Press Release

Geopolitical risks add to India's inflation woes

Nevertheless, MPC likely to continue on the accommodative path in near term

31 March 2022

The raging conflict between Russia and Ukraine and the imposition of unprecedented levels of sanctions on Russia by the western nations, have cast a fresh uncertainty on the global growth outlook which was steadily recovering from the scars of the pandemic. The amplifying hostilities between the two nations have resulted in a sharp rise in price of certain commodities such as crude oil, gas, wheat, fertilizers, coal, edible oils etc. amidst the creation of global supply shock. While no ceasefire has been reached so far, some signs of diplomatic progress in the context of the crisis have helped to marginally rein in crude oil price from the peak of USD 128 pb in the first part of Mar-22 to USD 110 pb currently. While we expect the crude oil price to moderate 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, they may remain higher than the pre-conflict levels as some sanctions and disruptions will linger**.** As of now, in our base case we expect crude oil price to average in the range of USD 95-97 pb in FY23 (average of monthly future prices for the next 12 contracts). **Says Suman, Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "From domestic standpoint, with India being a net importer of crude oil, the spike in energy prices is clearly a major macro-economic disruptor which will weigh on growth prospects and lead to a sharper rise in inflation as well as to a wider current account deficit".**

The Oil Marketing Companies in India (OMCs), after a virtual price freeze of nearly 4 months, have begun to increase the pump prices of petrol and diesel for the ninth consecutive day taking the increase in fuel rates to Rs 6.40 per litre till March 31. However, a larger upward revision (minimum of Rs 15-16 per litre) will be warranted to reduce the under-recoveries being accumulated by the OMCs at the current crude prices of USD 110 pb. The pass through of the higher prices to the retail consumers may be undertaken to a partial extent and in a calibrated manner, given its potential impact on inflation and the nascent state of the ongoing economic recovery. The government may also consider a partial absorption of the increased prices through a further excise duty cut on petrol and diesel.

From inflation perspective, the heightened pressure from commodity prices is coinciding with unlocking of the economy post Omicron wave while vaccination coverage continues to gain traction. Taking the average sensitivity of 20 bps (of first order impact) on CPI inflation for every 10% change in oil price, **we now project FY23 CPI inflation at 5.9% in our base scenario** (considering the residual price adjustment over Dec-Mar FY22, second order impacts, and another Rs 5 cut in excise duty by the central government). We also acknowledge the considerable challenge in projecting inflation due to the high volatility in commodity prices, which in the current environment is taking cues from unpredictable geopolitical events. This widens the balance of risk around our forecast. **From growth perspective, we expect GDP growth for FY23 at 7.5%** amidst government's strong thrust on infrastructure segment, solid coverage on vaccination, moderate recovery in rural consumption and the full play out of pent-up demand although it is likely to be partly offset by high crude oil prices and higher than expected inflationary pressures.

Amidst the deleterious impact of the war, the RBI will be walking a tightrope on its monetary policy decisions, striving to control inflation within the tolerance band while at the same time supporting nascent growth impulses. **Adds Suman Chowdhury "In our opinion, given the deteriorating global growth outlook and its cascading impact on India's growth recovery, there remains a limited scope for the RBI to tighten monetary policy at the current juncture. However, due to overwhelming risks to India's inflation outlook amid spurt in commodity prices along with tighter global financial conditions, we expect the central bank to revise its inflation forecast upwards and lay the ground for a gradual exit from their accommodative stance. Going forward, we expect RBI to restore the width of the LAF corridor to its pre pandemic levels by hiking the reverse repo rate by 40 bps over Jun-Aug 2022 policy review, followed by a cumulative 50 bps hike in the repo rate in the rest of FY23."**

Annexure

Chart 1: Commodity prices have been surging in 2022

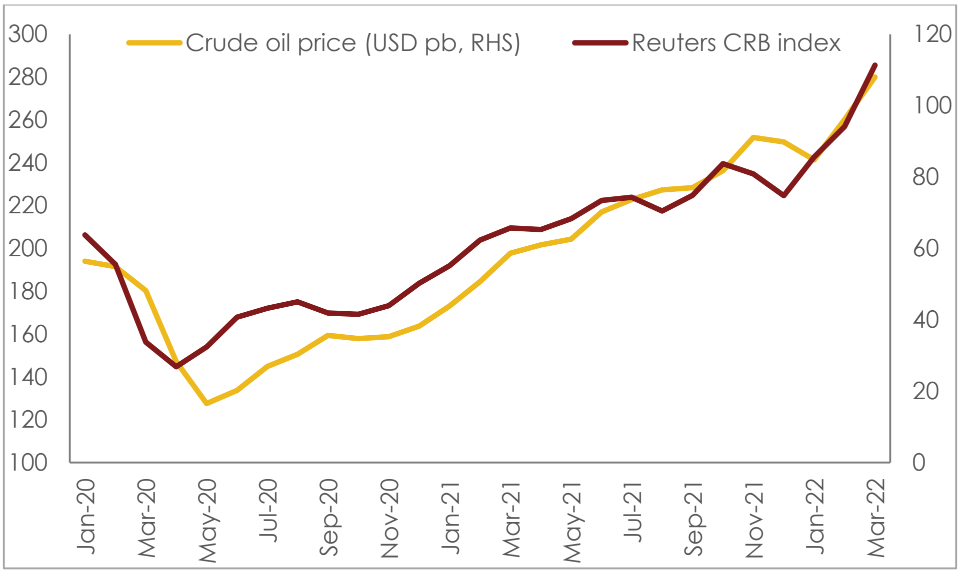
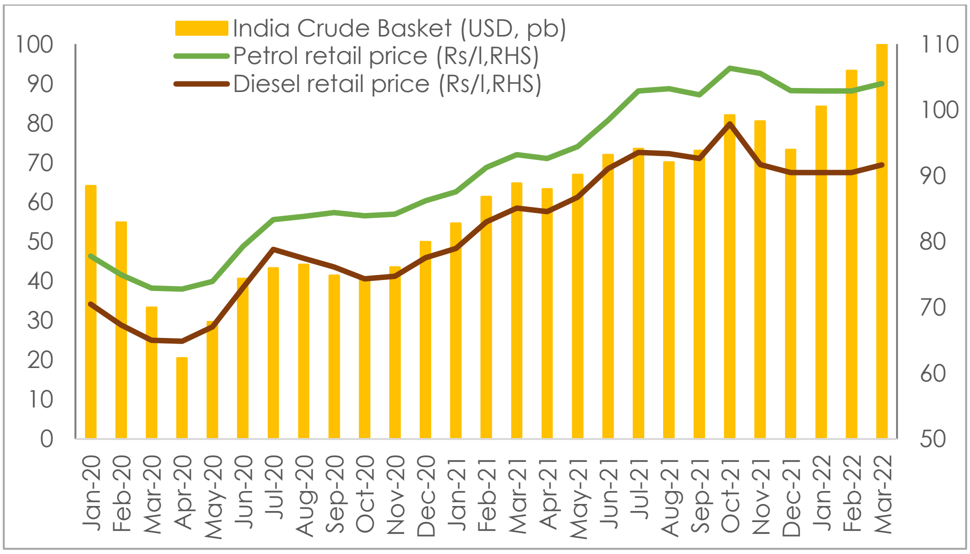


Chart 2: Increase in oil prices have begun to reflect in domestic retail fuel costs



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.

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