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Prime Plus
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A quarterly report on Pakistan's economy with a special section on pillars of economic prosperity

Policy Research Institute Of Market Economy

One of the top 100 thinktanks in Asia-Pacific according to the University of Pennsylvania's thinktank index

ABOUT PRIME:

Policy Research Institute of Market Economy is a public policy research and advocacy organization striving for an open, free, and prosperous Pakistan. PRIME was established in Islamabad in 2013 and has played a leading role in advancing ideas and policies for open trade and economic efficiency in Pakistan through its research and public education. PRIME is included in Top 100 think tanks in Asia-Pacific according to the University of Pennsylvania's Think Tank Index.

Prime Plus is a quarterly report by PRIME which tracks progress on the six pillars of economic prosperity, analyzes macro-economic indicators, and provides an economic outlook. The report focuses on the policies and their implementation in the domain of the federal government such as taxation, trade, and investment which influence business climate. It helps the reader to get a bird's eye view on Pakistan's economic direction while using publicly available data.

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Overview

In the first section of the report, the progress on the pillars of economic prosperity is critically analyzed for CY 2022. The report argues that negligible attention has been paid to the structural reforms contributed to suboptimal performance and prevalence of deep-rooted issues in the economy. The government needs to move ahead with the inevitable reforms by easing regulations and creating business enabling environment.

In Section 2 we present macroeconomic data of the second quarter of FY 2023 including Inflation, Current Account, Public Debt, Foreign Direct Investment, Government borrowing, and a general trend of how the economy is behaving, where we reach the conclusion that Pakistan's economy is currently facing insurmountable challenges and not performing at its potential level.

Section 3 paints an economic outlook of the country. Pakistan like other countries around the globe is experiencing severe inflationary pressures and a slowdown in economic activity due to disruptive trade policies, the continuity of the war Russia-Ukraine war, a decline in foreign exchange reserves and volatility in the exchange rate. Petroleum prices have moderated in the recent months but gas prices remain elevated and government faces problems in the timely procurement. Destruction of crops from floods has resulted in a possible shortage of food items and food insecurity in the country. Pakistan might experience increase in current account deficit than the budgeted amount. The economic activity, especially the output of the manufacturing sector, has experienced a declining trend due to adoption of import substitution policy and implementation of administrative controls to stop imports. Therefore, proactive measures at the fiscal and monetary policy fronts along with easing of trade restrictions to mitigate the slowdown of the economy. Furthermore, reforms are needed in the energy sector to ensure sustainability and promote economic activity in the country.

TABLE OF CONTENT

Section 1: TRACKING PROGRESS ON THE PILLARS OF ECONOMIC PROSPERITY............... 1

Role of the Government in the Economy.. 2

Size of the Government.. 3

Financing the government spending.. 3

Fiscal Prudence... 4

Government spending and deficits.. 4

Untargeted subsidies.. 5

IMF conditions and spending restraints.. 5

Efficient Taxation system.. 6

Composition of taxes.. 6

Tax Expenditure... 8

Reluctance to file returns.. 8

Trade Openness.. 8

Restrictions on the imports... 9

Imports suppression through administrative controls... 9

Sound Money... 10

Volatility in exchange rate... 10

Management of exchange rate.. 11

Privatization... 12

What needs to be done?... 14

Section 2: MACROECONOMIC ANALYSIS........ 16
Inflation........ 17
Fiscal Sector........ 17
Foreign Investment........ 18
Credit to Private Sector........ 19
Manufacturing Sector........ 19
External Sector........ 20
Business Environment........ 22
Macroeconomic Indicators........ 23
Section 3: MACROECONOMIC OUTLOOK........ 29
Annexure........ 32

LIST OF FIGURES

Figure 1: Pillars of Economic Prosperity............ 2

Figure 2: Composition of Tax Revenues in FY 2022............ 7

Figure 3: Exchange Rate............ 11

Figure 4: Growth in Money Supply-M2............ 12

Figure 5: Composition of Commercial SOEs............ 13

Figure 6: Inflation............ 23

Figure 7: Revenue Collection............ 23

Figure 9: Government Domestic Borrowing............ 24

Figure 9: Public Debt of Pakistan............ 24

Figure 10: Foreign Investment in Pakistan............ 25

Figure 11: Private Sector Borrowing from Banks............ 25

Figure 12: Large Scale Manufacturing Sector Performance............ 26

Figure 13: Current Account Balance............ 26

Figure 14: Foreign Exchange Reserves of Government............ 27

Figure 15: Exchange Rate Trend............ 27

Figure 16: Stock Market Performance............ 28

Figure 17: Market Capitalization in Stock Market............ 28

LIST OF TABLES

Table 1: Current Account Indicators of Pakistan.. 32

Table 2: Foreign Direct Investment in Pakistan.. 33

Table 3: Large Scale Manufacturing Sector Growth.. 34

Table 4: Inflation.. 34

Table 5: Public Debt of Pakistan.. 35

Table 6: Domestic Borrowing of Government.. 36

Table 7: Private Sector Borrowing.. 37

Table 8: Exchange Rate and SBP Reserves.. 38

Table 9: Performance of Stock Market... 39

TRACKING PROGRESS ON THE PILLARS OF ECONOMIC PROSPERITY

Pakistan remained in troubled waters in CY2022 as the country remained exposed to rising inflation and diminishing purchasing powers compounded by havoc caused floods, significant depletion in foreign exchange reserves and currency devaluation. The economic performance of Pakistan has remained bleak and unsatisfactory as compared to the regional economies.

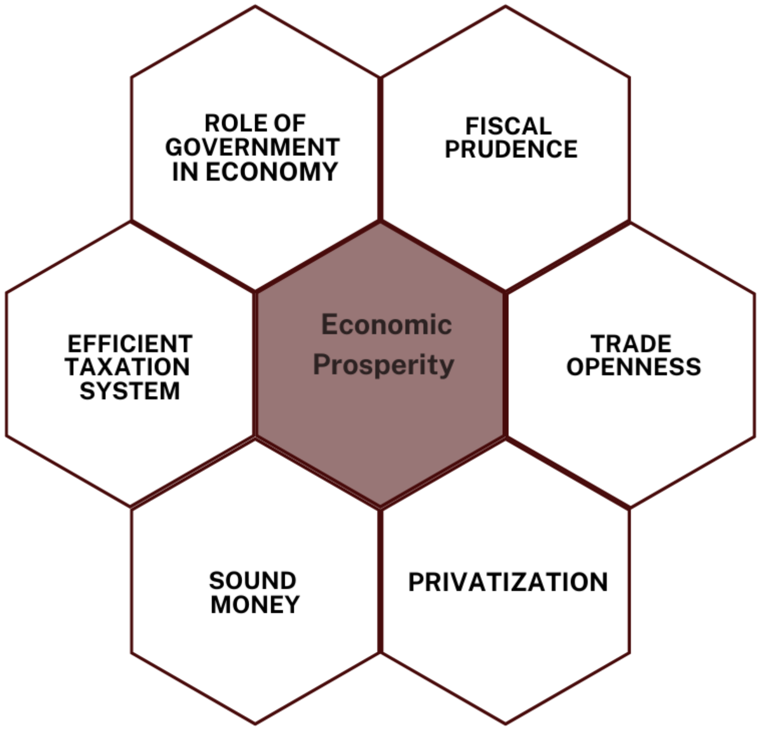
Whenever the economy grew by 5 percentage or more, country ended up with balance of payment crisis. Historically, there have been recurring periods of fiscal contraction and stabilization during IMF programs followed by fiscal extravagance and expansion. Moreover, there were periods of import restrictions through tariff and non-tariff barriers followed by depletion of foreign exchange reserves and high imports during expansionary periods. This highlights the fact that there are structural issues in the economy, which remain unaddressed and country faces similar problems time and again.

Consequently, it becomes imperative to understand and highlight problems prevalent in the economy emanating from the government policies that tone down the economic performance and exacerbate crises.

The main determinants of the economic prosperity are the role of government in the economy, fiscal prudence, efficient taxation system, trade openness, sound money and privatization of loss-making state-owned enterprises (Dr. Arthur B. Laffer)[1].

[1] Dr. Arthur B. Laffer is a renowned supply-side economist and tax expert. The set of six pillars are taken from a keynote address delivered at Pakistan Prosperity Forum in 2021.

Figure 1: Pillars of Economic Prosperity



This section comprises analysis on the progress and developments in the six pillars of economic prosperity in last one year from January 2022 to December 2022.

Role of the Government in the Economy

The government plays a critical role in the sustainable economic growth by creating business conducive environment and providing stimulus to enhance economic activity. The efficiency of government is linked to its role and size in the economy. If the government is continuously expanding its size through spending, then there will be a multiplier effect but also crowding out of the private sector.

Size of the Government

In Pakistan, the size of government has been continuously increasing on the back of spending. Every year, there is an increase in recurring expenditures of the government, which illustrates the size of the government. In FY 2022, the current expenditures were budgeted at Rs. 7.5 trillion and it increased to Rs. 8.6 trillion[2] in FY 2023, an increase of more than 15 percent.

The grants and transfers can also be used to represent the size of the government. Every year government allocates significant amount under this category. The government allocated Rs. 1.1 trillion in FY 2022 and Rs. 1.2 trillion in FY 2023. Another indicator representing the size of government is the pensions. The government allocated Rs. 480 billion as pensions in FY 2022 and Rs. 530 billion in FY 2023, an increase of more than 10 percent in a year.

According to a report by Pakistan Institute of Development Economics (PIDE), the share of government in economy is more than 40 percent[3]. The highest share of government is in mining and quarrying, construction, transport and communication, and agriculture sector.

Financing the government spending

The expansion of the government increases revenue generation requirement and subsequently, the government has to impose and raise taxes to finance the expenditures. Moreover, the government increases its borrowing from the domestic sources, which is convenient but costly. The credit to government by banking sector increased by 36 percent from Rs. 11.6 trillion in January to Rs. 15.8 trillion[4] in December. In contrast, the credit to private sector by banks increased by 9 percent from Rs. 7.7 trillion to Rs. 8.4 trillion in the

[2] Budget in Brief 2022-23, Ministry of Finance.
[3] PIDE Blog: What is the size of government footprint in Pakistan's economy?
https://pide.org.pk/blog/what-is-the-size-of-the-government-footprint-on-pakistans-economy
[4] Credit Classified by Borrowers, State Bank of Pakistan.

period under review. This illustrate a structural flaw in the banking sector's investments that banks are skewed to invest in safe and short-term government securities instead of lending to risky but growth oriented private sector. This manifests the crowding out of private sector.

Fiscal Prudence

Sustainable economic growth is contingent upon efficient allocation of public resources. The public spending should be according to the revenue generation. In contrast, when the public spending outpaces revenue generation, then the government has to borrow money form external and domestic sources having negative externalities at the multiple fronts. The most prominent consequence of fiscal mismanagement is the accumulation of debt followed by balance of payment crisis and currency devaluation.

Government spending and deficits

On the fiscal side, Pakistan remains under stress due to low revenue generation and higher expenditures. In FY 2022, the share of total expenditures as a percentage of GDP was around 20 percent out of which current expenditures' share was 17.2 percent[5] while development expenditure was 2.5 percent. Subsequently, budget deficit stood at 7.9 percentage of GDP. Consequently, the government had to borrow money to finance the expenditures where domestic borrowing stood at Rs. 4,081 billion. Similarly, the fiscal deficit stood at 1.6 percent in first four months of FY 2023 (July-October) and is expected to bypass the budgeted level of 4.9 percent due to slow down in the economy, unfettered inflation and closure of industries. Moreover, the inclusion of the impact of floods has resulted in the downgrading of growth estimate from 5 percent to around 2 percent[6] by the World Bank.

[5] Pakistan Fiscal Operations Report 2021-22, Ministry of Finance.
[6] Press Release October 6, 2022. Pakistan's economy slows down while inflation rises amid catastrophic floods. World Bank. shorturl.at/jLNP8

Untargeted subsidies

A key factor behind fiscal slippage is untargeted subsidies. In CY 2022, the subsidy given by government on petroleum products and electricity in January 2022 contributed significantly to fiscal imbalances. The budgeted subsidies amounted to Rs. 682 billion whereas actual subsidy expenditure was Rs. 1,514 billion in FY 2022. The impact of subsidy announced for petroleum products under Prime Minister's Package costed Rs. 286 billion[7].

Similarly, the government has provided untargeted subsidy in FY 2023 through provision of electricity to export oriented industries at Rs. 19.99/ unit[8], which will put additional burden of Rs. 110 billion. Moreover, the government announced agriculture package of Rs. 1.8 trillion in October 2022 where loans will be provided to the farmers but collateral requirement of the bank loans will crowd out small farmers and will benefit only big farmers.

IMF conditions and spending restraints

Fiscal prudence implies curtailment of recurring expenditures; however, these expenditures i.e., government spending and untargeted subsidies have continued to balloon despite intimation from the IMF and World Bank. The current expenditures increased by more than 15 percent from Rs. 7.5 trillion in FY 2022 to Rs. 8.6 trillion in FY 2023. Moreover, the government has been unable to fulfill agreed upon commitments with the IMF in terms of spending and revenue generation, which resulted in significant delay in combined seventh-eighth reviews, and currently, the ninth review. Therefore, the budgeted target of 4.9 percent of fiscal deficit will be missed, exceed beyond the target and create more financial burden on the government to increase taxes and cover the expenditures.

[7] Budget in Brief 2022-23, Ministry of Finance.
[8] Business Recorder, October 7. https://www.brecorder.com/news/40201832

Efficient Taxation system

The taxation system in Pakistan has remained a bottleneck in the path of sustainable development. According to Arthur B. Laffer, a renowned supply-side economist and tax expert, taxes act like disincentives. The higher the tax rates, the lower will be the revenue collection and the higher will be the tax evasion.

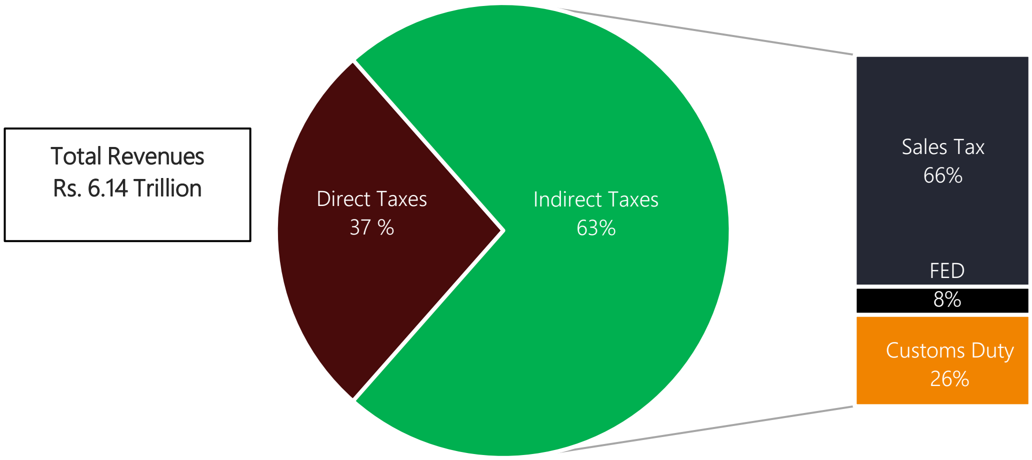
Pakistan's taxation system continues to remain complex and difficult to administer. The unsatisfactory growth in the revenue generation on the back of narrow tax base, reluctance of people to become a taxpayer, prevalence of evasion and continuity of exemptions have constrained the government's ability to finance the development activities in the country. This illustrates structural issues, which have hindered the efficiency.

Composition of taxes

The taxation system in Pakistan is skewed towards indirect taxes as the country is unable to increase revenues from direct sources. In FY 2022, the FBR crossed Rs. 6 trillion mark for the first time in history. The composition of tax revenues comprises 37 percent from direct taxes and 63 percent from indirect taxes[9]. It is imperative to highlight that indirect taxes are regressive in nature with higher burden felt by the lower income groups.

[9] Year Book 2021-22, Federal Board of Revenue.

Figure 2: Composition of Tax Revenues in FY 2022



In FY 2023, the government introduced several amendments in the taxation system to increase the revenue collection. These amendments include imposition of super tax on income greater than Rs. 150 million, changed slabs for salaried income with effective tax rate up to 30 percent, and imposed fixed sales tax on retailers other than Tier 1. However, sales tax on retailers could not be implemented due to strong protests and opposition from the traders. Moreover, the government budgeted the collection of Rs.750 billion as petroleum development levy by raising maximum limit to Rs. 50 per liter. Therefore, FBR has collected Rs. 3.42 trillion in the first half of FY 2023 against the target of Rs. 3.65 trillion[10]. However, the share of indirect taxes remained higher than the direct taxes.

[10] Press Releases, Federal Board of Revenue.

Tax Expenditure

The tax revenue collection in Pakistan is also below the mark due to higher share of forgone revenues. In FY 2022, the tax expenditure stood at Rs. 1.48 trillion, which was 2.67 percentage of GDP.[11] The tax expenditure increased by 13 percent from the previous year. The tax expenditure comprises Rs. 400 billion of income tax, Rs. 740 billion of sales tax and Rs. 343 billion of customs duty. The prevalence of exemptions and reliefs in the form of lower rates contributes to discrimination among the taxpayers by selecting winners and losers, and distortion in the system.

Reluctance to file returns

The higher number and rates of taxes have contributed significantly to the reluctance of the people to become part of taxation system and file returns. This can be illustrated from the fact that government extended the deadline to file tax returns for FY 2022 from September 30th to October 31st and then to December 15. The active taxpayers till December 2022 are 3.9 million, according to FBR's ATL, while data on total returns filed for FY 2022 are not public yet.

Trade Openness

Trade is one of the key components of sustainable economic growth. It not only facilitates the transfer of knowledge and technology through imports but also promotes value addition and exports. However, CY 2022 remained a spectacle of trade suppression through imposition of tariff and non-tariff barriers to curb imports. Import substitution remained a prominent component of government's policy at the time of high trade and current account deficits. Such policy has proved to be futile in past and it was imprudent to expect different results now.

[11] Tax Expenditure Report 2022, Federal Board of Revenue.

Restrictions on the imports

In April 2022, SBP imposed the 100 percent cash margin restriction on imports of all commodities and directed the banks to share details of cash margins on monthly basis. On May 19, 2022, the government imposed a ban on the imports of 33 categories of the goods comprising 860 tariff lines along with the imposition of quota restrictions on the import of cars, cellular phones and home appliances. These products accounted for 4.8 percent of total imports in FY 2021 and $2.6 billion in worth.

Imports suppression through administrative controls

In August 2022, the government lifted the ban on the imports, which was a precondition for 7th and 8th review of the IMF program. However, the government increased the regulatory duty on the imported goods up to 400 percent to restrict imports and trade deficit.

Moreover, the government linked the rates of the Export Financing Scheme (EFS) and Long-Term Fixed Financing (LTFF) to the policy rate to slowdown the imports. The mark-up rate for EFS was increased from 7.5 percent to 13 percent[12] and the mark-up rate for financing under LTFF was increased from 7 percent to 13 percent in phases.

Despite the lifting of ban, the government made sure that imports are suppressed through the use of administrative controls such as decreasing the limit of foreign purchases, increasing cash margin requirement and blocking LCs. These administrative controls made it impossible to import raw materials and gradually industries started to halt operations.

Resultantly, the government was able to bring down imports, but it contributed to the fall in our exports too. The current account deficit stood at $8.3 billion in first half of CY 2022 (Jan-June) and declined to $3.11 billion in later half (Jul-Nov). However, this decrease also comprises fall in exports and remittances.

[12] Circular No. 13, SME, Housing & Sustainable Finance Department, State Bank of Pakistan.

The restrictions on imports and administrative controls have contributed significantly to the slowdown of the manufacturing sector. The Quantum Index of Manufacturing declined from 153.6 in March to 112.3 in November. The sectors showing highest slowdown are automobile, cement, petroleum and cotton.

Sound Money

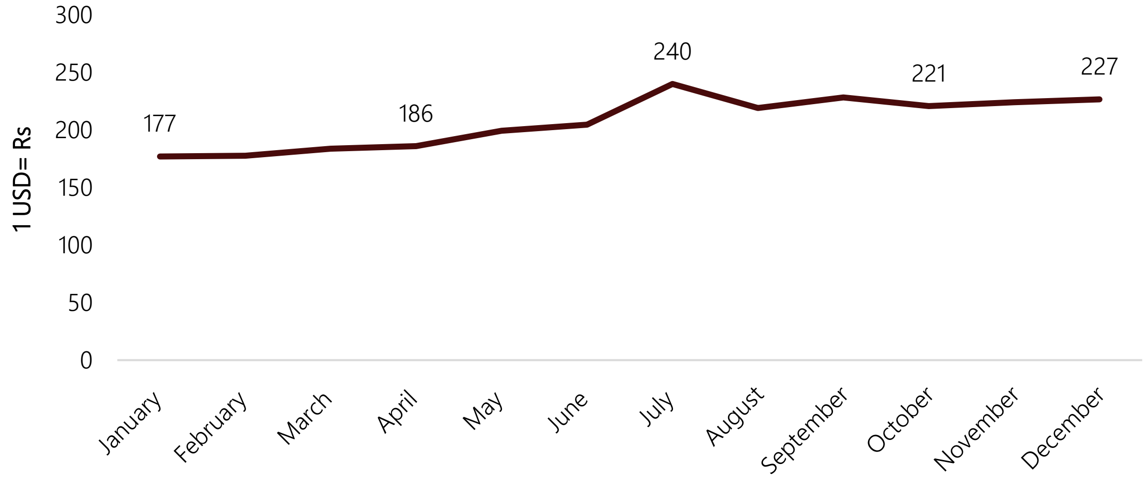
Sound money acts as a stimulus for economic activity. Stable currency creates conducive environment for businesses to plan operations and future investments. In contrast, volatile currency makes entrepreneurs and investors reluctant for future investments.

Volatility in Exchange Rate

The CY 2022 experienced significant volatility in the currency market. The fragility of the domestic currency can be illustrated by the fact that rupee lost its value against dollar by 28 percent from Rs. 177 in January to Rs. 227 in December. The fall in rupee resulted from lower economic performance of the country. The currency devaluation adjusts market expectations and spending patterns to stabilize the economy in a flexible exchange rate system. However, if the government intervenes to manage the currency, then it leads to depletion of foreign exchange reserves.

Figure 3: Exchange Rate

Month end Position



Source: State Bank of Pakistan

Management of exchange rate

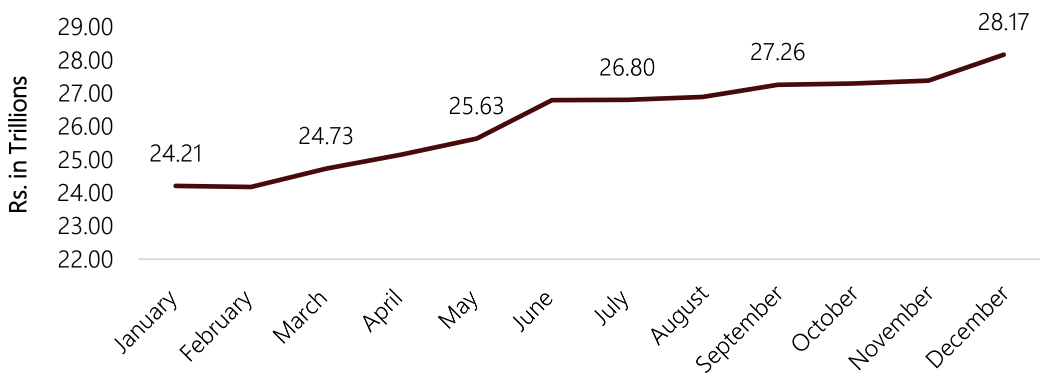
The government is in agreement with the IMF regarding market-based determination of the exchange rate. However, it is widely believed that there is some management of exchange rate by the government. The exchange rate management results in the widening of the gap between interbank rate and the price at which dollar is being trade in the open market. Currently, there are three rates in Pakistan; interbank rate, open market rate at which dollar is not available and black-market rate at which dollar is actually being traded. The gap between interbank rate and the rate at which dollar is being traded has increased to more than Rs. 35[13]. Consequently, the dollar inflows in the form of remittances has also declined

[13] https://www.brecorder.com/news/40220598/were-not-acting-prudently-so-to-speak

and transfers are being carried out through informal channels. Moreover, exporters are also bringing in proceeds through informal banking channels to maximize returns.

Another factor that contributes to the currency instability is the monetary growth. In CY 2022, the money supply i.e., M2 increased by 16.3 percent from Rs. 24.2 trillion in January to Rs. 28.1 trillion at the end of December. The underlying problem of money growth is inflation if money supply outpaces the growth in output. Another consequence is the fall in the price of domestic currency against foreign currencies.

Figure 4: Growth in Money Supply-M2



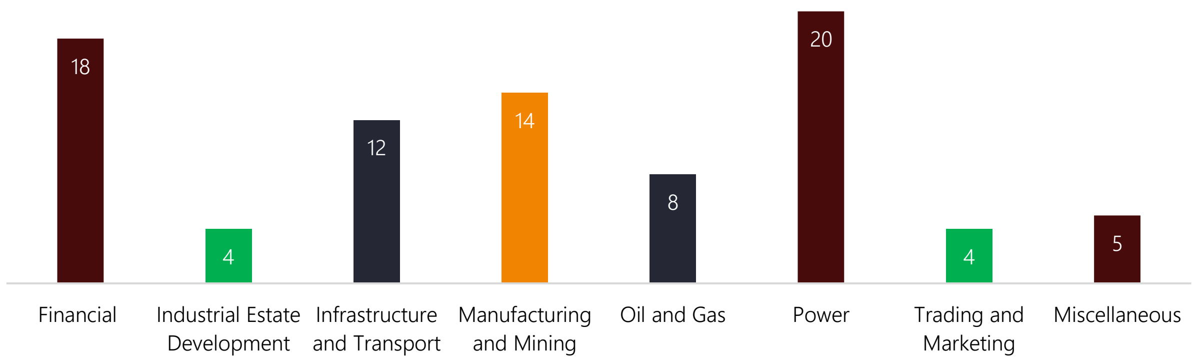
Source: State Bank of Pakistan

Privatization

The state-owned enterprises (SOE) in Pakistan continue to remain a burden on the national exchequer due to inefficiency and losses. The debate on SOEs revolve around privatization or structural reforms for better performance and efficiency. Although there is consensus among the policymakers with privatization as a way forward, yet no significant progress has been made in this regard.

There are 212 SOEs in Pakistan where 85 are commercial, 44 are noncommercial and 83 are subsidiaries of commercial SOEs[14]. The composition of commercial SOEs is illustrated in Figure.

Figure 5: Composition of Commercial SOEs



Source: State of Industry Report, Ministry of Finance

The performance of SOEs has remained dismal with continuous losses and accumulation of debt. Subsequently, the government has to finance the operations of enterprises to keep them afloat. Total losses of SOEs in 2019 was Rs. 143 billion and accumulation of debt till May 2022 was Rs. 1.74 trillion[15]. Resultantly, the government includes privatization of SOEs in budget every year to minimize losses. The government projected revenue of Rs. 252 billion from privatization in FY 2022 and Rs. 96 billion in FY 2023. However, not a single entity has been privatized in last couple of years.

The government has identified 20 SOEs for privatization and are in initial stages of assessment. The majority of SOEs under consideration for privatization are from energy

[14] State Owned Enterprises Triage: Reforms and Way forward 2021. Ministry of Finance.
[15] The Nation. Gigantic Losses in SOEs. https://www.nation.com.pk/31-Oct-2022/gigantic-losses-in-soes

sector with 8 power sector distribution companies and 2 power plants[16]. The progress on privatization of SOEs is negligible due to higher political costs and lack of will among the policymakers as privatization will require restructuring of enterprises and downsizing of human resource.

What needs to be done?

The analysis of the determinants of sustainable economic growth shows unsatisfactory performance as there has not been any progress towards structural reforms. The government continues to expand its scope and scale of involvement in the economy and resultantly, contributes to higher deficits. Moreover, the inability of the government to enable business conducive environment has pushed government towards higher taxes and import substitution policy. Therefore, the path to sustainable development requires following steps

- The government needs to reduce its footprint in the economy to create space for the private sector to become an engine of growth.
- The government needs to cut its expenditures to improve fiscal management and move away from domestic borrowing to ensure availability of capital for the private sector.
- Taxation system in the country needs to be overhauled by reducing the number and rates of taxes to broaden the tax base and promote compliance.
- Import substitution policy has failed to reap desired objectives. The government needs to open trade by reducing tariff and nontariff barriers to allow transfer of knowledge and technology and incentivize innovation for the domestic industry through exposure to international competition.

[16] Ongoing Privatization Program, Ministry of Privatization.

- The government needs to control the monetary expansion by reducing borrowing for public expenditures to control inflation.
- Market determined exchange rate is the key to stability in the currency market and stopping depletion of foreign exchange reserves.
- Loss making SOEs needs to be privatized on priority basis to reduce burden on the government and pace of debt accumulation,

__________End of Section 1__________

ECONOMIC ANALYSIS

The economic recovery around the globe remained subdued due to intermittent disruptions emanating from the reemergence of COVID-19 infections, especially in China, as the virus continues to mutate and strengthens uncertainty. The continuity of Russia-Ukraine war has further moderated the prospects of expeditious economic recovery due to food related supply chain disruptions. However, the energy prices have come down thus easing burden on the balance of payments. The Oil Producing and Exporting Countries (OPEC) crude oil prices hiked from $92 per barrel in October to $96 per barrel in November and then declined to $82 per barrel at the end of December. Whereas, the LNG prices remained elevated to more than $30 per mmbtu due to shift in demand from Russia to Gulf by Europe. Moreover, the food prices have also remained elevated and contributed to inflation. The global inflation is likely to revolve around 9 percent in early 2023 and will fall to 6 percent at the end of 2023, according to the IMF[17]. Therefore, countries are moving towards monetary tightening by raising policy rates, which will slow down the economic activities and growth prospects.

The second quarter of FY 2023 (October-December) remained challenging for Pakistan due to the devastation caused by the floods. The government carried out surveys to evaluate the extent of damages and financing required for relief and rehabilitation. The estimated loss to the economy from floods is around $35 billion. The country also witnessed significant deterioration in economic fundamentals such as inflation, currency devaluation, depletion of foreign exchange reserves and stagnancy of the manufacturing sector. Moreover, the government faced significant burden on the external front in terms of fulfilling external financial obligations as the government was unable to complete the 9th review of the IMF program, which completely diminished the business confidence in the country.

[17] World Economic Outlook, October 2022. IMF.

Inflation

Inflation remains one of the key challenges haunting the government as people witnessed significant deterioration in the purchasing power and standards of living. In the second quarter of the FY 2023, average national CPI stood at 25 percent as compared to 11 percent in the previous year, SPI stood at 26 percent as compared to 18 percent and WPI stood at 29 percent as compared to 18 percent last year. Inflation in the rural areas remained higher than the urban areas; rural CPI cloaked at 29 percent as compared to urban CPI of 22 percent in December. The main factor behind inflation is a significant hike in the food prices ranging up to 13 percent followed by petroleum and utility prices as compared to the previous year. Floods and Russia-Ukraine war are primarily responsible for food inflation and consequently, food insecurity has increased significantly in the country. Political uncertainty and volatility in the currency market are also contributing to the slowdown in business activities and the inflation.

Fiscal Sector

The public finance has remained under pressure due to unanticipated expenditures for floods relief and rehabilitation activities. The government has spent Rs. 69 billion as cash transfers and in the provision of supplies to the flood victims. On the expenditure side, the total expenditures increased by 26 percent from Rs. 2.17 trillion in Jul-Oct 2022 to Rs. 2.73 trillion in Jul-Oct 2023. The development spending in the period was Rs. 98 billion as compared to Rs. 207 billion last year. Another prominent feature of the second quarter is the provision of subsidy to exports sector and agriculture package, which was unfunded and will likely result in higher than budgeted fiscal deficit. The fiscal deficit in the period rose to Rs. 1.26 trillion as compared to Rs. 587 billion last year. The increase in government spending resulted from higher debt servicing.

On the revenue side, FBR collected Rs. 3.4 trillion as tax revenues against the target of Rs. 3.6 trillion in first half of FY 2023, a shortfall of Rs. 200 billion. The government has budgeted the collection of Rs. 855 billion as petroleum development levy; however, higher international prices and lower consumption will likely contribute to less than expected collections. The consumption of petroleum products declined by 19 percent from 11.1 million tons Jul-Dec 2021 to 9 million tons in Jul-Dec 2022. Therefore, the government may not be able to achieve budgeted revenue target.

The government borrowing declined by Rs. 44 billion in first two months of second quarter as compared to the borrowing of Rs. 201 billion in the same period last year. The total government borrowing stood at Rs. 20.4 trillion at the end of November 2022. The govern retired Rs. 1 trillion borrowed from the State Bank of Pakistan in the two months of second quarter while borrowed Rs. 992 billion by selling securities to the commercial banks. The government borrowing from SBP stood at Rs. 4.5 trillion and from commercial banks at RS. 15.8 trillion.

The government borrowing from domestic and international sources resulted in the accumulation of debt. In the first two months of second quarter of the FY 2023, the public debt (central government debt) increased by Rs. 1.4 trillion and stood at Rs. 50.9 trillion. On the domestic side, the domestic debt increased by Rs. 1.5 trillion in the first two months of the second quarter of FY 2023 and stood at Rs. 32.9 trillion. The external debt remained the same and reached Rs. 18 trillion in the period under review.

Foreign Investment

Foreign investment in Pakistan slowed down in the first quarter of FY 2023. In the second quarter of FY 2023, the net FDI to Pakistan stood at $160 million as compared to $577 million in the corresponding period last year and $301 million in the first quarter of FY 2023. The inflow of FDI was $119 million, $166.5 million and $222 million in October, November and

December while the outflow was $24.3 million, $87.4 million and $239 million. The global uncertain economic environment, recessionary trends, increase in the policy rates abroad and Volatile political and economic environment at home are the factors resulting in the reluctance of foreign investors to invest in Pakistan.

Credit to Private Sector

The private sector borrowing illustrated a declining trend in the second quarter of FY 2023. The total private sector borrowing declined by Rs. 21 billion in the first two months (Oct-Nov) of second quarter of FY 2023 as compared to a growth of Rs. 293 billion in the same period last year. The total private sector borrowing stood at Rs. 7.21 trillion till the end of November 2023. The long-term fixed financing (LTFF) decreased by Rs. 2 billion in Oct-Nov this year as compared to the growth of Rs. 42 billion last year. The LTFF stood at Rs. 648 billion till the end of November 2023. The short-term financing (working capital) increased by Rs. 9 billion in Oct-Nov as compared to growth of Rs. 7 billion last year and total short-term financing stood at Rs. 291 billion. The private sector borrowing under export financing scheme increased by Rs. 16 billion in Oct-Nov as compared to growth of Rs. 39 billion last year and total export financing stood at Rs. 714 billion. The overall decline in private sector borrowing can be contributed to the high cost of borrowing. In November 2022, the Monetary Policy Committee (MPC) increased the policy rate by 100 basis points to 16 percent to cater the inflationary pressures.

Manufacturing Sector

The performance of large-scale manufacturing (LSM) remained subdued due to uncertain economic environment in the country. LSM output declined by 7 percent in Oct-Nov 2022 as compared to last year. LSM declined by 5.49 percent in November 2022 as compared to November 2021 and increased by 3.55 percent as compared to October 2022. The output of the textile sector declined by 20 percent, chemicals by 7 percent, fertilizers by 13 percent and nonmetallic minerals by 5 percent. In contrast, the output of food sector increased by 18 percent, petroleum by 24 percent and pharmaceuticals by 3 percent. The slowdown in manufacturing output comes from import restrictions imposed by the government, increase in utility tariffs, an increase in the policy rate and a significant increase in the prices of inputs due to currency devaluation.

External Sector

On the external front, Pakistan remained under pressure due to the inability to fulfill external financial obligations. Resultantly, the government had to impose several administrative restrictions to manage foreign transactions. The exports of Pakistan declined by 13 percent in second quarter of FY 2023 as compared to the last year and by 1.4 percent as compared to first quarter of FY 2023. Total exports stood at $7 billion in the second quarter where exports in October, November and December were $2.38 billion, $2.39 billion and $2.30 billion respectively. The imports of country declined by 31 percent in the second quarter of FY 2023 as compared to the last year and by 8 percent as compared to first quarter of FY 2023. Total imports stood at $15.1 billion in the second quarter where imports in October, November and December were $4.7 billion, $5.18 billion and $5.16 billion respectively.

The total trade deficit declined by 41 percent in second quarter of FY 2023 as compared to last year and 13 percent compared to first quarter of FY 2023.The underlying reasons for decline in exports are restrictions on the imports, rise in energy prices and shortages, low output of manufacturing sector, higher cost of inputs from currency devaluation and decline in the global demand. Whereas the decline in imports resulted from import restrictions such as banning import of certain commodities, blockage of LCs and 100 percent cash margin requirement.

Remittances play an important role in the managing inflow and outflow of foreign exchange and fulfilling the country's external obligations as the country's exports are much lower than the country's imports. Inflow of remittances declined by 16 percent in the second quarter of FY 2023 as compared to last year and 17 percent compared to first quarter of FY 2023. Pakistan received remittances of $6.36 billion in the second quarter of FY 2023 as compared to an inflow of $7.6 billion last year and $7.68 in the first quarter of FY2023. The significant fall in remittances is due to shift of inflow of money from formal banking channels to informal channels as returns through informal channels are much higher than the formal channels.

The performance of the country on the external front remained weak as a result of higher external financial obligations. The government was able to slow down the current account deficit on the back of import restrictions and administrative controls like imposing restrictions of 100 percent cash margin and blocking letters of credit to carry out imports. The current account deficit in October and November was $845 million as compared to $3.7 billion last year. The current account deficit in October and November was $569 million and $276 million respectively.

The demand for dollars for import payments and servicing of debt has put significant pressure on the foreign exchange reserves of the country. The foreign exchange reserves of the government declined by 29 percent i.e., $2.3 billion in second quarter of FY 2023 from $7.9 billion at the end of September 2022 to $5.6 billion at the end of December 2022. In the second quarter of FY 2023, the government was unable to complete the 9th review of the IMF program, which promoted uncertain economic environment and contributed to expeditious depletion of reserves.

The decline in forex to low levels, which are not sufficient to finance imports of even one month, and rising external financial obligations exerted more pressure on the local currency. However, the exchange rate in the second quarter of FY 2023 improved by 2.5 percent from Rs. 231.2 at the end of September 2022 to Rs. 225.2 at the end of December 2022.

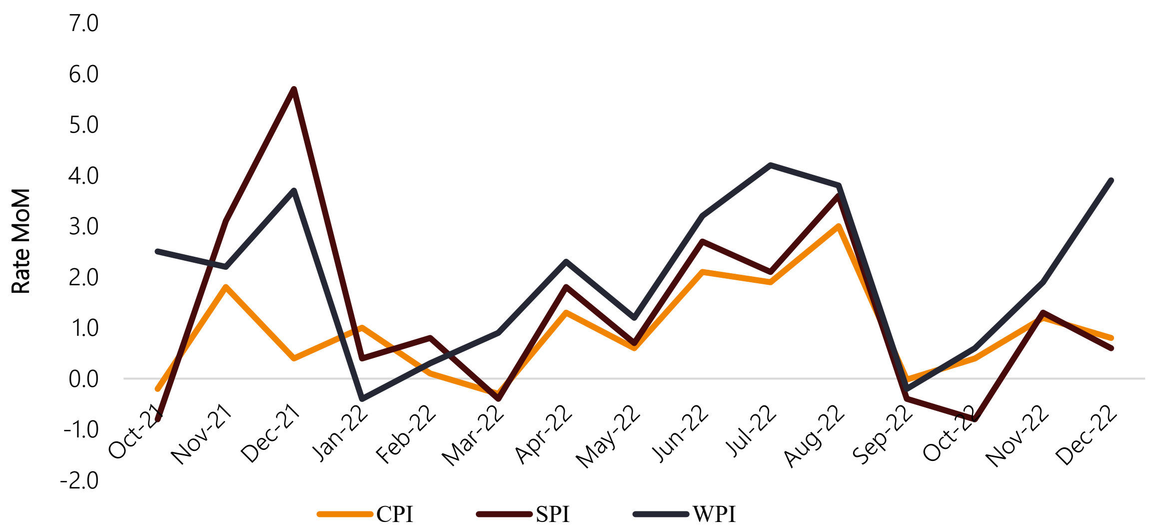
Despite the increase in external financial obligations, fall in foreign exchange reserves and growing uncertainty due to stalling of IMF program, the exchange rate improved in the second quarter, which highlights that there is some credence to the assumption that the government is managing the exchange rate.

Business Environment

The economic certainty deteriorated significantly in the second quarter of FY 2023 due to a colossal drop in the foreign exchange reserves, unfettered inflation, slowdown in manufacturing sector's output and a rise in political instability. Furthermore, the inability of the government to complete 9th review and revive the IMF program further exacerbated the crisis. Therefore, the performance of the stock market reflected the uncertain economic environment of the country. The KSE-100 Index stock position at the start of second quarter was 41,129 and it declined to 39,747 at the end of December, a decline of 3.4 percent in the quarter. The stock position declined by 11 percent as compared to December 2021. The market capitalization dropped by 6 percent in the second quarter as compared to first quarter and by 16 percent as compared to second quarter of FY 2022. The total market capitalization till the end of December 2022 stood at Rs. 6.3 trillion.

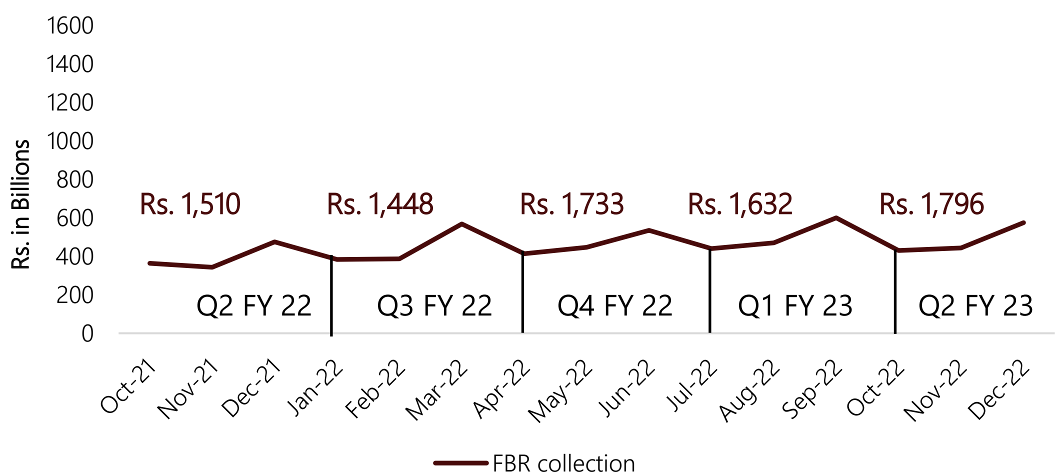
Macroeconomic Indicators

Figure 6: Inflation



Source: Pakistan Bureau of Statistics

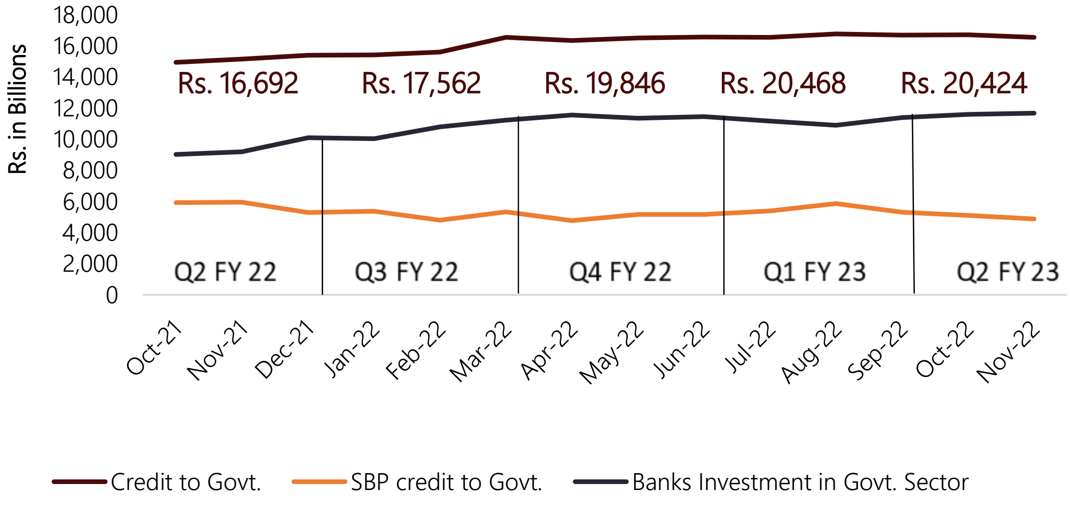
Figure 7: Revenue Collection



Source: Federal Board of Revenue

Figure 8: Government Domestic Borrowing

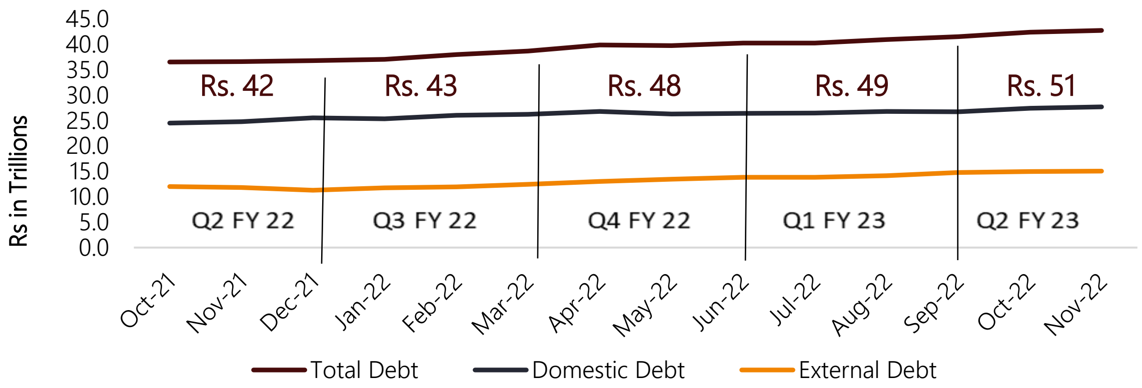
Outstanding Period end Position



Source: State Bank of Pakistan

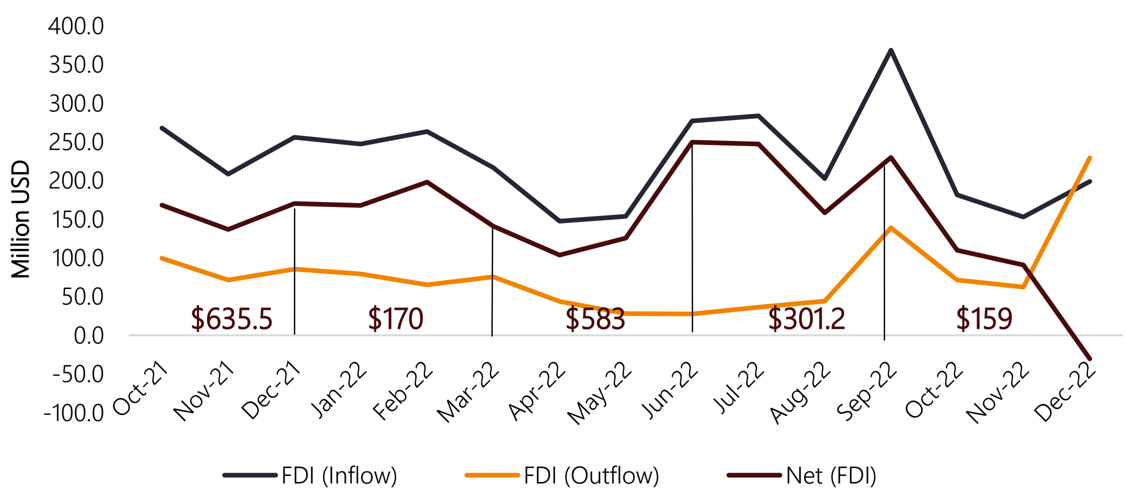
Figure 9: Public Debt of Pakistan

Outstanding Period end Position



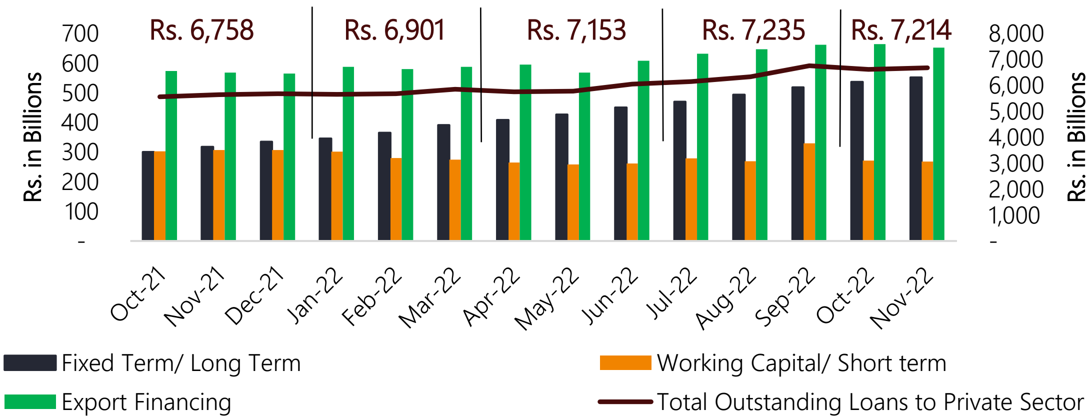
Source: State Bank of Pakistan

Figure 10: Foreign Investment in Pakistan



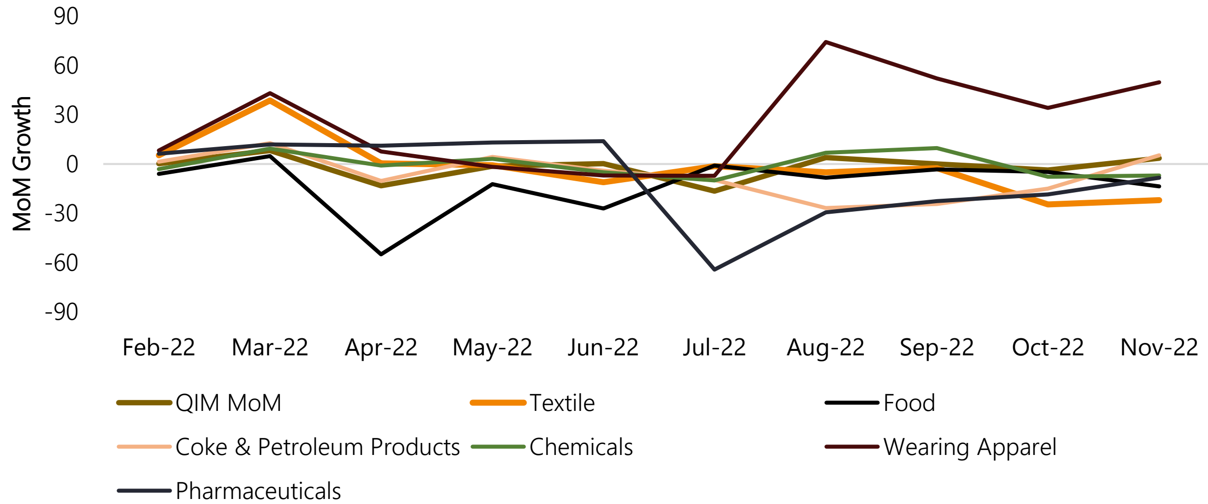
Source: State Bank of Pakistan

Figure 11: Private Sector Borrowing from Banks



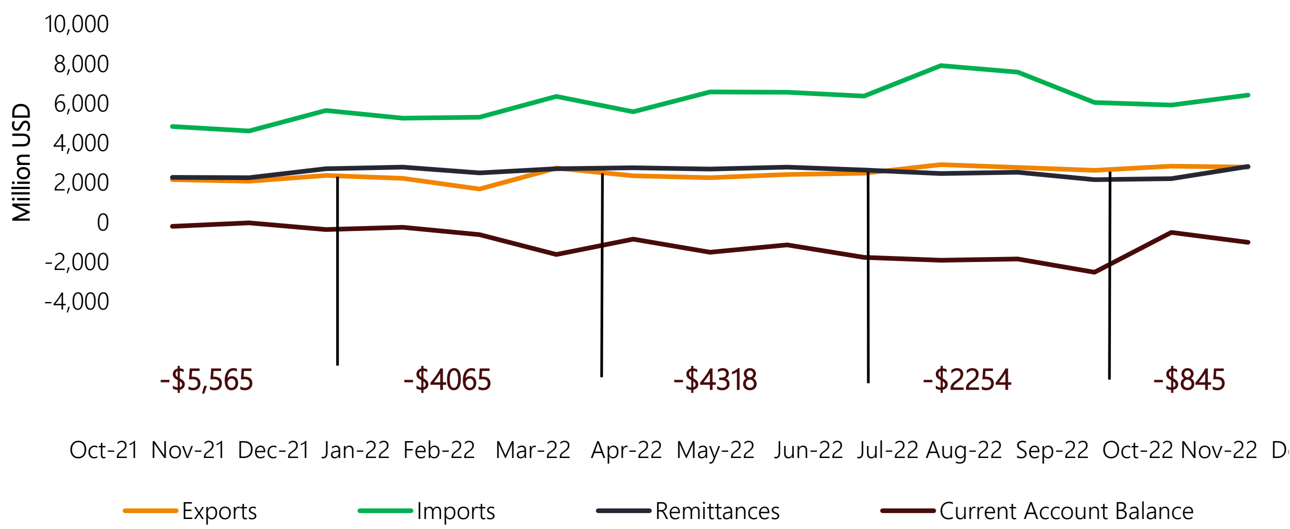
Source: State Bank of Pakistan

Figure 12: Large Scale Manufacturing Performance



Source: State Bank of Pakistan

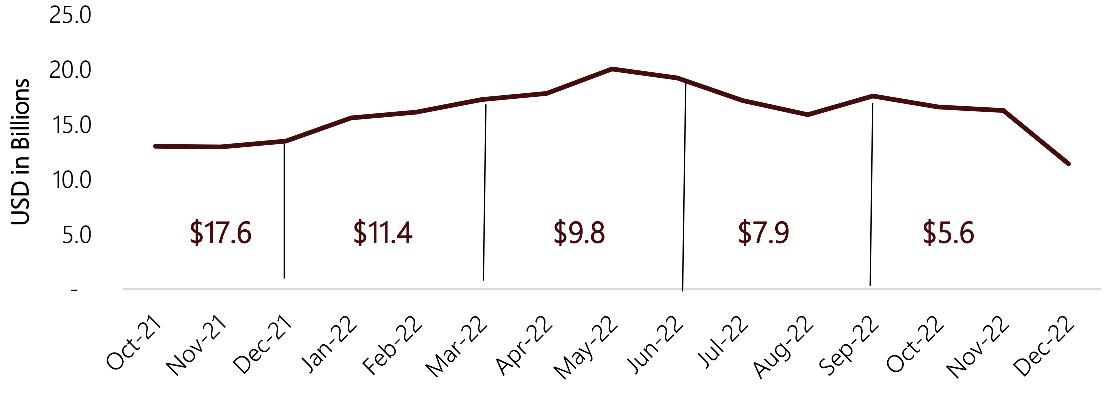
Figure 13: Current Account Balance



Source: State Bank of Pakistan

Figure 14: Foreign Exchange Reserves of Government

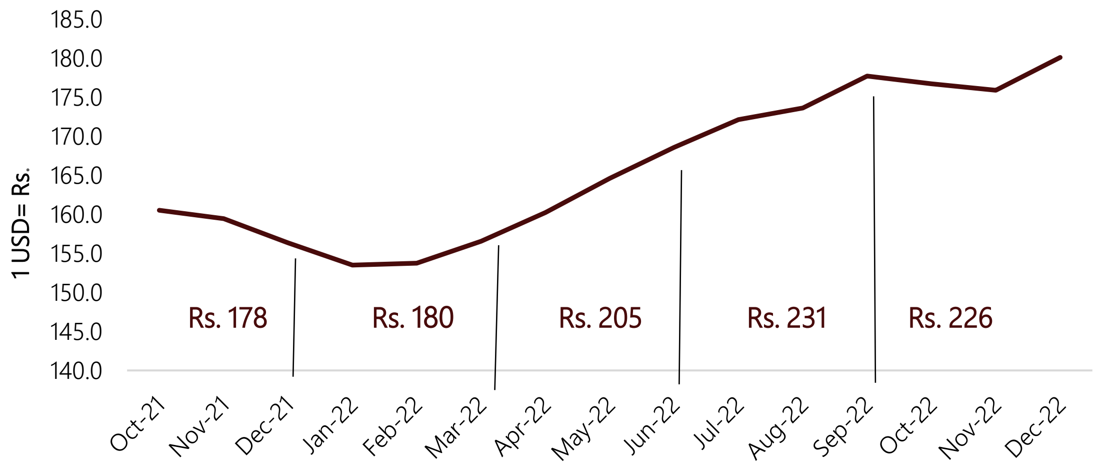
Outstanding Period end Position



Source: State Bank of Pakistan

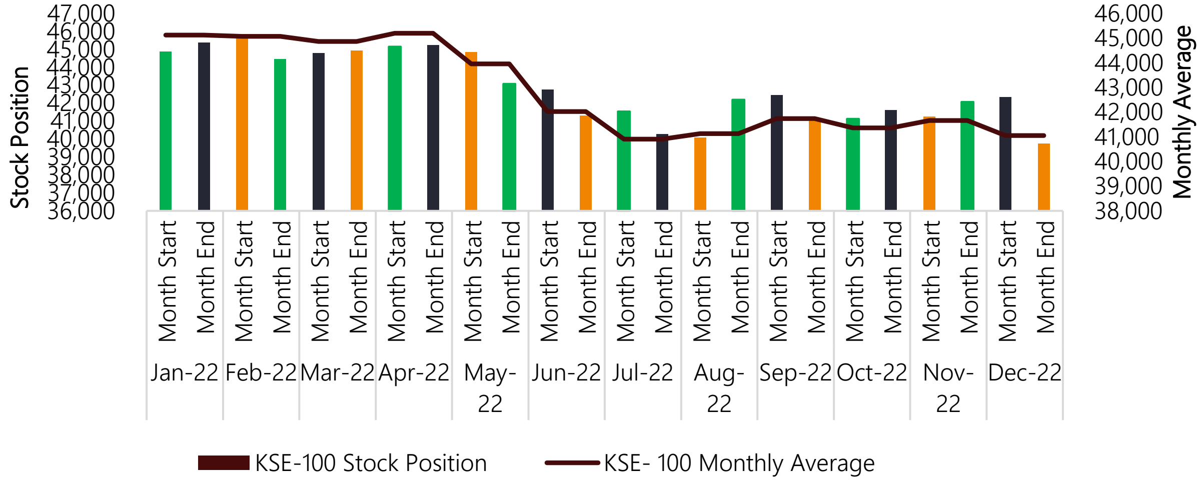
Figure 15: Exchange Rate Trend

Outstanding Period end Position



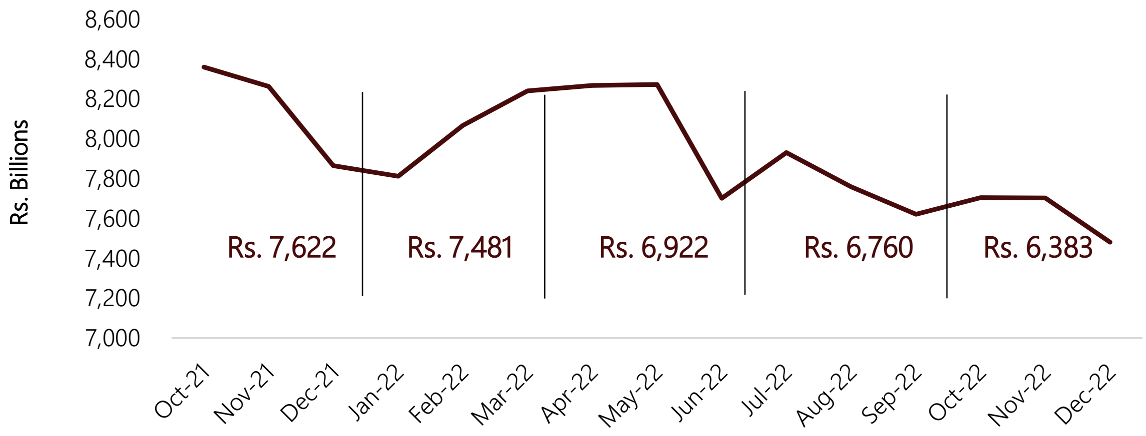
Source: State Bank of Bakistan

Figure 16: Stock Market Performance



Source: Pakistan Stock Exchange

Figure 17: Market Capitalization in Stock Market



Source: Business News, Dawn

_________End of Section 2_________

MACROECONOMIC OUTLOOK

Pakistan is currently facing significant challenges on the domestic and external fronts. Although the country managed to stay afloat amid distortions emanating from pandemic; the Russia-Ukraine war and floods at home have taken a deep toll at the economy. Countries around the globe have moved towards monetary contraction by raising policy rates to tame down inflation. Pakistan has also raised policy rate but inflation expectations remained unanchored. The closure of industries at home due to administrative restrictions put in place by the government to arrest current account deficit has actually contributed significantly in the widening of supply and demand gap of commodities and subsequently, prices have remained higher not only of capital goods but also of consumer goods.

The most important and immediate concern is the deterioration in political stability in the country as the divide among coalition government and opposition has grown to irreparable level. Moreover, the lack of ownership by the ruling party over the state of affairs and reluctance to carry out much needed and difficult structural reforms have contributed to uncertainty. The political instability at the federal and provincial levels will continue to mount in the coming months until the local government and by-elections are held and timeline for general elections is announced.

The delay in resumption of IMF program is another hurdle for the government. The management of exchange rate, provision of unfunded subsidies, delay in the power sector reforms along with an increase in tariffs and higher than budgeted fiscal deficit, which are in contrast to the commitment with the IMF, will make the resumption of program more challenging as IMF will demand progress on the issues for completion of 9^{th} review. Therefore, the completion of 9^{th} review is expected to be further delayed.

Trade restriction through administrative controls is another point of conflict with the IMF and also a bottleneck for the operation of domestic industry. The government is not allowing the imports of raw materials and necessary inputs for the manufacturing sector. Resultantly, the output of the manufacturing sector will fall significantly in the coming months, which will not only contribute to fall in exports but also the economic growth.

The inflow of export proceeds and remittances through formal banking channels has declined due to prevalence of three exchange rates in the country. Although the government has realized the underlying factors of the problem, no progress has been to return to market-based exchange rate. Therefore, people will continue to use informal banking channels to bring remittances, export proceeds and carry out imports in the short term.

The continuity of Russia-Ukraine war has kept the petroleum and gas prices elevated as Europe has left the conventional source and demand has shifted to the gulf. Resultantly, Pakistan is unable to procure LNG in the required amount which will lead to shortage of energy and slowdown in economic activity. Furthermore, the war is also responsible for hike in the prices of imported food items, which along with floods at home will put extra burden on the foreign exchange reserves. However, with limited reserves, the timely imports of food items will not be ensured and food insecurity will increase in the short term.

Energy sector reforms remained neglected by the government while power and gas sector circular debt continue to soar. The government is likely to increase the prices of utilities as a short-term fix to mend ways with the IMF. Therefore, the consumers will face higher burden and have to adjust their consumption behaviors accordingly.

Inflation continues to soar and essential daily household commodities are getting out of the reach for lower income segments. SBP has done the upward revision of annual inflation range. People will keep experiencing drop in their purchasing powers and standards of living in the remaining half of the fiscal year.

__________End of Section 3_________

ANNEXURE

Table 1: Current Account Indicators of Pakistan

Month	Exports	Imports	Remittances	Current Account Balance
	Million USD			
Oct-21	2,464	6,369	2,629	-1,779
Nov-21	2,901	7,899	2,460	-1,929
Dec-21	2,764	7,580	2,520	-1,857
Jan-22	2,614	6,036	2,144	-2,531
Feb-22	2,820	5,907	2,190	-519
Mar-22	2,777	6,407	2,810	-1,015
Apr-22	2,897	6,661	3,125	-618
May-22	2,626	6,777	2,333	-1,425
Jun-22	2,887	7,722	2,761	-2,275
Jul-22	2,254	4,993	2,524	-1,215
Aug-22	2,482	6,071	2,724	-703
Sep-22	2,446	5,347	2,431	-336
Oct-22	2,384	4,771	2,216	-569
Nov-22	2,391	5,182	2,108	-276
Dec-22	2,304	5,161	2,041	-

Table 2: Foreign Direct Investment in Pakistan

Month	Net	Inflow	Outflow
	Million USD		
Oct-21	247.3	283.6	36.3
Nov-21	158.4	202.7	44.2
Dec-21	229.8	368.6	138.8
Jan-22	110.0	181.6	71.6
Feb-22	90.8	153.2	62.4
Mar-22	-30.4	199.0	229.4
Apr-22	170.6	194.4	23.8
May-22	141.2	167.3	26.1
Jun-22	271.1	293.4	22.3
Jul-22	74.8	124.0	49.2
Aug-22	126.6	143.4	16.8
Sep-22	99.8	157.3	57.6
Oct-22	94.9	119.2	24.3
Nov-22	81.8	166.5	84.7
Dec-22	-17.0	222.0	239

Table 3: Large Scale Manufacturing Sector Growth

Month	QIM	Textile	Wearing Apparel	Food	Chemicals	Pharmaceuticals
Feb-22	0.3	5.21	-6.09	1.46	-3.14	8.14
Mar-22	8.2	38.7	4.8	12.7	9.4	43.1
Apr-22	-13.3	0.43	-55	-10.3	-0.96	7.67
May-22	-1.3	-0.77	-12.3	4.37	3.24	-1.64
Jun-22	0.2	-11	-27	-4.02	-5.02	-6.94
Jul-22	-16.5	-1.37	-0.9	-9.8	-10	-7.17
Aug-22	3.9	-5	-8.4	-26.8	6.8	74.3
Sep-22	0.1	-2.5	-3.2	-24.4	9.7	52.2
Oct-22	-3.62	-24.62	-4.88	-15.04	-7.68	34.14
Nov-22	3.55	-22.04	-13.61	5.26	-7.06	49.7

Table 4: Inflation

Month	CPI	SPI	WPI
Oct-21	1.9	2.1	4.2
Nov-21	3.0	3.6	3.8
Dec-21	-0.02	-0.4	-0.2
Jan-22	0.4	-0.8	0.6
Feb-22	1.2	1.3	1.9
Mar-22	0.8	0.6	3.9
Apr-22	1.6	1.5	3.2
May-22	0.4	0.6	1.4
Jun-22	6.3	6.2	8.2
Jul-22	4.3	7.3	2
Aug-22	2.4	5.2	3.1
Sep-22	1.2	-1.4	1.4
Oct-22	4.7	-1.5	-0.5
Nov-22	0.8	6.1	0
Dec-22	0.5	0.2	-0.7

Table 5: Public Debt of Pakistan

Month	Public Debt	Domestic Debt	External Debt
	Rs. in Trillions		
Oct-21	40.3	26.5	13.8
Nov-21	41.0	26.8	14.1
Dec-21	41.6	26.7	14.8
Jan-22	42.4	27.4	15.0
Feb-22	42.8	27.7	15.1
Mar-22	43.0	28.1	14.9
Apr-22	43.7	28.9	14.8
May-22	44.6	29.0	15.6
Jun-22	47.8	31.0	16.7
Jul-22	50.5	31.1	19.4
Aug-22	49.5	32.1	17.4
Sep-22	49.4	31.4	18.0
Oct-22	50.2	32.5	17.7
Nov-22	50.9	32.9	18.0

Table 6: Domestic Borrowing of Government

Month	Total Credit	SBP Credit to Government	Banks Credit to Government
	Rs. in Billions		
Oct-21	16,549	5,392	11,158
Nov-21	16,759	5,870	10,889
Dec-21	16,691	5,298	11,393
Jan-22	16,700	5,108	11,592
Feb-22	16,547	4,877	11,670
Mar-22	17,562	5,326	12,235
Apr-22	18,111	5,456	12,655
May-22	18,907	5,918	12,989
Jun-22	19,846	5,188	14,658
Jul-22	20,081	5,286	14,795
Aug-22	20,073	4,499	15,574
Sep-22	20,468	5,611	14,856
Oct-22	20,453	4,708	15,744
Nov-22	20,424	4,576	15,848

Table 7: Private Sector Borrowing (Rs.in Billions)

Month	Total Loans to Private Sector	Fixed Term/ Long Term	Working Capital/ Short term	Export Financing
Oct-21	6,145	470	278	632
Nov-21	6,336	493	269	647
Dec-21	6,758	519	329	662
Jan-22	6,615	536	272	664
Feb-22	6,682	552	268	653
Mar-22	6,901	594	277	689
Apr-22	6,961	603	283	700
May-22	7,077	613	281	716
Jun-22	7,153	629	286	728
Jul-22	7,100	637	285	722
Aug-22	7,122	645	279	706
Sep-22	7,235	650	282	698
Oct-22	7,195	646	283	710
Nov-22	7,214	648	291	714

Table 8: Exchange Rate and SBP Reserves

Month	Exchange Rate	SBP Reserves (USD Billions)
Oct-21	172.1	17.2
Nov-21	173.6	15.9
Dec-21	177.7	17.6
Jan-22	176.7	16.6
Feb-22	175.9	16.3
Mar-22	180.1	11.4
Apr-22	185.1	9.4
May-22	196.3	9.7
Jun-22	204.9	9.8
Jul-22	220.6	8.4
Aug-22	221.1	8.8
Sep-22	231.2	7.9
Oct-22	220.9	8.8
Nov-22	222.81	7.7
Dec-22	225.22	5.6

Table 9: Performance of Stock Market

Month	KSE-100 Index Status		Monthly Average	Market Capitalization
	Month Start	Month End		(Rs. in Billions)
Oct-21	44,872	4,6185	45,528	7,931
Nov-21	46,975	45,072	46,024	7,759
Dec-21	45,369	44,596	44,983	7,622
Jan-22	44,887	45,375	45,131	7,705
Feb-22	45,675	44,461	45,068	7,703
Mar-22	44,804	44,929	44,866	7,481
Apr-22	45,152	45,249	45,200	7,519
May-22	44,841	43,078	43,960	7,136
Jun-22	42,756	41,297	42,026	6,922
Jul-22	41,540	40,276	40,908	6,790
Aug-22	40,075	42,195	41,135	7,015
Sep-22	42,460	41,013	41,737	6,760
Oct-22	41,129	41,602	41,365	6,741
Nov-22	41,204	42,071	41,668	6,733
Dec-22	42,348	39,747	41,048	6,382