

AUGUST INFLATION NUMBERS COULD BE UNPLEASANT: RATE CUT HOPES FADE?

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There is now an emerging thought suggesting that one should look through the current increase in inflation as episodic, and look through the cycle as price disruption is mostly induced from supply disruptions in food items that is perishable. Interestingly, the gap between WPI and CPI is most often quoted as an example of the food induced increase in headline CPI. However, a closer look at the WPI and CPI food basket reveals that food items have contributed to a jump in both the headline numbers, though the jump in CPI is magnified because of the disproportionately larger weight of food in CPI. Additionally, if we replicate the WPI basket with the CPI food basket weights, the gap between food WPI and food CPI declines to around 150 basis points, implying that all other things remaining unchanged, the decline in WPI because of factors than food is around 150 basis points. We estimate that fuel and light contribute to around 110 points of such. Hence only 40 basis points is the difference between CPI and WPI on a comparable scale.

Interestingly, we estimate that the MSP impact is nearly identical at 39 basis points. Thus, we postulate that the jump in food prices is largely because of huge procurement by Government and supply disruption that pushed up prices of cereal, potato, tomato and protein items.

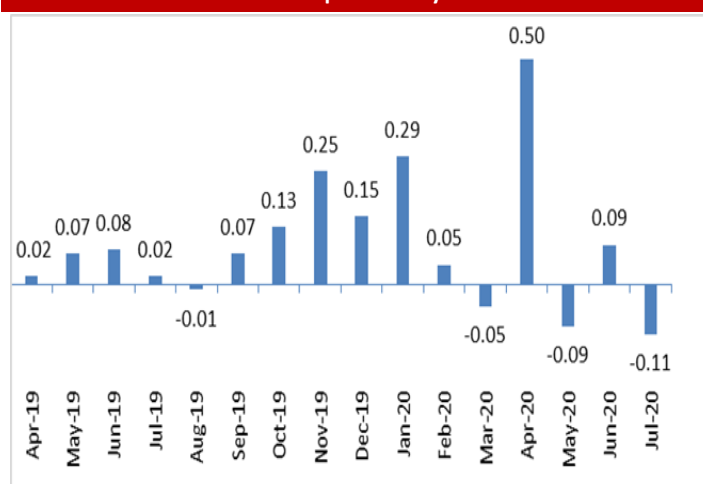
We expect August inflation numbers to be elevated at around 7% or even higher and if the base effect is the primary reason, inflation could only come down to below 4% possibly beyond December. However, it looks difficult to believe that supply disruptions would normalise against the huge upsurge in pandemic in rural areas and this now poses an upside risk to inflation numbers. We are thus less hopeful of any rate cut in current fiscal / at best 25 bps as February MPC meeting would consider December inflation only.

As inflation targeting comes up for review in 2021, we believe, one way to make inflation targeting successful in the Indian context as time goes by is to reach the 4% target over a particular business cycle rather than for a particular date such as 2 year ahead. This would encourage predictable inflation targeting in the face of persistent negative shocks and recently US Fed has also espoused such a conviction.

SOME THOUGHTS FOR INFLATION TARGETING

- ◆ With the inflation targeting up for review in 2021, and given the recent clamour for flexible inflation targeting, let us digress to look at Indian experience. The RBI had fixed lower CPI target of 8% by Jan'15 and 6% by Jan'16. India then formally adopted flexible inflation targeting in Jun'16 to place price stability, defined in terms of a target CPI inflation of 4% (+/-) 2%, as the primary objective of the monetary policy.
- ◆ We believe, one way to make inflation targeting successful in the Indian context as times goes by is to reach the 4% target over a particular business cycle rather than for a particular date such as 2 year ahead. This would encourage a predictable inflation targeting in the face of persistent negative shocks and recently US Fed has also espoused such a conviction.
- ◆ Such history dependent policy has been effectively implemented by Reserve Bank of Australia, with 2-3% target on average over the business cycle. The inflation target is defined as a medium-term average rather than as a rate (or band of rates) that must be held at all times. This formulation allows for the inevitable uncertainties that are involved in forecasting, and lags in the effects of monetary policy on the economy. Experience in Australia and elsewhere has shown that inflation is difficult to fine-tune within a narrow band. The inflation target is also, necessarily, forward-looking. This approach allows a role for monetary policy in dampening the fluctuations in output over the course of the cycle. When aggregate demand in the economy is weak, for example, inflationary pressures are likely to be diminishing and monetary policy can be eased, which will give a short-term stimulus to economic activity. Following this method of inflation-targeting since early 1990s has resulted in excellent economic performance of Australia. Average inflation in Australia since 1995 is 2.7%, very close to 2.5% mid-point with no record of recession in 25 years!
- ◆ India's GDP decline of 23.9% in Q1 FY21 is far greater than the average decline of 12.2% of 60 economies. We expect a set of measures quickly like augmenting the PMNREGA budget.

MSP Impact till July 20



Source: SBI Research

Difference in weighted contribution from February to July (in Bps)

Sub Group	Wt	Feb-20	Jul-20	Difference
Increase in Weighted contribution				
Food Items	9.3	79.8	168.7	88.9
Pan, tobacco and intoxicants	0.4	2.6	10.6	8.0
Transport and communication	3.6	8.7	32.4	23.7
Personal care and effects	1.1	20.7	39.1	18.4
Decline in Weighted contribution				
Food Items of which	1.6	132.8	6.0	-126.7
Onion				-77.6
Garlic				-24.7
Housing	9.5	43.5	31.0	-12.5
Fuel and Light	3.7	39.0	10.9	-28.0
All India	100.0	657.6	693.5	35.9

Source: SBI Research

WTD Contribution in CPI								
Items	Weight	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20
Cereals	9.67	0.50	0.50	0.50	0.73	0.69	0.74	0.65
Pulses	2.38	0.34	0.34	0.33	0.47	0.44	0.38	0.34
Vegetables	6.04	2.84	1.77	1.06	1.38	0.33	0.25	0.76
Fruits	2.89	0.16	0.11	0.10	0.08	0.06	0.01	0.00
Milk	6.61	0.38	0.41	0.43	0.63	0.59	0.46	0.44
Eggs, Meat and Fish	4.04	0.46	0.43	0.38	0.41	0.68	0.81	0.80
Condiments and Spices	2.50	0.21	0.22	0.24	0.32	0.31	0.33	0.33
Other food articles	2.62	0.07	0.07	0.07	0.13	0.10	0.08	0.09
Food Articles	36.75	4.96	3.85	3.12	4.14	3.20	3.06	3.41
Prepared meals, snacks, sweets etc.	5.55	0.16	0.17	0.17	0.28	0.26	0.23	0.24
Oils and fats	3.56	0.21	0.24	0.23	0.33	0.36	0.35	0.38
Food and Beverages	45.86	5.29	4.26	3.53	4.74	3.81	3.63	4.01
Pan, tobacco and intoxicants	2.38	0.10	0.11	0.13	0.16	0.17	0.31	0.34
Clothing and footwear	6.53	0.13	0.14	0.14	0.24	0.23	0.18	0.19
Fuel and light	6.84	0.25	0.43	0.45	0.20	0.11	0.03	0.18
All Items	100.00	7.59	6.58	5.84	7.22	6.27	6.23	6.93

Source: SBI Research

WTD Contribution in WPI with CPI Weights								
Items	Weight	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20
Cereals	9.67	0.99	0.66	0.34	0.46	0.45	0.34	0.10
Pulses	2.38	0.35	0.31	0.32	0.40	0.35	0.29	0.29
Vegetables	6.04	3.68	2.01	0.77	0.25	-1.06	-0.84	0.79
Fruits	2.89	0.06	-0.02	-0.07	0.01	0.03	0.08	-0.11
Milk	6.61	0.31	0.37	0.44	0.46	0.43	0.32	0.37
Eggs, Meat and Fish	4.04	0.36	0.33	0.20	0.11	0.10	0.22	0.25
Condiments and Spices	2.50	0.58	0.47	0.46	0.41	0.31	0.24	0.14
Other food articles	2.62	-0.06	-0.11	-0.12	-0.17	-0.04	0.08	0.21
Food Articles	36.75	5.03	3.38	2.05	1.73	0.76	0.94	1.91
Prepared meals, snacks, sweets etc.	5.55	0.33	0.28	0.27	0.21	0.16	0.13	0.08
Oils and fats	3.56	0.50	0.41	0.40	0.37	0.37	0.46	0.52
Food Articles Plus Oils & Fats Plus Prepared Meals	45.86	5.86	4.08	2.73	2.31	1.29	1.53	2.51
All Items	100.00	3.52	2.26	0.42	-1.57	-3.37	-1.81	-0.58

Source: SBI Research

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