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India’s Economic Growth Falls to a Seven-Quarter Low in Q2-FY25; Need for Policy Support Grows

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- India’s Q2 FY25 real GDP growth slumped to a seven-quarter low of 5.4% YoY, below our expectation of 6.3%, the market consensus of 6.5%, and the RBI’s projection of 7.0%.
- The economic slowdown in Q2 is primarily driven by a broad-based deceleration in investment and private consumption, along with an outsized drag from "discrepancies." Net exports continued to contribute positively for the second consecutive quarter.
- Government consumption expenditure remained subdued but recovered from election-related disruptions in Q1.
- From the production side, real GVA growth also fell to a seven-quarter low of 5.6% YoY in Q2, driven by weakness in the manufacturing, mining, and electricity sectors.
- Agriculture growth showed a robust performance, rising to a five-quarter high, supported by above-normal monsoon rainfall and estimated growth in Kharif production. Services and construction moderated but remained relatively resilient.
- We expect a recovery in the second half of FY25, driven by the fading of weather-related disruptions and a positive outlook for rural demand. Additionally, government spending is likely to pick up.
- High-frequency indicators showed a pick-up in demand conditions and overall economic activity in early Q3, driven by the festival season. However, the sustainability of this improvement will be key, especially as the festive season fades.
- While we anticipate better economic growth in the second half of FY25, the sharper-than-expected slowdown in Q2 poses downside risks to our full-year real GDP growth projection of 6.7%.
- We reiterate that there is a need for a countercyclical policy response to address the slowing economic momentum.
- Government spending is expected to rise in H2-FY25, but monetary policy flexibility remains constrained in the near term due to elevated inflation.
- A policy rate cut will have to wait for significant moderation in inflation (expected by Feb 25), but in the interim, the RBI could consider supporting the economy in the near term through targeted interventions (to boost credit flow to specific sectors) and/or liquidity support.

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Real GDP growth fell to a seven-quarter low in Q2-FY25

India's real GDP growth slumped to a seven-quarter low of 5.4% YoY in Q2 FY25, down from 6.7% in Q1, despite the waning of temporary factors like elections and the heatwave that had weighed on growth in Q1. This performance was significantly below our projection of 6.3%, the market consensus of 6.5%, and the RBI's projection of 7.0%. The slowdown in economic growth is primarily due to a broad-based deceleration in investment and private consumption growth, alongside an outsized drag from "discrepancies."

From the production side, real GVA growth slowed from 6.8% YoY in Q1 to a seven-quarter low of 5.6% in Q2. While we still anticipate better growth in the H2-FY25 compared to the first, the sharper-than-expected slowdown in Q2 presents downside risks to our FY25 real GDP growth projection of 6.7%.

Outlook for H2 FY25: Support expected from rural consumption and government expenditure

Economic growth in the second half of FY25 is expected to recover compared to the first half. Early high-frequency indicators for Q3 suggest a pick-up in growth momentum, with broad-based improvements observed across multiple sectors. Both the manufacturing and services PMI indices inched up in October. Demand-side proxies also gained momentum, with a rise in sales of passenger vehicles, two-wheelers, and tractors during the month. Vehicle registrations surged during the festival season. However, the sustainability of this improvement will be key, especially once the festive season effect fades.

We expect consumption to remain supported in H2 FY25, bolstered by continued recovery in rural demand, aided by robust Kharif production and promising prospects for Rabi crops. Additionally, government expenditure is expected to pick up pace in the second half of the year. The fiscal deficit stood at 29% of the Budget Estimate (BE) in the first half of FY25, down from 39% in the same period last year. This provides the government with significant headroom to ramp up spending in H2 FY25.

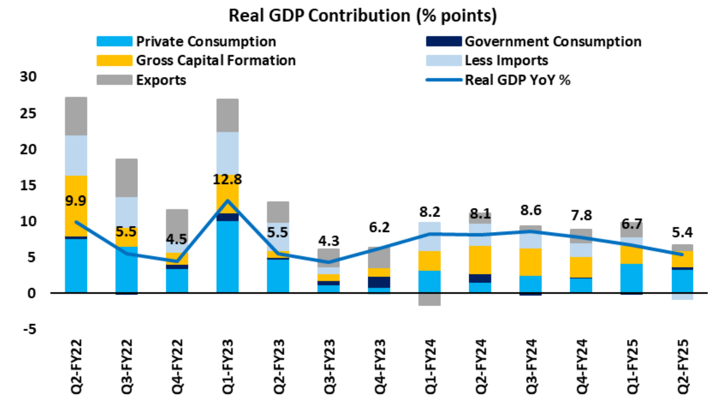
Broad-based slowdown was observed in private consumption and investment

Private consumption growth slowed to 6.0% YoY in Q2 from 7.4% in Q1 and contributed ~3.3 pp to GDP. This slowdown is likely driven by urban consumption with weakness observed in passenger vehicle sales, retail credit demand, and consumer durables. On the other hand, the high-frequency indicators for rural demand were mixed. The outlook for rural demand continues to remain positive with bright prospects for rabi crops. Urban demand, on the other hand, is likely to remain subdued, though it may improve incrementally due to expected easing in inflation and potential recovery in labour market conditions as reflected in an improvement in the hiring activity in the formal sector.

India's GDP estimates at a constant price

(GDP Constant Prices)	% YoY					
	Q2-FY24	Q3-FY24	Q4-FY24	FY24	Q1-FY25	Q2-FY25
Private Consumption	**2.6**	**4.0**	**4.0**	**4.0**	**7.4**	**6.0**
Government Consumption	**14.0**	**-3.2**	**0.9**	**2.5**	**-0.2**	**4.4**
Gross Capital Formation	**10.7**	**11.5**	**8.0**	**9.4**	**7.1**	**5.9**
Exports	5.0	3.4	8.1	2.6	8.7	2.8
Less Imports	11.6	8.7	8.3	10.9	4.4	-2.9
Discrepancies	-118.0	-113.3	-73.4	-123.3	-22.2	-463.3
Real GDP	**8.1**	**8.6**	**7.8**	**8.2**	**6.7**	**5.4**
Real GDP Excluding Govt Exp	**7.5**	**9.7**	**8.7**	**8.8**	**7.4**	**5.5**

Contribution to real GDP growth



Source: MOSPI, CMIE

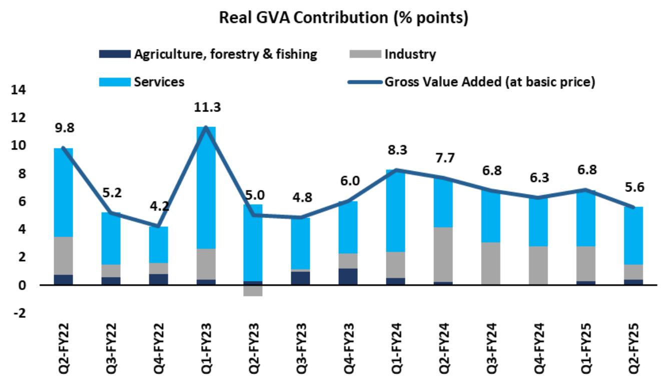
Investment spending – gross capital formation (GCF) slowed to 5.9% YoY vs 7.1% in Q1. This is likely led by the sluggish government capital spending despite the fading of the election-related disruptions barring in a select few states. The central government's CAPEX grew by 10.3% in Q2 (vs 35% contraction in Q1), while the state governments' capital expenditure continued to remain in red (-5.5% in Q2 vs -21.7% in Q1). Regarding the private sector, while there are tentative signs of improvement, the broader pick-up is yet to be seen. According to CMIE, new capacity creation projects amounted to Rs 6.7 trillion (~77% from the private sector) in Q2 FY25, nearly doubling from Rs 2.2 trillion in the previous quarter and up 54% YoY. Looking ahead, while factors like improving capacity utilization and strong corporate balance sheets are supportive of increased private investment, uneven consumption recovery and global uncertainties will act as a deterrent.

Meanwhile, government consumption recovered moderately to 4.4% YoY from a contraction of 0.2% in the previous quarter, in line with a pick-up in government revenue expenditure. We expect government consumption to remain positive going forward as the revenue expenditure needs to grow over the double pace of H1 to meet the budget target.

The positive contribution of the external sector rose in Q1, adding 1.5 pp to the real GDP growth due to the growth in exports (0.7%) outpacing the degrowth in imports (-0.8%). This is reflective of the strong growth in services exports even if the growth in good exports remained muted. With the conclusion of the US elections, we could see rising trade-related uncertainties which could potentially weigh on the growth.

Lastly, discrepancies (residual expenditure which is not captured in investment, consumption and net exports) dragged the overall GDP growth by ~2 pp, marking the second consecutive quarter of a drag (compared with positive contribution in FY24). Accordingly, from a data quality perspective, the GVA gives a more reliable picture of growth.

Real GVA fell to a seven-quarter low of 5.6% driven by the industrial sector



Source: MOSPI, CMIE

Real GVA growth for Q2 FY25 came in at 5.6% YoY, below our expectation of 6.2% and a decline from 6.8% YoY in the previous quarter. The deeper-than-expected weakness was driven by the manufacturing and mining sectors. As anticipated, the agriculture sector showed improvement, and the services sector maintained a stable growth trajectory.

The agriculture sector grew by 3.5% YoY in Q2 FY25, up from 2% in Q1 FY25. This improvement was largely driven by above-normal monsoons, which boosted Kharif crop production. According to the first advance estimates for FY25, Kharif foodgrain output is expected to rise by 5.7% compared to FY24's final production. We expect continued robust growth in agriculture for the remainder of the fiscal year, supported by higher reservoir levels that should bolster Rabi crop prospects.

The industrial sector saw a sharp slowdown in Q2 FY25, growing at just 3.6% YoY compared to 8.3% in Q1. This moderation was seen across all sub-sectors and was primarily driven by base effects, disruptions from heavy rains, and weaker demand conditions. The more-than-expected slowdown in real GVA was led by manufacturing, which grew by just 2.2% YoY in Q2, down from 7.0% in Q1, and mining, which contracted by 0.1% YoY, a stark reversal from 7.2% growth in Q1. Meanwhile, electricity generation slowed to 3.3% YoY in Q2 from 10.4% in Q1, partly due to excess rainfall in August and September. These trends broadly align with the Index of Industrial Production, which fell to an eight-quarter low of 2.6% YoY in Q2. Corporate quarterly earnings also reflected a decline in profits in the manufacturing sector due to slowing sales and margin pressures. However, the degree of slowdown in manufacturing real GVA is somewhat surprising.

India's GVA estimates at a constant price

(GVA Constant Prices)	% YoY					
	Q2-FY24	Q3-FY24	Q4-FY24	FY24	Q1-FY25	Q2-FY25
Agriculture, Forestry & Fishing	**1.7**	**0.4**	**0.6**	**4.6**	**2.0**	**3.5**
Industry	**13.6**	**10.5**	**8.4**	**7.9**	**8.3**	**3.6**
Mining & Quarrying	11.1	7.5	4.3	6.6	7.2	-0.1
Manufacturing	14.3	11.5	8.9	6.7	7.0	2.2
Electricity and Other Utility Services	10.5	9.0	7.7	7.9	10.4	3.3
Construction	13.6	9.6	8.7	10.1	10.5	7.7
Services	**6.0**	**7.1**	**6.7**	**9.5**	**7.2**	**7.1**
Trade, Hotels, Transport, Communica	4.5	6.9	5.1	6.3	5.7	6.0
Financial, Real Estate & Professional	6.2	7.0	7.6	9.7	7.1	6.7
Public Administration, Defence and C	7.7	7.5	7.8	13.5	9.5	9.2
Gross Value Added (at Basic Price)	**7.7**	**6.8**	**6.3**	**8.2**	**6.8**	**5.6**
Core GVA	**8.6**	**8.4**	**7.3**	**8.0**	**7.3**	**5.3**

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

The construction sector's growth moderated to 7.7% YoY in Q2 (from 10.5% in Q1), in line with moderation in cement production and steel consumption during the quarter. However, it managed to avoid a sharper slowdown as a pick-up in infrastructure spending possibly provided some support.

Activity in the service sector remained somewhat flat at 7.1% YoY in Q2, (vs 7.2% in Q1). Within the services sector, growth in trade, hotels, and transportation improved to 6% YoY in Q2 (from 5.7% in Q1). Improved sales in hotels & tourism, as well as transport and communication services, boosted growth for the sector. On the other hand, the financial, real estate, and professional services sectors moderated slightly to 6.7% YoY in Q2 (from 7.1% in Q1). This could be due to the financial sector with slowing growth observed in high-frequency indicators such as credit growth, insurance premiums etc. Meanwhile, the public administration, defence, and other services sectors, though moderated, grew robustly at 9.2% YoY in Q2 FY25 (vs 9.5% in Q1). This growth was supported by revenue expenditure (excluding interest and subsidies), which grew at a robust pace of 7.2% YoY in Q2 FY25, compared to a contraction of 1.5% YoY in Q1 FY25. With improving hotel occupancy in the coming months due to the beginning of the tourism season, expected growth in rural consumption, and anticipation of a pickup in government spending, the outlook for the sector looks favourable.

Need for a counter-cyclical policy response grows

As mentioned in our Indian Economic Monitor Report published on 27th November 2024, we reiterate that there is a need for a countercyclical policy response to address the slowing economic momentum. Government spending is expected to rise in H2-FY25, but monetary policy flexibility remains constrained in the near term due to elevated inflation. A policy rate cut will have to wait for significant moderation in inflation (expected by Feb 25), but in the interim, the RBI could consider supporting the economy in the near term through targeted interventions (to boost credit flow to specific sectors) and/or liquidity support.

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