Chapter 1: Global and Domestic Macro Financial Environment

Global economy experienced a sharp but slightly uncertain recovery after facing historic losses owing to COVID-19 during CY20. Policy support measures were largely effective in containing the negative effects of the pandemic and strongly supported the economic recovery in CY21. With the release of held up demand and supply chain disruptions, commodity prices increased sharply, with some commodity prices surpassing their pre-pandemic levels. This was reflected in inflationary pressures in both advanced as well as emerging economies. Globally, fiscal and monetary policy support that was introduced in CY20, continued during CY21, though some consolidation, especially in fiscal measures, was also observed during the reviewed period. However, the already elevated levels of public debt were pushed to new highs in the wake of fiscal support in advanced and emerging markets. The recent monetary policy normalization due to persistent inflationary pressures, tighter fiscal space and geo-political dynamics may present challenges for any further contingency measures and an early normalization of policy regime to pre-COVID level.

In Pakistan, timely and effective policy interventions to support the economy during pandemic, enabled a robust rebound in domestic economy, exhibited by 5.7 percent Gross Domestic Product (GDP) growth during FY21. Manufacturing in general and large-scale manufacturing in particular benefitted from strong growth of private sector credit amid the low interest rate environment, availability of refinance schemes and Economic Stimulus Package by the government. Fiscal consolidation led to reduction in budget deficit to GDP ratio despite COVID-related expenditures and increased debt servicing. Banking sector solvency and profitability remained firm. However, inflation remained volatile and elevated, primarily on account of supply side factors. The Current Account Deficit (CAD) widened in H2CY21, which also reflected in pressure on exchange rate and Foreign Exchange (FX) reserves. To respond to external account pressures and rising inflation, SBP took various monetary and macro-prudential policy measures. Going forward, the state of political stability and global commodity prices would be the key elements to determine domestic macroeconomic performance in the near term.

Global Developments

Global economy remained firmly on a recovery path in 2021 despite the continued resurgence of pandemic waves throughout the year. A significant uptick in the economic activity was observed, with rebound in consumption and investment levels. The IMF's latest estimates for 2021 put the global growth at 6.1 percent compared to a contraction of 3.1 percent in 2020 **(Table 1.1)**.

However, a few factors posed concerns for global recovery. For instance, new COVID-19 variants, such as Delta and Omicron, affected growth prospects in several countries; disruptions in global supply chain negatively impacted manufacturing; and, the rise in commodity prices and wage growth increased production costs. Overall, the risks to global growth remained on the downside in comparison to 2020.

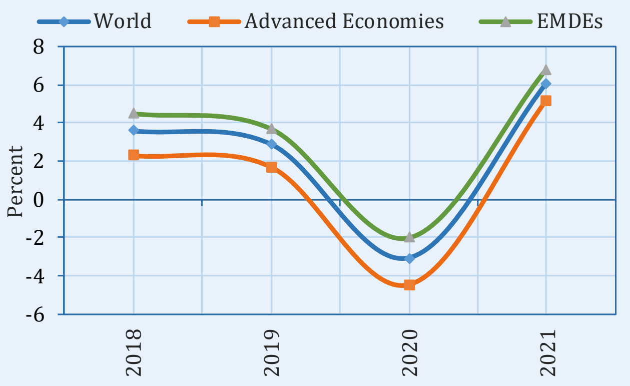
Table 1.1: Global Economy: Real GDP Growth (percent)	2019	2020	2021	2022*	2023*
World	2.9	(3.1)	6.1	3.6	3.6
Advanced Economies	1.7	(4.5)	5.2	3.3	2.4
EMDEs	3.7	(2.0)	6.8	3.8	4.4
EMDEs - Asia	5.3	(0.8)	7.3	5.4	5.6
USA	2.3	(3.4)	5.7	3.7	2.3
Euro Area	1.6	(6.4)	5.3	2.8	2.3
U.K	1.7	(9.3)	7.4	3.7	1.2
Japan	(0.2)	(4.5)	1.6	2.4	2.3
China	6.0	2.2	8.1	4.4	5.1
Turkey	0.9	1.8	11.0	2.7	3.3
India	3.7	(6.6)	8.9	8.2	6.9
Russia	2.2	(2.7)	4.7	(8.5)	(2.3)
Saudi Arabia	0.3	(4.1)	3.2	7.6	3.6
United Arab Emirates	3.4	(6.1)	2.3	4.2	3.8
Pakistan	3.1	(1.0)	5.7	4.0	4.2

*Projections

Source: IMF World Economic Outlook Report, April 2022

The rollout of new vaccines/mass vaccination, continued policy support and sustained uptick in trade volumes amid a surge in global demand supported the worldwide economic recovery in 2021 **(Chart 1.1)**.

Chart 1.1: Global Economic Growth Rates

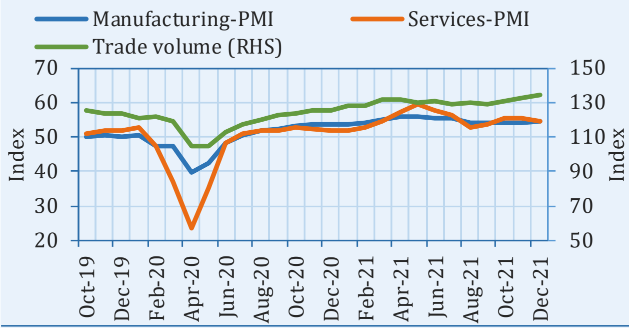


Source: IMF

... Strong recovery in global demand supported the economic recovery ...

Global demand has sharply recovered from the COVID-19 induced recession of 2020. The robust recovery in economic activity across the major economies, led by pent-up demand after ease in restrictions on businesses and movement of people, the impact of excess savings (especially in Advanced Economies (**AEs**)), and the effects of policy support measures taken during the pandemic in 2020 contributed to the recovery in global demand for goods and services during 2021. Global trade improved with sustained performance throughout the year, as evident from the highest ever volume of traded goods and services in the month of Dec-21 **(Chart 1.2)**.

Chart 1.2: Global High Frequency Economic Indicators



Note: PMI= Purchasing Managers Index

Source:Bloomberg and CPB Netherlands Bureau of Economic Policy Analysis

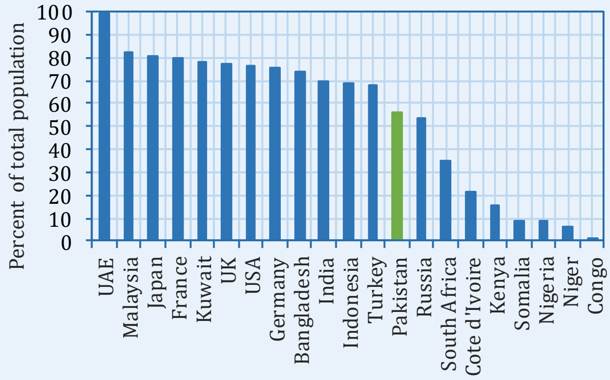
... Inequality in vaccine access, a key concern for recovery in some developing countries ...

Inequality in access to vaccines between advanced economies and emerging markets and developing economies (**EMDEs**) widened the divergence in their respective economic recovery by hindering economic activity with greater intensity in low income countries.[7] On top of relatively low access to vaccines, the resurgence of new variants during 2021 further exacerbated the difficulties for EMDEs **(Chart 1.3)**.[8]

[7] World Economic Outlook (WEO) – Oct 2021

[8] By 4th Quarter 2021, over 96 percent population in low income countries remain unvaccinated in contrast to 60 percent fully vaccinated population in AEs.

Chart 1.3: Share of Population Vaccinated



Source: Our World in Data

Relatively better economic recovery seen in GCC Countries ...

Economic rebound during CY21 has been particularly pronounced in Gulf Cooperation Council (**GCC**) economies in the MENAP region.[9] In particular, recovery in global demand, rise in oil prices,[10] higher vaccination rates and relaxation of travel restrictions supported the stronger revival of economic growth in the GCC countries. The recovery in oil-based economies, like Saudi Arabia and UAE, proved to be a boon for economies like Pakistan whose labor force are employed by these countries, and their current accounts get critical support from the workers' remittances (**Table 1.2**).[11]

Table 1.2: Gulf Cooperation Council (GCC) Macroeconomic Performance

	2018	2019	2020	2021*
Real GDP (annual growth rate)	2.0	1.0	(4.8)	2.5
Current Account Balance (percent of GDP)	8.6	5.8	(0.4)	6.0
Fiscal Balance (percent of GDP)	(1.5)	(1.5)	(8.8)	(1.8)
Oil Price (US$ per barrel)**	68.5	61.5	41.6	69.1
Inflation (annual average, percent)	2.2	(1.5)	1.2	2.8

* IMF-Projections

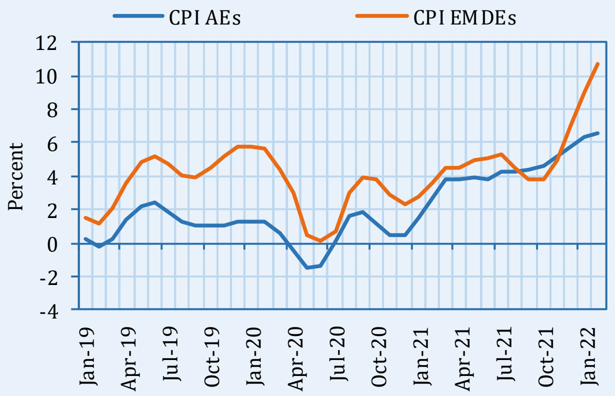
** Average of UK Brent, Dubai Fateh and West Texas Intermedital crude oil prices.

Source: Regional Economic Outlook, Middle East and Central Asia, IMF, October 2021 and World Bank

Rising consumer price inflation in advanced and emerging economies ...

Strong global economic recovery and consequent surge in global commodity prices amid continued supply constraints led to build-up of inflationary pressures across the globe during 2021 in sharp contrast to the subdued levels observed in 2020. However, the increase was somewhat sharper in the latter part of the year **(Chart 1.4),** as the rise in global aggregate demand and input shortages amid supply chain disruptions started to weigh more heavily on global commodity prices.

Chart 1.4: Rising Inflation in AEs and EMDEs



Source: IMF

Increase in demand and supply chain bottlenecks jacked up the commodity prices ...

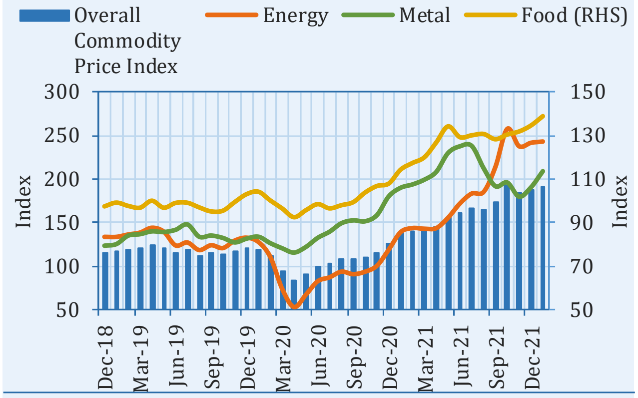
In fact, global commodity prices were already on a rising trend since Jun-20 resulting from reopening of the economies amid global supply chain issues, and the trend was further accentuated in CY21 due to pervasiveness of these disruptions **(Chart 1.5).**

[9] MENAP = Middle East, North Africa, Afghanistan and Pakistan

[10] The annual average price of crude oil remained 66.2 percent higher in 2021 than 2020.

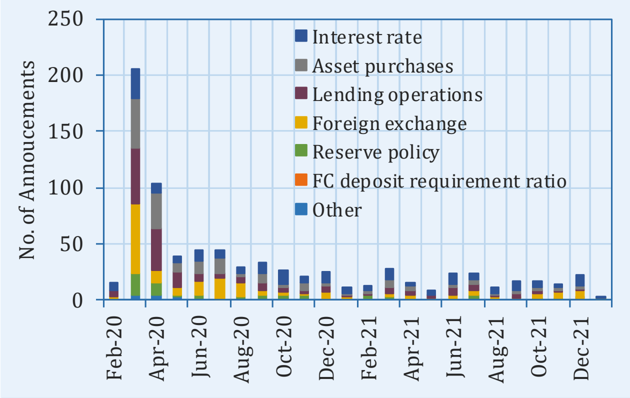
[11] World Economic Outlook (WEO) Middle East & Central Asia – Oct 2021

Chart 1.5: Global Commodity Prices



Source: IMF

Chart 1.6: Monetary Policy Responses to the



Source: Bank for International Settlements (BIS)

In case of food items, besides robust demand and supply side disruptions, the weather conditions also contributed in pushing prices up. For instance, bad weather conditions in Kazakhstan and Russia, kept wheat prices on a rising trend in CY21.[12] Besides, prices of other food items such as maize, soybean, palm oil and sugar remained on an upward trajectory throughout CY21.

Monetary policy stance generally remained accommodative across majority of the world economies…

Despite price pressures, however, the central banks around the globe generally chose a cautious approach by keeping key policy rates unchanged to continue support for economic recovery in CY21. One of the major reason was that initially the leading central banks considered the surge in commodity prices to be transitory.

Except UK, other major advanced central banks kept the policy stance unchanged during CY21.[13] The Federal Reserve maintained its Federal Funds Rate at 0.125 percent, which was last changed in Mar-20. Likewise, European Central Bank (**ECB**) also continued with an accommodative monetary policy and kept the key rates unchanged.[14]

On the other hand, within major EMDEs, central banks of Brazil, Russia and South Africa had to resort to some tightening to fight the emerging inflationary pressures while China and India broadly maintained status quo in policy rate during CY21.

Incidentally, central banks worldwide had a high level of unprecedented policy response in reaction to the pandemic in 2020. With generally improved outlook of economic recovery and building inflationary pressures, central bank's policy response during 2021 was based on the approach of gradual normalization. Moreover, emerging economic concerns in late 2021 from Omicron variant posed a major challenge **(Chart 1.6).** In the start of CY22**,** when the intensity of the pandemic had receded and the inflationary pressures seemed to have become an entrenched phenomenon, the central banks in AEs started reversing the policy stance and have gradually been increasing key rates, with Fed signaling further rates hikes in 2022.[15]

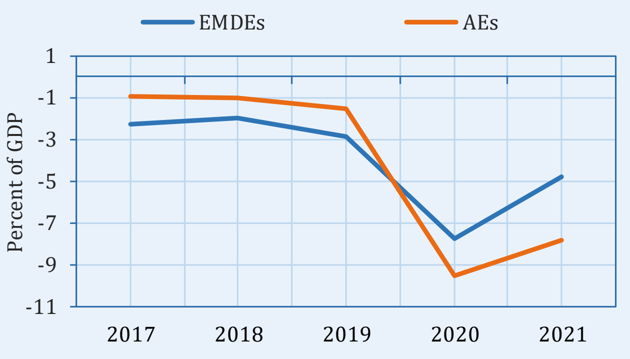
However, fiscal stance exhibited some tightening in CY21 …

Alongside the expansionary monetary policy, fiscal authorities across the globe adopted overwhelming supportive policies to dampen the impact of COVID-19 in 2020. However, the fiscal

[12] Box 3.1: Drivers of the Sharply Rising Global Commodity Prices: Shortages and Supply Constraints. *SBP Quarterly Report on The State of Pakistan's Economy for Q1FY22.*
[13] Bank of England (BoE) raised its Bank Rate by 0.15 percentage points to 0.25 percent in December 2021.
[14] ECB sustained the deposit rates at 2019 levels i.e. 0.5 percent.
[15] Federal Reserve increased the fed funds rate by 0.25% in March 2022 with the strong signal for further increase to reach 1.9% by end of 2022.

stance went through some tightening in 2021 in both AEs and EMDEs. While the AEs, with relatively larger fiscal space, gradually rolled back their fiscal support to some extent, the tightening was relatively sharper in EMDEs, which have limited fiscal space and capacity **(Chart 1.7).**

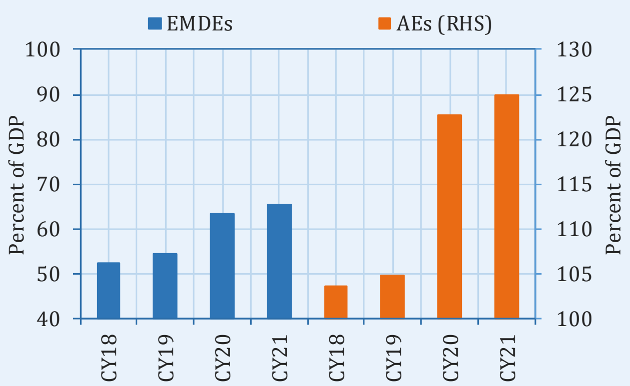
Chart 1.7: Primary Balance in EMDEs and AEs



Source: IMF-Haver Ana:vtics

The extraordinary policy support provided during 2020, pushed already elevated public debt to new heights. In 2021, despite the economic recovery, the recurrence of COVID-19 waves resulted in persistence of high debt levels, which could have otherwise seen contraction **(Chart 1.8).** The sustainability of high levels of public debt is particularly a source of concern for EMDEs, which have constrained fiscal space.

Chart 1.8: Government Gross Debt in AEs and EMDEs



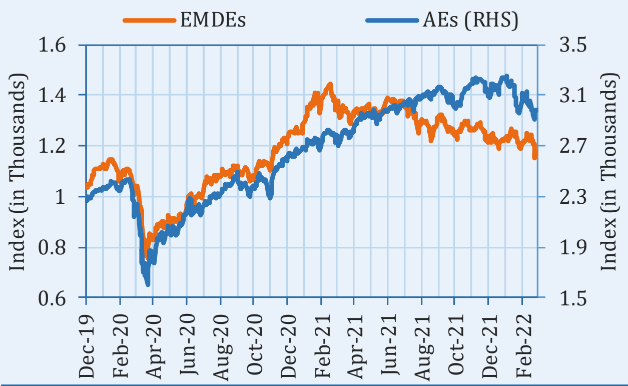
Source: IMF

Additionally, external debt servicing costs for EMDEs may increase given the expected normalization of monetary policy in AEs to cope with persistent inflationary pressures and avoid the buildup of any asset price bubbles. Besides, the rising global commodity prices may add further challenges for EMDEs.

Financial markets showed a relative calm during CY21 though investors' confidence tapered off towards the year end ...

Responding to the reopening of economies, policy support measures and the rollout of various vaccines around the globe, the financial markets generally showed exuberance during most of CY21. However, brief episodes of volatility were observed in response to emergence of new COVID variants such as Delta. Moreover, as the inflationary pressures got more persistent, market participants expected gradual reversal in monetary policy stance. Resultantly, equity markets in AEs witnessed some correction in the latter part of CY21 while equity markets in EMDEs were already on a gradual declining trend since the start of CY21 **(Chart 1.9a).**

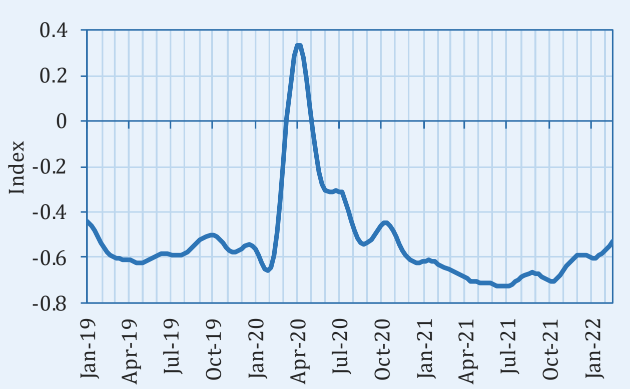
Chart 1.9-a: Equity Prices in AEs and EMDEs



Source: Bloomberg

Financial conditions have remained accommodative, consistent with macro-developments for most of CY21 **(Chart 1.9b).** But the emergence of inflationary pressures led to the expectations of reversal in key interest rates.

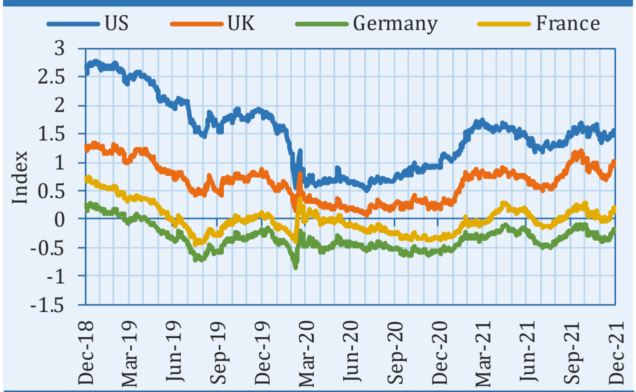
Chart 1.9-b: Financial Conditions Index



Source: US Federal Reserve

After recording rise in the first half of CY21 (due to better growth outlook), the 10-year yields on government bonds in major economies (US, UK, Germany and France) started falling in Q3CY21, responding to the investors' concerns about Delta variant. Yields started rising again in early Q4CY21 but underwent some moderation due to emergence of new wave of COVID-19 (Omicron). Though the yields on 10-year bonds have trended upward by end of CY21, barring France, yields for other economies (US, UK and Germany) remained lower than the pre-pandemic level (Jan-21) **(Chart 1.10)**.

Chart 1.10: Ten-Year Government Bond Yields



Source: Bloomberg

Going forward, while COVID-19 has receded with its Omicron variant seemingly lesser of a threat on the horizon, the global growth outlook largely hinges on the dynamics of international commodity prices and inflationary pressures, supply chain dynamics, and the recently unfolding geopolitical tension between Ukraine and Russia.

These two countries are major suppliers of various key commodities like wheat, oil and gas, etc. The current tensions have implications for the supply of fuel to various countries of Euro Area and may adversely affect the pace of global recovery. Moreover, in the start of 2022, the trend of rising global commodity prices has sustained with no clear signs of weakness. Consequently, developments in global economic activity and inflationary trends will be key concerns (among others) for investors' sentiments in financial markets, going forward.

Domestic Developments

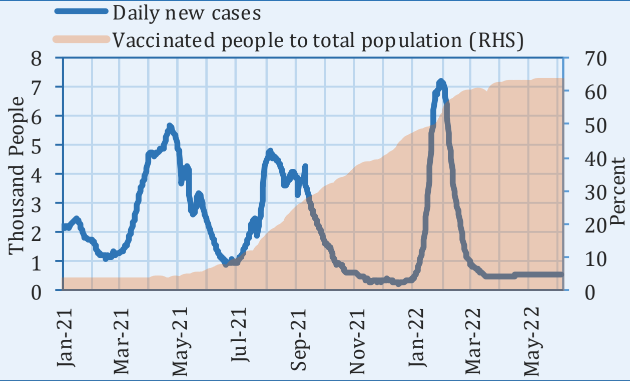
COVID-19 led to historically low growth during FY20 and recurrent waves continued afterwards…

The domestic economy was hit by multiple waves of COVID-19 during CY20 and CY21. Lockdowns and other pandemic containment measures led to losses in services and industrial activity, pushing the economy towards contraction of 0.9 percent for FY20 (**Chart 1.12, Table 1.3**). To contain the spread of the virus, Pakistan resorted to strict lockdowns in the initial phase of the pandemic. However, after Q2CY20, although the most stringent restrictions were gradually eased away, yet smart lockdowns and partial restrictions on mass gatherings continued till the end of CY21.

…yet, targeted and timely policy interventions successfully contained the pandemic and supported economic recovery…

Focused efforts in the areas of vaccination, smart lockdowns and contact tracing proved to be successful in controlling the pandemic, as indicated by the low death rate amid healthy inoculation rate (**Chart 1.11**).

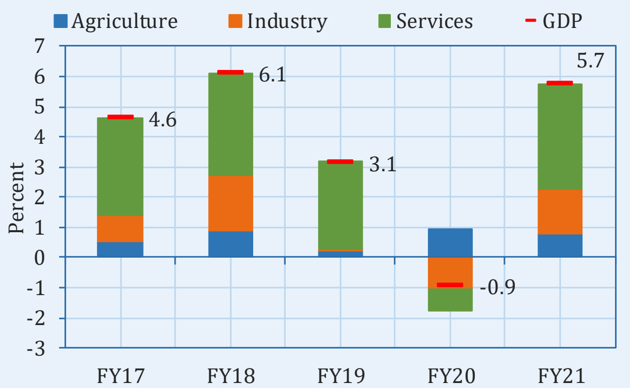
Chart 1.11: Covid-19 Vaccination and Deaths



Source: Ministry of National Health Services and National Institute of Population Studies

Besides the efforts to control the pandemic, the government provided financial support to more than 15 million of the most vulnerable families via Ehsaas emergency cash program.[16] Through Economic Stimulus Package (**ESP**), the government provided targeted incentives to support recovery in manufacturing, exports and agriculture sectors that was equivalent to around two percent of GDP in size.

Chart 1.12: GDP Growth and Sectoral Contributions



Source: PBS

Along with the government, the SBP made targeted and timely interventions to limit the COVID-induced economic fallout and safeguard financial stability. These interventions included 625 bps reduction in the monetary policy rate (**Chart 1.15**), introduction of refinance schemes to avoid layoffs (Rozgar Scheme), support the health sector (Refinance Facility for Combating COVID-19-**RFCC**) and promote long term investment through Temporary Economic Refinance Facility (**TERF**).[17] To support the borrowers and insulate the financial sector from delinquencies arising out of lockdowns, SBP allowed deferment of principal and restructuring of loans. Collectively, the SBP relief measures were around five percent of GDP.

...leading to robust rebound in economic activity in FY21 ...

Timely and targeted policy interventions not only helped in containing a sharp fall, they also supported a strong recovery in economic activity with GDP growth rebounding by 5.7 percent in FY21. Moreover, as compared to FY19 and FY20, the FY21 growth outcome was remarkable in the sense that it was broad-based and contributed by all three sectors proportionately (**Chart 1.12, Table 1.3**).

Table 1.3: Key Economic Indicators of Pakistan*

	2017	2018	2019	2020	2021
Real Sector			(Percent)		
Real GDP Growth (FY)	4.6	6.1	3.1	-0.9	5.7
Industrial Sector Growth (FY)	4.6	9.2	0.2	-5.8	7.8
Agricultural Sector Growth (FY)	2.2	3.9	0.9	3.9	3.5
ServiceSector Growth (FY)	5.6	6.0	5.0	-1.2	6.0
LSM Growth (Average YoY)	7.1	2.2	3.1	-10.9	18.4
Inflation (Average YoY)	5.0	5.3	9.4	9.5	9.5
External Sector			(USD Billion)		
SBP Reserves (End-of-Period)	14.1	7.2	11.3	13.4	17.7
Current Account Balance	-16.3	-18.8	-7.1	-0.7	-12.3
Exports (Goods)	21.5	23.4	23.3	21.9	29.1
Imports (Goods)	57.3	60.1	50.0	44.1	66.6
Trade Balance	-35.8	-36.6	-26.7	-22.2	-37.5
Remittances	19.7	21.0	22.1	25.9	31.1
PKR/USD Rate (Year Average)	105.5	121.7	150.0	161.9	162.9
Fiscal Sector			(Percent)		
Fiscal Deficit (as % of GDP, FY)	-5.8	-6.5	-9.1	-8.1	-7.1
Revenue Growth (YoY)	20.3	-3.0	12.3	10.1	17.5
Expenditure Growth (YoY)	17.0	6.0	18.9	9.4	12.5
Monetary Sector			(Percent and PKR Trillion)		
Credit to Private Sector (YoY Growth)	14.2	19.1	5.2	4.7	20.3
Government Budgetary Borrowing	8.6	10.0	11.8	14.2	15.6
Borrowing from Schedule Banks	6.2	5.2	5.8	8.2	10.3
Borrowing from SBP	2.3	4.9	6.0	6.0	5.3

*All data are on Calendar Year unleas stated otherwise.

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

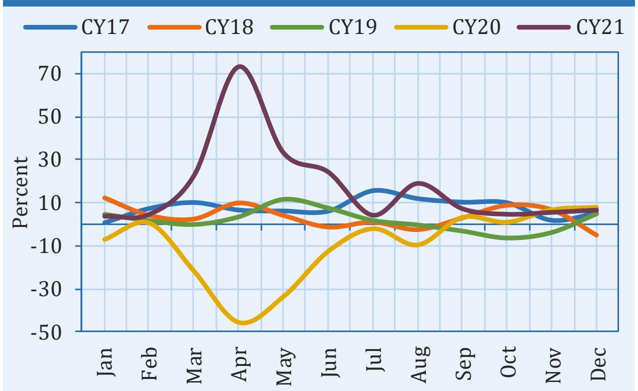
16 PASS- Ehsaas Emergency Cash Program. Accessed on April 19, 2022

17 SBP's COVID Loans: RFCC and TERF.

Recovery in manufacturing and resilience in agriculture paved the way for turnaround in services ...

During FY21, large- and small-scale manufacturing sectors grew by 11.4 percent and 9.0 percent, respectively. The manufacturing sector, Large-Scale Manufacturing (**LSM**) in particular, reflected a robust recovery during CY21 by growing at the rate of 18.3 percent compared to the contraction of 10.9 percent in CY20 (**Table 1.3, Chart 1.13**).[18] Most of the key subsectors of LSM exhibited remarkable growth during CY21 vis-à-vis the last four years (**Chart 1.14**). Fiscal and monetary stimuli (**Chart 1.16**), base effect of low production during lockdowns, impact of pent-up demand during the recovery phase, construction sector package and attractive financings under TERF and Long Term Financing Facility (**LTFF**) were the key factors that explain the robust recovery of LSM.

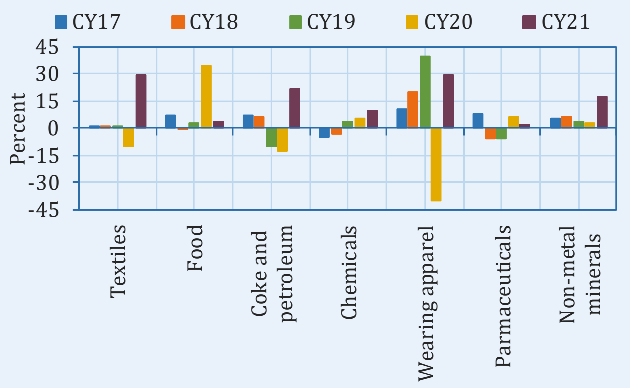
Chart 1.13: LSM Growth Rate (YoY)



Source: PBS

The vibrant growth outcome in industry and reasonable growth in agriculture, coupled with removal of lockdowns and travel restrictions, paved the way for recovery in the services sector. Within services, the two key subsectors, wholesale & retail trade, and transport & communication grew by 10.6 percent (FY20: -5.3 percent) and 5.1 percent (FY20: -9.0 percent) during FY21, respectively.

Chart 1.14: Growth Rates of Key Sectors of LSM



Source: PBS

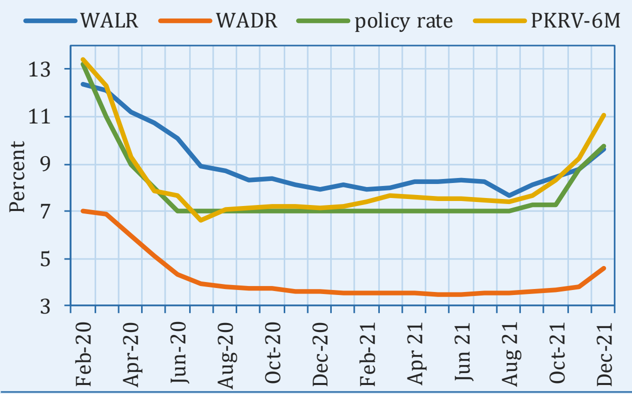
Expansionary monetary policy and refinance schemes supported the recovery in private sector credit...

After reducing the monetary policy rate from 13.25 percent to 7 percent during Mar– to Jun-20, SBP kept the policy rate unchanged till Sep-21. The transmission of reduction in policy rate to lending rates (**Chart 1.15**), coupled with SBP refinance schemes in general and TERF[19] in particular, boosted private sector credit during CY21. Higher input prices also led to an increase in demand for working capital loans. After lackluster growth of 4.7 percent during CY20, credit to private sector grew at a healthy rate of 20.3 percent during CY21 (**Table 1.3**). Manufacturing and personal finance were the largest contributors to the healthy increase in private sector credit (**Chart 1.16**).

[18] Wholesale and retail trade and transport & communication subsectors grew by 10.6 percent (FY20: -5.3) and 5.1 percent (FY20: -9) during FY21.

[19] Total loans approved and disbursed under TERF at the end of CY21 stood at PKR 436 billion and PKR 269 billion, respectively.

Chart 1.15: Inerest Rates



Source: SBP

Chart 1.16: Credit to Private Sector

Source: SBP

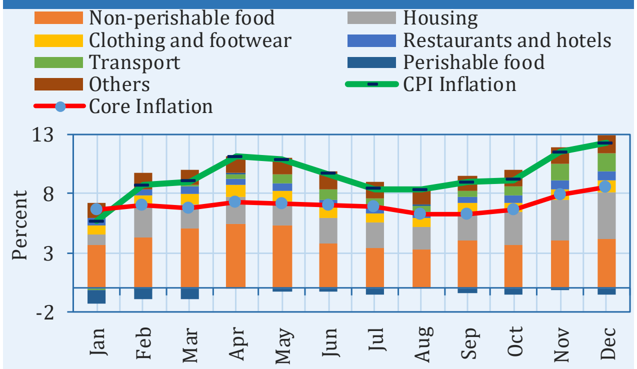
...however, external sector pressures and increasing domestic prices pivoted the focus of monetary policy to stability towards the end of CY21

With the revival in economic activities and rising trend in global commodity prices, the current account balance began to widen from mid-CY21, resulting in USD 12.3 billion deficit in CY21 (USD 0.7 billion deficit in CY20) (**Chart 1.18**). The rising imbalance (from May-21 onwards) was also reflected in the movement of PKR-USD parity, which depreciated by 13.7 percent between end-May to end-Dec-21 (**Chart 1.20**). Meanwhile, the rising global commodity prices not only deteriorated the external account but also resulted in increasing domestic headline and core inflation rates from Aug-21 (**Chart 1.17**). Responding to these developments, SBP recalibrated its monetary policy stance by taking monetary policy and macro-prudential measures to contain the emerging risks to the macro economy and financial stability. Starting from September 20, 2021, SBP policy rate was increased by a cumulative 275 bps in three tranches to 9.75 percent by the end of CY21 (**Chart 1.15** and **Box 3.3**).[20]

Attributable to supply side factors, headline inflation was somewhat volatile and elevated...

Average CPI inflation for CY21 was recorded at 9.50 percent, almost equal to 9.53 percent observed during CY20 (**Table 1.3**). During the year, following factors explain the elevated level of inflation. First, electricity prices were raised in February 2021 on account of increase in base tariff, quarterly adjustment for capacity payments and fuel charge adjustment. Second, inflation in non-perishable food (wheat and sugar) (**Chart 1.17**) emanated from commodity management issues and higher global food prices which rose due to COVID-induced supply constraints (**Chart 1.5**).

Chart 1.17: CPI Inflation, its Key Components and Core Inflation

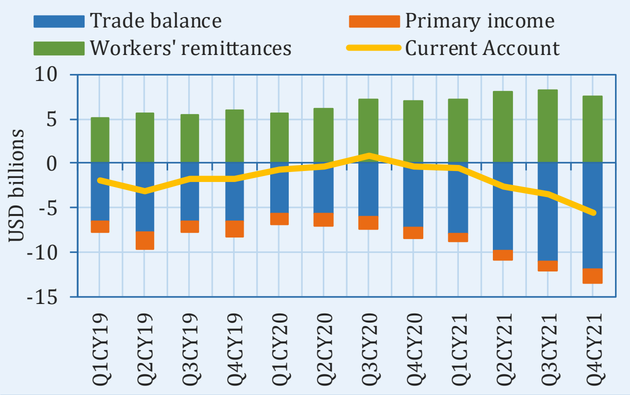


Source: SBP

[20] Policy rate increased by a cumulative 400 bps to 13.75 percent after review period up till May CY22.

Third, world oil prices rose quite persistently, although, in somewhat staggered manner from USD 21 per barrel in Apr-20 to more than USD 80 per barrel towards the end of CY21. Following the rise in global oil prices, domestic fuel prices also witnessed an increase which led to a rise in inflation and inflation expectations. Finally, 13.7 depreciation of local currency during May- to Dec-21 also contributed in pushing up domestic inflation.[21]

Chart 1.18: Current Account Balance



Source: SBP

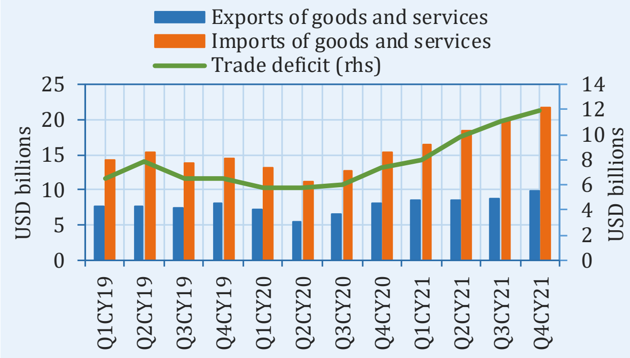
...pushing up core inflation towards end of CY21

Despite considerable pressure on headline inflation, core inflation remained broadly stable at around 6.9 percent during the first nine months of CY21.[22] However, towards the end of CY21, a gradual rising trend in core inflation was observed inching it up to 7.4 percent in last four months.

Persistent rise in imports led to a rapid surge in CAD ...

On balance of payment front, the increase in CAD resulted from persistently deteriorating trade balance since Q4CY20 (**Chart 1.18 and Table 1.3**). During CY21, exports and remittances grew by 32.5 percent and 19.8 percent, respectively. However healthy performances of exports and remittances were overshadowed by a 50.9 percent increase in imports, which can be explained by the following factors. First, strong recovery in domestic economic activity after ease in COVID restrictions led to a rise in import demand. Second, disbursements under TERF boosted imports of capital goods, especially in the textile sector. Third, import of industrial raw materials such as cotton to fill the demand-supply gap of the inputs. Fourth, import of COVID vaccines. And finally, imports of key non-perishable food items e.g. wheat and sugar also contributed in increased imports. Besides the rising volumes, the elevated international prices, such as oil and food, owing to longer than previously anticipated disruptions in global supply chain also led to a rise in domestic imports bill.

Chart 1.19: International Trade Flows and Trade Deficit



Source: SBP

...leading to pressure on the rupee

The external imbalances (CAD) also translated into stress on parity. After 5 percent appreciation during the initial four months, rupee depreciated by 13.7 percent during the last eight months of CY21. On a cumulative basis, rupee depreciated by 9.4 percent in CY21 (**Chart 1.20** and **Chapter 2**).

Policy measures to restrain imports and inflation were taken...

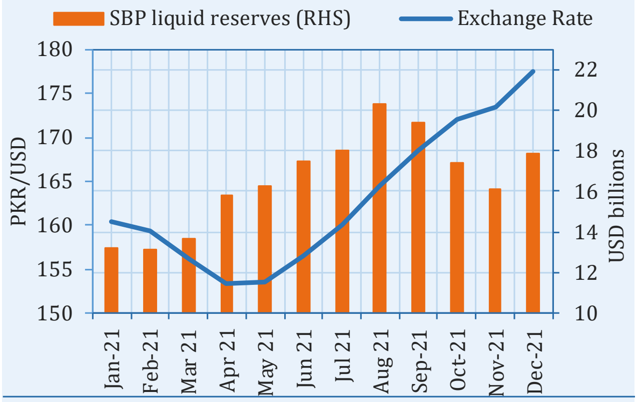
To counter the pressure on current account and domestic prices amid the global inflationary environment, SBP took monetary as well as macro-prudential policy measures. First, the SBP policy rate was raised by a cumulative 275 bps from Sep- to Dec-21, and two subsequent hikes of 250 bps and 150 bps in Apr-22 and May-22,

[21] Depreciation is calculated based on end of period date mark-to-market rate.

[22] Measured by average of rural and urban NFNE inflation rates.

leading to a cumulative increase of 675 bps. Second, the Cash Reserve Requirement (**CRR**) was increased from 5 percent to 6 percent. Third, macro-prudential measures such as amendments were made in prudential regulation for consumer financing to contain growth in consumer finance.[23] Finally, Cash Margin Requirements (**CMR**) were increased by enhancing the list of items subject to CMR to contain imports of non-essential items.

Chart 1.20: Exchange Rate and FX Reserves



Source: SBP

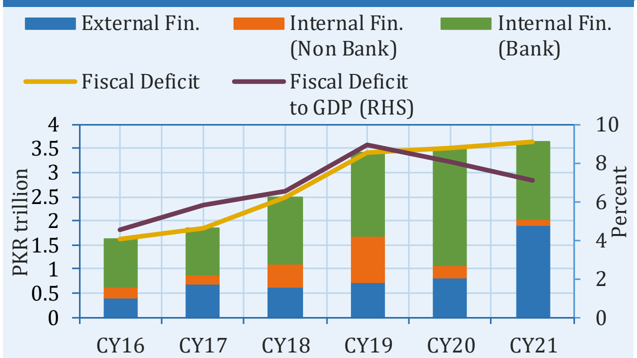
...while availability of multilateral, bilateral and private flows led to a rise in reserves despite widening CAD

During first half of the year, official and private inflows led to a rise in foreign exchange reserves. The country received USD 2.5 billion in Eurobonds in Apr-21, USD 0.5 billion on resumption of IMF Extended Fund Facility (**EFF**) in Apr-21, an additional USD 1 billon through Eurobonds via tap option in Jul-21 and USD 2.8 billion Special Drawing Right (**SDR**) allocation by IMF in Aug-21. These inflows supported the level of SBP liquid FX reserves till Aug-21. However, rising CAD and repayment of Sukuk led to a fall in SBP FX reserves afterwards (**Chart 1.20**). Bilateral deposits of USD 3.0 billion from Saudi Arabia in Dec-21 also provided support to FX reserves. Further, USD 2.0 billion gross inflows were received in Naya Pakistan Certificates (**NPC**) through Roshan Digital Accounts (**RDA**) during CY21. On a cumulative basis, SBP FX reserves increased by USD 4.26 billion during CY21.

Fiscal consolidation led to lower deficit relative to GDP ...

The process of fiscal consolidation that was started after COVID-related extraordinary expenditures in Q2CY20, continued to improve fiscal deficit. This helped in reducing the fiscal deficit to GDP ratio to 7.1 percent in FY21 from 8.1 percent a year earlier. Rise in Federal Board of Revenue's (**FBR's**) tax revenues and reduction in non-interest current spending enabled the government to reduce deficit despite additional spending on cash transfers and pandemic induced ESP (**Chart 1.21**).

Chart 1.21: Fiscal Deficit and Financing



Fiscal Deficit to GDP ratio is based on FY baisis

Source: SBP

On a calendar year basis and in absolute terms, fiscal deficit increased by 3.3 percent (CY20: 3.2 percent) to PKR 3.6 trillion during CY21. Major part of fiscal deficit for CY21 (52.5 percent) was financed through external financing in the form of multilateral and private flows as discussed earlier. While the government adhered to the restriction of zero fresh budgetary borrowing from SBP, scheduled banks and non-bank financial institutions financed 43.6 percent and 3.9 percent of the total budget deficit, respectively.

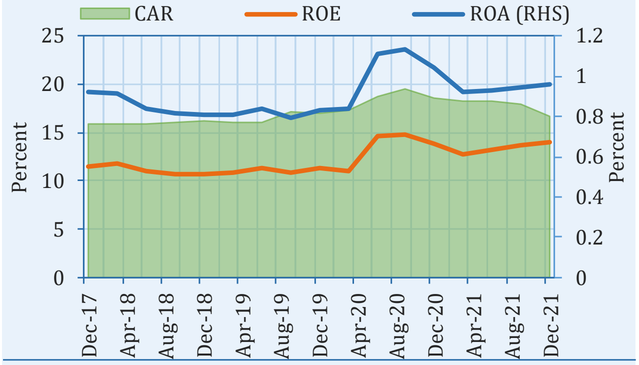
[23] BPRD Circular Letter No. 29 of 2021

Banking sector credit risk reduced while profitability and solvency continued to remain strong ...

The banking sector remained resilient and solvent. Asset quality improved as Gross Non-Performing Loans Ratio (**GNPLR**) declined to 7.9 percent by the end of CY21 from 9.2 percent at the end of CY20. Although Capital Adequacy Ratio (**CAR**) lowered to 16.7 percent from 18.6 percent a year earlier, it still remained well above the regulatory minimum requirement of 11.5 percent (**Chart 1.22**). This decline in CAR was attributable to rise in risk weighted assets (**RWA**) owing to significant expansion in private sector credit (**Chart 1.16**).

After-tax profits of the banking sector increased Year on Year (**YoY**) by 8.19 to PKR 264 billion in CY21, mainly due to a reduction in provisioning expenses and rise in non-interest income. Return on Assets (**ROA**) of the banking industry marginally declined to 0.96 percent at the end of CY21 from 1.04 percent a year earlier due to volume driven growth in income as the lower interest rate environment prevailed during most part of the year (**Chart 1.15** and **Chapter 3**).

Chart 1.22: Profitability and Solvency of Banking Sector



Source: SBP

Going forward, political stability and global commodity prices are the critical factors to determine domestic economic outcomes ...

Assuming low probability of new vaccine resistant variants of COVID-19, near term domestic macroeconomic outcomes are contingent upon domestic political stability and global commodity prices, especially in the context of supply chain disruptions and geopolitical situation in Eastern Europe. In addition, evolving domestic political scenario may have a bearing on the continuity of the ongoing stabilization program as well as sentiments of investors.