PRIME
ECONOMIC THINK TANK

Prime Plus
April 2023

A quarterly report on Pakistan's economy and pillars of economic prosperity

Policy Research Institute of Market Economy

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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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Table of Contents

List of Figures

List of Tables:

Overview

In the first section of the report, the progress on the pillars of economic prosperity is critically analyzed using time series data. The report argues that no substantial progress has been made in terms of structural reforms that contributed to suboptimal performance and the prevalence of deep-rooted issues in the economy. The government needs to move ahead with the challenging but inevitable reforms by easing regulations and creating a business-enabling environment.

In Section 2 we present macroeconomic data for the third 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 drop in foreign exchange reserves to alarmingly low levels and volatility in the exchange rate. Petroleum and gas prices have moderated in recent months, but the unavailability of forex constrains the government to ensure timely procurement. The government has managed to bring down the current account deficit than the budgeted amount at the cost of the overall economy. The economic activity, especially the output of the manufacturing sector, has experienced a declining trend due to adoption of import substitution policy, the uncertain economic environment, and implementation of administrative controls to stop imports. Therefore, proactive measures at the fiscal and monetary policy fronts are needed 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.

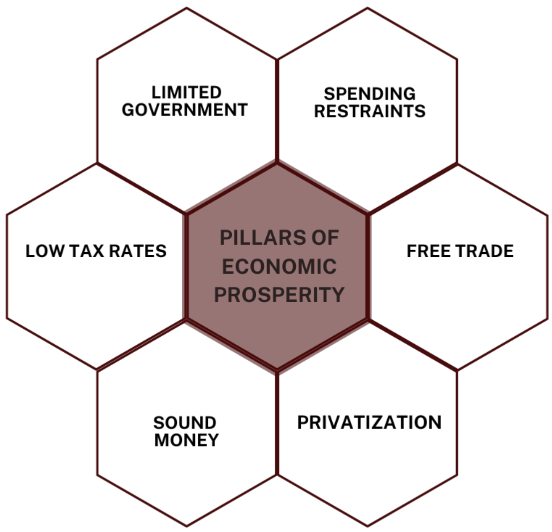
Section 1

1. TRACKING PROGRESS ON THE PILLARS OF ECONOMIC PROSPERITY

Countries around the globe are struggling from economic challenges on the back of disruptions initially caused by COVID-19, the Russia-Ukraine war and subsequently, from fiscal pressures and inflation due to monetary growth from relief packages and prevalence of supply chain disruptions. The challenges encompassing Pakistan exacerbates due to floods in 2022 and political uncertainty.

Pakistan has been facing twin deficits for years and the current economic crisis is also an amalgamation of both. At the start of FY 2023, the government budgeted a growth 5 percent; however, trade restrictions, steep fall in foreign exchange reserves, political uncertainty, cessation of IMF program and economic slowdown pushed the government and multilateral to downgrade the forecast to around 3 percent and recently all multilaterals have forecasted growth in the range of 0.4 to 0.6 percent.

Dr. Arthur B. Laffer evaluated the underlying causes of recurring economic crises in Pakistan and put forth 6 pillars i.e., limited government, spending restraint, low taxes, free trade, Sound Money and privatization, to be inevitable for economic prosperity. This report analyzes the progress made by the government in those 6 key areas over a period of time.



Pillars of Economic Prosperity (Arthur B. Laffer, 2021)

1.1. Limited Government

1.1.1. Size of the government

The role of the government varies in literature from stabilization of economy through policy interventions to creating enabling environment for the private sector through regulations to spur economic growth. It is imperative to understand that the government is entrusted to provide services that are not feasible for the private sector to provide; however, this does not necessitate the presence of the government in businesses besides a regulator nor acknowledges the role of the government in providing employment.

1.1.2. Government regulations

Pakistan is a highly regulated country where myriad approvals are required from the government to carry out businesses. Although there is no readily available measure to assess the prevalence of regulations; however, time required to get necessary approval and cost of getting approvals could be used to examine government regulations (Table 1). The time required to set up a business increases due to involvement of multiple government agencies and preparation of documentation. Moreover, the numerous steps in getting approvals increases the overall cost of the regulation.

Table 1: Government regulations and Associated Costs

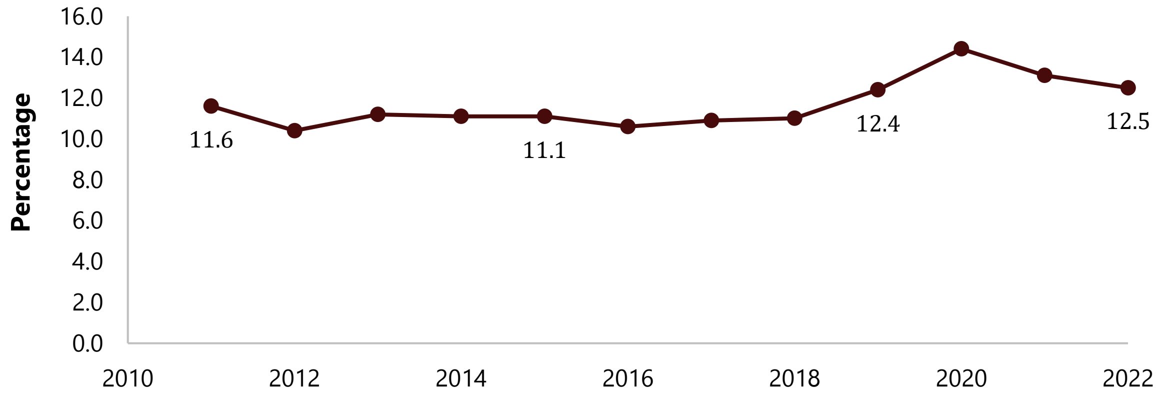
Sr. No.	Activity	Time Taken for Approval	Number of Agency Visits	Cost of Regulation
1	Opening a Restaurant	5.7 months	31	Rs. 110,040
2	Opening a hotel	1.5 years	75	Rs. 11 million
3	Cash & Carry Business	5 months	36	Rs. 375,800
4	Intercity private bus service business	2.1 years	91	Rs. 750 million
5	Business loan from Bank	3.7 months	12	Rs. 24,000
6	Residential Electricity Connection in Islamabad	5.3 months	12	Rs. 12,100
7	Commercial Electricity Connection in Islamabad	4.8 months	12	Rs. 81,700
8	Registration of New Medicine	1.7 years	28	Rs. 200,000
9	Software house / IT business	3.7 months	18	Rs. 42,710
10	Obtaining Intellectual Property Right	1.9 years	37	Rs. 200,000

Source: Sludge Series, PIDE

1.1.3. Government spending as a percentage of GDP

The continuous increase in the scope and scale of government's responsibilities result in higher government spending and requirement for more funds. The government's expenditures as a percentage of GDP is illustrated in Figure 1. Overtime, there is an increase in overall government spending starting from 11.6 percent in 2011 to 12.5 percent in 2022. Among the federal expenditures, the Debt servicing and Defense spending are the most prominent expenditures ranging up to 4.7 percent and 2.1 percent respectively.

Figure 1: Federal Current Expenditures as a Percentage of GDP



Source: Pakistan's Fiscal Operations, Ministry of Finance

The increase in the size of the government by increasing scale and scope of responsibilities results in higher government footprint in the economy, which is a movement against the pillars of economic prosperity.

1.2. SPENDING RESTRAINTS

Fiscal discipline is the building block of sustainable growth and economic prosperity. Excessive spending has multifaceted impact on the economy starting from putting pressure on the government to raise taxes to generate revenues, prompting the government to borrowing money from commercial banks thus resulting in buildup of debt and simultaneously, pushing the government to borrow money from bilateral, multilateral and international financial institutions to finance expenditures and imports of the country. All these factors end up with reducing financial space for private businesses and people to operate in markets and subsequently, the economic slowdown.

Fiscal discipline has a direct relation with economic growth as indicated by Von Hagen and Harden (1995)[1]. In addition, spending restraints to achieve balanced budget not only promotes economic growth but also fosters economic activity in the country and helps in job creation (Alesina and Perotti, 1996)[2]. Similarly, Reinhart and Rogoff (2010)[3] stated

[1] Von Hagen, J., & Harden, I. J. (1995). Budget processes and commitment to fiscal discipline. *European Economic Review*, *39*(3-4), 771-779.

[2] Alesina, A., & Perotti, R. (1996). Fiscal discipline and the budget process. *The American Economic Review*, *86*(2), 401-407.

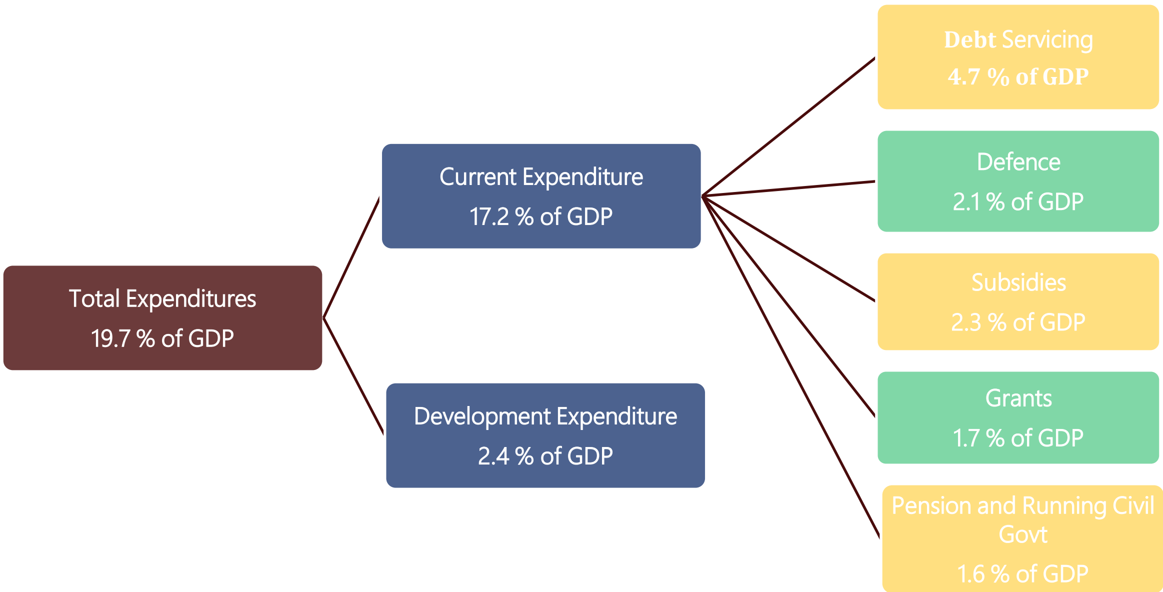
[3] Reinhart, C. M., & Rogoff, K. S. (2010). Growth in a Time of Debt. *American economic review*, *100*(2), 573-578.

that countries with high levels of debt experience slow growth and fiscal discipline helps to prevent financial crises. The aforementioned literature provides empirical evidence suggesting that fiscal indiscipline at home not only distorts economic activity at home but also makes a country vulnerable to external shocks.

1.2.1. Composition of the government expenditure

The government spending is skewed towards recurring expenditures which are not growth oriented while having a role to play in jacking up prices. The composition of the government expenditures is illustrated in *figure 2*.

Figure 2: Federal Government Expenditures

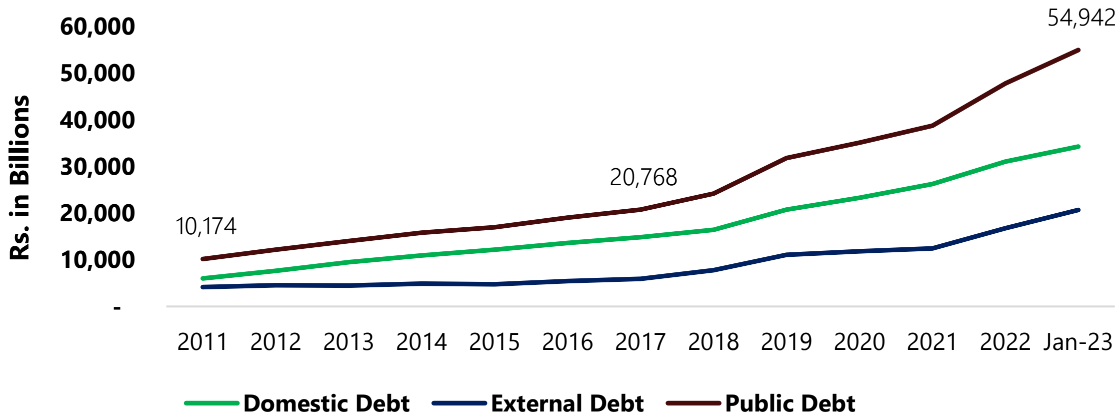


The development spending remains the least priority of the governments due to limited fiscal space and is the first area experiencing cuts when budget deficit soars. The point of concern is that debt servicing is the biggest expenditure of the federal government, which increased to 4.7 percent of GDP, more than 36 percent of total budget and more than 50 percent of FBR tax revenues in FY 2022. The next expenditure in line is the Defense affairs, which was 2.1 percent of GDP, 15 percent of total expenditures, and 23 percent of FBR tax revenues.

Subsidies also emerged as a major expenditure in FY 2022. The government spent Rs. 1.52 trillion as subsidies, more than double of the budgeted amount. The subsidy expenditure was 2.3 percent of GDP, more than 16 percent of total expenditures and around 25 percent of the FBR tax revenues. The transfers of divisible pool share to the provinces under 7th NFC Award, debt servicing, defence and subsidies leave little room for the federal government to carry out development activities in the country.

Resultantly, the government had to borrow money to finance the expenditures. It is pertinent to mention that now, the government is not only borrowing to return the previously borrowed money but also to finance current expenditures. This resulted in the accumulation of debt *(Figure 3).*

Figure 3: Central Government Public Debt



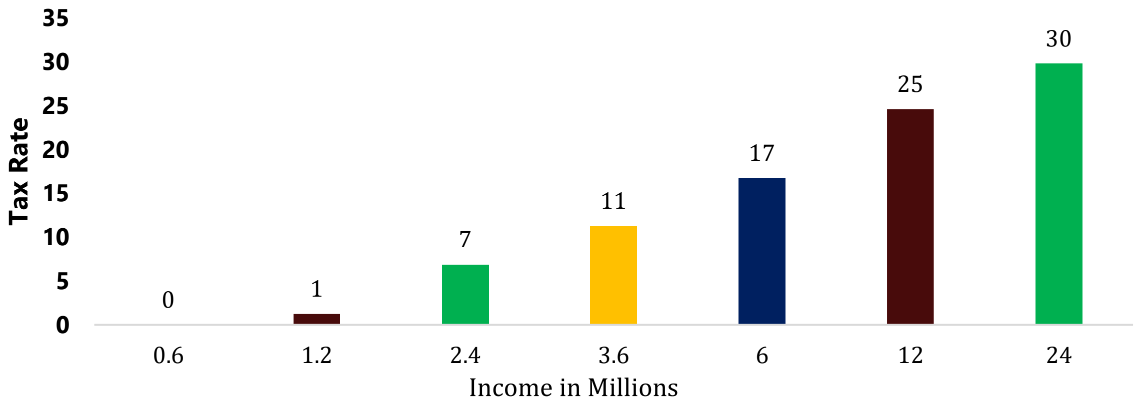
Source: State Bank of Pakistan

The central government public debt increased by 292 percent from Rs. 12.1 trillion in 2012 to Rs. 54.9 trillion in 2022. Of the total public debt, more than 62 percent i.e., Rs. 34.2 trillion is the domestic debt while 38 percent i.e., Rs. 20.6 trillion is the external debt. The accumulation of the debt puts pressure on the public finance in the form of debt servicing and leaves little room for development activities.

1.3. LOW TAX RATES

The taxation system of Pakistan is complex due to plethora of taxes and rates of taxes, which makes it also difficult to administer by the authorities. Moreover, the current taxation system is regressive in nature as the country relies more on indirect taxes and less on direct taxes. The underlying reason behind higher dependence on direct taxes is that people are reluctant to become part of tax base and pay income tax at high rates. The effective tax rates applicable on income is illustrated in *Figure 4*. Let alone income tax rates are high and the government levied super tax on income greater than Rs. 150 million.

Figure 4: Effective Tax Rate on Salaried Income



Source: Federal Finance Bill 2023

In contrast, indirect taxes continues to remain the major revenue source for the government. The main components of the indirect taxes are sales tax, customs duty and federal excise duty. Sales tax is the top revenue generating source of FBR with a share of around 41 percent in total revenue collection. Recently, the government presented a supplementary finance bill in February 2023 and raised rates of sales tax to increase revenue collection the sales tax rates are shown in Table 2.

Table 2: Standard Rates of Sales Tax on Goods and services

Nature of sales tax	Authority	Federal	Punjab	Sindh	KPK	Balochistan
Sales tax on goods	FBR	*18%	17%	17%	17%	17%
Sales tax on services	Federal – FBR Punjab – PRA Sindh – SRB KPK – KPRA Balochistan- BRA	16%	16%	13%	15%	15%

**Rate increased to 18% from 17% w.e.f. 23.02.2023 vide Finance (Supplementary) Act, 2023*

The analysis indicates that the taxation system is intricate on the back of a number of taxes and high rates of taxes, which make the administration difficult and inculcates reluctance among people to become part of tax base.

In the Finance Supplementary Bill 2023, the government increased the taxes on cigarettes in an attempt to generate more revenues. The government raised Federal excise duty on cigarettes up to 150 percent (Table 3). The revenue collection in Jul-Mar 2022 was around Rs. 85 billion; whereas, despite the increase in taxes, it increased by 14 percent to Rs. 97 billion. According to Pakistan Tobacco Company (PTC), more than 100 brands of smuggled cigarettes have penetrated the market and the government is unable to regulate the market. PTC highlighted that the sales of legitimate cigarettes stand at 1.84 billion sticks in March 2023 as compared to 4.84 billion sticks in January 2023 before raising taxes and the sale of smuggled cigarettes increased by 30 percent during March 2023[4] alone.

Table 3: Federal Excise Duty on Cigarettes

Product Type	Old FED	New FED	Increase (%)
Tier 1 cigarettes	Rs. 130	Rs. 330	154
Tier 2 cigarettes	Rs. 41	Rs. 101	146

1.4. SOUND MONEY

A stable currency is a cardinal factor in facilitating and promoting business activities in the country. A stable currency provides an auspicious ambience for investors; whereas, a volatile and fluctuating currency diminishes the investors' confidence in the country and contributes to capital flight. Pakistan is also struggling from currency volatility not only due to weak economic fundamentals of the country but also due to imprudent policymaking in the country.

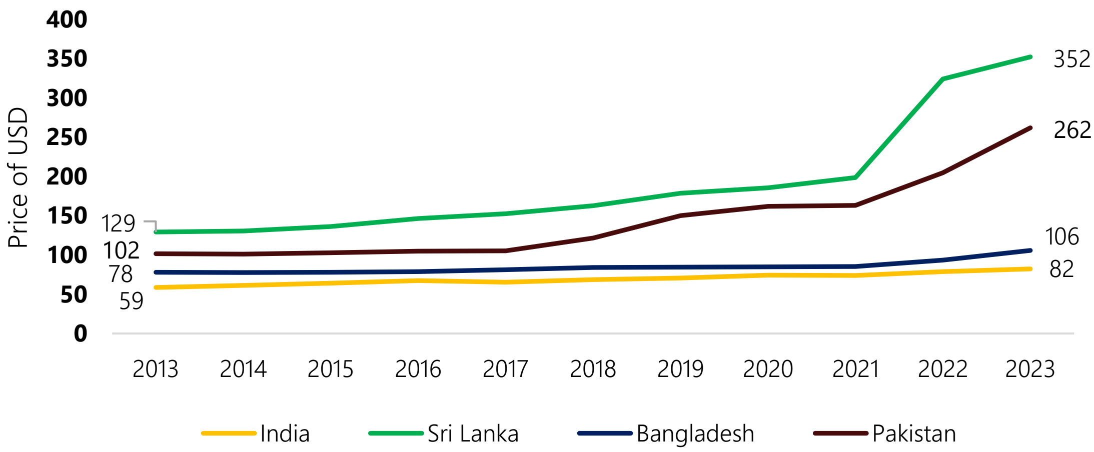
1.4.1. Exchange rate depreciation

The Pakistani rupee experienced significant deterioration in the exchange rate due to fall in the inflow of forex and higher outflow. Among regional peers, Pakistani currency lost its value by more than 150 percent in last 10 years and more than 60 percent since the COVID outbreak (Figure 5). In contrast, Bangladeshi currency lost its value by 25 percent,

[4] https://profit.pakistantoday.com.pk/2023/04/12/cigarette-smuggling-plummets-by-39-in-just-two-months-due-to-recent-fed-hike/#:~:text=PTC%20officials%20recorded%20a%2030,in%20full%20letter%20and%20spirit.

India by 11 percent and Sri Lanka by 90 percent after the start of COVID-19.

Figure 5: Reginal Comparison of Exchange Rate



Source: Exchange Rates, UK

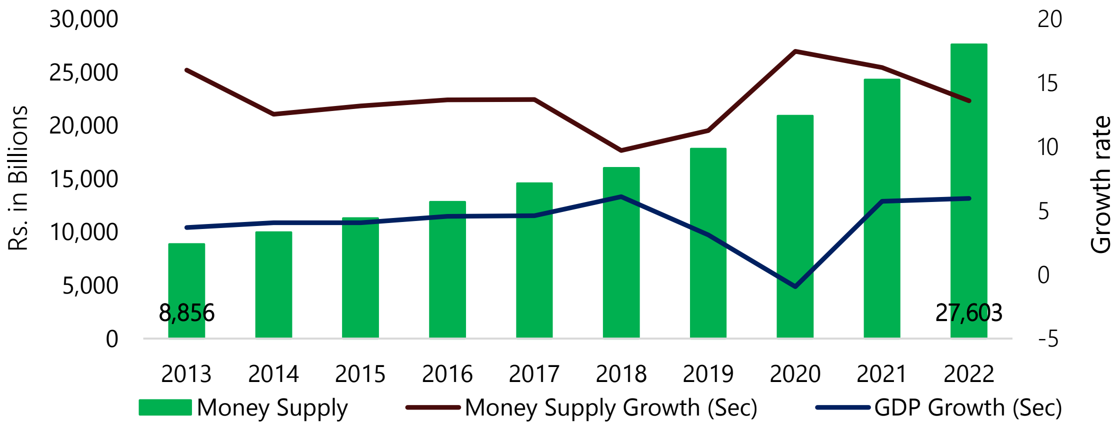
There are several factors in play for the steep fall in the value of rupee and most important is the management of the exchange rate by the government. Pakistan has been pursuing the policy of managed exchange rate intermittently, which has not only prevented the currency to realize its real market value but also led to deterioration of the country's foreign exchange reserves.

The recent stint of the government after the combined IMF 7th/8th reviews of fixing the exchange rate resulted in the creation of a grey market in the country. The exchange rate management led to the emergence of three exchange rates in the country; interbank rate, open market rate and black-market rate at which currency was traded. This management of exchange rate for several months was the cardinal factor behind the deadlock between the Government Of Pakistan and the IMF. Until now, the government could not succeed in reviving the IMF program and the country's foreign exchange reserves are insufficient to provide cover for even one month of imports.

1.4.2. Increase in money supply

Another important factor that contributed to depreciation of exchange rate is profligate government spending thorough borrowing and subsequent rise in the money supply. The rise in money supply can also be attributed to the government's relief package for the revival of economy after COVID outbreak. The growth in money supply has been significant in last couple of years (Figure 6). The growth in money supply was 211 percent in 10 years while after pandemic has been more than 32 percent till June 2022.

Figure 6: Monetary and Output Growth



Source: State Bank of Pakistan

In contrast, the growth in output of the country remained miniscule against the monetary growth and this contributed not only to inflation but also to higher trade and current account deficits, which translates into depreciation of exchange rate.

1.5. REDUCE TRADE BARRIERS

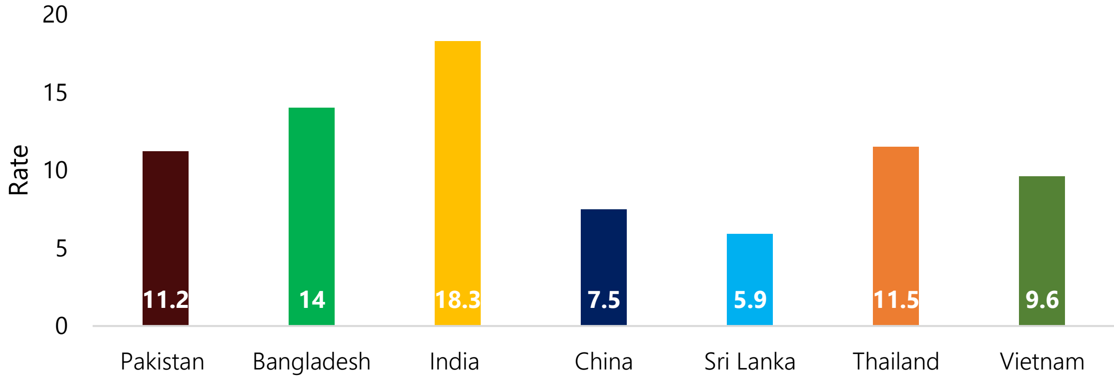
Trade is an important component of the economy which not only facilitates transfer of knowledge and technology but also provide access to necessary raw materials and inputs to carryout manufacturing activities in the country. The county's history is ripe of intermittent policy fluctuations between trade and trade restrictions. The rationale behind restriction on trade is to bring down the trade deficit and subsequently, the current account deficit. However, the deficits increase exponentially after easing restrictions and government resorts to new restrictions.

1.5.1. Pakistan's tariff profile

Pakistan is believed to be a highly protected country with high tariff and non-tariff barriers. Though the protection still exists and is high, it is not exponentially higher than the neighbors and peers (Figure 7). The average Most-Favored-Nation tariff rate of Pakistan is 11.2 percent as compared to 18.3 percent in India, 14 percent in Bangladeshand

11.5 percent in Thailand. Whereas, Vietnam, China and Sri Lanka have lower rates of 9.6 percent, 7.5 percent and 5.9 percent respectively. Therefore, Pakistan is not as protected as it is perceived but the tariffs are still high and needs to be brought down to facilitate trade.

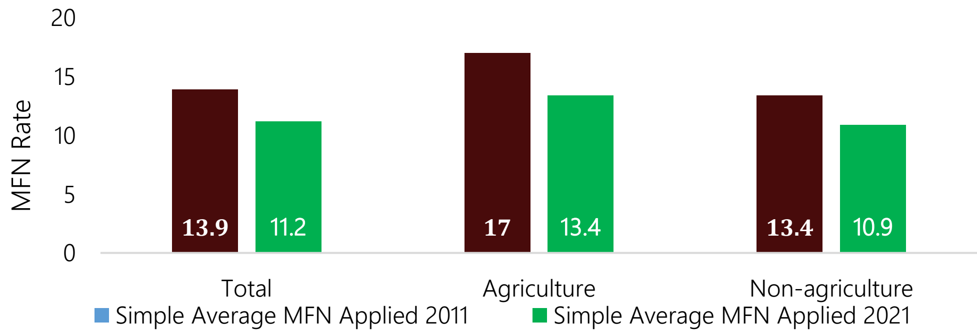
Figure 7: Simple Average MFN Applied



Source: Country Profile, WTO

The analysis on the extent of protection requires decomposition of the level of protection across sectors. Pakistan has fared well in terms of lowering the tariffs. The average MNF applied rate of Pakistan was 13.9 percent in 2011 and it was brought down to 11.2 percent in 2021 (Figure 8). Similarly, the tariffs applicable for the agriculture sector were brought down 17 percent to 13.4 percent and non-agriculture sector was brought down from 13.4 percent to 10.9 percent respectively. Moreover, the tariffs have been brought down across majority of groups with some categories experiencing significant reductions like chemicals and non-electrical machinery, while some categories experienced an increase in protection like petroleum (Table 3)

Figure 8: *Pakistan's Tariff Profile*



Source: Country Profile, WTO

Table 4: Category Wise Tariff Application

Product	MFN Applied Duty 2021		MFN Applied Duty 2011	
	Average	Maximum	Average	Maximum
Minerals & metals	10.2	35	12.4	35
Chemicals	5.9	20	9.6	53
Petroleum	11.3	20	10.7	25
Electrical machinery	12.1	35	14.8	35
Non-electrical machinery	5.3	35	9.3	35
Oilseeds, fats & oils	7.7	20	8.8	25

1.5.2. Imports restrictions as a measure to control current account deficit.

Time and again the government has resorted to restrictions and administrative controls to restrict trade and current account deficits; however, one thing the government did not realize that this policy has proved futile throughout our history and expecting different results is imprudent. Nonetheless, the Government Of Pakistan resorted again to import substitution policy in 2022 by using administrative controls to manage looming balance of payment crisis.

The balance of payment crisis started to get worse in 2022 with the growing difference between inflow and outflow of dollars. In 2021, the current account deficit was $2.8 billion but not due to exceptional exports but due to fall in aggregate demand from COVID enforced restrictions and lockdowns. Later, with mass vaccinations and opening up of the economy, the aggregate demand increased albeit an increase in international commodity prices due to supply chain disruptions and Russia-Ukraine war. Resultantly, the current account deficit rose to $17.2 billion in FY 2022 and the country's forex fell to $9.8 billion.

Therefore, the Government Of Pakistan took administrative steps to restrict imports to control outflow of Forex. These steps include nominating some tariff lines as luxury/nonessential imports and banning the imports of those commodities (33 categories of the goods comprising 860 tariff lines). These products accounted for a mere 4.8 percent of total imports in FY 2021. Pakistan under the IMF program was forced to open trade for the completion of IMF 7th/8th reviews so government lifted the ban in

August 2022 but slammed regulatory duty up to 400 percent to ensure that imports cannot be happen.

The State Bank of Pakistan also used administrative controls in the form of blocking the opening of Letter of Credits (LCs) and increasing the cash margin requirement. Until now, the SBP claims that these restrictions have been removed and the government is slowly opening up the imports but this in in contrast to reality. The imports are still restricted, and manufacturing sector is gradually moving towards the brink of closure. The outcome of trade restriction has been positive but won't be sustainable and as soon as restrictions are lifted, the deficit will rise exponentially. The current account deficit declined from $12 billion to $3.86 billion in 8MFY 2023 (July-February). But the downside is halt in manufacturing activities and significant slowdown of economy.

The restrictions imposed in the form of regulatory duty were lifted after 31st March 2023. This will initiate some ease in the opening up of imports. However, the restriction on the opening of LCs is still in place and will continue to hinder the imports.

1.6. PRIVATIZATION

The performance of state-owned enterprises (SOE) has remained a challenge for the governments in last couple of decades. At independence, there were only 12 SOEs in Pakistan. This number gradually increased in the 1950s and 1960s and later nationalization in 1970s resulted in creation of numerous SOEs. Although the process of reversal of nationalization initiated in the 1990s and 172 transactions were completed till 2015. The process of privatization slowed down afterwards and governments remained unsuccessful to complete even one transaction.

There are currently 85 commercial SOEs in Pakistan, 83 subsidiaries attached to one or more SOEs, and 44 non-commercial entities, according to *State Owned Enterprises Triage: Reforms and Way Forward 2021*. The total losses of commercial SOEs in FY 2019 was Rs. 143 billion and Rs. 287 billion.[5] On the revenue side, the total revenues of SOEs was Rs. 4 trillion and the book value of their assets was Rs. 21 trillion[6]. The overall financial performance of SOEs recorded a profit of Rs. 204 billion in FY 2014. Later, the profits decline to Rs. 61 billion in FY 2015 and then morphed into a loss in FY 2016. Since then, the SOEs have been continuously incurring losses.

[5] The latest estimate of losses is not available publicly on Ministry of Finance Website.
[6] Dr. Ishrat Husain (2022). The Future of State-Owned Enterprises in Pakistan. CDPR.

Every year the government not only envisages cutting losses of state-owned enterprises but also to generate revenues from sell offs. In FY 2022, the government projected collection of Rs. 252 billion from privatization and in FY 2023, Rs. 96 billion. The government and all political parties though support privatization but could not complete one transaction due to political considerations and potential fallout in the form of lost political capital.

At the moment there are several SOEs under consideration for privatization such as power sector distribution companies, house building and finance cooperation, Pakistan Steel Mills, Pakistan International Airlines, Jinnah Convention Center and many more public properties. These entities have been under consideration for years now but no significant progress has been made so far.

1.7. WAY FORWARD

The progress on the pillars of economic prosperity has been dismal as the majority of the economic indicators have deteriorated. The underlying reasons behind this unsatisfactory performance are inefficiency emanating from excessive government footprint in the economy, conflict of interest due to simultaneous roles of government in the form of doing business and regulation as well, inability of the government to realize the how to raise revenues when everyone is paying tax in the form of sales tax, and absence of determination among the policymakers and bureaucracy to curtail bleeding of public finances. Therefore, the following suggestions are in order:

1. The role of the government and its presence in the economy should be reevaluated to ensure the elimination of conflict of interest i.e. business and regulation.
2. Expansion in the scope and responsibilities of the government will only make the provision of public services inefficient so long as the core functions of the government remained neglected.
3. The insinuation that people do not pay taxes is far from reality as everyone single individual in the country pays tax i.e., sales tax. The problem lies in the complex nature of taxation system and multiplicity of taxes and rates, which needs to be simplified to promote compliance.
4. The profligate spending of the debt-ridden government is bound to put country on verge of collapse. The rationalization of public expenditure is the only way to ensure economic prosperity.
5. Trade restrictions have never worked in the past and only led to exponential deficits upon removal. The government needs to realize that sustainable growth will only

come from reducing trade barriers and exposing local industries to international competition as prolonged protection has crippled our industry.

6. The government cannot continue to borrow money from the banking sector for recurring expenditures, as it increases money supply thus causing inflation and also crowds out the private sector.
7. The government's manipulation in the money market has put the IMF program in jeopardy and country on the brink of default. The government needs to let market forces determine the exchange rate.
8. The state-owned enterprises need to be privatized on priority basis to reduce pressure on the national exchequer and create conducive environment for the private sector to operate.

Section 2

2. ECONOMIC ANALYSIS

The countries around the world are moving towards economic recovery amid stronghold of challenges like inflation and pressure on public finance, and emergence of new challenges like natural calamities. The continuity of Russia-Ukraine war has disrupted the food supply chain resulting in the hike in food prices. The petroleum prices are also not stable due to war and recent announcements made by Saudi Arabia to scale down the daily production of oil. The biggest concern for the developing countries is to manage finances domestically and externally as high international commodity and petroleum prices have raised prices of commodities at home also. The governments have raised policy rates to cater inflation but the inflationary pressures seems to remain anchored in the short term. The financial sector also experienced some jolts recently with run over of banks in the United States and raised questions about the health of the sector. Although there is some positive development also such as revival of diplomatic ties between Saudi Arabia and Iran, which will create stability and peace in the Middle East and promote economic prospects for Pakistan by fostering trade and integration.

The third quarter of FY 2023 (January-March) remained challenging for Pakistan and envisages continuity of distress as majority of economic fundamentals have experienced deterioration. The economic woes are attributed to imprudent policies adopted by the incumbent government which not only brought economic activities to a halt in the country but also contributed to strengthening of inflationary pressures. Moreover, the government was unable to curtail fiscal slippages due to which budget deficit is expected to be higher than the budgeted amount. The government's stint of fixing the exchange rate from September 2022 to February 2023 resulted in depreciation in exchange rate, prevalence of grey money market and loss of foreign exchange reserves. Furthermore, the government remained unsuccessful to revive the stalled IMF program due to continuous deviations from the agreed roadmap.

2.1. INFLATION

Inflation remained anchored against the expectations of the government and the State Bank of Pakistan. In the third quarter of the FY 2023, average national CPI stood at 31.5 percent as compared to 12.6 percent in the previous year, SPI stood at 34.8 percent as compared to 17.5 percent and WPI stood at 34 percent as compared to 23.8 percent last year. The July-March average inflation stood at 27.2 percent as compared to 10.7 percent last year. Moreover, the average urban inflation cloaked at 25 percent and rural inflation cloaked at 30.5 percent in the corresponding period. The upsurge in inflation can be attributed to existential high international commodity prices, currency devaluation by 25 percent, and raise in taxes, especially the sales tax in the supplementary finance bill 2023. Moreover, the recent floods can also be attributed to the hike in the prices of food items. Despite an increase in the policy rate by 100bps in January 2023 and 300 bps in March to 20 percent, the inflation remained unfettered. The Russia-Ukraine war continues to disrupt the supply chain of food and petroleum items and thus result in volatility in prices.

2.2. FISCAL SECTOR

The public finance has remained under pressure due to higher-than-expected expenditures on debt servicing due to increase in the policy rate, higher spending on social protection, and on population census. However, the overall performance of the government on the fiscal side remained satisfactory as the government was able to restrict fiscal deficit at 2.3 percent of GDP or Rs. 1.97 trillion in the first seven months of the FY 2023 as compared to 2.8 percent of GDP or Rs. 1.89 trillion last year.

The total government expenditure stood at Rs. 5,058 billion in Jul-Jan 2023 against the spending of Rs. 4,592 billion last year. This illustrates an increase of 10 percent in government spending. The decomposition of the government spending shows that spending on debt servicing increased by more than 70 percent and non-markup spending declined by more than 25 percent. The government increased the allocation for social protection by Rs. 40 billion from Rs. 360 billion to Rs. 400 billion. Moreover, the government also announced Ramzan Package for distribution of food items at subsidized rates.

The curtailment in fiscal deficit was achieved on the back of cut is development spending and increase in tax collection by raising tax rates through supplementary Finance Bill 2023. One of the most prominent feature was the increase in sales tax from 17 percent to 18 percent. The government collected Rs. 1,064 billion in the first two months of the third quarter of FY 2023 as compared to the collection of Rs. 873 billion last year. Moreover, the total collection in eight months of FY 2023 increased by around 18.8 percent and stood at Rs. 4,492 billion against Rs. 3,778 billion last year. The total revenue collection was less than the targeted amount by Rs. 198 billion, which prompted the government to present the supplementary bill.

The government spending outpaced the revenue collection and therefore, the government had to borrow money from domestic and external sources. The total government borrowing from domestic banking sector increased by Rs. 1.39 trillion in the first two months of the third quarter of the FY 2023 as compared to a decrease of Rs. 144 billion last year. The government borrowing stood at Rs. 21.7 trillion till the end of February 2023. In the first two months of the third quarter of the FY 2023, the government borrowed Rs. 239 billion from the State bank of the Pakistan and total borrowing stood at Rs. 5.59 trillion. Similarly, the government borrowed Rs. 1.15 trillion from commercial banks in January and February, and the total borrowing cloaked at Rs. 16.1 trillion.

The government borrowing from domestic and international sources resulted in the accumulation of debt. In the first two months of third quarter of the FY 2023, the public debt (central government debt) increased by Rs. 3.5 trillion and stood at Rs. 54.4 trillion. On the domestic side, the domestic debt increased by Rs. 1 trillion in the first two months of the third quarter of FY 2023 and stood at Rs. 34.1 trillion. The external debt increased by Rs. 2.43 trillion in the same period and cloaked at Rs. 20.3 trillion at the end of February 2023.

2.3. FOREIGN INVESTMENT

The inflow of the foreign investment in Pakistan improved in the first two months of the third quarter of the FY 2023 as compared to the previous year. The net FDI was $323.5 million (January and February) as compared to $200.8 million last year. The inflow of FDI was $364.5 million and outflow was $40.9 million. The net FDI in first eight months of the FY 2023 stood at $ 784.4 million as compared to $ 1,315.5 million last year, a decline of $531.1 million. The global uncertain economic environment, recessionary trends, increase in the policy rates abroad, political instability and uncertain economic environment at home due to inability of the government to resume IMF program are the factors resulting in the reluctance of foreign investors to invest in Pakistan.

2.4. CREDIT TO PRIVATE SECTOR

The private sector borrowing illustrated a declining trend in the third quarter of FY 2023. The total private sector borrowing declined by Rs. 219 billion in the first two months (Jan-Feb) of third quarter of FY 2023 as compared to a fall of Rs. 76 billion in the same period last year. The total private sector borrowing stood at Rs. 7.43 trillion till the end of February 2023. The long-term fixed financing (LTFF) increased by Rs. 8 billion in January and February 2023 as compared to the growth of Rs. 33 billion last year. The LTFF stood at Rs. 641 billion till the end of February 2023. The short-term financing (working capital) decreased by Rs. 3 billion in Jan-Feb as compared to a fall of Rs. 61 billion last year and total short-term financing stood at Rs. 305 billion till the end of February 2023. The private sector borrowing under export financing scheme decreased by Rs. 7 billion in Jan-Feb as compared to a fall of Rs. 9 billion last year and total export financing stood at Rs. 706 billion. The overall decline in private sector borrowing can be contributed to the high cost of borrowing and contraction of economy from restriction on the imports of raw materials. In January 2023, the Monetary Policy Committee (MPC) increased the policy rate by 100 basis points to 17 percent and in March 2023, the MPC increased the policy rate by 300 basis points to 20 percent to cater the inflationary pressures.

2.5. MANUFACTURING SECTOR

The performance of large-scale manufacturing (LSM) remained subdued due to uncertain economic environment in the country. The government-imposed restriction on the opening of LCs to restrict imports and subsequently, the current account deficit. Resultantly, the industry has to halt operations for weeks in several months due to unavailability of necessary raw materials. LSM output increased by 1.48 percent (MoM) in January 2023 as compared to December 2022. Whereas, the LSM output declined by 7.90 percent in January 2023 as compared to January 2022. The LSM output in first seven months of FY 2023 declined by 4.40 percent.

2.6. EXTERNAL SECTOR

On the external front, Pakistan remained under pressure due to the unavailability of foreign exchange reserves to finance imports and fulfill debt servicing obligations. Resultantly, the government had to impose several administrative restrictions to manage foreign transactions. The exports of Pakistan declined by 17 percent in third quarter of FY 2023 as compared to the last year and by 3.9 percent as compared to second quarter of FY 2023. Total exports stood at $6.8 billion in the third quarter where exports in January, February and March were $2.24 billion, $2.19 billion and $2.36 billion respectively. The imports of country declined by 30.6 percent in the third quarter of FY 2023 as compared to the last year and by 15.7 percent as compared to second quarter of FY 2023. Total imports stood at $12.7 billion in the third quarter where imports in January, February and March were $4.87 billion, $4.03 billion and $3.82 billion respectively.

The total trade deficit declined by 41 percent in third quarter of FY 2023 as compared to last year and 26 percent compared to second 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 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 10 percent in the third quarter of FY 2023 as compared to last year and increased by 0.8 percent compared to second quarter of FY 2023. Pakistan received remittances of $6.41 billion in the third quarter of FY 2023 as compared to an inflow of $7.1 billion last year and $6.36 billion in the second quarter of FY2023. The significant fall in remittances is due to shift of inflow of money from formal banking channels to informal channels till the exchange rate was fixed and then inflow improved after the government moved towards market-based exchange rate.

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 January and February was $304 million as compared to $3 billion last year. The current account deficit in January and February was $230 million and $74 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 25 percent i.e., $1.4 billion in third quarter of FY 2023 from $5.6 billion at the end of December 2022 to $4.2 billion at the end of March 2023. In the third quarter of FY 2023, the government was unable to reach staff level agreement with the IMF team and complete the 9th review of the IMF program, which promoted uncertainty and contributed to expeditious depletion of reserves.

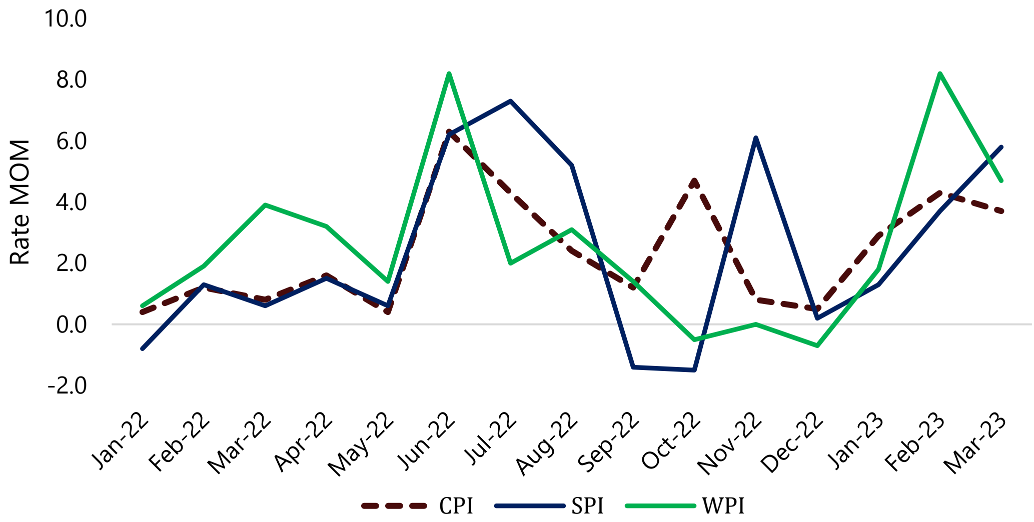
The decline in forex to low levels, which are not sufficient to finance imports of even one month, and rising external financial obligations exerted more pressure on the local currency. The exchange rate in the third quarter of FY 2023 depreciated by 25 percent from Rs. 225 at the end of December 2022 to Rs. 281 at the end of March 2023.

2.7. BUSINESS ENVIRONMENT

The economic certainty deteriorated significantly in the third quarter of FY 2023 due to a colossal drop in the foreign exchange reserves, unfettered inflation, slowdown in manufacturing activities and emergence of conflict between the government and judiciary regarding general elections, and between parliament and judiciary regarding powers of the chief justice. 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 third quarter was 40,816 and it declined to 39,848 at the end of March 2023, a decline of 2.4 percent in a quarter. The stock position declined by 11 percent as compared to March 2022. The market capitalization dropped by 18.5 percent in the third quarter as compared to March 2022 last year and by 4.5 percent as compared to second quarter of FY 2023. The total market capitalization till the end of March 2023 stood at Rs. 6.1 trillion.

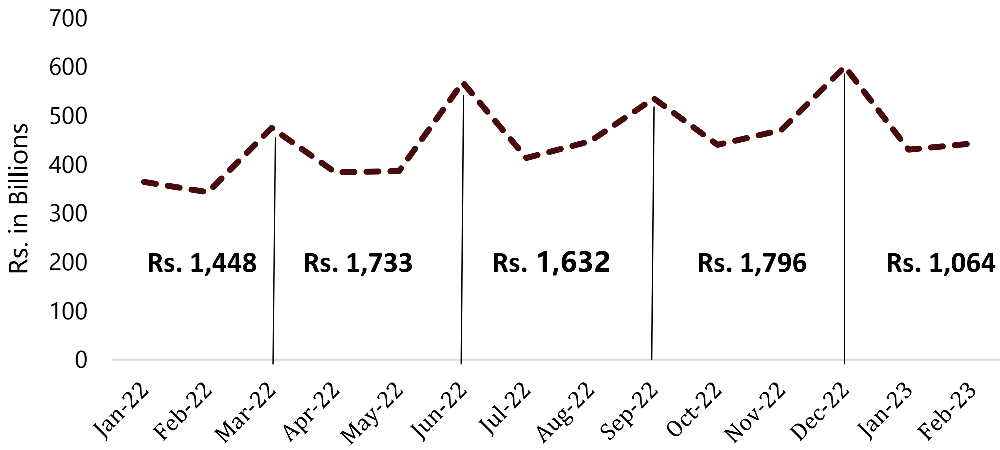
2.8. MACROECONOMIC INDICATORS

Figure 9: Inflation



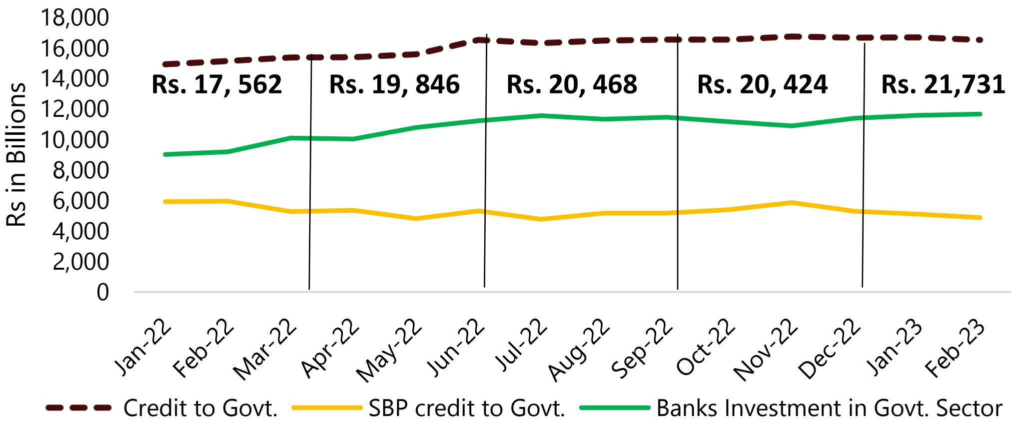
Source: Pakistan Bureau of Statistics

Figure 10: Revenue collection



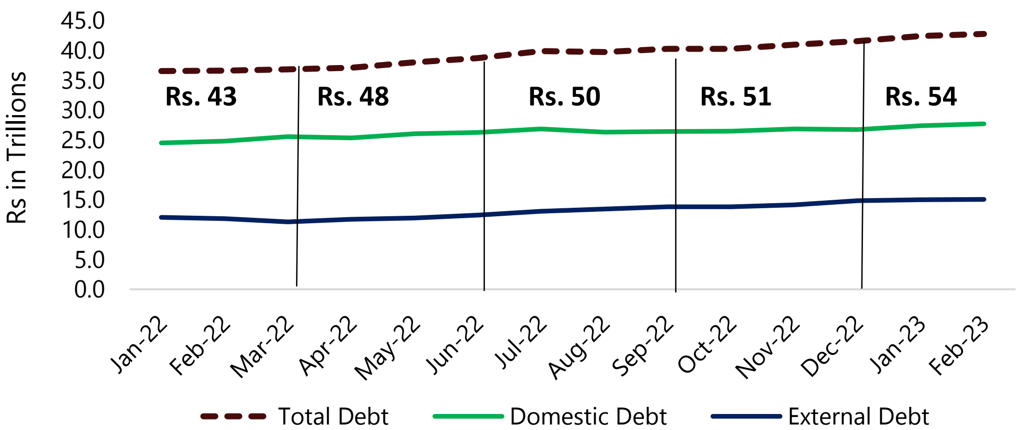
Source: Federal Board of Revenue

Figure 11: Government Domestic Borrowing
Outstanding period end position



Source: State Bank of Pakistan

Figure 12: Public Debt of Pakistan
Outstanding period end position



Source: State Bank of Pakistan

Figure 13: Foreign Direct Investment

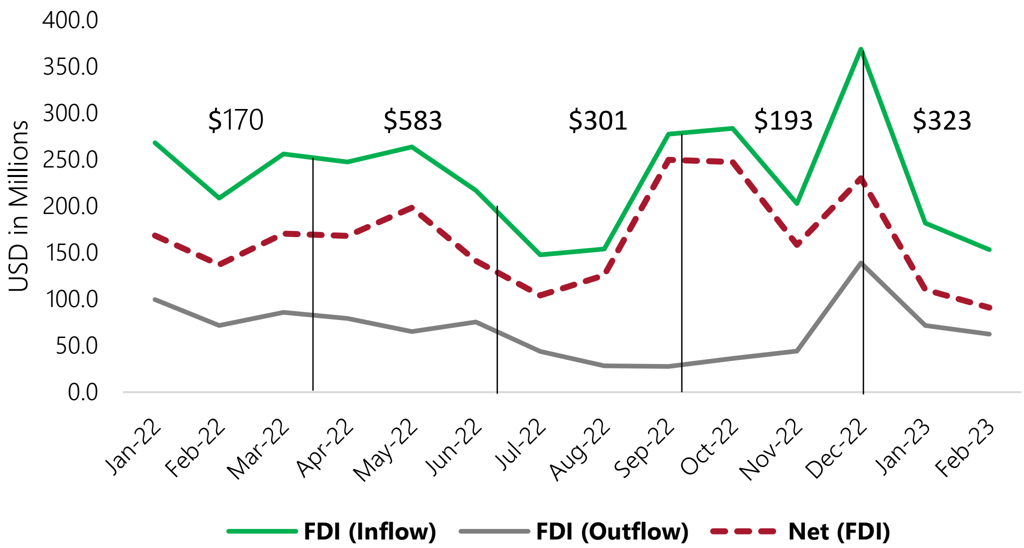
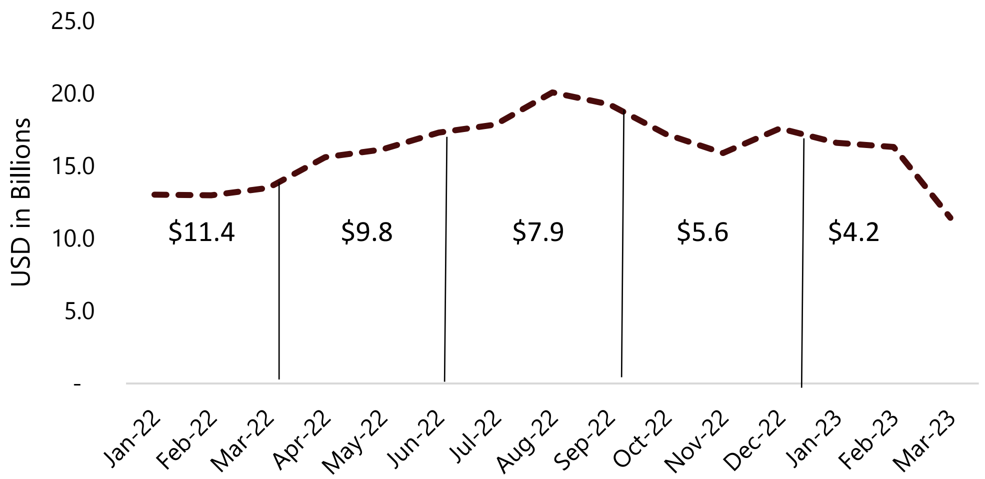
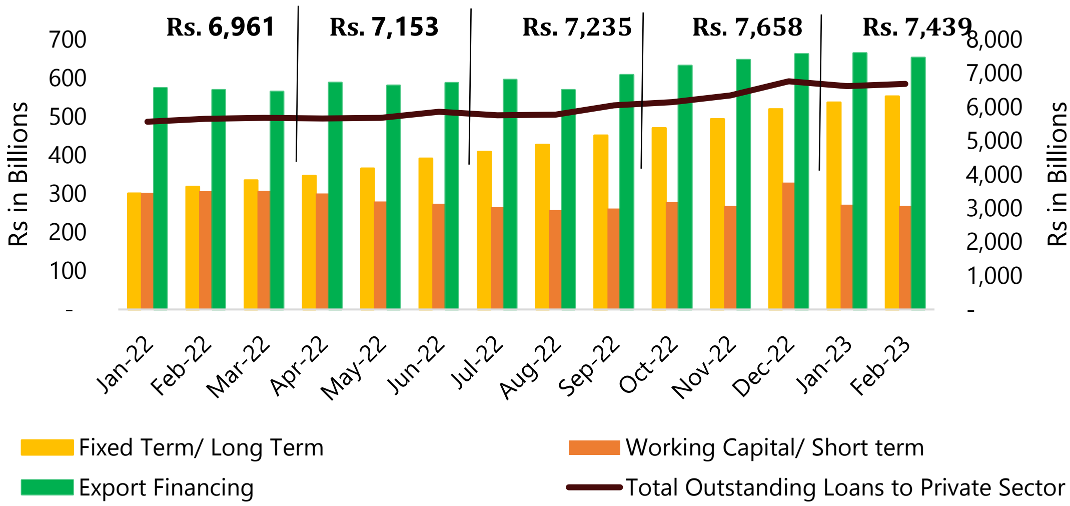


Figure 14: Foreign Exchange Reserve of Government Outstanding Period end Position



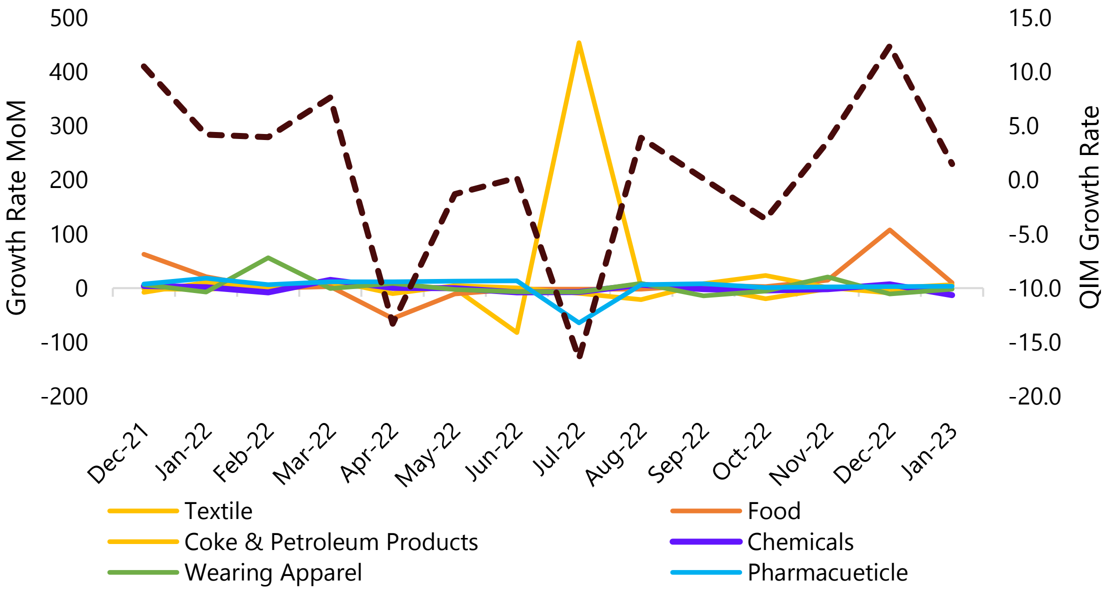
Source: State Bank of Pakistan

Figure 15: Private Sector Borrowing from Banks



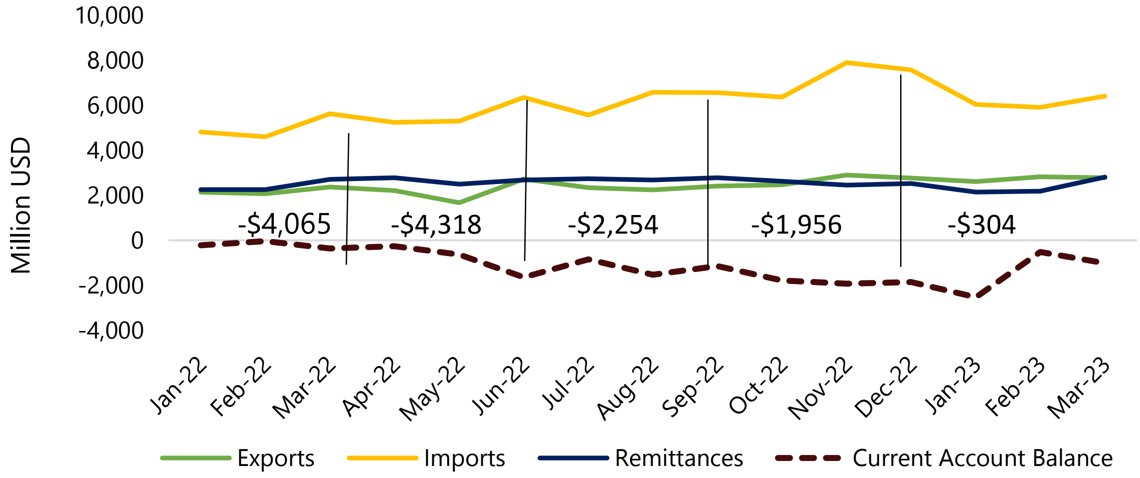
Source: State Bank of Pakistan

Figure 16: Large Scale Manufacturing Sector Performance



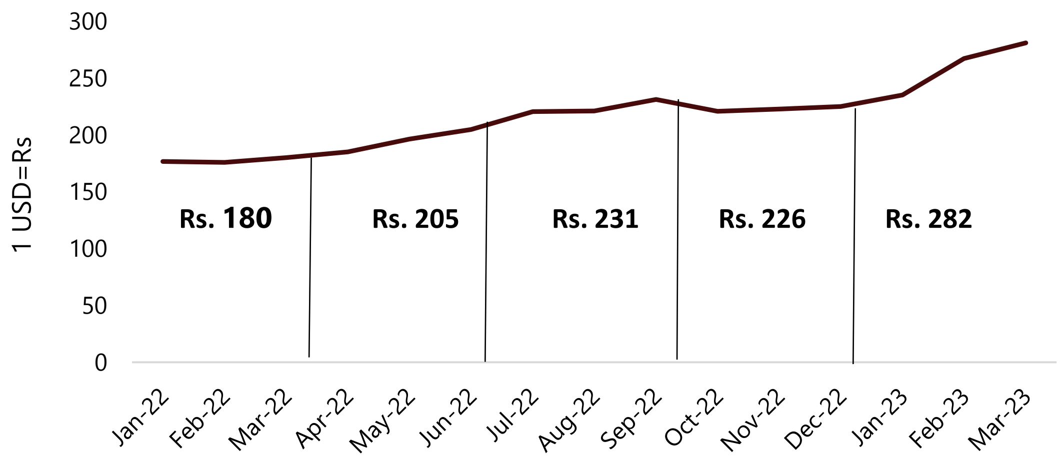
Source: Pakistan Bureaue of Statistics

Figure 17: Current Account Balance



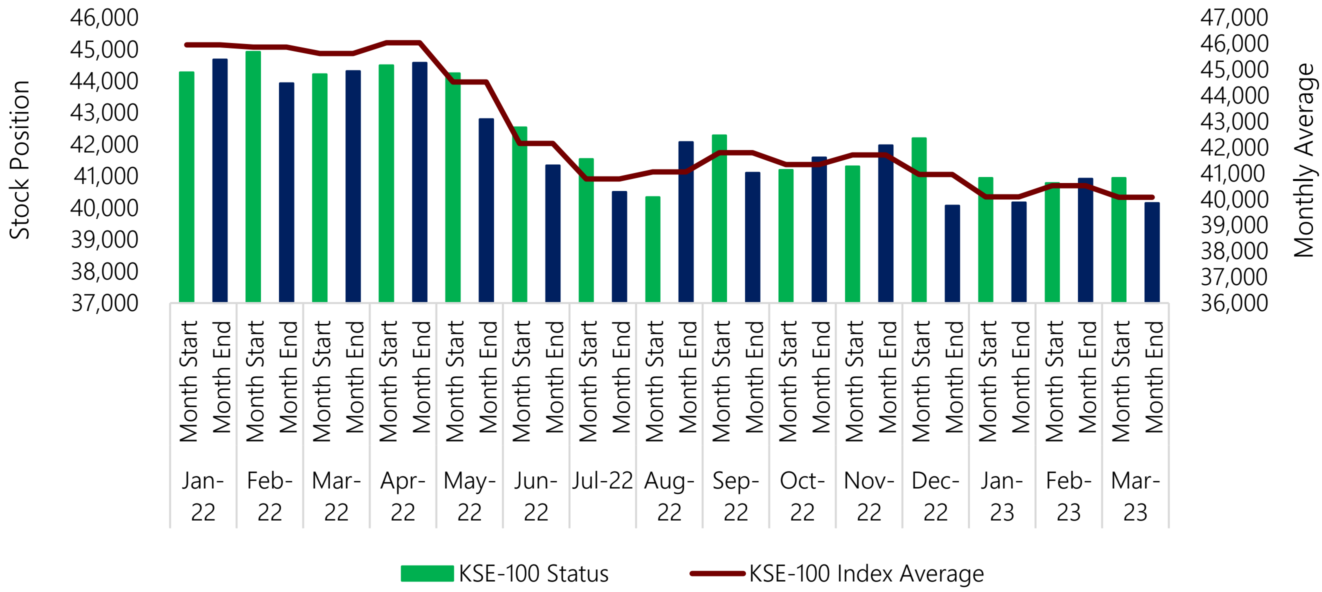
Source: Pakistan Bureaue Of Statistics

Figure 18: Exchange Rate Trend
Outstanding Period end Position



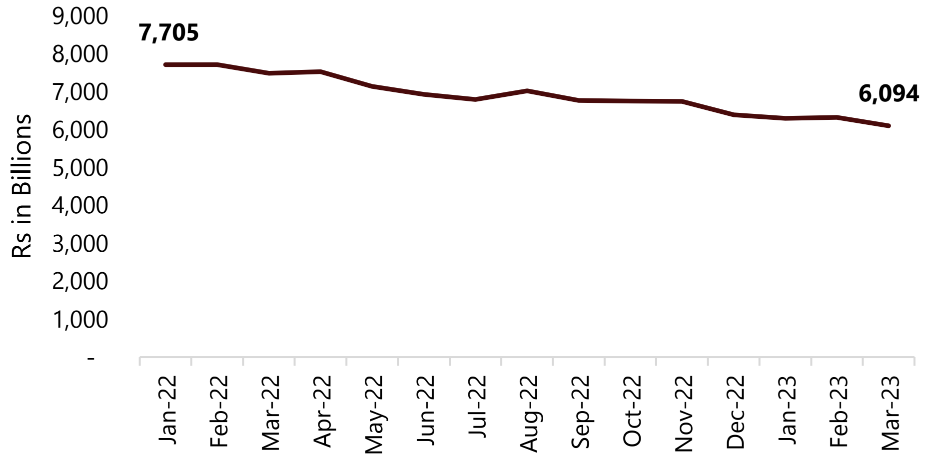
Source: State Bank of Pakistan

Figure 19: Stock Market Performance



Source: Pakistan stock Exchange

Figure 20: Market Capitalization in Stock Market



Source: Business News, DAWN

Section 3

3. MACROECONOMIC OUTLOOK

Pakistan is currently surrounded by challenges on multiple fronts. Besides economic and governance challenges, the country is in the middle of political crisis due to polarization of public and uncertainty about the provincial and general elections. Moreover, a new crisis has emerged between the parliament and the judiciary regarding powers of chief justice. The environment of the country will remain precarious until the timeline of general elections is announced.

In terms of economic challenges, Pakistan is under significant pressure domestically and externally. The continuity of Russia-Ukraine war and subsequent supply chain disruptions and high international commodity prices will keep the developing world in general and Pakistan in particular under duress in managing the current account. Although there is also some positive development in terms of revival of diplomatic ties between Saudi Arabia and Iran, which will not only promote peace in middle east but also opens prospects for trade and integration. Pakistan can also benefit from this development by improving scale of trade with Iran.

Inflation appears to be a daunting issue for the governments throughout the world and the governments are raising policy rates to control price hikes. The Government Of Pakistan

has revised the inflation expectations for the current fiscal year to around 30 percent. Pakistan has increased the policy rates by more than 300 basis points in last three months and is expected to increase more if the inflation remains unfettered. On the downside, the cost of borrowing for the manufacturing sector has increased and is likely to result in contraction in industrial activities. Therefore, the supply side hindrances will prevail and continue to effect the prices of goods and services in the country.

The revival of the IMF program is indispensable for promoting stability and economic certainty in the country. The government's several attempts fell short to reach staff level agreement despite the fulfillment of most of the prerequisites because the government is continuously finding new ways to diverge from the agreed plan and give untargeted subsidies for political gains. Moreover, the IMF is looking towards friendly countries of Pakistan to provide guarantee on the financial support as previously agreed. Therefore, pressure will continue to mount on the external front in next few months.

letters of credits are being blocked and industry is unable to import raw materials to continue the operation. The output of manufacturing sector has declined and will continue to decline in coming months until the trade is resumed.

The government's policy to manage exchange rate resulted in the emergence of black forex market in the country. Later, the government decided to let market forces determine the exchange rate, which led to depreciation of exchange rate but promoted stability in the market. Moreover, the inflow of remittances has also seen some improvement in last two months. The volatility of rupee will decrease in the coming months so long as the government sticks to market-based exchange rate.

The pandemic and Russia-Ukraine war disrupted the global energy market, which led to price hikes and significant burden on the countries to fulfill energy needs. Few months ago, Saudi Arabia announced cuts in daily production of oil to stabilize the prices. Again, in March, the Saudi Arabia has announced cuts in daily production of the oil to keep prices from falling in coming months. Therefore, the prices of oil will remain slightly elevated in coming months. The supply of gas will also remain disrupted due to hike in prices and shift in supply of gas towards Europe and the Far East. Moreover, the prices of utilities will remain high domestically as the government remains unable to find a sustainable solution to curtail circular debt.

ANNEXURE

Table A1: Current Account Indicators of Pakistan

Month	Exports	Imports	Remittances	Current Account Balance
	Million USD			
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	-1,111
Jan-23	2,244	4,875	1,894	-230
Feb-23	2,191	4,034	1,988	-74
Mar-23	2,367	3,828	2,533	----

Table A2: Foreign Direct Investment in Pakistan

Month	Net	Inflow	Outflow
		Million USD	
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	239.0
Jan-23	222.6	244.3	21.6
Feb-23	100.9	120.2	19.3

Table A3: Inflation

Month	CPI	SPI	WPI
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
Jan-23	2.9	1.3	1.8
Feb-23	4.3	3.7	8.2
Mar-23	3.7	5.8	4.7

Table A4: Public Debt of Pakistan

Month	Public Debt	Domestic Debt	External Debt
	Rs. in Trillions		
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
Dec-22	51.0	33.1	17.9
Jan-23	54.9	34.3	20.7
Feb-23	54.3	34.0	20.2

Table A5: Domestic Borrowing of Government

Month	Total Credit	SBP Credit to Government	Banks Credit to Government
	Rs. in Trillions		
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
Dec-22	20,334	5,358	14,976
Jan-23	21,633	5,260	16,373
Feb-23	21,731	5,597	16,134

Table A6: Private Sector Borrowing

Month	Total loans to Private Sector	Fixed-Term/ Long Term	Working Capital/ Short term	Export Financing
	Rs. in Billions			
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
Dec-22	7,658	633	308	713
Jan-23	7,424	643	308	699
Feb-23	7,439	641	305	706

Table A7: Exchange Rate and SBP Reserves

Month	Exchange Rate	SBP Reserves (USD Billions)
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	222.8	7.7
Dec-22	225.2	5.6
Jan-23	235.2	3.1
Feb-23	267.2	3.9
Mar-23	281.0	4.2

Table A8: Performance of Stock Market

Month	KSE-100 Index Status		Monthly Average	Market Capitalization (Rs. in Billions)
	Month Start	Month End		
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
Jan-23	40,815	39,871	40,344	6,293
Feb-23	40,619	40,784	40,702	6,316
Mar-23	40,815	39,848	40,332	6,094