

Inflation Watch

March 2017

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Multiple upside risks to inflation but CPI will undershoot forecast

- According to the April Monetary policy report, the RBI's baseline path for headline CPI inflation is expected to take it from its current level to 4.2 per cent in Q1:2017-18, and 4.7 per cent in Q2. It is then forecast to edge higher to 5.1 per cent in Q3 on account of the demonetisation induced base effect before moderating to 4.9 per cent in Q4:2017-18. The 50 per cent confidence interval for inflation in Q4:2017-18 is in a range of 3.4-6.4 per cent and the 70 per cent confidence interval is in a range of 2.6-7.2 per cent. **Such wide confidence intervals suggest that while the RBI is concerned with the inflation trajectory it is not very confident on its baseline forecast.**
- **The RBI's projection of higher inflation is predicated on the view that food inflation is headed higher.** As per the RBI's assessment the price of perishable food items has played the most decisive role in the fall in inflation over the las several months especially during the post demonetisation period. In fact the RBI's analysis suggest that excluding vegetables food inflation would have been higher by 2.7% and headline CPI by 1.3% during November. The March data is partly supportive of this view as some food items have edged higher but the March data does not show any rapid acceleration as feared by RBI
- **The other major risk that imparts upside pressure to inflation is the implementation of the HRA increase.** The higher HRA would have a direct and immediate impact on headline CPI through an increase in housing inflation. Assuming a rate of increase in the HRA as proposed by the 7th CPC is implemented from early 2017-18 onwards and the State Governments implement a similar order of increase with a lag of one quarter, the RBI expects that CPI inflation could be 100-150 bps higher than the baseline for 2017-18. The RBI expects the HRA impact on inflation to persist for 6-8 quarters, with the peak effect occurring around 3-4 quarters from implementation.
- **Furthermore, factors driving the recent surge in WPI are imparting input price pressures for firms.** Pricing power is also expected to improve, as reflected by manufacturing firms surveyed in the RBI's latest industrial outlook Staff costs in the manufacturing sector are also expected to increase in Q1:2017-18. The combination of these factors can keep core inflation at elevated levels.
- **While we share the concerns highlighted by the RBI on the upside risks to the inflation path, our reading of the trends suggests that actual inflation is likely to undershoot the RBI's forecast.** Even as the economy improve we believe that firms pricing power will take additional time to materialize and the Rupee's appreciation will keep a lid on imported inflation. However even if inflation undershoots the RBI's projections, we still expect the RBI to maintain its neutral stance given the many risks that it has highlighted. The RBI may however be forced to recalibrate its tone if CPI undershoots its forecast over the next few months.

CPI Inflation Summary

Headline Inflation

- March headline CPI inflation rose 3.8% compared to a year earlier. The core inflation excluding food and fuel remained around 4.9%.
- The March CPI inflation was lower than the median estimate of 3.98 % in the Reuters survey
- The buildup of CPI inflation in the financial year so far was 2.7% compared to the buildup of 4.4% in the corresponding period the previous year

Food, Beverage (Weight 45.9%)

- Y-o-Y food and beverages inflation stood at 2.54% in March compared with 2.46% the previous month.
- Within food and beverages, the pulses inflation fell dramatically from 34.2% in May to -12.4% in March. However sugar inflation remained elevated coming in 17.1 for 12th month of consecutive double digit growth.

Fuel and Light (Weight 6.8%)

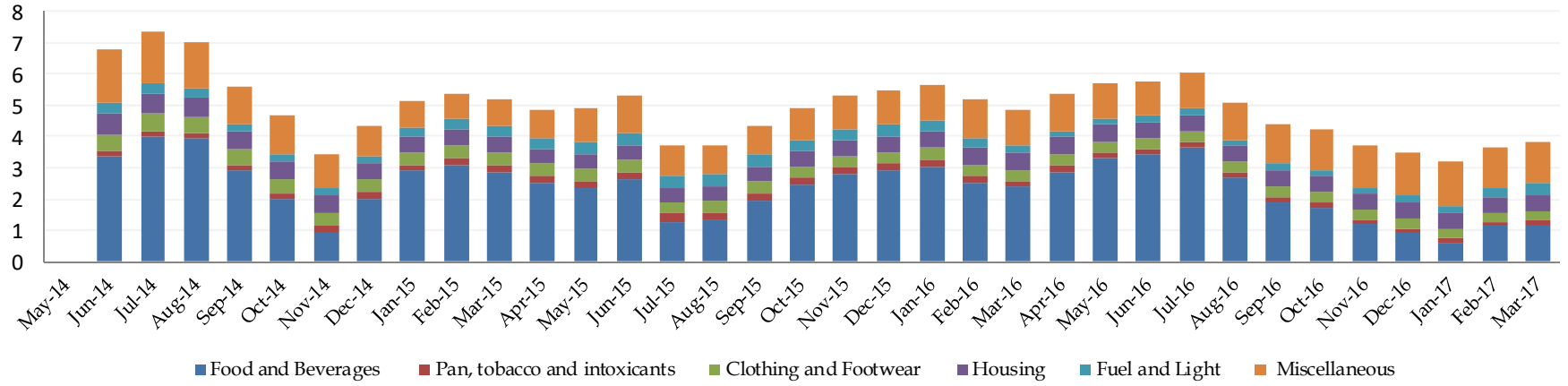
- Y-o-Y Fuel and Light inflation stood at 5.6% in March higher than 3.9% the previous month
- The March growth is the highest y-o-y growth over the last year.

Miscellaneous (Weight 28.3%)

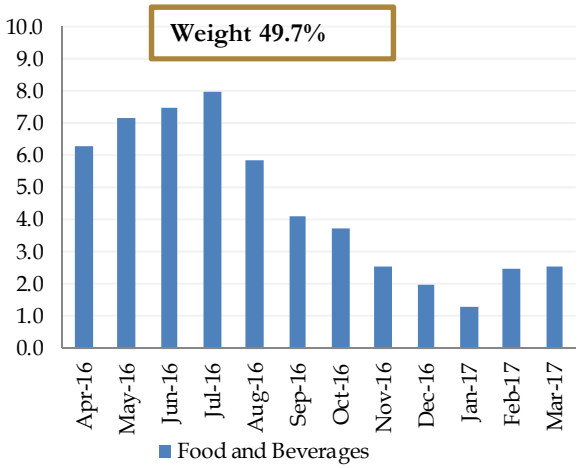
- Y-o-Y Miscellaneous Products inflation stood at 4.8% in March compared with 4.8% the previous month
- Within miscellaneous, the transportation and communication component which had been muted rose to 6% its highest level since July 2014

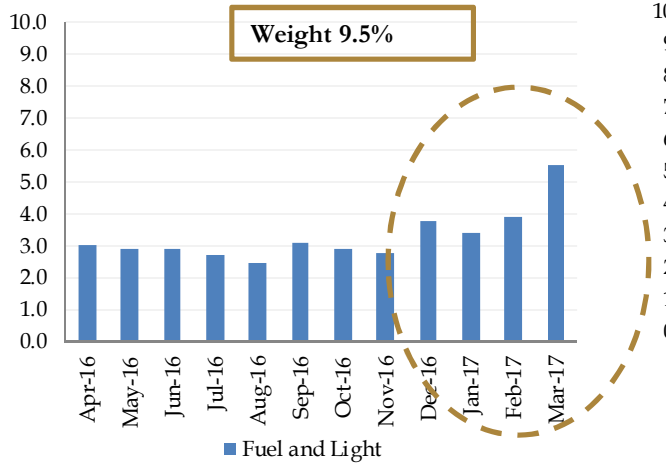
CPI Inflation by Component

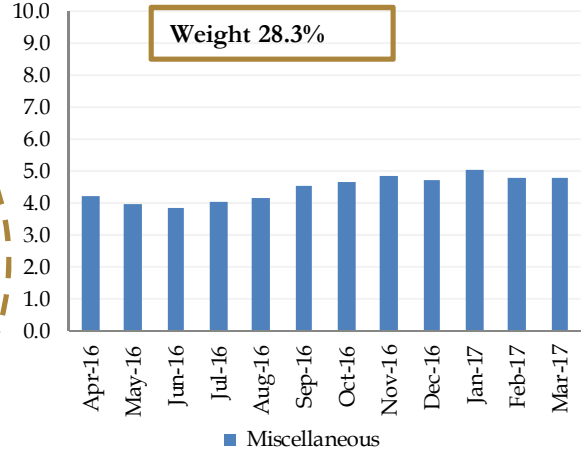
CPI Inflation



CPI Inflation by Component

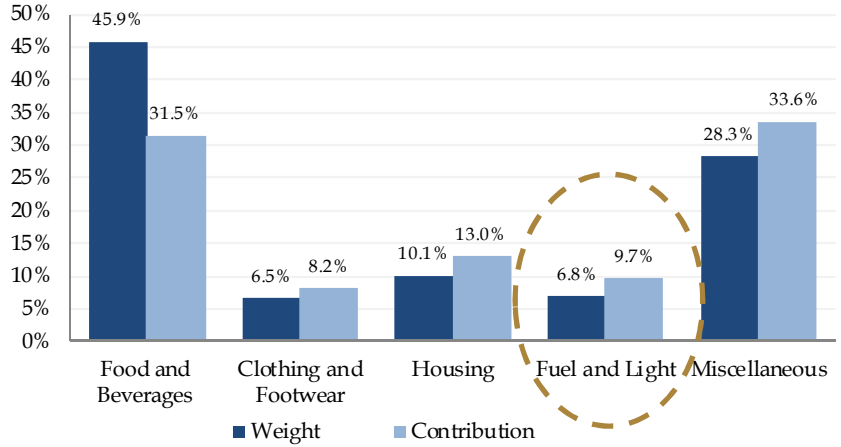




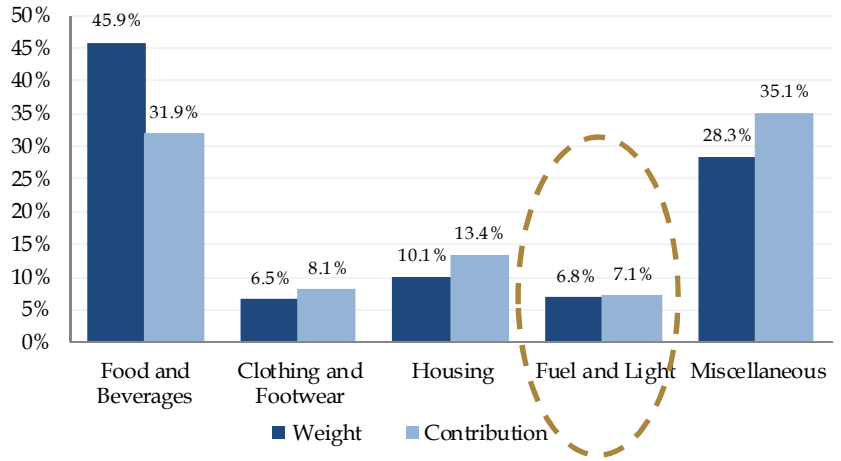


CPI Contribution Analysis: fuel and power rose in March

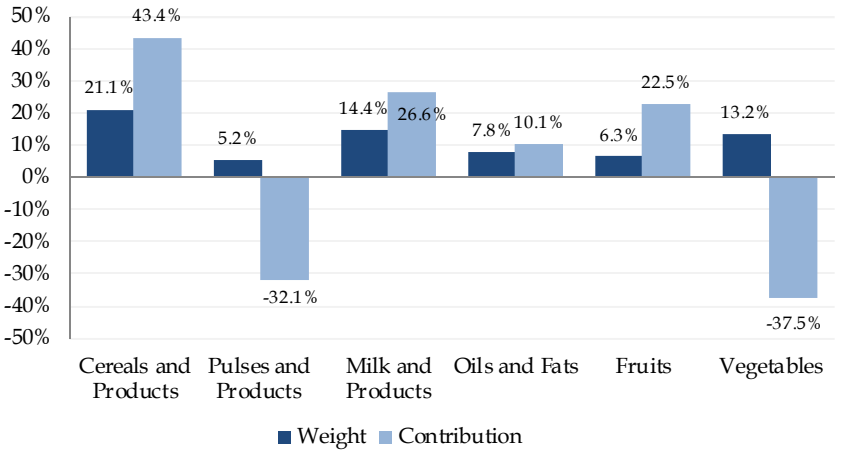
Component Contribution to CPI Headline Inflation (Mar)



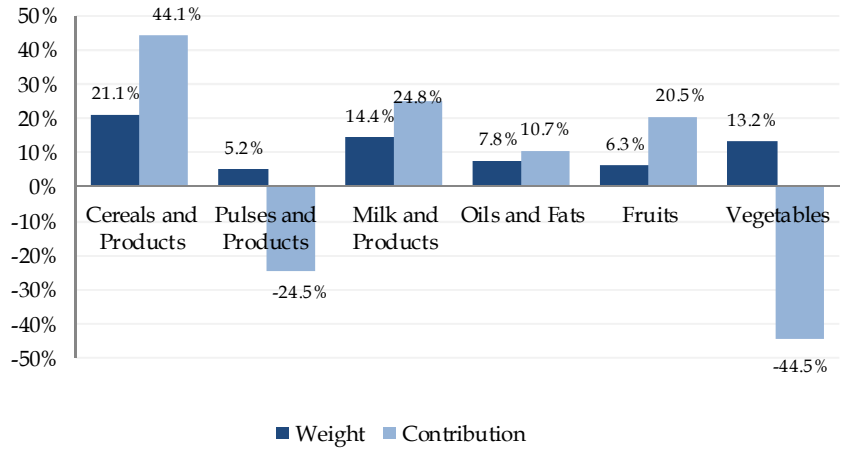
Component Contribution to CPI Headline Inflation (Feb)



Component Contribution to Food Articles Inflation (Mar)

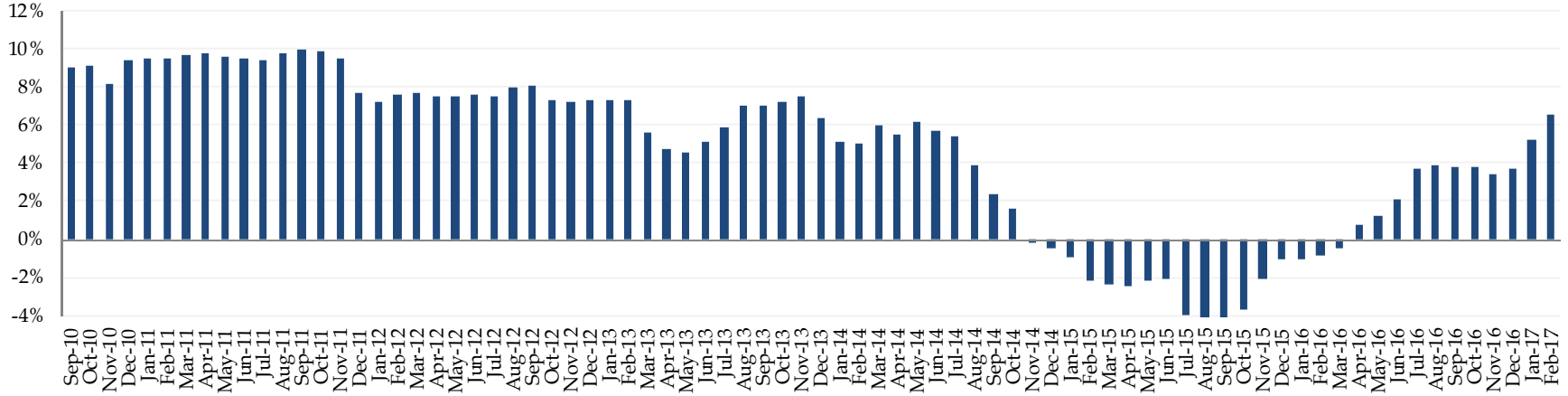


Component Contribution to Food Articles Inflation (Feb)

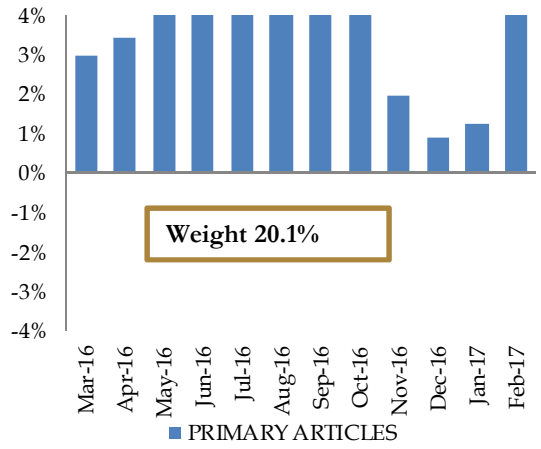


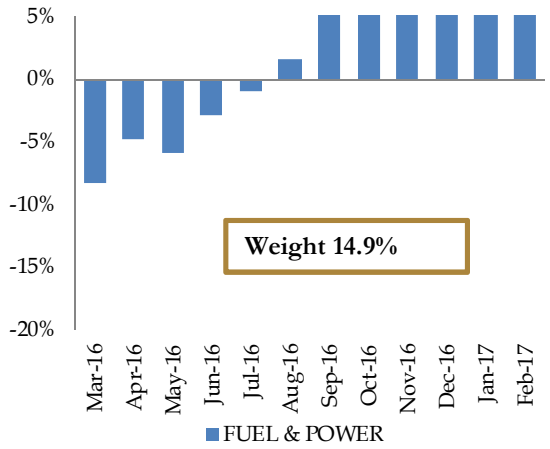
WPI Inflation by Component

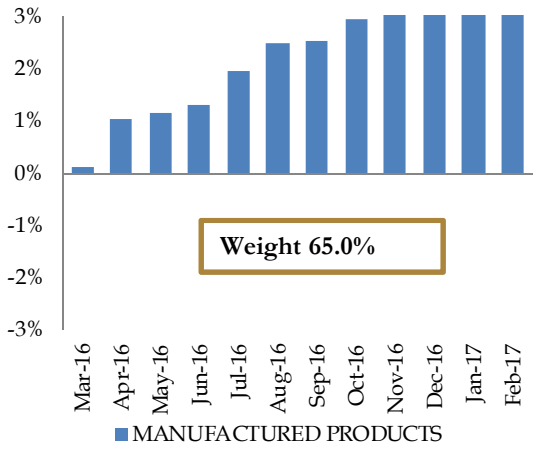
WPI Inflation



WPI Inflation by Component

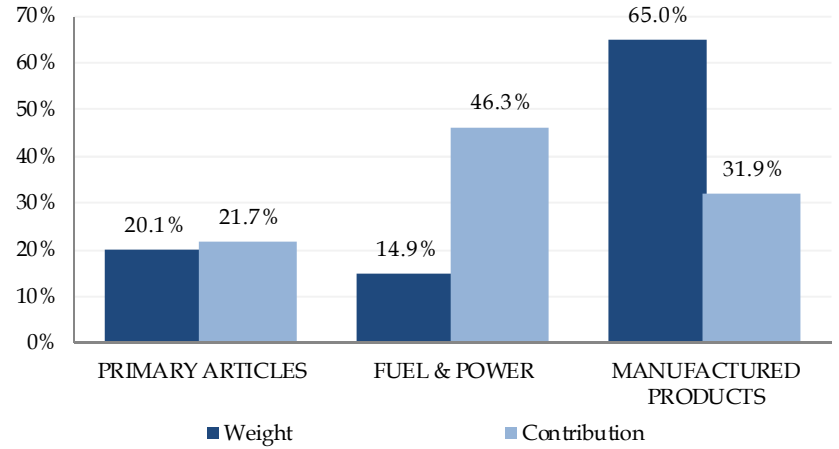




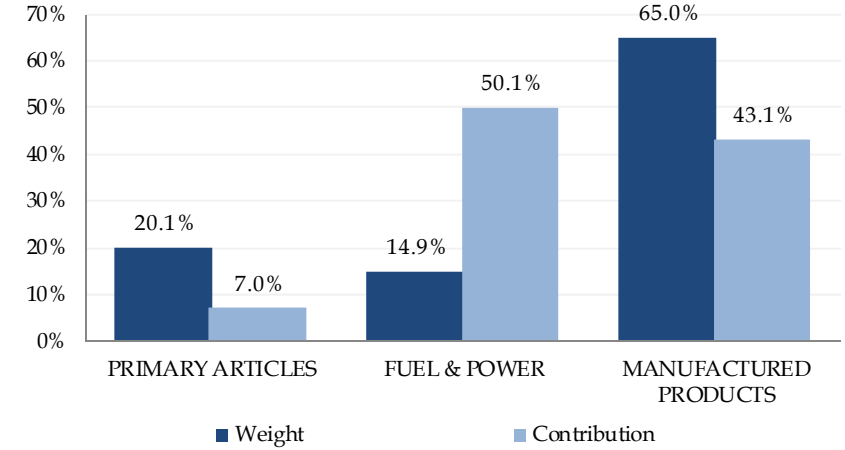


WPI Contribution Analysis

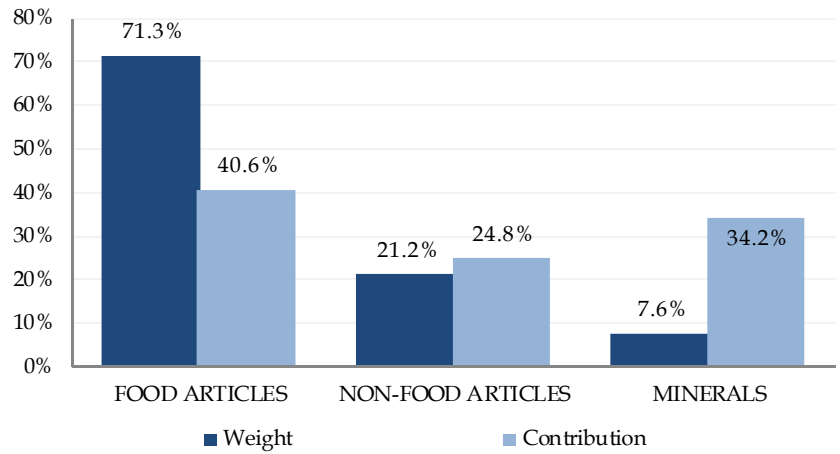
Component Contribution to WPI Headline Inflation (Feb)



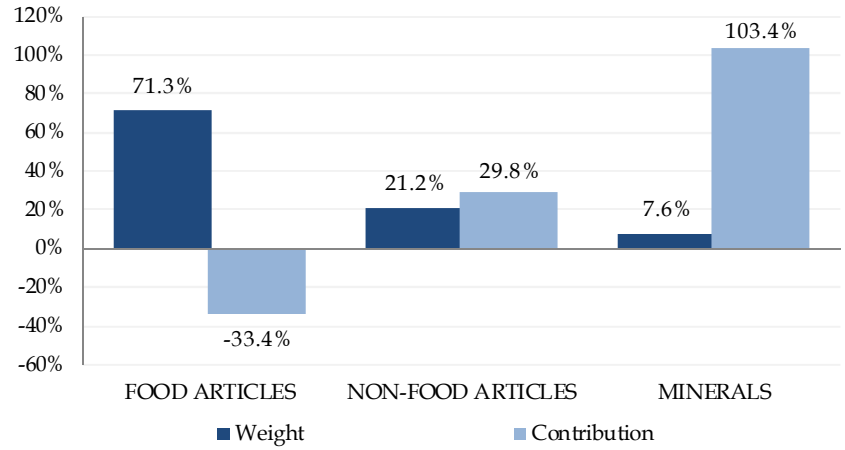
Component Contribution to WPI Headline Inflation (Jan)



Component Contribution to Primary Articles Inflation (Feb)

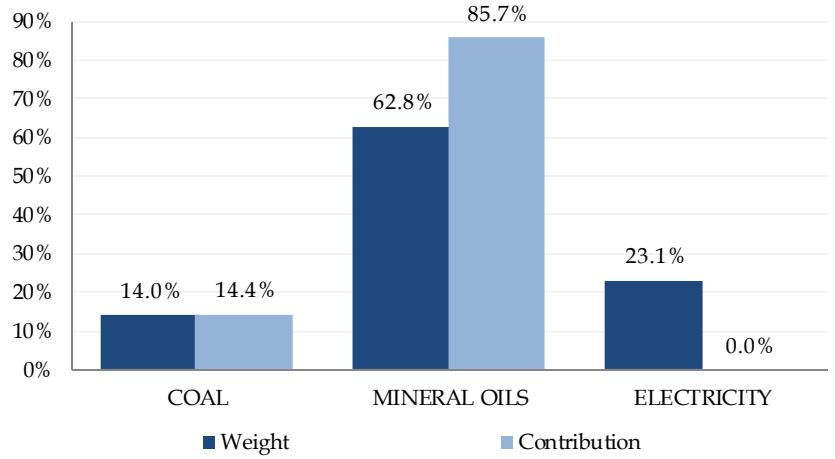


Component Contribution to Primary Articles Inflation (Jan)

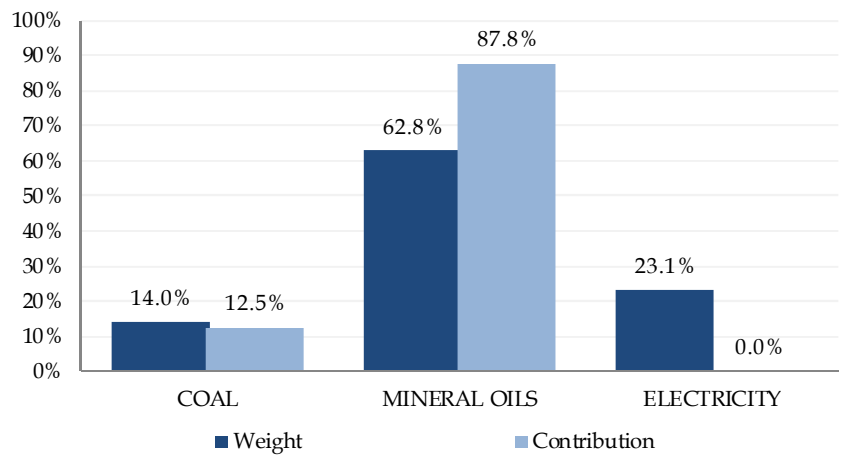


WPI Contribution Analysis

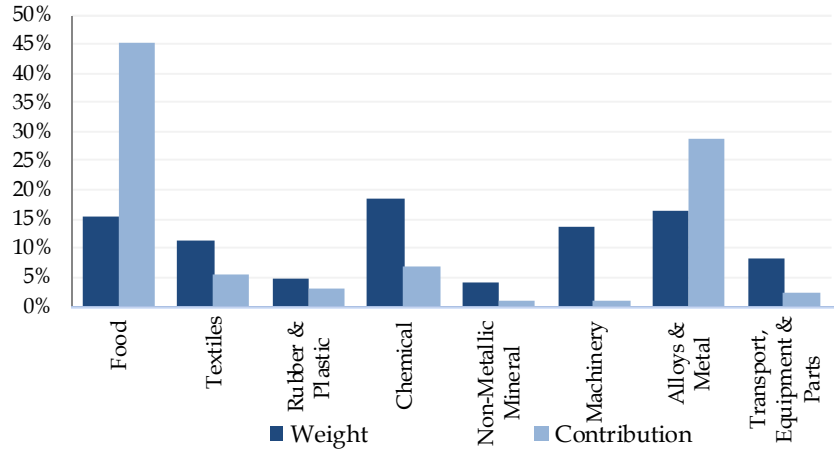
Component Contribution to Fuel and Power Inflation (Feb)



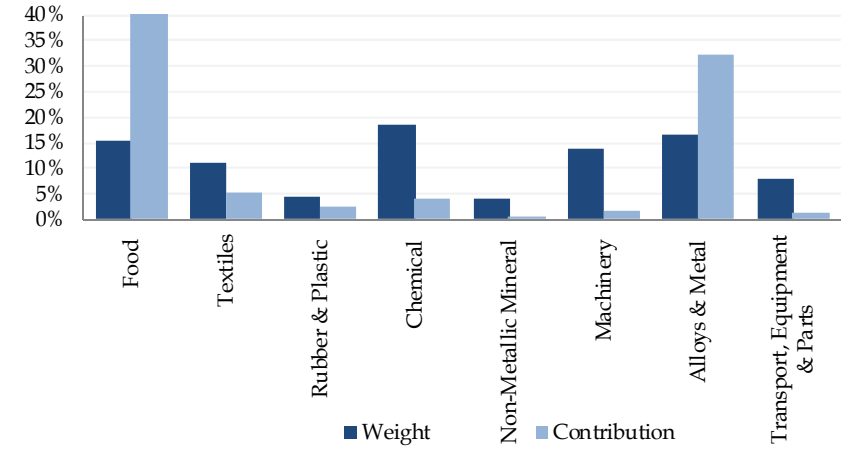
Component Contribution to Fuel and Power Inflation (Jan)



Component Contribution to Manufactured Products Inflation (Feb)

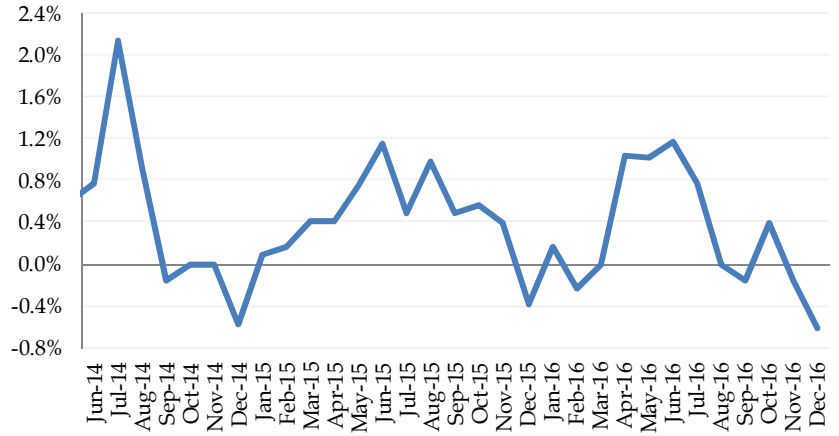


Component Contribution to Manufactured Products Inflation (Jan)



Global food prices have seen a dramatic increase

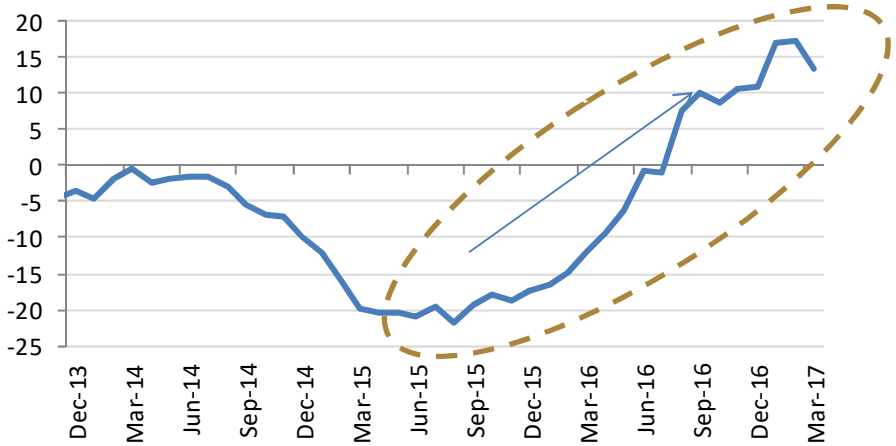
Month on Month CPI



Selected Prices



FAO Global Food Index (% growth)



CRB Commodity Index



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Thank You

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