Research

Inflation back in range, IIP dips

CRISIL First Cut | January 2021

CPI inflation back in target range

After eight months above the Reserve Bank of India (RBI's) target band of 2-6%, Consumer Price Index (CPI) inflation was finally back in range, declining for the second straight month to a below-consensus 4.6% in December, from 6.9% in November. Average CPI inflation during April-December now measures 6.6%, down from the April-November average of 6.9%.

Not only did CPI inflation fall on-month, aided by a massive decline in food prices, but the high base effect of last year also helped pull down headline inflation. But while core inflation softened marginally, fuel inflation went up in December.

Food inflation, with 39.05% weight, softened substantially to hit a 16-month low of 3.5% in December, from 9.5% in November. Most of the decline in food inflation was due to a slump in vegetable inflation to -10.4%, from 15.5% in November, driven by a broad-based decline in vegetable prices, especially that of staples like onions, potatoes and tomatoes, partly reflecting the success of government initiatives like timely imports.

However, price pressure in other high food inflation categories like proteins declined only marginally. Animal proteins, for instance, continued to witness double digit inflation, with *meat and fish* inflation at 15.2% (compared with 17% in November), and *eggs* inflation at 16.1% (20.4% in November). Pulses inflation clocked 16.0% in December, compared with 18.1% in November. On the other hand, *oil and fats* inflation rose to 20.0% from 17.9%, in line with rising international oil prices. Fruit inflation also rose to 2.7%, from 0.2%.

Core inflation, i.e., headline sans *food and beverages*, and *fuel and light*, softened only marginally at 5.6%, just 15 basis points (bps) lower than November, suggesting continuing stickiness in core inflation. This could be reflective of mild improvement in demand conditions on one hand and rising input prices on the other. Core inflation has a weight of 47.3%, and is a sizeable contributor to headline inflation.

Clothing and footwear inflation rose to 3.5% in December, from 3.4% in November. Another category that saw upward inflation price pressure was *recreation and amusement* that rose to 5.2% from 4.5%. Health *inflation* also rose to 6.0% from 5.6%. That said, inflation softened in idiosyncratic categories, i.e. *personal care and effects* (to 11.7% from 12.0%) and *transport and communication* (to 9.3% from 11.1%).

With rising international commodity prices and an improvement in domestic industrial activity, fuel inflation reversed its declining trend to rise to 4.7% in December from 3.3% in November. Within that, *fuel and light* inflation rose to 3.0% from 1.6%, and *petrol and diesel* inflation to 11.4% from 10.0%.

With inflation back in the target range of 2-6%, December has offered the RBI some much-needed respite. However, the RBI will still need to be watchful of the inflation trajectory going ahead with global commodity prices on the rise and the favourable base effect starting to taper off from January 2021

This suggest that it may be a while before inflation firmly reverts to the RBI's medium-term inflation target of 4.0%. Rate cuts will have to wait till then, while the upcoming budget will also have a bearing on the MPC's upcoming monetary policy decisions.

For fiscal 2021, CRISIL projects CPI inflation at 6.4%.

Weak export demand and base effect drive down IIP in November

Industrial output – measured by the Index of Industrial Production (IIP) – fell 1.9% on-year in November 2020, after expanding in the preceding two months. The decline was perplexing since November was a festive month and onground sales data across consumer segments such as automobiles, consumer durables and other related sectors was healthy.

Behind the slump in November are two factors: The first factor was the base effect – IIP in November 2019 had jumped 2.1% on-year from a 6.6% decline in the preceding month. Second, a hit to exports during the month as some of India's trade partners saw a rise in Covid-19 case spread and consequent restrictions.

Both the mining and manufacturing segments recorded a decline while power generation continued to grow. Within manufacturing, textiles and petroleum products registered setbacks, being export-dependent sectors that bore the brunt of rising Covid-19 cases and consequent restrictions in Europe and the US. Meanwhile, the core sector also did not perform well with sectors like crude oil, natural gas, refinery products, and steel and cement registering a decline. Data on use-based classification recorded the sharpest decline in capital goods, followed by intermediate and primary goods.

Deepest slump in investment, followed by consumption activity this year. Data for April to November records a 15.5% decline in IIP with the sharpest fall in manufacturing (-17.3%), followed by mining (-12.4%) and electricity (at 4.6%). From a use-based perspective, capital goods saw a sharper decline (-31.1%), compared with consumer goods (-28.1% seen in consumer durables), suggesting that investments have been hit harder than consumption. Some support to this sector came from government spending on construction (mainly roads and highways, railways and metros).

High frequency indicators show mixed signals for industrial activity in December. The IHS Markit Manufacturing Purchase Managers' Index was fairly unchanged in December at 56.4. For the second month in a row, **power consumption declined on-year**. **Goods and Services Tax (GST) e-way bill collections** data, however, showed a sharp pick-up in December. Further, exports also reported a contraction, but the pace of decline slowed.

The National Statistical Organisation recently released GDP estimates for fiscal 2021 which place growth at -7.7% for the economy. Industrial GDP is estimated to decline 9.6%, with manufacturing at -9.4%, mining at -12.4% and electricity, gas and water supply at 2.7% growth. Splitting the year into two halves sees a fastest improvement in manufacturing (second half at 0.5% versus -19.4% in first half), followed by mining (-8.3% Vs -17.2%) and electricity, gas and water supply (7.1% Vs -1.4%).

In summation

- Industrial output declined on-year in November by 1.9%, compared with a 4.2% growth in October. While the electricity sector saw an expansion in output (by 3.5%), the sharpest contraction was in mining (-7.3%) followed by manufacturing (-1.7%)
- As per use-based classification, only output in the infrastructure and construction segment registered growth (of 0.7%). Capital goods saw the sharpest decline (-7.1% in November compared with 3.5% growth in October), followed by intermediate goods (-3% Vs 2.1%) and primary goods (-2.6% Vs -3.2%). Both consumer durables and non-durables were relatively stagnant (at -0.7% in November)
- Within the manufacturing heavyweights, textiles (at -9.8%), wearing apparel (-18.8%) and petroleum products (-3.2%) were the worst hit. There was a silver lining though as sectors like food products, chemicals, metals and automobiles were positive despite a decline in pace of growth
- The core infrastructure sector continued to lag, posting a sharper decline of 2.6% in November compared with -0.9% in October. Energy-related sectors, cement and steel were the worst performers, while coal, fertilisers and electricity production continued to provide support

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