The analysis and projections presented in this report were prepared on data outturns for the first quarter of FY22 and finalized in November 2021, using data available as of then. As such, the report did not incorporate the rebasing of the large-scale manufacturing and GDP in January 2022.

1 Overview

Pakistan's economy maintained the growth momentum of FY21 in the first quarter of FY22 (**Table 1.1**). Broad-based expansion in large-scale manufacturing (LSM) and improved *kharif* crop outcomes reflected the favorable supply side dynamics. The demand side remained buoyant, as the trends in sales of fast-moving consumer goods and cars, import volumes, energy consumption, and consumer financing were all strong. The pick-up in economic activity also contributed to higher tax revenues, with positive implications for the fiscal position. However, in the face of a substantial increase in the global commodity prices, the growth recovery was accompanied by a build-up in inflationary pressures and a widening current account deficit.

Selected Economic Indicators **Table 1.1**

	Q1	
	FY21	**FY22**
Growth rate (percent)		
LSM [a]	4.5	5.1
National CPI [1 a]	8.8	8.6
Private sector credit [b]	-1.1	3.0
Money supply (M2) [b]	1.2	0.6
Exports [b]	-10.7	35.1
Imports [b]	-5.7	64.4
Workers' remittances [b]	31	12.5
Exchange rate [2 b]	1.4	-7.7
Tax revenue –FBR [c]	4.8	38.3
Policy rate [3 b]	7.0	7.25
billion US Dollars		
SBP's FX reserves [3 b]	12.2	19.3
Current account balance [b]	0.9	-3.4
percent of GDP		
Fiscal balance [c]	-1.0	-0.8
Primary balance [c]	0.5	0.3
Current account balance [b]	1.2	-4.2

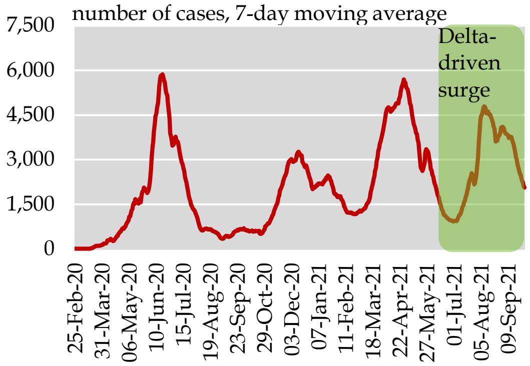
[1] period average [2] app. (+)/dep. (-) in percent during period [3] end period

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

This presented a challenging environment for the policymakers. The primary concern was to avoid disrupting the ongoing economic momentum, especially given the heightened uncertainty created by the spread of the Delta variant-driven Covid-19 wave globally and in the country during the quarter (**Figure 1.1**). Some targeted, micro lockdowns were also imposed.

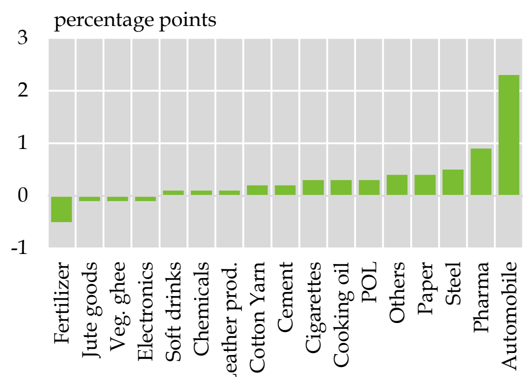
Nonetheless, economic activity continued broadly uninterrupted. On the fiscal side, there was a renewed policy focus on achieving a higher growth outcome, as outlined via the spending priorities in the Budget FY22. Also, monetary conditions remained accommodative. The policy rate was kept unchanged at low, post-outbreak levels during most of the quarter; whereas the Export Finance Scheme (EFS) and the Long-Term Financing Facility (LTFF), continued to be in place to support firms' working capital and fixed investment needs. In addition to ensuring that the growth recovery remained on track in the face of the uncertainty created by the Delta variant, this policy support also provided some cushion

Trend in Daily Covid-19 Cases Detected in Pakistan **Figure 1.1**



Source: World Health Organization

Sectoral Contribution to YoY LSM Growth in Q1-FY22 **Figure 1.2**



Source: Pakistan Bureau of Statistics

to firms facing rising input costs amidst the sizable uptick in global commodity prices.

The industrial sector was a major beneficiary of this policy support, with supply-side dynamics improving, as reflected by LSM growing at a higher rate than last year. Industries that benefited directly from the fiscal support – such as automobiles (tax reduction on sales and imported inputs) and construction-allied sectors (lower taxes on cement sales) – were among those with higher output growth during the quarter (**Figure 1.2**). Also, preliminary estimates for the three major *kharif* crops – rice, sugarcane and cotton – indicated encouraging agricultural activity. Higher market prices, favorable weather conditions and better crop management practices all contributed to the improved agricultural output.

On the demand side, there was a sustained increase in consumption during the quarter. High frequency economic indicators – such as sales of cars and fast-moving consumer goods, consumer financing and POL products – continued to record strong, double-digit YoY growth. Energy consumption, as captured by power generation, also surged from last year's levels. While a deceleration was noted in the growth of these indicators from the previous quarter owing to waning base effects, the activity was still at elevated levels.

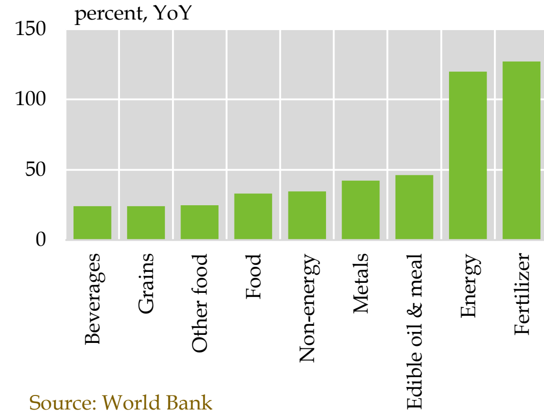
The availability of affordable credit played a major role in propping up industrial activity. This support proved instrumental in meeting the eligible firms' higher working capital requirements, amidst rising input costs. This was especially the case with the export-oriented textile firms, which were faced with higher external demand and rising imported cotton prices. At the same time, capacity expansion in textiles and telecommunications sectors largely drove the offtake of fixed investment loans, with LTFF and the Temporary Economic Refinance Facility (TERF) accounting for a large share of the textile firms' long-term borrowing during the quarter.

The increased economic activity and rising imports had favorable implications for tax revenues, which helped maintain fiscal consolidation despite a growth-oriented budget. Non-interest expenditures rose substantially in the quarter, amidst higher development spending, purchase of Covid-19 vaccines, and power sector subsidies. The fiscal space to undertake this spending was partly available from a sizable rise in the FBR tax collection. The fiscal position also materially benefited from the reduction in interest payments during the quarter, which reflected lower payments on domestic debt via lower rates on both short- and long-term instruments. Interest payments on foreign debt declined amidst the continuation of the Debt Service Suspension Initiative (DSSI), along with low levels of global interest rate benchmarks, such as LIBOR.

As a result, the primary balance continued to remain in surplus, although the magnitude of the surplus was lower than last year. In particular, the fiscal deficit reduced to 0.8 percent of GDP from 1.0 percent last year. Notwithstanding the lower financing needs, the public debt increased during the quarter, mainly due to revaluation losses.

Nonetheless, these macroeconomic gains were tested by the significant upswing in global commodity prices and shipping costs (**Figure 1.3**). At the same time, domestic demand pressures also became evident.

Growth in Global Commodity Prices during Q1-FY22 **Figure 1.3**



Source: World Bank

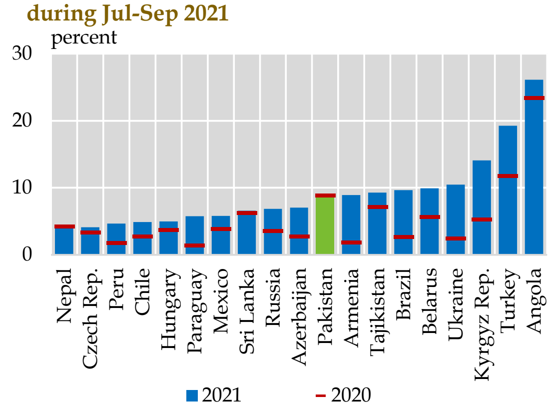
For Pakistan, despite some deceleration from last year, CPI inflation remained at an elevated level of 8.6 percent during Q1-FY22, with major contribution coming from higher global commodity prices, especially of food and energy items. The food group remained the top contributor to the headline inflation, on the back of a strong increase in the prices of edible oil, poultry, wheat and sugar. That said, some relief came from the perishables group (such as fresh vegetables), in the wake of higher domestic production as well as imports. Higher global oil prices contributed to higher energy inflation readings in the quarter, despite the government's decision to partially absorb the price hike by lowering the sales tax rate and the petroleum development levy. Meanwhile, the economic momentum, coupled with higher global commodity prices, also began to reflect in core inflation, which inched up in urban areas during the quarter.

The surge in global commodity prices also played an important role in exerting pressures on the external account during Q1-FY22, by significantly pushing up import payments. This occurred at a time when the country's import demand for energy as well as non-energy products was already elevated amidst strong industrial activity. Further upside pressures emerged from the imports of capital equipment. Despite the sizable increase in export receipts – which crossed the US$ 7 billion mark – the rise in import payments was large enough to significantly increase the merchandize trade deficit. This deficit was partially financed by the growth in workers' remittances (which continued to exceed US$ 2 billion in each month of the quarter). As a result, the current account deficit widened to US$ 3.4 billion in Q1-FY22, against a surplus of US$ 0.9 billion in the same period last year. These payment pressures in the current account were also reflected in the market-based exchange rate, which depreciated by 7.7 percent against the US Dollar during the quarter.

Despite the widening current account gap, the country's external buffers remained intact during the quarter. This was largely due to the availability of substantially higher external financing, especially from the additional Statutory Drawing Rights (SDR) allocation (US$ 2.8 billion) and tap issuance of Eurobonds for US$ 1.0 billion. Consequently, the SBP's FX reserves increased by US$ 2.0 billion and reached US$ 19.3 billion by end-September 2021.

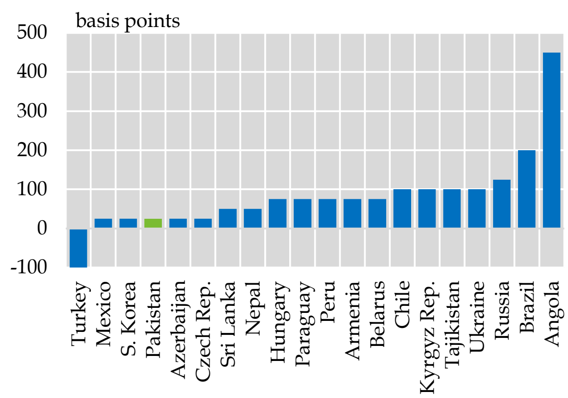
While the reserves position improved, the payment pressures in the current account, along with expectations of higher inflation readings going forward, necessitated a reorienting of the policy and regulatory levers to consolidate the macroeconomic gains achieved since the outbreak of Covid-19 in March 2020. In response to the emerging pressures, the SBP's Monetary Policy Committee decided to increase the policy rate by 25 basis points in its September 2021 meeting. However, it is worth noting that Pakistan is not the only emerging market (EM) to begin monetary tightening in response to rising inflationary pressures (**Figure 1.4a**); several other EM central banks have also responded by raising interest rates (**Figure 1.4b**).

Inflation Rates Across EMs during Jul-Sep 2021 **Figure 1.4a**



Source: Haver Analytics

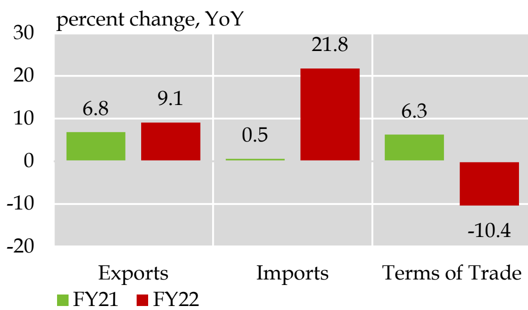
Change in Policy Rate of EMs during Jul-Sep 2021 **Figure 1.4b**



In addition to raising the policy rate, the SBP also undertook regulatory measures to restrain the import momentum. These included the imposition of 100 percent cash margin requirement on 114 non-essential import items (bringing the total number of items attracting the restrictions to 525); and changes in prudential regulations to tighten auto and consumer financing.

The developments in the first quarter of the current fiscal year clearly highlight Pakistan's susceptibility to global commodity price shocks, partly due to the country's limited export base. While textile exports benefitted from rising global cotton prices, Pakistan could not capitalize on the surging global prices of items that it used to export – wheat and sugar – and instead had to import them to stabilize domestic prices and ensure local market availability. On the other hand, as mentioned before, higher prices of energy commodities, edible oil and steel, have contributed significantly to widening import payments. As a result, the commodity price pressures had a largely negative impact on the trade balance, as evident by the worsening in Pakistan's terms of trade during the quarter (**Figure 1.5**).

Change in Pakistan's Terms of Trade and Unit Prices of Exports & Imports in Jul-Sep* **Figure 1.5**



*YoY change in index levels
Source: Pakistan Bureau of Statistics

Apart from pursuing reforms to attain macroeconomic stability that were outlined in detail in the SBP's Annual Report for FY21, there is also a need for consistent and coherent policies at the sectoral level. One industry that requires a long-term policy focus is edible oil. Around 86 percent of the country's edible oil consumption comes from imports. Given the serious implications of the surging global palm and soybean oil prices on the external account and inflation dynamics, this report contains a Special Section on the domestic oilseed sector in Pakistan. The section highlights that while reference to domestic oilseed development can be found as far back as in the first Five-Year Plan (1955-60), the absence of an overarching policy and a dedicated and functional implementation agency over the years has gradually but steadily increased the country's reliance on imports. While the section finds that palm plantation does not have much potential in Pakistan in the short to medium term, soybean can be produced at a large scale in the medium term, if policy support is provided.

Economic Outlook

Real GDP growth is projected within the previously announced range of 4-5 percent for FY22, in line with the government's target of 4.8 percent and higher than last year's provisional growth of 3.9 percent. Better-than-expected agricultural output and growing industrial activity, with positive spillover on services sector, are projected to contribute to the higher growth outcome.

The reversal in the monetary policy stance from September onwards, which has resulted in a 175 bps increase in the policy rate (until November), and other policy measures – such as revisions in prudential regulations for auto and consumer financing, and a 1 percentage point increase in the cash reserve requirement for commercial banks –are projected to lead to a slight slowdown in industrial growth compared to earlier expectations. Furthermore, overall credit conditions are expected to somewhat tighten in the wake of the policy rate hike. However, the major export-oriented industries, especially textiles and rice, would be largely shielded from the impact by their continued access to the SBP's concessionary refinance schemes; despite the rise in the policy rate, mark-up rates on these refinance schemes are still unchanged at low levels. The slight slowdown in industrial activity is expected to be more than offset by the encouraging agricultural performance, based on output estimates of major *kharif* crops so far, along with the assumption that the higher target for wheat set by the government, from an already record-high output last season, will be met.

The government is targeting to reduce the fiscal deficit to 6.3 percent in FY22 from 7.1 percent in FY21, by increasing revenues via expansion in the tax net and the ongoing growth momentum, which would contribute to tax collection. Recent proposed cuts to development spending, imposition of additional duties on automobiles and luxury goods, and the withdrawal of a wide range of tax exemptions, are all expected to further improve the fiscal position. Meanwhile, downside risks to the fiscal outlook include a slowdown in economic activity, which would impact tax revenues.

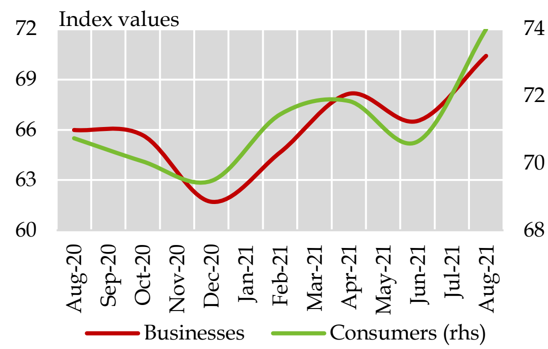
It is also worth noting that there is uncertainty with regards to the economic outlook. A major reason is the emergence of new Covid variants, which have direct implications for global commodity prices; the policy rate path in the advanced economies; demand dynamics in major export markets; the longevity of supply chain disruptions; and international travel by Pakistani residents, which could impact the current account. Oil prices have appeared particularly prone to downward movements following the discovery of new Covid variants, including Delta and now Omicron.[1] In addition, the evolving situation in Afghanistan is another source of uncertainty.

For the full-year FY22, the SBP is projecting headline CPI inflation to remain higher than FY21's reading of 8.9 percent. The risks are tilted towards the upside, mainly due to the higher-than-expected increase in global

[1] After reaching US$ 86.1 per barrel on November 9, 2021, Arab Light crude oil prices fell to as low as US$ 71.7 (on December 2, 2021), before recovering slightly. The sharp drop was mainly due to concerns over the emergence of the Omicron Covid variant in southern Africa, which was initially deemed to be more contagious than the Delta variant.

prices of commodities imported by Pakistan, including energy (oil, coal and LNG) and non-energy items (edible oil, cotton and steel, among others). Further impetus has come from the likely upward adjustments in administered prices, including power tariffs and taxes on transport fuels (GST and petroleum development levy), as well as the pass-through of PKR depreciation so far. These pressures have also begun to seep into pricing expectations of consumers and businesses, as gauged from the SBP's Consumer and Business Confidence Surveys (**Figure 1.6**). In contrast, prominent downside risks to the inflation outlook include a sharp drop in oil prices and higher-than-expected moderation in industrial activity amidst normalization of monetary and fiscal policies.

Inflation Expectations of Businesses and Consumers **Figure 1.6**



*expectations over the next 6 months
Source: State Bank of Pakistan

In the external sector, the current account deficit is also projected to exceed last year's level of 0.6 percent of GDP by a wide margin, mainly due to a higher-than-accounted for trade deficit, stemming from the rising trend in worldwide commodity prices. While the recent adjustment in the policy rate would somewhat constrain import demand, import payment pressures are expected from capital goods imports and from the continued need to import Covid-19 vaccines. While export receipts are also projected to rise, they are not likely to offset the rise in import payments. On the other hand, downside risks to the current account gap mainly relate to a sharp drop in global commodity prices and freight costs. Nonetheless, the external account is expected to remain manageable, given that the automatically stabilizing PKR is now complemented by the necessary monetary policy tightening.

Furthermore, the country's financing requirements – i.e. the expected current account gap and the upcoming debt repayments – are projected to be fully met by the available financial flows. The approval of the staff-level agreement by the IMF Board in H2-FY22 would unlock around US$ 1.0 billion from direct Fund financing, and facilitate continued engagement with other multilaterals. In addition to the US$ 3 billion deposits from the Saudi Fund for Development, a planned sovereign Sukuk by the government would further help build the SBP's FX reserves.