Macroeconomics | First cut

Inflation fo(u)rced down, IIP surges

June 2023

Base effect + Dipping energy/metal prices + Easing supply chains + rabi crop arrivals

India's consumer price inflation (CPI) slowed for the fourth consecutive month in May, stamping 4.3%, compared with 4.7% in the preceding month.

Four factors have influenced the downward trajectory over the past few months. First, a strong base effect that will fade out for headline inflation.

Second, a fall in global oil and commodity prices. The global energy index fell an average 31.1% on-year in the last four months, while the metals index is down 17% on average.

Third, easing supply chain pressures leading to better availability of inputs and therefore reduced pressure on prices. As input cost pressures abate, though retail prices are higher than a year ago, month-on-month the increase is lesser.

Fourth, easier food inflation as the rabi crop enters the market — sequentially, food inflation fell 0.2% on a seasonally adjusted on-month basis, compared to 0.1% rise in the preceding month.

While there is cheer on overall inflation, the internals warrant some attention. For instance, food inflation has been easing for three months now with the latest reading at 2.9%. Encouragingly, there is also easing of sequential momentum. Much of this is being led by fruits and vegetables, edible oils and meat and fish where there is either deflation or low inflation. Of concern though are the still high inflation rates in cereals (12.7%), milk (8.9%), spices (17.9) and the recent uptick in pulses (to 6.6%). In the months to come, rainfall conditions will play a key role in shaping food inflation.

Inflation inching closer to 4% gives relief to the Monetary Policy Committee (MPC). However, part of this softening is driven by one-off base effect and inflation will lift to 5% when it fades over the next few months. We expect CPI inflation to average 5% this fiscal from 6.7% in the last. A supportive monsoon is a key assumption underlying this forecast. In this scenario, we expect the MPC to maintain a pause as it continues to watch the impact of past rate hikes. As growth slowdown seeps in and inflation moderates, we expect it to cut rates by the end of this fiscal.

The Indian Meteorological Department has predicted overall normal rains this year. However, timeliness and regional distribution are very critical for crop production, price signalling and hence inflation expectations. With rabi harvest entering the market, some respite for cereal and pulses prices could be felt in the next 2-3 months. However, any distortion in rains could bring a reversal of gains in categories experiencing low/easing inflation (vegetables and edible oils), or worse, keep inflation elevated in cereals. However, some recently announced policy measures (imposing stock limits on wheat and pulses, and, possible imports of milk or milk products) could cap some of the upside to food inflation

Key data points in May

- CPI inflation moderated further to 4.3% in May, from 4.7% in April
- Food inflation fell to 2.9%, from 3.8%, driven by edible oils, vegetables, and some softness in cereals
- Fuel[1] inflation moderated at a slower pace to 4.6% from 5.5%
- Core CPI[2] inflation stood unchanged at 5.1%

Moderation in food inflation

- Food inflation fell to 2.9% in May from 3.8% in April driven by vegetables (-8.2% inflation), edible oils (-16%), meat and fish (-1.3%) and moderation in cereals (to 12.7% in May from 13.7% in April)
- But apart from meat and fish, other protein categories saw inflation rise. Inflation in milk ticked up from 8.8% to 8.9%. Inflation is milk has been elevated over the last year driven by higher procurement cost. Demand of milk remains high while stocks of dairy products are lower than the previous year prompting the government to consider importing milk and/or milk products.
- Pulses saw inflation firm to 6.6% from 5.3%, while in eggs the inflation rate more than doubled from 3.1% in April to 6.7%
- Though inflation in cereals cooled, it remains in double digits at 12.7%. The easing in cereals inflation was led by cooling inflation in wheat (from non-PDS sources) (12.6% vs 15.4%). As inflation in wheat remains in double-digits, the government signalled that it would continue to ban exports of wheat. The government has also imposed stocking limits on wheat and some pulses till the next crop arrivals in March 2024 and October 2023, respectively for these crops.
- Inflation in sugar also hardened to 2.5% from 1.9% due to surge in international sugar prices, while that in spices remains high at 17.9% as several spices such as salt, jeera, dry chillies see inflation in double-digits.

Slower correction in fuel inflation

- Fuel inflation cooled to 4.6% from 5.5% in the previous month, the lowest rate since March 2021. A large part of this fall was due to a high base and moderating global crude oil prices. Price of brent crude oil decreased from $84.1/bbl to $75.7/bbl.
- Prices of kerosene fell 18% on-year, while that of liquified petroleum gas (LPG) by PDS sources rose 11.1%. Coal inflation moderated to 9.1% from 11.1% in April helped by a fall in international prices of coal.
- On the other hand, inflation in electricity accelerated to 4.5% from 2.3% in April.

Broad-based moderation in core inflation

- Core inflation stood at 5.1% in May, the same as the previous month.
- Inflation in some essential categories remained broadly unchanged- health (6.2% vs 6.3%), transport and communication (1.1% vs 1.2%), housing (4.8% vs 4.9%)
- Inflation in clothing and footwear moderated to 6.6% from 7.5%. On the other hand, inflation in personal care and effects accelerated sharply to 9.9% from 9.0% in the previous month as inflation in gold (18.2% vs 13.8%) and silver (13.0% vs 4.7%) accelerated.

Urban poor face the least burden as food inflation eases

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 lower income classes.

Using data from the National Sample Survey Organisation (NSSO), CRISIL has mapped expenditure baskets of three broad income groups – bottom 20%, middle 60%, and upper 20% of the population – with May[3] inflation trends. The table below presents the average inflation faced by each income class.

[1] Refers to CPI fuel and light
[2] CPI excluding food and beverages, and fuel and light
[3] For detailed methodology and findings, refer to CRISIL Quickonomics: *Same inflation, different burdens by income* (October 2021)

Inflation burden cooled across income classes in May. Core inflation was elevated above food and fuel inflation and therefore the top income bracket faces the highest inflation burden in both rural and urban areas. Food inflation (the largest consumption category for the poor) was lower in urban settings (2.4%) compared to rural (3.2%) and therefore the urban poor face a lower burden than the rural poor.

CPI inflation across income classes (% on-year)

Income segment	May 2023	
	Rural	Urban
Top 20%	4.3	4.3
Middle 60%	4.1	4.0
Bottom 20%	4.0	3.9

Source: NSSO, National Statistical Office, CEIC, CRISIL

Industrial activity rises at the start of this fiscal

The Index of Industrial Production (IIP) growth improved to 4.2% on-year in April, compared with 1.7% previous month. Manufacturing sector drove the rise, supported by domestic-oriented sectors. However, certain export-oriented sectors capped the gains.

Stronger IIP growth in April was driven by domestic-oriented sectors. While easing inflation and improving rural prospects seemed to have buoyed demand for essential goods, government's capex push spurred demand for infrastructure and construction goods.

Going ahead, industrial prospects will depend on monsoon performance and inflation trajectory that will particularly shape rural demand. Some drag is inevitable from weakening global demand and impact of higher interest rates on domestic demand. Overall, we expect India's real gross domestic product (GDP) to slow to 6% this fiscal from 7.2% in the previous one.

Data highlights

- IIP growth rose to 4.2% on-year in April, compared with 1.7% previous month and 6.7% in April 2022.
- IIP shot up significantly for manufacturing (4.9% on-year growth in April vs 1.2% in the previous month). However, mining IIP dropped (5.1% vs 6.8%), and remained negative for electricity (-1.1% vs -1.6%).
- Within manufacturing, growth was led by infrastructure and construction goods (12.8% vs 5.4%) and consumer non-durables (10.7% vs -3.1%). However, activity slowed for primary goods (1.9% vs 3.3%), intermediate goods (0.8% vs 1.0%) and capital goods (6.2% vs 8.1%). Consumer durables remained in the red (-3.5% vs -8.4%)

Domestic demand holding up manufacturing sector

- Consumer non-durables, comprising essential items such as food products, saw the sharpest rebound in growth relative to previous month. Easing inflation in the past few months seems to be improving demand from poorer segments. In particular, rural inflation fell more swiftly in the past 3 months, which contributed to increasing real wages for their workforce. This, coupled with robust rabi production, seems to be hinting at an improvement in rural demand.

- Infrastructure and construction goods rose in April after three months of slowdown, reflecting the pickup in government capital expenditure with the start of the fiscal. At 12.8%, it was the strongest contributor to IIP growth in April
- However, certain export-oriented sectors saw slowing growth, such as chemical products (2.9% vs 7.0%), textiles (-6.3% vs -7.4%), and wearing apparel (-29.1% vs -30.7%). However, pharmaceuticals recovered (24.5% vs -2.5%)
- Consumer durables saw IIP decline for the fifth month in a row., Growth fell for automobiles (3.6% vs 5.3%), and computer, electronic and optical products (-11.1% vs -28.7%).
- Commodity-linked sectors saw varied performance, with growth improving for basic metals (10.2% vs 5.5%), but worsening for coke and petroleum products (-1.7% vs 1.0%)

Outlook

Industrial performance seems to be getting a leg-up from the easing in inflationary pressures in the past few months. Falling commodity prices eased input cost pressures for producers, while softening retail inflation has boosted consumers' purchasing power. S&P's Purchasing Managers Index (PMI) for manufacturing rose further 58.7 in May from 57.2 in April, recording the strongest expansion since October 2020. This suggests healthy manufacturing performance in May as well.

However, industrial prospects going forward will get influenced by progress on monsoon. While robust rabi production this season seems to be improving rural demand at present, kharif production faces threat from the looming El Nino. Besides influencing rural demand, this will influence inflation trajectory that will impact broader domestic demand as well.

External demand will inevitably be a drag on growth with major advanced economies are expected to slow on the sharp rise in interest rates. While the rise in domestic interest rates is relatively lesser than in advanced economies, lending rates in India too are now higher than the pre-pandemic five-year average. This is expected to moderate domestic demand, especially in interest-sensitive segments such as automobiles and housing.

Overall, we expect India's GDP to grow 6% this fiscal, compared with 7.2% expected in fiscal 2023.

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