ECONOMIC LANDSCAPE AMID PANDEMIC

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The year 2020 has been unequivocally unique, for obvious reasons. During the global storm, Pakistan remained relatively sunny, all considered. Yes, the economy suffered, jobs and even lives were lost. But looking back, the fears that had gripped the nation in the earlier part of the year thankfully remained shy of reality. Here, the Government's bold step of not opting for a blanket curfew despite criticism from a number of groups turned out to be a well-calculated call – one that went on to receive international acclaim.

This article aims to provide an economic recap of the year from various lens and present an outlook for 2021 along with shedding light on the broader issues at hand. This year is expected to be friendlier than the last, assuming that the pandemic is reined in, even if not completely eliminated. However, a mutating virus remains a lurking threat to a smooth journey back to the old normal. Hence, the pandemic could continue to be the pivot for major decisions in 2021.

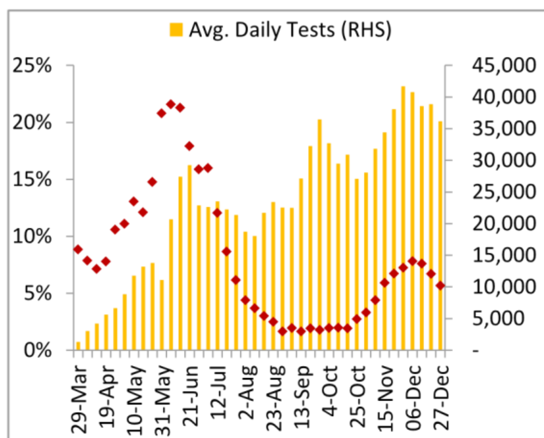
For Pakistan, a key barrier to sustainable growth has been the tendency to get tangled up in treating short term symptoms, leaving little to no room for addressing the structural weaknesses that cause them. While neither can be ignored, it is imperative that the short- and long-term barriers be removed in tandem. It goes without saying that treating the broader issues should automatically eliminate the symptoms. Hence, it is time to take a step back and reflect upon what has been done so far and what needs to be done going forward. A long-term outlook beyond 2021 is solely contingent upon removal of the structural weaknesses that have plagued the country for decades. That should be the resolution for 2021!

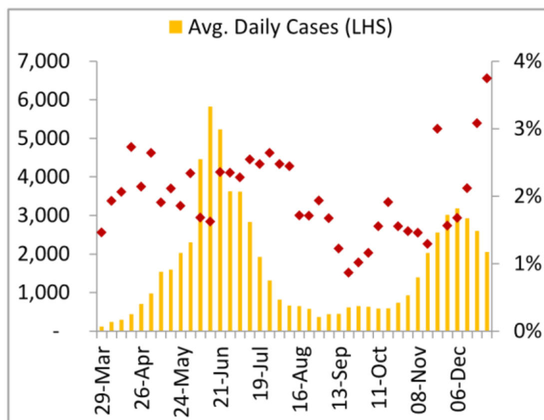
The Corona effect

The year 2020 is surely not one to be forgotten. After all, who could have thought that a handful of infections could escalate to a full-blown pandemic in a matter of weeks? Today, even as global active infections have breached the 23 million mark (total of over 80 million cases recorded) and total deaths head towards a catastrophic 1.8 million, there is no scientific evidence to suggest that the virus might relent. Instead, infection curves that had flattened out by the middle of the year are climbing even more mercilessly in the second wave that coincides with the colder weather. Some countries have been more unfortunate than others. For instance, the two hardest-hit countries (in terms of total cases) account for 37% of global infections and 27% of total deaths. Epidemiologists believe this wildfire to have been sparked by rapid irresponsible

urbanisation that has disturbed ecosystems. This was perhaps a less-talked-about risk embedded in the concept of a global village. In light of the eerily prescient warnings of such a threat, to term this as a Black Swan event would be erroneous at best. Even as some countries have started administering vaccines (that have been developed in record time), new strains of the virus are slowly emerging. It seems then the longer the virus prevails, the bigger a threat it will become.

Pakistan Covid-19 Cases: Weekly Trend





Obviously the economic fallouts of such a crisis cannot be ignored. The Great Lockdown, as it has been aptly termed, has dwarfed even the Financial Crisis of 2008; some have found it to be more comparable to the Great Depression of the 1920s and 1930s. Experts at the World Bank are of the view that despite the unprecedented fiscal and monetary support offered globally, the world's economy could contract by as much as 5.2% in 2020 while per capita income could see the largest contraction since 1870! Similarly, the IMF projects the world economy to shrink by 4.4% in 2020. However, given that these projections were made before the second wave gained traction, one can expect revisions in growth forecasts. Notwithstanding, the recently approved US stimulus package speaks volumes of what is still to come. An immediate impact of the pandemic was seen relatively early when US oil futures plunged into uncharted territory in April. However briefly the prices remained negative, they served as a stern indication of the broader repercussions that we see today.

The Real Sector

In a world engulfed in the chaos of Coronavirus-resultant casualties, lockdowns, and a complete paralysis of business activity, it was inevitable that Pakistan too would face

the ramifications of this unforgiving virus. GDP contracted marginally by 0.4% during FY20 against pre-Covid expectations of 2.4% growth. One might argue that this was an impressive performance given the detrimental impact on other economies in the region and beyond. Pakistan has been relatively fortunate in terms of the breakout than most. Smart lockdowns despite vociferous criticism helped cushion the blow on the economy as did government support and Central bank incentives.

Looking at sector-wise data, agriculture was the saviour with 2.7% growth recorded in FY20, mainly on the back of higher wheat and rice output. Industrial activity plunged by 2.6% in FY20, largely due to a 7.8% decline in large-scale manufacturing. Automobiles, textiles and electronics were the largest contributors to the reduction in LSM. The services sector, which constitutes slightly over 60% of GDP, shrank by 0.6% during FY20, with (1) transport, storage & communication, and (2) wholesale and retail trade contributing most significantly to the decline.

Measures taken in Pakistan

The fiscal and monetary support provided within Pakistan is well documented – not to say impressive – given that the timing of the virus could not have been worse from the perspective of the country's economic health. Efforts by the SBP and the government to support growth, income and employment have paralleled the unprecedented nature of the crisis.

Measures taken by the State Bank of Pakistan (SBP)

Within a short span of just over three months, the State Bank of Pakistan slashed the Policy Rate by almost half, from 13.25% in March-2020 to 7.00% by June-2020. While monetary easing had become widely-discussed with global peers having taken similar steps to support the slowdown in their respective economies, Pakistan's Covid-19 induced monetary easing spree was very timely.

As a matter of fact, the efforts of the SBP during the pandemic went far beyond interest rate cuts. Support extended to existing borrowers under the Debt Relief Scheme not only offered existing borrowers an opportunity to defer their scheduled loans, but also provided troubled borrowers the option to apply for loan restructuring. The response from the banking sector has been generous, as it accepted more than 95% of applications under this scheme, which amount to loans worth nearly Rs875 billion (approximately 11% of the sector's gross loans).

In order to promote investment and offer opportunities to industry, the SBP introduced a Temporary Economic Refinance Facility (TERF), where Greenfield projects, Balancing, Modernization and Replacement (BMR) and expansion on existing projects would be offered refinancing at a concessionary 5% rate. So far, more than Rs250 billion worth of loans have been approved under TERF through various banks.

To minimize the pandemic's impact on employment, the SBP Rozgar Scheme was introduced. Under this scheme, private corporates and businesses were given the option to finance the salaries for a period of six months at a cost of 3%-5%, depending on whether the business appears on the Active Taxpayers' List. The scheme was not only affordable, but also completely transparent as SBP would credit salaries directly to the respective employees'/wagers' bank accounts, simultaneously promoting financial inclusion. This scheme saved jobs for more than 1.8 million employees, as per SBP data.

SBP also played a key role in supporting importers and exporters through various measures such as providing time leniency in settlement of foreign currency loans, enhancing credit limits and further reducing rates under the Long Term Financing Facility. Furthermore, all fees on digital banking transactions were waived to promote greater financial inclusion. To facilitate the healthcare sector, the SBP introduced another refinance facility aimed at enhancing the overall infrastructure which included but was not limited to procurement of protective gear and kits, hospital beds and ventilators.

Fiscal Stimulus in Pakistan

Similarly, the Government of Pakistan provided support on the fiscal side as it announced a Rs1.2 trillion stimulus package in March-2020. This included steps to support industries, businesses, farmers and low-income earners. A particular feature of the package (that received international acclaim) was the disbursement of Rs225 billion in cash to daily wage workers and low-income families. This step lent crucial support to more than 6 million daily wagers, while keeping afloat more than 12 million low-income families.

To ensure availability of affordable groceries Rs50 billion were earmarked for the Utility Stores Corporation (USC) while an amount of Rs280 billion was also set aside for wheat procurement. Meanwhile, tax refunds worth Rs100 billion were released to exporters to support working capital requirements and SMEs were offered relief in electricity bills

and tax incentives. The healthcare sector too received support from the Government through abolishment of import duties on a number of health equipment.

Relief measures that have not been implemented thus far have been carried forward till end of FY21. The Government also made COVID relief measures a part of Budget FY21, increasing focus on healthcare and other social sectors through further reduction in various custom duties.

The Government further announced a construction package to boost economic activity. This has so far proven to be rewarding with a number of construction projects availing the amnesty.

Growth to return in FY21

Looking ahead at the remainder of FY21, it would not be wrong to say that we are still encumbered with a fair amount of uncertainty as we plough ahead. For instance, our best performing sector in FY20, i.e. agriculture, is proving to be a challenge in FY21. Overall output has plunged owing to a multitude of unfortunate occurrences, such as pest attacks, water shortage and unfortunate timing of monsoon rains. And with no serious planning measures to turnaround the situation, it appears that the agriculture sector will continue to struggle for the remainder of the fiscal year. While official figures estimate the sector's contribution to overall GDP at about 20%, this number could be much higher, considering the many forward and backward linkages to other industries., not to mention that a bulk of the labour force is employed in agriculture. Yet it has not received attention worthy of its weight in the national economy.

Industrial growth is expected to be the outperformer this year. While this is being widely celebrated, one should keep in mind the severe low base effect that will come into play in the last quarter of FY21 owing to the pandemic. In fact, absolute numbers are expected to remain in the shadows of pre-pandemic levels. Similarly, since services are also interconnected with manufacturing, some improvement can be expected, but with caution due to the pandemic situation.

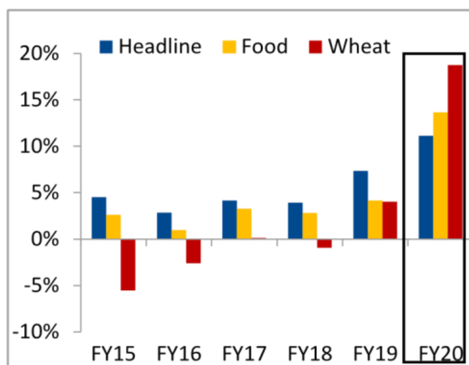
Overall GDP growth for FY21 would most likely remain low, close to 0.5% and 1.5% forecasted by World Bank and IMF, whereas the Government's official target is 2.1%. With positive developments on the vaccine, GDP growth close to 2% is not unachievable.

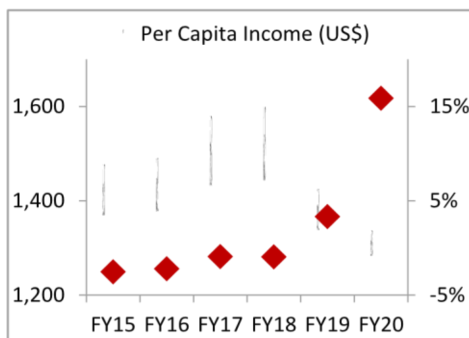
Inflation to taper off, eventually

During FY20, inflation remained a sore point for the incumbent Government (and

continues to be so in FY21), rising by 10.74% compared to last year when it averaged 6.74%. Dissecting the inflation data, the trend was worse for the more vulnerable segment, as seen by a higher increase in Rural-CPI (11.62%), when compared to 10.17% in Urban-CPI. In terms of contribution, food-related inflation accounted for more than half of overall headline inflation, with house rent, utilities, motor fuel, and clothing cumulatively contributing more than 30%.

Inflation in Pakistan





In FY20, food inflation actually surpassed headline inflation. And given food's high weight in the lower and middle income segments' consumption baskets, backlash was writing on the wall. What is tragic is that the rise in prices of some of the commodities, such as wheat and sugar was avoidable and could have been managed better, to say the least. Rising food prices becomes even more frustrating when one considers that despite primarily being an agrarian economy, Pakistan had to resort to imports of key commodities to avoid further escalation of prices.

In FY21, high food inflation has persisted so far and it remains to be seen how the situation unfolds in the coming months. Notwithstanding, some respite in headline inflation during Jan-Mar21 can be expected owing to a high base effect, whereas, inflation is expected to average around 8.2%-8.5% in FY21. In the political backdrop, it can be said that controlling inflation will remain at the top of the pecking order of the Government's to-do list. If external factors (such as oil prices) remain at manageable levels, national inflation could converge to its historical average of ~7% in FY22. The same can also be inferred from the Central bank's recent discussions that ~7% is an acceptable level of inflation for Pakistan. And quite interestingly, this view gets credence from none other than IMF in its recent long term economic forecasts on Pakistan. But this scenario will materialize only with unerring focus from the

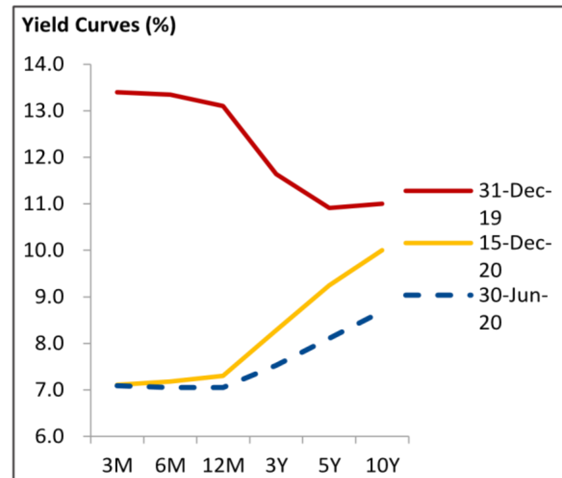
Government on controlling prices (food in particular) and minimizing administrative mishaps of the recent past.

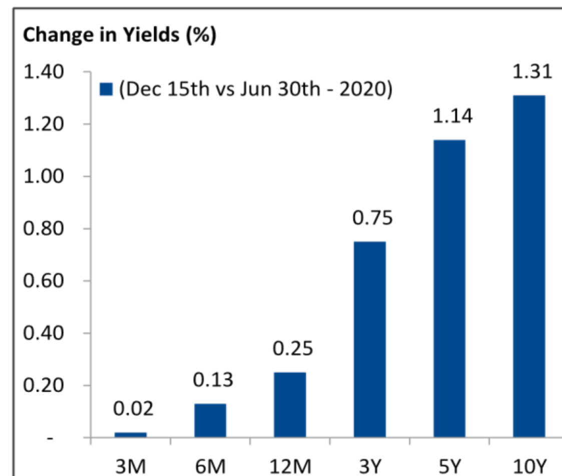
Monetary Policy has played its part

Having already discussed the drastic steps taken by the SBP to mitigate the impact of the pandemic, it is fair to say that the policy rate has been sufficiently brought down. In fact, one may even go as far as to say that monetary policy has been stretched to its limit, at least with regards to the policy rate. However, in a recent meeting of the Monetary and Fiscal Policies Coordination Board, media reports claim that arguments were made in favour of further reductions.

On the other hand, the bond market seems to be betting on – almost yearning for – a 50-100 bps rate hike sometime during 2021. This hope is reflected not only in the now normalised yield curve, but also in the bidding behaviour observed in bond auctions where most of the financing being raised is in the shorter tenors. However, one should pause and deliberate on the consequences of *'earlier than warranted'* monetary tightening. With economic growth still frail, would it be wise to raise interest rates and risk undoing the efforts made so far? Considering the inflationary outlook and the fact that the SBP employs a forward looking view, status quo on the policy rate should prevail in 2021.

Yield Curves Journey





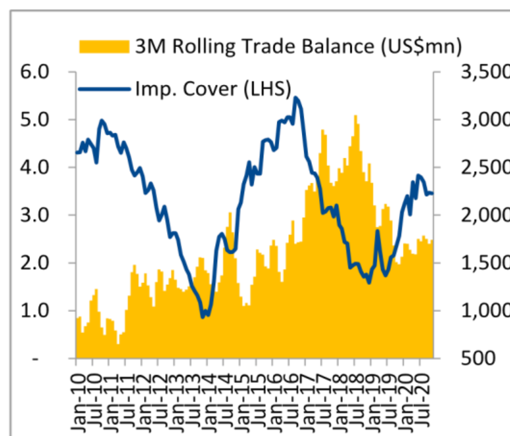
Source: Bloomberg

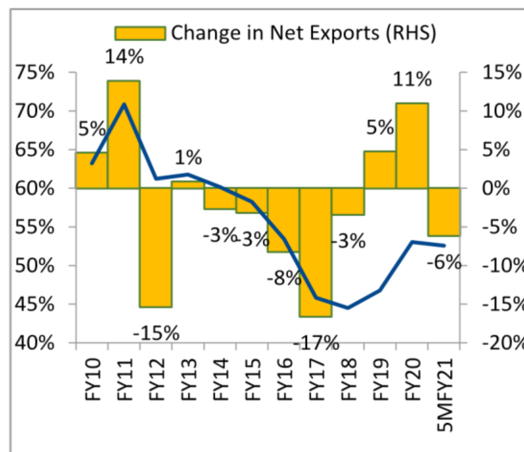
External Account to remain in check

For FY20, probably the silver lining for Pakistan's economy – on face value – was the country's external account situation, with the Current Account Deficit (CAD) shrinking by US$10.5 billion to US$2.97 billion compared

to US$13.43 billion in FY19. Delving deeper, the improvement comes solely from a US$9.5 billion decline in import of goods, whereas exports of goods contracted by US$1.8 billion during the year. Combined, the two culminated in a US$7.7 billion reduction in the trade deficit. Moreover, a pickup in remittances (growth of US$1.4 billion) during the year also contributed to the lower CAD in FY20. While the decline in the trade deficit is indeed commendable, bear in mind that import of goods during FY18 and FY19 stood at US$56 billion and US$52 billion, respectively, i.e. at highly unsustainable levels and there really was only one direction for both imports and the trade deficit to go – downwards. In fact, the lowest CAD in absolute terms surfaced in 4QFY20, which coincided with the pandemic, and led to record high remittances. This trend of higher remittances, by the Central bank's own admission was possibly due to pandemic-related assistance by overseas Pakistanis to their families in Pakistan, coupled with higher inflows through official banking channels as travel restrictions did not allow most other means of funds transfers.

Pakistan Balance of Trade





Source: SBP

Looking at the financial account, there was a reduction in inflows in FY20 as disbursements from bilateral and multilateral lenders slowed down in wake of the pandemic. While foreign investment inflows improved in sum, they remained inconsequential in terms of the overall balance. Nevertheless, despite a weaker performance in the financial account, the massive reduction in CAD ensured a US$4.8 billion increase in SBP FX reserves in FY20

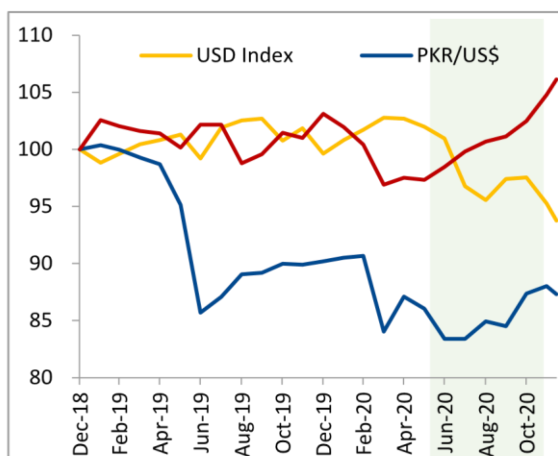
versus a decline of US$2.5 billion in FY19. As a result, the import cover also doubled from a precariously low level in FY19.

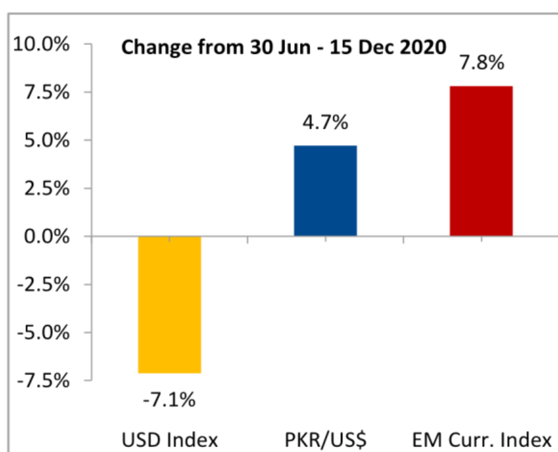
So far during FY21, there has been further improvement in the current account, with surpluses in each of 5 months so far, amounting to a cumulative surplus of US$1.6 billion vs. a deficit of US$1.7 billion in FY20. Most of this is attributable higher remittances in the current period, with some support from an improved services' trade balance. On the other hand, financial account inflows continued to remain soft in the period.

Now looking ahead, the Central bank's FX reserves should not change materially by the end of FY21 and should stay at safer levels above US$13-14 billion. This is based on the assumption that even if a suitable vaccine is found soon, the situation in both current and financial accounts will reverse, or more aptly, normalize. Higher demand will create import pressure and this coupled with lower remittances could see the country returning to a deficit in the Current Account. Simultaneously, higher inflows in the financial account might resume.

With regards to the IMF program, the US$6 billion Extended Fund Facility (EFF) that Pakistan secured in 2019 went on hold just ahead of the virus being elevated to pandemic status. By this time Pakistan had already received nearly US$1.5 billion in two tranches. However, under the new emergency circumstances, the IMF released nearly US$1.4 billion to the country under the Rapid Financing Instrument (RFI) banner – funding that came with no strings attached. The key takeaway here is that the IMF has maintained an empathetic view. Given that the EFF is meant to work in a normal, non-chaotic global environment, the impressions of meeting pre-conditions may not be reflect the entire picture. In fact, the Government is already in contact with the IMF and the resumption of the EFF can be expected as the world reverts to its old normal and the program becomes more relevant. It must be kept in mind that the lag has significantly altered economic dynamics. Hence it should be safe to say that the IMF would employ a lenient approach.

FX performance





Source: SBP, Bloomberg

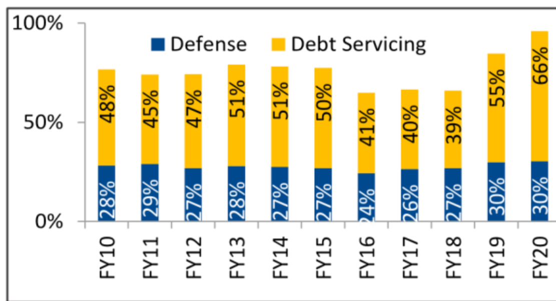
As far as the exchange rate is concerned, the recent unexpected appreciation has been particularly noticeable. It would not wrong to assume that the Covid-19 scenario has been a blessing in disguise, at least for our exchange rate. While a weakening US Dollar has provided due support, further proof can be found in the strengthening Emerging Markets currency index of late. To sum up, keeping in view the external account situation discussed above, the PKR could remain in the range of 160 to 165 during 2021.

Fiscal policy expected to lead

Virtually everywhere one looks, focus seems to have drastically shifted from monetary to fiscal policy, given that monetary policies have been completely exhausted in many countries/economic blocs with zero or even sub-zero interest rates. To provide further stimulus, massive fiscal packages have been announced in wake of the pandemic and Pakistan has not been an exception to this trend. Effective administration of fiscal policy in developing countries like Pakistan becomes even more critical given gaps or inefficiencies in the institutional framework. Looking at expenditures, one needs to realise that as a country with the tendency to fall short even on vital spending, Pakistan should consider detailed audits (perhaps every five years) to identify and cut down on unproductive spending. For instance, fiscal space may be created by increasing efficiency through eliminating overlapping functions. On the other hand, revenue generation is without a shadow of doubt an area where significant progress should be made. In that vein, just like IMF can be expected to remain supportive in the pandemic climate on

resumption of EFF, it is equally plausible that the lender remains steadfast in demanding implementation of progressive taxation. Moreover, documentation of the economy would become more significant to achieve the aforesaid objective and while there have been some commendable measures taken in this aspect there is ample room for further improvement.

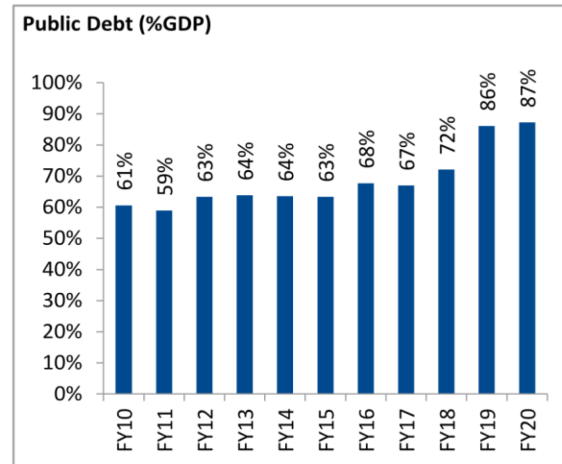
Debt & Defense Defence Expenditure as % of FBR revenues

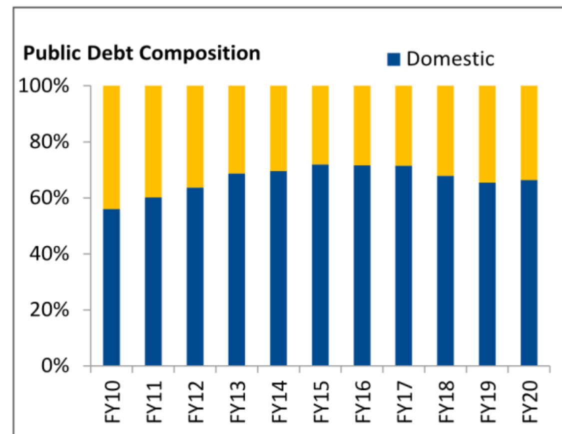


Source: Ministry of Finance

One hotly contested debate in recent times has been our national debt which has reached new highs. Debt is in fact a global issue, with many countries (both developing and developed) facing high debt to GDP ratio. However, it is undeniable that in Pakistan there has been sharp acceleration in debt of late. Total public debt as a percentage of GDP has shot up to 87% by end of FY20, as compared to 72% by end of FY18. Historically, higher debt levels in Pakistan have coincided with a slowdown in the economy, peaking when economic growth hits a trough in its typical boom-bust cycle and declining once growth begins to pick up.

Pakistan Government Debt





Source: SBP

Looking at the composition of the country's public debt, there has been a notable increase in the domestic portion over the years. One obvious reason for this trend has simply been that domestic funding is more conveniently accessible. However a sharp depreciation in the Pak rupee vis-à-vis the Dollar has led to

external debt (in rupee terms) shooting up sharply during the last few years. In the current situation, raising funds in international markets has become difficult given the pandemic. And with the IMF's program on hold, dependency on domestic funding has soared once more. Domestically, a higher interest rate in recent years had made debt servicing quite painful for the Government. Now, with a lower rate, while servicing the debt has become cheaper, a new challenge has emerged in the form of considerably lower investor interest in longer tenor bonds. Hence, floating rate bonds have recently been introduced by the Finance ministry, which have definitely encouraged greater participation but still remain in infancy.

Going forward, once economic growth picks up in 2021 and beyond, debt levels are expected to recede. Recent economic projections for Pakistan by the IMF also support this view of manageable debt levels.

The big picture

Entering the New Year, some key events merit special attention. First and foremost, the political landscape has become heated just ahead of the Senate elections. Yet, one can expect the government to sustain the pressures of the politics of 'sit-ins' and 'long marches' that have now become a norm in Pakistan. Secondly, there has been much talk of the IMF program which has been on hold throughout the pandemic-ridden year. As mentioned above, the program's resumption is based more upon the right (non-Covid) environment materialising than anything else; after all, was Pakistan not among the initial few countries to receive IMF financing during the first wave of the virus? Another key event is the FY22 federal budget which is expected to be critical both on the revenue and expenditure side. With two happening years in power, the sitting government is now more experienced with regards to the country's financial needs and one can expect this experience to reflect in the federal budget. Last, but not the least, given recent geopolitical developments particularly with regards to the Middle East, Pakistan's foreign policy could remain in the limelight in 2021. Here, a perception of change of blocs and a tendency by countries to take relatively unconcealed stances warrant a constant watch.

Recently three broad areas of concern that have been in the spotlight include food inflation, the circular debt and the gas crisis. Needless to say, each of these has been debated at every fora countless times and libraries of literature are available on each. With the problems identified and the solutions common knowledge, the only

missing ingredient to rid us of these evils, by simple process of elimination, is execution. If this is an unfortunate casualty of lack of direction setting, it is perhaps time to re-evaluate priorities. After all, there is no dearth of examples where effective implementation of policy is needed.

Food inflation for instance is one such example. And this links back to agriculture; the sector that was once hailed as a saviour is swiftly becoming a challenge this year. Not only can agriculture play a key role in keeping food prices in check, it is a crucial means to the goal of poverty alleviation. Yet, as mentioned above, the sector has hardly received the treatment that it demands.

The ever-rising circular debt, now reportedly at a new high of Rs2.3 trillion, is another major cause for concern. And even this has started to mutate, much like the Coronavirus. Lately, a new 'strain' of the debt has emerged in the LNG segment. Pakistan neither has enough pipelines to meet domestic demand nor does it have the terminal capacity to compensate for the domestic shortfall. While the Government has recently approved two new LNG terminals and work on various pipelines is expected to commence shortly, the effects of these are not expected to materialise in the short term.

While the above are clear symptoms of an ineffective policy framework, one needs just glance at State Owned Enterprises (SOEs) and public infrastructure – where transport is a prime example – to understand that the problem is deeply rooted.

It appears then that policymaking in Pakistan has for decades been reigned by a reactionary approach that panders to short-term solutions – an approach that is known to subdue symptoms while leaving the root causes untouched. One cannot rationally expect the country to unshackle itself from the chains of frequent boom-bust economic cycles without an effective policymaking and implementation framework in place. Until such steps are taken, menaces such as food inflation and circular debt will continue to threaten sustainable growth.

It goes without saying that the vision of a prosperous Pakistan cannot be attained without education and Pakistan's demographics make this a particularly crucial area. Serious efforts need to be made at the highest levels to ensure no child is deprived of the right to quality education. And education is not defined here as simply routine school education. Training courses on foreign languages and Information Technology should be made accessible to all and sundry.

Then and only then can one expect the nation to truly prosper.

Obviously, widespread education will open floodgates of innovation and this disruptive wave will require funding. Institutions that specialize in tailored financing such as Venture Capital firms, DFIs and microfinance solutions should be rejuvenated to deliver on this front. The Pakistani diaspora can also play a crucial role through the recently launched Roshan Digital Account. This would not only create employment opportunities but ensure growth in the real sector. Furthermore, vocational training in collaboration with international firms is a low hanging fruit waiting to be plucked. Needless to say, a trained workforce will attract Foreign Direct Investment that will have beneficial spill-over effects in the form of technology transfer.

Of course, Pakistan is blessed with a diverse topography like perhaps no other country in the world. In the south, there is a pristine coastline at, in the North there are some of the highest peaks of the planet, and in between we find numerous architectural masterpieces, rivers, deserts and numerous vibrant cultures, to name a few. This creates a conducive environment to build on the tourism industry which could grow into a sustainable source of valuable foreign exchange for the country. Here, accessibility from Central Asia and Europe makes Pakistan's strategic location of vital importance. Moreover, investing in the Blue Economy alone offers immense potential.

In reality, Pakistan is still miles from its potential. To truly develop into a strong economy, what is most needed is a change in perspective. After all, this is a debt that we owe to our flag.

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