

June inflation rises to 5.77%, May IIP increases by 1.2%

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India's factory output rose unexpectedly in May and retail inflation quickened for the fourth straight month in June, reducing the chances of a rate cut by the Reserve Bank of India in its monetary policy review in August, the last under governor Raghuram Rajan.

Consumer price index-based (CPI-based) inflation accelerated marginally to 5.77% in June from 5.76% a month ago on higher food prices while the Index of Industrial Production (IIP) rose 1.2% in May, against Bloomberg's estimate of a 0.3% contraction, on the back of a pick-up in manufacturing activity. It shrank by 1.3% (revised) in the previous month.

A Reuters survey of economists had estimated retail inflation at 5.73% in June. The central bank and the government have set a target of 5% retail inflation by March 2017.

There is limited room for a rate cut in the August policy as RBI would be closely monitoring the surge in vegetable prices along with rainfall progress during the monsoon season, said Upasna Bhardwaj, an economist at Kotak Mahindra Bank Ltd.

"While the cumulative rainfall has improved to a surplus of 1% from 11% deficiency witnessed in June, monsoon in the rest of July and August is very crucial for Kharif production," she added.

Between January 2015 and April 2016, Rajan has cut the policy rate by 150 basis points to 6.5%. One basis point is one-hundredth of a percentage point.

Rao said while short-term seasonal spikes due to food-price volatility cannot be ruled out, she expects headline CPI to show a sustained downward momentum beginning August, which could provide a window for RBI to cut rates by a final 25 basis points in the third quarter (October-December) of 2016-17.

The central government is expected to name a new RBI governor and operationalize the monetary policy committee soon, ahead of the August policy review. This could mean the August review could be the first which will be decided by a six-member monetary policy committee to be presided over by Rajan, whose three-year term ends on 4 September.

According to the agreement between the finance ministry and RBI, both stakeholders will be evenly represented in the committee, with the governor retaining a veto in case of a tie.

RBI sounded a note of caution about the likelihood of CPI inflation accelerating in its monetary policy review on 7 June, when it kept policy rates unchanged.

In its June monetary policy review, RBI said an upside inflation surprise in April to 5.39% made the future trajectory of inflation somewhat more uncertain.

“The expectations of a normal monsoon and a reasonable spatial and temporal distribution of rainfall, along with various supply management measures and the introduction of the electronic national agriculture market (e-NAM) trading portal, should moderate unanticipated flares of food inflation. In addition, capacity utilization indicators suggest that the available headroom in industry could keep output prices subdued even as demand picks up,” it said.

However, RBI cautioned on upside risks including “firming international commodity prices, particularly of crude oil; and the implementation of the 7th Central Pay Commission awards which will have to be factored into projections as soon as clarity on implementation emerges”.

The government has also announced implementation of the recommendations of the pay panel, effectively raising the salaries of central government employees, which is expected to boost demand for consumer durables, but deferred an increase in housing rent allowance (HRA), a key contributor to retail inflation. Deferring the hike in HRA may reduce an immediate flare up of rentals.

Within IIP, manufacturing continued to remain weak, growing at 0.7% in May; electricity and mining grew at 4.7% and 1.3%, respectively.

Production of capital goods, an indicator of investment demand in the economy, shrank 12.4% in May, the seventh consecutive month of contraction, signaling that private investment demand remains weak.

While consumer durables, a proxy for urban demand, continued to grow at a robust 6% in May, consumer non-durables, an indicator of rural demand, contracted for the seventh month in a row, by 2.2%.

Higher retail inflation in June was driven by higher vegetable (14.74%) and sugar (16.79%) prices compared with the previous month while price rise for pulses (26.86%) slowed marginally during the same period.

A good monsoon may help cool down food prices. The south-west monsoon has, so far, progressed more or less according to the projection of the India Meteorological Department, with the country receiving 35% surplus rainfall in the week ended 6 July, with all regions barring the southern peninsula recording above-normal rainfall.