February 2015

CRISIL Economy First Cut

Inflation on track despite base revision; No cheer for IIP

Overview: In January CPI inflation rose to 5.11% from 4.28% in December as per the new CPI series. The December figure according to the old series was at 5%. CSO has revised the CPI series with a new price reference year (Base year 2012 = 100) and a new weight reference year (2011-12). In addition, the CSO has also introduced a number of methodological improvements that will make CPI a more accurate and less volatile measure of inflation. In addition, the new CPI gives greater weight to core categories than before.

Despite the rise in inflation in January, inflation remains in the comfortable zone. We expect RBI to deliver rate cuts in the range of 50-75 bps in the next fiscal. We expect inflation to average at 6.5% for this fiscal. For 2015-16, we expect inflation to average at 5.8% supported by lower oil prices, normal monsoons, pro-active steps by the government and better monetary and fiscal coordination.

Industrial production growth slowed to 1.7% in December from 3.9% in November. The slowdown was led by the mining and electricity sectors where average growth fell to 0.6% from 6.8% in the previous month. Manufacturing growth also slumped in December. With this, IIP growth in the fiscal so far stands 2.1%, which is much below the 5.6% industrial GDP (ex-construction) growth measured by the new GDP series, for the same period. The existing IIP series therefore is now a poor representative of industrial GDP growth as the wedge between IIP growth and Industrial GDP growth has increased. For fiscal 2014, IIP growth was estimated at -0.1% in contrast to industrial GDP at 5.3%. A similar pattern is expected to play out in fiscal 2015- IIP growth in the first three quarters of this fiscal is estimated at 2.1% as against industrial GDP (ex- construction) growth of 5.6%.

All about the new inflation series – Key Highlights

- In today's release, the **CSO revised the base year** from 2010 to 2012. Also the weighting diagram is based on the results from the Consumer Expenditure Survey (CES) of 2011-12 versus the 2004-05 survey earlier used. As a result the gap between the base year and the weight reference year has reduced and CPI now captures inflation dynamics better than the previous series.
- **CPI inflation stands at 5.1%** according to the new series for the month of January. Food inflation stood at 6.1% while core inflation was below 5% (4.6%) in the month. According to the old series, numbers for food and core inflation for the month of December stood at 4.8% and 5.5% respectively.
- **Inflation in categories** such as fruits, milk and milk products, vegetables, pulses and products was above 9% for the month of January according to the new series. These account for 46% of the food basket. For fuel and light, inflation continued to remain subdued at 3.7%. In line with declining oil prices, transport and communication saw a decline in prices (-1.2%) in January. Amongst miscellaneous items, inflation in education category was above 7%.
- The **weights in the CPI** index have **reduced for food and beverages and fuel and light** while rising for categories such as clothing and footwear, housing and miscellaneous items (Figure 2). This consistent with the observed pattern

of consumption away from food towards discretionary items as incomes rise. This has resulted in increasing the weight of core in the CPI from 47.8 to 54.1 in the new series. However, the change in the category wise weights is minimal. A 1% increase in inflation in food and fuel category will raise overall CPI by 0.5 ppt as compared to 0.6 ppt according to the earlier weights. Food and beverages continue to have the highest weight in CPI (45.9).

- The **weight amongst the food basket** has seen a greater change (Figure 1). The weight of cereals and products has been reduced from 14.6 to 9.7 while for fruits and vegetables it has risen from 7.3 to 8.9 in the new series. This will result in lower sensitivity to cereal and products inflation in the future. Other categories where the weights have risen are meat and fish and spices.
- The new release has also incorporated some **methodological improvements** that will make the CPI a more accurate and less volatile measures of inflation (for detail see Box 1).

New GDP deflator versus CPI inflation

Inflation in the new GDP deflator is much lower than what is indicated by CPI. Inflation computed based upon changes in the GDP deflator (ratio of nominal and real GDP) fell to 3.8% in this fiscal from 6.3% in the last, while CRISIL estimates CPI to fall to 6.5% from 9.5% (Figure 3).

RBI to continue easing monetary policy

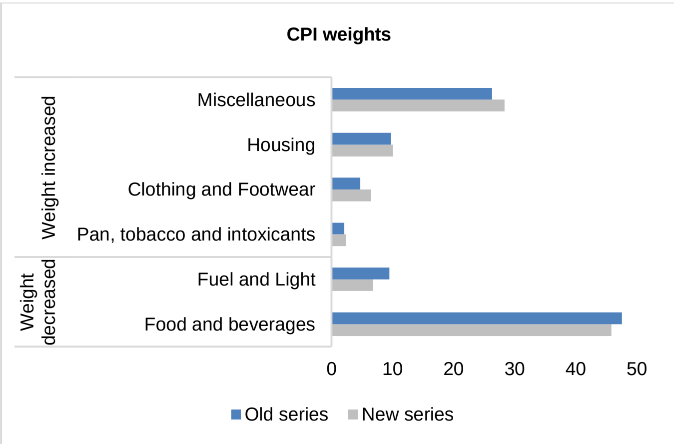
Looking ahead, we expect inflation to average at 5.8% in 2015-16 as compared to an estimated 6.5% for 2014-15. The one of dampeners to inflation next fiscal will be 1) lower crude oil prices - we expect crude oil prices to decline to $60-65/barrel (Brent) in FY16 from $85-90/barrel in FY15. This is the first round effect. Additionally, second round effects through lower production and transportations costs will also play out. 2) Normal monsoons in 2015-16. Factors that will keep inflation low in 2015-16 and beyond include 1) proactive steps by the government such as lower MSP increases and better utilization of food grain stocks 2) improved monetary and fiscal coordination. Trajectory of inflation beyond 2015-16, will strengthen further once the government adopts an inflation target as recommended by the Urjit Patel Committee report.

Figure 1: Weights of food components

Weights in CPI	New Series	Old series
Cereals and products	9.7	14.59
Meat and fish	3.6	2.89
Egg	0.4	
Milk and products	6.6	7.73
Oils and fats	3.6	3.90
Fruits	2.9	1.89
Vegetables	6.0	5.44
Pulses and products	2.4	2.65
Sugar and confectionery	1.4	1.91
Spices	2.5	1.71
Consumer food price index	39.1	42.71

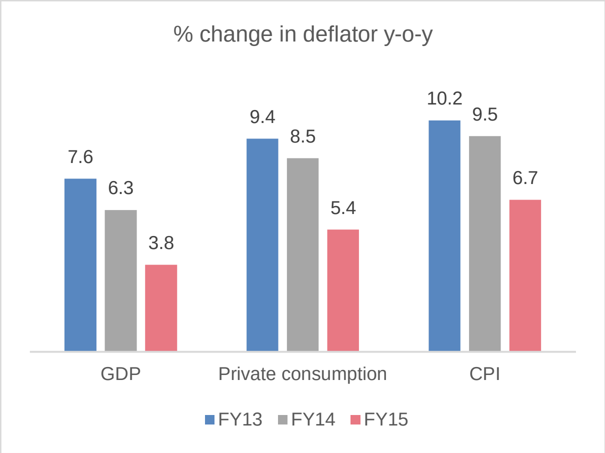
Source: Central Statistical Office, CRISIL Research

Figure 2: Broad weights remain more or less unchanged



Source: Central Statistical Office, CRISIL Research

Figure 3: Inflation through the GDP deflator



Source: Central Statistical Office, CRISIL Research

Box 1: Changes in the new series versus old series of CPI

- *Weights are determined according to the Modified Mixed Reference Period (MMRP) data of the Consumption Expenditure Survey (CES) to make it consistent with international practice. According to this **consumption for food items is measured for a shorter reference period while items infrequently consumed are measured over a larger reference period**. In the old series, Uniform Reference period (URP) data was used. In this the survey captures consumption of all items in the last 30 days by households.*
- *Following the Classification of Individual Consumption According to Purpose completely. In the previous series it was broadly followed.*
- *Use of geometric mean, rather than arithmetic mean to calculate price relatives with respect to base prices. This implies that the index is less affected by extreme values in comparison to an index made using arithmetic mean (Australian Bureau of Statistics, 2013), thereby **reducing volatility**.*
- *In the case of **PDS items**, prices of Antyodaya Anna Yojana (AAY) have also been included.*
- *In CES 2011-12 some items have been dropped and a few items added as compared to the CES 2004-05. As a result the **number of items have changed** from 437 to 448 in rural and 450 to 460 in urban index.*
- *Sample size for house rent data has increased. Also the item egg has been made into a separate sub-group and Pan, tobacco and intoxicants has been made into a separate group (earlier part of food, beverages and tobacco)*

IIP: December IIP posts 1.7% growth, Q3 at 0.5% compared to 4.6% as per new GDP series

Industrial production grew by 1.7% in December compared to 3.9% in November. The slowdown was led by the mining and electricity sectors where average growth fell to 0.6% from 6.8% in the previous month. Core sector growth too therefore slowed during the month, to 4.3% from 6.7% in November. December also saw manufacturing growth slump to 2.1% from 3.1% in

November. But the silver lining was consumer goods output which expanded y-o-y, for the first time in 15 months. However, overall in Q3 IIP growth slowed to 0.5% from 1.3% in Q2. High frequency indicators like auto sales and credit growth were already pointing towards a slower Q3 for industry. CRISIL Research too, in a release dated January 8, 2015, had estimated Q3 to record the lowest revenue growth for corporates, in six quarters. This slowdown in growth was also evident from the GDP estimates released as per the new series. CSO's estimates however, placed Q3 growth for industry (ex-construction) at 4.6%. Nevertheless, CSO's advance estimates suggest a sharp pick-up in growth (particularly industrial growth) in Q4 so as to deliver 7.4% GDP growth for the full year.

For April to December, the IIP records industrial growth at 2.1%, whereas as per the new GDP series, industry (ex-construction) grew by 5.6% (Figure 4). The IIP series therefore is now a poor representative of industrial growth. Such discrepancy in measurement of industrial activity will continue until March 2016, when the existing IIP series (at 2004-05 base year) is replaced with a new IIP series (computed at 2011-12 base year). The existing series also suffers from much narrower coverage of industrial activity. In addition, IIP is a measure of output, while GDP measures value-added. According to the CSO, the value-added component in GDP is higher as inputs are being used more efficiently than before, and the new series captures this well.

Figure 4: IIP an imperfect measure for new GDP series

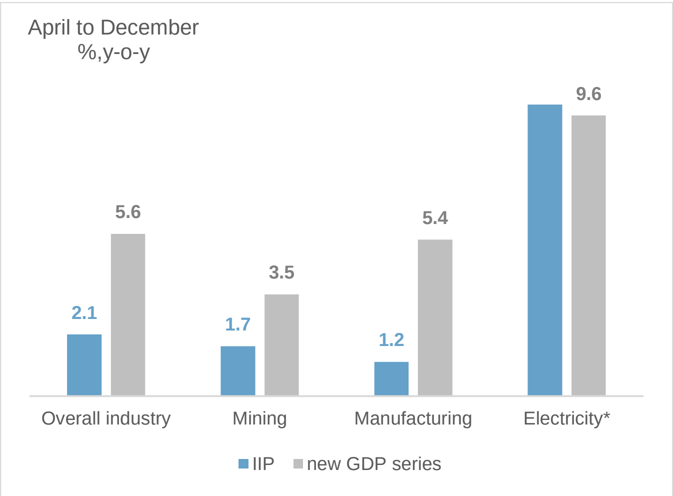
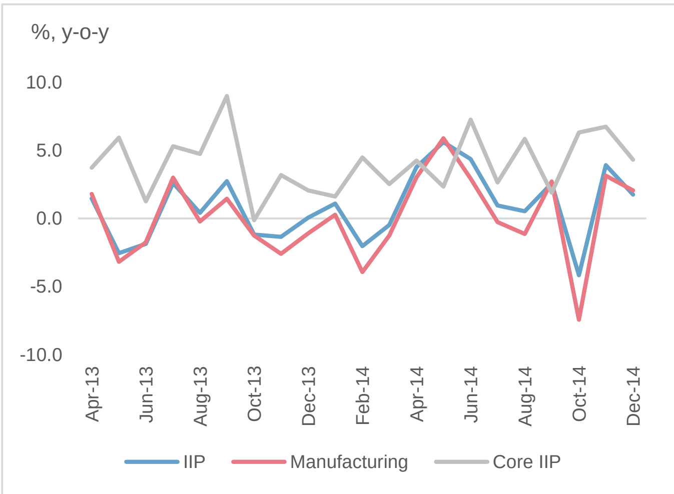


Figure 5: Core sector contributing to growth slowdown



Note: ***In addition to electricity production, new GDP series measures water supply, gas, sewage, waste management, recycling and remediation activities**

Source: CSO, CRISIL Research

- Lower growth in core infrastructure sector was mainly due to lower growth in coal, electricity and cement sectors.
- In the manufacturing sector, growth slowed to 2.1% in December from 3.1% in November. Of the 22 industries tracked by the index, 13 recorded positive growth compared to 16 in November. Among the sectors where output declined, the sharpest fall was in radio, TV and communication equipment, and office, accounting and computing machinery, where growth fell by an average 67.7% in December compared to 58.9% in November. Fall in output, in these two sectors which is more than twice that of fiscal 2014, could perhaps be explained by rising demand for imports of these goods.
- In December, consumer goods posted a growth in output for the first time in 15 months, growing at 0.2%. The fall in consumer durables' output reduced to 9% in December, from 14.5% in the previous month.

Figure 6: Sectoral Growth (%, y-o-y)

	Weight	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14	Dec-14
General	1,000.00	-2.0	-0.5	3.8	5.6	4.4	0.9	0.5	2.6	-4.2	3.9	1.7
Mining	141.6	2.3	0.5	1.7	2.5	4.8	0.1	1.2	0.1	4.9	3.9	-3.2
Manufacturing	755.3	-3.9	-1.3	3.0	5.9	2.9	-0.3	-1.1	2.7	-7.4	3.1	2.1
Electricity	103.2	11.5	5.4	11.9	6.7	15.7	11.7	12.9	3.9	13.3	10.0	4.8
Use-based classification												
Basic	355.7	4.5	4.6	8.6	7.5	10.2	7.0	9.0	5.0	5.9	7.1	2.4
Capital	92.6	-17.6	-11.5	13.4	4.2	23.3	-3.0	-10.0	12.3	-3.2	6.6	4.1
Intermediates	265.1	4.0	1.3	3.0	3.5	2.6	2.9	-0.1	2.0	-3.5	4.5	0.1
Consumer Goods	286.6	-5.2	-2.2	-4.8	4.6	-8.8	-5.9	-6.2	-4.0	-18.0	-2.1	0.7
-Durables	53.7	-9.8	-11.8	-7.7	3.6	-23.3	-20.4	-15.0	-11.1	-35.2	-14.5	-9.0
-Non durables	233	-2.0	5.0	-2.7	5.2	1.9	5.2	0.4	1.3	-3.3	6.2	5.7

Analytical Contacts:

Dharmakirti Joshi

Chief Economist, CRISIL Ltd.

Email: dipti.deshpande@crisil.com

Dipti Deshpande

Senior Economist, CRISIL Ltd.

Email: dipti.deshpande@crisil.com

Sakshi Gupta

Junior Economist, CRISIL Ltd.

Email: sakshi.gupta@crisil.com

Media Contacts:

Tanuja Abhinandan

Communications and Brand Management

Email: tanuja.abhinandan@crisil.com

Phone: +91 22 3342 1818

Jyoti Parmar

Communications and Brand Management

Email: jyoti.parmar@crisil.com

Phone: +91 22 3342 1835

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CRISIL Limited
CRISIL House, Central Avenue, Hiranandani Business Park,
Powai, Mumbai – 400076. India
Phone: +91 22 33423000 | Fax: +91 22 33428088
www.crisil.com

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