grown by 1.5% in FY22 and reached a record-high of 162.5 million tons which bodes well for agriculture growth in the final quarter of the fiscal year.

India GVA estimates at constant prices

(Constant Prices)	% YoY						Q2 FY22 v/s	Q3 FY22 v/s
	Q2-FY21	Q3-FY21	Q4-FY21	Q1-FY22	Q2-FY22	Q3-FY22	Q2 FY20	Q3 FY20
Agriculture, Forestry & Fishing	**3.2**	**4.1**	**3.1**	**3.5**	**3.7**	**2.6**	**7.0**	**6.8**
Industry	**0.6**	**6.3**	**7.9**	**46.6**	**7.0**	**0.2**	**7.6**	**7**
Mining & Quarrying	-7.9	-5.3	-5.7	17.6	14.2	8.8	5.2	3.1
Manufacturing	5.2	8.4	6.9	49.0	5.6	0.2	11.0	8.6
Electricity and Other Utility Services	-3.2	1.5	9.1	13.8	8.5	3.7	5.0	5.2
Construction	-6.6	6.6	14.5	71.4	8.2	-2.8	1.0	3.6
Services	**-10.9**	**-0.9**	**1.5**	**10.5**	**10.2**	**8.2**	**-1.7**	**7.2**
Trade, Hotels, Transport, Communication etc	-18.8	-10.1	-2.3	34.3	9.5	6.1	-11.1	-4.6
Financial, Real Estate & Professional Services	-5.2	10.3	5.4	2.3	6.2	4.6	0.6	15.3
Public Administration, Defence and Other Services	-10.2	-2.9	2.3	6.3	19.5	16.8	7.3	13.4
Gross Value Added (at Basic Price)	**-5.9**	**2.1**	**3.7**	**18.4**	**8.4**	**4.7**	**2.0**	**6.9**
Core GVA	**-6.5**	**2.5**	**4.1**	**24.6**	**7.3**	**3.0**	**0.3**	**5.7**

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

With the dampening of the base effect and the sluggish momentum reported in manufacturing and construction sub-sectors, the growth of the industrial sector moderated to a mere 0.2% YoY in Q3 FY22 against 7.0% YoY in Q2 FY22. In contrast to our expectation, the industrial sector noted a sequential contraction of 0.5% QoQ in Q3 FY22 (v/s expansion of 6.1% QoQ in Q2 FY22). Despite the sequential moderation, the industrial activity remained at ~107% of its pre-pandemic level. Among major sub-sectors, the manufacturing sector noted a modest growth of 0.2% YoY in Q3 FY22 v/s 5.6% YoY in Q2 FY22 and stayed at ~109% of its pre-COVID level. This is broadly in line with IIP manufacturing which noted a growth of 2.4% QoQ in Q3 FY22 compared to 10.5% QoQ in Q2 FY22. Supply chain disruptions such as semi-conductor shortages and margin pressures due to elevated input prices have possibly weighed on the sector's performance. However, the magnitude of the slowdown was a surprise given the robust performance of the manufacturing sector as per the PMI survey, which noted the index marched up to an average of 56.3 in Q3 FY22 compared to 53.8 in Q2 FY22. Despite the elevated price pressures and declining volumes, the profitability of the corporates in the manufacturing sector remained strong as the corporates noted healthy profit margins of 7.23% in Q3 FY22. Keeping the performance of the high-frequency indicators in mind, we expect an upward revision to the official estimates of the manufacturing sector. In comparison, the mining sector grew by 8.8% YoY in Q3 FY22 and posted a significant sequential pick up of 16.6% QoQ compared to a contraction of 14.4% QoQ in Q2 FY22. Meanwhile, the growth in the construction sector also deteriorated as it posted a contraction of 2.8% YoY in Q3 FY22 compared to an expansion of 8.2% YoY in Q2 FY22, led by the waning of the base effect as the construction activity noted a sequential pick up of 9.7% QoQ in Q3 FY22. Moreover, the production of finished steel and cement grew by 3.7% YoY and 8.5% YoY, respectively (v/s 6.7% YoY and 23.3% YoY in Q2 FY22), reflecting the continued recovery in the construction activity. Meanwhile, the electricity, gas, and other utilities registered moderation in growth as it expanded by 3.7% in Q3 FY22 compared to 8.5% in Q2 FY22, led by the unfavourable base effect. Further, we expect the industrial activity to gain traction in the coming months, as the impact of the third wave remains contained. However, its pace is likely to be tempered by input cost pressures, supply-side constraints, and global headwinds.

Meanwhile, the services sector led the momentum in the real GVA as it noted a robust expansion of 8.2% YoY in Q3 FY22 compared to 10.2% YoY in Q2 FY22 despite the unfavourable base effect and reached above its pre-pandemic levels (~107% in Q3 FY22 v/s ~98% in Q2 FY23). Accordingly, the services sector contributed 4.2 pp to the overall GVA growth. The expansion of the services sector was led by a strong performance of the public administration, defence, and other services, which noted an impressive growth of 16.8% YoY in Q3 FY22 compared to 19.5% YoY in Q2 FY22. With government non-interest, non-subsidy expenditure moderating from 17.2% YoY in Q2 FY22 to 5.2% YoY in Q3 FY22, the increase noted in the above sub-sector potentially reflects the increased contribution of other services like education, health, etc. Further, the economic recovery continues to widen to the contact-intensive sector as trade, hotel, transport, and communication sectors noted a growth of 6.1% YoY in Q3 FY22 (v/s 9.5% YoY in Q2 FY22) buoyed by the improved vaccination coverage, increased mobility levels amidst the festive season and tariffs hikes introduced by the major telecom giants in November 2021. Financial, real estate and professional services also noted a robust expansion of 4.6% YoY in Q3 FY22 (v/s 6.2% YoY in Q2 FY22). With Omicron-led restrictions weighing the services sector for some time in the final quarter, we expect the recovery in the services sector to be only mildly disruptive, as indicated by the high-frequency indicators. The PMI for the services sector has moderated from 55.5 in December to 51.5 in January but continues to remain in the expansionary terrain. Further, the ultra-high frequency indicator like economic mobility, which had slipped by 9.5 pp to an average of 7% above the baseline levels in January, has quickly rebounded to 16.5% above the baseline levels (data till February 25th).

Annual forecast revised downwards, partly thanks to a revision in the base year

The National Statistical Office (NSO) also released the second advance estimates for the real GDP and GVA for FY22. As per the second advance estimate, FY22 real GVA growth is now pegged at 8.3% compared to 8.6% earlier. Similarly, the real GDP is projected to grow by 8.9% YoY in FY22 compared to the earlier estimate of 9.2% YoY. Part of the downward revision is due to a higher than the previously estimated base. The govt recently revised the FY21 GDP estimates to a contraction of 6.6% from the earlier estimated 7.3%. Given this and a lower-than-expected Q3 growth number, we now see FY22 real GDP growth at 8.8% YoY compared to our earlier projection of 9.3% YoY. Further, NSO projects the nominal GDP to grow by 19.4% YoY in FY22, reflecting a huge divergence in the real and nominal GDP. This is led by the elevated inflationary pressures as indicated by the double-digit WPI, which averaged 12.6% (Apr'21-Jan'22). With oil prices remaining elevated amidst the Russia-Ukraine conflict, we could expect inflation to inch up further while weighing on economic recovery. Fiscal and monetary policies remain supportive of economic growth revival in this highly uncertain environment, though high commodity prices could eat policy space through higher subsidy and inflationary pressures.

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