The analysis and projections in this report were prepared on data outturns for the July-December period of FY23 and finalized in March 2023, using data and developments as of then.

1.1 Overview

Pakistan's macroeconomic conditions deteriorated during H1-FY23. The policy measures introduced since last year had succeeded in constraining domestic demand. However, the fallout of flash floods, adverse global economic conditions, uncertainty surrounding the completion of IMF program's 9th review, the foreign exchange constraints, and political instability exacerbated the underlying domestic structural issues posing challenges to macroeconomic stability.

During H1-FY23, both agriculture production and Large scale manufacturing (LSM) contracted substantially; whereas, headline inflation rose to multi-decade high level. Despite policy induced improvement in external current account (on the back of curtailment in imports) and primary fiscal balance (due to rationalization of non-interest current spending and decline in federal development spending), external financing and low level of FX reserves remained as major concerns (**Table 1.1**). However, slowdown in external demand as well as persistence of domestic structural issues pulled exports below last year's level. Moreover, the below target growth in FBR taxes also indicate the need to speed up the structural reforms.

Continuing with its contractionary stance, SBP raised the policy rate by a further 225 bps in H1-FY23, on top of the 675 bps increase during FY22. On the fiscal side, the government resorted to curtail federal expenditures on grants, subsidies and development. Furthermore, to contain pressures on external account the government and the SBP introduced various regulatory measures to restrict imports.

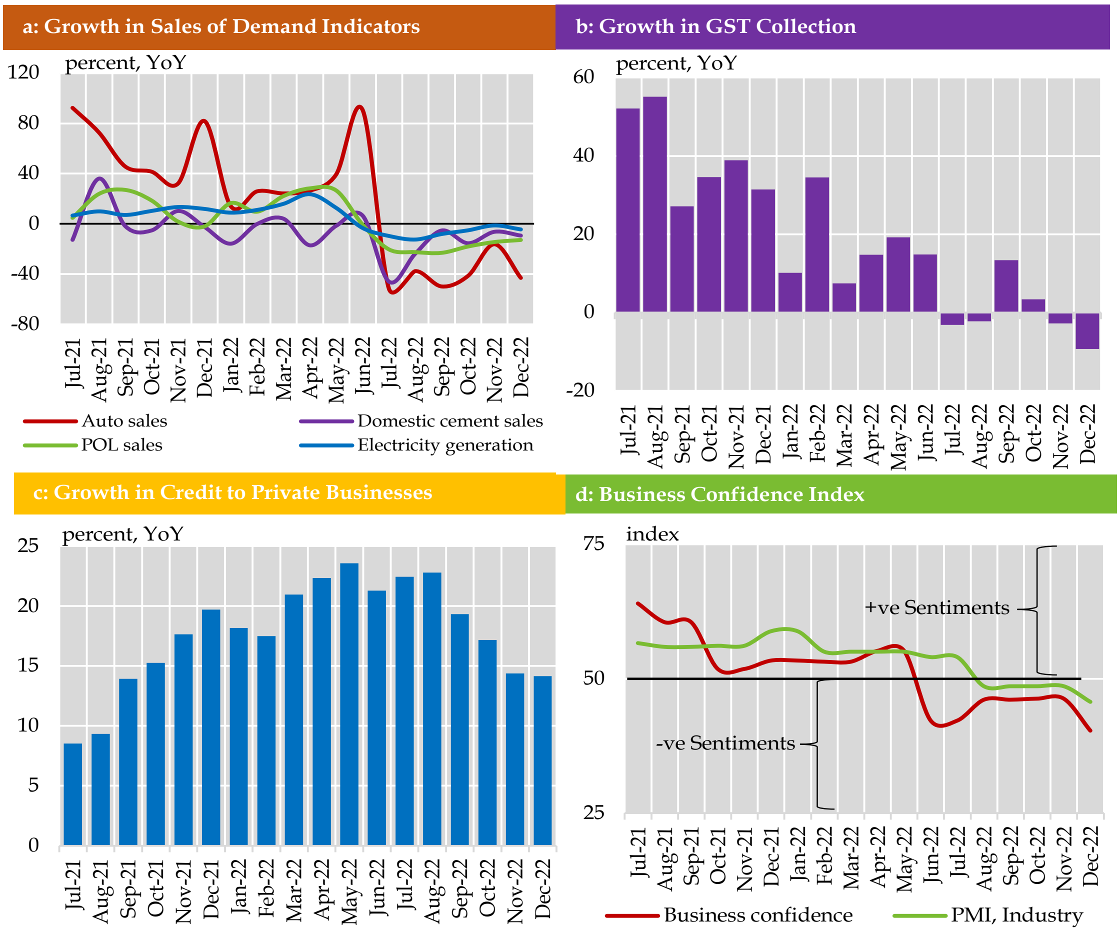
Selected Economic Indicators **Table 1.1**

	FY22	FY23		
	H1	Q1	Q2	H1
Growth rate (percent)				
LSM [a]	7.7	-1.5	-5.7	-3.7
National CPI [a]	9.8	25.1	24.9	25.0
Private sector credit [b]	13.7	0.9	3.3	4.3
Money supply (M2) [b]	4.3	1.2	0.03	1.2
Exports [b]	29.0	2.6	-15.2	-6.7
Imports [b]	51.8	-5.8	-29.8	-18.2
Exchange rate app (+)/dep(-) [b]	-3.5	-26.7	-21.7	-24.1
FBR tax revenue [c]	32.1	16.9	17.9	17.4
Policy rate (end period) [b]	9.75	15	16	16
billion US$				
Remittances [b]	15.8	7.7	6.4	14.1
FDI in Pakistan [b]	1.1	0.3	0.2	0.5
FX loans (net) [b]	9.8	0.1	-0.9	-0.9
Current account balance [b]	-9.1	-2.4	-1.1	-3.6
Change in SBP reserves [b]	1.6	-2.0	-2.3	-4.2
percent of GDP				
Fiscal balance [c]	-2.0	-1.0	-1.0	-2.0
Primary balance [c]	0.1	0.2	0.9	1.1

Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Ministry of Finance

In addition to policy induced compression in domestic demand, flash floods also played a significant role in overall economic downturn. The floods submerged a substantial area of country's land, and inflicted heavy losses to lives, livelihood and infrastructure. In agriculture, *Kharif* crops sustained considerable production losses due to floods. Low fertilizer offtake, on account of higher prices in global markets, further aggravated the situation. As per ministry of National Food Security and Research (MNFS&R) estimates, cotton and rice

High Frequency Economic Indicators **Figure 1.1**



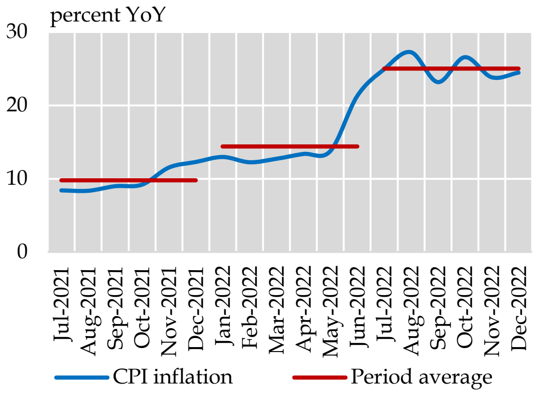
Sources: SBP, APCMA, PAMA, OCAC, NEPRA & FBR

production witnessed a decline of 24.6 and 40 percent respectively. The below par performance of agriculture and industry, indicate subdued activity in services sector as well.

In manufacturing, LSM witnessed a broad-based contraction, where output fell in 18 out of 22 sectors. In particular, production of textile, automobile, pharmaceutical, non-metallic minerals, petroleum, and construction-allied sectors dipped significantly. Furthermore, the worsening macroeconomic environment led some businesses to partially suspend operations during the period. In line with the overall downturn in economic activity, the labor markets also showed contraction in employment generation.

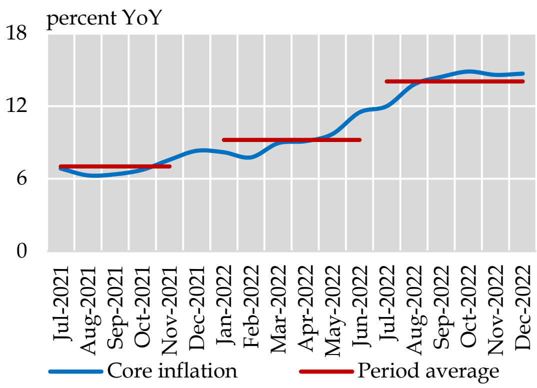
Also, high frequency indicators showed a downturn in general economic activities during H1-FY23 (**Figure 1.1**). In particular POL, cement and automobile sales posted double digit declines. The GST collection

National CPI Inflation **Figure 1.2a**



Source: Pakistan Bureau of Statistics

Non-Food Non-Energy (Core) Inflation - Urban **Figure 1.2b**

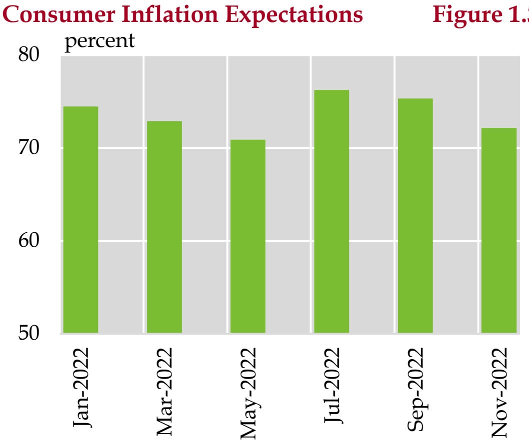


also slowed down in line with weakening economic activity. The deterioration in macroeconomic environment affected business confidence in H1-FY23, which also contributed to sluggish offtake in credit to private businesses.

Despite visible contraction in domestic demand, inflation outturns have remained stubbornly persistent since H2-FY22 (**Figure 1.2a**). Elevated inflation expectations along with a range of domestic supply side factors pushed the national CPI (NCPI) inflation to 25.0 percent during H1-FY23 as compared to 9.8 percent in the same period last year. Higher food prices mainly drove overall inflation followed by NFNE and energy groups (**Figure 1.2b**). Particularly, flood induced losses to agriculture produce and livestock caused supply shortages in the food group and excerbated the impact of high global commodity prices. In addition, the pass-through of PKR depreciation to domestic prices also contributed to inflationary pressures. Similarly, the increase in power tariffs and energy prices provided further impetus to inflationary pressures during H1-FY23.

The second round effect of these supply shocks to broader prices and wages along with rising inflation expectations pushed core inflation to a nine-year high level in H1-FY23. Importantly, consumer inflation expectations continued to creep up and remained at an elevated level during H1-FY23, as shown by SBP-IBA Consumer Confidence Survey (CCS) **(Figure 1.3)**. A persistent uptrend in domestic prices amid supply shocks, adverse global commodity price outlook, and exchange rate pressures led to worsening of inflation expectations during H1-FY23.

Consumer Inflation Expectations **Figure 1.3**



Source: State Bank of Pakistan

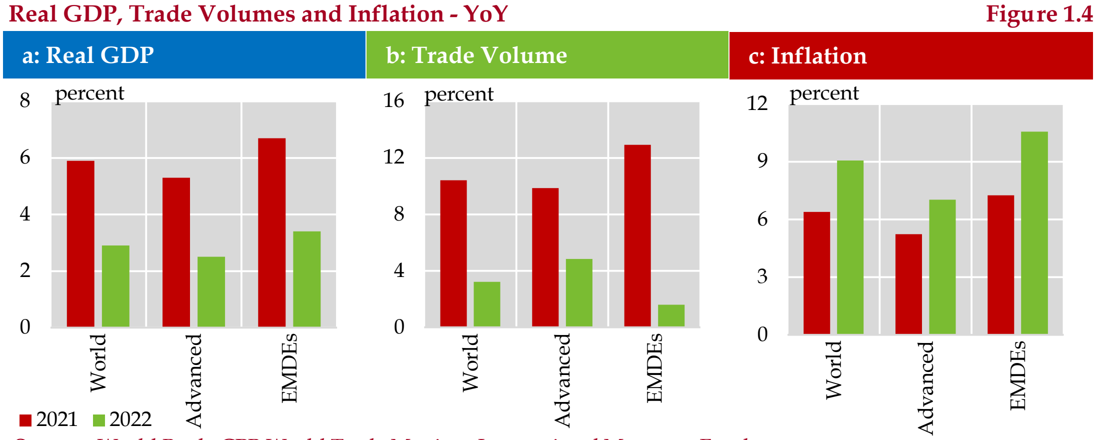
In the fiscal sector, contraction in major non-interest current expenditure, particularly subsidies, grants, and development spending, contributed to improvement in primary surplus during H1-FY23. However, fiscal deficit remained at last year's level, in terms of GDP, because of a sharp expansion in interest payments. Rising interest rates, depreciation in PKR and resumption of mark-up payments to foreign creditors after end of the DSSI were instrumental in driving growth in interest payments during H1-FY23. On the revenues side, tax administration efforts, inflation and higher return on deposits led to an expansion in FBR taxes. However, a sharp contraction in imports and an overall dip in economic activity constrained tax collection below the target for the first half of FY23.

In the absence of sufficient external inflows, the government mainly relied on domestic bank and non-bank sources to meet its borrowing requirements. Specifically, the government fulfilled its financing requirements mostly through medium term floating rate instruments. While the lengthening of debt profile through these floating rate bonds reduced the rollover risk, it aggravated debt servicing and repricing risk in the rising interest rate environment.

The higher government budgetary borrowing mainly drove expansion in net domestic assets (NDA) to the last year's level, whereas, private sector credit (PSC) decelerated during H1-FY23 amid economic downturn. Within PSC the growth in working capital loans weakened significantly, while fixed investment remained around the last year's level. On the other hand, inadequate external inflows along with scheduled repayments of external debt resulted in sharp contraction of net foreign assets (NFA) during H1-FY23. Consequently, the broad money growth slowed down during H1-FY23.

The external sector faced headwinds from paucity of external financing, slowdown in global demand, and fallout of flash floods during H1-FY23. In particular, external financing remained under significant pressure due to uncertainty regarding the resumption of IMF program, along with tight global financial conditions. Also, supply chain disruptions resulting from Russia-Ukraine conflict and China's zero - Covid

Real GDP, Trade Volumes and Inflation - YoY **Figure 1.4**



Sources: World Bank, CPB World Trade Monitor, International Monetary Fund policy, hampered global demand, which also weighed on Pakistan's export performance (**Figure 1.4**). On the supply side, flood-related disruptions led to lower crop outturns, which not only dented the food exports but also deteriorated the commodity import outlook.

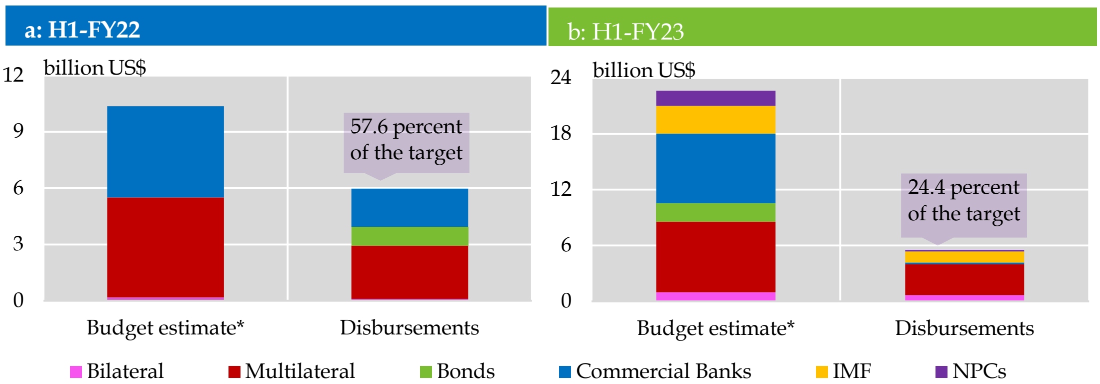
Similarly, workers' remittances also declined during H1-FY23. In addition to the global economic slowdown, increase in the use of informal channels also affected remittances flows to the country. However, the decline in exports and remittances was more than offset by a much larger fall in imports during H1-FY23, leading to a notable decline in current account deficit (CAD).

Despite this improvement in CAD, the dearth of financial inflows led to significant decline in FX reserves during H1-FY23. In addition to the delays in the disbursements of the IMF tranches and the political uncertainty in the country, higher net FX outflows on account of scheduled debt repayments, (including a US$ 1.0 billion Eurobond), as well as disinvestments added to external account pressures (**Figure 1.5**). The combined effect of these developments, in the backdrop of US dollar's appreciation against a basket of global currencies, led to 24.1 percent depreciation in PKR during H1-FY23.

Pakistan's recurring external account vulnerabilities and increasing number of supply side shocks, especially due to climate change underscore the necessity for building economic resilience. Pakistan, in fact, is one of the most exposed country to natural calamities with the frequency and severity of these events increasing by the year. H1-FY23 was no exception as Pakistan faced one of the worst flooding in its history with sizeable loss to property, economic activity and most importantly life. The country, therefore, needs to direct policy attention towards building buffers to weather various shocks.

Specifically, it is imperative to improve water management to ensure water security in the country by building water reservoirs to cushion against extremes and uncertain events. In this regard, water received from abundant rainfalls and through the melting of glaciers should be preserved to make productive use of any windfall gain. Similarly, there is an urgent need to ensure

Budget Estimates vis-a-vis Disbursements of External Loans **Figure 1.5**



* Budget estimate for full year FY23

Source: Economic Affairs Division

availability of ample food stocks to address the issue of food security in the country, which requires addressing market failures and investments in storage facilities and cold chain management. Also, as a net energy importer, enhancing storage capacity of energy products assumes importance as well.

Furthermore, maintaining FX reserves buffers is crucial to ensure external account sustainability to enhance the country's ability to ward off the impact of adverse global supply shocks especially emanating from higher oil and commodity price. Given Pakistan's huge dependence on food and energy imports, any supply shock in international market quickly erodes the country's external sustainability through worsening of terms of trade. The long-standing structural issues have weakened the country's ability to accumulate FX reserves through conventional means, which has increased the country's dependence on borrowed resources. Therefore, there is urgent need to upgrade policy efforts for attracting foreign private investments and expanding export earnings.

In the same vein, unconventional means may also be used to reduce import dependence; for example, by adopting energy conservation measures. These may include, introducing day-light saving, early closure of markets, introducing remote work, creating awareness about social responsibility, usage of energy efficient technologies and a gradual shift towards alternative energy sources, such as solar and wind.

1.1 In addition to addressing the above mentioned structural issues, Pakistan has to prioritize its envisioned transition to digitalization, which offers developing countries an opportunity to leapfrog. The recent sharp growth in Pakistan's software-led IT exports and technology start-ups appear as emerging signs of digitalization. However, as the **Special Section** in this report shows, the country's share in global IT exports remains very small, dominated by small-sized firms and concentrated to a few markets. Domestic software usage is also negligible; whereas, the start-up space also lags behind peer economies in terms of producing unicorns, funding, overall ecosystem and their presence across the economy. With a focus on software exports and technology start-ups, the special section sheds light on the enabling policies that have facilitated growth in this space, such as Digital Pakistan Policy 2018 and the SBP's Electronic Money Institutions regulations 2019. The section also highlights some of the critical gaps that are to be addressed, if recent growth in these sectors is to be sustained.

1.2 Economic Outlook

The demand management measures and 2022 floods, have weighed heavily on the growth outlook for FY23. The data on sales volumes of automobiles, POL, and cement recorded a significant decline in H1-FY23. In agriculture sector, rice and cotton crops were severely damaged; the LSM output, on the other hand, fell by 3.7 percent. Therefore, real GDP growth in FY23 is expected to remain significantly lower than the previous year's growth rate, as well as SBP's revised projection of around 2 percent. This reflects a broad-based moderation in economic activity in the wake of dampened performance of both agriculture sector and industrial output, with its negative spillovers for the services sector.

On the fiscal side, the deceleration in FBR tax collection on account of temporary import restrictions and subdued economic activity, alongside sharp growth in current expenditures driven by higher interest payments on public debt during H1-FY23 have caused narrowing of the fiscal space. As a result, the contraction in federal development expenditures to contain deterioration in fiscal position has posed challenges for FY23 economic outlook. Meanwhile, the anticipation of further slowdown in economic activity amid monetary tightening and other demand curtailing measures is likely to decelerate the current growth momentum of tax collection, thus, widening the fiscal deficit.

Despite a substantial improvement in CAD by US$ 5.5 billion during the first half of FY23, the external account pressures continued to persist amidst scheduled debt repayments and markedly lower foreign inflows which, in turn, resulted in a severe drawdown in foreign exchange reserves. In view of the prevailing domestic macroeconomic uncertainty, impact of flood, and increasing interest rate environment globally, the external account vulnerabilities are likely to remain at an elevated level in FY23. However, the resumption of IMF's EFF program would help assuage the overall external sector concerns by increasing access to multilateral and bilateral financing avenues. The downside risks to the external sector outlook are: sharper than expected slowdown in global demand that could impact exports and workers' remittances negatively. Likewise, global and domestic uncertainty also pose downside risks. On the upside, more than expected slowdown in domestic demand or relatively sharp fall in global commodity prices, could improve the current account deficit.

Meanwhile, NCPI inflation is projected to remain elevated within the range of 27-29 percent in FY23. The deteriorating inflation outlook is predominantly ascribed to the persistent uptick in food and energy inflation, while core inflation may continue to edge up as well. The near-term risks to inflation outturns could be explained by various factors: the second round impact of recent exchange rate depreciations, fiscal adjustments including upward revisions in GST, gas and electricity tariffs, and an upward drift in inflation expectations. In addition, uncertainty regarding crude oil price increase due to faster than expected growth in Chinese economy and lower than target wheat production in Pakistan are other upside risks to the inflation outlook.

Nonetheless, both the government and the SBP have been undertaking policy measures to tackle the current economic challenges. The government has rationalized expenditures through contraction in subsidies and grants, and has introduced additional revenue mobilization measures in February 2023 aimed at fiscal consolidation. The SBP, on the other hand, has increased policy rate by 625 basis points during 9M-FY23, taking the total rate hike to 1300 basis points during the current cycle of monetary tightening. Going forward, this policy mix, alongside necessary structural reforms to moderate the impact of various supply shocks, would help anchor inflationary expectations in the medium term, and put the economy on a more sustainable growth path.