What is really Happening in Indian Manufacturing?*

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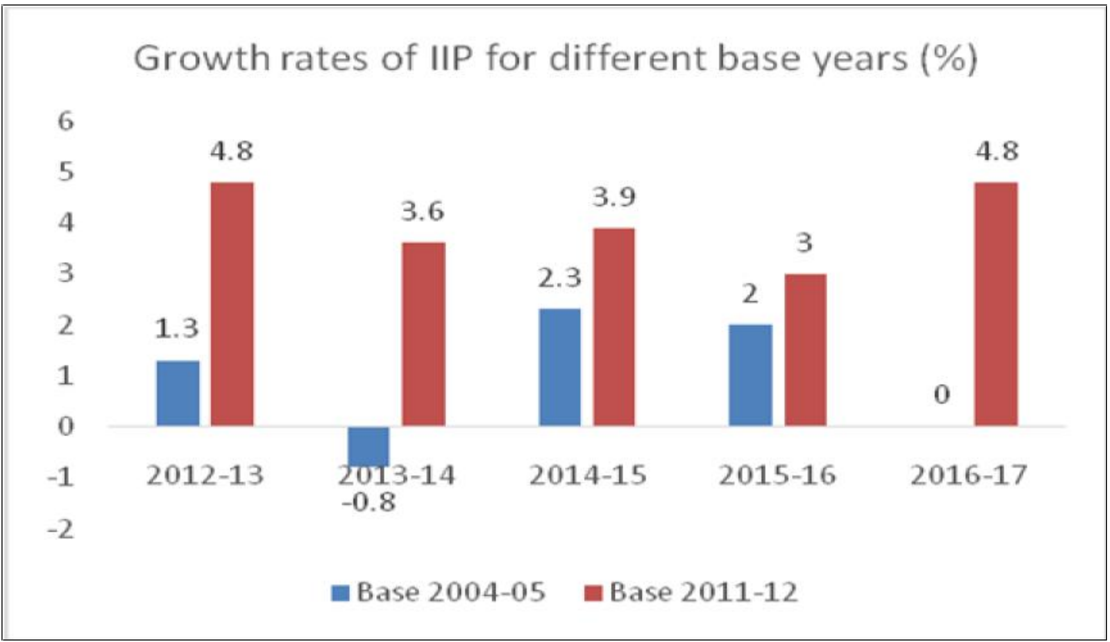
One of the major puzzles about recent trends in the Indian economy is with respect to what is happening to manufacturing output. Since domestic investment rates were declining even before Indian manufacturing was hit by headwinds from the global economy, some deceleration in the expansion of production in this sector was to be expected. And then there was the drastic demonetisation move of November 2016, which created the widespread presumption that manufacturing activity would be substantially hit because of the collapse in domestic demand induced by the cash crunch.

But the recent data at first sight appear to bely such expectations. Aggregate manufacturing value added has decelerated from 10.8 per cent in 2015-16 to 7.9 per cent in 2016-17, but this is much less of a decline than was expected. And the Index of Industrial Production (IIP) appears to have accelerated in this same period, from 3 per cent growth in 2015-16 to 4.8 per cent in 2016-17.

It is true that the IIP was revised recently, with a new base year of 2011-12, and this has led to dramatically different estimates of growth than the series with the previous base year of 2004-05. Chart 1 shows that both the extent and the direction of change of the IIP are completely different in the two series, with the earlier base year series showing a sharp deceleration in the past three years, to the point of no growth at all in 2016-17. By contrast the new series shows higher rates of growth in general and an acceleration in the latest year.

Chart 1.



As is usually the case, much of the variation between series results not only from the deletion/addition of different sub-sectors, but also the change in weights across these sub-sectors. As Table 1 shows, the earlier Basic Goods category has been divided into

Primary Goods and Infrastructure/Construction Goods, but there is only a marginal increase in share. The big change is the decline in the weight of consumer non-durable goods. One reason is the reclassification of textiles from non-durables to durables, but this accounts for only around 3 percentage points of the change. So the reduced importance of all other consumer non-durables is one major reason for the difference between the two series.

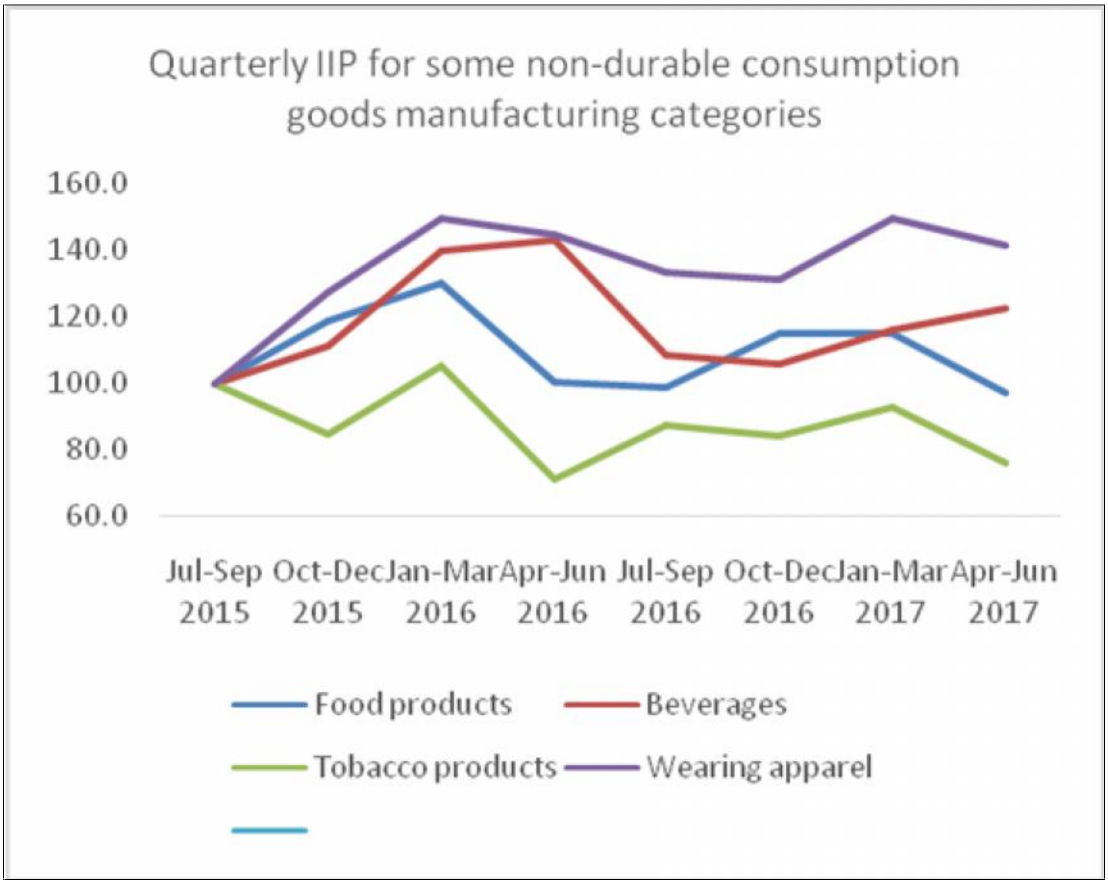
Table 1: Sectoral weights for IIP with different base years (%)

	2004-05	2011-12
Basic/Primary Goods	45.7	34.1
Infrastructure/Construction goods	NA	12.3
Capital goods	8.8	8.2
Intermediate goods	15.7	17.2
Consumer durables	8.5	12.8
Consumer non-durables	21.3	15.3

This already suggests one reason why the IIP may not be capturing changes in the aggregate manufacturing sectors in the recent past and therefore any slowdown resulting from the hit to the informal sector. Unfortunately, the IIP only covers the organised manufacturing sector, and within that, the larger units. So it cannot provide us with an understanding of how unorganised manufacturing activity has fared over this period. In addition, within the non-durable consumer goods sector, the drugs and pharmaceutical sector has become very significant, to the point where its weight is roughly similar tothat of food products. Since the estimation of production of pharma is heavily dependent upon prices, even the IIP data on this sector may not be a useful guide to actual production.

But if the demonetisation did have an impact on demand as was widely noticed by observers at the time, it is likely to have impacted on other sectors of non-durable production even in organised manufacturing, that are standard elements of consumption among those working in the informal economy.

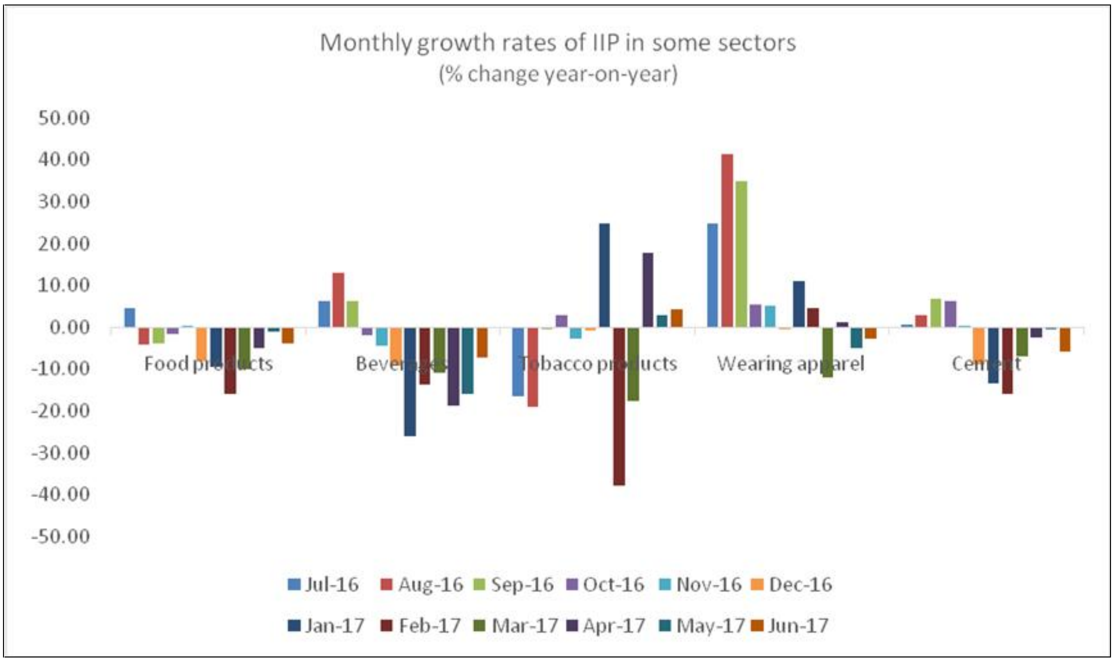
Chart 2.



Therefore Chart 2 provides data on quarterly IIP for the sectors that are most likely to show the impact of such a squeeze on demand: food products, beverages, tobacco products and wearing apparel. In the case of food and tobacco products, there were declines (therefore negative growth) in the IIP from or after Oct-Dec 2016, the period when the demonetisation occurred. The IIP for beverages had already been on a declining trend from the middle of 2016 and deteriorated further in Oct-Dec 2016; even the mild recovery since has left it well below that peak. The only subsector for which the output been roughly stagnant is wearing apparel, which could also be affected by global trends of garment export.

An examination of the monthly IIP data for these sectors and for the additional sector of cement provides further insights. Chart 3 provides year-on-year percentage changes in IIP by month from July 2015 to June 2017, and the results are striking. Food products had been showing an absolute decline from August 2016, but the decline worsened sharply from December 2016, and continued till the most recent month, June 2017. In the case of beverages a similar tendency is evident. Tobacco products have been more volatile, but even these declined significantly in November-December 2016 and again in February-March 2017. Wearing apparel has been on a definitively declining trajectory since March 2017.

Chart 3.



But the most telling indicator of the impact on demand may be what is happening to cement production. As Chart 3 shows, the IIP for cement started showing negative growth from December 2016, and since then has continued falling – with the year-on-year decline for February 2017 as much as 16 per cent. This is significant, since cement output essentially reflects construction activity, which happens to be the largest (and in the recent past the most dynamic) non-agricultural employer. The collapse of cement production in the organised sector may therefore be an indication not only of depressed informal sector demand but also depressed employment conditions in the economy.

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