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INDIAN ECONOMY

CRISIL Insights

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Through the monthly CRISIL Insights Indian Economy series, we offer incisive analysis of macroeconomic parameters of the country. In this issue, we focus on the short-term implications of GST on inflation.

GST and the bogey of inflation

The Modi government's biggest victory so far in economic reforms is – the passage of the goods and service tax (GST). Preparations are on in full swing for the July 1 rollout of GST, the most fundamental and far-reaching indirect tax reform in decades. Though not in its ideal form, GST can usher in significant benefits, especially through a quantum leap in transaction trails and logistical efficiencies.

A four-tier tax rate structure – 5%, 12%, 18% and 28% – has been finalised, with essential items of daily use attracting the lowest rate and demerit/temptation goods, the highest. Luxury and demerit goods, such as luxury automobiles and tobacco, attract additional cess above the peak rate. Most mass-consumption goods will be taxed at a lower rate, and several essential food commodities have been exempted. A few petroleum products and alcohol are also out of GST's ambit.

From a macroeconomic perspective, the long-term impact of GST will be positively felt on efficiency improvement, widening of the tax base leading to improved tax collections and fiscal health. It may lower inflation in categories where efficiency gains push productivity higher and costs lower. Specifically, GST could usher in significant efficiencies and benefits in the transportation and logistics chains. Cost will reduce for manufacturers, though it will increase for the services sector. In addition, GST will help narrow the gap between unorganised and organised firms, as input sourcing from compliant firms will be needed for tax setoff.

In the short term, however, there could be disruptions and likely loss of revenue for some firms as businesses transition to the new system. Small- and medium-sized firms could face initial hiccups in terms of getting onto the GST network, readying IT systems, and understanding the effective tax incidence on their businesses. Also, lower thresholds imply that a manufacturer, service provider, or retailer who earlier did not face a tax levy, will now enter the GST net. This could push up costs. However, the big picture is favourable over the longer term as a GST environment facilitates ease of doing business or starting business for smaller firms, who typically find tax laws daunting. Similarly, logistics cost is expected to go down.

In a nutshell, GST rollout will be a watershed event. While short-term hiccups cannot be ruled out, the efficiency gains will, over time, accrue across sectors, and the fiscal gains, as the net widens, will ensure the economy is a net gainer.

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Monetary Policy	Industrial Production	Inflation
Monetary policy stance stays, tone eases	Slow and volatile beginning for IIP	Inflation plummets on food; core stays sticky

MONETARY POLICY

- The Monetary Policy Committee (MPC), in its review on June 7, announced no policy rate change, continuation of its neutral monetary policy stance, but significantly softened its tone on inflation. Five out of six members were in favour of the monetary policy decision
- The MPC's fiscal 2018 forecasts on gross value added (GVA) growth and consumer price inflation (CPI) were both lowered. GVA growth was mildly reduced to 7.3% (down 10 basis points, bps) but the inflation forecast was brought sharply down to ~3.5% (from 4.8% average)
- Liquidity conditions in May somewhat eased as currency in circulation ramped up
- Meanwhile, bank credit growth stayed in the lull, recording 5.2% growth as of May 12, while retail credit growth surged
- This fiscal, CRISIL Research expects the banking credit to grow at 8-10% supported by an improvement in economic growth and domestic demand, while deposit growth will hover around 10-12%

INDUSTRIAL PRODUCTION

- The Index of Industrial Production (IIP) grew by 3.1% on-year in April from 3.8% in March
- Even as manufacturing activity recorded a mild upturn in April (growing 2.6% compared with 2.4% in March), it was the sharp slowdown in mining sector growth and moderation in the growth of electricity sector that pulled the overall IIP growth down
- Manufacturing sector – the largest segment of IIP with a weightage of 77.6% – displayed marginally higher positive growth
- While the new category of IIP – infrastructure and construction goods – displayed a surge in growth in April to 5.8% from 0.9% in March, capital goods growth shrunk to -1.3% from 9.6%, reaffirming the volatile nature of this category

INFLATION

- CPI-based inflation in May slipped to a record low of 2.2%, as food inflation dipped into the negative zone to record -1.1%. Meanwhile, wholesale price inflation dipped for the third straight month to record 2.2%, down from 3.9%
- Fuel inflation eased further in May as global crude oil prices stayed benign and rupee gained some strength. Fuel inflation, measured by adding petrol, diesel, fuel and light components, slowed to 6.2% in May, from 7.1% in April
- Core CPI inflation somewhat moderated but stayed stubborn in sectors such as housing and education. Core inflation (CPI excluding food, fuel and light, petrol and diesel) eased slightly to 4.1% in May, from 4.2% in April, led by lower inflation in health, personal care and effects, transport and communications segments and some pick-up in inflation in recreation and amusement segment
- We expect food inflation to stay low this fiscal, which should keep a tab on overall inflation. Our inflation forecast now stands at 4% for fiscal 2018, down from 4.5% in fiscal 2017

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Interest rate	Rupee	Trade
Yields soften on rate-cut expectations	Rupee rally loses steam	Trade deficit spikes as imports surge

INTEREST RATE

- Yield on the 10-year government security (G-sec) ended May at 6.66%, down 30 bps on-month, while yield on the 1-year G-sec remained sturdy, rising 5 bps to 6.53%
- High systemic liquidity and expectations of lower rates post subdued inflation numbers, put downward pressure on yields in May
- Comfortable liquidity, benign inflation outlook and lower net borrowings by the government should keep the yields range bound next fiscal
- CRISIL expects the 10-year G-sec yield to settle ~6.9% by March 2018

RUPEE

- Rupee continued to appreciate vis-à-vis the US dollar, although the magnitude of gain moderated in May
- While foreign inflows and weaker dollar supported the rupee, some gains were eroded by the global sell-off
- Rupee closed the month at 64.5/$, 0.5% weaker on-month. On average, however, the rupee was 0.1% stronger compared with April
- As the dollar remained weak, most currencies, including the euro gained significantly following the French elections
- Rupee can face some pressure this fiscal due to higher imports relative to exports. Imports are expected to rise due to improved domestic consumption and some pick-up in global commodity prices
- CRISIL expects the rupee to settle ~67.5 to the dollar by the end of fiscal 2018

TRADE

- India's merchandise imports continued to rebound strongly in May, but export growth showed signs of fatigue compared with the previous month. The result was a larger than before trade deficit of $13.8 billion - a record high in two-and-a-half years
- While imports have sustained double-digit growth since the start of 2017 after a weak run for three years, they have far outdone exports in all these months. Imports grew 33.1% on-year in May, compared with exports at 8.3%
- Oil fuelled both increases. After falling to a record low in 2016, oil prices recovered significantly, leading to rising export and import value. However, the impact on imports was far greater, as India imports far more oil than it exports
- While non-oil exports decelerated in May, imports stayed robust. That was another contributing factor
- We expect current account deficit to rise moderately to 1.0% of GDP in fiscal 2018 from 0.7% in fiscal 2017

Source: CRISIL Research

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