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UPDATE

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Lackluster growth, sticky inflation. Headline CPI inflation of 7.8% in August was lower than that in July but food inflation was high at 9.2%. Core inflation eased by ~50 bps, indicating weak underlying demand-side dynamics. Industrial production weakened to a meager 0.5% rise in July. The demand slack is also indicated in a contraction in the consumer goods sector, and the capital goods sector, which contracted 3.8%. With an 8% CPI target by January 2015 looking achievable, the RBI is expected to focus more on the next target of 6%, to be achieved by January 2016, leaving little scope for it to change the course of monetary policy.

August headline CPI stays high on food inflation

Headline CPI inflation softened to 7.8% in August from 8.0% in July. The food component remained steady at 9.2%. Within food, the sequential increase in vegetable prices moderated to 7% (15.1% yoy) from 16% (16.8% yoy) a month earlier. Inflation in other sub-categories in food was mixed, with increases seen in milk, pulses and fruits and a mild correction in cereals. Although the monsoons have significantly revived—the deficit is now just 11%—the impact of late rains on prices of crops (such as onions) and of higher precipitation in some regions poses some upside risk to food inflation.

Moderation of core CPI sustained

Core CPI (ex food and fuel) inflation continued its secular decline, easing substantially in August to 6.9%—the lowest since the inception of the series. The correction was across the board, with the largest contribution being from miscellaneous items (education, medical care and household requisites) which corrected from 6.6% to 5.9% in August. The consistent easing of core CPI inflation indicates the tight monetary policy is likely working to depress demand-side pressure on inflation. We expect favorable base effects along with continuing demand compression to help to ease core CPI inflation in the coming months to average 6.8% in FY2015 from 8% in FY2014.

July IIP plummets on weak consumer and capital goods

IIP plunged to 0.5% in July (average 4.2% in 1QFY15), with the manufacturing sector contracting by 1% from average growth of 3.5% in 1QFY15. More importantly, the sequential momentum of the IIP has abated sharply, now at ~1.2% 3m/3m SAAR (see Exhibit 2). Capital goods were volatile, contracting 3.8% after a sharp pick-up to 23.3% a month earlier. But excluding capital goods, IIP looked sluggish at 1.2%. This was partly due to a plunge in consumer durables (contracted for the second consecutive month: (-)20.9% in July from (-)23.4% in June), even as consumer non-durables grew at 2.9%.

RBI to remain in wait-and-watch mode

The favorable combination of a lower IIP growth and lower headline CPI inflation is unlikely to change the RBI's monetary policy stance immediately. With an 8% target for January 2015 now apparently achievable, the RBI will turn its focus on the 6% target, to be achieved by January 2016. With most of India's inflation remaining a supply-side phenomenon, any policy-driven push to growth can be inflationary in the medium term. We believe the RBI will continue to be watchful of such a situation. Further, the other worry for the RBI could be the change in the interest rate dynamics in the US, especially the pace of the same. These factors are expected to keep the RBI in pause mode, at least until the end of FY2015.

QUICK NUMBERS

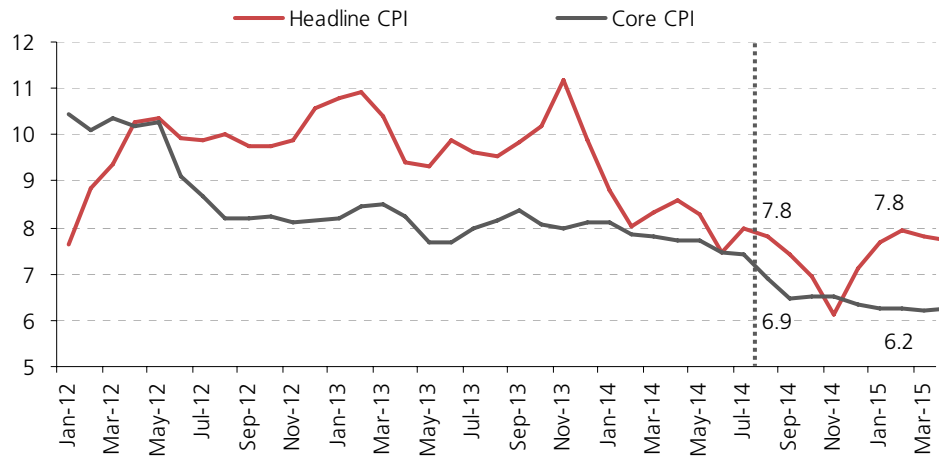
- **August CPI inflation at 7.8%; core inflation at 6.9%**
- **July IIP prints 0.5%; consumer durables sector contracts 20.9%; capital goods sector contracts 3.8%**
- **RBI likely to be on an extended pause**

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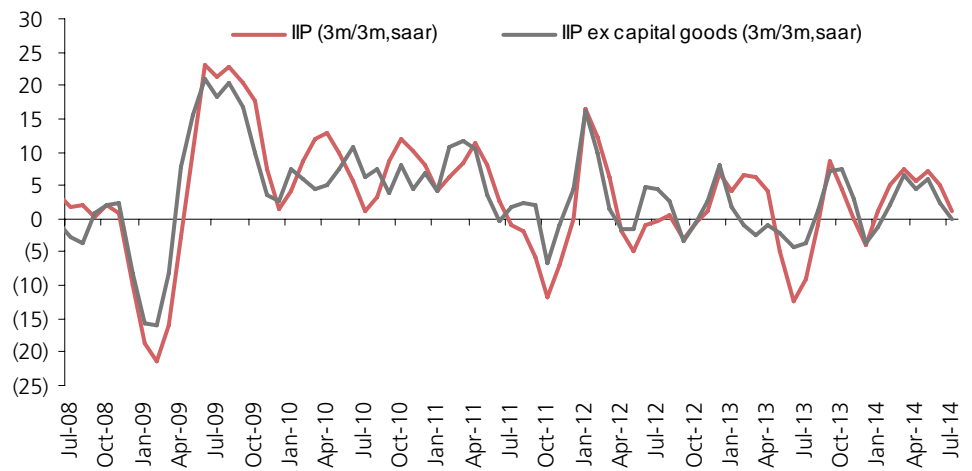
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Exhibit 1: 8% CPI inflation by January 2015 looks achievable
Headline and core CPI inflation (%)



Source: CEIC, Kotak Economic Research estimates

Exhibit 2: IIP momentum has plummeted sharply
Trends in India's IIP (%3M/3M,SAAR)



Source: CEIC, Kotak Economic Research

"I, Indranil Pan, 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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