26 June 2024

India's K-shaped inflation

Economics
India

What does it mean for policymaking?

- The same developments driving a K-shaped recovery seem to be driving K-shaped inflation dynamics
- Indeed, food inflation is outstripping core, rural outdoing urban, goods more than services, and input prices higher than output
- With supply shocks becoming more frequent, monetary policymaking and reforms may need to adjust

While the K-shaped growth recovery debate has been raging for a while, many have missed the K-shaped price dynamics. There are different ways to slice the inflation data, and across most of them, one part of inflation is rising while the other is falling (see report for details). Perhaps inflation and growth dynamics were never meant to differ. The same shocks that are driving the variance in growth, like the pandemic and climate change, hurting some groups more than others, are also likely driving the variance in prices.

Let's work with one example, the ongoing heat waves, which have made us realise that climate change is not just about uncertain rains, but also higher temperatures. It can be argued that crop damage and livestock mortality led to a rise in food prices as well as a loss in income for rural Indians, explaining the coexistence of **higher food and lower core inflation**. Where food imports were possible, prices did not go up much, leading to **high but not too widespread food inflation**. The government lent a helping hand by cutting several fuel prices, but many of those fuels are not commonly used in rural areas, like they are at urban centres, leading to **rural inflation being much higher than urban**.

With falling incomes, this group just about managed to afford necessary goods, keeping demand and price of services low, and explaining why **goods inflation remains higher than services**. Corporates facing weak demand did not raise prices, instead taking a hit on margins, and explaining why **input inflation is outpacing output inflation**.

And this is not just limited to weather shocks. We can apply the same reasoning to several others – the pandemic and global commodity price volatility. Such supply-side shocks that impact income and inflation faced by various groups differently, are becoming more frequent. And this will complicate policymaking. For instance, should the RBI, ruminating its next move, worry about the c5ppt wedge between food and core inflation, or should it take solace that headline inflation is the closest to target in several months?

There are no simple answers. Eventually the RBI may have to focus on the expected direction of change in the short run. For instance, if rains pick up, reservoirs fill back up, and sowing rises, eventually food inflation will soften. The RBI may find a little bit of room to ease later in the year, even if medium-term pressures from "recurring and overlapping" climate related events, as the RBI governor called them recently, remain. Meanwhile the government, too, may need to be more sensitive about the impact of policy changes across different groups already reeling under supply-side shocks. Reforms may need careful explaining and planning. Welcome to the brave new world.

HSBC

We see inflation from various lenses, and it looks rather K-shaped. The divergence in the inflation faced by different groups is often times driven by the same shocks that create disparities in their incomes. Some of these supply shocks include the pandemic, climate change, commodity prices shocks, and in certain cases can also include policy shocks.

Here we elaborate on India's K-shaped inflation across various cuts:

Food versus core inflation

Over the past year, food inflation has been rising while core inflation has softened (Exhibit 1). The drivers of both have also seen a sea change.

Core inflation has fallen, led partly by Chinese disinflation and the RBI's resolve

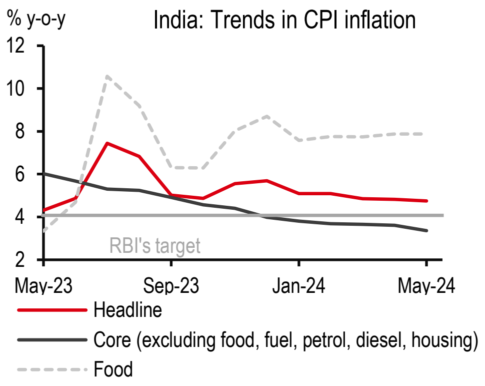
Let's start with core inflation. We update our model, and it throws up some interesting new drivers of disinflation. **One**, during the last bout of core disinflation, the main driver was the output gap; while this time around it is imported disinflation from China (Exhibit 2).

Two, some normalisation in informal sector production (proxied by consumer staples production), after disruption in the pandemic period has also helped ease core price pressures this time around. This wasn't amongst the drivers last time.

Three, in earlier times, past inflation was a driver of future inflation. If inflation was high, it would remain high for longer. Now future inflation expectations matter much more, and the belief that RBI's hawkishness will keep inflation anchored around the 4% target has played a role in driving down core prices. In other words, inflation targeting seems to have had some of the desired results.

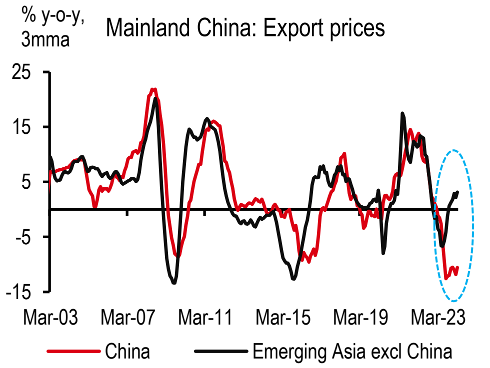
As long as the three factors remain supportive, core inflation is likely to remain under control (Exhibits 3 and 4). The risk, in our view, is rising global commodity prices, already up 10% since the start of the year.

Exhibit 1: Food inflation has been rising while core inflation has softened



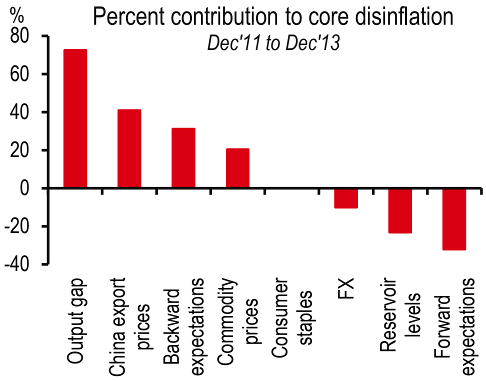
Source: CEIC, HSBC

Exhibit 2: Imported disinflation from China has partly been driving India's core disinflation



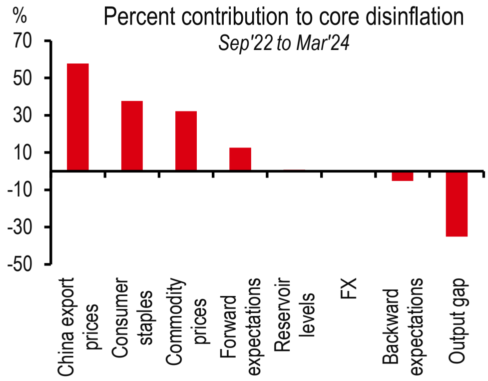
Source: CPB, HSBC

Exhibit 3: Drivers of core disinflation in the past



Source: CEIC, HSBC calculations

Exhibit 4: Drivers of core disinflation now



Note: This is based on our core inflation model.
Source: CEIC, HSBC calculations

Food prices have shot up, led by weak rains and heatwaves

Food inflation remains a big worry. It has, in our view, been impacted by the changing nature of weather events. In the past, El Niño came with low rainfall, and the country's obsession with following daily rains was well known.

But now, it is not just about rains (Exhibit 5), but also high temperatures leading to an unprecedented heatwave over the past few months. This combination of low rains and high temperatures has impacted the price of:

- **Vegetables** (for which prices have risen 27% y-o-y, Exhibit 6),
- **Wheat** (for which the government's open market sales to keep market prices down have been much higher than the regular public distribution for welfare schemes, and now global prices have risen back up making imports more expensive), and
- **Pulses** (for which despite large imports and open market sales, inflation is at 17% y-o-y, Exhibit 7).

And this is not where it ends. **Livestock** mortality has shot up as a result of the heatwaves, and is hurting the production of eggs, meat, and milk.

With **WPI food** rising recently, our worry is that **CPI food** inflation could tick higher over the short run (Exhibit 8). And if rains don't normalise over July and August, the resultant food stress of 2024 could arguably be worse than in 2023, given low stocks of wheat and pulses in the granaries.

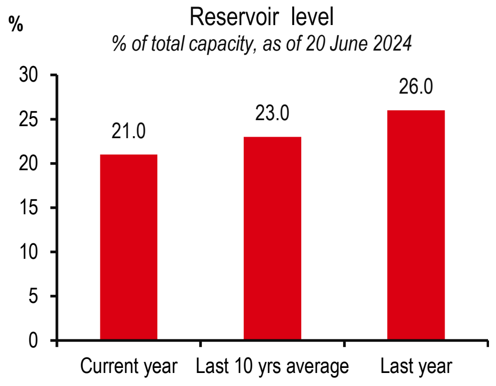
Whether or not it rains in the next few weeks will determine RBI action

Will the weather turn? Rainfall is forecast to be above-normal in the season running from June to September 2024, as a La Niña is expected to develop over the next few months. In the past, La Niña has been associated with more rains and cooler temperatures.

But so far in June, rains remain 17% below normal with the Northwest region, which grows most of India's cereal, at a c63% deficit. **Whether or not rains increase over the next few weeks, and sowing activity, are likely to determine future inflation.**

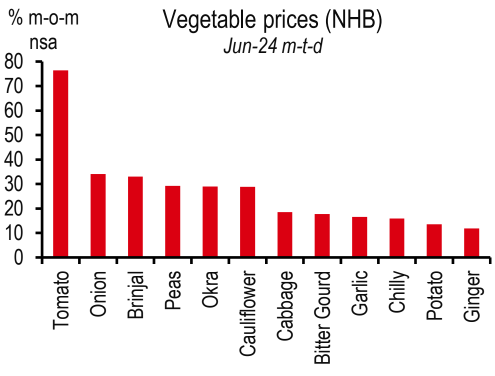
If, indeed, rains normalise, inflation could fall sharply and the RBI may be able to cut rates. This is our base case assumption and we forecast a shallow rate cutting cycle of 50bp, taking the repo rate from 6.5% now to 6% by March 2025. The risks are of no easing if rains do not pick up.

Exhibit 5: Reservoir levels are weak



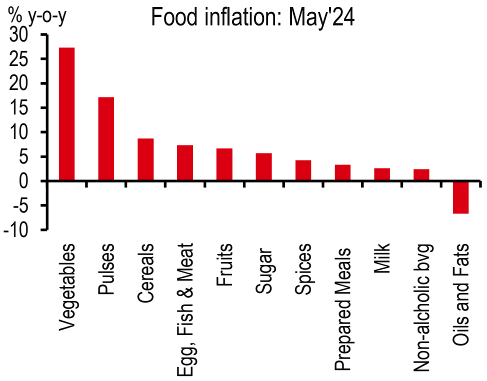
Source: CEIC, HSBC

Exhibit 6: Several vegetable prices have risen in June



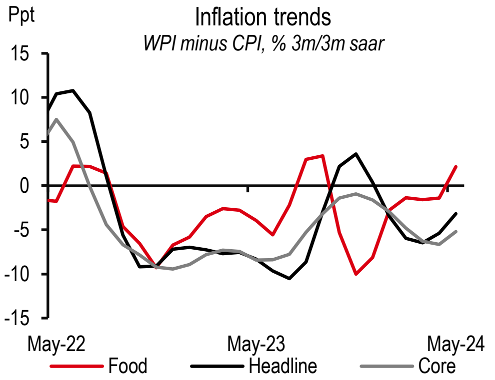
Source: CEIC, HSBC

Exhibit 7: Weather events have impacted food prices meaningfully



Source: CEIC, HSBC

Exhibit 8: WPI food has been rising recently



Source: CEIC, HSBC

Depth versus spread of inflation

Higher food imports of some items may have ensured that…

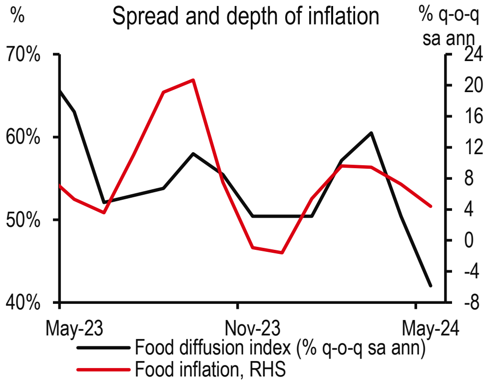
We have created a diffusion index that picks up the proportion of items where inflation is high, which we define as items where inflation has crossed the 4% mark. As such, it is a measure of the spread of inflation.

For the food basket, we find that the **spread of inflation has fallen in recent months, even as overall inflation rates remain elevated** (Exhibit 9). Less concentrated food inflation is likely to be related to the fact that the country is importing a lot of food, as can be seen from a considerable rise in agricultural imports (Exhibit 10).

…the spread of inflation is not as worrisome as its depth

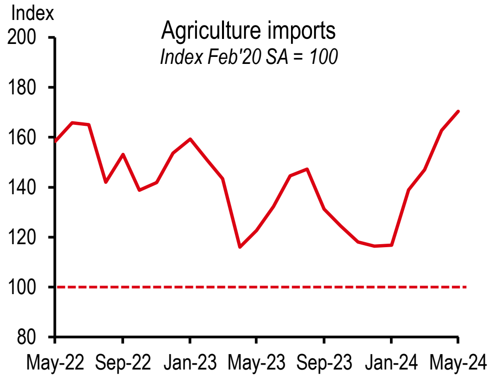
And on the margin we think this is good news. A high inflation problem across more food items would have been harder to solve.

Exhibit 9: Spread of food inflation has fallen, while food inflation rates remain elevated



Source: CEIC, HSBC

Exhibit 10: Agriculture imports have risen



Source: CEIC, HSBC

Rural versus urban inflation

Rural inflation is higher than urban…

Rural inflation at 5.3% in May outstripped urban inflation by 1.1ppt. And we see much of this driven by the wedge in food and fuel inflation (Exhibit 11), even as there is no real wedge between rural and urban core inflation.

Let's starts with core inflation. On a sequential basis, it seems core inflation is the same in rural and urban India. One would like to think that rural core inflation should be lower than urban since rural economic growth has been slower. But back-to-back disruption in rural income also means that potential growth has arguably fallen and just with little growth, core inflation can remain high (Exhibit 12).

…led by peculiarities of rural India when it comes to fuel and food prices

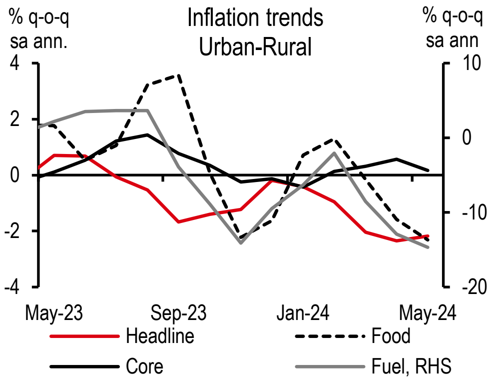
Fuel inflation dynamics are different. The government cut the price of petrol, diesel, and LPG, each of which are consumed more in urban India. As such urban energy inflation fell more quickly than rural inflation.

Food inflation dynamics are most mysterious. One would think rural food inflation should be lower than urban food given rural India grows the food. But there are two hypotheses on why rural food prices remain so much higher:

One, with incomes hurt, farmers are making more effort to sell food to urban procurers where the return may be higher, leaving a shorter supply left back in rural areas.

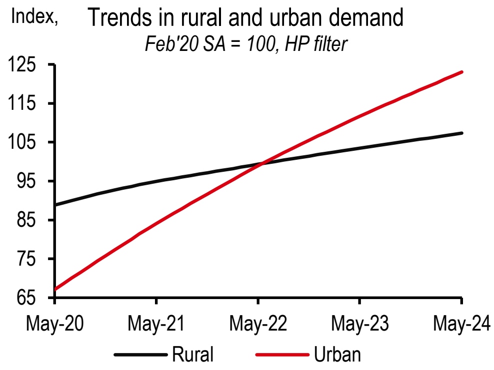
Two, a higher proportion on food was imported this time around, and port-to-fork infrastructure is likely to be more efficient in urban India.

Exhibit 11: Much of the wedge between rural and urban inflation is driven by food and fuel



Source: CEIC, HSBC

Exhibit 12: Back-to-back disruption in rural India has likely hurt potential growth



Note: Based on our rural and urban activity indicator.
Source: CEIC, HSBC

Input versus output inflation

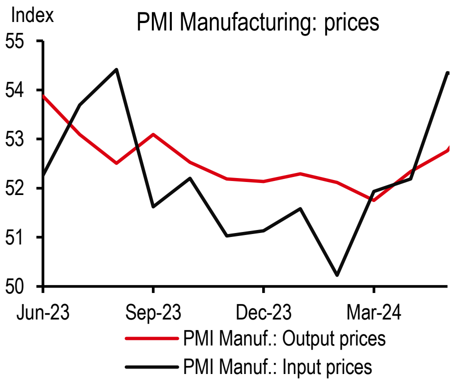
Input prices are far outpacing output prices

With higher food inflation, rising global oil and industrial metal prices, it is no surprise that input prices are rising quickly. But we notice that output prices are not rising as swiftly (Exhibit 13).

This means that manufacturers are not finding it prudent to pass on higher prices to consumers, perhaps because overall consumption demand is weak (partly weighed down by supply-side shocks).

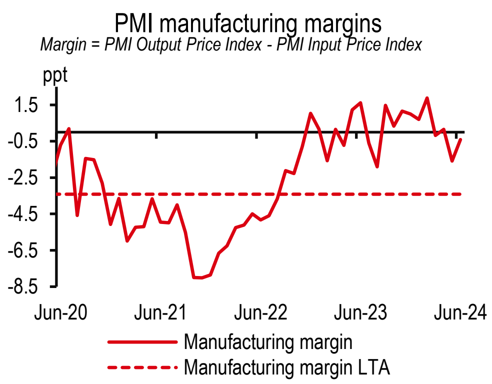
Instead they are taking a hit on the margins (Exhibit 14).

Exhibit 13: Input prices are rising quickly



Source: S&P Global PMI, HSBC

Exhibit 14: Manufacturers are taking hit on their margins



Source: S&P Global PMI, HSBC

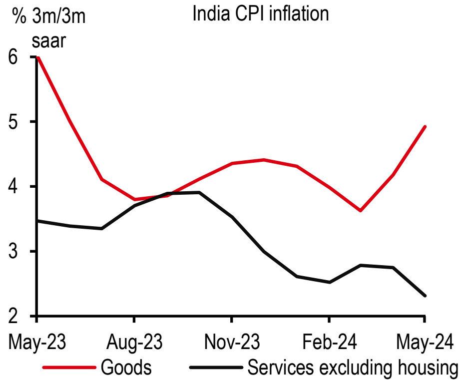
Goods versus services inflation

Goods inflation remains well above services inflation, indeed looking like a perfect K (Exhibit 15). It is worth noting here that India is amongst the few large economies where services inflation did not take off post-pandemic.

Goods demand and inflation have been running higher than services

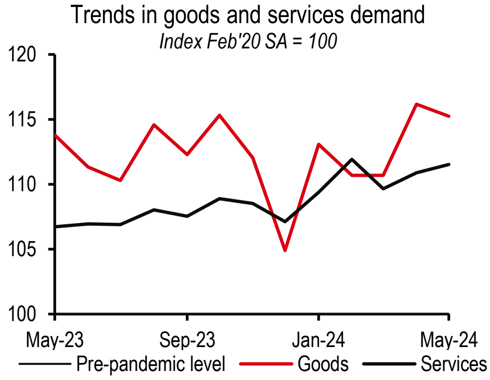
Again, we believe it's all interlinked. Supply shocks that kept incomes weak (for instance high temperatures hurting rural demand), likely led to a situation where incomes were just about enough to afford the necessary goods. Demand for services and therefore the price of services remained low (Exhibit 16).

Exhibit 15: Goods inflation remains well above services inflation



Source: CEIC, HSBC

Exhibit 16: Demand for services is lower than for goods



Source: CEIC, HSBC

Disclosure appendix

Additional disclosures

1 This report is dated as at 26 June 2024.

2 All market data included in this report are dated as at close 25 June 2024, unless a different date and/or a specific time of day is indicated in the report.

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