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The Wall Street Journal

INDIAREALTIME
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January 15, 2013, 9:21 AM

Data Increase Chance of Rate Cut

By Kunal Kumar Kundu

Mukesh Gupta/Reuters

Food inflation continues to be the major driver of overall inflation in India, says Kunal Kumar Kundu.

India released the December wholesale price index, its main inflation barometer, Monday. For a change, this piece of economic data offers some hope after a dismal industrial production data released last Friday.

The official gauge of inflation eased to an annual rate of 7.18%, lower than 7.24% recorded in November. This is the lowest reading since December 2009.

There is a possibility of the final number being revised upward. But it's worth noting that there was a downward revision of the October inflation data, from 7.45% to 7.32%, the first downward revision since August 2011.

That offers hope that inflation has peaked and will continue to ease, albeit slowly. This belief stems from a couple of factors. First, despite some recent upward revisions, the three-month moving average shows that annual inflation remained below 8% for 11 consecutive months. Second, there's the high base effect. India has never experienced such a period of sustained high inflation: The average annual inflation rate for the past three years has touched 8.86%. December's reading was the lowest during this period.

A closer look at the data shows that food inflation continues to be the major driver of overall inflation in India. Within this category, soaring food grain prices (caused in part by aggressive food grain procurement by the government) and higher prices of protein (driven by changing consumption patterns) ensure that inflation remains at an elevated level.

As a result, core inflation (headline inflation stripped off volatile food and energy prices) for December clocked in at only 4.24%, the lowest since March 2010.

This will encourage the Reserve Bank of India to consider lowering interest rates though the central bank will remain wary of high retail prices. The Consumer Price Index for December, released by the Central Statistical Organization Monday, shows that retail prices rose at an annual rate of 10.56%, compared with 9.90% in November.

On balance, I believe the RBI will be inclined to make its first monetary easing since March later this month at its regular monetary policy meeting Jan. 29.) Its case will be helped by the poor industrial production data.

Readers would do well to remember that India's industrial production for November shrank by 0.12% after rising by 8.34% in October, as the effects of the autumn festivals wore off.

How fast will the RBI ease? I predict it will cut the repo rate by a total of 0.50 percentage point in the first quarter of this year (either by opting for 0.50 percentage point cut in January or two cuts of 0.25 percentage points each during the January and March meetings.)

After that, however, the central bank will likely pause since inflation could pick up as the effects come through of higher diesel and kerosene prices. Also, the government is mulling the reintroduction of import duty on crude oil in next month's budget as it aims to increase revenue collection and ward off the threat of a sovereign debt ratings downgrade.

In June 2011, the government abolished the 5% import duty on crude oil and cut the excise duty levied on diesel by 2.6 rupees a litre to help cushion the retail price of fuel against a sharp rise in international oil prices. That was a costly move and while restoring the duty might help the government's financial health, the central bank will be watching to gauge its impact on inflation.

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