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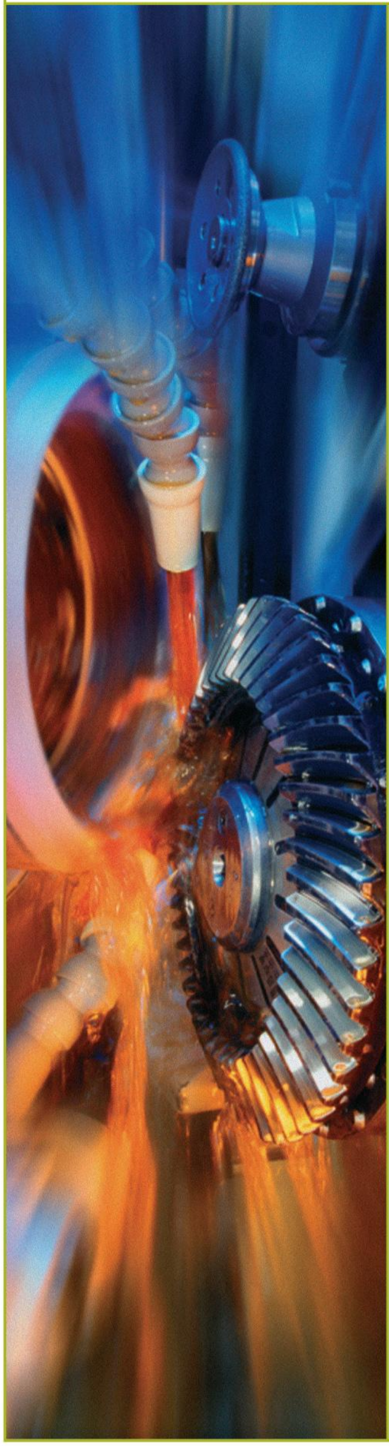

The Manufacturing Sector in India: Recent Performance and Emerging Issues

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Introduction

As India's economic growth accelerates, it is gaining interest from U.S. manufacturers as a production location and for its considerable sales potential. To further expand the Manufacturers Alliance/MAPI growing program of industrial forecasting in key countries and regions, we will be teaming with a number of prominent Indian economists and statisticians in an effort to develop a model that will predict annual output growth in major Indian industry sectors. The purpose of this *Issues in Brief* is to review the recent performance of the Indian manufacturing sector and to consider the economic and policy climate for manufacturing in the world's second most populous country.

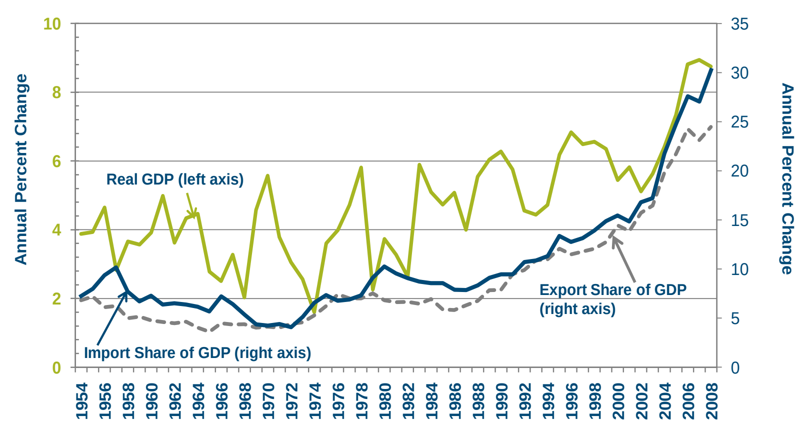
The Evolving Indian Economy

In the decades following World War II the Indian economy was a model of misguided policy and weak performance. After independence from Britain in 1947, the Indian government adapted an inward-focused economic policy framework in response to what was perceived to have been an exploitative, mercantilist approach to India's development.[1] Quantitative restrictions on imports, onerous licensing requirements for industry, and a centrally run system of capital allocation became facts of life for business. The restrictive commercial environment significantly impacted social and economic progress. Between 1960 and 1980 gross domestic product (GDP) per capita growth averaged just over 1 percent per year.[2]

The government attempted to spur growth and development with heavy fiscal stimulus. And, while public spending did provide a temporary boost to GDP per capita growth, the resulting sizable fiscal imbalance was the prime contributor to a severe balance of payments crisis in 1991. Foreign exchange reserves fell to less than one month of imports.[3] International Monetary Fund (IMF) assistance was required, and the Indian currency (rupee), which had already fallen significantly against the dollar since the early 1980s, was further devalued.[4]

The crisis provided incentives for a host of policy reforms that accelerated the more modest changes which began during the 1980s. Regulations on domestic industries were relaxed and steps toward freer trade, including enhanced exchange rate flexibility, were taken. As in China, the results of Indian reforms, at least by the standards of overall macroeconomic performance, have been impressive. Figure 1 shows that since 1980 a four-year moving average of annual real GDP growth has

Figure 1
Four-Year Moving Average of Indian GDP Growth and Growth in the Export and Import Share of GDP



Sources: India Central Statistical Organization, Global Insight, and MAPI Calculations

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[1] Beth Anne Wilson and Geoffrey N. Klein, "India and the Global Economy," *Business Economics*, pp. 28-36, January 2006.

[2] Ibid, p. 30

[3] *Ibid*, p. 30

[4] For a further discussion of the India financial crisis, see Ernest H. Preeg, *India and China*, Manufacturers Alliance/MAPI and Center for Strategic & International Studies, March 2008.

accelerated significantly and was just shy of 9 percent between 2006 and 2008.

As with many developing economies, accelerated economic growth and poverty reduction have been accompanied by increasing integration into global markets. As Figure 1 also shows, the export share of GDP has risen dramatically from less than 10 percent during the early 1990s to nearly 25 percent during 2008, partially a function of trade liberalization and partly boosted by the long-term fall in the value of the rupee. While the import share has risen even further, to 30 percent of GDP during 2008, external imbalances are not yet a major issue. For Fiscal Year 2008-2009 (April to March), the Reserve Bank of India estimates that the current account deficit will be about 2.6 percent of GDP, a healthy equilibrium especially when compared to the outsized surplus in China and the still high (albeit falling) current account deficit in the United States.

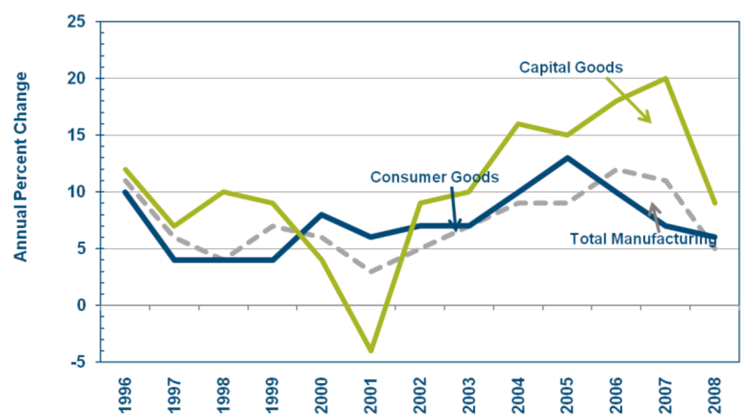
But considerable development challenges remain, many of which have direct or indirect implications for manufacturing. At 17 percent of GDP, India remains overly dependent on what, by all accounts, is a highly inefficient agricultural sector. At the same time, in spite of the impressive growth performance of recent years, manufacturing remains stuck at about 15 percent of GDP, an unusually low factory sector share for an emerging economy like India at its stage of development.[5] Additionally, the poor state of India's infrastructure is a constant complaint by manufacturers with any type of production or sales presence in India and is persistently cited as a major impediment to development. Such issues as an unreliable power supply, a faulty communications system, and an inadequate roads system are always cited as examples of this problem. Further, the financial system has been a long-term problem. Many analysts fear that credit constraints arising from a poorly developed banking sector may be holding back small- and medium-sized firm expansion.

And India's growth path remains uncomfortably biased against low-skilled labor. Still onerous labor regulations have allowed for the growth of capital intensive and skill intensive industries at the expense of labor intensive industries, an especially difficult problem for a country with a still relatively low per-capita income and a large labor surplus.[6]

Manufacturing Performance

In spite of considerable domestic economic challenges, the remarkable growth of Indian exports, of which 65 percent are manufactured goods, has catalyzed a relatively impressive performance in Indian manufacturing. Figure 2 shows the acceleration of manufacturing growth since 2001, with notable double-digit gains during 2006 and 2007. While growth slowed during 2008, it remained impressively positive during the early stages of a global downturn that sent manufacturing output in more than a few major countries into a double-digit decline. As shown, capital goods output growth has been especially strong, undoubtedly reflecting the growing share of gross investment in GDP from about 25 percent in 2000 to nearly 38 percent in 2008. Output in the capital goods sector registered annual growth of 9 percent during 2008, although

Figure 2
Annual Growth in Total Manufacturing, Capital Goods Manufacturing, and Consumer Goods Manufacturing in India



Sources: Global Insight and Reserve Bank of India

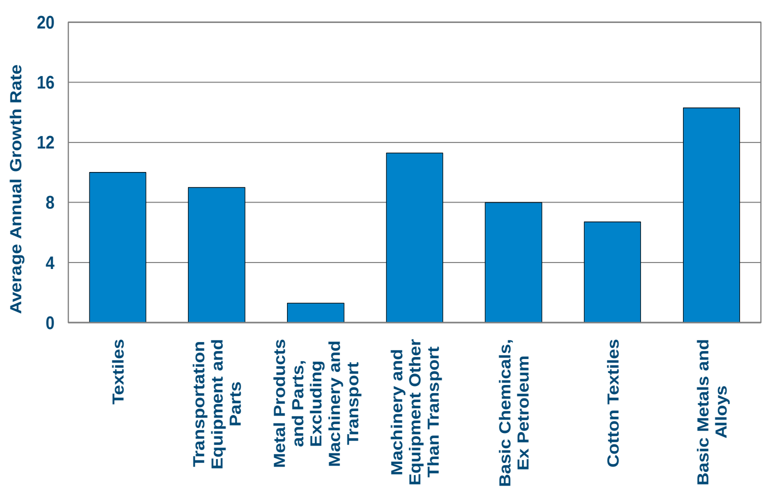
[5] These share data were taken from the Annual Report of the Reserve Bank of India.

[6] For a discussion, see Richard Grabowski, "An Alternative Indian Model?," *Journal of Asian Economics*, Volume 20, Issue 1, pp. 50-61, 2009.

this is significantly slower than the nearly 16 percent average for the 2003-2007 period. Consumer goods output, which enjoyed double-digit annual gains between 2004 and 2006, slowed modestly from 7 percent during 2007 to 6 percent during 2008.

Figure 3 shows average annual growth of broad industry sectors between 2004 and 2008, the most recent five-year period. As shown, most sectors posted moderate to strong growth. The weak link has been metal products and parts, excluding machinery and transport, whose growth since 2003 has been weak and sporadic. The industry sectors with strong growth have been textiles, machinery and equipment, and basic metals. While little empirical work has been conducted to explain differential growth rates among Indian industries, a recent study unsurprisingly showed that dependence on infrastructure, dependence on bank and capital market financing, and high labor intensity in production characterize the industries that perform relatively worse, a pattern that is likely to persist until these policy issues are addressed.[7]

Figure 3
Average Annual Growth of Key Indian Industries: 2004-2008



Sources: Reserve Bank of India, Global Insight, and MAPI Calculations

Conclusions: A Look Ahead for Indian Manufacturing

In spite of impressive recent performance, questions remain about the sustainability of strong Indian manufacturing growth. The strength and breadth of the nascent global economic recovery will first and foremost dictate the outlook for manufacturing in both advanced and emerging markets. But Indian policy makers must think beyond the next cycle of global growth. A report at a New York University summit that addressed Indian manufacturing competitiveness raises questions for the long-term: How will Indian manufacturers fit into global supply chains? How will they impact the relative advantage and disadvantage of different countries as locations for industrial activity?[8]

Particularly for the second question, much depends on policy. While some progress has been made, India's domestic business climate still needs much improvement. According to the World Bank's 2009 "Doing Business in India" report, India ranks 122 out of 181 countries for the ease of doing business.[9] Notable weaknesses are in enforcing contracts, with a rank of 180 and trading across borders, with a rank of 90. The much-discussed problems with infrastructure and still burdensome labor regulations only add to the problematic business climate and are obvious deterrents to accelerated foreign direct investment (FDI) inflows that are needed to sustain robust manufacturing activity. Policies that are fostering a more liberal export climate will benefit manufacturing. But the benefits will be muted if a more supportive domestic business environment is not developed.

India has clearly made a start toward creating an environment for sustained strong growth in industry. Indian policy makers and global manufacturers, however, must realize that sizable challenges remain in infrastructure, finance, regulation, income distribution, and labor surpluses.

[7] Poonam Gupta, et al., "What Constrains Indian Manufacturing?," Indian Council For Research on International Economic Relations, Working Paper No. 211, March 2008.

[8] Globalizing Indian Manufacturing; Competing in Global Manufacturing and Service Networks, a report on the Summit on Indian Manufacturing Competitiveness, April 2007.

[9] For the full report, go to *www.doingbusiness.org*.