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LSM’s post-mortem report

One swallow does not make a summer. But for the sake of records, in aggregate terms the second quarter of fiscal year 2020 was not as bad for manufacturing sector as previously thought.

When Pakistan Bureau of Statistics (PBS) reported its data for December 2019, the manufacturing sector, measured by the Large-Scale Manufacturing (LSM) index was down six quarters straight. However, revised numbers available on the central bank’s website show that quarterly contraction that began in 1QFY19 had ended in 1QFY20, and that 2QFY20 actually eked out a negligible growth of 0.03 percent, whereas original data release by the PBS had put that number to negative 0.7 percent.

That negligible growth in 2QFY20 was largely driven by one-time sugar-led high in December 2019, a growth that dissipated in the ensuing months. Sugar’s December high was only because this year, crushing began earlier than last milling year. Sugar production fell 1.68 percent in nine months ending March 2020, and if it weren’t for one-off sharp growth in sugar production in December 2019, the proverbial swallow wouldn’t have appeared in the second quarter fiscal year 2020. (For LSM’s sugar outlook: Large scale’s small manufacturing, Mar 25, 2020)

But all of that hardly matters now. With March 2020 reporting the worst contraction in LSM in recent memory, the view that pandemic will hit harder than the Great Recession of yester decade has gained strength. (Read also: LSM: brace for impact, Apr 21, 2020)

How will the contraction look like, and when can one expect recovery? The answer to these questions largely depends on how the pandemic pans out in Pakistan and its exporting countries, and how in turn it affects the governments’ lockdown decisions. Manufacturing performance will likely follow public health indictors and interventions. However, in times like these Paul Krugman’s analogy of an economic crash is worth reflecting on.

Writing in his book titled ‘the return of depression economics’, Krugman asked readers to imagine a long closely spaced line of cars speeding along a highway at 120 kilometers an hour. Suddenly, the car at the front reaches a stretch of bad road, which forces it to slow to half its former speed. Unless the drivers behind that lead car have inhumanly fast reactions, the line of cars will not smoothly slow down to 60 km/h.

This is because the second driver will take some time to realize that the car in front of him has slowed sharply by which time the gap between the cars will have narrow considerable, which means he will temporarily have to slow to something less than 60 km/h perhaps 40 km/h to reestablish his position. The car behind him will have to slow even more and so on and so forth, and as the shock wave from the bad stretch of road ahead propagates down the line of drivers, many of them will actually be forced to come to a complete stop.

The average speed of the cars drops not from 120 km/h to 30 km/h, but to 15 or even 10 km/h. Eventually this shock effect will dissipate even if the road ahead is still bad, and the average speed gradually rises to 30 km/h again. Krugman wrote that something similar happens to economies when they face a crash.

Applying that analogy to Covid-19's impact on Pakistan's manufacturing sector, it appears that different sectors were already operating at different speeds and each of them will be slowing at different pace, or perhaps come to a screeching halt in different times.

The auto sector, for instance, has already come at a screeching halt. The sector reported 43 percent contraction in units produced in March 2020, and given zero auto sales in April 2020, their production numbers will show even sharper fall in LSM data release for April and May 2020. (Read: 'Autos dialing zero' May 14, 2020)

Similar is the situation with cement whose production fell 17 percent in March 2020. Channel checks suggest that total cement production in the country in April and May is likely to remain around March 2020

Level, which means further drop in LSM's cement numbers is on the cards – likely to the tune of 25 percent.

For some sectors, such as cigarettes, it's a different story. Following a good year in FY18, cigarette production has been on a gradual decline on account of FED-led price hikes that have come to hurt formal sector players whose production is tracked by the LSM index. This will worsen in the times of corona.

Refinery production is also in the same league. It fell the most in recent memory in March 2020, largely on account of the lockdown. However, given slowing economy that affected diesel sales and the phasing out of furnace oil, refinery production was already falling before Covid-19 struck the economy. In all likelihood, refinery production will show further dent in April and May numbers, on account of the lockdown extended to-date, and the government's decision to allow imports of refined POL products. (For details, read 'OMC sales and lockdown', May 7, 2020)

Perhaps the most jaw dropping movements among LSM index heavy weights is seen in the production of cotton yarn and cotton cloth. Movement in those two sectors had been flat lined for a long time. However, March 2020 saw production in these sectors drop by more than 25 percent. LSM's textile sub-index has hardly been a good proxy for the country's textile sector, but it will be interesting to see how such a big movement will reflect in sales data of listed textile companies, and textile exports numbers whenever those numbers are reported in the next few months.

So if some sectors are yet to slowdown on Krugman's proverbial bad stretch of the road, others have already come to a screeching halt. How soon will they start the engines again depends on the questions surrounding the pandemic. In a sense, the pandemic may not just be a bad stretch of the road; it may be a road blocked by landslides. But considering that production units essentially started closing in the second half of March and much tither closures in April 2020 are sure that April's LSM numbers will be worse than those reported for March.