Economics

India's inflation: worst yet to come

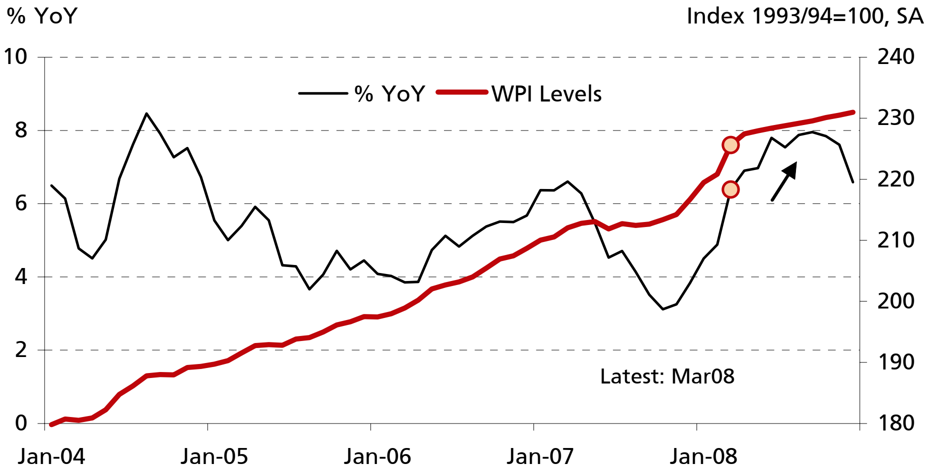
DBS Group Research | 22 April 2008

Inflation to breach 8% in coming months, led by food....

Whole sale price inflation (WPI) jumped to 6.5% YoY in Mar08 from 3.5%-4.5% range in the preceding six months. The rise was not unexpected but it came a bit earlier than anticipated due to a sharp rise in food prices. We had been expecting inflation to jump 200bps to 6% in 3Q08. This anticipated rise is yet to play out, and is still expected. So it now appears that, barring a cut in fuel prices (chances of which are falling by the day), inflation is likely to stay above 7% in Apr-June and reach / breach 8% in Aug-Oct. Full FY08 (ending Mar09) inflation should reach 6.5% from 5.4% forecasted earlier. Should oil prices remain above USD 100/bbl, inflation could surpass 9% in 3Q08 and average over 7.5% in FY08. Against this backdrop, and given the apparent political will to tackle inflation, we have brought forward our forecast for two 25bp rate hikes (repo and reverse repo) forecasts by a quarter. We now expect the first rate hike to come at next week's policy meeting.

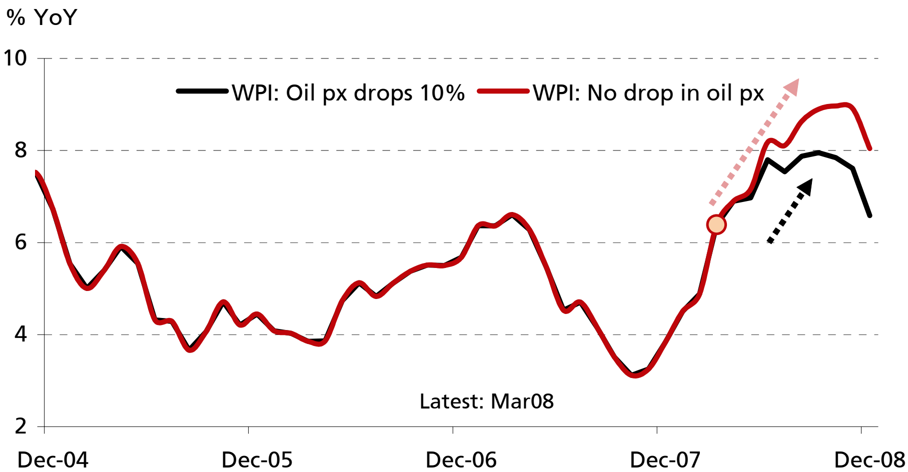
Barring a cut in fuel prices, inflation is likely to rise to 7% YoY in Apr-June and touch 8% in Aug-Oct

WPI headline



Should oil prices stay above USD 100/bbl, inflation could even breach 9% in 3Q08

WPI forecast by scenario



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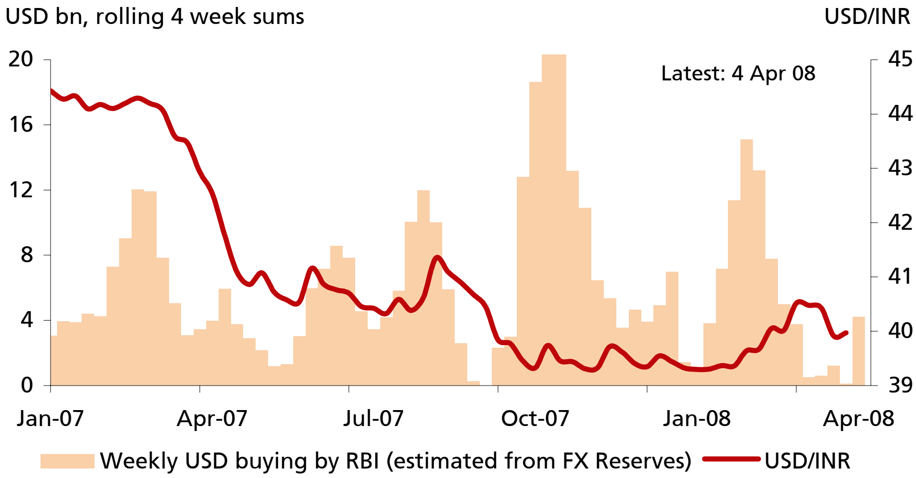
...that doesn't diminish the govt's or the central bank's concerns

The current rise in inflation does exaggerate underlying core inflationary pressures as it is pulled up by food prices. The manufacturing sub-component of WPI, usually used as a guide for core inflation by the RBI, has also risen to 5.9% (YoY) in Mar08 from 4.5% average in the preceding six months. This too is pulled higher by manufactured food sub-component. Nonetheless, we reckon that underlying inflation is also on the rise. Anyhow, as food prices are a sensitive matter, the government is left with little choice but to pour all energy in controlling inflation. After all, inflation hurts the poor disproportionately and they form the majority of the country's voters.

Although inflation is exaggerated by higher food prices, the government is worried about electoral losses, and the RBI about a wage-inflation spiral

From the Reserve Bank of India's (RBI) point of view, food inflation can push inflation expectations higher and lead to a wage-price spiral - especially with the economy growing above potential. Even if growth slows from 9% rate, to 8% - 8.5%, the RBI has to figure whether the economy is running "above" or "below" potential in order to decide if policy should be tightened. This is not easily done in emerging economies undergoing rapid structural change. However, rising core inflation is one red flag in this respect and it may behoove the RBI to err on the side of caution and anchor inflation expectations. Furthermore, the governor may well believe that higher food prices is not without a demand-side element too. From this perspective, the RBI's 50bps cash reserve ratio (CRR) hike late Thursday evening is still a delayed policy action. Indeed, we believe this hike was warranted in 1Q08 when RBI's USD buying intervention was massive (***graph***). It is interesting to note that intervention (estimated from rise in USD FX reserves adjusted for FX re-valuation effects) has dropped off in the past few weeks even as the USD/INR has eased.

IN: Weekly RBI intervention vs USD/INR - intervention has dropped off



What is new? Political "will" or "compulsion" to tackle inflation

Early CRR hike reflects political will to tackle inflation. That suggests a rate hike is around the corner

That the CRR hike came two weeks before the policy meeting suggests that the government wants to be seen as taking action. It is also apparent that the dovish rhetoric from the government (in particular the Finance Minister) has given way to a sense of urgency in controlling inflation, even if it means slower growth. Earlier this year, worries over slowing industrial production and the losses in many state elections meant that the political leadership was not happy with further monetary tightening. The high inflation reading changed all the dynamics - not in spite of being led by food and global factors, but (almost) because of it.

As the price rise was led by supply side factors, it has had a sudden and significant impact on both the WPI index and the poor. At the same time, the scope for supply side measures to curb inflation now appear limited because: (1) further rises in crude oil prices limits scope for reversal of February's 4% fuel price hike

The global nature of higher food prices and the persistent rise in oil prices limit the ability of supply side measures to tackle inflation

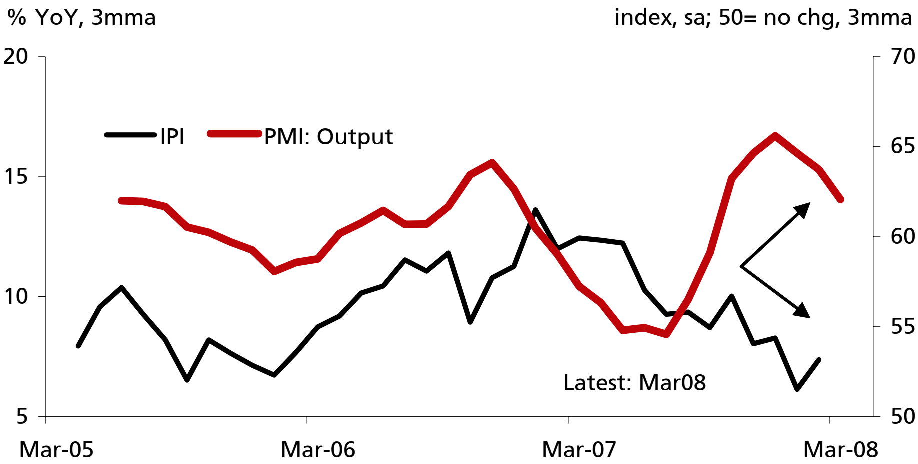
(2) the global nature of higher food prices limits effectiveness of import duty cuts and restricts the ability to meet domestic shortage with imports and (3) the magnitude of the rise in global food prices dwarfs the measures that the government has taken. The government now faces an urgent and difficult war on inflation.

RBI governor worried about "aggregate demand pressures"

Given the sense of urgency now prevailing within the government, we think we no longer have to wait till 3Q08 to see rate hikes, as previosuly envisioned. Our impression of Governor Reddy's leanings is that he is cautious and conservative, worried about maintaining financial stability in the face of capital inflows. He is also concerned about the lags in aggregate supply response and the resulting limitations in absorptive capacity of the economy. In fact, in the last policy meeting in Jan08, the RBI raised its rhetoric by one notch, expressing in unequivocal terms that "aggregate demand" pressures are present and that it may need to take measures to bring monetary growth down. Yet, it did not hike rates or even the CRR in 1Q08. This may not be merely due to government interference. It is probably due in part to the confusion arising from the divergent signals on growth momentum coming from industrial production and PMI surveys (***graph***). We think the former is distorted by old base year and other measurement problems, and the PMI data is more consistent with other indicators of domestic demand, such as non-oil imports and real money demand, and even GDP. That said, the growth outlook is increasingly uncertain due to worries over possible US recession and India's dependence on the US centric software sector. Therefore, the RBI is likely to act with caution.

Recent industrial production data should be discounted

IN: PMI and industrial production diverge



Rate hikes or CRR? Probably both

The RBI is likely to raise both interest rates and the CRR with the latter likely to move by more. Inflation is in good part a fall-out of the continued large capital inflows and the inability to sterilise FX intervention. Therefore, the RBI is likely to prefer CRR hikes as it goes some way towards sterilisation of foreign exchange intervention (25bp hike removes circa USD 2.2bn in the 1st round) and helps directly control credit growth by raising the amount banks must set aside as reserves for every dollar of deposits they raise. This also helps address financial stability concerns. Besides, to make any rate hike effective, the RBI has to absorb liquidity, which may be difficult without CRR hikes.

We bring forward our rate hike expectations by a quarter and expect CRR to be hiked to 9% by Dec-08

New f'cast	Current	Jun-08	Sep-08	Dec-08	Old f'cast	Jun-08	Sep-08	Dec-08
Repo (%)	7.75	8.00	8.25	8.25		7.75	8.00	8.25
Rev Repo (%)	6.00	6.25	6.50	6.50		6.00	6.25	6.50
CRR (%) *	8.00	8.25	8.75	9.00				

** CRR hikes would wary depending of size of FX intervention, MSS issuance etc*

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