Executive Summary

The advent of year 2020, has put the whole world at a war against a pandemic, with a certainty of an uncertain future. With casualties ranging in hundreds of thousands and reported cases in millions, no country — from the most developed to the poorest — has been spared. The world is defining itself as pre-COVID-19 and post COVID-19, much as it does with pre-WWII and post-WWII. Over the second half of 2019, it was already becoming clear that the global economy was entering a recession, however the situation was expected to improve in 2020, led by the large emerging economies, with a return to potential global growth by 2021. However, with Covid-19 and its devastating effects, all bets are off, and all forecasts for 2020 being revised downward.

The scale of the negative impact globally is so huge that some experts have indicated it to be even worse than the Great Depression witnessed in the past century. According to Moody’s rating agency, real global GDP will contract by 0.5% in 2020, followed by a pickup to 3.2% in 2021 as against its pre-Covid-19 estimate of growth by 2.6% this year. Conditions accordingly are unlikely to improve till 2021, with an expected $2 trillion shortfall in global income, and a $220 billion hit to developing countries (excluding China). However, incentives and stimulus packages announced globally can give some respite in such an unprecedented of times. This is certainly not good for achieving the Sustainable Development Goals (SDGs) where prior to this crisis, the world was already falling behind in efforts to achieve them.

The Covid-19 virus can be expected to infect developing economies like Pakistan, through three transmission channels. Firstly, it will affect the aggregate demand, owing to the measures taken to contain the spread of the virus. Already witnessing a slowdown in the economy, the situation will worsen given the impending unemployment (rise to 8.1 percent, with 12.3 million to 18.53 million expected layoffs), as an aftermath of a lockdown. These layoffs will certainly decrease the disposable income of these households thereby sending a demand shock throughout the economy. This is then augmented by the expected decrease in the remittances, that is expected to take a hit of 10 to 50%, depending on the spread of the virus and the measures taken to contain it. These hits to the disposable income are expected to decrease the aggregate demand, with an expected fall in private consumption expenditure of 4 to 8 percent, thereby not only changing the economic outlook of the country but also changing the lifestyle of its masses.

Secondly, via supply channel, a sudden stop of manufacturing activity in the most affected regions will cause bottlenecks in Global Value Chains (GVC). Inventory decumulation can support supply for a while, but with today’s just-in-time globalized production structures, it seems reasonable to assume that the Covid-19 outbreak has already exhausted inventory stocks. Such disruption will in turn trigger widespread factory closures for lack of intermediary inputs, even in zones still immune to the virus. Despite all unknowns, a moderate hypothesis is that profits will be initially hit and, if the crisis persists, employment and wages will also decline. The consequences of disruptions on the supply side can therefore contaminate aggregate demand, as well as threaten financial stability.

Lastly, a classic transmission of exogenous shocks to the real economy is via financial markets as they become part of the problem. As markets fall and household wealth contracts, household savings rates move up and thus consumption must fall. Pakistan was already experiencing rough waters before COVID-19 struck. Equity markets were already seeing a decline due an economic slowdown, Bond markets were seeing an influx of money due to high interest rates, that were kept high to combat inflation, on the other hand making it costly to venture into new businesses with debt financing. Debt
had reached 68.8% of GDP. However, Rupee was at a stable position against dollar, mainly due to the contraction in CAD. Forex Reserves were enough to cover 3 to 4 months’ worth of imports. The economic trajectory although bleak was to pick up pace given the IMF’s Second successful review. As the COVID-19 is spreading, so is its impact on the financial front. Equity market (PSX) has tipped and turned, while forex reserves have declined by a massive $1 billion. On the external financial front, the debt servicing payments will soon be due. Fiscal deficit will only grow in days of crisis where government is giving stimulus and the revenue collection is to be compromised as well. With exports falling and remittances slowing down, debt servicing cannot be financed solely by import saving. Loans are to be renegotiated and new loans are to be solicited to provide for the fiscal space government needs to get out of this crisis.

Likewise, social countermeasures to fight COVID-19 will cause substantial social disruptions. Social distancing has changed the dynamics of religion, education, hospitality, travel, entertainment, sports. A shock of this scale will create a discontinuous shift in the preferences and expectations of individuals as citizens, as employees, and as consumers. These shifts and their impact on how we live, how we work, and how we use technology will emerge more clearly over the coming weeks and months. Institutions that reinvent themselves to make the most of better insight and foresight, as preferences evolve, will disproportionally succeed.

Given the impaired liquidity position of potential investors and heightened risk perceptions, there is likely to be a big fall in private investment in coming months when faced with industrial closures and the obvious reluctance of banks to offer loans. The COVID-19 pandemic may bring a 30-40 percent drop in global foreign direct investment (FDI) flows during 2020 and 2021, according to a report released by UNCTAD. The reduction in profit due to economic slowdown will take away a major component of FDI that is the reinvested earnings. These reinvested earnings make up 40% of the FDI for developing countries like Pakistan.

Pakistan’s economy is projected to face a loss of up to 4.64 percent in GDP because of disruptions in trade, both in imports and exports after the outbreak of COVID-1916. This could be roughly quantified to around Rs700 to Rs800 billion losses in the April-June period of FY2020 if the exchange rate in terms of the dollar versus rupee is estimated at Rs165 against the dollar.

The major reason behind this unfortunate decline in output is the fact that, out of the five major trade partners (with more than 50% share in trade) of Pakistan (China, USA, UK, Japan, and Germany), four (China, USA, UK, Japan, and Germany) also happen to be the worst hit countries by the COVID-19. These estimates do not include the effect of an internal slowdown or shutdown, which when factored in would amplify the supply shock estimates.

Scoping the FDI sectors reveals Basic materials industries to have been on a downward trend since FY18. For Energy the investments have been made mostly with G2G collaborations that will continue, given our counterparts do not have policy changes in that regard. Automobiles sector has been a promising outlet for attracting foreign investment in the past couple of years, with its own policy guiding and incentivizing many landmark investments. However, with the decline in LSM output in the Second Quarter of FY20, automobiles industry has been struggling, with big names like Honda, contemplating shutdowns. Any investment into this sector was already a hard sell, even with a lucrative incentive package in the shape of Automotive Development Policy (2016-21).

Of the sectors i.e. energy and basic material industries, airlines and the automotive industry, that are expected to be the hardest hit, the most we need to worry about is the basic materials (expected FDI hit $40.49 Mn, 51% of total expected FDI hit) as it includes all the raw materials that are used in other
industries. Being rich in resources, puts Pakistan in line with the countries that will struggle in utilizing their resources. The FDI stock (FY2002-Sep20) in this sector amounts to $11.57 bn, that is 28% of the total FDI stock of Pakistan. Any adverse implications, in the form of divestment can affect other sectors as well.

The social and economic disruptions while threaten the reality as we know it, they also bring significant opportunities. In response, companies in multiple sectors are already transforming their products, processes, and business models. While FDI is expected to witness a major decline in Physical Tourism, Entertainment, Retail, Luxury goods, Aviation, Real estate, Coal, Oil & Gas, and Automotive due to the social restrictions, price wars, lock downs and shutdowns. However, there are growth opportunities that can be harnessed in food processing, consumer goods, logistics, entertainment & communications, financial services, eCommerce, EdTech, HealthTech, textile and tourism.

Pakistan needs an investment strategy response in order to reverse some of the Post COVID-19 distress on investment and trade. In the wake of the disruptions caused by Covid-19 and the new opportunities they provide, following 10-point agenda can act as a preliminary strategy response for attracting investment into Pakistan:

1- Industrial Relocation under CPEC-IC to cater for non-Chinese companies as well;
2- Incentivizing backward linkage-ing in SEZs;
3- Fast tracking of CPEC Projects;
4- 5G deployment be expedited to enable the industrial cooperation in technology;
5- Building IT and security capacity;
6- Revisiting priority sectors for investment;
7- Diaspora investment certificates to solicit funds into quality projects;
8- Incentivizing and facilitating industrial transformation;
9- Devising an SME Survival plan; and,
10- Providing due diligence for mergers & acquisitions.

While government has for the past several years focused on export-led growth; however, COVID-19 has exposed the vulnerability of betting only on trade and disregarding investment, with almost 4.64% expected loss in the GDP. The often separately considered topics of trade and investment must be thought about as one if Pakistan is to build the economy of the future.

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