A Curious Recession

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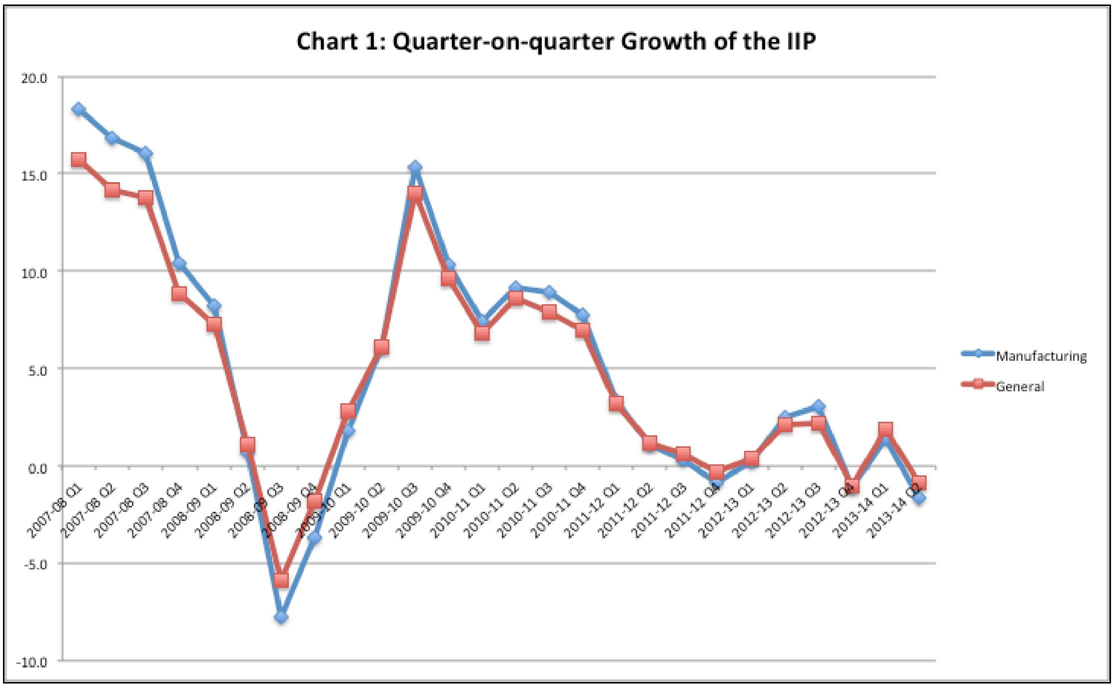
India's organised industrial sector, especially its manufacturing segment, seems mired in a recession. The provisional indices of industrial production (IIP) for February 2014 recently released by the CSO suggest that over the first 11 months (April-February) of financial year 2013-14, the overall IIP fell by 0.1 per cent and that for manufacturing by 0.7 per cent, relative to the corresponding period of the previous financial year. Moreover, the increase in the monthly indices of manufacturing production relative to the corresponding month of the previous year was negative in 7 of the first 11 months of financial 2013-14 and nil in one.

Not surprisingly, the quarterly figures indicate that manufacturing growth has been negative in the first and third quarters of 2013-14 (Chart 1). One definition of a recession adopted by many analysts requires the rate of growth to be negative for two or more consecutive quarters. Others adopt a broader definition and use the term to refer to a decline in industrial sales and production over many months. That does seem to be the case in India in recent times.

But the real cause for worry is the medium term trend in industrial production. As Chart 1 shows, quarter-on-quarter growth rates of the IIP, which were ruling high before 2008-09 collapsed that year, influenced clearly by the spill-over effects of the financial crisis and recession in the developed countries. There are two ways in which the global crisis could have affected Indian industry. First, through the direct effect on exports of the global contraction. And second, through the reduction in credit-financed domestic demand, because of the liquidity squeeze precipitated by the exodus of foreign investors needing to take their capital back to meet commitments at home. Given the overwhelming influence of domestic demand on industrial growth in India, the second was likely to have been more important than the first.



However, Indian industry experienced a smart recovery in 2009-10, winning the country accolades from domestic and external analysts for its 'resilience'. The recovery was driven, it appeared, by the government's stimulus in the form of additional spending and some tax benefits adopted in response to the crisis, and by the return of foreign investors armed with the cheap liquidity that had been pumped into the financial sectors of the developed countries to counter the crisis. The government's stimulus response in India was not as significant as in China, say. Yet, it did matter much. But the sharpness of the recovery suggests that it was also attributable to the return to an easy money situation in India facilitated by the reversal of the capital outflow and the restoration of large annual inflows.

Unfortunately, the government's inability to mobilise resources to finance the stimulus, its own commitment to neoliberal fiscal reform in the form of a lower fiscal deficit, and the relatively high level of consumer price inflation in the country, resulted in its unwinding the stimulus effort rather quickly. What is remarkable is that the slowdown that this possibly triggered has been followed by a continuous deceleration in industrial growth leading to the near stagnation and recession since the third quarter of 2011-12. 'Remarkable' because this was a period in which foreign capital flows into the Indian economy have been substantial. The indirect role of these inflows, which injected the liquidity that resulted in a huge expansion of credit-financed consumption and investment demand, in driving the boom during 2003-04 to 2007-08 is well known. In fact, these were years when the government's success in reining in its fiscal deficit substantially reduced the stimulus to industrial growth provided by debt-financed public expenditure. So the increase in the ratio of scheduled commercial bank debt to GDP from around 20 per cent to more than 50 per cent was crucial to sustain demand and industrial growth.

Hence, one implication of the medium term deceleration in industrial growth and the onset of a recession of sorts, at a time when foreign capital inflows have been substantial, is that the translation of the resulting liquidity into credit-financed demand has been much less effective recently. There could be a number of reasons for this, among which three are likely to be important. The first is that the huge expansion in credit, which was made possible by a corresponding expansion of the universe of borrowers, seems to have resulted in a debt overhang in the household sector that is limiting credit offtake. The second is that the policy of the Reserve Bank of India of keeping interest rates high in its unsuccessful attempt to combat inflation, could be further discouraging potential borrowers worried about their ability to service additional debt. And, finally, the banks themselves, faced with actual and potential defaults in both the infrastructural sector to which they had lent hugely and in the retail segment (involving loans for housing and purchases of automobiles), are reportedly trying to limit increases in their exposure to these markets. In the event, both the demand for and the availability of credit has been negatively impacted, with attendant adverse effects on demand and industrial growth.

This possibly explains the incongruous coexistence of large capital inflows and an exuberant capital market, on the one hand, with a recession in the industrial sector, on the other.

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