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Macroeconomics | First cut

Inflation undershoots, IIP at pandemic lows

December 2022

Veggies surprise positively, but sticky core inflation a worry

Inflation, as measured by the Consumer Price Index (CPI), moderated sharply to 5.88% on-year in November, from 6.77% October. This is the first print below 6% (the RBI's upper tolerance limit for inflation) since January 2022. While a moderation was expected (due to lower vegetable prices and some sequential easing of post-festive demand), the fall is a positive surprise. The headline number was largely brought down by sharper-than-expected easing of vegetable prices. But pricey cereals and milk continue to exert pressure on overall inflation.

Retail inflation fell in November largely due to deflation in vegetable prices (both on-year and sequentially). Contribution of food inflation to headline thus fell to 31% in November (from ~41% in October). Fuel inflation jumped up on-year, but that can be attributed mostly to a low-base effect from last year. Core inflation remains around 6% indicating recovering demand and continued pass-through of input prices, even post the festive season. We thus maintain our CPI inflation forecast of 6.8% for this fiscal, compared with 5.5% previous year.

Inflation trends in November: Highlights

- CPI inflation slowed to 5.88% on-year in November, from 6.77% in October — though it was higher than 4.9% a year ago
- Food and beverage inflation saw the maximum softening to 4.7% from 7% in October
- Fuel[1] inflation broke the trend of continuous moderation, jumping higher to 10.6% in November (vs 9.9% previous month- largely from base effect)
- Core CPI[2] inflation remained sticky at 6%, same as in previous two months

Lower vegetable prices support easing of food inflation

- Vegetable prices, notorious for imparting volatility to overall inflation, lived true to its characteristic in November: vegetables experienced deflation (prices fell) of 8.1% on-year (vs 7.8% inflation last month). The fall was a combination of both, high base effect from last year and sequential easing in prices (with winter arrivals, prices of vegetables tend to go down). Prices of most 'winter vegetables' — that is, cauliflower, cabbage, leafy vegetables, peas- declined more than 10% on-month.
- Another major contributor for food inflation- cereals- remains elevated though (13% on-year vs 12.1% in October). Sequential uptick in cereal prices points towards continued pressure on rice and wheat stocks.
- Inflation for milk and milk products continued to climb, reaching 8.2% in November from 7.7% in October. Rising feed costs have led milk manufacturers to raise retail prices.

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

- Prices of spices, too, jumped by 19.5% (vs 18.1% previous month). The RBI governor in his statement after the December monetary policy review meeting highlighted the pressure from spices, milk, cereals on near-term on inflation

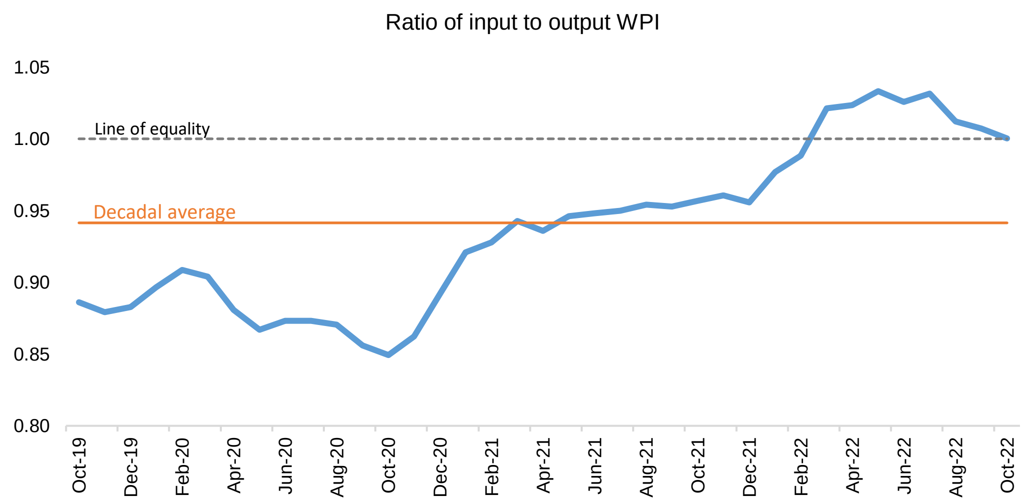
Fuel inflation up in double digits again

- Fuel inflation broke its moderating trend of the past four months and rebounded to 10.6% on-year in November (from 9.9% in October and 10.4% in September). This was largely due to a high-base effect from last year — though there was some sequential uptick, too, from rising kerosene and coal prices
- Elevated international coal prices are having their bearing on domestic fuel inflation: Australian coal prices are up 117% on-year in November. Accordingly, domestic coal inflation has been elevated in and in fact, jumped to 13.3% in November (from 12.3% in previous month)

Core inflation remains elevated

- Last month, we had highlighted that despite the moderation in headline inflation, the biggest takeaway from October CPI print was the persistent stickiness in core inflation, which was elevated at 6%. We reiterate our stance this month: sticky core inflation — again at 6% in November — remains the major risk to the headline. This was amply pointed out by the RBI governor in his December statement
- Core inflation components across 'transportation and communication' (particularly, conveyance), 'personal care and effects', 'household goods and services', 'medical costs', either jumped on-year or remained same (compared to previous month)
- Sticky core inflation is partly due to passthrough of elevated input prices to consumers. Despite wholesale input prices coming down since last quarter, wholesale output prices remain elevated- implying the passthrough to retail prices will continue if demand continues to recover. Ratio of input to output wholesale prices remained high at 1.0 in October 2022, above the decadal average of 0.94[3]

Ratio of input to output WPI remains much above decadal average, indicating elevated input prices



Source: Office of the Economic Adviser, CRISIL

Some respite for the poor from lower food 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.

[3] For details, refer to CRISIL Quickonomics: *The passthrough effect* (December 2022)

Using data from the National Sample Survey Organisation (NSSO), CRISIL has mapped expenditure baskets of three broad income groups — the bottom 20%, middle 60%, and upper 20% of the population — with November[4] inflation trends. The table below presents the average inflation faced by each income class.

Inflation faced by each income class across regions slowed in November-similar to trend in headline inflation. Across rural 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). But given the sharp moderation in food prices between October to November, the rural poor saw the largest reprieve in inflation between these two months.

CPI inflation across income classes (% on-year)

Income segment	November 2022	
	Rural	Urban
Top 20%	6.1	5.7
Middle 60%	6.1	5.6
Bottom 20%	6.2	5.6

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

Outlook

The November CPI inflation print undershot our expectations largely due to sharp correction in vegetable prices. Going ahead, food inflation may moderate with winter arrivals and expectation of rabi harvest (sowing so far has been robust in on-year terms). But elevated inflation in cereals and milk remains a monitorable.

Some relief on fuel inflation can be expected if the recent decline in Brent crude oil prices is sustained (which would bring down domestic fuel prices at the pump).

Core inflation remains the biggest worry- as producers continue to pass on elevated input prices to consumers. That said, household inflation expectations have inched down in December for both three month and one-year horizons- this would come as some relief for the RBI as it seeks to tackle these second order effects of inflation.

Considering the risks emanating from sticky core inflation and pressure from cereals on food inflation, we retain our CPI inflation forecast at 6.8% for this fiscal, with the upcoming last quarter inflation likely to average below 6%.

IIP declines for both export and consumer-oriented sectors

The Index of Industrial Production (IIP) stayed volatile, falling 4% on-year in October in contrast to 3.5% growth in September. This was the sharpest fall since August 2020. While an unfavourable base was partly responsible, activity slipped sequentially as well. All major sectors saw IIP fall, with manufacturing seeing the sharpest decline.

The decline in manufacturing activity was imminent given the sharp decline in exports seen in October. However, consumer-oriented sectors also witnessed a sharp decline in IIP despite the festive season setting this month. Domestic demand has been posting uneven recovery with lower-ticket items lagging higher-value items. Tighter financial conditions could moderate domestic demand next year, while exports will remain under pressure from slowing global growth. We expect India's GDP to slow from 7.0% in fiscal 2023 to 6.0% next year.

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

IIP in October: Highlights

- IIP contracted -4.0% on-year in October compared with 3.5% growth in September and 4.2% in October 2021. Sequentially, IIP declined 4.6% on-month on a seasonally adjusted basis[5]
- Mining IIP grew 2.5% on-year in October compared with 5.2% previous month and 11.5% in October 2021. Sequentially, it grew 0.6%
- Manufacturing IIP growth sunk to -5.6% on-year in October compared with 2.2% previous month and 3.3% in October 2021. Sequentially, it declined 5.3%
- Electricity IIP growth fell to 1.2% on-year in October compared with 11.6% previous month and 3.1% in October 2021. Sequentially, it declined 5.9%
- On a use-based classification, IIP saw the sharpest on-year decline in consumer durables, followed by consumer non-durables, intermediate goods and capital goods. However, growth remained positive for infrastructure and construction goods

Consumer-oriented sectors post sharpest decline

- Among the manufacturing sub-sectors, consumer durables saw the sharpest decline (-15.3% on-year in October versus -3.2% previous month). Electronics, wearing apparel, leather articles and furniture were among the sectors that saw declining IIP. However, auto production was an outlier with double-digit growth in IIP, which ties up with robust retail sales being seen in this sector.
- Consumer non-durables IIP declined for fourth month in a row (-13.4% vs -6.3%), indicating significant weakness for low value items. Food and tobacco products saw declining production.
- Besides IIP falling in consumer-oriented sectors, core imports (i.e., imports excluding crude oil and gold) had also slowed significantly to 2.4% on-year in October from 20.5% previous month. Both these indicators signal some weakening of domestic demand.

Sharp decline in exports brought down manufacturing growth

- Several export-oriented sectors saw a sharp decline in IIP such as pharmaceuticals (-21.4% vs -17.2%), textiles (-18.6% vs -12%), and machinery (-9% vs 5.3%)
- Exports had declined 16.7% on-year in October, the steepest since May 2020. Export demand fell sharply from major destinations such as United States, European Union, and ASEAN[6], indicating that a global slowdown has set in.

Construction activity offers mild support

- IIP for infrastructure and construction goods saw a mild growth of 1% on-year in October, though sharply slower than 7.7% previous month. Even though centre's capital expenditure is posting strong growth

[5] All on-month numbers are seasonally adjusted
[6] Association of Southeast Asian Nations

(61.5% on-year in April-October 2022), spending from states and private sector remains relatively subdued, limiting pickup in overall investment activity.

Outlook

The industrial sector faces a grim external outlook, as aggressive rate hikes and elevated inflation hit growth in major advanced economies and global demand. S&P Global expects a recession in the US and the UK, and flat GDP in European Union in calendar 2023.

Domestic demand has been posting uneven recovery. In contrast to consistent weakness in consumer non-durables IIP growth, automobile retail sales touched record high in November. S&P Global Purchasing Manager's Index (PMI) for Indian manufacturing also increased to 55.7 in November from 55.3 previous month. India's manufacturing PMI remains one of the highest among emerging markets, signalling relative resilience of domestic demand.

Going forward, increasing transmission of RBI's rate hikes to lending rates could take some steam off domestic demand. However, healthy rabi sowing augurs well for rural demand. Government capex should further offer some support to domestic demand.

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.

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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