

Economic Analysis

# Inflation eases sharply in June, but imminent upside risks keep RBI on hold for longer

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Indian policymakers, who have been battling high inflation for a protracted period, would take comfort from a moderation in price pressures last month. The benchmark CPI inflation eased sharply to 7.3% y/y in June (Consensus: 7.7%), the lowest in 29 months, compared to 8.3% in May. Separately, wholesale price inflation (WPI) fell as well, to 5.4% y/y in June from 6.0% in the previous month. The decline in CPI inflation was led by lower food inflation (accounts for 50% of the CPI basket), especially vegetable prices (8.7% y/y vs. 15.2%), helped in large part by a favorable base effect from last year. Reassuringly, core CPI inflation slowed to 7.4% y/y from 7.7% previously, signaling easing demand pressures.

A gradual decline in core inflation (from 8.4% y/y last September) could widen room for the Reserve bank of India to consider policy actions for stimulating a sluggish economy. However, we believe it is still early for the RBI to let its guard down on inflation. Core CPI inflation still remains elevated and could re-stoke demand pressures if policy rates are eased prematurely. Also importantly, impending upside risks to food prices from weak monsoon rains and to oil prices from the ongoing geopolitical conflict in Iraq are too grave to ignore. So far, seasonal rains (June to September season) have been deficient at 43% below normal (weakest in decade), which raises the risks of drought during the critical sowing month of July.

Against this backdrop, we expect the Reserve Bank of India to keep policy rates on hold (repo rate at 8.0%) at its next policy meeting on August 5<sup>th</sup>. Hopeful of an effective fiscal response as outlined in India's recently unveiled union budget (See our [Budget Review](#)) 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 if inflation bounces back.

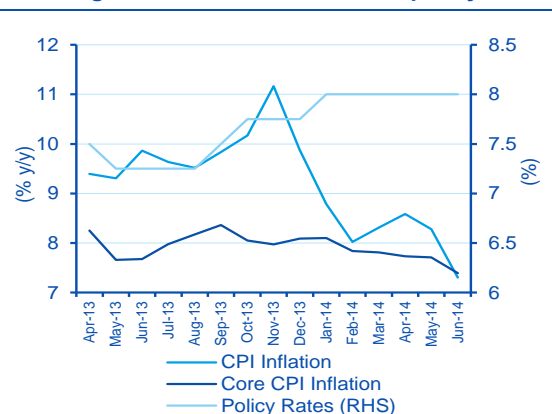
**India's budget saw positive steps to stem inflation – implementation is key:** India's budget, unveiled last week, announced a raft of long lasting measures to stem inflation, particularly on the food front. These include, efforts to reorient the archaic Agriculture Produce Marketing Committee Act (APMC), a Rs 5 bn (USD 83 mn) 'Price Stabilization Fund' to mitigate the risk of price volatility in agriculture produce, transformation plan to invigorate the warehousing sector, restructuring an ineffective public distribution system and empowering the government to undertake open market sales to keep prices under control.

Figure 1  
June CPI inflation fell sharply but is still elevated..

% Change Y/Y	India CPI Inflation				
	Weight	Jun-14	May-14	Apr-14	Mar-14
Consumer Price Index (CPI)	100	7.3	8.3	8.6	8.3
Food	50	7.9	9.2	9.6	9.2
Fuel	9	4.6	5.0	5.9	6.3
Clothing	5	8.6	8.8	8.7	9.0
Housing	10	9.1	9.2	9.7	9.9
Services	26	6.5	6.9	6.8	6.8
<b>Core CPI (Ex food and fuel)</b>	<b>41</b>	<b>7.4</b>	<b>7.7</b>	<b>7.7</b>	<b>7.8</b>

Source: BBVA Research

Figure 2  
...Offering little room for RBI to ease policy rates



Source: BBVA Research

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