Chapter 1: Global and Domestic Developments

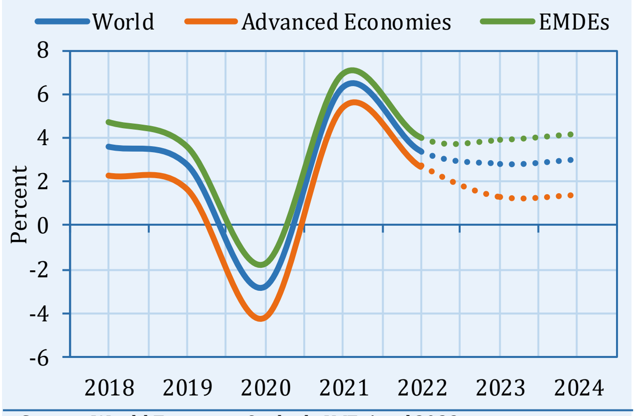
The global economy posted a notable decline in CY22 after registering a robust growth in CY21. The deceleration was observed due to elevated inflation levels, post-Covid steep rise in international commodity prices, emergence of geopolitical tensions and resurgence of Corona virus wave in China. The inflationary pressures prompted central banks to respond by monetary tightening. An appreciation of USD coupled with stressed macro financial conditions in emerging and developing economies resulted in a marked depreciation in their currencies, an increase in already elevated levels of debt and capital outflows. Domestically, Pakistan's post-pandemic economic rebound reversed during CY22, amid unfavorable global and domestic dynamics. Stabilization measures taken to address macroeconomic imbalances coupled with flash floods during Q3CY22 resulted in diminished economic activity, particularly during H2CY22. Elevated global commodity prices, delays in completion of IMF review along with external debt repayments led to a continuous decline in forex reserves and a depreciation of domestic currency. On the fiscal front, a surge in expenditures due to debt repayments and subsidies undermined the planned consolidation. Amid dearth of external financial flows, government's exposure on banks' balance sheet increased significantly. In short term, macroeconomic outcomes remain reliant upon global developments, completion of IMF program reviews and improvement in country's forex reserves.

Global Developments

Global economy lost growth momentum in CY22 against the headwinds of macroeconomic and geostrategic challenges ...

The global real output grew by 3.4 percent in CY22, substantially down from 6.3 percent recorded in CY21 **(Chart 1.1)**.[10]

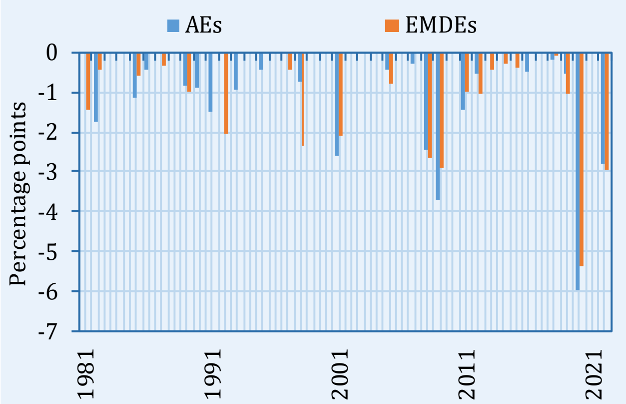
Chart 1.1 Global growth has lost momentum



Source: World Economic Outlook, IMF, April 2023

When reviewed in the context of last four decades, the slowdown seems quite significant as it is smaller than only the downfall caused by the catastrophic episodes of global financial crisis in CY09 and Covid-19 in CY20 **(Chart 1.2)**. Three key factors ignited the chain of events that led to this massive deceleration in global growth.

Chart 1.2: Output growth deceleration



Source: World Economic Outlook Database, IMF, April 2023

[10] International Monetary Fund. (2023). World Economic Outlook: A Rocky Recovery. *Washington, April*. For details, please visit https://www.imf.org/en/Publications/WEO/Issues/2023/04/11/world-economic-outlook-april-2023

...Russia-Ukraine war was a key factor in the deceleration, ...

Firstly, the Russia-Ukraine war deteriorated global economic landscape by causing a surge in global commodity prices, rise in uncertainty and a further increase in the ongoing process of economic fragmentation that started after Brexit and US-China trade tensions.

... a synchronous contractionary monetary policy further triggered the macro-financial conditions, ...

Secondly, a synchronized contractionary monetary policy stance was adopted around the globe to tame the broad and persistent inflationary pressures that emerged after Covid-19. The inflation was attributed to both demand as well as supply factors. On demand side, historic economic stimuli administered to counter Covid related recession and pent-up demand were the main factors. On supply side, Covid related supply chain disruptions, lack of investments in energy sector and shipping industry during Covid and Russia-Ukraine war led to rise in global core and non-core measures of inflation.

...and resurgent waves of Covid in China further compounded the global macroeconomic challenges.

Thirdly, China, the second largest economy of the world, grew by only 3.0 percent in CY22 – far lower than the pre-Covid average growth rate of 7.7 percent.[11] Resurgent waves of Covid and ensuing lockdowns were the key factors behind deceleration in Chinese economy. Besides, unprecedented droughts and stress in the property sector also weighed on the economic activity in China.[12]

Both AEs and EMDEs observed the third largest growth declaration in decades...

The advanced economies (AEs) and emerging markets and developing economies (EMDEs) faced the third largest growth deceleration observed over last four decades **(Chart 1.2)**. Among AEs, the USA saw the largest growth deceleration in CY22, followed by UK, Euro Area and Japan. The growth moderation in these economies was observed as i) high inflation significantly impacted consumer confidence and purchasing power that further led to moderation in demand, and ii) gas supply disruptions in Europe fueled the energy prices and inflation that ultimately impacted the industrial production.

In line with global slowdown, EMDEs managed to grow only by 4.0 percent during CY22 as compared to a robust growth of 6.9 percent in the previous year. Among leading EMDEs, Russia experienced steep economic slowdown followed by Türkiye and China **(Table 1.1)**.

Table 1.1: Global Economy: Real GDP Growth

Percent	2021	2022	2023*	2024*
World	6.3	3	3	3
Advanced Economies	5.4	3	1	1
EMDEs	6.9	4	4	4
EMDEs - Asia	7.5	4.4	5.3	5.1
USA	5.9	2.1	1.6	1.1
Euro Area	5.4	3.5	0.8	1.4
U.K	7.6	4.0	(0.3)	1.0
Japan	2.1	1.1	1.3	1.0
China	8.4	3.0	5.2	4.5
Türkiye	11.4	5.6	2.7	3.6
India	9.1	6.8	5.9	6.3
Russia	5.6	(2.1)	0.7	1.3
Saudi Arabia	3.9	8.7	3.1	3.1
United Arab Emirates	3.9	7.4	3.5	3.9
Pakistan	5.7	6.0	0.5	3.5

Source: IMF, World Economic Outlook, April 2023
*Projections

... however, growth momentum continued in GCC economies.

Growth momentum continued in Gulf Cooperation Council (GCC) as the output expanded by 7.7

[11] Average of GDP growth rate during CY10 to CY19.
[12] World Bank. (2023). Global Economic Prospects. *Washington, January*. For details, please visit https://openknowledge.worldbank.org/server/api/core/bitstreams/254aba87-dfeb-5b5c-b00a-727d04ade275/content

percent in 2022 compared to 3.5 percent a year earlier **(Table 1.2)**.

Table 1.2: Macroeconomic performance of Gulf Cooperation Council (GCC)

	2020	2021	2022	2023*	2024*
Real GDP (annual growth rate)	(4.7)	3.5	7.7	2.9	3.3
Current Account Balance (percent of GDI	(1.1)	8.6	15.2	8.6	6.5
Fiscal Balance (percent of GDP)	(8.0)	0.0	6.0	2.4	1.6
Oil Price (US$ per barrel)**	41.3	69.1	97.1	-	-
Inflation (annual average, percent)	1.3	2.2	3.3	2.9	2.3

Source: Regional Economic Outlook, Middle East and Central Asia, IMF, May 2023 and World Bank

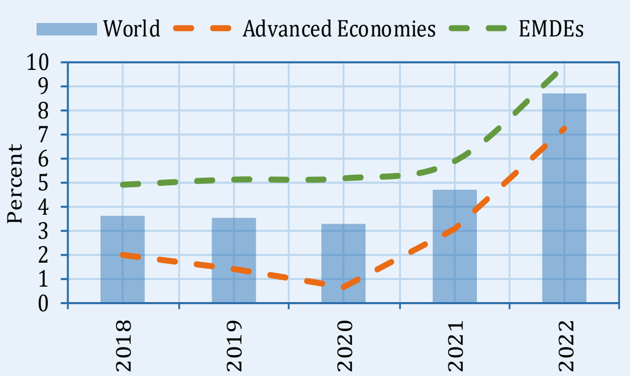
* IMF-Projections

** Average of UK Brent, Dubai Fateh and West Texas Intermediate crude oil prices.

In the first half of CY22, a continued increase in oil prices and an expansion in production provided significant support to these economies. The region benefitted from Russia-Ukraine war, as European countries reduced their oil purchases from Russia.[13] Moreover, non-oil growth activities such as rebound in tourism activities in Dubai and spillover impact of FIFA world cup in Qatar also contributed to growth in these countries.

Inflation emerged as a key challenge to global economy, surpassing multi decade high levels...

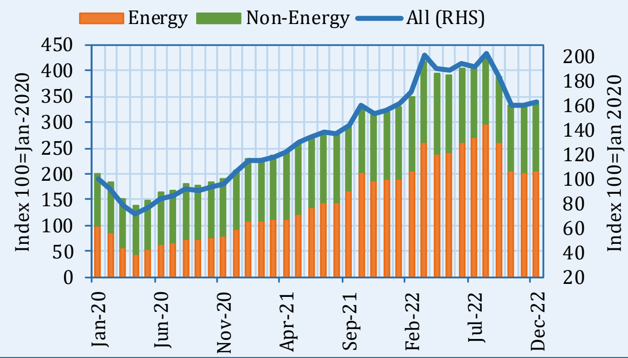
Chart 1.3: Global inflationary pressures further intensified in CY22



Source World Economic Outlook database, IMF, April 2023

Inflation increased throughout CY22 in almost all economies. Global inflation ticked in at 8.7 percent in CY22 compared to 4.7 percent last year **(Chart 1.3).** Rising inflationary pressures were also attributable to combination of demand and supply factors. On demand side, policy support through accommodative fiscal and monetary policies was the key factor.[14] On supply side, earlier supply chain disruptions were accentuated by the Russia-Ukraine war, which fueled energy and food prices **(Chart 1.4)**. Besides, elevated levels of core inflation were observed in many jurisdictions due to tight labor market conditions and substantial currency depreciation against USD, the latter owing to high interest rate on dollar denominated assets. As a consequence, the inflation in AEs reached 7.3 percent in CY22 – the highest level since 1982. In the USA, rising energy and food prices along with tight labor market led to multi-decade high inflation (8.0 percent) in CY22. In Euro Area, energy prices increased markedly due to disruptions in supply of natural gas from Russia (**Chart 1.5)**.

Chart 1.4: International commodity prices index

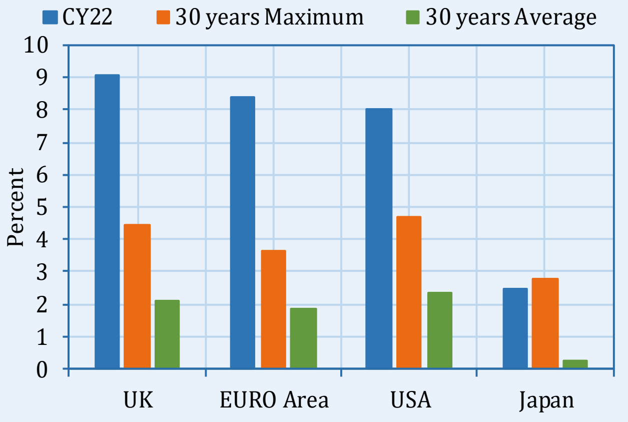


Source: IMF

[13] International Monetary Fund. (2022). Regional Economic Outlook (Middle East and Central Asia). *Washington, October*. For details, please visit https://www.imf.org/en/Publications/REO/MECA/Issues/2022/10/13/regional-economic-outlook-mcd-october-2022

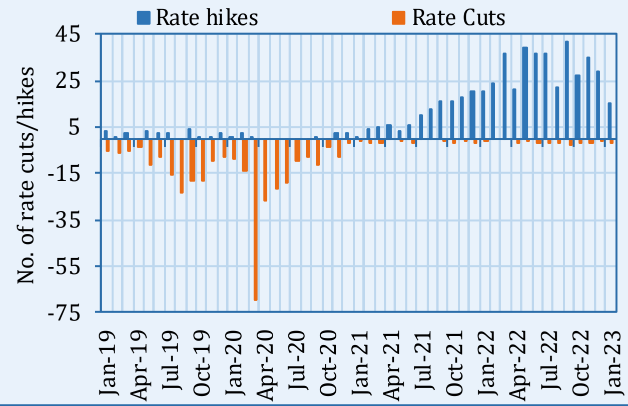
[14] World Bank. (2023). Global Economic Prospects. *Washington, January*. For details, please visit https://openknowledge.worldbank.org/server/api/core/bitstreams/254aba87-dfeb-5b5c-b00a-727d04ade275/content

Chart 1.5: Inflation in AEs hit 30 year high



Source: Bank for International Settlements

Chart 1.6: World wide central banks' policy rate decisions



Source: Cbrates

Inflation in EMDEs increased sharply, and reached 9.8 percent in CY22 – the highest level observed in the last two decades. However, inflation in China remained low compared to other EMDEs, as consumer demand remained in check due to zero Covid policy amid episodes of Covid infection in China. Low inflation in China moderated the global inflation numbers as well.

...prompting a sharp reversal of earlier accommodative monetary policy stance by the central banks...

By the start of CY22, it had become clear that the emerging inflationary pressures were not transient in nature and required stronger policy response to preserve the price and economic stability and keep inflation expectation from de-anchoring. Accordingly, central banks in EMDEs and AEs started the monetary tightening in CY21. During CY22, the policy of monetary tightening further got traction and jurisdictions moved to jack-up the policy rates. The review of monetary policy stances across the globe shows that central banks announced rate hikes by 367 times during CY22[15] **(Chart 1.6).**

...leading to tightening of global financial conditions ...

Central banks' aggressive response to elevated inflation led to rise in interest rates and tightening of financial conditions[16] **(Chart 1.7)**. However, the conditions somewhat improved towards the end of 2022 reflecting market expectations of ease in federal funds rate.[17]

Chart 1.7: Financial Condition Index

Source:fred.stlouisfed.org

[15] Analysis is based on central banks data listed on Cbrates.com

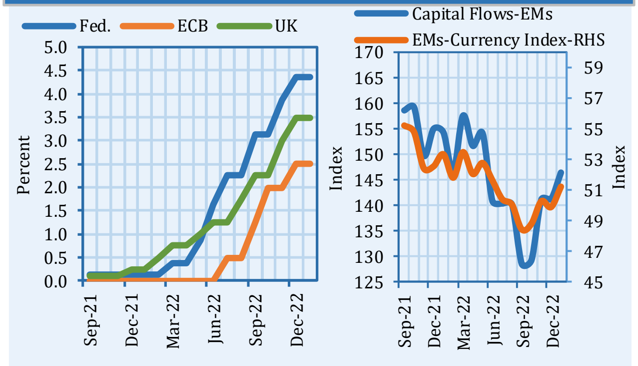
[16] The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

[17] International Monetary Fund. (2023). World Economic Outlook Update. *Washington, January*. For details, please visit https://www.imf.org/en/Publications/WEO/Issues/2023/01/31/world-economic-outlook-update-january-2023

... causing capital outflows and exchange rate depreciation for EMDEs...

Notable tightening in global financial conditions and substantial USD appreciation caused record capital outflows from EMDEs **(Chart 1.8).**[18] Resultantly, currencies of many emerging markets depreciated against USD despite substantial liquidation of FX reserves to support their domestic currencies.[19] Exchange rate pressures were particularly pronounced for EMDEs with limited fiscal space. EMDEs with fiscal deficit to GDP ratio exceeding three percent faced eight times more depreciation than EMDEs with lower deficit ratio. Nonetheless, capital flows from EMDEs began to improve towards the end of 2022 as USD appreciation moderated.

Chart 1.8: A rapid monetary policy tightening in AEs created the vulnerabilities for EMDEs

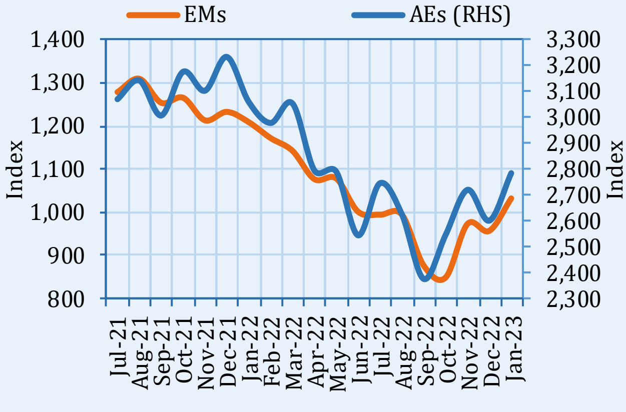


Source:cbrates.com Source: Bloomberg

...together with synchronized decline in equity prices in AEs and EDMEs...

EMDEs and AEs equity price indices declined by 22.4 percent and 19.5 percent, respectively over the course of CY22. Higher inflation, aggressive interest rate hikes and uncertain economic conditions weighed on investor sentiments throughout the year **(Chart 1.9)**. Particularly, stock prices fell sharply in August 2022 as Federal Reserve indicated the rate would remain high.[20]

Chart 1.9: Equity Prices Index



Source; Bloomberg

However, in the last quarter of CY22, the situation improved in the wake of ease in inflationary pressure and, expected decreases in interest rates: equity pricing started to recover in the last quarter of CY22.[21]

Public debt slightly improved for AEs but remains elevated for EMDEs...

Covid 19 and associated aggressive global fiscal response led to a substantial rise in public debt in both AEs and EMDEs. As COVID related measures came to an end and GDP posted strong nominal growth during 2021-22, the global public debt ratio declined to 92.1 percent in CY22, compared with 99.7 percent in CY20 and 84.3 percent in CY19.[22]

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[18] World Bank. (2023). Global Economic Prospects. *Washington, January*. For details, please visit https://openknowledge.worldbank.org/server/api/core/bitstreams/254aba87-dfeb-5b5c-b00a-727d04ade275/content

[19] Around one-fifth of EMDEs liquidated more than 15 percent of their gross official reserves. Source: World Bank. (2023). Global Economic Prospects. *January*. For details, please visit https://openknowledge.worldbank.org/server/api/core/bitstreams/254aba87-dfeb-5b5c-b00a-727d04ade275/content

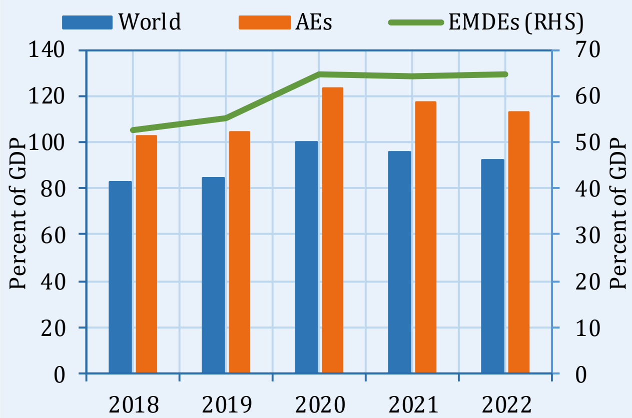
[20] Speech by Chair Powell on monetary policy and price stability (August 26, 2022) - Federal Reserve Board. For details please visit https://www.federalreserve.gov/newsevents/speech/powell20220826a.htm

[21] International Monetary Fund. (2023). World Economic Outlook Update. *Washington, January*. For details, please visit https://www.imf.org/en/Publications/WEO/Issues/2023/01/31/world-economic-outlook-update-january-2023

[22] International Monetary Fund. (2023). Fiscal Monitor Report. *Washington, April*. For details please visit https://www.imf.org/en/Publications/FM/Issues/2023/04/03/fiscal-monitor-april-2023

Public-debt dynamics significantly varied across the different income groups, though. In AEs, public debt ratio continued to decline in 2022 but remained above pre-pandemic levels. The continued decline in debt ratio was mainly due to decline in debt in 2022 along with rebound in growth in CY21 and a swift rise in inflation in CY22.[23] However, debt to GDP ratio in EMDEs marginally inched up **(Chart 1.10)** from 64.3 percent in CY21 to 64.6 percent in CY22.

Chart 1.10: General Government Debt



Source: Fiscal Monitor, IMF, April 2023

...leading to substantial debt servicing burdens for vulnerable EMDEs

This rise in EMDEs' debt was also due to depreciation against USD coupled with idiosyncratic issues faced by these economies. Governments of many EMDEs are facing a challenging global macro financial environment which is characterized by high commodity prices, tight financial conditions and concomitant pressure on many EMDEs' currencies. The current global macro financial environment is quite challenging in terms of debt servicing for vulnerable sovereigns.[24] Interest payments of EMDEs significantly increased by USD 273.8 billion to USD 4,287.2 billion in CY22 compared with USD 175.2 billion increase in last year.

Alongside debt servicing pressure on sovereigns, the recent stress in US banking sector[25] and resolution of Credit Suisse manifest the financial stability risks inherent in the challenging global macro financial environment.

Domestic Developments

CY22 began with elevated level of economic activity in the wake of post pandemic recovery ...

Pakistan's economic recovery from COVID-19 pandemic was remarkable as the better management of the pandemic and stimulus measures supported the economic activities. The economy grew at a rate of 5.8 percent in FY21 and the momentum continued in FY22, with the growth of 6.1 percent for the year. Key drivers of this growth were commodity-producing sectors, while services also provided impetus on the back of strong support from large-scale manufacturing (LSM) and enhanced agricultural output. **(Table 1.3, Chart 1.11)**

Table 1.3: Key Economic Indicators of Pakistan*

	2018	2019	2020	2021	2022
Real Sector			**(Percent)**		
Real GDP Growth (FY)	6.1	3.1	(0.9)	5.8	6.1
Industrial Sector Growth (FY)	9.2	0.2	(5.8)	8.2	6.8
Agricultural Sector Growth (FY)	3.9	0.9	3.9	3.5	4.3
Service Sector Growth (FY)	6.0	5.0	(1.2)	5.9	6.6
LSM Growth (Average YoY)	3.8	1.9	(9.0)	17.5	6.0
Inflation (Average YoY)	5.3	9.4	9.5	9.5	19.7
External Sector			**(USD Billion)**		
SBP Reserves (End-of-Period)	7.2	11.3	13.4	17.7	6.5
Current Account Balance	-18.8	-7.1	-0.7	-12.3	-12.1
Exports (Goods & Services)	30.8	30.7	27.3	35.6	38.8
Imports (Goods & Services)	68.4	58.0	52.1	76.4	76.3
Remittances	21.0	22.1	25.9	31.1	29.6
PKR/USD Rate (Year Average)	122	150	162	163	207
Fiscal Sector			**(Percent)**		
Fiscal Deficit (as % of GDP, FY)	(6.5)	(9.1)	(8.1)	(7.1)	(7.9)
Revenue Growth (YoY)	(3.0)	12.3	10.1	17.5	16.9
Expenditure Growth (YoY)	6.0	18.9	9.4	11.3	31.1
Monetary Sector			**(Percent & PKR Trillion)**		
Credit to Private Sector (YoY Growth)	19.1	5.2	4.7	19.6	13.4
Financing	2.5	3.4	3.5	3.6	5.6
Domestic	1.9	2.7	2.7	1.7	5.7
External	0.6	0.7	0.8	1.9	(0.1)

*All data are on Calendar Year unless stated otherwise.

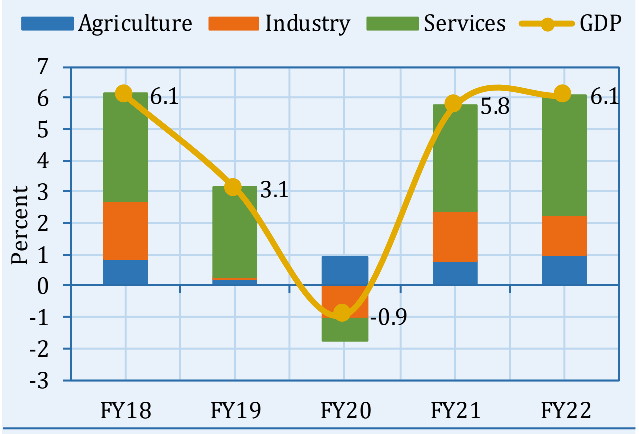
Source: Ministry of Finance, Pakistan Bureau of Statistics and State Bank of Pakistan

[23] As Inflation and economic activity moved up together in CY21 this led to swing in nominal GDP and contributed to decline in debt ratios.

[24] International Monetary Fund. (2022). IMF Annual Report: Crisis Upon Crisis. *Washington*. For details, please visit https://www.imf.org/external/pubs/ft/ar/2022/

[25] In USA, a number of small and medium-sized regional banks failed in Q12013 due to, inter alia, revaluation losses on long-term assets on account of sharp rise in interest rates, increase in funding costs, maturity mismatches, etc.

Chart 1.11: GDP Growth & Sectoral Contributions



Source: PBS

...however, a combination of external and internal factors led to deterioration of macro environment and a decline in growth...

Persistent shocks to international commodity prices, unplanned fiscal stimulus, delays in the resumption of the IMF program and domestic political instability undermined the sustainability of economic growth during CY22. These developments led to a surge in pressures on external account and widening of fiscal deficit along with concomitant currency depreciation and higher than expected inflation. Policy response to growing imbalances and rising economic uncertainty led to a deceleration of economic growth in the second half of CY22.

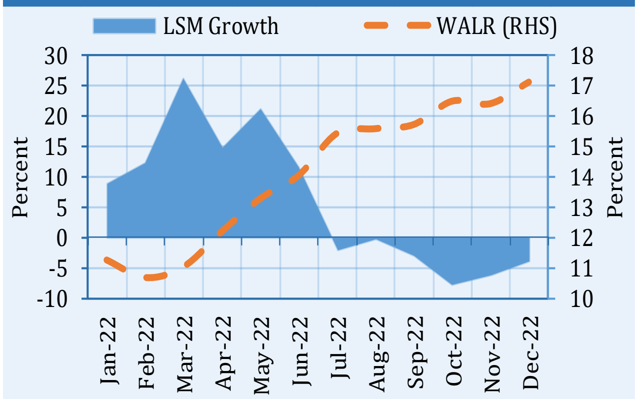
In the wake of post-Covid recovery, the LSM registered 15.8 percent average growth during H1CY22; however, it contracted by 3.8 percent in H2CY22 as macro-economic conditions deteriorated and stabilization measures started to take hold (**Table 1.4**, **Chart 1.12)**. Moreover, Business Confidence Index fell in H2CY22 to its lowest level since April 2020 when COVID pandemic set in.

Table 1.4: Stabilization measures taken by the Government and SBP

Sr. No.	Measures
I	Increase in policy rate by 900 bps from Sep-2021 to Dec-2022
II	Increase in CRR from 5 to 6 percent in Nov-2021.
III	Discontinuation/expiry of Covid related refinance schemes and prudential measures CY21-CY22
IV	Increase in list of import items subject 100 percent cash margin requirement in Apr-2022 (later relaxed in Aug-2022 and then withdrawn in Mar-2023)
V	Tightening of prudential regulations for consumer finance in Sep-2021
VI	Increase in rates of LTFF and EFS (Apr-2022), which were later linked to policy rate.
VII	Increase in duties on import of luxury items in Jul-2022.
VIII	Mandatory prior approval of SBP for import of non-essential items in May-2022 (later on withdrawn in Dec-2022)
IX	Ministry of Commerce's interim ban on import of certain items in May-2022

Source: Government of Pakistan and SBP

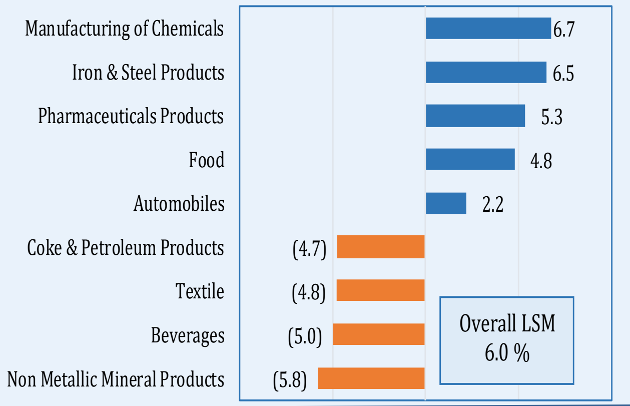
Chart 1.12: Large scale manufacturing and lending rate



WALR=Weighted Average Lending Rate, Source: PBS and SBP

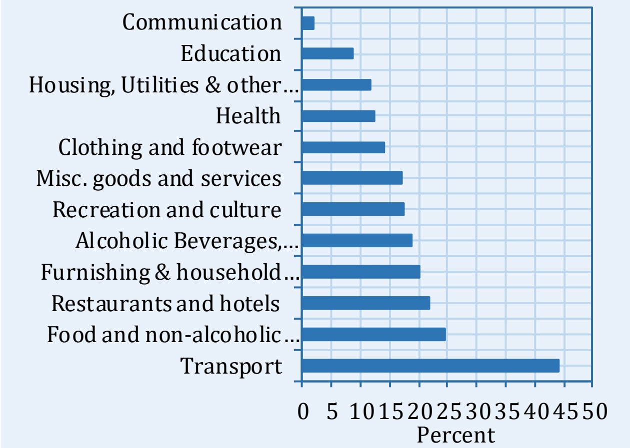
Cumulatively, LSM grew by 6 percent in CY22 as compared to 17.5 percent growth in CY21. The growth was mixed as 10 out of the 22 sectors contracted. Wearing apparel (69 percent) and furniture sector (142 percent) led the growth, whereas textile (-3.3 percent) and coke/ petroleum sector (-5.5 percent) posted negative growth (**Chart 1.13**).

Chart 1.13 : Sector Wise growth - Large Scale Manufacturing



Source: PBS

Chart 1.14: Component Wise average Inflation

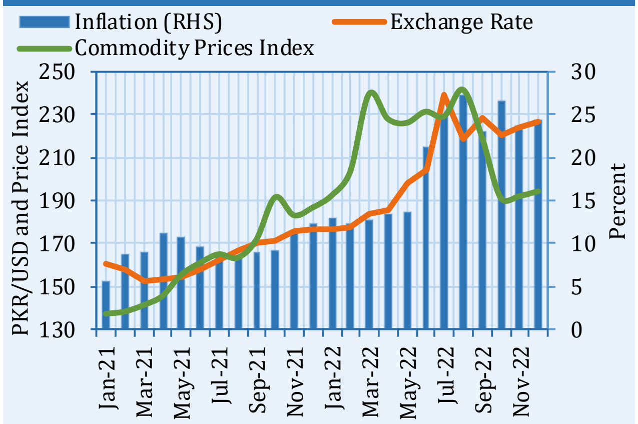


Source: PBS

...macro conditions were further aggravated by flash floods...

Climate change and the associated increase in the frequency and quantum of rains led to massive floods in the country during Q3CY22. Besides severe damage to infrastructure, large swathes of crop lands were inundated. As a result, economic imbalances were compounded in several ways. Firstly, disruptions in agricultural supply chains resulted in higher food inflation. Secondly, damage to domestic agricultural produce affected the exports and necessitated the imports of certain agricultural products that put further pressure on already strained external account.

Chart 1.15: Inflation, Exchange rate and Commodity prices



Source: PBS, SBP and IMF

...leading to high and broad-based inflation

Rising more than two folds, average CPI inflation reached 19.7 percent in CY22 from 9.5 percent in CY21. Most of the components of CPI basket recorded double-digit inflation. Among these components, major contribution came from transport, housing/utilities and food groups (**Chart 1.14**). Alongside elevated aggregate demand in the wake of post-COVID recovery, supply side shocks i.e. floods, elevated global commodity prices and domestic currency depreciation led to phenomenal rise in inflation.

Reversal of subsidies on fuel and energy prices by the government also pushed up energy prices and overall inflation rate during H2CY22. **(Chart 1.15)**

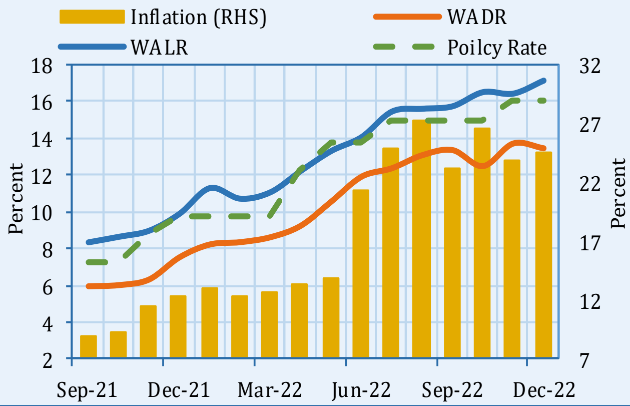
... rising macroeconomic imbalances necessitated appropriate policy response ...

After maintaining the policy rate at 7 percent till Q3CY21, SBP reversed the accommodative policy stance in the wake of rising inflation in September 2021. By the time CY22 began, it had become clear that inflationary pressures were persistent and higher.

To curb the inflationary pressures, SBP pursued aggressive tightening and increased the policy rate by 900 bps to 16 percent by December 2022

(Chart 1.16).[26] In addition to monetary policy response, a host of prudential and administrative measures were taken to moderate macroeconomic imbalances (**Table 1.4**).

Chart 1.16: Interest Rates and Inflation

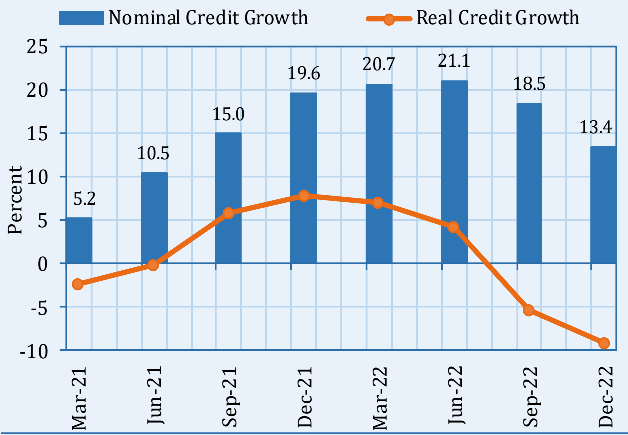


WALR & WADR = Weighted Average Lending and Deposit Rates; Source: SBP & PBS

...leading to deceleration in private sector credit growth.

Private sector credit (PSC) data shows that the lagged impact of Covid stimulus plateaued in first half of CY22. H2CY22 was characterized by a deceleration in nominal growth rate of PSC, which in fact reflects contraction in real terms if adjusted for inflation **(Chart 1.17).** This slowdown came on the back of rise in interest rates and slowdown in economic activity, while government demand for bank credit also remained high due to its fiscal needs. On a cumulative basis, credit to private sector growth moderated to 13.4 percent in CY22 as compared to a healthy growth of 19.6 percent in CY21.

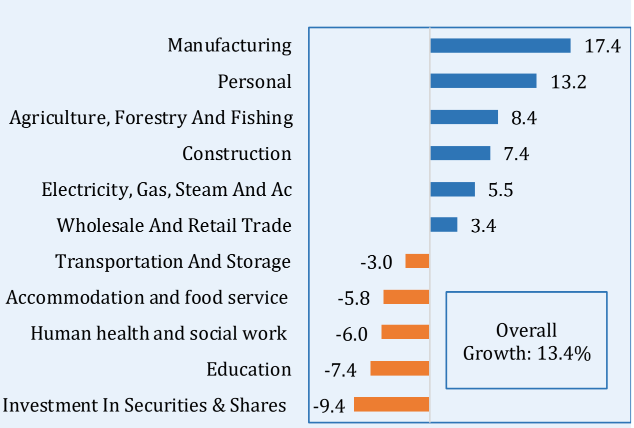
Chart 1.17: Nominal and Real Credit Growth



Source: SBP

Growth in PSC was led by manufacturing, consumer finance and retail/ wholesale trade, among other sectors of the economy **(Chart 1.18)**. As can be expected in an inflationary environment, the major portion of this financing was obtained for working capital and short-term financing needs.

Chart 1.18: Sector Wise Credit Growth



Source: SBP

High import demand and elevated commodity prices exerted pressure on current account...

Amid vibrant domestic demand and substantial increase in global commodity prices during H1CY22, the import of goods and services increased significantly to USD 42.7 billion; 23 percent higher relative to the corresponding period last year.

[26] Inflation continued rising trajectory after review period and reached 35.4 percent in March 2023. Consequently, monetary policy rate was further increased to 21 percent in April, 2023.

This substantial increase in imports came from petroleum group, which increased by 86.2 percent from USD 5.4 billion in H1CY21 to USD 10.1 billion in H1CY22.[27] Besides petroleum group, other major contributions came from machinery, agriculture / other chemicals, textile group and edible oil imports, which grew, by 9.1 percent, 12.6 percent, 7.9 percent and 14.7 percent, respectively.

...accordingly, measures were taken to ease the pressure on current account...

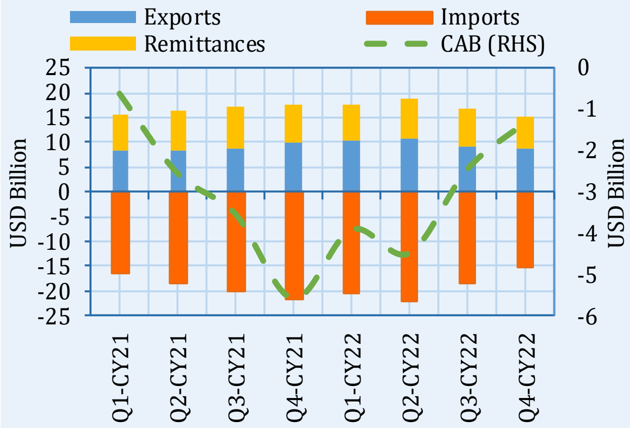
Price and non-price measure were taken to control the widening current account deficit. Under price measures, market-based exchange rate mechanism discouraged imports and encouraged exports. Non-price measures included restrictions on import of certain items, increase in import duties, imposition of 100 percent cash margin on import of luxury items, mandatory prior approval of letters of credit (LCs) for import of non-essential items. As a result of these measures, imports were significantly curtailed in the second half of CY22, contracting by 19.5 percent relative to H2CY21.

...stabilization measures coupled with steady exports helped contain the current account deficit

Exports of goods and services on the other hand remained resilient and grew by 9.2 percent from USD 35.6 billion in CY21 to USD 38.8 billion in CY22. This growth in exports was an outcome of favorable global demand dynamics particularly during H1CY22 and conducive policies of the government and SBP.[28] However, remittances contracted by 4.8 percent from USD 31 billion in CY21 to USD 29.6 billion in CY22. This decrease in remittances was observed due to slowdown in advanced economies, gap between open market and interbank exchange rate and normalization of air travel post pandemic.

As a result of stabilization measures taken by the government to ensure external account sustainability, current account deficit on a cumulative basis contracted by 1.1 percent from USD 12.3 billion in CY21 to USD 12.1 billion in CY22 **(Chart 1.19).**

Chart 1.19: Current Account Balance



Source: SBP

Slowdown in official inflows along with debt repayments led to a fall in FX reserves and depreciation in exchange rate...

FX reserves of SBP declined over CY22, falling from USD 17.8 billion in Dec-21 to USD 5.6 billion at end Dec-22 **(Chart 1.20)**. This fall in reserves was recorded largely due to debt repayments, current account deficit and government payments pertaining to settlement of an international arbitration award related to a mining project. Moreover, delays in completion of the reviews of IMF program resulted in drying up of multilateral and bilateral official inflows. Also, an increase in policy rates in AEs further dampened the prospect of external commercial borrowings.

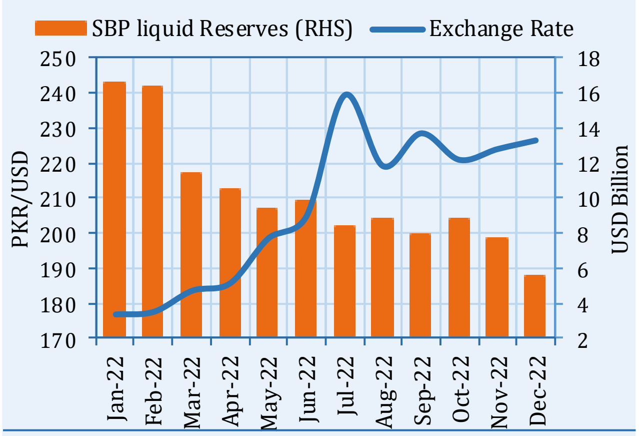
The rupee-dollar parity depreciated by 22 percent over the year from PKR 177/$ at end Dec-21 to PKR 226/$ at the end of Dec-22 **(Chart 1.20)**. This depreciation in the value of rupee was driven by the economic uncertainty, a continuous decline in SBP reserves and strengthening of dollar in

[27] Average spot price of Dubai oil increased from 63 $/b in H1CY21 to 103 $/b in H1CY22.

[28] Energy subsidy by the government for export industries, Market determined exchange rate and concessionary export finance scheme up to April 2022.

international markets following monetary tightening by Federal Reserve.

Chart 1.20: SBP Reserves and Exchange Rate



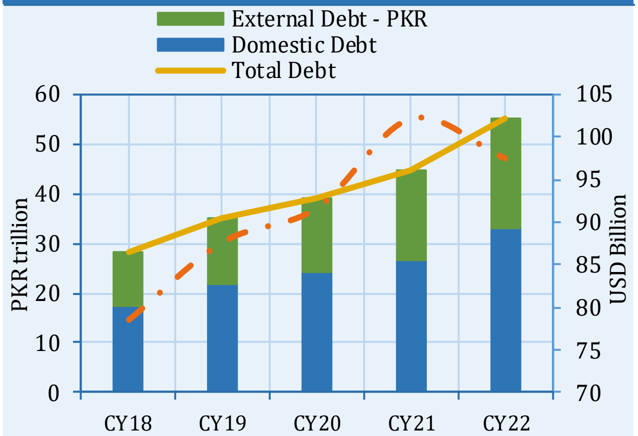
Source: SBP

Keeping in view the deterioration in external liquidity amid declining FX reserves, the challenges in reining in the twin deficits and associated risks, the sovereign rating of the country was downgraded from B- to CCC+ by S & P in October 2022.[29]

...resultantly, external debt position deteriorated in rupee terms

Public external debt[30] reduced from USD 102.2 billion in CY21 to USD 97.5 billion by the end of CY22. This decline in external debt can be attributed to dearth of fresh external financing, debt repayments and decline in dollar equivalent value of debt denominated in other foreign currencies, which depreciated vis-à-vis dollar following increase in interest rates by Federal Reserve. However, in nominal PKR terms, the external debt surged by 22.5 percent due to depreciation of domestic currency **(Chart 1.21).**

Chart 1.21: Pakistan debt profile

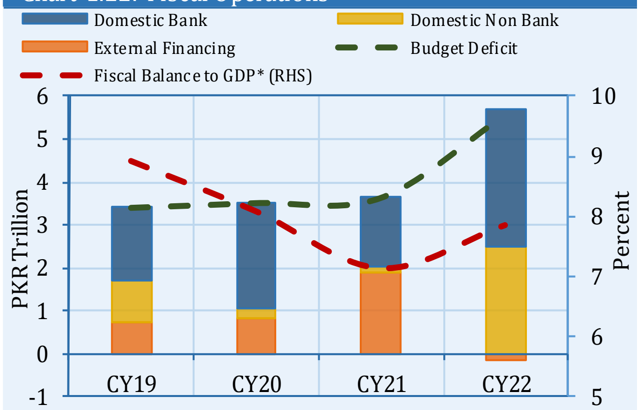


Source: SBP

Fiscal slippages led to higher than expected fiscal deficit...

Contrary to the consolidation planned by the government, fiscal deficit rose from PKR 3.4 trillion (7.1 percent of GDP) in FY21 to PKR 5.3 trillion (7.9 percent of GDP) in FY22 **(Chart 1.22)**.

Chart 1.22: Fiscal Operations



Source: MoF
* Fiscal Balance to GDP represented on FY basis

Government revenues increased by 17 percent during CY22 (from PKR 7.5 trillion in CY21 to PKR 8.7 trillion in CY22). This increase in revenues was more than offset by the expenditures, which increased by 31 percent from PKR 11.1 trillion in CY21 to PKR 14.6 trillion in CY22. This annual increase in expenditures was an outcome of subsidies and higher markup payments amid rising interest rate environment coupled with

[29] In February 2023, Moody's and Fitch downgraded the rating for Pakistan to Caa3 and CCC-.

[30] Includes Government debt from IMF and Foreign exchange liabilities.

floating-rate nature of a significant portion of domestic debt. Impact of increase in subsidies was most pronounced in the first half of CY22, following the government's decision to freeze fuel and power prices at the end of February 2022.[31] On calendar year basis, budget deficit grew by 53.2 percent from PKR 3.6 trillion in CY21 to PKR 5.6 trillion in CY22.

...and the budget deficit was financed exclusively through domestic sources

The substantial gap in fiscal balance was financed through domestic sources amid lack of external financing. Of the PKR 5.7 trillion domestic financing,[32] 56.4 percent came from the banks whereas 43.6 percent of the financing was sourced from non-banking sector **(Chart 1.22)**. Financing from banking sources grew by 103 percent, pushing up the share of public sector credit in banking sector's asset base to 55.5 percent.[33]

As a result, the domestic debt increased by 24 percent i.e., from PKR 26.8 trillion at end CY21 to PKR 33.2 trillion at the end of CY22 **(Chart 1.21)**.

In terms of sources, most of the expansion in domestic debt came from PIBs and Shariah compliant bonds. This increase in reliance on long-term instruments resulted from GOP's drive to enhance public debt profile by shifting towards long-term instruments. Although, lengthening of the debt profile reduced rollover risk, however the large concentration of floating rate instruments in the domestic debt significantly enhanced the repricing risk amid high interest rate environment. Incidentally, the debit servicing cost significantly increased over the period.

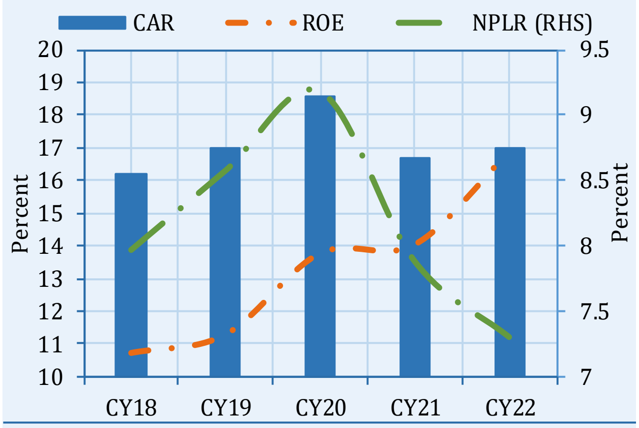
Banking sector continues to show steady performance with contained credit risk amid deteriorating macro-economic environment.

Due to scarce external financing, government borrowed PKR 3.2 trillion from banks to fulfill its financing needs in CY22. As a result, banking sector's investment portfolio grew by 26.4 percent, a major driver of growth in asset base. Advances, on the other hand, decelerated amid slowdown in the economy and increased cost of borrowing.

On liability side, this strong expansion in asset base was financed through increased reliance on borrowings, as they grew by 65.6 percent in CY22 amid slowdown in deposits mobilization.

Even in the face of stressed macroeconomic conditions, profitability of the banking sector showed some improvement as the after-tax profit grew by 27.4 percent in the year under review. Strong rebound in interest earnings driven by high interest rates supported bank's profitability as return on equity (ROE) of the sector increased from 14.1 percent in CY21 to 16.9 percent in CY22 **(Chart 1.23)**.

Chart 1.23: Key FSIs of Banking Sector



Source: SBP

Credit infection of the banking industry, as measured by the non-performing loans to gross

[31] Subsidies increased by 132 percent from PKR 609 billion in CY21 to PKR 1413 billion in CY22.
[32] Of the 5,715 billion PKR raised, 5,572 billion were used to finance deficit and 144 billion PKR were used to retire external debt.

[33] Includes both banks' investments in government securities and public sector advances.

loans ratio (GNPLR), improved from 7.9 percent at the end of CY21 to 7.3 percent at end CY22. Net infection ratio was only 0.8 percent at the end of CY22. Overall, the solvency of the banking sector remained firm as capital adequacy ratio (CAR) stood at 17 percent, which is well above the regulatory requirement of 11.5 percent (**See Chapter 03 on banking for detailed analysis**).

However, stress test results show that in the near future, persistence of economic uncertainty, high interest rate environment and slowdown in the economy for an extended duration may lead to a rise in corporate delinquencies (**see Chapter 08 on corporate sector and Chapter 04 on resilience of banks for detailed analysis**).

Going forward….

On global front, tighter financial conditions, geopolitical tensions and sluggish recovery in China are the key risk factors affecting the global growth. Although global headline inflation is receding due to ease in food and energy prices, core inflation may persist for longer than anticipated. Such unfavorable outcomes may translate into tighter financial conditions, challenging the stability of macro-financial systems.

The domestic economic and financial dynamics is, inter alia, contingent upon global economic and geo-political conditions. Additionally, Pakistan's internal political stability in the wake of upcoming general elections in CY23, the prudent management of government debt in a high interest rate environment and resumption of IMF program would be key determinants affecting economic outlook.