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Industrial growth expectedly spikes on low base, inflation remains flat albeit softer than feared

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The recent data prints for the Indian economy, namely the growth in the Index of Industrial Production (IIP) and the CPI inflation point to a continuing unevenness in domestic demand as well as inflationary pressures.

The year-on-year (YoY) growth in the IIP spiked to a 12-month high 19.6% in May 2022, from the revised 6.7% in April 2022, led by the subdued base of the second wave of Covid-19, and printed in line with our forecast (+19.0%). The sharp sequential increase in industrial growth in May 2022 was led by that of manufacturing and electricity, with a more modest uptick reported from mining activity, relative to April 2022. In terms of the use-based categories, all the sub-indices, except consumer non-durables, which had witnessed a limited disruption owing to the second wave of Covid-19 in May 2021, displayed a high double-digit growth in May 2022.

On a sobering note, the IIP was a mild 1.7% higher in May 2022, relative to May 2019, with the output of capital goods, consumer durables and consumer non-durables trailing the pre-Covid levels, and intermediate goods (+9.7%), primary goods (+9.6%), and infrastructure/construction goods (+5.6%) posting a rise in May 2022, relative to the May 2019 levels. Consumption demand remains tentative overall, with underlying unevenness amidst elevated prices; led by pent-up demand, we expect services to outperform demand for goods in the near term.

In line with the moderation in YoY performance recorded by most high frequency indicators in June 2022, we expect IIP growth to ease to ~11-13% in that month. Industrial growth is subsequently expected to moderate to single digits in Q2 FY2023, as the base effect dissipates.

The headline CPI inflation eased marginally to 7.01% in June 2022 (+6.26% in June 2021) on a year-on-year (YoY) basis, from 7.04% in May 2022 (+6.30% in May 2021). While the June 2022 CPI print remained firmly above the 6.0% threshold of the Monetary Policy Committee's (MPC's) medium term forecast range of 2.0-6.0% for the sixth consecutive month, it was lower than our forecast of 7.2%. The underlying trend was mixed; there was a mild moderation in the YoY inflation for miscellaneous items (owing to the impact of excise duty cut on fuels by the Government), and food and beverages, which outweighed the uptick in the inflation for the other constituents.

The recent moderation in global commodity prices, amid fears of a global recession, is likely to ease the domestic input cost pressures, providing some respite to the core-CPI inflation in the near term. Besides, a decline in global food prices and domestic edible oil and vegetable prices is also expected to augur well for the food inflation trajectory. Consequently, we expect the CPI inflation to print between 6.6-7% over the ongoing quarter. The progress of kharif sowing, which has trailed year ago levels so far, the temporal and spatial distribution of monsoon rains and the recovery in the demand for services, which is expected to put upward pressure on inflation in this segment, would remain key monitorables.

The CPI inflation averaged at 7.3% in Q1 FY2023, undershooting the MPC's forecast of 7.5% for this quarter. With expectations of readings below 7% over the next few months, we expect inflation to further undershoot the MPC's Q2 FY2023 forecast of 7.4%, prompting some downward revisions in the full-year FY2023 projection of 6.7%. We maintain our view that the MPC will increase the policy rate by 35 bps and 25 bps, respectively, in the next two Policy reviews, followed by an extended pause, as it will focus on containing inflationary expectations, without sacrificing growth.

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