Economic reforms bankrupting capital goods sector in India

by Ramtanu Maitra and Susan Maitra

One of the fundamental differences between the fast-growing Southeast Asian nations and the stodgy Indian economy was that while India had developed indigenous manufacturing capabilities over the years, the Southeast Asian nations were making money off money or through "screwdriver" technologies imported from abroad. Though flawed and technologically vastly inept, this manufacturing capability gave India the long-term edge, at least potentially, over faster-moving neighbors. But, this capability has now come under intense pressure with the increasing "globalization" of the Indian economy. The capital goods sector, the backbone of India's efforts to build the nation following the end of the British Raj, is in deep turmoil as cheap imports of new and used machinery are choking off the much-touted prospect of modernization and growth of this sector. "Most of us [manufacturers of capital goods] will not make any investments to expand or modernize our units if this situation continues," a captain of industry recently warned.

The increased flow of imported machinery could not have begun at a worse time. Already the industrial sector, particularly the manufacturing sector, has been undergoing a severe recession for more than three years. High interest rates, slashing of development budgets by the economic reformers, and suddenly exposing Indian manufacturers to technologically advanced foreign competitors are the principal reasons. In addition, the deep recession in the West, which has enhanced availability of new and used machinery at a lower cost, has brought further woes to local manufacturers. In the third quarter of this fiscal year, the manufacturing sector grew at a rate of a measly 0.6% over the previous year's growth in the corresponding period. If this trend continues, the annual growth rate of the manufacturing sector will be close to 1%, a growth rate India can hardly afford. Faced with the Darwinian socialism which seems to be the mind-set of many in the Finance Ministry, major manufacturers such as ABB, Larsen and Toubro, Triveni Engineering Works, Godrej and Boyce, Lakshmi Machine Works, Usha Telehoist, Bharat Frit Werner, Alfa Laval, Walchand Industries, MOI Engineering, and Frick India Ltd., have written to the premier industry organization, the Confederation of Indian Industry, for immediate government intervention.

It has also been reported that a leading engineering company has already lost orders worth 6 billion rupees in the fertilizer and refinery sector as clients have opted for imported machinery and is apprehensive of losing orders of similar size from new projects. There are also reports of textile machinery manufacturers who are losing orders against this onslaught of imported machineries, old and new.

The avalanche began when the government changed its export promotion capital goods (EPCG) regulations on April 1, 1992. The new EPCG permitted import of capital goods at a concessional duty of 15% and the export obligation was stipulated at four times the cost, insurance, and freight (CIF) value of imports. The period allowed to discharge the export obligation is five years, which counts from the date of the issue of the EPCG. The ostensible reason behind the change in the EPCG, which reduced the concessional rate of customs duty from 25 to 15%, was to encourage exports of manufactured products. It was argued that with the help of more advanced machinery, Indian manufacturers who are committed to export will stand a better chance in the global competition and reduce India's perennial trade imbalances. No matter what the argument, the fact was that it put pressure on existing manufacturing facilities at a time when investors were shying away from fresh investments and the flow of fresh orders were few and far between. The hard-core backers of the economic reforms argued, again without apparent concern about the on-the-ground realities, that to become competitive and strong, Indian manufacturing industries have to face foreign competition, and the stark realities of this competition will force these industrialists to pull themselves up by their shoelaces and modernize their plants.

Cheaper imports

Armed with such arguments, Indian Finance Minister Dr. Manmohan Singh brought down the tariff ceilings on finished capital goods to between 0 and 35%. Furthermore, imported capital goods are not subjected to countervailing duties, whereas domestic products attract excise duties and sales tax. As a result, the manufacturers of capital goods are confused and hurt. They are questioning the government's much-professed statements that Indian industries must improve their performance. If that statement is sincere, the manufacturers ask, why has the government clamped a 70-

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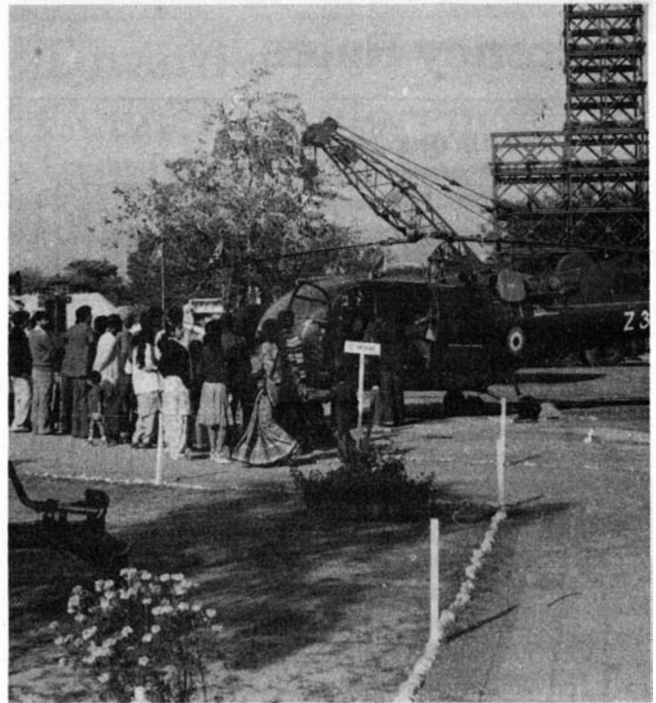
85% tariff on raw materials required for capital goods and 40-50% on various components? Moreover, if the government's high principles dictate that Indian industries must improve their competitiveness in the global market, why, then, does the EPCG allow importation of used machinery which is, by definition, less efficient and technologically inferior? So far, the government has not answered these thorny questions, and the grave silence that prevails indicates that the anomalies in the tariff structure, for whatever reason they were imposed, have been taken note of.

Quicksand

There is no question that the economic reform has run into serious trouble once the minor objective of having a comfortable foreign exchange reserves position has been attained. The more important issue of improving the health of the economy—in other words, to improve the infrastructural capabilities, to modernize industries, to improve agricultural productivity and to improve the living conditions of hundreds of millions—is yet to be tackled. The reformers continue to harp that if India's creditworthiness improves, India can modernize its industrial and agricultural sectors. However, what we are seeing at the moment is the growing fear that increased foreign exchange reserves may give a boost to inflation, and this fear itself is preventing the lowering of interest rates that the investors demand. There are indications that the government, fearing higher inflation caused by the growing foreign exchange reserves, will be willing to allow some foreign exchange to remain parked abroad. Also, a new line of thinking advocates paying off the International Monetary Fund-World Bank loans in advance. In addition, the government is doing its best, by selling billions of dollars, to keep the rupee weak and thus enhance exports.

The anomalies exist not only in the present tariff structure, but also within the entire economy. The slashing of the developmental budget has given rise to, among other things, recession in industrial activities. As a result, industry has begun to decay and the issue of modernization is now a mere dream for some; the slowing down of industry has cut down on the orders placed to the manufacturing sector and this, in effect, has brought about reduced bulk freight in the railroads, causing the railroads to suffer increased losses; the lack of modernization has made industry even more uncompetitive, allowing imports to be even more attractive; lowering of tariffs has opened the floodgates to the EPCG, but lowered tariffs and the slowing down of industrial activities have reduced government revenues.

In order to reduce the deficit of an even more austere budget in the offing, the government is passing the buck to certain sectors, causing further anomalies. For instance, the petrochemical sector, a heavily capital-intensive sector, is in the same predicament as the capital goods sector. Besides the dumping of various chemical products by foreign manufacturers, an offense against which the government is ill-equipped to fight, the petrochemical industry in India has been made more inefficient because of bad policies. As an economic journalist in *The Hindu* pointed out recently, the Indian petrochemical industry was heavily protected for the past three decades through import bans and high tariffs. In 1993, tariffs were brought down from 150% to 85%. However, the actual duty on finished products ranges from 45 to 75%. The lower tariffs have increased imports and cut heavily into industry's profits.



An industrial fair in New Delhi in 1980. Now economic reforms which make India's exports unattractive threaten the country's industries.

While the reformers point out that industry should be able to cope with the tariff barrier that exists, the fact remains that industry has to pay far higher prices for its raw materials and intermediaries than its foreign competitors. For instance, the present administered price of naphtha, the feedstock for petrochemical products, is $215 per ton. This is not only some 50% higher than the international price as of the end of December, but some $15 more than the average price of naphtha over the past 20 years. This is all happening at a time when petrochemical prices are at their lowest in two decades internationally.

While it is obvious that the government is making a "killing" by selling Indian manufacturers feedstock at such a high price, since other sources of revenue have nosedived thanks to reforms-related policies, the process is killing off the petrochemical manufacturers fast and sure. There is now talk of reducing the tariff further, and this has created a panic within the industry.