



The surge in manufacturing input costs

Assessing the impact of higher input costs on Australian manufacturers

 AUSTRALIAN INDUSTRY GROUP

August 2005





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Ai Group Economics

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Published in Sydney by The Australian Industry Group
51 Walker Street North Sydney NSW

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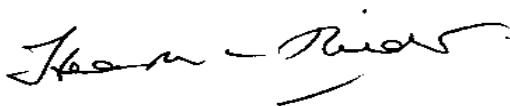
Preface

The recovery in world growth over the past two years has underpinned significant rises in the global prices of energy and industrial commodities. However, the accompanying appreciation of the Australian dollar has only partly shielded local manufacturers from these increases. Moreover, and again partly reflecting the impact of the stronger exchange rate, the increase in Australian manufacturing output prices has failed to keep pace.

For many Australian manufacturers, the earlier strength of domestic demand has cushioned the effects of these cost increases on profitability. For others, however, especially those exposed to international competition, there has been little relief from the pressure on earnings and profits. Furthermore, it is clear domestic demand peaked in 2004 and now appears poised for a period of considerably weaker growth.

At another level, these cost increases also have the potential to simultaneously curb Australia's economic growth and add to underlying inflationary pressures. Given these potentially wide-ranging ramifications, Ai Group sought to understand more fully the extent of these cost increases, the impact on manufacturing pricing decisions and profitability, other responses among manufacturers, and the outlook for both costs and selling prices over the next 12 months.

The results of the survey re-affirm the challenging environment currently facing Australian manufacturers. Importantly, however, local companies are pursuing a wide range of strategies to preserve profitability. These responses should not only enhance manufacturing productivity growth, but also mitigate the inflationary impact of the cost increases.



Heather Ridout
Chief Executive
Australian Industry Group

Summary of key findings

Ai Group surveyed 730 manufacturers (with a combined total of over 72,000 employees) in the June quarter 2005, seeking to determine the extent of input cost increases in the past 12 months and the impact on profitability. Specifically, the survey sought to ascertain the extent to which manufacturers have absorbed these cost increases, as well as identifying the nature and breadth of company responses. Finally, survey participants were questioned on the outlook for costs and selling prices over the next 12 months.

The survey confirmed substantial increases in a wide range of manufacturing input costs in the past year, and across all 12 major sectors. However, the survey also found local manufacturers absorbed over half of these cost increases. While a majority of companies raised selling prices in the past year, the increases generally lagged the rises in costs. Moreover, a significant proportion of manufacturers were unable or unwilling to increase prices, or even lowered prices.

The survey found little direct correlation over the past year between the absolute size of the increase in either input costs or selling prices, and changes in profitability. Rather, movements in manufacturing profit margins tended to be driven by a combination of cost increases, 'pricing power' (the extent to which cost increases were passed on to customers), the strength of demand, and the capacity and commitment of companies to introduce other efficiencies.

Despite a substantial majority of manufacturers lifting selling prices, and the implementation of other measures to counter the impact of rising costs, there has been a clear deterioration in manufacturing profit margins in the past year. Moreover, only modest improvement is anticipated over the next 12 months. While raw material and energy cost increases are forecast to moderate, wages growth is expected to continue drifting higher. The outlook for selling price increases also varies quite significantly across manufacturers of differing sizes.

Looking at the findings in more detail, almost nine in 10 Australian manufacturers reported increases in raw material costs in the past year, with an average rise of 11.7 per cent.

- *Increases were also spread across all 12 sectors, with the largest rises (of almost 20%) in basic and fabricated metals. Cost increases were generally around half this size in most other sectors, although falling further to a range of 4.0% - 6.0% in sectors processing rural commodities (food and beverages, textiles, and clothing and footwear).*
- *There was little variation among companies of different sizes.*

Despite the significant increase in the price of crude oil over the past year, the average increase in energy costs was a relatively modest 4.2 per cent. Compared with raw material prices, moreover, there was a much smaller range of increases across various sectors (although larger companies faced smaller increases than both medium- and small-sized companies).

Wages increased by an average of 4.3% over the past 12 months, and again with relatively little dispersion across sectors. Increases were also broadly similar for small-, medium- and larger-sized companies.

However, selling prices have clearly lagged the aggregate increase in input costs.

- *The survey found selling prices increased by an average of 4.0% over the past year, with the basic and fabricated metals sectors also reporting the largest increases (7.2% and 6.0% respectively). By contrast, increases remained below 2.0% in both the clothing and footwear and paper, paper products and furniture sectors.*
- *Small- and medium-sized companies (which tend to be oriented more towards domestic markets and have relatively less capacity to find alternative cost savings) both increased selling prices by a little over 4.0 per cent. Larger companies (which are more generally exposed to international competition and frequently have a wide range of strategies to lower other costs) increased prices by just over 3.0 per cent.*

Raw material cost increases were the major trigger for changes in selling prices over the past year, cited as a 'very important' factor in the pricing decision by 55% of manufacturers.

- *Labour costs were similarly important for almost one quarter of companies, but only one in 20 ascribed high importance to energy costs.*
- *Looking past cost increases, competitors' prices and demand were also very important for one quarter of all respondents, with the exchange rate cited by less than one in five.*

Nevertheless, manufacturers are estimated to have absorbed over half of the increase in input costs. On average, manufacturers estimated just 45% of the increase in costs was passed on to customers through higher selling prices.

- *Partly reflecting the size of raw material cost increases, only the basic and fabricated metal sectors managed to pass on more than half the increase in costs (and by less than 60% in both sectors). At the other end of the range, clothing and footwear absorbed over 80% of cost increases.*

Moreover, the average increase in selling prices masked a substantial proportion of manufacturers leaving prices unchanged (approximately 15% of companies), or even cutting prices (almost 10% of all respondents and reported in 11 of the 12 sectors).

- *Rather than passing on declines in costs (perhaps where productivity gains exceeded wage costs or where exchange rate appreciation offset increases in global prices), among these companies import competition appears to have been the over-riding issue. Raw material costs were a very important factor in the pricing decision of just one in 10 of this combined group.*
- *Among the 10% of manufacturers lowering prices, competitors' prices were rated a very important factor by 61%, and demand very important by 45 per cent.*

These developments contributed to a significant erosion in manufacturing profit margins in the past year.

- *Most manufacturers have undertaken specific actions to combat cost increases (with close to half pursuing better processes), and a further 40% reported general increases in sales and demand also cushioning the impact. Nevertheless, profit margins fell among over half of all manufacturers, compared with just one third reporting an increase.*

Unsurprisingly, the study detected considerable variability in profit performance across the 12 major sectors over the past year. However, it is difficult to ascribe the variability in performance to any individual factor.

- *At a very broad level, profit margins were most resilient in food and beverages and miscellaneous manufacturing, and under most pressure in textiles, clothing and footwear - consistent with Australia's comparative advantages in international trade.*
- *More specifically, while rising costs have eroded overall manufacturing profitability, the survey found little relationship between the size of the cost increase in an individual sector and the change in sector profitability. Similarly, there was only a weak correlation between the size of selling price increases across sectors and profit performance.*
- *Pricing power (defined as the ratio of selling price increases to cost increases) was found to have some influence on profitability by sector and by company size. In particular, companies lowering selling prices (most often an indication of negligible pricing power) were very likely to report a decline in profit margins.*
- *However, the impact of pricing power was mitigated by the relative strength of customer demand and the commitment to pursue alternative cost reductions.*

Manufacturers anticipate only a modest improvement in costs and pricing power over the next 12 months.

- *Raw material costs are expected to increase by a little over half the rate reported in the past year, accompanied by a slight moderation in energy costs.*
- *While wages growth is forecast to edge higher, only smaller-sized companies expect to increase selling prices by more than in the previous year.*
- *Large- and medium-sized companies expect to increase prices, but by less than in the past 12 months.*

Corresponding with this divergence in price expectations is a similarly mixed outlook for the proportion of cost increases passed through to customers, and the proportion absorbed internally.

- *Small companies expect to pass on two-thirds of total cost increases, slightly more than medium-sized companies, and compared with just over half for larger companies.*
- *Nevertheless, it is unclear whether this anticipated improvement in pricing power is likely to deliver a recovery in manufacturing profit margins. Evidence from the past year suggests broader demand conditions and efficiency improvements will remain equally important factors driving profit growth.*

The findings in detail

Global energy and other industrial raw material costs have increased substantially since early 2002. Despite a significant appreciation of the Australian dollar through much of this period, Australian manufacturers have not been fully insulated from these increases. Furthermore, after a lengthy domestic economic expansion and the emergence of widespread skills shortages, wages growth in the manufacturing sector has also been creeping steadily higher.

These cost increases have been captured in official data. According to the Australian Bureau of Statistics (ABS), prices of materials used in manufacturing increased by 9.1% over the year to June 2005, with the annual increase peaking as high as 9.7% over the year to December 2004.¹ While rebounding from declines through much of the preceding two years, nevertheless the recent increases resulted in the broader manufacturing input price index rising to record levels in late 2004.

ABS data also re-affirms the wide range of raw material cost increases. For example, prices of materials used in the petroleum and coal products industry (a proxy for the increase in crude oil products) increased by 29.5% over the year to the June quarter 2005 (and by as much as 40.0% over the year to the December quarter 2004). Similarly, prices of iron and steel used in the fabricated metals industry rose by 18.0% over the same period, while prices of zinc inputs increased by 20.0 per cent.

Concurrently, total hourly rates of pay in the manufacturing sector increased by 3.7% over the year to the March quarter 2005, up from a 3.4% increase over the previous corresponding period.² There is also increasing evidence of new enterprise agreements yielding larger increases in average annual wage increases, particularly in the metals manufacturing sector.³

Importantly, ABS data also suggests rises in output prices have been lagging the increases in costs (at least since mid-2004). Indeed, prices of articles produced by manufacturing increased by 6.9% over the year to the June quarter 2005, down from an 8.2% increase over the year to the December quarter 2004. Moreover, and in contrast to the broad-based rises in manufacturing input prices in the past year, the petroleum and coal products sector has accounted for much of the fluctuation in the output price series. Excluding this sector, manufacturing output prices have increased at a considerably weaker pace.

The findings of the Ai Group survey broadly mirror these developments, and re-affirm the importance of cost increases in the decision to change selling prices. This paper examines the extent of these cost and price increases across all 12 manufacturing sectors, and discusses the ensuing impact on sector profitability. The paper examines the extent to which cost increases have been absorbed or passed on to customers, and various other factors in the pricing decision. The paper also identifies other strategies adopted by manufacturers to counter the effects of higher costs. It concludes with a discussion of cost and price forecasts over the next 12 months.

¹ Australian Bureau of Statistics, Catalogue No. 6427.0, June quarter 2005.

² Australian Bureau of Statistics, Catalogue No. 6345.0, March quarter 2005.

³ Department of Employment and Workplace Relations, "Trends in Federal Enterprise Bargaining", March quarter, 2005.

Input Costs

Among the sample surveyed by Ai Group, 86% of respondents reported an increase in raw material costs in the past 12 months. Equally importantly, significant increases were reported in all 12 manufacturing sectors (Table 1).

Table 1: Percentage change in input costs over the past year

	Raw Materials	Energy	Wages
Food and beverage	6.1	4.3	3.7
Textiles	4.7	6.5	5.0
Clothing and footwear	5.3	1.1	2.9
Wood, wood products, etc	7.7	3.2	4.1
Paper, printing, etc	9.0	3.2	3.9
Chemicals, petroleum, etc	11.1	3.1	3.7
Construction materials	9.8	5.3	4.0
Basic metals	19.5	5.3	4.3
Fabricated metals	18.2	5.1	4.6
Transport equipment	9.8	3.7	4.9
Machinery and equipment	11.8	4.1	4.5
Miscellaneous manuf.	8.1	3.2	4.6
Small	12.3	4.8	4.3
Medium	12.2	4.3	4.1
Large	10.1	2.9	4.3
Total manufacturing	11.7	4.2	4.3

Rises over the past year ranged from close to 20.0% in the basic and fabricated metal products sectors (largely reflecting the rises in iron and steel and other metal prices), to an average of 5.0% in the textile and clothing and footwear sectors. Other significant increases were reported in machinery and equipment (11.8%), and in chemicals, petroleum and coal products (11.1%). Higher metal prices again accounted for much of the increase in the former, while the rise in the chemicals sector was largely attributable to the jump in crude oil prices.

The study found some modest variation by size of company. Large companies (those with over 100 employees) reported an average increase of 10.1%, compared with increases of 12.2% for medium-sized manufacturers (25 – 100 employees) and 12.3% for smaller enterprises (less than 25 employees).

By contrast, there has been relatively little cascading of higher oil, gas and coal prices into manufacturers' energy costs. The average increase over the past year was a relatively modest 4.2%, and which appears to reflect the greater significance of electricity as a source of energy for manufacturers (ABS data suggests oil-based energy costs are about one third of electricity costs for Australian manufacturers).⁴

⁴ Australian Bureau of Statistics, Catalogue No. 5209.0, 1998-99.

Unsurprisingly, there was relatively little variation in energy costs across sectors. Excluding the textile and the clothing and footwear sectors (which somewhat perplexingly reported the highest and smallest increases, respectively), cost increases ranged from a little over 5.0% in each of the basic and fabricated metals and construction material sectors, to slightly over 3.0% in chemicals, petroleum and coal products; paper, printing and publishing; and miscellaneous manufacturing.

Again, larger companies were confronted with smaller increases in energy costs (2.9%). By comparison, costs increased by 4.3% among medium-sized manufacturers and by 4.8% for small companies.

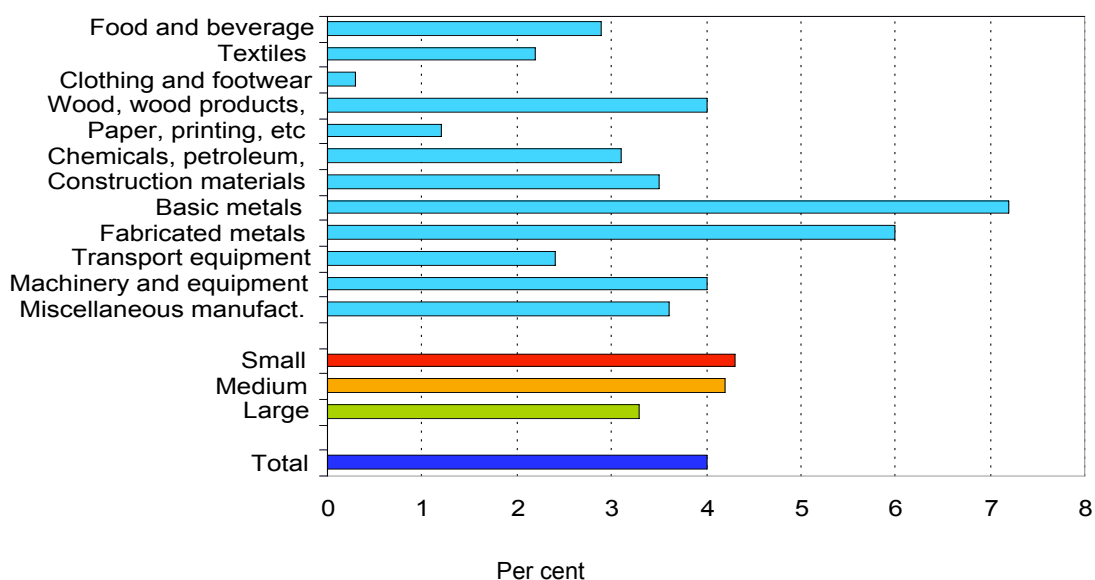
In addition to energy and raw material costs, the study found wages grew by 4.3% over the past year. Similar to energy costs, the increases were relatively tightly bunched, with eight sectors reporting annual increases in the range of 4.0% - 5.0 per cent. The four to report rises outside this range all paid lower average increases, and comprised paper, printing and publishing (3.9%); chemicals, petroleum and coal products (3.7%); food and beverages (3.7%); and clothing and footwear (2.9%).

Selling prices

By comparison, selling prices increased by an average of 4.0% over the past year (Chart 1). Price increases were highest in basic metals (7.2%) and fabricated metals (6.0%), and weakest in clothing and footwear (0.3%) and paper, printing and publishing (1.2%). Increases in the remaining eight sectors ranged between 2.2% in textiles and 4.0% in both wood, wood products and furniture and machinery and equipment.

Small and medium-sized companies (which tend to be oriented more towards domestic markets and have relatively less capacity to find alternative cost savings) both increased selling prices by a little over 4.0 per cent. Larger companies (which are more generally exposed to international competition and frequently have a wide range of strategies to lower other costs) increased prices on average by slightly more than 3.0 per cent.

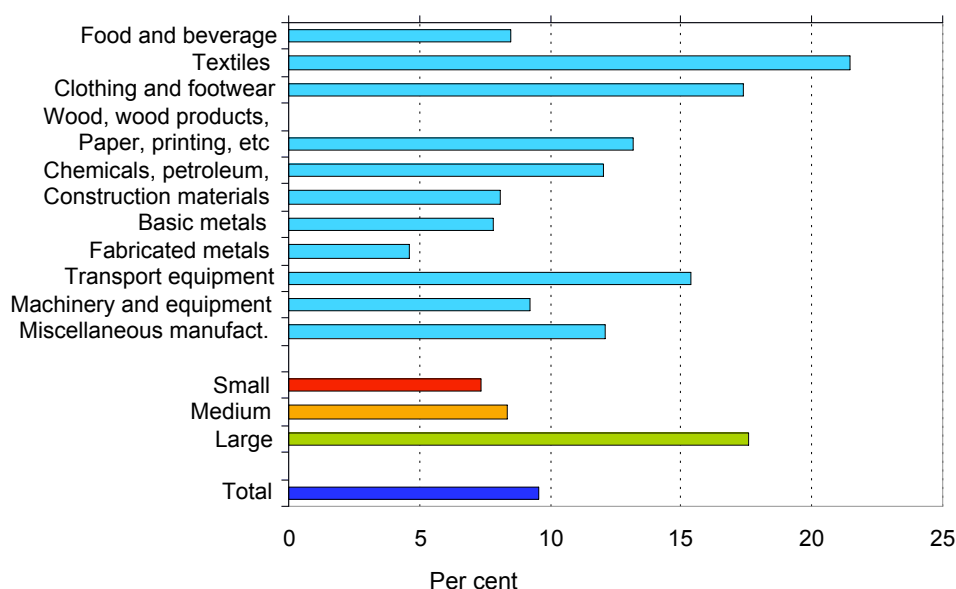
Chart 1: Percentage change in selling prices over the past year



Nevertheless, and consistent with official data, it is clear the rise in selling prices has lagged the increase in input costs in the past year. In the first instance, the average rise in selling prices is lower than each of the increase in all of raw material, energy, and wage costs. More specifically, while 86% of respondents reported higher raw material costs in the past year, just 65% were able to increase prices.

Indeed, the survey found 15% of companies leaving selling prices unchanged in the same period, and a further 10% lowering prices. Among companies cutting prices, the average decline was 7.1 per cent. Wood, wood products and furniture was the only sector where price cuts were not reported, with the proportion of companies lowering prices the largest in textiles, clothing and footwear and followed by transport equipment (Chart 2).

Chart 2: Percentage of manufacturers lowering selling prices



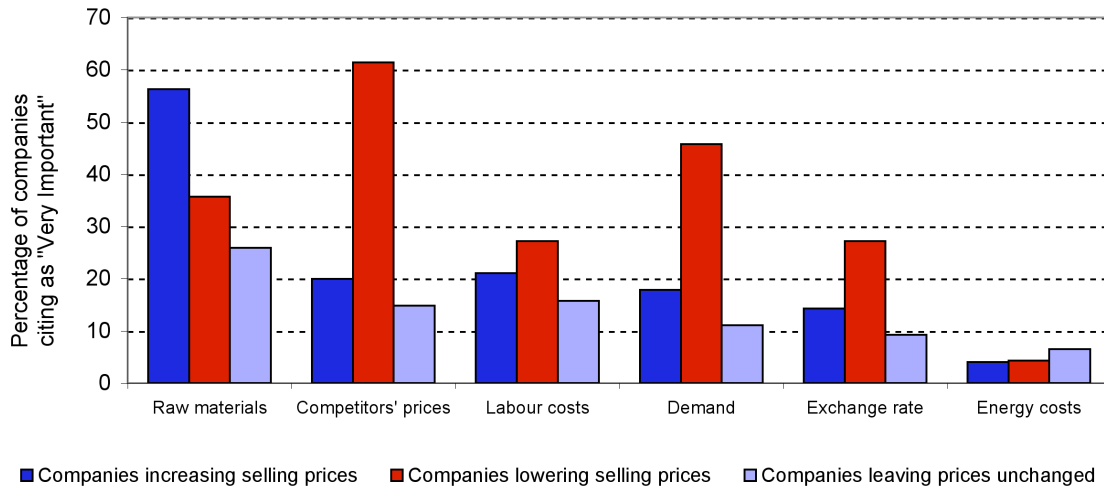
With almost two thirds of all manufacturers increasing prices, however, it is little surprise raw material costs were reported as the most important trigger. Well over half of all companies (55%) said raw material costs were a very important factor in the decision to change prices (Chart 3). With respect to other components of the cost base, 24% of manufacturers also reported labour costs a very important consideration. Energy costs were rated very important by just 5% of companies.

Costs were not the only factor to feature directly in the decision to change prices. Over one quarter (27%) also cited competitors' prices as a very important catalyst, while only a slightly smaller proportion (23%) nominated the strength of demand. The exchange rate was cited a very important issue by 18% of manufacturers.

Among companies lowering selling prices, however, (declines in) raw material costs were a relatively minor factor, rated very important by only 36% of this group. Rather, import penetration appears to have been a substantially more important force. In particular, competitors' prices were deemed very important by 61% of companies cutting selling prices in the past year, with 45% also nominating demand as very important. And neither was the

stronger exchange rate primarily responsible for the decline in competitors' prices, with the strength of the Australian dollar rated very important by only 27% of these companies.

Chart 3: Relative importance of factors triggering selling price adjustments

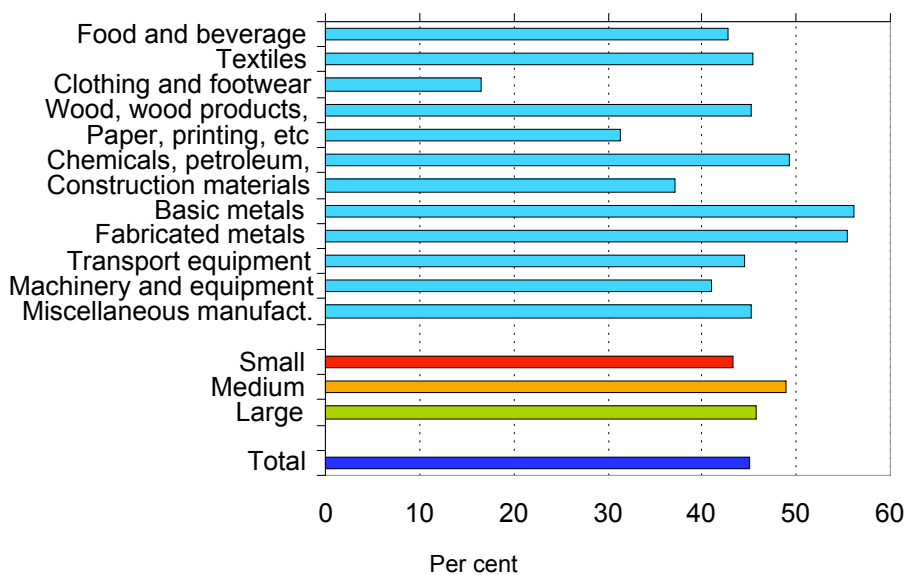


Profitability

This broad divergence in costs and selling prices has squeezed manufacturers' profit margins. In aggregate, respondents estimate only 45% of cost increases have been passed through to customers, forcing companies to absorb well over half (Chart 4).

Sectors to absorb a significant proportion of cost increases were generally those reporting weak increases in selling prices (irrespective of the size of cost increase), the most notable of which were clothing and footwear (84%) and paper, printing and publishing (69%). The only sectors to pass on more than half of all cost increases were basic and fabricated metals (the same sectors also reporting the largest increase in selling prices), although in both instances less than 60% of increases were captured in price adjustments.

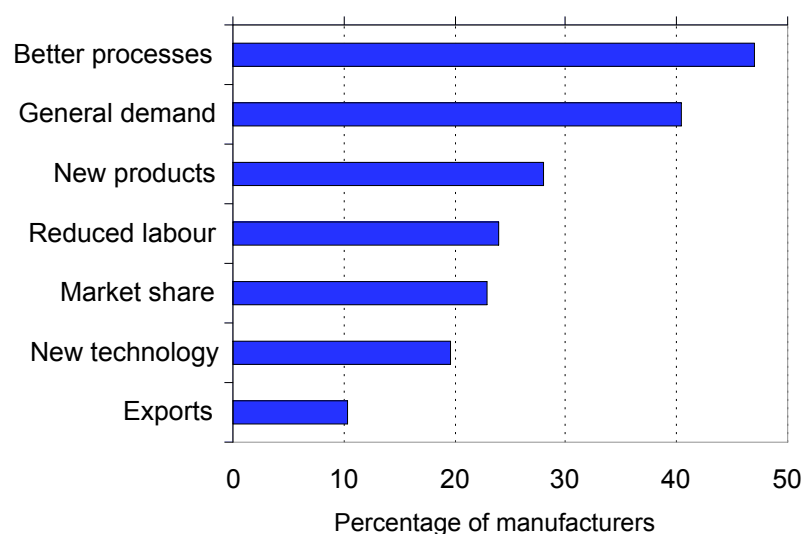
Chart 4: Percentage of cost increases passed on to customers



A different picture emerges in terms of company size. Despite implementing the largest increases in selling prices, small companies also were forced to absorb the highest proportion of cost increases (57%). Medium-sized companies, with only a slightly smaller rise in selling prices, absorbed just 51% of cost increases. Large manufacturers absorbed 54% of increases, although accompanied by a significantly lower increase in selling prices. To be sure, smaller companies were confronted with significantly larger cost increases (and larger companies the smallest). Moreover (as discussed later), small companies have less scope to improve efficiency, and subsequently price rises remain the only significant means of preserving profitability.

More positively, and illustrated in Chart 5, 40% of manufacturers reported general growth in sales and demand had offset some of the effects of higher costs on profit margins (possibly through improved economies of scale). In four sectors (construction materials; basic metal products; fabricated metal products; and miscellaneous manufacturing), at least half of respondents nominated a positive impact from demand growth in the past year. Those sectors where demand growth had a relatively minor positive impact were generally those where there was only a small average increase in selling prices (clothing and footwear and paper, printing and publishing). Larger companies also experienced a smaller offset from demand growth (and again likely reflecting a stronger orientation to the traded goods sectors).

Chart 5: Factors and strategies offsetting higher costs



An even larger proportion (47%) has also implemented better processes in the past year in response to higher costs. In broad terms, sectors reporting significant downward pressure on pricing appeared more active in pursuing improved processes. To be sure, four of the five sectors in which over half of respondents introduced better processes (textiles; clothing and footwear; paper, printing and publishing; and transport equipment) were also characterised by 10% or more of companies cutting selling prices. Conversely, the basic and fabricated metals sectors enjoyed the largest increase in selling prices, but the smallest proportion citing efforts to improve processes.

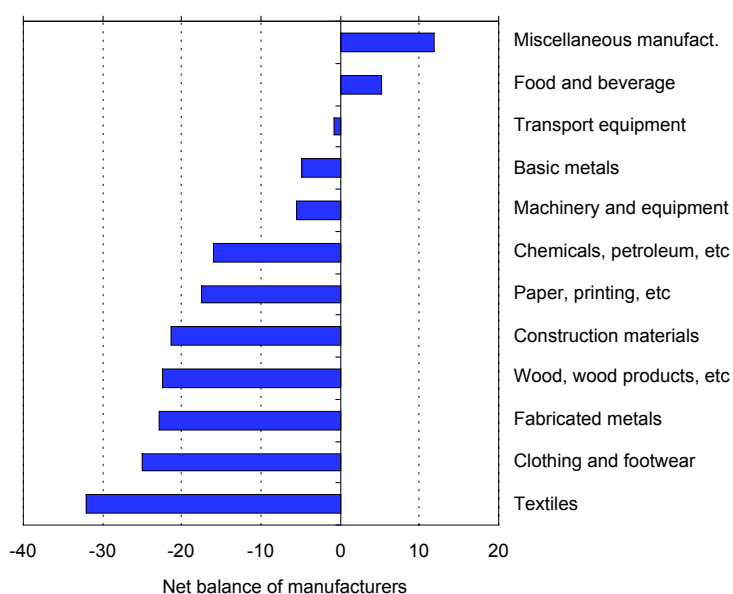
Almost one in four manufacturers (24%) has responded to the pressure on margins by reducing employment, while exactly one in five has also adopted some form of new technology. Significant proportions have also employed other measures to 'grow' out of cost pressures (beyond any general increase in demand), with 23% citing an offset from increased market share and 28% pointing to benefits from the introduction of new products. Somewhat disappointingly, only 10% have found export growth a significant counterbalance to domestic margin pressures.

Consistent with the above, larger manufacturers (which reported the lowest increase in selling prices and the smallest cushion from demand) were more active in seeking improved efficiencies (cited by 58% of companies). Indeed, less than half of both medium- and small companies have sought to adopt improved processes. Larger companies were also more likely to introduce new products and new technology. For smaller companies, reducing employment has been the means most frequently pursued to offset the effects of higher costs.

Despite many companies exploiting these internal and external developments to counter the effects of rising costs, manufacturing profitability has been eroded over the past year. In aggregate, exactly one half of manufacturers reported a decline in profit margins (including 17% reporting a significant contraction), while slightly less than one third said margins had increased. A further 17% reported margins unchanged, with a net balance of 10.4% of manufacturers subsequently suffering a decline in profitability. (The net balance is derived as the sum of respondents reporting increases and half those citing unchanged outcomes, less the sum of those reporting declines and half those citing an unchanged result).

Chart 6 reveals only two sectors – food and beverages and miscellaneous manufacturing – enjoyed positive net balances (i.e. an improvement in margins in the past year). Transport equipment recorded a net balance of close to zero (margins across the sector were essentially unchanged), with relatively small negative net balances in basic metals and machinery and equipment. By contrast, the largest negative net balances were recorded in textiles and clothing and footwear, with a large negative outcome also in fabricated metals. Negative net balances were reported across companies of all sizes, tending to increase as the size of enterprise decreased.

Chart 6: Net balance of manufacturers reporting increased profit margins



As implied by the foregoing analysis, it is difficult to ascribe the variability in profit performance (across both sectors and company size) to any specific factor. While the rise in costs has clearly impacted overall manufacturing profitability, the size of input cost increase only partly explained changes in a sector's profit margin. Similarly, there appears only a weak correlation between the size of the increase in selling prices and the change in margins.

Pricing power (defined here as the ratio of selling price increase to cost increase) had some influence in determining profit performance across sectors and company size. In particular, companies *lowering* selling prices (an indication of weak pricing power) were very likely to report a decline in profit margins.

General demand conditions and the propensity to adopt new technologies were also able to explain more of the movement in profitability than the size of cost and selling price increases. However, other company responses were less successful explaining changes in profit margins. Indeed, improved processes, reduced employment, new products, increased exports and market share appeared to have a negligible impact on profitability (although possibly requiring a lead time of over 12 months before becoming fully effective).

Outlook for the next year

Contrary to general expectations of slower international and domestic economic growth, manufacturers anticipate a more favourable cost and pricing environment over the next 12 months (Table 2). In broad terms, companies expect a substantial moderation in raw material cost increases and slightly smaller rises in energy costs. While wages growth is expected to strengthen slightly, in aggregate companies expect to raise selling prices marginally more than in the past year. Subsequently, a larger proportion of cost increases is expected to be passed on to customers (after years of absorption).

Raw material cost increases are expected to abate in all 12 sectors, with an expected average increase of 6.7% (down from 11.7% rise over the previous 12 months). Increases are expected to more than halve in the basic and fabricated metals sectors, although a more moderate slowing is anticipated in other sectors in which iron and steel are significant inputs (including transport equipment and machinery and equipment). A more marginal decline is also expected in chemicals, petroleum and coal products, where crude oil is a large input. Energy costs are forecast to rise by 3.9%, compared with a 4.2% increase in the past year, and with relatively little variation across sectors.

By contrast, wages growth is forecast to increase from 4.3% to 4.5 per cent. Again, however, there is little variation anticipated across sectors. Only in wood, wood products and furniture are wages expected to increase by less than 4.0%, while miscellaneous manufacturing is the only sector in which wages are forecast to increase by over 5.0 per cent.

Selling prices are forecast to increase by 4.3% in the next 12 months, up from 4.0% over the past year. However, the expected increase is confined entirely to small companies, among which the average increase is expected to rise from 4.3% to 5.2 per cent. By comparison, the increase is expected to fall from 4.2% to 4.0% among medium-sized enterprises, and from 3.3% to 3.0% among larger companies. The largest expected increases remain in basic and fabricated metals (5.1% and 5.5% respectively), while clothing and footwear and paper, printing and publishing both anticipate increases of below 3.0% (2.7% and 1.9% respectively).

Table 2: Forecast percentage change in input costs and selling prices in the next year

	Raw Materials	Energy	Wages	Selling Prices
Food and beverage	4.7	4.1	4.6	3.9
Textiles	3.8	5.2	4.7	3.3
Clothing and footwear	3.5	4.2	4.6	2.7
Wood, wood products, etc	5.9	4.0	3.8	4.3
Paper, printing, etc	4.5	3.6	4.1	1.9
Chemicals, petroleum, etc	6.1	4.3	4.1	3.9
Construction materials	5.9	3.6	4.1	4.3
Basic metals	8.5	3.9	4.6	5.1
Fabricated metals	9.3	4.1	4.6	5.5
Transport equipment	6.5	3.5	4.2	3.0
Machinery and equipment	7.5	3.5	4.9	4.4
Miscellaneous manufact.	5.5	3.4	5.2	4.6
Small	7.3	4.3	4.8	5.2
Medium	6.4	3.6	4.3	4.0
Large	5.3	3.6	4.3	3.0
Total	6.7	3.9	4.5	4.3

Manufacturers subsequently expect to absorb a much smaller proportion of input cost increases. Indeed, companies anticipate passing on 62% of all increases, compared with just 45% in the past 12 months. Small companies expect to pass on exactly two thirds of all cost increases, compared with 62% among medium-sized firms and 53% among large firms. Again, much of this divergence appears to reflect variations in pricing power, the size of cost increases and the capacity to find alternative reductions in costs. Among the 12 sectors, only clothing and footwear manufacturers are projected to pass through less than half of all cost increases (33%). At the other end of the range, basic metal product producers expect to pass on almost three quarters (73%) of cost increases.



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