Press Release

Inflation and IIP data reinforce RBI's "patiently hold" policy

The CPI inflation print of 7.6% in January 2020 has been uncomfortably high but surely not surprising. With steadily increasing headline inflation data year-on-year since August 2019 and well above the danger mark of 6.0% in the last 2 months, the average in the current fiscal to date is already 4.5% and is expected to settle at a higher level of 5.0%-5.5% for the full FY20. This underpins the latest MPC decision to hold rates in an economy characterised by lower growth and increased unemployment. Importantly, a persistently high level of CPI inflation above 4% over the next 2-3 months, is likely to translate into an extended hold period by RBI.

Food inflation continues to be the primary driver of CPI figure with a print of 11.8% in January 2020, only a marginal reduction from the high of 12.2% in December 2019. Within the food category, vegetable prices are yet to cool down appreciably with the inflation in that category continuing to be at 50.2% as compared to 60.5% in the previous month. The key contributors to the sharply higher inflation in vegetables are onions, tomatoes and potatoes. The unseasonal rainfall at the end of kharif season had impacted the shorter cropping cycle for vegetables in many parts of the country and has not facilitated the higher supply that is typically witnessed in the winter months. However, the larger concern in Acuité's opinion is the rise in inflation in protein based items with meat, eggs and pulses' prices recording inflation at 10.5%, 10.4% and 16.7% respectively. Inflation in the latter categories are usually sticky and structural in nature. While we expect the food inflationary tendencies to ebb by March-April with the arrival of the rabi crop in the market, it is unlikely to come below 5.0% in the next two quarters, given the spike in the protein based product prices.

The other critical aspect in the inflation data is the steady rise in core inflation. At 4.2% for January 2020, it has reached a five month high due to sharply higher inflation of 7.0% and 6.1% in the personal care and the transport and communication segment. The latter may have been bolstered by the increase in telecom tariffs witnessed in December 2019. This apart, the likelihood of food inflation spreading to other services is also high. This may create an upward pressure on core inflation notwithstanding the continuing weakness in overall demand, visible from the IIP data released simultaneously.

The IIP data released for December 2019 is yet to reflect any material revival improvement in industrial activity. The overall index actually declined by 0.3% in December 2019 as compared to a modest growth of 1.8% that was seen in November. This has been mainly on account of the chronic weakness in the manufacturing output that comprises the bulk of the index; while it had shown an encouraging 2.7% rise in November, it has dropped back again to negative territory at 1.2% in December. The broad nature of the slump is further indicated by the fact that 16 of the 23 industry groups in the manufacturing segment of IIP has seen a contraction in December. Both consumer durables and non-durables contracted during this month, highlighting the weakness in demand mainly from the rural areas. In particular, the capital goods segment saw an output drop to the extent of 18.2% as against 8.6% in the previous month and points to the continuing weakness in private sector investments in the industrial segment.

The mining output has picked up by 5.4% in December (vs 1.7% in Nov) partly due to higher coal production by CIL and a likely spurt in iron ore production before the upcoming disruption related to fresh mine auctions. The electricity generation has continued to disappoint, marginally contracting by 0.1% on the back of a 5.0% lower output witnessed in Nov. 2019. Lower power generation may be partly attributed to the weakened financial flexibility and purchasing ability of some of the state distribution companies. Overall, the risks of a stagnation in IIP remain despite the likely pick up in production in some segments to build year end inventories given the external headwinds like the outbreak of Corona virus. The virus contagion has already disrupted the manufacturing sector in China and has implications for sectors like chemicals and pharmaceuticals which depend on the latter for key raw materials.

In the opinion of Acuité Ratings, a lack of clear growth visibility in the high frequency indicators such as the IIP will lead to a prolonged 'accommodative stance' by RBI despite the inflation risks getting elevated from a shorter to a medium term concern. RBI has accordingly adopted several new liquidity management measures such as the long term repo operations (LTROs) to improve the liquidity and rate transmission further in the banking system with an objective to nudge demand but without any fresh cut in the interest rates. It will be important to monitor the emerging stagflation risks and take appropriate actions from time to time.

Chart 1: CPI Trajectory

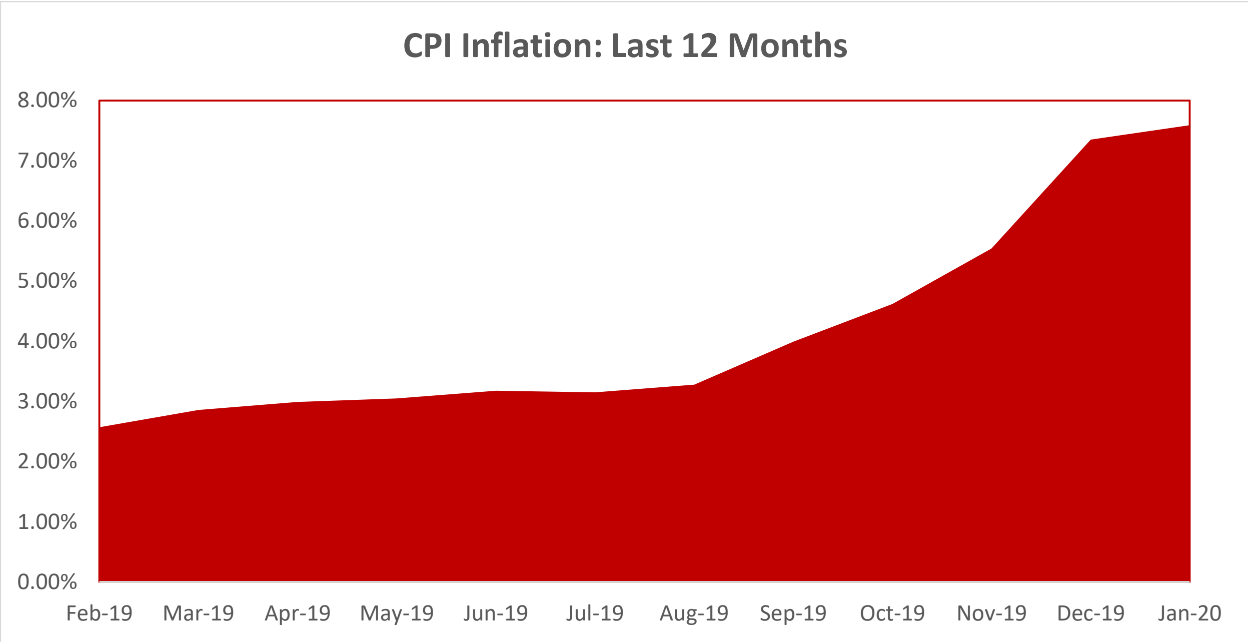
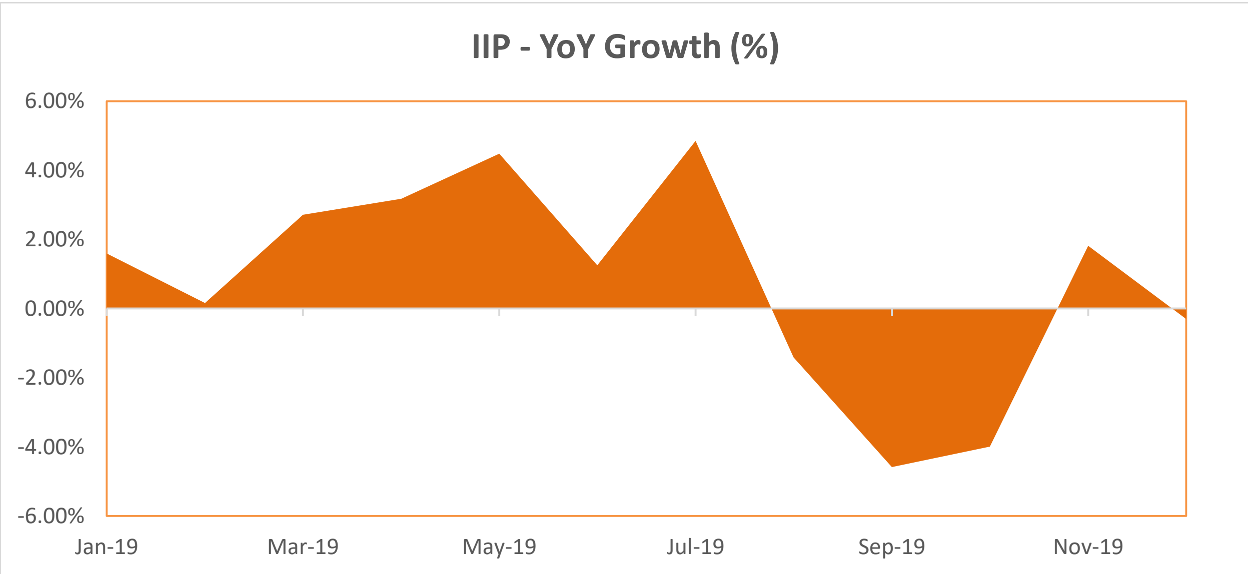


Chart 2: IIP Trajectory



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