Economic Analysis

Indian economy picks up steam – Q2 GDP rebounds to a nine quarter high

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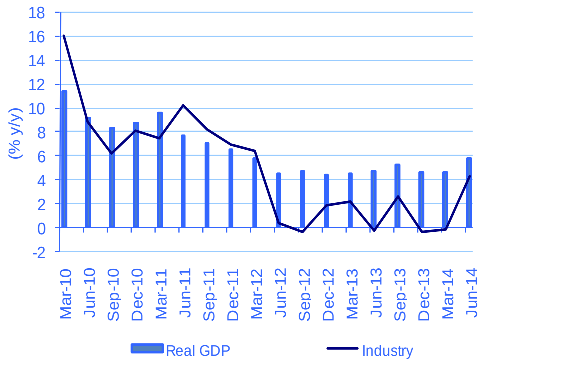
Having suffered two straight years of sub-5% y/y GDP growth, the Indian economy picked up steam last quarter, thus providing a shot in arm to the new Modi Government which took office last May. Q2 GDP growth rebounded to 5.7% y/y (Consensus: 5.5%, BBVA: 5.0%) from 4.6% in Q1, led by a sharp recovery in industrial growth and gradual improvement in services. On the expenditure side, rising investment demand, higher exports and fiscal expansion offset continued weakness in private consumption. Key factors abetting India's economic recovery in Q2 include election led spending, an upbeat business sentiment boosted by a favorable election outcome, improving global growth and currency stability.

Looking ahead, the new government's commitment to reforms, speedier project clearances, facilitating project completion, moderating inflation and a favorable external demand outlook should support continued improvement in activity. Furthermore, a seasonal pick up in consumption demand is likely ahead of the festive season. However, a late pick up in monsoon rains along with fiscal consolidation efforts could drag on sequential growth momentum. Nevertheless, the latest GDP reading places India's full year growth on a firmer footing than previously anticipated and poses upward bias to our 2014 and 2015 GDP growth forecast of 5.2% y/y and 5.7% y/y respectively, inching closer to India's current potential GDP growth rate of 6.2% y/y (BBVA est.)

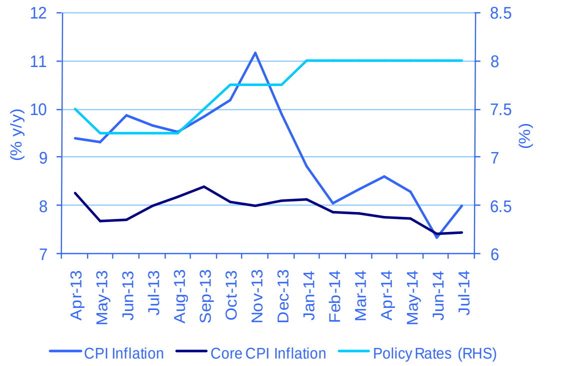
Maintain expectations of a 25 bps interest rate cut in 4Q14: While we expect RBI to hold interest rates unchanged at 8.0% in its next policy meeting on September 30th, our base case for a token 25 bps rate cut in Q4 remains intact unless exogenous factors such as geopolitical concerns or a global risk-off scenario triggered by renewed QE tapering concerns keeps RBI on an extended pause. The risk of a weak monsoon has receded meaningfully, global commodity prices have softened, the current account deficit is under control and the new government is taking proactive steps to stem supply side issues on the food inflation front. We believe that an interest rate cut would serve largely as a signal rather than a precondition to revive India's still sluggish growth. Effective government action in building infrastructure capacity and enhancing energy security is critical for sustaining India's medium to long term growth prospects.

Figure 1
India's Q2 GDP rebounded led by Industry



Source: RBI, BBVA Research

Figure 2
RBI has held interest rates high to tame inflation



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