Little scope for MPC to continue with monetary policy easing at least in the short-term

Economy Report

CPI inflation at 5.5 years high, Crosses MPC’s upper band target of 6% for the first time since 2016

- The Consumer Prices Index (CPI) increased by 7.35% over the previous year largely due to spike in food inflation. This is also partly due to the base effect.
- Fuel inflation turned positive after a gap of 5 months
- Core inflation continued to remain below 4% levels.

As per the provisional estimates on CPI inflation released by MOSPI on 13 January 2020, the Consumer Prices Index (CPI) registered an increase of 7.35% for December 2019, on account of sharp upick in food price inflation led by increase in the prices of vegetables and pulses. This is also partly on account of the base effect. Consumer Food Price Inflation (CFPI) which crossed 14% levels, the highest in the current series, continued to exert pressure on overall inflation outlook. Breaching of the upper band in the inflation target constrains further easing of monetary policy and the Monetary Policy Committee (MPC) is likely to hold the rates until the situation improves.

On the other hand, Core Inflation (excluding food and fuel) has continued to be benign at 3.8%, and lower fuel inflation, provides some respite. However, these two components of CPI also have started moving upwards in December. Core inflation shows some acceleration compared to the previous month whereas, the fuel inflation turned positive after a gap of 5 months.

The current level of CPI inflation is elevated by spike in vegetables and fruits (onions are the main contributor) which is transitory. Rising prices of pulses and cereals compared to last year despite a good Rabi output reflect diverse factors. Much of the rise is partially due to base effect, as many of the items in food group reported deflationary trend during the period between October 2018 to February 2019. So, the current trend of rise in food inflation may continue in the near future, but expected to moderate in the next fiscal.

<table>
<thead>
<tr>
<th>Groups</th>
<th>Weights (%)</th>
<th>Rate (Y-o-Y in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI Combined (1+2+3+4+5+6)</td>
<td>100.0</td>
<td>Dec-18</td>
</tr>
<tr>
<td>1. Food and beverages</td>
<td>45.9</td>
<td>-1.99</td>
</tr>
<tr>
<td>2. Pan, tobacco and intoxicants</td>
<td>2.38</td>
<td>6.14</td>
</tr>
<tr>
<td>3. Clothing and footwear</td>
<td>6.53</td>
<td>3.50</td>
</tr>
<tr>
<td>4. Housing</td>
<td>10.07</td>
<td>5.99</td>
</tr>
<tr>
<td>5. Fuel and light</td>
<td>6.84</td>
<td>7.24</td>
</tr>
<tr>
<td>6. Miscellaneous</td>
<td>28.32</td>
<td>6.15</td>
</tr>
<tr>
<td>Consumer Food</td>
<td>39.06</td>
<td>-2.65</td>
</tr>
<tr>
<td>Core *</td>
<td>44.91</td>
<td>5.66</td>
</tr>
</tbody>
</table>

Note: The weights are indicative to show relative importance of groups.
*calculated (excluding ‘Food & Beverages’, ‘Pan, Tobacco & Intoxicants’ and ‘Fuel & Light’)

Source: MoSPI, BWR Research
Onion prices: The major contributor to food inflation

Onion is a seasonal crop with harvesting period of Rabi (March to June), Kharif (October to December) and late Kharif (January to March). Due to disruption in production and supply, onion prices escalated since September and continued to rule high, despite government’s various efforts to arrest the prices by improving supply. As per the estimates of Department of Agriculture, Cooperation and Farmers Welfare, combined Kharif and Late Kharif production for 2019-20 is estimated at 54.73 LMT as against 69.91 LMT in 2018-19. In the intervening period (July to October), the market is fed by stored Rabi onions. During 2019-20, there was a 3-4 weeks delay in sowing as well as decline in sown area of the Kharif onion because of late arrival of monsoon. Further, untimely prolonged rains in the major growing States of Karnataka, Maharashtra and Madhya Pradesh during the harvesting period, i.e., September/October, caused damage to the standing crops in these regions. All these factors adversely impacted production and quality of the Kharif crop. The rains during September/October also affected transportation of the crop from these regions to consuming areas. This led to limited availability of Kharif onion in the market and put pressure on its prices. Despite the various initiatives by the government to improve the supply of onions including imports, the prices increased by 50% in December 2019. However, the prices are expected to moderate and return to the normal range in the near term, yet its impact on food inflation continue to be felt in the month of January as the prices remained relatively benign in the previous year.

Changing trend in Fuel and Core inflation warrants cautious approach by RBI

After showing deflationary trend since July 2019, the ‘Fuel and light group’ reported 0.7% inflation in December 2019. The current level of fuel inflation is relatively lower than that of last year. Due to the stand-off in the Middle East there is fear of further escalation in the crude oil prices. Any rise in the inflation trajectory in fuel is always a cause of concern for the inflation outlook. Lower crude oil prices helped easing domestic fuel prices throughout 2019, hence if the trend reverses, maintaining inflation at RBI MPC’s target range of 4% (+/-2%) becomes difficult. Moreover, the core inflation has also started showing signs of acceleration, which increased to 3.8% in December from 3.5% in the previous month. Increase in monthly charges for cable TV connection (6.5% yoy) coupled with tariff hike by telephone operators (increase in mobile or telephone charges by 10% yoy) contributed to this rise. These are not merely temporary factors; hence the RBI may adopt a wait and watch approach in its monetary actions at least till food inflation subsides (Chart and Table).

*calculated (excluding 'Food & Beverages', 'Pan, Tobacco & Intoxicants' and 'Fuel & Light'). Data is provisional.
Source: www.mospi.gov.in, BWR Research
Little scope for MPC to continue with monetary policy easing at least in the short term

After remaining below the mid-point target of 4% for 14 months till September 2019, the CPI inflation crossed the upper band target of 6% for the first time since RBI’s Monetary policy Committee was formed. Though the pressures are emanating from the food group, which is transitory and also partly due to base effect, the rising core and fuel inflation would not be easy for the RBI to ignore.

The monetary easing cycle which started from February 2019, may not continue in the short run, hence the scope for further rate cuts are restrained. Yet, given the underlying economic concerns with CSO estimating 2019-20 GDP at decade low of 5%, the MPC may decide to maintain its accommodative monetary policy stance. If the core inflation crosses 4% levels and CPI inflation continued to rule above 6% levels, the RBI MPC may change its policy stance as well in the next fiscal.

The December inflation has already exceeded the MPC’s projections of 5.1-5.7% for H2:2019-20, and the month-on-month or sequential rise in inflation rate is much sharper than witnessed earlier. BWR feels CPI inflation may moderate slightly in January supported by ease in food inflation, but likely increase in fuel and core inflation may continue to keep the inflation above the MPC’s upper target range in the rest of the current fiscal.

Industry Perspective

“Inflation is expected to remain high in the remaining months of this fiscal year, close to 7% thus averaging to 5.0% for FY20. The rise in domestic food price inflation has been in line with global food prices which have jumped to double digits in Dec’19, mainly on account of meat, dairy and oil price increase. Meanwhile, overall inflation is expected to average around 4.8% next year. Given the situation of low growth and high inflation we believe that the coming months are crucial for RBI to decide on any action at rate front. RBI did not cut the rate in December when Oct’19 inflation rate was 4.62%, now that CPI inflation has surged to 7.35% in Dec and Jan inflation is also expected to remain high (above 8%), RBI is likely to hold rate in the next policy. We believe that RBI will go for a long pause possibly throughout 2020 as inflation is likely to remain above 6% till June-July 2020”

Adds Soumya Kanti Ghosh,
Group Chief Economic Adviser
at State Bank of India

Disclaimer: Views expressed by the third-party industry commentators and experts is personal and not the view of Brickwork Ratings.
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