Annual Report
2019-20

The State of Pakistan's Economy

State Bank of Pakistan

ANNUAL REPORT
2019 – 2020

THE STATE OF PAKISTAN'S ECONOMY

STATE BANK OF PAKISTAN

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
November 11, 2020

Dear Mr. Chairman,

In terms of Section 9A(2) of the State Bank of Pakistan Act, 1956, the Annual Report on the State of the Economy which includes the review of fourth quarter on the State of the Economy for the year 2019-20 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament), by the Board of the State Bank of Pakistan.

Yours sincerely,

(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Muhammad Sadiq Sanjrani
Chairman
Senate
Islamabad

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Yours sincerely,

(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Asad Qaiser
Speaker
National Assembly
Islamabad

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Chapter 1

Economic Review

1 Economic Review

1.1 Overview

Prudent monetary and fiscal policies, supported by the IMF's Extended Fund Facility program, helped the economy move progressively along the stabilization path during the first eight months of FY20. The economy also saw a notable, smooth transition to a market-based exchange rate system, which was pivotal to addressing the external imbalances and rebuilding the foreign exchange reserves buffer. This structural adjustment, along with the government's adherence to its commitment of zero SBP borrowing, improved overall monetary management and functioning of financial markets. A significant contraction in the twin deficits was visible from the start of the year. However, as the exchange rate was made more flexible and utility prices and taxes adjusted to rein in the fiscal deficit, inflationary pressures rose temporarily. Overall, the improving macroeconomic fundamentals helped restore consumer and business confidence, which set the stage for a recovery in the real sector.

However, just as early signs of this recovery were beginning to emerge, the global and domestic spread of the coronavirus (Covid-19), and ensuing containment measures, hit the economy hard. Manufacturing, retail, transport and trade-related activities were disrupted, causing a severe contraction in real GDP growth. At this critical point, better macroeconomic fundamentals and subdued inflation risks provided policy space to extend relief measures to businesses and households; without these measures, the economic and social fallout of the Covid crisis would have been much worse.

Macroeconomic trends and policies before and after the Covid spread

The country's external and fiscal sectors posted strong performances compared to last year, before the domestic spread of Covid-19 (**Table 1.1**). In particular, the current account had posted a significant improvement in the first 8 months of the year. This decline was attributed primarily to a sharp contraction in imports following demand compression and regulatory measures, alignment of the exchange rate with market fundamentals, and a steady shift in the energy basket from expensive fuels to hydel and coal. The economy also saw a record surge in foreign investment in the domestic debt market, as global fund managers expressed confidence in better macroeconomic and exchange rate policies while tapping on the interest rate differential and tax-related reforms. The improvement in the current account bolstered market sentiment and helped the SBP rebuild its foreign exchange reserves; support also came from reengagement with the IMF and other multilateral lenders. The elevated level of foreign exchange inflows allowed the SBP to unwind its short-term forward and swap contracts to the tune of US$ 5.2 billion during the period. This implied that the actual increase in the SBP's reserves position was US$ 10.7 billion during Jul-Feb 2020 – an average improvement of US$ 1.3 billion a month.

Similarly, on the fiscal front, the consolidation momentum gathered pace during the pre-Covid period, as reflected in the first primary surplus over the first nine months of the fiscal year since FY16. On the revenue side, the government reversed multiple tax concessions given last year, which led to an increase in the GST rate on petroleum products, resumption of collections on telecom, and an increase in the minimum threshold for income tax collection. In addition, the government eliminated the concessionary tax regime for voluminous items, such as textiles, sugar, edible oil, steel, and cigarettes, which led to higher collections compared to last year. Nonetheless, overall tax performance fell somewhat below the ambitious target, as import-related collections weakened significantly. Here, non-tax receipts, stemming primarily from higher SBP profits and GSM license renewal fees, supported

Major Macroeconomic Indicators **Table 1.1**

	FY18	FY19			FY20			
		Jul-Feb	Mar-Jun	Full-year Actual	Jul-Feb	Mar-Jun	Full-year Actual	Full-year Target
				percent growth				
Real GDP	5.5			1.9			-0.4	4.0
Agriculture	4.0			0.6			2.7	3.5
Industry	4.6			-2.3			-2.6	2.3
o/w LSM	5.1	-1.6	-3.7	-2.6	-2.9	-24.0	-7.8	1.3
Services	6.3			3.8			-0.6	4.8
Private sector credit	14.9	10.3	1.2	11.6	3.8	-0.8	2.9	
National consumer price index	4.7	6.0	8.3	6.8	11.7	8.9	10.7	5-7
Exports	13.7	1.7	-6.1	-1.1	3.6	-26.7	-6.8	6.2
Imports	14.9	-6.3	-16.4	-9.9	-13.9	-28.2	-18.6	0.8
Exchange rate (+app/-dep%)	-13.7	-12.5	-13.3	-24.1	3.8	-8.2	-4.8	
				percent of GDP				
Current a/c balance	-6.1	-3.4	-1.4	-4.8	-1.0	-0.1	-1.1	-3.0
Primary balance*	-2.2	-1.2	-2.4	-3.6	0.5	-2.3	-1.8	-0.9
Fiscal balance*	-6.5	-5.1	-4.0	-9.1	-4.0	-4.1	-8.1	-7.5
Gross public debt*	72.1	74.2	86.1	86.1	84.4	87.2	87.2	NA
				billion Rupees				
Total revenue*	5,228.0	3,583.7	1,317.0	4,900.7	4,689.9	1,582.3	6,272.2	7,458.0
Total expenditure*	7,488.4	5,506.2	2,839.4	8,345.6	6,376.1	3,272.4	9,648.5	10,740.0
				billion US$				
Change in SBP FX reserves	-6.4	-1.7	-0.8	-2.5	5.5	-0.6	4.9	
Workers' remittances	19.9	14.3	7.4	21.7	15.1	8.0	23.1	24.0
Foreign portfolio investment	2.2	-0.4	-1.0	-1.4	2.1	-2.7	-0.5	2.3
FDI in Pakistan	2.8	0.8	0.6	1.4	1.9	0.7	2.6	4.3
Change in net forward position (incl. swaps)	-2.8	-0.8	-0.3	-1.1	5.2	-2.9	2.3	

*The data in Jul-Feb and Mar-Jun column is for Jul-Mar and Apr-Jun respectively.
Source: PBS, SBP, MOF

revenue mobilization. Progress on expenditure control on the development side was also evident, although high debt servicing cost and a steady increase in social transfers (grants) doubled the growth in overall expenditures. Nonetheless, the authorities refrained from issuing supplementary grants during the year.

Trends in inflation also pointed toward subsiding demand-side pressures. Although inflation in the non-food-non-energy segment of CPI remained at an elevated level – as the economy absorbed the impact of the exchange rate depreciation of the previous year, taxation measures announced in the FY20 budget and higher fuel and transportation costs – its trend stabilized as the year progressed. Nonetheless, supply-side pressures remained strong in the food market, as temporary disruptions triggered speculative sentiments and contributed to price build-up. While these developments weakened consumer confidence, they were not entrenched enough to affect the SBP's full-year inflation projections and influence monetary policy decisions. Thus, after increasing the policy rate by 100 bps in July 2019, the SBP kept the policy rate unchanged. As expected, after plateauing in January 2020, food inflation also began to recede, as seasonal (and import) supplies resumed and the government initiated a countrywide crackdown on hoarding practices.

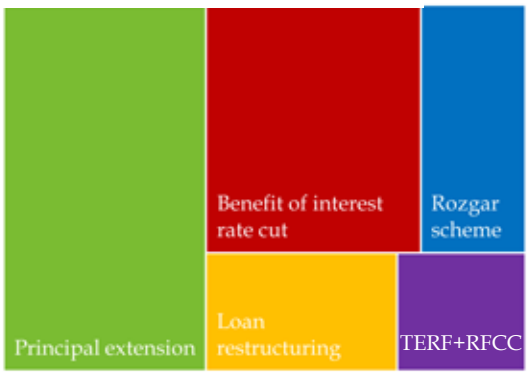
Thus, at the time the Covid-19 infections began to increase, the country had already made noticeable gains on the macroeconomic stability front. This made it possible to extend aggressive policy support to businesses and households to help them cope with the necessary mobility restrictions and ensuing supply-chain disruptions. Those in special need of immediate policy support included manufacturing firms – as factory closures tightened cash cycles and raised the risk of surging unemployment – and a number of services concerns, especially in the hospitality industry, such as event management, catering, restaurants, food deliveries, salons/barber shops, and travel and ticketing. Wherever possible, the adoption of digital channels (such as teleworking and e-commerce) supported business continuity, but given the weak digital

landscape, most businesses struggled (**Special Section**). Although the agriculture sector remained largely immune to the Covid shock (since major crops for the year had already been harvested), repayment risks began to emerge in the farm segment of micro loans. Consequently, the scale and breadth of the needed efforts meant that the relief measures would entail large fiscal and quasi-fiscal costs, requiring adjustments in the consolidation agenda. Accordingly, the government expanded the volume and outreach of its ongoing social uplift programs, enabling over 12 million households to receive emergency cash transfers (Rs 12,000 per family) for meeting essential needs.

At the same time, the SBP arranged multiple emergency meetings of the Monetary Policy Committee (MPC) to take frequent stock of the fast evolving situation and decide accordingly. The MPC cut the policy rate by 625 bps in a roughly 3-month time period, which not only favorably repriced most of the existing loans by the private sector, but also made borrowing viable for firms that would otherwise have been priced out due to high interest rates and weakened profitability. Importantly, the SBP also rolled out multiple unprecedented schemes, including the deferment of principal repayments; subsidized financing for firms to pay salaries to their employees; relaxations in operational criteria for export-related refinance schemes; and concessionary refinance facilities for investment projects and hospitals. Businesses have shown a keen interest in these financing schemes and actively used them to plug their cash flow gaps. Put together, the estimated liquidity impact of the SBP's relief measures was equivalent to 4.0 percent of GDP (**Figure 1.1**).

The size and scope of these novel measures were instrumental in ensuring business continuity and job security. Encouragingly also, data-intensive verification process for social transfers, banks' strict compliance with prudential norms, better financial management and the strictly targeted nature of relief provision avoided the build-up of excessive cost. Thus, it turned out that although the Covid crisis led to temporary output losses, weakened consumer and businesses' confidence, and pushed the government to recalibrate the economic reform process, it did not have a strong

Composition of the Estimated Liquidity Impact of SBP's Major Relief Measures (as on Oct 16, 2020)* **Figure 1.1**



* The overall size of the rectangle is equivalent to 4.0 percent of GDP.
TERF: Temporary Economic Refinance Facility
RFCC: Refinance Facility for Combating Covid-19
Source: State Bank of Pakistan

bearing on the economy's risk profile. Specifically, the improvement in underlying macroeconomic fundamentals remained intact despite the Covid-related strain.

On the fiscal side, plummeting economic activity significantly dented tax revenue growth in Mar-Jun 2020, and a steep surge was observed in non-interest current spending, as the government had to respond to the country's social safety and healthcare needs (including ensuring supplies of testing kits, ventilators, stipends to health personnel, data management, contact tracing, etc). As a result, the primary surplus accumulated in the first three quarters turned into a deficit, causing a slippage in the target set in the FY20 budget as well as committed under the EFF program. But it is imperative to note that despite these challenging and unprecedented conditions, the full-year primary deficit during the year was only half the level seen last year.

Importantly, even after accounting for the Covid-related borrowing strain, the increase in the public debt-to-GDP ratio was contained to 1.1 percent of GDP during the year, as the government used its cash buffers held with the SBP. These buffers were particularly helpful in financing unanticipated expenditures during the Covid period: over 53 percent of the increase in budgetary borrowings from the banking system during the Mar-Jun period comprised withdrawals from deposits with the SBP. Also, as the exchange rate was relatively more stable in FY20 compared to last year, the revaluation losses were

contained; recall here that these losses alone were responsible for nearly 40 percent of the increase in the country's debt stock in FY19. From a debt management standpoint, the composition of public debt in FY20 remained favorable, as most of the increase came from longer tenor borrowings, which helped contain the rollover risk for the government. Having said that, while the damage from Covid-19 was limited on the overall debt profile, the Covid shock disrupted the targeted reduction in the level of public debt burden. At end-FY20, public debt stood at 87.2 percent of GDP, which was in excess of 80.5 percent envisaged for FY20 under the EFF program, and much higher than the 60 percent limit stipulated under the Fiscal Responsibility and Debt Limitation Act.

Similarly, on the external front, two concerns emerged during the Covid period. First, export growth tapered, as limited retail sales in advanced economies led to a fall in orders. Second, as uncertainties emerged with respect to the impact on the global economy, foreign fund managers pulled capital out from emerging market economies. In Pakistan also, the trend of portfolio inflows in the domestic debt market reverted during the Mar-Jun period, partially reversing the build-up in the country's foreign exchange reserves. However, these developments did not affect the external balance significantly, and the reserves still ended the year higher than in FY19.

First, the market-based exchange rate worked as a valuable shock absorber, as payment imbalances were appropriately reflected in movements in the Pak rupee-US dollar parity. The Pak rupee strengthened by around 4 percent in the pre-Covid period (between Jul-Feb FY20) – in line with the improvement in the current account and financial inflows, which supported the country's reserves position and market sentiment. This trend reversed from March onwards with the global sell-off causing a depreciation of 8.2 percent in the Pak rupee during the Mar-Jun period. It is important to highlight here that this weakening in the exchange rate took place in an orderly manner and was largely in line with pressures faced by other emerging markets. Second, contraction in manufacturing and the over 50 percent drop in global oil prices led to a broad-based decline in imports, which significantly eased outward payments. Third, the growth in workers' remittances remained intact, as the orderly exchange rate conditions, effective marketing campaigns under the PRI and increased incentives under TT charges reimbursement scheme provided valuable support. Fourth, inflows under the IMF's Rapid Financing Facility also proved helpful. As a result, the decline in the SBP's reserves was contained to US$ 625.9 million between March and June; on a full-year basis, reserves recorded an improvement of US$ 4.9 billion in FY20. With SBP's forward liabilities declining by US$ 2.3 billion, the increase in the net reserves buffer over the fiscal year was US$ 7.1 billion.

Developments on the inflation front also remained largely favorable, as the Covid-related steep fall in global crude prices, coupled with easing food prices and the government's decision to postpone further upward adjustments in power tariffs, led to a sharp fall in both headline and core inflation. While a significant amount of liquidity was injected into the system following the monetary and fiscal relief measures, domestic demand remained weak, helping contain inflation. This was because limited work opportunities, layoffs and subdued sales growth had put many firms and households under severe financial constraints. All the available high frequency indicators (such as petroleum sales, cement dispatches and automobile sales,) pointed at weak retail activity. As a result, after remaining at an elevated level of 8.0 percent on average during Jul-Feb FY20, core inflation (urban) declined from March onwards to reach 6.5 percent YoY at end-June.

Resuming the Pre-Covid Trajectory: Policy Considerations

Thus, with the pre-Covid improvement in macroeconomic fundamentals remaining intact and the strong policy response helping to cushion the shock, the economy seems poised to pick up from where it was before the Covid shock. Encouragingly, this process has already started taking hold following the flattening out of the Covid curve in the country and the resumption of economic activity. However, three risk factors bear watching. First, challenges emanating from Covid-19 have cut across the entire

operational value chain of businesses: their supply lines were disrupted; inventories cut short; savings dried up; and capital expenditures put on hold. The pace of the recovery would hinge on when they recoup the financial damage, and how soon and fast domestic demand picks up. Second, though export volumes have rebounded during the past couple of years, relatively modest growth (of 2.7 percent) was observed in export earnings during Jul-Feb 2020. Now, with a less vibrant outlook of advanced economies, a meaningful recovery in export receipts could be challenging. Third, the country's tax base remains narrow, heavily reliant on a few sectors, and excessively vulnerable to business cycle fluctuations. This implies that any pressure on the expenditure side could put a significant strain on the already high debt burden of the country.

Therefore, it has become crucial to build on the progress made on the reform front so far, and address the economy's structural bottlenecks to boost competitiveness, improve the business environment and ultimately raise the economy's growth potential over the medium term. Here, it is important to emphasize that a number of reforms were introduced in the earlier part of FY20 to address deep-seated problems, especially in the areas of taxes, documentation, power, access to finance, and financial scrutiny. However, progress on some of these reforms was temporarily interrupted by the more pressing economic and social concerns emanating from the Covid-related lockdowns, which required immediate policy attention. This progress needs to be put back on track, and further reforms initiated, to take the economy on a sustainable growth path. In this context, the following points are important:

First, a more sustainable solution to correct the country's fiscal vulnerabilities is needed, which requires more than just increasing tax rates. Documentation, reducing informality, and harmonizing the tax regime, are all needed to broaden the tax base and reduce reliance on non-tax revenues. Though exemptions and concessions in some sectors were phased out in the FY20 budget, they still prevail in other sectors (such as those included in 5th, 6th and 8th Schedules of Sales Tax Act) and contribute to below-potential revenue collections. Simplification and harmonization of the tax base and rates for agricultural income tax and sales tax on services, are also unfinished reform agendas. To make notable progress here, strong coordination is needed between the federal and the provincial governments. Tax enforcement also needs to be strengthened by tightening risk-based auditing and strengthening data cross-checks through CNIC, third-party data and/or point of sales. At the same time, concerted efforts are needed to facilitate businesses through simplifying tax filing and accelerating the payment of refunds.

Second, pricing and governance problems in the power sector need to be addressed as these not only represent significant quasi-fiscal risk, but have also dented the competitiveness of the economy. The government had devised a comprehensive strategy at the start of the year to improve the viability of the power sector and ensure a sustained decline in accumulated arrears. This strategy included a Circular Debt Reduction Plan, adopting amendments in the Nepra Act to ensure automaticity of tariff revisions and notifications, improving collections, and subsidy rightsizing. Furthermore, infrastructure investment to reduce technical losses, anti-theft drives, and upward tariff adjustments during the early months of FY20, had helped arrest the growth in arrears. However, postponement of tariff adjustments for monthly fuel and quarterly capacity payments since January, and payment deferrals from March onwards, diminished these initial gains. While the implementation of these adjustments would help correct immediate payment shortfalls, the long-term solution to the pricing issues (especially with respect to capacity payments) is more likely to be influenced by how the prospective revisions in the power purchase agreements with the IPPs roll out. Furthermore, a substantive progress on the Disco's governance, streamlining of tariff adjustments, and upgradation of transmission and distribution infrastructure, will remain key in improving the overall viability of the power sector.

Third, Pakistan's favorable progress on the Financial Action Task Force (FATF) front will be crucial from the foreign investors' confidence perspective. Several capacity development providers have been engaged to enhance the country's capacity with respect to

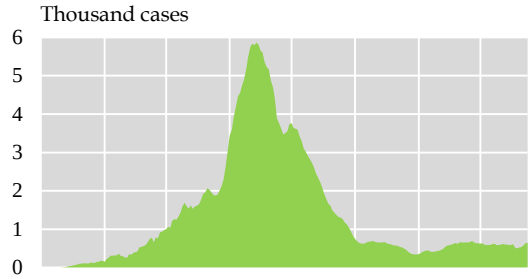
anti-money laundering and terror financing. As noted in the FATF's October 2020 plenary session, Pakistan has largely addressed 21 of the 27 action items, including all the primary deliverables relevant to supervision of financial institutions. In addition, the country was considered to be partially compliant with the remaining six items, and progress on these items is going at a fast pace. The adoption of the required AML/CFT-related amendments in Pakistan's legal framework – especially the Anti-Money Laundering Act and the Anti-Terrorism Act – by the Parliament, has been a major step forward. Accordingly, regulators in the country, including the SBP, SECP and Self-Regulated Bodies, have issued their updated AML/CFT regulations.

Fourth, consistent efforts are needed to consolidate the improvement in the country's financing landscape in order to promote investment, competition, businesses' growth and overall productivity. Creation of a secured transaction registry, licenses issued to private credit bureaus, and widespread adoption of digital financial services all bode well with respect to improving credit penetration and overall access to finance, especially for small and medium enterprises (**Chapter 7**). Moreover, the increased focus on low-cost housing and affordable mortgages would help deepen financial penetration and bring vibrancy in construction-allied industries. Importantly, the outreach efforts by the SBP and commercial banks for the provision of financing relief (such as SME tracing, aggressive marketing, close working relationship with business chambers, frequent stock-taking, and grievance handling) are proving helpful to ensure inclusivity.

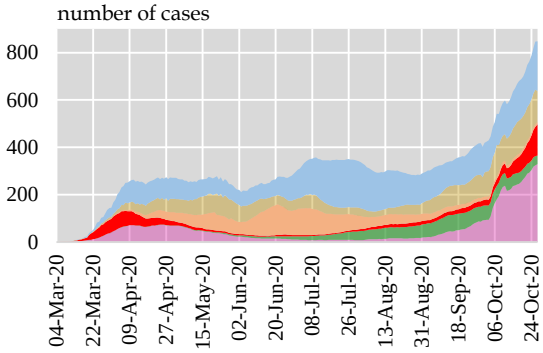
1.2 Economic Outlook

As things stand, Pakistan has managed to control the virus spread (**Figure 1.2a**). Although fresh infections have posted a slight increase in recent weeks, the overall level of active cases remain significantly lower than the peak observed in June 2020. While the prevalent risk of another spike calls for a continuation of social distancing norms, the reopening of the economy (including services) has helped reduce some of the uncertainty around the overall macroeconomic outlook.

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



New Covid-19 Cases per million (7-day rolling average) in Selected Economies **Figure 1.2b**



Source: WHO

However, the global containment of the virus still remains elusive. Active cases in the US, the UK, India, France, and Italy remain high (**Figure 1.2b**). Advanced European economies are bracing for another wave, with rising number of cases witnessed in the UK, Belgium, Italy and Greece. Social distancing norms and localized mobility restrictions are being re-introduced in many countries, whereas recent mobility data also suggests plateauing recovery across many countries. As a result, while a rebound in growth is expected in nearly all the regions in 2021, downside risks remain high (**Figure 1.3**).

For now, with the ease in containment measures, retail sales have recovered in the US and the major EU economies, though this recovery was mainly concentrated in groceries, healthcare supplies, and consumer electronics. Clothing retail sales have yet to recover, as they continued to decline in double digits between June and August in the US and EU. The overall global economic outlook also remains uncertain due to the still-high infection rate in some countries, expiration of temporary unemployment support measures in the US, and continuation of the US trade dispute with China. These uncertainties continue to present downside risks to

Real GDP Growth Projections for Major Regions **Figure 1.3**

Source: IMF WEO October 2020

Pakistan's exports growth. Preliminary customs' records for the first quarter of FY21 show a decline of 0.7 percent YoY in the country's exports, although a 7.0 percent increase was recorded in the month of September. For the full year, SBP expects export values within the range of US$ 23.4 – 23.8 billion in FY21 – higher than the US$ 22.5 billion recorded in FY20 (**Table 1.2**).

Similarly, the SBP expects full-year imports to remain higher than last year, given the anticipated pickup in economic activity following the lifting of lockdowns, and firms' efforts to replenish inventories. In particular, the concessions for the construction industry and progress on housing finance would revive steel imports. In addition, lower domestic production and supply-management issues have necessitated imports of wheat and sugar. Energy imports, however, would depend on

Key Macroeconomic Targets and Projections **Table 1.2**

		FY21	
	FY20	Target[1]	SBP Projections[2]
	percent growth		
Real GDP	-0.4	2.1	1.5 – 2.5
CPI (average)	10.7	6.5*	7.0 - 9.0
	billion US$		
Remittances	23.1	21.5	22.0 – 23.0
Exports (fob)	22.5	22.7	23.4 - 23.8
Imports (fob)	42.4	42.4	42.8 - 43.7
	percent of GDP		
Fiscal deficit	8.1	7.0	6.5 - 7.5
Current a/c deficit	1.1	1.6	1.0 - 2.0

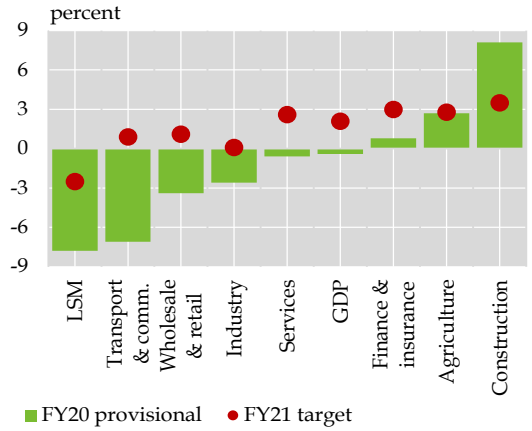
*Projection for CPI inflation, Annual Plan 2019-20, Planning Commission

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

the ongoing substitution trend between imported and local fuel sources. As for oil prices, though having more than doubled from 19-year lows (US$ 19/bbl) in April 2020, Brent still hovered around US$ 40 per barrel by end-October. Through the end of CY-2021, the crude oil market is projected to remain range-bound – due to weaknesses in the aviation sector and the risk of re-imposition of lockdowns amid a still high number of active Covid cases.

Given this stability in oil prices, domestic fuel prices are likely to remain steady during FY21. However, as previous adjustments in the power and gas tariffs are due, there is an upside risk to overall energy inflation. Conditions in the domestic food market are also subject to risk. The recent resurgence in wheat and sugar prices continues to highlight commodity-management problems in the country. Moreover, food prices may also come under pressure due to widespread torrential rains and increased risks of flooding, which may cause crop losses. In contrast, the non-food-non-energy segment of CPI is

Growth Targets for GDP and Major Sectors for FY21 **Figure 1.4**



Source: PBS and Planning Commission

expected to ease further, as chances of a significant pick-up in domestic demand remain low due to weak financial position of businesses and households. Overall, the SBP expects headline inflation to fall within the range of 7-9 percent in FY21.

On the fiscal side, challenges remain, as the government continues to focus on addressing Covid-related economic and social outcomes and supporting the initial economic recovery. For the full-year, the government has set the target for the fiscal deficit at 7 percent of GDP,

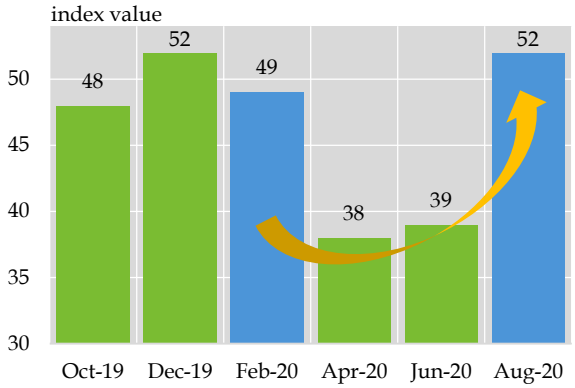
with the primary balance also estimated to show a deficit of 0.5 percent. Thus, with a tight fiscal position, a significant contraction in grants (social transfers) and subsidy outlay – the two major areas with large slippages in FY20 – is targeted for FY21. In case of any overshooting under these heads, the debt servicing relief of US$ 2.7 billion (equivalent to 1 percent of GDP) provided to Pakistan under the G-20's Debt Servicing Suspension Initiative will help create expenditure space for Covid-related spending (**Chapter 5**).

In terms of growth, the government has set the GDP growth target at 2.1 percent for FY21 (**Figure 1.4**). This year-on-year improvement is expected to come from a steady performance of agriculture and a recovery in the services sector, especially finance & insurance, and transport & communications. Industrial performance is also estimated to post a modest recovery, primarily on account of a much contained contraction in large-scale manufacturing as compared to FY20. The SBP expects GDP growth to stay within the range of 1.5 – 2.5 percent during FY21. Nonetheless, these growth projections are subject to risks, including from the evolution of Covid, extreme weather conditions, external demand, and progress on the reform front. In particular, earlier estimates for *kharif* crops (especially cotton) do not seem promising, given weaknesses in farmers' financial condition and heavy rains causing losses to standing crops.

There are also some upside risks, especially in the context of a resurgence in business confidence in the country following the ease in lockdowns and falling Covid cases. The August wave of the IBA-SBP confidence surveys suggests that the business confidence index not only posted a sharp surge compared to the previous two waves, but it has also come in positive territory after remaining in the negative zone for three consecutive waves (**Figure 1.5a**). The improvement in the expected business confidence index (a sub-component of the overall business confidence index) was more pronounced, as it touched its second-highest level since the start of this survey. Importantly, this optimism has also begun to reflect in planned investment activity in the country. As shown in **Figure 1.5b**, funding requests under the SBP's Temporary Economic Refinance Facility (TERF) have risen sharply in recent weeks. The scheme, which provides subsidized financing to businesses undertaking capex or BMR, has so far attracted 338 projects. These developments, along with optimism in the housing and construction sectors, could help accelerate the economy's recovery process in FY21.

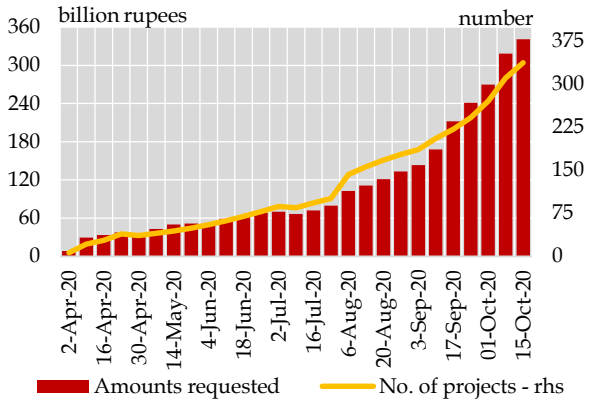
Given the fact that the TERF is geared towards supporting investment activities in the country, the uptick in its utilization is encouraging from a structural viewpoint as well. Pakistan has historically been a consumption-oriented economy, which resulted in unsustainable growth spurts and investment rates not only remaining lower than most EMDEs, but also declining in absolute terms over the past few decades. In this regard, a strong response to incentive schemes such as TERF bodes well for the future economic trajectory, as capital formation activities would help enhance and potentially diversify the output capacity of Pakistan going forward.

Business Confidence has Improved Significantly **Figure 1.5a**



Source: SBP-IBA Business Confidence Survey

Businesses' Demand for Capex Loans under TERF **Figure 1.5b**



Source: State Bank of Pakistan

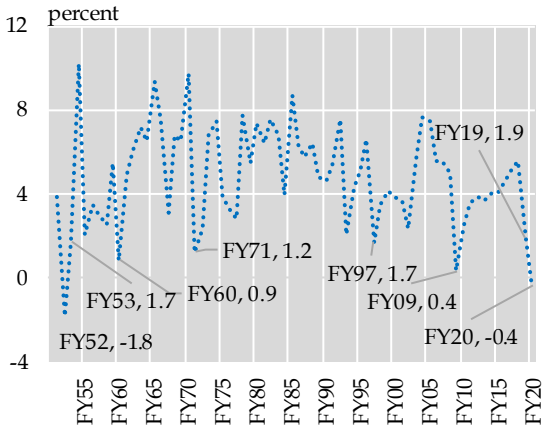
Chapter 2
Economic Growth

Pakistan's economy was on course towards steady recovery by February 2020 following moderation in the twin deficits. However, the nascent recovery was abruptly disrupted by the domestic onset of Covid-19. A strict lockdown imposed by the government helped contain the outbreak to manageable proportions, but at the same time created severe strain on economic activities. Manufacturing, transport and trade were among the hardest hit segments. By contrast, crop production in the agriculture sector remained relatively unscathed by the pandemic, since the harvest for most of the important crops was nearly completed by the time Covid-19 began spreading across the country. In a bid to revive the economy, the government relaxed some of the restrictions and opted for a smart lockdown by June 2020. Nonetheless, economic growth had already been hit by then, as Pakistan's GDP growth contracted by 0.4 percent in FY20 – the country's first brush with negative economic growth since FY52.

2.1 GDP Growth

After experiencing growth in each of the last 68 years, the economy recorded its first annual contraction in FY20 (**Figure 2.1**). Registering already the lowest growth of the decade in FY19, the economy was under the influence of fiscal consolidation, monetary tightening and transition to a market-based exchange rate regime as it entered FY20. However, nearly halfway through the fiscal year, the decline in some economic indicators were beginning to show signs of bottoming out, particularly in the export-oriented sectors. It was at this nascent stage of recovery that the economy was hit by the coronavirus pandemic (Covid-19).

Economic Growth in Pakistan **Figure 2.1**



Source: Pakistan Bureau of Statistics

The negative economic shock of Covid-19 was not a localized phenomenon, the contagion spread to all corners of the world, and the majority of countries imposed lockdowns to limit its spread. "Great Lockdown" resulted in suspension of economic activities across the globe. The IMF's World Economic Outlook clearly highlights the impact of Covid-19 at the global level in the growth projections of its October 2019 to June 2020 forecasts (**Table 2.1**). In case of Pakistan, the projections turned from a positive 2.4 percent growth to a contraction of 0.4 percent in FY20.

IMF Projections over the Course of FY20 **Table 2.1**

percent

	Projections for 2020		Diff. from
	Oct-19	Jun-20	Oct-19
World output	3.4	–4.9	-8.3
Advanced economies	1.7	–8.0	-9.7
United States	2.1	–8.0	-10.1
Euro area	1.4	–10.2	-11.6
Japan	0.5	–5.8	-6.3
United Kingdom	1.4	–10.2	-11.6
Canada	1.8	–8.4	-10.2
Other advanced economies	2.0	–4.8	-6.8
Emerging markets & developing economies	4.6	–3.0	-7.6
Emerging and developing Asia	6.0	–0.8	-6.8
China	5.8	1.0	-4.8
India*	7.0	–4.5	-11.5
ASEAN-5	4.9	–2.0	-6.9
Emerging and developing Europe	2.5	–5.8	-8.3
Russia	1.9	–6.6	-8.5
Latin America and the Caribbean	1.8	–9.4	-11.2
Brazil	2.0	–9.1	-11.1
Mexico	1.3	–10.5	-11.8
Middle East and Central Asia	2.9	–4.7	-7.6
Saudi Arabia	2.2	–6.8	-9.0
Pakistan*	2.4	–0.4	-2.8
Sub-Saharan Africa	3.6	–3.2	-6.8
Nigeria	2.5	–5.4	-7.9
South Africa	1.1	–8.0	-9.1

* Projections for Pakistan and India were presented on a fiscal year basis.

Source: International Monetary Fund, World Economic Outlook, October 2019, April 2020 and June 2020 Update. For more information please visit https://www.imf.org/en/Publications/WEO

From the perspective of expenditure side of the economy, public and private consumption combined as percentage of GDP declined by 2.9 percentage points to 91.6 percent in FY20 over last year, mainly due to decrease in household consumption. The decline in private consumption was expected given that both stabilization measures and the Covid-

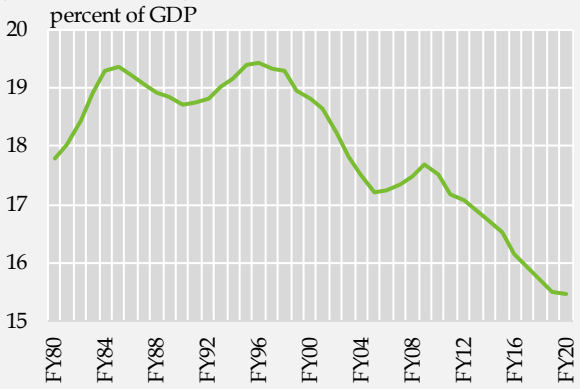
induced lockdowns curtailed consumer demand. On the other hand, government expenditure registered a noticeable increase with its share rising in GDP.[1] The increase was especially warranted in the aftermath of Covid-related need to support the healthcare sector and the economically vulnerable segment. To accelerate recovery in the post-Covid period, the government acted swiftly and announced relief packages for multiple sectors of the economy, especially the labor-intensive construction industry, which was afforded several economic incentives, such as rationalization of capital gains tax, reduction in project approval times, subsidy on housing finance etc., to help revive its growth.

Furthermore, investment as percent of GDP witnessed yet another contraction, falling by 0.2 percentage points to 15.4 percent of GDP in FY20. The incidence of low investment rates has been a persistent structural issue in the country restraining economic growth from reaching its potential (**Box 2.1**).

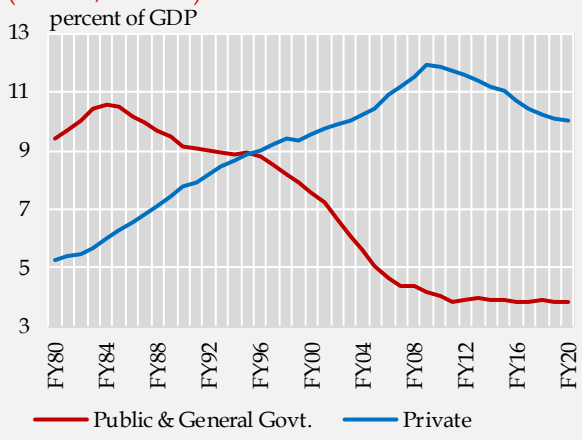
Box 2.1: Low Investment has been an Enduring Constraint to Sustainable Economic Growth

The investment rate in Pakistan has declined in the past few decades (**Figure 2.1.1a**). Its current level is low, both in absolute as well as in relative terms, vis-à-vis a number of emerging economies.[2] This shortage of investments has left Pakistan's economy increasingly vulnerable to boom-bust cycles of economic growth, since most of the growth spurts have been financed primarily by foreign inflows, rather than domestic savings.

Overall Investment **Figure 2.1.1a**
(Annual, 10Y MA)



Private vs Public Investment **Figure 2.1.1b**
(Annual, 10Y MA)



Source: Pakistan Bureau of Statistics

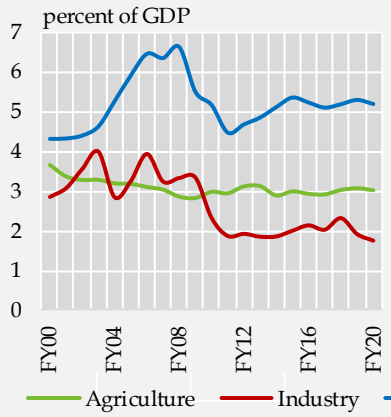
A closer inspection of the National Accounts shows that private investment which had been climbing steadily, could not sustain its momentum in the last decade (**Figures 2.1.1b**). The disinclination exhibited by the private sector towards investment is more evident in the industrial sector, which received, on average, only 2 percent of GDP over the last 10 years compared with 3 percent for the agriculture sector, despite both having a similar share in GDP (**Figure 2.1.2a**). The overall weak investment climate – characterized by macroeconomic instability, misaligned exchange rates, low domestic savings, a large informal sector and infrastructure bottlenecks – is primarily responsible for lower investment activity. Moreover, challenges with respect to ease of doing business – especially in the areas of contract enforcement, reliable and affordable energy supplies, operational facilitation,

[1] Private consumption as percent of GDP fell to 78.5 in FY20 from 82.9 in FY19. Meanwhile, government expenditure as percent of GDP increased from 11.7 in FY19 to 13.1 in FY20.
[2] According to the World Bank, gross capital formation as percent of GDP averaged around 25.4 percent in the Emerging Markets and Developing Economies (128 countries) during 2010-2019 period. Even in a smaller sample of just South Asian countries (Afghanistan, Bangladesh, Bhutan, India, Nepal, Pakistan, Sri Lanka; data for Maldives not available), the average investment to GDP ratio is 32.5% and Pakistan's ratio is lowest in the region.

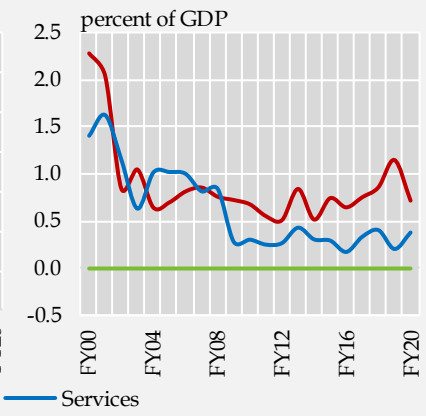
tax infrastructure, low-level of human capital and limited access to finance – are also behind the inadequate nature of investment activities in Pakistan.[3] In this regard, recent improvements in Pakistan's ranking in the Ease of Doing Business are welcome, and they need to be further consolidated to attract productive investments in the country.[4]

Moreover, public investment has also seen its share drop from nearly 10 percent of GDP during the 1980s to less than 4 percent on average in the 2010s. While public investment in agriculture sector has been low over the years, the industrial and services sectors have also witnessed notable declines (**Figure 2.1.2b**). On an aggregate level, the decrease in public investment in services has been compensated to some extent by increase in investment from the private sector (**Figure 2.1.2c)**. However, the same cannot be said about the industrial sector, which has received much less attention from public and private agents alike, thereby impeding its long-term growth prospects.

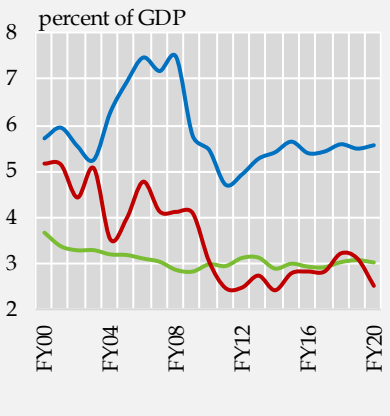
Private Investment **Figure 2.1.2a**



Public Investment Excl General Govt. **Figure 2.1.2b**



Overall Investment Excl General Govt. **Figure 2.1.2c**



Source: Pakistan Bureau of Statisitcs

The declining investment-to-GDP ratio in the economy requires determined policy attention. The decline should be a cause for concern for policymakers because investments support economic growth that in turn facilitates job creation for the growing population.[5] Keeping in view the strains on the fiscal sector, the government can engage private sector through a mix of incentives and necessary regulations. The policy measures should aim to encourage private sector to undertake investments on its own as well as to participate in arrangements like public-private partnerships.

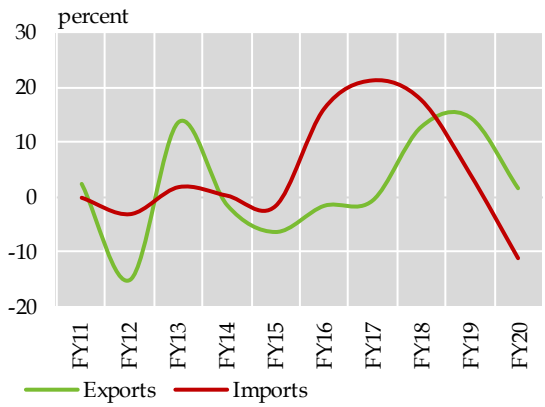
The moderation in domestic demand played a key role in improving the external sector imbalance. Imports in FY20 declined by 11.1 percent in real terms (at constant prices of FY06) compared to 4.3 percent growth in FY19 **(Figure 2.2**). Exports of goods and services, on the other hand, witnessed a marginal increase in real terms. Keeping the disruptive influence of Covid-19 in perspective both domestically and on the global scale, this was still a formidable performance (**Chapter 6**). These developments could be attributed in part to transition towards a market-based exchange rate regime, which has been a key component of the stabilization program.

Finally, in the wake of the Covid-19 shock, the supply side of the economy was adversely affected. Industry and services sectors could not cope with the challenging business environment, especially under the mobility restrictions that remained largely in place from March to June FY20. Prior to the onset of Covid-19, the industrial sector especially LSM,

[3] Source: Chapter 7, Factors Constraining Investments in Pakistan: Beyond the Macroeconomics, SBP Annual Report FY19- The State of Pakistan's Economy.
[4] Pakistan was ranked 108th in the Ease of Doing Business Ranking in the World Bank's Doing Business Report 2020, up from 136th position in its previous report.
[5] According to Pakistan Economic Survey FY20, the current annual population growth rate in the country is 1.94 percent and total population is expected to reach 263 million by 2030 based on estimates by the United Nations.

was showing early signs of recovery primarily on the back of export-oriented industries. The apparel segment in particular witnessed an increase in its exports price. However, the moderation in domestic consumption deepened the contraction in industries such as construction-allied, petroleum, and automobile. The performance of the industrial sector had a spillover effect on services as well. Specifically, wholesale and retail trading activities were subdued even in the pre-Covid period, owing to their linkages with declining LSM and imports. The Virus-induced lockdown compounded the situation further, given the direct and knock-on effects generated by the decline in transport services.

Developments in External Sector (YoY growth) **Figure 2.2**



Source: Pakistan Bureau of Statistics

However, in the midst of all this, the agriculture sector appeared to be the redeeming feature of the economy, as it maintained its growth despite some deceleration in livestock. Higher water availability during the year and increased application of fertilizer during the *Kharif* season compared to FY19 supported crop production. Still, unfavorable weather conditions and pest/virus attacks prevented some important crops, like cotton, rice and wheat, from realizing their full yield potential.

2.2 Agriculture

The agriculture sector grew by 2.7 percent during FY20, which was an improvement compared to its output last year (**Table 2.2**). Important crops posted a welcome turnaround overall, as wheat and rice output rose compared to a year earlier, mainly on the back of increased area dedicated to these two crops. There was some switching in cultivated area away from sugarcane and in favour of cotton. This appeared to be partly an outcome of deliberate policy reorientation, to move some area away from the more water-intensive sugarcane crop. Nonetheless, the cotton crop was unable to deliver, as yields were affected by weather conditions and pest attacks. Fortunately, agriculture remained somewhat insulated from the adverse impacts of Covid-19, as most of the important crops had nearly been harvested before the disruptions began.

Agriculture Sector Growth (Annual, FY16-FY20) **Table 2.2**

percent

	FY16	FY17	FY18	FY19	FY20[P]
Agriculture	0.2	2.2	4.0	0.6	2.7
Crops	-5.3	1.2	4.7	-5.0	3.0
Important crops	-5.9	2.6	3.6	-7.7	2.9
Other crops	0.4	-2.5	6.3	2.6	4.6
Cotton ginning	-22.1	5.6	8.8	-12.7	-4.6
Livestock	3.4	3.0	3.7	3.8	2.6
Forestry	14.3	-2.3	2.6	7.9	2.3
Fishing	3.3	1.2	1.6	0.8	0.6

P = provisional

Source: Pakistan Bureau of Statistics

Inputs

Water availability was higher during FY20 as compared to last year. Specifically, surface water availability grew by around 9 percent in *Kharif* and 18 percent during the *Rabi* season compared to FY19 (**Figure 2.3**). This may be explained by an increase in rainfall, which was

Rainfall Recorded during Jul-Mar FY20 **Table 2.3**

in millimetres

	Q1-FY20	Q2-FY20	Q3-FY20
	Monsoon	Post-monsoon	Winter Rainfall
Normal*	140.9	26.4	74.3
Actual	140.4	56.3	123.0
Excess**	-0.5	29.9	48.7
as percent	-0.4	113.3	65.5

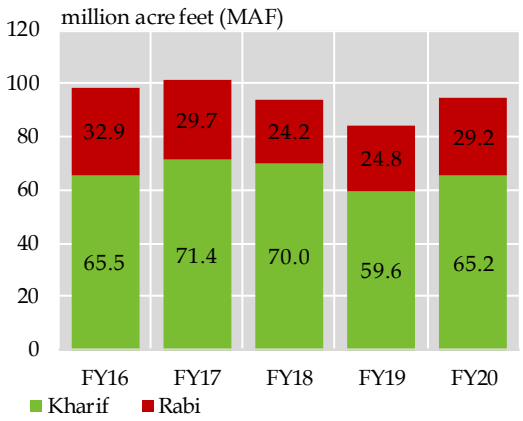
* The normal level is defined as period average from 1961-2010

** The minus sign represents a shortage compared to 'normal'

Source: Pakistan Meteorological Department

notably higher during Q2 and Q3-FY20 compared to the average level observed during these periods in the past (**Table 2.3**).

Actual Surface Water Availability **Figure 2.3**



Source: Indus River System Authority

Total fertilizer offtake during FY20 was marginally lower as compared to last year; specifically, total urea offtake declined by 0.4 percent and total DAP offtake declined by 0.6 percent (**Table 2.4**). However, disaggregating the total offtake by season reveals that during *Kharif*, fertilizer offtake was higher for both urea (4.7 percent) and DAP (8.1 percent). The pattern then reversed in *Rabi*, as urea and DAP offtake fell by 5.3 percent and 7.3 percent respectively.

The rise in average retail price of fertilizers during April to September 2019, leading up to the *Rabi* season, appeared to play a part in depressing demand. In particular, urea prices rose by 20.2 percent during this period, and climbed by a further 7.8 percent during October 2019 to March 2020. More broadly, the *Rabi* 2020 season witnessed an increase in the general price level may have made growers more inclined to rationalize their expenditure on fertilizer. Non-food rural CPI inflation averaged 9.2 percent during October 2019 to March 2020, on top of 7.4 percent during April to September 2019.[6] As such, the overall price pressures during the *Rabi* season.

Season-wise Fertilizer Offtake and Price **Table 2.4**

offtake in thousand tons; growth in percent; prices in Rupees

		Offtake			Average Retail Prices		
		Kharif*	Rabi*	Total	Apr-19-Sep-19	Oct-19-Mar-20	Full year
Urea	2019	2,887	3,033	5,920	1,566	1,783	1,674
	2020	3,023	2,872	5,895	1,883	1,922	1,902
	Growth**	4.71	-5.31	-0.42	20.21	7.80	13.60
DAP	2019	901	1,164	2,065	3,281	3,576	3,428
	2020	974	1,079	2,053	3,596	3,601	3,599
	Growth**	8.10	-7.30	-0.58	9.63	0.69	4.97

* Kharif corresponds with Apr-Sep and Rabi with Oct-Mar
** YoY Growth in FY20

Source: National Fertilizer Development Centre (NFDC)

Agriculture Credit Disbursements **Table 2.5**

billion Rupees; growth in percent

				Growth	
	FY18	FY19	FY20	FY19	FY20
I. Farm sector (i+ii)	**482.7**	**592.7**	**637.9**	**22.8**	**7.6**
i. Production	450.1	553.1	594.3	22.9	7.4
o/w					
All crops	242.8	241.2	215.3	-0.7	-10.7
Corporate farming	120.5	179.7	194.7	49.1	8.3
ii. Development	32.6	39.6	43.6	21.5	10.1
Tractor	6.0	4.3	2.5	-28.3	-41.9
II. Non-farm sector (iii+iv)	**489.9**	**581.3**	**576.8**	**18.7**	**-0.8**
iii. Working capital	451.9	553.2	538.9	22.4	-2.6
Livestock/dairy	220.1	268.5	279.0	22.0	3.9
Poultry	119.9	150.6	209.9	25.6	39.4
iv. Fixed investment	38.0	28.1	37.9	-26.1	34.9
Livestock/dairy	33.6	20.5	14.5	-39.0	-29.3
Poultry	1.4	2.8	16.1	100.0	475.0
Total Agriculture (I+ II)	**972.6**	**1,174.0**	**1,214.7**	**20.7**	**3.5**

Source: State Bank of Pakistan

Agriculture credit disbursements experienced a slowdown during FY20 compared to a year earlier (**Table 2.5**). In the farm sector, the decline in production loans for crops deepened, while credit availed by corporate farmers grew at a relatively modest pace compared to the growth seen last year.

Meanwhile, in the non-farm sector, credit offtake by poultry segment stood out as a bright spot, with growth in loans for fixed

[6] Previously, during April to September 2019 (corresponding with the *Kharif* season), rural CPI had averaged 8.9 percent.

Area, Production and Yield of Cotton **Table 2.6**

	Area (000 hectares.)			Production (million bales)			Yield (kg/ha)		
	FY19	FY20*	Growth**	FY19	FY20*	Growth**	FY19	FY20*	Growth**
Punjab	1,887.8	1,889.4	0.1	6.8	6.3	-7.2	615.0	570.4	-7.3
Sindh	448.2	598.7	33.6	2.9	2.7	-6.5	1,115.0	780.1	-30.0
Balochistan	36.8	38.0	3.2	0.1	0.1	3.0	442.8	442.3	-0.1
KP	0.16	0.21	34.0	0.00048	0.00065	33.7	513.5	519.1	1.1
Pakistan	2,373.0	2,526.3	6.5	9.8	9.1	-6.9	706.8	618.2	-12.5

*provisional
** Growth in actual FY20 production, compared to FY19, in percent. The column entries for KP may be interpreted with caution: the large percentage growth is due to low base effect

Sources: Ministry of National Food Security and Research, SBP calculations

investment and working capital alike. The uptick in credit coincided with the launch of the government's Backyard Poultry Program in Q1-FY20. The program's key objectives include: nurturing of small flocks in traditional sheds; provision of better nutrition through the production of eggs and meat; and poverty reduction via the income derived from sale of poultry products.[7]

Output[8]

Cotton

The production of cotton declined by 6.9 percent during FY20, against a drop of 17.5 percent recorded last year. This outcome is a cause for concern, especially since area under the cotton crop had grown over last year (**Table 2.6**). The yield was estimated to have fallen by around 13 percent overall, due to unconducive weather conditions and water shortages during the early stages of sowing, as well as due to pest attacks.

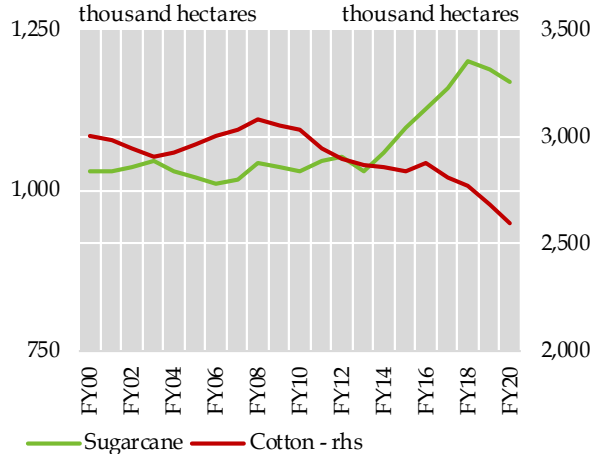
From a long-term trend perspective, the area dedicated by growers to cotton has been on the decline over the years. A key reason is that competing crops like sugarcane have, in general, tended to offer better returns, and had seen a corresponding increase in their areas under cultivation at the expense of cotton until FY18 (**Figure 2.4a**). Furthermore, cotton yields have also repeatedly been undermined by weather conditions and pest attacks (**Figure 2.4c**). There is a need to step up R&D efforts to combat such challenges. For instance, while the pink bollworm has time and again proven to be a menace for farmers in Pakistan, research in other parts of the globe has revealed novel ways to make Bt cotton more resistant to pest attacks, which could be assessed for domestic application.[9]

Sugarcane

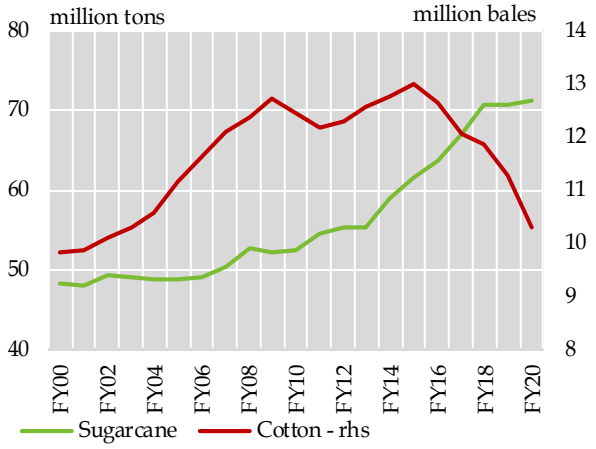
After peaking in FY18 at around 83.3 million tons, sugarcane production declined for the second season in a row, falling by 1.4 percent over last year (**Table 2.7**). The dynamics of sugarcane production in Punjab, the largest growing region, explain much of the overall outcome. The fall in production may be attributed to lower area dedicated to the sugarcane crop during FY19 and FY20 (**Figure 2.4a** and **2.4b**). It is worth recalling that the record production in FY18 had been achieved in a backdrop where indicative pricing had

[7] Source: Pakistan Economic Survey, 2019-20.
[8] The primary data source in this section is a Federal Committee on Agriculture working paper for the *Kharif* 2020-21 season released by MNFSR on 8th July, 2020. This explains the variation in some estimates compared to the earlier projections published in the Pakistan Economic Survey, 2019-20.
[9] Researchers at the University of Arizona and in China tested over 66,000 pink bollworm caterpillars over an 11-year period and created a hybrid seed mix by interbreeding Bt cotton plants with non-Bt varieties, resulting in significant pest suppression and reduced need to apply insecticides. Millions of small-scale farmers reportedly benefitted from this approach. Source: P. Wan, D. Xu, S. Cong, Y. Jiang, Y. Huang, J. Wang, H. Wu, L. Wang, K. Wu, Y. Carrière, and A. Mathias (2017). "Hybridizing Transgenic Bt Cotton With Non-Bt Cotton Counters Resistance in Pink Bollworm," *Proceedings of the National Academy of Sciences*, *114*(21): 5413-5418.

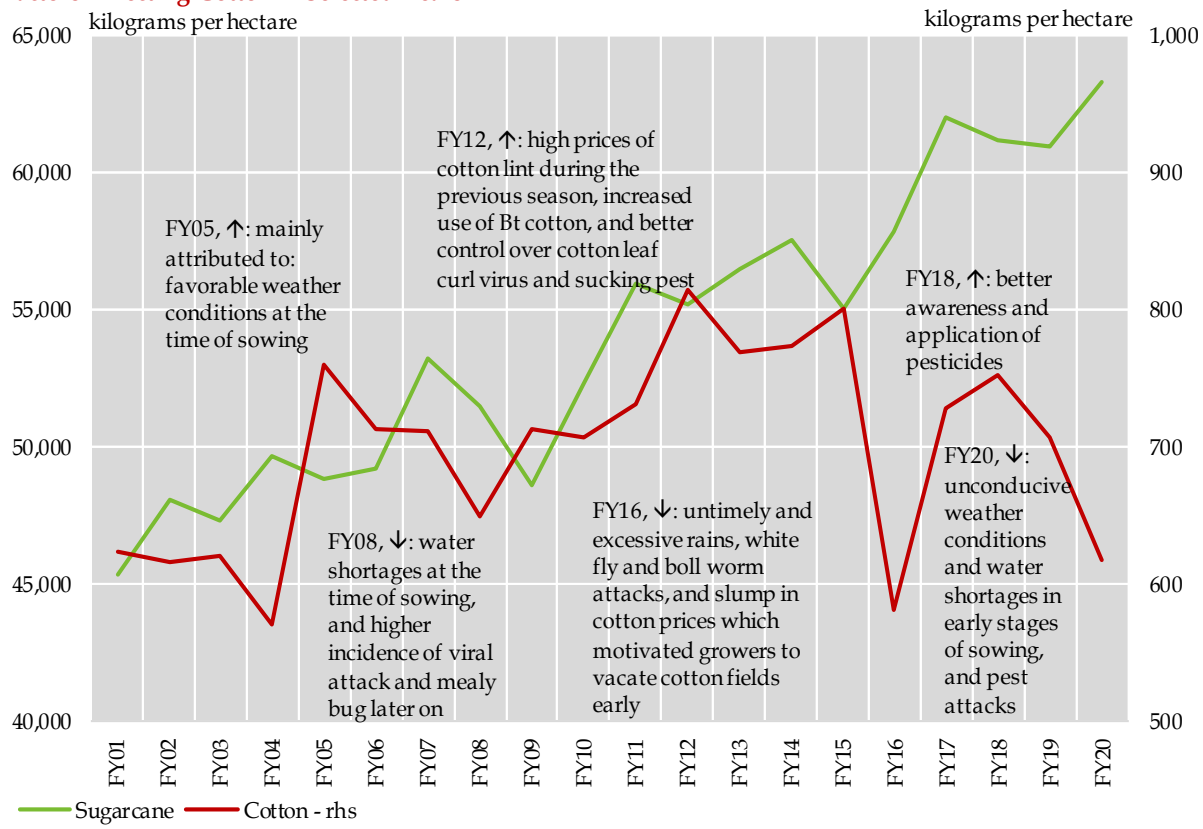
Area - Cotton & Sugarcane (5-year moving average) **Figure 2.4a**



Production - Cotton & Sugarcane (5-year moving average) **Figure 2.4b**



Yields for Cotton and Sugarcane Crops, Highlighting the Key Factors Affecting Cotton in Selected Years **Figure 2.4c**



Source: Agriculture Marketing Information Service; FCA

Performance of Sugarcane Crop **Table 2.7**

	Area (000 ha)			Production (000 tons)			Yield (kg/ha)		
	FY19	FY20*	Growth**	FY19	FY20*	Growth**	FY19	FY20*	Growth**
Punjab	710.6	643.4	-9.5	44,906.3	43,346.6	-3.5	63,194.0	67,368.0	6.6
Sindh	279.5	286.1	2.4	16,691.3	17,233.8	3.3	59,724.0	60,239.0	0.9
KP	111.0	115.7	4.2	5,532.0	5,623.8	1.7	49,842.0	48,611.0	-2.5
Balochistan	0.8	0.9	12.5	44.3	45.2	2.0	55,375.0	50,222.0	-9.3
Pakistan	1,101.8	1,046.1	-5.1	67,173.9	66,249.5	-1.4	60,963.0	63,329.0	3.9

* provisional

** Growth in actual FY20 production, compared to FY19, in percent

Source: Ministry of National Food Security and Research

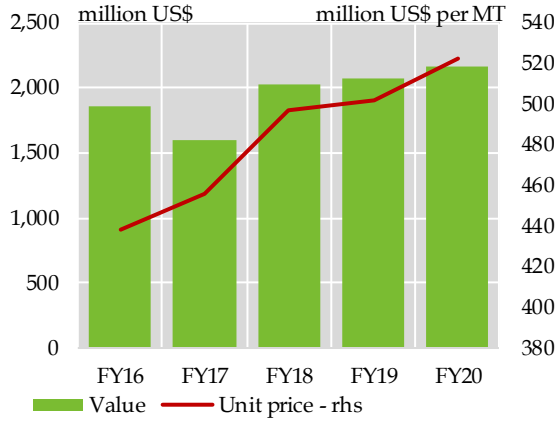
made the sugarcane crop more profitable relative to other crops, and millers had also made timely payments to growers in the preceding (FY17) season. However, delayed payments by millers to sugarcane farmers in FY18 and FY19 likely influenced the growers' decision to dedicate lesser area to the sugarcane crop in the FY20 season.

From a policy standpoint, the government appears to have realized that policies related to sugarcane need to be revisited. To tackle water scarcity, the Federal Committee on Agriculture, in its meeting for *Kharif* 2017-18, had encouraged the provinces to devise strategies to lower the area dedicated to sugarcane in favor of low-delta, high value crops.[10] This was an important development, given that estimates suggest that sugarcane production in Pakistan is relatively water inefficient compared to competing crops like cotton.[11] Moreover, the Annual Plan for 2018-19 also acknowledged that sugar surpluses (derived from rising domestic sugarcane production amid support prices) were creating issues because they could not be offloaded in the external market without subsidies. Consistent with this shift in mindset, the target for area under sugarcane was restricted to approximately 1.18 million hectares in FY20 – lower than the 1.34 million hectares of actual production observed in FY18.

Rice

Rice exports have been increasing in the past few years on the back of rising unit prices, as well as favorable demand-side dynamics in key European, and more recently, Middle Eastern markets (**Figure 2.5**; further details in **Chapter 6**). This favorable performance induced an 8.0 percent increase in the area under the crop during FY20. However, production did not grow at the same pace, and yields either fell or remained stagnant in the various rice growing regions, reportedly on account of unfavorable weather conditions (**Table 2.8**).

Pakistan's Rice Exports **Figure 2.5**



Source: Pakistan Bureau of Statistics

[10] 'Delta' refers to the depth of water required by a crop to come to maturity. Sugarcane and rice tend to be high delta crops, whereas cotton and maize, as well as certain vegetables, tend to have lower deltas.

[11] A recent estimate by the Pakistan Institute of Development Economics (PIDE) suggests that the sugarcane crop consumes around 3.5 times more water as compared to cotton on a per acre basis. Source: PIDE (2020). *Unravelling Water Use Efficiency in Sugarcane and Cotton Production in Pakistan*. Policy Viewpoint No. 220.19. Islamabad: Pakistan Institute of Development Economics.

Performance of Rice Crop **Table 2.8**

	Area (000 ha)			Production (000 tons)			Yield (kg/ha)		
	FY19	FY20*	Growth**	FY19	FY20*	Growth**	FY19	FY20*	Growth**
Punjab	1,904.0	2,029.0	6.6	3,979.0	4,143.7	4.1	2,090.0	2,042.0	-2.3
Sindh	690.2	775.9	12.4	2,571.1	2,576.5	0.2	3,725.0	3,321.0	-10.8
Balochistan	153.5	164.2	7.0	498.1	535.0	7.4	3,245.0	3,258.0	0.4
KP	62.3	64.9	4.2	153.8	155.2	0.9	2,469.0	2,392.0	-3.1
Pakistan	2,810.0	3,034.0	8.0	7,201.9	7,410.4	2.9	2,563.0	2,442.0	-4.7

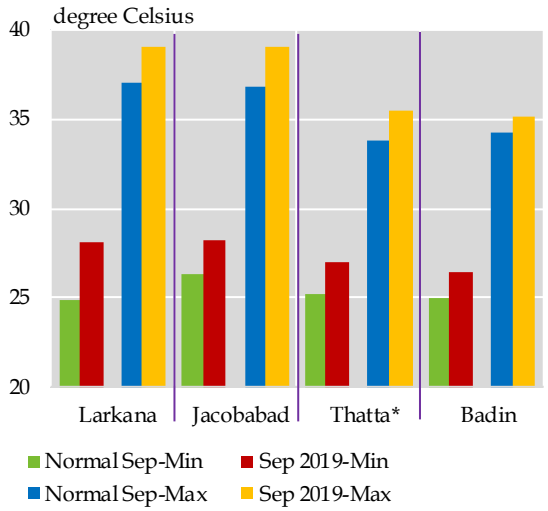
* provisional

** Growth in actual FY20 production, compared to FY19, in percent

Source: Ministry of National Food Security and Research

The rice crop is particularly susceptible to temperature and rainfall as it approaches maturity, which tends to be around September.[12] [13] On this note, high minimum temperatures at the start of September 2019 and rain towards the end of the month reportedly had a negative impact on the rice crop in the Kalar tract of Punjab.[14] [15] Similarly, higher than normal temperatures – particularly in September 2019 – affected yields in certain rice-growing areas in Sindh (**Figure 2.6**). This explains why rice production in the province remained almost stagnant at last year's level, despite a 12.4 percent increase in the area dedicated to the crop.[16]

Temperatures in Selected Rice-Growing Districts. Sep 2019 compared to Normal* **Figure 2.6**



* Normal temperature is represented by the long-term average during 1981-2010 for September. For Thatta only, it is given by long-term average for 2004-2019

Source: Pakistan Meteorological Department

Wheat

The wheat crop posted an increase of 2.5 percent during FY20 over last year (**Table 2.9**). The rise in output could mainly be traced to an increase in the area under production, while its yield also improved marginally compared to FY19.

That said, the crop missed its annual production target of 27 million tons, with actual production being just shy of 25 million

[12] The rice crop is typically sown during May/June in Punjab, and can take around four months to reach maturity, depending on the variety. (Sources: Pakistan Agricultural Research Council and Ayub Agricultural Research Institute Faisalabad).

[13] The rice crop goes through three broad stages of development: (1) vegetative, (2) reproductive, and (3) grain filling and maturation. These stages may be subdivided further, starting with germination of the seed and ending with formation of the grain.

[14] Source: SUPARCO Crop Situation and Forecast Report, Volume IX (Issue 10), October 2019.

[15] 'Kalar' is a term used by locals to describe soil that is suitable for Basmati rice cultivation. The Kalar tract is located along the Ravi and Chenab rivers, spread across districts such as Sialkot, Sheikhupura, Narowal, Gujranwala, Hafizabad and Lahore.

[16] Rice-growing areas in the province include Larkana and Jacobabad in upper Sindh, and Thatta and Badin in lower Sindh.

tons. The target had initially appeared to be achievable amid an uptick in the area

Performance of Wheat Crop** **Table 2.9**

area in 000 ha; production in 000 tons; yield in kg/ha; growth in percent

	Area	Growth	Production	Growth	Yield	Growth
FY17	8,972	-2.7	26,674	4.1	2,973	7.0
FY18	8,797	-1.9	25,076	-6.0	2,851	-4.1
FY19	8,678	-1.4	24,349	-2.9	2,806	-1.6
FY20*	8,825	1.7	24,946	2.5	2,827	0.7

* provisional

** Change in actual FY20 production, compared to FY19, in percent

Source: Pakistan Bureau of Statistics

dedicated to the crop, but heavy rains and unfavorable temperatures damaged the standing crop. Anecdotal evidence suggested that heavy rains in the Potohar region of northern Punjab during Q3-FY20 (especially March) created excess moisture and colder temperatures, triggering the onset of leaf rust disease.[17] Moreover, during April and May 2020, untimely rain, hail, and windstorms affected the harvesting and threshing of wheat in some parts of central Punjab and the Potohar region.[18]

The government uses a combination of support prices and public procurement to maintain strategic reserves of wheat to ensure food security. In principle, such strategic reserves allow it to stabilize domestic supply and price of wheat. However, FY20 witnessed financing and administrative challenges with respect to the implementation of this policy. Public procurement remained lower than the target, which triggered speculative sentiments in wholesale and retail markets and led to crisis-like shortages and price hikes through most of the year (**Chapter 3**).[19] As a result, wheat stocks at the start of the food year on May 1, 2020 amounted to just 0.6 million tons, compared to 3.8 million tons at the comparable date in 2019, and much lower than the average carry forward stock of around 4.5 million tons during FY15-FY19.[20] In this backdrop, the ECC set the procurement target of 8.25 million tons for 2020 in its February meeting. The latest available data shows that procurement by the provincial food departments and PASSCO for 2020 amounted to around 6.6 million tons – i.e. nearly 80 percent of the target.[21] As a result, the wheat stock as of July 16, 2020 amounted to 6.7 million tons, compared to 7.7 million tons at the comparable date last year.

Maize

The maize crop had provisionally been estimated to grow by 2.5 percent during the year, based on data for Jul-Mar FY20. However, updated data released in July 2020 indicated a 3.9 percent decline in production (**Table 2.10**).[22] According to the revised estimates, both the area under production as well as the output itself fell by nearly 4 percent, while yield stagnated.

The availability of maize seeds was an important constraint in terms of the area dedicated to the crop. During *Kharif* FY20, the available stock of maize seed for autumn sowing met only 65 percent of the total seed requirement, compared to 98 percent in *Kharif* FY19.[23] Similarly, during *Rabi* FY20, the seeds available for spring sowing accounted for just 68 percent of the total seed requirement, compared to 86 percent availability in the previous *Rabi* season.[24,25] It is pertinent to mention that Pakistan placed a ban on field trials and import of genetically modified (GM)

[17] The Potohar Plateau encompasses districts such as Rawalpindi, Islamabad, Chakwal, Attock and Jhelum.
[18] Source: Monthly Bulletin for April 2020 and May 2020, National Agromet Centre, Pakistan Meteorological Department.
[19] For details, see 'Report of the inquiry committee constituted by the Prime Minister of Pakistan regarding wheat/flour controversy'.
[20] Data source: Ministry of National Food Security and Research
[21] Source: MNFSR press release dated July 23, 2020.
[22] Source: Ministry of National Food Security and Research.
[23] Source: FCA *Kharif* Working Papers for 2019-20 and 2020-21.
[24] Source: FCA Rabi Working Paper, 2019-20
[25] Maize is grown in both the *Kharif* and *Rabi* season.

Performance of Maize Crop **Table 2.10**

	Area (000 ha)			Production (tons)			Yield (kg/ha)		
	FY19	FY20*	Change**	FY19	FY20*	Change**	FY19	FY20*	Change**
Punjab	899.8	860.4	-4.4	5,915.5	5,670.3	-4.1	6,575.0	6,590.0	0.2
KP	468.0	452.6	-3.3	904.6	881.6	-2.5	1,933.0	1,948.0	0.8
Sindh	3.5	3.9	11.4	3.5	4.0	14.3	1,016.0	1,015.0	-0.1
Balochistan	2.8	2.7	-3.6	2.8	2.7	-3.6	1,000.0	1,000.0	0.0
Pakistan	1,374.0	1,319.6	-4.0	6,826.4	6,558.6	-3.9	4,968.0	4,970.0	0.0

* provisional

** Change in actual FY20 production, compared to FY19, in percent

Source: Ministry of National Food Security and Research

Gross Value Added (GVA) of Livestock Sector **Table 2.11**

million Rupees; growth in percent

			Growth	
	FY19R	FY20P	FY19R	FY20P
A. Gross output	1,724,372	1,776,473	3.5	3.0
Animals sold for slaughtering	392,043	403,468	2.9	2.9
Natural growth/regeneration	245,172	252,460	3.0	3.0
Livestock products	897,855	924,696	3.0	3.0
Milk	771,223	796,050	3.2	3.2
Others	126,632	128,646	1.6	1.6
Poultry products	189,303	195,849	7.9	3.5
B. Intermediate consumption	294,580	310,518	1.6	5.4
C. Gross value added (A-B)	1,429,793	1,465,956	3.9	2.5
D. Other GVA*	8,616	9,284	-4.5	7.8
E. Total GVA (C+D)	1,438,408	1,475,240	3.8	2.6

R: revised; P: provisional, * hunting and husbandry

Source: Pakistan Bureau of Statistics

maize seeds early in FY20. The ban was enforced over concerns that GM maize might, inter alia, contaminate traditional crops and potentially harm maize exports in future to GM-free countries; this may have had a bearing on maize output during FY20, according to anecdotal evidence.

Livestock

The livestock sector grew by 2.6 percent in FY20, compared to 3.8 percent last year (**Table 2.11**). This represented the sector's lowest growth in the past six years; after the previous low of 2.5 percent in FY14, livestock had grown by 3.6 percent on average during FY15-FY19. However, despite the latest slowdown, the sector continued to be the biggest contributor to value addition in agriculture, accounting for 60.6 percent of overall agriculture and 11.7 percent of GDP in FY20.[26]

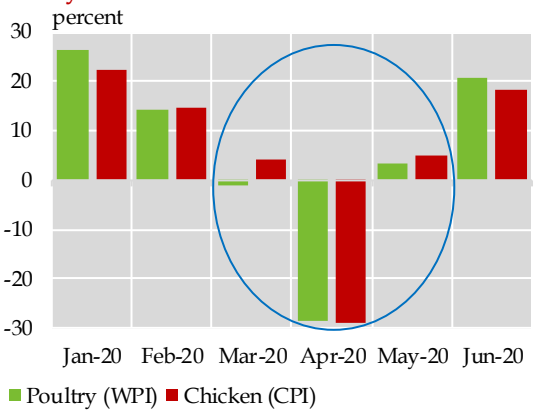
Within livestock, milk and related products continued to have the largest contribution to value addition. On this note, the Livestock Census used to be published every 10 years, with four editions prepared during 1976-2006. Thus, a fresh census is being anticipated since 2016; updated census data would be a more credible input for evidence-based policies for the milk segment in particular, and the livestock sector in general.

Meanwhile, the output of the poultry segment reflects recent developments, and as such, the slowdown in poultry products was mainly responsible for dragging down the GVA of livestock during FY20. Demand for poultry products fell in the wake of the Covid-induced

[26] Source: Pakistan Economic Survey, 2019-20.

lockdown, given the restrictions on banquets, marriage halls and hotels, and SOPs that limited the activities of restaurants to takeaway orders or deliveries only.[27] In addition, some unfounded rumors circulating through social media regarding the risk of Covid-19 spreading through chickens may also have temporarily dented demand, though the Pakistan Poultry Association (PPA) was quick to discredit these by issuing a clarification at the start of June 2020. The impact of subdued demand on wholesale and retail prices is reflected in the YoY WPI and CPI inflation for poultry items during March to May 2020 (**Figure 2.7**).

Impact of Lockdown on YoY Poultry Inflation **Figure 2.7**



Source: Pakistan Bureau of Statistics

2.3 Industry

Provisional National Accounts data shows that industrial sector output declined by 2.6 percent in FY20, compared to a contraction of 2.3 percent in FY19 (**Table 2.12**). It was the first time that industrial activity contracted for two years in a row. The decline in FY20 was led mainly by the dip in manufacturing and mining activities. In particular, the decline in large-scale manufacturing (LSM) activity was the largest ever registered, which in turn also weighed heavily on the overall performance due to its sizeable weight of more than 50 percent within the industrial sector.[28] In addition to the stabilization program that had moderated domestic demand, the lockdowns following the pandemic also affected industrial sector activities.

The LSM sector also could not escape the adverse economic implications of the Covid-19 pandemic (**Figure 2.8**). Prior to FY19, LSM growth was positive; however, the subsequent fiscal consolidation, monetary tightening and exchange rate realignment dampened the growth starting FY19. Finally, in the middle of FY20, signs of nascent recovery started to emerge, but this recovery was cut short by the Covid-19 pandemic, which resulted in a full-year contraction in LSM of 10.0 percent.[29]

From a policy perspective, high interest rates (prior to Covid-19) also played a role in subduing demand conditions. High interest rates largely prevailed throughout the year, but were eased substantially in the aftermath of Covid-19 (since March 2020).

Performance of the Industrial Sector **Table 2.12**
(YoY growth, percent)

	FY16	FY17	FY18	FY19	FY20
Industrial sector (1 to 4)	5.7	4.6	4.6	-2.3	-2.6
1. Mining and quarrying	6.2	-0.6	7.8	-3.2	-8.8
2. Manufacturing (i+ii+iii)	3.7	5.8	5.4	-0.7	-5.6
i) Large scale[29]	3.0	5.6	5.1	-2.6	-7.8
ii) Small scale	8.2	8.1	8.2	8.2	1.5
iii) Slaughtering	3.6	3.6	3.5	3.5	4.1
3 Electricity generation & distribution and gas distribution	9.4	-2.7	-17.2	14.5	17.7
4. Construction	13.7	9.0	10.8	-16.8	8.1

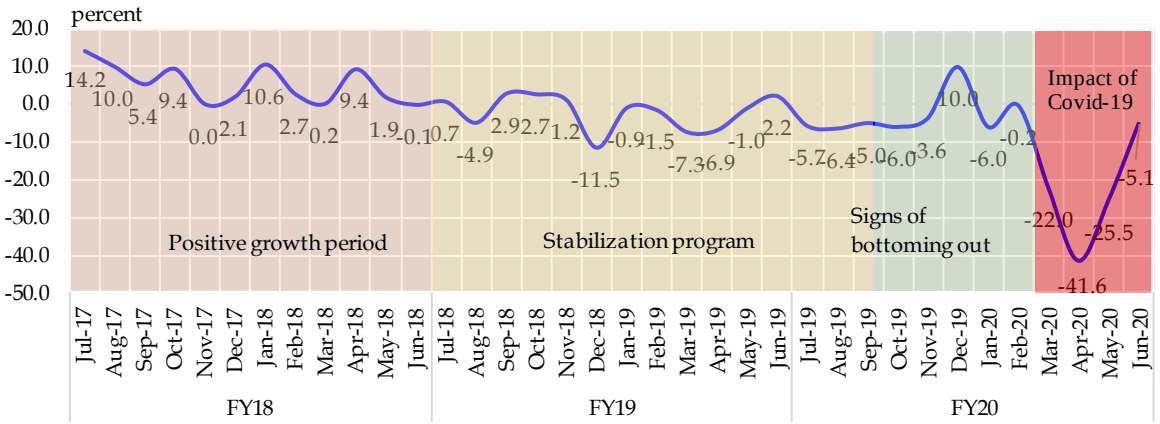
Source: Pakistan Bureau of Statistics

[27] According to anecdotal evidence available in August 2020, the Pakistan Poultry Association (PPA) claimed that the poultry industry had shrunk to Rs 800 billion compared to its pre-Covid level of Rs 1.1 trillion. PPA estimated poultry meat consumption as follows: marriage halls (15 percent); hotels and restaurants (30 percent); domestic open market (55 percent).

[28] More than 50 percent weight is the average of last 5 years (FY16-FY20).

[29] The analysis of LSM sector is based on data released by the Pakistan Bureau of Statistics' Quantum Index of LSM Industries for July 2020. The LSM numbers in the National Accounts data for the calculation of GDP and overall industrial sector were based on provisional estimates at the time, which was March 2020.

LSM Growth (YoY growth) **Figure 2.8**



Source: Pakistan Bureau of Statistics

On the other hand, the increase in fiscal expenditure was not sufficient to arrest the overall decline in the industrial sector. That said, government spending played a positive role in the output of energy and construction sub-sectors. In particular, *electricity generation and distribution and gas distribution* sub-sector posted an expansion of 17.7 percent in FY20, after growing 14.5 percent last year. The gross value addition of the electricity sector contributed significantly to the sub-sector's performance, which can be attributed to higher output growth relative to intermediate consumption. It is important to recall here that the government had rolled out a comprehensive circular debt reduction program at the start of the year to improve viability of the power sector and arrest the accumulation of arrears. Accordingly, power tariffs were increased in the initial months of FY20 to pass on the impact of rising capacity charges and fuel price adjustments. This had helped improve gross revenues in this sector. In contrast, the growth in intermediate consumption was modest due to a shift in the fuel mix in favor of cheaper sources, such as hydel and coal.

The construction sector also benefited from public sector spending, registering a growth of 8.1 percent in FY20 compared to a contraction of 16.8 percent in FY19. Increase in current as well as PSDP expenditure aided growth in the construction sector.[30] Large infrastructure projects, such as Diamer-Bhasha dam, Mohmand dam, highways (Sukkur-Multan motorway, Lahore Multan motorway etc.) and intra-city public transport network (BRT Peshawar) were fast-tracked during FY20. Furthermore, in the midst of the pandemic, the construction sector, due to its wider employment generating potential, was given several incentives by the government.[31]

The mining sector's output fell largely on account of a decrease in the output of fossil fuels. Crude oil and natural gas production fell by 10.6 and 6.4 percent respectively. The production of these commodities fell due to lower exploration activities, slowdown in demand for energy products and regulatory restrictions on production of furnace oil in the upstream refineries. Meanwhile, amid special circumstances related to the Covid-19 pandemic, the typical fixed-growth calculation methodology for small scale industry was not used by the PBS in FY20. Instead, detailed sectoral analysis was employed, and it showed that the output for this sector decelerated to 1.5 percent. Last year, a fixed growth rate of around 8.2 percent was used to derive

[30] Source: Fiscal Operations, July to June 2019-20, Ministry of Finance.
[31] Source: The Tax Laws (Amendment) No. 1 of 2020, Law and Justice Division Letter F.No.1(1)/2020, dated April 19,, 2020, Federal Board of Revenue.

estimates of gross value addition at constant prices of this cottage industry.[32]

Large-Scale Manufacturing

The developments in the LSM sector during FY20 can be explained more clearly by dividing it into two phases: pre-Covid, and the period after the onset of Covid-19. The pre-Covid period was from July 2019 to February 2020, while the second period covered the rest of FY20.[33] The LSM sector was showing some early signs of recovery in the pre-Covid-19 period; the contraction in a few industries had bottomed out (such as petroleum and steel), while others had started to gain some traction, such as textile, leather, fertilizer, cement, food and paper. As the Covid-19 infections started to climb and lockdowns ensued, almost all manufacturing activities came to an abrupt halt. It dragged even the previously better performing sectors into negative growth territory (**Table 2.13**).

Automobile

The automobile sector was the largest contributor towards the decline in the LSM index. The industry contracted by 43.8 percent in FY20 on the top of 11.8 percent contraction last year. The sector was already in downtrend before the pandemic struck, mainly due to stabilization measures like the Pak Rupee depreciation, increase in taxes as well as interest rates, and an overall economic slowdown. The situation worsened after Covid-19, as lockdowns adversely affected the production activities. Variant-wise data shows that production of majority of car categories fell by around half of last year's level (**Table 2.14**).

On the supply side, there was a sharp cost escalation. The Pak Rupee depreciation and increase in duties led to an increase in vehicle prices. The Pak Rupee on average depreciated by another 13.9 percent vis-à-vis USD in FY20, whereas it had depreciated by 19.3 percent in FY19. Low levels of localization in the automobile industry forced the assemblers to pass on the increase in import costs to customers. Moreover, the government-imposed federal excise duty and increased additional customs duty, which resulted in further increase in prices of vehicles.

LSM Growth (YoY percent) **Table 2.13**

	wt.	Jul-Feb		Mar-Jun		Full Year	
		FY19	FY20	FY19	FY20	FY19	FY20
LSM	70.3	-1.6	-2.9	-3.7	-24.0	-2.3	-10.0
Textile	20.9	-0.1	0.4	0.1	-31.8	-0.1	-10.4
Cotton yarn	13	0.0	0.1	0.1	-32.6	0.0	-10.8
Cotton cloth	7.2	0.1	0.2	0.5	-32.4	0.2	-10.7
Jute goods	0.3	-12.4	4.3	-4.0	-16.0	-9.5	-3.1
Food	12.4	-1.0	1.1	-13.9	-10.3	-5.6	-2.6
Sugar	3.5	-8.2	10.3	-38.9	-49.9	-19.9	-7.2
Cigarettes	2.1	9.0	-31.2	-9.5	-6.8	2.8	-24.1
Vegetable ghee	1.1	2.5	5.7	5.1	-0.1	3.3	3.8
Cooking oil	2.2	3.0	7.4	5.3	11.8	3.7	8.8
Soft drinks	0.9	-2.1	-10.0	3.0	-13.8	-0.2	-11.5
POL	5.5	-5.5	-13.6	-13.5	-32.9	-8.4	-20.1
Steel	5.4	-10.3	-7.0	-13.2	-39.6	-11.2	-17.4
Non-metallic Minerals	5.4	-4.0	4.4	0.7	-14.3	-2.4	-2.2
Cement	5.3	-4.5	4.3	0.0	-13.7	-3.0	-2.0
Automobile	4.6	-6.0	-35.1	-23.0	-64.8	-11.8	-43.8
Jeeps and cars	2.8	1.3	-45.7	-21.4	-78.8	-6.2	-54.8
Fertilizer	4.4	4.9	6.0	13.4	1.4	7.7	4.4
Pharmaceutical	3.6	-8.7	-5.2	-7.5	2.5	-8.3	-2.7
Paper	2.3	-3.2	5.1	-4.8	-3.4	-3.7	2.3
Electronics	2	36.0	-7.8	118.3	-67.8	59.4	-31.2
Chemicals	1.7	-3.9	0.5	-4.5	-19.8	-4.1	-6.4
Caustic soda	0.4	-2.5	-3.8	-18.9	-23.6	-8.7	-10.4
Leather products	0.9	0.0	10.1	-6.7	-45.6	-2.4	-9.1

Source: Pakistan Bureau of Statistics

Factors that had constrained demand during the pre-Covid period included reduced purchasing power of customers and a higher level of fuel prices. Prices of petrol and diesel remained on the higher side in FY20, compared to their levels in FY19. Similarly, prices of auto parts, such as tyres and lubricants, also rose sharply, increasing the cost of maintenance for vehicles. On the fiscal side, austerity measures like ban on purchase of vehicles (except motorcycles) for use in the

[32] This fixed growth rate was based on inter-survey annual compound growth rate of Small and Household Manufacturing Industries (SHMI) between FY97 and FY07.
[33] The government imposed mobility restrictions in March 2020.

Automobile Sector Production **Table 2.14**

	Number of units produced				Growth	
	FY17	FY18	FY19	FY20	FY19	FY20
All cars	167,405	195,895	191,526	89,875	-2.2%	-53.1%
Cars <800 cc	38,311	47,199	32,121	33,786	-31.9%	5.2%
Cars between 800-1000 cc	35,313	49,848	56,760	17,905	13.9%	-68.5%
Cars >1000cc	93,781	98,848	102,645	38,184	3.8%	-62.8%
Sports utility vehicles	3,530	13,364	7,525	3,564	-43.7%	-52.6%
Light commercial vehicles	43,796	50,934	42,182	16,518	-17.2%	-60.8%
Trucks	7,712	9,187	6,035	2,945	-34.3%	-51.2%
Buses	1,118	784	913	532	16.5%	-41.7%
Tractors	53,975	71,894	49,902	32,608	-30.6%	-34.7%
Motorbikes	1,632,965	1,928,757	1,766,423	1,370,417	-8.4%	-22.4%

Source: Pakistan Automotive Manufacturers Association

public sector subdued the demand further.[34] The ban was applied for both current as well as development expenditures of the government.

In the aftermath of the pandemic, production was completely halted in April 2020, and even when assembling resumed in subsequent months, the industry operated well below its installed capacity. This situation, due to Covid-19, was not specific to Pakistan alone. Across the globe, production of vehicles fell, as demand plummeted due to sharp increase in unemployment levels. All major players in the global automobile industry, except Kia and Hyundai, were projecting to report operating losses.[35] Moreover, automotive production in the US and the EU was estimated to fall by 25 percent in 2020.[36]

Construction Allied Industry

The output of steel and cement industries contracted further in FY20, after declining in FY19 as well. The decline in steel was more acute as it suffered double-digit contraction for the second year in a row. The cement sector, however, which was faring well in the pre-Covid-19 environment, also experienced decline when the lockdowns were imposed. It is worth noting that the contraction in both cement and steel sectors (**Table 2.13**) does not reconcile with the reported expansion in the construction industry (**Table 2.12**). Perhaps this gap has stemmed from the time horizon of data reporting in the National Income Accounts, which, in the case of the construction industry, spanned across July-March FY20, whereas the reporting period for cement and steel in the LSM sector ran for the entire fiscal year.

Analysis of the LSM data in tandem with borrowing pattern for the industry showed that construction activities slowed down, at least in the private sector. After witnessing an expansion of Rs 10.4 billion in consumer financing for house building in FY19, net retirements of Rs 9.3 billion were recorded during FY20. In a similar vein, borrowing by real estate developers decelerated from Rs 8.6 billion in FY19 to Rs 2.6 billion in FY20, owing largely to contraction in demand for fixed investment loans (**Chapter 3**). Analysis on

[34] Austerity measures for financial year 2019-20, Office Memorandum No: 7(1) Exp.IV/2016-812, Finance Division, Government of Pakistan

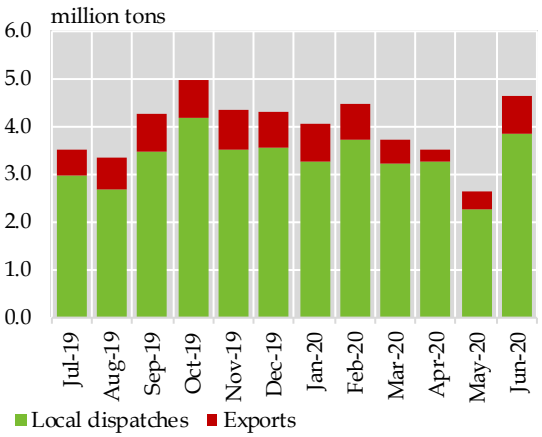
[35] Source: Auto Sector Amid Covid-19, S&P Global, https://www.spglobal.com/en/research-insights/featured/auto-sector-amid-covid-19

[36] Source: European Automobile Manufacturers Association, https://www.acea.be/press-releases/article/eu-car-sales-forecast-2020-record-drop-of-25-expected-this-year-says-acea
Credit FAQ: Q&A: COVID-19 And The Auto Industry--What's Next?, S&P Global Ratings, https://www.spglobal.com/ratings/en/research/articles/200609-credit-faq-q-a-covid-19-and-the-auto-industry-what-s-next-11518344

basis of Covid-19 situation shows the situation deteriorated further after pandemic. Whereas increase in interest rates and ban on non-tax-filers on purchase of property had hurt demand for housing credit in the pre-Covid phase, the impact on demand was accentuated further by mobility restrictions and loss of incomes during the pandemic period.

The steel industry downtrend deepened in FY20. In addition to a slowdown in housing demand, contraction in the automobile industry also played a role in depressing steel output. Production of long steel products, used mainly in construction sector activities, also dipped sharply. Moreover, the contraction in the automobile sector adversely affected flat steel producers throughout the year, as demand remained low.

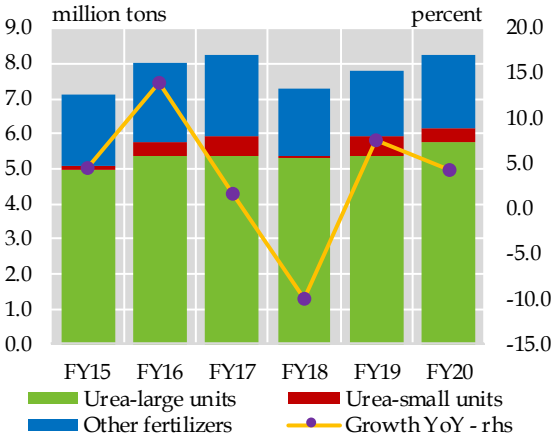
Cement Sales **Figure 2.9**



Source: All Pakistan Cement Manufacturers Association

The cement industry's output grew steadily during the year up until the Covid-19 outbreak. After a dull Q1-FY20, the output of the cement industry started to turn positive in the following two quarters. Robust local sales in the north and export-led activity in the south facilitated this growth. Increase in local dispatches during this period also indicated gradual recovery in construction-allied industries, especially in Punjab and Khyber Pakhtunkhwa. On the other hand, exports of clinker – a product produced in the manufacturing process of Portland cement – gained traction in the international market. However, after the Covid-19 outbreak, the cement industry's output started to fall in Q4-FY20. Local dispatches declined and exports also suffered a drop; however, they recovered sharply as soon as the restrictions were softened towards the end of Q4-FY20 (**Figure 2.9**).

Fertilizer Production & Growth **Figure 2.10**



Source: National Fertilizer Development Centre

Fertilizer

The fertilizer sector's output expanded by 4.4 percent in FY20 on the back of impressive performance by large urea firms and, to an extent, recovery in production of other fertilizer products (**Table 2.13**).[37] It was one of the few industries that remained insulated from the Covid-19 lockdowns, which aided its output. The demand for fertilizer products remained largely intact, as the agriculture sector's economic activities remained immune to strict mobility restrictions observed mainly in urban centers.

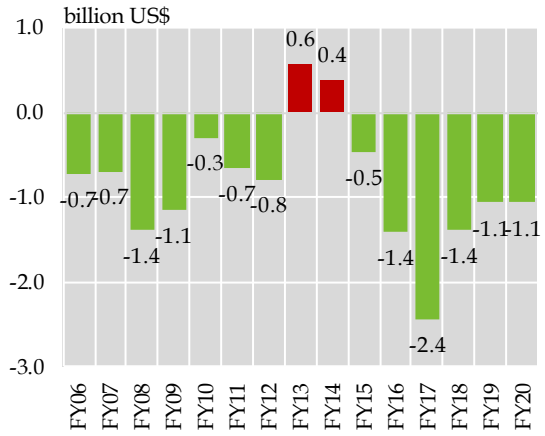
Output of larger urea processing units rose by 8.4 percent in FY20 compared to a negligible growth in FY19. It was the highest ever output by these plants. Together with the relatively smaller units, production crossed 6 million tons for the first time in the country's history (**Figure 2.10**). Smaller units' output

[37] The analysis of urea production in this section relates to production on the basis of fiscal year, whereas the earlier discussion in the agriculture section of the chapter relates to urea offtake, and is based on cropping seasons, which explains the apparent variation in numbers. Moreover, the YoY growth is slightly different from LSM

dropped due to gas supply disruptions. However, lower output from these facilities did not affect the overall production given their minor share in the industry (6.3 percent in FY20). As there was no corresponding increase in the installed capacity during this period, the performance can be attributed to enhanced operational efficiency of larger urea plants.[38]

In addition to urea, the production of other fertilizer products also recovered. After contracting in the last two years, this segment grew by 9.8 percent during FY20. Double digit growth was observed in processing of Calcium Ammonium Nitrate and Nitro Phosphate (20.4 and 31.3 percent respectively), which more than offset the decline in Di-Ammonium Phosphate, Single Super-Phosphate and other Nitrogen-Phosphorus-Potassium (NPK) products.

Net Food Exports **Figure 2.11**



Source: Pakistan Bureau of Statistics

Food

The food industry's output shrank by 2.6 percent in FY20, on the top of 5.6 percent contraction observed last year. Most of the activity in food processing group is concentrated within tobacco, sugar and edible oil industries. In FY20, output of edible oil industry expanded in line with last few year's trend. On the other hand, production of sugar and tobacco industry declined in FY20 compared to last year.

As things stand, Pakistan remained a net food importing country in value terms in FY20, despite witnessing improvement in its trade balance. The food trade balance remained at last year's level of negative US$ 1.1 billion (**Figure 2.11**). As also highlighted previously in SBP's Annual Report for FY19, for an agriculture- based economy like Pakistan, the trend in food imports does not bode well from a food security standpoint. Lack of modernization and low-productivity in the agriculture sector has a knock-on effect on the food-processing sector. For instance, the relatively low yields of oilseeds in the country make domestic edible oil processing industry dependent on imports of palm oil and oilseeds. Not only does this restrict growth of the industry as it only caters to meeting domestic demand, it also costs significant amount of foreign exchange. In a similar vein, low yield of pulses and milk also entails imports of these items.

Changes in FED on Cigarettes **Table 2.15**

Timeline	Tier	(Price=P in PKR/1000 cigarettes)	FED
Jun-16	Tier 1	> 4,000	3,436
	Tier 2	< 4,000	1,534
May-17	Tier 1	> 4,500	3,740
	Tier 2	2,925 < P < 4,500	1,670
	Tier 3	< 2,925	800
Apr-18	Tier 1	> 4,500	3,964
	Tier 2	2,925 < P < 4,500	1,770
	Tier 3	< 2,925	848
Sep-18	Tier 1	> 4500	4,500
	Tier 2	2,925 < P < 4,500	1,840
	Tier 3	< 2,925	1,250
Jun-19	Tier 1	> 5,960	5,200
	Tier 2	< 5,960	1,650

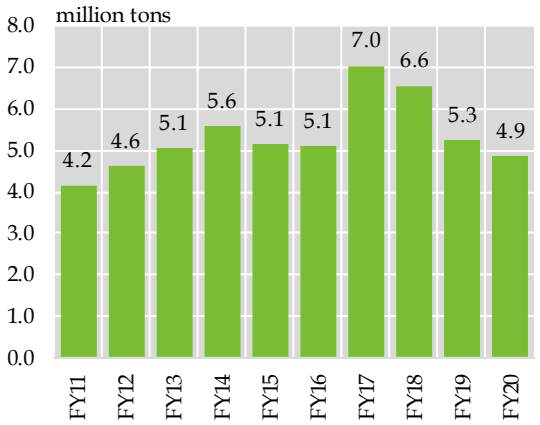
Source: Federal Board of Revenue

Meanwhile, a fall in the cigarette production can be attributed to the re-introduction of the two-tier excise duty structure in FY20 in place of the three-tier structure that had remained in place for the past couple of years (**Table 2.15**). Moreover, the duty was significantly increased compared to last year. The rationale for this measure was to discourage tobacco

[38] Sources: (1) Half Yearly Financial Statements, 30 June 2020, Fauji Fertilizers Company Limited and (2) Half Yearly Report 2020, Engro Fertilizers.

consumption as well as to increase revenues. Arguably, tobacco usage may not have fallen as envisioned, given the relatively inelastic nature of cigarette consumption; it may have just driven the consumers away from the formal market towards the informal one.

Sugar Production Trend **Figure 2.12**



Source: Pakistan Bureau of Statistics

Output of the sugar industry declined by 7.2 percent after dropping 19.9 percent last year (**Figure 2.12**). Lower availability of raw material (sugarcane) was one of the primary reasons for below-par results. The sugarcane production declined 1.4 percent in FY20, which directly affected the upstream sugar processing industry. This can be traced back to lower area under the crop in FY20 of 1.0 million hectares, against 1.1 million hectares last year.

Petroleum

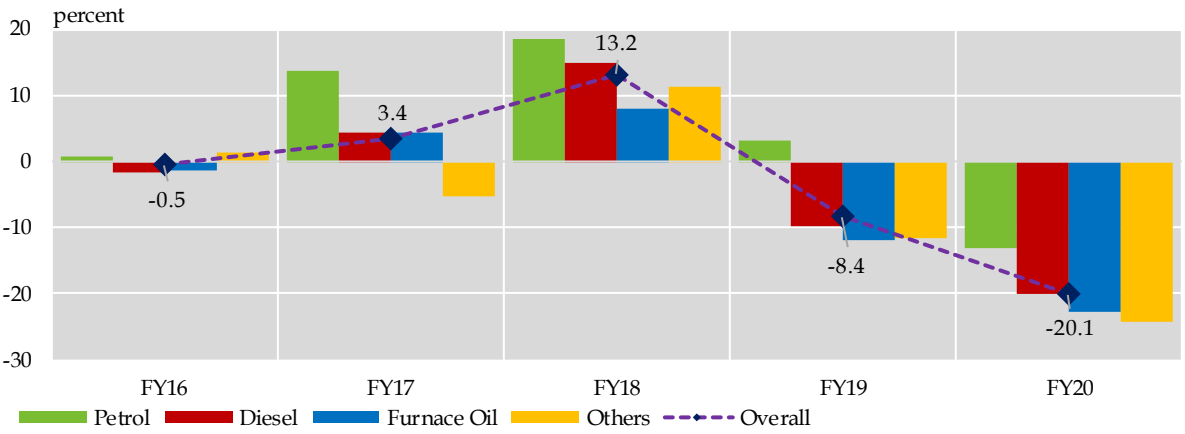
The petroleum industry was already reeling from the curbs on furnace oil production and economic slowdown in the pre-Covid-19 period. Post-outbreak mobility restrictions further diminished demand for energy products, which adversely affected the industry. The output eventually fell by 20.1 percent in FY20 compared to 8.4 percent contraction in the previous year (**Figure 2.13**).

After falling by 11.9 percent in FY19, the furnace oil output fell another 22.6 percent as a consequence of the government's policy to reduce its reliance on furnace oil-based electricity generating units. Increase in electricity generation from hydel sources and from coal did reduce dependency on furnace oil (FO) based units (**Figure 2.14**). The gradual phasing out of FO from the energy mix should be a concern for the industry because the production processes of number of refineries are outdated and produce large quantities of environmentally hazardous high-sulphur furnace oil.[39] Since refinery upgradation projects take years to complete, further delays in investment by refineries in modernizing their plants would affect the POL sector's performance for the foreseeable period.

Textile and Leather

The textile sector was showing signs of

Petroleum Industry, Product-wise Growth (Annual YoY, FY16-FY20) **Figure 2.13**

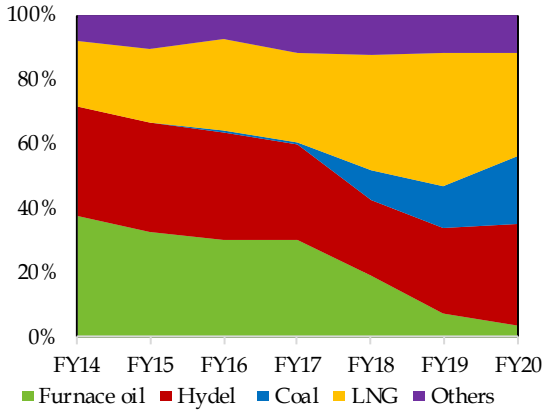


Source: Pakistan Bureau of Statistics

[39] Source: MoF (2020). "Energy". In *Pakistan Economic Survey*. Islamabad: Ministry of Finance (pp.273-285).

stability in the pre-Covid-19 period as it posted positive growth, unlike last year. During the Jul-Feb FY20 period, textile production rose by 0.4 percent, as compared to 0.1 percent contraction in the same period last year. Market-based exchange rate regime, continued concessionary access to the EU, and US-China trade tensions, all played a crucial role in supporting the competitiveness of the domestic textile industry (**Chapter 6**).

Share of Sources in Electricity Generation **Figure 2.14**

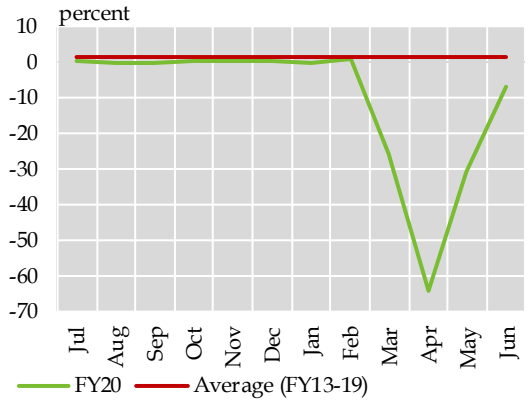


Source: NEPRA

The signs of recovery in the textile sector were evident further from exports data, which showed the highest growth in H1 since FY14. Activities in the apparel segment picked up in particular. Since China faced the onset of Covid-19 and subsequent lockdowns earlier than other countries, Pakistan along with a few other textile exporters managed to increase their share in some western markets at the start of Q3-FY20. However, this proved to be short-lived, as the government imposed lockdowns to contain the spread of the virus by late March (**Figure 2.15**). Export orders eventually dried up under the "Great Lockdown". With both demand and supply affected, the textile sector could not keep up its growth momentum and hence contracted sharply. The fallout of Covid-19 resulted in an output contraction of 10.4 percent in FY20, compared to the almost zero-growth in the last year. On quarterly basis, the production shrank by more than one-third in Q4-FY20 on YoY basis, dragging the overall FY20 growth downwards.

The developments in the leather industry were not much different. Output of the industry expanded by 10.1 percent during Jul-Feb FY20 compared to negligible growth during same period last year. Substantial growth in export orders of leather articles helps explain the output of the domestic leather industry. Another welcome development before the onset of Covid-19 was the diversification in exports away from the traditional EU market to destinations such as Australia, Brazil, and the US.

Textile Sector Growth (Monthly YoY) **Figure 2.15**



Source: Pakistan Bureau of Statistics

Electronics

The output of the electronics sector contracted by 34.8 percent in FY20 compared to an impressive growth of 59.4 percent in the preceding year. Last year's performance can be traced back to an expansion in the production of electric motors. The expansion was attributed to increase in demand for water extraction pumps, particularly the solar powered, in the agriculture sector. However, as the market for these motors saturated, the growth apparently stalled in FY20.

Furthermore, the electronics sector was also affected by the subdued demand for consumer electronics, especially during the Covid-19 lockdowns. As retail markets across the country were shut down, and demand ebbed, production of consumer durables also decreased. In the pre-Covid-19 period, the production of deep freezers posted growth of 7.0 percent, while that of air-conditioners and

refrigerators fell by 29.3 and 14.4 percent respectively. However, by the end of FY20, output of deep-freezers, air-conditioners and refrigerators, all had fallen, by 57.7, 58.3 and 33.9 percent respectively.

2.4 Services

Services sector had already experienced a notable deceleration in FY19, posting only a 3.8 percent growth compared to the average growth rate of 6.2 percent during the previous FY16-FY18 period. It is worth noting that in FY20, the services sector was already feeling the pinch from a slowdown in the industrial sector as well as from imports. Finally, the onset of Covid-19 significantly dampened the services sector growth to -0.6 percent; this contraction is unprecedented in Pakistan's economic history.

Performance of the Services Sector **Table 2.16**

percent

	Share in GDP-FY20	Growth	
		FY19[R]	FY20[P]
Wholesale & retail trade	18.2	1.1	-3.4
Transport, storage & communication	12.3	4.6	-7.1
Finance & insurance	3.6	5.0	0.8
Housing services	7.0	4.0	4.0
General government services	8.6	5.2	3.9
Other private services	11.8	5.8	5.4
Services	**61.4**	**3.8**	**-0.6**

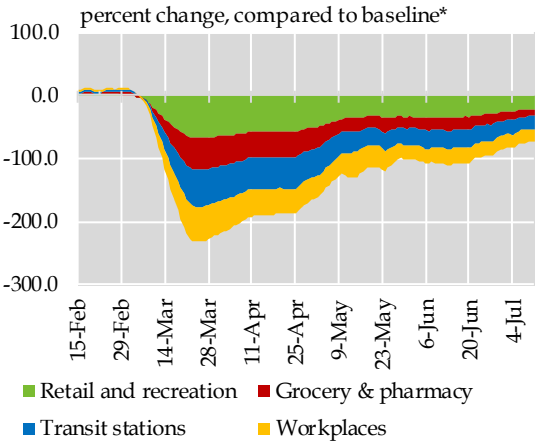
R: Revised P: Provisional

Source: Pakistan Bureau of Statistics

The *wholesale and retail trade* segment, with a share of 18.2 percent in GDP, posted a negative growth of 3.4 percent in FY20 on the back of contraction in LSM and imports (**Table 2.16**). The contraction in imports was due to continued macroeconomic stabilization policies such as monetary tightening and adoption of market-based exchange rate regime. Meanwhile, at the start of FY20, the documentation drive pursued by the government was met with resistance by various trade associations, and these frictions, continued until end-October 2019, when an agreement was finally reached among the stakeholders.

Furthermore, in the aftermath of the Covid-19 outbreak and the imposition of a country-wide strict lockdowns (entailing closure of shopping malls, non-essential retail shops, restaurants, and other commercial centers), economic activity in the *wholesale and retail trade* plunged sharply (**Figure 2.16**). However, in May 2020, with the aim of striking a better balance between lives and livelihoods, the government followed a smart lockdown strategy, which allowed businesses to resume their operations while observing the SOPs. Since then, activity in this segment started to pick up gradually (**Figure 2.16**).

Mobility Changes (15-days MA) **Figure 2.16**



* The baseline is the median value, for the corresponding day of the week, during the 5- week period Jan 3–Feb 6, 2020.

Source: Covid-19 Community Mobility Report (Google)

Within the *transport, storage and communication* segment, the transport sector faced major headwinds in FY20 (**Table 2.17**). The disagreement between government and transporters on the issue of axle load control kept surfacing during the year, affecting activities in the transport segment. The regime shift in axle load was intended to curb overloading of vehicles, in order to protect the road infrastructure and also to prevent accidents caused by overloading. However, the measure was met with resistance from certain quarters of the business community and transporters, who argued that it would unnecessarily increase the cost of doing business. Additionally, due to continued economic stabilization measures - monetary tightening, fiscal consolidation and exchange

GVA Transport, Storage and Communication Sector (Constant Prices) **Table 2.17**

percent	Share in FY20	Growth	
		FY19R	FY20P
Road transport	71.1	5.5	-9.6
Air transport	6.6	31.6	-6.5
Railways	0.4	68.6	-45.7
Water transport	3.7	75.7	16.0
Communication	15.3	7.6	4.1
Storage	2.7	0.7	-4.5
Pipeline	0.1	8.0	-12.2
Total	**100**	**4.63**	**-7.08**

R: Revised P: Provisional

Source: Pakistan Bureau of Statistics

rate adjustments - sales of trucks and buses dropped by 46.1 percent to 3,647 units only in FY20, compared to 6,763 units recorded last year.[40]

Furthermore, from March 2020 onwards, the government suspended transport services (flights, railways and public transport) for nearly six weeks to contain the spread of Covid-19, which ultimately led to a sharp contraction in the transport sector (**Table 2.17**).[41] Subsequently, operations were gradually restored, but lower demand and social distancing SOPs kept the sector's growth in check.

Meanwhile in the *communication* segment, cellular teledensity and broadband penetration rose to 80.0 percent and 39.2 percent respectively by end-June 2020, compared to 76.8 percent and 33.8 percent last year. In particular, PTCL recorded significant growth in internet traffic during the pandemic period, as e-learning, virtual meeting platforms, e-commerce, and other digital transactions gained traction (**Special Section**)[42]

In case of *finance and insurance*, a sharp deceleration in the growth rate of scheduled banks – carrying the largest share in this segment – slowed down the growth rate of the entire sector to 0.8 percent in FY20, from 5.0 percent recorded last year. The onset of Covid-19 in the second half of FY20 further diminished the growth prospects of this segment as a result of lower demand for credit from the private sector (**Chapter 3**). The deterioration in asset quality of the banking sector was also observed with the infection ratio rising to 9.7 percent in FY20 from 8.8 percent last year.

Meanwhile, the overall usage of e-banking channels, as measured by transactions via Real Time Online Banking (RTOB), ATMs, Point of Sale (POS), internet and mobile phone banking, call center banking and e-commerce, rose by 4.2 percent in volume and 12.2 percent in value during FY20 (**Table 2.18**).[43]

E-Banking Transactions **Table 2.18**

Volume in million & value in billion Rupees

	Volume			Value		
	FY19	FY20P	Growth	FY19	FY20P	Growth
E-Banking	869.8	905.9	4.2	58,820.7	65,987.3	12.2
Real time online branches (RTOB)	187.4	173.7	-7.3	49,430.7	54,433.2	10.1
ATM	523.3	512.1	-2.1	6,399.6	6,429.4	0.5
Point of sale (POS)	72.4	70.3	-2.9	366.2	364.2	-0.5
Internet banking	39.7	56.6	42.6	1,722.2	2,952.7	71.4
Mobile phone banking	41.1	82.8	101.5	866.8	1,763.6	103.5
Call centers/IVR banking	0.3	0.2	-33.3	9.2	9.3	1.1
E-commerce	5.7	10.2	78.9	26.1	34.9	33.7

P: Provisional

Source: State Bank of Pakistan

[40] Source: PAMA - Pakistan Automotive Manufacturers Association

[41] The operations of private ride-hailing services (Careem, Uber, Swvl and Airlift) were also suspended during the lockdown.

[42] Source: PTCL press release, dated July 15, 2020.

[43] Real Time Online Branches (RTOB) that are connected through Core Banking Application and provide real-time online banking across Pakistan.

Disaggregated data shows further that within e-banking channels, transactions through internet and mobile phone banking increased significantly, both by volume and value, when compared to last year. The rise in payments through these channels is a promising sign and clearly in line with the SBP's National Payment Systems Strategy (NPSS) objectives to transition people from cash-based transactions to digital ones. Furthermore, commercial banks were instructed by the SBP to waive service charges on fund transfers through online banking channels to ensure customer and employee safety during the pandemic, as well as to push digital payments through these two channels (**Special Section**).

Enhanced provision of government services also provided some cushion to the economy. For instance, considering the economic impact of the lockdowns on livelihoods of daily wage earners, the government allocated Rs 203 billion under "Ehsaas Emergency Cash Program". Around Rs 160.5 billion was already distributed among 13.3 million beneficiaries till July 27. Overall government current expenditure rose by 20.1 percent to Rs 8.5 trillion during FY20, compared to Rs 7.1 trillion last year (**Chapter 4**).

In the *other private services* segment, net ICT exports jumped by 36.0 percent YoY, to US$ 784 million (**Table 2.19**). Within this, software consultancy services and computer software witnessed growth of 23.0 percent and 48.3 percent respectively. Importantly, the jump in exports was more pronounced in the second half of FY20.[44] Amid the "Great Lockdown", the rise in ICT-related services exports indicated that Pakistani firms were able to benefit from the rise in global demand for these services. Social distancing measures adopted by governments may have further boosted demand for online services in work-from-home arrangements.[45]

Pakistan's Trade in Computer Services (Net) **Table 2.19**

(thousand US$)	FY19	FY20P
Computer services	**576,110**	**783,807**
Software consultancy services	245,690	302,194
Computer software	104,362	154,722
Hardware consultancy services	2,145	1,942
Maintenance & repairs of computer	4,640	805
Other computer services	219,273	324,144

Source: State Bank of Pakistan

[44] The net ICT export rose by 25.4 percent and 46.8 percent in H1-FY20 and H2-FY20, respectively, compared to same period of last year.
[45] WTO (2020). *Trade in Services in the Context of Covid-19*. Information Note May 26, 2020. Geneva: World Trade Organization.

Chapter 3
Monetary Policy and Inflation

Coordinated stabilization efforts, coupled with realignment of the exchange rate with market fundamentals, led to a visible improvement in twin deficits in the first eight months of FY20. Non-food-non-energy inflation also remained relatively stable, though one-off and seasonal factors kept headline inflation under pressure throughout this period. The improvement in macro fundamentals was also reflected in a steady improvement in consumer and business confidence, which paved the way for a sustainable recovery in economic growth. However, just when initial signs of this recovery became visible, the domestic and global spread of the coronavirus and the needed containment measures significantly disrupted economic activity. Businesses' supply chains were hit hard, as manufacturing and retail activities came to a near-halt. To handle the ensuing financial constraints, businesses turned to more lean operational practices and pulled the available cost-cutting levers, including optimizing inventory purchases and laying off workers. SBP responded swiftly to the emerging economic, financial, and social challenges, and introduced a series of measures aimed to alleviate financing constraints of households and businesses, protect work opportunities for the country's labor force, and extend support to the health sector. The Monetary Policy Committee (MPC) held multiple emergency meetings to review the evolving situation and cut interest rates by a cumulative 625 bps within almost 3 months, among the largest rate cuts in the world. This historically unprecedented cut was made possible by a commensurate fall in inflation and monetary policy shifting appropriately toward supporting growth in the wake of the Covid outbreak.

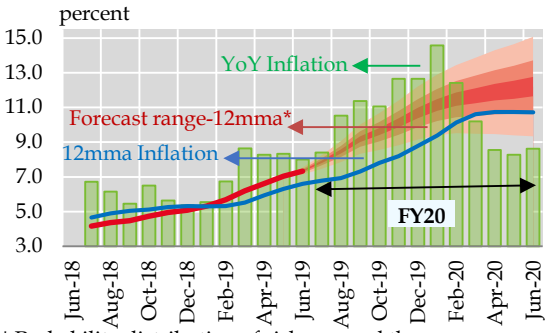
3.1 Policy Review

Following the increase of 575 bps in the policy interest rate and the realignment of the exchange rate with market fundamentals, the macroeconomic stabilization efforts to address the twin deficits had reached a mature stage at the start of FY20. These efforts had helped rein in demand pressures in the economy and strengthened the country's external position. However, headline inflation was elevated, and the forecast for the incoming year was much higher than the medium-term target. This unfavorable inflation outlook, coupled with a weak fiscal position, meant that the policy focus during FY20 would continue to center on consolidating macroeconomic stability. In fact, stabilization efforts were expected to gather momentum with the initiation of the economic reform program supported by the IMF's Extended Fund Facility from July 2019 onwards, the government's commitment to avoid deficit monetization, and comprehensive fiscal consolidation measures announced in the 2019-20 budget.

In its first meeting in July 2019, the Monetary Policy Committee (MPC) decided to raise the policy rate by 100 bps. The decision took into account upside inflationary pressures from previous depreciation of the exchange rate and a likely increase in near-term inflation from the one-off impact of adjustments in utility prices and other revenue enhancing measures announced in the FY20 budget. The SBP's CPI projections at the start of the year (July 2019) were at an elevated range of 11-12 percent, which was in excess of the medium-term target of 5-7 percent **(Figure 3.1)**. Although the cumulative change in the policy rate later proved successful in taming demand-side pressures (as reflected in consistent stability in the core inflation), the economy faced a fresh set of challenges as the year progressed.

The foremost concern was the steep surge in food inflation stemming from higher taxes (sugar, cigarettes and edible oil and ghee), increase in transportation costs, and temporary supply disruptions (fresh vegetables, wheat and sugar). However, SBP expected inflation to fall considerably in FY21, with the dissipation of one-off inflationary factors. Therefore, despite the higher inflation outturns in subsequent months, the MPC kept the policy rate unchanged in subsequent meetings. Nonetheless, a careful observation of inflation trends was necessary because if entrenched, the surge in food inflation could further damage consumer confidence, strengthen inflation expectations, and potentially spill over to non-food items in the CPI basket.

CPI Inflation Projections in July 2019 and Actual Outcome **Figure 3.1**

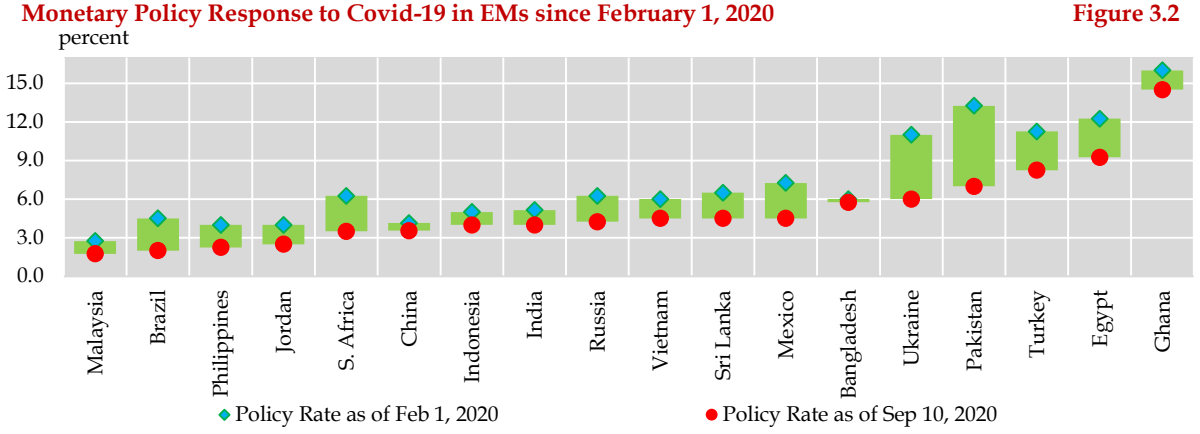


* Probability distribution of risks around the average forecast. Shades indicate various levels of confidence interval.

Source: PBS and SBP staff estimates

These price pressures kept intensifying till January 2020, but began to ease in February, as perishables' prices responded positively to administrative supply-management measures (including crackdown on speculative elements) and resumption of seasonal supplies. Inflation fell further in March when international oil prices declined significantly, following rising worldwide Covid infections and weakening global demand. But around this time, domestic infections also began to increase substantially. The domestic and global spread of the virus and the needed containment measures began unleashing disruptions of an unprecedented magnitude to

Monetary Policy Response to Covid-19 in EMs since February 1, 2020 **Figure 3.2**



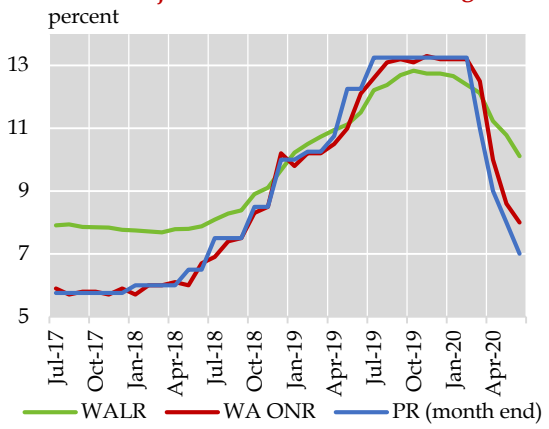
* The green bars show the magnitude of reduction in the policy rates.
Source:tradingeconomics.com; cbrates.com

the economy. Businesses' supply chains were hard hit, as manufacturing and retail activities came to a near-halt. To handle the ensuing financial constraints, firms began to adopt lean operational practices while pulling hard on multiple cost-cutting levers, including optimizing inventory purchases, laying off workers, and freezing further hiring. While profitable and cash-rich firms were expected to hold up against the crisis, solvency fears emerged for more illiquid firms – especially as the health crisis and its economic fallout worsened.

These disruptions, along with uncertainties associated with the duration of containment measures, led to a noticeable slowdown in domestic demand and weakening in consumer and business confidence. The SBP was also concerned with developments in the financial markets, as foreign fund managers pulled capital from a number of emerging market economies including Pakistan; this triggered significant selling pressure in domestic debt and equity markets. From the stability standpoint also, the evolving financial position of the corporate sector posed risk for the asset quality of the banking system. Finally, the fiscal position was also expected to deteriorate (Chapter 4), keeping in view heavy spending requirements to cover healthcare needs, social transfers, contact tracing, data management, and handling of returning migrants.

Therefore, it was imperative for SBP to respond preemptively and forcefully to handle these challenges before they morphed into an economic crisis. To cope with the challenge, SBP took comprehensive policy and regulatory measures to allay the cash-flow constraints of households and businesses, protect work opportunities for the country's labor force, and extend support to the health sector. The MPC held multiple off-schedule meetings to review the evolving situation and, leveraging the policy space available as inflation declined sharply, cut interest rates by a cumulative 625 bps within almost 3 months – the largest rate cut among the EM economies **(Figure 3.2 and Figure 3.3)**. In all these policy reviews, the MPC noted a marked reduction in inflation momentum amid a noticeable slowdown in domestic demand, softening food prices, decades low global oil prices, and a significant decline in inflation expectations. Given these factors, SBP projected the medium-term target inflation range of 5-7

Trends in Major Interest Rates **Figure 3.3**



Source: State Bank of Pakistan

percent to be achieved somewhat earlier than previously forecast. Moreover, although temporary pressures were visible on the exchange rate as well as the fiscal account, the MPC considered policy rate cuts crucial to provide cushion against slowing economic activity. This was particularly needed to make debt financing viable for firms whose interest coverage had weakened considerably during the recent monetary tightening cycle, and were therefore being priced out of the credit market.

Importantly, SBP also introduced a concessional financing scheme for businesses committing to retain their workers. To encourage banks to lend to small and medium-sized entities under this Rozgar Scheme, the SBP and the government later introduced a risk-sharing facility on first loss basis for SMEs and small corporates – 60 percent and 40 percent risk-sharing for entities with annual turnover not exceeding Rs 0.8 billion and Rs 2.0 billion, respectively. Furthermore, to provide temporary liquidity support to otherwise solvent firms and entrepreneurs, SBP allowed banks to extend the principal repayments on loans. Also, in an attempt to support investment activity in the country in these uncertain times, the central bank announced the Temporary Economic Refinance Facility to provide concessionary refinance facility for setting up new industrial units which was later extended for BMR activities as well. For the health sector, SBP introduced a refinance scheme to provide concessional credit to hospitals and other medical facilities seeking to build facilities to care for Covid-19 patients, and eased restrictions on import of medical supplies and equipment.

In the process, however, multiple structural weaknesses gained prominence, especially in the design and outreach of these measures, which necessitated scaling up the implementation efforts. In particular, the overall weak credit penetration in the economy made it challenging for SBP to achieve the desired level of policy outreach. While firms having an established relationship with banks could get financial support in these challenging times, it was feared that many financially excluded micro, small and medium-sized firms might struggle to manage their cash problems. Moreover, the informal sector, which employs over 71 percent of the country's non-agriculture labor force, was also hard to reach. The SBP took up these concerns head-on. SME tracing, aggressive marketing, frequent stock-taking, and grievance redressal became cornerstones of the implementation framework for the incentive schemes. To achieve this, the SBP worked closely with its field offices (BSC), business chambers, and commercial banks to address regulatory and operational constraints with respect to the credit offtake under these schemes. Policies were readjusted where necessary, whereas corrective actions were taken if a loan was rejected despite eligibility or when banks asked for higher than required collateral (especially under risk-sharing facilities).

The effective implementation of these measures helped alleviate the financial stress of myriad businesses, households and health-related institutions. By end-June 2020, around which the MPC held its third emergency meeting, over 1.3 million businesses had their principal payments worth over Rs 810 billion either deferred (for up to one year) or restructured. Similarly, over 2,784 businesses took financing help to pay salaries to 1.3 million employees. These developments notwithstanding, the downside risks to growth continued to remain high, as reflected in the contraction recorded in most high-frequency indicators of economic activity, including LSM, cement dispatches, petroleum sales, etc. Furthermore, consumer and business confidence remained in negative zones, as uncertainty prevailed with respect to the Covid trajectory, and the expected duration of smart lockdowns. Therefore, with demand-side inflation risks receding further and the external sector outlook becoming stable, the MPC brought down the policy rate further to 7 percent. With this decline in the policy rate, based on which an outstanding amount of Rs 3.3 trillion in loans were to be repriced by early July 2020, the cumulative potential cash flow impact to households and businesses from the SBP's collective measures reached approximately 4.0 percent of GDP.

3.2 Monetary Aggregates

The broad money (M2) grew by 17.5 percent during FY20 as compared to 11.3 percent last year. This higher expansion came on the back of a strong turnaround in net foreign assets (NFA) of the banking system. The Net Domestic Assets (NDA) also rose sharply, but their increase was lower than last year (**Table 3.1**).

Monetary Aggregates (provisional) **Table 3.1**

billion Rupees

	Jul-Feb		Mar-Jun		Fiscal Year	
	FY19	FY20	FY19	FY20	FY19	FY20
M2 (a+b)	**485.3**	**880.5**	**1,316.0**	**2,228.8**	**1,801.3**	**3,109.3**
a. NFA	-843.2	1,127.0	-455.5	-134.8	-1,298.7	992.2
b. NDA	1,328.5	-246.4	1,771.5	2,363.6	3,100.0	2,117.1
Budgetary borrowings*	**988.5**	**190.3**	**1,215.0**	**1,979.8**	**2,203.5**	**2,170.0**
SBP	3,178.1	-795.8	-99.6	660.9	3,078.5	-134.9
Scheduled banks	-2,189.6	986.1	1,314.7	1,318.8	-875.0	2,304.9
Commodity operations	-140.5	-96.9	77.2	153.9	-63.3	57.0
Private sector credit	**615.9**	**250.0**	**77.7**	**-53.7**	**693.5**	**196.4**
PSEs	115.9	-8.8	210.2	105.1	326.0	96.3
Other items net	**-254.0**	**-585.8**	**177.8**	**178.9**	**-76.2**	**-406.8**
Liability-side:						
Currency in Circulation	311.7	473.3	250.6	718.7	562.2	1,192.0
Total Deposits with Banks	166.0	407.6	1,066.5	1,502.4	1,232.4	1,909.9
Reserve Money	757.3	25.6	331.5	1,080.6	1,088.8	1,106.2

* These numbers are on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in Figure 3.4 and Table 4.1.

Source: State Bank of Pakistan

To have a clear understanding of the monetary sector developments during FY20, it is important to split the year into before and after the Covid shock. During the first eight months, the NFA remained the key driver of the overall growth in monetary base, reflecting an improvement in the current account, IFI support and foreign capital inflows in the domestic debt market. Here, it is important to recall that for the first time, the IMF's lending for balance of payments support under the ongoing program was also utilized by the government to finance its budget deficit (therefore, it was treated as a foreign liability of the government, not of the central bank). The NDA of the banking system during this period posted contraction, as foreign investment in domestic debt instruments lowered the government's appetite for bank funding. Private sector credit also weakened, as domestic industrial activity decelerated. Moreover, the sharp increase in SBP profits led to a fall in other items net.

These trends reversed completely after the spread of Covid-19: the NFA a posted net contraction, whereas the NDA recorded a steep rise. In case of NFA, two developments were important. First, foreign investors pulled their capital from the domestic market, which led to some pressures on the country's foreign exchange reserves. And second, because of these capital outflows, the Pak Rupee depreciated against the US dollar, which significantly inflated the outstanding stock of foreign liabilities (in Rupee terms) of the banking system. Foreign assets were also revalued, but given an outsized volume of foreign liabilities, the net impact was negative. This is evident from the fact that around 31 percent of the contraction in NFA during Mar-Jun 2020 stemmed from a 9 percent depreciation of the Pak Rupee. In the case of NDA, the key factor behind the expansion was a spike in the government's budgetary borrowings from the scheduled banks. This spike is explained by (i) banks' secondary market investments in government paper as foreign investors pulled out; and (ii) additional borrowing requirements of the government to handle Covid-related spending amid tapering revenue collection.

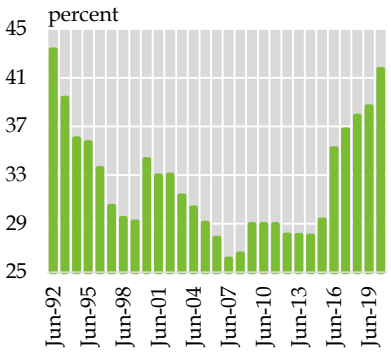
Developments on the liability side were not favorable either. As also highlighted in previous reports, the economy's cash preference has increased manifold in recent years, especially relative to the increase in bank deposits, since the imposition of withholding tax on banking cash and non-cash transactions. However, in FY20, additional challenges emerged which encouraged firms and individuals to keep more cash, as reflected in a higher currency to deposit ratio in all the quarters over last year (**Figure 3.4b**). At end-June 2020, this ratio touched 41.7 percent – a level last seen in FY92 (**Figure 3.4a**).

In the pre-Covid period, the increase in this ratio represented the impact of prevailing high levels of inflation (especially food inflation) and the resulting weak consumer confidence, as tight financial conditions may have induced firms and households to tap their savings held in the form of bank deposits, and also carry more cash. In addition to this, apprehensions of individuals and businesses with respect to the increased financial scrutiny in the country, intense monitoring against short-filing and tax evasion, and the increasing use of data on bank deposits and banking transactions (to identify high net-worth individuals and unregistered businesses) by tax authorities, also led to an increase in out-of-bank settlement for commercial and personal transactions.

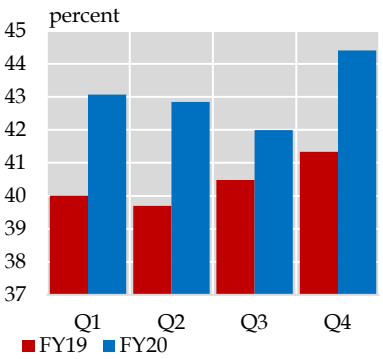
While these challenges persisted in the period after the Covid-19 spread as well, the uncertainties with respect to mobility restrictions triggered increased cash penetration in the economy. On average, the overall currency to deposit ratio hovered around 43.8 percent during Mar-Jun 2020. It appears that despite the SBP's proactive efforts to promote digital payments and uninterrupted banking operations, customers preferred cash holding for precautionary purposes. Probably this represents their attempt to minimize visits to banks amid reduced banking hours and restricted mobility. However, it is also important to note that this period (Mar-Jun) also included the month of Ramazan, when customers typically withdraw their deposits to avoid Zakat deductions and for Eid-related spending.[1] Meanwhile, the increase in currency in circulation may also reflect the impact of cash disbursements under the government's Ehsaas Emergency Cash program (to the tune of around Rs 150 billion up to June 30) to support families facing extreme financial hardship.

Nonetheless, the steady increase in cash penetration in the economy is concerning as, compared to other emerging market economies, it is already on the higher side in Pakistan. As shown in **Figure 3.4c**, the currency to deposit ratio in Pakistan is significantly higher compared to India and Egypt, almost double as compared to

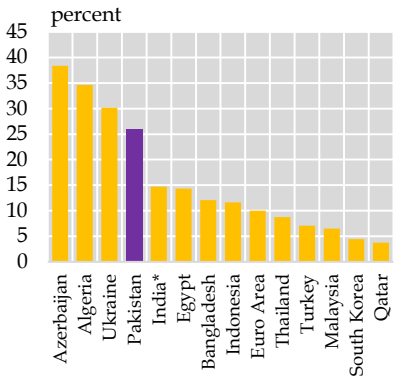
Currency to Deposit Ratio - Annual **Figure 3.4a**



Currency to Deposit Ratio - Quarterly **Figure 3.4b**



Currency in Circulation to M2 (Jun 2020) **Figure 3.4c**



*the ratio for India is calculated using monetary survey of RBI for Jun 19, 2020

Source: SBP, IMF and RBI

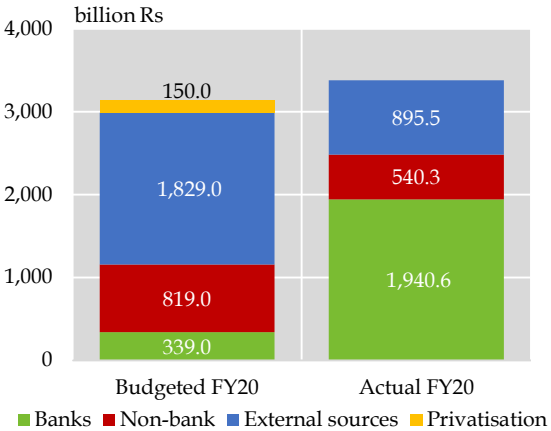
[1] In the initial weeks of May 2020, the currency to deposit ratio had touched 46.6 percent.

Bangladesh, Indonesia and Turkey, and over 4-times the ratio in Malaysia and South Korea. Although the impact of Covid-related uncertainties may dissipate going forward, the prevailing concerns with respect to financial scrutiny might linger for some time. That said, serious measures are needed to reduce informality from the economy and ensure inclusivity in the provision of financial services, if the cash penetration is to be reduced sizably.

Government Borrowings

Budgetary support from the banking system remained at an elevated level for the second consecutive year, although it witnessed a slight deceleration on a YoY basis.[2] As mentioned earlier, the government resorted to the domestic banking system mainly in the Mar-Jun period, when foreign investors divested from the debt market amid a sharp rise in the government's spending needs. In the earlier months of the year, budgetary borrowings from the banking system were quite contained as the government adhered to the fiscal targets laid out in the budget, and sufficient funding was available from external and domestic non-bank sources. Nonetheless, on a full-year basis, the financing outturns witnessed a tangible deviation from the budgeted estimates (**Figure 3.5**).

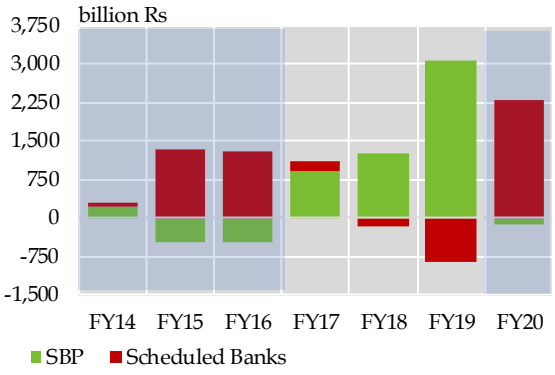
Financing Mix of Budget Deficit **Figure 3.5**



Source: Ministry of Finance

As opposed to the budgeted financing requirement of only Rs 339 billion from the domestic banking system, the government ended-up borrowing Rs 1.9 trillion (on-cash basis) during FY20. Within the banking system, the entire burden of the budgetary support fell on scheduled banks, as the government adhered to its commitment of refraining from deficit monetization, and at the same time avoided rolling over the maturing securities held by the central bank.[3] It is important to recall here that a similar trend was observed back in FY14-FY16 when the government had completely avoided central bank borrowing (**Figure 3.6**). But in all the years in between, including last year, borrowing from the central bank had constituted a major proportion of deficit financing.

Composition of Budgetary Support from the Banking System* **Figure 3.6**



*Highlighted area indicates IMF programs

Source: State Bank of Pakistan

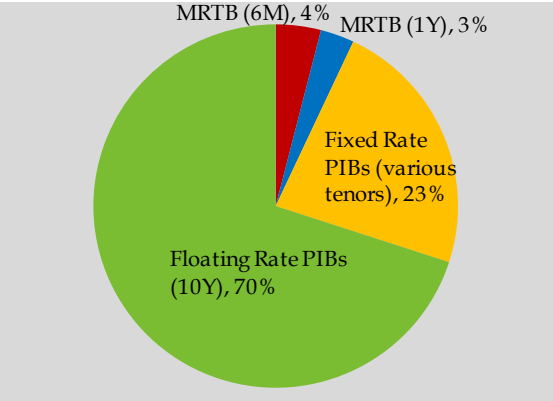
However, it is also important to recall here that at end-June FY19, the government had carried out major re-profiling of the SBP debt, when the entire outstanding portfolio of MRTBs was rescheduled. Nearly 70 percent of the SBP debt stock was converted into 10-Year Floating Rate PIBs (FR-PIBs). Also, towards the start of FY20, the government had built cash buffers (to the tune of Rs 1 trillion) to mitigate temporary cash flow problems that could possibly arise in the absence of fresh SBP funding. Together, these measures implied that (i) there will be no additional

[2] The budgetary borrowings from the banking system grew by 18.0 percent in FY20 as compared to 23.5 percent last year.

[3] During FY20, the government retired Rs 569 billion worth of securities that were held by the SBP.

financing pressure on the government to amortize the maturing SBP debt, as 93 percent of the SBP debt had a maturity greater than one year (only 7 percent of the stock held in 6- and 12-month T-bill was to mature before June 2020) (**Figure 3.7**); and (ii) the government could draw on cash buffers in case significant pressures emerged on secondary market yields.

Reprofiling of MRTBs (end-Jun 2019) **Figure 3.7**



Source: State Bank of Pakistan

Thus, at the start of the year, the interbank market knew that the supply of government bonds will remain contained despite the non-availability of SBP funding. This view was reinforced by the fiscal consolidation measures announced by the government in the FY20, and its adherence to these measures as the year progressed. On the other hand, the demand for government bonds remained strong, as market expectations of interest rates plateauing began to take hold, especially after the MPC's July decision. This encouraged banks to offer higher-than-target liquidity volumes against longer tenor instruments in primary auctions. In response, the government adhered to the targets set in the auctions, leveraged this demand-supply gap to slash the cut-off rates, and substituted its short-term debt with long-term papers. As a result, not only did the yields remain suppressed in the secondary market, but the overall maturity profile of the government domestic debt also improved. On net basis, the government's borrowings against PIBs (Rs 1.9 trillion net) were more than double than those against T-bills (Rs 738.9 billion) during FY20.

Further details on primary auctions of government securities and the behavior of market participants are presented below.

Primary auctions and market behavior

Investments via T-bills remained higher than last year on net-of-maturity basis, with competitive offers at a significantly higher level compared to the preceding years (**Table 3.2**). Importantly, a clear preference was observed for longer tenor instruments. The net-of-maturity offers for 12-month T-bills rose to an all-time high of Rs 14 trillion. This was on the back of expectations of plateauing interest rates and plunging yields from August 2020 onwards that drove the first round of shift in market's preference of 12- and 6-month T-bills over 3-month paper. However, the high inflation numbers in December and January 2020, and an inverted yield curve, resulted in a temporary reversal in the trend that persisted from mid-December to mid-February; again, 3-month T-bill offers constituted more than 50 percent of the entire competitive T-bill bids. Then after the Covid-19 outbreak, market's expectations for interest rate cuts again took hold and the demand for 12- and 6-month papers increased. On a full-year basis, the outstanding stock of 3-month paper witnessed a sharp decline of Rs 4.4 trillion, whereas an increase of Rs 0.9 and Rs 4.6 trillion in 6- and 12-month papers, respectively, was observed.

T-bill Auction Summary **Table 3.2**

billion Rupees

Tenor	Target	Maturity	Offered*	Accepted
FY20	15,050.0	13,986.3	32,354.2	15,167.1
FY19	19,500.0	19,183.7	23,343.2	18,875.9
FY18	16,925.0	16,388.0	21,105.2	17,550.6

*competitive bids only

Source: State Bank of Pakistan

In case of PIBs, the acceptances of both fixed and floating rate instruments remained at an elevated level during FY20 (**Table 3.3**). The government raised a cumulative Rs 1.97 trillion from PIBs in FY20 compared to only Rs 0.34 trillion in FY19 on net of maturity basis. This is indicative of a clear shift in the government's debt management strategy. Encouragingly, in an effort to increase the

range of long-term and medium-term bonds for the market, the government reintroduced the 15-year fixed-coupon PIB in April 2020 (that were last issued in August 2011), and new 3-year and 5-year floating rate PIBs in June 2020 to fill the gap of a medium-term floating rate instrument in the market. Along the same lines, in March 2020, the government accepted bids for 20-yr PIBs after a gap of more than 5 years.

PIB Auction Summary **Table 3.3**

billion Rupees

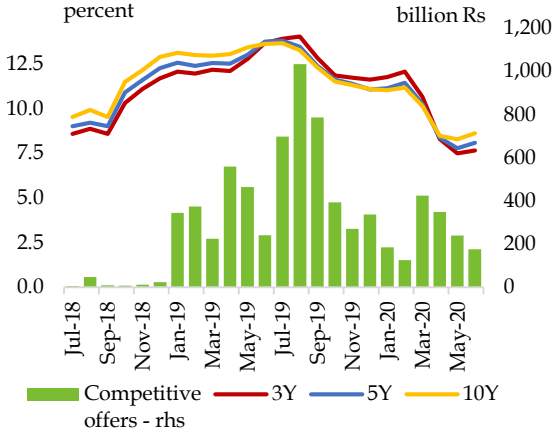
Tenor	Target	Maturity	Offered*	Accepted
Fixed coupon				
FY20	1,255.0	920.3	5,027.0	2,070.7
FY19	800.0	843.6	2,320.5	873.5
FY18	900.0	1123.4	338.5	101.7
Floating coupon				
FY20	950	-	1,578.1	818.3
FY19	850	-	706.3	311.7
FY18	100	-	296.1	43.1

*competitive bids only

Source: State Bank of Pakistan

On the demand-side, the competitive offers more than doubled compared to the preceding year, given the market's willingness to take more exposure on the long-term instruments, keeping in view the high level of long-term rates. Initially at the start of FY20, the volume of offers remained high but bids for PIBs dipped subsequently as the yields started declining and with inflation in double-digits (until March 2020). With the onset of Covid-19, the market's expectations of rate cuts increased, and in turn, resulted in a renewed interest for PIBs – though not as high as was observed during Q1-FY20 (**Figure 3.8**).

Bidding Pattern of Fixed Rate PIBs and Secondary Market Yields **Figure 3.8**

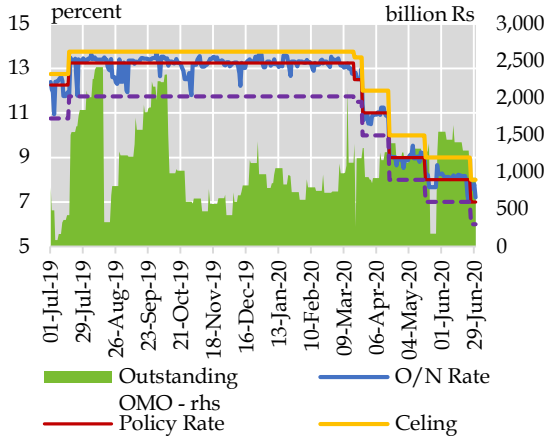


Source: State Bank of Pakistan and MUFAP

Sukuk issuance amid Covid-19

Keeping in view the surge in the fiscal deficit after the Covid-19 outbreak, along with outflow of foreign portfolio investment from local debt securities, the government responded by expanding the domestic investor base by issuing Shariah-complaint debt instruments. In Q4, Rs 198.2 billion worth of 5-year variable rental rate Sukuk were issued, against the target of Rs 300 billion. It was in June 2017 when the government had last issued Sukuk to finance its budgetary needs. The timely issuance this year was not only helpful in increasing Islamic banks' share in the government securities portfolio, but also provided them an opportunity to invest in risk-free Islamic government debt instruments. Importantly, comparing the auction results of 5-year floating rate (FR) PIB (auction held on June 17, 2020) and the Government Ijara Sukuk-Variable Rental Rate (GIS-VRR) of the same tenor (auction held on June 18, 2020) reveals that the cutoff margin for FR-PIB was +49 bps, whereas it was -10 bps for GIS-VRR – i.e. the Sukuk was almost 59 bps cheaper.

Overnight Repo Market **Figure 3.9**



Source: State Bank of Pakistan

Liquidity Management

During FY20, the domestic interbank market remained relatively less volatile as compared to the large liquidity swings observed last year. This stability was achieved on the back

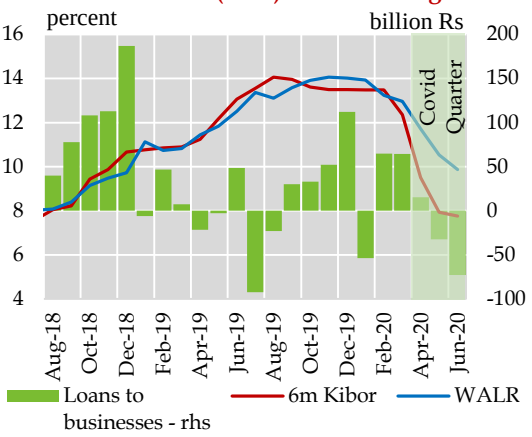
of a shift in the government's debt management strategy to increase the maturity profile, which was also supported by renewed market interest in the long-term sovereign debt instruments. This resulted in less voluminous maturities in each subsequent auction as opposed to the situation last year. The stability gains from this gradual increase in average time-to-maturity of the government debt portfolio continued to unfold throughout the year. This can be gauged from the fact that the overnight rates remained less volatile during H2-FY20 as compared to H1-FY20 (**Figure 3.9**). Nonetheless, the SBP stepped up OMO injections in the Mar-Jun 2020 period, in response to the increase in the government's borrowing requirements from the scheduled banks, and to adjust the overnight rates close to the steeply reduced policy rate.

3.3 Credit to Private Sector

The momentum in private sector credit weakened significantly during FY20, as the overall offtake stood at only Rs 196.4 billion, as compared to Rs 693.5 billion last year. This primarily represented subdued industrial production (mainly LSM) during the year – initially on account of stabilization measures and regulatory changes announced in the FY20 budget, and later due to factory closures amid the Covid-related lockdowns. It is important to recall here that the cash flow constraints stemming from inventory build-ups and rising cost pressures in the country had induced many firms to leverage excessively last year. However, as the interest rates rose steadily and stayed at double-digits till March 2020, additional bank financing became less viable for many firms. In the first 8 months of FY20 also, businesses struggled with weak interest coverage, and in some industries, such as technology and communication, electric goods, food and personal care, cement, textile, the finance cost was more than 70 percent of the operating income (for steel, power, leather it was over 39 percent during the quarter ending March 2020). Although credit demand gained some strength during the third quarter amid decent export activity, the credit numbers plummeted again in the fourth quarter as businesses retired Rs 90 billion (**Figure 3.10**).

Importantly, this net retirement was despite the steep cut in policy rates and the relief measures announced by the SBP, whereby firms could request for deferral of principal component of installment for a one-

Loans to Businesses (flow) **Figure 3.10**



Source: State Bank of Pakistan

year period at no fee or increase in mark-up. Furthermore, borrowers who were unable to even service the mark-up amount or needed deferment exceeding one year, could get their financing rescheduled or restructured. In addition, a large number of firms also applied to avail the "Rozgar Scheme" announced by the SBP to provide concessionary loans to cover the salary component of firms' expenditures. The SBP also introduced the Temporary Economic Refinance Facility (TERF) and the Refinance Facility for Combating Covid-19 to incentivize fresh investment activity and cover health-related expenditures, respectively. Under these favorable dynamics in the credit market, some recovery in credit offtake was expected.

Three factors primarily explain the subdued credit offtake during the fourth quarter. First, while a large amount of loans was approved under the Rozgar Scheme, actual disbursements remained low up till end-June 2020. Against the total approval of Rs 119.1 billion by June 26, actual disbursements stood at Rs 51.1 billion. The outstanding amount of credit will eventually increase when banks will disburse the approved funding. Second, anecdotal evidence suggests that some firms have been retiring their previously taken bank loans against conventional facilities, through

Loans to Private Sector Businesses* **Table 3.4**

(Flow in billion Rupees)

	Total Loans		Working Capital**		Fixed Investment	
	FY19	FY20	FY19	FY20	FY19	FY20
Private Sector Businesses	574.6	97.3	491.6	60.3	82.9	37.0
Manufacturing	411.6	162.5	362.1	111.0	49.5	51.5
Textile	132.0	170.0	105.9	127.1	26.1	43.0
Cement, lime and plaster	33.1	26.2	15.5	26.3	17.5	-0.2
Sugar	-19.6	15.1	-31.0	12.8	11.4	2.2
Basic iron and steel	11.3	17.6	10.7	11.6	0.6	6.0
Motor vehicles	20.5	14.6	14.5	11.3	6.0	3.3
Rice Processing	26.5	-1.4	26.0	-1.7	0.5	0.3
Paper & paper products	2.8	-7.1	2.8	-5.0	0.0	-2.2
Vegetable and animal oils and fats	30.4	-11.1	34.6	-12.8	-4.2	1.7
Refined petroleum	36.9	-20.4	42.3	-18.9	-5.4	-1.4
Fertilizers	23.7	-31.9	32.3	-26.6	-8.6	-5.3
Telecommunications	-6.4	25.5	11.7	-8.0	-18.1	33.5
Mining and quarrying	22.2	15.0	14.7	7.7	7.5	7.3
Real estate activities	8.6	2.6	3.9	3.7	4.7	-1.1
Power generation, transmission and distribution	95.6	9.0	47.0	15.1	48.6	-6.0
Administrative and support service activities	-	-14.7	-	-7.6	-	-7.1
Transportation and storage	3.4	12.9	8.7	22.9	-5.4	-9.9
Agriculture, forestry and fishing	-5.1	-21.3	6.2	-10.4	-11.3	-10.9
Construction	-12.8	-27.5	6.6	-17.2	-19.4	-10.3
Wholesale and retail trade	62.8	-46.2	42.2	-42.7	20.6	-3.5

*The sector-wise data for FY19 and FY20 may not be fully comparable, as the flows for FY19 are based on ISIC 3.1 whereas the flows for FY20 are based on ISIC 4.0 classification.
**includes trade financing

Source: State Bank of Pakistan

borrowing under recently announced concessionary funding facilities. Therefore, the net addition in the outstanding credit may not be large. Third, anecdotal evidence also suggests that due to uncertainties prevailing with respect to the Covid trajectory and the duration of the containment measures, firms with sufficient liquidity on-hand preferred to repay their outstanding loans and postponed additional borrowing plans.

Working capital loans

Private businesses took only Rs 60.3 billion in working capital loans in FY20, as compared to Rs 491.6 billion last year (**Table 3.4**). The demand for working capital did not appear vibrant, as banks actually received 10 percent fewer applications for working capital loans during FY20 on YoY basis. With higher borrowing cost, export-oriented firms, especially in the textile sector, managed to avail financing under the SBP's concessional Export Finance Scheme (EFS), thus increasing the overall borrowing under EFS to Rs 114.8 billion in FY20 from Rs 87.2 billion in FY19. This means that excluding EFS, firms actually retired previously taken working capital loans during the year. Around 58 percent of the increase in EFS loans came in Q3-FY20, as from January 2020 onwards, the SBP had enhanced the aggregate limit for the scheme by Rs 100 billion to facilitate export-oriented sectors and promote export growth.

Similar to textiles, the cement sector's borrowings were also concentrated in the second and third quarters, with higher PSDP spending leading to some revival in construction activity in the country. At the same time, however, the financial position of most cement firms remained weak (as evident from the after-tax losses booked in Q3), as the overall economic slowdown did not allow them to pass on the impact of higher taxation and freight to end-consumers.

Developments in the sugar sector were not different either. Short-term borrowings by the sector in Q3 alone were enough to dilute the impact of loan retirements in the other

quarters of the year. With the goods' transporters strike in January 2020, sugar prices rose sharply, and continued to increase even after the strike ended. In the absence of a reliable stock position, the government announced a ban on exports and allowed the import of sugar. As a result, the sector borrowed Rs 93.4 billion during Q3, taking its cumulative borrowing to Rs 12.8 billion in FY20.

In contrast, oil refineries opted to deleverage to shield their profit margins from getting further eroded by high borrowing cost, decreased demand for fuels due to reduced industrial activity coupled with shut down of factories, complete halt of public transport, and interprovincial movement during country-wide lockdown. The refining sector was already facing serious cash flow constraints stemming from regulatory changes for furnace oil-based power generation, and import-led compression in the commercial transport activity in the country.

Among the non-manufacturing firms, the transport sector's borrowing was noteworthy at Rs 22.9 billion in FY20, compared to Rs 8.7 billion last year. Almost the entire increase in the offtake came in H1-FY20, reflecting borrowing by a deep seaport operator that is upgrading its operations.

Fixed investment loans

Over the past couple of years, fixed investment loans recorded a consistent increase on the back of higher PSDP expenditures and progress on CPEC-related infrastructure projects. A number of sectors, including cement and power generation, had spent on capex and resorted to bank financing for the import of machinery and equipment. In FY20, however, long-term loans grew by only Rs 37 billion – less than a half of the Rs 82.9 billion increase recorded in FY19. It seems that the recent investment cycle in many sectors had peaked out, and now these businesses are retiring their long-term loans. Furthermore, firms may not be expected to take a long-term view of the economy with macroeconomic stabilization policies in place and overall weak business confidence. In particular, frequent increases in interest rates last year had raised the investment finance cost substantially. This coupled with market perception of exchange rate risk – stemming from frequent exchange rate adjustments as the country moved towards adopting a market-based exchange rate system – might have made it challenging in the short term to carry out robust project evaluations and feasibility studies for industrial investment.

Three sectors, that recorded some fixed investment activity during FY20 included telecom, textile, and iron & steel. Textile firms continued to position themselves to take advantage of the improved market opportunity in the key export destinations and the pricing edge stemming from the exchange rate realignment. The sector also enjoyed concessional rates under the SBP's Long Term Financing Facility (LTFF) for export-oriented projects, as LTFF loans constituted around 84 percent of the textile sector's overall fixed investment borrowing during FY20, and a full 100 percent during Q4. This suggests that the policy measure of extending the limit of LTTF by Rs 100 billion in January 2020 was quite helpful.

The telecom sector borrowed Rs 24.8 billion in Q1-FY20 to pay for the submission of renewal fees to the government for GSM licenses – also an important source of non-tax revenue for the government (Chapter 4). In addition, the sector borrowed another Rs 19.1 billion in Q4-FY20 for network expansion plans. Encouragingly, in May 2020, a leading cellular firm operating in Pakistan announced a partnership with a multinational payment technology company to strengthen the payments ecosystem for merchants and customers in Pakistan, and is expected to invest accordingly.

In addition to these two sectors, some activity was also recorded in the steel sector. It is important to highlight that the existing south-based key players are focusing on increasing their footprint in the northern region of the country, apart from vying for market share in non-construction segments, such as the home appliance and the auto sectors.

Consumer financing

After growing in the last couple of years, consumer financing lost pace and fell into the negative territory in FY20 (**Table 3.5**). Consumer financing posted a net retirement of Rs 6.4 billion, as compared to an increase of Rs 57.3 billion last year. Consumers perceived this year to be challenging to borrow from banks to finance their spending on house building, car purchases and other consumer items, as interest rates remained in double-digits through most of the period. The overall consumer confidence also remained weak amid high inflation and weak economic activity.

Consumer Financing **Table 3.5**
flow in billion Rupees

	FY18	FY19	FY20
Total	**86.5**	**57.3**	**-6.4**
Personal loans	12.5	13.9	7.3
Consumers durable	1.1	3.7	1.3
Credit cards	7.4	7.0	-1.3
Transport e.g. cars	43.3	22.2	-4.3
Housing	22.3	10.4	-9.3

Source: State Bank of Pakistan

The major drag came from housing and auto financing segments, which posted negative growths of 9.3 percent and 4.3 percent, respectively. These segments also struggled to perform because the government had placed a ban on non-filers from purchasing/ registering assets, such as cars and residential properties (above Rs 5 million). In case of auto finance, consumers faced additional challenges, as car assemblers raised their ex-factory prices several times since the beginning of FY19 (citing the impact of the currency depreciation). On top of that, regulatory measures, including the imposition of FED on various car models, and additional customs duty on auto part imports, further escalated retail prices. This, coupled with high interest rates, significantly increased the volume of monthly installments of car financing products. As a result, many customers were priced out.

In order to promote and develop housing finance in the country, the SBP has decided to set mandatory targets for banks to extend mortgage loans and financing for developers and builders. Banks will be required to increase their housing and construction of building loan portfolios to at least 5 percent of their private sector credit by end December 2021. The SBP is gearing up efforts for housing projects in the light of the government's plan to build low-cost housing projects for low-income people.

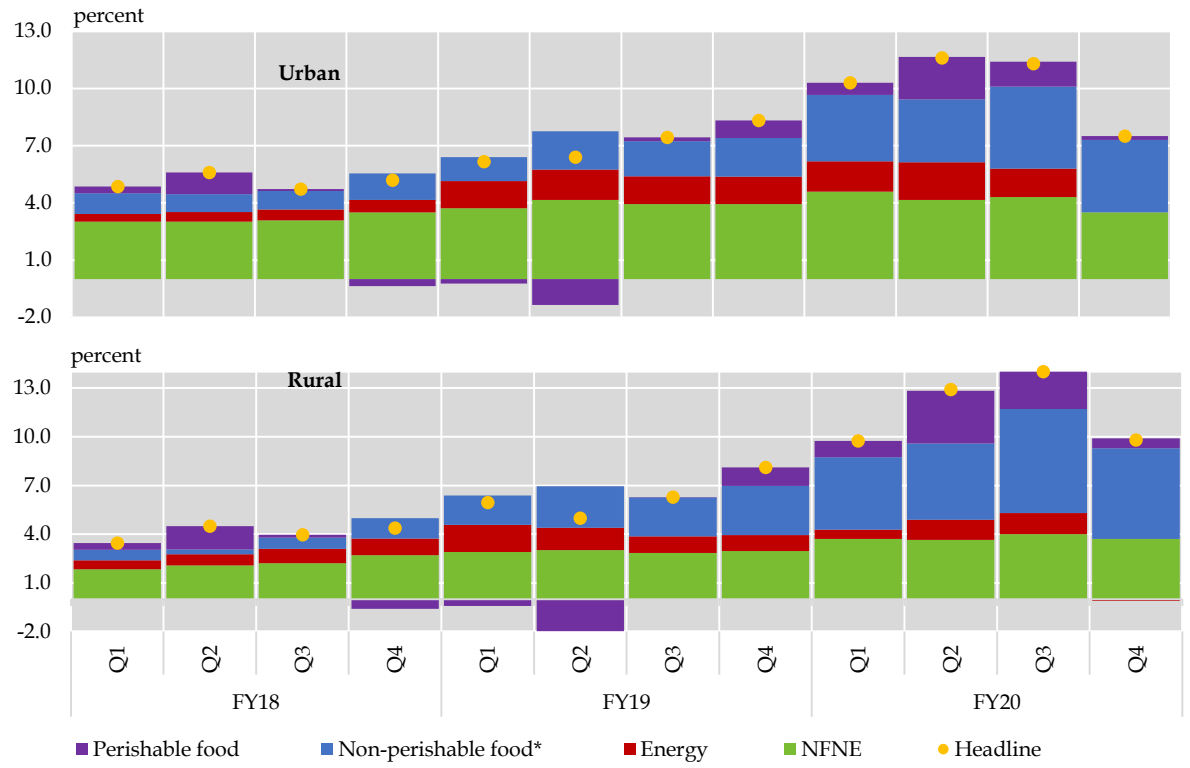
3.4 Inflation[4]

While keeping the policy rate aligned with the medium-term inflation target, SBP was able to keep the underlying inflationary pressures in the economy in check during FY20. This was reflected in the stability in the non-food-non-energy (NFNE) component of CPI (**Figure 3.11**). Nonetheless, multiple factors of a temporary and seasonal nature kept the overall level of inflation high during the year. These included: (i) supply disruptions in major food items stemming from delayed crop arrivals, speculative activities and weak commodity management; (ii) duties and taxes levied/ increased in the Budget 2019-20 on multiple food items including sugar, cigarettes, edible oil and ghee; (iii) price adjustments on account of exchange rate depreciation that took place towards the end of FY19; (iv) tighter border management by custom authorities; and (v) higher transportation costs following the increase in fuel prices as well as the implementation of the axle-load policy. As a result, headline inflation posted a sharp increase and clocked in at 10.7 percent in FY20 as compared to 6.8 percent in FY19.

It is important to note that though higher than last year, FY20's inflation outcome was lower than the SBP's projection of 11-12 percent at the start of the year. This outcome should be viewed in the context of a shift in regulatory and policy dynamics in the country through

[4] In August 2019, the Pakistan Bureau of Statistics (PBS) started publishing a new set of price indices with FY16 as the base year. For details see *Box 3.2: Rebasing of Price Indices* in the State of Pakistan's Economy Report for Q1-FY20.

Composition of YoY CPI Inflation **Figure 3.11**



*Inclusive of alcohal beverages and readymade food
Source: Pakistan Bureau of Statistics

the course of the year. Specifically, at the start of the year, temporary pressures on inflation were envisaged on account of revenue-enhancing budgetary measures, the approval of up to 168 percent rise in gas tariffs, higher transportation cost, and the absorption of recent exchange rate depreciation. While these pressures materialized as the year progressed, fresh challenges emerged in the form of crop damages (leading to profiteering and speculative activities in the domestic food market), which persisted up till January 2020. Furthermore, although the full-year average for energy inflation remained lower than last year, the administrative prices of energy items increased steadily during Jul-Jan FY20, as the government passed on the impact of energy sector arrears to end-consumers (in both gas and electricity segments). As a result, headline inflation increased to 14.6 percent YoY in January 2020, taking the year-to-date average inflation to 11.6 percent.

However, the situation in both food and energy sectors changed significantly from February 2020 onwards. In the food market, while some improvement was attributed to seasonal resumption of perishables' supplies and imports, major support came from the government's effective crackdown on speculative elements in the non-perishable market. Similarly, in the energy sector, Nepra postponed the fuel price adjustment applicable in February 2020, following the government's decision to freeze electricity prices till June 2020. This regulatory decision was crucial to stabilize energy prices in the country. This was reinforced by a sharp decline in global crude oil prices in early March 2020, the impact of which was immediately passed on to domestic fuel prices. In addition, the overall weak demand conditions following the Covid-related containment measures between March and June 2020, also pushed core inflation down. As a result of these developments, the headline inflation dropped from 14.6 percent in January 2020 to 8.2 percent in May 2020 and 8.6 percent in June 2020.

In terms of dispersion, for the complete year, the higher level of inflation was wide-ranging,

Average CPI Inflation and Contribution **Table 3.6**
(percent)

Items	Urban						Rural					
	Wt.*	FY20		FY			Wt.*	FY20		FY		
		H1	H2	FY19	FY20	Cont.*		H1	H2	FY19	FY20	Cont.*
CPI	100.	11.0	9.4	7.1	10.2	10.2	100.0	11.3	11.9	6.3	11.6	11.6
Food & non-alcoh. bev.	30.4	14.8	14.5	4.4	14.6	4.2	40.9	15.5	17.2	4.4	16.4	6.5
Clothing and ft.wear	8.0	8.9	9.6	5.7	9.2	0.7	9.5	9.1	11.3	7.4	10.2	1.0
Housing, Elec., Gas	27.0	8.7	6.5	8.2	7.6	2.1	18.5	4.5	6.1	7.4	5.3	1.0
Electricity charges	4.6	6.0	-2.3	11.5	1.8	0.1	3.4	6.0	-2.3	11.5	1.8	0.1
Gas charges	1.1	79.9	54.8	29.0	66.4	0.8	n.a	n.a	n.a	n.a	n.a	n.a
Furnish. & H.H equip.	4.1	11.8	9.0	7.9	10.4	0.4	4.1	10.1	10.2	7.0	10.1	0.4
Health	2.3	11.2	10.3	6.7	10.8	0.3	3.5	12.1	11.6	7.1	11.8	0.4
Transport	6.1	17.2	6.1	16.6	11.5	0.7	5.6	14.9	4.0	15.0	9.3	0.6
Motor fuel	2.9	19.8	2.0	20.7	10.7	0.4	2.5	19.7	1.1	20.5	10.2	0.3
Communication	2.4	5.4	3.7	3.0	4.5	0.1	2.0	1.9	1.2	2.0	1.5	0.0
Education	4.9	6.6	4.4	9.5	5.5	0.3	2.1	5.2	4.2	5.9	4.7	0.1
Restaurants and hotels	7.4	5.1	7.3	5.5	6.2	0.5	6.2	7.9	10.5	4.9	9.2	0.6
Misc. goods & services	4.8	11.6	10.7	8.6	11.1	0.5	5.0	12.7	13.2	7.4	13.0	0.7
NFNE	53.7	8.0	7.1	7.2	7.5	4.1	42.6	8.4	8.9	6.8	8.7	3.8

*wt. = weight and Cont.= Contribution for FY20
Source: Pakistan Bureau of Statistics

as a majority of the sub-indices (67 out of 94, with around 71 percent share in urban CPI indices) posted higher inflation during FY20 as compared to last year.

Food remained the dominant source of inflation

Food inflation not only surged significantly during FY20, but was also the major contributor to the overall rise in inflation (**Table 3.6**). Both perishable and non-perishable food items registered double-digit inflation, but the impact of the latter was more pronounced and persistent (**Figure 3.12**).

Non-perishables

Among the non-perishable food items, the major concern emerged from wheat and wheat flour. A crisis-like increase in their prices was observed from Q2 onwards, which stemmed from production shortfall compared to its target and lower procurement of the crop in the previous season by procurement agencies (as pointed out in detail in the SBP's Third Quarterly Report of FY20).

While these developments triggered speculative activity in the wheat market, the situation deteriorated further in January 2020 due to transportation disruptions following a 15-day strike by goods' transporters against the heavy rise in penalties over violation of traffic rules on highways and motorways. These constraints were also reflected in the strong momentum in the wholesale and retail prices, which appeared to have encouraged stockpiling of the commodity. Therefore, when the transporters' strike ended and the government allowed import of wheat from February 2020 onwards, a significant drop in wheat prices was observed in February (down 3.5 percent MoM) and March (down 8.4 percent MoM), as shown in **Figure 3.13**. Nonetheless, after falling for nearly 4 months in a row, prices surged again towards the end of May 2020, when the Pakistan Flour Mills Association announced a hike in the prices of flour by Rs 20 per 20kg bag, and wheat-grinding operations in Punjab, Khyber Pakhtunkhwa and Balochistan shut down as millers were unable to purchase wheat from either the open market or the government food authorities.

Other than wheat, prices of cigarettes, sugar, edible oil and ghee, and pulses also came under pressure during the year. In case of cigarette, the significant revision in FED pushed up prices. Similarly, in case of edible oil and ghee products, the increase in FED rate

Heat Map - YoY Urban Inflation (Food) **Figure 3.12 a**

	Wt.	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Food Index	36.8	7.5	7.9	11.9	15.0	13.7	16.6	16.7	19.5	15.2	13.0	10.4	10.6	12.9
Perishable food	4.5	14.3	5.4	13.3	27.2	35.9	66.0	76.4	68.8	25.2	12.9	9.2	1.5	4.2
Non-perishables	26.0	6.5	8.1	12.5	14.4	11.1	10.8	10.8	15.2	14.9	13.9	11.0	12.9	15.7
Poultry(Chicken,Egg)	1.9	-12.4	-6.6	50.0	52.0	-0.3	-13.0	-11.5	21.0	6.7	3.1	-13.8	7.9	24.5
Pulses	0.7	15.1	16.9	18.6	18.7	19.0	22.8	21.7	34.9	35.8	30.4	50.7	41.9	35.2
Fresh fruits	1.4	0.6	9.7	8.2	6.7	5.4	7.9	9.1	8.5	1.8	3.1	3.0	-3.6	4.3
Condiments & spices	1.3	20.3	18.9	21.9	20.5	18.1	19.2	17.6	24.4	25.6	27.0	23.2	24.7	29.8
Vegitables	2.9	23.3	2.1	13.3	34.5	47.5	92.5	118.3	105.6	34.5	14.5	11.2	3.7	3.2
Grains	4.9	6.0	7.7	7.9	9.8	9.2	12.9	13.9	21.0	16.5	12.9	13.4	11.3	19.4
Edible oil	2.2	12.4	13.9	18.4	19.3	18.0	16.0	16.5	16.4	30.0	29.7	24.2	23.0	22.4
Readymade Food	5.5	5.2	6.1	5.8	6.3	6.2	6.6	6.2	6.9	8.6	8.2	7.7	7.4	8.0
Meat (Meat, Fish)	2.4	11.1	11.8	12.2	12.6	13.5	13.2	13.5	13.2	12.7	11.4	11.3	9.1	8.2

Heat Map - YoY Rural Inflation (Food) **Figure 3.12 b**

	Wt.	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Food Index	45.9	9.1	9.3	12.6	15.0	14.6	19.3	19.7	23.8	19.7	15.5	12.9	13.7	15.2
Perishable food	5.8	14.7	12.1	17.3	26.1	34.3	73.9	89.3	90.3	41.2	18.2	13.5	11.4	10.9
Non-perishables	35.1	8.0	8.2	11.4	12.3	10.6	12.0	12.0	17.0	17.6	14.5	11.8	13.4	15.5
Poultry(Chicken,Egg)	2.0	-6.4	-9.3	37.3	42.1	4.4	-10.4	-13.9	16.5	13.0	-2.6	-16.0	7.6	16.9
Pulses	1.1	16.3	17.8	19.9	18.1	19.5	23.9	23.7	35.4	38.5	34.8	47.2	44.9	40.1
Fresh fruits	1.5	3.6	15.9	14.7	10.7	6.7	13.2	21.5	12.5	10.4	7.1	3.9	8.2	5.2
Condiments & spices	1.5	15.2	11.5	13.4	13.7	11.1	14.7	22.1	27.0	34.6	34.0	43.9	53.3	59.1
Vegitables	4.2	20.8	10.0	16.7	29.8	41.3	93.0	115.5	123.3	50.0	19.7	16.1	11.4	12.7
Grains	8.5	9.9	9.4	9.2	10.7	10.5	17.4	17.8	24.5	23.6	18.8	18.3	13.8	19.9
Edible oil	3.0	9.7	14.0	16.8	17.9	17.8	17.5	19.1	26.0	32.1	32.1	28.9	27.7	26.2
Readymade food	3.8	4.6	7.0	7.8	7.8	7.7	8.4	8.1	8.7	11.0	11.5	11.0	12.1	12.4
Meat (Meat, Fish)	2.0	13.0	12.5	11.3	12.1	12.7	12.0	12.2	11.6	9.0	9.6	8.3	8.6	7.7

* lighter shades depict lower (and negative) inflation and darker shades indicate higher inflation on YoY basis.

Source: Pakistan Bureau of Statistics

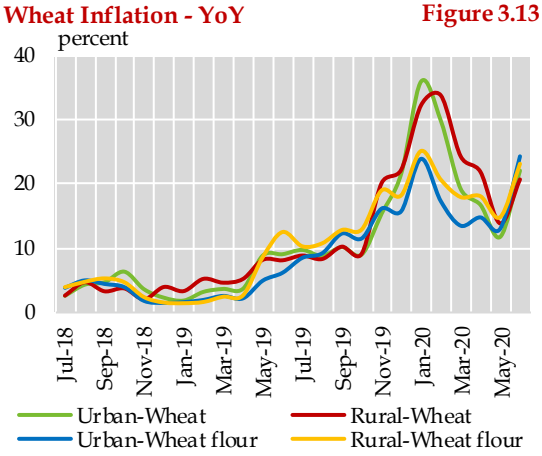
from 8.0 percent to 17.0 percent primarily contributed to the higher inflation. Edible oil refineries were also struggling with rising international prices of palm oil and soybean almost since the beginning of Q2-FY20, which they passed on to end-consumers.[5] Furthermore, the double-digit inflation in sugar can also be at least partially attributed to a steep rise in the rate of sales tax from 8.0 percent to 17.0 percent. In addition to budgetary measures, the price hike also reflected the expected low production of the commodity and the absence of a reliable stock position, which had activated speculative behavior in the sugar market. In March 2020, the government announced a ban on exports and allowed the import of the commodity to release the price pressures.

In case of pulses, however, inflationary pressures were largely imported. Wildfires in Australia (among the top-3 global exporters) and drought-like conditions in Thailand and Burma, have affected the global pulses production. Moreover, prices also rose on account of increased demand from India, which is one of the world's largest consumers as well as producers of pulses. In fact, there had been a general push by India in the second half of the year to shore up food security by making huge purchases in response to Covid-related uncertainties. Pakistan saw approximately 15 percent increase in unit values of imported pulses in

[5] International palm oil prices rose by 13.8 percent in FY20 as compared to a 19.9 percent deflation in FY19, and prices of soybean increased by 2.6 percent during FY20 compared to a 12.9 percent decline last year.

FY20 as compared to last year, which was passed on to prices in the domestic retail market.

Wheat Inflation - YoY **Figure 3.13**



Source: Pakistan Bureau of Statistics

Perishables

FY20 remained quite a challenging year in terms of managing perishable food prices, especially of vegetables (**Figure 3.14**). High temperatures and untimely rains disrupted crop cycles this year, as delayed arrivals exerted temporary price pressures in the market. It is important to mention here that the rise in perishable food prices was not just a domestic phenomenon, but also emerged as a regional concern in the second half of 2019. Specifically, unfavorable weather damaged crops in India, which is the largest producer and exporter of onion, tomatoes and potatoes in the region. India not only explicitly banned the export of onions and tomatoes in September 2019, but it also imported onions to bridge the supply-demand gap, which escalated regional prices. For Pakistan, the situation got much worse because while regional prices were not helpful, the import procedures were not smooth due to the prevailing regulatory restrictions (non-tariff barriers).[6] Delays in the issuance of import permits and valid phytosanitary certificates, and lack of quarantine department staff at the borders to allow no-objection certificates, affected imports of various vegetables and created temporary shortages in the domestic market.[7]

Core inflation somewhat stabilized in urban regions, while it rose marginally in rural areas

According to the 12-month-moving-averge of non-food-non-energy (NFNE) index, the inflationary pressures stabilized during FY20, especially for urban areas (**Figure 3.15**). This moderation primarily represented the impact of macroeconomic stabilization efforts, especially the high level of interest rates, which were needed to bring the headline inflation down to the medium-term target of 5-7 percent. The considerable alleviation in cost push pressures in the economy during the year was also a factor. Notably, with the stability in global fuel prices along with the appreciation of the Pak Rupee against the US dollar in H1-FY20, domestic prices of key raw materials stabilized in recent months. The wholesale price index (WPI), after plateauing in October 2018 with 18.7 percent rise, recorded inflation as low as 0.9 percent YoY, in June 2020. Furthermore, the last quarter saw a significant decline in core inflation in urban areas, which represented a noticeable weakening in the demand on account of Covid-related containment measures.

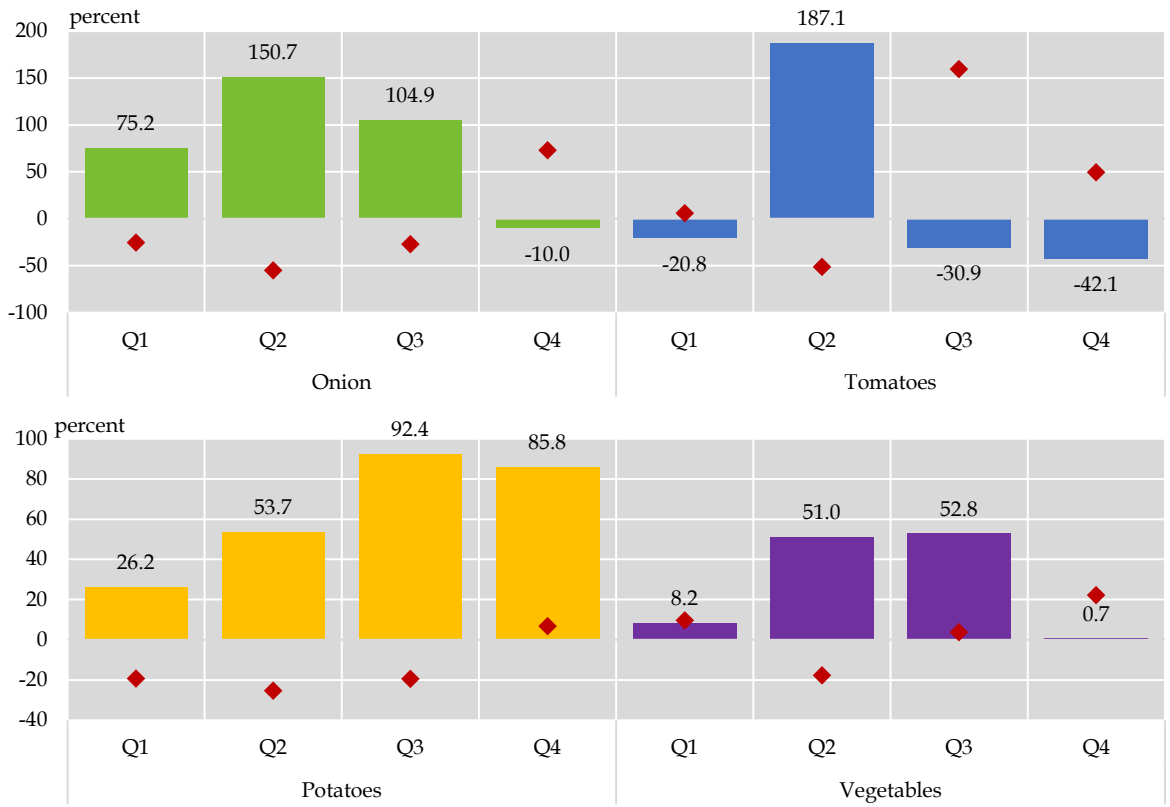
Within NFNE, the goods' index posted a double-digit inflation during FY20. It appears that this increase partially represents the impact of overall increased transport costs amid higher motor fuel prices than last year, and the implementation of the axle load policy. Furthermore, revenue-enhancing measures taken in the FY20 budget have also affected goods' prices: (i) inflation in the clothing and footwear group can be attributed to the impact of ending of the zero-rating regime (effectively, an imposition of 17 percent GST); (ii) the rise in steel prices can partly be explained by the imposition of 17

[6] For details, see A. Khalid and Sabahat (2020). *Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges*. SBP Staff Note 2/20. Karachi: State Bank of Pakistan (http://www.sbp.org.pk/publications/staffNotes.htm)

[7] For details, see SBP's State of Economy Report for Q2-FY20.

Inflation in Perishable Food Items - YoY

Figure 3.14



* bars denote FY20 and dots denote FY19
Source: Pakistan Bureau of Statistics

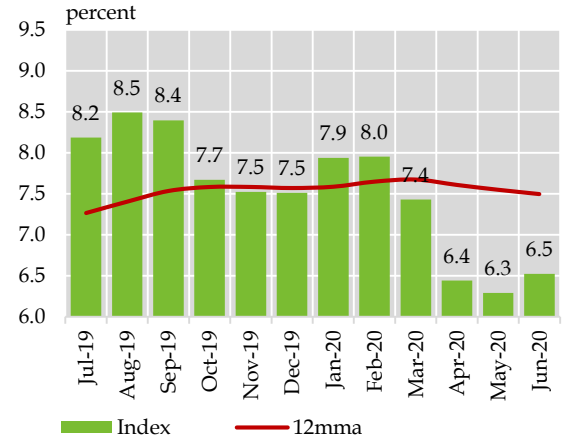
percent federal excise duty on various steel products; and (iii) the increase in cement prices reflects the impact of the increase in FED this year.

In contrast, inflation in services items remained on the lower side as compared to FY19. Component-wise analysis suggests that house rent and education played a significant role in driving down the overall services inflation for urban areas. In education, the decline in inflation came from private school fees following the Supreme Court's decision.

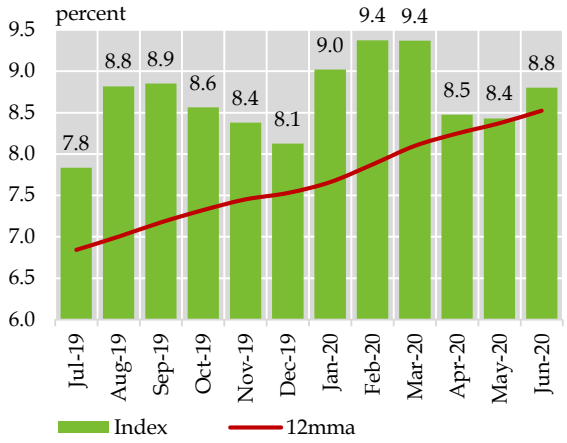
However, within services, upward pressure on low-end wages and service charges was registered, especially in the urban areas. The index of low-end urban wages and service charges (with 3.4 percent weight in overall CPI) – incorporating services such as household servants, cleaning & laundering, tailoring, garbage collection, motor cycle tyre puncture, car service, carpenter, mason, plumber and electrician – posted 8.9 percent inflation, on average, during FY20, as compared to 7.2 percent last year. This possibly reflects the impact of the overall inflationary pressures in important food items and rise in the transportation cost, which had affected real incomes of the low-income group the most in Q2-FY20. However, the inflationary pressures subsided visibly from March 2020 onwards in the same group, which can be attributed to restricted mobility and limited work opportunities amid weak demand for such services.

In this context, it is not surprising to see the overall NFNE softening in the fourth quarter, specifically in the months of April and May 2020. Around 70 percent of the NFNE indices registered no change in prices (33 out of 47 indices) in April 2020 and around 38 percent registered no change in May 2020 (**Figure**

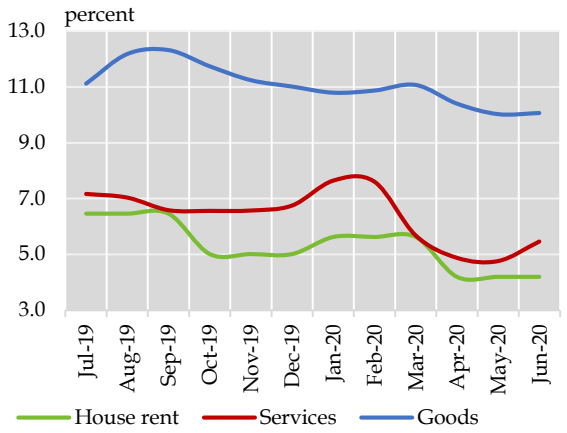
Urban NFNE - YoY Growth **Figure 3.15a**



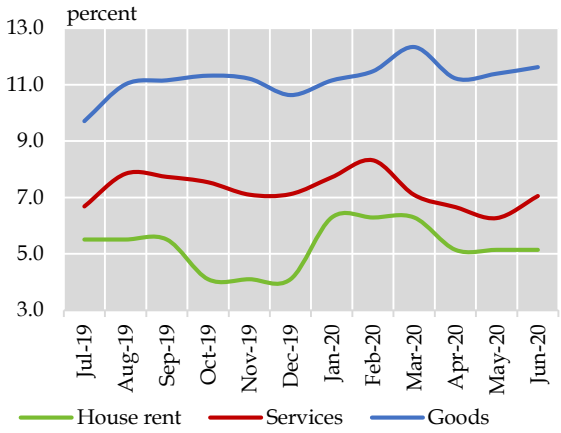
Rural NFNE - YoY Growth **Figure 3.15b**



Urban NFNE - YoY Growth **Figure 3.15c**



Rural NFNE - YoY Growth **Figure 3.15d**



Source: Pakistan Bureau of Statistics

3.16).[8] As mobility remained restricted and a number of retail centers were not operational, the Pakistan Bureau of Statistics (which collects countrywide prices and computes the price indices) kept prices of various items unchanged while constructing the inflation index for April 2020. Particularly, prices of clothing and footwear, various household items, auto parts and services, healthcare, recreation services, personal grooming services and marriage hall charges exhibited no change during the month.

Energy inflation decelerated

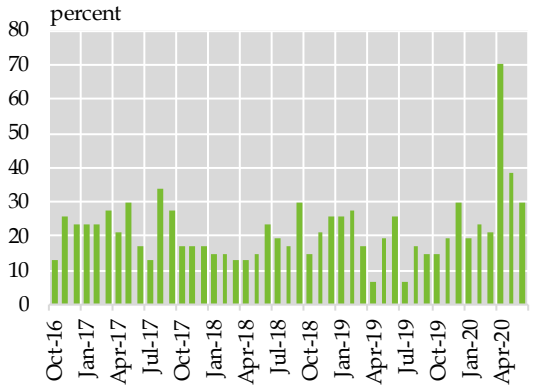
The energy index posted 12.7 percent increase during FY20, compared to 16.3 percent previous year. This relative softening was contributed primarily by a fall in prices (deflation) of motor fuel and electricity during the last quarter of FY20.

In case of motor fuel, the price index remained stable at an elevated level during the first eight months. However, from March 2020 onwards, the motor fuel index dropped significantly, both on MoM and YoY basis, following the slump in global crude oil prices on account of the Covid-19 pandemic. On a cumulative basis, the index posted a 31.4 percent decline during March and June 2020.

Substantial ease in the electricity inflation was observed during FY20, as it rose by only 1.8 percent compared to significant rise of 11.5 percent during FY19, both for urban and rural areas. During the first seven months, the index rose by 7.2 percent on average compared to

[8] In terms of composition, urban NFNE index comprises almost half of the sub-indices. i.e. 47 out of the total 95.

Indices with No Change - Core Group **Figure 3.16**



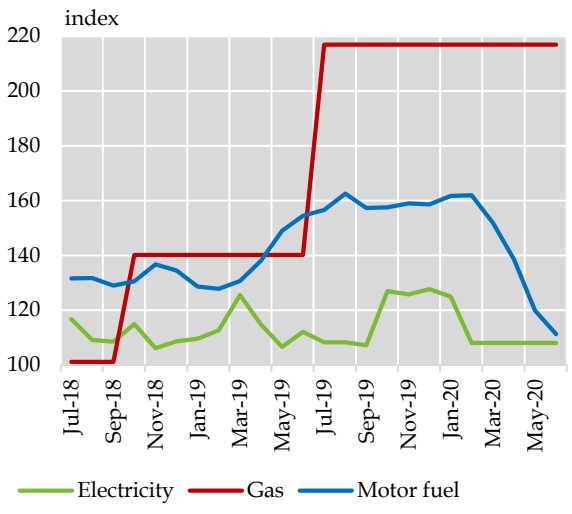
Source: Pakistan Bureau of Statistics

same period last year. This reflected the impact of passing on the impact of increased capacity payments, T&D losses and low recoveries, in an attempt to rein in the growing circular debt, improve the energy sector's viability, and tackle the rising arrears. However, the electricity inflation declined by 5.5 percent on average during the last five months of FY20 on YoY basis. This decline primarily came from the postponement of fuel price adjustments (FPA) for November 2019 (and onwards), which was expected to become applicable in February 2020. This reversed a positive trend observed in the electricity index since the beginning of the year. Also, Nepra deferred the subsequent FPA decisions following the government's plan to freeze the electricity tariff for the next six months. This decision also considered the request of the Central Power Purchasing Authority (CPPA) to introduce changes in the FPA mechanism. Thus, in the absence of the FPA component from February 2020 onwards, on cumulative basis, the electricity index posted 13.5 percent decline in June 2020, as compared to February 2020.

In contrast to fuel and electricity, the urban gas prices witnessed the highest rise in the energy group during FY20, contributing 0.8 percentage points alone to the total inflation and accounting for around 64 percent of the energy inflation. This was in response to the revision in natural gas prices by the Oil and Gas Regulatory Authority (OGRA) for various consumers, effective from July 1, 2019. According to OGRA's notification, dated June 29, 2019, gas tariffs for consumers using 201-300 mmbtu/month were raised by up to 168 percent. For consumers using 51-100 and 101-200 mmbtu/month of gas, tariffs were raised by 136.2 and 109.5 percent, respectively.

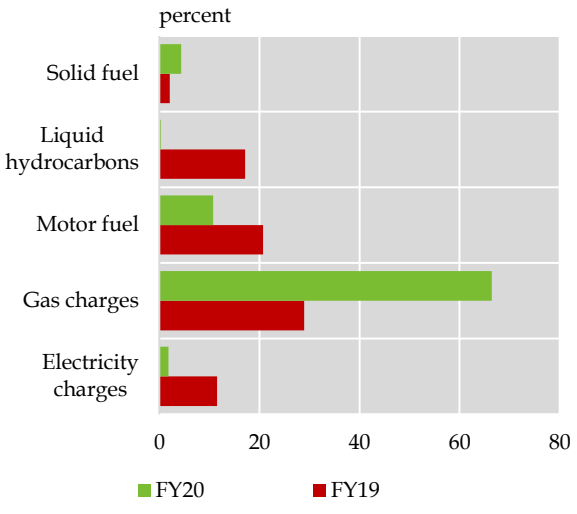
Together, these three slabs constitute over half of the total gas consumption in domestic sector. This measure was taken to address the concern of emerging arrears in the gas sector, coming mostly from delays in tariff notifications and rising technical losses. In addition to revising the tariff structure for

Energy Indices - Urban **Figure 3.17a**



Source: Pakistan Bureau of Statistics

Energy Inflation - Urban **Figure 3.17b**



reducing the unaccounted for gas (UFG) losses, improvements in infrastructure, rehabilitation of networks, and theft control are also part of the plan. However, for the rest of the year, the index posted no change, reflecting stable prices (**Figure 3.17**).

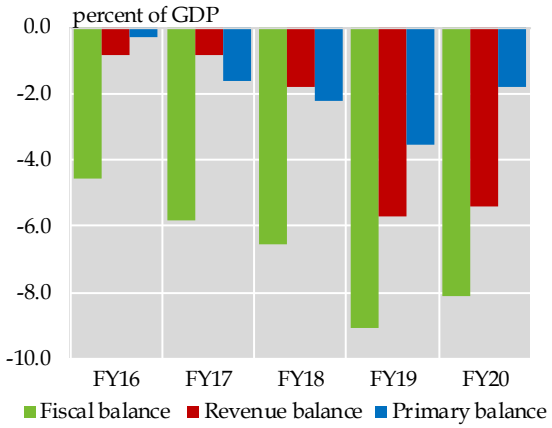
Chapter 4
Fiscal Policy

Controlled expenditures, along with a pick-up in revenue growth, yielded a visible improvement in the fiscal position in the first eight months of FY20. The steady improvements were, however, challenged by the outbreak of Covid-19 in the last four months of the year. The response to the outbreak led to a doubling of the fiscal deficit in Q4 alone undermining the gains of the first three quarters. The pressures emerged simultaneously on both expenditure and revenue sides, as the fiscal stimulus package entailed cash transfers to the vulnerable population and efforts to shore up healthcare facilities, just as revenues shrank considerably amid the lockdowns. Nevertheless, the earlier gains had created the fiscal space to tackle the Covid-19 shock, and kept the full-year budget deficit lower than last year. That said, the budget deficit was still high from a sustainability standpoint. Also, revenue growth was driven partly by the withdrawal of some earlier tax concessions and increase in tax rates, and by substantial contributions from one-off factors like non-tax revenues, especially SBP profits and GSM license renewal fees. Therefore, renewed strong commitment to revenue and expenditure reforms would be needed once the economy recovers from the pandemic's fallout.

4.1 Major Fiscal Indicators

The fiscal consolidation efforts to reduce the deficit during the first quarters of the year largely paid off, as, despite the Covid-19 shock, the budget deficit declined from 9.1 percent of GDP in FY19 to 8.1 percent in FY20. This performance owes to multiple policy measures to enhance the FBR's tax collection, along with *one-off* gains from non-tax revenues and prudent management of expenditures in the first 8 months of FY20. In effect, the primary surpluses accumulated during this period largely compensated for the adverse impact of Covid-related additional expenditure on health and cash transfers, and resulted in relatively better fiscal outcomes than FY19 **(Figure 4.1)**.

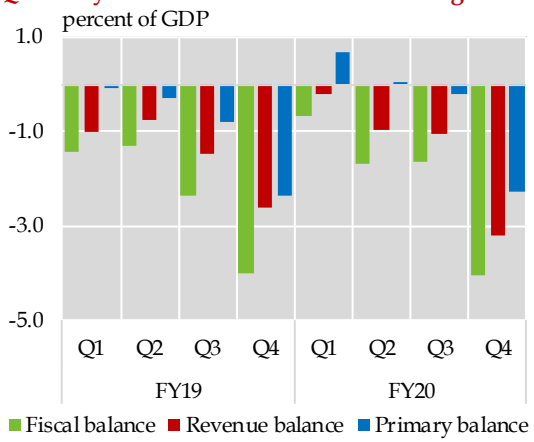
Fiscal Indicators **Figure 4.1**



Source: Ministry of Finance

The government rolled out a number of tax and administrative measures in the budget 2019-20 to enhance revenue mobilization. These included reversal of earlier tax exemptions to certain sectors, increasing slab-wise income tax rates, and upward revision in sales tax and FED rates on selected items. On the administrative front, e-filing and refund systems were improved to facilitate businesses and other taxpayers and promote the filing culture. Importantly also, the government took measures to enhance documentation in the economy and reduce informality; notable measures included the implementation of the CNIC condition for high-value purchases, and the introduction of Point of Sales Integration System for retailers across the country. Meanwhile, non-tax revenues posted a substantial increase following increased transfer of SBP profits and payments of GSM license renewal fee.

Quarterly State of Fiscal Indicators **Figure 4.2**



Source: Ministry of Finance

On the expenditure side, sizable efforts were taken to control the growth in current spending. Development expenditures also remained subdued, as the relevant government departments – that were delegated the responsibility to execute PSDP spending as part of the public financial management reforms – could not initiate the committed projects in the earlier part of the year. Later on, when Covid-19 hit, these projects were delayed further. As a result, the government was able to record a cumulative primary surplus of Rs 193.5 billion in the first three quarters of the year. Although Q3 witnessed a slight primary deficit, the fiscal and revenue deficits remained largely within the contours of the IMF program. By that point, the fiscal position seemed well positioned to achieve the full-year targets. In particular, the revised FBR tax revenue target of Rs 4,803 billion was within reach, given the high growth in major revenue categories in the first eight months. However, with domestic outbreak of Covid-19, the trend in both

revenue generation and expenditures turned unfavorable **(Figure 4.2).**

The FBR's tax collection weakened from March-2020 onwards, with all the major revenue categories reporting YoY declines during Mar-Jun FY20 **(Table 4.1)**. As the bulk of revenue collection typically occurs at quarter-ends, even Q3 witnessed a substantial fall in revenue growth, whereas the revenue growth in Q4 plummeted into negative territory.

FBR Tax Collection in FY20 **Table 4.1**

billion Rupees; growth in percent

	Pre-Covid-19 Jul-Feb	Covid-19 Mar-Jun
Direct taxes	1,005.1	517.9
growth	***19.8***	***-13.1***
FED	163.0	87.5
growth	***17.9***	***-14.7***
Customs	433.3	193.1
growth	***-2.4***	***-19.7***
Sales tax	1134.1	462.7
growth	***24.6***	***-15.6***
Total	2,735.5	1,261.2
growth	***17.3***	***-15.2***

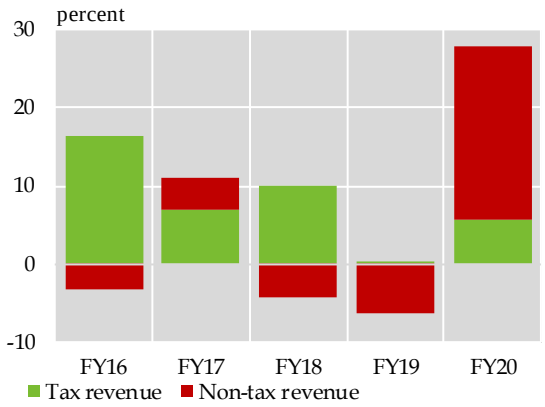
Source: Federal Board of Revenue

In overall terms, Covid-19 resulted in an estimated loss of about Rs 1 trillion in tax revenue, as the full year collection stood at Rs 3,996.7 billion. The expenditure side also took a similar hit, as the government spent heavily on health and cash transfers in Q4 to control the disease spread and alleviate unfavorable social outcomes. Current expenditures in Q4 were Rs 1 trillion higher than the average spending in the first three quarters. Thus, if it were not for the fiscal efforts of the first eight months and the windfall gains from non-tax revenues, the overall fiscal outcome could have deteriorated sharply.

4.2 Revenues

The total revenues grew by a sizable 28.0 precent during FY20, as compared to a decline of 6.3 percent last year. While tax revenues grew modestly, the major contribution to this growth came from higher SBP profits and submission of GSM license fees, which led to a sharp rise in non-tax revenues for the government **(Figure 4.3)**.

Growth Contribution in Total Revenue **Figure 4.3**



Source: Ministry of Finance

FBR Taxes

The FBR tax revenue grew by 4.4 percent, compared to a decline of 0.4 percent last year **(Table 4.2)**. The tax revenue growth recorded during Jul-Feb mainly resulted from the measures announced in the FY20 budget. As discussed earlier, revenue mobilization rose following the elimination of the preferential tax treatment for certain sectors (e.g. sugar, steel and edible oil), and withdrawal of the zero-rating regime for five export-oriented sectors (textile, leather, carpets, sports goods and surgical goods).

FBR Tax Collection **Table 4.2**

billion Rupees; growth in percent

			Growth	
	FY19	**FY20**	**FY19**	**FY20**
Direct taxes	1,445.5	1,523.1	-5.9	5.4
Indirect taxes	2,383.0	2,473.7	3.3	3.8
Customs	685.6	626.4	12.7	-8.6
Sales tax	1,459.2	1,596.8	-1.8	9.4
FED	238.2	250.5	11.6	5.2
Total FBR	**3,828.5**	**3,996.7**	**-0.4**	**4.4**

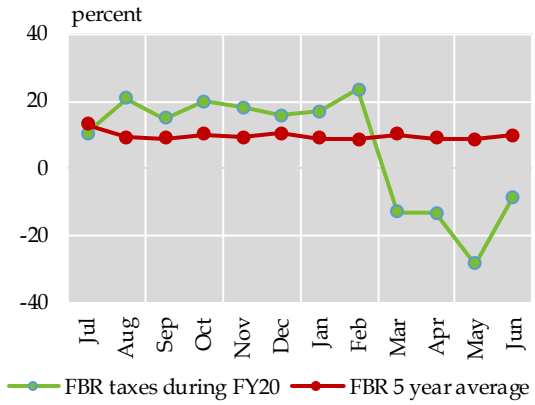
Source: Federal Board of Revenue

Similarly, measures such as the increase in sales tax rates, especially on petroleum products and sugar; upward revision in income tax rates for both salaried and non-salaried persons; reinstatement of withholding tax and sales tax on mobile top-ups; increased excise duty on cement and cigarettes; and upward adjustment in power tariffs,

supported the revenue collection. These measures helped domestic taxes (62.2 percent of FBR taxes) grow by 7.2 percent in FY20, as compared to a decline of 3.1 percent last year.

Keeping in view the encouraging growth in tax revenues during Jul-Feb FY20 – with monthly growth exceeding the 5-year average – it was expected that the FBR would meet its revised revenue target of Rs 4,803 billion.[1] However, the target had to be substantially revised down to Rs 3,907 billion because of Covid-related developments, and the FBR was able to achieve this target. The overall collections also recovered slightly in June 2020 following the ease in countrywide lockdowns. However, this performance could not continue after the Covid-19 outbreak in the country.

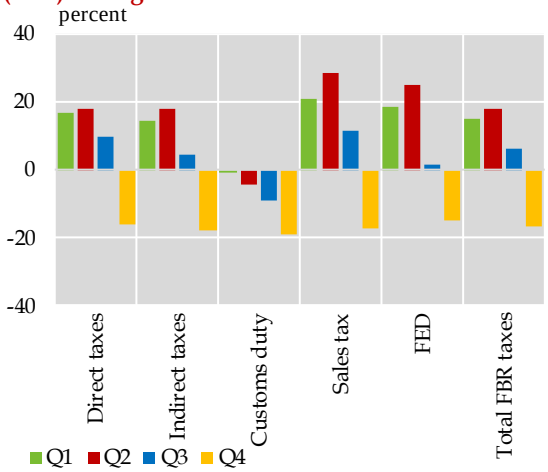
Monthly Growth in FBR Taxes during FY20 (YoY) **Figure 4.4**



Source: Federal Board of Revenue

With the imposition of lockdowns around the last week of March-2020, the growth in FBR taxes fell by 13.2 percent in that month **(Figure 4.4)**. Customs and FED declined the most in the month (22.7 and 16.7 percent, respectively), followed by direct taxes and sales tax (11.1 and 10.4 percent). This was particularly worrying, given that the bulk of collections are usually concentrated at quarter-end. Consequently, the growth in FBR taxes deteriorated in Q3-FY20 **(Figure 4.5)**. Importantly also, import-related taxes, constituting around 40 percent of the FBR taxes, continued to remain under stress throughout the year due to the declining trend in imports.

Quarterly Growth in FBR Taxes (YoY) during FY20 **Figure 4.5**



Source: Federal Board of Revenue

Direct Taxes

Direct taxes increased by 5.4 percent during FY20, as compared to a decline of 5.9 percent in FY19. This mainly emanated from higher growth in withholding taxes (WHT), which offset the declining impact from voluntary payments and collection on demand.

WHT, having a share of more than 70 percent in direct taxes, recorded a double-digit growth in FY20, as compared to a decline of 8.3 percent during FY19. This rise came mainly from a noticeable surge in the collection from salaries, interest & securities, and telephone. Tax measures taken in the FY20 budget, such as the upward revision in tax rates on various salary slabs, increase in tax rates on profit on debt, and the re-enactment of WHT on mobile phone top-ups, all improved the collection from these heads (**Table 4.3**). In contrast, WHT collection on imports declined by 10.0 percent during FY20, primarily due to a decline in import values even in Pak Rupee terms.[2] Collection from contracts during FY20 were almost at last year's level, as the PSDP - the major contrubutor to collection from

[1] The budgeted FBR revenue target was set at Rs. 5,555 billion.
[2] The import value declined by 5.5 percent on YoY basis as compared to 11.3 percent positive growth last year.

contracts - slightly increased by Rs 81.5 billion during FY20.

Voluntary payments, having a share of around 26 percent in the overall direct taxes, declined 11.0 percent in FY20, as compared to a decline of 1.0 percent in FY19. This was mainly due to negative growths of 10.2 and 48.7 percent in collection from returns during FY19 and FY20, respectively. It may be recalled that tax amnesty schemes were announced in the last two fiscal years, and the response in FY18 was overwhelming, given that the collection from returns had grown by a substantial 189.1 percent. The high base effect of FY18 would have affected the growth in collection from returns both in FY19 and FY20 – more so in the current year, as no such scheme was announced in FY20. A similar trend was visible in the collection on demand, which declined by 40.8 in FY20, as compared to a 0.2 percent decline in FY19.

Break-up of Direct Taxes **Table 4.3**

billion Rupees; growth in percent

			Growth	
	FY19	FY20	FY19	FY20
Voluntary payments	**462.2**	**411.1**	**-1.0**	**-11.0**
Collection on demand	**102.6**	**60.8**	**-0.2**	**-40.8**
Withholding taxes	**960.2**	**1091.9**	**-8.3**	**13.7**
of which				
Imports	221.8	199.7	1.4	-10.0
Exports	34.4	38.4	21.7	11.6
Contracts	234.7	237.4	-17.0	1.1
Salary	76.4	129.4	-42.7	69.4
Interest & securities	58.1	128.3	27.5	120.7
Cash withdrawal	32.1	15.3	-5.5	-52.3
Dividends	57.2	55.1	-1.1	-3.6
Electric bills	35.6	45.4	5.2	27.8
Telephone	17.2	54.6	-63.7	217.9

Source: Federal Board of Revenue

Indirect Taxes

Indirect taxes, constituting more than 60 percent of the overall FBR taxes, grew by 3.8 percent during FY20, as compared to a 3.3 percent increase last year. After recording a double-digit growth in Q1 and Q2 of FY20, the growth deteriorated in Q3 because of the Covid-related developments. Futhermore, disaggregated data reveals that the monthly collections of indirect taxes remained around 16 percent lower YoY during the last four months of FY20.

Sales Tax on Domestic & Import Stage Table 4.4

billion Rupees; growth in percent

			Growth	
	FY19	FY20	FY19	FY20
Domestic				
of which				
POL products	248.5	234.6	-16.9	-5.6
Electrical energy	51.4	91.8	5.8	78.8
Cement	21.6	21.2	-10.2	-1.8
Sugar	26.6	41.2	31.8	54.9
Textile sector		61.2		
Sales tax (domestic)	**669.9**	**813.1**	**-8.4**	**11.0**
Imports				
of which				
POL products	221.3	231.3	-16.2	4.5
Iron and steel	69.6	82.9	1.8	19.2
Vehicles	63.0	42.9	-5.6	-31.8
Plastic resins etc.	52.1	55.2	15.4	5.9
Organic chemicals	20.2	31.2	14.9	54.9
Sales tax (imports)	**810.4**	**876.3**	**-1.7**	**8.1**
Gross sales tax	**1,480.4**	**1,689.4**	**-4.8**	**14.1**
Net sales tax	**1,459.2**	**1,596.8**	**-1.8**	**9.4**

Source: Federal Board of Revenue

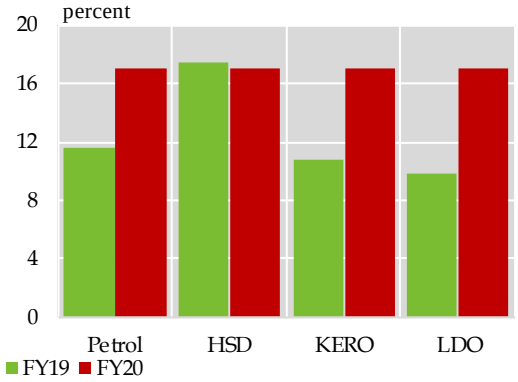
Sales tax

Sales tax collection increased by 9.4 percent during FY20, as compared to a decline of 1.8 percent during FY19 **(Table 4.4)**. During Jul-Feb FY20, the sales tax collection posted a YoY growth of 24.6 percent, mainly due to the upward price adjustments in power tariffs, which led to a significant rise in collection from electrical energy (Discos). Moreover, collection from the textile sector also added a substantial amount to the sales tax collection after the abolishment of the zero-rating regime for the sector. Furthermore, sales tax collection on sugar increased due to the elimination of preferantial treatment for the sugar sector.

Similar to other categories, collections from POL products also remained subdued during the Covid period. This mainly came from the domestic stage, following the lockdowns and mobility restrictions and reduced economic activity in general. However, before the Covid outbreak and until Q3, the POL products were the main contributor to the overall sales tax collection on account of the rise in sales tax rate **(Figure 4.6)**. Meanwhile, collection from

the cement sector and motor vehicles declined during FY20. The drop in cement is explained by the lower construction activity **(Chapter 2)**, whereas collection from vehicles declined primarily due to the continuation of import compression policies and lower production of cars.

Sales Tax Rates on POL Products **Figure 4.6**



Note: Sales tax rates for FY20 are calculated on basis of weighted average formula.

Source: Federal Board of Revenue

Customs and Federal Excise Duties

There has been a declining trend in the collection from customs duty since May 2019, as imports have contracted sharply following the exchange rate adjustment, along with the imposition of import compression measures like regulatory duties and additional customs duty (ACD). The ACD was increased from 1.0 to 2.0 percent in the FY19 budget; whereas in the FY20 budget, concessions on customs duty on plants, machinery, equipment & apparatus were withdrawn, and 5.0 percent customs duty on natural gas was restored. The drop in collection from customs duty deepened in Q4 on account of Covid-19. In overall terms, the collection from customs duty declined by 8.6 percent in FY20, as compared to a growth of 12.7 percent last year **(Table 4.5)**. Almost all the categories of custom duty declined during FY20 besides collection from POL. Meanwhile, FED collection grew by a relatively subdued 5.2 percent in FY20, as compared to an increase of 11.6 percent recorded last year.

Major Revenue Spinners of Excise and Custom Duty **Table 4.5**

billion Rupees; growth in percent

			Growth	
	FY19	FY20	FY19	FY20
Custom duty	**685.6**	**626.4**	**12.7**	**-8.6**
POL products	79.4	83.2	12.3	4.9
Vehicles	81.5	56.9	-16.1	-30.2
Iron and steel	47.2	45.4	13.9	-3.7
Other	477.6	440.9	19.7	-7.7
FED	**238.2**	**250.5**	**11.6**	**5.2**
Cigarettes & tobacco	91.0	88.6	35.5	-2.6
Cement	57.6	71.5	6.7	24.1
Concentrate/ water/beverage	23.0	24.1	2.9	5.0
Indirect tax	**2,383.0**	**2,473.7**	**3.3**	**3.8**

Source: Federal Board of Revenue

This increase was mainly backed by a 24.1 percent growth in cement due to the upward revision in FED rates.[3] However, the growth in collection from cement was offset by hits to FED collection from cigarettes and tobacco **(Table 4.5).** The upward revision in FED rates on cigarettes and tobacco negatively affected the growth in FED collection from the formal cigarette industry, as many consumers likely shifted towards cheaper and smuggled products **(Chapter 2)**.

4.3 Non-tax Revenues

Non-tax revenues rose significantly in FY20, on the back of higher SBP profits and the GSM license renewal fee **(Table 4.6).** Mark-up payments from PSEs also increased on account of higher interest rates, which added Rs 69.5 billion to the non-tax revenue. Profits from the SBP and the PTA, and the mark-up income from PSEs, contributed the most to the non-tax revenue growth in FY20.

Compared to an average of Rs 226.5 billion during the last 10 years, the SBP transferred Rs 935.5 billion in profit during FY20 **(Figure 4.7).** These transfers stemmed primarily from higher interest earnings on the existing debt stock and revaluation gains **(Chapter 5)**.

[3] The FED rate for beverages was increased to 13.0 percent from 11.5 percent, while that on cigarettes and cement was increased by Rs 700 per 1,000 sticks and Rs 0.5 per kg, respectively.

Non-Tax Revenues **Table 4.6**

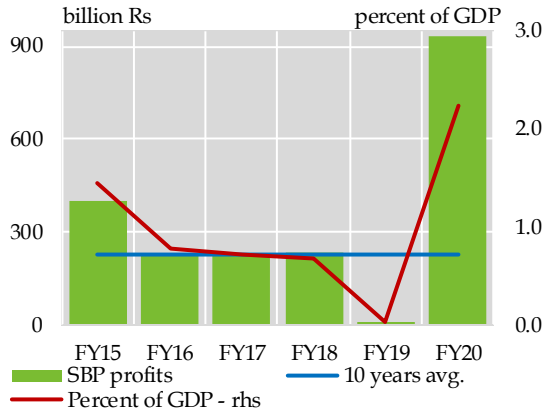
billion Rupees

			Abs. Change	
	FY19	FY20	FY19	FY20
Mark-up (PSEs & others)	35.7	105.2	-52.1	69.5
Dividends	60.2	40.1	2.7	-20.1
SBP profits	12.5	935.5	-220.7	923.0
Defence	15.6	14.4	2.9	-1.2
Royalties on gas & oil	87.9	79.4	29.7	-8.5
Profits post office dept./PTA	18.2	127.0	2.3	108.8
Passport & other fees	23.0	17.7	7.1	-5.3
Discount retained on crude oil	14.0	13.0	4.9	-1.0
Windfall levy against crude oil	7.7	5.2	3.8	-2.5
Petroleum levy on LPG	3.7	3.2	1.6	-0.5
Other	148.7	183.7	-115.8	35.0
Total non-tax revenue	**427.3**	**1,524.4**	**-333.6**	**1,097.1**

Source: Ministry of Finance

Furthermore, PTA profit was mainly driven by GSM licence renewal fee which contributed Rs 127.0 billion to the non-tax revenue. Also, the higher interest earnings from the government's lending to PSEs added Rs 105.2 billion to the non-tax revenue in FY20 because of the higher interest rates. Mark-up receipts mainly came from coporations such as WAPDA and NHA. Profits from hydro-electricity increased by Rs 4.7 billion to Rs 25.7 billion during the review period. Moreover, Rs 26.9 billion were received against the services provided by Pakistani troops in various international peacekeeping missions.

Trend in SBP Profits **Figure 4.7**



Source: Ministry of Finance

In contrast, dividends on the government's shareholding in commercial enterprises, declined by Rs 20.1 billion during FY20, after rising by Rs 2.7 billion last year. In fact, dividends remained below their five-year average. This decline was attributed to the lower profitablity of various PSEs, such as OGDCL, PTCL and Pak Arab Refinery, which led to a decline in reported dividends by these entities.

Furthermoe, the collection from passport & other fees eclined Rs 5.3 billion in FY20, possibly due to the closure of passport offices following the Covid-19 outbreak. Royalties on gas and oil declined by Rs 8.5 billion in FY20 as compared to an increase of Rs 27.9 billion last year. This decline was concentrated in Q4 amid Covid-19, as the royalties had actually increased by Rs 3.8 billion until Q3.[4] Windfall levy against crude oil declined by Rs 2.5 billion during FY20, as compared to a rise of Rs 2.7 billion recorded last year.

4.4 Expenditures

Despite a decline in the development spending, total expenditures grew by a sizable 17.0 percent during FY20, as compared to an 11.3 percent increase last year **(Table 4.7)**. This was mainly due to a higher, Covid-related growth in current expenditures. Although a better fiscal performance was seen in the first nine months of FY20, the last quarter saw pressures on public finances due to higher Covid-19 related expenditures on health and social transfers. Total expenditures constituted around 23.3 percent of GDP, the FY20. The current expenditures surged in Q4-highest since FY98.[5] As a result, the fiscal deficit increased in the last quarter of FY20 to reach 4.1 percent of GDP.

Current Expenditures

Expenditure-control efforts in the first three quarters were reversed in the fourth quarter of

[4] According to Exploration and Prduction Policy (2012), oil exploration and production companies pay 12.5 percent of the value of petroleum as royalty.

[5] Fiscal Policy Statement of Pakistan (2019-20), Ministry of Finance.

Analysis of Fiscal Spending **Table 4.7**

billion Rupees

	Jul-Jun		Absolute change		Growth	
	FY19	FY20	FY19	FY20	FY19	FY20
Current expenditures	**7,104.0**	**8,532.0**	**1,249.8**	**1,428.0**	**21.3**	**20.1**
Federal	4,776.2	6,016.2	986.4	1,240.0	26.0	26.0
of which						
Interest payments (i+ii)	2,091.1	2,619.7	591.2	528.6	39.4	25.3
(i) Domestic	1,820.8	2313.1	498.2	492.3	37.7	27.0
(ii) Foreign	270.3	306.6	93.0	36.3	52.5	13.4
Defense	1,146.8	1,213.3	116.4	66.5	11.3	5.8
Public order and safety	171.6	176.3	46.9	4.7	37.6	2.7
Others	1366.6	2,006.9	231.9	640.2	20.4	46.8
Provincial	2,327.9	2515.8	263.4	187.9	12.8	8.1
Development expenditures	**1,178.4**	**1,155.2**	**-405.6**	**-23.2**	**-25.6**	**-2.0**
PSDP	1,008.2	1,089.7	-448.0	81.5	-30.8	8.1
Federal	502.1	467.7	-74.0	-34.3	-12.9	-6.8
Provincial	506.2	622.0	-374.0	115.8	-42.5	22.9
Others (including BISP)	170.2	65.5	42.4	-104.7	33.2	-61.5
Net lending	40.8	48.5	3.1	7.8	8.3	19.1
Total expenditure*	**8323.2**	**9,735.8**	**847.3**	**1,412.5**	**11.3**	**17.0**

* Excluding statistical discrepancy

Source: Ministry of Finance

FY20 due to additional spending requirements following the Covid-19 outbreak for healthcare, social transfers and grants.

That said, for the full year, the growth in current expenditures was mainly led by interest payments, which grew by 25.3 percent during FY20, as compared to 39.4 percent last year. This mainly emanated from higher payments on domestic debt in the wake of higher interest rates during FY19 and most of FY20. Another factor was the substantial increase in grants for spending on social fronts, such as the Benazir Income Support Program (BISP) under the umbrella of the *Ehsaas* Program. In addition, the government announced a fiscal stimulus package worth Rs 1.2 trillion amid Covid-19. The package aimed to provide relief to the small businesses, and the economically vulnerable low-income groups whose livelihood was badly affected by the pandemic-related lockdowns. First, about Rs 570 billion were allocated to support the public; this included funding for the Utility Stores; power and gas subsidy for bill deferrals; sizable reduction in petrol and diesel prices; support for daily wage workers and the poor; and *panahgahs.*

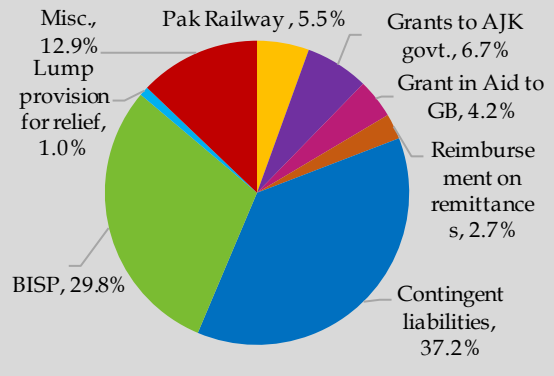
Second, Rs 480 billion were kept for the business sector and to support SMEs, agriculture, exporters, and to pay wheat farmers. Third, emergency measures of Rs 190 billion were taken, which included tax relief on food and health items, incentives for medical equipment, and emergency funding (including for the National Disaster Management Authority).

The government also launched the "Ehsaas Emergency Cash Program", with an allocation of Rs 144 billion. This program aims to distribute Rs 12,000 among 12 million poor families of daily wage earners. Around Rs 160.5 billion was already distributed among 13.3 million beneficiaries till July 27.[6] Contributing around 2.0 percent of GDP in FY20, the grants included support for Pakistan Railway, AJK and Giglit Baltistan, and also for contingent liabilities **(Figure 4.8)**. Furthermore, the spending in this category registered Rs 813.4 billion, which exceeded the target of Rs 734.7 billion.

[6] Source: Pakistan Economic Update for July 2020, Ministry of Finance.

Subsidies are estimated to have recorded a significant increase during FY20. Major contribution came from power, food & agriculture sectors; moreover, the share of petroleum revved up during the year which included subsidies to the LNG sector and oil marketing companies **(Figure 4.9)**.

Dissection of Grants for FY20* **Figure 4.8**
(share in percent)

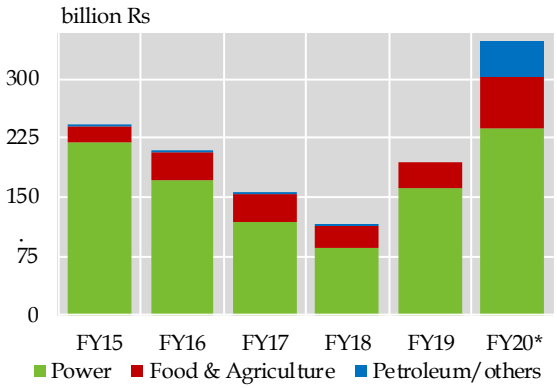


* Revised estimates for FY20
Source: Budget in Brief (FY21)

In the power sector, subsidies were granted to Wapda, Pepco and K-Electric. The subsidies to Wapda/Pepco constituted the major share of Rs 201 billion in the budget and increased to Rs 211 billion, mainly due to inter-Disco tariff differential as well as electricity bill deferment following Covid-19.

Within food & agriculture sector, the Pakistan Agricultural Storage and Services Corporation (PASSCO) received subsidies for wheat operations, and the Utility Stores Corporation for Ramzan and Covid-related stimulus packages; whereas fertilizer plants also received subsidies. Subsidy expenditure on Utility Stores rose to Rs 43.5 billion against the targeted Rs 5.5 billion during FY20, owing to sales of essential items, including under the Covid stimulus package. In the energy sector, subsidies were granted to the gas companies to supply imported LNG to the industries at reduced rates. Besides, oil marketing companies also received a significant share. As a result, the petroleum-related subsidies reached Rs 47 billion, and exceeded their target by Rs 23 billion.

Subsidies by Major Sectors **Figure 4.9**



* Revised estimates for FY20
Sources: Fiscal Policy Statement FY20; Budget in Brief (FY21)

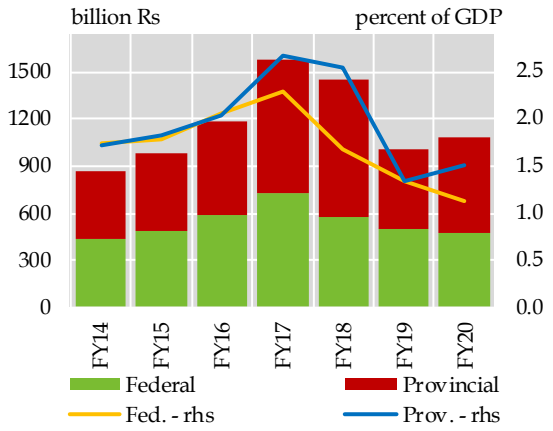
Development Expenditures

Development expenditures declined by 2.0 percent in FY20 as compared to a decline of 25.6 percent during FY19. This is the third consecutive year that the development expenditures have declined. The federal development expenditures, which reduced by 6.8 percent in FY20 as compared to a decline of 12.9 percent last year, were mainly responsible for the overall lower development spending.

The PSDP spending has been shrinking over the last few years, whereas the shares of federal and provincial governments have also changed. Specifically, the budgetary outlay for federal development expenditures has been decreasing. In terms of GDP, both federal and provincial PSDP expenditures have showed a declining trend since FY17 **(Figure 4.10)**. This may be explained by the lower fiscal space available for development spending, given that the federal government's expenditures are constrained by interest payments, defence expenditures, and grants.

According to a World Bank study, the main bottleneck was effective public financial management (PFM), which encompasses issues like the timely release of funds, transparent and efficient procurement, and federal-provincial coordination.

Trends in PSDP **Figure 4.10**



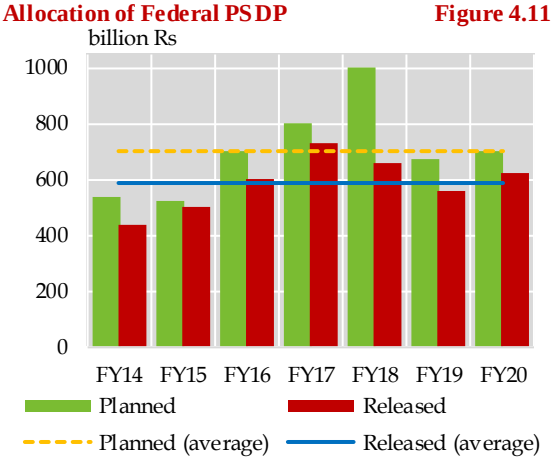
Source: Ministry of Finance

These bottlenecks can be addressed by enhancing the capacity of the PFM institutions, such as the Pakistan Audit and Accounts Academy (PAAA) and the Public Procurement Authority across various government departments.[7] With the enactment of the Public Financial Management (PFM) Act in FY19, the respective divisions and departments were made responsible for executing the sectoral PSDP projects.[8] However, anecdotal evidence suggests that the institutions have struggled with administrative and capacity constraints in executing projects in the earlier part of FY20.

In addition, the budgeted and actual PSDP spending may also be an indicator of the capacity to spend the budgeted funds. On average since FY14, the planned federal PSDP expenditure continued to remain around Rs 700 billion, out of which about Rs 600 billion were actually spent. This was particularly evident in FY18, when the actual spending was far lower than the federal budget outlay for the year **(Figure 4.11)**.

The federal divisible pool is distributed among the provinces according to the budgeted target at the beginning of the year, as per the NFC (2009) award. The federal PSDP was significantly compromised due to the shortfall of more than Rs 1,500 billion in FBR taxes as compared to the budgeted target, along with urgent, additional expenditures incurred amid the Covid-19 pandemic.

Allocation of Federal PSDP **Figure 4.11**



Source: Ministry of Finance

Encouragingly, the actual PSDP released for federal was about 89 percent of the budgeted target set in the beginning. About 30 percent of the release was dedicated to infrastructure and power-related spending, such as those pertaining to the National Highway Authority (NHA), Pakistan Electric Power Company (PEPCO), and the National Transmission and Dispatch Company (NTDC). Some of the special projects (mostly managed by the Finance Division) were nearly aligned with the budget targets, such as the Special Federal Development Program for temporarily displaced persons (TDPs) and security-related projects. About half of the releases were disbursed for projects like the PM Youth Hunarmand Program, Gas Infrastructure Cess, and the Merged Areas 10-year KP development programs.

Within federal ministries, the water resource and cabinet divisions, and the Higher Education Commission (HEC) received major shares. Importantly, construction of dams in Balochistan and the Diamer Bhasha Dam (in KP and Gilgit Baltistan) received major allocations under the water resources division.

[7] Cole, W. P. O. (2016). *Pakistan-Public Financial Management and Accountability to Support Service Delivery Project No. 109788*. Washington, DC: World Bank.
[8] Source: Public Financial Management Act 2019 for Pakistan, Ministry of Finance.

Meanwhile, the cabinet division's major expenditure components included allocations for the SDGs Achievement Program and the Greenline Bus Rapid Transit System (BRTS) for Karachi. The HEC's major projects included the establishment of a NUST campus in Quetta, and the initiative of MS leading to Ph.D. program of faculty development for engineering universities, and other projects comprising various foreign scholarships and fellowships.

4.5 Provincial Fiscal Operations

The provinces remained committed to the objective of fiscal consolidation and posted a combined surplus of Rs 224.9 billion during FY20 **(Table 4.8)**. However, this surplus was only 53 percent of the target (Rs 423 billion) set for the year. Balochistan (Rs 74.8 billion) contributed the most, followed by Sindh (Rs 70.9 billion) and KP (Rs 66.4 billion) to the overall surplus yielded by the provinces.

Provincial Fiscal Operations **Table 4.8**

billion Rupees

	Total		Growth	
	FY19	FY20	FY19	FY20
A. Total revenue	2,995.9	3241.0	2.0	8.2
Provincial share in fed. revenue	2,397.8	2504.0	8.1	4.4
Provincial own revenue	488.1	516.0	-10.9	5.7
Taxes	401.8	413.6	0.1	2.9
Non-tax revenue	86.3	102.4	-41.2	18.6
Fed loans and transfers	110.0	221.0	-36.4	100.9
B. Total expenditure	2857.0	3163.9	-3.5	10.7
Current**	2350.8	2541.9	13.0	8.1
Development	506.2	622.0	-42.5	22.9
Gap (A-B)	138.9	77.1	-720.8	-44.5
Financing* (overall balance)	**-190.0**	**-224.9**	**-1183.8**	**18.4**

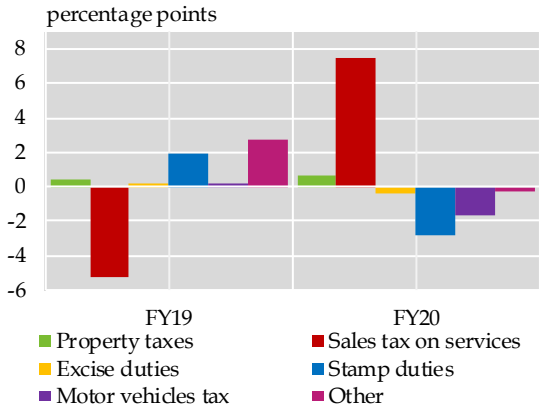
*Negative sign in financing means surplus. ** Current expenditure data may not match with those given in Table 4.7 as numbers reported here includes the markup payments to federal government.

Source: Ministry of Finance

Provincial Revenue

Total provincial revenues grew by 8.2 percent during FY20 as compared to 2.0 percent last year. The provincial share in federal revenue, which covers almost 79 percent of the total provincial revenue, grew by 4.4 percent during FY20 as compared to 8.1 percent last year. However, *provincial own tax revenue* grew by 5.7 percent during FY20, in contrast to a decline of 10.9 percent last year. Sales tax on services (GSTS), having a share of around 56 percent in provincial tax collection, contributed the most **(Figure 4.12)**.

Contribution of Provincial Tax Revenue Spinners **Figure 4.12**



Source: Ministry of Finance

Moreover, the higher collection from GSTS also came from a revoke of the ban on collection of sales tax on mobile top-ups in FY19. [9] The property tax is usually considered to be the potential source for extracting revenue, but its share in the overall provincial revenue is quite low. Despite its growth, it contributed only Rs 9.6 billion during FY20. There are various tax administration and coverage issues that hinder the property tax collection in Pakistan.[10]

That said, the provincial tax and non-tax collection were both affected by the Covid-19, which slowed down the pace of economic

[9] As per the Human Rights Case No. 18877 of 2018, there was a ban on collection of sales tax on mobile top-ups that was applicable to all the provinces. Since telecom services make as significant share of taxable services, the collection was lower in FY19. GSTS for provinces increased in FY20 with the revoke of the ban.

[10] Nabi, I., and H. Shaikh (2011). *Reforming the Urban Property Tax in Pakistan's Punjab*. Policy Brief PB1301. Lahore: Lahore University of Management Sciences. For more details on the topic, also see Special Section 1 of the SBP's State of the Economy Report for Q1-FY19.

activity. As a result, excise and stamp duties and motor vehicle tax declined. This also reflected the impact of lower production and sales of cars and motorcycles, amid the import-compression measures adopted earlier; the trend was further aggravated by Covid-19. Non-tax revenues, constituting around 20 percent of provincial own revenue collection, grew by 18.6 percent during FY20, against a decline of 41.2 percent in FY19. Profit from hydroelectricity increased to Rs 25.7 billion from Rs 21.1 billion last year. Most of this came from KP (Rs 18.7 billion) and Punjab (Rs 7.0 billion). Moreover, irrigation receipts of Rs 3.8 billion were collected during FY20, as compared to Rs 2.4 billion last year. Punjab contributed the most by reporting Rs 3.2 billion under this head.

It is important to note that federal loans and transfers reached Rs 220.9 billion in FY20, almost double the amount reported in FY19 – and about 62 percent of these transfers went to KP. These transfers mainly represent the funds allocated under the 10-year development program for the merged areas.[11] The development and uplift of the Federally Administered Tribal Areas remained a priority for both the federal and KP governments. The primary focus is to upgrade the health, education, and social protection framework, whereas the secondary focus would to improve infrastructure, including the construction of roads and provision of electricity. [12]

Provincial Expenditures

The total provincial expenditures grew by 10.7 percent during FY20, after declining by 3.5 percent last year. Since both current and development expenditures grew in FY20, the provinces could only achieve about half of the targeted annual provincial surplus. The provincial development expenditures rebounded in FY20, rising by 22.9 percent during the year, after dropping 42.5 percent last year.

Heat Map Showing Provincial Current Expenditure Preferences **Table 4.9**

Average shares in total current expenditure since FY16 (percent)

	Punjab	Sindh	KP	Balochistan
Admin affairs*	21.6	21.7	19.2	21.1
Transfers to districts	34.7	10.1	41.0	1.8
General services	0.7	0.7	0.5	1.7
Public order	14.3	14.9	14.9	16.6
General affairs**	0.1	0.3	0.1	0.6
Food and agri***	6.3	5.8	3.6	8.4
Fuel and energy	0.1	3.5	0.0	4.9
Mining and manufacturing	0.9	0.2	0.2	1.3
Construction and transport	2.5	2.1	1.5	4.6
Other industries	0.0	0.1	0.0	0.0
Housing and community	1.2	0.6	1.1	4.2
Health	10.1	12.7	7.7	9.1
Recreation and cul	0.3	1.1	0.3	1.1
Education	5.7	24.9	7.7	23.3
Social protection	1.4	1.3	2.1	1.3

Key: Lowest to highest

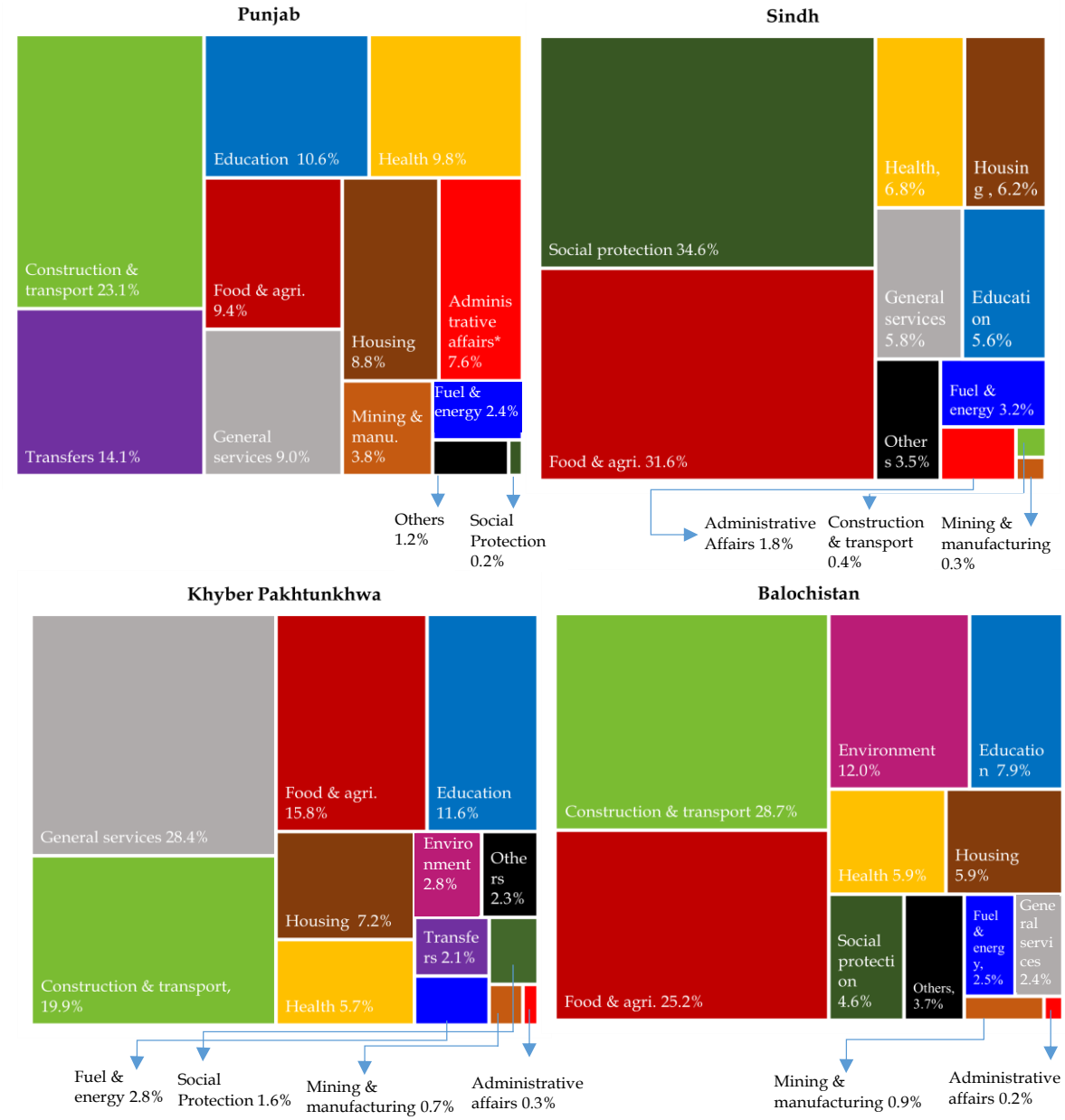
* This term includes Executive & Legislative Organs, Financial and Fiscal Affairs; ** General Economic, Commercial & Labor Affairs
*** Agriculture, Food, Irrigation, Forestry, and Fishing

Source: Ministry of Finance

However, current expenditures slowed down to 8.1 percent in comparison with the 13.0 percent growth last year. Province-wise analysis reveals that over the last five years, the trend in provincial current expenditures is tilted towards administrative affairs of the provincial governments, followed by public order, health, and food-related spending. Encouragingly, Sindh and Balochistan invested more in education, while Punjab and KP transferred the funds to district authorities for providing services to the general public **(Table 4.9)**. Although the provincial development expenditures rebounded from last year, there remain gaps in the budgeted estimates and the actual spending. For example, Punjab spent about 76 percent, Balochistan 86 percent, and KP 50 percent, of their respective budget allocations. Sindh, on

[11] Under the 25th amendment in 2018, the Federally Administered Tribal Areas (FATA) region was officially merged with Khyber Pakhtunkhwa.
[12] KP White Paper for FY21 (source: https://www.pakp.gov.pk/wp-content/uploads/White-Paper-2020-21.pdf).

Composition of Provincial Development Expenditure during FY20 **Figure 4.13**



* This term includes Executive & Legislative Organs, Financial and Fiscal Affairs;
Source: Ministry of Finance

the other hand, spent only 34 percent of the budget outlay, which is reflected in the decline of the province's development expenditure during the year. The provincial spending varied in different sectors during the year. For instance, the major preference points for Punjab remained construction and transport, transfers to district, health, and education. Likewise, KP and Balochistan focused their spending on construction, and food and agriculture, whereas Sindh spent largely on social protection and food and agriculture **(Figure 4.13)**. In overall terms, food and agriculture, construction, education, health, and housing remained the provincial priorities during FY20. These developments will help the provinces to invest in more productive areas, such as education, health, and infrastructure, to achieving the Sustainable Development Goals (SDGs) objective, and to impart social development. .

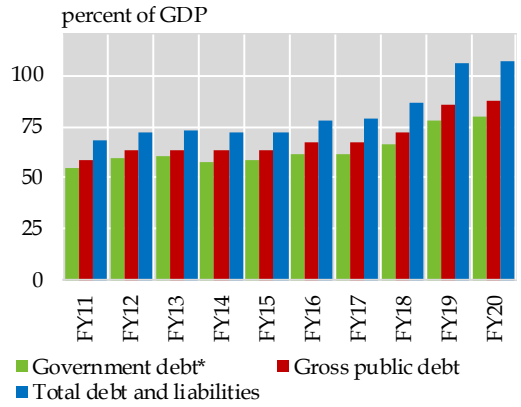
Chapter 5
Domestic and External Debt

The pace of public debt accumulation slowed considerably during FY20, despite an almost unchanged fiscal position from last year. Utilization of accumulated government deposits, lower revaluation losses, and higher debt servicing helped control the speed of debt buildup during the year. More than two-third of the rise in public debt during FY20 emanated from government domestic debt. Importantly, the government adhered to its commitment of zero fresh borrowing from the central bank and relied on scheduled banks and non-banks for its financing needs. The year also saw a record surge in foreign investment in domestic debt instruments, though most of this capital reverted during the Covid-driven global sell-off. In dollar terms, the rise in external debt was relatively modest compared to last year. External debt sustainability indicators broadly improved during FY20 due to lower debt accumulation and the rise in the country's FX reserves. Pakistan also applied for the G-20 Debt Service Suspension Initiative (DSSI) in the last quarter of FY20, which eased pressures on debt servicing and provided fiscal space to spend on social and health sectors.

5.1 Public Debt

The increase in public debt during FY20 was less than half the increase recorded during FY19. Lower revaluation losses on the existing outstanding stock of public debt, and utilization of accumulated government deposits to finance a similar level of fiscal deficit in rupee terms, as last year, contained the overall rise in public debt during FY20. In terms of GDP, the gross public debt rose by 1.1 percentage points to 87.2 percent of GDP by end-June 2020 (**Figure 5.1**). A decline in economic activity and rising fiscal deficit, particularly in the later part of FY20 amid the Covid-19 outbreak, led to an increase in this ratio.

Debt Indicators **Figure 5.1**

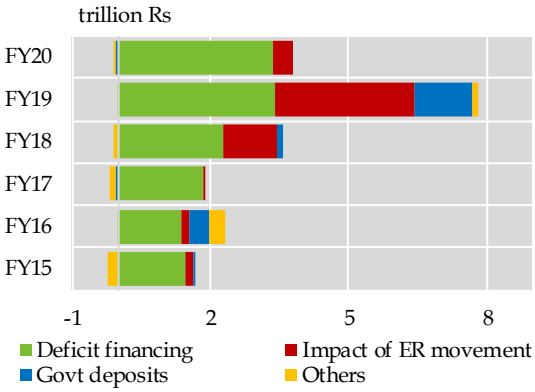


*As per FRDLA

Source: State Bank of Pakistan

The increase in government debt as per the Fiscal Responsibility & Debt Limitation Act (FRDLA) definition was also negligible compared to last year.[1, 2] However, the debt-to-GDP ratio remained higher than the 60 percent limit envisaged in the Act.[3] Although the total debt and liabilities of the country also grew at a slower pace as compared to last year, total debt and liabilities as percent of GDP remained higher than 100 percent for the second consecutive year (**Table 5.1)**.

Composition of Increase in Public Debt **Figure 5.2**



Source: State Bank of Pakistan

Almost 90 percent of the public debt piled up during the year was utilized for deficit financing, while roughly 10 percent of the increase was attributed to the depreciation of the Pak rupee against the US dollar. It may be recalled that last year, approximately 40 percent of the rise in public debt alone was due to the Pak rupee depreciation, and a significant contribution had also come from the government's effort to build cash buffers with SBP (**Figure 5.2**).

From a liquidity management perspective, these buffers were important to maintain, as the government had committed to avoid borrowing from SBP, including rollovers. As it turned out, withdrawals from these deposits were imperative to meeting the government's

[1] As per the FRDL Act, 2005 amended in June 2017, "total debt of the government is the public debt less accumulated deposits of the Federal and Provincial Governments with the banking system.

[2] The ratio increased from 66.5 percent in FY18 to 77.7 percent in FY19 – an increase of 11.2 percentage points. In FY20, the ratio increased from 77.7 percent to 79.7 percent – an increase of 2.0 percentage points.

[3] According to the FRDLA, the total public debt shall be reduced to sixty percent of the estimated GDP beginning from FY17; ensuring that within a period of five financial years (beginning from FY19), total public debt shall be reduced by 0.5 percent every year.

Summary of Pakistan's Debt and Liabilities **Table 5.1**

billion Rupees

	Stock			Absolute change		Percent of GDP	
	FY18	FY19	FY20	FY19	FY20	FY19	FY20
A. Total debt and liabilities (sum I to IX)	29,879.4	40,223.1	44,563.9	10,343.8	4,340.8	105.9	106.8
B. Gross public debt (sum I to III)	24,952.9	32,707.9	36,397.0	7,755.0	3,689.2	86.1	87.2
C. Total debt of the government (I+II+III-X)*	23,024.0	29,520.7	33,250.8	6,496.8	3,730.1	77.7	79.7
I. Government domestic debt	16,416.3	20,731.8	23,281.0	4,315.5	2,549.3	54.6	55.8
II. Government external debt	7,795.8	11,055.1	11,824.5	3,259.3	769.4	29.1	28.3
III. Debt from IMF	740.8	921.0	1,291.5	180.2	370.5	2.4	3.1
IV. External liabilities	622.3	1,710.1	1,663.3	1,087.7	(46.8)	4.5	4.0
V. Private sector external debt	1,654.5	2,481.3	2,641.7	826.8	160.4	6.5	6.3
VI. PSEs external debt	324.6	630.6	823.9	305.9	193.4	1.7	2.0
VII. PSEs domestic debt	1,068.2	1,394.2	1,490.5	326.0	96.3	3.7	3.6
VIII. Commodity operations	819.7	756.4	813.4	(63.3)	57.0	2.0	1.9
IX. Intercompany external debt	437.2	542.7	734.0	105.5	191.3	1.4	1.8
X. Deposits with banking system	1,928.9	3,187.2	3,146.2	1,258.2	(41.0)	8.4	7.5

*As per FRDLA definition

Source: State Bank of Pakistan

cash needs during FY20. Particularly during the Covid period, i.e., Mar-Jun, nearly 53 percent of the budgetary borrowing from the banking system were in the form of withdrawals from government deposits held with the SBP. As a result, while the overall fiscal deficit increased by Rs 1.7 trillion during Q4 due to Covid-19 related expenditures, the public debt increased by Rs 1.1 trillion.

The composition of public debt indicates that more than two-third of the rise in FY20 emanated from government domestic debt; the share of the government external debt decreased, while debt from the IMF increased by Rs 0.4 trillion. Importantly, the maturity structure of the debt stock improved, as the government was able to mobilize most funds (96 percent of total increase in government debt) via long-term instruments. With this, the share of long-term debt in the outstanding stock of government debt reached 83.4 percent. It may be recalled that at the end of FY19, the government re-profiled the existing stock of SBP borrowing from short-term to long-term (1 to 10 years). This re-profiling had increased the share of long-term debt (permanent and unfunded) in total domestic debt from 46 percent at end-FY18 to 73 percent at end-FY19. The share of long-term debt further increased to 76 percent at the end of FY20. This structural shift in the composition of domestic debt reduced the rollover risks, besides improving the average time to maturity. From the demand perspective, the money market also remained keen on investing in government papers, as evident by the amount of offered bids, which rose significantly during FY20 (**Table 3.2 & 3.3**, **Chapter 3**). Even before the outbreak of Covid-19, the market was expecting a reversal in monetary tightening stance, which resulted in a renewed interest for PIBs and 12-month T-bills.

Although the rising share of long-term instruments is encouraging, the development of the capital market remains vital, as it would help reduce financial risks and diversify the investor base. In this context, a record increase in foreign investment in domestic debt instruments during FY20 was encouraging. This increase was attributed to the introduction of a market-based exchange rate system and investors' confidence in the domestic reform program supported by the IMF. The government had also initially planned to float sovereign bonds worth US$ 3.0 billion during FY20, but foreign investment in the local government securities,

Interest payments on Public Debt **Table 5.2**

billion Rupees

	FY16	FY17	FY18	FY19	FY20
A. Total interest payments (i+ii)	**1,263.4**	**1,349.0**	**1,499.9**	**2,091.1**	**2,619.7**
i. Servicing of external debt	112.6	128.2	177.3	270.3	306.6
ii. Servicing of domestic debt	1,150.8	1,220.8	1,322.6	1,820.8	2,313.1
B. External principal repayments	**335.3**	**544.3**	**450.2**	**974.0**	**1,362.4**
Total servicing of public debt (A+B)	**1,598.7**	**1,893.3**	**1,950.1**	**3,065.1**	**3,982.1**
Change in public debt	**2,296.5**	**1,732.0**	**3,544.2**	**7,755.0**	**3,689.2**
Interest payments as % of additional public debt	55.0	77.9	42.3	27.0	71.0

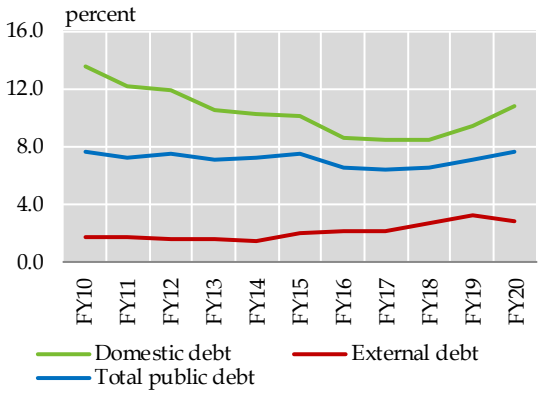
Source: Ministry of Finance

inflows from the IMF, bilateral and multilateral funding proved sufficient to finance a lower current account gap (**Chapter 6)**. The international market dynamics also changed owing to Covid-19, and the government showed restraint in the issuance of sovereign bonds during FY20 because of unfavorable market conditions.

In overall terms, debt sustainability indicators showed improvement during FY20, with a slowdown in fresh accumulation and the rise in the country's foreign exchange reserves. Nonetheless, concerted efforts are needed to entrench debt sustainability, place the debt-to-GDP ratio on a firm declining path, and improve the overall debt management framework. In this context, the foremost requirement is to incur primary surpluses, so that the government can generate funds to service debt obligations. It must be noted here that the volume of interest payments on public debt increased sharply during FY20, and was equivalent to more than 70 percent of the additional public debt accumulation (**Table 5.2**).

On average, during the last five years, overall interest payments stood at around 4-5 percent of GDP each year, eating up more than one-third of country's total revenues. The higher servicing requirements represent not just a persistent rise in the stock of public debt, but also the increase in the average cost of borrowing over the past few years (**Figure 5.3**).[4]

Average Cost of Public Debt* **Figure 5.3**



* Actual interest paid as percent of average level of debt

Source: SBP staff calculations

More recently, the retirement of expensive commercial loans from foreign sources and reengagement with IFIs will help improve the cost structure of public debt. On the domestic front, the steep decline in the policy rate during the Covid-19 crisis may also help reduce the average cost of domestic debt.

5.2 Domestic Debt

The government domestic debt increased by Rs 2.5 trillion during FY20, compared to a rise of Rs 4.3 trillion last year (**Figure 5.4**). Relatively lower volume of deficit financing from internal sources and utilization of existing cash buffers helped contain the pace of domestic debt accumulation. It may be noted that during FY19, the government

[4] The effective interest rate (average cost of borrowing) is calculated as the ratio of the interest bill in period t and the stock of public debt (average of debt stocks in t and t-1).Source: M. M. Badia, P. Medas, P. Gupta, and Y. Xiang (2020). *Debt is Not Free*. IMF Working Paper WP/20/1. Washington, DC: International Monetary Fund.

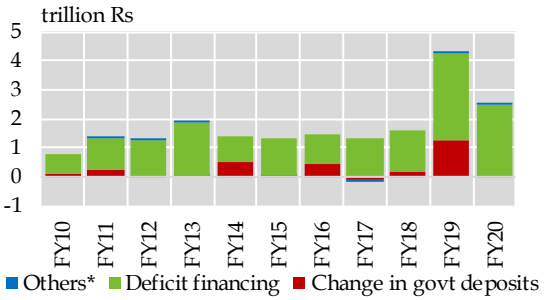
Instrument-wise change in Government Domestic Debt **Table 5.3**

billion Rupees; share in percent

	Stock			Flow		Share in total stock	
	FY18	FY19	FY20	FY19	FY20	FY19	FY20
Domestic debt	16,416.3	20,731.8	23,281.0	4,315.5	2,549.3	100.0	100.0
Permanent debt	4,653.8	12,080.0	14,023.5	7,426.2	1,943.4	58.3	60.2
o/w PIBs	3,413.3	10,933.2	12,886.0	7,519.9	1,952.8	52.7	55.3
Ijara Sukuk	385.4	71.0	198.2	-314.4	127.2	0.3	0.9
Prize bonds	851.0	893.9	734.1	42.9	-159.8	4.3	3.2
Floating debt	8,889.0	5,500.6	5,578.3	-3,388.4	77.7	26.5	24.0
o/w MTBs	5,294.8	4,930.5	5,577.1	-364.4	646.7	23.8	24.0
MRTBs	3,594.2	570.2	1.2	-3,024.0	-569.0	2.8	0.0
Unfunded debt	2,868.1	3,144.1	3,672.1	276.0	528.0	15.2	15.8

Source: State Bank of Pakistan

Sources of Change in Government Domestic Debt **Figure 5.4**



* Difference between the face value and the realized value of PIBs issued during the said period.

Source: State Bank of Pakistan

created substantial cash buffers (deposits with the banking system) to pay off future maturing debt obligations. The government used these deposits during FY20, which reduced its need for fresh borrowing as compared to FY19.

Zero fresh borrowing from the central bank

Importantly, the government adhered to its commitment of zero fresh borrowing from the central bank, and was also able to pay off maturing debt obligations to the central bank.[5] Resultantly, the share of SBP in the government's domestic debt decreased in FY20. Scheduled banks financed the bulk of the government's funding requirements, and as a result, the share of scheduled banks in total domestic debt increased from 33 percent during FY19 to 40 percent during FY20. The government also mobilized funds through non-banks, but their contribution was slightly lower than last year.

It is important to recall that from the debt management perspective, the government started to build up its deposits from FY19 onwards so that maturing obligations could be smoothly paid off in the absence of borrowing from the central bank. Effective utilization of these cash buffers also facilitated the government to partially compensate the rising fiscal deficit owing to Covid-19 in Q4-FY20.

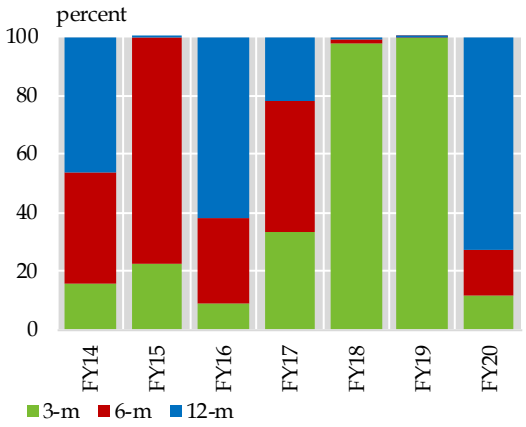
Maturity profile improved further

More than two-third of the rise in domestic debt came from permanent debt, which includes longer tenor instruments like PIBs, Ijara Sukuk and prize bonds (**Table 5.3**). Within floating debt, the government was able to lengthen the maturity profile. The share of 3m T-bills in total outstanding stock of T-bills declined, whereas that of 6m and 12m instruments increased during FY20 (**Figure 5.5**).

Foreign investment in local government securities recorded an uptick, particularly in H1-FY20. Investment by non-banks in government securities was also seen during

[5] The government retired Rs 0.6 trillion worth of securities that were held by the central bank.

Share in Outstanding Stock of T-bills Figure 5.5

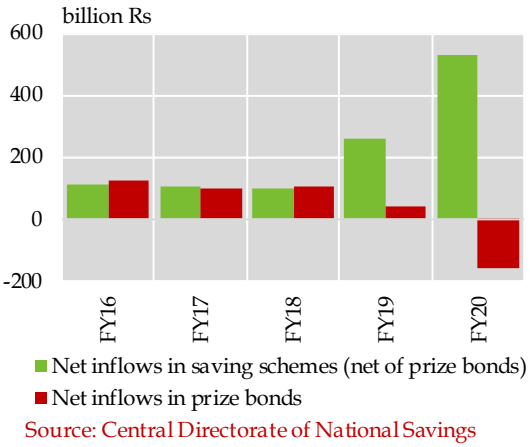


Source: State Bank of Pakistan

FY20. Active participation of foreign investors and non-banks helped in bringing down the yields, where there was no change in the policy rate in the initial part of FY20. From March 2020 onwards, a sharp reduction in the policy rate itself further shifted the entire yield curve downwards (**Chapter 3**).

Regarding PIBs, the government mobilized funds worth Rs 2.0 trillion (net of maturity) during FY20, compared to only Rs 0.3 trillion during FY19. This sharp increase in accumulation of funds via PIBs is attributed to: (1) reintroduction of the 15-year fixed-coupon PIB in April 2020; (2) introduction of new 3-year and 5-year floating rate PIBs in June 2020; and (3) acceptance of bids for 20Y PIBs after a gap of more than 5 years.

Net Inflows in Saving Schemes Figure 5.6



Source: Central Directorate of National Savings

From the demand perspective, the competitive offers increased compared to last year, indicating market's interest in the long-term instruments, keeping in view the high level of long-term rates and the anticipation of monetary easing. From the start of FY20, the volume of offers remained high, but subsequently as the yields started declining, bids for PIBs dropped as well. However, the dynamics changed once again as the process of monetary easing started a little earlier than market expectations due to Covid-19, which led to high investment in PIBs in Q4.

The government also issued Shariah-compliant debt instruments to meet its financing needs. Consequently, the share of Ijara Sukuk in the government domestic debt increased from 0.3 percent in FY19 to 0.9 percent in FY20. The diversification of debt instruments bodes well from the debt management perspective. Importantly, such instruments are also attractive for Islamic banks to park their excess liquidity.[6]

Profit Rates and Investment in NSS Instruments Table 5.4

billion Rupees

	FY18	FY19	FY20	FY20	
	Profit rates* (%)			Gross inflows	Net inflows
DSC	7.8	10.0	10.1	149.9	97.8
BSC	9.7	11.8	11.9	235.3	83.4
RIC	7.1	9.6	10.0	205.8	82.2
SSC	6.3	8.6	9.7	37.4	19.3
PBA	9.7	11.8	11.9	78.9	33.8

* Average profit rates during the year

Source: Central Directorate of National Savings

Inflows in saving schemes doubled in FY20

Net inflows in saving schemes (net of prize bonds) doubled mainly due to higher profit rates offered during FY20 (**Figure 5.6 & Table 5.4**). In contrast, prize bonds recorded net outflows. It is important to recall here that ever since the discontinuation of Rs 40,000 denomination bond at the end of FY19, net

[6] Debt of PSEs also increased in FY20, as the government raised Rs 200 billion through Sukuk to transfer costly Central Power Purchase Agency payables to the Power Holding Private Limited (PHPL).

Pakistan's External Debt and Liabilities **Table 5.5**

billion US$

	End-June Stock			Absolute change					
						FY20			
	FY18	FY19	FY20	FY19	FY20	Q1	Q2	Q3	Q4
Total external debt & liabilities (sum 1 to 7)	**95.2**	**106.3**	**112.9**	**11.1**	**6.5**	**0.7**	**3.7**	**-0.8**	**2.9**
External public debt & liabilities (1+2+3)	**75.4**	**83.9**	**87.9**	**8.6**	**3.9**	**0.6**	**3.1**	**-1.3**	**1.5**
External public debt (1+2)	**70.2**	**73.4**	**78.0**	**3.2**	**4.5**	**0.7**	**3.6**	**-1.2**	**1.5**
1. Government external debt	64.1	67.8	70.3	3.7	2.5	0.0	3.2	-0.9	0.3
i) Long term (>1 year)	62.5	66.5	68.8	4.0	2.2	-0.3	1.9	-0.8	1.4
of which	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Paris club	11.6	11.2	10.9	-0.4	-0.3	-0.2	-0.2	-0.1	0.1
Multilateral	28.1	27.8	30.9	-0.3	3.1	0.3	1.3	-0.5	2.0
Other bilateral	8.7	12.7	13.4	4.0	0.7	0.1	0.4	0.1	0.1
Euro/Sukuk global bonds	7.3	6.3	5.3	-1.0	-1.0	0.0	-1.0	0.0	0.0
Commercial loans/credits	6.8	8.5	8.1	1.7	-0.4	-0.5	1.3	-0.3	-0.9
ii) Short term (<1 year)	1.6	1.3	1.5	-0.4	0.3	0.3	1.2	-0.1	-1.1
of which									
Multilateral	1.0	0.8	0.8	-0.2	0.0	0.1	0.0	0.1	-0.2
Commercial loans	0.7	0.5	0.1	-0.2	-0.3	-0.2	0.0	0.0	-0.1
Local currency securities (Tbills)	0.0	0.0	0.6	0.0	0.6	0.4	1.2	-0.2	-0.8
2. From IMF	6.1	5.6	7.7	-0.4	2.0	0.7	0.4	-0.3	1.2
3. Foreign exchange liabilities	5.1	10.5	9.9	5.4	-0.6	-0.1	-0.4	-0.1	0.0
4. Public sector enterprises (PSEs)	2.7	3.9	4.9	1.2	1.0	-0.1	0.0	-0.3	1.4
5. Commercial banks	4.4	4.7	4.6	0.3	-0.1	-0.4	0.1	0.2	0.0
6. Private sector	9.2	10.5	11.1	1.3	0.6	0.4	0.1	0.2	-0.1
7. Debt liabilities to direct investors	3.6	3.3	4.4	-0.3	1.0	0.3	0.2	0.4	0.1

Source: State Bank of Pakistan and Economic Affairs Division

flows have declined in this category. While most of the holders of Rs 40,000-denomination bond opted for encashment, anecdotal evidence suggests that a fraction of the holders converted these bonds into other instruments under the NSS.[7]

5.3 External Debt & Liabilities

Pakistan's total external debt and liabilities (EDL) increased by US$ 6.5 billion during FY20 compared to a rise of US$ 11.1 billion during FY19 (**Table 5.5**). This slowdown in external debt accumulation was attributed to a marked contraction in the current account deficit; revaluation gains of US$ 0.4 billion on the outstanding stock of external debt; and higher debt repayments during the year.[8] Bifurcation of external debt & liabilities indicates that the share of short-term debt increased marginally during FY20, which was primarily attributed to foreign investment in local government securities. On a positive note, share of multilateral loans rose, whereas the share of commercial loans – which are relatively expensive – declined. Lastly, the share of loans from the IMF also increased during FY20, which not only included the tranches received under the Extended Fund Facility (EFF), but also the inflow of US$ 1.4 billion under the Rapid Financing Instrument (RFI) following the Covid-19 crisis.

[7] Some holders also likely replaced the old bonds with the newly introduced premium prize bonds.
[8] The US Dollar appreciation against the SDR, Chinese Yuan and Euro, led to revaluation gains of US$ 0.2 billion, US$ 0.1 billion, and US$ 0.05 billion, respectively in FY20.

External Debt Servicing **Table 5.6**

million US$

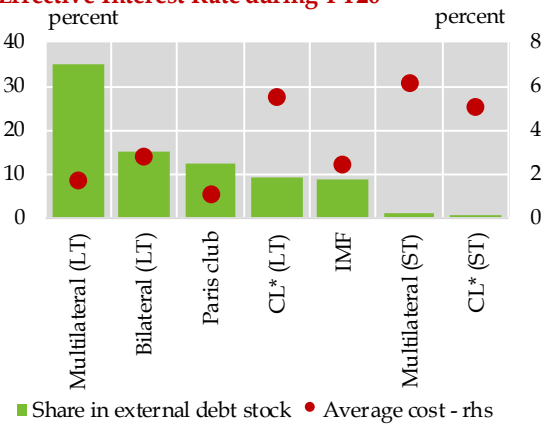
	Principal			Interest		
	FY18	FY19	FY20	FY18	FY19	FY20
1. Public external debt & liabilities	2,704.2	5,817.9	8,362.4	1,786.5	2,290.1	2,352.1
Multilateral	1,316.6	1,375.3	1,455.1	418.6	492.1	525.8
Other bilateral	182.0	329.4	407.2	203.3	310.1	364.4
Euro/Sukuk global bonds	0.0	1,000.0	1,000.0	422.8	502.7	396.0
Commercial loans /credits	488.9	2,097.0	3,879.3	270.4	423.5	466.1
External liabilities	0.0	0.0	500.0	102.8	187.3	320.1
Others	716.7	1,016.2	1,120.7	368.6	374.3	279.8
2. PSEs debt	297.8	223.7	437.2	78.5	130.4	137.8
3.Scheduled banks' borrowing	1.0	2.7	9.8	61.3	71.9	80.9
4. Private sector debt	322.7	482.9	816.8	391.2	458.9	662.3
5. Total external debt and liabilities (sum 1 to 4)	3,325.7	6,527.2	9,626.2	2,317.5	2,951.2	3,233.1
Memorandum Items						
Short term debt servicing - Principal						
Government debt	1,486.3	1,537.1	1,180.9			
PSEs non-guaranteed debt	33.7	0.0	12.0			
Private non-guaranteed debt	332.2	573.9	525.8			

Source: State Bank of Pakistan

Composition and average cost of borrowing of external debt turned favorable

The composition of external debt improved as the share of long-term multilateral loans in outstanding stock of external debt increased. From the debt management perspective, long-term multilateral loans are preferable, as they entail lower cost on average compared to commercial and bilateral loans (**Figure 5.7**).

Share in External Debt and Effective Interest Rate during FY20 **Figure 5.7**

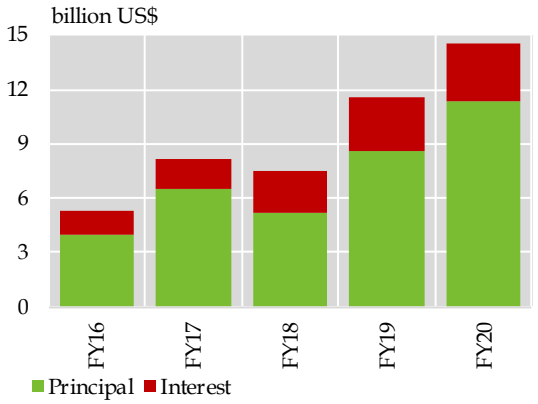


* Commercial Loans

Source: Economics Affairs Division and SBP

External debt servicing rose further during FY20 (**Figure 5.8**). Both principal and interest payments increased. Given the level of

External Debt Servicing **Figure 5.8**

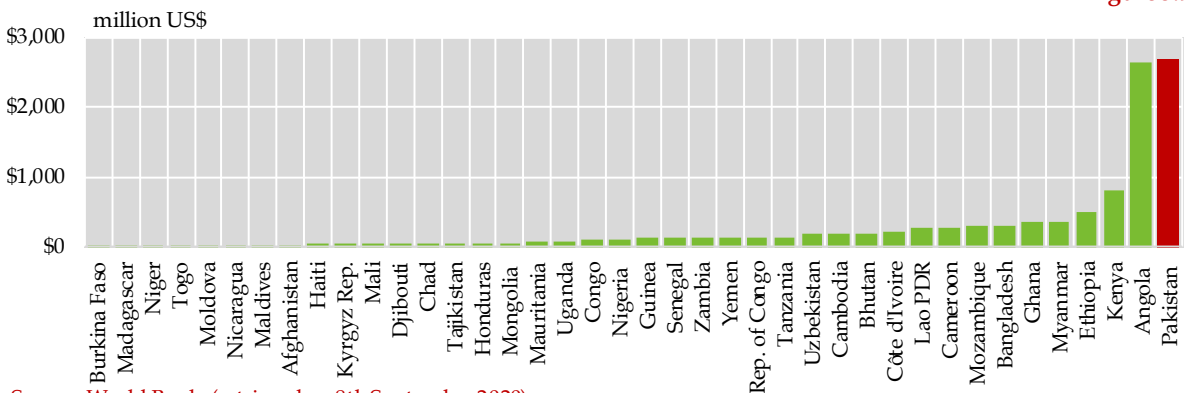


Source: State Bank of Pakistan

foreign exchange reserves at the start of FY20, maturing obligations seemed high.

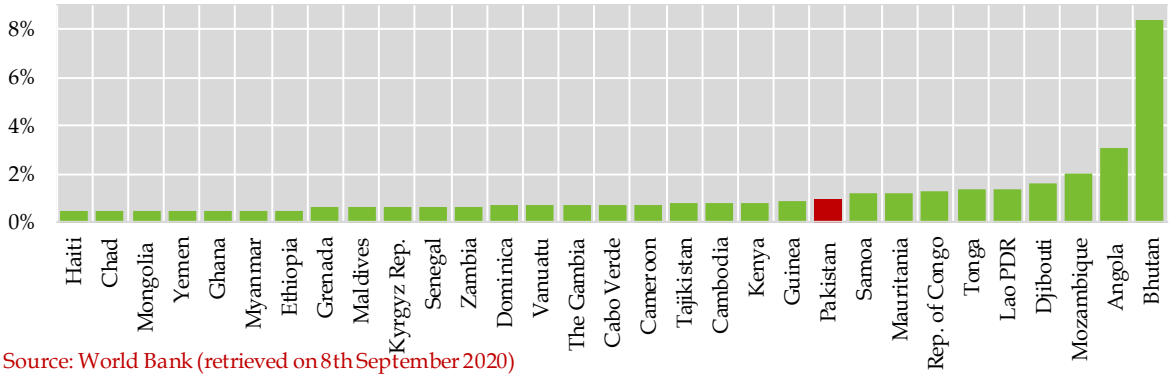
However, the improvement in foreign exchange reserves owing to better external sector position helped in smoothly paying off the debt repayments. Disaggregated analysis indicates that principal repayments of multilateral loans, external liabilities, commercial loans, and Sukuk contributed the most in external debt servicing during FY20 (**Table 5.6**). Principal repayments by the PSEs and private sector also increased during FY20 compared to during FY19. Regarding interest payments, multilateral, commercial and

Potential Savings from Debt Service Suspension Initiative **Figure 5.9a**



Source: World Bank (retrieved on 8th September 2020)

Potential Savings from Debt Service Suspention Initiative as percent of GDP **Figure 5.9b**



Source: World Bank (retrieved on 8th September 2020)

external liabilities had the largest share in the public external debt and liabilities. Interest payments on private sector external debt also rose during FY20.

Participation in the Debt Service Suspension Initiative (DSSI)

In April 2020, the Debt Service Suspension Initiative (DSSI) was launched to grant debt-service suspension (time-bound) to the poorest countries to facilitate them in managing the adverse impact of Covid-19. The key objective of DSSI is to enable an effective crisis response, in which borrowers are required to utilize the freed-up resources to increase spending on social and health fronts. Furthermore, countries are also committed to limit their non-concessional borrowings, other than the agreements under this initiative or in compliance with limits agreed under an IMF Program or the World Bank's policy on non-concessional borrowing. This implies that access to commercial and bilateral loans are limited, which bodes well from debt management perspective because these loans have usually a high cost of borrowing.

Pakistan applied for the DSSI in the last quarter of FY20. Collectively, Pakistan is estimated to get debt relief (potential DSSI savings) of US$ 2.7 billion, or around 1 percent of its GDP.[9] In a global context, Pakistan is likely to benefit the most from potential savings under the DSSI (**Figure 5.9a**). The total volume of debt relief under DSSI stands at US$ 11.5 billion, out of which Pakistan's share alone is around 23 percent. The share of other countries is negligible relative to Pakistan, with the exception of Angola. In

[9] As on September 8, 2020, source: https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative.

Indicators of External Debt Sustainability **Table 5.7**

percent

	Jun-16	Jun-17	Jun-18	Jun-19	Jun-20	Change
Solvency indicators						
Total external debt and liabilities/GDP	26.6	27.4	33.4	45.7	45.5	▲
Public external debt/GDP	20.8	20.5	24.7	31.5	31.2	▲
Total reserves/total external debt & liabilities	31.2	25.6	17.2	13.6	16.7	▲
SBP reserves/total external debt & liabilities	24.5	19.3	10.3	6.9	11.1	▲
External debt servicing/FX earnings	10.4	15.7	13.6	20.8	26.8	▼
External debt servicing/export earnings	19.4	29.6	24.4	38.3	52.1	▼
Liquidity indicators						
Short-term public external debt/PEDL	2.8	1.3	2.1	1.5	1.8	▼
Short-term external public debt/total reserves	7.3	4.1	9.9	8.7	8.2	▲
Short-term public external debt/SBP reserves	9.3	5.5	16.6	17.4	12.3	▲

▲ improvement ▼ deterioration

Source: EAD, SBP, PBS, SBP staff calculations

terms of percent of GDP as well, Pakistan is among the top-10 DSSI beneficiaries (**Figure 5.9b**). This debt relief will not only ease pressures on debt servicing but also create the needed fiscal space to mitigate the impact of Covid-19 in Pakistan. Lastly, participation in this initiative would further improve the debt sustainability indicators of Pakistan.

5.4 External Debt Sustainability

Persistent fiscal and current account deficits have led to debt accumulation over the years putting pressures on debt sustainability. External debt is considered sustainable if a country can meet its maturing obligations without debt rescheduling and without compromising on economic growth.[10] Broadly, two types of indicators assess the external debt sustainability: liquidity indicators and solvency indicators (that includes both debt bearing and debt servicing capacity of the country). The former look at the repayment capacity to meet the short-term obligations, while the latter take into consideration the long-term debt bearing capacity of the country. Majority of the indicators recorded an improvement compared to FY19 (**Table 5.7**). This improvement was primarily attributed to lower debt accumulation and an increase in foreign exchange reserves.

Debt bearing capacity shows an improvement

The most common measure used to assess debt-bearing capacity is the external debt and liabilities to GDP ratio, which improved marginally to 45.5 percent by end-June 2020 from 45.7 percent by end-June 2019 (**Table 5.7**). The indicator shows that the growth in nominal GDP outpaced the growth in external debt and liabilities during FY20. As highlighted earlier, the reduction in current account deficit and higher amortization contained the growth in external debt and liabilities. However, it is also important to emphasize that this ratio has been consistently increasing over the last few years: it increased from 26.6 percent during FY16 to 45.5 percent during FY20 (**Table 5.7**). This indicates that the cumulative growth in external debt surpassed the nominal GDP growth during this period.

Similar to the overall external debt & liabilities to GDP ratio, the public external debt to GDP ratio declined slightly during FY20. This improvement again is attributed to a deceleration in the pace of public debt accumulation. However, this ratio has also

[10] O. Kidochukwu. (2015). "IMF Recommended Debt Sustainability Threshold for Nigeria. Is it Growth Augmenting? An Optimization Algorithm Approach," *OIDA International Journal of Sustainable Development*. 8(11): 81-90.

been consistently rising i.e. from 20.8 percent in FY16 to 31.2 percent in FY20 (**Table 5.7**). Other measures of solvency, including foreign exchange reserves to total external debt & liabilities (TEDL), and SBP foreign exchange reserves to TEDL also recorded significant improvements during FY20 compared to FY19. The country was able to increase its foreign exchange reserves during FY20 on the back of a sharp contraction in current account deficit, along with inflows received from IMF and other multilateral lenders. The rise in foreign exchange reserves was more than enough to compensate the rise in total external debt & liabilities during the year.

Debt servicing capacity deteriorated

Two ratios are used to gauge the debt servicing capacity of the country, i.e. external debt servicing to exports and external debt servicing to foreign exchange earnings during a year. External debt servicing to exports ratio shows that out of 1 US dollar earned from exports, 0.52 cents were used for debt servicing in FY20. Similarly, the ratio of external debt servicing to foreign exchange earnings shows that out of 1 US dollar of foreign exchange earnings, 0.26 cents were used for external debt servicing. [11]

The rise in these ratios is attributed to large debt repayments made during the year. In addition, marginal declines in exports and foreign exchange earnings during the year also contributed to the deterioration of debt servicing capacity. These ratios have been consistently increasing over the past few years, indicating the growing burden of debt repayments (**Table 5.7**). The ratios of debt servicing capacity have more than doubled during the last five years, reflecting the urgent need to boost export and other earnings.

Liquidity indicators largely improved

Liquidity indicators, which are used to assess the ability to meet short-term obligations, largely present a positive picture, with two out of the three indicators recording an improvement during FY20 (**Table 5.7**). The ratios of short-term external debt to total reserves and SBP reserves improved due to the buildup of foreign exchange reserves during the year. Here, it is also important to highlight that the ratio of short-term external public debt to total reserves is in single digits, implying that the country's reserves were sufficient to meet the obligations maturing within a year. In simple terms, only 8.2 percent of the total reserves were required to meet the short-term obligations at end- FY20 (**Table 5.7**).

The share of short-term external public debt in total external debt rose marginally from 1.5 percent to 1.8 percent. However, this rise was mainly due to foreign investment in short-term local government securities. As this investment is treated as part of short-term external debt, the ratio increased during FY20. Encouragingly, the share of short-term bilateral loans declined during the year. Short-term loans are risky as they carry rollover risk, hence the decline in their share is a positive development from the debt management perspective.

To ensure external debt sustainability, it is imperative to increase revenues to minimize pressures on the fiscal front, and to boost exports and remittances to ensure smooth repayments of external debt without creating additional debt. In the absence of non-debt creating capital inflows, the rise in the current account deficit translates into higher debt stock of a country (or depletion of foreign exchange reserves). In this context, emphasis on viable export promotion policies, attracting non-debt flows, and stimulating domestic investment and growth is important to improve the debt servicing capacity and debt sustainability of the country.

[11] FX earnings include exports of goods & services, primary income credits and secondary income credits.

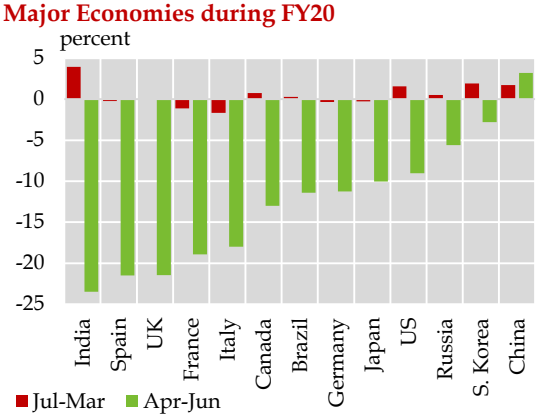
Chapter 6
External Sector

The external account improved significantly in FY20, as the current account deficit (CAD) fell to a five-year low. This was mainly on the back of a significant contraction in both goods and services import payments and record high remittance inflows. While non-energy import demand was reined in by the stabilization policies adopted earlier, a shift towards indigenous sources and a heavy drop in international oil prices led the energy imports to fall to a four-year low. The lower CAD significantly reduced the country's need to arrange external financing. The initiation of the IMF program unlocked sizable IFI funding in FY20, whereas the country was also able to attract foreign exchange inflows into the local currency debt market till February 2020. Though the Covid-19 pandemic brought some disruption in Q4 – as export receipts declined sharply after growing in the first three quarters and as outflows were recorded from portfolio investments – the cumulative impact was offset by a steep fall in import payments and increased financing from IFIs. On a full-year basis, the sharp contraction in the current account deficit, along with financial support from IFIs, led to a US$ 4.9 billion increase in the SBP's liquid reserves and a US$ 2.3 billion decrease in the central bank's net forward liabilities. Nevertheless, the Pak Rupee depreciated 4.8 percent vis-à-vis the US dollar in FY20, which was less than depreciations recorded by many other EM currencies. The Pak Rupee had been appreciating till February 2020, whereas pressures on the exchange rate emerged on account of portfolio outflows in March, and retirement of foreign obligations in Q4-FY20.

6.1 Global Macroeconomic Trends

Global economic growth had slowed down to a 10-year low of 2.9 percent in CY19, as global trade volumes stagnated and manufacturing activity lost momentum. Uncertainty stemming from trade disputes between the US and its major trading partners (China and the EU); a sizable slowdown in China; Britain's protracted exit negotiations with the EU; and a challenging regulatory environment for the worldwide automobile and aviation industries, were the primary reasons behind the low growth.[1,2] As such, the world economy entered the Covid-19 pandemic period with much weaker fundamentals than during the last worldwide crisis – the global financial crisis of 2008.[3] In the wake of the most serious challenge since the post-World War II era, world GDP growth is projected to contract 4.1 percent in the Jan-Jun period of 2020, with almost all major advanced and emerging market (EM) economies reporting negative growth (**Figure 6.1**).[4]

Average Real GDP Growth (YoY) in Major Economies during FY20 **Figure 6.1**

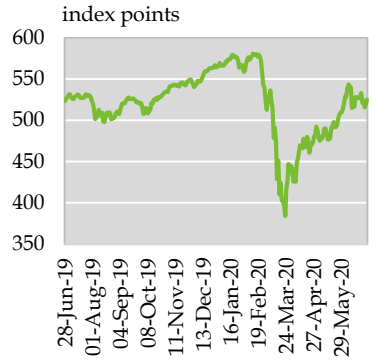


Source: Haver Analytics

Among the advanced economies, the US economy decelerated as the fiscal and trade-related uncertainty and some industry-specific issues (in aviation and automobiles) subdued investment and manufacturing activity; this

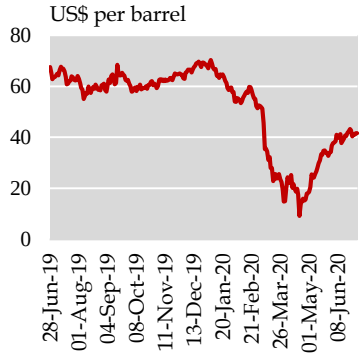
Trend in Major Financial Market Indicators & Oil Prices **Figure 6.2**

MSCI All World Index



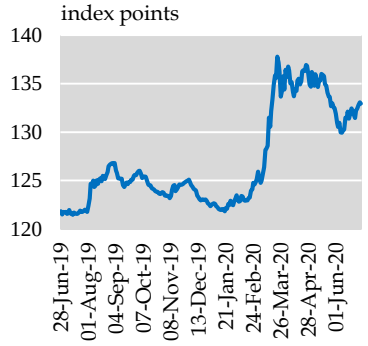
Source: MSCI

Brent Crude Oil (spot)



Source: US EIA

Trade-Weighted US Dollar Index for EMs



Source: US Federal Reserve

[1] The global trade volumes had dropped 0.4 percent YoY in CY19, after rising by 3.4 percent in CY18 (source: World Trade Monitor, CPB Netherlands Bureau for Economic Policy Analysis).

[2] The global car production was estimated to drop 6 percent in CY19 over CY18, according to the German Association of the Automotive Industry (VDA). Production dropped in the largest market (China), as well as in India, the EU, the USA and Japan. Tariff uncertainties (EU), efforts to increase electric vehicle usage (China), and stricter lending (India) were the main factors. In the US, aircraft maker Boeing halted production of its 737 Max airplane in January 2020 after 2 plane crash incidents, impacting industrial activity across its supply chain.

[3] At the onset of the GFC, most advanced and EM economies were coming from a brisk growth phase. In the five years before the GFC (2003-07), global real GDP growth averaged 5.1 percent. In contrast, real GDP growth in the five years preceding the Covid-19 outbreak (2015-19) averaged a much lower 3.5 percent (source: IMF).

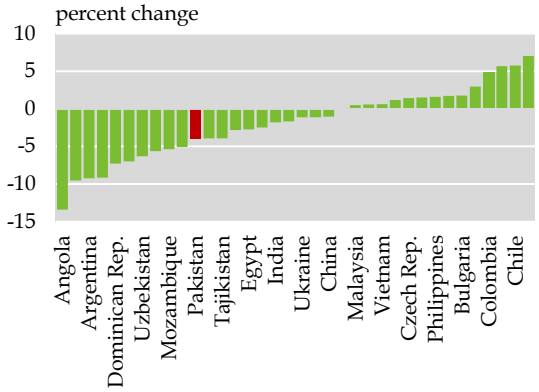
[4] As per the IMF's June 2020 projections, with Q3-FY18 (Jan-Mar 2019) quarter as the baseline.

slowdown prompted the US Federal Reserve to cut interest rates three times in Jul-Dec 2019. Nonetheless, consumer spending stayed strong as unemployment remained at multi-decade lows, and partially compensated for weaker investment.[5] In the EU, growth stalled in the major economies, as global trade headwinds – including the US imposing tariffs on Airbus aircraft (impacting France and other EU countries integrated with the supply chain) and pressurizing the German auto industry with the possibility of tariffs – curtailed investment and manufacturing activity. The ECB responded by lowering its policy rate further into negative territory and reinitiated asset purchases from September 2019 onwards.

Among the emerging markets (EMs), growth in China had fallen to a 29-year low of 6.0 percent in Jul-Dec FY20, as the trade dispute with the US weighed on exports; automobile production and sales (with cross-linkages across multiple industries) fell throughout the year amid weak demand and a push to adopt electric vehicles; and the government took a cautious fiscal stance to deal with the slowdown. In India also, growth fell to a 10-year low of 4.2 percent in the year ending March 2020, as banks and non-banks curtailed rampant lending witnessed in previous years, causing weaknesses in the construction and automobile sectors and hitting consumer spending in general.[6]

Amid this challenging global environment, Covid-19 first struck China (in January and February 2020) before spreading worldwide by March. Governments across the world responded by imposing strict mobility restrictions, which severely impacted the global services industry – especially retail, aviation, tourism and hospitality sectors. The resulting layoffs lowered consumer spending power, which, coupled with retail store closures, led into shrinking manufacturing activity and lowered import demand for a wide range of products. This, in turn, had adverse consequences for export-dependent EMs, though the resulting pressure was somewhat offset by a historic slump in global oil prices (**Figure 6.2**). The financial markets volatility increased with the evolving situation, with equities tanking, credit spreads widening, investors divesting from EM holdings, and the US dollar spiking to a multi-year high against the EM currencies.[7]

Change in EM Currencies during Mar-Jun 2020 **Figure 6.3**



Source: Haver Analytics

Resultantly, many EMs, including Pakistan, were suddenly faced with balance of payment challenges, as export receipts dried up and portfolio outflows began, leading to pressures on official foreign exchange reserves as well as the exchange rate parity with the US Dollar (**Figure 6.3**). Simultaneously, governments were forced to significantly increase fiscal outlays to shore up healthcare supplies and facilities; provide cash support to the newly unemployed; and save businesses from

[5] Average private investment in the US fell 0.1 percent YoY during Jul-Dec FY20. In contrast, average private consumption rose 2.5 percent YoY during the period (source: US Bureau of Economic Analysis). The unemployment rate had fallen to 3.3 percent during Sep-Nov 2019 – the lowest since December 1969 (source: Haver Analytics).

[6] India had imposed lockdowns on March 25, 2020, meaning that only one week's worth of economic activity was impacted in its fiscal year ending March 30.

[7] As measured by the Dollar index (trade-weighted against the US' EM trade partners) computed by the US Federal Reserve.

Pakistan's Balance of Payments **Table 6.1**

billion US$

	FY19	FY20	Abs change	FY20	
				Jul-Feb	Mar-Jun
Current account balance	-13.4	-3.0	10.5	-2.7	-0.2
Trade balance	-27.6	-19.9	7.7	-13.2	-6.7
Exports	24.3	22.5	-1.8	16.4	6.1
Imports	51.9	42.4	-9.5	29.6	12.8
Services balance	-5.0	-2.8	2.1	-2.3	-0.5
Primary income balance	-5.6	-5.7	-0.1	-3.8	-1.8
Secondary income balance	24.8	25.5	0.7	16.6	8.9
Workers' remittances	21.7	23.1	1.4	15.1	8
Capital account balance	0.2	0.3	0.1	0.2	0.1
Financial account balance	-11.8	-7.7	4.1	-7.6	-0.1
Direct investment in Pakistan	1.4	2.6	1.2	1.9	0.7
Portfolio investment in Pakistan	-1.4	-0.5	0.9	2.1	-2.7
Other investment	-11.6	-5.6	6.0	-3.6	-2.0
Net incurrence of liabilities	11.5	5.3	-6.2	4.2	1.0
General Government	4.3	5.8	1.5	4.5	1.3
SBP's liquid reserves (end-period)	7.3	12.1	4.9	5.5	-0.6
PKR app(+) / dep(-) against US$ (in %)	-24.1	-4.8		3.8	-8.2

Source: State Bank of Pakistan

bankruptcy by smoothening liquidity constraints. These public finance and BoP challenges forced many economies to seek support from IFIs as well as from commercial and bilateral lenders. In response, the IFIs expanded their grants and lending to the distressed economies, and also engaged the G-20 countries to work out a mechanism to defer official bilateral loan payments falling due this year for eligible countries.[8] Under the resulting Debt Service Suspension Initiative (DSSI) announced in May, the eligible countries are likely to see combined loan deferments of US$ 12.1 billion.[9]

While the impact of the IFI-led and local responses continues to play out, by end-June, many of the advanced economies had managed to control the outbreak and begun to ease lockdowns (with the US being a notable exception). Meanwhile, China was the earliest to control the virus and resume industrial activity, followed by South Korea and Vietnam. Global equities also rebounded strongly from May onwards, as investors were buoyed by the easing of lockdowns and strong earnings of e-commerce and technological companies.

6.2 Pakistan's Balance of Payments

Two key developments were responsible for the improvement in the country's external account in FY20. The first was the introduction of a market-based exchange rate system that acted as an automatic stabilizer, by correcting the accumulating imbalances in the trade account in the pre-Covid period and simultaneously helping the country attract record portfolio flows into domestic debt

[8] Between April and end-June 2020, the IMF disbursed US$ 87.8 billion in financing to member countries; the World Bank US$ 17 billion; and the ADB US$ 7.8 billion (by end-July). Sources: IMF Lending Tracker (as of August 10); World Bank (https://www.worldbank.org/en/news/factsheet/2020/05/11/debt-relief-and-covid-19-coronavirus); and ADB (https://www.adb.org/news/adbs-covid-19-response-reaches-93-billion-end-july-2020).

[9] As of October 16, 2020. Source: World Bank (https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative).

securities. After the Covid outbreak in Q4, this mechanism cushioned the impact of capital outflows by reducing the country's external financing needs, as the current account gap fell to a five-year low on the back of a significant reduction in goods and services import payments. And the second factor was the initiation of the EFF program in July 2019, which unlocked US$ 1.4 billion in direct financing in the year and also facilitated the country's engagement with other IFIs and private investors. Once the Covid crisis hit and Pakistan's reserves position and exchange rate, similar to other EMs, came under pressure, the country was able to secure US$ 1.4 billion from the IMF's Rapid Financing Facility, along with temporary debt relief under the G-20 led DSSI program (**Section 6.1**).

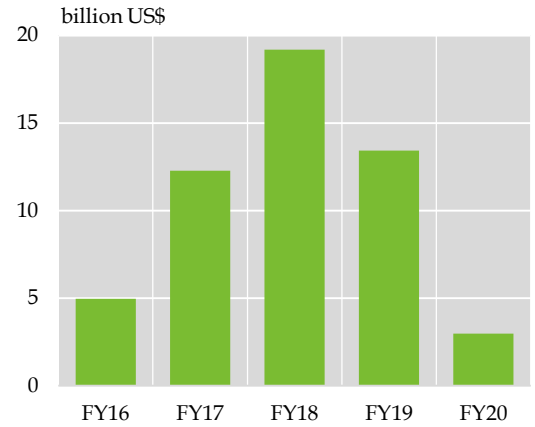
Besides, a number of policy measures – including the continued restriction on car imports under the baggage scheme (introduced in FY19), the substitution of relatively costly import-based power generation with cheaper alternatives, and the documentation drive necessitating submission of CNIC for high-end purchases – led to significant import compression from the start of FY20. Moreover, a number of incentives announced to attract remittances through formal channels, resulted in a notable rise in these inflows in FY20.

Although some disruption was observed in the Covid period, especially on the export side, the overall current account continued to improve and the country recorded a steep reduction in the current account deficit in the full year. (**Table 6.1**). This, along with inflows from IFIs and foreign private investments, helped to build the country's liquid FX reserves to US$ 12.1 billion by end-June 2020 from US$ 7.3 billion by end-FY19.

Current Account

The current account deficit fell to US$ 3.0 billion in FY20, almost a quarter of last year's level (**Figure 6.4**). This improvement was broad-based, as trade, services and secondary income accounts, all showed better performances compared to last year. The deficit in the primary income account was an exception, as it rose marginally from last year

Current Account Deficit **Figure 6.4**



Source State Bank of Pakistan

Primary income

The primary income account posted a deficit of US$ 5.7 billion during FY20; this was close to last year's level, despite increasing 14.5 percent in first three quarters of FY20 (**Table 6.2**). The economic condition after outbreak of Covid-19 reined in the profit repatriation in Q4-FY20 in all major sectors, including food, power, and communication. In the full year FY20, however, the decrease in profit repatriation was more than offset by the higher interest payments amidst an elevated level of external debt.

Primary Income Account **Table 6.2**

million US$

	Q4			
	FY19	**FY20**	**FY19**	**FY20**
Primary income	**-1,875**	**-1,406**	**-5,610**	**-5,682**
Direct investment	-1,018	-636	-2,916	-2,598
Portfolio investment	-284	-169	-673	-496
Other investment	-635	-637	-2,281	-2,792
Others	62	36	260	204

Source: State Bank of Pakistan

Services account

The services trade deficit declined by 43.1 percent YoY to US$ 2.8 billion in FY20 from

Trade in Services **Table 6.3**

billion US$

	Jul-Jun FY19			Jul-Jun FY20			Q4		
	Credit	Debit	Net	Credit	Debit	Net	FY19	FY20	Change
Services Account	6.0	10.9	-5.0	5.4	8.3	-2.8	-1.5	-0.4	1.1
of which									
Transport	0.9	3.6	-2.8	0.8	3.1	-2.3	-0.8	-0.5	0.3
Travel	0.4	1.7	-1.3	0.5	1.2	-0.7	-0.4	0.0	0.4
Other business services	1.6	2.5	-0.9	1.3	2.5	-1.2	-0.4	-0.3	0.1

Source: State Bank of Pakistan

US$ 5.0 billion last year (**Table 6.3**). This improvement largely came from the fall in services imports, as exports of services has also declined marginally during the year.

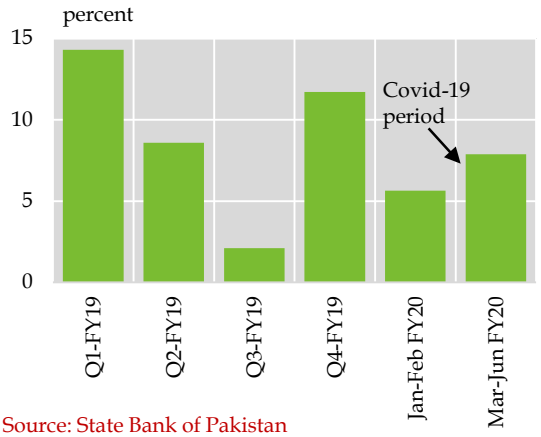
Around 50 percent of the decline in imports came from a fall in travel and transportation services. While the Pak Rupee depreciation against the US dollar helped curtail services' imports, a significant part of this improvement is also attributed to the lockdown in the Q4, when transport and travel services came almost to standstill, both in Pakistan and abroad. Moreover, the continuous fall in the merchandise imports led to an 8.9 percent decline in the net import of freight services in FY20.

Workers' remittances

Workers' remittances grew 6.4 percent and reached US$ 23.1 billion in FY20. In Q4, remittances witnessed a YoY growth of 7.3 percent, higher than the full year growth (**Figure 6.5**).

This was in contrast to projections that global remittance flows to developing countries would weaken sharply following the Covid-19 pandemic.[10] Remittances to Pakistan in particular were expected to be hit hard, given the presence of a large number of low skilled workers in the GCC, specifically Saudi Arabia (KSA) and the UAE. As the GCC countries

Workers' Remittances Growth (YoY) **Figure 6.5**



Source: State Bank of Pakistan

were passing through the dual crises of falling oil prices and a slowdown in economic activity amid pandemic-related lockdowns, remittance flows from these regions were expected to be adversely affected.[11]

Despite these projections, remittances to Pakistan actually grew in the fourth quarter on the back of 51.5 percent growth in June 2020, which more than compensated the 19.0 percent decline in inflows in May 2020 (**Figure 6.6**). Strict lockdowns imposed in April and May, specifically in GCC countries, restricted expatriates from sending Eid-related inflows in May, which later appeared in June as the lockdowns eased in the Middle East. Moreover, despite partial resumption in international flights, cross-border movement remained restrictive, which points towards

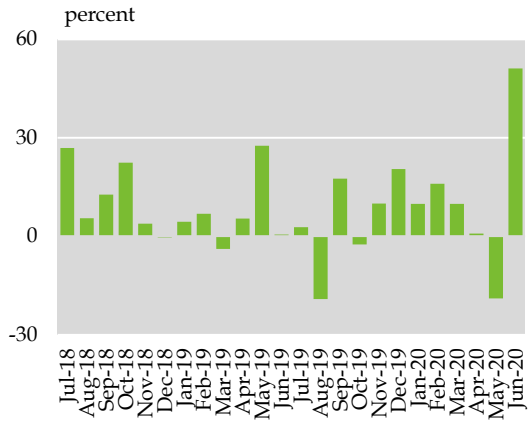
[10] The World Bank has projected that remittances to low- and middle-income economies may fall by 20 percent during CY-2020 (Migration and Development Brief 32, April 2020).

[11] The IMF had projected real GDP growth of the GCC countries to shrink by 7.1 percent during CY-2020 (source: IMF Regional Economic Outlook, Middle East and Central Asia, July 2020). Besides the sagging oil prices, these economies were facing severe problem in tourism and businesses, where most of the foreign workers are employed. As a result, a large number of migrant workers have already been laid off and returned to Pakistan.

increased use of official channels for sending remittances. This, interestingly, was happening at a time when a large number of migrant workers were been laid off and were returning to Pakistan. At this point, the government started developing a reintegration mechanism for returning migrants in the domestic labour market (**Box 6.1**).

From the policy perspective, a number of initiatives announced by the government last year, which were further enhanced during the Covid-19 period, may have also supported this increase in remittances through formal channels.[12] These include: (i) extension in the scheme for reimbursement of TT charges to small remitters by reducing the transaction threshold from US$ 200 to US$ 100; (ii) broadening the scope of the incentive scheme for financial institutions; (iii) on-boarding of a large number of technology-based money transfer companies by the SBP and the PRI; and (iv) use of effective marketing campaigns, with a focus on digital channels, for sending and receiving remittances.

YoY Growth in Monthly Remittances **Figure 6.6**



Source: State Bank of Pakistan

Box 6.1: Covid-19 and Forced Repatriation of Migrants in Pakistan: Government's Strategy and Challenges Ahead

This Box briefly presents the impact of Covid-19 on overseas work opportunities for Pakistanis, explains the contours of the reintegration strategy for returning migrants in domestic labor market, and presents recommendations derived from the International Organization for Migration (IOM)'s framework.

Number of Overseas Pakistanis Living and Proceeded for Work/Migration **Table 6.1.1**

	No. of Overseas Pakistanis* as on Dec 2017	No. of people proceeded for work/migration (During 2018-2020) **
Saudi Arabia	2,600,000	681,844
UAE	1,500,000	745,202
Oman	271,143	104,899
Qatar	140,000	57,900
Bahrain	117,000	25,729
Kuwait	107,575	1,407
Malaysia	75,235	30,650
UK	1,470,000	NA
USA	1,000,000	NA
Canada	350,000	23,000
Australia	100,000	NA
Others countries	1,109,779	10,613
Total	8,840,732	1,681,244

* Number of overseas Pakistanis living, working and studying in destination countries. **For UK, USA, Canada, and Australia, primarily the figure shows migration for permanent residency.

Source: Bureau of Emigration and Overseas Employment

<u>The global job market</u>

According to the ILO modelled estimates, the global working hours declined by an estimated 5.4 percent (equivalent to approximately 155 million full-time jobs) during Q1-2020, compared to the pre-crisis situation (Q4-2019).[13] For Q2 2020, the global working hours are estimated to further fall by 14.0 percent on a YoY basis, equivalent to 400 million full-time jobs. Advanced economies such as the US, the UK, Canada, Germany, and France were the most affected.

Availability of comparable information is a challenge in some migrant-rich countries such as those in the Gulf region; however, ILO estimates suggest that the region suffered severely from lockdowns and business closures during Q2-2020. Among the most affected in the labor market were the almost 1.6 billion informal-economy workers. Due to the fear of disease spread, almost all the countries adopted border closures and put in place travel restrictions. The abrupt suspension of flights made it virtually impossible for returning migrants or travelers to

[12] For details, see SBP's Q3-FY20 Report on the State of Pakistan's Economy.

[13] Source: ILO Monitor: "COVID-19 and the world of work". Fifth edition updated estimates and analysis, June 30, 2020. These estimates are based on working week comprising 48 hours.

reach their home countries, and left thousands of them stranded at airports and land borders. The conditions became more challenging for workers facing sudden dismissals and those who lost their job-linked visas, accommodations and health facilities in the host countries.

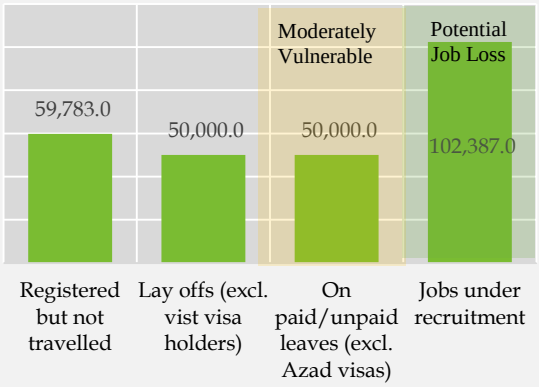
The Current Diaspora of Pakistan's Migrants and the Impact from Covid Shock

According to the official estimates from Bureau of Immigration and Overseas Employment (BEOE), more than 8.8 million Pakistanis were living abroad as of December 2017. Of these, 54 percent resided in the Gulf region, and the rest in other destinations, including Europe, UK, US, Canada, and Australia. Furthermore, during the last three years, around 1.7 million people left for different destinations, of which around 98 percent proceeded for employment in the Gulf region and only a small fraction went to acquire permanent residency in high-income countries (**Table 6.1.1**).

During the Covid-19 crisis, BEOE records reveal multiple channels of potential job losses for migrant Pakistanis (**Figure 6.1.1**):

(i) Over 100,000 overseas job for which the recruitment process was going on in Pakistan, was disrupted due to Covid and is not going to recover unless the recruiting projects are revived. The Bureau categorizes this category as a potential loss.
(ii) Around 50,000 Pakistani migrants faced layoffs in different countries. These jobs may not be recovered in the short term and are thus extremely vulnerable.
(iii) Around 60,000 Pakistanis were recruited for overseas work, but could not proceed abroad due to travel restrictions and suspension of flight operations. The Bureau also categorizes these jobs as extremely vulnerable.
(iv) In addition to these, 50,000 emigrants (Azaad Visa excluded) returned on paid/unpaid leaves as of June 20. These workers have not been laid off, but their job continuation entails risk.

Number of Pakistanis Facing Actual and Potential Job Loss **Figure 6.1.1**



Source: Bureau of Emigration and Overseas Employment

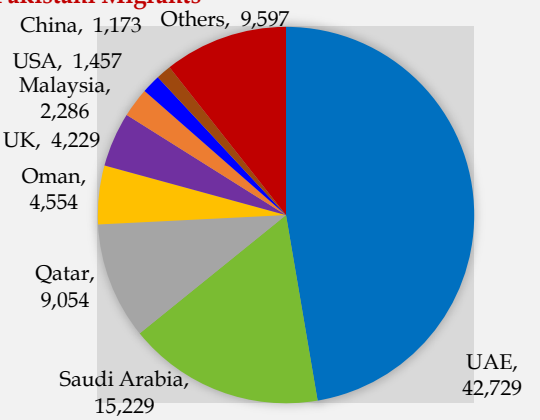
For most of the returning workers, the lockdowns resulted in permanent cessation of income along with the loss of legal status and end of accommodation and health benefits associated with employment. In case of forced dismissals, workers also did not receive compensation, and other dues and therefore found it difficult to arrange travel expenses on their own. The recent figure of stranded Pakistanis in different destinations is highly skewed towards the Gulf region with more than 91 percent in only two countries, i.e., Saudi Arabia and the UAE (**Figure 6.1.1**).

Pakistan's Immediate Strategy to Bring Back Stranded Workers

Initially, the government's capacity to bring back stranded Pakistanis (both worker and non-worker migrants) was limited, and the relevant authorities faced numerous challenges in tracing stranded citizens due to lack of a comprehensive database. In addition, the country did not have any testing capacity to screen the novel disease and could not meet the demand for all returning migrants.

In March 2020, the government established the National Command and Control Centre (NCOC) with the mandate of taking all stakeholders on-board, synergizing and unifying national efforts to prepare a national framework against the spread of Covid-19. The NCOC played a major role in designing and implementing a framework for bringing back stranded citizens. The airspace closure bought some time to initiate key measures, such as registration of stranded overseas Pakistanis, setting up of quarantine facilities at

Country-wise Repatriation of Pakistani Migrants **Figure 6.1.2**



Source: NCOC/MOFA

different airports and in cities, and increasing testing capacities and designing track and trace mechanisms. The whole process was built on coordinated effort of embassies, foreign missions, Ministry of Foreign Affairs (MOFA), Ministry of Overseas Pakistanis, health ministries, Ministry of Aviation, district administrations, FIA and the armed forces. Once all the necessary measures were put in place, the government started special flights to return stranded Pakistanis; in this operation, the national airline flew 490 special flights and repatriated 90,308 citizens during April-June 2020 (**Figure 6.1.2**).

A Reintegration Process of the Returning Workers during Covid-19 Should be Stepped Up

Given the expected slowdown in host economies, unemployment rates are expected to remain high in many migrant destination countries for some time. It is important to recall here that even before the Covid-19, important migrant destinations, including Saudi Arabia, Kuwait and others, had started internal reform processes and took comprehensive measures to encourage recruitment of local workers. Many GCC countries offered generous financial packages to support the retention of local employees, and indirectly discouraged retention of foreign workers. Now, with the Covid-19 crisis, the demand contraction and a dull crude oil market has further weakened the economic outlook of oil-exporting economies. Under such circumstances, a complete return to pre-Covid migrant employment levels does not appear in sight, at least over the next two years.

In this context, manpower exporting countries have begun focusing on reintegration mechanisms for returning migrants in the domestic labor market. A number of countries, including Indonesia, Philippines, Cambodia, Mexico and Sri Lanka, have been following national frameworks for the reintegration of returning workers under national migration legislation and policy frameworks. These existing frameworks promote and ensure delivery of sustainable reintegration services to returning workers. In coming months, thousands of repatriated Pakistanis will require similar reintegration assistance in the form of financial support, entrepreneurship facilitation, skill upgradation and job resumption. Therefore, a well-planned and coordinated strategy is needed at provincial and federal level to address social and economic consequences of mass repatriation and cater to the basic needs of the returned migrants.

The Ministry of Overseas Pakistanis and Human Resource Development (OP&HRD) has also started developing a reintegration strategy with the consultation of relevant stakeholders, including Ministry of Foreign Affairs, and BEOE. Under the plan, different agencies like Small and Medium Enterprises Development Authority (SMEDA), National Vocational and Technical Training Commission (NAVTTC), Benazir Income Support Program (BISP), Overseas Pakistanis Foundation and National Youth Development Framework (NYDF), are also to play a crucial role in providing necessary support to returning workers:

(i) **Return**: This process comprises collection and compilation of data for the impact assessment and addressing challenges to labor migration and sharing of the same with all stakeholders. In this process, Ministry of Foreign Affairs has a leading role in collecting personal details of returning migrants, which is then used by local and international airlines. The government ensures the proper quarantine arrangements for returning migrants at airports, centers and home.

(ii) **Reintegration:** This process involves facilitating returnees to obtain jobs in national and international job markets through upskilling and certification. The returning migrants are required to register at a specified link on the Overseas Employment Corporation (OEC) website and share different dimensions of personal details, including skill level, education attained, reason for return etc. The registration data would be shared with the Ehsaas program, NAVTTC, NYDF, SMEDA, and Employees' Old-Age Benefits Institution (EOBI).

(iii) **Claims**: The complaint redressal mechanism ensures the recovery of unpaid compensation, retirement benefits and other dues of returning migrants. Once the returning migrant lodges a complaint for unpaid dues against the foreign employer, the overseas ministry and other relevant authorities may pursue legal actions for early resolution of grievances.

(iv) **Social inclusion**: This includes social protection to returning migrants by offering them loans for entrepreneurship through the NYDF, and emergency cash funds via Ehsaas cash transfers. The social safety net will also provide assistance in paying the school fees of children of returning migrants.

Planning, Execution and Monitoring of the Reintegration Process: Some Guidelines from the IOM (UN) framework

It is encouraging to note that the concerned authorities have been able to outline the broad contours of a reintegration strategy for returning migrants, it is now imperative to lay out step-by-step measures and develop key performance indicators for the effective implementation of reintegration strategy. Furthermore, we also envisage a greater role of data management and geographical mapping of the returning migrants. In addition to skills development institutions and those that exclusively cater to overseas Pakistanis, we also see an important role of banking system, and SECP in a more successful absorption of returning migrants in the domestic economy. In this process, the guidelines of IOM on reintegration assistance may provide a strong foundation for the proposed strategy.

- The government is already developing the database of returning workers and recording the existing skill and education levels, nature of occupation, job status etc. The scope of database can be enriched with other features of returnees including their existing socioeconomic conditions, dues/complaints against foreign employers, monetary needs, aptitudes and interests. In addition, the database may include information on existing employment and business opportunities, potential growth sectors, and local ecosystem. These information synergies may facilitate development of evidence-based integration programs and harmonize returnees' needs with prevailing resources and opportunities.
- At the individual level, the case management approach can be used to address discrete nature of vulnerabilities of returning migrants, such as financial position, health condition, etc. This approach takes into account individual circumstances including migratory experiences, reason of return, existing skills and capacities of returning migrants and offers tailored assistance in the form of cash, in-kind support or other facilitation measures. In addition, services like skill development & vocational training, job placement, business development support, easy access to banking services and loans etc. can also be offered to returning migrants.
- In case where a large number of returning migrants belong to specific areas or communities, community level interventions can be used to mitigate the concerns of non-migrant population, including families of returnees. In this layer, different approaches can be used to support the economic reintegration at community level, such as, collective income generating activities in the form of agricultural cooperative farms, artisan groups, youth employment programs etc. and financial support activities like collective investment schemes, group-based micro credit and collective saving schemes etc.
- Once the process of mapping the assigned roles and responsibilities is completed, the ministries and institutions should articulate a step-by-step progression of different but interlinked activities, starting from registration and recording of returning migrants, to ensuring social security coverage, easing redress mechanism, and recognition and certification of existing skills.
- At each level of intervention, a conceptual framework should be adopted to monitor and evaluate the intended objectives. Monitoring and evaluation procedures may assist policy makers to determine the current progress of planned activities and identify existing gaps in the implementation of specific programs at different stages.
- Commercial banks and microfinance institutes are already playing a key role in mitigating the impact of Covid-19 by providing support to the economy. These services may be extended to returning migrants and families of non-resident Pakistanis facing difficulties. Similarly, the role of the SECP and tax authorities in facilitating the setting up of new enterprises and offering tax amnesties to returning migrants, could also be mulled over.
- While the short- to medium-term focus seems appropriate given the abruptness of the Covid-19 crisis, the government must also frame a long-term view and adopt a comprehensive national migration policy. The existing framework does not share any comprehensive action plan to address the problems of migrant workers in case of forced repatriation.
- The government must improve governance framework in migration-related operations to improve policy effectiveness. As per the ILO's assessment, such operations in Pakistan currently face multiple challenges, such as the absence of properly designed systems, weak standard operating procedures, inadequately trained assigned staff and coordination weaknesses among different departments.[14]

[14] ILO (2016), "Where to go for help: Pakistani migrant workers' access to justice at home and in Gulf Cooperation Council Countries."

Financial Account

In FY20, the net financial inflows were recorded at US$ 7.7 billion, 34.6 percent lower than US$ 11.8 billion received in FY19. While the Covid-19 outbreak restricted the surging foreign portfolio inflows, foreign direct investment and inflows under other liabilities remained largely unaffected by the outbreak of the pandemic. The net inflows in foreign liabilities remained lower, as both gross borrowing and retirements in FY20 were higher than the last year.

Foreign direct investment

Net FDI inflows in Pakistan surged 88 percent to US$ 2.6 billion in FY20, compared to US$ 1.4 billion received in FY19. Actually, in the first three quarters of FY20, the FDI grew 136 percent, while declining marginally in the fourth quarter (**Table 6.4**). This nominal decline in net FDI in Q4-FY20 was in sharp contrast to the marked slowdown in the global foreign investment trend prevailing in the second half of the FY20. Widespread lockdowns imposed by the governments across the globe amid the risk of Covid-19 spread, specifically in Q4, slowed down the worldwide FDI flows. As per the UNCTAD (2020), the announcements in new greenfield investment projects and cross-border mergers and acquisitions fell globally by more than 50 percent in the initial months of 2020 from last year.[15] Besides, new investments in infrastructure projects declined by more than 40 percent. Moreover, as reinvested earnings account for more than 50 percent of the total global FDI flows, earnings expectations and thus its reinvestment for 2020 between February and May for the majority of the top 5,000 multinational enterprises (MNEs) across the world were revised downward by more than 35 percent.[16]

Sector-wise Inflow of Net FDI in **Table 6.4**

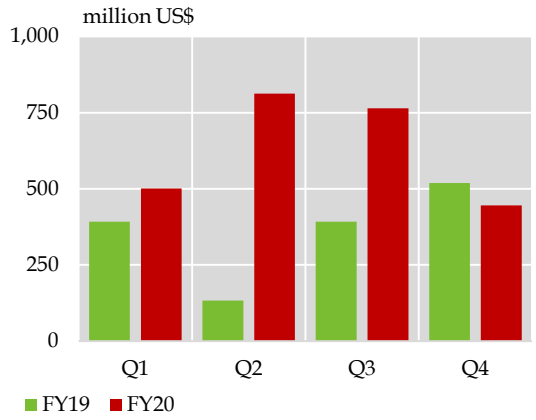
million US$

	FY18	FY19	FY20	Q4	
				FY19	FY20
Power	1,179.5	-323.9	764.3	29.2	21.9
Construction	40.4	70.2	20.7	14.6	9.0
Financial business	400.3	286.5	273.8	38.9	63.3
Oil & Gas	372.0	349.8	311.4	82.1	93.1
Pharmaceuticals	15.9	63.2	34.6	8.1	6.0
Telecommunication	100.1	-77.6	622.5	79.8	157.7
Electrical	22.2	153.4	164.3	37.8	10.1
Textile	49.7	76.8	37.7	23.0	6.3
Others	600.3	764.0	332.1	143.8	60.6
Total	**2,780.3**	**1,362.4**	**2,561.2**	**457.3**	**428.0**
of which					
CPEC	1,064.7	-267.6	724.2	39.5	15.6
non-CPEC	1,715.6	1,630.0	1,837.0	417.8	412.4

Source: State Bank of Pakistan

Despite these global FDI trends, the inflows to Pakistan declined marginally to US$ 428 million in Q4-FY20, from US$ 457 million in the same period last year (**Figure 6.7**). Substantial inflows in the telecommunication and in oil and gas exploration sectors prevented the overall FDI from sagging sharply in Q4-FY20.

Quarterly Net FDI Inflows **Figure 6.7**



Source: State Bank of Pakistan

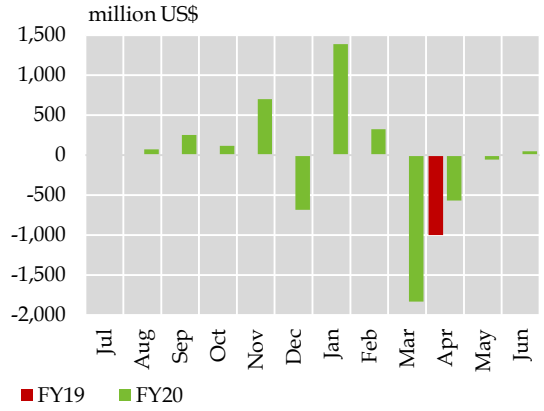
Telecommunication and power sectors were the major recipients of the inflows during the year. While a one-off payment from multinational cellular companies for renewal of their operating licenses in Pakistan led to increased inflows in telecommunication, upturn in activity in the CPEC-related projects led to inflows in power and the electrical

[15] World Investment Report 2020, UNCTAD.
[16] The global FDI flows are forecast to decrease by up to 40 percent in 2020, compared to their 2019 value of US$ 1.54 trillion (source: World Investment Report 2020, UNCTAD).

machinery sectors. Furthermore, some key entities in oil & gas exploration sectors also continued to receive inflows for their operational requirements.

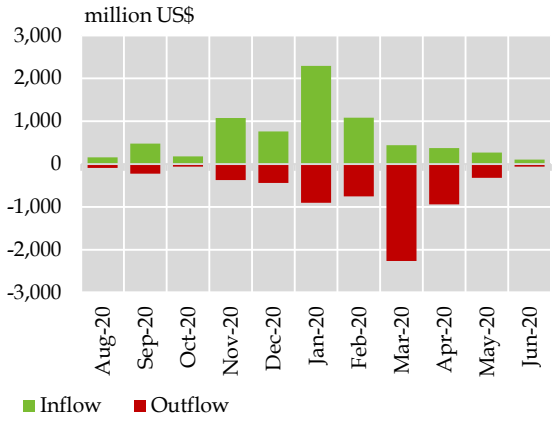
More than 40 percent of these net FDI inflows were sourced from China and Hong Kong, and a significant part of these inflows were for CPEC-related power projects. Moreover, a Chinese company operating in Pakistan received an intercompany loan of US$ 190 million for working capital needs from its parent company.

Portfolio Flows in Pakistan **Figure 6.8a**



Source: State Bank of Pakistan

Portfolio Flows in PKR Debt Securities **Figure 6.8b**



Foreign portfolio investment

In FY20, activities in the local currency debt securities largely drove the portfolio investment, with net portfolio inflows surging to US$ 2.1 billion during Jul-Feb, and then reversing to a net outflow of US$ 2.7 billion in the Mar-Jun period (**Figure 6.8a**). It is important to highlight that the reversal in capital flows in this latter period was not unique to Pakistan. The outbreak of the Covid-19 pandemic, specifically in advanced economies, led to a global flight of capital from emerging and developing economies.[17]

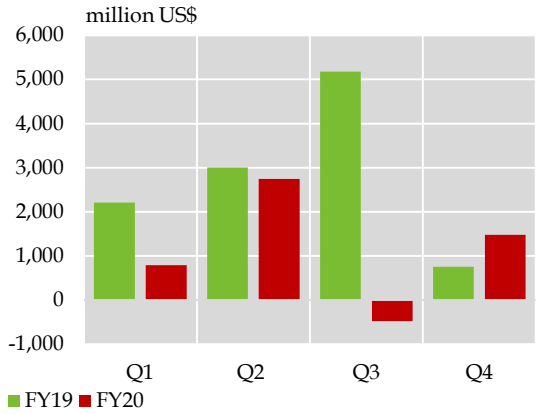
Further disaggregation shows that the Pak Rupee debt instruments received record gross inflows during FY20 (**Figure 6.8b**). This was the first time that the domestic debt market instruments were able to attract global fund managers, despite offering higher returns on these instruments in the past. Attractive rates offered on the local currency instruments; initiation of various reforms for the local and foreign investors, besides the recent adoption of market-based exchange rate, led to an upsurge in inflows in these instruments.[18] On aggregate, the net outflows in FY20 amounted to US$ 521 million, much lower than the US$ 1,418 million registered in FY19. In FY20, Pakistan retired US$ 1.0 billion of maturing Sukuk in December 2019, while in FY19, the country had retired US $ 1.0 billion Eurobond in April 2019. Similar to debt securities, the outflow from equities also decelerated to US$280 million, while this amount was US$ 415 million in FY19.

Net incurrence of liabilities

The net inflow of foreign liabilities increased to US$ 1.7 billion in Q4, largely due to a US$ 1.4 billion loan received from the IMF under the Rapid Financing Instrument (RFI) to mitigate the economic impact of the Covid-19 shock (**Figure 6.9**). In Q4-FY19, the country had received US$ 0.8 billion of net inflows in foreign liabilities.

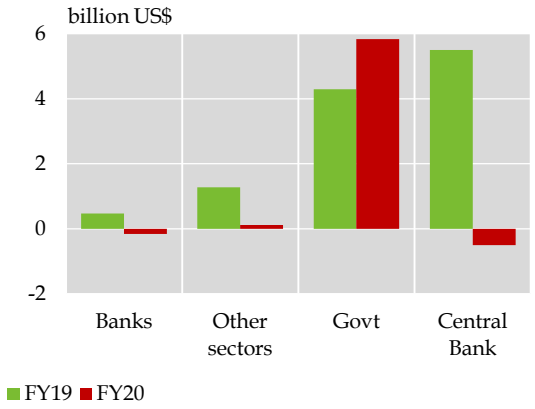
[17] For further discussion, see SBP's Q3-FY20 Report on the State of Pakistan's Economy.
[18] For details on tax incentives offered to investors, see SBP's State of Pakistan's Economy Report for Q1-FY20.

Quarterly Flows in Net Incurrence of Liabilities **Figure 6.9**



Source: State Bank of Pakistan

Net Incurrence of FX Liabilities (Jul-Mar) **Figure 6.10**



Source: State Bank of Pakistan

Despite increased inflows in Q4, the full-year net inflows remained much lower: US$ 5.3 billion compared to US$11.5 billion in FY19. This decline mainly represents the difference in foreign exchange deposits held with SBP. Specifically, in FY19, the central bank had received US$ 5.5 billion in foreign exchange deposits from friendly countries to shore up its BoP position; no such inflows were received in FY20. Instead, US$ 500 million was withdrawn from these deposits during FY20. Moreover, banks retired US$ 163 million in FY20 whereas they had borrowed US$ 500 million last year.

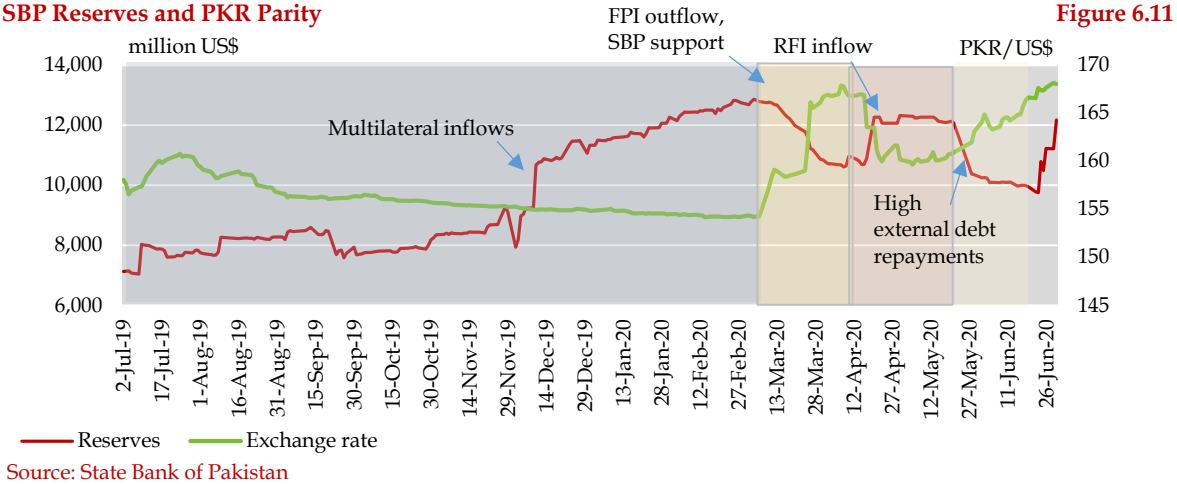
As far as the government was concerned, it borrowed 58.6 percent more (in gross terms) from last year. These inflows were mostly in long-term loans, including US$ 2.8 billion from the IMF, and US$ 767 million via the Saudi Oil Facility. At the same time, it made 22 percent higher retirement, of US$ 7.3 billion, as compared to last year (**Figure 6.10**). On net basis, the government incurred $ 1.5 billion more liabilities compared to FY19.

6.3 Reserves and Exchange Rate

After dropping for three consecutive years, and reaching US$ 7.3 billion in FY19, SBP's liquid foreign exchange reserves recovered to US$ 12.1 billion in FY20. A significant reduction in the country's current account deficit along with multilateral financing helped this recovery (**Figure 6.11**). Besides, reserves' quality also showed an improvement, as reflected in a sharp unwinding of the swap book as well as favorable trend in reserves adequacy.

Importantly, during July-Feb FY20, the SBP's reserves had posted a sharp increase of US$

SBP Reserves and PKR Parity **Figure 6.11**

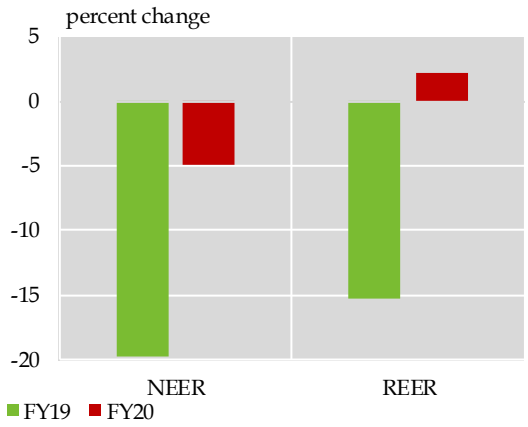


Source: State Bank of Pakistan

5.6 billion and reached US$ 12.8 billion. This allowed the SBP to unwind its short-term forward and swap contracts to the tune of US$ 5.2 billion during Jul-Feb FY20 and support the market when it came under excessive pressure due to portfolio outflows. While the IMF's disbursement of US$ 1.4 billion under the RFI in April eased some pressure, the SBP's reserves again came under pressure in May due to high debt servicing.

Despite this improvement in Jul-Feb, the Pak Rupee depreciated by 6.3 percent during the full year. Following the introduction of the market-based exchange rate system in May 2019, the movement in interbank exchange rate largely followed market fundamentals. For example, inflows in the portfolio investment and multilateral support in Jul-Feb period created an upward pressure on the Pak Rupee, leading to a 2.5 percent appreciation vis-à-vis the US Dollar. However, portfolio outflows following the spread of Covid-19 led the Pak Rupee to depreciate by 9.0 percent in Mar-Jun FY20; its worth noting that other EMs also experienced similar currency depreciations during the period (**Section 6.1**). Following the nominal exchange rate, Pak Rupee's nominal effective exchange rate (NEER) depreciated 5 percent against a basket of currencies during the year. However, this depreciation was not enough to offset the rise in relative prices, which led to an appreciation of 2.3 percent in REER during the year (**Figure 6.12**).

Trend in NEER and REER **Figure 6.12**

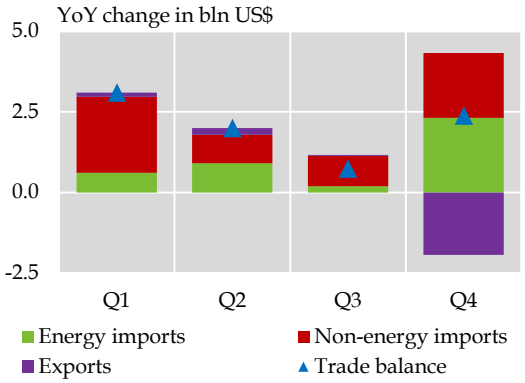


Source: State Bank of Pakistan

6.4 Trade Account (Customs Records)[19]

The trade deficit shrank 27.2 percent to a five-year low of US$ 23.2 billion in FY20. Exports were on track to record positive gains until March 2020, before declining sharply in the fourth quarter amid the Covid-19 pandemic (**Figure 6.13**). Effectively, the entire reduction in the trade deficit came from imports, which fell to a nine-year low in the year.

Improvement in Trade Balance* **Figure 6.13**



*Positive/negative values indicate respective contributions to trade balance

Source: PBS

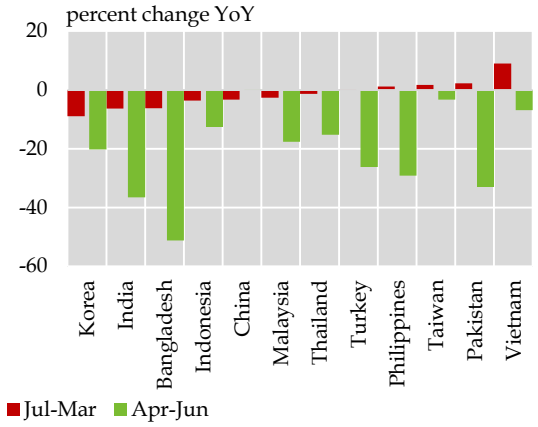
Both non-energy and energy imports had been dropping throughout the year on account of the macroeconomic stabilization policies and suppressed imported energy demand (amid switching in fuel sources in favour of indigenous coal and hydropower). However, the drop in imports deepened significantly in Q4, when energy imports fell to a 14-year low, aided by an over 50 percent drop in global oil prices.

For non-energy products, factors like regulatory measures, weak consumer demand, inventory build-ups from last year, and higher domestic production, led to sizable drop in import demand of multiple industries, including transport, construction-allied, and

[19] This section is based on customs data reported by the PBS. The information in this section does not tally with the payments record data, which is reported in **Section 6.1**. To understand the difference between these two data series, see Annexure on data explanatory notes.

edible oil, during Jul-Mar FY20. In Q4, these declining trends were accentuated by the Covid-related lockdowns, with transport imports hit particularly hard.

EMs' Export Growth in FY20 **Figure 6.14**



Data sources: Haver Analytics & PBS

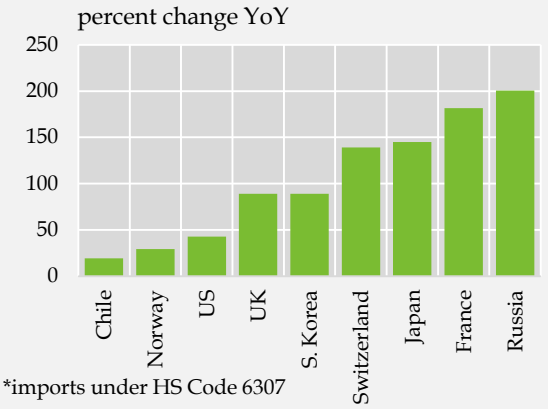
For exports, Pakistan was performing better than many EM peers before the pandemic (**Figure 6.14**), on the back of volume-led increases in major export products, such as apparel, rice, meat and leather items. The exchange rate realignment with market fundamentals, higher sales tax refunds, extension in size and scope of the SBP's concessionary Export Finance Scheme, and provision of electricity at regionally competitive rates, were all important factors in this regard. However, after the Covid-19 outbreak, demand for clothing items in Pakistan's major export destinations in the west was hit particularly hard; as a result, textile exports of Pakistan as well as other major Asian suppliers suffered in Q4. While global demand for food items (especially wheat and rice) surged post-outbreak as major importers accelerated purchases to shore up domestic supplies, Pakistan could not fully capitalize owing to domestic supply-side issues (**Box 6.2**).

Box 6.2: Export Performance of Emerging Markets and Pakistan after Covid-19 Outbreak

The economic fallout from the Covid-19 pandemic has been severe. Export performances of many EMs have suffered, though some have seen more drastic export declines than others. This Box identifies some major driving forces behind this disparate export performance, by focusing on products whose import demand surged after the pandemic, and on those whose import demand dropped significantly.

Three major trends stand out. First, global demand for textile products underwent a shift towards medical and surgical goods like masks and away from apparel.[20] Second, demand for electronics items rose sizably, helping support the tech-related exports of some EMs. And third, demand for food items rose, as major importers shored up domestic supplies amid fears of supply disruptions, hence propping up agricultural exports of some EMs.

Growth in Imports Quantum of Medical Supplies in Q4-FY20* **Figure 6.2.1**



*imports under HS Code 6307

Source: ITC

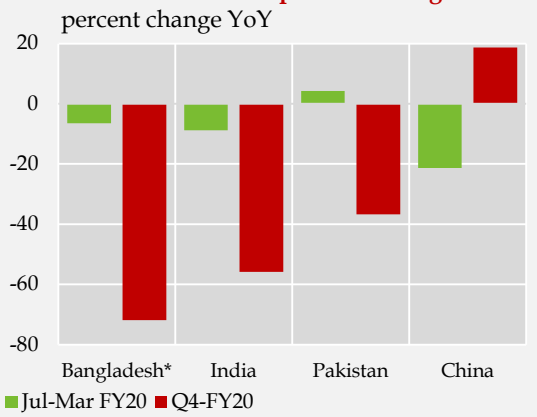
Textiles: As retail sales dropped significantly from March onwards across the major advanced economies, the clothing and apparel sector was particularly hard hit.[21] Unlike other household or electronics products, the

[20] Based on HS-4 level trading data of major economies (China, US and EU members), masks are classified under HS Code 6307, mostly under 'other textile made-ups' or 'other textile materials'. In this **Box**, data for this HS Code is used to analyze the trade of masks and similar medical coverings. It is possible that at the more granular (HS-8) level, some non-medical related items would also be included.

[21] In the US, retail sales of clothing and accessories dropped 57.6 percent YoY during Q4, against the 7.5 percent drop in the overall retail sales (excluding motor vehicle and part sales). In the EU-27, sales of clothing and related items dropped 46.3 percent, whereas the overall retail sales excluding vehicle sales fell 6.6 percent (sources: US Census Bureau and Eurostat).

majority of overall clothing sales still occur via retail stores instead of via e-commerce platforms, and were therefore more impacted by store closures.[22] This led to a sizable drop in import demand for apparel items from the advanced economies, which severely impacted the apparel exports of EMs (see **Exports** section below). However, the demand for medical and surgical masks rose exponentially during the period. In the advanced economies, imports under the relevant HS Code shot up (**Figure 6.2.1**), with most of it being met by China. As a result, China's overall textile exports rose 18.7 percent YoY in Q4-FY20, with the surge in shipments of masks and other textile-based medical gear entirely offsetting the drag from lower exports of apparel and low value-added products.

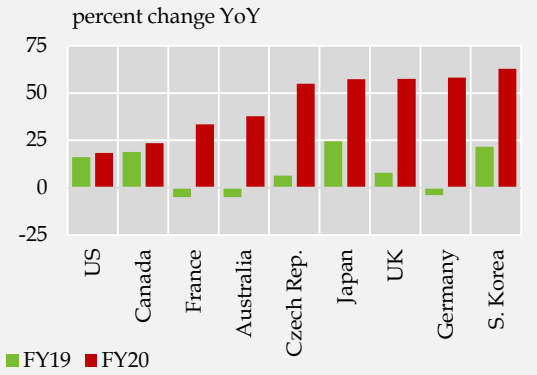
Growth in EMs' Textile Exports **Figure 6.2.2**



*during Apr-May
Source: Haver Analytics, PBS and Bangladesh Bank

However, other major textile exporters, like Pakistan, and also Bangladesh and India, could not adjust their production mix as rapidly and so missed out on capitalizing from the rising demand for such products. As a result, the overall textile exports of all three South Asian exporters dropped sharply in Q4 **(Figure 6.2.2)**. One reason was the early imposition of lockdowns by China (in January), which allowed it to control the outbreak and then resume manufacturing activities in time to meet the surging global demand for personal protective equipment (PPE). In contrast, the South Asian economies imposed the lockdowns relatively later (by late March), which meant that their firms were mostly shut down and could not effectively capture the global demand for PPE in Q4. And second, China was already a part of the global medical goods supply chain, with its own set of safety standards established (like KN-95); this allowed it to move quickly to ramp up production and meet external demand, whereas Pakistan and other EMs could not.

Growth in Computer & Tablet Imports in Q4* **Figure 6.2.3**



*Imports under HS Code 8471.30
Source: ITC

Electronics: As millions of workers and students adjusted to remote working and e-learning, demand for electronics items, like personal computers (PCs) and tablets, rose significantly.[23] Furthermore, corporations had to upgrade their network infrastructures to allow workers to connect remotely to their office systems. These developments created strong import demand across the electronics supply chain for finished electronics items (PCs and tablets) as well as for parts and components (circuit boards, semiconductors, etc.) and accessories for computer networks (**Figure 6.2.3**). This demand was met by countries like China and Taiwan, which are well-integrated in the global electronics value and supply chains.[24] As a result, the electronics sector further supported export performances of these countries.

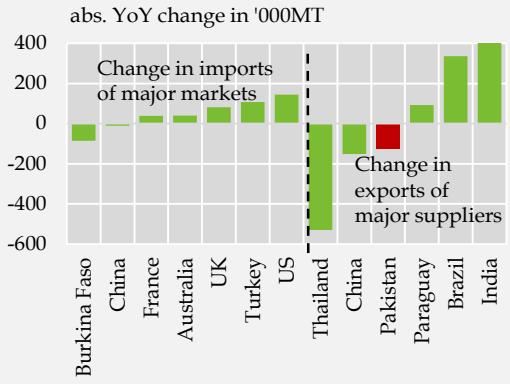
Food: As global logistics became disrupted, ensuring food security became a priority for large food importers,

[22] For instance, in the US, e-commerce platforms accounted for 8.5 percent of overall sales of 'clothing and other merchandize items' in Q4-FY20. That compares with a higher share of 18.3 percent of overall e-commerce sales in total retail sales of products excluding vehicles and auto parts (source: US Census Bureau).
[23] Global PC sales – comprising notebooks, desktop PCs and workstations – rose 11.2 percent YoY in Q4-FY20, according to a July 9-dated report from the International Data Corporation, an ICT-focused market intelligence firm. Similarly, global tablet sales were projected to have risen 17 percent in the same period, as per Strategy Analytics, another data analytics firm.
[24] Taiwan's exports of electronic components and information and communications equipment rose 18.1 percent in Q4-FY20. This rise partially offset the 23.1 percent drop in exports of all other items, and led its overall exports to decline by a relatively contained 3.3 percent in the quarter (source: Haver Analytics).

particularly China and the US. Food items whose import demand rose included cereals, such as wheat, rice and soybeans. As the pandemic initially played out in March and April, various agri commodity exporters – including those in Eastern Europe (wheat) as well as India (rice) and Vietnam (also rice) – either signaled their unwillingness to export the commodities to ensure sufficient supplies at home, or placed outright bans on exports. However, from end-April and May onwards, these restrictions were lifted and the grain trade became smoother.

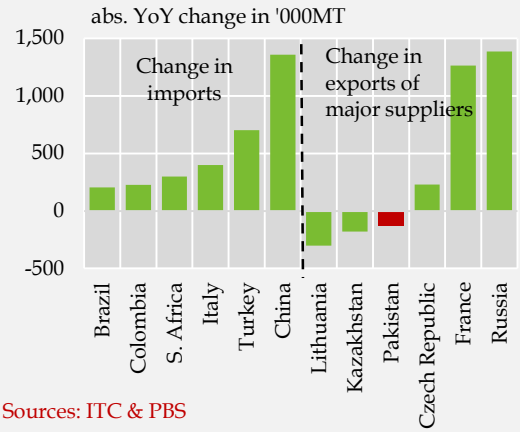
For rice, the demand surged in traditional markets in the west, and also in some major African and East Asian countries (April-onwards data for which are not yet available). Here, India and Brazil emerged as clear beneficiaries, as both recorded significant increase in exported quantities of rice, particularly from April onwards (**Figure 6.2.4**). However, Pakistan could not do the same, with rice export quantities dropping in the quarter. It is also important to note that rice demand was also likely strong from the Middle East economies, but the official import data for these countries for the relevant period is not yet available.

Demand & Supply of Rice in Q4-FY20 **Figure 6.2.4**



Sources: PBS, DGCIS (India) & ITC

Demand & Supply of Wheat in Q4-FY20 **Figure 6.2.5**



Sources: ITC & PBS

Meanwhile, global demand for wheat surged, mainly from China and some other countries, amid efforts to stockpile the staple (**Figure 6.2.5**). This demand was met by traditional wheat exporters in Eastern Europe (Russia and some other Baltic nations), and Europe (France). Similar to rice, wheat demand was also said to be strong from some African countries, but official export data for the Apr-Jun period for these countries is not yet available. Regardless, Pakistan could not benefit from this surge in wheat demand, especially from the neighboring China, as lower domestic production, supply bottlenecks, and rising prices ruled out any export possibility.

While multiple structural factors have constrained Pakistani firms from joining the global value chains for electronics and other high-tech products – and therefore not benefitting from the post-outbreak surge in demand for these items – the country also could not fully tap the sudden surge in demand for food items from March 2020 onwards. Given that agriculture forms around a fifth of GDP, such an outcome can be deemed sub-optimal, and thus requires greater efforts to increase production, and have access to real-time stock positions, to allow for better export planning.

Exports

The country's exports outperformed many other EMs in the first three quarters of FY20, as volume-led increases were noted in a wide range of products (**Figure 6.15**). However, following the Covid-19 pandemic, exports dropped sharply in Q4, and led to a 6.8 percent decrease in full-year to US$ 21.4 billion (**Table 6.5**). This also delayed the expected benefits from China-Pakistan FTA Phase- II, which became effective from January 2020 onward and was expected to provide boost to Pakistan's exports.

Textile exports

Textile exports declined by 6.0 percent to US$ 12.5 billion in FY20, with Q4 shipments declining to the lowest since Q1-FY07. In contrast with FY19, when the price decline had dominated the improved quantum effect, lower quantum exports this year, especially from March onwards, overshadowed some improvement in unit prices for apparel items (**Figure 6.16**). It is pertinent to mention that prior to Covid-19, textile exports had reached

Pakistan's Major Exports during FY20 **Table 6.5**

million US$

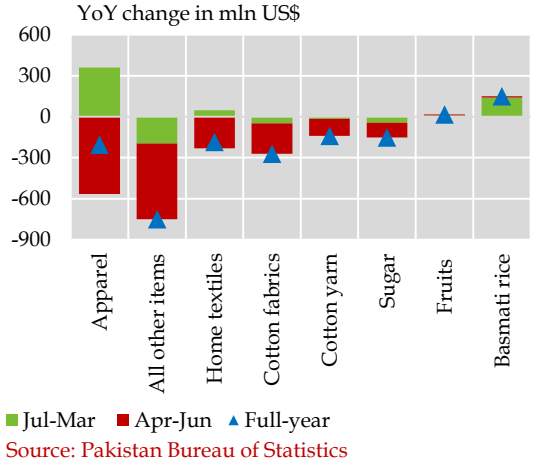
Items	FY19	FY20	Abs. change	Quant. effect	Price effect
Food group	**4,607.4**	**4,361.2**	**-246.2**	**-**	**-**
Rice	2,069.6	2,175.5	105.9	19.5	86.4
Fish & prep.	438.7	406.7	-32.0	-41.1	9.1
Fruits & veg.	649.4	730.3	80.9	-56.5	137.4
Meat & prep	242.7	304.2	61.5	66.1	-4.5
Textile group	**13,328.2**	**12,526.5**	**-801.1**	**-**	**-**
Cotton yarn	1,125.4	984.9	-140.5	-55.5	-85.0
Cotton fabrics	2,101.8	1,829.9	-271.9	-342.9	71.0
Apparel	5,553.6	5,347.1	-206.5	-599.9	393.4
Bedwear	2,261.8	2,150.8	-111.0	-52.7	-58.3
Towels	786.1	711.3	-74.8	-74.0	-0.9
POL group	**477.2**	**273.2**	**-203.9**	**116.1**	**-320.0**
Crude oil	285.4	185.9	-99.6	-49.1	-50.5
POL products	127.8	40.7	-87.1	236.2	-323.3
Other manuf.	**3,361.6**	**3,036.1**	**-325.5**	**-**	**-**
Sports items	308.6	262.4	-46.2	-	-
Leather	252.3	184.2	-68.1	-52.2	-15.9
Leather prods.	485.7	474.0	-11.7	-32.2	20.6
Medical items	388.4	355.6	-32.8	-	-
Chemicals	606.0	502.1	-103.9	-	-
Footwear	122.4	125.9	3.5	7.1	-3.6
Cement	271.7	259.5	-12.3	30.0	-42.3
Exports	**22,958.3**	**21,393.7**	**-1,564.6**	**-**	**-**

Source: Pakistan Bureau of Statistics

US$ 10.4 billion in Jul-Mar FY20 – a record high in the nine-month period since FY06.

Two key government measures and some extraneous factors supported this spurt. One was the flat 7.5 cents/KWh power tariff announced to subsidize electricity for the exporting units.[25] The second was the government expediting release of sales tax refunds to the manufacturers-cum-exporters.[26] These measures eased the industry's liquidity constraints and raised exporters' capacity to process more orders. Also, China has been slowly retreating from the US' and the EU-27's clothing market. With the onset of the US-China trade dispute and Pakistan's continued duty-free access to the EU under the GSP Plus,

Pakistan's Major Exports in FY20 **Figure 6.15**



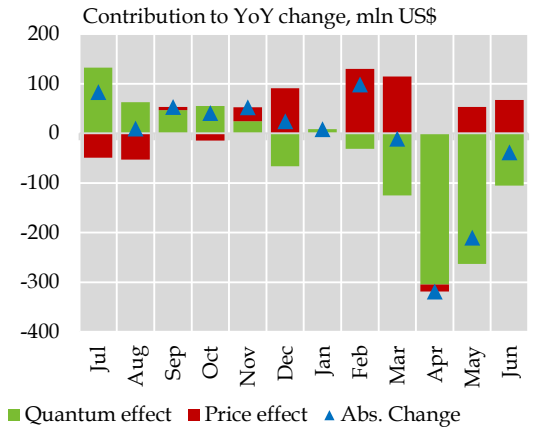
Source: Pakistan Bureau of Statistics

Pakistan expanded its access in both markets, benefitting from China's retreat.

[25] Vide S.R.O. 01(I)/2019 to S.R.O. 12(I)/2019, dated January 1, 2019 (source: Ministry of Energy).
[26] During FY20, refund claims on sales tax and customs duty amounted to Rs 104.8 billion, 178 percent more than last year, and were processed timely through the new online system called FASTER (source: FBR).

Consequently, in Jul-Mar, Pakistan's apparel shipments to these markets rose, despite a weakening in these economies' overall import demand for clothing in the period (**Tables 6.6 and 6.7**).

Apparel Exports in FY20 **Figure 6.16**



Source: Pakistan Bureau of Statistics

However, demand for value-added apparel in the major US and EU-27 markets fell heavily in Q4. Amidst a significant slowdown in buying activity, there was a massive build-up of inventories in the US, while retail sales of clothing in the EU also went down

Growth in EU's Quantum Apparel Imports from Major Countries **Table 6.6**

percent

	Jul-Mar		Apr-Jun	
	FY19	FY20	FY19	FY20
Pakistan	5.6	8.9	10.8	-21.4
Bangladesh	9.6	-2.8	2.8	-25.4
India	-3.7	-3.8	-1.1	-42.9
China	1.8	-7.9	-2.1	-39.3
Cambodia	6.1	-12.6	5.7	-40.1
Turkey	6.0	1.9	3.7	-59.0
World	5.2	-3.0	3.5	-36.7

Source: Eurostat

Growth in US's Quantum Apparel Imports from Major Partners **Table 6.7**

percent

	Jul-Mar		Apr-Jun	
	FY19	FY20	FY19	FY20
Pakistan	4.8	10.1	4.6	-27.6
Bangladesh	7.7	1.8	12.8	-47.2
China	4.3	-16.5	5.5	-44.2
Vietnam	7.2	3.1	4.8	-30.0
India	5.7	-1.7	5.1	-63.4
Indonesia	0.5	-9.6	-3.6	-39.4
Cambodia	2.4	9.7	2.9	-20.0
World	4.6	-6.7	4.0	-44.5

Source: Office of Textiles and Apparel, US Dept of Commerce

significantly.[27] These countries reduced their apparel imports from the whole world, including Pakistan, in the wake of Covid in Q4.[28]

Meanwhile, Pakistan's exports of low-value added textiles (cotton yarn and cotton fabrics) cumulatively fell 12.8 percent to US$ 2.8 billion in FY20, as compared to a decline of 9.7 percent last year. In Jul-Mar FY20, quantum cotton yarn exports to China increased, as the latter reshuffled its sourcing away from India after the China-Pak FTA Phase 2 was signed in April 2019.[29] Nonetheless, falling cotton yarn prices in the international market suppressed Pakistan's export values. Furthermore, unit prices fell much more sharply in Q4, as local and international demand both decreased, leading to a build-up of inventories at the spinning mills. On the other hand, quantum exports of cotton fabric to major destinations, Bangladesh and China, decreased by 20 percent in FY20, in line with the fall in these countries' overall import demand for the product.

[27] In the US, inventories-to-sales ratios for clothing and clothing accessories grew, on average, by 274 percent during Q4-FY20. In contrast, the ratio had, on average, declined 4.4 percent during Dec 2019-Feb 2020. In the EU-27, retail sales of 'textiles, clothing, footwear and leather goods' declined, on average, by 42.8 percent YoY during Q4-FY20; whereas sales had grown slightly in the prior eight months of FY20.

[28] Anecdotal evidence suggests that some orders had been diverted towards Pakistan from China in Jan-Feb 2020. China's two major apparel-producing hubs (Guangdong and Zhejiang) were shut down from January 24 till mid-February for New Lunar Year celebrations and then the Covid-19 outbreak.

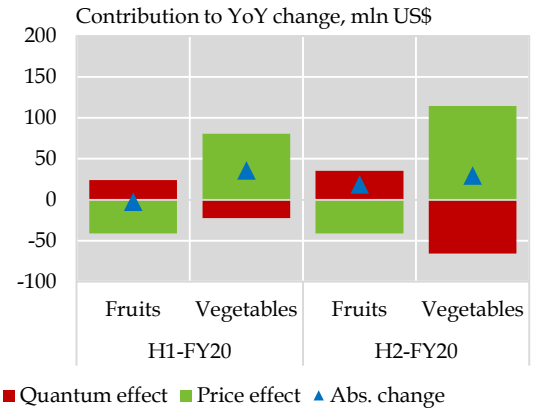
[29] Cotton yarn is among the 313 tariff lines (at HS 8-digit level) that were subjected to tariff elimination as soon as the CPFTA-II Agreement was signed in April 2019. In Jul-Mar FY20, Pakistan's quantum yarn exports to China increased 13.9 percent, while India's decreased by 48.1 percent (sources: PBS and Ministry of Commerce, India).

Non textile exports

Among the major non-textile items, rice exports increased by 5.1 percent to US$ 2.2 billion in FY20; the growth was higher than last year's growth of 1.7 percent. Basmati exports values rose throughout the year, with higher volumes during the first three quarters offsetting the drag from lower unit prices and leading to a 23.4 percent increase in full-year exports to US$ 783.3 million. Before the pandemic, Pakistani exporters were able to increase their share in the Middle Eastern markets like Saudi Arabia, which imposed regulatory restrictions on Indian rice over excessive pesticide usage.[30] Similarly, Pakistan also shipped significantly more basmati rice to the UAE, with at least some of the exports being transhipped to other regional countries like Iran, Iraq, Yemen, Oman and Somalia.[31] After the pandemic struck, basmati exports values continued to rise, though unlike the Jul-Mar period, the rise in international prices amid global supply disruptions played a dominant role and offset lower export volumes.

On the other hand, non-basmati rice exports dropped 3.0 percent to US$ 1.4 billion in FY20. China accounted for the bulk of this decline, though Pakistan's exports had, in fact, started to fall even before Covid-19 struck. This is partly because of lower imports by China in general (amid build-up in stocks in earlier years), as well as high base effect for Pakistan's exports from last year.[32] Among other countries, Pakistan's non-basmati exports to the Philippines and Afghanistan also dropped due to ample domestic stocks and improved local production in the two countries, respectively.[33]

Change in Exports of Fruits and Vegetables **Figure 6.17**



Source: Pakistan Bureau of Statistics

Fruits and vegetables exports grew by 12.5 percent to US$ 731 million in FY20. Higher quantums played a dominant role in pushing up fruit export values by 3.8 percent on a YoY basis (**Figure 6.17**), a result of better marketing and packaging by mangoes exporters and high demand for dates in the UAE. In case of vegetables, rising unit prices, especially in H2, led the overall exports to increase in FY20, despite a drop in exports in Q4 amid Covid-related disruptions and a ban on onion exports since March 2020.[34]

Petroleum group exports fell 42.7 percent to US$ 273 million in FY20 mainly due to lower shipments of jet fuel to Afghanistan, as NATO forces reduced their presence in the

[30] Saudi Arabia implemented stricter quality rules regarding rice imports in September 2019 (source: https://apps.fas.usda.gov/newgainapi/api/Report/DownloadReportByFileName?fileName=Grain%20and%20Feed%20Annual_Riyadh_Saudi%20Arabia_03-15-2020)

[31] For details, see the SBP's Annual Report on the State of Pakistan's Economy for FY19.

[32] China had imported sizable rice quantities from Pakistan in H2-FY19, following the Prime Minister's visit to the country in November 2018. For details, see SBP's Annual Report on the State of Pakistan's Economy for FY19.

[33] According to the Afghanistan government, the country had raised its rice production by 9 percent in CY19, which saw its imports of rice declining by 44 percent in the year's first three quarters (source: Ministry of Agriculture, Irrigation and Livestock. https://www.mail.gov.af/en/rice-production-increases-nine-percent).

[34] Ban on onion exports was enforced vide Ministry of Commerce S.R.O No. 238(1)/2020 dated March 24, 2020. This ban lapsed on May 31.

neighboring country.[35] Crude oil (condensate) exports also decreased, as local refineries were said to increase their usage of locally extracted crude oil, leading to a decline in volumes available for export. Meanwhile, in H2, a substantial fall in international oil prices played a major role in lowering petroleum group exports.

Lastly, footwear exports fetched US$ 125.9 million in FY20, 2.9 percent more than last year. A significant volumetric rise was witnessed in the first three quarters, as exporters readjusted their global supplies in response to the changing international trends, which included rising demand for non-leather footwear.[36] This pre-Covid performance was good enough to offset the drop in exports in Q4, as demand for footwear from major destinations, similar to clothing items, slumped dramatically.

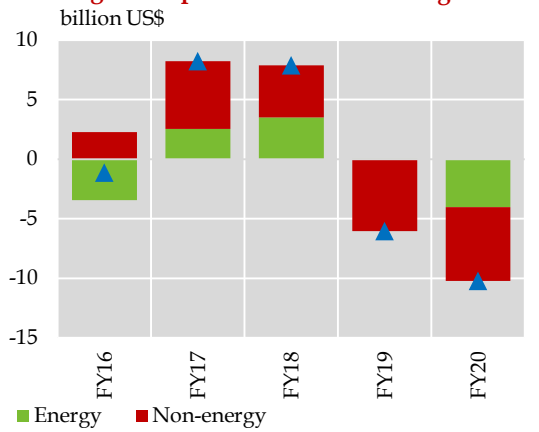
Imports

The country's imports dropped 18.6 percent to a five-year low of US$ 44.6 billion in FY20 (**Table 6.8**). While non-energy imports continued on their downward trajectory from last year, as the macroeconomic stabilization measures suppressed domestic demand in the first three quarters, the drastic drop in energy imports in Q4 was responsible for the deepening in the overall import decline in FY20 (**Figure 6.18**).

Energy imports

The country's energy demand showed signs of stagnation in the year even before the pandemic struck, as weak industrial activity amid the macroeconomic adjustment policies curtailed industries' energy demand. Furthermore, a shift in the power generation mix – towards hydropower (amid ample rainfalls) and coal and away from LNG – lowered the need for imported energy items in general.

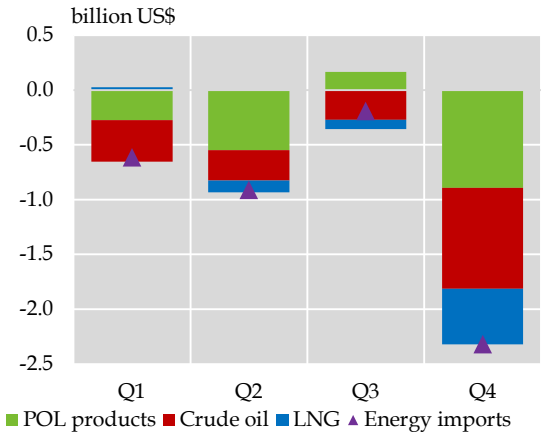
YoY Change in Imports **Figure 6.18**



Source: Pakistan Bureau of Statistics

In this backdrop, energy imports dropped by a sizable 27.9 percent to a four-year low of US$ 10.4 billion in FY20. While imports dropped in all quarters of the year, the decline was particularly steep in Q4 (**Figure 6.19**), when purchases fell to a 14-year low. The unprecedented fall in global oil prices – down nearly 53 percent YoY in Q4 – played a key role, whereas import volumes of crude oil and LNG also declined noticeably amid lower demand from oil refineries and the power sector, respectively.

YoY Change in Energy Imports **Figure 6.19**



Source: Pakistan Bureau of Statistics

[35] Afghanistan-bound quantum jet fuel exports decreased by 70 percent in H1-FY20.

[36] Between FY19 and FY20, the share of quantum leather footwear exports in Pakistan's total footwear exports decreased from 53 percent to 47 percent, while that of non-leather footwear increased from 47 percent to 62 percent. Import mix of top destinations of Pakistan's footwear (USA, Italy, Germany, and the Netherlands) was 47.5 percent leather and 52.5 percent non-leather in FY16. In FY20, the mix was 43.5 and 56.5 percent, respectively (data sources: PBS & ITC).

Pakistan's Major Import Items **Table 6.8**
million US$

Items	FY19	FY20	Abs. change	FY20	
				Quantum impact	Price impact
Energy group	**14,441.4**	**10,411.5**	**-4,029.9**	-	-
POL prods.	6,283.9	4,732.8	-1,551.0	310.8	-1,861.9
Crude oil	4,570.6	2,722.0	-1,848.5	-1,190.6	-658.0
LNG	3,336.5	2,662.2	-674.3	-32.5	-706.8
Agri and chemicals	**8,754.6**	**7,353.7**	**-1,400.9**	-	-
Fertilizer	798.7	568.9	-229.8	-104.0	-125.8
Other chem.	4,452.0	3,694.4	-757.5	-	-
Transport group	**3,085.9**	**1,545.9**	**-1,539.9**	-	-
Cars	1,040.3	577.1	-463.2	-	-
Aircraft & ships	694.0	251.0	-443.1	-	-
Metals group	**4,973.9**	**4,057.6**	**-916.3**	-	-
Steel scrap	1,461.0	1,522.0	60.9	-204.4	265.4
Iron & steel	2,229.2	1,538.0	-691.2	-577.2	-114.0
Food group	**5,668.0**	**5,424.0**	**-244.0**	-	-
Tea	571.7	532.8	-38.9	-3.6	-35.3
Palm oil	1,844.6	1,841.5	-3.1	-103.6	100.5
Pulses	506.0	614.6	108.6	121.5	-12.9
Textile group	**3,221.4**	**2,529.5**	**-691.9**	-	-
Raw cotton	767.5	880.1	112.6	225.0	-112.4
Other textile items	997.8	549.6	-448.2	-	-
Machinery group	**8,921.7**	**8,787.2**	**-134.6**	-	-
Power gen	1,262.6	1,372.9	110.3	-	-
Electrical	1,777.6	2,251.3	473.7	-	-
Cell phones	755.5	1,369.9	481.1	-	-
Other mach.	3,185.0	2,201.9	-983.1	-	-
All other items	**5,696.1**	**4,443.6**	**-1,252.5**	-	-
o/w Coal	1,511.3	1,288.7	-222.6	70.9	-293.5
Total imports	**54,763.0**	**44,552.9**	**-10,210.1**	-	-

Source: Pakistan Bureau of Statistics

For crude oil, import volumes had been declining throughout the year amid low demand from oil refineries, which had curtailed their production to avoid adding to a glut of furnace oil.[37] In Q4, however, this declining trend deepened considerably, with quantum imports falling 52.6 percent YoY to a 10-year low. Most of this decline was recorded in the months of April and May, when multiple refineries were operating at a very low throughput in response to low demand for products from the oil marketing companies (OMCs).[38] Given the challenges posed by fluctuating global oil prices and a sudden drop in demand for transport fuel as lockdowns went into effect (by late March), some previously planned oil and LNG imports were slightly pushed back or deferred, as per a global energy industry report and local

[37] Furnace oil has a roughly 25 percent share in the output of Pakistan's refineries (source: Pakistan Energy Yearbook 2018).
[38] In fact, April 2020 saw the lowest monthly domestic POL production in LSM records going as far back as July 2005, with May 2020 recording the second-lowest production level.

industry stakeholders.[39] Due in large part to this significant drop in demand in Q4, crude oil imports fell 40.4 percent in full-year FY20 to US$ 2.7 billion – a three-year low.

Meanwhile, POL product imports fell by 24.7 percent in full-year FY20, with the entire drop coming from lower unit prices. Global oil prices had been range-bound before the pandemic, but dropped sharply from March 2020 onwards in response to a sizable drop in demand and temporary disagreements over supply cuts between OPEC and Russia.[40] The drop in international prices translated into lower unit prices of Pakistan's POL product imports, and helped offset an increase in import volumes of the items. Overall POL product import volumes rose 4.9 percent in FY20 – mainly due to a 17.3 percent rise in petrol imports.

Before the pandemic, demand for petrol had risen in response to a shift from the alternative fuel (CNG) amid temporary hiccups in CNG supplies (during the winter months), as well as rising differential between CNG and petrol prices.[41] With lower domestic production, the demand had to be met via imports.[42] In contrast, demand for HSD was weak amid a slowdown in overall trade activity, and heavy vehicle transporters' issues with the axle load management policy (**Chapter 3**); the lower domestic demand eased the import demand for HSD. Among other POL products, the country did not import any furnace oil at all after July 2019, amid restrictions on power generation from the fuel.

Once the Covid-19 pandemic struck, domestic fuel demand slumped dramatically amid countrywide lockdowns, whereas global oil prices were also dropping sharply. OMCs and refineries scaled down their purchases, but given the general 30-45 day lag in the placement of import contracts and the arrival of fuel at ports, the impact was reflected in lower imports in May. By that time, the drop in demand for transport fuels was bottoming out amid the easing of lockdowns, which led to a recovery in import volumes in June (**Table 6.9**). In fact, June witnessed highest petrol sales since at least July 2013, and highest HSD sales since May 2018, as per data from the Oil Companies Advisory Committee.[43] This recovery in demand not only represented the increased mobility during the month, but also

Growth (YoY) in Quantum POL Product Imports & Sales during FY20 **Table 6.9**

percent change

	Jul-Feb		Mar-May		June		Jul-Jun	
	Sales	Imports	Sales	Imports	Sales	Imports	Sales	Imports
Petrol	1.7	23.7	-17.0	3.3	19.5	12.5	-1.8	17.3
High speed diesel	-13.9	-6.5	-16.8	-5.6	61.5	65.1	-9.8	-0.4
Furnace oil	-22.4	-92.4	-54.0	-100.0	-38.5	-100.0	-32.1	-94.9
POL products	**-9.4**	**4.6**	**-25.7**	**-1.4**	**16.4**	**21.7**	**-11.7**	**4.9**
Prods. excl. FO	-6.7	12.3	-19.7	1.9	31.8	42.2	-7.3	12.6

Sources: PBS & OCAC

[39] According to an April 29-dated report from S&P Global Platts, one OMC deferred 3 of its regular 5-6 monthly shipments of POL products booked in March for April delivery to May, and cancelled its April tenders altogether (source: https://www.spglobal.com/platts/en/market-insights/latest-news/oil/042920-pakistan-set-to-resume-oil-product-imports-in-may-as-lockdown-measures-ease-traders). Other OMCs likely did the same.

[40] Arab Light oil prices, on average, fell 8.6 percent YoY during Jul-Feb FY20, before dropping by a much sharper 24.1 percent YoY during March-June 2020. Both demand-side (lockdowns) and supply-side issues (temporary increase in supplies by Saudi Arabia and cut in prices of Arab Light and Dubai Fateh variants) were responsible for the price drop.

[41] During Jul-Mar FY20, CNG prices traded, on average, at a premium of Rs 14.7 to petrol. This was almost three times the premium of Rs 5.1 in the same period last year.

[42] Domestic petrol production declined 13.0 percent YoY in FY20.

[43] Industry representatives also attributed the rise in petrol demand in June to higher long-distance travelling via passenger vehicles amid reduced operations of flights, railways and commuter bus operations; and tendency of consumers to keep fuel tanks full given the sizable fluctuations in local prices.

a widening of CNG's price differential with petrol: while CNG was trading at a premium of around Rs 21 to petrol by end-March, the differential had more than doubled to almost Rs 49 by end-June.

Meanwhile, the country's power generation fuel mix underwent some major changes in the year, which in turn had led to changes in the composition of its import demand. Specifically, coal import volumes rose, whereas LNG purchases stagnated, as coal replaced LNG as the second-largest fuel source for electricity generation in the country (**Table 6.10**).[44] This shift came as two major CPEC power projects – a 1,320MW plant at Hub and 660MW plants in Thar – became operational in the first half of the year; whereas another 1,320MW imported coal plant at Sahiwal had started operations a few weeks before the start of the year.[45] As a result, coal-based power generation surged 56.7 percent in FY20, as per NEPRA data. Moreover, hydropower generation rose 19.6 percent and reached a record high in the year, owing to decent water availability and effective management of the hydropower stations.[46] These two factors contributed to lower LNG and FO imports in the year. Additionally, the fall in international prices further lowered import values of LNG as well as of coal.[47]

Fuel-wise Power Generation **Table 6.10**

shares in percent

	FY19	FY20
Hydro	26.3	31.8
Coal	13.3	21.0
LNG	23.0	19.6
Gas (piped)	17.9	12.4
Furnace oil	7.4	3.4
Others	12.0	11.9
Growth in total power gen (%)	1.7	-0.8

Source: NEPRA

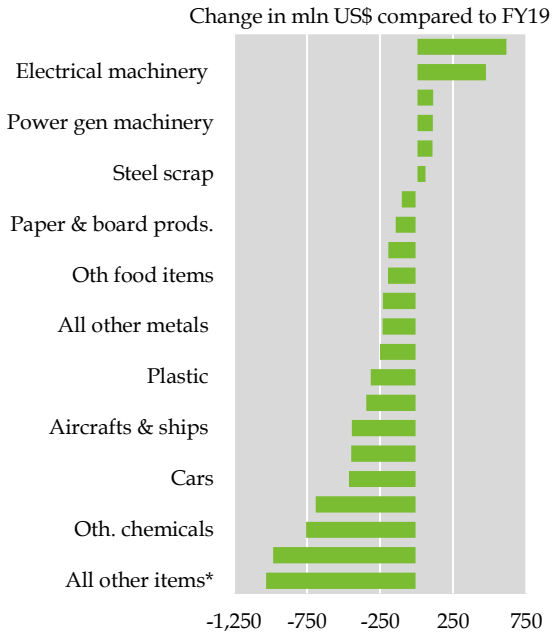
Non-energy imports

The country's non-energy imports dropped 15.3 percent to US$ 34.1 billion in FY20 – a five-year low. Most non-energy imports fell throughout the year (**Figure 6.20**), and unlike energy imports, did not exhibit any substantial deepening in Q4 relative to the other three quarters. Sharp drops were noted in imports of sectors that were particularly hit hard by the macroeconomic stabilization and regulatory measures taken before the Covid-19 outbreak, such as automobiles, construction (metal), and general industrial use items (plastics and chemicals). In some cases, inventory build-ups from last year and an increase in domestic production in FY20 lowered the demand for imports. Exceptions to the broad-based import decline were electrical and power generation machinery, whose imports increased, as work continued on some renewable power projects under CPEC.[48] Cell phone imports also almost doubled over FY19 and reached a record high, though the increase mostly reflected the diverting of grey-channel imports to formal channels.[49]

The transport group's imports fell to an 11-year low, as a sizable 26.5 percent drop in domestic automobile production in the year (**Chapter 2**) amid weak sales lowered the industry's demand for raw materials, including CKD kits. Also, the continuation of restrictions on CBU car imports via the gift and baggage schemes introduced in FY19, led

[44] Coal import volumes rose 4.7 percent in FY20, whereas the growth in LNG import volumes stagnated at 1.0 percent in the year, against an increase of 17.7 percent in FY19. In Q4, quantum LNG imports dropped by a sizable 50.7 percent YoY. Meanwhile, the country imported furnace oil in only one month in the year (July 2019).
[45] Source: http://cpec.gov.pk/energy
[46] Source: WAPDA press release dated June 30, 2020.
[47] Unit prices of Pakistan's LNG imports declined 21.0 percent YoY in FY20, whereas those of coal dropped 18.5 percent.
[48] Some CPEC hydropower projects that are currently under construction phase are the Suki Kinari (KP) and Karot (River Jhelum) stations (source: http://cpec.gov.pk/energy).
[49] Another supportive factor was the abolishment of a three percent value-added tax on commercial cell phone imports via the FY19 budget, which slightly reduced the cost of imported handsets.

YoY Change in Major Non-Energy Imports in FY20 **Figure 6.20**



*excluding coal
Source: Pakistan Bureau of Statistics

to a persisting decline in their imports in FY20.[50] Also, last year's transport imports were inflated by a one-time purchase of an underwater drilling platform worth around US$ 429 million, which led to a higher base effect for the imports.

The slump in the automobile segment spilled over into lower demand for steel products, such as steel strips. Local steel production, despite declining 17.4 percent in the year, did not necessitate higher imports. Lastly, the imposition of anti-dumping duties on some Russian and Canadian steel products in September 2019 also curbed imports of finished products. Mainly due to lower steel product imports, the overall metal group imports declined to a five-year low in FY20. Meanwhile, food imports dropped 4.3 percent to a four-year low. The primary reason seems to be a build-up in the inventory of raw materials and finished products by the edible oil industry last year amid multi-year low international prices. In FY20, import volumes of palm and soybean oil, along with oilseeds in general, showed a declining trend, as their international prices rebounded,[51] and as domestic edible oil production increased.[52] A quantum-led drop in soybean seeds (classified under 'other food items') was the single-largest factor behind the lower food imports. In contrast to edible oil and seeds, pulses import volumes rose 24 percent, with most of the increase coming in H2-FY20. Pakistani importers likely rushed to stockpile the staples to ensure smooth domestic supplies amid the Covid-19 outbreak; however, other major importers (such as India, Indonesia etc) were also in the global market at the same time, leading to a surge in international prices, and, subsequently, in unit prices of Pakistan's imports.[53] As a result, pulses import values rose 21.5 percent in FY20 to a three-year high of US$ 614.6 million.

[50] For details about these restrictions, see SBP's Annual Report on the State of Pakistan's Economy for FY19.
[51] In FY19, average international palm oil prices had fallen 18.6 percent YoY, whereas soybean oil prices had dropped 11.6 percent. In FY20, these prices had, on average, risen by 11.5 percent and 2.6 percent, respectively.
[52] Domestic cooking oil production had risen 9.0 percent in FY20. Local production of some oilseeds, such as rapeseed and canola seeds, also increased over the last year (source: Economic Survey of Pakistan 2019-20).
[53] The unit prices of Pakistan's pulses imports rose 3.3 percent YoY in Q3 and a mammoth 234.9 percent in Q4.

Chapter 7

Understanding Low Private Credit Penetration in Pakistan- Contextualizing Recent Policy Reforms

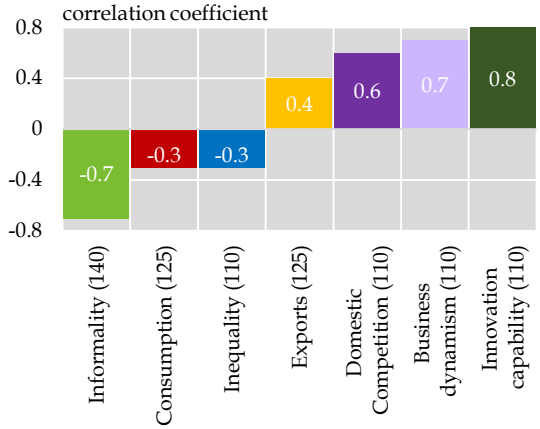
Private sector credit penetration and the state of access to finance in Pakistan is one of the lowest among emerging markets, characterized by persistent supply- and demand-side challenges. The financial sector reforms of the 1990s, aimed at addressing financial repression and leaving the credit offtake to market forces, proved successful in enhancing the efficiency and overall financial health of the sector, but gains in the domestic credit market remained limited. This was because the prevailing market failures (information asymmetries) in the absence of credit registries and private credit bureaus made commercial banks averse to lend to underserved segments of the economy. This risk aversion was reinforced by the high borrowing appetite of the government, which, in the presence of low savings and weak financial inclusion, put upward pressure on banking spreads and crowded out the private sector. Lack of suitable product development by the specialized institutions and their eventual phase-out also contributed to this end. Going forward, however, coordinated efforts by the government and the SBP to resolve issues related to affordable housing finance; create a secured transaction registry; develop private credit bureaus; and support the growing use of digital financial services, hold the potential to substantially improve credit penetration and overall access to finance in Pakistan.

7 Understanding Low Private Credit Penetration in Pakistan: Contextualizing Recent Policy Reforms[1]

7.1 Introduction

The growth-enhancing role of the financial sector has widely been evaluated and acknowledged on theoretical and empirical grounds. In pure theoretical terms, efficient financial systems influence economic growth in the following ways: (i) channelization of savings of diverse households into investment; (ii) allocation of resources to projects with higher marginal product of capital; (iii) provision of liquidity to individual investors with more profitable but illiquid projects; (iv) risk mitigation, by spreading investors' savings across many diversified investment opportunities; and (v) promotion of technological innovation.

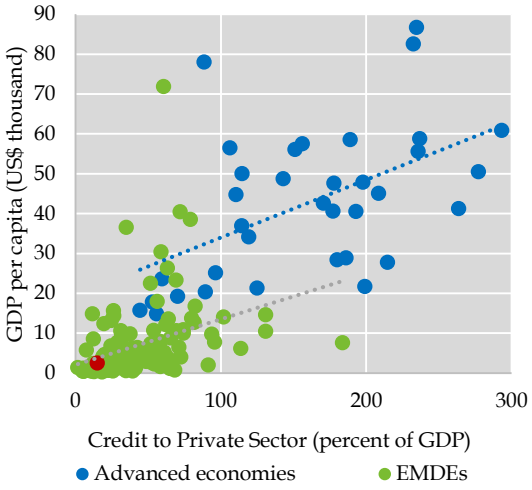
Cross-country Relationship between Financial Inclusion and Other Macroeconomic Variables **Figure 7.1**



Note: Bracket values indicate number of countries for which comparable data was available; all data is average for 2011-14 to match the availability of financial inclusion index numbers, except for competitiveness indicators, for which 2018 data was used.
Source: see Footnote 2

Thus, given the sufficient opportunities for capital formation available to households and firms, it is not surprising to find a negative correlation (cross-country) between financial inclusion and consumption (**Figure 7.1**).[2]

Relationship between Credit to Private Sector and Economic Growth (2010-19) **Figure 7.2**



Based on 173 AEs and EMDEs.
Red dot denotes Pakistan
Source: World Bank

A similar relationship is found between financial inclusion and the economy's level of informality, as the increased use of formal channels for savings/financing purposes can potentially push businesses and households towards documentation. Furthermore, a positive correlation is observed between financial inclusion and export-orientation of

[1] The authors acknowledge Talha Nadeem for his excellent support in the preparation of this chapter. The authors also acknowledge efforts of SBP's Development Finance Group for providing technical input and valuable feedback.

[2] Data sources for the graph: Financial inclusion index from Park, C., and R.V. Mercado, Jr. (2018). *Financial Inclusion: New Measurement and Cross-Country Impact Assessment*. DB Economics Working Paper Series, No. 539. Manila: Asian Development Bank; shadow economy numbers from Medina, L., and F. Schneider (2019). *Shedding Light on the Shadow Economy: A Global Database and the Interaction with the Official One*. CESifo Working Papers, No. 7981. Munich: Center for Economic Studies and Ifo Institute; data on domestic competition, business dynamism and innovation capability from WEF Global Competitiveness Rankings (2018); consumption to GDP ratio and GINI index numbers from World Bank open data.

the economy, as businesses can tap external funding to gain on innovation and productivity fronts. This, coupled with narrowing difference in scale, scope and growth of the established large players and small firms, would lead to an improvement in the overall competition environment of the country.

Improvement on all these fronts can then lead towards sustainable economic development and growth. For example, Levine and Zervos (1998) suggest that a developed banking sector – indicated by high proportion of bank credit to the private sector (as percent of GDP) – is a robust predictor of contemporaneous and future long-run economic growth;[3] indeed, cross country data lends support to this idea (**Figure 7.2**).

Furthermore, we also find sufficient evidence in the literature that supports a strong connection between financial development and advances in total factor productivity (TFP) growth; however, a more refined evaluation of this phenomenon maintained that this relationship was applicable only to middle-income and developed countries. In low-income countries, financial development primarily tends to boost capital accumulation instead, and it is through this channel that the growth is stimulated – not via TFP gains.[4]

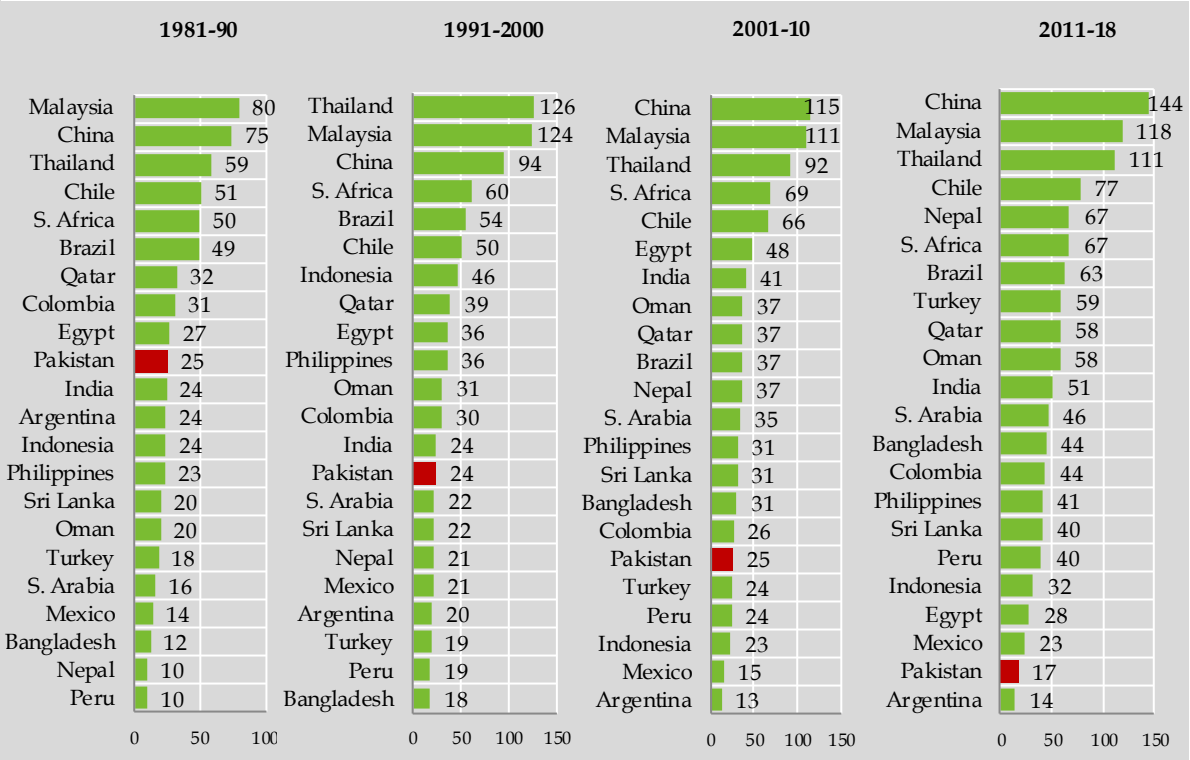
When it comes to Pakistan, it appears that the intermediary role of the financial sector in terms of resource allocation and mobilization has remained fairly limited, especially during the past few decades. In contrast, other emerging market and developing economies (EMDEs) leveraged heavily on this intermediary role during this period. As shown in **Figure 7.3**, the overall credit penetration in Pakistan, as measured by private credit to GDP ratio, is one of the lowest among EMDEs, and has actually shrunk in absolute terms over the past 3 decades. This looks particularly disconcerting, as in other EMDEs, households and firms significantly increased their dependence on bank credit for consumption and investment purposes to the tune of 10 – 20 percent of GDP over the same period. Even if we attribute weak credit penetration in Pakistan to an overall subdued macroeconomic performance, which might have suppressed overall financing needs, the indicators representing access to finance suggest deeper concerns at play. As becomes evident from **Figure 7.4**, the economy is still characterized by a weak and distant bank-firm relationship, as most businesses, especially micro, small and medium enterprises, resort to internal finance for working capital and capex needs (as these enterprises are often collateral-deficient and lack documented financials/business turnover), with banks catering to the financing needs of just a handful of firms and entrepreneurs.

Other than the more profound impact on capital accumulation, productivity and overall growth, an important fallout of inadequate access to finance is that it can potentially weaken the policy outreach to unserved sectors and firms, especially in the time of downturn and/or crisis. For instance, banking systems have become the major conduit of supply-centric government support to businesses in nearly all the countries affected by Covid-19 and the associated containment

[3] Levine, R. and S. Zervos (1998). "Stock Markets, Banks, and Economic Growth," *American Economic Review*, 88: 537-558.

[4] There is a growing empirical literature that highlights the importance of the finance-growth nexus in an economy. For example, please see Levine, R. and S. Zervos (1998). "Stock Markets, Banks, and Economic Growth," *American Economic Review*, 88: 537-558; Rajan, R. G., and L. Zingales (1998). "Financial Dependence and Growth," *American Economic Review*, 88: 559-586; Demirgüç-Kunt, A. and V. Maksimovic (1999). *Financial Constraints, Uses of Funds, And Firm Growth: An International Comparison*. Policy Research Working Paper 1671. Washington, DC: World Bank; Beck, T., Levine, R. and N. Loayza (2000). "Finance and the Sources of Growth," *Journal of Financial Economics*, 58(1-2), 261-300; and Rioja, F. and N. Valev (2004). "Finance and the Sources of Growth at Various Stages of Economic Development," *Economic Inquiry*, 42(1), 127-140. Recent literature also reveals that a nonlinear and inverted U-shaped relationship exists between credit and economic growth as private credit exceeds a certain threshold level. Law, S. H. and N. Singh (2014). "Does Too Much Finance Harm Economic Growth?" *Journal of Banking & Finance*, 41: 36-44.

Pakistan's Relative Standing in Credit-to-GDP Ratio Across Decades Against Selected EMDEs **Figure 7.3**



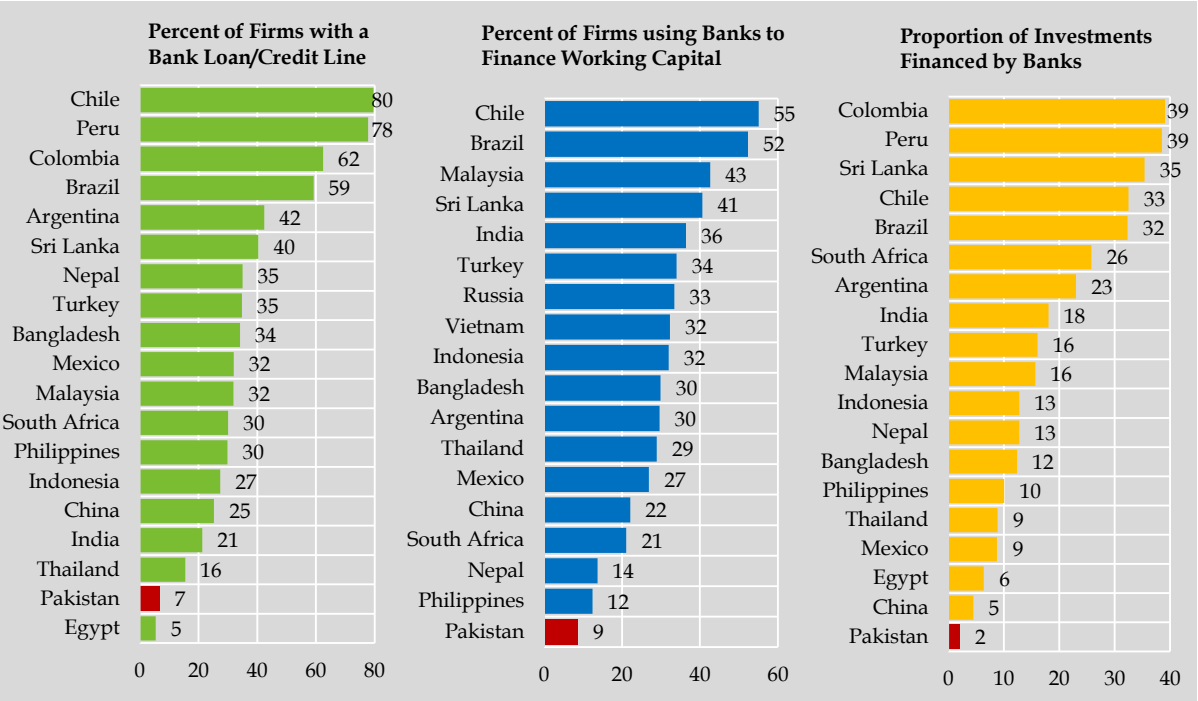
Source: World Development Indicators, World Bank

measures. Payment deferral programs, mark-up subsidies and easing capital regulatory restrictions for private lending, have all been positioned to ease credit conditions for firms and make up for their cash constraints. This was done to limit the transformation of a potential liquidity problem into a solvency crisis. However, sufficient outreach and effectiveness of this toolkit warrants a strong credit penetration and a close bank-firm relationship in the economy. Countries lacking on this front are likely to struggle with the scope and breadth of the recovery efforts, since it is too much to expect banks to develop fresh relationships in the middle of a crisis. In this context, while the finance-growth nexus was already weak in Pakistan, the Covid-19 pandemic has exacerbated the challenge, as it triggered serious liquidity concerns for many businesses, particularly those operating in the informal economy.

This chapter analyzes the reasons behind the underwhelming state of private credit and investment, and an overall weak access to finance in Pakistan's economy. In particular, it attempts to shed light on factors that impeded the development of a well-functioning credit market, even after it took a fairly reasonable start in the first few decades of industrialization. Importantly also, it analyzes the state of credit penetration in the context of a paradoxical weakening after the financial sector reforms, which were aimed at deregulating and liberalizing the market, alleviating financial repression of all kinds, and leaving the allocation of banking assets to market forces. The findings can be viewed along four dimensions.

First, in an economy as informal and savings-starved as Pakistan's, a strong deliberate push for promoting financial inclusion was unavoidable. But similar to the trend in other EMDEs, this did not gain much prominence in the reforms' design until much later. Second, efforts to address credit market failures proved insufficient and, coupled with stringent capital requirements and a fragmented approach towards incentivizing lending to micro, small and medium enterprises (MSMEs), resulted in marginalization of the unbanked and the underserved segments of the economy. Third,

The State of Access to Finance in Pakistan **Figure 7.4**



Source: World Enterprise Survey (latest available for each country). In case of Pakistan, business owners and top managers in 1,247 firms were interviewed from May, 2013 through May, 2015.

persistent uncertainties around loan write-offs and non-judicial foreclosures made banks increasingly risk-averse. Mortgages, which comprise nearly a third of EMDE's credit portfolio, were particularly sidelined, as this sector struggled with additional supply-side concerns from issues like land titling/registry, land management, etc. Fourth, the incomplete reforms in the fiscal and domestic debt market also weighed in: the ample supply of zero risk-weighted assets in the form of government papers explains banks' general lack of willingness to diversify and expand their lending portfolio.

In the later part of the chapter, we identify recent developments in the credit market with a potential to significantly increase credit penetration in the country. In particular, we highlight the establishment of the Secured Transactions Registry (STR), which will help banks to create charge on the movable assets of the micro, small and medium enterprises. This would enable MSMEs to acquire loans from the commercial banks using movable assets as collateral. This, in addition to the licensure of a couple of credit bureaus in the private sector, can significantly help address the major supply-side constraints to loan acquisition by such enterprises. In addition, the renewed focus on low-cost housing finance can rev up mortgages, especially because this is being complemented by government efforts to overhaul the complete supply side, from regulation and land entitlement to incentivizing builders and developers. Finally, advancements in digital connectivity and payments infrastructure, as well as the increased usage of digital financial services, can provide a big boost to financial inclusion. In particular, the underserved segments of the economy, where data regarding credit worthiness and banking history is lacking, should benefit heavily from the growing penetration of e-commerce, fintech and mobile wallets.

7.2 A Brief Review of Private Credit Offtake in Pakistan

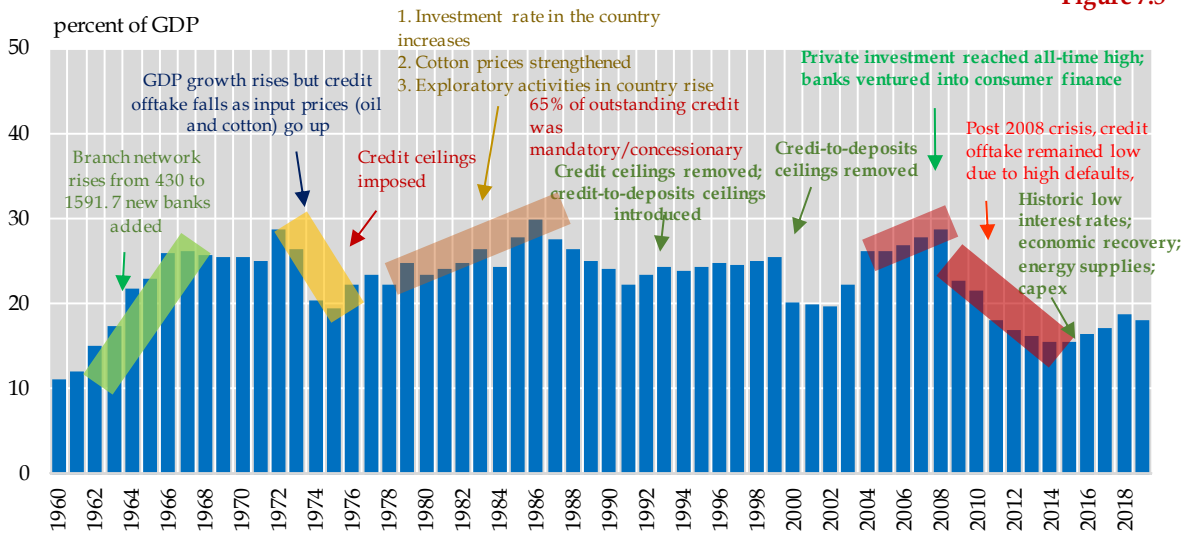
The financial sector played an important role in the initial years of industrialization, with

major contributions coming from specialized development finance institutions (DFIs). The DFIs came into the spotlight because they provided a way out of market failures in credit allocation and provided the necessary funds to the underserved or nascent yet policy-wise strategic sectors of the economy.

Prior to the 1960s, for example, the commerce sector had the biggest share of private sector credit in Pakistan. This was because of the relatively non-existent industrial base in the country. However, when the manufacturing sector became a priority for the government, as envisaged in the Five Year plans of the Planning Commission, DFIs were the envisioned medium for development finance for the sector, and they performed well.[5] Through the 1960s up to the mid-1980s, these DFIs were major channels for routing development funds to the private manufacturing sector and achieving multiple socio-economic objectives, such as broadening industrial ownership, facilitating and encouraging new entrepreneurs, and providing employment opportunities in less developed areas of the country (**Box 7.1**). The DFIs' main function was to provide industrial development credit finance and some agricultural finance for farm machinery and chemicals. Importantly, in keeping with the import substitution policies of those times, the DFIs also helped establish firms in textiles, cement, sugar, fertilizers, and petrochemicals sectors. Commercial banking industry also grew steadily in the 1960s, when new banks were established and the branch network began to spread out. Thus, private credit rose from only 11.1 percent of GDP in 1960 to 25 percent by end-1970 (**Figure 7.5**).

This momentum was disrupted by two major policy decisions taken in the early 1970s. First, the National Credit Consultative Council (NCCC) was set up to determine the real credit needs of the economy within the Annual Development Plan and the monetary targets. Mandatory credit ceilings were introduced for the commercial banks – practically leaving no room for banks to expand credit at a rate faster than what was stipulated by the SBP. Second, major banks

Credit to Private Sector in Pakistan - Historical Context **Figure 7.5**



Source: World Bank

[5] For instance, Faruqi (2015) notes that the newly minted business houses like the Adamjees, Saigols, Ispahanis and Dawoods got tremendous support from DFIs on the back of their characterized "transparency, accredited accountability, proven creditworthiness, profitability, sound management and solid performance all around."[S. Faruqi (2015). "The Role of DFIs in Industrial Growth and Transformation: Why the East Asian Countries Succeeded and Pakistan Did Not," *Lahore Journal of Economics*, 20: 13-30.]

Box 7.1: DFIs in Pakistan - Inception, Prominence and Diminution

In the Second Five Year Plan of Pakistan (1960-65), the government increased the focus on the industrial sector. According to the plan, "Basic industries are to be encouraged where economically feasible. Special emphasis is placed on the development of small-scale industries, both because of their intrinsic merits and because of their employment potential. In particular, those major industries are to be encouraged which stimulate agricultural development or which support small scale industries. Private investment in industry is to be given maximum encouragement" (MoF, 1960).

The expenditure allocation of the industrial sector was increased by 51 percent as compared to the First Five Year Plan and was the highest in the Second Plan, with the semi-public sectors, the newly-introduced classification in the plan, envisioned to contribute the most. The Semi-Public Sector was to "consist of government-sponsored corporations which draw their finances both from the public and private sectors".

The Second Five Year plan was considered an "undoubted progress", as all the major benchmarks were achieved or surpassed (Griffin, 1965). Pakistan Industrial Credit and Investment Corporation Ltd (PICIC) was the first DFI to be formed in 1957 with the help of the World Bank, with the objective of providing finance to medium and large industries and to act as a channel for foreign currency funds from multinational agencies for industrial projects. After that, the 1960s and 70s saw the formation of the Industrial Development Bank of Pakistan (IDBP), the National Development Finance Corporation (NDFC, to provide investment capital to state enterprises), the National Investment Trust (NIT), the Investment Corporation of Pakistan (ICP), the Pak Kuwait Investment Company (PKIC), Pak-Libya Holding Company (PLHC), Saudi Pak Investment Company (SAPICO), Regional Development Finance Corporation (RDFC), Small Business Finance Corporation (SBFC), and the Banker's Equity Ltd (BEL).

During the 1960s and 1970s, the DFIs performed appreciably and helped spur the growth in the industrial sector of the country. However, problems started emerging in the later years, with political interferences, poor governance issues and low recovery rates hurting their efficiency and effectiveness. Foreign aid dependence was another factor, as the DFIs over time were not able to effectively seek out adequate domestic sources to be channelized. Resultantly, when the foreign inflows started to deteriorate, the institutions experienced a cash squeeze. Exacerbating the situation was the inception of investment banks and leasing companies during the 1980s, considering that there was a significant overlap between the objectives and mandates of the two types of institutions (SBP, 2004).

As a result of these factors, the DFIs gradually faded into the background. Within DFIs, the Banker's Equity Limited was initially privatized in 1996 and subsequently liquidated in 1999. Meanwhile, the NDFC (whose equity had turned negative in 1999 after heavy losses in the second half of the 1990s) was merged with the National Bank of Pakistan in 2001. In addition, RDFC and the SBFC – which were both serving the SME sector – were merged to create the SME Bank in 2002. Among the few DFIs that survived this period of broad restructuring was the Pakistan Industrial Credit and Investment Corporation Ltd (PICIC) and some foreign-sponsored DFIs, which had generally performed better on the back of "strong support of their sponsors, sound capital structure and consistent profitability" (SBP, 2004). However, the PICIC was also privatized in 2007.

References:

MoF (1960). *Highlights of Pakistan's second five-year plan 1960-65*. Rawalpindi: Economic Advisor, Ministry of Finance.
Griffin, K. B. (1965). "Financing Development Plans in Pakistan," *Pakistan Development Review*, 5(4): 601-630.
SBP (2004). *Financial Sector Assessment 2004*. Karachi: State Bank of Pakistan.

were put under the direct control of the government in early 1974.

The key objective of this nationalization was to direct banking activities towards broader socio-economic objectives of the country and also to protect the depositors' funds. In addition, the SBP prescribed annual mandatory targets for commercial bank loans for specific sectors, and also for fixed investments and refinancing of loans for locally manufactured machinery and agri-based activities.

Following these steps, government interventions became a major feature of the

banking sector. Ultimately, the banking industry began losing its efficiency due to suboptimal governance structures in predominantly government-owned banks; excessive funding of budgetary deficits; poor recovery of loans handed out to "politically-connected firms"; burden of high taxes on the financial sector; and excessively high lending and low deposit rates.[6] Irrespective of these inefficiencies, the level of private credit-to-GDP ratio posted a steady increase, as the country witnessed high investment growth. However, since banks were directed to lend to certain sectors not on the basis of project viability, not all the credit was being lent out for productive investments. This view is supported by the fact that nearly 65 percent of the outstanding credit was mandatory and/or concessionary at end-1980s.[7] More importantly, it was difficult to ensure that the credit was being used by the intended beneficiaries.[8] The subsequent deterioration in the asset quality of banks may be an indication of this phenomenon.[9]

Not only did the poor asset quality heighten the solvency risk for the banking industry, it also restricted the earning capacity of banks. Then in the early 1990s, the government and the SBP embarked on a sweeping reforms agenda aimed at deregulation and liberalization of the country's financial sector. The reforms mainly encompassed privatization of state-owned commercial banks, instillation of corporate governance practices, strengthening of capital adequacy, improvement in asset quality, liberalization of foreign exchange regime, overhaul of the legal landscape, and the introduction of prudential regulations. From the perspective of private credit growth also, a number of measures were taken. These included: reduction in SLR requirements, which was expected to place significant amount of liquidity at banks' disposal; removal of mandatory credit requirements; relaxation of licensing procedures for micro and rural credit institutions; and removal of restrictions on consumer financing by nationalized banks. These reforms were clearly premised on the notion that the volume and quality of credit allocation would improve if left to market forces.

7.3 Despite Liberalization, Credit Penetration remained Weak

It is important to acknowledge that in terms of achieving efficiency and strengthening the financial health of the banking industry, the reform process was indeed beneficial. Hardy and Patti (2001) evaluated profitability and efficiency of Pakistan's banking system and noted that the reform process allowed Pakistani banks to improve cost efficiencies and expand their revenue base.[10] Similarly, using non-parametric data envelopment analysis, Ahmed (2011) concluded that the second phase of reforms was particularly

[6] Based on data for Pakistan between 1996 and 2002, Khwaja and Mian (2005) show that "politically connected firms receive substantial preferential treatment. Not only do such firms receive 45 percent larger loans, but they also have 50 percent higher default rates on these loans. Moreover, this preferential treatment is entirely driven by loans from government banks". Also, the SBP's Financial Sector Assessment Report 1990-2000 noted: "the ratio of nonperforming loans to gross advances increased from less than 17 percent in 1990, to 27.7 percent in 1999. This was due to substantial loans provided by NCBs (nationalized commercial banks) on political grounds, especially during the early and mid-1990s." [Khwaja, A. I. and A. Mian (2005). "Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market," *Quarterly Journal of Economics*, 120(4): 1371-1411.]

[7] Source: State Bank of Pakistan (2002). *Financial Sector Assessment Report 1991-2000*. Karachi: State Bank of Pakistan.

[8] As noted in the State Bank of Pakistan (2002) (pp 22): "the higher share of directed credit programs resulted in investments with low rates of return, which subsequently burdened banks with large non-performing loans. The effectiveness of such programs was also questionable on the ground that it was difficult to ensure that the credit was being used by actual intended beneficiaries".

[9] While gross NPLs to advances ratio was already high at 17.6 percent in 1990, it increased further to 22.0 percent by end 1999.

[10] Hardy, D. and E. Bonaccorsi di Patti (2001). *Bank Reform and Bank Efficiency in Pakistan*. IMF Working Paper No. 01/138. Washington, DC: International Monetary Fund.

helpful in improving the commercial banks' efficiency – especially the pure technical efficiency – in Pakistan.[11]

In terms of credit allocation also, the banking industry took leaps from the early 2000 onwards and significantly expanded the menu of services offered. For instance, banks aggressively took up consumer finance, and within a short span of time developed a reasonable customer base. SME finance was another area where banks keenly ventured in. But in hindsight, this active pursuit of banks into financing avenues in nontraditional sectors appears merely a direct outcome of a liquidity influx in the system in the aftermath of 9/11, amid a subdued appetite for budgetary funding during the period. While banks were on the lookout for avenues to park their funds, the easy monetary policy ensured an ample demand for bank loans.

However, things began to change course from 2008 onwards, following the deterioration in the overall macroeconomic and investment climate. Not only did the global financial crisis (GFC) trigger a sense of uncertainty, but the growing security concerns and energy shortages in the country significantly dented domestic business prospects.[12] Importantly, and despite these conditions, counter-cyclical macroeconomic policies could not be deployed as vulnerabilities in the external sector had morphed into a BoP crisis (by mid-2008). For the next 5 years, interest rates remained in double-digits, contributing to an anemic credit growth. Furthermore, severe energy shortages in the country, growing security concerns, and a slowdown in both the domestic and international economy, had a strong and negative impact on the financial position of SMEs, which led to a rise in their default rates. At this point, the resultant risk aversion from banks was reinforced by the growing government appetite for borrowing from the banking sector to meet the expenditure demands to stimulate the economy.

Here, it is important to acknowledge that in addition to the cyclical factors, there are deep-rooted structural challenges, such as low financial literacy and awareness, preference for cash, and cultural and religious factors, that suppress the demand for financial services in general, and credit in particular (**Box 7.2)**.

That said, the there are multiple major supply-side constraints for low financial penetration; these are discussed in detail in the following sub-headings (a-e).

a. The inclusion dimension and deepening was overlooked

The broader financial sector reform agenda that swept across the EMDEs in the late 1980s and the 1990s, had taken its cues from the IFI-led financial sector assessment programs. These programs focused primarily on identifying the financial system's vulnerabilities, strengthening supervision, risk management and ensuring market competition.[13] It was not until the mid-2000s, that the concept of financial inclusion started gaining traction and eventually became one of the key pillars of the broader financial development.[14] As things stand, both financial inclusion and financial stability appear high on the agenda of international policymakers. But conceptually, the nexus between the two is still evolving.

[11] Ahmed, U. (2011). *Financial Reforms and Banking Efficiency: Case of Pakistan*. MPRA Paper No. 34220. Munich: MPRA.

[12] The annual investment rate (as percent of GDP) declined from 17.7 percent on average during FY00 to FY08 to only 15.7 percent during FY09 to FY20. At its peak, the investment rate had been as high as 20.6 percent in FY06.

[13] As the World Bank (2007) puts it, "The World Bank Group has long recognized that well-functioning financial systems are essential for economic development. The work of its financial sector has, over the years, emphasized the importance of financial stability and efficiency. Promoting broader access to financial services, however, has received much less attention despite the emphasis it has received in theory. The access dimension of financial development has often been overlooked, mostly because of serious data gaps in this area". [A. Demirguc-Kunt, T. Beck and P. Honohan (2007). *Finance for All? Policies and Pitfalls in Expanding Access*. World Bank Policy Research Report No. 41792. Washington, DC: World Bank.]

[14] Source: same as in footnote 13.

Box 7.2: Access to Finance – The Demand-Side Dynamics

In Pakistan, demand-side factors are important to assess while explaining the low activity on the credit front. According to the SBP-Gallup Pakistan Access to Finance Survey (A2F) 2015, 53 percent of the population was financially excluded in the country. A key factor was the high and persistent use of cash in the economy. The A2F survey revealed that around 95 percent of the respondents received income in cash, and 86 percent stated preferring paying for goods and services face-to-face due to increased certainty of transactions. Overall, close to three-fourth of the respondents stated that there was no need for a bank account, and just 8 percent of the non-banked said that it would be useful to open a bank account. This was down from 38 percent in the A2F 2008.

Another reason for the lower demand for banking services is the low level of financial literacy. According to the A2F 2015, a majority of unbanked respondents (53 percent) identified a lack of knowledge about banks and bank accounts as the key obstacle to account ownership. Similarly, more than 30 percent of the respondents cited lack of knowledge for not making domestic P2P transfers using banks, mobile money, and post office.

Regarding credit, only 14 percent of respondents cited bank loans as a prime source of credit, although this was up from 3 percent in the comparable A2F 2008 survey. Instead, a majority of respondents (56 percent) preferred to obtain credit from neighbors and friends.

Religion is another factor that plays a key role in determining the demand for financial services. According to the 2017 World Bank Global Findex database, Pakistan ranked seventh highest out of 123 countries in terms of share of respondents (15 and above) not having a bank account due to religious reasons (11.5 percent). Islamic banking can help in this regard to bring the faith-sensitive financially excluded population into the formal channel. However, the issue of literacy and awareness is prevalent here as well.

According to the 2013 SBP-DFID study of Knowledge, Attitudes and Practices (KAP) of Islamic Banking in Pakistan, 95 percent of the unbanked population did not understand the Islamic Banking model, while for the banked population, the share was 89 percent. That said, there is a strong interest in Islamic Banking, as the KAP survey revealed that 89 percent of the Islamic banked participants were satisfied with their banking services, with the most cited reasons being products not based on interest, religious satisfaction and comfort, and helpful Islamic banking employees. Things were similar on the corporate front, as 86 percent of enterprises cited religious motivation for choosing Islamic banking.

First, growing body of literature is suggesting that the impact of improvements in financial access on financial stability depends on how these improvements are achieved and managed. For instance, Mehrotra and Yetman (2015) maintain that larger risks seem to prevail if greater financial inclusion results from rapid credit growth, and importantly, "if relatively unregulated parts of the financial system grow quickly".[15] Similarly, in context of the devastating impact of financial innovation on financial stability amid the global financial crisis of 2008, Hannig and Jansen (2010) advised policymakers to crucially "avoid backlash against financial inclusion while designing stricter regulations".[16] The study maintained that the potential costs of financial inclusion are compensated by the important dynamic benefits that enhance financial stability over time through a deeper and more diversified financial system.

The latter view was also supported by Han and Melecky (2013), who empirically established that financial inclusion can directly enhance stability: employing proxies for access to deposits and the use of bank deposits, the study found greater access to bank deposits

[15] Mehrotra A. N. and J. Yetman (2015). "Financial Inclusion: Issues for Central Banks." *BIS Quarterly Review*, March 2015: pp 83–96. Basel: Bank for International Settlements.

[16] Hannig, A., and S. Jansen (2010). *Financial Inclusion and Financial Stability: Current Policy Issues*. ADBI Working Paper 259. Tokyo: Asian Development Bank Institute.

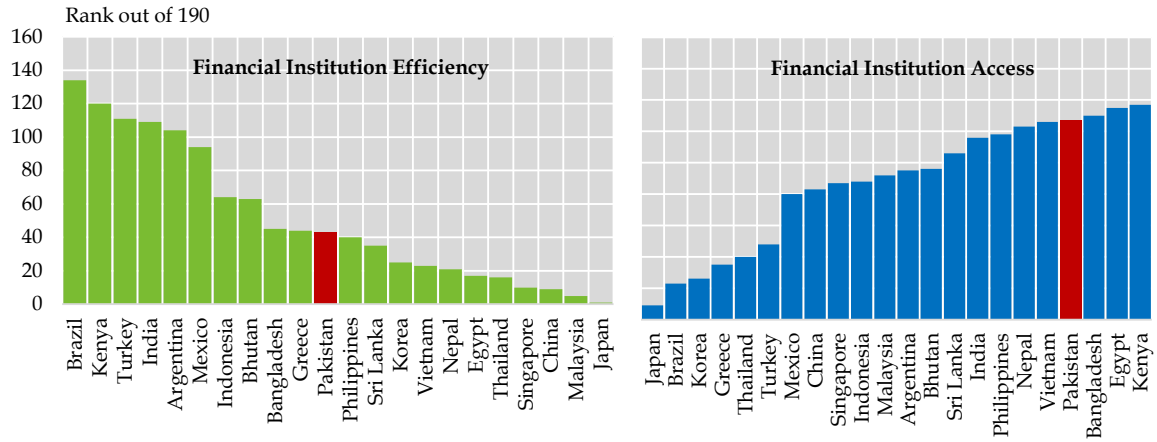
making the funding base of banks more resilient in times of financial stress.[17]

Therefore, it argued that the "policy efforts to enhance financial stability should not only focus on macro-prudential regulations, but also recognize the positive effect of broader access to bank deposits on financial stability". Prasad (2010) postulated a similar mechanism, suggesting that higher financial inclusion in savings enhances the financing of domestic investments by decreasing reliance on foreign financing, thus leading to greater stability.[18] Hawkins (2006) suggest that the central bank's objectives of financial stability and financial service access may be mutually reinforcing, and promoting access to finance enhances financial stability both in the short and long runs.[19] An important dimension gaining traction is that excessive emphasis on financial stability can prolong involuntary financial exclusion (BIS, 2015).[20] The bottom-line is that complex interlinkages (trade-offs and synergies) exist between financial inclusion and stability, and when ignored, these can potentially deliver unwarranted results – such as costly financial crises or continued financial exclusion.[21]

When it comes to Pakistan, strengthening the regulatory framework and improving the overall stability profile of the banking industry was the cornerstone of the comprehensive reform process of the 1990s and early 2000s. However, a deliberate policy push to ensure access of individuals and businesses to useful and affordable financial products and services was not keenly pursued in the process. This was true for both the liability and asset sides of the financial system.

From the liability side, the financial sector's restructuring was, in fact, disadvantageous initially from the inclusion standpoint. Specifically, an expected outcome of privatization was that banks would take several cost-cutting measures to improve their bottom-lines; this meant downsizing and closure of loss-making bank branches. Between June 1997 and June 2004, as many as

Pakistan's Ranking in Financial Institutions' Efficiency and Access (2008-18) **Figure 7.6**



Source: Revised 2018 database of R. Sahay, M. Čihák, P. N'Diaye, and A. Barajas (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," Revista de Economía Institucional, 17(33): 73-107

[17] Han, R. and M. Melecky (2013). *Financial Inclusion for Stability: Access to Bank Deposits and the Deposit Growth during the Global Financial Crisis*. Policy Research Working Paper, 6577. Washington, DC: World Bank

[18] Prasad, E.S. (2010). *Financial Sector Regulation and Reforms in Emerging Markets: An Overview*. IZA Discussion Paper 5233. Bonn: Institute for the Study of Labor

[19] Hawkins, P. (2006). *Financial Access and Financial Stability in Central Banks and the Challenge of Development.* Basel: Bank for International Settlements.

[20] BIS (2015). *Range Of Practice in the Regulation and Supervision of Institutions Relevant to Financial Inclusion*. Basel: Bank for International Settlements.

[21] Martin. C, Davide S.M, and M. Martin (2016). *The Nexus of Financial Inclusion and Financial Stability: A Study of Trade-offs and Synergies*. Policy Research Working Paper 7722. Washington, DC: World Bank

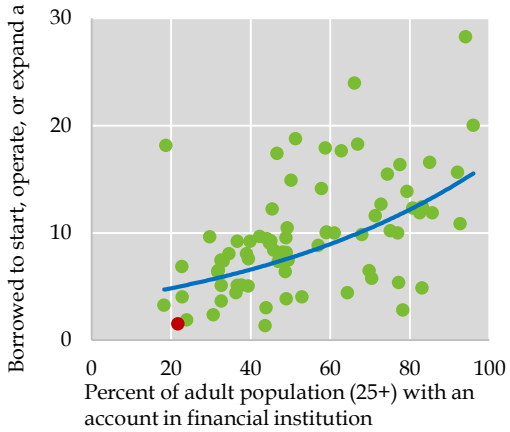
1,656 bank branches and 4.7 million accounts were closed down – around 4.1 million were small-sized accounts (i.e., with balances lower than Rs 5,000). In subsequent years, while banks expanded their outreach and opened new branches, their penetration in the underserved areas remained low. As a result, the number of small-sized accounts shrank by another 2.7 million between 2004 and 2019.

While Pakistan was not alone in terms of focusing on financial inclusion late as opposed to increasing regulatory measures, what made the situation more challenging here was the state of financial depth and access as compared to other emerging and regional economies. In particular, the country had (and still has) one of the lowest proportions of adult population with access to a transaction account, and one of the highest ratios of currency to deposits (**Chapter 3**) – major reasons why the country's ranking for efficiency of financial institutions remains far ahead of its ranking for access (**Figure 7.6**).[22] This had two major implications.

First, the deposit base did not grow the way it did in the other EMDEs, which limited the pool of loanable funds available with banks. Second, a large segment of the population does not have an adequate level of banking history. The latter point is important, because having a basic transaction account with commercial banks is considered as the first step towards broader inclusion. This is because small businesses and individuals with no credit history and coverage in credit registries can at least start building their banking history by opening and using basic accounts. Gradually, this banking history, coupled with other innovative techniques, can be used by banks to evaluate their credit worthiness. In this context, it is not surprising to see a strong positive correlation between access of population to financial services and credit penetration across countries (**Figure 7.7**).

With a large share of the population devoid of any relationship with financial institutions,

Relationship between Financial Access and Credit Penetration **Figure 7.7**



Red dot denotes Pakistan

Source: World Bank Findex Database for Middle Income

information asymmetries (while evaluating credit worthiness of potential borrowers) remained deeply engrained in the domestic credit market. This, in the presence of tightened regulatory conditions and contract enforcement issues, dented inclusivity in the provision of financing solutions to a large part of the economy. Details are presented in the following section.

b. Unaddressed credit market failures amid stringent regulations exacerbated challenges

The overall state of information and contractual infrastructure is crucial for the financial sector to achieve a broader clientele. Imperfections in these areas weigh particularly heavily on individuals and enterprises that lack collateral, credit/banking history, and connections, as the absence of a reliable collateral and legal ease of foreclosures increases loss potential for banks in the event of a default. Therefore, institutional reforms that secure property rights, ensure creditors' rights, and build credit registries are often cited as long-term prerequisites for well-functioning financial systems.

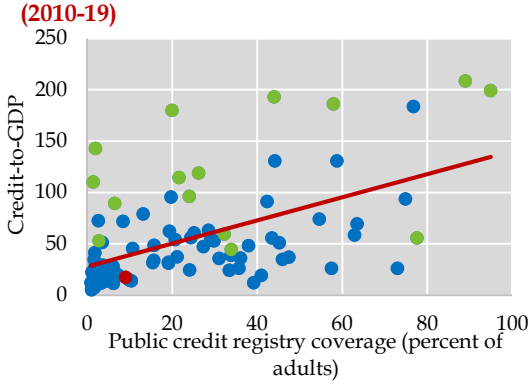
In particular, the success of credit bureaus may be gauged from the fact that their presence and coverage size in an economy is

[22] Revised 2018 database of R. Sahay, M. Čihák, P. N'Diaye, and A. Barajas (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," *Revista de Economía Institucional*, 17(33): 73-107.

positively correlated with the magnitude of private sector credit (**Figure 7.8**). When banking history is not available, non-bank third party data of first-time borrowers – such as the information on the customer's utility payments, telecom-related transactions, etc. – can work as important elements for risk assessment and loan appraisals, especially for unserved or under-served households and businesses. Without access to such information and/or appropriate collateral, banks are reluctant to extend financing. Here, alongside individual-level information, availability of sector- or group-level data can also be equally important in lending decisions of the commercial banks. Choudhary & Jain (2020) find that after the e-CIB, the only public sector credit bureau in Pakistan, stopped providing the group-level information of firms in 2006,[23] banks that had more private information ("informed banks") about other firms in a borrower's group lent more to that firm than other, less-informed banks. Importantly, this was found to be true even for banks that had pre-existing relationships with that firm. This suggests that past relationships cannot compensate for the information imperfection. Furthermore, businesses that borrowed from informed lenders were found to borrow 12.3 percent more than counterparts who borrowed from less-informed lenders. The paper also found that small firms were most disadvantaged by this information asymmetry.[24]

MSMEs are at a particularly disadvantageous position probably because their capital stock is concentrated mostly in movable assets, such as receivables, intellectual property, inventory, agricultural produce, petroleum or minerals, motor vehicles, etc. Such assets typically do not work as a working collateral for borrowing in most EMDEs, either because the law may not recognize them as security instruments, or the assets might not provide adequate protection for the lenders. Under such conditions, the role of credit registries becomes more important, as they alleviate the risk for a bank that the borrower will use the same movable property as collateral to secure loans from other banks without the knowledge of the original lender.

Correlation of Credit Registry Coverage and Private Credit (2010-19) **Figure 7.8**



Note: Based on 88 AEs (green) and EMDEs (blue) public registry coverage of at least 1 percent of adults. Red dot denotes Pakistan.
Source: WDI; World Bank Doing Business Database

Empirical evidence shows that credit registries are positively associated with credit growth (Miller, 2003).[25] From the supply side, the presence of credit bureaus was found to reduce processing time, costs and defaults for more than 50 percent of the firms (World Bank, 2004).[26] Meanwhile, on the demand side, 40 percent of firms were reported to be able to avail financing in economies with credit bureaus, compared to just 28 percent in countries without one (Love & Mylenko, 2003).[27] Similarly, when credit reports were available and accessible, businesses were found to rely less on internal financing,

[23] Group was defined by the e-CIB as all firms that shared at least one director with each other.
[24] Choudhary, M. A and A.K. Jain (2020). "How Public Information Affects Asymmetrically Informed Lenders: Evidence From a Credit Registry Reform," *Journal of Development Economics*, 143: 102407.
[25] K. Cowan, and J. De Gregario (2003). "Credit Information and Market Performance: The Case of Chile". In M.J. Miller (Eds.) *Credit Reporting Systems and the International Economy*. Massachusetts: MIT Press.
[26] World Bank (2004). *Doing Business in 2005: Removing Obstacles to Growth*. Washington, DC: World Bank.
[27] Love, I. and N. Mylenko (2003). *Credit Reporting and Financing Constraints*. Policy Research Working Paper 3142. Washington, DC: World Bank.

thereby reducing credit constraints (Galindo & Miller, 2001).[28]

In Pakistan, the movable assets' issue is more profound, given that around 70 percent of the country's MSMEs operate in the retail and other services' segments. For these businesses, acquiring immovable assets such as real estate is challenging. Furthermore, given the high level of informality among domestic MSMEs and their limited banking history, loan appraisals in these segments has been a cumbersome process, requiring acquisition and assessment of non-banking and alternate information.[29] On a regulatory level, the only information set available to banks for evaluating any loan-requesting entity has been the state-owned electronic Credit Information Bureau (eCIB) – launched in 1998 and operating under the SBP – and two privately owned bureaus, which maintain a credit database of individuals and businesses. But despite a periodic improvement in their performances, the coverage of these bureaus has remained minimal; the bureaus maintained data of only 10-20 percent of the borrowers and very few SMEs (requiring loans smaller than Rs 6 million).[30]

This low coverage is primarily because of the generally weak state of financial inclusion and also because these bureaus did not collect information from the telecom and utility companies, which could substantially contribute to building a credit history for MSMEs. Furthermore, Pakistan has a sizable credit registry only in the public domain (the SBP's eCIB); the main goal of such public registries is generally to support the regulation and supervision of the overall banking system. As such, they are geared for use by regulators like central banks, and do not cater to the needs of the commercial banks.

For example, just 14 percent of the public credit registries offered services like credit scoring, compared to 90 percent of private bureaus.[31] According to the Doing Business indicators 2020, registries and bureaus in a number of economies that collected third-party data (such as information from retailers and utility providers) were able to achieve an average coverage ratio (as percent of adults) of 67 percent. Therefore, the delayed focus on officially recognizing and licensing private credit registries proved costly for the country. Most of other regional economies, meanwhile, started to or expanded focus on this front after the Asian Financial Crisis (Hong Kong, Malaysia, Vietnam),[32] and/or the rapid credit expansion in the early 2000s (Singapore, India, Thailand, South Korea).[33] Pakistan, however, lags behind other countries in terms of credit coverage and strength of legal rights, despite showing progress on the depth of credit information collection (**Table 7.1**).

Furthermore, even in sectors where the provision of collateral should have helped allay banks' concerns, weak implementation of foreclosure laws kept lending suppressed. This particularly affected mortgages, which

[28] Galindo, A., and M. Miller (2001). *Can Credit Registries Reduce Credit Constraints? Empirical Evidence on the Role of Credit Registries in Firm Investment Decisions*. In Inter-American Development Bank Seminar, "Towards Competitiveness: The Institutional Path". Santiago: Inter-American Development Bank.

[29] For instance, a 2014 trader-agent intermediation lending (TRAIL) case study conducted by the SBP found that on average it took about 17 working days for a bank to finalize a loan. In addition, interactions with the treasury and revenue departments added 7 more working days to the process. Finally, delays due to factors such as weekends, law and order situation, and inadequate availability of public transport for growers, resulted in a single transaction needing 52 working days in total for completion. Reference: Baluch K. A., and M.A. Choudhary (2014), *Agent Intermediated Lending: The Matiari Case Study*. Occasional Research Papers. Karachi: State Bank of Pakistan.

[30] Nenova, T., C. Thioro Niang, and A. Ahmad (2009). *Bringing Finance to Pakistan's Poor: A Study on Access to Finance for the Underserved and Small Enterprises*. Report No. 48672. Washington, DC: World Bank.

[31] World Bank (2004). Doing Business in 2005: Removing Obstacles to Growth. Washington, DC: World Bank.

[32] Chakravarti, R., Chea, B. H., Citibank, N. A., & Bank, A. P. C. (2005). *The Evolution of Credit Bureaus in Asia-Pacific*. New York: Citi Bank, N.A.

[33] Federal Reserve Bank of San Francisco (2011). *Asia Focus: Credit bureaus in Asia*. Asia Focus Newsletter Oct 2011 Issue. San Francisco: Federal Reserve Bank of San Francisco.

Ease of Getting Credit - A Comparison* **Table 7.1**

Strength of Legal Rights (0-12)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Egypt	3	3	3	3	2	2	2	2	2	5	5
India	8	8	8	8	6	6	6	6	8	9	9
Indonesia	5	5	5	5	4	4	5	6	6	6	6
Malaysia	10	10	10	10	7	7	7	7	7	7	7
Pakistan	**5**	**5**	**5**	**5**	**2**	**2**	**2**	**2**	**2**	**2**	**2**
Philippines	4	4	4	4	1	1	1	1	1	1	1
Sri Lanka	4	4	4	5	2	2	2	2	2	2	2
Thailand	5	5	5	5	3	3	3	3	7	7	7
Vietnam	7	7	7	7	7	7	7	7	8	8	8
Depth of Credit Information Index (0-8)											
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Egypt	6	6	6	6	8	8	8	8	8	8	8
India	5	5	5	5	7	7	7	7	7	7	7
Indonesia	5	5	5	5	6	6	6	6	7	8	8
Malaysia	6	6	6	6	7	7	7	8	8	8	8
Pakistan	**2**	**2**	**2**	**2**	**3**	**3**	**3**	**7**	**7**	**7**	**7**
Philippines	0	0	0	4	6	6	6	7	7	7	7
Sri Lanka	5	5	5	5	6	6	6	6	6	6	6
Thailand	5	5	5	5	6	6	6	7	7	7	7
Vietnam	4	4	4	4	6	6	7	7	7	7	8
Coverage of Credit Bureau/Registry (percent of adults)**											
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Egypt	8	10	14	16	20	22	21	22	25	27	31
India	10	10	15	15	20	22	22	21	44	56	63
Indonesia	22	25	32	36	41	46	49	52	55	58	40
Malaysia	82	100	83	82	77	79	77	76	83	87	89
Pakistan	**6**	**6**	**7**	**7**	**8**	**7**	**7**	**9**	**10**	**11**	**12**
Philippines	1	1	1	7	7	7	8	10	11	12	14
Sri Lanka	14	19	29	34	39	45	50	57	35	47	49
Thailand	33	36	42	44	49	53	60	53	57	60	57
Vietnam	19	26	30	38	39	42	42	42	51	55	59

*Change in methodology from 2015 onwards; 2010-13 figures based on old methodology. Lighter shade represents lower scores and darker shade denote higher scores (higher is better).
** Higher of either bureau or registry coverage is taken

Source: Doing Business Indicators, World Bank

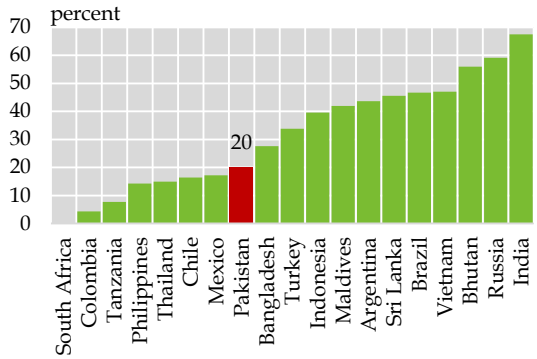
constitute the bulk of lending to households in developed and EMDEs alike (more on this later). Furthermore, recovery of bad loans has historically been an arduous, time consuming, and costly task in the country. As for loan write-offs, despite being permissible on regulatory grounds, implementation issues have held back commercial banks from cleaning up the accumulated bad loans from their books.

c. State intervention is still common in other emerging markets and may explain some of the cross-country differences in credit penetration

Importantly, the combination of these supply-side issues – large information asymmetries and banks' constraints with respect to write-offs and foreclosures – has a strong tendency to exacerbate pro-cyclical elements in private credit growth. This means that the prospects for using bank credit to stimulate growth in times of downturn or a crisis are fairly limited. In this context, it is important to note that in many EMDEs, the state is still engaged in rolling out counter-cyclical policies through selected institutions, and it also actively pursues a development finance agenda.

Following the liberalization and deregulation process starting in the late 1980s, the share of

Share of State-Owned Banks in Overall Banking Assets **Figure 7.9**



Source: Bank Regulation and Supervision Survey 2019 Database, World Bank; Figure are for 2016

state-owned banks relative to the total assets of the banking system in the world has fallen to only 14 percent in 2016, from an average of 67 percent in 1970.[34] However, some countries, such as China, India, Russia, Vietnam and Brazil, chose to retain state control on around half of the banking system's assets (**Figure 7.9**). The presence of state-owned banks in Argentina, Indonesia, Sri Lanka, and Turkey is also prominent, with shares ranging between 30 to 50 percent of banking assets.

In contrast, Pakistan chose to significantly reduce the state's role in the banking system, along the lines of most East Asian, European and Central Asian countries.[35] Compared to 90 percent in 1990, the share of state-owned banks has been reduced to only 20 percent by 2020.

The reason why some EMs continued with a large share of state-owned banks is because these institutions fulfill development roles by compensating for market imperfections, especially by providing long-term credit, infrastructure finance, and access to finance for underserved sectors like SMEs and agriculture. Furthermore, empirical evidence suggests a low responsiveness of lending operations of state-owned commercial banks to economic fluctuations (Duprey, 2015).[36] Lending by state banks is less pro-cyclical than that by private banks – especially if the bank operates in a country that ranks high in the scale of governance (Bertay et al, 2015).[37] Nonetheless, governance issues and political interventions in state-owned institutions often lead to resource misallocation and inefficiencies, and this pushed many countries (including Pakistan) towards private ownership.[38] Past experiences of many developing economies also suggest that "cronyism in lending may build up large fiscal liabilities and threaten public sector solvency and financial stability, as well as misallocate resources and retard development in the long run".[39] Pakistan's experience was no different.[40]

In terms of development finance also, while Pakistan withdrew from the use of directed credit in the post-reform period, this practice remained in place in a number of Asian countries. For instance, banks in India are directed to lend no less than 40 percent of their total loan portfolio to the so-called priority

[34] Cihak, M. and A. Demirgüç-Kunt (2013). *Rethinking the State's Role in Finance*. Policy Research Working Paper 6400. Washington, DC: World Bank.
[35] The share of state-owned banks reduced from 23 and 48 percent in 1994 in East Asia and Europe and Central Asia respectively, to 13 and 14 percent in 2010 [Cull, R., M.S.M. Peria, and J. Verrier (2018). *Bank ownership: Trends and implications*. Policy Research Working Paper. Washington, DC: World Bank.]
[36] Duprey, T. (2015). "Do Publicly Owned Banks Lend Against the Wind?" I*nternational Journal of Central Banking*, 11: 65-112.
[37] Bertay, A. C., A. Demirgüç-Kunt, and H. Huizinga (2015). "Bank Ownership and Credit Over the Business Cycle: Is Lending by State Banks Less Procyclical?" *Journal of Banking and Finance*, 50: 326-339.
[38] Cull, R., M.S.M. Peria, and J. Verrier (2018). *Bank Ownership: Trends and Implications*. Policy Research Working Paper 8297. Washington, DC: World Bank.
[39] Reference: same as in footnote 34.
[40] As noted in the State Bank of Pakistan (2002), "the state-owned banks were finding it difficult to maintain their market shares in terms of assets, deposits, advances and investment. In addition, political intervention, over-staffing, over-branching and inefficiencies in this group had led to the problems of large non-performing loans, high administrative expenses, huge losses, and eroding capital base."

sectors.[41] In Brazil, the earmarked lending constitutes nearly half of the overall bank credit;[42] importantly, banks are required to direct 65 percent of the liquidity from savings accounts for housing finance – of this, 80 percent of loan value is at subsidized interest rates. Similarly, in Indonesia, at least 20 percent of banks' total credit portfolio must be allocated to SMEs. In Thailand, banks' allocation of credit to SMEs must equal at least 20 percent of their deposits. In Philippines, lending to SMEs must constitute at least 8 percent of the lending portfolio.

There remains a debatable element to the efficacy of such approaches: even among countries that have achieved economic growth in the presence of directed credit, there is some resistance to the idea of forced lending. India is a classic example of this phenomenon. Priority sector lending (PSL) was a key element of the country's financial reforms during the 1990s, and continues – with some modifications – even today. Yet, despite the fact that GDP growth in India averaged around 6.3 percent in the 28 years from 1991-2019, the PSL element has been criticized on the grounds that the country's performance could have been even better in its absence.[43] Similarly, weaknesses in Vietnam's financial sector are also seen to be emerging from excessive state interventions in banks' credit and investment decisions.[44]

The only kind of interventions Pakistan has seen over the last decade included: i) the SBP's concessionary refinance facilities to exporters and export-oriented investment projects, SMEs and special segments (such as women entrepreneurs and special persons); ii) managing donor-funded risk-sharing financing scheme & establishing the first credit guarantee company (the Pakistan Credit Guarantee Company Limited); iii) indicative targets for SME financing to commercial banks and DFIs by the SBP; and iv) enhancing banks' capacity and creating financial sector awareness among SMEs. The results have been mixed so far.

For instance, the SBP has launched various refinance facilities, along with risk coverage, in the past and assigned institution-wise financing targets, to address the financing constraints of the SME sector. Though the above-mentioned efforts have brought improvement in the banks' SME financing portfolios, a large number of SMEs remained financially excluded. Then in 2017, the SBP launched a comprehensive policy for the promotion of SME finance based on a holistic strategy, ranging from simplified procedures to regulatory framework and from capacity

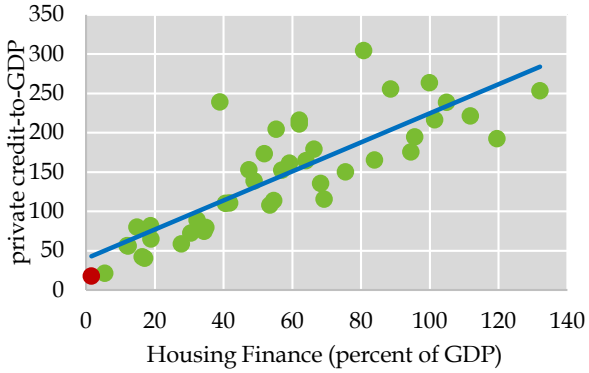
[41] This requirement is in place since 1980, when commercial banks were advised to raise the proportion of their advances to priority sectors to 40 percent of aggregate bank advances by March 1985. These priority sectors included agriculture, micro and small enterprises, education, microcredit, housing, export credit to certain sectors, etc. Since then, there have been several changes in the scope of priority sector lending and the targets and sub-targets applicable to various bank groups (source: Reserve Bank of India.

[42] The Brazilian government intervenes in the credit market through government-owned banks and earmarked loans. Firms may receive earmarked loans through programs designed to stimulate investment, exports or agriculture, among others. These loans are either directly granted by the government-owned banks or channeled via private banks. Interest rates charged on these loans are regulated and are substantially lower than those charged in the non-regulated loans market. [Bonomo, M., and B. Martins. (2016). *The Impact of Government-Driven Loans in the Monetary Transmission Mechanism: What Can We Learn From Firm-Level Data?* Working Paper 419. Brazilia: Banco Central do Brasil.

[43] It is contended that PSL in India had a negligible impact on production, and can be likened to a transfer program for agriculture and small-scale industry. For details, see J.A. Hansen (2006). "Indonesia and India: Contrasting Approaches to Repression and Liberalization". In G. Caprio, P. Honohan, and J.E. Stiglitz (Eds.). *Financial Liberalization: How Far, How Fast?* Cambridge: Cambridge University Press. Moreover, in the absence of forced lending, these funds might have been channeled more optimally to productive firms in the corporate sector, resulting in more output, job creation, and potentially higher tax revenues, which could address the government's welfare objectives better than directed credit schemes. For details, see Farrell, D., S. Lund, E. Greenberg, J. Rosenfeld, and F. Morin. (2006). *Accelerating India's Growth through Financial Sector Reform*. San Francisco: McKinsey Global Institute.

[44] Source: World Bank (2014). *Financial Sector Assessment: Vietnam*. Washington, DC: World Bank.

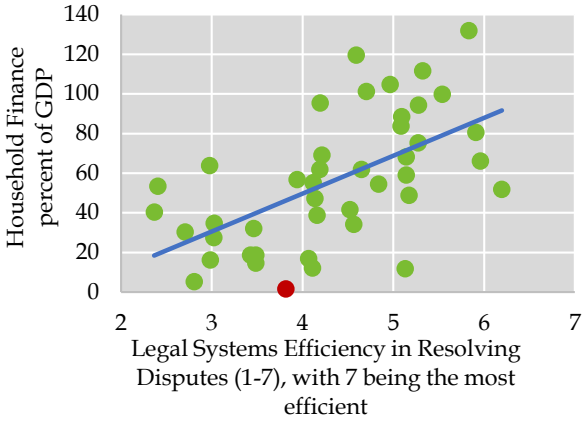
Relationship between Household Loans and Private Sector Credit (2019) **Figure 7.10a**



Note: Based on information of 43 AEs and EMDEs. Red dot denotes Pakistan

Source: BIS; SBP; WEF Competitiveness Report

Relationship between Household Finance and Dispute Resolution **Figure 7.10b**



building to handholding. The target was to increase SMEs' share in total private sector credit from 8 percent to 17 percent by 2020, and increase number of borrowers from then-174,000 to 500,000. As it turned out, the policy fell short of achieving its desired objectives. In case of export refinance facilities, however, the SBP's interventions have been effective. For instance, nearly half of the working capital activity in textiles in FY19 and FY20 was funded from the SBP's Export Finance Scheme (EFS).

d. Challenging dynamics in low cost housing and household finance

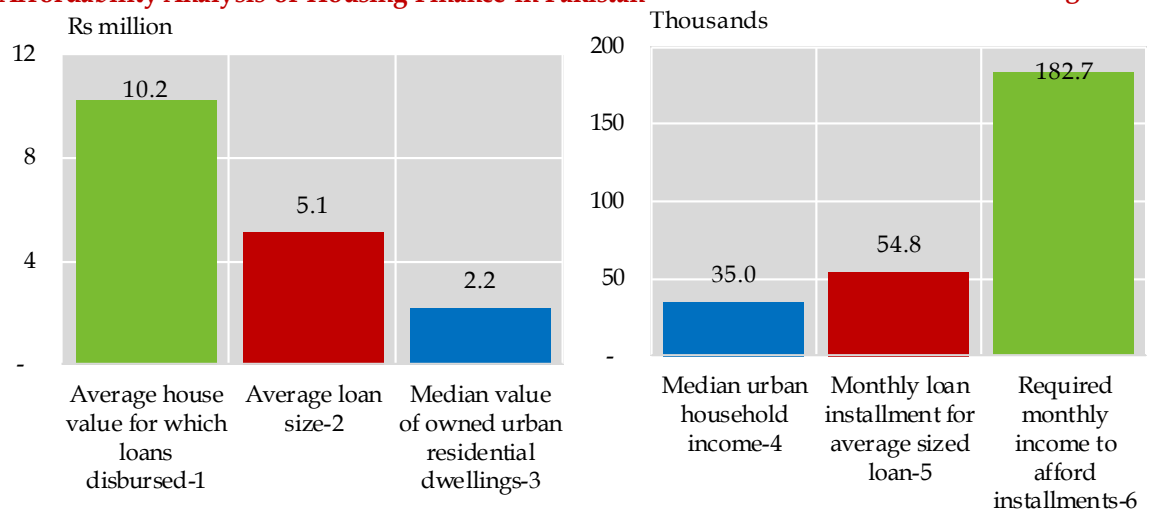
An important characteristic of countries with high credit penetration is the access of households to bank credit (**Figure 7.10a**). Mortgages, in particular, hold a dominant portion of overall private credit in a number of Asian countries like South Korea, Singapore, and Malaysia, where the overall housing finance ranges between 50 percent and 70 percent of GDP. Banks in the BRICS countries also have large household credit portfolios,

where this ratio lies within the range of 12 percent to 55 percent. In Pakistan, however, banks are confronted by various operational hurdles relating to recoveries. **Figure 7.10b** shows that not only is the level of household finance in Pakistan negligible, it is also lower than what should be expected given the current level of dispute settlement efficiency of the country's legal system (in the figure, this is represented by the vertical distance of Pakistan from the linear trend). Broadly speaking, there are four main reasons why housing finance growth has been sluggish in Pakistan.

The first pertains to land entitlement and registry. Land titling and registration can stimulate finance in two ways. First, it can lower search, transaction, and transfer costs of property by reducing processing time and standardizing procedures. Second, it can provide crucial information for third parties – commercial banks – about the ownership status, history and valuation.[45] This would lower risks for banks, thereby incentivizing them to expand credit supply using such properties as collateral. In Pakistan, land registration reforms were not focused upon adequately until very recently. The traditional way of land administration involved a lot of paperwork, significant bureaucratic bottlenecks, multiplicities of operations, and suboptimal awareness, transparency, and access. This discouraged banks from venturing into mortgage finance, and the usage of property as collateral for other types of loans for households and firms.

[45] Deininger, K, and A. Goyal (2010). *Going Digital: Credit Effects of Land Registry Computerization in India*. Policy Research Working Paper 5244. Washington, DC: World Bank.

Affordability Analysis of Housing Finance in Pakistan **Figure 7.11**



Source: 1 and 2: Based on average LTV ratio and average loan size from SBP Housing Finance Review Jul-Sep 2016

3 and 4: HIES 2018-19, PBS

5: authors' calculations based on LTV ratio of 50 percent, weighted average markup rate of 10 percent, and average maturity period of 15 years (figures rounded); data from SBP Housing Finance Review Jul-Sep 2016

6: Assuming 30 percent of household income as housing expediture criteria as used in the March 8, 2018 official document of the Pakistan Housing Finance Project, World Bank

Second, apart from the absence of concrete know-your-customer requirements, the real estate sector has been characterized by weak regulatory oversight and very low official valuation rates of land and property. This essentially presented a legal avenue for under-documenting transactions, benefiting those looking to conceal their wealth and reduce their tax liabilities. Resultantly, the sector has been attracting significant amounts of speculative and/or under-disclosed investments, which, in turn, have contributed sizably to escalating property prices. Importantly, a noticeable amount of sales activity took place in plots, without corresponding activity in real estate development.[46] These factors played a substantial role in widening the housing backlog in the country, and crowding out genuine buyers from the property market. This means that even if such families were able to afford mortgage financing, adequate housing remained out of their reach.

This situation is exacerbated by the low-income levels of the majority of the households in Pakistan. According to the Household Integrated Economic Survey (HIES), the median household income is Rs 56,000. Within the existing mortgage portfolio of commercial banks (excluding DFIs), the average loan size is Rs 5.1 million, with the loan-to-value ratio of almost 50 percent. Assuming a 15-year maturity period, this roughly implies that the required monthly income to afford mortgage installments is over 3 times the average household income (**Figure 7.11**). In other words, those seeking to avail housing finance must have substantial existing savings for down payment, and they must also be able to meet the relatively high monthly payments.

Third, interest from the private sector builders and developers has been disproportionate and limited. Initially, the federal and provincial governments and urban development authorities were the main players in the urban

[46] Since June 2011, from where any estimates of property prices are available, plot prices in Pakistan nearly tripled till June 2018, whereas house prices grew by 139 percent during the same period. For details, see Special Section 1: Real Estate - Implementing the Announced Reforms, in the SBP's First Quarterly Report on the State of Pakistan's Economy for FY19.

housing market. However, the situation changed dramatically during the past two decades, with numerous private sector players coming into the market and creating residential housing schemes in major urban areas. This was due to repeated introduction of incentives from the government to help address the growing housing shortage. These incentives included tax leniency, building code relaxations, processing expediency, subsidized land, etc.

However, the private sector schemes were not able to effectively serve their original purpose. This is because builders and developers, seeking high profits and aiming to avoid challenges associated with providing low-cost housing, mainly set up housing projects targeted at high and upper-middle income households of the country. Furthermore, due to changes in government regimes, the announced incentive packages also lost support and faded into the background. Resultantly, such schemes had the opposite impact, where they increased speculative interest in the market, raised property prices, and further deepened the housing backlog in the country.[47]

Fourth, banks often shy away from lending to households due to a lack of effective legal framework. Recovery, foreclosure and eviction laws are clearly laid out in the 2001 Financial Institutions (Recovery of Finances) Ordinance (section 15[2] and 15[4]), with the law empowering lending institutions to foreclose a mortgage property in the event of a default without recourse to the courts. However, courts' stay order on Section 15 has been one of the biggest bottlenecks impeding the growth of housing finance in Pakistan.

The SBP, in consultation with relevant stakeholders, has proposed amendments in the FIRO 2001. The SBP also facilitated the government in the drafting of rules as required under the amended act. The rules were notified by the federal government in July 2018, and they have been submitted to the court in compliance with its orders. In its final judgment in March 2020, the Lahore High Court did not hold Section 15 as unconstitutional. In October 2020, the Supreme Court also dismissed an appeal against this decision. Going forward, these developments should help allay banks' concerns while extending mortgages.

e. Incomplete fiscal and debt market reforms

In the pre-reform period, high SLR requirements, direct monetary controls, administered interest rates and the establishment of the NCCC were aimed at directly controlling the flow of bank credit to the private sector, and simultaneously fulfilling the government's budgetary borrowing requirement from banks. Thus, it was expected that by doing away with these repressive measures, banks would not be 'forced' to lend to the government, and instead would deploy their funds in the private sector.[48] Up until 2008, it appeared that these expectations were not entirely misplaced, as banks' investment in government papers was contained to some extent. However, it appears that more than anything else, this improvement stemmed from low fiscal deficits that the government incurred owing to higher receipt of non-tax revenues as well as privatization proceeds during this period. This argument gets support from the fact that as soon as the fiscal deficits began to increase again from FY08 onwards, banks' claims on the government also took a steep turn, and by end-2019, reached an all-time high (**Figure 7.12a**).

However, cross-country examination reveals that high fiscal deficits and higher allocation of bank liquidity for budgetary lending cannot entirely explain such a low private credit to GDP ratio. For instance, India, Sri Lanka, Egypt, Turkey and Malaysia ran persistently

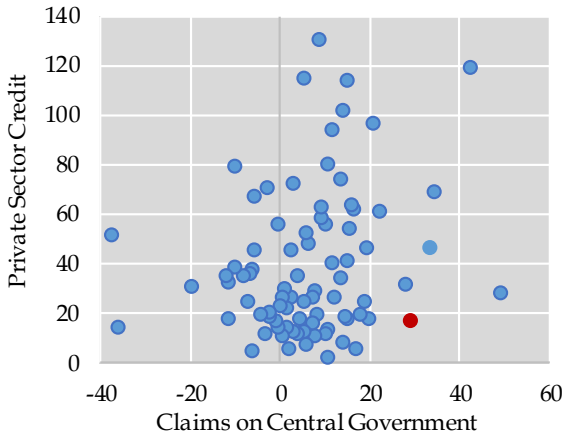
[47] UN Habitat (2018). "Housing in Pakistani Cities". In *The State of Pakistani Cities 2018.* Islamabad: United Nations Habitat (pp. 59-68).

[48] The required SLR was gradually reduced from 45 percent to 35 percent in October 1993, and further to 25 percent in May 1994. In May 1997, this ratio was further brought down to 20 percent, and to 15 percent in June 1998.

Claims on Central Government in Pakistan **Figure 7.12a**

Source: World Bank

Relationship between PSC and Claims on Government in EMDEs **Figure 7.12b**



Red dot denotes Pakistan

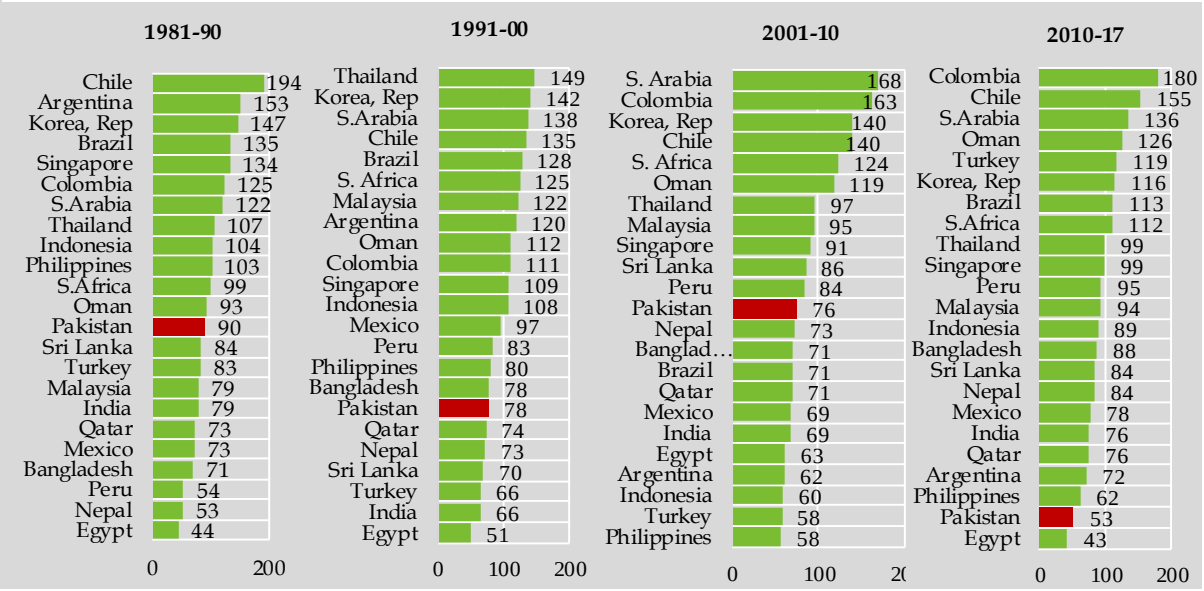
high fiscal deficits over the past 15 years, yet their credit growth through all these years was also substantially higher than Pakistan. More importantly, India, Egypt and Brazil even have a higher level of bank claims on government; still, their banks managed to contribute meaningfully to private sector growth, especially when compared to Pakistan (**Figure 7.12b**). While these comparisons are illustrative from a cross-country perspectives, they do not necessarily imply that private sector credit is not being crowded out in these economies. For example, Bouis (2019), in a multivariate analysis using data from 88 EMDEs, found that "higher banks' holdings of government debt are associated with a lower credit growth to the private sector and with a higher return on assets of the banking sector."

Furthermore, the study found that this negative relationship indicated the inclination of banks to rebalance portfolios towards safer assets during stress times.[49] Similar results are found in IMF (2015),[50] Altavilla et al. (2016),[51] and Bahal et al. (2015).[52] For Pakistan, the size of the banking industry and the depth in the domestic debt market appear to be important determinants of the extent of the fallout of fiscal borrowings on private credit. However, a crucial factor is the relationship between the share of government in banks' asset portfolio and the banking spread in the economy.

As mentioned before, the risk aversion of banks increased during the post-GFC period in Pakistan, as default rates of small businesses rose and the borrowing appetite of the government grew. By 2011, the government had become the dominant borrower of the banking system, and its share has continually risen ever since. Importantly, credit spreads in the country moved in the

[49] Bouis, R. (2019). *Banks' Holdings of Government Securities and Credit to the Private Sector in Emerging Market and Developing Economies*. Working Paper No. 19/224. Washington, DC: International Monetary Fund.
[50] IMF (2015). Arab Republic of Egypt, Staff Report for the 2014 Article IV Consultation, Country Report 15/33. Washington, DC: International Monetary Fund. The Fund noted that "low credit reflects crowding out from public sector borrowing, which pushes interest rates up and reduces incentives to lend to the private sector."
[51] Altavilla, C., M. Pagano, and S. Simonelli (2017). "Bank Exposures and Sovereign Stress Transmission," *Review of Finance*, 21(6): 2103-2139. Authors note that banks increase holdings of government securities during periods of high non-performing loans.
[52] Bahal, G., M. Raissi, and V. Tulin (2018). "Crowding-out or crowding-in? Public and private investment in India," *World Development*, 109: 323-333. The authors note that "… public investment 'crowded out' private investment in India over the period 1950-2012. In contrast, we found support for crowding in of private investment over the more recent period of 1980-2012. This change in the relationship can be attributed to the policy reforms which started during early 1980s and gained momentum after the 1991 Indian balance of payments crisis."

Bank Credit to Bank Deposit Ratio - A Comparison **Figure 7.13**



Source: Global Financial Development Data, IMF

same direction, and an increase in lending to the government was found to be positively correlated with higher spreads for new loans, thus leading to a decrease in private sector investment activities. As Choudhary et al. (2016) put it, this scenario becomes more likely during a recessionary phase, when the government has limited alternate avenues to raise finance.[53] This also prolongs and deepens the recessionary phase.

Zaheer et al. (2017) found that a one percentage point growth in the government borrowing led to an 8-basis point crowding out of the private sector credit in four months.[54] Controlling for a number of demand- and supply-side variables, including the policy rate and total deposits net of banks' balances with the SBP, the study regressed growth in private sector credit on the government's budgetary borrowing growth. The results showed that there was no significant difference in the relationship between the two variables before and after the implementation of the interest rate corridor.

This suggests that even though the thin deposit base of domestic banks contributed to weak level of private credit in Pakistan, its increased allocation towards government papers was crucial to further suppressing lending to the private sector. As shown in **Figure 7.13**, the bank credit to bank deposit ratio in Pakistan during 2011-17 stood at 53 percent, much lower than that in other regional and peer EMDEs. Importantly, the private credit penetration also significantly dipped during the post-GFC period. Here, it is important to acknowledge that the overall suppressed economic activity might have reduced the capex-related credit demand. However, it is noticeable that working capital finance did not increase either during the period, even though the commodity prices were on a rising trend after the Arab Spring, and businesses needed funding to support their day-to-day operations because of muted domestic and international demand. Furthermore, the opportunity cost of focusing less on the private credit front also proved negligible for the commercial banks, as evidenced by the fact that their assets

[53] Choudhary, M. A., S. Khan, F. Pasha, and M. Rehman (2016). "The Dominant Borrower Syndrome," *Applied Economics, 48(49): 4773-4782.*

[54] Zaheer, S., F. Khaliq, and M. Rafiq (2017). *Does Government Borrowing Crowd Out Private Sector Credit in Pakistan*. SBP Working Paper 83. Karachi: State Bank of Pakistan.

expanded by a CAGR of 13.3 percent, while their profit after taxes rose by a CAGR of 21.0 percent during CY09-13.[55] Thus, a more subtle impact of the government's funding appetite has been the lack of concentrated efforts by banks to venture into the underserved segments of the economy, including SMEs, agriculture and households, in the presence of credit market failures.

7.4 Recent Policy Interventions to Increase Credit Expansion in Pakistan

After putting Pakistan's current credit penetration in historical and cross-country contexts, we shift towards the way forward for the economy to enhance financial inclusion and credit expansion. Three elements hold the potential to change the landscape substantially: (i) the renewed emphasis on house financing by both the government and the SBP; (ii) the introduction of a secured transaction registry and private credit bureaus; and (iii) progress in digital payments and finance in the county.

a. Policymakers have started to actively focus on the housing sector

There has been renewed interest in the housing segment by government authorities in Pakistan, and progress is visible on all the four dimestions highlighted in the previous section (**Figure 7.14)**. Take the land entitlement and registration issue, for example. First, the FBR has increased the valuation rates in the country (by as much as 100 percent in some urban areas), to bring them closer to the market rates.

Second, there is an extensive focus on digitization of land records, especially in Punjab and Sindh, which will help on the data front. Within the first five years of introducing the Land Records Management and Information System (LRMIS) in Punjab, 10 million pages of old records were scanned, land records for over 55 million landowners were digitized, and land title information was digitized and uploaded online for easy access.[56] Resultantly, the time needed to complete a transaction significantly decreased from 2 months to just 50 minutes. In Sindh, under the Computerization & Establishment of Land Administration & Revenue

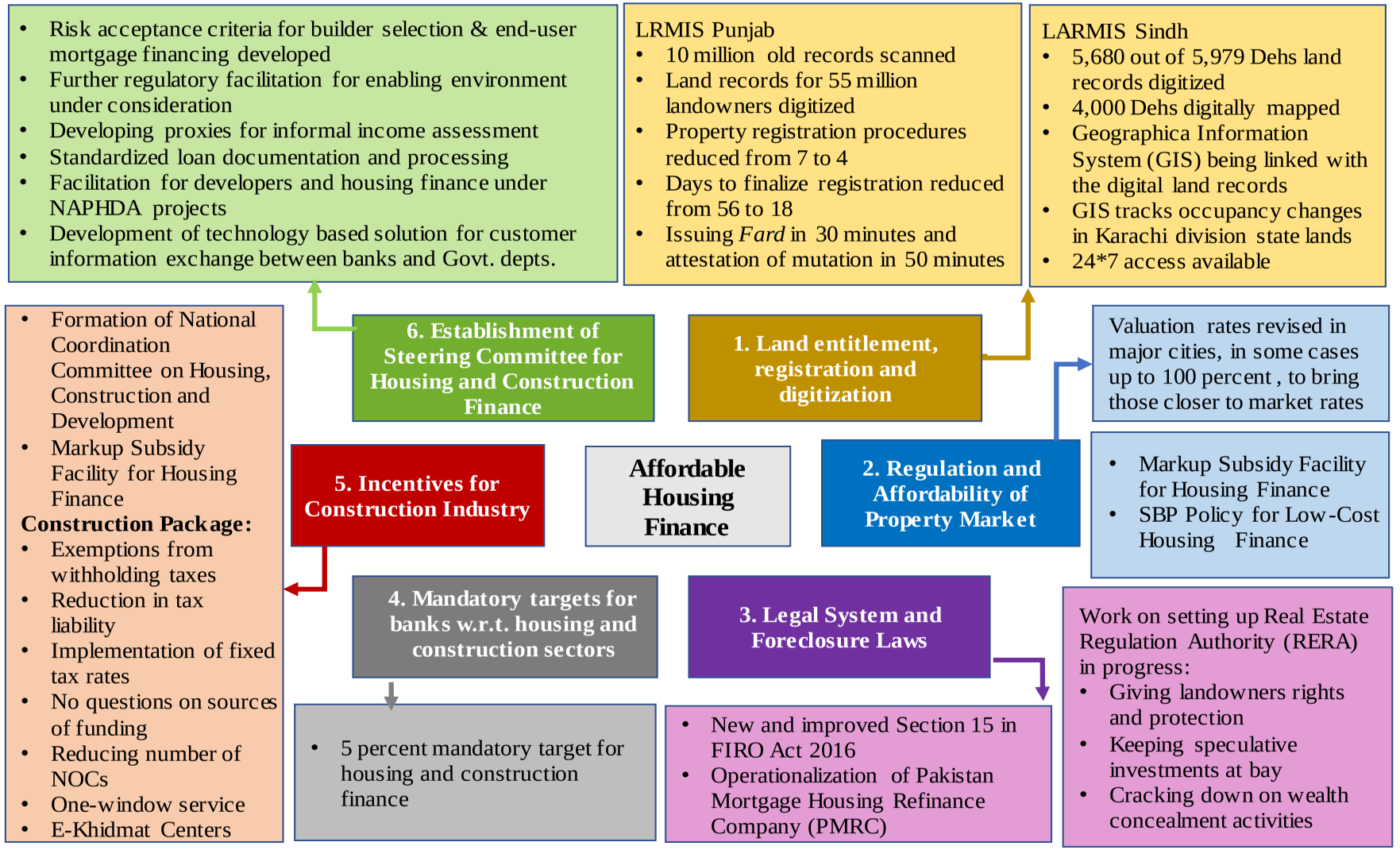
Management Information System (LARMIS), the record of 5,680 out of 5,979 Dehs has been computerized. Meanwhile, the development of the Geographical Information System (GIS) is also underway. So far, the mapping of 4,000 out of 5,979 Dehs has been completed, while progress on the remaining is underway. The digital maps are also being integrated with the computerized land records.[57] Both the increase in valuation rates and the digitization of land records are expected to reduce speculative buying and wealth concentration in the sector.

To tackle the issues on the affordability front, the government announced the Naya Pakistan Housing Project (NPHP) on October 10, 2018, aiming to establish 5 million dwelling units across the country to cater to the needs of the lower-income class. Moreover, the SBP has introduced a comprehensive policy package for low-cost housing finance – comprising a refinance facility for low-cost housing for special segments, regulatory relaxations to banks, and mandatory housing finance targets. Specifically, the SBP has assigned commercial banks mandatory targets to increase housing and construction financing to at least 5 percent of their private loan portfolios by December 2021 (**Figure 7.15**). As an incentive, from end-June 2020 onwards, the CRR requirement for complying banks in a quarter would be lowered by an amount equal to the increase in their housing and construction finance in the previous quarter.[58] Conversely, the banks

[55] Data source: Financial Soundness Indicators, SBP.
[56] https://pitb.gov.pk/lrmis_becomes_a_remarkable_success_story
[57] https://bor.sindh.gov.pk/land-administration-revenue-management-information-system-larmis
[58] This incentive, however, will be subject to a ceiling of 1 percent of the total demand and time liabilities based on which the CRR is calculated. Further, the banks will continue to maintain daily minimum CRR, which currently stands at 3 percent (source: https://www.sbp.org.pk/dmmd/2020/CL3.htm).

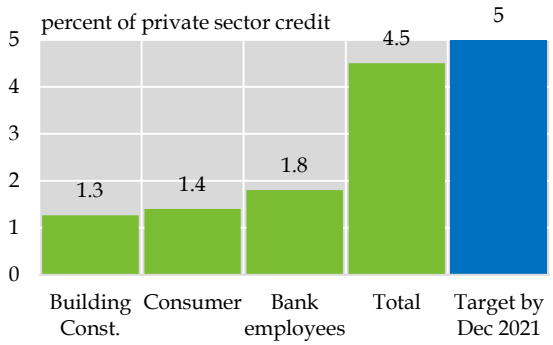
The Six-Pronged Strategy to Create an Enabling Environment for Affordable Housing Finance in Pakistan

Figure 7.14



Source: Board of Revenues Sindh and Punjab; Punjab Information Technology Board; Ministry of Finance; Office of the Prime Minister's website; Federal Board of Revenue; Naya Pakistan Housing Program; World Bank; State Bank of Pakistan;

Construction Loans in Pakistan - FY16-20 Average and New Minimum Target **Figure 7.15**



Source: State Bank of Pakistan

falling short of the quarterly financing target would be penalized by the requirement of maintaining additional CRR equal to the deficit from the target.

Furthermore, to improve access for genuine buyers, the government recently announced a Rs 30 million subsidy to finance the down payment of the first 100,000 houses under the NPHP. The end-user interest rate for 5 marla units would be 5 percent for the first five years and 7 percent for the next five years, while that for 10 marla units would be 7 percent and 9 percent respectively.[59] The scheme would also benefit from the aforementioned measures (such as automation and computerization of land and property records for facilitation of clean title for bank lending), as well as other in-process reforms, like the reduction in time taken for the registration of title & creation/perfection of mortgages, creation of a Real Estate Regulatory Authority (RERA) to address banks' concerns over adequate standards for developers and builders, and reduction in transaction costs for property transfers.

The government is also providing incentives to builders and developers to participate in the low-cost housing initiatives. Under the recently announced construction package, builders and developers would be given exemptions from withholding taxes on various inputs, reduction in tax liability, and implementation of fixed taxation rates; there would also be no question on the source of funds being invested in the development projects given that such projects are approved by end-December, 2020. The government authorities are also in regular consultation with the private sector players, conducting weekly meetings to raise awareness, answer questions, and take into consideration demands and issues faced by the builders and developers. A special National Coordination Committee on Housing, Construction and Development has been formed in this regard. Its convener is the chairman of the Naya Pakistan Housing and Development Authority (NPHDA), and members include representatives from the ministries of housing, finance, petroleum, and law and justice, chief secretaries of the provinces, AJK, and Gilgit Baltistan, and the chairman FBR and deputy governor SBP. The SBP has also established a Steering Committee on Housing and Construction Finance. Key responsibilities taken up by the committee include the development of risk acceptance criteria for builder selection and end-user mortgage financing; standardization of loan documentation and processing; and the development of income proxies for informal income assessment of loan applicants.

Further impetus to domestic mortgage financing comes with the operationalization of Pakistan Mortgage Refinancing Company (PMRC). Facilitated by the SBP, the PMRC aims to develop the primary mortgage market by: (i) providing financial resources so that primary mortgage lenders can grant more loans to households at fixed/hybrid rates for longer tenure; (ii) reducing the mismatch between house loan maturities and source of funds; and (iii) ensuring loan standardization across primary lending institutions. Simultaneously, it would also help develop

[59] The subsidy will be given on housing units whose price does not exceed Rs 3.5 million for 3-5 marlas, and Rs 6 million for 10 marlas. Rs 33 billion were allocated for the loan tenor of 10 years, with Rs 4.77 billion to be allocated in the current financial year for the payment of markup this year (source: PR No. 344, Ministry of Finance, dated July 22, 2020, http://www.finance.gov.pk/press_releases.html).

Box 7.3: Successful International Case Studies of Introducing Secured Transaction Reforms (STR)

Mongolia: STRs started in 2013 to help MSMEs improve access to finance. The Mongolian Pledge Notice Registry was launhced in 2017 under the Pledge Law 2017. The law allows enterprises to offer all types of movable and immovable assets as collateral to a financial institution. Of the 30,000 registrations just a quarter after launching, 38 percent covered equipment, 25 percent were related to livestock, 5.4 percent were regarding receivables, and 1.7 percent covered vehicles. Female-led buinesses accounted for almost one-fourth of the registrations.

Ghana: After the introduction of the STRs under the Borrowers and Lenders Law (Act 773, 2008), many MSMEs were able to avail credit facility using movable assets as collateral. A particular feature of the policy was to allow women entrepreneurs to use household assets (kitchen utensils, etc.) and equipment to apply for a business-starting or working capital loan. In the first four years of the launch, total registrations stood at 40,500 - more than five times the initial target. Over 5,000 SMEs and 22,000 micro businesses received loans amounting to more than US$ 3 billion, after registering movable assets as collateral.

Slovakia: The introduction of the Register of Pledges in 2003 by the Slovak Chamber of Notaries, which allowed registrations of movable assets as collaterals, the number of annual entries increased 50 percent on average during the first four years, from 7,508 in 2003 to 31,968 in 2007. The creation of the registry was termed by the World Bank as the main reason for Slovakia's success in the Doing Business rankings, where the eoncomy was the top performer in 2005.

Romania: Romania passed the Title VI legislation on Legal Treatment of Security Interests in Personal Property in May 1999. Among other reforms, it simplified the registration process for secured transactions, and expanded the scope of the kind of assets that could be used as a collateral, including products that could be aquired or manufactured/produced in the future (e.g. year-end crop harvest). From 2000 to 2006, the increase in registrations was around 60 percent per annum, taking the total entries from 65,227 in 2000 to 536,067 in 2006. The STRs also led to the creation of new financing products by the commercial banks, which made access to credit cheaper and efficient.

References:
K. Mathernova (2008). "The Slovak Secured Transactions Reform: Ingredients of a Successful Reform and Reflection on its Achievements" In F. Dahan, and J. Simpson (Eds.). *Secured Transactions Reform and Access to Credit*. London: European Bank for Reconstruction and Development (pp. 207-223).
De La Campa, A., E.T. Wohlers, Y. Baranes, and S. Simavi (2010). *Secured Transactions Systems and Collateral Registries* . Working Paper 112645. Washington, DC: World Bank.
Ouedraogo, A; I. Caruana, E. Rodriguez, and S. Tischendorf (2012). *It Started in Ghana : Implementing Africa's First Collateral Registry*. IFC Smart Lessons Brief. Washington, DC: World Bank.
World Bank (2019). *Secured Transactions, Collateral Registries and Movable Asset-Based Financing*. Knowledge Guide. Washington, DC: World Bank.

the capital markets – by providing more private debt securities (including asset-backed securities) to raise funds – and create a benchmark yield curve.

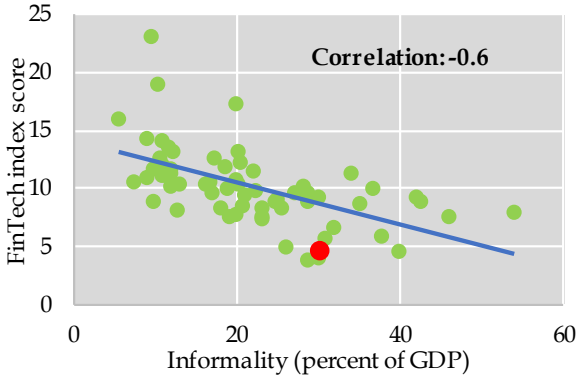
b. The introduction of the Secured Transactions Registry would help address market imperfections, particularly for the under-served segments

As mentioned above, in the absence of adequate information regarding creditworthiness, the already underserved sectors continue to be considered risky and get neglected by the commercial banks. However, there have been some positive developments in this regard as well to correct this trend.

First, the SBP in 2016 issued guidelines and licencing criteria for setting up credit bureaus in Pakistan; these bureaus would function in addition to the SBP's already functional e-CIB. As of July 2020, the SBP has granted licenses to two private sector bureaus, Data Check and AISL. This is expected to bode well for the credit expansion, especially for the under-served segments.

Second, the Financial Institutions (Secured Transactions) Act, 2016, has been enacted "for the promotion and conduct of banking business to provide for the creation of security interests over movable property to secure the obligations owed by a customer to a financial

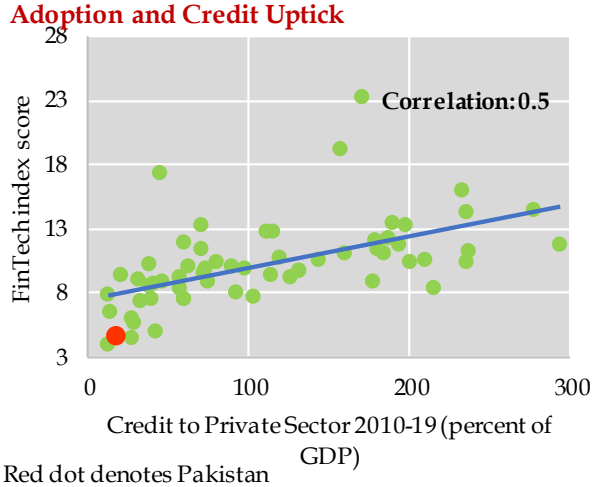
Relationship between FinTech Adoption and Informality **Figure 7.16a**



Red dot denotes Pakistan

Source: The Global FinTech Index 2020, Findexable; Medina and F Schneider, "Shedding light on the shadow economy: a global database and the Interaction with the official one", CESifo Working Papers, no 7981, 2019

Relationship between FinTech Adoption and Credit Uptick **Figure 7.16b**



Red dot denotes Pakistan

Source: The Global FinTech Index 2020, Findexable; World Bank

institution, clarify and expand for the purpose the meaning and scope of movable property, provide for the establishment of a secured transactions registry, define, ammend and codify certain laws relting to security interests over movable property and provide for matters connected therewith or incidental thereto."

Encouragingly, the Secured Transaction Registry (STR) has been operationalized under the Financial Institutions Act for unincorporated entities with the Securities and Exchange Commission of Pakistan (SECP). The registry will record charges/security interests created by entities on their movable assets. This would enable SMEs to aquire loans from the commercial banks using movable assets as collateral. Examples of eligble assets include receivables, intellectual property, inventory, and motor vehicles, etc. The SECP already maintains a security interests database created by companies for moveable and immovable assets under the Companies Act, 2017.

Together, these developments would help address the supply- and demand-side constraints and information gaps in the credit market. According to the 2017 World Bank Doing Business Report, over the past decade, 82 economies around the world reformed their legislation concerning secured transactions, and by mid-2016, 26 economies had operational modern collateral regstries. **Box 7.3** summarises case studies documenting the successful implementation of STRs and credit registries by four economies.

c. Digitization efforts under the National Financial Inclusion Strategy (NFIS) can enhance financial inclusion and credit expansion[60]

Digitization of financial services can provide a big boost to financial inclusion by enhancing the reach of financial services and increasing documentation of economic activities. This can prove particularly useful for the underserved segments of MSMEs and agriculture, where credit worthiness and banking history data is lacking. Indeed, high fintech outreach is negatively associated with the size of the informal economy (**Figure 7.16a**) and positively with the magnitude of private sector credit (**Figure 7.16b**).

However, three elements are important for the success of digital finance: (i) improvement in payment services; (ii) providing an adequate credit infrastructure (discussed above); and (iii) digital connectivity infrastructure.

[60] See **Special Section** in this report for more details.

Box 7.4: Initiatives under the NFIS

The SBP is pursuing financial inclusion as one of its strategic objectives to promote inclusive economic growth in the country. In this regard, it adopted a five-year comprehensive National Financial Inclusion Strategy (NFIS) in 2015, with a target of opening of digital transaction accounts for 50 percent of the adult population by 2020.

The NFIS has made significant developments for creating an enabling legal and regulatory environment for digital financial inclusion by introducing innovative products and services and initiating capacity building and awareness programs. As a result of these initiatives, unique account ownership in Pakistan has reached 66 million accounts, with 60 percent active unique accounts as of December 2019 - surpassing the NFIS' headline target well before the deadline. Some key initiatives taken under the NFIS include:

- Establishment of a public-private coordination mechanism that helped identify key reforms to push forward digital financial inclusion. These included reducing the cost of NADRA services, opening of unstructured supplementary service data (USSD) for financial transactions by the PTA, taxation reforms for Branchless Banking (BB) agents, and promotion of Government-to-Persons payments (cash transfers, salaries and pensions) through bank accounts, etc.
- Regulatory reforms to promote digital financial services, such as the issuance of Mobile Banking Interoperability regulations and revised regulations for Branchless Banking (BB).
- Development of the National Payment Systems Strategy (NPSS), which set a roadmap and listed an action plan for the design of a digital National Payments System that complied with international standards and best practices, and was tailored for the specific needs of a safe, efficient and inclusive national payment system in Pakistan.
- Development of the Asaan Mobile Account (AMA) scheme for interoperability of BB accounts on the USSD channel.
- Establishment of the Digital Financial Services Innovation Challenge Facility (ICF) to support financial service providers, financial technology providers and institutions to develop new or expand existing digital financial products, services and delivery platforms. This will increase financial access for the underprivileged and underserved segments of the population.
- Development of a scheme for the promotion of workers' remittances through mobile wallets ; this was launched by the Prime Minister in December 2017.
- Establishment of the Secured Transactions Law and E-Registry for the promotion of SME Finance.
- Launch of the National Financial Literacy Program (NFLP) to impart basic financial education among youngsters and the low-income segment.

The NFIS was revisited by the current government and prioritized as part of its 100-day agenda to achieve inclusive economic growth. The extended NFIS action plan is to be executed during 2019-23, and has set the vision to achieve inclusive economic growth through enhanced access to finance and deposit base, promotion of SMEs, easy and affordable access to finance to farmers, facilitation in low-cost housing finance, and provision of Shariah-compliant banking solutions.

In this connection, the government has set the following headline targets to be achieved by 2023:

i. Enhance usage of digital payments (65 million active digital transaction accounts, with 20 million accounts being of women);
ii. Increase the deposit base (the deposit to GDP ratio to be enhanced to 55 percent);
iii. Promote SME finance (extend finance to 700,000 SMEs; and SMEs to account for 17 percent of the private sector credit);
iv. Increase agricultural finance (serve 6 million farmers through digitalized solutions; enhance annual disbursement to Rs 1.8 trillion); and
v. Enhance the share of Islamic banking (to 25 percent of the banking industry; and increase branch network of Islamic banks to 30 percent of the banking industry).

Source: Agricultural Credit & Microfinance Department, SBP

Globally, digital payments by households and MSMEs in EMDEs in both volume and value terms have been rising appreciably over the past few years. These include both digital commerce (online shopping transactions paid for by non-cash methods) and Mobile Point of

Sale (MPOS) payments (via mobile wallets). Encouragingly, digital lending to consumers and SMEs has also been rising during the same period, reaching a total value of US$ 224.7 billion and 62.6 million loans across EMDEs.[61]

In Pakistan, the government and the SBP launched the National Financial Inclusion Strategy (NFIS) in 2015, to achieve universal financial inclusion in the country (**Box 7.4**). Although Pakistan was relatively late to the fintech boom and its outreach is modest so far, the potential for enhancing digital finance is sizable. The widespread use of digital payments could result in a 7 percent increase in the country's GDP, create 4 million jobs, mobilize over US$ 250 billion in deposits, and formalize a significant portion of the cash economy.[62]

Two developments bode well in this regard: the take-up of e-commerce, and the increased usage of mobile wallet accounts. E-commerce in Pakistan is consistently rising, with digital payments reaching Rs 93.8 billion by end-FY20. However, a sizable portion of the transactions (an estimated 60 percent in value) are via cash on delivery (COD) basis. A significant strengthening of consumer protection laws and better infrastructure is required for COD's share to fade.[63] On the demand side, mobile internet penetration is also on the lower end in Pakistan as compared to regional economies, with both usage and coverage gaps significantly high: 20 percent of the population is deprived of mobile internet access, while 54 percent has access but does not subscribe to internet service.

Mobile accounts have also risen substantially during the last eight years, with the number of total and active accounts at 52.5 million and 26.7 million, respectively, by end-June 2020. Encouragingly, m-wallets are also being used for payment of e-commerce sales as well as loan disbursements. Retail payments via branchless banking channels more than doubled to Rs 20.1 billion in FY20 from Rs 9.0 billion in FY19. Meanwhile, BB users have also been using this channel for financing services: during FY20, Rs 6.6 billion worth of loan disbursements were carried out.

However, all of these loans were disbursed via the over the counter (OTC) method, and government authorities as well as the m-wallet

operators need to incentivize online financing facilities as well. The government has made digitization a priority focus area, launching the Digital Pakistan Policy in 2018 and the e-commerce policy in 2019. The five focus areas of the policies are access and connectivity, digital infrastructure, e-governance, digital skilling and training, and innovation and entrepreneurship. It is important to reiterate here that the government must focus on digital financial inclusion as an active objective and not as an expected return due to other digitization measures. This is crucial to avoid a repeat of the results following the 1990s reform policies.

7.5 The Way Forward

Theory and empirical evidence, especially over the last two decades, support the notion that the financial sector can play a growth-enhancing role. Harnessing this finance-growth nexus was an aim of Pakistan's financial sector reforms in the 1990s, as leaving the credit allocation to market forces was envisaged to be a better strategy as compared to the directed credit schemes of the pre-reform era. However, while the reforms improved the efficiency and profitability of the banking system, the state of credit remained unsatisfactory – both in terms of its penetration and access.

The institutional infrastructure for project and long-term finance turned particularly unfavorable. This was because the lending

[61] Agur, I., S.M. Peria, and C. Rochon (2020). *Digital Financial Services and the Pandemic: Opportunities and Risks for Emerging and Developing Economies*. Special Series on COVID-19. Washington, DC: International Monetary Fund.
[62] Source: McKinsey (2016). *Digital Finance for All: Powering Inclusive Growth in Emerging Economies*. Report of McKinsey Global Institute.
[63] For details, see Chapter 7 in the SBP's FY18 Annual Report on the State of Pakistan's Economy.

capacity and portfolio management of the commercial banks, who were eventually delegated the responsibility to respond to both short- and long-term financing needs of the private sector, was strictly guided by their commercial concerns, risk appetite, as well as regulatory restrictions under the Basel Accord. As it turned out, large corporates continued to attract their focus, since lending to them drew a lower charge on banks' capital.

This narrow lending strategy was at the expense of agriculture, SME and household sectors, whose risk profile was relatively much weaker, and the loan loss probability higher due to prevalent information gaps and operational constraints that banks faced with respect to loan write-offs and foreclosures. Importantly also, unlike many other emerging markets, state ownership in the banking system as well as directed credit to priority sectors, has substantially declined in Pakistan.

Taken together, the contribution of the banking system to the country's development progress warrants some policy reassessment. In hindsight, one can argue that while banking institutions were prepared to conform to capital standards as laid out under the Basel Accord in terms of their data systems, technology adoption, internal risk assessment frameworks and overall organizational capacity, the economy was probably not.

On empirical grounds, there is only limited evidence on the direct link between capital regulation and economic growth.[64] But as observed in Peek & Rosengren (1995), Albertrazzi & Marchetti (2010), Berger & Udell (1994) and Popov & Udell (2012), sufficient evidence is available that banks' credit supply to the riskiest and most bank-dependent borrowers is most affected by capital regulations – the effect called flight to quality.[65] In the context of Pakistan, and particularly given its unique binding constraints – including low savings, perennial fiscal problems (especially low tax collection), and the level of informality – the required policy emphasis on deepening credit penetration and overall financial inclusion in the economy remained wanting.

Similarly, when it comes to state-driven credit and incentives, it appears that the way forward for Pakistan warrants choosing a clear dynamic path between the market-driven approach and the directed financing schemes, as the country moves along its reforms and development agenda. Here, it is important to highlight that the debate on selecting such a path is not unique to Pakistan. In fact, this debate is one part of the broader rethinking on neoliberalism and development strategies currently underway in both emerging market and advanced economies. Heterodox industrial policies have come back to mainstream economic thinking, as policies spawned by the Washington Consensus have increasingly been criticized for not delivering on the development front[66] – though the success of industrial policies and government interventions in the markets is also not clearly substantiated even in Japan, South Korea and Taiwan, which are cited as success stories. In fact, the global financial crisis of 2008-09 has contributed to a reevaluation of market efficiencies and the role of the government

[64] Martynova, N. (2015). *Effect of Bank Capital Requirements on Economic Growth: A Survey*. Working Paper No. 467, March 2015. Amsterdam: De Nederlandsche Bank.

[65] Popov, A., and G.F. Udell (2012). "Cross-Border Banking, Credit Access, and the Financial Crisis", *Journal of International Economics* 87: 147-161; Peek, J., and E. Rosengren (1995). "Bank Regulation and the Credit Crunch", *Journal of Banking and Finance* 19: 625–638; Albertazzi, U., and D.J. Marchetti (2010). *Credit Supply, Flight to Quality and Evergreening: An Analysis of Bank-Firm Relationships After Lehman*. Temi di Discussione (Working Paper) No. 756. Rome: Banca d'Italia; Berger, A.N., and G.F. Udell (1994). "Did Risk-Based Capital Allocate Bank Credit and Cause a "Credit Crunch" in the United States?, *Journal of Money, Credit and Banking* 26(3): 585-628.

[66] Rodrik, D. (2006). "Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in 1990s: Learning from a Decade of Reforms". *Journal of Economic Literature*. 44(4): 973-987

even in the advanced economies.[67] Meanwhile, the Brookings' report on *Beyond Neoliberalism* (2019) attributes this rethinking to China's successful model of state planning, concentration of corporate power, growing income inequalities, and unsuccessful efforts to avoid economic and financial crises.[68]

In Pakistan's case also, and strictly in the sense of development finance, a clear policy approach is needed. In the past, many incentive schemes (such as credit guarantees) were rolled out to encourage credit flow to SMEs, agriculture and other underserved segments, but their success remained limited. Lately, the government has taken a more holistic approach, and is actively focusing on enhancing financial inclusion under the broader ambit of the National Financial Inclusion Strategy. To ensure an effective implementation of this strategy, the SBP is currently working on more innovative and research-based interventions and incentives on both the demand and supply sides of the credit market. However, two aspects need to be highlighted. First, one lesson that we get from the experience of the Asian economies and other interventionist states is that development finance alone cannot help without the presence of quality institutions and governance framework. Also, for these policies to be effective and successful, the country must pursue sound macroeconomic policies and provide an overall conducive investment environment to businesses. Second, the continuation of such interventionist policies cannot be entrenched – especially at a large scale – given the associated fiscal and quasi-fiscal costs.

Thus, given the unique set of macroeconomic challenges Pakistan is currently facing – especially the size of the population that is currently excluded from financial services – it is important to highlight that policy interventions cannot completely be avoided. But side by side, interventions *alone* must not be viewed as *the* solution for access and outreach problems in the credit market; a clear and coordinated monitoring and evaluation approach should become an integral part of these policies, a consistent progress must be made to address the prevailing demand-side constraints.

Furthermore, the scale and duration of incentive schemes needs to be fine-tuned, as they have a direct bearing on the country's fiscal position. In the meantime, banks must be encouraged to make active use of newly established collateral registry and private credit bureaus to plug information gaps and improve their perception of the risk profile of businesses and households. Then, as the economic reforms agenda progresses, credit infrastructure strengthens and macroeconomic stability takes hold, the credit market will gain considerably on the inclusion front and will attain greater penetration in the economy.

[67] For instance, see J.E. Stiglitz, J.Y. Lin, and E. Patel (2013). "Introduction: The Rejuvenation of Industrial Policy". In J.E. Stiglitz, J.Y. Lin, and E. Patel (Eds.). *The Industrial Policy Revolution I: The Role of Government Beyond Ideology*. Basingstoke: Palgrave Macmillan (pp. 1-15).

[68] Gertz, G., and H. Kharas (2019). *Beyond Neoliberalism. Insights from Emerging Markets*. Washington, DC: Brookings Institute.

Special Section

Covid-19 and the Need to Boost Digital Connectivity in Pakistan

Growing availability of and access to ICT services over the past two decades has brought a structural shift in business operations and activities across the world. In Pakistan too, recent developments in the digital ecosystem have been impressive. During the Covid-19 crisis, the importance of digitization became more prominent; from cash transfers to telehealth, and e-learning to e-commerce, the ICT-led response helped consumers, households and government authorities to minimize the socio-economic fallouts of the pandemic-induced lockdowns and disruptions. Going forward, the government's increased focus under the Digital Pakistan Policy and the National Payments System Strategy would ensure that progress on the digitization front would continue. However, concerted efforts are required to tackle the various supply- and demand-side constraints to the high digital divide in the country. This would be crucial to ensure inclusive economic growth in the country.

Special Section: Covid-19 and the Need to Boost Digital Connectivity in Pakistan[1]

S1.1 Introduction

The Covid-19 pandemic has significantly accelerated the pace of digital transformation across the world. Necessitating widespread lockdowns and social distancing protocols, the pandemic has served as a litmus test for the preparedness and resilience of the global economy to deal with the unprecedented and unanticipated societal and commercial disruptions. Many organizations were forced to shift to teleworking almost overnight, whereas consumers started adopting digital channels for purchasing household essentials. Businesses accelerated the adoption of pre-Covid digitization strategies – both in business-to-consumer and business-to-business segments – that were earlier designed to be rolled out over the medium- to long-term. Governments, too, have relied on contactless solutions to deliver crucial public services like social transfers, and to implement stringent disease-mitigation measures via contact tracing.

Thus, in effect, the digital transformation has not only enabled continuity of the government and private sector activities (wherever possible), it is also expected to contribute significantly to the eventual recovery going forward. The key ingredient towards this transformation has been the robust connectivity levels, coupled with a dependable digital infrastructure. This is crucial to cater to the increased demand for data-intensive services, such as videoconferencing, file uploading and downloading, video calls, live streaming, and information pooling on internet platforms. In fact, data usage levels have witnessed around 50 percent rise during the Covid-19 crisis, with a surge in high-data "power" users.[2] Certainly, there was a sizable difference in the capability of countries to cope with this sudden surge in demand for digital services. This has been the case in many developing economies, including Pakistan.

The Covid-19 crisis has reinforced the need to upscale and improve accessibility of digital connectivity and infrastructure in Pakistan, strengthen the outreach efforts to enhance digital literacy and promote digital skills, increase interoperability between branchless and conventional banks, and embrace technology in the provision of financial and government services. While significant progress has been witnessed in the digital landscape of the country over the past few years – which enabled the continuation of socio-economic activities during the extended lockdown period – there exist several supply- and demand-side challenges that warrant timely resolution. For one, the assigned level of internet bandwidth in the country is lower than regional economies.[3] Second, the dispersion of internet services is heavily skewed towards urban areas, leaving tier-2 cities, remote regions, and rural areas digitally excluded. The challenges witnessed on the tele-schooling and telehealth front made this more prominent. Third, low spectrum allocation and high license fees place the country at a disadvantageous position for digital transformation as compared to the peer economies.[4] Moreover, with regards to retail, difficulty in meeting the stringent KYC requirements of on-boarding with banks and the high upfront costs of setting up a secure and user-friendly digital payment platform

[1] The authors acknowledge the valuable input and feedback provided by the Payment Systems Department of SBP.

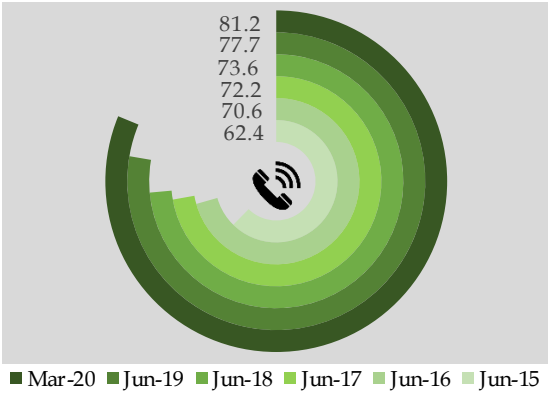
[2] Data source: OpenVault Broadband Insights Report Q1-2020 (https://openvault.com/complimentary-report-Q120/).

[3] GSMA (2020). Pakistan: Progressing Towards a Fully Fledged Digital Economy.

[4] Source: same as in footnote 3.

hold back the transition away from cash on delivery (COD), particularly for smaller businesses. High degree of informality in the economy further restricts the move towards the digital economy, as businesses want to avoid documentation of their activities. From the demand side, low levels of digital literacy, negligible perceived advantages of adopting digital services, and the low affordability of smartphones and internet services, serve as major constraints.

Teledensity in Pakistan (cellular and basic telephony) in percent **Figure S1.1a**



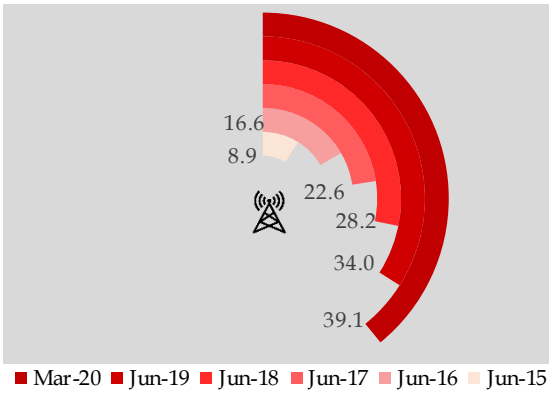
Source: Pakistan Telecommunication Authority

Within this context, it has become important to conduct stocktaking of the progress made so far in terms of the digital infrastructure and connectivity, and evaluate the country's preparedness to cope with similar disruptions in the future. This Special Section: (i) provides an overview of how governments, businesses and households worldwide took advantage of the digital services during the pandemic, and briefly discusses the policy measures that enabled this transition; (ii) highlights the state of digital connectivity in Pakistan on the eve of the Covid-19 crisis; (iii) analyzes how progress on this front helped the private sector address operational constraints, with particular focus on commerce and finance; and (iv) makes the case for bridging the existing digital divide to increase the economy's resilience against potentially similar disruptions in the future, and also to build an overall digitally inclusive ecosystem in the country.

S1.2 Developments in the Digital Ecosystem of Pakistan in Recent Years

Over the past few years, Pakistan has made significant progress towards increasing the digital penetration in the economy. For instance, telecom and internet penetration, being the basic building blocks of the digital economy, have remained a priority for governments. As a result, Pakistan's cellular tele-density increased from 60.7 percent in

Broadband Penetration in Pakistan (percent) **Figure S1.1b**



June 2015 to 80.0 percent in March 2020 (**Figure S1.1**). In addition, broadband penetration in the economy more than quadrupled in the last five years to 39.1 percent by March 2020, from only 8.9 percent in June 2015. This was primarily led by a surge in Next Generation Mobile Services (NGMS) subscribers after the auctions of 3G and 4G spectrum licenses in 2014. Keeping in view the surge in mobile data traffic and the medium-term connectivity goals, the Pakistan Telecommunications Authority (PTA) granted permission to two additional cellular mobile operators in the country to conduct non-commercial trials of 5G in January 2020.

The e-commerce market has shown an impressive growth over the past few years. Increasing digital penetration, lower costs and increased awareness about electronic commercial platforms have led to a significant shift in consumer purchasing patterns over the years. While similar infrastructure exists for business-to-business (B2B) exchanges, such

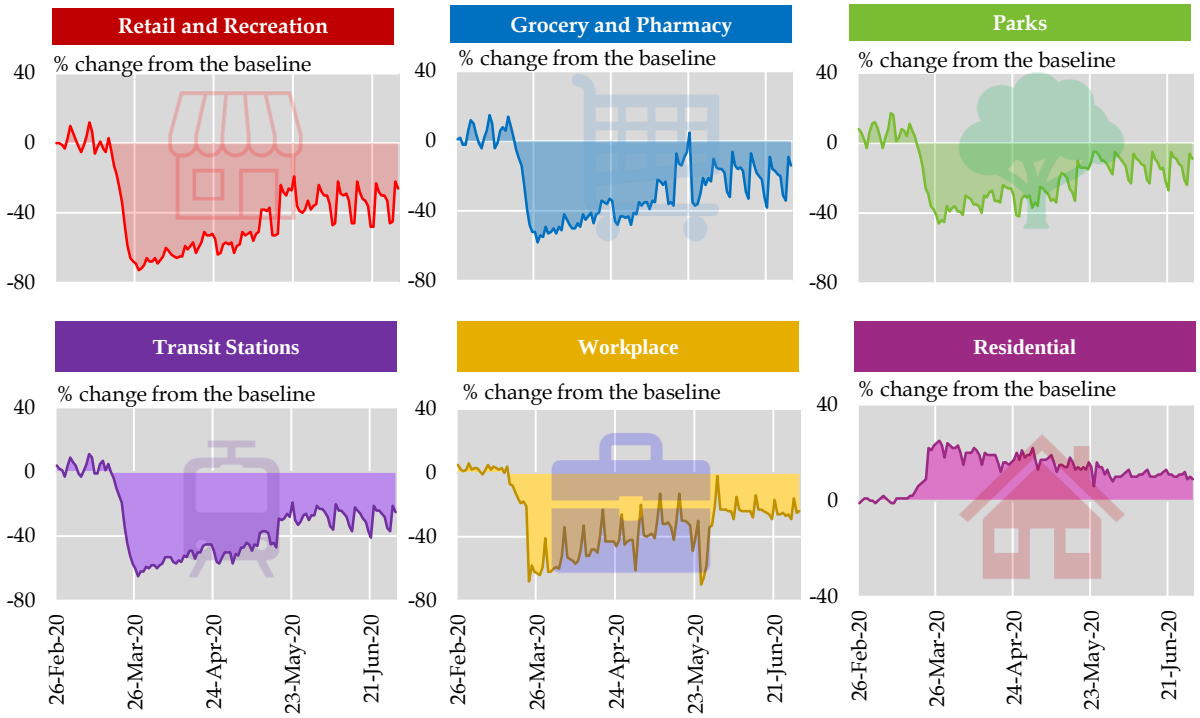
interactions have so far been rather confined to logistics services. In overall terms, the estimated e-commerce sales in Pakistan have grown at a CAGR of 62 percent during FY17-19. Importantly, the focus of e-commerce platforms on enhancing the customer experience via feedback and ratings mechanism have helped build customers' trust, while forcing sellers and vendors to improve their service delivery and product quality.

Although cash on delivery remains the most preferred mode of payment, use of debit/credit cards and IBFT has risen in both volume and value terms during this period. This progress had continued during FY20 as well; however, a significant development during the first three quarters was a notable surge in mobile wallet payments with e-commerce merchants. Anecdotal evidence also points towards marketplaces as well as one-to-many digital outlets leveraging on the expanding mobile wallets ecosystem to attract customers by occasionally offering special discounts. That said, the increasing trend of the already high level of cash penetration in the economy (**Chapter 3**) continues to undermine efforts to enhance the digital payments system infrastructure in the country.[5] The existing customer base also tends to avoid making cashless payments.[6]

S1.3 Progress made during the Covid-19 crisis

In late March, the government imposed strict lockdowns across Pakistan to curtail the

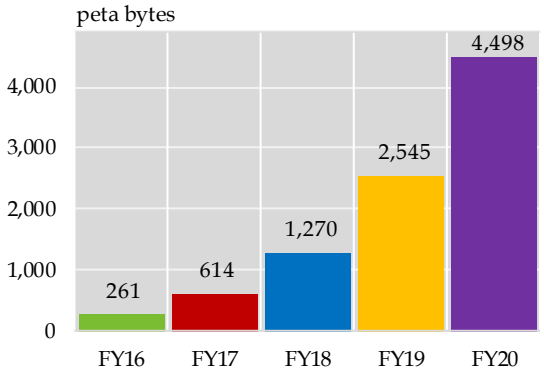
Mobility Remained Restricted in Pakistan Amid Covid-19 **Figure S1.2**



Note: Google Mobility Reports show how visits and length of stay at different places change compared to the baseline, the median value for the corresponding day of the week during the five week period 3 Jan – 6 Feb 2020.
Source: Covid-19 Community Mobility Report (Google)

[5] The currency to deposit ratio soared to 41.7 percent in June 2020 from 38.6 percent in June 2019.
[6] For instance, as of June 2020, there were around 28.4 million debit and credit cards holders in the country, who conducted only 2 transactions, on average, in an entire year via Point of Sale (POS) terminals. In contrast, a debit card was used, on average, 17 times for mostly cash withdrawal transactions from ATMs during FY20.

Broadband Data Usage has Increased Significantly **Figure S1.3**



Source: Pakistan Telecommunication Authority

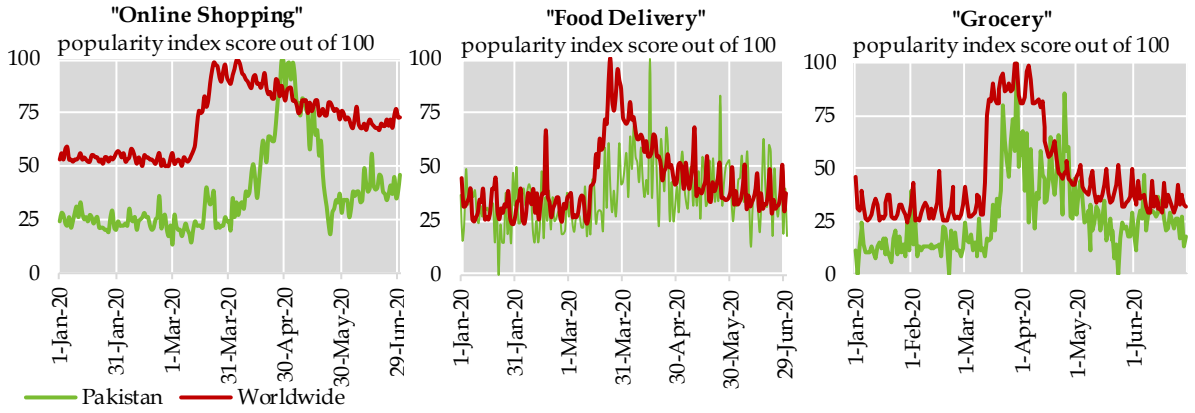
local transmission of the disease. This included closure of schools, shopping centers, restaurants, factories, public transport, and restrictions on public gatherings. Only a few essential industries, like food and healthcare, were allowed to operate.

Towards the end of the fiscal year, when the government had officially moved towards a smart-lockdown strategy, the activity had somewhat revived, yet retail and recreation, grocery and pharmacy, transit stations, and workplace mobility were down by 26 percent, 14 percent, 25 percent and 24 percent, respectively from the baseline (pre-Covid) position (**Figure S1.2**).

In this backdrop, the shift towards electronic channels became inevitable for government institutions, businesses and households, as reflected in a sharp growth in the internet usage across the country during FY20 (**Figure S1.3**). Internet traffic surged 15 percent immediately following the lockdown, despite the reduction in the default bandwidth requirement by popular content platforms, such as Netflix and YouTube, to ease congestions. As per the telecom regulator, the Pakistan Telecom Authority (PTA), the overall broadband capacity was deemed adequate to meet the country's growing needs.[7] The overall broadband data usage grew 76.7 percent in FY20, with the highest growth (89 percent) recorded in the fourth quarter, with government institutions, and especially the central bank, actively encouraging and facilitating people to use digital communications and payment channels.

Similar to other economies, Pakistani households and firms also had to adapt to the sudden disruption in usual business activities. Households began utilizing online solutions for purchasing essentials (groceries) and other items, as the containment measures extended. As seen from users' activity on the Google search engine, consumers worldwide as well as in Pakistan increasingly looked up for

Interest in Online Shopping and Delivery Increased During the Lockdown* **Figure S1.4**



* Index score represents search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term.

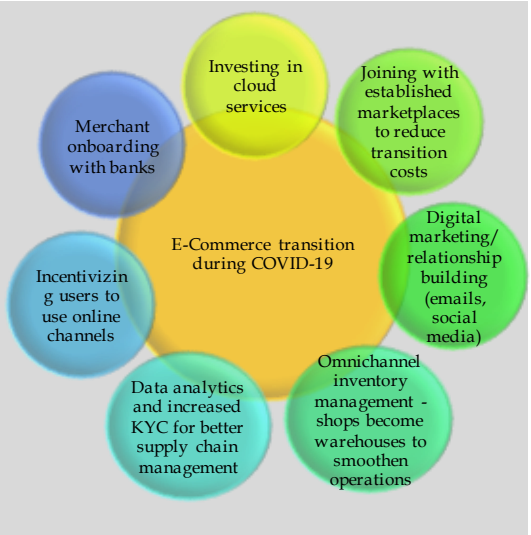
Source: Google Trends

[7] https://www.pta.gov.pk/en/media-center/single-media/internet-usage-increases-by-15-in-pakistan-270320

groceries, food delivery and online shopping (**Figure S1.4**). While not all types of businesses could transition to online, manufacturing firms, retail and logistics players showed remarkable resilience. Here, it is important to reiterate that a gradual openness to and experimentation with online channels was already underway in the domestic market before Covid-19 as well. However, the pandemic quickened this transition in multiple ways.

For instance, businesses increased their digital marketing – via email newsletters, and advertising on traditional and social media – and actively engaging with potential customers via their websites and social media profiles. Second, the prevalent preference for physical shopping and cash necessitated incentivizing customers to switch to online shopping via discounts and general awareness campaigns (**Figure S1.5**).

Strategies Adopted by Businesses to Transition to Online Channels During the Lockdown **Figure S1.5**



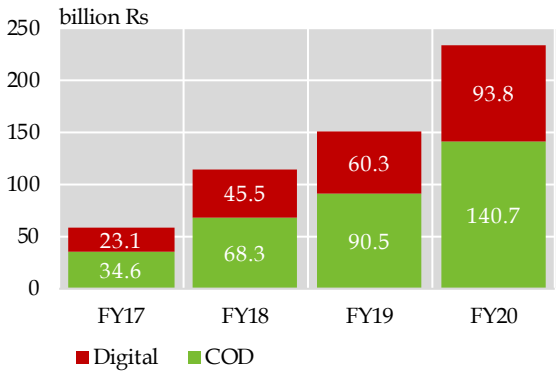
Source: Soft information based on company websites; marketplaces blogs; retail sector webinars; and Daraz e-commerce index

Moreover, data compiling and analytics became the key to smoothen supply chain operations, improve KYC protocols, and increase order fulfilment levels. Here, new players venturing into the e-commerce space had to build the entire digital infrastructure from scratch. This included hiring new teams to set up an online store or otherwise help them sign up and operate as a merchant on an existing online marketplace; installing a dynamic inventory management system; on-boarding with financial institutions to manage digital payments; and most importantly, manage all this while ensuring the health and safety of the employees. The restricted working hours, coinciding with the urgency, made the process of digital transformation even more challenging. Therefore, the offline retail industry allocated additional budgets for capacity-building and kick starting their online footprint.

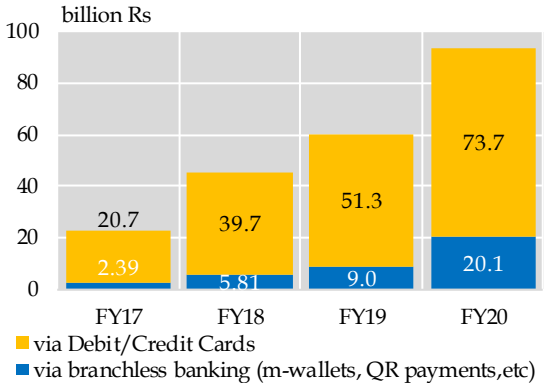
Getting businesses online usually involves high upfront costs for cloud computing and inventory management software integration across the supply chain. Hence, there was a surge in small sellers registering with existing online market players to circumvent these costs and avoid delays in resuming operations. A big online platform, for example, in collaboration with Visa International, registered close to 3,000 MSMEs during Q3-FY20. On the whole, the number of e-commerce merchants registered with commercial banks increased by 25.3 percent in FY20 as compared to 24.5 percent in FY19. As there was a steep rise in demand for deliveries, businesses also started optimizing their inventory management towards a just-in-time model – a strategy to increase efficiency by receiving goods only as they are needed in the production process, thereby reducing inventory costs. In this regard, in major metropolitan cities, businesses started using physical stores as warehouses for timely order fulfilment and reducing delivery times.

Restaurants and hotels utilized online food delivery channels during the lockdowns. Similar to retailers joining online platforms, many new restaurants registered with online food delivery channels, providing discounts and ensuring compliance with safety protocols to attract orders. In cities where such platforms were absent, phone-call ordering became the norm.

E-Commerce Sales Continued to Rise... **Figure S1.6a**



... As Digital Payments Became More Popular **Figure S1.6b**



* These numbers include retail payments made via branchless banking channels, therefore, may not tally with estimates shared in Annual Report, Chapter 7 of 2017-18

Source: State Bank of Pakistan; market estimate for COD sales

Resultantly, the e-commerce market in FY20 is estimated to have expanded to Rs 234.6 billion, up 55.5 percent on YoY basis (**Figure S1.6**). Within the digital payments, e-commerce transactions made via branchless banking channels more than doubled from last year. That said, during the fourth quarter, the YoY growth in digital payments for e-commerce activities dropped to only 10.6 percent compared to the average growth of 74.1 percent during the preceding three quarters.

This might suggest three things:

- The cash-on-delivery transactions might have increased due to a sharp increase in cash penetration in the economy (**Chapter 3**). Most people still rely on the branchless banking agent networks to top-up their m-wallets, as well as on physical branches of commercial banks, to carry out cash payments and transfers, as opposed to using credit or debit cards. Reduced working hours and restricted mobility made it challenging for people to access these avenues. At the same time, cash preference in general remained elevated, as people tried to hold money as a precaution, given the high uncertainty. From the businesses' perspective, getting into e-commerce was the only option to keep operations afloat. However, given the restricted mobility, enterprises found it challenging to get on-boarded with the commercial banks and thus had to resort to providing deliveries on COD basis only.

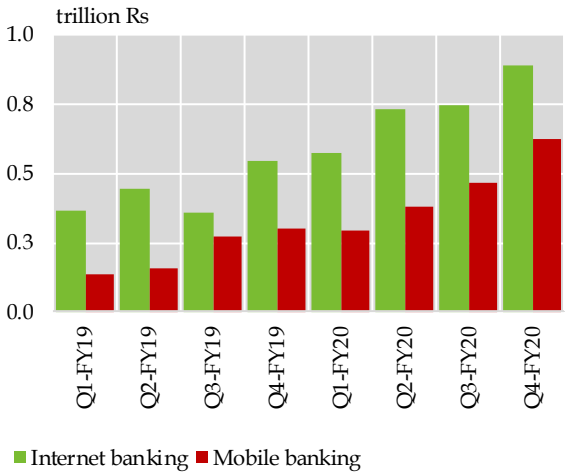
- This increased the proportion of cash transactions in the overall e-commerce market.

- Further, it seems that the e-commerce industry was not ready to cater to a sudden surge in customer demand due to the Covid-19 crisis. Resultantly, a large number of orders were reportedly cancelled and refunds were either not processed on time or were indefinitely delayed. Since digital payment-based orders are processed on a pre-payment model as opposed to a post-payment model in case of COD, customers were swayed away from digital payments and towards cash settlement, as they could minimize their risk by holding the payments until order completion.

- On the other hand, most of the existing non-retail e-commerce players with digital payment options had to suspend their operations due to restrictions in major cities. For instance, restaurants were forced to suspend operations in the initial days of lockdowns, which might have caused a dip in food deliveries. Likewise, there were restrictions on pillion-riding and ride-hailing services in some cities, causing the overall volume of digital e-commerce sales to fall.

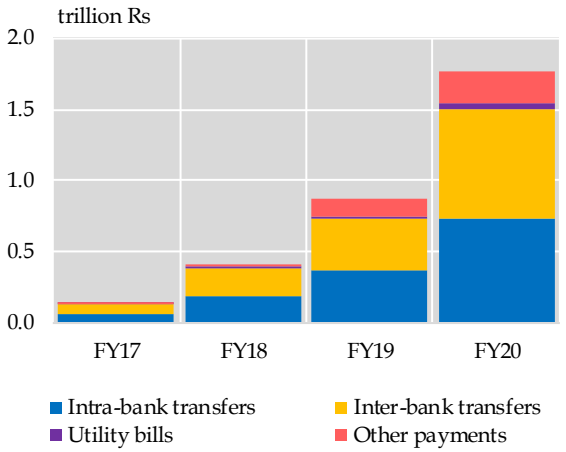
However, beyond e-commerce, there was a noticeable shift towards digital payments and alternate delivery channels. As discussed before, the importance and usage of electronic banking and alternative delivery channels increased during the post-Covid-19 period. Realizing this, the SBP further incentivized the use of digital financial channels by instructing banks to waive all inter-bank and intra-bank charges on digital transactions. Further instructions were given to ensure proper functioning of ATMs and 24/7 access to customer helplines and call centers to smoothen customer support and IVR banking.

E-Banking Transactions in Pakistan **Figure S1.7a**



Source: State Bank of Pakistan

Mobile Banking Transaction in Pakistan **Figure S1.7b**



These developments were a key factor behind the sizable 19.5 percent QoQ and a massive 63.7 percent YoY increase in the values of internet banking payments during Q4-FY20. For mobile banking, the transaction volumes rose by 33.0 percent QoQ and 106.8 percent YoY during Q4. On aggregate basis, mobile phone banking transaction values doubled for the third consecutive year to Rs 1.7 trillion by end-FY20, as consumers increased the use of smartphone apps to transfer funds, pay utility bills, or carry out other payments, such as for retail purchases (**Figure S1.7**).

S1.4 Substantial policy support and guidance means that the progress would continue…

The rapid digitization of the financial, retail, health and government services over the past decade – buoyed by rising smartphone sales, internet users and IP traffic – increased the global preparedness to respond to disruptions such as the one caused by the Covid-19 crisis. In particular, the advancement in ICT capability and accessibility increased the resilience of households, businesses and government institutions, and softened the blow of the pandemic-induced lockdowns. Pakistan is no different in this regard. That said, the world is facing extraordinary socioeconomic ramifications of Covid-19, which may likely persist at least till the availability of an effective vaccine. With a lingering threat of a second wave of the virus, people will continue to remain cautious and social distancing will be exercised globally. In this regard, key bottlenecks in Pakistan, such as lack of digital and financial literacy, limited access to ICT service platforms, and preference for cash, must be addressed.

This is particularly important now that the drive towards the fourth industrial revolution and the internet of things is well underway. Technologies like artificial intelligence, robotics, block-chain and augmented reality, would come to dominate the economic sphere by fueling the industries of the future, blurring

the gap between manufacturing and services, and driving the economic growth. According to a 2018 International Telecommunication Union (ITU) report, an increase in the overall digitization of 1 percent in an economy leads to a 0.13 percent growth in GDP per capita and a 0.23 percent increase in labor productivity.[8] Furthermore, the transition towards e-government is also digitizing the fiscal and monetary policy transmission and communications channels, nearing us towards a future of electronic social transfers and, potentially, digital currencies, etc. All this would require a significant leap in the digital infrastructure's capacity to handle the expected demand for big data. Pakistan, like all economies, would need to prioritize bridging the intra- and inter-country digital gap to prepare for the needs of tomorrow.

In this regard, an important development has been the launch of the National Payment System Strategy (NPSS), under which a roadmap for a modern and robust digital payment network has been adopted. The NPSS aims to increase Pakistan's GDP by 7 percent, create 4 million new jobs and attract US$ 263 billion in new deposits by leveraging digital channels by 2025. The key objectives of the NPSS include the development of a national payments infrastructure to enhance interoperability between different players and payment instruments; digitizing government collections (including taxes), payments (including salaries, pensions, and social benefits) and remittances; and enabling and encouraging merchants and other private sector businesses to enhance the usage of digital payment channels. Specifically, to address the challenges faced by POS acquirers – which discourages more widespread deployment of POS machines at retail outlets – the SBP has introduced policy measures such as setting a floor on the Merchant Discount Rate (MDR) and capping the Interchange Reimbursement Fee (IRF) for debit and prepaid cards. The SBP has also observed early positive indicators in the form of increase in the POS install base, with 2 new banks entering the POS acquiring market in the coming months. Furthermore, the number of POS terminals that were on a downward trajectory (with only 47,567 as of end-December 2019) has again started to increase. The figure now stands at 51,667 (as of end-August 2020).

Moreover, in order to simplify the cumbersome and lengthy account-opening and on-boarding process for merchants, the SBP has issued Rules for Digital On-boarding of Merchants to facilitate the growth of digital payment acceptance points in the country. The rules provide the minimum requirements for simplified due diligence process and should facilitate the acquiring institutions to on-board small retail merchants and enable them to accept payments digitally. To further support the digitization of payment services, the SBP has issued standards on QR codes for accepting payments in Pakistan, with the aim to ensure interoperability in the longer run and promotion of digital retail payments at low cost.

Along the same lines, the SBP has recently allowed local businesses to make instant payments for acquiring services from globally recognized digital services providers. This would help businesses to increase their outreach to a wider customer base by accessing various services, including advertising, hosting, customer support etc. The SBP has allowed commercial banks to release up to a maximum of US$ 200,000 per year for each local company for the import of digital services, primarily from the top 62 global digital service provider companies (including their affiliates or associated entities). However, within this limit, banks

[8] The increase in digitization is gauged from the ITU Digital Ecosystem Development index, which is based on 64 high- and low- frequency indicators (related to infrastructure, connectivity and competition) for 75 developing and developed countries. Furthermore, this increase is on top of the 0.08 percent and 0.15 percent growth in GDP, respectively, by an increase of 1 percent each in fixed broadband penetration and mobile broadband penetration. Source: ITU (2018). The Economic Contribution of Broadband, Digitization and ICT regulation. https://www.itu.int/en/ITU-D/Regulatory-Market/Documents/FINAL_1d_18-00513_Broadband-and-Digital-Transformation-E.pdf

can release foreign exchange up to a maximum of US$ 25,000 per annum to digital service providers that are not included in the list.[9]

The SBP is also working on the development of a Micropayment Gateway (MPG), in collaboration with the Bill & Melinda Gates Foundation and Karandaaz. MPG is a faster payment system, offering retail payments with advanced Application Programming Interfaces (APIs) and directory services; it will simplify and smoothen payment mechanisms in the country. A related development is the work on the Asaan Mobile Accounts (AMA).[10] The AMA scheme provides an integrated platform, allowing any person with a basic mobile phone to swiftly open a digital transaction account through a Unified Unstructured Supplementary Service Data (USSD) code at any time. The scheme's objective is to facilitate new customers with account opening, and to drive the usage of digital financial services through increased number of account-to-account transactions across various networks. The AMA scheme is currently in a development phase, and holds the potential to increase financial inclusion manifold.

Moreover, the SBP has issued regulations for non-bank e-money institutions willing to provide innovative, affordable, and user-friendly payment solutions. These regulations are aimed at removing the barriers to entry for new players and providing an enabling environment to promote cashless payments and financial inclusion. Furthermore, to facilitate overseas Pakistanis, the SBP has allowed the opening of Roshan Digital Accounts, which would allow expatriates to open a foreign currency value account or a Non-Resident Rupee Value Account (NRVA). The account holders would be able to use their accounts to invest in government bonds, securities via the CDC, and real estate, etc.

Encouragingly, Pakistani authorities have been proactively working on the digitization front during the past half-decade or so; positive developments include the approval of the country's first ever e-commerce policy in 2019. The policy aims to provide an enabling environment to private businesses, create new employment opportunities for youth and women, and provide an opportunity to the government to regulate the e-commerce sector in the public interest. To track the implementation of the policy and to facilitate e-commerce businesses, a National E-commerce Council (NEEC) has also been established. Its main functions are to monitor and support the advancement of e-commerce in the private sector, foster innovation in the implementation of the necessary programs and initiatives, create awareness of the importance of e-commerce towards the overall growth in the economy, and provide relevant feedback and recommendations to the government.

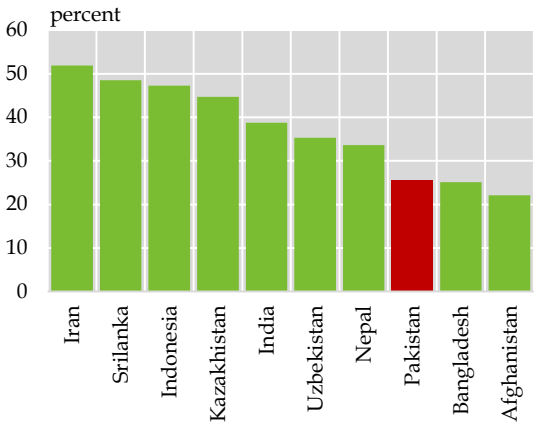
Notably, the Ministry of Commerce has also facilitated enlisting more than 30 exporters on the world's leading online marketplace, Amazon.com, on a trial basis. On a successful completion of the test-run, this will provide an opportunity to more domestic firms to sell via Amazon and expand their outreach to global markets. This could potentially open a new avenue for Pakistan to increase its exports and create new employment opportunities locally. Going forward, the cross-border B2C e-commerce regulatory framework developed by the SBP and the Web Based One Customs e-commerce module that is to be developed by the FBR, will help facilitate online sales of exporting firms by allowing hassle-free documentation and shipment of export orders.

S1.6 …However, more needs to be done to make the transition inclusive and sustainable

As encouraging and welcome as these developments are, they are not sufficient to

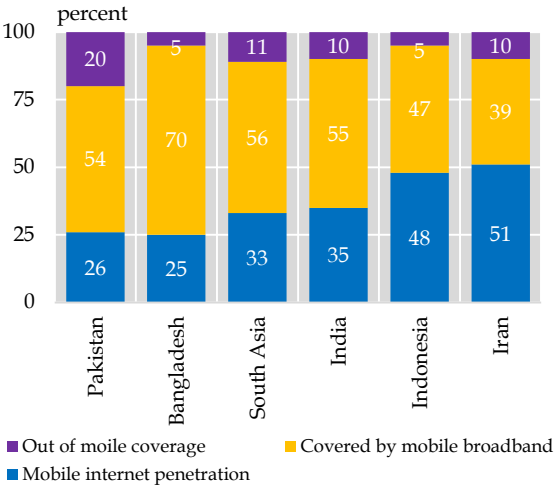
[9] http://www.sbp.org.pk/epd/2020/FEC4.htm
[10] http://www.sbp.org.pk/reports/annual/arfy17/vol-1/Chapter-4.pdf

Mobile Internet Penetration in Pakistan Lags Behind Most Regional Economies **Figure S1.8a**



Source: GSMA Intelligence (2019)

Usage and Coverage Gaps in Mobile Broadband Connectivity **Figure S1.8b**

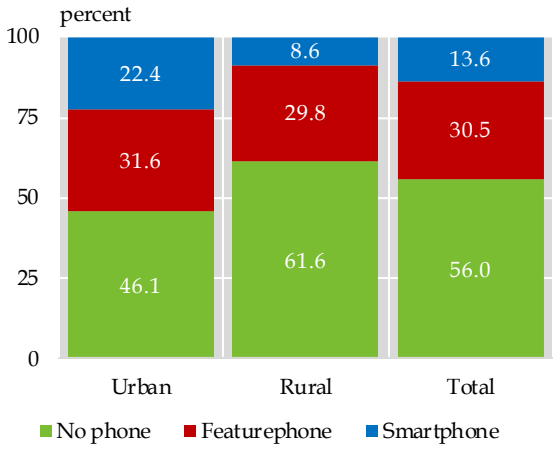


achieve the overall objective of digital and financial inclusion in the country. For that, a parallel focus would be required on addressing the demand dynamics.

Pakistan has low unique mobile subscriber penetration and also has lower mobile internet penetration as compared to regional countries (**Figure S1.8a** and **b**). The digital divide in the economy is still significant. There are both coverage as well as usage gaps. Specifically, around 54 percent of the population has access to mobile broadband coverage, but they do not subscribe to internet bundles (usage gap). Similarly, around 20 percent of the population does not have access to mobile internet services (coverage gap).

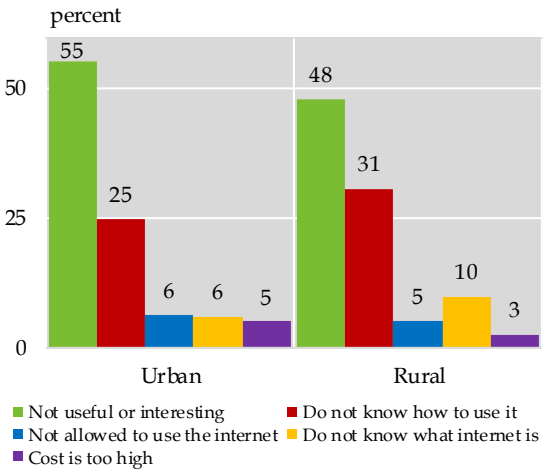
There is also a significant variation in mobile phone ownership between urban and rural areas (**Figure S1.9a**). Here, both the demand and supply factors come into play. Given the low-income level in the country, high taxes on cell phones curtails the ability of people from owning a smartphone.[11] Meanwhile, inadequate level of literacy, especially digital

Composition of Mobile Phone Ownership by Region in Pakistan **Figure S1.9a**



Source: PSLM/HIES 2018-19, PBS

Top 5 Reasons For Not Using Internet in Pakistan **Figure S1.9b**



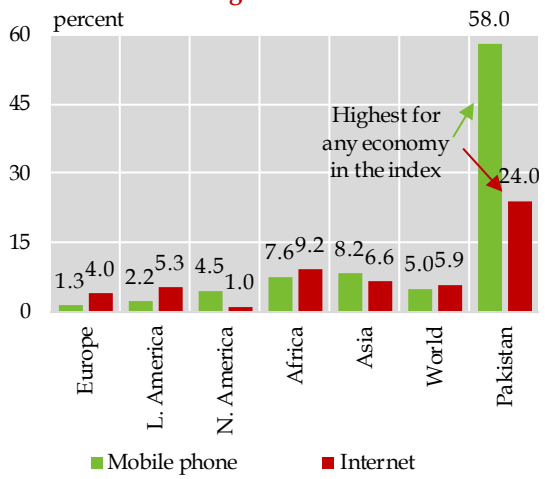
[11] In Pakistan, customers face multiple taxes related to smartphones: sim card taxes, custom duties, activation charges, additional value-added taxes, handset fees, and usage taxes. This is the most in any South Asian economy. Source: GSMA (2020). Pakistan: Progressing Towards a Fully Fledged Digital Economy.

literacy, is also behind the low smartphone and internet usage levels in the country. So much so, that about a quarter of the population does not know how to use the internet, while around half does not deem it as a useful or interesting activity (**Figure S1.9b**).

It is important to emphasize here that amid the already low inclusivity levels, gender inequality in terms of both smartphone/internet access and digital literacy is stark, and further hinders progress. According to the Economist Intelligence Unit (EIU) Internet Inclusiveness Index 2020, the global average gender gap (difference between proportion of male and female population) in terms of mobile phone access and internet access is 26.5 percent and 19.8 percent, respectively. In Pakistan, these gaps rise to 58.0 percent and 24.0 percent, respectively – both are the highest out of the 100 economies in the index (**Figure S1.10**).

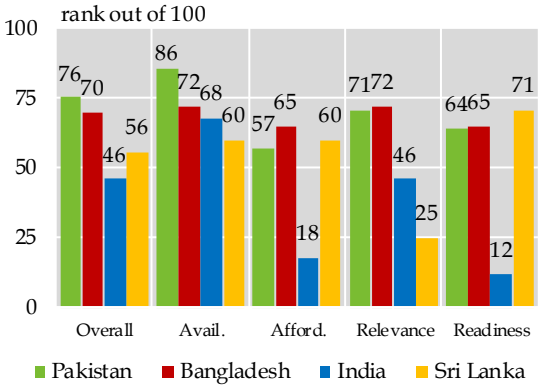
Pakistan lags behind regional and peer economies in the digital connectivity indicators (**Figure S1.11**). Furthermore, it is vital to understand that the digitization of services is not a development that can happen in isolation; the overall human capital and economic development ecosystem needs to be geared towards addressing the inefficiencies from the grass-roots level. The adult literacy rate is currently only 59.1 percent in the country, and support for digital literacy is inadequate. Similarly, low income levels mean that affording a smartphone and running a data network is challenging. In such a landscape, the following proposals may help address the shortcomings.

Gender Gap in Mobile Phone and Internet Access is Highest in Pakistan **Figure S1.10**



Note: Calculated as the difference in the proportion of males and females having access to mobile phones and internet.
Source: EIU Inclusiveness Index 2020

Pakistan Ranks the Lowest in South Asia in Internet Inclusiveness **Figure S1.11**



Availability measures the quality and breadth of infrastructure; *Affordability* examines the cost of access relative to income level and marketplace competition; *Relevance* indicates the existence and extent of local language/relevant content; *Readiness* shows the level of capacity, skills, cultural acceptance, and policy environment to access the internet

First and foremost, Pakistan has to substantially upgrade its digital infrastructure. This is because in the nearing era of 5G and the internet of things, capacity and bandwidth would be crucial. Currently, the level of assigned bandwidth in the country is amongst the lowest in the region.[12] Here, the PTA needs to ensure timely investments and proper planning. Rural areas and tier-2 cities need to be prioritized to bring them at par with the urban localities to ensure equal accessibility. Likewise, over-1 GHz bands need to be expanded to ensure big data

[12] GSMA (2020). Pakistan: Progressing Towards a Fully Fledged Digital Economy.

analytics and transmission, and smoothen network exchanges in commercial areas in the near future.

Second, the government authorities need to educate the population about the benefits of using digital services. Here, the National Financial Literacy Program and the Digital Skills Strategy are already in implementation phases, and positive results have been achieved so far as well. However, going forward, it would be necessary to put digital literacy at the forefront of the country's entire education system. The curriculum needs to incorporate material to equip students with the rapidly evolving needs of the job market.

The skillset needed to excel in a number of jobs in the future will be profoundly different from what was required before. To this end, the content must be aligned with the needs of the private sector, with an eye towards both domestic and global trends.

Third, government authorities need to incentivize marketplaces and shopping outlets to offer mobile wallet payments, which would help increase the use of e-commerce and financial services in general. Anecdotal evidence suggests that many online outlets and marketplaces still either do not provide an option for digital payment, or allow only bank deposits and/or credit and debit card payments, while ignoring the growing mobile wallet users. Small businesses, in particular, prefer COD and are deterred from accepting digital payments due to the upfront costs for developing a secure and reliable infrastructure for payment processing, negotiating contracts with payment system providers, and banks' stringent KYC requirements for merchant on-boarding. Even in cases where payment gateways and platforms are provided, lack of market-level standardization, lengthy and repetitive payment procedures, absence of escrow facilities, and low user-friendliness, discourage consumers from choosing online payment channels. Furthermore, many banks do not allow the issued debit cards to be used for online purchases or require customers to activate such a facility for every transaction. Meanwhile, credit card penetration in the economy is very low and limited to higher-middle to high-income individuals.

Fourth, the federal and provincial governments must incentivize consumers, merchants, and other businesses to pay or receive their payments digitally. As highlighted earlier, a large number of debit and credit cards are being used to withdraw cash through ATMs. It is pertinent to note that cash leaves no digital signature and does not contribute towards documentation of the economy. In contrast, when a card is used on a POS terminal at a merchant location, the authorities get an end-to-end trail of where the money is being spent, and the transaction also contributes towards digitization. From the supply side, more support can be provided to the POS acquirers in Pakistan. In this regard, one way to expand the POS network would be to waive the taxes/duties on the import of the digital acceptance equipment. Meanwhile, on the demand side, an immediate step would be to provide incentives in tax rates for transactions that are conducted using digital payment channels.

Finally, the digital financial services would not pick up on their own. For that, three things are important. First is the overall orientation of the economy towards digitization. If the various sectors of the economy are digitized, the resultant ease and efficiency in the whole ecosystem would automatically increase the attraction of using digital financial services.[13] Second, the digitized services must be well-integrated. Here, interoperability must be focused upon and incentivized. For example, the current mobile wallet infrastructure allows interoperability among all service providers via 1-Link. However, the players are not fully utilizing this facility, mainly to retain their existing market shares. In particular, major telecom players are hesitant to share access to their sizable agent networks that they have

[13] Recent developments, such as electronic land records, digital supply chain invoicing, registration of vehicles, and online access to government resources, etc., have been encouraging and would go a long way towards meeting this objective.

established over the past decade or so. Hence, the third factor is to provide incentives to the market players to get them to be more cooperative with each other and be open to the whole ecosystem. It needs to be realized that, in the long term, the provision of an integrated channel would increase the overall pie of the digital users, which would also lead to an increase in the share of users of all the service providers.

Annexure A: Data Explanatory Notes

1) **GDP:** In case of an ongoing year, for which actual GDP data is yet not available, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI (national, urban, or rural) from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation } (\pi_{Ht}) = \left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation } (\pi_{YoYt}) = \left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation } (\pi_{MoMt}) = \left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where I_t is consumer price index in t^{th} month of a year. The CPI can be national, urban or rural. For detailed information on the methodology, please see:
http://www.pbs.gov.pk/content/methodology-2

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of gross public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing, whereas financing is calculated by adjusting the government borrowing with its deposits held with the banking system; (ii) changes in the stock of debt also occur due to movements in exchange rates, both PKR and other currencies against US Dollar, which affect the rupee value of external debt.

4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). Ways and Means Advance allows government to borrow up to Rs 100 million at a time in a year at an interest rate of 4 percent per annum;

higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir (AJK) may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum. However, the Federal Government has taken over from the State Bank of Pakistan (SBP) the business of direct credit to provincial governments on 29th June 2020. In this regard, the federal government has executed tripartite agreements with four provincial governments and SBP (as executer) for extension of Ways and Means loans on account of Federal Government Central Account No.I (non-food) on 29th June 2020.

Borrowing from scheduled banks: This is mainly through (i) fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs); (ii) monthly auction of 3, 5, 10, 15, 20 and 30 year fixed rate Pakistan Investment Bonds (PIBs); (iii) fortnightly auctions of 3, 5, 10 year floating rate PIBs; (iv) Sukuk and (v) Bai Muajjal of Sukuk (on deferred payment basis). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

(a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

(b) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on banking data, which depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record).

List of Acronyms

A

ACD	Additional Custom Duty
ADB	Asian Development Bank
AJK	Azad Jammu and Kashmir
AMA	Asaan Mobile Accounts
ASEAN	Association of Southeast Asian Nations
ATM	Automated Teller Machine

B

B2B	Business-to-business
BB	Branchless Banking
BEL	Banker's Equity Ltd
BEOE	Bureau of Emigration and Overseas Employment
BIS	Bank of International Settlements
BISP	Benazir Income Support Program
BMR	Balancing Modernization and Replacement
BRICS	Brazil, Russia, India, China, South Africa
BRT	Bus Rapid Transit
BRTS	Bus Rapid Transit System
BSC	Banking Services Corporation

C

CAD	Current Account Deficit
CAGR	Compound Annual Growth Rate
CBU	Completely Built Up Unit
CDC	Central Depository Company
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CNIC	Computerised National Identity Card
COD	Cash on Delivery
CPB	Centraal Planbureau/Bureau for Economic Policy Analysis, Netherlands
CPEC	China Pakistan Economic Corridor
CPFTA	China Pakistan Free Trade Agreement
CPI	Consumer Price Index
CPPA	Central Power Purchasing Authority
CRR	Cash Reserve Ratio
CY	Calendar year

D

DAP	Diammonium Phosphate
DFI	Development Finance Institutions
DSSI	Debt Service Suspension Initiative

E

ECB	European Central Bank
ECC	Economic Coordination Committee
e-CIB	Electronic Credit Information Bureau
EDL	External Debt & Liabilities
EFF	Extended Fund Facility
EFS	Export Finance Scheme
EIU	Economist Intelligence Unit
EM	Emerging Markets
EU	European Union

F

FASTER	Fully Automated Sales Tax e-Refund
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FCA	Federal Committee on Agriculture
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FIA	Federal Investigation Agency
FIRO	Financial Institutions (Recovery of Finances) (Amendment) Act, 2016
FO	Furnace Oil
FPA	Fuel Price Adjustment
FPI	Foreign portfolio investment
FPS	Fiscal Policy Statement
FRDLA	Fiscal Responsibility & Debt Limitation Act
FR-PIBs	Floating Rate Pakistan Investment Bonds
FTA	Free Trade Agreement
FX	Foreign Exchange
FY	Fiscal Year

G

GB	Gilgit Baltistan
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product

GFC	Global Financial Crisis
GIS	Geographical Information System
GIS-VRR	Government Ijara Sukuk-Variable Rental Rate
GM	Genetically Modified
GSM	Global System for Mobile
GSMA	Global System for Mobile Communications Assocaition
GSP	Generalized System of Preferences
GST	General Sales Tax
GSTS	General Sales Tax on Services
GVA	Gross Value Added

H

H.H	House hold
HEC	Higher Education Commission
HIES	Household Integrated Economic Survey
HS Code	Harmonized System Code
HSD	High Speed Diesel

I

IBFT	Inter Bank Funds Transfer
ICP	Investment Corporation of Pakistan
ICT	Information Communication Technology
IDBP	Industrial Development Bank of Pakistan
IFI	International Financial Institution
ILO	International Labour Organization
IMF	International Monetary Fund
IOM	International Organization for Migration
IP	Internet Protocol
IRF	Interchange Reimbursement Fee
ISIC	International Standard Industrial Classification
ITC	International Trade Center
ITU	International Telecommunication Union
IVR	Interactive Voice Response

K

KERO	Kerosene Oil
KP	Khyber Pakhtunkhwa
KSA	Kingdom of Saudi Arabia

	KYC	Know Your Customer
L		
	LARMIS	Land Administration & Revenue Management Information System
	LDO	Light Diesel Oil
	LNG	Liquefied Natural Gas
	LPG	Liquefied Petroleum Gas
	LRMIS	Land Records Management and Information System
	LSM	Large Scale Manufacturing
	LTFF	Long Term Financing Facility
M		
	MDR	Merchant Discount Rate
	mma	Monthly Moving Average
	MNFSR	Ministry of National Food Security & Research
	MOFA	Ministry of Foreign Affairs
	MoM	Month on Month
	MPC	Monetary Policy Committee
	MPG	Micropayment Gateway
	MPOS	Mobile Point of Sale
	MRTBs	Market Related Treasury Bills
	MS	Master in Science
	MTBs	Market Treasury Bills
N		
	NATO	North Atlantic Treaty Organization
	NCCC	National Credit Consultative Council
	NCOC	National Command and Control Centre
	NDA	Net Domestic Assets
	NDFC	National Development Finance Corporation
	NEEC	National E-commerce Council
	NEER	Nominal Effective Exchange Rate
	NEPRA	National Electric Power Regulatory Authority
	NFA	Net Foreign Assets
	NFC	National Finance Commission
	NFDC	National Fertilizer Development Centre
	NFIS	National Financial Inclusion Strategy
	NFNE	Non-Food Non-Energy

NGMS	Next Generation Mobile Services
NHA	National Highway Authority
NIT	National Investment Trust
NPHDA	Naya Pakistan Housing and Development Authority
NPHP	Naya Pakistan Housing Project
NPK	Nitrogen, Phosphorus, and Potassium
NPSS	National Payment Systems Strategy
NRVA	Non-Resident Rupee Value Account
NSS	National Saving Schemes
NTDC	National Transmission and Dispatch Company
NUST	National University of Science and Technology

O

OCAC	Oil Companies Advisory Council
OGDCL	Oil and Gas Development Company Limited
OGRA	Oil and Gas Regulatory Authority
OMC	Oil Marketing Company
OMO	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
OTC	Over the Counter

P

PAAA	Pakistan Audit and Accounts Academy
PAMA	Pakistan Automotive Manufacturers Association
PASSCO	Pakistan Agricultural Storage and Services Corporation
PBS	Pakistan Bureau of Statistics
PC	Personal computer
PEDL	Public External Debt & Liabilities
PEPCO	Pakistan Electric Power Company
PFM	Public Financial Management
PIBs	Pakistan Investment Bonds
PICIC	Pakistan Industrial Credit and Investment Corporation Ltd
PIDE	Pakistan Institute of Development Economics
PKIC	Pak Kuwait Investment Company
PKR	Pakistani Rupee
PLHC	Pak Libya Holding Company
PM	Prime Minister

PMRC	Pakistan Mortgage Refinancing Company
POL	Petroleum, Oil, and Lubricants
POS	Point of Sale
PPA	Pakistan Poultry Association
PPE	Personal protective equipment
PR	Policy Rate
PRI	Pakistan Remittance Initiative
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSL	Priority Sector Lending
PTA	Pakistan Telecommunications Authority
PTCL	Pakistan Telecommunication Company Limited

Q

Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
QR	Quick Response

R

RDFC	Regional Development Finance Corporation
REER	Real Effective Exchange Rate
RERA	Real Estate Regulatory Authority
RFI	Rapid Financing Instrument
Rs	Pakistani Rupee
RTOB	Real Time Online Banking

S

SAPICO	Saudi Pak Investment Company
SBFC	Small Business Finance Corporation
SBP	State Bank of Pakistan
SDGs	Sustainable Development Goals
SECP	Securities & Exchange Commission of Pakistan
SHMI	Small and Household Manufacturing Industries
SLR	Statutory Liquidity Requirement
SME	Small and Medium Enterprises
STR	Secured Transactions Registry

	SUPARCO	Space and Upper Atmosphere Research Commission
T		
	T&D	Training and Development
	T-Bills	Treasury Bills
	TEDL	Total External Debt & Liabilities
	TERF	Temporary Economic Refinance Facility
	TFP	Total Factor Productivity
	TT	Telegraphic Transfer
U		
	UAE	United Arab Emirates
	UFG	Unaccounted for Gas
	UK	United Kingdom
	UNCTAD	United Nations Conference on Trade and Development
	US/USA	United States of America
	US$	US Dollars
	USSD	Unstructured Supplementary Service Data
V		
	VDA	Verband der Automobilindustrie/German Association of the Automotive Industry
W		
	WALR	Weighted Average Lending Rate
	WAONR	Weighted Average Overnight Rate
	WAPDA	Water and Power Development Authority
	WEO	World Economic Outlook
	WHT	Withholding tax
	WPI	Wholesale Price Index
Y		
	YoY	Year on Year

Industry & Agriculture I (1961) by Sadequain

The right hand side of the mural shows the ripening fields of agriculture and the left shows the industrial progress. The center figures of a man and a woman are showing the results of their endeavor. The woman naturally holds the fruit of the earth and the man is the bearer of industrial output.