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Overview

1 Overview

The analysis and projections in this report were prepared on data outturns for the July-December period of FY24 and finalized in March 2024, using data and developments as of then.

1.1 Overview

Pakistan's macroeconomic conditions somewhat improved during H1-FY24. Real economic activities moderately recovered against the contraction in last year, while Stand-By Arrangement (SBA) with the IMF helped reduce stress on external account. Meanwhile, current account deficit narrowed considerably, amid continued contractionary monetary and fiscal policies, better agriculture output and ease in global commodity prices. Despite restrained domestic demand, inflationary pressures remained persistent at elevated levels (**Figure 1.1**).

The real GDP grew by 1.7 percent during H1-FY24 compared to 1.6 percent in H1-FY23, and a contraction of 1.9 percent in H2-FY23 (**Table 1.1**). The growth in H1-FY24 was led by agriculture, with significant increases in the production of cotton and rice, mainly owing to favorable weather conditions, better availability of inputs and policy incentives. These factors also encouraged farmers to increase area under wheat cultivation.

The recovery in agriculture sector supported some of the agro-based industries. In addition, withdrawal of import prioritization measures improved availability of raw materials for industry. This is reflected in a considerably lower contraction in large-scale manufacturing (LSM) during H1-FY24 compared to H1-FY23. In fact, the LSM output posted an increase in Q2-FY24 after showing contractions for the preceding five quarters. This was despite muted domestic demand amid tight fiscal and monetary

Selected Economic Indicators

Table 1.1

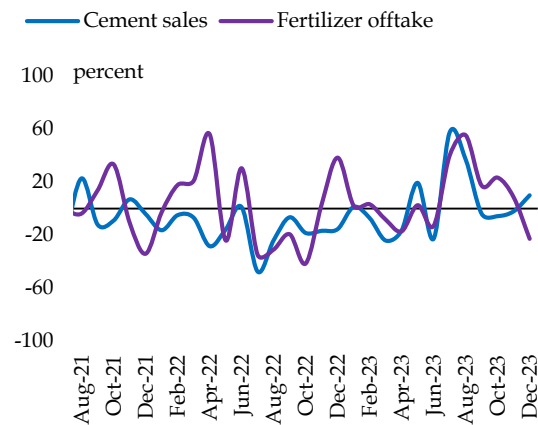
	FY23		FY24		
	H1	H2	Q1	Q2	H1
<i>Growth rate (percent)</i>					
Real GDP	1.6	-1.9	2.5	1.0	1.7
Agriculture sector	1.8	2.7	8.6	5.0	6.8
Services sector	2.2	-2.0	0.9	0.01	0.5
Industrial sector	-0.6	-6.7	-0.2	-0.8	-0.5
LSM ^a	-1.6	-16.9	-0.9	0.5	-0.2
National CPI ^a	25.1	33.1	29.0	28.6	28.8
Private sector credit ^b	6.5	-3.9	-2.1	6.5	4.2
Money supply (M2) ^b	1.2	12.8	0.0	4.5	4.5
Exports ^b	-6.7	-20.9	-5.2	21.1	7.4
Imports ^b	-16.0	-36.5	-25.4	-1.2	-14.6
Exchange rate app (+)/dep(-) ^b	-24.1	-31.8	-20.1	-21.3	-22.2
FBR tax revenue ^c	17.4	16.1	24.9	35.3	30.3
Policy rate (end period) ^b	16.0	22.0	22.0	22.0	22.0
<i>billion US\$</i>					
Remittances ^b	14.4	12.9	6.3	7.1	13.4
FDI in Pakistan ^b	0.6	0.9	0.4	0.5	0.9
FX loans (net) ^b	-0.8	-1.2	2.9	0.3	3.2
Current account balance ^b	-3.6	1.4	-1.0	0.2	-0.8
SBP's liquid FX reserves (end-period)	5.6	4.4	7.6	8.2	8.2
<i>percent of GDP</i>					
Fiscal balance ^c	-2.0	-5.8	-0.9	-1.3	-2.3
Primary balance ^c	1.1	-2.0	0.4	1.3	1.7

Sources: ^aPakistan Bureau of Statistics; ^bState Bank of Pakistan; ^cMinistry of Finance

policies and costlier energy compared to same period last year.

Notwithstanding the improved performance of the commodity producing sectors, growth in services sector decelerated in H1-FY24. The wholesale and retail trade grew in line with the recovery in agriculture and LSM during H1-FY24. Growth in information and communication services also edged up on account of 5.6 percent increase in broadband users during H1-FY24. The growth in transport and storage services

Growth in Demand Indicators

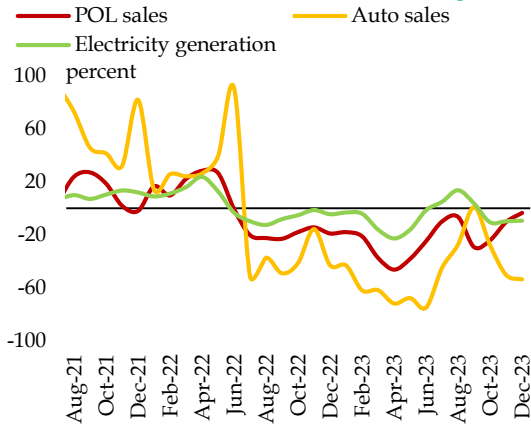


Sources: PBS, APCMA, OCAC, NEPRA and PAMA

somewhat decelerated, as reflected by decline in POL sales to transport sector, as well as sales of commercial vehicles. On the other hand, finance and insurance and general government services recorded contraction.

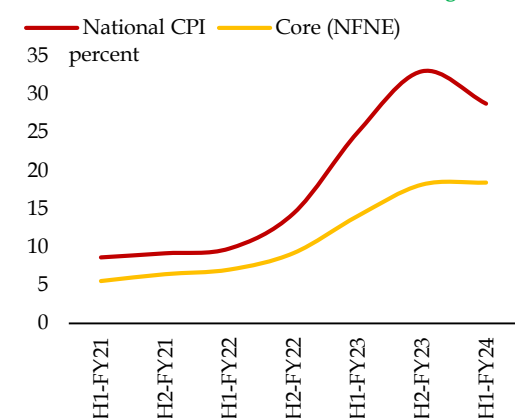
Despite subdued domestic demand and decline in global commodity prices, National CPI (NCPI) inflation remained at elevated levels due to a combination of lingering structural issues, PKR depreciation compared to H1-FY23, increase in government spending, and supply shocks (Figure 1.2). In particular, the rise in administered food and energy prices along with high inflation expectations pushed the average NCPI inflation to 28.8 percent during H1-FY24 compared to 25.0 percent in H1-FY23 (Figure 1.3). In addition, political uncertainty and weak public administration that magnified the impact of market imperfections - like hoarding, smuggling, and price manipulations - also contributed to the inflationary environment.

Figure 1.1



Although core inflation in H1-FY24 plateaued around the H2-FY23 level, it was much higher compared to H1-FY23. A number of factors including higher input costs, increase in indirect taxes, and implementation of upward revision in minimum wage announced in the FY24 budget, alongside the second-round effects of administered prices of food and energy items, were responsible for the persistence in the core inflation. Considering elevated inflation and its expectations, the Monetary Policy Committee (MPC)

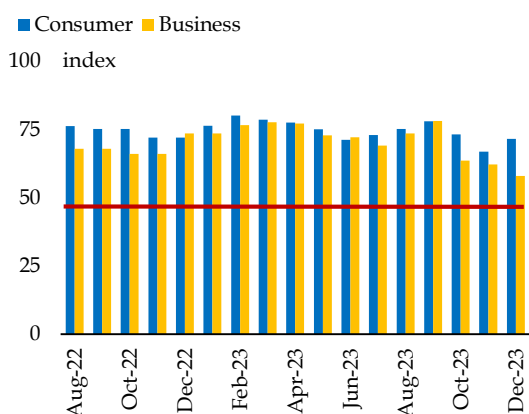
Headline and Core Inflation Trends Figure 1.2



Source: Pakistan Bureau of Statistics

Inflation Expectations

Figure 1.3



Source: State Bank of Pakistan

decided to maintain the tight monetary policy stance in all of its meetings held in the first half of FY24.

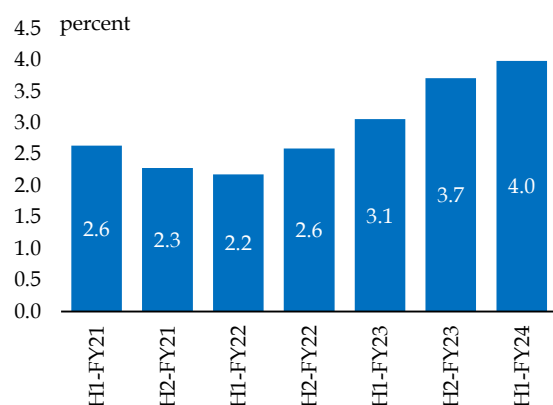
The lagged impact of monetary tightening, combined with fiscal consolidation and government’s administrative measures to curb hoarding and smuggling, resulted in lowering inflation trajectory in H1-FY24 compared to H2-FY23. Specifically, the NCPI inflation fell to 29.7 percent YoY in December from its peak of 38.0 percent in May 2023.

The primary balance posted a higher surplus during H1-FY24 on account of strong growth in revenue that outpaced the increase in non-interest expenditure. However, fiscal deficit remained marginally higher during H1-FY24 compared to the same period last year, primarily due to a sharp rise in interest payments (Figure 1.4a & 1.4b). Non-interest expenditure also rose due to increased disbursement of power subsidies, grants for settlement of contingent liabilities pertaining to Public Sector Enterprises (PSEs), and higher expenses for running of the civil government, defense, and pensions.

On the other hand, increase in total revenue (as percent of GDP) was largely due to higher non-tax revenue; as tax-to-GDP improved only slightly. New tax measures, a moderate recovery in economic activities, higher inflation, PKR depreciation compared to H1-FY23, and increase in corporate profits and returns on deposits supported the Federal Board of Revenue (FBR) tax collection to grow by

Interest Payments as Percent of GDP

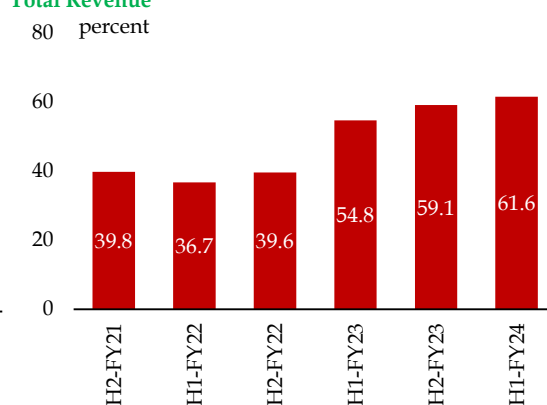
Figure 1.4 a



Source: Ministry of Finance

Interest Payments as Percent of Total Revenue

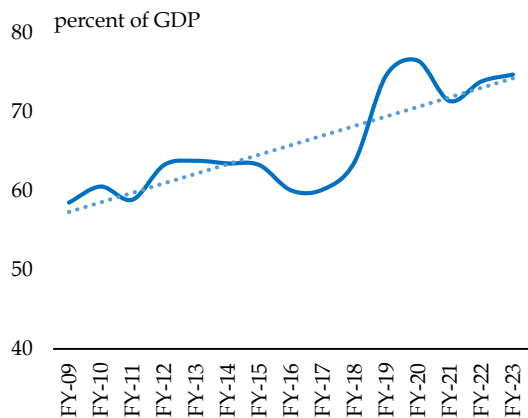
Figure 1.4 b



Source: Ministry of Finance

Public Debt

Figure 1.5



Source: State Bank of Pakistan

nearly 30 percent in H1-FY24, only slightly higher than the average NCPI inflation. In case of non-tax revenues, higher SBP profit, increased collection from petroleum development levy (PDL) primarily due to hike in PDL rates, and interest receipts on federal loans to PSEs and provinces were the primary contributors.

The improvement in primary balance and PKR appreciation compared to end-June 2023 slightly slowed the pace of public debt accumulation in H1-FY24. Nonetheless, in view of the rising burden

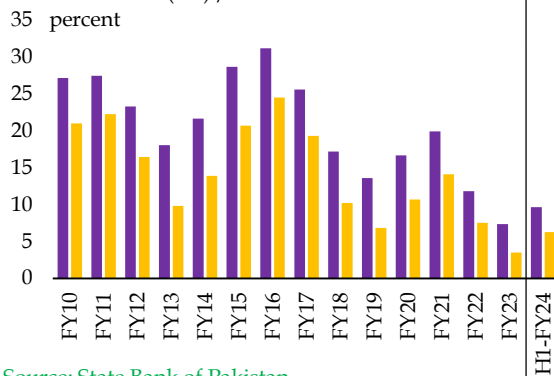
of debt servicing, increasing stock of public debt remains a concern (**Figure 1.5**). In terms of composition, the share of domestic debt increased as government relied more on domestic sources to finance the deficit. Further, maturity profile of the public debt lengthened during H1-FY24 that considerably reduced the rollover risk. However, the repricing risk still persists as the bulk of financing was raised through floating rate instruments.

From the debt sustainability standpoint, there was a slight improvement in external debt servicing relative to foreign exchange earnings during H1-FY24, however, its long-term trend indicates gradually waning repayment capacity (**Figure 1.6**). Despite securing sufficient financial inflows to meet scheduled repayments and build foreign exchange reserves during H1-FY24, the escalating external debt servicing burden poses another challenge.

The approval of the IMF’s SBA partially eased external borrowing constraints, leading to an increase in financial inflows during H1-FY24. In addition, lower

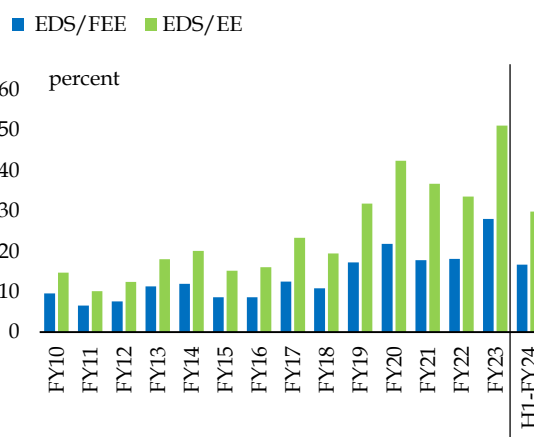
External Debt Sustainability Indicators

- Total reserves (liquid) / TEDL
- SBP reserves (net) / TEDL



Source: State Bank of Pakistan

Figure 1.6



scheduled external loan repayments compared to H1-FY23 and significant reduction in current account deficit supported the build-up in SBP's FX reserves (Figure 1.7). This, together with the reforms related to exchange companies introduced by the SBP in early September and the government's administrative actions, helped in reducing pressures on exchange rate since mid-September 2023.

The narrowing of current account deficit (CAD) mainly owes to a considerable contraction in trade deficit on account of reduction in imports as well as increase in exports. Factors such as restrained domestic demand amid continued contractionary policies, moderating global commodity prices, and higher agro-food production contributed to the improvement in trade balance, which was large enough to outweigh the decline in workers' remittances. Thus, the CAD in H1-FY24 was primarily due to enlarged primary income deficit on account of higher interest payments on external debt and repatriation of profits and dividends. This poses a challenge in the face of still-weak foreign exchange earnings.

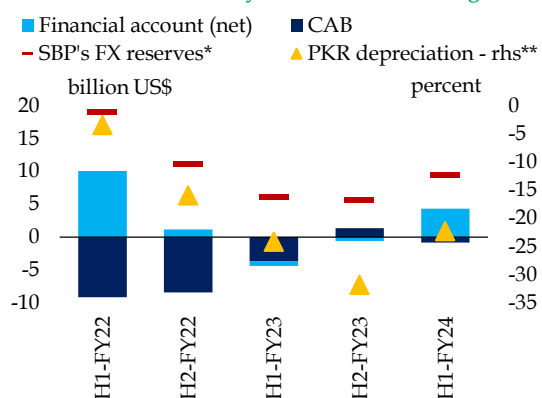
Consequent to the improvement in external account, Net Foreign Assets (NFA) of the banking system witnessed a significant expansion. On the other hand, growth in Net Domestic Assets (NDA) of the banking system decelerated due to slowdown in credit to private sector and PSEs, and retirement in commodity operations financing. However, large fiscal deficit amid limited non-bank financing resulted in a sharp rise in government borrowing from the commercial banks. As

a result, liquidity requirements in the interbank market remained elevated, prompting the SBP to inject substantial liquidity through Open Market Operations (OMOs).

Despite some improvement in macroeconomic indicators, Pakistan's economy continues to grapple with structural bottlenecks that are hampering the achievement of low and stable inflation with sustainable growth. The major issues include limited savings, low investments in physical and human capital, weak productivity, stagnant exports, narrow tax base, and inefficiencies in PSEs. Additionally, political uncertainty exacerbates the situation through inconsistency in economic policies, weak governance and public administration. These underscore the need for policy reforms to ensure sustainable development over the medium to long-term.

One of the most significant economic challenges that is amplified by these structural issues is high and persistent inflation. To this end, Chapter 6 of this

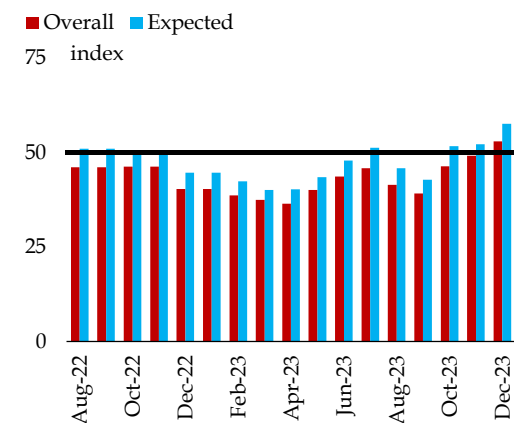
Pakistan's Balance of Payments Figure 1.7



Source: State Bank of Pakistan

Business Confidence

Figure 1.8



Source: State Bank of Pakistan

report analyzes long-term trends in inflation in Pakistan, followed by a review of the determinants of inflation in the country, with a focus on the ongoing high inflationary episode, as well as the episode between 2005-2015. The chapter also sheds light on policy and structural factors influencing inflation, including monetary policy framework, fiscal and debt policy, trade openness, agricultural efficiency, productivity and demographic trends. The chapter concludes that reducing political and policy uncertainties; ensuring fiscal prudence; and addressing longstanding structural issues are needed to achieve low and stable inflation, without overburdening monetary policy and the consequent high economic costs.

1.2 Economic Outlook

The modest economic recovery in H1-FY24 is expected to continue in the second half of FY24. This is also reflected by improvement in business confidence about expected economic conditions since November 2023 (Figure 1.8). On the other hand, the inflationary pressures, albeit

elevated, are expected to moderate. Moreover, the external account outlook has improved. The CAD is expected to be lower than the earlier projection, whereas disbursement of last tranche of US\$ 1.1 billion under the IMF’s SBA would help maintain external buffers.

High-frequency indicators suggest a moderate recovery in economic activity from November 2023 onwards. In addition to rebound in cotton and rice production, the prospects for good wheat harvest during FY24 also increased. This is mainly on the back of higher area under cultivation, better input availability, and favorable weather conditions. The continued easing of FX constraints ameliorated the supply chain situation and availability of industrial raw materials that is supporting some of the large industries. In view of these developments, the SBP projects real GDP growth in the range of 2 – 3 percent for FY24 (Table 1.2). Going forward, further adjustments in energy prices and fiscal consolidation, warranted for slowing the pace of debt accumulation, may continue to weigh on economic activities. In this context, achieving higher

Macroeconomic Targets and Projections for FY24

Table 1.2

	Target	SBP Projections
<i>Growth rate (percent)</i>		
Real GDP ^a	3.5	2.0 – 3.0
CPI (average) ^a	21	23.0 – 25.0
<i>billion US\$</i>		
Remittances ^a	30.5	27.1 – 28.1
Exports (fob) ^a	30	29.0 – 30.0
Imports (fob) ^a	58.7	51.0 – 52.0
<i>percent of GDP</i>		
Fiscal deficit ^b	6.5	7.0 – 8.0
Current account deficit	-	0.5 – 1.5

Sources: ^a Annual Plan 2023-24, ^b Federal Budget 2023-24

growth trajectory over the medium to long-run depends on reforms addressing lingering structural issues.

Continued tight monetary policy stance and fiscal consolidation are expected to keep domestic demand in check. Moreover, the anticipated increase in wheat production may help maintain downward trajectory in food inflation by improving supply and discouraging any speculative sentiments. On the other hand, any significant increase in administered energy prices may offset the impact of these positive developments on inflation outlook. Incorporating these factors, the SBP has revised its inflation projection range to 23.0 – 25.0 percent for FY24. However, escalating geopolitical tensions, unfavorable weather conditions, adverse movements in global oil prices, and subsequent external account pressures are some important upside risks to this outlook.

On external account, slightly improved global outlook and domestic growth prospects are anticipated to boost foreign exchange earnings from exports and remittances. While resilient global demand may have a positive impact on Pakistan's exports, moderating global commodity prices may significantly suppress import prices, leading to an overall contraction in import bill and, hence improvement in trade balance. Taking these factors into account, the SBP projects the current account deficit in the range of 0.5 – 1.5 percent of GDP for FY24. This outlook remains susceptible to unfavorable movement in international commodity prices and continued tight global financial conditions. Under these circumstances, it is imperative to boost exports through reforms aimed at enhancing productivity and attracting FDI in export-oriented sectors to keep the CAD at sustainable level without constraining domestic economic activities.