Quickonomics

July 26, 2023

Tracing the knock-on

Falling WPI, easing goods CPI and corporate margins

- Consumer Price Index (CPI) inflation tends to be in the positive territory, while Wholesale Price Index (WPI) inflation can swing to the negative (deflation) as well — as seen now
- CRISIL MI&A data from the June 2016 quarter shows corporate profit margins typically improve when WPI inflation falls
- Consumers of goods, too, benefit from lower input costs, as evident from the drop in goods CPI inflation
- But with revenue growth slowing, the incremental prop to company margins will abate. Goods CPI inflation would tend to stay soft amid slowing growth and reduced pricing power
- Overall, CPI-based headline inflation may not decline despite softer goods inflation because goods have only 34% weight in the gauge, compared with 39.1% for food and 26.7% for services, which are currently under pressure. Demand pressure is emanating from the knock-on effect of a strong rebound in services. To boot, monsoon poses an upside threat to food inflation

Wholesale price inflation came in at -4.1% for June 2023, the lowest in 92 months. It could fall further if global oil, commodity and other raw material prices slip anew.

While producers of oil and commodities such as metals are facing the heat of slack market prices, companies using these products as inputs — and consumers of goods made from them — are heaving a sigh of relief after two years of rising-price heat.

What gives?

One, domestic consumer price inflation for goods (i.e., CPI excluding food and services) is seeing a sustained benefit (chart 1).

Two, corporate profit margins are experiencing sustained improvement (chart 2). However, there is now a shadow of slower demand hovering above revenue and profit margins.

A sustained decrease in input costs over the next few months will continue to benefit both producers and consumers — the latter more

Chart 1: Huge benefit to consumers as input costs drop

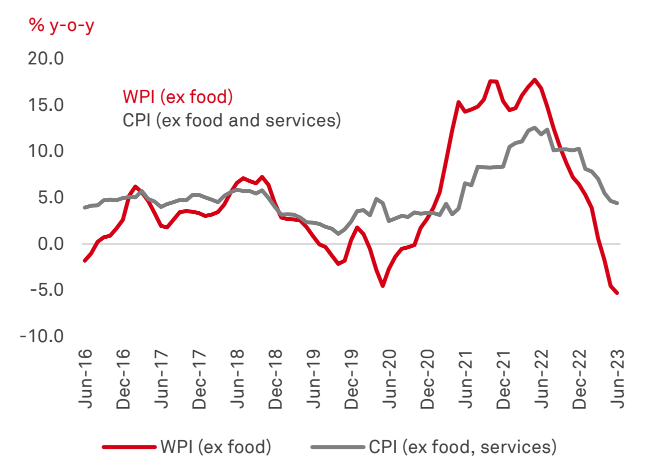
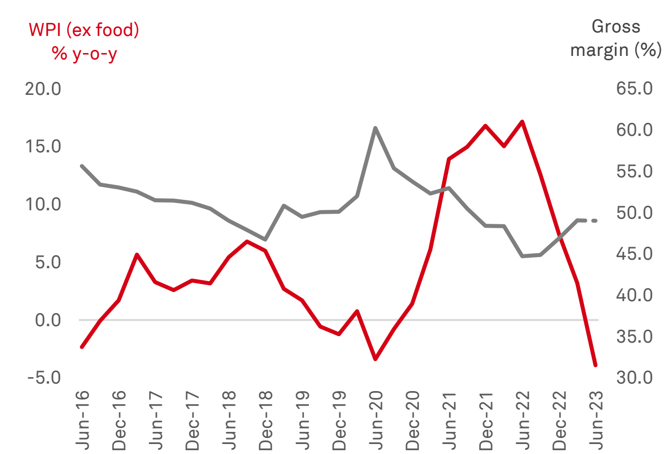


Chart 2: Profit margins improve as cost pressures reduce

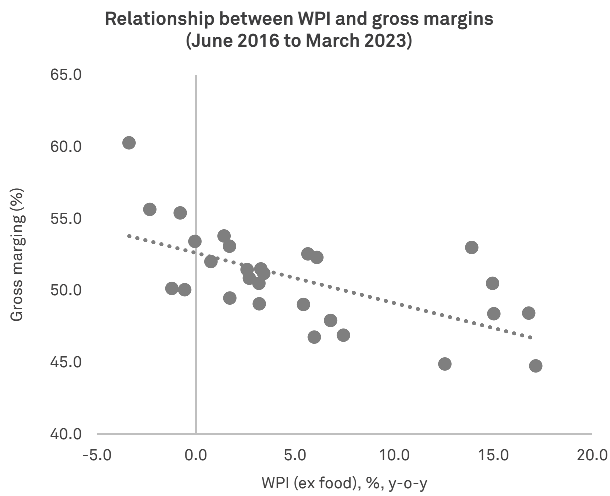


Source: Ministry of Industry and Commerce, National Statistical Office (NSO), CEIC, CRISIL

Impact on producers

Data for the past 28 quarters shows a close correlation between WPI (excluding food) and gross margins of corporate India (charts 2 and 3). Margins fall when WPI shoots up, and vice-versa.

Chart 3: As input costs fall, corporate gross margins improve



Source: Ministry of Industry and Commerce, NSO, CEIC, CRISIL

Based on data from the quarterly results of corporate India collated by CRISIL MI&A Research, gross margins increased to 49% in the March 2023 quarter, after dipping to a low of ~45% in the June 2022 and September 2022 quarters.

Early results[1] for the June 2023 quarter indicate further improvement, which ties well with the steep fall in WPI inflation.

WPI (excluding food) inflation rose to a high of 17% and 13% in the June 2022 and September 2022 quarters, respectively. Thereafter, it fell steadily to 3.2% and -3.9% in the March 2023 and June 2023 quarters, respectively.

The sharpest fall among the WPI segments was in fuel — down to -6.9% in the June 2023 quarter from 46.3% in the June 2022 quarter.

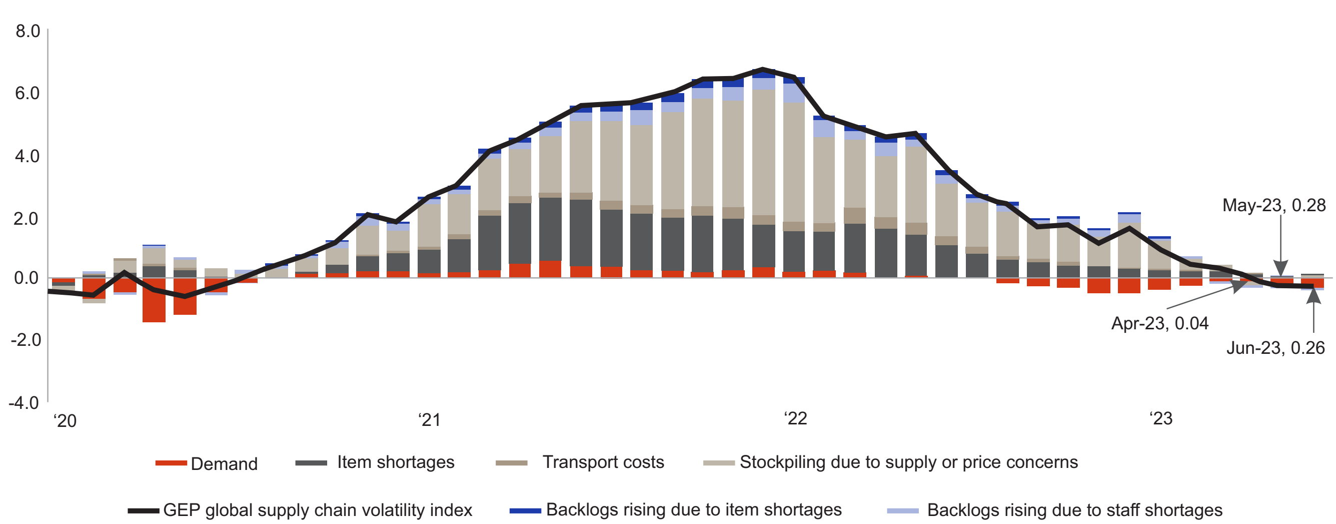
Rest of the manufacturing WPI fell to -2.7% from 10.3%. The sharp decline in metal prices (global metals index dropped 17.7%) and the steady easing of global supply-chain bottlenecks have facilitated this fall.

The GEP Global Supply Chain Volatility Index[2], which tracks demand for raw materials, commodities and components, inventories, material and labour shortages, and transportation, suggests a downside to input costs (chart 4).

As per the report, global supply-chain spare capacity rose for the third consecutive month in June 2023 and remained at the highest level since May 2020.

Demand for raw materials, commodities and other components has been weakening on the back of softening demand from manufacturers in Europe and the US, while demand in Asia, led by India, has held up better.

Chart 4: GEP Global Supply Chain Volatility Index shows downside to input costs



Source: GEP, S&P Global, 2023

[1] *July 2023, 'CRISIL MI&A Research QUIP: Revenue growth slows for the fourth time'*
[2] *July 14, 2023, 'Demand for raw materials and components weakens sharply in Europe and North America in June, indicating greater risk to the economy heading into the second half of 2023: GEP Global Supply Chain Volatility Index'*

For consumers

In the June 2022 quarter, high manufacturing input costs had translated into a surge in retail inflation for goods to 12.2%, the highest is 29 quarters (chart 1). Retail inflation for goods dropped to 4.8% in the June 2023 quarter, lower than the 5.4% average seen during the entire period considered for this analysis (June 2016 to June 2023).

This also suggests that that low input costs are percolating to the goods component of CPI inflation.

CPI goods categories such as electronics, automobiles, fast moving consumer goods (FMCG), clothing and footwear, and other household goods are already seeing a steep fall in inflation.

To sum up, continuing decline in input costs will benefit both producers and consumers.

However, for companies, further margin gains (profit as a percentage of revenue) would be a challenge as a slowing economy — caused by reduced exports, normalisation of discretionary consumer demand domestically— curbs pricing power and revenue growth (Box1).

So what could reverse the gains?

A flare-up of geopolitical tensions would limit the drop in or, in a worse case, push up input prices.

How the impact works

When the cost of raw materials, labour, transportation and other items increases, businesses can either pass on the increased cost to retail prices or let it hurt their profit margins to stay competitive.

Passing on increased costs to the consumer is possible when demand conditions are strong and there is pricing power with the manufacturer.

It is also an option for manufacturers of items with less elastic or price-sensitive demand — for example, purchases towards meeting healthcare or educational requirements. Several non-durable consumption items also fall in this category.

Transportation may also fall in this category, where consumers might adjust their demand but not reduce it much.

But when demand conditions are weak, pricing power is restrained and manufacturers may have to absorb the high costs. Alternatively, if the hike in input costs is substantial and persistent, it may also impede manufacturers' ability to pass on the entire increase to retail prices due to fear of losing out to competition.

Higher retail prices and lower profit margins could induce lower sales. A surge in retail prices could push consumers to cut consumption for commodities where price hikes are large. Alternatively, for commodities considered essential, sharp prices hikes could result in lower consumption of other commodities considered less essential or discretionary.

Input costs play a significant role in driving corporate profits and consumer price inflation and demand. A persistent increase or decrease in input costs can also alter consumer demand and, hence, sales.

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