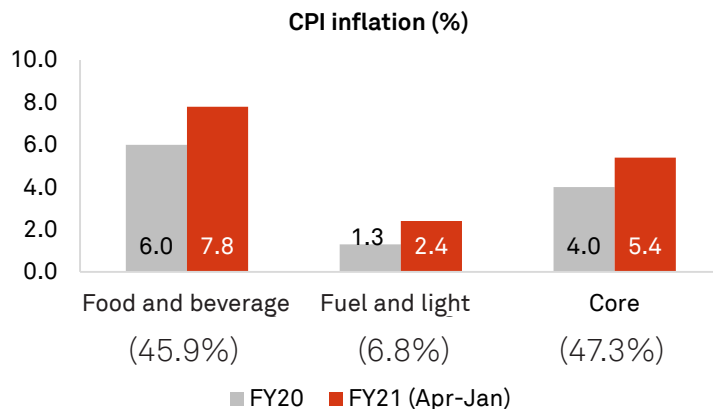


And then the price-rise heat



PS: Figures in parentheses are weights of respective categories in Consumer Price Index (CPI)
Source: National Statistical Office (NSO), CRISIL

Inflation spurts across the board

- Inflation has risen across all three categories – food, fuel, and core – in the pandemic year
- Rise in food inflation is understandably linked to supply-side disruptions (both domestic and international) and unseasonal rains towards end of monsoon
- Uptick in core inflation (an indicator of underlying demand conditions) during an economic slump is, however, surprising

Core inflation

not demand-driven

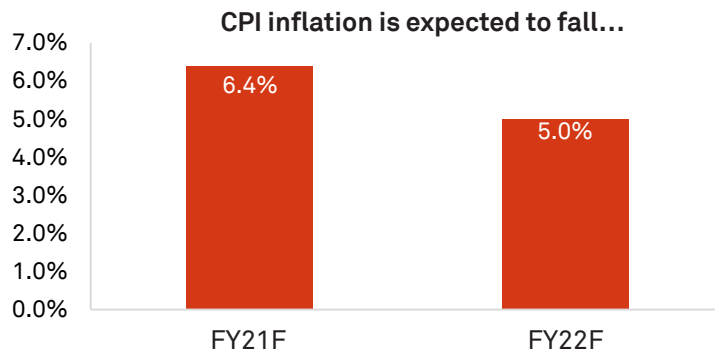
Inflation	Weights (%)	Categories	FY13-FY20 (average) %	FY20 %	FY21 (Apr-Jan) %
↑	3.89	Personal care and effects	5.3	5.6	12.1
	2.38	Pan, tobacco and intoxicants	7.7	4.2	9.9
	8.59	Transport and communication	3.6	2.4	9.4
	5.58	Clothing	6.4	1.6	3.2
	0.95	Footwear	5.5	1.6	2.9
↔	1.68	Recreation and amusement	4.9	4.9	4.9
↓	5.89	Health	5.9	6.2	4.9
	10.07	Housing	6.3	4.5	3.3
	3.8	Household goods and services	5.7	3.1	3
	4.46	Education	6.5	5.5	2.9

The categories on fire

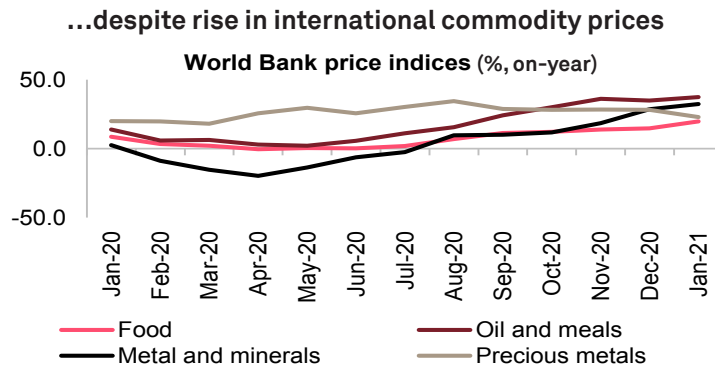
- Core categories that saw highest inflation in fiscal 2021 so far (and also much above their previous eight-year averages) are:
 - Personal care and effects, largely reflecting a sharp rise in gold and silver prices
 - Pan, tobacco and intoxicants, likely on account of higher taxation; and
 - Transportation and communication, on account of fuel excise tax hikes and increased telecom tariffs, respectively

Source: MoSPI, CRISIL

CPI inflation to moderate next fiscal



Source: MoSPI, CRISIL

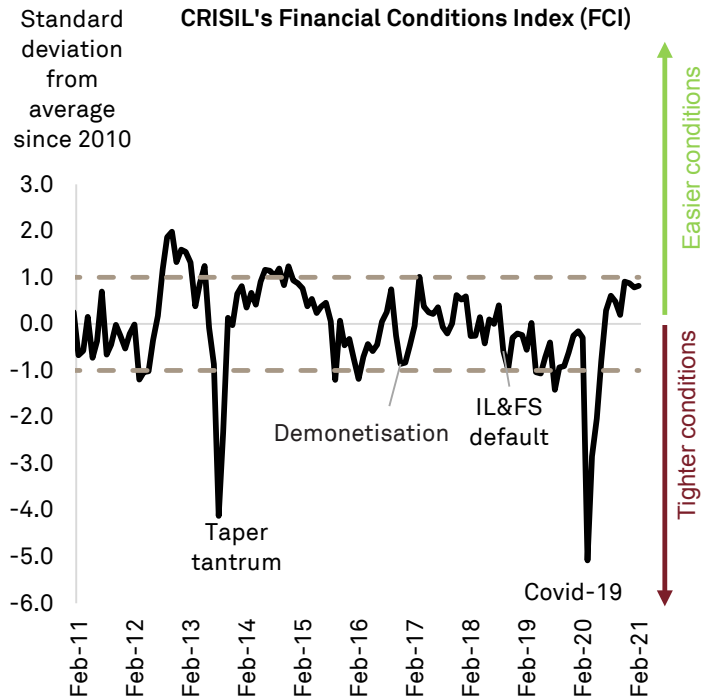


Source: World Bank

- **Food and beverage:** Helped by a steep fall in vegetable inflation and a broad-based softening in other categories, food inflation has subsided substantially in recent months. Going ahead, prospects of a bumper rabi harvest, expectation of a normal monsoon and fully functional supply chains suggest food inflation should remain in check
- **Core:** It remains stubborn around 5.5% and the ongoing economic recovery/improvement in demand is expected to keep it sticky. Rising commodity prices, especially that of crude oil, would add to price pressures. On balance, a decline in gold prices (one of the key idiosyncratic factors that pushed up core this fiscal) should tame the upside to core
- **Fuel and light:** Inflation in this category, which includes coal, electricity and other petroleum products like LPG, kerosene, etc., is also expected to gather pace. However, its contribution to overall inflation will remain low, given its low weight

Upshot: Softer food inflation is set to offset price pressures in other categories and lower headline inflation next fiscal

Will financial conditions challenge monetary policy?



Note: CRISIL's FCI is a monthly tracker that combines 15 key parameters across equity, debt, money and forex markets along with policy and lending conditions. A positive index value implies easier conditions and a negative index, tighter conditions relative to long term average since 2010

Source: CRISIL

Despite easy monetary policies from the Reserve Bank of India (RBI) and other central banks, financial conditions have started tightening in 2021.

Stress persists because of

- Weak bank credit growth
- High term premium
- Wider spreads on lower-rated corporate bonds

Fiscal 2022 could see tighter conditions

- High government borrowing leading to firmer government bond yields
- Moderation of excess liquidity by the RBI
- Adverse global factors (rising commodity prices, US Treasury yields)
- Inflation, a key monitorable

Fiscal-monetary coordination becoming tough...

- Both fiscal and monetary policies have been expansionary and well-coordinated this fiscal
- Fiscal policy stance will remain expansionary into the next fiscal, as the government has announced a significant relaxation in the fiscal consolidation path
- But monetary policy, which did the heavy lifting so far, needs to start moving towards normalisation, as the economy recovers (introduction of variable reverse repo auction and restoration of cash reserve ratio, or CRR, to pre-pandemic level of 4.0% of NDTL*, can be considered as initial steps in that direction)

*NDTL = net demand and time liabilities

Where is the conflict?

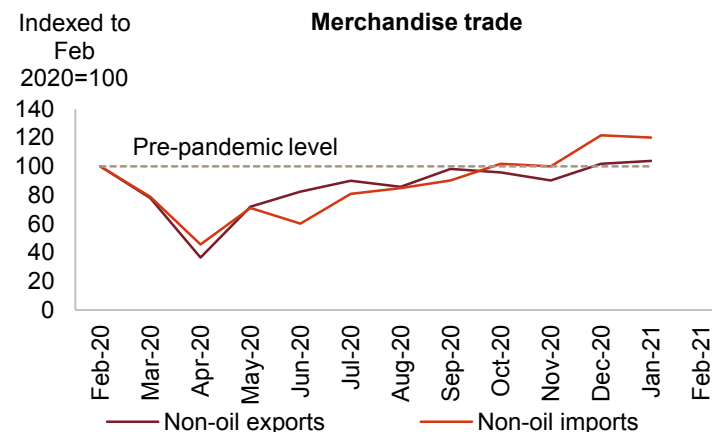
- Given the need to support the nascent recovery and the government's large borrowing plan, the RBI has assured continuation of accommodative monetary policy
- But excess liquidity in the system could add to the inflation risk, currently being looked through by the RBI and most other central banks which have communicated higher tolerance to inflation in the near term
- The rise in yields in most major economies also poses a challenge in keeping domestic 10-year G-sec yields low – they have already risen 20 bps in the last one month

...reflecting the new challenge of reining in yields

- **Supply of G-secs will not pull back to pre-pandemic levels next fiscal**
 - That's because the Centre's gross market borrowing is budgeted at Rs 12.1 lakh crore in fiscal 2022, only marginally lower than Rs 12.8 lakh crore in fiscal 2021, and sharply up from Rs 7.1 lakh crore in fiscal 2020
- **Excess liquidity needs to be reduced**
 - Else, a rapid surge in asset prices could lead to financial instability. And elevated CPI inflation could play spoilsport
- **Credit will find other takers**
 - Improving growth prospects could spur credit growth by banks and reduce attractiveness of safe-haven G-secs
- **Adverse global developments could weaken foreign investor appetite**
 - Surging crude oil prices, a rise in US Treasury yields could affect capital flows to emerging markets like India



Current account
will return to
deficit as
imports rise



Note: Export and import values are indexed relative to their values in February 2020
Source: Ministry of Commerce, CEIC, CRISIL

- Non-oil exports and imports turned higher in January 2021 than in February 2020
- Imports have seen a stronger recovery, indicating a consistent improvement in demand
- Current account is set to return to deficit with rising imports. Rising crude oil prices will further crank up import growth in fiscal 2022

Exports to major destinations have taken off

Top 10 export destinations	Share in India's exports (%)	India exports (y-o-y growth, %)			
		FY20	Q1 FY21	Q2 FY21	Q3 FY21
US	17	-38.9	3	5.5	
UAE	9.2	-64.5	-44.2	-35.5	
China	5.3	32.9	20.4	2.3	
Hong Kong	3.5	-35.7	-22.3	14.4	
Singapore	2.9	-23	-18.1	30.4	
UK	2.8	-54.5	-0.3	14.3	
Netherlands	2.7	-58.4	-14.9	-19.7	
Germany	2.7	-37.8	3	5.3	
Bangladesh	2.6	-46.7	27.5	9.9	
Nepal	2.3	-60.7	-19.1	16.5	

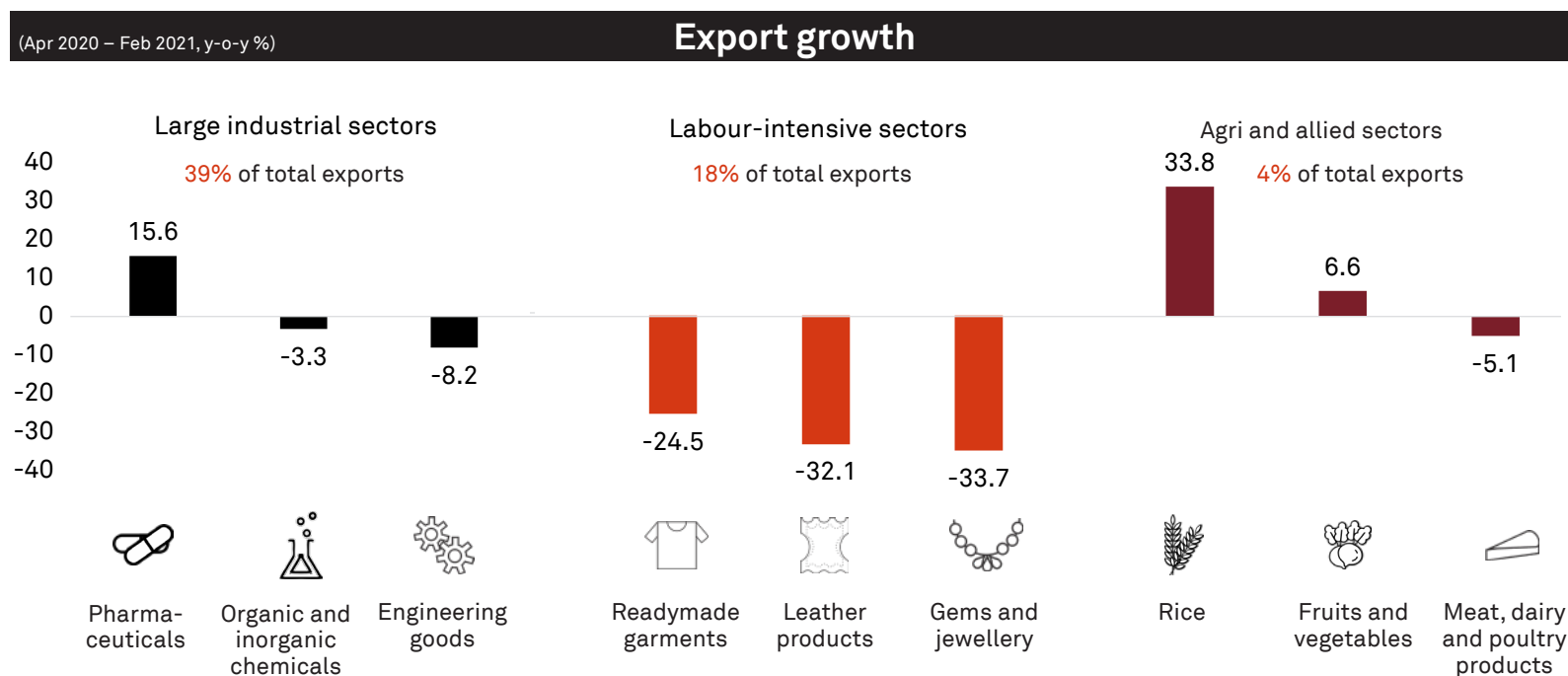
Note: Q1, Q2, Q3 – first, second and third quarter, respectively
Source: Ministry of Commerce, CRISIL

- Exports to China and Asian economies have been the strongest
- Rising global growth this calendar year should further strengthen export growth



But recovery has a 'missing middle'

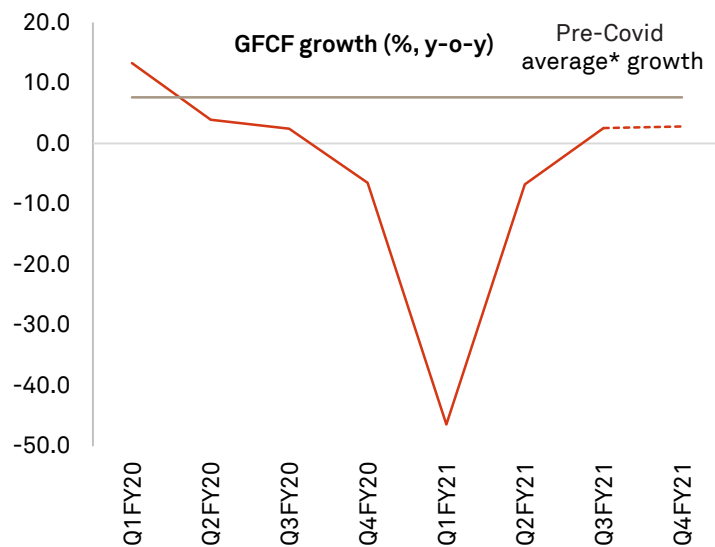
Exports are recovering well for large industries and the agri and allied sectors, but remain weak in low-end manufacturing – a segment that creates significant employment for the low and semi-skilled workforce.



Source: Ministry of Commerce, CRISIL

Investments

climb out of trench, but remain sub-par



Note: *FY15-FY20, Q4 growth is estimated; GFCF – gross fixed capital formation
Source: MoSPI, CEIC, CRISIL

