Economic Review

1 Economic Review

1.1 Overview[1]

Pakistan's economy faced multiple challenges during FY23, as lingering structural weaknesses amplified the impact of successive domestic and global supply shocks of unprecedented nature. The country's macroeconomic situation had already started to deteriorate since the second half of FY22 amid the fallout of Russia-Ukraine conflict, high global commodity prices and an unplanned fiscal expansion. The situation worsened during FY23 owing to the impact of floods, delay in the completion of the 9th review of the IMF's EFF program, continuing domestic uncertainty, and tightening global financial conditions.

A large supply shock in the form of floods that hit the country during the initial months of FY23 weighed heavily on economic conditions. The resultant supply chain disruptions did not only fuel inflationary pressures and constrained economic activity, but also had implications for the external and fiscal accounts. Likewise, the impact of uncertain global economic and financial conditions, softening – but still elevated – global commodity prices, higher debt servicing and dearth of external inflows increased stress on external account, which reverberated across the economy. The country managed to meet its external debt obligations; however, fall in the SBP's FX reserves along with negative sentiments in foreign exchange market, led to a large PKR depreciation during FY23 (**Table 1.1**).

In order to reduce pressures on external account, the government and the SBP introduced various temporary restrictions on imports during the year. The limited availability of inputs compounded the effect of supply bottlenecks and various demand compression policies in place since late FY22, restricting the pace of economic activity, and thus exports.

Selected Economic Indicators — **Table 1.1**

	FY21	FY22	FY23
Growth rate (percent)*			
Real GDP [a]	5.8	6.1	0.3
Agriculture	3.5	4.3	1.6
Industry	8.2	6.8	-2.9
o/w LSM	11.5	11.9	-8.0
Services	5.9	6.6	0.9
National CPI (period average)[a]	8.9	12.2	29.2
Private sector credit [b]	11.2	21.1	-0.8
Money supply (M2)[b]	16.2	13.6	14.2
Exports [b]	13.8	26.7	-14.1
Imports [b]	24.4	31.8	-27.3
Tax revenue –FBR [c]	19.2	28.9	16.7
Exchange rate (+app/-dep)[b]	-1.3	-9.8	-28.5
Policy rate (end-period) [b]	7.0	13.75	22.0
billion US dollars			
SBP's reserves (end-period) [b]	17.3	9.8	4.5
Workers' remittances [b]	29.5	31.3	27.0
Current account balance [b]	-2.8	-17.5	-2.4
percent of GDP			
Fiscal balance [d]	-6.1	-7.9	-7.7
Current account balance	-0.8	-4.7	-0.7
Investment [a]	14.5	15.7	13.6

* The numbers relating to real GDP growth rate and its sub-components for FY21, FY22 and FY23 are on constant basic prices of 2015-16 and represent final, revised, and provisional estimates, respectively.
Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c,d] Ministry of Finance

Simultaneously, exchange rate depreciation and FX constraints exacerbated the impact of flood-
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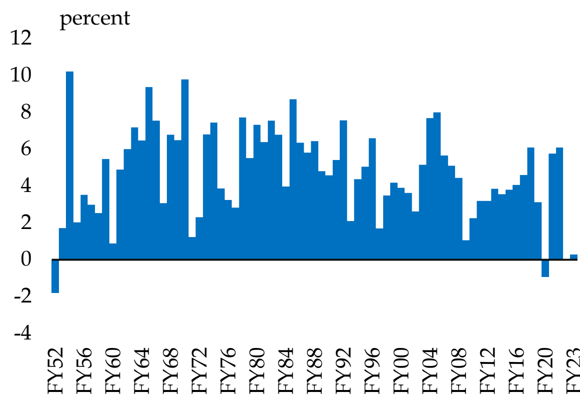
induced supply shortages and fanned inflationary pressures. Lastly, global monetary tightening and lackluster external demand contributed to reduced exports and weak capital inflows. These factors compounded the impact of existing structural deficiencies that have marred a sustainable expansion in Pakistan's exports.

In addition to these supply shocks, the longstanding inefficiencies in the energy sector,

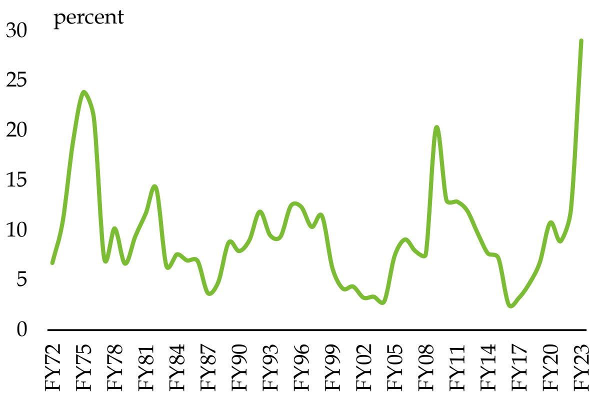
[1] The analysis and projections presented in this report were prepared on data outturns for FY23 and finalized in September 2023, using data and developments as of then.

Real GDP Growth **Figure 1.1a**



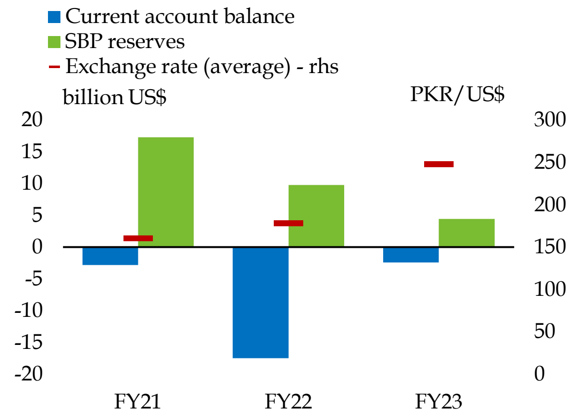
Source: Pakistan Bureau of Statistics

CPI Inflation* **Figure 1.1b**



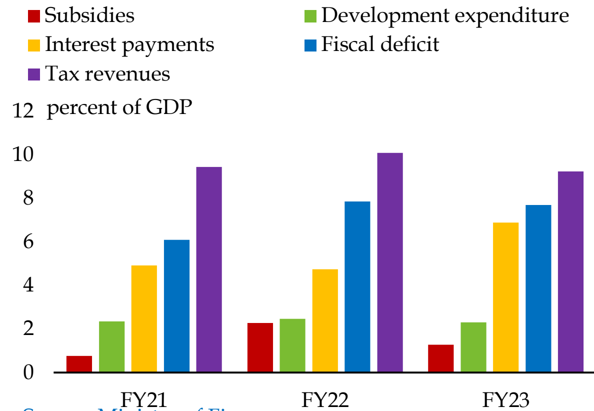
*Base 2015-16 (NCPI)
Source: Pakistan Bureau of Statistics

External Account **Figure 1.1c**



Source: State Bank of Pakistan

Rising Interest Payments Overshadow Fiscal Performance **Figure 1.1d**



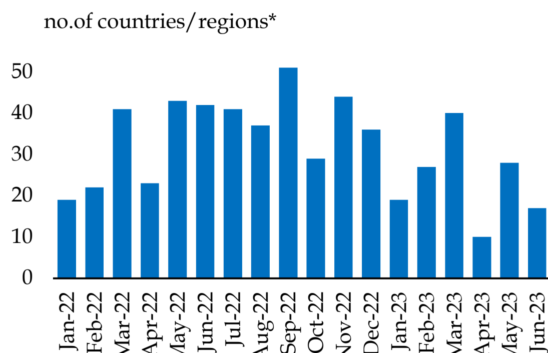
Source: Ministry of Finance

which include high operational and distribution losses and overdue capacity payments, as well as un-targeted subsidies and delayed tariff adjustments, pushed power sector circular debt stock to a historic high level in FY23. Therefore, the government resorted to increasing energy tariffs on multiple occasions during the year despite a decline in global energy prices during the second half of FY23. This, together with less than planned fiscal consolidation and the need to boost revenues, necessitated re-imposition of Petroleum Development Levy (PDL) on petroleum products, which further stoked inflationary pressures.

The combined effect of these developments led to substantial deterioration in Pakistan's macroeconomic performance during FY23. The real GDP growth fell to the third lowest level since FY52 (**Figure 1.1a**), whereas average National CPI (NCPI) inflation soared to a multi-decade high (**Figure 1.1b**). While current account deficit (CAD) narrowed considerably, inadequate foreign inflows kept external account under consistent pressure, leading to a decline in SBP's FX reserves for the second consecutive year during FY23 (**Figure 1.1c**). Meanwhile, reflecting the unsustainable fiscal policy stance of the past several years, a sharp increase in interest payments, persistently large energy subsidies and lower-than-targeted tax collection led to less than envisaged fiscal consolidation during FY23 (**Figure 1.1d**).

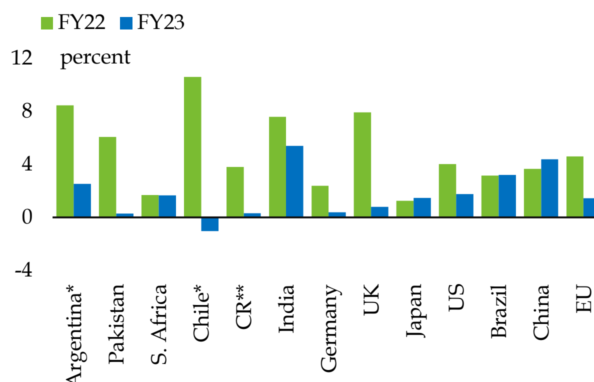
The SBP responded to the escalating macroeconomic challenges by continuing

Number of Countries Increasing Policy Rates **Figure 1.2a**



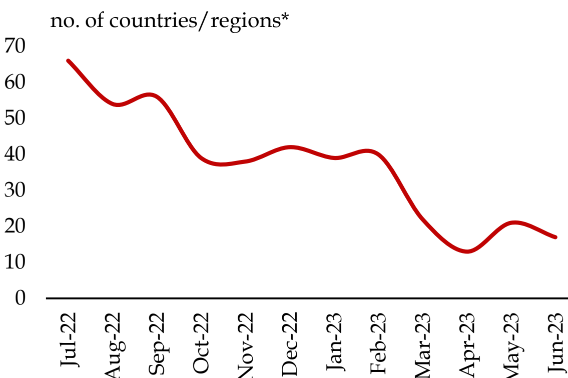
* 96 EMDEs and AEs, including one region, EU-27
Sources: IMF, Haver Analytics

Real GDP Growth Across Major Economies **Figure 1.2b**



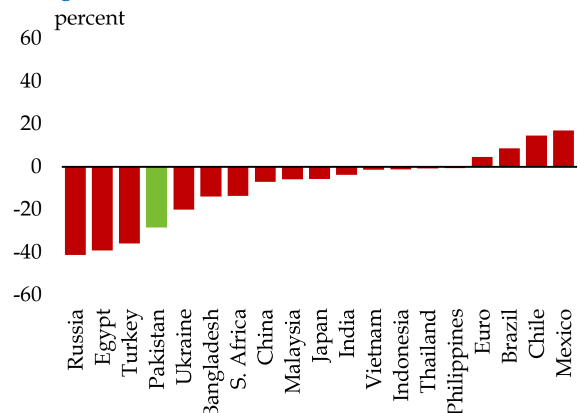
* Jul-Mar FY23, CR** stands for Czech Republic
Sources: Bloomberg, OECD and PBS

Economies Reporting Rising Inflation in FY23 **Figure 1.2c**



* 96 EMDEs and AEs, including one region, EU-27
Source: Haver Analytics

Change in Emerging Markets Currencies during FY23 **Figure 1.2d**



Sources: IMF, Haver Analytics

monetary policy tightening that had started since September 2021. The SBP raised the policy rate by a cumulative 825 basis points (bps) during FY23, after a 675 bps increase in the previous year. This was in addition to various administrative measures to slow domestic demand and placate pressures on the external account. Furthermore, to bolster revenue collection, the government introduced new tax measures in the second half of FY23.

Given the significant role played by domestic challenges, Pakistan's macroeconomic conditions somewhat diverged from the experience of other emerging economies, especially during the second half of FY23. The fallout of Russia-Ukraine conflict had further added to already strong global inflation, pushing it to multi-decade peaks around the start of FY23. In this backdrop of worsening inflationary outlooks, central banks across emerging and advanced economies had started monetary tightening since 2021 (**Figure 1.2a**). The synchronous policy tightening and persistent geo-political tensions weighed down global economic activity and financial conditions during FY23 (**Figure 1.2b**).

The moderating demand, alongside some improvement in supply prospects, induced a downtrend in global commodity prices, especially the energy prices, for the most part of FY23. While the headline inflation had started to ease globally (**Figure 1.2c**), central banks continued to hike policy rates, albeit at a slower pace in the second half of FY23, amid the

challenge to achieve inflation targets and persistence of underlying inflationary pressures. This was in contrast to Pakistan's experience, where deteriorating inflation and external account outlooks necessitated large increases in policy rate during H2-FY23.

The continuation of tight monetary policy stance had serious repercussions for global financial conditions. First, the ensuing increase in financial vulnerability, including hefty mark-to-market losses on debt securities, and concentration of deposits, triggered failure of two banking institutions in the United States, and the loss of market confidence in one bank in Europe during FY23. Second, increasing policy rates in advanced economies contributed to exchange rate depreciation in a number of emerging economies (**Figure 1.2d**). Third, the rising cost of funding, along with weakening currencies reinforced debt distress in vulnerable economies.

In the case of Pakistan, a variety of domestic shocks augmented the impact of tightened global financial conditions and slowdown in external demand during FY23. Particularly, summer flash floods inundated large swathes of the country's land and caused enormous loss of lives, livelihood and infrastructure. Agriculture was one of the hardest hit sectors with significant damages reported to important Kharif crops.

The weather conditions remained unfavorable for cotton crop from the beginning of the Kharif season. Amid drought like situation, the target for cotton sowing area was missed. This, together with the havoc wreaked by record high rainfall and flooding, especially in the provinces of Sindh and Balochistan, suppressed cotton production to a multi-decade low in FY23. In the same vein, rice production also posted a double-digit decline. However, a bumper wheat crop and a decent performance by livestock sector partly offset the impact of these losses during FY23. Conducive weather conditions mainly helped a notable increase in wheat production during Rabi season, despite lower usage of fertilizers. Although livestock sector suffered losses from floods, the overall impact remained muted. Meanwhile, various incentives announced by SBP during the year led to a sizeable increase in agriculture credit, which also supported the overall performance of the sector.

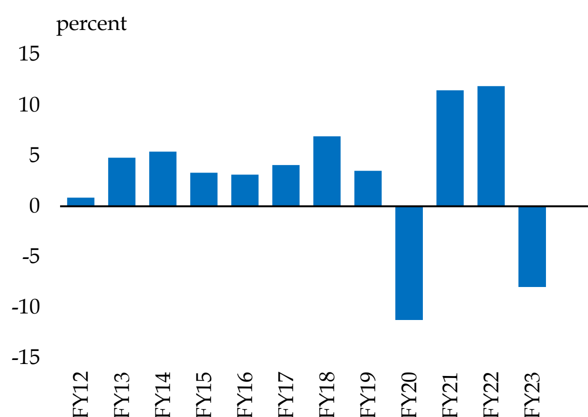
With the backward and forward linkages with the rest of the economy, the impact of the losses in agriculture spilled to industry and services sectors. In addition, a range of unfavorable domestic and global events including FX constraints, weaker currency, rising cost of production, slowing global demand and heightened domestic uncertainty dented economic activity during FY23. These shocks magnified the impact of contractionary policies introduced since FY22. Hence, after witnessing a consistent expansion during the preceding two years, a broad-based decline in Large-scale Manufacturing (LSM) drove contraction in industrial activities during FY23 (**Figure 1.3a**).

Production in around one-fifth of the industries covered in LSM, mainly textile, food, pharmaceuticals, petroleum refining, automobiles, non-metallic minerals, tobacco, and chemical products, fell to the lowest level since FY16. A number of factories announced intermittent closures of operations during the year (**Figure 1.3b**). In line with the performance of manufacturing sector, industrial employment in the provinces of Sindh and Punjab also saw a notable decline during FY23.[2] Furthermore, tracking the shrinking value addition by commodity producing sectors, wholesale and retail and finance and insurance services contracted, driving a notable deceleration in services sector growth in FY23.

In addition to the slowdown in economic activity, demand compression policies and administrative measures, translated into a broad-based drop in imports during FY23.

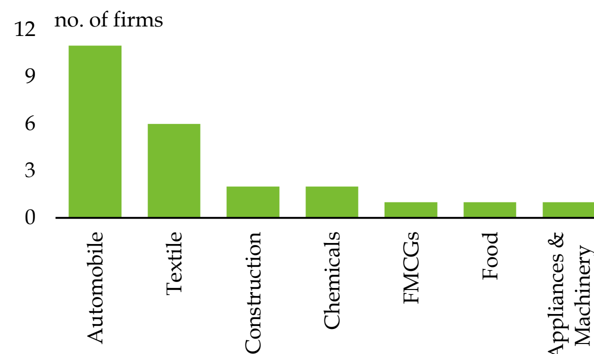
[2] Sources: Bureaus of Statistics of Punjab and Sindh.

LSM Growth Shrinks Considerably **Figure 1.3a**



Source: Pakistan Bureau of Statistics

Major Sectors Announcing Temporary Plant Closures during FY23* **Figure 1.3b**



*information before December 2022 was not available
Sources: Pakistan Stock Exchange, Securities and Exchange Commission of Pakistan

Softening global prices also contributed to this downtrend. On the other hand, the combined effect of the constrained domestic production and anemic global demand stifled both textiles and non-textile exports during FY23. The PKR depreciation, however, provided room to exporters to renegotiate prices to maintain market share in some products.

Moreover, after witnessing a consistent expansion in the past six years, workers' remittances saw a double digit decline during FY23, with inflows from all major corridors shrinking with the exception of the US. Apart from the role played by the global economic slowdown, resumption of cross-border air travel and elevated spread between interbank and open market rates also partly explain this decline. However, significant reduction in goods and services imports more than offset the impact of weakening foreign exchange earnings from exports and workers' remittances, and CAD fell to an eleven-year low of 0.7 percent in terms of GDP during FY23.

Notwithstanding the respite provided by the narrowing CAD, unfavorable external financing conditions weighed heavily on the external account position during FY23. Specifically, the delay in finalization of the 9th review under the IMF's EFF program considerably undermined the confidence of international investors and lenders. The rising domestic uncertainty and weakening FX liquidity conditions led to downgrading of Pakistan's credit ratings, whereas the country's risk premium also spiked significantly. The worsening outlook of the external account discouraged adequate official inflows and private investments required to meet scheduled debt repayments. This, in addition to tightened global financial conditions, contributed to net outflows from financial account during FY23, leading to a sizeable decline in the SBP's liquid reserves to US$ 4.5 billion and 28.5 percent depreciation in PKR by the end of FY23.

Weaker rupee, together with substantial supply disruptions, fueled imported inflation during FY23. In addition, upward adjustment in energy prices, increase in taxation, and other levies, alongside rising domestic uncertainty, kept inflation on a strong and persistent uptrend during the most part of the year. The impact of these supply shocks seeped into general prices and inflation expectations, pushing NCPI inflation to a multi-decade peak of 29.2 percent during FY23, around the upper bound of SBP's revised inflation projection range of 27 – 29 percent. This was despite a slump in domestic demand amid a range of contractionary measures introduced since last year.

Non-perishable food items were the chief source of inflation, followed by the Non-Food Non-Energy (NFNE) and energy group during FY23.

Within food group, milk and milk products, wheat, edible oil and vegetable ghee, and ready-made food were the leading contributors to inflation. In addition to the impact of supply shocks, longstanding structural deficiencies, such as inadequate policy attention on development of food supply chain, low Research & Development (R&D) for developing climate change resistant high yielding crop varieties, and persistent imperfections in the food commodities market, also partly explain the rising spree in food prices during FY23 **(Box 3.1).**

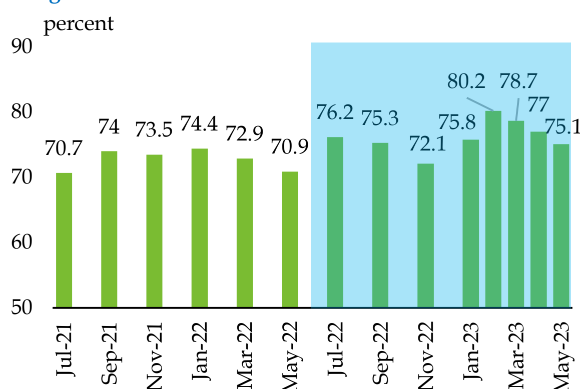
Importantly, core inflation remained in double digits throughout the year, largely manifesting the second-round effects of rising food and energy prices to broader prices, wages and inflation expectations (**Figure 1.4a**). Mainly tracking the increase in energy prices, inflation expectations rose notably in FY23, compared to last year, and reinforced the increase in underlying inflationary pressures (**Figure 1.4b**).

Despite the hike in energy tariffs, energy subsidies widely exceeded budget estimates during FY23, reflecting sluggish pace of reforms in the energy sector. In overall terms, both interest and non-interest current spending exceeded budget targets in FY23. Specifically, a cumulative 1,500 bps hike in the policy rate since the start of FY22, government's growing reliance on domestic sources to finance fiscal deficit, weakening currency and expiry of Debt Service Suspension Initiative (DSSI) last year, contributed to a jump in interest payments during FY23.

Meanwhile, spending under the Benazir Income Support Program (BISP) also increased substantially to address rising social vulnerabilities. The catastrophic floods are estimated to have pushed over 8 million more people into poverty during FY23.[3] This, together with multi-decades' high inflation had serious repercussions for general social wellbeing. In this context, the expansion in BISP envelope mainly encompassed emergency cash transfers to flood affected families, and increase in the coverage, as well as, size of per beneficiary cash grant. In addition, the government also ramped up running of civil government expenditures and introduced various relief measures for current and retired employees in the shape of increments in salaries and pensions. Furthermore, federal PSDP spending saw a decent increase in FY23, after falling consistently for the past many years.

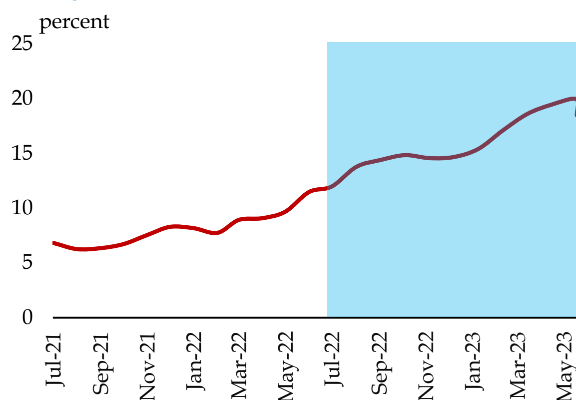
On the revenues side, import compression, lackluster economic activity, and continued sales tax exemption on petroleum products drove a

Inflation Expectations Remained Elevated during FY23 — Figure 1.4a



Source: State Bank of Pakistan

Core Inflation Maintained an Uptrend in FY23 — Figure 1.4b



Source: Pakistan Bureau of Statistics

[3] Source: Ministry of Finance (2023). *Pakistan Economic Survey 2022-23*. Islamabad: MoF.

slowdown in the pace of FBR tax collection during FY23. This is despite some additional tax measures announced through the Finance (Supplementary) Act 2023 in the second half of the fiscal year. However, PDL collection helped a steep increase in non-tax revenues and shored up overall revenue collection during the year. Nevertheless, a high growth in spending overshadowed the increase in revenues, pushing both fiscal and primary imbalances widely above target levels during FY23, contrary to a significant fiscal consolidation envisaged in the budget.

The large fiscal deficit underpinned a commensurate increase in public debt burden during FY23. Although scheduled repayments and inadequate external inflows led to a drop in the public external debt stock in terms of US$, weak rupee led to increase in external debt in PKR terms. Given the dearth of external financing, the government mostly relied on domestic sources for deficit financing. To benefit from the rising interest rates, market preference remained tilted towards floating-rate PIBs (PFLs) through most of the year. The government's growing reliance on floating-rate long-term instruments has, however, increased repricing risks.

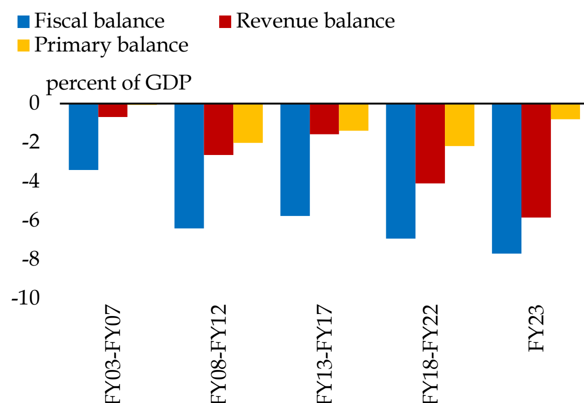
Amid continued reliance on commercial banks to finance the fiscal deficit, Net Domestic Assets (NDA) of the banking system grew sharply during FY23. However, the stress in the external account led to a sizeable contraction in Net Foreign Assets (NFA), partially offsetting the impact of increased government budgetary borrowing on broad money growth during FY23. Moreover, Public Sector Enterprises (PSEs), especially in the power sector, also stepped up borrowing from the commercial banks, mainly to settle circular debt related payments. On the other hand, private sector credit slowed considerably during FY23 due to aggressive monetary tightening together with a slump in economic activity. Specifically, the working capital loans posted a noticeable decline, whereas fixed investment also remained muted during the year. The soaring budgetary borrowing needs of the government, and expanding currency in circulation inflated liquidity requirements of the money market. In response, SBP considerably increased the frequency and volume of longer-tenor OMOs during FY23.

Pakistan's economic performance in FY23 highlights the importance of addressing lingering structural impediments that pose serious risks to macroeconomic stability on a recurrent basis. Foremost among these are challenges in fiscal policy reforms. Particularly, inadequate and slow tax policy reforms with focus on one-off quick fixes have constricted the resource envelope even for meeting current expenditures. In addition, increasing use of indirect and withholding taxes as compared to focusing on income tax, has significantly impacted both the inflation and inflation expectation. On the other hand, slow pace of reforms to address inefficiencies in PSEs has led to permanent drain on fiscal resources. The resultant chronic fiscal imbalances have straitjacketed the government's ability to undertake development spending required to enhance the economy's productive capacity **(Figure 1.5a)**. To put things into perspective, interest payments consumed more than half of the FBR tax collection on average during the past five years, limiting fiscal space for development spending.

The scarcity of public resources to match the country's development needs has also discouraged private investment. Hence, the country is grappling with a low-investment trap, while the growth model is mainly centered on consumption **(Figure 1.5b)**. Meanwhile, anemic investment in physical and human capital, as well as R&D over the last few decades has prevented development of a technology-intensive manufacturing base, which is manifested in concentration of low value-added goods in country's exports **(Figure 1.5c)**.

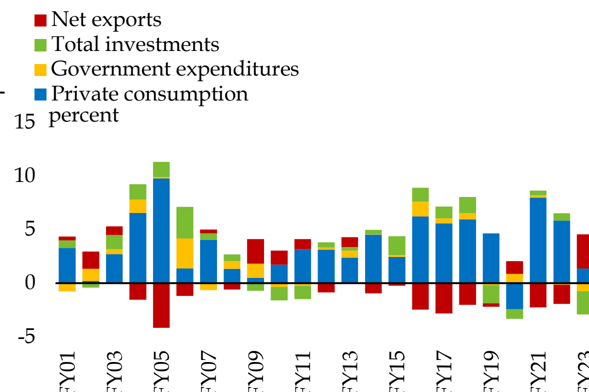
In addition to sub-optimal state of human and physical capital, multifaceted factors, which are offshoots of the country's archaic policy

Large Imbalances in the Fiscal Account **Figure 1.5a**



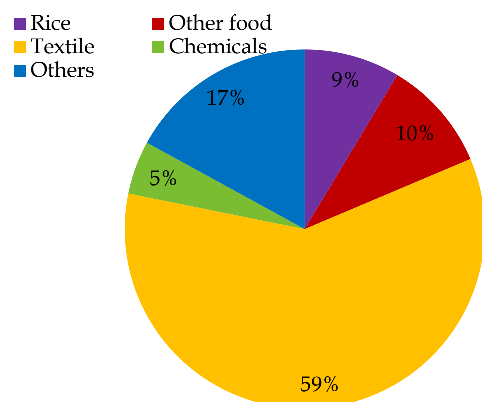
Source: Ministry of Finance

Low Investment is a Hallmark of Pakistan's Growth Experience **Figure 1.5b**



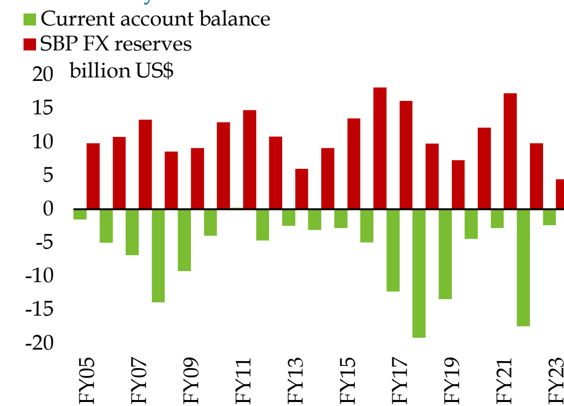
Source: Pakistan Bureau of Statistics

Commodity Concentration of Exports (Average FY19-FY23) **Figure 1.5c**



Source: Pakistan Bureau of Statistics

Consumption-led Growth Frequently Causes Balance of Payments Crisis **Figure 1.5d**



Source: State Bank of Pakistan

environment, have marred the country's ability to generate sustained increase in exports. These include low competitiveness of exports, lack of innovation and product development, high cost of doing business, lack of product and market diversification, inability to meet quality standards, unavailability of efficient supply chains, continued reliance on imported raw materials and capital goods and a long range of sector specific issues. At the same time, stagnant crop yields and lack of attention to development of food supply chain and imperfections in food market have considerably increased the country's reliance on imported food commodities. These trends underpin unsustainable current account balance, which has increased the country's vulnerability to global supply shocks through pressures on FX reserves and exchange rate **(Figure 1.5d).**

The situation requires initiation of comprehensive reforms with an aim to address various sectoral imbalances to ensure availability of resources for economic growth and development. To this end, expediting tax policy reforms aimed at increasing documentation, widening of tax base, improving tax administration, eliminating leakages and creating a culture of tax compliance, assume a center stage. Similarly, restricting non-interest current spending by ensuring speedy implementation of governance reforms in PSEs is instrumental to contain fiscal slippages and create fiscal space for undertaking needed

public investment in human and physical capital.

Especially, energy sector reforms need to be prioritized to stem the buildup of circular debt by minimizing transmission and distribution losses, aligning energy tariffs with cost, eliminating untargeted subsidies, and speedy implementation of reforms for reducing the energy cost. Also, there is a need to lower energy intensity of the economy through adoption of unconventional means. Furthermore, strengthening Public Financial Management (PFM) is required to improve efficiency and transparency of fiscal spending. An improvement in public investment will go a long way in crowding in private investment in the key sectors.

Furthermore, manufacturing and exports sectors require technological upgradation to improve competitiveness and minimize reliance on imports. In this regard, there is also a need to create conducive environment to support inflow of FDI in exportable sectors, to encourage technology transfers and advancements in labor skills. Similarly, agriculture sector reforms aiming at enhancing crop yields (**Box 2.1**), development of food supply chain and addressing market imperfections are required to brace for the rising challenge of climate change. These measures will not only help alleviate import reliance but are also crucial for achieving price stability. There is a crucial need to expedite these reforms to achieve a high and sustainable economic growth, required to absorb the new entrants in labor market, improve social welfare and lift the general standard of living in the country.

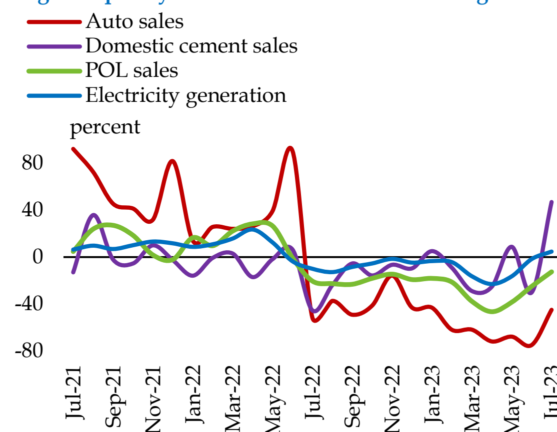
In this context, the availability of factual information about macroeconomic conditions, markets, businesses, as well as individual welfare, is an important ingredient for evidence-based policy making. This report includes a special chapter on the need to streamline the state of Pakistan's National Statistical System (NSS). The chapter discusses preparedness of Pakistan's NSS statistical system to meet the growing need for informed decision-making and highlights important gaps in Pakistan's official statistics in terms of coverage and frequency and identifies some suggestions for NSS reforms.

1.2 Economic Outlook

After a year of turbulence, Pakistan's economic situation has started to show some early signs of improvement. The country was able to secure a US$ 3.0 billion Stand-By Arrangement (SBA) from IMF, towards the end of FY23, which helped in alleviating immediate risks to some extent. The initial disbursement of US$ 1.2 billion under the SBA in July 2023, alongside US$ 3 billion bilateral inflows, helped reverse the declining trend in the SBP FX reserves. Furthermore, according to the July 2023 World Economic Outlook, the prospects for global economic growth in 2023 have somewhat improved, compared to earlier projections. Similarly, the non-energy global commodity prices have also eased compared to last year. These trends may have positive implications for Pakistan's economy.

The high frequency indicators are suggesting bottoming out of economic activity from July 2023 (**Figure 1.6**). The withdrawal of guidance on import prioritisation from end-June 2023, alongside gradual ease in FX position, is expected to somewhat ameliorate supply chain

High Frequency Demand Indicators — Figure 1.6



Sources: APCMA, PAMA, OCAC and NEPRA

situation and lift growth in LSM as well as exports.

Moreover, an expected rebound in cotton and rice production will support agriculture growth in FY24. To encourage cotton production, the government announced a minimum price of Rs 8,500 per 40 kg for the FY24 crop. According to the preliminary information, the incentive has helped in securing increase in cotton sowing area, and is also likely to encourage farmers to scale up crop management practices despite rising prices of fertilizers and pesticides. Reflecting the impact of these incentives, cotton arrivals posted a strong 97.5 percent increase as on September 1, 2023, compared to the same period last year. Similarly, favourable weather conditions and a steep increase in domestic rice prices incentivised growers to expand area under rice crop and hence production in the ongoing year.

The expansion in commodity producing sectors is expected to have a knock-on impact on services in FY24. However, the impact of various demand compression measures introduced in past two years may contain the pace of recovery in economic activity. Reflecting these considerations, the SBP expects the real GDP growth to fall in the range of 2 – 3 percent in FY24 **(Table 1.2)**.

The lagged impact of monetary tightening, and other contractionary measures, is expected to keep domestic demand in check. Moreover, prospects of improvement in supply situation on account of likely increase in production of important crops and resumption of imports, is expected to further moderate inflationary pressures in FY24. In addition to the improvement in domestic supplies, a high base from last year and sluggish trend in non-energy global commodity prices are expected to help bring down inflation in the range of 20.0 – 22.0 percent in FY24. However, unforeseen climate events, adverse movements in global commodity prices, especially oil, and external account pressures are some important upside risks to this outlook.

Macroeconomic Targets and Projections for FY24 **Table 1.2**

	Target	SBP Projections
Growth rate (percent)		
Real GDP[a]	3.5	2.0 – 3.0
CPI (average)[a]	21.0	20.0 – 22.0
billion US$		
Remittances [a]	30.5	25.5 – 26.5
Exports (fob)[a]	30.0	28.0 – 29.0
Imports (fob)[a]	58.7	50.0 – 52.0
percent of GDP		
Fiscal deficit [b]	6.5	7.0 – 8.0
Current a/c deficit		0.5 – 1.5

Sources: [a] Annual Plan 2023-24, [b] Federal Budget 2023-24

The SBP projects fiscal deficit in the range of 7.0 – 8.0 percent in FY24. Higher interest payments may continue to prevent a notable reduction in spending during FY24. Non-interest expenditure, however, is expected to remain contained on account of lower subsidies and grants. A tepid recovery in economic activity is likely to shore up revenue collection during FY24. In FY24, the government has envisaged to boost revenues by increasing PDL to Rs 60/litre, and announcing higher rates on top income tax brackets, builders, developers and property, and introducing additional GST on unregistered businesses.

The outlook for the external account improved at the start of FY24. The finalization of Stand-By Arrangement with the IMF was instrumental in reviving confidence of multilateral and bilateral creditors, as well as international investors, and led to sizeable foreign inflows during the first two months of FY24. On the other hand, slightly improved global and domestic growth prospects are expected to bolster foreign exchange earnings from exports of goods and services. Although import volumes are likely to increase, lower commodity prices may prevent a significant expansion in imports bill during FY24. Workers' remittances in FY24, however, are expected to remain slightly lower compared to the last year's level. Accounting for these factors, SBP projects the current account deficit to fall in the range of 0.5 – 1.5 percent of GDP in FY24.