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Macroeconomics | First cut

Inflation rises, IIP loses steam

January 2022

CPI inflation jumps as base effect wears off

Inflation based on the consumer price index (CPI) rose significantly to 5.6% on-year in December compared with 4.9% previous month and 4.6% in December 2020. Wearing out of a favourable base (4.6% in December last year compared with 6.9% previous month) was the key factor bumping up the current inflation reading. This was especially for seen for food inflation, which more than doubled in December 2021 relative to previous month. Non-food inflation moderated slightly relative to previous month.

CPI inflation is expected to rise in the coming few months as the benefit from a high base wears off, especially for food inflation. Persistent growth in cost pressures for producers over the past few months will further make them pass some burden to consumer prices. That said, stabilisation of commodity prices and easing of supply disruptions should help cap further rise in inflation next fiscal. On average, we expect CPI inflation at 5.5% in fiscal 2022 and 5% in fiscal 2023.

Inflation trends in December: highlights

- CPI inflation rose to 5.6% in December compared with 4.9% previous month and 4.6% in December 2020
- Sequentially, CPI grew 0.5% on-month in December, similar to the rate seen in November
- Food inflation rose to 4% on-year compared with 1.9% in November and 3.4% in December 2020
- Fuel[1] inflation moderated to 11% from 13.3% in November, but higher than 2.9% in December 2020
- Core[2] inflation also moderated to 6% from 6.2% in November
- Urban inflation remained higher than rural. Urban inflation came at 5.8% in December compared with 5.5% in November, while rural inflation jumped sharply to 5.4% in December compared with 4.3% previous month

How key items saw inflation move

- **Food and beverages** inflation almost doubled to 4.5% on-year in December compared with 2.6% previous month. Important food items such as cereals, vegetables and milk, along with manufactured food products drove the rise. However, edible oils and certain protein items saw inflation ease during the month.
  - Cereals rose to 2.6% from 1.5% previous month.
  - Vegetable inflation declined at a lower rate of -3% in December compared with -13.6% previous month. Sequentially, vegetable prices grew for third consecutive month

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

- Milk inflation rose to 3.8% in December compared with 3.4% previous month
- Prepared meals, snacks and sweets rose 6.6% compared with 6.5% previous month.
- Edible oils inflation, while staying in double digits for 21st successive month, moderated to 24.3% in December compared with 29.7% previous month.
- Among protein items, pulses inflation reduced to 2.4% from 3.2% previous month. Eggs, meat and fish also eased to 4.3% from 4.9%
- Fruits inflation eased to 3.5% from 6%, while sugar and confectionery reduced to 5.6% from 6.2%

- **Fuel inflation** eased to 11% in December from 13.3% previous month. Declining electricity prices, coupled with slowing growth in liquefied petroleum gas (LPG) prices, contributed to the moderation.
- **Core inflation**, while staying beyond comfort zone, moderated to 6% from 6.2% previous month
    - The easing was mainly on account of lower transportation and communication inflation (9.7% in December versus 10% previous month), due to falling petrol and diesel prices. Falling global crude oil prices, coupled with reduced excise duties have reduced pressure on these fuels. Brent crude oil prices slid 8% on-month in December to $74.3 per barrel on average.
    - Slight moderation was seen for recreation and amusement (7.4% vs 7.6%), health services (7.1% vs 7.3%), and housing (3.6% vs 3.7%)
    - However, prices of other goods and services continued to rise, such as household goods and services (6.8% vs 6.4%), personal care and effects (3.7% vs 3.2%), and education services (3.3% vs 3.1%)

Rise in inflation was the sharpest for the poor

The burden of inflation varies across different income groups, as the share of spending on food, fuel and core categories differs across classes. Using the National Sample Survey Organisation data, we estimated the average expenditure patterns across three broad income groups (bottom 20%, middle 60%, and upper 20% of population) and map them with the inflation trends[3].

Based on this, the effective inflation rate for urban poor (bottom 20%) rose to 6.2% in December compared with 5.6% previous month. For rural poor too, inflation jumped to 5.3% from 4.1% previous month. This was because of a jump in food inflation in both urban and rural areas. Food occupies the highest share in consumption basket of bottom 20% of the income segment.

In comparison, inflation for urban rich (top 20%) grew to 5.8% in December from 5.5% previous month, and for rural rich grew to 5.5% from 4.6%.

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

Income segment	December 2021	
	Rural	Urban
Top 20%	5.5	5.8
Middle 60%	5.3	6.0
Bottom 20%	5.3	6.2

** with share of commodity groups in expenditure basket of respective income class as weights*
Source: NSSO, National Statistics Office (NSO), CEIC, CRISIL

Outlook

In the first 3 quarters of this fiscal, CPI inflation averaged 5.2%, compared with 6.6% in the same period last year. We expect it to move higher in the coming quarter, as the benefit from a high base wears off, especially for food inflation. In addition, non-food inflation will remain elevated given that cost pressures for producers continue to surge. This is reflected in WPI inflation staying in double-digits since April and reaching a record-high of 14.2% in

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

November. The pass-through of cost pressures to selling prices, which has already been underway, is expected to gain momentum as domestic demand recovers in the coming months. That said, the impact of the third Covid wave on demand recovery will be a monitorable.

Going forward, while commodity prices are expected to stay elevated, they are unlikely to record as sharp a rise as seen last year. The reduced excise duties on petrol and diesel will limit rise in inflation to some extent. This is expected to limit further rise in rate of inflation next fiscal.

Due to these factors, we expect CPI inflation to average 5.5% in fiscal 2022 and 5% in fiscal 2023.

Industrial production softened in November

The Index of Industrial Production (IIP) printed at 128.5 in November, representing 1.4% on-year growth.

Industrial production declined in a broad-based manner in November, perhaps signalling the weakness in economic recovery momentum, after the festive-led push ended previous month. Factors such as heavy rainfall in southern part of the country also believed to have led to supply disruption other than the semiconductor shortages which has plagued the manufacturing activity across a range of industries for a while now. To be sure, fall in exports in November, likely on account of the rising Omicron cases in the key importing destinations of US and Europe, also contributed to a lower domestic industrial activity.

Highlights

- The slowdown in on-year IIP growth to 1.4% in November, from 4.0% in October, was predominantly due to the fall in momentum i.e. on-month decline in IIP. In fact, if not for the low base effect of last year (as IIP had fallen in Nov'20 over Oct'20), on-year IIP growth would have been even weaker.

- The decline in IIP was broad based. On a seasonally adjusted basis (which is an even better indicator of the sequential or on-month movement) IIP contracted 3.0% on-month in November, after having grown 3.5% previous month. According to this indicator, the largest decline in November was seen in electricity (-4.3% on-month), followed by manufacturing (-3.0%) and mining (-1.0%).

- Within manufacturing, biggest monthly decline was seen in *other transport equipment* (-23.3% on-month), followed by *computer, electronic and optical products* (-17.5%), *wearing apparel* (-17.2%), *electrical equipment* (-15.8%), *other non-metallic mineral products* (-15.3%) and *machinery and equipment* (-13.9%). According to this auto sector appears to be the worst hit as is reflected in the continued weakness in sales, partly a reflection of chip shortages.

- According to the use-based classification, *consumer durable goods* saw the biggest decline (-17.3% on-month), followed by capital goods (-9.7%). While the former is a reflection of both weak consumption demand, frail consumer sentiment and input shortages, the latter could be on account of the slowdown in government capex recently.

Outlook

The industrial activity could remain subdued in the short-term going ahead. The manufacturing PMI softened to 55.5 in December from 57.6 in November. Give the high input prices and their pass-on to the end consumers, the demand for manufactured goods could weaken, if the Omicron led third Covid wave again softens the process of economic recovery. The exports trajectory (in view of the rising Covid cases globally) and supply side bottlenecks would remain key monitorables.

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