

Macroeconomics | **First cut**

Inflation peeps above upper band, IIP ticks up a touch

March 2022

CPI inflation rises for the fifth successive month

Inflation based on the Consumer Price Index (CPI), or retail inflation, rose to 6.1% on-year in February compared with 6.0% in January and 5.0% a year ago. This marks the fifth consecutive month of rising inflation, and the second month of it staying above the Reserve Bank of India's (RBI) upper target of 6%. Food has been driving the rise, as benefit from a favourable base is wearing off. Core¹ retail inflation remains sticky around 6% mark, while fuel² inflation softened as domestic fuel prices did not change.

*The Russia-Ukraine crisis has amplified the cost pressures and supply disruptions across the world. For India, the impact will be predominantly felt through high crude oil price. While a cut in excise duties on petrol and diesel can offset some impact, that will not be sufficient if crude stays above \$90 per barrel next fiscal. Core inflation is further expected to face pressure from companies passing on costs to retail prices to a greater extent next fiscal. Food inflation is likely to remain benign on account of normal monsoon, though rising fertiliser costs and international food prices could add some upside. **Due to these factors, we expect CPI inflation to average 5.4% next fiscal compared with an expected 5.5% this fiscal. The estimate assumes average Brent crude at \$85-90 per barrel next fiscal.***

Inflation trends in February: Highlights

- CPI inflation rose to 6.1% on-year in February from 6.0% previous month and 5.0% a year ago
- Food inflation rose to 5.9% from 5.4% previous month and 3.9% a year ago
- Fuel inflation moderated to 8.7% from 9.3% previous month and 3.5% a year ago
- Core CPI inflation was slightly lower at 5.8% compared with 6% seen previous month and also a year ago. Within core, goods inflation averaged 6.3% and services averaged 5.1%
- Rural CPI inflation rose to 6.4% in February from 6.1% previous month. Urban CPI inflation moderated to 5.8% from 5.9% previous month
- Inflation based on wholesale price index (WPI) rose to 13.1% in February from 13.0% previous month and 4.8% a year ago

¹ CPI excluding food and beverages and fuel and light

² CPI fuel and light

How key items saw inflation move

- **Food inflation** was driven up by major items such as cereals (4% in February versus 3.5% previous month), vegetables (6.1% vs 5.1%), and eggs, meat and fish (7.1% vs 5.1%)
- Easing inflation in edible oils (16.4% vs 18.7%), and milk (3.8% vs 4.1%) limited a sharper rise in inflation. Pulse prices remained stable at 3% as previous month
- **Fuel inflation** declined because of a fall in electricity price (-1.5% vs -1.7%), and slowing inflation in liquified petroleum gas or LPG (19.1% vs 25.8%). Domestic LPG price was unchanged in February even as international crude oil price surged 12% on-month on average
- **Core inflation** moderated as transport and communication prices eased (8.1% vs 9.3%). Rising international crude price was not passed on to petrol and diesel prices as well. This, and a high base (11.4% a year ago), contributed to the softening of transportation inflation
- Slight easing was also seen in health services (6.8% vs 6.9%), and recreation and amusement (6.9% vs 7.0%)
- However, inflation rose in clothing and footwear (8.9% vs 8.8%), household goods and services (7.2% vs 7.1%), personal care and effects (5.4% vs 3.5%), housing (3.6% vs 3.5%) and education (3.6% vs 3.3%)

Inflation burden increases in hinterland

In February, inflation saw a sharper rise in rural areas than urban. The rise in rural inflation was broad-based across all income segments.

The burden of inflation varies across different income groups, as the share of spending on food, fuel and core categories differ across classes. Using the National Sample Survey Organisation data, we estimated average expenditure across three broad income groups — bottom 20%, middle 60%, and upper 20% of population — and mapped them with the inflation trends³. We have estimated this separately for rural and urban areas.

Based on this, we find all rural income segments faced average inflation of 6.4%. The rise was sharper for the bottom 80%, which faced 6.1% inflation previous month. In comparison, in the urban areas, the bottom 20% faced the highest inflation, followed by the middle 60% and the upper 20%. Rural population bore more burden because of higher inflation in food and core.

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

Income segment	February 2022	
	Rural	Urban
Top 20%	6.4	5.7
Middle 60%	6.4	5.9
Bottom 20%	6.4	6.0

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

Outlook

The Russia-Ukraine crisis has amplified the cost pressures and supply disruptions across the world. International commodity prices have surged across agricultural, energy, and metal items.

In India, the impact will be predominantly through crude oil price, which crossed \$100 per barrel in February for the first time since 2014. The price continues to hold above the \$100 mark still. Crude oil impacts the country's retail inflation directly (through elevated fuel prices), and indirectly (through impact of elevated transportation costs on other goods). While a cut in excise duties on petrol and diesel can offset some impact, it will not be sufficient if

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

crude stays above \$90 per barrel next fiscal. CRISIL expects Brent crude to average \$85-90 per barrel next fiscal on average, compared with ~\$79 per barrel this fiscal.

Cost pressures for Indian producers, as indicated by WPI inflation, were in double-digits throughout the current fiscal. Some of these cost pressures were passed on to consumers. However, the pass-through was weak given the slack in demand. The pass-through was mostly seen in goods and not in services, reflecting the uneven pickup in activity in these two sectors. We expect the pass-through to increase next fiscal as demand strengthens and becomes more broad-based.

Food inflation is broadly expected to remain benign next fiscal on expectation of normal monsoon and adequate buffer stocks. However, it faces upside risks from rising cost on account of surging fertiliser prices, and minimum support prices rising in tandem with international food prices.

Government interventions to tackle these pressures will remain a key monitorable.

Due to these factors we expect CPI inflation to average 5.4% next fiscal compared with an expected 5.5% this fiscal.

Industrial production steady in the face of the third wave

The Index of Industrial Production (IIP) printed at 138.4 in January, same as in December, but up 1.3% on-year versus 0.7% growth in December.

Despite the third Covid-19 wave intensifying in January, industrial activity was relatively less impacted than the previous waves. The low base effect also helped prop up on-year IIP growth. In terms of sectoral composition, pick up in infrastructure provided support, while capital and consumer goods continued to remain weak, indicating a broad-based revival in the economy still remains elusive.

Highlights

- Better growth in manufacturing and mining sectors boosted IIP 1.3% on-year in January, up from 0.7% in December. Electricity, however, saw a decline. Another factor that supported the growth was a low base as the industrial activity had fallen in January last fiscal from the previous month.
- Growth in manufacturing (which has the highest weight of 77.6% in the IIP) improved to 1.1% in January, from 0.2% in December, suggesting some of the supply side issues may have eased. Robust goods exports in January also seemed to tie up with better manufacturing growth. The mining sector (14.4% weight), too, did better, growing 2.8% on-year, up from 2.6% in December. The growth in electricity (7.9% weight), on the other hand, slowed to 0.9% from 2.8%.
- Of the 23 manufacturing categories, 11 saw an annual increase in activity. Together these represent 42.5% of the manufacturing group. The three sectors that witnessed the maximum improvement in growth in January were *wearing apparel* (21.8% on-year growth in January vs 8.6% in December), followed by *printing and reproduction of recorded media* (13.0% vs 1.7%), and *pharma, medicinal chemical and botanical products* (7.0% vs -1.3%). On the other hand, three sectors that witnessed the most decline were *leather and related products* (-19.0% on-year growth in January), *other transport equipment* (-14.4%) and *electrical equipment* (-9.7%).
- The use-based classification of the IIP suggests infrastructure saw increased activity as *infrastructure and construction goods* growth improved to 5.4% on-year in January, from 2.1% in December, suggesting a pick-up in spending towards the close of the fiscal. That said, the IIP data continues to point towards weakness in both investment and consumption demand. *Capital goods* growth was negative for the fourth consecutive month in January (-1.4%). *Consumer durable goods*, too, witnessed the fourth straight month of growth decline (-3.3%). However, there was some improvement in *consumer non-durable goods* as the sector's growth swung into positive territory (2.1% vs -0.1% in December). It remains to be seen if the trend sustains given the multiple headwinds that consumption revival faces, like high inflation and limited direct fiscal support.

Outlook

While industrial activity seemed to have weathered the impact of the third wave of afflictions, going forward it could face newer roadblocks because of the Russia-Ukraine conflict. For one, prices of energy, especially oil, of which India is a large importer, have been sharply rising. This, and higher non-energy commodity prices could pile up input cost pressure for manufacturing. Being the largest component of the IIP, this would mean a range-bound movement in the near term. The length and magnitude of the conflict would remain key monitorables. Beyond that, broad-basing of domestic economic activity and forecast of a normal monsoon augur well for the industrial activity. The government's capex should also continue to lend a helping hand.

Analytical contacts

Dharmakirti Joshi

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

Adhish Verma

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

Pankhuri Tandon

Economist, CRISIL Ltd.
pankhuri.tandon@crisil.com

Media Contacts

Hiral Jani Vasani

Media Relations
CRISIL Limited
D: +91 22 3342 5916
M: +91 982003 9681
B: +91 22 3342 3000
hiral.vasani@crisil.com

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