1

Global and Domestic Developments

Global economy continued to decelerate in CY23 owing to tight monetary policy, low investments, and weak trade growth while global inflation declined on account of softening demand, recovery in supply chains and moderating commodity prices. Although major central banks in Advanced Economies (AEs) kept a tight monetary policy course, overall global financial conditions eased in CY23, primarily due to expectations of interest rate cuts and higher equity valuations. Public debt continued to improve in AEs but remained elevated in Emerging and Developing Economies (EMDEs). The on-going conflicts in Middle East and Europe are the most important prevailing risk factors for the global economy. On domestic front, the long standing structural issues were compounded by the lagged impact of supply shocks, macroeconomic imbalances, and political uncertainty. Macroeconomic conditions started to improve in H2CY23, as with a resumption of multilateral financing, the FX reserves improved, risk premium moderated, exchange rate stabilized and, amid softening demand, the current account improved. Backed by positive developments, inflation moderated while signs of economic recovery emerged in the second half of CY23.

1 Global and Domestic Developments

1.1 Global Economic Dynamics

Global economic activity continued to decelerate in CY23…

The global economic growth continued to recede for another year, manifesting the impact of a tight monetary policy stance in the context of elevated inflation levels, low investment, and weak trade growth.[1] The growth moderated to 3.2 percent in CY23 from 3.5 percent in CY22 (**Table 1.1**).

The slowdown was mainly driven by moderating economic momentum in Advanced Economies (AEs) to 1.6 percent from 2.6 percent in CY22. Among AEs, the UK and Euro Area experienced a sharp deceleration in growth. In Europe, consumer spending and manufacturing activity remained subdued due to higher energy prices and interest rates. However, despite a tight monetary policy environment, the US maintained a strong growth trajectory owing to an expansionary fiscal policy and robust consumer spending.

Emerging and Developing Economies (EMDEs), especially EMDEs-Asia, nonetheless, continued to propel the global growth at a steady pace. Robust economic activity in Asia, notably India and China, contributed towards overall growth in EMDEs. Fast-paced expansion in India was largely driven by robust growth in investment and services. In case of China—despite soft consumer spending and contraction in the property sector—post COVID recovery helped spur economic activity to 5.2 percent GDP growth in CY23 as compared to 3.0 percent in CY22.

Global Economy: Real GDP Growth **Table 1.1**

					percent
	2021	**2022**	**2023**	**2024***	**2025***
World	6.2	3.5	3.2	3.2	3.2
Advanced Economies	5.4	2.6	1.6	1.7	1.8
EMDEs	6.7	4.1	4.3	4.2	4.2
EMDEs - Asia	7.4	4.5	5.6	5.2	4.9
USA	5.8	1.9	2.5	2.7	1.9
Euro Area	5.3	3.4	0.4	0.8	1.5
GCC	3.8	7.8	0.5	2.7	4.6
UK	8.7	4.3	0.1	0.5	1.5
Japan	2.6	1.0	1.9	0.9	1.0
China	8.5	3.0	5.2	4.6	4.1
Türkiye	11.4	5.5	4.5	3.1	3.2
India	9.7	7.0	7.8	6.8	6.5
Russia	6.0	-1.2	3.6	3.2	1.8
Saudi Arabia	5.1	7.5	-0.8	2.6	6.0
United Arab Emirates	4.4	7.9	3.4	3.5	4.2
Pakistan (FY)	5.8	6.2	-0.2	2.0	3.5

*IMF Projections

Source: International Monetary Fund

The Gulf Cooperation Council (GCC), an important destination for exports and a source of remittance flows for Pakistan, experienced a pronounced downturn and registered a muted growth of 0.5 percent in CY23. This was owing to oil production cuts (especially in Saudi Arabia). The non-oil activity, however, remained robust in these economies based on moderating inflation and supportive fiscal policies.[2]

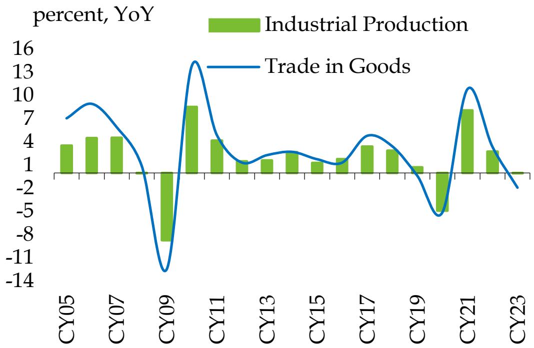
… along with weak trade growth

Importantly, barring the global financial crisis (GFC) of 2007-08 and pandemic shock, the global trade observed the sharpest slowdown during CY23 **(Figure 1.1).** This was owing to a weak global demand and more restrictive trade policies. Reflecting intensifying trade fragmentations, the number of trade restrictions

[1] World Bank. (2024). Global Economic Prospects. Washington, January
[2] International Monetary Fund. (2024). Regional Economic Outlook (Middle East and Central Asia). Washington, January

significantly increased to 3,000 in CY23; nearly three times the corresponding figure in 2019.[3]

Growth of Global Trade and Industrial Production **Figure 1.1**



Source: CPB Netherlands Bureau for Economic Policy Analysis

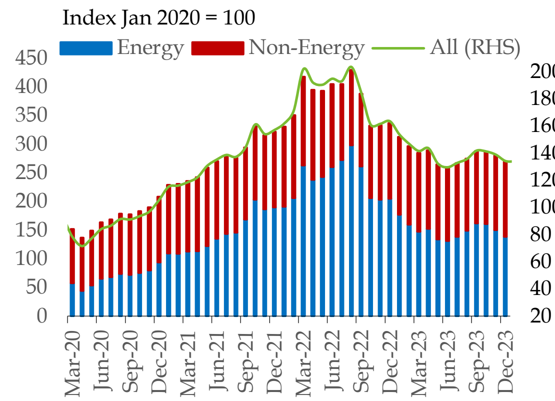
After surpassing multi decade high level last year, inflationary pressures eased during CY23

Global headline inflation fell to 6.8 percent in CY23 from 8.7 percent in the previous year. Several factors contributed to this ease in inflationary pressure including softening consumer demand in the wake of tight monetary policy stance, recovery in global supply chains and moderating commodity prices. Barring an interim surge in energy prices in second half of CY23, international commodity prices witnessed a fairly consistent decline during CY23; albeit remaining above the pre-pandemic levels **(Figure 1.2)**. Despite this temporary surge; that can be attributed to oil production cuts by OPEC+ and the Middle East conflict, average energy prices fell by 35.1 percent in CY23.

Non-energy prices, mainly represented by food and metals, also depicted moderating trend by registering a decline of 5.3 percent in CY23. Improved supply conditions in major crops and weak demand in major economies respectively explain the decline in food and metals prices in CY23.

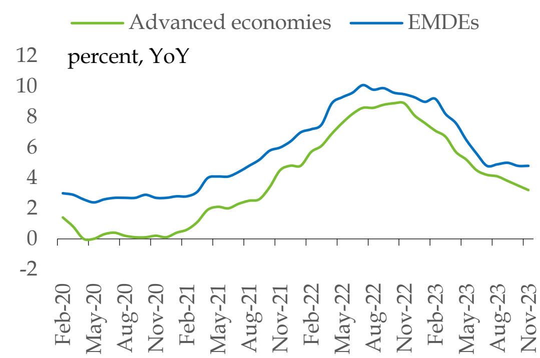
It is noteworthy that although overall global inflationary pressure substantially declined, the levels in general remained above the targets set by most of the advanced countries. Nonetheless, half of the countries in the EMDEs group witnessed inflationary pressures subsiding below their targets **(Figure 1.3)**.

International Commodity Prices Index **Figure 1.2**



Source: World Bank

Consumer Price Inflation **Figure 1.3**



Note: Data represents median headline inflation
Source: World Bank

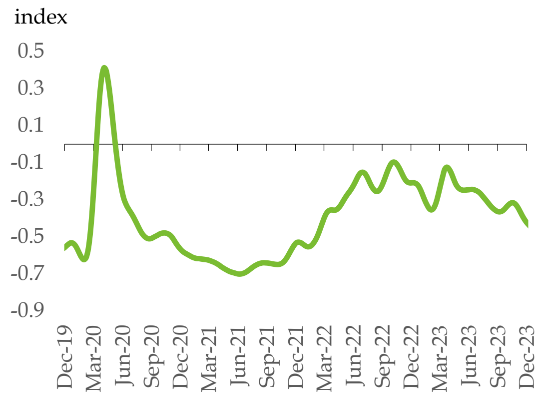
Despite tight monetary policy of major central banks in AEs, global financial conditions eased markedly in CY23

In order to bring down inflation to their respective targets, major central banks in AEs maintained a tight monetary policy stance. However, global financial conditions eased substantially after first quarter of CY23 **(Figure 1.4)**. This was primarily due to high expectations

[3] International Monetary Fund. (2024). World Economic Outlook: A Rocky Recovery. Washington, January.

of a reversal in key policy rates amidst softening inflationary pressures. Besides, higher equity valuations and lower stock volatility supported improvement in financial conditions.

Financial Conditions Index **Figure 1.4**

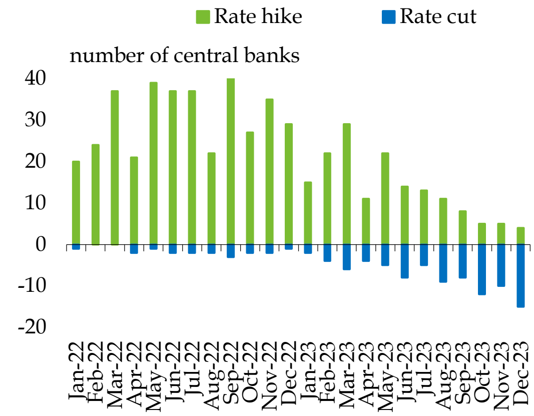


Source: fredhelp.stlouisfed.org

It is important to note that unlike central banks in AEs, certain emerging market economies, having achieved inflation targets, moved to cut policy rates during CY23. Among advanced economy central banks, the Federal Reserve and European Central Bank (ECB) adopted remarkably aggressive policy stance. As a result of tight financial conditions in the US and other vulnerabilities that were exposed by sudden change in macroeconomic conditions in the wake of the pandemic, certain banks in the US turned insolvent triggering global financial stability concerns in March 2023 (**for further details, see Box 1.1).** However, timely policy actions helped avoiding any further spread of contagion to USA and global financial system.

Analysis[4] of the monetary policy across the world reveals that during the first three quarters of CY23, 145 rate hikes and 51 policy rate cuts were observed, indicating a tight policy stance. However, the trend reversed during the last quarter in which 14 rate hikes and 37 rate cuts were observed. This accommodative monetary policy stance was majorly adopted by EMDEs while the most of the advanced economy central banks continued their tighter stance to signal their commitment to attaining inflation targets and anchor inflation expectations (**Figure 1.5**). The widening of interest rate differentials triggered capital outflow[5] from EMDEs and strengthened the AE currencies, especially the US dollar.[6]

Central Banks' Policy Rate Decisions **Figure 1.5**



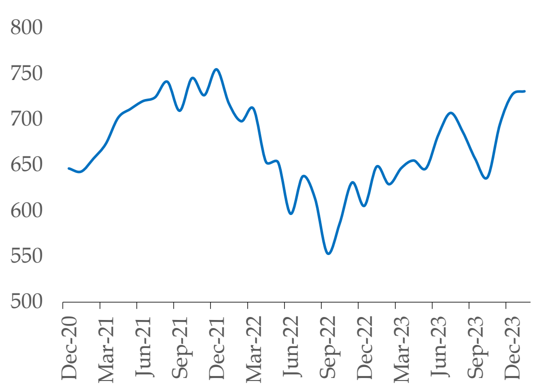
Source: CBrates.com

Global equity prices rebounded in CY23

Global equity markets manifested bullish sentiment as evidenced by a 20.0 percent rebound in the global equity price index in CY23. This was in contrast to the marked decline in valuations last year. Improved risk sentiments in AEs primarily drove up the equity indices. Although upbeat sentiment largely prevailed among AEs in CY23, equity prices observed a short-lived steep decline during October 2023 due to increased uncertainty in the wake of conflict in the Middle East **(Figure 1.6)**.[7]

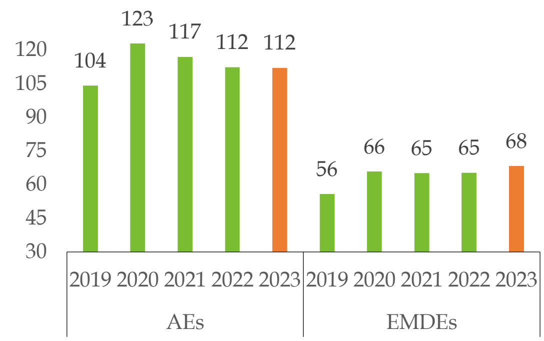
[4] Analysis is based on data listed on Cbrates.com.
[5] World Bank. (2024). Global Economic Prospects. Washington, January
[6] Around one-fifth of EMDEs- with weak credit rating- observed a substantial (30 percent) depreciation during 2023.
[7] Crude oil and Natural gas prices increased significantly. IMF Blog December 01, 2023.

Global Equity Price Index **Figure 1.6**



Source: Bloomberg

General Government Debt **Figure 1.7**



Note: 2023 represents projections of IMF.
Source: International Monetary Fund

Sovereign debt level remained contained in AEs but grew further in EMDEs

Sovereign debt levels increased substantially during the pandemic as governments around the world aggressively responded to mitigate the impacts of pandemic. However, after 2020, public debt continued to improve in AEs though still higher than pre pandemic level. The debt remained at elevated levels in EMDEs. The debt-to-GDP ratio in EMDEs increased to 68.3 percent at the end of CY23 from 65.3 percent at the end of CY22 **(Figure 1.7)**.[8] Besides idiosyncratic issues faced by these economies (e.g., fiscal constraints), depreciation of EMDEs' currencies against USD also played role.

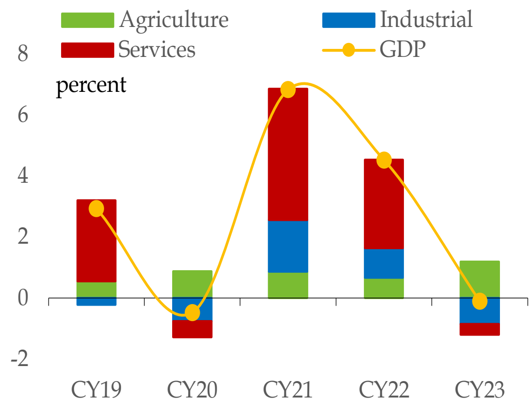
1.2 Domestic Economic Developments

A host of factors contributed to sub-optimal economic growth in CY23 …

Pakistan's economy experienced a challenging macroeconomic environment during CY23. Confluence of long standing structural issues,[9] the lagged impact of supply shocks, internal and external imbalances, the shocks to country risk premium and sentiments of economic agents and tight monetary policy to counter inflationary pressures, led to a sharp deceleration of GDP growth. The real GDP *contracted* by 0.1 percent in CY23 compared to a growth of 4.5 percent in CY22.[10] The slump in GDP was mainly attributable to industrial and services sectors, while a robust performance of agriculture sector helped contain the overall slowdown in economic activity **(Table 1.2, Figure 1.8).**

[8] Public debt increased to USD 24.9 trillion in September 2023 from USD 22.8 trillion in same period last year. Source: BIS Data Portal
[9] Key structural issues include low levels of private savings and investment, tax to GDP ratio, productivity growth, exports, and global investment flows.
[10] In terms of fiscal year (FY), real GDP growth declined from 6.2 percent in FY22 to -0.2 percent in FY23. Calendar year estimates of GDP provided in Table 1.2 are based on Quarterly NIA data recently released by PBS.

GDP Growth and Sectoral Contributions **Figure 1.8**

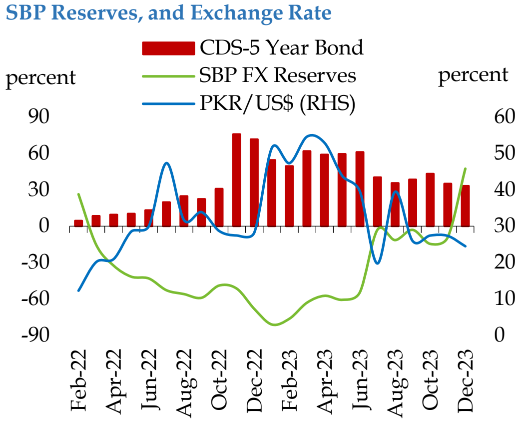


Source: Pakistan Bureau of Statistics

…particularly, the first half was marked by multidecade high inflation, and a sharp rupee depreciation…

Within CY23, first half remained particularly challenging. Political uncertainty, delays in IMF's stabilization program and low FX reserves led to a substantial rise in country risk premium and culminated into a considerable pressure on domestic currency (**Figure 1.9**). A sizeable currency depreciation precluded the trickle down of overall ease in global commodity prices (**Figure 1.2**) to domestic inflation outcomes. At the same time, the elevated risk premium restricted the country's access to global financial markets despite a broad easing of global financial conditions (**Figure 1.4**).

Credit Default Swap and YoY Change in SBP Reserves, and Exchange Rate **Figure 1.9**



Source: State Bank of Pakistan and Bloomberg

Key Economic Indicators of Pakistan* **Table 1.2**

	CY19	CY20	CY21	CY22	CY23
Real Sector			(percent)		
Real GDP Growth	2.9	-0.5	6.8	4.5	-0.1
Industrial Sector Growth	-1.2	-4.1	9.0	5.1	-4.7
Agricultural Sector Growth	2.4	3.7	3.8	3.0	5.1
Service Sector Growth	4.6	-0.9	7.4	4.9	-0.6
LSM Growth (Average YoY)	1.9	-9.7	14.7	6.7	-9.8
Inflation (Average YoY)	9.4	9.5	9.5	19.7	30.9
External Sector			(billion US dollars)		
SBP Reserves (End-of-Period)	11.3	13.4	17.7	5.6	8.2
Current Account Balance	-8.6	-0.7	-12.3	-12.2	-0.4
Exports (Goods & Services)	30.7	27.3	35.6	39.0	36.4
Imports (Goods & Services)	58.0	52.1	76.5	76.6	57.8
Remittances	22.1	25.9	31.1	29.9	26.4
PKR/USD Rate (End-of-Period)	154.8	159.8	176.5	226.4	281.9
Fiscal Sector			(percent)		
Fiscal Deficit (as % of GDP, FY)	-8.9	-8.1	-7.1	-7.9	-7.8
Revenue Growth (YoY)	12.3	10.1	17.5	16.9	34.3
Expenditure Growth (YoY)	18.9	9.4	11.3	31.1	30.3
Monetary Sector			(percent and trillion Rupees)		
Credit to Private Sector (YoY)	3.8	4.5	19.6	13.4	-1.1
Financing	3.4	3.5	3.6	5.6	7.2
Domestic	2.7	2.7	1.7	5.7	7.0
External	0.7	0.8	1.9	-0.1	0.2

*All data are on Calendar Year basis unless stated otherwise.

Source: Ministry of Finance, Pakistan Bureau of Statistics and State Bank of Pakistan

Coupled with the lagged impact of floods of CY22, administrative adjustments in prices of some commodities, and substantial currency depreciation translated into a multi-decade high level of inflation; necessitating appropriately tight monetary policy stance to tame inflation and anchor expectations.

Further, administrative measures to temporarily restrict imports in order to ease pressure on external account were introduced in CY22 and continued till H1CY23. The limited availability of imported inputs compounded the effects of supply bottlenecks and negatively affected growth while pushing up inflation. Against this backdrop, the LSM *contracted* by 17.3 percent during H1CY23, on average, while average CPI inflation reached 33.0 percent (**Figure 1.10**). The H2CY23, however, witnessed not only the recovery of manufacturing activity but moderation of inflation as well.

Large Scale Manufacturing **Figure 1.10**

Source: Pakistan Bureau of Statistics

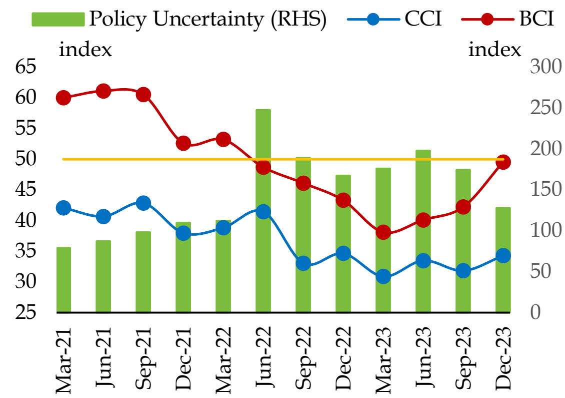
…however, macroeconomic environment improved in the latter half of CY23.

Macroeconomic environment moderately improved in H2CY23. The improvement was evident in the recovery of business confidence index (BCI), reduction in policy uncertainty, decline in risk premium and stability in exchange rate (**Figure 1.11**). As a result of these positive developments, and the favourable base effect, the average inflation declined to 28.8 percent (33.0 percent in H1CY23) and LSM contracted by 0.9 percent in H2CY23 (*negative* 17.3 percent in H1CY23).

External account posted substantial improvement amid reduced domestic demand and softening in global commodity prices

Due to subdued economic activity, stabilization policies, prioritization of essential imports during H1CY23 and ease in global commodity prices, import bill observed a significant compression. Imports of goods and services declined substantially to USD 57.8 billion in CY23 from USD 76.6 billion in CY22, representing a fall of 24.5 percent.

Consumer and Business Confidence **Figure 1.11**



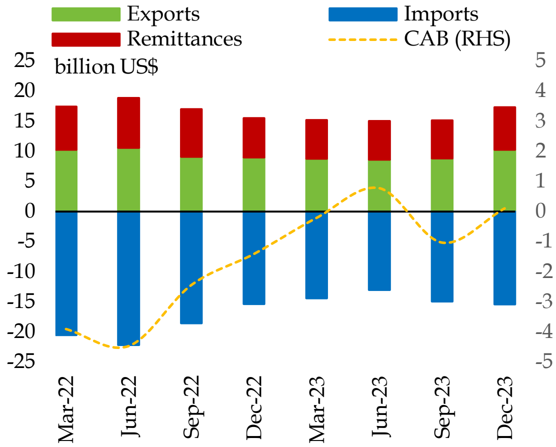
Source: State Bank of Pakistan and PolicyUncertainty.com

Amidst slowdown in global economic activity, particularly in Pakistan's major export destinations, supply chain disruptions affecting imported raw materials, high production costs, and continued impact of losses to agriculture produce due to flood-induced damages, the exports contracted as well. The exports of goods and services declined by 6.5 percent, from USD 39.0 billion in CY22 to USD 36.4 billion in CY23.

Remittances, the second largest source of foreign exchange, also contracted by 11.8 percent to USD 26.4 billion in CY23 from USD 29.9 billion in CY22. This decline in remittances was attributed to slowdown in advanced economies, higher spread between open market and interbank exchange rates especially in Q3CY23, and the gradual normalization of air travel following the pandemic.

However, on a positive note, the decline in imports outweighed the contraction in exports and remittances, leading to an improvement in current account balance, which posted a deficit of merely USD 0.4 billion in CY23 compared to a deficit of USD 12.2 billion in CY22 **(Table 1.2 & Figure 1.12)**.

Current Account Balance **Figure 1.12**



Source: State Bank of Pakistan

Pressures on domestic currency mounted in H1 but eased in the second half

In the first half of CY23, FX reserves—already ebbing— further decreased by USD 1.1 billion due to timely repayments of external debt and lower-than-expected official and bilateral inflows, amid delays in completion of 9th review of the IMF Extended Fund Facility (EFF) program. Low level of FX reserves coupled with domestic uncertainty adversely impacted investor confidence and translated into downgrade in the country's credit rating.[11] Additionally, tight monetary policy in AEs and elevated country risk premium kept it challenging to borrow from commercial sources.

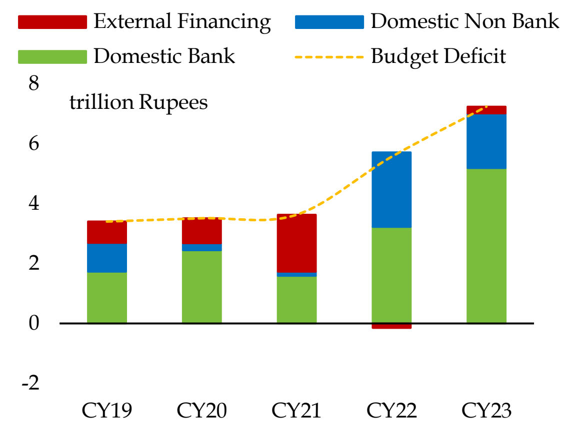
These developments exerted pressure on the domestic currency and the average monthly exchange rate depreciated by 24.4 percent in first nine months of CY23.

However, partly driven by the successful completion of the 9th review of the IMF EFF, SBP's FX reserves increased by USD 3.8 billion in H2CY23, compared to USD 1.1 billion decline in H1CY23. As a result of improvement in FX reserves and administrative measures to curb speculative demand for FX, stability in the FX market restored and average monthly exchange rate appreciated by 5.1 percent from PKR 297.7 per USD in September 2023 to PKR 283.3 per USD in December 2023.

Fiscal deficit continued its rising trend…

Fiscal deficit increased to Rs 7.2 trillion in CY23 from Rs 5.6 trillion in CY22, representing an annual increase of 30 percent. The major rise was owing to an increase in expenditures, which outweighed mobilization of revenues. Inadequate external financing flows forced the government to finance 97 percent of its deficit from domestic sources. Among domestic sources, banking sector financed 72 percent of the total budget deficit in CY23 **(Figure 1.13)**. (**for details see Chapter 3 on Banking sector**).

Fiscal Deficit and its Financing **Figure 1.13**



Source: Ministry of Finance

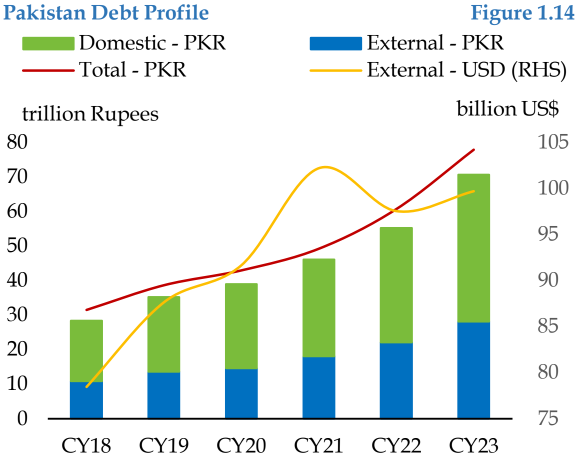
…leading to rise in public debt

Total public debt increased by 28.3 percent in CY23; up from 23.3 percent growth in CY22. The external debt, denominated in USD[12], increased by 2.2 percent, reaching USD 99.7 billion by the end of CY23. This modest rise in dollar denominated external debt was primarily due to low external financing and timely debt repayments in the first half of CY23. However,

[11] In February 2023, Moody's and Fitch downgraded the rating for Pakistan to Caa3 and CCC- respectively from Caa2 and CCC+.
[12] Includes Government debt from IMF and Foreign exchange liabilities.

in PKR terms, the external debt surged by 27.2 percent, due to the depreciation of the domestic currency **(Figure 1.14)**.

Pakistan Debt Profile **Figure 1.14**

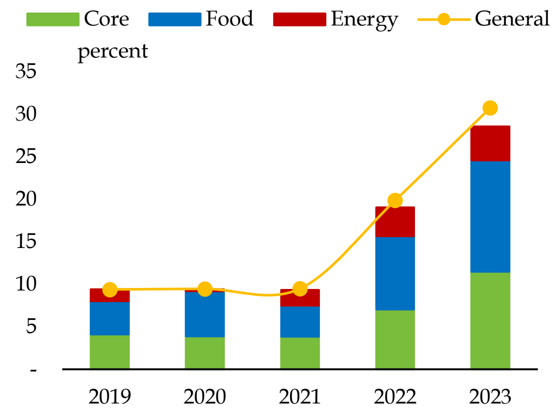


Source: State Bank of Pakistan

CY23 observed broad-based and multi-decade high inflation

Average national CPI inflation reached to 30.8 percent in CY23, up from 19.9 percent in CY22. With food sector being the main contributor, core and energy sectors also showed rising trends. Despite a notable contraction in domestic demand, the effects of escalating food and energy prices and currency depreciation trickled into inflation expectations and wages, driving core inflation up **(Figure 1.15)**.

CPI Inflation and Components **Figure 1.15**



Source: Pakistan Bureau of Statistics

Rising macroeconomic imbalances necessitated appropriate monetary policy response…

In response to elevated inflation and vulnerabilities in external sector, SBP continued its tight monetary policy stance. Subsequent to 900 bps rise in policy rate in CY22, policy rate was further increased by 600 bps to 22 percent in CY23. However, the entire increase in policy rate occurred in H1CY23 and policy rate was kept unchanged during H2CY23. With the implementation of effective monetary policy measures, YoY inflation decreased by 831 basis points to 29.7 percent in December 2023 from its peak of 38.0 percent in May 2023. [13]

…and confluence of stressed macro-financial conditions led to a deceleration in private sector credit growth…

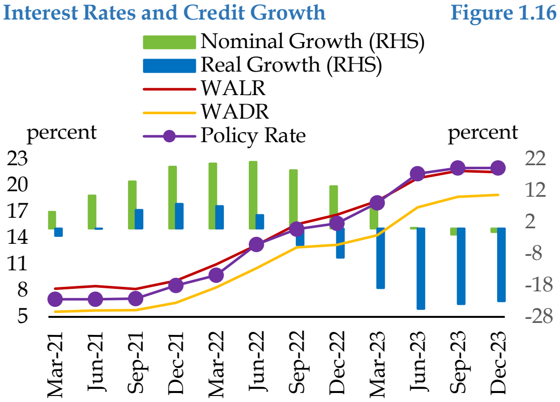
Private sector credit continued its decelerating trend, and even entered *negative* growth territory, during H2CY23. Similarly, inflation adjusted private sector credit *contracted* by 23.1 percent on YoY basis at the end of CY23 **(Figure 1.16)**.

The pronounced deceleration in private sector credit was driven by reduced economic activity

[13] Inflation continued its downward trajectory post-review period and declined to 23.1 percent in February 2023. However, monetary policy rate maintained status quo at 22 percent in March, 2024 amidst risks of any further adjustments in administered prices or fiscal measures that may weigh on inflation outlook.

owing to weak sentiments, higher borrowing costs, supply constraints amid import restrictions and administrative measures. On the supply side, banks' increased risk aversion towards lending to private sector in the wake of stressed macro-financial conditions and high government borrowing determined slowdown in private sector credit.

Interest Rates and Credit Growth **Figure 1.16**



WALR = Weighted Average Lending Rate, WADR = Weighted Average Deposit Rate
Source: State Bank of Pakistan

The contraction in private sector credit was particularly pronounced in the manufacturing, consumer finance, and energy sectors, among others. In an inflationary environment, the majority of financing was directed towards meeting working capital requirements and short-term financing needs.

…accordingly, banking sector exposure to government further increased

Due to the government's consistently increasing reliance on the banking sector for budgetary support, the exposure to the government further rose to 60.6 percent by December 2023 (55.8 percent in December 2022).

The banking sector, however, showed steady performance during the year. Its financial soundness indicators related to solvency, earnings, and liquidity showed improvement while asset quality indicators reflected a contained risk from delinquencies (**for details Chapter 3: The Banking Sector**).

Going forward

On global front, geopolitical tensions, trade fragmentations, and climate change are key risks to global growth. Rising geopolitical tensions create uncertainty and risks of surge in global commodity prices which could eventually translate into tighter financial conditions and may raise financial stability concerns.

With improvement in business confidence and reduction in country risk premium, domestic economic activity has started to recover while inflation is coming down. Current account deficit remains in check while fiscal consolidation is on track. These positive developments are setting the stage for a gradual recovery. To ensure sustainable growth and price stability, meaningful reforms in fiscal and energy and state-owned-enterprises are critically required.

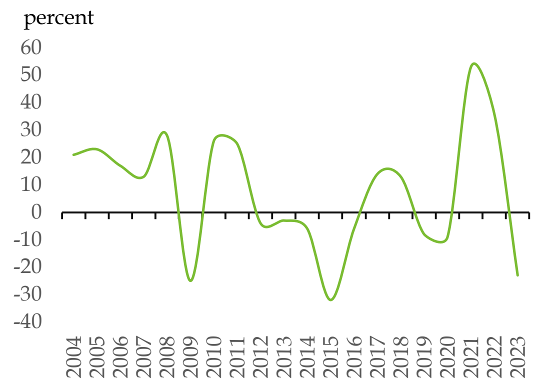
Alongside consistent pursuit of reforms agenda, economic outlook is also contingent upon availability of multilateral financing, political stability and movements in global commodity prices.

Box 1.1: Financial Stability Risks amid Rising Geopolitical Tensions and Changing Global Financial Conditions

In the past few years, the world has been increasingly exposed to distinct and complex challenges emanating from rapidly evolving global economic and geopolitical environment. In the wake of Covid-19, not only abundant liquidity and deep cuts in interest rates—driven by extraordinary monetary and fiscal stimuli—created financial fragilities[14] globally but also triggered questions about the resilience of complex supply chains.

Amid weak global economic conditions and enhanced financing needs of the governments during the pandemic, banks channeled ample deposits and liquidity mostly into risk free long-term securities[15] which exposed them to mark to market losses in case interest rates move-up. As the global economy navigated pandemic shock and manifested marked turnaround in 2021[16], inflationary pressures rapidly began to emerge showing the impact of post-pandemic recovery in demand and supply chain bottlenecks. Global commodity prices surged by 53.0 percent in 2021—highest increase since 2004 (**Figure 1.1.1**). Unlike emerging markets, most of the central banks in advanced economies, considering inflationary pressures transitory, kept monetary policy stance accommodative until towards the end of 2021.[17]

Global Commodity Price Index (YoY growth) Figure 1.1.1



Source: International Monetary Fund

In the early months of 2022, the outbreak of conflict between Russia and Ukraine not only reinforced global commodity prices[18] but also highlighted serious concerns over economic security driven by geopolitical dependence for critical goods. In the wake of uncertain evolution of the conflict and risk of entrenching inflation expectations, major central banks moved on monetary tightening course which was unprecedented in terms of magnitude and frequency. For example, Federal Reserve increased federal funds rate by 75 basis points in June 2022, the most aggressive tightening since 1994.[19,20] Also, European Central Bank (ECB) raised its key policy rates by 50 basis points in July 2022 for the first time in 11 years.[21] Moreover, Bank of England (BoE) raised its key interest rate by 325 basis points and 175 basis points, respectively in CY22 and CY23.

Global economic growth, as a result of multi-decade high inflation, tightened financial conditions, and conflict in Eastern Europe etc., fell to 3.5 percent in CY22.[22] Although global inflationary pressures moderated in CY23, central banks in AEs maintained a contractionary stance. The pace of global output expansion further slowed down to 3.2

[14] General government debts across AEs and EMDEs surged due to pandemic driven stimuli. Debt level soared to 123 percent of GDP in 2020 from 104 percent in 2019 in case of AEs (112 percent in 2023). EMDEs debt level jumped to 66 percent from 56 percent in 2019 (68 percent in 2023).
[15] For instance, American banks held USD 24 trillion in assets at the beginning of 2022. Around one fourth of the total assets was invested in securities, mostly Treasuries or mortgage backed bonds.
[16] Global output grew by 6.5 percent in 2021 as compared to contraction of 2.7 percent in 2020.
[17] Only Bank of England commenced monetary tightening in December 2021.
[18] The conflict further added pressure on prices because Russia and Ukraine are two key players in the global supply chain of various food and energy items
[19] https://www.cnbc.com/2022/06/15/fed-hikes-its-benchmark-interest-rate-by-three-quarters-of-a-point-the-biggest-increase-since-1994.html
[20] Cumulatively, federal funds rate increased by 425 bps in 2022 while 2023 observed another 75 bps rise reaching federal funds rate to 5.25 percent by end 2023.
[21] ECB raised its key interest rates by 200 bps in 2022 and 200 bps in 2023 reaching its main refinancing operation rate to 4.5 percent by end 2023.
[22] IMF. (2022). World Economic Outlook. *October*

percent in CY23, among others, increasing geo-economic fragmentation[23] and effects of monetary tightening, were major growth barriers.[24]

Besides remarkable pace of monetary tightening by major central banks; global economy is facing increasing risks of geo-economic fragmentation. This is evident from nearly threefold increase in trade restrictions between 2019 and 2022. The number of newly imposed trade barriers almost reached to 3,000—highest since 2010.[25] According to IMF, greater trade restrictions could shave global output by 7 percent in the long-term. In the backdrop of growing rivalry between the US and China, Covid-19 outbreak and Russia-Ukraine conflict, major economic powers are shifting towards "de-risking"[26] in order to preserve their critical infrastructure and supply chains.[27] CHIPs and Science Act of 2022[28] in the US and EU's new Economic Security Strategy[29] are a manifestation of changing global economic order.[30] World Trade Organization (WTO) maintains that international trade is gradually being aligned with geopolitical interests, a process called near-shoring/friend-shoring.[31]

Although risks to macroeconomic and financial stability stemming from geo-economic fragmentation appear to materialize gradually,[32] the sharpest pace of rate hike in four decades[33] by Federal Reserve exposed serious vulnerabilities among certain banks in the U.S. triggering global financial stability concerns during CY23. Within the span of one week during March 2023, three mid-sized banks failed in the U.S. Silicon Valley Bank (SVB)—16th largest lender in the US—rapidly came under stress owing to swift deposits withdrawal of USD 42 billion in a single day. SVB funding, that surged during pandemic, was concentrated in technology starts-ups, largely uninsured (i.e. above the USD250,000 threshold) while its assets were heavily invested in Held to Maturity (HTM) portfolio. In the wake of marked rise in interest rates and resultant expensive access to financing, SVB clients increasingly began to rely on their deposits amid liquidity pressures. Having faced with large deposits withdrawal, the bank sold USD 21 billion of its securities and suffered mark to market losses worth USD 1.8 billion. Deposits outflow further triggered owing to SVB's large exposure to interest rate risk and its announcement to raise capital to cover losses. Eventually, SVB was placed under the receivership of Federal Deposit Insurance Corporation (FDIC) on March 10, 2023.[34]

On March 12, 2023, Signature Bank—30th largest bank by deposits—also failed owing to run on its deposits .[35] Like SVB, 90 percent of its deposits were uninsured. Backed by SVB generated panic, the customers of Signature Bank

[23] According to WTO, geo-economic fragmentation refers to the turning away from the cooperative approach embedded in the current multilateral trading system towards more local and bloc-based trade and unilateral policies
[24] IMF. (2023). World Economic Outlook. *October*
[25] https://www.imf.org/en/Blogs/Articles/2023/08/28/the-high-cost-of-global-economic-fragmentation
[26] The process of managing the vulnerabilities generated by an interdependent world.
[27] According to McKinsey, amid the war between Russia and Ukraine, the share of global firms planning to regionalize their supply chain almost doubled to around 45 percent in 2022 against 2021.
[28] The Act aims to strengthen American manufacturing, supply chains, and national security, and invest in research and development, science and technology, and the workforce of the future to keep the United States the leader in the industries of tomorrow, including nanotechnology, clean energy, quantum computing, and artificial intelligence.
[29] Released in June 2023, the strategy would carry out thorough assessment of risks to economic security in four areas including resilience of supply chains, physical and cyber security of critical infrastructure, technology security and technology leakage, and risks of weaponization of economic dependencies or economic coercion
[30] https://www.centralbank.ie/news-media/press-releases/navigating-risks-geo-economic-fragmentation-remarks-vasileios-madouros-deputy-governor-1-september-2023
[31] WTO. (2023). World Trade Report: Re-globalization for a secure, inclusive and sustainable future
[32] It is because the share of global trade in world GDP—at 60 percent—remains relatively stable but signs of fragmentation are emerging in bilateral trade relations.
[33] https://www.economist.com/leaders/2023/03/16/whats-wrong-with-the-banks
[34] The latest information revealed by FDIC indicates that First–Citizens Bank & Trust Company agreed to buy all deposits and loans of Silicon Valley Bridge Bank.
[35] Flagstar Bank, National Association, Hicksville, New York, a wholly owned subsidiary of New York Community Bancorp, acquired almost all deposits (except approximately USD 4 billion of deposits related to digital-assets banking business) and certain loan portfolios of the Signature Bank.

started moving their deposits to large banks including JPMorgan Chase and Citigroup. The speed and magnitude of deposits outflow, in both cases, was unprecedented due to digital banking and social media networks of depositors.[36]

The failure of SVB and Signature Bank led to increased pressure on First Republic Bank, 14th largest by assets with 68 percent uninsured deposits. In Q1CY23, 41 percent deposits of the bank were withdrawn. Although, 11 biggest banks together provided USD 30 billion to shore-up finances of the First Republic during March 2023 but market sentiment didn't improve and the bank was eventually closed on May 01, 2023.[37] The failure of the Silvergate bank, one of the biggest banks dealing in cryptocurrency, was primarily driven by governance issues related to the collapse of crypto exchange-FTX. The bank experienced USD 8 billion deposits outflow during Q4CY22 and lost USD 1 billion in mark to market losses on sold debt securities, intended to be held to maturity, to cover deposit withdrawals.[38] The governance issues also made Credit Suisse—a Globally Systemically Important Bank (G-SIB) and 2nd largest bank in the Switzerland— to collapse during March 2023. Swiss Central bank raced to beef-up the liquidity by providing $54 billion but eventually UBS bank purchased the bank for about USD 3.25 billion

The banking turmoil in the U.S. underscored three key aspects.[39] First, the failed banks had funding concentration risk because they significantly relied on uninsured depositors.[40] These depositors responded quickly and in common way when stress emerged. Second, these banks were exposed to large revaluation losses, in the face of sharp rise in interest rates, as they had un-hedged long-term fixed rate debt securities. Third, poor interest rate risk management by banks along with less stringent regulatory regime for banks below the USD 250 billion asset threshold contributed to the crisis.[41]

Policies to ensure financial stability amid geopolitical risks:

Since geopolitical tensions could induce financial fragmentation[42], it is crucial to monitor the interaction between geopolitical risks and credit, market, liquidity and operational risks.[43] Moreover, supervisors need to develop a systematic approach to assess the transmission of geopolitical shock to the financial institutions. Countries that are highly exposed to geopolitical conflict must aim for strong buffer of international reserves should they experience sudden relocation of cross border capital flows. Also, large capital buffers at financial institutions could help mitigate such risks.

Lessons learnt from the banking turmoil in the U.S.:

- The crisis revealed that strong regulations makes for strong banks. Strong and consistent regulatory frameworks that strengthen capital ratios and risk management and mitigate the potential impact of vulnerabilities are critical for banks' resilience.
- The turmoil revealed that in times of rapid information flows, even a bank that is not considered to be a systemic bank, could still cause a lot of stress in the financial markets.
- The combination of high net worth depositors and investing a large chunk of assets in fixed rate (long-term) securities reveals that supervisors must be fully aware of banks' business models for a timely assessment of the emerging risks.

[36] Prior to SVB, the largest bank failure in US history was the failure of Washington Mutual, which experienced deposit outflows of around USD 28 billion in 39 days. On the contrary, SVB experienced a deposit outflow of more than USD 40 billion in single day and more than USD 100 billion was anticipated in queue for next day.
[37] JPMorgan Chase Bank, assumed all of the deposits and substantially all of the assets of First Republic Bank
[38] The bank was voluntarily liquidated on 08 March 2023 and the depositors were announced to be fully paid.
[39] Reserve Bank of Australia (2023). Financial Stability Review. *April*
[40] In the beginning of 2022, American banks held USD 19 trillion of total deposits—roughly half of them were not insured by FDIC
[41] The failed banks in the US were not considered systematically important one because their asset size was below the defined threshold. In America, such banks are exempted from maintaining and publicly reporting standard risk metrics like the Liquidity Coverage Ratio (LCR) or Net Stable Funding Ratio (NSFR).
[42] Financial fragmentation could increase banks funding cost, reduce profitability and trigger contraction in lending leading to adversely impact real economic activity.
[43] IMF. (2023). Global financial Stability Report. *April*

- Banks need to ensure that the capital positions, risk management and governance frameworks strengthen their resilience to prevail in uncertain and volatile environment.
- Bank supervisors needs to accurately comprehend evolving macrofinancial risks and ensure that banks adequately manage corresponding exposures and vulnerabilities
- It is essential that in times of stress, a regulator must have multiple policy choices to cater to dynamics of the situation.
- Finally, the unpreceded outflow of deposits driven by digital banking and social media interaction are posing a critical challenge for bank' liquidity management.

Pakistan's case:

Since the conflict between Russia and Ukraine further induced global commodity prices (e.g., oil and Liquefied Natural Gas) and contributed noticeably in tightening of global financial conditions, Pakistan faced challenging environment on external account front. The fresh conflict between Gaza and Israel involves risks of disruptions to global supply chains, as Middle East is a major international energy supplier, complicating macroeconomic stability landscape for Pakistan. In the wake of continued Red Sea disruptions, container shipping cost has risen sharply.[44]

In the context of potential strains on banking sector, the domestic banking sector of the country does not share unique balance sheet characteristics similar to the failed banks in the US The sector has remained sound and resilient under a robust regulatory and supervisory framework of SBP. The domestic banks, irrespective of their size[45], are required to recognize unrealized gains/losses (in their income and capital)[46] on the holdings of securities under Held for Trading (HFT) and Available for Sale (AFS) categories.[47] Moreover, banks investments in Held to Maturity (HTM) portfolio accounts for only 9 percent of the total investments. All the banks are subject to Basel-III framework which, inter alia, requires the internal capital adequacy planning process to cover all the potential risk and envisages stress testing as a key tool. SBP has also provided detailed guidelines on stress testing that cover both scenario (macro stress test) and single factor sensitivity analysis. It is noteworthy that the banking sector has adequate capital buffers to absorb severe shocks to market prices including interest rate risks — stress test results show that CAR would still remain above the regulatory requirement—including HTM portfolio.

On liability front, the domestic banks have stable funding base. In addition, Deposit Protection Corporation (DPC) has provided safety net by giving insurance cover up to Rs 500,000 to every depositor.[48] Under the DPC Act of 2016, presently 94 percent of the total depositors are fully protected.

[44] IMF. (2024). World Economic Outlook Update. *January*
[45] In the US, only very large banks must mark to market all of their bonds that are available for sale
[46] Unrealized gains/losses against HFT and AFS impact income and capital, respectively.
[47] As of end December 2023, banks' investments in AFS and HFT stood at 87 percent and 3 percent respectively of the total investments. Moreover, Banks' revaluation losses on government securities declined to PKR 126.7 billion by end December 2023 from PKR 235.8 billion a year before
[48] https://www.sbp.org.pk/press/2023/Pr-05-Oct-2023.pdf