1 Overview

The recovery in Pakistan's economy gained further traction in the third quarter of FY21. The growing momentum over the three quarters of FY21 is reflected in the provisional estimates of GDP growth of 3.9 percent for the full year **(Table 1.1).** Compared to last year's contraction of 0.5 percent, the recovery this year was mainly achieved through a turnaround in large scale manufacturing (LSM) industry, and the services sector, particularly the expansion in the wholesale and retail trade segment. In the agriculture sector, growth in wheat, rice, maize and sugarcane — all expected to achieve record or near record high output this year — offset the decline in cotton production. The rebound in activity has also been reflected in the strength of a variety of demand indicators through the first three quarters of FY21, including sales of fast-moving consumer goods, automobiles, cement, and POL products. Moreover, other macroeconomic indicators remained stable during Jul-Mar FY21, as evident from the surplus in the current account and primary balance, and lower average headline inflation compared to last year.

One of the key factors behind the relatively contained impact of the pandemic and the on-going rebound in economic growth has been the deft response of policymakers. On the health side, the spread and fatality of the virus were controlled through a smart approach to testing, contact tracing and quarantine. As a result, cases which peaked at 30 per million in the beginning of the fiscal year were quickly brought down. In contrast to the wide-scale shutdown of industry and services during the first wave of Covid, the government opted for smart lockdowns during FY21, and continued to offer timely and targeted fiscal support, complemented by the SBP's flexible and aggressive initiatives to counter the pandemic. The successful containment of the spread of the pandemic, the various measures and incentives by the government and the SBP, as well as the optimism of households and businesses, converged to take the economy out of the Covid-induced recession. Higher than expected wheat production was also a contributing factor.

Selected Economic Indicators **Table 1.1**

		FY19	FY20	FY21
Growth rate (percent)*				
Real GDP	Jul-Jun	2.1	-0.5	3.9
Agriculture	Jul-Jun	0.6	3.3	2.8
Industry	Jul-Jun	-1.6	-3.8	3.6
o/w LSM	Jul-Jun	-2.6	-10.1	9.3
Services	Jul-Jun	3.8	-0.6	4.4
CPI (period average)[a]	Jul-Mar	6.3	11.5	8.3
Private sector credit [b]	Jul-Mar	10.2	4.8	7.3
Money supply (M2)[b]	Jul-Mar	5.1	8.5	7.8
Exports [b]	Jul-Mar	-1.1	1.3	2.3
Imports [b]	Jul-Mar	-3.4	-13.2	9.4
Tax revenue –FBR [c]	Jul-Mar	2.8	13.2	10.9
Exchange rate (+app/dep%)[b]	Jul-Mar	-13.7	-4.0	10.0
Policy rate [b]	end-Mar	10.25	11.00	7.00
ONMMR [b]	end-Mar	10.0	10.7	7.8
billion US dollars				
SBP's reserves (end-period) [b]	Mar	10.5	10.8	13.5
Workers' remittances [b]	Jul-Mar	16.0	17.0	21.5
FDI in Pakistan [b]	Jul-Mar	0.9	2.2	1.4
Current account balance [b]	Jul-Mar	-10.3	-4.1	1.0
percent of GDP				
Fiscal balance [d]	Jul-Mar	-5.0	-4.1	-3.5
Current account balance	Jul-Mar	-4.8	-2.1	0.4
Investment	Jul-Jun	15.6	15.3	15.2

* The numbers relating to real GDP growth rate and its sub-components for FY19, FY20 and FY21 represent final, revised, and provisional estimates respectively.
Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c,d] Ministry of Finance

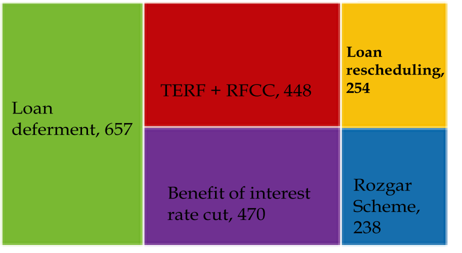
In addition to the successes in managing the health side of the pandemic, a number of policy measures are responsible for the rebound in economic activity. First, the monetary policy environment during FY21 was highly accommodative, in contrast to the necessary focus on stabilization before the Covid outbreak to deal with the severe balance of payments crisis. Having cut the policy rate from 13.25 percent to 7.0 percent between March to June 2020, the SBP's Monetary Policy Committee (MPC) maintained the status quo throughout FY21.

Second, fiscal support was targeted, cognizant of high public debt. Making use of the primary surplus achieved through the first nine months of FY21, the government was able to reorient expenditure toward the most vulnerable and priority areas, while still delivering a fiscal consolidation for the year as a whole. As a result, the pace of public debt accumulation decelerated considerably – its lowest increase in absolute terms since FY17. The fiscal consolidation has continued in FY21, despite the government not imposing any new taxes and offering support in the form of an energy package, which included major tariff relief for industry; faster tax refunds to exporters; and comprehensive social protection initiatives, such as the Ehsaas Emergency Cash program. Healthy revenue growth and restraint on spending have underpinned the continued fiscal consolidation, which has lifted market sentiment and supported the investment outlook.

Third, liquidity support was channeled through the SBP's wide-ranging measures to combat the Covid shock. The relief measures included low interest rates and regulatory relaxations for restructuring debt and deferring principal repayments, which eased the debt burden of firms and households. The central bank also rolled out refinance

Liquidity Impact of SBP's Major Relief Measures (as of 27 May, 2021)* **Figure 1.1**

Rs billion



* The overall size of SBP support is Rs 2,067 billion.
TERF: Temporary Economic Refinance Facility
RFCC: Refinance Facility for Combating Covid-19
Source: State Bank of Pakistan

facilities to support employment, investment, BMR, and setting up of health facilities (**Figure 1.1**). These quantitative interventions were focused on addressing specific challenges emanating from the pandemic, with specific credit allocation decisions left to the banks. This helped to deliver liquidity assistance where it was most needed. Furthermore, the export and construction sectors were facilitated through measures such as an expanded scope for the Export Financing Scheme (EFS), and SBP's mandatory targets to encourage banks to extend more housing and construction loans.[1]

Fourth, the government's agriculture policies also played an enhanced supporting role. These mainly comprised subsidized inputs, such as fertilizer, pesticides, and weedicides, as well as increase in the minimum support price, such as for wheat and sugarcane crops. The resulting increase in production of most of the important crops supported the rural households.

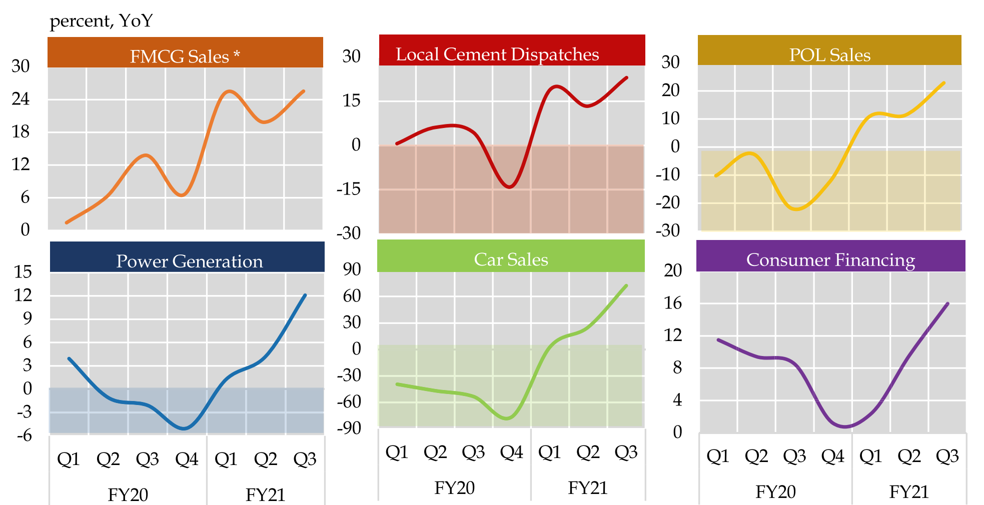
[1] For more details on sector-specific policies, see Chapter 1 of the SBP's Second Quarterly Report on The State of Pakistan's Economy for FY21.

Further support to both urban and rural households came from a surge in workers' remittances, which rose by US$ 4.5 billion to touch a record high of US$ 21.5 billion during Jul-Mar FY21. The resulting increase in demand is reflected in a consistent growth in high frequency demand indicators over the three consecutive quarters of FY21 (**Figure 1.2**).

Workers' remittances were also instrumental in generating a cumulative current account surplus during Jul-Mar FY21. Further support to the external account came from deferred interest payments on external debt through the Debt Service Suspension Initiative (DSSI), curbs on international air travel, and lower global oil prices. Collectively, these factors offset a growing merchandize deficit stemming from: (a) substantial import of agriculture commodities at elevated prices; and (b) growing imports of raw material and capital goods to meet industrial demand, together with sluggish growth in export receipts. On the financing side, inflows were available from commercial, bilateral and multilateral sources (including the IMF), as well as new inflows under Roshan Digital Accounts, which crossed US$ 1 billion in April 2021. Overall, the SBP's liquid FX reserves rose by US$ 1.4 billion, its net forward liabilities moderated by US$ 1.5 billion, and the PKR strengthened by 10 percent against the US Dollar during Jul-Mar FY21.

Continuing their improving trend, fiscal accounts yielded a primary surplus of Rs 452 billion, while the fiscal deficit in terms of GDP was lower during Jul-Mar FY21 compared to last year. The improvement stemmed from a pronounced slowdown in spending and a decent increase in taxes. Rationalization of non-interest spending was instrumental, as there was a slowdown in non-priority current expenditure. On the other hand, growth in tax collection was supported by improvement in economic

Growth in Demand Indicators **Figure 1.2**



* FMCG Sales are based on the financials of 25 listed companies.
Sources: SBP, APCMA, PAMA, OCAC, NEPRA & Corporate reports (various issues)

activity, FBR efforts to improve tax administration, as well as low base effects. However, development spending remained constrained and interest payments remained a significant burden, consuming 62.0 percent of tax revenues in the period.

Meanwhile, the pace of debt accumulation eased during Jul-Mar FY21. This could be traced to the lower fiscal deficit, revaluation gains stemming from PKR appreciation, and DSSI relief.

Average headline inflation during Jul-Mar FY21 remained lower than last year. On a quarterly basis as well, Q3-FY21 CPI inflation was lower in relation to the comparable period of last year. The third quarter outturn was largely on the back of deceleration in January 2021, in which inflation decelerated to 5.7 percent. This deceleration was led by food and poultry groups. Also, the outlook for inflation remained broadly unchanged, and the SBP's MPC maintained a status quo on the policy rate in its March 2021 meeting. However, during February and March 2021, rising prices of electricity, sugar, edible oil, cotton cloth and readymade garments contributed to increased momentum in inflation.

Credit to the private sector was nearly 50 percent higher during Jul-Mar FY21 compared to last year. During the third quarter, however, retirements of short-term loans led to a slowdown. In addition to seasonal retirements by rice-processing firms, the retirements were primarily attributed to better liquidity conditions of manufacturing businesses on account of improved export earnings (for high-value added textiles); greater profitability (for sectors such as fertilizer and refined petroleum); and higher sales tax refunds by the government. The offtake for fixed investment loans was robust during Q3-FY21 though, driven by the SBP's concessionary refinance schemes such as the TERF. Moreover, consumer financing remained upbeat during Jul-Mar FY21. In addition to growth in auto and personal loans, there was an increase in house building loans, as banks responded to the SBP's mandatory targets for housing and construction finance.

Overall, while the economy made significant gains during FY21 compared to a year earlier, a few structural vulnerabilities still persisted. First, in the agriculture sector, the secular decline of the cotton crop continued, with acreage and yield falling short of the annual targets and previous year's performance. The below-par yields can mainly be attributed to issues in seed quality, adverse climate change impact, and pest attacks (whitefly and pink bollworm). Thus, reforms relating to research and development of improved varieties of cotton, which are resistant to pests and climate change, are needed. Such endeavors need to be backed up with timely availability of seeds and the support services of agriculture extension departments, so that growers can be motivated to dedicate more area to cotton cultivation, utilize quality inputs, and adopt climate-smart practices to increase cotton production in a sustainable manner.

Second, while the new flexible exchange rate regime should help to attenuate pressures, the impact of the recovery in economic activity on the external sector will need to be monitored carefully. Specifically, the monthly current account surpluses observed during Jul-Nov FY21 gave way to monthly deficits during Dec-Mar FY21. In particular, the merchandize trade deficit widened, as the growth in exports could not keep up with import growth. While the import of raw materials and capital goods is inevitable to spur industrial output, the import of certain agricultural commodities (such as cotton, wheat and sugarcane) to bridge domestic supply gaps and/or stabilize prices needs to be contained by adopting better farming and crop management practices. In addition, the balance between consumption and investment items in the import basket will need to be monitored. Finally, merchandize exports still remain restricted to a handful of sectors and markets, underscoring the need for greater diversification.

Third, inflation out-turns seen in Q3-FY21 underscore the need for continued vigilance. The CPI inflation remained volatile during the third quarter, with a low reading in January 2021 followed by a rebound in February and March. Moreover, urban core inflation picked up during the quarter on the back of a rise in prices of clothing and footwear. Elevated cotton prices, triggered in part by lower domestic production, contributed to the inflation in clothing items. More broadly, despite being lower than last year, headline inflation remained at elevated levels during FY21, with supply side issues in the management of agriculture commodities triggering bouts of food inflation. This vulnerability needs to be addressed through better coordination among stakeholders, especially the federal and provincial food departments; provision of accurate data and monitoring of stocks and prices of food items; and timely decisions and import of items as required.

On the fiscal side, the space available for public investment, which is a vital lever for economic growth, continues to be constrained by debt servicing payments and a narrow revenue base. Another vulnerability worth highlighting is circular debt, which underscores the long-standing structural issues in the power sector. Therefore, efforts to broaden the tax base by minimizing exemptions, documenting the informal economy, and simplification of tax rules and procedures need to be strengthened. In addition, the process of restructuring of the loss-making PSEs, and introduction of reforms in the energy sector need to be expedited to reduce burden on the scarce fiscal resources.

Finally, credit to the private sector has a skewed distribution, which could be improved through lending more extensively to a broader cross-section of creditworthy firms and individuals, including MSMEs. In general, the removal of information asymmetries tends to improve credit penetration in an economy. Information asymmetries can, in turn, be addressed by setting up private credit bureaus as part of a well-functioning credit reporting system. The government and the SBP have taken steps to improve credit reporting, including the introduction of the Credit Bureaus Act 2015 and the granting of licenses to two private credit bureaus. However, a number of legal, operational and policy level challenges continue to hold back private credit bureaus from realizing their potential. A special section in this SBP report highlights these challenges and makes policy recommendations to make private bureaus more effective in tackling information asymmetries, ultimately facilitating greater penetration of private sector credit.

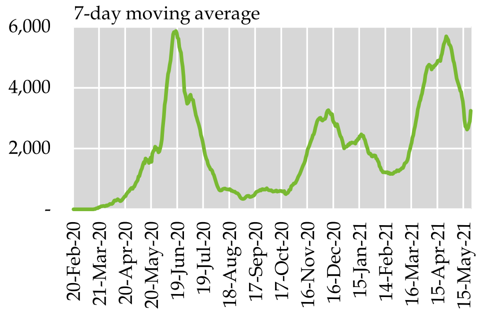
Economic Outlook

Going forward, in FY22, the economic momentum that became evident during FY21 is expected to strengthen further. The ongoing rollout of vaccines, coupled with the continuation of economic activities during the virus' second wave and most of the third wave, offers some optimism. On the agricultural side, the impetus is likely to come from a further improvement in output, with the government emphasizing the use of better seed varieties and modern technology. In particular, cotton production is expected to recover from the multi-year low recorded in FY21. The government's Kharif and Rabi packages, which typically include subsidies on fertilizers and other inputs, are also anticipated to support growth in the agriculture sector.

Further impetus to economic growth is likely to come from expected investments under TERF and the policy-driven boost in construction activities. While the former has seen a substantial increase in March 2021, the latter has received support from the government's Naya Pakistan Housing Scheme, coupled with the mark-up subsidy on house loans and the SBP's regulatory push for banks to increase the proportion of housing finance in their outstanding credit by end-December 2021. Furthermore, the government has indicated its intention to increase PSDP spending, which would also be a major contributing factor to the higher growth outcome. These favorable trends across agriculture and industry would also spill over to the services sector. However, a major downside risk to the overall growth outlook for FY22 is the ongoing third and potentially additional waves of Covid-19, which might necessitate the imposition of mobility restrictions and therefore disrupt the ongoing economic momentum (**Figure 1.3**).

Recent CPI outturns have indicated a consistent YoY increase in inflation in

Trend in Daily Covid-19 Cases Detected in Pakistan* **Figure 1.3**

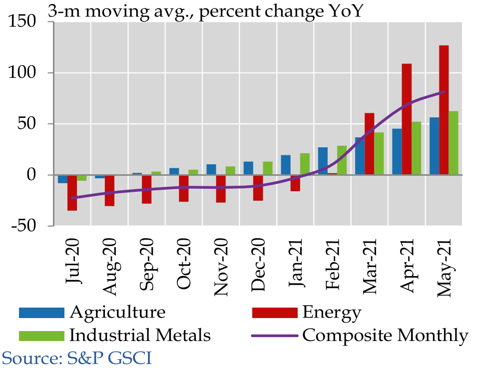


*As of May 23, 2021
Source: World Health Organization

February, March and April 2021, but it may be noted that these increases are primarily originating from the supply side, with the output gap still estimated to be negative. The current uptick is concentrated among food items and utility (electricity) prices, whereas wage pressures are judged to be stable at this point. Furthermore, better commodity management, including by building strategic reserves of staple food items, is likely to alleviate supply-side pressures from food items. As a result, second-round effects of the supply-driven shocks to inflation are currently muted and inflationary expectations continue to remain well-anchored.

However, there are multiple upside risks to the inflation expectations. First, the ongoing rising trend in international commodity prices is broad-based, with prices of oil, food and metals, all rising significantly (**Figure 1.4**). Second, upward adjustment in administered utility tariffs (electricity, gas, and fuel) could further feed into inflation as well as inflationary expectations. Third, wage pressures will need to be watched carefully, particularly in the context of any increases in the minimum wage and public

Trend in Global Commodity Prices Figure 1.4



Source: S&P GSCI

sector pay. Fourth, the withdrawal of sales tax exemptions and other potential revenue-generating measures in the FY22 budget may also lead to an increase in inflation during the fiscal year.

In the fiscal sector, a decent growth in revenues has been noted so far in FY21, with collections until April 2021 being higher than the target. Furthermore, the growth in expenditures is lower than last year (FY20), mainly due to lower development spending and restraint on non-interest current spending. On this basis, the fiscal deficit for FY21 is expected to be 6.5-7.5 percent of GDP. However, an upside risk to this projection are higher payments on account of circular debt settlements. For FY22, while the budget is awaited, an improvement in the fiscal deficit is expected amid a continuation of the current growth trends in revenue collection into FY22, as well as the acceptance of the proposal to remove corporate tax exemptions. Lastly, the higher growth outcome in FY22 would further boost revenue collection, while PSDP spending is expected to increase.

In the external sector, while remaining bounded, the current account deficit is expected to rise, mainly due to a further widening in the trade deficit on account of likely rise in import payments. The increase in imports reflects higher oil prices, which are now projected to add to the pressures coming from consistently growing import volumes of energy commodities. Second, the ongoing rising trend in global non-energy prices, including food and metals, would also contribute to the increase in import payments (**Figure 1.4**). And third, capital goods imports are projected to increase, in the wake of the significant borrowing under the TERF. While borrowing amounts under the scheme have been approved, the actual imports are expected to materialize over the next few months.

On the other hand, the growth in export receipts is mainly projected to come from the continued strong momentum in high value textile items (that is, apparel and home textiles), as well as a rebound in rice exports amid better crop expectations (which would allow exporters to offer more competitive prices). However, potential downside risks to the export growth include continually rising international prices of textile inputs (including cotton yarn), which might impact exporters' competitiveness; as well as the resumption in economic activity in key competitors (especially India and Bangladesh) amid vaccinations and a subsiding in Covid cases. Finally, workers' remittances are projected to remain buoyant, as the main factors (switch to formal channels, incentives for banks and MTOs, etc.) will still be in place. In addition to this, progress on the IMF program would help the continuation of foreign exchange inflows from external sources, while promoting further stability in the balance of payments.