ICICI Bank Global Markets
Data Release
Treasury Research Group
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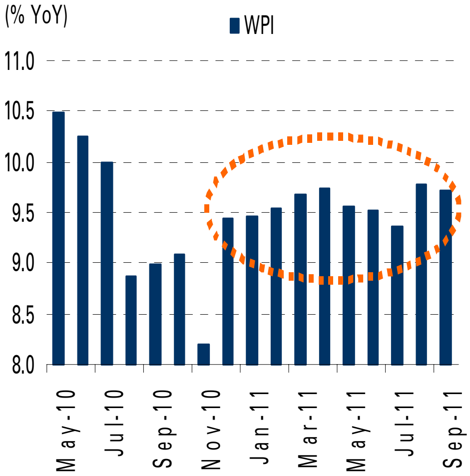
A 25 bps rate hike on the cards as inflation remains elevated

- WPI inflation stood at 9.72% YoY for September 2011, as compared to 9.78% YoY in the previous month. The July headline number was revised upward to 9.36% YoY as compared to 9.22% YoY earlier
- Inflation pressures in the manufacturing sector continue to remain elevated, with prices of manufactured products registering a growth of 7.69% YoY in September
- Core (manufacturing ex food) inflation eased to 7.55% YoY from 7.77% YoY in July
- We continue to hold on to our call of a 25 bps hike in the October 25th policy meeting. However, the risk to our view emanates from global developments, which could tip the balance in favour of a pause

WPI remained above 9% for the tenth consecutive month



Source: CEIC, *ICICI Bank Research*

Core inflation remains sticky above the 7% mark

WPI Inflation		
(% YoY)	FYTD 2012 (avg)	Sep-11
Headline	9.61	9.72
Primary	12.53	11.84
of which Food	8.93	9.23
Manufacturing	7.56	7.69
of which Manufacturing-ex-food	7.54	7.55
Fuel	12.86	14.09

Source: CEIC, ICICI Bank Research

Headline inflation remained above the 9% mark for the tenth consecutive month, with September print coming in at 9.72% YoY, marginally lower than previous month's data print of 9.78% YoY and our expectations of 9.76% YoY. On a seasonally adjusted sequential basis, the WPI rose by 0.74% MoM (as compared to 0.59% MoM in the previous month), with primary articles and manufactured products witnessing a pick up.

Keeping up with the recent trend of upward revisions, the inflation rate for July was revised to 9.36% YoY from the provisional estimate of 9.22% YoY. The average inflation for the period April – September 2011 stood at 9.61% as compared to 9.91% in the corresponding period previous year.

Trends in components

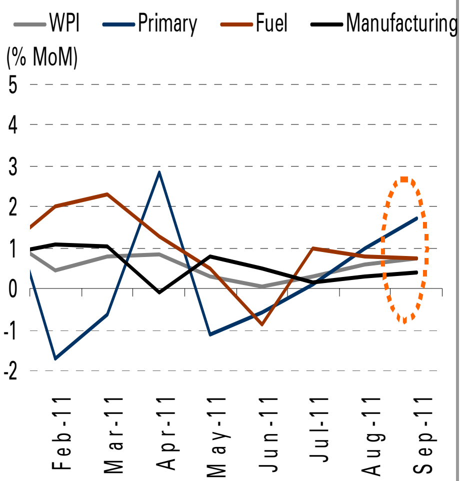
Primary Inflation

Inflation in primary articles eased to 11.84% YoY in September from 12.58% YoY in the previous month, primarily on the back of base effect. On a seasonally adjusted sequential basis, the primary index rose by 1.71% MoM, much higher than the sequential growth of 0.99% MoM witnessed last month.

Within primary, prices of food articles eased to 9.23% YoY in September from 9.62% YoY in the previous month. The primary contributors of food inflation are vegetables (14.04% YoY), fruits (15.98% YoY), and protein rich group with milk, 'egg, meat & fish' rising to the tune of 10.28% YoY and 9.69% YoY respectively. On the other hand, rise in prices of staples was muted, with wheat exhibiting deceleration in prices to the tune of 2.10% YoY. Despite normal monsoons this year, food inflation continues to remain above the 9% mark due to off-season demand for vegetables and inefficiencies in the distribution chain.

Going forward, food inflation is likely to remain sticky in the near term, as the minimum support prices have been increased in the range of 8 – 19%, which will act as a floor. Moreover, prices of milk and protein rich group will continue to rise due to increased consumption of these items, which is also being reflected in the recent consumption surveys.

On a seasonally adjusted MoM basis primary articles witness a significant pick up



Source: CEIC, ICICI Bank Research

Meanwhile, non-food components of primary inflation also remain elevated at 14.82% YoY but slightly lower than the previous month's print of 17.75% YoY. At the disaggregated level, fibres, minerals and oilseeds rose by almost 24% YoY, 15% YoY and 25% YoY respectively.

Fuel inflation

Fuel index accelerated to register a growth of 14.09% YoY in September as against 12.84% YoY in the previous month. This pick up in fuel inflation is primarily due petrol price hike of INR 3 per litre in mid September. According to our calculations, the rate hike will add around 7 bps to headline inflation. On the other hand, the price of non-administered aviation turbine fuel declined by 1% on a month on month basis. On a seasonally adjusted basis, the fuel index rose by 0.75% MoM.

Manufacturing inflation

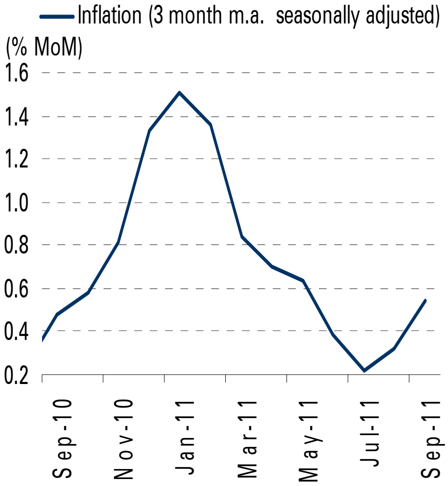
Inflation pressures in the manufacturing sector continue to remain elevated, with prices of manufactured products easing only marginally to 7.69% YoY in September as compared to 7.79% YoY in August. Along with this, the manufacturing ex-food index, which can be construed as core inflation in India, has eased to 7.55% YoY as compared to 7.77% YoY in the previous month. On a seasonally adjusted sequential basis, manufacturing inflation has shown a pick up in September (0.4% MoM s.a.), which is partially on account of the lagged impact of pass through of global commodity prices. Within manufactured products, prices of 'cotton textiles', 'edible oils', 'beverages, tobacco & tobacco products', 'iron & semis' and 'basic metals, alloys and metal products' continue to remain the primary contributors.

Going ahead, this component is expected to ease, as subdued demand is likely to reduce the pricing power of manufacturers and help contain core inflation. The recent decline in commodity prices will also help ease core inflation but the recent Rupee weakness could offset the impact to some extent. Our analysis shows that commodity prices impact manufacturing inflation with a lag of 3 months and the sensitivity turns out to be 0.1, i.e for every 1% decline in the commodity price index, manufacturing inflation declines by 0.1%.

RBI likely to hike rates by 25 bps in the October policy meeting

Given the current macroeconomic dynamics, the RBI once again faces the classic dilemma of growth inflation trade-off. There has been tremendous pressure on the Central Bank to end its rate hiking cycles as the prevailing high rates have attributed to the stalling of the investment cycle. Moreover, banks have also expressed their concern that further rate hikes will also lead to an increase in their non performing assets resulting in an increased pressure on their asset quality. Additionally, the proponents of a pause also cite example of a majority of Central Banks in the emerging market space that have put

Worryingly, sequential momentum continues to show an uptick



Source: CEIC, ICICI Bank Research

rates on hold while some have even begun to loosen their monetary policy stance (like Brazil, Indonesia, Singapore and Turkey), thus reflecting a change in their stance due to heightened global uncertainty.

Signs of slowdown in the Indian economy are evident, with manufacturing PMI at a 30 month low of 50.4 and PMI services at 49.6 (slipping into the contractionary territory). But despite the current moderation in domestic growth, we are of the view that RBI would continue with its current rate hiking cycle as inflation is likely to remain stubbornly high above the 9% mark atleast till November before easing to around 7% in March on the back of base effect. Inflation is exxpected remain sticky in the near term as the pass through of global prices is still incomplete and electricity prices to see further upside since it does not completely reflect the rise in input costs. Moreover, the recent depreciation in Rupee would offset the commodity price decline, thus resulting in a rise in input costs, which could result in further inflationary pressures on the economy. In addition, persistence in Rupee weakness could offset some of the impact of the earlier rate hike as it leads to easier monetary conditions.

Thus, we hold on to our call of 25 bps rate hike in the October policy meeting as RBI remains committed to anchoring inflationary expectations stating that '"a premature change in the policy stance could harden inflationary expectations…diluting the impact of past policy actions". The RBI Governor reiterated his commitment to tame prices even if it hurts growth in the near term, which further supports our view. However, the risk to our view emanates from uncertainity in the global economy, which could tip the balance in favour of a pause. The crucial aspect of the policy meeting will be RBI's guidance, which will help determine the future course of rate action. The Central Bank's rhetoric might turn a little cautious given the heightened global growth concerns.

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