# Chapter 1
# Economic Review

***The analysis and projections presented in this report were prepared on data outturns for FY22 and finalized in October 2022, using data and developments as of then.***

# 1 Economic Review

## 1.1 Overview

For a second consecutive year, Pakistan's real GDP growth reached around 6 percent in FY22 (**Table 1.1**). The growth was broad-based as both agriculture and industry saw a notable increase that spilled over to the services sector as well. Large-scale manufacturing (LSM), in particular, showed a double-digit increase. Private consumption mainly drove the expansion in GDP, while investment rose marginally. The continued reliance on consumption as an engine of growth amid sluggish improvement in productivity once again left the country vulnerable to adverse developments in the global economy. Hence, a combination of adverse global and domestic developments marred the country's economic performance, leading to the reemergence of macroeconomic imbalances during FY22.

In particular, the expansionary fiscal stance in FY22, an upsurge in global commodity prices, and the fallout of the Russia-Ukraine conflict, led to a marked deterioration in the current account deficit (CAD). In addition, the delay in the resumption of the IMF program and political instability exacerbated the country's vulnerability through the depletion of FX reserves to critical levels. The ensuing depreciation in PKR amplified inflationary pressures by compounding the pass through of elevated global commodity and oil price increases.

Pakistan's experience was somewhat similar to other countries at the start of FY22. Strong policy stimulus and access to inoculation aided a rebound in the global economy **(Figure 1.1a).** The robust momentum of economic growth widened global supply-demand imbalances, giving rise to inflationary pressures. In addition, rising global trade volumes, alongside the emergence of new Covid variants (Delta and Omicron) choked distribution networks and fueled large increases in freight costs. The eruption of the Russia-Ukraine conflict further propelled the commodity super cycle, with prices of energy and non-energy commodities soaring sharply **(Figure 1.1b).**

**Selected Economic Indicators** **Table 1.1**

| | FY20 | FY21 | FY22 |
|---|---|---|---|
| ***Growth rate* (percent)*** | | | |
| Real GDP [a] | -0.9 | 5.7 | 6.0 |
| Agriculture | 3.9 | 3.5 | 4.4 |
| Industry | -5.7 | 7.8 | 7.2 |
| o/w LSM | -11.2 | 11.5 | 10.5 |
| Services | -1.2 | 6.0 | 6.2 |
| National CPI (period average) [a] | 10.7 | 8.9 | 12.2 |
| Private sector credit [b] | 2.9 | 11.2 | 21.1 |
| Money supply (M2) [b] | 17.5 | 16.2 | 13.6 |
| Exports [b] | -7.1 | 13.8 | 26.6 |
| Imports [b] | -15.9 | 24.4 | 32.9 |
| Tax revenue –FBR [c] | 4.4 | 19.2 | 28.9 |
| Exchange rate (+app/dep%) [b] | -4.8 | 6.7 | -23.1 |
| Policy rate (end-period) [b] | 7.00 | 7.00 | 13.75 |
| ***billion US dollars*** | | | |
| SBP's reserves (end-period) [b] | 12.1 | 17.3 | 9.8 |
| Workers' remittances [b] | 23.1 | 29.5 | 31.3 |
| Current account balance [b] | -4.4 | -2.8 | -17.4 |
| ***percent of GDP*** | | | |
| Fiscal balance [d] | -7.1 | -6.1 | -7.9 |
| Current account balance | -1.5 | -0.8 | -4.6 |
| Investment [a] | 14.8 | 14.6 | 15.1 |

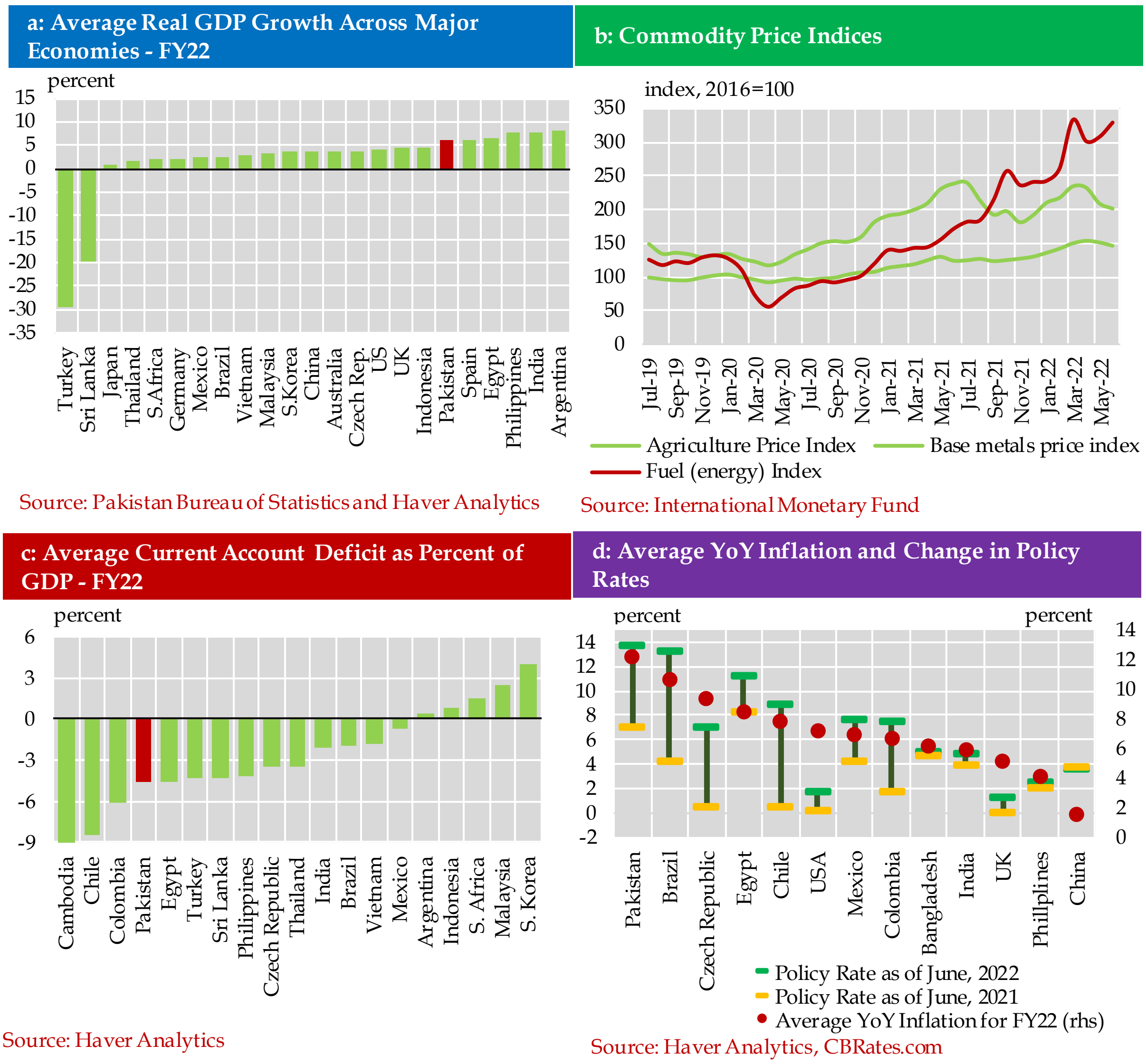
* The numbers relating to real GDP growth rate and its sub-components for FY20, FY21 and FY22 are on constant basic prices of 2015-16 and represent final, revised, and provisional estimates respectively.

Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, growth based on US dollar values; [c,d] Ministry of Finance

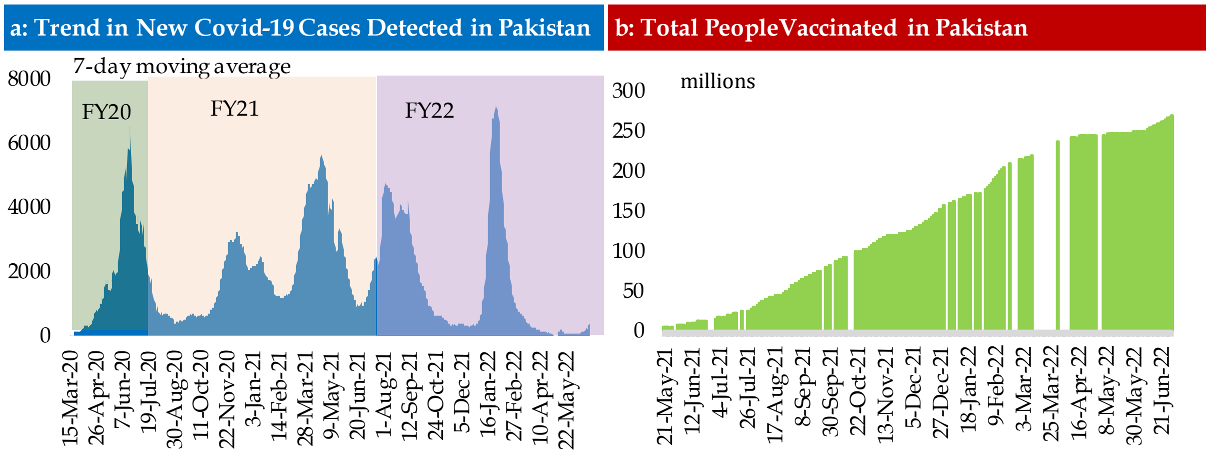
Rising global commodity prices strengthened inflationary pressures and widened current account imbalances across countries, especially commodity importers, warranting policy responses (**Figure 1.1c**). Some emerging economies had started to unwind policy stimulus and increased interest rates in FY21; whereas advanced economies followed suit in FY22 (**Figure 1.1d**). However, the rapid tightening of monetary policies in advanced economies stifled access to international markets, engendering currency depreciations, and fueling further inflationary pressures in emerging and developing economies. With elevated inflation, rising supply chain disruptions, and spread of new Covid strain (Omicron), global growth began to taper off towards the end of H1-FY22.

Pakistan also witnessed a notable expansion in economic activity during FY22. The policy environment was mostly conducive for real economic activity during the fiscal year. Fiscal policy support in the form of tax incentives for industry, export and construction and a large increase in provincial development spending supported growth in these sectors. Similarly, the government introduced multiple tax incentives and subsidies to protect consumers from the impact of rising international oil prices, which further shored up demand. This resulted in a large and unbudgeted fiscal expansion, marking a visible divergence from the fiscal consolidation agenda pursued in the past two years. At the same time, the lagged impact of monetary stimulus rolled out during the pandemic, SBP's targets for housing and construction, and capacity expansions under Temporary Economic Refinance Facility (TERF) and Long Term Financing Facility (LTFF) continued to underpin GDP growth. The sustained rally in domestic and global demand and receding concerns about the pandemic also catalyzed the momentum of economic activity during FY22. The country

**Commodity Price Shock Dominated Global Macroeconomic Dynamics in FY22** **Figure 1.1**



**COVID-19 Cases and Innoculation in Pakistan** **Figure 1.2**




Source: ouworldindata.org

witnessed two waves of the pandemic (Delta and Omicron) during FY22. However, with the increased pace of inoculation and lowering severity of the infection, the pandemic did not obstruct economic activities during FY22 (**Figure 1.2**).

The GDP growth was broad-based with a prominent contribution of LSM and wholesale and retail trade; whereas agriculture also saw a notable increase. LSM presented an upbeat performance as 19 out of 22 sectors showed YoY increase, with major contributions from wearing apparel, sugar, automobiles, and pharmaceuticals. The increase in exports was mainly responsible for the expansion in wearing apparel that alone added about one-third to LSM growth in FY22. The sector benefitted from the post-pandemic revival of global demand, as the volume of ready-made garments exports rose sharply during FY22. To help the sector capitalize on elevated demand, the government provided a number of incentives for the sector, such as tax and duty relief on the import of raw materials, energy subsidies and faster payment of tax refunds. In addition, depreciation of PKR and increased international price of cotton also buoyed sector's profitability. Although, the increase in domestic cotton prices inflated the input costs, the gains from rising export unit values helped to neutralize this impact. In addition to the export thrust, sugar, automobiles and pharmaceuticals also demonstrated strong performance buoyed by high domestic demand.

The agriculture sector showed a strong growth during FY22 mainly because of improved performance of livestock and, on the back of favorable weather conditions, a sizeable increase in the production of all *Kharif* crops. In the case of cotton, large yield gains solely contributed to the expansion in production, as farmers continued to switch area to more profitable crops of rice, maize and sugarcane. Specifically, given a steady demand from poultry and livestock feed industry, availability of high yielding seeds and competitive prices, maize production is witnessing a consistent increase for the past many years, and had the highest contribution in GDP growth during FY22, within important crops. Similarly, elevated export demand motivated farmers to increase the area under rice cultivation; whereas higher procurement prices encouraged expansion in area under sugarcane. The production of wheat, a main *Rabi* crop, however declined during FY22, amid lower availability of water and fertilizer. The strong upturn in commodity producing sectors translated to a sustained expansion in wholesale and retail trade services for a second consecutive year.

In FY22, the impact of accommodative policies contributed to higher than planned growth in the economy. Together with the rapid rise in global commodity prices, this overheating of the economy posed risks to the country's macroeconomic stability. First, the commodity price rebound in conjunction with the continued pace of economic activity led to a large increase in the import bill in FY22 that significantly outpaced the expansion in exports. Second, the external account pressures gave way to a substantial depreciation in the PKR, which further intensified inflationary pressures during the year. Third, the fiscal outcome was also affected. While the sharp pickup in imports boosted tax collection, a broad-based increase in fuel subsidies led to the deterioration of fiscal performance during the year. Fourth, rising interest rates during the year increased domestic debt servicing requirements amid increasing reliance on floating debt.

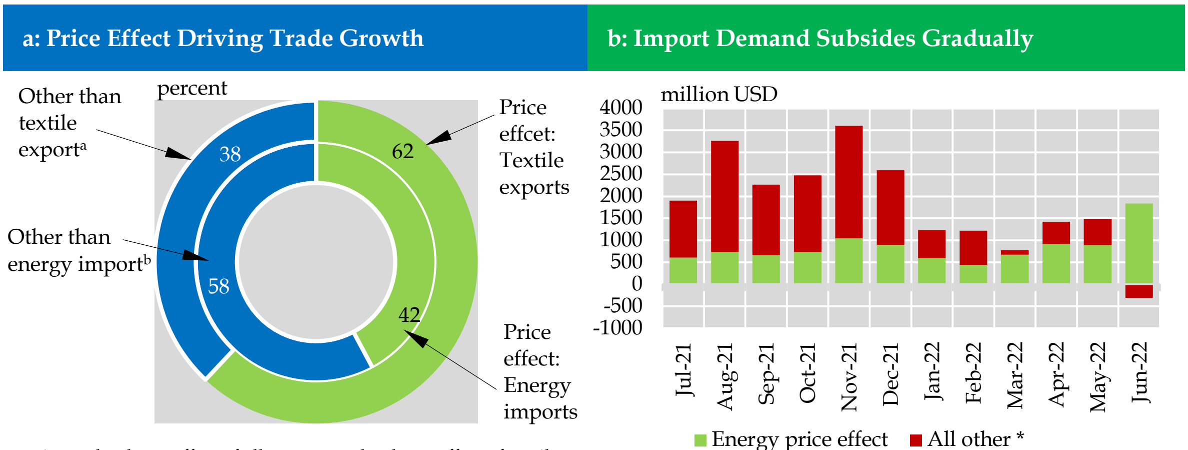
The combination of strong demand and commodity price increase placed considerable pressure on the country's external account in FY22. Central to this deterioration were imports, which surged by a marked 32.9 percent YoY during FY22. A large part of this increase came from rising prices of energy products (**Figure 1.3a**). Most of the expansion was observed during the first half as the persistent momentum of economic activity and the need to import Covid vaccines spurred import demand for both energy and non-energy products. The increase in global commodity prices became more intense with the emergence of a fresh Covid wave in China towards the end of H1-FY22 and the outbreak of the Russia-Ukraine conflict in February 2022 that caused additional disruptions in supply chains. Hence, the upsurge in commodity prices kept imports at an elevated level despite a visible slowdown in import demand (**Figure 1.3b**).

On the other hand, there was a substantial growth in earnings from both exports of goods and services and workers' remittances. Exports witnessed a pronounced 26.6 percent YoY broad-based increase and crossed the US$ 30 billion mark for the first time. Among other factors, depreciation of PKR has also helped in improving export growth. Textile exports had a notable share in this increase, as the sector benefitted from elevated prices of cotton and its products in the international market. Higher export unit prices of textile products contributed about two-thirds to the entire increase in export earnings in FY22 (**Figure 1.3a**). The sector also enjoyed policy support in the form of energy subsidies, tariff rationalization for key textile imports, higher sales tax and customs duty refunds, and subsidized lending through refinance schemes, including TERF, that helped in maximizing gains from recovery in global demand.

Non-textile exports also remained strong, with rising volumes contributing one-tenth in the total expansion in exports during FY22. In addition to some traditional categories such as rice, some non-traditional exports such as sesame seeds; maize (corn); and refined copper also grew significantly. Improved production of agriculture commodities, duty-free access to China and increased demand in the international market were the main drivers of this increase. Similarly, inflows from workers' remittances remained above US$ 2 billion per month, rising by 6.2 percent in FY22. However, this increase in foreign exchange inflows was not adequate to meet the growing financing requirements.

In addition to the deterioration in trade deficit, interest payments on external debt also edged up during FY22. The expiry of Debt Servicing Suspension Initiative (DSSI) in December 2021, increasing stock of external debt, and rising global interest rates were mainly responsible for the increase that further widened the CAD to a four-year high level. On the financing side, net inflow of FX loans and liabilities rose to US$ 12.1 billion in FY22, compared to US$ 5.7 billion in FY21. The largest increase was from bilateral sources, mainly Saudi Arabia and China. The country also received loan inflows from multilateral creditors, and the IMF released a tranche of US$ 1.1 billion in February 2022 after the completion of the 6th Extended Fund Facility (EFF) review. This was in addition to the US$ 2.8 billion inflows under the IMF global SDR allocation in August 2021 for Covid management. The government also mobilized US$ 2 billion through sovereign bonds during the year. However, delay in the resumption of the IMF program and political instability led to significantly lower than planned external inflows. FDI flows showed a sluggish increase; whereas, portfolio investment witnessed net outflows from equity securities during the year. In overall

**The Impact of Commodity Price Shock on Pakistan's Macroeconomic Performance** **Figure 1.3**




[a]price and volume effect of all exports and volume effect of textile exports; [b]price and volume effect of all imports and volume effect of energy imports

Source: Pakistan Bureau of Statistics and SBP calculations

*All other: price and volume effect of all imports and volume effect of energy imports

Source: Pakistan Bureau of Statistics and SBP calculations

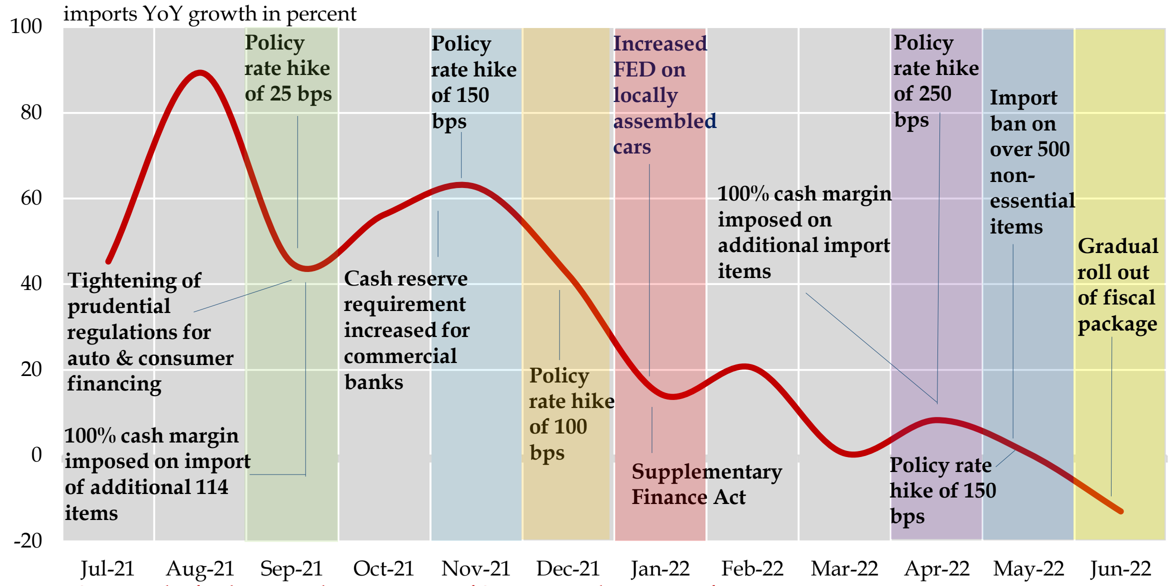
Source: State Bank of Pakistan

Source: Pakistan Bureau of Statistics and SBP calculations

terms, net financial inflows were not adequate to meet the rising financing requirements, leading to a US$ 7.5 billion drawdown of SBP's liquid FX reserves during FY22 (**Figure 1.3c**). With the mounting pressures in the external account, the PKR depreciated by 23.1 percent during FY22.

The depreciation in PKR magnified the combined effect of elevated domestic demand and the global commodity price increase during the year. NCPI inflation reached the double-digit level of 12.2 percent in FY22, exceeding the SBP's revised projection of 9-11 percent. Inflation in the non-food-non-energy (NFNE) group also swelled during FY22, indicating both demand and cost push pressures. Following the surge in global commodity prices, NCPI inflation escalated during the second half (**Figure 1.3d**). Food group, particularly the non-perishable category was the major source of inflation. Persistent increase in global food prices of imported commodities (such as palm oil and tea), alongside the supply-demand gaps in some commodities (in particular, milk and meat), spurred inflationary pressures in this group, and contributed one-third in overall inflation during FY22. On the other hand, supply shortages of some perishable categories such as tomatoes, fresh fruits and vegetables fanned food inflation during the second half of FY22.

**Policy Efforts Aided in Containing Import Growth in FY22** **Figure 1.4**




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

Fuel inflation also remained at an elevated level during the year. This was despite the tax relief provided to protect households from the effect of the global price surge for the most part of the year. With the outbreak of the Russia-Ukraine conflict, fuel prices came under further pressure from Q3-FY22 onwards. The government ramped up the volume of fuel subsidies, under the relief package announced in February 2022. However, the strain on the external account necessitated withdrawal of this policy support from end-May 2022. After the elimination of energy subsidies, fuel inflation spiked to 58.5 percent in Q4-FY22

The non-budgeted energy subsidies and circular debt payments inflated the current expenditures above the last year level by a large margin, widening the fiscal and primary deficit during FY22. This unanticipated change in the policy mix of the last two years, which had been characterized by fiscal prudence together with monetary support, contributed to macroeconomic imbalances. The expansion in current spending pared the fiscal space for federal development spending during the year. Revenues, however, posted a healthy performance. Tax collection at both federal and provincial levels edged up. FBR taxes achieved a six-year high growth and slightly exceeded the upward revised budget estimate for the year. The major impetus came from import related taxes that constituted more than two-third in overall FBR tax collection in FY22. These gains mainly emerged from the upturn in international prices, and PKR depreciation. In addition, policy efforts to broaden the tax base through removal of exemptions, administrative reforms and imposition of new taxes also contributed to growth in tax collection. Similarly, amid the pickup in domestic demand and tax policy efforts, provincial tax collection remained upbeat during FY22. The notable increase in the collection of the provincial revenues and an increase in receipts under federal divisible pool provided a significant boost to provincial development spending during the year. However, in overall terms, a lackluster performance of non-tax revenues partly neutralized the impact of the sizeable increase in tax collection. The drag mainly came from lower collection of petroleum development levy (PDL) and partial transfer of SBP profits due to change in transfer mechanism, under the amendment in SBP Act. According to the new mechanism, SBP profits will be transferred to the government on annual basis after the finalization of financial statements at the end of the financial year. Hence, the transfer of SBP profits halted after the passage of the Act in January 2022, leading to a decline in transfer of SBP's profits to the government during FY22.

In line with the widening imbalances in the external and fiscal account, public debt burden increased during FY22. In terms of composition, both external and domestic debt contributed to the accumulation of public debt during the year. Although the maturity profile of public debt continued to improve in FY22, the increasing reliance on floating rate debt securities magnified the interest rate risk, in an increasing rate environment. The rising burden of debt servicing, taints future debt repayment capacity of the country and squeezes fiscal space for other expenditures like development spending. Although the availability of debt relief under DSSI and an import led increase in taxes has propped up servicing ability in FY22, the durability of these gains requires strong commitment to fiscal consolidation.

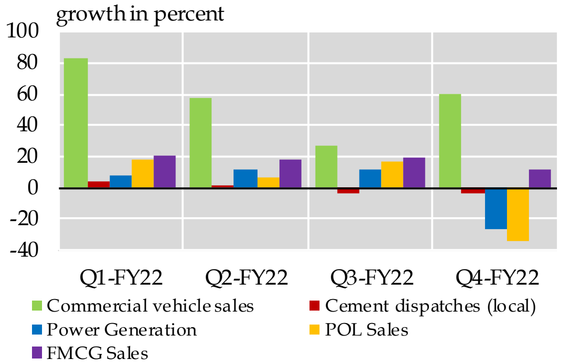
The government's reliance on the banking system to meet the deficit financing requirements contributed to a sharp growth in the net domestic assets (NDA) of the banking system. In accordance with the amendment in SBP Act, the government did not borrow from SBP and mainly relied on commercial banks for financing the deficit. Similarly, with the continued upsurge in economic activity and rising input costs, the credit requirements of the private sector spiked in FY22 both for short-term financing and fixed investment, adding further impetus to NDA. At the same time, the marked deterioration in the external account and ensuing contraction in net foreign assets (NFA) contained the growth in the money supply during FY22. The overall financial market conditions remained challenging during FY22, as the deviation of overnight rates from the policy rate increased progressively during the year. The gulf between market expectations of rate hikes and SBP policy stance amid rising inflationary pressures; soaring budgetary borrowing needs of the government; and greater demand for credit from the private sector mainly drove the increase in money market spreads during FY22.

In effect, the rising macroeconomic challenges during the year demanded a policy response. Therefore, the government and the SBP undertook various corrective measures to curb the pace of domestic demand as the year progressed. These included: (i) raising the policy rate by a cumulative 675 bps; (ii) tightening the prudential regulations for auto and consumer financing; (iii) imposition of 100 percent cash margin requirements (CMR) on a number of import items; (iv) increasing the cash reserve requirement (CRR) for commercial banks; (v) increasing FED on locally assembled cars; (vi) elimination of various tax exemptions under the Supplementary Finance Act; (vii) imposition of ban on import of non-essential items; and (viii) gradual roll back of fiscal package. These measures succeeded in arresting the pace of growth in imports (**Figure 1.4**). High frequency demand indicators including cement dispatches and sales of petroleum products, also started to moderate towards the end of FY22 (**Figure 1.5**). However, the outlook for inflation and CAD continued to deteriorate.

The experience from FY22 brings to fore once again the need to address the country's structural weaknesses. Conforming to the boom-bust nature of the country's growth trajectory, the current episode of rapid growth also morphed into the familiar Balance of Payments (BoP) stress. A narrow base of the country's foreign exchange earnings and meagre inflows of foreign investment amid lower than expected official inflows, contributed to a sharp drawdown of SBP's liquid FX reserves. This deterioration eclipsed a substantial expansion in the country's export of goods and services during the year; such as, exports of information, communication and technology (ICT) services, which have doubled in the last four years.

Given the low sophistication level of Pakistan's manufacturing sector, a large share of the country's merchandise exports comprise low value added products. Transforming the structure of industry to a high technology intensive sector requires a voluminous increase in investment in physical and human resources for a sustained period. The rising share of young population in Pakistan also provides an opportunity to reap the demographic dividend. However, the realization of these gains requires a conducive,

**Domestic Demand Loses Steam by end-FY22*** **Figure 1.5**



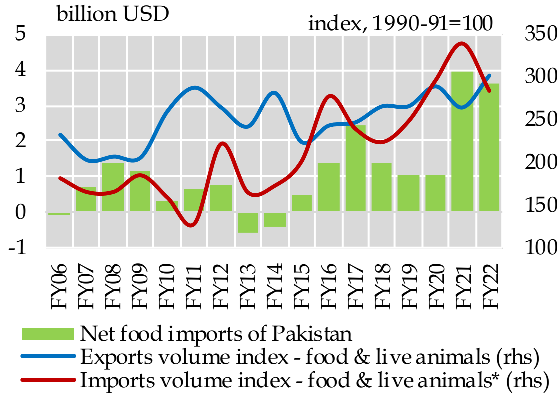

*cement dispatches in 000 tons, power generation in Gwh POL sales in 000 MT, FMCG sales is million Rs
Sources: APCMA, PAMA, OCAC, NEPRA, Corporate reports (various issues)

nurturing environment. In this regard, the special chapter in this report sheds light on understanding the potential of demographic dividend in Pakistan. It outlines policies required to capitalize on the demographic window and harness benefits of a favorable age structure. The chapter suggests that investment to improve quality of human capital, good governance, alongside an enabling macroeconomic environment that ensures high savings and investments, pro-industrial policies, and efficient markets are some key requirements to yield gains from the demographic window.

Similarly, a concerted approach to encourage increased localization of the manufacturing base would be a viable option to relieve strains on the country's meagre foreign exchange earnings. There is also a need to curtail reliance on energy imports that constituted around one-quarter of the entire import bill on an average during FY20-22. This would require policy focus aiming at lowering the energy intensity of the economy by ensuring energy efficiency and conservation. Furthermore, in view of Pakistan's high dependence on fossil fuels, there is a need to move towards power generation through renewable resources that is self-sufficient, cost efficient and economically viable.

Food imports are another significant drag on the country's foreign exchange earnings. With the exception of a few years, Pakistan has mostly remained a net importer of food

**Net Food Imports of Pakistan** **Figure 1.6**




*also includes vegetable/animal oils & fats
Source: Pakistan Bureau of Statistics

commodities (**Figure 1.6**). Amid the growing challenges of climate change, the inadequate food security situation in Pakistan is a source of alarm. The increasing pace of climate change may lead to variation in rainfall pattern and recurrent flooding or droughts in the coming years. The unpredictability of weather pattern has serious repercussions for agriculture sector of Pakistan. In this background, there is an urgent need to formulate a well-thought-out strategy to meet the rising challenge of climate change. In particular, priority should be given to Research & Development in the seed development sector to produce new varieties of seeds that are suitable to varying weather conditions and to devise a policy framework that emphasizes water management strategies to increase agricultural productivity.

## 1.2 The Economic Outlook

Pakistan's economic growth is expected to moderate considerably during FY23. As suggested by the tapering sales of high frequency demand indicators, the demand compression measures introduced by the government and the SBP have started to cool down the overheated economy in the initial months of FY23. The economy was already in a stabilization phase, when wide scale flooding hit a large part of the country in the start of FY23.

The flooding in FY23 is likely to impinge on the country's real economic activity through various channels. Specifically, the losses in agriculture emerging from the damages to crops and livestock are likely to transmit to the rest of the economy through various backward and forward linkages. Similarly, the wide scale destruction of infrastructure in the affected provinces may also undermine the country's growth prospects during the year.

On the other hand, continuing the policy efforts to arrest demand pressures, the government and the SBP announced further corrective measures in the ongoing year. These included: (i) temporarily halting fresh disbursements under the schemes of Mera Pakistan Mera Ghar (MPMG) and Kamyab Jawan Youth Entrepreneurship for revisiting it later (KJYE); (ii) imposition of additional import duties on various categories including steel, food preparations and transport; (iii) restoration of fuel taxation; (iv) introduction of temporary restrictions on certain imports; (v) a further 125 bps increase in policy rate in July 2022; and (vi) linking markup rates on EFS and LTFF loans with policy rate. These measures, together with the lagged impact of 675 bps hike in policy rate and other demand management measures announced in FY22, and the government decision to unwind the fiscal package for fuel and electricity subsidies towards the end of FY22 are likely to slow the momentum of economic activity during FY23. Taking into account the destruction caused by floods and the policy focus on stabilization, the SBP projects real GDP growth below the previously announced range of 3 – 4 percent for FY23.

The NCPI inflation is expected to rise above the previously announced range of 18-20 percent during FY23. Supply shocks in the form of the roll back of energy subsidies and resumption of fuel taxation and losses to agriculture produce caused by floods are likely to influence the inflation trajectory during the year. The elimination of subsidies and increase in fuel taxation triggered a sharp increase in inflation since June 2022, and the trend is likely to persist in FY23. Similarly, the supply shortages of perishable food commodities stemming from floods is expected to add further stimulus to prices. On the other hand, the stabilization policies introduced since last year and flood induced losses to incomes may suppress the magnitude of demand-pull inflation during the year.

The government has targeted to reduce the fiscal deficit to 4.9 percent of GDP in FY23 from 7.9 percent in FY22. This outcome would be achieved through both revenue and expenditure measures. Widening of tax base through elimination of exemptions, increase in tax rates and reinstatement of fuel taxes are expected to boost tax receipts during FY23. The non-tax revenues will also recover with the re-imposition of PDL. On the expenditure side, the rationalization of subsidies is likely to keep current spending under check. However, the government has envisaged an increase in social protection grants under BISP, because of increase in the amount of stipend and extension in the coverage of beneficiaries. Similarly, the relief and rehabilitation efforts in flood affected regions may also raise spending needs during the year. The containment in the pace of non-priority current spending and increase in revenue collection may provide fiscal space to expand the volume of development spending during FY23.

The coordinated fiscal and monetary policy stance is likely to reduce external account pressures in FY23. The SBP projects CAD to fall below last year's level of 4.6 percent of GDP in FY23**.** This improvement would be driven by a sizeable contraction in import growth. As evident from the YoY declines in imports since July 2022, a range of demand compression measures introduced since last year, have succeeded in trimming the growth momentum of imports. Likewise, global commodity prices have also started to soften after reaching multiyear peaks in FY22, which will reduce the pressure caused by a large price impact.

However, the losses to agriculture produce, induced by the recent floods, is likely to step up import of agriculture commodities, particularly cotton. On the other hand, the slowdown in global demand may also weaken the growth in exports during FY23 and policy tightening in advanced economies would dampen the prospects of capital flows to emerging and developing economies. The workers' remittances after witnessing a spike in FY21 appear to have plateaued in FY22 and are likely to remain at around the similar level in FY23. The windfall gain from oil price in GCC countries offers an upside risk to this projection. Moreover, with the resumption of the IMF program, the outlook of financial account has also improved. Alongside the IMF program disbursements, the country is expected to receive external financing from multilateral and bilateral creditors that will considerably strengthen FX reserves position during FY23.