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THE EMERGING ECONOMIC ENVIRONMENT

by

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ABSTRACT (within 250 words)

This paper examines the likely developments on the industrial front on the basis of a diagnosis of recent economic developments. Special attention is paid to the possibility of an industrial recession emerging in 1975. The analysis indicates that while a generalised recession is unlikely to develop, the capital goods segment of the industrial sector is likely to be hit as a result of the prevailing economic conditions. Short term measures to deal with the problems posed by such a recession as well as the long term remedies for toning up industrial development have been proposed toward the end of the paper.

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Date 6 January 1975.

Signature of the Author

THE EMERGING ECONOMIC ENVIRONMENT

by

Samuel Paul

What are the chances of a major industrial recession enveloping the Indian economy by 1975? This question is being asked today by a great many people both in industry as well as government even as the impact of the anti-inflationary policies of the Government is being increasingly felt in the different parts of the economic system. Newspapers have reported on the actual and imminent fall in prices in important commodity markets. Cotton textiles, sugar and oilseeds are among the items whose prices are reported to have declined. Open market prices of steel, cement and other industrial raw materials have sagged and their availability has visibly improved over the past few weeks. Orders for machine tools which had reached an all-time high are reported to have started declining. These are the signals which the layman interprets as evidence of an emerging recession. The argument is that the declining prices and accumulation of stocks in some cases are the result of consumer resistance and Government's stiff anti-inflationary policies which in turn must lead to a decline in production.

It is useful at the outset to define what recession means so that semantic problems are minimised. Falling prices by themselves do not imply a recession. Increased supplies and changes in the psychology of consumers, traders, and producers could lead to a declining trend in prices. And, of course, both could have been triggered off by the policy measures of the Government. Nor can it be said that a fall in output necessarily constitutes recession. By this criterion, many segments of the Indian economy must be regarded as having been in the grip of recession for several years. A look at our agricultural and industrial production statistics will reveal numerous cases of stagnant or falling output in the past few years. But if these cases are examined closely, it will be seen that, for the most part, the major factor responsible for stagnation or decline in output was the shortage of critical inputs or what I shall call "supply constraints." The phenomenon of recession, on the other hand, occurs when inadequacy or deficiency of demand rather than constraints on the supply side causes a decline in output in a significant segment of the economy. This distinction is important because the policy prescription for a demand induced recession is quite different from that for a decline in output caused by supply constraints. Thus, it is possible that as a result of the policy of credit squeeze, a decline in production has occurred in certain manufacturing units. When a major shakedown is attempted and commercial banks are not geared to the task of refined credit planning at the enterprise level, it is not surprising that some adverse effects on production occur in the ensuing period of readjustment. But the problem here can be solved by a careful reallocation of credit because there is no deficiency of demand, the constraint being on the supply side. This is not the case in a recessionary situation. If, for instance, the effective demand for machine tools falls, increased availability of

credit may do little to relieve the situation. The answer may have to be sought elsewhere. In 1967, when an industrial recession set in, there was evidence of output falling in the capital goods segment as a result of declining demand. The big question now is whether we are about to witness a repetition of the same phenomenon, perhaps with greater intensity.

Conflicting Signals

Anyone who scans the Indian economic and political scene today will be struck by the mixed and confused signals at work which make it rather difficult to predict the direction the economy is likely to take in the immediate future. Government spokesmen do not agree that the country is on the verge of a serious recession. Most others, especially businessmen, do not share this optimism. The problem is that except for the reports on falling prices and accumulation of stocks in certain industries, no hard evidence or pointers are available on the likely profile of the emerging environment. Let us examine the available signals and indicators and see whether any decisive trends emerge from our analysis.

No one will seriously suggest that the phenomenon of declining output as a result of deficient demand is about to occur in our agricultural sector. The problem here has been one of persistent shortages, a classic case of supply constraints holding back production. In fact, a major challenge facing the government is one of finding an additional seven million tonnes of foodgrains to bridge the supply gap. Industry has also been in the same predicament for the past several years. The real question now is whether the situation is going to change in the industrial sector. The two critical segments of industrial output which get hurt first as a recession sets in are capital goods needed for investment and consumer durables. Consumer goods of an essential and non-durable variety will be the last to get affected in the event of an economy wide slowdown.

What evidence do we have of the developments on the investment front? A number of factors at work in 1973-74 would seem to portend a rising trend in investment intentions in the private sector in spite of the severe inflation and resource squeeze in the economy. Firstly, the number of new investment projects for which licences were issued increased substantially during 1973-74. In fact in the first six months of 1974, nearly twice as many licences were issued as in the same period in 1973. Similarly, capital goods clearances have almost doubled in the first half of 1974 as compared with the same period in 1973. Secondly, the leading term lending institutions (IDBI, IFCI, ICICI) together have achieved a record rise in their sanctions from Rs.296 crores in 1972-73 to Rs.429 crores in 1973-74. This is an important factor since nearly two thirds of the cost of new projects is financed by debt. Thirdly, the industrial sector as a whole has done exceedingly well in the past two or three years. Given the high levels of

profitability reported by many industries, increased investment could be expected to follow. This probably explains why public financial institutions were faced with a growing demand for additional loan assistance.

These are certainly important signals which point to a rise in the planned levels of industrial activity in the economy. It is, however, necessary for us to examine them closely to ensure that they are not false signals. Let us first take a look at the spurt in the licences and capital goods clearances issued. It is well known that the overhauling of the licensing system through the establishment of the Secretariat for Industrial Approvals (SIA) has resulted in a speedy disposal of licence applications since November 1973. In fact, many entrepreneurs and companies who were used to the old and cumbersome system were taken by surprise by the government's improved performance on this front. However, the speedy disposal of cases at the licensing stage is no guarantee that the entrepreneurs will move as fast through the subsequent stages leading up to actual investment especially if new uncertainties emerge in the environment.

Similarly, the impressive in the sanctions of the term lending institutions does not reveal the whole story. In 1973, when the credit squeeze was initiated, commercial banks were forced to give up their function of grating medium term loans to industry. The burden of investment financing thus fell exclusively on the public financial institutions. Meanwhile, the costs of new investment projects have risen in an unprecedented fashion. In industries such as paper, sugar and tyres, to take only a few examples, a new project today costs nearly 100 per cent more than its cost two years ago. A good part of the increased volume of sanctions does not therefore signify a genuine growth in investment. Further, as budgetary difficulties increased, the Government began to push the financing of some of the new public sector and joint sector projects on to the financial institutions. Institutional finance to some extent may therefore have been substituted for budgetary resources. Similarly, the credit squeeze would have caused industry to substitute institutional funds for bank finance. The net increase in real investment reflected in the loan sanctions of term lending institutions will thus be significantly lower than the increase in the monetary value of the sanctions.

The spurt in private investment intentions reflected in the increase in licences and capital goods clearances issued and the expansion in the sanctions by the financial institutions has no doubt been encouraged by the fine recent record of corporate profitability and the optimistic expectations of the industrial sector for the future. But as the inflationary spiral rises, it is becoming increasingly clear that there is a mirage in this phenomenon of profitability. Once an allowance is made for inventory profits and the high replacement costs which will have to be incurred when new investments are made, real profitability is not all that high, or at least will not be high enough to sustain a state of expanding real investment. This realisation is bound to affect the willingness and ability of

the entrepreneur to implement his investment intentions as originally planned. When all these factors are taken into account, it is reasonable to conclude that there is no evidence of a downturn in private investment intentions as of 1974, although the extreme optimism implied in the different signals we have examined is unwarranted to a large extent. What needs to be explored is whether other developments are taking place in the economy which will offset this trend and dampen the private expectations which in turn could lead to a slowing down of the planned level of activity in the industrial sector.

Public memory is short. Not many are likely to recall today the circumstances which led to the industrial recession of 1966-68. There is a clear and terrifying similarity between the conditions which existed in 1966 and 1967 and the current economic situation. During the two years preceding 1967, the country suffered a severe setback in agricultural production, a steep rise in the price level, especially in food articles and industrial raw materials and a reduction in real terms of public investment by Government. It was this constellation of factors which heralded the recession that had severe repurcussions on the capital goods and consumer durable goods segments of the industrial sector during the period 1966-68.

Is the same constellation at work in 1974? The answer, unfortunately, is in the affirmative. Since 1970-71, the agricultural sector has experienced a major decline in output and in spite of the improved production in 1973-74, the overall deficit in food continues to be substantial. As in the mid-sixties, the price level has risen rapidly and is dominated by the phenomenal increase in the prices of food articles and industrial raw materials. The rate of inflation in the past two years has been more spectacular than anything we have witnessed before. In 1973-74 alone, the wholesale price index has risen by 29.5 per cent on top of a 13.6 per cent price rise in 1972-73, whereas the highest annual rate of inflation experienced in the last recession was 15.6 per cent in 1966-67. The deadly combination of a severe agricultural setback and raging inflation which in turn reflects the stagnation in our national income and the failure of the Government to control aggregate expenditure in the economy has been rendered even more vicious by international developments such as the oil crisis and inflation abroad. Faced with an admittedly difficult situation, the Government as in 1965 and 66, has resorted to a reduction of its developmental expenditure in real terms in order to keep its budgetary deficits within limits. Thus, the developmental expenditure of the Government and especially its investment component has gradually declined since 1972. The share of capital formation in the total expenditure of the Central Government was 48.3 per cent in 1964-65. It has been hovering around 30 per cent in the seventies. The <u>Economic Survey</u> of the Government of India for 1973-74 has put it mildly when it stated that public investment in 1973-74 is not expected to be

higher than it was in 1972-73. The fact is that when adjusted for price increases, public investment will in real terms be lower both in 1973-74 and 1974-75 than in 1972-73.

The constellation of an agricultural setback, rampant inflation and reduction in public investment that we observe today in a perfect replica of what was witnessed in 1966 and 1967. But in its scope and intensity, it appears to be a more vicious incarnation of the earlier phenomenon. The Government therefore had no option but to deal with it more firmly. The credit squeeze, fiscal measures to impound part of the incomes of people, pruning of public expenditures and measures against smuggling and black money must be seen in this perspective. It is quite clear that the fall in commodity prices and accumulation of stocks reported in certain industries have resulted from these measures, aided by the consumer resistance built up over time due to a fall in real incomes of the people. To the extent that these measures succeed in curbing excess demand in the system, they should help to bring about price stability, but need not necessarily lead to a recession in the process.

Likely Consequences

The decline in public investment, the pruning of government spending and the inflationary spiral together will tend to reduce the demand for capital goods, and to some extent for a variety of consumer goods, especially of the durable type through the working of the price and income effects. The impact of this development on the industrial sector is likely to manifest itself in the next few months as follows: (1) Private investment intentions which appeared optimistic according to our analysis will get dampened as it becomes clear that the momentum of public investment has slowed down thereby undermining the rationale for a lot of private investment projects. Many private projects are complementary to public sector investments and are dependent on them for their survival. Such private projects will therefore be deliberately delayed, shelved or abandoned. (2) This trend will be reinforced as the Government finds it difficult to provide adequate resources to sustain the momentum of the term lending institutions. New projects will find it difficult to arrange financing since there is no easy alternative to loan capital to which industry has got accustomed during the past several years. (3) Many industries will feel the direct impact of the slow down of public investment. Government restrictions on new building construction have already resulted in a perceptibly reduced demand for cement and steel. Public industrial investment is nearly half of the total industrial investment and any deceleration in it will therefore make a direct and substantial impact on all supplier industries. (4) The combined effect of these three factors will be to progressively reduce the demand for capital goods of all kinds. If timely action is not taken to stem the tide of recession in the capital goods sector, the trouble will certainly spread to other industries too.

(5) Recessionary tendencies in the consumer durable goods sector may not be felt as severely as in the investment sector. Cuts in Government spending are less likely to affect consumption expenditure. The real threat is from inflation itself which has so eroded the real incomes of the masses that more consumer resistance is likely to develop. However, one cannot imagine a situation in which output will have to be curtailed in the area of consumer goods for lack of demand, except temporarily as has happened in the case of textiles.

The threat of recession is therefore real and imminent for the capital goods segment of the industrial sector in spite of the apparently optimistic private investment signals. The recent slackening of orders in the machine tool industry is a pointer in this direction. Not all capital goods industries are likely to be affected simultaneously. During the last recession, it was observed that the recessionary impact on the electrical equipment industry was felt much later than was the case in the machine tool industry. A recent study completed at IIM, Ahmedabad, shows that the total value of the orders for plant and equipment with 27 major machinery manufacturers in the country has gone up in real terms only by 5 per cent in 1973-74 over the preceding year when an increase of over 35 per cent was observed. Although the coverage here is incomplete and the value of orders amounts only to Rs.290 crores, this may well be the signal of a deceleration which has begun in the capital goods sector. The order position was comfortable for most companies in 1973-74. What is striking is that the growth in orders when adjusted for price level changes shows a severe deceleration. While we do not know the progress on the receipt of orders in 1974-75, reports from individual companies indicate concern about a slow down. The orders outstanding with these companies are still quite large and therefore there is no danger of their output declining in 1974. But as the slow down in orders gathers momentum, the consequence will be a fall in production in the subsequent period, the time lag depending upon the complexity of the machinery involved.

To sum up, the vicious combination of the price inflation and decline in public investment that we have witnessed in the past two years and still continues is likely to initiate a recession in the capital goods segment of the industrial sector in 1975. The deceleration will first manifest itself in the form of a slowdown or cancellation of orders and only with a time lag will a decline in output emerge. The impact will also be felt by industries which manufacturer consumer goods of a durable type. There is no evidence at all that a recession will develop in the industries producing essential consumer goods. Even if the prices of some of these items fall as a result of the Government's anti-inflationary measures and consumer resistance, a decline in demand which would warrent a reduction in output is unlikely to develop. Given the steady increase in population and the essential nature of consumer goods like food, drugs, etc., the overall demand for such items will tend to move up. Unless manufacturers adopt restrictive policies or new supply constraints emerge, there is no likelihood of a decline in the output of essential consumer goods industries.

An Action Plan

It will be too late to do anything about a recession if we recognise it only when we are in the middle of the crisis. This is what happened in 1967 when both Government and industry were taken by surprise as the recession set in leaving little time to think and plan for remedial action. This time, the same error need not be repeated if Government and industry are willing to take note of the signals ahead and take action before the crisis deepens. It is in this context that the following proposals for action are being suggested.

(1) Trends in public and private investment cannot be reversed all of a sudden. In the short run, therefore, an all out effort to secure orders for the export of plant and equipment should be made. Government should facilitate Indian turn-key projects and joint ventures abroad through which our exports can be stepped up. Exports today account for only a negligible part of the production of machinery manufacturers. With the onset of recessionary trends in the developing countries, competition should be expected to get stiffer in international markets. On the other hand, we have a competitive edge in view of the labour intensive nature of fabrication work. Exports could make up for some of the slack that may result from a fall in the domestic demand for capital goods.

(2) While little could be done to step up public investment in the short run, Government should keep itself ready with a shelf of projects in all important areas so that as the availability of scarce raw materials improves and prices stabilise, action could be initiated on projects on a selective basis without much delay. To illustrate, if the availability of building materials eases significantly, Government should be able to lift its ban on new construction partially and take advantage of the recession to step up public and private construction selectively. Fine tuning in these matters is indeed difficult and it is only on the basis of a careful monitoring of the trends in the prices and availability of critical materials that timely decisions could be taken to step up expenditure.

(3) Government has rightly decided to conserve its scarce resources for investment in core industries which are critical to the economy. If, however, the public financial institutions are starved of resources in 1975, private investment in such industries will dry up. It is important, therefore, that the resources of term lending institutions are augmented with strict guidelines for the choice of industries and projects to be financed.

(4) The existing system of raw material allocations for industry and other users has been a millstone around the country's neck and a major source of shortages, corruption, economic distortions and inefficiency. Taking advantage of the emerging recession, this system should be scrapped. The only exception should be where imports are involved and even here, alternative ways of dealing with the problem should be thought of. With the progressive relaxation of price controls, it should be left to enter-

prises to compete for their indigenous raw materials. It is strange that in our country, we have elaborate systems for the allocation of steel, cement, cars and other items needed by organised groups, but no system to ensure that the common man gets a minimum of food, cloth and other essential goods. Since the Government's administrative resources are limited, should not its first priority be to establish a viable public distribution system for the masses at least in all vulnerable areas? It is reported that nearly a third of the small scale units which is a protected group under our control system are bogus units which thrive on trading in scarce inputs. There is no economic or social justification for controls which perpetuate shortages and inequity in the total economy.

(5) Apart from the credit squeeze, a major factor which has made an apparent impact on rising prices is the offensive against smuggling. This healthy trend will not last unless the pressure is kept up against all operations involving black money. What is needed is a shake-down of the whole gamut of these activities in which people in politics, business and Government are all mixed up. The present lull in foodgrains prices should not deceive anyone into the belief that the outlook for food supply is going to turn bright in the near future. Given the domestic demand-supply gap and the difficult international situation, a good deal of tight rope walking will be required in 1975. An active offensive against speculation, hoarding and related operations should be part of our conscious strategy for averting a catastrophe next year.

Long term Tasks

One of the depressing features of our industrial scene is the relatively slow growth of industrial output in the past decade and the virtual stagnation of the past three years. We have a highly diversified industrial base and a great wealth of technological and managerial talent which remain unutilised. This chronic imbalance between the creation of capacities and their utilisation is a characteristic of underdevelopment and many other poor countries have the same experience. In addition to dealing with an immediate crisis such as a recession, it is important that we address ourselves to the long term task of raising the level of our industrial performance. Some areas for action on this front are summarised below:

(1) When industrial output statistics are disaggregated, it becomes quite clear that the slowest growing segment of the industrial sector in the past decade has been those industries which depend on agriculture for their raw materials. The RBI input-based index of production shows that agro-based industries accounted for a weight of 44 per cent in the total. This group's growth rate has been about half of the total sectoral growth rate. A sizable improvement in the growth of the industrial sector cannot take place unless there is a significant productivity increase in agricultural crops such as cotton, sugarcane and oilseeds. Since extending the

land under commercial crops does not appear feasible, technological break-throughs, irrigation and other inputs seem to be the only answer to this bottleneck. The interdependence between agriculture and industry in India is such that not much progress is feasible in one without the other moving up.

(2) Supply constraints for other industries have been contributed by the inadequate growth and imbalances in basic industries such as steel and coal and infrastructure facilities such as power and rail transport. It is a sad commentary on our total system that those industries which were accorded high priority and regarded as the key to growth were precisely the ones which stagnated and held back the growth of other industries and sectors. Much of the phenomenon of underutilisation that characterises Indian industry could be traced to the problems of these key industries and infrastructure projects. The problem here is not one of lack of investment, but of getting organised to deliver the goods and to perform as has been demonstrated by some of our heavy industries. The political determination that mounted the offensive against smuggling and black money must now be directed towards a shake-down in our key industries with a view to improving their performance.

(3) Part of our problem is that we have tolerated the development of all kinds of industries in the name of import substitution and without regard to their future maintenance requirements. The heavy or basic industry thesis has further contributed to this trend, by creating pressures for starting industries of all kinds to use the raw materials of these basic industries. Seldom is it realised that many industries thus brought about have no justification if we were to consider the needs of the masses seriously. Thus, the availability of steel or petrochemicals could easily create compulsions to start inessential or luxury industries which would not have been permitted if the required inputs had to be imported. Given our scarce resources and concern for income distribution, it is high time that we banned the manufacture of specified non-essential products except for export if there is scope. Public speeches and exhortation to stop luxury goods production will be of little avail as long as these goods are not defined and decisive action is not taken to prevent their production. In fact, the basic control we need is at the stage of investment when long term commitment of resources is made. If the Government is permissive at that stage, it is difficult later on to bring about a desired pattern of production through other kinds of detailed controls on raw materials, credit, output, prices, etc. The most misunderstood and misused term today is "priorities" which mean different things to different parts and people in Government with no central authority willing and able to define it as a basis for action by the various agencies concerned with industrial development including banks and term lending institutions.

(4) To improve the rate of industrial growth, it is not essential that a great deal of new investment should take place immediately. Certainly, investment must be stepped up in areas where existing capacities are inadequate and long gestation periods are involved so that creation of capacity well ahead of demand takes place as in major infrastructure industries such as power. In many other industries whose capacities remain idle half the time, the standard answer of investment is not so relevant. Most of our fiscal incentives and other policy aids are designed to encourage investment and not output. Many companies do quite well financially in spite of their low levels of output because of all these incentives and the facility of low volume-high price policies. Perhaps among the measures being considered by the Government to improve capacity utilisation, the question of introducing incentives for increased production and multi-shift working in high priority industries through devices like excise rebates for increased output beyond the first shift, may also be examined. Obviously, such incentives will pull industry towards better utilisation and away from inertia and the standard low volume-high margin psychology, only if supply constraints are removed simultaneously.