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CPI INFLATION TO BREACH 8% IN JANUARY DUE TO GOP EFFECT : NEED TO REVAMP CSO DATA METHODOLOGY

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CPI inflation jumped to 7.35% in December, on the back of significant increase in ginger, onion and potato (GOP) prices. Stripping aside the GOP impact, the headline inflation declines to 4.48%. The impact of increase in telecom tariff has added another 16 bps to inflation. We now expect inflation to breach 8% in January and then start bottoming out. However, this jump in inflation will perforce the RBI to relook at the inflation trajectory but in our view any change to a possible change in stance could be unwarranted as we find compelling evidence of significant slowdown in discretionary consumption. We believe RBI missed the bus in cutting rates in December. Our worry is that if the food price inflation does not mean revert, we can slip into stagflation. Our inflation trajectory shows headline will only materially decline beyond September, with Dec 2020 -Jan 2021 inflation declining to below 3%. This means RBI will possibly remain on hold in Calendar 2020, going by current trends. We thus expect g-sec yields to inch closer to levels at where it was before operation twist started (6.7%).

The imminent fear that is looming now is the increase in protein inflation going forward after such a whopping increase in vegetable prices. Our Granger casualty tests shows that **increase in vegetable inflation Granger causes increase in protein inflation** with a lag of 2-months. One of the plausible reasons for such a result is that people might shift from costly vegetables to pulses/egg/meat and subsequently it leads to further increase in prices.

It is also an irony that paddy procurement by Food Corporation of India (FCI)/ State agencies for Kharif Marketing Season (KMS) has started from October, 2019, but many States like West Bengal, Karnataka, and Rajasthan have yet to start their procurement of paddy during this kharif season, while for Tamil Nadu, Bihar and Jharkhand, the procurement figure (as on 13.01.2020) is even less than 5% of total procurement in previous season (KMS 2018-19). This again exposes the problems in Indian farmers getting a proper remuneration of their crops. The coming budget must shed its inhibitions about reforming the agri sector.

The uptick in international food prices through the import channel will have some bearing overall trajectory of CPI (Combined) inflation. The imported inflation component of CPI has registered some uptick since November. The only redeeming feature is the growth in IIP in November. Specifically for the year as a whole, the strong growth in intermediate goods is attributed to high intermediate demand from chemical products and metals.

We are staring at low growth and high inflation at least for H1FY20. Difficult times indeed! Unfortunately, CSO methodology of using CES Survey data has resulted in CPI being overstated by 200 bps. Its high time we question the CSO methodology of CPI estimation as it results in erroneous policy decisions!

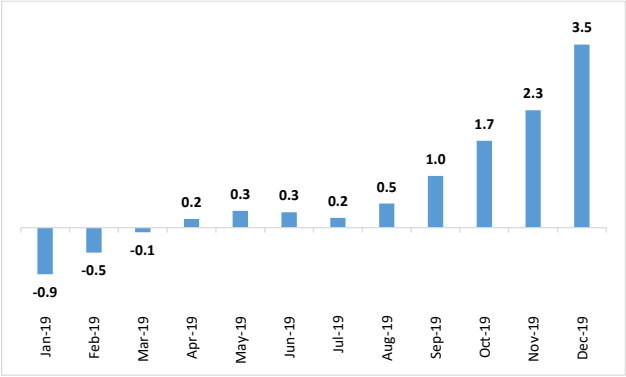
CPI INFLATION IS AT 7.35% IN DEC'19

- Year 2019 apparently ended on a worrying note as CPI inflation rose sharply to 64-month high to 7.35% in Dec'19 as against 5.54% in the month of Nov'19 solely on account of huge jump in vegetable prices. The food & beverages inflation rose to 12.16% in Dec'19 as compared to 8.73% in previous month. The prices of vegetables (including the onion) rose sharply to 60.5% in Dec'19. The recent surge in CPI inflation is largely due to exorbitant increase in vegetable prices due to which the weighted contribution of vegetables in overall CPI has increased from 0.2% in Jul'19 to 3.5% in Dec'19. The inflation in transport and communication segment has increased from 0.88% in Nov'19 to 4.77% in Dec'19 due to increase in telecom tariff.
- Core CPI increased marginally to 3.73% in Dec'19 from 3.49% in Nov'19.
- The imminent fear that is looming now is the increase in protein inflation going forward after such a whopping increase in vegetable prices. Our Granger casualty tests shows that **increase in vegetable inflation Granger causes increase in protein inflation** with a lag of 2-months. One of the plausible reasons for such a result is that people shift from costly vegetables to pulses/egg/meat and subsequently it leads to further increase in prices.

INFLATION GOING FORWARD AND RATE ACTION

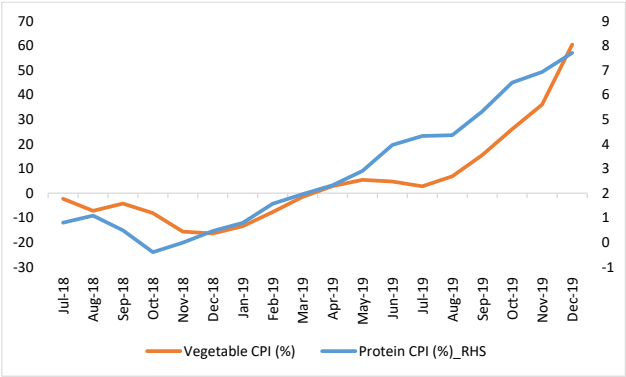
- Inflation is expected to remain high in the remaining months of this fiscal year, close to 7% thus averaging to 5.0% for FY20. The rise in domestic food price inflation has been in line with global food prices which have jumped to double digits in Dec'19, mainly on account of meat, dairy and oil price increase. However, on monthly basis the pace of food price increase has declined compared to Nov'19.
- Furthermore, more than normal south-west monsoon which has led to good water reservoir storage and high soil moisture content should result in better food production of rabi crops. Monsoon for this year is expected to remain normal and recharged aquifers owing to healthy rainfall in 2019 are likely to yield good Kharif harvest this year. Thus, we expect food price increase to moderate in the next fiscal.
- However, overall inflation is expected to average around 4.8% next year.
- Given the situation of low growth and high inflation (a possible situation of stagflation though it is too early to dubbed it as stagflation) we believe that the coming months are crucial for RBI to decide on any action at rate front.
- RBI did not cut the rate in December when Oct'19 inflation rate was 4.62%, now that CPI inflation has surged to 7.35% in Dec and Jan inflation is also expected to remain high (above 8%), RBI is likely to hold rate in the next policy. **We believe that RBI will go for a long pause possibly throughout 2020 as inflation is likely to remain above 6% till June-July 2020.**

Weighted contribution of Vegetables in CPI (%)



Source: SBI Research

Vegetables and Protein CPI (%)



Source: SBI Research

STATE WISE INFLATION

- In the last one year (since Jan'19), CPI inflation has increased from 1.97% in Jan'19 to whopping 7.35% in Dec'19. Among States, the CPI inflation has increased sharply in Telangana, Odisha, Andhra Pradesh, Haryana, etc. However, in States like Karnataka, Bihar, Kerala, etc. the increase in inflation was moderate compared to all India level.
- Onion prices softened further in various centres and are expected to come-down with arrival of the new crop in the market. In the last month, Government has taken various measures like banning exports, restricting hoarding, and increasing imports to restrict the rising onion prices.

PROCUREMENT

- Paddy procurement by Food Corporation of India (FCI)/ State agencies for Kharif Marketing Season (KMS) has started from October, 2019. The procurement data available in FCI portal shows that, many States like West Bengal,
  Karnataka, and Rajasthan have yet to start their procurement of paddy during this kharif season while for Tamil Nadu, Bihar and Jharkhand, the procurement figure (as on 13.01.2020) is even less than 5% of total procurement in previous season (KMS 2018-19).
- Two successive years of bumper production and higher procurement have led to significant increase in stocks of rice and wheat in central pool. The storage capacity is fast getting exhausted. As against the buffer stock norm of 30.7 million tonne of rice and wheat, total central pool stock was 56.4 million tonne as on 31st Dec'19.
- FCI's grain stocks (central pool stocks built up under a virtually open-ended procurement policy) is already close to its capacity of 76 million tonne. Given the expected (low) pace of offtake under PDS and other government schemes, the requirement to shift the huge paddy stocks now lying with millers and the mandated rabi wheat purchases effective April, it may face a serious storage problem in a few weeks.

IS CPI CORRECTLY MEASURED BY CSO?

- There is significant difference between the share of food and beverages (30%) in the Private Final Consumption Expenditure (PFCE), published by the National Account Statistics (NAS), and the weights derived from the CES (45.86%). Subsequently, the episodic spikes in CPI inflation, which is largely contributed by rise in food and vegetable prices (as it is happening currently), makes the RBI decision difficult. Interestingly, if we reduce the weightage of food in CPI to 30%, the headline CPI declines to 5.46% from 7.35% in Dec'19.

State-wise Trend in CPI Inflation

State	Jan'19	Dec'19	Change (in bps)
Telangana	-0.29	9.39	968
Odisha	-0.07	9.41	948
Himachal Pradesh	-2.38	6.48	886
Andhra Pradesh	-1.20	7.44	864
Haryana	0.30	7.40	710
Uttar Pradesh	2.16	8.92	676
Rajasthan	1.74	7.62	588
Uttarakhand	2.04	7.82	578
Tamil Nadu	2.87	8.64	577
Madhya Pradesh	2.17	7.88	571
West Bengal	2.25	7.63	538
All India	**1.97**	**7.35**	**538**
Jharkhand	2.23	7.20	497
Chhattisgarh	0.43	5.31	488
Maharashtra	1.87	6.56	469
Punjab	2.39	7.02	463
Gujarat	1.81	6.11	430
Kerala	4.53	7.98	345
Jammu and Kashmir	3.66	6.66	300
Bihar	1.72	4.08	236
Karnataka	4.29	6.54	225

Source: SBI Research

Procurement of Paddy (Fig. in LMTs)

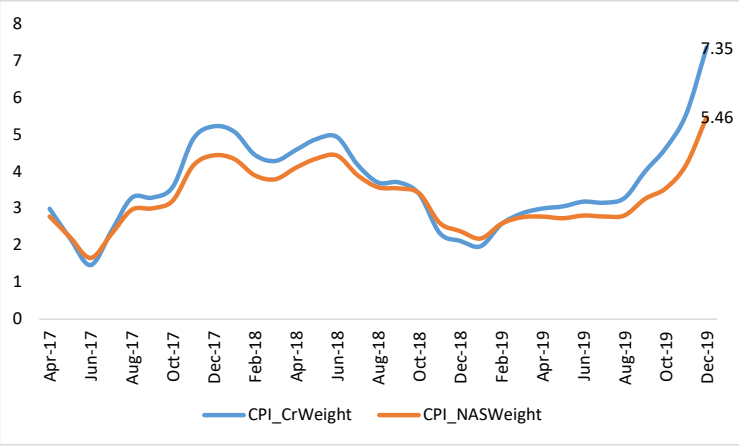
	2018-19	2019-20 (as on 13.01.2020)	Share
AP	71.72	20.94	29.2%
Telangana	77.46	42.2	54.5%
Bihar	14.16	0.79	5.6%
Chhatisgarh	58.4	37.77	64.7%
Haryana	58.83	64.23	109.2%
Jharkhand	2.28	0.06	2.6%
Kerala	6.94	1.69	24.4%
Madhya pradesh	20.82	12.4	59.6%
Maharashtra	8.66	3.59	41.5%
Odisha	65.41	23.62	36.1%
Punjab	169.16	162.28	95.9%
Tamil nadu	19.03	0.56	2.9%
Uttar Pradesh	48.25	45.27	93.8%
Uttrakhand	6.89	9.22	133.8%
West Bengal	29.11	0	0.0%
Total	660.1	425.2	64.4%

Buffer Norms w.e.f. 01.07.2017 (Figure in lakh MT)

Quarter	Operational Stock			Strategic Reserve		
	Rice	Wheat	Total	Rice	Wheat	Total
1st April	115.8	44.6	160.4	20	30	210.4
1st July	115.4	245.8	361.2	20	30	411.2
1st October	82.5	175.2	257.7	20	30	307.7
1st January	56.1	108	164.1	20	30	214.1

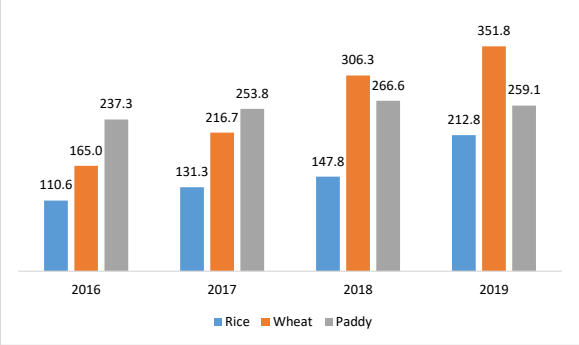
Source: FCI, SBI Research

CPI based on NAS and NSS data (%)



Source: SBI Research

Food grains Stock in Central Pool (in lakh MT)



Source: FCI, SBI Research

INTERNATIONAL FOOD PRICES AND CPI INFLATION

- The UN FAO Food Price Index registered its strongest rise in Dec 2019 on the back of strong rallies in vegetable oils, sugar and dairy markets pushed up the overall value of the Index to its highest level since December 2014. The latest upturn was primarily driven by firming palm oil prices, while soya, sunflower and rapeseed oil values also increased. International palm oil prices rose for the fifth consecutive month on solid demand, especially from the biodiesel sector, coinciding with prospects of tightening supplies.
- The steady rise in international prices of oil notably palm oil can not be ignored in the context of India which net importer of palm oil and will have implications for CAD if this rally continues its momentum. The uptick in international food prices through the import channel will have some bearing overall trajectory of CPI (Combined) inflation. The imported inflation component of CPI has registered some uptick since November.

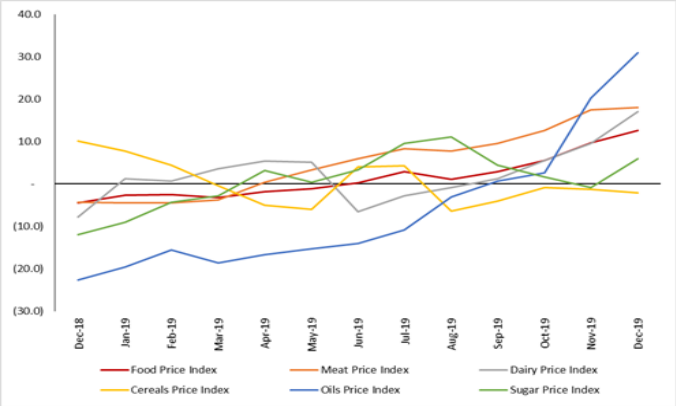
IIP DE-GROWTH ARRESTED

- After contracting for three consecutive months, Index of Industrial Production (IIP) grew at 1.8% in Nov'19 on the back of improving manufacturing sector. The IIP growth in Nov'18 was at 0.2%, thus providing a favourable base for the Nov'19 IIP.
- Looking at the use based classification, except the intermediate and consumer non-durables all the other sub-sectors are in red. This is the 11th month when capital goods growth was negative signaling trouble for the economy. Consumer durables have also remained in the negative territory.
- We analyzed the growth rate of export-oriented sectors (under manufacturing) during the current FY. As the engineering goods have the highest component in India's exports, their faltering production is also reflecting in their slowing exports. During Apr-Nov'19, vehicles excluding railways etc. grew by -3.78% and in IIP, too, Manufacture of motor vehicles, trailers and semi-trailers has been negative this entire fiscal. Other machinery and equipment n.e.c. have also been showing de-growth. Leather manufacturing and exports are also in the red zone in Apr-Nov'19 period. One diverging trend is between electronic exports and their domestic production. Manufacture of computer, electronic and optical products and electrical equipment was –6.2% while, electrical machinery and equipment exports grew by 26.23%. Although manufacturing of readymade garments was robust, their exports have been slow.

PICKUP IN IIP INTERMEDIATE GOODS

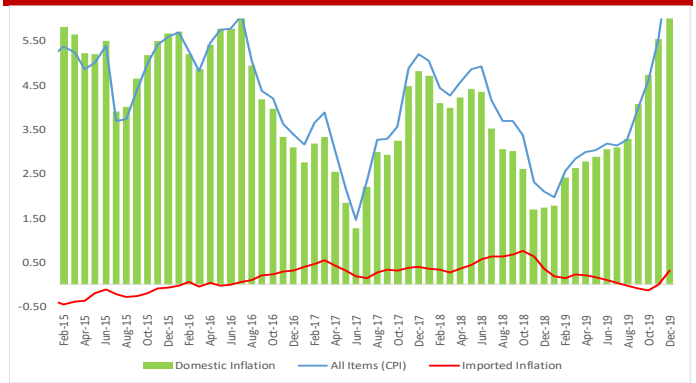
- As per Use-based classification of IIP, the intermediate goods component of IIP registered very high growth of 17% in Nov 2019 and an overall growth of 12.2% for the period Apr-Nov 2019. The sudden uptick in November is squarely attributed to very high growth registered in sub-components Fragrances & Oil essentials, MS slabs and Pipes and tubes of Steel which are classified as intermediate goods in IIP 2011-12 base. However, for the year as a whole, the strong growth in intermediate goods is attributed to high intermediate demand from chemical products and metals. This strongly corroborates with strong growth in fertilizer component of core and also the exports of chemical products.

UN FAO Food Price Indices



Source: UN FAO

Domestic and imported component of CPI



Source: SBI Research

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