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Stagnant sector: Manufacturing drag on growth

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Coupled with downside risks from Omicron, monetary tightening in the West, supply bottlenecks, the 9.5% GDP growth estimate is in question

Although Covid-related restrictions on economic activity have been substantially relaxed, stagnant manufacturing sector output is a matter of concern. The expansion of GVA (gross value-added) in the manufacturing sector during the second quarter was the lowest among secondary and services sectors at just 5.5%. As compared to the pre-pandemic level, it was just 3.9%. The performance of the sector in the two months of the third quarter too does not infuse much confidence.

The growth of industrial production in October was at 3.2%, an eight-month low. It is not only that the growth was unimpressive, but it was virtually stagnant at the previous month's growth of 3.3%. The output of the eight core industries comprising coal, crude oil, natural gas, refinery products, fertilisers, steel, cement and electricity actually recorded an increase of 7.5% over October 2020, which implies that the contraction has come about mainly in the consumer goods industry. In fact, the weight of the eight core industries in the Index of Industrial Production (IIP) is 40.27%, which means that contraction in other industries must have been really steep.

The stagnancy in industrial production growth has come about mainly from the automobiles and transport equipment segment. The production of motor vehicles, trailers, and other transport equipment declined by 12.6% in October, on top of the 9% contraction in the previous month. The manufacture of other transport equipment contracted by 15.6% in October, as against 18.5% in the previous month. The manufacture of consumer durables declined by 6.1% as compared to 1.9% last year, and the contraction in the output of capital goods was 1.1%, as compared to the growth of 2.4% in September.

The major reason for the contraction in manufacturing was supply-side constraints. In fact, the cheer of festive season demand was severely dampened by the contraction in the manufacturing output due to coal shortage, power cuts, an increase in raw material prices and more importantly, the non-availability of semiconductors.

According to the Society of Indian Automobile Manufacturers (SIAM), the passenger vehicle despatches in October dropped by 27% (year-on-year) from 3,10,694 units last year to 2,26,353 this year. This is compounded by the 18% fall in despatches in November as compared to the sales in the period last year.

Thus, it is not the lack of demand which is the source of the problem but the shortage of semiconductors. The problem is not likely to ease soon as there are no easy or fast solutions. The industry relies on the import of semiconductors, and there is a severe global supply shortage. The excess demand due to reduced manufacturing is stretching the delivery period, with many turning to buying used vehicles.

In all possibility, the November estimate of IIP may fare worse. While the supply shortage of semiconductors has continued, unseasonal rains have caused problems in the transportation of coal, affecting not merely coal production but also the generation of power, and these have impacted the production of steel and cement. The power disruptions must have impacted the production of other consumer goods industries as well. The actual position will be known only when the core industries' output and IIP are available later in the month.

These problems will adversely affect the output growth of industry in general and the manufacturing sector in particular in the third and fourth quarters. With the contact-intensive sectors, particularly travel, trade, hotels, transport and communication sectors, still to open up fully and the real estate sector still suffering from inertia, the services sector, too, may not register high growth unless government spending is increased substantially.

Besides, there are downside risks arising from the spread of new variants of the virus, the impact of draining out liquidity by the advanced countries, including the US Fed, elevated international crude oil prices, and global supply bottlenecks.

These developments could pose difficulties in achieving the growth of 6.6% in the third quarter and 6% in the fourth quarter assumed by the Monetary Policy Committee of the RBI, and that would mean that the feasibility of the economy growing at the 9.5% estimated for the whole year is in question.

The coal supply and power situation would improve but the shortage of semiconductors cannot be overcome any time soon. Immediately augmenting domestic supply to ease the constraints is not feasible and attempts to augment imports may not be easy. As there is a significant global supply shortage, the imports will be at significantly higher prices.

The only short-term remedy to accelerate growth seems to be to increase public spending by both the Union and state governments. This would help revive government consumption and capital formation as other growth engines, namely private final consumption, will continue to be in slow motion and capital formation from the private sector is yet to take off.

However, the lack of fiscal space constrains loosening of the public purse. The higher buoyancy in tax revenues and additional dividend from RBI is expected to exceed the budget estimate by Rs 1.7 lakh crore at the Centre. The Centre has also placed a supplementary demand for grants amounting to Rs 3 lakh crore. This implies that the revenue and fiscal deficit may increase when the actual numbers come out, unless the budgeted disinvestment proceeds of Rs 1.75 lakh crore are realised.

At the state level, too, there would be higher revenues from the states' own tax revenues due to better buoyancy of GST and VAT on petroleum products as well as shared taxes from the Centre. However, it is customary for state governments to show lower fiscal deficit in the budget estimate, and considering the additional expenditure incurred during the second wave of the pandemic and the additional spending they had to incur to strengthen the health infrastructure, it may be difficult to adhere to the budgeted revenue deficit of 0.5% of GDP and fiscal deficit of 3.7%. Thus, the economic revival process is not likely to be smooth, the challenges to accelerating growth are formidable.