Macroeconomics | First cut

Losing momentum

December 2022

Industry puts spanner in GDP print

India's real gross domestic product (GDP) rose 6.3% on-year in the second quarter of fiscal 2023 vis-a-vis 13.5% in the previous quarter. The sharp deceleration was partly because of a high base effect, as GDP had printed 8.4% in the second quarter of fiscal 2022. That said, GDP was dragged down by weakening industrial growth as well, particularly in the manufacturing sector that was hit by slowing global growth and compressed margins.

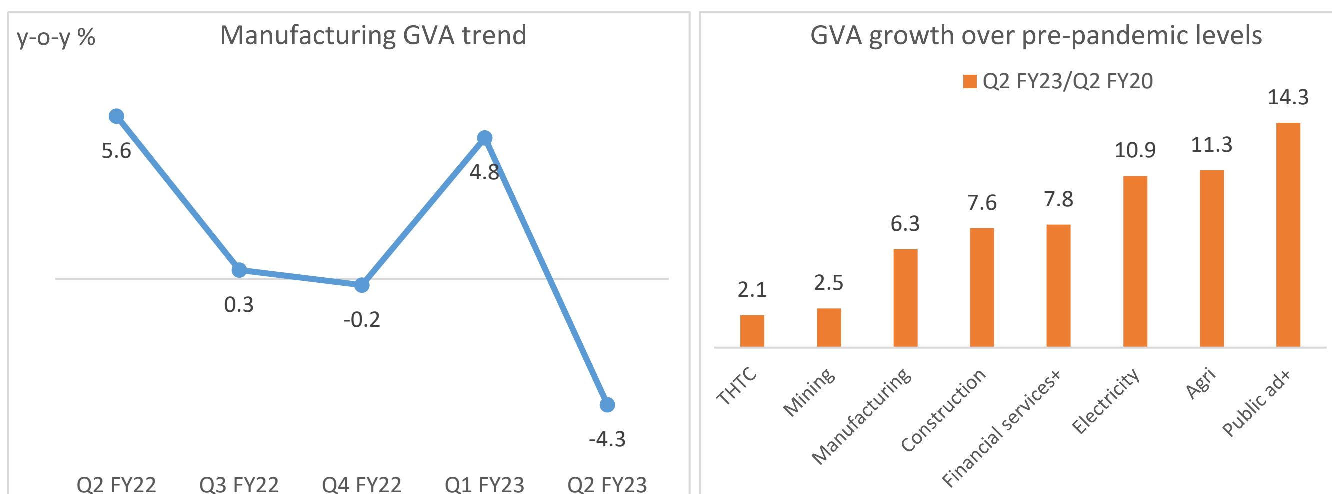
Weakening industrial activity was the primary drag on GDP growth in the second quarter, while agriculture and services provided support. Industrial activity will continue to face headwinds through next fiscal as waning global growth weighs on export demand. Domestic demand is also expected to feel the pressure next year from external spillovers and tighter domestic financial conditions. Consequently, we expect GDP growth to slow further to 6% next fiscal from 7% in fiscal 2023.

Manufacturing impacted by external headwinds; services and agri eke out growth

- On the supply side, gross value added (GVA) grew 5.6% on-year in the second quarter of fiscal 2023, much slower than the 6.3% growth in GDP during the period. The reason for the slowdown was industry, with improving agriculture and services arresting a further slowing
- Within the industry basket:
    - Manufacturing GVA turned *negative* 4.3% in the second quarter vs. 4.8% in the previous quarter, as weakening global growth hit export demand. Narrowing margins added pressure, as cost pressures for producers rose at a faster pace than retail prices. This was indicated by Wholesale Price Index-linked inflation averaging 12.4% on-year in the quarter compared with 7.0% for Consumer Price Index (CPI). But the slide in manufacturing growth was at odds with Purchasing Managers' Index manufacturing, which was in the expansion zone in the July-September quarter, at ~55. Historical data further shows the first estimates of GVA based on Index of Industrial Production underestimate the actual manufacturing growth. Hence, there is a possibility of an upside to manufacturing as more data becomes available over the next few quarters
    - Construction GVA also slowed to 6.6% from 16.8% in the previous quarter, suggesting that the overall investment environment remained subdued, despite the central government's capex push
    - Other industrial sectors too saw declines, such as mining (-2.8% vs. 6.5%) and electricity (5.6% vs. 14.7%). In fact, core sector output growth slowed to 0.1% in October, implying that industrial weakness is spilling over to the current quarter
- In contrast, agriculture GVA growth rose to 4.6% in the second quarter vis-à-vis 4.5% in the first quarter. A normal monsoon for the fourth year in a row appears to have supported production, despite uneven temporal and spatial distribution and a heatwave

- While services posted slowing on-year growth, it was primarily the result of an unfavourable base. In fact, activity continued to improve sequentially across all major components
    - In particular, contact-based services, i.e. trade, hotels, transport and communication (THTC), recorded strong growth of 14.7% on-year in the second quarter of fiscal 2023, after growing 25.7% in the previous quarter, reflecting a catch-up to pre-pandemic activity. It is notable that the share of THTC in overall GVA was slightly lower in the second quarter (18.5%) compared with its corresponding quarter pre-pandemic, i.e. second quarter of fiscal 2020 (19.5%). The catchup of THTC services to pre-pandemic levels remains slower than other industrial sectors (see chart below)
    - Financial, real estate and professional services grew 7.2% in the second quarter compared with 9.2% in the first quarter, while public administration, defence and other services rose 6.5 vs. 26.3%

Manufacturing GVA slides… **…yet industry is stronger than pre-pandemic**



Note: THTC refers to trade, hotels, transport and communication services; Financial services+ refers to financial, real estate and professional services; Public ad+ refers to public administration, defence and other services
Source: National Statistics Office (NSO), CEIC, CRISIL

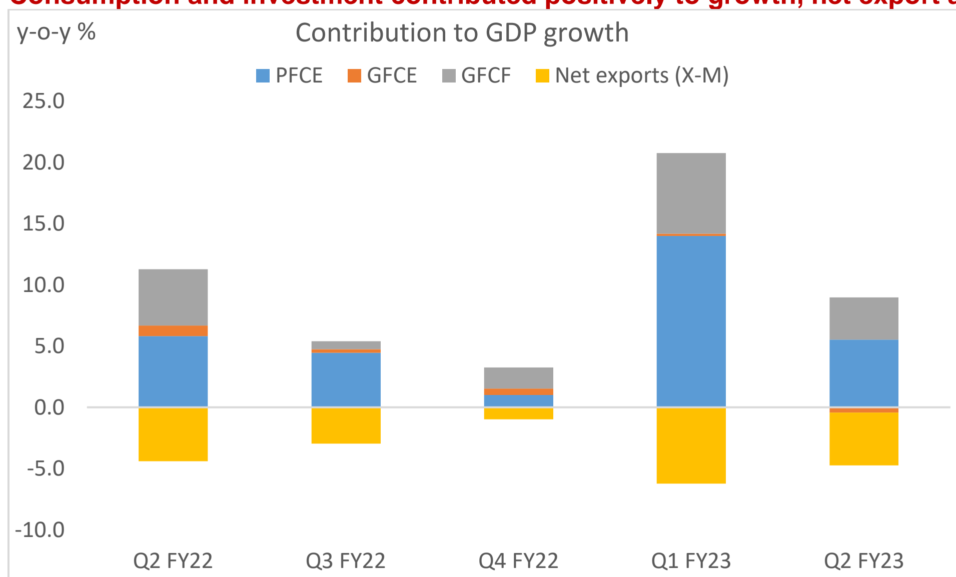
Net export drags growth; uneven recovery in domestic demand

- Private final consumption expenditure (PFCE) increased 9.7% in the second quarter compared with 25.9% in the previous quarter. It continued to contribute positively to growth (see chart below).
    - PFCE growth reflected uneven demand conditions. However, the catch-up of contact-based services to pre-pandemic levels contributed positively, especially in the case of urban demand
    - Demand, though, grew faster for higher-value items (like passenger vehicles) than lower-ticket items (like consumer non-durables), reflecting unequal nature of income growth
    - Overall demand was supported by relatively accommodative financial conditions, though. Despite bank lending rates rising in response to the Reserve Bank of India's rate hikes, the former was lower than the pre-pandemic five-year average. Also, strong bank credit growth of 19.6% on-year for personal loans supported demand in the second quarter
    - However, high inflation remained a drag on purchasing power, as CPI inflation moderated only slightly

to 7.0% in the second quarter from 7.3% in the first quarter. We believe the poor have been facing higher inflation[1], which seems to have kept demand weak for lower-ticket items. Also, wages remained subdued in rural areas, and had not caught up with inflation

- Fixed investment, as measured by gross fixed capital formation (GFCF), slowed to 10.4% in the second quarter vs. 20.1% in the previous corresponding quarter. This suggests that private sector investment activity was yet to pick up materially, with the Centre driving the capex agenda. Also, while the Centre's capex growth was robust at 42.4% on-year in the second quarter, it was lower than the 57.0% increase in the previous quarter. That said, state capex could accelerate in the second half of this fiscal, thereby supporting overall capex growth
- Meanwhile, the government's consumption spending, as measured by government final consumption expenditure (GFCE), turned *negative* 4.4% on-year in the second quarter vs. 1.3% in the previous quarter, reflecting ebbing of Covid-19-related spending
- Also, real export growth of goods and services slowed sharply to 11.5% in the second quarter from 14.7% in the previous quarter. Exports slowed considerably to major destinations – the US and the EU – as tightening financial conditions weighed on growth of these economies. In contrast, imports were strong at 25.7% in the second quarter (although lower than 37.2% in the first quarter) on relatively resilient domestic demand. Taken together, net exports continued to subtract from overall GDP growth
- Share in GDP expanded materially for PFCE (58.4% in the second quarter of fiscal 2023 vs. 56.6% in the second quarter of fiscal 2022) and imports (31.9% vs. 27%), while it fell for GFCE (8.8% vs. 9.8%), and was stable for GFCF (34.6% vs. 33.4%) and exports (23.3% vs. 22.2%)
- Nominal GDP was much higher at 16.2% in the second quarter compared with real GDP. Also, while the GDP deflator moderated to 9.3% on-year in the second quarter from 11.6% in the previous quarter, it was higher than the pre-pandemic level (0.2% in the second quarter of fiscal 2020)

Consumption and investment contributed positively to growth, net export a drag



Source: NSO, CEIC, CRISIL

[1] Refer to CRISIL's latest First Cut on inflation

Outlook

The second quarter fiscal 2023 data reflected how global slowdown had begun to spill over to the Indian economy. Long-term growth movements suggest that despite diverging now, India's growth cycles have been remarkably synchronised with that of advanced economies since the 2000s. Major developed economies are expected to fall into a shallow recession by next year. S&P Global expects US GDP to swerve from a growth of 1.8% in 2022 to *negative* 0.1% in 2023, and the EU from 3.3% to 0%. This will weaken the export prospects for India, thereby weighing on domestic industrial activity.

And while domestic demand has stayed relatively resilient so far, it would be tested next year by weakening industrial activity. It will feel the pressure from increasing transmission of interest rate hikes to consumers as well, and as the catch-up in contact-based services fades.

Also, rural income prospects remain dependent on the vagaries of the weather. Therefore, increasing frequency of extreme weather events remain a key monitorable. While lowering demand for Mahatma Gandhi National Rural Employment Guarantee Act jobs is an encouraging sign for the rural economy from a job perspective, depressed wages are a matter of concern for rural demand.

Because of these factors, CRISIL projects GDP growth to slow to 6% in fiscal 2024 from 7% in fiscal 2023, with risks to the downside.

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