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Macroeconomics | First cut

Veggies to the rescue, but…

…food and core remain pressure points for inflation

January 2023

Consumer Price Index (CPI) inflation moderated further in December to 5.72% on-year (from 5.88% in November), remaining below the RBI's upper tolerance limit of 6.0% for the second consecutive month. The slowdown was largely led by sharp fall in vegetable prices with the arrival of new crops in winter. But pressure points remain from both food (cereals, milk, pulses) and core.

Retail inflation again undershot expectations due to sharp correction in vegetable prices, as most other major categories saw on-year rise in prices, i.e., food ex-vegetables, fuel, and core. Sticky core inflation remains the biggest worry. We see a modest downside to our CPI inflation forecast of 6.8% for this fiscal, owing to the sharper-than-expected fall in vegetable prices.

Inflation trends in December: Highlights

- CPI inflation slowed to 5.72% on-year in December, from 5.88% in November and comparable to the 5.7% print of December 2021
- Food and beverage inflation softened to 4.6% from 5.1%
- Fuel[1] inflation continued to trend higher for the second straight month, jumping to 11% (vs 10.6%)
- Core CPI[2] inflation remained sticky at 6.1%, slightly higher than the 6% of previous three months

Sharp correction in vegetable prices eases food inflation

- Vegetables continue to impart volatility to headline inflation with sharp movements: prices fell 15.1% on-year in December (vs 8.1% decline in November). This was largely led by sequential softening of prices, some in double digits, of major vegetables like onion, potato, tomato, and leafy vegetables. Easing of prices is a seasonal phenomenon as winter arrivals of vegetable crops bring down prices
- Yet, prices of most other food groups rose on-year. Cereals, which contributed majorly to inflation zooming past 7% for most of first half of this fiscal, saw prices going up by 13.8% in December vs 13% in November, indicating continued pressure on supplies (particularly wheat, persistent momentum in which is also contributing to sequential rise in prices of derivative products like maida, suji, noodles, and bakery)
- Other categories that are seeing both sequential and on-year jump in prices compared with the previous month, include milk (8.5% on-year in December vs 8.2% in November), pulses (3.9% vs 3.1%), and spices (20.4% vs 19.6%)

Fuel inflation jumps sequentially

- It may seem puzzling that fuel inflation soared higher on-year for the second straight month (11% in December from 10.6% in November and 9.9% in October). This is despite some base effect from last year

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

and LPG and electricity prices remaining unchanged sequentially. However, sequential rise in kerosene, and coke and charcoal contributed to overall rise in inflation

- The sequential rise in kerosene CPI (by PDS: 2.3% on-month, by other sources: 2.5%) is especially surprising given that kerosene prices were lower across major metro cities in December: for instance, subsidised kerosene was Rs 82.8/L in Kolkata as on December 1 (vs Rs 83.4/L previous month). Similarly, price of non-PDS superior kerosene oil was at Rs 1.05 lakh/kL in Delhi on December 1 and lowered to Rs 0.96 lakh/kL on December 16 (compared with Rs 1.1 lakh/kL in November)[3]
- To some extent, rising coke and charcoal prices are being driven by the increase in international coal prices, given imports account for 25% of our domestic consumption. Australian coal prices rose more than 10.0% on-month in December

Persistent core inflation

- Persistence of core inflation, which remains around 6% since May 2022, poses the biggest risk to headline inflation. Core inflation in fact jumped to 6.1% in December (from 6% in November)
- Inflation rose mostly in health (6.2% vs 5.8%), education (5.9% vs 5.7%), and personal care and effects (8.1% vs 7%), while other categories like clothing and footwear saw some correction (9.6% vs 9.8%)
- The sharp rise in inflation in personal care and effects is largely due to higher gold prices (up 8.8% on-year in December vs 5% in November). International gold prices are rising sequentially and would have contributed to domestic inflation as well

Despite fall in food inflation, not much respite for rural poor due to fuel inflation

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 December[4] inflation trends. The table below presents the average inflation faced by each income class.

With inflation in food (the largest consumption category for the poor) coming down sharply to below core and fuel inflation, the bottom 20% is now effectively facing the same (in rural areas) or slightly lower inflation (in urban areas) than the top 20%.

However, inflation in urban areas saw much more easing in December as against rural areas. While slowing food inflation is offering some relief, particularly to the rural poor (bottom 20%), rise in fuel inflation is countering it to some extent (fuel accounts for a higher share of consumption expenditure in rural than in urban areas).

CPI inflation across income classes (% on-year)

Income segment	December 2022	
	Rural	Urban
Top 20%	6.1	5.4
Middle 60%	6.1	5.2
Bottom 20%	6.1	5.2

Source: NSSO, National Statistical Office, CEIC, CRISIL

[3] All data from Indian Oil website, https://iocl.com/Kerosen-Nonsubsid-Previous-Prices
[4] For detailed methodology and findings, refer to CRISIL Quickonomics: *Same inflation, different burdens by income* (October 2021)

Outlook

The December CPI inflation print, despite coming in below 6% and our expectations, can be considered to be influenced by idiosyncratic elements, particularly the sharp correction in vegetable prices. Indeed, barring vegetables, most major *movers and shakers* of headline inflation (viz., cereals, pulses, milk, meat, fuel, core) saw inflation going up on-year. Hence, the slowdown in inflation doesn't provide much comfort as of yet.

Average CPI inflation for the third quarter of fiscal 2023 thus comes to 6.1%, lower than the RBI's 6.6% forecast (per its December MPC meeting).

That said, going ahead, robust rabi harvest is expected to bring down wheat prices. Some relief can be expected from fuel inflation if decline in Brent crude oil prices sustains. However, trajectory of international coal prices will remain a monitorable. Core inflation remains the biggest risk to headline – with continued passthrough of input costs and persistent demand for services.

Taking all factors into account, we see a downward bias to our fiscal 2023 CPI inflation forecast of 6.8%. We expect the RBI to raise repo rate by 25 bps in February before hitting the pause button. Terminal rate for this cycle is likely to be 6.5%.

Next fiscal, inflation is expected to trend down to 5%, led by a combination of factors: base effect, lower international commodity prices, and impact of monetary policy actions (rate hikes and liquidity withdrawal) on inflation.

IIP revives amid the festive season

The Index of Industrial Production (IIP) surged 7.1% on-year in November 2022 in contrast to -4.2% previous month. The rise was a result of the base effect, and strong sequential growth across major sectors. Export and consumer-oriented sectors turned supportive of IIP, after weakening in the preceding four months. Investment and infrastructure-related goods continued to be among the top contributors to industrial growth.

While investment and infrastructure-related goods saw the highest IIP growth, improvement was also seen in consumer and export-oriented sectors amid the festive season. Domestic demand has been supported so far by robust central capital expenditure, recovery of household consumption to pre-pandemic levels, and conducive financial conditions. This resilience, however, could be tested by rising borrowing costs next fiscal. We expect this, combined with weakening global growth, to bring down GDP growth to 6.0% next fiscal from 7.0% in the current year.

IIP in November: Highlights

- IIP grew 7.1% on-year in November compared with -4.2% previous month and 1.0% in November 2021. Sequentially, IIP grew 6.7% on-month on a seasonally adjusted basis[5]
- Mining IIP grew 9.7% on-year (vs 2.5% previous month and 4.9% in November 2021). Sequentially, it grew 2.9% on-month
- Manufacturing IIP grew 6.1% on-year (vs -5.9% and 0.3%). Sequentially, it grew 7.6% on-month
- Electricity IIP grew 12.7% on-month (vs 1.2% and 2.1%). Sequentially, it grew 10.7% on-month
- Based on the use-based classification, IIP saw strongest growth in capital goods, followed by infrastructure and construction goods, consumer non-durables, consumer durables, primary goods, and intermediate goods

Capital goods shore up IIP growth

- Among manufacturing sub-sectors, capital goods saw the highest IIP growth (20.7% on-year in November versus -1.7% previous month), followed by infrastructure and construction goods (12.8% vs 1.1%)
- Robust capital expenditure (capex) by the central government has been driving demand for these goods. The central government has frontloaded capex this fiscal, which rose 63.4% on-year until November. State capex is also expected to pick up towards the end of this fiscal
- Sustained demand for capex goods may also be indicating an uptick in private investment

Manufacturing revives on festive domestic and external demand

- After falling between July and October, consumer durables and non-durables saw IIP growth rise in November, driven by the festive season on the top of a favourable base effect. Consumer durables saw IIP growth increase to 5.1% (vs -17.8% previous month) and non-durables, 8.9% (vs -13.4%)
- IIP growth also rose for major export sectors such as machinery and equipment (20.8% vs -9%), pharmaceuticals (9.9% vs -21.4%), basic metals (8.1% vs 4.1%), and chemical products (6.2% vs -2.4%). Exports turned positive in November (0.6% on-year vs -12.1% previous month) amid robust demand from advanced economies ahead of their festive season

Strong growth in input sectors reflects upbeat domestic activity

- The sharp rise in IIP growth of input sectors such as electricity (12.7% vs 1.2%) and mining (9.7% vs 2.5%) further indicate improving demand conditions in the broader economy

Outlook

Domestic demand has proved to be resilient so far amid the global headwinds. S&P Global's Purchasing Managers'

[5] All on-month numbers are seasonally adjusted

Index (PMI) indicates that economic activity in India has been the strongest among major emerging markets. In December, PMI manufacturing for India came at 57.8, compared with 49.0 for China[6], 46.4 for Vietnam, 50.9 for Indonesia, and 44.2 for Brazil. A reading above 50 indicates expansion, and vice versa.

Domestic demand has been resilient so far driven by the demand catch-up post the pandemic, pickup in investment and conducive financial conditions. Credit growth has been strong and broad based, and major bank lending rates were still below the pre-pandemic levels until November.

However, transmission of the RBI's rate hikes to lending rates is picking up. In December, key bank loan rates such as the 6-month MCLR[7] benchmark, housing loans, and auto loans, reached close to the pre-pandemic 5-year average (i.e., between fiscals 2016 and 2020). Further rise in lending rates will test the resilience of domestic demand in the coming year.

Global factors will also eventually turn negative after the festive season ended in December and high borrowing costs pinch purchasing power in advanced economies.

Due to these factors, we expect India's GDP growth to slow from 7.0% in current fiscal to 6.0% next year. Risks are tilted to the downside.

[6] Caixin China General Manufacturing PMI
[7] Marginal cost-based lending rate

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