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India Economics

Inflation: Likely to Ease to 5% Levels by May

► **Current Trends in Inflation:** Inflation has been a concern since it breached the RBI's target of 5.5% in October, and touched a high of 6.73% for the week ended February 3. However, the latest data pegs it at 6.05% yoy, for the week ended February 17. While the Index for Primary Articles was up 11.5%, Manufactured Products saw a 5.9% rise and the Fuel Index was up by just 1.1%.

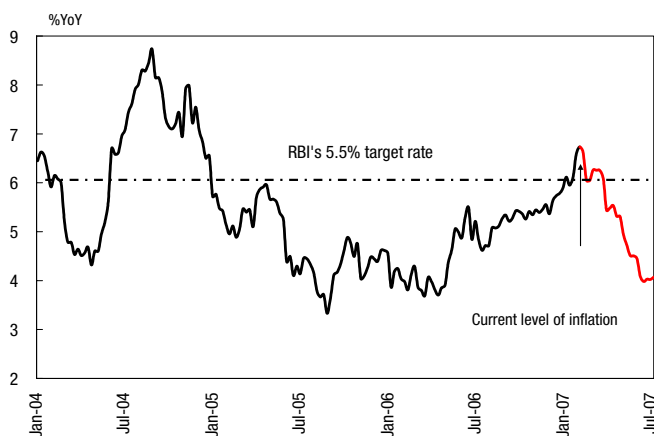
► **Inflation to come off to 5% levels by May:** We expect headline inflation numbers to remain in the 5.5%-6.5% for the next three months. However, we maintain our view that on the back of monetary and fiscal measures, the base effect as well as political pressures, headline inflation is likely to come off to 5% levels by May. Key measures to control inflation so far include:

1 **Monetary:** Besides policy interest rates moving up 150bps since October 04, the RBI has raised the CRR by 100bps in two hikes of 50 bps each. In addition, there has been a shift in monetary policy stance in the January 31 policy from an equal emphasis on price stability and growth, to one of reinforcing just price stability with immediate monetary measures.

2 **Fiscal:** The gov't has reduced customs duties on capital goods, metals and cement, permitted imports of wheat and sugar. In addition, it banned exports of pulses, sugar, skimmed milk powder and forward trading in certain food grains – measures we see as regressive. In this week's budget, import duties on several commodities were cut, while a dual excise structure was introduced for cement which penalizes producers those who charge more.

► **Policy Implications:** We expect inflation to remain in 5.5%-6.5% range till March/April, and maintain that policy rates could rise by 25bps in the April. We expect 2007 to be the year of multiple policy instruments wherein if liquidity conditions ease (either via govt spending or capital flows), we could see the RBI not hesitating to hike the CRR again to absorb excess liquidity but to sustain the growth momentum, the possibility of an SLR reduction remains high.

Likely Trends in Inflation (%YoY)



Source: Office of the Economic Advisor; Citigroup

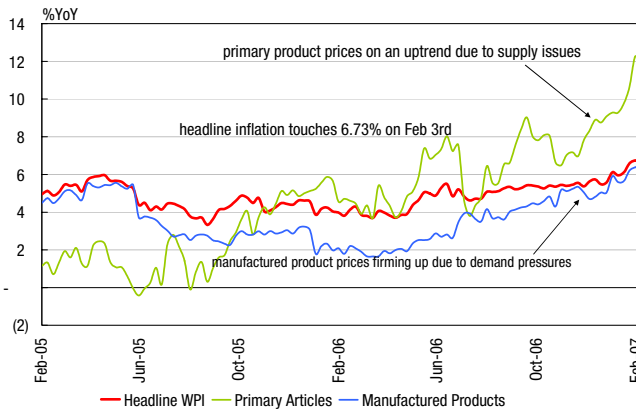
Components of the Wholesale Price Index

	FY94=100	%YoY
I. Primary Articles	22.0	11.50
(A) Food Articles	15.4	10.80
(B) Non-Food Articles	6.1	11.60
(C) Minerals	0.5	21.60
II. Fuel, Power Light & Lubricants	14.2	1.10
III. Manufactured Products	63.7	5.88
(A) Food Products	11.5	3.10
(B) Beverage Tobacco & Tobacco Products	1.3	7.70
(C) Textiles	9.8	1.90
(D) Wood & Wood Products	0.2	3.50
(E) Paper & Paper Products	2.0	6.98
(G) Rubber & Plastic Products	2.4	7.98
(H) Chemicals & Chemicals Products	11.9	1.94
(I) Non-Metallic Mineral Products (incl cement)	2.5	10.92
(J) Basic Metals, Alloys & Metal Products	8.3	16.16
(K) Machinery & Machinery Tools	8.4	8.20
(L) Transport Equipment & Parts	4.3	1.49
All Commodities	100.0	6.05

India- Inflation in Pictures

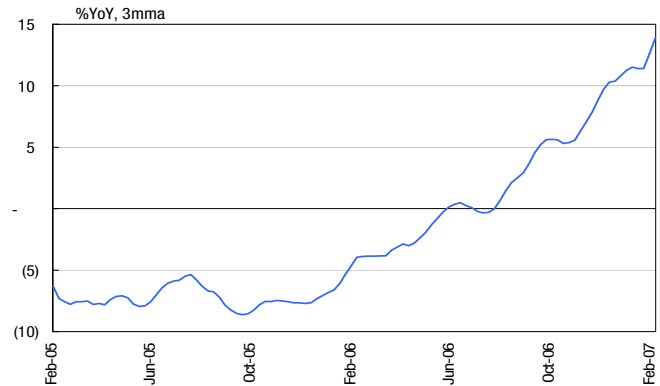
The recent uptrend in inflation has been led largely by Primary Articles (+11.5% currently), which comprise over 22% of the Index. Trends in Manufactured Products have also been strong, up 6%, while the Fuel index was up just 1.1%

Trends in Primary, Manufactured Products, and Headline WPI



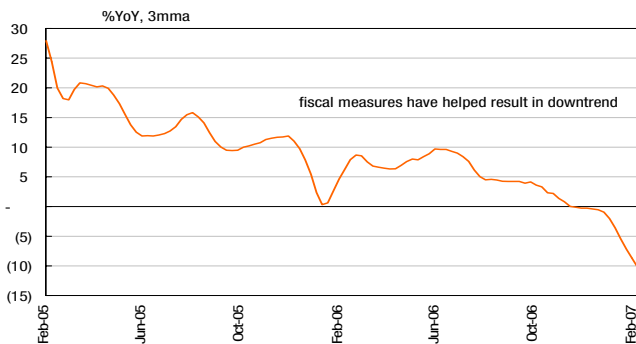
Within the Primary Articles Index, Edible Oils have seen a significant uptrend (+15.2%). However, recent duty exemption measures in the budget should quell higher prices in crude and refined vegetable oils.

Trends in Edible Oil Prices(%YoY, 3mma)



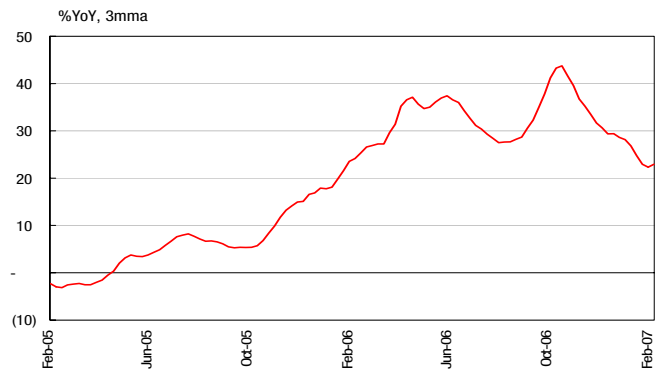
Sugar Prices have seen a considerable decline and are now in negative territory on the back of government measures- such as banning exports.

Trends in Sugar Prices(%YoY, 3mma)



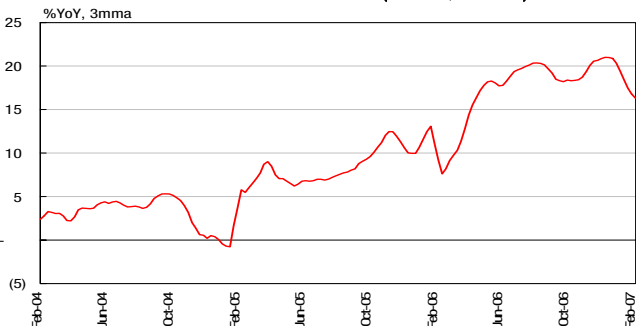
While imports may help in the short term, increasing yields and productivity are key factors for long term price stability

Trends in Pulses Prices(%YoY, 3mma)



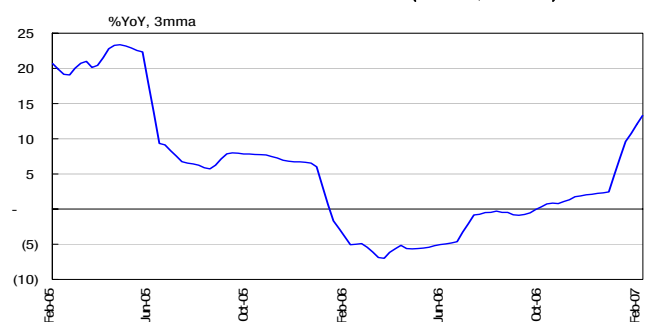
Cement comprises less than 2% of the WPI. However, on the back of rising prices, the budget proposed a dual excise structure that will penalize producers charging a higher price

Trends in Cement Prices(%YoY, 3mma)



Basic Metals prices have also seen an uptrend, largely on account of higher iron and steel prices (+15%YoY). Budget measures to impose an export tax on iron ore could result in easing trends.

Trends Basic Metals Prices (%YoY, 3mma)



Disclosure Appendix

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