

## Inflation Outlook: Time to worry about inflation?

*At its upcoming monetary policy meeting, the RBI is likely to find itself in a tough spot with inflation hovering above 6% and growth only beginning to show signs of recovery. Broadly, we expect the central bank to tilt towards supporting growth and follow in the footsteps of the US Fed and the ECB showing greater tolerance for inflationary spikes and labelling them as transitory.*

*However, whether inflation impulses will in fact be transitory in India is now becoming uncertain. While the inflation rise in India seems similar to the current global inflationary uptrend, there are some differences in India's case. The increase in inflation domestically seems more broad based in nature, has been higher for longer and is beginning to influence inflationary expectations as well.*

*Therefore, while policy action (in terms of interest rate – repo and reverse repo- increases) might be premature, a more cautious approach/narrative for inflation is perhaps prudent at this stage. The inflation view of the central bank, at its upcoming policy meeting, would be critical in this regard. We expect the RBI to revise up its inflation forecasts from the June estimates and we will watch out for its view on how inflationary risks are balanced. We expect inflation to average at 5.8% in FY22, with headline hovering above 5.5% for the next 1-2 months before settling at 5.0% by September-October due to a high base effect. However, once the base effect drops off, we expect inflation to pick-up to 6.45%, on average, by the last quarter of FY22.*

*We will also look out for any commentary around liquidity normalization by the RBI, although we suspect that the central bank is likely to communicate this, if at all, through contingent “if and then” statements. Anything in terms of concrete action is unlikely at this stage.*

*Additionally, the RBI is likely to reiterate its yield management objective. A GSAP 3.0 for Q3 might not yet be announced but the overall communication will continue to be one that is supportive of keeping borrowing costs low both for Centre and the States. Going forward, we expect the 10-year bond yield to trade between 6.15-6.25% in Q2 FY22 and rise to 6.25-6.30% by Q3 FY22.*

% YoY	Q2 FY22	Q3 FY22	Q4 FY22
RBI June's forecast	5.4	4.7	5.3
HDFC Bank estimates	5.5	5.5	6.45

Source: RBI, HDFC Bank

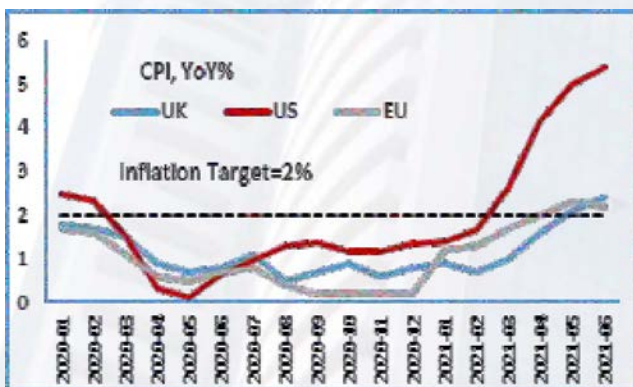
### How is the rise in inflation in India different from the developed world?

- ❑ **Higher for longer:** The inflation pattern in India is in many ways different from what we are seeing globally, especially in the US and the EU. For one, the deviation from the central bank's target has been for much longer in India than in the developed world. The latter started seeing an inflation spike only in 2021 once their economies started re-opening. On the other hand, in India inflation has breached the upper band of the RBI's target for most part of 2020 and more recently since May 21. Moreover, while a base effect plays an important part in the US and the EU inflation print, for India the recent inflation spike has

been despite a high base from last year. To recall, inflation in India averaged at 6.2% in FY21 (RBI target of 4+/-2%), compared to 1.24% in the US (target of 2%) and 0.68% in the EU (target of 2%) in 2020.

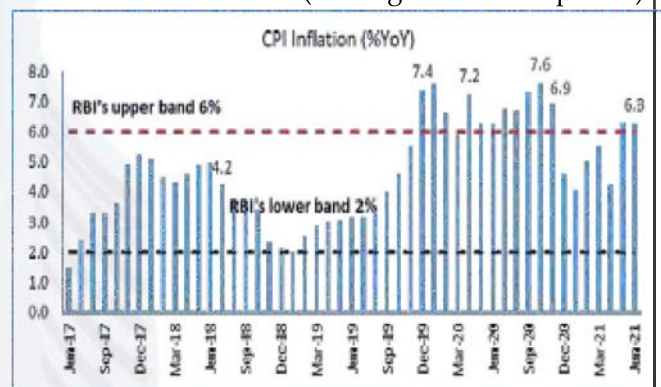
- **US inflation not broad based, transitory in nature?** Secondly, the inflation increase is not broad based in the US and is driven by a few items due to the re-opening effect and supply disruptions. For instance, almost 50% of the increase in US CPI in June 21 was led by the increase in new and used motor vehicle prices (led by the global semi-conductor supply shortage). In addition, while wage growth in the US has risen over the last two months (mostly in low paid services categories) it is led by labour supply shortages and one-time bonuses to attract workers and is expected to ease as workers return to work and the pandemic induced unemployment benefits lapse. As a result, a wage-price spiral – like the one seen in 1970s - is unlikely, reinforcing the transitory view of current inflation increases in the US.

US inflation has been tracking above the 2% target since March 21



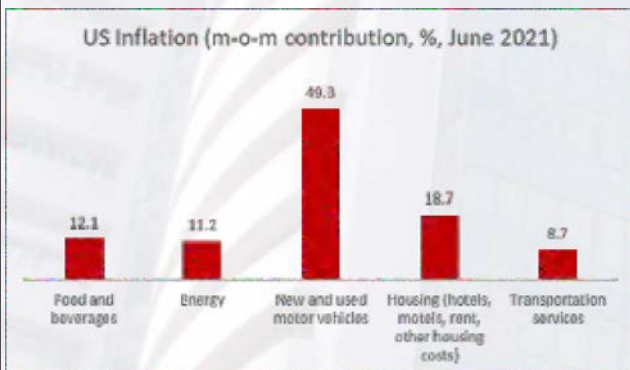
Source: OECD, HDFC Bank

India's inflation has remained above the RBI's upper band of 6% for most part of last year (since Dec-19) and in recent months (barring Dec-20 to April 21)



Source: CEIC, HDFC Bank

Motor vehicles inflation contributed the most to the headline inflation in Jun-21



Source: US Labour Bureau, HDFC Bank

US wage growth picked up in recent months but only led by some service categories (one time bonuses paid to attract workers due to supply shortages)



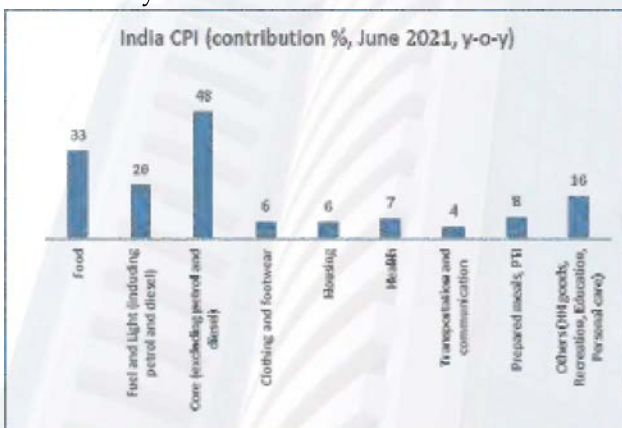
Source: US Labour Bureau, HDFC Bank

- **India's inflation rise is more broad based:** On the other hand, in India, the inflation increase seems much more broad based in nature. For June 2021, food contributed 33% to the inflation rise, fuel drove 20% of the rise and core inflation was responsible for 48% of the rise (evenly distributed within the core sub-categories). Moreover, core inflation increases tend to be more persistent in nature and therefore the recent increase is likely to linger on for longer.

While the increase has been led by supply side disruptions, global commodity prices increase and due to the re-opening effect, there are concerns that these inflation increases might become more entrenched in the system. The latest RBI household inflation expectation survey shows that one year ahead inflation expectations have risen from 10.2% in March 20 to 10.9% in May-21. While for now, wages remain subdued, a consistent rise in inflation (even if supply-led) and in turn in inflation expectations could trigger a more persistent wage – price spiral as the economy begins to recover.

Core (CPI ex food, fuel, petrol and diesel) contributed the most to the headline inflation, followed by food and fuel

1Y ahead inflation expectations increased to 10.9% in May from 10.2% in Mar-21



Source: CEIC, RBI, HDFC Bank



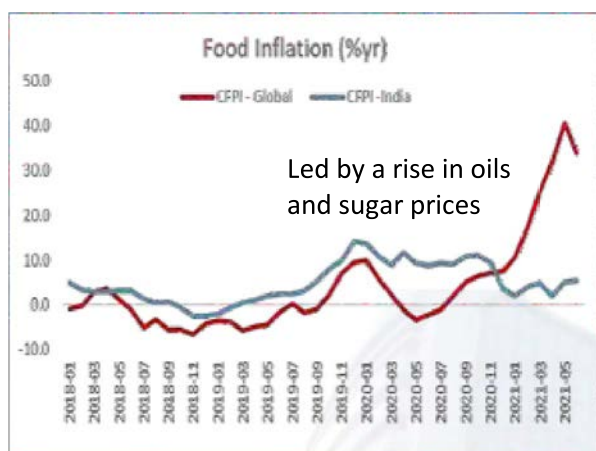
Source: CEIC, RBI, HDFC Bank

### Food inflation: Calm for now, but pressures building up?

Global food inflation has jumped up sharply in recent months led by supply disruptions, weather related disturbances, low production and high transportation costs. The FAO global food inflation index rose to 33.9% in June 21 from 10.6% in January 2021. A major part of this increase has been in oils and sugar prices.

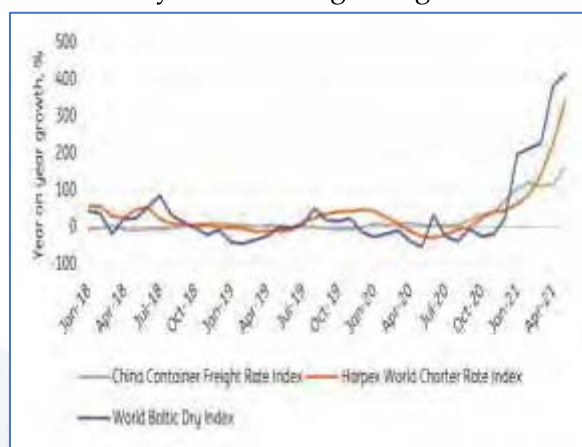
Despite this, the one support for India so far has been contained food inflation (except for some increase in pulses and oilseed inflation which has also moderated in the recent months). Two good years of monsoons and healthy agriculture production have supported food inflation. Moreover, the pass through of global food inflation spikes to domestic inflation is restricted to a few categories like oilseeds that have a relatively smaller weight in the CPI basket (3.6%). To recall, the country imports 13-15 million tonnes (mt) of edible oils every year and produces 7.5-8.5 mt, resulting in significant reliance on imports.

Global food inflation rose by 33.9% in Jun-21



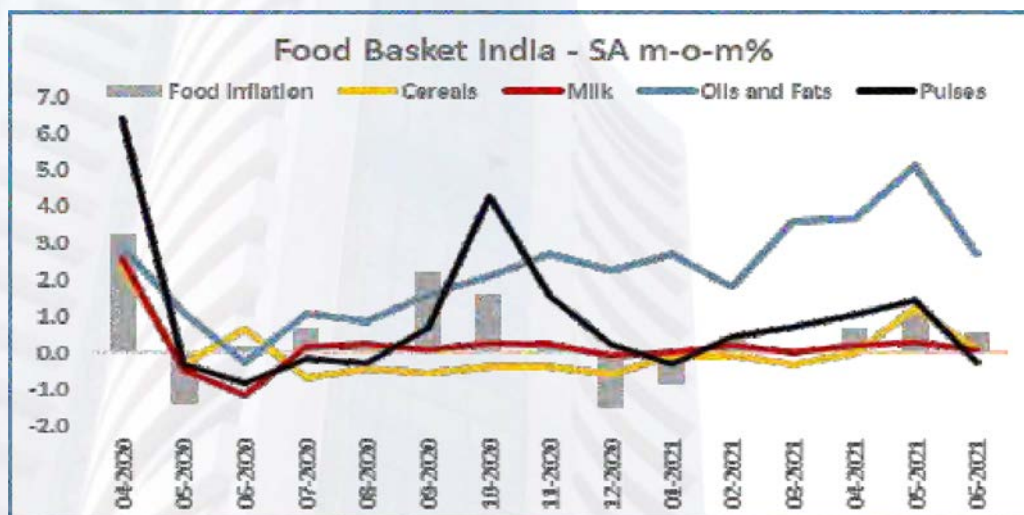
Source: FAO, HDFC Bank

Global transportation costs have increased substantially since the beginning of 2021



Source: China Ministry of Transport, Harper Petersen & Co. and Baltic Exchange via Macrobond, ING

India Food inflation softened in June 21 on a sequential basis



Source: CEIC, HDFC Bank

Moreover, the increase in input/transportation costs have not been passed on to the consumers in India as farmers/businesses have so far absorbed higher costs as pricing power remains weak. For instance, for milk, dairies have not raised prices for consumers significantly but rather paid lower price to farmers due to rising transportation costs.

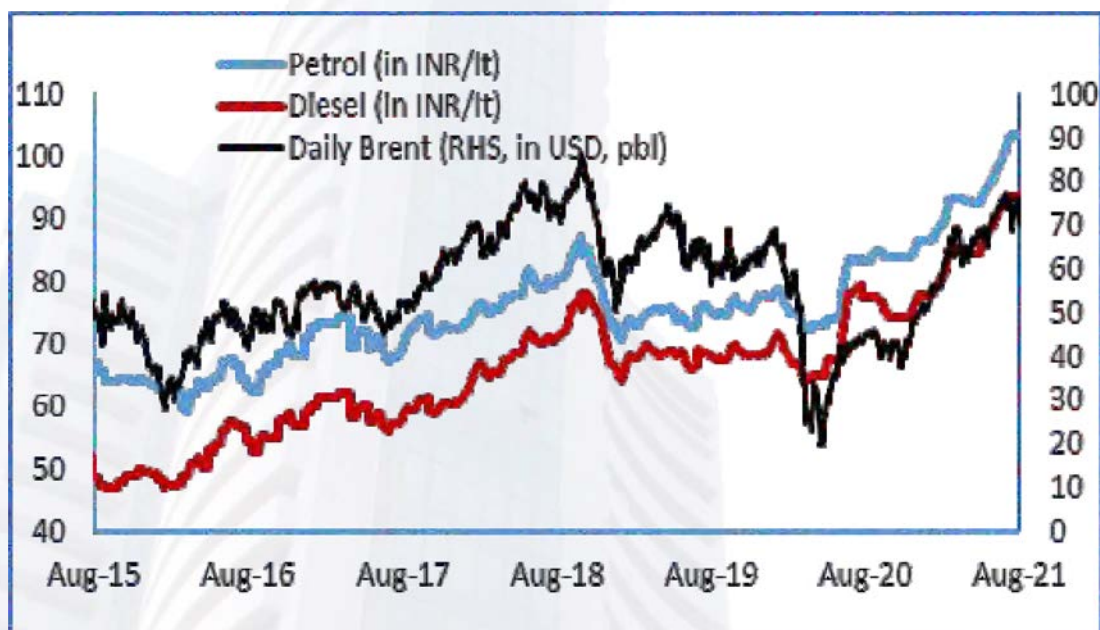
That said, as the economy begins to recover and if fuel costs continue to remain high, eventually this increase in input and transportation costs could be passed on at the retail level. The reduction in farm profitability (due to higher diesel prices – required for tractors, combine harvesters, irrigation pumps etc.) and profit margins for businesses with rising input costs is a risk for retail inflation even with a more fragile recovery in demand.

Therefore, for how long the comfort from relatively lower food inflation will last remains uncertain.

### Fuel inflation is the big worry!

The rise in transportation costs has been led by a sharp rise in petrol and diesel prices. Petrol prices have gone up by 19.8% and diesel by 20.4% since Dec-20. This has come on the back of higher global oil prices (rose by 35.9% since Dec-20) and high excise duties on petrol and diesel in India. Excise duties on petrol and diesel stand at INR 32.90/lt. and INR 31.80/lt., respectively.

Domestic fuel prices have increased on the back of higher global fuel prices and high excise duties

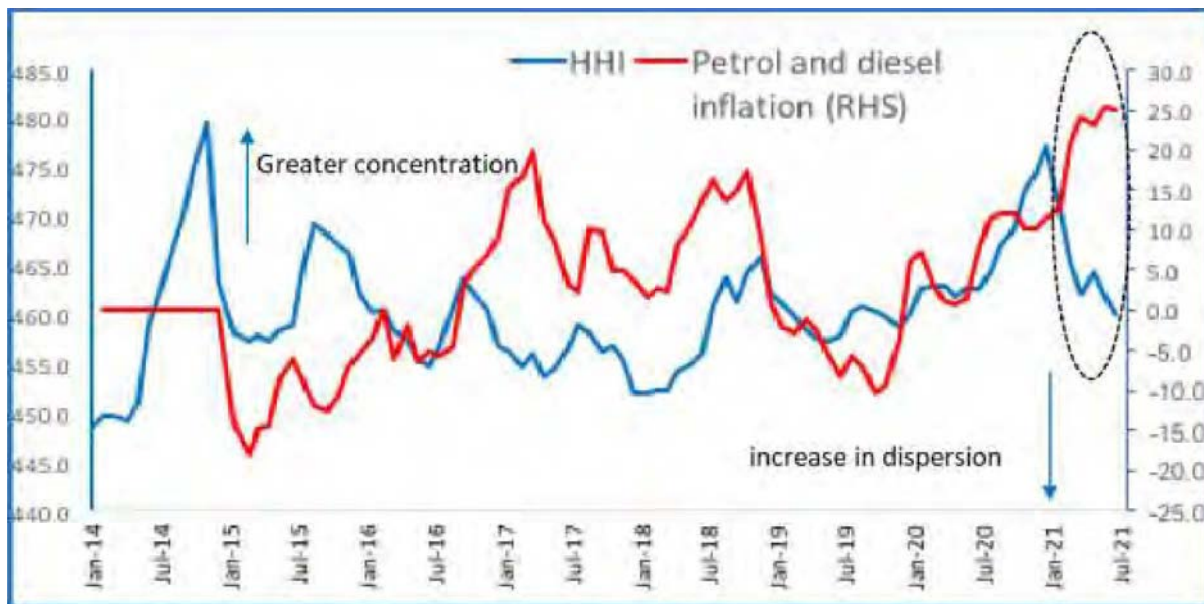


Source: CEIC, Reuters, HDFC Bank. Note: Daily petrol and diesel prices is the average price of four cities (Delhi, Mumbai, Chennai & Kolkata).

While higher fuel inflation impacts headline CPI through a direct channel (weight of 2.34% in CPI basket of petrol and diesel), it also has an indirect impact on the price of other items as well. We find that an oil shock to the system, like in the present situation, leads to a broad-based increase in retail inflation. To measure this, we create the Herfindahl index that captures how concentrated or dispersed the rise in CPI's sub-categories has been since 2014. A higher value of the index show greater concentration (inflation spikes are seen only in a few categories) and a lower value indicates a more broad-based/dispersed increase in the CPI basket. Our index shows greater dispersion within the inflation basket since the beginning of January 21, coinciding with the sharp increase in petrol and diesel inflation.

The significance and magnitude of the direct and indirect impact of higher fuel costs on the CPI trajectory builds a case for reducing excise duties on fuel items to prevent a wider increase in the inflation basket.

Relationship between Petrol and diesel inflation and the broader CPI basket: Herfindahl index for the CPI basket showing greater dispersion (more broad based) of inflation increases across categories in recent months.



Source: CEIC, HDFC Bank calculations

Notes: Herfindahl index is created as a sum of square of contribution share of different categories (such as cereals, vegetables, protein items, clothing and footwear, Household goods and services, personal care and effects, recreation and amusement, etc.) in CPI. A higher value indicates increase in concentration whereas a lower value indicates an increase in dispersion

### Case for an Excise duty reduction

Excise duties form a significant part of the price of fuels.

- Structure: Central Govt.: Presently the Central Govt. charges INR 32.90/lit. as excise duty on petrol and INR 31.80/lit. on diesel. Total tax levied by the Central Govt. is a mix of basic excise duty, special additional excise duty, agriculture development and infrastructure cess and road and infrastructure cess.

Source: Petroleum Planning & Analysis Cell

As per the CGA accounts, the Government has already collected ~28% of its receipts collections in Q1FY22. Beside excise duty collection, trend in GST collections and direct tax collections have also been encouraging. Moreover, robust market conditions are likely to support Government's divestment plan of INR 1.75 lakh crores in FY22. Therefore, the need for fiscal comfort from high excise duties might not be as pressing.

- **If excise duty on petrol and diesel remain the same in FY22 (at INR 32.9 and INR 31.8/ltr, respectively):** Assuming a moderate pickup in petrol and diesel consumption post a dip in Q1, total excise collection is estimated at ~ INR 4.4 lakh crore vs. BE of INR 3.35 lakh crore. **Additional revenue of ~ INR 1.1 lakh crore is expected if the government does not cut excise duty on petrol and diesel in FY22.**
- **This gives the government headroom to cut excise duty on petrol and diesel ~ INR 8/litre in FY22 while achieving its budget targets.**

### **Inflation Outlook**

Going forward, we expect inflation to remain above 5.5% for the next 1-2 months before moderating closer to 5.0% by September-October supported by a favorable base and easing of supply bottlenecks. However, as the base effect drops off and pricing up power improved in the system along with elevated input costs, we expect CPI Inflation to climb back above 6% from Dec-21 onwards. Upside risks to our forecast emanate from higher than expected crude oil prices (currently we have assumed crude oil prices to average in the range of USD-75-80 pb. in H2 2021) and an uneven distribution of monsoons.

## Treasury Economics Research Team

**Abheek Barua,**

Chief Economist

Phone number: +91 (0) 124-4664305

Email ID: abheek.barua@hdfcbank.com

**Sakshi Gupta,**

Senior Economist

Phone number: +91 (0) 124-4664338

Email ID: sakshi.gupta3@hdfcbank.com

**Swati Arora,**

Economist

Phone number: +91 (0) 124-4664354

Email ID: swati.arora1@hdfcbank.com

**Avni Jain,**

Economist

Phone Number: +91 (0) 124-4664354

Email ID: avni.jain@hdfcbank.com

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