ECONOMIC OUTLOOK

July 2020

Government of Pakistan
Finance Division
Economic Adviser's Wing

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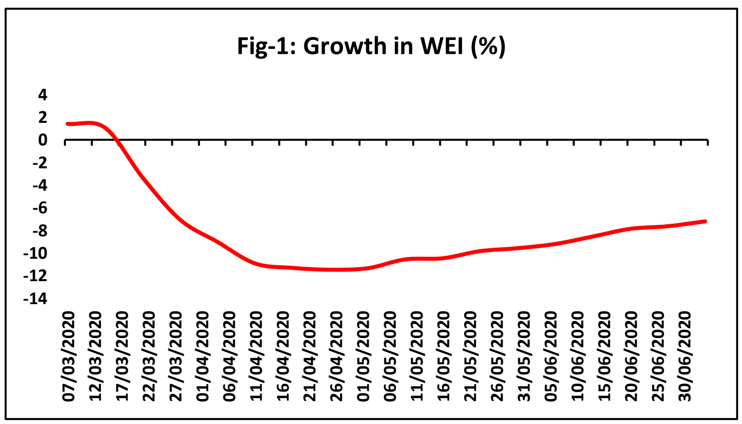
1. International Performance and Outlook

Many International Financial Institutions (IFIs) including IMF, WB, ADB etc realized that negative impact of the COVID-19 pandemic will continue in the first half of 2020. Although, extent of recovery depends on the discovery and availability of treatments and vaccines, the Covid-19 lockdowns brought deep economic dive. Many international institutions still believe that uncertainty will recover gradually. However, these expectations or forecasting were based on the information and events available in March and April of this year. Further, in prediction, these institutions are giving more weights to risk associated with second wave.

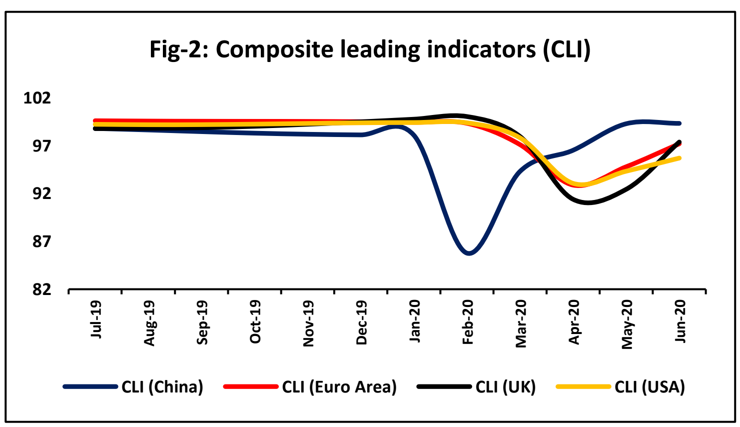
However, many economies are re-opening and economic activities are restarting. Thus, there is need to re-estimate the future prediction on the basis of high frequency data. As recent high frequency data is improving especially in the month of June 2020 which suggest that the economic activities are continuously restarting after lifting of lockdown. Further, historically, economies have experienced a V-shaped recovery after a recession. In COVID-19, the severity is different leading to unprecedented policy response. On the basis of following high frequency data, one can predict optimism in economic outlook for almost all economies.

The Weekly Economic Indicator (WEI) of the Federal Reserve Bank of New York is an index of 10 weekly indicators of real economic activity, scaled to align with the four-quarter GDP growth rate in the US. This index is continuously improving since early May (**Fig-1**).



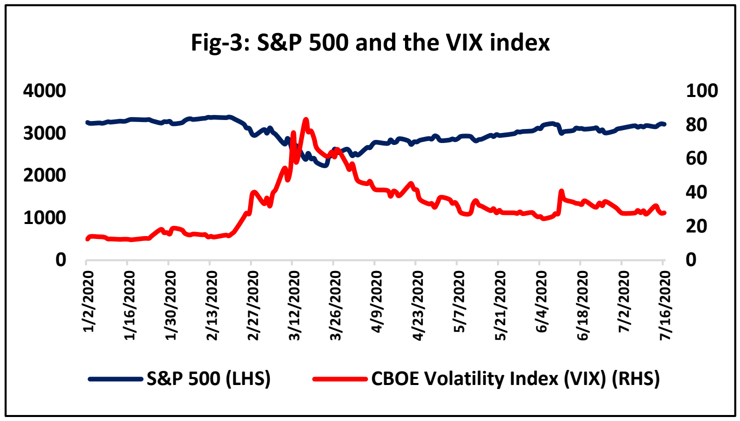
Source Federal reserve Bank of New York

Likewise, the Composite leading indicators (CLI), compiled by the OECD, in Pakistan's main trading areas are further improving. **Fig-2** shows that the crises first hit China in Feb 2020, followed by rest of the world. But since bottom of the crises, these indicators moved upwards and continue to do so up to June.



Source OECD

The US stock market indices are improving. The average of the S&P 500 index in July thus far is 3170, compared to 3105 in June and 2920 in May (**Fig-3**). Furthermore, the Chicago Board Options Exchange (CBOE) Volatility Index, which measures the implicit volatility in option prices is also well below crises levels which implies that uncertainty has come down.



Source: Yahoo Finance

Information Handling Services (IHS) Markit, London–based global information provider released its final purchasing managers' indices (PMIs) for services in multiple countries. The global services PMI increased from 35.1 in May to 48.0 in June, after having declined very sharply in the previous month. The worst sub-index was export orders, signalling that global trade in services remains muted. The best sub-index was sentiment about the future, which was up strongly, indicating that service businesses are optimistic.

Regardless of all these positive economic developments, risk still prevails. The stock markets are not yet at pre-crises levels. However, investors expect that the effect of the pandemic on future company profit growth will be relatively short lived. Thus, stock markets in the world, including Pakistan have been recovering.

Regarding International prices, energy prices rose 24.7% in June, following a 32.2% spike in May. Despite the recent gains, prices remain 37% below end-2019 levels. However, in June, global food commodity prices rose for the first time since the beginning of the year driven by a rebound in vegetable oils, sugar and dairy quotations. However, in the cereals and meat markets, most prices remained under downward pressure amid market uncertainties posed by the COVID-19 pandemic. This implies that consumer demand is picking up after lockdown

2. Monthly Performance of Pakistan's Economy

In June 2020, key macroeconomic indicators have shown improvement. External sector continued to perform better. Exports for June 2020 remained $ 1.6 billion compared to $1.3 billion in May 2020, thus showing a growth of 25%. Record high workers' remittances received in June 2020, and there was 32% growth compared to May 2020 while 51% growth when compared to June 2019. Likewise, FDI increased by 46% in June 2020 compared to May 2020.

Domestic Economic Activities also observed acceleration as many businesses started operating following SOPs directed by the government. Restaurants, educational institutions, etc are expecting to start soon. Pakistan Stock Market (PSX) also improving. Government's stimulus package provided relief to investors as KSE-100 index gained 10,422 points (↑38.3%) since March 25th and index closed at 37,651 points on 20th July. Similarly, Market Capitalization has received Rs. 1,737 billion (↑32.3%) since March 25th and closed at Rs. 7,117 billion on 20th July, 2020.

In a comparison of 30th June 2020, the KSE-100 index gained 3,229 points (↑9.4%) and the index closed at 37,651 points as on 20th July. Similarly, Market Capitalization has received Rs. 587 billion (↑9.0%) and closed at Rs. 7,117 billion on 20th July, 2020.

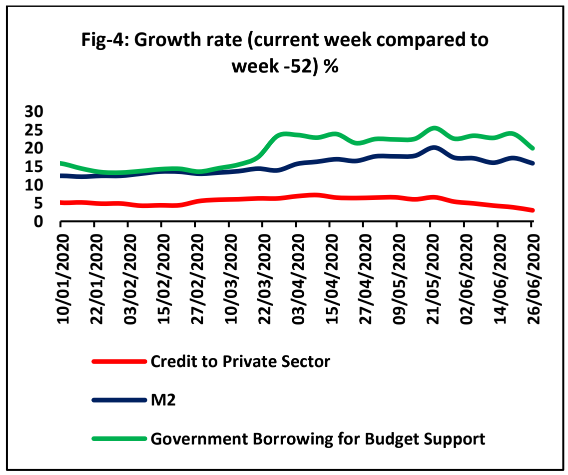
Likewise, FBR tax collection (FY2020) grew by 4.0 % to Rs3.98 trillion (provisional) compared to Rs. 3.83 trillion in FY 2019 while in June 2020, FBR tax collection remained Rs 448.7 billion compared to Rs. 223.9 billion FBR tax collection in May 2020 showing a growth of 100%. Thus, monthly indicators are indicating sign of improvement in economic activities.

3. Economic Outlook

3.1. Inflation

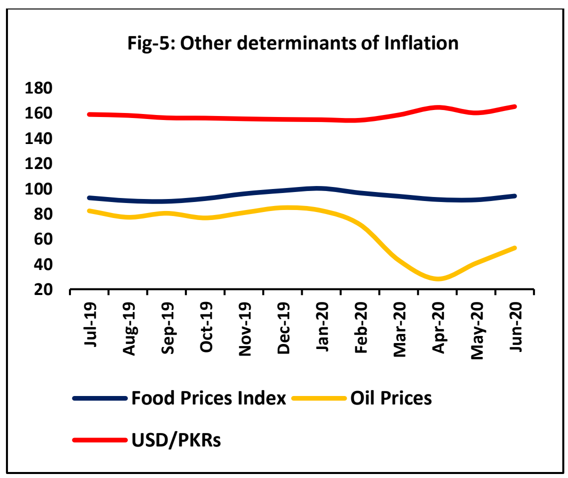
Main drivers of the CPI inflation in Pakistan are international and domestic commodity prices, especially food and oil products, the value of the USD/PKR exchange rate, monetary and fiscal policies.

The growth rate of broad money (M2) is considered to be a useful indicator and available on weekly frequency. **Fig-4** shows the year-on year growth rate of M2 per end of each week. Apparently, growth rate of M2 is still above pre-corona levels. This is mainly due to increased pace of government borrowing for budget support, as government is supporting economic activity to curb deflation due to COVID-19. Also, in June growth rate of Government borrowing remained above pre-crises levels. Historically, an increase (decrease) of M2 by 1% tends to increase (reduce) the CPI level by around 0.35% in the long run.



Source: SBP

During FY 2020, overall international food prices remained fairly stable (**Fig-5**). The deflationary effect of the decline in oil prices was compensated by a depreciation of the USD/PKR exchange rate. Historically, a combined increase (decline) of commodity prices and exchange rate depreciation (appreciation) with 1% increases (reduces) the CPI level by around 0.9% in the long run.



Source World Bank, SBP

Presently, some relief has been given in indirect taxes not only to industry but also to consumer in Federal Budget FY 2021, thus it will contribute to keep inflation in check in coming months. Likewise, the monthly average short-term interest rate (Overnight Repo rate) was guided downwards by SBP's interest rate policy. Historically, a change in the policy rate with 100 basis points tends to affect CPI inversely by around 0.4% in the long run.

The CPI level reacts to these developments with a time lag of at least one month, implying that they contain relevant information for short term inflation prediction. However, CPI follows SPI which comprises of 51 essential items having almost 35 percent weights in CPI. In July 2020, SPI for first week ended on July 2, 2020 was recorded 2.29 % growth, then decelerated to 0.98% in next week SPI and then recorded a decrease of 0.01% when compared with respective previous week. Thus, on the basis of the discussed dynamics, CPI inflation is expected to remain within a margin of 7.6 % and 9.3% in July FY 2021 where the higher and lower bounds of this range reflect probability margins surrounding model-based forecasts.

3.2. Agriculture

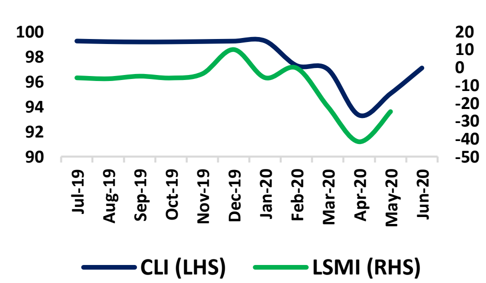
Agriculture performance is mainly dependent on weather conditions and inputs. Presently, Kharif crops are in the process of cultivation. However, in recent meeting of Federal Committee on Agriculture held on July 8, 2020, it has been informed that sufficient water will be available. Likewise seed and fertilizer situation is quite satisfactory. Thus, on the basis of these information, it is expected that there will be positive impact on cultivation, yield and productivity of important crops as well as on other crops. The risk of locust attack still persists, but timely measures taken by the government along with allocation of Rs. 10 billion for locust control will mitigate the risk. Further, international agencies especially FAO are providing special assistance in this regard.

3.3. Industrial activity

Industrial activity, measured by the LSM index is the sector which is most exposed to external conditions.

LSM is also exposed to developments in international markets. **Fig-6** compares the year-on-year growth rate of LSM with the weighted average Composite Leading Indicators in Pakistan's main export markets (CLI). LSM index is published with a time lag of around two to three months, whereas CLI is published with a one-month lag. Recently, the CLI index has improved. Thus MoM, LSMI recorded 20.5% growth in May 2020.

Fig-6: Relationship between CLI and LSMI Growth rates (%)

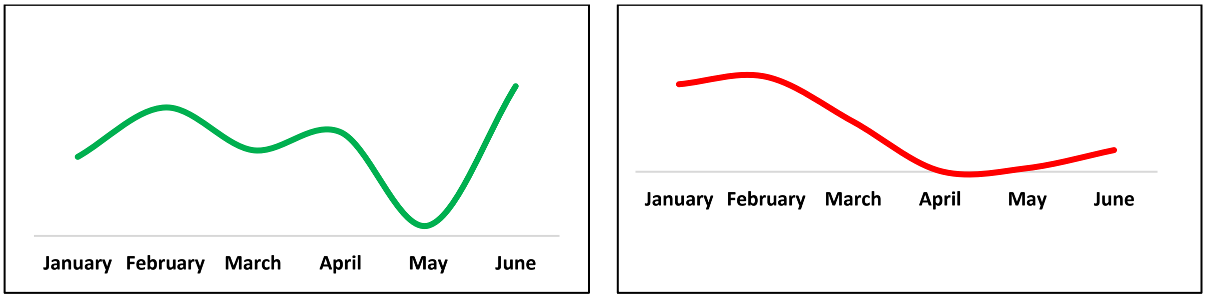


Source: OECD, PBS

Regarding cement production, there was 20% growth in Local dispatches while export dispatches have shown growth of 124% in June 2020 mainly because of government stance of opening construction sector to avoid unemployment and poverty.

Fig-7: Cement Dispatches

Local (Thousands) **Exports (Thousands)**

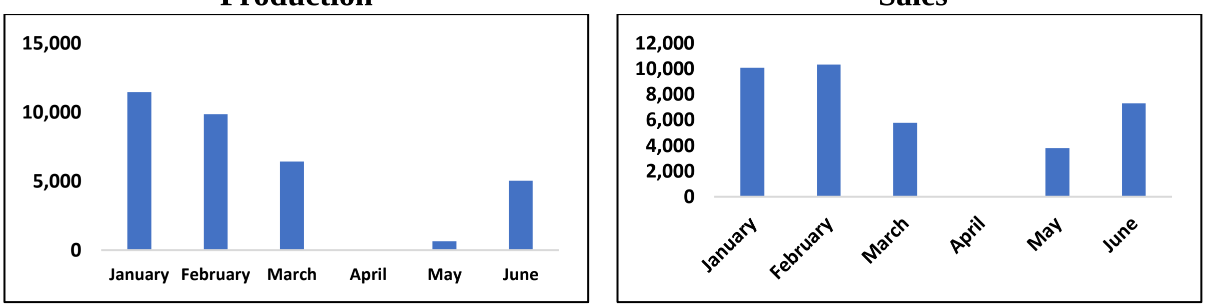


Source: APCMA

In FY 2020, Automobile sector alone accounted for major portion of contraction in LSM, however, recent data on car production and sales show that it has been rebounded after being remained silent in April 2020, due to lockdown.

Fig-8: Total Car Production & Sales

Production **Sales**

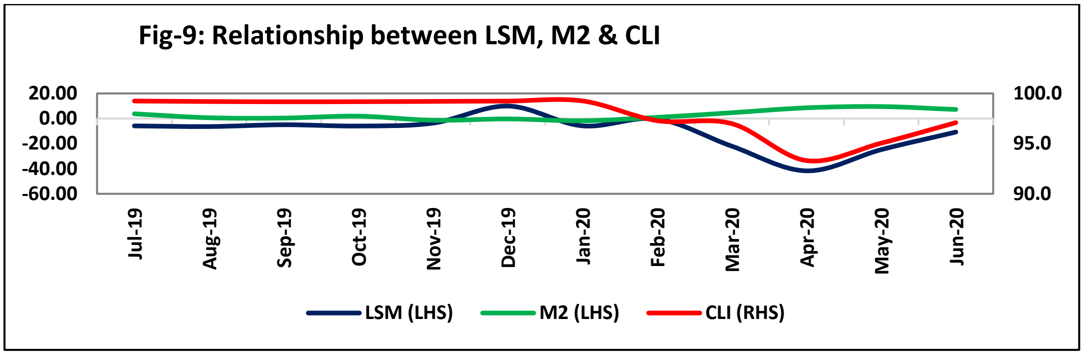


Source: PAMA

Given these recent improvements and taking into account the recent dynamics of LSM activity index itself, it is expected that the recession in industrial output will be tempered in recent months. In National Accounts Meeting, decline of LSM was provisionally taken 7.8% on the basis of COVID-19. Although July-May FY 2020, the overall output of LSMI decreased by 10.32% compared to corresponding period FY2019. However, LSMI output increased by 20.5% for May, 2020 which indicate economic recovery due to lockdown lift throughout the country. The trend will continue in June 2020 and further improvement is expected for July 2020.

3.4. Overall economic activity

Obtaining a useful indicator of ongoing overall economic activity is extremely important for policy purposes. The Monthly Economic Indicator (MEI) is based on combining monthly data of three variables (LSM Y-o-Y growth, M2 Y-o-Y growth adjusted for inflation[1] and weighted average Composite Leading Indicator (CLI) in main trading areas). **Fig-9** contains the movements in these indicators in recent history. These variables are proven to be correlated with GDP at constant prices. Table-I: presents the MEI in the months, quarters and complete FY 2020.



Source OECD, PBS, SBP

Table-I: MEI performance in FY 2020 (Monthly, Quarterly and for Complete FY 2020)

Months	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
MEI	1.01	0.75	1.15	0.93	1.47	5.34	0.86	2.27	-3.69	-9.48	-4.49	-0.73
Quarters	**Quarter - I**			**Quarter - II**			**Quarter - III**			**Quarter - IV**		
Average	0.97			2.58			-0.19			-4.90		
Fiscal Year	**FY 2020**											
MEI on average	-0.38											

Source: EAW calculations

The MEI shows small but positive growth in the first quarter of FY20. Growth accelerated in the second quarter, but turned negative in March 2020, following the COVID-19 pandemic. Deflation deepened in April, but the negative effects of this shock subsided in May and even more so in June. Over the complete FY 2019-20, the MEI shows average growth of -0.4%, which coincides with the provisional GDP growth published by PBS.

Regarding FY 2021, based on our discussion above, if recent trends continues, we expect positive growth in July 2020 indicating restart of economic activities. Further, as per expectations if number of cases further slowdown, economic activities will come to normal level. However, risk is more associated with the behaviour of public in following SOPs for avoiding pandemic spread.

[1] M2 adjusted for inflation is defined as growth in M2 minus inflation rate

3.5. External

***Exports of goods*:** Historically, the monthly profile of the share of domestic production that is exported is very volatile. However, this share is negatively correlated with the Real Effective Exchange rate and positively with the cyclical position in the main trading partners. International commodity prices also affect positively the export content of domestic output.

The exports of goods and services expressed in current USD prices (BOP definition) dramatically declined in April and May 2020, following the outbreak of the COVID-19 pandemic However, in June FY 2020, exports remained $ 1.6 billion which implies that revival of economic activities in trading partners has caused 25% growth in exports. For FY 2021, the target of exports is $ 22.7 billion which is almost $ 1.9 billion per month on average. It is expected that exports will further recover in July and may find themselves within a broad margin around $ 2.0 to $ 2.1 billion.

***Imports of goods*:** The monthly profile of the import propensity (share of imports of goods and services in domestic GDP, both measured at current prices), is very volatile. Nevertheless, high (low) levels of interest rates and REER exert deflationary (inflationary) shocks on the economy and affect the propensity to import. Import values are also positively correlated with the international commodity prices.

The target imports for FY 2021 is $ 42.4 billion which is almost $ 3.5 billion per month on average. It is expected that imports will recover in June and July and may find themselves within a broad margin around $ 3.5 to $ 4.0 billion.

Remittances: Historically, growth in workers' remittances helped in reducing Current Account Deficit significantly. Covid-19 outbreak has raised concerns of a substantial fall in remittance flows to the developing countries especially to Pakistan due to recent contraction in Gulf countries. However, the recovery is underway in major trading partner/ remittances destinations and further policy support will encourage people to send remittances to their families. Further the government is making efforts addressing issues related to Pakistani workers working abroad. In June-20, there was 51 % increase in workers' remittances compared to those in June-19. Thus, for FY 2020, workers' remittances remained $ 23.1 billion. The target of workers' remittances for FY 2021 is $ 21.5 billion which implies $1.8 billion per month on average. For July-20, due to Eid and revival of economic activities, it is expected that workers' remittances may remain with the range of $ 1.8 to $ 2.0 billion,

With these we expect that Current Account Deficit will be within last year level, however with improvement in Foreign Direct Investment and other Financial inflows, there will be no pressure on foreign reserves and thus stable exchange rate is expected in the next month.

3.6. Fiscal

Despite economic slowdown, during FY2020, FBR has collected Rs. 3981.4 billion, surpassing the target of Rs.3908 billion by Rs.73.4 billion. In July-18 and July-19, Rs 251.1 and Rs 277.3 billion were collected. Historically, about 5-7% of total FBR is collected in July. Presently, there is risk in FBR collection as economic activities have not started in full swing. The government has announced to refund Rs 50 million which will build business confidence and thus expected that in coming months with better economic activities, FBR will approach toward its target with more focus on improvement of tax system, broadening tax base and strengthening of administrative controls. As the budget strategy of the government for FY2021, is focused on keeping primary balance at the sustainable level. It is expected that the government will continue expenditure management with balancing Corona related expenditure to keep fiscal deficit financed as budgeted.

4. Way Forward

In recent months, the MEI is improving. If this trend continues, Pakistan may resume positive growth in the coming months. Thus, at this juncture, in absence of severe future cost push commodity price and exchange rate shocks, inflation may stabilize or gradually ease in coming months. Further, the government is committed to keep primary balance in line with sustainable budget deficits and stable debt dynamics. Regarding, external sector, the current account deficit is projected to remain within the limits of the external financing constraints, preserving levels of foreign exchange reserves at reasonable proportion of the level of imports.

Nevertheless, risks remain present and need to be monitored closely. From a worldwide perspective, the COVID-19 pandemic is still not under control. According to the Johns Hopkins University Coronavirus Resource Centre, number of cases in the US is still rising. Also, in the UK and the Euro Area, new (local) waves are being observed in July. This may endanger the further re-opening of these economies. In Pakistan, the daily numbers of new Coronavirus cases are on declining trend since June 25, 2020. However, risk still prevails due to upcoming Eid event. Failure to get the worldwide covid-19 pandemic under control may worsen economic sentiment in Pakistan's main trading areas and hence endanger a revival of export revenues. The gradual re-opening of the economy in Pakistan will be helpful in raising revenue collection.

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