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India's factories sound wake-up call

By Kunal Kumar Kundu

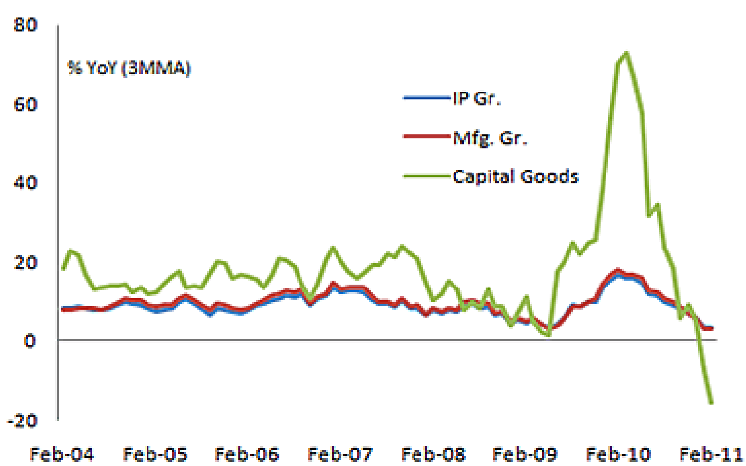
BANGALORE - Confirming a slowdown in manufacturing (if a confirmation was required), the India's Index of Industrial Production for February clocked growth of only 3.56%, the second-lowest growth rate since May 2009.

This February figure was not only lower than the upwardly revised 3.95% growth recorded in January, but substantially lower than 15.13% growth rate during the same month in the previous year.

Immediately after the release, the government mandarins took pains to affirm India's growth story and hinted that this performance will not impact the overall growth number. To a certain extent, they are correct. IIP accounts for only around 18% of the economy, and this year the farm sector is expected to show highly encouraging numbers which, to a certain extent, will offset the slowdown in manufacturing.

The problem is, whenever the IIP growth comes in at the lower side, the mandarins maintain that one should ignore this and look at the big picture, since the monthly numbers are very volatile.

Sure the numbers are volatile, but one is still hard-pressed to believe that a slowdown is not an issue. If one were to take a three-month moving average data to cut out the volatility, there is a clear sign of a slowdown from the high growth rate recorded earlier.



Source: MOSPI (Govt of India), author's calculation

As the chart indicates, the growth rate peaked about a year back and has been on a decline ever since, save for a few periods of resilience.

What is even more alarming is the performance of the capital goods sector. The decline has been as sharp (in fact even sharper) than the previous rise. More worrying yet is that it has actually been contracting of late.

For an economy that is facing tremendous inflationary pressure owing to continuous supply side bottlenecks, the dramatic fall in the capital goods sector indicates a clear case of a slowdown in investment. A look at the disaggregated data confirms a slowdown in capacity building, as is indicated by a substantial decline in computer systems and industrial machinery.

Manufacturers are also seemingly waiting to see how the rising interest rate scenario impacts consumer demand. Only if they are convinced that demand will still remain robust will they plan to go for capacity expansion.

I have been maintaining that there has been a frontloading of demand for some time as consumers were expecting the interest-rate hikes. Now that India is inching closer to the end of the rate rising cycle - I expect another couple of rate hikes before the Reserve Bank of India (RBI) pauses, unless the inflation scenario deteriorates significantly; the interest rate is close to peaking. The consumer response will be critical.

While the manufacturing slowdown seems to be the case of a high base effect kicking in, the turnaround in this downtrend can be expected towards the end of the first quarter of FY 2011-12, as low base effect starts showing up. There may, however, be a potential downward bias, depending on how the inflation scenario pans out.

The recent tone of India's central bank has remained quite hawkish. It seems to be concerned more about inflation than growth, and correctly so. With a couple more rounds of rate hikes expected, there is likely to be further pressure on demand going forward. The RBI is even exhorting banks to go slow on credit growth to fight inflation.

Bank credit growth has also slowed down sharply to 21% year on year, to 40,500 billion rupees (US$909 billion), as of March 25 from 23% in February and it is expected that, as of March 31, credit growth might have slowed down to 20%. The pace of growth has been slowing since December, when it recorded a 24% growth. While the slowdown in credit growth can partly be explained by the high base effect, this is also symptomatic of things to come.

However, there are quite a few positive developments of note, such as the steady growth in electricity output, which has 10.17% weightage in the IP. Buoyant capacity addition is clearly helping on this front. Production of transport equipment, essentially automobiles, continues to show tremendous growth. Even the growth in the consumer goods segment brings in a lot of cheer because, after a fairly long period of sluggish growth, there was sharp uptick in the production of consumer non-durables.

Overall, while the manufacturing numbers are a cause for concern, India's growth story has not been dented much. This does not mean that I have joined the double-digit growth story bandwagon. Far from it.

The fact that the farm sector is showing robustness is quite a matter of chance than of design. This sector has been seriously impacted by years of under-investment and being regulated by antediluvian policies. Reforms seem to be on the back-burner, save for occasional noise from policymakers. The Goods and Services Tax is taking an unduly long time to come, delivery leakages continue, there is no sign of labor reform and so forth.

In addition, the surge of the green brigade is another worry. While some of their causes are indeed commendable, there are cases of overreaching activism with the sole aim of scoring points irrespective of the actual benefit derived.

In effect, I believe that India is capable of recording a gross domestic product growth rate of 8 to 8.5%, cutting off the excessively optimistic clutter. Beyond that, it is all about the ability of policymakers to move beyond intent and to ensure real action on the ground.

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