CPI/IIP: Inflation shows signs of cooling

Highlights

- CPI inflation broadly unchanged at 6.26% in June-21; core at a 7-year high of 6.30%
- IIP moderated to 29.3% in May 2021
- RBI to watch inflation closely; we opine that the 6%+ Headline CPI print will not be enough for a change in RBI's reaction function

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India's headline CPI inflation stayed above RBI's upper tolerance level of 6.0% for the 2nd consecutive month at 6.26% in June 2021. While fuel prices remained on the boil, some steadiness appears to be coming on the core side when compared to the previous month. Our inflation model now predicts a drop below the critical 6% mark in the next month while average Headline CPI is likely around the 5.5-5.7% mark for FY22. Monetary policy actions will remain tilted towards growth with the expected drop in inflation to provide the comfort to the RBI to keep rates unchanged at-least till December. Any decision to tighten will be contingent on growth parameters and how consumption demand evolves from here on.

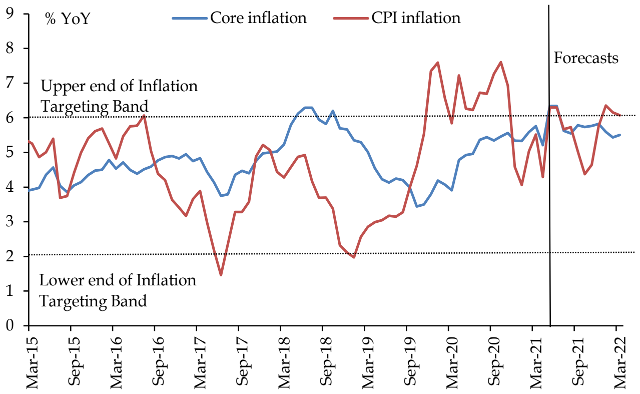
Food inflation cools sequentially: On sequential basis, food prices have increased by 1.18% in June 2021 after rising by 1.71% in May 2021. Barring eggs, vegetables and prepared meals all other categories of food saw a marked deceleration in sequential price pressures. On an annualized basis food inflation was at a 7-month high with y-o-y increases seen in eggs, oils & fats, fruits and pulses. For the coming months, price of edible oils might see some easing with government reducing basic customs duty on crude palm oil to 10% in order to help bring down its prices in the retail market. On the other hand, progress of monsoon has been below normal along with lower area sown compared to last year. However, we think that pressure on food prices could be mitigated with the substantial buffer stock with Food Corporation of India.

Core inflation also moderates on a sequential basis: Core inflation (ex. food, fuel and tobacco) on an annualized basis, jumped to a 7-year higher of 6.30% YoY in June 2021 vs. 6.17% in May 2021. However, sequentially it increased at a slower pace of 0.24% MoM in June 2021 from a sharp 1.28% MoM rise in May 2021. The sequential moderation in core inflation was broad-based with decline recorded in housing (-0.68% MoM) followed by moderation in clothing (+0.25% MoM) and miscellaneous products (+0.57% MoM). Within miscellaneous, sharp moderation was recorded for sub-components of recreation (-0.06% MoM), personal care and effects (+0.19% MoM), health (+0.3% MoM), household goods & services (+0.13% MoM).

IIP moderates as base support fades: Gradual waning of favorable statistical base led to a moderation in the IIP for May to 29.3% from a triple digit expansion of 134.6% in April 2021. Sequentially, IIP contracted by 8.0% in May 2021 vs. -12.9% in April 2021. While mining expanded on a sequential basis (+0.6% MoM), electricity (-7.0%MoM) and manufacturing (-9.5% MoM) continued to contract, albeit at a slower pace, as compared to the previous month. On a used-based classification, sequential contraction was recorded in all segments, of which consumer durables (-27.7% MoM) and capital goods (-18.0% MoM) recorded double-digit declines. While the gradual opening up of the economy and increase in vaccinations can lead to a normalization of the production process, the extent of ramp up in production will critically determine on the pace of revival in consumption and investment demand.

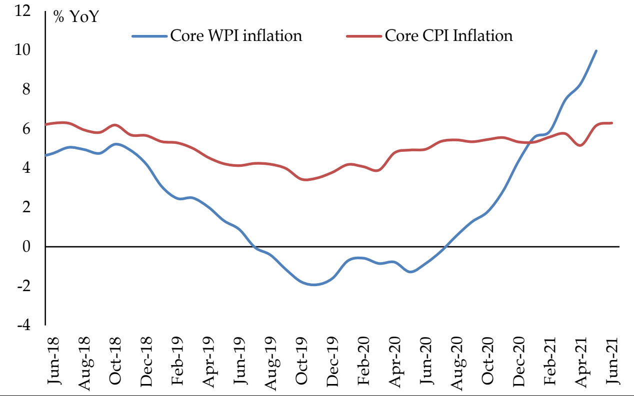
RBI to stay on hold: No doubt the RBI has a difficult job on hand with inflation continuing to remain higher than the 6% upper band while the uncertainty with respect to the growth conditions persist. In a recent interview to a daily newspaper, the RBI governor indicated that the RBI is currently aiming at a Headline CPI inflation in the target range of 2-6% and also reiterated that the recent spikes in inflation are transitory in nature, driven by supply side factors and that it is expected to moderate in the 3rd quarter. Furthermore, the RBI governor highlighted that any hasty withdrawal of monetary policy support will carry the risk of truncating the nascent recovery process. Our own assessment of Headline CPI inflation points towards a moderation in Q2 and Q3 of FY22 and a slight jerk up in Q4FY22 (due to a softer base from the previous year). First, the reduction in the import tariffs on the edible oil is likely to help contain inflation going forward. Further, we think that the global commodity prices are probably near its top, given that there are some indications that the pace of global growth may be losing some steam. Note here the recent RRR cut by PBoC was possibly to cushion a slowing economy. While we hold our average Headline CPI forecast for FY22 at around the 5.5-5.7% mark, we see reduced risks for a breach of 6.0% in this metric. Core inflation is expected to stay in the 5.5-5.8% range in the rest of FY22, unless there is a sharp change in consumer sentiment and hence consumption demand. Consequently, we think that the current 6%+ print is unlikely to change the RBI's policy reaction function and expect a hold at-least till December. We also think that the RBI will remain focused on domestic conditions and would not follow some EME central banks that have either already tightened monetary policy or are talking relatively hawkish.

Exhibit 1: Education spending in rural districts picks up pace



Source: CEIC, Yes Bank Economics Research

Exhibit 2: Health spending in urban areas increased sharply in May



Source: CEIC, Yes Bank Economics Research

Exhibit 3: IIP moderates as base support fades

IIP Components		*%YoY*			*%MoM*		
	Weights(%)	**Mar-21**	**Apr-21**	**May-21**	**Mar-21**	**Apr-21**	**May-21**
IIP	100	24.1	134.6	29.3	12.3	-13.0	-8.0
Sectoral Classification							
Mining	14.4	5.9	36.3	23.3	17.6	-22.1	0.6
Manufacturing	77.6	28.3	197.9	34.5	10.8	-12.6	-9.5
Electricity	8.0	22.5	38.5	7.5	17.0	-3.3	-7.0
Use Based Classification							
Primary goods	34.0	7.8	36.8	15.8	16.0	-12.6	-2.9
Capital goods	8.2	48.3	1,042.9	85.3	14.9	-23.5	-18.0
Intermediate goods	17.2	23.2	212.3	55.2	12.5	-11.0	-6.7
Infrastructure/construction goods	12.3	34.9	596.1	46.8	14.0	-15.1	-8.1
Consumer durables	12.8	55.0	1,880.0	98.2	3.1	-12.9	-27.7
Consumer non-durables	15.3	31.2	94.9	0.8	9.0	-10.9	-3.7

Source: CEIC, Yes Bank Economics Research

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