CPI dips on food, IIP on DeMo

CRISIL First Cut

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CPI: Sticky core now to the fore

Consumer price inflation (CPI) softened 20 basis points (bps) to 3.2% in January from 3.4% in December, primarily because of a 70 bps drop in food inflation. The fuel component of CPI rose afresh on rising crude oil prices and weaker rupee. Meanwhile, the persistent stickiness in core inflation is contrary to the refrain that demonetisation had materially dented core demand; core inflation (CPI excluding food) rose to 5.1% in January, from 5% in December.

For the year so far (April to January of fiscal 2017), overall CPI at 4.7% is 20 bps lower than in the comparable previous period, while food inflation is down 11 bps to 4.7%, and core inflation is unchanged at 4.9%.

Our view

CPI inflation could see upside pressures hereon as some benefits from a high-base effect will begin to wear out and as the imported component of inflation nudges up. Also, as the economy is remonetised, some pent-up demand will have returned. The stickiness in core inflation despite continued decline in other parts of the index is a worry since wage-price negotiations based on a sticky core can potentially lift overall inflation.

The Monetary Policy Committee (MPC) review of February 8 reiterated its medium-term inflation target of 4%. Given the inflationary pressures in the economy, policy space now remains constricted. The repo rate was accordingly left unchanged at 6.25%, and the monetary policy stance was shifted from being '*accommodative*' to *'neutral'*. That could very well mark the end of the current rate cut cycle, which began in January 2015 – at least in the near term. The shift reflects the central bank's decision to exert caution on the inflation front in its journey towards the medium-term inflation target.

CRISIL also expects CPI inflation to inch up to 5% in fiscal 2018, from an estimated 4.7% in fiscal 2017. This will be driven by 1) rising global oil and commodity prices amid geopolitical tensions and a weaker rupee (that can drive up imported inflation), and, 2) core inflation (non-food, non-fuel), which, despite seeing a small demonetisation-led decline, remains firm and could rise as demand picks up mildly in fiscal 2018. However, a prudent Union Budget does cap the upside pressures that a populist one could have had on inflation.

- Food inflation in January fell to 0.6% from 1.3% in December, the lowest in 5 years, and is a result of cooling vegetable prices thanks to good supplies and of a high-base effect. The statistical benefit will, however, begin to wear off now and curb further downshift. Within the food index, there was a sharp drop in vegetables' inflation to -15.6%, while protein inflation (eggs, meat, fish and pulses) fell to -1.2%.
- Fuel inflation saw a pick-up led by rising global oil prices and weakening rupee. This was reflected in the transport and communication category, where inflation surged 140 bps to 5.4%, compared with December. Since October 2016, gcrude oil prices have risen nearly 27% on-year, while the rupee is 2% weaker, providing lift to domestic fuel inflation
- The surprise, however, came from core inflation that, contrary to expectations, rose to 5.1% in January, from 5% in December. Within core, inflation in education and miscellaneous, which comprise 33% of the index, rose to 5.1% or 30 bps over November. While there was some decline in inflation in household goods and services, health, and personal care – reflecting the impact of demonetisation on demand - inflation in these items was high at 4.8% average in January.

IIP: De-growth hints at demonetisation impact

While the Index of Industrial Production (IIP) had failed to capture the impact of demonetisation in November owing to base effect, the latest number does so. IIP fell by 0.4% on-year in December on the back of 2% contraction in manufacturing sector. The decline in IIP was limited owing to a weak base of last year. That said, mining and electricity sectors managed to display healthy growth of 5.2% and 6.3%, respectively. When viewed from the user-based classification, the biggest negative contribution to IIP growth came from the consumer goods segment.

- IIP growth for December came in at -0.4% on-year, suggesting that demonetisation has had an impact on industrial activity. Manufacturing – the biggest contributor to IIP with roughly 75% weightage - was the sole contributor to the decline in IIP. Falling by 2%, manufacturing activity reflected the impact of cash crunch on demand and likely disruption in the supply chain. Micro, small and medium enterprises (the hardest hit by the cash crunch) form a large part of the supply chain to the organised manufacturing sector. 17 out of 22 manufacturing industries grew negatively. The other two segments – mining and electricity, however, registered steady growth of 5.2% and 6.3% respectively.
- Till now, industrial and investment-oriented sectors were persistently displaying weak demand, and December saw the consumer-oriented sectors also following suit, registering a growth of -5.8%. While the former managed to grow positively (1%), it was largely because of base effect. Almost all the consumer-oriented goods categories were down in December with performance of the biggest categories was as follows: *food products & beverages* grew by -3.5%, *textiles* by -6.8%, *motor vehicles* by -7.4% and *apparel & clothing* by -8.1%. Within industrial and investment-oriented sectors, *coke, refined petroleum products & nuclear fuel* managed to do well, growing 3%.
- According to use-based classification of IIP, too, there was broad-based weakness, barring basic goods, which managed to grow by 5.3% in December, up from 4.7% growth in November. Intermediate goods, capital goods and consumer goods were down by 1.2%, 3% and 6.8%, respectively. The decline in capital goods was limited not only on account of a weak base of last year but was also overshadowed by heightened decline in the consumer goods category. The latter wiped off 2.2% percentages points from the overall IIP growth compared to 0.32% by the former. Within consumer goods category, the negative impact of demonetisation was felt across both consumer durables and consumer non-durables where growth fell by 10.3% and 5%, respectively.

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