

# Inflation vs Growth

## Which way is the RBI likely to sway?

*Inflation jumped above the RBI's comfort zone in December 2019 and is likely to print above 7% even in January 2020. This increase has been driven by domestic supply disruptions, leading to a spike in vegetable prices (especially onions). However, it's not just an onion story, with the rise being more broad based, influenced by increasing global food prices. Moreover, while demand side pressures remain weak, one-off price revisions and rising inflation expectations are starting to put pressure on core inflation (excluding food and fuel) as well. We expect inflation to moderate only gradually in FY21, with a below 4% print likely only by the second half of the year.*

*The RBI naturally is faced with a difficult choice with inflation remaining elevated and growth slowing down. For now, we expect the RBI to stay on hold and keep its stance unchanged (accommodative) at tomorrow's meeting. However, going forward, we think that the scales could tip in the favour of growth as soon as inflation prints become more palatable. The RBI might look through the volatility in inflation and lay emphasis on the wide output gap, delivering a cut perhaps as soon as June 2020. Given the fact that the Union budget did not provide significant counter-cyclical stimulus to boost consumption and is unlikely to be inflationary, the case for further monetary policy accommodation has become even stronger. On liquidity, we expect the central bank to keep liquidity in surplus, in order to support growth, as the monetary implications of surplus liquidity are likely to be limited on inflation for some months to come (given moderate credit growth).*

## Key Findings

- **In the coming months, we expect headline inflation readings to remain elevated**, led by a low base effect, high food prices and some rise in the miscellaneous sub-component. We expect inflation to peak to 7.5% in Jan-20. For Jan-Mar 2020, we expect average headline inflation at 7.1%.
- **Over the next 6 months, we expect the headline inflation to moderate gradually (moving towards 5% by Aug-20)** as food prices decline on account of a correction in vegetable and cereal prices.
- While core inflation trended low in 2019 on the back of weak demand conditions, **one-off factors like revision in telecom and medicine prices, rise in gold prices, second round impact from higher food prices and rising inflation expectations could lead to some rise in core inflation figures over the coming months.** Our analysis shows that, in the financial year till date, a larger part of the core basket has become volatile. **This suggests that any reversal in the recent trend (67% of the core basket was falling in 2019 compared to only 22% in 2018) – any idiosyncratic factors like revision in prices – could make a greater part of the core vulnerable.**
- **Risks:** Watch out for a prolonged increase in global food prices given their strong correlation with domestic food prices. Protein inflation could remain a risk amidst any surge in milk, meat and pulses prices.
- **Looking at a broader time horizon, we expect inflation to ease below 3% in Dec-20** supported by a favourable statistical base and contained food prices amidst healthy production of rabi and kharif crops. **With the output gap (growth deviation from potential) unlikely to close in 2020, demand side pressures are likely to remain muted, moderating the pick-up in core inflation prints.**
- **We expect the RBI to keep rates on hold in Feb-20 policy meeting amidst mounting inflationary pressure. Over the next 6 months, as the inflation prints find some comfort and move down within the RBI's target range (4%+/-2%), the RBI could act (cut rates by 25 bps) and lean towards stimulating growth. We also expect the RBI to maintain liquidity in surplus for most part of 2020.**

## Inflation Drivers: Story so far

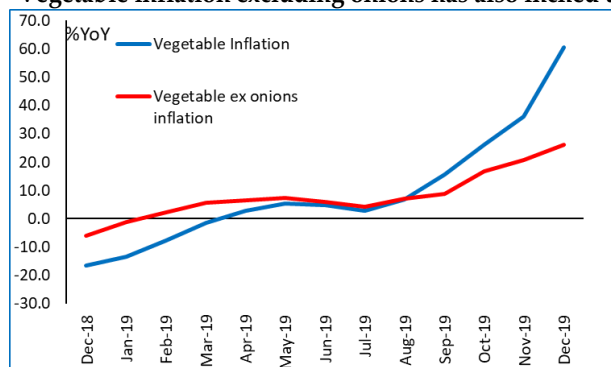
CPI inflation jumped up to 7.35% in December 2019, breaching the central bank's upper inflation target limit for the first time in over five years. A large part of the recent increase has been led by a spike in onion prices (contributed close to 200bps to the inflation reading in December 2019). However, a closer look at the data suggests, that CPI excluding onion has also picked up from 4.5% to 5.2% in Dec-19.

### Food inflation rise getting more broad-based

*Food inflation (which accounts for about 39% of the inflation basket) rose to 14% YoY in Dec-19 from 10.05% in Nov-19. While a large part of this increase has been led by a spike in vegetables prices (Weight of 6.0 in CPI) other items such as cereals and proteins have also been trending up. Moreover, apart from domestic supply disruptions, rising global food prices have also been a contributory factor in driving up inflation in items such as milk, meat, edible oil and sugar.*

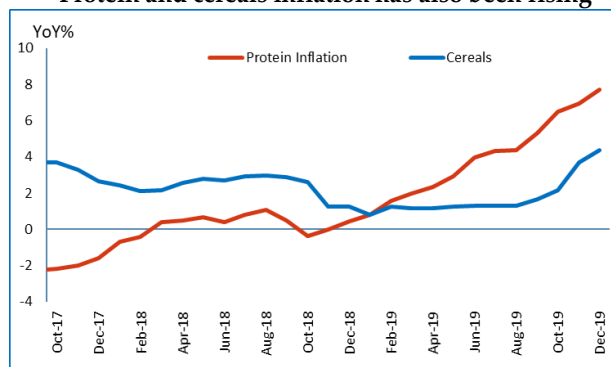
**Supply disruptions leading to higher vegetable prices:** Vegetable prices are up 17.9% on a FYTD basis (vs. a contraction of 3.4% in the same period FY19), largely driven by onions. But, vegetable inflation excluding onions has also picked up from 20.8% in November 2019 to 26.1% in December 2019. Uneven distribution of monsoon and supply disruptions have weighed on vegetable prices. To recall, kharif crop was damaged by the twin impacts of a delayed monsoon and excess rainfall in the key producer states Maharashtra and Karnataka.

**Vegetable inflation excluding onions has also inched up**



Source: CEIC and HDFC Bank

**Protein and cereals inflation has also been rising**



Source: CEIC and HDFC Bank

**Higher global food prices and cyclical in pulses leading to higher protein inflation:** Protein inflation registered an increase of 11% in Dec-19, taking the average increase to 8.2% on a FYTD basis (vs. a contraction of 1.3% in Apr-Dec FY19). The protein inflation basket includes pulses, meat, egg and fish, and milk and milk products.

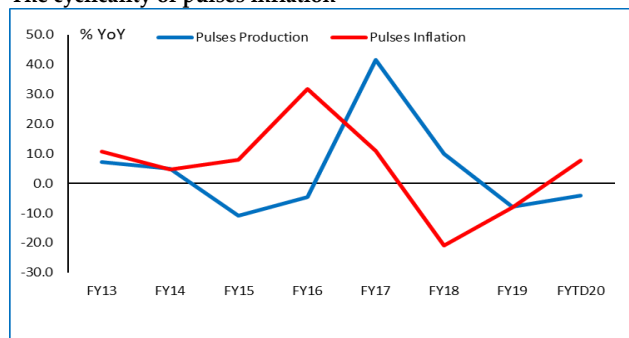
**Protein inflation rise getting more broad-based**

%YoY	Weights	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Protein Inflation	13.0	0.9	2.3	3.2	4.4	5.7	7.4	7.8	7.4	9.2	10.2	10.6	11.4
Meat and Fish	3.6	5.0	5.9	6.5	7.5	8.1	9.0	9.1	8.5	10.3	9.7	9.4	9.6
Egg	0.4	-2.4	0.9	1.4	1.9	1.8	1.6	0.6	0.3	3.3	6.3	6.2	8.8
Milk and Milk Products	6.6	0.7	0.9	0.8	0.4	0.3	0.7	1.1	1.5	1.7	3.1	3.5	4.2
Pulses	2.4	-5.5	-3.8	-2.2	-0.8	2.1	5.7	6.8	6.9	8.4	11.7	13.9	15.4

Source: CEIC and HDFC Bank

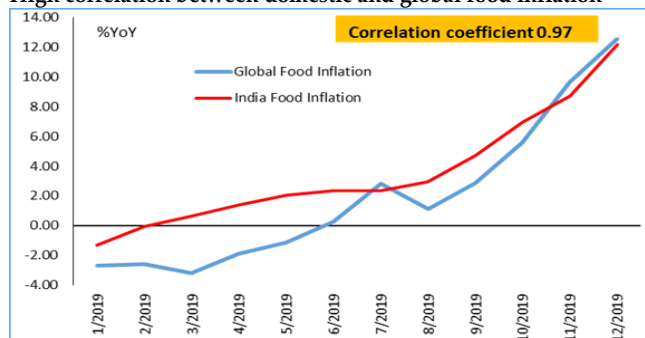
- The cyclical of pulses inflation:** Pulses inflation has been rising due to lower production over the last two years. Historical data shows that pulses inflation tends to follow a cyclical trend where a year of higher prices leads to overproduction over the next year and a consequent drop in prices followed by lower production the year after and so on. Average pulses inflation stood at 7.8% in Apr-Dec FY20 vs. a contraction of 9.7% in Apr-Dec FY19. Pulses production stood at 8.23 MT (according to 1<sup>st</sup> AE) as on 23<sup>rd</sup> Jan-19 registered vs. 9.31 MT in the same period a year ago.

### The cyclicity of pulses inflation



Source: CEIC, Agricoop and HDFC Bank

### High correlation between domestic and global food inflation



Source: CEIC, FAO and HDFC Bank

- **The Milk and Meat story:** The rise in milk and meat items has in part been due to the increase in fodder prices recently amidst a shortage of fodder. According to the Indian Grassland and Fodder Research Institute, there is a deficit of 23.4% in the availability of dry fodder and 11.2% in the green fodder. Furthermore, the surge in this category can also be attributed to the rise in global prices. It can also be argued that the rise in the protein basket, apart from these event specific factors, could be a reflection of an increase in demand for protein items as household consumption basket changes with a rise in incomes.
- **The rising correlation with global food inflation:** Global food prices jumped to double digits in December to 12.54% led by meat, dairy and oil price increase. The correlation between global food prices and Indian food prices stand at 0.97 (for Jan-19 to Dec-19). Global food prices affect commoditized items like edible oil, milk, meat and sugar in the Indian food basket and a rise in prices of these items contributed 79 bps in Dec-19 headline CPI inflation print.

### High correlation between global and domestic food CPI

Correlation coefficient	Global Food Inflation and Domestic Food Inflation	Global Meat and domestic meat inflation	Global dairy and domestic dairy inflation	Global cereal and domestic cereal inflation	Global oil and domestic oil inflation	Global sugar and domestic sugar inflation
Jan-19-Dec-19	0.97	0.88	0.71	-0.21	0.89	0.53
Jan-18-Dec-19	0.86	0.76	0.34	0.16	0.32	0.25
Jan-17-Dec-19	0.33	0.30	0.63	-0.12	0.44	0.38
Jan-18-Dec-18	0.66	0.23	0.59	-0.01	0.04	-0.85

Source: FAO, CEIC, Mospi and HDFC Bank

**An artificial scarcity in cereals:** Cereal prices have been on an upward trajectory for the past 8 months as undersupply in the market weighed on cereals prices as total buffer stock with FCI has been much higher than the prescribed norm. As of Jan-20, stock with FCI stand at 56.5 million tonnes (including 33 mt in rice and 23.5 mt wheat). The stock not only is higher than last year's stock but also higher than the actual buffer requirement for running the PDS, welfare schemes etc. set at 21.4 mt. This indicates both rice and wheat procured is still with the FCI and was not distributed through the PDS, resulting in undersupply. Furthermore, less than a million tonne of wheat was sold under Open Market Sale Scheme (OMSS) until 28 Nov 2019 while rice off-take under OMSS stood at 0.6 mt vs. the target of 5mt for the whole year. Cereals price rose by 4.4% in Dec-19 vs. 3.7% in Nov-19.

The government has cut the base price of wheat sold under OMSS to INR 2135/quintal from INR 2245/quintal in order to push out excess stock from the central pool. For wheat, the government has decided to lower the base price to INR 2080/quintal to clear up the stock. This should help in containing price of cereals somewhat, going forward.

### Buffer stocks are above the norm (combined figures for wheat and rice)

(million tonnes)	Buffer norm	Actual	Surplus
1 <sup>st</sup> April	21	46.3	25.3
1 <sup>st</sup> Jul	41.1	74.2	33.1
1 <sup>st</sup> Oct	30.7	64.2	33.5
1 <sup>st</sup> Jan	21.4	56.5	35.1

Source: FCI and HDFC Bank

### Core remains contained but some one-off shocks could put some pressure

*While food inflation has been on the uptrend, core inflation for most part of the year has been trending lower. This signals that demand conditions in the economy continue to remain subdued. However, looking ahead, revision in telecom tariffs and medicine prices, tick up in gold prices, and second round impact from high food inflation and rising inflation expectations could put some upward pressure on core inflation. Moreover, in the financial year till date, a larger part of the core basket has become volatile. Our analysis shows that 86% of the items in the core basket were volatile and only 14% of the basket remained sticky. This suggests that any reversal in the recent trend (67% of the core basket was falling in 2019 compared to only 22% in 2018) – any idiosyncratic factors like revision in prices – could make a greater part of the core vulnerable. That said, with the output gap unlikely to close in 2020, muted demand side pressures are likely to keep core inflation below 5.5% in FY21.*

**Trend so far:** Core CPI inflation (CPI Inflation excluding food, fuel, petrol and diesel) has been on a downward trajectory since Apr-19. Core CPI moderated to 3.5% in Dec 2019 from 5.5% in Dec 2018, taking the FYTD average to 3.9% vs. 5.7% in the corresponding period last year.

- We find that 14% items **remained sticky** in Apr-Dec FY20 vs. 23% of the items in the same period, last year.
- 67% of the core items recorded a **sustained decline** in Apr-Dec FY20, much higher than 22% of the core items in Apr-Dec FY19.
- 19% of the core items saw a **rise in inflation** vis-à-vis 55% of the core items in Apr-Dec FY19.

In the current financial year,

- **Core items that saw a sustained fall included clothing and footwear, housing** with rents easing, household goods, health, education and prepared meals.
- **Core items that remained sticky** included recreation & amusement and non-alcoholic beverages.
- **Core items that rose included** items such as petrol and diesel – as part of transport and communication and gold – as part of personal care and effects.

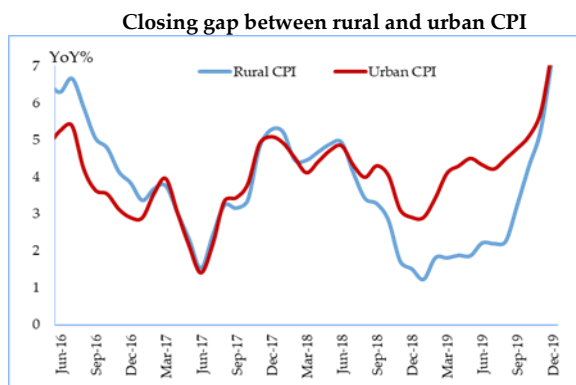
% of items	Core Sticky	Core Falling	Core Rising
Apr-Dec 2017	40.8	29.1	30.2
Apr-Dec 2018	22.6	21.8	55.5
Apr-Dec 2019	14.0	67.1	19.0

Source: CEIC, Mospi and HDFC Bank

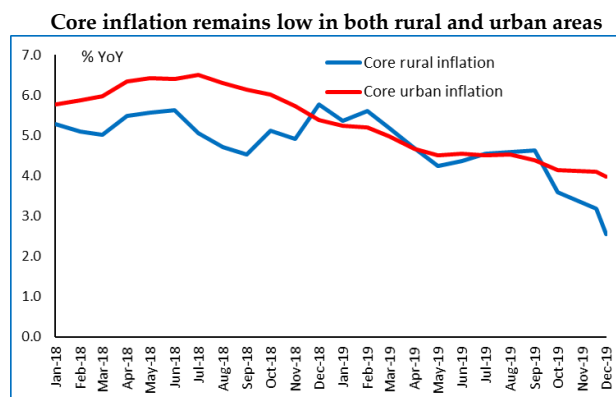
### The divergence between Rural and Urban inflation is closing

Urban inflation increased to a six-year high of 7.5% (vs. 5.8%) while rural inflation accelerated to a five-year high of 7.3% in December (vs. 5.3%, previously), narrowing the gap between the two indices. The surge in rural inflation was led by higher food prices while increase in urban inflation was led by higher food and miscellaneous sub-components. That said, core CPI moderated in both urban and rural areas, pointing at still weak demand conditions.

A silver lining: Food inflation, which has been on an upward trajectory in Rural India since Sep-19, bodes well for improvement in profitability for the farm sector. This could support rural consumption going ahead



Source: CEIC, Agricoop and HDFC Bank



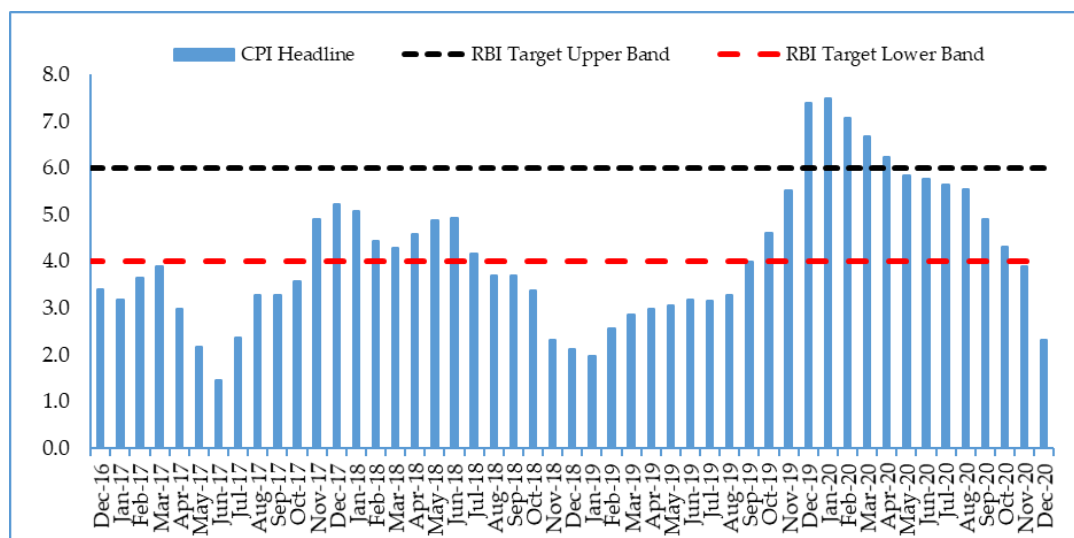
Source: CEIC, FAO and HDFC Bank

## Inflation trajectory from here on

*In the coming months, we expect inflation readings to remain elevated, led by high food prices and a rise in some of the miscellaneous sub-components. We expect inflation to peak in Jan-20, coming in at 7.5% and then ease somewhat in the remaining two months of FY 2020. As such, for Q4 FY20, we expect inflation to average at 7.1% (vs. 5.8% recorded in Q3), taking the full year average reading to 4.9% in FY20 vs. 3.4% in FY19. Looking at a broader time horizon, our analysis shows that inflation is likely to remain above 5% till Aug 2020 and ease below 3% in Dec-20.*

**Monetary Policy:** *We expect the RBI to keep rates on hold in Feb-20 policy meeting amidst mounting inflationary pressure. Over the next 6 months, as the inflation prints find some comfort and move within the RBI's target range (4%+/-2%: 2% to 6%), the RBI could act (cut rates by 25 bps) and lean towards stimulating growth. We also expect the RBI to maintain liquidity in surplus for most part of 2020.*

HDFC Bank Inflation Forecast FY21



Source: CEIC and HDFC Bank

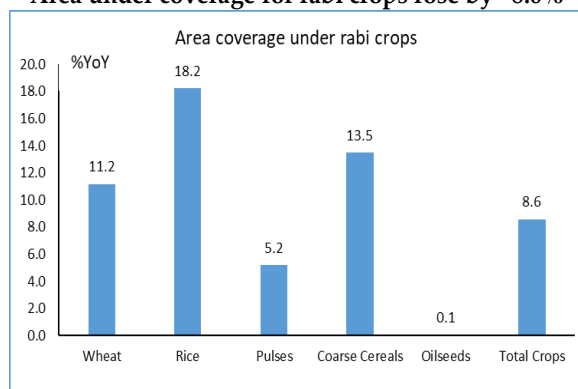
## Pressure points:

- 1) **Miscellaneous sub-components:** Higher telecom tariffs, gold prices, medicine and steel prices are likely to weigh on the core CPI in the next 2-3 months.
  - **Telecom tariff revision:** Recall, telecom companies revised their tariffs in the first week of December by as much as 40-50%. Telecom inflation contributed 16 bps to the headline growth in Dec-19. We expect, the contribution to further increase to 20 bps in Jan (as the full impact of the tariff hike was not transmitted in Dec-19).
  - **Gold prices:** Gold prices are up by 5.2% MoM in Jan vs. 0.85% MoM in December amidst rising geopolitical risks.
- 2) **Inflation expectations:** Inflation expectations rose to 8.2% (median) in Nov-19 from 6.9% in Q4 FY19. This in part is likely to feed into headline inflation through second round effects.
- 3) **Adverse base:** Unfavourable base is likely to add 40 bps to the headline CPI inflation in Jan-20 and 10 bps in Feb-20.

## Cushions:

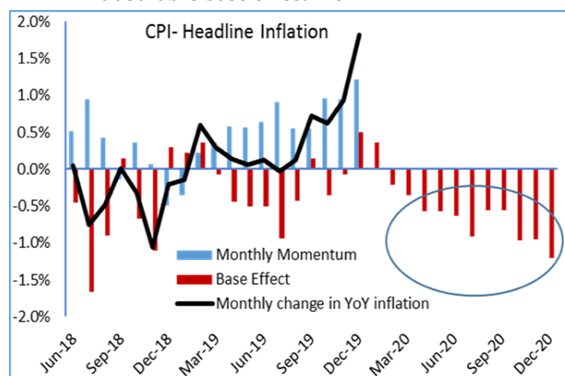
- 1) **Easing vegetable prices:** Import of onions and with the fresh crop hitting the markets, there has been a correction in onion prices as gauged from DOCA and daily mandi prices. Sequentially, onion prices have corrected by 32.4% in Jan 2020 vs. an increase of 55.5% recorded in Dec-19. Tomato prices have also corrected by 9% in Jan.
- 2) **Cereals prices could get some support from expected off-take of grains from FCI in OMSS:** Off-take from FCI is expected to pick up pace in the coming months.
- 3) **High water reservoir storage (led by normal monsoon) and higher area coverage under crops bode well for better production of rabi crops.** Storage at reservoirs stood at 126.6 bn cubic meters as of 16<sup>th</sup> Jan 2020 (55% higher as compared to the same period a year ago), accounting for 75% of total reservoir capacity.

Area under coverage for rabi crops rose by 8.6%



Source: Department of Agriculture and HDFC Bank

Favourable base effect kick-in in H2 FY21



Source: RBI and HDFC Bank

- 4) **Favourable statistical base:** Base is likely to add 40 bps to the headline CPI inflation in Jan-20 and 10 bps in Feb-20. However, favourable effect to bring down inflation prints in H2 FY21

## Treasury Economics Research Team

**Abheek Barua**

Chief Economist

Phone number: +91 (0) 124-4664305

Email ID: abheek.barua@hdfcbank.com

**Sakshi Gupta**

Senior Economist

Phone number: +91 (0) 124-4664338

Email ID: sakshi.gupta3@hdfcbank.com

**Avni Jain**

Economist

Phone number: +91 (0) 124-4664354

Email ID: avni.jain@hdfcbank.com

**Swati Arora**

Economist

Phone Number: +91 (0) 124-4664354

Email ID: swati.arora1@hdfcbank.com

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