ICRA Comment

Index of Industrial Production May 2010: Healthy Growth Albeit Considerably Lower than Expected

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The Index of Industrial Production (IIP) expanded by 11.5% in May 2010 in year-on-year (y-o-y) terms, led by a robust 12.3% growth of manufacturing, while the mining & quarrying and electricity sub-sectors expanded by 8.7% and 6.4%, respectively. Industrial growth was led by continued healthy domestic consumer demand as well as the sharp growth of exports in year-on-year (y-o-y) terms. The sustained high growth of capital goods suggests that some investment for capacity expansion is taking place in the Indian economy. The pace of IIP growth partly reflected a favourable base effect, with a low 2.1% growth of the index in May 2009.

Although the 11.5% growth recorded by the IIP index in May 2010 was healthy, it was lower than expectations and marked a considerable deceleration relative to the revised 16.5% pace of growth recorded in the preceding month. Further, in month-on-month (m-o-m) terms, the IIP index displayed a marginal contraction of 0.6% in May 2010 relative to April 2010, as compared to the trend of 2.8%-6% expansion seen in May in m-o-m terms in the past five years. However, the overall IIP index had displayed a higher than expected y-o-y growth in April 2010 and consequently a milder contraction in m-o-m terms in April 2010 relative to March 2010, as compared to the trend witnessed in recent years.

All three sectors, namely, manufacturing, mining & quarrying and electricity recorded a deceleration relative to the pace of growth witnessed in April 2010. The slowdown was the sharpest in the case of manufacturing growth, led by a slowdown in the pace of expansion of machinery & equipment (other than transport equipment), from a high 54.4% in April 2010 to a lower albeit healthy 24.8% in May 2010.

Continuing the trend witnessed in recent months, manufacturing growth remained uneven and concentrated in a few categories. Five categories accounting for just over half of the manufacturing index contributed to 9.4% of the 12.3% growth in the manufacturing sector in May 2010 while several categories displayed marginal growth during that month. Two sub-categories with a combined weight of 5.08% in the IIP index contracted in May 2010.

In terms of the use-based classification, the IIP growth in May 2010 was driven by the high growth of capital goods and consumer durables, which expanded by 34.3% and 23.7%, respectively. However, the pace of expansion of all five sectors decelerated in May 2010 relative to the preceding month.

Basic and intermediate goods logged healthy growth of 7.9% and 10.2%, respectively, in May 2010. A sustained trend of slowing growth witnessed for these two sectors suggests that although the demand for finished products remains strong, the boost derived from restocking of inventories is likely to have waned. The continued healthy growth of consumer durables suggests that consumer demand remains robust. Growth of consumer non-durables languished at 2.4% -- lower than the 4.5%

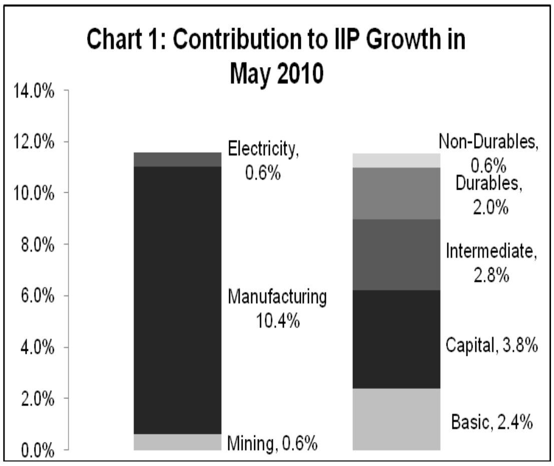
growth witnessed in May 2010 -- despite a favourable base effect arising out of a 5.5% contraction of this sector in May 2009. The dismal performance of this sector in recent months is likely to reflect the impact of stubbornly high food inflation on disposable incomes.

In line with expectations, the growth of capital goods slowed sharply to 34.3% in May 2010 from 70% in April 2010. Nevertheless, the pace of growth has remained elevated for several months in a row, and this category remained the highest contributor to IIP growth amongst the use-based industries for six consecutive months.

Table 1: Trend in IIP Growth

		May		April-May	
	Weight	2009	2010	2009	2010
IIP	100.0%	2.1%	11.5%	1.6%	14.0%
Mining	10.5%	3.4%	8.7%	3.4%	10.2%
Manufacturing	79.4%	1.8%	12.3%	1.1%	15.1%
Electricity	10.2%	3.0%	6.4%	4.9%	6.6%
Use-Based Classification					
Basic	35.6%	3.8%	7.9%	4.2%	8.5%
Capital	9.3%	-3.6%	34.3%	-4.8%	52.1%
Intermediate	26.5%	6.6%	10.2%	7.3%	10.4%
Durables	5.4%	13.2%	23.7%	15.4%	28.2%
Non-Durables	23.3%	-5.5%	2.4%	-8.0%	3.5%

Source: Central Statistical Organisation (CSO)



Sectoral Growth
The pace of growth of the manufacturing sector slowed in y-o-y terms to 12.3% in May 2010 from a revised growth of 17.9% in April 2010. Although the double-digit pace of growth was healthy, it was inferior to expectations for May 2010. With the sub-index having displayed low growth of 1.8% in May 2009, growth continued to benefit from a favourable base effect. However, with the index having displayed a resurgent 8% growth in June 2010, the benefit derived from the base effect is likely to diminish considerably from June 2010. In m-o-m terms, the manufacturing index displayed a marginal contraction in May 2010, a break from the trend seen in the past five years,

The trend of manufacturing growth remaining concentrated within a few sectors continued in May 2010, with several sectors displaying marginal growth. Two categories, namely, beverages, tobacco & related products and wood & wood products, furniture & fixtures, with a weight of 5.08% in the IIP index, contracted in May 2010. These categories had contracted in the previous month as well. Although the pace of contraction of the latter eased substantially in May 2010 relative to April 2010, the pace of contraction of beverages, tobacco & related products worsened in May 2010.

The five sectors with the highest contribution to the manufacturing growth (enumerated in Table 2) contributed to 9.4% of the 12.3% growth of the manufacturing sector in May 2010; these five sectors have a weight of 51% in the manufacturing index. Basic chemicals & chemical products (except products of petroleum & coal) and basic metals & alloy industries expanded by 7.5% and 9.4%, respectively. The former benefited from a favourable base effect, following the low growth of 2.1% in May 2009. Rubber, plastic, petroleum & coal products displayed a healthy 15.4% growth in May 2010, which is remarkable on the back of a 17.4% growth in May 2009.

Metal products & parts, machinery & equipment and transport equipment & parts, which together account for around 20% of the manufacturing index, have displayed a consistently high growth in 2010. Machinery & equipment (other than transport equipment) expanded by a healthy 24.8% in May 2010, although the pace of growth was sharply lower than the 54.4% growth witnessed in April 2010. As a result, the contribution of machinery & equipment to manufacturing growth, which increased to 8.6% in April 2010 from 4.6% in March 2010, declined to 4.1% in May 2010. This sector was largely responsible for the spike in manufacturing growth in April 2010: manufacturing growth had improved from 14.7% in March 2010 to 17.9% in April 2010 before declining to 12.3% in May 2010.

Transport equipment & parts expanded by a sharp 25.2% in May 2010 as compared to the low growth of 2% in May 2009. The sharp growth in transport equipment & parts is likely to reflect the high growth in the production of passenger cars, goods carriers and two-and three-wheelers, led by an increase in both domestic sales and exports, as indicated by the data released by the Society of Indian Automobile Manufacturers (SIAM).

Table 2: Significant Contributors to Manufacturing Growth

Sector	Weight	Growth		Contribution to Manuf. Growth
		May 2009	May 2010	
Machinery and Equipment other than Transport equipment	9.57	2.9%	24.8%	4.1%
Transport Equipment and Parts	3.98	2.0%	25.2%	1.8%
Basic Chemicals & Chemical Products (except products of Petroleum & Coal)	14.00	2.1%	7.5%	1.6%
Rubber, Plastic, Petroleum and Coal Products	5.73	17.4%	15.4%	1.0%
Basic Metal & Alloy Industries	7.45	5.5%	9.4%	1.0%
others	38.63	-1.8%	7.5%	2.9%
Manufacturing	79.36	1.8%	12.3%	12.3%

Source: CSO

The pace of growth of the mining sub-index, which had remained in double-digits since November 2009, declined in May 2010 albeit to a healthy 8.7%. With the high growth of this sub-index from June 2009 onwards, the pace of growth of mining is likely to diminish in the coming months. Electricity generation expanded by 6.4% in May 2010, relative to the same month in the preceding year. The pace of growth was marginally lower than the 6.9% growth displayed in April 2010.

In addition to sustained domestic demand, industrial growth benefited from considerable expansion in exports in y-o-y terms in the recent months. While exports continued to display a favourable y-o-y growth at 35% in May 2010, the level of monthly exports declined for the second consecutive month to US$ 16.1 billion in May 2010 from US$ 16.9 billion in April 2010 after peaking at US$ 19.9 billion in March 2010.[1] Although the same may represent a seasonal trend, concerns remain regarding the outlook for Indian exports, based on interplay between global growth dynamics and exchange rate movements. The global economic growth forecast remains somewhat clouded in the near term: calls to reduce Government deficits in a number of industrial countries led by concerns regarding debt sustainability, in conjunction with the eventual withdrawal of monetary stimulus measures are likely to weaken the momentum of economic growth. Diminishing business and consumer confidence following fiscal and monetary tightening is expected to constrain the demand for Indian exports in the near to medium term, particularly from the Euro region, in spite of the recent weakening of the Indian currency relative to the currencies of India's major trading partners, including the US dollar, the Japanese yen, the euro and the British pound since mid-May 2010. Broadly, the Indian rupee is expected to remain volatile in the near term: the upside arising from the relatively superior forecast for Indian economic growth is likely to be offset by the affinity for investors to hold safe assets in times of global uncertainty. The competitive position of Indian exports too remains uncertain: while the Chinese Government has recently indicated its willingness to allow an appreciation of its currency relative to the US dollar, uncertainty remains regarding a clear timeline for a considerable revaluation of the yuan.

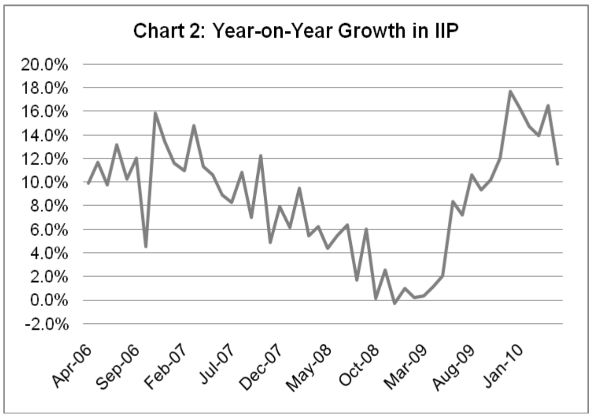


Chart 2: Year-on-Year Growth in IIP

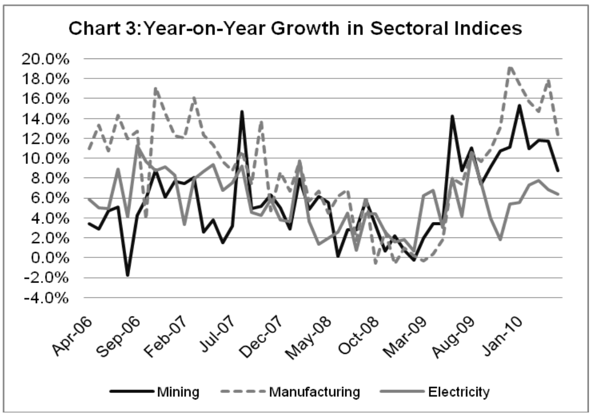


Chart 3: Year-on-Year Growth in Sectoral Indices

Source: CSO

[1] Provisional data released by the Ministry of Commerce and Industry, Government of India (GoI)

Use-based Classification
In terms of the use-based classification, IIP growth in May 2010 was led by high growth in capital goods and consumer durables, similar to the trend witnessed in the recent months. The pace of growth of both basic and intermediate goods declined to 7.9% and 10.2%, respectively, in May 2010. Consumer non-durables expanded by a low 2.4% in May 2010, considerably lower than the 4.5% growth witnessed in April 2010.

Capital goods expanded by 34.3% in May 2010, aided to an extent by a favourable base effect, with the sector having contracted by 3.6% in May 2009. This category remained the highest contributor to IIP growth amongst the use-based industries for six consecutive months. Growth of this sector has remained in excess of 28% since December 2009, which is remarkable. The continued high growth of this sector benefits from the aforementioned high growth in metal products & parts, machinery & equipment and transport equipment & parts, including a 50% growth of commercial vehicles (as per data released by SIAM). Along expected lines, the pace of growth of capital goods was substantially slower in May 2010 as compared to the revised growth of 70% witnessed in April 2010. The sector is likely to display double-digit growth for the remainder of the first half of 2010-11, as private investment sentiment is expected to become stronger as the Indian economy enters a phase of capacity expansion over the course of the fiscal year. Nevertheless, the pace of monetary tightening and the speed of transmission of the same into higher interest rates may dampen private investment growth in the coming months.

The growth of both intermediate and basic goods decelerated in May 2010. Intermediate goods expanded by 10.2% in May 2010, the lowest pace of growth recorded since July 2009. Basic goods expanded by 7.9% in May 2010 at the slowest pace since November 2009. These trends suggest that although the demand for finished products remains robust, the boost to industrial growth from inventory restocking is likely to have run its course.

The pace of growth of consumer durables slowed to 23.7% in May 2010 from a revised growth of 32.8% in April 2010. Coming on the back of 13.2% growth in May 2009, the pace of growth in May 2010 was strong and is likely to have been boosted by the high growth of passenger cars and two-wheelers in May 2010 (31% and 29%, respectively, as per data released by SIAM). However, the growth of consumer durables is expected to moderate substantially in the coming months: this sector has displayed expansion in excess of 20% since July 2009, resulting in an adverse base effect going forward. Additionally, consumer demand is expected to be dampened to a certain extent by the transmission of the recent monetary tightening to higher interest rates.

Growth of consumer non-durables slowed to 2.4% in May 2010 from a revised growth of 4.5% in May 2010. The pace of growth slowed despite the base effect remaining favourable: consumer non-durables had displayed a contraction of 5.5% in May 2009, albeit at a milder pace relative to the 10% contraction witnessed in April 2009. The pace of growth of this sector continues to languish and is expected to remain subdued in the near term as rising inflation diminishes disposable incomes and the demand for products in this category.

Outlook
The pace of growth of the manufacturing sector is expected to decelerate in June 2010, although remaining robust, following healthy consumer demand as well as continued export growth relative to the level in the preceding year. Electricity generation is expected to expand by a low 3.4% in June 2010 as per data released by the Central Electricity Authority. Mining growth is expected to decelerate, following sharply higher growth of 14.2% in June 2009.

With the IIP index having expanded by 8.3% in June 2009, the favourable base effect that boosted the pace of growth in the recent months is likely to wear off from June 2010 onwards. With domestic economic conditions expected to remain healthy and exports expected to continue to display considerable y-o-y growth, the IIP index is expected to expand by a healthy 9-10% in June 2010, albeit displaying a deceleration as compared to the sustained double-digit growth witnessed in the recent months. IIP growth is expected to remain at similar levels in the remaining months of the first half of 2010-11. With the monsoon rainfall expected to be favourable in 2010, *kharif* output and agricultural incomes are likely to receive a boost, which may improve the demand for non-durable goods arising from rural India. The strength of investment sentiment and the pace of investment growth are likely to remain critical determinants of the overall pace of industrial growth in the coming months.

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