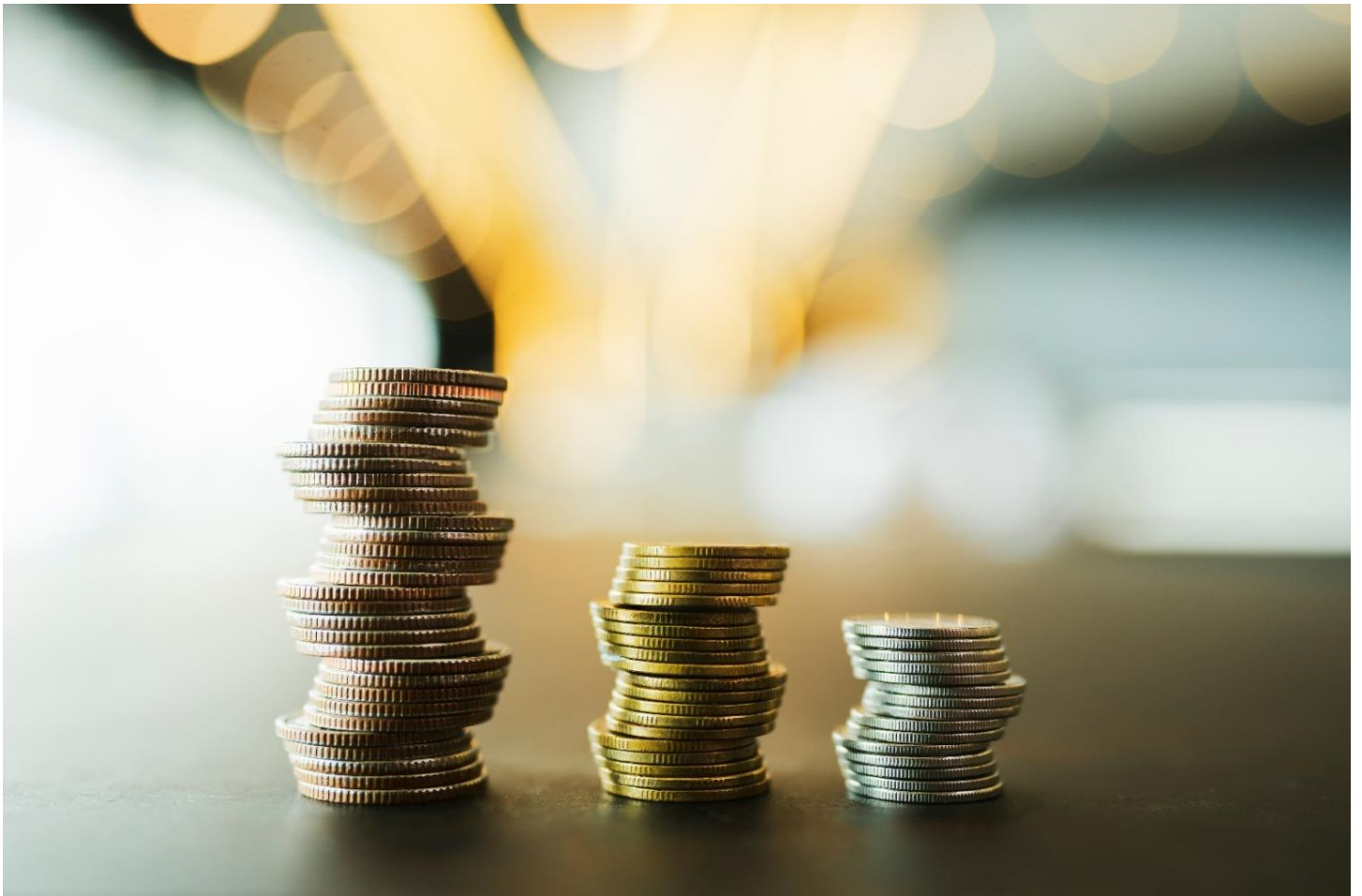


Why growth is moving to trend

After the pandemic swings

CRISIL Insight

December 2024



Snapshot

- In the aftermath of Covid-19, prices, subsidies and taxes fluctuated from normal levels, which spawned volatility in net product taxes and the GDP deflator (used in GDP computation), leading to abnormal swings in GDP growth. With pandemic disruptions normalising and GDP moving closer to its trend growth, the impact of these technical factors is returning to normal
- Last fiscal, net product taxes surged to a 14-year high, widening the gap between GDP and gross value added (GVA) growth. Additionally, the GDP deflator dropped sharply, which boosted real growth further. In this fiscal so far, net product taxes have been slowing over a high base. This, in turn, is pushing GDP growth closer to that of GVA. On the other hand, the GDP deflator is rising from the abnormally low levels of last year, which is pulling down real GDP growth
- The upshot is that the drag from technical factors, and the impact of high interest rates and fiscal consolidation will contribute to slower GDP growth this fiscal

India's gross domestic product (GDP) growth surprised on the upside post the pandemic but also fluctuated significantly. Different economic segments have recovered at different speeds. The fiscal policy focus of the government on infrastructure spending led to higher multiplier effects for the economy. The healthy balance sheets of corporates and banks and healthy external markets added to India's resilience.

That said, some technical factors such as net product taxes and the GDP deflator also disrupted the GDP's trajectory. Their movements have been large and volatile due to factors such as an abnormal surge in government spending and swings in commodity prices. This contributed to the GDP growth surging to 8.2% last fiscal and widened the wedge between GDP and GVA growth.

The current fiscal is seeing a normalisation of these technical factors with the impact of pandemic shocks receding. This is contributing to slower GDP growth.

To be sure, high interest rates, persistent and fiscal consolidation contributed to slower GDP growth this fiscal so far.

Yet the main macro drivers remain healthy. Private consumption growth has fared better than last year in the first half of the current fiscal. While investment growth has moderated relative to last year, its share of GDP remains higher than the pre-pandemic decade.

With normalisation of the abovementioned technical factors, GDP growth is likely to move closer to trend growth of 6.5-7%.

We explain the movement in these technical factors, along with their impact on GDP growth, in this insight.

External shocks caused technical factors to turn volatile in the past few years

- Net product taxes were significantly weighed down by a surge in subsidies during the pandemic and boosted by their phase-out thereafter. This caused abnormal divergence between GDP and gross value added (GVA) growth. Last fiscal, GDP grew 100 basis points stronger than GVA due to high net-tax growth
- The GDP deflator, which in turn, is influenced by volatile WPI, surged during the Russia-Ukraine conflict in 2022, but fell sharply in fiscal 2024

Normalisation in technical factors have weighed on GDP growth this fiscal

- Net tax growth is slowing on a high base this fiscal. This is narrowing the gap between GDP and GVA growth. GDP has been slowing more than GVA growth in the current fiscal so far, opposite to last year
- The GDP deflator is picking up again from its abnormally low level of last fiscal. In particular, the manufacturing deflator has risen sharply relative to last year in the first half of this fiscal. This, among other factors, has been weighing on manufacturing GVA

Chart 1: Net tax slowed sharply in Q2

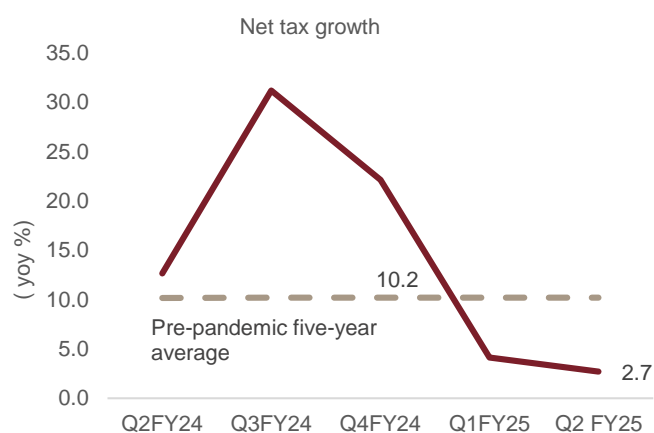
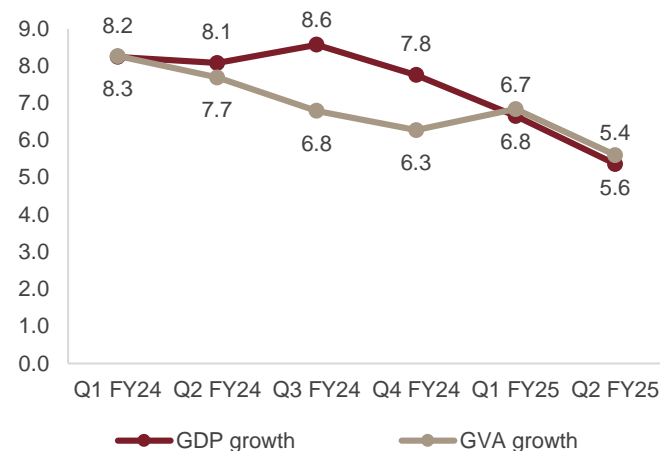


Chart 2: GDP-GVA-growth gap normalising after correction in net tax growth



Source: National Statistical Office (NSO), CEIC, CRISIL

Link between GDP and technical factors

Demand-side GDP = Private consumption + government consumption + fixed investment + exports – imports

Supply-side GVA = Agriculture + industry + services

GDP = GVA + net product taxes

Net product taxes = Product taxes - product subsidies

Where the GDP deflator comes in, as:

$$Real\ GDP = \frac{Nominal\ GDP}{GDP\ deflator} * 100$$

More details on these concepts, including how they are measured in India, are in the annexure.

Impact of technical factors on GDP growth this fiscal

Net taxes slowing over a high base

- Net product taxes have been slowing this fiscal. Its growth averaged 3.3% in the first half, compared with 10.5% in the corresponding period last fiscal

- Net taxes contributed 25 basis points (bps) to GDP growth in the first half of the current fiscal year, lower than 77 bps in corresponding period last year
- The sharp slowdown is partly due to a high base, as net taxes had grown 19.1% last fiscal (*for reasons, refer to 'Why did technical factors move abnormally?'*)
- The high-base effect will be more pronounced in the second half of this fiscal, as net tax growth rate was the highest in the second half last year
- Overall, lower net tax growth is narrowing the gap between GDP and GVA growth this fiscal, after abnormal divergence last year. GDP is seeing a sharper slowdown because of lesser push from net taxes

Deflator rising with rising WPI inflation:

- The GDP deflator rose to 2.7% on-year in the first half of this fiscal, compared with 0.8% in the corresponding period last year
- The rising GDP deflator is contributing to lower real GDP growth this fiscal (*refer to box on Page 3 and the annexure for details on the concept*)
- The manufacturing GDP deflator turned positive this fiscal from negative last year, contributing to a fall in manufacturing GVA growth
- The GDP deflator is rising primarily due to ascending WPI inflation — 2.1% in the first half versus -1.7% in the corresponding period last year. (*We have covered the impact of WPI and CPI on GDP deflator in the annexure*)
- WPI inflation has been normalising, following the large swings in the past three fiscals (*see chart 8*). The last fiscal saw an abnormal decline in WPI inflation to -0.7%. This fiscal WPI inflation has averaged 2.7%, closer to pre-pandemic 5-year average of 3.2%

Chart 3: GDP deflator is normalising this fiscal

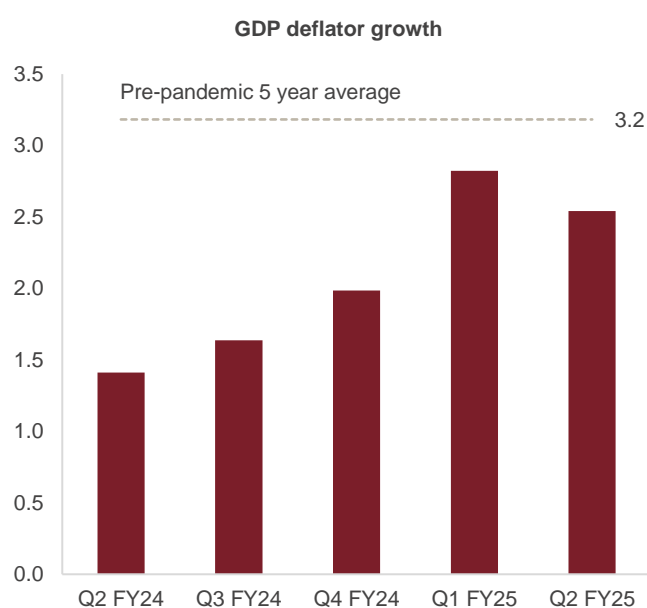
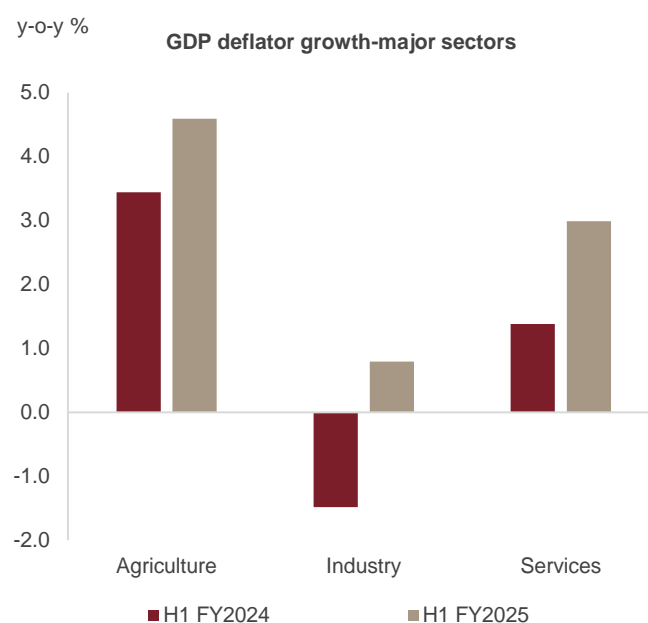


Chart 4: Industry deflator rising the most



Note: Industry-wise deflators are derived by using nominal and real GVA values for the given sector

Source: NSO, CEIC, CRISIL

Why did technical factors move abnormally?

There are a couple of reasons why these technicals have distorted the way the GDP and GVA move.

- After the pandemic began, net product taxes were hit by a surge in subsidies (see chart 6). Net product taxes contracted 22.4% on-year in fiscal 2021 because of a 12.3% decline in taxes and a 39% increase in subsidies (in real terms)
- As the subsidies were phased out and taxes rose with the economic rebound, net tax growth increased — so much so, it grew 19.1% last fiscal, the highest in 14 years
- The GDP deflator (chart 7) has largely mirrored the trend in WPI inflation in fiscal 2022 (13%), fiscal 2023 (9.4%) and fiscal 2024 (-0.7%) (chart 8). Fiscal 2023 saw multiple blows from pandemic-induced supply disruptions and geopolitical uncertainty, rising commodity prices, which heavily influenced the WPI. The effects of these shocks receded in fiscal 2024, significantly reducing commodity prices that year

Because of external shocks, the technical factors turned volatile, affecting GDP growth in the past few years.

So, this fiscal's movement in these technicals needs to be seen as a normalisation process.

How they contributed to unusual GDP trends

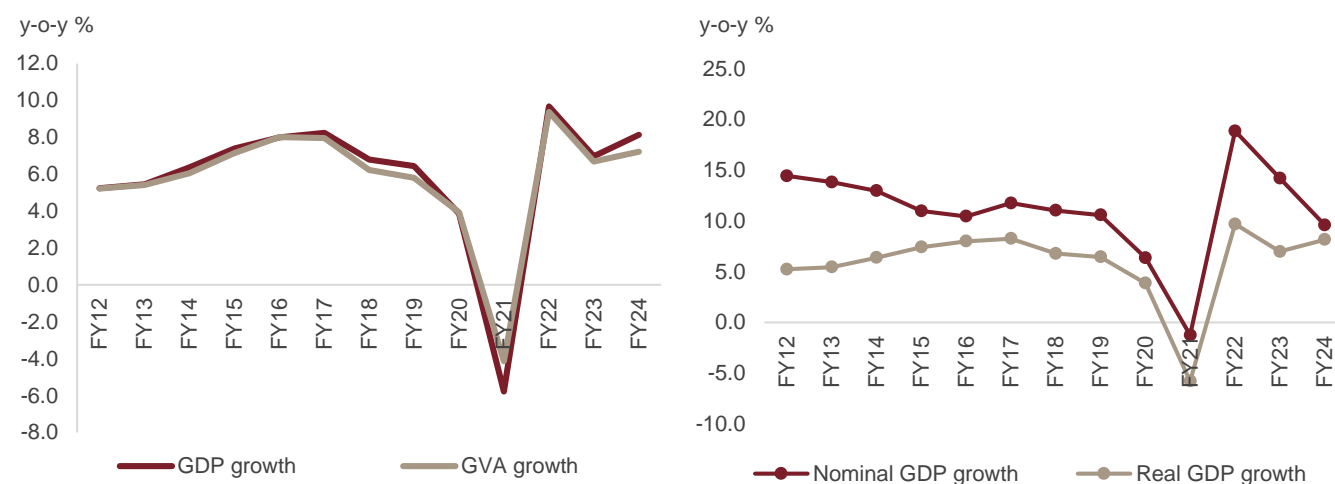
1. GDP and GVA growth diverged in the years after the pandemic

- GDP growth fell below GVA growth in fiscal 2021, the first year after the pandemic. However, in fiscal 2024, GDP grew 100 bps faster than GVA, driven by abnormal rise in net taxes

2. Divergent trends in nominal and real GDP growth

- Real GDP accelerated and nominal GDP slowed in fiscal 2024, due to an abnormally low deflator. The gap between nominal and real GDP has not been uniform due to the volatility in the GDP deflator (chart 5)

Chart 5: Headline GDP variables unaligned in fiscal 2024



Source: NSO, CEIC, CRISIL

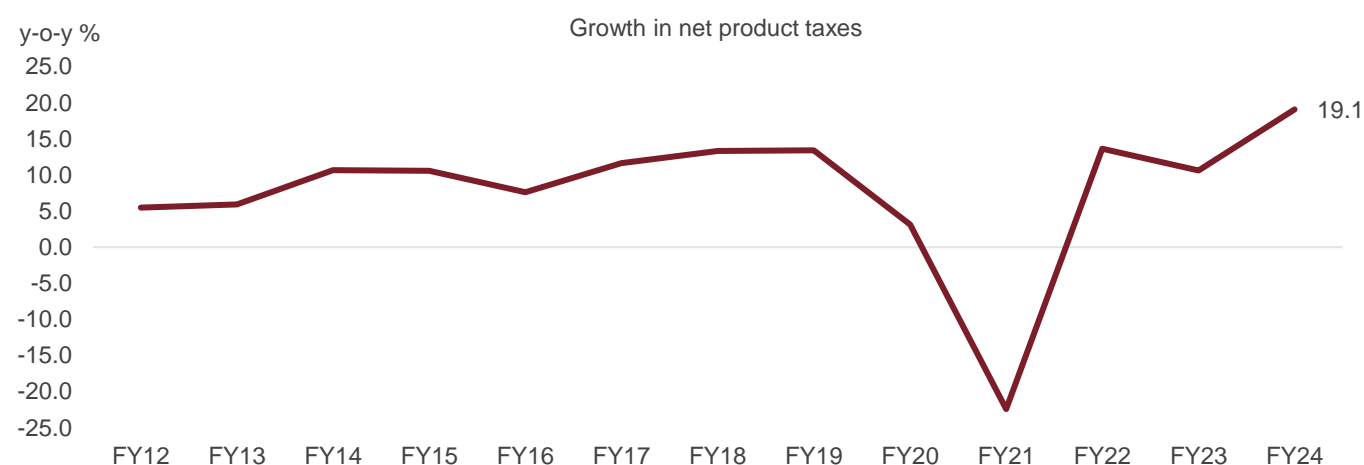
Maximum distortions in fiscal 2024

GDP growth surged to 8.2% in fiscal 2024 from 7% in fiscal 2023, but this was not broad-based. Among the major demand segments, only investment growth improved. Private consumption weakened to 4% from 6.8%. GVA growth was at 7.2% relative to GDP growth of 8.2%.

Net tax growth was at a 14-year high in fiscal 2024

- Net product taxes grew 19.1% in fiscal 2024, the highest in 14 years, accounting for 8.7% of GDP, above the 8.4% average share pre-pandemic (fiscals 2016-2020)
- A sharp decline in subsidies lifted net taxes. Data from the Union Budget shows that Centre's direct indirect taxes¹ grew 7.1%, in nominal terms, while subsidies declined 22.1%
- Food subsidies fell, as the free food programme during the pandemic was rationalised. Additionally, fertiliser subsidy declined significantly, driven by a sharp fall in international prices
- Surging net taxes last fiscal meant GDP grew 100 bps faster than the GVA – the opposite of fiscal 2021

Chart 6: Net taxes growth the fastest in a decade



Source: NSO, CEIC, CRISIL

GDP deflator growth fell to a record low

- GDP deflator growth fell to 1.4% in fiscal 2024 from 6.7% in fiscal 2023, the slowest in the latest GDP series²
- This was also a correction from the abnormally high GDP deflator seen in the previous two fiscals
- This was driven by deflation in the WPI (-0.7% versus 9.4%) as well as falling CPI inflation (5.4% versus 6.7%)
- Manufacturing GVA growth was particularly boosted by a negative deflator for this sector

¹ Indirect taxes include GST, customs, union excise duties and service tax

² On 2011-12 base

Chart 7: GDP deflator abnormally low last fiscal

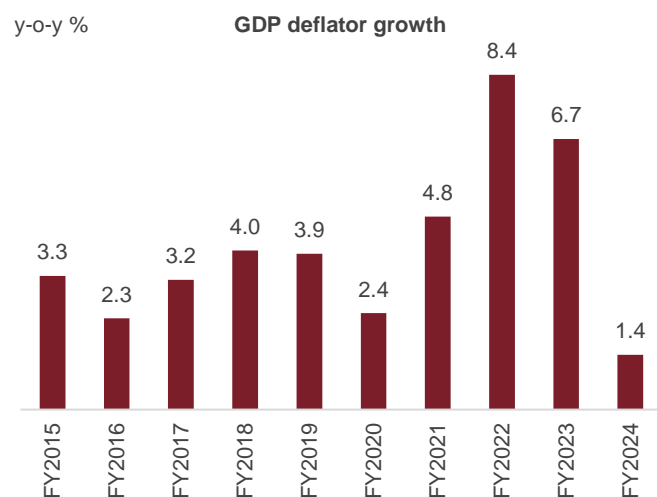
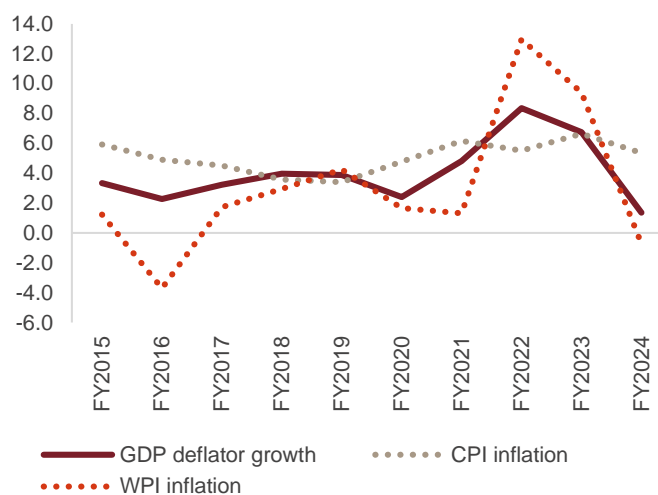


Chart 8: ...influenced by negative WPI inflation



Source: NSO, Office of Economic Advisor, CEIC, CRISIL

The base effect this fiscal

In a nutshell, technical factors contributed to an above-trend GDP growth last year. They are expected to have a moderating effect on GDP growth this current fiscal as they normalize. Additionally, high interest rates and fiscal consolidation will also weigh on GDP growth this year.

GDP growth had averaged 6.6% in the pre-pandemic decade. This fiscal is likely to see GDP growth move closer to trend growth of 6.5-7% with receding statistical shocks.

It is worth noting that the main macro drivers of growth remain healthy. Private consumption grew 6.7% on average in the first half of this fiscal, compared with 4.1% in the corresponding period last year. Its share in GDP at 56.3% this fiscal has been higher than 56.1% in the pre-pandemic decade.

Fixed investment growth at 6.5% in the first half this fiscal has been lower than 10.1% in the corresponding period last year. But it accounted for 34.6% of GDP, higher than 32.1% in pre-pandemic decade.

We expect improving consumption demand to drive growth momentum this fiscal, in contrast to it lagging behind last year. In particular, agriculture and rural demand are poised to improve after a healthy monsoon.

This means growth will be more balanced this fiscal, even if it is lower than last year.

Annexure

Understanding the concept and measurement of GDP technical factors

1. What are net taxes?

Taxes on goods and services are captured in GDP as a separate variable, from which subsidies on goods and services are subtracted to arrive at the net product tax.

Net product tax is the difference between demand and supply-side GDP numbers. These are two different approaches for measuring GDP. GDP from the supply side measures the value of goods and services produced in the economy, while GDP from the demand side measures the value of goods and services consumed.

Net product taxes include goods and services tax, excise duty, customs duty and sales tax by the Centre and states. Product subsidies include food, petroleum and fertiliser subsidies.

Where do discrepancies come in?

Theoretically, GVA + net product taxes should equal the GDP measured from the demand side. However, the measurement of demand-side indicators is less accurate in India, due to insufficient data.

Hence, the discrepancy variable is given as a difference between the demand- and supply-side GDP measures.

Discrepancy has not followed any systematic trend. It turned negative in the second quarter of fiscal 2025 at -1.6% of GDP. It added to GDP growth last fiscal but were negative for growth in fiscal 2023. Yet, it was lower than the past decadal average.

Discrepancies remain unpredictable, leading to unexpected movements at any point of the fiscal.

2. What is the GDP deflator?

GDP deflator is used to convert nominal GDP to real.

Since GDP measures the *value* of goods and services, it is a nominal variable. However, economists typically focus on GDP growth in *real* terms, which excludes the impact of inflation.

$$Real\ GDP = \frac{Nominal\ GDP}{GDP\ deflator} * 100$$

GDP deflator reflects the price movements in the economy. The higher the deflator, the lower the real GDP for a given nominal GDP.

3. How is the GDP deflator measured?

GDP deflator is based on the prices paid by producers and consumers. Each segment of nominal GDP is deflated using prices relevant for that segment. For instance, manufacturing GVA is deflated using manufacturing sector wholesale prices, while private consumption is deflated using consumer prices.

In India, WPI and CPI are used at the sectoral level as deflators.

GVA should ideally undergo '**double deflation**', where the value of output is deflated using the respective output price, while that of inputs is deflated using input prices.

A more simplistic measure is '**single deflation**', wherein GVA is deflated using only one price index. Typically, GVA is deflated using the output price index for a given sector. In India, a single deflation measure is followed for most GDP components, except agriculture, which is measured using double deflation. Lack of detailed price data has limited the NSO from using double deflation.

Why has the deflator been a contentious issue in recent times?

- a) **Choice of the deflation method:** The NSO uses varying deflation methods for GDP segments. While double deflation³ is used for agriculture, single deflation is used for most segments of industry and services. For some sectors, such as electricity and transport services, volume measures are taken directly as real GVA⁴.
- b) **Imperfect price measures:** Deflator for a given segment is based either on WPI or CPI. While the majority of sectors have specific WPI or CPI, certain others, such as hotels, do not have one. Moreover, wholesale prices do not completely capture the prices faced by producers. A producer price index is needed to fully capture the prices faced by producers for their inputs and output, which are mandated by the government as a prerequisite for adopting double deflation⁵.
- c) **Abnormal movements during bouts of volatility:** Abnormal movements in the GDP deflator during some periods in the past decade caused confusion around its trends. For instance, real GDP accelerated in fiscal 2024, but nominal GDP slowed.

The overall GDP deflator reflects a combination of WPI and CPI inflation. Abnormal movements in either of the two lead to unusual movements in the deflator. The divergence between the two has also led to confounding movements in the deflator.

- d) **Basket of WPI and CPI needs to be updated:** The WPI and CPI indices used currently are on 2011-12 base. More than a decade on, the usage of different goods and services has likely changed in the economy. Hence the weights of these commodities in WPI and CPI should also change based on their usage in the economy. New WPI-CPI indices on recent base year is needed to reassess importance of different commodities. This may help check the abnormal movements in GDP deflator as well.

³ Refer to annexure for definition

⁴ NSO (2015). *Methodology and data sources in the new series of national accounts, base year 2011-12*

⁵ <https://pib.gov.in/Pressreleaseshare.aspx?PRID=1573808>

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