Chapter 1: Global and Domestic Macro Financial Environment

After experiencing historic losses in CY20, global economy continues to face uncertainties and divergent recovery prospects in the wake of COVID-19 pandemic. With acceleration in immunization, growth is likely to rebound strongly in advanced economies while the pandemic may continue to disrupt economic activity in emerging market economies for some time. Although commodity prices have recovered to their pre-pandemic levels yet, inflationary pressures remain muted in advanced as well as most of the emerging economies. Aggressive use of counter cyclical monetary and fiscal policies has supported response to the crisis and economic recovery, while central banks' measures helped in both containing the negative economic effects and preserving the financial stability. However, a sharp rise in fiscal deficits and public debt has been observed in both advanced and emerging markets.

Domestically, the impact of outbreak and the associated containment measures led to substantial losses to the economic activity and prompted a policy recalibration of the ongoing stabilization program to minimize the economic fallout. As a result of prudent and well-targeted relief measures, economic activity rebounded, the fiscal deficit remained in check despite counter-cyclical expenditures, the current account and FX reserves showed marked improvements, exchange rate continued to follow stable trajectory and the banking sector remained profitable as well as resilient. However, inflation remained elevated primarily due to food supply shocks while private sector credit growth remained subdued owing to demand and supply factors.

Global Developments

Global community faced enormous human and economic losses due to COVID-19 pandemic…

Global community continues to face historic humanitarian, economic and social losses owing to Global Health Crisis (**GHC**) caused by the Corona virus (**COVID-19**) which emerged at the start of CY20. More than 3.9 million people have already died; whereas despite enormous counter cyclical economic relief measures undertaken by the authorities to dampen the economic fallout, world economy *contracted* by 3.3 percent due to mobility restrictions, lockdowns and closure of business activities to combat the pandemic (**Table 1.1**).[8] The contraction turned out to be 6.6 percentage points below the estimated growth rate of 3.3 percent projected for CY20 before the onset of the pandemic.[9]

Table 1.1: Global Economy: Real GDP Growth (percent)

	2019	2020	2021*	2022*
World	2.80	-3.30	6.00	4.40
Advanced Economies	1.60	-4.70	5.10	3.60
EMDEs	3.60	-2.20	6.70	5.00
EMDEs - Asia	5.30	-1.00	8.60	6.00
USA	2.20	-3.50	6.40	3.50
Euro Area	1.30	-6.60	4.40	3.80
U.K	1.40	-9.90	5.30	5.10
Japan	0.30	-4.80	3.30	2.50
Argentina	-2.10	-10.00	5.80	2.50
China	5.80	2.30	8.40	5.60
Turkey	0.90	1.80	6.00	3.50
India	4.00	–8.0	12.50	6.90
Russia	2.00	-3.10	3.80	3.80
Saudi Arabia	0.30	-4.10	2.90	4.00
United Arab Emirates	1.70	-5.90	3.10	2.60
Pakistan	1.90	-0.40	1.50	4.00

Source: IMF World Economic Outlook, April 2021
*Projections

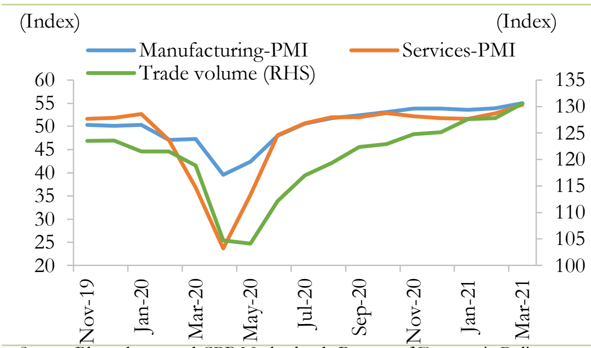
[8] Absent these counter cyclical relief measures, output losses could have been three times higher. International Monetary Fund. (2021). World Economic Outlook: Managing Divergent Recoveries. *Washington, April.*

[9] International Monetary Fund. (2021). World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? *Washington, January.*

…accompanied by economic losses, income disparity widened within-country and across-countries

Owing to unique nature of the crisis that puts the contact intensive sectors at disadvantage, incomes and employment prospects of daily wagers, informal sector and migrant workers have been affected disproportionately. Resultantly, around 95 million more people are estimated to have fallen below the extreme poverty benchmark of daily earning of two dollars during CY20, while income inequality has risen.[10] Apart from increasing within-country income inequality, the pandemic is likely to disrupt the pace of convergence between advanced economies (**AEs**), and emerging markets and developing economies (**EMDEs**) owing to disparity in the availability of vaccines and consequent divergent impacts on human health and economic activities.

Chart 1.1: Global High Frequency Economic Indicators

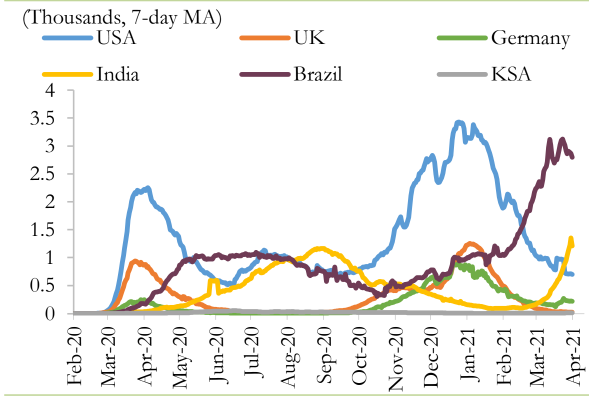


Source:Bloomberg and CPB Netherlands Bureau of Economic Policy Analysis
Note: PMI= Purchasing Manager Index

Economic recovery in second half of CY20 was followed by a second wave of the virus

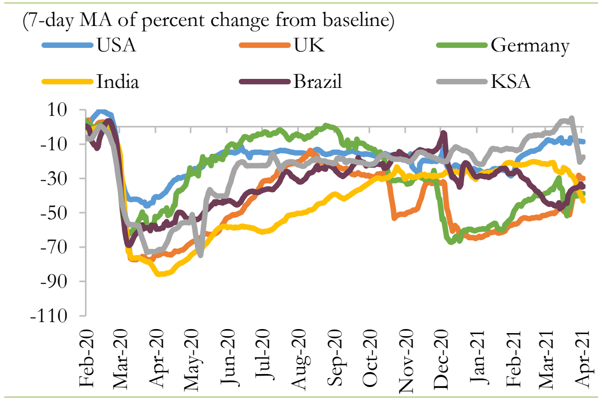
Almost all countries across the globe administered necessary containment measures after declaration of COVID-19 a pandemic in March 2020. At their peak level in April 2020, these restrictions substantially affected manufacturing, services and trade sectors. A gradual easing of the restrictions was observed in Q2CY20, which led to revival of economic activity in second half of CY20 (**Chart 1.1**).[11] However, the gradual lifting of lockdowns was followed by new waves of the pandemic towards the end of CY20, leading to re-imposition of containment measures in many countries (**Charts 1.2 a & b**).

Chart 1.2 - a: Daily New Deaths



Source: Datahub

Chart 1.2 - b: Change in Retail and Recreation Mobility



Source: Google COVID-19 Community Mobility Reports

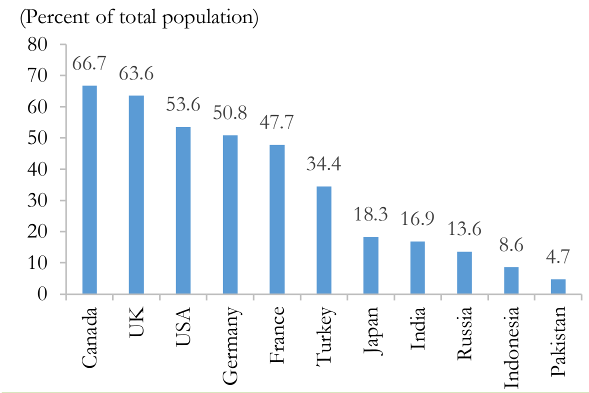
COVID-19 vaccines boost sentiments in AEs while most of the EMDEs continue to face high uncertainty…

With a breakthrough in COVID-19 vaccine in late CY20, the level of uncertainty reduced, which boosted the prospects of economic recovery. However, the materialization of recovery

[10] International Monetary Fund. (2021). World Economic Outlook: Managing Divergent Recoveries. *Washington, April.*
[11] The revival of activity was primarily attributed to a pent-up demand for consumer durables, increased demand for cars and electronic devices related to work-from-home arrangements.

prospects strongly hinges upon availability of inoculations, where a considerable variation between rich and developing countries is clearly visible (**Chart 1.3**). COVID-19 vaccine procurement data shows that AEs are likely to achieve a complete vaccination of population by June 2021 while most of the EMDEs may take longer to achieve the same level of inoculation.[12]

Chart 1.3: Share of Population Vaccinated - June 21, 2021



Source: ourworldindata.org

The pace of vaccination programs in developing world is likely to be key in addressing the spread, duration, and consequent normalization of economic activity. The Indian experience with the second wave sheds light upon the scale of risk posed by COVID-19 and importance of sufficient inoculation to mitigate the risk. Amid monetary and fiscal support measures coupled with the mass vaccination campaigns, the AEs are likely to grow by 5.10 percent and 3.60 percent during CY21 and CY22 while EMDEs are expected to grow by 6.70 percent and 5.00 percent (**Table 1.1**).

GCC countries show bright recovery prospects

Gulf Cooperation Council (**GCC**) countries are the key source of home remittances and important trade partners of Pakistan. GDP in these countries recorded a contraction of 4.80 percent during CY20; mainly on account of historic dip in oil prices coupled with disruptions caused by the pandemic. However, because of early start of vaccination drives, recovery prospects remain strong in GCC countries. Rebound in oil prices, primarily attributed to recovery in AEs and China and, production cuts by OPEC+,[13] are likely to help control pandemic-induced elevated levels of fiscal and current account deficits during CY21 and CY22 (**Table 1.2**).

Table 1.2: Gulf Cooperation Council (GCC) Macroeconomic Performance

	2018	2019	2020	2021*	2022*
Real GDP (annual growth rate)	1.90	0.70	-4.80	2.70	3.80
Current Account Balance (percent of GD	8.60	5.80	-1.30	4.20	3.80
Fiscal Balance (percent of GDP)	-1.60	-1.60	-9.20	-3.00	-1.40
Oil Price (US$ per barrel)**	68.5	61.5	41.6	58.5	54.8
Inflation (annual average, percent)	2.20	-1.50	1.20	2.70	1.90

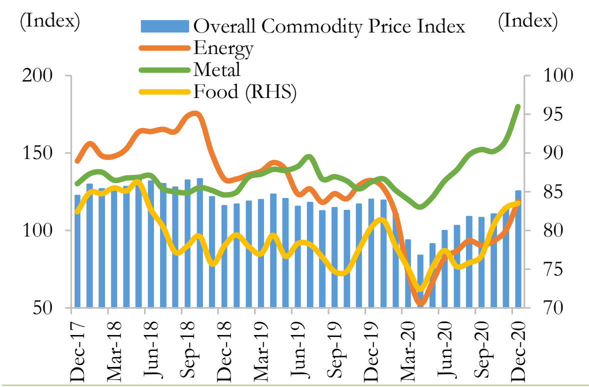
Source: Regional Economic Outlook, Middle East and Central Asia, IMF, April 2021
*IMF-Projections
**Average of UK Brent, Dubai Fateh and West Texas Intermedital crude oil prices.

Commodities prices depicted persistent rise since April 2020

Commodity prices, including oil, metals and food, observed substantial softening during February to April 2020, mainly in response to weak demand conditions. For instance, at the peak of crisis in April 2020, world oil prices touched the historic low of USD 21.04[14] per barrel. However, with easing in lockdowns, commodity prices exhibited a broad recovery after April 2020 (**Chart 1.4**). Oil prices rebounded strongly on account of improved demand conditions after relaxations in lockdowns and production cuts administered by OPEC+. Based on future markets, average oil prices are projected to remain in the range of USD 55-59 per barrel until CY22.

[12] At the end of March 2021, fractions of people vaccinated for G20 advanced economies (16 percent), G20 emerging economies (2 percent), non-G20 emerging economies (1 percent) and low-income developing countries (0.5 percent) depicted wide gaps in inoculation levels with respect to income level of countries. IMF WEO, April 2021
[13] Organization of Petroleum Exporting Countries and Russia.
[14] Monthly average of Brent, Dubai and West Texas Intermediate.

Chart 1.4: Commodity Prices



Source: Bloomberg and IMF

The global food price index also rose considerably by 20.90 percent, during March 2020 to February 2021. Substantial rise in prices of wheat, corn, soybeans and palm oil was observed during H2CY20. Soybeans and corn prices surged because of relatively poor production in USA and South America while wheat prices increased due to weak crop performance in USA and EU and, introduction of export tax by Russia. Strong demand conditions for the purpose of stockpiling; especially by China, also contributed to surge of wheat and overall food prices.

Inflation, though, remained contained in advanced and emerging economies

Weak demand conditions and substantial reduction in commodity prices before April 2020 lowered inflation rates in AEs that approached zero percent in USA, EU and Japan. After revival of economic activity amid massive support and relief measures, inflation exhibited some recovery in USA. However, inflation rates have remained negative in EU and Japan and, lower than long-term average in UK. In case of emerging economies, inflation remained stable as well except for China, where a deceleration was observed (**Chart 1.5**).

Chart 1.5 - a: Inflation in Selected AEs

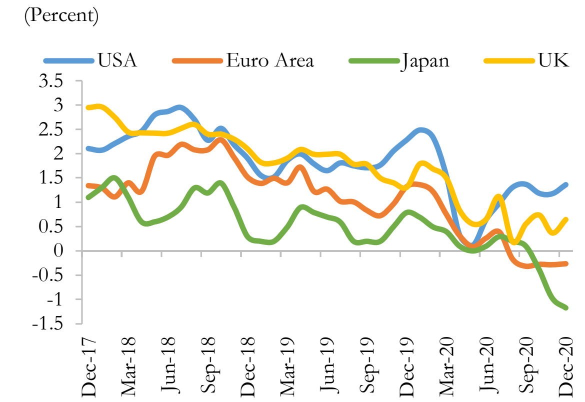
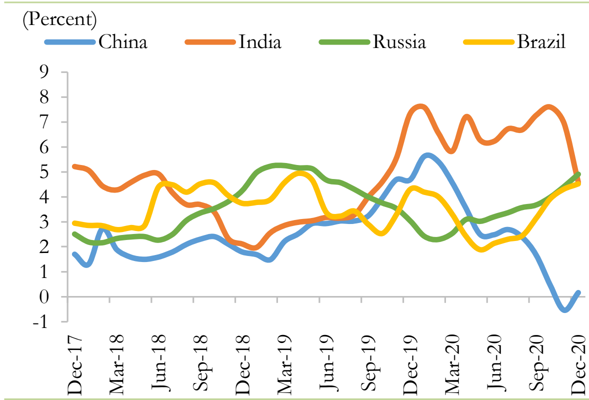


Chart 1.5 - b: Inflation in Selected EMDEs



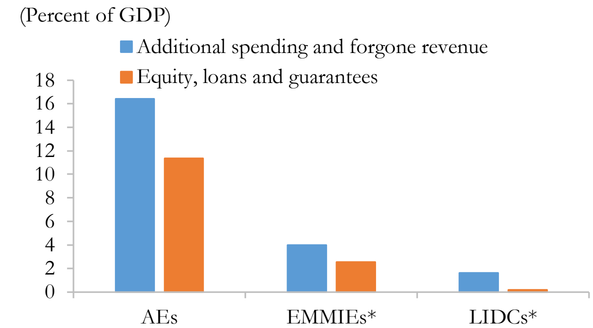
Source: Haver Analytics

Aggressive counter cyclical fiscal policies were introduced by AEs and EMDEs to contain economic fallout…

Considering the scale of economic fallout brought about by stringent lockdowns, fiscal authorities made efforts to provide a comprehensive policy response. The authorities, especially in AEs, adopted aggressive counter cyclical expansionary policies including revenue cutting and expenditures boosting measures to support vulnerable households as well as firms, which were facing severe impairment in their cash generation capacity and income. Estimated amount of global fiscal response to the crisis reached USD 16 trillion by March 2021. Relative to GDP, relief measures provided by advanced, emerging and low-income countries are 16.42 percent, 3.98

percent and 1.62 percent, respectively (**Chart 1.6**).[15]

Chart 1.6: Fiscal Policy Reponse to COVID-19

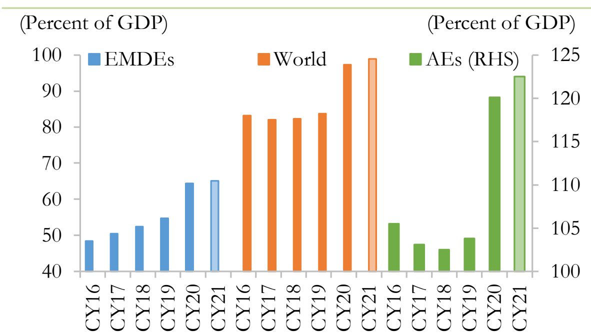


Source: IMF
* EMMIEs: Emerging Markets and Middle-Income Economies
LIDCs: Low-Income Developing Countries

…leading to a surge in deficits and debt levels…

The support measures correspondingly worsened the fiscal deficits and debt levels. This rise in deficits and loss of revenues owing to lockdowns led to a substantial rise in the public debt across the globe (**Chart 1.7**).[16]

Chart 1.7: Public Debt in AEs and EMDEs



Source: IMF
Note: Data for 2021 represents IMF forecast

Divergence in vaccine access and recovery could lead to varied fiscal performance in medium term

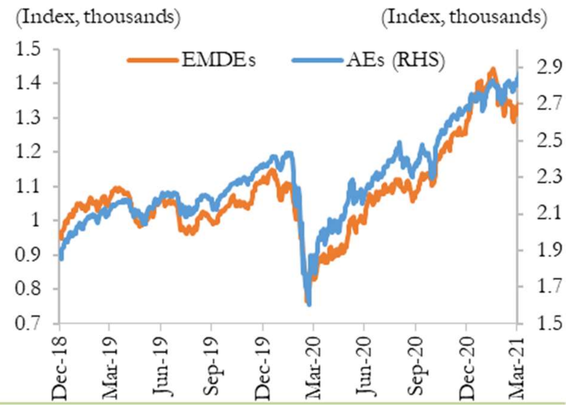
On account of vaccine-driven recovery leading to relatively low requirement of support measures, fiscal deficits in AEs are likely to recede. Resultantly, government debt-to-GDP ratio is likely to remain stable at around 121 percent in the medium term. However, owing to divergent recovery prospects, primarily attributed to lower access to vaccines, the debt levels in the emerging economies may observe gradual uptick from 64.4 at the end of CY20 percent to 73.2 percent in the medium term.[17]

Financial markets observed surge in volatility at the start of the crisis…

Starting from March 2020, rising infections across the globe caused a significant dent to investors' sentiments, leading to crash of markets in AEs, and EMDEs (**Charts 1.8 a & b**). Market liquidity conditions, as reflected in financial conditions index, tightened swiftly, leading to serious concerns about financial stability. In particular, EMDEs experienced sudden capital outflows due to shift in global investors' risk appetite in favor of financial assets based in AEs. This flight to safety led to tightening of financial conditions and pressure on the currencies of emerging market economies.[18]

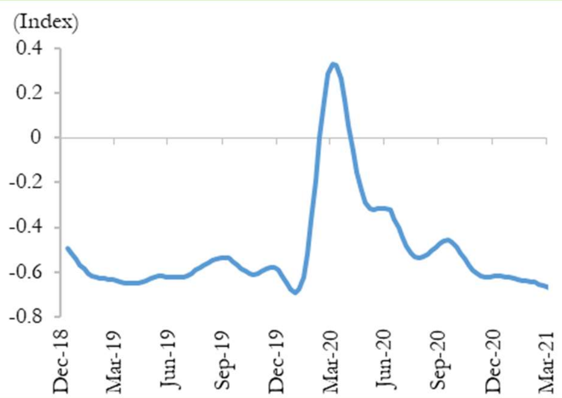
[15] IMF Fiscal Monitor, April 2021
[16] IMF Fiscal Monitor, April 2021
[17] IMF Fiscal Monitor, April 2021
[18] IMF Global Financial Stability Report, April 2021

Chart 1.8-a: Equity Prices in AEs and EMDEs



Source:Bloomberg

Chart 1.8-b: Financial Conditions Index

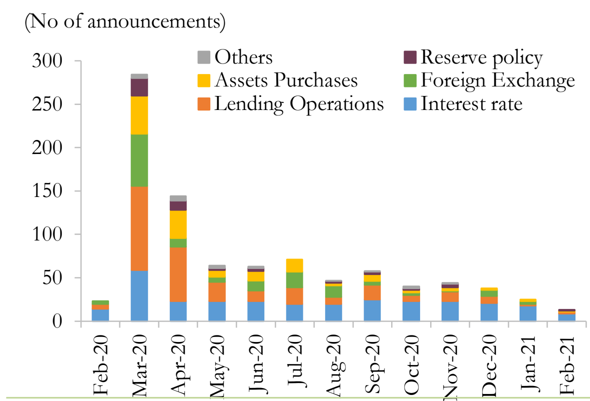


Source: fred.stlouisfed.org

…pushing central banks to use conventional and unconventional policy tools to support recovery and protect financial stability …

Under such precarious and unprecedented situation, central banks aggressively used both conventional and unconventional tools to support liquidity, flow of credit, and solvency conditions of the financial institutions. Policy tools utilized by the central banks can be categorized in five general types: interest rate measures, lending operations, FX operations, asset purchases and variations in reserves requirements. At the start of the crisis, central banks ensured viability of financial system against the backdrop of unprecedented levels of uncertainty through interest rate cuts.[19] These policy rate measures were augmented by lending operations to ensure supply of credit to liquidity constrained households and firms. Moreover, FX operations were used to ease pressure on exchange rates, especially in emerging markets. To ease domestic liquidity conditions via unconventional tools, asset purchases were also utilized abundantly by advanced economies, though less frequently by emerging economies (**Charts 1.9**).[20]

Chart 1.9: Monetary Policy Responses to the Pandemic



Source: Bank for International settlements (BIS)

Resulting easy financial conditions started to nurture vulnerabilities…

Impact of pandemic control measures on world GDP growth is estimated to be 6.6 percentage points.[21] However, abundant use of expansionary fiscal and monetary policies to support the economic activities, has led to extremely easy financial conditions giving rise to a number of vulnerabilities. First, a persistent rise in equity prices in advanced economies since April 2020 led to overvaluations.[22] Second, divergence in economic recovery between AEs and developing economies, mainly attributed to vaccine availability and policy response to COVID-19, has strong

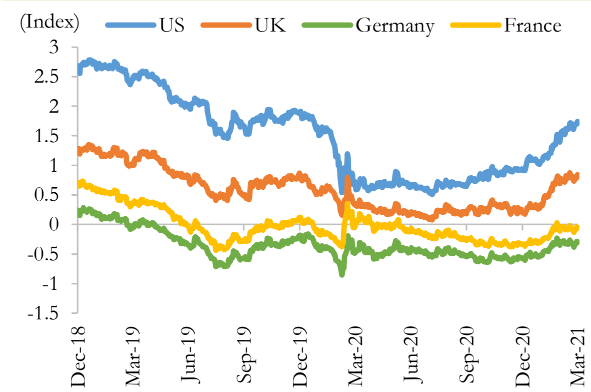
19 Carlos Cantú, Paolo Cavallino, Fiorella De Fiore and James Yetman (2021), "A global database on central banks' monetary responses to Covid-19", BIS Working Paper 934.
20 By March 2021, central banks have made USD 10 trillion worth of asset purchases. IMF (2021), Global Financial Stability Report, April

21 Estimated CY20 world GDP growth is -3.3 percent. In absence of support measures, output contraction could have been three times larger. IMF WEO, April 2021.
22 IMF Global Financial Stability Report, April 2021.

implications for developing countries. An improvement in advanced economies' growth and inflation expectations has already started to reflect as an uptick in long-term interest rates (**Chart 1.10**). This rise in interest rates may tighten the financial conditions for developing countries. Finally, combination of weak economic conditions and easy financial conditions has escalated corporate leverage and risk levels in both AEs and EMDEs. Under uncertainty, banks and investors may adopt a cautious approach in extending credit to vulnerable firms, which may prolong the economic recovery process.

Going forward, global economic recovery hinges upon various factors related to the pandemic, financial conditions and commodity prices. Importantly, contained pandemic outcomes, global access to vaccination and breakthrough in medical treatment of the COVID-19 and effectiveness of existing vaccines against new variants may boost recovery prospects.

Chart 1.10: Ten-Year Government Bond Yields



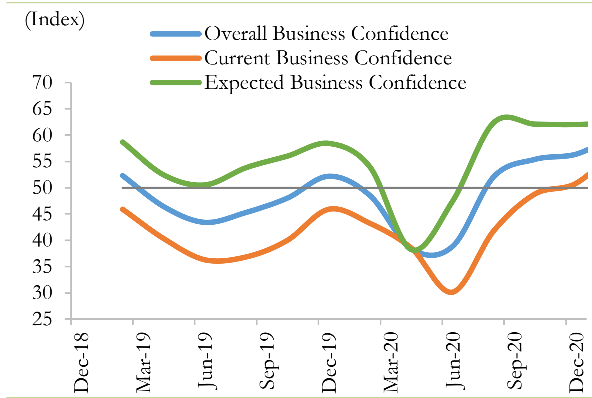
Source: Bloomberg

Domestic Developments

Early achievements of stabilization program marked bright prospects at the start of CY20…

The domestic economy entered CY20 in a situation when stabilization measures undertaken under the umbrella of IMF Extended Fund Facility (**EFF**) had just started bearing desired results. Cautious fiscal and monetary policies, market-based exchange rate and elimination of some preferential tax treatments had largely controlled the menace of twin deficits. These early achievements boosted domestic as well as foreign investors' sentiments. Optimism of domestic businesses was reflected in consistent improvement in Business Confidence Index since July 2019 (**Chart 1.11**), while foreign investors' confidence was manifested by portfolio investment inflows into local currency government debt securities.

Chart 1.11: Business Confidence Indices



Source: SBP

…but the advent of Global Health Crisis led to huge losses of economic activity

However, at the start of CY20, domestic as well as global economy was hit by Global Health Crisis brought about by COVID-19. In Pakistan, initial cases started to appear at the end of February 2020 while strict lockdowns to contain the spread of the pandemic were implemented in March 2020. Lockdown restrictions included closure of markets and manufacturing units except for essential services, ban on intercity and interprovincial transport, closure of educational institutes and ban on mass gatherings. These restrictions, which were gradually eased from May 2020, though shielded the country from massive spread of the pandemic yet proved to be costly in terms of loss of economic activity. Transport, trade, manufacturing, education and hospitality services sectors were affected badly leading to a contraction of overall economy by 0.47 percent during FY20 (**Table 1.3**). At the peak of the crisis in April 2020, the large scale manufacturing (**LSM**) contracted by a massive 41.90 percent on YoY basis. Exchange rate and FX reserves also temporarily came under pressure as foreign investors rebalanced portfolio investments in quest for flight to safety.

Table 1.3: Key Economic Indicators of Pakistan*

	2017	2018	2019	2020
Real Sector		(Percent)		
Real GDP Growth (FY)	5.22	5.53	2.08	(0.47)
LSM Growth (Average YoY)	7.10	1.32	(2.62)	(4.58)
Inflation (Average YoY)	5.04	5.32	9.35	9.53
External Sector		(USD Billion)		
SBP Reserves (End-of-Period)	14.11	7.20	11.34	13.42
Current Account Balance	(16.18)	(18.86)	(8.56)	0.25
Exports (Goods)	21.51	23.42	23.30	21.98
Imports (Goods)	57.31	60.05	50.01	45.81
Trade Balance	(35.80)	(36.64)	(26.70)	(23.83)
Remittances	19.71	21.04	22.12	25.96
PKR/USD Rate (Year Average)	105.45	121.73	150.04	161.87
Fiscal Sector		(Percent)		
Fiscal Deficit (as % of GDP, FY)	(5.84)	(6.53)	(9.07)	(8.09)
Total Revenue Growth	20.26	(3.01)	12.28	10.09
Total Expenditure Growth	17.00	6.05	18.90	9.43
Monetary Sector		(Percent and PKR Trillion)		
Credit to Private Sector Growth (Average YoY)	16.12	16.76	12.08	3.88
Government Budgetary Borrowing	8.60	10.04	11.78	14.19
Borrowing from Schedule Banks	6.25	5.17	5.83	8.23
Borrowing from SBP	2.35	4.87	5.95	5.95

*All data are on Calendar Year unless stated otherwise.

Source: Ministry of Finance, Pakistan Bureau of Statistics and State Bank of Pakistan

Early achievements of stabilization program allowed a prudent, proactive and comprehensive response to the crisis…

Policy space offered by initial achievements of stabilization program enabled the government and SBP to undertake a relief agenda that was commensurate with the scale of the pandemic-induced economic fallout. Government and SBP took several measures to contain the pandemic-induced recession. For example, to protect the most vulnerable segments of the society, emergency one-time cash transfers of PKR 12,000 were made to 16.9 million households. Measures taken by SBP included reversal of erstwhile consolidating monetary policy stance, supporting health sector to fight the pandemic (RFCC), concessionary financings for business to promote investment activities (TERF) and prevention of job losses (Rozgar Scheme), deferment of principal repayment and rationalization of prudential regulations to facilitate restructuring of pandemic-stricken loans of banks.[23] Cumulative estimated impact of these SBP measures was around five percent of GDP at the end of CY20. Timely receipt of IMF funding worth USD 1.39 billion in April 2020 under Rapid Financing Instrument (**RFI**) also helped stabilize external account and exchange rate.

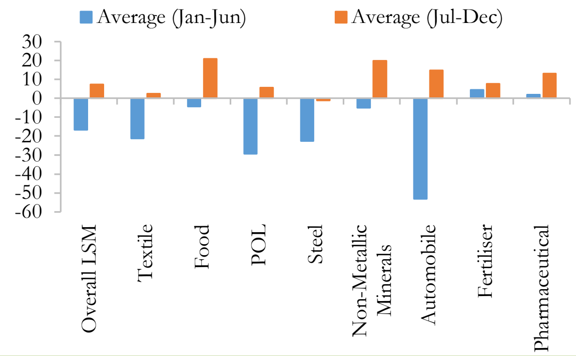
…which helped maintain, external and fiscal stability while economic activity rebounded strongly

As a result of the well targeted relief measures and careful execution of (smart) lockdowns, domestic economy was able to navigate through the pandemic without losing pre-COVID stability gains. The LSM indices reflected the revival of economic activity in the second half of CY20 after gradual phase out of lockdowns (**Chart 1.12**). Business Confidence Index has also been on the rise since June 2020 (**Chart 1.11**). Fiscal deficit, despite counter-cyclical expenditures due to COVID-19, reduced from 9.07 percent of GDP in FY19 to 8.09 percent of GDP in FY20. The current account balance displayed a remarkable improvement and turned to a surplus of USD 0.25 billion in CY20 from a deficit of USD 8.56 billion in CY19 (**Table 1.3**). Exchange rate remained broadly stable while SBP's liquid FX reserves showed a net improvement of USD 2.08 billion, reaching USD 13.42 billion at the end of CY20. These positive developments indicate that the domestic economy adequately managed first and second waves of COVID-19 crisis.

23 For details of these relief measures, please see https://www.sbp.org.pk/covid/index.html.

Chart 1.12: LSM YoY Growth in CY20

(Percent)



Source: Pakistan Bureau of Statistics

Despite low aggregate demand, increase in food prices kept inflation at an elevated level…

Average YoY inflation for CY20 was recorded at 9.53 percent, slightly higher than 9.35 percent for CY19 (**Table 1.3**). In both urban and rural markets, food prices turned out to be the key factor behind the elevated level of inflation (**Chart 1.13** & **1.14**). For instance, in January 2020, headline and food national CPI inflation rates reached 14.57 percent and 23.68 percent, respectively. Following factors explained substantial rise in food inflation during initial months of CY20: (i) supply disruptions in major food items, (ii) elimination of preferential tax treatments for sugar, cigarettes, edible oil and ghee in FY20, and (iii) pass-through of rising energy prices into food prices. Apart from food items, energy prices also contributed to the headline inflation.

Postponement of an increase in energy tariffs till June 2020, import of non-perishable food items (wheat and sugar), administrative measures to ensure smooth supplies[24], and a fall in world oil prices coupled with its immediate pass-through to the domestic oil prices were the key factors that helped ease inflationary pressure after Q1CY20. Owing to weak demand conditions and spare capacity due to lockdowns, core inflation depicted slight deceleration after Q1CY20 and for last three quarters of CY20 it averaged 5.82 percent and 7.96 percent in urban and rural markets, respectively (**Chart 1.13**).

Chart 1.13 - a: Urban Inflation Trends

(Percent)

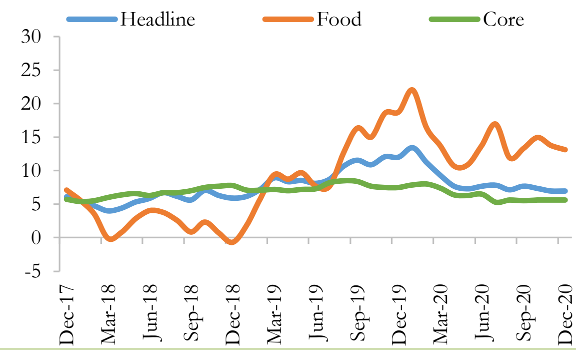


Chart 1.13 - b: Rural Inflation Trends

(Percent)

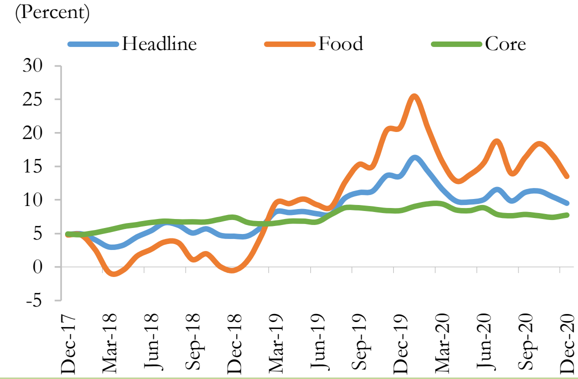
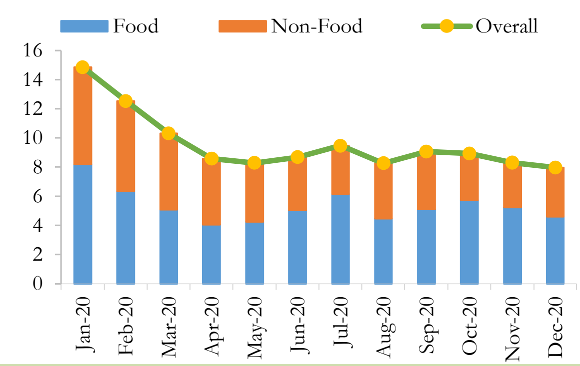


Chart 1.14: Overall, Food and Non-Food National CPI

(Percent)



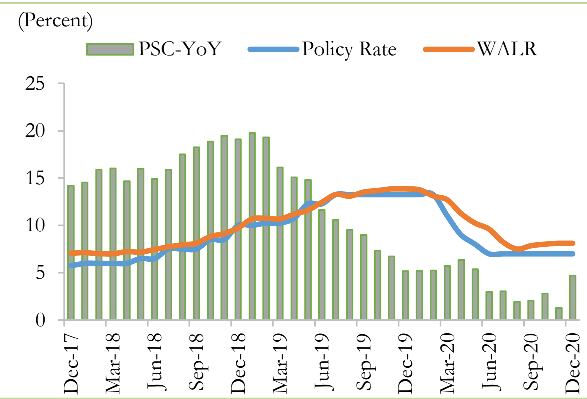
Source:Pakistan Bureau of Statistics

[24] See Annual Report 2019-20; The State of Pakistan's Economy; https://www.sbp.org.pk/reports/annual/arFY20/Complete.pdf

Monetary policy was recalibrated to cushion the slowdown in growth, ease out repayment capacity and maintain financial stability …

Monetary policy target rate was operating at 13.25 percent in March 2020 when COVID-19 hit the domestic economy. Monetary Policy Committee in its various regular and emergency meetings held between March and June 2020 gradually reduced the policy rate by 625 basis points to 7 percent. The healthy trickle down of monetary policy rate to weighted average lending rates coupled with other support measures preserved the flow of private sector credit (**PSC**). (**Chart 1.15**).

Chart 1.15: Interest Rate and Deceleration in Private Credit



Source: SBP

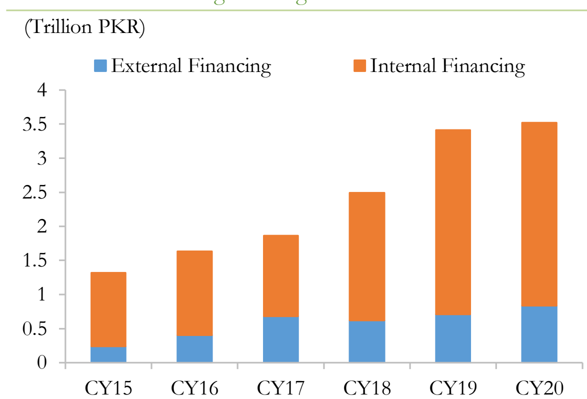
…but private sector credit growth remained weak due to credit demand factors…

Although SBP refinance schemes initiated after COVID-19 supported private sector credit growth to some extent, yet overall decelerating trend persisted as average growth fell from 12.08 percent in CY19 to 3.88 percent in CY20. The substantial deceleration in PSC can be explained by following factors. First, at the start of CY20, tighter monetary and fiscal conditions in the wake of ongoing stabilization program contained the demand for private sector credit. Second, closures of production and economic activities due to lockdowns adversely affected credit demand. Third, increase in exports in second half of CY20 and higher sales tax refunds particularly improved textile firms' liquidity position, thereby containing demand for additional borrowing. Finally, uncertainty caused by fresh waves and new variants of COVID-19 may have led to a risk averse behavior by the firms.

…and credit supply factors

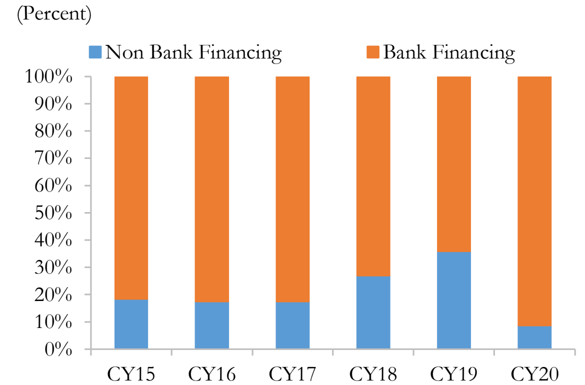
With a 3.22 percent rise over CY19, government budget deficit for CY20 was recorded at PKR 3.52 trillion. Owing to unfavorable external financing conditions, major portion of budget deficit (76.24%, PKR 2.68 trillion) was financed through internal sources. The mix of internal financing was heavily skewed towards banking sector (91.31 percent of total internal financing). Amid heightened uncertainty and increased government budgetary needs, banks deployed a key portion of their liquidity into treasury securities (**Chart 1.16** & **1.17**). The banks' risk aversion was clearly visible in the rising share of investments and declining share of advances relative to total assets (**Chart 1.18**); moreover, within their loan portfolios, banks prefer borrowers with better credit worthiness. Major component of rise in investments (90 percent) was parked in government securities (for details on banking sector performance, please **see Chapter 03**).

Chart 1.16: Financing of Budget Deficit



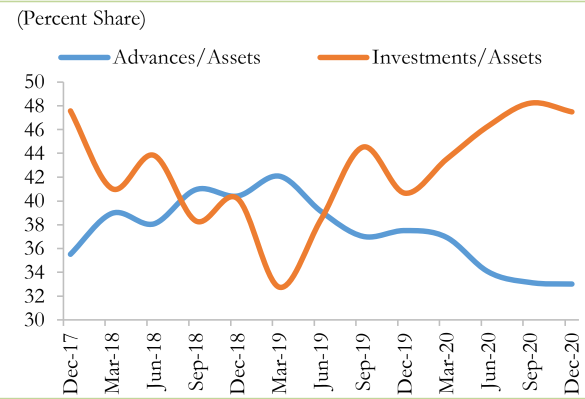
Source: MoF

Chart 1.17: Bifurcation of Internal Financing



Source: MoF

Chart 1.18: Asset Mix of Banking Sector

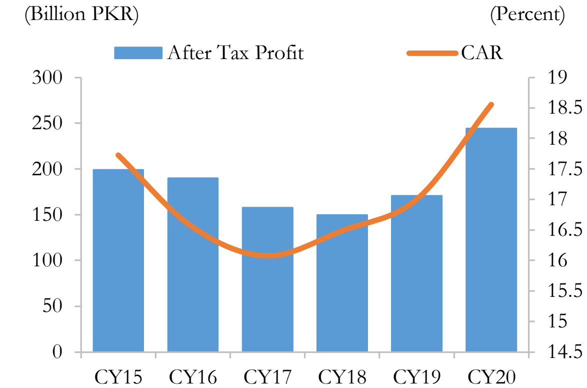


Source: SBP

Yet, banking sector profitability and resilience improved…

Banking sector enjoyed a substantial rise in profitability as after-tax profit grew from PKR 171 billion in CY19 to PKR 244 billion in CY20; registering a 42.92 percent increment (**Chart 1.19**). This phenomenal rise in profitability can be explained by reversal of monetary policy stance leading to relatively early repricing of deposits vis-à-vis variable-rate loans and healthy revaluation gains on the sale of securities. Rise in profitability led to a marked improvement in capital adequacy ratio (CAR) which increased from 17.00 percent at the end of CY19 to 18.55 percent at the end of CY20 (**Chart 1.19**).

Chart 1.19: Profitability and Resilience of Banking Sector

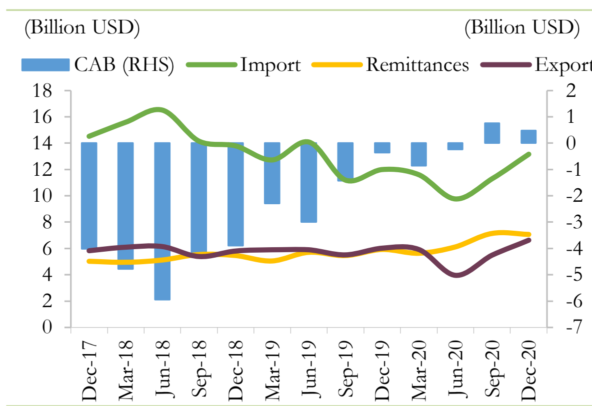


Source: SBP

Current account balance turned into surplus after 2003…

Current account balance (on full year basis) turned into surplus in CY20 for the first time after CY03, which was attributed to subdued imports, buoyant remittances and a strong recovery in exports after COVID-19 shock (**Chart 1.20**). A significant reduction in imports (i.e., by 9.4 percent) during CY20 can be attributed to the impact of stabilization policies which had been successfully implemented before COVID-19, low domestic demand during lockdowns and historic low oil prices. Although imports contracted in CY20, yet the trend reversed in second half of CY20, mainly attributable to a rise in domestic demand after opening up of economic activities. Further, weak performance of cotton crop and soaring prices of wheat and sugar in domestic market necessitated the import of these commodities.

Chart 1.20: Current Account Balance



Source: SBP

…as remittances continued to play critical role in supporting current account…

Remittances grew by 17.35 percent during CY20. This strong performance of remittances, which compensated for the loss of exports due to COVID-19, may be attributed to a number of factors. First, restrictions on air travel created frictions in informal channels of cross-border funds transfer and indirectly promoted flow of remittances through formal channels. Second, fiscal and monetary support measures taken in the western hemisphere and the Middle East might have boosted expatriates' incomes leading to a rise in remittances. Finally, regulatory measures taken by SBP to boost remittances e.g., doubling the rate of telegraphic transfer (**TT**), introduction of a tier-based system, digitization of inflows and exemption from withholding tax have also promoted remittances.

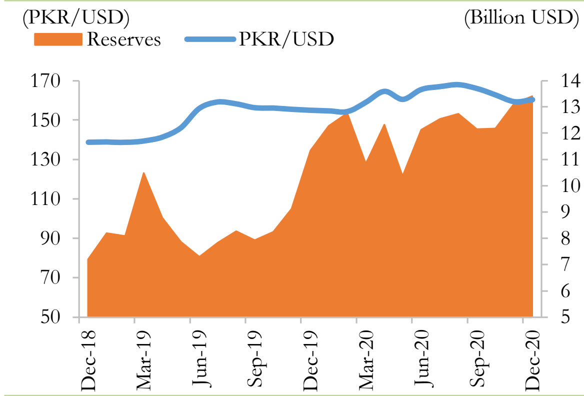
…and exports showed healthy recovery

Exports, which were showing voluminous gains at the start of CY20 owing to adoption of market based exchange rate, contracted by 31.7 percent on QoQ basis during second quarter of CY20, as the demand across the globe faltered due to lockdowns. However, with a growth rate of 10.56 percent during H2CY20, exports exhibited strong recovery. This quick recovery after first wave of COVID-19 crisis was attributable to government's conducive policies to support the industry.

Improvement in current account and external financing stabilized reserves and exchange rate…

On the back of positive outcome in current account, availability of multilateral and commercial financing, including the Rapid Financing Instrument, and rescheduling of external debt through G20's Debt Service Suspension Initiative (**DSSI**)[25], position of SBP foreign exchange reserves improved by USD 2.08 billion. While PKR/USD parity observed a slight depreciation in the first half of CY20 in line with market dynamics, the parity recovered as the situation improved on external front in the second half. Specifically, PKR/USD exchange rate appreciated by 3.18 percent from June 2020 to December 2020 with a further appreciation of 4.43 percent from December 2020 to April 2021 **(Chart 1.21)**.

Chart 1.21: Exchange Rate and Reserves



Source: SBP

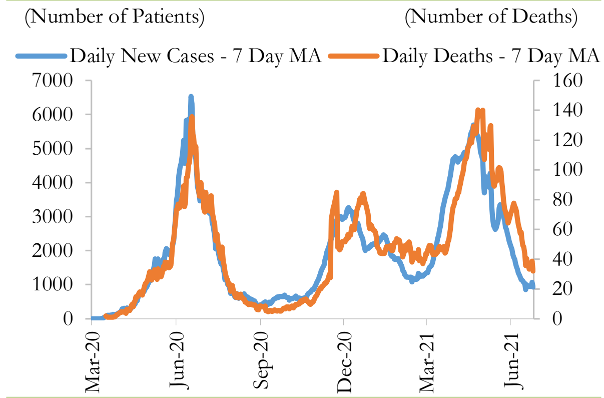
Going forward, path of domestic economy hinges upon the pandemic outcome

Going forward, domestic macroeconomic performance critically hinges upon a host of factors. First, Pakistan remained relatively safe during first and second waves of the pandemic, as the disease spread has been short-lived and contained when compared against many other countries. If the same pattern persists during the third wave, a stable recovery may be expected (**Chart 1.22**). Second, despite emergence of new variants of the virus, COVID-19 vaccination programs are saving lives and supporting economic recovery worldwide. However, any lax approach towards a domestic vaccination program may expand the pandemic duration and constrain economic recovery. Third, monetary policy normalization in advanced economies may lead to a rise in financing costs (**Chart 1.10**). Fourth, upward spiral in commodity prices and recovery in

[25] https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

domestic aggregate demand may lead to a surge in import bill and a corresponding deterioration in the current account balance. Finally, after resumption of IMF EFF, striking the right balance between stability and growth in the face of evolving pandemic outcomes is also critical for domestic economic performance and financial stability.

Chart 1.22: COVID-19 in Pakistan



Source: ourworldindata.org