Core inflation becoming broad-based; IIP droops

CRISIL First Cut l July 2018

CPI inches to 5.0%, led by fuel and core

Consumer price index (CPI)-based inflation rose another 10 basis points (bps) to 5% in June compared with May, which is more than thrice the 1.5% seen in the same month last year. Though food inflation decelerated, what took the number higher was firming up of fuel and core inflation. The Monetary Policy Committee (MPC) of the Reserve Bank of India had hiked its policy rate by 25 bps last month envisaging exactly such pressure.

Fuel inflation surged 160 bps to 8.5% in June amid rising oil prices and weakening rupee, which added to imported inflation. Global crude oil prices were up 60% on-year in June. And the rupee depreciated 30 paise to 67.8 against the dollar from 67.5 in May. In June last year, it was at 64.4.

Sustained rise in core inflation would worry the MPC and may require one more rate hike down the road. Core inflation is becoming broad-based with almost all categories such as health, recreation and amusement and education showing a rising trend. Core inflation edged up 10 bps to 6% in June, after beginning the year at 5.1%. Core inflation rose despite excluding the impact of house rent allowance revisions on housing inflation (which has 10% weight in CPI).

Going forward, inflationary conditions are likely to firm up. With improving domestic demand conditions, manufacturers will pass on higher input costs to consumers, which will show up in core inflation. On an upward trajectory, crude prices were nearly 12.7% higher on-year in fiscal 2018. CRISIL expects another 23% average increase in average crude oil prices this fiscal. Also, metal prices are also firming up.

Similarly, food inflation could also firm up. So far, progress on monsoon has been slow and lopsided because of which, kharif sowing has been lower (this may get corrected as the monsoon progresses into the crucial months of July and August). The bigger strain however is from the possible upside to food prices from the government recently announced hikes in minimum support prices (MSPs). But their impact on inflation would be a function of the efficacy of implementation.

For fiscal 2019, therefore, CRISIL expects CPI inflation to perk up to 4.7% from 3.6% a year before. We believe there is a possibility of another policy-rate hike by the RBI if crude oil prices stay at current levels. While monetary policy will stay vigilant, further rate action will come only if the rise is perceived as sustained, with pressures suggesting seepage into generalised inflation through stronger domestic demand.

Data readings

- Food inflation slowed down to 2.9% in June from 3.1% in May. This moderation was on account of lower inflation in cereals, fruits and vegetables and protein-related items – meat, and fish & milk. Meanwhile, pulses, and sugar & confectionery, continued to record negative inflation.
- Fuel inflation, calculated by adding petrol, diesel, fuel and light components, jumped to 8.5% in June, from 6.9% in May. In fuel and light inflation rose to 7.1% from 5.8%, while in petrol and diesel inflation rose much higher to 13.6% from 10.8% in May.
- Core inflation (CPI excluding food, fuel and light, petrol and diesel) rose to 6.0% in June, from 5.9% in May. Housing inflation, which had been reasonably rigid for the last 10 months, rose by 8.4% in June, same as in May. Excluding housing (to remove the impact of house rent allowance revisions), core inflation still went up by 10 bps - to 5.4% in June from 5.3% in May. There was a near broad-based increase in core inflation components in June and inflation rose the most in education (42 bps on-month), Recreation and amusement (39 bps) and health (15 bps). Personal care and effects was the only category which say inflation declining (18 bps).

IIP fails to hold momentum

The Index of Industrial Production (IIP) staged a steep drop from 4.8% in April. At 3.2%, IIP growth in May was lower than expected, dragged down by the manufacturing sector where growth slipped to 2.8% from 5.3%. Growth in IIP which picked up in April but failed to hold momentum despite higher growth in mining and electricity sectors.

The core infrastructure index (comprising indices for coal, crude oil, natural gas, refinery products, fertilisers, steel, cement and electricity) also moderated to 3.6% growth in May, from 4.6% in April. According to use-based classification, production of non-consumer durables took a beating in May as it clocked negative growth rate.

Data for the first two months of Q1 fiscal 2019 suggest that industrial growth (at an average 4%) is somewhat higher than last year's Q1 (3% average for the corresponding period), but slower than Q4 fiscal 2018 (6.3% average).

Going forward, some improvement in rural demand backed by normal monsoon, a pick-up in exports and positive spillover of pay commission revision on overall consumption demand will crank up industrial growth.

Accordingly, capacity utilisation of manufacturers is expected to pick-up in some select sectors where consumer-oriented demand and government-spending will support. Still, overall utilisation rates will not be significant enough to materially lift private sector investment demand this fiscal.

Data readings

- Industrial activity stepped back again in May, after seeing a pick-up in April. IIP growth clocked in at 3.2% compared with 4.8% in April. Growth slipped as manufacturing sector output tanked to 2.8% from 5.3%. Electricity sector growth, in contrast was stronger at 4.2% from 2.1% in April, while mining growth rose to 5.7% from 4%. Manufacturing sector has a weight of 77.63% in the IIP.
- Within manufacturing, 13 out of 23 industry groups showed positive growth on-year, compared to 16 in the previous month. Heavy-weight sectors which displayed positive growth were, food products (10.5% growth), refined petroleum (4.9%), chemical products (5.5%), and motor vehicles, trailers and semi-trailers (21.1%) although some of these also saw growth decelerate this month. Those that displayed negative growth rates included pharmaceuticals (-8.2%), tobacco products (-15.6%), wearing apparel (-12.8%) and rubber and plastic products (-7.8%). From an end-use perspective, the index that represents the industrial and investment-oriented manufacturing sectors saw growth dip to 4.9% from 7%, while the index for consumer-oriented sectors (accounting for 37% of the manufacturing sector IIP) saw growth slow to 1.6% from 4.2%.
- According to the use-based classification, all except primary goods saw growth decelerate. Growth in the capital goods sector fell to 7.6% from 11.9% in April; in infrastructure and construction goods growth slowed to 4.9% from 7%; consumer durables saw growth moderate to 4.3% from 4.5%, while that in non-durables dipped into negative at -2.6%. Intermediate goods also displayed weakness in May.

Analytical contacts

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

Dipti Deshpande
Senior Economist, CRISIL Ltd.
dipti.deshpande@crisil.com

Adhish Verma
Economist, CRISIL Ltd.
adhish.verma@crisil.com

Media Contacts

Saman Khan
Media Relations
CRISIL Limited
D: +91 22 3342 3895
M: +91 95940 60612
B: +91 22 3342 3000
saman.khan@crisil.com

Hiral Jani Vasani
Media Relations
CRISIL Limited
D: +91 22 3342 5916
M: +91 982003 9681
B: +91 22 3342 3000
hiral.vasani@crisil.com

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CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India

Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com

/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited

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