1 Overview

1.1 Economic Review

Halfway through the current fiscal year, stabilization efforts have yielded notable improvements (**Table 1.1**). The current account deficit has shrunk significantly, foreign exchange reserves have risen markedly, the primary budget balance has moved into surplus, and core inflation has lately eased. Moreover, export-led manufacturing has gained further traction and signs of a pickup in construction activities have emerged recently, suggesting the economy is on the path of gradual recovery. Also, performance under the ongoing IMF program remains strong, and international rating agencies maintained a stable outlook for Pakistan.

These gains primarily reflect the cumulative effect of stabilization and regulatory measures taken during the past one year. For instance, the reduction in the current account deficit to a six-year low level in H1-FY20 was facilitated by demand management measures, transition to a market-based exchange rate system, and regulatory efforts to curb non-essential imports and to increase the inflow of workers' remittances through formal channels. Similarly, the improvement in the fiscal position also reflects the impact of tax and non-tax measures to increase the revenue stream, and a significant restraint on expenditures by the government. In this stabilization process, domestic production and retail trade activities were adversely affected.

Table 1.1: Economic Indicators

	FY19	H1-FY19	H1-FY20
	Growth rate (percent)		
LSM[a,1]	-3.3	-1.7	-2.8
CPI National (period average YoY)[a,2]	6.8	6.0	11.1
Private credit[b]	11.6	9.5	3.2
Money supply [b]	11.3	3.6	5.2
Exports[a]	-1.1	1.9	3.1
Imports[a]	-9.9	-2.6	-17.0
FBR tax revenue (billion Rs)[c]	3,828.5	1,794.8	2,094.1
Exchange rate (+app/-dep%)[b]	-24.1	-12.5	3.4
	million US dollars		
SBP's liquid reserves (end-period)[b]	7,280.4	7,203.7	11,336.1
Workers' remittances[b]	21,838.6	11,030.0	11,394.9
FDI in Pakistan[b]	1,668.0	796.8	1,341
Current account balance[b]	-13,830.0	-8,614.0	-2,099.0
Fiscal balance (% of GDP)[d]	-8.9	-2.7	-2.3

[2]YoY growth in the average of CPI index for half year. New base (2015-16)

Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

While the economic activity has started to show signs of a recovery, it is important to consolidate gains on stability front. More specifically, progress in some areas remains vulnerable and more work is needed to put the economy on a firm path toward sustainable growth.

Developments in the balance of payments highlight this aspect. In particular, decline in the current account deficit has mostly stemmed from a reduction in the import bill; whereas, export receipts have yet to contribute significantly to this improvement. This is largely due to depressed international commodity prices, which partially offset the gains in terms of export volumes offered by a competitive exchange rate. Moreover, a narrow manufacturing base and limited market penetration of Pakistan's exports did not help either. Second, the outcome for foreign direct investment (FDI) inflow was also not encouraging as barring the telecommunication sector, inflows were about at the same level as last year. This dynamic needs to be addressed because FDI is intrinsically linked to the county's ability to expand its manufacturing and export base in the medium term. Therefore, to attract and sustain higher FDI inflows in the country, reform-related efforts need to be prioritized.

In the same vein, the primary budget surplus on the back of a substantial growth in revenues is encouraging. Domestic tax collection grew to its highest since H1-FY12, as the FBR reversed earlier concessions, resorted to new levies and also benefited from price increases especially in the energy sector. Nevertheless, the overall revenue targets were missed, primarily due to significant compression in the country's imports, which contributes heavily to revenue collection. These developments suggest scope for greater efforts to broaden the tax base and increase documentation in the economy. Moreover, the coordination between fiscal and tax authorities also needs to be enhanced to align expenditures' growth with expected revenue stream.

The real sector too has its long-standing challenges, especially in the agriculture sector. For instance, crop yields are low and water availability is constrained. With additional challenges such as climate change emerging, agriculture production appears less resilient to externalities. This year too, the cotton crop succumbed to unfavorable weather, low water availability, and pest attacks. The decline in cotton production is therefore set to undermine the agriculture performance in FY20, despite encouraging prospects for wheat crop and livestock.

On the inflation front, core inflation in both urban and rural areas has remained stable during H1-FY20, reflecting the impact of stabilization measures. However, easing of underlying inflationary pressures was not sufficient to arrest the climbing headline inflation, which was largely led by food inflation. Thus, headline inflation overshadowed the stability in core inflation, and consumer confidence (which remained low in H1-FY20) further declined in the November-2019 wave of the IBA-SBP Consumer Confidence Survey. The policymakers, nonetheless, anticipated only a temporary impact of these food supply shocks on the future inflation path and kept the policy rate unchanged in both the September- and November-2019 decisions of the Monetary Policy Committee. However, it was also recognized that if these shocks result in sustained increases in inflation (such as on a month-on-month basis) they could entrench inflation expectations.

Thus, to make the stabilization successful on a sustainable basis, current efforts must be complemented with further structural reforms. In effect, greater policy vigilance and more vigor are required for the needed transition from stabilization to growth. In this regard, in addition to several other recommendations made in the past SBP reports, this report identifies the suboptimal state of competition in the domestic economy as an area needing immediate attention of the policymakers.

In this context, **Special Section** in this report, assesses the current state of competition in the country, and highlights the importance of competition for achieving economic growth and price stability in the economy. The latter is particularly important from the point of view of monetary policy, as central banks across the world prioritize targeting price stability as one of their major objectives. The section argues that the overall competitive environment in Pakistan has not been favorable for productivity enhancement and growth. In this context, a fundamental rethinking is needed with respect to the regulatory structure of the economy. The role of the public sector should generally be limited to addressing market failures through structural reforms, and only providing broad institutional support to businesses. Where targeted interventions are inevitable to initiate activity in the presence of market failures, it may be ensured that these are not entrenched.

1.2 Economic Outlook

Pakistan’s economy had clearly moved out of the crisis-management mode before the Covid-19 infections started to be detected in the country. The current account numbers were getting better every month, and foreign exchange reserves were shoring up steadily. In addition, headline inflation was expected to revert to the medium-term target of 5–7 percent over the next 24 months. Nevertheless, achieving this year’s real GDP growth target of 4.0 percent was unlikely, as the agriculture sector’s performance was lower than expectations, whereas the export-driven growth in LSM was not sufficient to compensate for the subdued domestic market activity. Therefore, the SBP’s projections for GDP growth were revised to 3.0 percent in FY20, down from 3.3 percent last year. These projections are now likely to be revised downward further. But more broadly, with the twin deficits relatively under control, encouraging progress on FATF, a stable outlook from the credit rating agencies and confidence provided by the IMF program, Pakistan's economy had begun to improve. However, this optimism is now subject to risks arising from the global and domestic spread of Covid-19.

Covid-19 outbreak

Emerging from the city of Wuhan in China, the novel coronavirus has spread to 212 countries at the time of this writing, with around 1.4 million confirmed infections across the world. The World Health Organization has declared the virus a pandemic and urged countries to implement effective containment strategies. A large number of countries have completely suspended flight operations to contain the spread, and have implemented stringent measures to ensure social distancing. Nonetheless, the financial impacts of Covid-19 have already been sizable, and the economic effects are still unfolding.

At first, the Covid-19-related panic, along with the Saudi-Russia standoff over crude oil, jolted global capital and commodity markets. Global crude oil prices have fallen to 21-year low levels amid fears of a global recession and abundant supplies. From the demand standpoint, a significant impact on prices has also come from China, the original epicenter of Covid-19, which recorded a 13.5 percent contraction in industrial activity during the first two months of 2020 (though some recovery was recorded in March 2020).[1] In addition, sudden shutdowns faced by global aviation, automotive, tourism, and energy companies have significantly increased vulnerabilities in these sectors. In other sectors also, subdued retail buying, unsold inventories and disruptions in supply chains are triggering pressures – though improved liquidity buffers in the global banking industry (aided by recently announced monetary stimulus packages) have avoided financial distress so far.

As a result, the overall global economic outlook remains highly uncertain and clearly subdued compared to the pre-outbreak estimates, with layoffs expected to spike in response to lockdowns.[2] The OECD, ADB and IMF have all downgraded their growth outlooks for the global economy. Governments and central banks have responded with their traditional toolkits: many emerging market economies,

[1] Source: National Bureau of Statistics of China.

[2] According to the US Department of Labor, a record 6.6 million people filed for unemployment insurance in one week (ending March 28, 2020), which marks "the highest level of seasonally adjusted initial claims in the history of the seasonally adjusted series". This increase was on top of 3.3 million claims filed in the preceding week, which means that around 10 million people faced job losses in two-week time.

such as India, Indonesia, Malaysia, Philippines, South Africa, and Vietnam have lowered interest rates. The Fed has lowered interest rates to zero and also rolled out a quantitative easing program (initially worth US$ 700 billion). The ECB also put in place a similar program of US$ 820 billion to support EU economies. Later, both the Fed as well as the ECB removed the limits assigned to these bond purchase programs. Unemployment benefits are being scaled up in some countries, along with cash outlays, whereas selective tax breaks have also been offered.

Coming to Pakistan, the number of confirmed Covid-19 cases at the time of this writing has surpassed 4,400 – including both primary infections and secondary spreads. To minimize incremental infections, the government has suspended domestic and international flight operations and strictly tightened cross-border movement. Moreover, provincial governments have implemented lockdowns in various regions, allowing uninterrupted operations only in critical sectors, such as healthcare. Most avenues of social interactions, such as educational institutions, shopping centers, theaters and restaurants, have been closed down, whereas public transport, including ride-hailing services, have been suspended. Most employees of financial institutions, factories and businesses are working remotely, wherever possible, and only critical staff are being allowed at workplaces. All these measures will clearly weaken domestic economic activity and consumer demand.

Moreover, the spillover from the global economic slowdown may also be significant. On the positive side, as a net oil importer, Pakistan would benefit from the substantial decline in global oil prices. Apart from contributing to the SBP's disinflation efforts, this will further reduce the import bill and the current account deficit.

On the negative side, however, the outbreak of the virus in Europe and North America and the ensuing lockdowns may have an adverse impact on Pakistan's exports. Domestic exporters have already warned of cancellation of orders as retail sales in destination markets weaken and port and shipping activities are restricted. Under such circumstances, exporters may face a cash crunch for some time. Meanwhile, remittances from major destinations may decline temporarily in the coming months, with some transient downward impact on domestic consumption. Financial markets too have come under severe pressure. The equity market was the hardest hit, as domestic investors grew wary of the pandemic's trajectory. The corporate sector was already struggling with subdued demand and thin margins, which has now been compounded by the Covid-19 related uncertainty. The debt market too faced selling pressure, as foreign investors took

out over US$ 1.7 billion from T-bill investments in the month of March 2020, contributing to depreciation pressures in the foreign exchange market.
At this point, it is important to note that the situation with respect to Covid-19 is extremely fluid and uncertain. The government is responding fast to unfolding developments. Preventing the spread and ensuring robust healthcare facilities to test and treat patients, remains the top policy priority of the government. Ensuring food security is another important agenda on which the government is strategizing proactively and carefully. Moreover, social safety nets are also being beefed up to help minimize the impact of lockdowns on daily wage earners and laid-off workers. Certainly, all this requires a sizable amount of fiscal spending. More recently, the government has announced a Rs 1.2 trillion economic relief package which includes a steep cut in domestic petrol prices, stipend for daily wage earners and expansion in the scope for cash assistance under the Ehsas program, immediate release of export refunds by the FBR, deferment of utility bill payments, and additional allocation for the Utility Stores Corporation.

As for SBP, it has taken important measures to minimize the impact of Covid-19 on the economy. Within a span of 8 days (March 17 – 24, 2020), the Monetary Policy Committee (MPC) cut the policy rate by a cumulative 225 basis points. Furthermore, the SBP has announced multiple measures to facilitate the general public's access to financial services amid the Covid-19, simplified procedures for exporters and importers, and allowed banks leeway in booking losses pertaining to the outbreak on their financial statements (**Box 1.1**).

Box 1.1: Recent Measures Announced by the SBP to Mitigate the Impact of Covid-19

1. **Refinance Facility for Combating Covid-19 (RFCC)**: To support hospitals, medical centers for the purchase of equipment to detect, contain and treat the Covid-19; total size of the scheme is Rs5 billion.

2. **Advance payment limits withdrawn on coronavirus-related imports:** SBP has allowed all federal and provincial government departments, public and private hospitals, charitable organizations, manufacturers and commercial importers to make Advance Payment Import and Import on Open Account, without any limit, for the import of medical equipment, medicines and other ancillary items for the treatment of Covid-19.

3. **Facilitating credit flows to borrowers and easing loan repayment schedule:**
SBP has reduced the Capital Conservation Buffer from its existing level of 2.5 percent to 1.5 percent; this effectively increases the loanable funds available with banks by around Rs 800 billion. Furthermore, the debt burden ratio requirement for consumer loans has been relaxed from 50 percent to 60 percent, which is expected to allow about 2.3 million individuals to borrow more from banks.

To ease borrowers' financing constraints, banks have been instructed to defer the payment of principal on loans and advances by one year, with no adverse consequences for the borrowers' credit history. For borrowers whose financial conditions require relief beyond extension of principal repayment for one year, SBP has relaxed the regulatory criteria for restructuring/rescheduling of loans. The loans that are re-scheduled/restructured within 180 days from the due date of payment will not be treated as defaults, and banks would also not be required to suspend the unrealized mark-up against such loans. In addition, the timeline for classification of "trade bills" has been extended from 180 days to 365 days.

4. Extension in export performance periods for EFS & LTFF: Exporters availing the subsidized credit schemes are required to ship their goods within 6 months of availing credit under EFS. In case of failure, penalties are imposed. This period has been extended from six to twelve months.

Exporters were required to show performance under the EFS schemes by end-June 2020. This period has been extended by 6 months to end December 2020. Since the additional period will also be counted towards setting new limits, this will help the exporters in availing higher limits for FY21.

Exporters who want to avail credit under Long Term Financing Facility (LTFF) are required to have exports worth 50 percent, or US$ 5 million, of the total sales to become eligible. This limit has been reduced to 40 percent or US$ 4 million for all the borrowings under LTTF during the period January 01, 2020 to September 30, 2020. Moreover, the requirement of annual projected exports performance for four years to avail LTFF, has been extended by another year.

5. Extension in realization of export proceeds & arrival of goods under advance payment: SBP has allowed banks to enhance the time period for realization of exports proceeds from existing 180 days to 270 days on a case by case basis where the delay is related to Covid-19. To facilitate importers, SBP has extended the time period for import of goods into Pakistan against advance payment from existing requirement of 120 days to 210 days.

SBP has allowed exporters to directly dispatch the shipping documents of their exports' consignment to their foreign buyers without any limit, subject to some conditions. Earlier, exporters could dispatch the shipping documents directly to their foreign buyers for export consignments of up to USD 100,000, or equivalent in other currencies.

For importers, the SBP has enhanced the existing limit of US$ 10,000 per invoice for advance payment on behalf of manufacturing & industrial concerns and commercial importers for import of raw material, spare parts and machinery, to US$ 25,000.

6. Electronic submission of foreign exchange-related cases to SBP: The SBP has activated the Regulatory Approval System (RAS) for banks to electronically submit foreign exchange operations and policy-related cases to the Foreign Exchange Operations Department (FEOD) and the Exchange Policy Department (EPD).[3] The RAS would allow banks' customers to receive system-generated update status reports via email, from the time of case submission till completion.

7. Credit to SMEs: To incentivize banks to provide additional loans to retail SMEs, the existing regulatory retail limit of Rs 125 million per SME has been permanently enhanced to Rs 180 million.

8. Equity selloff and margin call requirements against bank financing: Keeping in view the steep decline in equities, margin call requirement of 30 percent vis-a-vis banks' financing against listed shares has been reduced to 10 percent. Banks have also been allowed to take exposure on borrowers against the shares of their group companies. Banks are also allowed to book impairment loss on their "available for sale" equity securities in a phased manner till December 2020.

[3] For cases pertaining to the EPD, banks are to submit the cases manually by surface mail as well, until further instructions are issued.

9. Disinfected cash notes: Detailed instructions have been provided by SBP to ensure to clean, disinfect, seal and quarantine all cash being collected from hospitals and clinics and to block circulation of such cash in the market. The banks shall report daily collection of cash from hospitals to SBP, which shall credit bank's accounts for the amounts so quarantined by them.

10. Stimulate investment in manufacturing via Temporary Economic Refinance Facility (TERF): SBP will refinance banks to provide financing at a maximum end-user rate of 7 percent for 10 years for setting up of new industrial units. The total size of the scheme is Rs 100 billion, with a maximum loan size per project of Rs 5 billion. It can be accessed by all manufacturing industries, with the exception of the power sector. It will require a letter of credit (LC) to be opened by end-March 2021.

11. No charges on IBFT/ATM withdrawals: SBP has instructed banks to waive all charges on fund transfers through online banking channels such as Inter Bank Fund Transfer (IBFT), SBP's Real Time Gross Settlement System, and ATMs

12. General customer facilitation measures
Banks have also been encouraged to adopt business processes that reduce customers' need to visit bank branches and minimize interaction time between customers and bank staff. These instructions cover processes where biometric verification of customers is required, such as account opening and branchless banking transactions. Banks have also been encouraged market their alternative delivery channels (online banking, ATMs etc), to reduce customer traffic at branches. SBP has also facilitated the cheque-clearing process, by allowing banks to provide Direct Cheque Deposit Facility under which a crossed cheque may be presented by the payee/beneficiary directly to the paying/drawee bank, instead of their bank branches (as per the prevalent practice). Banks have also been allowed to process scanned copies of cheques (for corporate and priority customers) after proper due diligence, and to facilitate customers by collecting cheques from customers' addresses.

1.3 Summary of the Report

Real sector

Overall, real economic activity was somewhat subdued during H1-FY20. The industrial sector in particular was affected by the impact of continuing macroeconomic stabilization measures. Nonetheless, a number of sectors managed to shrug off the economic slowdown and posted a solid performance, suggesting some bottoming-out of activity. The fertilizer sector was a case in point. Last year, small urea producing units had been inactive for three months during H1-FY19; however, this year, such small units remained active throughout the first half, leading to YoY growth in production. Furthermore, the current period saw an uptick in growth for the cement and textile industries, boosted by exports. The major drag on LSM came from the decline in production of the automobile sector; while the remainder was mostly attributed to petroleum and steel.

For agriculture, early estimates suggest that despite some improvement in area under wheat, the drag from decline in cotton production and negligible growth in sugarcane and rice output may limit the sector's growth during FY20. An increase in the area sown under wheat was reported compared to last year, and the availability of inputs was also better in the *rabi* season. However, the area under wheat still remained below its FY20 target.

In the services sector, proxy indicators for *wholesale and retail trade*, like LSM, sectoral credit offtake, and growth in imports, suggested subdued activity. A similar picture emerged for the transport sub-sector, judging from a sharp dip in commercial vehicle sales in H1-FY20 and lower sector-wise POL sales. By contrast, the communication sub-segment appeared to fare better, with further gains in cellular teledensity and a 69.2 percent growth in mobile phone imports. Meanwhile, within *finance and insurance*, the after-tax profits of the banking sector grew by 21.0 percent during H1-FY20 compared to a year earlier.

Inflation & Monetary Policy

Inflationary pressures continued to build through the first half of FY20, as the headline inflation rose by 11.1 percent, compared to 6.0 percent in the same period last year, primarily because of a steep surge in food inflation. This trend was attributed to a number of factors such as temporary supply disruptions in perishables, higher transportation costs and sales tax rates on major kitchen items including edible oil and sugar. In contrast, non-food-non-energy (NFNE) inflation moderated on the back of demand compression; not only did it remain almost at the previous year's level, but it also declined in Q2-FY20, compared to the preceding quarter.

Therefore, despite a rise in inflation during the period under review, SBP's projections for average headline inflation for FY20 remained broadly unchanged at 11-12 percent. In addition, a notable improvement in the country's balance of payment situation (that also led to appreciation in Pak rupee) and an overall adherence of the government to fiscal consolidation efforts, also contributed to stability in the short-term inflation outlook. Therefore, the Monetary Policy Committee of SBP decided to keep the policy rate unchanged in its meeting held in November 2019; the prevailing rate seemed appropriate to the committee for bringing inflation down to the target range of 5-7 percent over the medium term.

As for the implementation of monetary policy, fewer interventions were required to keep interbank overnight rates close to the target rate. Furthermore, overnight interest rates exhibited less volatility during Q2-FY20, compared to the previous quarter. The ease in liquidity stemmed from net retirement by government to scheduled banks, as the government mobilized higher financing from external and non-bank sources during Q2-FY20, and also used its deposits (cash buffers) held with SBP.

In addition, credit demand from the private sector was also weak as industrial activities remained largely subdued. Some vibrancy was observed in export-oriented sectors, but their borrowing registered only a marginal increase compared to last year. These sectors enjoyed improved liquidity on account of higher exports earnings and smoother disbursement of tax refunds. Importantly, there was a compositional shift in favor of foreign currency loans, which entailed a similar interest rate gap as was available in case of SBP's concessional rupee financing scheme (EFS).

Fiscal Policy and Public Debt

A significant improvement was seen in the fiscal sector during H1-FY20. Both fiscal and revenue deficits were contained compared to the corresponding period last year. The fiscal deficit as a percent of GDP reduced from 2.7 percent in H1-FY19 to 2.3 percent in H1-FY20. The primary surplus surpassed the target and revenue growth was substantially higher, while expenditures on social sector and development picked up strongly. The rise in revenue collection was attributed to both tax and non-tax revenues. Policy measures such as increase in GST on petroleum products, enactment of taxes on telecom services, increased excise duty on cement and cigarettes, upward revision in salary slabs, adjustments in power tariffs, end of preferential treatment for certain sectors and zero-rating regime for five export-oriented sectors played an important role in higher tax collection. Non tax revenues, mainly coming from SBP profits and GSM renewal fees, also provided impetus to overall revenue collection. That said, import compression continued to adversely affect revenue mobilization.

On the expenditure side, both current and development expenditures grew sharply during H1-FY20. In particular, a sharp growth in expenditures was witnessed in the second quarter which more than offset the rise in revenues. Higher growth of current spending was led by interest payments and grants. In addition, development expenditures also grew both at federal and provincial levels with a higher pace during H1-FY20, mainly led by a rise in spending on infrastructure projects and social sectors.

Public debt accumulation was contained partly due to lower financing needs and partly due to an appreciation of PKR against the US dollar. Moreover, the government utilized its deposits with the banking system (especially in Q2) to meet its financing needs and also for retirement of existing debt stock. The government strictly adhered to its commitment of zero borrowing from the central bank and mobilized funds through commercial banks (mainly in Q1) and NSS. Meanwhile, external debt increased in dollar terms by US$ 3.7 billion during H1-

FY20 on account of fresh borrowing from multilateral and commercial sources, receipts of IMF tranches, and a rise in foreign investment in government securities. Debt servicing (both principal and interest payments) of public external debt increased to US$ 5.9 billion. Within principal payments, Sukuk (US$ 1.0 billion), bilateral and short-term credit repayments recorded a significant increase.

External Sector

Primarily led by a broad-based contraction in imports, the external account recorded a notable improvement, with the current account deficit (CAD) falling to a six-year low in H1-FY20. The reduction in imports resulted from ongoing macroeconomic stabilization measures, lower oil prices and power sector's shift away from furnace oil-based generation. In particular, import demand in the transport sector remained subdued, as automakers faced a sizable drop in car sales. This had a spillover effect on the steel sector, reducing its demand for imported steel scrap and finished products. Moreover, regulatory measures aimed at curbing non-essential imports and dumping by trading partners played a role in curtailing import payments.

Meanwhile, low global commodity prices continued to suppress export earnings of Pakistan's major export products, i.e. textiles and rice, offsetting decent rises in export volumes. Textile and rice exporters managed to increase their market shares in the EU, US, and Middle East. The currency adjustment in the recent past allowed exporters to remain competitive in the challenging global environment. At the same time, remittances continued to grow, on the back of higher inflows from the US, the UK and Saudi Arabia.

Introduction of a market-based exchange rate, and foreign investors' perception about its sustainability, helped the country to attract external financing during the period. The sizeable inflows from IFIs (including the IMF), commercial banks and portfolio investors allowed debt and deposit repayments during the period. These inflows allowed SBP to unwind its net short position in the forward market and re-build its reserves, which reached a twenty month high of [US$ 11.3 billion] by end-December 2019. As a result, the Pak Rupee appreciated 3.4 percent against the US Dollar during the period.