Economic review for the second quarter of FY22

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NEXT CAPITAL

Pakistan Economy

January 25, 2022

Pakistan Economy

Key Data	
KSE100 Index	44,924
KSE-All Share Value (PKRmn)	5,742
KSE-All Share Value (USDmn)	32.6
KSE-All Share Volume (Shmn)	160.2
Market Capitalization (PKRtn)	7.7
Market Capitalization (USDbn)	43.7
1Year High	48,726
1 Year Low	42,780

Source: PSX, Next Research

INTRODUCTION

The initial optimism in June about the buoyancy of the economy with the growth rate rising to above 5 percent has given way now to concerns about the yawning current account deficit, double-digit inflation, and slowdown in industrial activity. This Second Quarterly Economic Review looks at the trends and developments in the global economy and in the Pakistan economy. The latter includes sections on the real sector, investment, inflation, trade, balance of payments and public finances. The last section contains an assessment of the prospects for the economy in 2021-22.

1. THE GLOBAL ECONOMY

The optimism about the continuing fast pace of recovery of the world economy has been moderated by the rapid spread of Omicron. The global economy has still approached in 2021 a high growth rate of almost 6 percent, after the negative growth rate of 3.9 percent in 2020. The volume of world trade in goods and services has also expanded rapidly in 2021 with a growth rate of 8.2 percent and risen above the level in 2019 before the first COVID-19 outbreak. Commodity prices have upsurged. The price of crude oil has risen by almost 60 percent compared to the level in 2020. Non-fuel prices are up by 27 percent. The inflation rate in emerging and developing countries has gone up to 5.5 percent on the back of higher prices of commodities and supply shortage. Following extraordinary monetary expansion, the US economy is currently facing the highest inflation rate ever of 7 percent. The rate of increase in commodity prices has had a large negative impact on the trade deficit of Pakistan which has reached the highest level ever of over $26 billion in the first half of 2021-22.

The big increases observed in import prices in the first quarter have generally been augmented further in November and December, especially in the case of palm oil, cotton, and energy inputs. There is no evidence of a fall in international prices following the rampant spread of Omicron. Pakistan's imports could remain high in coming months implying no significant scaling down of the trade deficit. In fact, the crude oil price has reached a new peak of $86 per barrel. For every $5 increase, the annual import bill of petroleum products rises by over $1 billion. There are even some projections that the price of crude oil could reach $100 per barrel later in 2022.

2. REAL SECTOR

The agricultural sector has performed well in the last Kharif Season. According to the latest estimates by the USDA, the cotton output rose by 29 percent to reach 9 million bales. This should reduce significantly the import requirement of raw cotton in 2021-22. However, the output is still substantially below the peak level of 14.6 billion bales attained as far back as 2004-05. The other Kharif crops are likely to have sustained their peak output levels. This includes rice and maize. In fact, the output of rice could be even higher as the quantity exported has increased by over 12 percent in the first six months of the year. However, there may be some decline in the output of sugar due to some substitution of crop area by cotton. The on-going Rabi season is characterized by a big jump in fertilizer prices and shortage of urea, due to a decline in domestic production and hoarding. The price of urea has gone up according to the PBS by 12 percent and that of DAP by 122 percent.

The wheat production is likely to be reduced by a drop in yield due to lower fertilizer input. The Authorities have not taken the necessary steps yet to ensure the availability of wheat. Wheat imports are down by over 46 percent or 1.1 million tons in the first six months. This could lead to a spike in the atta price in coming months. Overall, the major crop sector should see a relatively high growth rate in 2021-22, with the big jump in cotton production compensating for any fall in wheat output. A growth rate of 3.5 percent to 4 percent is likely in the agricultural sector in 2021-22. The large-scale manufacturing sector performed moderately in the first quarter of 2021-22, with a growth rate above 5 percent. However, the Quantum Index of Manufacturing (QIM) has plummeted in October with a negative growth rate of 1.2 percent and a near zero growth rate in November. Consequently, the growth rate over the five months is 3 percent. The fastest growing industries have been petroleum refining, cigarettes, steel, and automobiles as shown in Figure 1. Combined they have contributed to over 60 percent of the increase in the QIM. Industries which show a fall recently in growth rate include cement, motorcycles, vegetable ghee, pharmaceuticals and paints and varnishes

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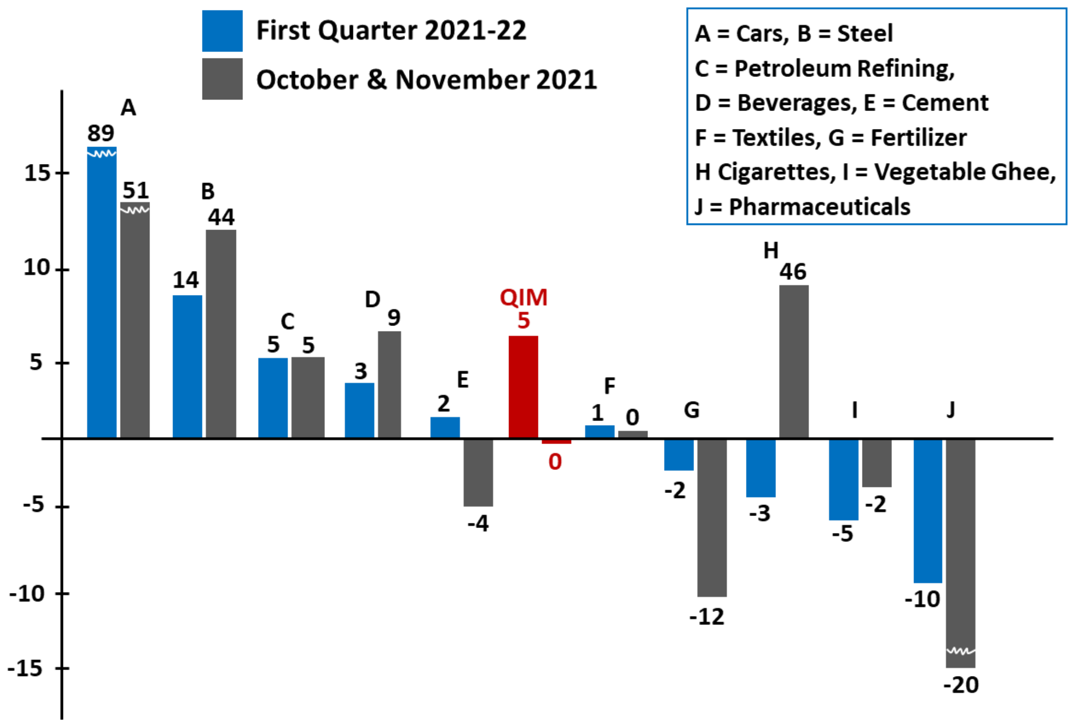
Figure 1: Growth Rates of Major Industries in July to November, 2021-22



Source: PBS

The negative growth in October and November in some industries is due to rise in prices of imported intermediate inputs as, for example, the big rise in the palm oil price and the impact on vegetable ghee price and output. Also, the construction boom seems to have slowed down with the fall in output of cement, paints and varnishes. The big question is whether there will be some recovery after November. This appears unlikely because of the large gas loadshedding in winter months, when the QIM is at its peak. Also, electricity tariffs have risen because of the high monthly fuel adjustment charge of over Rs 4 per kwh and there is also the likelihood of a rise in base tariff. Further, passage of the Finance (Supplementary) Bill will depress output in some industries where the sales tax has been enhanced. Overall, the five months growth rate in the QIM of 3 percent will be difficult to sustain in coming months. There are some other sectors of the economy which are showing more buoyancy. This includes the transport and communications sector and banking and insurance. The increased taxation of mobile phones and cars in the recent Finance Supplementary Bill may adversely impact on the growth of the telecom sector and the automobile industry.

3. INVESTMENT

There is some good news about the relatively rapid growth in private investment in the first two quarters of 2021-22, as revealed by the big increase in the flow of bank credit to the private sector and in the level of import of machinery. This recovery can be attributed more to the low interest rate in the aftermath of COVID-19 in 2020. In addition, the SBP launched the special financing facility of TERF and other financing packages. The TERF is a concessionary refinancing facility for promoting investment in expansion and in BMR. Approved financing had reached Rs 435 billion earlier and this is now being reflected in the higher import of machinery. The growth and composition of the flow of credit to the private sector from June to December 2021 is given in Table 1. The fastest growth of 46 percent is observed in long-term investment financing. Construction financing has increased by 30 percent. However, the growth in credit to the SMEs has been modest at 16 percent. Imports of machinery from June to December, have increased by 50 percent to $4.5 billion from $3 billion in the corresponding period of 2020-21. The positive development is the near doubling in the import of textile machinery. The prospects for private investment have been dimmed by the quantum jump in interest rates, to the ending of special financing facilities by the SBP and by the increase in sales tax on various types of machinery in the Finance (Supplementary) Bill. This will raise the up-front costs of investment.

Table 1: Level of Composition of Credit to the Private Sector (Rs in Billion)

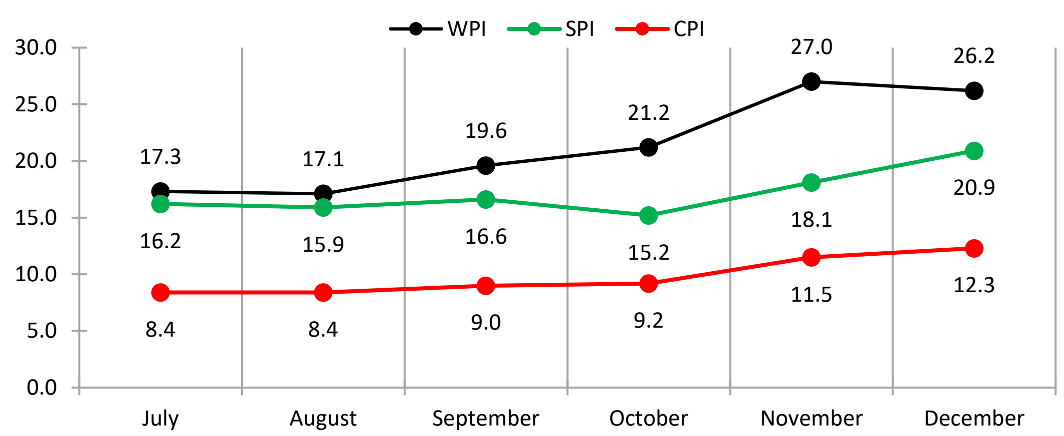
BY TYPE	End-June 2021	End-December 2021	Increase	Growth Rate (%)
Working Capital / ST	2,408	2,814	406	16.9
Fixed Investment / LT	1,496	2,184	688	46
Construction Financing	171	223	52	30.4
Export Financing	587	789	202	34.4
Import Financing	324	409	85	26.2
Others	877	368	-509	-
TOTAL	**5,869**	**6,757**	**894**	**15.8**
BY SIZE				
SMEs	469	542		15.6

Source: SBP

4. INFLATION

The rate of inflation has spiraled up to double-digit rate. It was up to 12.3 percent on a year-to-year basis in December from 8.4 percent in July, as shown in Figure 2, in the CPI. It is even higher in the case of the SPI and the WPI at 20.9 percent and 26.2 percent respectively.

Figure 2: Monthly Rates of Inflation on Year- to- Year basis



Source: PBS

There is one fundamental difference between the inflation in recent months and in the previous two years. The rate of increase in food prices has been less than in non-food prices, as shown in Table 2. This will limit the impact on lower income groups.

Table 2: Rate of Inflation in Food and Non-Food Prices

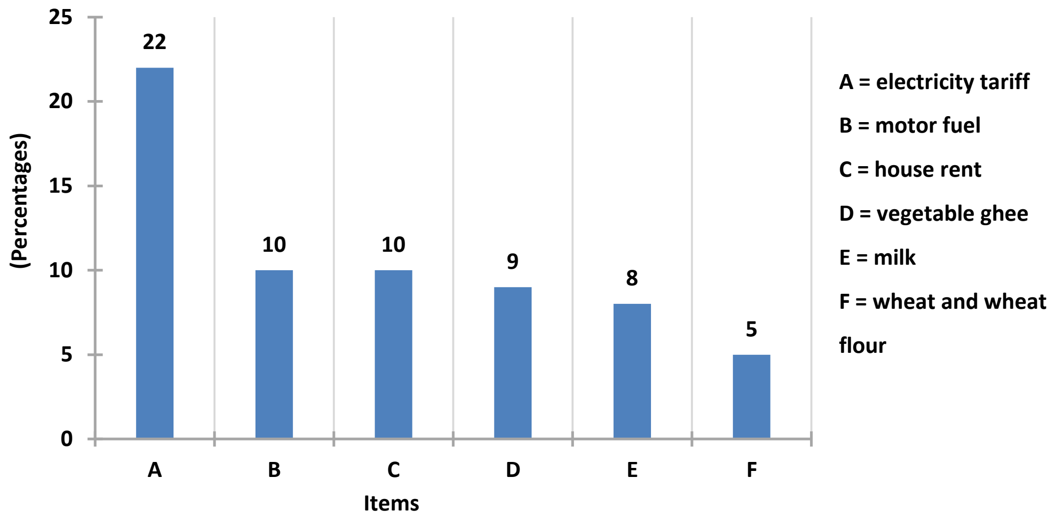
	CPI	Food Inflation	Non-Food Inflation (%)
FY 20	10.7	15.0	8.2
FY 21	8.9	12.8	6.7
1st Half, FY 22	9.8	9.3	10.1

Source: PBS

The fundamental question is why the rate of inflation in Pakistan is generally higher than that in other countries. Pakistan has higher imported inflation because of the larger devaluation of the rupee. Also, in the presence of supply shortages, monopolies and cartels have bid up prices. Further, the rate of expansion in money supply has been faster.

An analysis of the rate of inflation at the individual item level reveals that the major part of inflation in December has been contributed by only six goods and services as shown in Figure 3 below. The rise in electricity tariffs and price of motor fuel are the biggest contributors accounting for almost one-third of the inflation in the country. It is even greater if the cost-push impact on other goods and services is included.

Figure 3: Big Contributors to Inflation in CPI (%)



Source: PBS

There is a high likelihood that a double-digit rate of inflation will persist and even increase in coming months. This, will, of course, depend on whether global high prices, especially of crude oil, continue or even rise in the first six months of 2022. If the rupee continues to decline then this will add further to inflation. The recently passed Finance (Supplementary) Bill, the impending hike in the base tariff and higher fuel adjustment charges on electricity, the monthly increase of Rs 4 per liter on petroleum products and the partial failure of Rabi crops, especially wheat, will all add to inflationary pressures in the economy.

5. TRADE

Perhaps one of the most worrying developments has been the ballooning of the trade deficit. It was $11.8 billion in the first quarter of 2021-22 and $14.8 billion in the second quarter. The overall growth in the size of the trade deficit in the six months is 104 percent. The rise is due primarily to the phenomenal growth in imports of 66 percent. Exports have also shown growth, but less at 25 percent. Consequently, the level of imports now is more than two and half times the level of exports. This is increasingly unsustainable. What has caused the extra-ordinary growth in imports? The Table 3 breaks the increase in value between a rise in price and in volume respectively in the case of major imports. With the sole exception of a big increase in the volume of imports of petroleum products, the big jump is due to an unprecedented jump in prices from the extremely low levels after COVID-19. There is a mixed pattern in exports as shown in Table 4. Volumes went up substantially in the case of major exports in the first quarter. The pattern is more mixed in the second quarter. There has been a spectacular increase in the value of exports of basmati rice, cotton yarn and knitwear. Other manufactured goods exports have also performed well with a growth rate of 24 percent. A number of measures have been taken to stem the tide of imports, including levy of regulatory duties, change in import margins, recent increase in the sale tax rates and continuing depreciation in the value of the rupee. Unless these moves restrict imports by up to 7 to 8 percent, there is the risk that the balance of payments position could become unsustainable by the end of 2021-22.

Table 3: Growth in the Volume, Prices and Values of Major Imports (%)

	1st Quarter	2nd Quarter	1st Half
		VOLUME	
Wheat	-21.8	-50.3	-45.3
Palm Oil	-14.9	13.5	-2.8
Cotton	26.7	5.5	13.9
Crude Oil	0	0	0
Petroleum Products	10.5	51.5	29.6
Iron & Steel	-15.6	13	-1.3
		PRICE	
Wheat	24.1	33.5	30.2
Palm Oil	80.7	57.7	65.8
Cotton	4.4	40.1	35.4
Crude Oil	81	83.8	82.2
Petroleum Products	74.7	79.5	76
Iron & Steel	66.9	45.4	55.2
		VALUE	
Wheat	-3	33.6	-28.9
Palm Oil	53.9	78.8	65.8
Cotton	64.4	47.8	54.3
Crude Oil	81	83.8	82.2
Petroleum Products	93.1	171.7	133.2
Iron & Steel	40.9	64.1	53.1

Source: PBS

Table 4: Growth Rate in Volumes, Prices and Values of Major Exports 2021-22 (%)

	1st Quarter	2nd Quarter	1st Half
		VOLUME	
Basmati Rice	36	60.1	47.2
Other Rice	14.6	-1.2	7.5
Cotton Yarn	14.6	-3.7	4.6
Cotton Cloth	23	0.9	11.8
Knitwear	1.2	-1.9	-0.7
Bedwear	23.5	17.3	20.2
		PRICE	
Basmati Rice	-7	-12.1	-9.4
Other Rice	-1.5	-3.8	-3.2
Cotton Yarn	47.8	44.7	45.4
Cotton Cloth	-0.9	19.7	8.5
Knitwear	31.7	40	36.2
Bedwear	-0.1	-1	-2
		VALUE	
Basmati Rice	26.4	41.1	33.3
Other Rice	13	-1.2	3.7
Cotton Yarn	69.4	39.3	52.1
Cotton Cloth	21.9	20.7	21.2
Knitwear	32.9	37.3	35.2
Bedwear	23.3	15.2	19
Non-Food & Non-Textile Exports	**30.2**	**18.3**	**23.7**
Total Exports	**27.9**	**22.5**	**24.9**

Source: PBS

6. BALANCE OF PAYMENTS

The balance of payments position from July to December 2021 has been weakened by a big jump in the current account deficit to over $9 billion, equivalent to 5.5 percent of the GDP on an annualized basis, as shown in Table 5. This is due largely to the more than doubling of the trade deficit. Fortunately, home remittances have continued to grow at over 11 percent. Flows into the financial account have been large at $10 billion. This has been facilitated by net inflows into the Government account of $ 5.8 billion and the special allocation of SDRs of $2.8 billion by the IMF. Due to these large inflows, it has been possible to finance fully the large current account deficit. Consequently, there has been an increase of $0.3 billion in foreign exchange reserves, after also making the due debt repayment to the IMF. Reserves at the end of November stood at $15,966 million, enough to provide import cover for two and half months, but below the minimum safe level of three months.

Table 5: Balance of Payments July – November,2021-22 ($ million)

	2020-21	2021-22
A. Current Account	**1,247**	**-9,092**
Trade Deficit in Goods	-11,386	-21,176
Trade Deficit in Services	-944	-1,837
Balance in Primary Income	-2,673	-2,507
Balance in Secondary Income	16,250	16,428
(Workers Remittances)	(14,203)	(15,808)
B. Capital Account	**132**	**119**
C. Financial Account	**309**	**10,056**
Foreign Investment	384	602
SBP and others	-3,117	811
Government (net)	3,042	5,870
Allocation of SDRs	0	2,773
D. Errors and Omissions	**-406**	**-295**
Balance of Payments	**1,282**	**788**
Change in Reserves*	**725**	**272**

*After debt repayment to IMF
Source: SBP

The 3rd of December saw the receipt of a large $3 billion one-year loan from Saudi Arabia. This raised reserves to $18,658 billion. But since then, there has been further erosion and the latest figure of reserves is $17,036 million, still less than three months of imports. The recent trend of falling reserves indicates difficulties in meeting the likely total external financing requirements for 2021-22. The SBP has estimated these at $26 billion, with half required to finance the projected current account deficit of $13 billion, equivalent to 4 percent of the GDP, and external debt repayment of $13 billion. The total inflow of borrowing plus foreign investment up to the end of December has been close to $13 billion. Therefore, the additional inflow required is $13 billion from December 21 to June 22. It may be even higher at $16billion if the current account deficit approaches $16 billion or close to 5.5 percent of the GDP, in line with its present rate. Very importantly, the prospect for arranging the required financing will hinge on continuation of the IMF Program. The Executive Board of the IMF is expected to meet on the 28th of January, by which time the SBP (Amendment) Bill should have been passed by the Senate. There is need to recognize that even with the umbrella of the IMF arranging finances of between $13 to $16 billion in the last six months of 2021-22 will be difficult. The foreign exchange reserves are likely to remain under pressure, with implications on the value of the rupee.

7. PUBLIC FINANCES

Provisional estimates of fiscal operations in the first half of 2021-22 have been released. These estimates are presented in Table 6. The overall budgetary position has remained unchanged in relation to the outcome in the first half of 2020-21. The consolidated budget deficit of the Federal and Provincial Governments combined stands at 2.5 percent of the GDP. The Federal budget deficit has risen to 3.3 percent of the GDP in relation to 2.9 percent of the GDP last year. However, this has been compensated by an increase of 0.4 percent of the GDP in the cash surplus of the Provincial governments, especially of the Government of Punjab. The major positive development is the exceptional performance of FBR revenues, with an unprecedented growth rate of 32 percent. This has been due to the over 72 percent increase in the rupee value of imports. Consequently, over 65 percent of the revenues have been realized from the import tax base. Non-tax revenues have seen a decline of almost 12 percent, due to the scaling down of the Petroleum Levy from the budgeted rate of Rs 30 per liter in the face of the substantial jump in international oil prices. Overall, Federal revenues have shown growth of almost 20 percent. Over 46 percent of these revenues have been transferred to the provinces as per the NFC Award.

Table 6: Preliminary Estimates of Fiscal Operations in the first half of 2021-22 (%)

	(% of GDP*)		Growth Rate** (%)
	2020-21	2021-22	
FEDERAL			
A. Total Revenue Receipts	6.5	6.7	19.8
Tax Revenues	4.7	5.4	32.1
Non-Tax Revenues	1.8	1.3	-11.8
B. Revenue Transfers to Provinces	**-2.7**	**-3.1**	**32.8**
C. Net Revenue Receipts	**3.8**	**3.6**	**10.5**
D. Total Expenditure	**6.7**	**6.9**	**17.8**
Current Expenditure	**6.1**	**6.3**	**18.3**
Debt Servicing	3.1	2.5	-6.4
Defence	1.0	0.9	5.5
Other	2.0	2.8	63.4
Development Expenditure	**0.6**	**0.6**	**11.1**
PROVINCIAL			
A. Cash Surplus	**0.5**	**0.9**	**88.2**
CONSOLIDATED BUDGET DEFICIT	**-2.4**	**-2.4**	**13.5**
PRIMARY SURPLUS/DEFICIT	**0.7**	**0.1**	**-73.4**

*14.9 percent growth rate assumed in nominal GDP
**Growth Rate of Absolute Magnitude
Source: Estimated

There has been a small increase of 0.2 percent of the GDP in the level of current expenditure in relation to the level last year, with bulk of the increase in subsidies and grants. Federal PSDP expenditure has remained limited to 0.6 percent of the GDP. The surprise is the significant fall in the cost of debt servicing by 0.6 percent of the GDP, especially in light of the rise in the policy rate. A one percentage point increase raises the level of debt servicing annually by over Rs 200 billion. Clearly, the 2.75 percent point hike in the policy rate will raise interest costs significantly in the second half of the year. The expectation is that the annual deficit target may be difficult to meet, despite the recent mini-budget. However, the divergence is unlikely to be large. The overall level of net Federal government debt stands at Rs 37.9 trillion as of the end of November, equivalent to 74.2 percent of the GDP. The increase in relation to the level at the end of June is Rs 2.3 trillion. Almost 60 percent of the increase is due to the impact of rupee depreciation on the rupee value of external debt. Within domestic debt, almost 65 percent is in the form of (long-term) permanent debt. The government has floated Rs 565 billion of three- year Ijara Sukuk bonds since June. Also. the SBP has given a loan directly to the Federal government of Rs 475 billion against the $2.8 billion SDRs issued by the IMF. This has reduced the pressure of government borrowing on the domestic capital market. There has been little resort to unfunded debt in the form of special savings schemes of the National Savings Directorate.

The next and concluding section presents the outlook for 2021-22.

8. OUTLOOK FOR 2021-22

The previous sections have highlighted some positive and some adverse developments in the real sector of the economy, the high and rising rate of inflation, the relatively precarious position of the external balance of payments and the likelihood that there will be some spillover in the attainment of the fiscal deficit target for 2021-22.

Consequently, the likely range of magnitudes for key macroeconomic variables in 2021-22 is as follows:

GDP growth rate:	3.5% - 4%
Rate of Inflation:	11.0% - 13.0%
Level of Investment:	14% - 15% of the GDP
Current Account Deficit:	5% - 5.5% of the GDP
Budget Deficit:	6.5% - 7% of the GDP

We hope and pray that there are no serious economic difficulties during the remainder of 2021-22

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Sell	$R < 0\%$

Where;

R = Expected Dividend Yield + Expected Capital Gain

R' is before tax

Investment horizon is between six months to twelve months

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