1 Overview

The economic recovery that became visible in the first quarter of FY21, strengthened in the second quarter (**Table 1.1**). Business activities continued in a mostly undisrupted manner, as the country navigated the second wave of Covid-19 without needing to impose the strict mobility restrictions of early 2020. In particular, industrial output gained momentum as the year progressed and estimates of major *Kharif* crops – with the notable exception of cotton –exceeded their targets. The pick-up in economic activity was also reflected in services sector indicators and a steady improvement in business confidence. At the same time, headline inflation moderated during the period.

These favorable economic outcomes were facilitated by the continuation of the liquidity support measures introduced after the Covid-19 outbreak, as well as by the introduction of supportive sector-specific policies in H1-FY21. On the monetary side, interest rates were left unchanged at low levels, which helped contain debt financing and debt servicing costs for firms and households. At the same time, multiple refinance schemes were also introduced by the SBP to support critical activities such as payroll payments, fixed investment, and balancing, modernization and replacement (BMR), while regulatory interventions allowed restructuring of loans and deferment of principal repayments. These measures helped ease liquidity constraints of firms and households and prevented insolvencies. Furthermore, an exclusive financing facility was provided for the uplifting of the healthcare sector. Collectively, the estimated cash flow impact of these schemes for businesses and households was equivalent to nearly 5 percent of GDP (**Figure 1.1**).

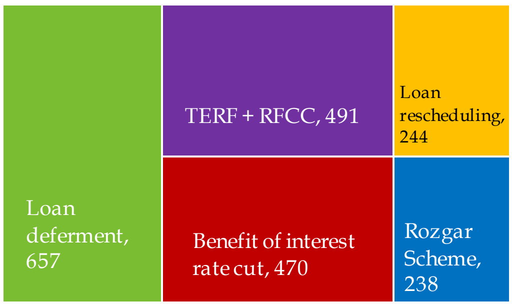
Selected Economic Indicators **Table 1.1**

	FY20		FY21		
	Q2	H1	Q1	Q2	H1
Growth rate (percent)					
LSM [a]	0.1	-2.7	5.0	11.0	8.2
National CPI [a]	12.1	11.1	8.8	8.4	8.6
Private sector credit[b]	3.5	3.2	-1.1	6.2	5.0
Money supply (M2)[b]	4.5	5.2	1.2	4.3	5.6
Exports [b]	7.4	4.6	-10.7	0.7	-4.8
Imports [b]	-11.5	-15.2	-5.7	4.4	-0.5
Ex. rate (+app/-dep %) [b]	1.0	3.3	1.4	3.7	5.1
FBR tax revenue [c]	2.7	5.0	2.2	2.6	4.9
Policy rate (end period) [b]	13.25	13.25	7.0	7.0	7.0
billion US$					
Change in SBP reserves [b]	3.4	4.1	0.02	1.3	1.3
Remittances [b]	5.9	11.4	7.1	7.1	14.2
FDI in Pakistan [b]	0.8	1.4	0.5	0.4	0.9
FX loans (net) [b]	4.2	5.3	0.02	1.5	1.5
percent of GDP					
Fiscal balance [d]	-1.7	-2.4	-1.1	-1.4	-2.5
Primary balance [d]	0.002	0.7	0.6	0.2	0.7
Current acct. balance [b]	-2.6	-2.6	1.3	0.5	0.9

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

Liquidity Impact of SBP's Major Relief Measures (as on Mar 15, 2021)* **Figure 1.1**

Rs billion



* The overall size of SBP support is Rs 2,101 billion.
TERF: Temporary Economic Refinance Facility
RFCC: Refinance Facility for Combating Covid-19
Source: State Bank of Pakistan

In addition, exports and construction sectors were also facilitated. Exporters were provided support by expanding the eligibility criteria under the existing Export Finance Scheme (EFS), expediting the disbursement of refunds, and allowing them additional time to bring back export receipts. Meanwhile, mandatory targets were set by the SBP for banks to increase their housing and construction loans to 5 percent of their overall private sector credit portfolio by December 2021.

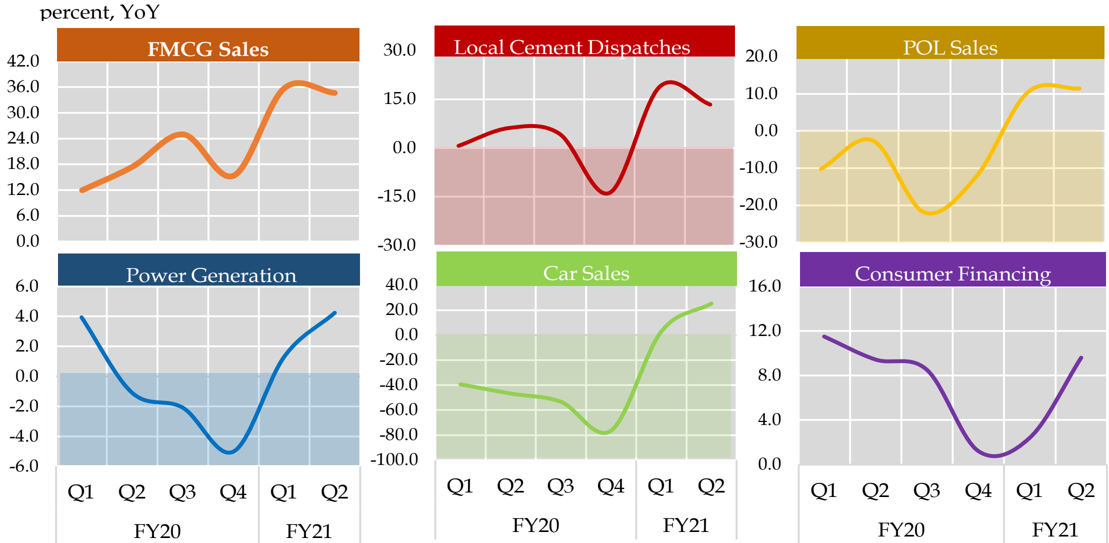
Furthermore, on the regulatory side, efforts were aimed at boosting the healthcare sector by easing the import procedures to facilitate timely imports of needed medical equipment and supplies. Simultaneously, macroprudential regulations, including those related to the capital conservation buffer, were adjusted to allow banks to meet the urgent credit requirements of firms and individuals.

On the fiscal side, despite the overall consolidation, targeted support was visible, in the form of tax concessions for the construction industry; disbursement of pending refunds; and a broader policy effort to lower input costs for businesses and farmers through concessions on energy prices, tax exemptions on imported raw materials, and subsidies and higher minimum support prices. Direct cash support for the economically vulnerable segments also continued for part of the period under review, to sustain households' consumption patterns.

This coordinated policy support was instrumental in enabling firms to meet the growing demand for industrial raw materials and consumer goods after the gradual easing in mobility restrictions from the start of FY21. Sales of products such as cement, petroleum items and fast-moving consumer goods (FMCGs), as well as power generation, all recorded higher YoY growth during H1-

Growth in Demand Indicators **Figure 1.2**

percent, YoY



* FMCG Sales are based on the financials of 19 listed companies.

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

FY21, as economic activities resumed (**Figure 1.2**). At the same time, external demand for major products exported by Pakistan – especially high value-added textile items, non-basmati rice, cement and pharmaceutical products – also recovered, leading to a significant uptick in export volumes of these industries. With favorable domestic and external demand-side dynamics, local firms' need for imported inputs, such as iron and steel, chemicals, plastic, industrial fuels, and cotton, picked up as well.

To finance this growing activity, firms' credit requirements also increased, especially in the second quarter. The overall credit to the private sector nearly doubled in H1-FY21 on a YoY basis, with disbursements in Q2 more than offsetting the retirements in the first quarter. In this regard, the SBP's concessionary refinance schemes played a major role, as the offtake under these schemes was substantially higher than last year. The textile and rice industries utilized the Export Finance Scheme (EFS) for most of their short-term credit needs. As for the fixed investment loans, multiple industries utilized the Long-Term Finance Facility (LTFF), including the Temporary Economic Relief Facility (TERF), to pursue capacity expansions and BMR activities. Meanwhile, consumer financing also increased over last year. Apart from a sizable uptick in personal and car financing, there was also renewed interest in housing loans.

Importantly, the pick-up in economic activity and the facilitative policies did not result in a widening in the macroeconomic imbalances. First, the country's external account improved significantly in H1-FY21, as the 24.9 percent surge in remittances and contractions in the services and primary income deficits were sufficient to offset the 4.4 percent widening in the trade gap. As a result, the current account was in surplus in the first five consecutive months in the period, with the cumulative surplus in H1-FY21 reaching US$ 1.2 billion. On the external financing side, inflows were available from multilateral, bilateral and commercial sources, whereas the G-20's Debt Service Suspension Initiative (DSSI) helped ease the repayment obligations. Thus, the current account surpluses, along with the available FX inflows, led to a US$ 1.3 billion increase in the SBP's reserves during H1-FY21, and a 5.1 percent appreciation in the PKR against the US Dollar during the period.

Second, the fiscal account also showed signs of improvement, as tax revenues rose relative to last year and the economy started to gain momentum. Tax collections increased from import-dependent sectors, such as steel, POL, edible oil, tea and automobiles. Import volumes and prices (in PKR terms) of all these items were greater than last year, and contributed to the uptick in collections during the period. The contribution to overall revenues from direct taxes also remained higher than last year. The higher revenues from these sources more than offset the impact of concessions on customs duties on many raw material imports. Similarly, on the expenditure side, non-interest expenses declined in both quarters, including on development, defence, pensions and the running of civil government. As a result, the primary balance remained in surplus in both quarters of FY21, while the overall fiscal deficit was almost unchanged at last year's level in terms of percent of GDP.

Meanwhile, on the inflation front, the overall national CPI inflation fell to 8.6 percent during H1-FY21 from 11.1 percent in the same period last year. This outcome largely reflected the softening in underlying price pressures – as captured by core inflation – across both urban and rural areas. The weakening in core inflation was enabled by the relative stability in the exchange rate, reduction in energy prices during the period and the presence of spare capacity; all these factors kept firms' input costs from rising markedly.

However, despite these improvements in the overall macroeconomic indicators, a few trends will need to be monitored. First, while the national CPI inflation for FY21 is still lower than last year and within the SBP's projection of 7-9 percent, the role of supply-side challenges across multiple agriculture commodities, especially food items, has become more prominent in driving the recent inflationary outcomes. For instance, while the headline inflation across urban and rural areas was 7.3 percent and 10.6 percent, respectively, in H1-FY21, inflation in the food and non-alcoholic beverages segment was much higher (14.0 percent and 16.2 percent, respectively). As such, there is a need to implement effective supply management and early warning systems, to ensure the availability of accurate and timely data on stocks of key commodities, and to monitor prices at the retail level. The government should also redress the hurdles that cause delays in the import of essential commodities, and ensure better coordination between federal and provincial food departments.[1]

Second, debt servicing continues to be a challenge, as revenue generation in the country is currently insufficient to finance the bulk of the mark-up payments. During H1-FY21, nearly 23 percent of the interest payments was financed via the accumulated primary surplus; rest was financed via additional debt accumulation. This indicates the need to expand the revenue base, notably by accelerating the ongoing documentation drive and plugging leakages in tax collection.

And third, import pressures are building up, in the wake of the pickup in economic activity and rising global commodity prices. Furthermore, shortfall of agricultural commodities in the domestic market, such as cotton, sugar and wheat, have necessitated their imports and pushed up overall import payments. So far, it is the surge in workers' remittances that has been offsetting the impact of these payments, as export receipts are still lower than last year.

Economic Outlook[2]

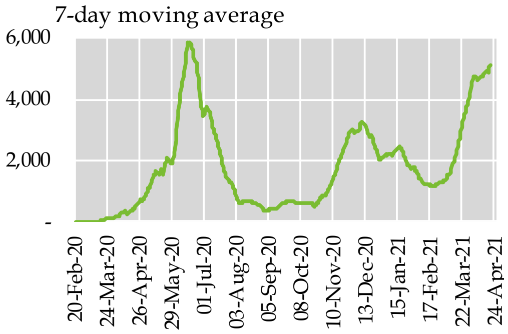
With half of FY21 now passed, the recovery in economic activity is becoming more visible. As such, it is likely that real GDP growth will exceed the target of 2.1 percent, and the SBP has revised its real GDP forecast for FY21 upwards, to 2.0-3.0 percent, from the earlier range of 1.5-2.0 percent provided in the First Quarterly Report of FY21 (**Table 1.2**). This revision mainly incorporates the continuation of recent trends in economic activities, including manufacturing; effective control of Covid's second wave (**Figure 1.3**); positive base effect from the Covid-caused slump in LSM in Q4 of FY20; and better prospects for wheat output. However, as

[1] For details, see SBP's Staff Note 02/20, titled Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges (April 2020).

[2] The macroeconomic analysis and projections in this section, including those in **Table 1.2**, were current as of April 30, 2021, when the Board of Directors of the State Bank of Pakistan had accorded approval to the State of the Economy Report for the Second Quarter of FY21.

before, the downside risk to the forecast primarily stems from a resurgence in Covid-19 cases with the onset of the third wave, which might necessitate the reimposition of mobility restrictions.

Trend in Daily Covid-19 Cases Detected in Pakistan* **Figure 1.3**



*As of April 27, 2021
Source: World Health Organization

The SBP's full-year CPI inflation projection is unchanged, in the range of 7-9 percent. The main upside risk to this assessment would come from a substantial increase in international commodity prices. Deepening in any domestic supply-side challenges for food items or utility tariff hikes, may also lead to higher inflation outturns.

The current account deficit is now projected to be in the range of 0-1.0 percent of GDP, against the earlier projected range of 0.5-1.5 percent shared in the First Quarterly Report of FY21. Based on the recent trend in forex receipts and payments, some factors have changed the projections for remittances and imports. The forecast for remittances has been increased by around 10 percent, based on two main factors. First is the continued surge in inflows across all the major corridors, despite initial apprehensions that inflows might subside as migrants return to Pakistan. And second is the welcome turnaround in the trend of Pakistanis going abroad for work: work-related emigration

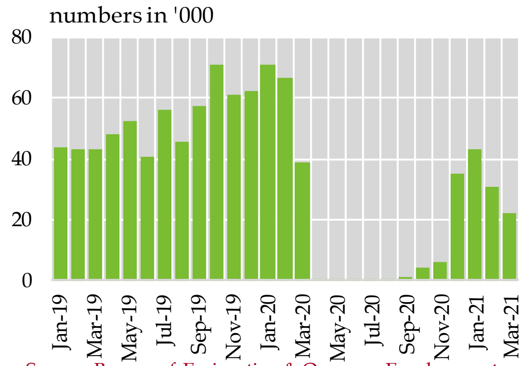
Key Macroeconomic Targets and Projections **Table 1.2**

	FY20	FY21	
		Target [1]	SBP Projections [2]
		percent growth	
Real GDP	-0.4	2.1	2.0 -3.0
CPI (average)	10.7	6.5	7.0 - 9.0
		billion US Dollars	
Remittances	23.1	21.5	26.5 - 27.5
Exports (fob)	22.5	22.7	23.0 - 24.0
Imports (fob)	43.6	42.4	47.0 – 48.0
		percent of GDP	
Fiscal deficit	8.1	7.0	6.5 - 7.5
Current a/c deficit	1.7	1.6	0.0 - 1.0

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

from Pakistan rebounded in December 2020, and the trend has continued since then (**Figure 1.4**). Moreover, the services account is projected to improve further, amid deeper drop in travel services imports after the reimposition of mobility restrictions in some advanced economies in response to the third wave of Covid-19.

Trend in No. of Pakistanis Going Abroad for Work **Figure 1.4**



Source: Bureau of Emigration & Overseas Employment

At the same time, the SBP's projections for import payments have increased by roughly 9 percent from the projection provided in the First Quarterly Report of FY21. This upward revision in the forecast mostly reflects the momentum in economic activity, additional imports of wheat and sugar, and the increasing trend in global commodity prices, especially crude oil. Arab Light prices have risen sharply from their end-June 2020 levels and are now close to their pre-Covid level.[3] With import volumes of all energy products – crude oil, POL products, LNG and coal – already higher than last year, rising oil prices from December 2020 onwards have been contributing to the rise in import payments. A positive development in the external sector is the growing interest of overseas Pakistanis in the newly launched Roshan Digital Accounts (RDA). An SBP initiative to provide a completely digital banking solution to non-resident Pakistanis, the RDAs allow remote customer on-boarding and provide access to a wide range of banking services in Pakistan as well as the opportunity to invest in special government bonds (Naya Pakistan Certificates), the stock market, and real estate. These accounts also have a simplified tax treatment and are fully repatriable. Within the first seven months of their launch, inflows into the RDAs have surpassed US$ 1.0 billion.

In the fiscal sector, the SBP's projection for the budget deficit is unchanged, reflecting balanced risks. On the downside, the receipt of the Gas Infrastructure Development Cess (GIDC) payments after the apex court's decision would improve the overall fiscal balance.[4] Meanwhile, the upside risk stems from some unbudgeted expenses that the government could likely incur in the remaining part of FY21. The largest of these is the government's recent MoUs with multiple independent power producers (IPPs), which may entail a sizable upfront payment. While clearing the outstanding dues of IPPs is a step in the right direction, holistic and deep-rooted reforms are also needed in the country's fragmented energy sector. In this regard, this report includes a special section dedicated to the LNG market dynamics in Pakistan, which discusses in detail how the current regulatory and operational framework is leading to sub-optimal outcomes in terms of planning, purchasing and supplying the imported commodity. In a positive development, the government has recently allowed private sector importers to utilize the excess capacity of the existing terminals. Greater private sector involvement would help accelerate the adoption of the cheaper fuel in the economy and smoothen supply-chain dynamics by streamlining procurement processes and enabling market-based price discovery.

To sum up, the macroeconomic outlook for the current fiscal year has improved, after taking into account the developments during the first two quarters of FY21. Further impetus to the current economic momentum could come from a successful rollout of vaccines in the coming months. Business confidence has also been steadily improving, as indicated by the continuation of the upward trajectory in positive sentiments across four consecutive waves of the IBA-SBP survey till March 2021. Finally, the resumption of the IMF program is expected to unlock additional external financing and also support the country's progress on the structural reform agenda.

[3] Arab Light prices have increased 75.2 percent between end-June 2020 (US$ 35.2 per barrel) and April 7, 2021 (US$ 61.7 per barrel).

[4] In its decision in November 2020, the Supreme Court asked the government to recover the outstanding collections under GIDC from industrial and commercial entities over a period of 60 months, from the earlier allowed timeframe of 24 months.