Quickonomics

June 16, 2023

The ins and outs of inflation

CRISIL's index registers finite signs of cooling prices

First came the decline in global oil and commodity prices. Now, the marked easing in global supply chain stress, which is lowering pressure from other costs for manufacturers.

CRISIL's input-output cost index — which has fallen to a seven-month low —reflects this. This indicates the second-round effects of high cost of production on CPI inflation may be fading, finally.

Earlier this week, India's Consumer Price Index-based (CPI) inflation print for May came in at a softer 4.3% (vs 4.7% in April). The Wholesale Price Index (WPI) release brought further cheer. It had sunk deeper into deflation (-3.5% vs. -0.9%).

While both measure inflation in the economy, the WPI tracks movement in costs of manufacturers, while CPI tracks prices for consumers. Unlike WPI, CPI covers services as well. A sustained sharp increase in WPI inflation over time seeps into CPI inflation, as manufacturers tend to pass on higher costs to protect their margins.

Input costs had sharply escalated in the past two years following the pandemic and geopolitical tensions. By mid-2022, however, oil and commodity prices started declining and cost pressures abated. But retail price hikes by manufacturers continued, as the pass-through of high input costs through these years had remained incomplete.

Prices also stayed high as global supply chain snarls had not quite resolved fully, impacting costs of other inputs, transport, and shipping.

In recent months, though, we see distinct signs of the tide turning.

Advanced economies have weaker demand for inputs as their growth slows. An uneven recovery in China this year, after initial exuberance post lifting of restrictions, has further contributed.

With this, pressures on manufacturers to pass on high costs to retail prices have abated, too.

While some sectors where demand is strong could still see price pass-throughs, in most others, they seem to have diminished.

This, in conjunction with slower expected demand in the second half of the current fiscal, means retail prices will increase at a slower pace than last year.

Reading off CRISIL's input-output cost index

CRISIL's input-output cost index reflects these trends. The index, computed as the ratio of input and output wholesale prices (essentially by disaggregating the WPI data) — fell to 1.01 — the lowest level since October 2022.

An increasing ratio indicates faster increase in input costs relative to output prices (proxy for retail prices), which, we know, necessitates a pass-through of costs to protect margins. In recent months, a sharper fall in input price pressures relative to output prices has brought down the index. After peaking between December 2022 and February 2023, the index has been softening since.

This suggests that the effects of high input costs on CPI inflation may be fading.

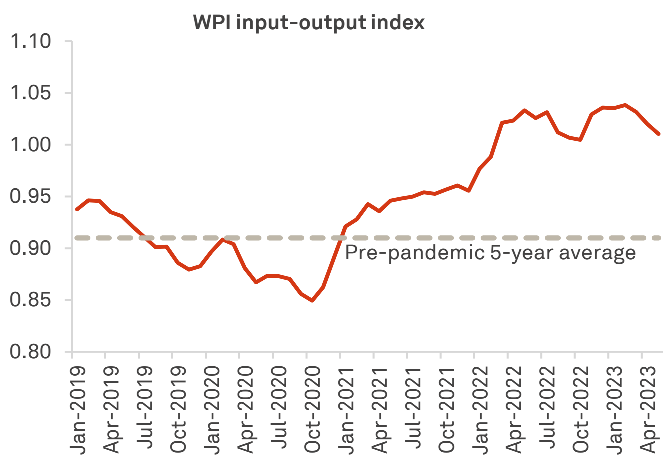
That, in turn, would have positive implications for core CPI inflation (inflation excluding food and fuel categories), as it is this category of CPI inflation that is typically stickier.

Core inflation in goods, particularly, may see more downside than upside, given easing costs of production and expected growth moderation in the current fiscal.

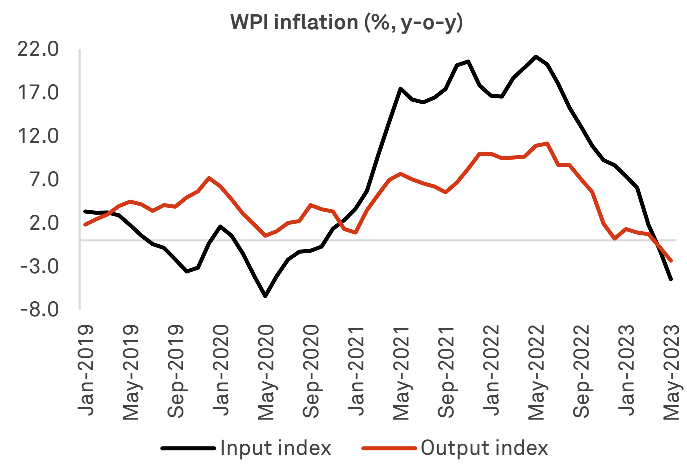
This bodes well for India's CPI inflation which, until March this year, was hovering above the Reserve Bank of India's comfort zone.

However, sudden shocks from ongoing geopolitical tensions cannot be ruled out, or accounted for, at this moment.

CRISIL's WPI input-output index at a 7-month low...



...led by a steeper drop in WPI input price index



Note: WPI input index comprises energy components, minerals, metals, and chemicals. WPI output index comprises manufactured food and beverages, machinery and transport equipment. The categorisation of WPI items into inputs and outputs is based on the 'Supply and Use Tables' published by the National Statistical Office

Source: Ministry of Commerce and Industry, CEIC, CRISIL

Three drivers steering lower inflation

India's WPI, which has a higher weight for items linked to global prices, has seen wild swings in the aftermath of the pandemic and geopolitical tensions. From an average of 1.7% in fiscal 2020, WPI inflation dipped to -3.4% in May 2020 before touching a peak of 16.6% in May 2022. It has softened, falling into negative zone since April 2023.

Broadly, a fall in global energy prices and commodity prices have played a huge role in easing pressures on WPI inflation.

These, along with sluggish demand, will continue to drive down inflation through the rest of the fiscal.

A third factor which has started to play a significant role is the easing of global supply chains.

The New York Fed's Global Supply Chain Pressure Index[1] declined for the fifth month straight to an all-time low, indicating significant resolution of stress. Similarly, a GEP Global Supply Chain Volatility Index report states that for the first time since June 2020, global supply chains have spare capacity, giving buyers better purchasing power, as companies expect lower prices going forward. According to the report[2], a buyers' market is expected to continue at least up to September 2023. The report also finds higher spare capacity with suppliers in Asia due to uneven recovery in China and overall weaker demand for inputs from advanced economies. This index

1 May 2023, Federal Reserve Bank of New York, Global Supply Chain Pressure Index, https://www.newyorkfed.org/research/gscpi.html
2 June 12, 2023, 'Sharper deterioration in global demand for raw materials and components sees spare capacity at suppliers further rise in May: GEP Global Supply Chain Volatility Index"

tracks demand for raw materials, commodities and components, inventories, material and labour shortages, and transportation. A decline in the index suggests a clear downside to input costs.

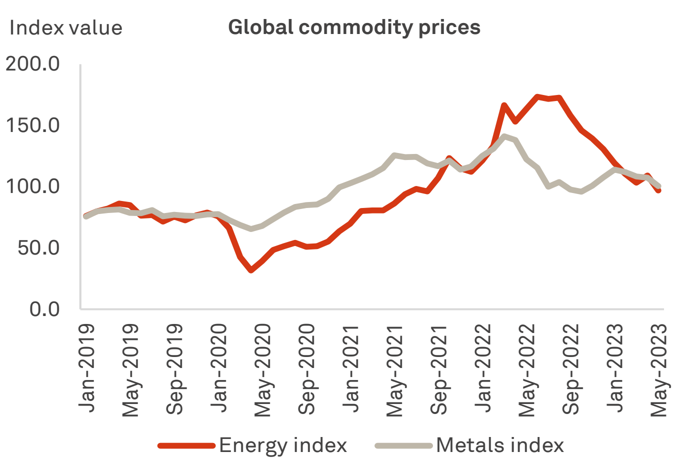
The Reserve Bank of India (RBI's) May Bulletin also echoes these findings. The Index of Supply chain Pressure for India (ISPI) computed by the RBI remained below the historical average since July 2022.

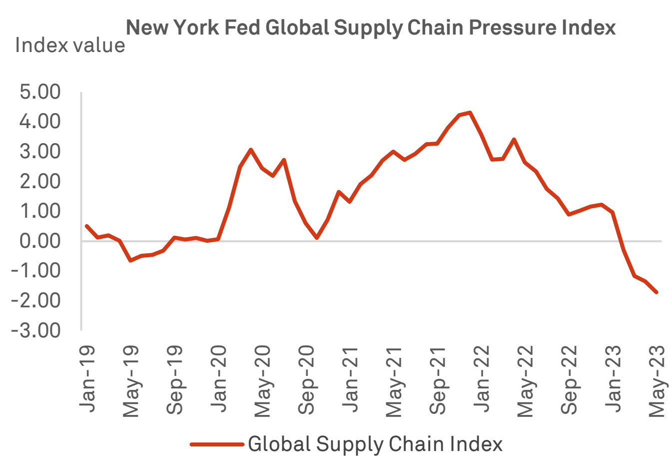
Three years through our index

Before going, check out how CRISIL's input-output cost index has lucidly captured global developments affecting costs and prices since the pandemic:

- Over the initial months of the pandemic, the input-output ratio was below the 5-year pre-pandemic average, as global commodity prices plummeted with a collapse in global demand. The input-output index was at a decadal low of 0.85 in October 2020
- Demand began to pick up in late 2020 as the world began adjusting to the pandemic. Soon, global supply chains pressures began to mount as industries could not keep up with the pent-up demand. Global commodity prices also began to rise
- From October 2020 onwards, the input-output index began to rise rapidly. By January 2021 it was above the pre-pandemic average. It continued to rise till the end of that year
- The ratio saw another sharp rise at the beginning of 2022 when the Russia-Ukraine conflict caused global commodity prices to surge. It has remained above one since then, peaking (at 1.04) between December 2022 and February 2023, driven by the initial exuberance in China's recovery. The ratio has since been declining
- Since March, the ratio has indeed declined steadily. In the past two months (April and May), input costs, on average, fell 2.8% on-year while output prices fell 1.6%

Together they fall





Source: World Bank Pink Sheet and Federal Reserve Bank of New York, Global Supply Chain Pressure Index, https://www.newyorkfed.org/research/gscpi.html

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