# Ecowrap

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## INFLATION PERSISTENCE VIS-À-VIS LOW GROWTH: RBI HAS LIMITED CHOICE

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CPI inflation increased to 6.30% on yearly basis in May'21 as compared to 4.23% in Apr'21. This 200 bps increase on yearly terms and 100 bps increase in monthly terms is a matter for concern and even small items are showing disproportionately larger increases. Rising food and commodity prices as well as localised lockdowns have led to sharp increase the headline numbers. Meanwhile, core inflation has also increased to 6.55% and the last time it was seen around this level was in Jun'14. We are now revising our CPI average for FY22 to 6.1% and core inflation is likely to print at 6.4%. interestingly latest core inflation is outside the mean plus 2* (standard deviation) if construct a bell curve using one year's data. Both core WPI and core CPI are positive and highly correlated , And the relentless increase in global commodity prices will only imply that core CPI is unlikely to correct anytime soon.

In the coming months, domestic inflation trends are likely to raise anxiety levels in the RBI and the MPC. Driven by several global and domestic factors, inflation may remain elevated in the coming months. Specifically, the faster than anticipated and robust recovery in some of the advanced countries is likely to exert upward pressure on international commodity prices, including oil. The latter being an intermediate good in leading EMEs, it would generate cost push inflation.

Moreover, the ravages after the second wave of the pandemic and location-specific lockdowns in major Indian states have further dislocated supply chains even in rural areas which is going to manifest in rising prices on essentials. Cumulatively, this could significantly ratchet up core inflation. Once that happens on a durable basis, it would be impossible for the MPC to look through inflation pressures and remain supportive of growth, given its primary mandate of ensuring price stability. Therefore, repairing the supply chain remains the top priority on which the RBI has little control – the Government of India needs to step in a big way. If the RBI has to ultimately increase interest rates / change its stance to combat inflation, it may impact any incipient signs of recovery; on the other hand, being a mute spectator can seriously impair RBI's credibility in fighting inflation.

We expect a status-quo in August. We believe RBI would still try to find a marriage of convenience of regulatory and developmental measures and monetary policy in August policy. The die has been cast, but the RBI can still hold out with a firm message of ratcheting up of inflationary pressures in August policy statement. On a separate note, India must meaningfully vaccinate a large segment of the rural population in Q2 so that it can effectively beat the new mutant strain in the town.

### CPI INFLATION

- CPI inflation increased to 6.30% on yearly basis in May'21 as compared to 4.23% in Apr'21 due to increase in almost every category. On monthly basis, the inflation rose to almost one-year high to 1.65% in May as against 0.64% in Apr.
- The increase in inflation in May has been persistence and across the board. Protein items, cereals and even vegetables have all witnessed increase in prices. Localised lockdowns by various states have possibly disrupted supply chains. However, supply side disruptions are not the only factor. The pandemic has resulted in significant increase in health expenses, consumption of household non-durable goods important for domestic hygiene and even intoxicants.
- As expected, the relentless surge in fuel prices has translated into higher prices for transportation (local conveyance) and fuel (electricity and even firewood chips). Global increase in raw material prices of cotton have also pushed up prices for clothing. Labour shortages are also resulting in steep increase in prices of labour for household services. Interestingly, the pandemic and the resultant lockdown and working from home have clearly resulted in rapid price surges in hitherto unknown categories that includes cable television, hobby goods and of course, mobile data, and laptop use.

**Top 20 Items MoM Change during Apr'21 to May'21 (%)**

| Items | Apr-21 | May-21 | Chg (bps) |
|---|---|---|---|
| **Food and Fuel Inflation (10 items)** | **0.7** | **1.8** | **103.9** |
| *of which* ,others: birds, crab, oyster, tortoise, etc. | 0.9 | 14.8 | 1389 |
| small millets & their products | -1.0 | 11.6 | 1264 |
| honey | -8.5 | 2.0 | 1044 |
| garlic (gm) | -4.9 | 3.6 | 843 |
| pickles (gm) | 0.8 | 9.1 | 824 |
| other fuel | -2.2 | 5.4 | 763 |
| grapes | 3.0 | 9.1 | 603 |
| gram products | -0.7 | 5.3 | 600 |
| cabbage | 7.6 | 12.6 | 501 |
| potato | 6.8 | 11.1 | 435 |
| **Core Inflation (10 items)** | **0.5** | **1.5** | **92** |
| *of which* ,goods for recreation and hobbies | 0.4 | 58.6 | 5819 |
| other conveyance expenses | -0.1 | 13.9 | 1394 |
| stove, gas burner | -10.7 | 1.5 | 1215 |
| hotel lodging charges | 1.0 | 12.6 | 1156 |
| sweeper | 0.5 | 9.9 | 938 |
| CD, DVD, audio/video cassette, etc | 1.2 | 8.9 | 768 |
| bedstead | 0.9 | 8.0 | 705 |
| cloth for upholstery, curtains, tablecloth, etc. (metre) | 3.5 | 9.6 | 615 |
| electric batteries | 1.3 | 7.1 | 578 |
| other intoxicants | -4.3 | 1.3 | 564 |
| **Overall CPI** | **0.6** | **1.6** | **101** |

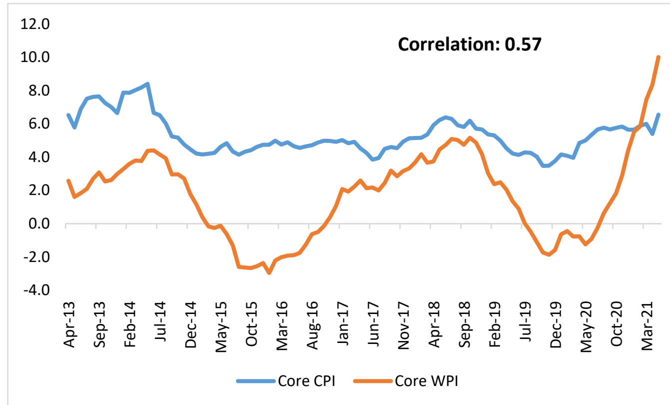
Source: SBI Research

- The core CPI increased to 6.55% and the last time it was seen around this level was in Jun'14. interestingly May's core inflation is outside the mean plus 2*(standard deviation) if construct a bell curve using one year's data. Even when we increase our observations to include data points since the inception of MPC, core inflation is still outside the mean plus 2*(standard deviation) indicating low probability. There is a broad-based increase in all components.
- Both core WPI and core CPI are positive and highly correlated. And the relentless increase in global commodity prices will only imply that core CPI is unlikely to correct anytime soon.

## US INFLATION: RETURN OF VOLCKER ERA OR TRANSIENT?

- US headline CPI inflation rose from 2.6% YoY in Mar'21 to 5.0% YoY in May'21 (May'20: 0.1% YoY), while core CPI inflation rose from 1.6% YoY to 3.8% YoY over the same period. These are the highest figures since Aug'08 and Jun'92. One reason the inflationary pressures are building is because demand is running well ahead of supply coming out of the pandemic. Indeed many economists (the June 4-10 Reuters poll of over 100 economists showing an upgrade to both growth and inflation forecasts) are apprehensive that the latest CPI number has again confirmed that US needs to be prepared for the biggest inflation scare since the early 1980s and the Volcker days of great inflation may come again. During that time CPI inflation rose from 1% in 1965 to 14% in 1980. To arrest that galloping inflation Paul Volcker, in office only two months, took the radical step of switching Fed policy from targeting interest rates to targeting the money supply. The days of "easy credit" turned into the days of "very expensive credit." The prime lending rate exceeded 21%.
- Both economists and Central banks learned crucial lessons during that period. The US Fed learned that to be effective, it must have the confidence of the markets and the public. If markets observed the Fed's lack of fortitude, they had no expectations that the Fed would conquer inflation. It is extremely costly to bring inflation down if inflation expectations don't come down. Not until Volcker showed that the Fed could take the heat did the markets believe that the Fed was serious this time.

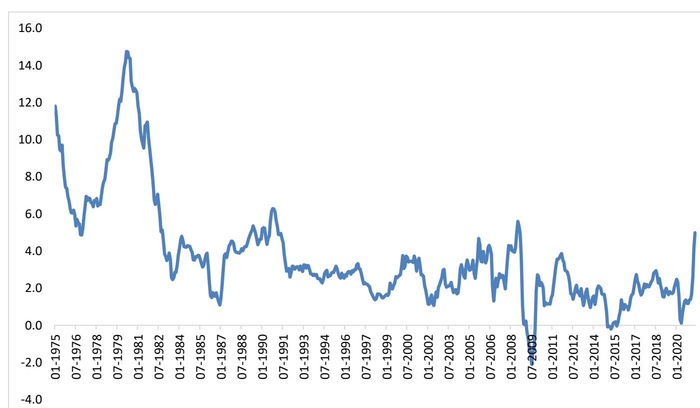
**WPI and CPI Core Inflation (%)**




Source: SBI Research

- Another lesson from the Great Inflation is that the Fed can only achieve its goal of maximum sustainable employment if it is successful in achieving its goal of price stability. The idea that we can let down our guard on inflation to increase employment is unwise in the long term because higher inflation eventually destroys rather than creates jobs.
- Now, the question arises as US is supposed to move towards high inflation what will be the strategy for US Fed. And if so, what will be the consequences for emerging markets including India? The obvious could be a pressure on currency. We keep our fingers crossed as of now.

**US CPI Inflation (% YoY)**



Source: SBI Research

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**Contact Details:**
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in
gcea.erd@sbi.co.in
Phone:022-22742440
:@kantisoumya