Industrial Recovery: Is It Sustainable?

India Inc. showed a strong performance in the fiscal year 2002-03 and continued the tempo through the first quarter of 2003-04. While this is a reason to celebrate, many doubts linger about the sustainability of this trend and also the factors behind this performance. Perhaps, many internal and external factors have contributed to this success. In this debate we focus on these issues.

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❑ On the End of the Slowdown

Dr. Subhajit Bhattacharyya: In general, we have been facing one crisis after another during the last few years, some of which are made by us, the others forced on us. However, the recent improvements in corporate performances are certainly the most welcome ones. This performance can be sustained for a longer-term if the market becomes broad-based. In fact, in a recent marketing summit in Delhi, the corporate leaders have recognized that broadening their marketing base to the rural areas helped them raising toplines significantly. Apart from the urban sector, it is the rural purchasing power that would determine the demand for industrial goods as well. One should not forget that the rural India represents 70% of our population, most of whom earn a living on agriculture. Unfortunately, not much is done to improve the condition of the rural masses. Notwithstanding the tremendous success of green revolution, our agriculture is still very much dependent on monsoon because of insufficient irrigation facilities, outdated technologies and insufficient use of agrochemicals. So, a bad monsoon would mean a bad agricultural season thereby impacting adversely the demand for industrial goods. Thus, in a way, our industry too depends so much crucially on monsoon.

Dr. B B Bhattacharya: The current recovery is short-term. It is the result of positive expectation of good monsoon. For long-term recovery, there has to be a rise in investment, especially in infrastructure, improvement in productivity and sustained increase in demand, not one shot impact of a good monsoon.

Prof. Rakesh Singh: Is the tide turning? Are Indian companies finally showing some sign of getting their acts together? This is a difficult question to answer. Growth in a quarter cannot help answer this question unless it is sustained over the next quarters in the year. But there are certain trends in the economy which Indian companies have incorporated in their business strategies and are reaping the benefits. They have accepted the changing environment of business. The environment where demand has become dynamic and market space highly competitive.

Dr. Suma Damodaran: Lower interest rates, global recovery leading to growth in exports, and low inflation have been the

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catalysts for the industrial recovery as indicated by the performance of the manufacturing sector. While it is relieving to see Indian corporates being buoyant and reacting quickly to the revival in industrial demand showing booming profits, the euphoria may not last long because each of the above catalysts may disappear soon. Low interest rate regime can be continued only if inflation is contained below the threshold level of 5%. With the rising international oil prices, this is going to be difficult. The first victim of the anticipated rise in inflation is going to be interest rates and this would put the brakes on the boom. When inflation becomes a factor to reckon with, a measure such as a boost in spending to sustain the recovery cannot be resorted to. The third catalyst, exports, is certainly going to face a setback with the appreciation of the rupee. So all in all, the present boom is going to be short lived.

A disaggregated analysis of the performance of the manufacturing sector reveals that 99% of the growth in manufacturing sector is accounted for by six sectors constituting 49% of the weightage in the manufacturing sectors. These six sectors are food products, transport equipment (grew at a rate of 24%), beverages and tobacco, basic chemicals, metal products and, textiles. Machinery and equipment registered a negative growth during late 2002 and a growth of 0.5% during the first seven months of 2003. A very important factor that can sustain the boom over a long period of time is high and growing investment activity, the performance of which has been disappointing. According to a report of NCAER, investment level was stagnant between 2001 and 2002 (as also indicated by he dismal performance of the Machinery and Equipment Industry). With this stagnation in the most crucial economic activity, the challenge faced by the policy makers is one of putting the economy firmly on the path of long-term growth.

Low interest rate regime can be continued only if inflation is contained below the threshold level of 5%

❑ Corporate Efforts for Growth

Dr. Subhajit Bhattacharyya: In general, a greater customer focus and broadening marketing base are the two important factors behind the growth of sales of some of the companies. This apart, various cost-cutting measures undertaken by the corporate over the last few years seems to have started paying off. Moreover, a significant fall in the rate of interest of late also has helped reduce the interest cost of the companies.

Dr. B B Bhattacharya: After globalization and liberalization, companies with better technology and productivity have performed better. Older industries with obsolete machines and poor labor productivity have performed poorly.

Prof. Rakesh Singh: In the last few years' Indian companies have relentlessly cut costs, reduced working capital overheads, and built in enough flexibility. Firms have adopted more streamline supply chain management practices, which have not only helped them to reduce costs but to also create an in-built flexibility on just-in-time basis. Firms are trying to use market information to align all their activity, resulting in decline in both logistics cost as well cost of holding inventories. Successful firms have been able to lessen their inventory holding, reduce production lead times as well as delivery lead-time. According to *The Economic Times* (ET) study "the reduction in the overall working capital cycle has been achieved on account of both a better control on inventory and faster recovery of receivables. The average inventory holding period has declined from 82 days in 98-99 to 68 days in 01-02. Over the same period, the average days of debtors fell from 52 days to 46 days". The *ET* study of 500 firms indicates that these firms are now adopting robust supply chain practices. According to this study, companies are now looking at further consolidating these gains and spreading the new passion for discipline across their supply chain. Firms like HLL, Godrej, Phillips, Marico, Mahindra and Mahindra all have embraced supply chain practices and have been able to reap the benefits. Smaller firms also are learning the rules of the game and are aligning themselves to the requirement of environment and restructuring themselves on the basis of the requirement of the economy and their competitive capability. The smaller firms have understood the need of customized efficient supplies and bigger firms are moving towards their core. All these have resulted in a drastic fall in the overall supply chain costs due to decreased inventory and thus inventory costs, logistics and warehousing costs. There is also a tendency towards, using information technology to align and integrate both internally as well as externally with their respective supply chain partners. The firms are moving ahead and are readying for meeting the challenges of integrating all the levels of the supply chain. The bullwhip effect which has been acting like a cancer in Indian organization is being tackled by these firms by moving towards a centralized information system, which makes demand changes in the market visible to all the partners in the supply chain, thus reducing business driven demand variability and the respective supply chain costs. It is clear that Indian businesses have realized that creating flexible and dynamic capabilities can only help organizations to reap competitive advantage in highly competitive markets.

Dr. Suma Damodaran: Indian corporates have improved their bottom line by 43% by mere reduction in interest cost through strategic debt-restructuring. Interest cost savings accounted for 31% of the rise in net profits. (Again a pointer to the crucial role played by low interest rates which may not be here to stay). For industries like steel, better price realization has been the main contributing factor. Beside these, the alert corporates have realized the importance of increasing efficiencies in their survival in the present scenario of intense global competition.

❑ Reasons for Turnaround

Dr. Subhajit Bhattacharyya: Recently there has been a turnaround in the overall Indian and global economy. Even though the openness of the Indian economy is not as much as is seen in our competing countries like China and the South-East Asian economies, India Inc. gets very much affected by happenings elsewhere in the world. Improvements in the global economy since the beginning of 2003 has given a boost to the Indian exports sector and therefore to the corporates. Also, the infrastructure investment by the government, primarily on golden quadrangle program, has given an impetus to the economy. In addition to that, a facilitating interest rate environment has given a boost to the housing, automobiles, consumer goods and the durable goods sectors. In a market oriented economy, where linkages among various sectors are much more intensive than otherwise, improvements in one sector create greater positive externalities for many of the other sectors. Hence, we see an overall improvement in the corporate performance.

Dr. B B Bhattacharya: Since, last year was a bad year, any growth this year would be higher than normal.

Prof. Rakesh Singh: While Indian businesses were concentrating on building capability, which helps them to be flexible dynamic and market responsive, the trends in the macroeconomy have also moved in their favors. The favorable trends in the macroeconomy have benefitted the micro foundation of Indian firms. According to the above mentioned *ET* study, "Companies have been lowering their financing costs. Interest as a percentage of sales has been declining steadily, falling to 4.2% in 01-02 from 5.4% in 97-98. The top 300 companies have better bargaining power with their lenders." All this definitely indicates high liquidity in the market and hence falling interest costs. We have reached here from a period in 90s when the interest rates in India was very high and a monetarist approach to inflation sucked away funds from the economy and stifled the growth rate of the Indian economy.

Since the third front came into power in 1996-97, the easy monetary policy followed. The BJP government has not only made availability of money easy but also cheaper. The interest rates have gone downwards. In the years when industry were grappling with the slowdown, and economy faced an unprecedented demand constrained due to the poor performance of the agricultural sector, Indian firms did not invest into new activity but they acted smartly by adopting financial engineering in their firms which help them reduce their interest costs. Thus, reducing the debt service cost to the firms and improving their financial position.

Despite a high fiscal deficit and Enron fiasco, infrastructure situation in the country is headed towards improvement and growth. The telecom revolution has dramatically lowered the cost of communication. The golden quadrilateral project is making good progress. There are quite an impressive investment into the roads sector. The port sector is getting privatized and its efficiency is on the rise. The diseconomies arising out of lack of infrastructure are being reversed. There is no doubt that this is just the beginning and more needs to be done. But improvement in infrastructure has definitely contributed to the growth of Indian industry. With improving infrastructure and emerging global opportunities, Indian firms have started eyeing global markets. They have been making impressive strides in the area of FMCG, auto ancillary, pharmaceuticals, engineering, farm equipments and food processing.

These are newer additions to the basket of Indian exports. Added to this the opportunity arising from information technology, business process outsourcing, biotechnology, and bioinformatics have helped Indian export grow significantly and keep current account deficit at a reasonably sustainable level. All this may also have contributed to the sensex reaching record height and within a short span of time. Lots of people raise doubts about sustainability of both the sensex and these new areas of competitive advantage accruing-to Indian firms.

❑ Sensex and the Bull Run

Dr. Subhajit Bhattacharyya: One needs to be very cautious about the capital market movements, be it in the Indian markets or elsewhere, as far as his decision of investing on bourses is concerned. There are enough reasons now for the sensex to go north, but whether by the extent which is observed presently or not is a moot point. Overall current economic environment, both domestic and global, is conducive for a significant improvement in the sensex by the simple logic that better environment creates expectations for better business, hence expectation of better profit and hence expectations for higher return to the shareholders. But if such upsurge is seen in the stocks of some of the companies as well whose financial fundamentals are not really that strong or eventually which are making losses, that creates a suspicion. We haven't yet forgotten the scams of 90s. Probably retail investors will continue to maintain a distance unless such upsurge is sustained for a sufficiently long period of time, until such time that they are convinced that the upward rise in the sensex is a true reflection of the improved business conditions in the economy only and not caused by the profit motives of a group of speculators.

Dr. B B Bhattacharya: The Indian stock market is a very poor indicator of the behavior of the economy. It is yet to attain maturity. However, since there has been a very long period of sluggishness, there would be a medium-term upturn, driven by pure speculative impulse.

Prof. Rakesh Singh: As far as sensex is concerned, the sensex rise and the stock performance are somewhat and symbiotically related to the performance of these sectors. As said earlier Indian industry is confident of doing well, the trends shows that a good agricultural year can create demand for their products and that is good enough an inducement to invest.

But as the history of stock markets goes, during upturn not only do the stocks of good companies trade well but also those of poorly performing companies. Speculation can create euphoric rise in the sensex. All in the sensex rise is not fundamental, it is also speculative. Speculation is good when it creates liquidity and lowers transaction cost, otherwise it turns evil.

Dr. Suma Damodaran: The sensex bouncing back and scaling new heights is a sign of a bull run and increased interest, but given the hypersensitivity of stock markets and the sensex to factors of ALL kinds (non-economic factors including), it is risky to bet on how long it would last!

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❑ Sustainability of Recovery

Dr. Subhajit Bhattacharyya: We buy more from the foreigners than we sell to them as only about 10% of our GDP is exports and about 12% of GDP is imports. Therefore, a, bigger market lies in India itself for the corporates in India. So, the success of the corporate India depends to a great extent on the purchasing power of Indian consumers. The fundamental questions that one can ask are whether this purchasing power is improving for the Indian masses over the period, whether that is concentrated or well distributed and whether the middle income group, the so called fast expanding market, is actually expanding. There is no denying of the fact that a facilitating retail credit environment has changed the consumption pattern from consumption out of saving to consumption out of future earning, the typical credit card and *EMI* culture as we see in most of the developed economies. A large section of the middle income group is of this kind. Whether this group has been growing is a big question as employment has remained more or less stagnant over the last few years, both in the private and public sectors. In fact, employment in the public sector has actually dwindled and is continuing to do so. Small businesses find it difficult to survive in the intensely competitive environment. The rural market is also under tremendous pressure as whatever excess income is generated is highly concentrated and rarely broad-based. High income for small group of people does not necessarily lead to higher demand in the economy. However, an increase in income, may be by a smaller amount, but for more people, would always lead to higher demand in the economy. This is not the phenomenon we are moving to given the current political, sociological and efficiency status of the governments, both at the Center and the States, in terms of fulfilling their fundamental economic objective of enhancing purchasing power of the masses. Therefore, corporate profitability will continue to be subject to some kind of seasonality depending on monsoon, temporal changes in government policies and the seasonality in global economic environment.

Dr. B B Bhattacharya: The recovery may sustain, provided corporate investment can be re-allocated along that line. Further, there has to be a lot of investment in R&D to sustain technological advantage in these industries. Public sector has slowed down R&D investment due to fiscal constraint. It is high time the Indian corporate sector fills this gap by stepping up R&D investment. So far they have only tried to be a free rider in this game. It is time for a reform in corporate behavior in India.

Dr. Suma Damodaran: Besides exogenous factors like global economic conditions, international oil prices and the like over which the corporates have no control, the levels of efficiencies attained in resource utilization at all stages is going to be the key determinant of whether they can continue to maintain the present profit ride. Ability to adapt quickly to correctly anticipated policy changes both locally and globally will contribute significantly in making them winners.

❑ Role of Emerging Sectors

Dr. Subhajit Bhattacharyya: As far as business process outsourcing is concerned, India clearly has an advantage over its competitors, and is thereby witnessing a more or less consistent increase in jobs in this service business. So is true for bioinformatics. In the case of biotechnology, though things look very much promising, we really have to take a big leap to be able to compete with the entities of the developed countries and some of the emerging technologically superior economies. BPO and bioinformatics have the potential to create a revolution in generating short-term employments, but cannot always offer to the prospective employee a long-term vision for himself. This is the limiting factor that is being faced today by most of the service provider in BPO. The high turnaround is actually hampering their business. An astute HR policy of the corporate can convert such potential into a reality.

Prof. Rakesh Singh: As far as BPO, Biotechnology and Bioinformatics are concerned. Care must be taken to understand that the best practices and efficient practices will only sustain when we can use our skilled and cheap labor advantages adopting best practices which makes us competitive. It should not be treated as one time opportunity as Indian firms are used to doing.

Thus, it can be concluded that Indian firms have created a base for high growth by restructuring themselves. But to really grow in sustained manner they need to move to higher level of supply chain integration and thus need to create organization, which are willing to change and adopt these practices in future. This is the most difficult transformation in organization and they get complacent after the first level integration is done.

At the macro level, the debate of recovery cannot be complete unless we understand that by the economy and industry during the period between March 1996 and April 2003 faced demand constraint. There was similar euphoria in 1999, which died its natural death once the agricultural sector that grew at 7.5% showed a negative growth next year.

Let us understand that demand is no enigma, demand is effective and we clearly know that incremental demand in the economy comes from the step treated sector called agriculture. Can we grow only on the mercy of Lord Indra? If, not we haven't done much to bring Indian agricultural sector into the mainstream of economic reforms, reforms in agriculture have only been promises. This is going to be major stumbling block in the revival of Indian economy.

Dr. Suma Damodaran: The biotechnology sector in India presently accounts for 2% of the global biotech market. But given our strength in "human capital" required for this knowledge-based industry, there is tremendous potential. We have good infrastructure (a good network of Research Laboratories) and adequate support from the govt. What is needed to make it happen is the emergence of risk taking entrepreneurs with large financial capital to translate the laboratory success stories into commercial success stories.

Business Process Outsourcing being an IT- enabled service, will naturally have the software majors entering. The result will be ruthless competition leading to near wiping out of margins. But it is a service where switching costs are very high and so is capital intensity. With these two features, BPO as a service is likely to evolve as an industry with few players, enjoying very strong brand loyalties and thereby big margins – the dream of many corporates. ♦