

## Retail inflation drops further; IIP rebounds

Headline CPI inflation fell to a 16-month low of 4.1% in January 2021, continuing its downward trend for the third month in a row and surprising market expectations on the positive side (Consensus: 4.4%; Source: Refinitiv Datastream). This higher-than-expected moderation was primarily led by a sharp fall in food inflation for yet another month, mainly driven by strong deflation in vegetables (-15.8%), albeit off a very high base, and continued drop in cereals inflation to lowest level in the series (+0.1%). Core inflation (headline inflation excluding food and fuel), however, stayed sticky at 5.3% in January—a reflection of steady improvement in consumption demand and higher commodity prices.

Industrial production (IIP) returned to the expansion zone in December 2020 with a modest 1% YoY growth, deriving support from a low base and favourable demand conditions. The improvement was primarily led by Manufacturing and Electricity, even as Mining recorded a contraction for the third month in a row. In the use-based classification, barring Primarily Goods that reflects weakness in the mining sector, all other categories recorded an expansion, led by Consumer Durables, signalling strong demand impulses. Recovery in capex cycle, however, remains weak with a modest growth in capital and infra/construction goods despite a supportive base.

We expect headline inflation to widen over the coming months but stay within the RBI's target band, as benefits from lower food inflation and higher base get outweighed by demand-side pressures and rising commodity prices. Economic recovery is expected to pick-up pace gradually as effective execution of vaccination drives translates into further normalisation of activities, particularly in the services sector. A contained inflation trajectory should provide comfort to the RBI with respect to maintaining adequate liquidity in the system to strengthen economic **recovery that's currently underway** and supporting the Government's borrowing programme. We see no change in policy rates and RBI's accommodative stance in 2021.

- Retail inflation fell to a **16-month low in January...:** Headline consumer inflation continued the declining trend for the third consecutive month and came in at 4.1% in January 2021—the lowest print in last 16 months. Further improvement in supply chains, coupled with steady arrivals of winter crops, has helped bring inflation levels down from the recent peak of 7.6% in October 2020. Headline CPI inflation has averaged 6.3% in FY21 thus far (April 2020-January 2021) as compared to 4.5% during the same period in FY20.
- ...Led by food inflation: The higher-than-expected drop in headline inflation was primarily led by a sharp fall in food inflation for yet another month to an 18-month low of 2.7%. Within food, it was vegetables that contributed the most to the sequential drop in food inflation (~70/120bps), recording a steep 15.8% YoY drop in prices—the lowest in last two years. Other items that contributed significantly to the declining food inflation trajectory include cereals (+0.1%—the lowest in the series), meat & fish (+12.5%—a consequence of rising bird flu cases), milk & milk products (+2.7%—the lowest in 16 months) and pulses (+13.4%). In fact, all categories within food, barring fruits, non-alcoholic beverages and prepared meals, saw a drop in inflation in January. Decline in food inflation was partly offset by a broad-based spike in other categories.
- Core inflation remained sticky at 5.3%: Core inflation (headline inflation excluding food and fuel) remained sticky at 5.3% in January 2021—a consequence of strong demand environment and rising commodity prices. All categories within core remained broadly at levels observed in December'20, barring personal care and effects (fell from 11.7% to 10.6%) and recreation & amusement (surged from 5.1% to 5.5%). Core inflation has averaged 5.2% over the April-January period of FY21 as compared to 4% during the same period of FY20. With daily COVID-19

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*Retail inflation declined for the third month in a row to a 16-month low of 4.1% in January 2021.*

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*A sharp fall in food inflation for yet another month was mainly driven by strong deflation in vegetables and continued drop in cereals inflation.*

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*Core inflation stayed sticky at 5.3% YoY in Jan'21*

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cases steadily falling in India and vaccine roll-outs progressing well, economic activity should strengthen further. This, along with higher commodity prices, points towards the sustenance of an elevated core inflation trajectory in the medium term.

- IIP growth enters the expansion zone in December: Industrial production grew by a modest 1% in December 2020 after contracting by 1.9% in the previous month, supported by a favorable base (+0.4% in December 2019) and strong consumption demand, leading to firms building inventory again. The average IIP growth in the current fiscal year (Apr-December 2020) is -13.5% as opposed to +0.4% growth during the same period in the previous fiscal year.
- Improvement led by Manufacturing and Electricity: Electricity and Manufacturing recorded a growth of 5.1% YoY and 1.6% YoY respectively in December 2020. Mining sector, however, remained in the contraction zone for the third month in row, declining by 4.8% YoY. That said, this was an improvement over the 6.7% YoY contraction seen in November 2020 despite an unfavorable base (+5.7% in December 2019). Within the Manufacturing sector, 9 out of 23 manufacturing sub-sectors recorded an expansion, led by growth in computer, electronic & optical products (+18.9% YoY), electrical equipment (+8.1% YoY), chemical & chemical products (+7.2% YoY), pharmaceuticals (+6.8% YoY), rubber & plastic products (6.3% YoY) and motor vehicles (5.4% YoY). This was offset by a contraction in the wearing apparel sector (-20% YoY), paper and paper products (-17.4% YoY) and printing & reproduction of recorded media (-27.4% YoY) that has seen continued contraction in last several months
- Use-based classification shows a rebound in consumption: In the use-based classification, barring Primarily Goods (-0.3% YoY) that reflects weakness in the mining sector, all other categories recorded an expansion. This was primarily led by Consumer Durables that grew by 4.9% YoY, followed by Consumer Non-Durables (+2.0% YoY), signalling strong demand impulses during the festive/holiday season. Recovery in capex cycle, however, remains weak with a modest growth in capital (0.6% YoY) and infra/construction goods (+0.9%) despite a supportive base (-18.3% YoY and +0.2% YoY in December 2019 respectively).

Out of the eight core sectors, coal and electricity were the only sectors to witness an expansion over the last few months, growing by 2.2% YoY and 4.1% YoY in December respectively. Fertilizers recorded a contraction of 2.9%, after growing steadily since May 2020. Crude oil, natural gas and refinery products contracted for the 37<sup>th</sup>, 19<sup>th</sup> and 10<sup>th</sup> month in a row respectively, thanks to weak domestic and global demand. On the positive side, both manufacturing and services PMI improved in January, rising to 57.7 and 52.8 respectively.

- Expect status quo on policy rates; RBI to focus on liquidity management: We expect headline inflation to widen over the coming months but stay within the RBI's target band, as benefits from lower food inflation and higher base get outweighed by demand-side pressures and rising commodity prices. Economic recovery is expected to pick-up pace gradually as effective execution of vaccination drives translates into further normalisation of activities, particularly in the services sector. A contained inflation trajectory should provide comfort to the RBI with respect to maintaining adequate liquidity in the system to strengthen economic recovery that's currently underway and supporting the Govt.'s borrowing programme. We see no change in policy rates and RBI's accommodative stance in 2021.

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*Industrial production growth flipped back to expansion zone, recovering to +1% in December 2020.*

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*Rebound in IIP was led by expansion in manufacturing (1.6% YoY) and electricity (5.1% YoY).*

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Figure 1: Consumer price inflation in January 2021 (%YoY)

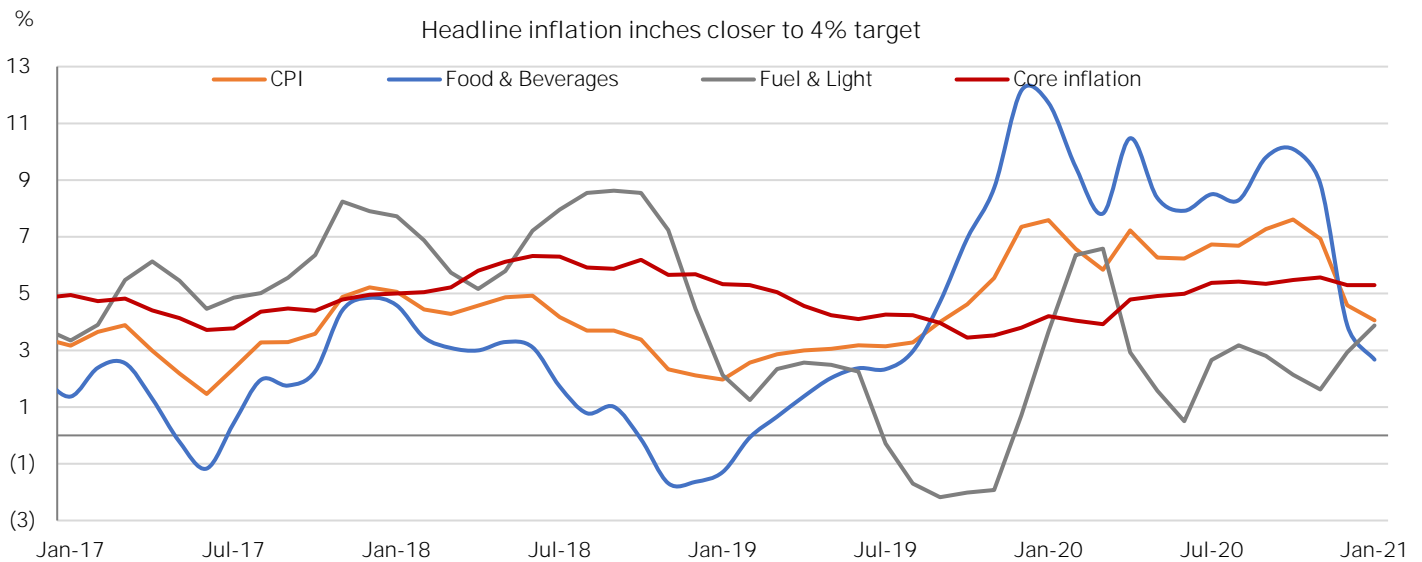
%YoY	Weight (%)	Jan-21	Dec-20	Jan-20	FY21TD	FY20TD
CPI		4.1	4.6	7.6	6.3	4.5
Food & Beverages	45.9	2.7	3.9	11.7	7.8	5.5
Pan, Tobacco & Intoxicants <sup>2</sup>	2.4	10.9	10.7	3.7	9.9	4.1
Clothing & Footwear <sup>2</sup>	6.5	3.8	3.5	1.9	3.2	1.5
Housing	10.1	3.2	3.2	4.2	3.3	4.6
Fuel & Light	6.8	3.9	2.9	3.7	2.4	0.3
Miscellaneous <sup>2</sup>	28.3	6.5	6.6	4.7	6.5	4.4
Core CPI inflation <sup>1,2</sup>	44.9	5.3	5.3	4.2	5.2	4.0

Source: CSO, NSE. NA = Not Available.

 Note: <sup>1</sup> Headline inflation excluding food & beverages, pan, tobacco & intoxicants and fuel & light.

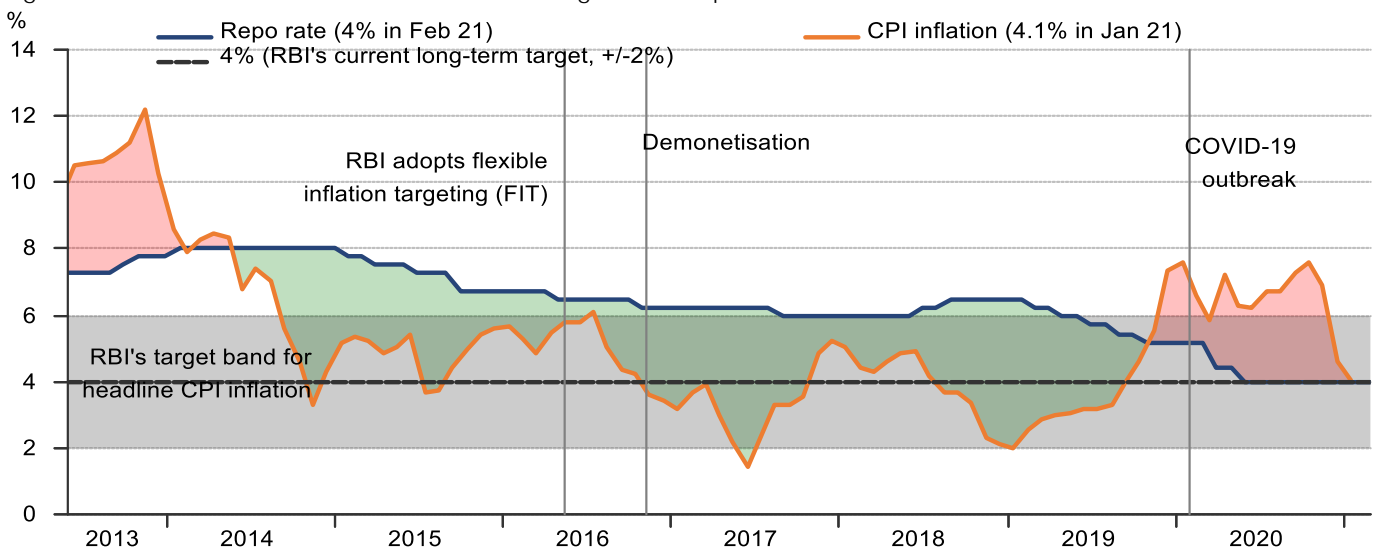
<sup>2</sup> Inflation data for these components for April and May 2020 are based on the imputed index calculated by MOSPI.

Figure 2: Headline CPI inflation trend



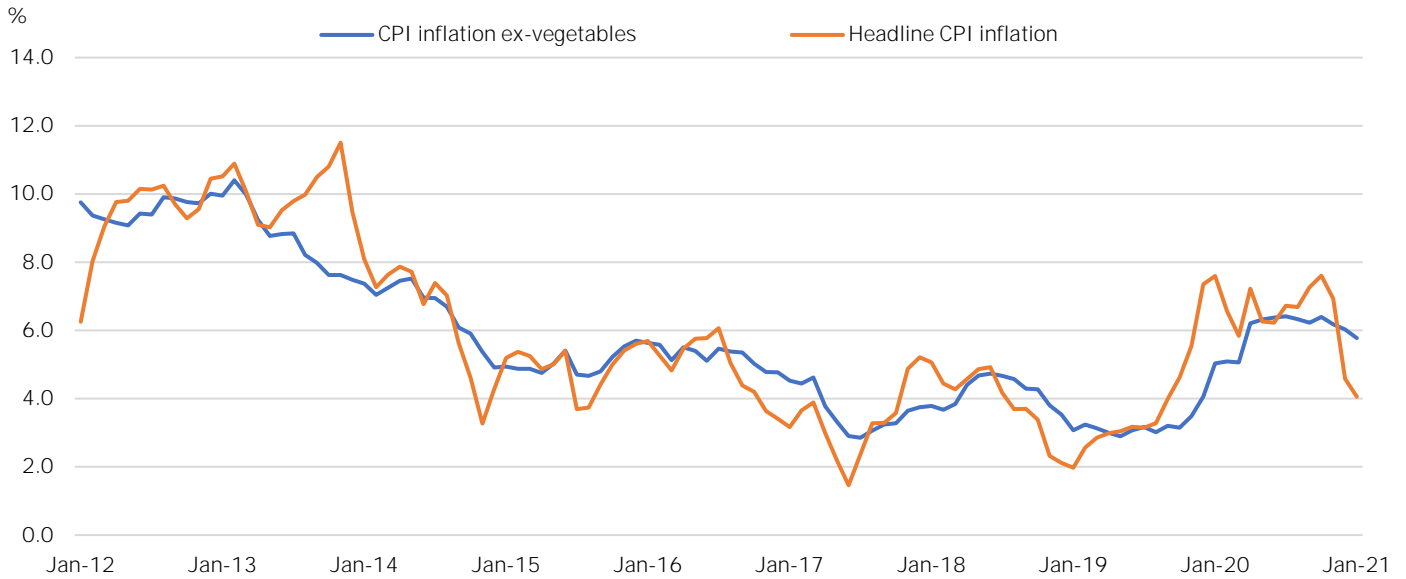
Source: CMIE Economic Outlook, NSE

Figure 3: Real interest rates have remained negative for quite some time now



Source: CMIE Economic Outlook, NSE

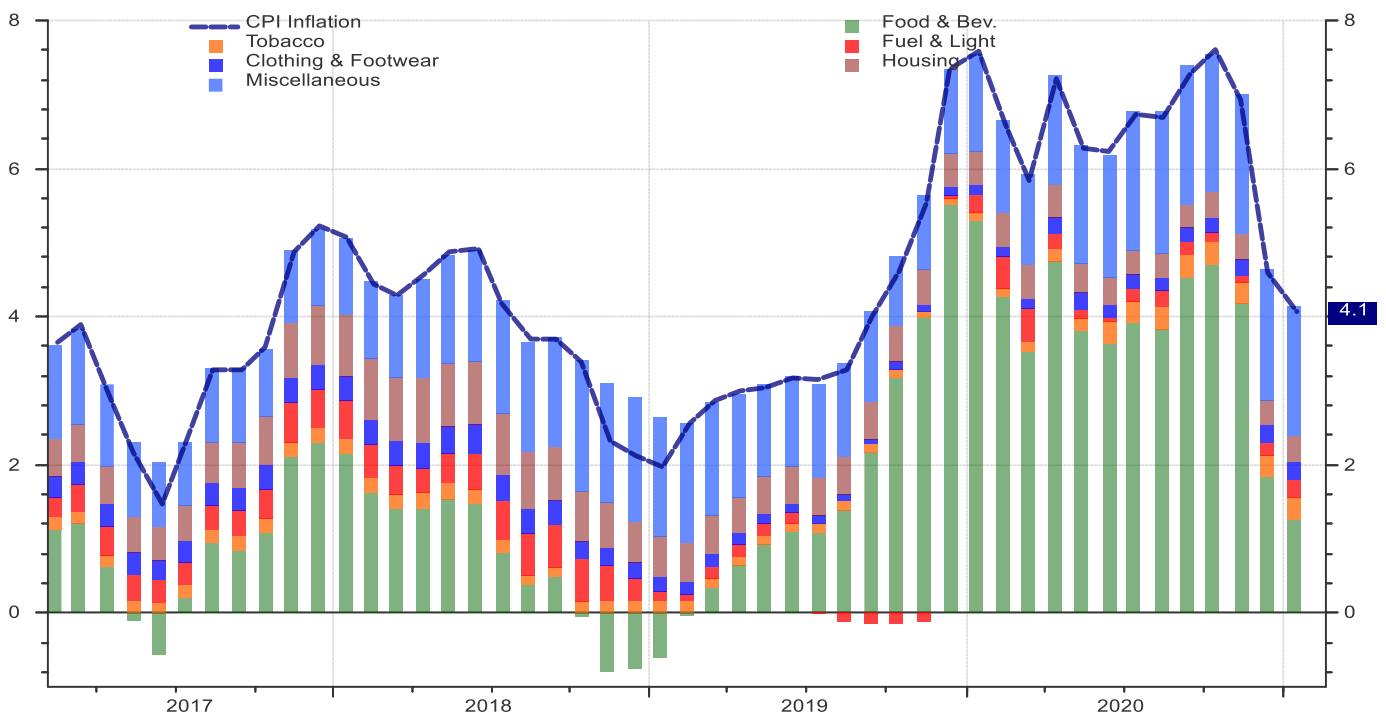
Figure 4: Fall in headline inflation primarily led by food inflation



Source: CMIE Economic Outlook, NSE

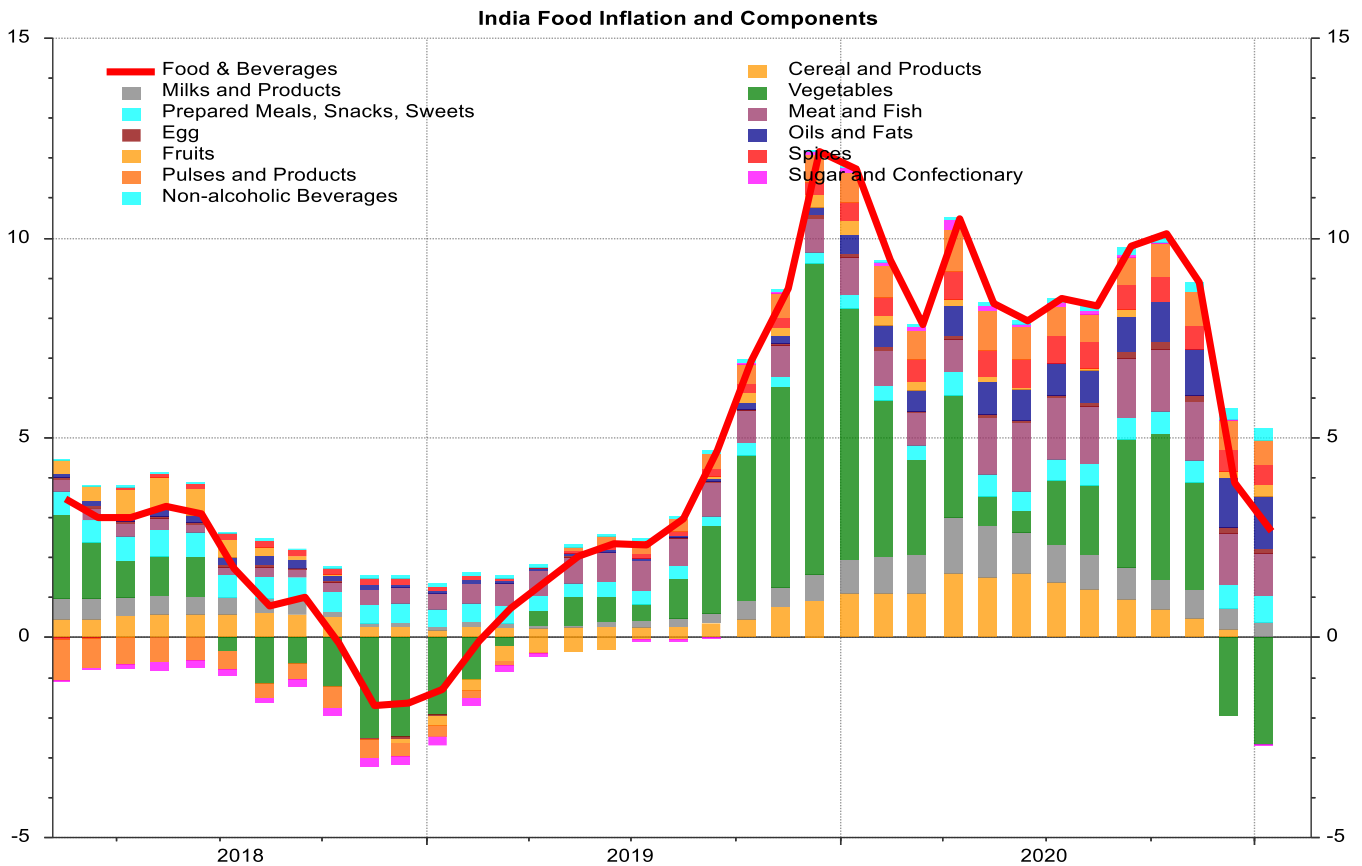
Figure 5: Category-wise contribution to India consumer price inflation (CPI)

**India Consumer Inflation and Components (Jan 21)**



Source: Refinitiv Datastream, NSE.

Figure 6: Category-wise contribution to India Food and Beverages inflation (CPI)



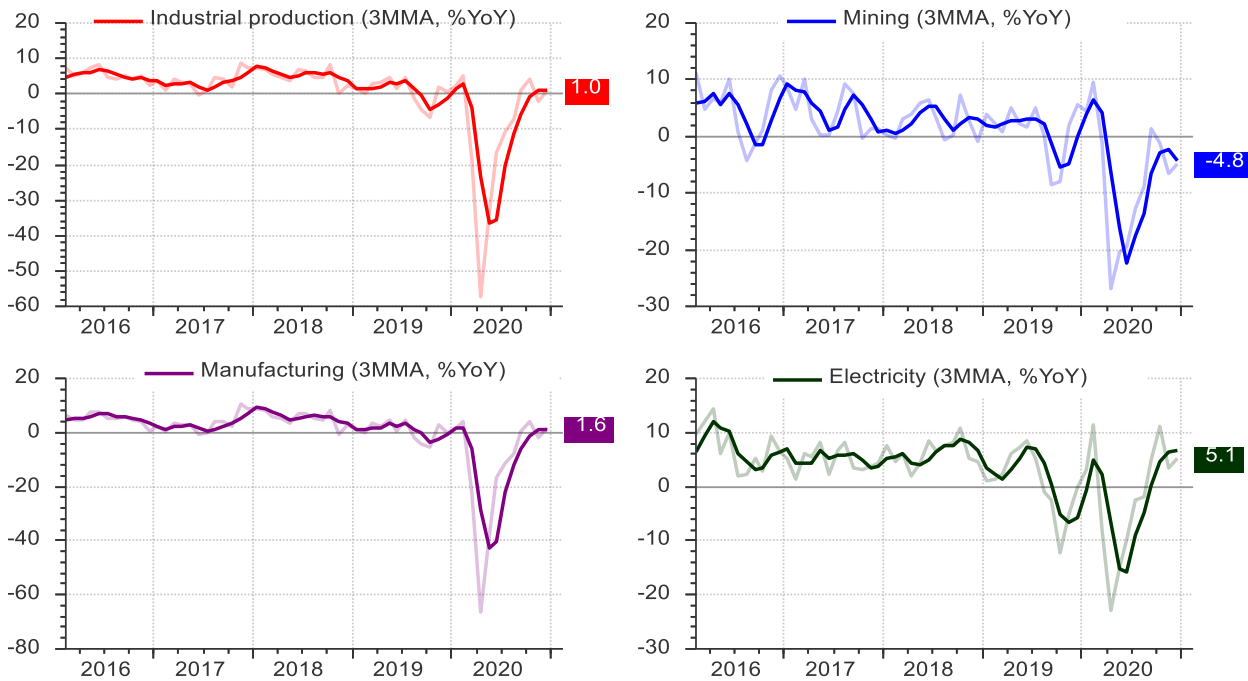
Source: Refinitiv Datastream, NSE.

Figure 7: India industrial production for December 2020 (%YoY)

%YoY		Weight (%)	Dec-20	Nov-20	Dec-19	FY21TD	FY20TD
	IIP		1.0	(2.1)	0.4	(13.5)	0.4
Sector-based indices	Mining	14.4	(4.8)	(6.7)	5.7	(11.4)	0.6
	Manufacturing	77.6	1.6	(2.0)	(0.3)	(15.1)	0.3
	Electricity	8.0	5.1	3.5	(0.1)	(3.6)	0.7
Use-based Goods	Primary Goods	34.0	(0.3)	(2.3)	2.4	(10.1)	0.4
	Capital Goods	8.2	0.6	(7.4)	(18.3)	(27.6)	(12.5)
	Intermediate Goods	17.2	0.4	(2.6)	13.1	(15.0)	10.7
	Infra/Construction Goods	12.3	0.9	1.7	0.2	(15.2)	(2.1)
	Consumer Goods	28.2	3.1	(2.1)	(4.1)	(12.9)	(1.3)
	Consumer Durables	12.8	4.9	(3.4)	(5.6)	(24.7)	(6.5)
	Consumer Non-durables	15.3	2.0	(1.3)	(3.2)	(4.6)	2.6

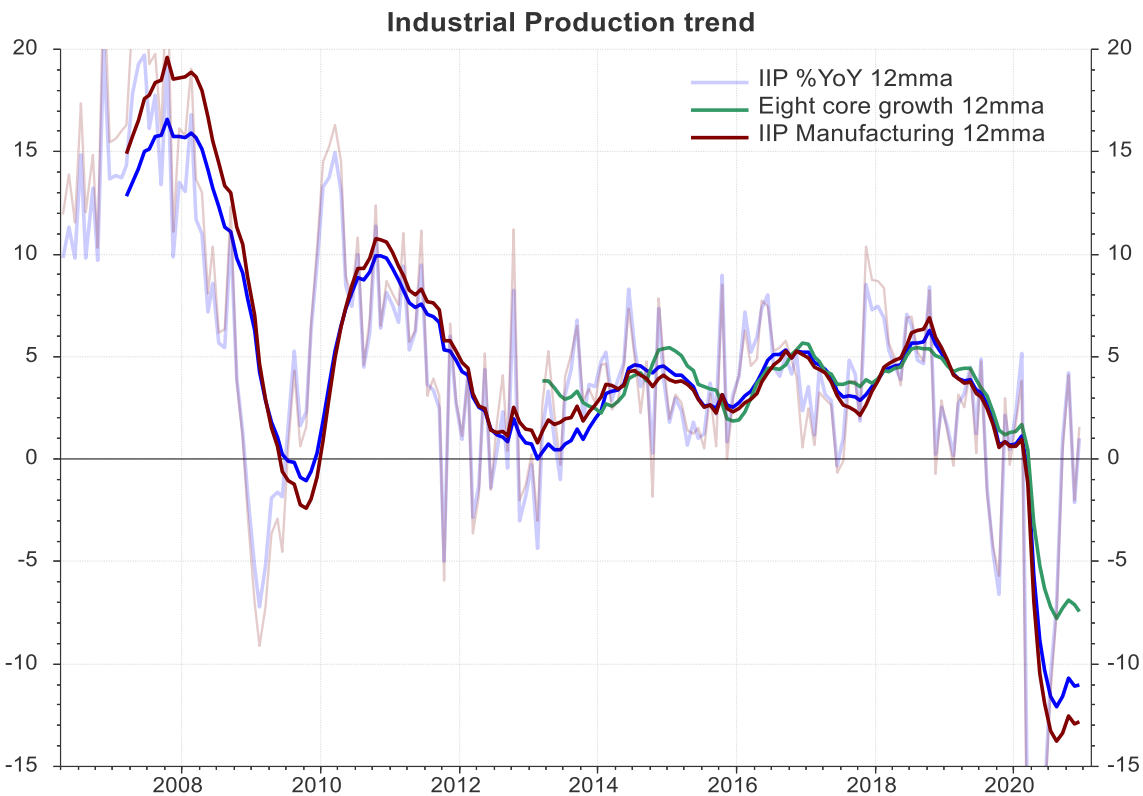
Source: CSO, NSE.

Figure 8: India industrial production (3MMA)



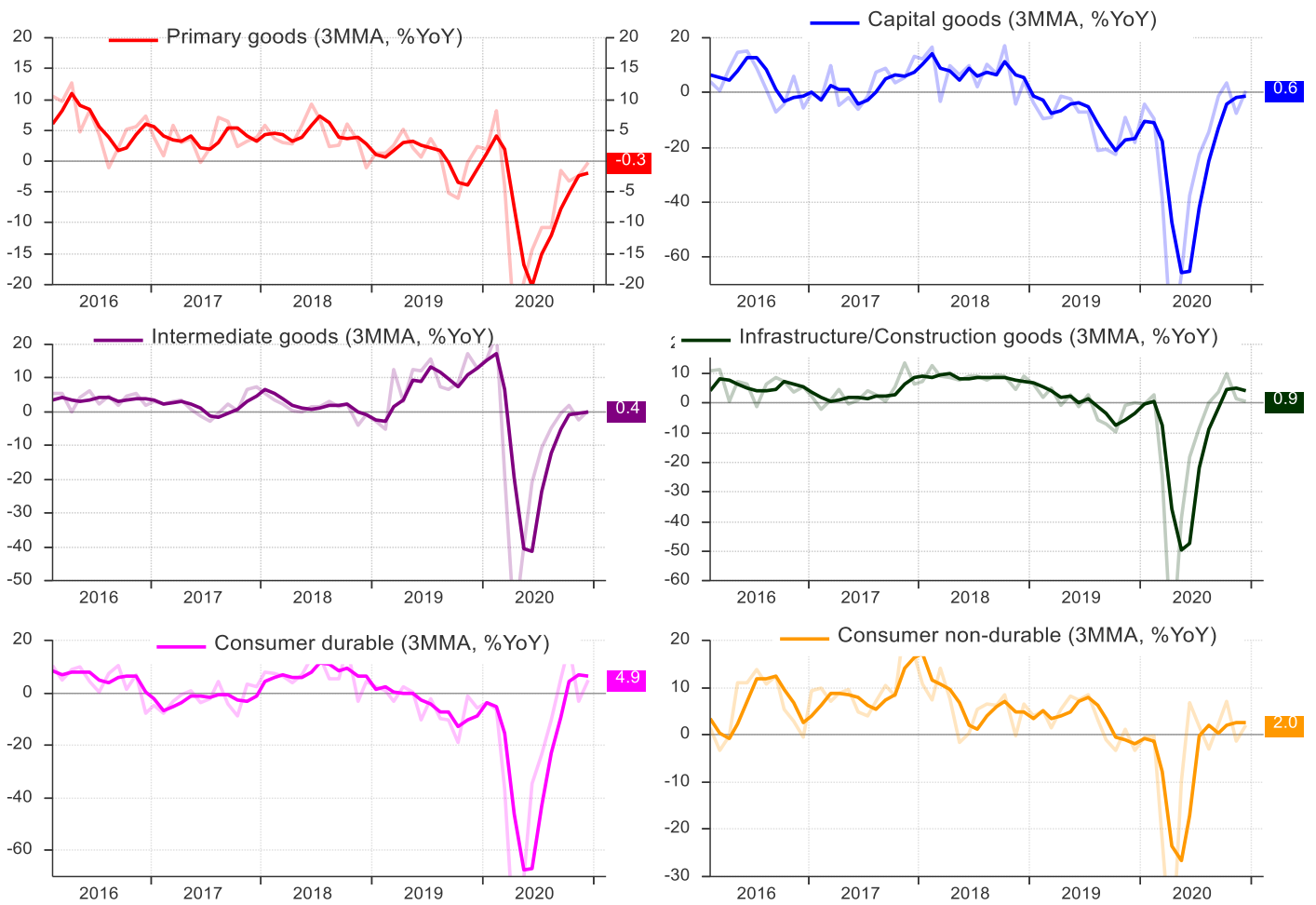
Source: Refinitiv Datastream, NSE

Figure 9: Long-term industrial production trend (12MMA)



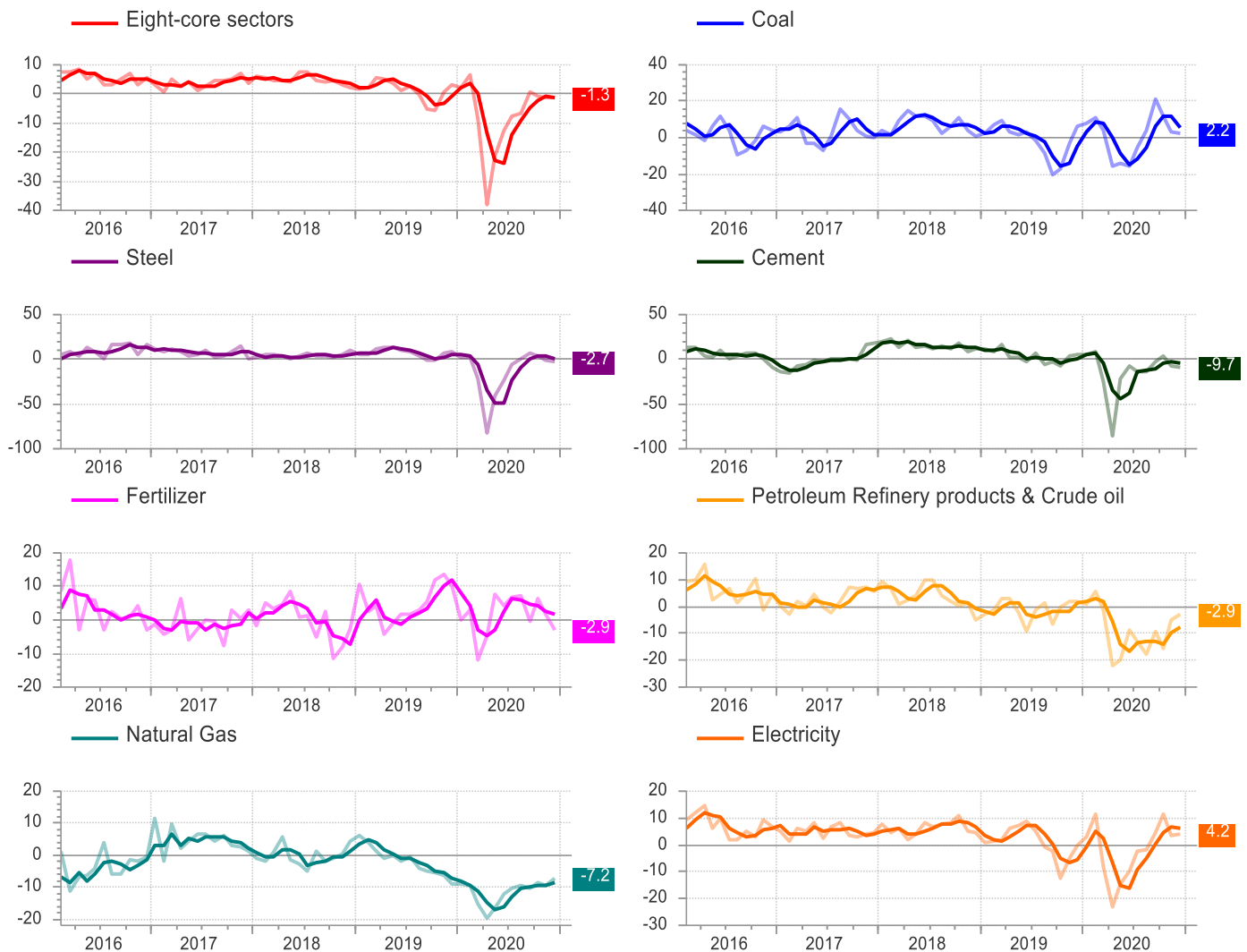
Source: Refinitiv Datastream, NSE

Figure 10: India industrial production use-based goods (3MMA)



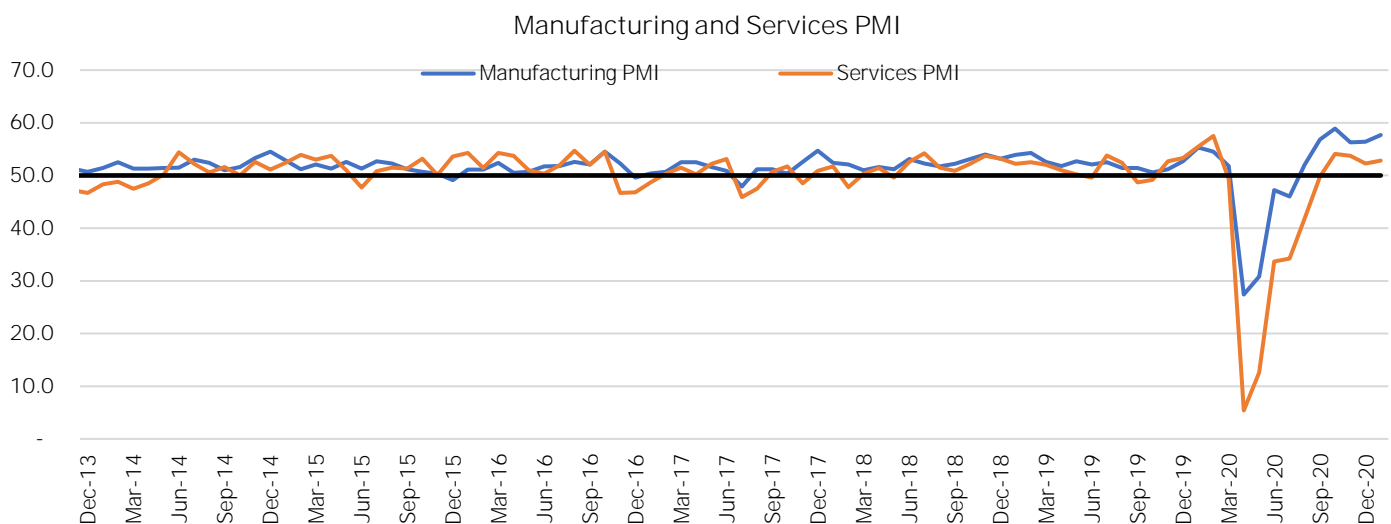
Source: Refinitiv Datastream, NSE

Figure 11: India eight-core sector growth (3MMA)



Source: Refinitiv Datastream, NSE

Figure 12: Manufacturing and Services PMI improves further in January



Source: CMIE Economic Outlook, NSE.



## Economic Policy &amp; Research

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