الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

Pakistan

June, 2022

TRUST . TRANSPARENCY . INDEPENDENCE

PAKISTAN ECONOMIC OVERVIEW

Pakistan is the sixth largest country in the world by population of about 213mn, and with a nominal GDP of about US$299bn in FY2021. Pakistan is categorized as 'a lower-middle income economy' under World Bank Atlas Method[1].

Table 5: Pakistan- Key Economic Indicators

Figures as stated	FY2019 A	F2020 A	FY2021 E
Population (mn)	205	217	213
GDP Per Capita (US$; Current)	1,473	1,285	1,394
Real GDP growth (%)	2.1%	-0.5%	3.9%
Inflation (CPI Average, %)	6.7%	10.7%	8.9%
Current Account Balance % of GDP	-4.9%	-1.7%	-0.6%
Fiscal Balance % of GDP^	-9.0%	-8.0%	-7.1%
Gross Public Debt % of GDP*	85.3%	87.6%	83.6%
Gross Reserves (US$'bn)	7.3	12.2	17.3

*(Source: IMF; FY: June ending; A: Actual; E: Estimate; ^ including grants;' -': not available; * excluding government guaranteed debt)*

Following contraction of 0.5% in FY2020, Pakistan's economy strengthened by 3.9% in FY2021. This was supported by the lifting of lockdowns that led to robust performance of manufacturing, wholesale and trade sectors, in addition to the government's accommodative macroeconomic policies and pandemic stimulus package. While positive economic momentum continued in H1'FY2022 with continued improvement in community mobility, robust remittance inflows, increased consumption and investment, external pressures have amplified during the recent months that pose substantial risks for Pakistan's economic outlook .

Pakistan's annual inflation in FY2021 averaged lower at 8.9% vis-à-vis 10.7% in FY2020 due to the delayed implementation of energy tariff adjustments, reduced petroleum development levy to offset rising international oil prices. Nonetheless, headline inflation rose to 9.8% YoY in H1'FY2022, driven by increasing global commodity prices and a weaker exchange rate. Further surge in commodity and crude price environment in recent months, is expected to keep average CPI inflation high in FY2022, and translated through recent terms of trade shock, continued energy price adjustments, and GST[2] reforms. After having kept the policy rate unchanged since June 2020, State Bank of Pakistan ("SBP") raised the rates thrice[3] between September 2021 and April 2022. Monetary policy tightening is expected to continue in the ongoing year as SBP continues to rein in inflation.

During FY2021, the current account deficit narrowed to 0.6% of GDP, aided by strong inward remittances. However, during H1 FY2022 external imbalance widened due to surging import values and is expected to remain so through the remaining fiscal period due to strong import growth, fuelled by strong domestic demand, higher commodity prices, and slightly receding remittances.

The central bank adopted a flexible market determined exchange rate regime in 2020. After having gained some ground in H1'21, value of Pakistani Rupee ("PKR") vis-à-vis US$ is noted to have weakened by 9.6% YoY at end-2021, and further losing about 3.8% YTD until end-March 2022. Growing import and related

1 Based on current US$ GNI per capita
2 General sales tax
3 September 20, 2021: 25bps increase to 7.25%, December 14, 2021: to 9.75%, and later by 250 bps to 12.25% on April 7, 2022

foreign currency demand and a higher current account deficit, will continue to put pressure on PKR over the near-term.

While gross international reserves rose in FY2021 to US$17.3bn (FY2020: US$12.2bn), the levels have reduced to US$12.9bn by end-March 2022, equivalent to 1.9 months of imports of goods and services. Most of the decline in the SBP's foreign exchange reserves was largely due to debt repayments and government payments pertaining to settlement of an arbitration award related to a mining project. The offshore mining company also announced to start developing the Reko Diq mine project in Pakistan.

Aided by large under-spending of budget allocations despite revenue shortfalls, particularly in Q4'FY2021, the budget deficit is noted to have improved 90bps to 7.1% of GDP at FY2021. However, during H1'FY2022 the fiscal negative balance widened by 20.6%[4] because of higher spending on vaccine procurement, settlement of power sector arrears and development projects, notwithstanding the high tax revenue growth due to higher tax collection and surge in imports. In January 2022, the government approved a supplementary finance bill to complement the tighter monetary policy in addition to withdrawing tax exemptions, cutting back on federal development spending, while protecting social sector spending. However, the ongoing political instability may deter the pace of these reforms in Pakistan in the near-term.

Public debt levels have remained elevated, although some decline was noted at FY2021 and H1'FY2022. Pakistan recorded net inflows to the tune of US$10.1bn in H1'FY2022 in the financial account, which was supported by the new IMF special drawing rights allocation, short-term government deposits from Saudi Arabia, and a Eurobond issuance in July 2021. Furthermore in Q1'22, the Government raised US$2.1bn from international Sukuk and the IMF Extended Fund Facility ("EFF"). Towards the end of April 2022, Pakistan approached IMF seeking to increase the size (to US$8bn) and duration of EEF program. IMF has pre-conditioned this deal subject roll-back of subsidies in Pakistan, for which negotiations are likely to be held in mid-May 2022. Further, the Government has also recently requested for non-withdrawal of deposits in SBP and extension of oil facility from Saudi Arabia. However, amidst existing conditions Pakistan faces heightened external debt refinancing risk. This may pose challenges for the financial system stability in terms of offshore payments and trade transactions. However, it be noted that instances of foreign currency borrowings in the banking sector are nil.

PAKISTAN ISLAMIC BANKING

Pakistan's banking sector is represented by 32 banks[5], of which 22 offer Islamic banking ("IB") services (5 full-fledged Islamic banks and 17 operating as Islamic windows of conventional banks). Having recorded over 20% growth in both deposits, the market share of Islamic banking deposits in the overall banking industry in Pakistan further expanded to 19.4% (2020: 18.3%; 2019: 16.6%; 2018: 15.5%)[6].

[4] Source: World Bank Economic update and outlook April 2022
[5] SBP: Quarterly Compendium: Banking Statistics – December 2021
[6] SBP: Islamic banking Bulletin - Dec. 2020

In line with SBP's strategic plan 2021-2025 rolled out in April 2021, SBP introduced Shari'a compliant standing ceiling facility and open market operations (injections) for IBs in Q4'21 to improve liquidity management framework and enhance the effectiveness of monetary policy implementation. Further in line with the latest verdict issued by the Federal Shari'a Court, the federal government and provincial governments have been directed to amend relevant regulatory changes for conversion of the entire banking system into Shari'a compliant system by end-2027[7]. This shall likely provide impetus to the existing Islamic banks by leveling the playing field and through the increased pace of conversions in the sector.

Islamic banking assets in Pakistan posted significant 31% Y-o-Y growth (highest since 2012) supported by higher pace of deposit mobilization, to PKR 5,577bn at end-2021, representing 18.6% share of overall banking sector assets (2020: 17.0%). Net financings- to- deposit ratio of the IBs edged up in 2021 to 61.7% partly due to ongoing conversion of a large bank, after having declined to 55.5% at 2020, following the general trend in the overall banking industry (2021: 46.6%; 2020: 44.8%). In addition, akin to overall banking sector IBs continued to invest funds into Government of Pakistan ("GoP") securities and public sector[8] Sukuk issuances. In tandem with overall industry, Islamic banks' asset quality indicators in terms of gross NPFs ratio and NPFs in relation to capital were reported lower at 2.7% and 2.1% in 2021, having improved 50bps and 210bps, respectively vis-à-vis prior year. Provisioning coverage of NPFs also stood enhanced to 90.8% at 2021 (2020: 82.4%) in lieu of IFRS 9 implementation starting January 2022, which has been further deferred until September 2022. Profitability in terms of return ratios for IB segment was reported lower in 2021 vis-à-vis prior year due to higher operating expenses.

In June 2018, the SBP issued the revised Shari'a governance ("SG") framework for Islamic banking institutions. Further, during 2021, SBP issued 2 circulars regarding Shari'a Board members and Shari'a non-compliance risk management ("SCNR"), which became effective in July and September 2021, respectively. SBP issued a circular in Q1'21[9] on SG framework with amendment regarding Shari'a Board members (except resident members) who may serve up to 3 IBs in Pakistan. This is subject to IBs ensuring at-least 2 members (other than resident) not serving any other Islamic bank. Other circular[10] provides instructions to reinforce the best practices in SCNR. Guidelines for establishment of a full-fledged IB, IB subsidiary and branches of conventional banks were also updated in 2020.

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[7] Source: dawn.com, Switch to Riba-free 'possible before 2027' (https://www.dawn.com/news/1688002), Federal Shariat Court declares interest-based banking system against Sharia (https://www.dawn.com/news/1687237)

[8] Government related entity – Pakistan Energy Sukuk by Power Holding (Pvt.) Ltd.

[9] Circular letter February 2021

[10] Circular letter July 2021

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