1 Overview

As the economy moved into the third quarter of FY20, COVID-19 related lockdowns began to take their toll on an otherwise favorable macroeconomic trajectory following the necessary stabilization measures of recent times. Improvement in the inflation outlook was the exception as the real, fiscal, and external sectors deteriorated. Both production and retail activities came near to a standstill towards the end of the quarter and led to a significant contraction in economic activity **(Table 1.1)**. Such was the severity of the COVID-19 shock that after 68 years Pakistan's real GDP is provisionally estimated to record a negative growth of 0.4 percent for FY20.

Table 1.1: Selected Economic Indicators

		FY18[F]	FY19[R]	FY20[P]
Growth rate (percent)				
Real GDP	Jul-Jun	5.5	1.9	-0.4
Agriculture	Jul-Jun	4.0	0.6	2.7
Industry	Jul-Jun	4.6	-2.3	-2.6
o/w LSM	Jul-Jun	5.1	-2.6	-7.8
Services	Jul-Jun	6.3	3.8	-0.6
CPI (period average)[a]	Jul-Mar	4.6	6.3	11.5
Private sector credit [b]	Jul-Mar	9.1	10.2	4.8
Money supply (M2)[b]	Jul-Mar	4.8	5.1	8.5
Exports [b]	Jul-Mar	11.9	-1.1	1.1
Imports [b]	Jul-Mar	18.4	-3.4	-16.2
Tax revenue –FBR [c]	Jul-Mar	16.2	2.9	12.6
Exchange rate (+app/dep%)[b]	Jul-Mar	-9.2	-13.7	-4.0
Policy rate [b]	end-Mar	6.0	10.75	11.0
ONMMR [b]	end-Mar	5.7	10.0	10.7
billion US dollars				
SBP's reserves (end-period) [b]	Mar	11.6	10.5	10.8
Worker remittances [b]	Jul-Mar	14.8	16.0	17.0
FDI in Pakistan [b]	Jul-Mar	2.1	0.9	2.1
Current account balance [b]	Jul-Mar	-13.0	-10.3	-2.8
percent of GDP[1]				
Fiscal balance[d]	Jul-Mar	-4.3	-5.1	-4.0
Current account balance	Jul-Mar	-5.4	-4.8	-1.4
Investment	Jul-Jun	17.3	15.6	15.4

P=Provisional; F= Final.

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

As expected in most other countries, this contraction in Pakistan's GDP is due to a decline in output of industrial and services sectors. Prior to the lockdowns, the industrial sector's performance continued to improve during the first two months of Q3-FY20 on account of gradual improvements in large scale manufacturing (LSM). While recovery in food and fertilizers helped, improved growth in exportable sub-sectors such as, textiles, leather and cement generated much of the momentum.

However, COVID-19 related disruptions during March FY20 adversely affected the nascent recovery in LSM as its growth declined by 22.0 percent on month-on-month basis. Nevertheless, the agriculture sector remained largely immune from the impact of COVID-19 and posted positive growth during FY20. Important crops managed to perform better despite missing their annual targets as unfavorable climate conditions and losses due to pest and locust attacks hurt yields. Faced with lockdowns and a lower level of output from the tradeable sectors, services sector growth deteriorated sharply towards the end of Q3-FY20 and turned negative for FY20.

Similarly, towards the end of Q3-FY20, the fiscal sector's performance also started to falter due to the large size of the shock to the economy. Specifically, notable gains in terms of primary budget surplus of the first half turned into a deficit during Q3-FY20. Growth in all categories of FBR taxes turned negative in March FY20 after recording encouraging gains earlier in the fiscal year. As the onset of lockdowns disrupted mobility and unemployment increased sharply, strong pressures to provide direct support to the most vulnerable segments of the society, especially in the informal sector, emerged.

Consolidation efforts during the earlier months of the fiscal year contributed positively towards creating the room that helped the government announce a meaningful relief package of PKR 1.24 trillion towards the end of Q3-FY20. Apart from direct handouts, it also includes sector specific outlays for agriculture, construction and exports. This package is being rolled out and would add to the deficit over the next few months.

On the external front, the current account deficit during Jul-Mar FY20 receded to only a quarter of last year's level. This was particularly led by a steep reduction in energy imports on account of lower international oil prices coupled with lower domestic demand, a decent growth in workers' remittances, and a significant reduction in the services deficit. The improvement in current account deficit along with multilateral financial inflows and some increase in foreign investments thus added to the SBP's FX reserves, which touched US$ 12.8 billion in February FY20 after 2 years.

However, as the COVID-19 led global panic resulted in foreign investors offloading their domestic debt holdings across emerging markets in March FY20, SBP reserves ticked down and the Pak rupee depreciated in the same month. Also, both export receipts and workers' remittances were adversely impacted, resulting in current account deterioration in Q3-FY20 compared to Q2-FY20. In general, the impact of COVID-19 on Pakistan's asset prices and financial markets has been very much in line with that in other emerging markets.

Conversely, inflation outcomes have actually improved during Q3-FY20. Early on, last quarter's supply disruptions in the food sector were keeping headline inflation accentuated despite relatively steady core inflation, as measured by NFNE component of CPI, and contained inflation expectations. As a result, the Monetary Policy Committee (MPC) kept the policy rate unchanged during its January 2020 meeting. However, the situation changed rapidly towards the end of Q3-FY20 as COVID-19 started to spread globally and in Pakistan. This led to a further improvement in medium-term inflation prospects due to a notable slowdown in domestic demand, stabilizing food inflation and historic low international oil prices.

Supported by the favorable outlook for inflation, the MPC reversed its stance after 22 months and sharply reduced the policy rate by a cumulative 625 bps, starting with its regular meeting in mid-March FY20; followed by two first-ever emergency meetings before its next regular meeting in May FY20, and another emergency meeting in June FY20. SBP further supplemented these decisions by rolling out various refinancing schemes. These were designed to meet the short-term liquidity needs of households and firms, safeguard employment during the lockdown, and facilitate import of medical equipment for treatment of the disease, while creating an enabling environment for a robust pick-up of economic activity and exports in the post-COVID-19 environment.

While taking stock of developments so far during FY20, it is evident that the steadfast conduct of prudent policies early on resulted in favorable outcomes. The half-yearly surplus in the primary budget balance—the first since 2016—stemmed from notable fiscal consolidation measures; prudent and proactive conduct of monetary policy led to a softening in core inflation; and the policy shift to a market-determined exchange rate policy played a crucial role in reducing the current account deficit sharply and building a robust FX reserves buffer in the pre-COVID-19 environment. In turn, these improved macroeconomic fundamentals provided room for fiscal and monetary policy adjustments to contain adverse impacts when COVID-19 suddenly hit the economy from the second half of the fiscal year.

At the same time, the advent of this pandemic-related shock should not undermine the urgency of addressing long-standing structural impediments to higher and sustainable medium-term growth. In this regard, a Special Section in this report underscores the importance of Technical and Vocational Education and Training (TVET) with regard to growth and development. It emphasizes the need to raise productivity and skills so that the labor force can meaningfully contribute to Pakistan's goals for industrialization and export-driven growth.

Economic Outlook

As the economy moves towards the end of FY20, it continues to be faced with high uncertainty owing to the challenges posed by the COVID-19 pandemic on several economic fronts. The biggest concern is the fast growth in the extent of the disease. As the count of new infections is increasing every day, this shows that the distribution has not yet peaked. High levels of uncertainty are also reflected in recent SBP surveys. The Consumer Confidence Survey of May 2020 recorded a sharp deterioration in both consumer confidence and expected economic conditions following their improvement in March 2020. Similarly, the Business Confidence Survey of April 2020 registered its lowest historical level for overall business confidence. Importantly, Pakistan is not an outlier in this regard, as the global economic uncertainty index[1] also recorded its historic peak in April 2020, indicating a global manifestation of uncertainty at present.

However, going forward, there are some prospects for gradual improvement in economic activity as the government is easing the lockdown while allowing many sectors to resume activities. This may result in a supply side revival, though agriculture sector outlook is at risk from locust attacks, which can unfavorably impact the ongoing *kharif* season's output. Nonetheless, achieving the target of 2.1 percent growth in real GDP during FY21 will require a parallel improvement in underlying demand. This requires effective utilization of PSDP as per its allocation in the budget for FY21, while SBP schemes continue to support liquidity needs of both businesses and consumers. High demand for these schemes is indicating the stress faced by economic agents due to COVID-19; whereas, a growing number of approvals is increasing liquidity support that is going to be helpful in containing the pandemic

[1] www.policyuncertainity.com

related adverse fallout on supply and demand (**Table 1.2**).

Table 1.2: Progress under Various SBP Schemes to Counter COVID-19 by June 26, 2020*

1. Refinance Scheme for Wages to Prevent Layoffs	
Numbers of businesses financed	1,817
Number of employees covered	1,183,242
Amount of financing approved (billion Rs)	119.1
2. Loans Deferment and Restructuring	
Number of borrowers provided relief	1,045,173
Amount of principal deferred up to 1-year (billion Rs)	566.2
Amount of restructuring allowed (billion Rs)	112.8
3. Refinance Scheme for Hospitals to Combat COVID-19	
Number of hospitals	35
Amount of financing approved (billion Rs)	6.3
4. Refinance Scheme for Setting-up New Projects or Expansion/BMR	
Number of projects	16
Amount of financing approved (billion Rs)	9.7

*Visit www.sbp.org.pk/corona-update.html for more details and updates on number of applications and approvals under SBP schemes to counter COVID-19.
Data source: State Bank of Pakistan

On the fiscal front, consolidation achieved earlier in the year reversed as the COVID-19 shock started unfolding. Expenditures increased while revenues saw a sharp decline in their growth during Q4-FY20. Thus, fiscal deficit is estimated to touch 9.0 percent of GDP for FY20, against 4.0 percent recorded during Jul-Mar FY20. As we step into FY21, roll out of the much-needed socioeconomic support package may continue to keep government expenditures high in the coming months. However, the gross revenue target of PKR 6.57 trillion for FY21 is challenging as it entails significant growth over FY20 in a low economic activity environment. As current expenditures, such as interest payments and pensions, are expected to consume major share of the revenues, the government needs to have an efficient debt management policy while ensuring PSDP expenditures as per budget during FY21.

The inflation outlook is encouraging, although not without risks. Low domestic demand should continue to support a further softening trend in CPI headline inflation and stability in core inflation over the coming months. As a result, inflation is expected to fall in the range of 7.0-9.0 percent during FY21. However, recent increase in petrol prices have tilted risks on the higher side of this range. While low global demand may keep international oil prices subdued in the coming months, any agreement for a large cut in oil supply by OPEC members can be another upside risk for both inflation and its future expectations. Similarly, any new locust attacks of high intensity or COVID-19 related supply chain disruptions may hurt food security, resulting in higher inflation.

The outlook for the external sector is reasonably comforting, with the current account expected to remain bounded. While higher competition among competing exporters amid recovering global demand in the post-COVID-19 setting may restrict any quick recovery in exports, imports are expected to remain subdued due to low domestic demand and soft international oil prices in the coming months. While workers' remittances may remain low as current disruptions and declining oil prices have strained economies of GCC countries, some cushion in services imports may come from restrictions on international travel. However, multilateral inflows may grow further and make up for some weakness in global capital inflows as more funds have been pledged by various international institutions to help governments cope with their pandemic related relief efforts.