ECOWRAP

CPI INFLATION INCREASED MARGINALLY: SEPTEMBER RATE HIKE A CLOSE CALL BETWEEN 35 BPS AND 50BPS

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The overall CPI inflation increased to 7% in August largely driven by consumer food prices. Both Rural and Urban CPI surged in August as compared to July, the increase in Rural CPI is more pronounced. Rural CPI increased by 35 bps m-o-m to 7.15% in Aug mostly due to 312 bps m-o-m increased in cereals prices.

A decomposition of CPI food inflation into sub-components show that on a weighted contribution basis, the food inflation was driven by cereal products and vegetables. The seasonal impact of rains on vegetable prices was discernible. The **prices of cereal have moved higher despite consecutive fall in cereal prices in international markets.** Spatial variation in rains and acreages across crop segments has affected the prices movements. With opening of sea routes in Black Sea there could be some moderation in cereal prices, but the general picture is not uniform across various cereal segments.

The most interesting trend is the negative growth in protein rich item eggs and steady deceleration in prices of meat and fish. This trend is rather surprising as current period of high inflation is not driven by protein rich items. Overall, with resumption of good movement from Black Sea the prices of various food items such as oil will see some moderation. Fluctuation in output due to climatic factors and high cost of transport still underscores the need to be watchful of inflation in general.

Using the idea from the recent paper by Shapiro (How Much Do Supply and Demand Drive Inflation? FRBSF Economic Letter, June 21, 2022), we have sliced CPI inflation into Supply/Demand CPI and Neutral. Our analysis shows that out of 299 commodities in CPI, 171 are categorised as supply driven, 99 as demand driven and 29 are neutral. **Our results show that supply side factors which were responsible for 65% of CPI inflation in May had dropped to 58% in Jul but has increased to 61% in August possibly reflecting the increase in unseasonal rains. Interestingly, demand factors continued to remain range bound and the contribution od demand seemed to have slowed down in August, though marginally. Clearly, the jump in inflation in India continues to be a by-product of supply disruptions.**

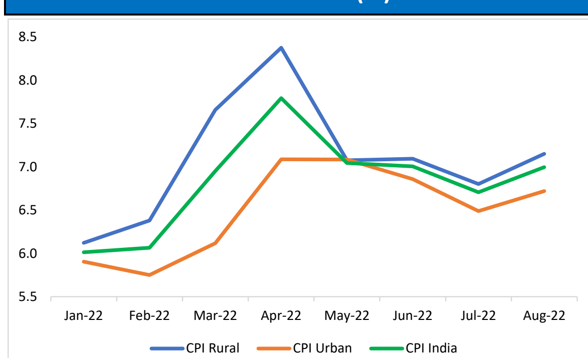
With the rising prices, Goods inflation (with weights 70%) is moving in tandem with the overall inflation, grew by 7.9% in August 2022, compared to 7.5% in July . In contrast, Services inflation, which accounts for a weight of 30%, is declining and is at 5.0% in August 2022. **This again substantiates that the current inflation is mostly supply driven**. **Among services, the contribution of 'Housing' & 'Education' prices is increasing, indicating the real estate market has now significantly recovered from the pandemic blues.**

We believe the RBI is likely to raise rates in September policy and it could be a close call between 35 and 50 basis points. Beyond September, we are penciling in a minimal and token rate increase as inflation is likely fall in a jiffy in H2FY23.

CPI INFLATION INCREASED MARGINALLY

- As expected, CPI inflation increased marginally to 7.0% in Aug'22 as compared to 6.71% in Jul'22 due to escalation in food inflation. Food CPI soared to 7.57% in Aug as compared to 6.71% in Jul due to huge increase in prices of cereals, vegetables, pulses and spices (by more than 200 bps m-o-m). Though Aug print is above RBI's target for the 8th straight month, we firmly believe that post-Oct India will witness the downward trajectory of inflation. Core CPI also increased moderately to 5.84% in Aug.
- Both Rural and Urban CPI surged in August as compared to July, the increase in Rural CPI is more pronounced. Rural CPI increased by 35 bps m-o-m to 7.15% in Aug mostly due to 312 bps m-o-n increased in cereals prices.

CPI Inflation (%)



Source: SBI Research

CORE INFLATION DRIVERS

- The Core CPI has held the trend in past month and is largely flat with a growth of 2.75% in August. Nearly all sub-components on weighted contribution basis witness no change from the last month.

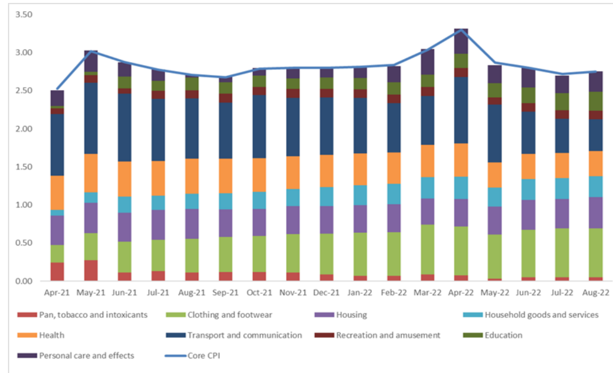
FOOD INFLATION TRENDS AND DRIVERS

- The overall CPI inflation increased to 7% in August largely driven by consumer food prices. A decomposition of CPI food inflation into sub-components show that on a weighted contribution basis, the food inflation was driven by cereal products and vegetables. The seasonal impact of rains on vegetable prices was discernible.
- The prices of cereal have moved higher despite consecutive fall in cereal prices in international markets. Spatial variation in rains and acreages across crop segments has affected the prices movements. With opening of sea routes in Black Sea there could be some moderation in cereal prices, but the general picture is not uniform across various cereal segments.
- The most interesting trend is the negative growth in protein rich item eggs and steady deceleration in prices of meat and fish. This trend is rather surprising as current period of high inflation is not driven by protein rich items.
- Overall, with resumption of good movement from Black Sea the prices of various food items such as oil will see some moderation. Fluctuation in output due to climatic factors and high cost of transport still underscores the need to be watchful of inflation in general.

DEMAND AND SUPPLY INFLATION

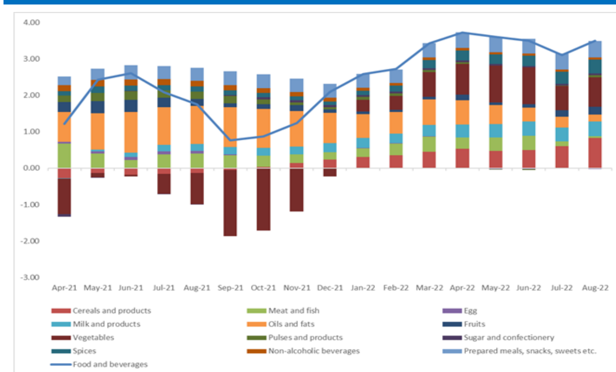
- Using the idea from the recent paper by Shapiro (How Much Do Supply and Demand Drive Inflation? FRBSF Economic Letter, June 21, 2022), we have sliced CPI inflation into Supply/Demand CPI and Neutral. Our analysis shows that out of 299 commodities in CPI, 171 are categorised as supply driven, 99 as demand driven and 29 are neutral.
- Our results show that supply side factors which were responsible for 65% of CPI inflation in May had dropped to 58% in Jul but has increased to 61% in August possibly reflecting the increase in unseasonal rains. Interestingly, demand factors continued to remain range bound.

Weighted Contribution Core CPI



Source: SBI Research

Weighted Contribution of Food and Beverages



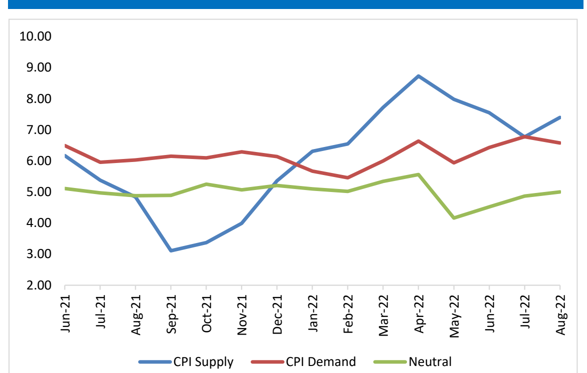
Source: SBI Research

Demand & Supply Inflation: Weighted Contribution (%)

	# of Items		Jun-22	Jul-22	Aug-22
Demand CPI	99	%	2.5	2.6	2.6
		Share	36%	39%	37%
Supply CPI	171	%	4.3	3.9	4.3
		Share	62%	58%	61%
Neutral	29	%	0.2	0.2	0.2
		Share	2%	3%	2%
Overall CPI	299	%	7.0	6.7	7.0

Source: SBI Research

Demand and Supply CPI inflation (%)



Source: SBI Research

WIDENING GAP BETWEEN GOODS & SERVICES INFLATION

- With the rising prices, the goods inflation (with weights 70%) is moving in tandem with the overall inflation, grew by 7.9% in August 2022, compared to 7.5% in July and 4.8% in August 2021. In contrast, services inflation, which accounts for a weight of 30%, is declining and is at 5.0% in August 2022, compared to 6.4% in August 2021.
- Among services, the contribution of 'Housing' & 'Education' prices is increasing.

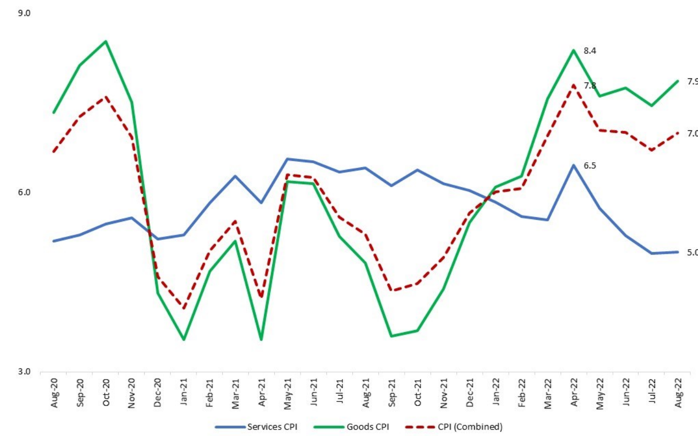
INFLATION TRAJECTORY & RATE CYCLE

- We believe inflation in FY23 is likely to come around 6.3-6.4% (below RBI projection of 6.7%) with inflation moving below 6% only in Nov'22. For FY24 it should come at 5.0-5.1%.
- However, there is another aspect that RBI would have to consider while increasing rates which is the impact of higher rates on growth. By Dec'21 around 39.2% of the loans are benchmarked to external benchmarks (EBR), so the increase in repo rate of 140 bps will eventually in-crease interest cost on consumers ~ Rs 42,500 crore on Retail & MSME consumers and demand is likely to be impacted. This may have an impact on growth. Rural demand has also been impacted going by the results of FMCG companies.
- Under the current situation interest rates will rise including in India. Under the evolving situation the repo rate will tend to be at 6% +/- 25 bps by end of FY23.

IIP METHODOLOGY—TIME TO CHANGE?

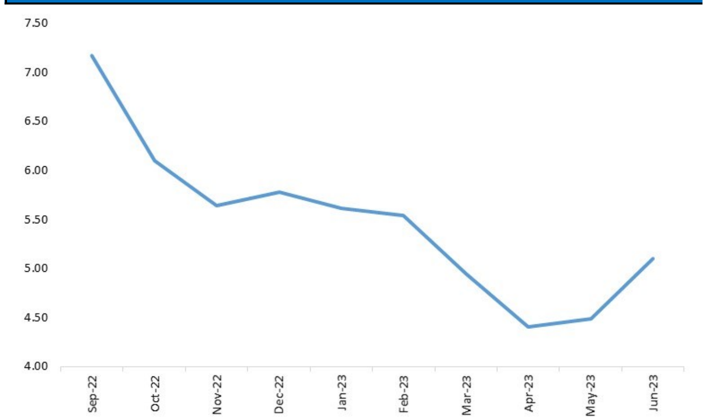
- For preparation of Monthly IIP, the department collects monthly production data directly from selected industrial units in the State through its District Statistical Officers and present base year is 2011-12.
- With India announcing a lot of incentives under the PLI scheme, there has been an exponential jump in manufacturing exports from India.
- Government announced PLI schemes in various sectors including automobile and auto components, electronics and IT hardware, telecom, pharmaceuticals, solar modules, metals and mining, textiles and apparel, white goods, drones, advanced chemistry cell batteries etc. and hence it's the time to expand the basket too.

Movement of Goods & Services Inflation



Source: SBI Research

Inflation Trajectory (%) - SBI Projections



Source: SBI Research

- For example, pre pandemic, the IIP and manufacturing exports have moved in close tandem, but they have completely diverged post pandemic.
- A logical corollary to all this is gross misappropriation (or underestimation) of manufacturing sector growth.
- We believe that the new base of IIP (on which the Government is currently working) will remove these glitches to have a fair representation.
- Meanwhile, listed Corporate reported growth in Net sales of 51% in Q1FY23 while PAT grew by 11% on a yoy basis.
- However, corporate margin seems to be under pressure, as reflected in results of around 3000 listed entities ex BFSI, on account of higher input costs with decreasing EBIDTA margin, on aggregate basis, from 17.65% in Q1FY22 to 12.51% in Q1FY23.

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