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Macroeconomics | First cut

Inflation eases a touch, IIP ticking along well

August 2022

CPI inflation easing gradually

Inflation, as measured by the Consumer Price Index (CPI), declined to 6.7% on-year in July from 7.0% previous month. Food drove the moderation in inflation, while non-food inflation rose. Headline inflation remains above 6%, the upper limit of the RBI's target range, for the seventh month in a row.

CPI inflation is gradually easing, helped by the dissipating impact of heatwave, softening global prices, and government interventions on certain items. Progress of monsoon and its impact on food production will shape the inflation trajectory in the second half. Pressure will remain from producers, increasing the passthrough of costs to consumer prices. With the revival in contact-based services, the pressure on services inflation will continue. Due to these factors, we expect CPI inflation to average 6.8% this fiscal, up from 5.5% in the previous year.

Inflation trends in July: highlights

- CPI inflation eased to 6.7% on-year in July from 7.0% previous month, but was higher than 5.6% a year ago
- Food inflation fell to 6.8% from 7.7% previous month, but was higher than 4.0% a year ago
- Fuel[1] inflation rose to 11.8% from 10.1% in the previous month, but was lower than 12.4% a year ago
- Core CPI[2] inflation remained sticky, at 6.0% in July compared with 6.0% in June and 5.8% a year ago
- Within core inflation, excluding transportation, both goods and services saw rising inflation
- Inflation eased in both rural (6.8% in July versus 7.1% previous month) and urban areas (6.5% vs 6.9%)

Many food prices soften, but cereals remain under pressure

- The moderation in food inflation was driven by softening vegetable, edible oil and protein prices.
- Vegetables – the most volatile category – saw inflation easing to 10.9% in July from 17.3% previous month, as supplies for major items, such as tomatoes, recovered after the heatwave
- Edible-oil inflation fell significantly to 7.5% compared with 9.4% previous month and 32.5% a year ago – benefitting from a high base, falling global prices, and domestic manufacturers passing on import duty cuts to consumers. International edible oil prices fell 13.1% on-month in July, but remained 7.3% higher on-year
- Inflation fell for protein items, such as milk (5.8% vs 6.1%) and eggs, meat and fish (2.3% vs 7.3%). While pulses inflation turned positive, it remained subdued (0.2% vs -1.0%)

[1] Refers to CPI fuel and light
[2] CPI excluding food and beverages and fuel and light

- However, cereal inflation rose for the second consecutive month (6.9% vs 5.7%), driven by both wheat and rice products
- Prepared meals, snacks and sweets saw sharp rise (7.5% vs 6.7%), reflecting increasing passthrough of cost pressures by manufacturers

No letting up in fuel inflation yet

- Fuel inflation rose despite a high base, driven by rising liquefied petroleum gas (23% vs 21.3%) and kerosene (108.8% vs 99.1%)
- However, excise duty cuts have benefitted prices of petrol (0.3% vs 5.4%) and diesel (-2.4% vs 0.7%)
- Brent crude prices eased 9.3% on-month to $108.9 average in July, but were 46.4% higher on-year

Core inflation sticky so far

- The rise in core inflation was capped by transport and communication (5.6% vs 6.9%) with falling petrol and diesel prices
- Excluding transport and communication however, core goods inflation rose (7.5% vs 7.2%). Items of clothing and footwear, FMCG goods like soap, washing powder, and durable goods like fans, refrigerator, and automobiles saw rising inflation.
- Services inflation is also catching up (5.2% vs 5.1%), driven by education, cinema tickets, and internet expenses.

Poor facing higher inflation

The burden of inflation varies across income groups, as the share of spending on food, fuel and core categories differs across classes. Essential items, such as food and fuel, occupy a greater share in the consumption basket of people having lower incomes.

Using data from the National Sample Survey Organisation, we mapped expenditure baskets of three broad income groups — bottom 20%, middle 60%, and upper 20% of the population — with July[3] inflation trends. The table below gives average inflation faced by each income class.

The poor continue to face effectively higher inflation than richer counterparts, as inflation on food and fuel items remains higher than core items.

CPI inflation across income classes (on-year, %)

Income segment	July 2022	
	Rural	Urban
Top 20%	6.7	6.4
Middle 60%	6.9	6.8
Bottom 20%	7.0	7.2

Source: NSSO, National Statistics Office (NSO), CEIC, CRISIL

Outlook

CPI inflation has been easing gradually since the peak of 7.8% in April. Relief has come from the dissipating impact of heatwave (on food prices), falling international prices (across food, energy and industrial commodities), and government interventions (duty cuts on edible oil imports and transport fuels).

[3] For detailed methodology and findings, refer to CRISIL Quickonomics: *Same inflation, different burdens by income* (October 2021)

A fall in food and transport fuel inflation helped ease household inflation expectations, as indicated by the RBI's August survey. Falling international commodity prices have eased cost pressures for producers to some extent. IIM Ahmedabad's Business Inflation Expectations Survey shows producers anticipating lower inflation one year ahead.

However, a number of pressure points remain:

1. Even as the monsoon continues to be normal, sowing is lower on-year for major kharif crops, such as rice and arhar. Wheat supplies are expected remain tight until fresh rabi supplies after March. The Food and Agriculture Organization's (FAO) global food price index also remains 13.1% higher on-year in July
2. Producers are expected to pass through costs to consumer prices to a greater extent amid recovering demand. The RBI's latest surveys of manufacturing and services sector indicate firms to increase selling prices in the remainder of the fiscal.

Due to these factors, we retain our CPI inflation forecast at 6.8% for fiscal 2023.

IIP displays healthy double-digit growth

The Index of Industrial Production (IIP) recorded 12.3% on-year growth in June, compared with 19.6% in May 2022. In absolute terms, however, IIP nudged up to 137.9 in June from 137.7 in May.

The slowdown in annual IIP growth in June reflects normalisation of favourable base effect that had led to a high IIP growth in May. In fact, IIP activity recorded marginal sequential improvement in June, which helped it maintain a healthy double-digit growth. June saw healthy growth in the manufacturing sector output and consumer non-durable goods too displayed some traction, indicating improvement in broader private consumption demand.

Highlights

- IIP rose 12.3% on-year in June, down from 19.6% in May. This is still a healthy pace of growth and the moderation from May is mostly a reflection of waning away of favourable base effect that led to a spike in May IIP print. In fact, on a sequential basis, i.e., on-month movement in the de-seasonalised series, which takes care of the base effect and seasonal variations, IIP growth improved to 1.3% on-month in June, from 0.4% in May.

- The sequential improvement in IIP was largely premised on the healthy growth in manufacturing sector output. Having the highest weight of 77.6% in IIP, manufacturing moves the needle for overall IIP. On the other hand, the other two segments – mining (14.4% weight) and electricity (7.9% weight) – registered a sequential decline in output. This trend could be attributed to the onset of monsoon season in June, which likely slowed down parts of mining activity and assuaged the excessive electricity demand in the earlier months on account of the heatwave

- The performance of the manufacturing sector was better than expected, as some of the indicators, such as manufacturing PMI (which fell to a nine-month low of 53.9 in June, from 54.6 in May), were indicative of a slowdown in the momentum. The robust manufacturing performance also seems to suggest easing in supply-related issues amid improving domestic demand and some support from external demand as indicated by a sequential rise in some of India's key core exports items, such as engineering and pharma goods in June.

- Of the 23 manufacturing components, thirteen recorded higher production in June over May. Five of these particularly saw production recording double-digit growth. These were computer and electronic products (48% on-month rise), tobacco products (29%), pharma products (16%), transport equipment (13%), printing products (12%) and fabricated metals (12%).

- Another way to assess the performance of IIP is to look at its use-based classification and June print presented an optimistic picture. Capital goods recorded a healthy 26.1% on-year growth in June despite a large unfavourable base suggesting investment revival gaining some traction (which ties up with the continuous improvement in manufacturing sector capacity utilisation rates). This was followed by consumer durables, which recorded the second highest annual growth of 23.8% again despite a high base. In a positive development, consumer non-durables witnessed annual growth in June (2.9%) compared with May (1.0%), despite an unfavourable base effect that pulled down growth in all other segments. If sustained, this could be the harbinger for improvement in wider private consumption demand in the economy.

Outlook

Statistically, annual IIP growth may still moderate next month, as the base effect continues to normalise. Sequentially, however, industrial activity should start rising gradually in sync with improving domestic demand, as the economy moves past the pandemic impact and festive-related demand kicks in. Softening in inflation should help support consumption demand, albeit the improvement will be gradual as the pass-through of earlier higher prices remains incomplete. The RBI's latest industrial outlook survey for the manufacturing sector pointed towards optimism, as suggested by the improvement in business expectations index to 137.7 in the second quarter of fiscal 2023 from

134.7 in the previous. That said, the manufacturing sector could face headwinds from a slowdown in global demand and hence exports.

Some support should also come from capital goods production, as investment activity is likely to improve, with the rise in capacity utilisation above the pre-pandemic levels. Government-led capex should also continue to lend a helping hand. Overall, broad-basing of domestic economic activity, especially with the contribution from contact-based services, would support industrial activity.

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