The analysis and projections presented in this report were prepared on data outturns for the July-December period of FY22 and finalized in April 2022, using data and developments as of then.

1 Overview

Pakistan's economic recovery continued in H1-FY22, with its momentum moderating in the second quarter. Indeed, from a first half perspective, the large scale manufacturing (LSM) exhibited broad-based expansion; exports grew buoyant alongside growth in FBR taxes; and *Kharif* crops recorded higher production **(Table 1.1)**. However, amid multi-year high global commodity prices, rising inflation and current account deficit posed a challenge as the year progressed. These pressures necessitated monetary tightening amidst other regulatory measures to moderate demand.

Selected Economic Indicators **Table 1.1**

	FY21		FY22		
	Q2	H1	Q1	Q2	H1
Growth rate (percent)					
LSM [a]	5.5	1.5	9.7	5.5	7.5
National CPI [a]	8.4	8.6	8.6	11.0	9.8
Private sector credit [b]	6.2	5.0	3.0	10.1	13.4
Money supply (M2) [b]	4.3	5.6	0.6	3.7	4.3
Exports [b]	0.7	-4.8	34.5	24.3	28.9
Imports [b]	4.4	-0.5	63.5	51.4	57.0
Ex. rate (+app/-dep percent) [b]	3.7	5.1	-7.7	-3.3	-10.7
FBR tax revenue [c]	6.2	5.6	38.3	26.9	32.1
Policy rate (end period) [b]	7.0	7.0	7.25	9.75	9.75
billion US$					
Remittances [b]	7.1	14.2	8.2	7.6	15.8
FDI in Pakistan [b]	0.4	0.9	0.5	0.6	1.1
FX loans (net) [b]	1.5	1.5	4.8	5.1	9.9
Current account balance [b]	0.4	1.2	-3.5	-5.5	-9.0
Change in SBP reserves [b]	1.3	1.3	2.0	-1.6	0.4
percent of GDP					
Fiscal balance [c]	-1.2	-2.1	-0.7	-1.5	-2.1
Primary balance [c]	0.1	0.6	0.3	-0.2	0.1

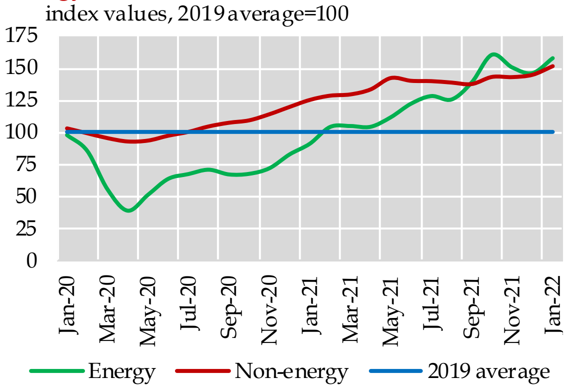
Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Ministry of Finance

Globally, the H1-FY22 period witnessed a Delta-driven surge in coronavirus cases in Q1, and the beginning of a new wave driven by the Omicron variant towards the end of Q2. However, the ongoing vaccine roll-outs, along with continuation of supportive policies (especially in the advanced economies), helped sustain the global economic recovery. Nonetheless, supply chain disruptions due to container shortages induced by Covid, and post-Covid global economic recovery, contributed to price hikes in internationally traded commodities **(Figure 1.1)**.

Within Pakistan, the slide in Covid-19 cases that began at the end of Q1 continued throughout Q2, as the Delta variant-driven wave fell rapidly by the end of H1-FY22. While the Omicron variant emerged by the end of H1-FY22, it did not lead to another wave of Covid cases during the review period **(Figure 1.2).** These improved conditions, alongside the government's vigorous vaccination drive, paved the way for largely uninterrupted economic activities.

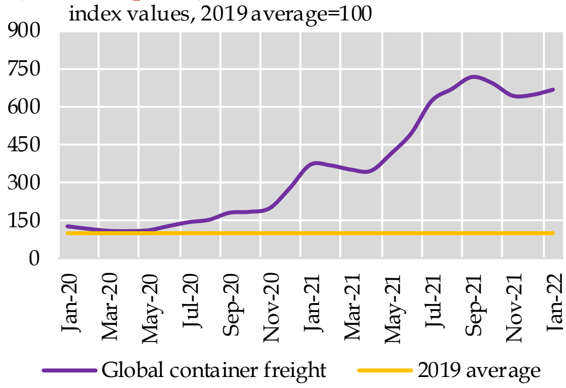
In addition, a combination of policy factors contributed to elevated domestic demand. In particular, expansion in federal and provincial development spending, along with an increase in non-interest current expenditures, supplemented economic growth outcomes. On the monetary side, two major factors facilitated capacity expansion and economic activities: the lagged impact of favourable monetary conditions of FY21 along with SBP's concessionary financing schemes; and an accommodative policy environment at the start of FY22. At the same

Trend in Global Energy & Non-Energy Prices **Figure 1.1a**



Source: World Bank Commodity Price

Container Freight Benchmark (WCI Composite) **Figure 1.1b**



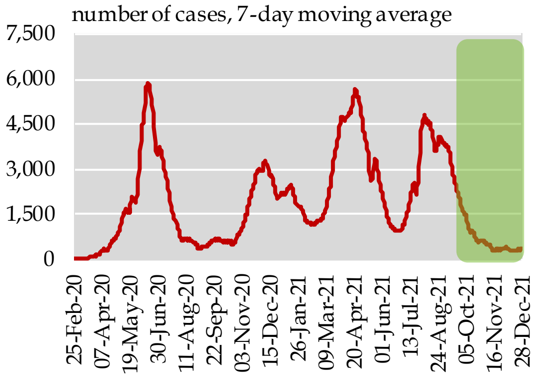
Source: Bloomberg

time, the continuation of the Export Finance Scheme (EFS) helped businesses cope with the surge in global commodity prices.

The LSM witnessed a broad-based increase in H1-FY22, although a rise of 9.7 percent in Q1 outweighed relatively moderate growth of 5.5 percent in Q2. In contrast to H1-FY21 when 11 out of 22 LSM sectors posted positive outcomes, 16 sectors recorded output growth in H1-FY22. In addition to SBP's Temporary Economic Refinance Facility (TERF), Long Term Financing Facility (LTFF) and other SBP schemes that helped the textile sector expand its capacity and output, fiscal policy measures also enabled this growth. Tax cuts (on domestic sales and imported inputs) for automobile were among the sector's drivers, whereas the steel sector continued to benefit from the government's construction package and higher development spending. Wearing apparel, a new addition to the LSM index, displayed a strong performance, in line with growing external demand for Pakistan's apparel products.

Growth in the agriculture sector during *Kharif* was primarily driven by record rice and sugarcane production, mainly due to an increase in the area under cultivation. Cotton production also increased over last year; it largely benefited from favourable weather conditions that enabled a sizeable increase in cotton crop yield, which offset the decline in its cultivated area. However, input utilization decreased during the second quarter in the *Rabi* season, with fertilizer usage declining notably due to higher prices.

Trend in Daily Covid-19 Cases Detected in Pakistan **Figure 1.2**



Source: World Health Organization

Private sector credit grew nearly fourfold in H1-FY22 on YoY basis. This was mainly on the back of working capital requirements that rose due to increased domestic demand, higher exports, as well as the global commodity price hike and ensuing jump in the Wholesale Price Index (WPI) during H1-FY22. The expansion in economic activities was also visible in the demand for loans for fixed investments and consumer financing. The growth in loans for fixed investments was mainly led by telecom and textile sectors; the former was on account of 4G license issuance and the latter due to TERF and LTFF-led machinery imports and capacity expansions. Despite slower growth in Q2, consumer financing grew 26 percent in H1-FY22. The pace of growth in consumer financing had experienced a policy-induced moderation in Q2, as auto and personal loans posted negative growth following increases in the policy rate and introduction of regulatory measures to curtail demand. However, this was offset by consistent growth in house building loans in both quarters partly due to the SBP's mandatory targets for housing and construction. Soaring global commodity prices, coupled with growing domestic demand, especially for industrial inputs, also resulted in a widening of the current account deficit, despite double-digit growth in workers' remittances to US$ 15.8 billion in H1-FY22. Exports grew considerably in the first half, notwithstanding some deceleration in the second quarter. Both higher unit prices and export volumes contributed to this growth. While these dynamics were generally visible across both textile and non-textile segments, rising export volumes of value-added textile items played a dominant role in pushing up the sector's exports. As a result, overall exports saw a US$ 3.4 billion year-on-year increase in H1-FY22 to US$ 15.2 billion – their highest ever half-yearly outturn.

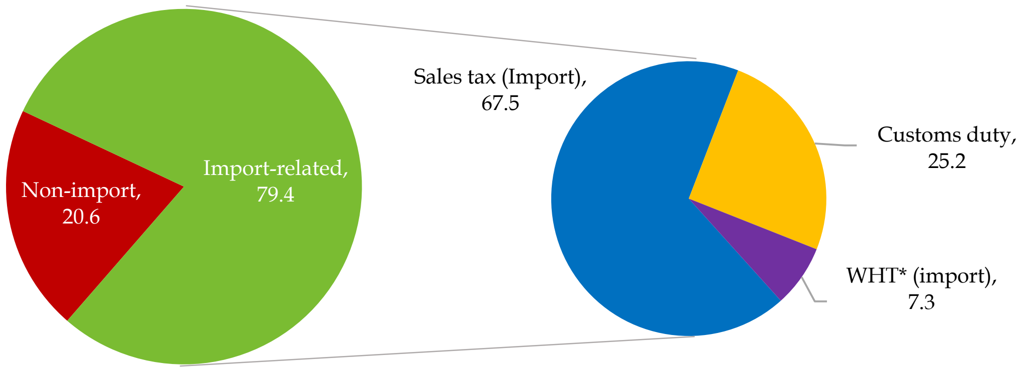
Nevertheless, despite slower import momentum in the second quarter, the increase in H1-FY22 imports was nearly four times the increase in exports. In addition to the dominant role of high global commodity prices, import growth was also buoyed by elevated demand for raw materials and capital goods; Covid-19 vaccine procurement; and the continued need to import wheat and sugar to plug domestic supply gaps.

Amid the widening current account deficit, the PKR depreciated 10.7 percent in the interbank market during H1-FY22. However, the SBP's FX reserves remained relatively stable. Complementing the US$ 1 billion inflow from Eurobond issuance and the additional SDR allocation of US$ 2.8 billion from the IMF in Q1, bilateral deposits of US$ 3 billion from Saudi Arabia in Q2 supported the SBP's FX reserves position.

The confluence of costlier imported commodities (such as edible oil and pulses) and some demand-side pressures pushed national CPI inflation (NCPI) into double digits during H1-FY22. Food inflation, the biggest contributor in H1-FY22, was mainly driven by non-perishables, which more than offset the decrease in the prices of perishable food items. In addition, upward adjustments in administered prices of petrol, LPG, and electricity continued to push up input costs. At the same time, core inflation also ticked up, with prices of more than half of non-food non-energy (NFNE) items in the urban and rural baskets posting above-average increases during the second quarter.

In the wake of broad-based inflationary pressures and the widening of the current

Growth Contribution of Import-Related Taxes in Overall FBR Tax Collection* - H1-FY22 (percent) **Figure 1.3**



*Import-related taxes include: sales tax (imports), custom duty and Withholding tax (WHT) on imports
Source: Federal Board of Revenue

account deficit, the monetary policy committee (MPC) increased the policy rate by 25 basis points at the end of Q1. Subsequently, with the balance of risks shifting more quickly than expected away from growth and toward inflation and the current account due to larger and more persistent global price increases, the MPC raised policy rates twice in the second quarter: 150 basis points in November 2021, followed by 100 basis points in December 2021. This normalization of monetary policy settings was aimed at ensuring sustainability in both economic growth and the external account, as well as anchoring inflation expectations.

Apart from the rate hikes, three additional measures were taken to moderate the demand pressures. First, the average cash reserve requirement for banks was increased to tighten the money supply. Second, prudential regulations for consumer financing were tightened by the end of Q1, and its impact became visible in Q2 through a contraction in auto and personal loans. Third, 100 percent cash margins were imposed on an additional 114 items in September 2021, bringing the total number to 525 items.

On the fiscal side, the overall deficit remained unchanged in H1-FY22 at last year's level of 2.1 percent of GDP. However, the primary balance narrowed to 0.1 percent of GDP in H1-FY22, from 0.6 percent in the same period last year, as the increase in non-interest expenditures more than offset the robust rise in tax revenues.

Non-interest expenditure rebounded sharply in H1-FY22, on the back of increased spending on social protection and subsidies. Federal PSDP rose by almost one-fifth in the first half, although it declined in Q2 due to the government's efforts to contain the fiscal deficit. On the revenue side, FBR taxes grew by 32 percent in H1-FY22, notwithstanding somewhat slower growth in Q2, as economic activities improved and general price levels rose as compared to last year. However, most of this increase stemmed from import-related taxes, on account of the broad-based increase in import volumes, international commodity prices and PKR depreciation **(Figure 1.3)**.

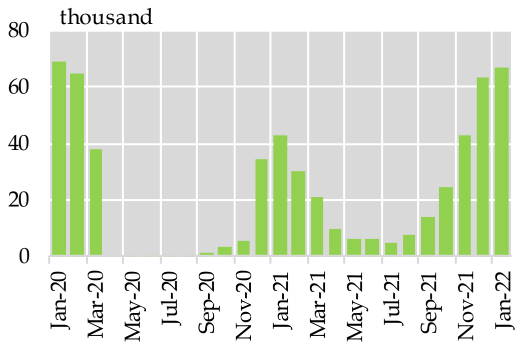
In addition to various structural impediments to sustained economic growth, as consistently highlighted in SBP's quarterly and annual reports, there is a need to increase public-private collaboration in the planning and implementation of different kinds of reforms. To this end, regular public-private dialogue (PPD) plays an important role for economic growth and development, especially as government planning around the world has become participatory, collaborative and market-oriented in nature.

In this regard, a special section in this report underscores the role of Trade Organisations (TOs). With a focus on local TOs, the section highlights their importance in making PPD effective and in providing market-complementing services to their members. It also identifies some gaps that need to be addressed to ensure that local TOs fulfil their intended objective of improving the business environment and contributing towards the country's economic growth and development.

2 Economic Outlook

The economy is expected to grow around the middle of the forecast range of 4-5 percent for FY22, lower than last year's growth of 5.6 percent. This outlook is based on three main factors. First, industrial output across some sectors may exhibit a slowdown, in part due to the lagged impact of monetary tightening and other regulatory measures taken in H1-FY22. In particular, the slowdown may also be visible in sectors affected by consumer financing, such as automobiles and other consumer goods. However, export-oriented sectors are expected to continue benefiting from the SBP's concessionary financing schemes (EFS and LTFF), as the increase in interest rate on EFS, announced in April 2022, is expected to have a lagged impact.

Number of Migrants Going for Work to GCC **Figure 1.4**



Source: Bureau of Emigration and Overseas Employment

Second, uncertainty surrounds the agriculture output. On one hand, estimates for *Kharif* agriculture output are promising, with record production estimated for sugarcane and rice and decent growth expected for cotton. However, on the other hand, downside risks stem from vulnerabilities faced by wheat crop, which was marked by lower input usage in Q2-FY22. Third, the performance of commodity-producing sectors would continue providing the impetus for service sector growth, whereas import growth would also provide support.

On the fiscal side, the rationalization of GST exemptions, including elimination in some cases, bodes well for the fiscal deficit in FY22, which is projected to be slightly lower than last year. However, higher than expected commodity prices, including oil, may increase the government's spending on subsidies, given its decision in March 2022 to freeze fuel and power rates.

NCPI inflation is expected to be slightly exceed the forecast range of 9-11 percent in FY22, as revised upward by the MPC in its decision on April 07, 2022. The government's decision to reduce and freeze administered prices of fuel and power in March 2022 significantly offsets the risks emanating from the persistent rise in global commodity prices. However, the upside risk stems from a more-than-expected increase in global oil, food and fertilizer prices, owing to the geopolitical tensions between Russia and Ukraine. Both these countries are major suppliers of multiple commodities including oil, gas, wheat, fertilizer, metals and edible oil (sunflower oil).

Workers' remittances are expected to post decent growth in FY22 on the back of rising incomes in oil-exporting GCC countries and the advanced economies. Moreover, the monthly flow of Pakistani workers has reverted to pre-Covid levels as well **(Figure 1.4)**.

Exports are projected to continue expanding in FY22, as the cuts in fuel and power rates would help exporters maintain competitiveness in international markets, amid continued support from the SBP's concessionary financing schemes and estimates of record rice output. However, export growth prospects face risks from policy reversal in advanced economies, which may impact consumer spending and thereby slow the pace of their economic growth. Moreover, the impact of the Russia-Ukraine war also poses a downside risk to demand in the EU, considering that Russia supplies nearly 40 percent of the EU's energy needs.

The sharp increase in global commodity prices will keep import payments at an elevated level in FY22, partly offsetting the expected decline in import volumes on account of lagged impact of monetary tightening on overall economic activity, and other demand-compressing regulatory measures. As a result, the current account deficit is projected to increase to around 4 percent of GDP.

Nonetheless, the external account pressure is expected to remain manageable. Some big-ticket import items, such as Covid-19 vaccines and energy imports (oil and LNG), are mainly imported in kind, which means that they are financed via external sources instead of the interbank FX market. External financing for these purchases is recorded in the financial account. Moreover, the completion of the 6th EFF review in February 2022 unlocked an additional US$ 1 billion from the Fund, whereas the country also issued a Sukuk for US$ 1 billion in January 2022. The country is also likely to retain access to multilateral and commercial financing, which would help sustain the SBP's liquid FX reserves.