beyondtheheadlines

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INDIA'S 7TH PAY COMMISSION: PAY HIKE TO BOOST CONSUMPTION

India's Cabinet has decided to raise central government employees' and pensioners' salaries by 14% to 23.5% this year, accepting the 7th Pay Commission's recommendations put forth in November last year. Pay commissions are carried out nearly every decade to reset public sector salaries, adjusting for gains in employees' productivity. In other years, employees still enjoy pay hikes, albeit on a smaller scale. This Pay Commission hike, to be implemented from July this year, will directly benefit c.10 million people (c.4.7 million central government staff and c.5.3 million pensioners), and potentially up to 20-30 million Indian households over next few years.

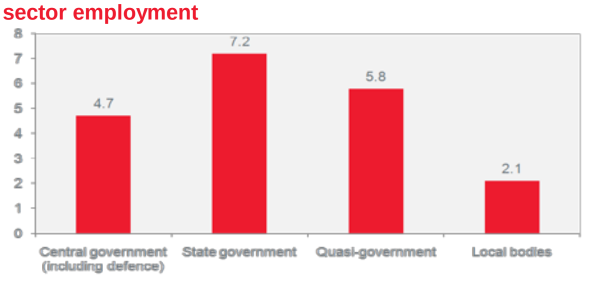
The government will also more than double entry-level employees' basic pay to INR18,000 (USD266) a month, from INR7,000. However, it deferred raising allowances and will leave it to a committee to review the Pay Commission's proposed 63% increase.

Why it matters

1. Consumption stimulus

In our view, the biggest potential impact from the pay hike is a boost to consumption, particularly in the urban segment. Once states and public sector companies follow suit and raise pay at similar rates—as has occurred in the past— the total wage rise could amount to USD50 billion over the next three to four years*. Taken together, this is a large workforce, accounting for 60% of organised sector employment.

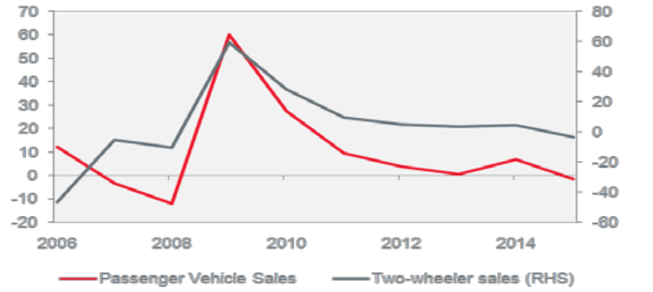
Fig 1: Government employees make up 60% of organised sector employment



*Source: CEIC, Macquarie Research, June 2016. *Macquarie Research, 30 June 2016.*

Automobiles, housing and fast-moving consumer goods are sectors likely to benefit. For example, the last Pay Commission, which handed payouts in October 2008, helped boost auto sales over the next few years.

Fig 2: Vehicle sales spiked post-2008 Pay Commission (% YoY)



Source: Bloomberg, Society of Indian Automobile Manufacturers, 2015.

Importantly, however, the pay rise will unlikely be the only catalyst for consumption. Over the longer term, improved aggregate demand will also hinge on other factors, such as lower interest rates and favourable monsoons—the latter is particularly important to boost rural consumption, which has stagnated for the past few years. Increased consumption will likely positive trickle-down effects on corporate earnings and India's overall economy.

2. Benefits outweigh the small fiscal impact

The pay hike is expected to dent government coffers to the tune of INR849 billion or 0.6% of GDP** in the current FY17. This includes arrears to be paid out this year. The Union Budget will bear most of the expenditure, with the remainder falling under the Railways Budget.

In addition, lower arrears (compared to the previous Pay Commission) and the delay in raising allowances also somewhat mitigate the fiscal burden. The government may also recoup a fraction of this liability through income and consumption taxes.

***Goldman Sachs Research, 30 June 2016.*

3. May fuel inflationary pressures

There are concerns that rising incomes and demand may fuel inflation—valid, in our view, as higher inflation could slow the central bank's hand in cutting interest rates. India's consumer price inflation (CPI) and wholesale price inflation (WPI) have edged up in April and May, but are still way below their 2013 highs.

The pay raise may pressure CPI due to a surge in demand for goods and services; but food inflation will hopefully be partly countered by better monsoons. WPI may see more muted impact, helped by lower commodity prices and spare capacity in some manufacturing sectors.

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