December 2014

CRISIL Economy First Cut

Inflation on track; IIP comes as a shocker

Overview: *Retail inflation dropped to 4.4% in November- largely led by falling vegetable prices. As the strong base effect wears off next month, inflation will bounce back up. However, we expect falling oil prices, lower MSP increases and proactive measures taken by the government to contain inflation close to 6% in Q4. With inflation falling and industrial growth still not picking up, we expect the RBI to cut rates by April 2015.*

Industrial production shocked in October, as it fell by 4.2%, led by a 7.6% fall in manufacturing output. A word of caution- today's figures could be overstating the downturn in industrial production as the data is generally very volatile and subject to revision. That said the demand for consumer goods remained weak despite the festive season. And though inflation fell rapidly, a dent in farm incomes due to poor monsoon season is believed to have kept consumption demand low. Meanwhile, investment demand stayed weak, as capital goods production fell faster than in Q2. Consumption turned out to be a much bigger drag on IIP.

Inflation hits bottom…

CPI inflation fell to 4.4% in November from 5.5% last month driven by a sharp fall in food inflation by 2.4 percentage points (fell to 3.14% from 5.6% in October). Prices for certain categories fell in the month with inflation turning negative for vegetables (-10.9%), oils and fats (-0.8%) and sugar (-0.3%). Inflation edged down in all food categories with the exception of egg, fish and meat (rose to 6.5% from 6.2%) and pulses – which remained sticky at 7.5%. The seasonally adjusted month on month food inflation picked up to 0.6% indicating that the fall in annual food inflation was driven majorly by a strong base effect from last year (chart 2).

In addition, even as inflation has declined in categories such as milk and products, fruits, condiments and spices in recent months (weight of 26% in food inflation) - it continues to remain sticky above 8% (Table 1).

Core inflation remained broadly unchanged – falling slightly from 5.9% last month to 5.8% in November. This is the lowest core inflation recorded since the beginning of the new CPI series. Inflation fell in household requisites for the fourth consecutive month to 2.1% and in transport and communication to 1.9% (from 2.7% in October). That said core inflation excluding these two categories actually rose marginally to 7% from 6.9% in November. This was as inflation in personal case and recreation remained high (accounting for 9% weight in the core).

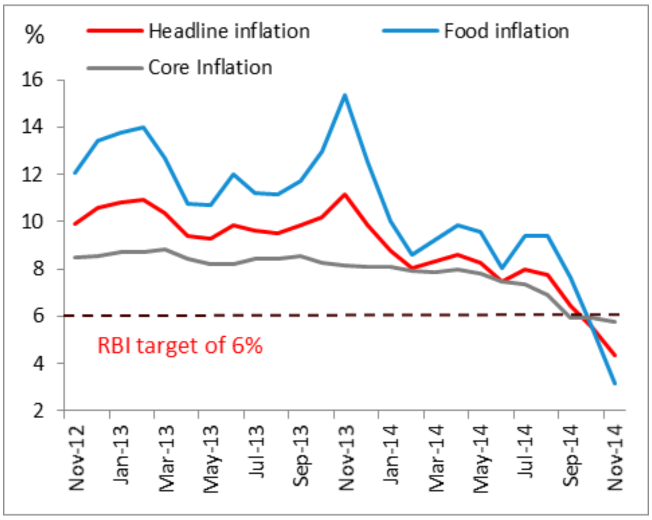
…RBI turns dovish

In its recent monetary policy meeting (December 2), RBI adopted a more dovish tone indicating that while a change in monetary policy stance was premature at the moment – a sustained fall in inflation in the coming months will open the door for a rate cut early next year. The RBI revised down its forecast for inflation to 6% by March-end FY15.

From next month, inflation will pick up from its current lows as the impact of a strong statistical base wears off - a weak base will push up the December print. However, we believe that falling crude oil prices, lower increase in MSP and controlled impact of any weather related shocks to food prices in the Rabi season (through government intervention) will keep inflation close to 6% in Q4. Also, the crude outlook has turned even more bearish for this, as well as the next fiscal. In the recent OPEC meeting, countries refrained from reducing production indicating that the downward pressure on oil prices is here to remain. We now expect oil to average at lower $ 88 – 93/bbl. in FY15 and at $77 – 82/ bbl. in FY16 compared to our earlier forecast of $100 - 105/bbl. in FY15 and $90 - 95/bbl. in FY17. Prospects of lower oil prices over the medium term will also temper inflationary expectations going ahead.

Given this, we expect RBI to cut rates by April 2015. By that time there would be more clarity on the inflation trajectory as well as the fiscal health of the economy. Also, in the coming months, the formal adoption of an inflation target by the government as per the recommendations of the Urjit Patel Committee report will determine the course of action for monetary policy beyond 2016.

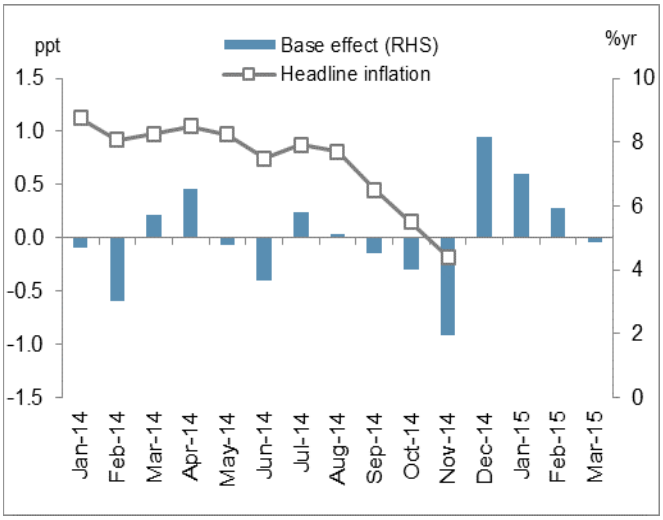
Figure 1: Inflation moderates as food inflation edges down



Note: RBI's target of 6% by Jan 2016

Source: Central Statistical Office, CRISIL Research

Figure 2: Base effect to wear off in Q4



Source: Central Statistical Office, CRISIL Research

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

CPI (%y-o-y)	Weight	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14
Headline CPI	100.0	8.0	8.3	8.6	8.3	7.5	8.0	7.7	6.5	5.5	4.4
Food CPI	42.7	8.6	9.2	9.8	9.6	8.0	9.4	9.4	7.6	5.6	3.2
Cereals & Products	14.6	9.8	9.5	9.5	8.8	7.6	7.5	7.3	6.4	6.0	5.2
Vegetable	7.3	14.3	17.1	17.7	15.2	9.1	16.9	15.0	8.6	-1.4	-10.9
Milk & Milk products	7.7	10.2	11.0	11.3	11.3	11.1	11.3	11.7	11.0	10.7	10.2
Fuel & Light	9.5	6.1	6.3	5.9	5.0	4.7	4.5	4.2	3.5	3.4	3.3
Core CPI	47.8	7.9	7.9	8.0	7.8	7.5	7.3	6.9	6.0	5.9	5.8
Housing	9.8	9.9	9.9	9.7	9.2	9.1	8.9	8.5	8.1	8.1	7.9
Clothing, bedding & footwear	4.7	9.1	9.0	8.7	8.8	8.6	8.7	8.4	7.6	7.4	7.0
Transport and communicatio	7.6	6.4	5.9	6.2	7.0	6.3	5.9	4.7	2.5	2.7	1.9

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

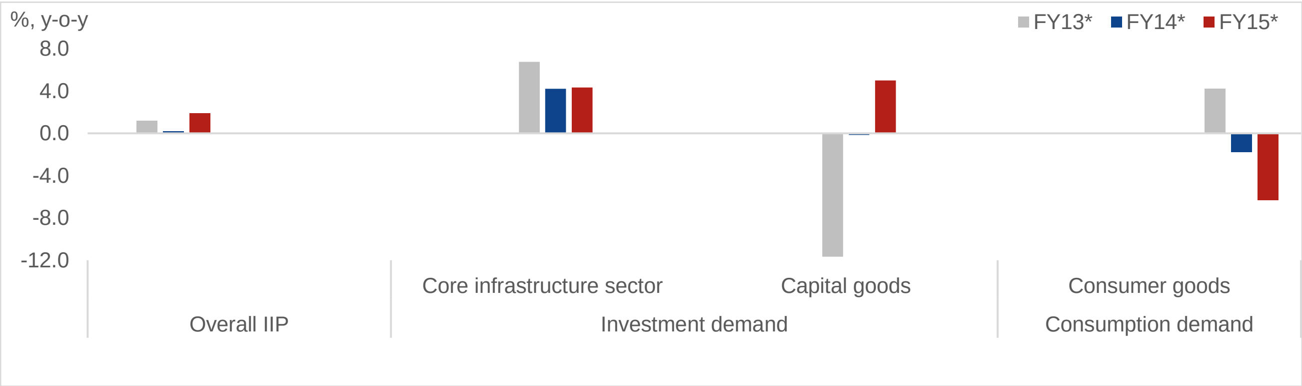
Source: CSO, CRISIL Research

IIP: Difficult times for industry – production falls 4.2% in October

Industrial production fell by 4.2% in October, led by a 7.6% decline in manufacturing output. This compares with last month's IIP growth, of 2.8%. This month, despite the sharp pick-up in core infrastructure sector output, a near 19% drop in consumer goods output, dragged down industrial growth. Although the weakness in consumer demand is disappointing – given that festive season demand should have spruced up sales in October – it is not a surprise. Dismal automobile sales recorded for the month, had provided early indications into such sluggishness. Even the capital goods sector continued to post negative growth for yet another month, reflecting continued weakness in investment demand. For the year so far (April to October), industrial production growth now clocks only 1.9%, with manufacturing at a tardy 0.7% growth.

- Manufacturing output fell 7.6% in October, with most of the decline coming from sectors such as chemical products, food and beverages, motor vehicles, trailers and semi-trailers, metals and machinery and equipment. The biggest fall – nearly 70% - was recorded in the 'radio, TV and communication equipment' segment. 14 out of 22 sectors saw a fall in output. **All these sectors which together account for 64% of the manufacturing index, posted an average decline of 15% in output**.
- During the month, consumer goods' output fell 18.6%, most of it led by the consumer durables sector where output fell 35.2%, while consumer non-durables output fell 4.3%. Capital goods sector too underperformed with output falling 2.3% compared to an average growth of 6.6% in the first half of this fiscal.
- Meanwhile, the fall in manufacturing output, wiped out gains from higher production in mining and other core infrastructure sectors. Core infrastructure sector output rose by 6.3% in October (4.3% during April to October), as coal and electricity output surgedto 16.2% and 13.2% respectively, on a low base of last year.In the coal sector, part of the higher production is also attributed to an easing of norms for providing of environmental clearances, the impact of which could also be felt in November. During the month, output from refinery products too jumped on a low base – in October last year, one of Indian Oil Company Limited (IOCL) refineries has stalled production.

Figure 3: Consumption demand tanks even as investments see some improvement so far



Note: *April to October 2014

Source: CSO, CRISIL Research

However, there are some mild, yet encouraging signs for investments. A recent CRISIL Research study finds an unprecedented pick-up in execution of road projects amid the government's proactive steps which have led to faster approvals by implementing agencies. The study highlights that work has already begun on 75% of the 16 projects awarded in fiscal 2014. This is a huge improvement given that for projects awarded in fiscals 2012 and 2013, at a similar juncture, work had only begun on 10% and 18% of the projects, respectively. It finds that the time taken between the award of a project and its commencement has reduced to an average 7 months, from 10-12 months earlier. This is expected to further come down to 6 months. To clear the snarl and spur execution, the government has been taking many proactive steps such as fast-tracking environmental nod, delinking forest and environment clearances, increasing limits on sand mining, and enabling online filing for clearances to construct rail over-bridges and underbridges. These are notable changes and bode well for existing and stalled projects, not just in the roads sector, but should also invite fresh investments in the entire infrastructure sector.

Overall this year, while investment growth remains slow, some improvement in prospects is visible, given the government's focus on eliminating inefficiencies. However, some challenges such as significant deleveraging of businesses due to huge debt, excess capacities and sluggish sales/weak consumption demand continue to challenge fresh investments.

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

	Weight	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14
General	1,000.00	0.1	1.1	-2.0	-0.5	3.7	5.6	4.3	0.9	0.5	2.8	-4.2
Mining	141.6	2.6	2.7	2.3	0.5	1.7	2.5	4.8	0.1	2.0	0.3	5.2
Manufacturing	755.3	-1.1	0.3	-3.9	-1.3	3.0	5.9	2.9	-0.3	-1.3	2.9	-7.6
Electricity	103.2	7.5	6.5	11.5	5.4	11.9	6.7	15.7	11.7	12.9	3.9	13.3
Use-based classification												
Basic	355.7	3.0	2.8	4.5	4.6	8.6	7.5	10.2	7.0	9.2	5.1	5.8
Capital	92.6	-2.5	-3.9	-17.6	-11.5	13.4	4.2	23.3	-3.0	-9.8	13.6	-2.3
Intermediates	265.1	5.2	4.3	4.0	1.3	3.0	3.5	2.6	2.9	-0.1	2.2	-3.1
Consumer Goods	286.6	-4.6	-0.5	-5.2	-2.2	-4.8	4.6	-8.8	-5.9	-6.5	-3.6	-18.6
-Durables	53.7	-16.1	-8.3	-9.8	-11.8	-7.7	3.6	-23.3	-20.4	-15.0	-11.2	-35.2
-Non durables	233	2.8	4.6	-2.0	5.0	-2.7	5.2	1.9	5.2	-0.4	2.1	-4.3

Source: CSO, CRISIL Research

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