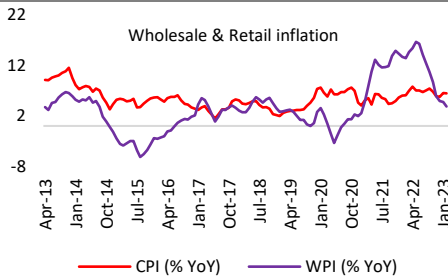


India Economy & Strategy

15 March 2023

INDIA ECONOMY



Source: CMIE

Structural persistence in inflation while growth spectrum narrows

Multiple elements ranging from changes in consumption pattern, gaining share of services and market power concentration among Indian firms point towards structural persistence of inflation. India's industrial production data is characterized by coexistence of limited growth sectors and contraction at the broader level. What makes RBI's role even more challenging is the continued rise in global interest rates and currency volatility.

Structural factors behind high food inflation: Food and beverages inflation continues to rise on a seasonally adjusted basis by 0.8% in Feb'23 MoM (6.3% YoY in Feb'23 vs 6.2% YoY in Jan'23). Moderation in headline inflation is capped by the rise in food inflation which is majorly driven by the sharp rise in cereal inflation to 16.7% in Feb'23 from 16.2% in Jan'23 and 4% in Feb'22.

There is a prominent reversal in vegetable prices which bottomed out a month early this season; with a decline in the pace of contraction from -11.8% in Jan'23 to 11.6% in Feb'23.

With the growing concerns regarding extreme weather conditions, there are increased chances of vegetable and cereal prices to exhibit higher than usual prices. Along with this, the increased demand for cereals in general coupled with its higher demand as a part of the PDS will continue to exert upward pressure on the cereal prices as the El Nino would impact the yield quantum.

Wholesale cereal prices moderated for the first time after consistently rising since Jul'21. It grew by 13.9% after rising to 15.5% in Jan'23 (highest since Aug'13). Upside was mainly due to higher paddy prices which grew by 8.6% in Feb'23, highest since Apr'17.

The increased consumption demand for cereals is creating demand pull pressure on the cereal prices whereas on the supply side impacted by the threat of extreme weather conditions are also creating cost push pressures on the cereal prices. With the wheat prices trending above the MSP, government has been forced to intervene by offloading wheat under OMSS via an e-auction. Though it has helped control prices, there are substantial upside risks of a rebound in prices – a) falling levels of wheat reserve, b) consistently rising consumption demand for cereals, and c) threat of extreme weather conditions.

Sticky core inflation driven by urban services and concentrating market power: Core inflation remains sticky at 6.2% in Feb'23 and remains at around 6.15% on average since Feb'21. Household goods & services (7.4%), and healthcare services (6.5%) created upside pressures on the core services.

The sticky and elevated core food inflation (ex-vegetables) at over 9%, reflects the severity of high cereal inflation. Despite the fall in core WPI inflation, we are unlikely to see a fall in core CPI inflation.

Also, with a structural shift in the consumption pattern, with a rising proportion of services consumption, particularly in urban areas, we might see the core inflation to remain elevated for an extended period. And given the persistent margin pressure experienced by Indian firms who have gained market power after the pandemic shock, the backdrop of incomplete passthrough of past elevated cost inflation will likely create upside bias for product price.

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Despite a fall in the headline rural inflation, there is a consistent upside pressure from rising cereal prices in the rural areas.

Idiosyncratic divergence between growth in limited discretionary items and contracting basic items reflective of an indented K-shaped income situation

High food inflation dominating rural inflation: Rural inflation moderated to 6.7% in Feb'23 after growing by 6.8% in Jan'23. Despite a fall in the headline rural inflation, there is a consistent upside pressure from rising cereal prices in the rural areas. Cereal prices grew by 17.8% YoY in Feb'23, highest in the new series 2011-12.

Core inflation in the rural areas inched upwards to 6.6% in Feb'23 after remaining sticky at 6.2% for the last 5 months. The broad-based price increase was seen in the components of services in rural areas.

We believe this traction in headline and core inflation in the rural areas to severely dent at the broader level. Moreover, with the increasing demand for cereals in rural areas, prices of the cereals would continue to see an upside trend.

Growth pivoted on narrow segments, broader universe remains fragile: Growth in industrial production increased from 4.7% YoY in Dec'22 to 5.2% in Jan'23, driven by the electricity (12.7%) activities; manufacturing sectors growth was lower at 3.7%.

a) **Urban revival behind discretionary items:** Rise in the manufacturing industry (2.6% MoM seasonally adjusted, SA) is majorly coming from an increase in production of food products & beverages, auto & auto parts, basic metals, and coke & refined petroleum products. All these contribute 12.8% in total manufacturing.

Interestingly, food components like ice cream (48.5% MoM) and fruit juices (201% MoM) have witnessed increase in production ahead of the expectations of an early onset of summer.

Under the consumer durables sector which contracted 7.5% YoY, motor vehicle (12.9%, YoY, 10% MoM) saw a substantial increase in production. Improved production in motor vehicles and infra (8.1% YoY) are driving the production of basic metals (6% YoY).

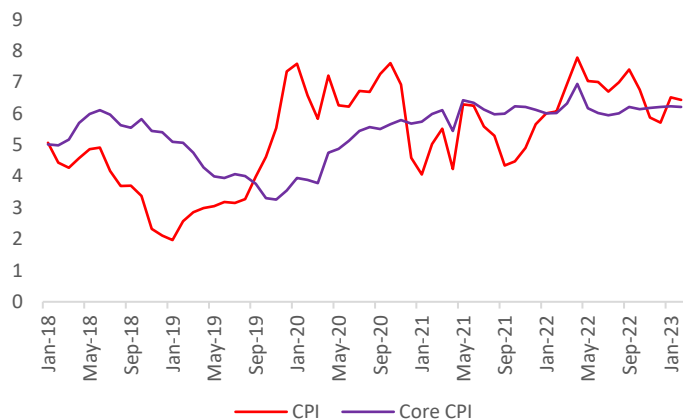
Consumer electricals such as TV set (11% YoY), air conditioner (14% YoY) have seen a significant rise in production.

b) **But most basic consumption items have contracted:** There has been a major contraction in the production of textile, upholstery, and ready-made garments segment: Bedlinen (-61.5% YoY), Quilts (-20% YoY), hosiery (-30% YoY), footwear (-2.6% YoY). Production of building material items have flattened as pent-up demand fizzles out. This segment is majorly driven by the demand in the urban areas. So as the demand stagnates, we expect the production in this segment to slow as well.

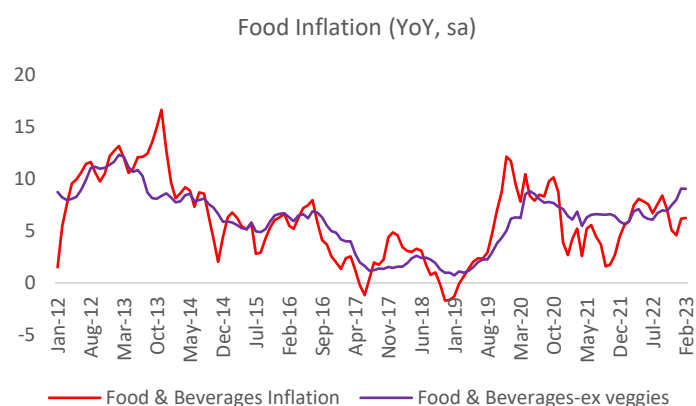
Economy preparing for surge in summer-time power demand: Coal production increased by 13.4% YoY and 8.3% MoM and consequently the electricity production also increased by 12.7% YoY and 4% MoM.

There is a higher risk for summertime power-cuts as there are delays in adding new coal fired and hydropower capacity which could limit the ability to address the seasonal and surging electricity demand.

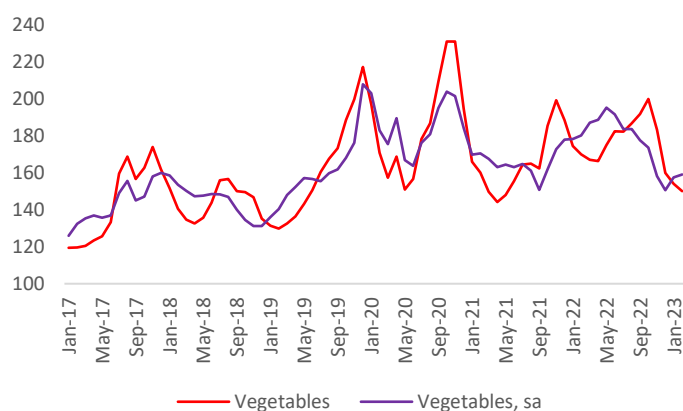
Inflationary concerns to still drive the monetary policy tightening: The evolving dichotomy of moderating WPI inflation and elevated retail inflation is in line with our earlier analysis and our consistent stance that as the RBI moves from the current stance of "removal of accommodation" to "neutral" and eventually towards "tightening" the terminal rate will scale over 7%. With the elevated print for Feb'23 the average inflation for FY23 will likely exceed the RBI's projection of 6.5%. In addition, the narrowing interest rate differential between the US and India bodes a weakening bias for INR/USD (our near-term projection stands at 85-86) and further rate hikes by the US Fed above 5% will also be a reason for RBI to run a full course of policy normalization.

Exhibit 1: Headline inflation treading above core inflation

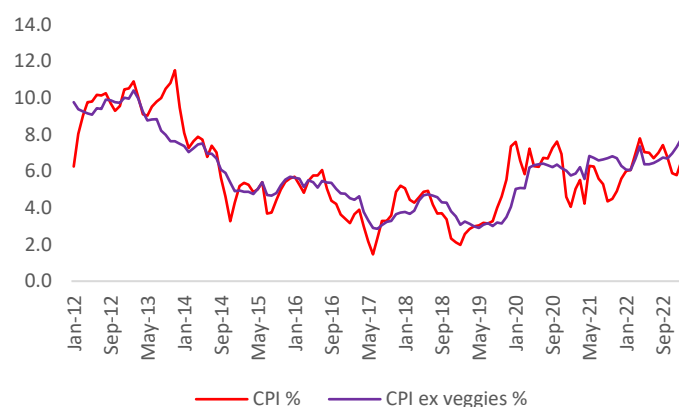
Source: CMIE, Systematix Research

Exhibit 2: Core food inflation continues to rise

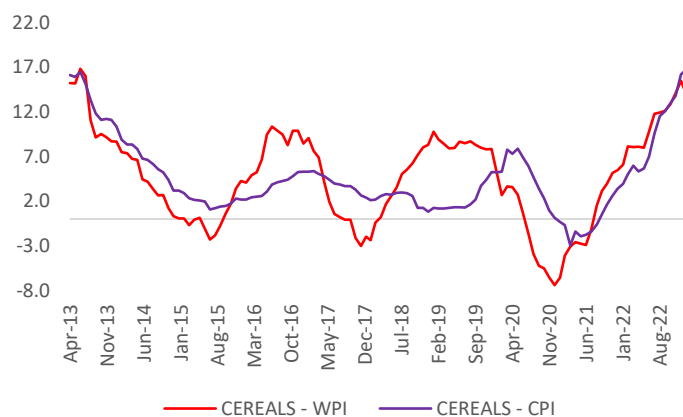
Source: CMIE, Systematix Research

Exhibit 3: Seasonally adjusted vegetable prices rebound

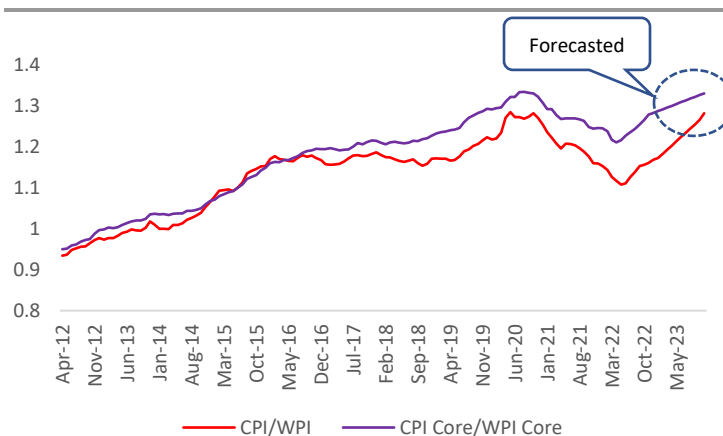
Source: CMIE, Systematix Research

Exhibit 4: Moderate decline in vegetable prices adjusted CPI

Source: CMIE, Systematix Research

Exhibit 5: Consumer cereal prices higher than the wholesale cereal prices

Source: CMIE, Systematix Research

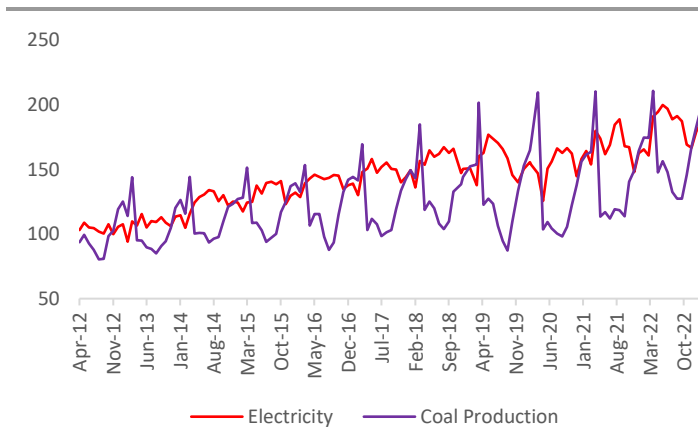
Exhibit 6: Pass-through of prices from WPI to CPI incomplete

Source: CMIE, Systematix Research

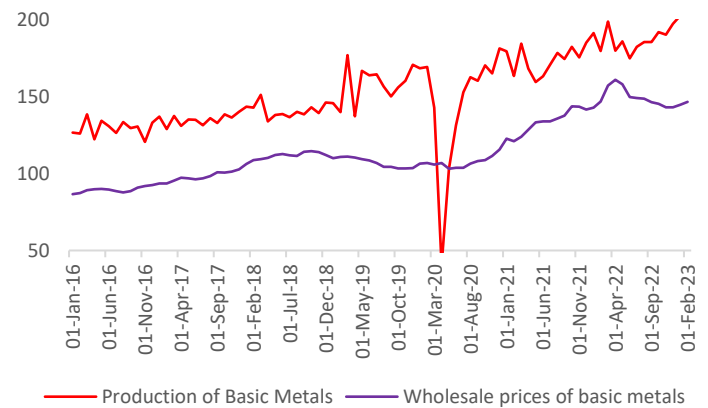
Exhibit 7: Concentrated growth in industrial production

YoY (%)	Mining	Manufacturing	Electricity	IIP	Primary goods	Capital goods	Intermediate goods	Infra goods	Consumer durables	Consumer non-durables
Apr-22	8.4	5.6	11.8	6.7	10.3	12.0	7.1	4.0	7.2	-0.8
May-22	11.2	20.7	23.5	19.7	17.8	53.3	17.5	18.4	59.1	1.4
Jun-22	7.8	12.9	16.4	12.6	13.8	28.6	10.5	9.4	25.2	2.9
Jul-22	-3.3	3.1	2.3	2.2	2.5	5.1	3.7	4.8	2.3	-2.9
Aug-22	-3.9	-0.5	1.4	-0.7	1.7	4.3	1.3	3.0	-4.4	-9.0
Sep-22	5.2	2.0	11.6	3.3	9.5	11.4	1.7	8.2	-5.5	-5.7
Oct-22	2.6	-5.8	1.2	-4.1	2.1	-2.9	-2.3	1.7	-18.1	-13.0
Nov-22	9.7	5.9	12.7	7.3	4.8	21.6	3.3	13.2	5.3	9.1
Dec-22	10.0	3.1	10.4	4.7	8.4	7.8	0.6	9.1	-11.0	7.6
Jan-23	8.8	3.7	12.7	5.2	9.6	11.0	0.1	8.1	-7.5	6.2

Source: CMIE, Systematix Research

Exhibit 8: Electricity production would remain pressure

Source: CMIE, Systematix Research

Exhibit 9: Rise in production of basic metals and declining prices indicative of inventory built up, not sustainable

Source: CMIE, Systematix Research

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