VI. PRICE SITUATION

Lower global commodity prices, a negative output gap and past monetary policy actions contributed to a decline in headline wholesale price index (WPI) inflation to below 5 per cent in Q1 of 2013-14. Non-food manufactured product inflation also came down sharply to its lowest level in the past three years. Food inflation increased again in May and June 2013, putting pressures on the general price level. It could moderate somewhat if the monsoon remains on track during the rest of the season. However, the recent currency depreciation and upward pressure on fuel prices due to geo-political uncertainties pose upside risks to inflation. Near double-digit consumer price inflation also remains a major concern.

Inflation remains moderate in advanced and some emerging economies

VI.1 Inflation pressures eased in advanced economies (AEs) and some emerging market and developing economies (EMDEs) during Q2 of 2013. In most AEs, inflation remained at low levels due to subdued demand and a correction in energy prices. Consumer price inflation in OECD countries was 1.8 per cent in June 2013, lower than the average of 2.3 per cent during 2012. In view of the subdued recovery and benign inflationary pressures, central banks in AEs continued with an accommodative monetary policy stance to support recovery. The European Central Bank reduced the policy rate by 25 basis points to 0.50 per cent against the backdrop of contracting output, high unemployment rate and depreciation in exchange rate *vis-à-vis* the US dollar (Table VI.1).

VI.2 Unlike AEs, mixed inflation trends appeared from EMDEs. In China inflation edged up to 2.7 per cent in June 2013 from 2.1 per cent in May. Similar upward pressures were seen in the case of Russia and Brazil. Most of the EMDEs kept their policy rate on hold, with Brazil and Indonesia being notable exceptions, which raised the policy rate on inflation concerns. Some decline in commodity prices in the wake of the withdrawal of stimulus measures and uneven recovery in major regions of the world pose a downside risk. However, a significant upside risk is expected from the recent currency depreciation in several countries with respect to the US dollar as well as geo-political tensions that could lead to further pressure on energy prices.

Global commodity prices eased in Q2 of 2013, but crude oil prices rebounded in recent weeks

VI.3 The moderation in global commodity prices witnessed in Q1 of 2013 continued in Q2. The IMF commodity price index declined by about 2.0 per cent during the first six months of the year (Chart VI.1). The moderation was driven by improved supply prospects in most commodities and weak demand conditions on account of growth slowdown, especially in EMDEs. Despite the benign trends, the pass-through of commodity price correction to domestic inflation was partly abated by the recent appreciation of the US dollar across different currencies.

VI.4 Global crude oil prices generally trended down in Q2 of 2013 on account of weak demand, build-up of stocks and improvements in supply. After increasing to US$ 119 per barrel in early February 2013, the Brent crude oil spot price fell to a low of US$ 97 per barrel in mid-April and then recovered to an average of US$ 103 per barrel in May and June. The US Energy Information Administration (EIA) had recently projected that the Brent crude oil spot price would average US$ 102 per barrel over the second half of 2013 conditional on the absence of disruptions to energy markets arising from the recent geo-political unrest. However, Brent oil prices rose to over US$ 108 in July 2013 as the escalating political crisis in Egypt increased fears that it could affect the rest of West Asia and disrupt world crude supplies.

Table VI.1: Global Inflation and Policy Rates

Country/ Region	Key Policy Rate	Policy Rate (as on July 26, 2013)	Changes in Policy Rates (basis points)		CPI Inflation (Y-o-Y, per cent)	
			Sep 2009 to Dec 2011	Jan 2012 to Jul 2013	Jun-12	Jun-13
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	2.75 (May 8, 2013)	125	(-) 150	1.2#	2.4#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	75	0	1.5	1.2
Euro area	Interest Rate on Main Refinancing Operations	0.50 (May. 08, 2013)	0	(-) 50	2.4	1.6
Israel	Key Rate	1.25 ((Jun 1, 2013)	225	(-) 150	1.0	2.0
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10* (Oct. 5, 2010)	(-) 10	0	-0.1	0.2
Korea	Base Rate	2.50 (May 9, 2013)	125	(-) 75	2.2	1.0
UK	Official Bank Rate	0.50 (Mar. 5, 2009)	0	0	2.4	2.9
US	Federal Funds Rate	0.0 to 0.25* (Dec. 16, 2008)	0	0	1.7	1.8
Emerging and Developing Economies						
Brazil	Selic Rate	8.50 (Jul 11, 2013)	225	(-) 250	4.9	6.7
China	Benchmark 1-year Deposit Rate	3.00 (Jul. 6, 2012)	125	(-) 50	2.2	2.7
	Benchmark 1-year Lending Rate	6.00 (Jul. 6, 2012)	125 (600)	(-) 56 (-) 150		
India	Repo Rate	7.25 (Mar. 19, 2013)	375 (100)	(-) 125 (-200)	9.9	9.9
Indonesia	BI Rate	6.50 (Jul.11, 2013)	(-) 50	50	4.5	5.9
Philippines	Reverse Repurchase Rate	3.50 (Oct. 25, 2012)	50	(-) 100	2.8	2.8
	Repurchase Rate	5.50 (Oct. 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep. 14, 2012)	(-) 275	25	4.3	6.9
South Africa	Repo Rate	5.00 (Jul. 20, 2012)	(-) 150	(-) 50	5.5	5.5
Thailand	1-day Repurchase Rate	2.50 (May 29, 2013)	200	(-) 75	2.6	2.3

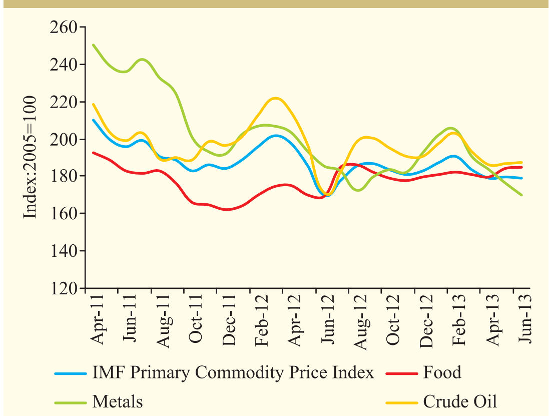
*: Change is worked out from the minimum point of target range. #: Q2 (Apr-Jun)

Note: Figures in parentheses in Column (3) indicate the effective dates when the policy rates were last revised. Figures in parentheses in Columns (4), and (5) indicate the variation in the cash reserve ratio during the period. For India, data on inflation pertain to New CPI (Combined: rural + urban)

Source: Websites of respective central banks/statistical agencies.

VI.5 Metal prices declined on concerns about the moderation in global demand, particularly from China. The FAO Food Price Index declined marginally in May and June, reflecting supply conditions in cereals, sugar and oil and fats. Going forward, the path of global commodity prices would largely depend on growth prospects in emerging and developing Asia, particularly China. Further, the recent global developments and overall macroeconomic conditions do not indicate any substantial rise in the oil and non-fuel segment of commodity prices, which is broadly in line with the baseline assumption for inflation forecast for 2013 across several central banks. However, commodity prices, especially oil prices, continue to remain vulnerable to short-term supply disturbances.

Chart VI.1: International Commodity Prices



Domestic headline inflation declines below 5 per cent

VI.6 Headline inflation, as measured by year-on-year changes in the Wholesale Price Index (WPI), declined to 4.7 per cent (provisional) in May 2013 before edging up to 4.9 per cent in

Chart VI.2: Wholesale Price Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes

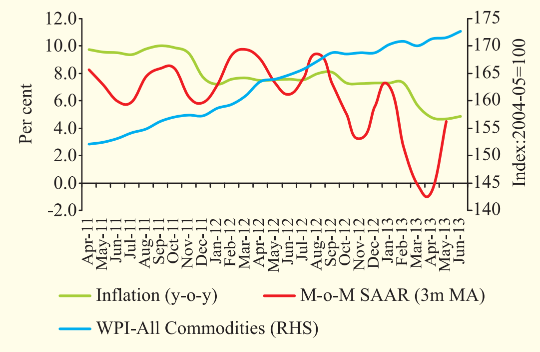
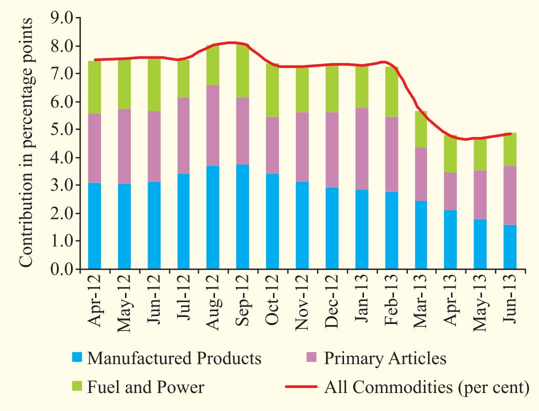


Chart VI.3: Drivers of WPI Inflation



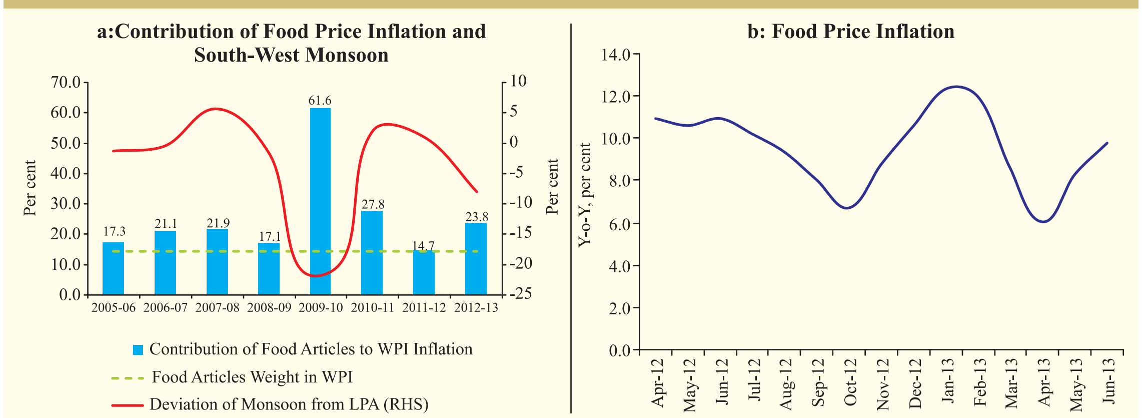
June 2013 on account of an uptick in food and fuel prices (Chart VI.2). Average inflation during Q1 of 2013-14 at 4.8 per cent remained significantly lower than the average inflation of 7.5 per cent during Q1 of 2012-13 and 7.4 per cent during the year 2012-13. The seasonally adjusted month-over-month (annualised) changes in the WPI (3-month moving average) (m-o-m saar), turned negative in the recent period, but returned to positive territory in June 2013, pointing to a turnaround in the momentum.

VI.7 On the whole, headline inflation exhibited a softening bias during Q1 of 2013-14, driven by all three major sub-groups, *viz.*, primary articles, fuel and power and manufactured products (Chart VI.3). The major contribution, however, came from the non-food manufactured products group, with inflation in this segment declining sharply to 2.0 per cent (by June 2013) and reaching its lowest level in the past three years. This was partly facilitated by lower international commodity prices, leading to benefits from lower imported inflation. The deceleration in growth to below the potential level also translated into weak demand conditions, contributing to moderation in inflation.

Food prices increased in recent months, but good monsoon may contain price rise

VI.8 Food price inflation has been a major driver of headline inflation in recent years (Chart VI.4a). High input costs, rising wages and inelastic supply responses to demand led to higher food price inflation. The delayed monsoon with a skewed spatial distribution contributed to high food inflation during most

Chart VI.4: Recent Trends in Food Price Inflation



part of 2012-13. Food articles inflation, however, receded sharply from 12.3 per cent in January 2013 to 6.1 per cent in April 2013 reflecting improved supply conditions and arrival of *rabi* crops. A surge in the prices of vegetables, cereals and 'eggs, meat and fish' led to a reversal of trend during May and June 2013 (Chart VI.4b). Going forward, the satisfactory progress of monsoon so far has boosted the prospects for improved foodgrain production for the current year. The increases in Minimum Support Prices (MSPs) for *kharif* food crops for 2013-14 work out to an average of 4.1 per cent (using WPI weights). This is significantly lower than the average increase of 16.3 per cent during 2007-08 to 2012-13. The lower order increase in MSPs this year could also ease some of the pressures on food inflation, although several other structural impediments still continue to put pressure on food prices.

Revisions in administered prices restrict the moderation in inflation

VI.9 The revisions in administered prices, particularly of diesel and electricity, led to a pick-up in inflation for administered price items during April-May 2013 (Chart VI.5). These revisions reflect both lagged pass-through of past increases in global prices as well as increases in input costs. Given these adjustments in administered prices, the moderation in overall inflation remained constrained. Inflation for the non-administered price group was much lower at 4.1 per cent compared with the headline inflation of 4.9 per cent for June 2013. Given the increase in global crude oil prices and rupee depreciation in recent weeks, further increases in administered prices could become inevitable which could lead to higher inflation readings.

Fuel inflation is driven by global oil prices and administered price revisions

VI.10 The moderation in international oil prices during Q1 of 2013-14 led to some decline in the prices of freely priced fuel products. This was reflected in a decline in fuel inflation to a 40-month low of 7.1 per cent in June 2013. The revision in the administered prices of diesel in a staggered manner, however, partly offset the impact of lower oil prices. Even though the gap between administered and non-administered products under the mineral oils group declined in the recent period, it remains significant (Chart VI.6). The depreciation of the rupee as well as the firming up of global crude prices following the political uncertainties in the Middle East led to some increase in the prices of freely priced fuel products in June–July 2013.

VI.11 During 2012-13, the total reported under-recoveries of the oil marketing companies (OMCs) was ₹1.61 trillion, of which 57 per cent was on account of diesel. Since September 2012, under-recoveries declined significantly, driven both by lower global crude prices and administered price revisions (Chart VI.7). During the initial months of 2013-14, falling

Chart VI.5:Administered and Non-Administered Price Inflation in India

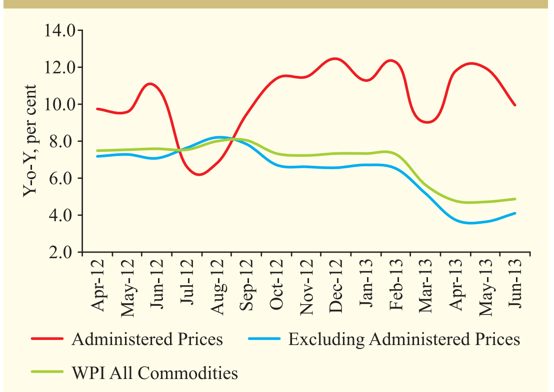


Chart VI.6: Global and Domestic Fuel Prices

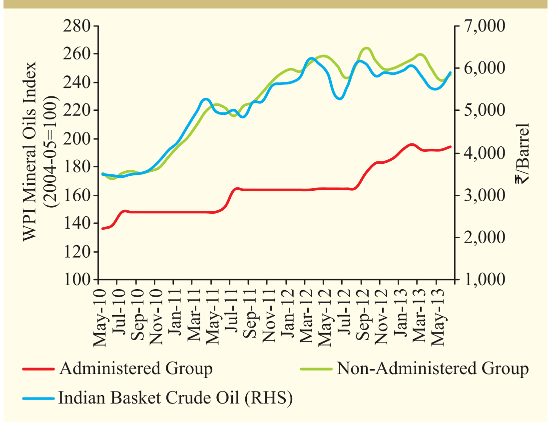
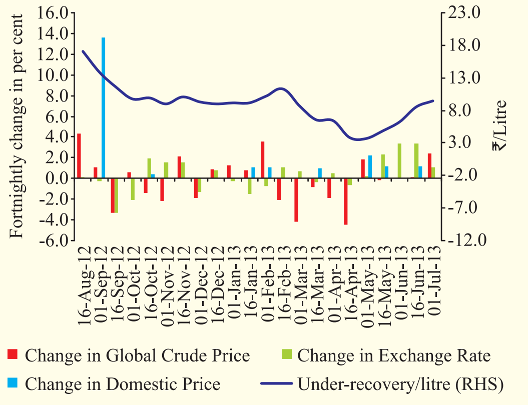


Chart VI.7: Trends in Under-recovery in Diesel



global crude prices and a relatively stable exchange rate led to a significant decline in the extent of under-recoveries. Since mid-May 2013, however, the depreciation in the exchange rate and the increase in global crude oil prices offset the moderating impact of staggered increases in domestic prices. The per-litre under-recovery for OMCs from the sale of subsidised diesel increased to ₹9.5 per litre effective July 16, 2013, from a low of ₹3.7 per litre during the second fortnight of May 2013.

VI.12 Coal India has revised upwards the prices of coal from May 28, 2013, which could lead to an increase in input cost pressures for coal-consuming industries. Given the problems in the coal sector in terms of availability of coal, the government approved the proposal to set up an independent regulatory authority for the coal sector and also approved the introduction of the Coal Regulatory Authority Bill, 2013 in Parliament. This is expected to remove constraints in the sector and ensure improved supply and better clarity in pricing.

VI.13 Several State Electricity Boards (SEBs) revised their prices upwards in May 2013, which led to a 13 per cent increase in the electricity price index in the WPI. Further increases in electricity prices cannot be ruled out, as the increase in coal prices could lead to input price pressures. Further, the government has approved the recommendations of the Rangarajan Committee on natural gas pricing, according to which, domestic natural gas prices would be based on competitive international prices from April 2014. This could lead to increases in costs of production for gas-based power and fertiliser plants. The impact on inflation, however, could depend on how end-user prices are adjusted in line with increasing costs.

Generalised inflationary pressures ease, as the output gap remains negative

VI.14 The non-food manufactured products (NFMP) inflation, which is seen as an indicator of generalised inflationary pressures, declined significantly in recent months to reach 2.0 per cent by June 2013, largely driven by a decline in inflation in the metals and chemicals groups (Chart VI.8). Global metal prices have declined significantly in recent months, leading to a decline in domestic prices, even after accounting for the impact of rupee depreciation.

VI.15 Along with declining input cost pressures, demand conditions also remained weak, leading to lower pricing power of the firms. The Purchasing Managers Index (PMI) for manufacturing indicates that both input costs and output price pressures had ebbed in recent months (Chart VI.9). The PMI for output price declined to below 50 in May 2013, indicating a contraction in output prices. However, the PMI for input price exhibited a sharp turnaround in June 2013, reflecting the impact of rupee depreciation.

Chart VI.8: Contributors to Non-food Manufactured Products Inflation

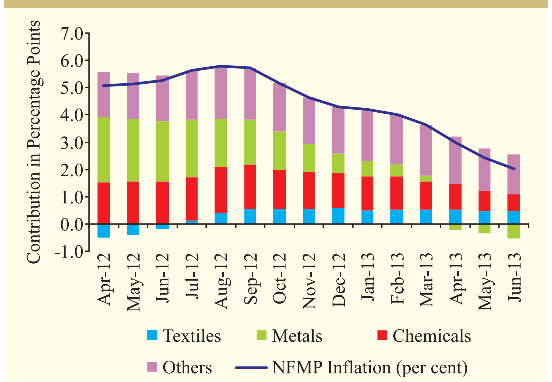
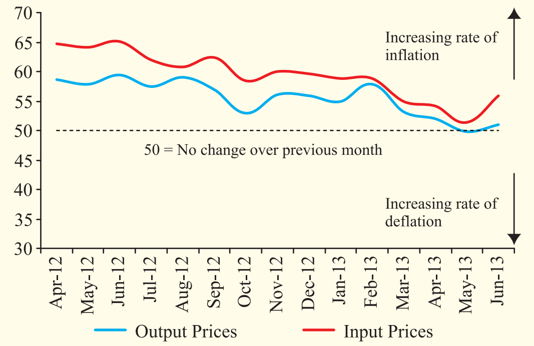


Chart VI.9: Purchasing Managers Index (PMI) Output and Input Prices (Seasonally Adjusted)



Source: HSBC Markit.

Pass-through of exchange rate depreciation could offset benefits from falling commodity prices

VI.16 Global commodity prices have exhibited negative inflation since March 2012. The impact of this on domestic inflation, however, remained muted, as the exchange rate depreciation acted as an offsetting factor (Chart VI.10). In the case of crude oil, the recent firming of global prices along with rupee depreciation pass-through could lead to higher domestic fuel prices. In terms of empirical estimates, while the pass-through of rupee depreciation has come down over period, the impact of the recent depreciation of the rupee on WPI inflation could still be significant. Recent estimates indicate that a 10 per cent depreciation could lead to about 1.0 percentage point increase in the WPI inflation. However, the exact impact could be conditional on a number of factors including how administered prices are adjusted in line with changes in rupee cost of imports and the pricing power of firms.

Real wage growth moderates in the recent period, driven by higher inflation in rural areas

VI.17 Rural wages, which were growing at over 20 per cent (y-o-y) during 2010-12, grew at a slower pace during 2012-13, but still remain in the high double digits. A significant pick-up in rural inflation in recent months contributed to a faster decline in real wage growth (Chart VI.11). There is, however, significant variation in wages and inflation across states (Chart VI.12).

Divergence between WPI and CPI inflation remains wide

VI.18 The Consumer Price Index (CPI-combined: rural + urban) inflation remained close to double digits compared with WPI inflation, which fell below 5 per cent during Q1 of 2013-14 (Chart VI.13). This further widened the gap between WPI and CPI inflation. From the compilation point of view, the CPI and the WPI differ on several counts, such as coverage of commodity/service, weighting diagram, the stage at which price quotations are collected, associated market (*i.e.*, wholesale market, retail market) and base year.

VI.19 The difference between wholesale and retail price levels can largely be attributed to trade

Chart VI.10: Exchange Rate and Commodity Price Movements

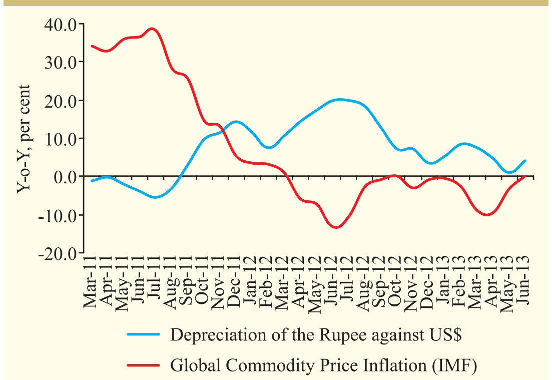


Chart VI.11: Rural Wages and Inflation

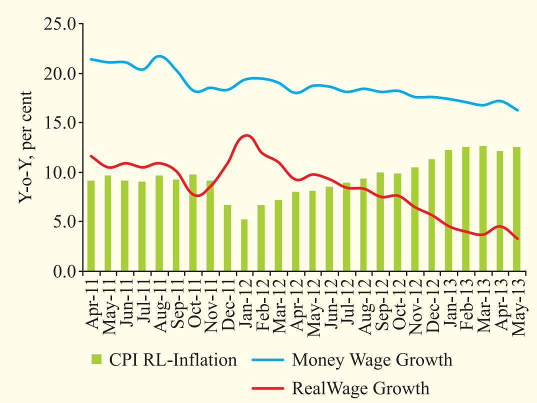
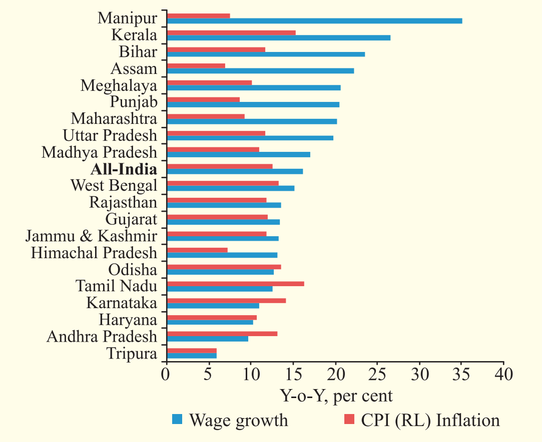


Chart VI.12: State-wise Inflation and Rural Wages, May 2013



and transports margins and taxes across states. In the case of market integration the price pressures should reflect identically in the wholesale and retail markets as movements in wholesale prices should translate to the retail market with some lag. However, supply-demand gap at the regional level, could lead to greater pressures on retail prices than in the wholesale market. This requires improving the current state of supply chain management to provide better market access to farmers, storage facilities and transportation.

Divergence in wholesale and retail inflation remains high in some food items

VI.20 Apart from the divergence attributed to weights and commodities, there has been a divergence in price movements at the commodity group levels. Food price inflation in the WPI moderated at a faster rate than in CPI during February-April 2013 (Chart VI.14). The sharper moderation in the WPI food inflation was due to a decline in inflation of fruits and vegetables along with some softening in the inflation of cereals and pulses, except in May and June 2013. In the CPI, inflation in cereals and pulses remained high, with some moderation in inflation in vegetables and fruits during the same period.

Headline inflation has moderated, but upside risks persist

VI.21 The moderation in headline inflation during Q1 of 2013-14 was on account of declining international commodity prices, negative output gap and past monetary policy actions. The pick-up in headline WPI and CPI inflation in June 2013 suggest that inflation remains a concern even as the non-food manufactured products inflation has recorded a sharp decline to a low of 2.0 per cent. Moreover, CPI inflation rules close to double digit. While slow growth is likely to keep demand conditions largely subdued, risks persist from the recent exchange rate depreciation and the pick-up in global commodity prices, especially of crude oil. These risks underscore the need for continuous vigil and monitoring on the inflation front.

Chart VI.13: WPI and New CPI Inflation

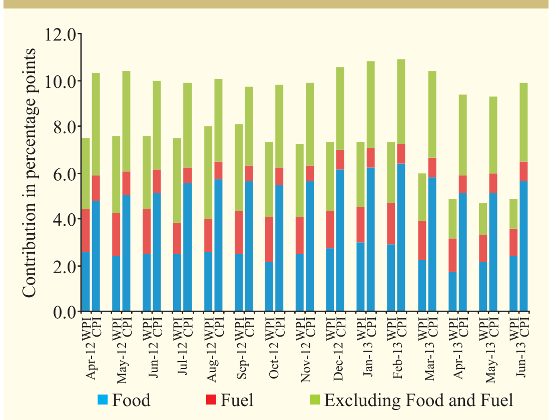


Chart VI.14: Divergence in Food Prices in CPI and WPI