CPI Inflation: Key Takeaways

July 14, 2017

The headline inflation has dropped to a multi-year low of 1.54%. While over the last few months several economists and market participants were forecasting a drop in inflation no one really expected the drop to be so dramatic.

The headline inflation is below 2% (which is below RBI's tolerance level) and interestingly lower than the inflation level in advanced economies.

We feel that over the last 3-4 years the government and RBI have worked together to achieve a benign inflation environment and are jointly working towards achieving a neutral inflation level of 4% (+/-2%).

The recent drop in inflation is primarily due to sustained drop in food prices, drop in prices of petrol & diesel and some moderation in prices of certain core components. While, the decline in prices of oil has been a function of global demand and supply dynamics, our sense is that the oil prices in the international market will remain subdued due to excess supply of oil in the markets compared to the total global demand. The reinstatement of several oil rigs in US underscores the viability of newer technology at the current lower market prices.

The present level of food prices in India is a result of several policy changes by the government over the last few years viz. smaller hikes of Minimum Support Price (MSP) and addressing the excessive profit margin amongst the middlemen. The government being proactive in import of food stuff during phases of low supply also helped to keep the speculative part in abeyance. Government has also controlled the rise in food prices during years of subnormal monsoon in 2014 and 2015 respectively. The drop in food prices domestically was also assisted by sustained decline in international food prices. The bumper food production over the last few years has been a result of advent of superior seeds and fertilizers, and improvement in irrigation water supply and introduction of cash crop viz., cotton has helped the production across most states of the country.

The recent actions of the government to address the sticky high prices in certain components of core inflation (viz., health, education) have started yielding results. Our opinion is that the drop in headline inflation is a sustained shift and the efforts to yield results over the short to medium term.

We expect the present headline inflation to remain subdued over the next few months as low credit growth from the banking sector to keep price rise under check. Credit growth lower than 7% and M3[1] around 7% (a multi-decade low) is expected to weaken pricing power amongst producers and manufacturers and the core inflation (including recreation, health, footwear and education) to remain subdued.

We expect the 2017 average inflation to be around 3% (approximately 200 bps lower than 2016). Hence, in order to push some demand revival, monetary policy tool might be used by RBI once again. With real rates (10 year yield minus CPI) closer to 500 bps (5-year average of 100 bps) calls for a big drop in the repo rate over 2017.

We expect the cumulative 75 bps repo rate reduction over remainder 2017 in order to reduce the excessive real rates within the system and improve the investment climate.

The effect of higher House Rent Allowance (HRA) on inflation and actual impact of Goods and Services Tax (GST) will remain as the main risks to our view. However, we feel that the structural alterations within the economic system leading to lower inflation will not be tilted much, basis higher HRA and uncertainty around effects of GST.

[1]M3 also known as broad money includes M1+ Time deposits with the banking system.