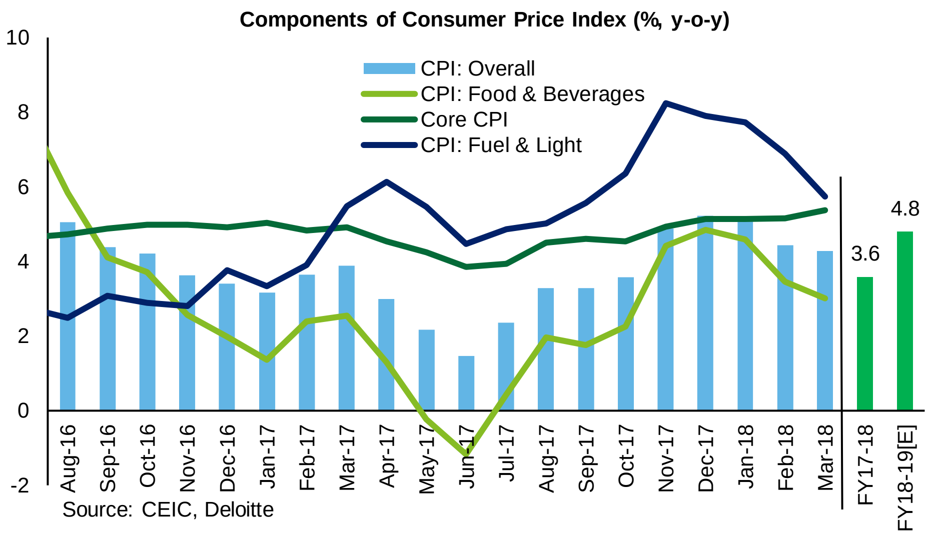
Deloitte.

Economy Gaining Traction However Inflationary Pressures Likely to Take Effect

In its lastest policy review, the Monetary Policy Committee mainted "status quo" on key interest rates with a cautious note on rising inflationary pressures. Since the announcement of the last monetary policy meeting, significant changes have been observed in the domestic and the international environment. Global economic activity has continued to gain momentum, especially finer prints have become visible across US and Euro area with unemployment marking gradual deductions. Domestically, there have been reasons to cheer with healthier production prints and significant improvement in manufacturing growth, especially a healthy pick up in capital goods. Inflation numbers have eased over the last months and with a further deceleration in March data, inflation is well within the RBI's 4% medium-term target for FY 2017-18.

A further softening in inflation rate to 4.3% in Mar'18 came primarily on the back of a slowdown in the more volatile food price inflation and to a larger extent may be a function of favorable base impact. Such impacts are expected to linger in the period ahead and may provide statistically promising inflation prints. Separately, basis expectations of normal monsoon and effective supply management, overall food inflation is expected to remain in comfortable range and may contain possible increase in prices emanating from crude price hike as well as uptick in domestic demand, at least to some extent. Recognizing this, the inflation projections for the coming year have been revised downwards against the estimations made in Feb'18 to 4.7-5.1% in H1FY 2018-19 and 4.4% in H2.

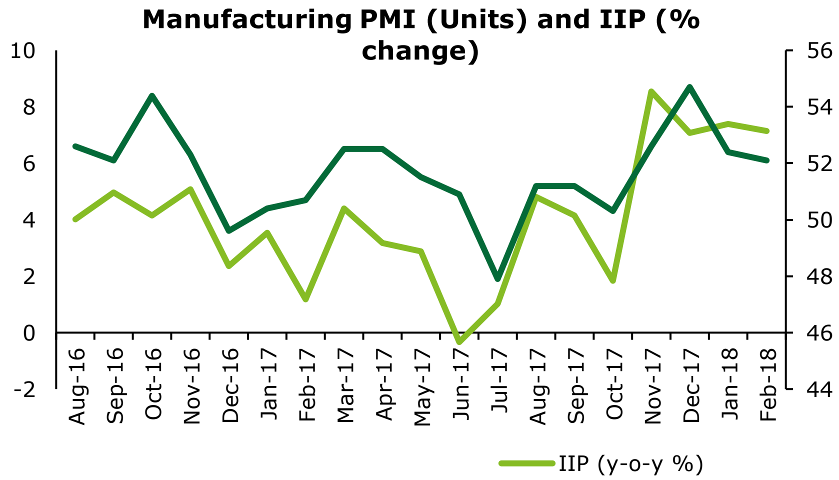


Source: CEIC, Deloitte

Production prints have become stronger over the previous few months, although much of this change can be a reflection of restocking. Even so, the risks (demonetization and goods and services tax) that had previously disrupted market mechnanism appear to have bottomed out. Industrial growth has continued to be led by a stronger than expected manufacturing output. The increase has emanated from better capital goods production and healthy consumer durables production. This data has largely followed survey-based Purchasing Managers' Index prints which has remained in the expansionary zone (see figure) and we believe that if IIP continues to mirror PMI, higher manufacturing output may be expected for the period ahead.

Even so, this segment is not without risks and the rising input costs and building price pressures may prevent a stronger production rebound.

Deloitte.



Source: CEIC, Deloitte

Also, the upside risks to inflation remain that may arise from factors such as fiscal slippage, higher crude and input costs and MSP hikes. These risks are further accentuated by the financial sector volatility and brewing trade wars. As such, inflation in FY 2018-19 is expected to hover around the 5% mark. In the coming months, the MPC is likely to continue to be data dependent while making monetary policy related decisions. That said, the rising gains in 10-year bond yields and risks of a larger fiscal deficit may deter any rate hike in the near term. With this combination of upside risks, continued issues around the NPAs and hardening bond yields, RBI can be expected to continue to tread the path of caution.

Information for the editor for reference purposes only

The authors are Anis Chakravarty, Lead Economist and Partner, Deloitte India and Umang Aggarwal, Economist Deloitte India