Capital Goods Conundrum*

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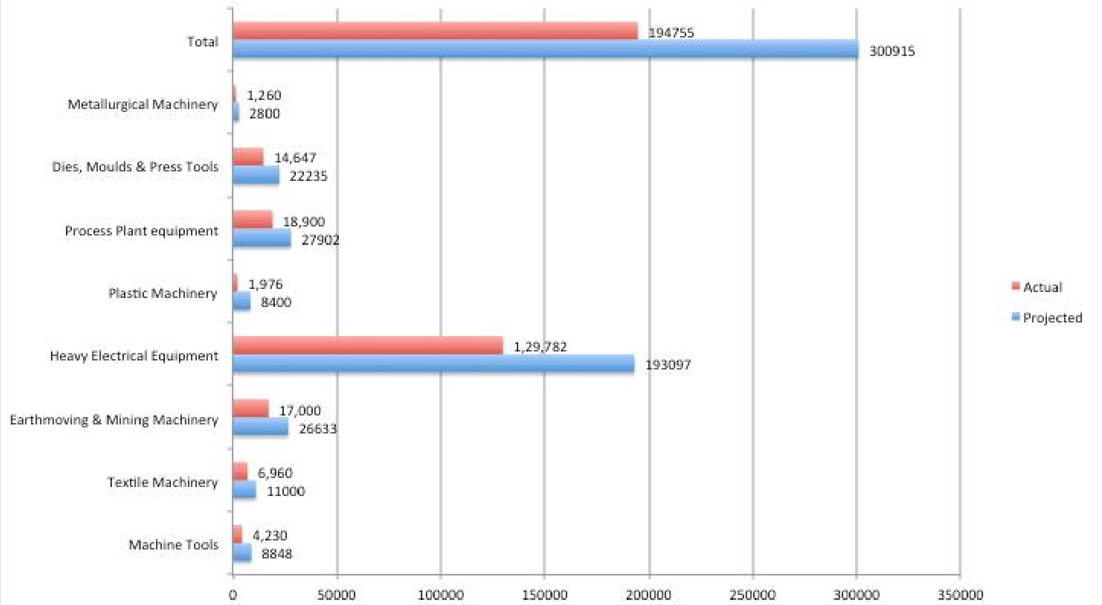
The Narendra Modi government's "Make in India" campaign seems to recognise the role of a strong capital goods sector in expanding the size of the manufacturing sector and its share in GDP. However, the official site for the campaign is overly self-congratulatory on the achievement in this area. Asserting that today the "Capital Goods sector is a robust, multi-level, diversified segment of the Indian industry environment, playing a critical role in driving growth, creating jobs, and boosting exports," it attributes that status to the steps undertaken during the economic reforms period which had a "huge positive impact on the overall manufacturing scenario including the Capital Goods sector in India."

Chart 1: Capital Goods Production 2014-15: Projected and Actual (Rs. Crore)

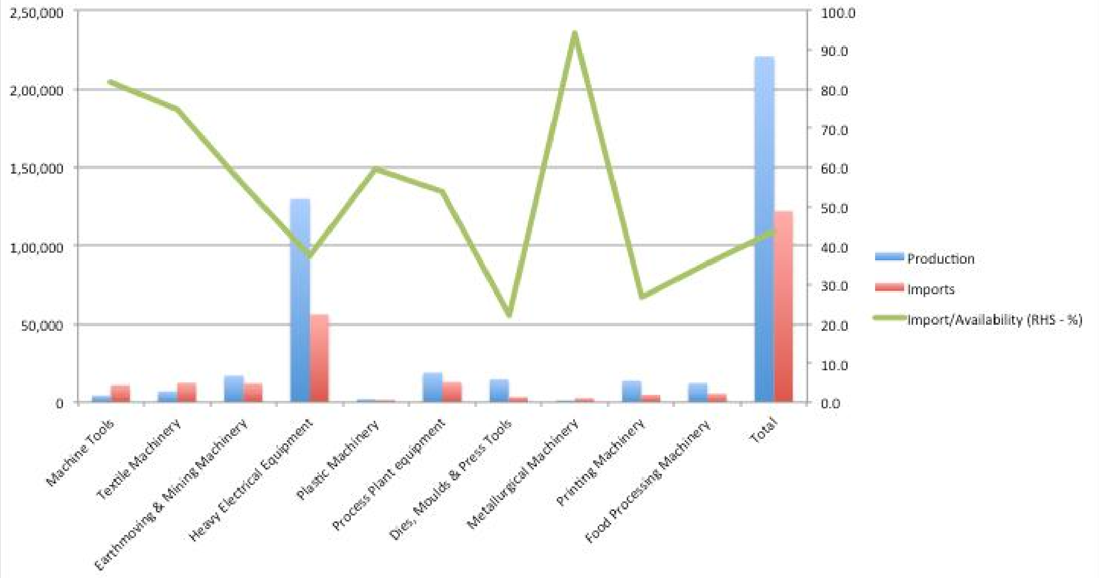


In complete contradiction to this position, the Draft National Policy on Capital Goods released by the Department of Heavy Industry last month, argues that while India's capital goods sector is large, its growth has been lagging. This difference between status and trend is not surprising. It has long been known that, despite its adverse effects in areas such as agriculture, the bias in India's post-1956 industrial policy in favour of domestic production of capital goods in general and machine tools in particular, created a strong capital goods sector. But that growth could not be sustained because the protection and support provided to the sector proved incomplete, and because the public investment that supported the growth of this sector from the demand and supply sides was not sustained. Instead of correcting for this, policy since the 1980s began dismantling the structure of import protection and public sector involvement, leading to a weaken of the domestic industry and a growing presence of imports and foreign firm production in the area.

With the intensification of such tendencies, the trajectory of the industry has changed considerably in recent years. The Draft Policy points to three disturbing consequences of that trajectory. One is the inadequate growth of the domestic market for capital goods. The second is a falling share of domestic production in total domestic consumption, with imports growing at 15 per cent over the 5 years ending 2014-15, as compared with a 7.2 per cent growth in domestic production, leading to substantial underutilization of domestic capacity and a slow down in domestic capacity creation. And the third is India's failure to make a mark in the global market for capital goods, with its share in global exports placed at less than one per cent.

In fact, a comparison of the projections of the erstwhile Planning Commission's Working Group on the capital goods sector for the XIIth Plan with actual production figures (Chart 1) points to a shortfall of 35 per cent in the 2014-15 output of key capital goods sectors relative to even official expectations. The shortfall in individual sectors varied from a low of 32 per cent in Process Plant Equipment to as much as 77 per cent in Plastic Machinery. This was in large part due to the failure of Indian producers to outcompete their foreign rivals in a liberalized market. The ratio of imports to domestic availability or consumption (defined as domestic production plus imports minus exports, but ignoring changes in stock, if any) averaged 44 per cent (Chart 2), with the figures varying from 27 per cent in Printing Machinery to as much as 75 per cent in Textile Machinery and 82 per cent in Machine Tools.

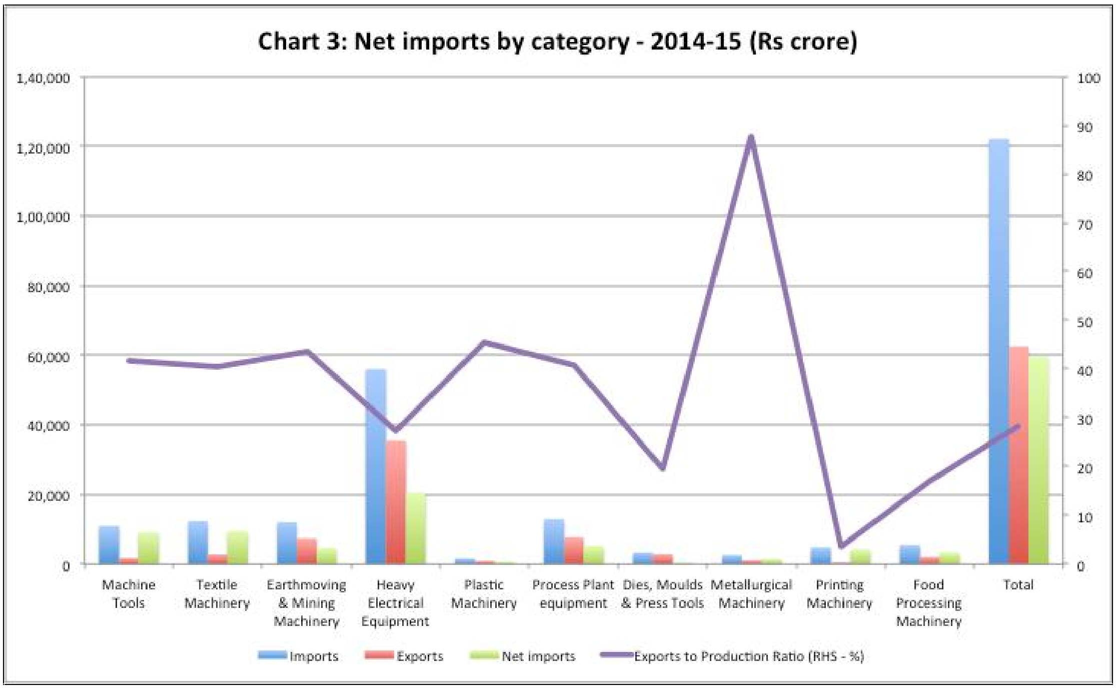
Chart 2: Production, Imports and Import-Availability ratio 2014-15 (Rs Cr and %)



Besides failures in downstream sectors, such as inadequate capacity expansion in infrastructure and power industries, and institutional issues such as inadequate inter-ministerial coordination, the draft policy identifies a set of policy failures with respect to capital goods that explains the low rate of expansion and high level of underutilization of capacity in the domestic industry. Among the specific policy inadequacies mentioned are the following: (i) contractual clauses in public procurement policy that inhibit domestic production and have a "limited positive bias" in favour of domestic value addition; (ii) permission to import second-hand machinery that hurts domestic production, with such imports amounting to 15 to 20 per cent of the latter; (iii) the provision of a zero import duty concession for several items imported under the "project imports" category, which places domestic producers at a disadvantage; (iv) trade agreements with several countries who have a comparative advantage over India in capital goods production, as opposed to those with respect to which India has strong export potential; and (v) a “skewed tax and duty structure” that adversely affects the cost structure and competitiveness of the industry. The last of these is illustrated with telling examples of the “inverted duty structure still prevalent” (with import duty on finished products being lower than on raw materials and components) in areas such as boilers, turbines and electric transformers.

In sum, inadequate support for domestic production and a damaging import policy are seen as important influences on domestic production, when viewed in comparison with similar policies in other competing countries, including many in Asia that have emerged as significant exporters to global markets. In addition, “low technology depth”is seen to be a critical problem with current levels ranging “from basic to intermediate”, “indicating limited ability in fundamental research on materials and components and low absorption of product technologies.” This too is seen as the result of policy failure, with R&D spend in India, at 0.9 per cent of GDP, ranked 30th worldwide and low compared to countries like South Korea and Japan. This together with a fragmented industry populated with many small units operating uneconomic scale capacities makes India uncompetitive. So though exports are growing, net exports are negative, with production geared to domestic markets in most industries (Chart 3).

Overall, this diagnosis of the factors explaining the relative poor performance of the capital goods sector in India, points to the need for correction of biases against domestic production in prevailing policy and enhanced intervention by the government. The policies recommended in Chapter 6 of the draft policy document are a detailed elaboration of the kind of interventions needed in this context. If adopted, they can have a stimulating effect on the growth of the domestic industry.



However, this is not the policy direction recommended by the Make in India campaign website, contrary to its own title. It celebrates the ostensibly “strong supportive architecture" set up under the liberalized industrial policy regime, which "helps companies strategize for meeting the domestic and export demand for Capital Goods." The policies that are seen to have contributed to this include, the opening up of almost all sectors for participation by the private sector, including foreign investors, with 100 per cent FDI permitted under the automatic approval route; the lowering of tariffs on capital goods and equipment to nil or 5 per cent; and the decision to enter into a number of free trade agreements with ASEAN, Japan, Korea, Malaysia, Singapore, and others. Such policies being in contradiction to what the draft national policy from the Department of Heavy Industry recommends, it is unclear in which direction the government would move. Since the latter draft justifies its recommendations with a strong analysis of actual industry trends it clearly is the one that should be favoured. But given the hype surrounding the Make in India "mission", that is unlikely to be the case in practice.

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