BUSINESS RECORDER
Founded by M.A. Zuberi

Dr Hafiz A Pasha

24th December, 2019

Fall in industrial output

The fall in output of the large-scale manufacturing sector has become pervasive and persistent in nature. Given the strong backward and forward linkages of this sector with other sectors of the national economy this does not auger well for GDP growth in 2019-20.

The latest estimate by the Pakistan Bureau of Statistics is that the Quantum Index of Manufacturing (QIM) has shown negative growth on a year-to-year basis of almost 8 percent in October 2019. During the first three months of 2019-20 the QIM fell by 5.8 percent in July; 6.2 percent in August and 5.6 percent in September. Cumulatively the decline in the level of industrial output is as much as 6.5 percent. This comes after a fall of 3.5 percent in 2018-19. In fact, over the last 12 months the growth rate has generally been negative. This kind of precipitate decline has seldom been seen in the country's history.

The fall in production is also widespread. The combined weight of industries in the QIM which are showing either near zero or negative growth is almost 80 percent. This includes nine out of the fifteen industrial groups in the index. These are textiles; food, beverages and tobacco; petroleum products; pharmaceuticals and chemicals; automobiles; iron and steel products; electronics and paper and board. Only two major industries, namely, fertilizer and cement are showing some positive growth.

Many of the industries have registered double-digit declines in the first four months of 2019-20. The production is down by 43 percent of cars; 19 percent of motor cycles; petroleum products by 14 percent; cigarettes by 36 percent; steel products by 30 percent; chemicals by 20 percent and so on. In fact, out of the 112 product lines covered by the QIM, there has been a decline in output in 65 lines.

Why has there been such an unprecedented crisis of industrial production? On the contrary, the large devaluation of the rupee by almost 40 percent over the last two years should have provided a major impetus to domestic industry. Export competitiveness ought to have been enhanced thereby enabling a big increase in the volume of export of manufactured goods. Simultaneously, imported goods became more expensive and this should have facilitated the process of import substitution.

There are some rare examples of a positive response. This includes the export from the small-scale sector of ready-made garments. The growth achieved in volume terms was spectacular at 35 percent. Big increases have also been observed in the case of knitwear and bed wear exports. Some emerging exports have also performed well like leather garments and footwear. The best example of an import-substituting industry which has shown almost double-digit growth is fertilizer.

However, the question which remains is why the positive response has not been more widespread? The answer lies in the large number of steps taken to manage aggregate demand like the big hike in the policy rate and a heavy bout of additional taxation in the 2019-20 Budget. In addition, gas and power tariffs have been escalated and prices of petroleum products have been enhanced. A number of industries have been hit by the decline in construction activity, caused especially by the big cut in development spending.

The rise in interest rates has not only reduced demand for machinery, both local and imported, but also substantially raised the costs of working capital to industrial units. Exporting activities have been hit by the withdrawal of the zero-rating facility on domestic sales and big delays in the payment of refunds.

Overall, the supply response by industry has been frustrated by the simultaneous implementation of a number of actions presumably for stabilization purposes which have hit industry and other sectors of the national economy. The big failure of the last cotton crop is at least partly attributable to the rise in fertilizer prices due mostly to the escalation in the gas tariff.

The impact of the continued slump in manufacturing activity is a potential direct loss of almost one percentage point in the GDP growth rate. But there are also a number of negative indirect impacts on growth due to the strong backward and forward linkages of industry.

The first sector to be impacted is the small-scale manufacturing sector. Activities on the side of backward linkages with large-scale industry will be affected like the vender industry supplying to the automobile sector. Alternatively, the stagnation in the textile industry will affect the production of value-added products.

Output of large-scale manufacturing and inputs of raw materials and intermediate goods are a vital part of wholesale and retail trade activities. Almost 52 percent of the income from trading margins is due to the sale of domestically produced manufactured goods. Similarly, a large part of the goods transported are to and from industrial units. Numerous other linkages also exist with manufacturing.

Inclusive of both the direct and indirect consequences of the downward slide in industrial production, the overall impact on GDP growth is likely to be sizeable. Along with the big cotton crop failure there is the growing realization that even the modest GDP growth rate expectation of 2.4 percent in 2019-20 is now clearly on the high side.

The downward revision of the GDP growth rate projection for 2019-20 will inevitably have other impacts on the economy. Foreign direct investment will be deterred by the depressed market environment. Falling profitability of many key industrial units will inevitably impact eventually on share prices. Banking profitability will also be affected by the low demand for credit and perhaps even more by the over 20 percent growth already in non-performing loans.

Finally, the sharp slowdown in the real economy will have an inevitable impact on the level of employment. For every one percentage point decline in the GDP growth rate, almost 360,000 less jobs are created. The rising unemployment then translates to a growth in the incidence of poverty in the country.

The time has come for the Government to review its overall policy posture. Should stabilization continue to be relentlessly pursued even after the massive curtailment in the current account deficit or has the time come to shift gear to somewhat more expansionary monetary and fiscal policies?

(The writer is Professor Emeritus at BNU and former Federal Minister)