The Overview

COVID-19: An unprecedented Global Health Crisis

The year 2020 has begun with a Global Health Crisis (**GHC**) triggered by the coronavirus (**COVID-19**) pandemic. It is causing human fatalities at an unprecedented scale and is threatening to damage the world economy like no other crisis in recent history. Until May 29, 2020, the disease has spread to 216 countries, infecting 5,724,342 persons and causing 359,151 deaths worldwide.[1] The necessary quarantines and social distancing practices adopted across the globe to contain the pandemic have resulted in a Great Lockdown, bringing large segments of the global economy to a complete halt. Consequently, the magnitude and speed of the collapse in global economic activity has been staggering **(see Box 1).**

For instance, oil prices—in response to a contraction in global demand—have sharply declined by 30.07 percent.[2] According to estimates of UNCTAD, the economic shock of COVID-19 has wiped out USD 50 billion of global exports in Feb-2020 alone.[3] The pandemic has injected substantial anxiety into the global financial markets. Equity prices—in several large and small economies—have moved down by 30 percent or more. Credit spreads have surged, particularly for lower rated firms and major short-term funding markets have experienced elevated stress.[4]

According to the IMF, the hybrid demand-supply-financial shock from the GHC is likely to contract global output by 3 percent during 2020; a downward revision of 6.3 percentage points from its Jan-2020 forecast.[5] World trade—amid wider disruptions in global supply chains and precipitous declines in demand—is likely to fall by 13 to 32 percent in 2020.[6] Further, intensification of the economic crisis resulting from the GHC may cause more damage to the global financial stability. According to the IMF, this is the worst economic downturn since the Great Depression.

In order to contain downside risks emanating from COVID-19, several countries—besides international financial institutions—have deployed extraordinary policy measures. These include fiscal stimulus worth about USD 8 trillion and liquidity injections by central banks amounting to over USD 6 trillion.[7]

In Pakistan's case, the impact of COVID-19 is still unfolding. Until May 29, 2020 the virus has infected 66,457 individuals and has caused 1,395 deaths.[8] Being a developing country, already dealing with external and internal imbalances that were beginning to be addressed over the last year, policy space is relatively limited compared to advanced economies. Moreover, due to widespread poverty, weak institutional infrastructure, insufficient health facilities, and low levels of literacy and awareness amongst the public, the implementation of complete lockdowns for an extended period, though important, are practically challenging. Therefore, the country is striving to strike a balance between health and economic concerns.

Having said that, because of a rising level of infection, the country initially imposed partial lockdowns, leading to a near halt in economic activities. Non-essential businesses were closed and domestic supply chains were disrupted. Consequently, the largest sub-sectors of the services sector (like, wholesale, retail trade,

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[1] World Health Organization

[2] Brent crude oil prices fell from USD 50.52 per barrel on February 28, 2020 to USD 35.33per barrel on May 29, 2020. West Taxes Intermediate (WTI) oil prices fell from USD 44.83 per barrel on February 28, 2020 to USD 35.32 per barrel on May 29, 2020.

[3] Source: https://news.un.org/en/story/2020/03/1058601

[4] IMF (2020).Global Financial Stability Report, *April.*

[5] IMF (2020). World Economic Outlook. *April*

[6] https://www.wto.org/english/news_e/pres20_e/pr855_e.htm

[7] https://www.imf.org/en/News/Articles/2020/04/15/sp041520-exceptional-times-exceptional-action

[8] http://covid.gov.pk/stats/pakistan

transport, storage, and communication) were severely affected. However, recently the country has moved towards easing of restrictions and opening-up of the targeted sectors of the economy. This could help provide support to the economic activity. Nevertheless, the situation remains uncertain and volatile.

As in other Emerging and Developing Economies (**EMDEs**), the changing risk sentiment of global investors has resulted in net outflows of foreign portfolio investment of around USD 2.8 billion from end February to May 21, 2020.[9] Exchange rate volatility has also increased considerably. The local currency depreciated by 8.19 percent against the greenback during a short span of 6 weeks since end Feb-2020, though it partially recovered afterwards and is now down by 5.90 percent.[10] The KSE-100 index touched the level of 27,228 on March 25, 2020, lowest in the last 5-years, before making a comeback and recovering to the level of 33,931 by May 29, 2020 due to various policy stimuli and participation of investors to take benefit of low valuations. Overall, the impact on the domestic markets has been in line with that observed on average across comparable emerging markets. This suggests that the effects have largely been exogenously driven, with Pakistan's improved fiscal and external fundamentals over the last year helping to contain the fall-out.

Against this backdrop, the federal government, the provincial governments and the State Bank of Pakistan (**SBP**) have taken broad-based and intensive policy measures. The federal government has announced fiscal support equivalent to USD 7 billion.[11] Also, the government has availed financing of USD 1.4 billion under IMF Rapid Financing Instrument (**RFI**).[12] SBP has used a wide variety of the tools at its disposal including monetary easing, release of macroprudential buffers, microprudential regulatory relaxations, facilitation and cost reduction in debt servicing to provide relief to the economy at this difficult time.

The policy rate has been cut by 525 basis points (**bps**), the Capital Conservation Buffer (**CCB**) has been reduced by 100 bps, debt deferral and rescheduling/restructuring has been announced, concessional financing has been made available including for healthcare and avoiding layoffs, and payments system related costs have been reduced. (**See Box 1 for details**). Within its domain, SBP has endeavored to ensure availability of uninterrupted financial services to the public.

Further, in order to assess the implications of the COVID-19 pandemic for financial institutions and to firm up policy response, SBP conducted two surveys in the month of March and April 2020.[13] Besides highlighting the risk of deterioration in the financial health of their clients and its spillover effects, banks estimated around 28.52 percent (PKR 2.51 trillion) of their advances as being at risk. Based on the first survey results, SBP issued an advisory circular to ensure the availability and continuity of financial services (**see Box 1**).

Going forward, the speed and extent of global and domestic economic revival are inextricably tied to the recovery from the breadth and depth of the disease's spread. As such, there is much uncertainty about the severity and duration of the pandemic as well as about the effectiveness of the adopted measures to contain it. Since the pandemic is still unfolding, a longer and more challenging recovery path could be on the cards.

With the continuing challenges posed by the COVID-19 outbreak, the outlook for the domestic

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9 SBP (http://www.sbp.org.pk/ecodata/SCRA_Arch.xls)
10 The mid weighted exchange rate stood at PKR 154.21 per USD on February 28, 2020, PKR 166.68 per USD on April 17, 2020 and PKR 163.31 per USD on May 29, 2020
11 World Bank (2020). South Asia Economic Focus. *April*
12 https://www.imf.org/en/Publications/CR/Issues/2020/04/16/Pakistan-Request-for-Purchase-Under-the-Rapid-Financing-Instrument-Press-Release-Staff-49342
13 The respondents included banks, Development Financial Institutions (DFIs), and Microfinance Banks (MFBs).

economy has trended downwards. The external account is likely to face some pressures, as around 30 percent of Pakistan's exports are concentrated in countries severely hit by the GHC.[14] At the same time, remittances might also decelerate or even fall.[15] However, weak import demand and lower oil prices are the mitigating factors. The fiscal account is likely to experience elevated pressures due to the rise in relief related expenditures and anticipated decline in revenues due to slowdown in economic activity. Against this backdrop of anticipated marked deterioration in domestic and external macroeconomic environment, Pakistan economy faces weak near-term prospects, with output projected to contract by 1.5 percent in FY20 according to the IMF.[16]

From the financial sector perspective, the impact of COVID-19 could be multifaceted. On the one hand, it would demand the industry to focus on managing the risks associated with the outbreak including health and safety of the employees. On the other hand, it offers opportunities to enhance the digitalization of financial services, such as IT based solutions for provision of credit. In the wake of social distancing practices, the increasing reliance on tech-based solutions also pose cyber security concerns, which the banks and other financial institutions need to manage.

As for the banking sector, if the COVID-19 outbreak prolongs, Non-Performing Loans (**NPLs**) could accelerate, profitability could reduce and solvency could potentially come under pressure. In order to quantify these impacts, stress tests were conducted. The results indicate that under the baseline scenario[17], the solvency of the banking sector could experience some moderation over the simulation horizon of 5-years; however, it is expected to remain well above the domestic regulatory capital benchmark. Under an adverse scenario[18], the banking sector can withstand some severe and protracted downturn induced by adverse global and domestic macroeconomic conditions, including the COVID-19 pandemic. However, the resilience of the small sized banks starts waning towards the end of the simulation period (**see Chapter 4**).

Besides the banking sector, non-bank financial institutions could also face challenging conditions. For instance, the insurance sector could experience stress due to a rise in claims related to life and health segments. Moreover, the disruptions in supply and demand, caused by the pandemic, are likely to dent the cash flows of the corporate sector, which may lead to lower repayment capacity and put pressure on financial stability.

State of financial stability prior to COVID-19

Prior to the COVID-19 outbreak i.e. in CY19, the global economy expanded by 2.9 percent—down from 3.6 percent in 2018. Both, Advanced Economies (**AEs**) as well as EMDEs experienced economic slowdowns. Increased trade tensions, uncertainty of a no deal Brexit, slowdown in China, and idiosyncratic issues in several EMDEs constrained the pace of economic activity across the globe.

The emergence of fading economic prospects in the early months of 2019 prompted major central banks to initiate another rate cutting cycle that was quite synchronized across the world.[19] While it helped limit downside risks to global growth, the resultant easing in financial conditions fueled further build-up of financial vulnerabilities in the form of stretched equity prices, increased financial

[14] World Bank (2020). South Asia Economic Focus. *April*
[15] According to World Bank estimates, remittances could decline by 22.1 percent in South Asia during 2020. https://www.worldbank.org/en/news/press-release/2020/04/22/world-bank-predicts-sharpest-decline-of-remittances-in-recent-history
[16] http://www.sbp.org.pk/m_policy/2020/MPS-Apr-2020-Eng.pdf
[17] It assumes that the spread of COVID-19 will be relatively contained and short-lived; mainly limited to the first half of CY20.
[18] The Adverse scenario assumes a protracted and wider spread of COVID-19 in CY20 and well into CY21.
[19] There were 71 interest rate cuts by 49 central banks across the globe during the year 2019.

risk taking, and rise in non-financial sector debt (**see Chapter 1**).

In the domestic context, as a result of stabilization measures (e.g. monetary tightening, realignment of exchange rate with the market fundamentals, fiscal consolidation measures including rationalization of subsidies, rise in taxes and duties etc.) adopted to contain rising macroeconomic vulnerabilities, the pace of economic activity weakened during FY19 (3.29 percent vs. 5.53 percent in FY18). However, signs of economic recovery emerged towards the end of CY19 as manifested, among other indicators, by the revival in the Large Scale Manufacturing (**LSM**) sector.[20] Also, Business Confidence Index (**BCI**) demonstrated gradual but consistent improvement in the second half of CY19.[21] This was a manifestation of healthy improvement in some key macroeconomic indicators such as current account balance, forex reserves, exchange rate, and fiscal balance.[22] Despite sluggish economic conditions, however, inflationary pressures persisted during CY19 owing to supply side issues (**see Chapter 1**).

Contrary to the weak economic activity during CY19, the **Financial sector** performed reasonably well. The consolidated assets of the financial sector expanded by 11.74 percent—up from 7.46 percent recorded in the previous year. However, financial depth (financial assets to GDP) slightly moderated because of higher inflationary pressures during the reviewed year **(see Table 1**).

Table 1: Assets Composition of the Financial Sector

	CY15	CY16	CY17	CY18	CY19
Assets (PKR Billion)	19,416	21,853	24,734	26,579	29,699
Growth rate (Percent)	15.46	12.55	13.18	7.46	11.74
YoY Asset Growth (Percent)					
MFBs	39.13	74.65	45.21	32.65	15.88
DFIs	8.14	9.63	9.18	4.60	58.12
NBFIs	11.10	15.77	-1.11	8.74	13.03
Insurance	17.76	31.81	8.21	9.95	8.09
CDNS	10.11	6.66	5.58	5.30	9.42
Banks	16.83	11.93	15.86	7.31	11.73
Percentage Share in Total Assets					
MFBs	0.50	0.78	1.00	1.23	1.28
DFIs	0.98	0.96	0.92	0.90	1.27
NBFIs	4.90	5.04	4.40	4.46	4.51
Insurance	4.90	5.74	5.49	5.62	5.43
CDNS	15.87	15.04	14.03	13.75	13.46
Banks	72.84	72.44	74.16	74.05	74.05
Assets as a Percentage of GDP*					
MFBs	0.34	0.56	0.74	0.90	0.92
DFIs	0.67	0.68	0.69	0.65	0.91
NBFIs	3.37	3.61	3.27	3.24	3.24
Insurance	3.37	4.11	4.08	4.08	3.91
CDNS	10.90	10.78	10.43	9.99	9.68
Banks	50.05	51.91	55.13	53.79	53.27
Overall Assets	68.71	71.65	74.34	72.64	71.94

Note: Data of Insurace sector for 2019 is as of September, 2019
*GDP at market prices,
Source: SBP, SECP, CDNS & PBS

After remaining volatile in the first half of the year, the **Financial Markets** observed stability in the second half due to softening macroeconomic vulnerabilities and lower uncertainty among market participants The operation of the forex market smoothed post transition to a market based exchange rate system. Moreover, the change in interest rate expectations pushed financial institutions towards longer-tenor government securities, which helped reduce the rollover risk for the government. The equity market also rebounded towards the end of CY19, though it remained quite volatile during the year (**see Chapter 2**).

Banking sector—with the highest share in financial sector assets—managed to improve resilience and profitability, despite the challenging environment. Though demand for financing softened—amid stabilization measures —banks' assets expanded by 11.73 percent in CY19 due to a surge in investments, mostly in government securities. Encouragingly, with a rise of 11.92

[20] LSM stopped contracting in Q2FY20 (0 percent growth against -5.7 percent in Q1FY20).
[21] http://www.sbp.org.pk/research/BCS-r.asp
[22] Current account deficit contracted by 75.0 percent during H2CY19. SBP forex reserves improved to USD 11.3 billion by end Dec-19 from USD 7.3 billion at end June-19. Fiscal deficit reduced to 2.3 percent (as percentage of GDP) in H1FY20 from 2.7 percent in H1FY19.

percent, deposits exhibited marked recovery. Also, banking sector's profitability rebounded to 14.34 percent during the reviewed year, after declining for the last few years. The Capital Adequacy Ratio (**CAR**) also inched up by 90bps to 17.0 percent well above the minimum regulatory requirements of 12.5 percent. However, the rise in NPLs for another year remained a concern (**see Chapter 3.1**).

The performance of **Islamic Banking Institutions** (**IBIs**) was remarkable as their assets—despite deceleration in financing—increased by 23.52 percent during CY19. The strong profitability of IBIs made a notable contribution to the overall earnings of the banking sector. Moreover, IBIs recorded healthy inflow of deposits. However, liquidity management challenges continued to prevail owing to the dearth of short-term investment avenues (**see Chapter 3.2**).

Likewise, the performance of the **Non-Bank Financial Sector** also remained satisfactory during CY19. The **Development Finance Institutions** (**DFIs**) observed strong expansion in assets, driven by investments in government securities. Consequently, interest income drove up DFIs' profitability. However, financing of asset growth through short-term borrowings is not an appropriate modus operandi in the long-run. DFIs continued to face challenges in expanding advances portfolio, owing to restrained access to longer tenor affordable funding. Aligning DFIs' operations with their mandate of project financing, housing, and SMEs finance remained a policy concern (**see Chapter 5.1**).

The **Non-Bank Financial Institutions** (**NBFIs**) experienced stress in the first half of CY19 due to challenging economic conditions. However, their performance rebounded during H2CY19 as assets expanded by 13.0 percent in CY19 (8.7 percent in CY18). The turnaround in NBFIs' performance was because of a recovery in the equity market, which in turn triggered growth of mutual funds (principal component of NBFIs). However, entities involved in the financing business faced a broad-based slowdown in assets growth owing to monetary tightening. Encouragingly, the risks emanating from interconnectedness between the banks and NBFIs remained muted during CY19 (**see Chapter 5.2**).

The **Insurance** and takaful industry observed a modest rise in the asset base during CY19.[23] After tax profit declined by 8.81 percent, owing to a substantial increase in net claims of the life sector and reduced investment income in the wake of weak equity market performance. However, a rise in investment income from government securities helped mitigate the decline in profitability (**see Chapter 5.3**).

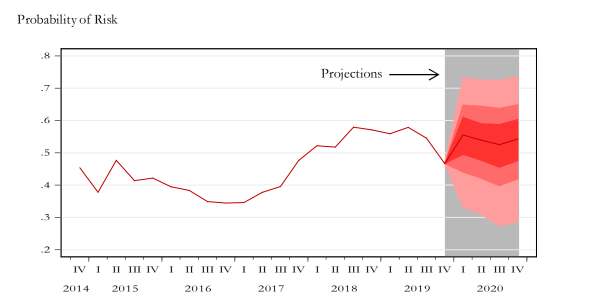
The non-financial **corporate sector** experienced a dip in sales and higher financial cost during CY19 due to monetary tightening and unfavorable economic conditions. However, corporates were able to improve profitability by minimizing their administrative expenditures and costs associated with sales. This consequently helped improve their debt repayment capacity. In terms of sectors, the automobile and cement sectors observed marked deterioration in sales performance. Positively, the probability of defaults, despite a minor increase, remained on the lower side (**see Chapter 6**).

The **Financial Market Infrastructures (FMIs**) remained effective and resilient. Pakistan Real-Time Interbank Settlement Mechanism (**PRISM**) handled a larger volume and value of transactions during CY19. Launching the National Payment System Strategy (**NPSS**)—in order to bring greater efficiency and accessibility—was a notable achievement. Encouragingly, operational risk remained lower as Automated Teller Machine (**ATM**) downtime reduced further. Moreover, regulations were issued for the promotion of

[23] The data was available up to Sep-2019.

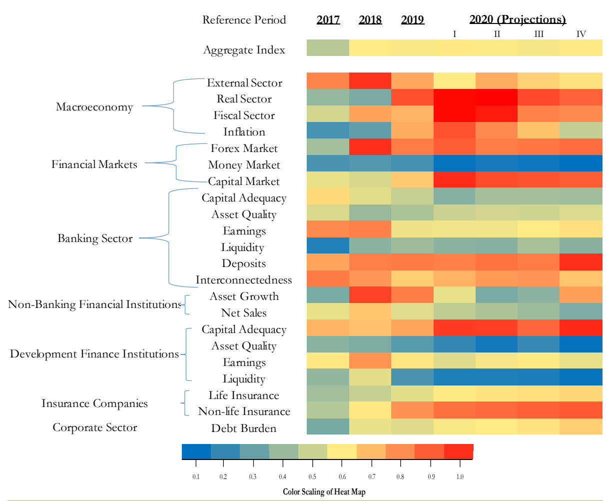
Electronic Money Institutions (**EMIs**) to ensure the availability of innovative payment options to the retail payments segment of the country (**see Chapter 7**).

Chart 1(a): Financial stability after easing in CY19 could come under stress in CY20



Source: SBP Staff estimates

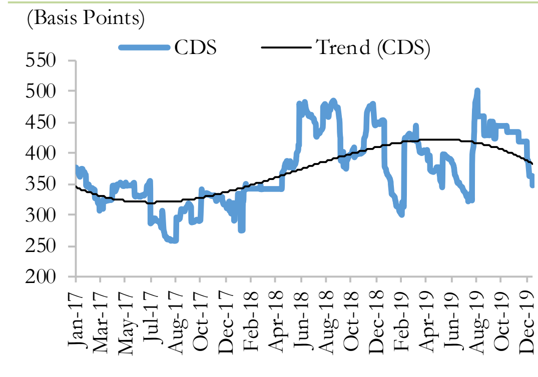
Chart 1(b): Macrofinancial indicators could exhibit higher stress in CY20



Source: SBP

Overall, financial system vulnerabilities increased during the first half of CY19, owing to sustained macroeconomic imbalances in the external and fiscal sectors and elevated uncertainty among market participants about the future economic direction. However, in the second half of CY19, the confidence of the financial market participants returned and uncertainty faded as the stabilization measures agreed under the IMF program started taking effect. Moreover, during CY19, SBP had taken a number of policy measures, which also contributed towards strengthening the state of financial stability in the country **(See Box 3).** As a result, the state of financial stability presented a reasonably better picture (**Chart 1a & 1b**). This was also evident by the declining Credit Default Swap (**CDS**) premium towards the end of CY19, reflecting reduced sovereign risk perceptions (**Chart 2**).

Chart 2: Pakistan's Risk Premium declined towards the end of CY19



Source: Bloomberg

Moreover, the 5th wave of **SBP Systemic Risk Survey** (conducted in Jan-2020 prior to COVID-19), revealed that domestic macroeconomic (increase in inflation, slowdown in growth and deterioration in household saving and income) and global risks would likely be the key concerns for the stability of the financial system for the next six months (**see Box 2**).

Nevertheless, given weak near-term growth prospects and uncertainties associated with COVID-19, financial sector vulnerabilities could rise going forward. Stress-tests suggest that the banking system should remain resilient overall, but smaller-sized institutions could face greater pressures over long-term in an adverse scenario. The stress-test results are, however, subject to a significant uncertainty due to unpredictability surrounding the severity, duration and path of the COVID-19 pandemic, both, globally and domestically. SBP is closely monitoring the emerging developments and is responding appropriately to limit the risks.