High input costs continue taking a toll on India's manufacturing sector

By Anand JC, ET Online Last Updated: Jun 01, 2022, 06:37 PM IST

Synopsis
Increasing inflationary pressures and supply chain bottlenecks remain a cause of concern for the manufacturing sector, which saw a contraction of 0.2% on an annual basis in May. Data shows that business sentiment was dampened by inflation concerns in May, with the overall level of confidence the second-lowest in just over two years.


Reuters

Increasing inflationary pressures and supply chain bottlenecks remain a cause of concern for the manufacturing sector, which saw a contraction of 0.2% on an annual basis in Q4FY22.

GDP data showed that India's economy grew by a modest 4.1% in Q4FY22, down from 5.4% in the previous quarter. Indian economy's pace of recovery slowed down owing to global supply bottlenecks caused by the Russia-Ukraine conflict and higher input costs.

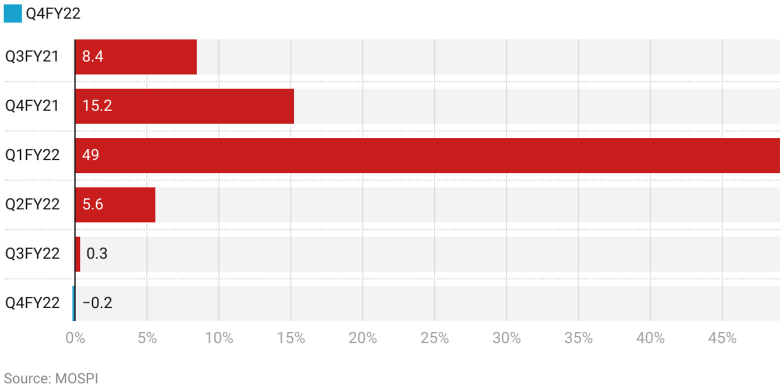
While the overall industrial activity in the fourth quarter registered a growth, the manufacturing sector remained the sole laggard.

"The contraction in the manufacturing sector - that struggled with supply bottlenecks and high input prices- in the last quarter of FY22 is a cause of concern," Rajani Sinha, Chief Economist, CareEdge said. Sinha added that high input prices will continue to negatively impact manufacturing sector.

ET Online

Rising cost pressures drag manufacturing sector growth

High commodity and input prices have been a pain point for the manufacturing sector (year-on-year growth in % terms)



Source: MOSPI

The S&P Global India Manufacturing PMI data on Wednesday pointed to a sustained recovery across the sector. However, input costs rose for the twenty-second successive month in May, with companies reporting higher prices for electronic components, energy, freight, foodstuff, metals, and textiles.

Data shows that business sentiment was dampened by inflation concerns in May, with the overall level of confidence the second-lowest in just over two years.

"While firms appear to be focusing on the now, the survey's gauge of business optimism shows a sense of unease among manufacturers. The overall level of sentiment was the second-lowest seen for two years, with panellists generally expecting growth prospects to be harmed by acute price pressures," Pollyanna De Lima, Economics Associate Director at S&P Global Market Intelligence, said.

Popular in Economy

By Dipti Deshpande, ET CONTRIBUTORS Last Updated: Jun 02, 2022, 09:47 AM IST

Synopsis
Consumer price index (CPI) inflation is expected to touch 6.3% average this fiscal from 5.5% in the last. Given this, the Reserve Bank of India (RBI) is expected to raise the policy repo rate by another 75-100 basis points (bps), taking the cumulative rate hike for the year to 115-140 bps.


Agencies
Representative image

A persistent and broad-based increase in prices is the biggest headwind consumers are facing today. The other worry is a concomitant increase in interest rates.

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Which of these will hurt growth more?

To be sure, both affect economic recovery. Higher prices push up the cost of living and, thereby, erode the purchasing power of consumers. Higher cost of borrowing strangles demand in interest rate-sensitive segments.

However, this fiscal, inflation could hurt growth more because of two key reasons.

First, the central bank's policy rate hikes typically impact growth with a lag (of 2-3 quarters), whereas the broad-based and high inflation — mainly in necessities — could impact demand immediately.

Second, at 6.3%, average inflation in fiscal 2023 will be 240 bps higher than the pre-pandemic three-year average rate, whereas the repo rate of ~5.4% at end-fiscal 2023, will still be 50 bps lower than the pre-pandemic three-year average of 5.9%, implying the real policy rate will still be in the negative zone.

In six of the past 12 months, CPI inflation has stayed above the RBI's upper tolerance band. Currently close to 8%, inflation is hurting more than it ever did.

To be sure, consumers don't have much choice to curtail spending since price rise is seen mostly in unavoidable necessities. Over the past three months (February to April 2022), food inflation rose 7.3% on average, while the cost of cooking food (cooking gas) shot up 15%. Prices of clothing have also been rising, as manufacturers raise retail prices to cushion the impact of higher input costs.

Moreover, necessities now go beyond roti, kapda and makaan to also include spending on healthcare, transportation and education. All these take up two-thirds of consumer spending, and inflation in this category jumped to 8% in April from 5.5% in December.

Within the healthcare, transportation and education category, inflation rates in some items are quite telling. For instance, the cost of running one's vehicle has surged — fuel inflation is in double digits. For those utilising public transport, inflation is 6-7%. Worryingly, healthcare bills and medical expenses have increased 7% as demand surpasses supply. This has constrained the consumer's ability to spend on other discretionary items.

Meanwhile, manufacturers are facing a double whammy. In India, in the absence of a producer price index, the wholesale price index (WPI) is often used as a proxy. WPI inflation has been in double digits for 13 months now, suggesting producers are facing a stiff rise in input costs for that long, necessitating a pass-through to retail prices. Consequently, companies in the cement, consumer staples, consumer durables, automobiles and other sectors are raising prices, while some are reducing the volumes sold at earlier prices to protect margins.

But the extent of input cost increase far outweighs retail price increase as weak discretionary demand from consumers constrains the pricing power of manufacturers. The wide wedge between WPI and CPI inflation reflects this pass-through, which is so far insufficient and expected to continue for a while.

Another dimension of the inflation problem is that ~50% (as of fiscal 2022) of the consumer's spending is on services, whereas inflation rate at ~5% has stayed lower than goods' inflation rate at close to 8%. Here, too, input cost pressures on account of transportation and raw materials have been pinching producer margins. With demand staying weak throughout the pandemic, the ability to pass on these costs to retail prices stayed low.

But this is set to change.

The pandemic had spurred a clear shift in demand from services to goods, led mainly by social distancing requirements. However, with a decline in the fear factor, buoyed by higher vaccination rates and lower incidence of the virus, pent-up demand is moving away from goods to services again. Part of the shift may be reflective of normalisation of spending.

Among services, the sharpest rise (so far in 2022) has been in hotel tariffs, cinema hall tickets, mobile and internet expenses, transportation fares and healthcare expenses, where inflation has been in the 7-13% range. But as demand for other services returns, so will pricing power in the hands of service providers, lending upside to services sector inflation.

In this milieu, the RBI again faces a tricky balancing act on the rate hike front. Rates need to be raised enough to control inflation and ensure that India's interest rate differential with other economies does not widen much. At the same time, demand is still weak, interest rates have already risen, and domestic financial conditions have begun approaching the 'tighter' zone. Rate hikes will thus have to be carefully handled so as to not disrupt the growth momentum.

In the short term, fiscal policy can coordinate with monetary policy to somewhat soften the inflation blow through duty rate cuts, extension of subsidies, and imposition of restrictions on exports (mainly for food). However, there is little room to do so, given a tight fiscal situation and the fact that most of the inflationary pressures are on account of external supply-side shocks.

(The writer is Principal Economist, CRISIL)

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