Economic Research

Inflation Outlook

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Mounting inflationary pressures; upward revision in inflation outlook by MPC likely

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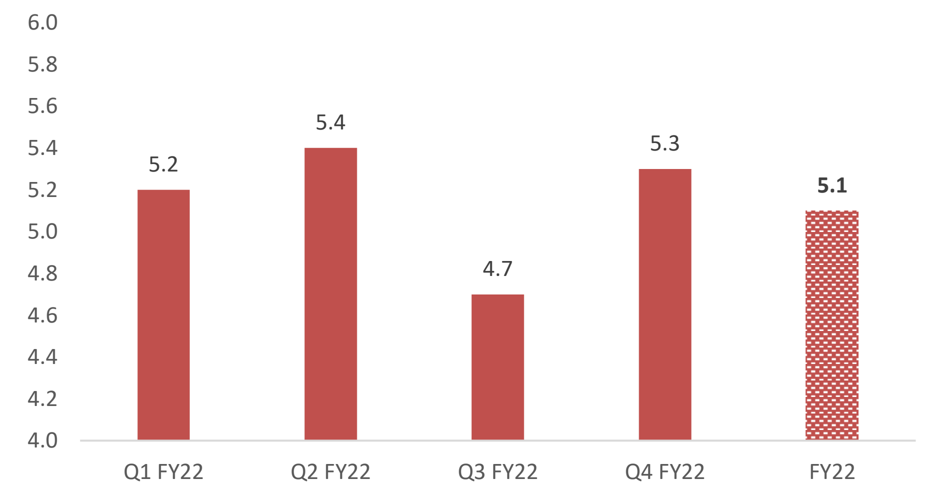
As per the monetary policy framework, the RBI's Monetary Policy Committee (MPC) has to maintain CPI inflation in the 2% to 6% range, with the median target of 4%. On 31 March 2021, the Government retained this target for the next five years (April 2021-March 2026), and therefore, keeping the inflation below 6% is crucial for the RBI. Meanwhile, in the June MPC meeting, the RBI projected a 5.1% inflation outlook for FY22.

Recent data on inflation in both the Wholesale Price Index (WPI) and Consumer Price Index (CPI) points towards a rising trend. WPI inflation in May rose to 12.94% (highest in the series), and CPI inflation surged to 6.3%, the highest since November 2020. With CPI inflation crossing the upper target of 6% in May for the first time in the last five months, the RBI's inflation outlook of 5.1% for the current fiscal looks challenging (or an underestimate), going by the prevailing price conditions. There is a likelihood of the Q1FY22 inflation breaching the RBI's projections of 5.2% at a substantial gap if the June inflation stays beyond 6%.

Moreover, it remains to be seen for how long the MPC will continue with the accommodative monetary policy stance. In the immediate context, the MPC may put the onus of controlling inflation to augment supply-side constraints, but if the situation persists, sooner or later, the MPC will be forced to rethink.

Chart 1: Inflation Outlook by RBI in its June MPC meeting



Source: Monetary Policy Statement, 2021-22 Resolution of the Monetary Policy Committee (MPC) June 2-4, 2021, BWR Research

Trends in WPI and CPI inflation rates

With the Covid-19 second wave hitting the most part of the country, the state governments imposed partial-lockdown-like restrictions to control the virus spread, beginning March 2021. The repeated and extended lockdowns resulted in a disruption in supply chains, high input costs and a delay in economic recovery.

When the second wave adversely impacting the domestic economy, global economy was seen emerging from the pandemic much faster than expected. This recovery, particularly in most of the advanced economies created considerable demand for commodities, leading to a broad-based surge in international commodity prices. Rising commodity prices also adversely impacted various commodities imported to India such as crude oil, edible oil and steel. Crude oil prices moved above USD60 per barrel (average) in February 2021 and increased further to cross USD70 per barrel recently. The rising fuel prices can aggravate the situation through the cost push effect. The matter is of concern is even food inflation has shown a rising trend, with the prices of edible oil and pulses showing increases.

Even before the lockdown was imposed to contain the second wave, the WPI had started rising due to a combination of a fluctuation in international commodity prices, rising taxes, excise duties and import duties leading to higher input costs. On the other hand, the CPI was showing easing signs due to high base effects and weak domestic demand.

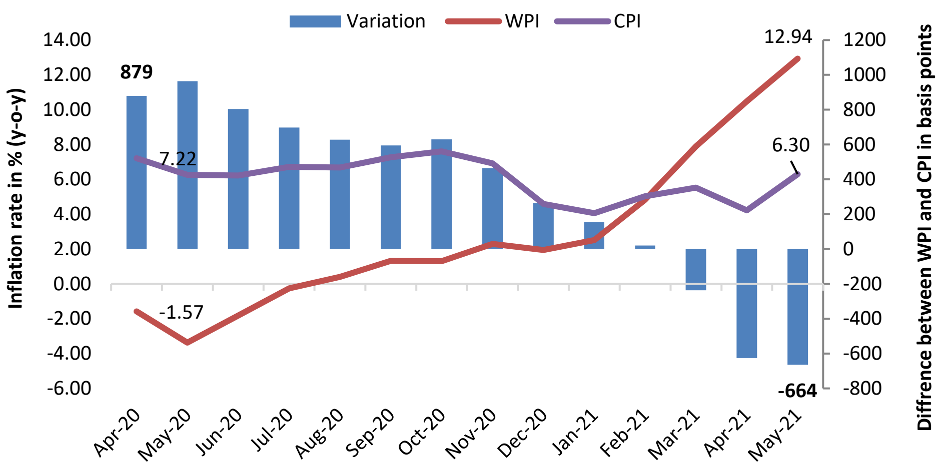
Inflation Indicators (WPI & CPI)					
	Weights (%)	**Year-on-Year Changes in %***			
		2019-20	**2020-21**	**Apr-21**	**May-21**
Inflation in Consumer Price Indices (Base: 2012=100)					
CPI (General Index) #	**100**	**4.77**	**6.16**	**4.23**	**6.30**
1. Food and beverages	45.86	6.03	7.31	2.60	5.24
2. Pan, tobacco and intoxicants	2.38	4.15	9.92	9.01	10.03
3. Clothing and footwear	6.53	1.62	3.38	3.49	5.32
4. Housing	10.07	4.53	3.33	3.73	3.86
5. Fuel and light	6.84	1.34	2.70	7.98	11.58
6. Miscellaneous	28.32	4.42	6.56	6.12	7.52
Consumer Food Price Index	***39.06***	***6.71***	***7.70***	***1.96***	***5.01***
Inflation in Wholesale Price Indices (Base: 2011-12=100)					
All Commodities (1+2+3)	**100**	**1.67**	**1.31**	**10.49**	**12.94**
1. Primary Articles	22.62	6.78	1.67	10.16	9.61
Food Articles	15.26	8.42	3.15	4.92	4.31
Non-Food Articles	4.12	4.55	1.40	15.58	18.37
Minerals	0.83	13.19	6.73	19.60	22.13
2. Fuel & Power	13.15	-1.83	-8.02	20.94	37.61
3. Manufactured Products	64.23	0.34	2.70	9.01	10.83
Food Products	**24.38**	**6.88**	**3.93**	**7.58**	**8.11**

Note: Data for April & May 2021 is provisional.
* Annual inflation based on monthly average of indices
# Combined Index (Rural and Urban)
Source: Ministry of Commerce & Industry (www.eaindustry.nic.in), Ministry of Commerce and Programme Implementation (mospi.gov.in), BWR Research

Rising wedge between WPI and CPI inflation

Since the RBI had adopted the CPI as the key measure of inflation beginning April 2014, the WPI lost its significance as a policy variable of inflation control. Inflation in the CPI generally co-moves most of the time with the WPI, but with a lag. It has also been observed that the transient effect of WPI is generally felt in CPI inflation in the succeeding 2 to 3 months. Although the gap between these two inflation indicators has widened notably in recent times (due to varied contributory factors and changes in the price levels of the selective items included in the two inflation baskets, which differ from each other; see annexure on Page number 6 for details), the pass through of the WPI to the CPI cannot be overlooked (Chart 2).

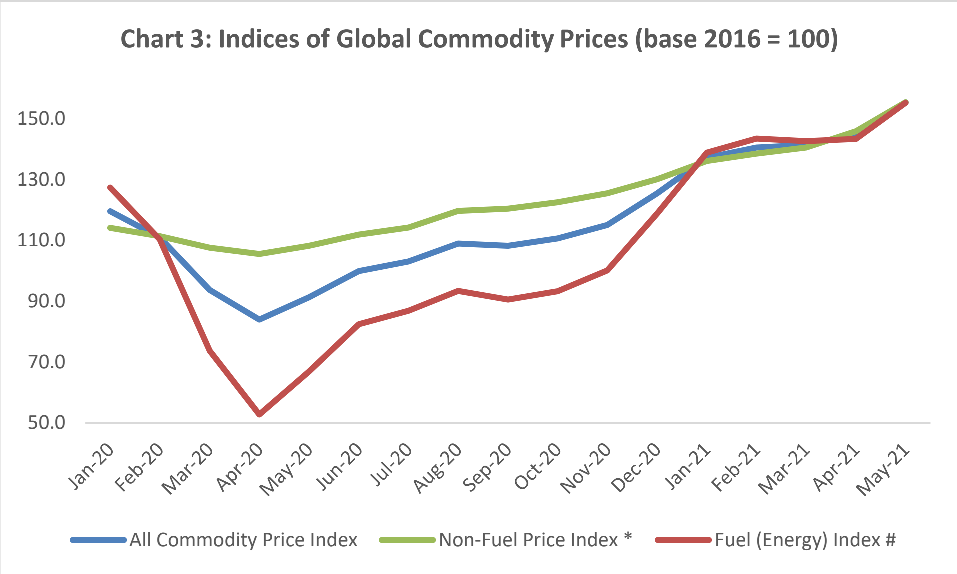
Chart 2: WPI inflation has remained more than 600 basis points higher than CPI Inflation in the first two months of FY22



Source: www.eaindustry.nic.in, mospi.gov.in, BWR Research

Price pressure emanating from rising international commodity prices

Higher recovery among emerging markets and developing economies has increased global demand and has kept international commodity prices at elevated levels (Chart 3). Not only in petroleum products, there has also been a broad-based surge in the prices of commodities such as metals (particularly steel), edible oil and chemicals. The surge in international commodity prices adds to cost push pressures. Rising input costs, particularly arising out of imported commodities, influenced the rise in WPI inflation since March 2021. As per the WPI, inputs into the steel making index (under the manufacture of basic metals group) surged by as much as 41% compared to last year. Rising wholesale inflation in the manufacturing products group (64.32% weight in the WPI) at 10.8% in May also reflects higher input costs, which is likely to be passed on to consumers gradually. With compressed domestic demand and huge capacity additions during the lockdown, this may not have an immediate impact, but will be felt through once the lockdown is completely lifted and demand conditions improve substantially.

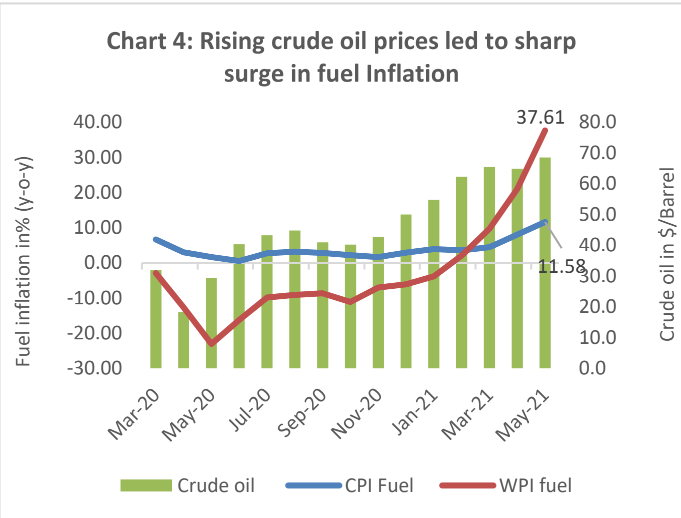


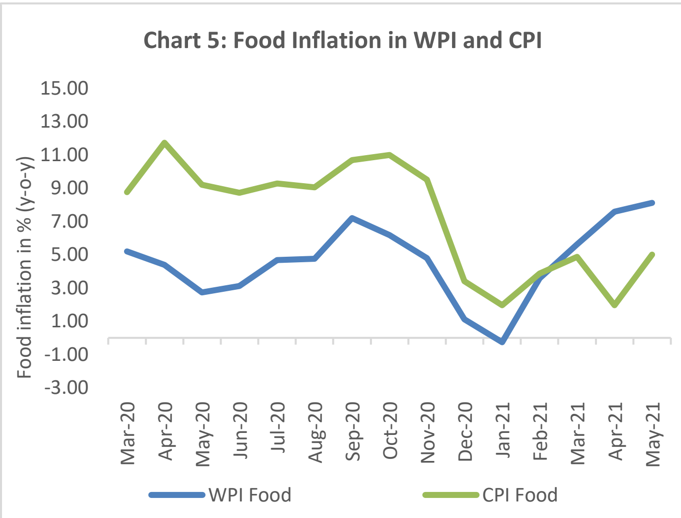
* Includes precious metals, food and beverages, and industrial inputs price indices
# includes crude oil (petroleum), natural gas, coal price and propane indices
Source: IMF, BWR Research

Food inflation may remain benign; non-food items to remain sticky

The WPI is more directly affected by international commodity prices compared to the CPI; hence, an increase or a decrease in commodity prices is faster reflected in the WPI than in the CPI. For instance, in the wake of falling crude oil prices in March last year, fuel inflation in the WPI fell much faster than in the CPI. Additionally, in recent months, when the fuel prices were swinging upwards, the rise in the WPI was sharper than in the CPI (Chart 4). In May 2021, fuel inflation in the WPI rose to 37.61%, and in the CPI, it increased to 11.6% (y-o-y).

Despite low demand and weak economic activities on the domestic front, fuel inflation may remain sticky as crude oil prices are not likely to cool down in the near-term due to high global demand and constrained supply. Its cascading effect may keep the other components also at a higher level.





Source: www.eaindustry.nic.in, mospi.gov.in, Ministry of Petroleum & Natural Gas (ppac.gov.in), BWR Research

A high base and ample food stocks have kept CPI food inflation (weight of 39.06% in the CPI) benign since December 2020, thus helping CPI inflation stay below the upper target of the MPC during the period between December 2020 and April 2021. The second wave and imposition of lockdown-like-restrictions across the country hit supply chains again in addition to rising transportation costs, leading the prices of most food items such as vegetables, fruits, edible oils and pulses to increase. Food inflation in the CPI increased moderately to 5.01% in May, while the wholesale food price index rose to 8.11%. Going forward, the predictions of a normal monsoon this year and expectations of bumper crops bring hope, but seasonal bottlenecks and rising commodity prices in the international market may exert upward pressure on food items.

Overall inflation outlook for current fiscal

With the lifting of the lockdown in phases, domestic demand conditions are expected to improve, and this may lead to a sudden spurt in prices. Given the heavy import dependence, the Indian economy is highly vulnerable to international crude oil prices, and the volatility in prices play spoilsport to the benign fuel inflation experienced last year. In addition to rising commodity prices, steady increases in excise duty at the centre level and sales tax (VAT) at the state level have led to a sharp rise in petrol and diesel prices recently. The repercussions of higher transportation costs impact retail inflation more than the wholesale segment, which is evident in the sudden rise in the food inflation basket of the CPI in May.

Once the lockdown is lifted completely, pent-up demand may lead to an uncertainty in price levels, particularly in the core inflation category of the CPI. Core inflation in the CPI, which continued to remain sticky at above 5% since last year, demands close attention, given the excess liquidity floating in the system. The RBI's measures to keep the interest cost low through G-Sap, OMOs and other liquidity boosting measures to incentivise Covid-19-battered sectors further augment liquidity, with a substantial increase in money supply. This can also bring in additional pressure on prices when the recovery and increase in output does not keep pace with the increase in money supply. In addition, crude oil prices are also increasing sharply, which otherwise acted as a cushion to price levels when the lockdown was first imposed last year. As the monetary policy has limited efficacy to deal with food and fuel inflation, its projections of 5.1% inflation for FY22 look challenging in the current scenario. We expect the MPC to revise its inflation outlook upwards in the next policy meeting, which could imperil the RBI's accommodative stance to support economic recovery.

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