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Is potential growth 8.5% then?

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Bottom line: Potential growth 8-8.5% in FY12 GDP series

What is potential growth in the new GDP series?, clients ask. Our preliminary estimate suggests it could be 8-8.5%, 100bp higher than our estimated 7-7.5% in the FY04 GDP series. "…in a sense I think we are using a better definition, which is we are using all value added in manufacturing enterprises…", Pranob Sen, chairman, National Statistical Commission, has pointed out, "…rather than just the production value which is what we were doing earlier…" Growth is systemically higher by about 100bp (and industrial growth 425bp) if we replace industrial estimates in the old GDP series with gross value added data from the *Annual Survey of Industries*. On balance, the new GDP data would also support our standing view that growth is bottoming out. With inflation well-set on the RBI's 6% January 2016 target, we would continue to expect it to cut 25bp in April and June to support recovery despite apparently very high FY15 7.4% growth. Needless to say, we have to wait for a longer FY12 base GDP series in end-February for a theoretically robust exercise to re-estimate potential growth. For details, do read our new GDP series report here.

New GDP series is based on value added rather than value

The new GDP series has shifted to using value added in manufacturing from production value used earlier. Pranob Sen, chairman, National Statistical Commission, has explained that:

"… Now on the manufacturing side in a sense I think we are using a better definition, which is we are using all value added in manufacturing enterprises rather than just the production value which is what we were doing earlier. Clearly what is happening is that the value added component is certainly growing faster than production. The IIP I think is still a very good indicator of what is happening to levels of physical production. However, value added has other things built into it such as, what is the relative price between the outputs and the inputs. So, you can have the same output and if input prices go down the value added goes up. Then you have other forms of income that corporates have treasury income for instance and all sorts of other things that corporates do which should have always been included in manufacturing. What is happening is very clear. The manufacturing growth you are seeing, of that somewhat less than half, about 40 percent appears to be volume growth and the remainder is on the growth of value added, value added per unit of output. So, it means basically that what we have seen in the last two years is not too much volume growth but quite strong efficiency growth taking place in manufacturing…

… Whether you are talking about imports, whether you are talking about auto sales, whether you are talking about excise collection, it doesn't matter. The data clearly indicates that volume production has not been high. What has been high is the value addition. So, in a sense for the same value of output you are getting higher value added. GDP is about value added, it is not about the value of production. So, in a sense the story is not of an economy which is growing faster because output is growing faster, it is a story where incomes are growing faster because value addition is going up…"

Refer to important disclosures on page 4 to 5.

Potential growth 8-8.5%, vs 7-7.5% in FY04 series…

Our preliminary estimates suggest potential growth could be 8-8.5%, 100bp higher than our estimated 7-7.5%, in the FY04 GDP series. Between FY04-12, in Table 1, industrial growth is higher by 425bp (and growth by about 100bp) if we replace industrial estimates in the old GDP series with gross value added data from the *Annual Survey of Industries*. The new FY12 GDP series will, of course, draw on the far more extensive MCA21 database.

We have always maintained that potential growth is around 7.5% in the old GDP series. We had never felt the need to raise our estimates in the up-cycle of 2004-07 just because headline growth had climbed to 8.9%. Similarly, we do not find any reason to cut it down just because actual growth came off to 5% levels in the current down-cycle. For details, do read our report here.

…with new methodology pushing up industrial GDP for now

It will be recalled that the CSO has revised FY14 growth to 6.9% in the new GDP series from 4.7% in the old series. This is largely driven by an upward revision of manufacturing growth to 5.4% from (-) 0.7% in the old series based on methodological changes.

So, what's going on? Well, industrial growth has been traditionally used on the basis of value of production. Initial quarterly estimates were initially based on lead volume data from the monthly Index of Industrial Production. Annual GDP estimates were revised – typically upwards because of wider coverage – based on data on value of output available in the Annual Survey of Industries that is published with a lag. In line with international standards, the CSO has shifted to measuring industrial GDP growth on the basis of value added. For details about IIP and ASI data coverage, do read our report here.

And, what have we done? We have compared industrial growth rates based on data on gross value added (*ie*, net value added + depreciation), also available in the *Annual Survey of Industries*, with industrial estimates in the FY04 GDP. During FY04-12, their difference works out to about 425bp, adding 85bp to GDP growth, assuming the share of industry at 20% (averaging across the old and new GDP series).

Table 1: Industrial growth higher in new methodology

FY/growth rate (%)	Real gross value added	Industrial GDP growth	Difference
2004	9.4	5.6	3.8
2005	14.8	7.5	7.3
2006	15.0	8.5	6.5
2007	19.4	12.9	6.5
2008	14.6	9.2	5.4
2009	4.2	4.1	0.1
2010	11.5	10.2	1.4
2011	12.0	8.3	3.7
2012	10.4	6.7	3.7
Average			4.3

Source: ASI, RBI, BofA Merrill Lynch Global Research estimates.

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