

## Macroeconomics | **First cut**

# Base effect-led moderation in inflation, capex boosts IIP

November 2022

## Headline inflation moderates, but core inflation remains sticky

Inflation, as measured by the Consumer Price Index (CPI), moderated to 6.8% on-year in October, down from 7.4% in September. This was expected due to the base effect from last fiscal. There was some easing in sequential momentum in cereal inflation, but it was offset by acceleration in vegetable inflation. Core inflation continues to remain sticky, exerting pressure on headline inflation.

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*Retail inflation climbed down in October owing to strong base effect from last fiscal. This is expected to continue playing out, leading to further moderation in inflation on-year. However, sequential momentum in prices of vegetables and cereals will be a monitorable given the weather-related impact on supplies. Core inflation remains around 6% indicating recovering demand and continued pass-through of input prices. We thus maintain our CPI inflation forecast of 6.8% for this fiscal, compared with 5.5% previous year.*

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### Inflation trends in October: Highlights

- CPI inflation slowed to 6.8% on-year in October from 7.4% in September — though it was higher than 4.5% a year ago
- Food and beverage inflation saw the maximum softening to 7% from 8.4% in September
- Fuel<sup>1</sup> inflation maintained the trend of continuous moderation to 9.9% (vs 10.4%)
- Core CPI<sup>2</sup> inflation remained sticky at 6%, same as in September

### Higher vegetable prices on-month imparts some sequential momentum to food inflation

- Moderation in food inflation on-year brought down the headline inflation in October: the drivers may seem difficult to disentangle as both base effect and momentum effect played opposing roles for major commodities. For instance, cereals inflation jumped higher to 12.1% on-year in October (from 11.5% in September), but sequentially, inflation slowed (1% on-month vs 2% in September).
- On the contrary, vegetable inflation slowed down sharply on-year to 7.8% (from 18.1% previous month) but prices jumped month-on-month to 4.1% (vs 2.7% in September). The seasonality effect in vegetable prices usually peaks around October-November, which explains the sequential rise in vegetable inflation on-month (prices of tomato rose 14% on-month, while that of onions rose more than 10%)
- Inflation for milk and milk products continued to climb, reaching 7.7% in October from 7.1% in September and 6.4% in August, as hike in prices of retail packaged milk seeps through milk products as well.

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<sup>1</sup> Refers to CPI fuel and light

<sup>2</sup> CPI excluding food and beverages and fuel and light

## Fuel inflation inches down on lower regulated prices of kerosene and LPG

- Fuel inflation continued to slow on-year in October, as kerosene prices come down sequentially and LPG prices remained unchanged from September
- Rising electricity tariffs in different states and their impact on CPI component of electricity would remain a continuous monitorable. So will passthrough of international coal prices on domestic inflation.

## Core inflation sticky

- The biggest takeaway from October CPI print seems to be the persistent stickiness in core inflation, which remains elevated at 6% in October and same as September, led by an increase in prices of pretty much the same components: clothing and footwear, housing, and household goods and services, personal care and effects, etc
- Services inflation was at (5.6% in October — same as September), driven by housing, medical and transport costs (particularly in airfare, where prices jumped 14.7% on-year in October compared with 0.7% in September).
- Steady inflation in services contrasts with moderation in inflation for ‘core goods’ (goods excluding food, fuel and services), which slowed for the third month in a row to 5.3% in October vs 6.8% in September

### 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 has mapped expenditure baskets of three broad income groups — bottom 20%, middle 60%, and upper 20% of the population — with October<sup>3</sup> inflation trends. The table below presents the average inflation faced by each income class.

Inflation faced by each income class across regions slowed in October-similar to trend in headline inflation. 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	October 2022	
	Rural	Urban
Top 20%	6.9	6.5
Middle 60%	7.0	6.8
Bottom 20%	7.1	7.0

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

## Outlook

CPI inflation may moderate in the coming few months as base effect comes into play and with the expectation of a healthy rabi crop. Further, seasonal effect for vegetable inflation comes down after November following fresh harvest. Yet, inflation will remain elevated above the RBI’s upper tolerance band of 6%, with pressure from both, food and core.

On food, lower rice sowing in the kharif season could continue to impart pricing pressures. Core inflation is now becoming more dominated by services inflation, indicating recovery in demand and greater pricing power for producers to pass on costs. Last, for fuel inflation, volatility in international crude oil prices owing to geopolitical tensions implies we are not out of the woods yet.

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

Considering these factors, we retain our CPI inflation forecast at 6.8% for this fiscal, with the upcoming last quarter inflation likely printing below 6%.

## IIP rebounds on capex support

Reversing the slowing trend, the Index of Industrial Production (IIP) grew 3.1% on-year in September compared with -0.7% in August. The rebound was a result of favourable base effect (for mining and electricity) as well as a pick-up in sequential growth (in manufacturing). Infrastructure, construction, and capital goods drove the sequential improvement in manufacturing.

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*Robust capital spending by government seems to be driving the demand for infrastructure-related goods and supporting manufacturing growth. This offset the impact of weakening growth in export-oriented sectors. The intensifying global slowdown could become a bigger drag on domestic industrial growth in the coming months.*

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### IIP in September: Highlights

- IIP grew 3.1% on-year in September compared with -0.7% in August and 4.4% in September 2021. Sequentially, IIP grew 1.5% on-month on a seasonally adjusted basis<sup>4</sup>
  - Mining IIP grew 4.6% on-year in September compared with -3.9% in August and 8.6% in September 2021
  - Manufacturing IIP grew 1.8% on-year in September compared with -0.5% in August and 4.3% in September 2021
  - Electricity IIP grew 11.6% on-year in September, compared with 1.4% in August and 0.9% in September 2021
  - On a use-based classification, IIP growth was strongest for capital goods, primary goods, and infrastructure and construction goods. However, IIP declined for consumer durables and non-durables
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### Manufacturing activity gets a capex boost

- Manufacturing IIP grew 1.8% on-year and 0.5% on-month in September
- The improvement in manufacturing IIP growth was driven by infrastructure and construction goods (7.4% on-year in September versus 2.1% previous month). This is reflective of robust government capex growth, which is corroborated by central government's capex growing 49.5% on-year in April-September 2022. State capex has also grown ~12% on-year during this period, based on data available for 24 states.
- Capital goods IIP growth strengthened (10.3% vs 4.3%), further indicating demand-revival for investment-related goods.
- However, activity continued to weaken in several export-oriented sectors, such as textiles (-12% vs -12.2%), wearing apparel (-21.7% vs -18.1%), and pharmaceutical products (-17.2% vs -18.1%).
- Coke and petroleum products were the only major export sector that grew (9.8% vs 6.6%).

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<sup>4</sup> All on-month numbers are seasonally adjusted

- IIP growth remained negative for both consumer durables (-4.5% vs -2.5%) and consumer non-durables (-7.1% vs -9.5%). Sequentially, while IIP declined for consumer durables, it stagnated for non-durables.

### **Mining and electricity IIP lifted up by base effect**

- The sharp rise in electricity IIP growth was primarily due to a favourable base (as it had sunk to 0.9% in September 2021 from 16% in August). Sequentially, it merely grew 0.1%
- Mining IIP growth too (4.6% in September 2022 vs -3.9% in August) was due to low base (8.6% in September 2021 vs 23.3% in August). Sequentially, it declined 0.3% on-month

### **Outlook**

In fiscal 2023 so far, domestic demand seems to be supporting industrial growth. S&P Global's Purchasing Manager's Index (PMI) remains in expansionary zone since July 2021, rising to 55.3 in October from 55.1 in September.

Manufacturing activity is finding traction from the catch-up to pre-pandemic trend (particularly in the ongoing festive season), robust government capex, and relatively accommodative financial conditions. Bank lending rates have remained lower than pre-pandemic 5-year average so far despite the recent hikes, and bank credit growth rose to a decadal high of 17.4% in October. However, as transmission of rate hikes progresses, higher borrowing costs could take off some steam from the current strength in domestic demand. Rural demand would also remain a key monitorable, as uneven weather has hit agricultural production for critical crops such as rice and wheat.

A bigger hit is expected from the intensifying global slowdown over the next 12 months, driven by tightening financial conditions and weakening demand. S&P Global expects the US and the European Union to tip into a recession in 2023, driven by tightening financial conditions and elevated inflation. Being India's major export destinations, their weakening growth prospects have increased downside risks for India's industrial outlook.

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