THE STATE OF PAKISTAN'S ECONOMY

2020-21

First Quarterly Report of the Board of Directors

State Bank of Pakistan

SBP BOARD OF DIRECTORS

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
January 05, 2021

Dear Mr. Chairman,

In terms of Section 9A(2) of the State Bank of Pakistan Act, 1956, the First Quarterly Report of the Board of Directors of the State Bank of Pakistan on the State of the Economy for the year 2020-21 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament).

Yours sincerely,

(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Muhammad Sadiq Sanjrani
Chairman
Senate
Islamabad

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Yours sincerely,

(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Asad Qaiser
Speaker
National Assembly
Islamabad

Acknowledgement

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The feedback from Financial Stability, Monetary Policy, Research and Statistics & Data Warehouse Departments; and logistic supports by Office of the Corporate Secretary and External Relations Department are also appreciated.

Contents

Chapters

Box Items

1 Overview

Pakistan economy started to regain its pre-Covid trajectory in the first quarter of FY21. There was a notable pickup in economic activity, as large-scale manufacturing (LSM) gained traction, demand indicators recorded encouraging growth, and all major *Kharif* crops, except cotton, exceeded their respective production targets. Consistent with this, the services sector also showed buoyancy. The external and fiscal sector indicators improved as well, with both the current account deficit and the primary deficit turning into surpluses during Q1-FY21 (**Table 1.1**). However, owing mainly to food prices, national CPI inflation remained on the high side.

The overall recovery is attributed to two main factors: the national strategy that contained the pandemic and the timely and well-calibrated support measures of the government and the SBP. The latter gave an extra impetus to the resumption of economic activity in Q1-FY21, after the lifting of lockdowns. In particular, compared to the demand compression focus in Q1-FY20, fiscal and monetary policies were accommodative in Q1-FY21, geared towards mitigating the economic fallout of the Covid shock.

Therefore, the contraction in economic activity in Q4-FY20 proved to be short-lived. In particular, industrial activity gathered momentum. Within LSM, the growth in cement and food processing sectors stood out during Q1-FY21, while the automobile segment also witnessed a revival. There was a corresponding uptick in demand indicators such as cement dispatches (which reached an all-time high), POL and car sales, power generation, consumer financing and fast moving consumer goods (FMCG) sales

Selected Economic Indicators **Table 1.1**

	FY20	FY20		FY21
	Full Year	Q1	Q4	Q1
Growth rate (percent)				
LSM [a]	-9.9	-5.5	-24.8	5.0
National CPI [1 a]	10.7	10.1	8.4	8.8
Private sector credit [b]	2.9	-0.3	-1.8	-1.1
Money supply (M2)[b]	17.5	0.6	8.2	1.2
Exports [b]	-7.2	1.6	-31.6	-10.4
Imports [b]	-18.2	-20.6	-24.4	-3.8
Exchange rate [2 b]	-4.8	2.4	-0.8	1.4
Tax revenue –FBR [c]	4.4	15.9	-15.2	4.8
Policy rate [3 b]	7.0	13.25	7.0	7.0
billion US Dollars				
SBP's reserves [3 b]	12.1	7.9	12.1	12.2
Workers' remittances [b]	23.1	5.5	6.1	7.1
FDI in Pakistan [b]	2.6	0.5	0.4	0.4
percent of GDP				
Fiscal balance [d]	-8.1	-0.7	-4.1	-1.1
Primary balance [d]	-1.8	0.7	-2.3	0.6
Current account balance [b]	-1.1	-2.3	-0.4	1.1

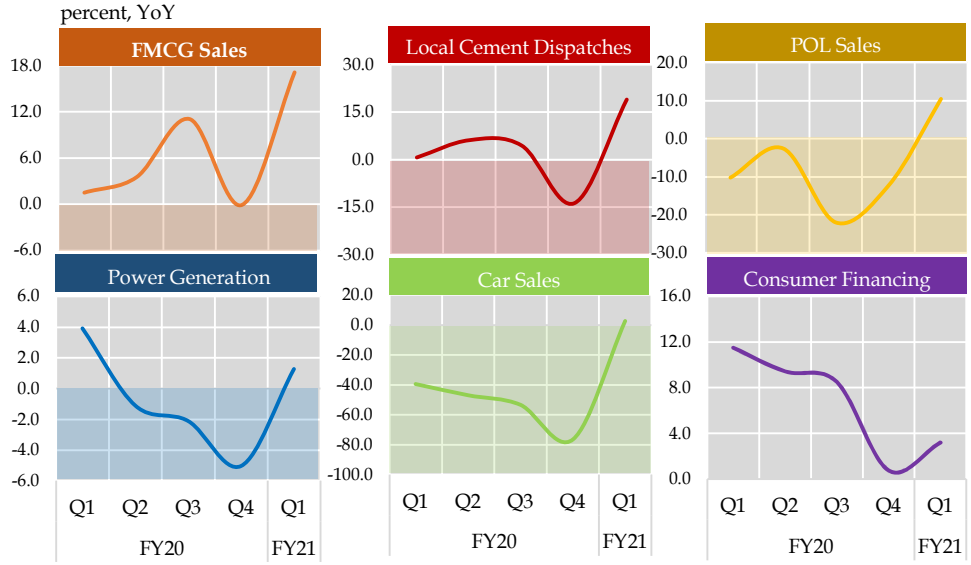
[1]period average [2]appreciation (+)/depreciation (-) in percent [3]end period

Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Federal Board of Revenue and [d] Ministry of Finance

(Figure 1.1). Consistent with these trends, indicators of the labor market, as collated from statistical bureaus of Punjab and Sindh, the SBP Business Confidence Survey (BCS), and PBS data on wages, also pointed towards growth in employment during July-August 2020. The improvement was also captured in the SBP BCS, of August 2020, as the sentiment of the business community turned positive for the first time since the February 2020 wave of the BCS.

Growth in Demand Indicators **Figure 1.1**

percent, YoY



Source: SBP, APCMA, PAMA, OCAC, NEPRA & Corporate reports (various issues)

Also, the government's incentives for the construction sector provided impetus for its allied manufacturing segments.[1] The SBP complemented this effort by assigning mandatory targets for housing and construction finance, which required banks to increase their mortgage portfolios to at least 5 percent of their private sector credit by end-December 2021.

In the agriculture sector, rice, sugarcane, and maize surpassed their production targets during the Kharif season. In addition to an increase in the cultivated area of rice and sugarcane compared to last year, the government's agriculture package, with a particular emphasis on fertilizer subsidy, also contributed to the favorable outcome. That said, the area for the competing cotton crop fell to its lowest level since FY82, and its yield was adversely affected by severe monsoon rains, particularly in Sindh, and pest attacks.

There was also improvement in the services sector during Q1-FY21, especially in key segments like *wholesale and retail trade* and *transport, storage and communication*. This was reflected in proxy indicators such as higher import volumes, FMCG sales and sale of commercial vehicles. Also, the mobility of people and, by extension, the delivery of services – which had been severely disrupted by the earlier lockdowns – was largely back to pre-Covid levels by end-September 2020.

Meanwhile, the external sector continued to navigate the Covid crisis smoothly, as the current account posted a surplus in Q1-FY21 after a lapse of 21 quarters. The surplus was

[1] This included subsidies for low-cost housing, relaxations for investors regarding source of income, and simplification of paperwork and approvals.

largely attributed to a noticeable increase in workers' remittances and a sharp fall in services imports, which more than offset the deterioration in the merchandise trade balance during the review period.

Within the trade balance, the deterioration came from a decline in export receipts compared to the same period last year, as demand remained soft among key trading partners and exporters were permitted to hold receipts abroad for a longer timeframe in the wake of Covid. Nonetheless, considering the pandemic-induced slowdown in the global economy, Pakistan's export performance was relatively better compared to a number of other emerging markets. This was partly due to the government's handling of the Covid outbreak and the relatively early resumption of economic activity, which gave export-oriented sectors like textiles a head start in capturing export orders. As a result, exports regained their pre-Covid trajectory in September 2020, helped by higher export receipts for textiles, cement and pharmaceuticals.

On the other hand, import payments also remained lower than the same period last year. This owed to the steep drop in global oil prices, which helped offset some of the upward pressure emanating from rising imported food prices. Meanwhile, Covid-related air travel restrictions dampened the level of Pakistan's services imports.

While these restrictions also helped divert workers' remittances from informal to formal channels, continued policy measures under the Pakistan Remittance Initiative (PRI) and the promotion of formal and digital channels had a major role as well. Thus, workers' remittances exceeded US$ 2 billion for the fourth consecutive month in September 2020, and contributed to the improvement in the current account balance.

This improvement gave a further boost to the country's overall FX reserves, and strengthened the exchange rate. Specifically, the country's FX reserves rose to US$ 19.4 billion by end-September 2020. At the same time, SBP reserves improved by a further US$ 4.2 billion over the last year. Meanwhile, the exchange rate appreciated by 1.4 percent during Q1-FY21.

The overall fiscal deficit was higher in Q1-FY21 in YoY terms. This outcome could be traced to the Budget FY21 which aimed to strike a balance between deficit reduction and extending support to the vulnerable segments. Moreover, tariff concessions on various raw materials were offered to catalyze the growth in industry and exports. Thus, FBR tax revenues recovered visibly as economic activities resumed, and also remained higher than the target set for the quarter. However, overall revenues remained lower than last year, with non-tax revenues recording a decline. On the expenditure side, development spending was scaled up, as the government expedited progress on ongoing infrastructure projects and uplifting of under-developed areas. However, spending on power and petroleum was rationalized, and wages and salaries were kept unchanged.

As a result, the primary balance posted a surplus of 0.6 percent during Q1-FY21, almost the same as in Q1-FY20. However, the steep rise in interest payments consumed over 73 percent of FBR taxes and constituted nearly 53.8 percent of total federal expenditures.

The government's continued adherence to fiscal discipline was also reflected in zero fresh borrowing from SBP. Nonetheless, the higher YoY fiscal deficit led to an increase in the stock of public debt. However, the build-up of government deposits was relatively contained compared to Q1-FY20, which contributed to a lower pace of debt accumulation this year. At the same time, the government was able to lengthen the maturity profile of public debt by mobilizing funds through floating rate, long-term instruments.

Moreover, a surplus in the current account and debt relief provided by G-20 countries under the Debt Service Suspension Initiative (DSSI) provided support to external debt management. The government reverted to concessional borrowing sources during Q1-FY21, and achieved a lower average cost of borrowing for the third successive quarter.

As for prices, there was a slight increase in headline inflation during Q1-FY21, compared to the preceding quarter. The upward pressure originated from food inflation, as supply side factors drove up the price of non-perishable and perishable food items. These factors have both a domestic component (below-target domestic production of wheat, commodity management issues, impact of heavy rain on yield of perishable crops), and a foreign component (recovery in prices of global agricultural products compared to Q4-FY20). Both domestic and foreign components have been affected by Covid-related supply chain disruptions and unfavorable weather conditions.

Nonetheless, the impact of rising food prices on headline inflation was partially offset by subdued underlying inflationary pressures, as measured by non-food-non-energy index. This tapering in core inflation during Q1-FY21, despite an uptick in domestic demand, was due to well-anchored inflation expectations. Furthermore, exchange rate appreciation, tax and tariff concessions of the Budget FY21, and relatively stable transportation costs played a part in keeping core inflation in check.

Therefore, the Monetary Policy Committee (MPC), in its September 2020 meeting, held the view that the accommodative stance created by the prevailing policy rate of 7.0 percent and other facilitative policies of both the government and the SBP were sufficient to support the emerging recovery while keeping inflation expectations anchored and safeguarding financial stability. Besides this monetary policy stance, the central bank's policy measures enabled banks to strengthen resilience and limit credit risk despite the Covid shock.[2] Take-up under the different regulatory relief and refinancing facilities of the SBP has also evolved in line with the trajectory of Covid cases in Pakistan. More recently, take-up of the Temporary Economic Refinance Facility (TERF), providing financing at low rates for investment, is now seeing healthy pick-up as the economy recovers and businesses feel more confident about future prospects. Specifically, the amount requested under TERF has increased from Rs 36.1 billion at end-April 2020 to Rs 441.1 billion as of 19 November, 2020, with approved financing rising from Rs 0.5 billion to Rs 192.2 billion during this period.

[2] For details of the central bank's measures to counter Covid, see the following SBP publications: (1) 'The State of Pakistan's Economy' Third Quarterly Report for FY20; (2) 'The State of Pakistan's Economy' Annual Report for FY20; and (3) Financial Stability Review - 2019. Furthermore, the features, timeline, and performance of the SBP's Covid-related measures are also available at: sbp.org.pk/COVID/index.html.

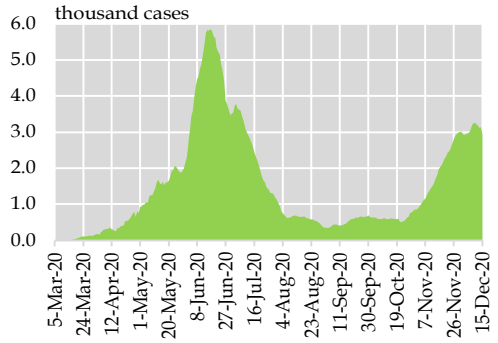
The improvement in various economic indicators during Q1-FY21 is encouraging. However, its continuation in the short term depends to a large extent on the trajectory of the pandemic, while sustainable growth over the medium term would require progress on the structural reforms front. For example, as noted in the SBP's Annual Report for FY20, reforms related to improvements in the tax structure, pricing and governance issues in the energy sector, and restructuring or privatization of loss-making state-owned enterprises are imperative. In addition to these, public pension restructuring is another important area for reform. This report includes a special section on public sector pension expenditure in Pakistan, which has risen rapidly over the past decade. Given the fiscal constraints, the section proposes improvements in the public pension framework through various steps like proper indexation of increments, elimination of retrospective increases, and rationalization of survivorship benefits.

Economic Outlook

As the economy recovers from the Covid-induced contraction, it is now faced with uncertainty related to intensification of the second wave of the pandemic. This concern poses both upside and downside risks to the SBP's macroeconomic projections.

Real GDP growth is projected to be in the range of 1.5 to 2.5 percent in FY21 (**Table 1.2**). This is based on the current trends of economic activity. However, downside risk to this projection includes the second wave of

New Covid-19 Cases in Pakistan (7-day rolling avg.) **Figure 1.2**



Source: World Health Organization

Key Macroeconomic Targets and Projections **Table 1.2**

	FY20	FY21	
		Target[1]	SBP[2] Projections
percent growth			
Real GDP	-0.4	2.1	1.5 - 2.5
CPI (average)	10.7	6.5	7.0 - 9.0
billion US Dollars			
Remittances	23.1	21.5	24.0 - 25.0
Exports (fob)	22.5	22.7	23.0 - 24.0
Imports (fob)	42.4	42.4	43.0 - 44.0
percent of GDP			
Fiscal deficit	8.1	7.0	6.5 - 7.5
Current a/c deficit	1.1	1.6	0.5 - 1.5

Source: [1]Ministry of Finance; Planning Commission; [2]SBP

Covid, which has swept across many countries and, in Pakistan's case, gained momentum in November 2020 (**Figure 1.2**). Supply-side shocks from uncertain weather conditions cannot be ruled out either.

At the same time, there are also potential upsides. These include the development and distribution of an effective vaccine and its possible early availability.[3]

[3] Encouraging news began surfacing in November 2020, with as many as three Covid vaccine trials showing promise. Of the three vaccines alluded to, anecdotal evidence suggested that the one developed by AstraZeneca and Oxford University may be particularly relevant for developing countries, given that it is cheaper and easier to store and distribute compared to the vaccines developed by Pfizer and Moderna (subject to approval of respective regulators).

Moreover, the announced increase in the wheat support price and subsidies on fertilizer and pesticides may contribute to a better than expected out-turn of *Rabi* crops. In addition, the October 2020 wave of the SBP BCS also reflects improved business sentiment, with the purchasing managers index (PMI) turning positive for the first time after eight waves.

The government's handling of the current surge in Covid infections includes keeping of business activities running under standard operating procedures (SOPs), thereby supporting economic activity and employment. The restrictions are focused more on reduced public gatherings, provisions for staff to work from home, and temporary closure of educational institutes. Nonetheless, the overall growth outcome hinges on how the Covid infections and the associated government response evolve.

The outlook for the external sector has improved since the previous set of projections published in SBP's FY20 Annual Report. The current account deficit is now projected to be in the range of 0.5-1.5 percent of GDP (earlier: 1.0 to 2.0 percent of GDP). The revision is mainly due to an upward adjustment in workers' remittances, which are now expected to be in US$ 24.0-25.0 billion (earlier: US$ 22.0-23.0 billion).

However, projections of workers' remittances are subject to risk from the outlook for the oil-exporting GCC economies, whose fiscal balances might deteriorate further with the escalation in global Covid infections. This may translate into a sizable reduction in their demand for foreign workers, leading to lower remittance inflows to Pakistan.

The outlook of exports and imports largely remains unchanged from their earlier assessment. The greater quantum of high value added textiles and food commodities – especially rice – are expected to generate above target growth in exports. That said, the key downside risk to this outlook stems from the resurgence of Covid in major export destinations of Pakistan, which has the potential to suppress demand. On the upside, the incentives given in the industrial support package since early November 2020 may help the textile sector exports perform better.[4] Similarly, imports are projected to surpass their annual target. The increase in food imports and domestic economic activity is mainly expected to drive import growth. That said, the increase in global Covid infections and associated further decline in crude oil price could lower import payments.

As for the fiscal deficit, the latest projections suggest that it remains on track to meet the annual target of 7.0 percent of GDP. Going forward, the fiscal situation would continue to depend on the domestic evolution of Covid. The upside risks mainly stem from: (a) the health fallout, and (b) the potential economic fall-out, in case of protracted or intensified lockdowns in the remainder of FY21. By contrast, faster than anticipated economic revival, which gives the government room to generate more revenues, either by rolling back certain tax concessions or imposing fresh levies, could contain the deficit further.
Regarding the inflation outlook, the SBP projects average inflation in FY21 to remain

[4] The package mainly comprised a reduction in the electricity rate for industrial consumers on incremental consumption and an end to peak and off-peak electricity rates.

in the 7.0 – 9.0 percent range. It is important to highlight that food inflation, triggered by supply side factors, has been driving up headline inflation recently. Meanwhile, core inflation has been relatively moderate, owing to benign cost and demand factors. Given the spare capacity in the industrial sector, high base effect, and actions being taken to correct the supply side issues in the food market, upside risks to the inflation outlook are largely contained. The latest SBP surveys also reflect well-anchored inflation expectations of both businesses and consumers.

2 Real Sector

As the government eased mobility restrictions following a significant reduction in domestic Covid cases, activity started to pick up in all sectors of the economy during Q1-FY21. Fiscal and monetary incentives had been offered to multiple sectors and the results of these measures became evident in Q1-FY21. The industrial sector showed a robust growth during the period, while preliminary estimates of important crops suggested an overall improvement in the agriculture sector as well. Buoyancy in the commodity-producing sector, in turn, trickled down to the services sector, with an improvement in wholesale and retail trade, transport, and financial sector indicators. The positive sentiment was further substantiated by a significant improvement in the SBP Business Confidence Index from July 2020 to August 2020. Commensurate with the increase in overall output, indicators of the labor market such as industrial employment, Business Confidence Survey-based employment index and wages in the construction sector, all suggested pick-up in employment.

2.1 Economic Growth

Prospects of economic growth showed visible signs of improvement during Q1-FY21. After a turbulent Q4-FY20 in which industrial and services sector activity remained largely subdued due to Covid induced mobility restrictions, Q1-FY21 started on a promising note for these sectors. Industrial sector activities proxied by Large Scale Manufacturing (LSM) posted an encouraging recovery. Pickup in petroleum and automobile industries indicated a normalization in transport activity, whereas expansion in cement and long steel production pointed towards growth in the labor-intensive construction sector.

With the exception of the cotton crop, the agriculture sector's performance during the *Kharif* season was also broadly encouraging. Estimates of sugarcane and rice production indicated a noteworthy improvement from last year. However, the cotton crop suffered due to exceptionally heavy monsoon rains and pest attacks.

The indicators for the services sector also pointed to a recovery, especially in the wholesale and retail trade, transportation, and general government services segments. Gauging from mobility data, activity in a number of related segments reverted back to pre-Covid levels by end-September 2020.

The labor market, in line with improvements in the LSM and services sector, also portrayed positive trends in the period. Indicators of employment suggested recovery during Q1-FY21. This was evident in the Punjab and Sindh manufacturing sector index of employment, Business Confidence Survey and positive growth in wages of both rural and urban construction sector. However, the labor market could not yet reach pre-Covid employment levels in these sectors during the review period.

Judging from the first quarter's performance, the economy appears to be on track to achieve the real GDP growth target of just over 2 percent (**Table 2.1**). In fact, in the Annual Plan for FY21, the government had expected the decline in the LSM to continue. Hence, the bright start made by the LSM during Q1-FY21 bodes well for the economy's full-year prospects. For agriculture as well, the output of major crops, such as rice, sugarcane and maize, surpassed the respective targets during the *Kharif* season. The upward revision of wheat support price and subsidies on fertilizer and pesticides are likely to aid recovery despite a

Growth Targets in Annual Plan FY21 **Table 2.1**

percent

	FY19	FY20	FY21[T]
Agriculture	0.6	2.7	2.8
Important crops	-7.7	2.9	1.9
Livestock	3.8	2.6	3.5
Industry	-2.3	-2.6	0.1
LSM	-2.6	-7.8	-2.5
Construction	-16.8	8.1	3.5
Electricity & gas	14.5	17.7	1.4
Services	3.8	-0.6	2.6
Wholesale & retail	1.1	-3.4	1.1
Transport & comm.	4.6	-7.1	0.9
Finance & insurance	5	0.8	3
Housing	4	4	4
General government	5.2	3.9	4.6
GDP	1.9	-0.4	2.1

T: target

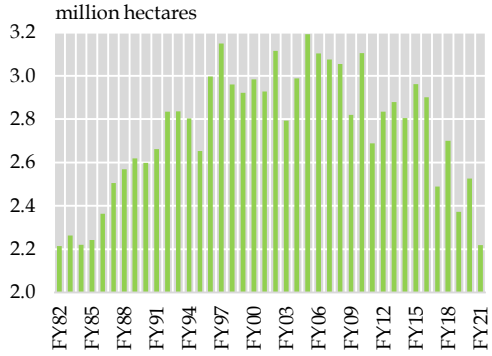
Source: Annual Plan 2020-21, Ministry of Planning, Development & Special Initiatives

shortfall in cotton production. Given its interlinkages with industry and agriculture, the services sector's annual target also appears to be attainable as long as the pace set during Q1-FY21 is maintained.

2.2 Agriculture

Among major crops, rice and sugarcane crops performed well during *Kharif* FY21. Estimated production for both crops was higher compared to last season as well as their annual targets. To some extent though, this came at the expense of a decline in area dedicated to the competing cotton crop. The area under cotton, at a little over 2.2 million

Area under Cotton in Pakistan **Figure 2.1**



Source: Pakistan Bureau of Statistics; Ministry of National Food Security & Research

hectares, was the lowest on record since FY82 (**Figure 2.1**).

As reported previously in the SBP's FY20 Annual Report, overall crop production in the agriculture sector was relatively less affected by Covid during FY20, since the harvest of most of the major crops had already been completed before the lockdowns came into effect. Similarly, while locusts had appeared to pose a considerable threat in H2-FY20, continuous survey and control operations enabled the country to contain a major fallout on crop output.[1,2]

Nonetheless, the outlook for agriculture remained subject to certain risks. In surveys conducted by the Asian Development Bank (ADB) with farmers to gauge the dual impact of locusts and Covid lockdowns on agriculture, several respondents – more so in Sindh, and to a lesser extent in Punjab –

[1] As of 10th November, 2020, the area surveyed amounted to around 62.3 million hectares, and control operations had been conducted over an area spanning 1.1 million hectares. Source: National Locust Control Centre, Government of Islamic Republic of Pakistan.

[2] Initial estimates suggest that crops in Balochistan incurred damages amounting to Rs 4 billion, while other provinces are still in process of assessment. Source: Minutes of the 15th Meeting of the Federal Committee on Agriculture for *Rabi* season .

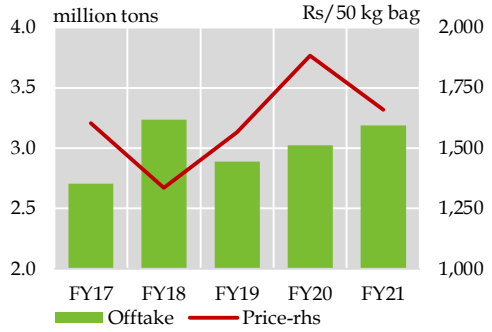
reported seeing locust swarms.[3] In addition, while farmers in Punjab did not report a major impact of the Covid lockdown on the wheat harvest, survey respondents in lower Sindh in particular cited labor shortages and Covid disruption as a factor that delayed their wheat harvest and marketing efforts. Moreover, growers of minor crops (including vegetable and fruit) and milk producers in both provinces reported difficulties in marketing their produce due to Covid-related restrictions. For perishables like tomatoes, supply-side disruptions contributed to an increase in prices of such items during Q1-FY21 (details in **Chapter 3**). Given the findings of the ADB surveys, official assessment of the province- and crop-wise impact of locusts and Covid lockdowns on agriculture is awaited for a more in-depth analysis.

Inputs

From a policy perspective, the government formulated an agriculture package as part of its broader Rs 1.2 trillion Covid relief package. This agriculture package, amounting to Rs 50 billion, had four main focus areas: fertilizers; agriculture loans, tractors, and cotton seeds. It was approved by the ECC in May 2020 and had a bearing on the *Kharif* FY21 season.

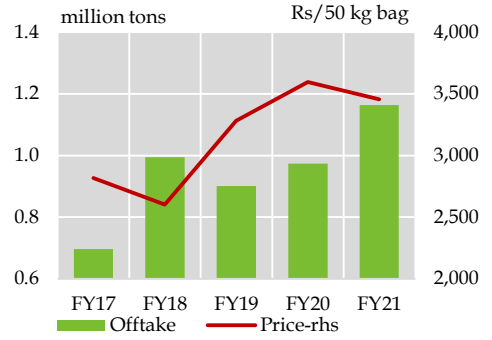
The bulk of the package was earmarked for subsidies on fertilizer purchase. The rationale was that fertilizers account for nearly 10 to 15 percent of the cost of production for major crops, and the subsidy would make this input more affordable for farmers. Enhanced application of fertilizer could, in turn, boost crop yields. The subsidy had a notable impact, as fertilizer prices for urea and DAP fell by 12 percent and 4 percent YoY, respectively, during the *Kharif* season and played a part in increasing their respective offtake (**Figure 2.2a, Figure 2.2b**).[4]

Urea Offtake and Price during *Kharif* (Apr-Sep) **Figure 2.2a**



Source: National Fertilizer Development Centre

DAP Offtake and Price during *Kharif* (Apr-Sep) **Figure 2.2b**



Source: National Fertilizer Development Centre

[3] Source: ADB (2020). *COVID-19 Impact on Farm Households in Punjab, Pakistan: Analysis of Data from a Cross-Sectional Survey*. ABD Briefs No. 149. Mandaluyong: Asian Development Bank; ADB (2020). *COVID-19 Impact of COVID-19 and Locust Swarms on Farm Households in Sindh, Pakistan: Analysis of Data from a Cross-Sectional Survey*. ABD Briefs No. 149. Mandaluyong: Asian Development Bank.

[4] The proposed subsidy for urea and DAP amounted to Rs 243 and Rs 925 per bag, respectively.

The agriculture package also had a provision for a reduction in the mark-up on agriculture loans, which could potentially drive up agriculture credit. However, while the weighted average lending rate (WALR) on agriculture loans fell subsequently, the disbursement of agriculture credit during Q1-FY21 remained lower than the comparable quarter last year (**Table 2.2**).[5] From a sectoral perspective, the drag emanated from the non-farm sector, as disbursements to the livestock, dairy, and poultry segments declined. This could be reconciled with the Covid related restrictions on marriage halls and restaurants, which continued to suppress the demand for segments like poultry during Q1-FY21.[6,7]

Agriculture Credit Disbursements (Q1) **Table 2.2**

billion Rupees

	FY20	FY21p
Farm sector		
A. Production	103.8	113.9
B. Development	9.3	5.6
Tractor	0.7	0.6
C. Total farm sector (A+B)	113.1	119.5
Non-farm sector		
Livestock/dairy	77.8	71.2
Poultry	64.3	49.5
Other	8.1	14.4
D. Total non-farm sector	150.2	135.1
Total agri (C+D)	263.3	254.7

p=provisional

Source: State Bank of Pakistan

Meanwhile, within the farm sector credit, disbursement of development loans remained subdued. In particular, disbursements for tractor purchases were lower compared to the same period last year, despite an extension of subsidy on sales tax of locally manufactured tractors for a period of one year. While tractor production and sales rose during Q1-FY21 (as indicated by the LSM and PAMA data), bank financing did not pick up in a commensurate manner. There is a possibility that higher remittance inflows during Q1-FY21 relative to the comparable quarter last year facilitated a greater amount of cash purchases of tractors during the review period. By contrast, production-related borrowing in the farm sector was on the higher side during Q1-FY21 compared to the same period last year, suggesting that better crop outcomes created demand for working capital loans.

Furthermore, up until end-September 2020, the government had budgeted Rs 1.5 billion to tackle the locust situation.[8] Owing to the priority focus and concerted survey and control operations, the impact of locusts on *Kharif* FY21 crop output was limited. Moreover, by October 2020, the locust prone area in Pakistan had largely been cleared of the threat, though the Food and Agriculture Organization (FAO) recommended that surveys be kept ongoing in Cholistan,

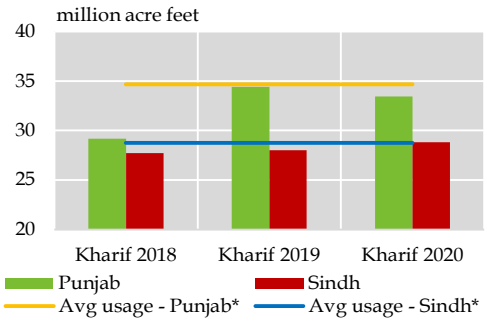
[5] The weighted average lending rate (WALR) for the agriculture sector fell to 11.8 percent by end-June 2020, compared to 13.7 percent as of end-June 2019.

[6] While the government issued guidelines for the reopening of food establishments and restaurants on 8th August, 2020, a number of restrictions – particularly on indoor dining – remained in place. Similarly, marriage halls remained closed till mid-September 2020.

[7] The poultry segment experienced a YoY deflation of 14.5 percent during Q1-FY21, compared to a 44.4 percent inflation during Q1-FY20.

[8] Source: Federal Budget 2020-2021, Details of Demands for Grants and Appropriations, Volume 3, Current Expenditure, Government of Pakistan, Finance Division, Islamabad.

Irrigation Water Releases **Figure 2.3**



* Ten-year average system usage
Source: Indus River System Authority

Tharparkar and Lasbella, and surveillance be continued till at least end-November 2020.[9]

In terms of water availability, irrigation water releases in Sindh were marginally higher compared to the same period last year, and at par with the ten-year *Kharif* season average system usage (**Figure 2.3**). Irrigation water released in Punjab was also broadly in line with the long-term average. However, heavy and untimely rains, especially in Sindh, damaged the cotton crop.

Output

Cotton

Cotton production fell for the third consecutive year, as area under production declined while yields failed to reach targeted levels. Specifically, cotton production declined by 7.7 percent to 8.4 million bales, according to provisional estimates (**Table 2.3**). Recall that, last year, the area dedicated to the crop had grown (by 6.1 percent), but the production had been undermined by low yield. However, in the *Kharif* FY21 season, the prospects of higher cotton production were slim from the outset, given that the area dedicated to the crop, recorded at 2.2 million hectares, is the lowest since FY82 **(**as depicted in **Figure 2.1** earlier).[10]

Cotton Crop Estimates **Table 2.3**

		FY21		Growth (percent)	
	FY20	Target	FY21 P	FY20	FY21
Area ('000 hectares)					
Punjab	1,879.6	1,600.0	1,546.0	-0.4	-17.7
Sindh	598.7	640	615	33.6	2.7
Pakistan	2,517.0	2,310.0	2,217.9	6.1	-11.9
Production ('000 bales)					
Punjab	6,306.6	6,000.0	5,300.0	-7.6	-16
Sindh	2,746.0	4,600.0	3,000.0	-6.5	9.2
Pakistan	9,149.0	10,897.5	8,442.7	-7.2	-7.7
Yield (kg/hectares)					
Punjab	570.7	637.8	583.1	-7.2	2.2
Sindh	780.1	1222.5	829.7	-30	6.4
Pakistan	617.8	802.4	647.5	-12.6	4.8

P: provisional
Source: Ministry of National Food Security and Research

[9] Source: 27th Commission for Controlling the Desert Locust in South-West Asia (SWAC)- Technical and Operational Coordination (TOC) Virtual Meeting on Locust Surveillance and Control for Pakistan, held on 12th October, 2020.
[10] Specifically, the area under cotton in FY82 was 2,214.1 thousand hectares, marginally lower than the 2,217.9 thousand hectares registered in FY21.

The area under cotton has witnessed a secular decline in the past decade: it averaged 2.7 million hectares during FY12 to FY21, compared to nearly 3 million hectares between FY92 to FY11. The crop has lost its competitiveness relative to other major crops, in particular sugarcane.[11]

Being a tradable commodity, there is higher competition in the cotton market, which effectively puts a ceiling on its price growth. Meanwhile, sugarcane is generally non-tradable, and the market structure does not allow it to be traded across borders. Moreover, the minimum support price for sugarcane also gives comfort to growers. Therefore, the pricing dynamics have tended to give sugarcane an edge over cotton, which has manifested in the switching of area away from the latter in favor of the former.[12]

In terms of yield, the cotton yield in Sindh in *Kharif* FY21 was affected by severe monsoon rains. The rainfall received by the province during August 2020 was a staggering 363 percent above the normal average for this month, making it the wettest August observed in the past sixty years.[13] Among the more prominent cotton-growing regions, Mirpurkhas and Dadu received 348 mm and 180 mm of rain during August 2020, compared to the normal levels of 76.5 mm and 29.9 mm, respectively. This caused widespread damages to the standing crops in Sindh. Specifically, the rains and flash floods completely damaged around 27 percent of the cotton crop grown in Sindh. At the district level, as much as 80 percent of the crop in Mirpurkhas and Umerkot was affected. In Punjab, also, around 8,034 acres (or 3,251 hectares) of crop area was badly affected by excess rain. [14] As a result, the provisional cotton yield was estimated to be 47.3 percent short of the FY21 target in Sindh, and 9.4 percent shy of the annual target for Punjab.

While heavy rains played an outsized role in depressing the cotton yields during *Kharif* FY21, the yields have been erratic over the past decade on the whole. This can primarily be traced to the gaps in cotton seed quality, which leave the crop susceptible to weather-induced damages and attacks by pests like the pink bollworm and whitefly.[15,16] Thus, research and development of high-yielding varieties of cotton seed, along with improved availability of certified cotton seeds, needs priority focus.

[11] For details, see the SBP Annual Report on The State of Pakistan's Economy for FY20.
[12] The switching towards the water-intensive sugarcane crop appears to be more prominent in Punjab, where groundwater of adequate quality is more widely available in addition to canal water, compared to the relatively saline groundwater available in many districts of Sindh.
[13] Source: Pakistan Meteorological Department (2020). *Pakistan's Monthly Climate Summary, August 2020*. Karachi: Pakistan Meteorological Department
[14] Source: Pakistan Cotton Grower, 2020, Central Cotton Research Institute Multan, Vol.3, No. 3.
[15] Regarding seed quality, anecdotal evidence suggests that the downward relaxation of germination standard, from 70 percent in *Kharif* FY20 to 50 percent in *Kharif* FY21, may have contributed to the relatively low yield during the latest season relative to the annual target.
[16] The government had provided a subsidy on imported PB Ropes to combat pests like the pink bollworm. Even so, some cotton farmers could not afford the technology, and their cropped area fell prey to pink bollworm attacks.

Early Estimates of Sugarcane Crop Performance **Table 2.4**

		FY21		Growth (percent)	
	FY20	Target	FY21P	FY20	FY21
Area ('000 hectares)					
Punjab	643	752.7	776	-9.5	20.7
Sindh	286.1	310	288.8	2.4	1
Pakistan	1,039.3	1,180.60	1,174.2	-5.7	13
Production ('000 tons)					
Punjab	43,346.6	44,906.0	52,528.6	-3.5	21.2
Sindh	17,233.8	19,000.0	17,325.2	3.3	0.5
Pakistan	66,379.6	69,801.5	75,646.7	-1.2	14
Yield (kg/hectare)					
Punjab	67,413.0	59,659.9	67,691.5	6.7	0.4
Sindh	60,239.2	61,290.3	59,982.1	0.9	-0.4
Pakistan	63,867.0	59,123.8	64,426.2	4.8	0.9

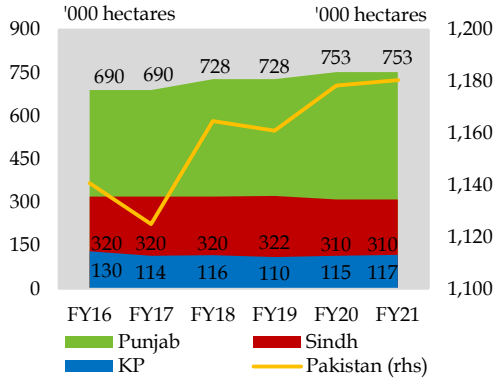
P= provisional

Source: Ministry of National Food Security and Research

Sugarcane

The sugarcane crop experienced an increase in area under cultivation, while yields remained more or less unchanged compared to last year **(Table 2.4**). The crop has generally given attractive returns to growers in the recent past compared especially with the cotton crop; estimates suggest that this relative profitability of sugarcane was maintained in FY21.[17]

Target area for Sugarcane **Figure 2.4**



Source: Ministry of National Food Security & Research

It is worth recalling that back in April 2018, the Federal Committee on Agriculture (FCA) had advised the provinces to develop strategies that encouraged a shift away from sugarcane production towards lower delta crops, with an eye towards mitigating water scarcity. However, sugarcane continued to be a favored crop for growers, contradicting the expected shift. The FCA recommendation can possibly be implemented through targeted area and support price signals (**Figure 2.4**).

[17] From a profitability angle, the grower's *ex-ante* anticipation of better returns from sugarcane this season (reflected in greater area under cultivation) were validated *ex-post*. For Punjab, the profit at farm gate was estimated to be Rs 22,993 per acre for sugarcane, compared to Rs 9,051 per acre for cotton (both estimates are based on weighted average cost of production, for growers paying land rent). Source: Crop Reporting Service, Government of the Punjab.

Rice Crop Performance **Table 2.5**

		FY21		Growth (percent)	
	FY20	Target	FY21P	FY20	FY21
Area ('000 hectares)					
Punjab	2,029.0	1,900.0	2,441.0	6.6	20.3
Sindh	775.9	800.0	707.7	12.4	-8.8
Pakistan	3,034.0	2,957.0	3,380.80	8	11.4
Production ('000 tons)					
Punjab	4,144.0	4,200.0	4,984.00	4.1	20.3
Sindh	2,576.5	3,000.0	2,493.00	0.2	-3.2
Pakistan	7,414.0	7,990.0	8,184.30	2.9	10.4
Yield (kg/hectare)					
Punjab	2,042.4	2,210.5	2,041.8	-2.3	-0.03
Sindh	3,320.8	3,750	3,522.8	-10.9	6.1
Pakistan	2,443.6	2,702.1	2,420.8	-4.7	-0.9

P= provisional

Source: Ministry of National Food Security and Research

Rice

Building on the previous season, the overall cultivated area for rice grew by 11.4 percent during *Kharif* FY21 (**Table 2.5**). Rising unit prices and upbeat demand for the country's rice in export markets have made the rice crop a profitable investment for growers.

That said, on a provincial basis, there was some decline in the area under the rice crop in Sindh. This may have been a reaction to the last season's unfavorable experience, when above normal temperatures in rice-growing districts like Larkana, Jacobabad, Thatta and Badin during September 2019 contributed to a double-digit decline in yields in Sindh.

2.3 Large Scale Manufacturing

The output of the LSM sector expanded during Q1-FY21 compared to Q4-FY20 and Q1-FY20 (**Table 2.6**). Analyzed in context to the preceding quarter, when the economy was hamstrung by the Covid shock, the recovery in the review period was expected on the back of resumption of production activities. However, compared to Q1-FY20, when the LSM sector was in the middle of a sustained downturn, the performance in Q1-FY21 was noteworthy (**Figure 2.5**).

The blow to the industrial sector was mitigated by well-coordinated fiscal and monetary stimulus. The government announced incentive packages focusing primarily on the construction and export-oriented sectors.[18, 19] In addition, the SBP lowered its policy from 13.25 percent to 7 percent, and initiated several facilitative schemes to speed-up the recovery. While the incentives were largely implemented in the preceding period, the positive impact of these measures became more prominent in Q1-FY21.

[18] Source: Ministry of Finance (2020). *Monthly Economic Update, April 2020*. Islamabad: Economic Advisor's Wing, Ministry of Finance.

[19] Source: The Tax Laws (Amendment) No. 1 of 2020, Law and Justice Division Letter F.No.1(1)/2020, dated April 19, 2020, Federal Board of Revenue.

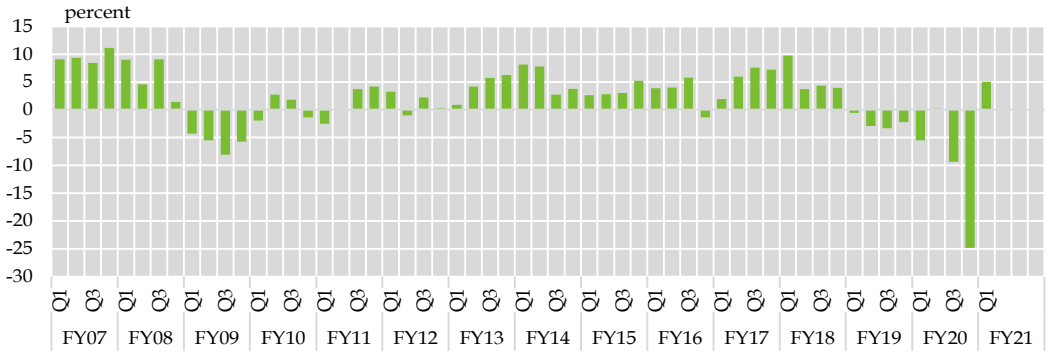
LSM Growth (Q1) **Table 2.6**

percent, YoY

	wt.	Growth					Contribution in growth				
		FY20				FY21	FY20				FY21
		Q1	Q2	Q3	Q4	Q1	Q1	Q2	Q3	Q4	Q1
LSM	**70.3**	**-5.5**	**0.2**	**-9.4**	**-24.8**	**5.0**					
Textile	20.9	0.2	0.5	-8.3	-33.9	2.2	0.0	0.1	-1.9	-9.2	0.6
Cotton yarn	13	0.2	0.0	-9.0	-34.5	0.1	0.0	0.0	-1.4	-6.2	0.0
Cotton cloth	7.2	0.1	0.3	-8.8	-34.3	-0.1	0.0	0.0	-0.6	-2.9	0.0
Jute goods	0.3	-14.8	3.5	37.6	-31.3	10.7	0.0	0.0	0.1	-0.1	0.0
Food	12.4	-9.0	15.8	-7.6	-4.0	13.4	-1.4	2.6	-2.3	-0.6	2.0
Cigarettes	2.1	-34.5	-24.3	-35.2	6.6	31.2	-0.7	-0.5	-0.7	0.1	0.5
Vegetable ghee	1.1	2.0	8.4	6.4	-1.5	-5.6	0.0	0.1	0.1	0.0	-0.1
Cooking oil	2.2	0.0	13.7	14.0	7.3	3.2	0.0	0.5	0.4	0.3	0.1
Soft drinks	0.9	-14.1	-6.5	-10.7	-10.3	7.6	-0.5	-0.1	-0.2	-0.4	0.3
POL	5.5	-14.5	-5.9	-32.0	-27.8	2.7	-1.0	-0.4	-1.7	-1.7	0.2
Steel	5.4	-17.0	-6.8	2.0	-47.1	-8.1	-0.8	-0.3	0.1	-1.9	-0.4
Non-Metallic minerals	5.4	-0.9	6.3	-0.2	-13.6	22.2	-0.1	0.8	0.0	-1.7	2.6
Cement	5.3	-1.4	6.3	0.0	-12.8	22.8	-0.2	0.8	0.0	-1.6	2.7
Automobile	4.6	-34.6	-39.5	-37.7	-70.1	-5.7	-2.8	-2.9	-2.3	-4.3	-0.3
Jeeps and cars	2.8	-38.6	-54.6	-50.4	-85.4	-21.1	-1.7	-2.2	-1.8	-2.5	-0.6
Fertilizer	4.4	15.9	-5.1	7.9	0.4	2.0	0.9	-0.3	0.3	0.0	0.1
Pharmaceutical	3.6	-11.9	-0.7	-3.6	5.6	14.4	-1.0	-0.1	-0.3	0.4	1.1
Paper	2.3	-1.3	16.0	-1.2	-4.2	11.0	-0.1	0.6	0.0	-0.1	0.4
Electronics	2	11.0	-6.1	-34.1	-72.8	-20.4	0.4	-0.2	-1.4	-4.1	-0.9
Chemicals	1.7	4.9	4.7	4.2	-24.1	10.5	0.1	0.1	0.1	-0.5	0.3
Caustic soda	0.4	35.0	15.7	-4.5	-25.8	2.5	0.2	0.1	0.0	-0.1	0.0
Leather products	0.9	6.3	16.0	-2.1	-55.4	-44.5	0.1	0.2	0.0	-0.8	-0.7

Source: Pakistan Bureau of Statistics

LSM Growth YoY **Figure 2.5**



Source: Pakistan Bureau of Statistics

The industry-wise analysis of the LSM sector suggests that cement and food processing segments were the key drivers of growth during Q1-FY21. On the other hand, major drag came from the electronics and leather industries.

Petroleum

The petroleum industry's production expanded by 2.7 percent during Q1-FY21 against a decline of 14.5 percent during Q1-FY20. The increase in output of petrol and diesel led to an overall improvement, which more than compensated for the decline in the production of other products, such as jet fuel. A couple of factors also facilitated growth in petrol and diesel production. Resumption of activities in the transport sector drove public and private sector demand for petroleum products. Stricter border controls also deterred illicit smuggling of diesel to Pakistan which led to increase in demand for products produced locally.[20]

The output of the high sulfur furnace oil (HSFO) remained at almost the same level despite an increase in electricity generated from HSFO-based power plants. The higher demand for the commodity was met primarily by imports. In the past few years, the government had focused on reducing its reliance on HSFO for electricity generation in favor of cheaper alternatives, such as gas.

In addition to restrictions on HSFO, the government has now set its target to move to the *Euro-5* standard compliant fuels. Whereas it is a step in the right direction, there are certain ramifications of this measure on the petroleum and automobile industries (**Box 2.1**).

Box 2.1: Introduction of Ultra-Low-Sulfur-Fuel (ULSF) and its Implications for Domestic Automotive and Petroleum Industries

The decision by the government to move to a new emission standard is expected to affect domestic automobile and crude oil refining industries in the short- to medium-term, whereas in the long-term the measure will improve urban air quality and modernize these industries. This transition is in line with the steps being taken around the world to cut down air pollution caused by certain gases and airborne particles.[21] Air pollution is one of the major causes of breathing, cardiovascular, mental, and reproductive health issues around the world and is responsible for around 7 million deaths worldwide, with the majority of these deaths reported in Asia. Air pollution accounted for 9 percent of deaths in Pakistan in 2017.[22] Moreover, according to IQAir, Pakistan was one of the most polluted country in the world in 2019.[23]

The advanced economies are dealing with air pollution in urban areas through regulatory measures, such as vehicle emission and fuel quality standards, since road transport is one of the major sources of air pollution.[24] For the vehicle emissions, *Euro* has become the global benchmark. At present, countries are

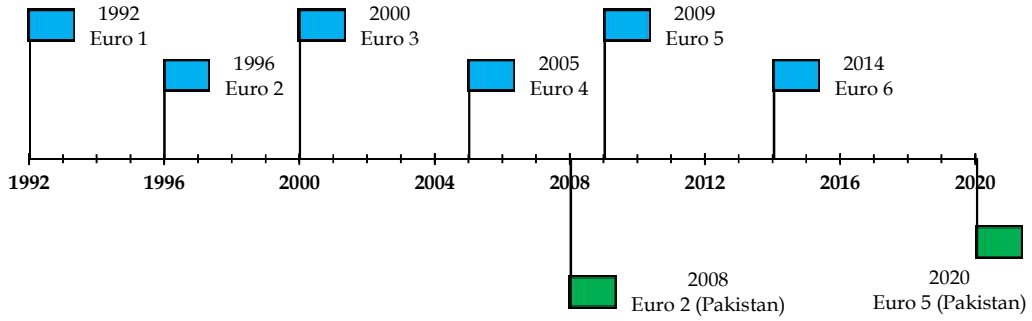
[20] Source: Federal Board of Revenue (source: fbr.gov.pk/pr/smuggled-items-worth-3800-millionconfiscated/152389).
[21] Source: National Aeronautics and Space Administration (climatekids.nasa.gov/air-pollution/).
[22] Source: World Health Organization.
[23] Source: iqair.com/us/world-most-polluted-countries.
[24] EU, US, China, India, Japan and South Korea consume more than 80 percent of global oil exports.

moving towards the *Euro-6* standard that was introduced in 2014. The fuel standard is also a necessary component of the global drive to reduce pollution. Sulfur content in petroleum products, a major health hazard, has witnessed a sharp reduction over the years due to improvements in the refining technology. Driven by regulatory measures in advanced economies, almost all the major oil exporting countries have switched to ultra-low-sulfur fuels (ULSFs). The interplay between major oil importers and exporters meant that the developing economies had to adapt to these standards as well. In Pakistan also, the government has outlined its plan to shift to *Euro-5* compliant fuels in FY21.

At the global level, the requirements on emissions and fuel quality had been based on the available technology and institutional capacity at the time of implementation. On the technology side, these industries were given realistic timelines to comply with the new parameters. Concurrently, the respective governments set up enforcement mechanisms to ensure adherence to the standards. The transition from one standard to the other was therefore carefully managed. From this perspective, Pakistan's jump from *Euro-2* standards to *Euro-5* may seem rather abrupt and is expected to create some frictions in the local automobile and petroleum industries. As the country lagged behind other nations for a long time with regards to transitioning towards improved standards, a relatively longer adjustment period may now be required to achieve full compliance (see **Figure 2.1.1**). That said, a few other countries have also leapfrogged to higher standards (for instance, India has jumped from *Euro-4* to *Euro-6*).

The implications of this measure on the automobile industry in Pakistan are straightforward. The assemblers would be required to install specialized equipment to meet the emission standards. These emission control components are standard in countries that have upgraded to *Euro-5/6* standards. However, it may be noticed that equipping domestic cars with *Euro-5* compliant parts is likely to increase the cost and, subsequently, the retail price of the vehicles. Another potential bottleneck is the rerouting of imports away from non-compliant countries such as Thailand and Indonesia and towards compliant countries like Japan (*Euro-6* equivalent), which may further escalate costs.[25]

Timeline - Euro Emission Standards and Adoption in Pakistan **Figure 2.1.1**



Source: DieselNet

[25] Thailand and Indonesia, still following *Euro-4*, account for around 40 percent of Pakistan's CKD vehicle imports. Source: Pakistan Bureau of Statistics.

Refinery Production by Product 2019-20 **Table 2.1.1**

percent of total

	Pakistan	US	EU
Petrol	22	49	18
Diesel	37	25	40
HSFO	20	2	13*
Others	21	24	29

*Ultra-low sulfur furnace oil

Source: PBS, EIA, OECD

The impact on the petroleum refining industry is expected to be more acute. The largely outdated petroleum industry was already feeling the strain in the face of an earlier measure that had curtailed demand for high-sulfur-furnace-oil (HSFO) which made up around a quarter of the industry's output (**Table 2.1.1**). The latest regulatory decision to move to *Euro-5* compliant fuel would make their task even more daunting, further necessitating the need to upgrade. It will also be a massive financial undertaking. For instance, the planned upgrade of the 47,000-bpd plant of Pakistan Refinery Limited to produce *Euro-2* compliant fuel was expected to cost around US$ 1 billion.[26] Compliance with *Euro-5* can possibly cost even more.

On the flip side, for a developing country coping with high public and foreign debt, the challenges in the implementation of the standards are substantial given the lack of resources. In particular, the lack of institutional capacity can hamper the efforts of the state for a trouble-free convergence to Euro-5 standards.[27] Necessary incentives can be provided to the automobile and the petroleum industry for a smooth transition. Here, Pakistan can learn from experiences of other countries that have made that transition. For instance, differential tax structure was imposed at pumps in Hong Kong, the United Kingdom and Germany. Meanwhile, the United States and Japan allowed tax incentives for refiners and, in some regions, also provided direct subsidies.28 Another option is to give tax-breaks to refineries and auto-assemblers that comply with new standards. A well-managed switchover may spur investment, create employment and build capacities in both the industries.

Automobile

Production activities in the automobile sector contracted by 5.7 percent in Q1-FY21 compared to the same period last year. The car and jeep segment, in particular the compact car segment, was again the major contributor towards this below-par performance. On the contrary, tractors and motorcycles production expanded relative to the same period last year and offset some of the drag from the other categories. Overall, the severity of contraction markedly decreased during Q1-FY21 (**Figure 2.6a, Figure 2.6b**).

The output of car and jeep segment declined to its lowest level in the review period since FY09 with exception of Covid-hit-Q4-FY20. Within this segment, there were contrasting results for compact hatchbacks and for sedan and jeeps. The former witnessed a sharp contraction, whereas the latter two observed production growth due to robust demand for new variants.

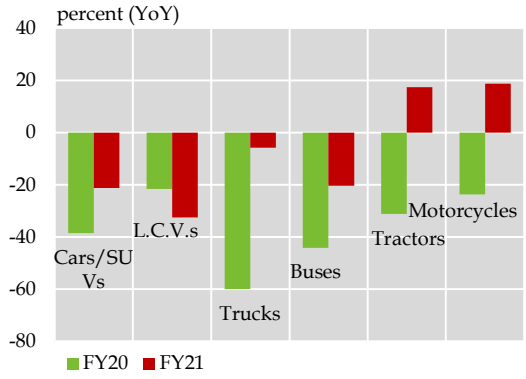
The downtrend in the compact car segment may be attributed to some demand-side factors; such as lack of demand from ride hailing services for hatchbacks in the

[26] Source: Radio Pakistan (radio.gov.pk/05-11-2019/govt-to-upgrade-pakistan-refinery-limited-with-1b-cost)

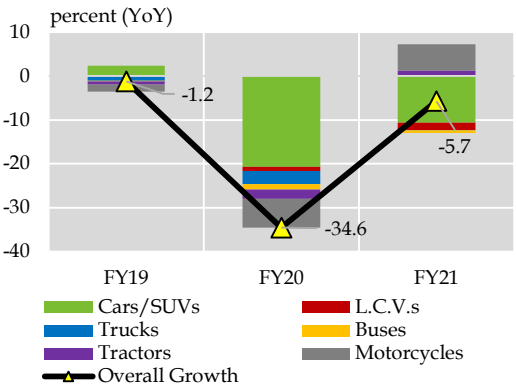
[27] Source: Timilsina, G. R. and H.B. Dulal (2009). "Regulatory Instruments to Control Environmental Transport Sector," *European Transport \ trasporti europei, 41:80-112.*

[28] Source: The International Council for Clean Transportation (theicct.org/sites/default/files/publications/ICCT_LSF-fiscalpolicy_June2013.pdf).

Growth in Auto Categories in Q1 **Figure 2.6a**



Growth in Auto Sector & Contribution in Growth in Q1 **Figure 2.6b**



Source: Pakistan Bureau of Statistics

ongoing Covid pandemic. The ride hailing services across the globe are suffering due to a downward shift in demand owing to the mobility restrictions.[29,30]

Contrary to the hatchbacks, significant growth in the sedans category was recorded in Q1-FY21 compared to same period last year, which can be attributed to relatively lower impact of Covid on the demand for sedans from the higher-income group. In particular, robust growth in output of new variants of the category was witnessed during Q1-FY21. The sedan segment was further aided by the low interest rate environment[31] and stable prices, which enhanced the ability of the consumers to buy these cars. However, higher production of sedans could not offset the sharp decline in hatchbacks which meant that overall car production declined during Q1-FY21.

The uncertainty caused by the Covid possibly resulted in a lower demand for commercial vehicles. As a result, production went down by 32.6 percent during Q1-FY21 compared to 28.3 percent contraction observed during the same period last year.

Meanwhile, robust sales in motorcycles and tractors segments reflects that the rural activities remained largely unaffected from the Covid crisis. The increase in tractor sales despite lower credit offtake in that segment can be explained by either lower liquidity constraints in the rural economy or pent-up demand, or both. Meanwhile, the increase in remittance inflows may have facilitated the rise in the share of cash transactions for tractors.

[29] Ride hailing services suffered a dip in demand across the globe. One of the major players in the Industry, Uber, has reported the number of trips declining by 35 percent YoY during Q1-FY21.
[30] Uber has reduced its global workforce by 25 percent due to the Covid (Source: uber.com/en-PK/newsroom/ubers-2020-people-and-culture-report/).
[31] Consumer financing for car purchases rose by Rs 21.3 billion during Q1-FY21 in stark contrast to the net retirements of Rs 2 billion during the same period last year.

Construction-allied Industry

The government had announced an incentive package for the construction industry when some of the mobility restrictions under the lockdowns were lifted and it seems to have kick-started activities in the private sector. Moreover, the construction sector received a boost from the rise in public sector development spending. Specifically, development expenditures rose sharply by 15.4 percent during Q1-FY21 on a YoY basis, with spending on large infrastructure projects such as dams and roads in particular increasing the demand for cement.

Cement

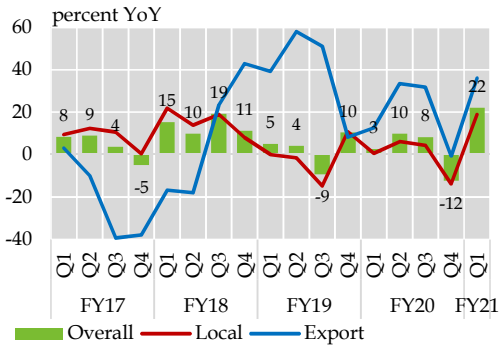
Cement output in Q1-FY21 rose to an all-time high, increasing by 22.8 percent during Q1-FY21 in contrast to a contraction of 1.4 percent recorded during the same period last year. Large-scale infrastructure projects such as Diamer-Bhasha Dam and Burhan-Dera Ismail Khan Motorway gathered pace during Q1-FY21, which increased the demand for cement from the public sector (**Chapter 4**).

In addition to domestic demand, exports of cement registered a decent growth during Q1-FY21 vis-à-vis Q1-FY20 (**Figure 2.7**), contributing more than a quarter to the overall growth during the period. Encouragingly, exports have gained traction in non-traditional destinations such as Bangladesh, China and Sri Lanka, which more than offset the decline in demand from neighboring countries of India and Afghanistan.

Steel

Production in the steel industry declined by 8.1 percent in Q1-FY21 compared to 17.0 percent drop witnessed during the same period last year. While the performance may seem in contrast to that of the cement industry, disaggregate analysis reveals that output of long steel products that are largely used in the construction industry started to show growth during Q1-FY21. In fact, billets production recorded an impressive YoY growth of 26.0 percent during the period (**Figure 2.8a, Figure 2.8b**).

Cement Dispatches-Local vs Exports **Figure 2.7**



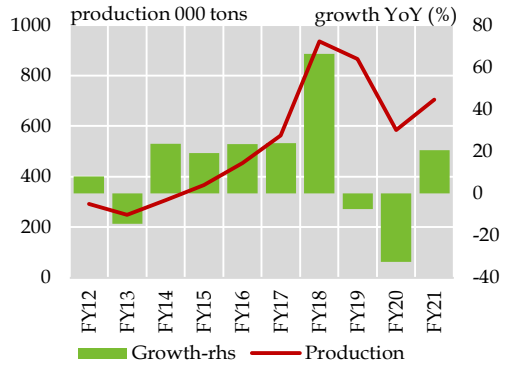
Source: All Pakistan Cement Manufacturers Association

On the other hand, demand for flat steel products is reflective of developments in the automobile and appliances sectors. As the demand from these sectors waned, the flat steel producers saw their capacity utilization levels drop and profit margins squeeze. The impact of lower demand for flat products more than offset the growth witnessed on the long-steel side and resultantly the overall impact was contraction in output.

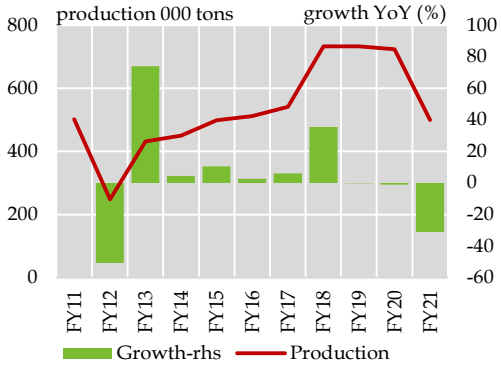
Fertilizer

The fertilizer sector continued to post positive results, with output growing by 2.0 percent in Q1-FY21 on a YoY basis; however, this performance pales in comparison to impressive growth (15.9 percent) recorded

Long Steel Production **Figure 2.8a**

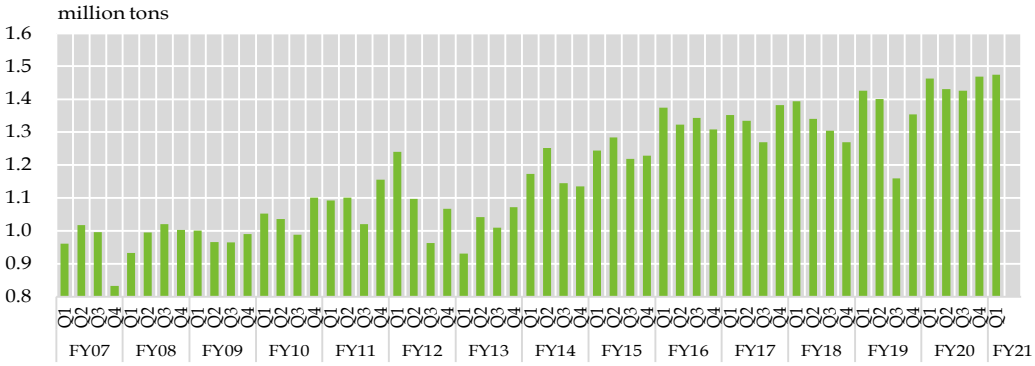


Flat Steel Production **Figure 2.8b**



Source: Pakistan Bureau of Statistics

Urea Production by Large Units **Figure 2.9**



Source: National Fertilizer Development Center

during the same period last year. National Fertilizer Development Center (NFDC) records show that the growth during Q1-FY20 was broad-based, as contributions from both urea and non-urea producing units had increased. In Q1-FY21, however, the urea output declined by 4.2 percent, but was offset by an impressive growth of 19.7 percent in the production of non-urea fertilizer products.

The urea-processing segment in Pakistan is characterized by two types of manufacturing units; large-scale and small-scale. At operational capacity, the production of large-scale units caters to almost 90 percent of the per annum local demand of roughly 6 million tons, whereas the supply from the small-scale units meets the rest. In Q1-FY21, the output of larger units rose by 2.1 percent compared to a decline of 1.3 percent during the same period last year. Incidentally, it was the highest production in any quarter since FY05 (**Figure 2.9**). Financial reports for Q1-FY21 of the large-scale producers point to

an enhanced operational efficiency of the plants that resulted in increased output.[32]

On the other hand, small-scale urea producing units remained largely shut during the month of July 2020. In the remaining two months of Q1-FY21, the resumption of gas supplies to these plants kickstarted production activities. Recall that in Q1-FY20, smaller units remained largely operational throughout the period. In overall terms, the impact of significantly lower production in smaller capacity units outweighed the slight increase in production of larger units.

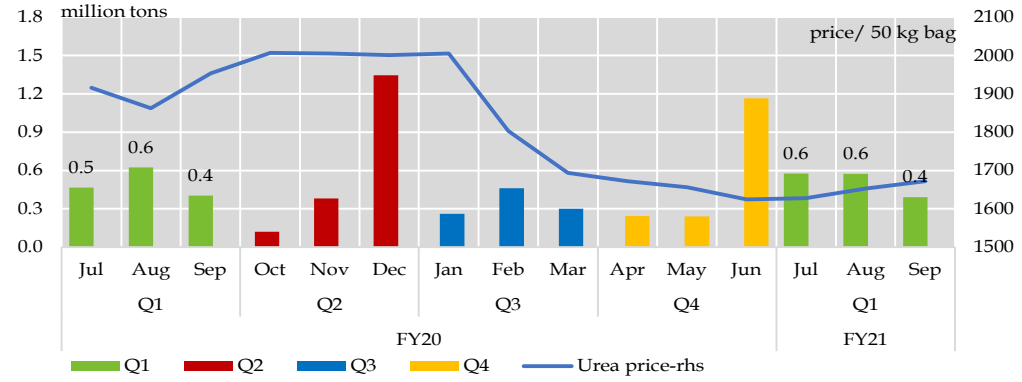
During Q1-FY21, the prices were lower than last year which led to an increased offtake of both urea and DAP fertilizers (**Figure 2.10**). However, the prices started to inch up as the quarter progressed, as uncertainty with regards to payment of Gas Infrastructure Development Cess (GIDC) and its modalities started to affect the market.

Textile

The output of the textile sector increased by 2.2 percent in Q1-FY21 compared to a marginal growth of 0.2 percent during the same period last year. This growth was largely driven by the increase in production of woolen products which can be linked to projections of early onset of winter season by international agencies that prompted millers to start production early.[33] Meanwhile, the cotton-based production of yarn and cloth (having a combined weight of 96.3 percent in textile industry within the LSM index) remained subdued.

The lackluster performance of the cotton textile industry can be attributed to a couple of factors. First, the local raw cotton, which serves as an input for the upstream cotton textile industry, witnessed a below-par harvest. Lower availability of the raw material, in turn, necessitated imports of the commodity to the tune of US$ 208 million,

Urea Offtake and Price **Figure 2.10**



Source: National Fertilizer Development Center

[32] Sources: (1) Engro Fertilizers, Third Quarter Report 2020; (2) Fauji Fertilizer Company Limited, Financial Statements, Third Quarter, September 30, 2020.
[33] Sources: Weather stations issued La Nina watch, which is associated with cooler weather around the globe (1) climate.gov/news-features/blogs/enso/july-2020-enso-update-la-nina-watch (2) iri.columbia.edu/news/july-climate-briefing-la-nina-watch-issued

which was the highest first-quarter import-bill since FY08. Increased reliance on imported cotton also raised costs for the export-oriented industry. The second factor that hampered the growth of cotton textile production was the low international demand for textile products. The exports grew by 2.9 percent in value terms on the back of better prices fetched by textile products, as the demand for cotton apparel has not picked up in major destinations in Europe (**Chapter 5**).

Food

Compared to a decline of 9 percent in Q1-FY20, production activities in the food processing industry rose sharply by 13.4 percent in Q1-FY21. This can be primarily attributed to a sharp increase in the production of tobacco and grain milling industries.[34]

The production of tobacco industry expanded by 31.2 percent compared to a contraction of 34.5 percent last year. The government decided to keep last year's duty structure intact, which was to incentivize the production in the formal industry. In addition, the government intensified its drive against illicit and counterfeit tobacco products by enhancing the monitoring mechanism.[35] These measures helped prop up production in the tobacco industry as demand shifted to locally produced tobacco products (**Chapter 4**).

That said, the duty structure is still incentivizing consumption of informal and illicit variants. A recent study by the Social Policy and Development Centre (SPDC) on the tobacco use in Pakistan states that around 45 percent of households in the country spend around 3 percent of their monthly income on tobacco. Furthermore, the illicit and counterfeit products, which account for around 40 percent of the market share, have an adverse impact on revenue collections. Therefore, there are potential gains for the formal industry and the government if the share of illegal products is reduced.[36]

2.4 Services

Preliminary indicators of the services sectors point to a recovery during Q1-FY21 compared to the same period last year. Growth in the commodity-producing sector, coupled with an increase in imports, suggest that activity in services sector, in particular the wholesale and retail trade segment, picked up during the quarter (**Table 2.7**).

Fast-moving consumer goods (FMCG) recorded a significant growth in Q1-FY21 compared to Q4-FY20, and more importantly against Q1-FY20, which can be traced to pent-up demand. Moreover, anecdotal evidence suggests that strong demand for health and hygiene related products such as sanitizers, soaps and cleansers also played a role in high demand for FMCG.

[34] Increase in wheat production is due to increase in the number of reporting units in the LSM survey.
[35] Source: Federal Board of Revenue - various press releases (1) FBR Seizes Non-Duty Paid Cigarettes - September 17, 2020 (2) Huge Quantity of Counterfeit Cigarettes Seized by I&I-Inland Revenue Peshawar Directorate - September 15, 2020 (3) Smuggled Items worth 3800 Million Confiscated In July - July 30, 2020.
[36] Source: Social Policy and Development Centre (2020). *The Impact of Tobacco Use on Household Consumption Patterns in Pakistan*. Karachi: Social Policy and Development Centre.

Selected Services Sector Indicators **Table 2.7**

	FY20		FY21
	Q1	Q4	Q1
Wholesale and Retail Trade (18.2%)			
Sectoral credit off take*-flow (billion Rs)	-43.8	-0.8	17.8
Petroleum products[1]	0.3	-3.5	17.6
Construction materials[2]	-27.1	-0.1	-0.05
Other	-16.9	2.8	0.25
Imports (billion US$) [a]	11.2	9.8	11.3
LSM (YoY growth)	-5.5	-24.8	5.0
FMCG sales (YoY growth)	1.5	-0.1	17.1
Agriculture credit (disbursements – Rs bln)	263.3	302.5	254.7
Transport, Storage and Communication (12.3%)			
POL sales to transport sector (million MT)	3.4	3.7	3.7
o/w Road Transport	3.3	3.7	3.6
Railways	0.04	0.02	0.03
Commercial vehicle sales (units)	5,000	2,949	6,618
Cellular teledensity (%)	76.8	78.8	79.6^
Broadband users (million)	74	83.1	87^
Finance and Insurance (3.6%)			
Assets (billion Rs)*	21,655	23,705	23,808
Deposits (billion Rs)*	14,945	17,404	17,543
ROA (percent)	0.8	1.1	1.1
ROE (percent)	10.8	14.6	14.8
Profit after tax (billion Rs)	37.3	80	69
Infection ratio	8.9	9.7	9.9
General Government Services (8.6%)			
Expenses on general govt & defense** (billion Rs.)	1,009.3	1,925	1,205

Note: Values in brackets are sectoral shares in GDP, as of FY20.
[1]Solid, liquid, gaseous fuels and related products [2] Construction materials, hardware, plumbing and heating equipment and supplies
* Stocks, as of end-September 2020 **Only federal government ^as of August 2020.
Source: SBP, [a] PBS, OCAC, PAMA, PTA and MoF

Increase in demand for credit from the services industry also suggests recovery in the sector during the review period. Credit offtake witnessed a rise of Rs 17.8 billion compared to net retirements of Rs 43.8 billion during Q1-FY20. The borrowing was largely driven by petroleum products traders. The oil marketing companies (OMCs) borrowed money to meet the rising fuel demand, as economic recovery started to gain momentum following the lifting of Covid-related mobility and production restrictions (**Chapter 3**).

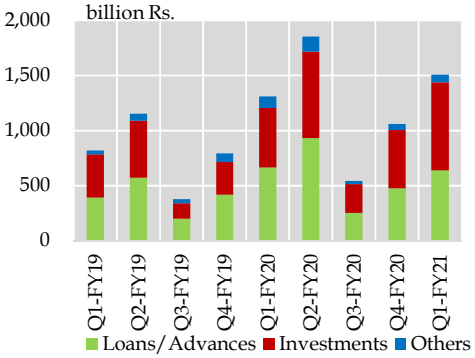
The *transport, storage and communication* segment indicators also showed improvement during Q1-FY21 (**Table 2.7**). The transport sector gained traction with rise in inter-city and inter-provincial travelling and resumption of tourism services after Covid-induced restrictions were lifted. In addition, the increase in sales of commercial vehicles also indicated an uptick in the transport sector.

Meanwhile, in the communication segment, demand for mobile phones and internet services remained strong and was driven by remote-working and online-education arrangements. Consequently, there was a marked increase in cellular teledensity and in the numbers of broadband users in the country. Moreover, a notable rise in the import of cell phones was witnessed during Q1-FY21.[37] This increase can be traced back to reduction of sales tax and advance tax on import of low-end mobile phones and pent-up demand from the lockdown during the previous quarter (**Chapter 5**).

[37] In Q1-FY21, import of cell phones increased by 83.2 percent compared to the corresponding period of last year.

Within *finance and insurance,* the performance of the banking sector showed significant improvement during Q1-FY21. The profit after tax increased to Rs.69 billion, up from Rs.37.3 billion recorded during the same period last year. The profitability indicators, such as return on assets (ROA) and the return on equity (ROE), also improved over the same period (**Table 2.6**). The growth in bank's profits can be traced to higher net interest income mainly from investments. Specifically, the amount of scheduled bank's investments increased to Rs.797.4 billion during Q1-FY21 compared to Rs.541 billion recorded during the same period last year (**Figure 2.11**).

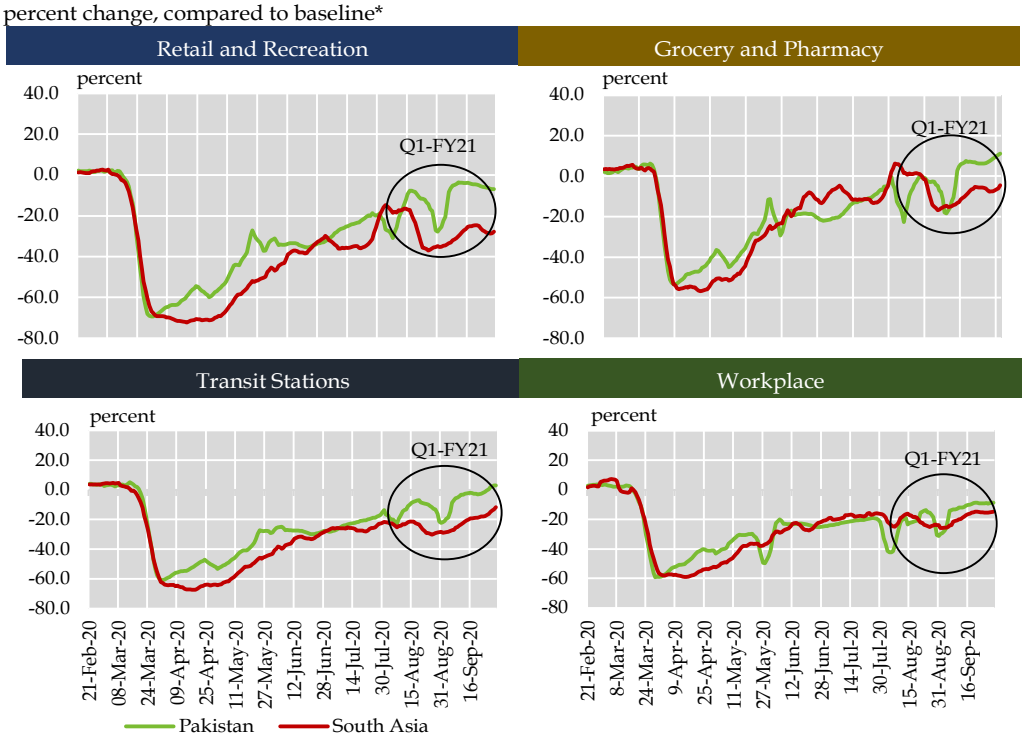
Break-up of Mark-up Earned of Scheduled Banks **Figure 2.11**



Source: State Bank of Pakistan

Google Mobility Changes (7-Days MA): Pakistan vis-a-vis South Asia **Figure 2.12**

percent change, compared to baseline*



*The baseline (pre-Covid) is the median value for the 5- week period (Jan 3–Feb 6, 2020). The negative value represent acitvity is down while positive value represent activity is up from the baseline.

Source: Covid-19 Community Mobility Report

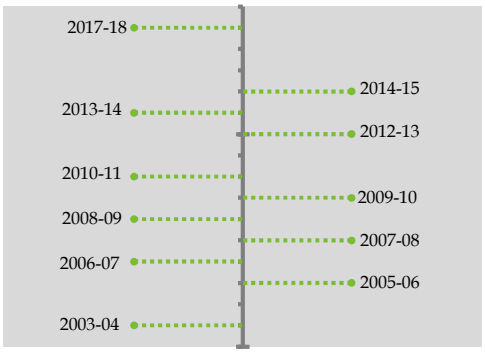
In addition to these indicators, the pickup in services sector activities is evident from the Google mobility data. This dataset covers four segments that are closely associated with the services sector, namely retail and recreation, grocery and pharmacy, transit stations and workplace activities. Analysis of the data shows that in the aftermath of Covid-related restrictions, activities in these sectors had fallen sharply. By the end of March 2020, retail and recreation, grocery and pharmacy, transit stations and workplace declined by 68 percent, 53 percent, 60 percent and 62 percent, respectively, from their baseline (pre-Covid) in Pakistan. In fact, the other South Asian economies excluding Pakistan witnessed a decline of 69 percent in retail and recreation, 57 percent in grocery and pharmacy, 66 percent in transit stations and 63 percent in workplace from the baseline position (**Figure 2.12**).[38] However, as the governments gradually eased the mobility restrictions, the activities started to pick up in all the indicators.

Along with the ease in restrictions, the government authorities also introduced various incentive packages for industries such as construction and small and medium enterprises (SMEs), which aided recovery in the services sector. Cross-country analysis of these indicators in Q1-FY21 highlights that the pace of recovery in Pakistan was higher compared to the rest of South Asia (**Figure 2.12)**. In fact, in Pakistan, visits to grocery stores and pharmacy and transit stations were up 12 percent and 3 percent, respectively, from the baseline position compared to decline of 3 percent and 8 percent, respectively, in South Asia.

2.5 Labor Market

Employment is one of the key indicators of an economy's performance. Therefore, it is important to understand the dynamics of the labor market where various changes in employment, due to structural shifts or different shocks, can be captured. In Pakistan, besides the fact that there are 1.3 million new entrants in the domestic labor force every year, [39] its labor market has had to deal with several shocks, including the recent Covid-related lockdowns.

Labore Force Survery Publication Timeline — Figure 2.13



Source: Pakistan Bureau of Statistics

[38] For the analysis in this section, the 'South Asia' category excludes Pakistan, Bhutan and Maldives. Comparable data for Bhutan and Maldives was not available, whereas date for Pakistan was deliberately excluded to facilitate comparison with the rest of South Asian countries.
[39] Source: World Bank (2018). *South Asia Economic Focus Spring 2018: Jobless Growth?*. Washington DC: World Bank.

However, the analysis of the domestic labor market is challenging due to the limited availability of periodic datasets. For instance, the primary source of information on the labor market for Pakistan is the Labor Force Survey (LFS) which was last published for 2017-18 (**Figure 2.13**).[40] Nonetheless, some useful alternative sources can be utilized to analyze the labor market in Pakistan such as the monthly surveys of industrial performance and employment conducted by provincial statistical bureaus, the employment index from the SBP's Business Confidence Survey, and CPI wage rate data (**Box 2.2**).

Box 2.2: Collating Labor Market Data Sources for Pakistan

To gauge the performance of the labor market key insights can be derived from the Labor Force Survey (LFS). The survey is published by the Pakistan Bureau of Statistics and provides details of socio-demographics, employment status, provincial and sector-wise distribution of the labor market. According to the survey, the agriculture sector contributes 38.5 percent in total employment, followed by service and industry with 37.8 percent and 23.7 percent share, respectively **(Table 2.2.1)**. Note that the services sector makes up the major share of total GDP, while its share in employment is nearly equal to that of agriculture. The LFS also includes data on wages and information on unemployed and employed in the country. However, due to lag in publication, with the latest edition published in 2017-18, it does not cover the current developments in the labor market.

To fill the gaps left by LFS and understand the ongoing trends in the labor market the "Monthly Survey of Industrial Production and Employment", published by the Punjab Bureau of Statistics (BoS) and Sindh

Sector-wise Distribution of Employment **Table 2.2.1**

	GDP Share 2020[41]	Employment Share 2018[42]	Indicators of Employment Trends
Agriculture	19.3	38.5	(1) Labor Force Survey – Pakistan Bureau of Statistics
Industry	19.3	23.7	(1) Labor Force Survey – Pakistan Bureau of Statistics (2) Survey of Monthly Industrial Production and Employment by Punjab and Sindh Bureau of Statistics (3) Construction sector wages from CPI – Pakistan Bureau of Statistics (4) State Bank of Pakistan's Business Confidence Survey
Services	61.4	37.8	(1) Labor Force Survey – Pakistan Bureau of Statistics (2) State Bank of Pakistan's Business Confidence Survey

[40] LFS was published quarterly for 2010-11 and 2012-13

[41] Source: Ministry of Finance (2020). *Pakistan Economic Survey of Pakistan 2019-20.* Islamabad: Ministry of Finance

[42] Source: Pakistan Bureau of Statistics (2019). *Labour Force Survey 2017-18*. Islamabad: Pakistan Bureau of Statistics.

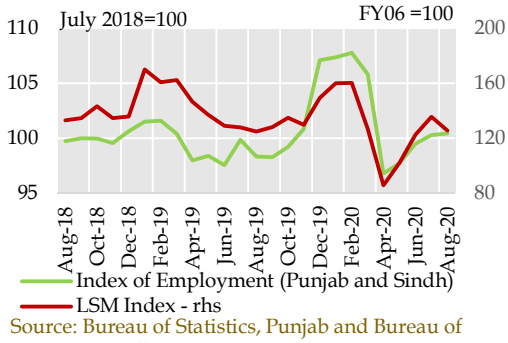
BoS is used.[43] Both provinces can serve as a good proxy to analyze the national trends since they collectively account for 84 percent of the total labor force[44] and 84.1 percent of the total GDP.[45],[46] Punjab BoS collects data from 1,900 industrial units of 45 major industries and Sindh BoS collects data from 535 units of 22 industries. These publications contain pertinent information about workers employed across the industrial sectors. Overall, the industrial sector employs around 24 percent of the labor force, while its share in GDP is around 19.3 percent (**Table 2.2.1**).

Another useful proxy to gauge the recent trends in the labor market is the State Bank of Pakistan's Business Confidence Survey (BCS). The BCS is a bi-monthly telephonic survey in which employers from a sample of 1000 registered firms are asked about their perceptions of the economy, including employment.[47] One advantage of using the BCS-based index is that it is available separately for industrial and services sector in addition to the overall index. A separate metric of the services sector is relevant since the sector contributes more than 60 percent to GDP and employs 38.6 percent of the labor force (**Table 2.2.1)**.

The monthly Consumer Price Index (CPI) data released by the Pakistan Bureau of Statistics also contains information on the wages of the construction related unskilled and skilled workers (painters, carpenters, masons, plumbers). The survey is conducted every month and covers 35 urban and 27 rural centers.

The employment data for the provinces of Punjab and Sindh suggests that there was an improvement in the manufacturing sector during the Jul-Aug FY21 period when compared to peak-restriction period of mid-March 2020 to April 2020. Note that increase in employment index in the post-lockdown period is in tune with the recovery observed in LSM (**Figure 2.14**). The gradual ease in mobility restrictions since then explains the increase in employment in the industrial sector in these provinces. During the initial phase of the lockdowns, as much as 10 percent of the industrial workers lost their jobs. Gradual ease in restrictions in the

Combined Sindh and Punjab Industrial Employment and LSM Index **Figure 2.14**



Source: Bureau of Statistics, Punjab and Bureau of Statistics, Sindh

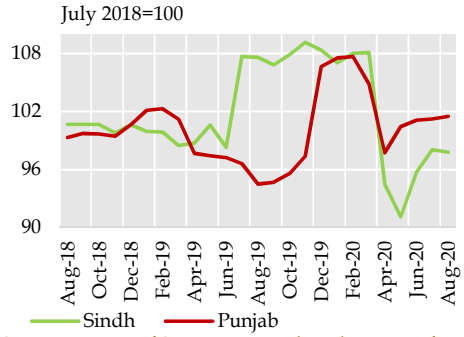
[43] Khyber Pakhtunkhwa Bureau of Statistics also publishes Monthly Survey of Industrial Production but the relevant and latest publications for developments in Q1-FY21 were not available.
[44] Source: Pakistan Bureau of Statistics (2019)
[45] Share of Punjab in GDP was estimated at 54.2 percent (Source: Punjab Growth Strategy 2023, Planning and Development Board, 2018). Share of Sindh in GDP was reported to be 28 percent. Source: Planning and Development Board (2018). *Punjab Growth Strategy 2023.* Lahore: Planning and Development Board. Source: World Bank (2017). *Sindh Public Expenditure Review.* Washington DC: World Bank.
[46] Pakistan Bureau of Statistics (2019).
[47] Questions ask employers, inter alia, about their perception about employment levels in the past 6-months and the expected employment in the next 6-months. Based on the responses, an index reveals positivity in job creation if it is above 50 and pessimism if it is below that mark. For more information visit: sbp.org.pk/research/BCS.asp

following months allowed some recovery; however, the industrial labor market had been unable to regain its pre-Covid level by end-August 2020.

In particular, the province-wise data suggests that job losses in the manufacturing sector in Sindh were higher and the pace of recovery was also slower (**Figure 2.15)**. Higher job losses in Sindh can possibly be linked to heavy monsoon downpour and subsequent flooding especially during August 2020 in the industrial hub of Karachi.[48]

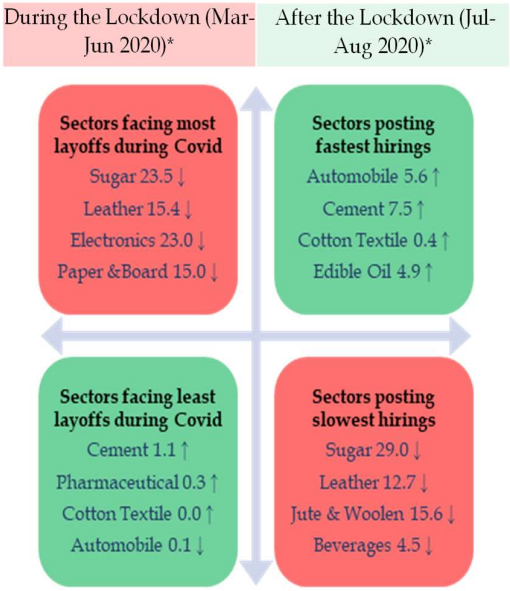
From a sectoral perspective, although there were job losses across the board during the peak Covid period, they were more noticeable in sugar and leather industries (**Figure 2.16**).[49] Compared to February 2020 levels, 23.5 percent of the workers lost their jobs during the lockdown period in the sugar industry. Even after the lockdown was lifted, the sugar industry continued to post job losses. The leather industry also saw employments levels drop during the lockdown period; however, unlike sugar, jobs in the leather industry started to inch up in post-lockdown scenario. As the restrictions were gradually eased, a few industries started to hire more workers. For instance, job opportunities in cement and textile industry rose above the pre-Covid levels by August 2020. The positive developments are consistent with growth in output of these industries (**Table 2.6**); output of the cement and textile sector grew by 22.8 and 2.1 percent in Q1-FY21, compared to

Sindh and Punjab Industrial Employment **Figure 2.15**



Source: Bureau of Statistics, Punjab and Bureau of Statistics, Sindh

Employment in Industrial Sector **Figure 2.16**



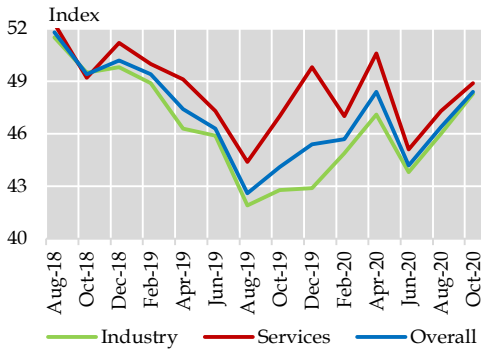
*Compared to February 2020 level of employment

Source: Bureau of Statistics Punjab, Bureau of Statistics Sindh

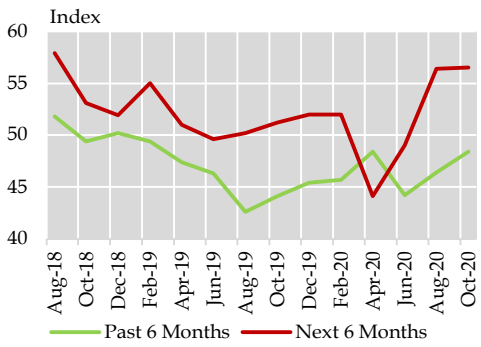
[48] The industrial hub of Karachi accounts for 67.0 percent of the total industrial establishments in Sindh (Source: Sindh Bureau of Statistics). Moreover, according to the Census of Manufacturing Industries 2005-06, Karachi accounted for highest number of total reporting industrial establishments at 17.0 percent while contributing 26 percent overall value of production in the country.

[49] Note, however, that sugar industry also includes non-crushing season job losses.

Business Confidence Survey-Employemnt Indices (Past 6 months) **Figure 2.17a**



Business Confidence Survey-Employment Indices **Figure 2.17b**



Sources: State Bank of Pakistan

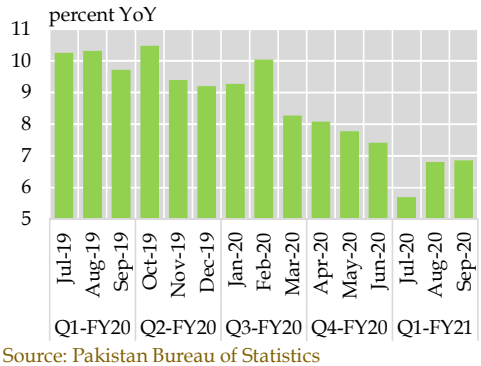
visible contraction of 12.8 and 33.9 percent in Q4-FY20.

The BCS October 2020 wave broadly reflects similar employment trends. Like the industrial sector employment data, a pre-Covid spike, followed by Covid-related job losses during the peak restriction period, and lack of momentum thereafter, are again visible. One advantage of the BCS database is that it provides separate results for the services sector as well. While the employment index follows a similar path for both the categories, the optimism in the services sector is more noticeable (**Figure 2.17**). In conjunction with positive trends witnessed in the Google Mobility statistics, the BCS index lends weight to the recovery in the services sector.

Meanwhile, the construction wage-rate index from the CPI-dataset (another indicator of labor market trends) also depicted growth during Q1-FY21, which highlights the increase in compensation for laborers. The YoY change in the wage-rate index endorses the impact of Covid on the labor market **(Figure 2.18)**.

Further analysis of wage rates points to similar trends within the skilled and unskilled labor force.[50] Unskilled labor wage grew by 7.4 and 6.6 percent in rural and urban areas respectively during Q1-FY21. Similarly, in the skilled labor category, growth of 9.8 and 6.4 percent was recorded for the rural and urban regions, respectively. The noticeably higher growth rate of wages in the country-side areas can partly be attributed to higher rural inflation (10.8

Growth in Construction Sector Wages **Figure 2.18**



Source: Pakistan Bureau of Statistics

[50] Carpenter, mason, plumber and painter are classified as skilled labor.

percent) compared to urban inflation (7.5 percent) during Q1-FY21.

While the improvement in the available employment indicators owes to the resumption of economic activities after the lockdowns, the government and the SBP have also played an important role in restricting job loss through their policies. Accommodative fiscal and monetary measures were geared for retention of employment and recovery of the labor market. In particular, SBP introduced the "Refinance Scheme for Wages to Prevent Layoffs" specifically aimed at cushioning the Covid shock. Latest numbers show that the scheme prevented layoffs of more than 1.6 million workers across Pakistan. By September 2020, 83 percent of the total requested amount under the scheme was approved (**Table 2.8).** Moreover, other SBP initiatives like the Temporary Economic Refinance Facility (TERF) and Debt Relief Scheme also played a role in speeding up the recovery in various sectors, which eventually supported employment in the economy.[51]

SBP Rozgar Scheme **Table 2.8**

	Requested Amount (billion Rs.)	Approved Amount (billion Rs.)	Employees Covered (millions)
Apr-20	0.1	0.0	0.2
May-20	129.3	89.9	0.6
Jun-20	13.9	29.2	0.3
Jul-20	59.7	28.4	0.1
Aug-20	36.6	42.6	0.2
Sep-20	21.7	26.8	0.1
Total	261.3	216.9	1.6

Source: State Bank of Pakistan

On the fiscal side, the government gave incentives to the construction sector, which is quite labor-intensive. This led to increased economic activity in the construction sector and facilitated its employment generation and retention. Growth in construction-allied manufacturing sectors (such as cement and long steel) and increase in rural and urban construction wages support this. In addition, the government through its Ehsaas Program for social support provided financial assistance to the highly vulnerable daily-wage laborers, the majority of whom lost jobs during the period of economic inactivity.[52]

[51] The SBP initiated several other schemes in the aftermath of Covid shock to support the economy namely *Progress on Loans Deferment and Restructuring*, *Progress on Refinance Scheme for Hospitals to Combat COVID-19* and *Progress on Refinance Scheme for Setting-up New Projects or Expansion/BMR*. (Source: State Bank of Pakistan)

[52] Source: Ministry of Finance, Press Release No. 311 dated May 15, 2020.

3 Monetary Policy and Inflation

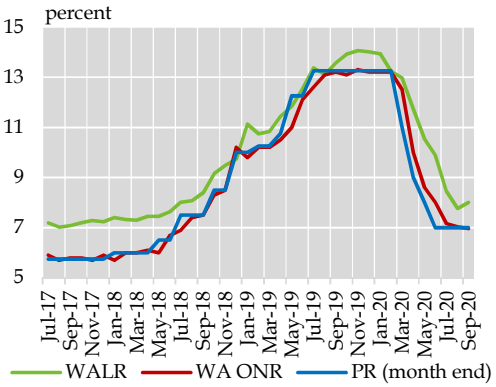
With improving demand indicators and no change in the inflation forecast, SBP kept the policy rate unchanged at 7 percent during Q1-FY21. Continuation of the accommodative monetary stance was deemed appropriate to provide necessary support to the ongoing economic recovery while keeping inflation expectations well-anchored and maintaining financial stability. On the inflation front, food prices remained at an elevated level due to supply-side shocks, offsetting the impact of largely stable non-food prices and leading to a slight increase in the headline inflation for Q1-FY21 compared to Q4-FY20. These developments contributed to an uptick in secondary market yields. Meanwhile, credit to the private sector recorded higher net retirements of working capital loans, reflecting improvement in the liquidity situation of businesses on the back of higher sales tax refunds from the government, SBP's regulatory relief on debt servicing, muted inputs cost and availability of surplus carry-over stocks. In contrast, borrowing under fixed investment loans quadrupled, supported by the SBP's LTFF and TERF schemes. Furthermore, consumer financing posted substantial growth in response to a steep decline in lending rates during Q1-FY21.

3.1 Policy Review

The economy entered FY21 with some lingering damaging impacts of the Covid pandemic as growth slipped into negative territory in FY20. However, timely measures taken by the SBP and the government, including a host of refinance schemes and concessionary packages, to mitigate the impacts of the Covid shock, prevented the economy from plunging into a deeper recession.[1] In addition to this, frequent meetings of the Monetary Policy Committee (MPC) were held in the second half of FY20 to closely monitor the evolving situation and take necessary policy measures. With relatively benign inflationary projections compared to last year, the MPC decided to cut policy rate by a cumulative 625 bps during Mar-Jun FY20. [2]

During the first quarter of FY21, the accommodative environment continued: real interest rates remained slightly negative and the availability of concessionary refinance schemes lowered funding costs for businesses and for the households (**Figure 3.1**). Despite this, the downward trend in the growth of overall private sector credit persisted during Q1-FY21 mainly on account of significant retirements in working capital

Trends in Major Interest Rates **Figure 3.1**



Source: State Bank of Pakistan

[1] For details, see SBP's Annual Report on The State of Pakistan's Economy FY20 and sbp.org.pk/COVID/index.html

[2] In the meeting held on 25th June 2020, a preponed meeting for July 2020, policy rate was reduced by 100 bps to 7 percent, reflecting improvement in the inflation outlook and downside risks to growth prospects.

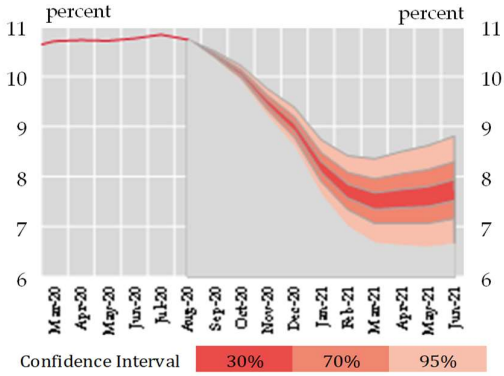
loans. The liquidity cushion available with the firms on the back of sales tax refunds by the government, debt relief measures (loan deferment and restructuring), availability of surplus carry-over stocks and muted input costs helped businesses in retiring their short-term loans.

Notwithstanding signs of recovery in the first quarter of FY21, overall demand side inflationary pressures remain contained due to negative output gap.[3] However, upward risks to inflation persist due to supply side factors. During Q1-FY21, core inflation stabilized but spikes in food prices were recorded in the months of July and September (on month-on-month basis) and, hence, in the overall average of the quarter. Headline inflation remained low (8.8 percent) as compared to the same period last year (10.1 percent), but was slightly higher than the level observed in the previous quarter (8.4 percent). Meanwhile, the inflation range projected for FY21 was kept unchanged at 7-9 percent as announced in May 2020, with broadly balanced risks. The upside risks included increase in food prices and potential tariff revisions whereas the downward risks included a protracted second wave of the pandemic (**Figure 3.2**).

The economic activity resumed with the removal of lockdown: large-scale manufacturing (LSM) displayed an expansion by the time of the monetary policy meeting in September 2020 after witnessing a deep contraction during Q4-FY20. High-frequency demand indicators including auto sales, cement dispatches, POL sales, and electricity consumption also indicated recovery (**Figure 1.1, Chapter 1**).

Therefore, in its meeting held in September 2020, the MPC decided to keep the policy rate unchanged at the level of 7 percent. This decision was taken in order to keep the monetary conditions accommodative given uncertainty over the growth trajectory and a slight upward revision to the inflation outlook.

Fan Chart-CPI Inflation (12mma) **Figure 3.2**



Source: SBP staff estimates

3.2 Monetary Aggregates

The growth of broad money accelerated to 1.2 percent during Q1-FY21 compared to a growth of 0.6 percent during the same period last year (**Table 3.1**). This expansion was the result of a sharp increase in the NFA of the banking system – similar to the trend observed in Q1-FY20 – reflecting an overall improvement in the country's balance of payments position. There was an increase in the NFA of both the scheduled banks as well as the SBP, the expansion in the former being higher compared to the latter.

[3] Negative output gap indicates that actual economic output is below the economy's full capacity; and the negative output gap was observed during the review period.

In case of the scheduled banks, the turnaround in the current account balance not only helped consolidate nostro balances, but was also instrumental in bringing down foreign liabilities. In case of the SBP, the increase in the NFA was primarily driven by a fall in the foreign liabilities alongside bilateral inflows from China. [4]

Monetary Aggregates (Q1)P **Table 3.1**

Table 3.1

billion Rupees; growth in percent

	Change in Stock		Growth	
	FY20	**FY21**	**FY20**	**FY21**
M2 (A+B)	105.2	260.5	0.6	1.2
A. NFA	259.6	307.3	17.2	59.5
B. NDA	-154.4	-46.8	-0.8	-0.2
Bud. borrowing*	156.0	285.2	1.3	2.1
SBP	-1,586.9	-281.9	-23.7	-4.3
Sch. banks	1,742.9	567.1	35.5	7.9
Com. operations	-15.6	-59.9	-2.1	-7.4
Pvt. sector credit	-16.9	-76.6	-0.3	-1.1
PSEs	-2.0	-11.9	-0.1	-0.8
Other items net	-275.2	-184.9	-24.9	-12.3
Reserve money	-207.4	-149.0	-3.2	-1.9

P: provisional

*These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in **Table 4.1.**

Source: State Bank of Pakistan

On the other hand, the NDA of the banking system fell by Rs 46.8 billion during Q1-FY21 compared to a contraction of Rs 154.4 billion during the same period last year. This contraction was mainly on the back of the net retirements recorded in private sector credit, PSE credit, and government loans for commodity operations alongside a fall in the other items net. Cumulatively, these factors more than offset the impact of the increase in budgetary borrowings on the NDA of the banking system.

On the liability side, the entire growth in the money supply during Q1-FY21 emanated from an increase of Rs 289.3 billion in bank deposits, whereas the currency in circulation fell by Rs 40.4 billion resulting in overall improvement in currency to deposit ratio.[5] It is important to recall here that cash penetration in the economy spiked in the aftermath of the Covid outbreak that continued till Eid-ul-Azha. Effectively, the decline in the currency to deposit ratio during Q1-FY21 is mostly a reversal of the excessive cash penetration in the economy.

In addition, this contrasting trend in comparison to Q1-FY20 was due to: (i) a 31.1 percent YoY growth in workers' remittances (in dollar terms) during Q1-FY21 translated into higher growth in personal deposits; and (ii) the limited availability of NSS (as only limited CDNS outlets were allowed to open during the lockdowns and institutional investors were barred from investing in NSS w.e.f. July 01, 2020) and additional scrutiny measures taken by the government resulted in lower investment in NSS instruments and prize bonds compared to the average mobilization during the first quarters of FY15-FY19 (barring Q1-FY20).[6] This potentially channelized some funds into

[4] Since these inflows were recorded as the liability of the federal government, the NFA of the SBP posted an expansion.

[5] Despite this improvement, the average currency to deposit ratio during Q1-FY21 remained on the higher side compared to same period last year.

[6] It is important to recall here that on June 24, 2019 government had notified the withdrawal of Rs 40,000 denomination prize bond. Therefore, in Q1-FY20 higher NSS investment was recorded whereas prize bonds posted a decline as many bond holders converted their prize bonds into NSS (see the SBP's First Quarterly Report for FY20 on The State of Pakistan's Economy).

remunerative deposits that posted an increase of Rs 249.7 billion compared to Rs 114.3 billion same period last year. Meanwhile, the deposits of private sector business also increased by Rs 104.8 billion during Q1-FY21 compared to a drop of Rs 135.6 billion during same period last year. This was primarily on account of sound liquidity position of firms (see Section 3.3).

The weekly data shows that the currency to deposit ratio increased from 41.7 percent at the start of the quarter to 45.4 percent by the end of the first week of August 2020. This was particularly due to two reasons: (i) a seasonal decrease in deposits during the month of July (a reversal of temporary increase in deposits in June 2020 on account of window dressing by banks) and; (ii) cash withdrawals related to Eid-ul-Azha that was celebrated on Aug 1, 2020 in Pakistan. Subsequently, the trend reversal started in the middle of August and continued throughout the quarter, as the currency to deposit ratio eased down to 40.6 percent by the end of September 2020. Despite some improvement during the quarter, the currency to deposit ratio is at an elevated level compared to other emerging economies.[7]

Government Borrowings

With an overall higher deficit during Q1-FY21, financing from the banking system (on accrual basis) increased to Rs 285.2 billion compared to Rs 156.0 billion during Q1-FY20. It is important to recall here that during same period last year, the government made sizable retirements to the SBP while financing these outlays and additional borrowing requirements from the commercial banks. In contrast, in the absence of voluminous retirements to the SBP during Q1-FY21, borrowings from the scheduled banks remained significantly lower compared to last year. In addition, the government's adherence for zero borrowings from the central bank continued; the outstanding position of securities held by the SBP remained on a decreasing trend that began at the start of previous fiscal year. During Q1-FY21, the government retired Rs 285.0 billion worth of securities held by the SBP, while mobilizing Rs 567.1 billion from the scheduled banks.

Primary Auctions

Pre-Auction Targets

During Q1-FY21, the government set a gross pre-auction target of Rs 3,200.0 billion against the maturities of Rs 2,805.2 billion (of which more than 96 percent were T-bill maturities). However, given the government's inclination towards raising debt through long term papers, the pre-auction target for T-bills was set at Rs 903.8 billion lower than the maturities due during the quarter.

Instead, the government leveraged on the floating rate PIBs (PFL) that not only offer a longer maturity period but also provide a flexible return in line with the interest rate cycle. Around 55 percent of the target for new issuances (on net-of-maturity basis) was concentrated in the floating rate PIBs of various tenors (**Figure 3.3**). [8] To put this in

[7] For details, see Chapter 3 in the SBP's Annual Report for FY20 on The State of Pakistan's Economy.
[8] Floating rate PIBs (PFL) were initially introduced in May 2018 with a maturity of 10 years, subsequently in Jun 2020, 3-year and 5-year PFLs were also made available for the market.

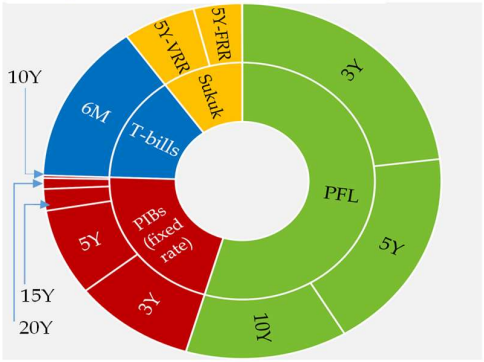
perspective, the pre-auction target for PFL during Q1-FY21 was set at Rs 830 billion versus a full year target for PFL of Rs 850 billion in FY20.

Auction summary and market behavior

In the backdrop of multiple rate cuts in the aftermath of the Covid shock, short term yields continued to decline initially. However, from mid-July onwards, as inflation expectations started to increase, the short-term yields began to inch up. This trend got further support from the decision of not holding the July 2020 MPC meeting (**Figure 3.4**). In contrast, the medium to long term yields had already started to rebound in May 2020. The long-end of the yield curve got further traction in July 2020 mainly on the back of the rising inflation expectations. This behavior may also reflect increased optimism of a rapid economic recovery as incidence of new daily Covid cases declined in the country.

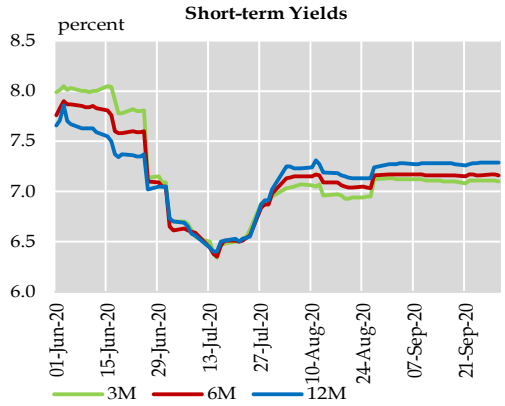
As a result, the market preferred investing in T-bills (particularly in 3M) and in medium-term floating rate PIBs (PFL). In case of T-bills, though the cumulative offers received during the quarter were nearly three times higher compared to the target, the government largely adhered to its auction plan. Therefore, T-bill issuance dropped to Rs 2,047.3 billion compared to Rs 6,482.7 billion during same period last year (**Table 3.2**). Likewise, in response to the introduction of 3Y and 5Y PFL and with increasing trend in the secondary market

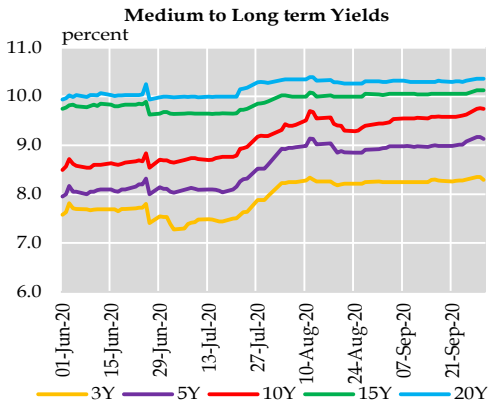
Instrument-wise Auction Targets during Q1-FY21 (net of maturity) **Figure 3.3**



* the targets for 3M and 12M T-bills on net of maturity basis was Rs -162.8 bn and Rs -963.8 bn respectively.
PFL: PIBs (Floating Rate)
FRR: Fixed Rental Rate
VRR: Variable Rental Rate
Source: State Bank of Pakistan

Trend in Secondary Market Yields **Figure 3.4**





Source: Mutual Funds Association of Pakistan

Auction Summary **Table 3.2**

billion Rupees

	Target	Maturity	Offered*	Accepted
Treasury bills				
Q1-FY21	1,800.0	2,703.8	5,112.4	2,047.3
Q1-FY20	6,900.0	5,179.6	8,715.7	6,482.7
Pakistan Investment Bonds				
Fixed Rate				
Q1-FY21	420.0	101.4	448.9	249.2
Q1-FY20	325.0	275.9	2,521.2	963.5
Floating Rate				
Q1-FY21	830.0	0.0	1,970.4	870.6
Q1-FY20	300.0	0.0	334.2	219.4
GOP *Ijarah Sukuk*				
Fixed Rental Rate				
Q1-FY21	60.0	0.0	56.0	44.6
Variable Rental Rate				
Q1-FY21	90.0	0.0	215.4	117.4

*competitive bids only

Source: State Bank of Pakistan

yields, the market responded positively by making record high offers of Rs 1,970.4 billion during Q1-FY21 compared to Rs 334.2 billion in the same period last year. Interestingly, the market's offers remained concentrated in the 3Y and 5Y PFLs, which signifies the importance of timely issuance of these securities. A high market participation also helped the government to inch up the cut-off prices that in effect brought down the quoted margins of PFLs.[9]

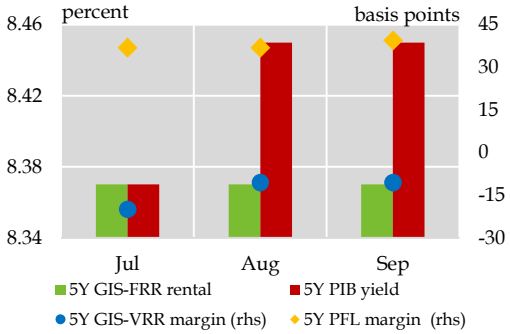
In contrast, despite a higher target set by the government for the fixed rate PIBs, the market's participation remained less than one-fifth of what was observed during Q1-FY20. The higher participation last year was on account of the interest rate cycle peaking out at 13.25 percent. As a result, the acceptance for fixed rate PIBs fell to only Rs 249.2 billion compared to a voluminous issuance of Rs 963.5 billion same period last year (**Table 3.2**). That said, with the policy rate at 7 percent a nearly Rs 250 billion mobilization in fixed rate PIBs is an encouraging development. This not only enabled the government to raise long term debt at relatively low interest rates but also helped diversify the portfolio of government securities.

As observed in case of conventional sovereign debt instruments, both the government and the market remained inclined towards variable rental Sukuk compared to fixed rental instrument. Given a decent market participation in the variable rental rate Sukuk, the government comfortably met the cumulative pre-auction target despite a shortfall in the acceptances of fixed rental rate Sukuk (**Table 3.2**).

For the auctions held during Q1-FY21, the comparison of the yields for Sukuks with PIBs highlights the underserved demand for Shariah compliant instruments in the market. In case of the fixed rate instruments the differential in yields grew from zero to around 8 basis points in the last two auctions in the quarter, whereas in case of variable rate instruments the implied margin for five-year Sukuk was nearly 52 basis points lower,

[9] The coupon of floating rate bonds has a flexible component (a benchmark interest rate) and a fixed component called quoted margin. In the fresh issuance of PFLs, the cut-off determines the quoted margin of that bond. In the subsequent reopening issuances, the cut-off is applicable on the price of the security. In case, a PFL is sold at a premium/discount, the implied margin becomes lower/higher than the quoted margin.

Shariah Compliant Instruments have Lower Yields* **Figure 3.5**



*the auction dates of comparable securities may differ.
Source: State Bank of Pakistan

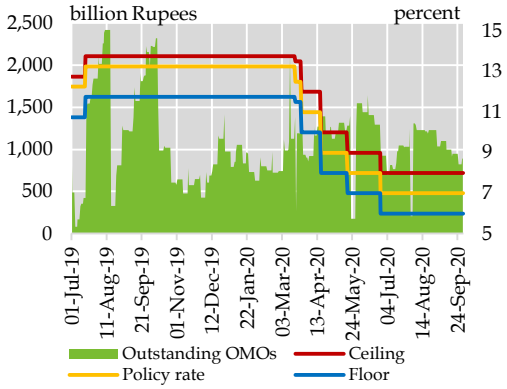
on average, compared to the five-year PFL (**Figure 3.5**).

Interbank Liquidity

An encouraging growth in the bank deposits together with higher retirements from the private sector, PSEs, and the government commodity procurement agencies helped in easing out liquidity requirements of commercial banks. Cumulatively, these inflows more than offset the liquidity requirement to meet government borrowings needs. Therefore, the average outstanding OMOs fell slightly to Rs 1,014.7 billion compared to Rs 1,192.4 billion in the preceding quarter and Rs 1,337.7 billion in the same period last year **(Figure 3.6).**

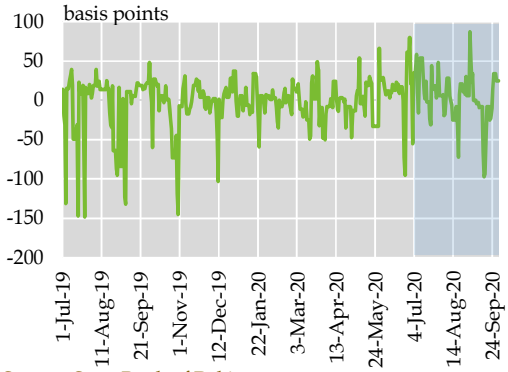
However, the interbank market remained relatively more volatile during Q1-FY21 **(Figure 3.7).** In the month of July 2020, the deviation of overnight rates from the policy rate remained highest at 17 basis points, on average, above the policy rate compared to a deviation of 3 and -4 basis points in August and September 2020 respectively. Rates remained on the higher side intially during

Interest Rate Corridor **Figure 3.6**



Source: State Bank of Pakistan

Deviation of O/N Rate from the Policy Rate **Figure 3.7**



Source: State Bank of Pakistan

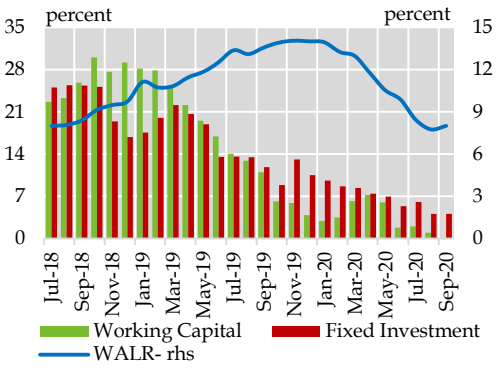
Q1-FY21 due to more than expected cashwithdrawls in July. From mid-August onwards, deposit mobilization picked up pace, which resuted in downward pressure on the overnight rates. This underlying uncertainty in the cash inflows and outflows of the banking system translated in to higher volatity in the overnight rates. Finally, on multiple instances the SBP either completely refrained from intervening in the market to let the market settle on its own or made interventions of lower volumes than was

demanded by the market, which also led to heightened volatility in the overnight rates.

3.3 Credit to Private Sector

During Q1-FY21, a host of positive factors prevailed compared to the same period last year. First, the policy environment was accommodative, with the policy rate down by 625 bps to 7.0 percent, from 13.25 percent in Q1-FY20. Second, the SBP had introduced a number of refinancing schemes to counter the impact of Covid, such as Rozgar Scheme and Temporary Economic Refinance Facility (TERF) since March 2020. Third, the overall business confidence improved during the quarter.[10] Finally, the industrial activity (proxied by LSM) registered improvement during the period under review.

Growth in Loans to Private Businesses (YoY) **Figure 3.8**



Source: State Bank of Pakistan

Despite this favorable environment, the declining trend in the private credit, which had started from the third quarter of FY19, continued in Q1-FY21 (**Figure 3.8**). The downward trajectory in loans to businesses until the outbreak of Covid mainly represented subdued credit demand on the back of slowdown in manufacturing activity, coupled with higher interest rates. The demand for credit was further dampened with the start of business closures amid Covid-related lockdowns in the country. In fact, private businesses (mainly export-oriented sectors) made relatively higher short-term loan retirements in Q1-FY21, over the same period last year.

The weak private credit momentum in Q1-FY21 is likely due to three factors. First, firms' sound liquidity position on the back of increased sales (see **Figure 1.1** in Chapter 1), higher sales tax refunds by the government (see **Table 4.4** in Chapter 4), and SBP's relief package (deferment and restructuring).[11] Indeed, during Q1-FY21, private businesses benefitted not only from SBP's concessionary financing facilities, such as Export Finance Scheme (EFS) and Long-term Financing Facility (LTFF), but also borrowed under the schemes introduced by SBP to counter the impact of Covid, mainly Rozgar Scheme and TERF.[12] As shown in **Table 3.3**, the disbursements under these schemes have been quite substantial in Q1-FY21. Thus, while the disbursements under LTFF and TERF have played their part in the

[10] Keeping in view the ease in lockdowns amid falling Covid infections in the country the overall business confidence improved during the quarter, as reflected by a positive Business Confidence Index (BCI) in SBP's August 2020 survey after three consecutive observations of negative BCI.

[11] Sales-tax refunds of Rs 43.9 billion were released during Q1-FY21 compared to Rs.16.0 billion during Q1-FY20.

[12] Importantly, in August 2020, SBP had enhanced the limit of refinancing provided to the banks under EFS by Rs 100 billion, and allocated Rs 90 billion under LTFF in order to further facilitate the exporters [Source: SBP press release, ERD/M&PRD/PR/01/2020-89, dated August 19, 2020].

quadrupling of fixed investments loans in Q1-FY21 over the same period last year (**Table 3.4**), they might have also induced few firms to retire their previously taken bank loans against the conventional facilities.

A second source of weak credit momentum could be the availability of surplus carry-over stocks, which led to a weak demand for working capital loans.[13,14] Subdued economic activity in the preceding two quarters gives credence to this assumption.

Finally, input prices remained muted, mainly driven by oil, glass sheets, steel bars and sheets and chemicals. This might have dragged down the working capital demand as well.

Consumer financing, nonetheless, did benefit from relatively accommodative policy environment in Q1-FY21. Under car financing and personal loans, a significant increase was registered in Q1-FY21 over the same period last year, when it had recorded net retirements (**Table 3.5**).

Working capital loans recorded net retirements

Working capital loans posted a net retirement of Rs 163.4 billion in Q1-FY21, compared to Rs 100.0 billion decrease recorded in Q1-FY20. Within manufacturing sector, more than sixty percent of the retirement was driven by sugar and textile. The sugar industry retired Rs 82.7 billion in Q1-FY21, compared to a relatively lower retirement of Rs 36.9 billion during the same period last year. This is mainly attributed to higher offtake in Q3-FY20 on account of increased sugar prices, which led to a persistent increase in loan retirements in the subsequent quarters.[15]

SBP's Major Concessionary Financing Schemes **Table 3.3**

flow in billion Rupees

	Approved Amount	Q1-FY20	Q1-FY21
EFS	-	4.7	14.7
LTFF	-	14.8	36.8
of which TERF	86.3**	-	4.5
SBP Rozgar Scheme	216.9*	-	99.9

*as on 25th Sep, 2020; **as on 24th Sep, 2020

Source: State Bank of Pakistan

Meanwhile, the textile sector retired Rs 42.7 billion in Q1-FY21, compared to a marginal retirement of Rs 2.0 billion during the same period last year. Textile businesses benefitted from SBP's concessional EFS, thus increasing the overall borrowing under the scheme to Rs 14.7 billion in Q1-FY21 from Rs 4.7 billion in Q1- FY20. In addition, with higher export proceeds in rupee terms, the businesses managed to retire their short-term loans during the period under review. Therefore, a strengthening in the repayment capacity of textile industry was not surprising. While the gross non-performing loans of overall private businesses increased,

[13] Analysis of the financial statements of major textile firms reveals that Covid-related lockdowns led to build-up of inventories till Q4-FY20, which reduced their short-term borrowing requirements in Q1-FY2.

[14] Banks received 24.7 percent lower applications of working capital loans in Q1-FY21, over the same period last year.

[15] Sugar sector posted a net retirement of working capital loans amounting Rs 40.0 billion and Rs 82.7 billion in Q4-FY20 and Q1-FY21, respectively.

Loans to Private Sector Businesses (Q1) **Table 3.4**
flow in billion Rupees

	Total Loans		Working Capital*		Fixed Investment	
	FY20	FY21	FY20	FY21	FY20	FY21
Private Sector Businesses	-85.4	-100.9	-100	-163.4	14.6	62.5
Manufacturing	-50.7	-157.4	-46.5	-196	-4.3	38.5
Fertilizers	-19.2	9.3	-16.5	12.8	-2.7	-3.5
Basic pharmaceutical products	2.2	17.4	1.7	3.6	0.5	13.8
Basic iron and steel	15.8	2.8	11.9	2.5	3.9	0.3
Basic chemicals	3.5	-15.4	2.8	-6	0.8	-9.4
Refined petroleum	-4.1	-6.6	-2.9	-6.7	-1.1	0
Electrical equipment	-6.2	-9.7	-3.1	-9.3	-3.1	-0.4
Cement, lime and plaster	-1.8	-10.3	1.4	-11.5	-3.2	1.2
Rice Processing	-21.6	-15.2	-21.7	-15.7	0.1	0.6
Motor vehicles	30.7	-16.5	29.4	-16.8	1.3	0.3
Textile	6.6	-28.7	-2	-42.6	8.6	13.9
Sugar	-42.7	-82.3	-36.9	-82.7	-5.9	0.4
Power gen., trans., and dist.	9.6	9.1	3.8	-9.3	5.8	18.4
Construction	-17.1	6.6	-19	2.5	1.9	4.1
Wholesale and retail trade	-43.8	17.8	-34.7	15.6	-9	2.2
Mining and quarrying	-5	-3.3	-5.8	-3.4	0.9	0.1
Transportation and storage	4.6	1.8	5.4	3.1	-0.8	-1.3
Real estate activities	5.3	-3.1	-0.2	-1.3	5.6	-1.8
Agriculture, forestry and fishing	-0.8	3.7	0.6	6.1	-1.3	-2.4
Telecommunications	24.4	1.7	-0.4	5.1	24.8	-3.4

*includes trade financing
Source: State Bank of Pakistan

the non-performing loans (NPLs) in the textile sector declined during the quarter.[16] Further, despite an increase of 3.8 percent YoY in cotton prices during Q1-FY21, the textile sector's demand for working capital loans remained weak mainly due to the availability of surplus carry-over stocks, besides the sector's sound liquidity position.[17]

In addition to textile, some activity was also recorded in cement and automobiles during Q1-FY21. Higher exports and increased local dispatches allowed cement industry to retire its working capital loans. In case of automobiles, local assemblers were able to retire their short-term loans with the help of higher sale proceeds during the period under review.

Meanwhile, fertilizer industry borrowed short-term loans amounting to Rs 12.8 billion in Q1-FY21, compared to a net retirement of Rs 16.5 billion during the same period last year. This was mainly on the back of higher

[16] The overall infection ratio increased marginally from 8.8 percent at end-September 2019 to 9.9 percent in September 2020. However, the infection ratio of textile sector declined from 16.7 percent in September 2019 to 14.3 percent in September 2020.
[17] See footnote 13.

fertilizer imports during the quarter.[18] In view of the government's recently announced agriculture package, the domestic demand for fertilizer picked up in Q1-FY21 **(see Chapter 2 for details**). Among non-manufacturing businesses, wholesale and retail trade borrowed Rs 15.6 billion in Q1-FY21, compared to a net retirement of Rs 34.7 billion during the same period last year. The borrowing was prominent in wholesale of fuels, as the major Oil Marketing Companies (OMCs) in the country borrowed short-term loans mainly to meet the rising fuel demand amid revival of economic activities in the country following the ease in lockdown restrictions.[19]

Borrowing for fixed investment purposes increased

Fixed investment loans increased by Rs 62.5 billion in Q1-FY21, compared to an offtake of Rs 14.6 billion during the same period last year. This increase was mainly driven by textile and pharmaceutical segments in the manufacturing sector, and electric power segment in the non-manufacturing sector Pharmaceutical sector borrowed long-term loans of Rs 13.8 billion in Q1-FY21, compared to an increase of only Rs 0.5 billion in the same period last year. This mainly represents the acquisition of a chemical manufacturing business by a renowned pharmaceutical firm in the country. Resultantly, the exposure of the former was transferred to the books of latter, as reflected by retirement in basic chemicals in August 2020 and an increase in pharmaceutical in the same month.

The textile sector took long-term loans of Rs 13.9 billion in Q1-FY21, compared to Rs 8.6 billion during the same period last year. The sector benefitted from SBP's LTFF for export-oriented projects, as loans under the facility constituted around 96 percent of the textile sector's overall fixed investment borrowing during Q1-FY21. Among non-manufacturing entities, electric power firms borrowed fixed investment loans of Rs 18.4 billion in Q1-FY21, primarily to import power generating machinery, compared to a borrowing of Rs 5.8 billion during the same period last year.

Consumer Financing (Q1) **Table 3.5**

flow in billion Rupees

	FY20	FY21
Total consumer financing	**-2.7**	**39.6**
For Transport: Car	-2	21.3
Personal loans	0.2	16
Credit cards	1.8	6.1
House building	-2.2	-1.2
Consumers durable	-0.5	-2.6

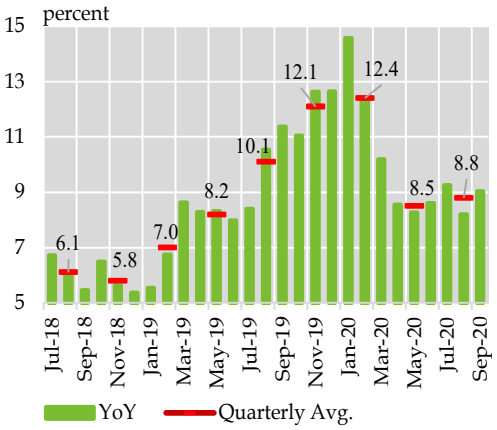
Source: State Bank of Pakistan

Consumer Financing

Consumer financing posted a significant increase of Rs 39.6 billion in Q1-FY21, compared to a decline of Rs 2.7 billion in Q1-FY20 (**Table 3.5**). The offtake was mainly driven by two segments: auto and personal loans, as consumers benefitted from lower bank lending rates in Q1-FY21 **(Figure 3.1)**.[20] Further, the increase in auto finance is also

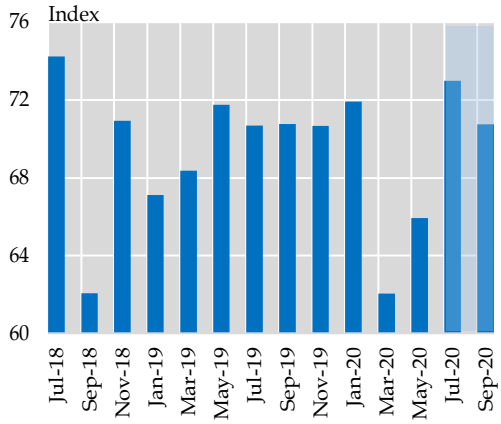
[18] The import of fertilizer during Q1-FY21 increased by 23.8 percent compared to a decline of 50.7 percent in same period last year.
[19] During Q1-FY20, POL sales grew by 10.5 percent over the same period last year.
[20] The Weighted Average Lending Rate (WALR) dropped from 13.4 percent in Q1-FY20 to 8.1 percent in Q1-FY21.

National Consumer Price Index **Figure 3.9**



Source: Pakistan Bureau of Statistics

Inflation Expectation Survey **Figure 3.10**



Source: State Bank of Pakistan

explained by higher demand of passenger cars, particularly in 1,300cc and above category. For instance, a renowned auto assembler introduced a new variant of passenger car in 1,300cc and above category which was well received by the market.[21]

3.4 Inflation

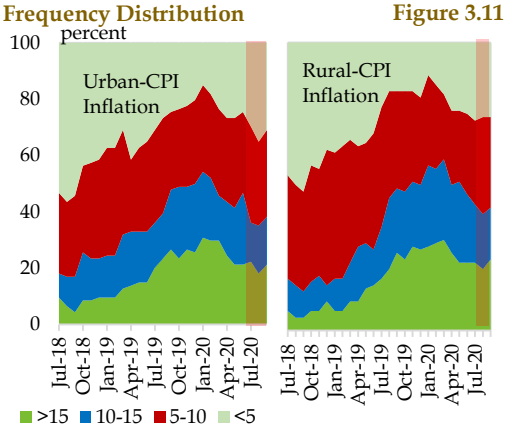
The pace of inflation stabilized around single digits during the first quarter of FY21. Macroeconomic stabilization efforts initiated earlier in FY19, administrative measures (including crackdown on speculative elements), resumption of seasonal supplies of perishables and the Covid-related steep fall in the global crude prices largely helped to rein in inflationary pressures in the economy by the end of FY20. In addition, the tax relief measures in Budget 2020-21 in response to Covid also provided relief in terms of stable prices of various goods.

Accordingly, the average national headline CPI inflation clocked in at 8.8 percent during Q1-FY21 compared to double digit growth of 10.1 percent in the same period last year, and at almost the same level observed in the previous quarter (**Figure 3.9**). Nonetheless, inflation expectations (gauged by the IBA-SBP Consumer Confidence Survey (CCS)), crept up by the start of the year, mainly reflecting surging food prices, after having experienced a steep downward movement in Q4-FY20 amid Covid-related sluggish demand (**Figure 3.10**).

In terms of dispersion, for the quarter under review, the inflation increase was concentrated in half of the sub-indices (48 out of 94- with around 51 percent share in CPI in urban indices and 48 out of 89- with around 54 percent share in CPI in rural indices) compared to the broad-based rise last year during the same period. Meanwhile, in terms of both distribution and magnitude, the trends reversed during Q1-FY21 compared to last year. The number of items

[21] According to PAMA, sales of 1300cc and above passenger cars jumped from 9,953 units in Q1-FY20 to 16,736 units in Q1-FY21.

Frequency Distribution **Figure 3.11**



Source: Pakistan Bureau of Statistics

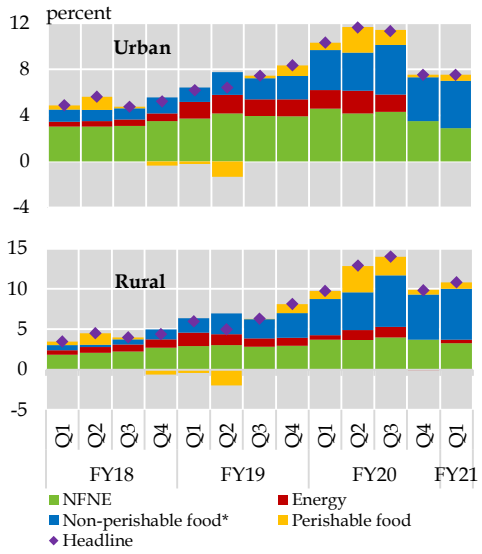
posting double-digit inflation during the first nine months of the FY20 started to shift toward the less than 5 percent bracket. This depicted subsiding inflationary pressures on account of waning underlying demand as well as subdued cost-push pressures in the economy (**Figure 3.11**).

The category-wise breakdown suggests that food inflation remained the major contributor to headline inflation in both urban and rural areas, whereas underlying inflationary pressures (reflected in NFNE) were largely stable (**Figure 3.12**).

Food continued to remain the main source of inflation

After subsiding by the end of FY20, food inflation rose again significantly during Q1-FY21, contributing more than half (around 62 percent) to overall inflation (**Table 3.6**). Both perishable and non-perishable food items registered increasing price trends, with the latter trend being stronger. Details suggest that domestic agriculture production and commodity management issues mainly led to higher prices. Harvesting disruptions amid lockdown and locust attacks dented the local production of various food items. Moreover, rising trends in prices of global agricultural products also escalated pressures on domestic food prices (**Box 3.1**).

Composition of YoY CPI Inflation **Figure: 3.12**



*inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

Non-perishables

Among non-perishable food items, the major thrust came from staple group: wheat and wheat flour. Prices continued a steep upward trajectory in Q1-FY21 as well, as was observed during FY20.[22]

For the 2020 wheat crop, the procurement target was set at 8.25 million metric tons (MMT), keeping in view: (1) the estimated crop size of 25.25 MMT against a target of 27.03 MMT; (2) carryover stocks of 0.602

[22] See the SBP's Third Quarterly Report for FY20 on The State of Pakistan's Economy for details.

Average CPI Inflation and Contribution (Q1) **Table 3.6**

percent

Items	Urban				Rural			
	Wt.*	FY20	FY21	Cont.**	Wt.*	FY20	FY21	Cont.**
CPI	100.0	10.3	7.5	7.5	100.0	9.7	10.8	10.8
Food & non-alcoholic beverages	30.4	12.2	14.0	4.1	40.9	12.3	16.3	6.6
Wheat	0.6	9.5	38.3	0.2	3.5	9.2	38.9	1.2
Wheat flour	3.0	10.0	20.7	0.5	3.4	11.3	24.9	0.8
Potato	0.4	26.2	64.3	0.4	0.7	24.1	74.1	0.7
Tomatoes	0.3	-20.8	45.3	0.1	0.5	-21.1	60.1	0.3
Sugar	1.1	34.2	23.5	0.2	2.0	35.7	22.6	0.4
Condiments and spices	1.3	20.4	39.8	0.6	1.5	12.8	55.3	0.8
Clothing and footwear	8.0	8.5	8.4	0.7	9.5	8.4	10.9	1.1
Housing, electricity and gas	27.0	8.3	4.9	1.3	18.5	2.8	6.7	1.2
House rents	19.3	6.5	4.3	0.8	8.6	5.5	4.9	0.4
Electricity charges	4.6	-3.2	7.7	0.3	3.4	-3.2	7.7	0.2
Furnishing and household	4.1	12.4	6.3	0.2	4.1	10.0	10.0	0.4
Health	2.3	11.0	6.6	0.2	3.5	11.8	9.2	0.3
Transport	6.1	18.4	-3.4	-0.2	5.6	16.6	-2.8	-0.2
Motor fuel	2.9	21.5	-9.1	-0.3	2.5	21.0	-9.3	-0.3
Communication	2.4	5.6	0.4	0.0	2.0	2.0	0.2	0.0
Education	4.9	7.0	1.0	0.1	2.1	5.2	1.0	0.0
Restaurants and hotels	7.4	5.2	7.7	0.6	6.2	7.6	8.3	0.5
Miscellaneous goods and services	4.8	12.1	11.2	0.5	5.0	12.9	14.5	0.7

*wt. = weight; **Cont.= Contribution for Q1

Source: Pakistan Bureau of Statistics

MMT; and (3) estimated demand of 27.47 million tons for the year. However, this target could not be achieved, despite higher production compared to last year (24.34 MMT). Shortfall of 1.619 MMT was expected given the consumption requirement for FY21.

Box 3.1: Rising Global Food Prices

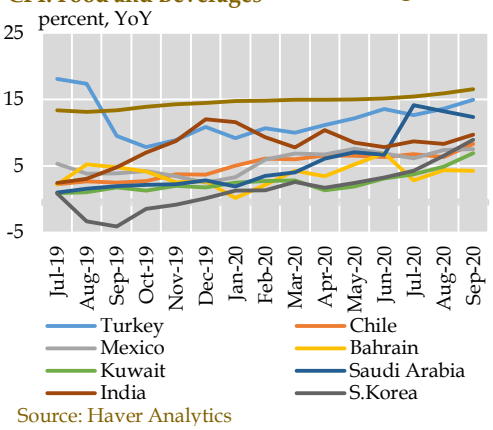
Initial readings of inflation data from advanced and emerging economies provided sufficient evidence of rising food inflation since the start of the pandemic (**Figure 3.1.1**). However, no solid indication of inflation in broader indices, barring food group, has been registered. Particularly, headline inflation dropped mainly on account of low energy prices, whereas core inflation also declined or stabilized due to weaker demand.

Food prices started to rise with the beginning of the Covid containment phase. South Asia, Sub-Saharan Africa, and Latin America have been among the most affected regions. The following supply-chain

factors are considered to be the major contributors to rising food inflation during pandemic: [23]

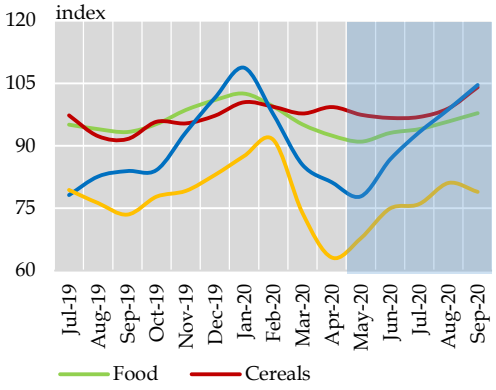
- Lockdown and restricted mobility measures affected the supply and demand of certain products.
- Panic buying and hoarding escalated food prices of non-perishable items.
- Supply disruptions in agriculture products due to labor shortages resulting from a decline in the number of migrant workers: Palm oil harvesting and processing operations have been increasingly affected by labor force reduction, especially in Malaysia, where several plantations are suffering from acute shortages of migrant laborers triggered by policies to curtail the spread of Covid.[24] Similarly, the value chain for fruits, the most perishable items which require labor-intensive handling and rapid (often airborne) transport, was also affected.[25]
- Reliance on imported goods especially in case of emerging and developing economies, given the currency depreciation episodes.
- Hoarding practices in international trade as countries fail to coordinate their emergency policies. [26]

CPI: Food and Beverages **Figure 3.1.1**



Source: Haver Analytics

Food Price Indices **Figure 3.1.2**



Source: FAO

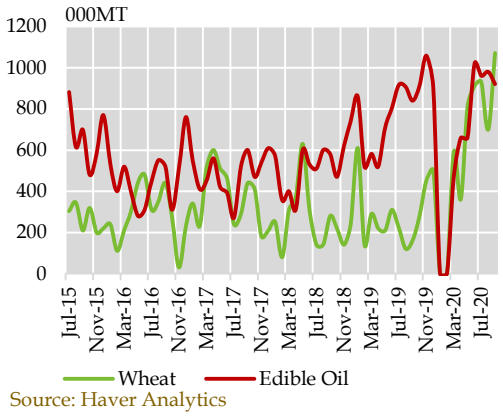
Here, it is important to note that major grain prices were almost stable during this period (March and April 2020); in fact, they rather declined on account of sufficient production and stocks available with the major grain producing countries. However, prices started posting rise since May 2020 and surged nearly 8 percent by end-September 2020. This reversed the stable trend witnessed earlier in the year (**Figure 3.1.2**). Recent gain in agricultural commodity prices are mainly driven by a) greater demand for grain-based food by major consumers such as China and b) supply shortfalls in some agri-products on account of unfavorable weather.

From the global demand perspective, China has stepped up its purchases for edible oil and grains

[23] Ebrahimy, E.., Igan, D. and S.M. Peria (2020). *The Impact of COVID-19 on Inflation: Potential Drivers and Dynamics*. Special Notes Series on COVID-19. Washington DC: International Monetary Fund.
[21] FAO price indices for oilseeds, vegetable oils and oil meals, October 2020
[25] FAO (2020, June 06). *COVID-19 causes havoc to supply chains for fresh fruits and vegetables*. New York: Food and Agriculture Organization of the United States. fao.org/support-to-investment/news/detail/en/c/1278468/
[26] According to the World Trade Organization, as of the end of April, around 80 countries and customs territories had introduced export restrictions as a result of the pandemic on both food and nonfood items.

significantly to secure domestic food requirement (**Figure 3.1.3**). Similarly, India is reported to have increased its imports for edible oil.[27] As per industrial experts, second round of stockpiling has started by the consumers in fear of another Covid wave. Moreover, towards the end of September 2020, Malaysia's top producing state considered imposing a new set of temporary restrictions (state-wide movement control) on palm oil producers, in an effort to contain fresh outbreaks of Covid. Limiting plantations' workforce numbers and mills' operating hours is expected to affect the production significantly during peak harvest season. Similarly, Russia's agriculture ministry is planning to limit the amount of grain (wheat, barley and maize) that can be exported from February 2021, over constrained production prospects and high world demand.

Imports by China **Figure 3.1.3**



Source: Haver Analytics

While the supply-chain disruptions were already shaping up food inflation expectations, weather related reduced production prospects further escalated the food inflation. For instance, prices of edible oil gained most in the quarter due to supply shortfalls. Palm oil also registered gain amid the problems that suppliers are having in securing enough labor to proceed with the palm harvest, as mentioned earlier. Wheat prices, in particular, posted significant rise in prices reflecting strong global demand, unfavorable growing conditions in Argentina and Australia and continued dry weather adversely affecting winter wheat conditions in some parts of Europe, northern America and the Black Sea region. Meanwhile, international soybean quotations maintained their upward momentum due to unfavorable weather conditions in key growing regions of the US.

In view of the Covid-driven supply disruptions and grain production outlook, food insecurity persists. Stockpiling behavior, increasing protectionism, limited food exports and unfavorable production prospects are likely to keep the global food inflation at elevated level for some time.[28]

In view of the constrained stock position with the public sector and missed production target, Economic Coordination Committee (ECC) allowed wheat imports by end June 2020. Particularly, the Trading Corporation of Pakistan (TCP) was allowed to place an order for the import of 200,000 tons of wheat in the public sector following the import of 500,000 tons of wheat by the private sector in the country.[29] Also, ECC approved the request of the Ministry of Commerce to reduce the margin of commission of TCP on the import of wheat and sugar to 0.75 percent from the existing 2.0 percent in order to reduce the import cost.

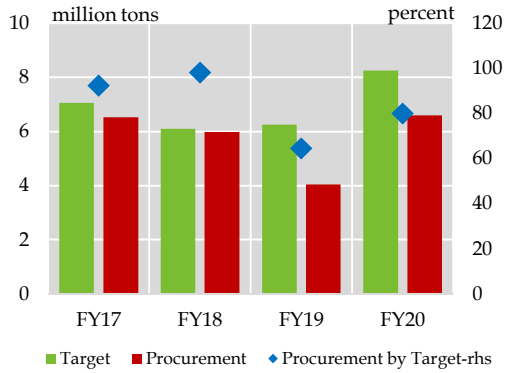
Despite these measures, wheat inflation rose significantly during the period under review.

[27] 11.5 percent rise on YoY basis in Q1-FY21 in terms of USD compared to similar period last year, whereas 46.8 percent rise was observed compared to Q4-FY20.
[28] World Bank (2020). *Food Security and Covid-19*. Webpage Brief. Washington, DC: World Bank.
[29] By end Q1-FY21, around 432 thousand MT of wheat import has been made with only around 39 thousand MT in August 2020 and around 392 thousand MT in September 2020.

One issue may be related to government's commodity operations. For the second consecutive year, procurement agencies are missing the procurement targets by large margins (**Figure 3.13**). One probable factor behind this could be the rising spread between the support price and the wholesale price of wheat. In fact, in six wheat producing districts in Punjab (including the top-two wheat producers, Bahawalpur and Rahim Yar Khan), the wholesale price of wheat was above the government support price (GSP) during these procurement months (mid-April to July) (**Figure 3.14**). Second, release of timely stocks by the procurement agencies also plays an important part in determining the price pressure. Despite the Public sector's procurement above the level of last year, price pressures could not be controlled, indicating supply-demand gaps managed by the procurement agencies. Third, the import process seemed to be slow in making a significant impact on the market prices: ECC allowed import by end- June 2020 whereas first shipment arrived in August 2020. Moreover, a considerably high level of international wheat price, though lower than domestic prices, seems to have demotivated the private sector in aggressive participation in imports.[30] Fourth, speculative activities in the market also seemed to have played a dominant role in price hike as government was consistently warning hoarders for strict action against those found involved.

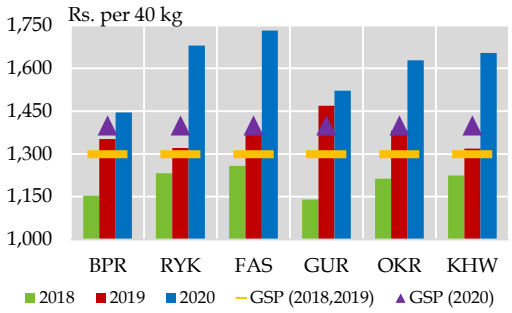
In addition to wheat, sugar prices continued to rise in Q1-FY21. The double-digit inflation in sugar can partially be attributed to slightly

Public Sector Wheat Procurement **Figure 3.13**



Source: Provincial Food Departments

Government Support Price & Regional Wholesale Prices **Figure 3.14**



*procurement season generally starts in Punjab around mid-April and ends in July.

Source: Agriculture Marketing Information Service

low production of sugarcane in FY20, [31] absence of a reliable stock position and speculative activities in the market. During Q1-FY21, the ECC also considered a proposal to allow import of refined sugar up to 300,000 metric tons by the TCP to maintain buffer stocks in addition to the ban imposed on sugar exports by the mid of FY20. Despite import of around 30 thousand MT sugar in

[30] Wheat prices rose by 19.4 percent in Q1-FY21 compared to 23.3 percent decline last year same period as per IMF commodity prices.

[31] In FY20, 66.37 million tons of sugarcane was produced compared to 67.17 million tons in FY19.

Q1-FY21 compared to 7.6 thousand MT imported in FY20 and better sugarcane production prospects for FY21, prices continued on their upward trajectory.[32] Speculative activities and price fixing behavior seems to have put upward pressure on the commodity price, with the Competition Commission of Pakistan (CCP) noting that Pakistan Sugar Mills Association (PSMA) has maintained cartels among its members to keep the commodity's prices high.[33]

In addition to wheat and sugar, prices of cigarettes, edible oil and ghee, and pulses also remained under pressure during Q1-FY21. In case of cigarettes, the significant revision in FED announced in the Budget 2020-21 pushed up its price. Particularly, FED on imported cigarettes, cheroots, cigarillos, cigars and other tobacco substitutes has been enhanced from 65 percent to 100 percent in line with WHO (World Health Organization) standards.

In case of edible oil and ghee products, edible oil refineries were struggling with rising international prices of palm oil and soybean registered during Q1-FY21. [34] In terms of unit prices of imports, 0.7 percent and 21.8 percent rise has been observed in Q1-FY21 for soybean and palm oil respectively (**Box 3.2**). Heavy rainfall brought on by La Nina disrupted output in palm-producing countries,[35] whereas, soybean prices have surged to their highest levels driven by heavy buying from Chinese importers.

In case of pulses also, inflationary pressures were mostly imported. The international market for pulses experienced various supply and demand pressures among the major exporters and importers (as pointed out in detail in the SBP's Third Quarterly Report for FY20). As a result, Pakistan saw approximately 11 percent increase in unit values of imported pulses in Q1-FY21 as compared to same period last year.

Perishables

Issues related to managing inflation in perishable food items (limited domestic production, timely import hurdles etc.) persisted in Q1-FY21.[36] The index of perishables rose but with significant variation among its components. The substantial surge in the prices of potatoes and tomatoes pushed the headline numbers of perishable items towards a high level despite relative stability in fruit prices and significant deflation in onion prices compared to same period last year.

The pandemic-induced lockdown has interrupted food supply chains across major agricultural products (**Box 3.2**). For instance, tomato farmers faced substantial disruption

[32] Estimated sugarcane production for FY21 increased to 75.64 million tons
[33] Hussain, S., Laiq, N. and M. Quddus (2020). *Enquiry Report in the Matter of Alleged Anti-Competitive Activities in the Sugar Industry*. Islamabad: Competition Commission of Pakistan.
[34] International palm oil prices rose by 34.5 percent in Q1-FY21, and prices of soybean increased by 10.5 percent during Q1-FY21.
[35] Commodity Markets Outlook, October 2020, World Bank
[36] For details, see the SBP's The State of Pakistan's Economy report for Q2-FY20 and Khalid, A. and Sabahat (2020). *Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges*. SBP Staff Note 2/20. Karachi: State Bank of Pakistan.

Box 3.2: Covid Impacts on Domestic Production

The Asian Development Bank (ADB) conducted a survey of farmers in Sindh and Punjab to gauge the impact of Covid on their production and marketing activities. More than 400 farmers were contacted in this regard both in Punjab and Sindh using computer-assisted telephone interviewing. The survey of farmers revealed that Covid crisis had a significant impact on the production and marketing of agricultural products, including wheat, vegetables and fruits.

Impacts on Farm Households in Punjab*

- More than 27.0 percent of respondents reported facing disruptions related to Covid while purchasing or receiving farm inputs for the next cycle of sowing. Respondents indicated disruptions in the supply of the following farm inputs: seed (81.2 percent); fertilizer (23.9 percent); pesticides (19.7 percent); and diesel fuel (17.1 percent).
- The lockdown took place just as the wheat harvesting season and sowing of summer (kharif) crops began. Disruptions such as higher rental charges, labor shortage, and farmers' limited access to markets were also reported (FAO 2020).

Impacts on Farm Households in Sindh**

- Most respondents (78.9 percent) reported facing Covid-related disturbances while purchasing farm inputs for the next cycle of sowing. The shares of respondents noting disruptions to the purchase and/or delivery of farm inputs caused by Covid are as follows: seed (97.2 percent), fertilizer (43.6 percent), pesticides (36.1 percent), diesel fuel (22.1 percent), and machinery (14.3 percent).
- Tomato farmers faced substantial disruption, with 61 percent of respondents unable to complete their harvest at the usual time. The challenges most often cited were the farmers' inability to travel to markets and cities and the unavailability of traders to purchase the crops.
- Around one-third of the farmers (32.5 percent), felt their harvest of vegetables and fruits had been delayed compared with the past years; of these, 41.5 percent cited the unavailability of labor as the primary reason for the delay.

References: *ADB (2020a). *COVID-19 Impact on Farm Households in Punjab, Pakistan: Analysis of Data from a Cross-Sectional Survey*. ABD Briefs No. 149. Mandaluyong: Asian Development Bank. **ADB (2020b). *COVID-19 Impact of COVID-19 and Locust Swarms on Farm Households in Sindh, Pakistan: Analysis of Data from a Cross-Sectional Survey*. ABD Briefs No. 149. Mandaluyong: Asian Development Bank

in completing timely harvest. In addition to that, severe locust invasions and heavy rains also damaged Sindh's tomato crop.[37] It is pertinent to note here that price pressures persisted despite significant imports from Iran and Afghanistan.[38]

Potatoes index also registered 64.3 percent and 74.1 percent rise in urban and rural areas, respectively, during Q1-FY21. This is despite significant imports from Iran, Afghanistan and Bhutan.[39] Exports also almost halved compared to the same period last year.

Core inflation tapered down

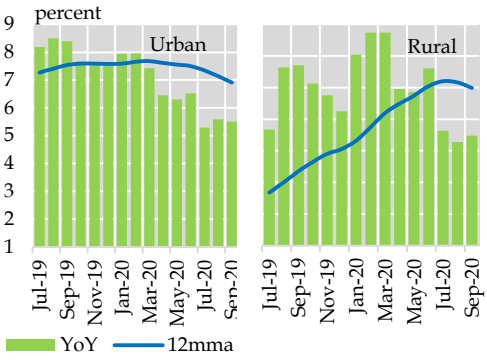
The underlying inflationary pressures eased during Q1-FY21 for urban areas, whereas rural inflation depicted stabilizing trend after

[37] 73.7 percent of respondents reported having seen locust swarms in their area as per a survey conducted in June 2020 under Asian Development Bank (ADB) technical assistance. Source: ADB (2020b).

[38] Import of tomatoes rose by around 38 percent in Q1-FY21 compared to last year same period

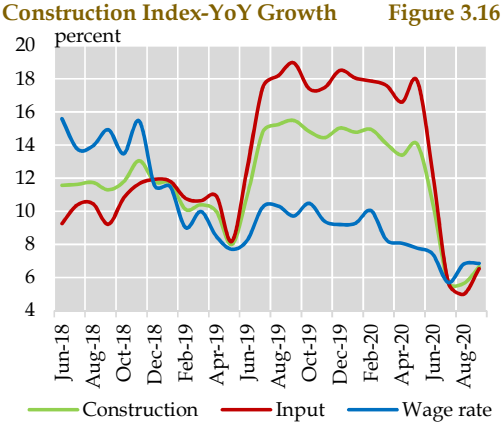
[39] Pakistan imported 14,377 thousand kg in Q1-FY21 compared to 19.5 thousand kg last year same period.

Non-food Non-energy Index-YoY Growth **Figure 3.15**



Source: Pakistan Bureau of Statistics

Construction Index-YoY Growth **Figure 3.16**



Source: Pakistan Bureau of Statistics

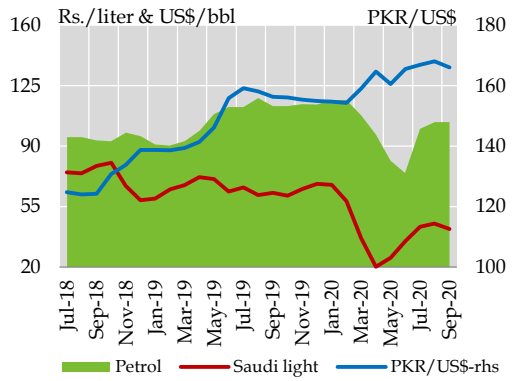
posting consistent rise since July 2019 as gauged by the 12-month-moving- average of non-food-non-energy (NFNE) index (**Figure 3.15**). The overall moderation in prices represented the impact of macroeconomic stabilization measures taken earlier in FY20, along with a considerable alleviation in cost-push pressures in the economy. For instance, muted fuel prices and tax relief measures announced for construction industry and tariff concessions for a number of industrial raw materials in Budget 2020-21 largely curbed the cost-push pressures.

Within urban NFNE, both the goods and services indices decelerated during Q1-FY21, however, the impact of latter was more pronounced. The subdued growth in goods category in urban areas can be attributed to motor vehicles, construction inputs, education and recreation and culture. In case of rural NFNE, services index declined over comparable period last year as well as Q4-FY20, whereas goods index rose slightly on YoY basis, but decelerated compared to Q4-FY20. It is important to mention here that significant slowdown in almost half of the services group mainly altered the rising trajectory of rural NFNE observable for the last four consecutive quarters.

Disaggregated analysis reveals that downward pressure on construction related prices has been observed, especially in cement, *bajri* and iron bars. The FED on Portland cement, aluminous cement, slag cement, super sulphate cement and similar hydraulic cements has been reduced in Budget 2020-21 from Rs 2/kg to Rs 1.75/kg in the wake of Covid. As shown in **Figure 3.16,** the CPI construction index – which includes items related to cement, iron, bricks, paints, sand, painter, mason, unskilled labor, plumber and electrician – has been dropping since the start of the year, and clocked in at 6.0 percent in Q1-FY21 compared to 15.2 percent in the same period last year.

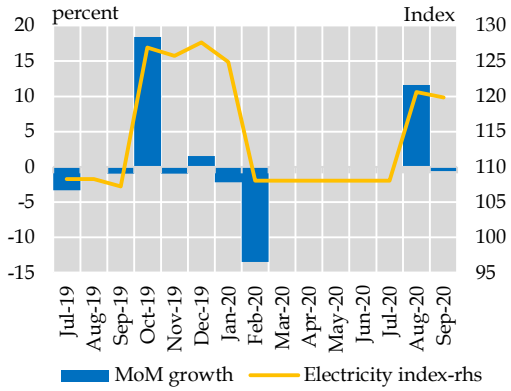
In services category, both for urban and rural areas, component-wise analysis suggests that house rent, motor vehicle tax, construction wages and education played a significant role in driving down the overall services inflation. In education sector, the decline in inflation came from private school fees. This can be attributed to: (a) the Supreme Court's

Domestic and Global Oil Prices **Figure 3.17**



Source: PBS and Bloomberg

Electricity Inflation **Figure 3.18**



Source: Pakistan Bureau of Statistics

decision taken earlier in Q1-FY20 to restore school fees to the 2017 level, on which it fixed the maximum increase in fees at 5 percent a year; (b) concession in tuition fees as provided in the Sindh Covid Emergency Relief Ordinance, 2020, as well as The Punjab Private Educational Institutions Ordinance, 2020; and (c) withdrawal of collection of advance tax on tuition fee by some educational institutions. In addition, postal services and motor vehicle taxes posted no change in inflation during Q1-FY21 on account of no new taxes imposed by the government in order to provide Covid-related relief to the masses.

Decelerating trend in energy inflation persisted

The urban-energy inflation continued to decelerate in Q1-FY21 whereas it rose marginally in case of rural areas. In case of motor fuel, the average inflation declined by 9.1 percent compared to 21.5 percent rise in same period last year. This substantial softening is attributed to the overall Covid-related global decline in the fuel prices since January 2020 and allied weak demand (**Figure 3.17**). On MoM basis, domestic fuel prices rose during Q1-FY21 in response to recent marginal recovery in global oil prices; however, on YoY basis, the domestic oil prices are still at a relatively lower level.

Electricity index, on the other hand, posted robust growth after witnessing deflation for almost two consecutive quarters. This decline in the previous quarters was on account of the postponement of fuel price adjustments (FPA) to freeze the electricity tariff for November 2019 (and onwards). However, by the start of FY21, NEPRA approved the tariff on account of variations in fuel charges for the months of November 2019 till June 2020, for power distributing companies (DISCOs), in an attempt to rein in the growing circular debt. These adjustments were realized in August 2020 and September 2020.[40] Thus, the revised tariffs to address power sector issues contributed to the rise in electricity inflation in Q1-FY21 (**Figure 3.18**).

[40] As per details, fuel cost adjustment (FCA) pertaining to January, February, March, and May 2020 have been charged in August 2020, while FCA for the months of November 2019, December 2019, April 2020 and June 2020, have been charged in September 2020.

4 Fiscal Policy and Public Debt

Fiscal indicators resumed their pre-Covid trajectory during Q1-FY21, as tax collections improved with the resumption of economic activity, and the government started unwinding its crisis spending on healthcare and social protection. As a result, the primary balance turned into a surplus again after recording a deficit in the preceding quarter, and the size of the overall fiscal deficit also shrank on a quarter-on-quarter basis. However, the fiscal position was weaker compared to the same period last year due to higher interest payments and provincial development spending, as well as a sharp decline in non-tax revenues. As a result, the stock of public debt ticked up further during the quarter; nonetheless, the pace of public debt accumulation was considerably contained compared to Q1-FY20, primarily due to lower volume of incremental government deposits with the banking system. Also, following the introduction of new long-term instruments in the domestic debt market, the government was able to lengthen the maturity profile of public debt. Furthermore, the surplus in the current account, debt relief under the Debt Service Suspension Initiative (DSSI), and available funding from multilateral sources eased the pressure on external debt management.

4.1 Fiscal Indicators

The improvement post lockdowns of the first Covid pandemic wave

With the ease in domestic lockdowns in Q1-FY21, fiscal indicators began to revert to their pre-Covid trends. While tax collection picked up as economic activity resumed, crisis spending to extend health facilities (purchase of medical equipment and testing kits) and social protection subsided as number of infections dropped in the country. The resultant decline in non-interest current spending (on QoQ basis) more than offset the increase in development spending which both the federal and provincial governments deemed crucial to accelerate the pace of economic recovery. As a result, the government partially regained the consolidation momentum of the first three quarters of FY20, and recorded a healthy primary surplus in Q1-FY21 compared to a deficit recorded in the preceding quarter. Moreover, the overall fiscal deficit in Q1-FY21 was only a quarter of the deficit recorded in Q4-FY20.[1]

Nonetheless, compared to the same period last year, the primary surplus recorded in Q1-FY21 was 9.9 percent lower due to a steep fall in non-tax revenues and a sharp rise in development spending of the provincial governments. Additional strain to fiscal accounts came from a 29.8 percent growth in interest expenses as bulky coupon payments for longer tenor instruments as well for 12-month instruments fell due. As a result, the overall fiscal deficit recorded almost 70 percent growth in Q1-FY21 over last year (to reach 1.1 percent of the targeted GDP for the year). However, these developments must be viewed in the context of a shift in fiscal policy from last year: while deficit reduction was at the core of Budget FY20 that introduced a number of tax-enhancement and expenditure-control measures, relief provision to vulnerable segments and growth support had set the broad contours of Budget FY21.

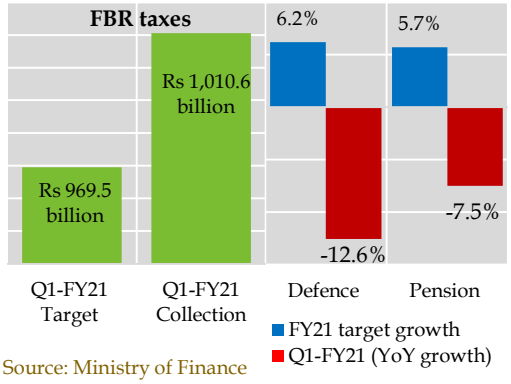
[1] There is an element of seasonality in quarter-wise accumulation of fiscal deficits, as the deficit in the fourth quarter is mostly on the higher side. However, the 249 percent reduction in the deficit in Q1-FY21 compared to Q4-FY20 was more than double the average reduction of 104.0 percent over the last 5 years (FY16-FY20) for the same quarters.

Transition from a consolidation budget to a relief budget

The fiscal policy objective for FY21 was to strike a challenging balance between containing the deficit and public debt levels, and managing Covid-related expenses. Efforts were also put in place to adequately provide for social protection and growth stimulus for the economy. Therefore, on the revenue side, while the government kept intact the tax measures it had announced last year – such as the elimination of zero-rated and reduced rate regimes in certain sectors – it did not push further ahead on the reform agenda to expand the tax base and also avoided rolling out additional measures to enhance collections (except for the increase in petroleum levy on motor fuels, and the increase in FED rates for cigarettes and energy drinks). Instead, the government announced incentives for the construction industry and introduced tariff concessions on multiple industrial raw materials to support exports and general economic activity.

Similarly, on the expenditure side, protection of social spending remained the government's utmost priority. Significant provisions were also made for locust control, hospital services, and disaster management. In addition, the government increased PSDP allocations for FY21 compared to actual spending in FY20, especially to expedite infrastructure projects including dams/hydel power, logistics, and development of underserved regions. To carve out fiscal space for these expenditures, the government cut allocations for untargeted subsidies on power and petroleum, and exercised a nominal freezing of salaries and pensions for the year.

Fiscal over-performance during Q1-FY21 **Figure 4.1**



Source: Ministry of Finance

In overall terms, the government has set the fiscal deficit target at 7 percent of GDP for FY21, lower than the actual deficit last year (8.1 percent). For the primary deficit, the government has set a target of 0.5 percent of GDP compared to the actual deficit of 1.8 percent last year.

Fiscal over-performance in Q1-FY21 and the debt trajectory

When seen in the context of targets, the fiscal sector over-performed during Q1-FY21. Compared to the deficit targeted for the full year, the government recorded a primary surplus during the first quarter. This performance was attributed primarily to FBR tax collections (4.2 percent higher than the quarterly target), which partially offset the expected decline in non-tax revenues – these had risen exceptionally strongly last year due to one-off collections of license fee by PTA as well as SBP profits. On the expenditure side, the government was also able to curtail its non-interest spending such as pensions and defence, against the increases targeted for the full year under these heads **(Figure 4.1)**.

In overall terms, though higher than the same period last year, the fiscal deficit recorded during Q1-FY21 was 15.2 percent of the deficit envisaged for the full year. During the past five years, the average contribution of the first quarter has remained around 18.3 percent of the full-year deficit. This performance, along with the debt management strategy the government rolled out last year, was instrumental in keeping debt accumulation at a manageable level.

Specifically, despite higher financing needs during Q1-FY21, the rise in public debt was almost one-third of the increase recorded in the same period last year. This improvement primarily reflects the impact of lower deposit accumulation by the government (Rs 74.2 billion in Q1-FY21 compared to Rs 1.8 trillion in Q1-FY20). The Medium-term Debt Strategy (2020-23) of the government allowed provision for a revolving cash buffer in the wake of its commitment of zero fresh borrowings from SBP (including rollovers).[2] In addition, revaluation gains on the existing debt stock due to appreciation of the PKR against the US dollar also helped contain debt accumulation.

Moreover, the overall profile of public debt has also improved during Q1-FY21, as the maturity profile was lengthened, rollover risks were contained, and the share of concessional external funding increased. The government achieved this primarily via the introduction of long-term instruments with floating returns in the domestic debt market, which helped keep investments in long-term papers intact. Moreover, the appetite for foreign funding from commercial creditors remained subdued, as the surplus generated in the current account and servicing relief from G-20 countries under the DSSI helped alleviate pressure on external debt management. Nonetheless, the repricing risk of the public debt stayed at an elevated level.

Fiscal challenges and the needed reforms

Notwithstanding these improvements, a high amount of uncertainty persists with respect to the Covid trajectory and possible policy adjustments that it might necessitate. Although the government has made significant provisioning against contingencies in the Budget, the trends in Q1-FY21 call for a tighter control on discretionary spending. Specifically, mark-up payments are already weighing heavily on limited fiscal resources (73.4 percent of FBR taxes), and these could put further pressure on public financial management if debt accumulation is not sustainably contained.

In this context, it is important for the government to strictly adhere to its medium-term fiscal strategy that is centered on broadening the tax base, reducing informality in the economy, and simplifying the tax system (via harmonization of the tax base and rates across provinces and elimination of exemptions, among other measures). As things stand, FBR's tax base is concentrated heavily on indirect sources, within which import- and energy-related collections dominate, making the revenue stream excessively vulnerable to business-cycle and external shocks. Furthermore, quasi-fiscal pressures in the areas of energy (circular debt) and losses in other PSEs also warrant decisive policy actions. PSE debt

[2] Ministry of Finance (2020). Management Strategy (2019/20-2022/23). Islamabad: Debt Policy Coordination Office, Ministry of Finance.

(including energy-related entities) had already touched 5.0 percent of GDP at end Q1-FY21, and convincing progress in this area is still awaited.

4.2 Federal Fiscal Accounts

Before discussing the federal fiscal accounts, it is important to mention that the government has introduced a number of changes in fiscal data disclosure in Q1-FY21, as part of the public finance management reforms. While the treatment of refunds has been modified both in terms of reporting as well as for the calculation of the divisible pool, a number of heads have been reclassified under different categories. Details of these changes are presented in **Box 4.1**.

Box 4.1: Implementation of Public Financial Management Rules and Data Reclassification in Q1-FY21

Public Financial Management (PFM) Act was introduced in Pakistan in 2019. The prime objective of introducing PFM Act was "to strengthen management of public finances with the view to improving definition and implementation of fiscal policy for better macroeconomic management, to clarify institutional responsibilities related to financial management, and to strengthen budgetary management." Last year, the government had introduced significant changes in the procedures with respect to PSDP spending in accordance with the PFM. These had included delegation of the execution of development projects (especially those not classified as core projects) to relevant ministries or divisions instead of the Planning Commission. Importantly, the criteria for PSDP authorization was also introduced on a quarterly basis.

In Q1-FY21, the most significant development with respect to the implementation of PFM procedures was the reclassification of fiscal accounts. This reclassification was done through Parliament's approval of the Public Finance Management Act (Amended as on 30th June 2020), notified by the Ministry of Finance on July 29, 2020. Major amendments included the following:

1) Tax refunds through Finance Division

In the past, sales tax refunds to businesses were made by the Federal Board of Revenue (FBR). However, these refunds will be made through the Ministry of Finance from FY21 onwards. These refunds have now been included under the head "grants to others" within the current expenditures of the federal government.

2) Deduction of Refunds from the Divisible Pool

Previously, the payment of tax refunds was the sole responsibility of the federal government. Provinces despite taking 57.5 percent share in the federal taxes were not contributing to disbursements of refunds. Therefore, the PFM Act allowed for the deduction of refunds from the divisible pool.

3) Reclassification of federal taxes (not collected by FBR) as Non-tax revenues

Federal collections including GIDC, petroleum levy, natural gas development surcharge and some other federal receipts (including airport fees) were earlier part of the federal taxes. These have now been classified under non-tax revenues.

4) PSDP allocation in compliance with PFM

The projects managed previously by the finance division are now reclassified outside PSDP in other federal development expenditures. These included spending against security enhancement as well as

development initiatives by the PM office, especially those related to youth development and rehabilitation of internally displaced persons.

5) Adjustment in provincial expenditures to reflect statistical discrepancy

Prior to the PFM reforms, an implicit discrepancy was observed in the balance of provincial fiscal accounts: the reported deficit/surpluses (gathered from the movement in balances held in bank accounts of provincial governments) did not equal the difference between provincial revenues and expenditures. Now, this discrepancy has been explicitly included under provincial expenditures.

Therefore, the Q1-FY21 data reported by the MoF needs to be evaluated carefully, especially when comparing it with the same period last year. While **Table 4.1** presents the data as per the classification in respective years, the data reported in subsequent sections have been largely adjusted to make it comparable across years. Nonetheless, where needed, data reclassification will be discussed in order to bring clarity in the underlying trends.

Summary of Fiscal Operations (Q1) **Table 4.1**

billion Rupees

	Actual	
	FY20*	**FY21**
A. Total revenue (1+2)	1,489.1	1,478.7
a. Tax revenue	1,142.9	1,122.4
FBR taxes	964.4	1,010.6
Refunds' adjustments^	0	40.0
Other federal taxes	74.1	0
b. Non-tax revenue	346.1	356.3
SBP profit	185.0	105.0
Items moved from federal taxes (other than FBR)	0	149.5
B. Total expenditure (a+b+c+d)	1,775.1	1,963.1
a. Current spending	1,582.2	1,812.6
Interest payments	571.7	742.1
Non-interest expenditures	1,010.5	1,070.5
Defence	242.6	224.5
Grants to others	68.9	108.3
of which Refunds^	0	40.0
Subsidies	0	2.8
b. Development spending	142.5	164.5
c. Net lending to PSEs/provinces	4.7	50.7
d. Statistical discrepancy	45.8	-64.7
C. Fiscal balance (A-B)	-286.0	-484.3
Revenue balance**	-93.1	-333.8
Primary balance***	285.7	257.7
Financing	286.0	484.3
External sources	166.5	161.4
Domestic sources	119.5	322.9
Banks	-123.0	230.8
Non-bank	242.5	92.1

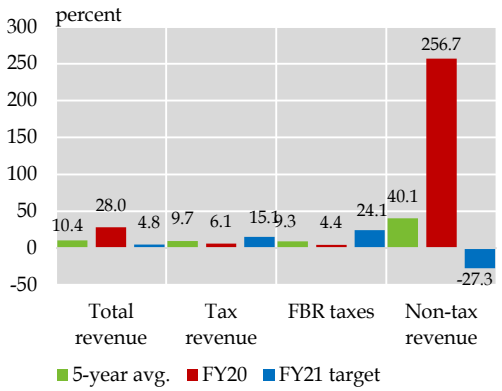
*The numbers quoted are based on the older format. **Revenue balance is total revenue less current expenditures. ***Primary balance is fiscal balance excluding interest payments. ^Changes in accounting treatment under PFM Act 2019

Source: Ministry of Finance

Federal Revenues

Keeping in view the expected pick-up in economic activities, the government anticipated an annual growth of 4.8 percent in revenue collection during FY21. This growth was expected to come from tax revenues as their target was set higher than the five-year average growth **(Figure 4.2)**. However, non-tax revenues were expected to present a major drag in revenue collection due to one-off nature of PTA profit that had increased the overall non-tax revenues (NTRs) last year. SBP profits were also expected to remain low due to prevailing low interest rates.

Growth in Revenues **Figure: 4.2**



Source: Ministry of Finance

During the first quarter of the year, the overall revenue collection saw a slight decline compared to Q1-FY20. This was a result of the expected fall in non-tax revenues, which more than offset the improvement in tax collection during the quarter.

FBR Taxes

The target for FBR tax collection (net of refunds) for Q1-FY21 was set lower compared to Q1-FY20 in the wake of uncertainties associated with the Covid trajectory **(Figure 4.3)**.

Composition of Domestic Taxes (Q1) **Table 4.2**

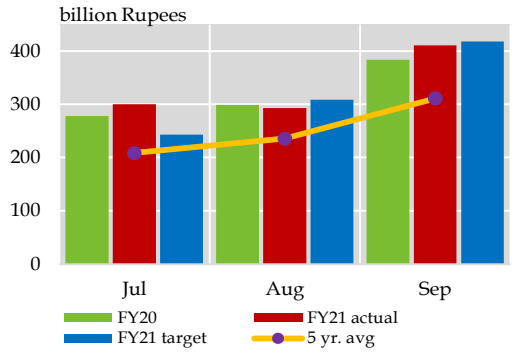
billion Rupees; growth in percent

			Growth	
	FY20	**FY21**	**FY20**	**FY21**
Sales tax (gross)	200.2	242.6	41.3	21.2
Sales tax (net)	184.1	198.7	29.9	7.9
Sales tax refunds	16.3	43.9	--	169.3
Energy related	89.6	111.9	31.2	24.8
of which				
POL	65.5	74.0	23.0	13.0
Electrical energy*	24.1	37.8	60.3	56.9
Non-energy	110.5	130.7	50.6	18.3
of which				
Textile sector	11.9	16.9	--	42.3
Sugar	7.7	16.7	99.4	116.4
Federal excise duty	47.2	53.2	21.6	12.7
Cement	14.6	17.8	31.1	21.7
Cigarettes	11.6	18.8	9.1	61.2
Beverages	7.2	8.5	19.1	18.8
Total (gross)	247.3	295.7	37.0	19.6
Total (net)	231.3	251.8	28.2	8.9

* electrical energy also includes collection from IPPs

Source: Federal Board of Revenue

FBR Tax Collection and Targets **Figure 4.3**



Source Federal Board of Revenue

However, as it turned out, these collections posted a growth of 3.9 percent on top of 15.2 percent growth in the same period last year. This performance can be attributed to an early recovery in the domestic economy; pent up collections from the preceding quarter; impact of higher prices (electrical energy and sugar); and crackdown on illegal trade (diesel and cigarettes). Meanwhile, the import-related taxes also showed a marginal improvement due to an increase in import values during the quarter (6.2 percent YoY in Pak rupees).

In July 2020, FBR collected noticeably more than its target for the month as well as from the last year's collection for the same month. This was possibly due to the delayed tax receipts of last year amid the operational constraints caused by lockdowns. This provided a cushion in the month of August 2020 when tax collection faced a setback due to heavy rainfalls in Karachi – the Karachi-based collectorates mobilize around 56 percent of the FBR taxes.[3]

[3] Average of previous five years. Source: FBR Year book 2018-19

The increase in domestic sales tax collection was attributed to the economic recovery

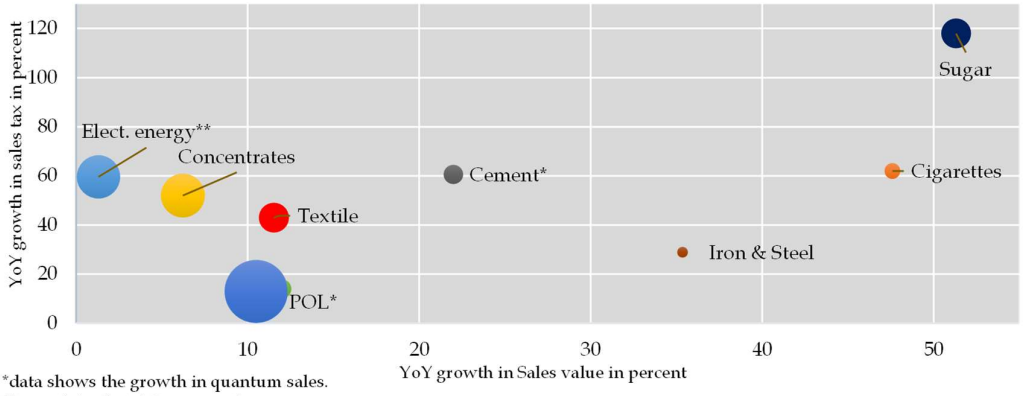
In gross terms, sales tax (domestic) grew by 21.2 percent on top of 41.3 percent growth last year despite no major increase in tax rates and higher refunds. This increase mainly represents growing economic activity as evident in rise in sales of both energy and non-energy items **(Table 4.2 & Figure 4.4)**.

Within the energy items, the increase came majorly from the electrical energy. This stemmed from both the partial pass-through of pending adjustments in fuel cost in power tariffs during the quarter, as well as increase in electricity generation. In the petroleum sector, consumption of high speed diesel remained the main contributor, which more than offset the negative price effect. Also, anecdotal evidence suggests that controlling the illegal trade of diesel from Iran has led to increased consumption of documented HSD, which contributed to higher sales tax collection.

Among the non-energy items, sugar contributed the most. This growth primarily represents a sharp rise in sugar prices (23.5 percent YoY in urban centers) during the quarter, which inflated the overall sales value of the commodity. A similar price-driven growth was observed in the sales of cigarettes, which significantly improved FED collections on the commodity. It is also important to mention here that the intensified crackdown against the illicit trade of internationally produced cigarettes has made these brands more expensive in the retail market; resultantly, the consumers shifted to local brands.

Textiles was another sector where the tax collections posted improvement during the quarter. It is important to recall here that last year, the government had eliminated the zero-rating regime for this sector, which took the collections to Rs 11.9 billion in the first quarter. This year, collections improved further as domestic sales values of textile items and cotton yarn remained

Growth in Sales Value and Domestic Sales Tax Collection during Q1-FY21 **Figure 4.4**



*data shows the growth in quantum sales.
**growth in electricity generation.
Note: Bubble size represents the share in total sales tax collection
Source: FBR, NEPRA, OCAC and APCMA

Sector-wise Collection of Import Related Taxes (Q1) **Table 4.3**

billion Rupees; growth in percent

			Growth	
	FY20	FY21	FY20	FY21
Sales tax	220.5	228.1	14.0	3.4
POL	65.4	52.2	16.0	-20.2
Iron and steel	20.3	23.1	17.1	13.8
Animal or veg. oils	11.0	16.2	-2.8	48.2
Vehicles	12.7	10.3	-29.5	-18.6
Custom duty	155.2	153.2	-0.8	-1.3
POL	21.8	18.7	19.8	-13.9
Vehicles	16.8	14.0	-32.0	-16.8
Iron and steel	10.4	13.6	-14.3	31.3
Animal or veg. oils	7.1	8.5	-7.5	19.6
Federal excise duty	2.8	3.0	-14.5	7.3
Total	378.5	384.3	6.8	1.6

Source: Federal Board of Revenue

11.5 percent and 8.5 percent higher, respectively, than the last year.

Finally, in wake of the government's support for the construction sector, the demand for cement increased significantly in the country. The growth in local dispatches was strong enough to offset the impact of reduction in FED rates; as a result, collections grew by 21.7 percent over last year.[4]

Import-related taxes rose marginally

Compared to a 6.8 percent YoY growth in imports during the quarter, the growth of 1.6 percent in the import-related tax collections appears subdued. The growth is also significantly lower than the one observed last year. This performance is attributed primarily to a steep decline in global crude prices, which led to a drop in POL-related collections this year **(Table 4.3)**; [5] excluding these, the growth in import-related collections increases to 7.5 percent. However, it is important to note here that the government compensated the decline in POL-related import taxes with higher mobilization of petroleum levy during the quarter (now classified as NTR).

In addition to POL products, a drag in import-related collections may also have come from the exemptions on additional customs duty on 1,600 tariff lines (which include around 20,000 items).[6] These items include the raw material used in the chemical, leather, textile, and fertilizer industries.

Among the items where customs collections improved over last year, iron and steel featured prominently. Attributed primarily to construction-related incentives announced by the government, there has been a rise in import quantum of associated materials like iron and steel. Due to this, the customs duty and sales tax collection at import stage for iron and steel increased.

Another segment where the collections posted improvement was edible oils. This improvement primarily reflects a significant rise in the import value of palm oil and soybean oil (partly due to higher international prices), which more than

[4] Source: FBR and Ministry of Finance (2020). *Yearbook 2018-19*. Islamabad: Revenue Division, Ministry of Finance.
[5] The quantum of oil imports increased in Q1-FY21 owing to high domestic demand.
[6] These tariff lines constitute around 20 percent of all imports (Source: Ministry of Finance (2020). *Federal Budget Speech 2020-21*. Islamabad: Ministry of Finance.).

Major Revenue Drivers of Direct Taxes (Q1) **Table 4.4**

billion Rupees; growth in percent

			Growth	
	FY20	FY21	FY20	FY21
Withholding taxes	256.5	266.7	19.7	4.0
Imports	50.7	41.2	-11.5	-18.7
Salaries	25.4	33.6	64.9	32.3
Bank int. & securities	29.8	38.5	112.7	29.1
Contracts	51	52.4	3.6	2.9
Electricity bills	11.4	11.9	22.5	4.1
Telephone	12.6	15.1	562	20.2
Collection on demand	5.8	12.0	-48.3	105.8
Voluntary payments	109.4	95.2	68.8	-13.0
Gross direct taxes	374.0	385.1	15.4	3.0
Refunds	24.8	25.2	-2.6	1.6
Net direct taxes	349.2	359.9	17.0	3.1

Source: Federal Board of Revenue

offset the impact of exemption of additional customs duty under the PM's Covid relief program (**Chapter 5**).

Higher collection from WHT and collection on demand improved the direct tax collection

Direct taxes grew marginally in Q1-FY21 compared to the corresponding period of last year **(Table 4.4)**. The major contribution to direct taxes came from withholding taxes and collection on demand. The increase in withholding taxes could be traced to salary, telephone, and bank interest and securities. Saving deposits increased in Q1-FY21 compared to corresponding period of last year, which added to the collection from profit on debt.[7]

Meanwhile, the collection from WHT on telephone rose on account of higher consumption of telecom services, as evident from the higher revenues of telcos compared to the first quarter of last year.[8] In addition, the improvement in the collection on demand shows enhanced administrative measures by FBR as higher demand notices have been issued to taxpayers.

In the absence of one-off flows, non-tax revenues remained lower during Q1-FY21

Non-tax revenues declined in Q1-FY21 compared to last year on account of relatively low profit transfers from SBP and PTA **(Table 4.5)**. In case of transfer of SBP profits, two factors played an important role: (i) Throughout FY20 (and first quarter of

Federal Non-Tax Revenues (Q1) **Table 4.5**

billion Rupees, growth in percent

			Growth	
	FY20	FY21	FY20	FY21
Mark-up (provinces)	6.0	6.8	43.7	12.1
Mark-up PSEs	3.3	25.7	187.4	674.7
PTA profits	71.8	8.2	1078.8	-88.7
SBP profits	185.0	105.0	264.8	-43.2
Discount retained on crude oil	3.7	1.5	17.7	-60.7
Royalties on oil\gas	23.8	14.6	0.5	-38.4
Others	14.2	19.1	-1.1	34.6
Sub Total (A)	321.2	189.3	175.8	-41.1
NGDS	1.7	8.1	-33.2	376.8
Petroleum levy	64.8	136.4	45.7	110.4
GIDC	2.7	5.0	-54.3	83.3
Receipts of ICT	4.8	4.4	90.3	-9.3
Sub Total (B)	74.1	153.8	66.5	107.7
Total (A+B)	395.3	343.1	131.4	-13.2

Source: Ministry of Finance

[7] Saving deposits grew by 20.6 percent in Q1-FY21 compared to 7.7 percent growth last year.
[8] The revenues of major telecom companies (Mobilink, Telenor and PTCL) grew by 4.9 percent YoY on Q1-FY21 (source: financial statements data of respective firms available on their websites).

FY21), the government had adhered to its commitment of zero fresh borrowing from the SBP, and instead made net retirements through borrowings from other domestic and external sources. This had led to a Rs 600 billion decline in the SBP debt stock between June 2019 and June 2020; and (ii) the impact of lower debt stock was reinforced by lower

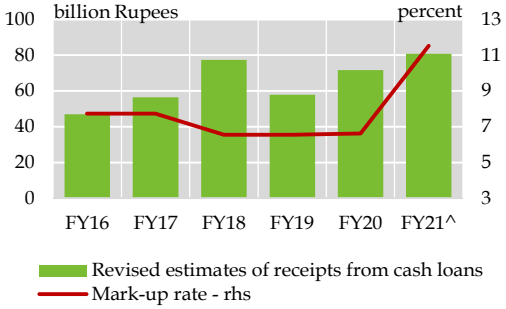
interest rates. Specifically, market interest rate (yield of 6m paper) in Q1-FY21 was on average 674 bps lower compared to Q1-FY20. Since the bulk (70 percent) of the SBP debt was converted into floating rate PIBs (with yields benchmarked with the 6-month paper) at end June 2019, the impact of the fall in policy rate was quite pronounced on SBP's interest earnings. As a result, the transfer of SBP profits to the government posted a YoY decline of 43.2 percent in Q1-FY21.

PTA, on the other hand, had transferred receipts of around Rs 70 billion to government on account of GSM license renewal fee in the same period last year. It is important to recall here that the telcos had to pay half of the renewal fee in FY20 while the rest of the amount has to be paid in five-year installments. Therefore, the government had targeted only Rs 27 billion under PTA profits for the full FY21, of which Rs 8.2 billion has been transferred in the first quarter. This also caused a drag in the overall non-tax revenues.

Another major development was that the GIDC, petroleum levy, natural gas surcharge and some other federal receipts are now classified as non-tax revenue. Among these items, a prominent development was the doubling of collections from petroleum levy during Q1-FY21 compared to the same period last year. This improvement reflects the increase in the rate of this levy to Rs 30 per liter on petrol and diesel by the government at the start of the year.

Meanwhile, mark-up receipts from PSEs and other local bodies increased significantly compared to last year. This rise is explained by the higher mark-up rate charged by the federal government from these entities compared to last year **(Figure 4.5)**. It is important to mention here that the government had last changed mark-up on loans to PSEs and other local bodies back in December 2019, increasing it by 491 basis points from December 2018, based on the change in policy rate during the same period. Since then, although policy rates have been revised downwards, the mark-up on PSE loans has remained unchanged – this basically represents a general lag involved in aligning these rates with the policy rate.[9]

Receipts from Development Loans and Mark-up Rate* **Figure 4.5**



*notification No. F.8(2) GS-I/2018-1775, MoF
^budgeted

Source: Ministry of Finance

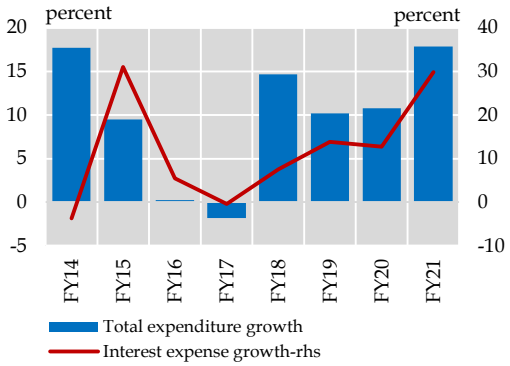
[9] The Budget Wing of Finance Division determines mark-up on loans to PSEs and other local bodies during July-December every year, and notifies the same around December.

Federal Expenditures[10]

On aggregate, the federal government set the expenditure growth at 4.7 percent compared to 21.8 percent recorded in FY20. This growth was expected to come entirely from interest payments, as non-interest expenditures are targeted to remain roughly at the last year's level (a negative growth of 0.2 percent).

The Q1-FY21 outcome was to a large extent in line with the targets set for the year. Although the growth in total federal expenditures almost doubled from the last year, this was entirely due to interest payments which grew by 29.8 percent YoY during the quarter **(Figure 4.6)**. Non-interest expenditures on the other hand, grew by 6.8 percent; but it is important to mention that after excluding the impact of reclassification of FBR refunds (now classified under grants), these expenditures stayed at almost last year's level. This containment in the non-interest expenditures was reflected primarily in two major heads under these expenditures – defence and pensions – which posted a YoY decline. Nonetheless, spending for social protection (BISP under Ehsaas program) remained at an elevated level compared to the last year.

Growth in Federal Expenditure (Q1)* Figure 4.6



* excluding statistical discrepancy
Source: Ministry of Finance

As a result, the entire growth in federal expenditures was visible in current spending and higher lending to PSEs and provinces, as development spending by the federal government remained lower than the last year (as explained in subsequent section, this trend was primarily attributed to lower disbursement of development grants to provinces by the federal government; excluding this, development expenditures, including net lending, of the federal government remained higher than last year).

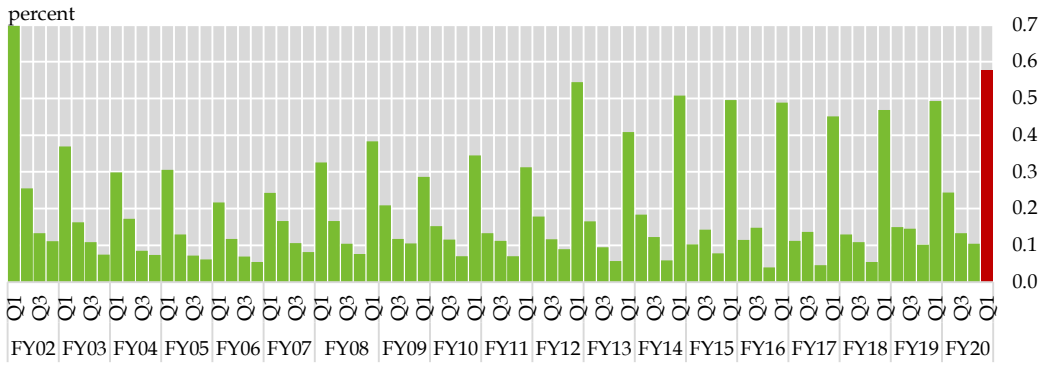
Federal Current Expenditures

Within current spending, most of the increase came from interest payments; these payments contributed 95.2 percent to the YoY increase in total current spending during Q1-FY21. In terms of growth, the overall interest payments increased by 29.8 percent as compared to 12.7 percent recorded last year. Importantly also, this is the first time since Q1-FY02 that the share of interest expenses has approached almost 60 percent of the total expenditures **(Figure 4.7)**. This implied that nearly half of the total revenues and 73.4 percent of FBR taxes were consumed by interest payments during Q1-FY21.

The higher interest payments primarily came from: (i) increased level of public debt stock; (ii) lengthening of the maturity profile of public debt (which added term premium to the borrowing cost); and (iii) scheduled coupon payments of longer tenor

[10] The discussion in this section is based on expenditures excluding statistical discrepancy.

Interest to Non-Interest Expenditure Ratio during Q1* **Figure 4.7**



*this is calculated by subtracting interest payments from consolidated expenditures

Source: Ministry of Finance

instruments and 12-month papers that were mobilized last year.

In terms of social protection, BISP under Ehsaas increased to Rs 13.9 billion in Q1-FY21, compared to Rs 5.8 billion in Q1-FY20. *Ehsaas Emergency Cash program* was exclusively designed to lessen the adversities of the most vulnerable pandemic-stricken segments. In this regard, Rs 178.9 billion has been disbursed to 14.8 million beneficiaries under the program up till 22-09-2020.[11] In addition to BISP, the federal government has also been spending on various programs under the Pakistan Poverty Alleviation Fund.

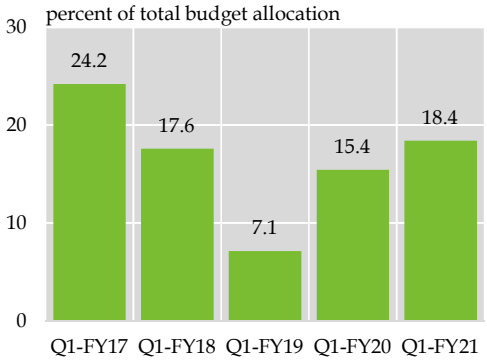
Two heads where a decline was visible on a year on year basis, included defence and pensions, as mentioned earlier. For both these heads, the government has envisaged higher spending in FY21 compared to last year. In case of pensions, while the government had kept the allowances unchanged in the Budget, the overall expenditures were set at a slightly higher level due to expected increase in number of pensioners. In case of defence, it is important to note that FY21 is the second consecutive year when the government has targeted a containment in expenditure.

Federal development expenditures and net lending

The focus of development spending in the FY21 budget was on ongoing public sector development projects (about 73 percent of the total projects), with 27 percent allocated for new projects. This allocation was attributed to a large number of incomplete projects in the last fiscal year, as the relevant government departments – which were delegated the responsibility to execute PSDP spending as part of the PFM reforms – could not initiate the committed projects. Hiring of project directors was delayed and needed procurements also fell behind the schedule. It was earlier expected, therefore, that the progress will pick up in the later part of the year. However, lockdowns and restricted mobility from March 2020 onwards delayed the progress on these projects further. Thus,

[11] Ministry of Finance (2020). *Monthly Economic Updates & Outlook September, 2020*. Islamabad: Economic Advisor's Wing, Ministry of Finance.

PSDP Releases (Rupee component) during Q1 **Figure 4.8**



Source: Planning Commission

most of the projects spilled over to FY21. In addition to the phased projects, the federal government also initiated new projects in less developed regions of the country.

In Q1-FY21, the federal government spending against its own development projects remained higher than last year, but due to a drop in its development grants to the provinces (a component of federal PSDP), the overall number showed a decline of 7.6 percent YoY. Another factor that dragged down the growth in federal PSDP during Q1-FY21 was the impact of data reclassification: spending against security enhancement, which was earlier included in PSDP spending, has been taken out and shifted to other development expenditures under the revised PFM guidelines.

Here it is important to mention that the first quarter of FY21 was also affected by Covid-related restrictions. Throughout July and most of August 2020, social distancing norms were followed and strict SOPs were exercised for projects' execution. Still, the releases of rupee component by the federal government was around 18.4 percent of the annual allocations. Though this ratio is much lower than the release ratio of 43.0 percent for foreign component in Q1-FY21, it is much higher than the releases of rupee component in the first quarter of last three years (**Figure 4.8**).

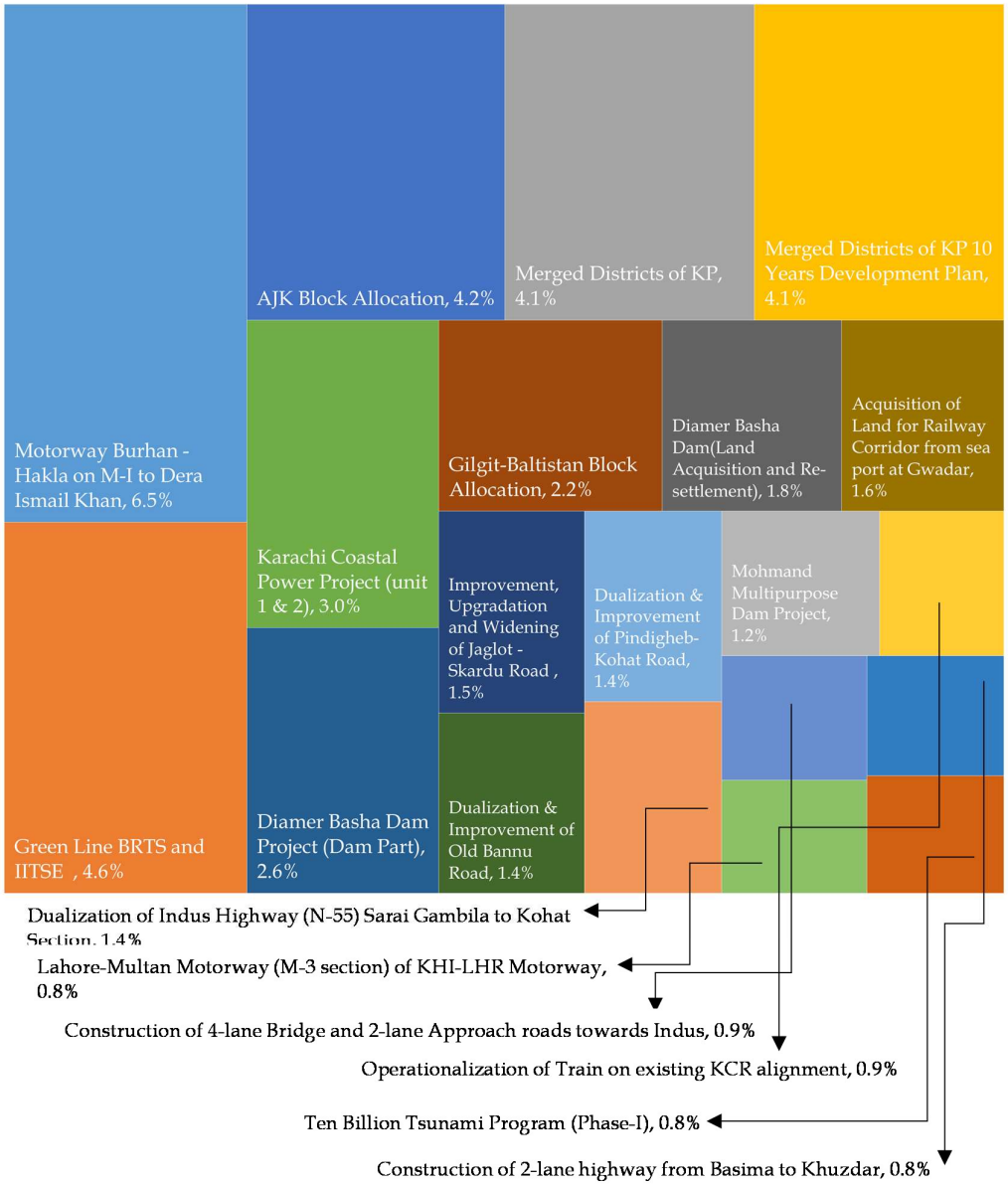
The available project-wise information on PSDP releases suggests that road infrastructure, development of AJK, GB and merged areas of KP, and construction of dams were prioritized by the federal government. Importantly, the top-20 projects in terms of releases of rupee component, which together constitute around 46.0 percent of the total releases during the quarter, had a balanced geographical spread across the country **(Figure 4.9)**. For instance, these projects included the transport upgradation project in Sindh, railway-related project in Balochistan, dam construction in KP, road projects that cover areas in Punjab and KP, and then regional development of underserved areas of AJK, GB and merged districts of KP.

Among the foreign funded projects, two major projects stood out – both in the power sector: (i) ADB-funded coal-fired power station in Jamshoro; and (ii) US-funded refurbishment of Mangla Power Station. Together, these two projects constituted two-thirds of the PSDP releases against foreign disbursements. Out of the total authorization up to September 2020, around 90.0 percent of disbursement came from national exchequer while the remaining from foreign aid.

4.3 Provincial Fiscal Operations

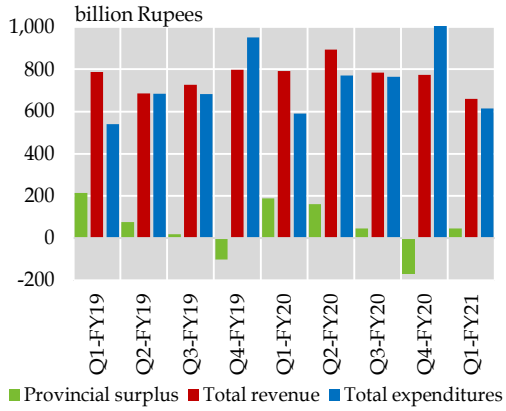
The Covid-19 and its fall-out on government's healthcare and associated expenditures had caused a heavy strain on provincial fiscal accounts as well. While

Top 20 Federal PSDP Projects in terms of Release Authorization during Q1-FY21 **Figure 4.9**



Source: Planning Commission

Provincial Fiscal Indicators **Figure 4.10**



Source: Ministry of Finance

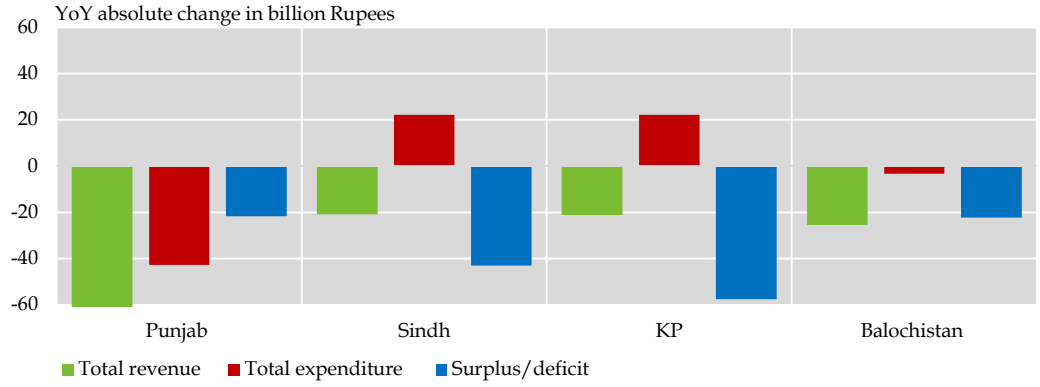
transfers from the divisible pool declined as federal tax collection weakened, this was largely offset by a significant increase in federal loans and grants. However, higher spending needs led to a provincial deficit during Q4-FY20 **(Figure 4.10)**.

During Q1-FY21, provinces posted a combined surplus of Rs 44.4 billion, which is one-fourth of the surplus recorded in Q1-FY20 and around 18 percent of the full-year target of FY21. This lower surplus was contributed both by a decline in their revenues as well as increase in their expenditures from last year on a consolidated basis. This performance was attributed to deficits recorded by Sindh and KP during Q1-FY21, as well as lower surpluses recorded by Punjab and Balochistan compared to last year. While revenues posted a decline for all the provinces, expenditures recorded an increase for deficit-accumulating provinces and a decline for surplus-accumulating provinces **(Figure 4.11)**.

Provincial Revenues

The provincial revenue mobilization remained subdued during the first quarter of FY21 due to lower transfers from federal government under the NFC **(Figure 4.12)**. This development is explained by the deduction of Rs 100 billion of refunds (those pertained to Q1-FY21 and also pent-up disbursements from Q4-FY20) from the federal divisible pool – as mentioned earlier, these deductions were made in accordance with the PFM reforms. It is important to note here that the government had targeted refunds' deduction of Rs 50 billion for the full year, but due to faster processing system of outstanding claims by the FBR, Rs 100

State of Provincial Accounts during Q1-FY21 **Figure 4.11**



Source: Ministry of Finance

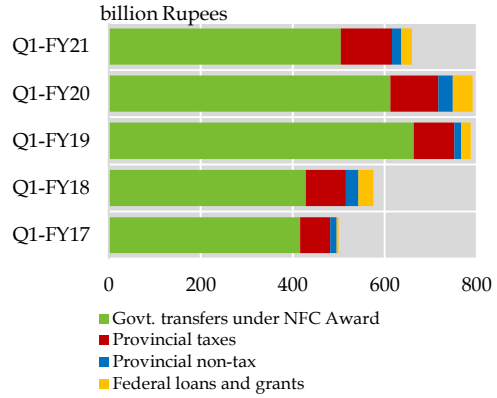
billion were disbursed to businesses during the quarter.

As far as provincial own revenue collection is concerned, these also recorded a decline over the last year. The decline is explained entirely by a drag in provincial non-tax revenues (NTRs), as their tax collections improved over last year. The decline in NTRs was due to the lower payments of net hydel profits to the KP government. While the issue of delayed disbursements of net hydel profit has been around for the last couple of years, this year the decline in hydel generation over the past couple of quarters may also have contributed.

Nonetheless, total provincial taxes remained higher in Q1-FY21 on a YoY basis, which can be attributed to an improvement in collection of general sales tax on services (GSTS) and motor vehicle tax (MVT).

This improvement reflects the pick-up in domestic activity in the economy, especially cellular and other telecom services which improved provinces' GSTS collections.[12] Similarly, higher sales of automobiles in the country have increased the MVT. Yet, this growth is relatively lower as compared to the five-year average growth. This is because the provinces announced tax relief measures in

Structure of Provincial Revenues **Figure 4.12**



Source: Ministry of Finance

Q4-FY20 amid Covid-19 which continued in the first quarter of FY21.

For instance, the government of Punjab announced a tax relief package of Rs 56.5 billion for FY21, which included various exemptions in the services sector and stamp duty.[13,14] Sindh also exempted payment of taxes relating to property, motor vehicles, professions, trades, callings and employment amid Covid-19.[15] Furthermore, KP also provided exemption on stamp duty and capital value tax for FY21.[16]

Provincial Expenditures[17]

Similar to federal government, budgetary priorities of the provincial governments for

[12] The revenues of Telcos grew by 4.9 percent during Q1-FY21 which shows a higher activity in telecom services

[13] Notification No. SO (TAX) 1-110/2020 (COVID-19), Government of Punjab.

[14] The stamp duty on various property transactions have been slashed to 1 percent from the existing 2 to 5 percent. Source: Punjab Finance Act, 2020.

[15] Government of Sindh (2020). *Budget 2020-21: Budget Speech*. Karachi: Finance Department, Government of Sindh.

[16] Notification No. AS(S)3/240/2020-21/20210-90 dated August 25th, 2020.

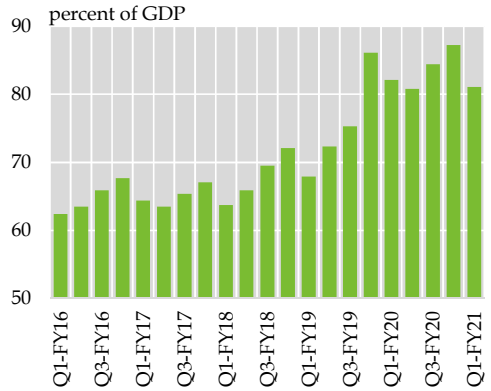
[17] This section is based on information available on current and development expenditures only. Statistical discrepancies are not included while analyzing the expenditures of provincial governments.

FY21 were also targeted towards Covid-related spending along with supporting the economic growth. Here, it is important to mention that all the provinces have aimed to create fiscal space for the development expenditures to help the economy back to pre-Covid path and supporting the most vulnerable during the pandemic period. This was done by containing the unnecessary expenditures while extending resources to the most needed sectors such as health and social protection.

During the first quarter of FY21, the total provincial expenditures grew by 11.3 percent compared to last year. This growth stemmed from both current and development expenditures. Province-wise data suggests that the higher growth in expenditures came primarily from Sindh and KP, as Punjab and Balochistan spent less than last year.

Within Punjab, a slowdown was observed both in current and development expenditures. The development expenditures in Sindh more than doubled as compared to the corresponding period last year. The major increase came from higher expenditure on agriculture, housing, education, and health. Likewise, KP also increased its development spending by around 50 percent in the quarter, mainly in the areas of construction, transport and education. Meanwhile, Balochistan reported a decline in development expenditure during the quarter. Both Sindh and KP also showed a higher increase in current expenditures during the quarter. The priorities remained tilted towards administrative affairs, transfers to districts, public order, and health.

Gross Public Debt **Figure 4.13**



Source: State Bank of Pakistan

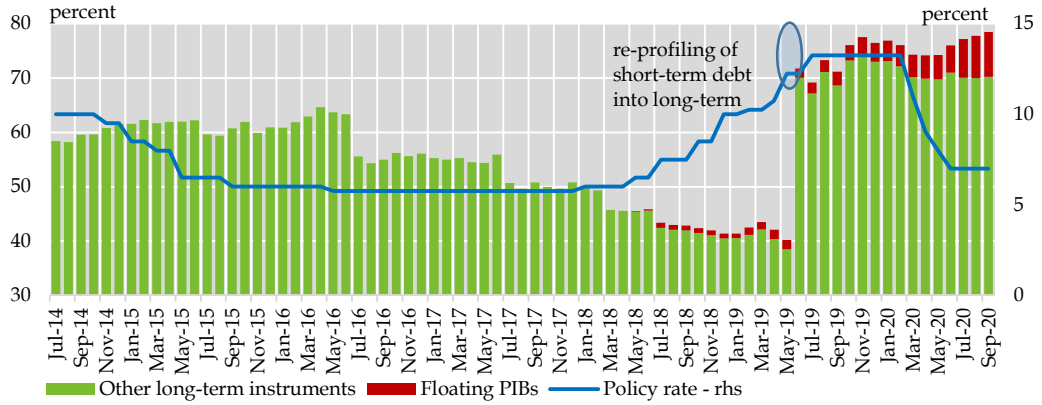
4.4 Public Debt

With the start of the Extended Fund Facility (EFF) program of the IMF, fiscal constraints with respect to debt sustainability have come to the forefront. The government had committed to bring the public debt ratio down by 0.5 percent every year[18]. In the first two quarters of the preceding year, the downward trend in public debt to GDP ratio was steeper than projected, as the ratio had fallen to 80.8 percent by end-December 2019. However, due to Covid-related fiscal strain emerging from March 2020 onwards, this ratio rose again to reach 87.2 percent at end-June 2020 (**Figure 4.13**).

Thus, at the start of FY21, rising debt was a major constraint for Pakistan's fiscal

[18] According to the Debt Policy Statement 2019-20, within a period of five financial years, beginning from the FY19 total public debt shall be reduced by 0.5 percent every year and from 2023-24 and going up to FY33 a reduction of 0.75 percent every year to reduce the total public debt to fifty percent of the estimated GDP.

Share of Long-Term Instruments in Domestic Debt **Figure 4.14**



Source: State Bank of Pakistan

operations. However, the government accommodated a deficit budget and a rise in public debt for FY21 in order to extend pandemic-related relief and to accelerate the pace of economic recovery. Compared to the estimates available at the time of budget preparation, the government envisaged an increase of 0.2 percent of GDP in gross public debt.[19] Therefore, the debt management strategy during FY21 was centered primarily on reducing the borrowing cost, extending the maturity profile and improving the liquidity position of the government.

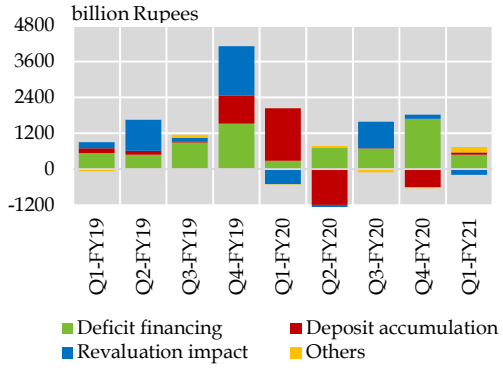
In this context, three developments were important. First, with the introduction of floating rate long-term instrument (PFL), the government has effectively deepened the domestic debt market.[20] Market participants are now keen to invest in long-term paper even in the low interest rate environment, since their returns will be repriced in line with any change in the benchmark interest rate (in most cases, it is 6-month T-bill cut-off rate). In Q1-FY21, almost the entire domestic debt accumulation came from these long-term floating rate PIBs. While higher investment in these instruments have kept the repricing risk at an elevated level, this has significantly lengthened the maturity profile of public debt: the share of long-term instruments in total domestic debt increased further by 2.4 percentage points to reach 78.5 percent at end September 2020 (**Figure 4.14**).

Second, the government's appetite for external funding was quite low during the quarter due to a surplus in the current account, the availability of multilateral funding (especially from ADB and IDA to make progress on on-going projects), and relief on principal payments by G-20 countries under the DSSI. Therefore, the government retired commercial loans to foreign creditors during the quarter both under the short-term as well as long-term facilities. This improved the cost profile of the public external debt.

[19] Ministry of Finance (2020). *Medium Term Budgetary Statement 2020-21 to 2022-23*. Islamabad: Fiscal Division, Ministry of Finance.

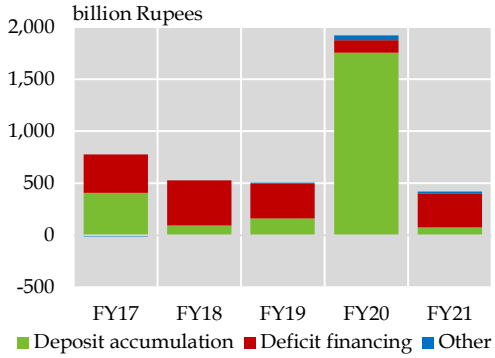
[20] Floating rate PIBs (PFL) were initially introduced in May 2018 with a maturity of 10 years, subsequently in Jun 2020, 3-year and 5-year PFLs were also launched.

Source of Change in Public Debt **Figure 4.15**



Source: State Bank of Pakistan

Source of Change in Domestic Debt during Q1 **Figure 4.16**



Source: State Bank of Pakistan

Third, given the government's commitment to avoid SBP borrowing (including rollovers), liquidity management has come to the forefront of the overall public debt sustainability. To manage the expected constraints, the government had resorted to increasing its deposits with the banking system (to the tune of Rs 1.8 trillion) in Q1-FY20 through fresh borrowings. It is important to recall here that these deposits were quite useful in managing Covid-related expenditures in the fourth quarter of FY20, as government was able to increase its spending without a significant strain on the overall fiscal deficit. This year, the government deposited an additional Rs 74.2 billion with the banking system. The overall government deposits reached Rs 3.2 trillion by end-September 2020. Replenishment of these deposits has further improved liquidity profile of public debt; this would facilitate the government in plugging its financing needs and payment obligations in a timely manner.

Therefore, despite a higher fiscal deficit (in nominal terms) during the first quarter of FY21, the pace of public debt accumulation weakened considerably compared to the same period last year. As evident in **Figure 4.15**, key contribution in debt came from financing needs of the government, as deposit accumulation was quite limited compared to last year. Similar to Q1-FY20, revaluation gains due to appreciation of the PKR against the US dollar contained the rise in public debt during Q1-FY21.

Domestic Debt

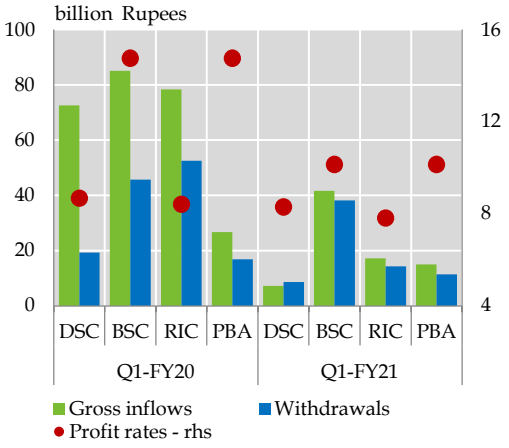
The rise in domestic debt during Q1-FY21 was only one-fourth of the increase recorded in the same quarter last year. As highlighted earlier, the government increased its deposits with the banking system as part of its debt management strategy during Q1-FY20. These deposits helped the government smoothly manage its debt obligations as well as other expenditures during FY20. Nonetheless, the volume of deposit accumulation was much lower in FY21, which helped contain the domestic debt accumulation (**Figure 4.16**).

Institution-wise breakup shows that almost 75 percent of the rise in government domestic debt was sourced from the banking system. Within the banking system, the

entire mobilization came from scheduled banks as the government continued to retire SBP debt during the quarter. Non-banks, especially insurance companies and non-financial corporates, provided for the remaining 25 percent of the government's financing needs (**Table 4.6**).

In terms of instruments, permanent debt instruments dominated the domestic debt accumulation during Q1-FY21. No major activity was observed in other categories except for heavy retirements in floating debt instruments. The weak activity in NSS instruments stemmed primarily from limited operations of sales centers during lockdown (July and August 2020), imposition of ban on institutional investments, and a cut in profit rates (**Figure 4.17**).

NSS Flows and Profit Rates **Figure 4.17**



Source: Central Directorate of National Savings

Auction profile of government securities suggests that the government as well as the market participants were inclined towards long-term instrument, as evident by the offer and acceptance amount of floating rate PIBs (**Table 4.7**). An important determinant for

Change in Government Domestic Debt (Q1) **Table 4.6**

billion Rupees

	Net Flows	
	FY20	**FY21**
Government domestic debt	1,918.0	419.3
institution-wise		
A. Through banking system	1,631.7	312.0
From scheduled banks	1,631.7	597.0
From SBP	0.0	-285.0
B. Through non-banks	286.6	107.4
Instrument-wise		
A. Permanent debt	754.1	898.6
B. Floating debt	1,028.2	-480.0
C. Unfunded debt	136.0	0.8
NSS (net of prize bonds)	137.7	5.7
D. Foreign currency instruments	-0.2	-0.1

Source: State Bank of Pakistan

banks' preference for long-term instruments over short-term instruments was the rise in the term premium for PIBs.

As stated earlier, the government imposed a ban on institutional investment in National Saving Instruments effective from the start of FY21, which resulted in limited mobilization of funds through these instruments. However, with the introduction of 3Y and 5Y PFL (floating rate PIBs) and with market perception of bottoming out interest rates, non-banks' investment in PIBs remained intact (**Figure 4.18**). Here, it must be recalled that profit rates on NSS are already linked with the market yields on long-term government paper. Hence it was more suitable for non- banks to shift their investment portfolios in favor of PIBs.

Keeping in view the market appetite for long-term instruments, unmet investment needs of Islamic banks and to diversify the domestic debt portfolio, the government also introduced a new instrument in Q1-FY21: the 5-year GoP Ijara Sukuk with both fixed- and

Auction Profile of Government Securities (Face Value) **Table 4.7**

billion Rupees

	Q1-FY20				Q1-FY21			
	Offer (competitive)	Maturity	Accepted	Accepted net of maturity	Offer (competitive)	Maturity	Accepted	Accepted net of maturity
MTBs								
3-M	4,805.2	5,178.1	4,548.9	-629.2	2,298.9	722.8	945.8	223.0
6-M	396.1	1.5	289.9	288.4	1,529.6	337.2	674.1	336.9
12-M	3,514.4	-	1,643.8	1643.8	1,283.9	1,643.8	427.3	-1,216.5
Total	8,715.7	5,179.6	6,482.7	1,303.1	5,112.4	2,703.8	2,047.3	-656.5
PIBs (fixed rate)	2,521.3	275.9	878.9	603.0	448.8	101.4	241.0	139.6
PIBs (floating rate)	334.2	-	219.4	219.4	1,970.4	-	870.6	870.6

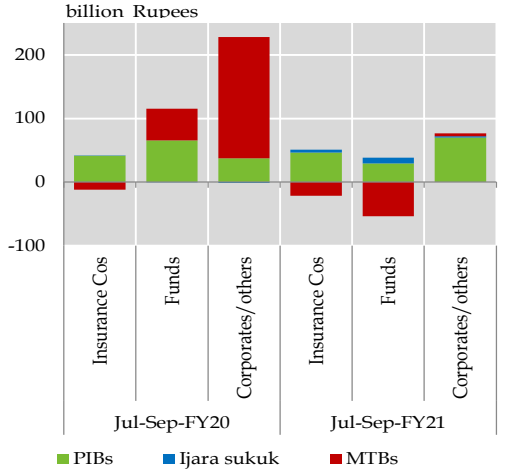
Source: State Bank of Pakistan

flexible-rate options. The overall mobilization against these instruments stood at Rs 162.0 billion during the quarter. Market participation was more inclined towards variable rental rate – more than two-third of funds were raised through variable rental Sukuk. Mobilizing funds through such long-term instruments not only bodes well from maturity profile point of view, but also from the perspective of diversification of the investor base.

Public External Debt & Liabilities

The stock of public external debt and liabilities increased by US$ 1.05 billion in Q1-FY21, compared to US$ 0.58 billion in Q1-FY20. Revaluation losses due to depreciation of US dollar against other currencies had a significant role in inflating the external debt stock in dollar terms.[21] In addition, high fresh disbursements from multilateral donors (ADB, IDA) and bilateral sources more than offset the retirements in commercial loans and foreign exchange liabilities (**Table 4.8**).

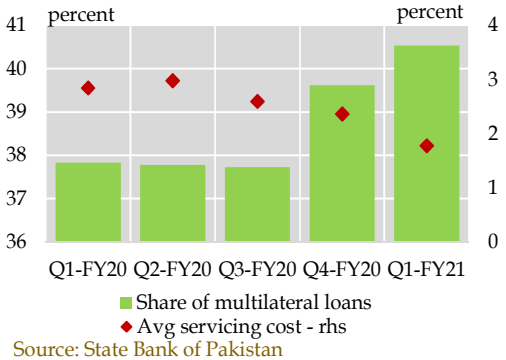
Change in Non-Banks Holdings of Govt. Securities (Face Value) **Figure 4.18**



Source: State Bank of Pakistan

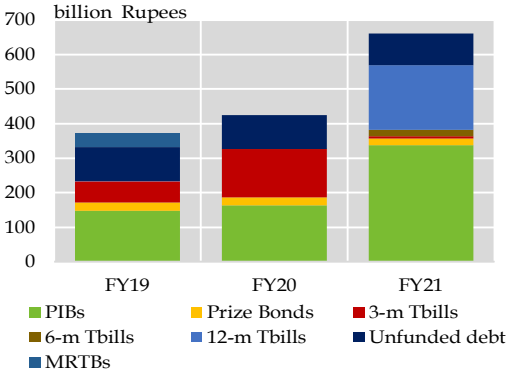
[21] Compared to revaluation gains of US$ 0.7 billion during Q1-FY20, the country suffered revaluation losses of US$ 0.9 billion during Q1-FY21 on the existing outstanding stock of external debt (in US$ terms). One-half of the revaluation losses emerged due to appreciation of special drawing rights (SDR) against the US dollar

Avg. Servicing Cost of Govt. External Debt & Share of Multilateral Loans **Figure 4.19**



Source: State Bank of Pakistan

Instrument-wise Interest Payments (Q1) **Figure 4.20**



Source: State Bank of Pakistan

On a positive note, most of the incremental borrowing was sourced through multilateral donors. As shown in **Figure 4.19**, the share of concessional multilateral debt has increased over the previous two quarters(along with a corresponding decline in the share of commercial loans), which has contributed to reducing the average servicing cost for the government.[22]

Change in Public External Debt & Liabilities (Q1) **Table 4.8**

million US Dollar

	FY20	FY21
Public external debt & liabilities	581.9	1,052.7
1. Government external debt	7.3	1,987.5
of which		
i) Long term (>1 year)	-299.6	2,357.5
Paris club	-157.9	278.4
Multilateral	268.3	1,487.3
Other bilateral	70.7	984.0
Commercial loans/credits	-493.1	-425.5
ii) Short term (<1 year)	307.0	-370.0
Multilateral*	144.1	-303.7
Local currency securities	359.8	-39.9
Commercial loans/credits	-197.0	-26.5
2. From IMF	703.2	-75.4
3. Foreign exch. liabilities	-128.6	-859.3
Central bank deposits	-	-1,000.0

Source: State Bank of Pakistan

External loan disbursements saw an increase of 25.4 percent during Q1-FY21 over the same period last year. These disbursements amounted to almost 22 percent of the annual budget estimate, as opposed to 17.0 percent during Q1-Y20. Disaggregated analysis indicates that almost half of the inflows were for program/budgetary support; one-third inflows were in the form of bilateral deposits; and roughly 12 percent were received as project assistance to finance the development projects.

[22] It is important to mention here that the average servicing cost in this Figure is based on actual interest payments during the quarter. To compute the overall cost of external debt, however, it is more useful to look into the interest rates at which different loans were contracted. But due to unavailability of this data, average servicing cost has been estimated by taking actual interest payments in the current quarter as percent of average of total outstanding stock of external debt in the current and previous quarters.

Total Debt & Liabilities Servicing

Servicing of total debt and liabilities stood at Rs 1.2 trillion during Q1-FY21 compared to Rs 0.9 trillion during the same quarter last year. Total servicing during Q1-FY21 was equivalent to 2.7 percent of GDP. Within public debt servicing, interest payments on domestic debt increased by Rs 661 billion during Q1-FY21 against the rise of Rs 426.5 billion during Q1-FY20. This increase primarily stemmed from higher coupon payments of fixed-rate PIBs and 12-month T-bills **(Figure 4.20)**.

On the other hand, servicing of external debt and liabilities increased by US$ 0.5 billion in Q1-FY21, compared to an increase of US$ 0.8 billion in the same period last year. This rise in external debt servicing is largely attributed to the repayment of US$ 1.0 billion. However, debt relief provided under the G-20 DSSI eased some pressures on overall servicing.[23]

[23] Pakistan is expected to get a debt relief of US$ 3.6 billion in total (updated 8th November 2020).

5 External Sector

Pakistan's external account showed signs of stabilizing in Q1-FY21 as the country managed to contain the initial domestic spread of Covid-19 and economic activities resumed from July onwards – helped by a significant easing in both the monetary and fiscal policy stances. Consequently, imports began to pick up, and were further accentuated by supply-side challenges faced in key agricultural commodities. The significant (31.7 percent YoY) reduction in global oil prices played a major role in curtailing energy and overall import payments, and alleviating some pressures from lower export receipts. Workers' remittances, on the other hand, proved to be instrumental in generating the first quarterly current account surplus in more than five years, as inflows reached a record high. The resulting improvement in the current account led to increased foreign exchange liquidity in the interbank market, and was reflected in a build-up in the country's foreign exchange reserves and an appreciation in the Pak Rupee. The available external financing, while lower than last year, was sufficient to meet official debt repayments.

5.1 Balance of Payments

As Pakistan managed to control the domestic spread of Covid-19 by the end of FY20, the policy focus during Q1-FY21 was geared towards reviving growth. This included fiscal support for the construction sector, higher PSDP spending, and concessionary lending for capex investments – along with continued progress on CPEC projects. At the same time, supply-side issues became prominent in food commodities like wheat and sugar, whereas cotton production was estimated to be substantially lower than its target. As a result, a surge in import demand was noted. International commodity prices displayed a mixed trend, with sharply lower energy prices offsetting upward pressures from higher food prices. Meanwhile, export receipts recovered from their Q4-FY20 troughs but remained lower than the same period last year. This was mainly due to continued weak import demand in advanced economy trading partners and temporary Covid-related relaxations that allowed exporters to hold their receipts abroad for an extended period. Still, Pakistan's export performance in the quarter was better than that of many other emerging markets.

Restrictions on air travel played a key role in determining the current account outcome, as they contributed to the record-high remittance inflows in Q1-FY21 by diverting flows from informal channels to formal ones, and also led to a sizable reduction in service import payments.

On the external financing side, the lower financing needs and a trend reversal in trade nostros helped commercial banks to build their foreign assets and retire short-term borrowings. This, along with the retirement of bilateral loans, more than offset the lower inflows from FDI and the government's multilateral and bilateral borrowings. The end-result was an increase in commercial banks' reserves of US$ 477 million (7.1 percent) during the quarter, and a further rise in the SBP's reserves. The available liquidity in the interbank market led to a 1.4 percent appreciation in the Pak Rupee during the quarter.

Pakistan's Balance of Payments **Table 5.1**

million US Dollar

	Q1-FY20	Q1-FY21	Absolute Change
Current account balance	-1,492	778	2,270
Trade balance	-5,048	-5,251	-203
Exports	5,985	5,363	-622
Imports	11,033	10,614	-419
Services balance	-1,098	-546	552
Primary income balance	-1,424	-1,526	-102
Secondary income balance	6,078	8,101	2,023
Workers' remittances	5,452	7,147	1,695
Capital account balance	110	77	-33
Financial account balance	-1,995	744	2,739
Direct investment inflow	546	415	-131
Portfolio investment inflow	344	-26	-370
Net incurrence of liabilities	957	31	-926
General government	1,092	1,423	331
Banks	-438	-642	-204
Central bank	3	-1,000	-1,003
Other sector	300	250	-50
Change in SBP's liquid reserves*	651.4	22.0	-
PKR app(+)/dep(-) in percent	2.4	1.4	-

*between end-June and end-Sep

Note: negative sign with financial account balance means FX inflow into Pakistan; positive sign means FX outflow

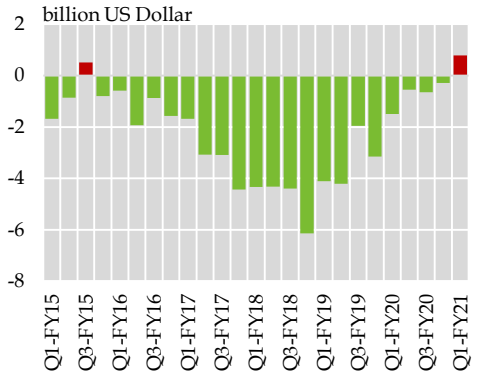
Source: State Bank of Pakistan

Current Account

After recording deficits in the last 21 quarters, Pakistan's current account (CA) posted a surplus of US$ 0.8 billion in the first quarter of FY21 **(Figure 5.1)**.[1] Record-high workers' remittances, low oil prices and a reduction in services imports mainly contributed to the improvement in the current account (**Table 5.1**).

Furthermore, the primary income deficit grew 7.2 percent YoY in Q1-FY21; this growth was lower than the 33.3 percent rise recorded in the same period last year. The increase in the deficit this year was mainly due to a rise in profit and dividend repatriation by foreign firms operating in the country (**Figure 5.2**). However, the higher profit repatriation was partially offset by a reduction in interest payments on external debt. The drop in LIBOR, along with the

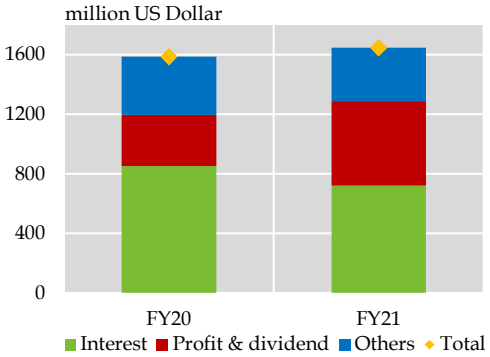
Current Account Balance **Figure 5.1**



Source: State Bank of Pakistan

[1] The current account surplus in Q3-FY15 (of US$ 0.5 billion) was mainly due to inflows received under the Coalition Support Fund (CSF), and a slump in global oil prices.

Outflow from Primary Income Account in Q1 **Figure 5.2**



Source: State Bank of Pakistan

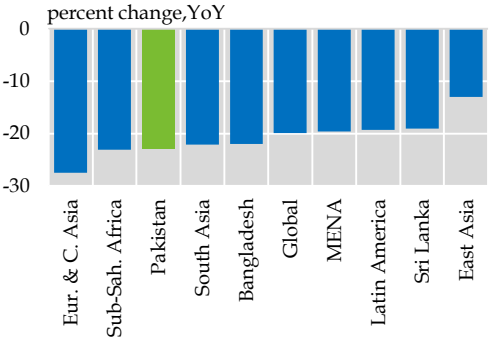
relief in debt servicing through the G20's Debt Service Suspension Initiative (DSSI) for the Covid pandemic, were the major factors behind the lower interest payments during the quarter.

Workers' Remittances

With Covid-19 paralyzing economic activities across the globe from March 2020 onwards, immigrants and expatriates residing in the developed and emerging economies were expected to become financially constrained due to the mobility restrictions and job losses. These developments were initially forecast to lead to a steep drop in the flow of remittances to the recipient economies **(Figure 5.3)**. In line with the weakening labor market conditions in the major destinations for migrant workers, the number of Pakistani workers going abroad for work also fell drastically from March 2020 onwards **(Figure 5.4)**. Furthermore, data from the Bureau of Emigration and Overseas Employment (BEOE) indicates that roughly 125,000 Pakistani workers have returned from abroad since the pandemic began (till mid-November 2020).

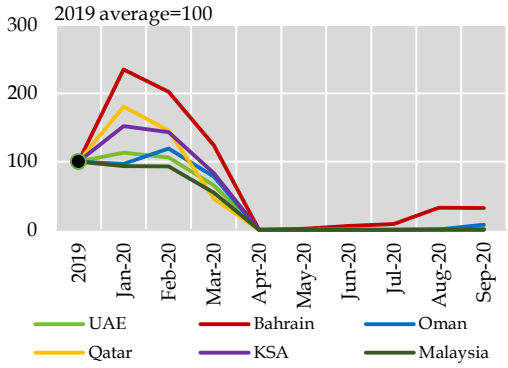
However, with the passage of nearly six months since the Covid outbreak (from April 2020 onwards), this feared drop in remittances has yet to materialize at least for some major recipients, including Pakistan **(Figure 5.5)**. In fact, workers' remittances to Pakistan grew 31.1 percent YoY to a quarterly record of US$ 7.1 billion in Q1-FY21, with all-time high monthly flow of US$ 2.8 billion realized in July 2020. Inflows rose from all major corridors, including the advanced economies and the Middle East region (**Table 5.2**). As a result, the World

Initial Projected Declines in Remittances to Major Recipients in CY20 **Figure 5.3**



Source: Migration & Development, World Bank, Apr-20

Trend in Pakistani Emigrants Going Abroad for Work **Figure 5.4**



Source: Bureau of Emigration & Overseas Employment

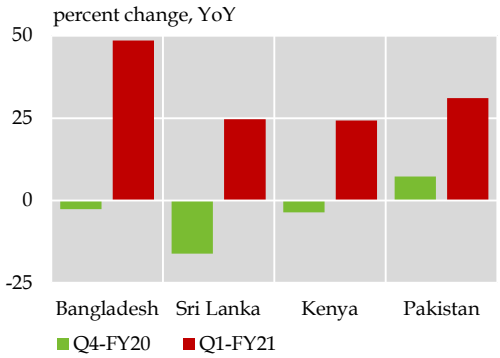
Country-wise Remittances in Q1 **Table 5.2**

million US Dollar

	FY20	FY21	Abs. Change
USA	388.6	632.6	244.0
U.K.	574.5	985.5	411.0
GCC	3,601.2	4,285.7	684.5
Saudi Arabia	1,556.5	2,080.5	524.0
UAE	1,318.3	1,420.8	102.6
o/w Dubai	1,114.8	1,140.0	25.2
Other GCCs	726.4	784.4	58.0
EU	448.9	601.4	152.5
Malaysia	58.1	56.3	-1.8
Others	381.2	585.6	204.3
Total	5,452.5	7,147.0	1,694.6

Source: State Bank of Pakistan

Actual Remittance Flows to Major Recipients after Covid Outbreak **Figure 5.5**



Source: State Bank of Pakistan & Haver Analytics

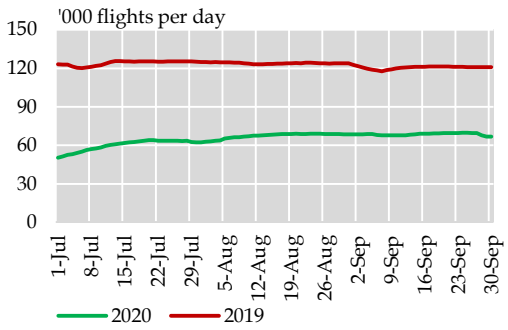
Bank has also significantly revised its forecast for remittances for CY20, from an initial projection of a 23 percent decline to a growth of 9 percent.[2] A major reason was the orderly foreign exchange rate conditions throughout the pandemic, which helped create a conducive environment for remitters to send money to Pakistan. Some other possible factors behind this favorable development are discussed below.

(i) Air travel restrictions: Formalization of informal remittance flows and build-up in savings

As lockdowns went into effect across the globe from March 2020 onwards, air travel was among the first activities to become restricted. At the peak of the lockdowns, the global commercial air travel was down almost 80 percent from a year ago.[3] While some air travel has resumed since then, the daily number of flights was still down around 47 percent in Q1-FY21 on YoY basis **(Figure 5.6)**.

Previously, air travel used to be a major source of cross-border funds transfers. The informal channel involved sending funds (cash) through friends or family members travelling from one country to another. Meanwhile, the other channel comprised hundi/hawala agents, which specifically utilized air travel to transfer funds from one

Trends in Commercial Air Travel (Jul-Sep) **Figure 5.6**



*based on real-time tracking of over 180,000 flights

Source: Flightradar24.com

[2] World Bank (2020). *COVID-19 Crisis through a Migration Lens*. Migration and Development Brief 32. Washington, DC: World Bank.

[3] On April 12, 2020, the number of commercial flights was down 79.7 percent from the same day in 2019, according to data from Flightradar24.com.

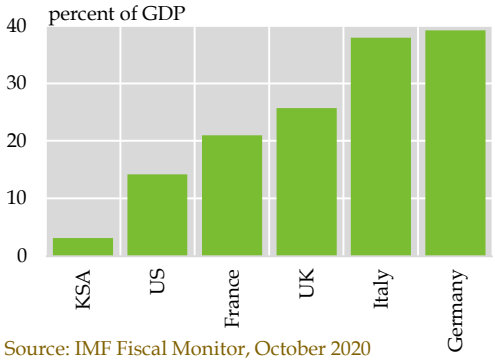
country to another, generally in large volumes. With the severe restrictions on air travel, funds transfers through both these channels came to a near-halt, and likely played a major role in pushing expatriates to adopt formal banking channels to remit funds back home.

At the same time, the air travel restrictions, including curbs on religious travel, likely contributed to a build-up in savings with the overseas diaspora. As a result, expatriates were able to remit back higher funds.

(ii) Post-outbreak fiscal support has helped shore up expatriates' incomes

The unprecedented fiscal and monetary support measures in the world's top migrant-destination economies in the western hemisphere and the Middle East have likely played a key role in supporting workers' cash flows, either via continued provision of wages or through cash transfers (**Figure 5.7**). The global economic policy response to the Covid-19 pandemic has amounted to a staggering US$ 11.7 trillion or 12 percent of global GDP.[4] The policies across the major destinations can be broadly categorized into two major areas: (i) measures that directly impact budgetary balances (like targeted cash transfers, unemployment benefits, and tax concessions); and (ii) liquidity injections into firms via equity and debt, as well as government guarantees for loans undertaken by firms. It is likely that many migrants, including those from Pakistan, benefited from these fiscal measures and were able to continue sending funds back home.

Post-Outbreak Fiscal Policy Support in Major Migrant Destinations **Figure 5.7**



Source: IMF Fiscal Monitor, October 2020

(iii) Covid-related incentives to formalize remittance flows

After the Covid outbreak, Pakistan and Bangladesh were among the countries that announced incentives to attract remittances via formal channels. In Pakistan, the SBP announced new measures on April 15, 2020, to encourage banks and exchange companies to process higher amounts of remittances.[5] These included a doubling in the rate of reimbursement for telegraphic transfer (TT) charges; [6] and the introduction of a tiered-based system to reimburse marketing transactions (where higher growth in remittances would lead to higher reimbursement of marketing charges).[7] The banks were also encouraged to promote

[4] As of September 11, 2020 (IMF (2020). Fiscal Monitor October 2020: Policies for the Recovery. Washington, DC: International Monetary Fund).
[5] Via EPD Circular Letters 11 and 12 of 2020.
[6] For remittance transactions between US$ 100-200, the per-transaction reimbursement rate for TT charges was increased from SAR 10 to SAR 20.
[7] ADs generating remittances above the defined threshold growth became eligible to receive Rs 0.5, Rs 0.75 and Rs 1 for every US dollar generated.

digital channels for sending and receiving remittances and to introduce incentive schemes for their own customers. Furthermore, from July 1, 2020, withholding tax was exempted on cash withdrawals, issuance of banking instruments, and on transfers from domestic bank accounts, to the extent of the amount of remittances received into the accounts in a year.[8]

(iv) Digitization and other longstanding efforts to formalize inflows

The Covid pandemic has accelerated the adoption of digital channels for service delivery across the world, including in Pakistan; these efforts have also likely contributed to the recent rising trend in remittances.[9] The SBP and the government, under the Pakistan Remittance Initiative (PRI), had already been encouraging banks and other service providers to utilize digital channels to attract remittances. The PRI launched a scheme to channelize remittances via mobile wallets (m-wallets) in 2017 by awarding cell phone airtime for every US dollar (or equivalent) received into m-wallets; in January 2019, the benefit under the scheme was raised to Rs 2 for every US dollar received. The scheme relies on the 12 Branchless Banking Operators (BBOs) that have a network of 400,000 branchless banking agents across the country, including in the remote areas.[10] Also, the outreach of the domestic remittance-distribution network has increased substantially over the past decade: already over 1,000 non-exclusive bilateral arrangements existed as of June 2019 between domestic financial institutions and foreign entities, against only 80 such arrangements in 2009.

Financial Account

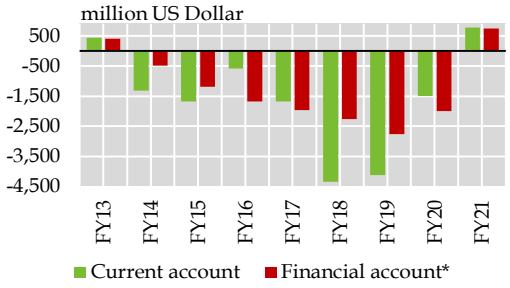
After a gap of seven years, the financial account recorded a net outflow in Q1-FY21. However, this net outflow was nearly of the same magnitude as the surplus in the current account (**Figure 5.8a**). The reduced external financing needs and a build-up in trade nostros with commercial banks helped them increase their foreign assets and retire short-term foreign exchange borrowings. This, along with the retirement of bilateral loans, more than offset the lower inflows from FDI and the government's multilateral and bilateral borrowings during the quarter **(Figure 5.8b)**.

Foreign direct investment

FDI inflows to low and middle-income countries in CY20 were projected to fall by over 30 percent.[11] Even before the Covid pandemic, the investment outlook was already weak, in the wake of slowing global

[8] Similarly, in May 2020, Bangladesh relaxed the limit for transfer from US$ 1,500, to US$ 5,000 for awarding 2 percent cash incentive to the beneficiary without any verification.
[9] For details, see the Special Section titled "Covid-19 and the Need to Boost Digital Connectivity in Pakistan" in the SBP's Annual Report on the State of Pakistan's Economy for FY20.
[10] Apart from BBO, the domestic remittances distribution network consists of 24 banks, 5 microfinance banks and 17 exchange companies.
[11] KNOMAD (2020). Phase II: COVID-19 Crisis through a Migration Lens. Migration and Development Brief 33. Washington, DC: Global Knowledge Partnership on Migration and Development. KNOMAD is a global hub of knowledge and policy expertise on migration and development, supported by a multi-donor trust fund established by the World Bank (knomad.org/publication/migration-and-development-brief-33).

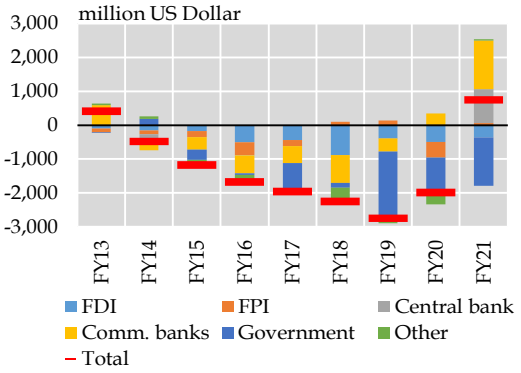
Current and Financial Account Balances in Q1 **Figure 5.8a**



*A positive number for the financial account balance reflects a net FX outflow from the country and negative number a net FX inflow

Source: State Bank of Pakistan

Financial Account Breakdown in Q1 **Figure 5.8b**



growth, falling commodity prices and rising protectionism; the pandemic shock further aggravated these foreign investment prospects.[12] After the Covid outbreak, investors' confidence was further eroded by the disruption in input supplies, rising uncertainties, and liquidity and credit constraints for multinational corporations (MNCs). Moreover, re-invested earnings which have a significant share in FDI were likely impacted as well, whereas investments into new projects could have been withheld due to the prevailing uncertainties.

In the case of Pakistan, however, the ripple effect was not felt as strongly because FDI is mainly concentrated in long-term projects, involving government-level collaboration. While net FDI into Pakistan during Q1-FY21 fell by 23.8 percent over the same period last year, the decline primarily reflected the base year effect, as last year's FDI was inflated by a one-time inflow into the telecom sector to pay the GSM license renewal fees.[13] Adjusting for this one-off development, the net FDI rose by around 75 percent in Q1-FY21 over last year where higher inflows were recorded in power, oil & gas exploration and financial business. These inflows partially offset the drop in other sectors (**Table 5.3**).

Sector-wise Net FDI inflow in Q1 **Table 5.3**

million US Dollar

	FY20	FY21	Abs. Change
Food	8.7	5.6	-3.1
Textiles	17.3	5	-12.4
Chemicals	-2.8	-5.4	-2.7
Oil & Gas Explorations	39.8	67.2	27.4
Pharma. & OTC Products	13.8	4.7	-9
Electrical machinery	65	36.5	-28.5
Electronics	-9.5	0.4	9.9
Transport equipment	4.4	-0.7	-5.1
Power	32.3	113.3	81.1
Communications	307.4	37.5	-269.9
Financial business	30.7	102.5	71.8
Others	38.5	49	10.5
Total	**545.5**	**415.7**	**-129.8**

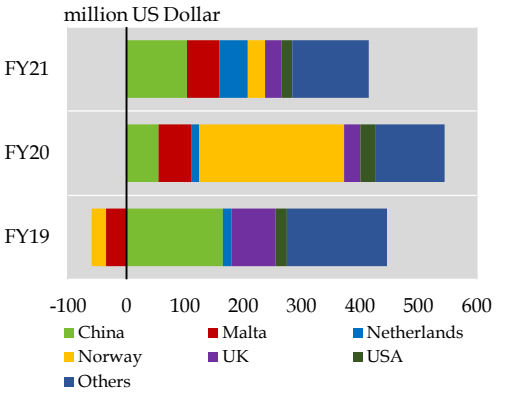
Source: State Bank of Pakistan

[12] World Bank (2020). *Global Investment Competitiveness Report 2019/2020 : Rebuilding Investor Confidence in Times of Uncertainty*. Washington, DC: World Bank.

[13] In FY20, a cellular company received funds from its parent company to pay the license renewal fee.

Disaggregated analysis shows that FDI inflows during the review period are partially attributed to investment from China to finance the ongoing work on CPEC-related projects.

Country-wise FDI in Q1 **Figure 5.9**



Source: State Bank of Pakistan

With substantial increase in these inflows, China's share in the country's net FDI rose to 24.9 percent in Q1-FY21 from 10.2 percent in Q1-FY20 **(Figure 5.9)**. Apart from CPEC-related inflows from China, FDI was mostly concentrated in financial business, oil and gas exploration, and communications sectors.

CPEC has now entered its second phase, with the planned emphasis shifting from infrastructure development to industrial development, agriculture mechanization, tourism, high-tech finance, and social development. Several Special Economic Zones (SEZs) are going to be established that could enhance the country's productive capacity, expand the exports base, and provide a major impetus for economic and social development through their backward and forward linkages with the rest of the domestic economy.

However, FDI in Pakistan remains concentrated in a few non-export oriented manufacturing sectors, such as power, construction, financial business, oil and gas exploration, electric machinery and telecommunications. In Q1-FY21, these sectors attracted around 90 percent of total FDI that came into the country, while investment in key exporting sectors, such as textiles, food and leather products, had a very little share in the total investment. This suggests the need to continue promoting foreign investment in export-oriented manufacturing sectors to further boost overall exports.

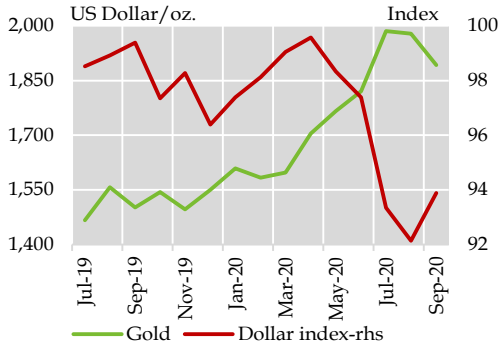
Furthermore, the government has carried out several reforms under the IMF's Extended Fund Facility (EFF) program to enhance trade and investments by improving business climate. Significant improvement has been made in simplifying the registration processes, automating land records, introducing online/electronic tax payments, and facilitating cross-border trade by improving electronic submissions and processing of trade documents. Resultantly, Pakistan is now ranked 108th out of 190 countries in the Ease of Doing Business ranking in 2020, up by 28 places as compared with 2019.[14] The SBP has also simplified the procedure for repatriation of profit and disinvestment proceeds and made the process more convenient for foreign investors. Under the new mechanism, the cross-border payments can be made directly by the commercial banks without first referring to the SBP.[15]

[14] Source: World Bank Doing Business Index 2020
[15] sbp.org.pk/epd/2020/FEC5.htm

Foreign portfolio investment

With the start of the Covid pandemic, emerging markets (EMs) witnessed a massive outflow of portfolio investment. The investors started shifting their portfolios to safe assets like the US dollar and gold from equities, to hedge against expected volatility in the equity market. Although the markets in emerging economies somewhat recovered from the lows observed in the early days of the pandemic, the portfolio investment outflows by the foreign investors continued due to uncertainty over new waves of infections. In the meantime, the US dollar started weakening against the major currencies, which further increased the demand for gold and put upward pressure on its price (**Figure 5.10**).[16] Moreover, the central banks were also aggressively cutting interest rates during the pandemic to stimulate domestic economies. The lower yields may have created disincentive for debt market investors, as the bond prices started to rise and thereby reduced yields.

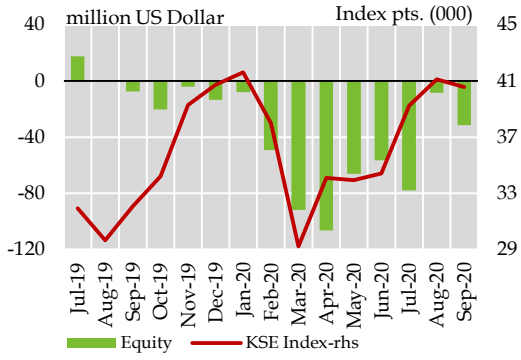
Values of US Dollar Index and Gold Prices **Figure 5.10**



Source: Bloomberg

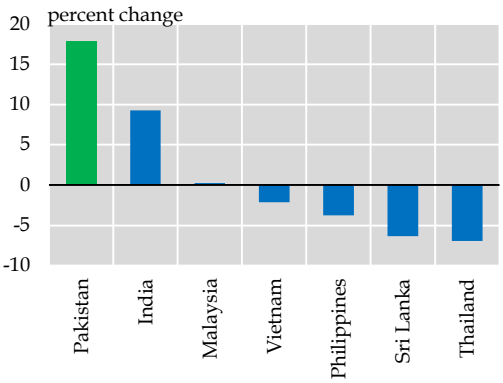
In this backdrop, foreign portfolio investment in Pakistan in Q1-FY21 remained subdued, with outflows recorded from both debt and equity markets. In contrast to high foreign investment seen in debt securities in Q1-FY20, there was an outflow of US$ 37.4 million in Q1-FY21. Similarly, foreign portfolio investors also pulled out US$ 117.7 million from the equities in the quarter (**Figure 5.11a**). In terms of regional performance, Pakistan's equity market performed well compared to some other Asian equity markets, reflecting the

Equity Investment & KSE-100 Index **Figure 5.11a**



Source: SBP, Pakistan Stock Exchange & Bloomberg

Equity Price Movement in Asian Markets in Q1-FY21 **Figure 5.11b**



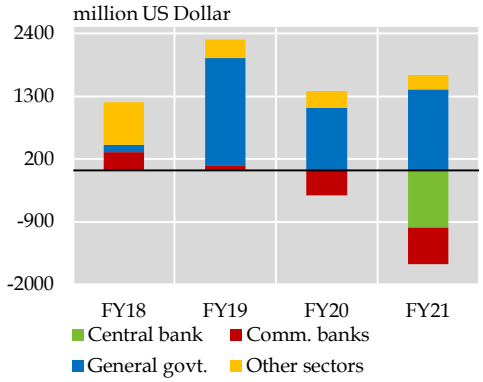
[16] Gold traded at US$ 1,893/oz. in September 2020, against US$ 1,466/oz. in July 2019.

country's relatively better economic management during the pandemic (**Figure 5.11b**). The equity market had recovered with KSE-100 index rising by around 17.9 percent in Q1-FY21.

Net Incurrence of Liabilities

The net inflow of external loans into the country amounted to only US$ 31.0 million in Q1-FY21, as compared to US$ 957 million in the same quarter last year. The lower net inflows were mainly on account of: (i) repayment of bilateral loan by the central bank; and (ii) retirements of short-term foreign exchange borrowings by commercial banks (**Figure 5.12**). Nonetheless, an increase in the net liabilities incurred by the government was noted during the quarter.

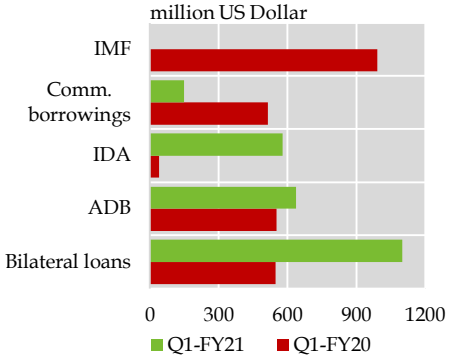
Net Incurrence of Liabilities in Q1 **Figure 5.12**



Source: State Bank of Pakistan

With regards to official inflows, the government's borrowings were sufficient to cover both its own and the central bank's loan repayments, without having any impact on the official reserves.[17] In gross terms, the government borrowed US$ 2.9 billion in Q1-FY21, which was slightly lower than last year. While last year's government borrowing was dominated by the IMF tranche of US$ 991.4 million, bilateral inflows of US$ 1.1 billion comprised the government borrowings this year (**Figure 5.13**).

Government's Gross Official Loans from Major Sources **Figure 5.13**



Source: SBP & Economic Affairs Division (GoP)

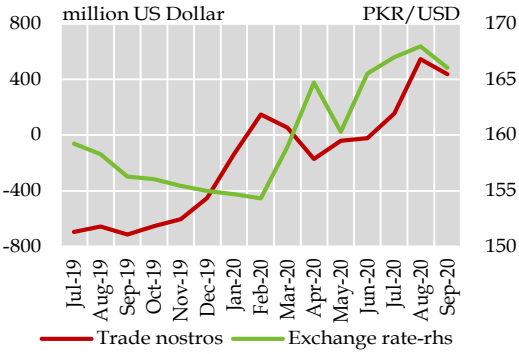
Besides bilateral loans, the disbursements by IFIs (other than IMF) were higher in Q1-FY21 over the same period last year. The continued support from the major IFIs, like the World Bank, Asian Development Bank (ADB) and the Asian Infrastructure Investment Bank (AIIB), bodes well in terms of debt servicing cost for the government.

5.2 Exchange Rate and Reserves

In line with developments in the balance of payments position, the country's foreign exchange reserves rose 2.6 percent during the quarter to US$ 19.4 billion by end-September 2020. Within these, the SBP's foreign exchange reserves increased by 0.2 percent to US$ 12.2 billion; indicating that the available inflows were sufficient to meet debt

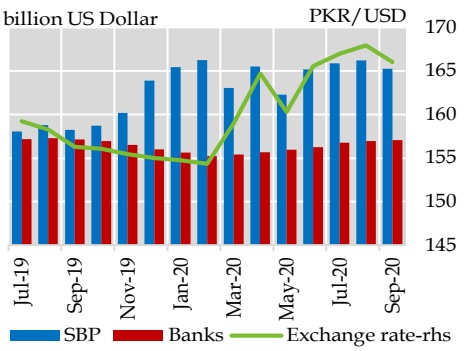
[17] With almost no change in Q1-FY21, the SBP Reserve stood at US$ 12.2 billion as of end-September 2020.

Trend in Banks' Trade Nostros & Exchange Rate **Figure 5.14a**



Source: State Bank of Pakistan & Haver Analytics

PKR Exchange Rate & Liquid FX Reserves **Figure 5.14b**



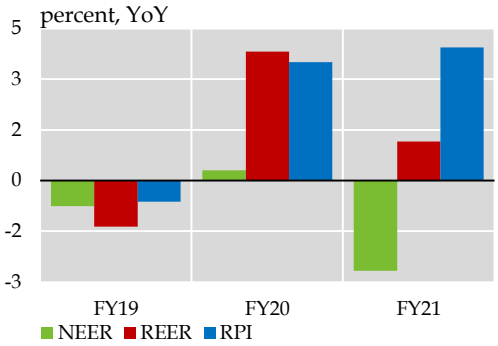
repayments. Meanwhile, the commercial banks' liquid FX reserves increased by 7.1 percent to US$ 7.2 billion in Q1-FY21, and were the driving factor behind the country's overall reserves trajectory as well as the exchange rate movements during the quarter.

The Pak Rupee parity appreciated by 1.4 percent against the US dollar in Q1-FY21, as compared to a 2.4 percent increase witnessed in Q1-FY20. It is worth noting that the appreciation observed last year was primarily driven by the receipt of the first EFF tranche, reengagement with IFIs in the wake of the start of the IMF program, improvement in the current account after the May 2019 adoption of the market-based exchange rate regime, and receipt of portfolio inflows into debt securities. This appreciating trend in the Pak Rupee had continued till February 2020, before the onset of Covid-19. Subsequently in March-June 2020, the Pak Rupee had also witnessed some depreciation, although this was comparatively lower than depreciations recorded by major emerging markets like Brazil, Russia, South Africa and Turkey.

However, the Pak Rupee appreciation in Q1-FY21 was supported by the sizable improvement in the current account balance and a trend reversal in commercial banks' trade nostro balances abroad from June 2020 onwards (**Figure 5.14a**). The inflows under trade nostros contributed to the build-up in the commercial banks' reserves (instead of SBP's reserves), and improved the foreign exchange liquidity in the interbank market. Under these circumstances, the Pak Rupee appreciated against the US dollar during Q1-FY21 (**Figure 5.14b**).

Despite this appreciation in the parity, however, the Nominal Effective Exchange Rate (NEER) depreciated by 2.7 percent in Q1-FY21, as compared to 0.3 percent appreciation recorded in the same period of FY20 (**Figure 5.15**). Appreciation in a number of trading partners' currencies against the US dollar outpaced the gain in the Pak Rupee against the US dollar, which led to the decline in the NEER. Meanwhile, the Real Effective Exchange Rate (REER) appreciated by 1.2 percent in Q1-FY21. Higher domestic inflation relative to the inflation in the trading partners of Pakistan, led to the appreciation in the REER in this quarter.

Change in Effective Exchange Rate* in Q1 **Figure 5.15**



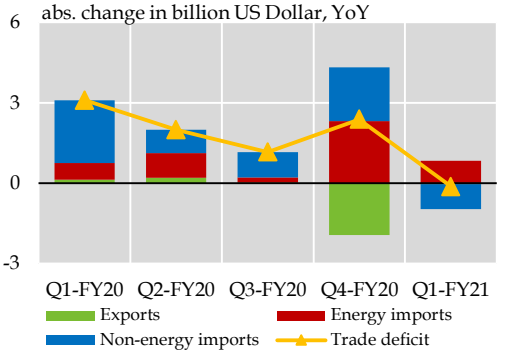
*Depreciation (-)/Appreciation(+)
Source: State Bank of Pakistan

5.3 Trade Account[18]

The trade deficit widened during Q1-FY21 on YoY basis for the first time in over two years and reached US$ 5.8 billion, mainly due to a reversal in the declining trend in imports (**Figure 5.16**). Unlike last year when the policy stance was geared towards achieving macroeconomic stabilization, the fiscal and monetary policies in Q1-FY21 were coordinated to revive growth and encourage long-term capex investments after the Covid-induced contraction by the end of FY20. This policy stance – coupled with rising prices of non-energy commodities and supply gaps in the availability of key agricultural commodities – led to an increase in imports during the quarter (**Figure 5.17**).

With imports rising, exports were stable at last year's level; that said, exports did depict a V-shaped recovery and were up significantly over the Covid-impacted Q4-FY20 (**Figure 5.18a**). In fact, Pakistan was among those economies whose exports recovered more strongly in Q1-FY21 on a QoQ basis (**Figure 5.18b**). The country's relatively better performance in keeping Covid cases under check allowed the easing of lockdowns from the start of FY21, which allowed industrial and transport activities to resume. As the quarter progressed and

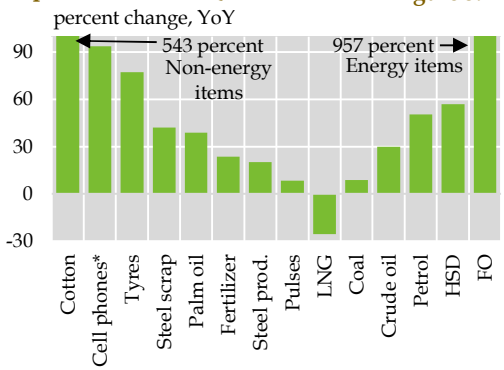
Breakdown of Change in Trade Deficit **Figure 5.16**



Source: Pakistan Bureau of Statistics

economic activity picked up, export volumes

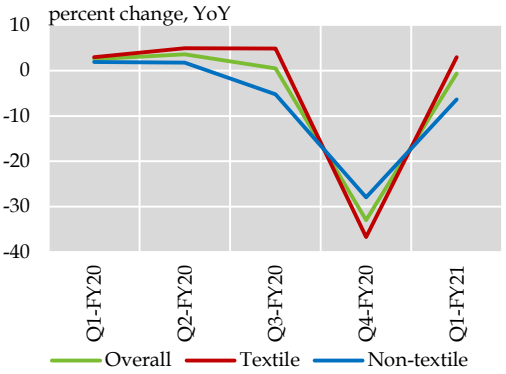
Import Volumes in Q1-FY21 **Figure 5.17**



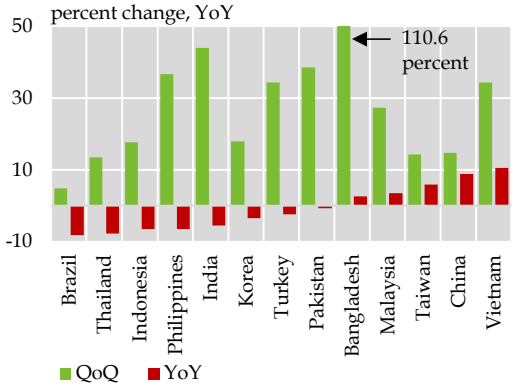
*growth in number of units imported
Source: Pakistan Bureau of Statistics

[18] This section is based on customs data reported by the PBS. The information in this section does not tally with the payments record data, which is reported in **Section 5.1**. To understand the difference between these two data series, see Annexure on data explanatory notes.

Trend in Pakistan's Export Growth **Figure 5.18a**



EMs' Export Growth in Q1-FY21 **Figure 5.18b**



Source: Pakistan Bureau of Statistics & Haver Analytics

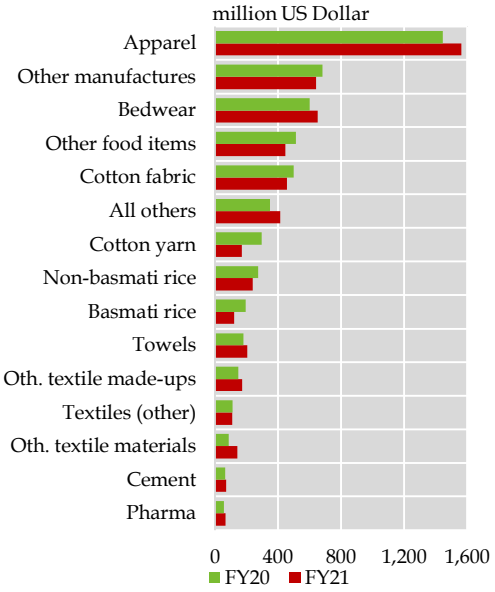
of industries like textiles, cement and pharmaceutical products, also rebounded. The improved export performance of these sectors partially offset weaker exports of food commodities, especially rice.

Exports

The country's exports rebounded to US$ 5.5 billion in Q1-FY21 from the 14-year low level of US$ 4.0 billion in the Covid-impacted Q4-FY20. However, on YoY basis, the exports were stable at last year's comparable level. It is worth noting that exports had risen during both July and September 2020 on a YoY basis, but overall Q1 exports were dragged down by the sharp 14.8 percent drop in August 2020, when record rainfalls, especially in the port city of Karachi, had disrupted intra-country transport activity.[19]

Among the major products, textiles and cement exports posted YoY growths, which helped partially offset weaker exports of food items and various other manufactured products (**Figure 5.19**). Meanwhile,

Pakistan's Major Exports in Q1 **Figure 5.19**

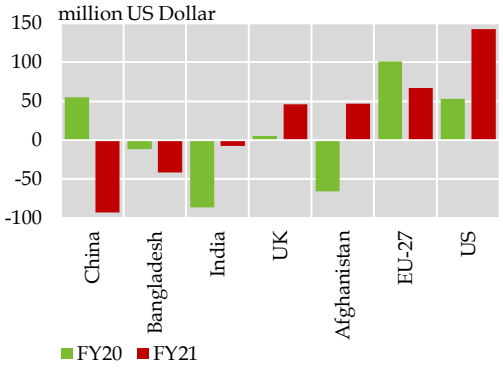


Source: Pakistan Bureau of Statistics

destination-wise data indicates a YoY pick-up in exports to the advanced economies (US, UK and the EU-27) during the quarter (**Figure 5.20**), mainly on the back of higher textile exports. In contrast, most of the YoY

[19] On a yearly basis, exports had grown 6.1 percent in July, before dropping in August and then again rising by 6.9 percent in September 2020.

Change in Exports to Major Destinations in Q1 **Figure 5.20**



Source: Pakistan Bureau of Statistics

stagnation in exports could be traced to the UAE and China, with rice and cotton yarn respectively emerging as the major drags (as discussed below). Within the South Asia region, exports to Afghanistan were strong on the back of some diversion of rice from the traditional Middle Eastern markets; whereas lower fabric exports to Bangladesh led to a drop in overall exports to the country during the quarter.

High value-added segment props up overall textile exports

The textile sector's export performance recovered in Q1-FY21 from the Covid-impacted Q4-FY20, with export values rising 2.9 percent YoY to US$ 3.5 billion; on QoQ basis, the growth was a much higher 64.1 percent. Customs records indicate that this YoY growth mostly originated from higher unit values.

The EU-27 market (excluding the UK) presented a challenging environment, as the bloc's overall apparel imports continued to drop sizably amid the uncertain retail environment due to the second and third waves of Covid. The bloc's apparel imports

Growth in EU-27's Apparel Import Volumes from EMs during Q1 **Table 5.4**

percent

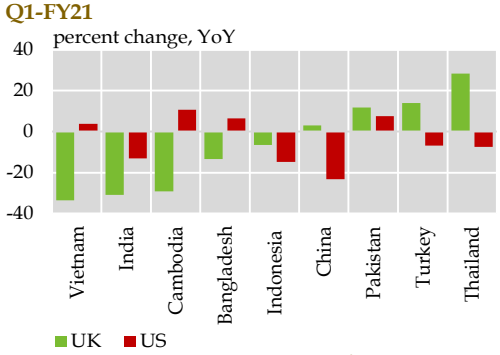
	FY20	FY21
India	0.6	-18.1
China	-1.0	-17.6
Cambodia	-9.6	-24.0
Indonesia	-0.9	-17.7
Vietnam	1.2	-3.8
Bangladesh	-1.9	-9.7
Turkey	5.7	5.7
Thailand	-1.9	-2.7
Pakistan	**7.4**	**-5.9**
Overall (Extra-EU 27)	0.6	-11.0

Source: Eurostat

from Pakistan as well as other suppliers declined during Q1 (**Table 5.4**); though it is worth noting that the drop in imports from Pakistan was much lower than that from many other EMs.

Similar to the EU-27, the overall import demand for apparel from the US as well as the UK was also quite weak; however, what was different was that these two countries appeared to significantly increase their imports from Pakistani manufacturers during the quarter (**Figure 5.21**). In the US, Pakistani exporters (along with those from other major textile manufacturing countries) continued to benefit from China's withdrawal from the US' apparel market, as

Growth in Apparel Import Volumes of the UK & US in Q1-FY21 **Figure 5.21**



Source: Eurostat & OTEXA, US Dept. of Commerce

well as Covid-related disruptions in supplies from India.

Meanwhile, Pakistan's exports of home textile items – comprising bed wear and towels –grew 6.2 percent to US$ 829.9 million in Q1-FY21, whereas those of other textile materials and textile made-ups recorded a cumulative increase of 33.5 percent and reached US$ 314.3 million. It is worth noting that most of Pakistan's exports of masks and other personal protective equipment (PPEs), especially cotton-based gowns, are captured under the two above-mentioned categories.

In the low value-added textile product segment, comprising yarn and fiber, Pakistan's exports declined 21.2 percent to US$ 627.5 million in the quarter. Disaggregated data indicates heavy quantum-led drop in yarn exports to China. China's ongoing trade disputes with the US, along with the lower global apparel demand in general, have disrupted its textile industry value chain and reduced the country's import demand for textile raw materials.[20] Similarly, Pakistan's fiber exports were mainly pulled down by lower shipments to Bangladesh, whose own import demand of cotton-based raw materials was low amid availability of higher inventories by end-July.[21]

While the export performance of the textile sector – especially the apparel, home textiles and other cotton-based textiles – appears resilient so far, this performance is yet to translate into equivalent foreign exchange receipts for the country. Specifically, the overall textile export earnings (based on SBP data) declined 10 percent YoY in Q1-FY21. There are a few possible explanations for this.

First, anecdotal evidence suggests that exporters are utilizing the SBP's temporary Covid-related regulatory relaxations, which allowed them to hold back export receipts for up to 270 days after exporting their goods, up from the previous time limit of 180 days.[22] This also tallies with the build-up in the nostro balances with Pakistani banks abroad in the quarter (**Section 5.2**). And second, some exporters might be selling their export proceeds in the forward market; these transactions would increase foreign exchange liquidity in the interbank market, but would not be recorded in the exports data until the settlement of the forward contracts.

Higher international unit prices suppress demand for Pakistani rice

The country's rice exports dropped 23.5 percent to US$ 808.4 million in the quarter, with lower export volumes of both basmati

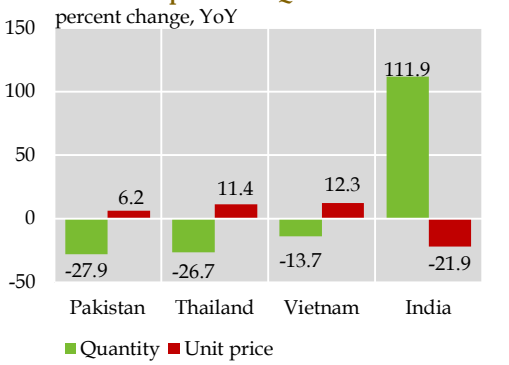
[20] China's imports of cotton and cotton-based raw materials fell by a sizable 26.0 percent in the year ending July 2020, whereas ending cotton stocks in the country were up 3.4 percent from the start of the year in July 2019 (source: Cotton World Markets and Trade Report October 2020, USDA).
[21] By end-July 2020, Bangladesh's ending stocks of cotton had amounted to 526,000 MT, higher than 388,000 MT at end-July 2019 (USDA (2020). *Cotton World Markets and Trade Report October 2020*. Washington, DC: United States Department of Agriculture.). This reduced the country's import demand for cotton and cotton-based products (under HS Code 52); as per ITC data as of December 1, 2020, these imports had dropped 95.3 percent in volume terms during Q1-FY21 (source: ITC). In line with this reduction in Bangladesh's import demand, Pakistan's fabric and yarn export volumes to the country dropped 43.7 percent and 10.9 percent respectively during the same period.
[22] Via EPD Circular Letter No. 7 of 2020, dated March 20, 2020.

and non-basmati rice responsible for the lower export values.

International prices of non-basmati rice varieties from Pakistan as well as from other major suppliers like Thailand and Vietnam were higher in this quarter, amid tight supplies ahead of the arrival of fresh crops. The higher prices encouraged major rice importers, especially in the fiscally challenged African economies, to shift their purchases to the lowest-cost supplier – India. The Indian exporters were able to price rice at much lower rates given the availability of relatively higher stocks in the country.[23] As a result, India was able to export significantly higher quantities in the quarter **(Figure 5.22 and 5.23a)**.

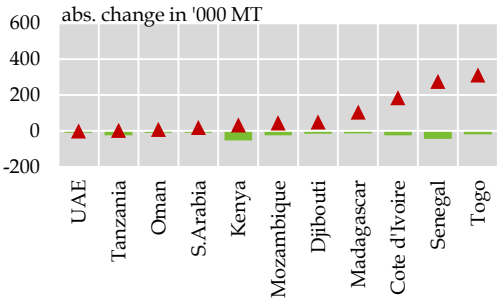
In the basmati segment, Pakistan's export volumes to the UAE dropped by a sharp 77.4 percent YoY during Q1-FY20; this drop to the UAE alone accounted for almost 62 percent of the decline in Pakistan's overall basmati exports in the period. Anecdotal evidence suggests that last year, Pakistan was indirectly meeting some of Iran's rice demand by shipping the grain to the UAE, from where it was transshipped to the Persian Gulf country. This year, due to the deepening BoP challenge in Iran, the foreign exchange payment channels for such transactions became limited, and ultimately reflected in Pakistan's lower exports to the UAE. Instead, Iran appeared to divert its rice

Growth in Export Quantities & Unit Prices of Rice Exporters in Q1-FY21 **Figure 5.22**

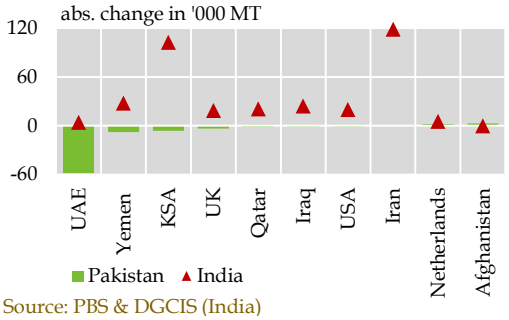


Source: PBS, Haver Analytics & DGCIS (India)

Pakistan & India's Non-Basmati Exports to Major Markets in Q1-FY21 **Figure 5.23a**



Pakistan & India's Basmati Exports to Major Markets in Q1-FY21 **Figure 5.23b**



Source: PBS & DGCIS (India)

[23] Rice production in India had risen 1.7 percent in 2019-20 YoY, whereas it had declined 1.4 percent in Pakistan (Source: USDA 2020. *World Agricultural Production Report October 2020*. Washington, DC: United States Department of Agriculture). Over the past four years (2016-17 to 2019-20), closing rice stocks in India have risen at a CAGR of 9.9 percent. Moreover, the USDA is projecting a record rice crop in India as well as record rice exports in the ongoing (2020-21) year (Source: USDA 2020. *Grain World Trade Report October 2020*. Washington, DC: United States Department of Agriculture).

demand to India (**Figure 5.23b**), with which it already has a barter-like trade mechanism in place. Meanwhile, Pakistan's basmati exports to other traditional Middle Eastern and European markets were also relatively weak, with exporters mostly losing market share to Indian competitors.[24]

Cement export volumes reach 7-year high

Among other major items, cement exports recorded a decent growth of 8.3 percent and reached US$ 72.3 million in the quarter, on the back of 7-year high export volumes. Disaggregated data shows that export volumes of clinker (a raw material used to make cement) rose significantly to the traditional markets, like Sri Lanka, China and Bangladesh. Heavy public investment in infrastructure is a key plank of China's "dual circulation" model to derive economic growth from local sources, leading to an uptick in cement production and construction activities to boost its economy after the Covid.[25] In case of Sri Lanka, a switch appeared to be underway, where the country imported higher volumes of clinker from Pakistan but lowered its purchases of finished Portland cement.

Imports

Imports increased slightly by 0.8 percent to US$ 11.3 billion in Q1-FY21, as opposed to declining by 20.9 percent Q1-FY20. The rise in values came entirely from a wide array of non-energy imports, which rose for the first time since Q1-FY18 mainly on account of cell phones, palm oil, raw cotton, and power generating machinery. These imports dominated the impact of price-driven lower energy imports in the quarter (**Table 5.5**).

A common theme that emerged across almost all major categories of imports was volumetric increases. The QoQ volumetric growth could be attributed to revival of economic activities from the pandemic and stronger Rupee, providing some relief amidst rising international commodity prices.[26]

Meanwhile, the YoY growth could be traced to the following major factors: lower interest rate environment; adverse agricultural supply shock and forward buying by food importers to cater to winter demand amidst fears of second wave of Covid, leading to higher food imports[27]; shortfall in domestic cotton production and demand from the

[24] Here, it is also worth noting that in September 2020, India filed a claim with the EU, asking for an exclusive geographic indicator (GI) tag for basmati rice grown in its northern provinces. With a GI tag, a product is recognized to have specific and distinct characteristics that are exclusive to a particular area where it is produced. If India's claim is granted by the EU, then Pakistan would not be able to market its rice using the 'basmati' label in the EU. Pakistani rice exporters and the government are currently challenging India's GI tagging claim for basmati rice.

[25] Local cement production in China had risen 6.0 percent in Q1-FY21, higher than the rate of 5.6 percent in Q1-FY20 (source: Haver Analytics).

[26] After declining by 30.6 percent QoQ in Q4-FY20, LSM Index grew by 28.7 percent in Q1-FY21. Between April 1, 2020 and September 30, 2020, the Pak Rupee appreciated by 0.7 percent; whereas during the corresponding period of 2019, it had depreciated by 9.9 percent. Average international commodity price indices rose 5.6 percent YoY and 4.5 percent QoQ in Q1-FY21 (Source: World Bank).

[27] Many countries around the globe, including Pakistan, Jordan, Morocco and China, have been stocking up food supplies as the Covid-19 cases resurge around the world. Furthermore, demand-driven rising international food prices have also incentivized forward buying by the food importers.

export-oriented textile sector, leading to higher textile imports; higher gross FDI inflow into the power sector, prompting imports of power-generating machinery for projects under CPEC; higher demand for energy products due to increased spending on construction activities, heavier road transportation, and peak power demand during the summers.

With the effort to support local industrial production, the government's accommodative policy environment may also have contributed in pushing imports up in Q1-FY21. It was reflected, on one end, in the concessionary lending for capex investments, and, on the other end, either in the reduction of customs duty or removal of additional customs duty on a number of raw materials and intermediate goods, such as edible oils and seeds, raw cotton, and hot rolled coils, imported for domestic use. Besides, government also removed segregated advance tax rates levied on filers and non-filers.[28] The government also enhanced the monitoring of borders for illicit movement of assorted items, like motor vehicles, cloth, Iranian diesel, and cigarettes, bringing those imports to the formal channel.[29]

Energy imports pulled down by lower international crude prices amidst higher demand

The energy imports decreased 26.6 percent YoY to US$ 2.3 billion in Q1-FY21, mainly due to lower international crude prices in the wake of the pandemic (**Figure 5.24**). The fall

Pakistan's Major Imports in Q1 **Table 5.5**

million US Dollar

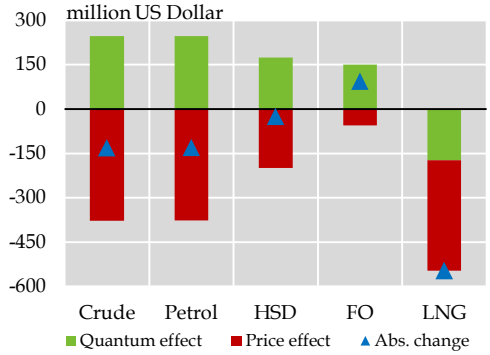
Items	FY20	FY21	Abs. Change
Energy group	**3,169.7**	**2,328.1**	**-841.6**
POL prods.	1,319.9	1,126.1	-193.8
Crude oil	823.3	692.7	-130.6
LNG	965.6	419.9	-545.7
Agri and chem	**1,815.2**	**1,922.9**	**107.7**
Fertilizer	127.7	149.7	22
Other chem.	926.6	928.5	1.9
Transport group	**538.1**	**414.3**	**-123.7**
CBUs	29.3	65.9	36.6
CKDs	261.4	180.7	-80.7
Aircraft & ships	131.1	86.7	-44.4
Metals group	**1,005.5**	**1,084.0**	**78.5**
Iron & steel scrap	388.8	484.9	96.1
Iron & steel	370.6	375.1	4.6
Food group	**1,097.4**	**1,712.5**	**615.1**
Tea	102.2	142.0	39.7
Palm oil	362.4	579.0	216.6
Wheat unmilled	0.0	101.8	101.8
Sugar	0.6	13.2	12.6
Other items	405.6	588.8	183.2
Textile group	**450.9**	**676.8**	**225.8**
Raw cotton	37.4	208.1	170.7
Synthetic fiber	114.1	142.1	28
Synth. silk yarn	118.5	140.5	22.1
Machinery group	**2,032.2**	**2,105.4**	**73.2**
Power gen	312.1	424.1	112
Electrical	506.0	324.2	-181.9
Cell phones	269.1	492.9	223.8
Other mach.	551.2	525.6	-25.6
All other items	**878.7**	**772.0**	**-106.6**
o/w Coal	271.8	241.3	-30.5
Total Imports	**11,199.2**	**11,286.1**	**86.9**
Energy imp.	3,169.7	2,328.1	-841.6
Non-energy imp.	8,029.5	8,958.0	928.5

Source: Pakistan Bureau of Statistics

[28] Previously, the non-filers would be charged higher advance tax rates as compared to their filers on imports of products like remeltable steel, directly reduced iron, DAP, urea, cotton, pulses, coal, etc. Source: Income Tax Ordinances, amended up to 30-06-2019 and 30-06-2020.

[29] The FBR confiscated Rs 3,800 million worth of smuggled items in July 2020, which was 143 percent higher than July 2019 (fbr.gov.pk/pr/smuggled-items-worth-3800-million-confiscated/152389).

Quantum and Price Effects for Energy Imports in Q1-FY21 **Figure 5.24**



Source: Pakistan Bureau of Statistics

was much steeper than that of 16.2 percent during the same period last year.

Disaggregated data shows that in Q1-FY21, there was an increase in the quantum imports of major petroleum products, mainly petrol, HSD and furnace oil. On a broader level, the phased resumption of transportation services following the ease in nationwide lockdowns around June-July 2020, led to higher QoQ demand for these products during Q1-FY21. That said, there was considerable increase in YoY sales of these products as well. In case of petrol and HSD, the following four factors mainly triggered their demand.

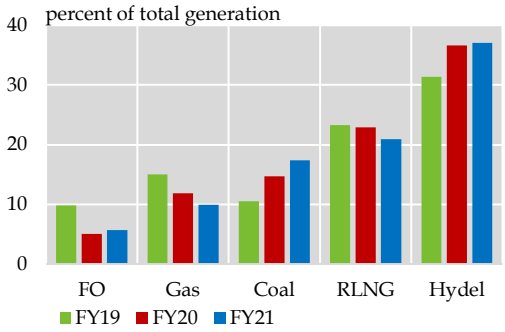
First, a higher number of vehicles were on the road, as reflected by higher sales of motor vehicles, particularly motorcycles and rickshaws.[30] Second, tighter border controls saw the informal HSD imports shift to formal channels.

Third, there was incremental number of intercity and interprovincial commuters and migrant workers that travelled by road, given that air travel was either fully or partially closed at least till late August. This substitution led to, on one hand, record low consumption of jet fuel, and, on the other hand, record high usage of petrol in Q1-FY21 (at least since FY14).[31]

Fourth, construction activities picked up in the quarter, as indicated by higher PSDP spending, especially in the housing and works sector.[32] This directly translated into higher transportation of construction-related materials (like cement, iron and steel) by heavy vehicles; which led to higher demand for HSD and petrol.

As for furnace oil, there was a trend reversal from the last few years, as its share in cumulative sales of petroleum products increased for the first time since Q1-FY17 (**Figure 5.25**). This transpired after the

Source-wise Generation of Electricity in Q1* **Figure 5.25**



*Excluding K-Electric

Source: National Electric Power Regulatory Authority

[30] Units of two- and three-wheelers sold rose by 22 percent year-on-year in Q1-FY21. (Source: PAMA)
[31] In case of HSD, sales of Jul-Aug FY21 were highest since FY17. (Source: OCAC)
[32] PSDP spending in the quarter rose 12.8 percent YoY to Rs 160 billion. Source: Pakistan Fiscal Operations, Ministry of Finance

government lifted the ban on import of furnace oil in order to supply more fuel to the power sector to curtail load-shedding in the country's southern region during the peak demand season.[33]

It is pertinent to note that this decision was taken in light of a major systemic constraint in the country's transmission network. According to NEPRA, due to limited transmission capacity (650 MW), the NTDC cannot transfer power to the country's southern region in case of sudden increase in demand there. In such a situation, the southern region is left with two options: either generate electricity using expensive FO, or purchase it from smaller FO-based power plants within the region, despite having cheaper coal-based or gas-based electricity from Port Qasim, Hub Power and other plants in the country available for "evacuation" should the need arise.[34]

As a result of this reshuffling in the energy mix, electricity generated using FO was 14.6 percent higher in Q1-FY21—rising for the first time in any quarter since Q4-FY17. It should be noted here that higher imports of FO had also prompted lower imports of cheaper fuel, LNG, in Q1-FY21 **(Table 5.5)**.[35]

Moreover, for all the reasons discussed above—pertaining to higher demand of major POL products—quantum imports of crude oil also rose 30 percent YoY to 2.4 million MT in Q1-FY21—the highest level in the last three years.

Having said that, lower unit values more than offset the rise in quantums of petroleum products and crude oil. During the quarter, international oil prices were still below the pre-pandemic levels. In fact, the price recovery slowed down as Covid cases resurged across the world. Additionally, the OPEC+ countries were also violating mutually agreed oil production cuts. In this backdrop, Arab Light oil prices dropped 31.7 percent YoY to US$ 43 per barrel during Q1-FY21; this helped significantly pull down the energy import bill. Finally, demand-driven lower LNG prices in the international market also considerably brought down the quarterly gas import bill **(Table 5.5)**.[36]

Non-energy imports more than offset impact of lower energy imports

Non-energy imports increased by 11.6 percent YoY to US$ 8.9 billion in the first quarter. There was a significant growth across wide sets of product categories, mainly mobile phones, palm oil, raw cotton, power generating machinery, and iron and steel (in that order). The increase in these segments more than offset the lower energy imports in value terms.

Food imports rose by 56.1 percent to US$ 1.7 billion—the highest level since at least Q1-FY06 (**Table 5.5**). This sharp rise came on account of following main reasons: shortage of local cotton seed oil (used in making ghee) due to poor cotton crop, resulting in higher imports of edible oils and seed (palm oil and soya bean seed/oil). This explains why palm

[33] Last year, there had not been much need to resume FO imports, as the local refineries had enough stocks available to dispose of.
[34] NEPRA (2020). *State of Industry Report 2020*. Islamabad: National Electric Power Regulatory Authority.
[35] Similarly, import of another cheaper fuel, coal, was lower in Jul-Sep FY21 than last year.
[36] International LNG Price Index was down 22 percent in the quarter. (Source: World Bank Pink Sheet)

oil imports, the largest imported food item, increased by 59.8 percent to US$ 579 million. It should be noted that rising international prices of palm oil also elevated its import bill.[37] Moreover, to facilitate the essential food imports, the government had also announced extension in the exemption of additional customs duty—of 2 percent—on edible oils and seeds under the PM's Covid Relief Program till September 30, 2020.[38]

Another factor driving food imports was the accelerated buying of some items (for instance, tea and pulses) in anticipation of higher winter demand amidst risk of second wave of Covid distorting food supplies and increasing prices. Finally, inflation in local wheat and sugar prices forced the government to allow the private sector to import these items to plug supply gaps **(Table 5.5)**. In case of wheat, regulatory duty was lifted altogether.[39]

Meanwhile, textile sector was another major source of increase in overall imports, whose imports rose 50.1 percent to US$ 676.8 million. Around three-fourth of this increase came from raw cotton only.[40] The primary reason was the shortfall in local cotton production, as evident by the lesser year-on-year cotton arrivals at the ginning factories.[41] In light of export orders for high value-added textile products, raw cotton had to be imported aplenty. Moreover, the government also had exempted additional customs duty on these items to facilitate their imports.[42]

Overall machinery imports rose 3.6 percent to US$ 2.1 billion in the quarter. The increase was led by power generating machinery and mobile phones. Rising 35.9 percent YoY, power generating machinery imports amounted to US$ 424 million. Among other things, progress of construction works on the

Rising Usage of Mobile Phones and E-Commerce in Pakistan **Table 5.6**

	Volumetric Share of Total			QoQ Growth (Value)		
	MPB[1]	E-Com[2]	Paper-Based	MPB[1]	E-Com[2]	Paper-Based
Q4-FY19	3.9	0.49	32.7			
Q1-FY20	4.5	0.65	33.9	-3	5.2	-11.8
Q2-FY20	4.9	0.8	33.6	31.1	25.9	4.4
Q3-FY20	6.1	0.81	31.6	22.2	-30.4	-7.1
Q4-FY20	10.0	0.81	27.5	33	32.4	-8.4
Q1-FY21P	10.3	1.1	27.6	46.1	26.6	21.3

[1]MPB: Mobile Phone Banking, [2]E-Com.: E-Commerce, P: Provisional

Source: State Bank of Pakistan

[37] Prices rose over stronger global demand (including from Pakistan) in the wake of easing of initial Covid restrictions, and lower year-on-year production in the key source market, Malaysia.
[38] Source: FBR SRO 572(I)/2020
[39] Source FBR SRO 633(I)/2020
[40] Raw cotton imports, at US$ 208 million, were the highest since Q1-FY08 (US$ 231 million).
[41] As of October 1, 2020, 1.9 million bales of cotton had arrived at the ginning factories, which were 35 percent lower than at the same point last year. (Source: Pakistan Cotton Ginners Association)
[42] Source: FBR SRO 572(I)/2020. It should be noted that the exemption had been available last year too, but only for a short period (from July 1, 2019 to August 22, 2019), and bore no impact on cotton imports.

projects under the CPEC had contributed towards their higher imports.[43]

Meanwhile, mobile phones imports rose 83.2 percent to US$ 493 million in the quarter. The increase could be traced to reduction of sales tax and advance tax on import of low-end mobile phones,[44] and increased usage of cell phones in day-to-day commercial transactions as well as in other activities like distance learning, initially prompted by social distancing (**Table 5.6**). Higher import of mobile phones was in line with the general trend in other EMs (like India) as well, which witnessed stronger than expected rebound in demand for these products in Q3-2020.[45]

Meanwhile, iron and steel imports increased 13.3 percent to US$ 860 million. Although the entire increase came mainly from iron and steel scrap, government's incentive offered through reduced customs duty on Hot Rolled Coil (an intermediary product) also saw quantum imports of finished products increase YoY.[46] This demand could be partly traced to higher consumption of reusable scrap as input in the steel industry, which makes billets, among other things, for the construction industry.[47] Finally, the transport group imports decreased, led mainly by the CKD kits, whose imports declined more sharply than last year, as the government imposed 7 percent additional customs duty on them **(Table 5.5)**.[48]

[43] Power sector received US$ 178 million in gross FDI in Q1-FY21, as compared to US$ 76.5 million last year.
[44] Sales tax on smart phones worth US$ 30-100 was reduced from Rs 1,320 to Rs 200 per set, whereas, advance tax on the same was lowered from Rs 730 to Rs 100 per set. Sources: Tax Laws (Second Amendment) Ordinance 2019 dated 28-12-2019 and Income Tax Ordinance as amended up to 30-06-2020
[45] Source: International Data Corporation's Q3-2020 Report, accessible at idc.com/getdoc.jsp?containerId=prUS46974920
[46] Duty on imports of HRC was brought down from 12.5 percent and 17.5 percent to 6 percent and 11 percent respectively for HS Codes 7208, and 7225 and 7226.
[47] Led by demand in the construction sector, billets produced in Q1-FY21 were 26 percent higher than last year.
[48] Source: FBR SRO 572(I)/2020

Special Section: Public Pension Expenditures in Pakistan – The Need for Reforms[1]

Public sector pension expenditure in Pakistan has risen rapidly over the past decade. Retrospective increments, alongside generous commutation and restoration facilities, are fueling early retirements of civil servants. This, coupled with the highest replacement rate in South Asia, growing headcount of government employees, and the unfunded nature of pension payments, is making the current structure unsustainable in Pakistan. While limited fiscal space is a major reason why the accelerating pension expenditure is worrisome, improvements in the public pension framework via several parametric and systemic reforms, such as proper indexation of increments, elimination of retrospective increases and rationalization of survivorship benefits, would go a long way towards addressing this concern. Lastly, measures that are introduced must also be periodically reviewed to ensure timely policy interventions and a sustainable functioning of the pension system.

S1.1 Introduction

Pension payments are an important source of old-age income support and serve as a crucial poverty prevention mechanism. However, since the turn of the century, pension reforms have come to take a central stage in the policymaking sphere across the world. While ageing populations, low fertility rates and high dependency ratios are increasing pension expenditure in most advanced economies, structural problems and limited fiscal space is making such spending unsustainable in some developing economies as well.

According to the United Nations World Population Prospects 2019, the share of population older than 65 in advanced economies is estimated to increase from 19.3 percent in 2020 to around 26.9 percent by 2050. At the same time, the proportion of working age population (20-64) is projected to decline from 58.9 percent to 53 percent. This means that even funded pension schemes of advanced economies will come under pressure. According to Amaglobeli et al. (2019), this is mainly because of two factors.[2] First, increases in life expectancy extend the duration of pension support. Second, lower than expected investment returns (owing to very low interest rates, for instance) could lead to a funding shortfall. As a result, Lee and Mason (2017) project that tax expenditures would have to increase around 26 percent, 11 percent, and 14-28 percent between 2010 and 2050 in the US, Japan, and European countries, respectively, just to offset the increased cost of ageing population.[3] It is pertinent to note that this would be on top of the already growing pension liabilities. In the US, for example, the retirement of the baby boomer generation workers and suppressed investment returns in the aftermath of the Global Financial Crisis

[1] This chapter draws heavily from our discussions with the officials from the Ministry of Finance, Office of the Accountant General of Pakistan. Punjab Pension Fund, and provincial Accountant General Offices of Punjab, Sindh, and KPK.

[2] Amaglobeli, D., Chai, H., and Dabla-Norris, E. (2019). *The Future of Saving: The Role of Pension System Design in an Aging World*. IMF Staff Discussion Note SDN/19/01. Washington, DC: International Monetary Fund.

[3] Lee, R., and Mason, A. (2017). "Cost of Aging". *Finance & Development*, 54(1), 7.

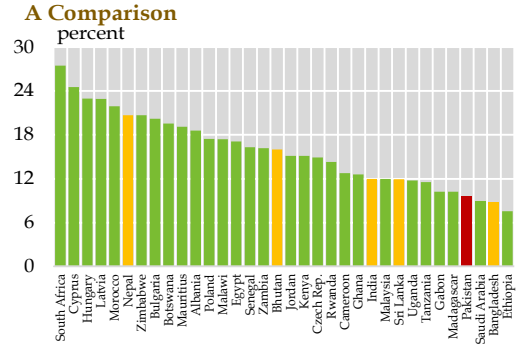
have already put sustainability of pension payments into question and necessitated the need to focus on reforms (Munnel et al. 2010).[4] By one estimate, the obligations of public pension funds exceed their assets by around US$ 4 trillion in the country (Rauh, 2017).[5]

Public pension expenditures are also increasingly becoming a fiscal burden in developing economies (Palacious and Whitehouse, 2006).[6] Pension payments as a percent of tax revenue average around 15.4 percent in emerging and developing economies for which comparable data is available.[7] Relatively limited fiscal space means that even pension payments of smaller magnitudes become difficult to sustain in such economies.

In Pakistan, too, the absolute level of old-age income support coverage is on the lower side. For instance, the pensions to GDP ratio stands at just 2.2 percent,[8] while the proportion of the population participating in programs that provide old-age contributory pensions, health and/or social security insurance is only 5.9 percent – much lower than the developing economies average of 20.3 percent.[9] The old age dependency ratio – the number of people aged 65 and above compared to the number of working age people – is 8.5 percent, and is expected to rise only marginally to 11.2 percent by 2040. But even with such a low pension coverage in the country, reforms to public pensions have become unavoidable in Pakistan in the face of the worrying acceleration in the associated public sector spending witnessed over the last decade. This is principally because public pensions are of an unfunded nature and thus are burdening the already tight fiscal revenue situation (**Figure S1.1a**). Specifically, the pension expenditure at the federal level has risen by a CAGR of 18 percent in Pakistan during FY11-21. Provincial pension expenditure has also witnessed a similar surge (**Figure S1.1b**). Within consolidated pension expenditures, civil pensions (including federal and provincial) constituted 63.2 percent, whereas military pensions made up around 36.8 percent on average during the last 5 years (**Figure S1.2**).[10] The overall pension spending as a share of tax revenue has reached 18.7 percent as of FY20, almost double the level a decade earlier (**Figure S1.3a**). If this proportion continues to grow, it could result in the crowding out of other valuable spending avenues: pension

[4] Munnell, A. H., Aubry, J., and Quinby, L. (2011). "Public Pension Funding in Practice". *Journal of Pension Economics & Finance*, 10(2), 247-268.
[5] Rauh, J. D. (2017). *Hidden Debt, Hidden Deficits: 2017 Edition*. Hoover Institution Essay 32. Stanford: Hoover Institution, Stanford University.
[6] Palacios, R., and Whitehouse, E. (2006). *Civil-Service Pension Schemes Around the World*. Social Protection Discussion Paper No. 0602. Washington, DC: World Bank.
[7] Pension-to-GDP numbers taken from the World Bank Pensions Database GP Social Protection. Figures ranged from 2011 to 2018 (latest available). Converted to proportion of tax revenues by using the 2011-18 tax-to-GDP ratio sourced from the World Bank Open Data.
[8] This is compared to the average pension-to-GDP ratio of 2.5 percent for the 40 EMDEs covered in the World Bank Pensions Database GP Social Protection (Figures range from 2011 to 2018).
[9] Source: The Atlas of Social Protection: Indicators of Resilience and Equity (ASPIRE), World Bank. Data from 2015 or latest for fifty developing economies.
[10] The structure and regulations pertaining to civil and military pensions are mostly identical. However, the size of the respective pension expenditures varies due to the difference in terms of service.

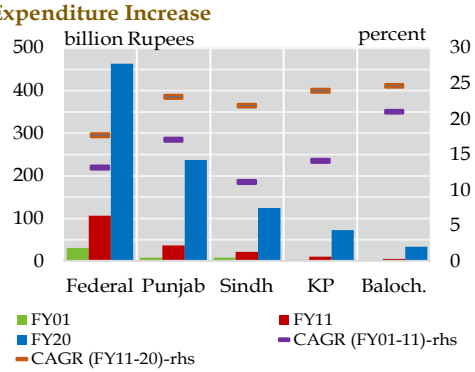
Tax-to-GDP Ratio - A Comparison **Figure S1.1a**



South Asian countries in gold; Pakistan in maroon

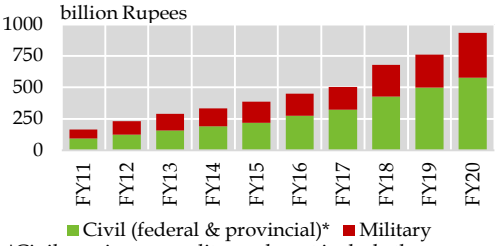
Source: World Bank

Magnitude of Pension Expenditure Increase **Figure S1.1b**



Source: Revised federal & provincial budget estimates

Composition of Public Pension Expenditures in Pakistan **Figure S1.2**



*Civil pension expenditures do not include those pertaining to Pakistan Railways & SOEs/autonomous bodies (PIA, PSM, WAPDA, etc.)

Source: Revised estimates from Budget in Brief, MoF (Federal) and respective provincial Annual Budget Statements

spending as percent of total budgeted expenditures for FY20 exceeded health and education spending on both federal and provincial fronts and is almost half the level of consolidated development expenditures (**Figure S1.3b**). In this regard, International Financial Institutions (IFIs), such as the World Bank and the International Monetary Fund (IMF) have also started flagging the rising pension expenditure as a pressing concern for Pakistan's debt sustainability.[11]

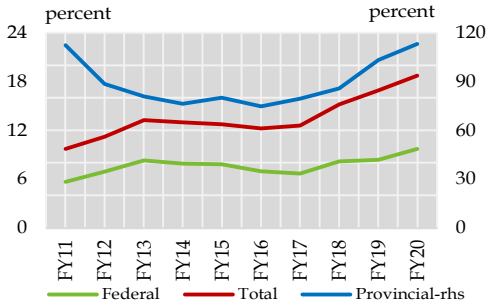
What is even more concerning is the fact that pension expenditure is expected to rise further going forward, given the increase in both retiree headcount and the lifespan of future retirees. If fiscal revenues continue on their existing trajectory, the rising pace of pension-related spending would become worrying from the sustainability point of view. According to the World Bank's projections, civil service pension payments would overtake wage expenditures by 2023 and 2028 in Punjab and Sindh, respectively, and come near to their level in the federal government by around 2050 (**Figure S1.4**).[12]

Within this context, this special section intends to: (i) describe the existing public sector pensions and benefits system in Pakistan; (ii) highlight major factors that are making pension expenditures unsustainable; and (iii) provide a set of policy

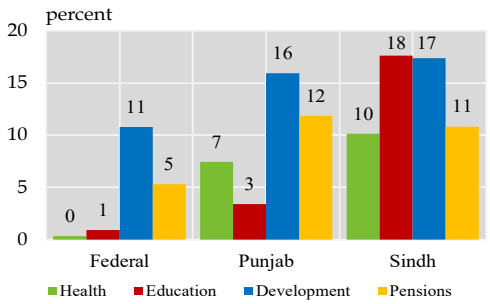
[11] For example, see World Bank (2020). Pakistan Assessment of Civil Service Pensions. Report AUS0001350. Islamabad: World Bank; and Amaglobeli et al. (2019).

[12] The exercise was done for Punjab and Sindh only, hence projections pertaining to KP and Balochistan are not available. For more details, see World Bank (2020).

Pension Expenditures as percent of Tax Revenue **Figure S1.3a**

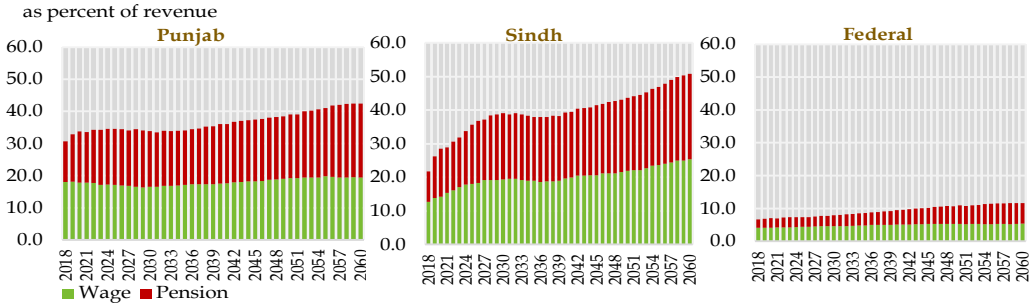


Spending as a Proportion of Total Expenditures **Figure S1.3b**



Source: Revised estimates from Budget in Brief, MoF (Federal) and respective provincial Annual Budget Statements

Comparison of Civil Servant Wage and Pension Expenditure Projections for Pakistan **Figure S1.4**



Source: Projections from World Bank (2020). *Pakistan Assessment of Civil Service Pensions*. Report AUS0001350. Islamabad: World Bank.

recommendations to make the growing post-retirement expenditures sustainable going forward. Here, it is important to mention that structural factors, such as the size of the civil government and the military, the unfunded nature of pensions, and disproportionally high share of non-gazetted employees (95.3 percent of total federal government employees), are all important factors governing the overall level of pension expenditures in the country. However, these factors are beyond the scope of this section; here, we intend to highlight system-bound aspects that explain the steady rise in these expenditures over the last decade.

S1.2 Public Sector Pension Framework in Pakistan

Pakistan had adopted the underlying principles of the civil-service pension from the British Pension's Act 1871.[13] This Act clearly stipulated the right to pensions and

[13] According to the Civil Service Act 1973, "civil servant" means a person who is a member of an All-Pakistan Service or of a civil service of the Federation, or who holds a civil post in connection with the affairs of the Federation including any such post connected with defence. By public sector employees, this special section is considering federal and provincial government employees (civil servants) on a salary scale 1 to 22.

gratuity; restricted the role of civil courts to entertain any suit relating to grant of pension; and defined the mode of pension payment and other related rules. Similar practices were also followed in other previously colonized countries in the region, for example India, Bangladesh and Sri Lanka. However, India had introduced the civil service pension reforms in 2004 and adopted the defined contribution schemes for new recruits. The country later increased the coverage of this framework and included private sector workers under a voluntary scheme. In 2009, Maldives also introduced the pension reform process and converted the defined-benefit scheme for civil servants and private sector workers to a contributory defined-benefit scheme (see **Annexure I** for the glossary of technical terms).

In case of Pakistan, these principles were subject to frequent changes, but the underlying model of pensions continued to remain non-contributory with a defined-benefit mechanism. In its current form, the pension structure can be classified as pay-as-you-go (PAYG) under which the government guarantees pensions and other retirement benefits to employees who do not make personal contributions from their salaries.

Currently, the regulatory pension framework is being governed by different acts and regulations including the Pension-cum-gratuity Scheme (1954), the Provisions of Civil Servant Act, 1973, and the Liberalized Pension Rule and Ancillary Instructions, 1977. Moreover, the government issued several notifications and amendments from time to time to revise the pension structure, admissibility of the family members, and rate of commutation and pension scale. The following points sum up the key features:

- The retiring civil servant is entitled to receive periodical pension payments after completing permanent qualifying service (25 to 30 years) in any government department (**Table S1.1**). In some cases, the required service duration and age conditions are relaxed. For instance, when the government discharges an employee due to the abolition of a permanent post, the concerned employee may take 'compensation pension'. Similarly, in case of permanent incapacitation due to physical or mental illness, the civil servant is entitled to receive 'invalid pension'.

- In case of death of an in-service or a retired worker, the eligible family members are authorized to draw pension and allied benefits at the rate of 75 percent of the net pension until marriage or death (more on this later).

- The amount of pension is usually determined by the length of completed years of qualifying service of the concerned employee. Once the employee has completed 25 years of service and/or becomes 60 years of age, he/she can receive a pension amount equivalent to 70 percent of the last pay/emoluments drawn, including special pay and other allowances. The incidence of completing 25 years of service before turning 60 is particularly prominent with regards to BPS 1-16 officers as well as employees in the police departments and the armed forces. In case the qualifying service is greater than 10 years but less than 30 years, the pension is calculated at a prescribed rate according to the length of service.

- The pensioner can also avail commutation option, according to which he/she can avail in advance a maximum of 35 percent

Key Parameters of Civil Service Pension **Table S1.1**

Beginning of Service	The service of an officer begins to qualify for pension from the date s/he takes charge of the office to which s/he is first appointed.
Conditions of Qualification	*First*: The service must be under government *Second*: The employment must be substantive and permanent. *Third*: The service must be paid by Government
Conditions of Grant of Pension	*Compensation pensions*: If a Government servant is selected for discharge owing to the abolition of a permanent post he has the option: i) of taking any compensation pension or gratuity to which he may be entitled for the service he has already rendered, or ii) of accepting another appointment or transfer to another establishment even on a lower pay, if offered, and continuing to count his previous service for pension. A Government servant not employed in a substantive permanent capacity is granted Compensation Gratuity / Pension if he is discharged after completing qualifying service of his post or is replaced by a "qualified" candidate. *Invalid Pension*: Invalid pension is awarded to a Government Servant on his retirement from the public service, who by bodily or mental infirmity is permanently incapacitated for the public service. *Retiring Pension*: A retiring pension is granted to a Government servant who is permitted to retire after completing qualifying service of 25 years. *Superannuating Pension*: A superannuating pension is granted to a Government servant who is entitled or compelled, by rule, to retire at a particular age i.e. 60 years.
Amount of Pensions	The amount of pension that may be granted is determined by length of service
Admissibility of Pension	*Exchange rate*: pension is fixed in Rupees *Gratuity*: After a service of five years or more but less than ten years, a gratuity not exceeding one month's emoluments for each completed year of service. *Pension calculation*: After a service of ten years or more, pension shall be calculated at the rate of 70 percent of average emoluments on completion of thirty years qualifying service in accordance with the prescribed scale. If qualifying service is less than thirty years but not less than ten years, proportionate reduction in percentage shall be made. *Commutation*: Commutation shall be paid according to date of birth. A pensioner shall be allowed to commute up to 35 per cent of the gross pension. *Family pension*: In the case of death of a civil servant while in service, gratuity in lieu of one-fourth of the gross pension shall be allowed at the existing rates. In addition, family pension shall be admissible for life or until remarriage of the widow, at 50 per cent of the gross pension. In the case of death of a pensioner, family pension shall be admissible for life or until remarriage of the widow, at 50 per cent of the pension.
Allowances Reckoned for Pension	The term "**emoluments**" means the emoluments which the officer was receiving immediately before his retirement and shall include pay; Senior Post Allowance; Special Pay of all types and nature; Personal Pay; Technical Pay; Indexed Pay; Increments accrued during leave preparatory to retirement; Any other emoluments. With effect from 01-07-1986, the pension of a civil servant who shall retire on or after this date shall be calculated at the existing rate on last pay/emoluments drawn provided the post has been held by him on a regular basis.
Commutation of Pension	A government servant shall be entitled to commute for a lump sum payment any portion, not exceeding one-half, which has been or may be granted to him under civil rules. In 2015, government had reduced this payment to 35 percent of last drawn salary.

Source: Excerpt from Compendium of Pension Rules and Orders 2018, Finance Division, Government of Pakistan

of gross pension for a number of years according to the commutation table set by the government.[14]

It is important to note that the current framework lacks any form of a sizable fund that could finance the orderly payment of pension expenditures. In countries like Canada, Japan, Korea, and the USA, the government maintains two main categories of public pension reserve funds: (i) the social security reserves mainly financed with employee and/or employer contributions; and (ii) the sovereign pension reserve funds which are financed through government fiscal transfers.

However, in Pakistan, federal and provincial governments instead utilize fiscal revenues to discharge the retirement benefits and pension obligations. The continuity of this practice stands to yield incessant growth in pension expenditure and puts unsustainable pressure on the fiscal accounts, thereby crowding out other development priorities such as education, health, and infrastructure spending.

S1.3 Why is Pension Expenditure Rising in Pakistan in recent years?

There are five major reasons why the pension-related spending in the country is increasing at a worrying pace (as evidenced in (**Figure S1.1c**). These include: (a) ad-hoc and retrospective increments in pensions announced by the government; (b) commutation and restoration facilities offered to pensioners; (c) early retirements; (d) generous survivorship benefits; and (e) resultantly, a high replacement rate. These reasons are presented in detail below:

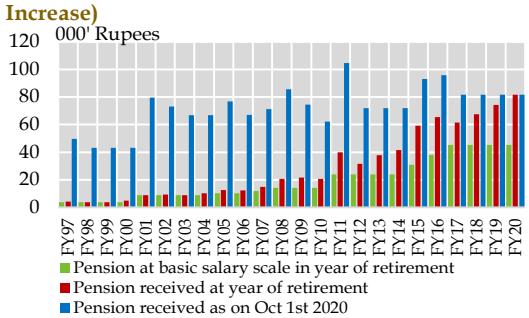
a) Pension benefits are inflated by factoring in ad-hoc and retrospective increments

In most countries, the pension benefits are indexed with consumer prices, workers' wages, or a combination of both. For instance, the UK, Canada, and the EU countries like France and Italy are indexing pension benefits with the CPI, whereas other countries such as Australia, Brazil and Turkey use wages to adjust the pension amounts. The indexation protects the pensioners against loss of purchasing power and gives some degree of predictability to policymakers.

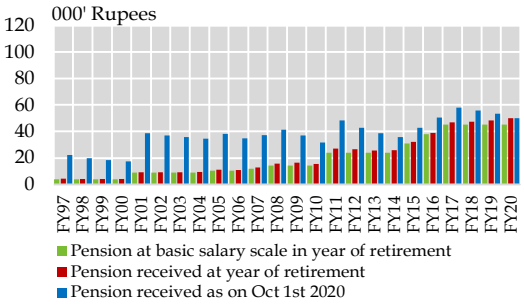
In Pakistan, however, the government uses an unstructured approach to adjust the yearly pension increments and increases the assigned benefits in an ad-hoc manner. Unlike general practice, the guidelines are limited to define the pension structure, commutation, list of eligible beneficiaries and pension procedures. However, these guidelines have largely remained silent on factors such as the indexation procedure, maximum pension limits and potential eligibility of employees (past or future) to receive these benefits. Currently, the rate of pension increment seems independent of any indexation and appears to be overcompensating the pensioners in real terms. For instance, in FY17 and FY18, the pension increment announced by the government was 10 percent in each year, whereas inflation for the same years was only 4.1 and 4.7 percent, respectively. This implies that the pension bill could have been

[14] A lump sum amount to replace certain proportion of future pension. This payment is generally calculated using actuarial methods.

Pension Increment of a Representative of Grade 16 Cohort (Computed with Annual Pension Increase) **Figure S1.5a**



Pension Increment of a Representative of Grade 16 Cohort (if indexed with CPI of respective year) **FigureS1.5b**



Source: Authors' computation based on data of pension increments available on website of Ministry of Finance. For complete calculation see Annexure Tables A1, A2 and A3.

relatively contained had the increments been based on CPI indexation (**Figure S1.5)**; for more detail, see **Table A2 and A3** in **Annexure II.**

Another element that seems unique in the public sector pension structure of Pakistan is that alongside the existing pensioners, future retirees (current employees) are also entitled to enjoy the benefits of contemporaneous pension increments announced by the government. In other words, once an employee retires from civil/public service, she/he will be able to receive all pension benefits, accumulated (due to retrospective increases announced in previous years) on the latest drawn salary. For instance, if an employee retired in FY19, he/she will also receive the increment of 15 percent announced by the government in the year FY12, 7.5 percent in FY16, 10 percent in FY17, 10 percent in FY18 and 10 percent in FY19. Moreover, it is also important to note that even this retrospective increase in future pension is at the discretion of the government; for instance, in some years like FY08 and FY09, the pension increase was only offered to current pensioners without any adjustments for future retirees, whereas in years FY12, FY16, FY17, FY18 and FY19, the equal increment was offered to current and future pensioners. Similarly, the government can also discontinue these rates at any time for future retirees (see **Table A1** in **Annexure II** for details). These ad-hoc adjustments in pension increment provide minimum certainty to future retirees.

b) Commutation and Restoration Facilities Further Distort the Structure

Federal and provincial government employees have the option of availing up to 35 percent of their pensionable amount lump-sum in advance (commutation) either when they retire or sometime later.
The following example will help illustrate the problem. Consider a BPS-16 or a BPS-17 representative retiree with a minimum wage deciding to avail maximum permissible commutation (i.e. 35 percent of gross pension) at the time of retirement at 60 years of age in FY20 (**Table S1.2**). It is pertinent to note that even after availing maximum allowed commutation, the representative pensioner is receiving net monthly pension (item 'J' in **Table S1.2**) higher than the last-drawn salary. This replacement rate

Example of Commutation Availed by Representative BPS-16 and BPS-17 Retirees at age 60 (FY20) **Table S1.2**

Rupees

	BPS-16	BPS-17
A. Last drawn salary	18,910	30,370
B. Current year increment	1,520	2,300
C. Total emoluments (A + B)	20,430	32,670
D. Gross pension (70 percent of C)	14,301	22,869
E. Commuted portion (35 percent of D)	5,005	8,004
F. Net pension (D – E)	9,296	14,865
G. Commutation factor	≈ 12.4	≈ 12.4
H. Total lump-sum payment (G * E * 12)	743,108	1,188,296
I. Retrospective increases applicable in 2020	10,245	16,382
J. Net pension payable (F + I)	19,540	31,247
K. Year of restoration	2,032	2,032

A: Salary drawn during the last month of service.
B: Increment awarded in the last year of service.
C: Total emoluments amount to the last drawn salary plus the current year increment.
D: Retirees are awarded 70 percent of total monthly emoluments as pension.
E: A retiree can avail up to 35 percent of the lifetime pension payment. The representative retiree in this example avails maximum commutation.
F. Net pension is the monthly pension payable after deducting the commutated portion
G. As commutation is based on estimated lifetime pension, a commutation table is used to reach the total amount payable to the retiree. For a retiree at 60 years, commutation period is around 12 years in Pakistan.
H. Total lump-sum commutation paid to a retiree is equal to the monthly commuted value multiplied by the total months applicable (according to the commutation table).
I. All the retrospective increments and medical allowance increase is applied on the net pension after deducting the commuted value.
J. Net pension payable is the monthly value paid to the retiree by the government after the availment of commutation facility and the application of retrospective increments and medical allowance increases.

Source: Authors' calculations using Compendium of Pension Rules and Orders 2018, Ministry of Finance

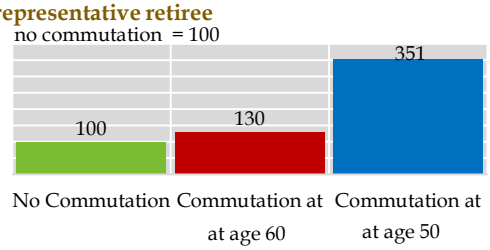
(pension payments as a proportion of last salary) of nearly 100 percent is uniquely generous (more on this later) and thus incentivizes retirees to almost always opt for commutation.

Making commutation further attractive to retirees, these payments are also restored (added back in the monthly pensions) after the time equal to the commutation factor (12 years, in our example) passes. This restoration is inclusive of increments.[15]

As a result, the benefits enjoyed by two fellow retirees can be significantly different if one opts for commutation and the other does not. Likewise, government expenditures, both present and going forward, increase by a much larger portion in case the commutation facility is availed. As illustrated in **Figure S1.6**, the commutation structure and the associated benefits are such that if a government employee takes retirement at the age of 50 and lives till the age of 80, the total compensation will be

[15] While the commutation rate used to be as high as 60 percent at one time in Pakistan, it was eventually reduced and the restoration facility was also removed. As a result, a petition was filed in the Supreme Court on behalf of pensioners. As per the 2015 Supreme Court ruling, the restoration facility was reinstated.

Total Pension Expenditures till age 80 for a 2020 BPS-16 representative retiree **Figure S1.6**



For simplicity, calculations assume a 10 percent annual increase in pension rate throughout the period, the rate equal to the increments available to retirees of last four years.
Source: authors' calculations using KPK government pension calculator and Compendium of Pension Rules and Orders 2018, Ministry of Finance.

more than three-times the compensation of a retiree who does not avail commutation at all. Compared to a government employee who retires at the age of 60 and avails commutation, the overall compensation will be around 2.7 times. This makes a strong case for government employees to opt for an early retirement, avail commutation and maximize their overall compensation. More details are presented in the following point.

c) *Early retirements are increasingly being preferred*

Over the past few years, government employees have been retiring early in large numbers. For the latter two, the terms of service is different For example, as of January 2019, the month for which the latest data is available, more than 60 percent of all new retirees in Punjab were below the age of sixty, and the ratio was 67 percent for employees retiring from grade 16 and lower.

Early retirements are rising due to three major reasons:

(i) The retrospective increase in pensions of future retirees and their abrupt withdrawal make the future income stream uncertain for in-service employees. For instance, a representative Grade-16 employee who retires at superannuation in 2020 is entitled to receive 158 percent of their last gross pay. However, if the same employee retires at age 55 or 50 (in 2010 or 2015), the pension would have been more than 200 percent of the last drawn salary as on 2020 (**Table S1.3**). Compatible results are found in the case of a representative Grade-17 employee.

(ii) Given that the pension payments are inequitable for superannuation retirees, and that the structure allows retirees to draw pensions higher than their salaries, the current employees favor early retirement to maximize their future pension benefits. This is because they are likely to receive pension benefits for a longer period compared to the early retirees. As shown in the **Figure S1.7**, the replacement rate (pension payments as a percent of last drawn salary) started consistently crossing the 100 percent level after around FY12, which coincides with the rapid rise in the annual proportion of early retirees *after* that period.

(iii) The existing pension scheme equally treats the retirees attaining the age of 60 or completing 30 years of services, assuming the employee joins the public service at 30 years of age.[16] The rules penalize early withdrawal i.e., before serving 30 years by reducing a share of post-retirement benefits. However, they remain silent in the case of an employee joining the service at 20 years and planning retirement at age 60. In such cases, the 10

[16] Source: OECD (2011), "Pensions at a Glance 2011, Retirement-Income Systems in OECD and G20 Countries", OECD.

Pension Computation for Representative Pensioners Retired in Grade 16 and Grade 17 at Different Retirement Ages (without commutation) **Table S1.3**

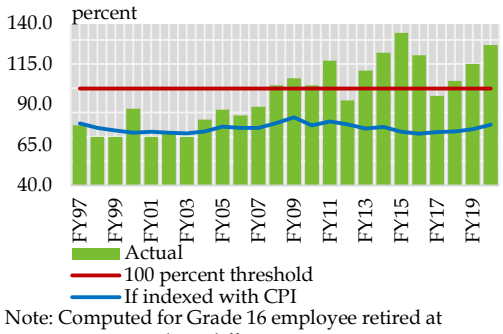
Rupees

	Grade 16 employee			Grade 17 employee		
Date of Retirement	1-Oct-20	1-Oct-15	1-Oct-10	1-Oct-20	1-Oct-15	1-Oct-10
Age at Retirement	60 y	55 y	50 y	60 y	55 y	50 y
Length of Service	35 y	30 y	25 y	35 y	30 y	25 y
A. Basic Pay @ minimum scale	18,910	12,910	6,060	30,370	20,680	9,850
B. Retiring Year Increment	1,520	1,035	0	2,300	1,555	0
C. Total Emoluments (A +B)	20,430	13,945	6,060	32,670	22,235	9,850
D. Gross Pension (as percent of C)	14,301	9,762	3,535	22,869	15,565	5,746
E. Net Pension (=D as no commutation)	14,301	9,762	3,535	22,869	15,565	5,7456
F. Retrospective Increases						
i. 15% increase of 2010	0	1,464	530	0	2,335	862
ii. 15% increase of 2011	2,145	1,684	610	0	2,058	912
iii. 20% increase of 2012	0	0	935	0	2,264	1,003
iv. 10% increase of 2013	0	1,291	561	1,972	1,868	828
v. 10% increase of 2014	0	1,420	617	2,827	2,678	1,186
vi. 7.5% increase of 2015	1,233	1,172	509	3,110	2,945	1,305
vii. 10% increase of 2016	1,768	1,679	730	3,421	3,240	1,435
viii. 10% increase of 2017	1,945	1,847	803	0	2,058	912
ix. 10% increase of 2018	2,139	2,032	883	0	2,264	1,003
x. Minimum Pension Payable Rs.			10000			
xi. 10% increase of 2019	2,353	2,235	1,000	3,762	3,564	1,579
xii. 20% Medical Allowance of 2010	2,860	2,245	813	4,574	3,580	1,322
xiii. 25% increase on Medical Allowance	715	561	203	1,143	894	330
G. Net Pension Payable (Without commutation) (E + F)	**29,460**	**27,392**	**12,016**	**47,110**	**43,676**	**19,018**
H. Pension as % of basic pay (Replacement Rate) (G/A*100)	156	212	198	155	212	193

Note: The representative pensioner was born on 1st Oct 1960, and the appointment date was 1st Oct 1985.

Source: Authors' calculations based on pension increase circulars available on the website of Ministry of Finance. The calculation has also been validated using the Pension calculator available on the website of the Government of KP.

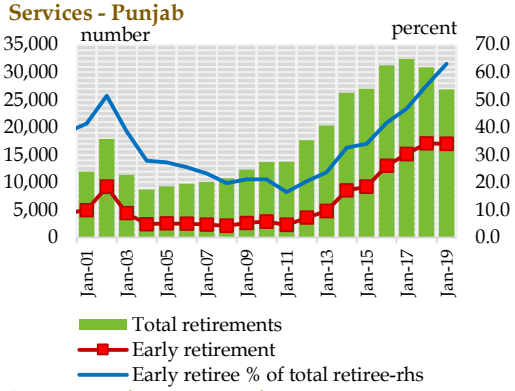
Actual Gross Replacement Rate (with Annual Pension Increase) **Figure S1.7a**



Note: Computed for Grade 16 employee retired at maximum pay scale in different years

Source: Authors' calculations; Ministry of Finance

Retirement Trend in Civil Services - Punjab **Figure S1.7b**



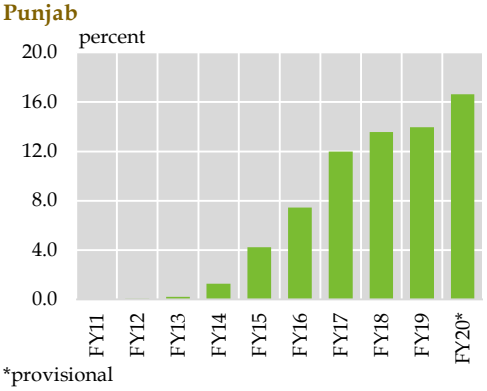
Source: Punjab Pension Fund

additional years of service would not earn extra benefits for the employee. The zero marginal benefits after 30 service years, hence, encourages early retirements in employees joined at relatively younger age and cause an increase in the fiscal cost.

d) Survivorship regulations are also generous

The pension rules allow eligible family members to draw survivorship benefits (70 percent of the existing pension) in case of death of a present employee or a retiree. Fiscal authorities have been facing a growing size of survivorship benefits during the last ten years. For instance, in Punjab, family pension has increased from Rs 3.5 million in FY11 to Rs 28.6 billion in FY19 (**Figure S1.8**). Similarly, in Sindh, the survivor payment had reached Rs. 16.7 billion in FY18. In the absence of a time series data on life expectancy of retirees, plausible factors that explain the higher liabilities in terms of survivorship benefits are: (i) increased rate of family pension benefits from 50 percent of the worker's pension benefit entitlement to 75 percent in 2009; and (ii) the extension in family pension tree and lifelong entitlement to elder widow/divorcee daughter. Specifically, eleven family members at present are legally entitled to receive the survivorship benefits including surviving widow/widows, minor son (up to the age of 21), unmarried/ divorcee/widowed daughter (till her marriage), special children (till their death), surviving unmarried sister, eldest widow of deceased son, eldest surviving grandson, eldest surviving granddaughter, mother, father, widowed/divorcee sister and minor brother. The inclusion of multigenerational family

Family Pension Expenditures in Punjab **Figure S1.8**

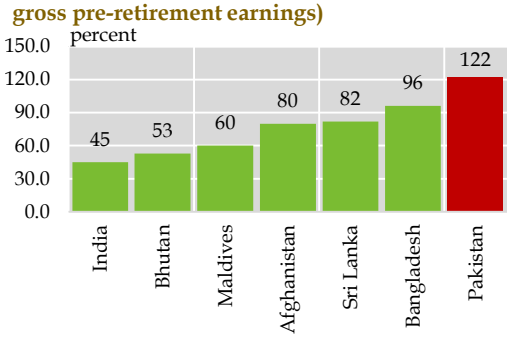


*provisional

Source: Punjab Pension Funds

members multiplies the average duration of pension benefits from 12 years (in case of pension to retiring employee) to 45 years and beyond (depending upon the age structures of survivors).

Gross Pension Replacement Rate for Civil Servants (gross pension entitlement divided by gross pre-retirement earnings) **Figure S1.9**



Source: World Bank(2020), full reference in footnote 11

In contrast, the survivorship benefits in the OECD and other developed countries are generally limited to widows (for a certain number of years) and to minor children, with no entitlement to a pensioner's father, mother, adult daughters, sister, brother or grandson etc.[17]

The current pension tree in Pakistani regulations would be financially unsustainable even in case of a funded structure since the duration of pension withdrawal exceeds service years of a particular employee. Moreover, the entitlement of multigenerational members makes the pension calculation and evaluation a cumbersome task for the authorities.

e) All this makes the replacement rate in the country one of the highest in the world

The retirement/pension benefit acts as a guaranteed income to civil/public servants and offers a provision of income security in their retirement period. The proportion of average/last drawn salary a pensioner receives determines the replacement rate (expenditures on pension as a proportion to the expenditures on the pensioner's last drawn emoluments); a higher replacement rate is beneficial to the retiree but at the same time proves costly to the employer. As per the pension rules, government employees in Pakistan are entitled to receive a replacement rate of 70 percent of their last drawn salary.[18] However, medical and other allowances, coupled with the retrospective increases in pension rates, generous commutation factors, and the possibility of restoration of the commuted amount, all make the replacement rate in the public sector the highest in the South Asian region, averaging 122 percent (**Figure S1.9**). For some pay scales, the rate can go even higher. For example, gross replacement rate for a representative grade 16 employee (retiring at 60 years of age) after completing 35 years of service in year 2020 effectively turns out to be 156 percent. This ratio would further increase in case of early retirements (**Table S1.3).**

In addition to being high, the replacement rate varies largely and retirees in different cadres or even in same service groups are entitled to get different proportion of their

[17] For more details, see OECD (2019). *Pensions at a Glance Asia/Pacific 2018*. Paris: OECD.
[18] This rate applies for those who either complete 25 years of service or retire at the age of sixty. If qualifying service is less than thirty years but not less than ten years, proportionate reduction in percentage shall be made

last drawn salary. This income disparity surfaces due to the existing method of pension calculation which incorporates two factors i.e., employee's last drawn salary, and including service allowances and length of qualifying service. Often, employees having equivalent level of age profile and service history receive diverse replacement rates due to differences in their last drawn salaries, assigned allowances (such as special pay, personal pay, technical pay and senior post allowance etc.) and pension/wage adjustments in certain years. It is also important to mention that as the government has to recruit another officer in place of a retiree, it has to in effect pay more than double the salary of the post to continue the current level of work.

S1.4 Policy Reforms

Traditionally, the government service pension reforms fall in two categories (i) *parametric reforms*, also known as short-term reforms since these include "adjustments of the structural characteristics of the pension system, such as the contribution rate, retirement ages, or pension benefit indexation formulas, possibly combined with building up financial reserves" (Chand and Jaeger, 1997);[19] and (ii) s*ystemic reforms,* or the long-term reforms since these involve "developing a significant, defined-contribution, fully funded pillar inside or outside the existing public pension scheme in the long run". For Pakistan also, both kinds of reforms are needed.

A. Parametric Reforms

In the present PAYG system of Pakistan, the pension obligations are made when they come due.[20] With limited fiscal space, Pakistan may not afford the immediate switching from PAYG to a funded system, since the latter will require the government to make exclusive contributions along with the existing pension payments. Instead, parametric reforms may be introduced initially to rationalize the cost and incentive structure of pension system and improve the fiscal sustainability of future expenses. Later, the government could consider adopting the comprehensive framework of funded pension system. The following are some parametric reforms that helped in addressing pension related challenges in a number of countries including India, Chile, and the UK, and may also prove helpful in the case of Pakistan.

a. Ceiling and price indexation measures would help reduce the excessively high replacement rate

The current pension structure defines the minimum pension limit, which has been revised quite frequently in the last ten years. However, the system does not enforce any ceilings for maximum pension benefits and thus the gross replacement rate has exceeded the 100 percent level in the country.[21] To

[19] Chand, S. K. and A. Jaeger, 1997. *Ageing Populations and Public Pension Schemes*. IMF Occasional Papers No. 147. Washington, DC: International Monetary Fund.
[20] On the contrary, a funded system relies on invested assets and accumulated reserves where the returns can sufficiently meet the current and future pension obligations.
[21] In India, for example, the maximum pension limit is INR 125,000 per month, which is half of the highest salary in government of India (Source: Pension Portal Government of India).

rationalize the replacement rate, the government can reinforce ceilings on pensionable earnings as imposed in many countries including the US, Canada, India, Hong Kong, Japan, Germany, and Italy etc.[22] This would also have the effect of making the pension benefits equitable among the different retirees.

Likewise, the government could start the practice of indexation of pension benefits to the general price level (such as that indicated by the consumer price index, for example). This would offer two major advantages: i) it would protect the beneficiaries against loss of purchasing power; and ii) it would considerably reduce the fiscal cost of increasing pension payments on ad-hoc basis. The price indexation also improves the predictability of future burden of public pension expenditures.

Moreover, the benchmark earning used to measure the pension benefits can be altered from last-drawn salary to the average of lifetime earnings (total accumulated earnings since joining divided by total months of service). Countries such as China, Indonesia and Viet Nam, for example, use lifetime earnings to calculate pension benefits, whereas the Philippines uses the average of final five-year earnings.

b. Elimination of retrospective increases is a must to avoid exponential rise in future obligation

The retrospective increases in pension of future retirees seem to be a unique feature of the government service pension scheme in Pakistan.[23] The eligibility of future retirees for current pension rise not only creates distortions in the existing framework but also makes retiring benefits inequitable among different cohorts. Since these retrospective increments are computed on final salary, the financial impact compounds in favor of future retiree. However, for fiscal authorities, this generates a huge liability. The impact is so significant that only the elimination of these back dated pension increases would go a long way in bringing the gross replacement rate from current rate of 156 percent to a much more manageable 88 percent.[24]

c. The government may also consider increasing the retiring age and/or contributory years

As stated earlier, the pension system follows two eligibility criteria for retirement: the qualifying service of 25 years and the threshold of 60 years of age. Interestingly, most of the employees in federal, provincial and defense service join their departments in early- to mid-twenties, and complete 25 years of services during their early- to mid-50s and therefore become eligible for early retirement. It is pertinent to mention here

[22] For more details, see OECD (2019).
[23] Various annual publications of the OECD (*Pension at Glance*), the World Bank, official government documents, official pension websites and calculators of different countries, and theoretical and empirical papers were reviewed; however, we did not find evidence of the presence of a structure similar to Pakistan (with regards to retrospective increases) in other countries.
[24] This has been calculated for Grade 16 employee, assuming retired at 60 years of age in 2020, and receiving a minimum monthly pay of Rs 18,910, and availing zero commutation.

that the retirement age of 60 years is already markedly lower than many other countries, and so the early withdrawal after completion of qualifying service puts further strain on fiscal sustainability of pension expenses. In this regard, the increase in level of standard pension age may reduce the average coverage period of retirement benefits. In addition, the delayed retirement age will support in increasing the contribution period once the government opts for a funded system in the subsequent round of reforms. The government can use one or multiple approaches to reduce the early retirement incentives. For instance, measures such as restricting early retirement eligibility, reducing the marginal benefits below a threshold retirement age, and marginalizing the disincentive to work can all help achieve this objective.[25]

d. The survivorship benefits need to be considerably rationalized

In contrast, rise in family pension due to increased applicable benefits and inclusion of large set of family members has become a major cause of concern in Pakistan (For the calculation of family pension please see **Table A4** in **Annexure II**). To address this, the first and foremost reform should be to exclude all family members other than minor children and widows from the list of eligible survivorship beneficiaries. Any delay in such reform will cause family pension to grow manifold in the coming years due to the probable increase in time span of pension benefits in each individual case.

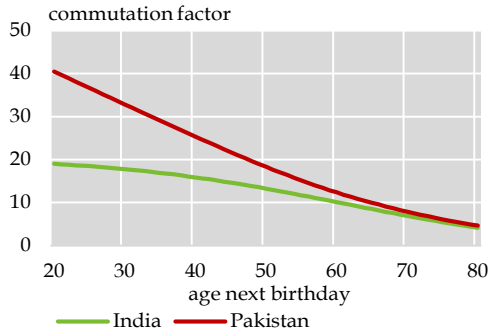
In the case of widows, the survivorship benefits can be rationalized in accordance with the increasing labor force participation rates of women. In the last few years, many countries have downsized the survivorship benefits by limiting the adjustment period or by eliminating the mandatory benefits for survivors. For instance, in Japan, widows (with no children) under the age of 30 were entitled to receive permanent earnings-related survivor pension, which were reduced to five years after comprehensive pension reforms in 2007. Similarly, in Sweden, widows were entitled to receive the flat survivorship benefit, which after reforms was switched by the minimum income guarantee, eligible for a shorter period than the earlier facility.[26]

e. Commutation and restoration benefits must be streamlined

The computation of commuted benefits involves a particular factor assigned to each year after retirement which determines the advance payment amount for each retiree. The commutation table laid out by the Ministry of Finance incentivizes early retirement with excessively high commutation factor applied to the younger cohort. This is in stark contrast to the traditional pattern followed in most other countries. For example, in the UK, the commutation facility is only offered to retirees after attaining a certain age for different employee groups (48 years in the police department, for example). Whereas, the Indian pension structure offers minimal variance in commutation factor to different age groups (**Figure S1.10**). The growing fiscal burden due to high commutation expenses calls for a restructuring of the commutation mechanism, with rationally

[25] Jackson, R. (2002). *The Global Retirement Crisis: The Threat to World Stability and what to Do about It*. Washington, DC: Center for Strategic and International Studies.
[26] OECD (2018). "Are Survivor Pensions Still Needed?". In *Pensions Outlook 2018*. Paris: OECD.

Commutation Factor at Different Retirement Age **Figure S1.10**



Source: Finance Division Pakistan and Indian Pensioners' Portal

designed factors and revision in eligible age profile to make the overall pension structure actuarially fair: the lifetime benefits enjoyed by those who retire early or choose to avail commutation and those who opt out of such facilities.

B. Systemic Reforms

Once the features of current pension structure are successfully streamlined through sufficient parametric restructuring, the next step would be the adoption of a comprehensive systemic reform to ensure fiscal sustainability of pension liabilities in the long-run. In this process, the current non-contributed, defined-benefit and pay-as-you-go pension scheme would need to be gradually phased out and replaced with a contributory and funded structure in which the benefits are closely linked with the value of pre-retirement contributions. In recent decades, many countries in the EU, Latin America and Asia have adopted various systemic reforms focused on reducing the public pension expenditure by switching to pre-funded-defined contribution schemes.[27] Due to the systemic reforms a number of EU countries including Bulgaria, Estonia, Lithuania, Latvia, and Sweden etc. experienced a downward projection in future pension expenditures, with survivorship benefits also projected to decline.[28]

S1.5 Concluding Remarks

This special section has made the case that public pension expenditure in Pakistan is on the path to becoming unsustainable. While limited fiscal space is a major reason why increasing pension spending is worrisome, improvements in the pension framework can substantially help make future payments manageable. Eliminating the generous retrospective increments and reducing the list of dependents eligible for pension payments appear as quick and easy-to-implement measures. However, the policy recommendations mentioned in the special section are intended to suggest a general direction. The concerned authorities must carry out specialized evaluation exercises at their own end and implement the required legislative reforms accordingly. Finally, it is important to undertake periodic review of implemented reforms in order to ensure long-term sustainability of the pension structure.

[27] Source: Anderson, K.M. (2019). Financialization Meets Collectivisation: Occupational Pensions in Denmark, the Netherlands and Sweden. *Journal of European Public Policy* 26:4, 617-636.
[28] Source: Banca d'Italia (2009). *Pension Reform, Fiscal Policy and Economic Performance*. Banca d'Italia workshop paper.

Annexure I: Glossary of Technical Terms

This glossary provides definitions of the key technical terms used in the Special Section. The objective is to make the findings of the section more accessible to the general reader.

Actuarial Fairness: If a pensions structure is actuarially fair, then the lifetime benefits availed by two fellow retirees would be equal regardless of the time and amount of commutation or restoration facility Actuarial Fairness availed (or not availed) by each.

Beneficiary: Any individual who is entitled to a facility (including the dependents).

Commutation: Facility of receiving a certain portion of future payments lump-sum in advance. In Pakistan, pensioners can commute up to 35 percent of their gross pension.

Commutation Factor: The factor calculated to determine the amount of pension that needs to forgone in order to receive the lump-sum advance commutation. For example, a commutation factor of around 12 is applied for a person commuting at age 60 in Pakistan.

Contributory Pension Plan: A pension plan where the employer (or the government), the employee, or both have to contribute during the service period in order to receive pension payments.

Defined Benefit Scheme: A pension scheme in which the employer guarantees future pensions based on a prescribed formula.

Emoluments: The total of gross salary plus current year's increment and job-related special allowances.

Gross Pension: Amount equal to a certain percentage of last-drawn or average wages. In Pakistan, gross pension in the public sector amounts to 70 percent of the last-drawn emoluments. This rate applies for those who either complete 25 years of service or retire at the age of sixty. If qualifying service is less than thirty years but not less than ten years, proportionate reduction in percentage shall be made.

Indexation: When pension payments are subject to incremental changes based on an index (for example, the country's consumer price index).

Net Pension: Gross pension after deducting the commutable portion (up to 35 percent) of the pension.

Non-Contributory Scheme: A pension scheme in which employees do not have to contribute during their service period in order to receive pension benefits when they retire.

Replacement Rate: Pension payments as a proportion of the last-drawn (or average) emoluments.

Restoration: After a certain period, the commuted amount is restored (added back) in the monthly pension payments of a retiree. For example, the restoration period in

Pakistan for an individual who retires at age 60 is around 12 years.

Survivorship Benefit: Pension payments provided to select surviving dependents of a deceased pensioner.

Voluntary Contributions (Scheme): A scheme in which an extra contribution is made in addition to the compulsory contribution in order to increase the future pension benefits.

Annexure II: Actual and Representative Increases in Public Sector Pensions in Pakistan

Table A1 shows the actual annual rate of increase in public sector pensions in Pakistan, with last two columns indicating the cumulative rise for representative retirees from Grade 1 to 16 and for those from Grade 17 and above.

Table A2, meanwhile, shows the monthly pension payment of a representative Grade 16 retiree after applying the compound increases shown in **Table A1**, assuming that the representative person retired with maximum PayScale salary. The table clearly shows the significant impact of retrospective additions to the pensions. For a representative person retiring in FY11, for example, the initial pension was around 38,000, which then reached to around Rs 105,000 by FY20. By contrast, the representative worker's last drawn salary was around Rs 28,000.

Last, **Table A3** illustrates a representative scenario in which, instead of the actual pension increases, the pensions rose by the rate of the change in the country's consumer price index. The difference comes out significant: for a representative employee retiring in FY11, for instance, the gross pension would have risen from around Rs 27,000 to around Rs 45,000, much lower than both the starting and the ending points in **Table A2**.

The blue shaded cells indicate the year of retirement, the green shaded cells indicate the annual increases in pension after the retirement year, and gold shaded cells indicate past pension increases that are retrospectively fed into the final gross payments at the end of the year the representative person is retiring. The red D indicates the end of availability of a specific past pension increase for future retirees. All the increases are compounded when calculating the gross pension expenditure.

Table A4 provides computation of family pension for representative BPS-16 and BPS-17 employees retiring at different age.

Matrix Showing Rate of Increase in Public Pension (Federal) from FY1997 to FY2020

Table A1

Cumulative increase

Year of retirement	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	(Grade 1 to 16)	(Grade 17 above)
FY97	10	0	0	25 & 20*	0	5	0	15	8	10	15	20	20	20	20	20	20	10	10	7.5	10	10	10	10	275.5	260.5
FY98	0	0	0	25 & 20*	0	5	0	15	8	10	15	15	20	20	20	20	20	10	10	7.5	10	10	10	10	260.5	255.5
FY99	0	0	0	25 & 20*	0	5	0	15	8	10	15	15	20	20	20	20	20	10	10	7.5	10	10	10	10	260.5	255.5
FY00	0	0	0	25 & 20*	0	5	0	15	8	10	15	15	20	20	20	20	20	10	10	7.5	10	10	10	10	260.5	255.5
FY01	0	0	0	0	0	5	0	15	8	10	15	15	20	20	20	20	20	10	10	7.5	10	10	10	10	235.5	235.5
FY02	0	0	0	0	0	5	0	15	8	10	15	15	20	15	15	20	20	10	10	7.5	10	10	10	10	225.5	225.5
FY03	0	0	0	0	0	0	0	15	8	10	15	15	20	15	15	15	20	10	10	7.5	10	10	10	10	215.5	215.5
FY04	0	0	0	0	0	0	0	15	8	10	15	15	20	15	15	15	20	10	10	7.5	10	10	10	10	215.5	215.5
FY05	0	0	0	0	0	0	0	15	8	10	15	15	20	15	15	15	20	10	10	7.5	10	10	10	10	215.5	215.5
FY06	0	0	0	0	0	0	0	D	8	10	15	15	20	15	15	15	20	10	10	7.5	10	10	10	10	200.5	200.5
FY07	0	0	0	0	0	0	0	0	D	10	15	15	20	15	15	15	20	10	10	7.5	10	10	10	10	192.5	192.5
FY08	0	0	0	0	0	0	0	0	0	10	15	15	20	15	15	15	20	10	10	7.5	10	10	10	10	192.5	192.5
FY09	0	0	0	0	0	0	0	0	0	10	15	0	20	15	15	15	20	10	10	7.5	10	10	10	10	177.5	177.5
FY10	0	0	0	0	0	0	0	0	0	10	15	0	0	15	15	15	20	10	10	7.5	10	10	10	10	157.5	157.5
FY11	0	0	0	0	0	0	0	0	0	10	15	0	0	15	15	15	20	10	10	7.5	10	10	10	10	157.5	157.5
FY12	0	0	0	0	0	0	0	0	0	D	D	D	D	D	15	15	20	10	10	7.5	10	10	10	10	117.5	117.5
FY13	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	15	20	10	10	7.5	10	10	10	10	117.5	117.5
FY14	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	15	20	10	10	7.5	10	10	10	10	117.5	117.5
FY15	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	15	20	10	10	7.5	10	10	10	10	117.5	117.5
FY16	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	15	D	10	10	7.5	10	10	10	10	97.5	97.5
FY17	0	0	0	0	0	0	0	0	0	0	0	0	0	0	D	15	0	D	D	7.5	10	10	10	10	62.5	62.5
FY18	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	0	0	0	7.5	10	10	10	10	62.5	62.5
FY19	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	0	0	0	7.5	10	10	10	10	62.5	62.5
FY20	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	15	0	0	0	7.5	10	10	10	10	62.5	62.5

*25 percent rise for Grades 1-16; 20 percent for Grades 17 and above; D means discontinued (through notification)

Matrix Showing Pension Increments for a Representative Grade 16 Employee (Computed with Annual Pension Increase) **Table A2**

thousand Rupees

Year of retirement	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Pension	3.8	3.8	3.8	3.8	8.9	8.9	8.9	8.9	10	10	12	14	14	14	24	24	24	24	31	38	45	45	45	45
FY97	4.2	4.2	4.2	5.3	5.3	5.5	5.5	6.4	6.9	7.6	8.7	11	13	15	18	22	26	29	32	34	37	41	45	50
FY98		3.8	3.8	4.8	4.8	5	5	5.8	6.3	6.9	7.9	9.1	11	13	16	19	23	25	27	30	32	36	36	43
FY99			3.8	4.8	4.8	5	5	5.8	6.3	6.9	7.9	9.1	11	13	16	19	23	25	27	30	32	36	36	43
FY00				4.8	4.8	5	5	5.8	6.3	6.9	7.9	9.1	11	13	16	19	23	25	27	30	32	36	36	43
FY01					8..9	9.3	9.3	11	12	13	15	17	20	24	29	35	42	46	51	54	60	66	72	80
FY02						9.3	9.3	11	12	13	15	17	20	23	27	32	38	42	47	50	55	60	67	73
FY03							8.9	10	11	12	14	16	19	22	25	29	35	39	42	46	50	55	61	67
FY04								10	11	12	14	16	19	22	25	29	35	39	42	46	50	55	61	67
FY05									13	14	16	18	22	25	29	34	40	44	49	53	58	64	70	77
FY06										12	14	16	19	22	25	29	35	39	43	46	50	55	61	67
FY07											15	17	21	24	27	31	37	41	45	49	53	59	65	71
FY08												21	25	28	33	38	45	50	54	59	64	71	78	86
FY09													21	25	28	33	39	43	47	51	56	62	68	75
FY10														21	24	27	33	36	39	42	47	51	56	62
FY11															40	46	55	60	67	72	79	87	95	105
FY12																32	38	42	46	49	54	59	65	72
FY13																	38	42	46	49	54	59	65	72
FY14																		42	46	49	54	59	65	72
FY15																			59	64	70	77	85	93
FY16																				65	72	79	87	96
FY17																					61	68	74	82
FY18																						68	74	82
FY19																							74	82
FY20																								82

Matrix Showing Pension Increments for a Representative Grade 16 Employee (If indexed with respective yearly CPI-Inflation) **Table A3**

thousand Rupees

Year of retirement	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
Pension	3.8	3.8	3.8	3.8	8.9	8.9	8.9	8.9	10.2	10.2	11.7	14.1	14.1	14.1	23.8	23.8	23.8	23.8	30.8	38	45.2	45.2	45.2	45.2
CPI YoY	11.8	7.8	5.7	3.6	4.4	3.5	3.1	4.6	9.3	7.9	7.8	12	17	10.1	13.7	11	7.4	8.6	4.5	2.9	4.1	4.7	6.8	10.7
FY97	4.3	4.6	4.9	5.1	5.3	5.5	5.7	5.9	6.5	7	7.5	8.4	9.8	10.8	12.3	13.7	14.7	16	16.7	17.2	17.9	18.7	20	22.1
FY98		4.1	4.4	4.5	4.7	4.9	5.1	5.3	5.8	6.2	6.7	7.5	8.8	9.7	11	12.2	13.1	14.3	14.9	15.3	16	16.7	17.9	19.8
FY99			4.1	4.2	4.4	4.6	4.7	4.9	5.4	5.8	6.2	7	8.2	9	10.2	11.4	12.2	13.2	13.8	14.2	14.8	15.5	16.6	18.3
FY00				4	4.2	4.3	4.4	4.6	5.1	5.5	5.9	6.6	7.7	8.5	9.7	10.7	11.5	12.5	13.1	13.5	14	14.7	15.7	17.4
FY01					9.2	9.6	9.9	10.3	11.3	12.2	13.1	14.7	17.2	18.9	21.5	23.9	25.7	27.9	29.1	30	31.2	32.7	34.9	38.6
FY02						9.2	9.5	9.9	10.8	11.7	12.6	14.1	16.5	18.1	20.6	22.9	24.6	26.7	27.9	28.7	29.9	31.3	33.4	37
FY03							9.1	9.6	10.4	11.3	12.1	13.6	15.9	17.5	19.9	22.1	23.7	25.8	26.9	27.7	28.9	30.2	32.3	35.7
FY04								9.3	10.1	10.9	11.8	13.2	15.4	17	19.4	21.4	23	25	26.1	26.9	28	29.3	31.3	34.7
FY05									11.1	12	13	14.5	17	18.7	21.3	23.6	25.3	27.5	28.8	29.6	30.8	32.3	34.5	38.2
FY06										11	11.9	13.3	15.6	17.1	19.5	21.6	23.2	25.5	26.3	27.1	28.2	29.5	31.5	34.9
FY07											12.6	14.2	16.6	18.2	20.7	23	24.7	26.8	28	28.8	30	31.5	33.6	37.2
FY08												15.8	18.5	20.4	23.1	25.7	27.6	30	31.3	32.2	33.6	35.1	37.5	41.5
FY09													16.5	18.2	20.7	22.9	24.6	26.8	28	28.8	30	31.4	33.5	37.1
FY10														15.5	17.7	19.6	21	22.9	23.9	24.6	25.6	26.8	28.6	31.7
FY11															27.1	30	32.2	35	36.6	37.7	39.2	41.1	43.8	48.5
FY12																26.4	28.4	30.8	32.2	33.1	34.5	36.1	38.6	42.7
FY13																	25.6	27.8	29	29.8	31.1	32.5	34.8	38.5
FY14																		25.9	27	27.8	28.9	30.3	32.4	35.8
FY15																			32.2	33.1	34.5	36.1	38.5	42.7
FY16																				39.1	40.7	42.6	45.5	50.4
FY17																					47	49.2	52.6	58.2
FY18																						47.3	50.5	55.9
FY19																							48.2	53.4
FY20																								50

Pension Computation for Family of Representative Pensioners Retired in Grade 16 and Grade 17 **Annexure Table A 4**

		Grade -16 employee			Grade -17 employee		
	Date of retirement	1-Oct-20	1-Oct-15	1-Oct-10	1-Oct-20	1-Oct-15	1-Oct-10
	Age at retirement and death	60 y	55 y	50 y	60 y	55 y	50 y
	Length service	35 y	30 y	25 y	35 y	30	25 y
A.	Basic pay @ minimum scale	18,910	12,910	6,060	30,370	20,680	9,850
B.	Retiring year increment	1,520	1,035	0	2,300	1,555	0
C.	Total emoluments (A+B)	20,430	13,945	6,060	32,670	22,235	9,850
D.	Gross pension (70 percent of C)	14,301	9,762	3,535	22,869	15,564	5,746
E.	Family pension w.e.f date of death (75 percent of D)	10,726	7,321	2,651	17,152	11,673	4,309
F.	Retrospective Increments						
I	15% increase of 2010	0	1,098	398	0	1,751	646
II	15% increase of 2011	1,609	1,263	457	2,573	2,014	743
III	20% increase of 2012	0	0	701	0	0	1,140
IV	10% increase of 2013	0	968	421	0	1,544	684
V	10% increase of 2014	0	1,065	463	0	1,698	752
VI	7.5% increase of 2015	925	879	382	1,479	1,401	620
VII	10% increase of 2016	1,326	1,259	547	2,120	2,008	890
VIII	10% increase of 2017	1,459	1,385	602	2,332	2,209	979
IX	10% increase of 2018	1,604	1,524	662	2,566	2,430	1,076
X	Minimum pension payable Rs.			7,500			
XI	10% increase of 2019	1,765	1,676	750	2,822	2,673	1,184
XII	20% Medical allowance of 2010	2,145	1,684	610	3,430	2,684	991
XIII	25% increase on medical allowance	536	421	152	858	671	248
G.	**Net pension payable (without commutation) (E + F)**	**22,095**	**20,544**	**9,012**	**35,332**	**32,757**	**14,263**
H.	**Pension as % of basic pay (replacement rate) (G/A*100)**	**117**	**159**	**149**	**116**	**158**	**144**

Note: The representative employee was born on 1st Oct 1960 and was appointed on 1st Oct 1985.

Source: Authors' calculations based on pension increase circulars available on the website of Ministry of Finance. The calculation has also been validated using the Pension calculator available on the website of the Government of KPK.

Annexure: Data Explanatory Notes

1) **GDP:** In case of an ongoing year, for which actual GDP data is yet not available, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI (national, urban, or rural) from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation } (\pi_{Ht}) = \left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation } (\pi_{YoYt}) = \left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation } (\pi_{MoMt}) = \left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where I_t is consumer price index in t^{th} month of a year. The CPI can be national, urban or rural.
For detailed information on the methodology, please see:
http://www.pbs.gov.pk/content/methodology-2

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of gross public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing, whereas financing is calculated by adjusting the government borrowing with its deposits held with the banking system; (ii) changes in the stock of debt also occur due to movements in exchange rates, both PKR and other currencies against US Dollar, which affect the rupee value of external debt.

4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). Ways and Means Advance allows government to borrow up to Rs 100 million at a time in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir (AJK) may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum. However, the Federal Government has taken over from the State Bank of Pakistan (SBP) the business of direct credit to provincial governments on 29th June 2020. In this regard, the federal government has executed tripartite agreements with four provincial governments and SBP (as executer) for extension of Ways and Means loans on account of Federal Government Central Account No.I (non-food) on 29th June 2020.

Borrowing from scheduled banks: This is mainly through (i) fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs); (ii) monthly auction of 3, 5, 10, 15, 20 and 30 year fixed rate Pakistan Investment Bonds (PIBs); (iii) fortnightly auctions of 3, 5, 10 year floating rate PIBs; (iv) Sukuk and (v) Bai Muajjal of Sukuk (on deferred payment basis). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

(a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

(b) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on banking data, which depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record).

List of Acronyms

A

ADB	Asian Development Bank
AEO	Authorized Economic Operators
AIIB	Asian Infrastructure Investment Bank
AJK	Azad Jammu and Kashmir
AMIS	Agriculture Marketing Information Service
AML	Anti-Money Laundering
APCMA	All Pakistan Cement Manufacturers Association
ATM	Automatic Teller Machine

B

bbl	Barrel
BBO	Branchless Banking Operators
BCI	Business Confidence Index
BCS	Business Confidence Survey
BEOE	Bureau of Emigration and Overseas Employment
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BOI	Board of Investment
BoP	Balance of Payments
Bps	Basis points
BPR	Bahawalpur
BPS	Basic Pay Scale
BRTS	Bus Rapid Transit System
BSC	Behbood Savings Certificate

C

CAA	Civil Aviation Authority
CAB	Current Account Balance
CAD	Current Account Deficit
CAGR	Compound Annual Growth Rate
CBRT	Central Bank of the Republic of Turkey
CBU	Completely Built Up
CCI	Consumer Confidence Index
CCP	Competition Commission of Pakistan

CCS	Consumer Confidence Survey
CDNS	Central Directorate of National Savings
CFT	Combating the Financing of Terrorism
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CNIC	Computerized National Identity Card
COVID	Corona Virus Disease
CPEC	China–Pakistan Economic Corridor
CPI	Consumer Price Index
CRC	Cold Rolled Coil
CSF	Coalition Support Fund
CY	Calendar Year

D

DAP	Diammonium Phosphate
DGCIS	Directorate General of Commercial Intelligence and Statistics (India)
DPP	Department of Plant Protection
DSC	Defense Saving Certificate
DSSI	Debt Service Suspension Initiative

E

ECC	Economic Coordination Committee
EFF	Extended Fund Facility
EFS	Export Finance Scheme
EIA	Energy Information Administration
EM	Emerging Market
EPD	Exchange Policy Department
EU	European Union

F

FAO	Food and Agriculture Organization
FAPMMEC	Food and Agricultural Product Markets Monitoring and Evaluation Committee
FAS	Faisalabad
FATF	Financial Action Task Force
FBR	Federal Board of Revenue
FC	Financial Cost
FCA	Federal Committee on Agriculture
FDI	Foreign Direct Investment
FE-25	Foreign Exchange-25
FED	Federal Excise Duty
FMCG	Fast Moving Consumer Goods
FO	Furnace Oil
FPA	Fuel Price Adjustment

FPI	Foreign Portfolio Investment
FRDLA	Fiscal Responsibility and Debt Limitation Act
FRR	Fixed Rental Rate
FTA	Free Trade Agreement
FWO	Frontier Works Organization
FX	Foreign Exchange
FY	Fiscal Year

G

GB	Gilgit-Baltistan
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GI	Geographic Indicator
GIDC	Gas Infrastructure Development Cess
GoP	Government of Pakistan
GSM	Global System for Mobile
GSP	Government Support Price
GST	General Sales Tax
GSTS	General Sales Tax on Services
GB	Gilgit-Baltistan
GCC	Gulf Cooperation Council
GUR	Gujranwala

H

H1	First Half
H2	Second Half
HS	Harmonized System
HSFO	High Sulfur Furnace Oil
HSD	High Speed Diesel

I

IBA	Institute of Business Administration
ICT	Information and Communications Technology
ICT	Islamabad Capital Territory
IDA	International Development Association
IFEM	Inland Freight Equalization Margin
IFFCF	International Fast Food Chains Franchisees
IFI	International Financial Institution
IGC	International Growth Centre
IMF	International Monetary Fund
INR	Indian Rupee
IPPs	Independent Power Producers

ISIC	International Standard Industrial Classification
ITC	International Trade Center

K

KCR	Karachi Circular Railway
KERO	Kerosene Oil
KG	Kilogram
KHI	Karachi
KHW	Khanewal
KM	Kilometer
KNOMAD	Global Knowledge Partnership on Migration and Development
KP	Khyber Pakhtunkhwa
KSA	Kingdom of Saudi Arabia
KSE	Karachi Stock Exchange

L

LDO	Light Diesel Oil
LFS	Labor Force Survey
LIBOR	London Inter-Bank Offered Rate
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSM	Large scale manufacturing
LT	Long-term
LTFF	Long-term Financing Facility

M

MIEWS	Market Intelligence and Early Warning System
mma	12 month moving average
MMT	Million Metric Ton
MNFSR	Ministry of National Food Security and Research
MoC	Ministry of Commerce
MoF	Ministry of Finance
MoM	Month on Month
MPC	Monetary Policy Committee
MRTBs	Market-related Treasury Bills
MRTPO	Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance
MT	Metric Ton
MTBs	Market Treasury Bills
MVT	Motor Vehicle Tax
MW	Megawatt

N

NDA	Net Domestic Asset

NEER	Nominal Effective Exchange Rate
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Asset
NFC	National Finance Commission
NFDC	National Fertilizer Development Center
NFNE	Non-food-non-energy
NGDS	Natural Gas Development Surcharge
NHA	National Highway Authority
NITB	National Information Technology Board
NLC	National Logistics Cell
NPL	Non-performing Loans
NPPO	National Plant Protection Organization
NSER	National Socio-Economic Registry
NSS	National Savings Scheme
NTC	National Tariff Commission
NTDC	National Transmission and Dispatch Company
NTP	National Tariff Policy
NTR	Non Tax Revenue

O

O/N Rate	Overnight Rate
OCAC	Oil Companies Advisory Council
OECD	Organization for Economic Cooperation and Development
OG	Operation Green
OGRA	Oil and Gas Regulatory Authority
OKR	Okara
OMC	Oil Marketing Company
OMO	Open Market Operation
OPEC	Organization of Petroleum Exporting Countries
OPEC+	Organization of Petroleum Exporting Countries Plus
OTC	Over-the-Counter
OTEXA	Office of Textile and Apparel (US Department of Commerce)
OUP	Oxford University Press
OZ	Ounce

P

PAMA	Pakistan Automotive Manufacturers Association
PAYG	Pay As You Go
PB	Prize bond
PBA	Pensioners' Benefit Account
PBO	Provisional Booking Order

PBS	Pakistan Bureau of Statistics
PCRCL	Pakistan Corporate Restructuring Company Limited
PEDL	Public External Debt Liability
PFL	Pakistan Investment Bond Floating Rate
PFM	Public Finance Management
PFMA	Pakistan Flour Mills Association
PIB	Pakistan Investment Bond
PKR/Rs.	Pakistan Rupee
POL	Petroleum, Oil and Lubricants
POS	Point of Sales
PPA	Pakistan Poultry Association
PPRO	Plant Protection Release Order
PR	Policy Rate
PRA	Pest Risk Analysis
PRI	Pakistan Remittance Initiative
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PSM	Pakistan Steel Mills
PSMA	Pakistan Sugar Mills Association
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Limited

Q

Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
QoQ	Quarter over Quarter

R

REER	Real Effective Exchange Rate
RIC	Regular Income Certificate
ROA	Return on Assets
ROE	Return on Equity
RPI	Relative Price Index
RYK	Rahim Yar Khan

S

SAR	Saudi Arabian Riyal
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SFWA	Shuhadas Family Welfare Account

	SIM	Subscriber Identity Module
	SNGPL	Sui Northern Gas Pipeline Limited
	SOPs	Standard Operating Procedures
	SPS	The Agreement on the Application of Sanitary and Phytosanitary Measures
	SPDC	Social Policy and Development Centre
	SRO	Statutory Regulatory Order
	SSA	Special Savings Account
	SSC	Special Savings Certificate
	SSGC	Sui Southern Gas Pipeline Limited
	ST	Short-term
	SUPARCO	Space and Upper Atmosphere Research Commission
	SUV	Sports Utility Vehicle
	SWAC	South-West Asia
T		
	T-bills	Treasury bills
	TCP	Trading Corporation of Pakistan
	TERF	Temporary Economic Refinance Facility
	TOP	Tomato, Onion and Potato
	TOC	Technical and Operational Coordination
	TT	Telegraphic Transfer
U		
	UAE	United Arab Emirates
	UK	United Kingdom
	ULSF	Ultra-Low-Sulfur-Fuel
	US	United States of America
	USA/US	United States of America
	USD/US$	US Dollar
	USDA	United States Department of Agriculture
V		
	VRR	Variable Rental Rate
W		
	WALR	Weighted Average Lending Rate
	WAONR	Weighted Average Overnight Rate
	WHO	World Health Organization
	WHT	Withholding tax
	WTO	World Trade Organization
Y		
	YoY	Year on Year