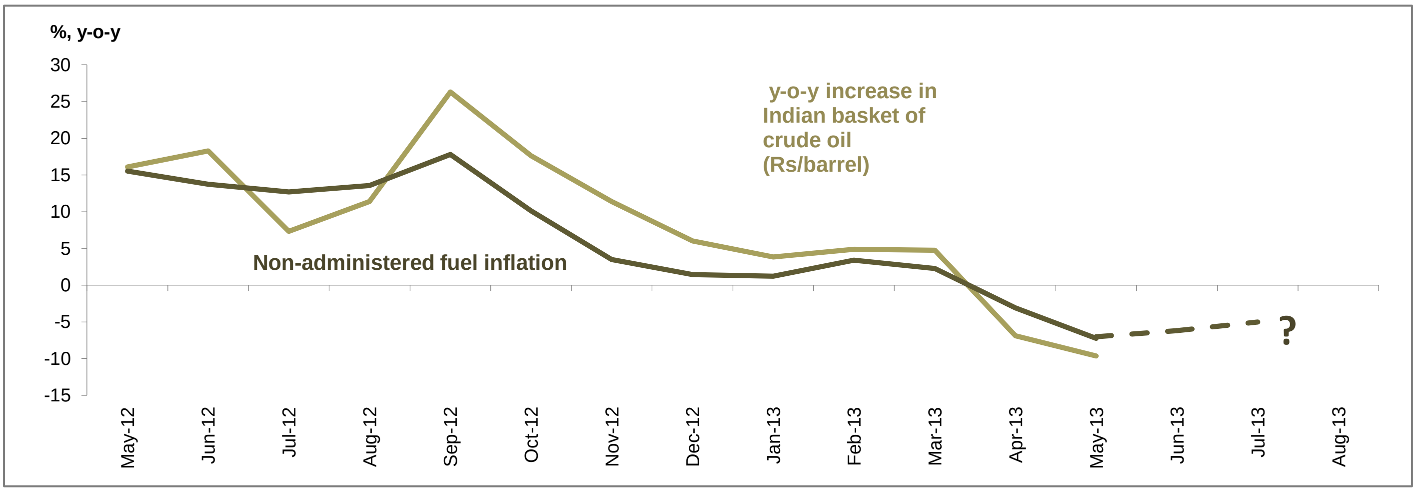
June 2013

CRISIL EconomyFirstCut

Inflation: Rupee emerges as upside risk to inflation

Figure: Depreciating rupee creates upside risks to inflation



Note: The price of Indian basket of crude oil is plotted with one month lag.

Source: RBI, CRISIL Research

The recent slide in the rupee to near 60 per dollar mark has raised eyebrows on all fronts. A sharp depreciation can adversely impact inflation. We believe that the current slide will be temporary and that the rupee will strengthen from current lows. However, it will be interesting to see how inflation will behave if the rupee ends 2013-14 at 57 to a dollar, against our current expectations of 54 to a dollar. In this scenario WPI inflation could move up close to 6 per cent, from our current forecast of 5.3 per cent.

A weak rupee will impact the imported component of inflation, of which crude oil is a major component. CRISIL Research expects crude oil prices (Indian basket) to average around $103 per barrel in 2013-14, down from last year's average of $108 per barrel. Had the currency not depreciated sharply, rupee price of imported crude oil would now be falling compared to the same time last year. Rupee depreciation however, would wipe away the gains emerging from lower crude oil prices.

Sustained rupee depreciation will also increase under-recoveries on administrative fuels such as diesel, kerosene and LPG. Rupee depreciation will put further pressure on hiking fuel prices (especially those of diesel) to contain subsidies within budgeted estimates. Overall, if the rupee continues to stay at current lows, fuel inflation rather than falling, will edge up closer to 9 per cent same as last year.

India imports many other intermediate goods. As the rupee weakens, the imported cost of manufacturing will go up. With margins shrinking, companies will need to pass on some of the burden to consumers, if demand begins to recover. If rupee continues to remain at current levels, we expect CRISIL Core Inflation Indicator (CCII) to breach 4.5 per cent from current estimate of around 4.0 per cent.

With the RBI intending to sustain WPI inflation to 5.0 per cent by end of this fiscal even as the rupee slides, the central bank may have to pause further cuts in the repo rate.

Inflation in major inflation groups (2004-05 base)	Weight	May-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	April-May FY13	April-May FY14
General	100.0	7.5	7.3	7.3	5.7	4.9	4.7	8.6	4.8
Primary	20.1	10.3	11.4	10.5	7.4	5.8	6.7	11.8	6.2
- Food articles	14.3	10.6	12.3	12.0	8.6	6.1	8.2	13.0	7.2
- Non-Food articles	4.3	8.6	13.0	10.7	9.3	7.6	4.9	2.6	6.2
- Minerals	1.5	11.5	4.0	2.8	-2.0	0.9	0.6	22.1	0.7
Fuel	14.9	11.5	9.3	10.6	7.8	8.8	7.3	12.8	8.1
of which									
- Petrol	1.1	10.5	3.4	4.8	6.6	3.0	-4.4	13.7	-0.7
- Diesel	4.7	9.2	18.5	20.8	20.2	21.4	21.2	9.2	21.3
Manufacturing	64.9	5.2	4.9	4.8	4.3	3.4	3.1	6.0	3.3
- Food	9.9	5.8	8.7	8.8	7.5	6.6	6.5	7.2	6.6
- Non Food	55.0	4.5	4.2	4.0	3.6	2.8	2.4	5.1	2.6
- CCII	55.9	5.1	5.5	5.4	5.0	4.3	4.0	4.5	4.1

Source: Ministry of Commerce and Industry, CRISIL Research

- Headline WPI inflation remained below the RBI's threshold of 5 per cent for the second consecutive month in May. Manufactured inflation fell, driven by deflation in ferrous metals and very low levels of inflation in non-ferrous metals. This is also reflected in CRISIL core inflation indicator (CCII) (which excluding prices of ferrous and non-ferrous metals) remaining higher than non-food manufacturing inflation.
- Fuel inflation eased to 7.3 per cent from 8.8 per cent in the previous month, driven by a fall in prices of coal and petrol in May 2013, relative to May 2012.

CRISIL Research has revised its average WPI inflation forecast downwards to 5.3 per cent, from 6.3 per cent as estimated earlier. The downward revision is guided by steady and sharp decline in metal prices and weaker demand momentum than anticipated earlier. A sharp and fast-paced decline in demand has severely impaired the pricing power of corporate. Moreover, growth in rural wages - a significant driver of demand in recent years- has also begun to decelerate. The current slide in rupee however, has created upside risks to inflation.

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