Macroeconomics | First cut

Inflation darts up, industrial activity moderates

February 2023

Food, core push inflation above the RBI target band again

Consumer Price Index (CPI) inflation jumped sharply in January to 6.52% on-year (from 5.72% in December). The acceleration was driven largely by a rise in food (cereals, protein-based items) and core (personal care and effects) inflation. Both momentum (from on-month price increases) and some low-base effect contributed to pulling up the headline inflation, overwhelming the effect of deflation in vegetables. In fact, excluding vegetables, CPI inflation would have jumped to 7.7% (compared to 7.2% in December).

Retail inflation surprised again, this time on the upside: outlining the volatility arising from food (earlier vegetables, now cereals and protein) and the importance of supply-side factors in determining the trajectory of inflation. Sticky core inflation continues to pose challenges from the demand side. We maintain our CPI inflation forecast for fiscal 2023 at 6.8%, given the underlying pressures from food and core.

Highlights of inflation trends in January

- CPI inflation rose to 6.52% from 5.72% in December 2022, and 6% print of January 2022
- Food and beverage inflation jumped the most: to 6.2% from 4.6% previous month
- Fuel[1] inflation moderated slightly to 10.8% from a downwardly revised 10.9% of December
- Core CPI[2] inflation remained sticky at 6.2%, slightly higher than the 6.1% of December

Price rise in cereals and protein push up food inflation

- Food inflation continues to drive swings in headline inflation: in November and December, sharp seasonal correction in vegetable prices brought down inflation below 6% (the RBI's upper tolerance band). This, despite continued on-year rise in cereals, milk, egg, pulses. However, in January, acceleration in price rise in the latter group countered the deflation in vegetable prices (-11.7% on-year)
- Inflation in cereals rose to 16.1% (from 13.8% in December) indicating continued pressure on wheat supplies (built up since heatwave of early last year)
- Protein items saw inflation rise across the board: milk: 8.8% (vs 8.6% previous month), pulses 4.3% (compared to 3.9%), eggs: 8.8% (vs 6.9%), and meat & fish: 6% (vs 5.1%)
    - Increases in retail milk prices is reflecting the price hike effected by manufacturers in August 2022 (prompted by higher input costs)
    - Lower production of tur, chana in the current agricultural year is adding to some price pressures, though there is some low base effect at play, too, in the rise in pulses inflation in January

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

- Spices inflation is showing a secular uptrend since May 2022 (in on-year terms): jumping to 21.1% in January (vs 20.4% in December). Thus, even with a relatively smaller weight of 2.5% in overall CPI, spices inflation contributed an outsized 8% to headline inflation

Meaningful moderation in fuel inflation held back by momentum in coal prices

- Slight moderation in fuel inflation (10.8% on-year in January vs 10.9% in December) is arising from sequential decline in PDS kerosene prices and high base effect in coal prices
- That said, sequential momentum in coal and charcoal prices is providing some floor to fuel inflation slowing meaningfully: charcoal prices rose 2.9% on-month, and coal prices by 1.2%. Volatility in international coal prices may be contributing to swings in domestic coal prices as well

Sticky core inflation

- Stickiness of core inflation, which jumped to 6.2% in January (vs 6.1% in December) is seen from demand in both goods and services: particularly in sequential momentum in price rise of clothing and footwear, household goods and services (household appliances, utensils, and furniture items) and health and recreation services. That said, most items under core category saw inflation slowing in on-year terms (high base effect overwhelming the sequential price rise)
- Yet, the largest contributor to rise in core inflation in January was the surge in ‘personal care and effects’ inflation to 9.6% on-year from 8.1% in December- this was led by gold prices rising 13.3% in January (vs 8.8% previous month). International gold prices have risen sharply in December 2022 and January 2023, contributing to domestic inflation as well

Outlook

The January CPI print highlights that pressures on headline inflation from food and core items continue, warranting caution. We had highlighted last month that the December and November CPI numbers, which had printed below expectations, could be considered as idiosyncratic. If the CPI print for remaining months of Q4 remains at the elevated January levels, average annual CPI inflation could print at 6.7% in fiscal 2023 (above the RBI’s revised forecast of 6.5%)

That said, going ahead, food inflation outlook is expected to improve: from both a robust rabi harvest (providing relief for wheat and pulses prices) and improved procurement. Fuel inflation inching down (albeit, only gradually) is providing some comfort: though the trajectory of international crude oil prices remains a monitorable amid persistent geopolitical tensions and re-opening effect from China

Core inflation remains the biggest concern – as also highlighted by the RBI governor in the latest monetary policy statement-with continued passthrough of input costs and domestic demand proving to be resilient

Taking all factors into account, we maintain our fiscal 2023 CPI inflation forecast of 6.8%. Next fiscal, inflation is expected to trend down to 5%, led by a combination of factors: base effect, lower food inflation as cereals’ supplies shore up, lower international commodity prices, and impact of monetary policy actions (rate hikes and liquidity withdrawal) on core inflation

Manufacturing drags IIP growth in December

The Index of Industrial Production (IIP) slowed to 4.3% on-year in December compared with 7.3% previous month. Manufacturing recorded the sharpest slowdown, driven by both consumer and investment-oriented sectors.

Industrial growth is expected to come under pressure next fiscal as global demand slows. Domestic demand too, could lose momentum as the transmission of RBI's rate hikes progresses. We expect these factors to slow GDP growth to 6.0% in fiscal 2024 from 7.0[3]% in current year.

Data highlights

- IIP grew 4.3% on-year in December compared with 7.3% previous month
- Slower growth was seen in manufacturing (2.6% in December versus 6.4% previous month), and electricity (10.4% vs 12.7%). Mining remained stable (9.8% vs 9.7%)
- Within manufacturing, consumer durables saw the sharpest decline, followed by intermediate goods, capital goods, infrastructure and construction goods, and consumer non-durables

Growth falters for both consumer and investment-oriented sectors

- Consumer durables saw the sharpest decline (-10.4% vs 5.3%), driven by computer and electronic products, textile products, leather products and furniture. Consumer non-durables too, slowed to 7.2% from 9.1%, indicating waning festive season demand
- Capital goods IIP slowed sharply (7.6% vs 21.6%), driven by machinery and electrical equipment, reflecting weaker domestic and external demand
- Infrastructure and construction goods slowed (8.2% vs 13.2%) despite capital expenditure rising sequentially by centre and most major states in December
- A chunk of export-oriented sectors slowed down, including machinery, metals, textiles and chemicals, while petroleum products and pharmaceuticals did better

Outlook

IIP data continues to be volatile. The December print came at odds with S&P Global's Purchasing Manager's Index (PMI) for manufacturing, which surged to 57.8 in December from 55.7 previous month. Overall IIP growth in the third quarter (2.5% on-year average) improved over the second quarter (1.6%), helped by festive demand and government capex.

That said, demand momentum is expected to ease both at the domestic and global levels going ahead. The transmission of the Reserve Bank of India's (RBI's) rate hikes has picked up since December. This could take some steam off domestic demand next fiscal. Advanced economies will also inevitably face slower growth in 2023 as a sharp rise in borrowing costs constrains purchasing power.

Due to these factors, we expect India's GDP growth to slow to 6.0% next fiscal from 7.0% this fiscal.

[3] First advance estimate by National Statistics Office

Analytical contacts

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

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

Amruta Ghare
Economist, CRISIL Ltd
amruta.ghare@crisil.com

Media contacts

Aveek Datta
Media Relations
CRISIL Limited
M: +91 99204 93912
B: +91 22 3342 3000
aveek.datta@crisil.com

Riddhi Savla
Media Relations
CRISIL Limited
M: +91 98199 57423
B: +91 22 3342 3000
riddhi.savla1@crisil.com

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