India Outlook

A resilient economy will face rising inflation as a headwind in 2018

After a narrow election win in Gujarat in December, the ruling BJP will be tested in four large states in 2018, three of which it currently holds. The Congress, the lead opposition party and until recently in decline, did better than expected in Gujarat by targeting specific communities and rural voters and patching up alliances with rising local parties. It will hope to build on this strategy in the coming state elections by focussing on distressed voter groups and leveraging popular beliefs about inadequate job creation. However, Prime Minister Narendra Modi continues to enjoy public support amidst evidence of sustained consumption growth and a shift of employment towards the formal sector which comes up with social security and better income prospects. Nevertheless the BJP will seek to adjust policy settings to keep its flock of allies together and counter the Congress.

On February 1, Finance Minister Arun Jaitley presented his Government's last full budget before the 2019 elections. He announced a slippage in the current year's fiscal deficit which is now estimated at 3.5 per cent of GDP instead of the targeted 3.2 per cent, while setting a modest target of 3.3 per cent for next year. Markets are not convinced that even this will be achievable as a lot depends on the buoyancy in GST collections. For the rest, the Budget offered a mix of rural upliftment in the form of higher crop procurement prices and a large scale health insurance scheme together with significantly higher allocations for infrastructure development and a welcome cut in the corporate tax rate for SMEs.

Inflationary pressures and firm interest rates will hallmark 2018; an eventual lift in CapEx on account of bank recapitalisation could be a strong foil

Meanwhile, the government continues to amend the GST, introduced last July, as collections have slipped since November. Amongst the major changes is the elimination of one of the more complex steps in the tax filing process. This will provide some relief to small taxpayers but the step will eventually need to be compensated for in some other manner. The GST Council has also realigned tax rates on a few items to improve compliance and remove anomalies.

With some clients reporting strong growth in the final months of 2017, the short term outlook has improved. Households seem to have adjusted to the GST relatively well and continue to spend. Passenger vehicle sales grew 3.2 per cent yoy in Q4'17, taking annual sales close to the 4m mark for the first time. Two and three-wheeler sales rebounded 17 per cent yoy and 52 per cent yoy respectively from the impact of demonetisation a year earlier; 2-wheeler sales reached a record 21.8m units, with 8 per cent pa growth from 2010.

Central to the outlook is the success of the government's recapitalisation of state-owned banks, which account for 75 per cent of lending, but are currently choked with bad loans (15.8 per cent of all loans at end-2016). The Rs 2.1 trillion recapitalisation plan will kick off shortly with the issuance of bonds worth Rs 800 billion followed by equity issuances by banks themselves.

However, there are risks stemming from poor winter rains, which will hit spending in farming states, a persisting slowdown in fixed investment and rising inflation. Consumers have been caught by the sudden jump in inflation to 5.2 per cent yoy in December, with prices moving up rapidly in areas like housing (8.3 per cent yoy), fuel and light (7.9 per cent yoy) and food (5 per cent yoy). GST introduction may be contributing to this but so too is a slip in rural production that is likely to get worse due to a shortfall in winter rains. The phenomenon will be better understood when the next harvest hits the market in March-April.

India also faces rising trade deficits due to increasing oil prices. Oil imports jumped 33 per cent in 2017 to account for 23 per cent of the total import bill, pushing the trade deficit to US$145bn. This may well continue into 2018 and will impact domestic inflation. If so, further rate cuts by the Reserve Bank can be ruled out; in fact, a rate hike may well be on the cards. ■

Fiscal year starting 1 April	2014-15	2015-16	2016-17	2017-18	2018-19
GDP mp (FY12 series), real growth, %	7.2	7.9	7.1	6.5	7.0
Inflation - CPI, yr avg (FY12 series), %	6.0	4.9	4.5	3.5	4.5
RBI lending (repo) rate, year end, %	7.5	6.75	6.25	6.00	6.00
Rupee to US$1, RBI Ref Rate, yr end	62.5	66.2	64.8	64.5	67.0

Sources: 2015-2017 data from the government (NCI, RBI) and CEIC.