Press Release

Govt joins RBI in the war against inflation

Excise and custom duty cuts, higher subsidies and export duties to cool prices

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With the prolonged strife between Russia and Ukraine taking the global inflation threat to serious proportions, the Central Government has decided to take coordinated policy actions along with RBI to address the challenge. With a series of fiscal measures to ease supply side pressures, it has started to complement the monetary policy actions initiated by RBI which includes an out-of-turn 40 bps rate hike in May-22 to rein in India's runaway inflation.

To recall, inflation metrics scaled to new highs at the start of FY23. While CPI inflation soared to a near 8-year high of 7.79% YoY in Apr-22, WPI inflation accelerated to a fresh record high in the current series to 15.08% YoY. The headline CPI inflation is in risk of breaching 7.0% mark in Q1FY23 and the wholesale inflation is set to remain in high double digits given the input cost pressures.

The key fiscal measures announced by the government to address the inflation threat comprise the following:

- **Excise duty on petrol and diesel has been reduced by Rs. 8 per litre and Rs. 6 per litre respectively** further to the cuts effected in Nov-21, bringing down the taxes to their respective pre-Covid levels. From the fiscal perspective, a cut in excise duty on petroleum products is expected to have a revenue implication of around Rs. 850 bn over the remainder of FY23 which will be entirely borne by the Central Government. Further, many states such as Maharashtra, Kerala, Odisha, and Rajasthan have followed up with VAT rate reductions. This should lead to a reduction in retail fuel prices by at least 10%., which is expected to have a positive and direct impact on headline CPI inflation.
- **Fertilizer subsidy has been increased by Rs. 1.1 tn** doubling it to Rs. 2.15 tn from the budgeted level for FY23, to insulate farmers from the spike in the global prices of DAP (Di-ammonium Phosphate) and MoP (Muriate of Potash) in the last one year.
- **LPG subsidy of Rs. 200 per gas cylinder (up to 12 cylinders)** to be provided to over 90 mn beneficiaries under PM Ujjwala Yojna. This is expected to have a revenue implication of around Rs. 61 bn a year on the exchequer.
- **Custom duty on the import of certain industrial raw materials including coking coal, ferronickel and coke** has been cut from 2.5%/5.0% to nil. This move is expected to reduce the input cost pressures faced by the steel industry. Additionally, in a bid to improve the domestic availability of raw materials in the steel sector, the export tax on iron ores and concentrates has been hiked to 50% from 30%, while that on iron pellets a fresh 45% duty has been imposed.

Overall, the fiscal slippage of these measures announced by the government is estimated at around Rs. 2 tn. Apart from the aforementioned set of measures, the government had earlier decided to extend PM Garib Kalyan Anna Yojana by 6-months till Sep-22 which involves an additional outlay of Rs. 800 bn. Moreover, a likely deferment of the big-ticket BPCL divestment due to subdued interest by the bidders amidst volatile market conditions along with lower than budgeted dividend/surplus RBI dividend of Rs. 303 bn (vs. FY23 budget estimate of Rs 650-700 bn) will put pressure on government's budgeted fiscal arithmetic. Despite buffers from the recently concluded LIC IPO (garnering Rs 205 bn on revised valuation) along with the likelihood of higher than budgeted tax revenue collections, we now see the possibility of fiscal slippage risks, aggregating to 0.3%-0.4% of GDP from the budgeted 6.4% of GDP for FY23. Importantly, these steps may not be one-off in nature and follow-up measures may be taken through additional subsidies or additional rounds of tax cuts on petroleum products, if warranted.

On inflation front, based on our sensitivity analysis, the cut in excise duty on petrol and diesel is likely to have a direct impact of around 20 bps on headline CPI inflation, which can get reduced further as some states have followed centre's announcement by a reduction in VAT. Taking the second-round benefit (primarily on logistic costs) into consideration, the average inflation rate may reduce by around 30 bps with full impact of the excise duty cut reflecting from Jun-22 onwards. While difficult to quantify, the reduction in customs and import duties announced by the government on a range of raw materials used in steel and plastic industries, will offer some respite to producers. Further, the domestic wheat export ban announced earlier by the government along with reversal of export ban on edible oils by Indonesia and prospects of a normal monsoon will help to moderate the food price pressures in FY23. While we have already revised our CPI inflation forecast to 6.5% for FY23 given the intensified and broad based price pressures, the effectiveness of the fiscal measures may lead to a downward bias in the forecast.

From the monetary policy perspective, we expect the RBI to go for an additional rate hike of 35-40 bps in the Jun-22 policy meeting. Overall, in our base case, we expect the central bank to raise repo rates by a cumulative100 bps in FY23, with frontloading in the first half of the fiscal. Any continued pressure on the headline CPI could potentially tilt the balance in favour of additional hikes thereby taking the repo rates to the pre-pandemic level of 5.15% or higher. The monetary policy action is expected to be complemented with further calibration of liquidity surplus. Post the 50 bps hike in the CRR in May-22, we now expect the RBI to hike reserve requirement by another 50 bps in an upfront manner. Cumulatively, this would impound Rs 1.8 tn of durable liquidity from the banking system and help in amplifying the monetary policy stance.

Going forward, the funding of the fiscal deficit will play a major role in determining the trajectory of India's yield curve. While higher collections from taxes particularly GST and personal income taxes is expected to neutralize the additional spending of food and fertilizer subsidies, the loss to the exchequer due to excise duty cut may be borne by additional market borrowings. This could further impact India's bond market, where 10Y g-sec yields are already under pressure post the surprise one-shot normalization of the width of the policy rate corridor in Apr-22, followed by an unanticipated repo rate hike of 40 bps along with 50 bps increase in the CRR in an unscheduled policy review in May-22. For FY23, we expect 10Y g-sec yields to move higher towards 7.75%-8.00% range before the end of FY23. With increasing pressure on India's bonds, we do expect the central bank to rely on tools like Operation Twist and Verbal Suasion, to support yields and ensure an orderly completion of government's record high net borrowing program of Rs. 11.2 tn in FY23.

Concludes Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "Clearly, inflation control is the topmost priority of the policy makers at this juncture. Not only will a sustained level of high inflation impact the nascent growth momentum but it will have a bearing on macroeconomic stability apart from being socially and politically acceptable. Therefore, coordinated policy actions have been set into motion by RBI and Government to counter the inflationary attacks. If these measures are successful, the interest rate hikes will be slower and lesser than what is anticipated at this stage. However, there will be costs in terms of a weaker fiscal position and slower export growth in near term."

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