ECONOMIC RESEARCH

INFLATION AND IIP REVIEW

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Inflation remains within target, but deepening concerns of economic slowdown continues

Economy Report

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CPI Inflation reaches near MPC mid-point target at 3.99% in September 2019

- Spike in food inflation led the CPI inflation to increase by 55 basis points in a month
- Fuel price inflation remained negative capping additional rise

As per the provisional estimates on CPI inflation released by MOSPI on 14 October 2019, the Consumer Prices Index (CPI) increased by 3.99% for September 2019, on account of sharp uptick in vegetable prices (15.4%). The CPI inflation touched a 14-month high in September and for the first time in 12 months, the inflation rate crossed last year's inflation level. The current level of inflation is almost near the mid-point target of RBI MPC. Although the flexible inflation targeting framework has some scope for further rate cut, the MPC will take a cautious stance if the trend of increasing retail inflation continues. The fact that Core Inflation (excluding food and fuel) softened to 4% in September compared to 4.24% in the previous month, provides some hope as the spike in food prices is temporary and seasonal (Table 1 and Chart 1).

As expected by BWR in its earlier reports on **IIP and Inflation Review**, vegetable prices increased sharply in September, (inflation in onion stood at 66%), largely due to disrupted production and supply conditions after the flood- like situation witnessed in the country across regions in the last few months. The Central Government has taken several key decisions to curb rise in prices of onions in September like requesting the States to lift the stock of 35,000 tons available with the Central Government, directing NAFED to distribute buffer stocks of onions in Delhi, fixing the minimum prices for exports initially and later banning exports of all varieties of onion.

With the arrival of the Kharif crop of onion from Karnataka, the prices are likely to settle at normal levels from October. Late onset and delayed withdrawal of monsoon may result in lower kharif production, as per the first advance estimates of Production of Foodgrains for 2019-20. However, a delayed withdrawal bodes well for sowings of rabi crops hence the food inflation is likely to moderate from November.

Table 1: Inflation rate in CPI and its Major Components

Groups	Weights (%)	Rate (Y-o-Y in %)		
		Sep-18	Aug-19	Sep-19
CPI Combined (1+2+3+4+5+6)	**100.0**	**3.70**	**3.28**	**3.99**
1. Food and beverages	45.9	1.01	2.96	4.70
2. Pan, tobacco and intoxicants	2.38	5.57	5.00	4.59
3. Clothing and footwear	6.53	4.64	1.22	1.02
4. Housing	10.07	7.07	4.84	4.75
5. Fuel and light	6.84	8.63	-1.70	-2.18
6. Miscellaneous	28.32	5.65	4.71	4.45
Consumer Food	*39.06*	*3.70*	*3.28*	*3.99*
*Core **	*44.91*	*5.88*	*4.24*	*4.00*

Note: The weights are indicative to show relative importance of groups

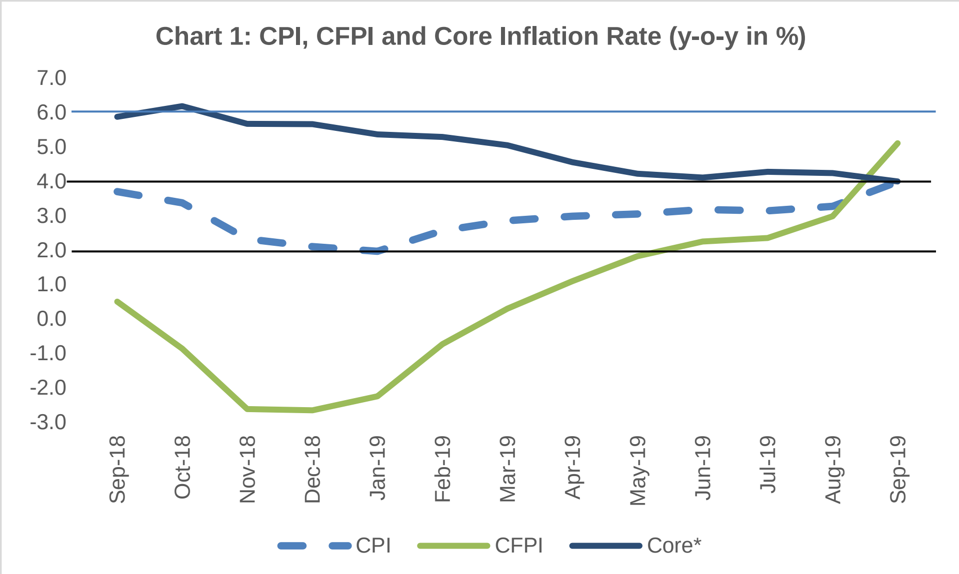
**calculated (excluding 'Food & Beverages', 'Pan, Tobacco & Intoxicants' and 'Fuel & Light')*

Source: MoSPI, BWR Research

Deflation in fuel prices offsets sharp rise in food inflation

Consumer Food Price Inflation (CFPI) accounting ~ 39% of the overall inflation basket, rose to 37-month high at 5.11% in September as the prices of vegetables, pulses and meat and fish accelerated significantly. In the CPI basket, 'Food and beverages group' is the only to report increase in inflation compared to the year ago period.

'Fuel and light group' continued with deflationary trend for the third straight month, balancing the firming up of food inflation (Chart 1 and Table 1). Sustained fall in crude oil prices overseas helped easing domestic fuel prices, resulting in deflation in fuel items. If the trend continues, maintaining inflation at RBI MPC's mid-point target of 4% level becomes easier.



*calculated (excluding 'Food & Beverages', 'Pan, Tobacco & Intoxicants' and 'Fuel & Light'), Data is provisional.
Source: www.mospi.gov.in, BWR Research

Industry Perspective

"For FY20, we continue to expect inflation trajectory to remain benign with average annual inflation at 3.5%, marking the third consecutive year of undershooting vis-à-vis RBI's 4% target. With the current state of negative gap in both inflation and GDP, we continue to expect the MPC to opt for incremental monetary accommodation with another 25-40 bps scope for rate cuts in the remaining part of FY20, as the RBI remains watchful of incoming data along with the degree of anticipated revival in domestic growth momentum, global trade outlook, and movements in currency and commodity markets"

Adds Shubhada Rao, Chief Economist, YES BANK

Disclaimer: Views expressed by the third-party industry commentators and experts is personal and not the view of Brickwork Ratings.

Rising inflation warrants cautious approach by MPC

In the October Policy, MPC stated that it will continue with accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target. The current level of inflation has already surpassed the MPC's projections of 3.4% for Q2:2019-20. Moreover, the urban inflation has reached 4.7% in September and the month on month acceleration in the rural inflation is much quicker than urban. Though, the country has received 10% higher rainfall than the Long Period Average (LPA), uneven distribution of monsoon is likely to exert pressure on food inflation, particularly kharif crops. Current level of crude oil prices is the only respite, but is unpredictable and the movement of prices are largely dependent on global events. Thus, the RBI needs to be cautious in its policy steps, though the inflation is still within its comfort zone. BWR feels CPI inflation continue to remain within the RBI's target, but may inch up moderately in October, and may soften from November. Hence, RBI still has scope for further monetary easing as the priority has been shifted to propel growth.

Weak manufacturing activity drags IIP growth to -1.1% in August

- 15 out of the 23 industry groups in the manufacturing sector reported negative growth
- Fall in automobile production contributed to the negative growth in Manufacturing IIP

As per the quick estimates of Index of Industrial Production (IIP) for August 2019, released by the Ministry of Statistics and Programme Implementation (MoSPI) on 11 October 2019, the Index of Industrial Production (IIP) declined by -1.1% in August 2019, compared to 4.6% growth registered a month ago, led by fall in manufacturing activity (Table 2).

Manufacturing activity after showing some revival in July, reported negative growth in output at (-1.2%) in August 2019, as the production in 15 out of the 23 industry groups has shown negative growth compared to previous year. Manufacturing index in IIP represents nearly 77.6% of total industrial production. Manufacture of motor vehicles, trailers and semi-trailers reported the major decline in production (-23.1%), and the industry group is witnessing negative growth since November 2018, reflecting slowdown automobile sector. Most of the manufacturing items used in the production of automobiles (auto parts and services like logistics) continued to cut down production, on account of reduced sales and production of automobiles. On the flip side, Manufacture of basic metals, food products, and wearing apparel industries witnessed increase in production amid festive related consumption demand for these goods (Chart 2 and 3).

In terms of use-based classification, industrial output, Capital Goods and Consumer Durables continued with negative production growth trends witnessing the demand slowdown in the economy, whereas Intermediate Goods and Primary Goods are the only to report positive growth in output in August. Both these use-based categories reported relatively weaker growth compared to previous month and corresponding period previous year (See Table 2).

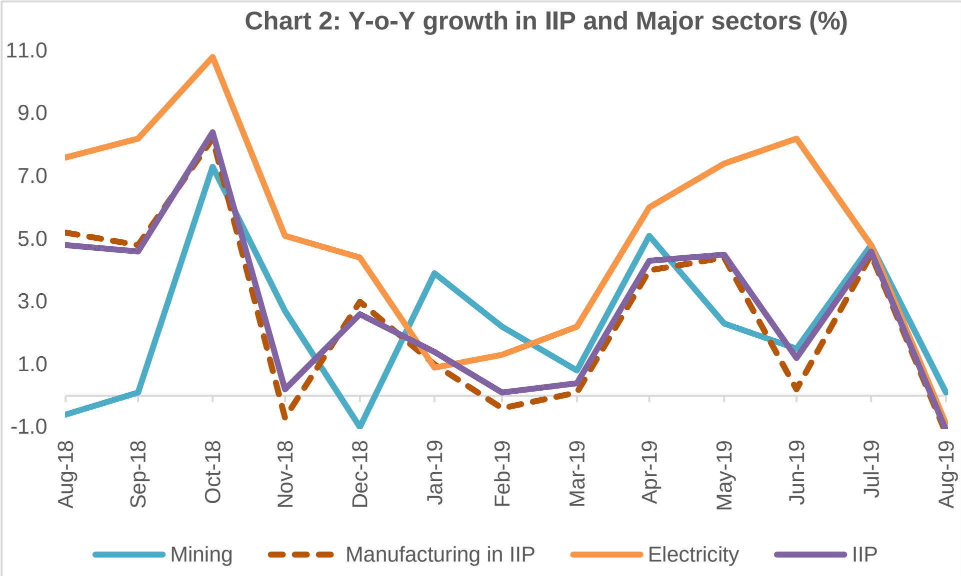
Table 2: IIP and Sectoral growth rates (y-o-y in %)

	Weights	April to August		Aug-18	Jul-19	Aug-19
		2018-19	2019-20			
IIP (General)	**100**	***5.3***	***2.6***	**4.8**	***4.6***	***-1.1***
Mining	14.4	*3.8*	*2.8*	-0.6	*4.8*	*0.1*
Manufacturing	77.6	*5.5*	*2.4*	5.2	*4.5*	*-1.2*
Electricity	8.0	*5.8*	*5.0*	7.6	*4.8*	*-0.9*
Use-based category						
Primary goods	34.0	*5.4*	*2.4*	2.5	*3.5*	*1.1*
Capital goods	8.2	*7.7*	*-8.0*	10.3	*-7.2*	*-21.0*
Intermediate goods	17.2	*1.3*	*10.0*	2.9	*14.7*	*7.0*
Infrastructure/ construction goods	12.3	*8.6*	*-0.1*	8.0	*3.5*	*-4.5*
Consumer durables	12.8	*8.7*	*-4.0*	5.5	*-2.7*	*-9.1*
Consumer non-durables	15.3	*3.5*	*6.6*	6.5	*8.4*	*4.1*

Data is provisional, Source: http://www.mospi.gov.in, BWR Research

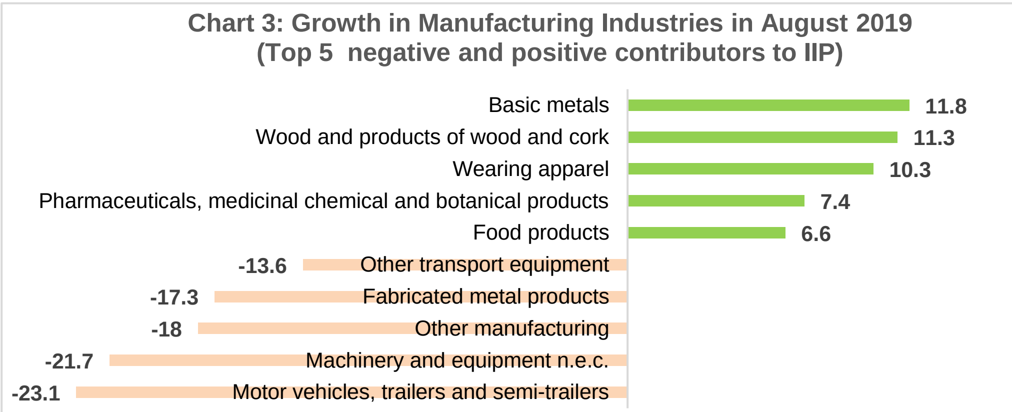
In line with Manufacturing sector, Electricity sector also reported negative growth (-0.9%), whereas the growth in mining sector reported a meagre 0.1% in August 2019 (Chart 2). Weaker demand condition also reflected in the output of eight core industries which represents 40% of the weight of items included in the IIP. Core sector output contracted in August by 0.5%, lowest in 52 months pulled down by coal, electricity, crude oil and cement.

The fall in IIP growth in August is the lowest in 81 months. With the negative growth, the cumulative growth in IIP for April to August also stood much lower at 2.6% compared to corresponding period last year (5.3%). Moreover, the item groups under use-based classification reported erratic growth trends in the current fiscal compared to previous year's growth trends. All these portrays the structural slowdown in the economy (Table 2).



Note: IIP data for August 2019 are quick estimates. Source: CMIE, MoSPI, BWR Research

With the RBI continuing with easing cycle and recent measures announced by the government such as corporate tax cut, scrapping the angel tax on start-ups, faster GST refunds to MSMEs, opening up some more sectors such as single brand retail and coal mining for FDI and activating the government purchase of new cars to replace the old, etc may not have immediate impact on the industrial activity, though in the medium term it may help to reverse the trend. Further, the recent RBI MPC highlighted that Capacity utilisation (CU) in the manufacturing sector, declined to 73.6% in Q1:2019-20, but expected to moderate in Q2:2019-20. RBI's business assessment index (BAI) also fell in Q2:2019-20 due to a decline in new orders, contraction in production, lower capacity utilisation and fall in profit margins of the surveyed firms. The manufacturing Purchasing Managers' Index (PMI) for September 2019 was unchanged at its previous month's level at 51.4; new orders and employment improved, albeit marginally, and new export orders declined. All these portend no immediate respite to the stagnant manufacturing activity.



Going by the current trend, BWR feels that Intermediate and Primary Goods are the only potential growth drivers for IIP in the coming months, hence expansion in IIP is expected to improve marginally helped by festive demand. The increase in Dearness Allowance for central government staff may also help perk up festival demand.

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