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Macroeconomics | First cut

Inflation soars anew, IIP weakens

September 2022

CPI inflation quickens

Inflation, as measured by the Consumer Price Index (CPI), printed above the upper tolerance limit of the Reserve Bank of India's (RBI) target for the eighth straight month in August, at 7% on-year, compared with 6.7% the previous month. This jump was largely driven by accelerating food inflation and the fading base effect of last year, even as non-food inflation moderated slightly.

After moderating between May and July, inflation has again risen in August, driven by surging food inflation, especially cereal prices. Core inflation will remain sticky as producers are expected to pass through cost increases to consumers amid demand recovery (especially in contact-based services). Although international energy prices have declined from 2022 highs, renewed fears of natural gas and coal supply disruption pose fuel inflation risks. We thus maintain our CPI inflation forecast at 6.8% for this fiscal, up from 5.5% in the previous year.

Inflation trends in August: Highlights

- CPI inflation rose to 7% on-year in August from 6.7% the previous month, and was also higher than 5.3% a year ago
- Food inflation saw the highest jump, from 6.7% in July to 7.6% in August
- Fuel[1] inflation moderated the most, to 10.8% from 11.8% in the previous month, and was lower than 12.9% a year ago
- Core CPI[2] inflation came down a notch, decreasing to 5.9% vs 6.0% in July, and 5.8% a year ago
- Inflation jumped in both rural (7.2% vs 6.8% in July) and urban areas (6.7% vs 6.5%)

Food inflation driven by cereals and vegetables

- The surge in food inflation was broad based, with prices of cereals, pulses, fruits, vegetables, milk and milk products increasing on-year
- Inflation in cereal prices jumped to 9.6% in August from 6.9% the previous month, largely led by an increase in wheat/flour prices, as per daily retail prices of cereals provided by the Department of Consumer Affairs. Wheat prices were already under pressure due to the impact of a heat wave earlier this year. Moreover, deficient rains in some of the rice growing regions led to lower kharif sowing (rice sowing was down 5.6% on-year as of September 2, 2022)
- Vegetables saw inflation rising to 13.2% from 10.9% in July due to a combination of both, base effect (inflation in this category was -11.7% last year in August 2021) and sequential momentum: prices of potato,

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

leafy vegetables, brinjal and cabbage jumped on-month, overwhelming the sequential easing in tomato prices (as supplies recovered after the heatwave)

- Prices of milk and milk products jumped to 6.4% on-year in August from 5.8% in July as major milk manufacturers hiked retail packaged milk prices, citing input cost pressures
- Edible-oil inflation slowed significantly to 4.6% in August from 7.5% in July. Edible oil prices have fallen since April 2022, benefitting from a high base, falling global prices, and domestic manufacturers passing on import duty cuts to consumers. International edible oil prices fell 0.7% on-month in August

Fuel inflation inching down

- Fuel inflation slowed in August, driven by a decline in liquefied petroleum gas (22.5% vs 22.9%) and kerosene (87.2% vs 108.8%) prices, reflecting a downward revision of LPG and kerosene prices in June by oil marketing companies
- Petrol and diesel prices fell due to the combined impact of excise duty cuts in May this year and the fall in global crude prices in August. Brent crude prices eased 9.5% on-month to $98.6 on average in August. Prices averaged below $100/barrel for the first time since the Russia-Ukraine conflict began, driven down sequentially by global slowdown concerns

Core inflation climbs down, but ever so slightly

- The marginal 0.1 percentage point slowdown in core inflation between August and July was largely driven by transport and communication (5.2% vs 5.6%) on falling petrol and diesel prices
- That said, prices of appliances such as refrigerators, ACs, washing machines too grew at a slower pace, contributing to moderation in core inflation
- Gold prices, however, rose 6.4% on-year in August (vs 4% in July), potentially due to the lag effect of the duty hike on gold imports announced by the Centre in July
- Services inflation inched up for the third month in a row (5.3% vs 5.2%), driven by education, medical and 'personal care and effects' costs

Poor facing higher inflation as food inflation jumps in August

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

Inflation faced by each income class across regions jumped in August. Across rural and urban areas, the poor (bottom 20% income class) continue to face effectively higher inflation than their richer counterparts (top 20%), as inflation on food and fuel items remains higher than core items (as per on-year values). The poorer classes across regions also saw the highest jump in inflation between July and August.

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

Income segment	August 2022	
	Rural	Urban
Top 20%	7.0	6.7
Middle 60%	7.2	7.1
Bottom 20%	7.4	7.5

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

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

Outlook

CPI inflation rebounded in August after easing since May, exacerbated especially by rising cereal, vegetable, and services inflation that offset the impact of moderating inflation in the past few months (from the dissipating impact of heatwave, falling international crude oil prices, and government interventions).

Going ahead, as the base effect wears down further, CPI inflation may once again come under pressure, particularly from food and core inflation:

1. Tight wheat supplies are contributing to higher cereal inflation. Further, despite adequate rice buffers, lower rice kharif sowing has begun to push up rice inflation and prompted the government to impose a 20% export duty on rice 'other than basmati and parboiled' in September
2. Demand conditions in the economy are improving, as seen from respondents' optimism in RBI's latest surveys for the manufacturing and services sector (August 2022). Respondents expect to raise selling prices in the third and fourth quarter of this fiscal, which will feed into consumer prices. Demand for contact-based services is recovering quickly in particular, resulting in services inflation inching up
3. Even though international energy commodity prices have come down from their highs of 2022, they remain higher on-year. Further, persisting geopolitical tensions arising from the Russia-Ukraine conflict indicate that natural gas and coal could continue to face supply disruptions and volatile price movements. Non-coking coal prices were particularly elevated in July, amid supply constraints from Australia and an increase in demand from Europe to replace Russian coal (CRISIL Research). International natural gas prices too have risen a sharp 36.5% on-month in August

That said, inflation expectations, which the RBI is keen to anchor through its monetary policy actions, have come down: household inflation expectations eased in August owing to a fall in food and transport fuel inflation (as indicated by RBI's household surveys). IIM Ahmedabad's Business Inflation Expectations Survey too shows producers anticipating lower input cost pressures going ahead.

Considering the factors above, we retain our CPI inflation forecast at 6.8% for fiscal 2023.

IIP weakens across major sectors

The Index of Industrial Production (IIP) grew 2.4% on-year in July, declining sharply from 12.7% the previous month. While the slowdown was partly led by a high base (IIP grew 11.5% on-year in July 2021), activity softened sequentially as well (IIP declined 4.6% on-month in July on a seasonally adjusted basis). The trend was, however, at odds with S&P Global India Manufacturing PMI, which at 56.4 in July, remained in the expansionary zone.

Industrial activity showed a broad-based weakness across mining, manufacturing, and electricity. Key export-oriented sectors are beginning to get hit by slowing global growth. Domestic demand did not seem to have lent support to the industry either, with consumer durables and non-durables, infrastructure and construction goods showing softer industrial production in July

IIP in July: Highlights

- IIP grew 2.4% on-year in July compared with 12.7% the previous month and 11.5% in July 2021. Sequentially, IIP declined 4.6% on-month on a seasonally adjusted basis[4]
- Mining IIP growth sunk to -3.3% on-year in July compared with 7.8% the previous month and 19.5% in July 2021. Sequentially, it declined 8.5% on-month
- Manufacturing IIP growth slowed to 3.2% on-year in July from 13% the previous month and 11.1% in July 2021. Sequentially, it declined 5% on-month
- Electricity IIP growth slowed to 2.3% on-year in July from 16.4% the previous month and 16% in July 2021. Sequentially, it declined 8.3% on-month
- On a use-based classification, IIP saw the sharpest sequential decline in capital goods, followed by primary goods, consumer durables, consumer non-durables, and infrastructure and construction goods

Key export goods seem to be hit by slowing global growth

- Within manufacturing, the sharpest fall in IIP was seen in capital goods (5.8% on-year in July versus 29.1% the previous month). Capital goods, among India's top exports, seem to have been hit by slowing global demand as corroborated by trade data for July, with engineering goods exports declining 2.1% on-year in July
- Declining exports also hit IIP growth of textiles (-8.6% vs -2.9%) and petroleum products (7.2% vs 17.4%)

Manufacturing activity weakens in domestic-oriented sectors

- Consumer non-durables IIP declined on-year (-2.0% vs 3.0%), while growth slowed sharply for consumer durables (2.4% vs 25.1%) potentially due to shifting demand from manufacturing to services. In July last year, pandemic restrictions were still at play, which affected services to a greater extent and diverted some of the demand from services to goods. This is normalising, with services benefitting from pent-up demand at present
- Infrastructure and construction goods IIP slowed (3.9% vs 9.3%), indicating domestic investment activity is yet to see a robust pickup. Even as central government spending is registering strong growth (62% on-year between April and July 2022), weak investment activity by states and the private sector seems to be limiting a pickup in overall investment growth.

Outlook

Manufacturing activity is expected to contend with an improving domestic economy and worsening global demand. S&P Global India Manufacturing PMI remained stable at 56.2 in August compared with 56.4 the previous month.

Slowing global growth could be the key headwind to domestic industrial growth. The sharp pace of interest rate hikes, coupled with high inflation, is expected to weaken demand over the next 12 months in major advanced economies

[4] All on-month numbers are seasonally adjusted

which are among India's major export destinations. Latest trade data showed India's exports falling sequentially in August for the second month in a row.

However, recovering local demand is expected to partly support domestic manufacturing this fiscal. Consumer sentiments are gradually improving, as indicated by the latest Reserve Bank of India (RBI) survey, with the incoming festive season expected to provide a fresh impetus to demand.

Capital expenditure is generally lumpy and monthly production data may not fully capture its dynamics. That said, while central government capex is broadly on expected lines, spending of states is yet to gain momentum. Improving capacity utilisation and heathy corporate financial profiles should support an uptick in private investments in some industrial segments, especially those linked with the government's infrastructure spend.

Overall, broad-basing of domestic economic activity, especially with the contribution from contact-based services, could support industrial activity via spill over effects.

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