Press Release

Stronger inflationary headwinds, economy in for a bumpy ride

Spurt in the headline CPI print may induce quicker rate hikes

13 April 2022

The strong headwinds from the spurt in commodity prices driven by the continuing geopolitical conflict between Russia and Ukraine have started to manifest in India's inflation trajectory. **As such, India's CPI inflation print rose unexpectedly and sharply, to 6.95% YoY in Mar-22 from 6.07% in Feb-22.** On a sequential basis, the index rose by 0.96% as compared to 0.24% in the previous month. This is the highest YoY print over the last 18 months and in sequential terms, a high over the last 5 months. Taking into consideration today's print, inflation for FY22 averaged at 5.5%, in line with our revised forecasts.

While retail fuel prices have been steadily raised over the last few weeks as a pass through of the spiralling crude oil prices, they are yet to be the driver of the higher inflation print. After remaining ranged bound for nearly sixteen months, annualized food and beverage inflation rose to 7.47% YoY in Mar-22 from 5.93% in Feb-22. Sequentially, the price of food products notched up by 1.32% primarily led by edible oils & fats followed by meat & fish and fruits.

The war-driven supply chain disruption (Chart 2) has led prices of certain food commodities such as edible oils and cereals (particularly wheat) to surge significantly. This is also reflected in the UN FAO Food Price Index, which has risen to its highest-level averaging at 159.3 in Mar-22, recording an increase of 12.6% MoM from Feb-22 levels (Chart 3). Given India's heavy reliance on imports of edible oils (~70% of total consumption of edible oils is imported) we expect the price pressures in the edible oil category to continue thereby largely offsetting the impact of government's earlier intervention of rationalizing import duties to control its rising prices. On the other hand, while India is the second largest producer of wheat, the high global prices has offered lucrative export opportunities which could partly reduce domestic availability, thereby pushing up its price in domestic markets. However, with Food Corporation of India (FCI) maintaining adequate buffer stocks, the likelihood of any shortage in the availability of cereals is limited.

Another source of discomfort has emerged from increasing fertilizer costs. With Russia being top exporter for fertilizers, the crisis between the two nations has led its price to increase to more than a decade high (Chart 4). With India being the net importer of fertilizers, the soaring prices could dampen fertilizer usage (except urea which is subsidised) and impact crop yields pushing up prices of agricultural commodities, fueling inflation. That said, prospects of normal monsoon and robust rabi arrivals is expected to marginally cushion the blow from the increasing food inflation trajectory in FY23.

Interestingly, overall fuel & light eased to 7.52% YoY in Mar-22 from 8.73% in Feb-22. Sequentially, fuel inflation rose by 0.91% for the second consecutive month, despite the significant jump in crude oil prices as the oil marketing companies started to transmit the higher prices to the retail prices of petrol and diesel only from the end of Mar-22. The retail fuel prices have already been raised by Rs 10-12 per liter over the last two weeks. Therefore, we believe that the comfort in this category will be short lived with the impact of volatile crude oil prices and the rise in retail prices of petrol and diesel to start fully reflecting in the CPI print of Apr-22.

While we expect the crude oil price to moderate (from the current levels of USD 100+ pb) with increased supplies from other OPEC+ countries, likely removal of Iran sanctions, US shale production growth along with gradual de-escalation in conflicts between Russia and Ukraine, it may remain higher than the pre-conflict levels as the unprecedented level of sanctions on Russia and further disruptions will linger. As of now, in our base case we expect crude oil price to average at USD 97 pb in FY23 (RBI's expectation at USD 100 pb in its latest policy).

Continued rise in price of clothing & footwear followed by miscellaneous category led core inflation (inflation ex. fuel and food) to rise materially to 6.53% YoY in Mar-22 from 6.22% YoY in Feb-22. While the former reflects the impact of a hike in GST rate on footwear, the latter is led by jump in transport & communication on the back of a partial rise in retail pump prices along with increase in gold and silver prices which led personal care and effects to increase significantly.

Going forward, we expect the core inflation to remain elevated as the OMCs will continue their upward revision of petrol and diesel prices at the retail level (minimum of Rs 14-15 per liter) to reduce the under-recoveries being accumulated by them at the current crude prices of USD 100+ pb. The government, however, may also consider a partial absorption of the increased prices through a further excise duty cut on petrol and diesel which could provide marginal comfort from inflation perspective.

For FY23, inflation drivers are likely to face considerable pressure from persistent hardening of input prices. What started as a supply side disruption (exacerbated by elevated transportation costs and aided by a recovery in global demand) in major part of FY22, later gave way to a spike in geopolitical risk premium on account of the ongoing conflict between Russia and Ukraine. The heightened pressure from commodity prices is also coinciding with unlocking of the economy post Omicron wave while vaccination coverage continues to gain traction. Taking the average first order impact of 20 bps for every 10% change in oil price on CPI inflation, we project FY23 CPI inflation at 5.9% in our base scenario (considering the average crude oil price of USD 97 pb in FY23) as compared to RBI's forecast of 5.7%.

While we acknowledge the considerable challenge in projecting inflation due to the high volatility in commodity prices and unpredictable geopolitical events, we believe there are upside risks to such forecasts which can take the inflation print beyond MPC's upper band particularly in H1FY23. In our opinion, there is a significant likelihood that the CPI figure will remain around 7% for the next few months. RBI has already taken cognizance of the increasing inflationary headwinds and has provided signals of an impending change in the monetary policy stance. The high inflation print of Mar-Apr'22 may act to expedite the transition process and the probability of a repo rate hike in Jun-22 can't be ruled out.

Annexure

Chart 1: Mar-22 inflation rises to a 17-month high of 6.95% YoY

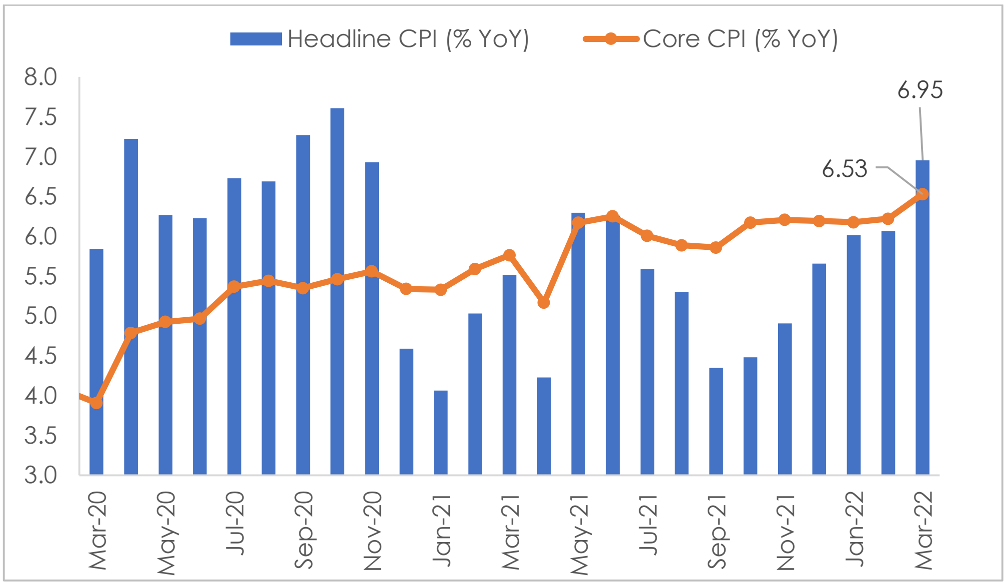


Chart 2: Geo-political concerns to further increase supply chain bottlnecks

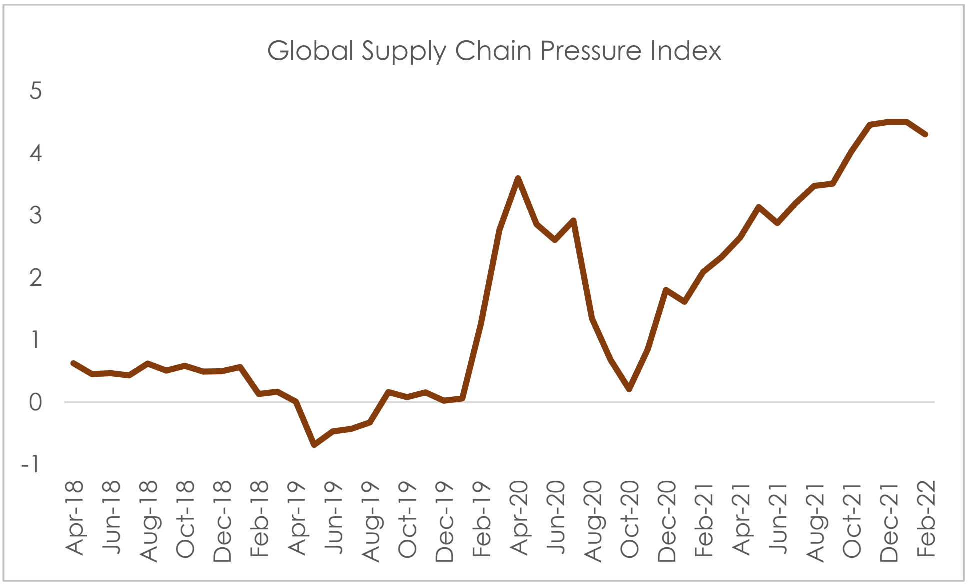


Chart 3: Raging Russia-Ukraine conflict has led price of edible oils and cereals to soar

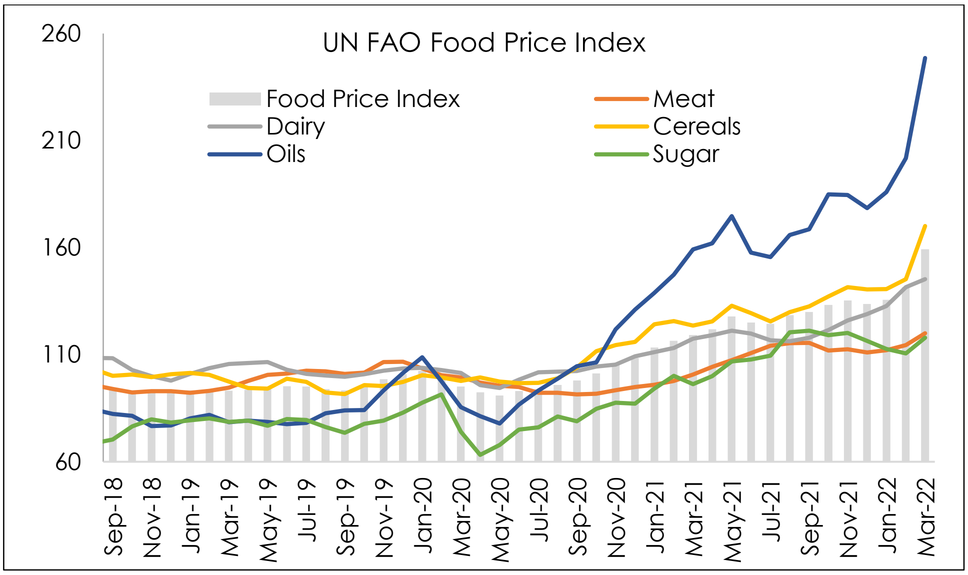
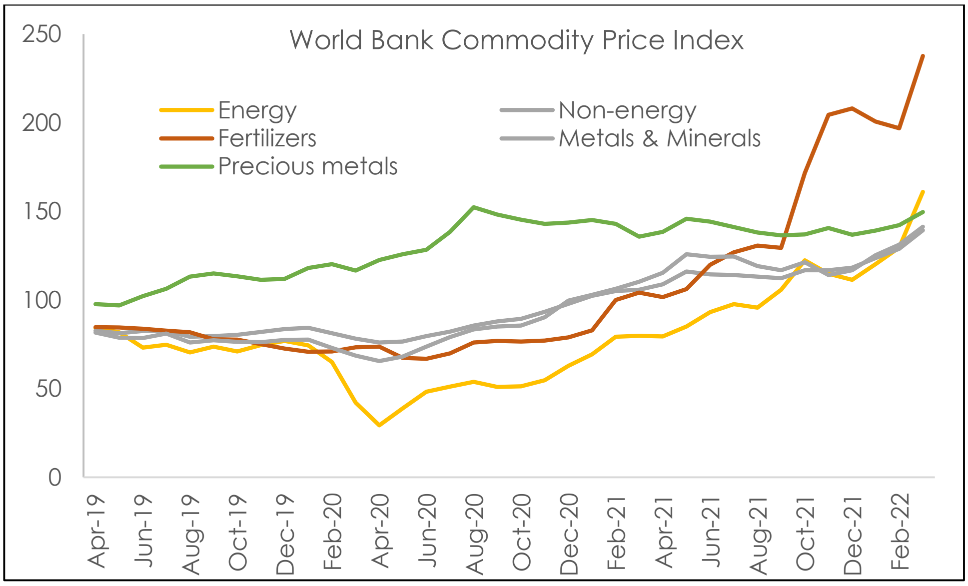


Chart 4: Rising commodity prices to keep input costs inflated



About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

Media Contacts:

Roshni Rohira Ph: + 91-9769383310 roshnirohira@eminenceonline.in	Sahban Kohari Ph: + 91-9890318722 sahban@eminenceonline.in

Investor Outreach: **Analytical Contact:**

Rituparna Roy Deputy Vice President Ph: + 91-7506948108 rituparna.roy@acuite.in	Suman Chowdhury Chief Analytical Officer Ph: + 91-9930831560 suman.chowdhury@acuite.in