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EFFECTS OF GST ON PRICE STABILITY IN CONTEXT OF INFLATION IN THE INDIAN ECONOMY

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EFFECTS OF GST ON PRICE STABILITY IN CONTEXT OF INFLATION IN THE INDIAN ECONOMY

1. 1st Quarter 2017

The single biggest indirect tax regime has kicked into force, dismantling all the inter-state barriers with respect to trade. The GST rollout with a single stroke has converted India into a unified market of 1.3 billion citizens. Fundamentally, the $2.4-trillion economy is attempting to transform itself by doing away with the internal tariff barriers and subsuming central, state and local taxes into a unified GST.

Impact of GST on Indian Economy: Reduces tax burden on producers and fosters growth through more production. The current taxation structure prevents manufacturers from producing to their optimum capacity and retards growth. GST will take care of this problem by providing tax credit to the manufacturers. Different tax barriers, such as check posts and toll plazas, lead to wastage of unpreserved items being transported. This penalty transforms into major costs due to higher needs of unwanted stock and warehousing costs. A single taxation system will eliminate this problem. There will be more transparency in the system as the customers will know exactly how much taxes they are being charged and on what base. GST will add to the government revenues by extending the tax base. GST will provide credit for the taxes paid by producers in the goods or services chain. This is expected to encourage producers to buy raw material from different registered dealers and is hope to bring in more vendors and suppliers under the purview of taxation. GST will remove the custom duties applicable on exports. The nation's competitiveness in foreign markets will increase on account of lower costs of transaction.

Indian economy gave mixed signals in 2018 with growth remaining volatile and inflation cooling. However, food inflation reflected rural distress. On twin deficits, the fiscal deficit presented a worrying picture, and the current account deficit touched around 3 per cent of gross domestic product by the third quarter of the year. The economy began the year with a 7.7 per cent GDP growth rate in the January-March Quarter. It further rose to a two-year high of 8.2 per cent in the next quarter. When the low-base effect waned, the economy gave the real picture by expanding at just 7.1% in July – September.

Economists say growth will come down in the next and the following quarters. “Growth is likely to decrease to 6.7 percent in January-March,” SBI group Chief Economist Soumya Kanti Ghosh said. He saw slight recovery in growth only from July-September 2019-20. However, substantial recovery will start only after that, he said.

“Investment and consumption are the worrying part. Investments are currently driven by the government and not the private sector even though investment rate is going up. There are mixed signals for urban and rural consumption. We will have to wait for the ongoing quarter to see if there is revival,” said Madan Sabnavis, chief economist at care. The government managed to control inflation. The widely-tracked Consumer Price Index (CPI)-based inflation rate declined by more than half to 2.3 percent by November compared to where it stood at the beginning of the year. Nowadays, the Reserve Bank of India has to statutorily keep the inflation rate in the range of 2-6 percent. So, now the issue would be to prevent it from falling below 2 per cent. However, economists are not worried about that. “It will rise to around 4 per cent by the end of March,” said Sabnavis.

2. **3rd Quarter 2017**

India’s GDP grew 7.2% in the third quarter, surpassing expectations and wresting back the mantle of fastest growing economy from China on the back of a rebound in industrial activity, especially manufacturing and construction, and an expansion in agriculture. China grew 6.8% in the quarter and is expected to grow same pace the whole year. Experts also pointed to the growth in Gross Fixed Capital Formation (GFCF) as a sign that investment which has been a laggard, may be resurgent, although the slowing of private consumption was a concern. The numbers indicated that the economy had shaken off the effects of demonetization and come to grips with the Goods and Services Tax (GST). India’s FY18 growth projection was revised marginally upward to 6.6% from 6.5% estimated earlier, compared with 7.1% in FY17, according to data. Released by the ministry of statistics and programmer implementation on Wednesday. Second-quarter growth was revised to 6.5% from 6.3% earlier. Economists had estimated December quarter GDP growth at 6.5-6.9%.

“Robust growth in manufacturing and significant acceleration in construction mark a turnaround in the country’s economic growth momentum,” the finance ministry said in a release. “Heralding an improvement in the investment climate, real gross fixed capital formation is estimated to grow at a robust 7.6% for 2017-18, accelerating from 6.9% in Q2 2017-18 to 12% in Q3 2017-18."

The revival theme was backed up by core sector growth, which picked up pace in January following an uptick in sectors including cement, electricity, coal, refinery products and steel, indicating a strong start to the last quarter of FY18. The combined index of the eight core industries rose 6.7% in January 2018 compared with 4.2% in December 2017, according to data released separately by the government.

India's manufacturing activity meanwhile fell to a four-month low in February but remained firmly in the expansion zone as firms raised staffing levels, according to the Nikkei India Manufacturing Purchasing Managers Index (PMI). It's the seventh consecutive month that the index has remained above the 50-point mark, which separates expansion from contraction. The index touched a 60-month high of 54.7 in December.

"The current growth rate reflects that reforms by the government have started showing results," Bibek Debroy, chairman of the Economic Advisory Council to the Prime Minister said. The GDP trend is consistent with the robust growth of PMI, Index of Industrial Production (IIP) and consumer demand, he said adding, "Higher growth in industries, services and central government spending to aid further growth." Manufacturing grew 8.1% in the third quarter and is projected to expand at 5.1% for the full year, compared with 7.9% growth in FY17, indicating that factories and companies have come to terms with GST which was put in place on July 1st.The Reserve Bank of India will likely keep rates unchanged, said DK Pant, chief economist. Beyond that, it will consider factors such as the monsoon banks' bad loans and oil prices he said. "While a 12% growth in fixed capital formation pulled up GDP growth, the need of the hour is how we can nurture this budding investment revival with conducive policies," he said. "However, an area of concern is the decline in private consumption growth to 5.6% in 3QFY18 from 6.6% in 2QFY18. Ind-Ra believes growth momentum will spill over in FY19 and the GDP growth will be 7.1%". The next meeting of the RBI monetary policy committee will take place in early April.

“Though excellent GDP numbers have come on the back of the low base of Q3FY17 (demonetization quarter), it signifies that the economy is recovering and expanding at a reasonable speed before picking up the pace in the near future said by Arun Thukral, CEO, Axis Securities. “Also, growth in Gross Fixed Capital Formation (GFCF) in nominal terms is indicative of increased investment happening, especially from the government side which eventually lead to higher private will spend over the next 12-18 months.” Growth started to pick up in the July-September quarter within the April-June period due to destocking in the run-up to the GST rollout and the lingering impact of demonetization.

The Economic Survey had projected that a series of major reforms undertaken over the past year will allow real GDP growth to rise to 7.5% in FY19; thereby reinstating India as the world’s fastest growing major economy. Some experts said India could exceed the International Monetary Fund’s 6.7% GDP growth estimate for the current year if the recovery trajectory improves even further, possibly allowing it to retain the fastest-growing economy**.** “There is quite a lot of project activity on ground led by government investment, which has shown traction and feeds through to manufacturing,” said HDFC Bank chief .The IMF projects India’s GDP to grow at 7.4% in FY19 and 7.8% in FY20. The last time India grew faster than China was in October-December 2016 Reuters said. “The significant improvement in GDP growth… strengthens the perception that the Indian economy is at the threshold of a sustained rebound in growth,” said Confederation of Indian Industry director general Chandrajit Banerjee.

“Manufacturing and some services sub-sectors are the key drivers of growth during the quarter.”
Anil Khaitan, president, PHD Chamber of Commerce and Industry said: “The GDP growth at 7.2% in Q3 of 2017-18 is inspiring and a strong sign of in Q3 of 2017-18 is inspiring and strong signs of economic revival are visible. Going ahead, we believe the growth trajectory should continue to improve as teething problems of GST are almost over and the economy is looking up once again.”

- **Expert view: GST's impact on inflation**

One of the fears about the Goods and Services Tax (GST) globally, is that consumer prices can stay higher for longer because tax increases are passed on faster than tax cuts. Thus Australia and Malaysia had to take steps to curb inflationary pressures after introducing GST. GST Council in India has assured that the effective tax on all businesses put together would be lower under GST than now. But the impact on inflation will depend on the extent to which businesses pass on the tax changes to consumers. When we mapped GST rates with components in the Consumer Price Index (CPI) basket-- which closely represents the household consumption pattern--we found that GST rates are broadly lower than or even on a par with current rates. Most mass-consumption goods have been taxed at a lower rate and several essential food commodities have been exempted. However, for some items such as services to higher education institutes, utility bills, personal care products, sugar, prepared meals, snacks and sweets, pan, tobacco and intoxicants, where current inflation is already high the tax incidence too will be higher under GST. These items have around 20 per cent weightage in the CPI basket and could see a one-time transitory inflation hump. For a little over half of the CPI basket, the tax incidence remains unchanged. The remaining third of items see lower tax incidence, allowing for price cuts at the discretion of the manufacturer, who may choose not to do so. Although the GST Council has inserted an anti-profiteering clause in the Act to punish companies that fail to pass on the tax benefit to consumers, the rules to identify profiteering cases have not been finalized yet. Globally anti-profiteering measures to combat temporary inflation during the tax transition phase work best when implemented well before implementing GST. Australia for instance applied an anti-profiteering rule a year in advance Consumer Price Index-based inflation, currently low at 2.2 per cent, is expected to rise after July-August. But that may have more to do with the wearing off of the base effect. We don't expect GST to have a significant impact on inflation and maintain our CPI inflation forecast at 4 per cent for this fiscal. While short-term hiccups cannot be ruled out, the efficiency gains over the long term will ensure that the economy is a net gainer in terms of growth, inflation, ex 2.18 per cent ports and fiscal health.

- **Reserve Bank of India says GST won't raise inflation**

The implementation of the Goods and Services Tax (GST) has disrupted businesses, supply chains and to some extent consumption as well. But when it comes to retail inflation, GST is likely to have minimal or no impact at all. The Reserve Bank of India's (RBI's) monetary policy report says that GST is non-inflationary. The report suggests that more than 50% of the Consumer Price Index (CPI) basket will not come under GST. The chart shows the impact on the rest of the CPI basket. For every product which will see a price increase due to higher taxation, there is an offsetting price fall elsewhere. Prepared meals, clothing and footwear, recreation and amusement will see price increases, while personal care and select food sub-groups like spices and pulses will see prices slip, the report said. At best, GST will result in a 10 basis points increase in the headline CPI inflation number.

However, the central bank noted that a one-off increase in prices could be seen in the first year of the tax reform implementation because companies will choose to hike prices initially. A dipstick survey of price movements of 18 commodities (dominated by consumer durables and fast-moving consumer goods) by RBI showed that their weighted average price has gone up by 0.8%.

3. **6th Quarter 2017**

- **Benefits**

1. Removal of bundled indirect taxes such as VAT, CST, Service tax, CAD, SAD, and Excise.

2. Less tax compliance and a simplified tax policy compared to current tax structure.

3. Removal of cascading effect of taxes i.e. removes tax on tax.

4. Reduction of manufacturing costs due to lower burden of taxes on the manufacturing sector. Hence prices of consumer goods will be likely to come down.

5. Lower the burden on the common man i.e. public will have to shed less money to buy the same products that were costly earlier.

6. Increased demand and consumption of goods.

7. Increased demand will lead to increase supply. Hence, this will ultimately lead to rise in the production of goods.

8. Control of black money circulation as the system normally followed by traders and shopkeepers will be put to a mandatory check.

9. Boost to the Indian economy in the long run.

- **GST impact on the Indian Economy**

1. Reduces tax burden on producers and fosters growth through more production. The current taxation structure, pumped with myriad tax clauses, prevents manufacturers from producing to their optimum capacity and retards growth. GST will take care of this problem by providing tax credit to the manufacturers.

2. Different tax barriers, such as check posts and toll plazas, lead to wastage of unpreserved items being transported. This penalty transforms into major costs due to higher needs of buffer stock and warehousing costs. A single taxation system will eliminate this roadblock.

3. There will be more transparency in the system as the customers will know exactly how much taxes they are being charged and on what base.

4. GST will add to the government revenues by extending the tax base.

5. GST will provide credit for the taxes paid by producers in the goods or services chain. This is expected to encourage producers to buy raw material from different registered dealers and is hoped to bring in more vendors and suppliers under the purview of taxation.

6. GST will remove the custom duties applicable on exports. The nation's competitiveness in foreign markets will increase on account of lower costs of transaction.

Most lead indicators cited by the RBI suggest an upside risk to core inflation. These include improved pricing power of manufacturing firms, above-average capacity utilization in the manufacturing sector, a rise in purchasing manager index, a surge in non-food credit growth to 15.6 per cent in November 2018 higher than nominal GDP growth, and most importantly low output gap, i.e., actual GDP growth minus potential growth. Indeed, the responsiveness of the RBI repo rate to the lags in headline inflation is found to be very low (0.25-0.30 for every 100 bp rise in inflation; from the time when the RBI has adopted price stability as its target objective. In contrast, the responsiveness of the policy repo rate to core inflation has been significantly high and characterized by rising lags - from 0.63 to 0.91 over lags of 1 to 5 months. As a result, the shocks in core inflation get completely factored into RBI's policy rate action over a period of six months. To be fair, the Indian economy had started decelerating even before demonetization was announced. After hitting 9.1 percent in the March 2016 quarter, GDP growth had been on a gradual decline. As such, the twin shocks of demonetization and GST hit an economy which was already weakening. Both were the hardest on job creating sectors like manufacturing, which also have a large informal segment.

Growth in the economy plunged to 5.7 percent in the June 2017 ended quarter – the lowest in three years. Weakness in the manufacturing, real estate and financial services sectors told the story of the impact of demonetization. The September-ended quarter saw some improvement with growth picking up to 6.3 percent. While the trend of weakness appeared to have bottomed out, economists pointed out that levels of economic activity were nowhere close to levels before the twin shocks. **Shrugging off the impact of demonetization and the Goods and Services Tax (GST),** the economy seems to be on the rebound. Official data released showed that GDP grew 6.3 per cent in the July-September quarter, with robust expansion in manufacturing, electricity production and trade and hotels sectors. This is higher than the 5.7 per cent GDP growth in the April-June quarter, but lower than the 7.5 per cent growth in the second quarter of last fiscal. Gross value added (GVA) grew by 6.1 per cent in the second quarter, against 5.6 per cent in the first quarter. The economic rebound may be carried forward into the third quarter, with core sector industries growing by 4.7 per cent in October, unchanged from the previous month, supported by strong growth of refinery products and steel output. Finance Minister Arun Jaitley said the GDP data showed the impact of demonetization and GST has worn off. "It marks a reversal and is driven by manufacturing, and investment is growing," he told reporters. "We had been seeing declining numbers from the fourth quarter of 2016-17. This marks a reversal, and is encouraging," said TCA Anant, Secretary, Ministry of Statistics and Programme Implementation. In fact, Q2 GDP growth may have been underestimated due to lack of adequate data on GST collections and sales tax, he added. Finance Secretary Hasmukh Adhia noted that taxes paid in the July quarter are still to be calculated and could be revised upwards. The data come ahead of the monetary policy review on December 6; most analysts expect the Reserve Bank of India to maintain rates. However, the Centre's financial health remains under pressure: the fiscal deficit rose to ₹5,25,321 crore between April and October, or 96.1 per cent of the

Budget Estimate as receipts lagged expenditure. The revenue deficit overshot the full-year target by 24.7 per cent to 4,01,085 crore between April and October. The centre hopes to maintain its fiscal deficit at 3.2 per cent of GDP.

India's economy grew at its fastest in seven quarters in the January-March period, bolstered by strong performance in construction, manufacturing and public services, pointing to a persistent revival trend and bringing cheer to the government ahead of next year's general election. The full FY18 growth estimate was revised upward to 6.7 per cent from 6.6 per cent in the second advance estimate released in February. This is in line with the 6.75 per cent growth forecast by the Economic Survey and down from 7.1 per cent in FY17 with the slowdown being attributed to the lingering effect of demonetization and the rollout of the Goods and Services Tax (GST) in July last year. Gross domestic product rose a better-than-expected 7.7 per cent in the fourth quarter, retaining India's ranking as the world's fastest-growing major economy, outpacing China by nearly a percentage point. The economy grew at the highest rate since September quarter of FY17, ahead of the demonetization drive that began November 2016. An ET poll of economists had pegged fourth-quarter growth at 7.1-7.5 percent. October-December FY18 growth was revised down to 7 per cent from 7.2 per cent estimated earlier. The economy grew 6.1 percent in the year ago March quarter. "GDP growth has been increasing continuously every quarter with growth of 7.7 per cent in Q4 of 2017-18," finance minister Piyush Goyal tweeted. Growth measured in Gross Value Added (GVA) terms rose 6.5 per cent in FY18, slower than 7.1 per cent in the previous fiscal. GVA growth in the fourth quarter was the fastest in seven quarters at 7.6 percent. Earnings growth in the fourth quarter is expected to be quite widespread. However, analysts point out that so far it has been restricted to a few sectors. "While overall earnings are improving, the quality leaves much to be desired— commodities account more than 80% of the profit growth," says an Edelweiss report. The RBI has allowed banks to make partial provisioning for loans that have gone to the National Company Law Tribunal (NCLT). Banks have also been hit on their treasury holdings due to the sudden spike in yields in the last quarter. Here again, the RBI has allowed them to spread their fourth quarter losses to the other quarters. This means the loss declared by some of the PSU banks in the fourth quarter will be less than the actual losses incurred by them.

4. **1st Quarter April to June (2018)**

GST the biggest tax reform in Indian founded on the notion of “One Nation, One Market, One Tax” is finally here. The moment that the Indian government was waiting for a decade has finally arrived. The single biggest indirect tax regime has kicked into force, dismantling all the inter-state barriers with respect to trade. The GST rollout with a single stroke has converted India into a unified market of 1.3 billion citizens. Fundamentally $2.4-trillion economy is attempting to transform itself by doing away with the internal tariff barriers and subsuming central, state and local taxes into a unified GST.

The rollout has renewed the hope of Indian’s fiscal reform program regaining momentum and widening the economy. There are fears of disruption, embedded in what’s perceived as a rushed transition which may not assist the interests of the country. Will the hopes triumph over uncertainty would be determined by how our government works towards making GST a “Good and Simple Tax”. The idea behind implementing GST across the country in 20 states and 7 Union Territories is that it would offer a win-win situation for everyone.

- **GST: The Short-Term Impact**

From the viewpoint of the consumer, they would now have pay more tax for most of the goods and services they consume. The majority of everyday consumables now draw the same or a slightly higher rate of tax. Furthermore the GST implementation has a cost of compliance attached to it. It seems that cost of compliance will be prohibitive and high for the small scale manufacturers and traders, who have also protested against the same. They may end up pricing their goods at higher rates.

- **What the Future Looks Like**

Talking about the long term benefits it is expected that GST would not just mean a lower rate of taxes but also minimum tax slabs. Countries where the Goods and Services Tax has helped in reforming the economy apply only 2 or 3 rates – one being the mean rate, a lower rate for essential commodities, and a higher tax rate for the luxurious commodities. Currently in India we have 5 slabs, with as many as 3 rates- an integrated rate, a central rate and a state rate. In addition to these, Cess is also levied. The fear of losing out on revenue has kept the government from gambling on fewer or lower rates. This is very unlikely to see a shift anytime soon; though the government has said that rates may be revisited once the RNR (revenue neutral rate) is reached.

The impact of GST on macroeconomic indicators is likely to be very positive in the medium-term. Inflation would be reduced as the cascading (tax on tax) effect of taxes would be eliminated. The revenue from the taxes for the government is very likely to increase with an extended tax net, and the fiscal deficit is expected to remain under the checks. Moreover exports would grow, while FDI (Foreign Direct Investment) would be also increase. The industry leaders believe that the country would climb several ladders in the ease of doing business with the implementation of the most important tax reform ever in the history of the country. The survey also indicates a positive impact of GST on employment as well as on the demand for goods and services. Given that it is the biggest tax reform of independent India, one must compliment the government on its efficient and transparent administration. The survey found that respondents were largely satisfied with implementation of the e-way bill.

5. **3rd Quarter**

GST has bought with it a lot of anxiety in terms of implementation. There is a confidence that in long term it will lead to benefits in form of higher GDP. As per the GST tax rates finalized, nearly 50% of the goods fall under the 18% tax rate. In the earlier indirect tax regime for many items excise duty plus state VAT and all other taxes added up to more than 25%. Hence for many of the manufactured goods prices should fall under GST. Under GST for all goods and services the producers can claim input tax credit. This means that at the time of paying tax on output, producers can reduce the tax they have already paid on inputs. In the earlier regime, many of the taxes like CST, Entry tax and several Cesses. This resulted in cascading effect of the taxes. Removal of cascading effect under GST should also help reduce prices. There is an apprehension of inflation in the services sector. The services sector contributes more than 50% to India's GDP. The GST rate applicable on most services is now 18% as compared to 15% under the older tax regime. This will put upward pressure on prices in the services sector. Service providers will get input tax credit for goods as well as services purchased by them which will to some extent help in reducing service cost. However, another aspect to be taken into account is that for many of the service providers like banking, insurance, telecom the compliance cost is going to increase under the GST. Under GST they will be required to do state-level registration, whereas earlier the registration was only required at the central level. This will add to the cost of the service providers and mitigate some benefits of the Input Tax Credit (ITC).

While the anti-profiteering clause says that the service providers have to pass on the benefit of ITC, again it may not be easy to implement. In the last few days, service providers have been intimating their clients about the increase in tax due to GST, but there is still no clarity on reduction in service cost due to ITC. Also to take into account that there are many small/unorganized players also in the market hence keeping a track of reduction in cost due to ITC could be difficult.

Another aspect to be taken into account is that many items are not yet covered by the GST. Potable alcohol, crude oil, natural gas, aviation fuel, diesel, petrol, electricity and real estate are currently out of GST, and states will levy their own taxes on these. Take the case of petroleum companies, their final output petroleum products are out of GST. Hence the amount of GST that petroleum companies pay on the hiring of rigs and purchase of equipment and services for crude oil production and refining cannot be offset against the tax paid on the final products (as petroleum products are out of GST and will continue to be covered by central excise duty and VAT). The resultant increase in cost for these industries could pose an inflationary threat.

As far as, direct tax impact on CPI basket is concerned, GST may not be a significant threat on inflation. For food & beverages (which has a high weight of 46% in the CPI index), prices are expected to come down due to lower GST rates. Housing (weight of 10%, includes rental on residential property) are exempted from the GST rate. Hence, there will be no impact of GST. The miscellaneous category in the CPI (28% weight) mainly covers services like health, education, transportation, etc. For most services, as discussed earlier the tax rate is increasing from 15% to 18%. Health continues to be exempted under GST. It is to be noted that while primary and secondary education is exempted, higher private education is not exempted from GST. Overall, tax rates on 40% of items in the CPI basket will remain unchanged. The tax rate will come down for 22% of the items and will go up for only 13% of the items in the CPI basket.

While the CPI basket does not show an adverse impact of GST on inflation, we must not ignore the fact that tax on services which is a big chunk of our GDP, is increasing. Moreover, a large part of the economy (items like petrol, diesel) are outside the ambit of GST. That may also have an inflation distortionary impact as an offset on these items will not be available under GST. In the short-term, it may not be easy to pass on the reduction in cost due to GST. Overall, we feel GST impact on inflation could be somewhere between neutral to a marginal increase in the short-term. In the medium to long-term, GST should put downward pressure on inflation through efficiency gains, reduction in supply chain rigidities and lower transportation cost.

6. **6th Quarter**

The Indian economy exhibited resilience during 2017-18, with upturns in investment and construction. Inflation eased on a year-on-year basis in an environment characterized by high variability. In the evolution of monetary aggregates, currency in circulation surpassed its pre-demonetization level while credit growth revived to double digits from a historic low in the previous year.

Domestic financial markets were broadly stable, with rallies in equity markets and intermittent corrections, hardening bond yields, the rupee trading with a generally appreciating bias except towards the close of the year and ample liquidity in money markets. The implementation of GST achieved another important milestone towards an efficient indirect tax structure. On the external front, the current account deficit was comfortably financed with accretions to foreign exchange reserves.

The pace of expansion in the Indian economy once again surprised analysts on the upside. The Gross Domestic Product (GDP) released on Friday showed that the economy grew at 8.2% in the first quarter of the current fiscal. Although this was on a relatively lower base, data suggests that the economy has recovered well from the twin policy shocks of demonetization and the implementation of the Goods and Services Tax (GST).

The growth during the quarter was fairly broad-based. For instance, the agriculture sector expanded by 5.3%, while manufacturing registered a growth of 13.5%. Construction activity expanded by 8.7%. It is also encouraging to see that investment demand is picking up. Higher private sector investment will help improve potential growth. The headline growth is likely to moderate in the second half of the fiscal because of the base effect. Also, there are a number of factors that will require close monitoring and can affect economic outcomes in the coming quarters.

First, financial conditions in the international market are tightening and the cost of money is likely to go up. Further the rupee is depreciating and renewed pressure on emerging market currencies over the last few days indicates that things may not stabilize in a hurry. All this could affect businesses looking to raise capital from international markets. Although the Indian banking system is said to have entered into the final phase of the bad loan problem, it is likely to take some time to stabilize before it begins to fund India’s growth. Besides, trade tensions are a big risk for the global economy and can affect growth at a time when India’s exports are showing signs of a turnaround. Therefore in the coming quarters the external environment may not be as supportive as it has been in recent years.

Secondly, fiscal constraints may not allow the government to push growth. Higher oil prices and relatively higher minimum support prices could push expenditure, while the reduction in GST rates could affect revenues. The Union government is aiming to restrict the fiscal deficit at 3.3% of GDP in the current year. Further, state government finances have worsened in recent years. Although they are looking to reduce the fiscal deficit in the current year as the Reserve Bank of India (RBI) noted in its annual report, risks could arise from farm loan waivers announced outside budget allocations and impending elections in several states. Pressure on government finances could lead to a reduction in capital expenditure. However it is important that, government finances be carefully managed and deficit targets maintained even if this requires sacrificing some amount of growth in the short run. In the given global context, fiscal slippage along with higher current account deficit could affect market sentiment and increase risks to macroeconomic stability. Sustained pressure on capital flows will impede investment revival and affect growth in the medium term.

Finally, further monetary policy tightening could be in store. Although the Monetary Policy Committee (MPC) of RBI has raised rates pre-emotively, a pick-up in economic activity can increase the risk of higher core inflation getting generalized. Thus, the dilemma for the MPC in the October 2018 meeting will be whether it should wait and see the effect of its past policy action or move forward with another hike to contain aggregate demand. Capacity utilization is increasing, which will give firms more pricing power and the MPC believes that the output gap is virtually closed.

However, this is not the only risk. The pressure in the currency market might also warrant a monetary policy response. The MPC has maintained that the policy is determined only by the inflation-targeting mandate and a rate hike may be needed even to avoid inflationary consequences of depreciation in rupee. Therefore, despite the positive surprise growth numbers should be interpreted with care as the given macroeconomic situation particularly on the international front could pose challenges. The situation requires policymakers to remain vigilant and preserve macroeconomic stability. A significant increase in currency market volatility can dent market confidence and affect investment decisions.

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