Quickonomics

May 26, 2021

Why inflation is back to haunt

We have two reasons to believe that upside risks to CRISIL's consumer price index (CPI)-linked inflation projection of 5% for this fiscal have begun to kick in: surging input prices and rural economy disruptions.

But before we jump in to parse them, a word on available data.

Official data tells us that wholesale price index (WPI)-linked inflation crossed double-digit level at 10.5% on-year in April 2021 (from 7.4% in March), for the first time since 2010, while CPI inflation, moderated to 4.3% (from 5.5% in March) – led by a high base of the previous year (it had spiked to 7.2% in April 2020).

But last year's base may not reflect accurate trends, as data collection was disrupted in April and May 2020. Hence, we have focussed on sequential price trends on a seasonally adjusted basis.

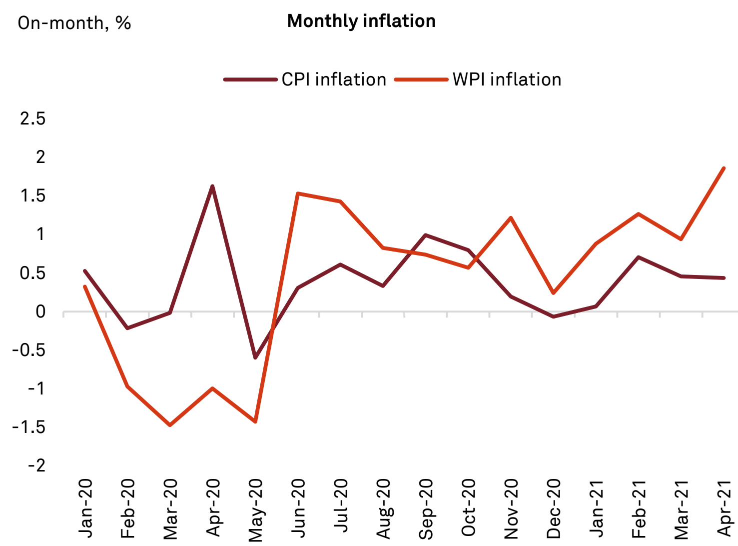
When viewed thus, both WPI and CPI indices continued to increase on-month[1] in April 2021, though the rise in WPI has been much sharper (see Figure 1).

Now, for the drivers.

How have international prices risen for key commodities?

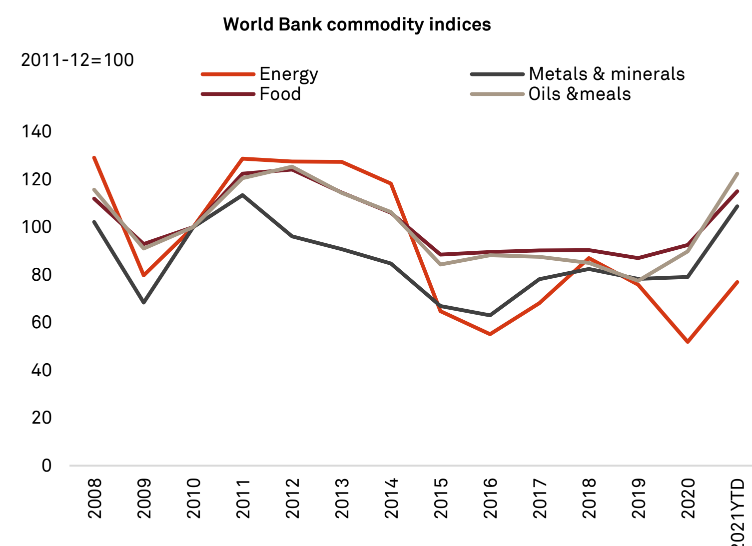
Surging international commodity prices, by raising manufacturing costs, are intensifying inflationary pressures (see Figure 2).

Figure 1: Wholesale and retail prices rising sequentially



Source: Ministry of Statistics and Programme Implementation (MoSPI), Office of Economic Advisor, CEIC, CRISIL

Figure 2: Runaway international commodity prices are driving up cost pressures



Note: Data for is on calendar year basis, 2021 YTD refers to Jan-Apr 2021 average
Source: World Bank, CRISIL

[1]*All monthly inflation numbers are seasonally adjusted*

While input prices have risen across the board, the following global commodities are particularly exacerbating domestic inflation:

- **Crude oil:** Brent crude prices crossed $65 per barrel in May 2021, more than double the year-ago level. Prices are currently at 2019 levels
- **Edible oils:** Price of vegetable oils – another major import item – shot up 57% on-year in April 2021 to reach a decadal high, driving up global food prices
- **Metals:** Here too, prices are close to decadal highs – the World Bank's Metals & Minerals index was 76% higher on-year in April 2021
- **Rising transportation costs:** International freight costs are escalating, the Baltic Dry Index – an indicator of shipping costs – also crossed a decadal high in April 2021

How is that impacting domestic inflation?

- Figure 3 depicts the direct impact of the above-mentioned commodities on India's WPI and CPI inflation levels. WPI inflation has surged in double digits in April on-year for items directly linked to these commodities. Crude-linked inflation has risen the sharpest, partly led by the base effect too. Edible oils-linked WPI, moving up since last year, has continued on its upward march. Rising inflation levels in fuel and edible oils and fats, have also directly impacted CPI inflation. The inflation effect in metals and minerals is being felt indirectly in some core CPI components (read on for details).
- The trend in WPI rising for other inputs is showing up in other manufacturing costs as well, including in chemicals, paper, and textile sectors (Figure 4)
- Figure 5 captures how rising fuel inflation is putting pressure on domestic CPI inflation

Figure 3: Direct impact of rising commodity prices on domestic inflation[i]

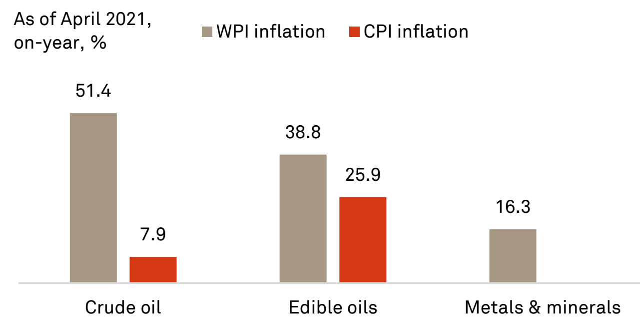


Figure 4: Sequentially, too, WPI inflation shows broad-based rise

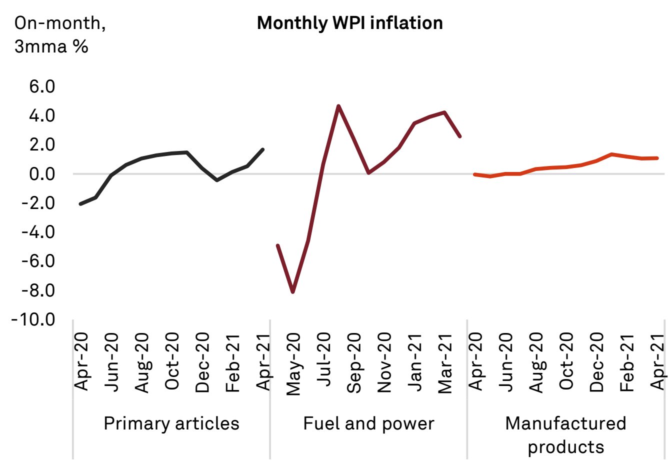
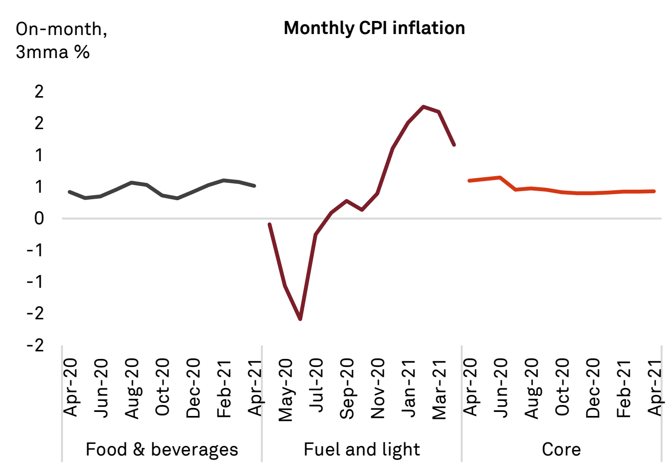


Figure 5: Core CPI stable so far despite pressures



Note: 3mma refers to three-month moving average of on-month inflation; Core refers to WPI excluding food and fuel
Source: MoSPI, Office of Economic Advisor, CEIC, CRISIL

[i] *Categories used to calculate: a) Crude oil WPI: crude petroleum & natural gas, mineral oils; b) Crude oil CPI: fuel & light (petrol & diesel not included due to insufficient data; c) Edible oils WPI: oilseeds and manufacture of edible oils; d) edible oils CPI: Oils & fats; e) metals and minerals WPI: minerals, manufacture of basic metals, and manufacture of fabricated metal products*

- Within food inflation, falling vegetable prices are capping the overall increase, while edible oils and protein items are rising sequentially
- The sequential rise in core CPI inflation has been moderate so far. Petrol and diesel prices have been the key inflation drivers of the rise, via raising inflation in the transport and communication sector.
- Inflation has gained momentum in consumer durables, where metals are key production inputs. However, consumer durables account for a small share (0.9%) of the CPI basket.
- In comparison, sequential inflation in fast-moving consumer goods (FMCG) goods – which account for 9% of CPI basket – has slowed since the start of calendar year 2021.
- This is consistent with CRISIL Research's expectations. According to our recent study[2],sectors such as consumer durables, steel products and automobiles are expected to pass on the rising input costs to consumers. However, cost pressures for organised retail (that includes from FMCG) have been relatively stable so far until April.
- Overall, producers are currently bearing a higher burden of rising input costs than consumers. However, as demand revives, these costs can get increasingly passed on to consumers.

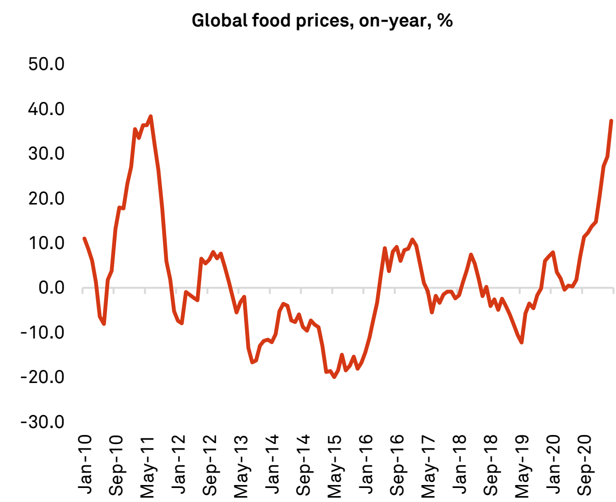
Emerging risks to inflation outlook

In our base case, we expected CPI inflation to moderate to 5% this fiscal from 6.2% last fiscal. This was based on lower food inflation benefitting from the high base of last year and assuming a normal monsoon.

However, upside inflation risks are clearly growing. On top of rising input prices, supply disruptions brought on by the intensification of the second Covid-19 wave in rural India are adding to the stock of inflationary pressures:

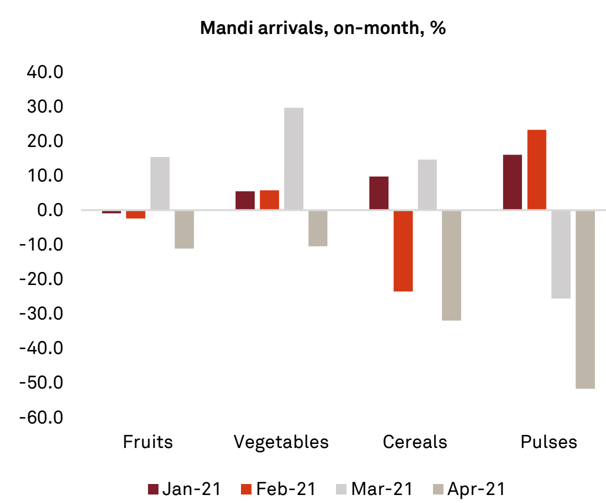
1. **Rising input prices:** CRISIL Research projects Brent crude prices to average $58-63 per barrel in calendar year 2021 compared with $42.3 per barrel the previous year. Rising fuel inflation will keep core inflation high through elevated transportation costs and aggravate the spiral we are already seeing, as explained earlier.

Figure 6: Secular rise in global food prices



Source: World Bank

Figure 7: Disruption in mandi arrivals



Source: CRISIL Research

[2]*CRISIL (May 2021). Second shock amid clawback*

2. **Risk of upside pressure on food prices:** Any shock to food prices can cause headline inflation to go off the mark, as food is the most volatile and largest weighted category in the CPI inflation group. Two risks emanate on this front:

   a. **Pass-through of high global food prices**: Global food prices have risen for 12 consecutive months now (see Figure 6)– the longest stretch in almost a decade. On average, they have registered a 30% annual growth until April 2021.

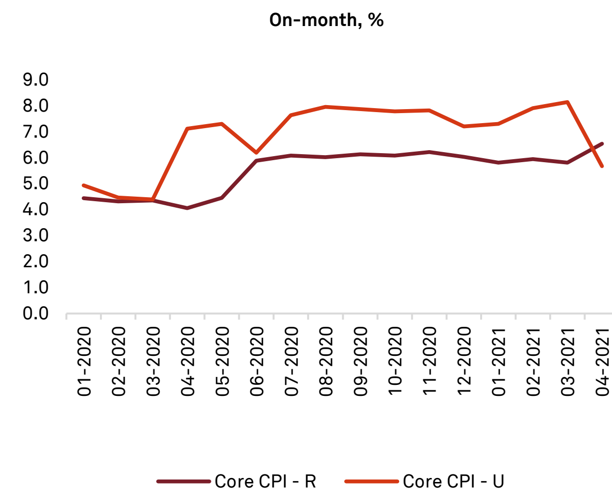
      Moreover, they may remain elevated given the surge in global demand (especially from China) amid subdued supply (caused by unfavourable weather conditions in several key agriculture commodity producing nations such as Brazil, US, Australia, etc.).

      While India is not a price taker in most food commodities, there is still some pass-through that could take place to the CPI food basket from high global food prices, especially through commodities such as edible oils and sugar. A recent Reserve Bank of India study suggested that a 10% rise in global food prices could lead to a 0.7% rise in India's food CPI in the short run and 3.0% in the long run.

   b. **Rural disruptions:** The rising spread of Covid-19 infections in the hinterland, could lead to disruptions in food production as well as its transportation to the wholesale markets/*mandis*. In fact, data for April 2021 (when the second Covid-19 wave was rising and localised lockdowns were implemented in several states) does indicate that (see Figure 7). Any further rise in rural caseload necessitating further localised lockdowns could slow down *mandi* arrival rates even more and lead to upward pressure in the coming months.

3. **Rising rural core inflation:** A spatial analysis of CPI inflation data shows the sequential rise in rural core inflation was higher than that in urban in April 2021, a phenomenon not seen in the previous 16 months (see Figure 8). Noticeably, when the pandemic was largely prevalent in urban areas in April 2020, leading to supply disruptions, urban core inflation had shot up. Rising rural core inflation this time around could be an indicator of a similar phenomenon.

Figure 8: Rural core inflation on an upswing



Source: NSO, CRISIL

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