

ANNUAL REPORT

2020 – 2021

THE STATE OF PAKISTAN'S ECONOMY



STATE BANK OF PAKISTAN

SBP BOARD OF DIRECTORS

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
November 24, 2021

Dear Mr. Chairman,

In terms of Section 9A(2) of the State Bank of Pakistan Act, 1956, the Annual Report on the State of the Economy which includes the review of fourth quarter on the State of the Economy for the year 2020-21 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament), by the Board of the State Bank of Pakistan.

Yours sincerely,



(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Muhammad Sadiq Sanjrani
Chairman
Senate
Islamabad

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Yours sincerely,



(Dr. Reza Baqir)
Governor
Chairman Board of Directors

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Chapter 1

Economic Review

1 Economic Review

1.1 Overview

After witnessing a Covid-led downturn in FY20, Pakistan's economy rebounded during FY21, with real GDP growth rising to 3.9 percent (**Table 1.1**). This growth was achieved without the widening of the twin deficits. The current account deficit (CAD) dropped to a 10-year low and contributed to the build-up in the foreign exchange reserves. The fiscal deficit edged down despite the Covid-related spending, allowing for a reduction in the public debt-to-GDP. Some easing was also noted in the headline CPI inflation on the back of stable core inflation, though overall price levels, especially of food items, stayed elevated owing to supply-side challenges.

Pakistan also fared well compared to many other countries in terms of real economic activity, exports and public debt accumulation during July 2020-June 2021 (**Figure 1.1**). This performance was enabled by two major factors: (i) the country's success in navigating through multiple waves of Covid-19 with targeted mobility restrictions; and (ii) a prompt, well-coordinated and targeted monetary and fiscal response, aimed at countering the impact of Covid on economic growth and livelihoods.

Selected Economic Indicators

Table 1.1

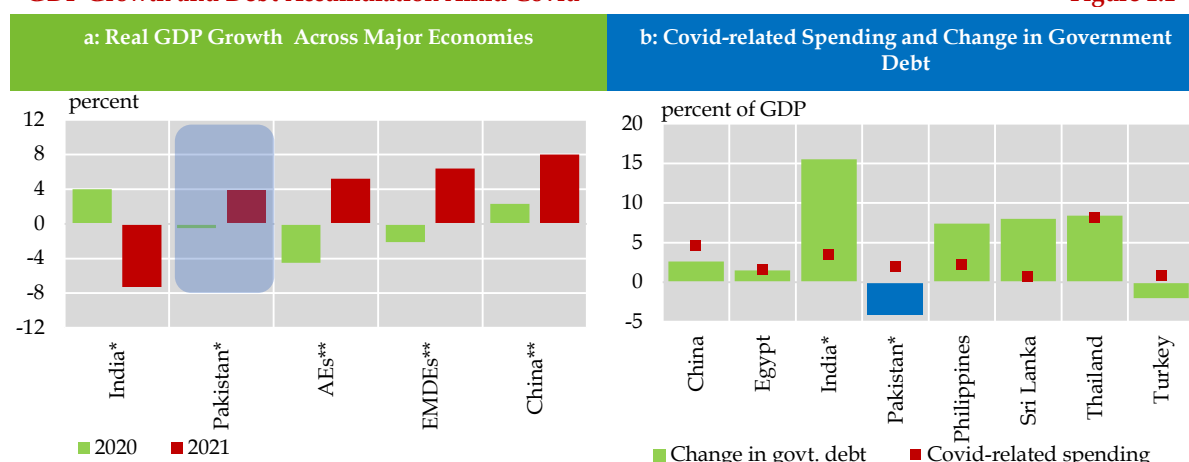
	FY19	FY20	FY21
<i>Growth rate* (percent)</i>			
Real GDP ^a	2.1	-0.5	3.9
Agriculture	0.6	3.3	2.8
Industry	-1.6	-3.8	3.6
o/w LSM	-2.3	-9.8	14.9
Services	3.8	-0.6	4.4
CPI (period average) ^a	6.8	10.7	8.9
Private sector credit ^b	11.6	2.9	11.2
Money supply (M2) ^b	11.3	17.5	16.2
Exports ^b	-2.1	-7.1	13.7
Imports ^b	-6.8	-15.9	23.3
Tax revenue –FBR ^c	-0.3	4.4	18.4
Exchange rate (+app/dep%) ^b	-24.1	-4.8	6.7
Policy rate ^b	12.25	7.0	7.0
<i>billion US dollars</i>			
SBP's reserves (end-period) ^b	7.3	12.1	17.3
Workers' remittances ^b	21.7	23.1	29.4
Current account balance ^b	-13.4	-4.4	-1.9
<i>percent of GDP</i>			
Fiscal balance ^d	-9	-8.1	-7.1
Current account balance	-4.8	-1.7	-0.6
Investment ^a	15.6	15.3	15.2

* The numbers relating to real GDP growth rate and its sub-components for FY19, FY20 and FY21 represent final, revised, and provisional estimates respectively.

Sources: ^a Pakistan Bureau of Statistics; ^b State Bank of Pakistan; ^c Federal Board of Revenue; ^d Ministry of Finance

GDP Growth and Debt Accumulation Amid Covid

Figure 1.1



*Fiscal year basis for Pakistan & India

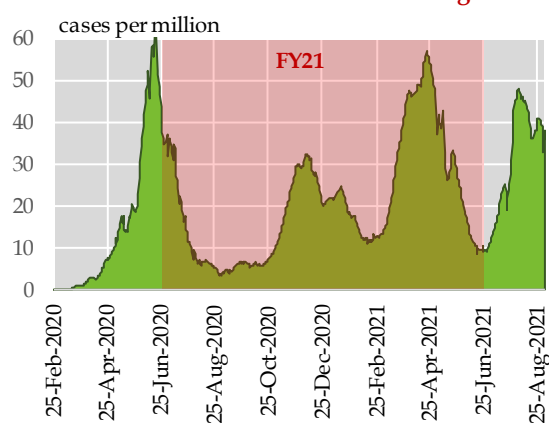
**Projected growth of 2021 on calendar-year basis

Source: IMF & Pakistan Bureau of Statistics

*Fiscal year basis for Pakistan & India; projections of calendar year 2021 for all others.

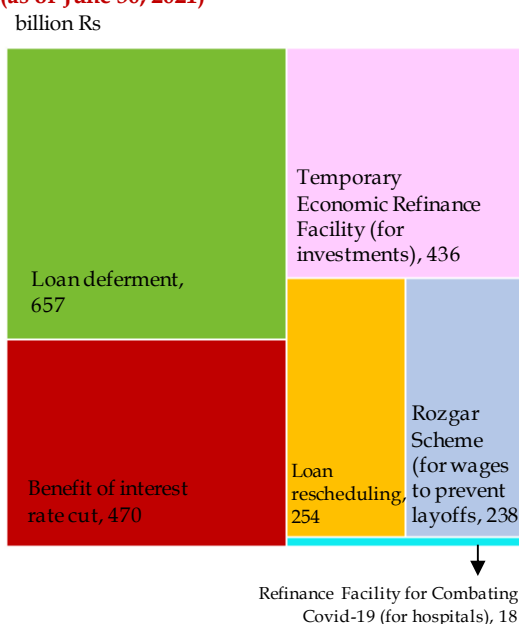
Source: IMF Fiscal Monitor & State Bank of Pakistan

Pakistan successfully navigated through two waves of the pandemic during FY21 without imposing wide-scale shutdowns of industry and services. The authorities' focus on strict implementation of SoPs, smart lockdowns and contact tracing helped contain the spread of the disease, especially during the third wave (**Figure 1.2**). Notably, Pakistan ranked among the best performing countries for its effective handling of Covid-19.¹ Furthermore, the initiation of Covid vaccinations from March 2021 onwards and the gradual pickup in its pace and coverage, together with supportive economic policies, helped sustain the economic momentum.

Pakistan: New Covid Cases**Figure 1.2**

Source: ourworldindata.org

In terms of policy stimulus, the SBP provided aggressive liquidity support via multiple policy tools after the outbreak in March 2020, which stood around 5 percent of GDP by the end of FY21. Refinance schemes were introduced to shore up employment and the healthcare system, and to stimulate long-term investment in the economy (**Figure 1.3**). Specifically, the Rozgar Scheme provided payroll support to businesses so they could retain their workers, and was instrumental in getting firms to restart their operations immediately after the reopening of the economy. In the same vein, the loan deferments and restructurings enhanced the liquidity position of firms and consumers, which helped prevent delinquencies. Meanwhile, the Temporary Economic

Estimated Liquidity Impact of SBP's Major Relief Measures (as of June 30, 2021)***Figure 1.3**

* The overall size of SBP support is Rs 2,073 billion.

Source: State Bank of Pakistan estimates

Refinance Facility (TERF) would shore up the long-term productive capacity in the economy. The SBP maintained an accommodative monetary stance, by keeping the policy rate unchanged during FY21, after a sharp 625 bps reduction during Mar-Jun 2020.

Importantly, SBP liquidity support sheltered both small and big businesses. Specifically, for the loan deferment and restructuring package and the Rozgar scheme microfinance institutions had about 94.1 percent and 74.4 percent share in the total applications approved by SBP, and constituted around one-fifth share in the actual benefits availed by businesses from these schemes.

In addition to the monetary stimulus, the SBP undertook other policy initiatives to bolster economic activity. These included: (i) measures to boost digitization in the economy amid Covid-related mobility restrictions; (ii) relaxing credit requirements for exporters and importers; and (iii) incentivizing housing and construction finance; and (iv) adopting forward guidance as a tool to communicate

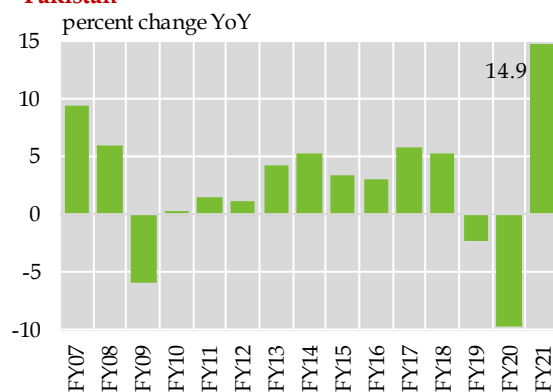
¹ Global Normalcy Index, *The Economist* (www.economist.com).

future monetary policy stance, to address Covid-related uncertainty and to facilitate economic decision-making.

Similarly, the government provided targeted fiscal support of around 2 percent of GDP through the Economic Stimulus Package (ESP), envisaging a coverage of more than 15 million families through emergency cash transfers. Importantly, Pakistan's emergency cash intervention was recognized as a global success and was ranked fourth in terms of the number of people covered, and third in terms of the share of population.² The ESP also included targeted incentives to buttress activity in agriculture, manufacturing and export sectors during FY21.

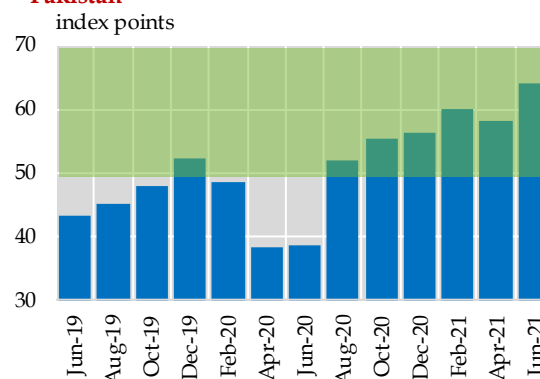
The agriculture sector gained further from the substantial increase in the minimum support price (MSP) of wheat, as well as from subsidized availability of inputs and machinery. Furthermore, the cost of production for manufacturing firms, especially export-oriented units, was reduced via a rationalization of duties on imported raw materials and elimination of peak-hour power tariff rates. The export sector further benefitted from the fast-tracking of GST refunds. To spur construction activity, the government extended the timelines to avail benefits under the amnesty scheme till June 2021, whereas the SBP implemented

Annual LSM Growth in Pakistan **Figure 1.4**



Source: Pakistan Bureau of Statistics

Trend in Business Confidence in Pakistan **Figure 1.5**



Source: State Bank of Pakistan

mandatory targets for banks to provide construction financing.

These policy efforts proved instrumental in driving the sharp recovery in real GDP growth in FY21, exceeding expectations. The growth was broad-based, with major shares from industry, and wholesale and retail trade services. Led by the conducive supply and demand dynamics as well as a low base effect from Covid-led contraction last year, large-scale manufacturing (LSM) posted a 14.9 percent increase, with production in some key industries, such as textiles, food, cement, fertilizer and chemicals, exceeding the peaks recorded during the high-growth years of FY17-FY18 (**Figure 1.4**). Construction activity benefitted from policy efforts as well as pent-up demand from previous years. The enabling policy environment also boosted business confidence during FY21 (**Figure 1.5**). Aside from the policy support, a surge in workers' remittances and sharp increase in production of important crops strengthened rural incomes adding further impetus to consumer demand.

Though the growth in agriculture was slightly lower than last year, it was at par with the target set for the year. Specifically, the production of wheat, rice and maize rose to historic levels during FY21, while sugarcane reached its second-highest level. The cumulative increase in the production of these crops offset the sharp decline in cotton

² Poverty Alleviation and Social Safety Division: ([www.pass.gov.pk/NewsDetailWerFf65%5ES23d\\$gH2a3c9cbf-2f66-47d3-a386-4ce516d8bdc30ecFf65%5ES23d\\$Pd](http://www.pass.gov.pk/NewsDetailWerFf65%5ES23d$gH2a3c9cbf-2f66-47d3-a386-4ce516d8bdc30ecFf65%5ES23d$Pd)).

production. The improvement in the commodity-producing sectors and a surge in imports drove wholesale and trade services growth to a 14-year high in FY21.

This rebound in economic growth was facilitated by a significant expansion in credit offtake by the private sector. The demand for fixed investment loans was high, and these rose close to the levels seen during the previous high-growth years of FY17-18. The SBP's concessionary refinance schemes, particularly for long-term investment under the Temporary Economic Refinance Facility (TERF), played a major role in increasing the fixed investment loans. The textile sector was the largest beneficiary of this scheme, followed by the food industry. Moreover, the lower cost of financing significantly increased consumer financing in FY21, with auto loans witnessing a sharp rise, supported by high demand owing to new car models, postponed purchases from last year, and subsidy on tractors. The working capital loans also recovered during FY21, with sizable demand witnessed from the non-manufacturing sector, agriculture, power, and wholesale and retail trade. Meanwhile, mandatory targets from the SBP and lower cost of financing stimulated housing and construction loans.

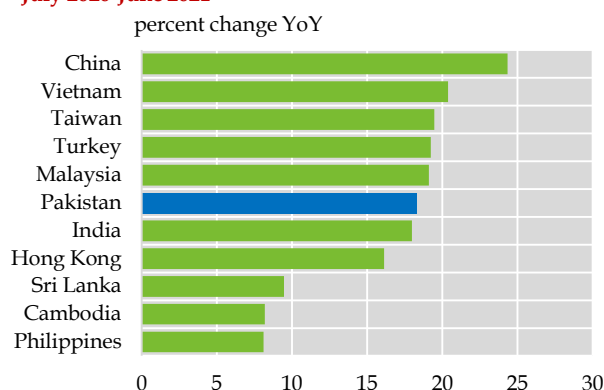
With the revival in private sector credit, the growth in money supply remained elevated during FY21, though it was marginally lower than last year. The government's borrowing from the banking system reduced slightly, amidst greater availability of external financing. The government adhered to its commitment of zero borrowing from the SBP, switching the financing requirement to commercial banks. The net foreign assets (NFA), on the other hand, grew sharply, given the favorable position of the external account and the ensuing build-up in the FX reserves.

The overall credit and financial market conditions were made further conducive by the issuance of forward guidance by the SBP in the January 2021 Monetary Policy Statement. The guidance provided comfort about the continuation of the current

monetary policy settings in the near term, in the absence of any unforeseen adverse developments. This guidance was reinforced in the subsequent MPC meetings, which helped ease secondary market yields, leading to increased participation in the auctions for medium- and long-term instruments. Specifically, market participation in fixed-rate PIBs increased during Q4-FY21, after remaining lackluster till Q3.

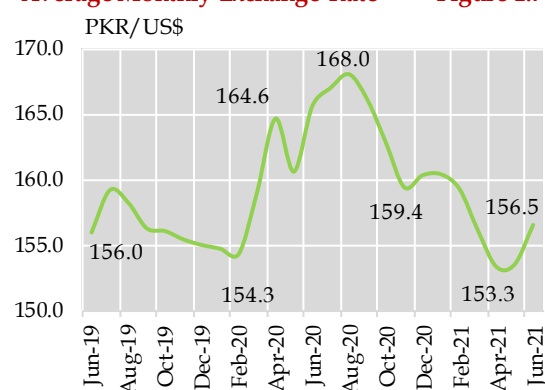
It was this prudent mix of policymaking which resulted in the economic recovery, without leading to a worsening in the macroeconomic imbalances. First, the external account improved considerably during FY21, as the current account deficit fell to a 10-year low of US\$ 1.9 billion and the SBP's FX reserves rose by US\$ 5.2 billion during the year. This encouraging outcome was achieved due to a surge in workers' remittances and export receipts, along with the availability of external financing from the IMF and other creditors, inflows into the Roshan Digital Accounts, and the issuance of Eurobonds, after a gap of three years. In addition to capturing some deflected orders from competitors amidst Covid-related lockdowns there, the policy focus was on improving export competitiveness on a sustainable basis – by the continued adherence to the market-based exchange rate system; provision of subsidized inputs via reduction in power tariffs, lower duties on imported raw materials and concessionary credit; and the fast-tracking of GST refunds. Pakistan's export performance during July 2020-June 2021 was quite prominent, as compared to other major global exporters (**Figure 1.6a**). This was evident particularly in case of high value-added textiles, where Pakistani exporters managed to increase their market share in the major destinations (**Figure 1.6b**).

In effect, the FX receipts from these sources partially offset a significant increase in the import payments. The upswing in economic activity; supply-side challenges across wheat, sugar and cotton; and elevated international commodity prices, all contributed to the

Export Growth of Major EMs during July 2020-June 2021**Figure 1.6a**

Source: Haver Analytics

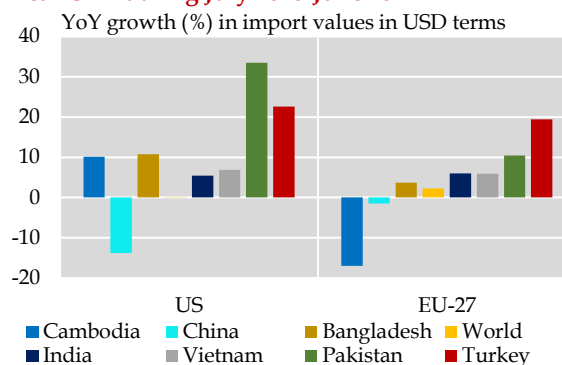
higher imports. These pressures had become more prominent towards the end of the year, and were reflected in the exchange rate movements: the PKR, after appreciating 10.0 percent during Jul-Mar, depreciated 3.0 percent against the US Dollar during the fourth quarter. Therefore, Rupee has been moving in an orderly way in both directions; responding to developments in the trade deficit, thus acting as a shock absorber (Figure 1.7).

Average Monthly Exchange Rate***Figure 1.7**

*Mark to market

Source: State Bank of Pakistan

Second, the fiscal consolidation efforts continued during FY21 and delivered a reduction in the fiscal deficit to 7.1 percent of GDP, from 8.1 percent last year. The policy efforts reprioritized spending towards social safety nets, the Economic Stimulus Package (ESP) and support for various sectors of the economy, and restrained non-interest current spending. Importantly, the incidence of these

Growth in Apparel Imports by US & EU-27 during July 2020-June 2021**Figure 1.6b**

Source: OTEXA (US Dept. of Commerce), Eurostat & Haver Analytics

adjustments did not fall on development spending, which recovered slightly after consistently declining over the past three years. However, the government had to make payment of power sector subsidies to partially clear circular debt of the independent power producers (IPPs) and the Power Holding Private limited (PHPL) under the Circular Debt Management Plan (CDMP). Similarly, the fiscal burden of the loss-making public sector enterprises (PSEs) continued to strain the fiscal account. On the revenue side, the FBR tax collection improved sharply with the turnaround in economic activity, along with the surge in imports, and efforts to streamline the tax administration.

Third, owing to the improvement in the primary balance, Pakistan's public debt dynamics improved in FY21. The pace of debt accumulation fell to a three-year low; the maturity profile of debt further improved, with favorable implications for debt sustainability; and the country was able to diversify its financing sources. The reduction in the debt burden was driven by the improvement in the twin deficits and an appreciation of the PKR against the US Dollar. The public debt-to-GDP ratio declined to 83.5 percent in FY21 from 87.6 percent last year. However, despite the reduction in the ratio of interest payments-to-tax revenues to 57.7 percent from 65.5 percent last year, interest expenses continue to consume a sizable share of tax revenues. Meanwhile, the improvement in the maturity profile was secured through the issuance of diversified debt instruments, including the Naya Pakistan Certificates

(NPCs) to attract investment from mostly non-resident Pakistanis, which fetched US\$ 1.0 billion during FY21. Moreover, the country also mobilized US\$ 2.5 billion via Eurobonds, after a gap of three years. In the domestic debt market, the country issued floating-rate PIBs with quarterly coupon payments.

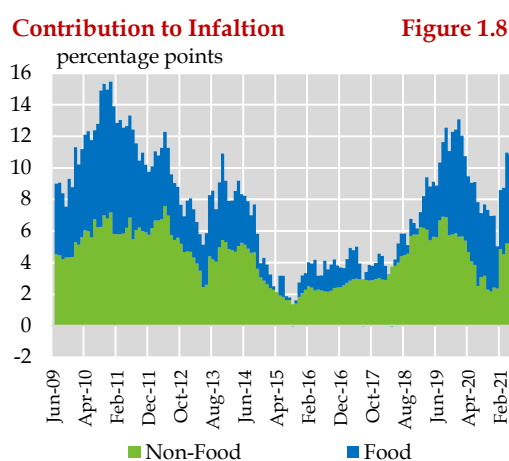
Fourth, the average headline CPI inflation fell to 8.9 percent in FY21 – within the SBP's forecast range of 7-9 percent. The resurgence in domestic demand did not give rise to inflationary pressures amidst the presence of some spare capacity in the economy. On the supply side, ample availability of perishable food products and tax relief measures kept inflation in check. In addition, an appreciation in the PKR exchange rate helped absorb some of the increase in international commodity prices. However, inflation remained volatile during the year. With the increase in power tariffs in January 21 and an uptick in fuel prices, inflationary pressures started to creep up from March 2021, pushing the average inflation to 10.6 percent during Q4-FY21 from 8.9 percent during Jul-Mar FY21.

Furthermore, while the underlying inflationary pressures were contained, food group emerged as the largest contributor to inflation during FY21. Within food items, price pressures were evident in wheat and sugar; moreover, these supply gaps had to be plugged in by imports at a time when international commodity prices had risen quite substantially.

The elevated food price inflation witnessed in FY21 is actually a recurring phenomenon in Pakistan (**Figure 1.8**). This needs to be addressed by ensuring market-availability of food items, thereby mitigating some of the impact of these pressures on CPI inflation. The needed measures include regular, timely and accurate monitoring of crops across the development stage; investments in human capital to improve demand forecasts for major commodities; addressing delays in procurement by public sector organizations;

and removing procedural impediments in arranging timely imports.³

In addition to this, addressing deep-rooted structural impediments is crucial for sustaining and improving the current growth momentum over the medium to long term. In this regard, following are some of the challenges that require immediate policy attention. First, consistently low yields of important crops, especially cotton, have constrained the agriculture sector's growth outcome (**Figure 1.9a**). Importantly, cotton



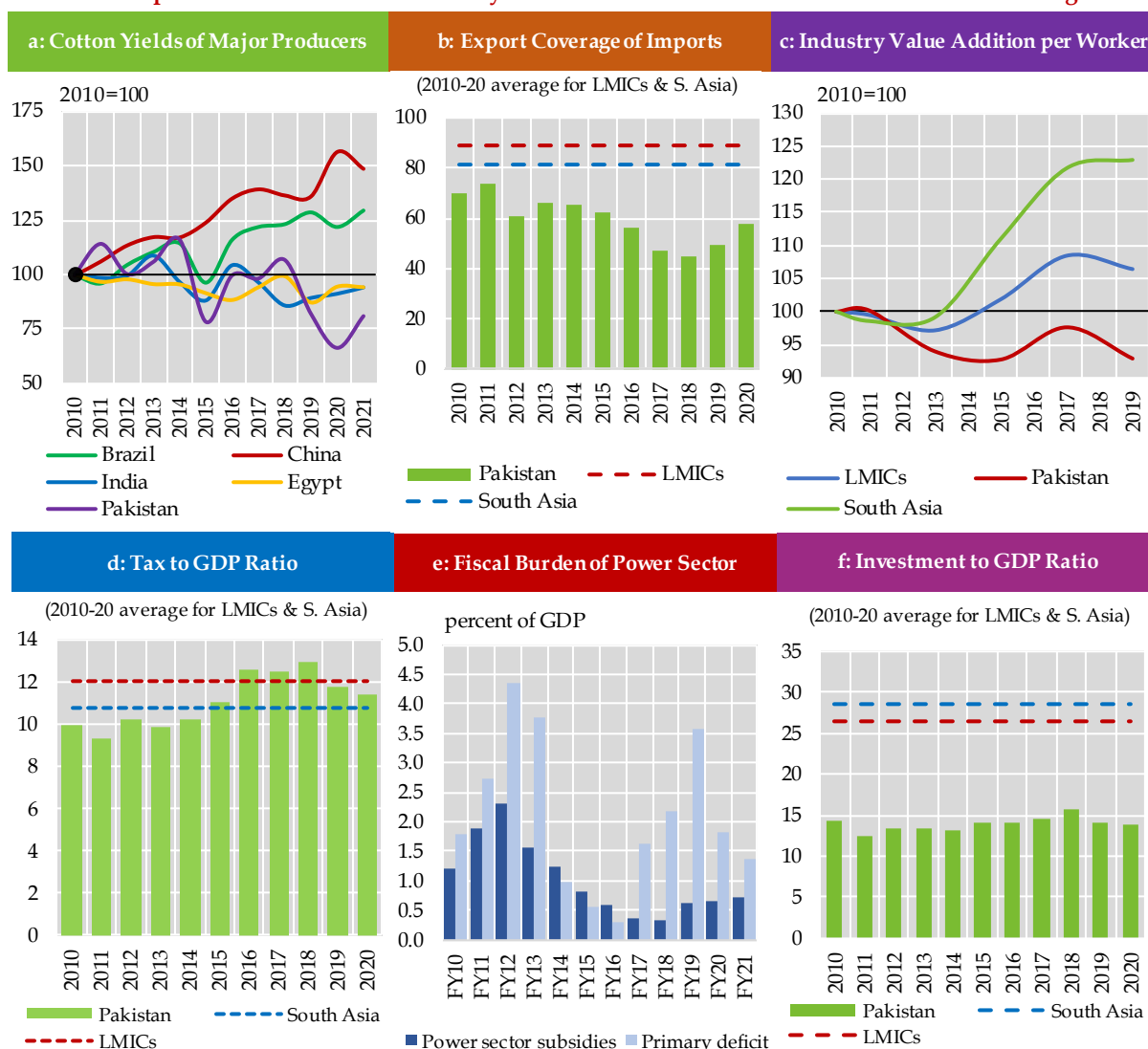
Source: Pakistan Bureau of Statistics

yields in Pakistan are considerably lower than those of other major producers. Inadequate availability and affordability issues related to quality inputs, such as certified seeds, water shortage, climate change, inefficient extension services, and poor regulatory oversight by relevant departments, have all contributed to this sub-par performance. To stem the declining trend in the yields of the important crops, the government introduced various supportive measures during the year including subsidized availability of inputs and increase in the minimum support prices of wheat. The long-term solution of these issues lies in a multipronged policy effort, incorporating significant upscaling of existing R&D setups in the public and private research institutes; addressing human and physical resource constraints; development of new

³ For details, see A.Khalid and Sabahat (2020). *Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges*. SBP Staff Note 02/20. Karachi: SBP.

Structural Impediments to Pakistan's Economy

Figure 1.9



Note: LMIC = Lower Middle Income Countries as per World Bank classification; VA = Value added

Sources: State Bank of Pakistan, Pakistan Bureau of Statistics, Ministry of Finance, World Bank

varieties of pest and climate change-resistant seeds; and strict enforcement of seed market regulations.

Second, the mismatch between the country's export earnings and import payments is a concern from the standpoint of the external sector's stability. It is worth noting that export receipts have risen to an all-time high during FY21, with high value-added textile items performing quite strongly, even relative to other major exporters. Also, the foreign exchange earnings of the country witnessed diversification during FY21 with a record surge in worker's remittances and a pickup in information, communications and technology

(ICT) exports. Despite this, the exports' coverage of imports is still under 60 percent, which is also below the average of some peer economies, including those in South Asia (**Figure 1.9b**). A number of factors may explain this outcome, including low quality of products, inadequate product and market diversification, limited integration with the world market through value chains, and lack of entrepreneurship and of international certifications. The concentration of the country's exports in a few markets and products has limited its ability to achieve a high growth path. In this context, there is a need to introduce a long-term policy

framework to address the aforementioned structural issues.

In addition, the pressure on the scarce foreign exchange earnings may also be partly alleviated by encouraging import substitution industrialization. The adoption of a market based exchange rate system is an important step in this regard. Further policy push can be provided by encouraging domestic production in sectors that do not require sophisticated technological advancement such as light engineering industries, and telecommunication machinery and apparatus.

The quality of exportable products also often suffers owing to low labor productivity in the country. A cross-country comparison shows that labor productivity in Pakistan is one of the lowest within peer emerging economies; moreover, productivity in Pakistan has declined over the past 10 years and is still below 2010 levels (**Figure 1.9c**). To address this structural shortcoming, investment in quality education and vocational training, alongside investments in technology, R&D, and health, can hardly be overemphasized.

However, the domestic resource envelope is currently inadequate to undertake the needed investments. A perceptible improvement in the fiscal account requires generating sustained increase in tax revenues. To address the issues of widening fiscal imbalance and a narrow tax base, Pakistan has initiated tax policy reforms for the past few years. Some of the major reforms include the elimination of preferential GST rates, phasing out of income tax exemptions, strengthening tax administration efforts, and simplification of tax rules and procedures. Pakistan's tax-to-GDP ratio declined to around 11 percent in recent years, after increasingly slightly during FY16-18 (**Figure 1.9d**). A sustained increase in the tax base requires widening the scope of these efforts. Furthermore, for undertaking much-needed public investment and to provide targeted support to the economy, sustained primary surpluses are needed. Consistently large fiscal deficits have pushed the country's public debt to high levels,

whereas the consequent increase in debt servicing has constrained the government's capacity for undertaking public investment and might also discourage private investment.

At the same time, on the expenditure side, concerted efforts are needed to contain non-interest current spending by addressing inefficiencies in the SOEs. In particular, the scale of subsidies devoted to the energy sector, and the continued fiscal burden of a few major public sector enterprises, has become quite concerning (**Figure 1.9e**). Around 80 percent of the overall subsidies in the country go to the power sector; moreover, the sector's share in subsidies has almost doubled in just a span of 5 years. To check the continued build-up in the energy sector circular debt, the government has adopted the Circular Debt Management Plan (CDMP) during FY21, while efforts are underway to undertake restructuring of loss-making SOEs. A swift progress on governance reforms and expediting the privatization process will be instrumental in reducing the fiscal drain of these entities.

Finally, the consistently declining trend of investment in terms of GDP is one of the major factors behind the boom-bust cycle of Pakistan's economic growth, where the economy is not able to sustain temporary consumption-led growth spurts in the absence of a concomitant increase in investment (**Figure 1.9f**). The dearth of investments has marred the productive capacity of the economy, increasing its vulnerability to shocks. This trend needs to be reversed by addressing key bottlenecks that have discouraged investment activity. To this end, the government has introduced a number of reforms to improve the investment climate in the country over the past two years.

Further efforts to this end include harnessing the potential of one investment policy tool, i.e. is the Special Economic Zones (SEZs). The SEZs have been around globally for some decades and are starting to gain prominence in Pakistan, given the focus of second phase of the China-Pakistan Economic Corridor

(CPEC) on enhancing business-to-business cooperation between the two countries. In this regard, this report contains a Special Chapter on SEZs, which provides an overview of the SEZ landscape in the country from a regulatory and policy standpoint, explores some major reasons for the lack of success of industrial estates and export processing zones, and provides policy recommendations to ensure that the SEZs achieve their desired objective of stimulating foreign and domestic investments in the country.

1.2 Economic Outlook

The economic recovery during FY21 is projected to gain further momentum in FY22. This is evident in the significant increase in machinery and raw material imports, continued expansion in consumer financing, and strong uptrend in domestic sales as seen from high frequency demand indicators during the initial months of FY22. Partly capturing these dynamics, the SBP is projecting GDP growth in the range of 4-5 percent (**Table 1.2**).

The sustained pace of vaccine roll-out has created optimism about the normalization of economic activity, notwithstanding the risk of virus variants. The policy support provided after the Covid outbreak over FY20-21 has succeeded in reviving the real economic activity. Specifically, the refinance schemes provided by the SBP are likely to have a cascading effect on growth through a revival in private investment. In addition, the accommodative monetary policy stance, the pro-growth measures outlined in the FY22 budget, the government's focus on the revival of construction industry under the 'Naya Pakistan Housing Scheme commonly known as Mera Pakistan Mera Ghar (MPMG) Scheme' and the mandatory housing finance targets by the SBP, together with the rebound in external demand, has set the stage for stronger growth momentum in FY22.

Both the supply and demand channels are expected to contribute to this higher growth outcome. The FY22 budget stipulates a sharp expansion in development spending, which would give a push to construction and allied

Macroeconomic Targets and Projections

Table 1.2

	FY22	
	Target ¹	SBP Projections ²
percent growth		
Real GDP	4.8	4.0 – 5.0
CPI (average)	8.0	7.0 – 9.0
billion US\$		
Remittances	31.3	30.5 – 32.5
Exports (fob)	26.8	26.5 – 27.5
Imports (fob)	55.3	62.5 – 63.5
percent of GDP		
Fiscal deficit ³	6.3	6.3 – 7.3
Current a/c deficit	0.7	2.0 – 3.0

Sources: ¹Annual Plan 2021-2022, Planning Commission, ²SBP, ³Ministry of Finance

industries. Similarly, the extension in the social safety envelope under BISP is expected to smoothen consumption patterns of the economically vulnerable segments. For businesses, tax and duty incentives for raw materials and capital goods, and the availability of power subsidies, are likely to boost economic activity and support private investment. The agriculture sector is projected to further benefit from the support packages for the Kharif and Rabi crops, which would, in turn, have a positive effect on the services sector as well.

The national CPI inflation is expected to remain within a range of 7.0 to 9.0 percent. Better commodity management practices, especially the build-up of reserves for wheat and sugar, would likely contain supply-side pressures from seeping into the inflation during FY22. Importantly, headline inflation is expected to retreat more visibly in the second half of the year, with the phasing out of the base impact of the hike in power tariffs. That said, these projections are subject to multiple upside risks, including from a greater-than-anticipated increase in global commodity prices and upward revision in utility tariffs. In addition to triggering a sharp increase in domestic prices, these developments may also give rise to significant second-round impacts on inflation. In the fiscal sector, the government plans to continue with the adjustment measures, which are projected to reduce the deficit to 6.3 percent of GDP, from 7.1 percent in FY21. The

SBP envisages the fiscal deficit within a range of 6.3 to 7.3 percent of GDP for FY22. This outcome would be driven by the continued check on non-priority current spending and an expansion in both tax and non-tax revenues. Specifically, a strong upsurge in economic activity will have a corresponding positive implication for tax revenues. In addition, the Corporate Income Tax (CIT) reforms announced in March 2021, are likely to support FBR tax collection via the elimination of various income tax exemptions and normalization of tax rates. Similarly, sustained efforts to enhance tax administration will further beef up collections by increasing formality and expanding the tax base. On the non-tax revenue side, the government primarily relies on collection from the Gas Infrastructure Development Cess (GIDC), with the settlement of issues in litigation. Furthermore, the sustained turnaround in sales of petroleum products may also boost collection from the petroleum development levy.

In the external sector, pressures are emerging from the import side, with payments exceeding the US\$ 6 billion in three of the past four months (June, August and September 2021). The surge in imports is broad-based, partly reflecting the increasing pace of

economic activity, a further increase in the global commodity prices, continued imports of agricultural commodities, automobiles, and many consumption related items. On a positive note, this increase in imports also reflects increase in machinery, much of which is supported by TERF that should help to augment future productive capacity. In this scenario, the current account deficit is projected in the range of 2.0 to 3.0 percent of GDP during FY22. A part of the expansion in the import payments is projected to be financed through a consistent increase in the workers' remittances and export receipts. Particularly, remittances are expected to remain upbeat amid the recovery in the global economy. Similarly, the pickup in international demand and a range of incentives announced by the government to lower the domestic cost of production, would likely bolster the export performance. The services deficit is projected to expand, in line with some resumption in international air travel. Meanwhile, the outlook for financial flows is likely to remain conducive, on the back of the US\$ 3.8 billion already received from the global SDR allocations and from a Eurobond, along with further loan disbursements from multilateral and bilateral creditors, and inflows into the RDAs.

Chapter 2

Economic Growth

Pakistan's economy posted an impressive recovery from the initial shock of the Covid pandemic. After a real GDP contraction of 0.5 percent in FY20, the economy grew by 3.9 percent in FY21. The performance was all the more remarkable since it was achieved in spite of multiple waves of the virus. The policymakers responded judiciously to the emerging challenges throughout the year. The response included a prudent approach to virus containment and the rollout of vaccines; smart lockdowns; an accommodative monetary policy environment and liquidity support through the SBP's multiple refinance schemes; and targeted fiscal support by the government in the form of no new taxes, energy and construction packages, faster refunds for exporters, and social safety spending via the Ehsaas Emergency Cash program. Collectively, these measures were instrumental in the economic recovery of FY21, which was led by a turnaround in the industrial and services sectors. Specifically, within industry, the food, automobile, textile, and construction-allied sectors of large-scale manufacturing were stand-out performers. In the agriculture sector, an increase in the minimum support price of wheat, and subsidies extended through the Rabi and Kharif packages, played a part in pushing the wheat, rice, and maize production to record high levels. The services sector was spurred on by the performance of the commodity-producing sector, with a particularly notable rebound in wholesale and retail trade. Finally, the recovery in the labor market is ongoing, based on available industrial employment data and trends in the SBP's Business Confidence and Consumer Confidence surveys.

2 Economic Growth

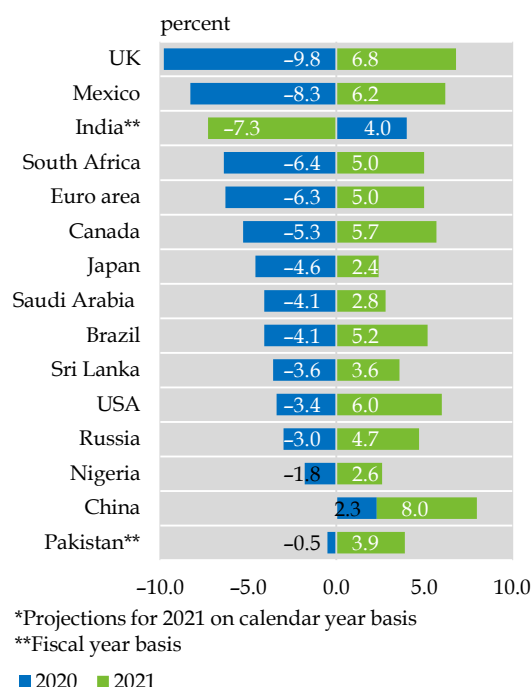
2.1 GDP Growth

Pakistan's economy recovered strongly in FY21 despite the uncertainty and challenges posed by the ongoing pandemic. Last year, the government had opted for a strict lockdown, for a limited period like most of the rest of the world, and the economy contracted by 0.5 percent in the immediate wake of the unprecedented health emergency created by Covid. The transition to smart lockdowns later on to deal with subsequent Covid waves enabled economic activities to rebound sharply in FY21 (**Table 2.1**). Moreover, the highly accommodative monetary policy, liquidity support channeled through the SBP's wide-ranging measures to combat Covid, and targeted fiscal support (in the form of no new taxes, energy and construction packages, faster refunds to exporters, and social protection via the Ehsaas Emergency Cash program), helped in minimizing the economic fall-out of the pandemic. These measures, complemented by packages for the agriculture sector and the recent vaccination drive, facilitated the economic recovery.

As a result of these measures, real GDP growth surpassed the government's target of 2.1 percent for FY21. Moreover, as **Figure 2.1** illustrates, Pakistan's economy fared well compared to other countries during the pandemic. While most of the countries observed sharp contractions in their output in 2020, the downturn in the domestic economy (-0.5 percent) was relatively modest. In FY21, Pakistan's real GDP growth rebounded to 3.9

Economic Growth of Selected Economies 2020 vs 2021*

Figure 2.1



Source: IMF, World Economic Outlook October 2021

percent. The varying base effects across the economies partially determined the extent of the rebound in FY21. A number of countries which are projected to post relatively high economic growth during 2021 – such as the United Kingdom, Canada, Mexico and South Africa – had seen sharp contractions in 2020. On a two year basis, Pakistan's growth of 3.9 percent through the Covid shock places it at the top end of most comparable emerging markets.

Real GDP Growth Rates, 2005-06 constant basic prices

Table 2.1

Growth and sectoral shares in percent; contribution to GDP growth in percentage points

	Growth		Contribution to GDP Growth		Sectoral Share	
	FY20 ^R	FY21 ^P	FY20 ^R	FY21 ^P	FY20 ^R	FY21 ^P
Agriculture	3.3	2.8	0.6	0.5	19.4	19.2
Industry	-3.8	3.6	-0.7	0.7	19.2	19.1
Services	-0.6	4.4	-0.4	2.7	61.4	61.7
GDP Growth Rate	-0.5	3.9				

P: Provisional, R: Revised

Source: Pakistan Economic Survey 2020-21

From the demand side, GDP growth was primarily driven by consumption and public sector investment during FY21. A multi-decade analysis highlights that Pakistan needs to bring its investment to GDP ratio at par with regional economies to achieve more sustainable growth (**Box 2.1**).

On the supply side, broad-based growth was witnessed across all the sectors in FY21. The industrial sector, driven mainly by large-scale manufacturing (LSM), posted a notable recovery on the back of resumption in business activities, which generally continued without major disruptions despite subsequent waves of Covid. Foreign demand for textile products and domestic demand for construction-allied material, automobiles and petroleum products, were major drivers of the LSM growth during the year. The ability of these industries to meet the consumer demand was facilitated by the temporary fiscal and monetary support measures, such as the construction and energy packages, low interest rates, and the SBP's Temporary Economic Refinance Facility (TERF).

Despite some deceleration compared to last year, the agriculture sector achieved its annual target of 2.8 percent growth during FY21. The government extended support to the sector through subsidies on inputs and increases in the minimum support price of wheat and sugarcane crops. Resultantly, almost all the important crops surpassed their targets: wheat, rice and maize delivered record high output, whereas sugarcane output was the second highest on record. However, the cotton crop was a notable exception, as the secular decline in its cultivated area was exacerbated by a fall in yield. Meanwhile, the livestock sector grew by 3.1 percent during FY21, compared to 2.1 percent last year. Within livestock, the poultry sector's performance – which had been severely affected in FY20 due to the strict Covid lockdowns and restrictions on large gatherings – improved notably during FY21

amid the ease in restrictions on gatherings and smart lockdowns.

In line with the positive performance of the commodity-producing sectors, services sector also rebounded and grew 4.4 percent during FY21, as compared to a contraction of 0.6 percent a year earlier. The major stimulus came from a turnaround in *wholesale and retail trade* sub-sector, which made a 1.5 percentage point contribution to real GDP growth during FY21 (**Table 2.1**). *Wholesale and retail trade* mainly grew on the back of the increase in domestic economic activities, and the increase in imports. The *finance and insurance* segment benefited from the growth in deposits and increase in advances by the banking sector. In contrast, the value-addition from the *transport, storage and communication* segment continued to contract during FY21, on account of the subdued performance of communications, air transport, and railways sub-segments. However, the upturn in value-addition in road transport – which carries the largest share in this segment – helped contain the magnitude of contraction of the *transport, storage and communication* segment.

The labor market recovered during FY21, based on employment data for the manufacturing sectors of Punjab and Sindh. The overall employment in both provinces grew by 2.4 percent during FY21. The improvement primarily owed to the resumption in economic activities, and was further facilitated by the targeted fiscal support and accommodative monetary policy. The SBP's Business Confidence Surveys (BCS) and the future unemployment index from the Consumer Confidence Surveys (CCS) also indicate that the labor market continued to improve throughout FY21. Similarly, sector-wise data from the Monthly Survey of Industrial Production and Employment for wages in Punjab witnessed a broad-based growth for the reported sectors.

Box 2.1: Repercussions of a Downward Trend in Investment on Economic Growth and Productivity

Investment as percentage of GDP in Pakistan is not only low, but has been in a state of long-term decline; this has ramifications for sustainable long-term growth.¹ Pakistan has not been able to sustain prolonged periods of economic growth and has faced frequent boom-bust cycles.² The declining long-term economic growth has adversely affected the country's ability to absorb its burgeoning labor force.³ The repeating pattern can be attributed to a lack of investment in technology, and in human and physical capital, stock that has curtailed the productive capacity while also making its economy prone to shocks.

Figure 2.1.1 illustrates that the downward trend in the investment-to-GDP is closely associated with declining long-term economic growth. A comparison with other regional countries, such as China, India and Bangladesh, shows that higher investment is linked with higher economic growth (**Table 2.1.1**). Another observation is that an increase in the investment-to-GDP ratio accelerates the GDP growth. Bangladesh is an interesting reference point in this aspect. Its investment-to-GDP ratio and economic growth were both lower than those of Pakistan in the 1980s. However, as its investment rose sharply over the years, its GDP growth almost doubled, in contrast to Pakistan's experience.

The slow pace of economic development in Pakistan is a source of concern. Assuming Chinese economy continues to grow by the same rate (7.7 percent), it will double its output in the next 10-years. On the other hand, it will take over 17 years for Pakistan (at 4.0 percent growth rate) to achieve that feat. This slow pace of growth will further widen Pakistan's income gap with peer countries.

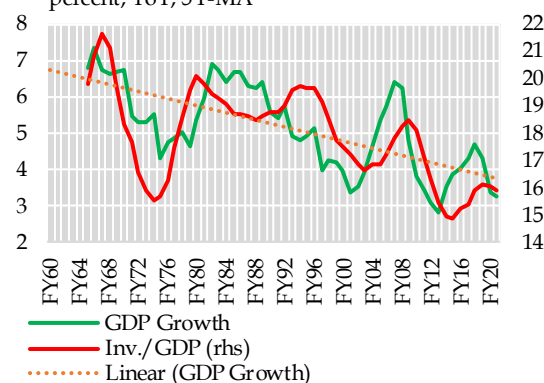
Another indicator of long-term growth is labor productivity, which in turn is affected by the level of human capital and capital investment in the country.

Labor productivity is approximated by output per worker by the World Bank. Comparison with the reviewed set of countries accentuates Pakistan's lagging performance (**Figure 2.1.2**). Despite leading other countries in labor productivity till the mid-2000s, Pakistan witnessed an almost stagnation in labor productivity over the next decade. In contrast, both China and India recorded notable improvements on this front, indicating that they are

Growth and Investment**Table 2.1.1**

	Bangladesh	China	India	Pakistan
Economic growth (percent YoY)				
1980s	3.5	9.7	5.7	6.9
1990s	4.7	10	5.8	4
2000s	5.6	10.4	6.3	4.5
2010s	6.8	7.7	6.7	4
Investment-to-GDP Ratio				
1980s	16.1	35.6	22.4	18.6
1990s	19.4	37.3	26.7	18.7
2000s	25.3	39.5	34.3	17.7
2010s	29.1	44.8	34.2	15.5

Source: World Development indicators, World Bank

Investment and Real GDP Growth **Figure 2.1.1**
percent, YoY, 5Y-MA

Source: World Bank

¹ For an extensive discussion on factors hampering investment in Pakistan, see Chapter 7, *Factors constraining Investments in Pakistan: Beyond the Macroeconomics* in the SBP's FY19 Annual Report on the State of the Economy.

² J.R. Calix, T.G. Srinivasan and M. Waheed (2012). *What do we know about Growth Patterns in Pakistan?* World Bank Policy Paper Series on Pakistan PK 05/12. Washington, DC: World Bank.

³ According to Planning Commission (2011), the economy needs to grow at 7 percent to absorb the youngsters entering the labor force. Similarly, the World Bank (2018) estimated that Pakistan would need to create 1.4 million jobs every year to keep its employment rate constant. This pace of job creation would be possible when the real GDP growth exceeds 6 percent per annum. Source: Planning Commission (2011). *Pakistan: Framework for Economic Growth*. Islamabad: Planning Commission; World Bank (2018). *South Asia Economic Focus, Spring 2018: Jobless Growth?* Washington DC: World Bank.

more efficiently utilizing their resources than Pakistan.⁴ Meanwhile, Bangladesh is catching up fast as well. Low productivity over a prolonged period has adverse implications for achieving progress on living standards, public and private debt, social protection systems, and the ability of macroeconomic policies to respond to future shocks.⁵

Pakistan has recently made some inroads in improving its investment climate. Installed electricity generation has almost doubled over the past decade.⁶ That said, efforts must be made to boost labor productivity in the country. Investments in productivity would help smoothen the economic cycles and enable sustained long-term economic growth.

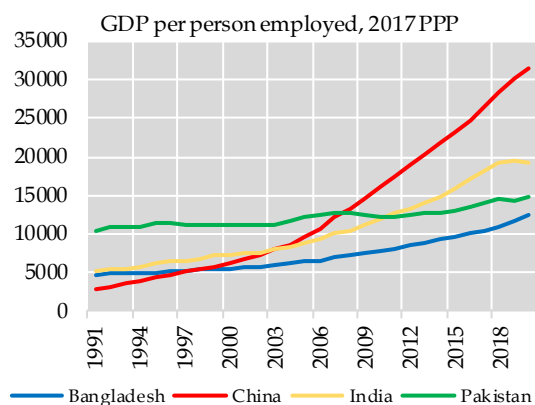
2.2 Agriculture

On the back of policy support, coupled with favorable weather conditions for important crops such as wheat and sugarcane, the agriculture sector met its growth target of 2.8 percent for FY21 (**Table 2.2**). The *Rabi* and *Kharif* support packages offered subsidies on various inputs, such as fertilizers and pesticides, whereas the Minimum Support Price (MSP) for wheat and sugarcane was also revised upward during the year. These measures helped increase wheat, rice and maize output to achieve record levels, whereas sugarcane output achieved its second highest level. The outlier was cotton, whose overall area under cultivation dipped to 2.1 million hectares – its lowest level since FY80.

Moreover, the cotton yield was adversely affected by the severe monsoon rains during the year. The *other crops* category also faced a collective slowdown, and similar to last year, was unable to make a positive contribution to GDP growth (**Table 2.3**). Within *other crops*, the gram production – the largest variety of pulses grown in the country – nearly halved over FY20, largely due to insufficient rainfall in the Thal region.

Output per Worker

Figure 2.1.2



Source: World Bank

Agriculture: Sectoral Growth

Table 2.2

	percent			
	FY19	FY20 ^R	FY21 ^T	FY21 ^P
Agriculture	0.6	3.3	2.8	2.8
Crops	-5.0	5.5	-	2.5
Important crops	-7.7	5.2	1.9	4.7
Other crops	2.6	8.1	1.5	1.4
Cotton ginning	-12.7	-4.8	0.9	-15.6
Livestock	3.8	2.1	3.5	3.1
Forestry	7.3	3.6	2.1	1.4
Fishing	0.8	0.6	1.5	0.7

R: Revised, T: Target, P: Provisional

Source: PBS; Planning Commission

Contribution to Real GDP Growth and Share of Agriculture in GDP

Table 2.3

	Contribution		Share	
	FY20 ^R	FY21 ^P	FY20 ^R	FY21 ^P
Agriculture	0.6	0.5	19.4	19.2
Crops	0.4	0.2	7.0	6.9
Important crops	0.2	0.2	4.3	4.3
Other crops	0.2	0.0	2.3	2.2
Cotton ginning	0.0	-0.1	0.4	0.3
Livestock	0.2	0.4	11.6	11.5
Forestry	0.0	0.0	0.4	0.4
Fishing	0.0	0.0	0.4	0.4

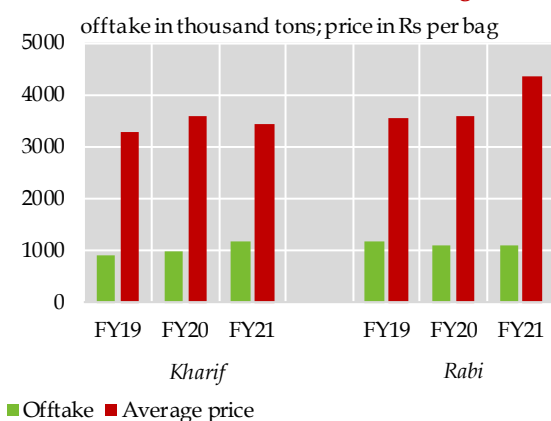
P: Provisional, R: Revised

Source: Pakistan Bureau of Statistics

⁴ Source: US Bureau of Labor Statistics (www.bls.gov/k12/productivity-101/content/why-is-productivity-important/).

⁵ G. Adler, R. Duval, D. Furceri, S.K. Celik, K. Koloskova and M. P. Ribeiro (2017). *Gone with the Headwinds: Global Productivity*. IMF Staff Discussion Note SDN/17/04. Washington, D.C.: IMF.

⁶ Ministry of Finance (2021). *Pakistan Economic Survey 2020-21*. Islamabad: MoF.

Season-wise DAP Offtake & Price Figure 2.2a

Source: National Fertilizer Development Center

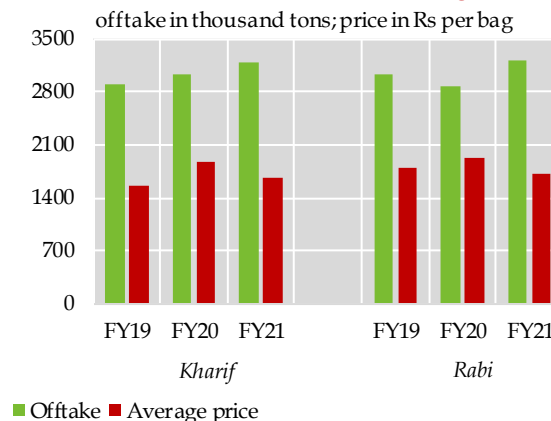
Meanwhile, the livestock sector grew by 3.1 percent during FY21, and its contribution to GDP growth also doubled over last year. This recovery was partly attributed to better performance by the poultry sector amid the ease in lockdown conditions.

Inputs

The government's support for the agriculture sector was channeled through two major packages in FY21. The first agriculture package was approved in May 2020 to support the *Kharif* crops, whereas the second agriculture package, approved in October 2020, helped improved the prospects of *Rabi* crops, especially wheat. The wheat crop also benefitted from upward revisions in its MSP, from Rs 1,400 per 40kg bag last season to Rs 1,650 in November 2020, and then further to Rs 1,800 in April 2021.

Fertilizer

A common element of both agriculture packages was the emphasis on fertilizer subsidies. Specifically, the *Kharif* package included a subsidy of Rs 925 per bag on DAP and Rs 243 per bag on urea.⁷ Similarly, the *Rabi* package included Rs 1,000 per bag subsidy on DAP.⁸ The DAP offtake after growing 19.4 percent during *Kharif*, could only

Season-wise Urea Offtake & Price Figure 2.2b

grow 2.3 percent during the *Rabi* season (**Figure 2.2a**). The *Rabi* offtake was dampened by the sharp increase in the commodity's global prices. Specifically, during October-March FY21, global DAP prices rose by 49 percent, and contributed to the 21 percent increase in the domestic DAP price on YoY basis. This constrained the farmers' ability to purchase and apply the input, despite the subsidized rates.

Meanwhile, the offtake of urea was 5.5 percent higher during *Kharif* and 12.4 percent higher during *Rabi* respectively (**Figure 2.2b**). Urea prices, which had moderated since February 2020 after the January 2020 decision of the Economic Coordination Committee (ECC) to reduce the Gas Infrastructure Development Cess (GIDC), remained lower during FY21 on YoY basis, enabling higher offtake of the commodity during the review period.

Agriculture Credit

Agriculture credit disbursements rose to Rs 1,365.9 billion during FY21, compared to from Rs 1,214.7 billion last year (**Table 2.4**). There was a noteworthy acceleration in disbursements to the farm sector, spurred in large part by an increase in production-related loans, especially for crops. This could be partly explained by the record production of the three important crops and the second-

⁷ Source: Ministry of Finance press release no. 308, dated May, 13, 2020.

⁸ Source: Ministry of Finance press release no. 391, dated October, 29, 2020.

Agriculture Credit Disbursements**Table 2.4**

billion rupees; growth in percent

	FY19	FY20	FY21	Growth	
				FY20	FY21
I. Farm sector (i+ii)	592.7	637.9	758.2	7.6	18.9
i. Production	553.1	594.3	711.8	7.4	19.8
o/w					
All crops	241.2	215.3	458.9	-10.7	113.1
ii. Development	39.6	43.6	46.4	10.1	6.4
High quality seed processing unit	14.1	14.6	18.5	3.5	26.7
Tractor	4.3	2.5	4.4	-41.9	76.0
II. Non-farm sector (iii+iv)	581.3	576.8	607.6	-0.8	5.3
iii. Working capital	553.2	538.9	552.5	-2.6	2.5
Livestock/ dairy	268.5	279	319.7	3.9	14.6
Poultry	150.6	209.9	192.8	39.4	-8.1
iv. Fixed investment	28.1	37.9	55.1	34.9	45.4
Livestock/ dairy	20.5	14.5	22.7	-29.3	56.6
Poultry	2.8	16.1	24.0	475.0	49.1
Total Agriculture(I+ II)	1,174.0	1,214.7	1,365.9	3.5	12.4

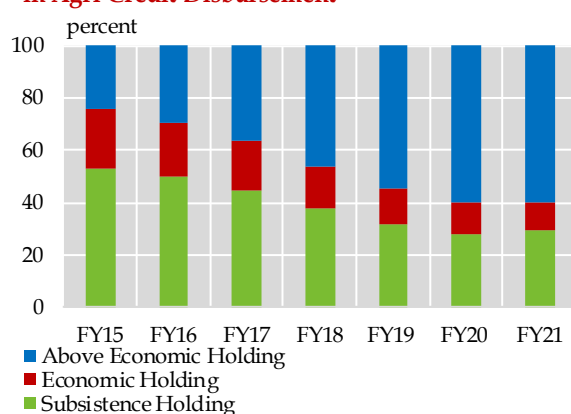
Source: State Bank of Pakistan

highest production of sugarcane; the favorable production dynamics increased the working capital needs of the farmers.

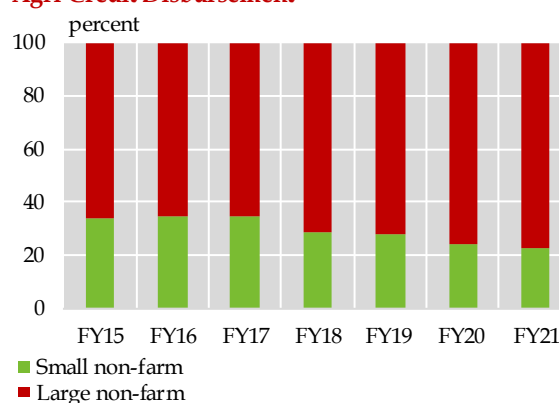
Meanwhile, disbursements to the non-farm sector recovered from the dip witnessed last year. There was a pick-up in working capital disbursements to the livestock/ dairy subsector. For the poultry sector, working capital loan disbursements declined by 8.1 percent to Rs 192.8 billion during FY21, from Rs 209.9 billion last year. This could be reconciled with the relatively subdued demand for financing when Covid waves were at their peaks at different times of the

year. However, fixed investment in the poultry sector was encouraging for the second year in a row, suggesting that the poultry producers did not anticipate an enduring drag on demand in the medium-to-long term.

Despite the challenges posed by the pandemic, the financial institutions collectively achieved 91 percent of their assigned agricultural disbursement target of Rs 1,500 billion for FY21. Specifically, the commercial banks, Islamic Banking Institutions (IBIs), Zarai Taraqiati Bank Limited (ZTBL), and the Punjab Provincial Cooperative Bank Limited (PPCBL) collectively disbursed Rs 1,210.6

Farm sector: Holding-wise share in Agri Credit Disbursement**Figure 2.3a**

Source: State Bank of Pakistan

Non-Farm sector: Size-wise share in Agri Credit Disbursement**Figure 2.3b**

billion, or 94.8 percent, against their assigned targets of Rs 1,277.0 billion.

However, the microfinance lending institutions missed their targeted credit disbursements by a considerable margin for the second year in a row, with the disbursements achieving 76 percent and 73 percent of their targets in FY20 and FY21 respectively, against 99 percent in FY19. Microfinance institutions and rural support programs, as a group, achieved 73 percent and 57 percent of their target in FY20 and FY21, compared to 97 percent in FY19. This performance is primarily attributed to the impact of Covid on the microfinance sector, particularly due the lockdowns.^{9 10}

Notwithstanding the overall 12.4 percent growth in agriculture credit disbursements over last year, the composition of lending

remained skewed towards larger borrowers (**Figure 2.3a and 2.3b¹¹**). This applied to borrowers with small (subsistence) holdings in the farm sector, as well as small-sized enterprises in the non-farm sector. It implies that financial institutions need to collectively expedite their efforts to reach out to small farmers, as part of the broader agenda of the National Financial Inclusion Strategy (NFIS).

Water

In terms of water input, surface water availability was around 2 percent higher compared to last year, as well as the five-year average for FY16 to FY20 (**Table 2.5**).¹² Season-wise breakdown reveals that availability was 6.8 percent higher during the FY21 *Rabi* season, whereas surface water availability in *Kharif* FY21 remained at a similar level as last year.¹³

Also, heavy monsoon rains during Q1-FY21 pushed the level of recorded rainfall well beyond normal (**Figure 2.4**). As discussed subsequently, this rainfall significantly dampened the cotton yield, particularly in Sindh. By contrast, there was a relatively dry spell during Q3-FY21, the latter part of the *Rabi* season, which was favorable from the viewpoint of wheat harvest.

Actual Surface Water Availability **Table 2.5**
million acre feet

	Kharif	Rabi	Total
FY16	65.5	32.9	98.4
FY17	71.4	29.7	101.1
FY18	70.0	24.2	94.2
FY19	59.6	24.8	84.4
FY20	65.2	29.2	94.4
FY16-FY20 avg.	66.3	28.2	94.5
FY21	65.1	31.2	96.3

Source: Pakistan Bureau of Statistics

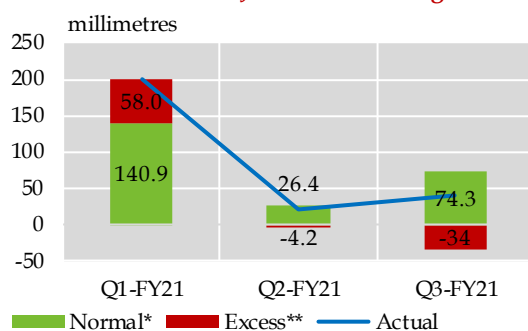
⁹ In surveys with microfinance stakeholders a week after the first lockdown was imposed in March 2020, Malik et. al (2020) found that the week-on-week sales and household income of microenterprises fell by about 90 percent; similarly, loan officers expected repayment rates to plunge from 98 percent and 81 percent in February and March to 34 percent in April 2020. While agriculture and livestock were not part of the sample in this paper, similar challenges may have affected the agri-related microfinance segment as well. (K. Malik, M. Meki, J. Morduch, T. Ogden, S. Quinn, and F. Said (2020). "COVID-19 and the Future of Microfinance: Evidence and Insights from Pakistan", *Oxford Review of Economic Policy*, 36 (Supplement 1), S138-S168.

¹⁰ Agriculture credit extended by the microfinance sector (including microfinance banks, microfinance institutions, and the rural support programs) amounted to Rs 155 billion in FY21, compared to Rs 168.2 billion last year. Meanwhile, total microfinance disbursement to all sectors (including agriculture) amounted to Rs 404.8 billion in FY21, up from Rs 384.1 billion last year. Therefore, around 38 percent of microfinance disbursements during FY21 were channeled to the agriculture sector, down from 44 percent in FY20.

¹¹ For definitions of holding-wise and size-wise categories, see the report on Indicative Credit Limits and Eligible Items for Agri. Financing 2020, enclosed with the SBP Agriculture Credit & Microfinance Department's Circular No. 1 of 2020: www.sbp.org.pk/acd/2020/C1.htm

¹² Surface water refers to any body of water above ground, and includes rivers and reservoirs. The Indus River is the main source of surface water in the country.

¹³ Kharif corresponds with April-September and Rabi with October-March.

Rainfall recorded in Jul-Mar FY21 Figure 2.4

* Normal level is defined as the period average from 1961-2010. ** Negative number represents a shortfall compared to 'normal'

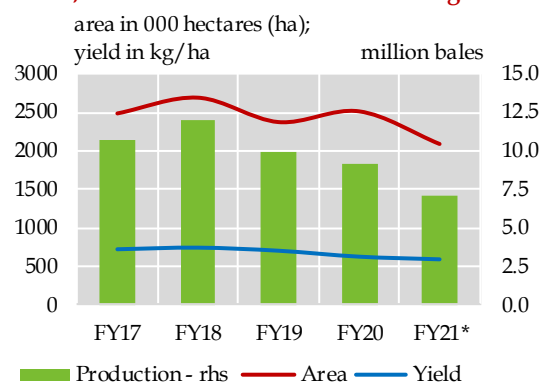
Source: Pakistan Meteorological Department

Output

Cotton

Cotton production, at nearly 7.1 million bales, was the lowest since FY85, while its cultivated area of around 2.1 million hectares was the lowest since FY80 (**Figure 2.5**). The area under cotton has witnessed a secular decline over the past decade, shrinking on-average from nearly 3 million hectares between FY92 to FY11 to around 2.7 million hectares between FY12 to FY21. During FY21 as well, growers continued to favor competing crops like sugarcane and rice, instead of cotton.¹⁴

The cotton yield in FY21 was also adversely affected by heavy monsoon rains. To put this into context, the review period witnessed the wettest August for Sindh in the past 60 years, as the rainfall received by the province was 363 percent above the normal average for this month.¹⁵ This caused widespread damages to the standing crops; specifically, the rains and flash floods completely damaged around 27 percent of the cotton crop grown in Sindh. In Punjab as well, around 3,251 hectares of the crop area was badly affected by excess rain.¹⁶

Area, Production & Yield of Cotton Figure 2.5

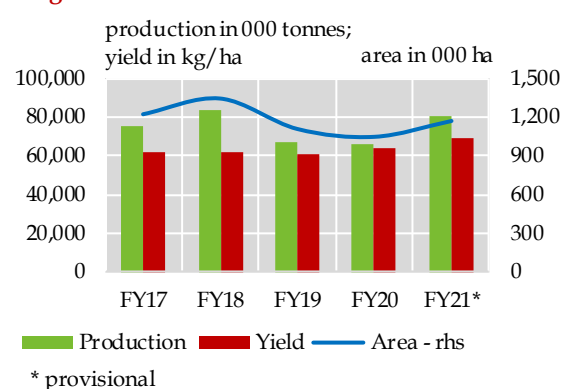
* provisional

Source: Pakistan Bureau of Statistics

Sugarcane

Sugarcane production increased by 22 percent over last year, and amounted to 81 million tons (**Figure 2.6**). The impressive performance was attributed to a 12 percent increase in the cultivated area, motivated in part by an increase in the MSP by Rs 10 to Rs 200 per 40 kg in Punjab, and Rs 202 per 40kg in Sindh.

There was also 8.9 percent increase in the yield, attributed mainly to better crop management and favorable weather conditions. Yield-enhancement efforts have

Area, Production & Yield of Sugarcane Figure 2.6

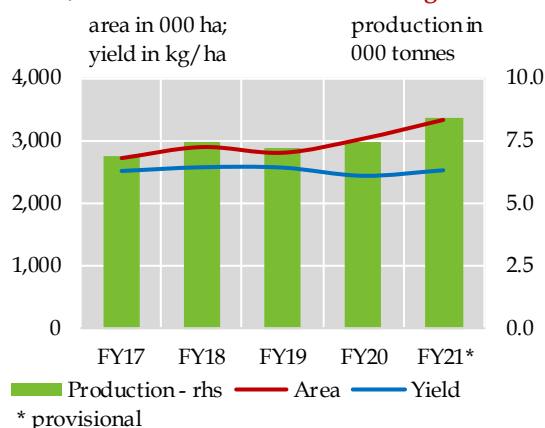
* provisional

Source: Pakistan Bureau of Statistics

¹⁴ For more details on the secular decline in cotton area, see the SBP's FY20 Annual Report on The State of Pakistan's Economy.

¹⁵ Pakistan Meteorological Department (2020). *Pakistan's Monthly Climate Summary, August 2020*. Karachi: Pakistan Meteorological Department

¹⁶ Pakistan Cotton Grower, 2020, Central Cotton Research Institute Multan, Vol.3, No. 3.

Area, Production & Yield of Rice Figure 2.7

Source: Pakistan Bureau of Statistics

received support from the government's five-year 'National Program for Enhancing Profitability through Increasing Productivity of Sugarcane', launched in FY20. The program includes provision of subsidized chisel ploughs, sugarcane planters and granular pesticide applicators for farmers, as well as demonstration plots to make the growers aware of how to utilize technology and adopt modern farming practices.¹⁷

Rice

The rice crop achieved record production of 8.4 million tons in FY21, which was 13.6 percent greater than last year (Figure 2.7). This was mainly achieved on the back of a 9.9

percent increase in area under cultivation during FY21, compared to 8 percent increase last year. The increase in the cultivated area is mainly attributed to favorable prospects of the country's rice exports, in terms of both unit prices and quantum demand.

The performance of the rice crop was particularly impressive in Punjab, which accounted for 63 percent of the FY21 output (Table 2.6). The cultivated area of rice grew by 18.0 percent in Punjab, whereas yields in the province grew 8.4 percent. To increase rice yields, the Punjab government launched a five-year 'National Program for Enhancing Profitability through Increasing Productivity of Rice' set to be executed between FY20 to FY24 at a total cost of nearly Rs 10 billion. The project includes provision of subsidized machinery, certified seeds and weedcides on cost-sharing basis, along with efforts to promote judicious use of pesticides.¹⁸

Wheat

Wheat production grew 8.9 percent and reached a record level of 27.5 million tons in FY21 (Figure 2.8a). The crop's cultivated area grew by 4.2 percent from last year, as growers were incentivized by the increase in the minimum support price.¹⁹ The wheat yield also increased by 4.5 percent during the year (Figure 2.8b). Favorable weather conditions,

Average yield of rice crop in selected districts of Punjab***Table 2.6**

Kg/ hectare; growth in percent

	Basmati			Non-Basmati		
	FY20	FY21	Growth	FY20	FY21	Growth
Punjab	1,952	2,145	9.9	2,452	2,462	0.4
of which:						
Okara	1,975	2,343	18.6	2,951	3,299	11.8
Bahawalnagar	2,082	2,438	17.1	2,368	3,028	27.9
Pakpattan	2,008	2,343	16.7	2,798	3,212	14.8
Jhang	2,028	2,225	9.7	2,322	2,665	14.8
Mandi Bahauddin	1,901	2,052	7.9	2,420	2,440	0.8

* These are the top-five rice producing districts in Punjab for FY21, based on provisional data

Source: Crop Reporting Service, Punjab

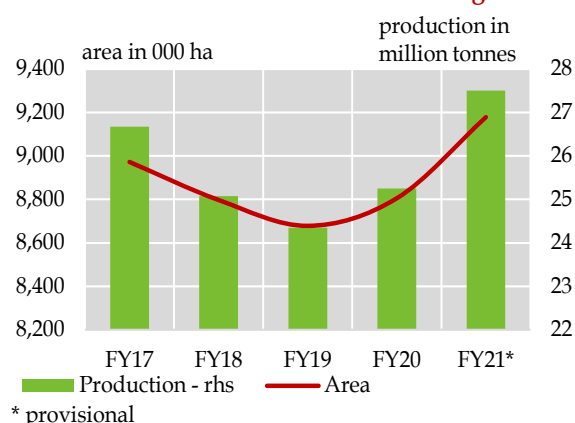
¹⁷ Directorate General Agriculture, Extension and Adaptive Research, Punjab

¹⁸ Directorate General Agriculture, Extension and Adaptive Research, Punjab: (www.ext.agripunjab.gov.pk/rice_project)

¹⁹ Specifically, the ECC recommended an increase in the minimum support price of wheat to Rs 1,800 per 40 kg bag in April 2021, from Rs 1,400 per 40 kg bag in FY20.

Area and Production of Wheat

Figure 2.8a



Source: Pakistan Bureau of Statistics

relatively contained onset of wheat rust disease, and healthy offtake and application of urea fertilizer, contributed to the improved yield.²⁰

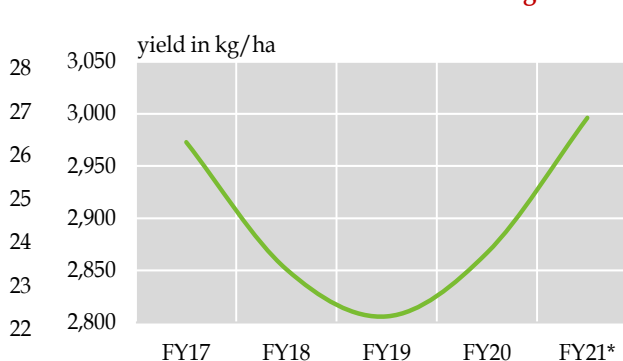
Despite the record production though, the government decided to supplement the domestic procurement with imports to maintain strategic reserves. Part of the rationale was that the annual wheat consumption was estimated to have increased by around 2 million metric tons (MMT) since last year, to 29.5 MMT in 2021.²¹

Consequently, in addition to the official procurement target of 6.3 million tons, the government also fixed the import requirement at 3 MMT, so that sufficient wheat stocks would be available for release during FY22.

The government's procurement drive has shown an improvement in the last two years. Specifically, following an underwhelming effort in FY19 when only 64.5 percent of the 6.25 MMT procurement target was met, the procurement drive for FY20 achieved 80.0 percent of its 8.25 MMT target. During FY21 as well, around 93.8 percent of the 6.3 MMT procurement target had been achieved by mid-September 2021.²²

Yield of Wheat

Figure 2.8b

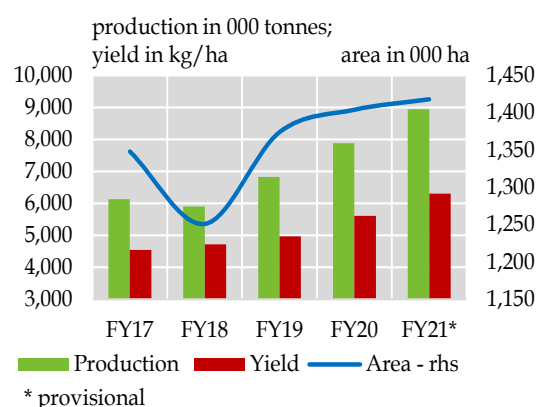


Maize

Maize production increased by 13.4 percent to 8.9 million tons during FY21 (Figure 2.9), primarily due to a 12.3 percent increase in yield, along with a 1 percent growth in its cultivated area.

Specifically, yields in Punjab – which accounted for 89.4 percent of the overall maize production in FY21 – improved by 7.7 percent in the year. Yields in the province have been rising since 2004-05, partly due to the use of high-yielding imported seed varieties. The

Area, Production & Yield of Maize Figure 2.9



Source: Pakistan Bureau of Statistics

²⁰ USDA Grain and Feed Annual Report, dated June, 24, 2021.

²¹ MNFSR (Working Paper of the Federal Committee on Agriculture for Kharif 2021-22).

²² MNFSR.

Performance of Selected Pulses Crops^P**Table 2.7**

area in 000 hectares; production in 000 metric tons; yield in kg/hectare

	Area			Production			Yield		
	FY20	FY21 ^T	FY21 ^P	FY20	FY21 ^T	FY21 ^P	FY20	FY21 ^T	FY21 ^P
Gram	943.9	983.0	872.7	497.6	525.5	261.2	527.5	534.6	299.0
Moong	172.9	180.7	231.1	125.9	140.0	204.5	728.2	774.8	884.9
Mash	13.9	17.0	11.0	6.5	10.3	7.0	467.6	605.9	636.4

P: Provisional, T:target

Sources: MNFSR; PBS

Performance of Gram Crop in selected divisions of Punjab^P**Table 2.8**

	Area		Production		Yield	
	000 hectares	000 tons	000 tons	000 tons	kgs/hectare	kgs/hectare
	FY20	FY21	FY20	FY21	FY20	FY21
Punjab	850.3	793.6	430	164	505.7	206.7
o/w:						
Bhakkar	385.5	390.9	188.8	64.8	489.6	165.7
Khushab	207.2	178.3	100.1	36.6	483.1	205.3
Layyah	119.0	105.2	61.8	29.1	519.3	276.6
Jhang	95.9	85.0	49.1	9.8	511.9	115.5

P: Provisional

Source: Crop Reporting Service, Punjab

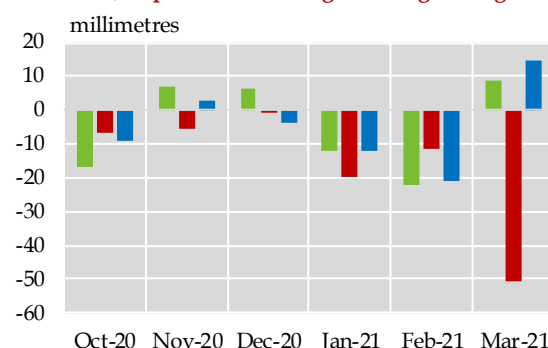
Punjab Agriculture Department has also been promoting the use of better farming practices and upgraded technology, such as drip irrigation and cob pickers.²³

Pulses

Among pulses, the gram (chickpea) crop is the most widely produced in Pakistan. However, gram production fell by nearly half in FY21 to 261,000 tons, from 498,000 tons last year (Table 2.7). This was mainly due to a sharp 43 percent drop in yield.

Around 90 percent of the cultivated area for gram is located in Punjab. Furthermore, the bulk of cultivation in the province consists of unirrigated, subsistence cultivation in the Thal desert region, including in districts such as Bhakkar, Khushab, Layyah and Jhang (Table 2.8).

The yield can be highly dependent on the amount of rainfall received during the *Rabi* season (October to March). In this regard, the Bhakkar, Layyah and Jhang districts received

Rainfall, Departure from Long-term Avg* Fig 2.10

* 2009-21 for Bhakkar; 2016-21 for Layyah; and 2003-21 for Jhang

Legend: Bhakkar (green), Layyah (red), Jhang (blue)

Source: Pakistan Meteorological Department

significantly lower rainfall compared to their long-term average; this contributed to significant declines in the gram yield in these districts as compared to last year, by around 66 percent, 47 percent, and 77 percent respectively (Figure 2.10).

Livestock

The livestock sector grew by 3.1 percent during FY21, against the growth of 2.1 percent recorded last year (Table 2.9). The impetus mainly came from the poultry sub-sector, which rebounded strongly from the Covid-induced slump in FY20. While the demand and prices of poultry products fell considerably during March to May 2020 amid the strict lockdown, the subsequent shift to smart lockdowns supported the poultry sub-sector. Resultantly, the contribution of livestock to GDP growth also doubled from 0.2 percentage points in FY20 to 0.4 percentage points in FY21.

²³ For more details, see the SBP's Second Quarterly Report for FY21 on the State of Pakistan's Economy.

Gross Value Added (GVA) of Livestock Sector

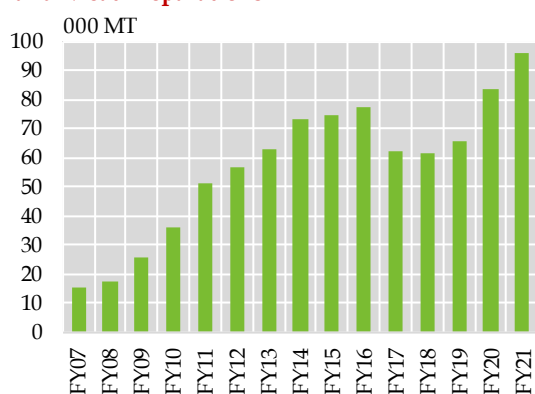
million Rupees; growth in percent

Table 2.9

	FY20 ^R	FY21 ^P	Growth	
			FY20 ^R	FY21 ^P
A. Gross output	1,776,473	1,848,642	3.0	4.1
Animals sold for slaughtering	403,468	415,242	2.9	2.9
Natural growth/regeneration	252,460	260,040	3.0	3.0
Livestock products	924,696	952,522	3.0	3.0
Milk	796,050	821,677	3.2	3.2
Others	128,646	130,845	1.6	1.7
Poultry products	195,849	220,838	3.5	12.8
B. Intermediate consumption	315,886	343,970	7.2	8.9
C. Gross value added (A-B)	1,460,587	1,504,671	2.2	3.0
D. Other GVA*	7,929	8,928	-8.0	12.6
E. Total GVA (C+D)	1,468,517	1,513,599	2.1	3.1

R: revised; P: provisional, * hunting and husbandry

Source: Pakistan Bureau of Statistics

Quantum Exports of Meat and Meat Preparations**Figure 2.11**

Source: Pakistan Bureau of Statistics

Within livestock, meat production increased from 4.7 million tonnes in FY20 to nearly 5.0 million tonnes in FY21, according to the Pakistan Economic Survey 2020-21. While the data for meat production is estimated through the somewhat dated inter-census growth rate of the Livestock Census 1996 and 2006, the elevated quantum of meat exports also supports the view that production has generally outpaced the domestic consumption requirements in the past decade (**Figure 2.11**). Future prospects of the sector are also encouraging. For instance, 81 percent of additional beef production globally is

projected to come from developing countries by 2029, especially from Pakistan, Argentina, Brazil, China, Turkey, and Sub-Saharan African countries, according to an OECD-FAO report.²⁴

Meanwhile, milk production rose from 61.7 million tonnes in FY20 to 63.7 million tonnes in FY21, according to estimates in the Pakistan Economic Survey 2020-21. This sub-segment mainly comprises buffalo milk (38.4 million tonnes) and cow milk (23.4 million tonnes), while the remainder consists of goat, camel and sheep milk.

The country's yield of fresh buffalo milk is comparable to several regional peers (**Table 2.10**). However, Pakistan's standing in terms of fresh cow milk indicates some room for improvement. Cattle farming in the country is largely of subsistence nature, dominated by households owning between 1 to 4 cattle.²⁵ Moreover, the majority of smallholder dairy farms use relatively low-quality fodder and less efficient herd management practices as compared to progressive dairy farmers.²⁶ By comparison, for example, China has posted significant improvement in its cow milk yield, due to the adoption of modern milking facilities and feed

²⁴ OECD-FAO Agricultural Outlook 2020-2029.²⁵ Pakistan Livestock Census, 2006.²⁶ A. Burki and M. Khan (2019). *Economic Impact of Pakistan's Dairy Sector: Lessons for Building Sustainable Value*. Lahore: LUMS.

Average Milk Yield**Table 2.10**

kg per animal/day

	Buffalo			Cow		
	1990	2019	Δ*	1990	2019	Δ*
Iran	3.1	7.8	4.6	2.6	9.9	7.3
Pakistan	4.6	6.3	1.7	2.3	4.0	1.7
India	3.1	5.6	2.5	2.0	4.7	2.6
Egypt	2.6	3.6	1.0	2.6	3.8	1.2
Turkey	2.5	2.7	0.2	3.7	8.7	5.0
Nepal	2.2	2.4	0.2	1.0	2.0	1.0
Sri Lanka	1.3	2.2	0.9	1.5	3.2	1.6
China	1.2	1.4	0.2	4.3	15.5	11.2

* Change between 1990 and 2019

Source: FAO

management techniques by large-scale dairy farms, which accounted for around 70 percent of dairy farms in China in 2020.²⁷

Forestry and Fishing²⁸

The forestry sector grew by 1.4 percent during FY21 compared to 3.6 percent last year, while the fishing sector posted growth of 0.7 percent, against 0.6 percent in FY20. As given in **Table 2.3** previously, the contribution of forestry and fishing sectors to real GDP growth, according to official estimates, is negligible.

Nonetheless, these sectors have room to grow and contribute to the national output.

The forestry sector's negligible contribution to GDP growth is partly because several non-timber forest products (NTFP) and non-tangible environmental and ecological benefits are unaccounted for in the methodology adopted by the PBS to compute national output. Specifically, the PBS methodology covers: "production of round wood for the forest-based manufacturing industries... as well as the extraction and gathering of wild-growing non-wood forest products. Besides, the production of timber forestry activities

results in products that undergo little processing, such as fire wood, charcoal, wood chips and round wood used in unprocessed forms."²⁹

This definition misses other NTFPs found in Pakistan, including medicinal, aromatic and culinary herbs, resin, oils, honey, silk, mushrooms, pine nuts, pistachio nuts, etc. Moreover, the data also needs to be collected at more regular intervals. Detailed national level forestry data was last collected during the preparation of the Forestry Sector Master Plan (FSMP) in 1992; subsequent data has mainly been generated by making adjustments to the FSMP data. Therefore, a fresh exercise of the scale of 1992 FSMP needs to be conducted to update the data and facilitate planning and monitoring of forestry developments.

Pakistan is a forest-deficient country, with only 5 percent of its area under forest cover as of FY21.³⁰ To put this into perspective, the UN recommends forest cover equivalent to 12 percent of a country's land area. However, forestry management efforts in the country have recently picked up. The 'One Billion Tree Tsunami' afforestation project in KP succeeded in planting 1.18 billion trees between 2014-2017.³¹ Subsequently, the federal government launched the four-year Ten Billion Tree Tsunami in 2019, which has already achieved an important milestone of one billion trees planted as of May 2021. Such mega initiatives can help bring about significant environmental and ecological benefits, and contribute to sustainable growth of the forestry sector.

Meanwhile, the fishing sector has displayed an encouraging potential to generate FX earnings for the country, with exports of fish and fish preparations averaging US 420.9 million during FY17-FY21 (**Figure 2.12**). The sector

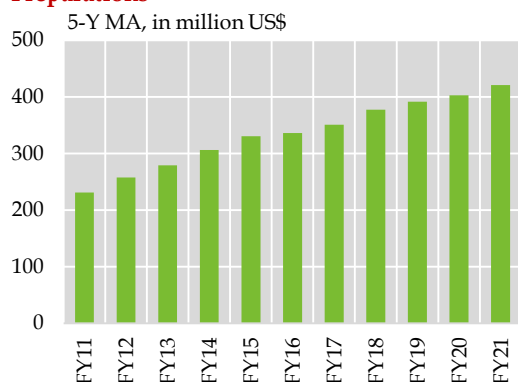
²⁷ USDA (2020). *China: Dairy and Products Annual*. Washington D.C: USDA.

²⁸ The analysis of forestry sector utilizes insights from the following source document on several occasions: FAO (2019). *Forestry Sector Review: Pakistan*.

²⁹ PBS (2013). *National Accounts of Pakistan, Change of base from 1999-2000 to 2005-06*.

³⁰ Pakistan Economic Survey 2020-21.

³¹ UNESCO.

Exports of Fish and Fish Preparations**Figure 2.12**

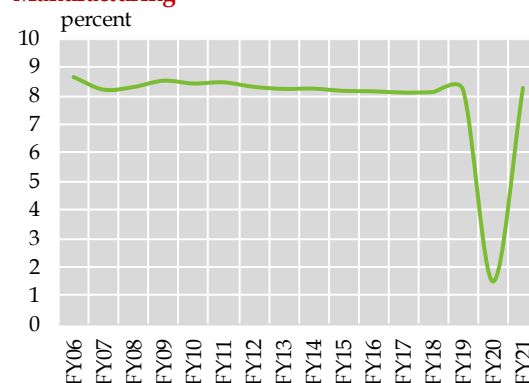
Source: Pakistan Bureau of Statistics

comprises both marine and inland fishing (based in rivers, lakes and dams). The government is emphasizing better extension services and greater value addition, such as the development of trout and shrimp farming in the country.³²

2.3 Industry

The industrial sector recovered during FY21, growing by 3.6 percent, against a decline of 3.8 percent last year (Table 2.11). While other sub-industries also contributed, the LSM sector's expansion drove the overall industrial performance during FY21. Pakistan's manufacturing sector performed either better or at-par with other regional economies, mainly owing to the temporary relief packages introduced by the fiscal and monetary authorities to speed-up the recovery after the Covid outbreak. The construction package provided major support to the construction-allied industries of cement and steel, which recorded double-digit production increases during the year.

Meanwhile, the small-scale manufacturing sector, which was especially impacted by the pandemic last year, returned to its long-term growth trajectory in FY21 (Figure 2.13). The approval and subsequent implementation of the National SME Policy Action Plan 2020 and

Growth in Small-Scale Manufacturing**Figure 2.13**

Source: Pakistan Bureau of Statistics

the SMEDA one-window initiative, which reduced the compliance burden for businesses – especially the small enterprises – may have contributed to this recovery.³³ In contrast, *electricity generation and gas distribution* witnessed sharp declines in FY21, despite an increase in electricity production. This can mainly be traced to reduced allocation of subsidies by the government to the distribution companies (DISCOs), and the higher proportional increase in intermediate consumption as compared to output.³⁴

The construction industry also expanded by 8.3 percent in FY21 compared to 5.5 percent last year. The construction industry, along with its allied industries of cement and steel in

Industrial Sector Growth**Table 2.11**

	percent YoY				
	FY17	FY18	FY19	FY20	FY21
Industrial Sector	4.6	4.6	-1.6	-3.8	3.6
Mining and Quarrying	-0.6	7.8	1.2	-8.3	-6.5
Manufacturing	5.8	5.4	-0.7	-7.4	8.7
LSM	5.6	5.1	-2.6	-10.1	9.3
SME	8.1	8.2	8.2	1.5	8.3
Slaughtering	3.6	3.5	3.5	4.1	3.9
Elect gen dist & gas distribution	-2.7	-17.2	13.6	22.4	-23.0
Construction	9.0	10.8	-15.5	5.5	8.3

Source: Pakistan Bureau of Statistics

³² Pakistan Economic Survey 2020-21, and Engro press release dated July 16, 2021.

³³ Ministry of Finance (2021). *Pakistan Economic Survey 2020-21*. Islamabad: MoF

³⁴ Pakistan Bureau of Statistics press release on National Accounts Committee Meeting, dated May 21, 2021.

the LSM, received support from the government through several incentives. Announcement of construction package reduced the cost for both buyers and sellers through tax reductions, while amnesty for real estate developers and Naya Pakistan Housing Scheme (also known as *Mera Pakistan Mera Ghar* (MPMG) Scheme) aided growth in this sector. SBP also played its part by reducing mark-up rates and introduction of mandatory targets for banks to ensure lending to the construction sector.³⁵ In addition to increase in general government expenditures, spending by the private sector on construction activities boosted growth in this segment. Significant inflow of remittances in FY21 in Pakistan may also help explain the growth in this industry.

LSM³⁶

The LSM sector rebounded sharply with 14.9 percent growth in FY21, compared to decline of 9.8 percent in the previous period (Table 2.12). The major push came from textile, construction-allied, automobile sectors and food-beverage-&-tobacco sector. The incentives introduced after the first Covid wave aided these industries. The textile sector was one of the beneficiaries of the energy package and the SBP's concessionary finance schemes, which lowered its cost of production. The market-based exchange rate also helped the export-oriented textile industry.

Meanwhile, the increase in capacity of the construction-allied industry the past few years facilitated the rebound, as the industry was well-placed to meet the surge in demand in

LSM Growth

percent, YoY

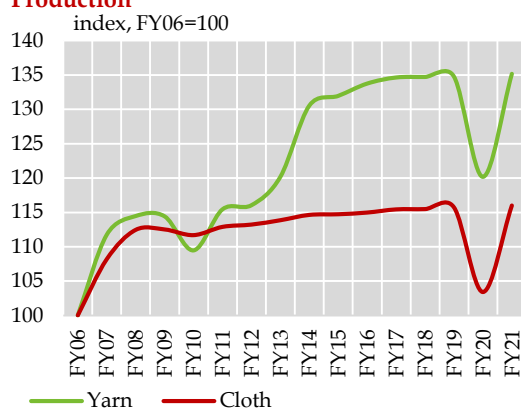
Table 2.12

	wt.	FY20				FY21				FY20	FY21
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
LSM	70.3	-5.5	0.1	-9.1	-24.6	4.5	10.4	11.5	38.2	-9.8	14.9
Textile	20.9	0.2	0.5	-8.4	-33.8	2.2	2.9	13.1	56.9	-10.4	15.3
Cotton yarn	13	0.2	0.0	-9.0	-34.5	0.1	0.1	9.9	53.9	-10.8	12.5
Cotton cloth	7.2	0.1	0.3	-8.8	-34.3	-0.1	0.0	9.7	53.1	-10.7	12.2
Jute goods	0.3	-14.8	3.5	37.6	-31.3	10.7	-5.8	2.2	29.6	-3.1	7.3
Food	12.4	-9.0	16.7	-7.1	-2.3	13.6	25.0	3.4	8.2	-1.8	11.0
Sugar	3.5	N/A	97.1	-14.3	-82.1	N/A	72.1	0.4	16.5	-7.2	16.7
Cigarettes	2.1	-34.5	-24.3	-35.4	6.5	31.2	0.9	23.8	-3.8	-24.1	11.9
Vegetable ghee	1.1	2.0	8.8	6.8	0.5	-4.2	-0.9	-3.4	4.2	4.5	-1.1
Cooking oil	2.2	0.0	13.9	14.0	7.3	3.4	-0.2	-2.9	13.8	8.8	3.4
Soft drinks	0.9	-14.1	-0.4	-3.2	-3.5	7.7	-9.4	21.4	9.3	-6.1	7.5
POL	5.5	-14.5	-5.9	-32.0	-27.8	2.4	7.0	33.8	36.5	-20.1	18.1
Steel	5.4	-17.0	-6.8	2.0	-47.1	-8.1	6.0	7.2	92.2	-17.4	15.6
Non-metallic minerals	5.4	-0.9	6.3	-0.2	-13.6	22.2	18.3	33.2	34.5	-2.2	26.7
Cement	5.3	-1.4	6.3	0.0	-12.8	22.8	19.2	34.1	34.5	-2.0	27.3
Automobile	4.6	-34.6	-40.1	-38.6	-70.5	-5.9	31.1	49.6	271.5	-44.6	51.1
Jeeps and cars	2.8	-38.6	-54.6	-50.4	-85.4	-21.1	42.6	67.4	712.3	-54.8	66.6
Fertilizer	4.4	15.9	-5.1	7.9	0.4	2.0	13.3	1.9	11.8	4.4	7.2
Pharmaceutical	3.6	-11.9	-0.7	-3.6	5.6	14.4	12.0	11.6	10.5	-2.7	12.0
Paper	2.3	-1.3	16.0	-1.2	-11.9	-2.2	-3.2	3.7	18.0	0.4	3.4
Electronics	2	11.0	-15.7	-34.2	-72.7	-20.4	-21.4	-20.3	109.1	-33.3	-4.2
Chemicals	1.7	4.9	14.7	14.6	-14.3	10.6	10.7	17.2	44.1	4.9	19.3
Caustic soda	0.4	35.0	60.5	42.2	18.4	2.5	5.1	17.1	42.1	38.8	15.1
Leather products	0.9	6.3	16.0	-2.1	-55.4	-44.5	-41.0	-29.4	57.8	-9.1	-26.4

Source: Pakistan Bureau of Statistics

³⁵ SBP's Report on the State of Pakistan's Economy for Q2-FY21.

³⁶ The analysis of LSM sector is based on data released by the Pakistan Bureau of Statistics' Quantum Index of LSM Industries for August 2021. The LSM numbers in the National Accounts data for the calculation of GDP and overall industrial sector were based on provisional estimates at the time, which was March 2021.

Cotton Yarn and Cloth Production**Figure 2.14**

Source: Pakistan Bureau of Statistics

the wake of the government's construction package. The growth in production of food processing industry was driven primarily by increase in sugar output, in the wake of the bumper sugarcane harvest. The automobile industry also recovered from constrained output over the past two years, on the back of the introduction of new models, pent-up demand from delayed purchases last year (amid the lockdowns) and low interest rates

On the other hand, the export-oriented leather sector was not able to return to growth despite the fiscal and monetary incentives offered. The introduction of low-priced alternatives, such as synthetic leather, have reduced the global appetite for leather products and resulted in lower exports of the sector.³⁷

Textiles

The production of the textile sector rose by 15.3 percent during FY21, compared to a contraction of 10.4 percent last year. Most of this growth was recorded during H2-FY21, as the cotton textile industry remained largely operational during this period in contrast to last year, when mobility restrictions had hampered production activities. The export-oriented high value-added textile industry performed quite strongly during the year on the back of the policy support and by capturing textile export orders from some competitor countries (Chapter 6).

Meanwhile, the production of cotton yarn and cloth witnessed double-digit growth during FY21 and the production level was the highest on record since the LSM was rebased in FY06 (Figure 2.14). The impressive production was achieved despite the country's lowest cotton output since FY85. Record high imports of raw cotton were instrumental in meeting the shortfall in the domestic market. High growth in production of primary textile goods, such as yarn and cloth, also facilitated the growth in the upstream textile sector, including knitwear and readymade garments.

Construction-allied Industries

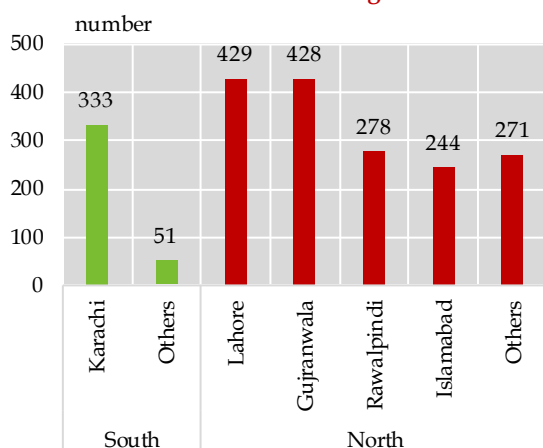
The output of the construction-allied industries expanded sharply, in line with the construction sector activities. The demand for products in this segment was enhanced by monetary and fiscal stimuli which drove growth in cement and steel industries. Cement production witnessed a sharp increase, whereas the output of the steel industry also rose by double digits, after declining consistently over the past two years.

Incentivized by the construction package, the private sector played a key role in revitalizing the construction industry. According to the FBR, more than 2,100 housing projects, both large and small, got registered to be included in the package. Real estate developers, especially in the north of the country, were the major beneficiaries of the package, as evident from Figure 2.15. With September 2023 set as the deadline for the completion of the projects, anecdotal evidence suggests that real estate developers are hastening their efforts to meet the requirements.

The higher development spending by the government also played a part in aiding the construction sector activities (Chapter 4). Overall development expenditure was 7.2 percent higher in FY21 compared to last year. The public sector's demand for cement and steel remained robust due to the increase in

³⁷ SOMO (2021). *Leather Products from Pakistan: Trends in Production and Trade*. Amsterdam: SOMO.

Number of Projects Registered Under PM's Construction Package* **Figure 2.15**



*Updated July 28, 2021

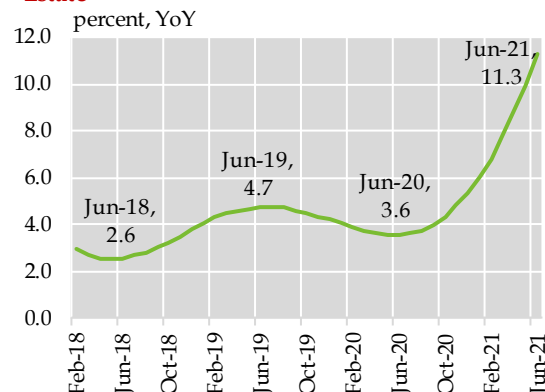
Source: Federal Board of Revenue

spending on large infrastructure projects, such as Bhasha and Dasu dams. This is in line with the trend of development expenditures as PSDP spending was largely concentrated in infrastructure development).

Furthermore, the SBP also contributed to the construction-allied industry's growth through multiple measures. Specifically, the SBP promoted housing and construction finance for the low-income group, and set mandatory targets for banks to increase their lending to this group. These measures contributed to an increase of Rs 101 billion in housing and construction finance loans during FY21 to Rs 249 billion by end-June 2021, from Rs 148 billion last year. Moreover, consumer financing for housing saw a surge in net disbursement of Rs 23.8 billion in FY21 in contrast to net retirements of Rs 12.8 billion the year before.

In addition to these incentives, substantial increase in remittances (**Chapter 6**) during FY21 fueled activities in the real estate development sector which further increased demand for cement and steel. A recent study by PIDE suggests that remittances have a positive impact on new housing demand as they increase the purchasing power of

Growth in Prices of Real Estate **Figure 2.16**



Source: Zameen.com

households. In addition, remittances also improve the room per person ratio in Pakistan, which is indicative of larger capacity of houses built by expatriates.³⁸

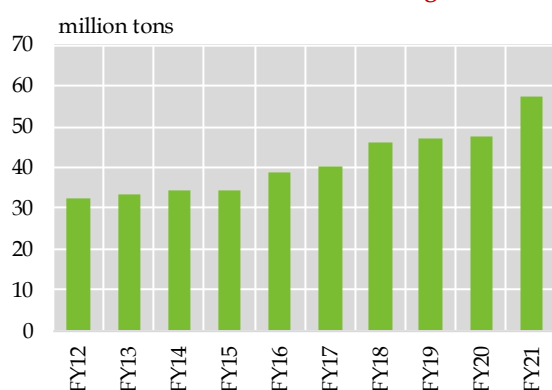
The impact of the coordinated fiscal and monetary measures on the construction sector can be approximated through the price trends of properties in the country. According to Zameen.com, average prices of residential property have been rising since the start of the year, which also coincides with the implementation of the construction package (**Figure 2.16**).

Cement

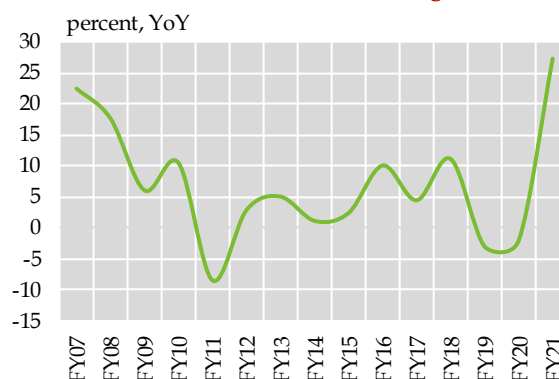
Aided by capacity expansions over the past few years, the cement industry responded to the increase in demand for the commodity by setting the record for output, which grew by 27.3 percent during FY21 (**Figure 2.17a, b**). The monetary and fiscal stimuli, along with the lowering of FED on cement, facilitated the growth in FY21. The duty was reduced from Rs 2 per kilogram last year to Rs 1.5, which reduced the price of 50 kilogram cement bag by Rs 25.

According to the All Pakistan Cement Manufacturers Association (APCMA), domestic offtake was the driving force behind

³⁸ A. Ahmed, N. Iqbal, and G. Mustafa (2020). *Measuring the Impact of Remittances on Housing Demand: Evidence from Large Cities in Pakistan*. PIDE Working Papers No. 2020:10, Islamabad: PIDE.

Cement Offtake**Figure 2.17a**

Source: All Pakistan Cement Manufacturers Association

Cement Production Growth**Figure 2.17b**

Source: Pakistan Bureau of Statistics

the production increase, as it contributed 17.1 percent to overall growth of 20.1 percent during FY21, which stood in contrast to last year when it had dragged growth down by 0.8 percent out of overall growth of 2.0 percent. Cement producers in the north and south saw their local dispatches increase by 18.2 percent and 33.7 percent, respectively (Table 2.13). Since large public infrastructure projects and majority of the private sector projects under the approved construction package were

undertaken in the north, the cement producers in that region gained more benefit.

On the export side, shipments decelerated marginally to 18.7 percent in FY21 compared to 20.0 percent last year, as per APCMA data. This can largely be attributed to Covid-related closure of the Pakistan-Afghan border during H2-FY21; however, in subsequent periods, cement exports picked up sharply, especially in H2-FY21. As trade restrictions between Afghanistan and Pakistan eased during FY21, cement shipments to the neighboring country rose by 33.7 percent, compared to 9.6 percent growth last year. Exports to non-traditional destinations, such as China, also grew during FY21. China's focus on protecting its environment and infrastructure development to revive its economic growth amid the pandemic led to increased dependence on imported cement.

Cement Dispatches**Table 2.13**

	Dispatches (million tons)					
	North		South		Combined	
	Local Export		Local Export		Local Export	
FY17	29.1	3.1	6.5	1.5	35.7	4.7
FY18	34.0	3.1	7.2	1.7	41.1	4.7
FY19	32.4	2.5	8.0	4.0	40.3	6.5
FY20	34.3	2.0	5.6	5.9	40.0	7.8
FY21	40.6	2.6	7.5	6.7	48.1	9.3

	Dispatches Growth (percent)					
	North		South		Combined	
	Local Export		Local Export		Local Export	
FY17	7.7	-18.2	9.5	-25.1	8.0	-20.6
FY18	16.6	-2.2	10.3	10.0	15.4	1.8
FY19	-4.7	-18.0	11.2	140.9	-1.9	37.8
FY20	6.1	-22.1	-29.4	46.5	-0.9	20.0
FY21	18.2	30.2	33.7	14.8	20.4	18.7

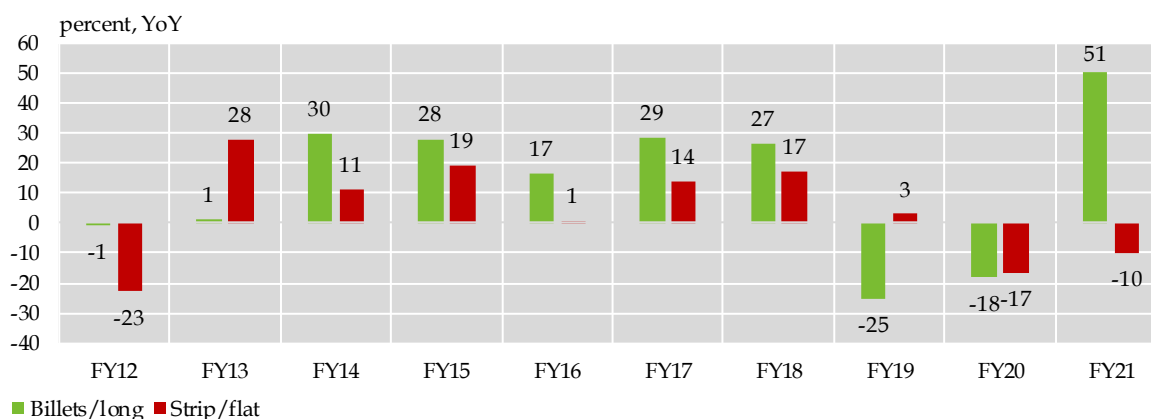
Source: APCMA

Steel

Driven by the production of long-steel products, the output of the steel industry expanded by 15.6 percent during FY21, compared to double digit decline in each of the past two years. The rebound in industry can be traced to an increase in construction activities in the country. This is evident from long-steel production, which is a primary building material for the construction sector. Its output increased by 51.0 percent compared

Steel Production Growth

Figure 2.18



Source: Pakistan Bureau of Statistics

to significant decline of 18.3 percent last year (Figure 2.18).

Unlike cement, Pakistan is not self-sufficient in steel and hence relies on imports to plug the domestic shortfall. Imports of intermediate steel scrap and finished products registered increase of 20.6 and 24.6 percent respectively in FY21. Similar to domestic pattern where growth in production is largely tilted in favor of long-steel products, the import growth in steel was mainly driven by bars for the construction sector. The price of iron bars increased sharply, especially during H2-FY21, owing to an increase in domestic demand as well as higher unit value of imported steel products.

The output of flat steel decreased during FY21, as demand for the commodity from various industries waned. In particular, the drop in demand for electronic appliances resulted in lackluster growth for this segment. In addition, saturation in the telecommunications sector also contributed to depressed demand for the flat-steel industry. While the recent revival in the automotive industry offset some of the drag, it was not enough to catapult the flat steel production into growth.

Fertilizer

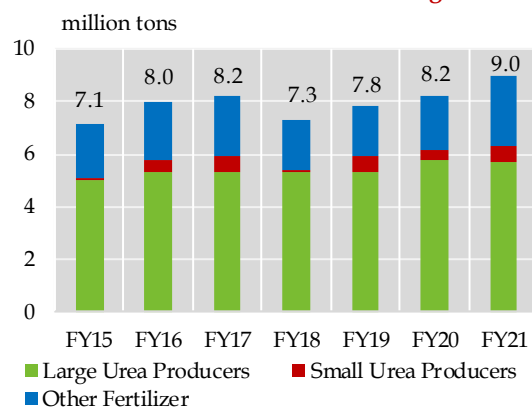
The fertilizer sector's output accelerated to 7.2 percent during FY21 from 4.4 percent a year earlier. According to the National Fertilizer Development Center (NFDC), the production

of non-urea fertilizer expanded sharply by 30.8 percent during FY21, against 9.8 percent growth last year. This resulted in record production of these commodities and increased its share in overall production from 25.1 percent last year to 30.1 percent in FY21. On the other hand, urea production decelerated from 4.1 percent a year earlier to 2.0 percent in FY21. Slight dip in production of large urea plants was more than offset by the expansion in output of smaller units (Figure 2.19).

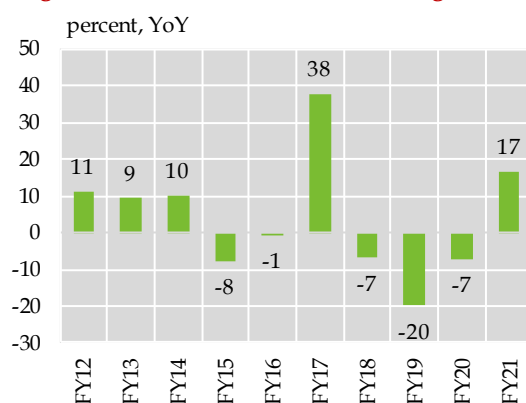
The production of non-urea fertilizers, such as nitro-phosphate (NP) and calcium-ammonium-nitrate (CAN) continued to increase. After growing 31.3 and 20.4 percent in FY20, the output of NP and CAN rose by 41.7 and 45.3 percent in FY21 respectively. The higher growth is explained by a large

Fertilizer Production

Figure 2.19



Source: National Fertilizer Development Center

Sugar Production Growth**Figure 2.20**

Source: Pakistan Bureau of Statistics

producer of NP and CAN remaining operational throughout FY21 whereas it was operational for 6 out of 12 months last year. Moreover, it also indicates the extent of demand for non-urea fertilizer, as growers have become more aware of using cheaper substitutes while also ensuring optimal nutrient mix to extract maximum output from their farms.

Meanwhile, the deceleration in urea production – an output dip of 1.8 percent in FY21 compared to growth of 8.4 percent last year – was predominantly a result of below-par production of the large fertilizer units. The data breakdown shows that urea production had slowed down during H2-FY21. This slowdown can be attributed to the government's sales tax registration drive for downstream fertilizer dealers, which adversely affected offtake of the larger urea firms, particularly during H2. The performance of the smaller units contrasted with the larger units: the output of this segment grew 59.0 percent in FY21, after declining 34.4 percent last year.

Food

The food processing industry's output increased 11.0 percent in FY21, after declining 1.8 percent last year. This growth was largely due to an expansion in the sugar output,

closely followed by that of the wheat-flour milling sector. The noteworthy growth in the latter can be attributed to the increase in the number of reporting units in the *Monthly Survey of Industrial Production & Employment in the Punjab* from 686 units in FY20 to 738 units in FY21. The tobacco industry's contribution to LSM growth was also noticeable, with 11.9 percent expansion recorded during FY21. The local industry was a beneficiary of the government's drive against illicit and counterfeit tobacco products, and was able to increase its production to meet the demand previously being met via products in the informal sector.

Sugar

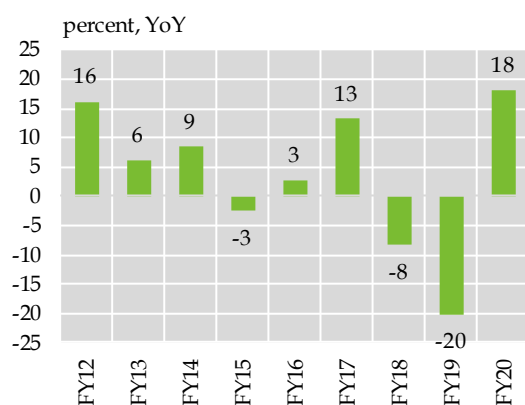
The second-highest output of sugarcane crop facilitated recovery in the upstream sugar industry, as sugar production swelled from 4.9 million tons to 5.7 million tons – a 16.7 percent increase in FY21 (**Figure 2.20**). The abundant supply of sugarcane prompted the government to order the sugar mills to start the crushing season earlier than usual, which helped reduce the need to import sugar. Resultantly, this measure prevented sugar prices from rising further. Another factor that helped the industry stage a recovery was the Rs 10 increase in the price of sugarcane per 40 kg to Rs 200 per 40 kg, which incentivized the sugarcane growers to supply their produce to sugar mills.³⁹

Petroleum

The petroleum sector was one of the major beneficiaries of the ease in mobility restrictions, as evident from the increase in output of petrol and diesel products. The growth in these categories led to an overall increase in the output of 18.1 percent in FY21, against a double digit decline last year (**Figure 2.21**).

The rebound in overall economic activities during FY21 had a spillover impact on the petroleum sector's production. As indicated

³⁹ The government of Sindh increased indicative price of sugarcane by Rs 10 to Rs 202 per 40 kilogram.

POL Production Growth**Figure 2.21**

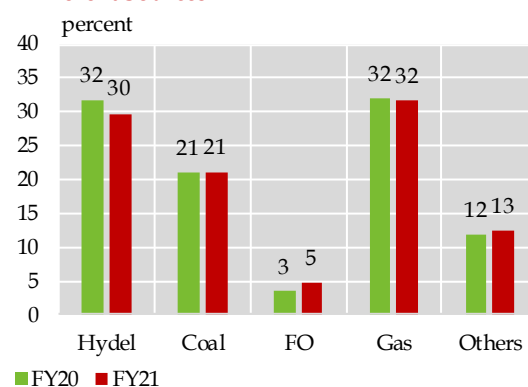
Source: Pakistan Bureau of Statistics

by mobility indicators, the transport and wholesale and retail trade activities returned to pre-Covid levels. Furthermore, the sharp rise in the import of energy products was also indicative of the revival of activities in the transportation sector. In addition, the increase in the number of vehicles on roads also helped increase the demand for petroleum products. Main transportation fuels, petrol and diesel, witnessed significant growth during the review period.

Meanwhile, furnace oil production increased by 14.7 percent in FY21, after declining 22.6 percent last year. The lifting of restrictions on utilizing furnace oil for electricity generation in FY21 in the wake of gas shortages supported the recovery in this segment (Figure 2.22).

Automobile

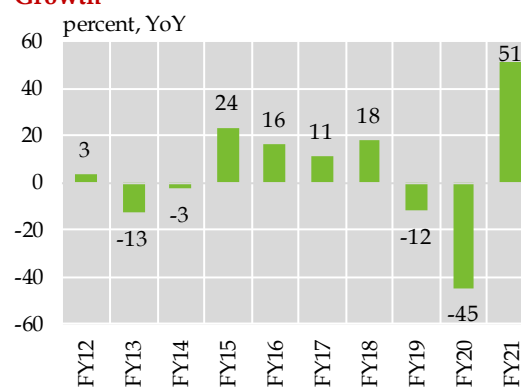
The automotive sector recovered from the significant dip of 44.6 percent in FY20 to double-digit growth of 51.1 percent in FY21 (Figure 2.23). It is worth noting that the growth number is underreported, as official production estimates for some new entrants are not entirely captured by LSM data.⁴⁰ The automotive sector continued to gain

Electricity Generation From Different Sources**Figure 2.22**

Source: National Electric Power Regulatory Authority

momentum throughout the year. Several factors played a key role in this rebound: ease in mobility restrictions, low interest rates, and the introduction of new car models. In FY20, the automotive sector had been subdued initially due to the stabilization measures, and subsequently due to the strict lockdowns during the first wave of Covid-19.

The low interest rates were pivotal in raising the demand for automobile sector, as evident by the sizable increase in auto finance: in FY21, outstanding auto loans increased by Rs 97.0 billion compared to increase of Rs 4.3

Automobile Production Growth**Figure 2.23**

Source: Pakistan Bureau of Statistics

⁴⁰ According to estimates by brokerage houses, the total car and jeep production numbers are 15 to 25 percent higher than the numbers reported in the LSM data. Furthermore, anecdotal evidence suggests that Kia Motors - one of the new entrants - is selling 1,500-2,000 locally produced vehicles per month in the country, whereas these figures are not reflected in the LSM production side data. Currently, this data is not included in the data set of the PAMA.

Automobile Sector Production**Table 2.14**

	Units produced			Growth (in percent)		
	FY19	FY20	FY21	FY19	FY20	FY21
All Cars	103,883	57,151	58,374	7.9	-45	2.1
Cars <800 cc	22,298	24,707	12,734	-5.1	10.8	-48.5
Cars between 800-1000 cc	29,108	13,470	12,037	13.5	-53.7	-10.6
Cars >1000cc	52,477	18,974	33,603	11.3	-63.8	77.1
Sports Utility Vehicles	3,926	2,094	4,107	-44.2	-46.7	96.1
Light Commercial Vehicles	22,198	11,525	12,465	-15.9	-48.1	8.2
Trucks	3,751	1,747	1,557	-16.9	-53.4	-10.9
Buses	515	326	281	25.9	-36.7	-13.8
Tractors	25,969	16,671	23,237	-20.4	-35.8	39.4
Motorbikes	1,766,423	1,370,417	1,902,415	-8.4	-22.4	38.8

Source: Pakistan Automotive Manufacturers Association

billion last year. The bulk of this surge in outstanding loans was recorded in H2-FY21.

In addition, increased competition –especially in the car and jeep segment –attracted customers (Table 2.14). Under the incentives for auto assemblers under the Automotive Development Policy 2016-21, the producers introduced new models in the market, which drew buyer interest due to their features and competitive pricing. The compact SUV sector in particular garnered significant interest, as there was previously a gap in the domestic market for these cars. Moreover, the domestic availability of vehicles in this segment also reduced the need to import these types of cars, as was the case previously.

Anecdotal evidence suggests that the increase in rural incomes is closely associated with the rise in sales of 2-wheelers and tractors. On the back of improved agricultural output and the higher remittance inflows, a rebound in these two segments of the automobile industry was noted. Two/three-wheeler and tractor production increased by 36.5 and 54.8 percent in FY21, after declining by 26.3 and 34.7 percent last year.

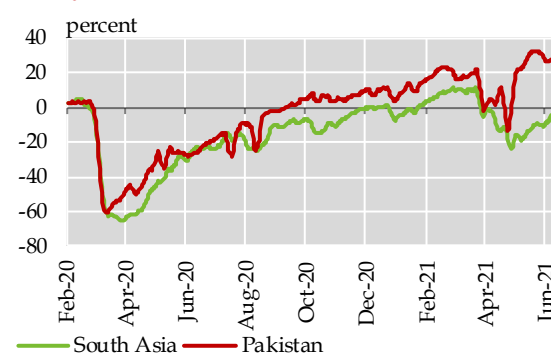
2.4 Services

The services sector grew by 4.4 percent during FY21, in contrast to the contraction of 0.6 percent last year. In FY20, the slowdown in the industrial sector and imports coupled with outbreak of Covid in the second half and the consequent complete lockdowns, had a deep

impact on the services sector. However, recognizing the implications of the complete lockdowns on the economy and livelihoods, the government resorted to the policy of smart and micro lockdowns to contain the spread of Covid in FY21. This policy proved pivotal, as the services sector made a rebound in FY21, despite the emergence of multiple waves of the pandemic. Importantly, the government's early adoption of smart lockdowns aided the services sector to recover sooner than other South Asian economies, as gauged through the Google Mobility statistics (Figure 2.24).

Along with the smart lockdowns, targeted fiscal support (including the construction package) and accommodative monetary policy (reduction in policy rate, and the SBP's refinance schemes) played an important role in reviving the commodity-producing sectors. Since the performance of the services sector is

Google Mobility Changes in Pakistan vis-a-vis South Asia (7-Days MA)

Figure 2.24

Source: Covid-19 Community Mobility Report

closely associated with the commodity-producing sectors, the rebound in the latter spilled over into the services sector as well.

The stimulus to the sector mainly came from *wholesale and retail trade* which grew by 8.4 percent during FY21, as compared to a contraction of 3.9 percent last year (**Table 2.15**). The *finance and insurance* segment rose 7.8 percent on the back of strong performance of the banking sector, coupled with healthy growth in the insurance sector. Meanwhile, *transport, storage and communication* continued to contract, although the magnitude of the contraction decreased.

Wholesale and Retail Trade

Wholesale and retail trade posted growth of 8.4 percent during FY21 – the highest growth since FY06. Along with the base effect, the segment gained traction on the back of strong LSM growth, better agriculture harvest, and increase in imports. During FY21, Pakistan's import bill grew by 26.6 percent to US\$ 56.4 billion, from US\$ 44.6 billion last year. The growth in imports was mainly due to higher demand for consumer necessities, such as food items (including wheat and sugar) and medicines (including Covid-19 vaccines). Moreover, the rise in import of raw materials, such as edible oil and raw cotton (and other textile inputs) contributed to the increase in imports (**Chapter 6**).

The rise in the activity in this segment was also reflected in Google Mobility data (**Figure 2.25**). For instance, as the government moved towards smart lockdowns and eased the mobility restrictions,⁴¹ the mobility in four segments -namely grocery and pharmacy, retail and recreation, workplace, and transit stations (segments closely related to services sector) - started to pick up and reached above the pre-Covid position by end of Q1-FY21 and remained at an elevated level during Q2 and

Services Sector

Table 2.15

percent

	Share in GDP	Cont. to GDP	Growth	
	FY21		FY20 ^R	FY21 ^P
Wholesale & retail trade	18.8	1.5	-3.9	8.4
Transport, storage & communication	12.2	-0.1	-3.8	-0.6
Finance & insurance	3.7	0.3	1.1	7.8
Housing services	7	0.3	4	4
General gov. services	8.2	0.2	1	2.2
Other private services	11.8	0.5	4.6	4.6
Services	61.6	2.7	-0.6	4.4

R: Revised, P: Provisional

Source: Pakistan Bureau of Statistics

Q3. In Q4, the mobility fell abruptly, in the wake of the third wave and subsequent tighter mobility restrictions, specifically around the Eid-ul-Fitr holidays.⁴² However, this appeared to be short-lived, as activities bounced back following the easing of restrictions after the Eid holidays. By the end of FY21, the visits to grocery and pharmacy, retail and recreation, workplace and transit stations were up by 48 percent, 23 percent, 11 percent and 27 percent compared to decline of 14 percent, 26 percent, 24 percent and 25 percent in June 2020 against the baseline position (pre-Covid) period.

Finance and Insurance

In case of *finance and insurance*, acceleration in gross value addition from commercial banks – the segment with highest share - augmented the sub-sector's growth to 7.8 percent in FY21, compared to 1.1 percent growth in last year (**Table 2.16**). The healthy growth in the flows of deposits and increase in advances facilitated growth in the banking sector.

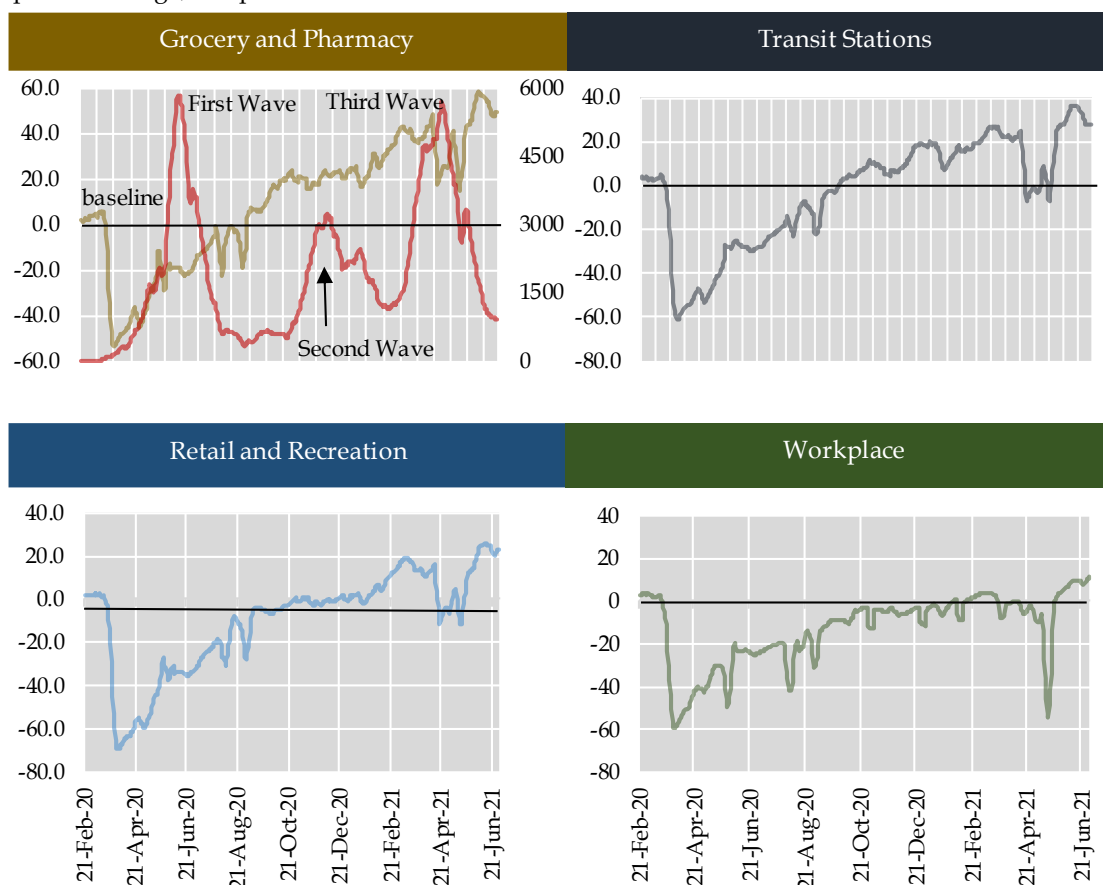
Specifically, deposits and net advances grew by 17.5 percent and 9.2 percent respectively during FY21. The rise in banking deposits could be due to multiple factors. People may

⁴¹ Under the smart lockdown policy, the Covid restrictions are implemented in a targeted manner on specific hotspots, with a view to contain the spread of virus. Moreover, the essential markets and shops, including grocery stores and pharmacies, are allowed to remain open.

⁴² Ministry of Interior letter dated April 27, 2021, titled "Decision on discussion points – National Command and Operations Centre".

Google Mobility Changes in Pakistan (7-Days MA)

percent change, compared to baseline*

Figure 2.25

*The baseline (pre-Covid) is the median value for the 5- week period (Jan 3–Feb 6, 2020). the negative value represent activity is down while positive value represent activity is up from the baseline.

Source: Covid-19 Community Mobility Report and WHO

GVA Finance and Insurance Sector Table 2.16
in percent

	Share in FY21	Growth	
		FY20 ^R	FY21 ^P
Other monetary intermediation	85.7	2.2	4.8
Scheduled banks	79.3	1.4	3.1
Non-scheduled banks	6.4	16.7	31.6
Insurance, reinsurance and pension funds	4.8	-21	45.3
Activities auxiliary to financial services	7.0	-4.2	49.3
Central banking	1.7	18	-16.7
Other financial services	0.8	1.3	-14.4
Finance and insurance	100	1.1	7.8

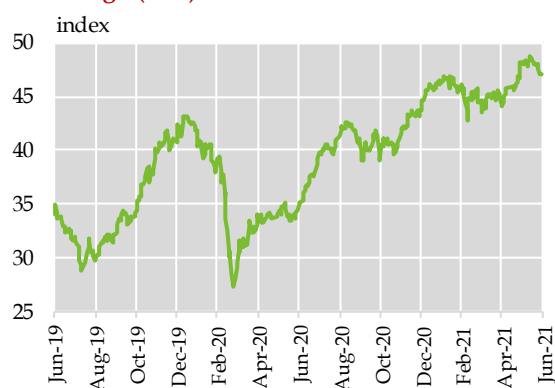
P: Provisional, R: Revised

Source: Pakistan Bureau of Statistics

have remained cautious about utilizing their savings to ward off against uncertain income flows following the emergence of multiple Covid waves and subsequent restrictions on non-essential business activities. The healthy inflow of workers' remittances also lifted the bank's deposits. Lastly, the liquidity support provided by the SBP to businesses in the wake of pandemic may have also resulted in expansion in banks' deposits.⁴³ In case of advances, the pick-up in economic activity, coupled with low interest rates, were major factors.

⁴³ Chapter 3.1: The Banking Sector, Financial Stability Review 2020, State Bank of Pakistan. (www.sbp.org.pk/FSR/2020/Chp-3.1.pdf)

Performance of Pakistan Stock Exchange (PSX)- KSE 100 index **Figure 2.26**



Source: Pakistan Stock Exchange

Furthermore, the profit after tax of commercial banks rose by 12.8 percent in FY21. The cut in the policy rate during March-June 2020 resulted in lower funding costs on deposits due to the immediate repricing of savings deposits.⁴⁴ On the other hand, banks' interest earnings were buoyed by the rise in the volume of investments in government securities as well as the lag in the repricing of loans.^{45 46}

The performance of *insurance, reinsurance and pension funds* was also notable, as it grew by 45.3 percent during FY21, compared to a contraction of 21 percent last year. During FY20, the business operations of the insurance companies were disrupted due to Covid-related restrictions, as the insurance distribution channels were unable to reach out to clients amid limited retail activities. However, with the lifting of the complete lockdowns and the recovery in the economic activity, the insurance industry also rebounded.⁴⁷

Similarly, the *activities auxiliary to financial services* sub-segment recorded growth of 49.9 percent in FY21 against a decline of 4.2 percent

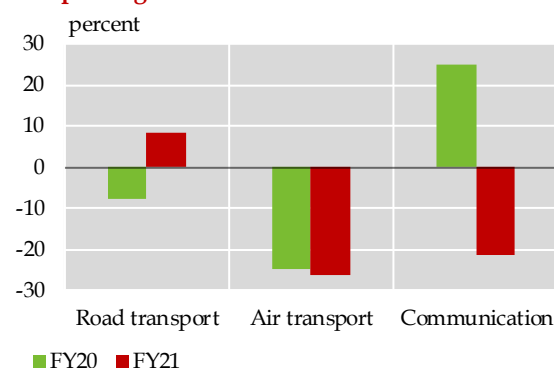
last year. Under this category, the GVA of non-depository financial institutions such as brokerage houses and asset management companies is reported. The recovery in this segment can be traced to the strong rebound in the Pakistan Stock Exchange (PSX), which contributed to the growth in the value of equity funds (Figure 2.26).

On other hand, the GVA of central banking contracted by 16.7 percent in FY21, mainly due to the sharp decline in SBP profits. The decrease in profits reflects the impact of lower interest rates and a decline in the government's debt stock with the SBP (Chapter 3).

Transport, Storage and Communication

The value-addition from *transport, storage and communication* segment continued to contract during FY21, on account of dull performance of the communication, air transport, and railways sub-segments. Nevertheless, the upturn in value-addition in road transport - carrying the largest share in this segment -

Transport, Storage and Communication - GVA of Top-3 Segments **Figure 2.27**



■ FY20 ■ FY21

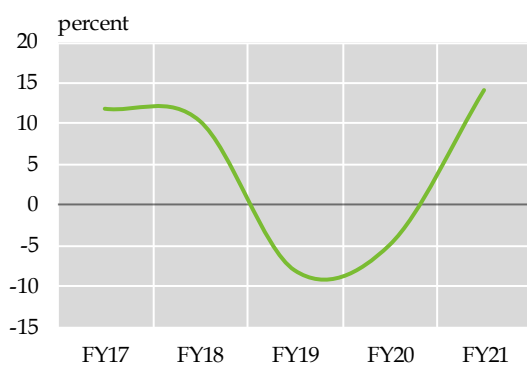
Source: Pakistan Economic Survey 2020-21

⁴⁴ According to BPRD Circular No. 07 of 2013, in the wake of change in policy rate, re-pricing of saving deposits is applicable with effect from 1st day of the subsequent month. (www.sbp.org.pk/bprd/2013/C7.htm)

⁴⁵ The loans are repriced as per the frequency set in the loan agreement between the bank and the borrower.

⁴⁶ Section A: Performance and Risk Analysis of Banking Sector. Financial Stability Review - 2020, State Bank of Pakistan (www.sbp.org.pk/FSR/2020/Chp-3.1.pdf).

⁴⁷ Chapter 5.3: Insurance and Takaful Companies, Financial Stability Review 2020, State Bank of Pakistan. (www.sbp.org.pk/FSR/2020/Chp-5.3.pdf)

Growth in POL Sales in Transport Sector***Figure 2.28**

*MS and HSD

Source: Oil Companies Advisory Council

helped contain the magnitude of contraction (Table 2.17).

The easing of the Covid restrictions and the economic rebound evidently benefited the road transport segment with the rise in inter-city and inter-provincial travelling and resumption of tourism services (Figure 2.27). Importantly, anecdotal evidence suggests that due to cross-border restrictions, people who used to travel abroad reverted to domestic destinations for tourism.⁴⁸ The increase in road transport activities could be observed from the surge in sales of petroleum products (Figure 2.28). In addition, cargo handling activities at various Pakistani ports also picked up. For instance, the total cargo handling (export and import) increased by 13.0 percent in FY21 compared to last year.

Category-wise Share in Transport, Storage and Communication Segment **Table 2.17**

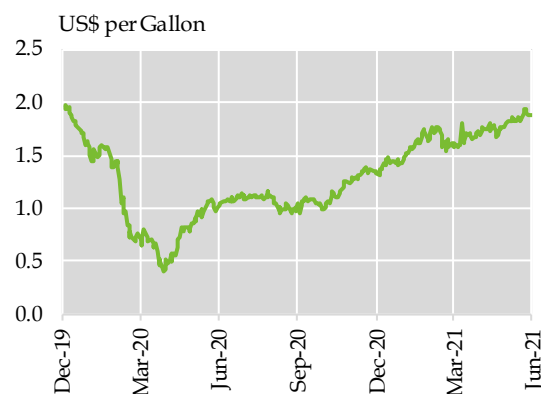
	FY20	FY21
Road transport	68.1	74.2
Communication	19.9	15.8
Air transport	5.4	4.0
Water transport	3.5	2.8
Storage	2.5	2.8
Railways	0.5	0.3
Pipeline transport	0.1	0.2

Source: Pakistan Economic Survey 2020-21

⁴⁸ Taking advantage of rise in domestic tourism and to further promote it, PIA started direct flight to Skardu and Gilgit from different parts of Pakistan, such as Faisalabad, Lahore and Karachi.

⁴⁹ PIA first quarterly report 2021

⁵⁰ European Union Aviation Safety Agency (EASA), letter ref. ares (2020)3421274 - 30/06/2020, subject "Suspension of Third Country Operator Authorization no. EASA.TCO.PAK-0001.01".

Jet Fuel Prices**Figure 2.29**

Source: Federal Reserve Economic Data

On the other hand, the Covid-induced restrictions on air travel continued to impact the aviation industry. Particularly, FY21 appeared to be more challenging for PIA, as its performance indicators displayed a weak picture (Table 2.18). Multiple factors appear to have played a role in dragging down the performance of national flag carrier. First, the Covid outbreak resulted in challenging operational environment for aviation industry around the globe, and PIA was no exception to this situation. Due to the decline in demand for international travel, PIA's key revenue generating routes, such as the Middle East, UK and Malaysia, were affected.⁴⁹

Second, Saudi Arabia's decision to ban travelers from abroad on performing Hajj also impacted PIA's revenue stream, since PIA caters to most of the Pakistani pilgrims. Moreover, in July 2020, the European Union Aviation Safety Agency (EASA) suspended PIA operations to fly to the bloc amid safety concerns, which also dragged down the airline's performance indicators.⁵⁰ Lastly, rising jet fuel prices further squeezed the national flag carrier's profits as fuel is one of the key expenses for airlines (Figure 2.29).

PIA Performance Indicators

Table 2.18

Indicators	Units	2018	2019	2020
PIA fleet	No. of planes	32	32	30
Available seat	mil Kms	18,081	18,372	8,902
Passenger load factor	in percent	77.3	81.3	74.5
Distance flown	000 Kms	70,089	70,515	38,114
Revenue hours flown	Hours	110,050	110,640	58,519
Revenue per passengers carried	000 nos.	5,203	5,290	2,541
Revenue passengers	mil Kms	13,975	14,938	6,629
Revenue load factor	in percent	58.4	58.6	51.3
Operating Revenue	Rs mil	100,051	146,097	94,683
Operating Expenses	Rs mil	170,447	160,037	102,912

Source: Pakistan International Airlines and Pakistan Economic Survey 2020-21

Similarly, the restriction on Pakistan Railways to operate at 70 percent of capacity, coupled with the risk-averse behavior amid Covid transmission concerns, resulted in a decline in the number of rail passengers, which in turn lowered the railway's gross earnings (Table 2.19).

The communication subsector contracted during FY21, despite the improvement in telecom indicators. Overall, telecom industry recorded decline in revenue stream by 4.1 percent to Rs 541.4 billion in FY21, despite a significant increase in the country's cellular teledensity and broadband subscription.^{51 52} According to the Pakistan Telecommunication

Performance of Pakistan Railways (Jul-Feb)

Table 2.19

in million	FY20	FY21	Percentage Change
No. of Passenger Carried	39.4	18.1	-54
Freight carried Tons	5.3	5.25	-0.9
Freight Tons Kms	5,266.0	5,229.4	-0.7
Gross Earning	36,916.8	30,966.1	-16.1

Source: Pakistan Economic Survey 2020-21

⁵¹ By end-June 2021, the cellular teledensity and broadband subscription penetration rose to historic levels of 84.1 percent and 46.9 percent, respectively.

⁵² Pakistan Economic Survey 2020-21.

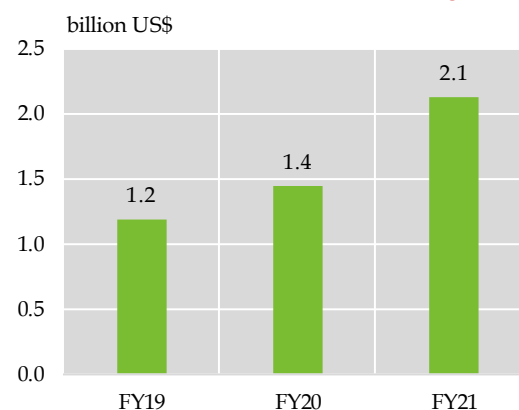
⁵³ One of the leading Norwegian telecom operators in Pakistan observed decrease in the average revenue per user (ARPU) from Rs 192 in 2019 to Rs 175 in 2020.

⁵⁴ N. Veligura, K.K. Chan, F. van Ingen, and G. Cufre (2020). *COVID-19's Impact on the Global Telecommunications Industry*. Washington DC: IFC

⁵⁵ Pakistan Economic Survey 2020-21

Pakistan's Export of ICT Services

Figure 2.30



Source: State Bank of Pakistan

Authority (PTA) Annual Report 2020, telecom operators had cut prices to facilitate the public, which resulted in lower revenues.⁵³ Moreover, it was also reported that many high value enterprise users such as schools, universities, hotels, restaurants, and offices - requested a temporary suspension of services, rebates, discounts, or payment holidays, amid liquidity challenges due to Covid.⁵⁴

Other Private Services

The *other private services* subsector grew by 4.6 percent during FY21. The sector comprises diverse economic activities, such as computer-related activities, professional, scientific and technical activities, and education, health, recreation, cultural and sports activities. The subsector *professional, scientific and technical activities*, which accounts for almost 61.0 percent share in this segment, grew 5.6 percent during FY21. On the other hand, recreation, cultural and sports activities contracted 21.0 percent, owing to closures of recreational places, hotels, wedding halls and marquees, and suspension of sports events.⁵⁵

Within computer-related activities, the exports of information and communications technology (ICT) related services grew by 47.4 percent on YoY basis and reached to US\$ 2.1 billion during FY21 (**Figure 2.30**). The country's IT firms continued to benefit from the rise in global demand amid pandemic for a wide range of IT services. This was further supported by incentives given by the government under the Digital Pakistan Policy. These incentives included zero income tax on IT and Information Technology enabled services (ITeS) exports till June 2025, tax breaks for the Pakistan Software Export Board (PSEB) registered IT start-ups for three years, up to 100 percent foreign ownership of IT and ITeS companies, up to 100 percent repatriation of profits for foreign IT and ITeS investors, and tax holiday for venture capital funds till 2024.⁵⁶

2.5 Labor Market

In overall terms, the available indicators pertaining to labor market exhibited broad-based improvement during FY21. The combined index of industrial employment of Punjab and Sindh points toward recovery, though it is still below pre-Covid levels.⁵⁷

The employment data for LSM sector of Punjab and Sindh also displayed a positive momentum. The overall employment for both provinces grew by 2.4 percent during FY21.⁵⁸ The improvement in the overall industrial employment situation owes primarily to resumption in the economic activities after the ease in lockdowns, as well as to the policy support.

On the fiscal front, the government incentivized labor-intensive industries such as construction and allied manufacturing sectors. The increased activity in these sectors also

provided a push to cement sector. Specifically, the production of cement in Sindh and Punjab increased by 37.3 percent in FY21, compared to a contraction of 2.1 percent in FY20. This could have also contributed to employment generation in cement sector, which grew by 2.7 percent during FY21, in contrast to a contraction of 5.4 percent last year.

The SBP also played a key role in minimizing the economic disruptions caused by the pandemic. For the labor market specifically, the SBP implemented a temporary "Refinance Scheme for Wages to Prevent Layoffs" (Rozgar Scheme) to assist businesses in paying their employees. The scheme helped prevent layoffs of almost 1.7 million employees. The employment trends gauged through the SBP's Business Confidence Survey (BCS) and future unemployment index from Consumer Confidence Survey (CCS) also indicate that the labor market continued to improve throughout FY21.

Employment

Prior to the onset of Covid, the seasonal employment pattern was visible, however as strict lockdown was enforced from March 2020 onwards during the first wave of Covid, employment numbers plummeted more than usual. Since Q1-FY21, the government transitioned towards smart lockdowns and allowed the resumption of industrial activities, which in turn led to a recovery in the labor market, with minimum disruption to the economy during subsequent Covid waves. As a result, the combined index for employment (Sindh and Punjab) for industrial sector shows a rebound in the labor market in FY21 (**Figure 2.31**).

⁵⁶ Ministry of Information Technology and Telecommunication

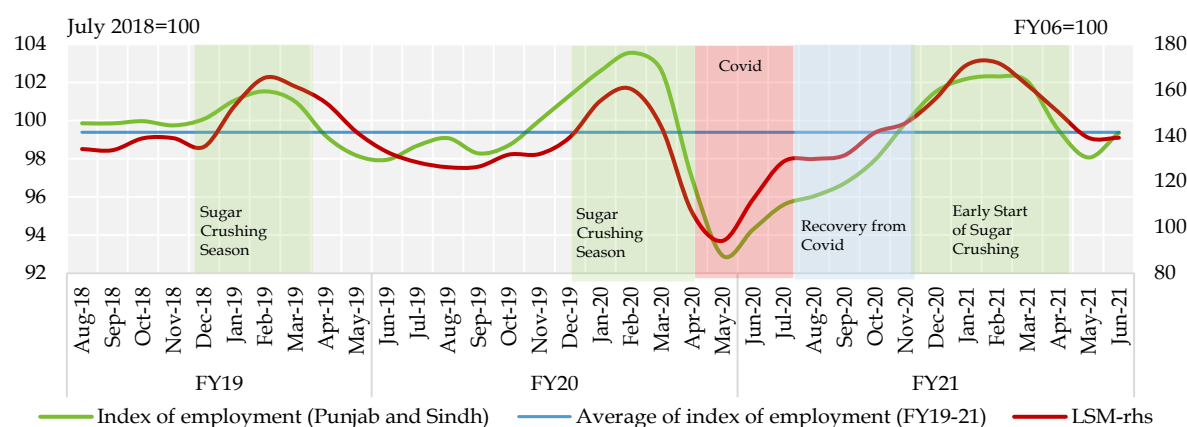
(www.moitt.gov.pk/NewsDetail/ZGNkZjdhYjAtMmMyZi00NDRIWfOTItYjhiMjZlZDZlOGFm)

⁵⁷ In every Monthly Survey of Industrial Production and Employment (MIPE), there are a few non-reporting firms, for which the data is estimated based on past trend. In FY20, non-reporting firms could be higher due to Covid-related lockdowns and work-from-home arrangements.

⁵⁸ The growth is calculated excluding steel industry data for Sindh province, because variation in it due to government decision to privatize Pakistan Steel Mills.

Combined Punjab and Sindh Industrial Employment and LSM Indices (2 month MA)

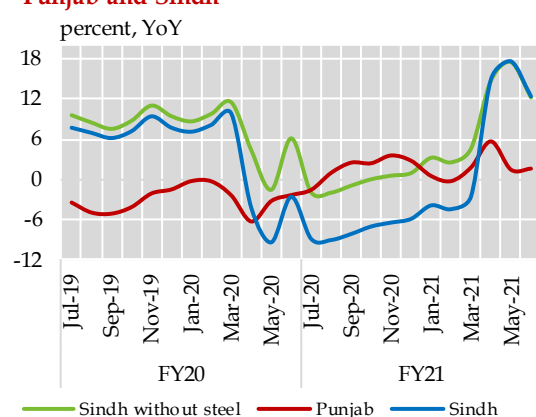
Figure 2.31



Source: Bureau of Statistics-Punjab, Bureau of Statistics-Sindh and Pakistan Bureau of Statistics

Employment Growth for Punjab and Sindh

Figure 2.32



Source: Bureau of Statistics-Punjab and Bureau of Statistics-Sindh

Punjab

At the provincial level, employment in Punjab witnessed growth of 1.7 percent during FY21 in contrast to contraction of 3.0 percent last year (**Figure 2.32**). The growth was mainly driven by food, drinks and tobacco, followed by textiles (**Table 2.20**). These two categories together make up about 80 percent of the reported industrial employment.

Within the food category, growth in sugar and wheat milling stood out. The higher sugar production on the back of better harvest may explain the increase in the labor employment in this sector. The upward revision in the number of reporting units for wheat mills in the Punjab Bureau of Statistics dataset, from 692 to 738, during FY21 may have played a

Sector-wise Employment Growth

Table 2.20

	No. of reported firms	FY20	FY21
Punjab			
Vegetable Ghee	50	18.4	2.2
Wheat Milling	738	3.6	18.1
Sugar	44	-6.1	4.0
Cigarettes	3	15.8	2.8
Cotton Textiles	285	-3.8	1.9
Automobile	1	0.0	0.3
Cement	12	-1.1	-1.0
Sindh			
Sugar	26	-6.0	-3.1
Pharmaceutical	78	-35.4	43.6
Fertilizer	3	-	0.3
Cement	11	-12.3	9.3
Steel Products	2	-31.3	-97.5
Automobile	17	-	7.7

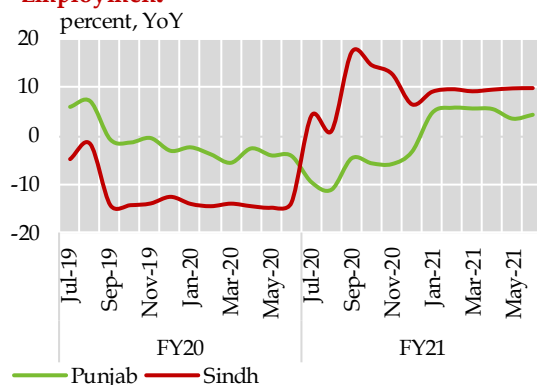
Source: Bureau of Statistics (Punjab and Sindh)

part in the higher employment numbers. Within textiles, the growth in employment of cotton textile rose by 1.9 percent during FY21, against a contraction of 3.8 percent last year.

In the engineering products segment, the employment in the motorcycle sector rose by 12.2 percent in FY21. The higher demand for two wheelers on the back of increase in agricultural income, coupled with the growth in workers' remittances, led to the growth in employment in this sub-segment.

The employment in the cement industry in Punjab declined 1.1 percent during FY21. It is important to note here that initially the growth in cement dispatches was mainly driven by

Growth in Industrial Cement Employment **Figure 2.33**
percent, YoY



Source: Bureau of Statistics-Punjab and Bureau of Statistics-Sindh

exports, which is mostly catered by the south region. This is reflected in Sindh's industrial cement employment in Q1-FY21, which increased significantly. With recovery in domestic cement demand the growth in employment numbers in Punjab improved as well (**Figure 2.33**).

Sindh

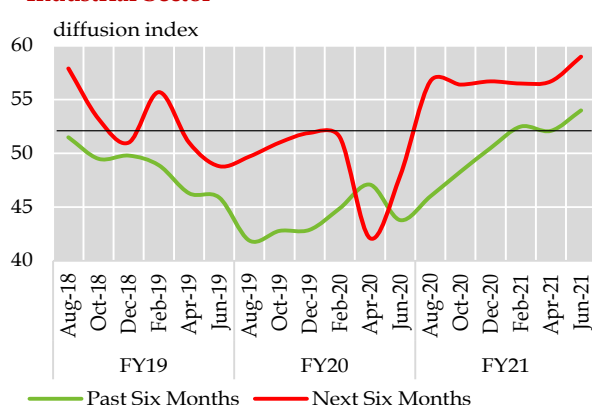
The industrial labor market of Sindh grew 4.1 percent during FY21, compared to the 7.8 percent growth in FY20 (**Figure 2.31**). It is important to note here that in July 2019, the Bureau of Statistics Sindh had updated the list of industrial units in some sectors such as tea, paper and board, fertilizer, sewing machines and automobiles, in its Monthly Survey of Industrial Production and Employment (MIPE). This may have resulted in the

substitution of sick units with operational plants. Moreover, the process of reporting was further strengthened to avoid underreporting of employment in the firms. Because of these measures, the number of employees in these five sectors jumped in July 2019. In this backdrop, the deceleration in the employment numbers in these sectors of the manufacturing industry can be attributed to the one-time adjustment in data.

During FY21, the growth in employment in Sindh was driven by automobiles, cement and pharmaceuticals sectors. Specifically, employment in the automobile sector grew by 7.7 percent in FY21 amid increase in the sector's production activities during the year. The growth in employment in this sector in Sindh relative to Punjab was mainly due to the concentration of automobile assembling plants in Karachi: there are 17 automobile firms in Sindh's MIPE dataset, whereas there is just one assembling unit in Punjab's MIPE data. Similar to the automobile sector, higher cement production also led to an increase in employment in the sector.

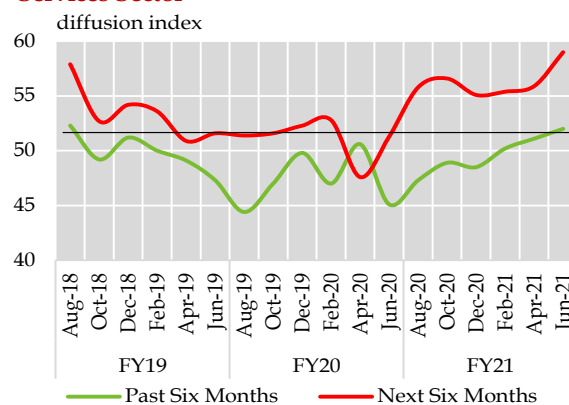
In the pharmaceutical sector, the employment grew by a substantial 43.6 percent in FY21 compared to contraction of 35.4 percent last year. Importantly, growth was more noticeable during Q4-FY21, which primarily contributed to the higher YoY growth in overall Sindh's industrial labor market. The employment in the pharmaceutical sector gained traction mainly on the back of surge in

BCS Employment Index for Industrial Sector **Figure 2.34a**
diffusion index



Source: State Bank of Pakistan

BCS Employment Index for Services Sector **Figure 2.34b**
diffusion index



demand for medical supplies, such as tablets, capsules and injections, due to the ongoing pandemic. Moreover, the start of the vaccination drive may also be generating additional demand for these products.⁵⁹

BCS Employment Index

The improvement in the industrial labor market was also reflected in the SBP's BCS FY21 waves. The BCS employment index (past six months) for the industrial sector was consistently declining since FY19 due to slowdown in economic activities. The diffusion index (DI) took a steep fall in the June 2020 wave amidst the Covid outbreak.⁶⁰ Conversely, perceptions about the labor market continued to improve throughout FY21. In fact, the DI rose above 50 in the February 2021 wave for the first time since August 2018; this further reflected the strengthening of perceptions for industrial labor employment (Figure 2.34a).

Similarly, the BCS employment index for the services sector also indicated an increase in employment expectations during FY21 (Figure 2.34b). This is clearly in line with the recovery in the services sector and the positive trends in the Google Mobility statistics (Figure 2.25).

In the latest wave of June 2021, the DI stood at 52 points for past six months. And for the next six months, it rose by 3 points to 59, displaying businesses' optimistic expectations about future employment situation in the country. This could be due to the easing of uncertainty amid the rollout of vaccines, coupled with the continuation of economic activities during the subsequent waves of Covid.

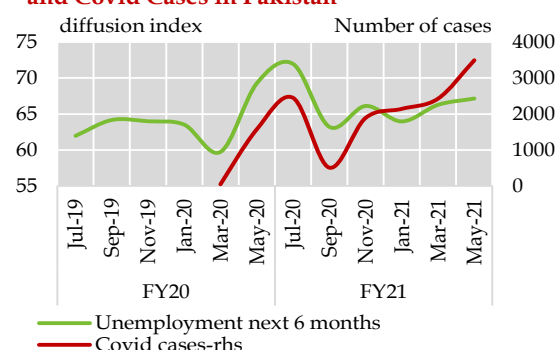
The trends depicted in the BCS can also be noticed in the SBP's Consumer Confidence Survey (CCS).⁶¹ As part of the Expected

Economic Conditions index in the CCS (similar to BCS), participants are asked about their unemployment expectations over the next six months. During FY21, household expectations about future unemployment coincided with the ongoing Covid waves, indicating that households largely anchored their expectation regarding employment with variability of pandemic (Figure 2.35).

Wages

Sector-wise data for wages from the Monthly Survey of Industrial Production Employment for Punjab witnessed a broad-based growth for the reported sectors (Figure 2.36). The growth in wages was more noticeable in the pharmaceutical sector. The pandemic was largely responsible for pushing the wages upward, due to the rise in demand for medical equipment and supplies. The vibrancy in construction activities also had a positive impact on wages in the cement industry: the industry recorded a 4.7 percent growth in wages compared to a contraction of 5.7 percent year earlier.

Future Unemployment Index (Next Six Months) -SBP CCS and Covid Cases in Pakistan Figure 2.35

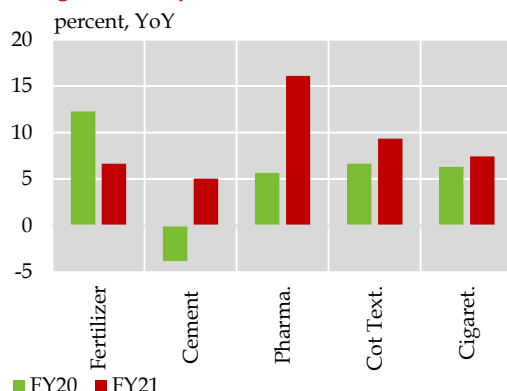


Source: State Bank of Pakistan; World Health Organization

⁵⁹ The production of injections in Sindh increased by 23.2 percent in FY21, compared to a decline of 3.0 percent last year.

⁶⁰ The Diffusion Index shows the general tendency of respondents about a certain aspect of a particular survey. The diffusion index ranges from the minimum value of 0 to the maximum value of 100 that is a value of 50 is indicative of neutrality, 0 indicates no confidence and 100 indicates extreme confidence.

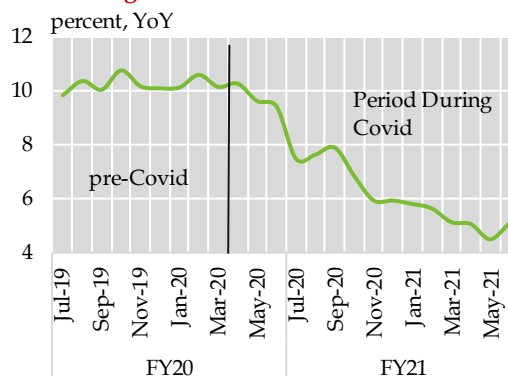
⁶¹ The survey is conducted by SBP and IBA, Karachi. It is a telephonic survey with approximately 1,670 households as participants.

Sector-Wise per Employee Growth in Wages for Punjab **Figure 2.36**

Source: Bureau of Statistics, Punjab

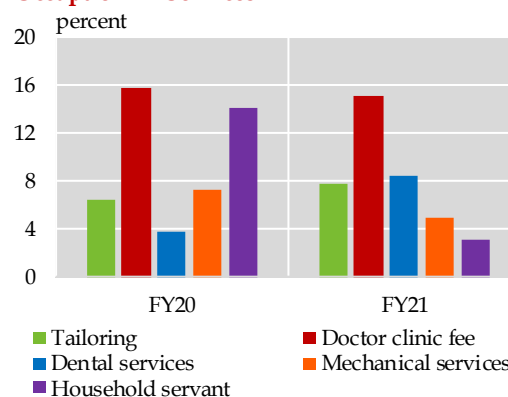
The dataset for the construction wage rate index obtained from the consumer price index (CPI) shows a growth of 6.1 percent during FY21, lower than the 10.1 percent growth recorded in FY20. Notably, the deceleration in growth started from March 2020 onwards, coinciding with the Covid outbreak (**Figure 2.37**). The slowdown in wage growth could be attributed to the creation of excess labor supply - especially in the unskilled category. The profound impact of Covid on these workers was primarily related to the nature of their work.⁶² Moreover, according to the Bureau of Emigration and Overseas Employment (BEOE), the number of people going abroad for work declined by 64.0 percent to 224,705 in 2020 from 625,338 in 2019. Along with this decline, there was also some return migration, especially from the Gulf countries, which could have also contributed to the increase in labor supply in Pakistan.⁶³

Apart from wages for construction, the CPI also includes indices for some occupations in the services sector (**Figure 2.38**). The dataset reveals that the earnings of household servants showed slower growth in FY21

Growth in Construction Sector Wages **Figure 2.37**

Source: Pakistan Bureau of Statistics

compared to last year: their wages grew by 3.1 percent in FY21, against 14.2 percent in FY20. The pandemic may have been the reason of deceleration in household servants' wages. Anecdotal evidence suggests that many domestic household workers either did not receive any income or were paid less amid the financial crunch faced by their employers due to Covid. In contrast, the earnings of doctors and dentists (based on doctor clinic fee index reported in CPI) showed the highest and most consistent growth amongst the reported

Growth in Earnings for Occupation in Services **Figure 2.38**

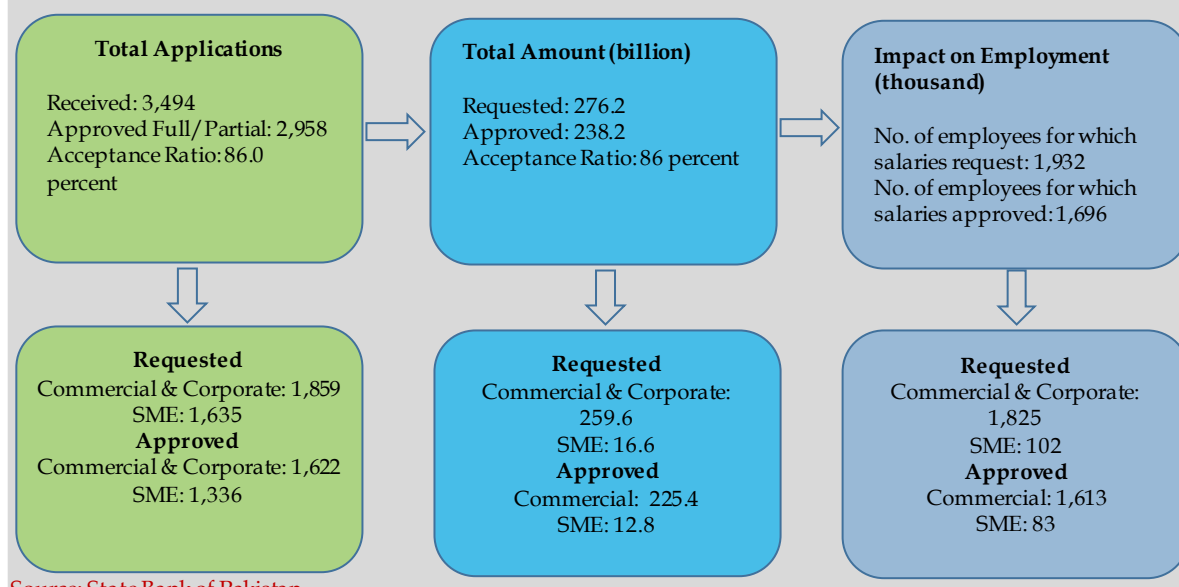
Source: Pakistan Bureau of Statistics

⁶² According to a survey conducted by the PBS to evaluate the impact of Covid-19 on the wellbeing of people, construction workers were hit worst by the shock, as almost 80 percent of workers either lost their jobs or faced a decrease in their incomes; they were followed by workers in the manufacturing sector, where 72 percent faced either job loss or decrease in income.

⁶³ SBP's Annual report on the State of Pakistan's Economy for FY20. Box 6.1: Covid-19 and Forced Repatriation of Migrants in Pakistan: Government's Strategy and Challenges Ahead.

Refinance Scheme for Wages to Prevent Layoffs (SBP Rozgar Scheme) Apr-Nov 2020

Figure 2.39



Source: State Bank of Pakistan

segments. This may be due to the high demand for medical services because of the pandemic.

Fiscal and Monetary Support for Employment

The labor markets across the globe were adversely affected in early 2020 by the containment measures to reduce the spread of Covid. Policymakers leveraged various tools to counter the adverse impact on jobs, including temporary employment protection schemes. In the Asia-Pacific region alone, 26 out of 37 economies introduced new schemes or adjusted an existing employment protection scheme in response to the crisis.⁶⁴ Similarly in Pakistan -beside fiscal support of cash allowance scheme for daily wage earners- the SBP announced the Refinance Scheme for Wages to Prevent Layoffs (also known as the SBP Rozgar Scheme) to support businesses in paying their workers and thereby supporting continued employment in the challenging economic environment.⁶⁵

Under the scheme, the SBP received applications from 3,494 businesses by end

November 2020, covering 1.9 million employees. The number of commercial applications stood at 1,859, while the remaining applications were from SMEs. Around 86 percent of the applications were approved, with an average approval time of 25 days, which allowed businesses to receive the funds in time. Moreover, Rs 238.2 billion for 2,993 (full/partial) business units, including 1,337 SMEs, was approved, which prevented the layoffs of almost 1.7 million employees (Figure 2.39).

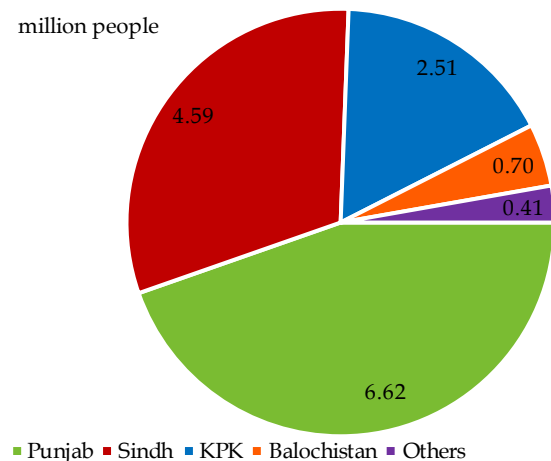
On the fiscal side, the government launched the Ehsaas Emergency Cash (EEC) assistance program to support the daily wage earners from the recessionary impact of Covid. Under this program, the government disbursed around Rs 180 billion as one-time emergency cash transfer to 14.8 million beneficiaries by September 30, 2020. Province-wise data shows that most of the beneficiaries were from Punjab-given its large population size- followed by Sindh, KP and Balochistan (Figure 2.40a and 2.40b). Given the joint

⁶⁴ Research Brief "Covid-19 and employment protection policies: A quantitative analysis of the Asia-Pacific region" ILO, July 2021. (www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/documents/briefingnote/wcms_810842.pdf)

⁶⁵ www.sbp.org.pk/COVID/Rozgar.html

Province-Wise Beneficiaries under Ehsaas Emergency Cash Program

million people



■ Punjab ■ Sindh ■ KPK ■ Balochistan ■ Others

Source: Poverty Alleviation & Social Safety Division

family social structure in Pakistan, this one-time emergency cash support program is estimated to have helped over 100 million

Figure 2.40a

Province-Wise Cash Disbursement

billion Rs

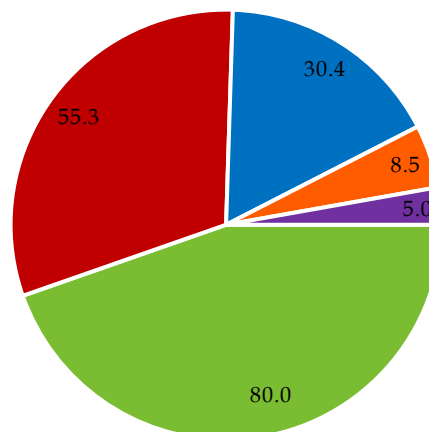


Figure 2.40b

people, or half the country's population, from the impact of pandemic.⁶⁶

⁶⁶ Chapter 15: Social Protection, Pakistan Economic Survey 2020-21, Ministry of Finance. (www.finance.gov.pk/survey/chapters_21/15-Social%20Protection.pdf)

Chapter 3

Monetary Policy and Inflation

Keeping in view the need to nurture the recovery, the supply-side and concentrated nature of inflation and uncertainties posed by the pandemic, the Monetary Policy Committee (MPC) considered it appropriate to continue with the accommodative stance throughout FY21. To provide necessary support to the ongoing recovery process, the policy rate was kept unchanged at 7 percent amid well-anchored inflation expectations and subdued underlying inflationary pressures. As economic activity indicators started to show signs of recovery, consumer and business confidence improved. This was also reflected in the credit off-take by businesses and households. Private sector credit recorded double-digit growth in FY21 with a significant increase in fixed investment loans, as businesses benefitted from SBP's concessionary financing schemes, mainly Long Term Financing Facility (LTFF) and Temporary Economic Refinance Facility (TERF). Further, the low interest rate environment led to a visible expansion in consumer financing, mainly in automobile, personal and housing loan segments. National CPI, on the other hand, decelerated in FY21 on the back of relatively contained demand-side pressures that in turn helped to offset the inflationary impact of temporary supply-shocks. Also, headline CPI remained within the SBP's projection range of 7-9 percent. Core inflation, measuring underlying inflationary pressures, remained lower compared to the previous year on account of contained cost-push factors such as low fuel price, favorable exchange rate conditions and spare capacity in the economy.

3 Monetary Policy and Inflation

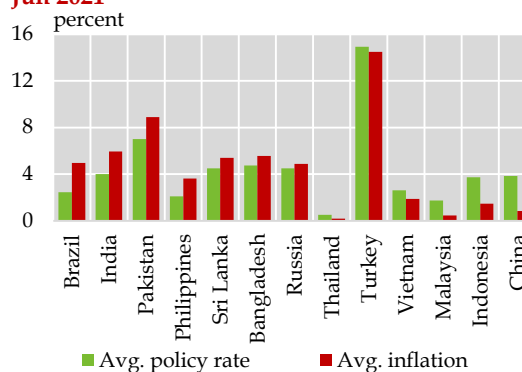
3.1 Policy Review

The Monetary Policy Committee (MPC) continued with the accommodative stance during FY21 to counter the impact of Covid-19 fallout and support the economic recovery. The policy decision was mainly supported by well-anchored inflation expectations, subdued inflationary pressures, improvement in the current account balance, adequate availability of external financing and improvement in foreign exchange reserves position. Taking all these factors into consideration, and heightened uncertainty created by the pandemic, the MPC deemed it appropriate to continue its emphasis on reviving economic growth. Therefore, the policy rate was kept unchanged at 7 percent in all its meetings held in FY21.

Recall that the MPC had announced the rate cuts of 625 basis points in a series of meetings during March-June 2020. Adjusting for inflation, Pakistan's monetary policy stance remained on the lower spectrum in comparison to many emerging economies during Jul 2020 – Jun 2021 (**Figure 3.1**), thereby providing a conducive environment for a revival in the economic activity. To further incentivize economic growth, SBP also announced extensions and relaxations for some of the refinance schemes launched after the outbreak of the pandemic in FY20.

The government also laid more emphasis on promoting housing and construction sector activities. In line with this, in July 2020, SBP mandated banks to increase their housing and construction finance portfolio to at least 5 percent of their private sector advances by December 2021. In addition, to minimize the economic impact and to protect businesses and daily wagers, the government adopted a more targeted strategy and remained inclined towards intermittent smart lockdowns instead of complete closure of businesses that was

Average Inflation and Policy Rate in Emerging Markets during Jul 2020 - Jun 2021 **Figure 3.1**



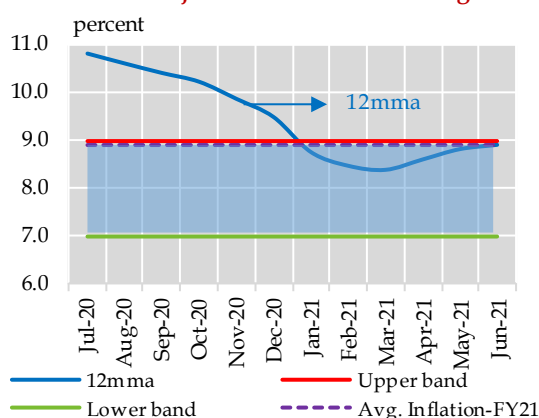
Source: Haver Analytics

implemented during the first wave of the pandemic in FY20.

Consequently, with the favorable policies, economic recovery gained momentum as the year progressed. High frequency demand indicators like FMCG sales, POL sales, power generation, cement and auto sales posted a significant recovery during the year.¹ Coordinated fiscal and monetary policy efforts were instrumental to this turnaround. SBP's concessionary financing schemes and accommodative monetary policy stance helped to contain debt financing and debt servicing costs for firms and households. On the fiscal side, targeted support was made in the form of tax concessions, disbursement of pending refunds, and subsidies. These measures enabled firms to meet the growing demand for industrial raw materials and consumer goods.

The supportive policies resulted in a significant improvement in the Business Confidence Index. With a pick-up in the economic activity, the private sector credit also registered an increase of 11.2 percent in FY21 compared to an increase of 2.9 percent last year. This recovery in credit offtake was mostly driven by the expansion in fixed investment loans and consumer finance. Also,

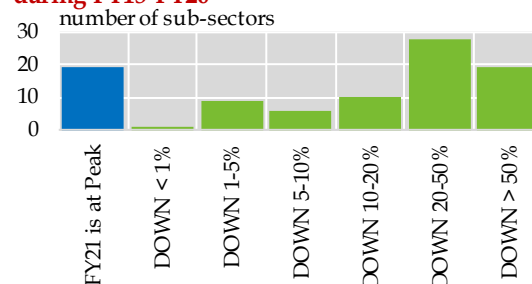
¹ During FY21, the domestic cement dispatches, car sales, power generation and POL sales grew by 20.4, 56.7, 6.9, and 14.3 percent respectively.

CPI Inflation Projection and 12MMA Figure 3.2

Source: PBS and SBP staff estimates

working capital loans increased mainly due to higher borrowings by the non-manufacturing sectors. In contrast, some of the major manufacturing businesses, such as textile, cement and motor vehicles retired their loans during FY21 on the back of improved cash flow position of the firms due to pick-up in domestic sales and higher tax refunds. Meanwhile, SBP's concessionary schemes particularly TERF and enhanced LTFF during Covid supported the growth in fixed investment loans.² During FY21, the fixed investment loans grew by 11.4 percent compared to a decline of 1.5 percent last year. Meanwhile, a renewed interest in auto and housing finance was behind the uptick in the consumer finance.

Both headline and core inflation moderated in FY21. Headline inflation eased to 8.9 percent during FY21 compared to 10.7 percent last year. Likewise, urban core inflation fell to 6.0 percent compared to 7.5 percent a year ago. The SBP's CPI projections at the start of the year (July 2020) were in the range of 7-9 percent, lower than FY20's forecast of 11-12 percent (Figure 3.2). The range for FY21 reflected improved outlook on account of low fuel prices, inflation neutral budget (with no additional taxes and some relief to construction industry) and relatively

Comparison of Sub-sectors of QIM with their Peak Production Level during FY15-FY20 Figure 3.3

*the bars show relative performance of sub-sectors in FY21 compared to their peak performance during FY15-FY20. The y-axis reflects number of sub-sectors that fall in respective categories on the x-axis.

Source: Pakistan Bureau of Statistics

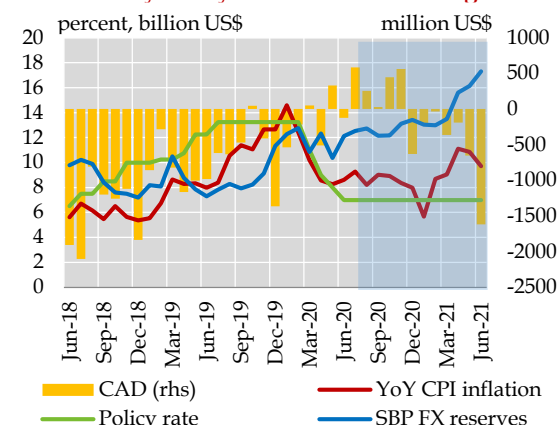
contained demand-side pressures. The inflation forecast was subject to many upside and downside risks as well throughout the year. The upside risks included rise in the prices of important food items, extreme weather conditions and adjustments in fuel and utility tariffs; whereas, the downside risks comprised second and third waves of the pandemic and related deceleration in demand.

As the year progressed, core inflation remained benign, given continued spare capacity in the economy.³ Moreover, as a proxy indicator of spare capacity, analysis reflects that a large majority of sub-sectors of LSM were still operating below their previous peak levels that were attained during FY15-FY20 (Figure 3.3).⁴ However, pressure on headline inflation persisted due to supply side disruptions, especially in food group, and administrative adjustments in electricity tariffs. YoY inflation readings also displayed volatile trends during the year. It ranged from a trough of 5.7 percent in January 2021, amid waning supply-side pressures from the food group and base effect, to a peak of 11.1 percent in April 2021 amid revised electricity tariffs, upward pressure on domestic fuel prices (on MoM basis) and high inflation in poultry group. Importantly, in the last quarter of FY21, the headline inflation decelerated from

² In FY21, gross disbursements under TERF amounted to Rs 138.6 billion, which did not exist last year, as the disbursements started in FY21

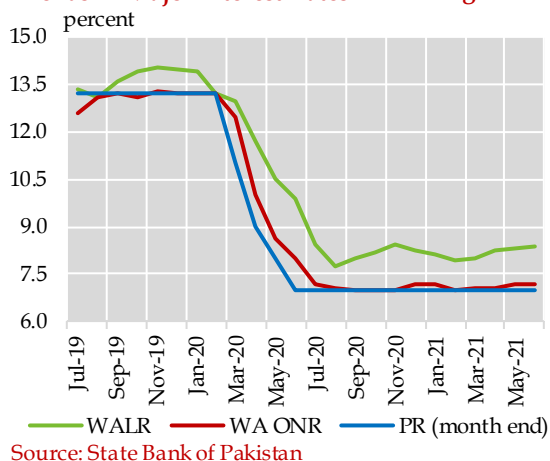
³ Capacity utilization data of various sectors such as Cement, POL, Auto (LTV, LCV, HCV) reveals that the activity is still less than the levels observed during FY16 and FY17.

⁴ 73 out of the 92 sub-sectors of the LSM were below their peak levels attained since FY15.

Trend in Key Policy Indicators **Figure 3.4**

11.1 percent in April 2021 to 9.7 percent in June 2021. This trend also supported the MPC's prior stance that recent price pressures were mostly supply-driven and temporary. Consequently, the average inflation in FY21 was in line with the SBP's forecast range of 7-9 percent announced in May 2020.

Country's external sector position during FY21 was strongest in several years (**Figure 3.4**). The current account deficit fell to a 10-year low level. This was supported by an improvement in the trade balance and record high remittances, primarily due to supportive policy measures and increased use of formal channels. These favorable developments, consequently, bolstered foreign exchange buffers.

Trends in Major Interest Rates **Figure 3.5**

With heightened uncertainty due to Covid, the MPC for the first time also provided forward guidance on monetary policy in its January 2021 meeting (**Box 3.1.1**). Moreover, in the subsequent monetary policy decisions during the fiscal year, the MPC reinforced its commitment by maintaining the existing level of policy rate. It also reiterated its expectations to continue with an accommodative interest rate environment in the near term, with any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates over time.

In a nutshell, with the aforementioned favorable macroeconomic environment, the MPC felt that the existing accommodative stance of the monetary policy was appropriate to support the nascent recovery (**Figure 3.5**).

Box3.1: Managing Interest Rate Expectations using Forward Guidance

The central bank communication is an important aspect of the monetary policy that aims to reduce economic and financial uncertainty. During unusual economic conditions, some central banks also communicate the future monetary policy stance which is referred to as forward guidance. It is an unconventional monetary policy tool that is used by the central banks to minimize interest rate volatility and to manage interest rate expectations. This could take various forms such as qualitative forward guidance, quantitative forward guidance, or guidance conditional on specific economic developments and/or for a given duration. In 1999, forward guidance was first adopted by the Bank of Japan in line with its zero interest rate policy. Subsequently, during the global financial crisis forward guidance became more prominent among developed economies as the interest rates in some developed countries touched the zero lower bound.

In the aftermath of Covid-19 outbreak, some developed and emerging market central banks adopted this approach to give confidence to investors and other economic agents in the forward-looking decisions given heightened uncertainties (**Table 3.1.1**).

Forward Guidance by Central Banks in the aftermath of Covid-19 Outbreak

Table 3.1.1

Central Bank	First Forward Guidance Communication after Covid-19 Outbreak	Most Recent Stance
State Bank of Pakistan	"In the absence of unforeseen developments, the MPC expects monetary policy settings to remain unchanged in the near term. As the recovery becomes more durable and the economy returns to full capacity, the MPC expects any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates." (Jan 22, 2021)	"Looking ahead, in the absence of unforeseen circumstances, the MPC expects monetary policy to remain accommodative in the near term, and any adjustments in the policy rate to be measured and gradual to achieve mildly positive real interest rates over time." (Jul 27, 2021)
Reserve Bank of Australia (RBA)	"The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2-3 per cent target band." (Mar 19, 2020)	"The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The central scenario for the economy is that this condition will not be met before 2024." (Aug 3, 2021)
Bank of Canada	"The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved." (Jul 15, 2020)	"We remain committed to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In the Bank's July projection, this happens sometime in the second half of 2022." (Jul 14, 2021)
US Federal Reserve	"The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals" (Mar 15, 2020)	"The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time" (Jul 28, 2021)
Reserve Bank of India	"The MPC also decided to continue with the accommodative stance as long as necessary - at least during the current financial year and into the next financial year - to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward." (Oct 09, 2020)	"The MPC also decided to continue with the accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward." (August 6, 2021)
Sri Lanka	"The Board observed the stronger than expected growth performance towards the end of 2020 and underscored the need for maintaining the prevailing low interest rate structure to support the sustained economic recovery in the period ahead." (Apr 03, 2021)	-
Brazil	"the Copom does not foresee reductions in the monetary stimulus unless inflation expectations, as well as its baseline scenario inflation projections, are currently close to the inflation target at the relevant horizon for monetary policy, 2021 and, to a lesser extent, 2022. This intention is conditional on the maintenance of the current fiscal regime and on the anchoring of long-term inflation expectations." (Aug 05, 2020)	"For the next meeting, the Committee foresees another adjustment of the same magnitude [interest rate was increased by 100 bps]. The Copom emphasizes that its future policy steps could be adjusted to ensure the achievement of the inflation target and will depend on the evolution of economic activity, on the balance of risks, and on inflation expectations and projections for the relevant horizon for monetary policy." (Aug 04, 2021)

Source: Central bank (respective) press releases

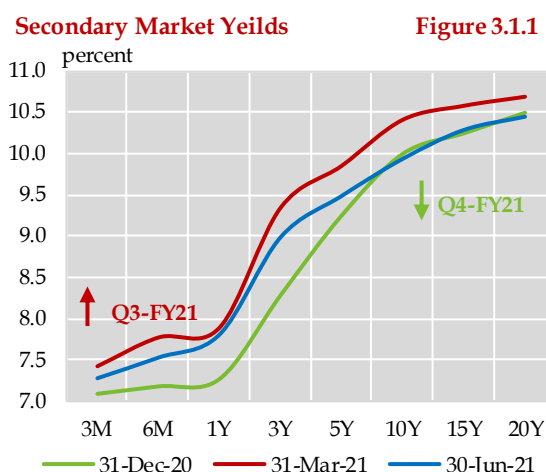
In Pakistan, the MPC started to provide forward guidance from January 2021, with an objective to reinforce the commitment of continuing accommodative monetary policy stance and to facilitate policy predictability and decision-making by economic agents. It was for the first time that the SBP explicitly mentioned that the interest rates will remain unchanged until the near term. The MPC leveraged a low probability of demand-side inflation and well-anchored inflation expectations to provide forward guidance to the market.

The secondary market (PKRV) yields on GoP debt securities were on the rising trend since the start of FY21 and it continued throughout the third quarter. Given the negative real rates, and with inflation edging-up, market showed somewhat delayed response to the guidance given by the MPC regarding the near-term interest rate path. However, the market gained confidence after the announcement of subsequent monetary policy in March 2021. From Q4-FY21 the yields eased out, with a relatively larger impact on the longer end of the curve (Figure 3.1.1). Meanwhile, guidance on future interest rate path also helped in increasing the market's participation in medium to long term instruments. The competitive bids for fixed rate PIBs increased to Rs 1,468 billion in Q4-FY21 compared to Rs 437 billion and Rs 186 billion in Q3-FY21 and Q2-FY21 respectively.

Other countries also benefitted by providing forward guidance during the crisis period. For instance, according to Reserve Bank of India (RBI) forward guidance helped in boosting market sentiments and eliminating 'illiquidity fears'.⁵ It also complemented other unconventional monetary policy tools used during the pandemic. On a similar note, a study conducted by Federal Reserve Bank of Cleveland shows that forward guidance communicated by FOMC during Covid19 was effective in managing public's expectations about the interest rate path in case it was accompanied by Summary of Economic Projections (SEP) - a report that provides forecasts of economic variables. However, it does not have an impact on altering expectations regarding economic fundamentals.⁶

3.2 Monetary Aggregates

Broad money expansion posted a growth of 16.2 percent during FY21 compared to 17.5 percent in the preceding year (Table 3.1). However, it is important to mention here that it is still at an elevated level compared to the growth recorded in previous years. On the asset-side, both Net Domestic Assets (NDA) as well as Net Foreign Assets (NFA) posted expansion, with a higher contribution of the NDA of the banking system. On YoY basis, the growth in NDA moderated slightly mainly on account of lower net budgetary borrowings from the banking system and net retirements made by Public Sector Enterprises (PSEs) compared to borrowings last year. The combined impact of these two developments more than offset the impact of a solid turnaround in the credit to private sector. Meanwhile, continuous improvement in the external position and buildup of FX reserves supported the growth in the NFA. This was on



Source: Financial Markets Association of Pakistan

the back of a contained current account deficit, due to record high exports and workers' remittances, and other official inflows. On quarterly basis, the fourth quarter recorded highest FX inflows in comparison to the first three quarters. These include fresh issuances of multi-tranche Eurobonds and green Eurobonds issued by WAPDA, inflows from multilateral agencies and other commercial loans.

On the liability side, the growth in currency in circulation nearly halved to 12.5 percent in FY21 compared to 24.1 percent in FY20, while deposits growth increased to 17.6 percent in FY21 compared to 14.9 percent a year ago. However, weekly data shows that the currency to deposit ratio remained at an elevated level during FY21 as the public's preference for holding cash and out of bank settlements continued to remain high.⁷ Several factors were behind this trend: (i) the demand

⁵ www.rbi.org.in/Scripts/BS_ViewBulletin.aspx?Id=20141

⁶ www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2020-economic-commentaries/ec-202027-forward-guidance-during-the-pandemic.aspx

⁷ On a weekly basis, the currency to deposit ratio remained on average at 43.1 percent during FY21 compared to 43.1 percent in FY20 and 40.4 in FY19.

Monetary Aggregates^P

billion Rupees

Table 3.1

	Abs. change in stock		Growth rate in percent	
	FY20	FY21	FY20	FY21
M2 (A+B)	3,109.5	3,389.7	17.5	16.2
A. NFA	990.9	1,241.0	65.8	240.4
B. NDA	2,118.6	2,148.7	11.0	10.0
Budgetary borrowing*	2,151.8	1,712.4	18.6	12.5
SBP	(153.1)	(1,119.0)	-2.3	-17.1
Scheduled banks	2,304.9	2,831.5	47.0	39.3
Commodity operations	57.0	90.6	7.5	11.1
Private sector	196.4	766.2	2.9	11.2
PSEs	96.3	(53.8)	7.0	-3.7
Other items net	(391.6)	(376.3)	-35.5	-25.2
Reserve money	1,106.4	983.6	16.8	12.8
Currency in circulation	1,192.0	767.9	24.1	12.5
Total deposit with banks	1,909.9	2,595.0	14.9	17.6

^P: Provisional

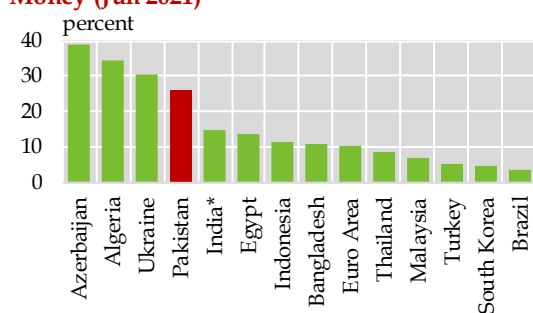
* These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented

Source: State Bank of Pakistan

for cash increased multiple folds in aftermath of the Covid outbreak. Though a sizable chunk of this high level of currency in circulation posted a reversal in Q1-FY21, the demand for holding cash remained on the higher side; (ii) reduced opportunity cost of holding cash as a result of low interest rates; and (iii) impact of cash transfers by the government via Ehsaas program.

Importantly, despite several initiatives taken by the State Bank of Pakistan to encourage the use of digital banking channels, the cash penetration in the economy is still hovering at a high level both in comparison to the

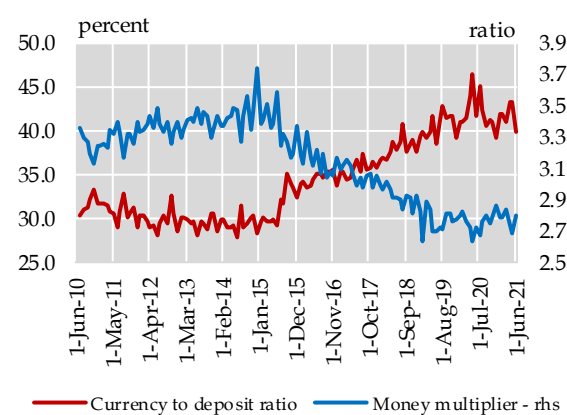
historical trend and also compared to other countries (**Figure 3.6**). Pakistan's currency to money supply is significantly higher compared to other regional economies like India, Egypt, Bangladesh, Turkey, etc. The recent surge in cash usage in the economy as well as issues such as withholding taxes on banking transactions for non-filers and increased scrutiny of financial transactions have also hurt deposit growth over past few years.⁸ Consequently, the credit creation capacity of financial intermediaries has been negatively affected as captured by a fall in the money multiplier (**Figure 3.7**).

Currency in Circulation to Broad Money (Jun 2021)**Figure 3.6**

* for India the ratio is calculated as C/C/M3

for Algeria, Egypt, Indonesia, Bangladesh and Thailand latest available figures were used as data for Jun 2021 is not available.

Source: Haver Analytics

Impact of High Cash Penetration in the Economy on Financial Intermediation**Figure 3.7**

Source: State Bank of Pakistan

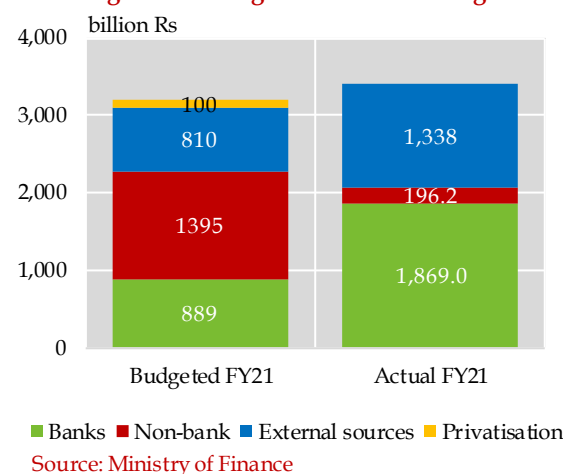
⁸ In the finance bill of FY22, the withholding tax on banking transactions for non-filers has been removed and its impact on the components of money supply may unfold in the coming months. On the other hand, the State Bank of Pakistan has reinstated the interbank funds transfer fee that remained suspended since the start of the pandemic in March 2020.

Government borrowings

Despite a slight increase in the fiscal deficit in absolute terms, the banking system's budgetary support (on cash-basis) marginally fell to Rs 1,869.0 billion in FY21 compared to Rs 1,925.2 billion in FY20. This was on the back of higher than budgeted financing from external sources. That said, the reliance on the banking system remained on higher side and was more than twice than was budgeted for FY21 (**Figure 3.8**). The main driver behind higher than estimated borrowings from banks was a sharp fall in the mobilization of funds from non-bank sources. The government was only able to raise Rs 196.2 billion from non-bank sources compared to the budgeted amount of Rs 1395.0 billion. This was because: (i) limited availability of NSS (due to limited availability of CDNS outlets due to lockdowns in the initial months of FY21 and institutional investors were barred from investing in NSS w.e.f July 01, 2020); (ii) low profit rates on NSS instruments; (iii) withdrawal of Rs 25,000, Rs 15,000 and Rs 7,500 denomination prize bonds during FY21; and (iv) nonbank investment in GoP securities was on the lower side compared to last year.

Within the banking system, the government mobilized Rs 2,831.5 billion in FY21 from the scheduled banks compared to Rs 2,304.9 billion in the preceding year. Meanwhile, the government adhered to its commitment of zero borrowings from the SBP. On net basis including the impact of government deposits, the government made sizable retirements to the SBP. During FY21, the federal government added around Rs 647.8 billion to its cash buffers maintained with the banking system. As a result the gross financing from commercial banks also increased. Importantly, this is for the second consecutive year that the government borrowing from central bank has remained zero, despite higher fiscal outlays to tackle the fall out of the pandemic. Had the crisis period coincided with a budgetary support from the central bank, it may have fueled inflationary pressures. Also, zero borrowing from the central bank over the past

Financing Mix of Budget Deficit **Figure 3.8**



two years has also enabled improved liquidity management by the SBP. This in turn leads to a smoother transmission of monetary policy and helps in anchoring inflation expectations.

Auctions

The government's pre-auction targets remained aligned with its objective of enhancing the maturity profile of the outstanding marketable securities. The net of maturity target for T-bills stood at negative Rs 1,165.8 billion for FY21 compared to Rs 1,163.7 in FY20 (**Table 3.2**). In contrast for fixed rate PIBs, the government increased the net-of-maturity targets to Rs 1,121.6 billion compared to only Rs 379.7 billion in the preceding year. Likewise, the government's target for floaters, that provide longer maturity with flexible rates, also remained on the higher side. The pre-auction target allocation to floaters was more than three times in FY21 compared to that of the last fiscal year. Additionally, the government, in Q2-FY21, also introduced new floating rate bonds of medium to long term maturities with multiple coupon frequencies.⁹

As far as the market participation is concerned, somewhat contrasting trend was observed during the first and second half of the fiscal year. During H1-FY21, the market remained inclined towards short term instruments and floaters. This was primarily on the back of the then relatively strong

⁹ In October 2020, the government introduced new floating rate PIBs of multiple tenors i.e. 3Y, 5Y and 10Y with quarterly coupon resetting and a 2Y floater with fortnightly coupon reset.

Instrument-wise Auction Summary

Table 3.2

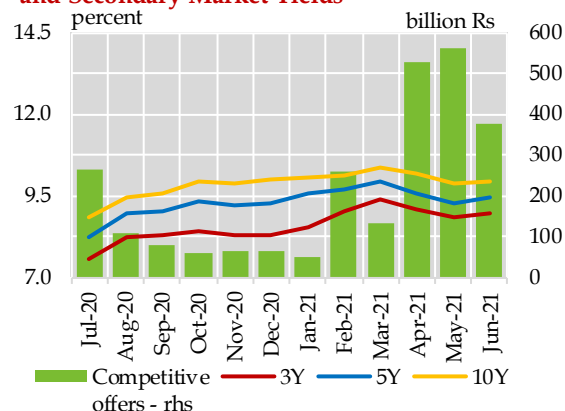
billion Rupees

	Target		Maturity		Offered*		Accepted (all)	
	FY21	FY20	FY21	FY20	FY21	FY20	FY21	FY20
T-bills	12,975.0	15,150.0	14,140.8	13,986.3	26,765.8	32,354.2	14,865.3	15,167.4
3M			7,674.9	13,186.00	14,594.3	14,225.50	8,698.5	8,811.9
6M			1,816.2	799.8	9,733.7	4,157.30	5,585.9	1,705.8
12M			4,649.7	0.5	2,437.8	13,971.40	580.9	4,649.7
PIBs (fixed)	1,510.0	1,300.0	388.4	920.3	2,539.7	5,027.0	1,056.3	2,070.7
3Y	530.0	520.0			1,115.3	2,262.0	479.3	1,102.2
5Y	430.0	395.0			815.9	1,530.8	301.2	612.8
10Y	300.0	265.0			439.9	1,188.7	149.7	332.8
15Y	140.0	30.0			96.5	22.9	64.0	16.8
20Y	80.0	90.0			72.1	22.6	62.1	6.1
30Y	30.0	-			-	-	-	-
PIBs (floater)	2,725.0	850.0	-	-	3,171.2	1,578.1	1,632.5	818.5
2Y - Qtrly	285.0	-	-	-	213.4	-	175.7	-
3Y - Qtrly	450.0	-	-	-	365.9	-	229.0	-
5Y - Qtrly	150.0	-	-	-	107.6	-	90.5	-
10Y -								
Qtrly	150.0	-	-	-	130.1	-	98.5	-
3Y - SA	550.0	50.0	-	-	1,193.3	84.1	624.8	60.6
5Y - SA	770.0	50.0	-	-	776.8	48.5	306.3	34.5
10Y - SA	370.0	750.0	-	-	384.1	1,445.5	107.8	723.4
GIS - VRR	230.0	300.0			605.2	597.0	385.2	198.2
GIS - FRR	120.0	-			83.2	-	52.8	-
Total	17,560.0	17,600.0	14,529.2	14,906.6	33,165.1	39,556.3	17,992.1	18,254.8

*competitive bids only

Source: State Bank of Pakistan

Bidding Pattern of Fixed Rate PIBs and Secondary Market Yields Figure 3.9



Source: State Bank of Pakistan and FMAP

market expectations of an interest rate hike in six to twelve months period. However, after the January 2021's meeting of the MPC in which the SBP issued the forward guidance, and at the same time the term premium of 6M

T-bills ticked up in comparison to 3M T-bills, the market's appetite for 6M T-bill increased.

Likewise, for fixed rate PIBs the market's participation started to revive in the third quarter (Figure 3.9). Subsequently, as the SBP maintained the accommodative monetary stance and restated the forward guidance in successive monetary policy statements, the market's participation for fixed rate PIBs improved further in the fourth quarter of FY21. Besides this, in February 2021 the SBP also withdrew the upper limit on investments in PIBs that can be counted towards maintenance of Statutory Liquidity Requirements (SLR) for banks and development finance institutions.¹⁰ This also helped in strengthening market's interest in longer tenor government securities.

With market's renewed interest in 6M T-bills and also fixed rate PIBs in the second half,

¹⁰ SBP DMMD Circular No. 04 of 2021

government leveraged the opportunity by increasing the acceptances. The cutoff rates slid by 47 bps for 3M T-bills and ticked up by 10 bps and 31 bps for 6M and 12M papers respectively. For fixed rate PIBs, the yields initially increased until Q3-FY21, but eventually eased out during Q4-FY21 (Figure 3.9). Meanwhile, the issuances of floating rate PIBs almost doubled compared to the preceding year. Bulk of the issuances for these instruments were made during H1-FY21. In H2-FY21, the issuances for floaters witnessed a marked slowdown owing thin market participation and lower acceptances by the government.

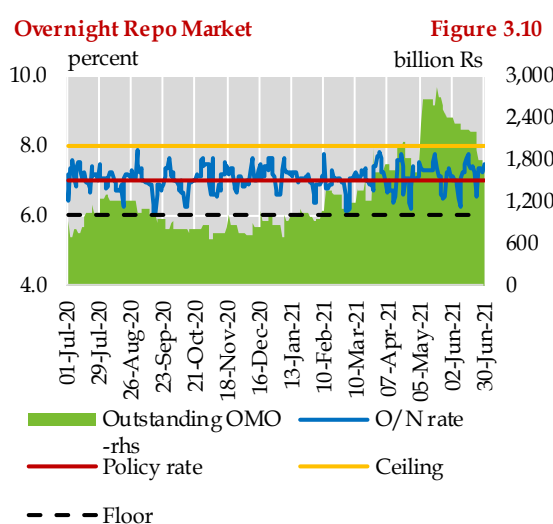
For Shariah compliant instruments, the market's appetite remained intact. The cumulative issuances of variable rental rate and fixed rental rate Sukuk more than doubled during FY21 compared to last year. However, since January 2021 the government has not conducted any Sukuk auction. It is important to recall here that the government had successfully conducted auctions of Shariah compliant instruments since April 2020 on regular basis and have benefitted from the lower yields they offer compared to conventional domestic debt instruments. Besides that, Sukuk issuances have also helped the government to diversify its outstanding debt. Therefore, it is crucial to ensure their timely and uninterrupted auctions.

Interbank Liquidity

The interbank repo market remained relatively liquid at the start of the fiscal year and required lower interventions. As the year progressed, liquidity pressures started to emerge. SBP proactively managed these pressures via its open market operations as reflected by the increase in outstanding OMOs towards the later part of the fiscal year (Figure 3.10). During H1-FY21 deposit mobilization coupled with other factors such as SBP's FX management, retirements from Public Sector Enterprises and government procurement agencies helped in easing out liquidity pressures in the overnight repo market. As a result of these inflows, the market required lower SBP's support. The average outstanding

OMO injections fell down to Rs 936.0 billion in H1-FY21 compared to Rs 1,125.2 billion in the same period last year.

In contrast, during H2-FY21 the liquidity conditions started to tighten as the government borrowings from the commercial banks continued to increase alongside an uptick in the private credit offtake. In particular during Q4-FY21, the liquidity pressures increased further and required higher volume of OMO injections. Therefore, average outstanding OMO increased to Rs 2.1 trillion in Q4-FY21 compared to Rs 1.0 trillion, Rs 0.8 trillion and 1.2 trillion in Q1, Q2 and Q3 of FY21 respectively. These pressures were mainly on the back of high government borrowings in Q4-FY21, outflows from the banking system in the form of tax payments, and seasonal withdrawals of deposits during the month of Ramzan and Eid. These liquidity outflows also resulted in more frequent and sporadic visits at SBP's discount window. Not only did the market require higher interventions, the volatility in the weighted average overnight rates rate also remained on the higher side compared to the preceding quarters. During Q4-FY21, the average absolute deviation of overnight repo rates from the policy rate increased to 33 bps compared to 24 bps, 26 bps and 23 bps in Q1, Q2 and Q3 of FY21 respectively.



Source: State Bank of Pakistan

3.3 Credit to Private Sector

Credit to private sector grew by 11.2 percent in FY21, compared to an increase of 2.9 percent last year. This year's growth was led by fixed investment loans and consumer financing.¹¹ The overall credit offtake during FY21 was driven by three main factors. First, a better domestic demand along with an improved business confidence during the year compared to subdued demand last year,¹² particularly during the fourth quarter of FY20 due to Covid-related lockdowns (**Figure 3.11**).

Second, in contrast to FY20, the low interest rate environment further augmented the overall credit offtake during FY21. Third, SBP's concessional financing schemes, mainly enhanced LTFF during Covid and TERF drove up the fixed investment loans during the period under review.

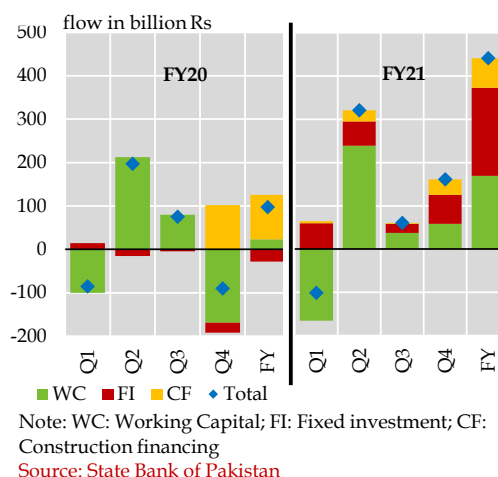
Higher borrowings by non-manufacturing sector pushed up working capital loans

Private businesses took Rs 169.5 billion in working capital loans during FY21, as compared to Rs 23.3 billion last year. The demand for these did not appear vibrant, as some of the major sectors such as textile, cement and motor vehicles that borrowed during FY20, retired their short-term loans this year (**Table 3.3**). This is consistent with the fact that banks actually received 8 percent fewer loan applications during FY21 on YoY basis. Although manufacturing businesses continued to dominate, the sevenfold increase in offtake during FY21 is mainly attributed to higher borrowings by non-manufacturing sectors, which posted net retirements last year.

Within manufacturing, bulk of the demand came from fertilizers, vegetable and animal oils and fats, and rice processing businesses. In the case of fertilizer, higher production raised

Loans to Businesses

Figure 3.11



the sector's short-term borrowings to Rs 41.0 billion in FY21, compared to a net retirement of Rs 26.6 billion last year.¹³ The increase was more pronounced in Q4-FY21, when a 221.6 percent YoY growth in fertilizer imports had raised the manufacturers' short-term borrowing needs.

In addition to fertilizer industry, vegetable and animal oils and fats also raised their short-term borrowings this year, compared to net retirements last year. The increase was on the back of higher edible oil prices in the international market, which is mainly imported by the edible oil businesses in the country.¹⁴

Likewise, the overall working capital loans of both the rice processing and sugar sector remained on the higher side than last year. Due to the seasonality factor, these businesses usually require short-term financing during the second quarter of a fiscal year, which coincides with the harvesting season of rice and sugarcane crops.¹⁵

Higher offtake by the rice processing firms more than offset net retirements during rest of

¹¹ Credit to the private sector mainly comprises loans to private sector businesses (84 percent of total private sector credit) and consumer financing (10 percent).

¹² LSM grew by 14.9 percent during FY21, compared to a decline of 10.2 percent last year. Further, the Business Confidence Index improved significantly from 39 in June 2020 to 64 in June 2021.

¹³ Fertilizer production rose by 7.0 percent during Jul-May FY21, against an increase of 5.6 percent last year.

¹⁴ During FY21, the import of soy bean oil rose by 261 percent (against 65 percent decline in FY20), and that of palm oil increased by 65 percent (compared to an increase of 12 percent in FY20), in rupee terms. (PBS)

¹⁵ For details, see SBP's second quarterly report on the State of Pakistan's Economy for FY21.

Loans to Private Sector Businesses

(flow in billion Rupees)

Table 3.3

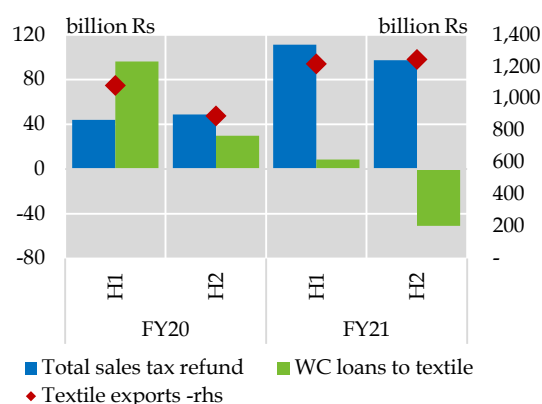
	Total Loans*		Working Capital**		Fixed Investment	
	FY20	FY21	FY20	FY21	FY20	FY21
Private Sector Businesses	97.6	441.4	23.3	169.5	-27.9	203.5
Manufacturing	161.4	258.2	109.8	111.1	48.3	141.5
Fertilizers	-31.9	37.6	-26.6	41.0	-5.3	-3.4
Vegetable and animal oils and fats	-11.1	34.8	-12.8	29.2	1.7	5.6
Rice Processing	-1.4	28.0	-1.7	26.7	0.3	1.3
Sugar	15.1	24.1	12.8	16.0	2.0	7.9
Refined petroleum	-20.4	13.7	-18.9	13.1	-1.4	0.5
Basic pharmaceutical products	7.9	18.5	5.0	6.2	2.8	12.3
Paper & paper products	-7.1	6.4	-5.0	2.3	-2.2	4.1
Cement, lime and plaster	26.2	0.2	26.4	-8.0	-1.2	7.8
Motor vehicles	14.6	-15.8	11.3	-23.7	3.3	7.9
Textile	168.8	26.3	125.9	-42.6	42.9	66.0
Non-manufacturing	-63.8	183.2	-86.5	58.4	-76.2	62
Electric power gen., trans., and distribution	9.0	66.5	15.1	7.2	-7.4	59.7
Telecommunications	25.5	21.8	-8.0	9.3	33.5	12.4
Wholesale and retail trade	-46.4	16.6	-43.4	7.5	-5.5	8.4
Transportation and storage	13.0	-5.9	22.8	-5.9	-10.1	-0.1
Accommodation	-3.7	4.1	-1.5	0.2	-8.3	-0.9
Mining and quarrying	15.0	-15.8	7.7	-13.4	7.3	-2.4
Real estate activities	1.1	1.5	-2.4	-1.0	-11.7	-2.7
Agriculture, forestry and fishing	-21.3	12.1	-10.4	17.0	-11.0	-5.0
Construction	-24.1	24.9	-46.0	3.0	-46.3	-16.7

*Total loans include construction financing of Rs 102.2 billion in FY20 and Rs 68.4 billion in FY21, as the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business (see IH&SMEFD Circular Letter No. 28 of 2020). Therefore, the loans data by type of finance for FY20 and FY21 may not be fully comparable; ** working capital includes trade financing

Source: State Bank of Pakistan

the year. On the other hand, besides seasonal offtake during Q2-FY21, sugar sector also borrowed in the subsequent quarter to cover higher sugarcane prices during Q3-FY21.

On the contrary, with a better liquidity position, some of the sectors managed to retire their loans, such as textile, motor vehicles and cement. Textile businesses posted a net retirement of Rs 42.6 billion in FY21, compared to an offtake of Rs 125.9 billion last year. Beside increased sales tax refunds by the government, higher export proceeds helped the sector in retiring its short-term loans (**Figure 3.12**).¹⁶ This is consistent with a 25 percent growth in textile exports during FY21, compared to an increase of 8.7 percent last year, in rupee terms. Despite higher cotton prices (major input in textile) that grew by over 18 percent in FY21, compared to an increase of 1.1 percent last year, textile sector

Working Capital Loans to Textile Figure 3.12

Source SBP, FBR, PBS

comfortably managed to retire its loans, as the sector had a better cash flow position in FY21, over last year. This is supported by the sector's profit after tax of Rs 35.6 billion during Jul-Mar FY21, compared to Rs 12.9 billion during the same period last year.¹⁷

¹⁶ As per the provisional estimates, sales tax refunds of over Rs 200 billion were released in FY21, compared to Rs 158 billion last year.

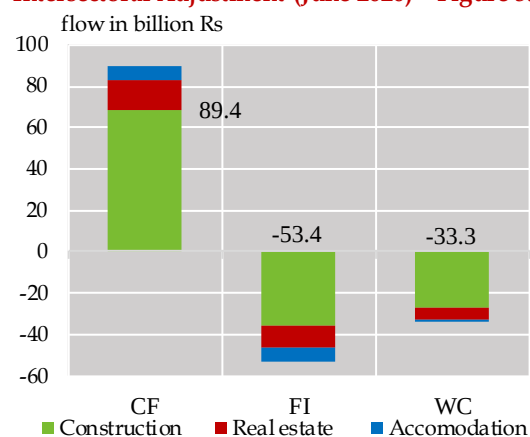
¹⁷ www.sbp.org.pk/departments/stats/pdf/FSA-Q.xls

With a better liquidity position, the automobile sector was also able to pay back its loans amounting to Rs 23.7 billion in FY21, compared to an offtake of 11.3 billion last year. The sector's overall profitability jumped to Rs 16.4 billion during Jul-Mar FY21 from Rs 52.0 million last year. This is also in line with 56.7 percent YoY growth in passenger car sales during the year. Likewise, cement manufacturing businesses were able to retire short-term loans of Rs 8.0 billion in FY21, compared to an offtake of Rs 26.4 billion last year. With the housing and construction activities gaining momentum, cement domestic dispatches rose by 20.4 percent during FY21, compared to a marginal decline of 0.9 percent last year. This mainly helped the sector in retiring its loans during the year.

In FY21, almost the entire increase in working capital loans was driven by the non-manufacturing sector, which posted an increase of Rs 58.4 billion in FY21, compared to a net retirement of 86.5 billion last year. Notably, loans to agriculture sector were prominent in FY21, which were entirely driven by lending to the farm sector. The increase in offtake can be traced to seasonal borrowings by rice and wheat growers. For instance, growers of rice increased their borrowings during Q2-FY21 (which coincides with the *Kharif* season); whereas, the wheat growers mainly resorted to bank financing during Q4-FY21 (*Rabi* season). Along with the seasonal factor, both the rice and wheat growers have borrowed working capital loans mainly to scale-up their production levels during FY21 (Chapter 2).¹⁸ Moreover, wholesale and retail trade sector borrowed Rs 7.5 billion in FY21, compared to a net retirement of Rs 43.4 billion a year earlier. This year's increase mainly came from wholesale of fertilizers, which was concentrated in the fourth quarter of FY21, as a significant rise in the international DAP prices during the quarter increased the borrowing needs of wholesalers.¹⁹

Further, last year's higher loan retirements mainly in construction sector dragged down the overall loans to non-manufacturing sector in FY20. It is important to note that with an inter-sectoral adjustment in credit to the private sector, banks have been separately reporting the data on credit/loans under construction financing since June 2020.²⁰ So, the loans for construction purposes have been shifted from working capital and fixed investment categories to a separate category for construction financing. As shown in Figure 3.13, loans to sectors, such as construction, real estate activities and accommodation were reclassified into construction financing. The sole purpose of this separate reporting is to monitor the progress on housing and construction finance in the country. This was consistent with an offtake of Rs 68.4 billion under construction financing.

Intersectoral Adjustment (June 2020) Figure 3.13



Source: State Bank of Pakistan

LTFF and TERF drove up fixed investment loans

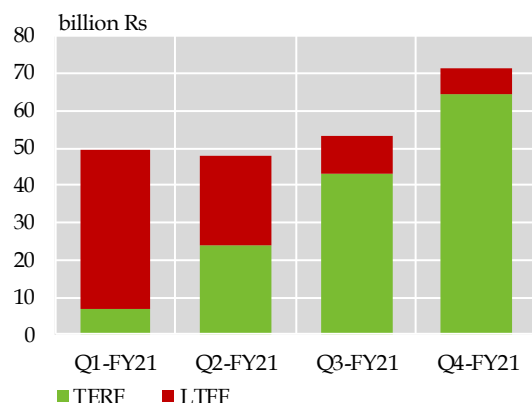
Fixed investment loans posted a significant increase of Rs 203.5 billion in FY21, compared to a net retirement of Rs 27.9 billion last year. The higher offtake in long-term loans was mainly on the back of SBP's concessionary financing schemes, mainly LTFF during the first half of FY21, and TERF afterwards (Figure 3.14).

¹⁸ During FY21, the production of wheat crop rose by 8.1 percent YoY, and that of rice grew by 13.6 percent over last year.

¹⁹ Average DAP prices in the international market grew by 110.6 percent YoY during Q4-FY21 (Haver Analytics).

²⁰ SBP IH&SMEFD Circular Letter No. 28 of 2020

Gross Disbursements under LTFF & TERF **Figure 3.14**



Source: State Bank of Pakistan

SBP launched TERF in March 2020 to counter the impact of Covid-19 pandemic through promoting industrial activity in the country. The scheme was valid for one year (till March 2021). By end-June 2021, a total financing of Rs 434.7 billion was approved under the scheme, out of which, Rs 138.6 billion (32 percent) were actually disbursed. Textile sector was the major beneficiary of the scheme, followed by construction, automobile, and food and beverages, as shown in **Figure 3.15**.

Textile sector dominated the overall fixed investment loans with a 54 percent YoY increase in the loan offtake during FY21. Benefitting from SBP's concessionary financing schemes, the sector availed long-term financing mainly to import textile machinery. This is consistent with a 52.8 percent growth in textile machinery imports

(in rupee terms) during FY21, compared to a decline of 21.5 percent last year.

Other than textile, pharmaceutical sector borrowed long-term loan of Rs 12.3 billion in FY21, compared to an increase of only Rs 2.8 billion in the same period last year. This mainly represents the acquisition of a chemical manufacturing business by a renowned pharmaceutical firm in the country during Q1-FY21.²¹

In the case of non-manufacturers, power sector was prominent with an offtake of Rs 59.7 billion in FY21, compared to a net retirement of Rs 7.4 billion last year. The sector availed long-term financing mainly to spend on capacity expansion, as well as to import machinery, as reflected by a 39.3 percent jump in the import of power generating machinery in FY21, compared to an increase of 8.7 percent last year.²²

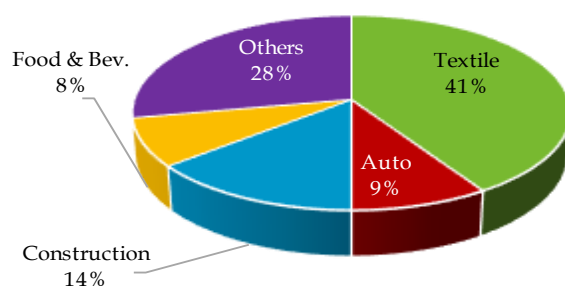
Telecom sector also increased its long-term borrowings in FY21, albeit at a slower pace than last year. The sector's borrowings were mainly concentrated in the last quarter of FY21, when two of the leading cellular firms operating in the country borrowed long-term loans for their network expansion.

Consumer loans recorded significant expansion

Given the low interest rate environment during the year, consumer loans increased by

Sector-wise share of TERF

Total Amount Approved



Source: State Bank of Pakistan

Total Amount Disbursed

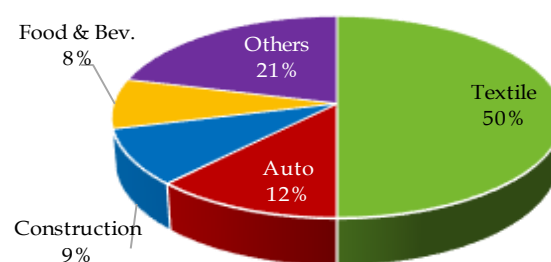


Figure 3.15

²¹ For details, see SBP's first quarterly report on the State of Pakistan's Economy for FY21.

²² PBS.

Rs 174.0 billion in FY21, compared to a retirement of Rs 7.9 billion in FY20. This increase mainly emanated from auto financing, which held 55.7 percent share in consumer financing during the year. Besides lower interest rates, the introduction of new variants of passenger cars by some auto assemblers and pent-up demand from delayed purchases last year played a significant role in driving up the auto-financing. Rest of the expansion in consumer lending is largely explained by financing in segments like personal and housing loans, which increased by Rs 43.0 billion and Rs 23.8 billion, respectively (**Table 3.4**).

The impetus to housing finance came from the measures taken by the government and SBP during FY21 in order to promote housing and construction financing in the country. For instance, in July 2020, SBP mandated banks to increase their housing and finance construction portfolio to at least 5 percent of their private sector advances by December 2021. Around 92 percent of the overall target set by SBP for June 30, 2021 has been achieved. Furthermore, the Government Markup Subsidy Scheme (G-MSS) was introduced in October 2020, commonly known as *Mera Pakistan Mera Ghar*, for low to middle income segments of the society. Later in March 2021, some of the features of G-MSS were revised to expand its outreach to the individuals and households who do not own a house.²³ As a result of these measures, the banks' housing and construction finance portfolio has increased to Rs 249 billion by end-June 2021 from Rs 148 billion a year earlier.

3.4 Inflation

National CPI inflation decelerated to 8.9 percent in FY21 compared to 10.8 percent last year, in line with the SBP forecast range for inflation announced in May 2020. Also, NFNE inflation, measuring underlying inflationary pressures, remained low and almost stable throughout the year. Broadly, five set of factors contributed to overall slowdown in inflation observed during the year. First, cost-

Consumer Financing
flow in billion Rupees

Table 3.4

	FY19	FY20	FY21
Total	65.8	-7.9	174.0
Auto loans	22.2	-4.3	97.0
Personal loans	13.9	9.2	43.0
House building	10.4	-12.8	23.8
Credit cards	7.0	-1.3	12.0
Consumers durable	3.7	1.3	-1.8

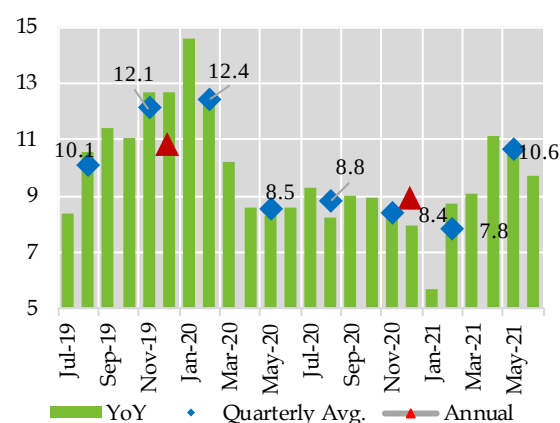
Source: State Bank of Pakistan

push inflation remained contained as domestic fuel prices have fallen from a relatively higher level a year ago and are below their pre-pandemic levels. This sharp fall in energy prices, which fed to household energy bills and motor fuel prices, were still weighing on overall inflation. Second, the overall demand-side pressures remained contained despite revival in the demand indicators, partly owing to the existence of spare capacity in the economy. Also, significant decline in the prices of some services like transport fares, fee of government institutions, tax on services etc., having relatively higher weight in core consumption basket, kept the underlying inflation in check. Third, tax relief measures in the wake of Covid-related situation in the Budget 2020-21 have proved largely effective. Fourth, favorable exchange rate environment during FY21 on account of improved current account deficit also helped pacify the underlying inflationary pressures. Also, it facilitated absorbing some of the increase in international commodity prices. Fifth, supply-side situation remained favorable in case of perishable food items that helped decelerating the inflation significantly in the said category. Notwithstanding the overall slowdown, inflation remained volatile during the year. Therefore, the full year inflation outcome should be analyzed in the context of volatile readings, particularly during H2-FY21 (**Figure 3.16**). With the start of the year, particularly in Q1-FY21, inflation continued to stabilize around single digit, a trend observed since April 2020, after experiencing double-digit inflation in FY20. In overall terms, with the exception of non-perishables food group, Covid-induced fall in the international fuel prices along with spare capacity in the economy largely helped to rein in inflationary

²³ SBP IH&SMEFD, SBP Circular No. 03 of 2021, dated March 25, 2021.

National CPI-Inflation

Figure 3.16



Source: Pakistan Bureau of Statistics

trends in the economy. While the inflation outturns were relatively low, further comfort to the pace of inflation came from decline in energy inflation and ease in prices of perishable food items in the second quarter of FY21.

With the start of H2-FY21, inflation further decelerated in January 2021 to lowest level (5.7 percent) on YoY basis since January 2019. Notwithstanding overall slowdown in Q3-FY21, CPI remained quite volatile during the quarter as inflation started inching-up from March 2021 onwards primarily on account of revision in electricity tariffs and rising fuel prices (on MoM basis). During first nine months of FY21, average inflation was 8.3

percent, however, high inflation in the last quarter (10.6 percent) dragged the average inflation to the higher end of the SBP forecast range. Meanwhile, food group, being the major contributor to overall inflation, persistently registered double-digit inflation throughout the year mainly on account of non-perishable food items.

In terms of dispersion, for the year under review, the inflation decline was concentrated in half of the sub-indices compared to the broad-based rise last year.²⁴ Meanwhile, in terms of both distribution and magnitude, the trends reversed during FY21 compared to last year. The number of items posting double-digit inflation during the first nine months of the FY20 started to shift toward the less than 5 percent bracket, depicting subsiding inflationary pressures in the economy (Figure 3.17).

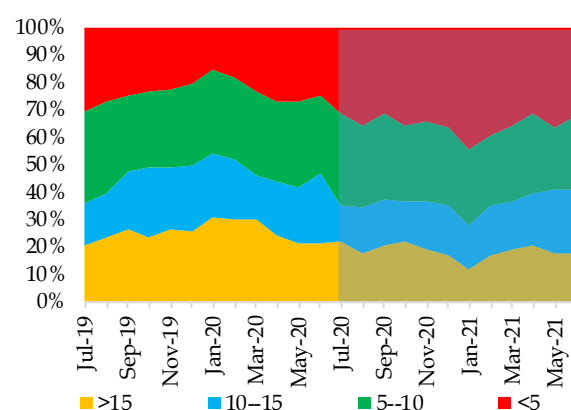
The category-wise breakdown suggests that food inflation remained the major contributor to headline inflation in both urban and rural areas, whereas underlying inflationary pressures (reflected in NFNE) were largely stable (Figure 3.18). Item-wise analysis reveals that around 75 percent of the inflation was concentrated in handful of commodities pertaining to energy and food groups (Figure 3.19).

Frequency Distribution of Urban CPI

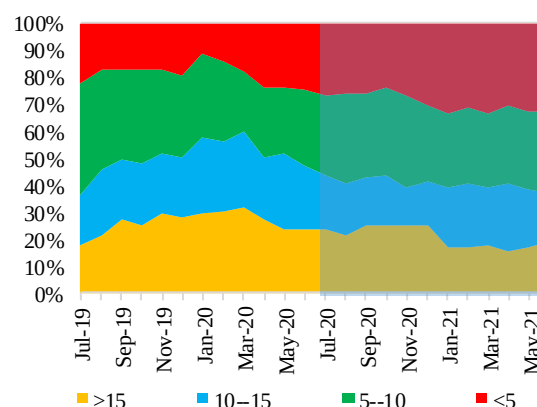
Figure 3.17a

Frequency Distribution of Rural CPI

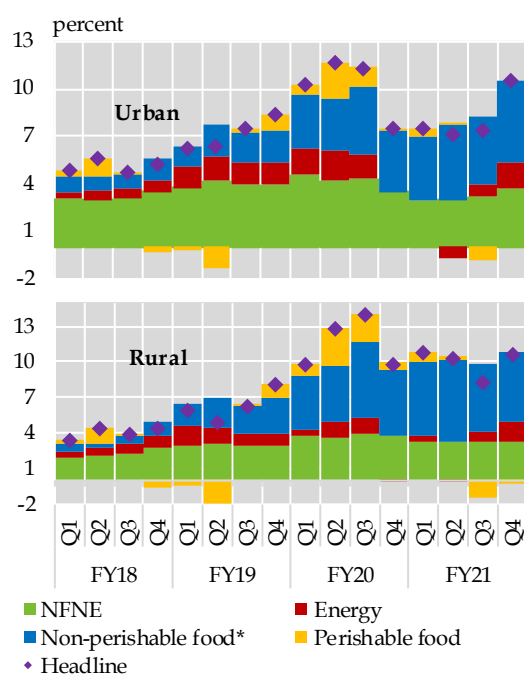
Figure 3.17b



Source: Pakistan Bureau of Statistics



²⁴ 53 out of 94-with around 56 percent share in CPI in urban indices and 49 out of 89-with around 55 percent share in CPI in rural indices.

Composition of YoY CPI Inflation Figure 3.18

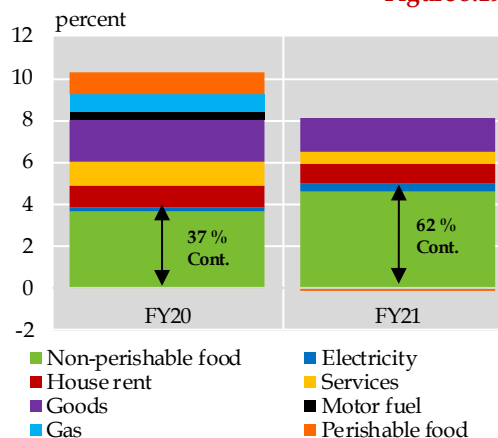
*Inclusive of alcohol beverages and readymade food
Source: Pakistan Bureau of Statistics

Inflation Expectations have been Broadly Stable and Remain Well Anchored

Inflation expectations, measured by IBA-SBP Consumer Confidence Survey (CCS), represented almost stable trends throughout FY21 (Figure 3.20). Notwithstanding overall stability, expectations readings remained somewhat elevated during second-half of the year. During first half, inflation expectations declined slightly on account of ease in food price expectations as non-perishable food prices registered significant decline. In H2-FY21, all the three categories (food, energy and NFNE), energy index in particular on account of revision in electricity tariffs, pushed the index slightly upwards. Broadly, overall inflation expectations remained anchored during the review period.

Food Remained the Dominant Source of Inflation

Though in double digits (12.4 percent) and main contributor to overall inflation (around 56 percent contribution), food inflation decelerated slightly in FY21 compared to FY20 (13.6 percent) on account of significant

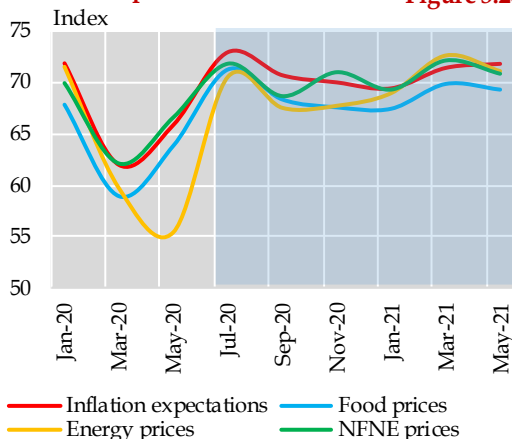
Inflation Contribution-Urban Figure 3.19

Source: Pakistan Bureau of Statistics

slowdown in perishable food items group (Figure 3.21).

Non-Perishable Food Items Registered Higher Inflation

After witnessing double-digit inflation in FY20, non-perishable food inflation further accelerated in FY21, contributing around 87 percent in total food inflation. Following factors led to further strengthening in inflation pace, (i) commodity management issues (wheat, sugar), (ii) rising international food prices on account of disrupted supply-chains owing to Covid situation across the globe and extreme weather-related unfavorable production prospects impacted domestic inflation directly and indirectly to a great extent, and (iii) Covid-related uncertainty regarding lockdowns gave rise to poultry inflation along with rising feed prices.

Inflation Expectations Figure 3.20

Source: State Bank of Pakistan

Heat Map- YoY Urban Inflation (Food Group)

Figure 3.21

	Wt.	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21
Food Index	36.8	15.1	11.3	12.4	13.9	13.0	12.6	7.3	10.3	11.5	15.7	15.3	11.0
Non-perishable food	26.0	16.2	13.6	13.2	16.7	15.9	15.9	12.2	15.4	17.2	19.4	19.3	13.5
Perishable food items	4.5	20.8	3.8	13.7	7.3	5.0	0.4	-18.9	-15.7	-15.6	4.6	-0.2	-2.5
Wheat	0.6	28.5	44.3	42.1	52.2	36.6	24.2	19.2	23.8	35.2	27.0	29.9	19.0
Wheat flour	3.0	18.5	23.4	20.2	24.7	13.3	13.4	7.2	13.5	18.9	16.9	28.5	13.4
Sugar	1.1	17.0	28.0	25.4	33.0	35.8	15.3	25.9	17.2	23.5	18.2	21.6	21.5
Condiments and Spices	1.3	39.5	38.9	40.9	36.6	37.6	47.4	27.2	31.1	28.7	31.6	26.7	23.3
Pulses	0.7	25.5	20.9	22.9	23.3	16.1	14.2	1.6	3.5	8.1	-7.4	-5.6	-4.3
Poultry (Egg, Chicken)	1.9	38.4	-23.3	-9.4	25.8	47.4	66.3	8.5	39.5	47.0	75.8	58.5	8.1
Edible Oil(Oil & Ghee)	2.1	19.7	13.8	13.4	13.5	12.4	13.8	17.6	16.3	16.4	20.1	21.4	22.9

Heat Map- YoY Rural Inflation (Food Group)

	Wt.	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21
Food Index	45.9	17.8	13.5	15.8	17.7	16.1	13.4	7.2	9.1	11.1	14.1	12.8	9.8
Non-perishable food	35.1	16.8	15.1	16.3	19.5	18.9	16.8	13.1	13.9	16.9	17.2	16.9	12.2
Perishable food items	5.8	25.4	3.7	16.9	13.4	7.4	-1.6	-23.7	-19.3	-19.4	0.5	-8.2	-5.5
Wheat	3.5	30.4	41.1	45.1	51.1	37.9	28.1	24.4	23.1	32.5	24.5	27.7	20.1
Wheat flour	3.4	21.6	26.2	26.7	29.4	19.6	15.8	13.7	16.6	20.8	19.3	26.0	14.4
Sugar	2.0	16.6	25.5	25.3	33.4	42.5	12.8	23.5	15.1	22.7	16.5	21.7	20.7
Condiments and Spices	1.5	59.6	48.8	57.8	53.7	53.7	49.6	31.4	24.2	23.3	13.7	4.0	-1.9
Pulses	1.1	28.4	20.8	25.2	23.5	16.4	13.2	3.2	2.4	6.8	-4.5	-5.9	-7.3
Poultry (Egg, Chicken)	2.0	37.0	-13.5	-7.1	23.7	43.3	63.7	12.0	29.4	52.9	71.9	58.0	12.6
Edible Oil(Oil & Ghee)	3.0	21.9	18.8	16.6	16.6	17.1	17.8	16.9	18.3	19.1	21.8	26.1	27.6

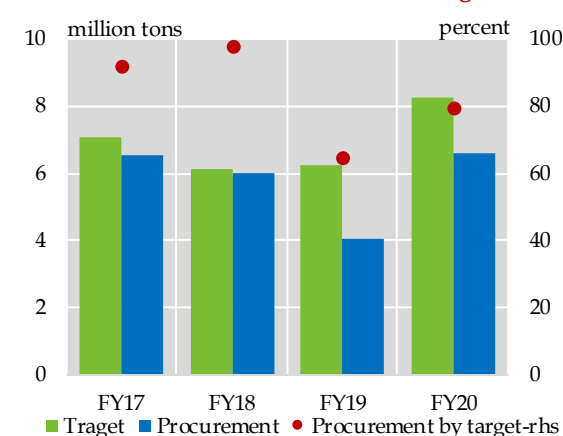
*Lighter shades depict lower (and negative) inflation and darker shades indicate higher inflation on YoY basis.

Source: Pakistan Bureau of Statistics

In the case of wheat, despite significant imports during the year, multiple factors kept the inflation on the higher side.²⁵ First, for the year 2020, wheat crop put upward pressures on prices because of low production (crop size of 25.25 MMT against a target of 27.03 MMT). Second, from the perspective of government's commodity operations, relevant agencies missed the procurement targets almost for the second consecutive year (Figure 3.22). One possible reason for this could be the increasing difference between the support price and the wholesale price of wheat at the time of procurement.²⁶ Also, timely release of stocks by the procurement agencies plays an important part in managing the price pressure which was somehow mismanaged during the first half of the year. Third, the import process seemed to be slow at the start of the year which could not fill the supply-demand gaps in the market as ECC allowed wheat import

Public Sector Wheat Procurement

Figure 3.22



by end- June 2020 whereas first shipment arrived in August 2020. Also, relatively high international wheat price seems to have discouraged the private dealers in aggressive participation in imports. Fourth, speculative activities also have played a central role in

²⁵ 3,613 thousand MT of wheat was imported during FY21.

²⁶ See Chapter 3, SBP's first quarterly report on the State of Pakistan's Economy for FY21.

price increase as government was persistently warning for strict action against those found involved in hoarding.

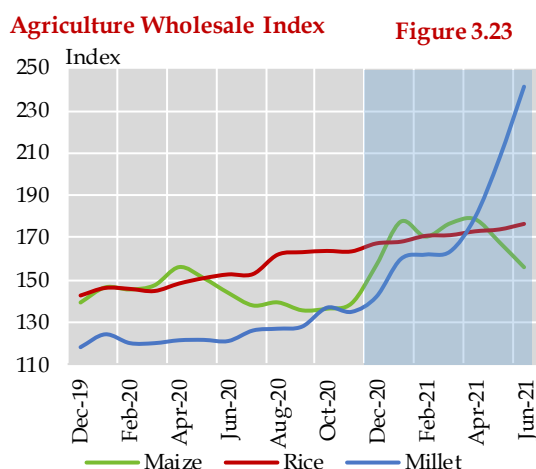
Inflation outturns for sugar also remained on the higher side during FY21. Price pressures persisted despite the significant imports during the year.²⁷ The double-digit inflation in sugar can be explained by the following factors. (i) decline in sugar stocks to 5.3 MMT in FY20 from 6.7 MMT in FY19²⁸ on account of low sugarcane production in FY20,²⁹ (ii) absence of information about reliable stock position and anti-competitive activities by the industry as noted by Competition Commission of Pakistan's enquiry report (October, 2020) and (iii) increase in Minimum Support Price (MSP) for sugarcane in FY21.

Poultry group posted double-digit inflation during the year, contributing around 12 percent and 14 percent to total food inflation of urban and rural areas, respectively. While consumers were struggling with supply- and demand-related price pressures amid Covid-related lockdowns and uncertainty, poultry feed prices also surged, following the trend of

international prices (**Figure 3.23**). As per industrial experts, poultry feed is around three-fourth of the total input cost of producing chicken and egg, while imported ingredients constitute major part of the poultry feed.

In case of condiments and spices, inflation surged significantly during the review period. Disaggregated information reveals that red chili powder dragged-up the overall index of condiments and spices. Production and area under cultivation of red chilies, both declined significantly during FY21.³⁰ Price pressures persisted despite significant imports made in order to fill the supply-demand gap.³¹

The increase in edible oil prices observed since the beginning of the year, persisted throughout the year, keeping the inflation at the higher side. Three sets of factors led to increase in inflation in this group. First, international palm oil and soybean prices started increasing with the reopening of the economies and release of pent-up demand. Second, supply-chain constraints due to labor shortages resulting from a decline in the number of migrant workers including shipping bottlenecks, pushed-up the prices of edible oil (**Box 3.2**)³². Third, tight inventory levels in major exporting countries due to weather-related concerns in the major producing areas put upward pressure on edible oil prices. Though inflation in the edible oil group, having higher imported content, was high amid rising international food prices, favorable exchange rate conditions absorbed much of the intensifying impact (**Figure 3.24**).



²⁷ 3597 thousand MT of sugar was imported during FY21 compared to 282 thousand MT last year.

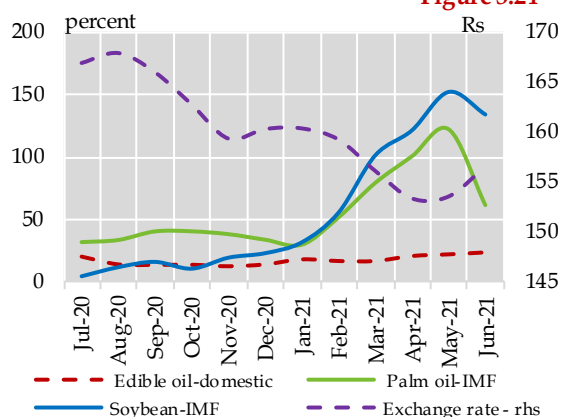
²⁸ Competition Commission of Pakistan, Enquiry Report October, 2020.

²⁹ In FY20, 66.37 million tons of sugarcane was produced compared to 67.17 million tons in FY19. In FY21, 81.00 million tons of sugarcane has been produced.

³⁰ Production registered 26.7 percent decline during FY21, while, area under cultivation reduced by 24.8 percent.

³¹ 198.5 thousand kg red chilies were imported during FY21 compared to 0.4 thousand kg last year.

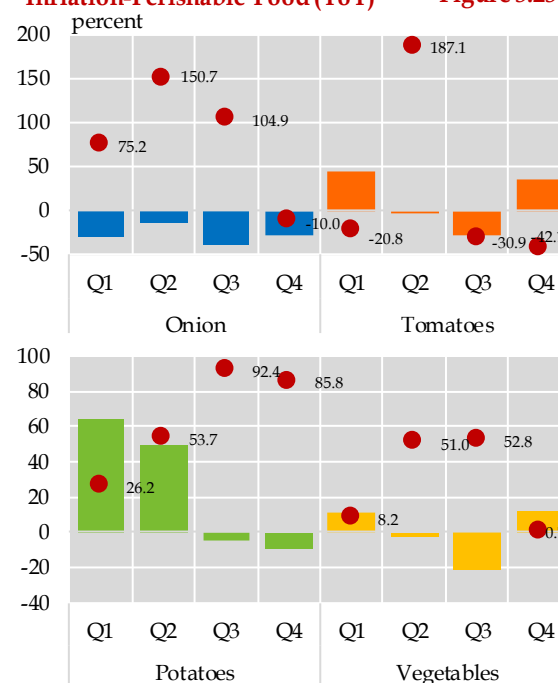
³² Palm oil harvesting and processing operations have been increasingly affected by labor force reduction, especially in Malaysia, where several plantations were suffering from acute shortages of migrant laborers triggered by policies to curtail the spread of Covid.

Inflation in Edible Oil**Figure 3.24**

Source: PBS, IMF

Inflation in Perishable Food Items Decelerated Significantly

After witnessing high inflation in FY20, perishable food group, consisting of fresh vegetables, fruits, tomatoes, potatoes and onions, registered significant deceleration in FY21.³³ For instance, in the case of tomatoes, improved local production and higher imports caused prices to remain low and stable.³⁴ Similarly, price of onions averaged around Rs 47 in urban areas this year compared to Rs 66 last year. Both better domestic crop and adequate imports caused decline in onion prices in FY21 (Figure 3.25).³⁵

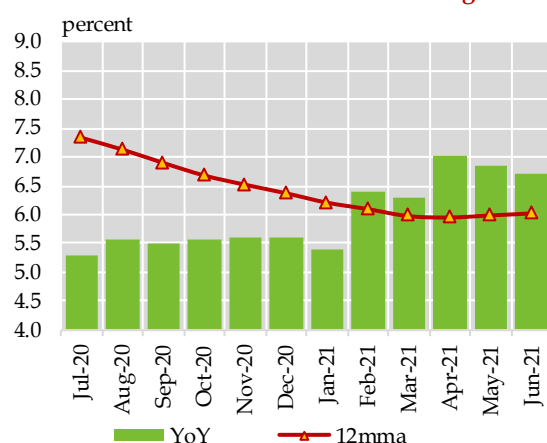
Inflation-Perishable Food (YoY)**Figure 3.25**

* bars denote FY21 and dots denote FY20

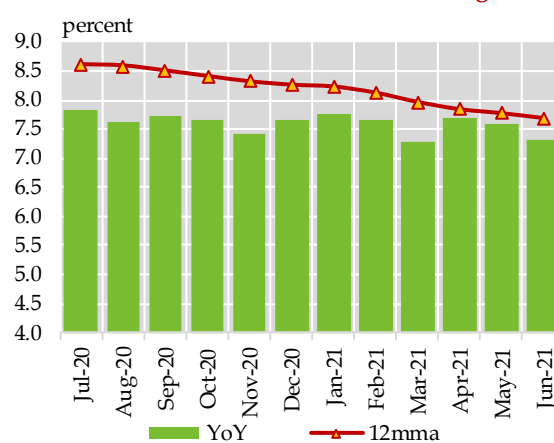
Source: Pakistan Bureau of Statistics

NFNE Remained Broadly Low and Stable

NFNE inflation decelerated for both urban and rural segment during FY21 compared to last year (Figure 3.26). Broadly speaking, slowdown implies that ease in cost-push pressures on account of muted fuel prices and

Urban NFNE - YoY Growth**Figure 3.26a**

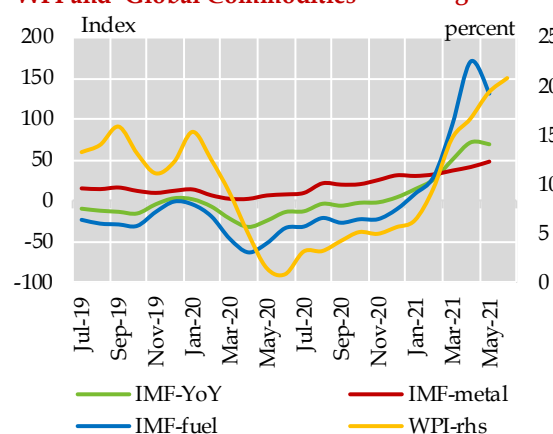
Source: Pakistan Bureau of Statistics

Rural NFNE - YoY Growth**Figure 3.26b**

³³ High temperatures, untimely rains and hurdles in issuance of import permits affected imports of various vegetables and created temporary shortages in the domestic market, exerting temporary price pressures in FY20.

³⁴ Local production of tomatoes increased by 12.8 percent during FY21, whereas, imports rose by around 55 percent during FY21.

³⁵ Local production of onions remained almost at FY20 level; imports rose by around 82 percent during FY21.

WPI and Global Commodities **Figure 3.27**

Source: Pakistan Bureau of Statistics and IMF

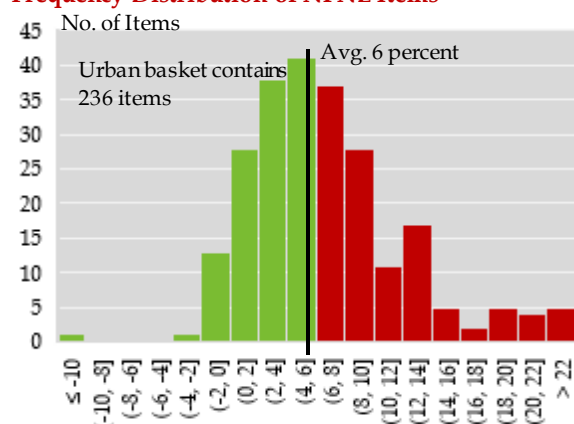
non-inflationary Budget 2020-21 have proved largely effective in arresting the pace of core inflation (**Figure 3.27**). Moreover, the presence of spare capacity in the economy (negative output gap) and favorable exchange rate conditions during the year also facilitated in containing the underlying inflationary pressures.

In the case of urban and rural areas, pace of inflation in both goods and services declined significantly, however, the impact of the latter was more pronounced. House rent inflation, on the other hand, remained almost at the same level observed last year. Indices-wise information (for goods group) reveals that barring few categories (clothing and footwear, furniture and household equipment and therapeutic appliances and equipment), broad-based deceleration was registered. Disaggregated analysis reveals that downward pressure on prices of construction

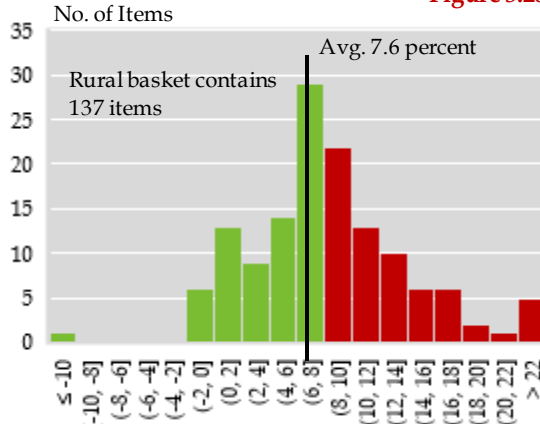
related items has been registered, especially in cement, crushed stone (bajri) and iron bars. The FED on portland cement, aluminous cement, slag cement, super sulphate cement and similar hydraulic cements has been reduced in Budget 2020-21 from Rs 2/kg to Rs 1.75/kg in the wake of Covid.

For services group, on the other hand, deceleration is concentrated in around one third of the indices in urban areas and around half of the indices in rural areas. Component-wise analysis, both for urban and rural areas, shows that this has been driven by a combination of Covid-related factors. For instance, no change in motor vehicle tax, subdued construction wages and education fee played a significant role in driving down the overall services inflation. In education sector, the decline came from both private and public school/college fees. This can be attributed to: (a) concession in tuition fees as provided in the Sindh Covid Emergency Relief Ordinance, 2020, as well as The Punjab Private Educational Institutions Ordinance, 2020; and (b) withdrawal of collection of advance tax on tuition fee by some educational institutions, in addition to the Supreme Court's decision taken earlier in FY20 to restore school fees to the 2017 level, on which it fixed the maximum increase in fees at 5 percent a year. In addition, motor vehicle taxes posted no change in inflation on account of no new taxes imposed by the government in order to provide Covid related relief to the masses.

Item-wise commodity basket of urban and rural areas reveals that around half of the

Frequency Distribution of NFNE Items

Source: Pakistan Bureau of Statistics

Figure 3.28

items posted above the average NFNE inflation during the year. Heavy-tail distribution hints towards the fact that inflation deceleration in the commodities having relatively higher weight in the overall NFNE basket is likely to have played a role in overall decelerating inflationary pressures (Figure 3.28).³⁶ For instance, items like fee of government institutes, transport fares, newspapers and service taxes have played substantial role in slowing down NFNE inflation.

Energy Inflation Posted Deceleration

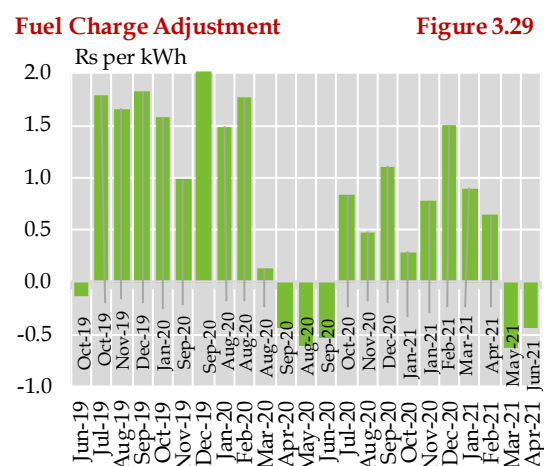
Energy inflation registered significant deceleration for urban areas in FY21 compared to last year, however, it rose marginally for rural areas during the same period compared to FY20. Notwithstanding overall deceleration in energy inflation for urban community in FY21, inflation remained volatile, particularly during the second half of the year. Barring gas index, all other sub-indices of energy group rose sharply during the last quarter.

Disaggregated analysis for full year, in case of urban segment, shows that double digit inflation in electricity prices was more than offset by deflation in fuel prices and liquefied hydrocarbon. For rural areas, though fuel and liquefied hydrocarbons registered deflation on YoY basis, rise in electricity tariffs and solid fuel predominantly dragged-up the energy inflation.

In the case of motor fuel, the prices remained stable, however, on YoY basis it posted deflation during the first eight months. However, from March 2021 onwards, the motor fuel prices rose significantly, dragging

YoY inflation on higher level, following the gain in global crude oil prices on account of improved global growth prospects with the arrival of vaccines and increased demand for oil-intensive activities such as transport and aviation.³⁷ On a cumulative basis, urban inflation rose by 17.2 percent during March and June 2021.

For electricity inflation, after posting 1.3 percent decline during Jul-Jan FY21, significant YoY rise was recorded from February 2021 onwards as government enhanced its efforts to address energy sector issues pertaining to circular debt. Measures included i) increase in base tariff of Rs 1.95/kWh of Distribution Companies (Discos)-including life-line consumers consuming up to 50 units per month and ii) notification of the Q2-FY20 and Q3-FY20 quarterly tariff adjustments (QTAs) in December 2020 and Q4-FY20 QTA in February 2021. Also, monthly fuel charge adjustments added to surge in inflation (Figure 3.29)



Source: NEPRA

Box: 3.2 Global Inflation Behavior after Covid-19

The Covid-19 pandemic posed significant challenges to global economy led by slowdown in demand, rising poverty levels amid loss of businesses and employment, disruption in supply chains, increasing financing need to meet Covid management spending, etc. In this backdrop, preliminary analysis of the global inflation behavior,

³⁶ Urban frequency distribution shows that around **49 percent items** remained in the group showing more than 6 percent average inflation whereas Around **7 percent items** posted inflation equal or less than zero. Rural frequency distribution shows that around **51 percent items** remained in the group showing more than 7.6 average percent inflation whereas around **5 percent items** posted inflation equal or less than zero.

³⁷ In addition to improved demand for crude oil, decision of cut in oil production by some OPEC countries also put upward pressures on oil prices.

especially in emerging economies highlights that dampened demand pulled down inflation levels in the initial months after the pandemic outbreak across countries. However, from May 2020, with a global shift towards smart lockdowns and the consequent pickup in economic activity, international commodity and fuel prices has started to rise. The trend further strengthened in April 2021, with the global availability of Covid vaccine. A persistence increase in these price pressures, may lead central banks to reverse the expansionary policy stance which may restrict the pace of economic recovery.

Waning inflationary pressures during January 2020 to May 2020-global scenario:

With the start of the pandemic, global inflation declined by 0.8 percentage points, during four months i.e., from January 2020 to May 2020. Similarly, the Emerging Markets and Developing Economies (EMDEs) and advanced-economies inflation also witnessed 1.2 and 1.6 percentage points declines in inflation respectively, during this period (Figure 3.2.1).

Demand-side factors put downward pressure on global inflation

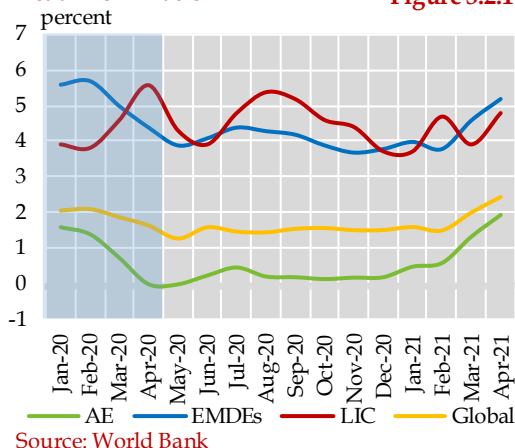
Subdued aggregate demand: Worldwide strict lockdowns along with weaker consumer confidence negatively affected the aggregate demand. Depressed economic activities along with weakened demand put downward pressure on prices.³⁸

Decline in global fuel prices: Oil prices dropped significantly after the onset of pandemic as lockdowns disrupted the transport and travel services that account for around two thirds of global energy consumption (Figure 3.2.2).³⁹ Reduced demand for fuel affected prices and contained the pace of inflation.

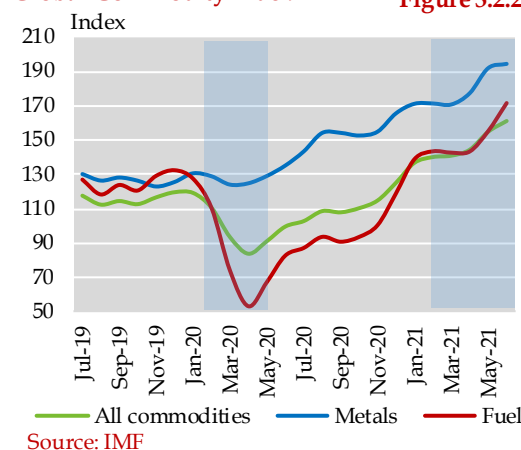
But few supply-side factors put upward pressure on prices

Supply-chain disruptions: Supply chain disruptions have been a major challenge since the outbreak of pandemic. Strict lockdowns at the start of Covid-19 interrupted economic activity, especially the services sector, as restrictions were imposed on dealings that required in-person collaboration. Likewise, labor shortages resulting from a decline in the number of migrant workers disrupted production. In addition, hoarding practices by some countries, increased border controls and customs regulations resulting in longer wait times affected the smooth supplies of goods and put upward pressure on prices of commodities.⁴⁰

Headline Inflation **Figure 3.2.1**



Global Commodity Index **Figure 3.2.2**



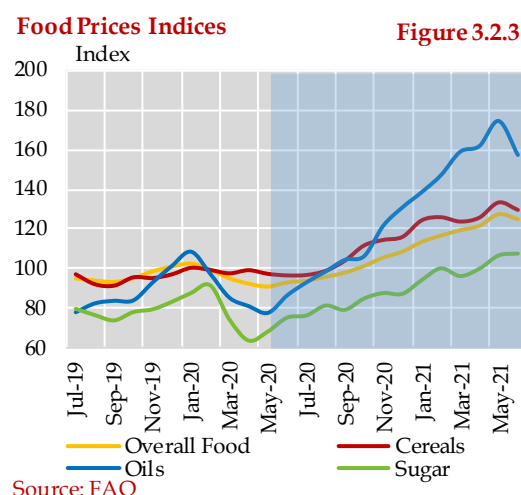
³⁸ A.C. Dunn, K. K. Hood, and A. Driessen (2020). *Measuring the Effects of the COVID-19 Pandemic on Consumer Spending Using Card Transaction Data*. Bureau of Economic Analysis Working Paper 2020-5. Washington D.C.: U.S. Department of Commerce

³⁹ C.M. Wheeler, J. Baffes, A. Kabundi, G. Kindberg-Hanlon, P. S. Nagle and F. Ohnsorge (2020). *Adding Fuel to the Fire: Cheap Oil during the COVID-19 Pandemic*. Policy Research Working Paper 9320. Washington, D.C.: WB

⁴⁰ According to the WTO, around 80 countries and customs territories introduced prohibitions or export restrictions as a result of the COVID-19 pandemic (IMF Research-September 2020)

Currency depreciations: In EMDEs, weakening of currency during the pandemic was one of the factors behind rising inflationary pressures, as around one fifth of EMDEs ended 2020 with weaker exchange rates than at the start of the year.⁴¹

Food supply disruptions: Market and trade restrictions, discussed earlier, affected domestic food supply chains in some countries. Supply disruptions in agriculture products due to labor shortages also caused price pressures.⁴² Similarly, the value chain for fruits, the most perishable items which require labor-intensive handling and rapid (often airborne) transport, was also affected.⁴³ Thus, rising wholesale and retail markups and non-availability of the products contributed to rising food price inflation.⁴⁴

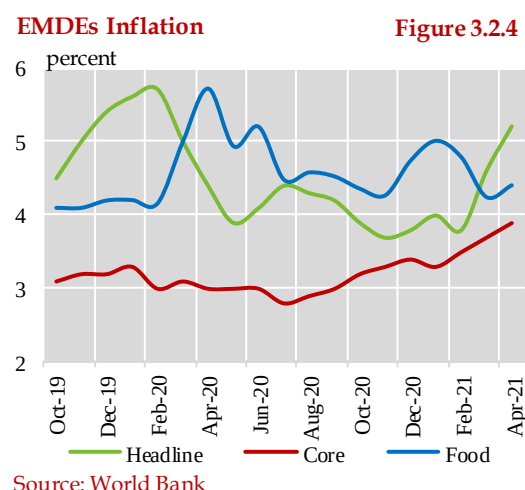


The significant dip in the global inflation reflects that the impact of demand-side factors more than offset the impact of supply-side factors during the initial four to five months.

Resurgence in global inflation – May 2020 onwards:

In May 2020, however, global inflation started to gain upward momentum, although it remained low by historical standards. With the revival in activity and demand on account of imposition of smart lockdowns, consumption shift from in-person to online transactions, prices of fuel and metal started rising. In addition to this, food prices started to surge as well (**Figure 3.2.3**). While the supply-chain disruptions were already developing rising food inflation expectations with the beginning of the Covid containment phase, weather related supply shocks further spiraled the food inflation. For instance, prices of edible oil increased most due to supply shortfalls (**Figure 3.2.3**). Similarly, wheat prices posted significant rise in prices reflecting strong global demand and unfavorable growing conditions in major parts of the wheat growing regions (for details see Box 3.1 of First Quarterly Report FY21 on the State of the Pakistan's Economy).

By April 2021, global inflation further picked up its pace and rose above pre-pandemic levels, especially in EMDEs. Improved global recovery prospects⁴⁵ with the rolling-out of vaccines, recovery in fuel prices and ever-rising global food prices accelerated the rising pace of inflation. Food group, in particular, witnessed surging inflation on account of Covid-related supply chain bottlenecks,⁴⁶ shipping delays, elevated transport costs and weather uncertainties. Consequently, in EMDEs, both headline and core has surpassed the pre-pandemic levels, however, the pace of latter is steeper (**Figure 3.3.4**).



⁴¹ Global Economic Prospects-June 2021, World Bank

⁴² Palm oil harvesting and processing operations were affected by labor force reduction, especially in Malaysia, where several plantations suffered from acute shortages of migrant laborers triggered by policies to curtail the spread of Covid.

⁴³ FAO price indices for oilseeds, vegetable oils and oil meals, October 2020

⁴⁴ J. Swinnen, and J. McDermott (eds.) (2020). *COVID-19 and Global Food Security*. Washington, D.C.: IFPRI

⁴⁵ World economy is projected to grow by 5.6 percent in 2021 (WB).

⁴⁶ Covid-related congestion at North European and Asian terminals interrupted trade plans by end FY21 (Institute of Export & International Trade-UK).

Rising inflation in EMDEs and low-income countries (LICs), particularly, may compound challenges for the policy makers. With the pandemic still a major risk on account of new emerging virus variants and a number of economies in some sort of lockdown, the disruption in supply chains still remains a concern. Supply chain issues from multiple waves of the pandemic, as well as weather-related subdued production prospects for some cereal crops have built price pressures. Consequently, higher inflation for food group, which accounts for about half of consumption in LICs and a large portion in EMDEs, may further add to inflationary pressures in these economies. From the policy perspective, a fleeting rise in inflation may not merit a monetary policy response. However, if rising price pressures persist and potential second-round impact emerges, EMDEs central banks may re-consider to change their accommodative monetary policy stance sooner than expected. For EMDEs particularly, inflation forecasts indicate towards rise in inflation in 2021 that may exceed their target bands.⁴⁷

⁴⁷ Global Economic Prospects-June 2021, Washington D.C.: WB.

Chapter 4

Fiscal Policy

Increase in tax revenues and restraint on non-interest current spending underpinned a reduction in fiscal deficit to 7.1 percent of GDP during FY21, from 8.1 percent last year. This improvement for the second year in a row was also helped by a combined provincial surplus that exceeded the budget target for FY21. The seasonal spending pressures during the last quarter of the year pushed the primary surplus seen during Jul-Mar FY21 into a deficit during FY21. However, the recovery in revenues kept the level of primary deficit at a two-year's low. The increase in tax revenue was contributed by both federal and provincial governments. The growth in FBR tax revenues was driven by a rebound in economic activity, surge in imports, tax administration efforts, and the impact of a low base of last year. On the spending side, federal non-interest current expenditures remained contained, while development spending posted a recovery during FY21, after a consistent decline in last three years. The government was able to create fiscal space for undertaking spending on social safety nets, Economic Stimulus Package (ESP) and provision of targeted support to various sectors of the economy to mitigate the recessionary impact of the pandemic. At the same time, the country made payment to partially settle the circular debt of Independent Power Producers (IPPs) and Power Holding Private Limited (PHPL), while loss making Public Sector Enterprises (PSEs) continued to strain fiscal accounts during the year.

4 Fiscal Policy

4.1 Fiscal Policy Review

The country successfully continued to implement fiscal consolidation during FY21 and witnessed a notable reduction in the fiscal deficit to 7.1 percent of GDP from 8.1 percent last year (**Figure and Table 4.1**). This improvement was driven by a large increase in tax collection and a slowdown in non-interest current spending. Moreover, a greater than target provincial surplus of 0.7 percent of GDP further supported this outcome.¹

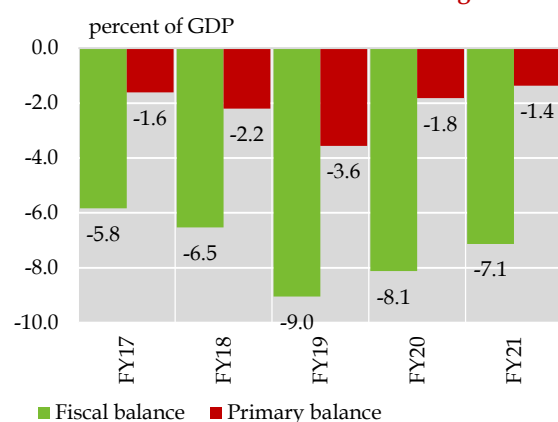
Tax revenue edged up by 19.5 percent during FY21, compared to 4.3 percent last year. This improvement was contributed by both the federal and provincial governments. Specifically, FBR taxes posted a five years' high growth of 18.4 percent and surpassed the revised target by Rs 41.0 billion. This growth was underpinned by a sustained recovery in economic activity, along with a strong increase in imports, FBR's administrative efforts to streamline the audit procedures, anti-smuggling measures, and steps taken to reduce informality. In overall terms, these reforms led to a slight uptick in FBR tax-to-GDP ratio during FY21, in the absence of any major increase in tax rates (**Figure 4.2**). The impact of these measures was compounded by the effect of a low base from the Covid-led contraction during the last four months of

FY20. To put things into perspective, FBR taxes posted 6.5 percent YoY increase during Jul-Feb FY21, however a 49.3 percent YoY surge in tax collection during Mar-Jun FY21, pushed the growth to 18.4 percent for the whole year.

The expansion in provincial revenue collection stemmed from the increase in GST collection on services and higher profits from hydro-electricity. The non-tax revenues, on the other hand, declined in FY21. This fall primarily came from lower SBP and PTA profits compared to last year. To partially offset the decline in non-tax receipts, the authorities resorted to increase the rates of petroleum development levy (PDL) during the year, which rose to a historic high in November 2020, before edging down with an increase in the international oil prices. However, since non-tax revenues are not necessarily recurring items with constant growth, they are not considered a stable source for financing expenditures.

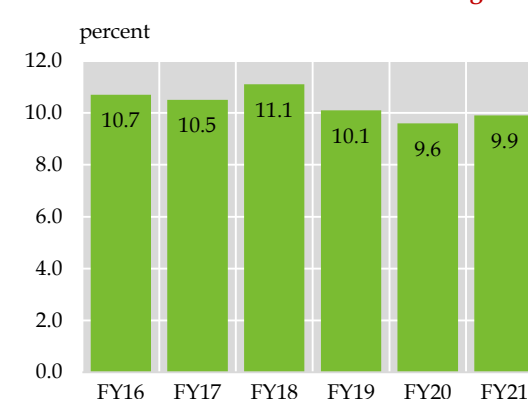
On the expenditure side, the government created fiscal space for undertaking spending on social safety nets, Economic Stimulus Package (ESP) and provision of targeted support to various sectors of the economy by restraining non-interest current spending. Specifically, the expenditures on running of civil government and pensions contracted in

Fiscal Indicators **Figure 4.1**



Source: Ministry of Finance

FBR Tax to GDP Ratio **Figure 4.2**



Source: Ministry of Finance

¹ The target for provincial surplus was set at 0.5 percent of GDP at the start of the year.

Consolidated Fiscal Indicators

billion Rupees, growth in percent

Table 4.1

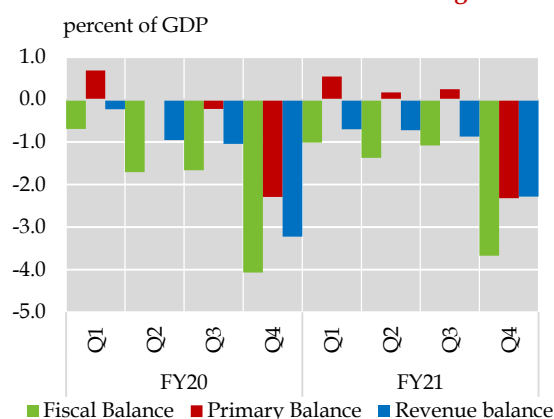
	FY20	FY21	YoY growth		Q4	
			FY20	FY21	FY20	FY21
1. Total revenue (a+b)	6,272.17	6,903.37	28.0	10.1	1582.3	1910.8
(a) Tax revenue	4,411.54	5,272.70	4.3	19.5	1046.0	1507.7
Federal	3,997.92	4,764.30	4.4	19.2	953.6	1369.4
Provincial	413.617	508.397	2.9	22.9	92.4	138.3
(b) Non-tax	1,860.63	1,630.67	177.9	-12.4	536.3	403.1
Federal	1,758.24	1,480.40	201.5	-15.8	513.5	335.0
Provincial	102.389	150.275	18.6	46.8	22.8	68.1
2. Total expenditure (a+b+c)	9,648.49	10,306.6	15.6	6.8	3272.4	3662.1
(a) Current expenditure	8,532.02	9,084.01	20.1	6.5	2920.5	2998.6
Of which : Mark-up payments	2,619.74	2,749.73	25.3	5.0	740.0	645.9
Non-markup expenditure	7,028.75	7,556.96	12.4	7.5	2532.4	3016.2
Defense	1213.281	1316.418	5.8	8.5	410.8	532.5
Subsidies	359.9	425.0	84.2	18.1	n.a.	220.8
(b) Development expenditure & net lending	1203.741	1315.7	-1.3	9.3	422.3	592.7
(c) Statistical discrepancy	-87.273	-93.0	-	-	-70.4	70.8
3. Overall budget balance	-3,376.32	-3403.3	-2.0	0.8	-1690.1	-1751.3
percent of GDP	-8.1	-7.1			-4.1	-3.7
4. Primary balance	-756.6	-653.6	-44.1	-13.6	-950.1	-1105.4
percent of GDP	-1.8	-1.4			-2.3	-2.3
5. Revenue balance	-2259.9	-2180.6	2.6	-3.5	-1338.2	-1087.8
percent of GDP	-5.4	-4.6			-3.2	-2.3
6. Financing (a+b)	3,376.3	3,403.32	-2.0	0.8	1690.1	1751.3
(a) External (Net)	895.5	1338.090	114.9	49.4	213.1	775.9
(b) Domestic (Net)	2,480.8	2,065.23	-18.1	-16.8	1477.0	975.3
Non-Bank	540.2	196.189	-29.4	-63.7	138.2	-95.9
Bank	1,940.6	1869.041	-14.3	-3.7	1338.7	1071.3

Source: Ministry of Finance

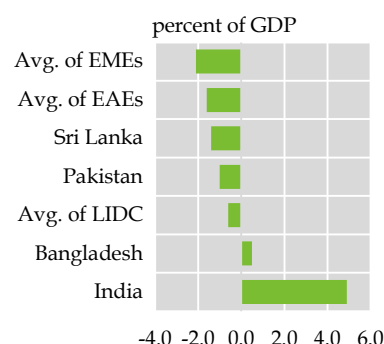
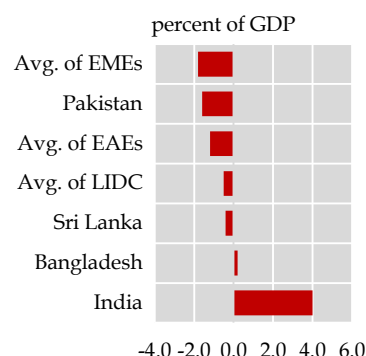
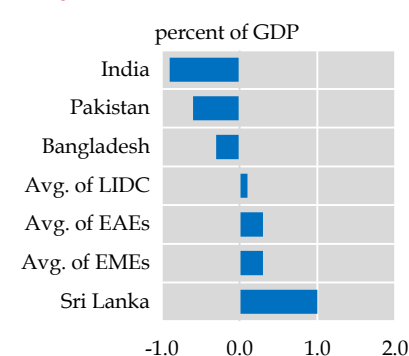
FY21, compared to last year. On the other hand, development expenditures staged a recovery after showing a consistent decline during the past three years. This rebound primarily came from a hike in provincial PSDP spending, while federal expenditures remained muted. Interest payments stood at 57.7 percent of FBR tax revenues, despite witnessing a slowdown amid lower interest rates during the year.

The quarterly analysis indicates a seasonal increase in the fiscal deficit during the fourth quarter of the year (**Figure 4.3**). This increase was seen despite a large expansion in revenues (Rs 328.5 billion) during the quarter, which was outpaced by a yet strong increase (Rs 389.7 billion) in expenditures. This spending pressure mainly came from a recovery in development expenditures, substantial increase in subsidies to the power sector, sustained burden of interest payments, and social protection grants. With this expansion in spending in Q4-FY21, the

primary balance for FY21 slipped into a deficit, after remaining in surplus during Jul-Mar FY21. Similarly, revenue deficit that shows the difference between total revenues and current expenditures also remained at an elevated level in FY21.

Fiscal Indicators**Figure 4.3**

Source: Ministry of Finance

Addition in Fiscal Deficit in 2021**Change in Expenditure in 2021****Change in Revenue in 2021****Figure 4.4**

AE: Advanced economies; EMEs: emerging market economies; EAEs: Emerging Asian economies; LIDC: Lower income developing economies. Note: The data is reported on calendar year basis for all countries except India, Bangladesh, and Pakistan. Projections are used for 2021 except Pakistan.

Source: IMF Fiscal monitor, MoF

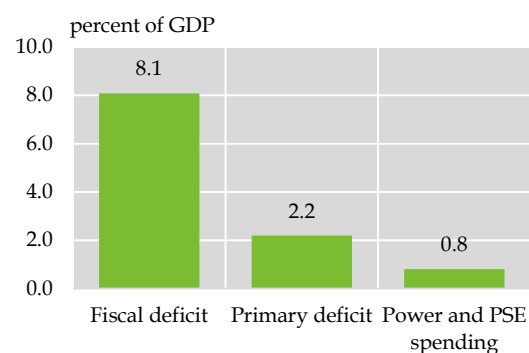
Specifically, the disbursement of power sector subsidies increased considerably during the year compared to the budget estimates set at the start of the year. This was in addition to the fiscal burden stemming from the need to cover losses of Public Sector Enterprises (PSEs) during the year. However, the accompanying recovery in tax revenues helped to contain the level of fiscal and primary deficit for FY21 – lower than the last two years.

In overall terms, the improvement in the fiscal account stemmed from both the revenue and the expenditures side. The increase in tax revenues was driven by a large base effect from last year along with the economic rebound and FBR policy efforts. On the other hand, the prudent management of non-interest current spending amid fiscal pressures arising from power sector subsidies, provision of economic stimulus, and pandemic management was instrumental in achieving a reduction in the fiscal imbalance.

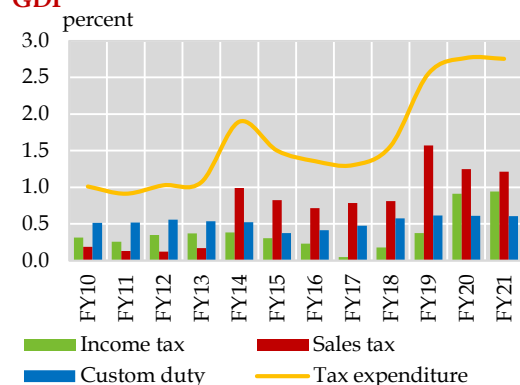
A large part of the deficit financing requirements were met through domestic commercial banks in FY21. However, external financing also rose sharply particularly in the fourth quarter as country tapped funds from international capital markets, Naya Pakistan Certificates (NPCs) in addition to the loan inflows from bilateral and multilateral creditors.

The fiscal performance of the country, remained strong compared to some of the peer economies and other regional averages during FY21 as seen from the change in fiscal deficit, tax revenues and expenditures in terms of GDP during the year. (Figure 4.4). The country was able to contain fiscal deficit, because of reduction in non-priority current spending in FY21.

While the government's efforts to implement fiscal adjustment measures remained on track during FY21, there is a need to address some emerging risks to fiscal sustainability. Specifically, subsidies to power sector rose sharply during FY21. This, in addition to the fiscal support to some large loss making PSEs such as PIA, Pakistan Steel and Pakistan Railways reached 0.9 percent of GDP in FY21, compared to 0.8 percent last year. The fiscal burden of these entities reached close to half of

Fiscal Indicators and Power Sector Non-development Spending (FY19-21)

Source: Ministry of Finance

Tax Expenditure as Percent of GDP **Figure 4.6**

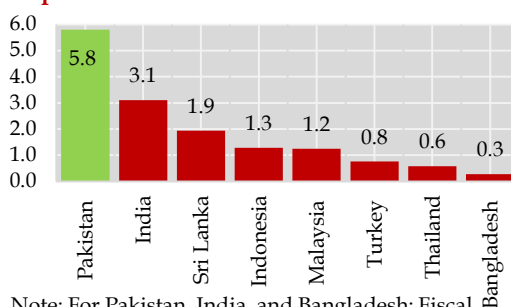
Source: Economic Surveys, Ministry of Finance

the primary deficit seen during FY19-FY21 on average (Figure 4.5). This highlights the need to expedite reforms in the power sector and PSEs to contain pressures on scarce fiscal resources. The process may also include advancing the process of privatization of the loss making entities.

Furthermore, there is a need to fast-track implementation of Public Financial Management (PFM) reforms such as transition to Treasury Single Accounts (TSA) to improve spending efficiency. The adoption of TSA will enhance cash management of the government by providing consolidated information on the availability and movement of funds and will lower the cost of borrowing. This will strengthen the government's control over budget execution, and lower transaction costs by eliminating delays emerging from the involvement of commercial banks for collection of tax and non-tax revenues.²

On the revenues side, the ongoing reforms aimed at broadening of the tax base such as stepping up tax administration efforts, phasing out of income tax exemptions have helped strengthen tax receipts. However, despite these policy efforts the volume of tax exemptions as measured by tax-expenditures-to-GDP, has remained at an elevated level for the past few years (Box 4.1 and Figure 4.6). This hints at the need to pace up the efforts to

widen the tax base through elimination of exemptions, improvement in tax design, etc. A sustained increase in tax collection is instrumental in ensuring sustainability of the country's fiscal position.

Interest Expenditures as percent of GDP in 2021 **Figure 4.7**

Note: For Pakistan, India, and Bangladesh: Fiscal year basis; for rest of the countries projections on calendar year basis

Source: IMF Fiscal Monitor; MoF, Government of Pakistan and India

In addition, Pakistan's debt servicing payments are considerably high compared to some peers (Figure 4.7). During FY21, the ratio of interest payments-to- FBR tax revenues stood at 57.7 percent. This implies that over half of the tax revenue collections are utilized for debt servicing, squeezing the space for undertaking development expenditures. A consistent strain on development spending has dampened the country's growth prospects as well as its debt repayment capacity.

4.2 Revenues

The overall revenues grew by 10.1 percent in FY21 compared to 28.0 percent last year. This growth entirely came from tax collections, while the non-tax revenue (NTR) declined due to lower SBP profits and absence of one-off GSM license renewal fee. The collection from petroleum levy showed a marked increase compared to last year, which partly neutralized the decline in NTRs during the year. The increase was driven by an uptick

² I.F. Yaker and S. Pattanayak (2010). *Treasury single account: concept, design and implementation issues*. Working Paper/10/143. Fiscal Affairs Department. Washington D.C.: IMF.

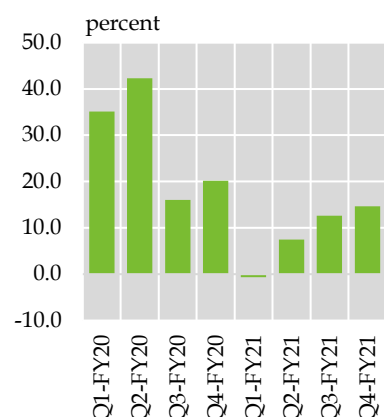
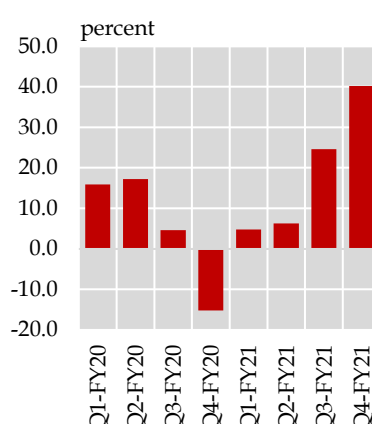
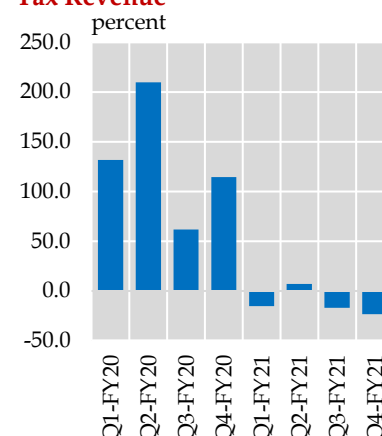
Box 4.1: Tax Policy Reform to Mobilize Additional Revenues Amid Covid Pandemic

Governments across the globe prompted unprecedented policy support to mitigate the economic and health fallout of the Covid pandemic. The ability of various countries to continue this policy support and its magnitude hinges on the availability of fiscal space. Countries with limited fiscal resources will need to strengthen revenue generation capacity to ensure fiscal and debt sustainability, amid persistent financing needs for large-scale vaccinations and provisions of targeted support. In this backdrop, a brief survey of literature presents several tax policy reforms to ensure high revenue mobilization amid the Covid pandemic. To address the issues of widening fiscal imbalance and declining tax-to-GDP ratio Pakistan has initiated tax policy reforms since past few years. These efforts were further streamlined under the IMF-EFF program in FY20. In overall terms, the ongoing tax policy reforms in the country, like eliminations of preferential GST rates, phasing out income tax exemptions, using third party data sources, etc., are in line with the best practices identified in the literature. However, there is a need to widen the scope of these efforts to ensure a sustained increase in tax base, as discussed in the following.

Taxes	Literature	Pakistan's Tax Reforms
Corporate Income Taxes (CIT)	(i) Excess profit taxes may be imposed; (ii) do not use CIT as an investment incentive; (iii) use CIT for providing R&D incentives, implemented through tax credits; (iv) avoid special tax incentives for SMEs as these restrict firm growth; (v) to encourage investment, countries may resort to measures like investment tax credits, accelerated depreciations, etc.	Corporate income tax reforms: To improve the base for direct taxes, Pakistan introduced wide ranging reforms in CIT in March 2021. These included: (i) withdrawal of tax exemptions on 36 categories; (ii) reversal of reduced tax rates to normal rates on various categories; and (iii) conversion of investment and income tax exemptions to tax credits, for instance, persons engaged in coal mining, start-ups certified by Pakistan Software Export Board, export of computer software or IT exports etc. These measure are likely to add around Rs 140 billion in the overall FBR taxes in FY22. To give further support to revenues, excess profit taxes may be imposed on selected sectors on the basis of profitability.
Personal Income tax (PIT)	(i) Adopting a progressive PIT rate schedule; (ii) setting exemptions threshold below per capita income or average wage, as a high PIT threshold reduces the tax base; (iii) introducing temporary surcharge.	Personal income taxes: PIT in Pakistan are collected through progressive rates on various income slabs. The tax rates on salaried and non-salaried individuals were also increased in FY20 and were kept unchanged in FY21. The revenue in this category may be propped up by increasing the tax rates on highest slabs or by introduction of temporary surcharge.
Consumption Taxes	(i) Reduce exemptions and preferential rates; (ii) improve FED design and enforcement; (iii) introduce / raise carbon taxes; (iv) introduce a single VAT rate; (v) implementing VAT on e-commerce.	Consumption taxes: FBR has introduced various reforms aiming at Simplification of GST, and elimination of preferential rates including: (i) replacing GST zero rating regime on five export oriented sectors (textile, leather, carpets, sports goods and surgical goods) with normal tax rates in FY20; (ii) eliminating preferential GST rates for sectors like sugar and steel in FY20; (iii) extending GST to e-commerce sales transactions through Finance Act 2021. This step was taken after the surge in sales through e-commerce platforms during the lockdowns. Although currently the contribution of this head in total collection is negligible, this is expected to grow with expanding size of digital transactions. ¹ The tax base can be further enhanced by curtailing exemptions and improving tax design. Specifically, the tax incentives given during Covid can be gradually rolled back once the economic recovery takes hold.
Capital Incomes Taxes	(i) Neutral taxation of all corporate incomes (interest, dividends and capital gains), as differential treatment of corporate incomes creates distortions; (ii) can be imposed in withholding tax form; (iii) reasonable rate to improve equity; (iv) can use third party information to discourage evasion.	Capital income taxes: To minimize tax evasion, FBR has initiated use of third party data sources through <i>Maloomat Tax-Ray</i> from September 2020. This system collects third party information (such as banks) for individual's assets and withholding deductions, which help in determining accurate tax liabilities. Moreover, it also facilitates the tax-payer in evaluating the accurate tax liability while filing the tax returns.
Property Taxes	(i) Raise property tax rates; (ii) update property values to market prices; (iii) strengthen administration, gift and inheritance taxes; (iv) strengthening property registry and administrative capacity	Property taxes: Need to expand revenue by aligning the property values with market prices. In this regard, FBR has revised the valuation of immovable property rates in July 2019 for various cities. There is a need to ensure continuity in this exercise to remove disparity between the property values and market rates

Sources: De Mooij, FenoChioffo R., Hebous S., Leduc S., Osorio Buitron C. (2020); IMF Fiscal Monitor (April 2021); A summary of the Responsible Tax roundtable discussions on potential tax policy responses to the COVID-19 pandemic – KPMG; Tax Laws (Second Amendment), 2021

¹ Non-filers to be charged 2 percent of tax on gross value of supplies by the online retailer (effective from the date as notified by the FBR).

YoY Growth in Overall Revenue**YoY Growth in FBR Taxes****YoY Growth in Non-Tax Revenue****Figure 4.8**

Source: Ministry of Finance

in PDL rates and a surge in sales of POL products during the year. Notably, most of the increase in revenues (52.0 percent of total) was seen in H2-FY21, because of a surge in tax collection during the last four months of the year (**Figure 4.8**). This increase came from a low base of last year when the outbreak of the pandemic halted economic activities amid strict lockdowns.

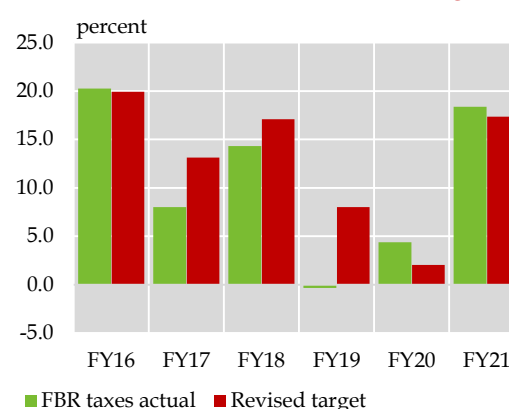
FBR Tax Collection**Table 4.2**

billion Rupees, growth in percent

	Collection		Growth		Growth Cont.	
	FY20	FY21	FY20	FY21	FY20	FY21
Direct taxes	1,523.4	1,726.0	5.4	13.3	2.0	5.1
Indirect taxes	2,474.0	3,008.3	3.8	21.6	2.4	13.4
Custom duty	626.6	747.3	-8.6	19.3	-1.5	3.0
Sales tax	1,596.9	1,981.0	9.4	24.1	3.6	9.6
Imports	876.3	1,118.2	8.1	27.6	0.5	6.1
Domestic	720.5	863.2	7.6	19.8	1.6	3.6
FED	250.5	276.6	5.2	11.6	0.3	0.7
Total taxes	3,996.7	4,734.2	4.4	18.4	4.4	18.4

Cont.: contribution

Source: Federal Board of Revenue,

Growth in FBR Taxes**Figure 4.9**

Source: Ministry of Finance

4.2). The actual collection stood at Rs 4.73 trillion during FY21.

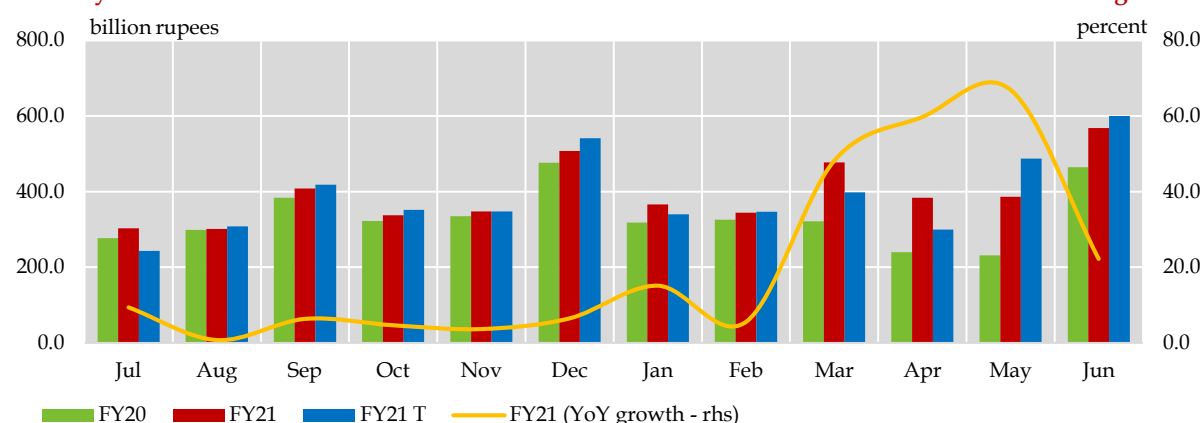
The growth pattern of FBR taxes can be distinguished in two phases during FY21: (i) an average monthly YoY growth of 6.5 percent during Jul-Feb FY21; and (ii) a significant growth of 49.3 percent during Mar-Jun FY21. The increase in FBR taxes during Jul-Feb FY21 was driven by a rebound in economic activity, surge in imports, FBR efforts to strengthen tax administration, and higher prices in some categories such as sugar and electricity. The impact of these factors became more pronounced during the last four months of the year because of a substantial low base effect (**Figure 4.10**). Importantly, this surge was achieved despite no major increase in the tax rates, rationalization of custom duties on

FBR Taxes

FBR taxes registered a 5-years' high growth of 18.4 percent in FY21 and surpassed the revised collection target by a slight margin (**Figure 4.9**). The tax collection target was set at Rs 4.96 trillion at the start of the year, which was revised down to Rs 4.69 trillion, in March 2021 amid the third wave of the pandemic (**Table**

Monthly FBR Tax Collections

Figure 4.10



Source: Federal Board of Revenue

various tariff lines,³ and higher payments of tax refunds during FY21.⁴

In terms of composition, the expansion in FBR taxes mainly came from indirect taxes during FY21, with major share of sales tax on imports. This was attributed to a surge in imports as well as higher commodity prices globally.⁵

FBR scaled up tax administrative efforts during FY21.

FBR's efforts were largely aimed at scaling up tax regulations, procedures and evaluation processes to broaden the tax base. Some of the important measures introduced during FY21 included: (i) improvement in audit procedures, for which FBR approved a new audit policy in August 2020. This policy focused on ensuring transparency and fairness while conducting audit of taxpayers. Some of the major reforms included electronic balloting of taxpayers to be audited, introduction of e-hearing portal for tax audit and assessment cases to minimize the interaction of the officials with the taxpayers; (ii) intensification of crack-down against

smuggled goods. Specifically, during FY21 FBR seized smuggled goods worth Rs 57.7 billion, compared to Rs 36 billion in FY20; (iii) to improve formality and increase the tax base, FBR initiated integration of the tier-I retailers with the centralized database of FBR.⁶ For this purpose 11,000 Point of Sales (POS) terminals were integrated during FY21, in the first phase; iv) to encourage filing of income tax returns, FBR revised the rate of penalties.⁷ Consequently, income tax returns during FY21 increased to 3.01 million from 2.67 million in FY21. While the tax deposited with returns increased to Rs 52 billion during the year compared to Rs 34.3 billion in FY20; and (v) to comply with Financial Action Task Force (FATF) recommendation, FBR filed 71 complaints under Anti Money Laundering Act involving a sum of Rs 62 billion.

Indirect taxes grew mainly due to increasing imports

Indirect taxes witnessed a broad-based growth of 21.6 percent in FY21, compared to 3.8 percent last year.

³ These tariff lines include materials used in chemical, leather, textile, and fertilizer industries.

⁴ Faster Plus system was introduced to ensure quick transfer of refunds to the export oriented sectors, to improve liquidity position of the exporting firms. The amount of refunds disbursed stood at Rs. 222.6 billion in FY21, compared to Rs. 173.5 billion paid last year.

⁵ Domestic prices of non-energy and energy products increased by 22.7 and 9.7 percent respectively during FY21.

⁶ Tier-I retailers include: retailer operating as a unit of a national or international chain of stores, or operating in air conditioned malls, or having a cumulative (12 months) electricity bill of Rs. 1,200,000, or operating in shop of 1000 square feet or more.

⁷ Chargeable late filing penalty was increased to Rs 5,000 for the taxable income of up to Rs. 800,000 in FY21, from 0.1 percent of the taxable income earlier.

Import Related Taxes**Table 4.3**

billion rupees, growth in percent

	FY20	FY21	Growth	Growth Cont.
Sales tax	876.3	1,118.2	27.6	27.6
POL	231.3	255.7	10.6	2.8
Iron and steel	82.9	110.8	33.7	3.2
Vehicles	42.9	81.4	89.6	4.4
Edible oil	52.0	75.2	44.7	2.7
Plastic	55.2	70.9	28.5	1.8
Machinery	52.0	55.6	6.9	0.4
Custom duty	626.6	747.3	19.3	19.3
Vehicles	56.9	110.9	95.0	8.6
POL	83.2	94.3	13.3	1.8
Iron and steel	45.4	55.6	22.3	1.6
Machinery	59.9	59.7	-0.3	0.0
Edible oil	29.4	34.4	17.0	0.8

Cont.: Contribution

Source: Federal Board of Revenue

Import related taxes (sales tax on imports and custom duty) contributed the most in the indirect taxes during FY21. The revival in economic activity translated into higher imports of POL, iron & steel, vehicles, edible oil and machinery, which augmented these receipts. The increase in global commodity prices further inflated tax receipts (Table 4.3 &

Sales Tax (domestic)**Table 4.4**

billion rupees, percent

	FY20	FY21	Growth	Growth Cont.
Electrical energy	91.8	127.2	38.6	4.9
POL	231.4	300.9	30.1	9.7
Sugar	39.8	62.8	57.8	3.2
Cement	20.8	37.3	71.2	2.5
Cotton yarn	25.8	44.1	317.1	1.7
Motor cars	3.8	15.7	19.8	0.1
Beverages	12.9	15.4	19.8	0.4
Cigarettes	20.3	27.9	37.2	1.1
Others	250.8	199.1	-20.6	-7.2
Total	720.5	863.2	19.8	19.8

Cont.: Contribution

Source: Federal Board of Revenue

Figure 4.11).

Similarly, the GST on domestic sales propped up with a revival in domestic demand for POL, automobiles, cement, electricity, etc. The increase in prices of some categories such as electricity, sugar, power tariffs provided further impetus to collection (Table 4.4).⁸ In

Direct Taxes**Table 4.5**

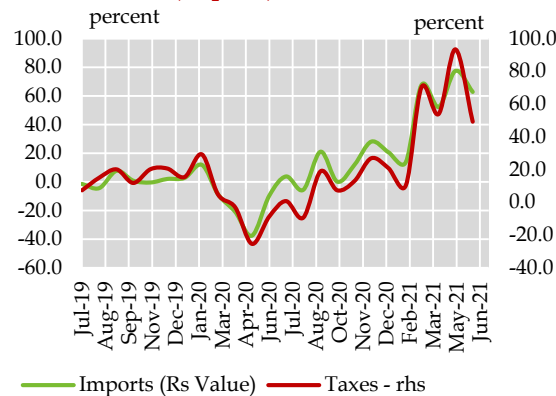
billion rupees, growth in percent

	FY20	FY21	Growth	Growth Cont.
Collection on demand	60.8	80.1	31.8	1.3
Voluntary payments	404.6	465.8	15.1	4.0
Withholding taxes	1,091.7	1,237.1	13.3	9.5
Imports	199.7	218.5	9.4	1.2
Salaries	129.4	151.8	17.3	1.5
Dividends	55.1	63.7	15.6	0.6
Bank interest and securities	128.3	134.8	5.1	0.4
Contracts	237.4	272.1	14.6	2.3
Export	38.5	42.2	9.9	0.2
Cash withdrawals	15.2	15.1	-0.2	0.0
Electric bills	45.4	51.3	12.8	0.4
Telephone	54.6	63.2	15.6	0.6
NET DT	1,523.4	1,726.0	13.3	13.3

Cont.: Contribution

Source: Federal Board of Revenue

addition, the strict enforcement of anti-smuggling measures switched the demand for certain categories such as cigarettes to domestic substitutes that bolstered the collection from this category.

YoY Growth in Imports and Sales Tax Collection (Imports)**Figure 4.11**

Sources: FBR and PBS

A broad-based increase was witnessed in direct taxes.

Direct taxes also posted a significant increase of 13.3 percent in FY21 compared to 5.4 percent last year. This growth mainly came from withholding taxes followed by voluntary payments and collection on demand (CoD) (Table 4.5).

⁸ Prices of electricity and sugar surged by 10.8 and 23.4 percent in FY21, respectively.

Within WHT, major contributors were telecom services, imports, bank interest & securities and contracts. The increased usage of telecom services due to online educational activities and virtual meetings during the pandemic, helped increase the collections from telecom services (Figure 4.12). Similarly, the rebound in construction activities, increased saving deposits and surge in imports shored up WHT receipts.

Voluntary payments showed a notable increase during the period. As mentioned earlier, FBR revised the penalty structure for non-filers, which prompted an increase in the number of filers. The deposited amount with the returns increased to Rs 52 billion during the year compared to Rs 34.3 billion in FY20.

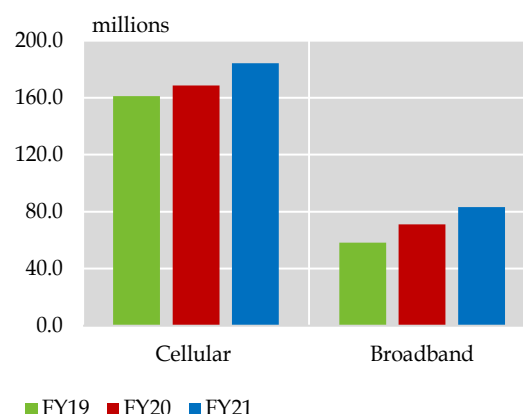
4.3 Non-Tax Revenue Declined due to Lower SBP and PTA Profits

The overall non-tax revenues witnessed a 12.4 percent contraction in FY21 compared to a large increase last year. This decline was seen in main categories of non-tax revenues with major contributions from transfers of SBP and PTA profits during the period. The markdown of Rs. 372.9 billion in these two components more than offset the expansion of Rs. 131.0 billion in collection from PDL during FY21 (Figure 4.13).

The transfer of SBP profits posted 30.5 percent decline in FY21, compared to a large increase

Number of Subscribers

Figure 4.12



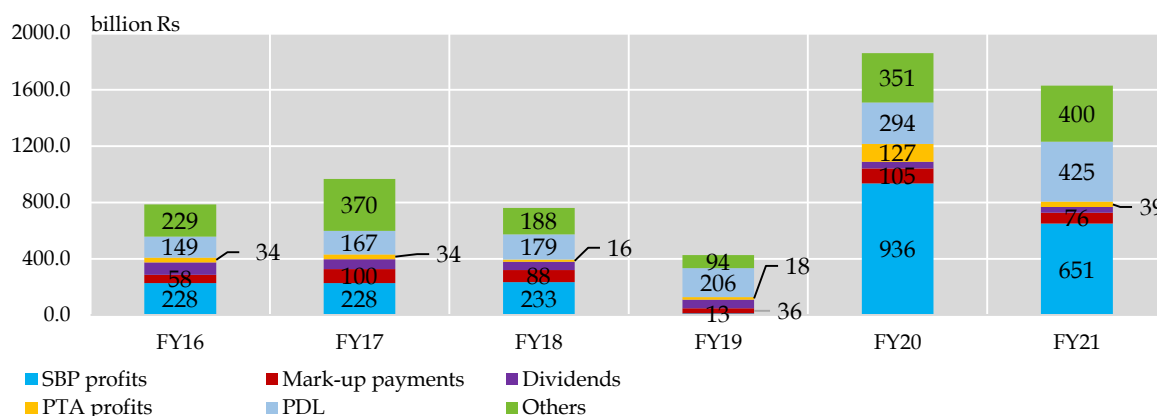
Source: Pakistan Telecommunication Authority

seen last year. The sharp reduction in interest rates that was announced in Mar-June 2020 and maintained through FY21 was mainly responsible for this contraction. Moreover, the government debt stock with SBP also edged down by 0.6 trillion during FY21 amid its commitment of zero borrowing from SBP that further dampened these earnings.⁹

PTA profits declined to Rs 39 billion in FY21, from Rs 127 billion in FY20, in the absence of the one-off payments for GSM license renewal fees. It may be recalled that last year telcos made payments for the renewal of the GSM licenses (half of their total renewal fee). The remaining amount has to be paid in 5-year installments in a staggered manner. Taking into account this factor, the government had envisaged a target of only Rs. 36 billion in the

The State of Non-Tax Revenue for Last 5-Years

Figure 4.13



Source: Ministry of Finance

⁹ However, SBP witnessed Rs 13.3 billion profits on loans under Covid-19 schemes.

budget estimates for FY21, compared to Rs. 136 billion last year.

Mark-up receipts fell by 27.5 percent in FY21 against a large increase last year.¹⁰ The contraction in payments by National Highway Authority was mainly responsible for this decline. The government had set a target of Rs 41.2 billion in the form of mark-up payments from NHA, however only Rs 13.1 billion was realized, according to the revised estimates for FY21. This can be attributed to inability of this organization to generate adequate stream of revenues to support debt servicing.¹¹

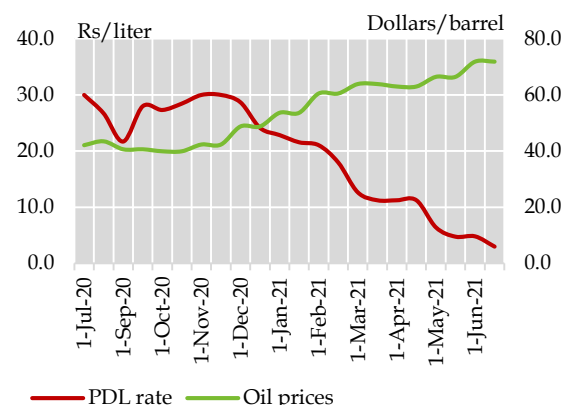
Similarly, the dividend income of the government fell short of target by 28.0 percent in FY21. This shortfall mainly came on account of lower payments by OGDCL that constitutes over 60 percent share in the total receipts in this head.¹²

OGDCL witnessed a lackluster financial performance during Jul-Mar FY21, with 20.1 percent YoY decline in profits that led to a slump in dividend payments.¹³ This slack mainly came from a respective 3.4 and 5.6 percent YoY fall in crude oil and gas extraction by this entity during the period. Receipts from PDL almost doubled during FY21, on account of higher PDL rates as well as a strong revival in the sales of POL products. Specifically, to benefit from the lower international oil prices fiscal authorities increased the PDL rates during first few months of FY21, which reached an all-time peak of Rs. 30 per liter in November 2020 (**Figure 4.14**).

However, with the recovery in international oil prices, the PDL rate was revised downwards to minimize the adverse impact of the price increase on consumer in the domestic market.

It is important to note that the fiscal authorities have changed the practice of adjustment in local oil prices (with international oil prices) from monthly basis to fortnightly, from September 2020. This step has enhanced the alignment of local POL prices and PDL rates with the international trend.

PDL Rates on Petrol during FY21 **Figure 4.14**



Source: State Bank of Pakistan

4.4 Federal Expenditures¹⁴

The federal expenditures rose by 4.7 percent during FY21 compared to 21.8 percent last year. This slowdown emanated from a restraint on non-interest current spending, while development expenditures & net lending posted a recovery during the year.

Federal Current Expenditures

The federal current spending grew by 4.2 percent during FY21, compared to 26.8 percent last year. Major contribution in this increase came from the higher domestic markup payments, defense, and subsidies, while the expenditure on running of the civil government, pensions and grants declined

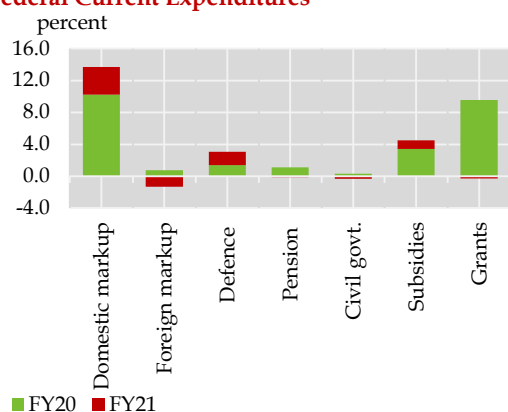
¹⁰ Federal government advances loans to the public sector enterprises, local bodies and others to carry out their development and social initiatives. A mark-up rate is charged on these advances, determined by Finance Division every year. The interest earning from this is being reflected in NTRs.

¹¹ MoF (2021). *State-Owned Enterprises Triage: Reforms and Way Forward*. Islamabad: MoF

¹² Dividend represents return on the federal government's shareholding of commercial enterprises. This vary each year based on the profitability of these enterprises.

¹³ www.ogdcl.com/sites/default/files/Chronology%20of%20Dividends%20updated%20D-78.pdf

¹⁴ The discussion in this section is based on federal expenditures excluding statistical discrepancy.

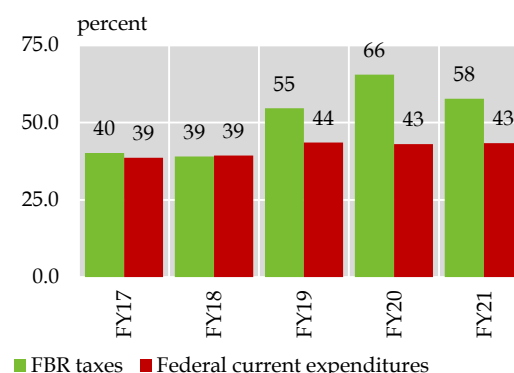
Growth Contribution in the Federal Current Expenditures**Figure 4.15**

Source: Ministry of Finance

during FY21 (**Figure 4.15**). However, in terms of GDP, federal current expenditures fell from 14.5 percent in FY20 to 13.1 percent in FY21.

Interest payments stood at 57.7 percent of FBR taxes

The interest payments grew by 5.0 percent during FY21 as compared to 25.3 percent last year. The country benefitted from lower interest rates and debt relief under the Debt Service Suspension Initiative (DSSI) during FY21.¹⁵ Despite this slowdown, the ratio of interest payments-to-FBR taxes stood at 57.7 percent during FY21. On average, more than half of the FBR taxes are utilized for interest payments since past three years (**Figure 4.16**).

Share of Interest Payments in Fiscal Indicators**Figure 4.16**

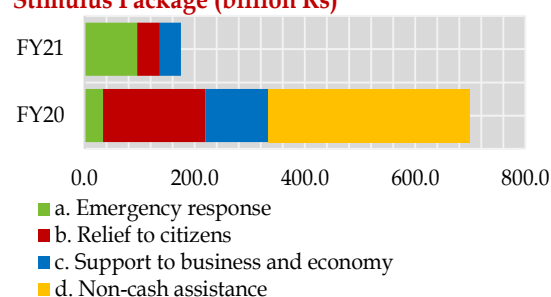
Source: Ministry of Finance

Spending on Economic Stimulus Package (ESP) in FY21

To mitigate the recessionary impact of Covid, the government announced an Economic Stimulus Package worth Rs 1.2 trillion in the second half of FY20. This was primarily designed to help the most vulnerable sectors such as daily wage earners and small businesses by providing cash assistance, lock down management and emergency relief for the purchase of Covid vaccine, management of hospital services. In addition, the package also provided relief to various segments of economy including exports, SMEs and agriculture.

During FY20, the government spent Rs 700.0 billion under this package, and the remaining amount was carried forward to FY21. Out of this amount, Rs 175.0 billion were spent in FY21 (**Figure 4.17**). The focus areas were lock down administration during the second and third waves of the pandemic, purchase and administration of Covid vaccine, awareness campaigns, and provision of hospital equipment and services for the Covid patients.

Furthermore, government provided relief to various sectors such as the power sector, SMEs, and agriculture for reviving economic activity (**Figure 4.18**).

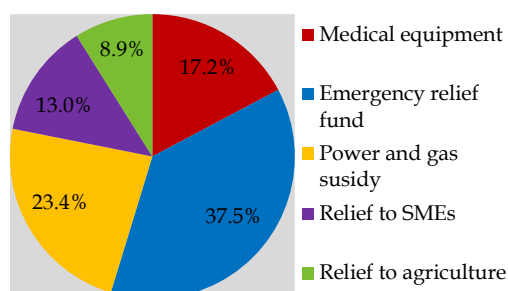
Disbursements under Economic Stimulus Package (billion Rs)**Figure 4.17**

a. Funds released for National Disaster Management Authority (NDMA), health sector, and emergency relief fund; b. Relief provided to the daily wage workers and poor families and support was provided in terms of food and energy sectors; c) Support to exporters, SMEs, and agriculture sectors; d) Tax exemptions and guarantees for the food, health, energy, and agriculture sectors.

Source: Ministry of Finance

¹⁵ For details, see Chapter 5 on "Domestic and External Debt."

Detail of Disbursements under Economic Stimulus Package (ESP) during FY21 **Figure 4.18**



Source: Ministry of Finance

Social protection spending in FY21

The government introduced Ehsaas Emergency Cash Program under the ESP and provided immediate financial support to the vulnerable, covering 15 million households all across the country with the total disbursement of almost Rs 179.2 billion.¹⁶

Furthermore, the spending on social protection (under BISP) for helping the vulnerable, stood at Rs 194.9 billion in FY21, compared to 242.3 billion in FY20.

Spending on running of civil government declined during the year

The running of civil government spending posted a decline of 3.5 percent during FY21, in contrast to a rise of 3.2 percent increase last year. This reduction was helped by various measures introduced by the fiscal authorities to keep a lid on spending by the federal ministries. The austerity drive which was

initiated in the beginning of FY21 encompassed a complete ban on the purchase of all vehicles (except motorcycles) in current expenditures; the creation of new vacancies; and restrictions on other official protocols – such as the entitlement of magazines and newspapers; rationalization of utility consumption; and constrictions on other operational expenditures.¹⁷

Power sector subsidies rose during the year

The government provided Rs 339.0 billion subsidies to power sector during FY21 in various heads, compared to Rs 269.8 billion last year and a budget estimate of Rs 139.5 billion for FY21. This amount also included payment made to Independent Power Producers (IPPs) and Power Holding Private limited (PHPL) to partially settle some of the payments related to circular debt. Because of this payment, the spending on power sector subsidies increased considerably compared to the budget estimates (**Box 4.2**).

Federal Development Expenditures

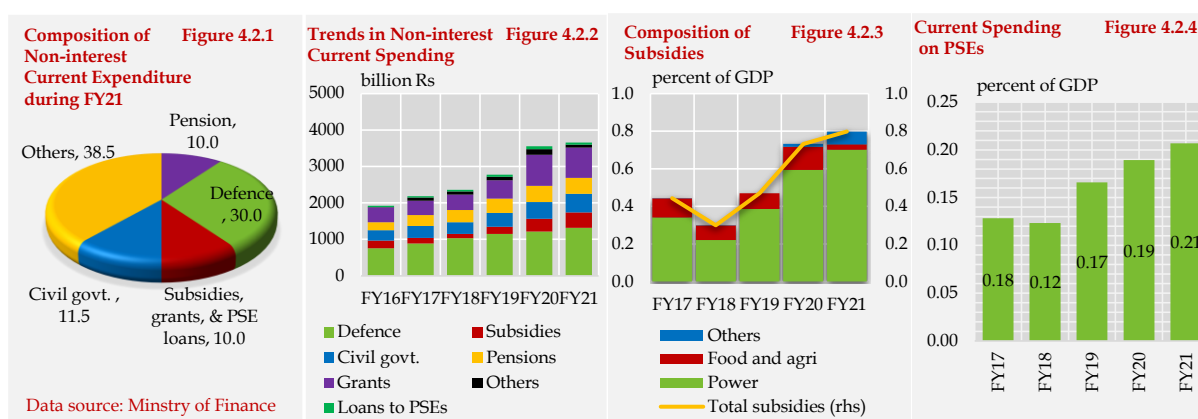
The federal development expenditures ticked up by 1.0 percent during FY21 as compared to a 6.0 percent decline last year. Federal development spending remained downbeat for most part of Jul-Mar FY21. This slack emerged from a number of factors including the government efforts to contain fiscal deficit, Covid-led disruptions in economic activity, and implementation of Public Financial Management (PFM) reforms.

Box 4.2: Fiscal Burden of the Power Sector and Public Sector Enterprises (PSEs)

Subsidies, grants, and loans to PSEs constituted a major share in the non-interest current expenditures of the federal government during FY21 (**Figure 4.2.1**). This share has been increasing overtime, adding increasing burden on the fiscal account (**Figure 4.2.2**). The major part of the subsidies is directed to power sector, capturing around 80.0 percent share in total subsidies (**Figure 4.2.3**). As a result, the share of power sector subsidies, loans and grants to PSEs reached close to half of the primary deficit in terms of GDP for the last three years, on average. In addition, the fiscal support to PSEs has also been increasing in terms of GDP (**Figure 4.2.4**).

¹⁶ Poverty Alleviation and Social Safety Division ([www.pass.gov.pk/NewsDetailWerFf65%5ES23d\\$gH2a3c9cbf-2f66-47d3-a386-4ce516d8bdc30ecFf65%5ES23d\\$Pdf](http://www.pass.gov.pk/NewsDetailWerFf65%5ES23d$gH2a3c9cbf-2f66-47d3-a386-4ce516d8bdc30ecFf65%5ES23d$Pdf)).

¹⁷ Circular No. 7(1) Exp. IV/2016-430, dated August 6, 2020, Expenditure Wing, Finance Division.

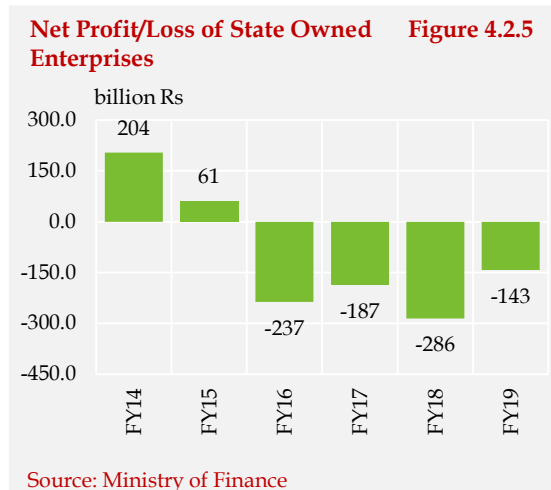


The Circular debt of the power sector rose to Rs 2,280.2 billion in FY21,¹⁸ amounting to 4.8 percent of GDP. The major drivers of the accumulation of arrears included delays in adjustment of power tariffs, DISCO's operation losses, and un-paid subsidies. To arrest the accumulation of power sector arrears and ensure a sustained decline in the circular debt stock, the government has prepared a Circular Debt Management Plan (CDMP) in consultation with the World Bank, ADB and the IMF. The plan included short and medium term measures to achieve the reduction in the debt stock such as automatic quarterly adjustment of power tariffs; rationalizing subsidies by improving targeting; and renegotiating power purchase agreements with IPPs.

The inefficiencies in PSEs are emerging from governance issues, political interventions and other administrative factors. In overall terms, PSEs are showing consistent losses since FY16 (**Figure 4.2.5**), with the sum of the losses of top-10 loss-making PSEs contributing around 90 percent to the total losses each year. NHA, Pakistan Railways, PIA and power sector DISCOs are among the major, top 10 loss-makings PSEs.

Expediting reforms in power sector and PSEs is crucial to lower the fiscal burden arising from their inefficiencies. These reforms should aim at improving governance, transparency and efficiency, strengthening monitoring, advancing privatization, enhancing legal/ regulatory framework, by minimizing government's interference in PSEs' operation, etc. Moreover, the power sector reforms should aim at rationalizing subsidies, boosting antitheft and collection efforts, upgrading generation and transmission infrastructure, expediting privatization of loss making DISCOs.

During FY21 as a part of transition towards Treasury Single Account (TSA), the government introduced some reforms in the procedure of release of development funds to ministries. Specifically, the government introduced a system where various ministries were required to open Assignment Accounts with the National Bank of Pakistan, which is a part of non-food account of the Government of Pakistan maintained by the central bank. The ministries were advised to close all accounts



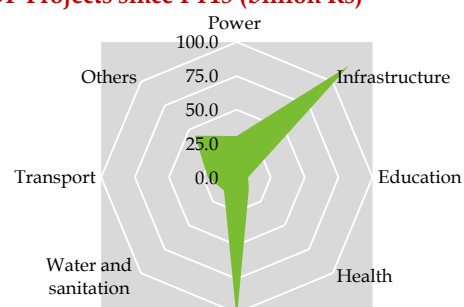
with the commercial banks and shift their balances to these accounts with the underlying objective of consolidation of cash resources by maintaining single account with SBP. The ministries received disbursements from the federal government for undertaking development projects in these accounts. However, anecdotal evidence suggests that delays in adopting to these new procedures led to slowdown in the disbursement of funds to various ministries, which in turn hampered

¹⁸ NEPRA (2021). *State of Industry Report*. Islamabad: NEPRA.

the pace of development spending during Jul-Mar FY21. However, these restrictions were relaxed towards the last quarter of FY21, leading to a 6-years high increase in development spending during Q4-FY21.

An analysis of the last five years reveals that the composition of PSDP projects was mainly tilted towards infrastructure spending such as construction of road, dams, bridges and programs aiming at social and regional development (**Figure 4.19**). However, various structural and administrative bottlenecks have hindered the timely completion of these projects (**Box 4.3**).

Average PSDP Release Authorization of the Major PSDP Projects since FY15 (billion Rs) **Figure 4.19**



This analysis is conducted on 70 percent of the PSDP projects for the last five years.

Source: Planning Commission

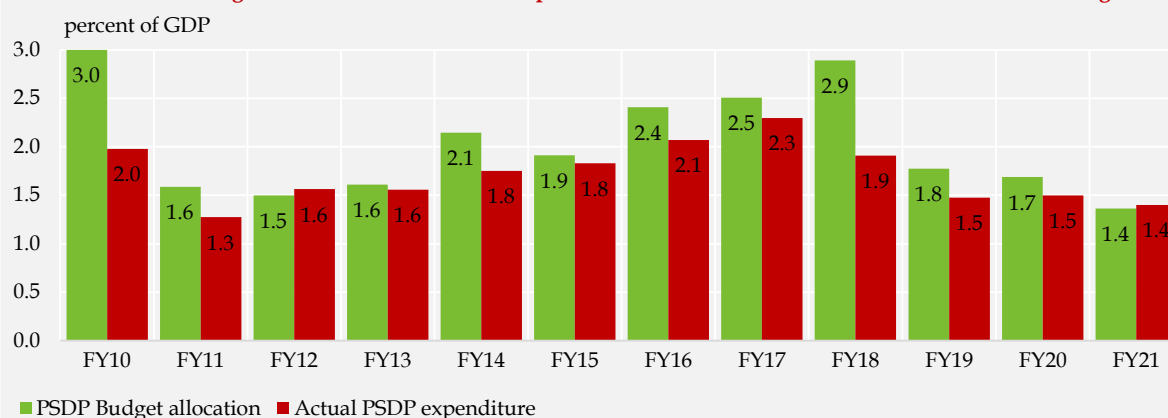
Box 4.3: Delays in Execution of Public Sector Development Program (PSDP) in Pakistan

Public sector spending is instrumental for the development of human and physical capital of a country. Sustained increase in public investment scale up productivity growth and crowd in private investment [Bivens (2012)]. However, these benefits are contingent upon efficient execution of various development projects within stipulated timeframe. The timely completion of projects not only provides fiscal space for new development priorities, this also prevents additional burden on the fiscal resources by avoiding cost overruns, caused by project delays. In this context, Pakistan's performance during the past few years highlights delays in the timely completion of PSDP projects. The experience of some recent years shows a consistent decline in the budget allocation for PSDP expenditures. However, the actual development expenditures could not keep pace even with the reduced allocations (**Figure 4.3.1**). This is particularly true for the infrastructure projects such as roads, bridges, and dams and the national development goals including achievement of Sustainable development goals (SDGs) and population welfare programs. The frequent delays result in the accumulation of throw forward liabilities, which squeeze the availability of fiscal resources for executing newer projects.

A number of challenges can be identified including dearth of financial resources, inadequate project management skills and lack of coordination between various government institutions, which has hampered the timely completion of various PSDP projects. The continued gap between the budgeted, released, and actual funding for

Federal PSDP - Budget Allocation versus Actual Expenditure

Figure 4.3.1



Source: Ministry of Finance and Planning Commission

PSDP projects highlights the need to reform the PSDP implementation process to ensure achievement of planned development agenda of the government. The delays also highlights issues in funding and the impediments in the implementation procedures such as procurement processes, appointment of contractors, land acquisition, etc. Moreover, lack of adequate project execution capacity particularly in the special areas and line ministries also affects the timely completion of the projects [Pasha et al (2012)].

Bottlenecks of Monitored Projects during 2011-2018 (Sector wise Number of Projects)**Table 4.3.1:**

Sr. No.	Major Issues	Others	Social	Infrastructure	Total
1	Delay in release of funds	113	164	176	453
2	Management capacity	32	236	90	358
3	Delay in procurement	47	35	56	138
4	Co-ordination issues	11	47	40	98
5	Land acquisition	51	27	18	96
6	Delay in recruitment	13	33	47	93
7	Law and order situation	38	12	27	77
8	Governance issues	1	58	12	71
9	Delays in consultants' appointment/designing	27	28	8	63
10	Lack of decision making	5	37	11	53
11	Contractor's problem	11	35	4	50
12	Turnover of project director/ staff	9	23	15	47
13	Non-existence of PMUs*	0	32	5	37

* PMUs: Project Management Units. Note: The above-mentioned 13 issues have been identified from around 500 projects for the time period 2011-2018

Source: Shah, S.A. (2018). Appraisal of PSDP Projects' Implementation.

Major factors underlying delays in the completion of PSDP projects¹⁹

Lags in the release of funds: During 2011-2018, delay in release of funds led to a slowdown in completion of around 453 projects out of a total 500 (Table 4.3.1) [Shah (2018)].

Issues in land acquisition: Lack of collaboration between various government agencies, and governance issues lead to delays.

Lack of project management and implementation capacity: Weak project management and implementation capacity arising from lack of decision making, mismatch between the required and actual skill set of human resources, governance issues, coordination issues, delay in recruitment, absence of Project Management Units (PMUs), are some impediments in the timely completion of projects. The problems regarding management capacity exist particularly in the social sector projects (Table 4.3.1).

Lack of coordination between federal/provincial/local leads to wastage of considerable time for settlement of such issues.

Delay in procurement. Insufficient knowledge about Public Procurement Rules (PPR) leads to delay in procurement of the machinery and other inputs.

Weak project design: Abrupt changes in the planned PSDP program, for instance, by introduction of new projects in the middle of the year also affects the functioning of overall projects.

Other issues: Generic problems on the part of project directors and interrelated ministries like, fulfillment of formalities, preparation of progress reports, unexpected delays in procurements, and non-availability of human resource are some other reasons explaining the gaps between authorized/released funds and their actual realization.

Nonetheless, the bottlenecks in the timely and efficient completion of infrastructure PSDP projects can be partially removed by considering the following aspects: (i) various stakeholders across federal, provincial, and local governments should be taken on board to devise some principles for the execution and handling the mega projects, which require higher funds and time. This cooperation should aim to ensure insulation of the project design and implementation from the negative administrative and political influences, guidance of the projects through research based motives and clearly defined goals and targets, well defined alternatives, involvement of citizens support, and establishment of the research organizations for the collection, research, and monitoring of the projects [Haque et al (2020)]; (ii) As suggested by United Nations Department of Economic and Social Affairs (UNDESA), developing guidance material²⁰ for the local and subnational governments is helpful for

¹⁹ This analysis draws heavily from our discussion with the concerned government representatives.

²⁰ The term refers to the procedures which are used to improve monitoring and reporting capacities, strengthening data utilization, data informed decisions and improvement in the knowledge and awareness of policy makers.

operationalizing the existing projects and facilitating their timely completion; (iii) The implementation of Public Financial Management (PFM) reforms will help streamline PSDP projects' identification and implementation by facilitating PSDP release strategy, technical approvals, etc.; (iv) The quality of project management should be improved by providing training to the relevant staff and by ensuring appointment of project managers with the required skills and expertise; and (v) Simplification of land acquisition process. The government has already introduced various reforms for improving the ease of doing business. The continued thrust of these reforms in simplification of land acquisition process will introduce efficiency in the implementation of PSDP projects.

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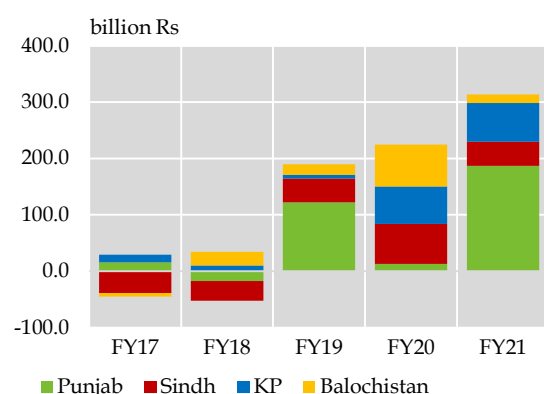
4.5 Provincial Fiscal Operations

Provinces posted a combined surplus of Rs 313.6 billion during FY21, exceeding the annual target of Rs 242.0 billion. Major contribution came from Punjab and KP. This was achieved by a higher growth in total provincial revenue that surpassed the increase in total expenditure during the year (Figure 4.20).

Provincial Revenue

Provincial Surplus

Figure 4.20



Source: Ministry of Finance

The provincial revenues rose by 15.0 percent in FY21 as compared to 8.2 percent last year (Table 4.6). All provinces recorded a double-digit growth in total revenues except Balochistan.

Provincial own revenues remained upbeat during FY21

The provincial own revenue collection went up by 27.7 percent during FY21 compared to 5.7 percent last year. The major impetus came from GST on services, and motor vehicle tax (Figure 4.21). A revival in the economic activity, higher imports, and turnaround in automobile sales primarily explain this increase.

This improvement was seen despite tax relief measures announced by the provincial governments in the FY21 budgets to support the economic activity. Specifically, Punjab government reduced GST on services from 16.0 percent to 4.0 percent for around 20 services including hotels, wedding halls, IT service providers, property dealers, agriculture service providers, and tax consultant agents etc.²¹ Furthermore, the

²¹ Tax Relief Measures by Punjab Revenue Authority (www.pra.punjab.gov.pk).

Provincial Fiscal Operations**Table 4.6**

billion Rupees; growth in percent

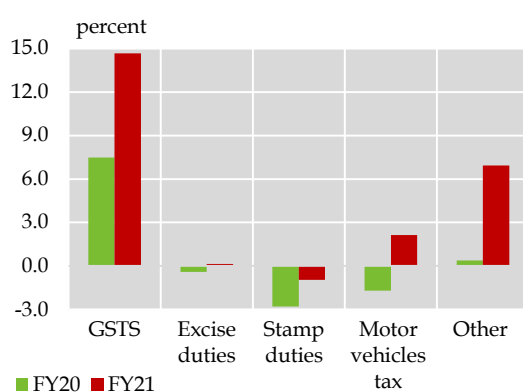
	FY20	FY21	YoY Growth	
			FY2	FY2
A. Total revenue	3241.0	3728.0	8.2	15.0
a. Provincial share in	2504.0	2741.9	4.4	9.5
b. Fed loans and	221.0	327.5	100.9	48.2
c. Provincial own	516.0	658.7	5.7	27.7
Taxes	413.6	508.4	2.9	22.9
Non-taxes	102.4	150.3	18.6	46.8
B. Total expenditures	3163.9	3614.4	10.7	14.2
a. Current	2541.9	2844.2	8.1	11.9
b. Development	621.9	770.2	22.9	23.8
Statistical discrepancy	-147.8	-200.0	-	-
Overall balance (A-B)	77.06	313.62	-44.5	307.0

Source: Ministry of Finance

services for health insurance, medical consultation, and bedroom charges for hospitals were tax exempted in the budget for FY21. Similarly, Sindh government provided GST exemptions to various services such as export of call centers, health insurance services.

The tax collection in Punjab grew by 18.3 percent in FY21, against a 1.5 percent reduction last year. The collection primarily came from GST on services and motor vehicle tax. Moreover, cross-input tax adjustment between FBR and the Punjab Revenue Authority during FY21 also contributed to the province's tax revenue collection.

Sindh's revenue performance also remained strong during FY21. The recovery in imports and telecom sector mainly explains the increase in collection from GST on services in

Growth Contribution of Provincial Own Revenue Collection **Figure 4.21**

Source: Ministry of Finance

Sindh during FY21. The categories with major contributions were port, airport, and terminal operations followed by franchise, banking, telecom, and insurance services.

Provincial non-tax revenues increased by 46 percent in FY21 compared to 18.6 last year. KP had the largest contribution in this growth emanating from higher hydel electricity generation that led to an increase in profits.

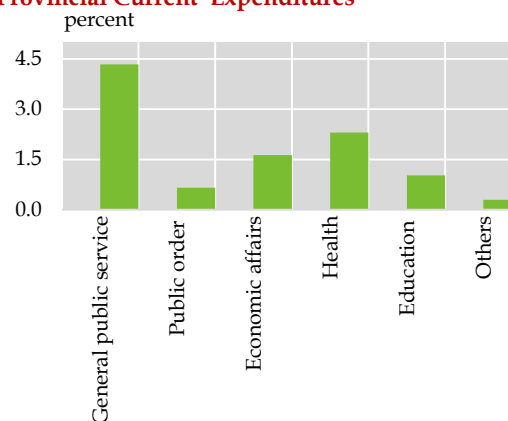
Provincial Expenditures

Provincial current spending rose by 11.9 percent during FY21 compared to 8.1 percent last year. Major areas of spending were general public service including transfers to district and local governments, financial, fiscal, and legislative affairs; economic affairs which mainly covers agriculture, food, construction, transport; and health (Figure 4.22).

The provincial development expenditures surged by 23.8 percent during FY21 compared to 22.9 percent last year. Broadly, all provinces contributed to this upswing during the year.

Provincial health spending saw a significant expansion for facilitating measures to handle pandemic induced disruptions. These expenditures were mostly directed towards improvement of hospital and public health services.

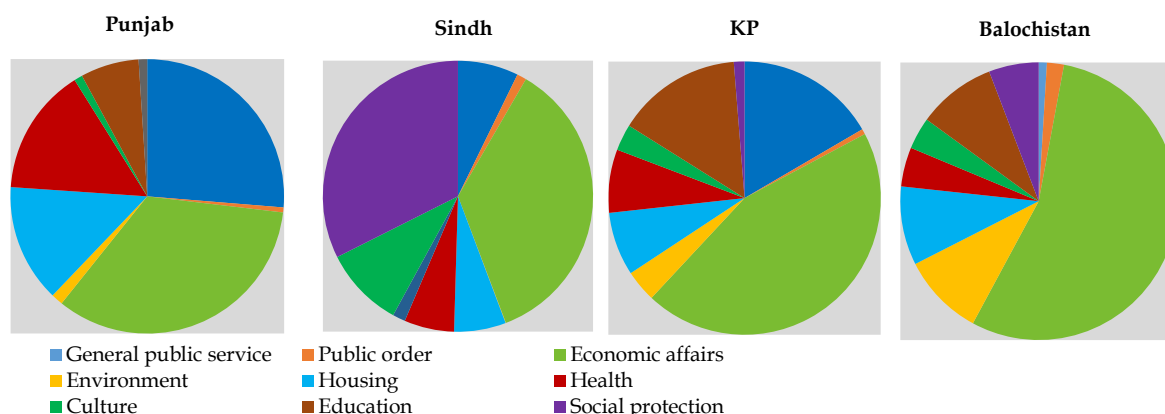
KP government focused on higher health spending during the year by providing better hospital services (Figure 4.23). The 'Sehat

Growth Contribution of Provincial Current Expenditures **Figure 4.22**

Source: Ministry of Finance

Provincial Development Priorities during FY21 (billion Rs)

Figure 4.23



General public services includes the financial, legislative, and fiscal affairs of the provincial governments. Economic affairs constitute transport, construction, food, agriculture, energy, and other industries.

Source: Ministry of Finance

Sahulat Program' was initially launched in KP in 2015 to provide health insurance services to the masses. The coverage of this program was enhanced in the subsequent years and was transformed into a universal health coverage in FY21.

The development priorities of Punjab remained uniform across sectors such as housing, health, education, social protection during the year. The province's development expenditures grew by 35.0 percent in FY21 against 9.4 percent last year. Specifically, the health spending of the province doubled to Rs 53.8 billion in FY21 compared to Rs 26.1 billion

last year. Following KP's experience, Punjab also launched 'Sehat Sahulat Program' in FY21 with coverage across the whole province (registered with NADRA), aiming at providing free health facilities.

Sindh also showed a growth of 19.6 percent during the year compared to a reduction last year. Social protection, food and agriculture constituted a major portion of development expenditures. The main focus of social protection was on women and childhood development. The development spending in Balochistan mainly focused on education, culture, housing, and social protection.

Chapter 5

Domestic and External Debt

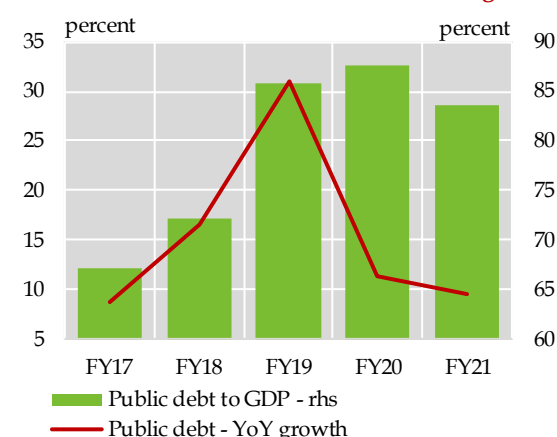
Pakistan's public debt in terms of GDP declined to 83.5 percent in FY21 from 87.6 percent in FY20. The improvement in the twin deficits, along with revaluation gains due to the appreciation of the PKR against the US Dollar, helped contain the pace of debt accumulation. Notably, the addition in the country's public debt was the lowest among international peers despite the Covid-induced increase in fiscal spending. The maturity profile of debt continued to improve towards long-term instruments and the government was also able to diversify the financing resources. In this regard, the introduction of the Naya Pakistan Certificates (NPC) provided investment opportunities to the Pakistani diaspora in both Rupee- and foreign currency-denominated debt instruments. The country also successfully tapped the international capital markets after a gap of three years. The sustainability of public debt also strengthened, with a turnaround in economic activity, expansion in foreign exchange earnings, and the availability of debt relief under the G-20's Debt Service Suspension Initiative (DSSI).

5 Domestic and External Debt

5.1 Public Debt

Pakistan's public debt dynamics improved considerably in FY21. The pace of expansion in public debt was the lowest since FY17 (**Figure 5.1**). The composition of public debt further tilted towards long-term debt, while the country was also able to diversify the financing resources during FY21.

Public Debt Profile Figure 5.1



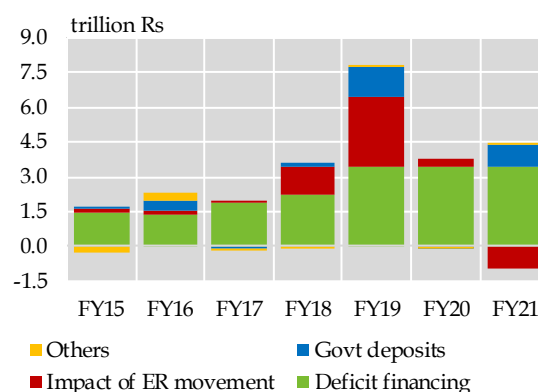
Source: State Bank of Pakistan

The reduction in the debt burden emanated from an improvement in the twin deficits and the revaluation gains on the external debt stock due to the appreciation of the PKR against the US Dollar (**Figure 5.2**).¹ Moreover, the debt sustainability indicators also strengthened in FY21, helped by recovery in economic activity, higher tax revenues, a strong increase in foreign exchange earnings (FEE), and debt relief of around US\$ 2.3 billion under the G-20's Debt Service Suspension Initiative (DSSI).

Specifically, the public debt-to-GDP ratio, edged down to 83.5 percent in FY21, from 87.6 percent in FY20 (**Table 5.1**), which indicates an improvement in the debt-bearing capacity of the economy. Meanwhile, the debt repayment capacity as measured by the interest payment-to-FBR tax revenues, and by external debt

Composition of Increase in Public Debt

Figure 5.2

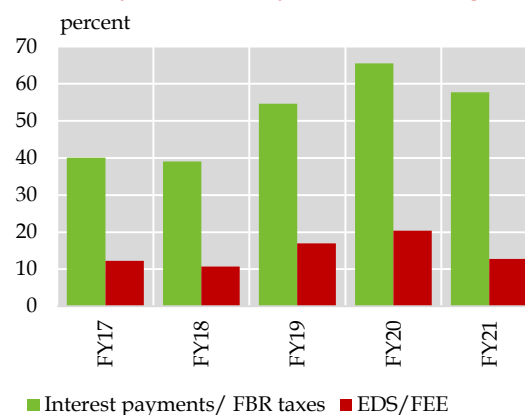


Source: Ministry of Finance and State Bank of Pakistan

servicing (EDS)-to-FEE, also improved during FY21 (**Figure 5.3**). Furthermore, an international comparison shows that the incremental addition to Pakistan's gross debt in FY21 was lower than the average for both emerging and low-income economies, despite the Covid-led increase in spending (**Box 5.1**).

Debt Repayment Capacity

Figure 5.3



Source: Ministry of Finance and State Bank of Pakistan

Around 86 percent of the expansion in public debt in FY21 came from domestic sources (**Figure 5.4**). This increase was driven by both deficit financing requirement, as well as a rise in the government's deposits with the banking

¹ The fiscal deficit declined to 7.1 percent of GDP in FY21 from 8.1 percent last year. The current account deficit reduced to 1.8 percent of GDP from 4.4 percent in FY20.

Summary of Pakistan's Debt and Liabilities**Table 5.1**

billion rupees

	Stock			Flows		Percent of GDP	
	FY19	FY20	FY21	FY20	FY21	FY20	FY21
A. Total debt and liabilities (sum I to IX)	40,223.1	44,591.5	47,829.1	4,368.4	3,237.6	107.3	100.3
B. Gross public debt (sum I to III)	32,707.9	36,398.6	39,859.2	3,690.7	3,460.6	87.6	83.5
C. Total debt of the government (I+II+III-X)*	29,520.7	33,235.3	35,738.1	3,714.6	2,550.7	80.0	74.9
I. Government domestic debt	20,731.8	23,282.5	26,265.3	2,550.7	2,982.8	56.0	55.1
II. Government external debt	11,055.1	11,824.5	12,432.4	769.4	607.9	28.5	26.1
III. Debt from IMF	921.0	1,291.5	1,161.5	370.5	(130.0)	3.1	2.4
IV. External liabilities	1,710.1	1,663.3	1,378.4	(46.8)	(284.9)	4.0	2.9
V. Private sector external debt	2,481.3	2,628.2	2,540.9	146.9	(87.3)	6.3	5.3
VI. PSEs external debt	630.6	869.5	1,061.0	238.9	191.5	2.1	2.2
VII. PSEs domestic debt	1,394.2	1,490.5	1,436.7	96.3	(53.8)	3.6	3.0
VIII. Commodity operations	756.4	813.4	904.0	57.0	90.6	2.0	1.9
IX. Intercompany external debt	542.7	727.9	648.7	185.2	(79.2)	1.8	1.4
X. Deposits with banking system	3,187.2	3,163.3	4,121.1	(23.9)	957.8	7.6	8.6

*As per FRDLA definition

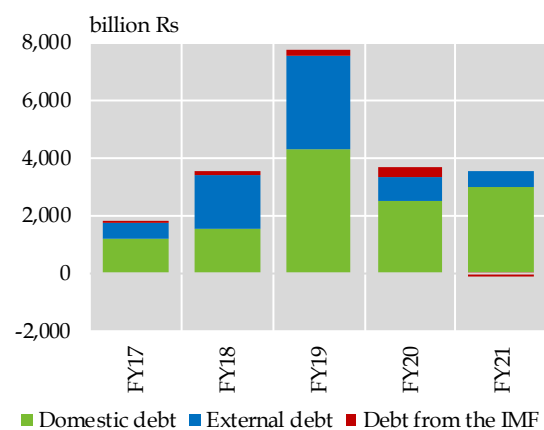
Source: State Bank of Pakistan

system. The government adhered to its commitment of zero fresh borrowing from the SBP and largely relied on commercial banks to finance the fiscal gap. On the other hand, the lower contribution of external debt to the public debt accumulation was primarily due to the 6.7 percent appreciation of the PKR against the US Dollar during the year, which led to a deceleration in the Rupee value of external debt.

The government was able to lengthen the maturity profile of public debt for the second

consecutive year, even in a low interest rate environment. Almost 72 percent of the increase in central government debt mobilized during the year was sourced through long-term instruments, which pushed the share of these instruments in total government debt to 82.3 percent by end-June 2021 (Figure 5.5).² The improvement in the maturity profile augurs well for the debt sustainability because of the reduction in rollover risk.

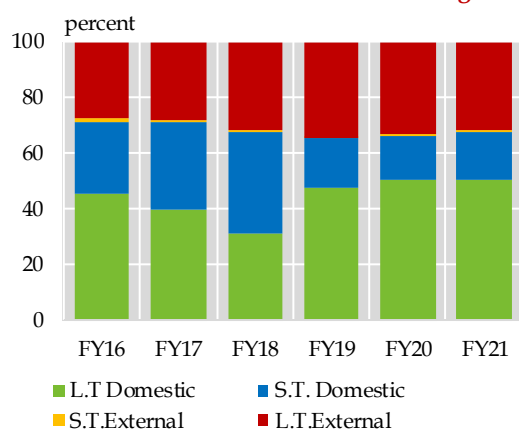
The improvement in the maturity profile was achieved through the introduction of various new and diversified debt instruments. In the domestic debt market, the government introduced floating-rate Pakistan Investment Bonds (PIBs) with quarterly coupon payments, and it continued to mobilize funds through the Shariah-compliant instruments.³ Furthermore, the government launched the Naya Pakistan Certificates (NPCs) in September 2020, to provide investment opportunities to overseas Pakistanis (residents and non-residents). These certificates attracted gross inflows worth US\$ 1.0 billion during FY21. The government also re-entered the international capital market in April 2021 and issued Eurobonds worth US\$

Category-wise Change in Public **Figure 5.4**

Source: State Bank of Pakistan

² The entire increase in government external debt came from long-term instruments during FY21. More than 60 percent of the rise in government domestic debt was sourced through long-term instruments.

³³ The government issued Ijara Sukuk in April 2020 after a gap of three years; last time the government issued Sukuk, in June 2017.

Tenor-wise Share in Public Debt **Figure 5.5**

Source: State Bank of Pakistan

2.5 billion. These instruments helped the government lengthen the maturity profile of external debt and repay some of its short-term external debt.

Despite the improvement in the debt sustainability indicators during FY21, further efforts are required on part of the government to reduce vulnerability of debt portfolio. First, the high level of public debt has given rise to a substantial increase in interest payments,

which stood at 57.7 percent of FBR tax revenues in FY21. Second, the increasing share of floating rate instruments entails repricing risk, in case of an increase in interest rates. Third, the excessive reliance on commercial banks for fulfilling the financing needs is fueling the risk-averse behavior of banks, with concerns over potential crowding out of the private sector.⁴ Finally, after the phasing out of the DSSI, the country will have to repay both the deferred principal and interest payments on the external debt, which may pose pressures on the external account, in the absence of a corresponding expansion in FEE.

A persistent improvement in the debt sustainability position warrants restraining the twin deficits to manageable levels. This would require concerted efforts to address the structural issues that have impeded country's exports and foreign direct investment.⁵ Similarly, efforts on the fiscal side should focus on widening the tax base and expediting reforms in the public sector enterprises (PSEs) that cause huge financing burden for the government.⁶

Box 5.1: The Debt Ramifications of Covid-related Spending: Pakistan vis-a-vis Peer Countries

Pakistan announced an unprecedented fiscal support of Rs 1.3 trillion (almost 2.0 percent of GDP) in response to the Covid pandemic.⁷ However, unlike the global experience, Covid-related spending did not result in a surge in Pakistan's public debt. Not only was the absolute addition in public debt during FY21 the lowest since FY17, but the public debt-to-GDP ratio actually declined in Pakistan (Figure 5.1.1). Importantly, Pakistan is one of the few countries out of 39 emerging market economies, in which the change in government debt as percent of GDP was less than the Covid-related spending (Figure 5.1.2).⁸

Covid has taken a significant toll on the global economy. The pandemic brought serious challenges for the health system, disrupted economic activity and mobility, and gave rise to widespread unemployment in almost all parts of the world. In response to the pandemic, countries around the globe provided a swift policy response by rolling out extensive fiscal and monetary support, including via tax concessions, wage subsidies, increase in social security spending, and additional spending on the health sector. As of September 2020, this support amounted to a sizable 12 percent of global GDP.⁹ While these policy measures helped contain the impact of the outbreak, the fiscal imbalances and hence general government debt levels also increased around the globe as a consequence.

⁴ For details, see Chapter 7 of the SBP's Annual Report on State of Pakistan's Economy for FY20.

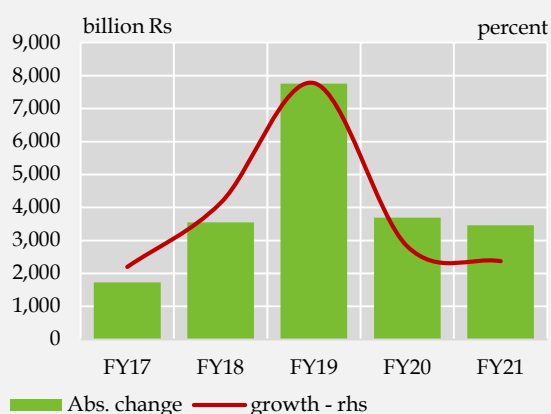
⁵ For details, see Special Section 1 of the SBP's First Quarterly Report of State of Pakistan's Economy for FY20.

⁶ For details, see Special Section 2 of the SBP's Second Quarterly Report on State of Pakistan's Economy for FY19.

⁷ Source: IMF Fiscal Monitor, October 2020.

⁸ For economies whose fiscal years end before June 30, data are recorded in the previous calendar year. For economies whose fiscal years end on or after June 30, data are recorded in the current calendar year.

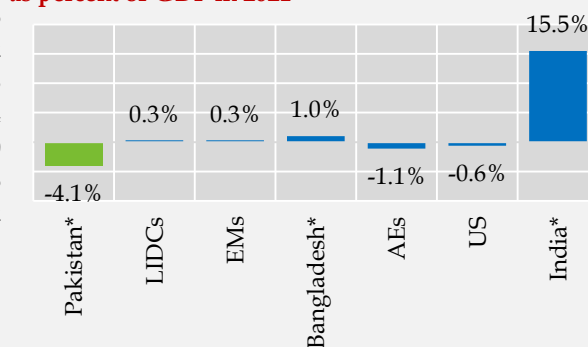
⁹ IMF, Fiscal Monitor, October 2020.

Public Debt Accumulation

Source: State Bank of Pakistan

Increase in Government Debt as percent of GDP in 2021

Figure 5.1.1



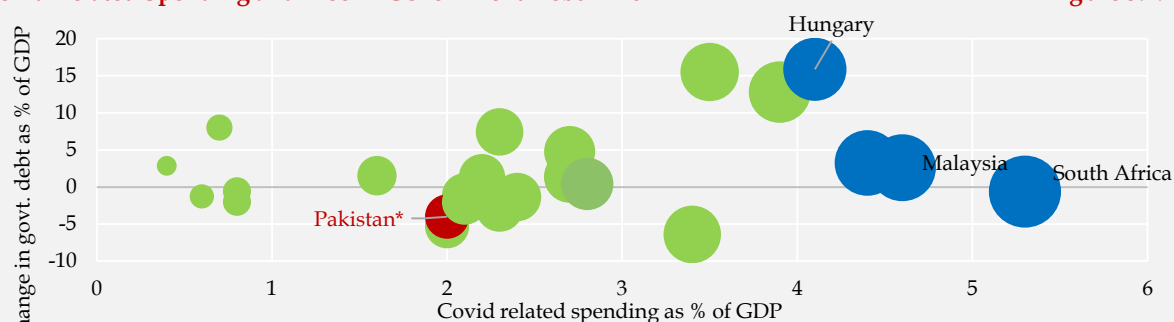
* Fiscal year basis for Pakistan, Bangladesh & India; projections of calendar year 2021 for all others.

Source: IMF Fiscal Monitor, State Bank of Pakistan

Pakistan's relative better position vis-a-vis other countries stemmed from a prudent fiscal policy stance that entailed strengthening revenue administration efforts and containment of non-priority current spending such as running of civil government. Importantly, Pakistan witnessed a large increase in tax revenues. On the other hand, the overall rise in expenditures as percent of GDP was relatively low in the case of Pakistan, despite the sizeable Covid-related spending.

Covid Related Spending and Rise in Government Debt in 2021

Figure 5.1.2



The bubble size refers to the share of covid related spending. Blue bubble indicates a spending of 4 percent of GDP or higher, green bubble implies spending of less than 4 percent.

* Fiscal year basis for Pakistan; projections of calendar year 2021 for all others.

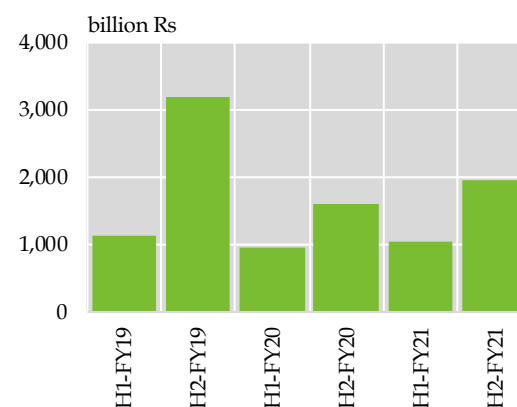
Source: IMF Fiscal Monitor, State Bank of Pakistan

5.2 Domestic Debt

With the accumulation of Rs 3.0 trillion over June 2020, the stock of domestic debt reached Rs 26.3 trillion by end-June 2021. This expansion was contributed by two factors. The first was the sustained deficit financing requirement, with 60.7 percent of the budget deficit being financed through internal sources. The second was the increase in the government's deposits with the banking system. Although, the government had been mobilizing deposits, however the emphasis increased since the end of FY19, with the goal to smoothen future debt repayments.

Change in Domestic Debt

Figure 5.6



Source: State Bank of Pakistan

The dynamics of domestic debt present some notable improvements during the year. First, the government continued to adhere to the commitment of zero fresh borrowing from the SBP, thus avoiding deficit monetization. Second, the authorities were able to secure long-term loans despite the low interest rate environment. Specifically, around 62 percent of the expansion in domestic debt during FY21 was sourced through long-term instruments. Third, the government also diversified its instrument base by introducing several new instruments, including floater PIBs with quarterly coupon payments, and conventional and Shariah-compliant Naya Pakistan Certificates (NPCs).

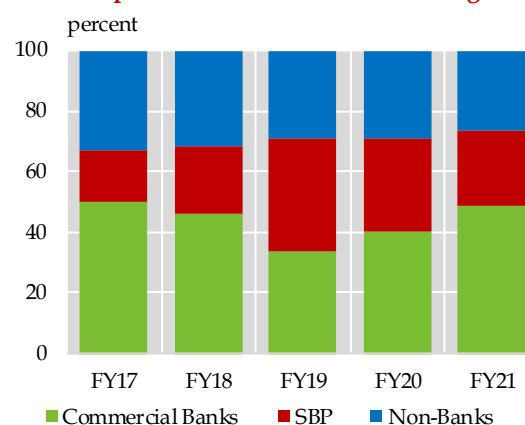
These new securities are expected to improve debt management by providing alternative sources of financing, and some of these, especially the NPCs, have already helped attract new investors, such as resident and non-resident overseas Pakistanis and Islamic Banking Institutions (IBIs). Most of the increase in domestic debt was recorded during H2-FY21, in line with the past trend (Figure 5.6) and mainly due to a high deficit financing requirement. In overall terms, around 84.0 percent of the increase in debt during H2-FY21 was mobilized through short-term floating debt.

Ownership of Domestic Debt

In terms of institutional composition, commercial banks were the main financiers of the government in FY21. The share of banks in total domestic debt increased from 40.3 percent during FY20 to 48.6 percent in FY21 (Figure 5.7). The government adhered to its commitment of zero fresh borrowing from the central bank for the second consecutive year. In fact the government made retirements of Rs 0.6 trillion to SBP during FY21. As a result, the

Ownership of Domestic Debt

Figure 5.7



Source: State Bank of Pakistan

share of domestic debt owned by the SBP declined.

The provision of funds by non-banks to the government was also limited as compared to FY20. This was due to a number of reasons. First, the government imposed a ban on institutional investment in the National Savings Schemes with effect from July 2020 in order to enhance institutional participation in the competitive primary and secondary markets of long-term debt.¹⁰ Second, the government discontinued the sale and purchase of various denominations of prize bonds with the objective to improve documentation. Third, overall low profit rates compared to last year kept the NSS relatively less attractive for savers and investors.

Permanent debt

The share of permanent debt (which mainly includes PIBs, Ijara Sukuk and prize bonds) in total domestic debt almost remained unchanged during FY21 (Table 5.2). With regards to PIBs, the government mobilized funds worth Rs 1.7 trillion (net of maturity) from these bonds during FY21, against Rs 2.0 trillion during FY20. This increase for the second consecutive year is attributed to the introduction of new instruments in the

¹⁰ Non-bank investment in government securities was on the lower side compared to last year. Non-bank investment in government marketable securities increased by Rs 446.2 billion compared to an increase of Rs 601.7 billion last year.

Change in Government Domestic Debt**Table 5.2**

billion rupees; share in percent

	Stock			Flow		Share in total stock	
	FY19	FY20	FY21	FY20	FY21	FY20	FY21
Domestic debt	20,731.8	23,282.5	26,265.3	2,550.8	2,982.8	100.0	100.0
Permanent debt	12,080.0	14,023.5	15,904.1	1,943.4	1,880.6	60.2	60.6
of which							
PIBs	10,933.2	12,886.0	14,590.0	1,952.8	1,704.0	55.3	55.5
Ijara Sukuk	71.0	198.2	665.3	127.2	467.1	0.9	2.5
Prize Bonds	893.9	734.1	443.7	-159.8	-290.4	3.2	1.7
Floating debt	5,500.6	5,578.3	6,680.4	77.7	1,102.1	24.0	25.4
of which							
MTBs	4,930.5	5,575.5	6,676.9	645.1	1,101.4	23.9	25.4
Unfunded debt	3,144.1	3,673.6	3,645.9	529.5	-27.7	15.8	13.9
Naya Pakistan Certificates (NPC)	0.0	0.0	28.1	0.0	28.1	0.0	0.1

Source: State Bank of Pakistan

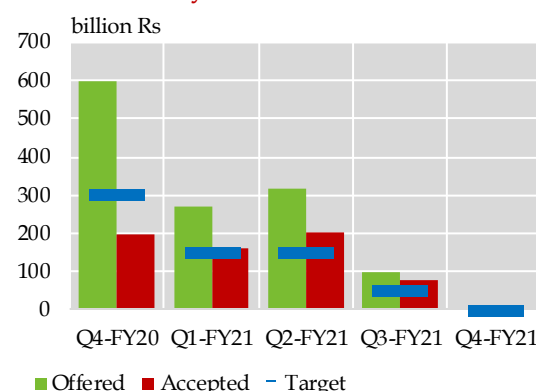
market. For instance, 3-year and 5-year floating rate PIBs were launched in June 2020, which attracted market interest.

Similarly, the government launched a 2-year floater PIB (PFL) in FY21, with a unique feature of fortnightly reset – quarterly payment coupon. The government also offered new coupon structures for the existing 3-year, 5-year and 10-year maturities PFL. These instruments were offered with quarterly coupon and quarterly resets, which were linked with the yields of 3-month T-bills. The pre-auction target allocation to floaters was almost three times higher in FY21 than the target of FY20.

The presence of floating long-term instruments in the market helped the government to mobilize funds of longer tenors in a low interest rate environment. The accepted amount of floater PIBs almost doubled in FY21, while the accepted amount of fixed rate PIBs remained one-half as compared to last year.

It is important to highlight that the market's participation in fixed PIBs remained lower compared to last year, primarily due to the market's perception of the bottoming out of interest rates. However, with the forward guidance issued in the January 2021 Monetary Policy Statement and reiterated in the subsequent MPC meetings (**Chapter 3**), the market's participation in fixed PIBs increased in

the fourth quarter (**Table 5.3**). Here, it is worth mentioning that with a reversal in the current monetary policy stance, the increased recourse to long-term floating PIBs will increase debt servicing cost going forward.

Government Ijara Sukuk - Auction Summary**Figure 5.8**

Source: State Bank of Pakistan

Meanwhile, the relaunch of the Shariah-compliant Ijara Sukuk of 5-year tenor with fixed rates after a gap of three years and variable rental rates after a gap of four years in April 2020– had helped the government mobilize Rs 0.1 trillion during FY20, and another Rs 0.5 trillion in FY21.

A large share of fund mobilization through Sukuk took place during the first two quarters of FY21. Both the offered and accepted amounts remained above the pre-auction target (**Figure 5.8**). However, in Q3, only one auction

was held, whereas no auction took place during the fourth quarter.

The relaunch of the Sukuk in late FY20 bodes well in terms of both diversification of the government's financing mix, and for the liquidity perspective of Islamic banks. One of the main objectives of the Medium-Term Debt Management Strategy is to increase the share of Shariah-compliant instruments in public debt, as these instruments are an important avenue to attract the liquidity available with IBIs.

On the other hand, prize bonds recorded net outflows for the second consecutive year. In December 2020, the government discontinued prize bonds of Rs 25,000 denomination to improve the documentation of the economy (Figure 5.9).

In this regard, the holders of these prize bonds were given three options: 1) convert to premium prize bonds (which are registered in the investor's name); 2) replace with special savings certificate/defense savings certificates; or 3) encash at face value, where the proceeds are transferred to the bond-holder's bank account. Anecdotal evidence suggests that only a fraction of the holders converted these bonds into premium bonds.

Specifically, net outflows of around Rs 150 billion were recorded from the discontinued Rs

25,000 prize bonds, but the net inflows into the premium (registered) Rs 25,000 prize bonds were only Rs 15 million (Figure 5.9). It appears that most of the bondholders encashed the bonds at face value. Furthermore, in April 2021, the government discontinued sales of Rs 15,000 and Rs 7,500 prize bonds.

Auction Summary of PIBs* **Table 5.3**

billion rupees

	Fixed PIBs			Floater PIBs		
	T	O	A	T	O	A
Q1-FY20	325.0	2521.2	963.5	300.0	334.2	219.4
Q2-FY20	300.0	1003.5	411.4	150.0	468.7	178.6
Q3-FY20	300.0	736.5	296.3	150.0	421.3	179.4
Q4-FY20	375.0	765.7	399.6	250.0	353.9	241.2
Q1-FY21	420.0	448.9	249.2	830.0	1970.4	870.6
Q2-FY21	390.0	186.1	42.4	930.0	622.7	455.1
Q3-FY21	325.0	436.8	182.4	515.0	206.8	112.2
Q4-FY21	375.0	1467.9	582.4	450.0	371.0	223.5

*Competitive & non-competitive combined

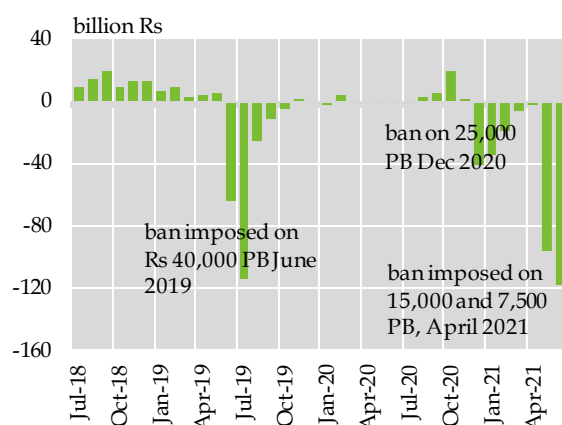
T: Targeted; O: Offered; A: Accepted

Source: State Bank of Pakistan

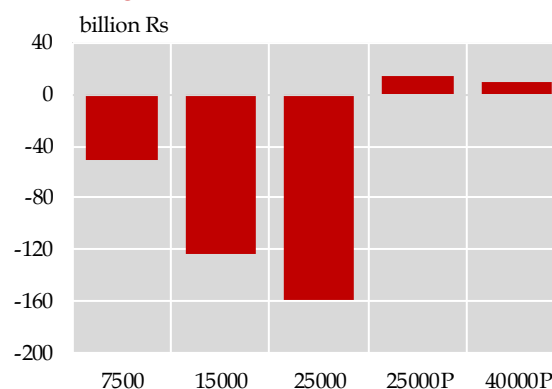
Floating debt

Floating debt (maturity within a year) increased by Rs 1.1 trillion during FY21, compared to a smaller rise of Rs 0.1 trillion in the previous year. The demand for T-bills during FY21 remained at elevated levels. However, within T-bills, the government was able to lengthen the maturity profile across quarters of FY21. The share of 3-month T-bills in the total outstanding stock of T-bills

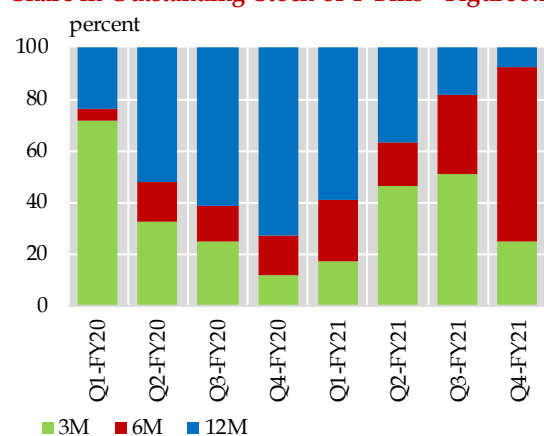
Monthly Inflows in Prize Bonds during FY21



Denomination-wise Net Inflows in Prize Bonds during FY21 **Figure 5.9**



Source: Central Directorate of National Savings

Share in Outstanding Stock of T-Bills Figure 5.10

Source: State Bank of Pakistan

declined, whereas that of 6-month instruments increased during FY21 (Figure 5.10).

During the first two quarters of FY21, the market remained interested in 3-month T-bills. However, with the forward guidance provided in the January 2021 monetary policy statement about no immediate rise in interest rates, the market's interest also increased towards 6-month T-bills in H2-FY21 (Figure 5.10).

Unfunded debt

Unfunded debt, which mainly comprises National Saving Schemes, recorded net outflows of Rs 27.7 billion during FY21, against an increase of Rs 529 billion in the previous year. The following factors explain the decline in NSS instruments. First, the government banned institutional investment in NSS in order to enhance institutional participation in competitive primary and secondary markets of long-term debt.

This ban not only kept the gross investment lower than last year, but also prompted the institutions to withdraw their funds from these schemes, which led to overall net withdrawals from NSS in FY21 (Table 5.4). Second, due to the prevailing low interest rate environment, the profit rates on various

instruments remained, on average, 100-150 bps lower than FY20 (Table 5.4).

Profit Rates and Investment in NSS Table 5.4

billion rupees

	FY19 FY20 FY21			FY20 FY21			
	Profit rates (%)			GI	NI	GI	NI
DSC	10.0	10.1	9.0	149.9	97.8	38.0	-9.1
BSC	11.8	11.9	10.8	235.3	83.4	172.8	2.5
RIC	9.6	10	8.6	205.8	82.2	87.1	26.7
SSC	8.6	9.7	7.9	37.4	19.3	95.5	-6.3
PBA	11.8	11.9	10.8	78.9	33.8	67.6	16.3

* average profit rates during the year; GI = Gross inflows, NI = Net inflows

Source: Central Directorate of National Savings

Naya Pakistan Certificates

An important highlight of the fiscal year was the inclusion of Naya Pakistan Certificates held by Pakistani residents in the category of domestic debt. The government was able to mobilize funds worth Rs 28.1 billion from these investors in the NPCs during FY21.¹¹ It is important to note that the NPCs are offered both in conventional as well as Shariah-compliant modes. The available data suggests that both versions of NPCs remained attractive during the period under review.

Interest payments on domestic debt remain at an elevated level

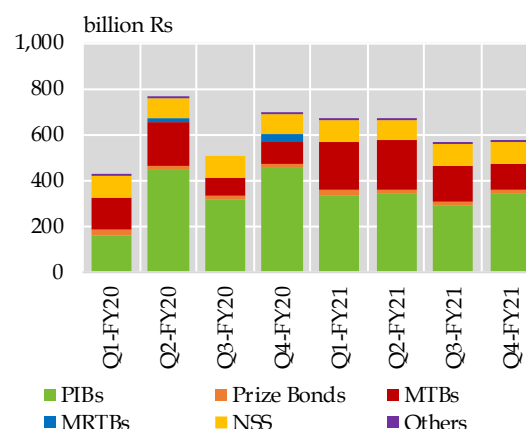
Interest payments on domestic debt grew 9.1 percent during FY21 compared to 27.0 percent during FY20. This deceleration was mainly due to high base effect from last year. In absolute terms, the interest payments on domestic debt stood at Rs 2.5 trillion during FY21, against Rs 2.3 trillion during FY20. It must be recalled that at end-June 2019, the government had converted the stock of MRTBs held by the SBP to PIBs, with maturities of 3 to 10 years. The spread between the 6-month T-bills (benchmark for MRTBs) and PIBs booked at end-June 2019 stood at almost 100bps; this had contributed to the sudden rise in the servicing cost in FY20.

¹¹ This amount includes the NPCs held by residents only. NPCs held by non-residents are part of external debt. Aggregate (gross) inflows worth US\$ 1.0 billion were recorded during FY21.

On a positive note, this debt re-profiling helped avoid the roll-over risks associated with MRTBs.

Analysis of instrument-wise interest payments indicates that almost one-half of the increase in debt servicing during FY21 stemmed from higher coupon payments on PIBs (Figure 5.11). Nearly 70 percent of the SBP's debt stock was converted into 10-year Floating Rate PIBs (FR-PIBs). With the cumulative 625 bps reduction in the policy rate from March 2020 onwards, the pace of debt servicing on domestic debt also decelerated. The weighted average rate on PIBs during the time of this re-profiling was around 13.7 percent, which had dropped to 9.6 percent in FY21. This

Instrument-wise Interest Payments Figure 5.11



Source: State Bank of Pakistan

reduction of almost 400 bps explains the gains achieved during FY21.¹²

Pakistan's External Debt and Liabilities

Table 5.5

billion US\$

	End-June Stock			Absolute change	
	FY19	FY20	FY21	FY20	FY21
Total external debt & liabilities	106.3	113.0	122.2	6.7	9.2
Public external debt (1+2)	73.4	78.0	86.4	4.5	8.4
1. Govt. external debt	67.8	70.3	79.0	2.5	8.7
i) Long term (>1 yr)	66.5	68.8	78.2	2.2	9.4
of which					
Paris club	11.2	10.9	10.7	-0.3	-0.2
Multilateral	27.8	30.9	33.8	3.1	2.9
Other bilateral	12.7	13.4	14.8	0.7	1.4
Euro/Sukuk global bonds	6.3	5.3	7.8	-1.0	2.5
Commercial loans/ credits	8.5	8.1	9.7	-0.4	1.6
Local government securities (PIBs)	0.0	0.1	0.5	0.1	0.4
NPC	0.0	0.0	0.8	0.0	0.8
ii) Short term (<1 year)	1.3	1.5	0.9	0.3	-0.7
of which					
Multilateral	0.8	0.8	0.5	0.0	-0.3
Commercial loans	0.5	0.1	0.0	-0.3	-0.1
Local currency securities	0.0	0.6	0.4	0.6	-0.2
2. From IMF	5.6	7.7	7.4	2.0	-0.3
3. Foreign exchange liabilities	10.5	9.9	8.8	-0.6	-1.1
4. Public sector enterprises (PSEs)	3.9	5.2	6.7	1.3	1.6
5. Commercial banks	4.7	4.6	5.3	-0.1	0.6
6. Private sector	10.5	11.0	10.9	0.5	-0.1
7. Debt liabilities to direct	3.3	4.3	4.1	1.0	-0.2

Source: State Bank of Pakistan

¹² The amount of short-term debt converted into long-term debt at end-June 2019 stood around Rs 6.4 trillion. Around 70 percent (Rs 4.5 trillion) of this stock was converted on floating rates. The remaining amount of almost Rs 1.9 trillion was converted on fixed rate of around 13.75 percent (almost 100 bps higher than the rate of MRTBs). This conversion to fixed rate long-term instruments led to an additional debt servicing of roughly Rs 20 billion in FY20. However, with the fall in interest rates by almost 400 bps since the re-profiling, the interest amount paid on floating PIBs stood at Rs 400 billion in FY21, which would have been Rs 580 billion if the interest rate had remained the same. Hence, the difference of almost Rs 160 billion represents savings on interest payments arising from lower interest rates during FY21.

Meanwhile, interest payments on T-bills increased to Rs 0.7 trillion in FY21, from Rs 0.5 trillion last year. As highlighted earlier, the rise in the outstanding stock of T-bills led to higher interest payments during FY21. In contrast, as the government did not borrow from the SBP over the last two years, there were no interest payments on MRTBs.

5.3 Public External Debt & Liabilities

Public external debt reached US\$ 86.4 billion by end-June 2021, registering a 10.8 percent increase. The pace of accumulation of external debt also increased, with the addition of US\$ 8.4 billion during FY21 against US\$ 4.5 billion in the previous year (Table 5.5).¹³ This acceleration in external debt growth is explained by revaluation losses due to the depreciation of US Dollar against other international currencies, which inflated the value of external debt in Dollar terms. More than one-half of the revaluation losses were due to the appreciation of the SDR against the US Dollar.

The profile of public external debt improved during FY21 on two counts. First, the entire increase in external debt emanated from long-term instruments, whereas, the government retired a part of short-term debt. Second, the government was able to mobilize funds through diversified sources, such as Eurobonds, Naya Pakistan Certificates, and foreign portfolio investment in local government securities. These were in addition to the traditional sources of external financing, such as multilateral, bilateral and commercial creditors.

Importantly, in an effort to diversify the investor base and attract foreign inflows, the SBP launched the Roshan Digital Accounts (RDAs) in FY21; these accounts also provide an opportunity to the Pakistani diaspora to

invest in a wide range of avenues, including NPCs, stock market, mutual funds and real estate (Chapter 6).

The NPCs attracted significant interest from non-resident Pakistanis, with US\$ 0.8 billion inflows till end-June 2021.¹⁴ Similarly, foreign investment in long-term local government securities increased by US\$ 0.4 billion during FY21, compared to US\$ 0.1 billion last year. It must be recalled that the tax regime for non-residents was simplified in FY20 to encourage investment in long-term government securities.¹⁵ Ample liquidity in the international market and stability of Pakistan's external account largely explains the higher investment in FY21. The diversification of financing resources is an important reform to address the vulnerability of the external account. The country has witnessed frequent episodes of BoP crisis in the past because of inadequate availability of external financing. Furthermore, the government secured debt relief of US\$ 2.3 billion under the G-20's Debt Service Suspension Initiative (DSSI) during FY21. This deferment eased the external debt servicing and helped improve the sustainability of Pakistan's external debt during FY21.

A large (57.0 percent) increase in external debt came in Q4-FY21.

A higher fiscal deficit compared to first three quarters and a slight deterioration in the current account balance led to higher mobilization of funds from multilateral and commercial sources during the quarter. Public external debt stock increased US\$ 4.8 billion during Q4-FY21, out of which US\$ 2.5 billion were mobilized via the issuance of Eurobonds (Figure 5.12). In addition, foreign investment in local government securities and non-residents' investment in the NPCs also picked up in Q4.

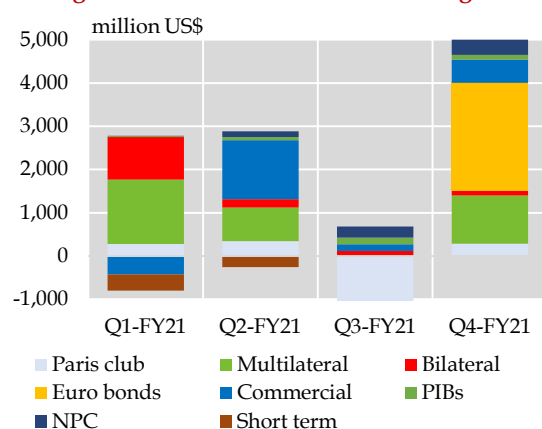
¹³ Foreign exchange liabilities recorded net outflows of US\$ 1.1 billion during FY21, compared to net retirements of US\$ 0.6 billion during FY20.

¹⁴ Gross inflows into the NPCs stood at US\$ 1.0 billion during FY21, whereas US\$ 0.8 billion were recorded in external debt.

¹⁵ Source: ERD/M&PRD/PR/01/2020-01 dated January 2, 2020

Change in Public External Debt

Figure 5.12



Source: State Bank of Pakistan

Gross External Disbursements

Gross external disbursements (public grants & loans) soared to US\$ 13.0 billion in FY21 from US\$ 10.7 billion in FY20, and US\$ 12.2 billion commitments envisaged in the Budget

Source of Foreign Disbursements¹⁶ Table 5.6
million US\$

	FY20		FY21	
	Commit.	Disb.	Comm.	Disb.
Multilateral	6,791.0	5,670.0	5,253.8	4,370.2
of which				
ADB	3,112.0	2,824.0	1,470.0	1,368.3
IDA		1,179.2	1,467.5	1,596.4
Bilateral	193.0	1,648.3	457.0	453.5
Safe deposit	-	-	-	1,000.0
Bonds	-	-	1,500.0	2,500.0
Commercial	3,463.0	3,373.3	3,922.5	4,721.2
Total disbursements	10,447.0	10,691.7	12,233.4	13,044.9
Grand total				14,282.9

Commit.: Commitment; Disb: Disbursement

Source: Economic Affairs Division

FY21. The government expanded external financing sources during FY21 by mobilizing funds from Eurobonds and NPCs. This led to a slight decline in loan disbursements from multilateral and bilateral creditors during FY21 (Table 5.6).

Within multilateral sources, major inflows came from the ADB and the IDA. The volume of disbursements through commercial sources also increased during the year, though the terms of foreign commercial loans contracted by Pakistan were favorable during the year (Jul-Mar) as compared to the previous year (Table 5.7).

Terms of Foreign Commercial Loans Contracted Table 5.7

Lender	FY20	FY21 (Jul-Mar)
	Terms	
USSE AG, UBL, ABL	Lib-3M + 3.25	Lib 12M+2
Dubai Bank	Lib- 3M + 2.2	Lib 12M+2.05
Bank of China	Lib- 6M+2.93	
China Development	Lib- 6M+3	
Citi Bank	Lib- 3M+2.2	
Ajman Bank	Lib- 6M+2.2	
ICBC		Lib 3M+2.75
Emirates NBD		Lib 12M+2.05

Lib=LIBOR

Source: Economic Survey of Pakistan 2020-21

Utilization of foreign disbursements

Disaggregated analysis of gross disbursements indicates that more than one-half of the inflows were utilized for budgetary support and around 12 percent (US\$ 1.8 billion) financed the ongoing projects; the utilization of the major loan inflows received during FY21 are presented in Table 5.8. Some of the important projects pertained to the power sector – including the Karachi Nuclear Power Project (almost US\$ 1.0 billion, financed by China) and the Jamshoro power generation project (US\$ 0.2 billion, financed by the ADB). The country also received US\$ 0.2 billion from the ADB for emergency assistance for Covid-19.

Issuance of Eurobond in FY21

In April 2021, Pakistan entered the international capital market after a gap of more than three years.¹⁷ Importantly, this was

¹⁶ Excluding inflows from IMF, Pakistan Banao Certificates, Naya Pakistan Certificates and non-resident investment in government securities.

¹⁷ The Medium-Term Note Program allows continuous fund raising from investors through the designated or appointed dealers. Under this programme, a bond is registered only once. However, the issuer can reenter the market more easily to raise additional capital.

Major Foreign Economic Assistance during FY21¹⁸**Table 5.8**

million US\$

Donor	Name of project	Purpose	Amount
Total disbursements			13,044.9
<i>of which</i>			
Project and Budgetary Support			
China	Karachi Nuclear Power Project	Project	1,114.0
China Development Bank	Term facility agreement	Budgetary support	1,000.0
IDB	Purchase of crude oil	Short-term contract	533.0
IDA	2nd Securing Human Investment	Budgetary support	397.4
ADB	Trade & Competitiveness Sub program-II	Budgetary support	300.0
ADB	3rd Capital Markets Development Program-I	Budgetary support	290.2
Emirates NBD	Emirates NBD Financing facility	Budgetary support	285.0
IDA	RISE Development Policy Financing	Budgetary support	256.1
IBRD	Resilient Institutions for Sustainable Economy	Budgetary support	250.0
AIIB	RISE Program	Budgetary support	249.4
ADB	Thermal for Installation of New Coal Fired Power	Project	204.1
ADB	Emergency Assistance for fighting Covid-19	Project	198.2
IDA	Crisis Resilient Social protection	Budgetary support	147.9
IDB	Polio Eradication Program	Project	75.0
IDA	Pakistan Raises Revenue	Project	70.7
IDA	Punjab Cities Program	Project	54.4
IDA	Sindh Barrages Improvement Project	Project	52.2
Euro Bonds			2,500

Source: Economic Affairs Division

the first time that Pakistan adopted a program-based approach for the bond issuance, with the registration of the Global Medium-Term Note (GMTN) program. The country raised US\$ 2.5 billion through a multi-tranche transaction of 5-year, 10-year and 30-year Eurobonds. It was the largest conventional bond issued by Pakistan with an order book of US\$ 5.3 billion – 2.1 times over subscription.¹⁹

The rates offered on these bonds are slightly higher compared to what the country had offered last time (Table 5.9). Furthermore, it is important to mention that as these bonds are issued at a fixed rate, they are not faced with repricing risk with adverse movements in interest rates. In addition, the oversubscription

for the country's sovereign bonds reflects foreign investors' confidence and a positive economic outlook of Pakistan.²⁰

Eurobonds and Sukuk Issued by GoP Table 5.9

value in million US\$

	Tenor	Value	Rate offered
FY04	5 years	500	6m libor + 323 bps
FY06	10 years	500	10y US T-bill + 240 bps
FY06	30 years	300	30y US T-bill + 302bps
FY07	10 years	750	10y US T-bill + 200bps
FY14	5 years	1000	7.25%
FY14	10 years	1000	8.25%
FY16	10 years	500	8.25%
FY18	5 years	1000	5.63%
FY18	10 years	1500	6.88%
FY21	5 years	1000	6%
FY21	10 years	1000	7.38%
FY21	30 years	500	8.88%

Source: Economic Affairs Division

¹⁸ The amount of US\$ 13,044.9 million is the total of public grants and loans. If the amount of publicly guaranteed inflows is also included, then the grand total for FY21 comes out to US\$ 14,282.9 million.

¹⁹ Pakistan Economic Survey 2020-21, Chapter 9 Public Debt. A green bond by WAPDA worth US\$ 500 million was also issued during FY21, however this transaction is part of PSEs debt and is not included in public debt.

²⁰ For reference, Egypt issued sovereign bonds worth US\$ 3.75 billion in February 2021 of various tenors (5, 10 and 40 years) in the international capital market at rates relatively lower offered by Pakistan. Egypt issued sovereign bonds of 5y, 10y and 40y at 3.875, 5.875 and 7.5 percent respectively. Turkey also issued two sovereign bonds worth US\$ 3.5 billion of 5 and 10 year tenors in January 2021. The coupon rate offered on the 5-year bond

The successful issuance of sovereign bonds has improved the maturity profile of external debt. Also, the availability of these funds has boosted the adequacy of the FX reserves to finance external payments.

5.4 External Debt Sustainability

The sustainability of the country's external debt and liabilities is gauged through solvency and liquidity indicators. The solvency indicators, such as debt-to-GDP, debt-to-Foreign Exchange Earnings (FEE) and debt servicing-to-FEE, measure the country's ability to service its external payments on an ongoing basis. On the other hand, liquidity indicators measure the country's ability to service its immediate liabilities. These include short-term debt-to-reserves, etc.

Pakistan's external debt sustainability improved during FY21 in terms of both solvency and liquidity indicators. The turnaround in GDP and FEE during the year enhanced the debt-bearing capacity of the economy. The ratio of total external debt & liabilities (TDL)-to-GDP declined from 45.7 percent in FY20 to 40.3 percent in FY21 (**Table 5.10**). This ratio indicates that the growth in nominal GDP outpaced the growth in TDL during the year. Similarly, with the improvement in the external account, the ratio of total reserves-to-TDL also improved in FY21.

Furthermore, the indicators of repayment capacity, such as external debt servicing (EDS)-to-FEE, strengthened on two counts: the revival in export earnings (EE) and the record increase in workers' remittances; these inflows increased the stream of FEE available to service external debt. Second, the debt relief provided under the DSSI substantially reduced debt servicing needs.²¹ Specifically, the country secured deferment of US\$ 2.3 billion (US\$ 1.8 billion of principal payments

Indicators of External Debt Sustainability

Table 5.10

percent	FY16	FY17	FY18	FY19	FY20	FY21
Solvency indicators						
TDL/GDP	26.6	27.4	33.4	45.7	45.7	40.3
PED/GDP	20.8	20.5	24.7	31.5	31.2	28.2
TR/TDL	31.2	25.6	17.2	13.6	16.7	20.0
SBPR/TDL	24.5	19.3	10.3	6.9	10.7	14.2
EDS/FEE	8.5	12.3	10.7	17.0	20.4	12.8
EDS/EE	15.8	23.1	19.2	31.3	39.6	26.6
Liquidity indicators						
STPED/PEDL	2.8	1.3	2.1	1.5	1.8	0.9
STPED/TR	7.3	4.1	9.9	8.7	8.2	3.5
STPED/SBPR	9.3	5.5	16.6	17.4	12.7	5.0

TDL: Total debt and liabilities; PED: Public external debt; TR: Total reserves; SBPR: SBP reserves; STPED: Short-term public external debt; PEDL: Public external debt and liabilities; EDS: External debt servicing; FEE: Foreign exchange earnings; EE: Export earnings; GDP: Gross domestic product

Sources: EAD, PBS, SBP

and US\$ 0.5 billion in interest payments) during FY21. According to the terms of the DSSI, these payments will fall due in next 4-6 years. Hence, the absence of these heavy payments during FY21 led to an improvement in the debt-repaying capacity of the country.

The liquidity indicators bolstered with declining reliance on short-term loans during FY21. As mentioned earlier, the government aimed to lengthen the maturity profile of external debt and repaid some of its short-term loans during the year. The declining share of short-term debt reduces roll-over risk and bodes well for the sustainability of external debt.

External Debt Servicing

The country repaid sovereign debt (including short-term) worth US\$ 6.9 billion during FY21, against US\$ 9.0 billion last year (**Table 5.11**). This decline in debt servicing is largely attributed to the debt relief secured under the DSSI. With the exception of multilateral

was 5.25 percent and pricing of the 10-year bond was 6.25 percent – almost 100 bps higher than the coupon rate offered by Pakistan.

²¹ For details, see Box 4.1 in SBP Third Quarterly Report on State of Pakistan's Economy for FY21.

Pakistan's External Debt Servicing - Principal**Table 5.11**

million US\$

	FY20	FY21	Q1-FY21	Q2-FY21	Q3-FY21	Q4-FY21
1. Public debt (a+b)	7,862.0	6,151.0	1,423.5	1,381.1	1,597.9	1,749.0
a. Government debt	7,118.1	5,072.2	1,170.2	1,078.5	1,375.5	1,448.0
Paris Club	375.8	8.7	0.0	4.7	0.0	4.0
Multilateral	1,455.1	1,555.2	442.7	319.1	454.4	339.0
Other Bilateral	407.2	90.7	70.0	4.7	11.1	5.0
Euro/Sukuk global bonds	1,000.0	0.0	0.0	0.0	0.0	0.0
Commercial loans / credits	3,879.3	3,417.5	657.5	750.0	910.0	1,100.0
b. To the IMF	744.0	1,079.0	253.3	302.6	222.4	301.0
2. Foreign exchange liabilities	500.0	3,000.0	1,000.0	1,000.0	1,000.0	0.0
<i>Memorandum Items</i>						
Short-term government debt	1,181.0	784.0	272.3	154.5	318.1	39.0

Source: State Bank of Pakistan

sources, servicing to all other sources remained lower than last year. Meanwhile, a net reduction of US\$ 3.0 billion was also recorded in the stock of foreign exchange liabilities. The country repaid US\$ 1.0 billion each in the first three quarters of FY21 to a bilateral partner. These liabilities were held in the form of deposits with the central bank.

Interest payments on public external debt stood at US\$ 1.5 billion during FY21, against US\$ 2.0 billion during FY20. Debt relief of US\$ 0.5 billion under the DSSI primarily explains the slowdown in interest payments during the year. In addition, the relatively lower global benchmark rates (such as LIBOR) also helped decelerate interest payments to commercial lenders from US\$ 450 million in FY20 to US\$ 336 million in FY21.

Chapter 6

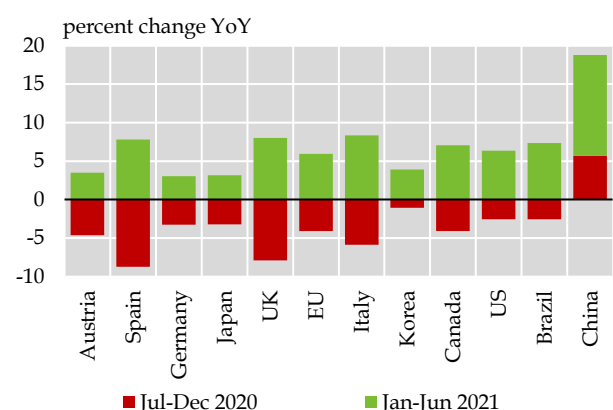
External Sector

Pakistan's external account improved significantly during FY21. The current account deficit fell to a 10-year low of US\$ 1.9 billion, primarily on the back of surging remittances and export proceeds. The Covid-related air travel restrictions, along with the market-based exchange rate, helped divert remittances to formal channels and curtailed services imports. Furthermore, Pakistan benefited from the G-20's Debt Service Suspension Initiative and the reduction in global benchmark interest rates, which reduced the interest payments on external debt. Meanwhile, the IMF program resumed in FY21, and facilitated the country's continued access to external financing from other multilateral agencies, and commercial and bilateral creditors. Pakistan also reentered the international capital markets after a gap of over 3 years and raised US\$ 2.5 billion from Eurobonds, and a state-owned firm capitalized on the global appetite for sustainable financing instruments by raising US\$ 500 million from a green bond. Under these dynamics, the country's FX reserves increased by US\$ 5.5 billion during FY21 to US\$ 24.4 billion, and the PKR appreciated 6.7 percent against the US Dollar. These positive developments notwithstanding, some challenges emerged, as the accommodative post-Covid policies and the resultant pick-up in industrial activity necessitated higher imports of both energy and non-energy products. Supply-side challenges around wheat, sugar and cotton necessitated imports at elevated global commodity price points. To ensure the external account's sustainability, the policy focus was on diversifying the source of forex earnings. This involves engaging the overseas diaspora to undertake investments, including into the Naya Pakistan Certificates, via the Roshan Digital Accounts, and incentivizing export-oriented industries.

6.1 Global Economic Review

The global economy continued to deal with the challenges of Covid-19 pandemic during FY21. To control the spread of the virus, mobility restrictions were imposed, followed by targeted lockdowns, and then the vaccine rollout.¹ Responding to the pandemic, countries implemented supportive fiscal and monetary policies to help millions of firms and households deal with the financial impact of the pandemic. However, the advanced economies (AEs) were able to mount a significantly stronger response than the developing economies,² and also managed to inoculate higher proportion of their populations by end-June 2021. As a result, the real GDP growth in many AEs rebounded from January 2021 onwards (**Figure 6.1a**) and their economies were projected to grow more strongly over the course of full-year 2021 (**Figure 6.1b**).

Average GDP Growth in Major Economies



Source: OECD/Haver Analytics

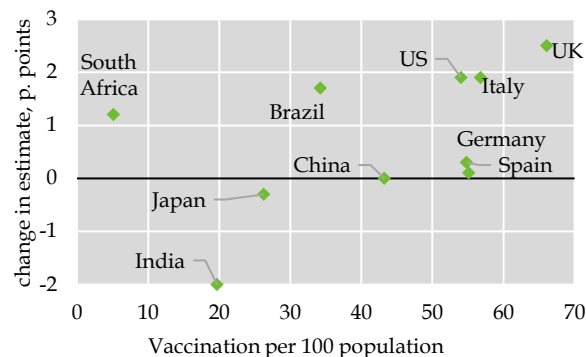
Figure 6.1a

Within the advanced economies, these trends were clearly visible in the US, where the GDP rebound in Jan-Jun 2021 was particularly strong, on the back of vaccinations, business re-openings, robust consumer spending, inventory build-ups, and low base effect. The major European economies also rebounded in Jan-Jun 2021. In the UK, growth stagnated during July 2020-June 2021 on YoY basis, as the impact of the Covid-related lockdowns on the economy was exacerbated by the culmination of the Brexit process in January 2021; nonetheless, similar to other EU economies, growth in the UK had also rebounded in the Apr-Jun 2021 quarter.³

In the emerging markets (EMs), China was the clear outperformer, as the country had broadly managed to control the virus before July 2021. Net exports accounted for a sizable share of this growth during July 2020-June 2021, as China was able to increasingly capture the

Change in GDP Forecasts & Covid-19 Vaccinations

Figure 6.1b



*change in 2021 GDP est. b/w Jan 2021 & July 2021 WEO
Source: Our World in Data/Oxford University and IMF

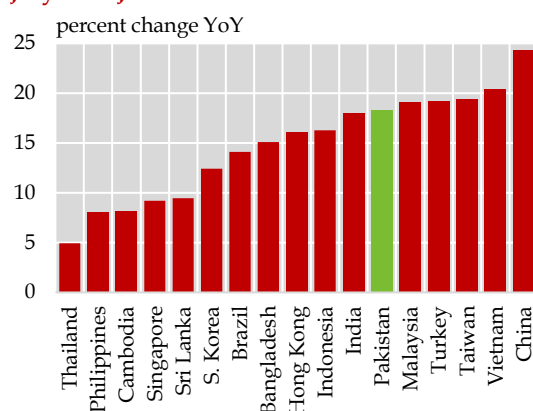
¹ The average Global Stringency Index score for all countries had peaked at 78.6 in April 2020 (100 being the most stringent), and then declined throughout July 2019-June 2020, with some intermittent spikes. By June 2021, the index average had fallen to 51.9 (source: Oxford Covid-19 Government Response Tracker).

² According to IMF estimates as of June 5, 2021, the fiscal response of advanced economies to the Covid-19 pandemic – via additional spending and foregone revenue, and equity, loan and guarantees – cumulatively amounted to 28.7 percent of 2020 GDP. In contrast, the fiscal response of emerging economies amounted to 6.7 percent of GDP.

³ The change in regulations and business disruptions, had a temporary, negative impact on output. The UK's average real GDP growth of 0.05 percent during July 2020-June 2021 was mainly due to a contraction of 22 percent YoY during July 2020-March 2021. In the Apr-Jun 2021 quarter, output had increased by a sizable 22.2 percent on YoY basis (source: OECD/Haver Analytics).

surge in demand for a wide range of consumer products amid shifts in consumption patterns away from services (such as travel and leisure) and towards goods (especially electronics, amid e-learning and remote work). Many other EMs, including Pakistan, also benefitted from this rebound in global trade, and posted higher export performances during July 2020-June 2021 (Figure 6.2).

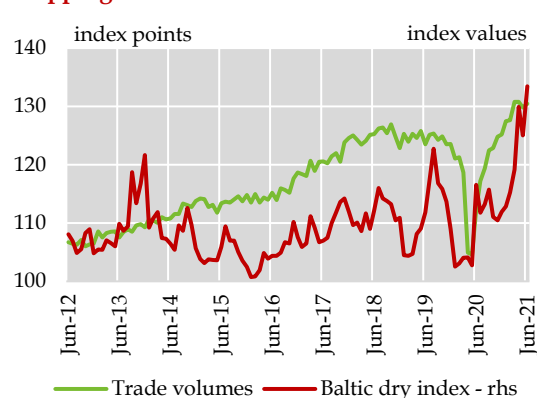
Export Growth of Major EMs during July 2020-June 2021 Figure 6.2



Source: Haver Analytics

This turnaround in global trade volumes was remarkable, given that there were severe supply-chain disruptions throughout the year. The strains on the logistics industry,

Surge in Global Trade Volumes & Shipping Rates Figure 6.3a

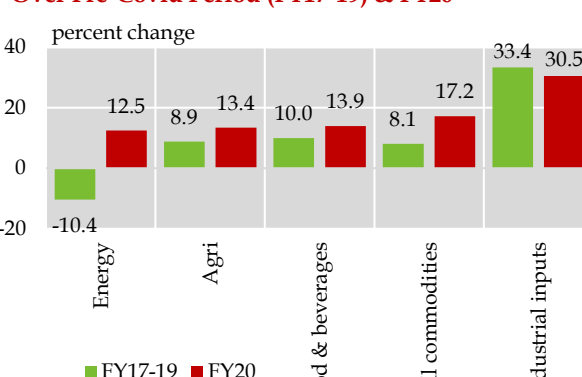


Source: CPB World Trade Monitor, Bloomberg

specifically the shipping industry, led to a sizable increase in freight rates (Figure 6.3a).^{4,5} These factors contributed to a so-called once-in-a-decade commodities “super cycle”, where international prices of a wide range of energy and non-energy commodities are surging at the same time (Figure 6.3b). Oil prices, which had fallen to under US\$ 30 per barrel in March-April 2020, more than doubled and ended June 2021 at around US\$ 75 per barrel due to production cuts by the OPEC + members and the gradual recovery in oil demand.⁶ Within non-energy commodities, food items (such as wheat and edible oil) were trading at decade-high levels by the end of FY21. This was due to lower output amid adverse weather events or labor shortages; efforts by some major global importers to preemptively build strategic reserves; and rising global shipping rates.

This surge in global commodity prices, along with the policy support to prop up aggregate demand, contributed to a build-up in headline CPI inflation across many developing and some advanced economies, particularly the US (Figure 6.4), during July 2020-June 2021. These inflationary outcomes have led financial markets to expect the scaling back of the Covid-related monetary support. This policy

Growth in Commodity Prices in FY21 Over Pre-Covid Period (FY17-19) & FY20* Figure 6.3b



*FY refers to July-June

Source: International Monetary Fund

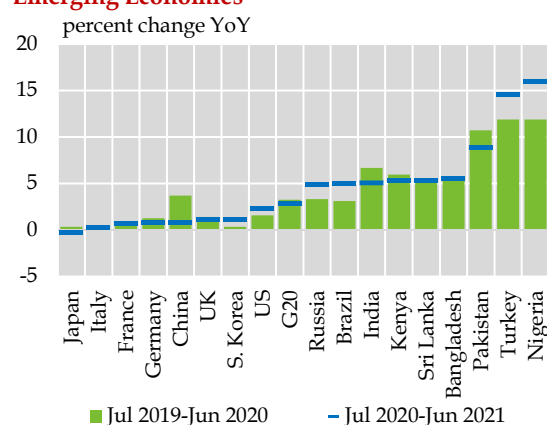
⁴ Around 90 percent of the global traded goods are transported over sea (www.oecd.org/ocean/topics/ocean-shipping/).

⁵ The Baltic Dry Index is a composite index and is widely used as a barometer of cost of transporting dry bulk cargo, and is based on quotations from leading shipbrokinghouses around the world.

⁶ Arab Light crude oil prices were, on average, 2.3 percent YoY higher in FY21 as compared to FY20. However, between end-June 2020 and end-June 2021, prices rose 112.9 percent, to US\$ 75 per barrel from US\$ 35.2 (source: Bloomberg).

normalization would begin by a winding down of asset purchases by the central banks, followed by an increase in policy rates. However, central bankers across multiple advanced economies, including the US Federal Reserve, appear to view the current inflation outturns to be “transitory” and expect the ongoing global supply chain disruptions to subside over the coming months. As such, these major central banks had yet to scale back their accommodative policies by end-June 2021.

CPI Inflation in Major Advanced & Emerging Economies **Figure 6.4**



Source: OECD & Haver Analytics

Due to the continued liquidity support from the major central banks, overall global financing conditions remained fairly liquid and conducive for borrowing by households, corporations as well as sovereigns. The sizable monetary stimulus in the advanced economies in times of near-zero short-term interest rates, has led investors to look for yields across riskier asset classes (such as equities) and markets (especially EMs).⁷ Pakistan was also among the EMs that utilized this opportunity in the global capital markets, by raising US\$ 2.5 billion via Eurobonds in April 2021, and state-owned Wapda following up by issuing the country’s first green bond for US\$ 500 million in May 2021.

6.2 Pakistan’s Balance of Payments

Pakistan’s external account improved significantly during FY21, with the country’s overall foreign exchange reserves rising US\$ 5.5 billion to US\$ 24.4 billion by end-June 2021, and the PKR being among those EM currencies that appreciated against the US Dollar (Table 6.1). The improvement in the reserves position was enabled by the accumulation of current account surpluses till November 2020, along with the availability of sizable official external financing, especially in the fourth quarter. The surge in workers’ remittances, which began in June 2020, continued throughout FY21, whereas export receipts also increased, with across-the-board growth in earnings recorded in both textile and non-textile segments. At the same time, import payments rose significantly, owing to broad-based demand-side pressures, supply-side constraints in key agricultural commodities, the substantial increase in global commodity prices, and the need to import Covid-19 vaccines.

Pakistan’s export receipts rose 13.7 percent to US\$ 25.6 billion in FY21 on YoY basis; and were also up 8.3 percent from the pre-Covid (FY17-19) average. The opportunities presented by the Covid-19 outbreak – in terms of creating demand for medicine-related textile items (such as hospital bedsheets and masks), and of pharmaceuticals and surgical instruments – played an important role in increasing the export receipts. Some shifting of textile import orders to Pakistan from competitors, including India and Bangladesh, was also noted. As a result, the export growth in major textile products, especially high value textile items, emanated from higher export volumes. In addition, mineral and metal exports, especially copper, also rose and

⁷ According to data compiled by Bloomberg, junk-rated bond issuances by EM sovereigns and corporates from January 1 to April 17, 2021, had amounted to US\$ 81 billion, which was close to the record of US\$ 89 billion these economies had raised in the same period of 2018.

Pakistan's Balance of Payments**Table 6.1**

billion US\$

	FY17-19 Average	FY20	FY21	YoY Abs. Change in FY21
Current account balance	-15.0	-4.4	-1.9	-2.5
Trade balance	-28.2	-21.1	-28.2	7.1
Exports	23.7	22.5	25.6	3.1
Imports	51.8	43.6	53.8	10.2
Services balance	-5.4	-3.3	-2.0	-1.4
Primary income balance	-5.4	-5.5	-4.6	-0.8
Secondary income balance	23.9	25.4	32.8	7.4
Workers' remittances	20.3	23.1	29.4	6.2
Capital account balance	0.3	0.3	0.2	-0.1
Financial account balance[^]*	-11.6	-8.6	-7.1	-1.4
FDI in Pakistan	2.2	2.6	1.9	-0.7
FPI in Pakistan	0.2	-0.5	2.8	3.3
Eurobond/Wapda bond	0.6	-1.0	3.0	4.0
FX Loans (net)*	9.7	6.2	3.1	-3.1
SBP*	2.2	-1.2	-2.5	-1.3
Government	4.7	5.9	5.7	-0.2
Bank & non-bank firms	2.7	1.5	-0.3	-1.5
SBP's liquid reserves (end-period)	7.3**	12.1	17.3	5.2
SBP's forward liabilities (end-period)	-8.0**	-5.8	-4.9	-0.9
PKR app.(+)/dep.(-) against US\$ (in %)	-12.6	-4.8	6.7	-

[^]Negative sign with financial account balance means a net FX inflow into Pakistan.

*Including below-the-line IMF loans. **As of end-June FY19.

Source: State Bank of Pakistan

contributed to the increase in overall export receipts.⁸

This increase in industrial and export-oriented activity, coupled with supply-side challenges across major agriculture commodities (cotton, wheat and sugar), played a major role in pushing up import payments by 23.3 percent to US\$ 53.8 billion in FY21. Data from the Pakistan Bureau of Statistics (PBS) indicates that the rise in import volumes – capturing the demand-side dynamics – had a bigger impact on the increase in import payments as compared to the higher international commodity prices (**Figure 6.5a**). Import volumes of both energy and non-energy products exhibited strong growth, even after

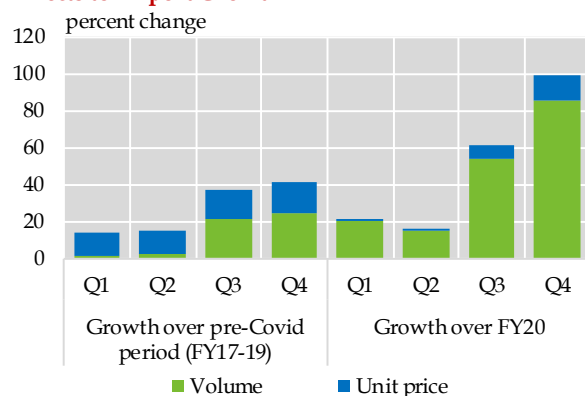
accounting for low-base effect of Covid-impacted FY20 (**Figure 6.5b**).

Some import-dependent and inward-oriented sectors of the economy – such as automobiles and construction – contributed sizably to the import growth, benefiting from the policy-induced recovery in demand and some targeted fiscal support.⁹ Imports of machinery items, including textile machinery, increased, partially in response to the investments under the SBP's Temporary Economic Refinance Facility (TERF). Energy import payments were up by 5 percent during FY21, though the increase became more pronounced in Q4 amid the uptick in international oil prices and already-elevated import volumes.¹⁰

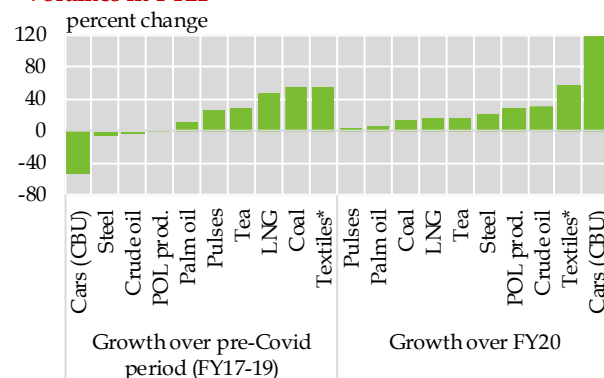
⁸ As per SBP data at the HS-8 level, refined copper was the single-largest contributor to the increase in overall export receipts in FY21, with its exports rising 79.3 percent to US\$ 456.7 million. The country's export receipts from minerals (HS-26) and metals (HS 72-83), including products, rose 64.5 percent to US\$ 1.2 billion in FY21.

⁹ Automobile financing extended by banks surged to its highest level of Rs 97.0 billion in FY21 (based on data going as far back as FY07), against a retirement of Rs 4.3 billion in FY20, and the average financing of Rs 34.6 billion disbursed in the pre-Covid period (FY17-19). In addition to increasing transport segment imports, automobiles also contributed indirectly to the steel industry's import demand.

¹⁰ Energy import payments more than doubled to US\$ 3.1 billion during Q4-FY21 on YoY basis, partly due to the low base effect of Q4-FY20, when the global oil prices had dropped significantly after the Covid-19 outbreak.

Contribution of Volume & Price Effects to Import Growth in FY21

Source: Pakistan Bureau of Statistics & SBP calculations

Figure 6.5a Broad-based Growth in Import Volumes in FY21

*Textile inputs (cotton, synthetic yarn and fiber)

Source: Pakistan Bureau of Statistics

The country's access to multilateral, bilateral and commercial creditors allowed foreign exchange reserves to continue rising throughout the year. During the third quarter, the completion of the combined 2nd-5th IMF reviews led to the disbursement of a US\$ 500 million tranche, and also facilitated the country's reentry into the international capital markets in Q4, when US\$ 3.0 billion were cumulatively raised from Eurobonds and a green bond by a state-owned entity. Furthermore, some switching was noted within official bilateral borrowings during the year, in the context of returning deposits to one partner and undertaking fresh deposits and drawing on swap lines from another.

On the other hand, foreign direct investment (FDI) inflows remained lackluster during the year. Though Pakistan was not alone within EMs to witness lower FDI inflows after the Covid-19 outbreak, the decline nonetheless also highlighted the country's reliance on very few economic sectors (such as power and telecom) and countries (China) for a large share of foreign investment.

The above discussion highlights the fact that while the country's external position improved markedly during FY21, the overall

policy mix is now geared towards supporting a higher near-term growth outcome.

Historically, such growth spurts have resulted in BoP challenges in Pakistan. However, this time, the PKR is responsive to the FX inflows and outflows in the interbank market, which is also reflected in the dual-sided exchange rate movement.

There has also been a steady diversification in the country's foreign exchange earnings.¹¹ From March 2020 onwards, FX inflows under remittances have exceeded goods exports. Furthermore, the share of the information, communications and technology (ICT) in Pakistan's overall services exports has risen consistently over the past 10 years, and especially after the Covid-19 outbreak.¹²

This creates the need for policymakers to further incentivize these two segments, by addressing any regulatory or procedural bottlenecks that might be constraining further contributions from these sectors. In this regard, there was a major policy push to integrate overseas Pakistanis with the formal banking system in Pakistan via the introduction of the Roshan Digital Accounts (RDAs) in September 2020 (**Box 6.1**).

¹¹ Taken as a proxy for non-debt creating inflows, foreign exchange earnings are defined as export proceeds (both goods and services), remittances and other current transfers, and foreign direct investment.

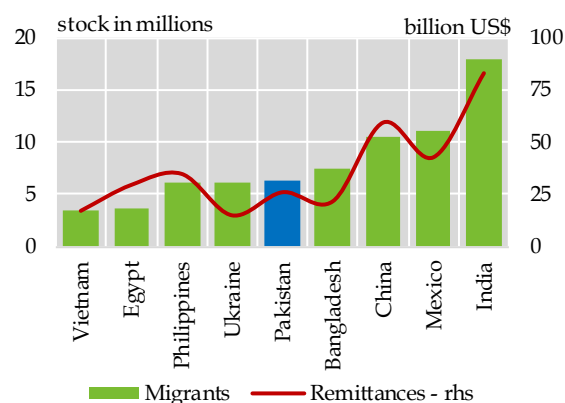
¹² Pakistan's net ICT exports have grown at a CAGR of 29 percent during FY12 to FY21, from just US\$ 123 million to US\$ 1.6 billion. The share of net ICT exports in overall services exports has risen from 2.6 percent to 26.5 percent during the same period.

Box 6.1: Integrating Overseas Pakistanis with Pakistan's Banking System – Roshan Digital Accounts

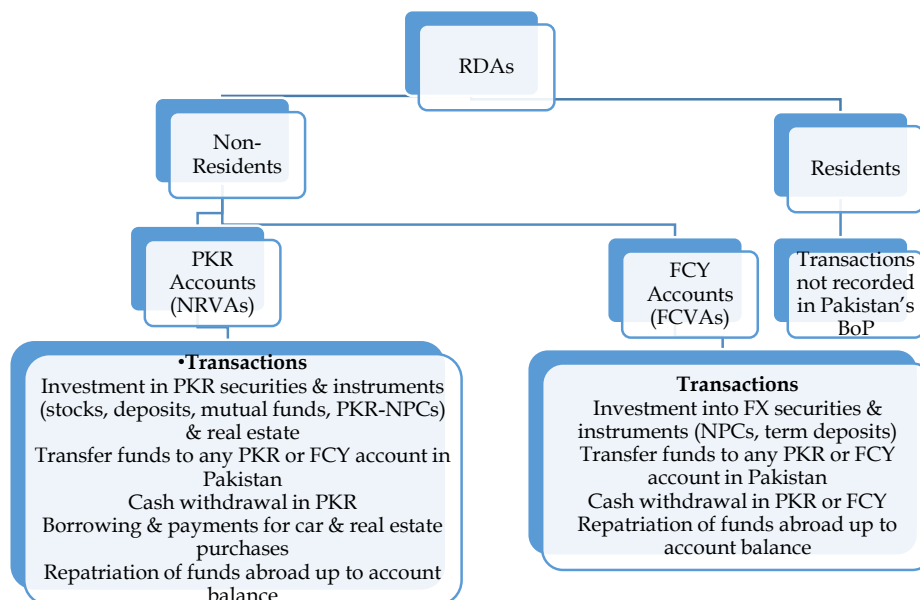
Pakistan has one of the largest diasporas in the world, with anywhere from 6.3 million (UN, 2020) to 8.8 million (GoP, 2018) Pakistanis living abroad (**Figure 6.1.1**).¹³ The foreign exchange sent by these migrants to support their families and for investment purposes, has led to the country being consistently ranked among the top 10 remittance-recipient economies. Given the importance of these inflows to the economy in general and for the external sector's sustainability in particular, there is a history of policy focus on facilitating migrants to remit funds back home. These include the formation of the Pakistan Remittance Initiative (PRI) in 2009, under which remittance processors (banks and money transfer operators) are given fiscal incentives, including the reimbursements for telegraphic transfer (TT) charges and marketing expenses, for channeling remittances into Pakistan.

More recently, there was a realization about the operational impediments in migrants investing in the stock market, mutual funds and real estate in Pakistan, via direct banking channels. The existing bank accounts for non-residents, the Special Rupee Convertibility Accounts (SCRA), were not ideally suited for individual emigrants and were geared more towards institutional investors and entities. The policy solution comprised a series of changes to the foreign exchange regulations in FY21, which allowed migrants (non-residents) and eligible residents, to digitally open bank accounts in six currencies – the US Dollar, Pounds Sterling, Euros, UAE Dirhams, Saudi Riyals and the PKR – with several

Countries with Largest Migrant Stocks Abroad & Remittances in 2020 **Figure 6.1.1**



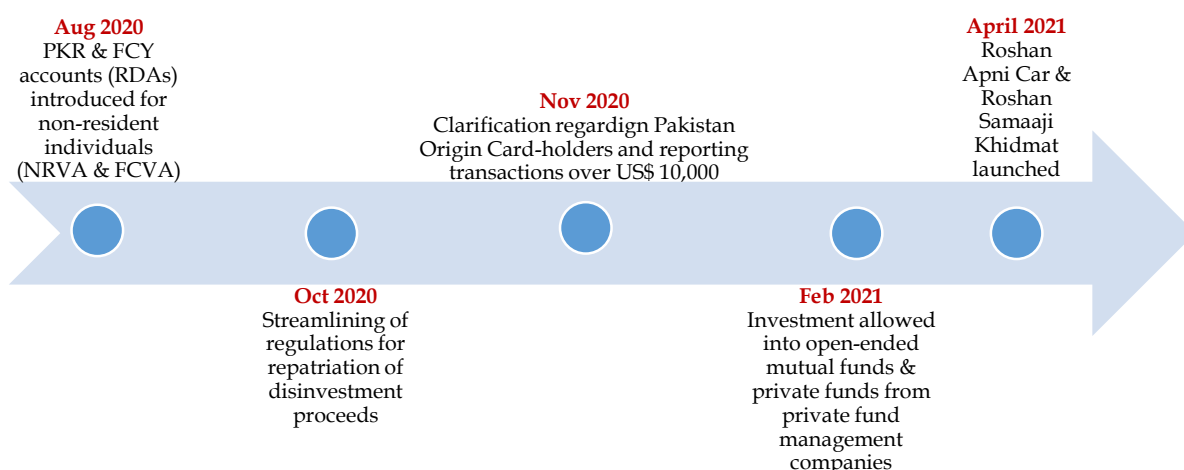
Source: UN Population Division & World Bank

Summarization of RDAs & Allowed Transactions**Figure 6.1.2**

¹³ Source: UN Department of Economic and Social Affairs, Population Division (2020), and Ministry of Overseas Pakistanis and Human Resource Development Yearbook 2017-18.

Timeline of Major Developments related to RDAs

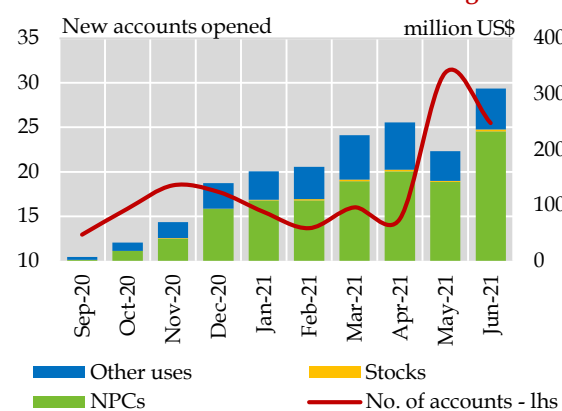
Figure 6.1.3



commercial banks in Pakistan. These accounts are now widely known as the Roshan Digital Accounts (RDAs).¹⁴ The definition for non-residents and residents is the same as in the income tax laws of Pakistan.

The RDA is a joint effort by the SBP and commercial banks to integrate the vast overseas diaspora with the country's banking system. With the continuously expanding scope of the transactions and investments that can be undertaken via these accounts, the country is able to diversify the sources of foreign exchange inflows. **Figure 6.1.2** summarizes the types of accounts within RDA, and the types of transactions that overseas Pakistanis can conduct via these accounts. **Figure 6.1.3** provides a timeline of the regulatory changes by the SBP with regards to the RDAs.

Since the introduction of these accounts by the SBP and the commercial banks and amid growing awareness, the number of accounts has steadily increased. Until end-June 2021, 181,556 RDAs had been opened by non-resident and resident Pakistanis, with cumulative inflows of US\$ 1.6 billion in gross terms (**Figure 6.1.4**). Furthermore, the available data indicates that an overwhelming amount of these funds were subsequently used to invest into Naya Pakistan Certificates (**Chapter 5**), followed by other purposes (such as family support etc), and then investments in the stock market and mutual funds. As of end-June 2021, non-residents could deposit fresh funds into the RDAs from abroad via banks only.

New RDA Accounts & Investments* **Figure 6.1.4**

*Investments are gross inflows during the month

Source: State Bank of Pakistan

The SBP subsequently expanded the types of transactions that could be conducted via these accounts. Around end-April 2021, the SBP allowed overseas Pakistanis to purchase cars via their RDAs, under the Roshan Apni Car scheme. Under this scheme, banks offer both lien- and non-lien-based loans to RDA-holders, and the car assemblers claim to deliver the cars on priority basis to RDA-holders. Under lien-based financing, the bank has a lien on the funds in the RDA or the depositor's holdings of NPCs; as such, these loans are available at relatively lower rates. Furthermore, both fixed- and variable-rate loans are offered to facilitate customers of varying risk appetites. The cost of financing under

¹⁴ The definition for residents and non-residents for the purpose of RDAs is the same as in the income tax laws (source: FE Circular No. 01 of 2020. According to the FBR, an individual is a resident Pakistani for a tax year if the individual: (i) is present in Pakistan for a period of, or periods amounting in aggregate to, one hundred and [eighty-three] days or more in the tax year; or (ii) is present in Pakistan for a period of, or periods amounting in aggregate to, one hundred and twenty days or more in the tax year and, in the four years preceding the tax year, has been in Pakistan for a period of, or periods amounting in aggregate to, three hundred and sixty-five days or more. Individuals not meeting the any of the above criteria are considered non-residents (source: www.fbr.gov.pk/income-tax-basics/51147/61148).

the available options is summarized in **Table 6.1.1**. A benefit of the Roshan Apni Car scheme over local, PKR-financed car purchases is that at least some of the import burden from the resultant car sales is offset by the FX inflows from abroad under the RDAs.

The scope of eligible transactions under the RDAs is continually being expanded, and its features are streamlined, in light of the feedback received from the overseas diaspora and from other relevant stakeholders. Already in FY22, non-residents can now apply for housing finance (under Roshan Apna Ghar), and deposit funds into the RDAs via money transfer operators (MTOs) such as Western Union and Money Gram.

Financing Rates under Apni Car Scheme

Table 6.1.1

percent	Variable Rate*	Fixed Rate**
Lien-based	SBP Floor + 1 %	8.25-9.5
Non-Lien based	KIBOR + 1 %	10.25-11.5

*SBP floor rate was 6 %, as of end-June 2021

**Fixed rates are set by banks, based on internal criteria. Data are from SBP website as of Sep 6, 2021.

Source: State Bank of Pakistan

Current Account

The current account deficit narrowed to a 10-year low of US\$ 1.9 billion in FY21, from US\$ 4.4 billion in FY20 and the pre-Covid average (FY17-19) of US\$ 15.0 billion. In fact, the cumulative current account balance (CAB) was in surplus till April 2021, before turning into deficit in the last two months. The improvement in the CAB mainly stemmed from workers' remittances, as well as the contraction in the services and primary income deficits. The net FX earnings from these sources had substantially covered the payments gap evident in the merchandise trade account, in the wake of a spike in import payments, especially in Q4.

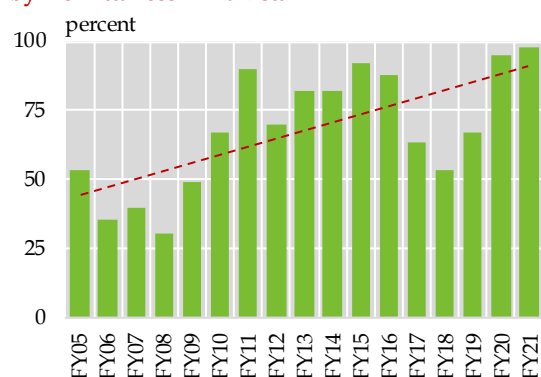
The positive impact of the curtailment in international air travel on the current account is also worth noting. The cross-border air travel restrictions directly reduced the air transport and the travel components of the services imports, and also contributed to the sizable pickup in workers' remittances by curbing cash-based FX transfers via informal channels.¹⁵

Workers' remittances

Remittances from overseas Pakistanis rose 27.0 percent to US\$ 29.4 billion in FY21. To put these FX inflows into context, remittances financed over 97 percent of the country's trade imbalance (both goods and services) during the year, thereby contributing to the FX reserves build-up and reducing the government's external financing requirements. In fact, the reliance on remittances for financing the trade gap has been growing consistently (**Figure 6.6**).¹⁶ The inflows had risen from all the major corridors in the Middle East and the advanced economies (**Table 6.2**).

The months following the Covid-19 outbreak have been quite remarkable for workers' remittances to Pakistan as well as to many other major recipients. The Covid-induced lockdowns around March 2020 across most countries had led to a sizable increase in unemployment, and contributed to

Magnitude of Trade Gap Financed by Remittances in Pakistan* **Figure 6.6**



*trade gap of goods & services

Source: State Bank of Pakistan

¹⁵ The average number of commercial flights tracked by Flightradar24 amounted to 78,356 in Jan-Jun 2021, which were up 18.8 percent from the Covid-impacted period of Jan-Jun 2020, but still 42.5 percent below the pre-Covid (Jan-Jun 2019) average.

¹⁶ From financing just 53.3 percent of the goods and services deficit in FY18, remittances financed 66.7 percent of the deficit in FY19, 94.7 percent in FY20 and finally 97.4 percent in FY21.

Corridor-wise Remittances to Pakistan

million US\$

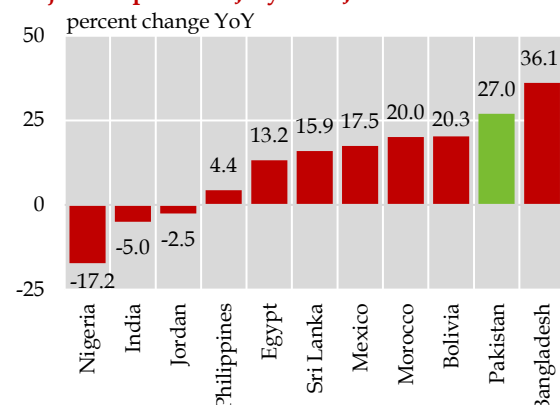
	FY20	FY21	Change
US	1,742.8	2,754.2	1,011.3
UK	2,569.0	4,067.1	1,498.0
GCC	15,135.4	17,090.9	1,955.4
KSA	6,613.5	7,667.0	1,053.6
UAE	5,611.8	6,114.0	502.2
Other GCC	2,910.2	3,309.9	399.7
Belgium	78.6	251.8	173.2
France	240.4	419.8	179.4
Italy	361.3	600.8	239.6
Australia	339.8	593.5	253.7
Canada	313.4	586.0	272.6
Others	1,948.7	2,849.9	901.2
Total	23,132.3	29,370.9	6,238.6

Source: State Bank of Pakistan

apprehensions that global remittances would drop quite significantly.¹⁷ However, instead of the expected drop in inflows, remittances to most major recipient economies surged during July 2020-June 2021, after the Covid-19 outbreak (**Figure 6.7**). A few factors behind this development are discussed below.

Diversion of flows to formal channels, especially via digital channels

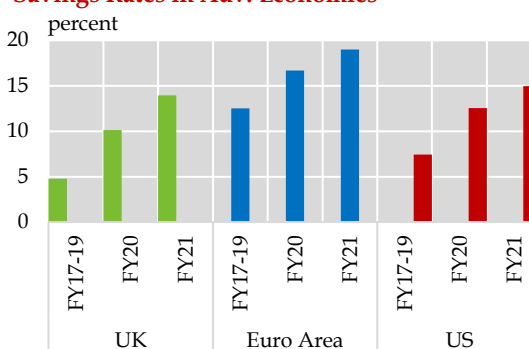
The curbs on international air travel, which began immediately after the Covid outbreak and continue to be in place (albeit with lesser stringency) have contributed to the channelization of flows via formal channels, and therefore resulted in an increase in FX inflows in the interbank market, as well remittances in the BoP statistics. This has also been confirmed empirically by Kpodar et al. (2021), who found the formalization of flows to be a statistically significant contributor to the surge in remittances to a sample of 52 countries (including Pakistan).¹⁸ Specifically, the researchers found that a 100 percent (i.e. complete) drop in air flight arrivals in the countries would lead to a 10 percent increase in remittances for the next 2 months, with the increase then gradually fading.

Table 6.2**Figure 6.7**
Growth in Workers' Remittances to Major Recipients in July 2020-June 2021

Source: Haver Analytics & State Bank of Pakistan

Increase in emigrants' savings, and higher need for support in home countries

Savings rates across the advanced economies, which are also host to large numbers of emigrants, have risen significantly after the Covid-19. This may initially appear counterintuitive, given the scale of the layoffs after the virus outbreak. However, fiscal support in these economies – via cash transfers and moratoriums on rent/utility payments – and lower expenditures (including on travel and leisure), helped increase household savings in the advanced economies (**Figure 6.8**). This allowed migrants to remit higher amounts to their home countries.

Figure 6.8
Pre- & Post-Covid Household Savings Rates in Adv. Economies*

*FY refers to July-June

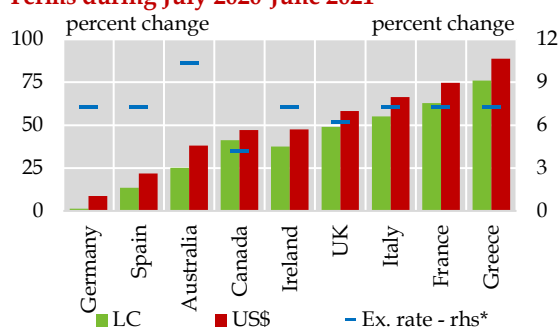
Source: Office of National Statistics (UK), Eurostat, US Bureau of Economic Analysis

¹⁷ In April 2020, the World Bank had projected a 19.9 percent drop in global remittances in CY-20, and a 23 percent drop in inflows to Pakistan.

¹⁸ K. Kpodar, M. Mlachila, S. Quayyum and V. Gammadigbe (2021). *Defying the Odds: Remittances during the Covid-19 Pandemic*. IMF Working Paper 21/186. Washington D.C.: IMF.

The need for financial support for families in the home countries was also higher after the Covid outbreak, in the wake of income losses, higher medical expenses and an inflationary environment (in some developing countries). Furthermore, Kpodar et al. (2021) found a statistically significant and positive relationship between the increase in remittances into an economy and the trend of Covid cases, after controlling for the domestic economic activities. The combination of these pull and push factors contributed to the broad-based surge in remittances to Pakistan during FY21.

Growth in Remittances from Major Corridors in Local Currency & US\$ Terms during July 2020-June 2021 Figure 6.9



*change in local currency against US\$ during July 2020-June 2021

Source: SBP, Haver Analytics & staff calculations

Cross-currency exchange rate movements increased remittances in US Dollar terms

In addition, the US Dollar's depreciation against multiple advanced economy currencies during FY21 contributed to an increase in remittances to Pakistan in USD terms. For instance, if the Dollar depreciates against the currency in which a migrant is remitting funds (such as Euros, for a migrant in Germany), a higher amount of Dollar remittances would be recorded, even if the migrant were to remit the same amount of

funds in the host country's currency (Euros, in this case). This was indeed the case in FY21, when the USD depreciated, on average, against the Pound Sterling, Euro, and the Australian and Canadian Dollars. In case of the corridors depicted in Figure 6.9, this exchange rate impact contributed an additional 7.1 percent (US\$ 516.3 million) to the cumulative increase in remittances in USD terms to Pakistan.¹⁹

Primary Income

The primary income deficit contracted 15.5 percent to a six-year low of US\$ 4.6 billion in FY21. The lower deficit originated entirely from a 27.6 percent drop in interest payments on external debt (Figure 6.10a), which offset a 20.5 percent increase in profit and dividend repatriations by foreign firms during the year.

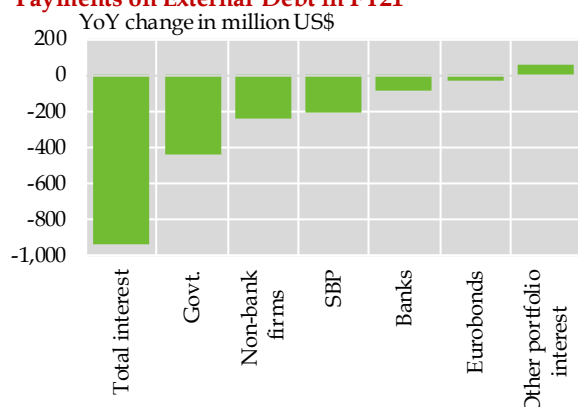
The reduction in interest on external debt can be mainly attributed to the debt deferment under the G20's Debt Service Suspension Initiative (DSSI), of which Pakistan has been the largest beneficiary in absolute terms of potential payment deferrals.²⁰ During FY21, the country's repayments of external debt (both principal and interest) reduced by an estimated US\$ 2.3 billion. Furthermore, the reduction in the benchmark LIBOR from the pre-Covid levels (Figure 6.10b), contributed to lowering the interest payment on floating rate debt during the year.²¹

The FX savings from the reduction in interest payments proved instrumental in offsetting the increase in the profit and dividend repatriation by foreign firms operating in the country. Sectors that posted a substantial increase in profits after the Covid-19 outbreak, such as multinationals in food, chemicals (including pharmaceutical and cleaning

¹⁹ The growth in remitting currency terms in Figure 6.9 is calculated by converting the monthly remittances received in US Dollar terms from these economies into the remitting currency at the average monthly exchange rate (GBP/USD), then aggregating the monthly data for FY20 and FY21, and then calculating the YoY growth.

²⁰ The potential debt deferment for which Pakistan is eligible under the DSSI is around US\$ 7.3 billion during May 2020 to December 2021, according to World Bank estimates.

²¹ A large share of the country's external debt is floating rate. For instance, of the US\$ 26.2 billion in new official borrowings between FY19 to Jul-Mar FY21 (excluding IMF and currency swaps), loans worth only US\$ 3.8 billion (14.7 percent) were contracted on fixed rate, with the remainder on floating rate or on a combination of fixed and variable rates (source: Economic Survey of Pakistan 2020-21).

Change in Source-wise Interest Payments on External Debt in FY21**Figure 6.10a**

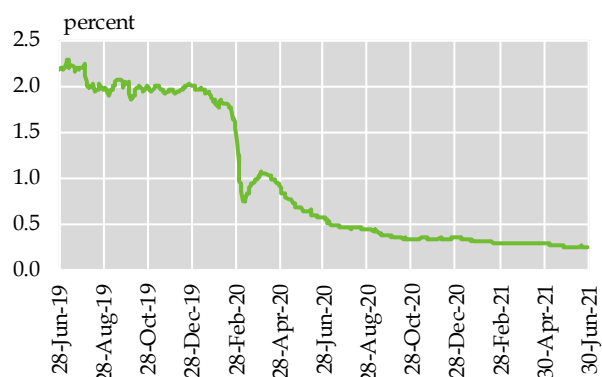
Source: State Bank of Pakistan

supplies companies), as well as banks, also recorded higher profit and dividend repatriations (**Figure 6.11a**). Conversely, sectors with weaker profitability, including those in the oil and gas (refining) sectors, witnessed lower profit repatriations during the year (**Figure 6.11b**).

Trade in Services

The services trade deficit contracted 41.0 percent to US\$ 2.0 billion in FY21, from US\$ 3.3 billion in FY20 (**Table 6.3**), largely due to Covid-related air travel restrictions, which lowered imports of air transport and travel services. Support to the services account also came from a 46.8 percent YoY improvement in net ICT exports in FY21.

The impact of international air travel restrictions was felt on two major services components: air transport and travel. The

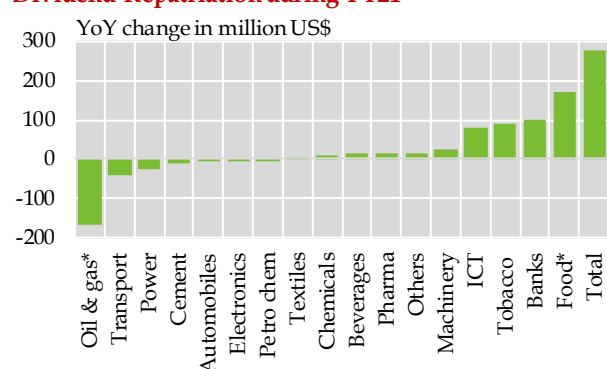
Trend in 12-m US\$ LIBOR Rate**Figure 6.10b**

Source: ICE/US Federal Reserve

curtailment of flight operations by multiple foreign airlines in the country after the Covid outbreak reduced the import of air passenger services by a sizable 76.9 percent as compared to last year.

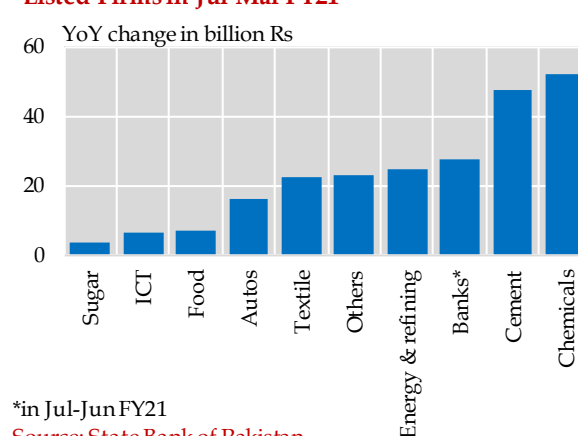
Furthermore, the FX purchases and payments by Pakistani residents for travel – including travel for religious purposes, such as Hajj, and for medical treatment – was also impacted by the air travel restrictions. These FX payments are considered as an import of travel services, and their magnitude in FY21 more than halved from last year's level.

Meanwhile, annual ICT exports crossed the US\$ 2 billion mark for the first time in FY21 and reached US\$ 2.1 billion. While the share of Pakistan in global ICT exports is still quite small, it is among those countries whose ICT exports have risen the fastest since Covid-19

Change in Sector-wise Profit & Dividend Repatriation during FY21**Figure 6.11a**

*including POL refining

Source: State Bank of Pakistan

Change in After-Tax Profits of Major Listed Firms in Jul-Mar FY21**Figure 6.11b**

*in Jul-Jun FY21

Source: State Bank of Pakistan

Breakdown of Services Balance**Table 6.3**

million US\$

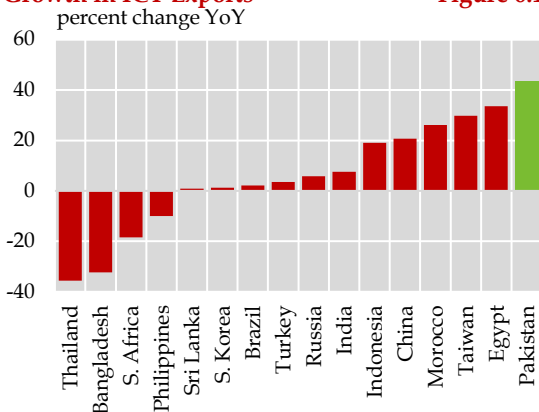
	FY20	FY21	Change**
Transport	-2,295.0	-2,385.1	-90.1
o/w Air passengers	-431.5	84.1	515.6
Freight	-1,753.9	-2,274.1	-520.2
Travel	-739.1	-323.8	415.3
ICT Services	1,055.1	1,564.2	509.1
Exports	1,440.0	2,114.1	674.1
Imports	384.9	549.9	165.0
Financial Services	-333.0	-157.0	176.0
Other Services	-1,004.0	-655.7	348.3
Services Balance (net)	-3,316.0	-1,957.4	1,358.6

*Negative balance means deficit and a positive sign means surplus.

**Positive sign shows YoY improvement in services account & vice versa

Source: State Bank of Pakistan

(Figure 6.12).²² This growth mainly originated from telecom, software development and consultancy, and other computer service-related segments.

Growth in ICT Exports***Figure 6.12**

*During Jul 2020-Mar 2021 (latest available data w/ WTO)

Source: World Trade Organization

Financial Account

The net financial flows into the country amounted to US\$ 7.1 billion during FY21 (including below-the-line IMF repayments), down from US\$ 8.6 billion in FY20 and from

the pre-Covid average of US\$ 11.6 billion (during FY17-19). The lower net inflows were mainly due to higher official debt and liability retirements by both the government and the SBP; sharply lower external borrowings by the non-bank firms; and a drop in net foreign direct investment. Most of the YoY reduction in financial flows was recorded during the first three quarters; inflows during Q4 were quite high (US\$ 6.5 billion), owing to bond issuances (US\$ 3 billion) and commercial borrowings (US\$ 1 billion).

Foreign direct investment

The net FDI to Pakistan dropped 28.3 percent to US\$ 1.9 billion during FY21, due to both lower inflows and higher outflows. Quarterly breakdown shows that inflows had dropped in the first three quarters, and then picked up marginally during Q4.

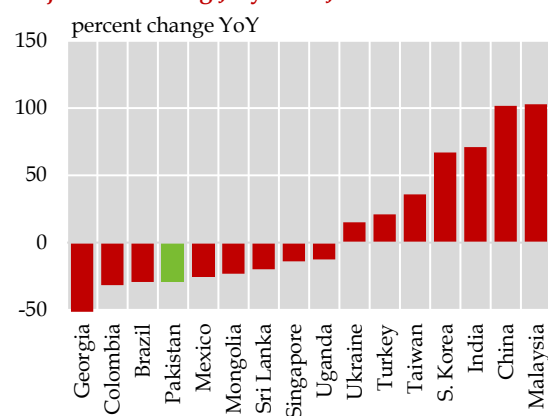
Globally, greenfield investments have been particularly impacted over the past year, due to a couple of factors. First, the Covid-19 outbreak and the resultant mobility restrictions dissuaded major corporations and investors from starting new projects in many industrial sectors. Also, the sharp drop in global oil prices after the Covid-19 outbreak had rippled across fresh investment into both upstream (extraction) and downstream (refining and retail) oil sectors.²³ Second, increased concerns over climate change and environmental sustainability have prompted major investors and financial institutions to discourage fresh investments into fossil fuel-based power projects, especially those that run on coal. China – the world's largest coal consumer – is also reassessing coal's usage as a major fuel source within its own borders, as well as for power projects under the Belt and Road Initiative (BRI).²⁴

²² Pakistan's share in global ICT exports is estimated at around 0.2 percent (source: Digital Pakistan: A Business and Trade Assessment, WB, May 2020).

²³ Global greenfield investment into the coke and petroleum sector was projected to have declined 69 percent during CY-20 to US\$ 30 billion, whereas the number of projects declined by 50 percent from CY-19 (source: World Investment Report 2021, UNCTAD).

²⁴ According to Beijing-based International Institute of Green Finance, Chinese investment in energy sectors of BRI countries were concentrated in gas, oil and hydropower projects during H2-FY21, and that no investments were made into coal-fired projects (source: Nedopil Wang, Christoph (July 2021): "China Belt and Road Initiative (BRI) Investment Report H1 2021", Green BRI Center, International Institute of Green Finance, Beijing".

Growth in Net FDI Received by Major EMs during July 2020-June 2021 **Figure 6.13**



Source: Haver Analytics

Under these macro dynamics, many emerging markets, including Pakistan, have been facing a challenging environment with respect to FDI (**Figure 6.13**).²⁵ For instance, while net FDI into the power sector increased 18.4 percent during the year, the entire increase came from an uptick in investment into non-coal-based power projects, whereas FDI into coal power projects declined slightly (**Table 6.4**). Similarly, FDI into the oil and gas sector (both upstream and downstream) dropped 41.0 percent YoY, mainly due to lower inflows into a few major exploration companies, and outflows from a couple of oil refineries and oil marketing companies.

However, apart from these global factors, the lower FDI inflows to Pakistan in FY21 also reflected some indigenous factors. First, in the wake of no major telecom spectrum issuance or license renewals, FDI into the telecom sector dropped quite sharply from last year's elevated levels. In FY20, the government had received license renewal fees from 3 major cellular service providers in the country. Telecom firms tend to take intercompany loans from their foreign sponsors to make such payments, and these loans had pushed

up the FDI inflows into the telecom sector in FY20.

Sector-wise Net FDI Inflows to Pakistan **Table 6.4**

million US\$	FY20	FY21	Change
Food*	27.5	13.1	-14.4
Textiles	37.7	6.9	-30.7
Trade	43.2	146.8	103.6
Oil & gas**	311.4	183.8	-127.6
Information tech.	41.5	73.2	31.7
Electrical machinery	153.4	114.3	-39.2
Automobiles	53.9	19.0	-34.9
Power	765.6	906.1	140.5
o/w Coal	545.0	511.9	-33.1
Non-Coal	220.6	394.1	173.6
Telecom	622.5	34.8	-587.7
Banks	274.8	235.5	-39.3
Others	266.0	128.2	-137.8
Total	2,597.5	1,862.8	-734.7

*incl. food packaging **incl. exploration & refining

Source: State Bank of Pakistan

The FDI into Pakistan is lately being driven by sector-specific activity in a few segments of the economy for many years now, and is primarily dependent on progress on CPEC-related projects. For telecom, this includes spikes in FDI whenever the government conducts auctions of telecom spectrums or when license fees of cellular firms become due. Meanwhile, since the advent of CPEC in FY16, the sizable investments into the power sector have primarily originated from China. As such, there is a need to actively pursue the second phase of CPEC, while also utilizing the opportunities presented by the upcoming special economic zones (**Chapter 7**) to attract FDI from China. In addition, a further enabling in the policy environment, including by simplifying and easing relevant regulations, may attract foreign investment into more dynamic sectors of the economy, such as ICT.

Foreign portfolio investment

²⁵ FDI into India has risen significantly after the Covid-19 pandemic, mainly due to mergers and acquisition activity in its telecom and technology sectors. One of the largest FDI inflows were recorded into Jio Platforms, the country's largest telecom firm, as the company looks to expand from a telecom and data services provider into a manufacturer of low-cost cell phones. The company has sold partial stakes to Silicon Valley giants like Facebook and Google in CY-20.

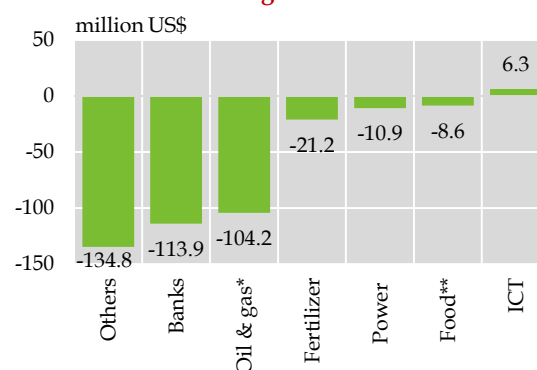
Net FPI inflows into the country rose to US\$ 2.8 billion in FY21, against net outflows of US\$ 0.5 billion recorded last year. The current year's inflows were dominated by proceeds from the issuance of Eurobonds (US\$ 2.5 billion) and a green bond by Wapda (US\$ 0.5 billion) during Q4. Meanwhile, outflows from the local equity market amounted to US\$ 0.3 billion, almost the same as the outflows recorded in FY20.

The Eurobond issuance marked the country's first entry into international capital markets in over 3 years. The global markets were fairly liquid, in the wake of the sizable monetary stimulus implemented by especially the advanced economies, whereas investors' appetite for higher yielding assets was also high. In addition, Pakistan had just successfully completed the combined 2nd-5th IMF program reviews, and received a tranche of US\$ 0.5 billion from the Fund.

As such, on balance, this provided a good opportunity for the country to tap the international capital markets. Of the US\$ 2.5 billion raised by the issuance, US\$ 1 billion were raised each from 5-year and 10-year bonds, and US\$ 0.5 million from 30-year bonds (Chapter 5).

Apart from the Eurobonds, local currency debt securities attracted marginal interest from foreign investors, to the tune of US\$ 41 million on net basis in FY21, against US\$ 746 million last year. It may be recalled that before the Covid-19 outbreak, the country had received sizable FPI into PKR-denominated government bonds amid the high interest rate differential with the advanced and EM economies, the realignment of the exchange rate with market fundamentals, and the initiation of the IMF program in July 2019. These capital flows had then reversed after the Covid outbreak, in line with similar movements across other EMs. In FY21, FPI continued to flow into longer tenor PKR government bonds, though outflows were recorded from shorter tenor bonds.²⁶

Net Foreign Buying(+)/ Selling(-) in Pakistan Stock Exchange in FY21 **Figure 6.14**



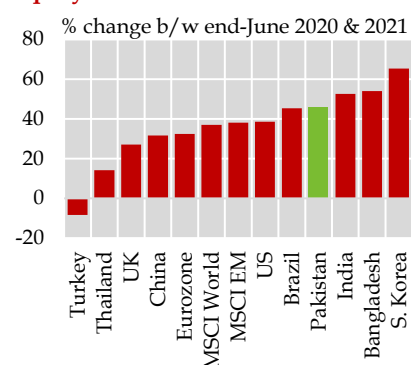
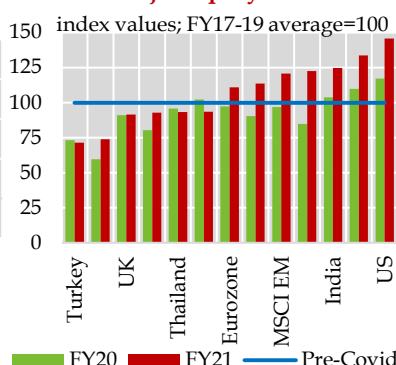
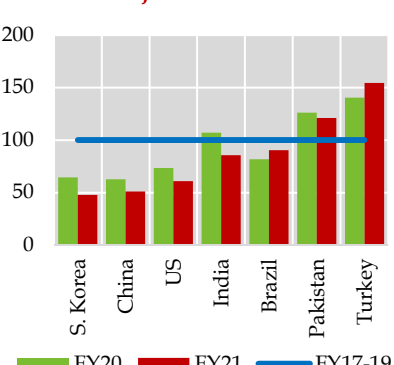
*incl. exploration & OMCs **incl. personal care items

Source: National Clearing Company of Pakistan Ltd.

In contrast to debt securities, equity securities recorded capital outflows of US\$ 292 million during FY21, almost unchanged from outflows of US\$ 282 million last year. Equity selloff was noted across almost all the major sectors, as indicated in **Figure 6.14**. The continued equity market selloff was somewhat intriguing, because the Pakistan Stock Exchange was among the best performing markets globally during July 2020-June 2021 (**Figure 6.15a**).

A couple of reasons likely explain this disconnect between market performance and capital flows. First, equity markets had recovered across the board during FY21, mainly due to the low-base effect from FY20, when equities had dropped sharply after the Covid outbreak. However, while many equity markets had recovered to their pre-Covid (i.e. average during July 2018-June 2019) levels during July 2020-June 2021 in US Dollar terms, the PSX was among those exchanges whose performance had not recovered to the pre-outbreak levels (**Figure 6.15b**). Second, investors continued to attach relatively higher risk premium to Pakistan. Pakistan's risk premium – as captured by credit default swap rates – had declined in July 2020-June 2021 on YoY basis, but was still marginally higher than the pre-Covid (average of July 2018-June 2019) level (**Figure 6.15c**). This was a likely deterrent for foreign investors, given that

²⁶ During FY21, net FPI into PKR-denominated debt securities amounted to US\$ 41 million. The breakdown shows that there was a net inflow of US\$ 317 million into longer tenured securities, and a net outflow of US\$ 276 million from shorter tenor securities.

Abs. Return of Major Equity Markets****Figure 6.15a Pre- & Post-Covid Trend in Major Equity Indices******Figure 6.15b Trend in 5-yr CDS Rates of Major Economies***

*FY refers to July-June **Equity indices in 6.15a & b are in US Dollar terms

Source: Bloomberg & staff calculations

equities in some of the major advanced economies with lower risk premiums, especially the US, were also offering high returns during the year.

FX Loans & Liabilities

The net inflow of FX loans into the country, including repayments of previous IMF loans, amounted to US\$ 2.9 billion during FY21 – down significantly from US\$ 6.2 billion received last year.

A couple of factors explain these developments. First, a significant part of the country's external financing requirements was met by the US\$ 3 billion raised from Eurobonds and green bonds issued during Q4.²⁷ Second, the financing requirements till Q3 were quite contained, given the sizable reduction in the current account gap during this period. Third, the central bank made higher liability retirements this year, which lowered the net inflow of external loans during the year (Table 6.5). And fourth, the external borrowing by non-banking firms, including those in the private sector, dropped quite sharply, from US\$ 1.6 billion last year to only US\$ 27 million in FY21.

Among the major sources of official external financing, some shifts were noted during FY21. First, financing from the IMF was sizably lower as compared to last year; one tranche of US\$ 500 million was released in

March 2021 after the completion of the 2nd-5th combined EFF reviews. At the same time, the country was also making repayments of previous loans to the Fund. On net basis, Pakistan repaid US\$ 0.6 billion to the IMF in FY21. This is in contrast to FY20, when two EFF tranches – worth a cumulative US\$ 1.5 billion – were received, along with US\$ 1.4 billion under the Rapid Financing Instrument (RFI) after the Covid-19 outbreak; on net basis, financing from the Fund had amounted to a sizable US\$ 2.1 billion last year (Figure 6.16).

Breakdown of Net Official FX Loan & Liability Inflows to Pakistan Table 6.5

million US\$		FY20	FY21
Government	IMF	2,834	499
	Bilateral Inflows*	37	1,783
	Other Inflows	10,347	9,304
	Repayments	-7,299	-5,855
SBP	Bilateral Inflows*	0	1,536
	Other Inflows	3	3
	IMF	-745	-1,080
	Bilateral Outflows*	-501	-3,007
Official**	Inflows	13,221	13,125
	Outflows	-8,545	-9,942
	Official Inflows-Net	4,676	3,183

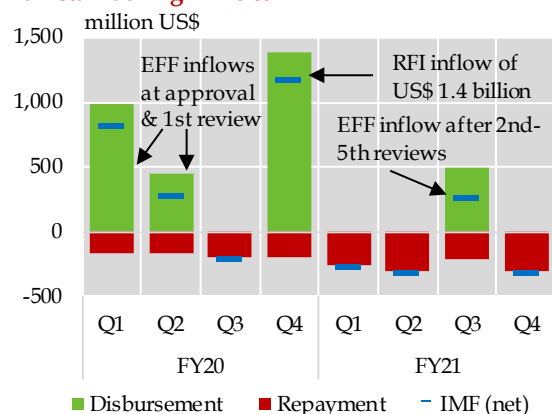
*Bilateral inflows/ outflows are in the form of FX deposits and swaps with foreign central banks

**Official comprises government & SBP

Source: State Bank of Pakistan

The lower Fund financing was offset by inflows under the Eurobonds, as well as from commercial loans. In fact, commercial loans

²⁷ Proceeds from Eurobonds bonds are recorded under FPI and not FX loans in the balance of payments data.

Breakdown of IMF Lending to Pakistan during FY20 & FY21**Figure 6.16**

Source: State Bank of Pakistan

were the single-largest source of official inflows (in gross terms) during the year (Table 6.6). Among other sources of external financing, the continued engagement with multilaterals, such as the World Bank and ADB, among others, contributed to the receipt of official loans during the year. The financing from multilaterals was focused on Covid-related support, infrastructure development (including renewable energy and agriculture-related), social sector programs, economic reforms, and financial-sector development.

Major Sources of Gross Official External Financing***Table 6.6**

million US\$	FY20**	FY21	Change
World Bank (IDA+IBRD)	1,376.0	2,035.5	659.5
ADB	2,824.0	1,365.9	-1,458.1
Bonds***	-	2,500	2,500.0
IDB (incl. short term)	879.0	623.9	-255.1
Bilateral deposits	-	1,000.0	1,000
Commercial loans	3,373.0	4,721.2	1,348.2
Others	2,208.0	1,785.9	-422.1
Total	10,660.0	14,032.4	3,372.4

*Excl. IMF (US\$ 2 billion in FY20, US\$ 500mn in FY21)

**Rounded to nearest full number, as per available data

***Excluding Wapda's bond of US\$ 500mn in FY21

Source: Economic Affairs Division, Ministry of Finance

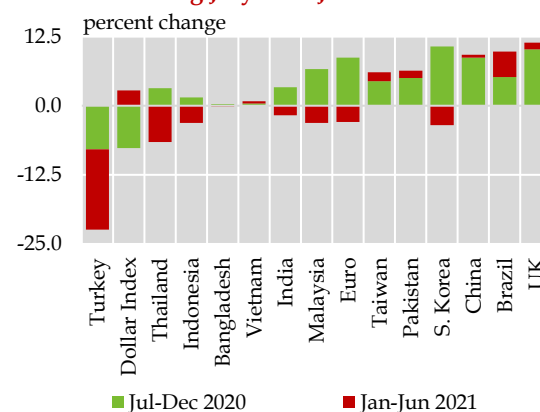
6.3 Exchange Rate and Reserves

The strengthening in the country's external account during FY21 was reflected in a consistent build-up in the SBP's FX reserves position, which rose by US\$ 5.2 billion to reached US\$ 17.3 billion by end-June 2021.

The central bank's net forward liabilities also reduced by US\$ 0.9 billion during the year. In line with this improvement, the PKR appreciated 6.7 percent against the US Dollar during FY21.

That said, the yearly data breakdown shows that during Jul-Dec 2020, the cumulative current account surpluses had led to an accumulation in the FX reserves of commercial banks (in Jul-Sep 2020) and the SBP (in Oct-Dec 2020). At the same time, the US Dollar itself was weakening against many EM currencies during this period, mainly due to the relatively earlier re-openings and pickup in industrial activity in the developing economies. Due to these factors and similar to other EMs, the PKR appreciated 5.1 percent against the US Dollar during Jul-Dec 2020 (Figure 6.17).

In Jan-Jun 2021, the PKR appreciated by a lower magnitude (1.0 percent); though the entire appreciation was noted during Jan-Mar 2021. The PKR's strength reflected the country's relatively better performance in controlling the second and third waves of Covid, continued economic recovery, and the successful completion of the 2nd-5th combined

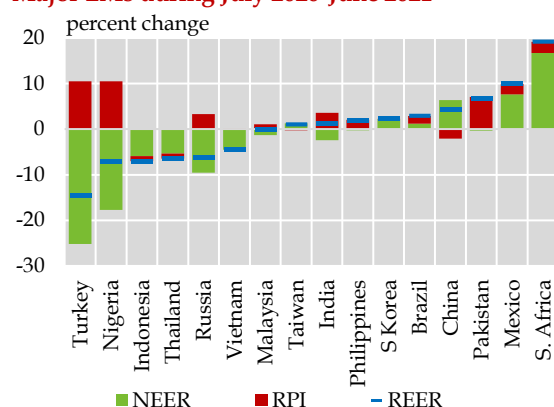
Trend in EM Exchange Rates against US Dollar during July 2020-June 2021**Figure 6.17**

Source: Bloomberg

IMF reviews.

However, from April 2021 onwards, the import payment pressures became more prominent and could not be completely offset by the export receipts and remittances. Resultantly, the current account deficit widened considerably during Apr-Jun 2021.

Breakdown of Change in REERs of Major EMs during July 2020-June 2021 **Figure 6.18**



Source: JP Morgan/Haver Analytics

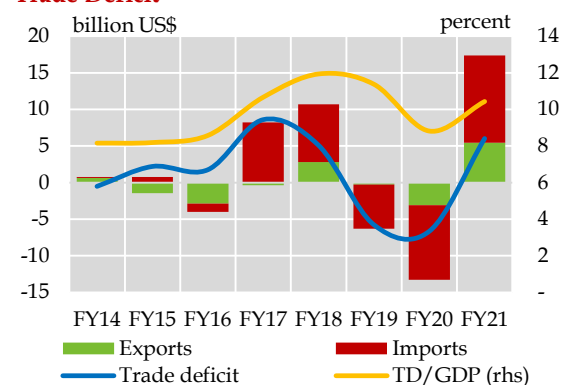
These payment pressures were reflected in the market-based exchange rate, which depreciated 3 percent during the quarter.

On the other hand, the country's Real Effective Exchange Rate (REER) appreciated 6.8 percent during July 2020-June 2021, though the entire appreciation was recorded during July 2020-March 2021, followed by a slight depreciation in Q4.²⁸ The breakdown of the change shows that the entire increase in REER originated from the increase in price levels in the country relative to its major trading partners; against this, the Nominal Effective Exchange Rate (NEER) remained mostly stable, dropping by a negligible 0.3 percent during the year (Figure 6.18). Such inflationary pressures, as measured by a rise in the Relative Price Index (RPI) were also noted across some other major EMs, such as India, Turkey and Nigeria; however, in their cases, the depreciation in their NEERs either partially or completely offset the rise in their RPI.

6.4 Trade Account²⁹

Pakistan's merchandise trade deficit increased to US\$ 31.1 billion in FY21 – closer to pre-covid FY18 deficit of US\$ 37.6 billion. While exports witnessed a significant turnaround and grew by 18.3 percent, this increase was

Trade Deficit to GDP ratio and Breakdown of YoY Change in Trade Deficit **Figure 6.19**



Source: Pakistan Bureau of Statistics

insufficient to offset the 26.6 percent growth in imports. As a result, trade deficit widened by 34.3 percent, amounting to US\$ 7.9 billion, on YoY basis in FY21.

The deficit in FY21 expanded after contracting consecutively in the preceding two years, which makes this rapid rise relatively unexpected in contrast to FY18. In FY18, the trade deficit grew by 15.7 percent, while in FY17, this growth was 35.9 percent (Figure 6.19). Moreover, in terms of GDP, the trade deficit in FY21 was only 10.4 percent, lower than 11.9 percent noted in FY18, and slightly above the average of 9.6 percent realized during FY12-20. Therefore, this increase was mostly in line with the recovering demand in the economy (Figure 6.19).

Importantly, exports in FY21 increased by 18.3 percent; a record over last 15 years, to US\$ 25.3 billion, while in FY18 it achieved a relatively lower growth of 13.7 percent YoY. This growth in FY21 stemmed mainly from apparel and home textiles, and also reflected some impact of the low base effect from last year. Moreover, the accommodative fiscal and monetary policies adopted to spur the economic growth after the initial Covid shock, and the surge in the international commodity prices, contributed to a 13-year high growth in imports during FY21. Additionally, incentive

²⁸ Pakistan's REER had appreciated 6.8 percent during Jul-Mar FY21, and then depreciated 0.3 percent during Q4-FY21, as per the CPI-deflated JP Morgan Broad Effective Exchange Rate Index (source: Haver Analytics).

²⁹ This section is based on PBS data, based on inputs received from customs. The information provided here may not reconcile with Section 6.1, which is based on the SBP (payments record) data. To understand the difference between these two data series, please see Annexure on data explanatory notes.

announced under Naya Pakistan Housing Scheme increased activity in the housing sector. As a result, Machinery, Transport, Metal, and Agriculture & chemicals groups witnessed a strong growth in imports.

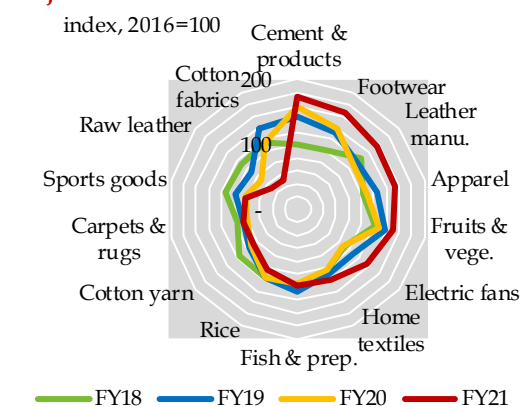
Exports

As per Customs data, Pakistan's exports increased by 18.3 percent to US\$ 25.3 billion in FY21 (Table 6.7), from US\$ 21.4 billion in FY20. This increase of US\$ 3.9 billion is partly attributable to a low base effect from the last quarter of FY20, when exports had declined by around 33 percent after the Covid outbreak. That said, this year's export performance fared better than pre-COVID levels as well (Table 6.7). Exports increased by 14 percent in FY21 over the average exports during FY17-FY19, from US\$ 22.2 billion to US\$ 25.3 billion. As such, it appears that the export growth during FY21 was also driven by the market forces of demand and supply, beyond the low base effect.

It is important to note that many of Pakistan's major export products – such as fruits and vegetables, apparel, home textiles, leather manufactures (leather garments and gloves), footwear, cement and products, and electric fans – recorded volumetric increases in FY21 as compared to recent years as well (Figure 6.20).

Quantum Exports of Pakistan's Major Products

Figure 6.20



Source: Pakistan Bureau of Statistics

Pakistan's Major Exports during Jul-Jun

Table 6.7

million US\$

Groups/Items	FY17-19 Avg.	FY20	FY21	Abs. change in FY21 over	
				FY17-19 Avg.	FY20
Textile group	13,100	12,527	15,399	2,299	2,872
Non-textile group	9,097	8,867	9,905	808	1,038
Textile	13,100	12,527	15,399	2,299	2,872
Low-end textiles*	3,394	2,815	2,938	-456	123
Apparel	5,174	5,347	6,848	1,674	1,501
Home textiles	3,015	2,862	3,709	694	847
Other textile made-ups^	668	591	756	88	165
Food	4,372	4,361	4,392	20	31
Rice (a+b)	1,904	2,176	2,042	138	-134
a) Basmati	557	783	570	13	-213
b) Non-basmati	1,347	1,392	1,472	125	80
Fish & prep.	428	407	415	-13	8
Fruits & vegetables	618	730	800	182	70
Meat & prep.	230	304	332	102	28
Petroleum	353	273	182	-171	-91
Petroleum crude	184	186	107	-77	-79
Petroleum products	115	41	43	-72	2
Other Manufactures	3,286	3,036	3,467	181	431
Raw leather	309	184	162	-147	-22
Leather manufactures	500	474	562	62	88
Medical instruments	369	356	428	59	72
Chemicals & pharma	1,020	1,008	1,149	129	141
Cement & products	244	259	268	24	9
Total Exports	22,198	21,394	25,304	3,106	3,910

*Low-end textiles: cotton yarn and cotton fabrics; ^excluding bedwear and towels

Source: Pakistan Bureau of Statistics

Textile exports increased from US\$ 12.5 billion in FY20 to US\$ 15.4 billion in FY21, accounting for around three-fourth of the growth in total exports. Apparel (knitwear and readymade garments) and home textiles (bedwear and towels) were the leading product categories, followed by other textile made-ups (which include items like washing and dish cloth, curtains, table linen). Exports of pharmaceuticals and surgical goods also posted higher exports amidst the pandemic. In contrast, rice exports, despite amounting to over US\$ 2 billion, declined during the year.

The recovery in overall exports during the year was facilitated by the measures taken by the government and the SBP to support the industrial activity after the Covid outbreak. These measures facilitated higher capacity utilization by the value-added textile firms, which received and delivered more orders than last year. Some of these supportive policy measures included: extensions in the validity of the erstwhile zero-rating certificates to provide power and gas subsidies to top five export sectors until November-2020; gas and power subsidies under the industrial support package from November-2020 onwards; and the reduction in the policy rate from 13.25 percent to 7.0 percent between mid-March and June-2020, which lowered the working capital cost for industries.^{30, 31}

Moreover, the government upgraded FASTER to FASTER Plus to further expedite sales tax refunds for exporters.³² Overall, sales tax refunds were up significantly during the year, bolstering the liquidity positions of exporters, especially the textile firms.³³ Regulatory duty and customs duty on imported cotton yarn were also removed in December 2020 and May 2021, respectively, to reduce the imported cost of the raw materials

for the export-oriented industry amidst domestic shortage of the items.³⁴

Apparel and home textiles register highest levels in both value and quantum terms

Apparel and home textiles, high value-added textile products, registered a cumulative increase of 28.6 percent to US\$ 10.6 billion in FY21, as compared to US\$ 8.2 billion last year.

Apparel grew by 28.1 percent to US\$ 6.8 billion in FY21. Higher export volumes played the dominant role, with the country shipping around 39 percent higher volumes than last year. The growth in volumes came mainly from the US, UK and the EU-27, and partially reflected the low base effect from last year. However, there was also higher demand for Pakistan's apparel, amidst the circumstances created under the pandemic. It is evident by the fact that apparel imports of these advanced economies from Pakistan were higher than the pre-Covid (FY19) levels as well. In contrast, the apparel imports of these major markets from Pakistan's competitors – such as India, Indonesia and Bangladesh – either declined or did not rise sufficiently enough to cross their FY19 levels.

During July 2020-June 2021, imports of the US and UK from Pakistan rose by about 37.4 percent and 32.4 percent, respectively (**Figures 6.21 and 6.22**). It was despite the fact that the US' and UK's overall imports from the world had declined for the better part of this period. Not only that, imports of the US and UK from some competitor countries of Pakistan – for instance, India, Cambodia and Bangladesh –

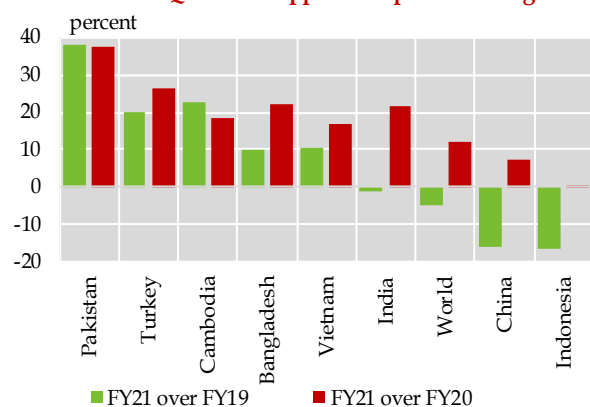
³⁰ For more details, see Chapter 5: External Sector of SBP's State of the Economy Report for Q2-FY21.

³¹ For instance, net borrowing under the Export Finance Scheme by the textile sector amounted to Rs. 59 billion in FY21.

³² FASTER (Fully Automated Sales Tax e-Refund), introduced by the FBR in July 2019, was upgraded to FASTER Plus in October 2020 due to some technical issues in the system. (source: FBR Press Release, fbr.gov.pk/pr/fbr-upgrades-faster-to-faster-plus-system-for/152507)

³³ Sales tax refunds increased to Rs 155 billion in Jul-Mar FY21, which were 158 percent higher than last year's comparable refunds of Rs 60 billion (source: FBR).

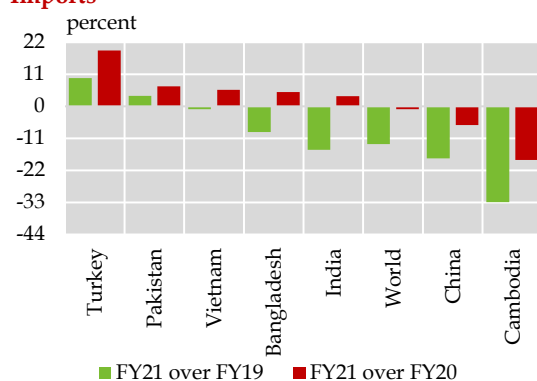
³⁴ Source: FBR SROs 1352(I)/2020 and 533(I)/2021 dated 23-12-2020 and 05-05-2021 respectively.

Growth in US' Quantum Apparel Imports*

*FY refers to July-June

Source: Office of Textiles & Apparel (USA)

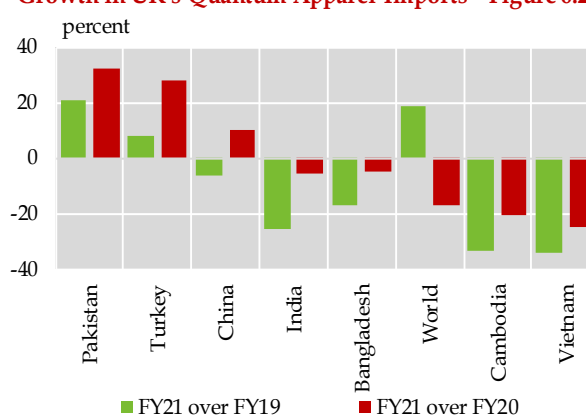
had declined simultaneously as well.³⁵ It could be explained, in part, by the anecdotal evidence that Pakistan was on the receiving end of some deflected orders from countries whose exporters were impacted more profoundly by the pandemic.³⁶

Growth in EU-27's Quantum Apparel Imports*

*FY refers to July-June

Source: Eurostat

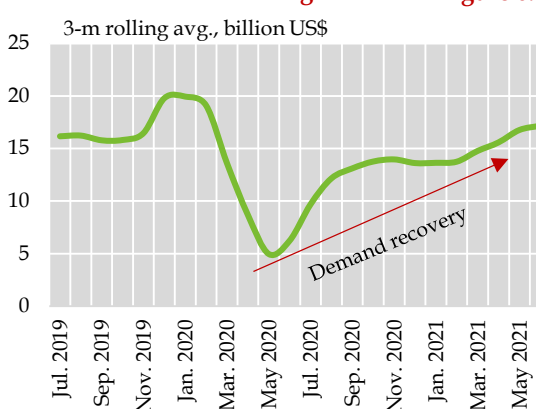
In case of the EU-27 as well, there was an increase of 6.9 percent YoY in quantum apparel imports from Pakistan during July 2020-June 2021 (Figure 6.23). Although, there

Figure 6.21 Growth in UK's Quantum Apparel Imports* Figure 6.22

*FY refers to July-June

Source: UK Trade Info

had been a decline in these imports of the bloc in July 2020-March 2021, it was very limited in comparison to the country's major competitors. One factor behind higher demand for Pakistan's apparel was gradual recovery, despite being interrupted, in retail demand for these consumer goods in the advanced economies following the first wave of the pandemic; Figure 6.24 depicts this trend in the US' case. This gradual recovery initiated in the second half of CY-20, and proceeded

Retail Sales at US' Clothing Stores Figure 6.24

Source: US Census Bureau

³⁵ "Due to the pandemic, all economic activities except for the essential goods and services came to a standstill. The textile and apparel industry was no exception to this ... Due to the uncertainty across the market, international and domestic buyers cancelled or suspended their orders, adding to the woes of the industry." (Indian Textile and Apparel Industry Annual Report 2021, Apparel Export Promotion Council, India).

³⁶ For example, in India, Covid-19 resulted in permanent loss of jobs in key textile manufacturing hubs there, such as Bengaluru, as noted in Chapter 5 of SBP's State of the Economy Third Quarterly FY21 report. Moreover, India also witnessed massive labor displacements as migrant workers moved back to their far-flung home states to see off the Covid outbreak. That led to massive labor shortages, especially of skilled workers, in the southern Indian knitwear hub of Tipuru and other places, amidst strongly recovering demand from the advanced economies. (www.just-style.com/features/skilled-worker-shortage-latest-to-hit-india-exporters/)

onwards. Pakistani exporters benefited from recovering demand on the one hand and orders diverting from competitors due to Covid-related disruptions on the other.

Another factor was that, due to loss of purchasing power, some apparel consumers developed greater propensity for cheaper apparel products as the world toiled through the pandemic. At the same time, retailers and brands, mostly running in losses from the pandemic, were also looking for discounts on new orders. Under these circumstances, Pakistan offered lower prices than most of its competitors, such as Cambodia, India and Indonesia.

Average Unit Values of EU-27's Imports of Home Textiles by Origin* **Table 6.8**

US\$/100 KG

	Absolute			Growth	
	FY19	FY20	FY21	FY20	FY21
China	611	604	590	-1.2	-2.3
Pakistan	622	596	614	-4.2	3.0
Bangladesh	691	698	687	1.1	-1.6
India	687	689	710	0.3	3.0
Turkey	864	849	896	-1.8	5.5
World	689	672	684	-2.4	1.8

*FY refers to July-June

Source: Eurostat and Haver Analytics

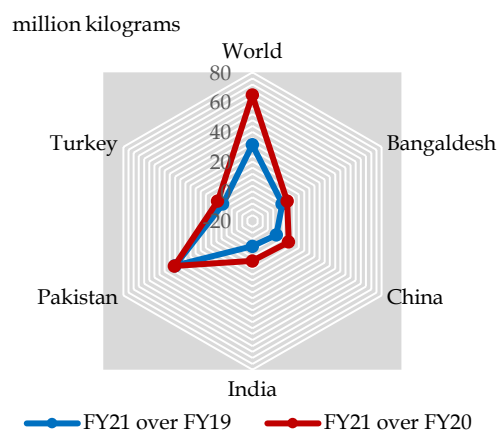
Meanwhile, home textiles (comprising bedwear and towels) also made significant contribution to the textile exports, by bringing in US\$ 3.7 billion in FY21. These exports were US\$ 847 million higher than last year, and similar to apparel, had surpassed their pre-Covid (FY19) levels as well, in terms of both value and volumes. Both the price and quantum effects contributed to the higher home textile exports.

The price effect came about as the input cost of the home textiles grew over the last year in response to elevated cotton prices in the domestic and international market. Faced

with domestic shortage, the country had to import cotton fiber in sizable quantities.³⁷ It may be noted that the increase in Pakistan's unit values was in line with the international trend (Table 6.8). That said, as the year progressed, Pakistan also started to receive deflected orders from competitors.³⁸ That, combined with the low base effect, resulted in a positive quantum effect for the entire fiscal year. Quantum imports of home textiles by the EU-27, Pakistan's major market, had risen around 17.7 percent during July 2020-June 2021. The country's shipments also rose over FY19 levels by a large margin, especially in contrast to India and other competitors (Figure 6.25).

Absolute Change in EU-27's Quantum Home Textiles Import*

Figure 6.25



*FY refers to July-June

Source: Eurostat

Pakistan was able to increase its shipments to the bloc even at slightly higher per unit cost, indicating its established market there and deflection of some orders. It may be noted that despite an increase, Pakistan's unit values were still lower than those of Bangladesh, India and Turkey, making it competitive even at nominally higher unit values (Table 6.8).

³⁷ Pakistan imported 0.86 million tons of cotton fiber in FY21, around three-fourth more than annual average of 0.49 million tons between FY16 and FY20, as per Customs data. The country's cumulative imports of cotton fiber from the US and Brazil increased by 31 percent to 0.50 million tons in FY21, up from 0.38 million tons last year.

³⁸ Talking about not being able to meet demand for home textiles completely due to lockdowns in India during its second wave, managing director of a textile mill told Just-style that: "The risk of not meeting this demand is clear. Two of [our] clients shifted some of their orders to Pakistan and Bangladesh to ensure they met their own commitments." (Source: www.just-style.com/features/skilled-worker-shortage-latest-to-hit-india-exporters/).

Besides, Pakistan's exports of 'other textile made-ups' also rose by a sizable 28 percent to US\$ 756 million in FY21. This product category includes personal protective equipment (PPE) and medical items, such as cleaning cloth, whose international demand had risen quite strongly after the Covid outbreak.³⁹

In the low value-added segment, cotton yarn and fabric exports rose by a cumulative 4.4 percent to US\$ 2.9 billion in FY21. The growth in exports of these items was mainly due to higher unit values, which could be, in turn, attributed to higher cotton prices in the domestic and international market. In the domestic market, higher input prices were reflective of a shortfall in the cotton crop output. Moreover, demand from high value-added textile segment left low exportable surplus of the intermediary products like cotton yarn and fabric, which translated into lower export shipments; in particular, shipments of cotton fabrics fell precipitously throughout the year. Besides, international demand for Pakistan's cotton yarn and fabric was also lower YoY due to global disruptions in apparel trade.⁴⁰

Rice exports faced increased competition

Rice exports declined by 6.1 percent to US\$ 2 billion in FY21, in contrast to an increase of 5.1 percent in FY20. Lower export volumes were the dominant factor for the decline in exports, overcoming the positive price effect of higher unit values. Pakistan's rice shipments fell at the expense of India mainly on account of

price competitiveness, which, in turn, could be traced to the latter's massive rice stocks, among other reasons.⁴¹ Within rice categories, volumes of basmati rice witnessed much sharper decline than non-basmati rice.

Basmati rice exports decreased by 27 percent to US\$ 576 million in FY21. Slightly positive price effect was completely overcome by the negative quantum effect. Pakistan's quantum exports to the major basmati markets in the Middle East – Bahrain, Iraq, Oman, Saudi Arabia, UAE and Yemen – almost halved in FY21, whereas, India's shipments to the region increased by 5.8 percent in Jul-Apr FY21. Average unit value offered by India on its basmati rice decreased from US\$ 941 per ton in Jul-Apr FY20 to US\$ 856 per ton in Jul-Apr FY21.⁴² In contrast, Pakistan's average unit value rose from US\$ 905 per ton to US\$ 919 per ton in FY21.

On the other hand, non-basmati rice exports increased slightly by 5.3 percent to US\$ 1.5 billion in FY21. It was the result of a significant and positive price effect (**Figure 6.26**). There were two major reasons behind this development. Initially, Pakistani unit values had risen amidst tight supplies in the first quarter ahead of a new crop. Later, after the arrival of a new crop in Sep-Oct, the country witnessed significant demand for the grain from China compared to last year, which further pushed up its export prices.^{43, 44} Nevertheless, these higher unit values induced major African buyers to switch to Indian suppliers, who had offered more competitive

³⁹ Rising exorbitantly by 1,083 percent YoY in Q4-FY20, global imports of Covid-related medical textile made-ups (HS 630790) kept up a rising momentum until Q4-FY21, when they tapered due to high base effect from last year. In Jul-Mar FY21, they had risen by 239 percent to US\$ 38.5 billion, up from US\$ 11.3 billion during same period last year. (Source: ITC)

⁴⁰ For instance, Pakistan's shipments of cotton fabric more than halved to some major destinations like China, Bangladesh, Germany, UK, Spain and Italy. (PBS)

⁴¹ "India rice exports have been supported by large supplies and successive bumper crops, the world's most competitive pricing, and improved export infrastructure capable of shipping rice in bulk." source: USDA 2021: *Grain World Trade Report*. June issue. Washington, DC: USDA.

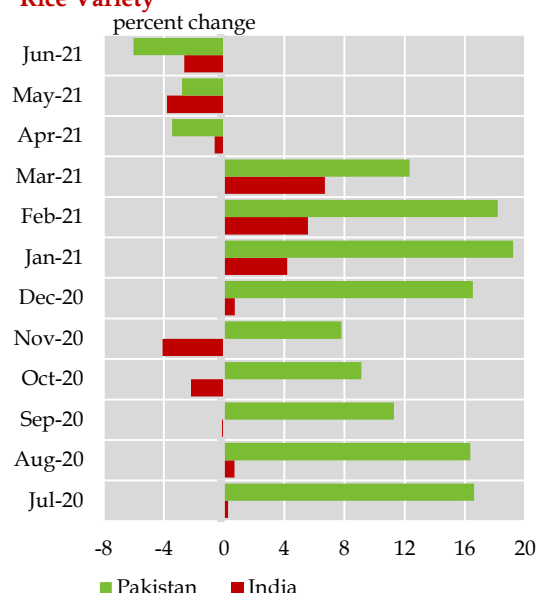
⁴² Ministry of Commerce and Industry, India and SBP calculations.

⁴³ Accounting for about 0.9 million tons out of a total of 3 million tons non-basmati rice exports, Pakistan's China-bound shipments were 2.5 times, or 148 percent, higher in FY21 than the same period last year. (PBS)

⁴⁴ Impact of higher Chinese imports on Pakistan's non-basmati rice quotes was also identified in a market research report. "... A trader described the market as a 'mini rollercoaster' that moved according to the volume of Chinese demand." (Source: S&P Global Platt's Rice Weekly Feb 26, 2021)

Percentage Change (YoY) in Pakistani and Indian Non-Basmati Rice Variety*

Figure 6.26



*25% broken

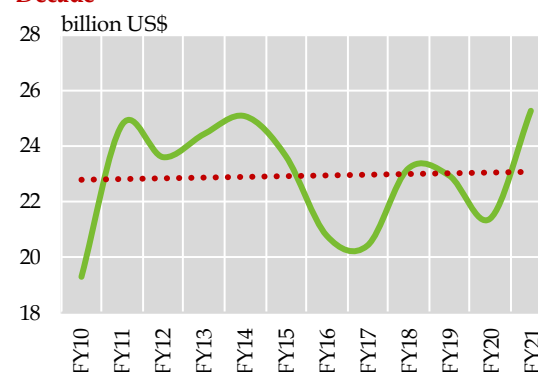
Source: Food and Agriculture Organization

rates.⁴⁵ Lower shipments to Africa offset the impact of higher demand from China, dragging down overall shipments. That said, the fall in non-basmati rice volumes was moderate as compared to basmati rice.

In FY21, Pakistan's exports witnessed decent YoY growth of 18.3 percent to US\$ 25.3 billion.

Pakistan's Exports over the Last Decade

Figure 6.27



Note: dotted line is the trend line

Source: Pakistan Bureau of Statistics

As discussed before, major factors that contributed to this growth included: accommodative monetary and fiscal policies, market-based exchange rate system, governments' facilitative policies to revive the industrial activity, as well as the export sector, in the wake of the Covid outbreak in early 2020, and deflection of orders of some key export products. That being said, over the years, Pakistan's exports have, however, not grown sustainably, resulting in stagnancy (Figure 6.27). Box 6.2 discusses some major factors behind this phenomenon.

Box 6.2: Factors Impacting Sustainable Growth in Exports: Why Pakistan Lags Behind Some Peer Countries

In the last decade, growth in Pakistan's exports has been sporadic and unsustainable. In comparison, some peer countries, such as India and China, have fared better than Pakistan. These countries have not faced any recurrent BOP crises, whereas Pakistan has. As per World Integrated Trade Solutions, between CY10-19, Pakistan's exports have risen by mere US\$ 2 billion; whereas, for India and China the absolute changes amount to US\$ 103 billion and US\$ 921 billion, respectively. In the same period, Pakistan's exports averaged US\$ 23 billion; while, India and China averaged US\$ 293 billion and US\$ 2.2 trillion, respectively. In terms of GDP, in 2019, exports of Pakistan, India and China were around 9 percent, 11 percent and 17 percent, respectively. Already paltry, Pakistan's share of world exports has declined from 0.13 percent in CY10 to 0.12 percent in CY19. On the other hand, India's global share has increased from 1.31 percent to 1.57 percent; and China's from 9.37 percent to 12.17 percent. Based on several studies, we briefly summarize four main reasons as to why exports of Pakistan have not risen sustainably.⁴⁶

a) Labour productivity

⁴⁵ Pakistan's quantum non-basmati exports to Kenya, Tanzania, Mozambique, Somalia, Togo, Senegal in East Africa and West Africa more than halved to 0.5 million tons (15 percent of the total non-basmati exports) in FY21 from one million tons (32 percent) last year. Whereas, India's rice exports to both East Africa and West Africa reached 4.7 million tons in Jul-Apr FY21, registering an eight times increase over last year. (PBS and Ministry of Commerce and Industry, India)

⁴⁶ It may be noted that these reasons are by no means exhaustive.

According to Deshmukh and Pyne (2013), there is an extensive evidence of the self-selection hypothesis, which states that firms that are more productive are more likely to enter the export market and ship out more of their output. Melitz (2003) and Ghironi and Melitz (2005) also found a link between a firm's productivity and its ability to enter into the export market. They showed that more productive firms would export, the less productive firms would stick to the domestic market and the least productive firms would exit.

One of the major determinants of a firm's overall productivity level is its labour productivity. Labour productivity, measured as output per worker and determined mainly by the quality of human and physical capital, and technological innovation, varies across the countries under consideration. National productivity levels of China and India are higher than Pakistan, which partly explains differences in their export profiles over the years. In 2017, China and India's labour productivity levels (in 2010 constant dollars) were 3.4 times and 1.4 times that of Pakistan.⁴⁷

Furthermore, on a sectoral level, manufacturing sector is the cornerstone of a country's exports. For instance, Soderbom and Teal (2002), while attributing economic success of Taiwan, Hong Kong, Singapore and South Korea to their export performances, held manufacturing exports as the leading variable. Reis et al. (2013) also noted that manufactures are the most important products in international trade of goods. Pakistan's labour productivity in manufacturing lags behind India and China by large margins as well. In 2017, Pakistan's manufacturing productivity (in 2011 PPP exchange rate) stood at US\$ 12,000, India at US\$ 22,000 and China at US\$ 35,000.⁴⁸

b) Product diversification

Product diversification can help boost export earnings in the long run, making them sustainable as well, argue McMillan, Rodrik and Verduzco-Gallo (2014). It is particularly true for developing countries vulnerable to terms of trade shock due to products concentration, such as Nigeria. Moreover, Feestra and Lee (2004) showed that a 10 percent increase in export diversification in all industries of a country would lead to a 1.3 percentage point rise in a country's productivity growth.

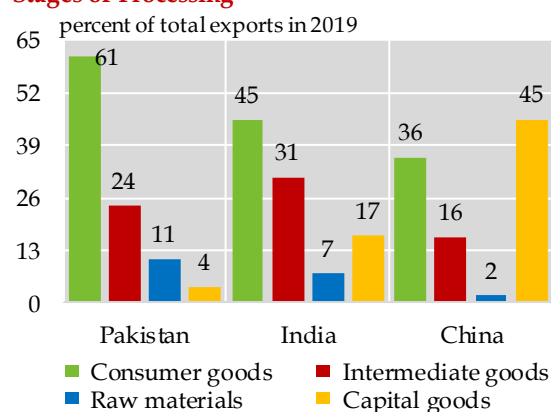
On this front, Pakistan's export basket lacks diversity, especially in comparison to India and China (**Figure 6.2.1**).

On an aggregate level based on stages of processing, Pakistan's exports pie is predominantly occupied by consumer goods – over 60 percent. Whereas, export baskets of India and China are more evenly divided among consumer goods, intermediate goods and capital goods.

On a disaggregated HS-2 level, Pakistan's exports are dominated by a few categories of consumer and intermediary goods, namely apparel (knitwear and woven clothes), home textiles and other textile made-ups, cotton and its articles, and cereals, which together make around 65 percent of total exports. In 2019, these exports raked in US\$ 15.5 billion out of a total of US\$ 23.8 billion.

For India, at HS-2 level, a number of categories of products represents the mix, which shows more diversity than Pakistan. They include mineral oils and fuels, precious stones and metals, pharmaceutical products, machinery and mechanical appliances, iron and steel, cereals, plastics and products, etc. In 2019, these groups together accounted for around 60 percent of India's overall exports. Similarly, China's major product categories are also well-spread across various HS-2 chapters, which include: electrical machinery and equipment, machinery and mechanical appliances, furniture, plastics, optical devices, vehicles, textile made-ups, toys, iron and steel and articles thereof, apparel, organic chemicals, footwear, etc. In 2019, these groups were responsible for around 73 percent of China's exports.

Product Diversification Based on Stages of Processing **Figure 6.2.1**



Source: World Integrated Trade Solutions

⁴⁷ A. Dieppe, S. Kilic Celik, and G. Kindberg-Hanlon (2020). "Global Productivity Trends". In A. Dieppe (eds.). *Global Productivity: Trends, Drivers, and Policies*. Washington, DC: WB.

⁴⁸ Ibid footnote 47.

Furthermore, at HS-6 level, Pakistan's lack of product diversification is also reflected in the fact that its top 50 export products (in terms of USD value in 2019) occupy around 63 percent of total exports. Whereas, in case of India and China, top 50 products account for about 49 percent and 38 percent, respectively.

c) Market diversification

Market diversification leads to new opportunities of higher and more sustainable earnings, while making exporting firms less vulnerable to market-specific demand fluctuations (Ghani, Mehmood, Din, 2012). Pakistan's export destinations are far less diverse than India and China. To understand the gap, first consider World Integrated Trade Solutions' regionalization of the world, as shown in Figure 6.2.2.

In 2019, Pakistan's average number of HS 6-digit products shipped to all these regions was 47 percent of the total 2,824 products (Figure 6.2.2). In contrast, India's and China's averages were 87 percent and 90 percent, respectively, of a little over 4,400 products in each case. These numbers show untapped potential in regional markets around the globe for Pakistan, which include: Latin America and Caribbean; Sub-Saharan Africa; North America; South Asia; East Asia and Pacific.

For instance, Latin America and Caribbean countries imported textiles and clothing items to the tune of US\$ 33 billion in 2019. Imports from China and India clocked in at US\$ 13 billion and US\$ 1.6 billion, respectively. Whereas, imports from Pakistan were only US\$ 344 million.

d) Global Value Chains

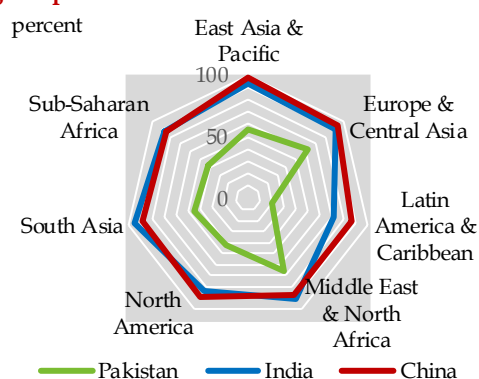
According to Global Value Chain Development Report 2019, more than two-thirds of global trade channels through global value chains (GVCs), wherein production crosses at least one border, and usually many borders, before final assembly. GVCs help accelerate growth in export through two channels. (1) Backward participation or integration, where a country imports intermediary goods to produce and export products where it may have competitive advantage. For example, Bangladesh imports cotton fibre and yarn to make and export cotton-based apparel. (2) Forward participation, where a country exports intermediary goods because it does not have the competitive advantage in making the related finished products. For instance, the US exports iPhone's design and engineering items to China for assembly, which is cheaper and more competitive.

Pakistan's GVC participation, which is a sum of backward and forward participation, has been behind that of India and China for the better part of time period since 1990 (Figure 6.2.3). Although its participation has converged in the post-2007 crisis period, it is still lagging.

SBP (2020) notes that Pakistan is still not deeply integrated into GVCs because of two major reasons. One, the country's exports are concentrated in low value added products and primary commodities which generally do not require imported inputs. Two, high protectionism – Pakistan's tariffs on intermediate goods are four times the East Asia average. World Bank (2019), while analyzing, Pakistan's textile and apparel exports, noted that the exporters are dependent on low-quality cotton input, leading to lack of integration in the global textile and apparel value chain. This dependency could be traced to the domestic cotton industry and the exporters not being able to easily access synthetic fibres and high-quality cotton at world prices (due to high protectionism) and in time to fulfill orders, as in the case of Bangladesh.

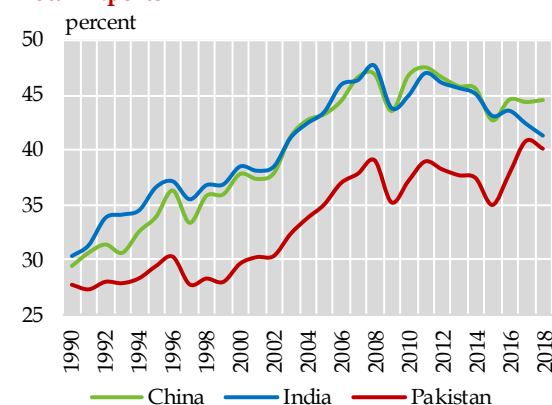
Sources and references:

Region-wise Share of HS 6-digit Products in Total Number of HS 6-digit Export Products in 2019 Figure 6.2.2



Source: World Integrated Trade Solutions

GVC Participation as Percent of Total Exports Figure 6.2.3



Source: UNCTAD EORA

- World Integrated Trade Solutions
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Imports

In FY21, Pakistan's imports rose to US\$ 56.4 billion from US\$ 44.6 billion in FY20. However, the imports remained well short of the record level of US\$ 60.8 billion in FY18. Imports had remained constricted in FY20 due to the strong macroeconomic stabilization policy environment prevalent in the first three quarters, and then due to the Covid-induced slump in aggregate demand in the fourth quarter. In FY21, however, three important factors contributed to the sharp growth in imports.

Necessities within consumer goods, especially food and medicines, and raw materials for consumer goods scaled up the demand for commodity imports

Higher demand for consumer necessities, such as food items (including wheat and sugar) and medicines (including Covid vaccines) drove the imports of consumer goods, which rose by US\$ 2.3 billion to US\$ 10.4 billion during FY21 (Table 6.9). Moreover, the import of raw materials for consumer goods weighed heavily, contributing 11.6 percentage points to the 26.4 percent growth in overall imports during FY21 (Figure 6.28). This category includes edible oil (comprising palm oil), textile raw materials (including raw cotton)

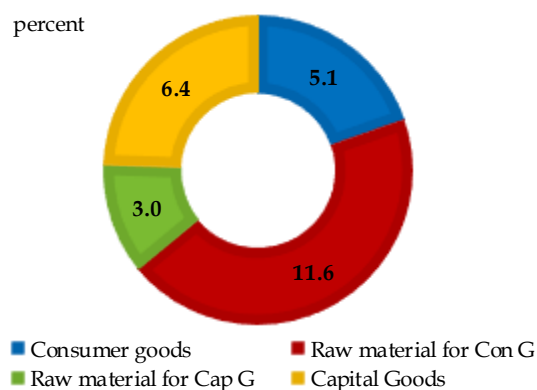
and energy imports. Together, these two categories contributed more than 64 percent of the total increase in imports during FY21. Importantly among these, most of the heavy weight items, by increase, are agricultural commodities (Figure 6.29).

Pakistan's Imports by Economic Category **Table 6.9**
million US\$

	FY20	FY21	Abs. Change
Consumer Goods	8,084	10,367	2,284
Food	5,372	7,068	1,695
Wheat	-	983	983
Sugar	3	128	125
Medicines	949	1,308	359
Vaccines	219	531	312
Raw material (A+B)	23,640	30,155	6,515
A. Consumer goods	18,847	24,025	5,178
Palm Oil	1,842	2,669	827
LNG	2,662	2,617	-45
Petroleum	4,733	5,160	427
Raw Cotton	880	1,480	600
B. Capital Goods	4,793	6,129	1,337
Capital Good	12,762	15,610	2,849
Mobile Phones	1,370	2,065	695
Road Motor Vehicles	1,279	2,458	1,179
Total	44,553	56,405	11,852

Source: Pakistan Bureau of Statistics

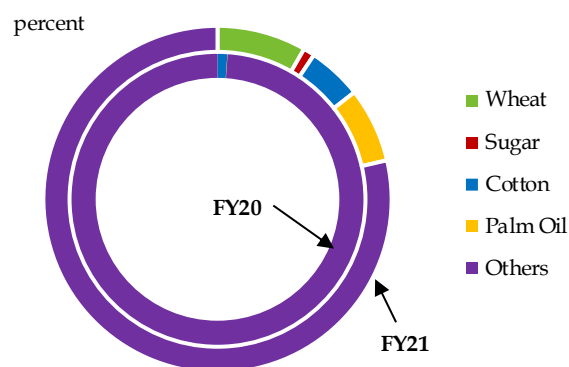
The decline in agriculture output in FY19 and adverse developments like unfavorable

Contribution to Growth by Economic Category

Source: Pakistan Bureau of Statistics

weather, locust attack and fall in the cultivation area of sugarcane and cotton, had repercussions for the agri sector outputs in FY20 and on their carry forward stocks for FY21. Pakistan had exported around 2.0 million tons of wheat in FY19 to reduce the cost of maintaining large stockpile.⁴⁹ However, below-target output in FY19-20, risks posed by climate change and pest attack to the future wheat output, and Covid-induced frequent spike in wheat and wheat flour demand, forced the government to change its stance. As a result, the government allowed the import of wheat not only to meet the domestic demand in FY21, but to also maintain large strategic reserves for future consumption.

Similarly, besides the unusual weather fluctuations and pest attack, lack of interest from farmers in producing cotton, sugarcane and edible oilseed crops warranted the import of these commodities in large volume in FY21. Specifically, Pakistan imported 3.1 million metric tons of palm and soybean oil, 8.2 percent more from FY20 and around 90 percent of its consumption need. Domestic production of the edible oilseeds and oil declined due to the fall in cottonseed, rapeseed & mustard, sunflower and canola production, as crop areas under these commodities shrunk by 21.4 percent in FY21.⁵⁰

Figure 6.28 Contribution of Key Agri Commodities in Import Growth

Source: Pakistan Bureau of Statistics

Importantly, the decline in oilseed crop and the area under its cultivation does not bode well from Pakistan's perspective, especially when international palm oil prices are increasing sharply due to the supply bottlenecks in Indonesia and Malaysia amid increased demand from China and India. China is inclined to build its edible oil reserves, whereas India has lowered the tax on palm oil imports to fight inflation.⁵¹ Pakistan requires a strategy to increase edible oilseed production, which could help in reducing edible oil import bill. While Pakistan had produced a bumper wheat crop and higher sugarcane output in FY21, which may alleviate future import pressure of these items, a more comprehensive agricultural policy ought to be designed with dual objective of increasing food security and reducing dependence on food imports. This will help curtail import pressure whenever the agriculture sector had a sluggish period.

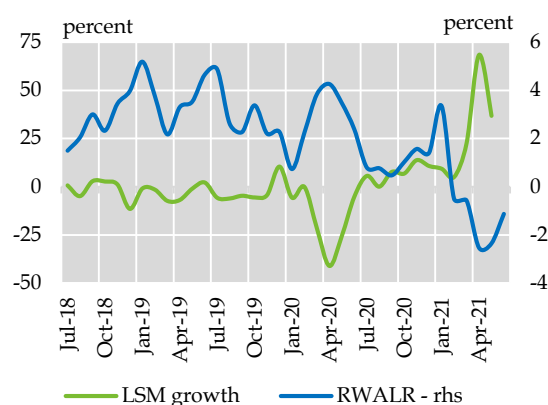
Accommodative policy delivered the necessary impetus to economy

Most of the accommodative monetary and fiscal stimulus announced after the Covid shock in late FY20 remained in place in FY21. SBP's policy measures, aftermath of Covid shock, made ample liquidity available under various schemes. Not surprisingly, the real weighted average lending rate (RWALR)

⁴⁹ USDA (2021). *Grain and Feed Annual – Pakistan*, (June), Washington D.C.

⁵⁰ Pakistan Economic Survey 2020-21.

⁵¹ SBP 3rd Quarterly Report FY21 on State of Pakistan's Economy.

Real Weighted Average Lending Rate and LSM Growth**Figure 6.30**

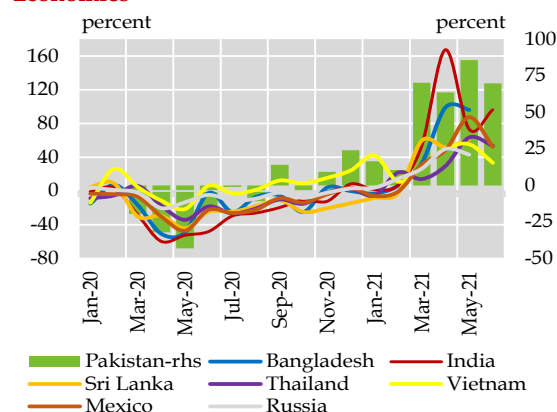
Source: Pakistan Bureau of Statistics

declined significantly as the year progressed, boosting aggregate demand, which pushed the LSM growth to 14.8 percent during FY21 (Figure 6.30).⁵² Moreover, around 27 percent increase in the workers' remittances and more than US\$ 1.5 billion inflows in the Roshan Digital Accounts during the year, of which around US\$ 500 million received by households, augmented the consumption demand of the recipient households.⁵³ Consequently, import demand responded to the reviving aggregate demand in the economy.

Rising global commodity prices buffeted imports from March 2021 onward

The unexpected increase in the global commodity prices also contributed to the increase in Pakistan's import bill, albeit at the margin. In the second half of FY21, specifically from March 2021 onwards, the global commodity prices scaled up across the spectrum (Section 6.1) supported by the stronger than expected recovery and expedited vaccination drive.⁵⁴

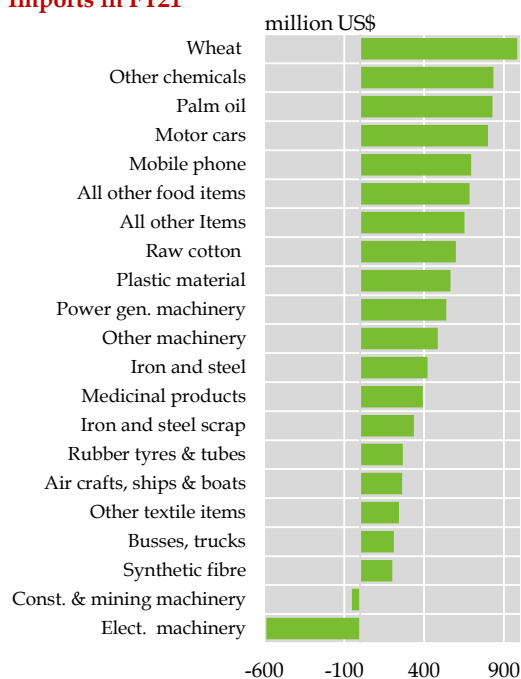
On the back of the global economic recovery and sustained production cuts by OPEC and its partners, crude oil prices reverted back to pre-pandemic level from record lows reached

Import Growth in Regional Economies**Figure 6.31**

Source: World Bank & International Monetary Fund

during the pandemic. Agricultural prices, on the other hand, pushed up by the substantial supply bottlenecks in Latin America and strengthening demand from China.

At the same time, the reviving industrial activity in China and other advanced economies, coupled with expected rollout of US fiscal stimulus package, improved the YoY Change in Major Non-Energy Imports in FY21

Figure 6.32

Source: Pakistan Bureau of Statistics

⁵² RWALR declined by 350 bps by June 2021. Moreover, during Jul-MayFY20, LSM by decline of 10.2 percent.

⁵³ www.sbp.org.pk/rda/progress.html

⁵⁴ As per World Bank, global commodity prices include prices of energy products such as, crude oil, natural gas, and coal, and host of non-energy products, including prices of agricultural products (both food and non-food items), fertilizers, metal and minerals, and precious metals.

outlook of metals. As a result, most of the emerging economies witnessed sharp increase in the import bills (**Figure 6.31**), though the fuller impact of the current price surge will be realized in second half of 2021 calendar year.

Non-Energy imports

Apart from the key agricultural commodities, including food items, raw cotton, and medicines, the overall increase in non-energy imports was broad-based (**Figure 6.32**). The notable contributors among the groups were transport, machinery and metals.

Transport

Imports of transport increased by 93.2 percent, with major thrust coming from road motor vehicles, specifically light vehicles (motor cars) and aircrafts, ships and boats sub-group. Recovering aggregated demand largely drove the demand for car imports.

Importantly, CKD/SKD imports dominated both heavy and light vehicles category, the latter increased to US\$ 2.5 billion in FY21, from US\$ 1.3 billion in FY20. Specifically, the light vehicle (motor car) imports increased by US\$ 799 million to US\$ 1.4 billion in FY 21; with CKD/SKD contributing 81.3 percent to the total car imports (**Figure 6.33**). Incentives under the Automotive Development Policy 2016-21 played an important role in facilitating the entry of new assemblers in the local auto market and the introduction of new car variants, which led to the rise in CKD/SKD imports.

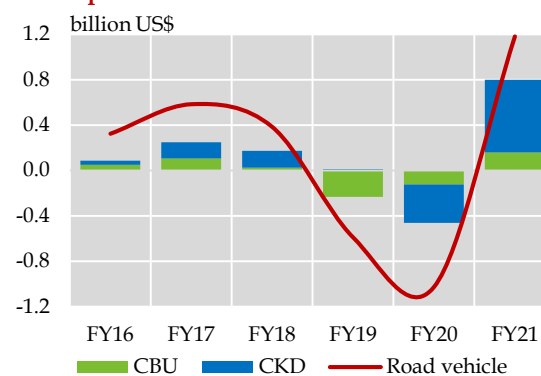
Meanwhile, CBU imports, after declining in the last couple of years, also increased by US\$ 157.2 million in FY21, to US\$ 256.2 million. Most of these cars are of 1,000cc or lower capacity. Assemblers in Pakistan are focused on producing high-end cars, and very few recognized brands were introduced in this segment in the last few years. Moreover, the existing brands carry exorbitant price tags.

Amid the crumbling public transport infrastructure, the lower-end purchasers are forced to buy the imported vehicles, which offer better features at a reasonable prices. On a positive note, the government announced various incentives for local production of lower end cars in Pakistan, which may encourage other manufacturers to enter into this segment of the automobile market.⁵⁵ This may lead to some import substitution in the lower end car market, supplementing economic activity by generating employment, and may lead to lower CBU car related import bills.

In line with transport, imports of rubber tyres and tubes increased by US\$ 266.8 million to US\$ 374.8 million, a significant rise of 247.2 percent. Addition of new vehicles and the rising activity in the transport sector raised the demand for the tyres and tubes imports. Additionally, increased vigilance by the custom authorities may have diverted some of the grey-channel imports to the legal channel, resulting in the steep rise in imports of tyres and tubes in official data.⁵⁶

Meanwhile, the strategy of smart lockdown adopted helped revitalize the ship-breaking activities in the country at the time when Pakistan's competitors were struggling to contain Covid outbreak and reopen their

Changes in Total Road Vehicle Imports With Contribution from Car Imports **Figure 6.33**



Source: Pakistan Bureau of Statistics

⁵⁵ Incentives-for-Autosector-1.pdf (www.engineeringpakistan.com)

⁵⁶ SBP's Third Quarterly Report on State of Pakistan's Economy FY21.

economies. This elevated the imports of ships for breaking to US\$ 256.6 million in FY21, from only US\$ 34.4 million during FY20.

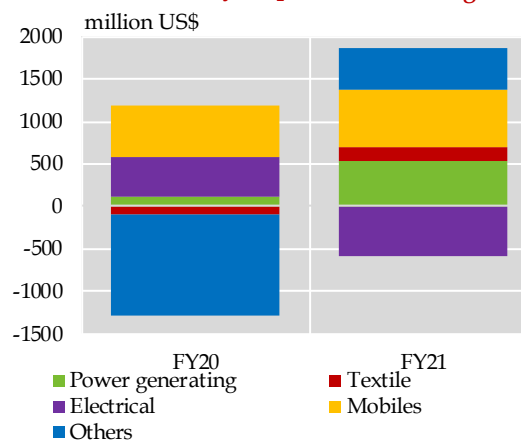
Machinery

Buoyed by SBP's TERF refinancing facility, machinery imports increased to US\$ 10.1 billion in FY21 from US\$ 8.8 billion last year; accounting for around 18 percent of the country's total import bill. Except electrical machinery, the increase in machinery imports was broad-based, with mobile phones standing out. Cell phone imports grew 50.7 percent in FY21, after increasing by 81.3 percent in FY20 (Figure 6.34).

Importantly, the mobile phone market in Pakistan has expanded significantly in FY21, largely due to the pandemic-related restrictions on educational and some office-related activities. Similar to car imports, a visible improvement is noted in product localization in this sector. In FY20, more than 19.4 million CBU mobile phones worth US\$ 1.3 billion were imported, which increased to 21.8 million sets for US\$ 1.5 billion in FY21 (Figure 6.35). A further disaggregation shows that around two-third of these mobiles were imported in H1-FY21. On the contrary, CKD/SKD exceeded the CBU phone imports

in H2-FY21, suggesting that CBU cellular imports not only decelerated in quantum and value, but also became increasingly tilted towards the high end brands in FY21.⁵⁷

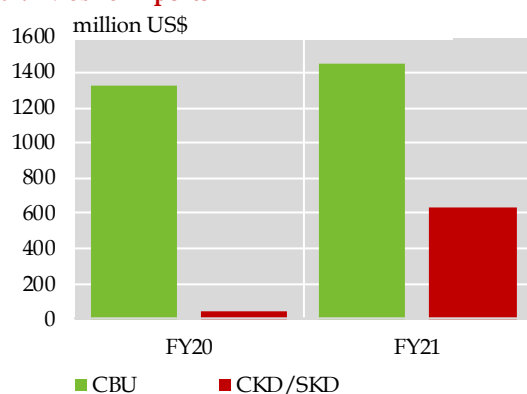
Pakistan's Machinery Imports **Figure 6.34**



Source: Pakistan Bureau of Statistics

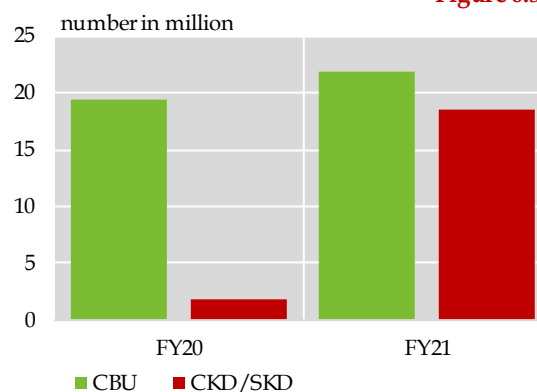
In contrast, CKD/SKD mobile imports increased from 1.8 million units (US\$ 47.5 million) in FY20 to 18.5 million units (US\$ 636.2 million) in FY21, indicating that the local production of mobile phones is gaining momentum.⁵⁸ Implementation of Device Identification Registration and Blocking System (DIRBS) to curtail the use of non-duty paid mobile in the country and incentives announced under the Mobile Device Manufacturing Policy (MDMP) 2020 have

Cellular Mobile Imports



Source: Pakistan Bureau of Statistics

Figure 6.35



⁵⁷ Among 21.8 million CBU sets imported in FY21, 14.4 million units worth US\$ 738.2 million were imported in H1, while only 7.4 million units worth US\$ 712.9 million were imported in H2. The unit values of these imports were US\$ 51.2 and US\$ 96.5 in H1 and H2-FY21 respectively.

⁵⁸ A disaggregation suggest that 7.8 million CKD/SKD mobile imports sets worth US\$ 199.9 million were imported in H1 while 10.8 million of these sets amounting US\$436.2 million were imported in H2-FY21.

started giving results. Under the MDMP 2020, regulatory duty on imports and advance income tax, up to US\$ 350, on manufacture of CKD/SKD units, were removed. At the same time, locally assembled or manufactured phones were exempt from the 4 percent withholding tax on domestic sales. Furthermore, 3 percent research and development allowance was offered to the local manufacturers for exporting mobile devices. More than 21 companies have started manufacturing/assembling mobile phones locally, which helped in increasing the quantum of CKD/SKD device imports. Meanwhile, a number of factors have led to a decline in electrical machinery and apparatus imports in FY21. The most important among these is the progress on the Matiari to Lahore ± 660 kV transmission line project, which had required large volume of imported electrical equipment in FY20. As the project is near completion and is expected to start commercial operations in September 2021, the imports of electrical equipment related to the project slowed down considerably in FY21. Additionally, the country imported a large number of electronic equipments, television sets, and transmission apparatus for radio telephones, and cordless telephones. Households and small businesses in the country are main users of these items. Both are facing hard times since the outbreak of Covid and therefore demand for these items remained muted in FY21.

Interestingly, imports of power generating machinery increased significantly by US\$ 539.5 million, after having risen by only US\$ 110.3 million in FY20. Tariff and non-tariff restrictions to curtail imports during FY19-20 had mostly exempted the machinery imports, however, the aggregate stabilization policy environment allowed only restrictive growth in this segment in FY20. A number of power projects, both CPEC- and non-CPEC-related nearing completion increased the import of power generating machinery in FY21. These projects include Hubco Thar coal power project (Thar Energy), Thal Nova Thar coal power project, 1,263 MW RLNG-based Trimmu power project, Suki Kinari hydropower station, and Karot hydropower project.⁵⁹

Textiles

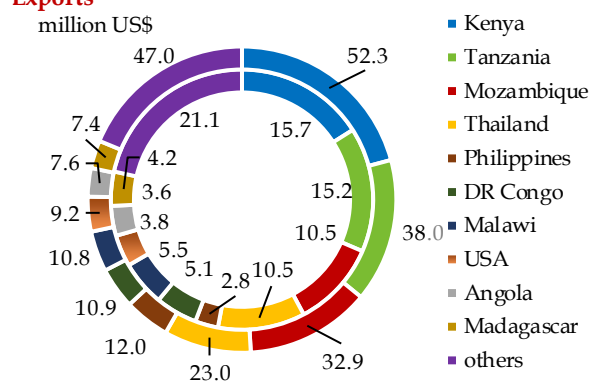
As discussed earlier, in FY21, cotton output remained low due to decline in its cultivation area. Pakistan imported raw cotton worth US\$ 1.5 billion in FY21; US\$ 600 million more from FY20. Besides raw cotton, the import of worn clothes rose to US\$ 309.6 million, rising by 83.4 percent YoY in FY21.

Traditionally, worn clothes were imported in Pakistan for domestic use mostly. However, (re)exporting industry of worn clothes has gained traction in last couple of years in the country, due to its labour intensive nature. As

Import and Exports of Worn Clothes



Figure 6.36 Destination of Worn Clothes' Exports



Source: Pakistan Bureau of Statistics

⁵⁹ For details, see Private Power and Infrastructure Board (www.ppib.gov.pk), and (www.cpec.gov.pk/energy).

a result, Pakistan exported worn clothes worth US\$ 98 million in FY20, 528 percent higher from FY19 (**Figure 6.36**). Covid outbreak in the fourth quarter of FY20 and lockdown imposed subsequently changed the dynamics of the sector further in favor of Pakistan in FY21. Pakistan gain edge over its competitors by better handling the pandemic, which allowed easing the lockdown and revival of the economic activity relatively early. This permitted the worn clothe industry to increase their imports for exporting after adding value, like sorting, mending, cleaning and packaging. Pakistan re-exported US\$251 million worn clothes in FY21, up 156.4 million YoY from FY20. Mostly African countries such as, Kenya, Tanzania and Mozambique and also some Asian countries like, Thailand and Philippine and some advance economies were the destinations of these exports (**Figure 6.37**).

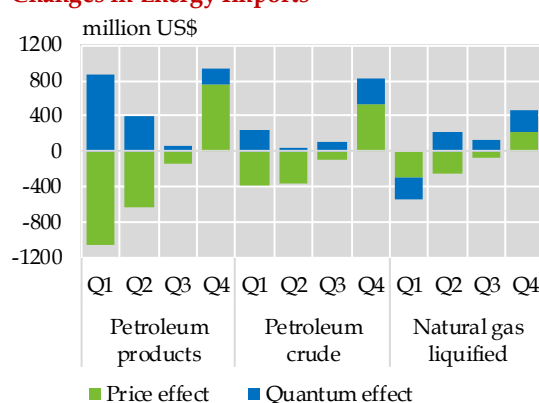
Energy imports

Energy imports (excluding coal) increased by 9.1 percent YoY in FY21, after remaining unchanged in FY19 and declining sharply by 27.9 percent in FY20. The global oil price shock in the second half of FY21, specifically in March 2021 onward, largely contributed to this increase.

In the first three quarters of FY21, lower prices depressed the petroleum and its products' imports despite quantum increase in most of

Quantum and Price Effect of Changes in Energy Imports

Figure 6.38

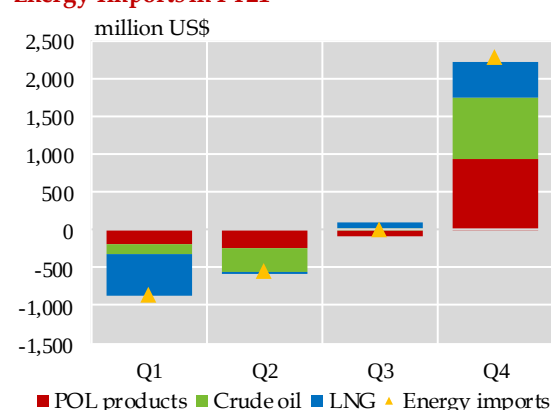


Source: Pakistan Bureau of Statistics

the products. However, in the final quarter, higher prices dominated the increase, offsetting some of the gains accrued due to the lower prices in the preceding quarters and thereby contributing to the growth in overall energy imports in FY21 (**Figure 6.38**).

Breakdown of YoY Change in Energy Imports in FY21

Figure 6.39



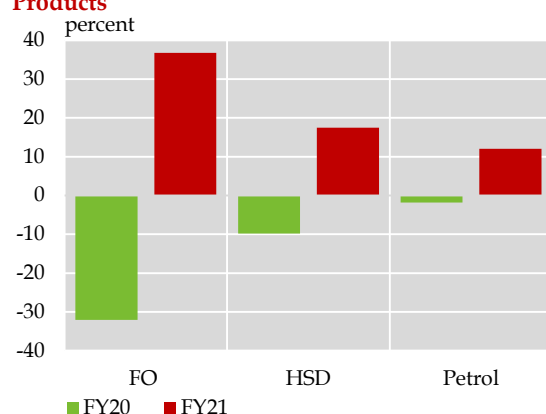
Source: Pakistan Bureau of Statistics

A closer look at the quarterly trend suggests that LNG imports actually declined in volume in Q1-FY21 (**Figure 6.39**), with quantum also decreasing from Q1-FY20 (**Figure 6.38**). Higher hydel generation in July and August and increasing use of furnace oil for power generation in September reduced the dependence on LNG imports in Q1-FY21.⁶⁰

On the other hand, crude imports in Q2-FY21 remained subdued, as its quantum imports increased by merely 4.9 percent (**Figure 6.39**). The government has directed refineries to upgrade their facilities in line with the Euro-V diesel and petrol standards, which led to disruption in crude imports in Q2.

On aggregate, the quantum of the energy imports increased by 26.6 percent YoY during FY21, as energy demand grew significantly with the reopening of the economy. Specifically, sales volume of petrol and diesel increased by 12.0 percent and 17.5 percent respectively in FY21, whereas the sales of these products had declined during FY20 largely due to the strict lockdown imposed in Q4-FY20 (**Figure 6.40**).

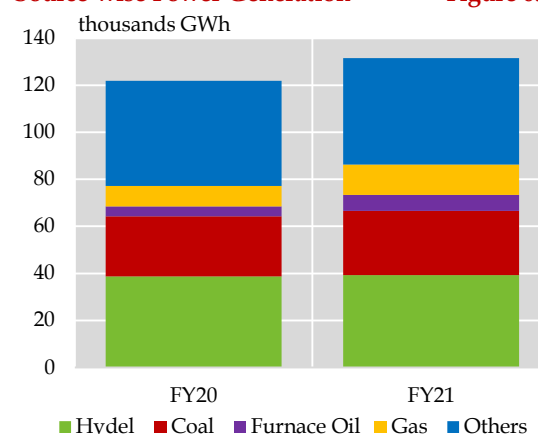
⁶⁰ In January 2019, the government banned the use of furnace oil for power generation. To cover the rising demand and slowdown in LNG supplies, government lifted the ban in July 2020.

Growth in Sale of Petroleum Products**Figure 6.40**

Source: Oil Companies Advisory Council

It is pertinent to note that amid the declining domestic gas output and moderate increase in LNG supply in FY21, the government allocated more gas to the power sector by restricting supplies to the transport sector. Besides, the gas prices were increased by Rs 17-18 per liter in July 2020 and an additional 5 percent GST was levied on LNG imports for CNG stations. These measures propelled CNG's sale price higher than that of motor spirit, and forced a number of CNG consumers to switch to petrol.

Moreover, the number of passenger vehicles on the roads has increased rapidly, growing by more than two million vehicles (including 2, 3 and 4 wheelers) in FY21. Most of these vehicles run on petrol, with exception of 3-wheeler rickshaws (which are designed to run on CNG). Non-availability of CNG also forced these 3-wheelers to run on petrol. Moreover, air and rail had restricted operation in H1-FY21. People travelling between cities opted for either personal transport or intercity buses, which also contributed to higher demand for petrol and HSD.

Source-wise Power Generation**Figure 6.41**

Source: National Electric Power Regulatory Authority

The sale of furnace oil (FO), on the other hand, also increased by 36.8 percent in FY21, as the government withdrew the ban on its use as fuel in power generation. Earlier in FY19, the government had imposed a ban on FO to mitigate growing air pollution in the country, which resulted in a decline in its sales in FY20. Despite the increasing use of FO in power generation in FY21, only 6.7 TeraWatt hour (1,000GWh) were produced on FO out of 131.5 TWh produced during the year, and higher from 4.2 TWh produced in FY20 (Figure 6.41).⁶¹

Recently, coal contributed more to the power generation in the country, with 27.3 TWh produced on this fuel in FY21, up from 25.6 TWh in FY20. Not surprisingly, coal imports increased to US\$ 1.6 billion in FY21 from US\$ 1.3 billion in FY20. However, coal import is reported as a non-energy product in the "All other items" category, as it is also used as an input in cement production; the picture of Pakistan's energy import remains incomplete without coal.⁶² Therefore, including coal, Pakistan's energy imports increased by 10.5 percent to US\$ 12.9 billion from US\$ 11.7 billion in FY20.

⁶¹ Power generation in FY21 has increased by 6.7 percent compared to 1.0 percent decline in FY20.

⁶² Besides, its quantum imports increased by 22.4 percent in FY21.

Chapter 7

Special Economic Zones in Pakistan: Isles of Excellence or Labs for Policy Reforms?

Special Economic Zones (SEZs) have emerged as an important investment policy tool to address the problems of low investments, exports, and industrialization. The SEZs address these issues by ensuring business-friendly environment within a designated boundary, with facilitative institutional, legal, and infrastructural architecture. Since developing economies find it difficult to reform business environment all across the country at once, they use SEZs both as an island of excellence, and as a laboratory for policy and regulatory reforms, before gradually rolling out these changes outside the zone. To promote industrialization and exports, Pakistan began setting up Industrial Estates (IEs) in the 1960s, and Export Processing Zones since the 1980s. However, these endeavors were unable to achieve the intended objectives due to the absence of business-friendly environment and weak infrastructure. In 2012, following the success of SEZs in other countries, Pakistan passed the SEZ Act, which paved way for the setting up of SEZs. However, the SEZs' potential in the country is constrained by the fact that they are not insulated from the overall business and investment climate of the country, vis-à-vis complex processes and procedures for approvals, registrations, and licenses; legal challenges; and sufficient availability of skilled labour. In addition, challenges to one-stop shops, a weak framework for long-term operational sustainability of the zones, technical hurdles in the financing of zone enterprises, and weak monitoring mechanisms, also pose challenges to the potential success of SEZs. Going forward, for the zones to prosper, it is imperative to ensure swifter provision of utilities and infrastructure. Also, a well-designed institutional, legal and infrastructural architecture is required to provide a favourable business environment.

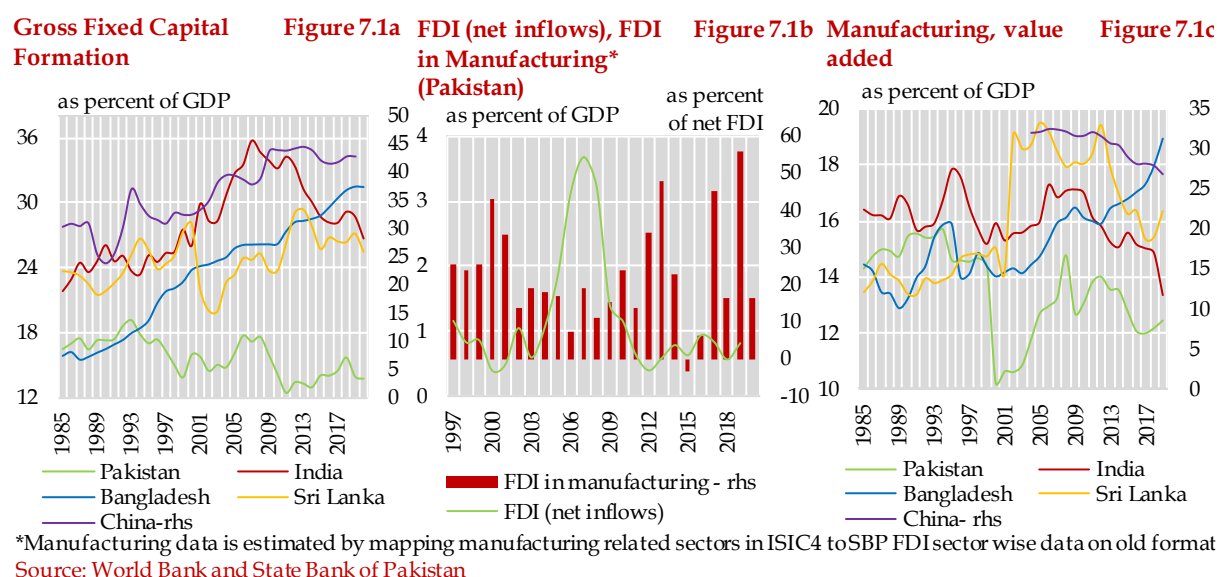
7 Special Economic Zones in Pakistan: Isles of Excellence or Labs for Policy Reforms?¹

7.1 Introduction

Investment, especially in manufacturing and industrial sector, is one of the key drivers of economic growth and development. However, in Pakistan, investments have been falling over the past few decades and remain low relative to other emerging and developing economies (**Figure 7.1a, b, and c**). A host of macroeconomic reasons are responsible for low investment in the country, including persistently low savings rate amid high informality and low level of financial

intermediation, high inflation, and low tax revenues.²

In addition to macroeconomic constraints, there are several other factors limiting investment growth, as evident from Pakistan's rank in multiple indicators covering infrastructural, legal, institutional and operational parameters (**Figure 7.2**).³ These include weak contract enforcement and dispute resolution mechanisms; lengthy documentation procedures; unfavorable tax administration; and regulatory uncertainty.



¹ This chapter has benefited from conversations with stakeholders from the Board of Investment (BOI); Export Processing Zone Authority; Sindh Economic Zones Management Company; Balochistan Industries and Commerce Department; Punjab Industrial Estate Development & Management Company; Faisalabad Industrial Estate Development & Management Company; Punjab Board of Investment and Trade; Khyber Pakhtunkhwa Board of Investment and Trade; Khyber Pakhtunkhwa Economic Zone Development & Management Company; Punjab Planning and Development Department; International Finance Corporation; Pakistan Business Council; Overseas Investors Chamber of Commerce and Industry; Pakistan China Joint Chamber of Commerce and Industry; former chairman BOI Mr Haroon Sharif, and former CEO National Industrial Parks Mr Syed Mohsin.

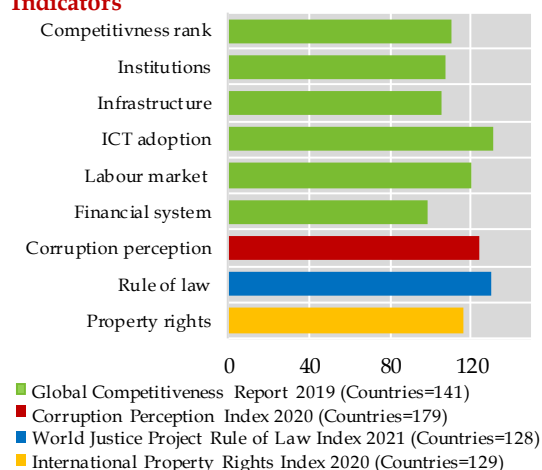
² A. Ali (2016). *Saving and Investment in Pakistan*. SBP Staff Notes 01/16. Karachi: SBP;

J. Lopez-Calix and I. Touqeer (2013). *Revisiting the Constraints to Pakistan's Growth*. World Bank Policy Paper Series on Pakistan, no. PK 20/12. Washington DC: World Bank; A.H. Khan and K. Yun-Hwan (1999). *Foreign Direct Investment in Pakistan: Policy Issues and Operational Implications*. Manila: ADB; N. Akram (2011). "Impact of Public Debt on the Economic Growth of Pakistan," *The Pakistan Development Review*, 50(4): 599-615.

³ E. Sanchez-Triana, D. Biller, I. Nabi, L. Ortolano, G. Dezfali, J. Afzal, and S. Enriquez (2014). *Revitalizing Industrial Growth in Pakistan: Trade, Infrastructure, and Environmental Performance*. Directions in Development Series-Private Sector Development. Washington, DC: WB; J. Weiss and S. Lall (2003). *Industrial Competitions: The Challenge for Pakistan*. Manila: ADB; N. Nazeer and R. Rasiah (2016). "Explaining Pakistan's Premature Deindustrialization," *Lahore Journal of Economics*, 21: 351-368.

Pakistan's Rank in Select Indicators

Figure 7.2



Source: World Bank, WEF, Transparency International, World Justice Project, Property Rights Alliance

High cost and poor accessibility of utilities, constraints to availability of skilled labour, and several other operational factors are also impediments to a business-friendly environment.⁴

An increasingly accepted solution to these infrastructural, legal, institutional and operational problems faced by several EMDEs is the creation of Special Economic Zones (SEZ), which address several of these problems by insulating investors from structural flaws in the host economy. This is achieved by creating an ideal business environment in a designated area. This makes it easier for developing economies to implement the required infrastructure and policy reforms, which would otherwise be challenging to implement all across the country at once. The setting up of SEZs also helps governments to test policy reform experiments before rolling them out in the rest of the country.⁵

As Pakistan enters the second phase of the China Pakistan Economic Corridor (CPEC), focusing on business-to-business cooperation, the SEZs can play a pivotal role in attracting investment, and promoting industrialization, increased market accessibility and regional connectivity.^{6,7} However, as literature on global best practices suggests, the success of SEZs depends partly on establishing a robust regulatory and institutional framework, with a focus on exploiting the country's competitive advantage.

In light of the literature on international best practices, this chapter evaluates the SEZ environment in Pakistan by surveying the SEZ framework, institutional setup, and various fiscal and non-fiscal incentives offered to investors. It explores Pakistan's experience with the Industrial Estates (IEs) and Export Processing Zones (EPZs), highlighting that on the whole, these initiatives did not achieve their potential because the promised utilities and infrastructure were not delivered, and real estate activities caused land prices to rise within these zones, crowding out industrial investments.

The chapter also discusses the challenges to the potential of SEZs in the country, where the absence of an effective One-Stop Shop (OSS) for ensuring a business-friendly climate in the zones, financing constraints for zone enterprises, and inadequate monitoring and evaluation mechanisms are found to be major stumbling blocks. In addition, the fact that the current regulatory regime does not insulate the SEZs from the overall legal environment of the country, and concerns over the availability of skilled labour, have also been identified as constraints to the potential success of SEZs.

⁴ For a detailed discussion on constraints for investment in Pakistan, see, SBP Annual Report on State of Pakistan's Economy for FY19. "Chapter 7: Factors Constraining Investments in Pakistan: Beyond the Macroeconomics".

⁵ World Investment Report (2019). *Special Economic Zones*. Geneva: UNCTAD; M. Alexianu, M. Saab, M. Teachout and A.K. Khandelwal (2019). *Doing Special Economic Zones Right: A Policy Framework*. London: IGC.

⁶ The first phase of CPEC focused on removing the infrastructural and energy constraints. The second phase aims to increase industrialization and modernization in agriculture Sources: CPEC Secretariat at Ministry of Planning, Development and Special Initiatives (www.cpec.gov.pk/news/167), and Ministry of Planning Development and Special Initiatives press release, dated September 19, 2019 (www.pc.gov.pk/web/press/get_press/348).

⁷ K. Khan and S. Anwar (2016). "Special Economic Zones (SEZs) and CPEC: Background, Challenges and Strategies." *The Pakistan Development Review*, 203-216.

In view of these challenges, the setting up of an effective OSS is recommended, with a single facilitator, and demarcated roles and responsibilities to avoid overlapping of mandates, along with a recommendation for swifter dispensation of cases for SEZs with special commercial courts at its center. Further, to fill the skill gap, incentives to train local labour may be offered; and to facilitate financing for investors, creative solutions, like tripartite agreements, may be explored.

Accordingly, the chapter is organized as follows: the ensuing section describes the taxonomy, evolution, and factors responsible for the success of SEZs around the world. Section 7.3 then sheds light on Pakistan's experience with industrial clusters and EPZs, as well as the current structure of SEZs in the country. Section 7.4 highlights some of the key challenges to SEZ growth in Pakistan, followed by policy options as a way forward for the SEZs (Section 7.5). Final remarks in Section 7.6 conclude the chapter.

7.2 Taxonomy, Evolution, & Factors of Success

As an umbrella term, SEZ encompass several types of industrial and non-industrial business clusters, which countries have been experimenting with over many decades while eyeing distinct objectives (**Figure 7.3**). Some countries offer duty-free areas with warehousing, storage, and distribution facilities to traders; these are termed as Free Trade Zones (FTZs). Others have established Export Processing Zones, which allow enterprises to operate in free-trade conditions, and offer incentives like duty-free imports of plant, machinery, and raw materials for manufacturing export items.

Similarly, some countries set up Industrial Parks/Industrial Zones and Industrial Estates as sites that provide a broad set of facilities, like roads, transportation, public utilities and some common amenities that can be shared by a group of manufacturers and investors, albeit without fiscal or other incentives (**Figure 7.4**).⁸ Increasingly, the term also includes technology development zones for high-tech

Special Economic Zones: Some Basic Features

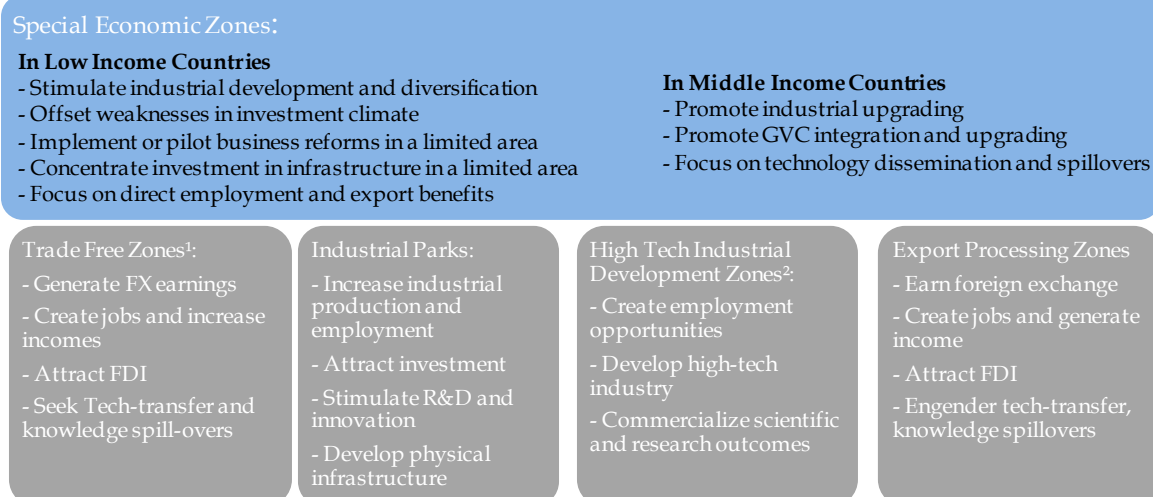
Figure 7.3



⁸ Source: UNIDO (1997). *Guidelines for the Establishment of Industrial Estates in Developing Countries*. Vienna: UNIDO.

The Objectives Governments Seek to Achieve by Establishing Different Types of Economic Zones in Low & Middle Income Countries

Figure 7.4



Source: ¹UNESCAP (2005). *Free Trade Zone and Port Hinterland Development*. Bangkok: UNESCAP

²S. Liang (2011). *Physical Planning Strategies of National High-Technology Industrial Development Zones in China*. Publicly Accessible Penn Dissertations 989. Pennsylvania: University of Pennsylvania.

UNCTAD (2019). *World Investment Report 2019*. Geneva: UNCTAD

industries, with a focus on industrial upgradation and creation of new industries, as well as health, tourism and education clusters.⁹

According to a 2019 survey, there were no less than 82 different terms to designate zones that were being used by countries to describe often similar types of zones in their legislation and publicity materials.¹⁰ However, most of these were clubbed under the generic label of SEZs. In Pakistan too, there have been instances in the past (before the passage of the SEZ Act 2012) when industrial estates, such as Gadoon Amazai, were loosely termed as SEZs by researchers and investment promotional agencies alike.¹¹

The term SEZ has only been recently defined, even though as an umbrella term the concept has existed for decades. The first notable

definition was used in a World Bank paper in 2015, where an SEZ was defined as an area with geographically delimited boundaries, administered by a single management/authority, offering fiscal incentives, such as reduced taxes and duties, and non-fiscal benefits like access to land, labour, utilities, infrastructure and administrative support.¹²

In 2019, the UNCTAD defined SEZs as “geographically delimited areas within which governments facilitate industrial activity through fiscal and regulatory incentives and infrastructure support”.¹³ It was only after this definition that it became less common in academic work and publications to conflate SEZs with Free Trade Zones and Export Processing Zones.¹⁴

⁹ World Investment Report, (2019). *Special Economic Zones*. Geneva: UNCTAD.

¹⁰ F. Bost (2019). “Special Economic Zones: Methodological Issues and Definition”, *Transnational Corporations Journal*, Vol. 26, No. 2.

¹¹ One such example is A.A. Burki, K.A. Munir, M.A. Khan, M.U. Khan, A. Faheem, A. Khalid, and S. T. Husaain (2011). *Industrial Policy, Its Spatial Aspects and Cluster Development in Pakistan*. Consultant Report for WB. Lahore: LUMS.

¹² Z. Douglas (2015). *Global Experiences with Special Economic Zones Focus on China and Africa*. Policy Research Working Paper 7240, Washington DC: WB.

¹³ World Investment Report (2019). *Special Economic Zones*. Geneva: UNCTAD

¹⁴ F. Bost (2019). “Special Economic Zones: Methodological Issues and Definition”, *Transnational Corporations Journal*, Vol. 26, No. 2.

In other words, an SEZ, especially in developing economies, is envisaged to be an island of excellence in a sea of weak governance and insufficient infrastructure. Industrial Estates, on the other hand, may be geographically delimited and may even offer basic infrastructure, but they do not offer special regulatory regimes for fiscal, land, labour and utilities. Likewise, EPZs are also geographically demarcated areas, often with exemptions from custom duties and local labour laws, but with strict conditions preventing zone enterprises from domestic sales.

Evolution of SEZs

Free economic zones have existed for over a millennium. The most ancient economic zones existed in the form of free ports that used to facilitate free trading activities.¹⁵ In the modern era, initially, countries built FTZs to facilitate trade; however, the goal of industrialization and exports led to the formation of manufacturing enterprises within FTZs. This, in turn, led to the novel idea of Export Processing Zones. Over time, countries started experimenting with various forms of zones, the most promising of which were tailored in China.

Chinese SEZs; promising example of transition:

China established four zones in two provinces - Guangdong and Fujian - in 1980. After four years, the country declared 14 coastal cities as 'Economic and Technical Development Zones (ETDZs)' with incentives similar to those for modern-day SEZs. The provinces with these zones attracted around 70 percent of total FDI in China during 1979-1991.¹⁶

The country also progressively transitioned to High-tech Industrial Development Zones (HIDZs), which promoted technology and

innovation. According to UNCTAD (2019), China alone has an estimated 47 percent share in total SEZs around the world. However, the Chinese model is unique, given its decentralized management structure, where a committee formed by the local government has enough powers to approve FDI projects (within certain limits) as well as regulate land and approve infrastructure improvements.¹⁷

SEZ growth, especially in developing countries:

Following the success of China, SEZs became a popular tool for investment policy. From 176 SEZs in 47 countries in 1986, the total number of SEZs increased to 3,500 across 130 countries in 2006. By 2018, this number had reached 5,400 SEZs in 147 countries, with another 500 new projects expected to be in the pipeline. Around 89 percent of all the economic zones are located in developing countries. For developing countries, SEZs offer an opportunity to experiment and introduce reforms, and provide supporting infrastructure on piecemeal basis, since it is often difficult for them to roll these out all at once across the country. In these countries, the governments initially adopted free trade and multi-activity zones, with the primary focus on labour-intensive and export-oriented industries. Eventually, however, they moved towards specialized, innovation-oriented and service sector-focused SEZs (Figure 7.5).¹⁸

Measuring Success

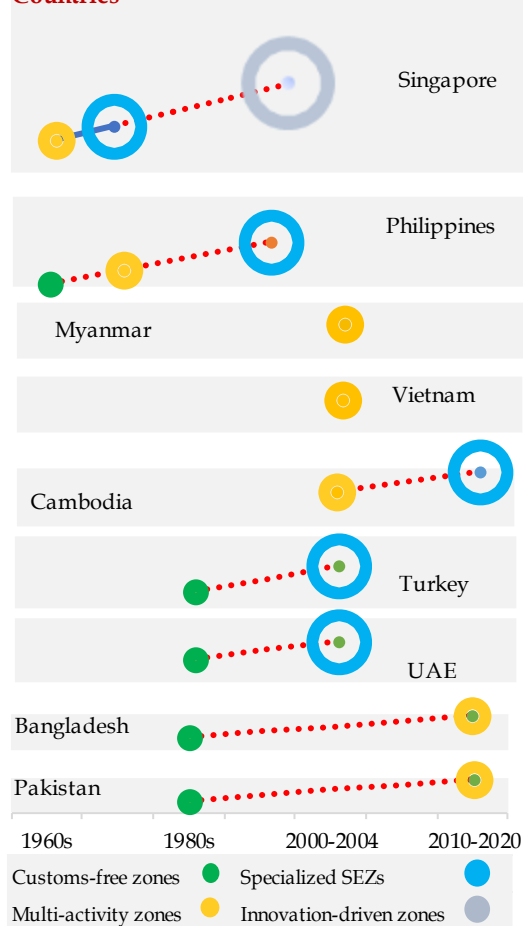
A universal criterion to judge the performance of SEZs is a challenging task. This is because of three main reasons. First, the primary goal of a zone can vary, and a verdict on its success or failure will mainly depend on achieving that goal. For some countries, the goal may be to attract FDI; for others it may be to

¹⁵ H. Grubel (1982). "Towards a Theory of Free Economic Zones." *Weltwirtschaftliches Archiv*, 118(1): 39-61.

¹⁶ Z. Zeng (2015). *Global experiences with special economic zones: focus on China and Africa*. Policy Research Working Paper Series 7240, Washington DC: WB; E. Graham (2004). "Do Export Processing Zones Attract FDI and its Benefits?" *International Economics and Economic Policy*, 1: 87-103.

¹⁷ UNESCAP (2017). *Handbook on Policies, Promotion and Facilitation of Foreign Direct Investment for Sustainable Development in Asia and the Pacific*. Bangkok: UNESCAP.

¹⁸ World Investment Report (2019). *Special Economic Zones*. Geneva: UNCTAD.

Evolution of SEZs in Different Countries **Figure 7.5**

Source: UNCTAD (2019)

experiment with different policy reforms.¹⁹ The desired outcomes from SEZs are also evolving (**Table 7.1**).

Second, there are multiple types of SEZs with different focus areas, which makes it challenging for a single metric to judge their performance. For example, the same parameters cannot assess the performance of a high-tech zone and a free trade zone. Lastly, differences in management styles and compilation of statistics also make it difficult to measure the impact of SEZs in standardized

cross-country comparisons;²⁰ empirical studies on various facets of SEZs, such as their spillover onto the local economy, is scarce.²¹

Despite different characteristics and objectives, there are some broad parameters to help assess the effectiveness of SEZs. These parameters include linkages with domestic economy, technology transfer, and environmental impact. The common measures of success are the SEZs' contribution to exports, employment and FDI.

Evolution of Special Economic Zones **Table 7.1**

	Goals
Zone 1.0	FDI, exports, foreign exchange
Zone 2.0	Zone 1.0 + domestic linkage, bigger size, less reliant on fiscal incentives
Zone 3.0	Zone 2.0 + environmental and social development

Source: Zeng (2016)²²

As documented in the World Investment Report 2019, current zone programs in China show that SEZs account for over 80 percent of cumulative FDI. In Vietnam that number is estimated to range between 60 and 70 percent, whereas in Malaysia, almost 90 per cent of total investment in SEZs is from foreign investors. In terms of exports, SEZs are estimated to contribute 31 percent to Mexico's total exports, 60 percent of the Philippines', 25 percent of Egypt's, and about 10 percent of India's. However, the economic impact and contribution of these zones, especially to FDI inflows, is hard to measure because of data scarcity. Countries and multilateral organizations do not track and consistently report key macroeconomic statistics separately for SEZs, whereas the fact that the consensus

¹⁹ T. Farole (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. Directions in Development Series - Trade. Washington, DC: WB.

²⁰ UNESCAP (2017). *Handbook on Policies, Promotion and Facilitation of Foreign Direct Investment for Sustainable Development in Asia and the Pacific*. Bangkok: UNESCAP.

²¹ S. Frick and A. Rodrigues-Pose (2021). "Special Economic Zones and Sourcing Linkages with the Local Economy: Reality or Pipedream?", *European Journal of Development Research*. Journal no. 41287.

²² D. Zeng (2016). *Special Economic Zones: Lessons from the Global Experience*. Private Enterprise Development in Low Income Countries, Synthesis Paper Series.

on the definition of SEZs is very recent adds to the problem of measurement.²³

Factors of Success

To create a successful special economic zone, a comprehensive strategy, based on multiple factors is required. Some of these observations, drawn from literature and experiences of other countries, are discussed below.

Stated objectives and goals:

A starting point for a successful SEZ is an explicitly stated clear set of objectives, which depends on the characteristics, comparative advantage, and location of that SEZ. The SEZs in China, which are amongst the world's most successful, have clear benchmarks and goals.²⁴ The identification of goals is crucial because they drive the overarching SEZ policy framework. For example, if the primary goal of an SEZ is to increase employment, then it would operate with a set of policies geared to attract labour-intensive industries. However, if the goal is to increase exports or transfer of technology, then the policy framework would reflect those objectives. Moreover, SEZs are more likely to be successful if the goals are aligned with the broader national industrial policy, followed by a practical actionable plan.²⁵

Establishing a robust regulatory framework:

For SEZs to be successful, it is imperative to have separate laws and institutional setups governing SEZs within the national legal framework. For instance, China regulates SEZs with a decentralized structure comprising three layers: national laws

providing policy directives; provincial laws factoring varying conditions within provinces; and individual SEZ laws to account for the uniqueness of every SEZ.²⁶ Laws are also used as a tool to attract foreign investors by safeguarding their interests and streamlining ambiguities in zone operations. For instance, the law for SEZs in Turkmenistan guarantees protection to foreign investors from adverse effects caused by future changes in the regulations.²⁷ A law of this kind creates certainty for investors and allows them to plan for long-term investment.

South Korea's Special Act on Designation and Management of Free Economic Zones, 2017, is a good example of a regulation that clarifies the roles of relevant parties in an SEZ. It explicitly delineates the responsibilities for different governmental departments and management of the zone.²⁸ The law also contains legislation on the ways to improve the living standards for foreign investors; for example, Article 20 and 22 provide for foreign language services and education system for foreigners.

Another example of a law increasing SEZs' efficiency is the Bangladesh Economic Zones Act, 2010. Article 13(d) of the law empowers the government to exempt a zone from the Electricity Act, 1910, which helped reduce the average time for a firm to obtain electricity connection within the SEZ to 31 days, from 100 days for firms outside the zone.²⁹ Article 13(h) allows exemptions from the Building Construction Act 1952, and the number of days to get a construction permit is two days, whereas it is 68 days for a firm outside the SEZ.

²³ World Investment Report (2019), Special Economic Zones. Geneva: UNCTAD.

²⁴ D.Z. Zeng (2015). *Global Experiences with Special Economic Zones: Focus on China and Africa*. Policy Research Working Paper No. 7240. Washington, DC: WB.

²⁵ A. Aggarwal (2019). "SEZs and Economic Transformation: Towards a Developmental Approach", *Transnational Corporations*, 26(2), 27-47.

²⁶ H.R. Zheng (1987). "Law and Policy of China's Special Economic Zones and Coastal Cities", *NYLS Journal of International and Comparative Law*. Vol. 8: No. 2.

²⁷ World Investment Report. (2019). *Special Economic Zones*. Geneva: UNCTAD

²⁸ Source: Korean Legislation Research Institute:

(www.elaw.klri.re.kr/eng_service/lawView.do?hseq=46782&lang=ENG)

²⁹ A.K. Khandelwal and M. Teachout (2016). *Special Economic Zones for Myanmar*. IGC Policy Note. London: IGC

Business friendly environment:

Another key factor of success is an enabling business environment with One-Stop Shop (OSS) or single-window operation. Here, the key driver of success is not merely the assembly of representatives of all regulatory institutions under one roof to fast-track registration, licensing, and other regulatory requirements, but more importantly, it is the explicitly notified preferential timelines and simplified procedures for SEZs that contribute to an SEZ's success.³⁰

Infrastructure:

The infrastructure – encompassing roads, railways, water, electricity, health, education, and training facilities for zone residents – is a critical success factor. Khadaroo and Seetanah (2008), found positive correlation between transport infrastructure and FDI inflows, modeling their analysis on Mauritius and applying it to 20 other African countries.³¹ All the successful zones in Dubai, Singapore, China and Malaysia have quality infrastructure, whereas zones in South Korea also provide recreation facilities for foreign investors, along with state-of-the-art educational and medical services.³²

Fiscal incentives:

Fiscal incentives like tax holidays, exemptions on dividends and income tax, and duty-free imports, positively correlate with the zone's performance and help it attract initial investment.³³ However, it is important to note

that fiscal incentives are usually effective for a limited period. In the long run, it is the locational advantage and provision of infrastructure and other services to the SEZ that makes it successful and keeps industries from moving out of the SEZ once fiscal incentives come to an end.³⁴

Mechanism for dispute resolutions:

This is an important feature behind the success of several SEZ, because it helps avoid escalation of disagreements and lengthy litigation.³⁵ Special courts or arbitration tribunals set up especially for swifter resolution of disputes related to zone enterprises can be attractive for foreign investors. The resolution of cases in a short amount of time becomes crucial for countries where the judicial system is overburdened. Dubai's Dispute Resolution Authority, the Dubai International Financial Centre (DIFC), is one such example of a special mechanism formed for resolving cases within SEZs.³⁶

Location, competitive advantage, and zone size:

Strategic location is also very crucial for zone success. Frick et al. (2018), who use data for 255 zones from 22 countries, show a negative correlation between SEZ growth and distance from major ports, cities, and markets.³⁷ Moreover, while calculating the zone growth for the first five years of zones operations, it also shows that larger zones have more potential to succeed. Also, the location

³⁰ T. Farole, C. Baissac and J. Gauthier (2013). *Special Economic Zones: A Guidance Framework for Policymaking*. Draft. Washington DC: World Bank

³¹ A. J. Khadaroo and B. Seetanah (2010). "Transport Infrastructure and Foreign Direct Investment". *Journal of International Development*, 22, 103-123.

³² Source: Korean Free Economic Zone (www.fez.go.kr/global/en/why/environment.do).

³³ A. Aggarwal (2005). *Performance of export processing zones: a comparative analysis of India, Sri Lanka and Bangladesh*. Working Paper No. 155. New Delhi: Indian Council for Research on International Economic Relations.

³⁴ T. Farole (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. Directions in Development Series- Trade. Washington, DC: World Bank.

³⁵ T. Cheng (2019). "From Special Economic Zones to Greater Special Economic Region-Hong Kong Special Administrative Region as a Model for Legal Infrastructure Design", *Transnational Corporations Journal*, Vol. 26 (3).

³⁶ D.Z. Sharar, and M.A. Khulaifi (2016). "The Courts in Qatar Financial Centre and Dubai International Financial Centre: A Comparative Analysis", *Hong Kong Law Journal*, Volume 46, Part 2.

³⁷ S. A. Frick, R. Andrés and W. Michael (2018). *Towards economically dynamic Special Economic Zones in emerging countries*. Papers in Evolutionary Economic Geography (PEEG) 1816, Utrecht: Utrecht University.

decision should be taken in consideration of the availability of skilled labour and raw materials.³⁸

7.3 Economic Zones: Review of Pakistan's Experience

The concept of delimited industrial estates in Pakistan goes back to its earliest economic policies. In the first five-year national development plan (1955-60), the government had adopted the idea of enabling industrialization through designated locations featuring reasonably priced land, which was furnished with roads, water, power, sewerage, telephone lines and rail sidings.³⁹ This was in accordance with other developing economies, such as Thailand, the Philippines and Singapore, which set up Industrial Estates in the same era as a steppingstone for industrialization, and subsequently rapid economic growth.⁴⁰

Setting up Industrial Estates at Provincial Level:

By the start of the 1970s, all the provinces began to set up Industrial Estates (IEs), mostly under the umbrella of their respective small-scale industries corporations. Based on locally available factors of production, these IEs were initially established to promote the formation of clusters in small and cottage industries by facilitating them with required infrastructure and utilities. Some of these IEs also offered fiscal incentives in the form of income tax holidays and exemption from customs duties on machinery imports; these incentives varied

across IEs, subject to the level of development in the region.⁴¹

Some of the earlier estates became hubs for different industries. For example, the manufacturing of surgical instruments, leather garments, and sports items successfully nurtured in Sialkot; whereas household appliances, machinery, foundry, and agriculture tools industries found their footings within Gujranwala IEs (IE-I, IE-II and IE-III).⁴² Meanwhile, few IEs befitted the large-scale manufacturing sector; for instance, Hub Industrial Trading Estate (HITE) attracted large automobile assembling units, auto vendors, as well as cement, textile spinning, food processing and light engineering clusters.⁴³

Notwithstanding these success stories, several IEs were unable to attain maximum colonization, despite fiscal incentives. This is because some of the IEs could not deliver on the promise of utilities⁴⁴ and other required infrastructure; whereas others faced location disadvantages since the time they were set up.⁴⁵ Even when provincial governments established new IEs, private enterprises resisted moving in because of poor planning, inadequate industrial zoning, deficient infrastructure and exorbitant land prices.⁴⁶

Another reason why several IEs did not succeed in subsequent years was real estate activities, which increased land prices and created disincentives for investments in industrial establishments in those IEs. Allottees of industrial lands in IEs kept holding on to the plots in anticipation of an

³⁸ A. Aggarwal (2005). *Performance of export processing zones: a comparative analysis of India, Sri Lanka and Bangladesh*. Working Paper No. 155 New Delhi: Indian Council for Research on International Economic Relations.

³⁹ First, Five Year Plan 1955-60, Planning Commission of Pakistan.

⁴⁰ ERIA Study Team (2016). 'The Development of Industrial Estates', in Nishimura, H., F. Kimura, M. Ambashi, and S. Keola (eds.), *Lao PDR at the Crossroads: Industrial Development Strategies 2016-2030*. ERIA Research Project Report 2015-2, Jakarta: ERIA, pp.61-98.

⁴¹ H. Pasha and Z. Ismail (1988). "Determinants of Success of Industrial Estates in Pakistan", *Pakistan Economic and Social Review*, 26(1), 1-19.

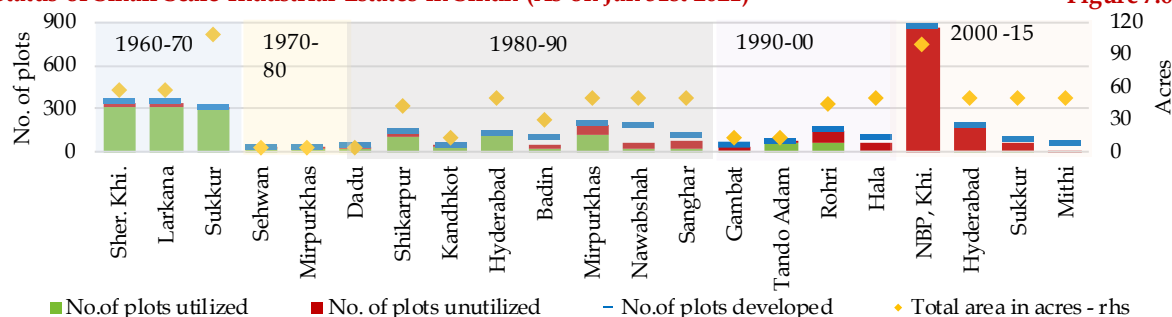
⁴² Punjab Small Scale Industries Corporation

⁴³ SMEDA, 'District Economic Profile Lasbela'

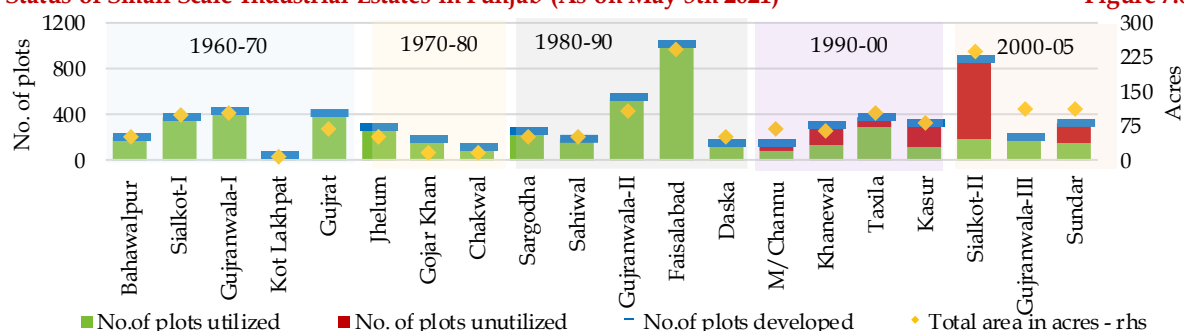
⁴⁴ According to the data compiled by Punjab Small Scale Industries Corporation, as of May 2021, 35 percent of IEs (7 out of 20) have been facing issues in supplying gas to industrial units

⁴⁵ H. Pasha and Z. Ismail (1988). "Determinants of Success of Industrial Estates in Pakistan", *Pakistan Economic and Social Review*, 26(1), 1-19.

⁴⁶ *Ibid* footnote 11

Status of Small Scale Industrial Estates in Sindh (As on Jan 31st 2021)**Figure 7.6a**

Source: Sindh Small Scale Industries Corporation

Status of Small Scale Industrial Estates in Punjab (As on May 5th 2021)**Figure 7.6b**

Source: Punjab Small Scale Industries Corporation

increase in land prices, instead of setting up industrial units. As a result, industrial plots were left unutilized. This trend was more prominent in the IEs established after the 1990s, including the estates located in Karachi, Hyderabad, Sialkot, Sukkur and Kasur (Figure 7.6a and 7.6b). Other IEs, such as the Gadoon Economic Zone, faced mass closure of industrial units, once tax holiday period came

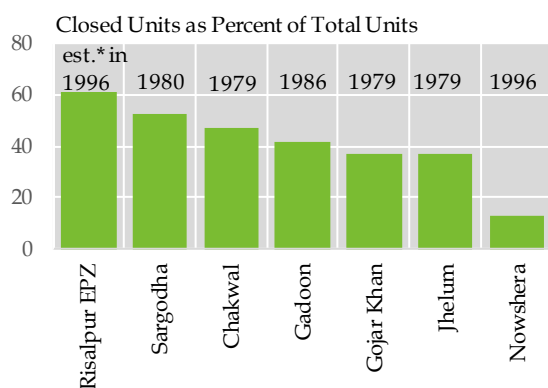
to an end, sales tax exemptions were withdrawn and utility subsidies were removed (Figure 7.7).

The Era of EPZs:

By 1980, the government started to consider export processing zones (EPZ) as a policy tool to focus on export-led growth. Accordingly, the autonomous EPZ Authority (EPZA) was constituted via an ordinance in February 1980, with the mandate to plan, establish and run the EPZs.

The EPZs offer many incentives to businesses, including: duty-free import of machinery, equipment and materials; freedom from national import and foreign-exchange regulations; ease of repatriation of capital and profits; and exemption from sales tax on inputs, including electricity and gas.⁴⁷

By FY20, the authority had developed seven EPZs across Pakistan. Of these, the Karachi EPZ is owned, developed and operated by the EPZA, whereas those in Gujranwala, Sialkot and Risalpur are owned, developed and operated by the respective provincial

Status of Closed Industrial Units in Different Industrial Estates**Figure 7.7**

* established

Source: Punjab Small Industrial Estates, KPK Industrial Directory 2020 by KPK Economic Zones Development and Management Company

⁴⁷ Export Processing Zones Authority (www.epza.gov.pk/incentives/).

The Status of Export Processing Zones**Table 7.2**

	Year of operation	Area Acre	Sectors/Products	Operating units	No. of workers as on Jun 2021	Exports Cumulative flows* (in million US\$)	Imports
Karachi EPZ	1981	305	Multiple	266	30,000	7,088	4,442.6
Risalpur EPZ	2002	92	Multiple	28	1,000	24.3	24.3
Gujranwala EPZ	2004	113	Multiple	13	100	5.8	4.6
Sialkot EPZ	2005	238	Multiple	37	1,000	72.7	53.3
Tuwairqi Steel Mill	2006	220	Steel billets/DRI	1		29.3	182.8
Saindak EPZ	2007	1284	Blister copper	1	1,500	2,445.8	994
Duddar EPZ	2009	1500	Zinc and lead	1	500	296.8	189.5
Total		3752		310	34,100	9,962.6	5,891.1

* Since respective year of operation.

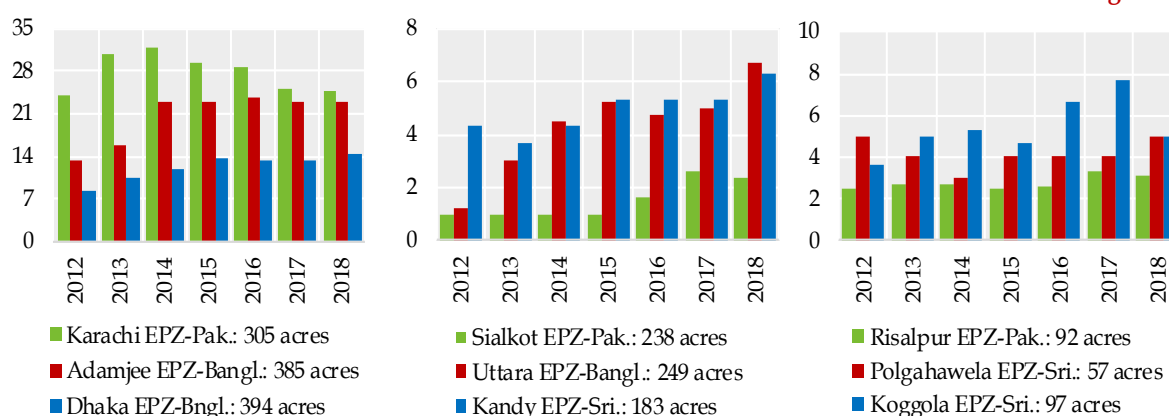
Source: Export Processing Zone Authority, as on June 30th 2021

authorities. The latter are under joint venture (JV) agreements,⁴⁸ where the EPZA's role is limited to few activities, such as issuing NOCs for import/exports, and income tax collection. In addition to these multi-party EPZs, three single-enterprise EPZs have also been established: Saindak EPZ, Duddar EPZ, and Tuwairqi Steel Mill.

The performance of EPZs in Pakistan has not been significant in comparison to those in the region. EPZs in Bangladesh, for instance, set up under Bangladesh Export Processing Act of 1980, have been able to attract a total investment of US\$ 5.2 billion since the first EPZ commenced operations in 1983. Between 2009 and 2019, US\$ 60.1 billion worth of exports were contributed by Bangladesh's EPZs, which equals 18.5 percent of total merchandise exports from the country during

this period. These EPZs produce goods for multiple international brands, including Nike, Reebok, Mother Care, Nikon, Sony, and Mitsubishi. As of 2019, these zones provided direct employment to almost half a million workers.⁴⁹

In contrast, exports by EPZs in Pakistan since their inception to-date totaled around \$10 billion, or 1.9 percent of the country's overall merchandise exports during this period (Table 7.2). About 70 percent of these exports came from a single EPZ – Karachi EPZ, where 49 percent of exports in FY21 (FY20: 44 percent) came from reprocessing worn (used) clothing. Exports by other EPZs, such as Risalpur, Gujranwala and Sialkot, have been much less. Insufficient activity in Pakistan's EPZs is also reflected from the Night Time Activity dataset

The Comparison of Night Time Activity Around Global EPZs**Figure 7.8**

Source: Devseed project by World Bank, for complete reference see foot note 50

⁴⁸ Gujranwala and Sialkot EPZ were developed under joint venture (JV) with Punjab Small Industries Corporation whereas Risalpur was developed under JV with Sarhad Development Authority.

⁴⁹ Bangladesh Export Processing Zones Authority, Annual Report (2018-19).

in comparison to similar EPZs in other developing countries (**Figure 7.8**).⁵⁰

Anecdotal evidence suggests that poor availability of infrastructure, utilities and absence of an OSS prevented EPZs set up under JVs in the country from taking off. Real estate activities were another reason why other multiparty EPZs were not successful. Unlike the Karachi EPZ where industrial land has been given on annual ground rent, the land in other multiparty EPZs were sold to prospective investors without putting in place effective safeguards to discourage real estate activities.

The Emergence of SEZs:

In the wake of the underlying issues that hindered the success of IEs and EPZs, Pakistan adopted the SEZ model of industrialization in 2012 with the passage of the Special Economic Zone Act 2012. The Act allows federal and provincial governments to set up SEZs either in the public or private sector, or in public-private partnership (PPP) mode. The first SEZs under the Act were notified around 2015-16, coinciding with a major amendment in the law. However, it was not until 2019 that regulatory activities and notification of SEZs picked up (**Figure 7.9**).

The SEZ Act 2012 originally treated the SEZs as extra-territorial zones outside the customs area of Pakistan,⁵¹ which meant that purchase of goods produced inside the SEZ by domestic buyers outside the SEZ would be subject to import duties and taxes. This limited the zones' attractiveness to local and foreign investors, who wanted to cater to the growing

domestic demand. Accordingly, the Act was amended in 2015, whereby the SEZs were brought into the country's customs territory. In addition to this amendment, a host of rules and regulations have been passed over the years to streamline the regulatory framework for the SEZs.

Currently, 22 SEZs have been approved, of which 21 have been notified.⁵² Thirteen of these 22 approved SEZs had previously existed as Industrial Estates and Industrial Parks, whereas nine SEZs have been approved under CPEC, of which four have been given priority status.⁵³

From the developers' perspective, a majority of the SEZs are by the public sector development companies, two are in public-private partnership mode,⁵⁴ and three are private sector SEZs, of which two are sole enterprise SEZs. However, two more private sector SEZs are in the pipeline.⁵⁵ The province-wise breakdown shows that Punjab hosts 10 SEZs, six are located in Sindh, three in Balochistan, two in Khyber Pakhtunkhwa, and one in Islamabad. As of June 2021, the notified SEZs were at different stages of development, and none of them were completely colonized with fully operational zone enterprises.

The latest available data suggests that the 22 approved SEZs cover more than 15,000 acres; plot demarcation has been completed for 11 SEZs, and more than 3,000 plots have been demarcated so far.⁵⁶ Per acre price of industrial plots varies from Rs 3.0 million (in Khairpur) to Rs 65 million (in Korangi Creek IP), depending on the costs of land acquisition

⁵⁰ Night Time Activity data captures nightlight images using satellites. The brightness or radiance in these images for the observed SEZ site boundaries have been used as a proxy to determine the consumption of electricity in these SEZs (WB).

⁵¹ Customs area refers to an area in which imported goods or goods for export are ordinarily kept before clearance by the customs authorities.

⁵² Dhabaji SEZ has been given in-principle approval; it has not been notified.

⁵³ These four are Rashakai SEZ, Allama Iqbal Industrial City, Dhabaji SEZ and Bostan SEZ (Source: Economic Survey of Pakistan 2020-21).

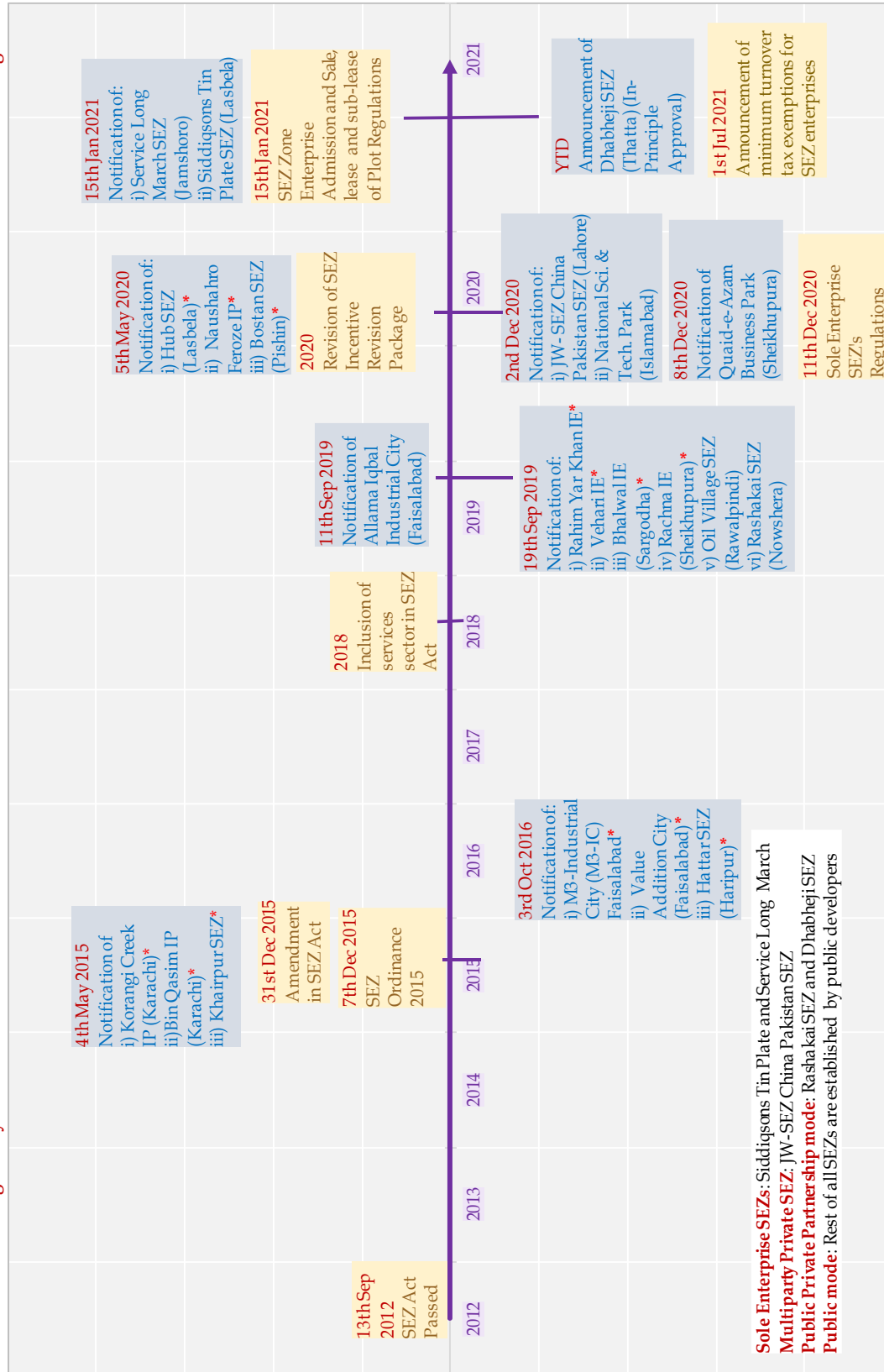
⁵⁴ These are Rashakai and Dhabaji SEZs.

⁵⁵ These are: Zameen SEZ and Roshan SEZ. Source: BOI Annual Report (2019).

⁵⁶ Source: BoI. (www.invest.gov.pk/sez)

Figure 7.9

Timeline of SEZs Regulatory Framework and Notification of SEZs



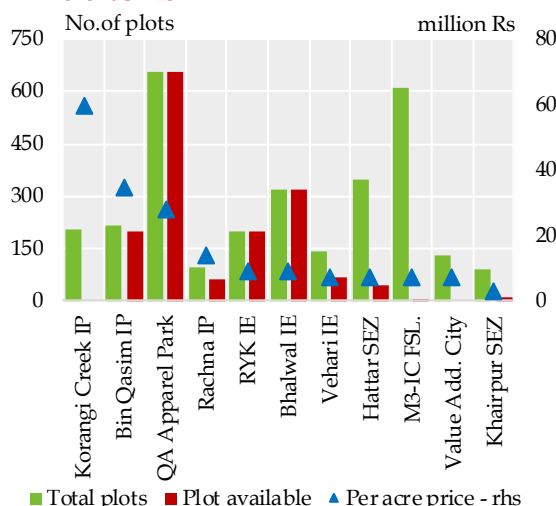
* shows the SEZ previously existed as an Industrial Estate
 Source: Board of Investment, Pakistan Economic Survey 2019-20

and development. Around 100 percent of the plots have been sold in three SEZs (Korangi Creek IP, M3-IC, and Value Addition City); and nearly 90 percent of the plots in Hattar and Khairpur SEZs have also been sold (Figure 7.10), whereas others are at different stages of sale.

From geographical perspective, these SEZs are mostly located near the coastal areas of Sindh, - i.e., in proximity of less than 100 kilometers - or in northern Punjab (Figure 7.11). Most of the approved SEZs are located in districts with relatively better multidimensional poverty index (MPI) scores, which in the absence of other detailed district-wise information may be construed as a proxy for the state of human development in those districts, since the MPI is based on education, health and standard of living indicators.

However, some SEZs are located in districts with poor MPI scores. This presents both an opportunity and a challenge. The opportunity exists because the SEZs have found to have had positive impact on the incomes of individuals and businesses located in the surrounding areas of the SEZ⁵⁷, with measurable impact up to a distance of 50 kilometers.⁵⁸ A signature example of this is Shenzhen, China, which became a major manufacturing base from a fishing village after an SEZ was set up in the region.⁵⁹ The challenge, however, stems from the availability of skilled labour, given poor literacy rates in some districts. This is because

Status of Plots and Price in Different SEZs **Figure 7.10**



Source: Board of Investment website, accessed on August 8th, 2021

the availability of skilled labour is often more critical to the success of SEZs than fiscal incentives.⁶⁰

In comparison to SEZs in the region, where some SEZs in China are province-sized,⁶¹ the size of Pakistan's approved SEZs so far is small, with M3-Industrial City, Faisalabad being the largest SEZ with a size of 4,356 acres, and Naushehro Feroze being the smallest manufacturing SEZ with a size of 80 acres (Figure 7.12)⁶². However, the Punjab Industrial Estates Development & Management Company plans to set up a 10,000-acre SEZ at Pind Dadan Khan, which, if approved would be two-thirds of total acreage currently under approved SEZs in Pakistan.⁶³

⁵⁷ J. Wang (2013). "The Economic Impact of Special Economic Zones: Evidence from Chinese Municipalities", *Journal of Development Economics*, p. 133-147, and P. Cizkowicz, M. Cizkowicz-Pekala, P. Pekala and A. Rzońca (2015). *The effects of special economic zones on employment and investment: spatial panel modelling perspective*. NBP Working Paper No. 208. Warsaw: Narodowy Bank Polski, Economic Research Department.

⁵⁸ World Bank (2017). *Special Economic Zones: An Operational Review of Their Impacts*. Economic and Sector Work (ESW) Studies. Washington, D.C.: WB

⁵⁹ T. Cheng (2019). "From Special Economic Zones to Greater Special Economic Region - Hong Kong Special Administrative Region as a Model for Legal Infrastructure Design.", *Transnational Corporations Journal*, Vol. 26 (3).

⁶⁰ UNESCAP (2017). *Handbook on Policies, Promotion and Facilitation of Foreign Direct Investment for Sustainable Development in Asia and the Pacific*. Bangkok: UNESCAP

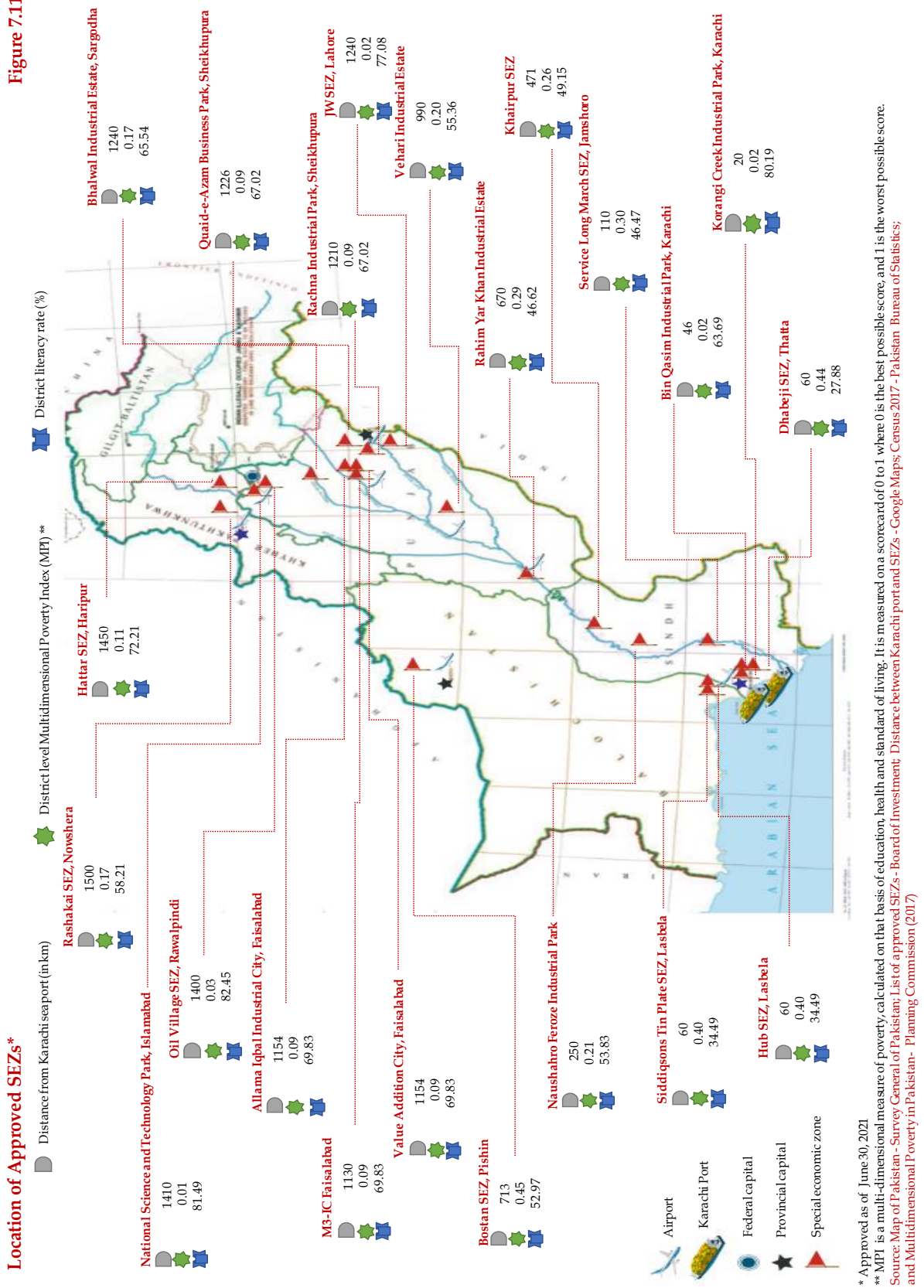
⁶¹ World Investment Report. (2019). *Special Economic Zones*. Geneva: UNCTAD

⁶² The average size of Pakistan's SEZs in Figure 7.12 is the average of all approved SEZs, as of June 2021.

However, the average size of SEZs of other countries are indicative in nature. These averages are calculated from the data of a subset of regional SEZs published by the World Bank in April 2021 under its project (P172858). This is the latest publicly available cross-country comparison of a sub-set of SEZs, whose total number is estimated to be more than 5,000 across the world.

⁶³ Punjab Industries Sector Plan 2018, Promoting Industrial Development and Investment, Government of Punjab

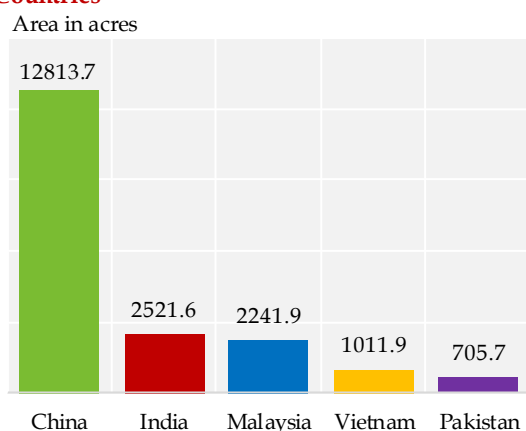
Figure 7.11



Comparison of Fiscal Incentive Structures Across SEZs in Different Countries**Table 7.3**

	Vietnam	India	Indonesia	Bangladesh	Pakistan
Developer incentive	No established framework	Yes	Yes	Yes	Yes
Type of corporate tax exemption	Abs. exemp.	Abs. exemp.	Depends on firm qualifications	Abs. exemp.	Abs. exemp.
Corporate tax exemption	100%	100%	20-100%	100%	100%
Duration of corporate tax exemption	4 years	5 years	5 - 15 years	2 years	10 years
Exemption on					
Withholding tax	0%	0%	0%	50%	0%
Property/ land tax	Land use tax postponed; depreciation of fixed asset at double rate	0%	Partial reduction in property tax	50%	0%
VAT/Sales tax	0%	100% exempt from sales tax (central and state)	100% exempt from VAT, luxury sales tax, and excise tax on raw materials	80% exempt from utility consumption tax	0%
Import duty on capex	100%	100%	0%	100%	100%
Import duty on input	0%	100%	0%	100%	0%
Capex duration	One-time	Perpetual	N/a	Perpetual	One-time
<i>Memorandum items</i>					
Legal framework year	2006	2005	2009	2010	2012
Minimum investment required	None	None	\$37mln	None	None
Standard corporate tax	20%	30%	25%	25%	29%

Source: World Bank 2017

Average Size of SEZs in Different Countries**Figure 7.12**

Source: Board of Investment and World Bank.

Incentive Structure:

The SEZ Act 2012 spells out different incentives for developers and zone enterprises. For zone developers, co-developers and zone enterprises, income tax is exempted for 10 years from the date of signing of the development agreement. Developers

and zone enterprises also have one-time exemption from all customs duties and taxes on the import of capital goods. In comparison to regional countries, the fiscal incentives for SEZs in Pakistan appear better on some parameters, such as the duration of corporate tax exemption. However, on other parameters, other countries offer better incentives, such as the duration of exemption on capital expenditures (capex). (Table 7.3).

Performance Criteria:

The SEZ Act 2012 and the ensuing rules and regulations do not stipulate specific economic or social policy parameters that zone enterprises must undertake at the time of filing an application on the SEZ MIS for the approval of SEZ Committee.

However, zone enterprises applying for Sole Enterprise SEZ must provide a host of undertakings. These include: investing at least

US\$50 million in the project,⁶⁴ of which at least 30 percent should be equity-financed; exporting at least US\$75 million in the first five years of operations;⁶⁵ ensuring net foreign exchange earnings after third year of commencement; giving 50 percent jobs to those residing in the district in which the SEZ is located; registering at least 200 employees with the EOBI; and providing entrepreneurship development training to locals under its vendor development plan. These conditions are relaxed for sole SEZ enterprises that invest in underdeveloped areas of the country or invest in top five importing sectors, the lists of which are identified in the regulations.⁶⁶

Regulatory Structure:

The SEZ regulatory framework is evolving, and the government continues to issue new regulations to deal with the emerging concerns and opportunities. For example, in December 2020, 'Sole Enterprise Special Economic Zone' regulations were formulated to allow large enterprises to develop SEZs solely for themselves, whereas in January 2021, 'Zone Enterprise Admission and Sale, Lease and Sub-Lease of Plot Regulations' were announced. The latter has helped increase SEZ activities and eliminate risks of real estate speculation by providing digital solution for approval of zones by the government, and allocating plots and zone enterprise status to enterprises within the zone (**Annexure-I**).

The regulatory structure for SEZs involves several organizational layers and actors. Brief description of each of these, and their roles and responsibilities, are discussed in **Table 7.4**, whereas the list of members of various regulatory bodies and committees are in **Annexure-II**.

7.4 Challenges to SEZ Growth in Pakistan

Pakistan had a slow start to SEZs. As described in section 3, most regulatory developments and notifications of SEZs happened six years after the passage of the SEZ Act 2012. Even to date, there is no fully operational, completely-colonized SEZ in the country, albeit the number of SEZs has started to grow since the amendment in the law and the rolling out of new regulations.

It takes about two years from the conceptualization of an SEZ by a developer – public or private – to the preparation of its application documents (which includes market feasibility studies, master plans, development plans and other documents etc.) to its approval and official notification as an SEZ by the government. It then takes about another two years for the developer to develop the zone as per the development agreement, before it can admit zone enterprises. This entails both civil works (such as land leveling and provision of sewerage, roads) as well as supply of utilities infrastructure. Once a zone enterprise is admitted, it may take another two and a half years for setting up of the industrial unit, before the enterprise can commence operations. In total, it can take about six and a half years from the time an SEZ is conceptualized till it becomes fully colonized with operational zone enterprises.

Considering these indicative timelines, and the fact that most SEZs have been notified 2019 onward, things are appearing to be shaping up. Global experience suggests that the success or failure of SEZs can only be assessed after at least a decade of the SEZs becoming fully operational and sufficiently colonized.⁶⁷ Since the SEZs in Pakistan are still in development phase, it is early to evaluate their success or failure at present.

⁶⁴ In addition to cost of land acquisition and development

⁶⁵ Albeit, no less than \$7.5 million of exports each year

⁶⁶ Regulation 4 and 5, Sole Enterprise Special Economic Zone, Regulation 2020

⁶⁷ World Bank (2020). *Assessment of Special Economic Zones in Pakistan: Suggesting Steps towards Improved Performance*. Washington, D.C.: WB.

Main Features of Regulatory Structure of SEZs**Table 7.4**

Name of Organization/Committee	Description
Board of Approval (BOA)	Chaired by the Prime Minister, the BOA comprises top political, technical and business leadership of the country. Its main functions are: approval of regulations for implementation of the SEZ Act; approve or reject zone applications and development agreement; take decisions on policy issues; notify additional benefits for developers or zone enterprises as per law; and review annual reports by the SEZ Authorities.
Approvals Committee	This committee exercises the powers and responsibilities as delegated by the BOA, including the screening of zone applications.
Board of Investment (BOI)	Originally established as the federal Investment Promotion Agency (IPA), the BOI works as the Secretariat of the BOA and the Approvals Committee to implement the SEZs framework. It is a coordinating agency for all activities pertaining to SEZs, developers and zone enterprises; it processes applications for development of zones and submits them to BOA for its approval; and it also approves all development agreements proposed by SEZAs. The BOI is also the SEZ Authority for SEZs in the Islamabad Capital Territory.
Provincial investment promotion agencies (IPAs)	The responsibilities of provincial IPAs include assisting the concerned SEZ Authority in its overall operations, as well as facilitating developers and zone enterprises in various matters relating to the SEZ.
SEZ Authority (SEZA)	The Act requires SEZAs to be set up as the highest SEZ authority for a province. Its main responsibilities are: preparation of zone application; selection of developers; formulation of zone regulations; and liaison with federal and provincial government departments and organizations.
SEZ Committee	Chartered by the BOA for each SEZ, the SEZ Committee comprises representatives from the developer, the BOI, provincial IPAs, respective SEZA, and the relevant district government. The developer appoints the chairperson of the SEZ Committee, which in most cases is a representative from the developer itself. The SEZ Committee is responsible for examining and approving SEZ entry applications; providing certification of zone enterprises; oversight of enterprises; and coordinating with various government departments.
Zone Enterprises	A zone enterprise is an enterprise admitted to an SEZ by a developer through a detailed selection process involving the developer and the relevant SEZA, with the BOI as the monitoring authority. In the case of Sole Enterprise SEZ, the developer and the Zone Enterprise may be the same entities.
Developer	Developer means an enterprise which has entered into an agreement with the relevant SEZA to develop an SEZ. The development agreement is reviewed by the BOA.

Source: Special Economic Zones Act, 2012

However, certain challenges to the prospects of growth and success of SEZs in Pakistan require the attention of policymakers. This section sheds light on some of those challenges, where broader policy-oriented concerns will be in focus.⁶⁸

SEZ Policy & Objectives

Being the capstone of the Investment Policy 2013, the objective behind SEZs in Pakistan is stated to be a step towards ease of doing business and to stimulate industrial growth with quality infrastructure.⁶⁹ However, these are not clearly spelled out in the manner of a separate SEZ policy document.

Countries have a variety of objectives, from improving industrial growth, attracting FDI and job creation to supporting technology access and upgradation, skills transfer, and foreign exchange earnings (**Table 7.5**).

Although global literature suggests that wide-ranging objectives are not always desirable because of the often-competing priorities, scarce resources, and a lack of dedicated organization to prepare detailed policy and regulatory framework, clearly spelled out objectives are nevertheless needed to guide policymaking, including design of regulations and incentives, site selection for SEZs, industry clusters, and the selection of zone enterprises.

At present, Pakistan has provisions for Special Economic Zones under the SEZ Act

⁶⁸ In the absence of publicly available market feasibility studies for each SEZ, it would be difficult to comment on the feasibility aspects vis-à-vis factors of production and marketability of goods produced inside the SEZs.

⁶⁹ Paras 1.4(b) & 4.1, Investment Policy 2013, Board of Investment of Pakistan

Summary of Stated SEZs Objectives

Table 7.5

	Jobs	Exports	FDI	Technology	Diversification	Upgrading	Foreign Exchange	Others
Bangladesh	✓	✓	✓	✓	✓	✓		✓
India		✓	✓					✓
Vietnam	✓		✓	✓				
Ghana	✓		✓	✓	✓		✓	✓
Kenya	✓		✓	✓	✓	✓	✓	✓
Nigeria	✓	✓	✓	✓		✓	✓	
Senegal	✓	✓	✓				✓	
Tanzania	✓	✓	✓	✓	✓	✓	✓	✓
South Africa			✓	✓	✓	✓		✓
Pakistan			✓					✓

Source: Based on review of individual country SEZ laws of Pakistan and South Africa; Farole T (2011), *Special economic zones in Africa: Comparing performance and learning from global experiences*

2012; Industrial Estates under provincial industries departments; and Special Technology Zones under the Special Technology Zones Authority Act (STZA) 2021.

Meanwhile, the Export Processing Zones have a separate authority, with plans to establish new zones under Export Processing Zones Authority Ordinance 1980. In addition, Gwadar Free Trade Zone is being set up under a separate concession agreement and does not come under the SEZ or the EPZ law, whereas under Digital Pakistan Policy,⁷⁰ the Ministry of IT & Telecom plans to recommend incentives for technology SEZs under the SEZ Act.

These investment policy instruments often overlap with each other. For instance, technology SEZs can be set up under the SEZ Act (like the recently set up SEZ called the National Science and Technology Park), as well as under the STZA. Likewise, separate from the Gwadar Free Zone, the EPZA is setting up a 1,000-acre Gwadar EPZ.⁷¹ Similarly, at a time when SEZs are being promoted, the policy emphasis on EPZs adds complexity, considering that with the reduction in customs duties, EPZs (where imports are free) are not as attractive as

before.⁷² In addition, there have also been instances when different budgetary measures have given special incentives to industries outside the SEZs, which erodes the special fiscal incentives provided to companies inside the SEZs.⁷³ While these overlapping instruments offer choices to prospective investors, they also compete for same investors, add complexity to governance, and may prevent SEZs from realizing their potential.

One Stop Shop

Among the key policies and interventions that make a Special Economic Zone 'special' from the rest of the industrial areas is a business-friendly environment insulated from weak governance and overall difficulties of doing business that often mark developing countries. To that end, one stop shop (OSS), also known as one window operation, is a key intervention for zone enterprises. The OSS reduces delays and uncertainty around securing registrations, permits, licenses, and approvals as well as provision of public goods from multiple governmental agencies.

⁷⁰ Digital Pakistan Policy (2018), Ministry of Information Technology and Telecommunication (www.moitt.gov.pk/SiteImage/Misc/files/DIGITAL%20PAKISTAN%20POLICY.pdf)

⁷¹ According to EPZA, PC-1 has been submitted for 500 acres build through PSDP/CPEC funding, and financial and technical proposals have been invited for expression of interest for another 500 acres on build operate and transfer basis.

⁷² *Ibid* footnote 11.

⁷³ For instance, government has exempted industrial units located in erstwhile FATA and PATA of federal excise levy. Source: Federal Board of Revenue (Circular no. 02 of 2021, titled "Finance Act, 2021 – Explanation of Important Amendments in Sales Taxes Act, 1990 and Federal Excise Act. 2005.")

As per the SEZ Act 2012, there are two layers of the OSS. The Board of Investment is stipulated to act as an OSS for liaison and facilitation between all federal ministries, authorities and agencies at one end and provincial SEZ Authorities, developers and zone enterprises at the other. As for coordination of developers and zone enterprises with relevant departments, authorities and agencies at provincial and local government level, the provincial SEZ Authorities are to act as a liaison and facilitating agency.⁷⁴ However, in both cases,

the OSS does not exist in true sense in any of the SEZs in Pakistan.

As far as plots inside the zone are concerned, it is the developer's responsibility to ensure the supply of gas, electricity, and other utilities to zone enterprises at the zero point of the plot, whereas the relevant provincial SEZ Authority is to ensure availability of public utilities to zero point of SEZ and serve as liaisons and facilitating agency.⁷⁵ At the same time, the SEZ Committee is to serve as the point of contact between the zone enterprise and utility

Responsibility Matrix: Infrastructure, Utilities and Security

Figure 7.13a

Responsibility Matrix: Infrastructure, Utilities and Security										Figure 7.13a	
Infrastructure and utilities				Co-ordinate with Federal Govt. (FG)/ Provincial Govt. (PG)				Facilitate interaction of Developer. & Enterprises.			
Ensure services within vicinity		Build and/or operate/ distribute within the zone	To SEZ zero point	To facilitate Developer		To facilitate Zone Enterprise		With all FG/PG	With PG/LG		
Firefighting facilities	SEZA	Developer						BOI	SEZA		
Medical facilities	SEZA	Developer						BOI	SEZA		
Acad. & voc. training fac.**	SEZA	Developer						BOI	SEZA		
Roads		Developer	FG & PG	SEZA				BOI	SEZA		
Electricity		Developer	FG & PG	SEZA	SEZ Committee	SEZA	SEZ Committee	BOI	SEZA		
Natural gas	SEZA*	Developer	FG & PG	SEZA	SEZ Committee	SEZA	SEZ Committee	BOI	SEZA		
Water		Developer	FG or PG	SEZA	SEZ Committee	SEZA	SEZ Committee	BOI	SEZA		
Sewerage/ drainage		Developer	FG or PG	SEZA	SEZ Committee	SEZA	SEZ Committee	BOI	SEZA		
Waste water treatment		Developer			SEZ Committee	SEZA	SEZ Committee		SEZA		
Security	SEZA/ PG	Developer						BOI			

Responsibility Matrix: Liaison among Different Agents

Figure 7.13b

	Between FG and SEZA/Developer/Enterprise		Between PG/LG and Developer/Enterprise	
	BOI	SEZ Committee	SEZA	SEZ Committee
Liaison for approvals/registration with regulators/tax authorities				

*SEZA obtains commitment from concerned gas pipeline company; ** Academic and vocational training facilities

FG: Federal government; PG: Provincial government, LG: Local government; BOI: Board of Investment; SEZA: Special Economic Zone.

Source: Special Economic Zone Act 2012 and Special Economic Zones Rules, 2013

⁷⁴ Section 29, SEZ Act 2012

⁷⁵ The zero point of an SEZ refers to the nodal point (in public goods delivery) which is the closest to the entry point of the SEZ. The zero point of a plot refers to the nodal point closest to the plot within the SEZ.

providers; facilitate between enterprises and government regulators and tax authorities; and assist zone enterprises in obtaining approvals and registrations (**Figure 7.13**).⁷⁶ This overlapping mandate and institutional fragmentation over responsibilities has caused delays in the provision of public goods needed by the SEZs.⁷⁷

In practice, different developers are experimenting with different models. For instance, in the case of Khyber Pakhtunkhwa Economic Zones Development & Management Company, and Faisalabad Industrial Estate

Development & Management Company, the OSS is based on new hires by these development companies. However, unlike the recommended new hires model (**Box 7.1**), new hires in these development companies are not officially operating on behalf of any government department or regulator, and instead get things done through personal relations. The Punjab Industrial Estates Development & Management Company, on the other hand, had adopted the secondment model, albeit one where the deputed staff did not have authority to approve or reject

Box 7.1: Three Models of OSS

According to Mangal M. (2019), SEZs can be institutionalized under three operating models differentiated on the basis of responsibilities of the front and back offices and hiring needs. These models have been categorized as Secondment, New Hire and Front Desk only.

The **Secondment model** comprises a front office and a back office, which are located inside the zone; the back office comprises government representatives from different departments. In this model, the front office acts as an intermediary between the investor and the government ministries. The office receives the investor's application for different permits and directs these applications to the back office. In the back office, different ministries depute their representatives to the SEZs, which are authorized to approve or reject the application. The decision is communicated to the front office, which then informs the investor. This model is cost-effective and does not need new hiring, but at the same time it may encompass bureaucratic hurdles, such as delays in approvals, lack of appropriate skills, and an unwillingness to implement the rules and regulations in SEZs.

In the **New Hire** model, instead of deploying the ministries' representatives, the regulator hires its own staff and trains it according to the SEZs' specific needs, and deputs them in the back office. These employees are authorized to perform respective duties under the different ministries. Similar to the Secondment model, the front office acts as the intermediary between the investor and the back office. Though this model circumvents the traditional bureaucratic hurdles, it may pose significant financial cost in terms of hiring and training new human resource.

The third model of **Front Desk Only**, operates without the back office at the SEZ, whereas the front office is responsible for taking investor applications to different government ministries individually or to an OSS. This model requires minimum human and financial resources. However, it may work only under certain conditions; for example when an SEZ is located near government offices; facing similar standard operating procedures as non-SEZs and; businesses may use digital means to apply and get permits.

Source: Mangal M. (2019). "Institutional Structure of Special Economic Zones." Reference No. MYA-1903. London: International Growth Centre.

applications, and only acted as post-offices for the respective departments.

Two major challenges with OSS are its the lack of authority, and weak integration of policies across the board. For instance, to improve the ease of doing business, the investment

promotion agencies (IPAs) of Punjab, Sindh and Khyber Pakhtunkhwa have launched online portals that contain relevant information for registrations, licenses and approvals, and direct businesses to the

⁷⁶ Sections 23, 17 & 27 Special Economic Zones Act 2012

⁷⁷ World Bank (2020). *Assessment of Special Economic Zones in Pakistan: Suggesting Steps towards Improved Performance*. Washington, D.C.: WB

respective federal and provincial government websites.⁷⁸

However, these portals are one stop windows that lead to other windows i.e., the portals lead to websites or portals of other government departments, because every department has its own systems and requirements. Real fast-tracking of permits, licenses, approvals etc. has not taken place yet, as there is no stated policy or regulation that fast-tracks government procedures for SEZ developers and enterprises. Nor do SEZ Authorities have authority to hold federal or provincial bodies accountable to ensure the provision of public goods at the zero points of SEZs or SEZ plots, or to fast-track various registrations and approvals.⁷⁹

Similarly, as far as infrastructure outside the zone is concerned, it is the responsibility of the federal and provincial governments to ensure provision of gas, electricity, other utilities, and road access to the zero point of the SEZs. At the same time, the law tasks the SEZ Authority to obtain commitment from the relevant gas pipeline company.⁸⁰

This structure of responsibility is based on the fact that gas companies are owned and controlled by federal government whereas in the case of electricity, generation and

transmission are a federal domain and distribution is a provincial domain. Similarly, providing access road to an SEZ is the responsibility of provincial government; however, connecting that road to national highway via interchanges is a federal subject.

In practice, when a developer faces delays in provision of public goods at the SEZ zero point, it approaches the relevant SEZ Authority, which then writes to the BOI, and the BOI coordinates with the relevant federal authority. However, in the absence of clearly spelled out preferential turnaround time for SEZ projects, and a dedicated delivery unit that can coordinate among various federal and provincial agencies, administrative delays and the absence of an effective OSS pose a challenge to the success of SEZs in Pakistan.⁸¹

Other Investment Environment Constraints

In addition to inadequate infrastructure and coordination failures that the SEZs help address by insulating businesses from a relatively weak governance environment in the rest of country, successful SEZs are effectively also islands of excellence in terms of ensuring a business-friendly environment.

Pakistan's Ranking and Scores in Relevant factors of WJP Rule of Law Index

Table 7.6

	Pakistan	India	Sri Lanka	China	Singapore	Republic of Korea
Regulatory Enforcement Rank (out of 139 countries)	123	78	72	76	4	21
Administrative proceedings are conducted without unreasonable delay *	0.33	0.43	0.41	0.61	0.90	0.78
Due process is respected in administrative proceedings *	0.20	0.53	0.42	0.33	0.88	0.66
Civil Justice Rank (out of 139 countries)	124	110	103	74	8	13
People can access and afford civil justice *	0.40	0.39	0.48	0.60	0.63	0.69
Civil justice is not subject to unreasonable delay *	0.33	0.20	0.21	0.72	0.91	0.81
Civil justice is effectively enforced *	0.36	0.41	0.38	0.60	0.92	0.80
Alternative dispute resolution mechanisms are accessible, impartial, and effective *	0.51	0.60	0.57	0.67	0.75	0.85

* Indicates score where 1 is best

Source: The World Justice Project Rule of Law Index 2021

⁷⁸ Punjab Board of Investment and Trade, Government of Punjab (www.pbit.gop.pk/Investors%20Facilitation/); Sindh Investment Department (sindhinvestment.gos.pk/#/);

Khyber Pakhtunkhwa Board of Investment and Trade (www.kpboit.gov.pk/investment-facilitation/)

⁷⁹ Source: JICA (2020). *Special Economic Zone Survey Report 2020*. Tokyo: JICA.

⁸⁰ Section 27 SEZ Act 2012 and Rule 14 SEZ Rules 2013.

⁸¹ Source: JICA (2020). *Special Economic Zone Survey Report 2020*. Tokyo: JICA

To this end, the challenges pertaining to legal environment and availability of skilled labour force at competitive wages are worth considering.

Legal environment:

Pakistan does not fare well in the legal environment with respect to business. Both local and foreign investors often face weak contract enforcement, and delays in case filing, serving, trial, judgement and the enforcement of court decision. Dispute involving the Pakistani government and well known foreign investors have also raised concerns regarding contract enforcement issues in the country⁸² (Table 7.6). The SEZs in Pakistan are not currently insulated from the country's legal environment.

In Pakistan, the current SEZ law assigns exclusive original civil jurisdiction⁸³ to the High Court of the province in which the SEZ is located with respect to all disputes between the developer and any governmental authority or agency. Similarly, exclusive original civil jurisdiction rests with the district court of the district in which the SEZ is located, for disputes between the developer and the zone enterprises and between zone enterprises of the concerned SEZ.⁸⁴ The law is silent on disputes between zone enterprises and businesses outside the SEZs, i.e. suppliers and vendors to the enterprises inside the zone or the domestic buyers of the goods produced by zone enterprises.

Experience from SEZs around the world has shown that in addition to geographical location and physical infrastructure, a well-designed legal infrastructure is crucial to success.⁸⁵ The absence of a business-friendly

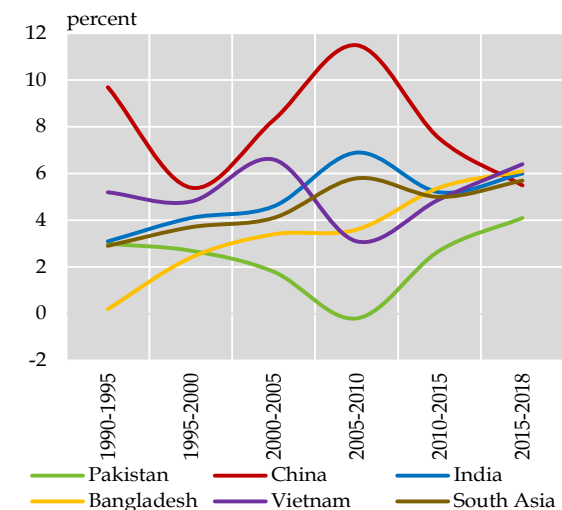
legal framework, therefore, can prove to be a challenge for SEZs in Pakistan.

Skilled labour:

The availability of skilled labour is one of the problems faced by investors in developing economies. To this end, the SEZs do not only provide an opportunity to experiment with different labour policies, they also help create a pool of well-trained workers for businesses.

For instance, the SEZ framework in the early period of China's Shenzhen SEZ allowed to experiment with more flexible labour markets and incentive-based compensation; at that time, it was the only place in China where employee wages comprised both flat wages as well as performance-linked wages.⁸⁶ Similarly, South Korea's Foreign Investment Zone offers differentiated labour regimes for its various sectoral clusters.⁸⁷ On the other hand, low-skilled workforce and limited

Per-Hour Labour Productivity Growth Figure 7.14



Source: APO Productivity Databook 2020

⁸² For details see Chapter 7, "Factors Constraining Investments in Pakistan: Beyond the Macroeconomics" in the SBP's Annual Report on the State of Pakistan's Economy for FY19.

⁸³ Exclusive jurisdiction refers to power of a court to adjudicate a case to the exclusion of all other courts. Original jurisdiction of a case refers to the court that first hears a case through to its conclusion.

⁸⁴ Section 38, SEZ Act 2012

⁸⁵ C. Teresa (2019). "From Special Economic Zones to Greater Special Economic Region – Hong Kong Special Administrative Region as a Model for Legal Infrastructure Design", *Transnational Corporations Journal*. Vol. 26 (3).

⁸⁶ A. Khandelwal and M. Teachout (2016). "Special Economic Zones for Myanmar." London: IGC

⁸⁷ World Bank (2020). "Assessment of Special Economic Zones in Pakistan: Suggesting Steps Towards Improved Performance". Washington, D.C.: WB

opportunities to conduct vocational trainings proved to be a drag in some SEZs in Africa.⁸⁸

In Pakistan, labour productivity is weak, as is the supply of well-trained skilled labourers (**Figure 7.14**). According to the World Bank's Enterprise Surveys, 24.2 percent of firms in Pakistan identified inadequately educated workforce as a major constraint, compared to 9.4 percent in India, 15.7 percent in Bangladesh, and 16 percent in Sri Lanka.⁸⁹ In Punjab, for example, the total supply for the top 30 most demanded manufacturing sector occupations is only 10.6 percent of the total demand; in Sindh, the supply meets only 20.7 percent of total demand.⁹⁰ Even though the M3-IC and the Value Addition City have not yet been fully colonized and completely operational, firms in these SEZs have been facing scarcity of quality labour.⁹¹

Under the current SEZ law, the SEZs are not insulated from the labour and employment laws applicable in the rest of the country.⁹² On the other hand, labour training institutes have not yet been set up within SEZs, because the developers are waiting for the SEZs to be sufficiently colonized by operational industries.

Zone Operation & Maintenance

Global literature on SEZs suggests three major types of stakeholders, apart from the regulator: owner, developer, and operator.⁹³ In some cases, development and running of operations are done by the owner. In other cases, the owner may give the contract for development to a separate entity, and for operations to another. In Pakistan's SEZ law, the concept of separate operator or manager does not exist. Instead, developers have been tasked with the maintenance of infrastructure

and utility services.⁹⁴ Accordingly, developers can charge for maintenance and other services, such as fees for the issuance of No-Objection Certificates (NOCs), sales deed, and for change in directorships. However, proceeds from the sale of land contributes the most to the developers' total earnings.

Discussions with stakeholders suggest that some developers are considering purchasing electricity from power distribution companies at bulk rates and sell it to zone enterprises at the government-notified industrial tariff, and thereby earn the spread between the two rates. As per the SEZ law, developers have the right to set up captive electric power plants or install hydel power generators to sell electricity within a particular SEZ, and outside the SEZ in case of excess supply. However, the developers have not yet set up their own captive power plants. On the other hand, developers can only charge for maintenance on a no-profit-no-loss basis for medical facilities and vocational training facilities.⁹⁵

Aside from these, no explicit framework for incentives exists for operators as a separate entity or for developers running the SEZ as operators. The current SEZ law and regulations in Pakistan focus on first-time colonization, with little focus on operations and maintenance of the SEZs in the long run. For investors, this is a concern over long-term sustainability of the SEZ projects given Pakistan's experience with Industrial Estates and EPZs in the past.

Financing for Zone Enterprises

The current SEZ framework in Pakistan bounds zone enterprises to commence construction of facilities within six months of the acceptance of its zone entry application. It

⁸⁸ T. Farole (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. Direction in Development Series- Trade. Washington D.C.: WB.

⁸⁹ World Bank. *Enterprise Survey 2011-14*. Washington DC: WB.

⁹⁰ For details, see Special Section 1 in SBP's Third Quarterly Report on The State of Pakistan's Economy for FY-20.

⁹¹ Source: JICA (2020). *Special Economic Zone Survey Report 2020*. Tokyo: JICA.

⁹² Section 30, SEZ Act 2012

⁹³ M. Mangal (2019). "Institutional Structure of Special Economic Zones." ICG Policy Note, Reference No. MYA-1903. London: IGC

⁹⁴ Section 21, clause (iv), SEZ Act 2012 & annexure (7) of SEZ Rules 2013.

⁹⁵ Section 27, SEZ Act 2012, & Rules 9(14) and 9(15) of SEZ Rules 2013

also bounds them to start commercial activities within 24 months of being admitted into the SEZ and the acquiring of the required licenses and permits. In addition, title to land purchased by zone enterprises can only be registered in their name only after they have been in operations in the concerned SEZ for at least six months.⁹⁶

If a zone enterprise does not want to construct facilities after being allotted the plots inside the SEZ, it cannot sell the plot to any other investor; the plot can only be surrendered back to the developer at the original purchase price, net off any administrative charges deducted by the developer.⁹⁷ Even if a zone enterprise sells its business (including land, plant & machinery and other facilities) to another company, the new owner of the enterprise cannot later sell the plot to anyone else;⁹⁸ it can only surrender it to the developer at the original purchase price of the plot net off any administrative charges. These requirements are aimed at preventing real estate speculation of plots inside the SEZs and to fast-track the colonization with operational zone enterprises. However, there are corollaries to this.

At one end, since the land title is not transferred until at least six months after a zone enterprise commences operations, the enterprises are unable to mortgage the land to obtain bank financing for the construction of manufacturing and other facilities. This is so even if zone enterprises have paid for the land in full. At the other end, in the scenario where a zone enterprise commences operations, gets the land title, and then wants to obtain bank financing for expansion or any other purpose, the amount of bank financing is constrained by the surrender value of the plot as described above.

In normal course of business, different banks offer different loan-to-value ratios for mortgaged properties, where the collateral value of mortgaged properties is pegged to the market value. However, in case of SEZs, there is no market to sell off the plots purchased by the zone enterprises. Therefore, the surrender value of the SEZ plot becomes the collateral value. The collateral value of the SEZ plots is limited to the respective surrender value even if the selling price of new plots in the same SEZ is higher.

Monitoring & Evaluation

Effective Monitoring and Evaluation (M&E) are crucial for a successful SEZ programme.⁹⁹ It is a critical part of SEZ policy framework, especially if developing economies want to expand the policy, legal and institutional experiments outside the zones, or want to scale up the number of zones across the country. Adequate M&E also ensures whether or not the financial and non-financial economic objectives achieved in a desired period outweigh the fiscal cost of the incentives provided to the SEZs.

To this end, M&E is aimed at cost-benefit analysis; qualitative evaluation of policy experimentation for infrastructure and regulation; spillovers (such as developing local vendors, technology transfer, worker training); attracting foreign investors and integrating with global value chains; and to make constant improvements towards a business-friendly environment.¹⁰⁰

In Pakistan, both the developers and the SEZ Authorities are stipulated to monitor and ensure compliance with all applicable zone regulations by zone enterprises. The SEZ Committee is also required to conduct

⁹⁶ Rule 44, SEZ Rules 2013 & Section 16, clause (g), SEZ Act 2012

⁹⁷ These charges range between 6-10 percent of the purchase price, and vary from one developer to another as per zone regulations.

⁹⁸ Section 16, clause (h), SEZ Act 2012, & Rule 6 of SEZ Zone Enterprise Admission and Sale, Lease and Sub-Lease of Plot Regulations, 2021.

⁹⁹ M. Alexianu, M. Saab, M. Teachout and A.K. Khandelwal (2019). *“Doing Special Economic Zones Right: A Policy Framework”*, IGC Policy Note. London: IGC

¹⁰⁰ P. Manwaring, M. Teachout (2020). *“Special Economic Zones Policy Considerations for Uganda.”* IGC Policy Note. London: IGC.

oversight of zone enterprises, whereas provincial SEZ Authorities are required to report bi-annually to the BOA about the SEZs in their respective province. They also have to submit an annual report whose key components comprise: (a) summaries of the status of each SEZ, including the number of zone enterprises in operation, new zone enterprises starting operations in the year, the amount of remaining unsold or un-leased land; and (b) details of any problems or issues within SEZ that require remediation.¹⁰¹

Similarly, the secretary BOA/BOI are required to submit an annual report to the BOA that contains information related to: (a) SEZs activities, progress and future outlook; (b) estimated addition made to exports, GDP, employment and generally acceptable performance indicators; (c) seminars, conferences, training programs organized; and (d) recommendations by Chairman BOI.¹⁰² In practice, however, these reports are not publicly available.

7.5 The Way Forward: Policy Options

A 'one size fits all' approach to the analysis of SEZs' problems and their solutions is not recommended. This is because SEZs serve different purposes for different countries – not only in terms of the desired outcomes but also the country's specific broader economic and governance challenges. However, based on the most common factors of success discussed in Section 7.2, the unique challenges to investment and industrial growth in Pakistan in general and the challenges for SEZs discussed in the preceding section, the following recommendations can help the country realize the potential that SEZs characteristically offer.

SEZ Policy & Objectives

An SEZ policy framework with clearly stated objectives is one of the key factors of success of SEZs around the world, as highlighted in section 7.2. Given the absence of such a framework in Pakistan, it is pertinent to draft a detailed SEZ policy to guide the evolving legal

framework and to address various facets of provincial industrial policies. Equally important is the reconciliation of the SEZ policy with other instruments of investment policy, such as the STZA and EPZA, and with various federal and provincial industrial policies, economic growth frameworks and budgetary measures.

While the concerned authorities are to carry out specialized evaluation exercises on their own end and accordingly implement the required regulatory changes, as part of general direction, the following themes could be considered. For instance, a clear policy framework is needed to inform whether or not different objectives may be assigned to different SEZs. If so, then the design, facilities, infrastructure and incentive structures for the SEZs may need to be tailored accordingly.

Similarly, the policy needs to shed light on whether or not SEZs are to be used to transform undeveloped regions. And if so then what measures shall be taken to ensure availability of enabling environment such as road, health and education facilities in the vicinity of the SEZ, and what facilitative policy instruments may be available for such SEZs without simultaneously creating disincentives for enterprises in other SEZs. Likewise, if hi-tech zones are a part of policy priority, then whether or not regulatory frameworks exist to enable and incentivize pro-active creation of a network of researchers; start-ups; venture capitalists and other financiers; academia and well established relevant businesses. Lastly, the SEZ policy may also address the issue of overlapping mandates to reduce complexity.

One Stop Shop

A successful SEZ requires a policy regime that speeds up coordination among all relevant ministries, departments, and agencies at various levels of government. As identified in the previous section, presently there are several bodies with overlapping responsibilities, which leads to project delays. In recognition of these risks, the SEZ

¹⁰¹ Sections 17, 20, 23 of SEZ Act 2012 & Rule 56 of SEZ Rules 2013.

¹⁰² Rule 58, SEZ Rules 2013.

framework stipulates the BOA, BOI and SEZAs to promote simplified administrative procedures for SEZs with regards to relevant federal and provincial authorities and agencies, which in turn are to fully cooperate to facilitate developers and zone enterprises.¹⁰³

Accordingly, the government has already approved one window operation by SEZAs whereby the provincial government will either delegate authority for implementing labour, environment and other laws and the collection of local and provincial taxes from SEZs, or it will depute representatives of various departments in the SEZA office. In addition, federal government departments (FBR, SECP etc.) will depute representatives to perform similar functions in the zone.¹⁰⁴

With increasing number of zone enterprises, there is a need to fast-track the implementation of the approved SEZ legal framework, where four key measures may be considered.

First, the proposed legal framework needs to clearly define the final responsibility and

accountability in terms of coordination with various ministries and departments. For instance, in South Africa, the country's SEZ Policy assigns the responsibility of "oversight and accountability" of the development and operations to the relevant minister or the mayor, as the case may be.¹⁰⁵

Second, the simplification of procedures needs to include measures such as; not asking businesses the same information many times, which can be made possible by creating a centralized database with unique identification of businesses. The SEZ Act in India simplifies this process by empowering the government to issue a single form for permission under multiple acts for developers and enterprises.¹⁰⁶

Third, the system should also ensure limited human interaction achieved by means of automation and creation of platforms that allow businesses to submit all documents and payments along with applications in one go.¹⁰⁷

Box 7.2: Establishment of Commercial Courts in Punjab: A Recent Development

Commercial courts specialize in lawsuits arising from commercial disputes, such as contract violation, breach of intellectual property rights, and fraud cases. These specialized courts improve the business environment and investor confidence by reducing the time and cost of commercial litigations.

In line with international best practices¹, the Punjab government has recently established a mechanism for setting up commercial courts in the province through the Punjab Commercial Court Ordinance notified on April 13, 2021. The ordinance grants the government power to constitute the commercial courts at the district level. The court is empowered to preside over all commercial disputes within its jurisdiction, with claim values of Rs 500,000 or more. The ordinance clearly spells out the parties to the dispute, including domestic or foreign companies, partnership firms as well as private individuals.

A Commercial Court Secretariat will also be established under the ordinance. Along with maintaining case records, the secretariat will be responsible for training and education of commercial court judges on matters related to business and finance.

¹⁰³ Sections 28 & 29, SEZ Act, 2012.

¹⁰⁴ BoI, Annual Report (2018-19).

¹⁰⁵ Policy on the Development of Special Economic Zones in South Africa (2012) (www.thedtic.gov.za/wp-content/uploads/NIPF-1.pdf)

¹⁰⁶ Chapter V (Single Window Clearance), Section 19, The SEZ Act, 2005, India

¹⁰⁷ A. Stone (2006). *Establishing a Successful One Stop Shop: The case of Egypt*. Presented at IMF/AMF High-Level Seminar on Institutions and Economic Growth in the Arab Countries. Washington, D.C.: IMF

The ordinance also provides for an e-filing system for cases, and binds the court to dispense verdict within 180 days after the case is filed, with no more than two adjournments. This is significantly swifter dispensation as compared to the 1,071 days it currently takes to resolve a commercial case in Pakistan. In fact, it is close to the best performing country, Singapore, where it takes 164 days to dispense a case.²

The ordinance also directs the creation of the Commercial Appellate Tribunal. An aggrieved party can appeal to the tribunal within 30 days of the court's judgment, and the tribunal is bound to resolve the appeal within 120 days (Figure 7.5.1).

References:

¹ The Punjab Planning & Development Board, "Enforcing contracts under ease of doing business 2021"

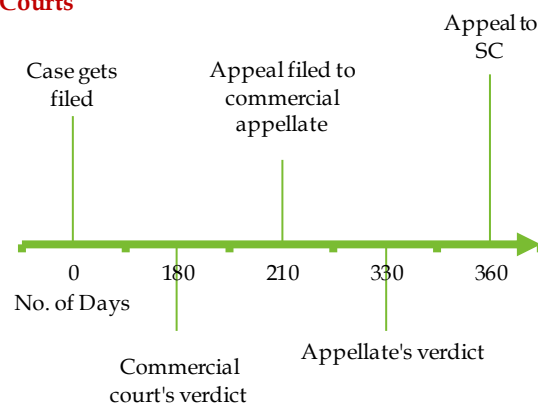
² *Ibid* reference 1

Such a system should have time-stamped process flow, from receipt of application to completion of request. For example, "Digital Beijing" initiative in the Zhongguancun e-Park in China simplifies documentation procedures using technology.¹⁰⁸ Using an online system, companies in this park can submit applications and documents, register with government bodies, and interact with government officers online.

Fourth, equally important is to ensure shorter timelines for applications concerned with SEZs. These will not be possible only by moral suasion but by clearly codifying preferential turnaround times for SEZs. In the case of a physical OSS model, the representatives of various ministries, departments and organizations need to be empowered to act on behalf of their ministries.¹⁰⁹ Otherwise, coordination failures will continue to exist, and the one stop will remain ineffective. A physical OSS may also consider longer work hours, as was successfully experimented in Egypt, to help fast-track applications.¹¹⁰

Case Timeline under Commercial Courts

Figure 7.2.1



Source: Punjab Commercial Court Ordinance, 2021

Other Investment Environment Constraints

In order to insulate the SEZs from the country's overall weak investment environment, the following measures can help create business-friendly legal environment and increase the availability of skilled labour force.

Legal environment:

Until April 2021, when the Punjab government promulgated the Punjab Commercial Courts Ordinance 2021, Pakistan did not have a dedicated commercial court. The establishment of commercial courts in Punjab is an encouraging development, considering that commercial courts can improve the state of contract enforcement in the country and to provide speedy justice to domestic and foreign investors.

In light of this development, it is recommended that these courts are set up in the districts in which the SEZs have been established. Alternatively, the jurisdiction of the nearby commercial courts may be

¹⁰⁸ V.D. Ndou (2004). "E-government for Developing Countries: Opportunities and Challenges", *The Electronic Journal of Information Systems in Developing Countries*, 18(1), 1-24.

¹⁰⁹ P. Manwaring and M. Teachout (2020). *Special Economic Zones: Policy considerations for Uganda*. IGC Policy Note. London: IGC.

¹¹⁰ A. Stone (2006). *Establishing a Successful One Stop Shop: The case of Egypt*. Presented at IMF/AMF High-Level Seminar on Institutions and Economic Growth in the Arab Countries. Washington, D.C.: IMF.

expanded to include the SEZs as well. In Punjab's case, the government can set up a commercial court by notification under the current ordinance. Other provinces will have to pass their own laws to set up commercial courts with defined timelines for the dispensation of original verdicts as well as appeals at all levels.

Accordingly, since the SEZ Act 2012 grants exclusive original civil jurisdiction to the district and high courts for disputes between various parties, the SEZ legal framework will need to provide jurisdiction to these commercial courts for SEZ-related disputes, involving zone enterprises, developers, all tiers of governments/governmental bodies, and non-SEZ enterprises doing business with anyone involved with SEZs.

After having set up commercial courts, in the medium to long term, another solution could be to introduce international judges by setting up international commercial court with strong arbitration rules for SEZs to increase the trust of foreign investors. Since the proceedings and judgements of these courts are in English language under British common law, the model for international commercial court has been a success.¹¹¹

In just the last ten years, a host of international commercial courts have sprung up in developing, emerging and developed economies. These include the Dubai International Financial Centre (DIFC) Courts in 2004, Qatar International Court in 2009, Abu Dhabi Global Market Courts in 2015, Singapore International Commercial Court in 2015, Astana International Financial Centre Court in 2015, China International Commercial Court in 2018, and the Netherlands Commercial Court in 2019. Although some of these are housed in financial SEZs, such as the DIFC Courts, others have countrywide jurisdictions. In the spirit of SEZs being fenced-in test beds for

broader economic reforms, an SEZ specific international commercial court can inspire confidence of foreign investors that Pakistan seeks to attract.

Skilled labour:

Addressing the challenge of labour availability at internationally competitive prices at SEZs in Pakistan requires assessments and deliberations on four broad areas before the right steps could be taken.

The first revolves around incentives. The current SEZ framework in Pakistan does not offer any incentive to zone enterprises for labour training. In contrast, in Philippines, SEZ enterprises get additional tax deductions for labour training expenses.¹¹² Similarly, the Slovak Republic and Serbia offer grants and aid for training and re-skilling labour, while Albania allows tax deductions equivalent to 200 percent of the training costs.¹¹³

The current SEZ framework in Pakistan stipulates SEZ developers to operate vocational training centres on a no-profit-no-loss basis.¹¹⁴ In order to incentivize developers, especially those in the private sector, and to ensure that the institutes grow and evolve with the industry's changing needs, one solution is to allow developers to set up for-profit institutes, whilst simultaneously addressing monopolistic concerns vis-à-vis training centres inside the SEZ.

In consideration of vocational training as a public good, another option for the government, SEZA in particular, is to partner with developers and zone enterprises to set up vocational training centres in public-private partnership (PPP) mode. This can help identify skills development needs, create programs to address those needs, and find sustainable funding sources. The PPP model was followed by Malaysia's Penang Skills Development Centre, which is credited for

¹¹¹ G. Dimitropoulos (2021). "International Commercial Courts in the 'Modern Law of Nature': Adjudicatory Unilateralism in Special Economic Zones", *Journal of International Economic Law*, Volume 24, Issue 2.

¹¹² Section 42, The SEZ Act of 1995 (Philippines SEZ act)

¹¹³ M. Petrovic (2017). *Tracking Special Economic Zones in the Western Balkans: Objectives, Features and Key Challenges*. Regional Study under Economic Reform Programmes. Paris: OECD

¹¹⁴ Rule No.15, SEZ Rules 2013.

being a key factor for Malaysia's economic transformation over the past two decades.¹¹⁵

The second area of assessment relates to the availability of skilled labour itself. The National Vocational & Technical Training Commission (NAVTTTC) recently published a study on future employment opportunities in fast-track prioritized CPEC SEZs in light of potential industries and indigenous endowments.¹¹⁶ In addition to such demand side assessments, the supply side also needs to be evaluated vis-à-vis availability of skilled labour in various vocations demanded and indicative wages through various skill gap surveys.

These supply-side surveys need to be conducted in the districts in which SEZs are located or planned, and in the districts from where labour may be expected to travel from or migrate, given current and historical trends. To this end, annual district-level labour force surveys will go a long way, since the Labour Force Survey currently conducted by the Pakistan Bureau of Statistics is only representative at the provincial level.

The third area relates to assessing the needs of the business community vis-à-vis existing labour laws. For instance, one related concern flagged by the business community is that the increase in minimum wages is higher than the increase in labour productivity, which is leading to a decrease in competitiveness compared to other countries.¹¹⁷ To this end, periodic construction of labour productivity data,¹¹⁸ and indices like CPI for Industrial Workers,¹¹⁹ to gauge workers' cost of living,

can help set minimum wages that are suitable for businesses and workers alike.

Lastly, there is a need to integrate national and provincial labour policies and skills strategy with the SEZs. For instance, the existing National Skills for All Strategy and the Technical and Vocational Education and Training (TVET) Policy for Pakistan does not spell out explicit measures for SEZs.¹²⁰ In light of increasing emphasis on the SEZs in Pakistan, there is a need to revisit SEZ-related federal and provincial policies and surveys, including the need for English and Chinese language training for workers in case of foreign investor concentration, and traveling and housing facilities for workers if the SEZs are located far from the pool of skilled labour sources.

Zone Operation & Maintenance

The current SEZ framework allows developers to set up captive power plants or install hydel power generators. In addition, the cabinet has also approved the policy of allowing developers to purchase gas, electricity and other utilities in bulk and supply the same to the enterprises at rates notified by SEZA in consultation with the stakeholders.¹²¹

These are encouraging developments that require a policy framework to give clear direction to stakeholders, and address risks, such as monopolistic concerns. In addition, it requires creating awareness among the business community, and encouraging it to bring their enterprise mindset to SEZs as developers and operators, which public sector

¹¹⁵ Farole, T. (2011). *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*. Directions in Development Series- Trade. Washington D.C.: WB.

¹¹⁶ The study, "Job Market Forecast and Skilled Labour Profiling Fast Track Special Economic Zones – China Pakistan Economic Corridor", is published by the NAVTTTC, and was conducted jointly with the Centre of Excellence for CPEC and the PIDE.

¹¹⁷ Charter of Economy (2020), The Pakistan Business Council (www.pbc.org.pk/wp-content/uploads/PBCs-charter-of-economy.pdf).

¹¹⁸ For example, the U.S Bureau of Labor Statistics publishes the Labor Productivity and Costs (LPC).

¹¹⁹ Labor Bureau India, for instance, publishes a monthly Consumer Price Index for Industrial Workers.

¹²⁰ National Vocational and Technical Training Commission, National Skills for All Strategy, (www.navttc.gov.pk/wp-content/uploads/2020/10/National-Skills-for-All-Strategy-2018.pdf); Technical and Vocational Educational Training Policy (www.navttc.gov.pk/wp-content/uploads/2020/10/NTP2018.pdf)

¹²¹ BoI, Annual Report (2018-19)

developers may not necessarily have given the incentive structure in the public sector.¹²²

Successful SEZs earn from services rather than sale of plots. This is because plot sales generate one-time revenue, which is often used for setting up another SEZ or is paid off as dividends to the developer. For SEZs to be sustainable, developers need a source of continuous inflows, such as income from various services.

Captive power is one such example of income from service: the sooner a developer colonizes the SEZs with operational zone enterprises, the earlier it would start earning revenues from selling power. Similar opportunities exist for selling RLNG; offering warehousing services; providing effluent treatment plants, desalinization plants and labs for testing; arranging conferences, seminars and meeting halls alongside co-working places; and setting up for-profit vocational training institutes. A policy framework that covers these aspects can help provide the necessary direction for long run sustainability of SEZ projects.

Financing for Zone Enterprises

In the absence of collateralizable land at the SEZs, the borrowing needs of zone enterprises may be facilitated by provincial and federal governments, since under the current SEZ framework the first charge remains with the developer i.e., the SEZ plot can only be surrendered back to the developer, which makes banks hesitant to lend to zone enterprises. These considerations necessitate a clear bank financing policy framework for the SEZs, where lessons may be drawn from the Chinese experience. Literature on Chinese SEZs shows that preferred credit policies, such as bank guarantees by the government and subsidized loans, were offered to zone enterprises in various SEZs and clusters.¹²³

In light of this, government guarantees could be provided to secure bank loans taken by zone enterprises for which the SEZ framework may be accordingly revised, facilitating banks to meet the borrowing needs of zone enterprises. Subsidized financing facilities may also be introduced for exporting and non-exporting zone enterprises with collateral requirements in sync with the realities of land title and valuations inside the SEZ.

Another option on the policy menu is to strengthen the cancellation policy of the SEZ plots sold to zone enterprises in case they do not commence operations in time or fail to meet other criteria, and to accordingly transfer the land title sooner rather than later. Currently, the title of the SEZ plot is not transferred to zone enterprises until six months have passed since the commencement of operations, even if purchase price of the plot has been paid in full. The government is hesitant to transfer the title before this period because it is concerned that zone enterprises may not set up production units at all or may not set them up in time, which will negatively affect SEZs performance. However, a stronger plot cancellation policy with clearly defined milestones may be considered in light of the proposed commercial courts solution and their potential jurisdiction over SEZs.

Lastly, instead of selling SEZ plots to zone enterprises, an altogether new regime may be considered, where the government provides land to developers on rent and the developers in turn provide the plots to zone enterprises on ground rent. This can substantially reduce the upfront cost of land paid by the developers and the zone enterprises, leading to a lowering of the amount of capital expenditure required for the setting up the project. In addition, this measure may also nudge developers away from the real estate model of developing and operating SEZs and may instead encourage innovative service-focused business models.

¹²² S. Burgess and M. Ratto (2003). "The Role of Incentives in the Public Sector: Issues and Evidence", *Oxford Review of Economic Policy*, 19(2): 285-300.

¹²³ Zeng D, 2010, Building Engines for Growth and Competitiveness in China Experience with Special Economic Zones and Industrial Clusters, World Bank

Monitoring & Evaluation

Given the importance of Monitoring and Evaluation (M&E) to the success of the SEZs, the information basis required for M&E needs to be expanded to include various indicators of inputs, outputs, outcomes and impact. This means that in addition to conventional datasets related to annual investment, number of companies, production, sales, exports, and taxation, indicators measuring spillovers also need to be tracked. These may include education and skill level of employees; ratio of foreign employees and consultants in total employees; spending on research & development; share of imports against sourcing through local vendors as well as surveys on types of goods and services sourced locally or imported along with the reasons for not sourcing locally.

A host of government agencies may be relied on for the purpose of monitoring and evaluation. For instance, Nepra can undertake monthly performance assessments in SEZs to assess average frequency and duration of power interruption. Similarly, sales tax and customs data can shed light on the degree of value-addition as well as linkages to vendors located outside the zones. A combined manufacturing index for SEZs may be constructed by Pakistan Bureau of Statistics to evaluate the trends in production inside the SEZs.

In addition, a periodic regulatory impact assessment would help towards improving the regulatory and legal environment for the SEZs. Another dynamic dimension of M&E is motivational studies of existing and prospective investors, which are important tools to assess the changing needs and interests of investors in various sectors of economy.

In terms of investor feedback, lessons may be learnt from South Korea, where a centralized investor feedback portal allows SEZ-related enterprises to provide feedback directly to the

highest government offices, including the PM office and key line ministries.¹²⁴ The usage of online reporting platforms for feedback and surveys, as against brick and mortar complain centres, can improve the feedback process, and hence improve the aftercare services at the SEZs. For the purpose of independent evaluation, a periodic specialized survey may be commissioned to assess different aspects of business environment in SEZs across the country.

Lastly the M&E framework of SEZs in Pakistan may also be revised to adopt international best practices as per which SEZ performance reports are to be submitted to the parliament, or otherwise made public via a government website.¹²⁵

7.6 Final Remarks

The two main rationales and conceptions of SEZs around the world are islands of excellence and laboratories for policy reforms. In both these conceptions, the SEZs in Pakistan have room for improvement.

The current SEZ framework and the ensuing government decisions have envisioned SEZs as designated areas that offer a business-friendly environment, as per international best practices. There have been some positive developments recently, such as the passing of the SEZ MIS regulations, which prevent real estate speculation. However, that vision is yet to be fully implemented; the one stop shop has not been set up, whereas overlapping coordination functions have led to delays in provision of infrastructure and utilities. In addition, policy frameworks to ensure business friendly climate in SEZs with respect to skilled labour and facilitative legal environment have not been announced.

As far as policy reforms is concerned, the current SEZ framework does not envision SEZs in Pakistan as areas that offer special policy and regulatory environment to businesses. Under current SEZ framework, all

¹²⁴ Source: JICA (2020). *Special Economic Zone Survey Report 2020*. Tokyo: JICA

¹²⁵ M. Alexianu, M. Saab, M. Teachout and A.K. Khandelwal (2019). *Doing Special Economic Zones Right: A Policy Framework*. IGC Policy Note. London: IGC

the SEZ authorities, organizations and persons engaged in the creation, development, operations and management of a SEZ are required to follow respective applicable laws and standards of Pakistan including vis-à-vis environment, employment, procurement, and building code, unless specifically exempted, relaxed or otherwise provided in the SEZ Act.¹²⁶

However, the current SEZ framework does not offer exemptions, with the exception of building codes. Here, Bangladesh's SEZ Act offers some useful insights. Not only does it exempt the SEZs in Bangladesh from various national and local government laws, it also allows the government to modify any other Act or do any other thing necessary to remove difficulties for growth and development of SEZs.¹²⁷

A concerted effort is required to address the challenges to the growth of SEZs in Pakistan, by graduating the SEZ framework from one that focuses on first-time colonization to one that also provides direction on operation and maintenance, financing, sustainability, monitoring and operation, and so forth. This necessitates deliberations over the creation of a separate centralized autonomous SEZ authority that would perform several functions. In addition to approving zones and developers, these functions include providing and updating regulatory guidelines; coordinating with relevant government departments across different levels on SEZ-

related matters; continuously monitoring zone performance aimed at providing best infrastructure and facilities within the SEZs; and assessing the impact of various policy reforms on the business climate within the SEZs.¹²⁸

In some countries, the role of the SEZ authority is performed by existing ministries; for example, in Kosovo, the Ministry for Trade and Industry acts as the regulator for all its free economic zones.¹²⁹ In others, such as Uganda and Sri Lanka, the Investment Promotion Agencies control the SEZs.¹³⁰ However, UNCTAD's World Investment Prospects Survey 2019, which includes 120 IPAs from 110 countries, notes that only 7.5 percent of the IPAs were performing the role of the SEZ authority in their country.

The findings of UNCTAD's survey resonate with international best practices, which suggest not to delegate regulatory powers to an IPA. Generally, the mandate of IPAs is to facilitate investment, and regulatory responsibility may lead to a conflict of interest and affect the performance of its core functions.¹³¹ Instead, autonomous or separate bodies are established as an institutional structure, with the mandate to regulate and manage SEZs and act as principal interface with developers and zone enterprises,¹³² as is the case in Bangladesh, Jamaica, Kenya, and Philippines.¹³³

¹²⁶ Rule 35, SEZ Rule, 2013.

¹²⁷ L. Cotula (2017). "The State of Exception and the Law of the Global Economy: A Conceptual and Empirico-legal Inquiry", *Transnational Legal Theory*, 8(4), 424-454.

¹²⁸ World Investment Report. (2019). *Special Economic Zones*. Geneva: UNCTAD

¹²⁹ M. Petrovic (2017). *Tracking Special Economic Zones in the Western Balkans: Objectives, Features and Key Challenges*, Paris: OECD

¹³⁰ Page, J. and F. Tarp (2017). *The Practice of Industrial Policy: Government-Business Coordination in Africa and East Asia. WIDER Studies in Development Economics*. Oxford University Press.

¹³¹ OECD (2021). *Middle East and North Africa Investment Policy Perspectives*. Regional Study under Economic Reform Programmes. Paris: OECD

¹³² A. Altbeker, K. McKeown and A. Bernstein (2012). *Special Economic Zones: Lessons for South Africa from International Evidence and Local Experience*. Proceeding of Round Table convened by CDE. Johannesburg: Centre for Development and Enterprise

¹³³ SEZs in Bangladesh, Jamaica, Kenya and the Philippines are regulated and supervised by Bangladesh SEZA (BEZA), the Jamaica SEZA (JSEZA), Kenya SEZA, Philippines Economic Zone Authority (PEZA), respectively. The institutions are constituted under their countries SEZ acts.

Annexure-I: Selection of Zone Enterprises

As per the latest regulations, potential zone enterprises have to submit an application to purchase land from the developer and apply for zone enterprise status through an online Special Economic Zone Management Information System (SEZMIS) maintained by the BOI. The regulatory framework has a set of defined documents and other criteria for zone enterprise applications, which potential zone enterprises have to file through the SEZMIS. Once the SEZ committee approves the zone enterprise application, the developer admits the zone enterprise into the SEZ.¹³⁴ The module is aimed at increasing transparency and shortening the time taken to complete the application process.

Approved by the Board of Approvals (BOA), the SEZMIS came into force in January 2021. It is a digital solution for registering zones for BOA's approval, and allocating plots and zone enterprise status to enterprises within the zone through an application made to the SEZ Committee.¹³⁵ Once the SEZ Committee awards zone enterprise status to an investor, it must commence construction within six months and business operations within 24 months;¹³⁶ the zone enterprise status on the other hand is needed by enterprises to become eligible for fiscal incentives.

Prior to the SEZMIS, land allocation and awarding of zone enterprise status took place separately. Neither were there regulations binding allottees to apply for zone enterprise status within a prescribed time, nor did a mechanism exist for simultaneous application for land allotment and zone enterprise status. Developers allotted the land, and then application for zone enterprise status was presented to the SEZ Committee via a separate process. The allottees looking to benefit from real estate activity did not apply for the enterprise status with the intention of avoiding construction deadlines, and instead sought capital gains on the allotted SEZ land.

This lacuna was corrected in SEZ Zone Enterprise Admission and Sale, Lease, and Sub-Lease of Plot Regulations, 2021. Article 3(20) of the regulation directs simultaneous admission and transfer of land possession to the investor with the status of zone enterprise. In addition, Article 3 (3-4) mandates potential investors to register on SEZ MIS, keeping all the stakeholders informed of the status of plots and applications. Accordingly, through the SEZMIS, the SEZ committee provides simultaneous time-bound approval for: (a) sale of plot, (b) possession of plot, (c) provision of utilities, and (d) enterprise status, leaving no room for real estate speculation. The developers too can only sell those to which infrastructure has been provided at their respective zero points, or has given an undertaking and timeframe for the same.

The portal's design complies with all the necessary regulations, and its interface acts as a checklist for all essential documents. It can only be used by an SECP-registered company, and have two types of users: zone developers and zone enterprises. After signing into the portal, the developer and the enterprise follow the application flow, with a different set of documents required at each step. Apart from this, complaints can also be registered via the portal.

The SEZ MIS increases the efficiency of the filing system and contributes towards creating an enabling business environment in the country. Within five months of its establishment, there were 70 active zone enterprises, compared to 200 for the eight years before the SEZ MIS (**Table A1**).

	Approvals under SEZ MIS	
	Before SEZ MIS	After SEZ MIS
	2012-20	Jan-May 2021
Approved Zone Enterprises	200	70
Investment (billion Rupees)	334.2	304
FDI (million US\$)	1,081.7	646.6

Note: FDI is not actual flows but commitment at the time of zone enterprise admission.

Source: Board of Investment

¹³⁴ SEZ Zone Enterprise Admission and Sale, Lease, and Sub-Lease of Plot Regulations, 2021.

¹³⁵ According to the SEZ Act, 2012, BOA will charter a committee for zones.

¹³⁶ Section 16, clause (1) (e), SEZ Act 2012

Annexure-II: List of Members for Different Regulating Bodies of SEZs

Board of Approval	Approvals Committee	Provincial SEZ Authority	SEZ Committee
Chairperson: Prime Minister; Vice Chairperson: Minister of Finance	Executives: heads of Provincial investment boards	Chairperson: Chief Minister of concerned province	The developer shall appoint the chairperson of the committee
Ministers for Industries, Production, Commerce, State & Frontier Regions Division	Representatives from Ministers for Industries, Production, Commerce, State & Frontier Regions Division	Vice Chairperson: Minister of Investment Department	Representatives from the developer
Two members from Majlis-e- Shoora	Private sector representatives	Chief Executive Officer appointed by Chief Minister of the province	Representatives from BOI, provincial investment promotion agency,
Chairman and Secretary BOI; Chairman FBR; Deputy Chairman Planning Commission; Governor SBP	Co-opted members from concerned federal and provincial government	Secretary of Provincial BOIs	Representative from SEZ Authority and relevant district government
Chief Minister of each province		Secretaries of provincial industries, finance, commerce, investment, work and services, livestock, agriculture and planning and development departments	
Executives: heads of Provincial investment boards		Two members to be appointed by CM of relevant province	
Presidents of: Federation of Pakistan Chambers of Commerce and Industry; Pakistan Business Council; and Overseas Investors Chamber of Commerce		A member to be appointed by the relevant chamber of commerce and industry	
A professional nominated by Prime Minister			

Source: Modified & Amended Special Economic Zones Act, 2012, as amended up to December 31, 2015

Annexure A: Data Explanatory Notes

- 1) **GDP:** In case of an ongoing year, for which actual GDP data is yet not available, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.
- 2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI (national, urban, or rural) from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation } (\square_{\text{Ht}}) = \left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation } (\square_{\text{YoYt}}) = \left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation } (\square_{\text{MoMt}}) = \left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where I_t is consumer price index in t^{th} month of a year. The CPI can be national, urban or rural. For detailed information on the methodology, please see:

<http://www.pbs.gov.pk/content/methodology-2>

- 3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of gross public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing, whereas financing is calculated by adjusting the government borrowing with its deposits held with the banking system; (ii) changes in the stock of debt also occur due to movements in exchange rates, both PKR and other currencies against US Dollar, which affect the rupee value of external debt.
- 4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

- (a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the “Ways and Means Advance” channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). Ways and Means Advance allows government to borrow up to Rs 100 million at a time in a year at an interest rate of 4 percent per annum;

higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir (AJK) may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum. However, the Federal Government has taken over from the State Bank of Pakistan (SBP) the business of direct credit to provincial governments on 29th June 2020. In this regard, the federal government has executed tripartite agreements with four provincial governments and SBP (as executer) for extension of Ways and Means loans on account of Federal Government Central Account No.I (non-food) on 29th June 2020.

Borrowing from scheduled banks: This is mainly through (i) fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs); (ii) monthly auction of 3, 5, 10, 15, 20 and 30 year fixed rate Pakistan Investment Bonds (PIBs); (iii) fortnightly auctions of 2, 3, 5, 10 year floating rate PIBs; (iv) Sukuk and (v) Bai Muajjal of Sukuk (on deferred payment basis). However, provincial governments are not allowed to borrow from scheduled banks.

(b) **Commodity finance:**

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

- (a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.
- (b) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on banking data, which depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record).

List of Acronyms

A

ADB	Asian Development Bank
AE	Advanced Economies
AEO	Authorized Economic Operators
AIIB	Asian Infrastructure Investment Bank
APCMA	All Pakistan Cement Manufacturers Association

B

bbl	Barrel
BBO	Branchless Banking Operators
BCS	Business Confidence Surveys
BEOE	Bureau of Emigration and Overseas Employment
BISP	Benazir Income Support Program
BOA	Board of Approval
BOI	Board of Investment
BOP	Balance of Payments
bps	Basis points
BRI	Belt and Road Initiative

C

CAB	Current Account Balance
CAD	Current Account Deficit
CAGR	Compound Annual Growth Rate
CAN	Calcium-Ammonium-Nitrate
CBU	Completely Built Up Unit
CCS	Consumer Confidence Surveys
CDMP	Circular Debt Management Plan
CDNS	Central Directorate of National Savings
CF	Construction Financing
CiC	Currency in Circulation
CIT	Corporate Income Tax
CKD	Completely Knocked Down
CM	Chief Minister
CNG	Compressed Natural Gas
CPB	Centraal Planbureau/Bureau for Economic Policy Analysis, Netherlands
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index

	CY	Calendar year
D		
	DAP	Di-Ammonium phosphate
	DI	Diffusion Index
	DIFC	Dubai International Financial Centre
	DIRBS	Device Identification Registration and Blocking System
	DISCOs	Distribution Companies
	DMMD	Domestic Money Market Department
	DRI	Direct Reduced Iron
	DSSI	Debt Service Suspension Initiative
E		
	EASA	European Union Aviation Safety Agency
	ECC	Economic Coordination Committee
	EDS	External Debt Servicing
	EE	Export Earnings
	EEC	Ehsaas Emergency Cash
	EFF	Extended Fund Facility
	EMs	Emerging Markets
	EMDEs	Emerging Market and Developing Economies
	EOBI	Employees' Old-Age Benefits Institution
	EPZA	Export Processing Zones Authority
	EPZs	Export Processing Zones
	ESCAP	Economic and Social Commission for Asia and the Pacific
	ESP	Economic Stimulus Package
	ETDZs	Economic and Technical Development Zones
	EU	European Union
F		
	FAO	Food and Agriculture Organization
	FASTER	Fully Automated Sales Tax e-Refund
	FATF	Financial Action Task Force
	FBR	Federal Board of Revenue
	FCVA	Foreign Currency Value Account
	FCY	Foreign Currency
	FDI	Foreign Direct Investment
	FED	Federal Excise Duty

FEE	Foreign Exchange Earnings
FI	Fixed Investment
FMCG	Fast Moving Consumer Goods
FO	Furnace oil
FOMC	Federal Open Market Committee
FPI	Foreign Portfolio Investment
FRDLA	Fiscal Responsibility and Debt Limitation Act
FTZs	Free Trade Zones
FX	Foreign Exchange
FY	Fiscal Year
G	
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GIS-FRR	Government of Pakistan Ijara Sukuk - Fixed Rental Rate
GIS-VRR	Government of Pakistan Ijara Sukuk - Variable Rental Rate
G-MSS	Government Markup Subsidy Scheme
GMTN	Global Medium-Term Note
GSM	Global System for Mobile communication
GST	General Sales Tax
GVA	Gross Value Addition
GVC	Global Value Chains
H	
HCV	Heavy Commercial Vehicle
HIDZs	High-tech Industrial Development Zones
HITE	Hub Industrial Trading Estate
HS	Harmonized System
HSD	High Speed Diesel
I	
IBA	Institute of Business Administration
IBIs	Islamic Banking Institutions
IBRD	International Bank for Reconstruction and Development
ICE	Intercontinental Exchange
ICT	Information and Communications Technology
IDA	International Development Association

IDB	Islamic Development Bank
IEs	Industrial Estates
IFPRI	International food Policy Research Institute
IGC	International Growth Centre
IH&SMEFD	Infrastructure, Housing and Small and Medium Enterprises Finance Department
IMF	International Monetary Fund
IPAs	Provincial investment promotion agencies
IPP	Independent Power Producers
IT	Information Technology
ITC	International Trade Centre
K	
KP	Khyber Pakhtunkhwa
KPMG	Klynveld Peat Marwick Goerdeler
KSA	Kingdom of Saudi Arabia
L	
LCV	Light Commercial Vehicle
LIBOR	London Interbank Offer Rate
LIC	Low Income Countries
LIDCs	Low Income Developing Countries
LMICs	Low and Middle Income Countries
LNG	Liquefied Natural Gas
LSM	Large Scale Manufacturing
LTFF	Long Term Financing Facility
LTV	Light Transport Vehicle
LUMS	Lahore University of Management Sciences
M	
M&E	Monitoring and Evaluation
M3-IC	M3-Industrial City
MDMP	Mobile Device Manufacturing Policy
MIPE	Monthly Survey of Industrial Production and Employment
MIS	Management Information System
MMT	Million Metric Ton
MNFSR	Ministry of National Food Security and Research
MoF	Ministry of Finance

MoM	Month on month
MPC	Monetary Policy Committee
MPI	Multidimensional Poverty Index
MPMG	Mera Pakistan Mera Ghar
MRTBs	Market Related Treasury Bills
MSCI	Morgan Stanley Capital International
MSP	Minimum Support Price
MT	Metric Ton
MTBs	Market Treasury Bills
MTO	Money Transfer Operator
MW	Megawatts
N	
NADRA	National Database and Registration Authority
NAVTTTC	National Vocational & Technical Training Commission
NBER	National Bureau of Economic Research
NDA	Net Domestic Assets
NEER	Nominal Effective Exchange Rate
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NFDC	National Fertilizer Development Center
NFIS	National Financial Inclusion Strategy
NFNE	Nonfood non energy
NHA	National Highway Authority
NOCs	No-Objection Certificates
NP	Nitro-Phosphate
NPC	Naya Pakistan Certificate
NRVA	Non-Resident Rupee Value Account
NSS	National Saving Center
NTFP	Non-timber forest products
NTR	Non-tax Revenue
O	
OCAC	Oil Companies Advisory Council
OECD	Organization for Economic Co-operation and Development
OGDCL	Oil and Gas Development Company Limited
OMO	Open Market Operation

	OPEC	Organization of the Petroleum Exporting Countries
	OSS	One-Stop Shop
	OTEXA	The Office of Textiles and Apparel
P		
	PBS	Pakistan Bureau of Statistics
	PDL	Petroleum Development Levy
	PED	Public external debt
	PFL	Floating Rate PIBs
	PFM	Public Finance Management
	PHPL	Power Holding Private Limited
	PIA	Pakistan International Airlines
	PIBs	Pakistan Investment Bonds
	PIDE	Pakistan Institute of Development Economics
	PIT	Personal Income Tax
	PKR	Pakistani Rupee
	PKRV	Pakistan Revaluation
	PM	Prime Minister
	POL	Petroleum, Oil, and Lubricants
	POS	Point of Sales
	PPCBL	Punjab Provincial Cooperative Bank Limited
	PPE	Personal protective equipment
	PPIB	Private Power and Infrastructure Board
	PPP	Purchasing Power Parity
	PPP	Public-Private Partnership
	PPR	Public Procurement Rules
	PR	Policy Rate
	PRA	Punjab Revenue Authority
	PRI	Pakistan Remittance Initiative
	PSDP	Public Sector Development Program
	PSE	Public Sector Enterprise
	PSEB	Pakistan Software Export Board
	PSX	Pakistan Stock Exchange
	PTA	Pakistan Telecommunication Authority
Q		
	Q1	First Quarter

	Q2	Second Quarter
	Q3	Third Quarter
	Q4	Fourth Quarter
	QIM	Quantum Index of Manufacturing
	QTA	Quarterly Tariff Adjustment
R		
	RDA	Roshan Digital Account
	REER	Real Effective Exchange Rate
	RFCC	Refinance Facility for Combating Covid-19
	RLNG	Regasified liquefied natural gas
	RPI	Relative Price Index
	RWALR	Real weighted average lending rate
S		
	SBP	State Bank of Pakistan
	SCRA	Special Rupee Convertibility Accounts
	SDR	Special Drawing Rights
	SECP	Securities & Exchange Commission of Pakistan
	SEZ	Special Economic Zone
	SEZA	SEZ Authority
	SEZMIS	Special Economic Zone Management Information System
	SEZs	Special Economic Zones
	SKD	Semi Knocked Down
	SLR	Statutory Liquidity Requirements
	SMEDA	Small and Medium Enterprise Development Authority
	SMEs	Small and Medium Enterprises
	SOE	State-Owned Enterprise
	SRB	Sindh Revenue Board
	SRO	Statutory Regulatory Orders
	STPED	Short-term public external debt
	STZA	Special Technology Zones Authority Act
	SUV	Sport Utility Vehicle
T		
	TDL	Total external debt & liabilities
	TERF	Temporary Economic Refinance Facility
	TR	Total reserves

	TSA	Treasury Single Account
	TT	Telegraphic Transfer
	TVET	Technical and Vocational Education and Training
	TWh	TeraWatt hour
U		
	UAE	United Arab Emirates
	UK	United Kingdom
	UN	United Nations
	UNCTAD	United Nations Conference on Trade and Development
	UNDESA	United Nations Department of Economic and Social Affairs
	UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
	UNIDO	United Nations Industrial Development Organization
	US	United States of America
	USD/US\$	United States Dollar
	USDA	United States Department of Agriculture
V		
	VA	Value Added
	VAT	Value Added Tax
W		
	WA ONR	Weighted Average Overnight Rate
	WALR	Weighted Average Lending Rate
	WAPDA	Water and Power Development Authority
	WB	World Bank
	WC	Working Capital
	WEO	World Economic Outlook
	WHT	With-holding Tax
	WPI	Wholesale Price Index
	WTO	World Trade Organization
Y		
	YoY	Year on Year
Z		
	ZTBL	Zarai Taraqiati Bank Limited