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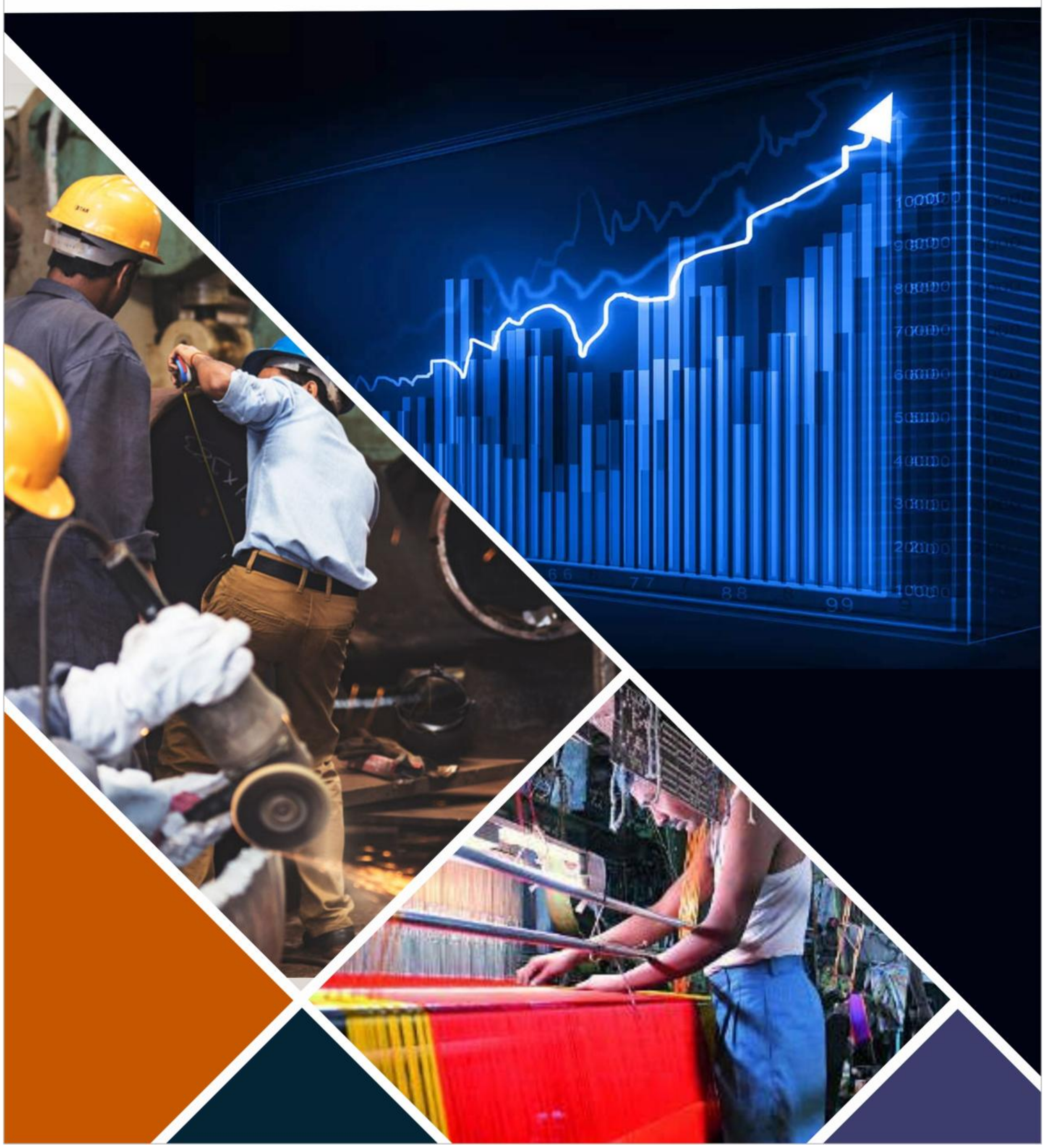
White Paper on

Impact of Commodity Price Inflation on Trade and Industry

An MVIRDC Research Initiative



Key Policy Recommendations made during the Panel Discussion on 'Impact of Commodity Price Inflation on MSMEs'

Wednesday, May 18, 2022, WTC Mumbai

Dr. Madhavan Kutty, Senior Economist, Aditya Birla Group, Mumbai

- Banks and NBFCs have adequate capital above the RBI prescribed limit and their NPAs are also at a manageable level. They should use their better financial position to support MSME borrowers by increasing flow of credit to MSMEs.
- Today, 57% of private banks' loan portfolio is linked to external benchmarks and 30% of public sector banks' loan portfolio is linked to external benchmarks. By linking their loan portfolio to external benchmarks such as RBI's repo rate, banks are compelled to transmit policy rate hike to their borrowers. However, in this challenging time, banks may refrain from passing on the RBI policy hike to MSME borrowers.
- Public sector banks should introduce innovative derivate products to hedge interest rate risks and thereby support MSME borrowers.

Mr. Avinash Misar, Director & CEO, Advanced Material, Texport Syndicate India Ltd & Vice Chairman, Indian Tech Textiles Association

- The textile industry should increase spending on R&D to bring out new products based on man-made fibre and thereby reduce dependence on cotton.
- India should also increase cotton yield, which is hardly 486 kg/hectare, compared to more than 1,000 kg/hectare globally, through innovation in seed varieties.
- The government should reduce the eligibility threshold under the Production Linked Incentive scheme for man-made textile sector from Rs. 100 crore investment to Rs. 50 crore investment so that MSMEs can benefit from this scheme.

Dr. Vijay Kalantri, Chairman, MVIRDC World Trade Center Mumbai

- In order to provide relief to industry, the central and state governments should consider lowering petroleum taxes and GST. This is important since the RBI's recent hike in Cash Reserve Ratio (CRR) has reduced nearly Rs. 87,000 crore liquidity from the system, and will thus impact the growth prospects of sectors dependent on bank finance.
- The government should also seek industry views to address the impact of rising input costs on growth and development.

Highlights of the White Paper

Wholesale price inflation touched a nine-month high of 15% in April 2022 and it has been growing in double digit for the last 13 consecutive months. MSMEs from food processing, textile, engineering and plastics sectors are struggling to manage their margins amidst rising input prices.

Cost of materials has risen 35% in FY 2021-22 from the previous year for 96 manufacturing companies listed on BSE, while their sales expanded 30% (according to a study by MVIRDC). On an average, these 96 companies spend 50% of their total expenditure on raw materials and intermediate goods.

The share of material cost in the overall expenses of these 96 companies grew cumulatively from 50% in FY 2020-21 to 54% in FY 2021-22. Among these 96 companies, cost of materials consumed has grown faster in FY 2021-22 from the previous year than the corresponding growth in annual sales for 68 companies.

Steps proposed for the central and state governments and RBI to provide temporary relief to MSMEs affected by rising raw material cost:

1. Open raw material depots to supply input materials to MSME clusters at affordable cost.
2. Reduce import duty on certain critical raw materials
3. Discourage export of raw materials and intermediate goods to ensure availability in local market at affordable cost
4. Enhance flow of bank credit (especially working capital loans) against GST invoices to MSMEs
5. Include price escalation clause in public procurement contracts for MSMEs
6. Exempt MSME vendors from penalty or other penal actions for cancelling contracts due to increase in raw material cost
7. Take stringent action against large corporate buyers who delay payment to MSME vendors. Large corporates may be mandated to disclose their bills payables to MSME vendors on a periodic basis in their financial statements to bring transparency in their payment track record to vendors.
8. Prioritize supply of power to MSME units, to prevent loss of jobs and disruption to exports

Background Note

The great monetary economist Milton Friedman said inflation is a taxation without legislation. The global economy will witness the largest commodity price shock since the 1970s, warns the latest World Bank report on Commodity Markets Outlook. Energy prices are expected to rise more than 50% in 2022, while prices of agriculture goods and metals may rise almost 20% in the current year, the report predicts. In India too, the consumer price inflation has consecutively breached the RBI's upper limit of 6% in the last three months. This relentless rise in inflation will prompt RBI to tighten monetary policy and thereby increase borrowing cost for trade and industry.

Sectoral Impact

In the last two years, companies from textile, automobile, energy and heavy machinery sectors are facing sharp rise in input materials such as steel, aluminium, copper, coal, semiconductors, petroleum products etc. Inflation has not spared even FMCG companies as rise in edible oil, food grain and other food ingredient prices have affected their profitability.

Aviation sector, which witnessed handsome recovery with the easing of COVID restriction, is facing fresh challenge in the form of rise in fuel price, which accounts for more than 40% of their overall cost. The sharp rise in price of steel, coal and cement may prompt property developers to increase property prices, thereby affecting demand in the real estate sector, which has a multiplier effect on the economy.

Exporters and importers are facing rising cost pressure because of increase in ocean freight as well as container shortage. According to an IMF estimate, increase in shipping costs in 2021 could increase inflation by about 1.5% in 2022.

Impact on MSMEs

Some large companies have already raised prices of their products to maintain their profit margin, while some companies, especially in the MSME sector are unable to pass on the increase in raw material prices as it might affect demand and sales for their products. MSME vendors that are supplying intermediate goods to corporate buyers are unable to hike prices of their products because of absence of such price escalation clause in their orders.

Key Facts about Inflation

- The price of Brent crude oil may average USD 100 a barrel in 2022
- World food prices grew nearly 13% to a new record high in March 2022, shows FAO's Food Price Index
- Metal prices are projected to increase by 16 percent in 2022
- Cost of shipping a container on the world's transoceanic trade routes grew 7-fold in the 18 months following March 2020
- Cost of shipping bulk commodities spiked even more

Source: World Bank and IMF

Micro, small and medium enterprises, which are the backbone of India's manufacturing sector, is suffering from eroding profit margin, working capital strain and indebtedness because of rising cost of steel, aluminum, miscellaneous metals, plastics and other raw materials. MSMEs contribute more than 30% to our GDP, support 120 million jobs and contribute 49% to our exports.

Since the outbreak of the pandemic, these units have been facing immense cost pressure because of rise in raw material cost, shipping and ocean freight, which increased their working capital need. The rising cost of input, coupled with the problem of delayed payment from large corporate buyers, is straining the working capital position of MSMEs.

As can be seen from the following table, inflation in core raw materials such as petroleum, natural gas, minerals, chemicals, steel, basic metals, paper products and textile has been rising in double digit since October 2021.

Double Digit Inflation (%) in Raw Materials

Commodities	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22
Crude Petroleum & Natural Gas	86.36	71.11	47.50	55.40	46.14	69.20
Minerals	16.57	26.18	18.87	30.03	11.12	19.46
Chemicals and Chemical Products	14.98	5.40	14. 9	13.82	13.16	12.66
Mild Steel - Semi Finished Steel	25.94	19.30	14.53	12.50	14.96	15.96
Basic Metals	32.14	28.79	22.54	16.53	19.82	25.97
Paper and Paper Products	14.91	16.33	16.41	14.60	13.29	12.24
Textiles	17.42	18.24	16.88	13.89	14.01	12.64

Source: Wholesale Price Index, Ministry of Commerce & Industry, Government of India

On account of sharp rise in raw material prices, the operating cost of small and medium family enterprises has risen nearly 20%, compared to the rise in wholesale price inflation of 14%, according to a study conducted by SP Jain Institute of Management and Research (SPJIMR). The study found that while rise in raw material cost has affected the operation of manufacturing enterprises, the increase in wages and fuel prices have adversely impacted service sector units. As a result of increase in petrol and diesel prices, MSMEs are facing rise in logistics cost and cost of ferrying their workers to factory units.

In fact, the record high GST collection of Rs. 1.68 lakh crore in April 2022 is a result of rising commodity prices, rather than improvement in economic activity, according to the findings of a recent report by Ambit Capital.

Many MSME vendors who supply intermediate goods to large corporate buyers have long term contracts without price escalation clause. Absence of price escalation clause hampers the ability of MSMEs to increase prices in response to rising raw material cost and thus it affects their profitability. With the recent hike in policy rate by Reserve Bank of India, MSME borrowers also face the risk of rising cost of loans from banks and NBFCs. For the first time since August 2018, Reserve Bank of India has hiked its policy repo rate by 40 basis points and CRR by 50 basis points in response to the surge in retail inflation beyond its upper threshold of 6% for consecutively three months.

Key Reasons why MSMEs need Policy Support amidst Rising Cost Pressures

Major Source of Employment and GDP

- We cannot allow MSMEs to incur losses and shut down as they account for 30% of GDP and provide jobs to 120 million people. Timely government support will prevent MSMEs from closing down their units because of unsustainable input cost inflation.
- Compared to large corporates, MSMEs cannot pass on the rise in input cost to their customers because of intense competition, both in the domestic as well as global markets.
- MSMEs have limited ability to absorb cost price inflation because of their thin profit margins. Therefore, they need support from government in the form of supply of raw materials at affordable cost or subsidies on raw material.

Protecting Asset Quality of Banks

- MSMEs account for 14% of the loan book of scheduled commercial banks.
- NBFCs and microfinance institutions have substantial exposure to MSME sector.
- In order to protect the MSME loan portfolio of banks and other financial institutions from turning into stressed assets, government may have to support MSMEs in overcoming the inflation crisis.

Maintaining Export Growth

- MSMEs contribute 49% to India's merchandise exports. In FY 2021-22, India's merchandise exports reached a record USD 418 billion and in the current financial year, industry expects merchandise exports to grow to USD 600 billion.
- In order to maintain the strong growth in exports, we need to support MSMEs in navigating through this cost inflation crisis.

Impact of Commodity Price Inflation on MSMEs in Textile industry

The textile and apparels industry is a cornerstone of the Indian economy as it is the second-largest employer after agriculture and it contributes 5% to GDP and 7% to gross value added in industry. Despite being the world's second largest producer of cotton and silk, India ranks sixth in world export of textile and apparel because of stiff competition from developing Asian countries. The ongoing cotton shortage crisis may impede our ability to strengthen India's position in world textile exports. Currently, the textile sector has a share of around 12% in India's exports and it is a significant contributor to the foreign exchange earnings of the country. If we allow the cotton scarcity crisis to hurt our textile exports, it will not only weaken our position in world textile exports, but also reduce surplus foreign exchange earnings from this sector. At a time when India is staring at a record 3% current account deficit, we should take all efforts to maintain the current export growth momentum to prevent heavy drawdown on our foreign exchange reserves.

Comments receieved from Mr. Avinash Misar, Director & CEO, Advanced Material, Texport Syndicate India Ltd & Vice Chairman, Indian Tech Textiles Association

- Cotton is the most important commodity in the textile industry, with the largest producers being China, India, Pakistan, and the United States.
- These producers continue to experience escalation in cotton prices, adversely affecting garment and textile industries.
- There are various factors that cause cotton prices to go up, chief among these being shortage of the raw material. Although a rise in cotton prices is advantageous for farmers, the textile manufacturing industry bears the brunt of the effects.

Textile Inflation

- With the rising cotton costs and diminishing stocks of the raw material, textile mills around the world have rushed to secure cotton stocks.
- This has had a negative impact -- textile inflation in major cotton-producing countries around the world. In countries such as India and China, the textile inflation index is now higher than overall average inflation.

- The situation is different for the United States, whose cotton prices have remained low relative to other crops.
- Still, the textile industry is globally interconnected and inflation in any one major cotton producer will be experienced in the textile industry worldwide.

Causes of Rising Cotton Prices

- In recent years, the sluggish global economy saw acreage dedicated to cotton farming in all major cotton-producing countries fall considerably as farmers succumbed to the effects of the economic recession.
- Part of the fall in production was due to the lack of any subsidy efforts by governments in most cotton-producing countries.
- Only the United States and India have elaborate measures to promote cotton farming.
- The global meltdown was later compounded by floods in Australia, Pakistan and some parts of India, leading to a fall in cotton production that sparked price increases.

Rise in Competition

- Spiking cotton prices result in higher operational expenses for the textile industry, and the most likely strategy is to pass this along to consumers.
- But this is a double-edged sword: increasing cotton product prices will rapidly correlate to an increase in non-cotton clothing in retail outlets. Competition from such products as rayon and Lycra will increase, as stores replace higher-priced cotton in a bid to retain their customers.
- For the home textiles industry, especially the bath segment, a rise in cotton prices can be a major problem.
- Bath towel manufacturers will face reduced orders from retailers wary of passing higher prices to consumers and interfering with their customer base.
- The alternative is to retain prices but implement blending with polyester.
- However, given that consumers have traditionally expected that towels are for the most part an all-cotton product, blending may not be an option for many customers.

Current Scenario

- Relentless rise in cotton prices a hurdle to textile exports revival
- 80% spurt in cotton prices in the past one year has pressured margins of textile and garment firms. Most firms are struggling to pass on the rise in raw material costs to consumers.
- Lucrative orders are promised in FY 2021-22.
- However, these orders may not be forthcoming in FY 2022-23 due to an inexorable rise in the prices of cotton, a key raw material, and its shortage in the domestic market.
- Conventionally, during the January-February period, mandi arrivals of cotton peak and remain in the range of 2.5-3 lakh bales (one bale is 170 kg), but this year has been quite an exception.
- According to trade sources, cotton arrivals in markets across key producing states – Telangana, Andhra Pradesh, Karnataka, Gujarat, Maharashtra, Madhya Pradesh, Haryana, Punjab and Rajasthan – have seldom crossed 1.5 lakh bales in last the two months.
- Prices are skyrocketing – in many key markets these are ruling at three times the minimum support price due to year-on-year decline in the production of the key natural fibre.
- Also, there are unconfirmed reports of farmers resorting to hoarding stocks, in anticipation of a further rise in prices.
- In fact, an up to 80% spurt in cotton prices in the past one year has pressured margins of textile and garment firms.
- Most firms are struggling to pass on the rise in raw material costs to consumers. This has forced the manufacturers across the textile value chain – from spinning mills and weaving units to garment makers – to seek the abolition of an import duty on cotton (effectively to the tune of 11%, including cesses) and the creation of a strategic reserve of about 10-15% of market supplies by the government to help stabilize prices.
- Overseas buyers have started scouting for alternate destinations to broaden their supply base for fear that elevated input costs in India would push up prices of garments. Apparel companies, in such a scenario, may be forced to absorb much of the rise in costs themselves.
- Cash flow has been hit very badly.
- The garment industry is dominated by MSMEs, whose capacity to absorb input cost pressure is even more limited.

Data Analysis

MVIRDC World Trade Center Mumbai conducted an analysis of 96 manufacturing companies listed on the Bombay Stock Exchange (BSE) to examine the impact of commodity price inflation on their cost of materials consumed. The companies in this list belong to the entire spectrum of micro, small, medium and large companies, with annual sales ranging from at least Rs. 10 crore (Unjha Formulations Ltd.) to more than Rs. 1.2 lakh crore (Tata Steel). These companies are chosen from diverse sectors ranging from edible oil, other processed food, furniture, construction materials, packaging, auto-components, textile, power, pharmaceuticals, chemicals, paper, iron & steel, gems & jewellery, agro-chemicals etc.

Our analysis shows that the cumulative annual sales of these 96 manufacturing companies grew 30% in FY 2021-22 from the previous year as economic condition recovered from the pandemic. At the same time, cumulative cost of materials consumed by these 96 companies grew 35% in FY 2021-22 from the earlier year. On a quarterly basis, cost of materials consumed by these 96 companies rose 9% in March 2022 quarter from December 2021 quarter, while it grew 31% from March 2021 quarter.

On an average, these 96 companies spend 50% of their total expenditure on raw materials and intermediate goods. The share of material cost in the overall expenses of these 96 companies grew cumulatively from 50% in FY 2020-21 to 54% in FY 2021-22. Out of these 96 companies, the cost of materials consumed in total expenditure has increased for 71 companies in FY 2021-22 compared to the previous year.

Among these 96 companies, cost of materials consumed has grown faster in FY 2021-22 from the previous year than the corresponding growth in annual sales for 68 companies.

Sectoral Analysis

In this section, we have analysed financial data of 95 companies across 36 manufacturing sectors to examine the change in cost of materials consumed and change in sales revenue in FY 2021-22 from the previous year. Out of these sectors, cost of materials consumed has grown faster than annual sales revenue in 29 sectors, while in six sectors, cost of materials consumed has grown less than or at the same pace as annual sales in FY 2021-22.

Out of these 36 sectors, companies in 26 sectors spent more on materials consumed as a share of total expenditure in FY 2021-22, compared to last year. In other words, the cost of materials consumed as a share of total expenditure has remained constant or declined only in 10 sectors. These sectors include dairy products, edible oil, iron & steel, diesel engines, power generation, consumer goods, pharmaceuticals, industrial machinery, industrial glass and construction materials. Despite sharp increase in the price of raw materials in these sectors, companies have managed to control the overall material cost as a share of total cost because of their efficient operating performance and commodity hedging.

The following table highlights the sector-wise cost of material consumed as a share of total expenditure in FY 2021-22 and FY 2020-21. Rows marked in green are those sectors where cost of materials consumed as a share of total expenditure has either declined or remained constant between FY 2021-22 and FY 2020-21.

Sector-wise Cost of Materials Consumed as a percentage of Total Expenditure			
Sr. No.	**Sector**	**FY 2021-22**	**FY 2020-21**
1	Packaging	103	86
2	Edible Oil	91	91
3	Diesel Engines	89	89
4	Gems & Jewellery	85	68
5	Cables- Electricals	79	72
6	Capital goods	78	51
7	Petro-chemicals	75	74
8	Automobile and Auto Components	74	70
9	Batteries	73	68
10	Dairy Products	72	77
11	Fast Moving Consumer Goods	72	70
12	Rubber & Tyres	70	60
13	Other industrial goods	69	64
14	Fertilizer	69	56
15	Textile	67	54
16	Packaged Food	66	64
17	Paints	65	58
18	Furniture, flooring, home furnishing	60	54
19	Consumer Durables	59	52
20	Paper	58	46
21	Auto	58	52
22	Agrochemicals	58	54
23	Consumer Electronics	58	54

Sector-wise Cost of Materials Consumed as a percentage of Total Expenditure			
Sr. No.	**Sector**	**FY 2021-22**	**FY 2020-21**
24	Power generation	57	57
25	Castings and Forgings	57	54
26	Iron & Steel	49	49
27	Metals	46	41
28	Consumer goods	44	45
29	Cigarettes and Tobacco	44	43
30	Pharmaceuticals	40	42
31	Industrial Machinery	40	42
32	Chemicals	39	34
33	Glass-Industrials	28	28
34	Breweries	22	20
35	Construction Materials	15	15
36	Glass-Consumers	12	11
	Grand Total	**54**	**50**
Source: Financial Statements of companies listed on Bombay Stock Exchange; Compiled by MVIRDC			

The following table highlights annual growth in material cost and annual growth in sales in FY 2021-22 across 36 sectors. Rows marked in green are those sectors where cost of materials has grown less than or at the same pace as growth in annual sales.

Sector-wise Annual Growth in FY 2021-22 (%)			
Sr. No.	**Sector**	**Cost of Materials Consumed**	**Annual Sales**
1	Paper	73	59
2	Fertilizer	71	36
3	Metals	70	69
4	Textile	69	40
5	Paints	62	37
6	Cables- Electricals	62	53
7	Gems & Jewellery	59	36

Sector-wise Annual Growth in FY 2021-22 (%)			
Sr. No.	**Sector**	**Cost of Materials Consumed**	**Annual Sales**
8	Auto	57	40
9	Agrochemicals	55	45
10	Packaging	55	40
11	Glass-Consumers	54	42
12	Chemicals	51	40
13	Rubber & Tyres	49	21
14	Consumer Electronics	45	31
15	Edible Oil	43	30
16	Breweries	38	30
17	Castings and Forgings	36	-37
18	Automobile and Auto Components	35	25
19	Iron & Steel	34	56
20	Capital goods	33	23
21	Batteries	33	20
22	Furniture, flooring, home furnishing	31	16
23	Consumer Durables	31	17
24	Glass-Industrials	27	28
25	Other industrial goods	25	18
26	Packaged Food	25	15
27	Petro-chemicals	24	22
28	Construction Materials	22	18
29	Fast Moving Consumer Goods	17	14
30	Diesel Engines	15	15
31	Pharmaceuticals	13	7
32	Consumer goods	11	12
33	Dairy Products	11	16
34	Cigarettes and Tobacco	8	6
35	Industrial Machinery	5	15
36	Power generation	-4	-1
Grand Total		**36**	**31**

Source: Financial Statements of companies listed on Bombay Stock Exchange; Compiled by MVIRDC

Conclusion

Economists expect inflation to remain elevated and global crude oil price to firm above USD 100 a barrel in the foreseeable future because of supply disruption due to geopolitical tension, adverse weather condition and crackdown on polluting industries in China. In this circumstance, government, RBI, industry and academia may work together to find collective solution to mitigate the impact of inflation on economy and common man.

Financial results of listed companies shows that so far large companies have managed to protect their margins from inflation either by passing on the input cost rise to end consumers or by improving operational efficiency. However, if inflation continues to remain elevated in the coming months, even large firms may not be spared from the adverse impact of inflationary pressure. This will in turn affect MSME vendors who may face further delay in realising their bills for supply of goods and services to large companies. Therefore, policy makers may introduce measures such as reduction of import duty on input materials, discouraging export of critical raw materials, augmenting domestic production of cotton, polymers and other raw materials.

MSME borrowers also need support from banks and other financial institutions in this challenging time. Banks and NBFCs have adequate capital above the RBI prescribed limit and their NPAs are also at a manageable level. They should use their better financial position to support MSME borrowers by increasing flow of credit to MSMEs. Banks and NBFCs should shed their risk aversion and increasing lending to MSME customers. They should also support existing MSME borrowers by not raising lending rates even though RBI has increased policy rate in its monetary policy. MSMEs are heavily dependent on bank loans to meet their credit needs and hence they need liquidity support from banks and NBFCs in this challenging time.

It is important to support textile sector, which is the second largest employer after agriculture, in this challenging time. The current size of textile industry in India is USD 100 billion and we can attain the government's target of USD 200 billion industry by 2026 only if we can come out with innovative solution to tide over rising input cost. Textile industry may increase spending on R&D to bring out new products based on man-made fibre and thereby reduce dependence on cotton. This challenging period can be transformed into an opportunity if we invest in R&D and transform the entire textile value chain by shifting to man-made fibre. India may also increase cotton yield, which is hardly 486 kg/hectare, compared to more than 1,000 kg/hectare globally, through innovation in seed varieties.

Government may reduce the eligibility threshold under the Production Linked Incentive scheme for man-made textile sector from Rs. 100 crore investment to Rs. 50 crore investment so that MSMEs can benefit from this scheme.