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India Journal: Reasons to Worry in the Economic Numbers

By Kunal Kumar Kundu

The Index of Industrial Production in India for September grew by a mere 4.36%. That is close to half of what it was a year before, at 8.22% and a 16-month low. The latest number shocked many an analyst. Not only was the actual number far lower than the market forecast, it was lower than even the lowest forecast of 4.5%.


Kunal Kumar Kundu

It seems that economic recovery is losing steam, what with the multiplier effect of the fiscal stimulus waning and export growth moderating from the heady rate experienced a few months back.

In fact, the Reserve Bank of India statement on Sept. 16 attributed the gross domestic product growth in the three months ended June 30 of 8.8% to a favorable base effect. During September, capital goods production shrank by 4.21%, an 18-month low. Even the growth rate of the manufacturing index slowed down to 4.53%. We will see what the latest GDP numbers, to be released later today, show us.

But these lackluster numbers do not surprise me. Private consumption demand is failing to match the exuberance shown by producers, save for possibly the auto and a few other consumer durables.

In fact, for the past eight quarters, private consumption grew at an average of only 5% year on year, while the average for the past five quarters was even lower, at 4.2%, indicating a clear waning of demand. A lot of domestic demand had been attributable to the tax breaks that were provided as part of the stimulus packages.

The reversal of tax breaks, hiking of fuel prices and an indifferent monsoon this year (which followed the worst monsoon in 24 years in 2009) has lead to stubbornly high inflation. While the RBI did tighten the monetary screws through periodic hiking, the effect on inflation containment has been less than desirable.

It is interesting to note here that demand for consumer durables (which are interest-rate sensitive) remained robust as consumers made purchases in anticipation of higher interest rates. But as interest rates continued to rise, demand for consumer durables started to come off, albeit slowly. This is evident from the gradual slowdown in production of consumer durables. From a high of a 48.57% increase in production in December 2009, the growth rate came down to 27.06% in August. In September, the growth rate dwindled further to 10.87%. Further rises in interest rates could impact demand further.

Meanwhile, demand for consumer non-durables (which account for more than 80% of the overall consumer goods segment), has been persistently weak. As a result, production of consumer non-durables has hardly budged. From January 2009 to September 2010, the average growth rate in the production of consumer non-durables was a mere 2.34%. In fact, over the last 10 quarters, consumer non-durables grew at less than 3% while the actual index value dropped from 300.1 to 280 – an overall decline of 6.7% during this period.

Even external demand (i.e. exports) is showing signs of slowdown.

It therefore seems that while some economic activity is leading to capacity creation – a desirable thing — other activities are possibly adding to inventories, which can put pressure on growth in the coming few quarters unless demand picks up.

Not surprisingly, too, corporate sales growth is showing signs slowing down. The yearly growth in sales and operating profits of 375 of the BSE-500 companies shows that while profit growth has improved during the quarter ended Sept. 30, there has been a gradual decline in sales growth over the past three quarters.

With private expenditure failing to live up to expectations, increased government expenditure has been able to prop up the economy. During the past eight quarters, government spending grew at a rate of 16.7%.

The question is, how long can the government go on spending without deficit concerns coming to the fore? This year, the targeted fiscal deficit of 5.5% of GDP (to be reduced from 7.6% last year) is likely to be achieved. In fact, the successful auction of 3G spectrum for mobile telephony and some successful big-ticket disinvestment should ensure that the deficit will be under control. However, this luxury will not be afforded in future years unless the government mends its profligate ways – a much less likely scenario.

My sense is that with production on overdrive and domestic demand failing to hold up (and external demand showing signs of slowdown), the latest industrial production number was a reality check. Going forward, IP growth is unlikely to be in double digits.

This financial year which ends March 31, India’s GDP growth should hover around 8% and not 8.5% to 9% that government officials are claiming. While GDP growth was clocked at 8.8% in the quarter ended June 30, the growth rate for the quarter ended Sept. 30, being released today, will struggle to touch 8.5%. I believe that the second half of the financial year will show a much larger impact of the slowdown and the growth rate will come off substantially, leading to a possible 8% increase for the year ending March 31.

Make no mistake, even 8% is an enviable growth number. The Indian economy has many positives going for it. In fact, when the financial crisis was blowing all over the globe in the year ended March 31, 2009, India's GDP growth rate dipped, but only to 6.7%.

In the year ended March 31, 2010, the growth rate improved to 7.4% when there were splashes of red all round, especially in the developed world. The reason India managed to stay afloat has a lot do with prudent regulation and an economic structure that is not as dependent on external demand.

While domestic consumers buoy the economy, they continue to repose faith on the virtues of savings rather than leveraged consumption. Given that, 8% growth is par for the course. However, any intent to jack up growth toward 9% or higher would require substantial monetary easing which will lead to additional inflationary pressures that can have an debilitating impact on the economy.

Kunal Kumar Kundu is senior practice lead, Knowledge Services, Infosys Technologies Ltd. Views are those of the author.