FLASH REPORT

A Primer on the Indian Economy—
1Q18 GDP Growth Rate the Slowest in 13 Quarters

Figure 1. India: Key Macroeconomic Metrics

Metric	Period	Type of Metric	This Year	Last Year
GDP	1Q18E June 30	YoY change	5.7%	7.9%
CPI	July 2017	YoY change	2.4%	6.1%
Unemployment Rate	August 2017	Actual rate	4.0%	9.6%
Fiscal Deficit	Annual	As a % of GDP	3.2% (FY18 forecast)	3.5%
Total FDI Inflows	Annual	YoY change	8.0%	23.0%

Note: India's financial year runs from April 1 to March 31.
Source: MOSPI/Bombay Stock Exchange/Centre for Monitoring Indian Economy/Ministry of Finance: Department of Economic Affairs/Ministry of Commerce and Industry

1) The Indian government has implemented two key initiatives in the past 12 months that have had a negative impact on the economy: demonetization of high-value bank notes and putting into action a new goods and services tax (GST) regime.
2) In 1Q18, India's GDP growth was 5.7%, the slowest in 13 quarters.
3) Other economic indicators, such as the CPI and the unemployment rate, seem to tell a more positive story.

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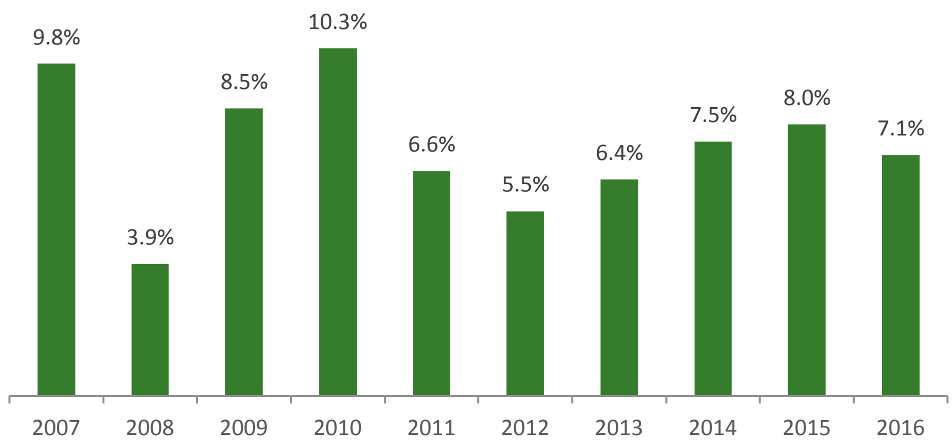
An Overview of India's Key Macroeconomic Data

India has been garnering much global attention for the pace of its economic growth and has attracted billions of dollars in investments.

India vies with China for the title of fastest-growing major emerging economy. India's economy is more liberal than China's, and in recent years India has been shedding its protectionist policies and growing faster than China. However, recently released numbers reveal that India's GDP growth slipped back significantly, to 5.7%, in the first quarter, ended June 30, 2017.

Figure 2. India: Annual GDP Growth Rates



Source: World Bank

In this report, we scrutinize key data to understand the country's macroeconomic health. In particular, we highlight two radical initiatives that the government of India has implemented in the past 12 months that have had a significant impact on the country's economy:

1) Demonetization of high-value bank notes.
2) The introduction of a new GST regime.

Both these events have had near-term negative impacts on several of India's economic indicators and their far-ranging impacts remain to be seen.

Initiative 1: Demonetization of High-Value Bank Notes (November 8, 2016)

On November 8, 2016, the government of India announced that two banknotes would be scrapped overnight—the INR 500 ($8) and INR 1,000 ($16). These were the highest-denomination notes in the country and represented about INR 14.2 trillion or 86% of the currency in circulation at the time.

There were three key goals behind this move:

1. **Curb the shadow economy**, which includes undeclared, unaccounted, taxable income. Many reports estimated this to have been in the range of 15%–30% of India's GDP.
2. **Deter counterfeit currency** that was in circulation and was being used to fund terrorist activities.

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3. **Push digitalization of the economy**, as most transactions in India are paid for in cash.

India's central bank, the Reserve Bank of India (RBI), stipulated a window of 50 days until December 30, 2016, to allow people holding the scrapped notes to deposit them in banks and exchange them for newly issued INR 500 ($8) and INR 2,000 ($32) notes. However, this came with certain restrictions: there were limits on the amounts that could be deposited and withdrawn per day and week, and the overall amount people could deposit without being scrutinized by the RBI was INR 200,000 ($3,122).

Initiative 2: Introduction of a Goods and Services Tax (GST) to Replace Other Taxes Levied (July 1, 2017)

On July 1, 2017, the government of India implemented a new, comprehensive GST to replace the complex multiple taxes that were levied by the central and state governments. This has been touted as the biggest tax reform in India's 70-year history as an independent nation.

The tax structure is formulated into four slabs ranging from 5% to 28%, with certain categories exempt from being taxed. The government has provided the GST rates for hundreds of goods and services, specifically mentioning those that fall under each slab, but not for broad categories, which may make it time-consuming for some businesses to arrive at the appropriate tax rate. We outline in the following table, some products under each tax slab for an indication of the new tax regime.

Figure 3. India: GST Rates and Categories

Tax rate	Categories
0%	Unbranded staple items, books, newspapers, health services and education services.
5%	Apparel below INR 1,000, certain seafood, some processed and packaged foods (such as fish fillets), coffee, tea, spices postage and revenue stamps, transport services and small restaurants.
12%	Apparel above INR 1,000, frozen meat products, processed dairy, board games, cutlery, state-run lotteries, hotels and restaurants without air-conditioning and business-class air tickets.
18%	Most items fall under this tax slab, including footwear above INR 500, software, biscuits and other bakery items, mineral water, tissues, financial services, IT services, telecom services and restaurants that serve liquor or have air-conditioning or are situated within five-star hotels.
28%	Several personal care products, large home appliances, automobiles, motorcycles, aircrafts for personal use, five-star hotels, race-club betting and cinema tickets.

*Source: Central Board of Excise and Customs/*The Economic Times

The government has even put into operation a new website and system to help businesses file taxes easily. As businesses were informed about the GST implementation months in advance, they had time to prepare their goods and services for sale under the new regime. Many retailers attempted to de-stock products with the old tax rates printed on price tags before July 1 and held "pre-GST" discount sales.

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GDP: India's Economic Growth Slows

Recently released numbers reveal that India's GDP growth was 5.7% in the first quarter, ended June 30, 2017.

- This is the slowest pace of growth in 13 quarters, or just over three years.
- Growth in the corresponding quarter of the previous year was 7.9%, and in the last full fiscal year was 7.1%.
- Earlier this year, the International Monetary Fund (IMF) forecast India's GDP would expand by 7.2% at the end of this fiscal year, and the UN had initially forecast 7.7%, which it revised to 7.3% in May 2017.

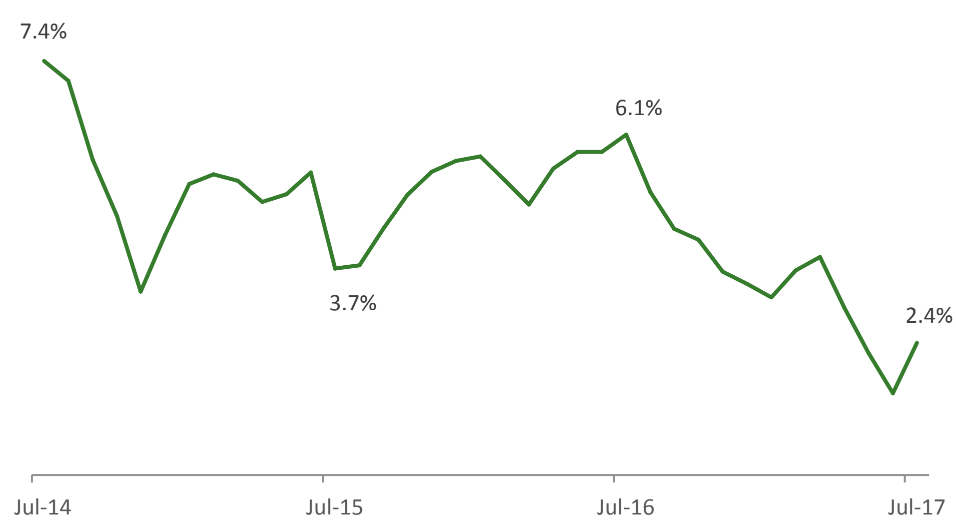
While the demonetization and GST implementation impacted business across sectors, slow growth in the agriculture, manufacturing, utilities, construction, financial services and real estate sectors weighed on GDP growth. Several analysts at financial institutes are set to revise down the outlook for the rest of the year since the latest numbers emerged, according to Reuters.

CPI: Price Growth Softens

The Consumer Price Index (CPI) in July (latest) grew by 2.4%, compared to 6.1% in the same month last year and 1.5% in June 2017. Growth in July was primarily led by higher vegetable prices. Among the other components of CPI, inflation for housing was 4.98% (pushed up by the increase in house rent allowance in the 7th Central Pay Commission) for fuel and light was 4.86%, and for clothing and footwear was 4.22% (likely impacted by the implementation of the GST).

CPI inflation rates have been on a downward trend since July 2016 and it is highly likely this will continue. While the overall impact of the GST on prices appears to be soft from the CPI figure in July, it remains to be seen how much it may have impacted prices across sectors through August and the rest of the year.

Figure 4. India: CPI Inflation



Source: MOSPI

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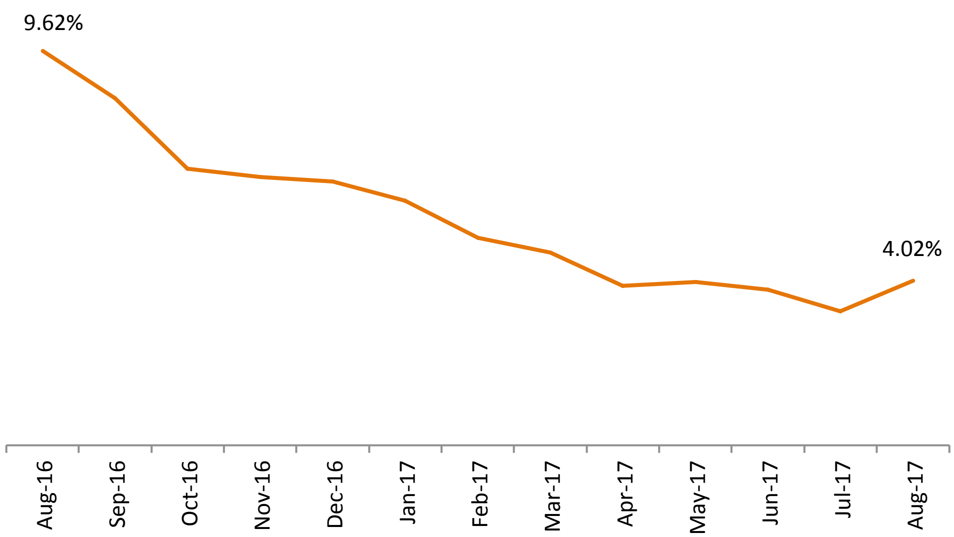
Unemployment Rate Falling

The unemployment rate in August 2017 was 4.0%, a fall from the 9.6% recorded in August 2016. A UN report released earlier this year forecasts the number of unemployed people in India will increase by 300,000 to 18 million by next year, but in terms of the unemployment rate, it is expected to fall further to 3.4%.

In an action plan released by the government in August 2017, it hopes to tackle underemployment where multiple workers are performing the role of a single worker, and intends to cut back investments on labor-intensive industries.

Figure 5. India: Unemployment Rate



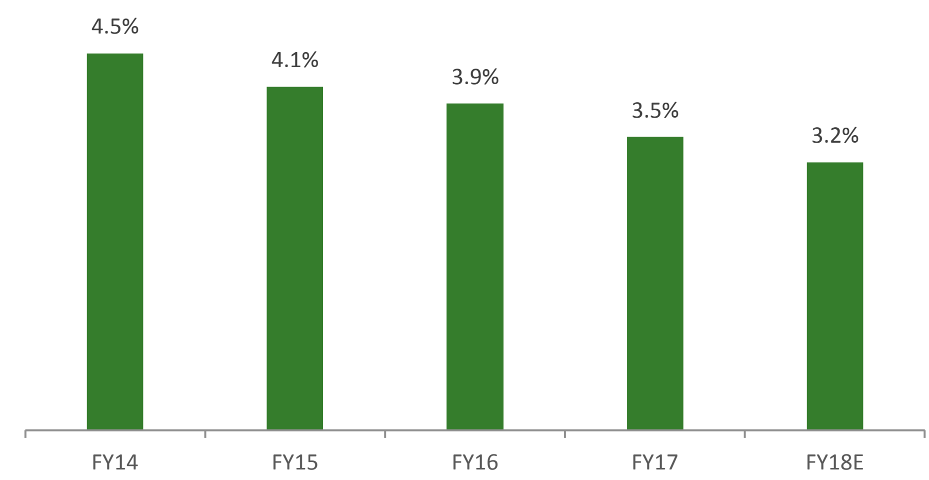
Source: Centre for Monitoring India Economy

Fiscal Deficit Narrows

India's fiscal deficit has been narrowing over the years, denoting a recovering exchequer. The Indian government has forecast the fiscal deficit for FY18 to be 3.2% of GDP, a narrowing from 3.5% last year. It hopes to reduce it further, to 3.0% of GDP, by FY19.

The two initiatives outlined earlier seem likely to help move the economy toward this goal. Demonetization, which will help reduce the shadow economy and increase the visibility of taxable income, should help bring in more tax revenues. As the hiccups in implementing the new GST subside and businesses are expected to file taxes seamlessly, tax revenues seem set to grow.

Figure 6. India: Fiscal Deficit as a % of GDP



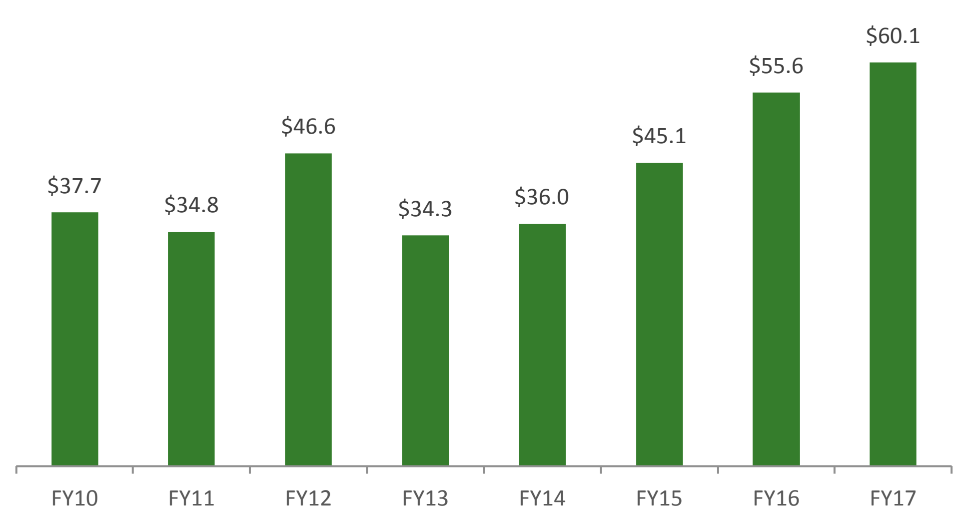
Source: Ministry of Finance: Department of Economic Affairs

Total FDI Inflows

India has been receiving a steady stream of foreign direct investment (FDI), but in terms of growth, FY16 saw a higher increase (23% growth) than FY17 (8% growth). In the current fiscal year up to June 2017, India has received $14.5 billion in total FDI inflows, reflecting 23.8% year-over-year growth for the quarter, according to RBI data.

India operated a somewhat closed economy until 1991, after which it brought in a wave of reforms to open various sectors to foreign investment. We discussed these reforms in detail in our earlier report *International Apparel Retailers in India—Jumping the Hurdles in Pursuit of Growth*. As the government continues to ease restrictions on foreign investment in India, particularly in retail, more international funds are expected to flow into India.

Figure 7. India: Total FDI Inflows (USD Bil.)



Source: RBI

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What We Think

With India being portrayed as one of the fastest-growing large economies in the world, the GDP growth rate is a closely watched figure. While demonetization and the GST implementation have impacted the most recent quarter's figures, the economy will eventually stabilize as market forces come into play, unless there are further economic shocks in the coming quarters.

As other economic indicators seem to tell a more positive story, and with the government claiming to work toward cushioning the impact of both moves, it is possible India will regain its strong growth trajectory, however, it may not reach those ambitious levels in the immediate quarters that were forecast prior to these economic shocks.

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