Press Release

Change in inflation alert to 'orange' from 'red'

Base factor and lower sequential pressures bring down CPI in May-22 by 75 bps

13 June 2022

After making rapid strides in the last two months, headline CPI inflation eased moderately to 7.04% in May-22 from an eight-year high of 7.79% in Apr-22 partly aided by the favorable statistical base of the previous year. On a sequential basis, the index rose at a slower pace of 0.94% MoM as compared to 1.43% in the previous month with moderation recorded in the categories of fuel, miscellaneous and housing. Nevertheless, the month of May-22 marked the fifth consecutive month of CPI inflation remaining way above the 6.0% policy tolerance threshold.

Sequentially, food and beverages index further rose by 1.46% MoM in May-22 from an increase of 1.43% in Apr-22 with price pressures seen in vegetables (primarily led by tomatoes) followed by oils & fats, meat & fish, spices, and cereals. This largely reflects the impact of adverse summer seasonality, exacerbated by elevated commodity prices impacting agricultural inputs, and second order effect of the ongoing conflict between Russia and Ukraine on items like wheat and edible oil. Additionally, elevated feed costs are also translating into escalation in poultry, milk, and dairy product prices. Going forward, food inflation could continue to face pressures from global factors. An increase in input prices has already pushed up the cost of production leading the government to recently announce higher MSP for kharif crops (average price hike is of 5.8% higher than that in the previous season, with biggest hike reserved for pulses and oilseeds). This could marginally boost rural incomes thereby stoking additional inflationary pressures in FY23. However, the adverse impact of MSP hike is expected to be marginal as prices in the open market for some crops particularly for oilseeds (soyabean and groundnut) is already ruling above the revised MSP for FY23 kharif season.

The spillover effect of rise in crude oil price has led fuel inflation to increase sequentially, albeit at a moderate pace of 1.28% MoM in May-22 from 3.11% in Apr-22. Broad-based moderation was recorded across categories of fuel inflation with major easing seen in the price of diesel, coke, dung cake and kerosene. Despite continued rise is commodity prices, some offsetting impact came from reduction in excise duties on petrol and diesel towards the end of May-22. Based on our sensitivity analysis, the cut in excise duty is likely to have a direct impact of around 20 bps on headline CPI inflation, which can get reduced further as some states have followed centre's announcement by a reduction in VAT. Taking the second-round benefit (primarily on logistic costs) into consideration, the average inflation rate may reduce by around 30 bps with full impact of the excise duty cut reflecting from Jun-22 onwards. Going forward, the persistent rise in crude oil price which is currently hovering close to USD 120 pb is expected to keep fuel inflation elevated, warranting further intervention by the government to tame inflation and anchor inflation expectations. As per the latest RBI's survey on inflation expectations undertaken after the excise duty cuts, household inflation expectations declined significantly by 190 bps in the three months scenario and 90 bps in one year scenario.

Core (i.e., CPI ex indices of Food & Beverages, Fuel and Light) inflation momentum eased to 0.5% MoM from 1.22% in Apr-22, leading the annualized rate of core inflation to ease to 6.41% from a ten year high of 7.24%. Sequential momentum in Clothing & Footwear category continued to inch up by 1.04% in May-22 from 0.99% in Apr-22. This captures the impact of earlier hike in GST rate along with strong pickup in retail mobility in the post Omicron phase. On the other hand, miscellaneous inflation rose at a slower pace of 0.42% MoM in May-22 from 1.34% in Apr-22 led primarily by easing prices for transport & communication (capturing excise duty cut on petrol and diesel prices), along with decline in price of personal care & effect. However, price of household goods & services rose reflecting the impact of pent-up demand and pass-through of input prices as services opened up post the Omicron wave.

The opening up of the economy, strong pick-up in retail, and vaccination attaining critical mass (with 70% of the population having achieved two doses) is hastening the pass-through of elevated input prices. This is likely to provide stickiness to core inflation at around 6% levels in FY23.

The Russia-Ukraine conflict is not showing any signs of abatement. In fact, on the margin, the geopolitical environment seems to have deteriorated amidst unrelenting posturing by the two sides. This has raised the pressure on commodity prices incrementally and have escalated inflationary concerns both in the global as well as domestic economies. Globally most economies have completely shifted their focus to tackling strong inflationary concerns, causing key central bank's monetary policy rhetoric to switch to severe hawkishness and policy tightening in 2022 from pandemic-era accommodative policies.

From domestic standpoint, for FY23, inflation drivers are likely to face considerable pressure from persistent hardening of input prices. The heightened pressure from commodity prices is also coinciding with unlocking of the economy post Omicron wave while vaccination coverage continues to gain traction. The increasing depreciation pressures on the rupee will further add to the inflationary pressures. As per our inflation model, in the base case assumption, headline CPI inflation is likely to average at 6.5% in FY23 slightly lower than the RBI's estimate of 6.7%. Our forecast factors in the government measures including the domestic wheat export ban along with reversal of export ban on edible oils by Indonesia and prospects of a normal monsoon that will help in moderating the food price pressures in FY23. It also anticipates further duty cuts by both the central and the state governments to moderate the impact of increased crude oil price. However, we do acknowledge risks to our estimate to stem from the unusually high degree of volatility in global commodity prices especially crude oil prices.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "If such a moderating trend sustains on the CPI front over Jun-22, there is a likelihood that RBI may reduce the extent of rate hike in the next policy meeting. With 90 bps hike already undertaken, there is a likelihood of another 60-75 bps rate hike in the remainder of the year unless inflation data surprises on the upside."

Annexure

Chart 1: May-22 inflation eases to 7.04% YoY aided by favorable base at play

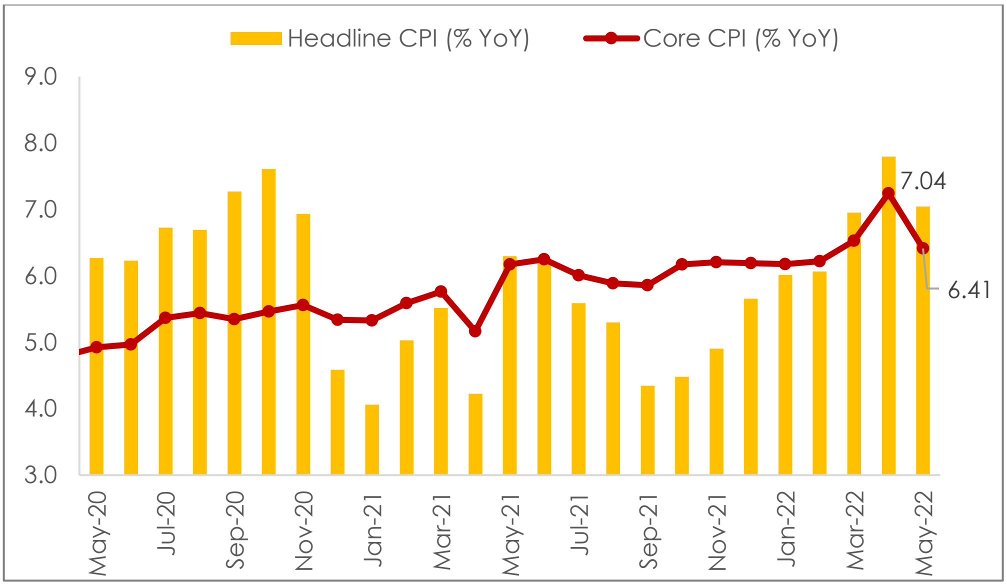
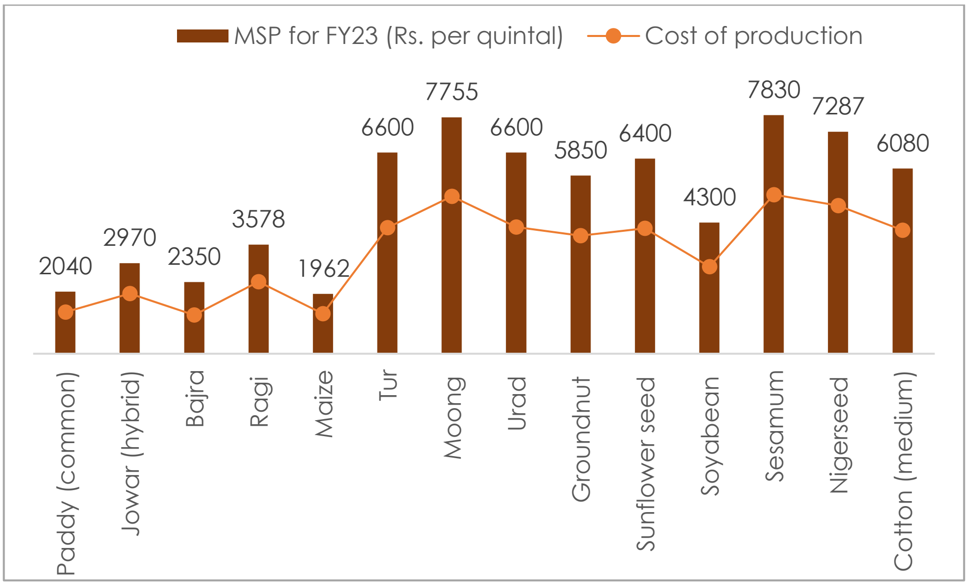
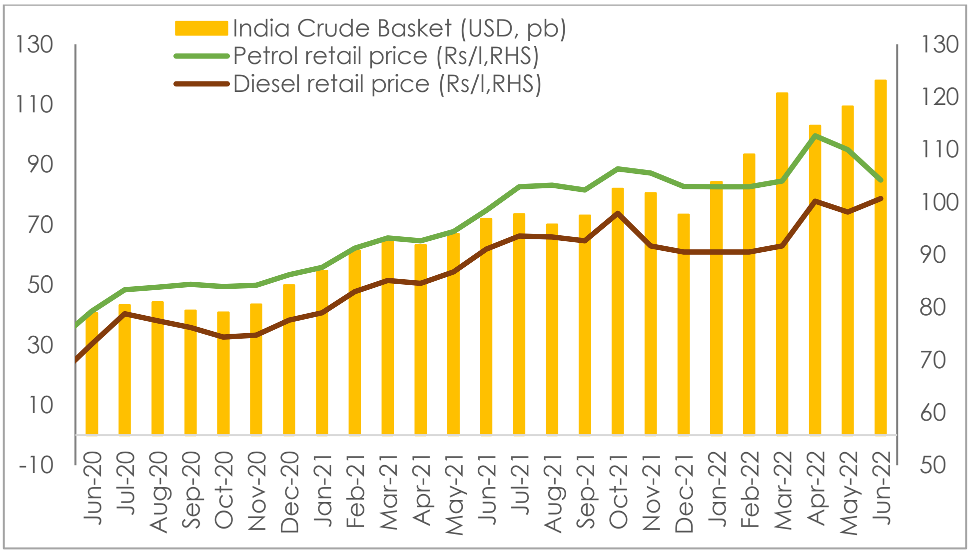


Chart 2: MSP for kharif crops for FY23 season



Note: cost of prodcution refers to comprehensive cost which includes all paid on costs such as those incurred on account of hired human labour, bullock labour machine labour, rent paid for leased in land, expenses incurred on use of material inputs like seeds, fertilizers, manures, irrigation charges, depreciation on implements and farm buildings, interest on working capital, diesel/electricity for operation of pump sets etc., miscellaneous expenses and imputed value of family labour

Chart 3: Excise duty cut in pertol and diesel provides some respite in May-22



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