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UPDATE

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**Wholesale prices softer, RBI to stay cautious on food inflation.** As expected, fruits and vegetables inflation in July restricted any significant softening in headline WPI inflation trajectory, even as core WPI moved lower. Barring fruits and vegetables, on a yoy basis, most of the key components saw inflation falling or remaining stable, except for manufactured food products. However, the overriding concern on the food price inflation will keep the RBI on a cautious stance.

#### Vegetables lead WPI inflation higher

Vegetable prices increased 23% mom leading to WPI inflation remaining above the 5% mark. This was expected and the trend in vegetable prices was mirrored in the CPI inflation release earlier. Exhibit 1 shows the indicative price increase in July compared to last month. Given the higher weight of food in CPI, the impact of higher vegetable and fruits inflation was different for headline CPI inflation than for headline WPI. July WPI inflation came in at 5.19% (June at 5.43%). This compares with headline CPI inflation of 7.96% (June at 7.46%).

#### Core inflation softens but momentum remains unchanged

Core (non-food manufactured products) inflation fell sharply to 3.58% after a print of 3.91% in June. On a yoy basis, there was softening across almost all of the components. For the core index, momentum remained unchanged (mom seasonally adjusted) and showed an uptick on a 3m/3m annualized basis. Some of the recent depreciation in the currency will likely feed into the core inflation over the next few months. This will likely keep the core inflation stable for the next few months. However, we will need to closely watch the changes in core inflation to gauge the impact of the recent uptick in consumer sentiments on core inflation.

#### Wholesale inflation will be of limited importance in RBI's policy

After the establishment of headline CPI inflation as the nominal anchor, the WPI inflation seems to be the less favored child. The most important information is to be derived from the core inflation that can also provide some indications of changes in the imported inflation apart from the likely pricing power of manufacturers. With core inflation remaining stable, there is unlikely to be many other cues that one can draw from the WPI reading. We expect headline inflation to average 5.2% in FY2015 with core inflation remaining at around 3.5% to 3.6% for the rest of FY2015.

#### RBI's likely focus for monetary policy: 6% retail inflation and monsoon-led food price distortions

The RBI's reaction function will hinge on retail inflation transitioning to 6% by January 2016, which would require a structural shift in inflation dynamics. The RBI will continue to stay cautious on the risks out of a deficient monsoon (headline CPI inflation be higher by 70 bps in 2HFY15 and 30 bps lower GDP growth) in FY2015, even as such issues will continue to haunt policymakers unless significant improvements in the agricultural productivity and production is attempted. Similarly, speedy removal of bottlenecks to growth on the manufacturing side is also envisaged so that supply responses are smoother from the manufacturing side towards rises in aggregate demand.

In the near term, upside risks to the 8% mark by January 2015 (as is also indicated by our CPI model) will keep the RBI guarded and hence, we maintain our call for an extended pause till end-CY2014. To reiterate, key risks for the RBI on inflation would be: (1) meaningful and sustained reduction in food prices, (2) qualitative and quantitative correction of fiscal imbalances, (3) supply-side correction to accommodate higher aggregate demand without inflationary pressures and (4) global events like geopolitical risks, commodity prices and other global central banks' action.

#### QUICK NUMBERS

- July WPI inflation at **5.2%**
- Vegetable price index increased **23% on mom basis**
- Core inflation at **3.58%**

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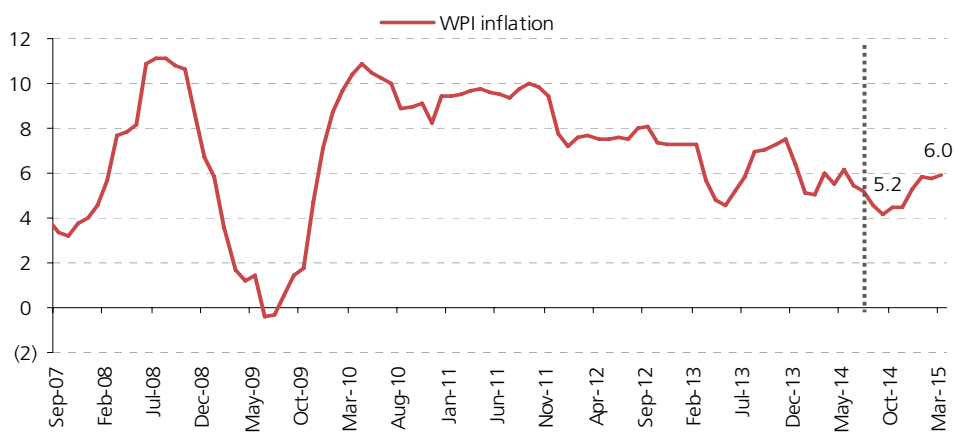
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**Exhibit 1: Vegetables prices have increased more than normal in July**  
Change in select vegetables average prices over last month (%)

	Weightage WPI	mom changes (%)						
		January	February	March	April	May	June	July
Brinjal	0.30	(16.6)	5.8	8.9	(9.6)	10.3	15.1	28.6
Cabbage	0.19	(30.9)	(10.0)	1.1	12.2	14.7	45.5	34.7
Cauliflower	0.24	(19.1)	(12.8)	8.5	13.2	44.5	39.2	20.5
Onion	0.18	(33.4)	(19.2)	6.9	(0.4)	11.5	25.7	43.0
Potato	0.20	(21.1)	(9.6)	10.6	13.0	11.6	11.1	15.4
Tomato	0.27	(48.3)	(20.2)	13.5	4.7	2.7	17.1	166.0

Source: National Horticulture Board, Kotak Economic Research

**Exhibit 2: WPI inflation likely to fall till November on base effects**  
Trend in headline WPI inflation (%)



Notes:

(a) Assuming Rs0.5/liter per month increase in diesel prices till March 2015.

Source: CEIC, Kotak Economic Research estimates

"I, Suvodeep Rakshit, hereby certify that all of the views expressed in this report accurately reflect my personal views. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the views expressed in this report."

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