Q1 FY26 GDP Surges to 7.8%; Outlook Shrouded with External Headwinds

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- Real GDP rose by a five-quarter high of 7.8% YoY in Q1 FY26 up from the 7.4% growth observed in Q4 FY25 with the key factor supporting growth being a lower deflater due to moderation in inflation.
- The economic growth was supported by front-loaded government spending. Private consumption also recovered, likely supported by sustained rural demand and a moderate recovery in urban demand. Meanwhile, the external sector was a drag on the growth.
- From the supply side of the economy, real GVA grew by a six-quarter high of 7.6% vs 6.8% in Q4 FY25.
- Activity was supported by a resilient services sector and still healthy agriculture performance despite some moderation likely due to non-farm activity. The industrial activity was mixed with recovery in manufacturing being offset by slowdown in construction, mining and electricity.
- Given the larger-than-expected Q1 print, we see some upside to our FY26 real GDP projection of 6.2%. Consumption demand for the remainder of the year is expected to draw support from the proposed rationalisation of GST rates, previously announced income tax cuts, lower inflation and the resulting support for real income, and continued pass-through of policy rate cuts.
- However, the imposition of 50% US tariffs on India is expected to weigh on economic growth. We see a potential of ~25–35 bps direct impact on India's GDP in FY26 (assuming a partial rollback of tariffs in Q4).
- Further, a potential slowdown in government fiscal spending in the rest of FY26, both to preserve fiscal discipline and to offset revenue pressures from weaker tax collections will also pose a risk to economic momentum.
- A positive Q1 surprise does reduce the possibility of a policy rate cut in Q3 FY26; however, it is still not off the table given the escalated external headwinds. In the near-term, we could see targeted support from the RBI/Government for the sectors adversely impacted by the US tariffs.

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Real GDP Rose by a Five-Quarter High of 7.8% Surpassing the Market Expectations

Real GDP rose by a five-quarter high of 7.8% YoY in the first quarter of the current financial year (Q1 FY26), up from the 7.4% growth observed in Q4 FY25. This is higher than the market consensus of 6.7% and our estimate of 6.5%. A key factor boosting the real growth rate was the lower deflator due to moderation in WPI and CPI in Q1 FY26, as GDP/GVA is first computed on nominal prices and then scaled down basis these deflators. Indeed, the nominal GDP growth slowed down to 8.8% from 10.8% in Q4 FY25. The economic growth in Q1 was supported by a front-loaded government capital spending. Private consumption also recovered likely supported by sustained rural demand and a moderate recovery in urban demand. Meanwhile, the external sector was a drag on the growth.

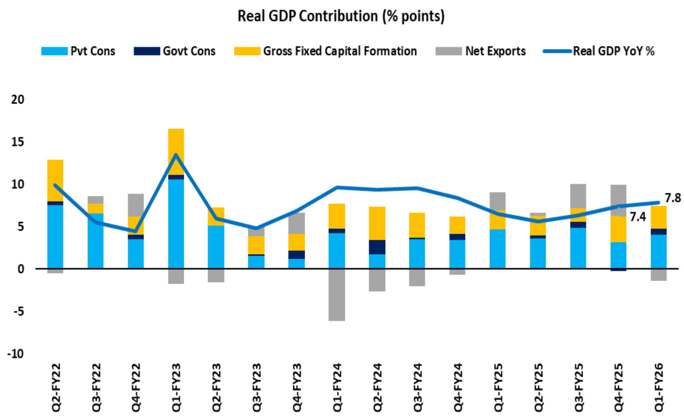
From the supply side of the economy, the real GVA growth came in at 7.6% in Q1 FY26 up from 6.8% in Q4 FY25. Activity was supported by a resilient services sector and still healthy agriculture performance despite some moderation. The industrial activity was mixed with recovery in manufacturing being offset by slowdown in construction, mining and electricity.

Economic Growth & Monetary Policy Outlook

In light of the Q1 surprise, we see some upside to our FY26 real GDP projection of 6.2%. The consumption demand is expected to get support from proposed rationalisation of GST rates, previously announced income tax cuts, lower inflation and the resulting support for real income, and continued pass-through of policy rate cuts. This could, in turn, encourage selective private investment (which has been subdued hitherto) in domestic demand-oriented sectors. Having said that, significant external headwinds remain in place. The recent imposition of an additional 25% tariff by the US, on top of the previously announced 25%, poses headwinds. Further, the pace of fiscal spending is expected to moderate in the coming quarters, both to preserve fiscal discipline and to offset revenue pressures from weaker tax collections and planned GST cuts.

A stronger-than-expected GDP print reduces the possibility of a policy rate cut in Q3 FY26, however it is still not off the table given the escalated external headwinds. Meanwhile, in the near term we could see targeted policy support from the RBI/Government for the sectors adversely impacted by the US tariff policy. More broadly, as long as inflation remains under control, the central bank is well-positioned to step in and cushion the economy against such negative shocks.

Real GDP Growth was Led by Private Consumption, Investment and Government Spending while the External Sector Exerted a Drag



Source: MOSPI, CMIE

Private consumption growth improved to 7.0% in Q1 FY26 vs 6.0% in Q4 FY25 and contributed ~4 percentage points (pp) to the real GDP growth. This was likely led by the sustained momentum in rural demand reflected in strong FMCG sales volume, and improvement in two-wheeler registrations. Higher rabi season production likely supported rural incomes and consumption in Q1. In contrast, urban demand showed signs of uneven recovery constrained by the subdued real wage growth. While the FMCG sales volumes showed moderate gains, proxies of discretionary spending such as vehicle registrations, air passenger traffic etc. slowed further. Looking ahead, rural demand is expected to continue to lead recovery due to a favourable farm sector outlook. We also expect a moderate pick-up in urban demand supported by a gradual pick-up in wages, lower inflation, income-tax cuts (announced in the Budget) and planned GST rationalisation.

Investment (Gross Fixed Capital Formation) spending rose by 7.8% in Q1, moderating slightly from 9.4% in the previous quarter. To reiterate from our Monthly Monitor, the government spending continued to anchor the investment cycle in Q1, with strong front-loading of capex providing the primary support to overall fixed capital formation as private sector investment likely remained subdued. Central capital spending grew by 52% YoY in Q1 FY26 (vs 33% in Q4 FY25), while State capital expenditure rose by 22% (vs 14.9% in Q4 (based on 18 states). For the outlook, private sector investment will likely remain tentative in the face of elevated global uncertainties, weaker external demand, and uneven domestic consumption growth. As per CMIE data, new project announcements showed a recovery in Q1, but it was primarily on a low base of last year. Meanwhile, with government front-loading the spending, the fiscal space for the remainder of the year looks constrained especially amidst the weaker tax collections and now proposed GST rationalisation. Therefore, we could see moderation in the pace of investment activity.

Government final consumption expenditure accelerated sharply by 7.4% from a contraction of 1.8% in the previous quarter and contributed ~0.7 pp to the real GDP growth. This was reflected in the central government revenue expenditure (excluding interest and subsidies) rising by 9.8% YoY vs 1% in Q4 FY25. Based on the budget estimates, the centre's revenue expenditure (excluding subsidies and interest) is estimated to rise at a more moderate pace of ~4.7% in the remainder of the year (Aug-Mar).

India's GDP Estimates at a Constant Price

(GDP Constant Prices)	% YoY					
	Q1-FY25	Q2-FY25	Q3-FY25	Q4-FY25	FY25	Q1-FY26
Private Consumption	**8.3**	**6.4**	**8.1**	**6.0**	**7.2**	**7.0**
Government Consumption	**-0.3**	**4.3**	**9.3**	**-1.8**	**2.3**	**7.4**
Gross Capital Formation	**6.2**	**7.7**	**4.9**	**7.8**	**6.7**	**7.3**
Gross Fixed Capital Formation	6.7	6.7	5.2	9.4	7.1	7.8
Exports	8.3	3.0	10.8	3.9	6.3	6.3
Less Imports	-1.6	1.0	-2.1	-12.7	-3.7	10.9
Real GDP	**6.5**	**5.6**	**6.4**	**7.4**	**6.5**	**7.8**
Real GDP Excluding Govt Exp	**7.3**	**5.7**	**6.1**	**8.5**	**6.9**	**7.8**

Source: MOSPI, CMIE

On the external sector, the net external trade was a drag on GDP growth and shaved off 1.4 pp from the real GDP growth as the growth in imports (10.9%) outpaced the growth in exports (6.3%), despite front-loading of shipments to the US. The tensions in external trade have amplified with India now facing a 50% US tariff, significantly higher than for peer economies. In our baseline scenario this could mean a potential 25-35 bps direct impact on India's GDP growth (assuming a partial rollback of tariffs in Q4). We expect targeted policy measures to be announced to support the negatively impacted sectors such as textiles, gems & jewellery etc.

Real GVA Grew by a Six-Quarter High of 7.6% YoY in Q1

On the production side of the economy, real GVA in Q1 FY26 grew by 7.6% YoY up from 6.8% in Q4 FY25 and 6.5% in the corresponding quarter of the previous year. This strong outturn was underpinned by a robust expansion in the services sector, recovery in manufacturing and healthy growth in agriculture.

Activity in the services sector rose by 9.3% YoY, higher than the 7.3% in Q4 FY25 and was the primary driver of the real GVA growth. Within the services sector, the growth was mostly broad-based. Financial, real estate, and professional services growth improved further to an eight-quarter high of 9.5% likely supported by robust real estate. Growth in the 'trade, hotels, transport, and communication' segment outpaced the previous quarter partly supported by a supportive base effect. Growth in public administration, defence, and other services grew by 9.8% supported by the government's increased revenue expenditure (excluding interest and subsidy payment). The services sector is showing resilience, with its PMI indicator rising to an 11-month high of 60.5 in July, however the moderation in global growth and elevated uncertainty could weigh on the sector.

India's GVA Estimates at a Constant Price

(GVA Constant Prices)	% YoY					
	Q1-FY25	Q2-FY25	Q3-FY25	Q4-FY25	FY25	Q1-FY26
Agriculture, Forestry & Fishing	**1.5**	**4.1**	**6.6**	**5.4**	**4.6**	**3.7**
Industry	**8.5**	**3.8**	**4.8**	**6.5**	**5.9**	**6.3**
Mining & Quarrying	6.6	-0.4	1.3	2.5	2.7	-3.1
Manufacturing	7.6	2.2	3.6	4.8	4.5	7.7
Electricity and Other Utility Services	10.2	3.0	5.1	5.4	5.9	0.5
Construction	10.1	8.4	7.9	10.8	9.4	7.6
Services	**6.8**	**7.2**	**7.4**	**7.3**	**7.2**	**9.3**
Trade, Hotels, Transport, Communication etc	5.4	6.1	6.7	6.0	6.1	8.6
Financial, Real Estate & Professional Services	6.6	7.2	7.1	7.8	7.2	9.5
Public Administration, Defence and Other Services	9.0	8.9	8.9	8.7	8.9	9.8
Gross Value Added (at Basic Price)	**6.5**	**5.8**	**6.5**	**6.8**	**6.4**	**7.6**
Core GVA	**7.1**	**5.6**	**6.0**	**6.7**	**6.4**	**8.0**

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

Industrial sector activity moderated with real GVA growing by 6.3% in Q1, down from 6.5% in Q4 FY25, led by a contraction in mining and slowdown in construction and electricity, partly due to the monsoon related disruptions, offsetting the improvement in manufacturing real GVA. The slowdown in construction is slightly puzzling with the strong government capital expenditure and robust growth in steel and cement industry and hence we could see some correction in future.

Manufacturing staged a handsome recovery with its real GVA growing by a five-quarter high of 7.7% (vs 4.8% in Q4 FY25) supported by improved profit growth in nominal terms and lower deflator. Based on the RBI's performance data for private sector listed companies, net profit of manufacturing companies grew by 27.7%, higher than 24.9% in the previous quarter. This is due to lower input costs as the topline performance remains weak with single-digit growth in revenues. Nonetheless, the improvement in manufacturing is surprising given the weakness seen in other high frequency indicators such as IIP manufacturing growth slowing to a three-quarter low of 3.4%. Looking ahead, industrial momentum may recover marginally in the near term as seasonal drags on mining and electricity begin to fade, but manufacturing could face pressure due to increased US tariffs.

The agriculture sector registered a healthy growth despite some moderation in its real GVA to 3.7% from 5.4% in Q4 FY25. This moderation could be reflective of some weakness in non-farm sector as in our opinion, the farm sector continued to remain healthy supported by strong rabi production and robust kharif sowing (tracking 3.7% YoY by mid-August) performance. Prospects for the upcoming rabi season (winter crops) are also positive, underpinned by healthy reservoir levels. Overall, agriculture is expected to provide stability to the growth momentum in FY26, supporting rural consumption demand.

Overall, while the Q1 print brings a positive surprise, the headwind to economic growth remains in the form of escalated trade tensions. Accordingly, there could be additional policy support needed especially for sectors expected to be adversely impacted by US tariffs.

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