الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & FINANCIAL SECTOR OVERVIEW

Islamic Republic of Pakistan

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ECONOMIC OVERVIEW

Pakistan is the sixth largest country in the world, with a population of about 217mn representing a nominal GDP of about US$263bn in FY2020. Pakistan is categorized as 'a lower- middle economy', with gross national income ("GNI") per capita of US$1,280[1] in 2020.

Table 1: Key Economic Indicators				
Figures as stated	**FY2018 A**	**FY2019 A**	**F2020 A**	**FY2021 F**
Population (mn)	201	205	217	-
GDP Per Capita (US$; Current)	1,467	1,473	1,285	-
Real GDP growth (%)	5.5%	1.9%	-0.4%	1.5%
Inflation (CPI Average, %)	3.9%	6.7%	10.7%	8.7%
Current Account Balance % of GDP	-6.1%	-4.9%	-1.1%	-1.5%
Fiscal Balance % of GDP^	-6.4%	-9.0%	-8.0%	-7.1%
Gross Public Debt % of GDP*	72.1%	85.6%	87.2%	87.7%
Gross Reserves (US$'bn)	9.8	7.3	12.2	14.4

(Source: IMF; FY: June ending; A: Actual; F: forecast; ^ Including grants;' -': not available; * excluding government guaranteed debt)

As the global economy entered recession in 2020, Pakistan's economy was also impacted, having posted a GDP -0.4% contraction. Prior to Covid-19, Pakistan was on track to control its structural imbalances under the IMF program, progress on which has slowed due to the pandemic. Major adverse impact of the pandemic and lockdowns was largely seen in the manufacturing and services sector. However, with the easing of lockdowns since August 2020, manufacturing, construction and agriculture sectors show a rebound. On the other hand, services sector, forming around 60% of the GDP, still remained weak.

After posting a high of 14.6% in January 2020, inflation eased to 5.7% in January 2021. While having noted some spikes during H2' FY2021, the full fiscal period inflation is expected to be lower at 8.7% vis-à-vis 10.7% in FY2020.

The State Bank of Pakistan ("SBP") has continued monetary easing to combat the impact of the global pandemic, cutting the policy rate over the course of last year cumulatively by 625bps from 13.25% to 7.0% until June 2020 and since then the rates are unchanged. The central bank is expected to continue a supportive monetary policy until the economic recovery. Further, the central bank has also adopted a flexible market determined exchange rate regime. Since the adoption of the regime, Pakistani Rupee ("PKR") lost some value against the US$ to move around a parity of about 160US$/PKR at end-2020 having depreciated by 3.4%, and thereafter registered 1.6% appreciation YTD[2] until end-June 2021.

Reflective of the severely impacted global trade during the pandemic, Pakistan's imports declined at a faster rate than exports during FY2020. Coupled with this, remittances also posted an increase to US$23.1bn during FY2020 (FY2019L US$21.7bn), translating into reduced current account deficit of -1.1% of GDP during FY2020 (FY2019: -4.9%). The positive improvement in the external sector continued during the ten months[3] of FY2021 (i.e. 10M'FY2021) as reflected in current account surplus balance of US$773mn[4] (10M'FY2020: deficit of US$4.7bn), primarily supported by higher remittances (10M'FY2021: US$24.2bn, up 29% Y-o-Y). Increase in remittances was largely led by Covid-19 travel restrictions that channelized inflows towards the formal channels. SBP expects current account deficit to remain around 0%-1.0% of GDP during FY2021. The contribution of financial account has remained limited in the external sector. While lower activity was noted, net inflows were to the tune of US$3.5bn during 10M'FY2021 (10M'FY2020: US$8.9bn).

Improvement in external accounts translated into higher gross international reserves[5] of US$12.1bn as at FY2020 vis-a-vis US$7.3bn at previous fiscal end, further having increased to US$16.1bn at end-May 2021.

Fiscal policy has remained one of the major concerns for Pakistan, with fiscal deficit reaching a high of -9.0% of GDP during FY2019. As the government aims to consolidate the fiscal position, various measures have been taken to increase the revenues. Despite the economic slowdown amid lockdowns, government revenues are estimated to increase 15.4% Y-o-Y

[1] *Source: World Bank Atlas Method (current US$)*
[2] *Year-to-date*
[3] *July - April*
[4] *SBP - Monetary policy information compendium, May 2021*
[5] *Excluding foreign currency deposits held with SBP (cash reserve requirements) and gold*

vis-a-vis FY2020. This shall be driven by: a) revenue measures (hike in the petroleum levy on gasoline and diesel towards PKR30/litre), and b) reinforced tax administration efforts. The government is also committed to bringing changes in corporate income tax, in addition to streamlining the expenses. During the nine months of FY2021 (i.e. 9M'FY2021), Pakistan registered 6.5% Y-o-Y growth in aggregate government revenues having booked higher tax and non-tax revenues of PKR3.8trn (up 4.7% YoY) and PKR1.2trn (up 12% Y-o-Y), respectively. The government aims to improve spending efficiency through the gradual unwinding of crisis-related spending, rationalization of non-priority current spending and streamlining of subsidies and recalibration of development spending to reflect Covid-19 related execution delays. Despite the expenses rationalization, the government is committed to continue with the income support program. In 9M'FY2021, federal expenditures grew slower at 4.2% Y-o-Y to PKR6.6trn, translating into slightly improved overall fiscal deficit of PKR1.6trn (down 2% Y-o-Y) during the period. Fiscal deficit in FY2021 is expected to remain around -7.0% of GDP.

While gross public debt has trended up on a timeline, in relation to GDP it stood relatively lower at 81.4%[1] at end-9M'FY2021 from 87.2% at FY2020. Lengthening of average time to maturity of domestic public is also noted favourably. Further, improvement in the current account balance kept the external financing requirement lower during this period. In addition, revaluation gains due to appreciation of PKR vis-a-vis USD has helped contain the pace of external debt and liabilities accumulation, which stood at 38% of GDP during 9M'FY2021 (FY2020: 45.5%). The government has taken a number of initiatives to manage debt well, which include fiscal discipline and revenue mobilization, better cash flow management through a treasury single account, establishment of a central Debt Management Office and the successful implementation of the Medium Term Debt Strategy. The strategy covers economic projections for next three years, with an aim of lowering the fiscal deficit to -4.4% of GDP by FY2024 and bringing the debt- to- GDP ratio down to sustainable levels.

During March 2021, amendment to SBP Act was finalized and submitted to the parliament. In response to Covid-19, SBP has offered various schemes via banking sector to support the corporate sector and the economy, which include monetary easing, reduction in capital conservation buffer, financing repayment moratorium by one year, relaxed criteria for restructured/rescheduled financing for borrowers requiring relief of principal repayment exceeding one year, relaxing debt burden ratio and time based criteria for non-performing financings classification etc. Since the inception of these schemes in March 2020 and through end-November 2020, SBP has allocated PKR707.9bn to banks. Of this, the banks had disbursed PKR234.2bn until November 2020. As at March 15, 2021, roughly about a third of total SBP support to the tune of PKR2.1trn[7] was indicated to have been allocated in the form of loan deferment, followed by about 23% towards refinancing facility schemes[8], 22% as interest rate cut benefits, about 12% as loan rescheduling and balance as liquidity support for job protection[9].

ISLAMIC BANKING

As of end-2020, Pakistan's banking sector comprised 32 banks[10], of which 22 offer Islamic banking ("IB") services (5 full-fledged Islamic banks and 17 operating as Islamic windows of conventional banks). The market share of Islamic banking deposits in the overall banking industry in Pakistan witnessed growth to 18.3% at the end-2020 (2019: 16.6%; 2018: 15.5%)[11].

In April 2021, SBP rolled out "Strategic Plan 2021-2025" for Pakistan's Islamic banking industry that set the target to increase Islamic banking assets and deposits to reach 30% by 2025 through structural and regulatory reforms[12]. During this same period, the plan also entails to increase the share of private sector financings to SMEs and agriculture to 10% and 8%, respectively. Accordingly, the plan is based on the following six pillars: (1) strengthening legal landscape; (2) enhancing

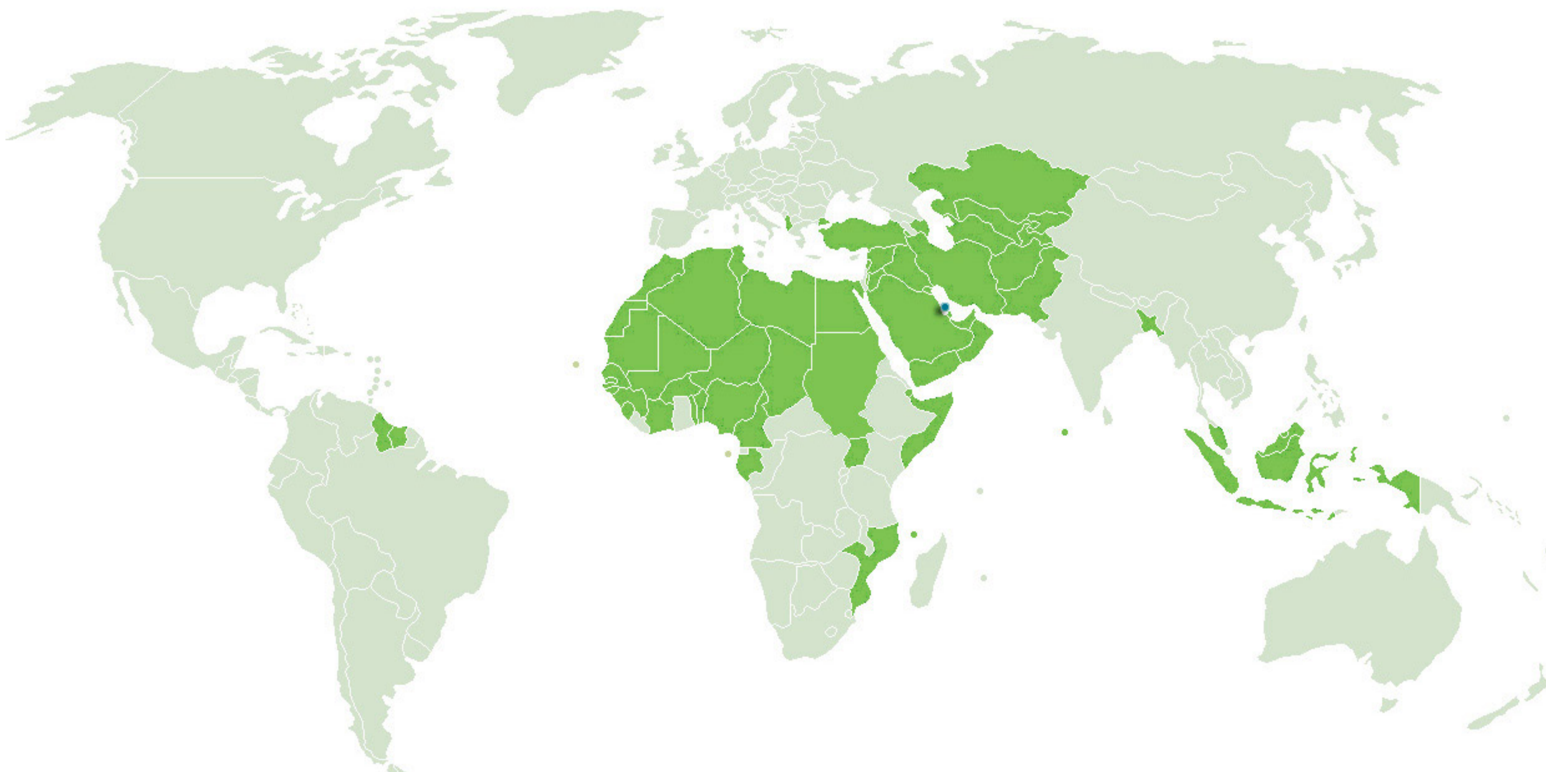
[6] Based on targeted GDP for FY2021
[7] SBP – The State of Pakistan's Economy 2020-21 (2nd quarterly report of the Board of directors)
[8] Temporary Economic Refinance Facility and Refinancing Facility for Combating Covid-19 and Islamic versions of the respective schemes
[9] Rozgar Scheme and Islamic versions of the respective scheme
[10] SBP: Quarterly Compendium: Banking Statistics – March 2021, compared to 33 banks at end-2019
[11] SBP: Islamic banking Bulletin - Dec. 2020
[12] https://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Strategic-Plan-2021-25.pdf

regulatory framework; (3) reinforcing comprehensive Shari'a governance framework; (4) improving liquidity management framework; (5) expanding outreach and market development; and (6) bolstering human capital and raising awareness.

With higher pace of deposit mobilization, Islamic banking assets in Pakistan posted significant 30% Y-o-Y growth (highest since 2012) to PKR4,269bn at end-2020, representing 17% share of overall banking sector assets (2019: 14.9%). Net financings- to- deposit ratio of the IBs has trended down on a timeline, having stood at 56.5% at Q1'21 from 61.2% at 2019, albeit remained higher than the overall banking industry (Q1'21: 45.2%; 2019: 51.7%). Despite SBP support policies, overall banking sector-wide financings decelerated during 2020, and thereby available liquidity was redirected towards investments; particularly in Government of Pakistan ("GoP") securities. On the contrary, IBs financings exhibited 15.9% Y-o-Y growth in 2020, in addition to surged channeling of liquidity into GoP securities. While generally there is still a deficit of Islamic liquidity instruments in the market, during 2020 GoP and public sector[13] Sukuk issuances witnessed an increase. Islamic banks' asset quality indicators in terms of NPFs-to-total financings improved to 3.5% at Q1'21 (2020: 3.2%; 2019: 4.3%), comparing favorably vis-à-vis overall industry (Q1'21: 9.3%; 2020: 9.2%; 2019: 8.6%). In view of Covid-19 impact, SBP decided to further defer the implementation of IFRS-9 until January 2022 instead of the ongoing year. However, from Q2'20 onwards IB provisions increased as some Islamic banks also target to implement the standa**rd in the ongoing year. This is** reflected in higher provisioning coverage at 82.2% at Q1'21 (2020: 82.4%) vis-à-vis 54% at end-2019. With this it may be notable that for IBs, net NPLs in relation to total capital substantially reduced in Q1'21 to 4.6% (2020: 4.2%; 2019: 14.6%). This also compares well vis-à-vis overall banking industry in Pakistan at Q1'21: 5.9% (2020: 5.3%). Nonetheless, non-performance in the banking sector may increase once the effect of deferments allowed by SBP due to Covid-19 wane. Profitability in terms of return ratios, for both overall banking sector and IB segment edged up in 2020 vis-à-vis prior year.

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 shall be effective in July and September 2021, respectively. SBP issued a circular in Q1'21[14] 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[15] provides instructions to reinforce the best practices in SCNR. Guidelines for establishment of a full-fledged IB, IB subsidiary and branches of conventional banks was also updated in 2020.

[13] Government related entity – Pakistan Energy Sukuk by Power Holding (Pvt.) Ltd.
[14] Circular letter February 2021
[15] Circular letter July 2021



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