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Macroeconomics | First cut

Inflation accelerates, IIP turns red

October 2022

CPI inflation swells led by food and services

Inflation, as measured by the Consumer Price Index (CPI), printed at 7.4% on-year in September, compared with 7% in August and above the Reserve Bank of India’s (RBI’s) upper tolerance limit for the ninth straight month. The jump was driven by accelerating food inflation and the low base of last year, even as non-food inflation remained sticky. Services inflation also inched up.

Retail inflation surged anew in September, driven by food (cereals and vegetables). Core inflation was sticky and is expected to remain so, as producers pass on input costs to consumers amid demand recovery (especially in contact-based services). Imported inflation continues to be a concern given the depreciation in the rupee and elevated international energy prices amid persisting geopolitical tensions. This was reflected in a sequential pick-up in fuel inflation. We thus maintain our CPI inflation forecast of 6.8% for this fiscal, higher than 5.5% previous year.

Inflation trends in September: Highlights

- CPI inflation rose to 7.4% on-year in September from 7% previous month — it was also higher than 4.35% a year ago
- Food and beverage inflation soared the highest to 8.4% from 7.6%
- Fuel[1] inflation moderated to 10.4% from 10.8%, but rose sequentially
- Core CPI[2] inflation remained sticky at 6% compared with 5.9%
- Inflation jumped in both rural (7.6% vs 7.2%) and urban (7.3% vs 6.7%) areas

Food inflation driven by cereals, vegetables and milk

- The surge in food inflation was broad-based in September (like previous month), with prices of cereals, pulses, vegetables, milk and milk products increasing on-year
- Cereal inflation jumped to 11.5% in September from 9.6% in August, led by wheat/flour and rice. Wheat inflation (17.4% in September) has, in fact, been in double digits since June, when supplies came under pressure from the impact of a heat wave. Lower rice sowing (down 4.7% on-year as of September 30) and delayed monsoon withdrawal exacerbated pricing pressures on rice- inflation in rice was at 9.2% in September, up from 6.9% in August
- Vegetable inflation rose to 18.1% from 13.3%, due to both a low base (inflation in this category was down 22.4% in September 2021) and sequential momentum (prices of vegetables such as tomato rose 24.7% on-month[3]).

[1] Refers to CPI fuel and light
[2] CPI excluding food and beverages and fuel and light
[3] Non-seasonally adjusted

- Inflation for milk and milk products jumped to 7.1% from 6.4%, reflecting the hike in retail packaged milk prices effective August. Further spread of lumpy cow disease remains a monitorable as it could hurt milk production and put pressure on its prices
- Edible-oil inflation slowed significantly to 0.4% from 4.6%, reflecting the impact of a continued fall in international edible oil prices (since April) and reduction in import duty

Sequential pick-up in fuel inflation

- Fuel inflation slowed on-year in September, driven by liquefied petroleum gas and kerosene, whose prices are down from last year
- That said, on a sequential basis (non-seasonally adjusted), some pressures emerged from rising electricity, coal and coke prices: fuel inflation was 0.4% on-month, led by electricity (prices up 1.6% on-month), coal (0.9%) and coke (1.5%). Electricity tariffs have been revised upwards in many states since the start of the fiscal. International coal prices are elevated due to constraints in supply from Australia, Russia and China — they rose ~1% on-month in September

Core inflation sticky

- Core inflation remained elevated at 6% in September, led by an increase in prices of clothing and footwear, housing, and household goods and services
- Services inflation inched up for the fourth month in a row (5.5% in September vs 5.3% in August), driven by education and medical costs
- A higher services inflation contrasts with moderation in inflation for 'core goods' (goods excluding food, fuel and services), indicating a revival in demand for services propelling inflation in the segment
- Rising services inflation is impacting urban areas more, which have a higher share in consumption of services than their rural counterparts. Inflation in urban areas jumped 0.7 percentage point (pp) from August to September, while that in rural areas increased 0.4 pp (of course, in absolute terms, rural inflation remains higher than urban inflation, owing to higher weightage given to the food component)

The poor facing higher burden of inflation due to elevated food prices

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 mapped expenditure baskets of three broad income groups — bottom 20%, middle 60%, and upper 20% of the population — with September[4] inflation trends. The table below presents the average inflation faced by each income class.

Inflation faced by each income class across regions jumped in September. Across rural and urban areas, the poor (bottom 20% income class) continued to face effectively higher inflation than their richer counterparts (top 20%), as inflation for food and fuel items remained higher than for core items (as per on-year values).

CPI inflation across income classes (% on-year)

Income segment	September 2022	
	Rural	Urban
Top 20%	7.3	7.2
Middle 60%	7.7	7.7
Bottom 20%	7.8	8.1

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

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

Outlook

CPI inflation may moderate in the coming few months as base effect emerges and prices of vegetables correct (seasonal effect comes down in winter with fresh harvest). But it will remain elevated above the RBI's upper tolerance band of 6% with pressures particularly from food and core inflation.

1. Tight wheat supplies will continue to contribute to higher cereal inflation until the rabi season. Further, despite rice buffers, lower rice kharif sowing is leading to pricing pressures for the crop.
2. A slight sequential pick-up in fuel inflation, arising from electricity and coal prices, is causing fuel inflation on-year to remain elevated. International energy prices, particularly of crude oil, have again turned volatile with OPEC (Organization of the Petroleum Exporting Countries) producers contemplating supply cuts. This, combined with a depreciating rupee, means that imported inflation could continue to seep into domestic retail prices. Thus, sequential momentum in fuel inflation would be a monitorable given persisting geopolitical tensions impacting international energy prices.
3. Improving demand conditions in the economy are expected to reflect in producers raising selling prices in the third and fourth quarters this fiscal. This was reiterated in responses to the RBI's latest survey of the manufacturing and services sectors (September 2022).
4. Inflation expectations are inching up: The RBI's latest survey for September showed households' median inflation expectations have increased since July, both for three-month and one-year ahead periods, across product groups. That said, the RBI has communicated that its monetary policy actions are aimed at ensuring inflation expectations do not get de-anchored.

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

Steepening and broadening decline in IIP

The Index of Industrial Production (IIP) declined 0.8% on-year in August, compared with 2.2% growth previous month. This marked the third successive month of IIP slowdown, and the first month of decline since February 2021. While the slowdown was partly led by a high base (IIP grew 13.0% on-year in August 2021), activity softened sequentially as well (IIP declined 2.8% on-month in August on a seasonally adjusted basis). This is in contrast to the expansionary signal from PMI manufacturing at 56.2 in August.

The decline in IIP was driven by the manufacturing sector. Export-oriented sectors were hit by slowing global growth. Domestic-oriented sectors like consumer non-durables and infrastructure and construction goods also witnessed falling activity. Downside risks to the industrial outlook are expected to increase with intensifying global slowdown over the next 12 months. The hit to agricultural incomes from uneven monsoon could hurt domestic demand prospects.

IIP in August: Highlights

- IIP declined 0.8% on-year in August, compared with 2.2% growth previous month and 13.0% growth in August 2021. Sequentially, IIP declined 2.8% on-month on a seasonally adjusted basis[5]
- Mining IIP declined 3.9% on-year in August, compared with 3.3% fall previous month and 23.3% growth in August 2021. Sequentially, however, it grew 4.0% on-month
- Manufacturing IIP declined 0.7% on-year in August, compared with 3.0% growth previous month and 11.1% growth in August 2021. Sequentially, it declined 3.7% on-month
- Electricity IIP growth slowed to 1.4% on-year in August from 2.3% previous month and 16% in August 2021. Sequentially, however, it accelerated to 6.2% on-month
- On a use-based classification, IIP growth decelerated for all sectors, with the sharpest fall in consumer non-durables, followed by consumer durables, intermediate goods, and infrastructure and construction goods

IIP growth sinks further for export-oriented sectors

- IIP growth fell for all export-oriented sectors, the weakest being pharma products (-19.0% on-year IIP growth in August versus -3.5% previous month), followed by apparel (-18.3% vs 15.2%), textiles (-12.2% vs -8.6%), basic metals (2.9% vs 6.1%), and petroleum products (6.6% vs 7.2%)
- Exports have been on a downtrend since July, as major economies like the United States (US), European Union (EU) and China face weakening growth momentum. In August, India's exports grew 1.6% on-year, compared with 2.1% growth previous month.

Slowdown permeates to consumer and investment-oriented sectors

- Consumer non-durables IIP declined for the second consecutive month (-9.9% vs -2.8%), despite the low base of last year. Consumer durables, too, slipped in the red (-2.5% vs 2.3%)
- IIP growth fell for investment-oriented segments such as infrastructure and construction goods (1.7% vs 3.8%). IIP growth for capital goods moderated (5.0% vs 5.7%), albeit influenced by a high base (20% in August 2021). Even as central government spending is surging (47% on-year between April and August 2022), weak investment activity by states and the private sector is limiting the pick-up in overall investment growth. The persisting Russia-Ukraine war and intensifying global outlook have further hurt investment appetite, despite healthy balance sheets of the corporate sector and higher capacity utilisation.

Outlook

India will not be immune to the effects of a global slowdown, which will play out over the next 12 months. S&P Global expects the US and the EU to sink into a recession in 2023. China's economic outlook continues to be weak on account of Covid-19 pandemic restrictions. A sharp slowdown can materially impact export-oriented industrial growth.

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[5] All on-month numbers are seasonally adjusted

Domestic demand has broadly been resilient so far, reflecting catch-up to the pre-pandemic trend. The latest RBI survey indicates consumer sentiment is continuing to improve, while bank credit offtake has risen further. However, rural demand would remain a key monitorable, as uneven and unseasonal monsoon has hit agricultural production for critical crops such as rice and wheat. Persistent high inflation, which destroys purchasing power, remains a significant headwind for demand recovery. These factors could increase downside risks for industrial growth.

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