Why is the MPC cautious despite FY25 CPI projection of 4.5%?

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- **We expect FY25 CPI inflation to cool to 4.5%, similar to the MPC's forecast**
- **MPC stays cautious given high volatility in domestic food & global commodity prices**
- **We expect the MPC to cut rates "later rather than sooner", by 50bps in H2FY25**
- **Strong domestic growth, financial stability concerns to limit urgency for rate cuts despite likely rise in real rates in FY25**

FY25 CPI inflation expected to cool to 4.5% primarily led by food

Headline inflation is likely to continue its downward trend for 3rd year in a row, averaging 4.5% in FY25 (lowest since FY19) vis-à-vis an estimated 5.4% in the current fiscal year. Segment wise, we see food inflation dipping to 5.2% in FY25, vs 7.4% estimated for FY24 (FY23:6.6%). However, within food, the trends in cereals, pulses and vegetables will be pivotal to watch for during FY25 after having stayed in double digits during most of FY24. Meanwhile, core CPI is expected to stay stable at 4.4% in FY25 while fuel likely to remain in low single digits (Fig 1).

Our FY25 CPI inflation forecast is in line with the Monetary Policy Committee's (MPC's) projections. Despite this forecast, the MPC has been cautious regarding inflation trajectory and most members (except the two doves) have warned against premature shift in policy stance. This is probably attributed to the significant role played by the volatile domestic food and global commodity prices in the CPI inflation which is keeping the MPC cautious, in our view.

MPC stays cautious on high volatility in domestic food and global commodity prices

Food prices remain highly volatile, especially for vegetable, cereals and pulses

During the last two years, food prices have been the key driver in shaping headline inflation, given high volatility seen in key sub segments. In fact, in January Bulletin, the RBI (aptly) titled its occasional paper as "Are Food Prices the 'True' Core of India's Inflation?".

In specific, price pressures have been witnessed in cereals, vegetables and pulses with a weight contribution of c.50% in total food CPI (Fig.1, Fig. 4 and 5). Within cereals, inflation has averaged c.11% in FYTD24, highest in 10 years, on account of drop in production levels while the government continued with the free food grain distribution program. As per the media sources, the food stocks with the government have plunged to close to buffer norms with wheat stocks likely to be at 16-year lows (Fig. 3). Sowing during rabi season was robust but procurement post harvesting would be key for maintaining stocks level.

Interestingly, within vegetables, there has been a delay in terms of seasonal correction with the index level as of Feb-24 at 195.5 levels unforeseen in this month since the start of current CPI series. Historically, the trough in vegetables CPI index usually settles below 170 levels by March/April in every financial year. However, based on data of on-the-ground prices available for March till date, seasonal correction is likely to be delayed to April/May (Fig. 4).

The other key food sub-segment on watch is pulses within which correction in inflation is underway which usually extends for 1.5-2 years as per historical trends. In the current context, improved winter crop production and stepping up of imports is likely to help cool pulse inflation levels (Fig 5).

Commodity prices explain c.70% of cooling in FY24 core CPI; stay vulnerable to geopolitical shocks

Global commodity prices eased during FY24 from the sharp spike clocked last year post the Russia Ukraine war. They played a key role in domestic inflation dynamics and help explain c.70% of the cooling in core CPI to 4.4% average in FYTD24 from a sticky 6.1% in FY23 (Fig 7). This solves the mystery of sharp cooling in core CPI this year despite strong growth dynamics this year. Going forward, in FY25 commodity price trends will be the key to watch, especially crude prices under the light of resurfacing geopolitical tensions.

Meanwhile, policy steps to cushion the impact of higher crude oil prices is likely to continue to support inflation outlook. For instance, the recent reduction in petrol/diesel prices by ₹ 2/L each by Oil Marketing Companies and LPG cylinder price cut by ₹ 100/cylinder is likely to cool inflation by c.20bps over the next 12 months. This is already included in our FY25 inflation projections.

Another important factor keeping core CPI inflation low is subdued housing inflation at 4.01% in FYTD24 (Fig 6). However, we believe that this does not corroborate well with the on the ground rental price moves which are aligned at 10% plus levels. Hence, we will also watch out for any change in data methodology in this regard.

What to expect on 5th April, 2024?

We expect the MPC to cut rates later than sooner

From the global perspective, markets expect major central banks especially the Fed, to start the rate cut cycle from June 2024. This is leading to expectations that the RBI led MPC is likely to follow suit from August, as CPI inflation likely moves towards 4% in Q2-FY25 with 50-75bps rate cuts expected by most economists. However, we are biased that the timing is likely to be later rather than sooner as per factors highlighted below.

Rise in real rates likely to open space for rate cuts in FY25

First and foremost, we agree that the scope for rate cuts is likely to open up, as real rates increase on cooling of inflation levels in FY25 unless risks of food price volatility and spike in commodity prices materialize.

The RBI in its article titled "*Revisiting India's natural rate of interest*" *in* June 2022 bulletin, highlighted that pandemic induced factors have altered the natural real rate to 0.8-1.0% from 1.6-1.8% in the pre-covid period. However, post-Covid the numbers are yet to be revisited. With inflation expected at 4.5% in FY25, the real rate of 200bps is likely to open a small window for rate cut(s) (Fig 8). Consequently, we expect the repo rate to be cut by 50 bps to 6% in FY25 (Fig 8). Historically, repo rate has not slipped below the 6% mark sustainably except for crisis period(s) (Fig 9). Hence, while the space for rate cuts may open up, we don't see scope for more than 50 bps rate cut cycle to 6% repo rate in the current phase of high growth.

Strong growth dynamics may limit the urgency to cut rates

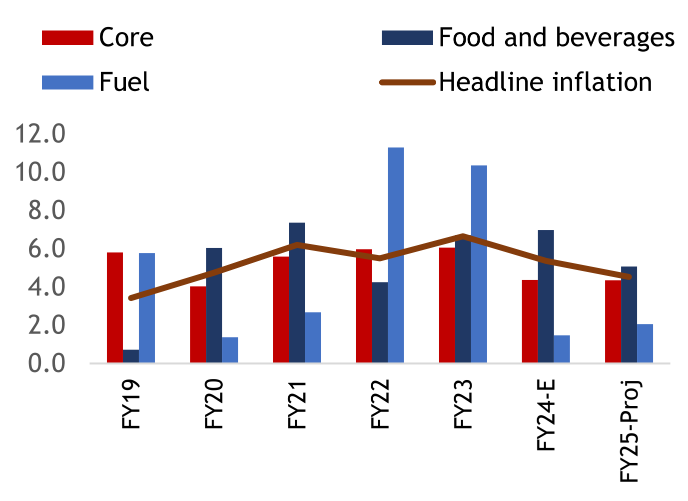
Strong growth momentum may not warrant early rate cuts with FY25 GDP growth expected at 7% from 7.8% in FY24 (with upside risks). With growth surprising to the upside in recent quarters, the flexible inflation targeting MPC may choose to wait and watch if the softening in inflation towards the 4% target is durable.

Financial stability concerns also likely to keep policy easing at bay

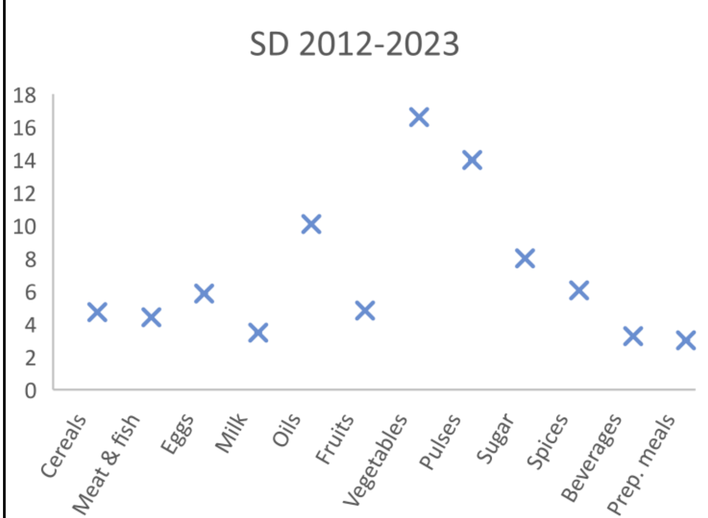
Apart from macro factors, the RBI is also paying due attention towards financial stability. This was reflected in the preemptive regulatory measures taken to limit credit excesses in some segments. For instance, in November 2023, the RBI increased the risk weightage for unsecured loans to 125% from 100% for banks and NBFCs, along with bank credit to NBFCs (ex HFCs). This has been followed up by various regulatory steps including the increased scrutiny on various Fintechs and other NBFCs. Hence, in an attempt to ensure a sustainable credit cycle which has started after a decade, the RBI may continue to stay cautious and defer shift of policy / liquidity stance. *On balance, we expect a shallow 50bps rate cut cycle in H2-FY25 likely starting from October with our bias of easing to be seen later rather than sooner.*

Key charts

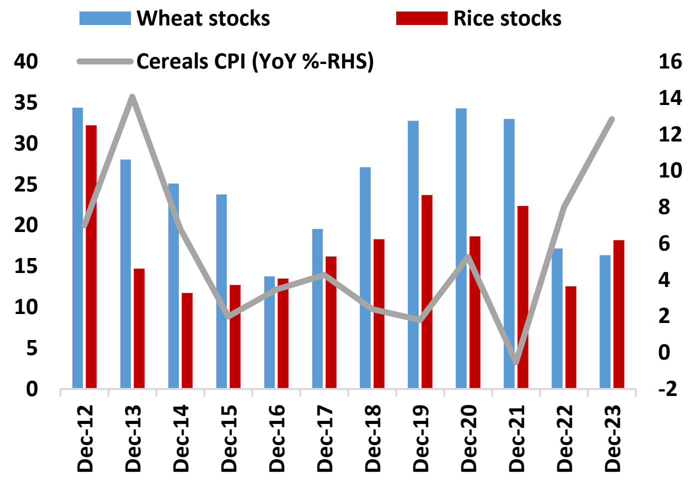
CPI in FY25 likely to drop three year low, core CPI likely to be steady; *% y/y* *(Fig.-1)*



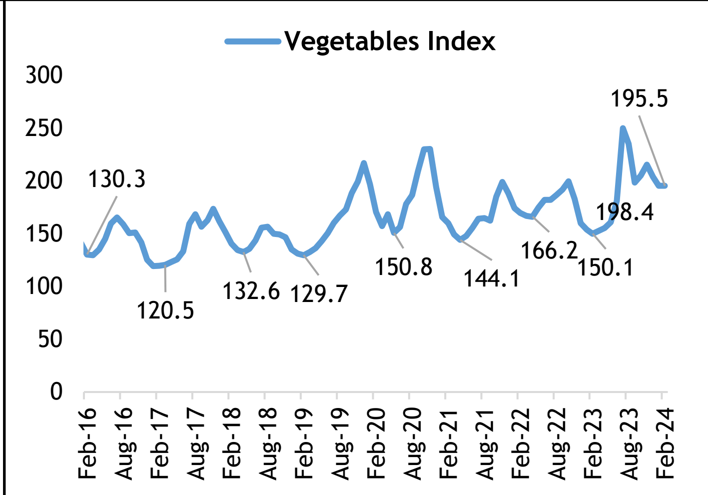
Vegetables remained main driver of volatility in inflation *(Fig.-2)*



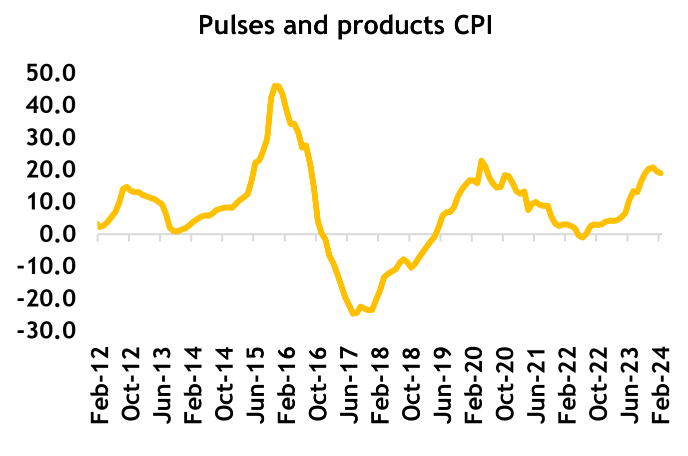
Cereals inflation remained elevated; wheat stock is lowest in 7 Years *(Fig.-3)*



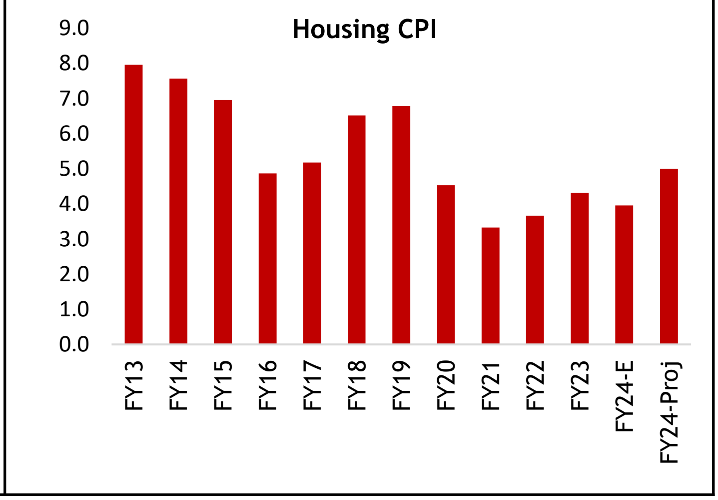
Delay in seasonal correction in vegetables CPI keeping inflation elevated *(Fig.-4)*



Pulses inflation remained elevated; % y/y *(Fig.-5)*

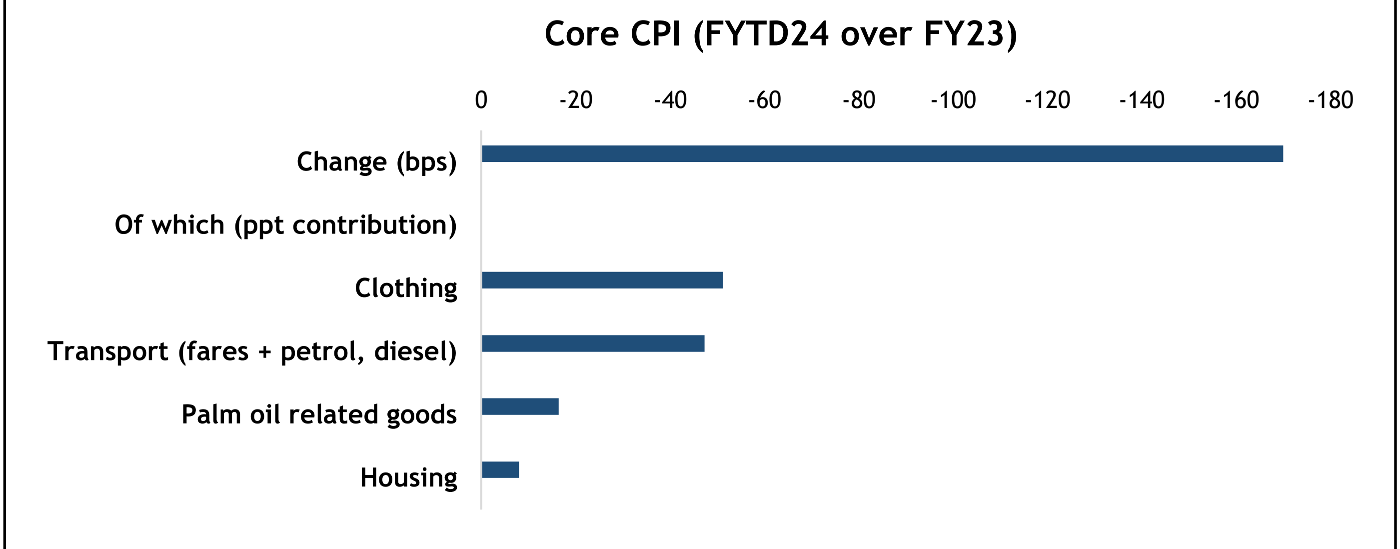


Housing inflation remained steady and likely to remain steady in FY25; *% Y/Y* *(Fig.-6)*

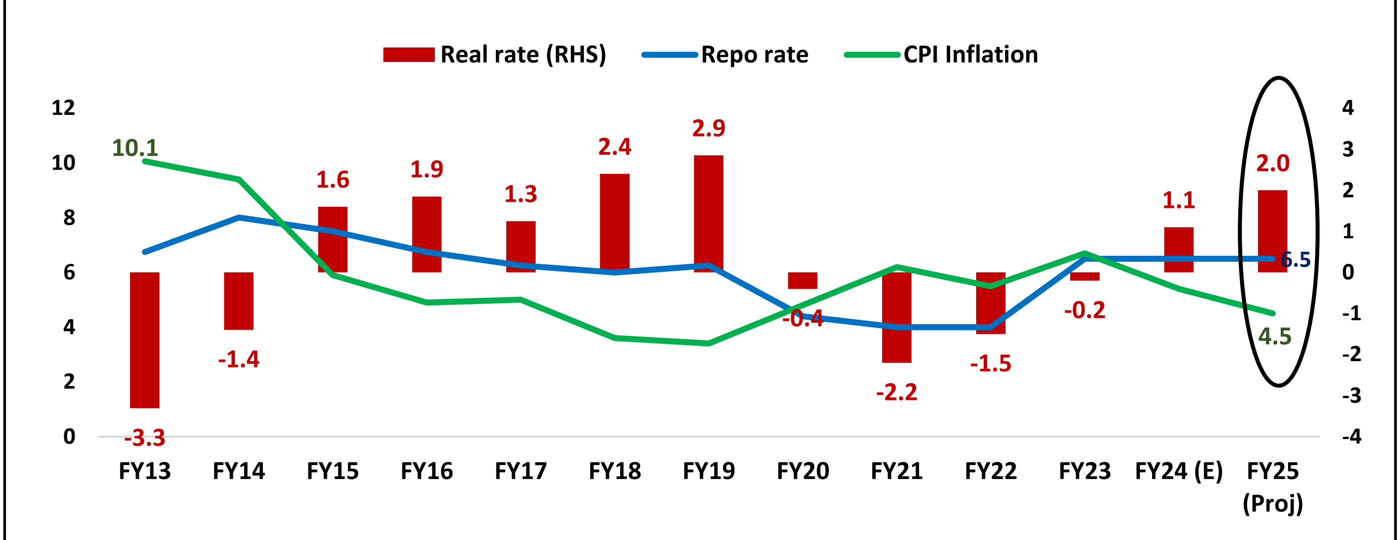


Source: CEIC, UBI research

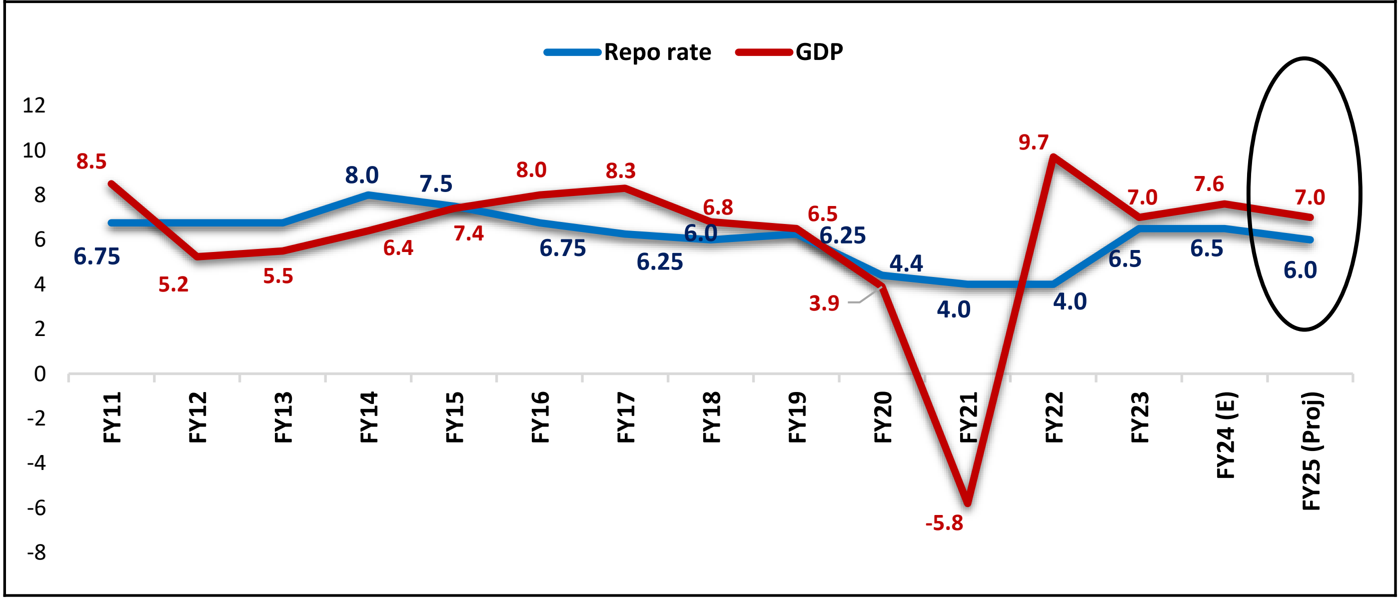
Lower commodity prices explain c.70% of cooling in core CPI *(Fig.-7)*



Rise in real rate to 200bps in FY25 likely to open space for rate cut(s) *(Fig.-8)*



Repo rate has not slipped below 6% sustainably except for crisis period(s) *(Fig.-9)*



Source: CEIC, UBI research

Thank you!

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