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UPDATE

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Keep an eye on monsoon-led price pressures. Even as the wholesale and retail inflation provided comfort, the next few months will prove to be challenging. Signs of a deficient monsoon and weak acreage have increased the risks of a repeat of the 2009 phase of high food inflation. With uncertainty on inflation trajectory and the fiscal situation remaining precarious, we maintain our call for an extended pause in policy rates.

Phase of comfortable retail inflation...

Headline CPI inflation eased substantially in June at 7.3%—the lowest yoy print since the inception of the series. Though the correction was across the board, the largest contributor was moderation in food inflation to 7.9% from 9.2% in May. Broad-based correction in miscellaneous items inflation (comprising education, medical care, household requisites) has largely helped ease June core inflation by ~33 bps to 7.4%. The consistent easing of core CPI inflation indicates that demand-side pressures on inflation are subdued at this point in time. On the other hand, the favorable base effect that kicks in from July could further ease headline and core CPI inflation.

...with wholesale inflation providing some relief

WPI inflation moved lower in June, printing 5.4% after 6.0% in May. Significant yoy moderation was owing to decline in primary and fuel inflation to 6.8% and 9.0%, respectively, partly helped by a favorable base effect. Within primary articles, food inflation eased to 8.1% from 9.5% in May, but sequentially increased 2.2% led by a sharp acceleration in vegetable prices (16% mom). With incremental news on *kharif* sowing not too encouraging and vegetable inflation pressures re-emerging strongly, food inflation may be impacted materially in the next few months. Separately, manufactured goods inflation rose marginally in June to 3.61% with core picking up to 3.91% from 3.82% previously. However, the sequential momentum of core has remained comfortable.

Risks of monsoon-led food price surge remain

The upside risk to inflation remains strong with the monsoon yet to pick up in most parts of the country. Risks of drought are increasing as we enter the critical sowing month of July. According to our estimates, July rainfall has ~50% correlation with *kharif* production. The seasonal rainfall deficit remains at an abysmal 42.6% below normal while the *kharif* acreage till July 4 is ~43% of last year. The reservoir and basin levels have turned deficient (10% over the last 10 years' average levels and 34% over last-year level). This removes the comfort of sustaining sowing with lower precipitation level and increases the risks of lower agricultural production.

Lower retail inflation may not imply lower policy rates

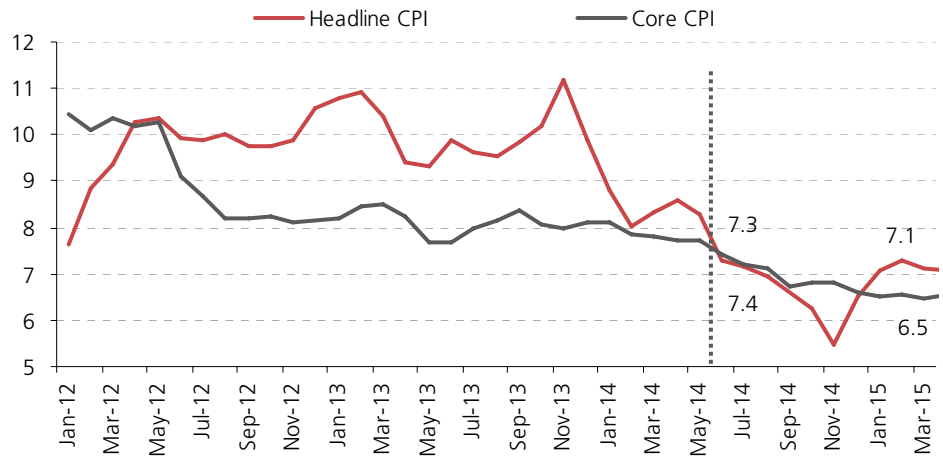
The inflation prints paint a relatively comfortable picture without any significant uptick in the core inflation. However, we remain cognizant of the inflation risks emanating from (1) resurgence of food inflation on the back of weather uncertainties, which could have significant impact on secondary inflation given higher weight of food in India's consumption basket and (2) possibility of exacerbating the aggregate demand-supply mismatch and thus inflation expectations if growth picks up in 2HFY15 given the government's pro-growth policies. The RBI would watch the supply response of the government to combat these inflationary pressures. Given risks of higher price pressures over the next few months, we maintain our call for an extended pause in policy rates.

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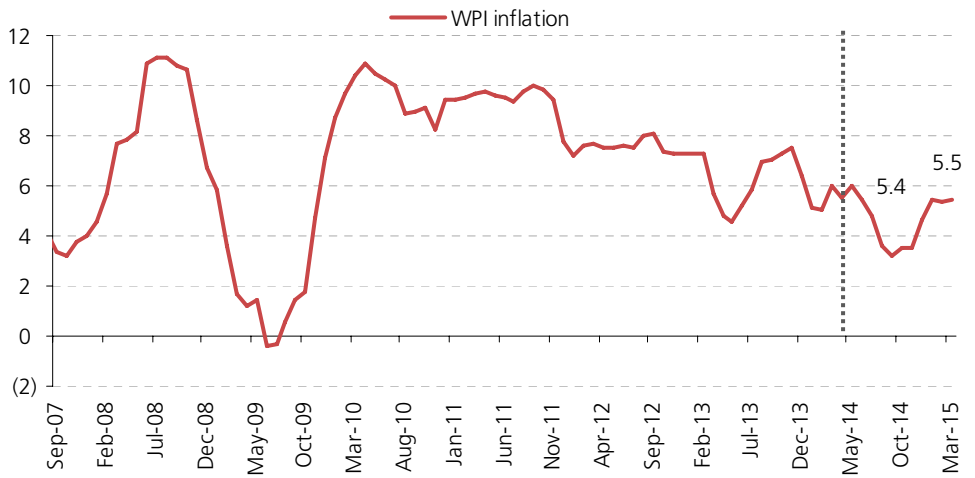
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Exhibit 1: CPI inflation eases across the board
Trends in headline and core CPI inflation (%)



Source: CEIC, Kotak Economic Research estimates

Exhibit 2: WPI inflation also moderates in June
Trends in headline WPI inflation (%)



Source: CEIC, Kotak Economic Research estimates

Exhibit 3: Rainfall in India remains deficient

Deviation of cumulative actual rainfall from normal (%)

	4-Jun-14	11-Jun-14	18-Jun-14	25-Jun-14	2-Jul-14	9-Jul-14
India	(28)	(40)	(42)	(38)	(43)	(42)
All-India normal rainfall (mm)	19	49	86	132	188	250
Scanty (< -59%)						
Gujarat region	(90)	(97)	(78)	(86)	(92)	(92)
Saurashtra and Kutch	(83)	(95)	(18)	(64)	(77)	(83)
West Madhya Pradesh	(91)	(96)	(53)	(63)	(75)	(74)
East Rajasthan	(28)	(66)	(56)	(51)	(68)	(73)
West Uttar Pradesh	(79)	(92)	(55)	(63)	(63)	(69)
Madhya Maharashtra	(21)	(35)	(51)	(59)	(70)	(69)
Vidarbha	(81)	(83)	(29)	(56)	(66)	(67)
West Rajasthan	(42)	(65)	(74)	(50)	(57)	(66)
Marathwada	(82)	(69)	(74)	(75)	(80)	(63)
Konkan and Goa	(71)	(78)	(37)	(51)	(66)	(60)
Deficient (< -19% to -59%)						
Uttaranchal	(64)	(78)	(57)	(58)	(56)	(58)
Nagaland, Manipur, Mizoram and Tripura	(52)	(68)	(62)	(51)	(52)	(55)
Chhattisgarh	(38)	(76)	(62)	(50)	(49)	(54)
Telangana region	49	(35)	(37)	(49)	(59)	(52)
Odisha	(66)	(74)	(72)	(66)	(53)	(52)
Punjab	(70)	(91)	(83)	(65)	(36)	(51)
Coastal Andhra Pradesh	(7)	(44)	(65)	(72)	(67)	(50)
Coastal Karnataka	(83)	(71)	(35)	(30)	(46)	(50)
East Madhya Pradesh	(95)	(97)	(25)	(19)	(42)	(50)
Haryana, Chandigarh and Delhi	8	(64)	(10)	(32)	(41)	(47)
Kerala	(53)	(31)	(29)	(18)	(31)	(41)
Jammu & Kashmir	13	(43)	(49)	(48)	(34)	(38)
Himachal Pradesh	45	(36)	(31)	(37)	(22)	(35)
North interior Karnataka	(15)	(15)	(35)	(40)	(51)	(34)
Lakshadweep	(42)	0	(12)	(30)	(27)	(30)
South interior Karnataka	122	22	(3)	1	(18)	(28)
Arunachal Pradesh	(55)	(27)	(44)	(32)	(29)	(27)
Assam & Meghalaya	(50)	(18)	(37)	(21)	(22)	(24)
East Uttar Pradesh	(61)	(84)	(57)	(40)	(50)	(21)
Normal (-19% to +19%)						
Andaman & Nicobar Islands	(55)	(15)	16	(3)	(15)	(8)
Gangetic West Bengal	35	(41)	(44)	(19)	(10)	(8)
Jharkhand	(57)	(69)	(62)	(26)	(22)	(3)
Rayalaseema	118	59	9	(11)	(8)	(2)
Bihar	18	(6)	(34)	(9)	(16)	7
Sub-Himalayan West Bengal and Sikkim	20	61	15	20	14	9
Excess (> +19%)						
Tamil Nadu and Pondicherry	85	41	(0)	(6)	26	20

Source: IMD, Kotak Economic Research

Exhibit 4: Reservoir levels have turned deficient

Reservoir levels for 84 large reservoirs, bn cubic meters (BCM)

	12-Jun-14	19-Jun-14	26-Jun-14	3-Jul-14	10-Jul-14
Current live storage (BCM)	39.3	37.7	38.0	36.9	36.5
Live capacity at FRL (BCM)	155.0	155.0	155.0	155.0	155.0
Corresponding storage last year	31.2	36.5	37.2	44.6	57.0
Corresponding storage last 10-year average	26.0	26.6	29.0	33.1	40.6
% storage as FRL capacity	25.4	24.3	24.5	23.8	23.5
Corresponding % last year	20.1	23.5	24.0	28.8	36.8
Corresponding % (last 10-year average)	16.8	17.1	18.7	21.3	26.2
Current years's storage as % of last year	125.9	103.3	102.1	82.6	64.0
Current years's storage as % of last 10-yr average	151.0	141.8	131.0	111.5	90.0
Reservoir surplus/(deficiency) (%)	51.0	41.8	31.0	11.5	(10.0)

Source: Ministry of Water Resources, Kotak Economic Research

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