

Economic Analysis

December CPI inflation extends gains, RBI likely to stay on hold in Feb

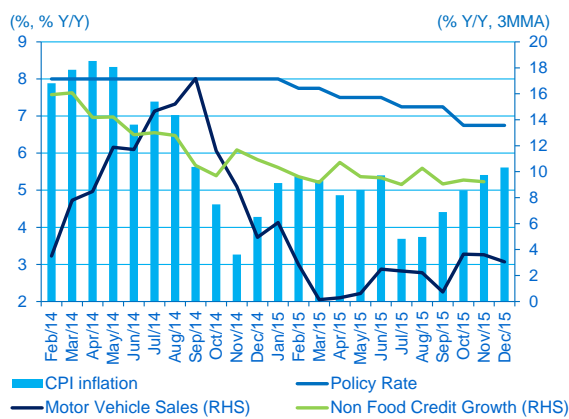
Sumedh Deorukhkar / Le Xia

India's December 2015 CPI inflation outturn extended recent gains since hitting an 8 month low last August; which consequently limits room for the RBI to exercise interest rate cuts later this year. The latest CPI outturn edged up to 5.6% y/y compared to 5.4% y/y in November (BBVA & Consensus Est.: 5.5%), led mainly by a low base effect from last year and the sharper than expected pick up in food inflation (46% weight in CPI), particularly beverages, meat, fish and oils. Core inflation, which excludes food and fuel, picked up marginally as well, up 4.5% y/y from 4.3% previously, on the back of price increases across housing and health. For the full calendar year 2015, India's average headline CPI inflation stood at 4.9% (BBVA Est.: 5.0%), an improvement from 6.5% in 2014 and is expected to be stable at 5.2% in 2016.

Looking ahead, we think risks to India's inflation remain balanced. Key factors stoking inflation pressure ahead are - 1) the El Nino effect on winter crop, and 2) the impact of the proposed 24% hike in total pay, allowance and pension of Central government employees. On the flipside, factors such as 1) wilting global oil and commodity prices, 2) weak rural wage growth, 3) industrial capacity underutilization and weak momentum in investment demand and 4) waning unfavorable base effect, are expected to weigh on inflation.

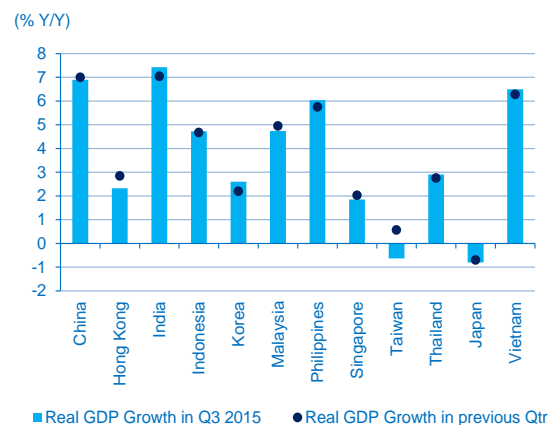
Expect 25 to 50 bps policy rate cuts in FY17: While RBI should comfortably achieve its January 2016 inflation target of 6.0% y/y (BBVA Est.: 5.8%), the central bank's longer term CPI inflation target of 5.0% y/y for March 2017 will be tested. Government's efforts to deliver quality fiscal consolidation and address food supply bottlenecks and the nature of monsoon rains in 2016 following two successive years of deficient rains, will be crucial in this regard. From a policy perspective, we maintain that India's rate cutting cycle is not over yet. RBI awaits banks to transmit the bulk of its cumulative 125 bps rate cuts over 2015 (60 bps passed), and tests India's ability to stay on the disinflationary path. With India's economic recovery still far from robust and risks to inflation evenly balanced, we foresee room for another 25 to 50 bps of policy rate cut over the fiscal year 2017 which commences this April. Thus, RBI is expected to remain on hold at its next policy meeting on February 2nd, maintaining the repo rate at 6.75%.

Figure 1
Inflation picked up further in December



Source: BBVA Research, CEIC

Figure 2
India is the region's fastest growing economy



Source: BBVA Research, CEIC

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