Economic Analysis

Stubborn core inflation offers no downward room to RBI

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India's benchmark inflation indicator, the CPI, moderated in May to 8.3% y/y from 8.6% in April (Consensus: 8.5%) led by a let up in food prices, which account for 50% of the CPI basket. However, core inflation was sticky at 7.7% y/y (7.7% previously) and suggests that demand side pressures, although contained, have not eased meaningfully so far. The latest CPI inflation outturn is broadly in line with RBI's expected inflation trajectory. The Central bank left interest rates unchanged at 8.0% (repo) last week so as "to allow the disinflationary effects of rate increases undertaken during September 2013-January 2014 to mitigate inflationary pressures in the economy". RBI's anti-inflationary stance and its adherence to an explicit 'glide path', which aims to reduce CPI inflation to 8% y/y by January 2015 and to 6% y/y by January 2016, is helping curb inflation expectations and rein in demand pressures. However, the pace of disinflation has been rather slow and food inflation is fraught with near term upside risk given prospects of weak monsoon rains (July to September season) on account of El Nino effect.

In this regard, the new government's ability to keep food price spikes in check, especially across vegetables, by effectively managing existing buffer stocks, improving delivery time and preventing pilferage, strengthening storage infrastructure and reducing minimum support prices, would be tested. Furthermore, the new government's budgetary response in early July would be decisive in shaping India's medium term inflation trajectory. A concrete roadmap on fiscal consolidation associated with an aggressive cut back in non-merit subsidies and other wasteful revenue expenditure is critical to contain inflation pressures and anchor inflationary expectations. Against this backdrop, while we believe that the RBI is likely done with policy rate tightening, an interest rate cut remains elusive until core CPI inflation dips meaningfully and on a sustained basis. Hopeful of an effective fiscal response given a strong and stable government at the Centre, we maintain our base case of a 25 bps policy rate cut in 4Q14, although we do not rule out a status quo on rates throughout 2014 if inflation fails to decline meaningfully.

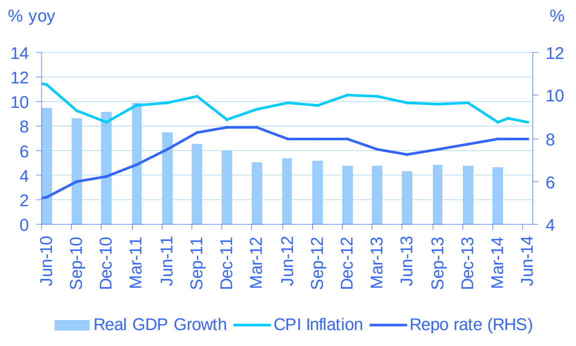
India's recent activity indicators are encouraging – Notwithstanding a muted start to 2014 with Q1 GDP growth sluggish at 4.6% y/y (4.6% in 4Q13), India's activity indicators for Q2 have surprised positively. Aided mainly by upbeat business and investment sentiment post a favorable election outcome and a pick up in external demand, April industrial production jumped 3.4% y/y (a 12 month high), May exports growth was robust at 12.4%, May PMI rose to a 3 month high of 51.4 while May auto sales picked up 10% m/m sa, highest since September 2012.

Figure 1
May CPI inflation softens but core remains sticky

India CPI Inflation					
% Change Y/Y	Weight	May-14	Apr-14	Mar-14	Feb-14
Consumer Price Index (CPI)	100	8.3	8.6	8.3	8.0
Food	50	9.3	9.6	9.2	8.6
Fuel	9	5.1	5.9	6.3	6.1
Clothing	5	8.9	8.7	9.0	9.1
Housing	10	9.2	9.7	9.9	9.9
Services	26	6.9	6.8	6.8	6.8
Core CPI (Ex food and fuel)	41	7.7	7.7		

Source: BBVA Research

Figure 2
RBI's rate tightening cycle is probably over but a rate cut remains elusive until core inflation meaningfully subsides



Source: BBVA Research