MANUFACTURING - THE NEED TO EXCEL

INFONALYSIS

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Research & Development Cell

Karachi Chamber of Commerce & Industry

The gateway to economic prosperity…

The nation's GDP has been dominated by the services sector. This should be a cause of concern for the industrialists and agriculturists and national economic managers.

Stagnant share of industrial sector is a cause of concern

The industrial sector is one of the core components of Pakistan's domestic sector. Unfortunately, this sector has failed to substantially increase its share in the economy where it has contributed an average of 21% to the national GDP since FY06 with the only notable exception being a share of 22.10% in FY08, before the global recession took its toll on the world. The nation's GDP has been dominated by the services sector. The irony of the matter is that even the share of the agriculture sector is experiencing a gradual decline despite Pakistan being termed as an 'agrarian' economy. On the contrary, the relatively higher share of the services sector is further inclining. This should be a cause of concern for the national economic managers, industrialists and agriculturists.

Contributions of Three Major Sectors in National GDP

	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Industrial	20.60%	21.40%	22.10%	20.90%	21.00%	21.20%	20.90%	20.90%
Agriculture	23.00%	22.50%	21.90%	22.50%	22.00%	21.70%	21.50%	21.40%
Services	56.00%	56.10%	56.00%	56.60%	56.90%	57.10%	57.60%	57.70%

Source: *KCCI Research; PBS*

The industrial and agriculture sectors, jointly called 'commodity producing sectors', are known to catalyze high productivity and output resulting in robust maintainable growth while the services sector usually supports any such growth. The graph below indicates that periods of high manufacturing growth stimulate high GDP growth while low or negative manufacturing growth provokes low GDP growth.

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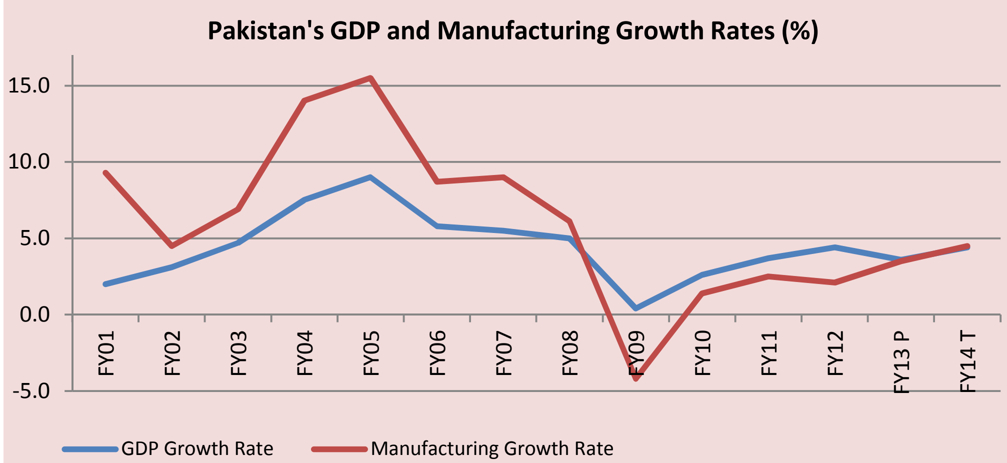


*P: Projected; *T: Targeted

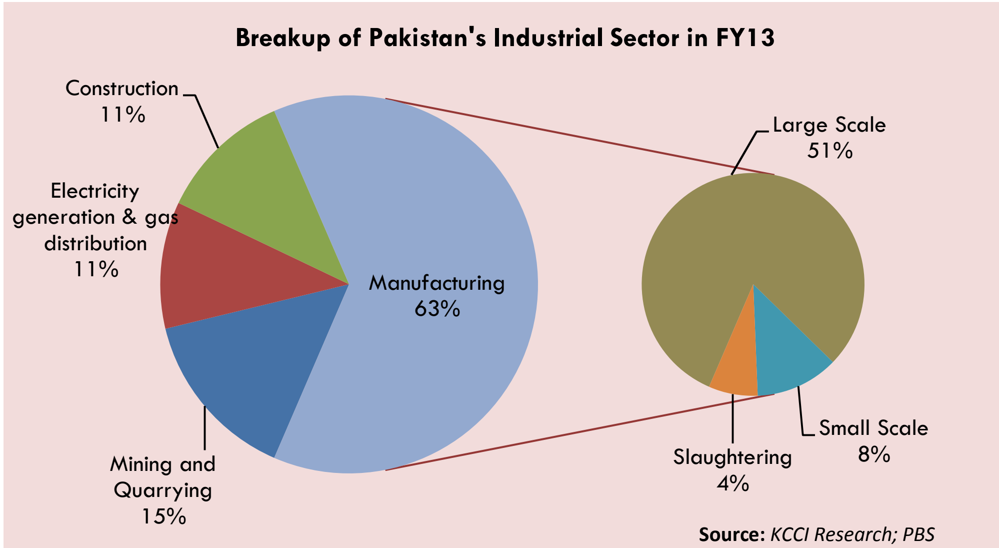
Source: *KCCI Reserach; MoF*

Pakistan would not be able to bring about a sustainable turnaround in its economy by continuing to rely heavily upon its services sector alone. Surely, urgent steps need to be taken to invigorate the commodity producing sectors, specifically the industrial sector, in order to bootstrap the economy and induce a culture of self-reliance.

Large Scale Manufacturing: A proxy to the industrial sector

LSM contributes 51% to the industrial sector and hence can be considered a proxy to the whole sector.

Pakistan's industrial sector comprises of the manufacturing sector, mining and quarrying sector, electricity generation & distribution and construction.



The manufacturing sector in turn is composed of Large Scale Manufacturing (LSM), Small Scale Manufacturing and slaughtering (the chart above gives an apt representation of this breakup). LSM contributes 51% to the industrial sector and hence can be considered a proxy to the whole sector. The LSM is considered to be an important indicator of economic growth and improvement in LSM reflects heavily upon signs of improvement in the industrial sector and consequently in the national GDP.

Paper, Petrol and Food groups jacked up LSM in FY13

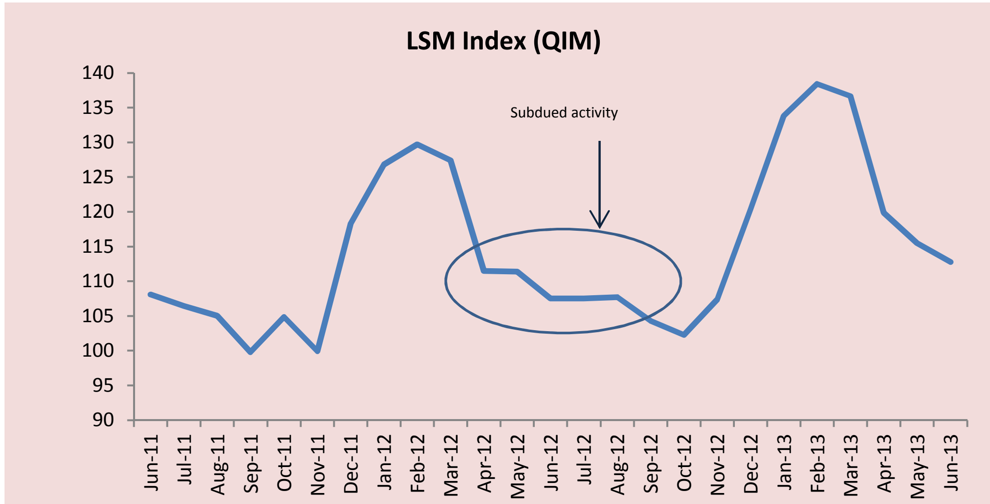
Higher production of goods lying within the Paper & Board, Coke & Petroleum Products, Pharmaceuticals and Food Beverages & Tobacco sectors jacked up LSM in FY13.

Large Scale Manufacturing posted an encouraging growth of 4.3% for fiscal year 2013, which is a very healthy figure as compared to a paltry growth figure of 1.18% recorded for FY12. This growth in LSM was mainly due to higher production of goods lying within the Paper & Board, Coke & Petroleum Products, Pharmaceuticals and Food Beverages & Tobacco sectors. Production within these sectors recorded yearly growths of 18.40%, 16.18%, 10.01% and 9.30% for the afore-mentioned sectors respectively. On the contrary, Engineering, Automobile and Fertilizer sectors declined by 15.55%, 12.46% and 4.02% in FY13 and thus restrained higher growth of LSM.

Elections' 13 instrumental in healthy LSM growth of 4.3%

Interestingly, the LSM growth of 4.3% for FY13 steeply inclined from the earlier recorded growth for period Jul-Feb'13. Two reasons become apparent for this steep incline in the last four months of FY13. First is the low base effect caused by subdued industrial growth in the period March to June of FY12, as depicted by the low index values of the Quantum Index of Manufacturing (QIM) below. (The QIM is an index used to represent industrial production activity).

Low base effect of subdued industrial activity during Mar-Jun'12 and heightening of industrial activity in the period due to the general elections of May'13 caused LSM to incline steeply in Mar-Jun'13.



Source: *KCCI Research; PBS*

The second reason is heightening of industrial activity in the period leading to the general elections of May'13. Election processes are known to set in motion wheels of entire economies due to their far-reaching effects on all cadres of the economy. As an example, a whopping amount in excess of PKR 400Bn was spent by the Pakistan govt. and politicians on the polls as per estimates. This spending mostly came in the form of paper, printing material and stationery used in balloting and campaigning, as extra fuel used in transportation for mobilization of workers and voters, and in the form of food and beverages consumed in the whole process; hence the elections had a profound positive impact on the domestic economy.

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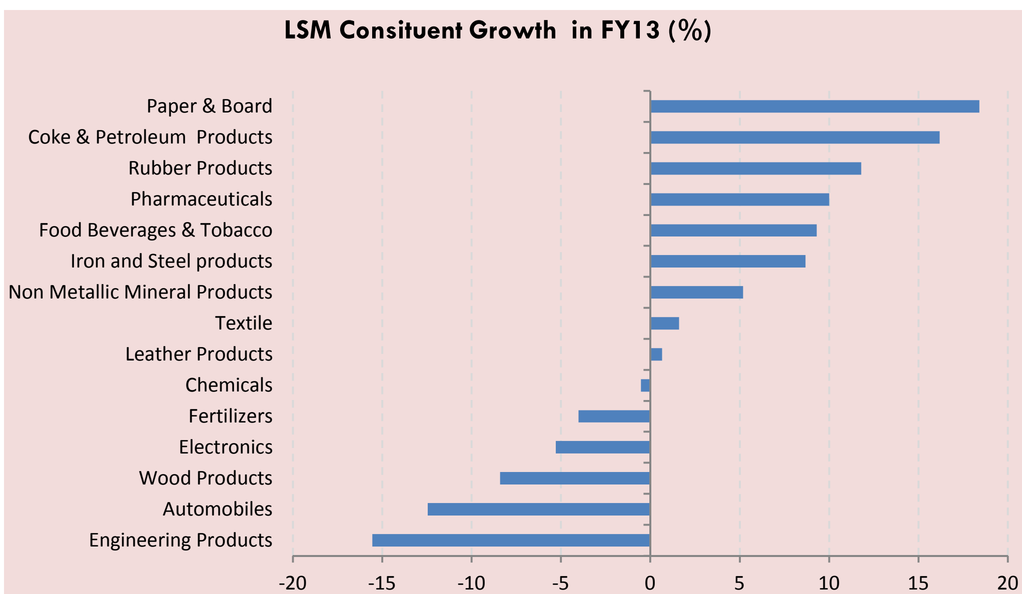

Source: *KCCI Research; PBS*

Outlook on the constituents of the QIM – the positives

Duty free access to the EU under the GSP Plus status, coupled with the dwindling value of the PKR and with some respite on the energy front, export related manufacturing activity is expected to grow significantly in the country.

The textile sector has the highest weight of 20.91% in the QIM (LSM index). Surprisingly, leather, one of the large export-oriented industries of the country, contributes only 0.86% to the index. Despite suffering heavily from the electricity crisis and extended gas curtailment, both the sectors have effectively managed to grow by 1.61% and 0.65% respectively in FY13 which can be called a marked achievement. Pakistan has applied to the European Union for inclusion in the GSP Plus Scheme. Under the scheme, Pakistan would be able to export nearly all of its items duty free or at very low duty rates. If Pakistan's bid is successful, this would result in significant broadening of the European market for Pakistani exports from January 2014, particularly in the textile and leather segments. The EU is expected to reach a decision on grant of the GSP Plus status to Pakistan in Oct-Nov'13. With duty free access to the EU, coupled with the dwindling value of the PKR and with some respite on the energy front, textiles and leather sectors are expected to catalyze export manufacturing activity in the country.

The Food, Beverages and Tobacco sector having a weight of 12.4% in the QIM also looks poised to grow significantly. With a population of 184Mn people increasing by 2% a year, food requirements are only going to increase. Further, the GSP Plus is also going to open doors for Pakistan's Halal food exports, and will supplement the exports of sea food which have been re-allowed entry into the EU. Pakistan's food exports have grown by 10.5% in FY13, and this trend is expected to continue in the years to come.

The recent clearance of dues to oil refineries has resulted in petroleum related production growth of 30% in the month of June'13 alone.

The petroleum sector has 5.51% weight in LSM. Of particular note is the positive effect, the resolution of the circular debt is expected to have on this sector. As case in point, the recent clearance of dues to oil refineries has resulted in production growth of 30% in the month of June'13 alone, as compared to May'13. Another key development in this sector is the commissioning of Byco Oil's 120,000 barrels per day refinery in mid-March'13. Smooth functioning of this refinery will not only reduce Pakistan's dependence on imported petroleum products, but it would also enhance LSM growth.

The incumbent govt. is endeavoring to alleviate the power and gas crises in the country. While following a multi-pronged strategy of increasing power and gas supply while reducing line losses and theft, it is simultaneously reducing subsidies to the power sector. Subsidy reduction and proper recovery of bills will play an instrumental role in curbing the menace of circular debt from resurfacing. These steps may yield the desired results in overcoming the energy shortfall that has been crippling the economy in the form of increased costs of production and low efficiency and output, and may result in higher industrial productivity.

Infrastructure development is also high on the list of govt.'s priorities. Development of dams as part of renewable energy initiatives, construction of roads, and revamp of rail links are all expected to contribute heavily to LSM, which has more than 6% by weight of cement and steel.

Outlook on the constituents of the QIM – the negatives

On a segmental basis, diminishing output at the Pakistan Steel Mills is cause for concern in the context of LSM, bearing in mind the substantial 5.4% weight of steel in the index. Furthermore, fertilizers, contributing 4.4% to the index, are a lucid example of inefficient handling of gas resources and ill planning when it comes to gas prioritization. Continuity of problems within both the sectors mentioned above will serve to pressure manufacturing growth in the country.

Higher GST and gradual increase in electricity prices would fuel further inflation.

Inflationary pressures would increase cost of production and reduce disposable income; both detrimental to the cause of LSM.

The govt. in its efforts to enhance revenue collection to bridge the rising fiscal gap, has increased the GST by 1% to 17%. Furthermore, the govt. has also announced its intentions to gradually increase electricity prices as part of programmed removal of subsidies given to the power sector in order to overcome the problems of circular debt and consequent load shedding. These two factors are expected to further fuel inflation in the economy which has already on the rise after a temporary low period. Higher inflation, while having a profound bearing on the disposable income of the consumer, is suggestive of higher costs of production, which are detrimental to the cause of LSM. As an example, the increase in the indirect tax (GST) has already had a pronounced cascading effect on inflation, which has recorded an average value of 8.4% in 2MFY14.

Weights of Top Ten QIM Items	
Items	**Weight**
Textile	20.90%
Food Beverages & Tobacco	12.37%
Coke & Petroleum Products	5.51%
Iron and Steel products	5.39%
Non Metallic Mineral Products	5.36%
Automobiles	4.61%
Fertilizers	4.44%
Pharmaceuticals	3.62%
Paper & Board	2.31%
Electronics	1.96%

Increase in discount rate by 0.5% to 9.5% is totally uncalled for!!

The SBP has already reacted to the higher inflationary pressures by increasing the discount rate by 0.50% to 9.50%. The move can be termed uncalled for at the least. Increasing interest rates at a time when the economic recovery through industrial growth is in a nascent stage will undoubtedly take the steam out from the growth momentum. The SBP would have done better to adopt a wait and see approach till the end of the calendar year instead of submitting meekly to the tough IMF demands and increasing rates, which appear to lead the economy to stagflation.

Manufacturing target of 4.5% in FY14 unlikely to be met

The govt. has set a manufacturing growth target of 4.5% in FY14 with agriculture and services projected to grow by 3.8% and 4.6%, for a cumulative GDP growth target of 4.4%. Recent widespread flooding in the country may leave the agricultural sector well short of its target as standing crops of cotton and sugar cane (two major cash crops) have been the worst affected. The manufacturing sector too looks unlikely to achieve its target as inflation and interest rates take center stage, although LSM growth for Jul'14 has come out at 3.7% which is in line with the full fiscal year target.

To conclude, the country's economy and industry will find it difficult to achieve the growth target that its managers have set for themselves, until industries are provided a growth oriented operating environment, and until the strategies mutually laid out by the public and private sectors are diligently implemented and executed.

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