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Macroeconomics | First cut

Inflation cools, IIP perks up

June 2022

CPI prints lower in May, but above RBI's target for the fifth month

Inflation based on the Consumer Price Index (CPI) moderated to 7.0% in May, compared with 7.8% the previous month.

A high base of last year, along with softening of sequential momentum, moderated the inflation print. Significant easing was seen in fuel[1] and core[2] inflation.

Despite the moderation, the inflation print remained a full percentage point above the upper limit of the Reserve Bank of India's (RBI's) 2-6% target. It has been above the target for five month on the trot now.

The inflation outlook for this fiscal remains worrisome. ***We expect CPI inflation to average 6.8% in fiscal 2023, up from 5.5% in the previous year,*** *as weather shocks add to high international commodity prices amid raising supply pressures. Food inflation faces significant upside risk after a heatwave affected production of several food items in the country, including major ones such as wheat and tomatoes. Persistently high international prices for several agriculture, energy, and industrial commodities will translate to broad-based pressure on retail prices as well. Also, the monsoon, while expected to be normal, will need to be monitored for intensity and distribution.*

Inflation trends in May: highlights

- CPI inflation moderated to 7.0% from 7.8% the previous month, but was higher than 6.3% in May 2021
- Food inflation fell to 8.0% from 8.4% the previous month, but was higher than 5.0% a year ago
- Fuel inflation eased to 9.5% from 10.8% the previous month and 11.9% a year ago
- Core CPI inflation eased to 5.9% from 7.1% the previous month, and 6.6% a year ago
- Rural inflation moderated to 7.0% from 8.4% the previous month; urban inflation was unchanged at 7.1%
- The poorest 20% of the population continued to face the maximum inflation burden in rural as well as urban areas, given the relatively higher inflation in food and fuel items

What dictated inflation?

- **Moderation in food inflation was primarily due to decline in prices of protein**, such as pulses (-0.4% inflation in May vs. 1.9% the previous month) and eggs (-4.6% vs. 0%). Inflation of pulses trended down for the past 11 months, supported by healthy output, import duty cuts, and the government making import arrangements with multiple countries
- Edible oils inflation moderated (13.3% vs. 17.3%) over a high base owing to lower import duties vis-à-vis the previous year

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

- Moderation was also seen in fruits (2.3% vs. 5.0%), sugar and confectionery (4.3% vs. 5.2%), and spices (9.9% vs. 10.6%)
- Cereal inflation eased (5.3% vs. 6.0%) primarily because of rice (2.8% vs. 4.0%). However, wheat inflation stayed elevated (9.5% vs. 9.6%) as a heatwave hit production
- Vegetable inflation also surged (18.3% vs. 15.4%) as the heatwave affected production of major produce, such as tomatoes. Inflation headed up for meat and fish (8.2% vs. 7.0%) and milk (5.6% vs. 5.5%) as well

- **Declining electricity prices moderated fuel inflation**. With limited revision in electricity tariffs so far, electricity inflation sank to -2.2% from -0.9%. However, inflation rose for liquefied petroleum gas (19.3% vs. 15,1%) and kerosene (95.2% vs. 91.1%) on high petroleum prices gradually getting passed on to these products. Also, Brent crude prices jumped 6.2% on-month to average $112.4 per barrel in May

- **Core inflation showed broad-based relief across goods and services**
  - Transport and communication inflation eased (9.5% vs. 10.9%), helped by excise duty cuts on petrol and diesel
  - Excluding petrol and diesel as well, core goods eased (6.7% vs. 7.7%). Also, services inflation fell again (4.8% vs. 5.4%)
  - The sharpest easing was in personal care and effects (6.2% vs. 8.6%), followed by health services (5.5% vs. 7.2%), paan, tobacco, and intoxicants (1.1% vs. 2.7%), recreation and amusement (6.0% vs. 7.3%), and household goods and services (6.9% vs. 8.0%)

Inflation eased for rural poor, but firmed up for urban counterparts

The burden of inflation varies across income groups, as the share of spending on food, fuel and core categories differs across classes. In the case of the lower income segment, inflation is driven by food and fuel as these comprise a higher share in their consumption basket.

With food and fuel inflation trending higher than core inflation, the poorest 20% of the population have been facing the highest inflation. However, with falling rural inflation, the burden comparatively eased for the rural poor as compared with their urban counterparts.

In the table below, we have estimated average inflation faced by different income segments in rural and urban areas. 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 May[3] inflation trends.

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

Income segment	May 2022	
	Rural	Urban
Top 20%	6.8	7.0
Middle 60%	7.1	7.5
Bottom 20%	7.2	7.8

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

The outlook on inflation remains worrisome as weather shocks and high international commodity prices have raised supply-side pressures on the economy. In fact, inflation is set to rise again once the favourable base-effect wanes from July.

The heatwave impacted the production of several food grains, vegetables and spices this year. This includes wheat, wherein production fell to a four-year low in crop year 2021-22. Low production affected procurement by Food Corporation of India, with buffer stock just above the stipulated norms as of June. While a normal monsoon is expected to augur well for kharif output, its intensity and distribution are monitorables.

Further, continued elevated international prices for a wide range of agriculture, energy, and industrial commodities will put broad-based pressure on food, fuel, and core inflation. Prices of crude oil shot up further to ~$120 per barrel after the EU's partial ban on Russian crude oil. CRISIL Research now expects Brent Crude to average $105-110 per barrel in fiscal 2023 compared with $80 per barrel last year.

Weakening rupee will further raise the imported price of crude oil and commodities.

Producers reeling under severe cost pressures since last fiscal will be forced to pass it on to retail prices. The RBI's latest surveys of manufacturing, services, and infrastructure sectors show expectation of further rise in input and output prices going forward.

Because of these factors, we expect CPI inflation to rise to 6.8% in fiscal 2023 compared with 5.5% the previous year.

IIP spurts on a low base

The Index of Industrial Production (IIP) printed 7.1% on-year growth, up from 2.2% growth in March 2022.

The latest IIP data points to a gradual, albeit continuing, recovery in industrial activity. While high on-year growth in April was partly low-base driven, IIP did show improvement sequentially as well. What is worrying, though, is that consumer goods growth remains weak, indicating sluggish private consumption.

Highlights

- IIP grew 7.1% on-year in April, up from 2.2% (revised from 1.9% earlier) in March. The high growth was partly a reflection of a low base as industrial activity slowed with the second wave of Covid-19 last year. That said, on sequential basis, i.e., on-month movement in the de-seasonalised series, which takes care of the base effect and seasonal variations, IIP performed better than in March, suggesting gradual improvement in industrial activity, despite supply disruptions on account of the Russia-Ukraine war
- Manufacturing, which has the highest weight of 77.6% in IIP, grew 6.3% on-year in April, up from 1.4% in March. Mining (14.4% weight) rose 7.8% (3.9% in March) and electricity (7.9% weight) registered 11.8% growth (6.1% in March). Manufacturing growth was the slowest among all components, and likely reflects challenges faced by the sector, in terms of high input prices amid subdued consumption demand.
- On the other hand, double-digit growth of the electricity sector is noteworthy, especially as it did not have much of a base effect. This largely points to increased electricity demand for cooling purposes on account of the heatwave in April. This phenomenon likely continued in May
- Of the 23 manufacturing categories, four posted annual decline in activity despite the low-base effect. These were paper and paper products (-5.4% on-year in April), pharma, medicinal chemical and botanical products (-3.6%), rubber and plastic products (-1.9%), and textiles (-0.3%), which have 0.9%, 2.4%, 5.0% and 3.3% weightage in the IIP, respectively
- Another way to assess the performance of IIP is to look at its use-based classification. While the annual growth numbers are masked by a low-base effect, two observations stand out. Growth of *infrastructure and construction goods* slowed to 3.8% on-year in April from 6.7% in March, indicating slackening of the government's capex programme (which is largely led by infrastructure creation). Sequentially, too, growth declined in this segment. Another is continued weakness in the consumer goods space, especially non-durables. Growth in this segment was almost stagnant (0.3% on-year) in April despite a low-base effect. These point to the challenge a broader private consumption recovery faces, mainly stemming from the hit to relatively lower income groups.

Outlook

Industrial activity, especially manufacturing, remains subdued as it faces challenges such as elevated commodity prices on account of the Russia-Ukraine war and increasing freight costs, implying input cost pressures. This would mean range-bound movement in manufacturing, the largest component of IIP, in the near term. Consumption-oriented manufacturing, in particular, is expected to revive only gradually. Also, duration and magnitude of the Russia-Ukraine war will remain a key monitorable as it continues to introduce new challenges. For instance, the recent EU decision to cut oil imports from Russia led to crude oil prices surging anew.

The next month would again see IIP getting a statistical lift as the index had fallen further in May last year on account of the second Covid-19 wave. Beyond that, broad-basing of domestic economic activity, especially with contribution from contact-based services, and forecast of a normal monsoon, augur well for industrial activity. Government-led capex should also continue to lend a helping hand.

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