1. Global and Domestic Macrofinancial Environment

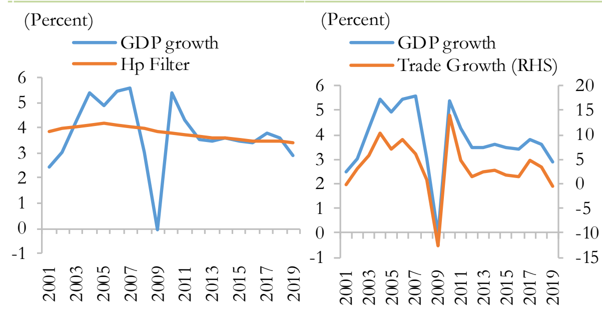
Global economic growth continued to trend downwards in 2019 amid trade tensions, fears of a no-deal Brexit, slowdown in China, and idiosyncratic issues in several EMDEs. While monetary policy easing in AEs supported economic activity, it created easy financial conditions, thereby, raising financial vulnerabilities further. However, resilience of the global banking system remained intact. The domestic economy—after remaining under stress till first half of CY19—started experiencing signs of economic recovery towards the end of CY19. The economic uncertainty prevailing in the first half receded during the second half owing to stabilization measures adopted under the IMF program, with visible improvement in the external and fiscal accounts. However, COVID-19 threatens to temporarily disrupt the recovery of the domestic economy.

Global Developments

Global economic momentum remained feeble during CY19…

Global economic activity further decelerated in 2019 to 2.9 percent (3.6 percent in 2018 and 3.8 percent in CY17).[113] Global growth rates even dipped below their long-term trend. A notable slowdown in trade growth amid rising trade policy uncertainty, geo-political tensions, a partly policy-induced slowdown in China, concerns related to a no-deal Brexit and downturn in automobile industry were key drivers of softening global economic expansion (**Chart 1.1**). Country specific issues in certain EMDEs also adversely affected the global economy during 2019.[114] However, the accommodative monetary policy adopted by several countries, somewhat, helped cushion downward growth pressures.

Chart 1.1: Deceleration in world trade dragged global growth level below its normal trend



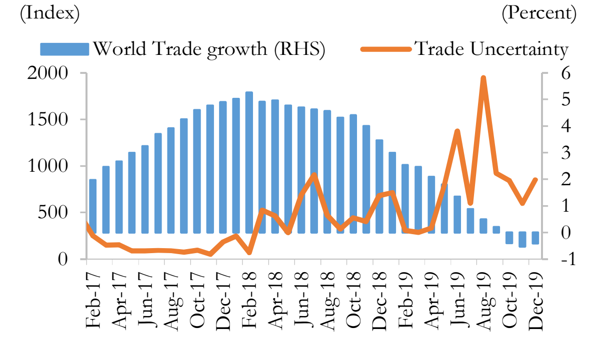
Source: IMF World Economic Outlook (Oct, 2019) and CPB Netherlands Bureau of Policy Analysis

as the gravity of trade war increased…

Trade and technology disputes between USA and China intensified until August-2019.[115] These further weakened business confidence across the globe, causing manufacturing firms to slow down the purchase of machinery and equipment. As a result, world trade growth turned negative for the first time since 2010 (**Chart 1.2**).

113 IMF made downward revisions in its global economic growth estimates for CY19 in Apr-19, Oct-19 and then Jan-20.
114 The referred EMDEs primarily include India, Russia, Turkey and GCC countries.
115 In WEO-Apr, 2019, IMF projected average USA tariffs on imports from China at around 12.25 percent, whereas, average China tariffs on imports from USA to about 16.5 percent by December, 2019. However, after tariff announcements in the month of May and August 2019, the IMF in WEO-Oct, 2019 revised tariff estimates at around 24 percent and 26 percent by December 2019, respectively.

Chart 1.2: Rising trade uncertainty weakening trade growth



Source: CPB Netherlands Bureau for Policy Analysis and Federal Reserve of St. Louis

AEs and EMDEs continued to observe a moderation in economic activity….

Growth in AEs continued to decelerate (**Table 1.1**). Moderation in the USA was mainly due to sluggish growth in investment and the fading impact of tax cuts made during 2018. The softening activity in the Euro Area was primarily driven by weakening of automobile exports, as the car industry—particularly in Germany—remained in the process of complying with new emission standards. Moreover, fall in demand for automobiles, especially from China, also affected the exports of automobiles.

While manufacturing sector observed a broad based slowdown, the services sector remained resilient and provided some respite to growth in several advanced economies.[116]

EMDEs also witnessed a moderation in growth, which was more pronounced than AEs. In China, economic growth slackened partially as a result of rising trade tariffs on Chinese products imposed by the USA, which considerably constrained its exports. In addition, slowing domestic demand in response to regulatory measures to curb rising non-financial sector debt contributed to the slowing growth momentum.[117]

In line with China, economic activity in India, Russia, Turkey, GCC countries and others also remained subdued. In India, growth moderated due to a sharp slowdown in gross fixed capital formation and private consumption, along with a steep slowdown in exports.[118] For Russia, external factors such as geopolitical risks and mounting trade conflict between US and EU translated into a growth slowdown.[119] In Turkey, a sharp decline in domestic demand restrained economic activity (**Table 1.1**).

Table 1.1: Global economy: Real GDP growth (percent)

	2017	2018	2019	2020*
World	3.90	3.60	2.90	-3.00
Advanced Economies	2.50	2.20	1.70	-6.10
EMDEs	4.80	4.50	3.70	-1.00
EMDEs - Asia	6.70	6.30	5.50	1.00
MENAP	2.10	1.50	0.70	-3.10
USA	2.40	2.90	2.30	-5.90
Euro Area	2.50	1.90	1.20	-7.50
U.K	1.90	1.30	1.40	-6.50
Japan	2.20	0.30	0.70	-5.20
Argentina	2.70	-2.50	-2.20	-5.70
China	6.90	6.70	6.10	1.20
Turkey	7.50	2.80	0.90	-5.00
India	7.00	6.10	4.20	1.90
Russia	1.80	2.50	1.30	-5.50
Saudi Arabia	-0.70	2.40	0.30	-2.30
United Arab Emirates	0.50	1.70	1.30	-3.50
Pakistan	5.22	5.53	3.29	-1.50

Source: World Economic Outlook, IMF, April 2020
* IMF-Projections

….. as did in GCC economies ….

Growth in GCC countries during 2019 was notably lower compared to 2018 (**Table 1.2**). The fall in oil prices by 10.2 percent during 2019 was one of the primarily factors weighing on activity. Softening global demand and the ongoing compliance of emission standards largely explained ebbing oil prices. The impact of these developments had been significant enough to outweigh the upward pressure on oil prices arising from oil production cuts by GCC countries, US sanctions on Iran and political tensions in other

116 World Economic Outlook – Oct, 2019
117 World Economic Outlook – Oct, 2019
118 Reserve bank of India "Financial Stability Review – Dec, 2019"
119 Bank of Russia, Financial Stability Review – Q2-Q3 2019"

major oil exporting countries such as Libya and Venezuela.[120]

Table 1.2: Gulf Cooperation Council (GCC) Macroeconomic Performance

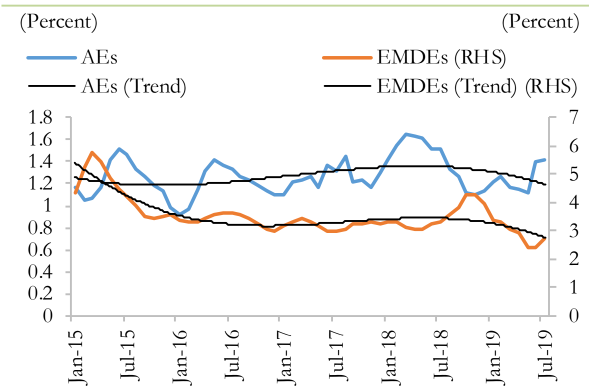
	2016	2017	2018	2019	2020*
Percent of GDP otherwise mentioned					
GDP (annual change, percent)	2.3	-0.4	2.0	0.6	-2.7
Current Account Balance	-2.8	2.8	8.6	5.6	-3.1
Fiscal Balance	-10.7	-5.7	-1.6	-2.1	-10.4
Average Oil Price (US$ per barrel)**	42.8	52.8	68.3	61.4	35.6
Inflation (year avg - percent)	2.1	0.2	2.1	-1.0	0.3

Source: Regional Economic Outlook, Middle East and Central Asia, IMF (Apr-2020)
* Projections
** Simple average of prices of UK Brent, Dubai Fateh and West Texas intermediate crud

Inflationary pressures further weakened in 2019

Inflationary pressures further weakened during 2019 across AEs and EMDEs, reflecting weak economic conditions. While core inflation across AEs dropped below target levels, in EMDEs it slid slightly below their historical average level (**Chart 1.3**).[121]

Chart 1.3: Core inflation softened across AEs and EMDEs



Source: IMF World Economic Outlook - Oct, 2019

In AEs, consumer price inflation further dropped to 1.4 percent in 2019 from 2.0 percent in 2018. Despite higher import tariffs and a modest rise in wages, particularly in the USA, inflationary pressures remained muted in 2019. Besides weak transmission of cost pressures to general price levels partly because of sluggish growth, declining international oil prices also kept inflation at a lower level.[122]

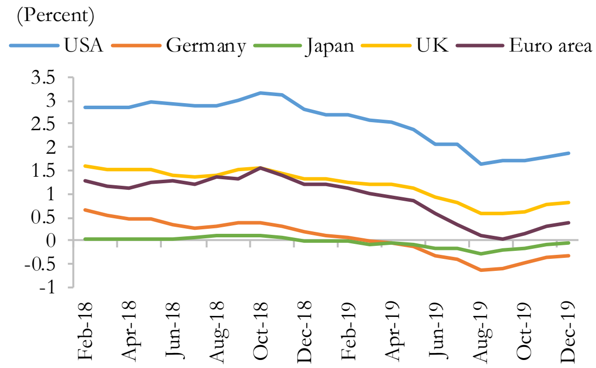
In EMDEs, inflation also remained contained (5.0 percent in 2019 vs. 4.8 percent in 2018). However, variations existed across countries. Middle Eastern and Central Asian countries contributed to easing in prices while other regional groups observed some rise in inflation owing to depreciation in their respective local currencies against the US dollar.[123]

Reversal in the monetary policy stance kept financial conditions supportive in AEs…

Major central banks in AEs moved towards a rate cutting cycle during 2019, owing to weakening economic prospects. The Federal Reserve cumulatively reduced the Federal Funds Rate by 75 bps. Also, the European Central Bank (**ECB**) relaxed monetary levers by reducing its deposit rate during 2019. There were 71 interest rate cuts by 49 central banks across the globe during the year 2019, indicating a synchronized easing of monetary policy.[124] As a result, sovereign bond yields declined, leading to easy financial conditions during the second half of CY19 (**Chart 1.4 and 1.5**). In Japan and Germany, yield on 10-year government bonds turned negative.

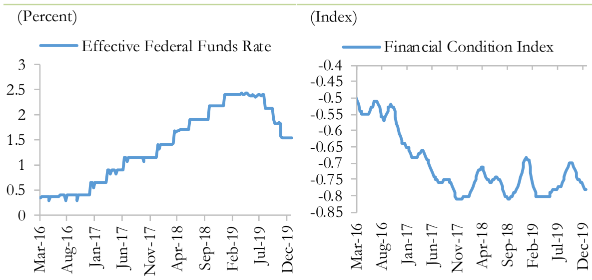
120 World Economic Outlook – Oct, 2019
121 World Economic Outlook – Oct, 2019
122 Weak transmission to inflation was possibly due to decline in profit margin of the corporate sector.
123 Argentina, Venezuela, Turkey, Pakistan are among the key economies where currency depreciation had fed higher inflation.
124 According to IMF, the broad based monetary easing is estimated to have lifted the 2019 GDP growth by 0.5 percentage point https://www.imf.org/en/News/Articles/2020/01/21/sp01202020-md-opening-remarks-at-weo-press-conference

Chart 1.4: Yield spread on 10 year government bonds dipped during 2019, turning negative in some AEs



Source: Federal Reserve Bank of St. Louis

Chart 1.5: Accommodative monetary policy eased financial condition

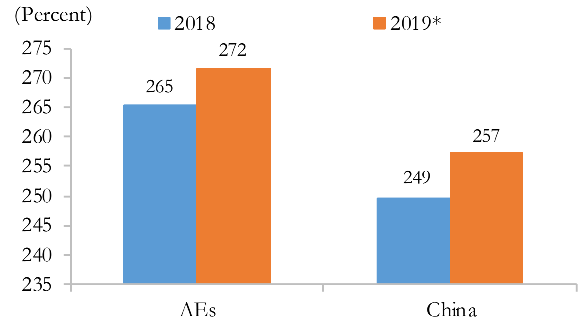


Source: Federal Reserve Bank of St. Louis

…whereas, corporate valuations in China marginally tightened financial conditions

In China, non-financial sector debt rose to 258.7 percent of GDP during 2019 from 249.6 percent in 2018. This debt level was higher than other EMDEs and many AEs. First of all, the acceleration in debt levels was supported by implicit guarantees by banks and state owned enterprises. This tends to indicate lending on compromised lending standards (**Chart 1.6**).

Chart 1.6: Non-financial sector debt elevated in key economies



*Data for 2019 is as off Sep, 2019
Source: BIS

Secondly, a large chunk of corporate lending was financed through lightly regulated NBFIs. It appears that much of this lending by NBFIs might have been sourced by banks, implying significant amount of risk at their end.[125] Chinese regulatory bodies made attempts to reduce vulnerabilities through various reform measures. As financing from NBFIs was restricted, it resulted in a tightening of availability of credit in China. Consequently, it acted as an additional factor slowing down economic activity in the country.

Banking sector in AEs remained resilient during 2019

The resilience of the banking sector in AEs (excluding Euro Area) remained intact during 2019, owing to strong compliance with regulatory requirements.[126] In particular, the global systemically important banks (**GSIBs**) exhibited more resilience than a decade earlier. The asset quality of the banking sector improved on account of strengthening of borrower's repayment capacity. As a result, loan loss expenses declined substantially, reaching their lowest level across several AEs (USA, UK, Japan, and Canada), which augmented the overall profitability of the banking sector.

[125] Banks facilitated the NBFIs in lending to corporate sector through repurchase agreements and by the purchase of investment products issued by NBFIs.
[126] The minimum Total Loss Absorbency Capital (TLAC) requirement, comprising of both regulatory capital and eligible debt, phased in for G-SIBs headquartered in advanced economies effective from 1st Jan., 2019. The required level of TLAC starts at 16 percent of risk weighted assets and 6 percent of the Basel III leverage ratio denominator. By 2022, the required level raises to 18 percent and 6.75 percent respectively.

However, financial vulnerabilities increased in AEs

While the fresh episode of interest rate cuts helped mitigate risks to growth, it also stimulated asset prices and encouraged further financial risk taking during 2019. Equity prices in the USA continued to rise above the economic fundamentals, along with lower volatility, suggesting higher vulnerabilities (**Chart 1.7**). [127]

Chart 1.7a: Sharp increase in equity prices in the USA

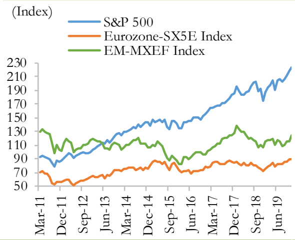
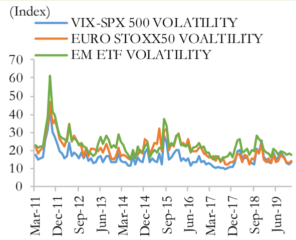


Chart 1.7b: Benign movement in market volatility



Source: Bloomberg

In addition to stretched equity prices, corporate leverage had also been increasing over the past few years (**Chart 1.6**). In some economies, including USA, France and Canada, it reached historic highs during 2019.[128,129] Besides, the increasing concentration of debt among risky borrowers was more worrying from a systemic risk perspective. This could trigger two adverse implications. First, in case of a negative shock to income, interest rates or funding, borrowers' capacity to service a higher debt level could become challenging.[130] Second, high concentration among riskier borrowers could constrain the ability of investors to sell their assets in times of rising stress in the financial system.[131]

In China, elevated non-financial sector debt remains a key source of vulnerability. The prevailing economic slowdown, owing to idiosyncratic and policy induced factors, could restrict the ability of firms to remain liquid and service their debts. Therefore, materialization of liquidity or credit shock could instill stress on the financial sector on a wider scale, given complex interconnectedness between the Chinese financial institutions.

The global economy is heading towards a recession because of Covid-19…

As per the IMF's latest WEO report, global growth was previously projected to recover to 3.3 percent in 2020 from 2.9 percent in 2019. However, the outbreak of the COVID-19 in late 2019 has significantly dented growth expectations for 2020. With several major economies in lockdown, the IMF has declared that 2020 will be a year of recession for the global economy, stating that it could be "*at least as bad as during the global financial crisis or worse*". [132]

While the degree of negative growth will largely depend on the longevity of the virus, local regulatory bodies across numerous jurisdictions are playing a critical role in mitigating its adverse impact on their respective economies. In addition, several international policymakers/organizations are also engaged in relief efforts to mitigate the expected global economic downturn (**see Box 1**).

Domestic Developments

In case of domestic macrofinancial environment, the year 2019 could be bifurcated into two halves. In the first, macroeconomic imbalances and uncertainties continued to surge, while in the second, in response to stabilization measures, the signs of improvement became visible in the

[127] Lower volatility suggests that equity market investors have been expecting favorable monetary policy stance by the Federal Reserve whenever risk to growth arise. In this backdrop, equity investors were increasing their exposure in the US equity market, thereby, pushing up the equity prices beyond what the economic fundamental suggests. In this way, lower stocks volatility was driven financial risk taking, hence, fueling financial vulnerability.

[128] By the end of 2019, corporate debt as percentage of GDP in USA, France and Canada was recorded at 254.2 percent, 327.4 percent and 300.8 percent, respectively.

[129] https://www.bis.org/statistics/totcredit/totcredit.xlsx

[130] Global Financial Stability Report, April 2019

[131] Global Financial Stability Report, October 2019

[132]https://www.imf.org/en/News/Articles/2020/03/23/pr2098-imf-managing-director-statement-following-a-g20-ministerial-call-on-the-coronavirus-emergency

external and fiscal accounts that gradually lifted the business confidence.

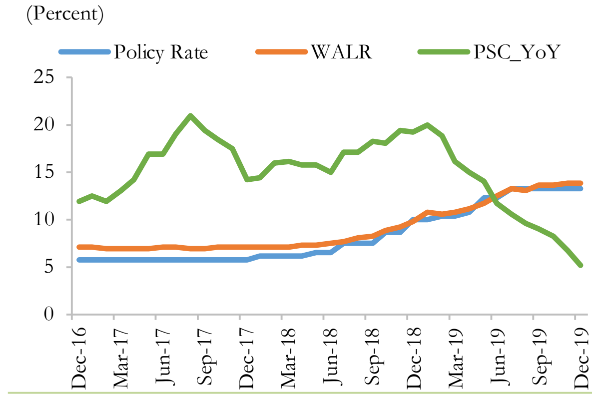
During FY19, the pace of economic activity and private sector credit receded amid stabilization measures…

Like the slowdown in pace of global economic activity, the domestic economy also observed slackness during FY19. GDP growth fell from 5.53 percent in FY18 to 3.29 percent in FY19 because of contraction in large-scale manufacturing and substantial slowdown in agriculture.[133]

To tame the growing macroeconomic imbalances in the external and internal accounts, stabilization measures, initiated during last fiscal year, continued this year. Besides fiscal consolidation, these measures included monetary tightening, exchange rate depreciation, and steps to curb imports.[134] These policy adjustments, along with bilateral inflows from friendly countries, helped address external account challenges. On the fiscal side, the government slashed development spending by 25.61 percent during FY19 to restrain the budget deficit. However, the macroeconomic imbalances continued to pose challenges, which were further addressed early on in FY20 i.e. in the second half of CY20.

Understandably, the private sector credit growth also decelerated during the period (**Chart 1.8**). It fell from 14.92 percent in FY18 to 11.61 percent in FY19. This growth further slowed down to 3.23[135] percent during second half of CY20.

Chart 1.8: Interest Rate and Deceleration in Private Credit

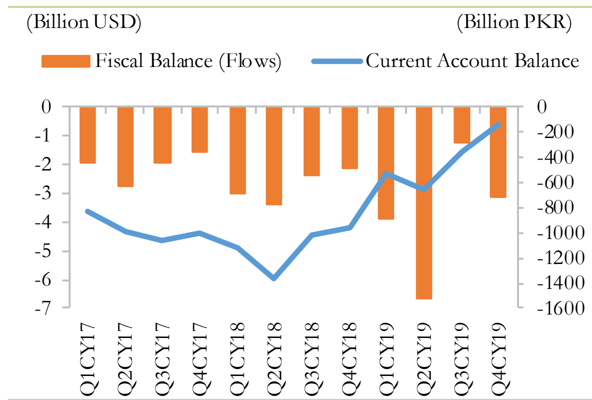


Source: SBP

However, the domestic economy witnessed notable improvements during the second half of 2019…

A widening fiscal deficit until the first half of CY19 and unabated pressure on the external account prompted Pakistan to secure IMF support via an Extended Fund Facility in July 2019.

Chart 1.9: Declining twin deficits



Source: SBP and MoF

The reassuring signals due to the IMF program and implementation of the associated stabilization measures helped to lower uncertainty among market participants about the future economic outlook, along with an improvement in the foreign exchange reserves during H2CY19. The stabilization measures included a monetary policy stance strong enough to ensure positive real interest rates, introduction of market based

133 LSM contracted by 2.1 percent while agriculture expanded by only 0.8 percent in FY19.

134 Policy rate increased by 575 basis points while the average exchange rate depreciated by 30.71 percent during FY19.

135 Jul-Dec 2019 growth in private sector credit.

exchange rate system, enhancement of documentation and, removal of exemptions and preferential treatment with respect to tax collection.[136] With a view to avoid fiscal pressures from power sector inefficiencies, administered prices of electricity and gas were also adjusted upwards.[137]

…and macroeconomic vulnerabilities receded

Further, policy measures helped to significantly contain the twin deficits (**Chart 1.9**). The current account deficit shrank by 62.62 percent by end CY19, primarily on account of a compression in imports (17.26 percent decline in CY19 vs. 5.41 percent rise in CY18) as well as a stable inflow of workers' remittances (5.75 percent in CY19 vs. 7.19 percent in CY18) (**Table 1.3**). Though exports improved in terms of volume, stiff competition in global markets amid USA-China trade tensions lowered unit values, such that the dollar value of exports remained stagnant.

Table 1.3: Key Economic Indicators of Pakistan*

	2016	2017	2018	2019
Real Sector	(Percent)			
Real GDP Growth (FY)	4.56	5.22	5.53	3.29
LSM Growth (Average YoY)	3.08	7.02	2.03	(3.52)
Inflation (Average YoY)	3.92	5.04	5.32	9.35
External Sector	(USD Billion)			
SBP Reserves (End-of-Period)	18.27	14.11	7.20	11.33
Current Account Balance	(6.74)	(17.68)	(19.65)	(7.34)
Exports (Goods)	26.81	28.89	30.08	30.20
Imports (Goods)	51.91	64.48	67.97	56.24
Trade Balance	(25.10)	(35.59)	(37.89)	(26.03)
Remittances	19.68	19.59	21.00	22.21
PKR/USD Rate (Year Average)	104.76	105.45	121.73	150.04
Fiscal Sector	(Percent)			
Fiscal Deficit (as % of GDP, FY)	(4.64)	(5.84)	(6.53)	(8.93)
Revenue Growth (YoY)	5.87	20.26	(3.01)	12.28
Expenditure Growth (YoY)	7.59	17.00	6.05	18.90
Monetary Sector	(Percent and PKR Trillion)			
Credit to Private Sector (YoY Growth)	11.90	14.21	19.10	5.18
Government Budgetary Borrowing	8.54	9.59	11.12	13.12
Borrowing from Schedule Banks	5.87	6.99	6.01	6.70
Borrowing from SBP	2.66	2.60	5.10	6.42

*All data are on Calendar Year unleas stated otherwise.
Source: MoF, PBS and SBP

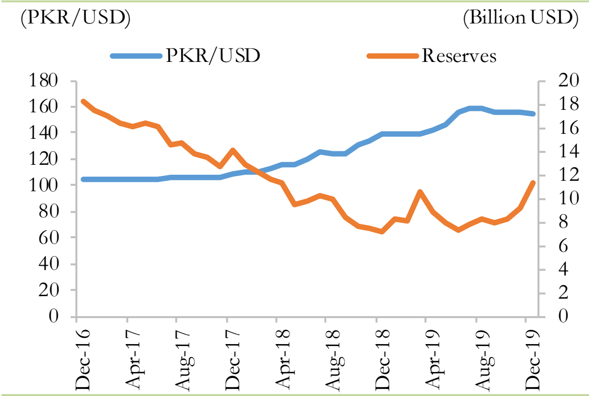
Consistent improvement in the current account deficit allowed SBP to accumulate FX reserves and retire its short-term liabilities of USD 3.82 billion during the second half of CY19.[138] These positive developments, together with the confidence instilled by the IMF program, helped to stabilize the exchange rate (**Chart 1.10**).

[136] Fiscal reforms included elimination of preferential tax treatment (sugar, steal and edible oil industries); end of zero-rated sales tax for export-oriented industries (textile, leather, carpets, sports and surgical instruments), focus on documentation and simplification of tax administration through introduction of technology-based solutions.

[137] CNG, motor fuel and electricity prices increased by 24.4, 22.5 and 4.2 percent, respectively, during FY19. SBP 2019, Annual Report on State of Pakistan's Economy.

[138] Monetary Policy Statement, January 2020, State Bank of Pakistan.

Chart 1.10: Stabilizing Exchange Rate and Reserves



Source: SBP

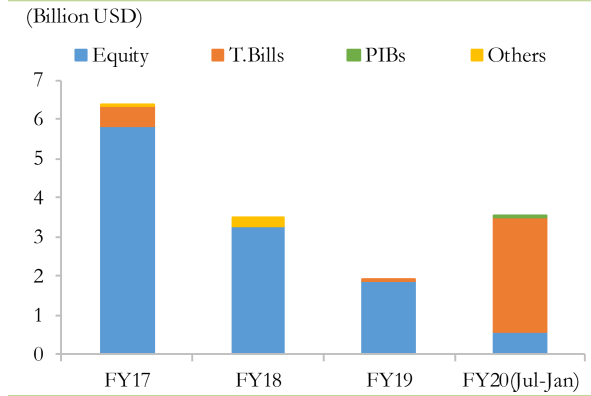
Besides narrowing of the current account deficit, the fiscal accounts also witnessed notable improvements owing to policy measures taken as part of the FY20 budget. During Jul-Dec 2019, the fiscal deficit reduced to 2.3 percent (of GDP) as compared to 2.7 percent in the comparable period of the previous year, whereas the primary balance turned into a surplus[139] for the first time in almost half a decade.

As a result, business confidence improved and foreign portfolio investment increased…

Since June 2019, the Business Confidence Index (**BCI**) gradually improved till December 2019. With business sentiments gaining some traction, the large-scale manufacturing activity increased in December 2019.[140]

Moreover, this improvement in sentiments and greater confidence in the direction of economic policies attracted foreign portfolio investment in treasury bills. During Jul-Jan FY20, the country received inflows of USD 2.91 billion in treasury bills **(Chart 1.11**). These inflows supported FX reserves and provided the government an alternate source of budgetary financing; thereby enabling banks to cater for private sector credit needs.

Chart 1.11: Foreign Portfolio Inflows in Govt. Securities

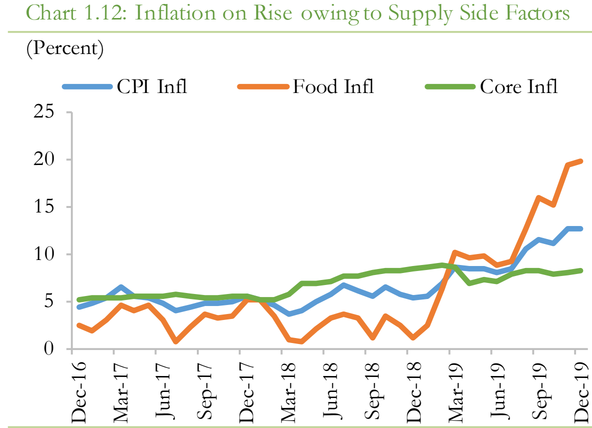


Source: SBP

Nevertheless, despite weak aggregate demand, the inflationary pressures remained elevated due to supply side factors…

Despite weak economic momentum, average inflation during CY19 was 9.35 percent—higher than 5.32 percent observed in CY18 (**Table 1.3**). Pressure on price levels further intensified during H2CY19 as inflation rose to 11.10 percent and even higher beyond the review period.

Chart 1.12: Inflation on Rise owing to Supply Side Factors



Source: PBS

As reflected in broadly stable core inflation, demand-pull factors remained somewhat contained because of stabilization measures.

However, supply-side factors pushed up food and energy inflation throughout CY19 (**Chart 1.12**).

[139] Ministry of Finance, Government of Pakistan

[140] LSM recorded 9.94 percent (YoY) growth rate in December 2019 after showing negative growth almost all months of 2019.

First, PKR/USD exchange rate depreciated by 27.16 and 11.69 percent during CY18 and CY19, respectively. Recurring bouts of depreciation and the subsequent second-round effects led to strong inflationary pressures during CY19. Second, fiscal policy measures taken in the budget for FY20 to minimize subsidies and eliminate tax distortions pushed up prices.[141] Third, upward revision of natural gas and electricity prices to control subsidies and the accumulation of circular debt, led to increase in energy prices. Finally, bottlenecks in regional trade and administrative issues regarding supply chain of a few essential items like wheat and sugar also pushed up the food prices.142

The onset of COVID-19 threatens to temporarily disrupt the recovery prospects of the domestic economy…

The outbreak of COVID-19 across the globe has led to unprecedented levels of uncertainty and economic distress, of the kind not observed in decades. In Pakistan, too, high levels of uncertainty and disruptions caused by much needed lockdown administered to control the contagion are likely to lead to a sharp slowdown in near-term growth. Ongoing expenditures to upgrade healthcare and social safety nets and, a fall in revenue are likely to lead to a temporary rise in the fiscal deficit and public debt. Further, the external sector could face some pressures, though weak import demand and lower oil prices are the mitigating factors. Under these circumstances, inflation is likely to recede faster than anticipated earlier.

Overall, given the improvement in Pakistan's fundamentals pre-COVID-19, the government and SBP's prudent and proactive response, the sound position of the financial system, and the continued support of international financial institutions, Pakistan's economy should be well-placed to resume along the path of reform and recovery once the pandemic subsides. (**For a detailed discussion of potential impact of COVID-19 and corresponding measures taken by SBP, please see Box 1 in Overview).**

[141] These fiscal policy measures include increase in Federal Excise Duty on cigarettes and edible oil, increase in sales tax rate for sugar and elimination of zero-rating for export-oriented industries. *Annual Report on State of Pakistan's Economy 2018-19*.
[142] Annual Report on State of Pakistan's Economy 2018-19.