1 Overview

Pakistan economy started to regain its pre-Covid trajectory in the first quarter of FY21. There was a notable pickup in economic activity, as large-scale manufacturing (LSM) gained traction, demand indicators recorded encouraging growth, and all major *Kharif* crops, except cotton, exceeded their respective production targets. Consistent with this, the services sector also showed buoyancy. The external and fiscal sector indicators improved as well, with both the current account deficit and the primary deficit turning into surpluses during Q1-FY21 (**Table 1.1**). However, owing mainly to food prices, national CPI inflation remained on the high side.

The overall recovery is attributed to two main factors: the national strategy that contained the pandemic and the timely and well-calibrated support measures of the government and the SBP. The latter gave an extra impetus to the resumption of economic activity in Q1-FY21, after the lifting of lockdowns. In particular, compared to the demand compression focus in Q1-FY20, fiscal and monetary policies were accommodative in Q1-FY21, geared towards mitigating the economic fallout of the Covid shock.

Therefore, the contraction in economic activity in Q4-FY20 proved to be short-lived. In particular, industrial activity gathered momentum. Within LSM, the growth in cement and food processing sectors stood out during Q1-FY21, while the automobile segment also witnessed a revival. There was a corresponding uptick in demand indicators such as cement dispatches (which reached an all-time high), POL and car sales, power generation, consumer financing and fast moving consumer goods (FMCG) sales (**Figure 1.1**). Consistent with these trends, indicators of the labor market, as collated from statistical bureaus of Punjab and Sindh, the SBP Business Confidence Survey (BCS), and PBS data on wages, also pointed towards growth in employment during July-August 2020. The improvement was also captured in the SBP BCS, of August 2020, as the sentiment of the business community turned positive for the first time since the February 2020 wave of the BCS.

Selected Economic Indicators **Table 1.1**

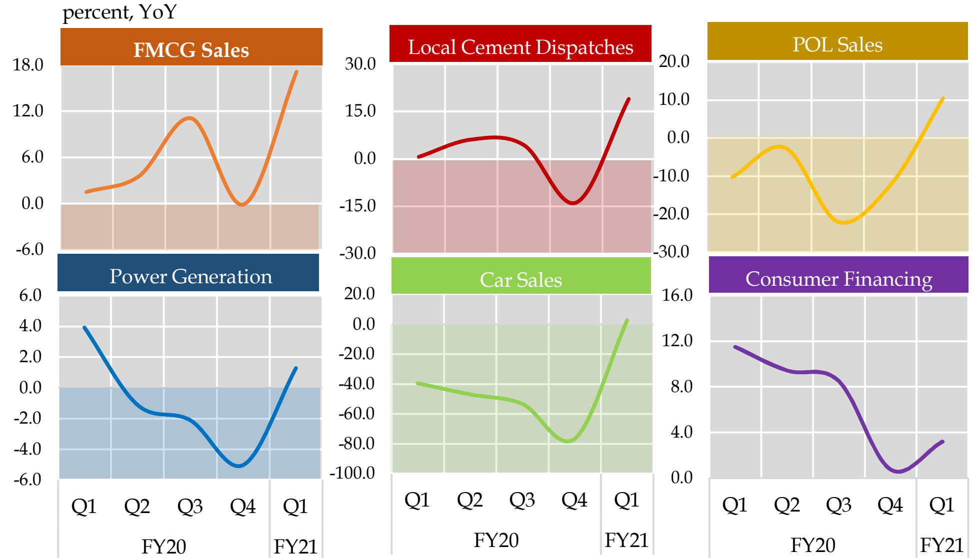
	FY20	FY20		FY21
	Full Year	Q1	Q4	Q1
Growth rate (percent)				
LSM [a]	-9.9	-5.5	-24.8	5.0
National CPI [1 a]	10.7	10.1	8.4	8.8
Private sector credit [b]	2.9	-0.3	-1.8	-1.1
Money supply (M2)[b]	17.5	0.6	8.2	1.2
Exports [b]	-7.2	1.6	-31.6	-10.4
Imports [b]	-18.2	-20.6	-24.4	-3.8
Exchange rate [2 b]	-4.8	2.4	-0.8	1.4
Tax revenue –FBR [c]	4.4	15.9	-15.2	4.8
Policy rate [3 b]	7.0	13.25	7.0	7.0
billion US Dollars				
SBP's reserves [3 b]	12.1	7.9	12.1	12.2
Workers' remittances [b]	23.1	5.5	6.1	7.1
FDI in Pakistan [b]	2.6	0.5	0.4	0.4
percent of GDP				
Fiscal balance [d]	-8.1	-0.7	-4.1	-1.1
Primary balance [d]	-1.8	0.7	-2.3	0.6
Current account balance [b]	-1.1	-2.3	-0.4	1.1

[1]period average [2]appreciation (+)/depreciation (-) in percent [3]end period

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

Growth in Demand Indicators **Figure 1.1**

percent, YoY



Source: SBP, APCMA, PAMA, OCAC, NEPRA & Corporate reports (various issues)

Also, the government's incentives for the construction sector provided impetus for its allied manufacturing segments.[1] The SBP complemented this effort by assigning mandatory targets for housing and construction finance, which required banks to increase their mortgage portfolios to at least 5 percent of their private sector credit by end-December 2021.

In the agriculture sector, rice, sugarcane, and maize surpassed their production targets during the Kharif season. In addition to an increase in the cultivated area of rice and sugarcane compared to last year, the government's agriculture package, with a particular emphasis on fertilizer subsidy, also contributed to the favorable outcome. That said, the area for the competing cotton crop fell to its lowest level since FY82, and its yield was adversely affected by severe monsoon rains, particularly in Sindh, and pest attacks.

There was also improvement in the services sector during Q1-FY21, especially in key segments like *wholesale and retail trade* and *transport, storage and communication*. This was reflected in proxy indicators such as higher import volumes, FMCG sales and sale of commercial vehicles. Also, the mobility of people and, by extension, the delivery of services – which had been severely disrupted by the earlier lockdowns – was largely back to pre-Covid levels by end-September 2020.

Meanwhile, the external sector continued to navigate the Covid crisis smoothly, as the current account posted a surplus in Q1-FY21 after a lapse of 21 quarters. The surplus was

[1] This included subsidies for low-cost housing, relaxations for investors regarding source of income, and simplification of paperwork and approvals.

largely attributed to a noticeable increase in workers' remittances and a sharp fall in services imports, which more than offset the deterioration in the merchandise trade balance during the review period.

Within the trade balance, the deterioration came from a decline in export receipts compared to the same period last year, as demand remained soft among key trading partners and exporters were permitted to hold receipts abroad for a longer timeframe in the wake of Covid. Nonetheless, considering the pandemic-induced slowdown in the global economy, Pakistan's export performance was relatively better compared to a number of other emerging markets. This was partly due to the government's handling of the Covid outbreak and the relatively early resumption of economic activity, which gave export-oriented sectors like textiles a head start in capturing export orders. As a result, exports regained their pre-Covid trajectory in September 2020, helped by higher export receipts for textiles, cement and pharmaceuticals.

On the other hand, import payments also remained lower than the same period last year. This owed to the steep drop in global oil prices, which helped offset some of the upward pressure emanating from rising imported food prices. Meanwhile, Covid-related air travel restrictions dampened the level of Pakistan's services imports.

While these restrictions also helped divert workers' remittances from informal to formal channels, continued policy measures under the Pakistan Remittance Initiative (PRI) and the promotion of formal and digital channels had a major role as well. Thus, workers' remittances exceeded US$ 2 billion for the fourth consecutive month in September 2020, and contributed to the improvement in the current account balance.

This improvement gave a further boost to the country's overall FX reserves, and strengthened the exchange rate. Specifically, the country's FX reserves rose to US$ 19.4 billion by end-September 2020. At the same time, SBP reserves improved by a further US$ 4.2 billion over the last year. Meanwhile, the exchange rate appreciated by 1.4 percent during Q1-FY21.

The overall fiscal deficit was higher in Q1-FY21 in YoY terms. This outcome could be traced to the Budget FY21 which aimed to strike a balance between deficit reduction and extending support to the vulnerable segments. Moreover, tariff concessions on various raw materials were offered to catalyze the growth in industry and exports. Thus, FBR tax revenues recovered visibly as economic activities resumed, and also remained higher than the target set for the quarter. However, overall revenues remained lower than last year, with non-tax revenues recording a decline. On the expenditure side, development spending was scaled up, as the government expedited progress on ongoing infrastructure projects and uplifting of under-developed areas. However, spending on power and petroleum was rationalized, and wages and salaries were kept unchanged.

As a result, the primary balance posted a surplus of 0.6 percent during Q1-FY21, almost the same as in Q1-FY20. However, the steep rise in interest payments consumed over 73 percent of FBR taxes and constituted nearly 53.8 percent of total federal expenditures.

The government's continued adherence to fiscal discipline was also reflected in zero fresh borrowing from SBP. Nonetheless, the higher YoY fiscal deficit led to an increase in the stock of public debt. However, the build-up of government deposits was relatively contained compared to Q1-FY20, which contributed to a lower pace of debt accumulation this year. At the same time, the government was able to lengthen the maturity profile of public debt by mobilizing funds through floating rate, long-term instruments.

Moreover, a surplus in the current account and debt relief provided by G-20 countries under the Debt Service Suspension Initiative (DSSI) provided support to external debt management. The government reverted to concessional borrowing sources during Q1-FY21, and achieved a lower average cost of borrowing for the third successive quarter.

As for prices, there was a slight increase in headline inflation during Q1-FY21, compared to the preceding quarter. The upward pressure originated from food inflation, as supply side factors drove up the price of non-perishable and perishable food items. These factors have both a domestic component (below-target domestic production of wheat, commodity management issues, impact of heavy rain on yield of perishable crops), and a foreign component (recovery in prices of global agricultural products compared to Q4-FY20). Both domestic and foreign components have been affected by Covid-related supply chain disruptions and unfavorable weather conditions.

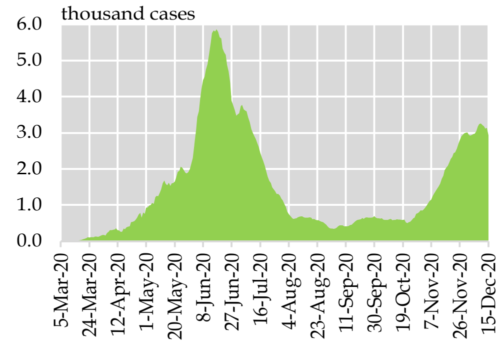
Nonetheless, the impact of rising food prices on headline inflation was partially offset by subdued underlying inflationary pressures, as measured by non-food-non-energy index. This tapering in core inflation during Q1-FY21, despite an uptick in domestic demand, was due to well-anchored inflation expectations. Furthermore, exchange rate appreciation, tax and tariff concessions of the Budget FY21, and relatively stable transportation costs played a part in keeping core inflation in check.

Therefore, the Monetary Policy Committee (MPC), in its September 2020 meeting, held the view that the accommodative stance created by the prevailing policy rate of 7.0 percent and other facilitative policies of both the government and the SBP were sufficient to support the emerging recovery while keeping inflation expectations anchored and safeguarding financial stability. Besides this monetary policy stance, the central bank's policy measures enabled banks to strengthen resilience and limit credit risk despite the Covid shock.[2] Take-up under the different regulatory relief and refinancing facilities of the SBP has also evolved in line with the trajectory of Covid cases in Pakistan. More recently, take-up of the Temporary Economic Refinance Facility (TERF), providing financing at low rates for investment, is now seeing healthy pick-up as the economy recovers and businesses feel more confident about future prospects. Specifically, the amount requested under TERF has increased from Rs 36.1 billion at end-April 2020 to Rs 441.1 billion as of 19 November, 2020, with approved financing rising from Rs 0.5 billion to Rs 192.2 billion during this period.

[2] For details of the central bank's measures to counter Covid, see the following SBP publications: (1) 'The State of Pakistan's Economy' Third Quarterly Report for FY20; (2) 'The State of Pakistan's Economy' Annual Report for FY20; and (3) Financial Stability Review - 2019. Furthermore, the features, timeline, and performance of the SBP's Covid-related measures are also available at: sbp.org.pk/COVID/index.html.

The improvement in various economic indicators during Q1-FY21 is encouraging. However, its continuation in the short term depends to a large extent on the trajectory of the pandemic, while sustainable growth over the medium term would require progress on the structural reforms front. For example, as noted in the SBP's Annual Report for FY20, reforms related to improvements in the tax structure, pricing and governance issues in the energy sector, and restructuring or privatization of loss-making state-owned enterprises are imperative. In addition to these, public pension restructuring is another important area for reform. This report includes a special section on public sector pension expenditure in Pakistan, which has risen rapidly over the past decade. Given the fiscal constraints, the section proposes improvements in the public pension framework through various steps like proper indexation of increments, elimination of retrospective increases, and rationalization of survivorship benefits.

New Covid-19 Cases in Pakistan (7-day rolling avg.) **Figure 1.2**



Source: World Health Organization

Key Macroeconomic Targets and Projections **Table 1.2**

	FY20	FY21 Target[1]	FY21 SBP[2] Projections
percent growth			
Real GDP	-0.4	2.1	1.5 - 2.5
CPI (average)	10.7	6.5	7.0 - 9.0
billion US Dollars			
Remittances	23.1	21.5	24.0 - 25.0
Exports (fob)	22.5	22.7	23.0 - 24.0
Imports (fob)	42.4	42.4	43.0 - 44.0
percent of GDP			
Fiscal deficit	8.1	7.0	6.5 - 7.5
Current a/c deficit	1.1	1.6	0.5 - 1.5

Source: [1]Ministry of Finance; Planning Commission; [2]SBP

Economic Outlook

As the economy recovers from the Covid-induced contraction, it is now faced with uncertainty related to intensification of the second wave of the pandemic. This concern poses both upside and downside risks to the SBP's macroeconomic projections.

Real GDP growth is projected to be in the range of 1.5 to 2.5 percent in FY21 (**Table 1.2**). This is based on the current trends of economic activity. However, downside risk to this projection includes the second wave of Covid, which has swept across many countries and, in Pakistan's case, gained momentum in November 2020 (**Figure 1.2**). Supply-side shocks from uncertain weather conditions cannot be ruled out either.

At the same time, there are also potential upsides. These include the development and distribution of an effective vaccine and its possible early availability.[3]

[3] Encouraging news began surfacing in November 2020, with as many as three Covid vaccine trials showing promise. Of the three vaccines alluded to, anecdotal evidence suggested that the one developed by AstraZeneca and Oxford University may be particularly relevant for developing countries, given that it is cheaper and easier to store and distribute compared to the vaccines developed by Pfizer and Moderna (subject to approval of respective regulators).

Moreover, the announced increase in the wheat support price and subsidies on fertilizer and pesticides may contribute to a better than expected out-turn of *Rabi* crops. In addition, the October 2020 wave of the SBP BCS also reflects improved business sentiment, with the purchasing managers index (PMI) turning positive for the first time after eight waves.

The government's handling of the current surge in Covid infections includes keeping of business activities running under standard operating procedures (SOPs), thereby supporting economic activity and employment. The restrictions are focused more on reduced public gatherings, provisions for staff to work from home, and temporary closure of educational institutes. Nonetheless, the overall growth outcome hinges on how the Covid infections and the associated government response evolve.

The outlook for the external sector has improved since the previous set of projections published in SBP's FY20 Annual Report. The current account deficit is now projected to be in the range of 0.5-1.5 percent of GDP (earlier: 1.0 to 2.0 percent of GDP). The revision is mainly due to an upward adjustment in workers' remittances, which are now expected to be in US$ 24.0-25.0 billion (earlier: US$ 22.0-23.0 billion).

However, projections of workers' remittances are subject to risk from the outlook for the oil-exporting GCC economies, whose fiscal balances might deteriorate further with the escalation in global Covid infections. This may translate into a sizable reduction in their demand for foreign workers, leading to lower remittance inflows to Pakistan.

The outlook of exports and imports largely remains unchanged from their earlier assessment. The greater quantum of high value added textiles and food commodities – especially rice – are expected to generate above target growth in exports. That said, the key downside risk to this outlook stems from the resurgence of Covid in major export destinations of Pakistan, which has the potential to suppress demand. On the upside, the incentives given in the industrial support package since early November 2020 may help the textile sector exports perform better.[4] Similarly, imports are projected to surpass their annual target. The increase in food imports and domestic economic activity is mainly expected to drive import growth. That said, the increase in global Covid infections and associated further decline in crude oil price could lower import payments.

As for the fiscal deficit, the latest projections suggest that it remains on track to meet the annual target of 7.0 percent of GDP. Going forward, the fiscal situation would continue to depend on the domestic evolution of Covid. The upside risks mainly stem from: (a) the health fallout, and (b) the potential economic fall-out, in case of protracted or intensified lockdowns in the remainder of FY21. By contrast, faster than anticipated economic revival, which gives the government room to generate more revenues, either by rolling back certain tax concessions or imposing fresh levies, could contain the deficit further.

Regarding the inflation outlook, the SBP projects average inflation in FY21 to remain

[4] The package mainly comprised a reduction in the electricity rate for industrial consumers on incremental consumption and an end to peak and off-peak electricity rates.

in the 7.0 – 9.0 percent range. It is important to highlight that food inflation, triggered by supply side factors, has been driving up headline inflation recently. Meanwhile, core inflation has been relatively moderate, owing to benign cost and demand factors. Given the spare capacity in the industrial sector, high base effect, and actions being taken to correct the supply side issues in the food market, upside risks to the inflation outlook are largely contained. The latest SBP surveys also reflect well-anchored inflation expectations of both businesses and consumers.