Favorable base effect, lower net indirect taxes lifted GVA growth above GDP in Q1-FY25

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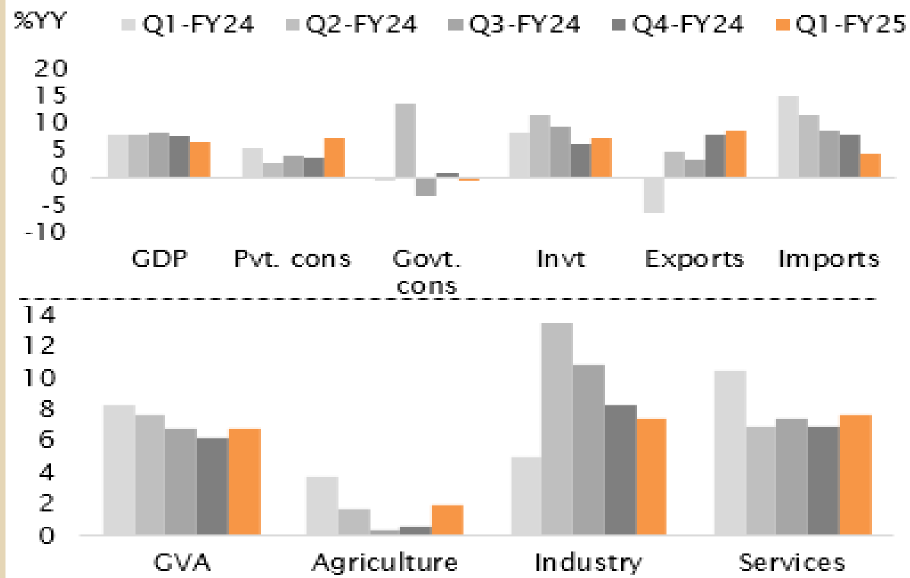
Key takeaways

- In Q1, real GDP growth at 6.7%YY marked a deceleration from 7.8% in Q4-FY24 but was largely in line with market expectations (Bloomberg estimate: 6.8%). Real GVA growth at 6.8%YY, up from 6.3% in Q4-FY24 not only surprised on the upside (Bloomberg estimate: 6.4%) but also exceeded GDP growth after four quarters, thereby reversing the wedge between the two metrics that had been a key feature of the past two quarter data releases.
- The drag on GDP growth during the quarter emanated from muted government spending due to the model code of conduct ahead of the general elections and lower growth in net indirect taxes. The contraction in government consumption was partly offset by an uptick in private consumption and continued strength in investment. Higher growth in capital formation despite decline in public capex bodes well from the perspective of pick up corporate capex and/or likely continued momentum in real estate investment.
- On the GVA side, in addition to higher year-on-year commodity prices that likely hurt manufacturers' profit margins, heatwave conditions during the quarter are also expected to have weighed on economic activity. The continued strength in services and moderation in industrial activity led to services growth surpassing industry after a gap of three quarters. It needs to be seen if this trend continues, marking a reversal from FY24 when industrial growth was stronger than services.
- The evolving trends in monsoon, sowing, and farm output will be crucial to gauge the trajectory of both growth and inflation for the remainder of FY25. The spillovers from weakening consumer and business confidence, partly attributable to the lagged impact of monetary and regulatory tightening, and increase in input costs need to be monitored to understand if the sub-7% growth in Q1 was more of a one-off instance. The RBI MPC is likely to remain in wait and watch mode at its October meeting but could soften its hawkish tone in upcoming meetings if risks to its growth outlook extend beyond Q1. The easing cycle is expected to be shallow of not more than 50bps, starting February unless growth surprises on the downside that could prompt the central bank to start cutting in December.

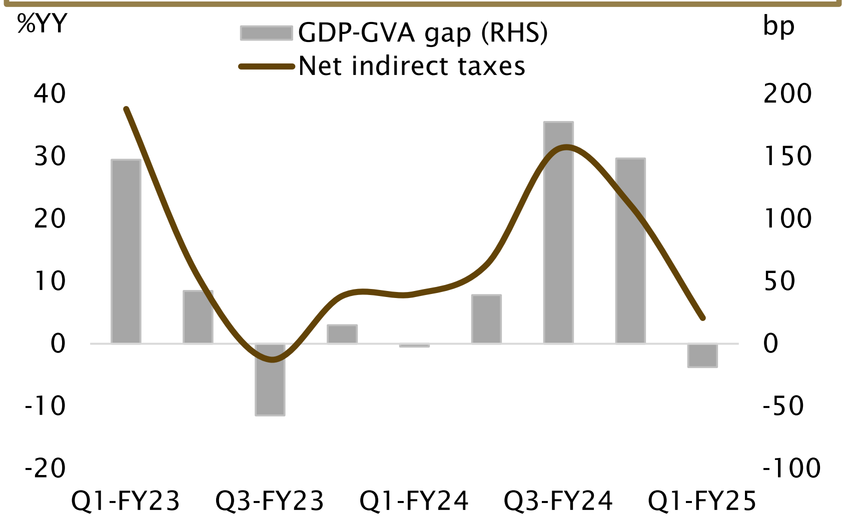
Government consumption fell, private consumption picked up in Q1; industrial growth continued to moderate



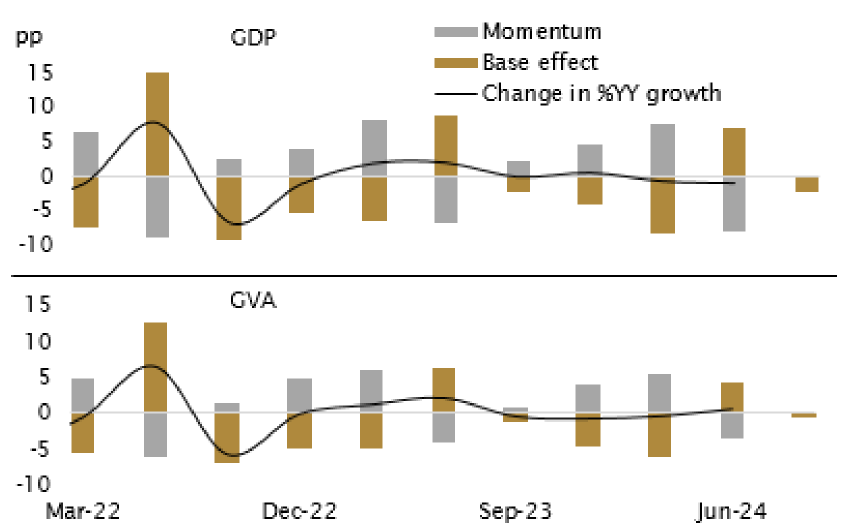
GDP-GVA gap eased; GVA growth above GDP after four quarters

- The high gap between GDP and GVA growth was a key highlight of the previous two quarter data releases in Q3- and Q4-FY24, with GDP growth surpassing that of GVA. This trend reversed in Q1-FY25 with GVA growth marginally exceeding that of GDP after a gap of four quarters, and the wedge between the two measures narrowing to around (-)20bps from an average of over (+)160bps in the past two quarters. Real GDP growth eased to a five quarter low of 6.7%YY in Q1-FY25 from 7.8% in the previous quarter. Real GVA growth improved to 6.8%YY in Q1-FY25 from 6.3% in Q4-FY24.
- Both GDP and GVA fell quarter-on-quarter, which generally tends to be the case for GDP in Q1 (based on data for FY13-20), though not for GVA that has historically posted average growth of 0.6% in Q1. Base effects were favorable for both the headline metrics, so that the improvement in year-on-year GVA growth from the previous quarter was driven by a favorable base, rather than the quarterly momentum that was negative. The quarter-on-quarter decline in GDP was steeper than the historical average.
- The moderation in year-on-year GDP growth also reflected the drag from lower net indirect taxes (indirect taxes net of subsidies) that is accounted for in GDP. The year-on-year growth in net indirect taxes eased to around 4% in Q1-FY25 after averaging 22% in the previous three quarters. Within indirect taxes, customs and union excise duty collections at the centre fell year-on-year, while subsidies increased.

GDP-GVA gap narrowed and inverted



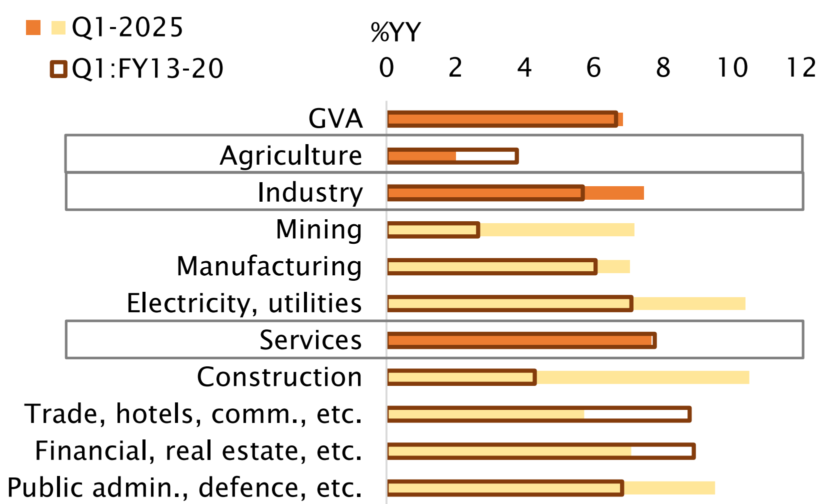
Improvement in GVA growth supported by base effect



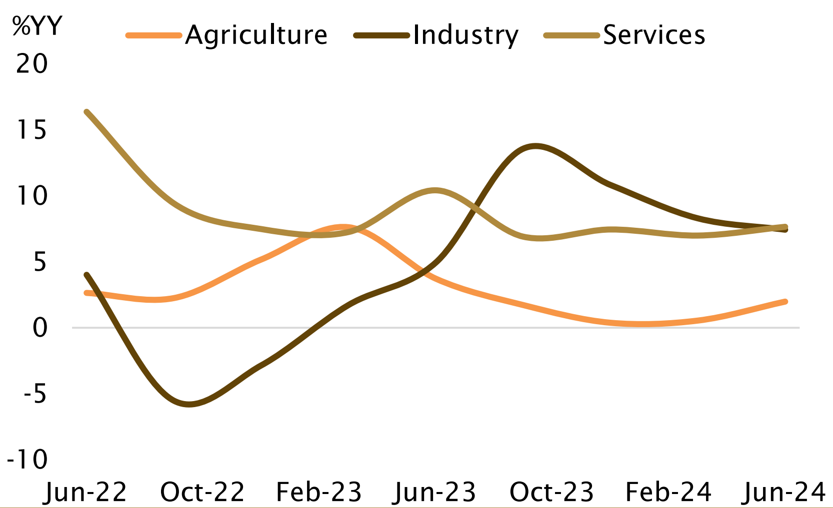
Industrial growth continued to moderate and slipped below services

- Real GVA growth of 6.8%YY in Q1-FY25 was above the pre-pandemic average (FY13-20) for the quarter at 6.6%. The improvement in year-on-year growth vis-à-vis the previous quarter was backed by favorable base effects amid quarter-on-quarter contraction in activity. Among sectors, the sequential fall in agriculture and industry was steeper than the pre-pandemic average, while the growth in services was positive but below average, and supported by financial, real estate, and professional services that is seasonal in nature and tends to peak in Q1.
- The year-on-year growth in agriculture and services improved from the previous quarter, but was lower than the pre-pandemic average for Q1. Industry growth moderated from the previous quarter but was higher than the pre-pandemic average. However, growth slipped below that of services after a gap of three quarters. This reversal of trend was due to manufacturing growth that continued to ease, as the tailwind from low commodity prices in FY24 faded and hurt profit margins. Among other industry groups, mining growth improved and electricity posted double-digit growth, attributable to the heatwave conditions during the quarter. With moderation in growth, contribution of overall industry to GVA growth eased, but remained above the pre-pandemic average.
- The year-on-year growth in agriculture was at a four-quarter high after remaining sub-1% in the previous two quarters but printed below the average for Q1.

Q1 GVA growth slightly above pre-pandemic average



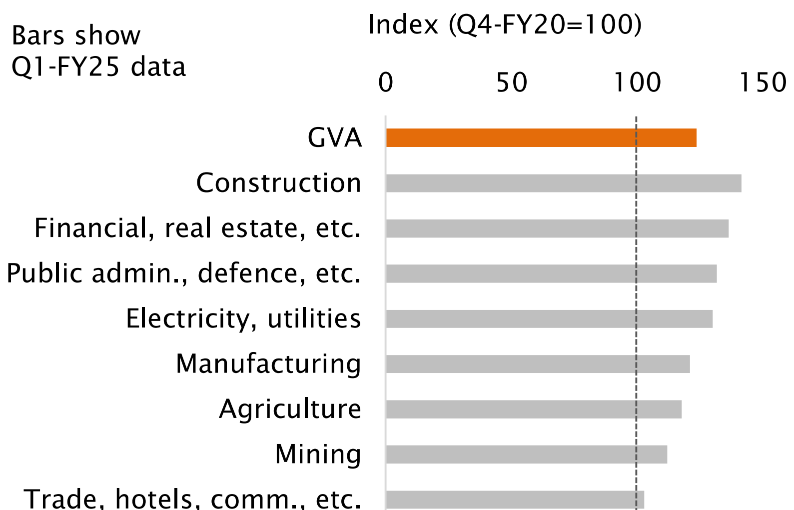
Services growth above industry after three quarters



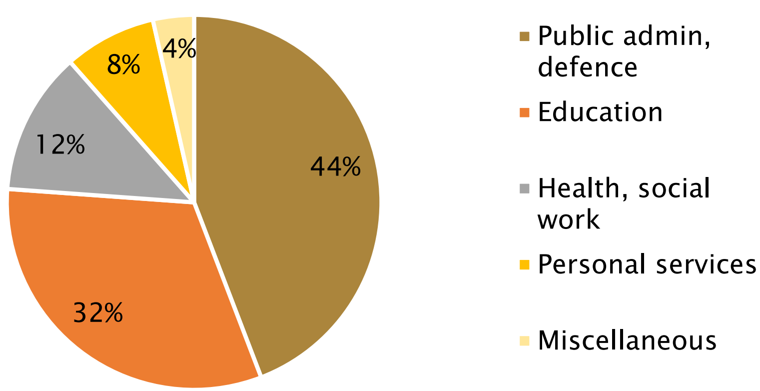
Recovery in trade, hotels remained sluggish; PADO grew strongly

- The improvement in year-on-year growth in services from the previous quarter was driven by higher contribution from 1) construction; 2) financial, real estate and professional services; and 3) public administration, defense, and other services (PADO). Overall services continued to add the most to growth due to high share in GVA, with contribution exceeding the pre-pandemic average for Q1.
- Construction posted double-digit growth, while growth in PADO was at an eight quarter high. Though growth in trade, hotels, etc. was higher than the previous quarter, it remained below the pre-pandemic average. Among all sub-sectors of GVA, post-pandemic recovery in this segment remains sluggish.
- Growth in financial, real estate, etc. eased from the previous quarter, but contribution to GVA growth rose and was the highest within services due to rise in its share. Compared to the pre-pandemic average, share of this segment has increased the most in GVA in seasonally adjusted terms. Also, the quarter-on-quarter momentum in this sector tends to peak in Q1, there supporting growth during the quarter.
- The robust growth in PADO is expected to have been supported by increases in revenue expenditure of both the central (2.2%YY) and state governments (6.7%YY for 20 states) in Q1. The segment also includes 'other services' that comprised more than half of PADO in FY23, while overall PADO made up 13% of GVA. Amid relatively tepid government spending during the quarter due to general elections, the strength in PADO also indicates support to growth from personal, social and community services.

Sluggish post-pandemic recovery in trade, hotels, etc.



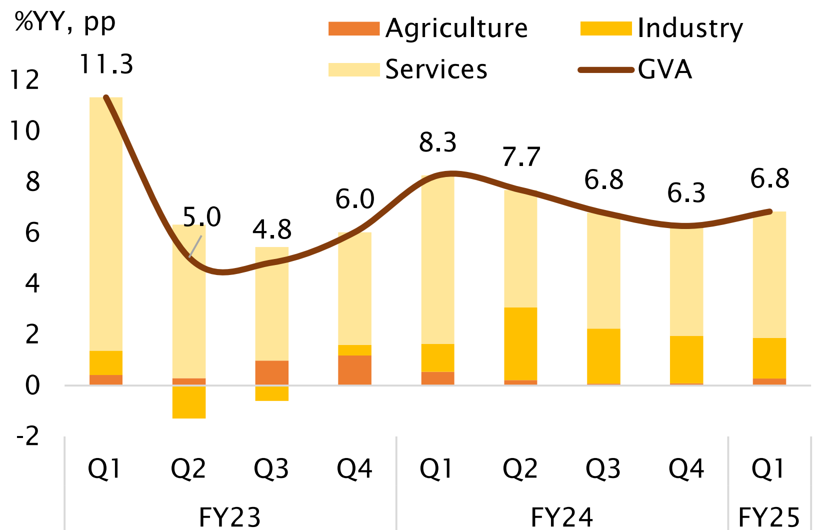
Share in PADO (FY23) that constituted 13% of GVA



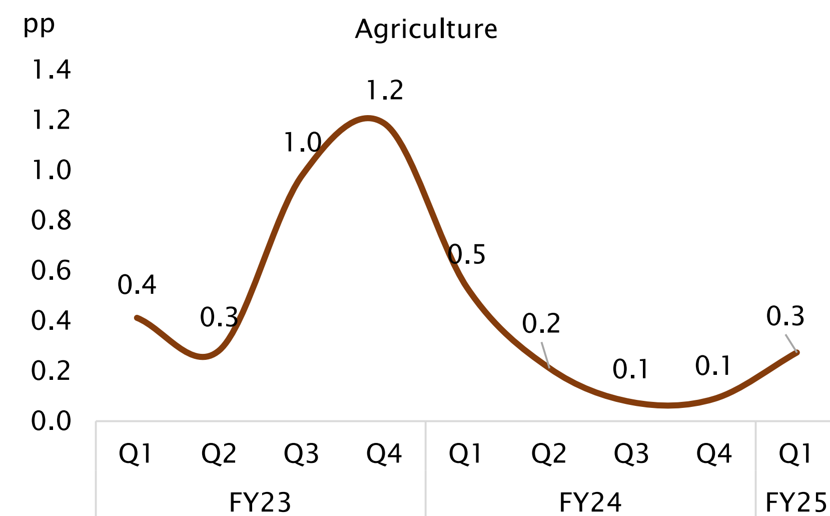
Personal services include washing, hair dressing, custom tailoring, funeral related services. Miscellaneous services include services of membership organisations; arts, entertainment, recreation; and persons employed with private households

GVA growth improved despite slower manufacturing growth

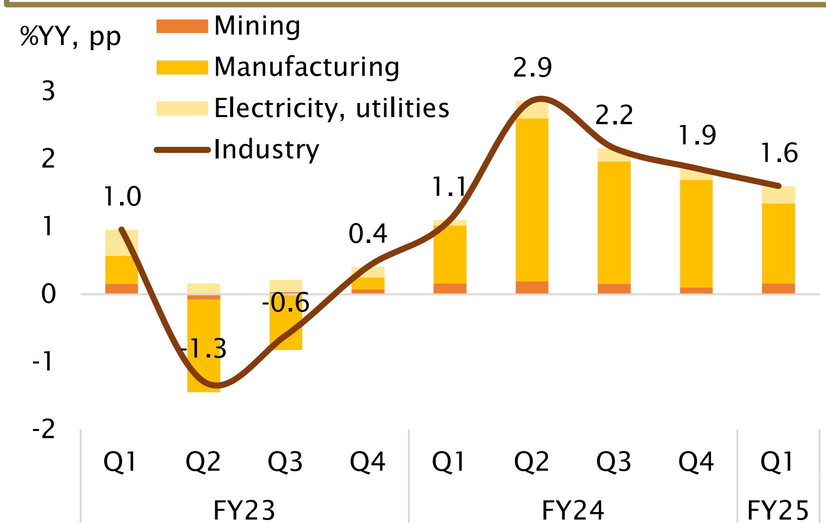
Year-on-year real GVA growth improved in Q1-FY25



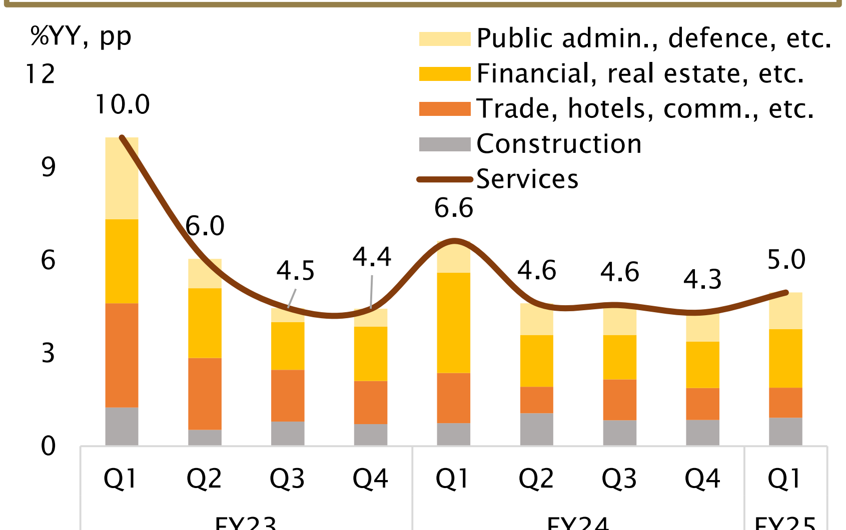
Farm contribution up but below 0.6pp average for Q1



Moderation in industrial growth due to manufacturing



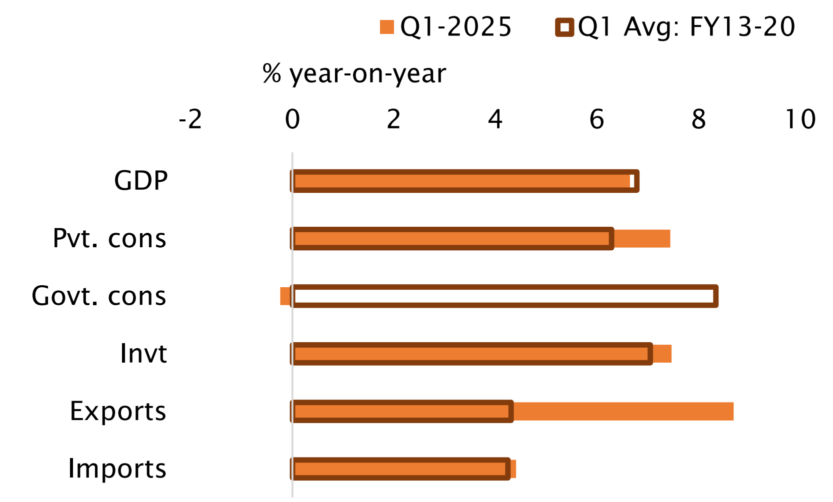
Financial services contributed the most within services



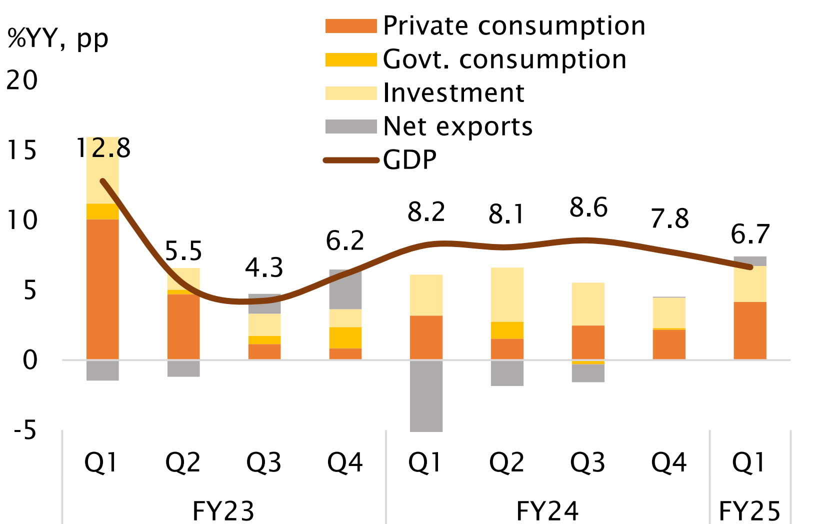
Contraction in government consumption dragged down GDP growth

- Real GDP growth of 6.7%YY in Q1-FY25 was largely in line with the pre-pandemic (FY13-20) average of 6.8% for the quarter. In the latest print, mild contraction in government consumption was partly offset by improvement in growth of private consumption and gross fixed capital formation (i.e. investment).
- Private consumption growth improved to 7.4%YY from 4% in each of the previous two quarters. Growth was the fastest in seven quarters, and outpaced historical average for Q1. The tailwind from external sector continued, with net exports adding more than in Q4-FY24. Investment growth rose to 7.5%YY from 6.5% in Q4-FY24 and was above the pre-pandemic average for Q1 but lower than 8.5% growth in Q1-FY24.
- Data for pre-pandemic years suggests that government consumption increased strongly in Q1 on an average (FY13-20), both year-on-year and quarter-on-quarter, reflecting front loading of public spending. The annual and sequential decline in government consumption in Q1 was the result of the model code of conduct imposed ahead of the general elections. Also, in Q1 of both FY23 and FY24, centre's capex surged by over 50%YY, while in Q1-FY25, it fell 35%. Data for 20 states shows 22% decline in capex compared to 70% growth in Q1-FY24. Higher investment amid decline in public capex suggests expansion from either households (spurred by demand for real estate) or a pick-up in the long-awaited private capex.
- In Q1-FY25, all key components of GDP declined quarter-on-quarter, except for imports. The sequential fall in private consumption was lower than average, but in line with pre-pandemic trend in case of investment.

Government consumption fell year-on-year in Q1



Pvt. cons., invt., net exports added more to growth



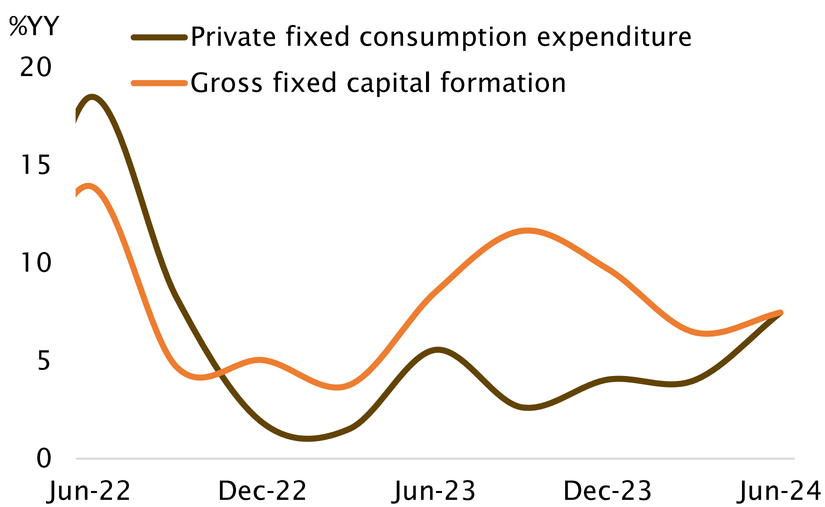
Private consumption catching up; tailwind from low deflator fading

- The improvement in private consumption growth in Q1 reflected the signs of revival in rural demand and steady urban demand. It is anticipated that moderating inflation and the above normal rainfall expected this year will raise farm output and lift rural incomes, further boosting consumption. Public spending, which was on hold ahead of the general elections, is expected to pick up. The positive contribution from net exports is expected to continue amid improved prospects for global trade compared to 2023.

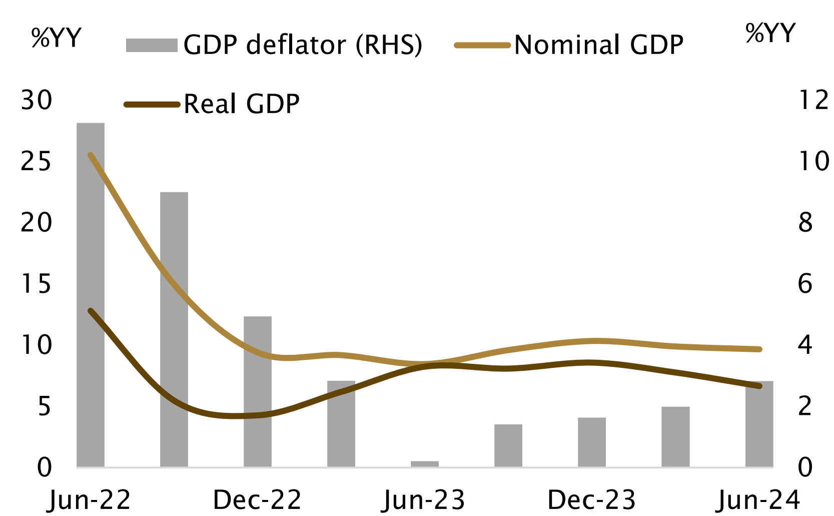
- Not only real but also nominal GDP growth moderated during the quarter to 9.7% year-on-year from 9.9% in the previous quarter. The GDP deflator reached a five quarter high, reflecting the increase in wholesale prices from the revival in prices of certain global commodities during the quarter. The tailwind from low commodity prices in FY24 seems to be fading and this could act as a strain on growth in FY25. In this context, geopolitical developments and their impact on commodity prices need to be watched out for.

- Additional risks include the indications of steady but slowing urban demand, partly reflecting the lagged impact of monetary and regulatory policy restraints. Latest RBI surveys show that while private investment intentions are picking up, these are yet to translate into a broad-based capex cycle. De-anchoring of inflation expectations, softening business and consumer sentiments could weigh on growth prospects.

Private consumption growth catching up



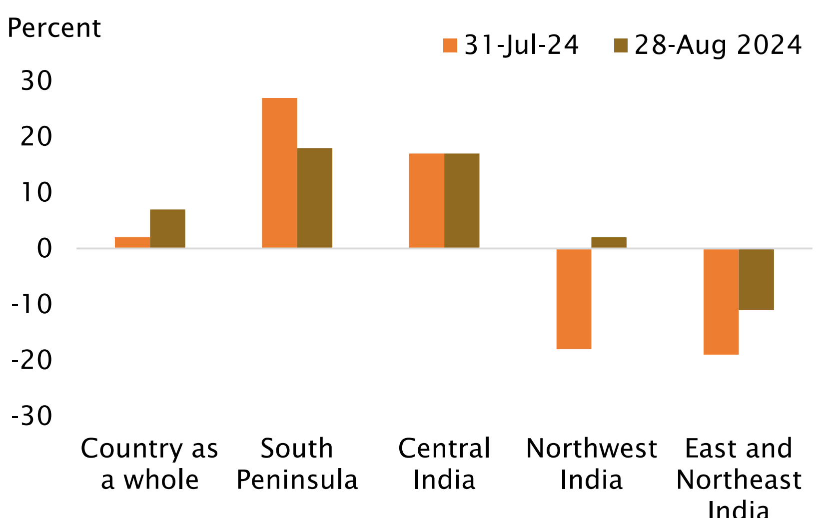
GDP deflator at five quarter high



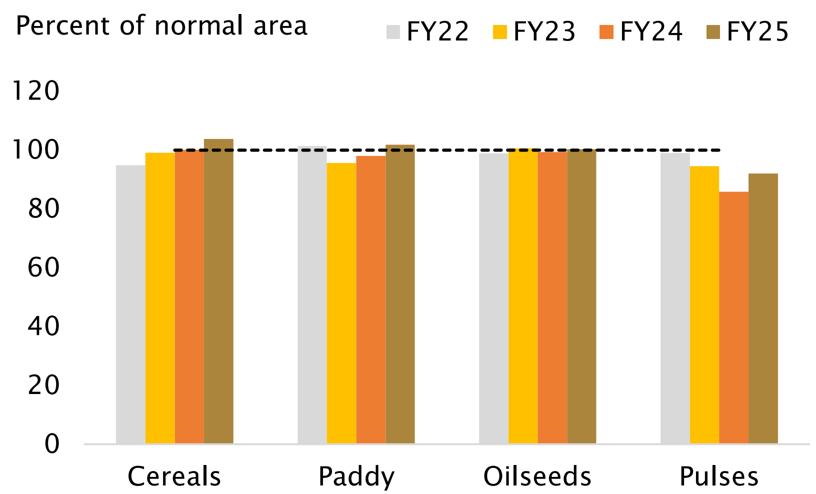
Outlook and policy implication

- The World Bank recently upgraded India's FY25 growth forecast to 7% from 6.6%, joining the IMF that had also raised growth estimate for the Indian economy to 7% in its July outlook update from 6.8% earlier. These match the RBI's forecast in its bi-annual Monetary Policy Report, published in April 2024 but are below the MPC's projection at 7.2%. The latest Q1 GDP print undershot the MPC's forecast at 7.1%. Below are some factors that will shape the growth trajectory in the remainder of the fiscal year:
  - **Monsoon:** The recovery in farm output from the El Nino impact last year hinges on how monsoon evolves in the remainder of the season. As of August 28, rainfall for the country as a whole was 7% above normal, and the spatial distribution has improved since the beginning of the season. Reservoir levels have increased that augur well for the Rabi crop too. Kharif sowing is progressing well, particularly in case of major food grains, though there is some distance to cover in case of pulses. The forecast of La Nina bodes well but needs to be monitored for the impact of extended rains on farm output.
  - **Rural consumption:** The hope is that good monsoon and the resultant agricultural bounty will lift rural incomes and ease food prices that have wrecked havoc on headline inflation for more than a year now. Lower inflation, in turn, is expected to lend support to the ongoing recovery in rural consumption.
  - **Urban consumption:** Even as private consumption picked up in Q1 and is expected to contribute more to overall growth compared to FY24, risks linger from the impact of monetary and regulatory policy

Southwest monsoon departure from normal



Kharif sowing progress as on August 30



Outlook and policy implication

tightening on urban consumption. This is showing up in lower sales of certain categories of automobiles and weakening consumer confidence, as suggested by the RBI's latest survey results.

- **Investment:** The drag from government expenditure in Q1 is expected to fade, as spending picks up and is being reflected in fiscal data for July. Also, robust growth in investment in Q1 despite weak public spending indicates support to capital formation from either households or the private sector. Housing sales data suggests that the momentum in real estate investment could be playing out this fiscal as well.
- **External sector:** The contribution of net exports to growth has been improving for two quarters and could continue in the remainder of the fiscal year amid better global trade prospects compared to 2023. However, the tailwind could be muted, as global trade recovery has been a tad sluggish than expected.
- **Commodity prices:** In addition to the pick up in private consumption in Q1, another trend that emerged was that the ongoing deceleration in industrial output and the continued strength in the services sector enabled services growth to outpace industry after a gap of three quarters. This is partly attributable to higher global commodity prices during the quarter vis-à-vis FY24 that weighed on manufacturers' profit margins. While commodity prices are expected to remain range bound, the ongoing geopolitical risks and policy uncertainties need to be monitored for their impact on commodity prices.
- The latest GDP print suggests that GDP is more likely to be close to the upper bound of the 6.5-7% range, slightly lower than the RBI MPC's current projection at 7.2%.

- **Policy implication:** The headline GDP print for Q1-FY25 at 6.7%YY missed the RBI MPC's forecast of 7.1%, mainly due to lower government spending due to the model code of conduct ahead of the general elections. Higher GVA growth relative to GDP indicates the underlying strength in economic activity. While assessing this data point, the MPC is likely to be mindful of the evolving food prices are have been posing a challenge to its disinflationary process for more than a year now. If the high frequency indicators point to improvement in the momentum of economic activity, particularly ahead of the festive season in H2, the MPC could choose to remain in a wait-and-watch mode at its October meeting to understand how inflation behaves in Q3, beyond the statistically induced softening in Q2. However, if there are indications of continued easing in economic activity beyond Q1, the MPC could choose to soften its hawkish tone in the upcoming meetings to open a window for easing in CY2025. The easing cycle is expected to be shallow of not more than 50bps due to an increase in the economy's neutral rate of interest and the evolving inflation dynamics. The start of easing seems more plausible at its February meeting, unless growth surprises on the downside that could prompt the central bank to start cutting in December. Though not explicitly, but the MPC is also likely to weigh the impact of the start of an easing cycle by the US Fed in September.

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