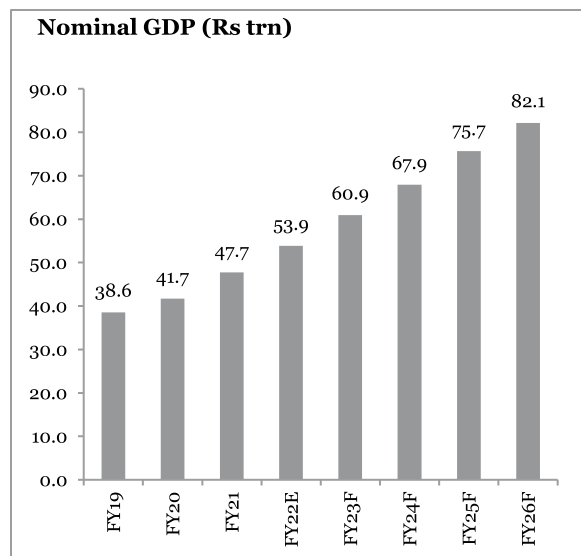


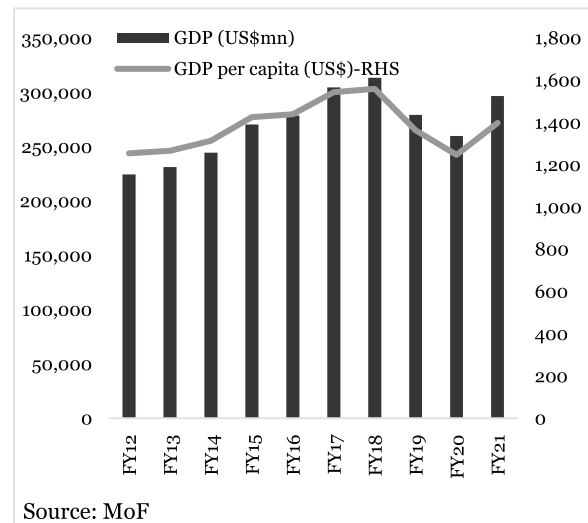
PAKISTAN'S ECONOMIC LANDSCAPE

Faran Rizvi

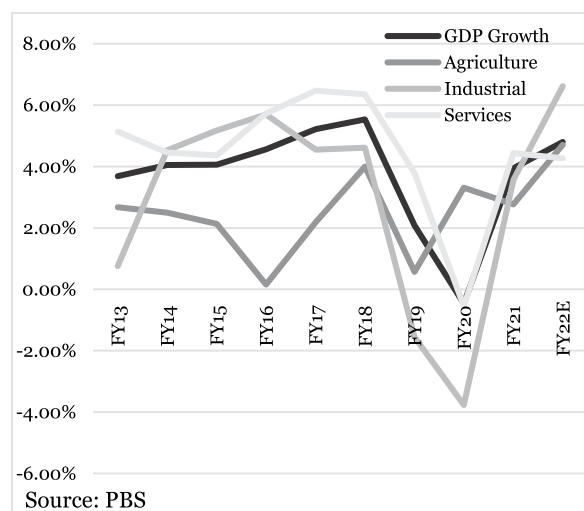
FY21 closed on a positive promising recovery of 3.9% and the government is now targeting 5% growth ahead which has become evident after vaccines were rolled out, coupled with continuation of stable economic activity during the last COVID19 waves. The agricultural sector is being provide and impetus as government seeks to enhance output by providing better seed varieties ad modern technology. More specifically the cotton output has grown at an extremely faster pace to recover from the multi-year low recorded in FY21. In addition to this, the government has introduced Kharif and Rabi packages, which includes subsidies on fertilizer and other inputs, in order to support growth. This is in addition to the increases in the minimum support price of wheat and sugarcane crops.



Pakistan's economic recovery has gained hold and GDP growth for FY22 is expected to near 4.5%, where growth is dispersed across nearly all segments, indicated by better agriculture, construction and other high frequency indicators. In doing so, the government is also tilting towards fiscal consolidation at a tepid pace to avoid the staple boom-bust cycle which the country has witnessed historically.



However, the second round of growth will continue to emerge from TERF and construction amnesty scheme, providing a shield to cyclical headwinds from stabilization measures, going forward.



However, emerging opaqueness of economic outlook of Pakistan is defined by growing uncertainty and risk factors which have engulfed both the external and domestic fronts. The external vulnerabilities hold paramount importance, despite SBP's stabilization measures, as stronger economic activity and higher commodity prices have begun to manifest in current account and exchange rate.

Most challenging task is approval of the Finance supplementary bill of PKR343bn and the SBP autonomy bill 2021, both having strong bearing on successful resumption of IMF program. Fund holds key to meeting the external financing requirements through multi/bi-lateral borrowing and issuance of Eurobond/Sukuks, which will also finance the current account deficit. This will likely bring stability to recent turbulence in exchange rate as difference between interbank and open

market has widened and PKR/USD trades 4% lower in underground banking channels, which can lead to evaporation of remittance growth ahead, especially after travel restrictions ease further.

IMF's prior actions regarding energy price hikes and petroleum levy collection have piled on to the transitory inflationary pressures of commodity price bull-run that is not expected to last beyond the pandemic related supply chain disruptions. We expect FY22 inflation to stand at 11.0% during FY22, entering single digit rate in Sep-2022.

Agriculture sector is growing strongly

Both agriculture packages introduced in FY21 laid emphasis on subsidies. The Kharif package included subsidy of PKR925/bag on DAP and PKR 243/bag on urea. And the Rabi package included PKR1000/bag subsidy on DAP. Despite that DAP offtake grew 19% in Kharif and 2% in Rabi season. It is pertinent to note that the offtake in Rabi was dampened by the sharp increase in the global commodity prices. Specifically, during Oct'20-Mar'21 where DAP prices rose sharply by 49%. This constrained the farmers' ability to purchase and apply the input, despite the subsidized rates.

The stock of agri-credit rose to PKR1.4tn during FY21, compared to PKR 1.2tn last year mainly due to increase in disbursements to

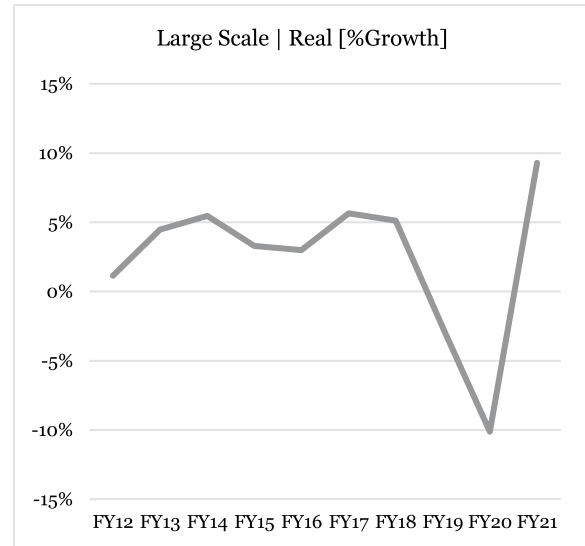
farming sector which spurred an increase in crop production loans. This can also be assessed by record production output of wheat, rice, and cotton. Working capital loan disbursements to dairy and livestock also improved.

Pakistan is a forest-deficient country, where only 5% of its area is under forest cover. UN recommends forest area to be at least 12% of country's land area. The 'One Billion Tree Tsunami' afforestation project in KP has planted 1.18 billion trees between 2014-17. Federal government launched the 4-year Ten Billion Tree Tsunami in 2019. Such mega initiatives can help bring environmental and ecological benefits.

On the other hand, fishing sector has an encouraging potential to generate FX earnings for Pakistan, with exports of fish and fish preparations averaging USD421mn during FY17-21.

Industrial sector has grown robustly

Mainly tracked by Large Scale Manufacturing (LSM), industrial sector has posted notable economic growth as business activities resumed. International demand for textile products and domestic demand for construction materials, automobiles and petroleum products have been major drivers of economic activity during FY21.

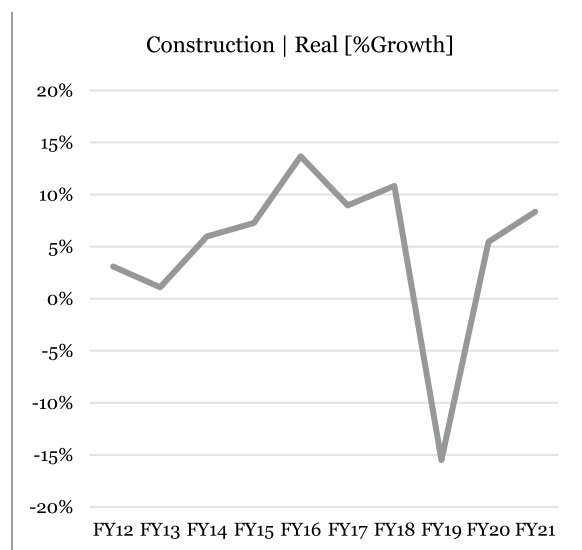


Owing to temporary relief packages introduced via fiscal and monetary stimulus, the economic recovery gained speed post lockdowns after COVID19 outbreak. Cement and Steel sector recorded double-digit growth in production during FY21. Electricity generation and gas distribution witnessed sharp decline in FY21, despite an increase in electricity output.

Construction sector expanded 8%

Construction industry grew by 8.3% in FY21 along with its allied industries of cement and steel in the LSM as it received incentives from the government. Construction package reduced the cost for both buyers and sellers via tax reduction while the amnesty for real estate developers attracted fresh investment liquidity. This is coupled with impact from government incentivizing the demand through Naya Pakistan Housing Scheme (also known as Mera Pakistan Mera Ghar (MPMG) Scheme). SBP

has also reduced mark-up rates and introduced mandatory targets for banks to ensure lending to construction sector.



However, this also triggered an increase in real estate prices as more private investment has flown in the system. As per FBR, more than 2,100 housing projects have been registered. With September 2023 set as the deadline for the completion of the projects, anecdotal evidence suggests that real estate developers are hastening their efforts to meet the requirements.

Aided by capacity expansions over the past few years, the cement industry responded to the increase in demand for the commodity by setting the record for output, which grew by 27% during FY21. The monetary and fiscal stimuli, along with the lowering of FED on cement, facilitated the growth in FY21. Domestic demand has been the driving force

in FY21, contributing 17% to overall growth of 20% in the year. Local cement dispatches increased by 18.2(North) and 34% (South). Since large public infrastructure projects and majority of the private sector projects are in North, the cement producers in that region gained more benefit.

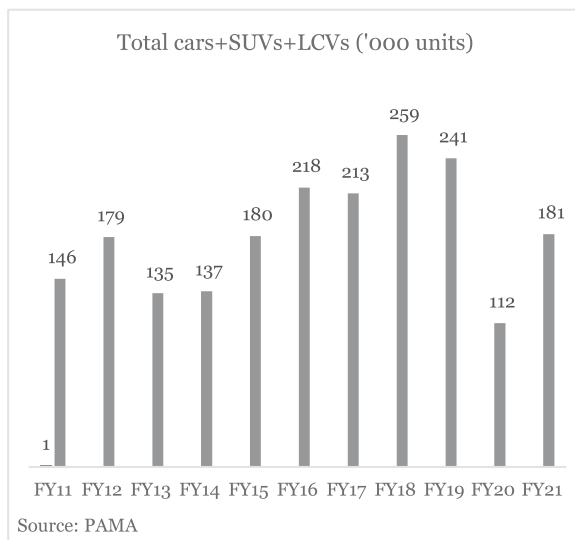
Pakistan is not self-sufficient in steel and relies heavily on imports to plug this domestic shortfall. Steel scrap and finished product imports also rose by 21% and 25%, respectively. Most of the import growth in steel sector was due to increase in demand for reinforced bars, a long-steel product, used in construction activity. The price of re-bars increased sharply due to higher cost of imports as well as the increase in domestic demand.

Textile also benefited from the energy package and the SBP's concessionary finance schemes, which lowered its cost of production. Textile output rose by 15% during FY21, compared to a contraction of 10% last year. The export-oriented high value-added textile industry performed quite strongly during the year on the back of the policy support and by capturing textile export orders from some competitor countries.

The automobile industry also recovered from constrained output over the past two years, on the back of the introduction of new models,

pent-up demand from delayed purchases last year (amid the lockdowns) and low interest rates.

The petroleum sector has been one of the key beneficiaries of post-pandemic demand growth from ease in mobility restrictions. The growth in both petrol and diesel is evident from the 18.1% growth in FY21. The spillover effect of economic rebound in POL sales was from increase in transport, retail trade and wholesale activities, owing to which we also saw a sharp rise in the import of energy products. With the lifting of restriction on utilizing FO for electricity generation during FY21 also induced 14.7% growth in furnace oil production during the year.



The automobile sector also recovered from a 45% decline in FY20 to a double-digit growth of 51% in FY21. Low interest rates and introduction of new car models as well as competition helped automotive sector gain

momentum. Auto financing increased by PKR 97bn in FY21, against a meager rise of PKR 4.3bn in FY20.

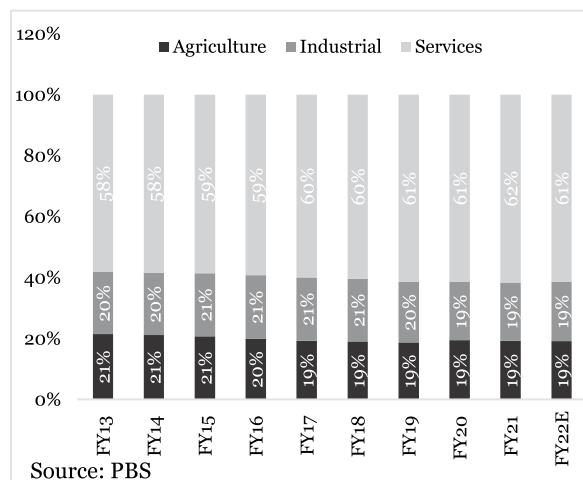
Under the incentives from the Automotive Development Policy 2016-21, new models and manufacturers were introduced which enhanced interest from the buyers as the new competition introduced world standard features and safety while pricing competitively. More specifically, the compact SUV gained a lot of traction as this new category filled a gap in the previous domestic car market.

A better farmer and rural income also gave rise to 2-wheelers and tractors whose volume sales grew by 37% and 55% in FY21, respectively.

Services have enhanced contribution to GDP growth

Services sector grew 4.4% in FY21. Early adoption of smart lockdowns helped the services sector output recover faster from the pandemic in FY21. Google Mobility statistics show Pakistan's recovery superseding various South Asian economies. Targeted fiscal support to various sectors and lower interest rates played a vital role in reviving commodity producing sector which effectively increases the demand for services as they have a spillover impact. The economic stimulus to the sector mainly came from wholesale and retail trade which grew 8.4% during FY21. Finance and

insurance segment also rose by 7.8% owing to strong performance of the banking sector, coupled with healthy growth in the insurance sector.



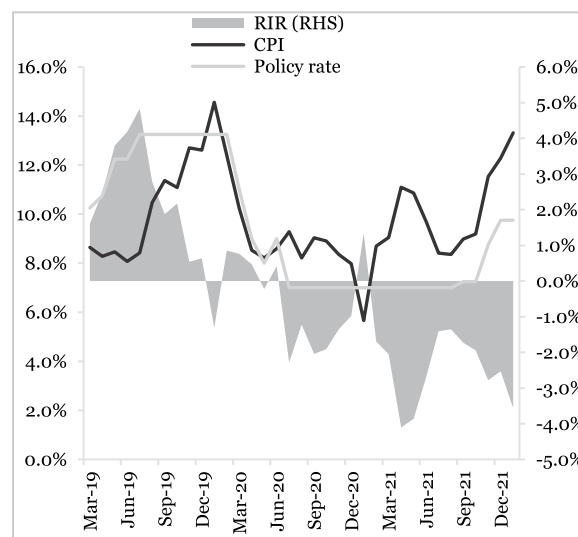
Inflation is skyrocketing at the moment

The Monetary Policy Committee at SBP considered it appropriate to continue with accommodative stance throughout FY21 in order to provide necessary support to the ongoing recovery process and hence policy rate was kept unchanged at 7% amid anchored inflation expectations and subdued inflationary pressures.

Inflation, if expectations of commodity bull-run are assumed temporary, is actually transitory. The recent broad inflation prints for Dec'21 has jumped by a whopping 12.3%, highest in 22 months. This has actually burdened an average Pakistani. They have to deal with this pressure when they purchase

groceries, fill fuel tanks, pay for electricity, health and education.

Pakistan is witnessing an unprecedented economic turmoil, with the inflation rate rising exponentially. The inflation being a temporary thing does not provide any respite to the masses, more specifically the low-middle income families that have been struggling over recent couple of years. At this pace, inflation is expected to stay at 11% for FY22. The core inflation has also inched upwards to 8.5% showing how entrenched inflation is at the moment.



Interest rates are on a rise now

The recent weakening of USD: PKR parity, which is about 10% during FY21 has also transmitted into inflation indicators. Even though a market-based exchange rate has served as a good shock absorber and has actually allowed the central bank to build

reserves, the global development including recoveries around the world and supply chain disruptions have caused a sharp hike in global commodity prices, which has pushed up current account deficit as well as inflation in Pakistan.

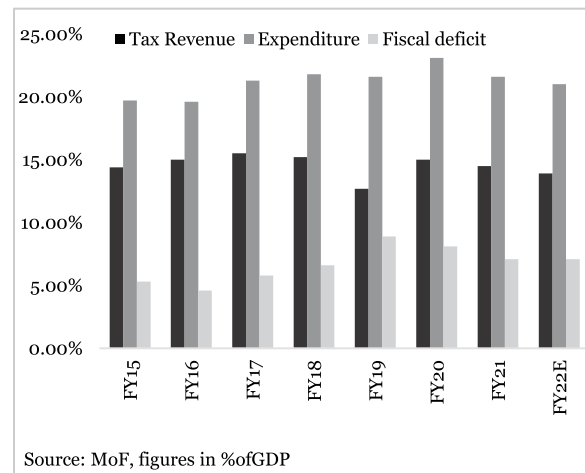
While fiscal policy has been very complimentary and is also withdrawing stimulus so a coordinated macroeconomic response, SBP raised rates by accumulative 275bps since Sep'21. SBP will take a "pause" in its interest rate hikes to sustain economic recovery after raising policy rate to 9.75%. Albeit, Pakistan is expected to witness more rate hikes this year.

Fiscal consolidation on the cards

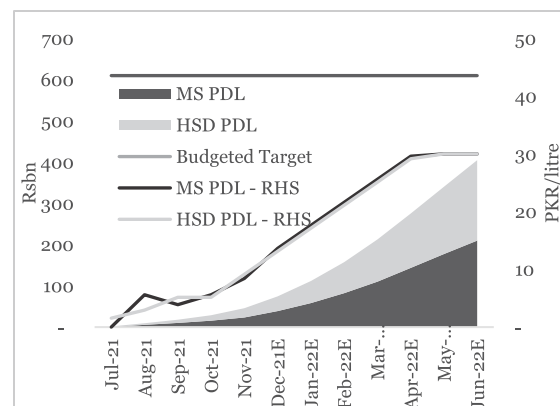
Pakistan continued to implement fiscal consolidation during FY21, witnessing a notable reduction in the fiscal deficit to 7.1% of GDP from 8.1% in FY20. This was driven by a large increase in collection and a slowdown in non-interest current spending. Also, greater than targeted provincial surplus of 0.7% of GDP further supported this outcome. Tax revenue jumped 19.5% in FY21, contributed by both the federal and provincial governments.

Specifically, FBR taxes gave a 5year high growth of 18%, underpinned by a sustained recovery in economic activity, along with a

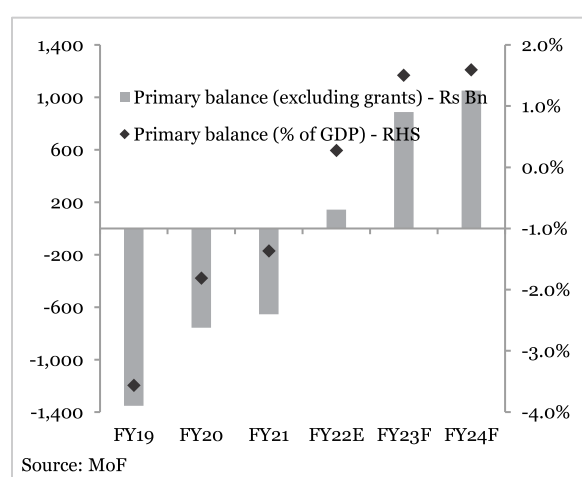
strong increase in imports. FBR's administrative measures to streamline the audit procedures, anti-smuggling and documentation led to a slight uptick in FBR tax-to-GDP ratio during FY21.



High GST collection by provinces on services and higher profits from hydroelectricity also added to the growth. On the other hand, non-tax revenues, declined in FY21 from lower SBP and PTA profits. The increase the rates of petroleum development levy (PDL) during the year acted as a buffer. However, since non-tax revenues are non-recurring in nature, they are not a stable source for financing expenditures.



Disbursement of power sector subsidies increased considerably in addition to the fiscal burden stemming from the need to cover losses of Public Sector Enterprises (PSEs). However, the recovery in tax revenues helped to contain the level of fiscal and primary deficit for FY21. Overall, fiscal improvement stemmed from both the revenue and the expenditures side.



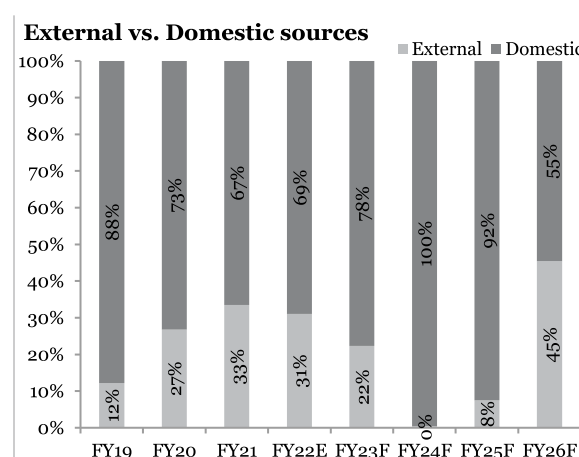
Most of deficit financing was met through domestic commercial banks in FY21. However, external financing also rose sharply from Naya Pakistan Certificates (NPCs) in addition to the loan inflows from bilateral and multilateral creditors.

Pakistan contained fiscal deficit from reduction in non-priority current spending in FY21. However, there is a need to address some emerging risks to fiscal sustainability.

There is a need for fast-track implementation of Public Financial Management (PFM)

reforms such as transition to Treasury Single Accounts (TSA) to improve spending efficiency. TSA will enhance cash management by providing consolidated information on availability of funds and lower the cost of borrowing, strengthening government's control over budget execution and lower transaction costs.

Ongoing reforms of broadening of the tax base by stepping up tax administration efforts, reducing income tax exemptions have helped strengthen tax receipts. However, despite these policy efforts the volume of tax exemptions as measured by tax-expenditures to- GDP, has remained elevated.



Pakistan's debt servicing cost is considerably high. The ratio of interest payments-to- FBR tax revenues stood at 58% in FY21 i.e., more than half of tax revenue is utilized for debt servicing, leaving less space for undertaking development expenditures. This has dampened

country's growth prospects as well as the debt repayment capacity.

FBR is making efforts to scale up tax regulations, procedures and evaluation processes to broaden the tax base. Important measures introduced during FY21 included: (i) improvement in audit procedures, focused on ensuring transparency and fairness while conducting audit of taxpayers; (ii) intensification of crack-down against smuggled goods; (iii) integration of the tier-I retailers with the centralized database of FBR; iv) revising the rate of penalties; and (v) filing complaints under Anti Money Laundering Act to comply with FATF.

Circular debt continues to be a menace

Subsidies, grants, and loans to PSEs constituted a major share in the non-interest current expenditures, 80% of total subsidies, of the federal government during FY21. Hence, the share of power sector subsidies, loans and grants to PSEs reached an average of nearly half of primary deficit in terms of GDP over last three years. Circular debt of power sector stood at PKR 2.28tn in Jun'21, 4.8% of GDP.

Growth in circular debt is driven by delays in adjustment of power tariffs, DISCO's operation losses, and un-paid subsidies. To arrest the accumulation of power sector arrears and ensure a sustained decline in the circular

debt stock, the government has prepared a Circular Debt Management Plan (CDMP) in consultation with the World Bank, ADB and the IMF. It also aims to rationalize subsidies and renegotiating Power Purchase Agreements with IPPs.

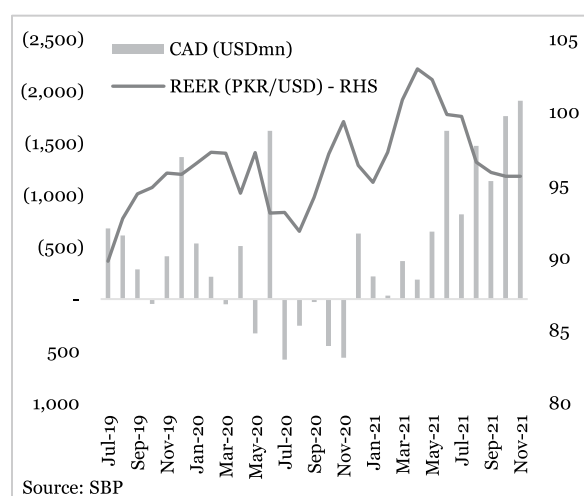
The inefficiencies in PSEs are emerging from governance issues, political interventions and other administrative factors. The top-10 loss-making PSEs contribute 90% to total losses per annum. NHA, Pakistan Railways, PIA and power sector DISCOs are among the major, top 10 loss-makings PSEs.

Expediting reforms in power sector and PSEs is crucial to lower the fiscal burden arising from their inefficiencies. These reforms should aim at improving governance, transparency and efficiency, strengthening monitoring, advancing privatization, enhancing legal/regulatory framework, by minimizing government's interference in PSEs' operation, etc. Moreover, the power sector reforms should aim at rationalizing subsidies, boosting antitheft and collection efforts, upgrading generation and transmission infrastructure, expediting privatization of loss-making DISCOs.

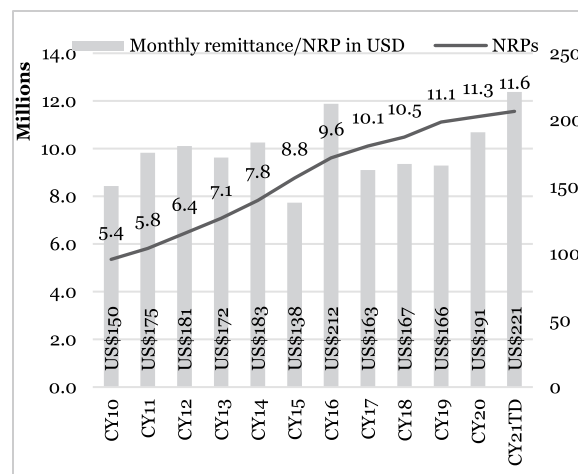
Taming CAD and IMF resumption are vital

IMF program of USD6bn Extended Fund Facility is vital and identifies time-bound

administrative measures targeted to attain full cost recovery focused on passing on sector inefficiencies to consumers by raising prices of utilities (instead of implementing structural reforms with the objective of dealing with the sector inefficiencies, particularly gas and electricity), and petroleum levy with direct impact on the cost of transportation of people and goods, including perishables.



The incumbent government's initial optimism on his ability to renegotiate the terms agreed with the IMF was slightly misplaced, and mini-budget envisaging the withdrawal of exemptions of over PKR343bn is a proof as is the public admission that the government will raise the petroleum levy by PKR 4 per liter to bring it to PKR 30 per liter levels.



Even though exports and remittances have been strong this year, the current account deficit has increased due to a sharp rise in imports. Higher commodity prices are the lead cause of rise in trade deficit and nearly 3/5th of this increase is estimated to come from commodity prices and shipping charges.

The 5MFY22 trade deficit of USD20bn is extremely unfavorable for Pakistan. Meanwhile, the SBP's foreign exchange reserves had begun to fall, sowing seeds of near depletion and a full-blown balance of payments crisis. Additional measures have also been taken to moderate the current pace of demand growth to a more sustainable level, including by curbing consumer finance through tighter macro prudential regulations. Together, these proactive measures will moderate the growth of imports going forward and allow a faster correction in the current account deficit.

External borrowing has jumped from USD95bn in Aug'18 to USD127bn today and domestic debt has jumped from PKR 16.5tn to PKR 27tn today. This does not go well with the government's initial target of paying off past loans.

Conclusion

At the core, Pakistan's near-term challenge is three-pronged: regionally, it is grappling with economic and financial fallout of Afghanistan situation; domestically, it is trying to arrest the decline in Pak Rupee and also overcome the lack of resources to keep prices of electricity, gas and oil in check; and most importantly, internationally, it faces soaring international commodities prices such as wheat, sugar, oil and gas amid high shipping freight charges as trade routes continue to remain choked.

These near-term challenges are a part of mismanagement of various policies which puts Pakistan in an extremely distorted situation that every single time the country plans to grow, it is mostly based on consumption and that effectively puts current account under an

extremely distressed situation. The increasing levels of commodity prices have a magnified impact on their expensive landing costs in Pakistan. A devaluing currency makes imports even more expensive and, hence, imported inflation continues to get transmitted into local inflation.

Moving away from these near-term problems, a bird's eye view provides that these instances emerge from deep-rooted structural problems in the economy. These structural challenges loom largely on the productivity of agriculture and industry, documentation of economy, fiscal management, external issues, banks intermediation of private sector credit and agriculture reforms.

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