Indian Economy: Inflation and Other Drivers

Indian economy is going under a major transformation due to various reforms such as Goods and Services Tax (GST) undertaken by the government. Recently published data shows that GDP growth recovered to 6.3% in the July-September quarter from a three-year low of 5.7% in the preceding quarter. Also, the growth of real gross value added (GVA) accelerated sequentially in Q2 of 2017-18, after five consecutive quarters of deceleration. This was powered by a sharp acceleration in all the three sub-sectors of industry. GVA growth in the manufacturing sector – the key component of industry – accelerated sharply on improved demand and re-stocking post GST implementation. While the construction sector remained sluggish, especially due to slowing demand of finished steel and cement, the biggest concern was agriculture, which continued to be under stress with growth slowing in the second quarter to 1.7%, compared with the 4.1% clocked in the year-ago period.

While the economy is being recovered, the obstacle in the upward trajectory of an economy has started showing up. Retail inflation zoomed to 15-month high of 4.88% in November mainly due to rise in food and crude oil prices which touched a two-and-a-half-year high in early November on account of the Organisation of the Petroleum Exporting Countries' (OPEC) efforts to rebalance the market. For a net oil importer like India, a sustained rise in crude oil price would have adverse macroeconomic implications. Higher oil prices are tantamount to a negative terms-of-trade shock that weakens growth, pushes up inflation and deteriorates the twin deficits (current account deficit and fiscal deficit). India's fiscal deficit at the end of October hit 96.1% of the budget estimate for 2017- 18, mainly due to lower revenue realization and rise in expenditure. In absolute terms, the fiscal deficit — the difference between expenditure and revenue — was INR 5.25 trillion during April-October of 2017-18, according to data of the Controller General of Accounts (CGA). During the same period of 2016-17, the deficit stood at 79.3% of the target.

Adding to this, the Indirect taxes collection by the government may fall short of the target during the current financial year due to disruption caused by the GST rollout. November goods and services tax (GST) collection stood at INR 80,808 crore, lowest since the new tax regime was introduced in July. The GST collections in October, the figure stood at INR 83,346 crore, in September at INR 92,150 crore, in August INR 90,669 crore and in July INR 94,063 crore. The sharp decline in the November numbers are also due to the cut in rate on over 200 items that became effective from mid-November. Due to inconsistencies in revenue trends the government would hesitate to make further experiments on the rate structure and process in the near future considering that it can further complicate matters. The government, which is set to unveil its last full budget in February 2018, will find it extremely difficult to make its tax projections due to inconsistency. If revenue collections fall way short, the government will have a tough situation to deal with and also not to breach the fiscal deficit target (3.2 percent this fiscal year). This deficit will in turn once again impact inflation.

Going forward, the inflation path will be influenced by several other factors. First, moderation in inflation excluding food and fuel observed in Q1 of 2017-18 has, by and large, reversed. There is a risk that the growing trend may continue in the near-term. Second, the impact of House Rent Allowances (HRA) by the Central Government is expected to peak in December. The staggered impact of HRA increases by various state governments may push up housing inflation further in 2018, with attendant second order effects. Third, the recent rise in international crude oil prices may sustain, especially due to the OPEC's decision to maintain production cuts through next year. In such a scenario, any adverse supply shock due to geo-political developments could push up prices even further. Despite recent increase in prices of vegetables, some seasonal moderation is expected in near months as winter arrivals kick in. Prices of pulses have continued to show a downward bias. The GST Council in its last meeting has brought several retail goods and services to lower tax brackets, which should translate into lower retail prices, going forward. To sum up, inflation is estimated in the range 4.3-4.7 per cent in Q3 and Q4 of this year.

Overall, the economy will get affected as rise in inflation due to higher prices could lower real disposable incomes of households and therefore hurt consumer discretionary demand. It would also lower the corporate profit margins due to rising input costs and accordingly impacts investment, among others. Additionally, the RBI is not expected to slash interest rates to stimulate growth. Higher interest rates would mean a corresponding rise in the currency as they attract more inflows of foreign capital that are seeking to exploit higher returns. To deal with this situation, the RBI and the government will have to maintain a fine balance between inflation, interest rates and foreign exchange.