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Economic review for 1st quarter of 2021-22 and outlook

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Pakistan Economy

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The year, 2020-21, came to an end with a significant recovery in the growth process in the country. The GDP growth rate approached 4 percent. The rate of inflation came down significantly to 8.9 percent from 10.7 percent in 2019-20. Also, there was a big containment in both the current account and the budget deficits. The former declined from 1.5 percent to 0.6 percent of the GDP and the latter from 8.1 percent to 7.1 percent of the GDP. The objective of this first Quarterly Economic Review of 2021-22 is to see if this process of improvement in the performance of the economy has continued or not. The review has six sections. The first section focuses on the real sector of the economy. This is followed by sections on investment, inflation, trade and balance of payments and public finances. The last section presents an assessment of the outlook for the economy in 2021-22.

1. The Real Sector

The first indications of the crop outputs in the Kharif season are positive. Cotton arrivals have increased by 50 percent and the expectation is that the output will be higher this year by 20 percent. According to the USDA, the record level of output of rice will be sustained this year. However, the prospects for the Rabi season may not be so positive. Due to low rainfall, there could be a large shortfall in water for this season. Also, fertilizer prices have gone up sharply, by 7 percent in urea and by over 48 percent in DAP. This increases the likelihood of a bigger shortfall in the output of wheat and the need thereby for larger imports.

Turning to the manufacturing sector, the Quantum Index of Manufacturing (QIM) has shown an increase of 7.3 percent in the first two months of 2021-22. Major Industries which have per- formed well include automobiles, pharmaceuticals and iron and steel products, with double-digit growth rates of 55 percent, 19 percent, and 14 percent respectively. Industries which show low growth rates below 4 percent include textiles, petroleum products and cement. However, the recovery in industrial output remains limited. The QIM stands at 139.38. Four years ago, in the corresponding months of 2017-18, the Index stood at 137.15. Therefore, the cumulative increase over the four-year period has been only 1.6 percent. Many industries, including petroleum products, cigarettes, steel, automobiles, vegetable ghee and beverages are still operating at lower levels of output compared to 2017-18. As such, it is unlikely that there has been a big increase in employment in the manufacturing sector.

2. Investment

The apparent trend in private investment is positive. There has been a 35 percent growth in the imports of machinery in the first quarter of 2021-22. This has been facilitated by the special financing packages offered by the SBP, including the TERF, in the aftermath of the COVID-19 attack. There has been a 46 percent increase in the imports of textile machinery, which augers well for an increase in the future quantity of textile exports. Other machinery imports, both agricultural and industrial, have shown growth of 42 percent. The expansionary stance of monetary policy is also confirmed by the rapid increase of credit to the private sector in the first quarter of 2021-22. It has increased by Rs 1019 billion up to September 30, 2021. During the corresponding period of 2020-21 there was a rise of Rs 137 billion only in the face of economic disruptions caused by COVID-19. A big question is whether the expansionary stance of monetary policy will be retained in coming months.

3. Inflation

The biggest problem facing the economy today is the persistence of relatively high rates of inflation. It has, however, moderated since June 2021. The rate of inflation averaged 8.6 percent, according to the CPI, in the first quarter of 2021-22, as compared to 10.6 percent in the last quarter of 2020-21. However, there is a considerable divergence in the rates of inflation as revealed by CPI, SPI and the WPI respectively, as shown in Table 1. It reaches a peak of 18 percent according to the WPI, as compared to the increase of 13 percent in the case of the SPI and 8.6 percent in the CPI. The big reason is the divergence in the rate of inflation in non-food prices. However, there is the likelihood that the faster increase in the WPI will be transmitted with a lag to higher retail prices.

Table 1: Average Rate of Inflation in 1st Quarter of 2021-22 According to the CPI, SPI and WPI

	Food (%)	Non-Food (%)	Overall (%)
CPI	9.1	8.1	8.6
SPI	N/A	N/A	13.0
WPI	10.9	22.4	18.0

Source: PBS

Key Data

KSE100 Index	45,429
KSE-All Share Value (PKRmn)	4,978
KSE-All Share Value (USDmn)	28.5
KSE-All Share Volume (Shmn)	166.0
Market Capitalization (PKRtn)	7.9
Market Capitalization (USDbn)	45.0
1Year High	48,726
1 Year Low	39,112

Source: PSX, Next Research

Two examples will illustrate this point. Vegetable prices in September 2021 have declined by 11 percent according to the CPI but the WPI shows an increase of 10.5 percent. Similarly, the prices of pulses have gone up by only 1 percent according to the CPI, but the WPI reports a bigger increase of 12 percent. There is the risk that the CPI will also rise at a double-digit rate in coming months.

4. Trade and Balance of Payments

There have been big changes in the current account deficit and in the overall external balance of payments in the first quarter of 2021-22 resulting in a significant deterioration. The primary reason for the increase in the trade deficit in goods by as much as 94 percent is the growth in imports of as much as 64 percent, while exports have risen by 35 percent. An analysis has been undertaken of the relative contribution of growth in prices and volumes to the growth in the value of major imports of Pakistan in Table 2

Table 2: Growth in Import Prices and Volumes of Major Imports in First Quarter of 2021-22 - *Growth Rate (%)*

Group	Imports (USD mn)	Prices	Volume	Value
Food	2,363	31.0	7.0	38.0
Machinery	2,845	-	-	35.1
Transport Equipment	1,117	-	-	169.7
Petroleum	4,592	91.0	6.2	97.2
Textiles	1,188	30.9	44.4	75.3
Agriculture & Chemicals	3,416	58.9	18.8	77.7
Metal	1,542	38.7	3.5	42.2
Miscellaneous	290	-5.8	12.9	7.1
Others	1,392	-	-	80.3
TOTAL	**18,745**	**51.1**	**14.9**	**66.0**

Source: PBS

There has been an unprecedented increase in import prices in dollars of over 51 percent on average. It has been high as 91 percent in the case of petroleum imports. Simultaneously, the import volumes have also gone up in relation to the level in the first quarter of 2020-21, which were low due to the slowdown after COVID-19. Overall, the import volume is estimated to have increased by almost 15 percent, with the biggest jumps in the imports of automobiles, textiles, agricultural products and chemicals. Turning to the performance of exports in the first quarter of 2021-22, there has been a big improvement with the growth rate rising to almost 28 percent, as shown in Table 3.

Table 3: Growth in Export Prices and Volumes of Major Exports in First Quarter of 2021-22 - *Growth Rate (%)*

Group	Exports (USD mn)	Prices	Volume	Value
Food	1,019	10.3	16.1	26.4
Textiles	4,420	28.4	-1.0	27.4
Other Manufactures	945	-	-	20.9
All Others	612	-	-	50.6
TOTAL	**6,996**	**-**	**-**	**27.9**

Source: PBS

The good news is that the volume of food exports has shown a high growth rate of over 16 percent, while export prices have gone up by 10 percent. However, the volume of textile exports has shown a marginal decline while there has been a big increase in export prices of over 28 percent. The balance of payments position in the first quarter of 2021-22 has deteriorated substantially. The current account deficit has increased to $3.4 billion as

compared to a deficit of $2.5 billion in the last quarter of 2020-21 and a surplus of almost $0.9 billion in the first quarter of 2020-21. The summary position of the balance of payments in the first quarter is presented in Table 4.

Table 4: Balance of Payments in First Quarter *($ billion)*

	2020-21	2021-22
A. Current Account	**865**	**-3,400**
Trade Deficit in Goods	**-5,283**	**-10,232**
Exports	5,354	7,241
Imports	10,637	17,473
Trade Balance in Services	***-533***	***-717***
Balance in Primary Income	***-,1489***	***-964***
Balance in Secondary Income	***8,170***	***8,513***
Home Remittances	7,143	8,035
B. Capital Account	**77**	**62**
C. Financial Account*	**-1,117**	**5,502**
Foreign Investment	589	1,353
SBP and others	-3,128	2,516
Government (net)	1,422	1,633
D. Balance of Payments	**-175**	**2,164**
E. Change in Reserves**	**-429**	**1,941**

Source: SBP
* Including errors and omissions
** After debt repayment to the IMF

As highlighted above, both exports and imports have shown exceptional buoyancy due to the upsurge in commodity prices. Home remittances have continued to grow on top of the big peak attained in 2020-21. There has been a quantum improvement in the financial account of the balance of payments of almost $6 billion. A big part of this increase is due to the receipt of $2.8 billion from the IMF of SDRs as part of the global support after COVID-19. Further, debt securities of $1 billion have been floated. Overall, the balance of payments is in surplus of $2.1 billion. However, if the once-and-for-all receipt of SDRs is excluded then the balance of payments is negative in the first quarter. This does not auger well for coming months. A straight-line projection of the annual current deficit in 2021-22 is as high as $13.6 billion. Clearly, the IMF Program targets for 2021-22 will be based on substantial reduction in this deficit rate by resort to intensive use of instruments like depreciation of the exchange rate, hike in the policy rate, rise in regulatory duties and import margin requirements. This process has already been ongoing for some time now.

5. Public Finance

Information on overall fiscal operations in the first quarter of 2021-22 has not yet become available. FBR revenues have shown extraordinary growth in the first quarter with a growth rate of 38 percent. The quarterly target has been exceeded by Rs 184 billion. However, bulk of the increase is in import-related taxes due to the 66 percent increase in the value of imports. The growth in import duty revenues is 47 percent and in the sales tax on imports almost 80 percent. Income tax and excise duty revenues have also shown some buoyancy with growth rates of 26 percent and 22 percent respectively. The only weak performance is that of the domestic sales tax with virtually no growth in revenues. This is probably attributable to more tax invoicing of imported inputs. Data has been made available by the SBP on total borrowing and rise in Government debt in the first two months of 2021-22. Accordingly, the Federal budget deficit in these months is estimated at 0.7 percent of the GDP. There has been a large increase in Government debt during these two months of Rs 1072 billion, equal to almost 2 percent of the GDP. This is due to a rise in the stock of external debt of Rs 723 billion because of depreciation of over 5 percent in the value of the Rupee in July and August 2021.

6. The Outlook for 2021-22

There is considerable uncertainty about the short-to-medium-term outlook for the economy of Pakistan. The primary source of this uncertainty is the future of the IMF program with Pakistan of $6.1 billion from the Extended Fund Facility. The Pakistani team led by the Finance Adviser has been in Washington since the 4th of October. However, no conclusion has been reached either on the sixth review or on the macroeconomic framework for 2021-22, along with the reforms and measures required to achieve the targets embodied in this framework. Apparently, the Fund is insisting on strict implementation of the structural benchmarks, performance criteria and setting of tough targets in the Macroeconomic Framework for 2021-22. The first critical target is the current account deficit in 2021-22. According to the projections for Pakistan in the IMF publication, World Economic Outlook, of October 2021, the deficit is to be contained at 3.1 percent of the GDP. During the first quarter the deficit recorded is equivalent to the annualized level of 4.5 percent of the GDP. As such, the deficit in the next three quarters will have to be reduced by almost one third from the level attained in the first quarter. This will require a sharp contraction in the volume of imports. Achievement of the reduced current account deficit will require strong measures for stabilization including, first, a rise in the policy rate of the SBP by 2.5 to 3 percentage points, second, devaluation of the rupee by 15 percent to 20 percent, in relation to the average level prevailing in 2020-21 and, third, measures like increase in import margin requirements and regulatory duties, especially on non-essential imports. These requirements in terms of the extent of use of the policy instruments have been determined by simulations of my Macroeconomic Model. The resulting projection of the balance of payments for 2021-22 is given in Table 5.

Table 5: Projection of the Balance of Payments in the Presence of the IMF Program - *($ billion)*

	2020-21	2021-22
A. Current Account	**-1.8**	**-9.0**
Trade Balance in Goods	**-28.2**	**-36.5**
Exports	25.6	29.4
Imports	53.8	65.9
Trade Balance in Services	***-1.9***	***-2.6***
Balance in Primary Income	***-4.7***	***-5.0***
Home Remittances	***29.4***	***31.6***
Others	***3.6***	***3.5***
B. Capital Account	**1.0**	**0.4**
C. Financial Account	**8.3**	**9.0**
Foreign Investment	*4.6*	*4.0*
SBP	*1.5*	*2.8**
Government (net)	*5.7*	*6.3*
*Others***	*-3.5*	*-4.1*
D. Balance of Payments	**5.5**	**0.0**
E. Foreign Exchange Reserves	**17.2**	**17.2**

Source: Estimated
*Including $2.8 billion of SDRs
**including errors and omissions

The projections are based on the following:

(i) Growth rates of exports and imports in 2021-22 of 15 percent and 22.5 percent respectively.

(ii) Growth rate in home remittances of 7.5 percent.

(iii) Gross inflows of foreign borrowing by Government of $15.7 billion and amortization of $9.4 billion.

Realization of the BOP projections will sustain foreign exchange reserves at the same level as at the start of 2021-22 of $17.2 billion at the end of 2021-22, equivalent to almost three months cover of imports of goods and services. The second critical target relates to the size of the consolidated budget deficit in 2021-22. An understanding had been reached earlier with the IMF that it would be fixed at 6.3 percent of GDP for 2021-22. This is likely to remain unchanged. The projected magnitude of key components of public finances in 2021-22 is given in Table 6.

The projections are based on the following:

(i) FBR revenues will have to be over Rs 500 billion higher than the budget estimates for 2021-22. This will require additional taxation proposals in the sales tax consisting of withdrawal of exemptions and reduced rates, reforms in the personal income tax system and enhancement in regulatory duties on imports. The new target growth rate for FBR revenues will be relatively high at 33 percent in 2021-22.

(ii) There will be a large shortfall in non-tax revenues of Rs 300 billion. The petroleum levy is likely to yield Rs 450 billion less than budgeted. However, this will be partly compensated for by larger SBP profits due to higher interest rates.

(iii) Federal current expenditure is expected to be at the budgeted level. Debt servicing will be higher by Rs 200 billion due to higher interest rates. This will require economy in other current expenditure of the corresponding amount.

(iv) A cut back in development spending of Rs 250 billion.

(v) Projection of a cash surplus of the provincial governments at a more realistic level of Rs 400 billion, which is still almost twice the level of 2020-21.

The implications of these adjustments both in the balance of payments and public finance fronts are that the GDP growth rate in 2021-22 is likely to be in the range of 3 percent to 3.5 percent and the rate of inflation between 12 percent to 14 percent.

In the event the IMF Program is terminated or suspended, a special report will be prepared on the impact on the outlook for the economy in 2021-22.

Table 6: Projection of Public Finances in 2021-22 - *(Rs in Billion)*

	Budget Estimate	Projection	Deviation
FEDERAL			
Federal Revenues	***7,909***	***8,130***	***221***
Tax Revenues	5,829	6,350	521
Non-Tax Revenues	2,080	1,780	-300
Federal Transfers	***-3,412***	***-3,714***	***-302***
Net Federal Revenues	***4,497***	***4,416***	***-81***
Federal Expenditure	***8,487***	***8,237***	***-250***
Current Expenditure	***7,523***	***7,523***	***0***
Debt Servicing	3,060	3,260	200
Defence Services	1,370	1,370	0
Others	3,093	2,893	-200
Development Expenditure	***964***	***714***	***-250***
Federal Budget Deficit	***-3,990***	***-3,821***	***-169***
Provincial Cash Surplus	***570***	***400***	***-170***
Consolidated Deficit	***-3,420***	***-3,421***	***1***
% of GDP	-6.3	-6.3	0.0

Source: Estimated

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