Slower inflation, contraction in IIP spur rate cut hopes

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India's industrial output slowed drastically led by a decline in manufacturing and an almost 30 per cent contraction in capital goods production, signaling a slump in investments. Retail inflation on the other hand slowed significantly, spurring expectations that the Reserve Bank of India (RBI) would likely reduce interest rates later this year to support economic growth. The Index of Industrial Production (IIP) contracted 2.4 per cent in July, compared with a growth of two per cent in June, mainly on account of weakness in manufacturing, which contracted 3.4 per cent. Inflation based on the Consumer Price Index (CPI) was 5.05 per cent in August, slower than 6.07 per cent in July, according to official data released on Monday.

Rate cut

The slowdown in industrial activity comes at a time when the April-June GDP growth rate eased to a 15-month low. Economists expect that the decelerating inflation and weak industrial growth, if sustained, increase the likelihood of an interest rate cut by the central bank this year. The next few readings of inflation "will be important from a policy standpoint as the central bank would like to assess if this fall is durable and the possibility of achieving its target of 5 per cent by March 2017," Rishi Shah, economist at Deloitte said. "The chance of another rate cut has increased and may happen by the end of the year." Within the CPI, the food category witnessed an inflation rate of 5.8 per cent in August, down from the blistering 8 per cent seen in July. Inflation eased in the fuel and light segment as well, coming in at 2.5 per cent in August compared with 2.75 per cent in July. Inflation in the housing segment also eased marginally to 5.3 per cent from 5.4 per cent over the same period.

"While a fall in inflation was expected, the extent has been more than anticipated as vegetable prices have shown a sharp correction," Mr. Shah said.

"Importantly, prices of pulses have also come down showing that the supply side measures undertaken by the authorities are having a dampening effect." With data on sowing acreage showing increases, price gains are expected to moderate further. "Every analyst was expecting a sharp drop in CPI," said D.K. Joshi, Chief Economist at Crisil. "It will drop further because pulses inflation is at 22 per cent and will come down further."

IIP accuracy

"Manufacturing sector has contracted by 3.4 per cent in July essentially on the back of the volatile cable, rubber insulated category," Richa Gupta, Senior Economist, Deloitte India said. "Electricity and mining growth were also weak."

The electricity sector grew 1.6 per cent in July, lower than 8.3 per cent in June, while the mining sector grew 0.8 per cent, down from 5.3 per cent.

By usage, the consumer durables category grew 5.9 per cent in July, from 5.6 per cent in the previous month.

However, there are problems with relying on the IIP as an economic metric, experts said, owing to its dated base year and its variance from the present methodology for calculating economic growth.

“The IIP is a very old based index. It is based on 2004-05 while everything else is at 2011-12,” said Mr. Joshi. “It is high time we got a more up to date industrial production index. One can’t conclude where industry is heading based on these numbers.”

There is a growing disconnect between IIP and Gross Value Added (GVA) data, according to Sunil Kumar Sinha, Principal Economist, India Ratings & Research. “IIP puts 1Q manufacturing growth at -0.8 per cent and the GVA manufacturing puts it at 9.1 per cent.”