Press Release

July CPI signals a drop in inflationary headwinds

Additional hikes in interest rates unlikely to exceed 50-60 bps in current fiscal

12-Aug-2022

India's headline CPI inflation showed further signs of moderation by slipping to a 5-month low of 6.71% in Jul-22 from 7.01% led by a combination of favorable base and significant easing of food prices. While the print has continued to remain above the 6.0% policy tolerance threshold in 2022 so far, CPI inflation seems to have now peaked from a high of 7.8% in Apr-22 led by significant correction in commodity prices and a positive turnaround in southwest monsoon. On sequential basis, the print eased to a 3-month low of 0.46% MoM from 0.52% with relatively benign food prices negating the increase in the other categories.

Sequentially, food and beverages index rose by just 0.1% MoM in Jul-22 from an increase of 0.9% in Jun-22 with decline in price of meat and fish, vegetables, and oils & fats. Clearly, the decline in vegetable and edible oil prices has more than neutralized the impact from the GST council's move to rationalize rates by levying 5% GST on pre-packaged unbranded food items such as wheat and rice, several dairy items, honey, jaggery, and puffed rice among others. Given the relatively lower weight of such packaged but unbranded food articles in the CPI basket, the impact of the hike in GST rates is expected to be lower.

The moderation in domestic food prices is in tandem with the decline recorded in global food inflation trajectory. The UN Food Price Index declined by 8.6% in Jul-22 on the back of significant drop in prices of edible oil, of which India is a major importer. Global palm oil prices declined due to prospects of increased export availability out of Indonesia, while sunflower oil prices dropped amid subdued global import demand, despite continued logistical uncertainties in the Black Sea region. We expect the domestic edible oil prices to moderate further on the back of improving supplies from key producing countries and government interventions. From domestic standpoint, rainfall activity has picked up pace since the start of Jul-22 with cumulative rainfall for the season swinging into an 8% surplus (as of Aug 12, 2022) at a pan-India level. Nevertheless, sowing of rice continues to lag, though a delayed catch-up has been seen for other crops. The intertemporal and geographical spread of monsoon remains on watch, as a pick-up in Kharif sowing will be critical to assuage food price pressures especially in the post-harvest season i.e., Sep-22 onwards.

On the other hand, fuel and light inflation rose by 2.1% in Jul-22 from 0.8% MoM in Jun-22 led by increase in LPG and kerosene prices. Amidst recessionary fears, the commodity prices have corrected sharply in the recent weeks. Crude oil prices, after averaging at USD 108 pb in the first four months of FY23, May-22 and Jun-22 respectively, has now moderated encouragingly to USD 99 pb in Aug-22. The pass-through of this correction could offer some reprieve to domestic price pressures and also help to tame inflation expectations going forward.

Core (i.e., CPI ex indices of Food & Beverages, Fuel and Light) inflation momentum rose by 0.6% MoM in Jul-22 from a flattish trend in the previous month. The increase was broad based with categories of clothing, housing and miscellaneous category recording a sequential increase. Going forward, we expect the sticky core inflation to persist with strong pick-up in retail, increased pace of the pass-through of elevated input prices and impact of GST rate hike on certain household consumption items.

In our opinion, price pressure points exist primarily due to factors such as GST rate hikes on some items of mass food consumption, upward revision to electricity tariffs in some states, along with MSP revisions which is yet to be formally captured in data. In addition, pressure from imported inflation amid significant rupee depreciation which has made inbound shipment of commodities such as oil, metals, coal and fertilizer costlier in rupee terms. As per an RBI study, a 5% depreciation in rupee leads the inflation to rise by nearly ~10-15 bps. Considering INR's ~6% depreciation in 2022 so far and given India's heavy reliance on crude oil imports, the inflationary pressures is expected to remain elevated in H1 FY23. Nevertheless, the sharp correction in commodity prices could outweigh the impact of rupee depreciation from inflation perspective. Global commodity prices have cooled down in recent weeks as risk of a pronounced global growth slowdown amidst aggressive monetary policy tightening in several countries has gained ground. The CRB Commodity Index has declined by 13% in Jul-22, marking its first monthly fall in 2022. The pass-through of this correction could offer some reprieve to domestic price pressures in H2 FY23. Nevertheless, the inflation trajectory would significantly depend on evolving geopolitical tensions and commodity market dynamics that are highly linked to the latter. Thus, we continue to hold to our average inflation forecast at 6.7% for FY23 albeit with some downward bias.

From monetary policy perspective, there is still a scope of another 50-60 bps of rate hike in the current year in line with the need to frontload rate hikes in tandem with global central banks; the pace of the residual hike will also depend on the inflation print over the next few months. The rate action is likely to be accompanied by simultaneous withdrawal of money market core liquidity surplus. RBI, however, in its recent policy outcome, indicated its preference for two-way fine-tuning operations through VRR and VRRR options whenever required, and this has been in evidence in the last week of July-22. We believe core liquidity surplus could moderate towards 1.0/1.5% of NDTL levels from 2.8% currently which could further help in taming the demand led inflation.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "There are enough indications that suggest that the headline inflation trajectory is on its way down globally as also in India. Unless there is a surprise development on the geo-political side, we would expect domestic CPI inflation print to be closer to 6.0% by Q3FY23. The risks of the repo rate going beyond 6.0% in the next 2 quarters is therefore lower at this stage. We also expect the 10 yr g-sec yield to remain in a range of 7.2%-7.6% till Dec-22."

Annexure

Chart 1: Jul-22 CPI print moderates to a 5-month low of 6.71% YoY in Jul-22

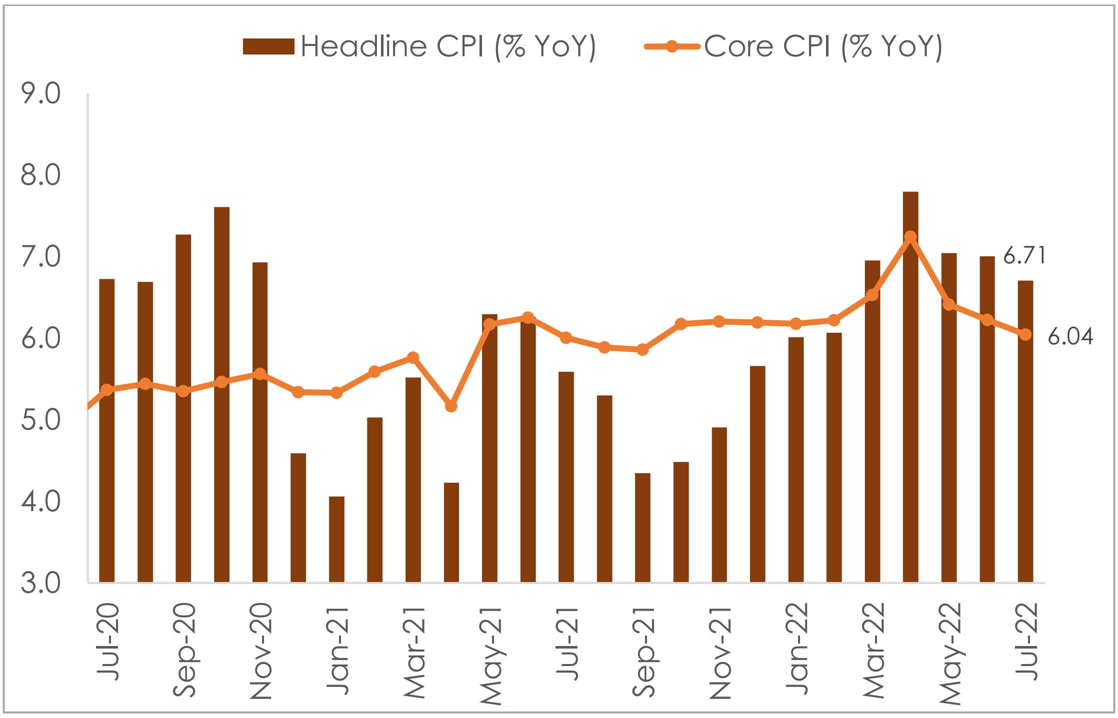
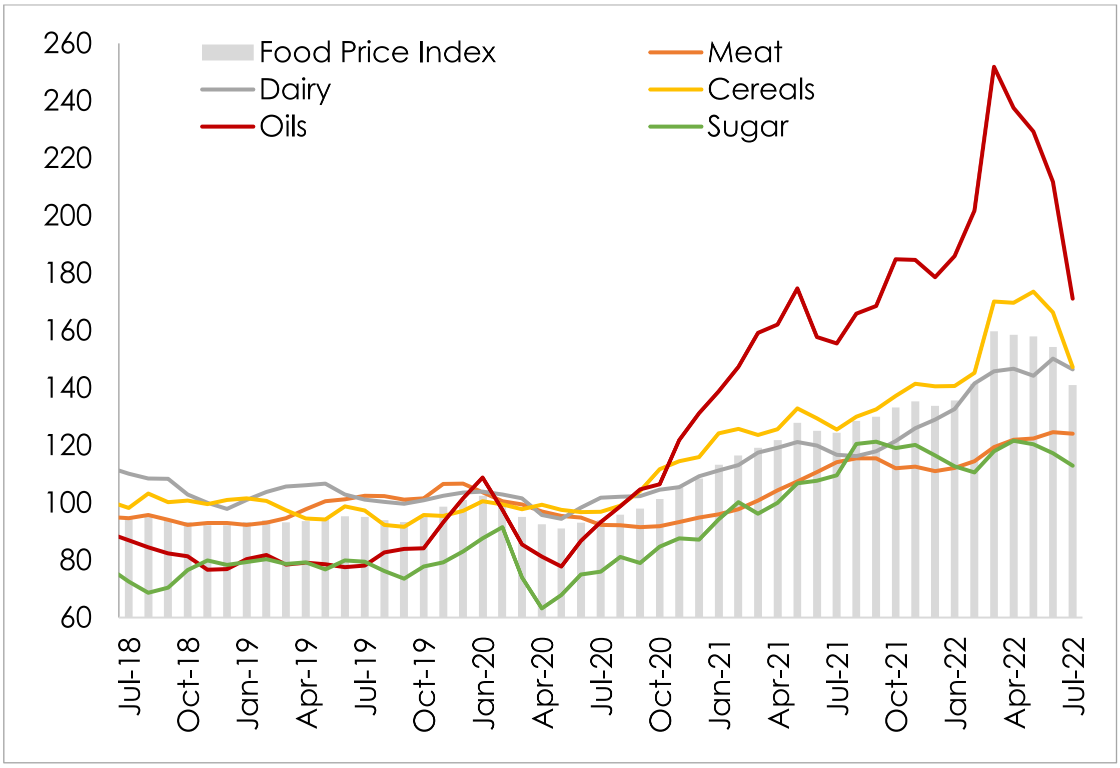


Chart 2: UN FAO price index at 6-month low in Jul-22 led by drop in edible oil price



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