Research

CRISIL
An S&P Global Company

IIP decline slows, inflation surges

CRISIL First Cut l October 2020

CPI inflation sharply up again, RBI's inflation targeting in a fix

India's consumer price index (CPI)-based inflation at 7.3% in September 2020 is the highest inflation print so far this fiscal. It was further up from 6.7% in August and even higher than 7.2% seen in April.

While it was expected that September CPI inflation would be marginally higher than August's, such a rise was not. With this, headline inflation has remained outside the upper bound of the Reserve Bank of India (RBI)'s target range of 2-6% for the sixth month straight this fiscal.

It looks like supply disruptions continue to plague the economy and keep prices elevated, especially for food.

The September surge was led by food inflation, which was back in double digits for the first time since April. Core inflation too remained stubborn. That said, there was some relief from fuel inflation which softened in September, after rising in previous two months. It is also important to note that the final August inflation data, released today, remained unchanged at 6.7% which could suggest that the pandemic related glitches in collecting data may be out of the way now, making incoming provisional inflation data more reliable.

Food inflation, with 39.05% weight, rose 167 basis points (bps) to 10.7% in September, from 9.1% in August. At a five month high, September food inflation was just one percentage point shy of 11.7% in April, the first month of the nationwide lockdown that likely witnessed the highest amount of supply disruptions. Feeding into high food inflation were protein categories and vegetables. In animal protein category, *meat and fish* inflation rose to 17.6% in September, from 16.5% in August and *eggs* jumped to 15.5% from 10.1%. *Pulses* inflation too, rose to 14.7%, from 14.4%, reversing the declining trend of the previous four months. *Vegetable* inflation jumped the most – to 20.7% from 11.5% - and led the rise in food inflation. In fact, *fruits*, which had hitherto remained low and stable (averaging 1.2% so far, this fiscal) also rose to 3.2% in September. Clearly, supply disruptions continue to perk up inflation, despite substantial unlocking of the economy.

Fuel inflation eased marginally to 4.8% in September from 5.0% in August. Within that, *fuel and light* inflation was down 30 bps to 2.9% and *petrol and diesel* inflation down 20 bps to 12.0%.

Core inflation, i.e., headline sans *food & beverages* and *fuel & light*, continues to remain stubborn making the management of inflation challenging at a time when food inflation refuses to calm down. At 5.62% in September, it was at a 22-month high and almost unchanged from August's 5.61%. This measure of core inflation has a weight of 47.3% and is a critical contributor to headline inflation. Core categories that continued to trend up were *clothing & footwear* (up 20 bps to 3.0%), *health* (up 10 bps to 4.9%), *transport and communication* (up 50 bps to 11.5%) and *education* (up 50 bps to 2.2%). On a positive note, there was a noticeable decline in *personal care and effects* inflation (to 12.3% from 14.5%) which has so far remained the biggest contributor to the core inflation.

Given the stickiness in CPI inflation above the RBI's target range of 2-6% and no clear signs of inflation cooling off yet, the space for a rate cut by the MPC is increasingly getting crunched. While inflation is expected to subside in the second half of the fiscal when fresh kharif harvest hits the market and a low base effect comes in handy, a rate cut may have to wait, unless there are clear signs of a sustained softening in inflation.

September's inflation print bring the first half inflation to an average of 6.7%. Not only does food inflation continue to surprise on the upside, core inflation too remains sticky. CRISIL therefore revises up its fiscal 2021 CPI inflation forecast to 5.6%, from 5.2% earlier.

Industry not yet out of the woods

Quick estimates of the Index of Industrial Production (IIP) for August released by the National Statistical Office (NSO) indicate the industry may not be as badly hit in the second quarter as in the first (when IIP de-grew 35.7%), output will still decline. IIP shrunk 8% in August compared with 10.4% contraction in July.

In August, select sectors such as coal mining, automobiles and other agriculture related ones performed better, while most others suffered. The Purchasing Managers' Index (PMI) for August entered the 'expansion zone,' rising to 52, suggesting an expansion of manufacturing activity over the previous month. However, exports worsened and cement and electricity production contracted further.

September promises to be a better month for industrial activity. High-frequency indicators, both conventional and unconventional (such as Google's Community Mobility Reports), have shown some improvement in September, yet these broadly stayed below pre-pandemic levels. But green shoots visible in September may not sustain unless the Covid-19 pandemic is contained. For instance, the PMI for September surged to 56.8 – the highest level since January 2012. Tractor sales were up at 28.3% supported by robust farm activity. Railway freight activity grew 15.5%, while exports rose 5.3% for the first time in six months of contraction. Fuel consumption by industry stayed weak, falling 6.1% though it did better than the 18% decline in August. Steel consumption too recorded a lower decline of 5.7% (18.5% in August).

Industry is facing the brunt of a delay in containment of Covid-19 cases. Restrictions and other supply-side disruptions are hindering seamless conduct of activity. In addition, social distancing, loss of incomes and weak exports have crimped demand. Going forward, under the assumption that Covid-19 cases are broadly contained by October, we believe gross domestic product (GDP) could enter mildly positive territory by the last quarter of this fiscal. Even then, manufacturing is expected to lead while services, worst hit during the pandemic, would lag.

Details

- Industrial output shrank 8% in August compared with 10.4% contraction in July and 35.7% contraction in the first quarter. Mining contracted less -- 9.8% compared with 13% contraction in July on higher coal output, while manufacturing shrank 8.6% (versus 11.1% contraction in July) and electricity output, -1.8% (-2.5%)
- As per the use-based classification, capital goods output fell the most (-15.4% in August vs -22.8% in July), followed by primary goods (-11.1% Vs -10.9%), consumer durables (-10.3% vs -23.6%), intermediate goods (-6.8% vs -12.5%), consumer non-durables (-3.3% vs 6.7% growth), and infrastructure and construction goods (-2.3% vs -10.6%)
- Among manufacturing heavyweights, textiles and wearing apparel, food products, coke and refined petroleum products, chemicals and products and motor vehicles contracted sharply, while basic metals registered a mild growth. Consumer-oriented manufacturing[1] sectors were worse off (-10.9%) than industrial and investment-oriented[2] manufacturing sectors (-4.8%) during the month. In the first five months of this fiscal, however, it is the latter that has posted a sharper contraction
- Core infrastructure sector contracted 8.5% in August, compared with an 8% contraction in July. Only fertiliser sector output continued to grow (at 7.3%) led by healthy agriculture activity. Coal output too grew, at 3.6% this month, after contracting for the four months in a row. But all other sectors saw output decline. The sharpest fall was in refinery products (-19.2%), followed by cement (-14.6%), natural gas (-9.5%), crude oil (-6.2%), steel (-6.3%) and electricity (-2.7%)

[1] Consumption-oriented manufacturing sectors include: food, beverages, tobacco, textiles, wearing apparel, leather, wood, and paper products, printing and reproduction of recorded media, pharma, medicinal and botanical products, rubber products, computer, electronic and optical products and motor vehicles and furniture.
[2] Industrial and investment-oriented manufacturing sectors include: coke and refined petroleum products, chemicals and chemical products, non-metallic mineral products, basic metals, fabricated metal products, computer, electronic and optical products, electrical equipment, machinery and equipment, and other transport equipment.

Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Ltd.
dharmakirti.joshi@crisil.com

Adhish Verma
Senior Economist, CRISIL Ltd.
adhish.verma@crisil.com

Dipti Deshpande
Senior Economist, CRISIL Ltd.
dipti.deshpande@crisil.com

Media Contacts

Saman Khan
Media Relations
CRISIL Limited
M: +91 95940 60612
saman.khan@crisil.com

Hiral Jani Vasani
Media Relations
CRISIL Limited
M: +91 982003 9681
hiral.vasani@crisil.com

Jagriti Mishra
Media Relations
CRISIL Limited
M: +91 841184 3388
jagriti.Mishra@ext-crisil.com

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