July 2014

CRISIL Economy First Cut

Inflation cooling off, Industry warming up

Overview: *Retail inflation fell to 7.3% in June, considerably below the Reserve Bank of India's target of 8% for January 2015. For the first quarter of fiscal 2015 CPI inflation averaged lower at 8.1% as compared to 9.5% last year. More recently, however, risks from a sub-normal monsoon have risen. Nonetheless, we do not expect food inflation to soar considerably due to a) proactive measures already taken by the government b) a strong base effect from last year. In the longer run, announcements in the budget to boost agriculture and improve the supply chain will help bring down CPI inflation, but lowering and sustaining it around 6% - the Reserve Bank of India's target for January 2016 will pose a challenge.*

Meanwhile, industrial activity gathered further momentum in May with the pick-up this time stemming from consumption-oriented manufacturing industries. IIP grew by 4.7% in May, with manufacturing sector growth at 4.8%. Industry (including construction), we believe, will grow by 3.6% in fiscal 2015 (compared to 0.4% in fiscal 2014) with some support from budgetary announcements for specific sectors, and favourable export demand. We have however, revised down, overall GDP growth for fiscal 2015, to 5.5% (from 6% earlier) due to weak rainfall progress and its consequent adverse impact on agriculture production.

CPI Inflation cools off further

CPI inflation fell to 7.3% in June, the lowest since the new CPI series started in January 2012, from 8.3% in the previous month (Figure 1). This was driven by a fall in food inflation to 7.9% y-o-y from 8.9% in the previous month. Inflation fell in all food items, sharply in cereals, eggs, fish and meat, vegetables and fruits. In part the decline seen in both headline and food inflation came because of a strong base effect from last year.

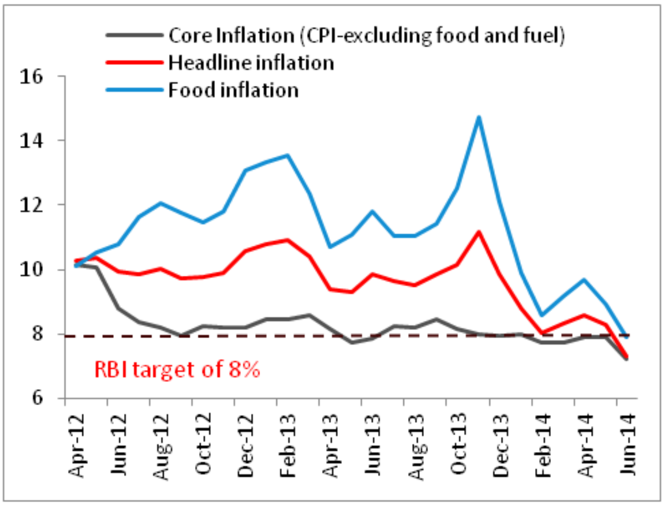
CPI Core inflation (excluding food and fuel & light) also fell down to 7.2% y-o-y in June from 7.9% in the previous month. In the core, inflation came down in all sub-categories – the most in transport equipment (6.3% from 7.0% in May), household requisites and medical care.

Recent monsoon update by the IMD signals 43% deficient rainfall as of July 9. The worst hit areas are central and north-west India. These areas accounts for about 70% of India's food grain production. Despite this we do not expect food inflation (with close to 50% weight in CPI) to soar in the coming months. In recent weeks, the government has announced a number of measures to counter rising food prices in case of a poor monsoon. These include keeping a strict check on hoarding activities, urging states to abolish the APMC act, raising the minimum export price of onions, and its willingness to offload excess food grain stocks to meet supply shortages.

Given the strong base effect from last year and measures taken by the government, we expect CPI inflation to hover around 7.5 – 8.0% in the coming months.

In the longer term, while we expect improved monetary and fiscal coordination to bring down inflation, lowering and sustaining it at 6% - the RBI's target for January 2016 will pose a challenge. Initial steps towards sustainably lowering inflation were taken in the recent budget. A number of reforms related to raising agriculture production and improvement in agriculture productivity, if implemented, will help lower inflationary pressures. Measures like setting up of a price stabilisation fund, encouraging states to set up of private agriculture markets/farmers' markets and higher budgetary allocation for rural infrastructure and warehousing will help improve the supply chain.

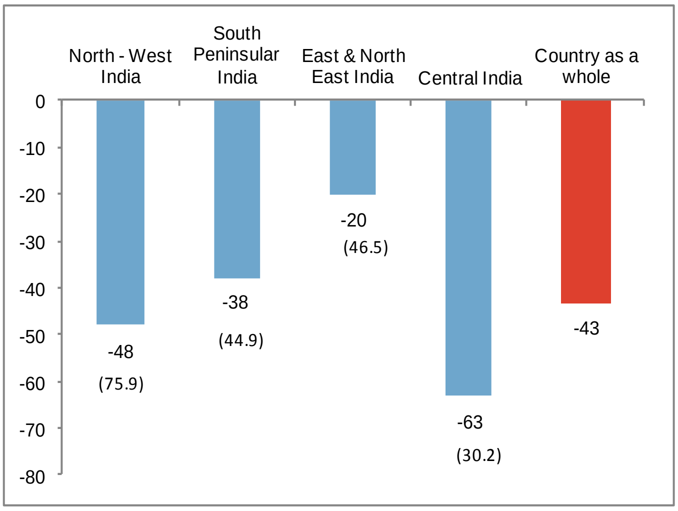
Figure 1: CPI Inflation (%y-o-y)



Note: 8% is the RBI's target for January 2015

Source: CSO, CRISIL Research

Figure 2: Rainfall deficiency (as on July 9, % of LPA)



Note: Figures in brackets show % area under irrigation in each zone

Source: IMD, CRISIL Research

Table 1: Persistence of CPI inflation, year-on-year

CPI (%y-o-y)	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14
Headline CPI	9.8	10.2	11.2	9.9	8.8	8.0	8.3	8.6	8.3	7.3
Food, Bev & Tobacco	11.3	12.4	14.5	12.0	9.9	8.6	9.2	9.6	9.2	7.9
Cereals & Products	12.8	12.0	12.0	12.1	11.3	9.8	9.5	9.5	8.8	7.6
Vegetable & fruits	28.4	37.3	48.9	32.0	20.1	14.8	17.1	18.8	17.3	11.8
Milk & Milk products	8.0	7.8	9.1	9.7	9.8	10.2	11.0	11.3	11.3	11.1
Fuel & Light	7.7	7.0	7.0	7.0	6.5	6.1	6.3	5.9	5.0	4.6
Core CPI	8.5	8.2	8.0	7.9	8.0	7.7	7.7	7.9	7.9	7.2
Housing	10.4	10.4	10.3	10.3	10.2	9.9	9.9	9.7	9.2	9.1
Clothing, bedding & footw ear	9.3	9.1	8.9	9.2	9.1	9.1	9.0	8.7	8.8	8.6
Transport and communication	9.0	7.7	7.1	7.2	7.3	6.4	5.9	6.2	7.0	6.3

4-6%	6-8%	8-10%	>10%

Source: CSO, Crisil Research

IIP: May IIP crosses 4% - first time in 19 months

The index of industrial production (IIP) grew by 4.7% in May. For the first two months of 1QFY15, industrial growth ticked 4.1%, (compared to 1% fall in 1QFY14) possibly marking the onset of industrial recovery. During May, all three sub-sectors of industry – manufacturing, mining and electricity looked up. But, higher growth was mainly led by manufacturing and electricity. In terms of contribution to growth, manufacturing contributed almost 80% to IIP growth in May, followed by electricity at 14% and mining at 6%.

The government in its maiden budget on July 10 announced a number of steps to boost private consumption and push manufacturing and construction sectors. While these steps would help in industrial recovery, a weak monsoon could dent growth this year.

Highlights of May IIP data:

- The manufacturing sector turned around in April and gathered pace in May expanding almost 4.8% during the month - the highest growth since October 2012. A look at sub-sectors of manufacturing revealed a sustained uptick in the domestic demand scenario. 16 out of 22 manufacturing industries recorded positive growth in May (compared to 12 in April). This month, in addition to the pick-up industrial and investment goods' output seen last month, the output of consumer demand-related goods (wearing apparel, furniture and tobacco products) also picked up.
- Mirroring this trend, growth in the consumer goods' segment, at 3.7%, was positive after 7 months and was led by a pick-up in both, consumer durables and non-durables sectors. Growth in the capital goods segment too was strong - at 4.5% compared to 3.7% fall a year ago.

The pick-up in industrial activity comes at the time when the new government has indicated its intention to revive the industry, with specific focus on sectors on job creation. The budget provided a glimpse of this with significant support provided to sectors such as textiles, footwear, food processing, construction, and tourism, all of which are highly labour-intensive. In addition, the support assured to the micro, small and medium enterprises (MSME) is also welcome, given that nearly half of total manufacturing output in currently generated by this sector. These include, the setting up of a Rs 100 billion venture capital fund to encourage entrepreneurship, putting in place a legal framework for easy exit for SMEs, revision of the definition of MSME to provide higher capital ceiling, and an amendment of the Apprenticeship Act.

Going forward, these steps, if well implemented, can have a significant impact on industrial recovery. This fiscal however is clouded with a weak monsoon which will also have spill-over effect on industry and services growth. Despite this, these sectors will do better compared to last fiscal. In manufacturing – a sector which has almost stagnated in the past two years - steps such as extended excise duty cuts in auto, and consumer durables should bring back growth this year as they support private consumption demand and spruce up capacity utilisation.

Figure 3: Revenue outlook for sectors in FY15(y-o-y,%)

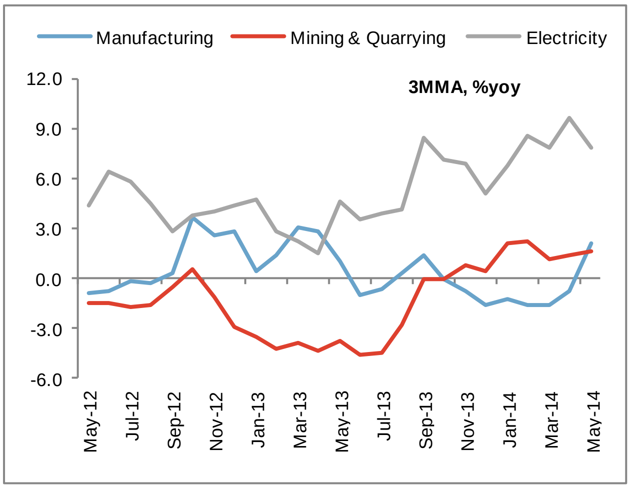
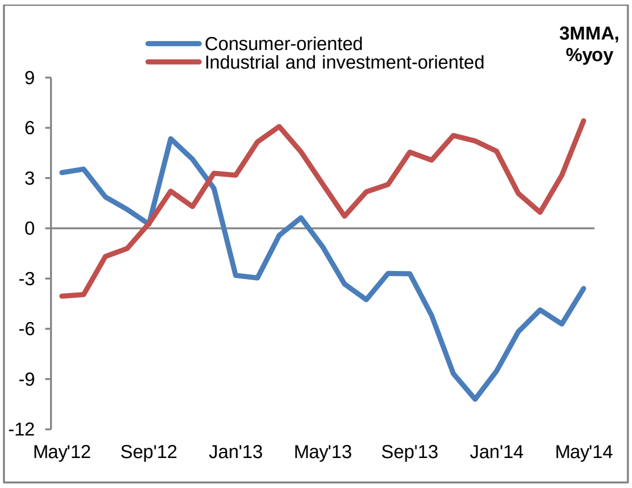


Figure 4: Sectoral Growth (y-o-y,%)



Note: Consumer oriented industries includes producer of food products and beverages, tobacco products, textiles, wearing apparel, leather products, wood products, paper products, publishing and printing, rubber and plastic products, office, accounting and computing machinery, radio, TV and communication equipment, motor vehicles and semi-trailers, and furniture. Industrial and investment oriented industries include coke and refined petroleum products, chemical products, other non-metallic mineral products, basic metals, fabricated metal products, machinery and equipment, electrical machinery and apparatus, and other transport equipment.

Source: CSO, CRISIL Research

Table 2: Sectoral Growth (y-o-y,%)

	Weight	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14
General	1,000.00	2.6	0.4	2.7	-1.2	-1.3	0.1	0.8	-2.0	-0.5	3.4	4.7
Mining	141.6	-3.0	-0.9	3.6	-2.9	1.6	2.6	1.9	2.3	-0.4	2.6	2.7
Manufacturing	755.3	3.0	-0.2	1.4	-1.3	-2.6	-1.1	0.0	-3.9	-1.2	2.5	4.8
Electricity	103.2	5.2	7.2	12.9	1.3	6.3	7.5	6.5	11.5	5.4	11.9	6.3
Use-based classification												
Basic	355.7	1.0	0.9	6.7	-0.4	2.7	3.0	2.5	4.5	4.4	7.3	6.3
Capital	92.6	15.9	-2.0	-6.6	2.5	0.1	-2.5	-4.1	-17.6	-11.6	14.3	4.5
Intermediates	265.1	3.2	3.8	4.4	2.7	3.7	5.2	3.6	4.0	1.6	3.4	2.7
Consumer Goods	286.6	-0.7	-0.9	1.0	-5.0	-8.9	-4.6	-0.5	-5.2	-2.1	-4.7	3.7
-Durables	53.7	-9.6	-8.3	-10.6	-12.0	-21.7	-16.1	-8.3	-9.8	-11.8	-7.8	3.2
-Non durables	233	7.4	5.4	12.0	1.9	2.2	2.8	4.6	-2.0	5.0	-2.5	3.9

Source: CSO, CRISIL Research

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