VI. PRICE SITUATION

Inflation declined significantly in December 2013, both in terms of the CPI and WPI, driven by falling food prices which had firmed up considerably during April-November. Despite the moderation, CPI inflation continued to remain high near 10 per cent with inflation excluding food and fuel components also persistent at 8.0 per cent. Going forward, inflation is expected to moderate gradually but stay above the Reserve Bank's comfort level. Upside risks to inflation in 2014-15 arise from likely upward revisions in domestic energy prices and growth acceleration. However, global commodity prices, especially for metals, are expected to remain soft and partially counter-balance these pressures.

Inflation continued to be benign in AEs while there were pressures in EMDEs, including in India

VI.1 Inflation remained low in advanced economies (AEs) aided by high unemployment and large spare capacity (Table VI.1). Annual CPI inflation in the OECD countries remained low at 1.5 per cent in November 2013. Negative output gaps and muted commodity price movements imparted a softening bias to inflation even as it remained range-bound, except in Japan. After a year of deflation, inflation in Japan picked up since June to reach a five-year high of 1.5 per cent in November

Table VI.1: AEs continue an accommodative stance while EMDEs hike policy rates

Global inflation and policy rates

Country/ Region	Key Policy Rate	Policy Rate (as on January 27, 2014)	Changes in Policy Rates (basis points)		CPI Inflation (Y-o-Y, per cent)	
			Sep 2009 to Dec 2011	Jan 2012 to Nov 2013	Dec 2012	Dec 2013
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	2.50 (Aug 7, 2013)	125	(-) 175	2.2#	2.7#
Canada	Overnight Rate	1.00 (Sep 8, 2010)	75	0	0.8	1.2
Euro area	Interest Rate on Main Refinancing Operations	0.25 (Nov 13, 2013)	0	(-) 75	2.2	0.8
Israel	Key Rate	1.00 (Oct 1, 2013)	225	(-) 175	1.6	1.8
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10@ (Oct 5, 2010)	(-) 10	0	-0.2*	1.5*
Korea	Base Rate	2.50 (May 9, 2013)	125	(-) 75	1.4	1.1
UK	Official Bank Rate	0.50 (Mar 5, 2009)	0	0	2.7	2.0
US	Federal Funds Rate	0.0 to 0.25 (Dec 16, 2008)	0	0	1.7	1.5
Emerging and Developing Economies						
Brazil	Selic Rate	10.50 (Jan 15, 2014)	225	(-) 50	5.8	5.9
China	Benchmark 1-year Deposit Rate	3.00 (Jul 6, 2012)	125	(-) 50	2.5	2.5
	Benchmark 1-year Lending Rate	6.00 (Jul 6, 2012)	125 (600)	(-) 56 (-150)		
India	Repo Rate	7.75 (Oct 29, 2013)	375 (100)	(-) 75 (-200)	10.6	9.9
Indonesia	BI Rate	7.5 (Nov.12, 2013)	(-) 50	175	4.3	8.4
Philippines	Reverse Repurchase Rate	3.50 (Oct 25, 2012)	50	(-) 100	3.0	4.1
	Repurchase Rate	5.50 (Oct 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep 14, 2012)	(-) 275	25	6.5	6.5
South Africa	Repo Rate	5.00 (Jul 20, 2012)	(-) 150	(-) 50	5.7	5.4
Thailand	1-day Repurchase Rate	2.25 (Nov 27, 2013)	200	(-) 100	3.6	1.7

@: Change is worked out from the minimum point of target range. #: Q4 (Oct-Dec). *: Nov.

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.

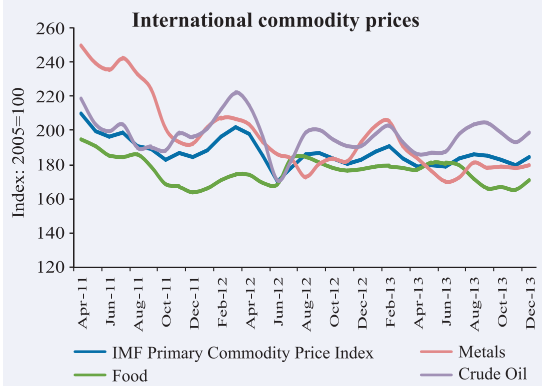
2013, aided by concerted policy efforts to stimulate demand that included the Bank of Japan setting a target of 2.0 per cent inflation in two years in January 2013. In contrast, inflation in some Emerging Market and Developing Economies (EMDEs) was high, driven largely by weaker exchange rates and supply disruptions.

VI.2 Most of the central banks in the AEs continued with unconventional monetary measures to support a fragile economic recovery amid low inflation and well anchored inflation expectations. The European Central Bank, faced with the likelihood of a prolonged period of weak economic activity and low inflation, cut its main refinancing rate by 25 basis points to 0.25 per cent in November 2013. Among the emerging economies, monetary policy was tightened further in Indonesia, India and Brazil as they confronted high inflation. Going forward, inflation risks for EMDEs are likely to remain firm in the near-term conditioned by structural factors and demand pressures in select countries emanating from narrowing output gaps.

Global commodity prices remain range-bound even as US taper begins

VI.3 Global commodity prices in terms of the IMF Primary Commodity Price Index remained largely range-bound during Q4 of 2013 with marginal increase in December as food and energy prices edged up (Chart V1.1). Global food prices declined up to November 2013, led by a downtrend in cereal prices, particularly the prices of wheat following rising supplies from Canada and Australia. Metals prices declined marginally in tandem with weak demand from the EMDEs. Average crude oil prices remained range-bound during November at around US$ 102 per barrel. Brent oil prices, however, rebounded to US$ 112 a barrel in December 2013 on the back of supply disruptions from Libya and South Sudan, while increased oil inventories in the US kept WTI prices range-

Chart VI.1: Range-bound global commodity prices



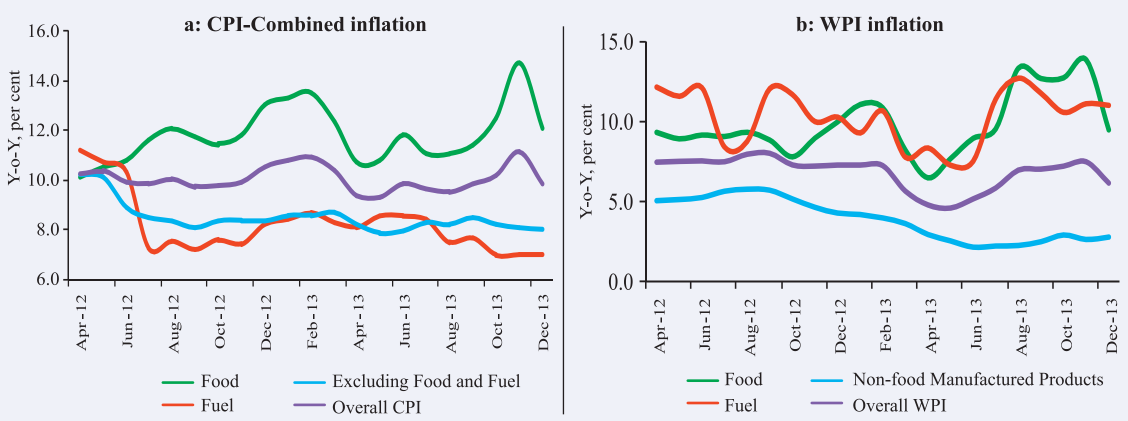
bound. Oil prices have moderated somewhat again in recent days. The immediate impact of the unwinding of the US stimulus taper on commodity prices remains limited as weak demand and improved supply prospects have kept commodity prices largely stable. Favourable outlook on supply and modest demand could keep commodity prices range-bound in 2014 as well.

Inflation in India declined in December 2013 driven by food price moderation

VI.4 Inflation in terms of the all India Consumer Price Index (CPI)-Combined (Rural + Urban) declined to 9.87 per cent in December 2013 from a high of 11.16 per cent in November 2013 induced by a fall in vegetable prices (Chart VI.2a). Despite the moderation, inflation remained persistent with the average CPI inflation at 9.9 per cent during first nine months of 2013-14. Excluding food and fuel components, CPI inflation stood at 8.0 per cent in December 2013 with significant contributions from housing, transport & communications and miscellaneous group, which includes services.

VI.5 Wholesale Price Index (WPI) inflation (y-o-y) in India also moderated to 6.2 per cent in December 2013 from 7.5 per cent in November primarily on account of a decline in vegetable prices. WPI inflation had steadily increased during July-November 2013 from a low of 4.6 per cent in May 2013. A number of

Chart VI.2: Declining food prices lead to moderation in both CPI and WPI inflation



supply-side factors contributed to the pickup in inflation. Vegetable prices more than doubled during April-November leading to y-o-y inflation at 15-year high of 95.2 per cent in November 2013. Fuel price inflation also edged up to the double digit level (11.0 per cent in December 2013) driven by prices of freely priced fuel products and administered price changes in diesel and electricity (Chart VI.2b). Non-food manufactured products (NFMP) inflation exhibited moderate increase as weak demand conditions contained generalised inflationary pressures to some extent, even with exchange rate depreciation and escalation in input costs.

VI.6 The build-up in inflation during 2013-14 so far, has been driven by continued increase in food and fuel group inflation, which accounted for about 70 per cent of the increase in the CPI during April-December 2013 (Chart VI.3). The contribution of these two groups to the increase in the WPI was even higher at nearly 78 per cent.

Food prices fall significantly in December after unprecedented rise during April-November 2013

VI.7 Supply-side shocks to inflation from food have become frequent and price rise cycles are getting elongated (Chart VI.4 and VI.5). Vegetable prices exerted persistent pressures on food inflation propelled by increasing potato prices during April-July, ginger prices during April-June, onion prices during June-September

Chart VI.3: Build-up of inflation during 2013-14 so far is dominated by the food and fuel segments

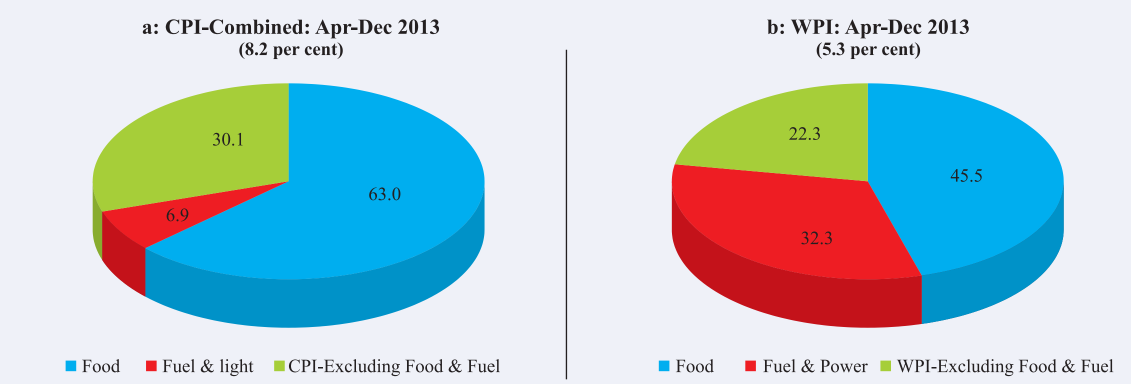
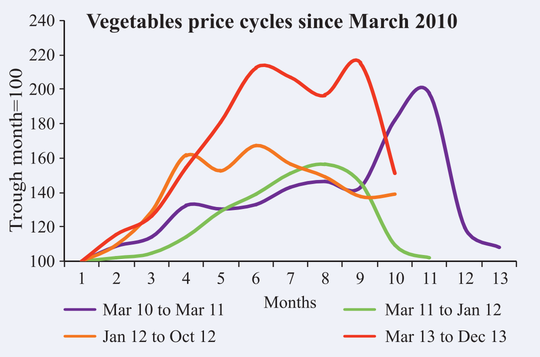


Chart VI.4: Recent spike in vegetables prices was more pronounced but decline has also been sharper



and tomato prices during November. Apart from seasonal pressures, rise in vegetable prices in the recent period also pointed to uncompetitive intermediation structures with multi-tiering of traders and cartelisation in APMCs, besides reflecting a rise in input costs, including rural wages. Among other food articles, rice price inflation escalated to over 20 per cent in Q2 of 2013-14 on the back of output shortfalls, rising input costs, higher procurement and an upsurge in exports. Rice prices declined in December 2013 with the new crop arrivals.

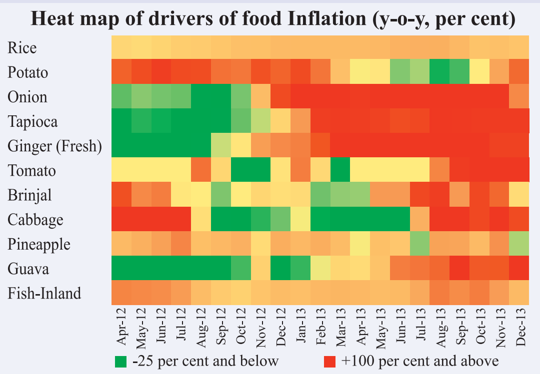
Prices of vegetables moderated with seasonal crop arrivals

VI.8 The spike in vegetable prices was adjudged to be temporary by the Reserve Bank while formulating its Mid-Quarter Review of Monetary Policy in December 2013. In line with this assessment, vegetable prices fell sharply in December 2013 with brinjal, onion, cabbage, tomato and peas recording monthly fall in prices in the range of 31-43 per cent at the wholesale level. Data from the Reserve Bank's regional price monitoring indicate that there were further corrections in vegetable prices in the first fortnight of January 2014. Tomato prices declined by over 15 per cent both in the wholesale and retail markets over the previous fortnight. Potato and onion prices also experienced a fall of over 7 per cent in both markets. Data on prices of essential commodities released by the Price Monitoring Cell (PMC) of the Ministry of Consumer Affairs, Food and Public Distribution also corroborate this trend.

Fuel inflation remains high driven by administered price changes

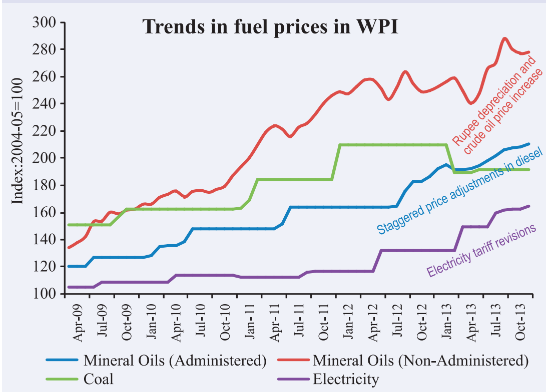
VI.9 High domestic fuel inflation amidst range-bound global crude oil prices reflected the impact of exchange rate pass-through and the role of administered price changes. Revisions in the administered prices hiked up fuel inflation even as prices of freely priced products showed some decline in recent months, thereby making fuel inflation more persistent (Chart VI.6). Retail prices of diesel were increased in a staggered manner during September-December 2013. Furthermore, rise in electricity prices in August and December 2013 also exerted pressure on the fuel group inflation.

Chart VI.5: Multiple pressure points on food prices



Note: Shades between green and red indicate increasing order of inflation.

Chart VI.6: Fuel group inflation led by administered price revisions



VI.10 Although the revisions in administered fuel prices led to some decline in suppressed inflation, the gap persists for certain subsidised items. The under-recoveries of oil marketing companies (OMCs) continued to remain high at ₹ 600 billion during H1 of 2013-14, of which around half was on account of diesel.

CPI ex-food and fuel inflation stays persistent

VI.11 CPI excluding food and fuel inflation averaged high at 8.1 per cent during 2013-14 so far. Housing and transport & communication emerged as major contributors to non-food non-fuel CPI inflation (Chart VI.7). Also, persistent contribution to CPI inflation from services such as education and medical care was reflective of the second round impact of increase in input costs and wages on aggregate inflation. The CPI excluding the food and fuel components includes transport and communication, wherein rising fuel prices exhibited input cost pressures.

Wage pressures continue to remain significant

VI.12 Wage inflation pressures remained significant despite some reduction in the rate at which wages increased. Staff costs for a sample of corporate firms increased at about 14 per cent (y-o-y) in Q2 of 2013-14 despite a weaker employment scenario. In nominal terms, rural wage growth showed a declining trend for over two years, but the rate of increase at 15.5 per cent in October 2013 was strong and continued to exert pressure on overall inflation (Chart VI.8). Real rural wage growth showed a sharper decline in the recent period as increasing CPI-rural labour (RL) based inflation eroded a part of the gains from rising nominal wages.

VI.13 State-wide dispersion in rural wage inflation was considerable (Chart VI.9). Such wide disparities in wage inflation linkages also point to the role of state-specific factors.

Chart VI.8: Rural wage inflation remains high despite deceleration in nominal and real terms

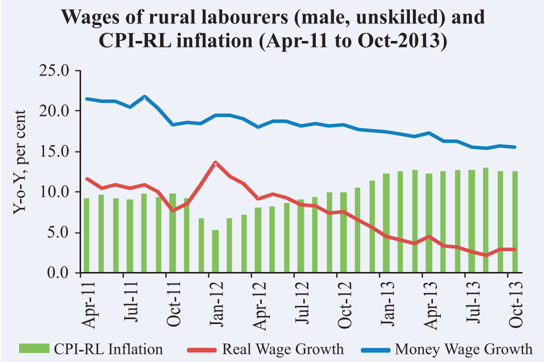
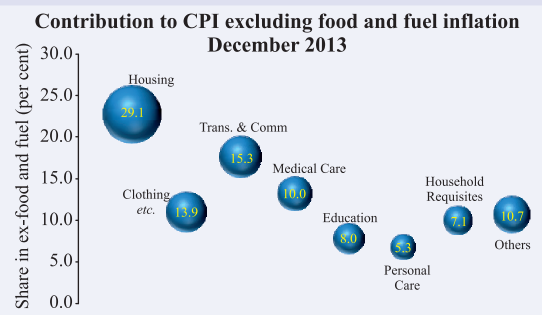


Chart VI.7: Pressure on CPI excluding food and fuel inflation from housing, transport & communication and services



Note: Figures within the spheres indicate the contribution to CPI-excluding food and fuel inflation.

Chart VI.9: Inter-state dispersion in rural nominal wage growth