



State Bank of Pakistan

Half Year Report

2023-2024

The State of Pakistan's Economy



The State of Pakistan's Economy 2023-2024

May 14, 2024



The State of Pakistan's Economy

Half Year Report
For the year 2023-2024
of the Board of Directors of State Bank of Pakistan

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
May 14, 2024

Dear Mr. Chairman,

In terms of Section 39(2) of the State Bank of Pakistan Act, 1956, the Half Year Report of the Board of Directors of the State Bank of Pakistan on the State of Economy for the year 2023-24 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament).

Yours sincerely,



(Jameel Ahmad)
Governor
Chairperson, Board of Directors

Syed Yousuf Raza Gillani
Chairman
Senate
Islamabad

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
May 14, 2024

Dear Mr. Speaker,

In terms of Section 39(2) of the State Bank of Pakistan Act, 1956, the Half Year Report of the Board of Directors of the State Bank of Pakistan on the State of Economy for the year 2023-24 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament).

Yours sincerely,



(Jameel Ahmad)

Governor
Chairperson, Board of Directors

Sardar Ayaz Sadiq
Speaker
National Assembly
Islamabad

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
May 14, 2024

Dear Finance Minister,

In terms of Section 39(2) of the State Bank of Pakistan Act, 1956, the Half Year Report of the Board of Directors of the State Bank of Pakistan on the State of Economy for the year 2023-24 is hereby enclosed.

Yours sincerely,



(Jameel Ahmad)

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Chairperson, Board of Directors

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1

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

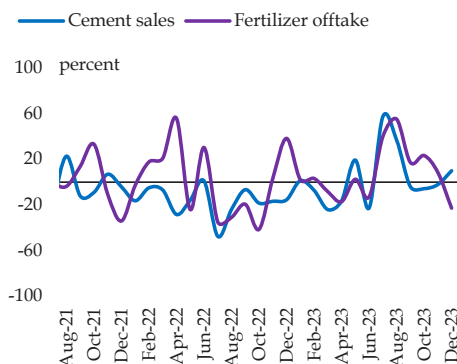
	FY23		FY24		
	H1	H2	Q1	Q2	H1
<i>Growth rate (percent)</i>					
Real GDP	1.6	-1.9	2.5	1.0	1.7
Agriculture sector	1.8	2.7	8.6	5.0	6.8
Services sector	2.2	-2.0	0.9	0.01	0.5
Industrial sector	-0.6	-6.7	-0.2	-0.8	-0.5
LSM ^a	-1.6	-16.9	-0.9	0.5	-0.2
National CPI ^a	25.1	33.1	29.0	28.6	28.8
Private sector 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

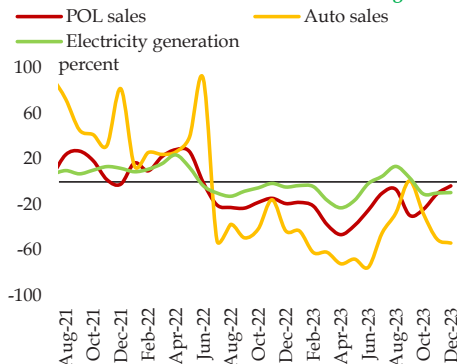


Sources: PBS, APCMA, OCAC, NEPRA and PAMA

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.

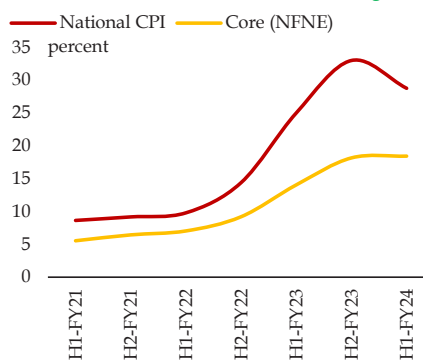
Figure 1.1



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

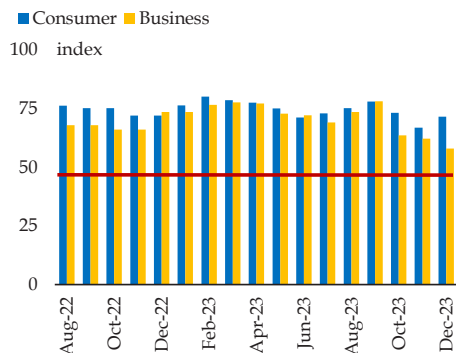
Figure 1.2



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.

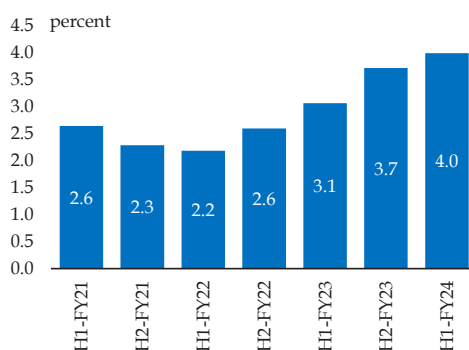
The lagged impact of monetary tightening, combined with fiscal consolidation and government's administrative measures to curb hoarding and smuggling, resulted in lowering inflation trajectory in H1-FY24 compared to H2-FY23. Specifically, the NCPI inflation fell to 29.7 percent YoY in December from its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

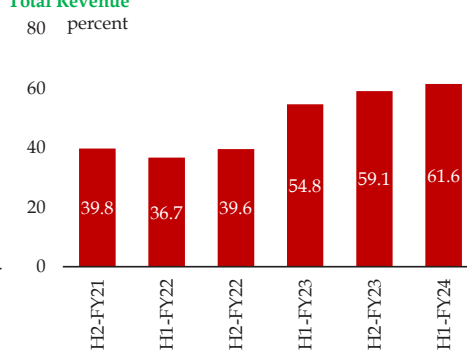
Figure 1.4 a



Source: Ministry of Finance

Interest Payments as Percent of Total Revenue

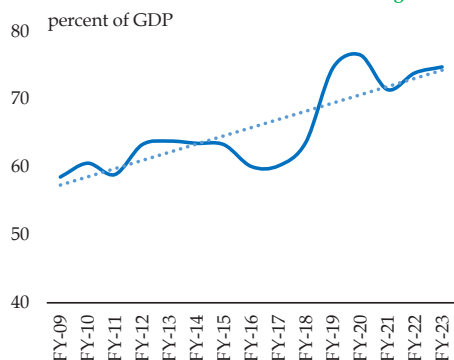
Figure 1.4 b



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

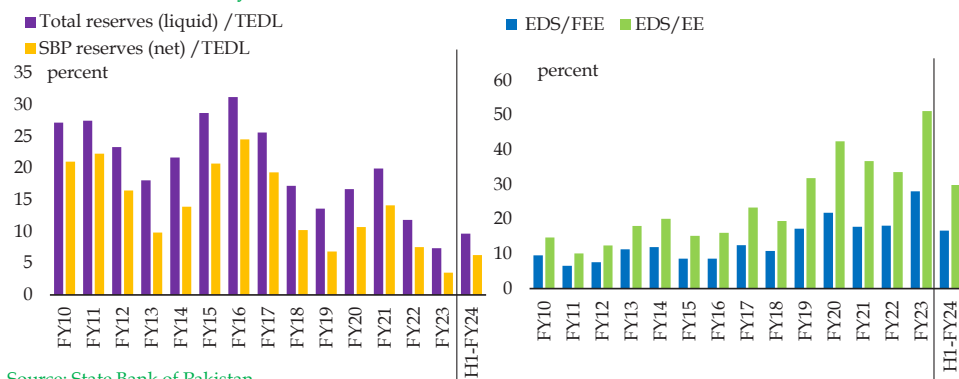
of debt servicing, increasing stock of public debt remains a concern (Figure 1.5). In terms of composition, the share of domestic debt increased as government relied more on domestic sources to finance the deficit. Further, maturity profile of the public debt lengthened during H1-FY24 that considerably 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

Figure 1.6



Source: State Bank of Pakistan

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.

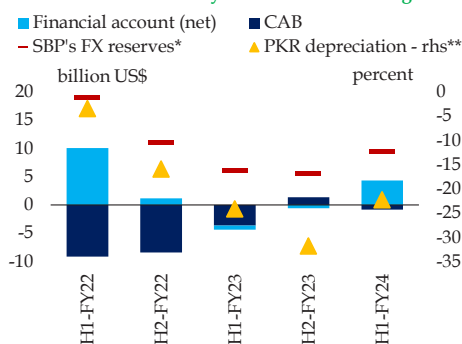
Consequent to the improvement in external account, Net Foreign Assets (NFA) of the banking system witnessed a significant expansion. On the other hand, growth in Net Domestic Assets (NDA) of the banking system decelerated due to slowdown in credit to private sector and PSEs, and retirement in commodity 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**

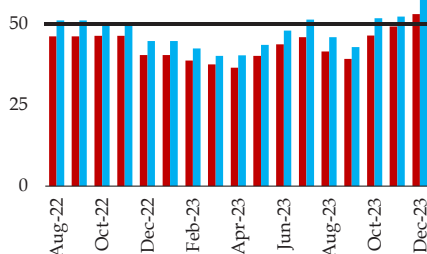


*end period, **Average; dep (-) / app (+)

Source: State Bank of Pakistan

Business Confidence**Figure 1.8**

■ Overall ■ Expected
75 index



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.



2

Real Sector

Domestic economic activity witnessed a moderate recovery in H1-FY24. The recovery is spearheaded by agriculture sector, especially crops and livestock. In particular, production of cotton and rice increased substantially on the back of favorable weather conditions and improved input availability. Large scale manufacturing (LSM) output also posted a lower contraction during H1-FY24, with slight increase in production recorded in Q2-FY24. Nonetheless, continued tight financial conditions, increase in power tariffs and fuel prices together with political uncertainty continued to hamper industrial activities in the country. Services sector showed mixed performance. Wholesale & retail trade improved in line with expansion in commodity producing sectors, while growth in other sub-sectors remained subdued. The labor market data showed slight deterioration in industrial employment during H1-FY24.



2.1 Economic Growth

Economic activity has moderately recovered in H1-FY24. The real GDP recorded increase in the first two quarters of FY24, after showing contractions in the last two quarters of FY23. The recovery was led by agriculture, having spill-over effects on manufacturing and services sectors. The growth though decelerated in Q2 compared to Q1, the composition somewhat improved with LSM also contributing positively in Q2-FY24 (Table 2.1).

The agriculture growth is spearheaded by important crops. More specifically, production of cotton and rice, has rebounded, while area under cultivation of wheat, an important *Rabi* crop, is estimated to have increased over last year.

In view of better soil quality after floods, agriculture production was expected to improve in H1-FY24. In addition, timely announcement of Minimum Support Price (MSP) together with better input availability (seed and fertilizer) and higher credit disbursement to agriculture further boosted crop output.

In cumulative terms, LSM showed lower contraction during H1-FY24 compared to the same period last year. In fact, LSM output recorded increase in Nov-Dec 2023 on both YoY and MoM bases. Further, more sectors contributed positively to the LSM growth in H1-FY24 compared to H1-FY23, when wearing apparel majorly contributed to overall LSM output (Figure 2.1).¹ Relaxation in import restrictions, together with lower international commodity prices, and improved availability of raw materials mainly explain bottoming out in LSM output. These trends are also corroborated by improvement in business and consumer confidence towards the end of H1-Y24.

Nevertheless, a confluence of global and domestic factors continued to weigh on industrial activity. Especially, continuation of tight monetary policy stance in most economies and a slower global GDP growth suppressed demand for traditional Pakistani exports (see Chapter 5). On domestic side, high inflationary environment, amidst costlier energy, higher nominal wages, contractionary monetary policy, fiscal consolidation, and

GDP Growth

YoY, Percent

Table 2.1

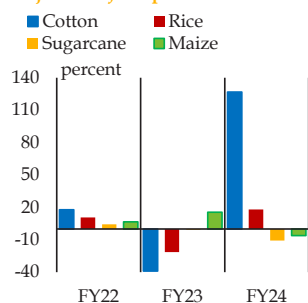
Sector	FY23						FY24		
	Q1	Q2	Q3	Q4	H1*	H2*	Q1	Q2	H1*
Agriculture	0.2	3.5	3.9	1.5	1.8	2.7	8.6	5.0	6.8
Important crops	-11.5	9.3	9.1	-8.5	0.2	0.8	31.5	8.1	17.2
Industrial	-1.9	0.8	-3.6	-9.7	-0.6	-6.7	-0.2	-0.8	-0.5
LSM	-1.3	-1.9	-14.5	-19.6	-1.6	-16.9	-0.9	0.5	-0.2
Services	2.3	2.2	-1.0	-3.0	2.2	-2.0	0.9	0.01	0.5
GDP	1.0	2.2	-0.4	-3.3	1.6	-1.9	2.5	1.0	1.7

* H1 GVA = Q1 GVA + Q2 GVA; H2 GVA = Q3 GVA + Q4 GVA

Source: Pakistan Bureau of Statistics

¹ LSM output excluding wearing apparel shows a lower contraction of 2.7 percent during H1-FY24, compared to 8.0 percent in the same period last year.

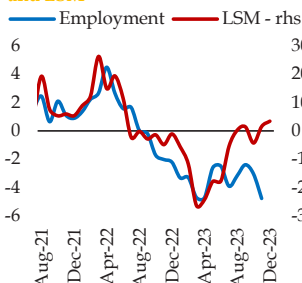
Growth in Production of Major Kharif Crops



Source: Federal Committee on Agriculture

Figure 2.1a

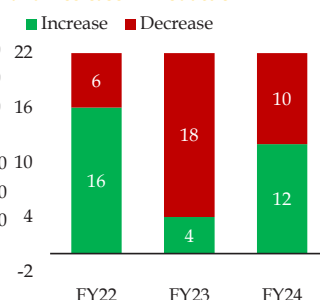
Punjab: YoY Growth in Industrial Employment and LSM



Sources: Pakistan Bureau of Statistics and Punjab Bureau of Statistics

Figure 2.1b

Number of Sectors in LSM Showing Increase and Decrease in Production



Source: Pakistan Bureau of Statistics

Figure 2.1c

political instability remained major factors constraining the industrial activity.

The available labor market data depicted deterioration in industrial employment, both in the provinces of Punjab and Sindh, during H1-FY24 compared to the same period of FY23.² The SBP business and consumer confidence surveys also showed slight decline in sentiments about employment in both services and industrial sectors during H1-FY24. The wage indices in CPI, mainly personal grooming, doctor fee, mechanical services, rose significantly during the current review period.

Rebound in agriculture and some improvement in manufacturing had knock on impact on the performance of services, especially *wholesale and retail trade, transport and storage, and hoteling restaurant services*. Sustaining this moderate agriculture-led recovery in economic activities, nevertheless, requires increased contribution from the industry and

services sectors. While the availability of imported raw materials has improved, it is important to develop domestic supply chain to reduce reliance on imported raw materials and technology. Further, there is a need to enhance labor productivity through investment in skill development. Similarly, more focus is needed to increase crop yields through better water management and developing high-yielding climate resistant seed varieties.

2.2 Agriculture

Agriculture output rebounded, with 6.8 percent growth in H1-FY24 compared to 1.8 percent in last year (**Table 2.2**). The growth was also broad-based, with major contribution coming from important crops and livestock. Among the important crops, production of cotton and rice increased considerably, with former leading to a notable increase in ginning activity as well. Production of sugarcane slightly declined, with losing some area to cotton. Favorable weather conditions alongside greater input

² Data for Punjab and Sindh is for Jul-Nov and Jul-Oct, respectively

Growth in GVA of Agriculture Sector
percent

Table 2.2

	FY23						FY24		
	Q1	Q2	Q3	Q4	H1*	H2*	Q1	Q2	H1*
Agriculture sector	0.2	3.5	3.9	1.5	1.8	2.7	8.6	5.0	6.8
Crops	-7.7	4.5	3.2	-5.2	-1.1	-0.8	17.7	6.2	11.1
Important crops	-11.5	9.3	9.1	-8.5	0.2	0.8	31.5	8.1	17.2
Other crops	-1.2	-0.4	-1.0	-1.2	-0.7	-1.1	0.3	-0.3	0.0
Cotton ginning	-22.4	-30.2	-26.8	-10.6	-26.4	-19.1	25.8	53.6	39.1
Livestock	4.0	2.3	3.9	4.4	3.2	4.1	4.4	4.3	4.4
Forestry	13.3	15.8	15.4	12.4	14.6	13.9	7.2	3.6	5.4
Fishing	0.6	0.6	0.6	0.6	0.6	0.6	0.7	0.8	0.7

* H1 GVA = Q1 GVA + Q2 GVA; H2 GVA = Q3 GVA + Q4 GVA

Source: Pakistan Bureau of Statistics

availability supported the overall better performance of the crops.³

The reported increase in area under wheat is likely to provide further boost to crop production in FY24. Adequate soil moisture at the time of sowing is also supportive for the upcoming wheat crop.⁴ However, concerns about fertilizer affordability due to high prices and its reported hoarding can be an issue.⁵ Nonetheless, current situation indicates optimistic outlook for wheat and other *Rabi* crops.

Inputs

Seed

Availability of certified seed exceeded the requirement in the case of rice and moong. However, there was shortage of seeds in case of cotton and maize during H1-FY24

(Table 2.3). These shortages were managed through informal sources such as seeds saved from the previous harvest by farmers and uncertified seeds sold by seed companies and input market dealers.⁶ Due to this and other perennial structural issues, Pakistan lags behind other economies in terms of yield, despite being among the top producers of certain crops (Figure 2.2).

For instance, USA ranks lower than Pakistan in terms of production of sugarcane but higher in terms of yield.⁷

Seed Availability for Kharif Crops

Table 2.3

Crop	FY23		FY24*	
	Availability (000' MT)	% of Req.	Availability (000' MT)	% of Req.
Paddy	67.3	148	52.0	114
Maize	28.0	85	24.7	75
Moong	5.2	93	6.9	122
Cotton	42.2	84	17.7	35

* Provisional

Source: FCA Working Paper - Kharif Season 2023-24

³ However, compared to FY22, only cotton and maize witnessed a rise in production.

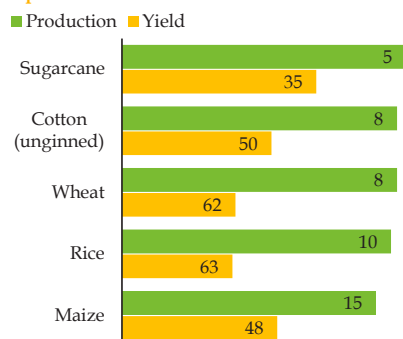
⁴ Source: FAO - GIEWS Country Brief, The Islamic Republic of Pakistan, November 14, 2023.

⁵ District administration to take immediate action against fertilizer hoarders on Prime Minister's instructions. Source: moib.gov.pk/News/58995

⁶ SBP Staff Note 02/22, Investigating Pakistan's Seed Industry Dynamics, June 2022.

⁷ USA ranks 9th and 17th in sugarcane production and yield respectively. Source: FAO Stats, 2022

Pakistan's Ranking in Terms of Crop Production and Yield



Source: Food and Agriculture Organization - 2022

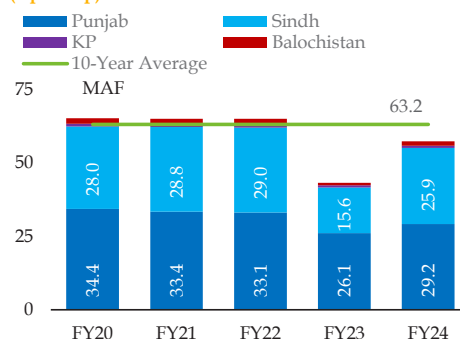
China, on the other hand, ranks higher than Pakistan in terms of both production and yield of rice and cotton.⁸

Water Availability

Water availability remained at par with the requirements of *Kharif* crops. Rainfall was close to or above the average for most parts of the season except August 2023, which was the second driest August in the last sixty-three years.⁹ This dry spell came soon after June 2023, which was the second wettest June in the last sixty-three years.¹⁰ These extreme rainfall patterns within a year can be traced to climate change.

In line with the rainfall patterns, water releases for irrigation, though higher during H1-FY24 compared to H1-FY23, were still lower than the average over the

Figure 2.2

Irrigation Water Releases during *Kharif* (Apr - Sep)

Source: Indus River System Authority

past ten years (Figure 2.3). In fact, FY23 required lower release of irrigation water due to heavy floods.

Fertilizer

Fertilizer offtake also improved in *Kharif* FY24 as compared to the previous year. Urea offtake increased by 5.8 percent despite the increase in prices (Figure 2.4a). DAP offtake also increased by 54.2 percent, which may be attributed to drop in prices (Figure 2.4b). As Pakistan relies on DAP imports to meet its domestic requirements, fall in international prices translated into a reduction of 7.1 percent in domestic DAP prices.^{11, 12}

In the international market, fertilizer prices have eased from their peak in May 2022 (Figure 2.5). The decrease in international

⁸ China ranks 1st in cotton seed production and yield, and 1st and 11th in the production and yield of rice. Source: FAO Stats, 2022

⁹ Source: Pakistan Monthly Climate Summary April 2023 – September 2023, Pakistan Meteorological Department

¹⁰ June 2023 witnessed a severe tropical bipolar affecting the region for about twelve days

¹¹ During *Kharif* FY24, DAP import stood 117,400 MT (NFDC).

¹² The average price of DAP during *Kharif* 2023 was Rs 11,128 per 50kg/bag as compared to Rs 10,342 per 50kg/bag for the same period this year (PBS).

Urea Offtake and Price during Kharif (Apr-Sep)

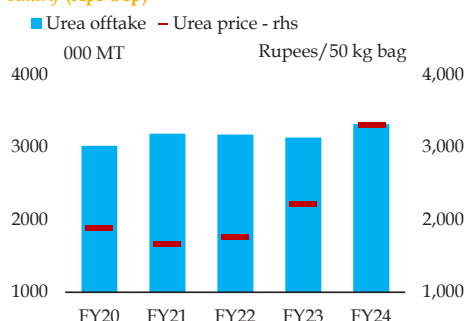


Figure 2.4a

DAP Offtake and Price during Kharif (Apr-Sep)

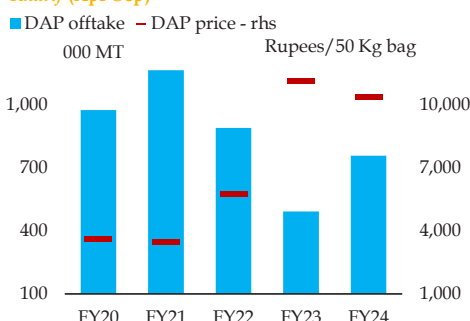


Figure 2.4b

Sources: National Fertilizer Development Centre and Pakistan Bureau of Statistics

prices was on the back of lower demand owing to eroding affordability.¹³ In effect, the global fertilizer industry is still constrained by supply side shocks from Russia-Ukraine conflict besides restrictions on exports by China and Morocco, and further escalation in natural gas prices due to Middle-East conflict.¹⁴

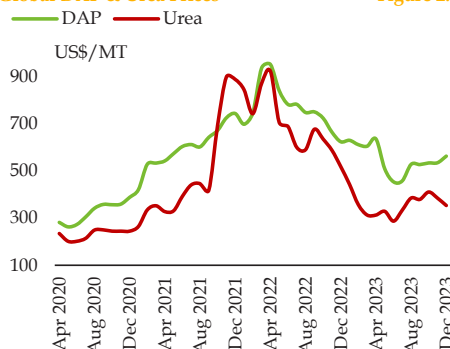
There was also significant increase in disbursements for purchase of tractors (farm sector - development). This is also reflected in tractor sales, which surged by 103.3 percent during H1-FY24, pointing towards increased agricultural activity as well as mechanization in the sector.¹⁶

Agriculture Credit Disbursements

Keeping in view the rising input prices, the target for agriculture credit disbursements was increased by 23.7 percent to Rs 2,250 billion in FY24. In line with that, disbursements increased by 31.3 percent in H1-FY24, achieving about 49.1 percent of the annual target.¹⁵ Most of the loans were disbursed for crop production, followed by livestock/ dairy in non-farm sector and poultry (Table 2.4).

Global DAP & Urea Prices

Figure 2.5



Source: World Bank

¹³ DAP usage fell in various regions notably in Asia where affordability was the main driver. Source: World Bank Report – Commodity markets outlook, October 2023.

¹⁴ Source: World Bank Report – Commodity markets outlook, October 2023.

¹⁵ Source: SBP, Agriculture Credit & Financial Inclusion Department: Targets, disbursements, recoveries & outstanding during July-December 2023.

¹⁶ Sale of tractor more than doubled to 23,411 units in H1 FY24 as compared to 11,513 units in H1 FY23 (source: PAMA – Production and Sales Data of Vehicles)

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Agriculture Credit Disbursements in H1

Table 2.4

billion Rupees, percent

	FY23		FY24	
	Amount	Growth	Amount	Growth
Farm sector				
A. Production	419.7	42.4	545.8	30.0
B. Development	25.3	1.6	58.9	132.8
<i>Tractor</i>	2.3	-50.0	27.8	1109.3
C. Total farm sector (A+B)	445.0	39.2	604.7	35.9
Non - farm sector				
D. Livestock/ dairy	222.1	39.9	270.5	21.8
E. Poultry	140.9	35.1	173.5	23.2
F. Other	34.4	50.2	57.1	66.0
G. Total non-farm sector	397.4	23.7	501.2	26.1
Total agriculture	842.4	31.5	1105.8	31.3

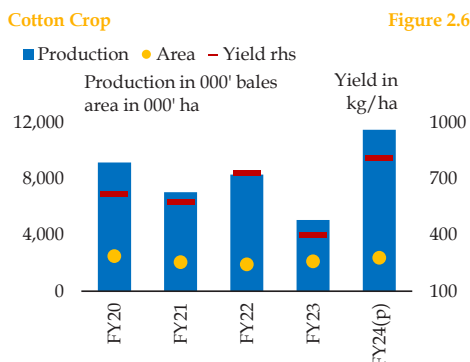
Source: State Bank of Pakistan

SBP's financing schemes such as Prime Minister's kissan package, crop loan insurance scheme, livestock insurance scheme for borrowers, and use of electronic warehouse receipt facilitated farmers in meeting their financing needs. In addition, 'champion bank model' accelerated penetration in the underserved regions, through increasing awareness, formulating specialized lending programs,

and addressing the challenges faced by local farmers.¹⁷ In order to enhance awareness regarding various agriculture credit schemes, Agriculture Finance Literacy Program (AFLP) of SBP conducted a series of five workshops in H1-FY24.¹⁸

Outputs

Cotton



Sources: Federal Committee on Agriculture Working Paper and Pakistan Bureau of Statistics

Provisional estimates show a sizeable increase in cotton production in FY24, after suffering substantial losses due to floods in FY23. Both the increase in area under cultivation (12.2 percent), and yield (122.7 percent) contributed to 126.6 percent increase in cotton production (Figure 2.6).¹⁹

Importantly, cotton area, production and yield were 4, 24, and 20 percent higher compared to their respective 5-year averages (FY18-22, to control for FY23

¹⁷ Source: SBP press release RD/M&PRD/PR/01/2022-74, June 15, 2022

¹⁸ Source: SBP press release (ECD/M&PRD/PR/01/2023-84), September 18, 2023

¹⁹ Working Paper, 21st meeting of Federal Committee on Agriculture (FCA) – Rabi Season 2023 -24, MNFSR

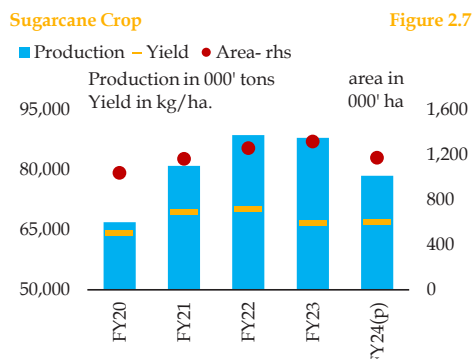
floods). This overall improvement can be linked to better quality of pest resilient seeds, favorable weather conditions, and announcement of attractive support price before the start of sowing season.^{20,21}

Cotton arrivals at 8.2 million bales as of January 1, 2024, though still considerably higher than last year, are reported to be less than the provisional estimates.²² This can be linked to lower output in Punjab as per SUPARCO estimates, mainly due to whitefly attacks and uneven rainfall patterns.²³ Sindh, on the other hand, exceeded the target supported primarily by increase in area under cultivation and better environmental conditions—dry weather during the picking season and lower pest attacks.

Sugarcane

Sugarcane production fell by 10.7 percent in FY24 as compared to a slight decrease of 0.8 percent in FY23 (**Figure 2.7**). This can be explained by an almost matching fall in area under cultivation, despite a marginal increase of 0.3 percent in yields.

In FY23, farmers had substituted cotton with sugarcane because of higher returns.²⁴ In FY24, however, the situation reversed in favor of cotton and area under cultivation



Sources: Federal Committee on Agriculture Working Paper and Pakistan Bureau of Statistics

of sugarcane decreased in both Punjab and Sindh despite increase in support prices.²⁵

Rice

Provisional estimates for FY24 indicate substantial increase in rice production, after suffering large flood-related losses in FY23 (**Figure 2.8**). The rise in rice production was on account of increased area under cultivation, supported by higher rice prices, favorable monsoon rains, and better export prospects since last year (see **Chapter 5**).

Maize

Production of maize rose by 3.0 percent with increase in area under cultivation by

²⁰ Better quality of pest resilient seeds was used in Punjab and Sindh. Source: Monthly Economic Update and Outlook, August 2023, Finance Division, Economic Advisor's Wing, Government of Pakistan.

²¹ Ministry of Finance (PR No. 325 - March 14, 2023), ECC approved the proposal of MNFSR and fixed the intervention price of cotton (Phutti) at Rs 8,500/40Kg for this year's sowing season.

²² Cotton Arrivals, Pakistan Cotton Ginners' Association: Multan

²³ Source: SUPARCO, PAK-SCMS Bulletin, January 1, 2024. Area under cultivation and production for Punjab is 1.39 million ha. and 5.07 million bales respectively in contrast to the 1.7 million ha and 7.0 million bales as per provisional estimates in FCA working paper.

²⁴ Source: The State of Pakistan Economy, Half Year Report 2022-23: SBP, Karachi.

²⁵ Support price in Sindh and Punjab increased from Rs 302/40Kg and Rs 300/40Kg (Source: PBS) to Rs 425/40Kg and Rs 400/40Kg (Source: SUPARCO) respectively.

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Rice Crop

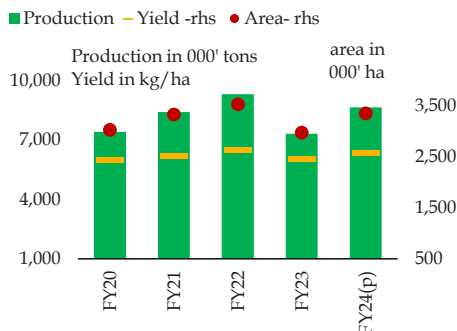


Figure 2.8

Sources: Federal Committee on Agriculture Working Paper and Pakistan Bureau of Statistics

Maize Crop

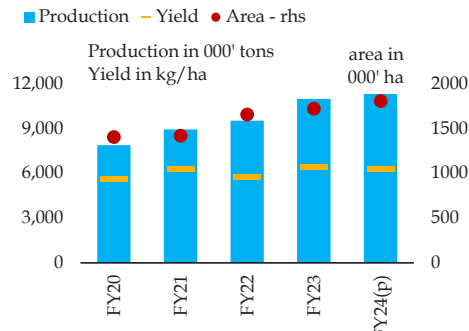


Figure 2.9

Sources: Federal Committee on Agriculture Working Paper - Minutes and Pakistan Bureau of Statistics

5.0 percent in FY24 (Figure 2.9).^{26, 27} Moreover, maize production in FY24 is 16.8 percent higher than the average during the past five years, reflecting increased sowing area and high yields.²⁸ Besides domestic consumption, export of maize also increased in H1-FY24 (see Chapter 5).

Wheat

Wheat production is targeted at 30 MMT for FY24 (Table 2.5). The area under cultivation of wheat is reported to have increased by 6.7 percent in FY24, surpassing the target by 1.8 percent.^{29, 30} However, dry spell in December 2024 could have negative impact on its yield.³¹ Nonetheless, considering the situation during the sowing season in terms of weather conditions, soil moisture, input

availability, and the sown area in various provinces, outlook of wheat is promising barring any unexpected bad weather at the time of harvest

Despite good crop outcomes, the country lacks self-sufficiency in wheat and has to rely on imports to meet rising consumption needs.³² Government maintained the minimum support price (MSP) at Rs 3,900/40Kg for FY24

Wheat Targets for FY24

Table 2.5

area in million ha; production in million MT

Country/ Province	Area		Production	
	FY23	FY24 (T)	FY23	FY24 (T)
Punjab	6.5	7.7	21.2	23.0
Sindh	1.2	1.3	3.9	4.0
KPK	0.8	0.6	1.5	1.8
Balochistan	0.5	0.4	1.5	1.2
Pakistan	9.0	10.0	28.2	30.0

Source: Federal Committee on Agriculture, Crop Reporting Service

²⁶ Source: Minutes of the 21st Meeting of FCA for Rabi season (2023-24), MNFSR.

²⁷ As reported in minutes of the 21st Meeting of FCA for Rabi season (2023-24), MNFSR. Whereas, maize production increased by 5.7 percent according to the QNA release 2023-24 Q2 by PBS.

²⁸ Maize production in FY24 exceeds the five-year average by 1.5 million tons

²⁹ Source: Pakistan Bureau of Statistics, QNA release 2023-24 Q2.

³⁰ Source: Government of Pakistan, Finance Division, Monthly Economic Update and Outlook, January 2024.

³¹ Rainfall in December 2023 was 92 percent below average. Source: Pakistan Meteorological Department

³² Estimated shortfall for FY24, keeping in view the increasing national requirement (32.21 MMT) is 2.4 MMT.

considering average farmer's cost of production.³³ The MSP policy of the government has played an important role in encouraging production of various important crops including wheat.

However, it entails the use of the government funds by the procuring agencies. **Box 2.1** briefly reviews different country practices to draw useful lessons to further improve the current MSP policy.

Box 2.1: MSP Mechanism in Pakistan – Lessons from international best practices

MSP is a form of market intervention in which governments sets a minimum price for agricultural produce to incentivize farmers to grow more of a certain crop in order to achieve self-sufficiency and food security, ensure smooth supply, and keep prices stable in domestic market. The minimum price is set considering cost of production such as land rent and input costs – fertilizers, pesticides, seeds, water, labor, machinery rates, fuel charges, etc. as well as demand and supply dynamics. However, MSP becomes an added fiscal burden in resource constrained developing countries.

Governments, in both developing and advanced economies, use various approaches to support farmers depending upon the needs and dynamics of their respective countries. In Pakistan, wheat is procured by the government at MSP while cotton and sugarcane are mostly supported through indicative MSP. The government also undertakes purchase and sale of key commodities to ensure equilibrium between demand and supply and maintain buffer stocks.

International Experiences

Countries such as India, Bangladesh, and China have MSP mechanism for important crops similar to Pakistan. India use MSP for numerous *Kharif and Rabi* crops including paddy, maize, soybean, cotton, wheat, barley, and gram.³⁴ Bangladesh announces MSP for paddy at the harvest time and procures it through Public Food Grain Distribution System (PFGDS). China, procures and announces support prices for wheat and rice based on production cost and market conditions before the crops are sown.³⁵ On the other hand, in addition to announcing support prices for selected agricultural commodities, the South African government provides a support of 30 and 5 percent of gross receipts of sugar and wheat respectively.³⁶ Whereas, the Kenyan government sets a floor price for wheat at which private traders and millers are required to buy domestic produce before they can import at a preferential tariff.³⁷

In USA, government has several support programs in place for their farmers such as commodity loan program, farm storage facility, honey recourse loan program, market loss assistance payment etc.³⁸ In commodity loan program, a hybrid approach is used by issuing 'loan rates' for selected commodities such as wheat, corn, and oilseeds.³⁹ Farmers can avail financing on the basis of these 'loan rates' by pledging their crop as a collateral. At maturity, farmers can either sell their crops in the market (if the market price

³³ Ministry of Finance (PR No. 510 – December 30, 2023), ECC maintained last year's intervention price of Rs 3,900/40Kg for wheat. Average farmer's cost of production of wheat in FY24 is estimated to be Rs 3,303.5/40Kg and 3,075.2/40Kg in Punjab and Sindh respectively. Source: Wheat Policy Analysis For 2023-24 Crop.pdf (api.gov.pk)

³⁴ Press Release – June 7, 2023. Source: Press Information Bureau (PIB), India.

³⁵ Source: The State Council, The people's Republic of China (english.www.gov.cn)

³⁶ Source OECD: Reforming Agriculture Policy for Climate Change Mitigation.

³⁷ Source: USDA Annual Grain and Feed Report, March 2022. Referenced wheat policy is periodically approved by the government and is expected to remain operational in MY23.

³⁸ <https://www.usda.gov/topics/trade/price-support>

³⁹ National Average Loan Rates 2023. Source: USDA

is higher than the 'loan rate') and repay the loan or deliver the commodity (pledged as the collateral) to as full settlement on maturity in case the market prices is lower than the 'loan rate'.⁴⁰

What Pakistan can learn from different country experiences?

Pakistan can restructure MSP mechanism mainly by prioritizing staple crops, especially wheat, and increasing the role of private sector in the procurement and supply management of other crops. Pakistan can draw useful lessons from international best practices and implement strategies such as loan rates for key crops. This can serve a dual purpose of providing farmers with financing and reducing their reliance on expensive loans from informal lenders, and simultaneously establishing a floor price for these crops. Such a system grants autonomy to farmers in terms of repaying their loan; either by selling their crops in the open market or by delivering pledged crops to the government procurement agency. In the long-run, government needs to slowly step back from direct procurement and play its role in monitoring demand and supply gaps and encouraging private sector to play its role in procurement and storage. Government may maintain strategic stock primarily for exigencies and extreme shortages.

Other Crops

Production of other *Kharif* crops (moong, mash, and chilli), which were severely affected by last year's floods, posted decent increases in FY24 (**Table 2.6**). Nonetheless, the production levels of other *Kharif* crops remained lower than FY22 – a flood-wise relatively normal year.

Furthermore, production of potato, a high yielding *Rabi* cash crop, is mainly concentrated in Punjab which accounted for 99 percent of the total production in FY23. Considering a surplus produce last year, a lower target was set for this year. Target set for other *Rabi* crops are given in **Table 2.7**.

Other *Kharif* Crops

Table 2.6

area in 000 hectares; production in 000 tons

Crops	Area			Production		
	FY22	FY23	FY24*	FY22	FY23	FY24*
Moong	302	218	198	264	135	144
Mash	8	7	7	6	4	5
Chili	58	54	55	144	119	122

*Provisional

Sources: Federal Committee on Agriculture Working Paper and Pakistan Bureau of Statistics

2.3 Industry

The industrial production recorded contraction for the fourth consecutive quarter in Q2-FY24 (**Table 2.8**). Subdued domestic demand and decline in Pakistan's traditional textile exports along with costlier energy were the major factors constraining industrial activity during H1-FY24.

Nonetheless, LSM output recovered in Q2-FY24, rising by 0.5 percent after showing declines in the previous five quarters, since Q1-FY23. This substantially reduced contraction in LSM during H1-FY24 compared to previous year. Improved availability of imported raw materials and

Other *Rabi* Crops

Table 2.7

production in 000 tons, growth in percent

Crop	Production		Growth
	FY23	FY24 (T)	
Onion	1844	2543	37.9
Tomato	621	653	5.2
Potato	8184	6331	-22.7
Gram	244	588	141.4
Lentil	5	10	104.3

Source: Federal Committee on Agriculture Working Paper

⁴⁰ Source: Commodity Credit Corporation, USDA

Growth in GVA of Industrial Sector

Table 2.8

percent

	FY23						FY24		
	Q1	Q2	Q3	Q4	H1*	H2*	Q1	Q2	H1*
Overall	-1.9	0.8	-3.6	-9.7	-0.6	-6.7	-0.2	-0.8	-0.5
Mining & quarrying	-17.7	-1.3	6.7	1.0	-10.0	3.8	7.8	-4.2	1.6
Manufacturing	1.1	0.7	-9.2	-12.4	0.9	-10.7	2.0	2.9	2.5
Large scale	-1.3	-1.9	-14.5	-19.6	-1.6	-16.9	-0.9	0.5	-0.2
Small scale	8.6	8.9	9.3	9.8	8.7	9.5	10.4	10.1	10.3
Slaughtering	6.1	6.2	6.4	6.9	6.2	6.7	7.5	7.3	7.4
Electricity, gas and water supply	-2.1	13.2	35.8	7.6	3.0	18.3	-12.7	1.5	-7.4
Construction	-3.6	-4.9	-5.8	-22.2	-4.4	-14.0	0.7	-17.6	-9.3

* H1 GVA = Q1 GVA + Q2 GVA; H2 GVA = Q3 GVA + Q4 GVA

Source: Pakistan Bureau of Statistics

rebound in production of cotton and rice were the key supporting factors.

Large-Scale Manufacturing (LSM)⁴¹

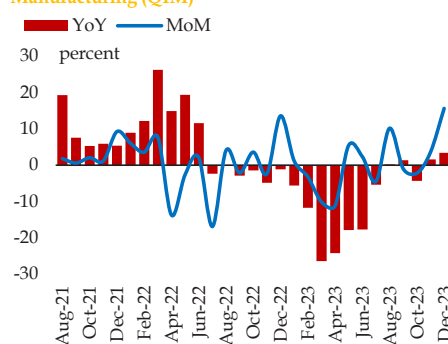
LSM recorded a lower contraction of 0.4 percent during H1-FY24 compared to a decline of 2.1 percent in the corresponding period of last year (**Table 2.9**). Monthly data shows LSM grew on both YoY and MoM basis in November and December 2023 (**Figure 2.10**). Also, the contraction was relatively less broad-based, as 12 out of 22 sectors registered positive growth in H1-FY24 compared to only 4 sectors in the corresponding period of last year (**Figure 2.11**).

The major drag to LSM growth came from textile, automobile, and furniture; whereas cumulative LSM growth excluding furniture. Specifically, after excluding furniture, the LSM shows 0.4 percent growth during H1-FY24 compared to 1.5 percent decline in the same period last

year.⁴² Food, beverages, petroleum, pharmaceuticals and wearing apparel contributed positively. The output of these sectors collectively rose by 11.4 percent during H1-FY24 compared to a 7.6 percent fall in the same period last year. Excluding these sectors, the contraction in LSM increases to 10.0 percent during H1-FY24 compared to 8.8 percent decline in the same period last year (**Figure 2.12**).

Growth in Quantum Index of Manufacturing (QIM)

Figure 2.10



Source: Pakistan Bureau of Statistics

⁴¹ The section is based on PBS Quantum Index Numbers of Large Scale Manufacturing Industries (QIM)

⁴² The furniture sector is excluded because of a large (-ve) contribution in LSM growth in current period despite its small share.

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Cumulative Growth and Contribution of Major LSM Sectors during H1

Table 2.9

Manufacturing Sector	Weight	Growth (percent)		Contribution	
		FY23	FY24	FY23	FY24
LSM	78.4	-2.1	-0.4	-2.1	-0.4
<i>of which</i>					
Food	10.7	-2.9	5.1	-0.4	0.8
Beverages	3.8	-8.2	3.1	-0.4	0.1
Tobacco	2.1	-23.5	-36.7	-0.6	-0.7
Textile	18.2	-13.1	-11.0	-2.8	-2.0
Wearing apparel	6.1	67.9	15.1	5.9	2.3
Coke & petroleum	6.7	-11.1	8.4	-0.8	0.5
Chemicals	6.5	-1.1	3.8	-0.1	0.3
Pharmaceuticals	5.2	-21.6	31.8	-1.2	1.4
Non-metallic minerals	5.0	-11.7	1.2	-0.9	0.1
Iron & steel	3.4	-2.1	-1.4	-0.1	-0.1
Electrical equipment	2.0	-5.1	-10.9	-0.2	-0.4
Automobiles	3.1	-30.2	-52.9	-1.4	-1.7
Furniture	0.5	102.3	-37.3	1.4	-1.0
Other manufacturing	0.3	52.9	8.2	0.2	0.0

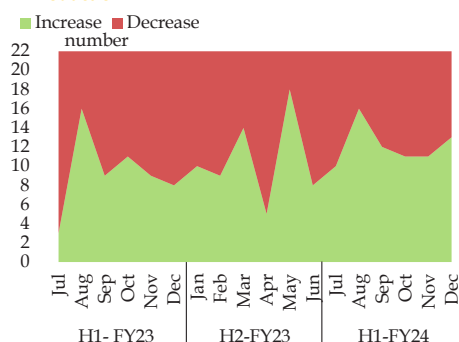
Source: Quantum Index Numbers of LSM for December, 2023, Pakistan Bureau of Statistics

This indication of bottoming out of LSM output largely reflects improved availability of raw materials for domestic and imported inputs. On the other hand, higher interest rates amid inflationary pressures kept the domestic demand subdued. Similarly, adjustments in domestic energy prices has partly offset the impact of ease in global commodity prices on cost of production.

Textile

Output of textiles, the largest component of LSM, declined by 11.0 percent during H1-FY24, compared to 13.1 percent contraction in the corresponding period last year. The decline was led by yarn and cloth sub-sectors that mainly remained suppressed due to rising input costs (Table 2.10).

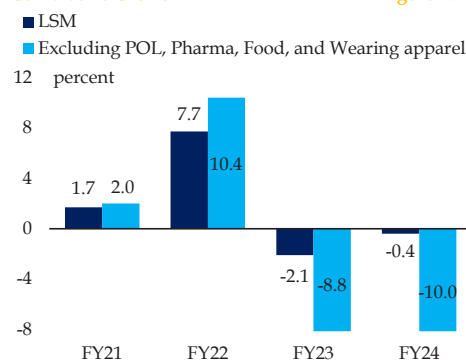
Sectors Showing Increase and Decrease in Production Figure 2.11



Source: Pakistan Bureau of Statistics

Cumulative Growth in H1

Figure 2.12



Source: Pakistan Bureau of Statistics

Textile and Wearing Apparel during H1

Table 2.10

	wt.	Cumulative Production (million MT)			Growth (percent)	
		FY22	FY23	FY24	FY23	FY24
Yarn	8.9	1.7	1.5	1.2	-14.2	-18.2
Cloth*	7.3	525.3	487.5	435.0	-7.2	-10.8
Jute goods	0.3	0.03	0.03	0.02	5.6	-33.4
Woolen & carpet yarn	0.1	0.00	0.01	0.01	95.6	40.5
Woolen blankets**	0.9	46.0	20.7	23.7	-54.9	14.4
Wearing apparel***	6.1	21.7	36.5	42.0	67.9	15.1

*million Sq. M, **000 Nos, ***million Dozen

Source: Pakistan Bureau of Statistics

The pace of increase in production of wearing apparel slowed to 15.1 percent during H1-FY24 compared to 67.9 percent in the same period last year. This deceleration may be attributed to decrease in export volume of readymade garments by 6.8 percent during H1FY24, against 89.7 percent increase in the same period last year. Decrease in unit value of exports in the face of weak external demand for textile and wearing apparel and intensified

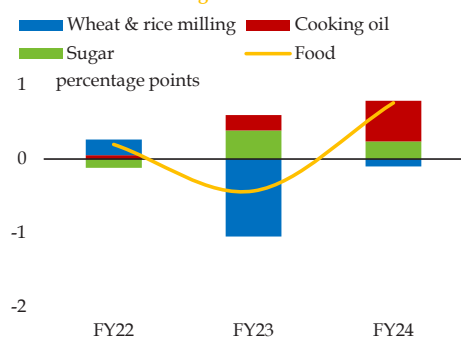
competition from China, was the main reason for reduction in production.⁴³ Increase in power tariffs, after elimination of energy subsidies for the export-oriented sectors, expensive imported raw materials and phasing out of EFS besides high interest rates were some other factors affecting textile output.⁴⁴

Food

Food, the second largest LSM group, witnessed 5.1 percent increase in output during H1-FY24 against 2.9 percent decline in the corresponding period last year. The growth in H1-FY24 was primarily driven by 25.5 percent increase in cooking oil production, supported by lower international palm oil prices (Figure 2.13).

The contraction in wheat and rice milling was also significantly lower during H1-FY24, which was primarily due to better crop harvests.⁴⁵ Moreover, despite lower output and delay in start of sugarcane crushing, sugar production increased by

Contribution to Cumulative Growth in Food Production during H1 Figure 2.13



Source: Pakistan Bureau of Statistics

⁴³ Owing to greater caution amidst potential US recession and lowering already burdensome inventories by the retailers, cotton products imports of USA, the largest importer, in calendar year 2023 were the second lowest in over 20 years. (Source: United States Department of agriculture).

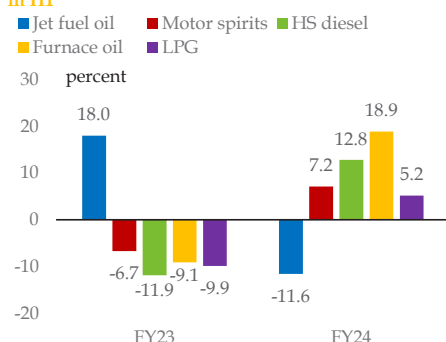
⁴⁴ Power tariff increased from cents 9/kWh to 14 cents which is higher than average prevalent for export sectors in regional economies.

⁴⁵ Rice exports surged by 48.3 percent during H1-FY24 compared to 18.2 percent decline in the same period last year.

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Growth in Output of POL Products in H1

Figure: 2.14



Source: Pakistan Bureau of Statistics

7.8 percent during H1-FY24. Higher sucrose recovery rate is reported as the main factor leading to increase in sugar production during H1-FY24.

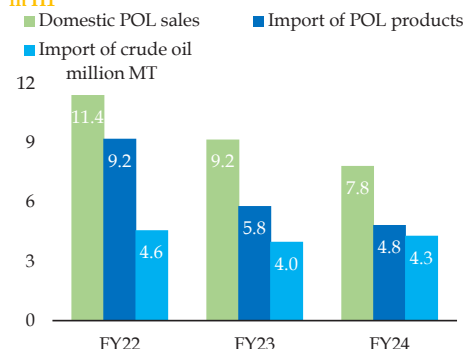
Coke and Petroleum

Petroleum refining picked up despite a decline in domestic sales. The production of petroleum products increased by 8.4 percent during H1-FY24, against a reduction of 11.1 percent in the same period last year. Production of POL products except for jet fuel and lubricating oil, increased compared to last year (Figure 2.14).

This increase, notwithstanding a decline in sales, is mainly attributed to a significant decrease in import volumes of POL products, as also reflected in higher volume of crude imports (Figure 2.15).^{46,47} In addition, rise in export volume of finished products, especially to UAE, also

Imports and Sale of Petroleum Products in H1

Figure: 2.15



Source: Oil Companies Advisory Council and PBS

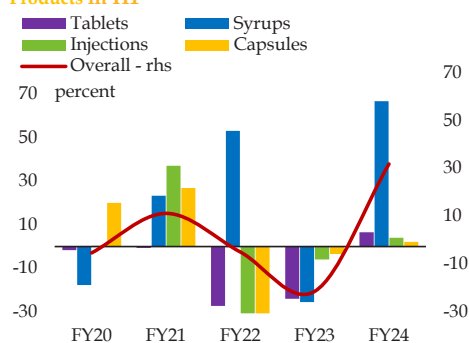
supported increase in production of petroleum products (see Chapter 5).⁴⁸

Pharmaceuticals

Production of pharmaceuticals increased by 31.8 percent during H1-FY24, against a reduction of 21.6 percent in the corresponding period of last year (Figure 2.16).

Growth in Production of Medicinal Products in H1

Figure: 2.16

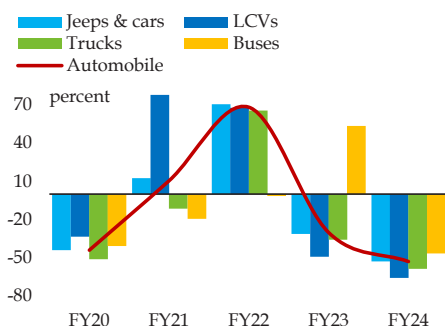


Source: Pakistan Bureau of Statistics

⁴⁶ The persistently high prices of petrol, diesel and furnace oil contributed to the sluggish sale of petroleum products.

⁴⁷ Volume of crude imports rose by 7.5 during H1-FY24 Compared to 12.7 percent decline in the same period last year.

⁴⁸ POL sale and imports of POL products decreased by 14.5 and 16.7 percent respectively, during H1-FY24. Whereas, POL exports to UAE increased to \$ 145.0 million during H1-FY24 from \$ 11.1 million in H1-FY23.

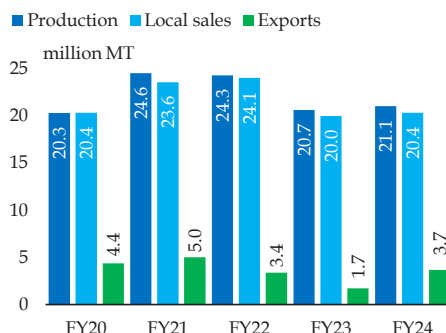
Growth in Automobiles Production in H1**Figure 2.17**

Source: Pakistan Bureau of Statistics

2.16). The upturn in pharmaceutical production mainly owes to increased availability of imported medicinal raw materials amid relative exchange rate stability, especially in Q2-FY24.⁴⁹ In addition, Drug Regulation Authority of Pakistan (DRAP) allowed upward adjustment in retail prices of both general and essential medicines, contributing to surge in pharmaceutical production.⁵⁰

Automobile

Continuing the declining trend, the automobile production plummeted further by 52.9 percent during H1-FY24, after declining by 28.8 percent in the same period last year. The decline was also broad-based (**Figure 2.17**). The automobile industry has been grappling with multiple challenges. Slow economic activity,

Cement Production and Dispatches in H1**Figure 2.18**

Sources: Pakistan Bureau of Statistics and APCMA

increased borrowing cost, and higher prices are some of the factors restraining automobile demand.^{51,52}

As per data released by Pakistan Automobile Manufacturing Association (PAMA), the auto sales slumped by 35.6 percent in the current review period compared with 40.4 percent decrease in the same period last year. Sector-specific import constraints leading to reduction in imports of Completely Knocked Down (CKD) and Semi Knocked Down (SKD) automobile kits, also exacerbated the drop in automobiles production during the review period.

Construction - Allied Industries

As shown in **Table 2.8**, construction registered higher contraction in H1-FY24

⁴⁹ Quantum imports of medicinal products expanded by 67.0 percent during H1-FY24 compared to 37.2 percent contraction in the same period last year.

⁵⁰ Drugs and medicine prices increased by 31.6 percent during H1-FY24 from 14.1 percent in the same period last year.

⁵¹ Motor vehicles prices increased by 24.7 percent during H1-FY24 on top of 31.1 percent in the same period last year. Similarly, fuel price went up by 22.1 percent on top of 70.5 percent in the last year.

⁵² There was a net retirement of Rs 42.5 billion against cars loans during H1-FY24 compared to the retirement of Rs 30.4 billion in the same period last year.

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Growth in GVA of Services Sector

Table 2.11

percent

	FY23						FY24		
	Q1	Q2	Q3	Q4	H1*	H2*	Q1	Q2	H1*
Services sector	2.3	2.2	-1.0	-3.0	2.2	-2.0	0.9	0.01	0.5
Wholesale & retail trade	0.3	0.8	-6.5	-10.1	0.6	-8.2	2.7	2.1	2.4
Transport & storage	3.7	3.3	4.2	1.9	3.5	3.1	1.2	1.1	1.2
Accommodation and food services activities (hotels & restaurants)	4.0	4.0	4.2	4.4	4.0	4.3	4.7	4.6	4.6
Information and communication	-1.6	2.5	-3.6	-7.5	0.5	-5.5	2.4	-5.4	-1.7
Finance & insurance activities	1.0	-1.6	-12.4	-18.5	-0.3	-15.6	-2.9	-11.1	-7.0
Real estate activities (ownership of dwellings)	3.6	3.6	3.7	3.9	3.6	3.8	4.2	4.1	4.1
Public administration and social security (general government)	-5.5	-8.7	-10.4	-10.9	-7.1	-10.7	-16.7	-16.2	-16.4
Education	10.5	10.0	9.8	9.6	10.2	9.7	-0.9	-0.8	-0.9
Human health and social work activities	10.8	11.2	10.8	9.5	11.0	10.2	-1.1	-2.5	-1.8
Other private services	5.3	5.2	5.1	4.5	5.2	4.8	4.0	3.6	3.8

* H1 GVA = Q1 GVA + Q2 GVA; H2 GVA = Q3 GVA + Q4 GVA

Source: Pakistan Bureau of Statistics

relative to H1-FY23. The higher financial cost, reduced real incomes and decrease in federal Public Sector Development Programme (PSDP) continued to weigh on construction activities. In addition, tight monetary conditions and political uncertainty also affected construction activities and house building finance during H1-FY24.

Cement

Cement production rose slightly by 1.9 percent during H1-FY24, mainly ascribed to higher export volume followed by uptick in domestic sales in latter months (**Figure 2.18**). Cement demand in the country's export destinations, mainly Afghanistan, Bangladesh, Hong Kong, Germany and Ghana, almost doubled to 3.7 MMT during H1-FY24 (see **Chapter 5**).

Also, domestic dispatches slightly increased by 1.7 percent in current period. However, subdued domestic demand and rise in coal prices somewhat dented cement production.

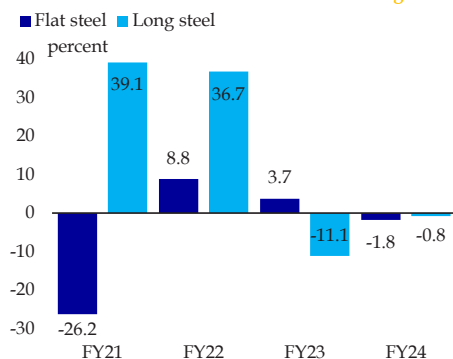
Steel

Steel production contracted by 1.4 percent in H1-FY24, compared to a contraction of 2.1 percent in the corresponding period last year. Production of Flat and long steel declined by 1.8 and 0.8 percent, respectively, during H1-FY24 (**Figure 2.19**). The sluggish demand from complementary industries including automobile, electrical equipment, heavy machineries & equipment, sewing and sugarcane machines led to subdued utilization of flat steel during H1-FY24.⁵³

⁵³ The production of electrical equipment, heavy machineries & equipment, sewing and sugarcane machines contracted by 10.9, 58.7, 31.9 and 27.3 percent respectively, during the review period.

Growth in Steel Products in H1

Figure 2.19



Source: Pakistan Bureau of Statistics

Similarly, the decline in production of long steel industry was due to noticeable expansion in imports of finished steel products besides muted growth in import of scrap. Also, transportation difficulties after implementation of axle load limits may have negatively impacted the sector by raising cost of transportation.⁵⁴

2.4 Services

Notwithstanding robust agriculture growth and a moderate recovery in LSM during Q2-FY24, services sector grew by only 0.5 percent in H1-FY24 compared to 2.2 percent in same period last year. The growth in services sector fell almost flat in Q2, after a modest recovery in Q1-FY24 from contractions in the preceding two quarters. Performance within the services sector, however, remained mixed.

Wholesale and retail trade, real estate, transport and storage, hotels and restaurants and other private services recorded increased, while other major sub-sectors saw decline. (Table 2.11).

Wholesale and retail trade services grew by 2.4 percent during H1-FY24, in line with the recovery in agriculture and manufacturing. The improved performance is also supported by higher sales of non-financial firms.⁵⁵

Transport and storage services grew at a slower pace in H1-FY24 compared to the same period last year. This slowdown can be associated with reduced use of air transport, and decline in sales of commercial vehicles and POL sales to transport sector.^{56, 57}

Information and communication services showed contraction in H1-FY24 compared to slight increase in the corresponding period of last year. This is despite 5.6 percent increase in broadband users during H1-FY24.⁵⁸ Furthermore, internet and mobile banking transactions also continued to gain momentum, indicating the growing reliance on digital services (Figure 2.20). The decline in communication services is mainly explained by surge in sector prices in Q2-FY24. The deflator for the sector increased by 9.3 percent in Q2 compared to the same period last year.⁵⁹

⁵⁴ The axle load regime was enforced from November 15, 2023. The axle load system may have also impacted industries such as cement and food, etc.

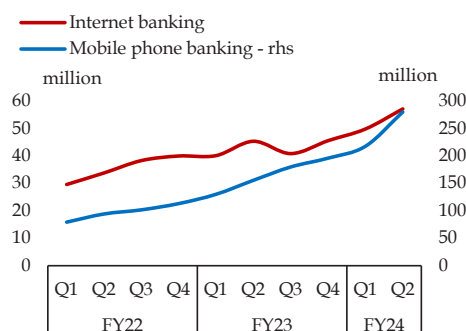
⁵⁵ Source: Financial Statement Analysis of Non-Financial Companies Listed at Pakistan Stock Exchange, September 30, 2023 (sbp.org.pk).

⁵⁶ Source: Pakistan Automotive Manufacturers Association.

⁵⁷ Source: Oil Companies Advisory Council.

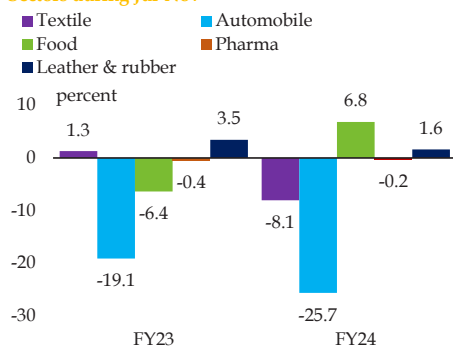
⁵⁸ Source: Telecom Indicators, PTA.

⁵⁹ Source: Pakistan Bureau of Statistics, QNA release 2023-24 Q2.

Volume of Internet Banking and Mobile Banking Transactions Figure 2.20

Source: State Bank of Pakistan

Finance and insurance services also contracted in H1-FY24, continuing the trend for the fifth quarter. This can be due to lower credit to private sector and increase in deposits of banking industry.⁶⁰ Likewise, *general government services*, fell further in H1-FY24. Whereas, *real estate activities* and *accommodation and food service activities*, retained their growth.

Punjab: Employment Growth in Major Sectors during Jul-Nov Figure 2.21

Source: Punjab Bureau of Statistics

2.5 Labor Market

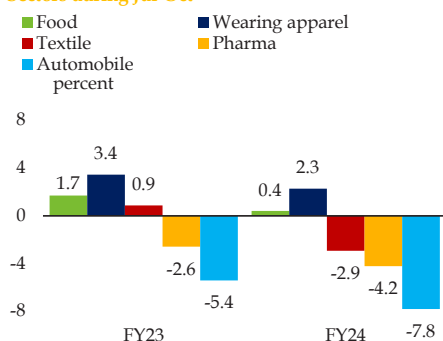
In line with indication of bottoming out in LSM output, the SBP surveys revealed some improvement in employment during November and December 2023. However, the sentiments regarding job creation for the next six months remained relatively less optimistic. However, the labor market data showed deterioration in employment during H1-FY24 compared to the same period last year.

Punjab

The industrial employment in Punjab deteriorated during Jul-Nov FY24 compared to the same period last year. A fall of 8.1 percent in textile sector employment, the largest employer, led the overall contraction in industrial employment in Punjab during Jul-Nov FY24. Employment in automobile industry, in particular, declined by 25.7 percent (Figure 2.21).

Food industry, on the other hand, registered 6.8 percent increase in employment during Jul-Nov FY24 against 6.4 percent contraction in the corresponding period last year. The employment growth in food sector was largely contributed by sugar, vegetable ghee, and dairy sub-sectors. Similarly, the petroleum, leather, rubber & plastic, and paper & paper board sectors reported marginal increase in the overall industrial employment during the review period.

⁶⁰ Although banks' profitability increased during this period, the value addition by this sector showed contraction. In fact, value addition in finance & insurance is computed by using a method called Financial Intermediation Services Indirectly Measured (FISIM) by PBS, which may not necessarily reflect the actual profitability of financial institutions.

Sindh: Employment Growth in Major Sectors during Jul-Oct**Figure 2.22**

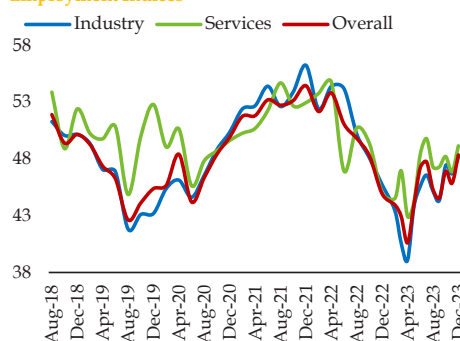
Source: Sindh Bureau of Statistics

Sindh

According to the latest data on Monthly Industrial Production and Employment Survey (MIPE), industrial employment in Sindh contracted by 0.8 percent during Jul-Oct FY24. Automotive, textile, and pharmaceutical industries mostly contributed to decline in employment in Sindh. Whereas, wearing apparel and food industries made new hiring during Jul-Oct FY24.

The employment in automobile industry in Sindh declined by 7.8 percent during Jul-Oct FY24 compared to 5.4 percent in the same period last year (**Figure 2.22**). Likewise, employment in textile and petroleum sectors decreased. On the other hand, employment in beverages and wood industries improved by 34.3 and 1.6 percent respectively during Jul-Oct FY24.

Factors such as lackluster export performance of textile industry, and significant decline in automobile sales caused reduction in employment

Business Confidence Survey: Employment Indices**Figure 2.23**

Source: State Bank of Pakistan

generation in Sindh and Punjab during the current review period.

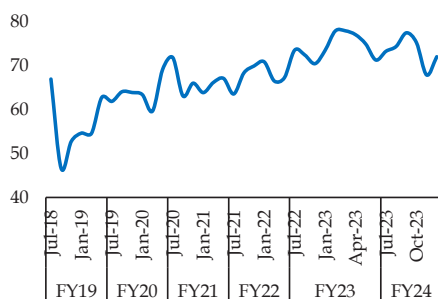
Business Confidence Survey

Despite improvement since November 2023, overall business confidence in H1-FY24 slightly weakened compared to last year. Trends in the SBP's Business Confidence Survey (BCS) show that perceptions of businesses about both overall and industrial employment for the past six months deteriorated in H1-FY24. The respondents were, nevertheless, moderately optimistic about employment in the services sector (**Figure 2.23**). On average, 46.5 percent of respondents were positive about overall job creation for the past six months, down from 48.5 in the same time last year.

Similarly, the diffusion index for employment in manufacturing sector declined during H1-FY24 for the past as well as next six months compared to the same period last year. On the other hand, the diffusion index for employment generation in the services sector remained

Consumer Confidence Surveys:
Unemployment Index (Next Six Months)

Figure 2.24



Source: State Bank of Pakistan

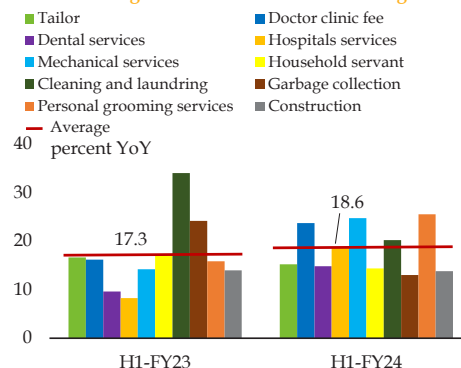
almost same. However, the index for expected jobs creation in the services sector increased slightly to 53.6 percent during H1-FY24 from 52.5 percent in the corresponding period of last year.

Consumer Confidence Survey

The results of SBP Consumer Confidence Surveys (CCS) conducted during H1-FY24 show that on the average 73.5 percent of the respondents had anticipated a rise in overall unemployment for the coming six months, marginally increased from 72.6 percent in the corresponding period of last year (Figure 2.24).

Growth in Wages of Services Sector

Figure 2.25



Source: Pakistan Bureau of Statistics

Wages

The CPI data shows upward momentum in wages during H1-FY24. Specifically, the average wages surged by 18.6 percent during the current period on top of 17.3 percent in the same period last year (Figure 2.25).

Detailed data shows that the wages of all categories of services maintained an upward trend. The wages increased for personal grooming services (25.6 percent), mechanical services (24.8 percent) and doctor fee (23.8 percent) during H1-FY24. Similarly, remuneration of cleaning & laundering services, hospital services and dental services also increased.



3

Monetary Policy and Inflation

Domestic supply shocks, particularly the hike in administered prices, alongside chronic structural issues and second round effects of commodity price shocks, kept the National CPI inflation elevated during H1-FY24. While global commodity prices witnessed a downtrend, PKR depreciation partially neutralized its impact on imported inflation during H1-FY24. Moreover, core inflation plateaued at elevated level, reflecting second round effects of higher food and energy prices, increase in minimum wages and high inflation expectations. Hence, to keep the real interest rate positive on a forward-looking basis and to bring inflation down to the medium-term target range, the Monetary Policy Committee maintained tight monetary policy stance and kept the policy rate unchanged at 22 percent during H1-FY24. Amid the contractionary policy environment and sluggish domestic demand, private sector credit uptake slowed down during the first half of FY24. However, the government's continued reliance on commercial banks for budgetary support contributed to expansion in Net Domestic Assets of the banking system. This, along with the expansion in the Net Foreign Assets of the SBP, led to acceleration in broad money growth in H1-FY24.



3.1 Policy Review

The Monetary Policy Committee (MPC) maintained tight monetary policy stance by keeping the policy rate unchanged at 22 percent during H1-FY24. Although inflationary pressures eased in H1-FY24 relative to H2-FY23 with some improvement in food supply amid administrative actions against illegal activities, such as hoarding and smuggling, and increase in agriculture output, the headline inflation remained higher compared to H1-FY23.

The sentiments about the country's macroeconomic environment had fairly improved at the start of FY24. Importantly, the country managed to secure a US\$ 3.0 billion Stand-by Arrangement (SBA) from the IMF in June 2023 that lowered near-term risks to the external account outlook. In terms of real economic activity, the domestic demand indicators in June 2023, continued to show policy-driven slowdown, whereas the YoY National CPI (NCPI) inflation came down by about ten percentage points, after peaking in May 2023.

These developments reflected positively on inflation outlook when the MPC met in July 2023. Taking into account these considerations alongside the lagged impact of the cumulative monetary tightening, budgeted fiscal consolidation, benign outlook for global commodity prices and the high base effect, the MPC projected the average NCPI inflation to fall in the range of 20.0 – 22.0 percent in FY24.¹ The

volatility in global commodity prices and domestic and external supply shocks presented significant upside risks to these projections.

The MPC also projected a moderate recovery in economic activity in FY24, mainly on account of expected rebound in agriculture output. While the withdrawal of import prioritisation measures in June 2023 ameliorated the outlook of industry, the continued contractionary monetary and fiscal policies were expected to keep the real GDP growth in the range of 2.0 – 3.0 percent in FY24.

With the policy-induced compression in domestic demand, the MPC projected current account deficit in the range of 0.5 – 1.5 percent of GDP in FY24. Furthermore, the MPC stressed the importance of continued fiscal prudence by expanding tax net, containing un-targeted subsidies and expediting reforms in loss-making Public Sector Enterprises (PSEs). These measures are seen as necessary conditions for achieving macroeconomic stability and bringing down inflation to the medium-term target range.²

The broad macroeconomic trends remained mostly in line with the MPC's projections during H1-FY24. In particular, according to the provisional estimates, real GDP grew by 2.1 percent in Q1-FY24, against a 1.0 percent growth in the same period last year.³ Similarly, the domestic demand indicators also started to show

¹ SBP revised the inflation projection range for FY24 to 23.0 – 25.0 percent in its January 2024 Monetary Policy Review.

² The government has announced its medium-term inflation range of 5 to 7 percent. Sources: Ministry of Finance (2020). Medium Term Budget Strategy Paper (2020-2023).

³ According to the National Income Accounts data released in March 2024, the real GDP grew by 1.7 percent in H1-FY24, against 1.6 percent growth in the same period last year.

Frequency Distribution of Urban CPI Basket

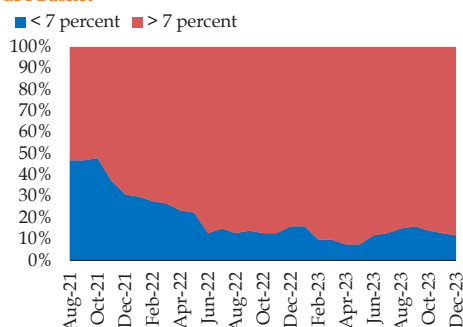
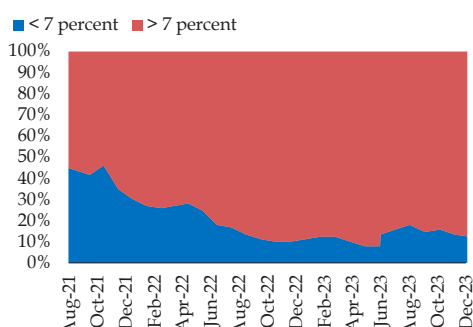


Figure 3.1 a Frequency Distribution of Rural CPI Basket



Source: Pakistan Bureau of Statistics

early signs of bottoming out from September 2023 onwards. With the recovery in economic activity and the withdrawal of guidance on import prioritisation in June 2023, current account balance slipped into deficit during Jul-Nov FY24, after showing surpluses during the last four months of FY23.

The fiscal outcome was also broadly in line with the consolidation envisaged in FY24 budget. The contractionary policy environment and subdued domestic demand underpinned slowdown in private sector credit during H1-FY24. However, the NCPI inflation during H1-FY24 surpassed the level seen in the same period last year.

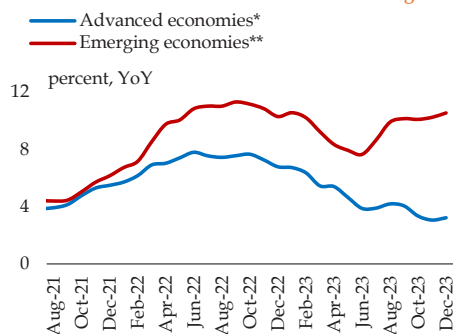
A greater-than-expected hike in administered prices of gas, as well as pervasive distortions in the commodities' market, had a large bearing on inflation during H1-FY24. Meanwhile, reflecting the impact of decreasing – but still elevated – costs, second round effects of commodity

price shocks, and increase in minimum wage, the core inflation also remained sticky at a higher level. Moreover, the items exceeding the upper bound of medium-term inflation target dominated the distribution of CPI basket across urban and rural segments (**Figures 3.1a and 3.1b**).

Taking stock of these developments, and to keep inflation expectations anchored, the MPC continued with the tight monetary policy stance in all of its meetings held during H1-FY24.⁴ In view of the lagged impact of monetary tightening in the past two years, budgeted fiscal consolidation, ease in global commodity prices and a favourable base effect, the MPC anticipated headline inflation to follow a downward trajectory in the second half of FY24. The MPC noted that with the real interest rates in positive territory on 12-month forward looking basis, the monetary policy stance was appropriate to bring down inflation to the medium-term target range of 5.0 – 7.0 percent by the end of FY25.⁵

⁴ MPC convened four meetings during H1-FY24.

⁵ In its March 2024 meeting, the MPC revised this timeline to September 2025.

Headline CPI Inflation

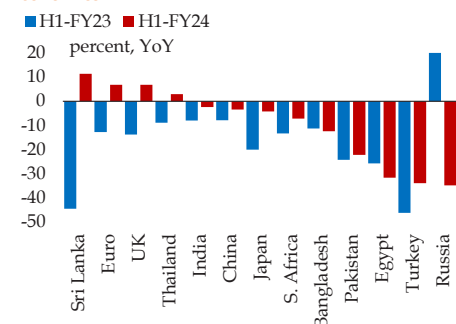
* include G7 countries; **based on 51 EMDEs

Source: Haver Analytics

3.2 Global Inflation and Monetary Policy Responses

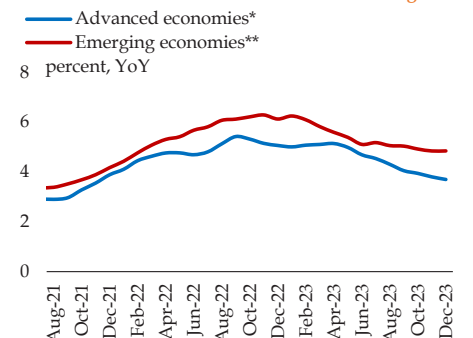
Global inflation saw diverging trends in H1-FY24. While the Advanced Economies (AEs) witnessed continuation of disinflationary trends that started towards the end of 2022, inflationary pressures resurfaced in Emerging and Developing Economies (EMDEs) during H1-FY24, after witnessing a downtrend in the second half of FY23 (Figure 3.2).

The ease in supply chain disruptions, decline in global commodity prices and a general slowdown in economic activity supported disinflation in AEs.⁶ In addition, relatively lower currency depreciations, as well as stronger and credible monetary policy frameworks, aided in continued moderation of headline inflation in these economies (Figure 3.3).⁷

Figure 3.2**Appreciation (+)/ Depreciation (-) of Currencies across Advanced and Emerging Economies**

Source: Haver Analytics

On the other hand, food supply disruptions, mostly due to climate change, restrictions on food exports from some of the large exporting countries, domestic supply shocks, and rising import costs contributed to spikes in food prices in a number of emerging economies.^{8,9}

Core Inflation

* include G7 countries; ** based on 51 economies

Source: Haver Analytics

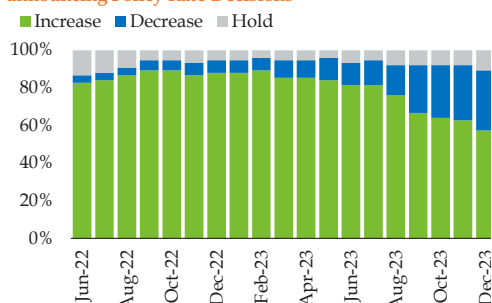
⁶ See Chapter 5 for details.

⁷ IMF, World Economic Outlook (2023)

⁸ In East Asia (Republic of Korea and Taipei, China), food prices edged up amid weather-related uncertainties.

⁹ Rice prices, a staple food commodity for most of developing Asia, rose to a 15-year high in November 2023, as India expanded ban on its rice exports. Source: Asian Development Outlook, December 2023

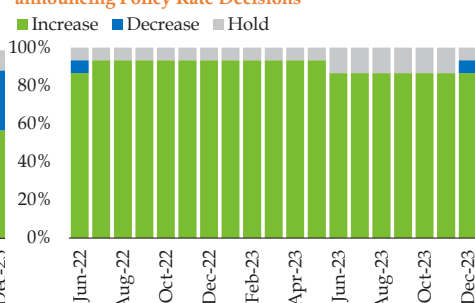
Number of Emerging Market Economies announcing Policy Rate Decisions



Note: The increase/decrease is calculated for 75 Emerging Market Economies.

Source: Haver Analytics

Figure 3.5 a Number of Advanced Economies* announcing Policy Rate Decisions



*15 Advanced economies

However, the core inflation declined only gradually in both AEs and EMDEs (**Figure 3.4**). The underlying inflationary pressures, primarily emanating from tight labor markets, increase in wages to compensate for escalating cost-of-living, and pass-through of higher energy prices, explain these trends.¹⁰

In view of the stubborn core and above target headline inflation, most central banks in AEs and EMDEs maintained tight monetary policy stance (**Figure 3.5**). Similarly, in view of sustained inflationary pressures, Pakistan kept the policy rate unchanged during the review period.

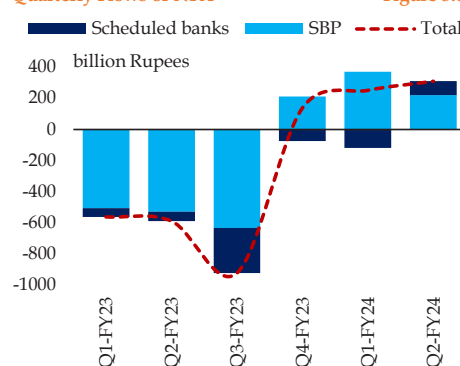
3.3 Pakistan's Monetary Aggregates

Despite a continued contractionary monetary policy stance, the broad money (M2) growth accelerated to 4.5 percent in H1-FY24, compared to 1.2 percent in the same period last year. Expansion in both Net Domestic Assets (NDA) and Net Foreign Assets (NFA) contributed to

acceleration in M2 growth (**Table 3.1**). The increase in NDA was largely on account of higher budgetary borrowings by the government from commercial banks, while expansion in NFA, specifically of the SBP, reflects improvement in external account (**Figure 3.6**).

Notwithstanding improved availability of external finance, the government relied heavily on budgetary borrowings from the commercial banks during H1-FY24. In

Quarterly Flows of NFA



Source: State Bank of Pakistan

¹⁰ IMF (2023). World Economic Outlook (October 2023)

Monetary Policy and Inflation

Monetary Aggregates (H1)

flows in billion Rupees, growth in percent

Table 3.1

	Change in Stock		Growth		Contribution to M2 Growth	
	FY23	FY24	FY23	FY24	FY23	FY24
Broad money (M2)	340.2	1,412.5	1.2	4.5	1.2	4.5
NFA	-1,150.4	561.7	N/A	N/A	-4.2	1.8
NDA	1,490.6	850.8	5.3	2.5	5.4	2.7
Budgetary borrowing	458.5	2,084.2	2.5	9.4	1.7	6.6
SBP	147.4	-1,744.0	2.9	-33.2	0.5	-5.5
Scheduled banks	311.1	3,828.2	2.3	22.5	1.1	12.1
Commodity operations	5.2	-229.2	0.5	-15.4	0.0	-0.7
Credit to private sector	584.5	385.0	6.5	4.2	2.1	1.2
Credit to PSEs	80.8	22.9	5.9	1.4	0.3	0.1
Other items net	32.3	-1,381.5	-	-	0.1	-4.4
Reserve money	-23.4	-747.5	-0.3	-6.5	-	-
Currency in circulation	114.7	-697.1	1.5	-7.6	0.4	-2.2
Deposits	218.3	2,102.3	1.1	9.4	0.8	6.7

Source: State Bank of Pakistan

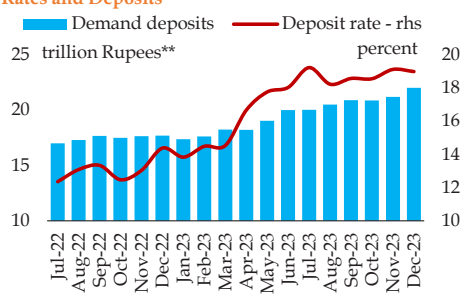
addition to a large fiscal deficit, this was because of net retirement to the non-banking sector, particularly in T-bills and National Saving Schemes (Chapter 4). However, net retirements in commodity operations financing, lower credit offtake by the private sector and a steep contraction in the Other Items Net (OIN), partially diluted the impact of the surge in government budgetary borrowing on NDA.¹¹

On the other hand, expansion in the SBP's NFA was the outcome of a sizeable increase in external financing inflows during H1-FY24. Successful negotiation for IMF's SBA in June 2023 was instrumental in reviving the confidence of multilateral and bilateral lenders, leading to significant increase in inflows during H1-FY24. Furthermore, the repayment of external debt was lower in H1-FY24 compared to last year (Chapter 5).

On the liability side, currency in circulation (CiC) declined by 7.6 percent during H1-FY24, compared to an increase of 1.5 percent in the corresponding period of last year. The decline in CiC was entirely concentrated in Q1-FY24. According to anecdotal evidence, besides lucrative interest rates offered by banks on saving accounts, as shown in Figure 3.7, the crackdown on smuggling and hoarding of US dollars, amid rumors of

Weighted Average Deposit Rates and Deposits*

Figure 3.7



* excluding zero mark-up and inter financial institutions

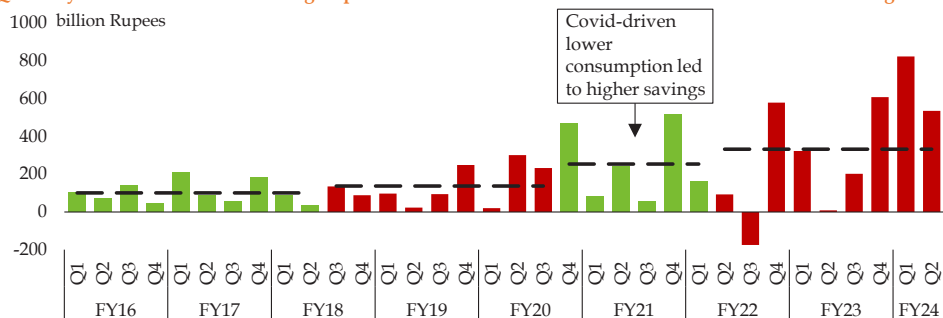
** outstanding stock position

Source: State Bank of Pakistan

¹¹ To facilitate their liquidity management, SBP has allowed Development Finance Institutions (DFIs) to participate in Open Market Operations (OMOs) since June 2022. The entries of these OMOs in monetary aggregates mainly resulted in a sizeable change of Rs 1.4 trillion in the stock of OIN during the review period.

Quarterly Flows of Customers' Saving Deposits*

Figure 3.8



* Red bars indicate flows in times of tight monetary policy, & vice versa for green bars; Dotted line shows average flows during monetary loosening/tightening episodes

Source: State Bank of Pakistan and SBP staff estimates

demonetization of Rs 5,000 banknote also contributed to reduction in CiC.¹²

This is also reflected in a 9.4 percent growth in bank deposits during H1-FY24, compared to an increase of 1.1 percent last year. In addition, as anticipated, high interest rate environment also encouraged individuals to save, as shown by quarterly flows of saving deposits (Figure 3.8).

Commodity Financing

Financing for commodity operations posted a net retirement of Rs 229.2 billion during H1-FY24, compared to an offtake of Rs 5.2 billion last year (Table 3.2). This was entirely driven by retirement of loans availed for wheat procurement. The provincial governments undertake commodity operations to ensure food security and to maintain stability in prices of food grains, particularly wheat. The procurement agencies purchase wheat at

an announced support price, and then release at subsidized rates for public consumption. To avoid strain on fiscal resources, the provincial governments rely on bank financing for purchase of wheat.

However, due to lack of adequate financial resources, the delay in payment of subsidy has led to a persistent increase in the stock of commodity debt over the years. To address this issue, the government made partial repayment of overdue subsidies to provincial food departments, which enabled them to make retirements during H1-FY24.^{13,14} In addition, timely release of wheat stocks also helped the procurement

Commodity Financing

Table 3.2

flows in billion Rupees

	H1-FY23	H1-FY24
Total	5.2	-229.2
Wheat	-54.7	-278.1
Sugar	16.5	-6.7
Cotton	0.1	0.2
Fertilizer	43.3	57.2

Source: State Bank of Pakistan

¹² Source: Senate of Pakistan document, dated November 17, 2023, available at: www.senate.gov.pk/uploads/documents/1700217467_224.pdf

¹³ Source: Punjab Debt Bulletin, September 30, 2023, Government of Punjab

¹⁴ The Punjab Government has released Rs 395 billion to Food Department by end-September 2023. Source: Debt Bulletin Jul-Sep 2023.

agencies to make loan retirements during the review period.¹⁵

Government Borrowings

The net budgetary borrowings from the banking system grew sharply by 9.4 percent in H1-FY24, compared to 2.5 percent increase in the same period last year. Besides higher fiscal deficit, scheduled repayment to the SBP, a sizeable decline in non-bank financing and buildup of the government deposits with the SBP were the major factors that spurred the government borrowing from the commercial banks during the review period (Figure 3.9).¹⁶

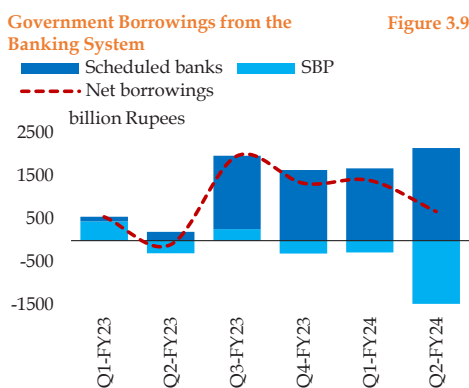
The government met most of its deficit financing requirements through floating rate PIBs (PFLs) during H1-FY24 (Table 3.3). To reduce the roll-over risk, the government kept the auction targets for T-bills slightly lower than the respective

maturities and assigned most of the targets to PFLs and Ijara Sukuk. Amid stubborn inflationary pressures, the cut-off rates on government securities increased during Q1-FY24. However, the spreads between the policy rate and the auction cut-off yields dropped significantly by December 2023.

Anticipating downward inflation trajectory in the second half of FY24, the MPC kept the policy rate unchanged in all of its meetings held during H1-FY24. The market also started to price in anticipated reduction in the policy rates going forward, as reflected by declining cut-off rates and secondary market yields. Correspondingly, market's tenor preferences for the government securities, as reflected in auction participation, also contrasted in the two quarters.

Anticipating interest rate hike, the market was increasingly keen in investing in 3-month T-bills during Q1-FY24. Later on, with the change in expectations about the interest rate path, the market started to lock in funds in longer-tenor bills during Q2-FY24 (Figure 3.10).

Similar trends were visible in longer-tenor government securities. Specifically, the market increased its offer-to-target ratio for fixed-rate PIBs to 3.2 times in Q2-FY24, from 1.5 times in the first quarter. However, in view of the elevated cost for the longer-tenor, the government accepted



Source: State Bank of Pakistan

¹⁵ The growth in hypothecated wheat stocks decelerated from 13.2 percent in H1-FY23 to 1.7 percent in H1-FY24.

¹⁶ The fiscal deficit as percent of GDP increased from 2.0 percent in H1-FY23 to 2.3 percent in H1-FY24. Further, non-bank financing posted a net retirement of Rs 251.6 billion in H1-FY24, compared to an increase of Rs 1.6 trillion last year.

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Auction Summary during Jul-Dec FY24

Table 3.3

billion Rupees

	Target	Maturity	Offered*	Accepted
Treasury Bills				
3-month	5,445.0	16,604.3	19,725.5	9,979.6
6-month	5,445.0	127.2	3,755.5	496.3
12-month	5,445.0	971.5	15,872.6	7,106.0
Total	16,335.0	17,703.0	39,353.6	17,581.9
Pakistan Investment Bonds				
<i>Fixed rate</i>				
3-year	370.0	519.8	1,560.9	684.6
5-year	280.0	337.0	339.1	92.7
10-year	250.0	-	461.2	175.3
15-year	30.0	2.9	-	-
20-year	30.0	-	-	-
30-year	30.0	-	-	-
Total	990.0	859.7	2,361.3	952.7
<i>Floating rate</i>				
2Y-Quarterly	1,030.0	1,111.8	969.6	576.1
3Y-Quarterly	1,030.0	876.2	1,679.5	788.1
5Y-Semi annual	790.0	-	5,460.3	2,943.0
10Y-Semi annual	790.0	-	1,273.3	861.0
Total	3,640.0	1,988.0	9,382.7	5,168.1
Ijarah Sukuk				
GIS-VRR	740.0	-	1,797.2	734.6
GIS-FRR	480.0	-	1,194.7	503.6
Total	1,220.0	-	2,991.9	1,238.2

*Competitive bids only

Source: State Bank of Pakistan

amount close to the overall target of these fixed rate securities during H1-FY24.

The PFLs remained the preferred mode of investment throughout the first half.

Given the expectation of the policy rate to have peaked, markets' appetite for bonds with semi-annual coupon re-set feature rose significantly relative to the auction targets during Q2-FY24 (**Figure 3.11**).¹⁷ In line with the market's interest, the

government fulfilled most of its financing requirements through these securities.

Regarding the GoP Ijarah Sukuk, the market found the Variable Rental Rate (VRR) lucrative in an increasing interest rate environment during Q1-FY24.

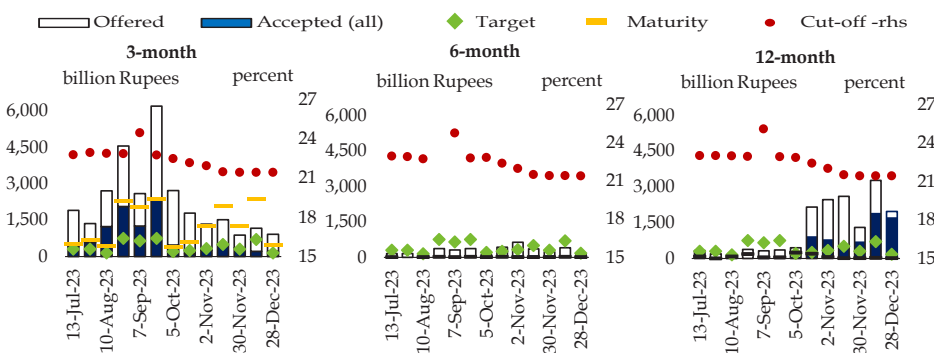
However, with the anticipation of monetary easing in Q2-FY24, the market's interest shifted towards Fixed Rental Rate (FRR).¹⁸ In the secondary market, the short-term yields dropped by December 2023,

¹⁷ The coupon of 2-year PFL is reset on fortnightly basis (Source: DMMD Circular No. 23 of 2020, dated October 16, 2020).

¹⁸ The offer-to-target ratio for FRR rose from 1.4 in Q1-FY24 to 3.2 in Q2-FY24. In the case of VRR, the ratio slightly declined from 2.7 in Q1-FY24 to 2.5 in Q2-FY24.

Auction Summary of T-bills during H1-FY24

Figure 3.10



Source: State Bank of Pakistan

after remaining elevated until September 2023, which reflects market's expectations of decline in inflation in the near future (Figure 3.12).

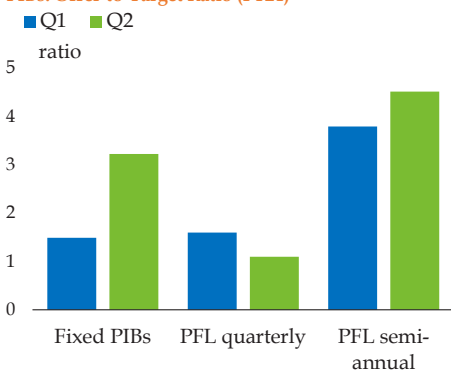
Interbank Liquidity

Amid increased reliance on commercial banks to finance the fiscal deficit, the liquidity requirements of the interbank market increased in H1-FY24, compared to

the corresponding period of last year (Figure 3.13). The increase in liquidity requirements in Q1-FY24 was despite retirement in loans for commodity operations, as well as a sizeable increase in bank deposits. In Q2-FY24, a marginal growth in currency in circulation, along with sustained increase in government's budgetary borrowing from scheduled banks, put further drain on the interbank liquidity.¹⁹

PIBs: Offer-to-Target Ratio (FY24)

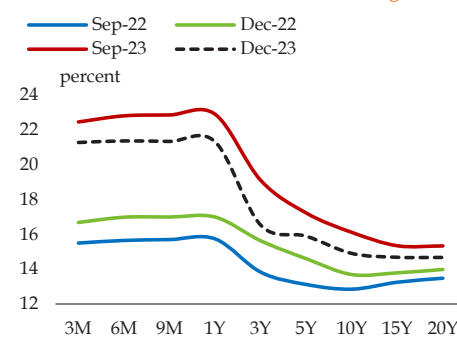
Figure 3.11



Source: State Bank of Pakistan

Yield Curve*

Figure 3.12

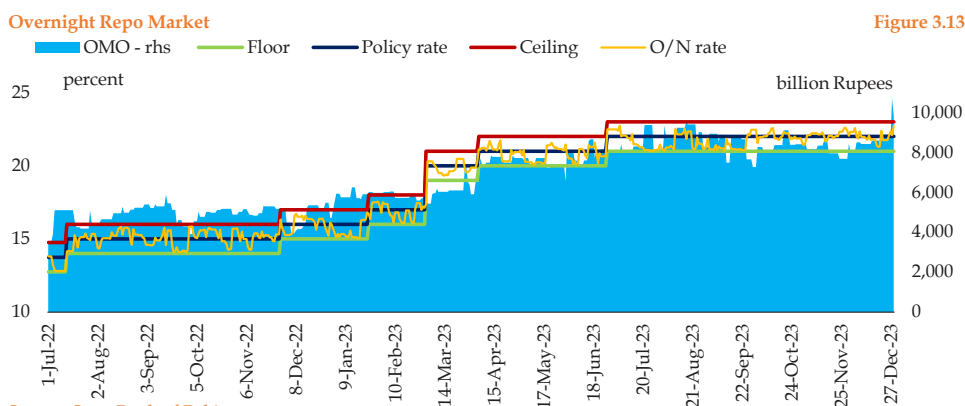


* end-period PKRV rates

Source: Financial Market Association of Pakistan

¹⁹ Currency in circulation declined by 9.4 percent during Q1-FY24, followed by an increase of 2.0 percent in Q2-FY24.

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Average Outstanding OMO Stock
billion Rupees

Table 3.4

	FY23	FY24
Q1	4,839.1	8,580.3
Q2	4,938.3	8,409.5
H1	4,888.7	8,494.9

Source: State Bank of Pakistan

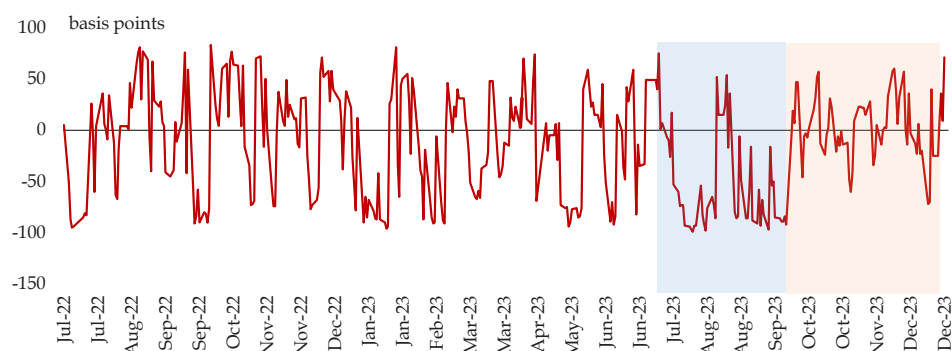
Consequently, the SBP made significantly higher OMO injections during H1-FY24, resulting in a substantial increase in the

average outstanding OMOs stock during the review period compared to the same period last year (**Table 3.4**).

Given significant liquidity pressures and market's anticipation of interest rate hikes during Q1-FY24, the SBP provided bulk of the liquidity through longer-tenor OMOs, i.e., having maturity period of 60 days and above.²⁰

Deviation of Average Daily ONR from the Policy Rate

Figure 3.14



²⁰ Out of the total OMO injections of Rs 12.0 trillion in Q1-FY24, about 76 percent or Rs 9.1 trillion were having maturity period of 60 days and above, including 60, 63, 70, 73, 74, 77 and 82 days.

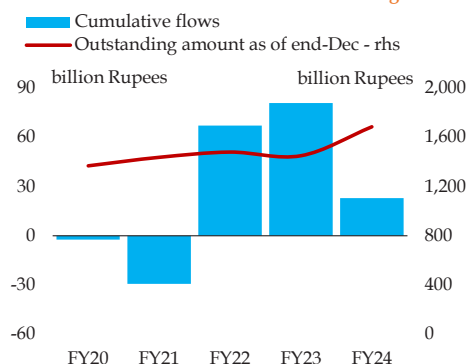
However, the market sentiments changed in the second quarter, as it viewed the interest rates to have peaked-out, and expected monetary easing going forward. With the shift in market's sentiments, the SBP provided liquidity through shorter-tenor OMOs (mostly having a maturity of 7, 14 and 28 days) during Q2-FY24. In line with this shift, the O/N rate moved relatively closer to the policy (target) rate in Q2-FY24 (**Figure 3.14**).

Credit to Public Sector Enterprises (PSEs)

Credit uptake by the PSEs moderated to Rs 22.9 billion in H1-FY24, compared to Rs 80.0 billion in the first half of the previous year (**Figure 3.15**). While Sui Northern Gas Pipelines Ltd. (SNGPL), Sui Southern Gas Co. Ltd. (SSGC) and Pakistan International Airline (PIA) continued to borrow, large retirements by Pakistan State Oil (PSO) reduced overall credit to the PSEs during H1-FY24.

Credit to PSEs-H1

Figure 3.15



Source: State Bank of Pakistan

Borrowing by the PSEs from banks has experienced a significant increase over the past few years. Chronic structural issues primarily explain this increased borrowing by the PSEs, particularly by those related to energy sector. A number of factors including subsidized power tariffs, delayed release of (tariff differential) subsidies by the government and accumulation of sales tax refunds has undermined the ability of power and gas companies to clear outstanding dues to PSO on account of LNG imports. Hence, for the settlement of these payables, these companies resorted to borrowing from commercial banks during H1-FY24.

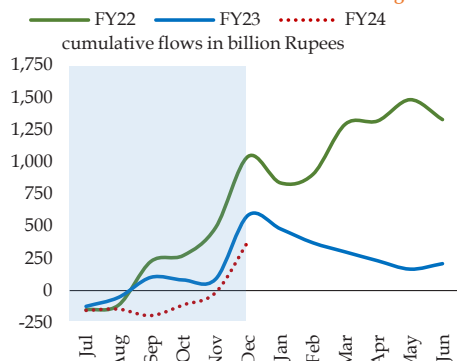
Likewise, continued liquidity constraints due to lingering structural inefficiencies led the PIA to approach banks during H1-FY24 to settle fuel payments to the PSO. On the other hand, as opposed to same period last year, PSO retired a part of its outstanding debt in H1-FY24 with improvement in its sales and hence cash flow position.²¹

3.4 Credit to Private Sector

Private sector credit continued to remain subdued, increasing by 4.2 percent during H1-FY24 compared to 6.5 percent in the same period last year. After remaining depressed in Q1-FY24, credit demand picked up slightly during the second quarter, with most of the increase being concentrated in December 2023 (**Figure 3.16**). Disaggregated data indicates a broad-based expansion in working capital

²¹ PSO witnessed unprecedented sales during Q1-FY24 on account of effective business strategies, as per first quarter financial report (September 30, 2023).

Private Sector Credit Figure 3.16



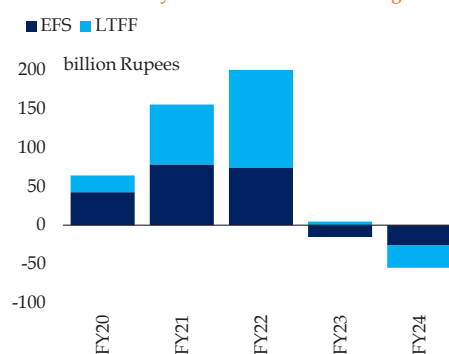
Source: State Bank of Pakistan

requirements in Q2-FY24, whereas demand for fixed investment loans and construction finance stayed muted throughout the first half of FY24.

Several factors contributed to the slowdown in credit demand during the review period. Persistently elevated cost of borrowing and fiscal consolidation during H1-FY24 were instrumental in dampening credit demand.²² Meanwhile, political and economic uncertainty weighed on fixed investment loans. In addition, the start of a gradual phasing-out of the SBP concessory financing schemes (EFS and LTFF) to Export-Import Bank also affected advances under these schemes (Figure 3.17).^{23,24}

Apart from these factors, slight moderation in the cost of production as indicated by WPI (Wholesale Price Index) inflation, reduced working capital requirements of a

SBP Concessory Schemes - H1 Figure 3.17



Source: State Bank of Pakistan

number of industries, despite a relatively lower contraction in LSM output (Table 3.5). This is with the exception to gas prices, which were revised upward from November 2023 onwards.

Meanwhile, improved profitability and liquidity indicators (except textiles), also reduced borrowing requirements of the

Input Prices - H1 Table 3.5

growth in percent	FY23	FY24
WPI inflation	34.1	25.4
Coal	79.4	39.5
Electrical energy	48.8	27.7
Motor spirit	77.3	25.3
Diesel oil	94.0	7.7
Furnace oil	42.9	22.6
Construction inputs	28.3	24.9
Liquefied hydrocarbons	23.8	14.0
Global commodity index	19.6	-22.8

Source: Pakistan Bureau of Statistics, International Monetary fund

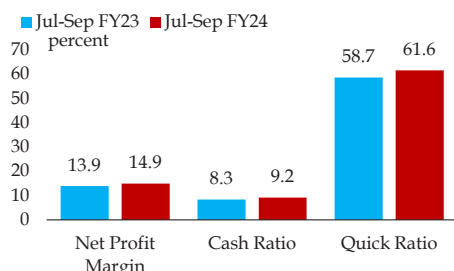
²² Federal PSDP declined by 4.4 percent in H1-FY24, whereas provincial PSDP slowed down in H1-FY24. Primary surplus stood at 1.7 percent of GDP in H1-FY24 as compared to 1.1 percent in H1-FY23.

²³ As part of IMF conditionality, the SBP's operational involvement in the two largest refinancing schemes (EFS and LTFF) is set to cease at the end of a five-year transition period beginning from July 2023.

²⁴ SBP plans to reduce the portfolio under EFS and LTFF schemes by 10 percent during FY24.

Financial Ratios of Non-Financial Firms*

Figure 3.18



* excluding textile sector

Source: SBP - Quarterly financial statement analysis of selected non-financial listed companies, SBP staff calculation

firms (Figure 3.18).²⁵ A decrease in the cost of goods sold and improvement in sales values led to a notable increase in gross margins. This also improved the liquidity position of the firms.

Nonetheless, slight improvement in economic activity during Q2-FY24, as seen from increase in LSM output and capacity utilization in some of the industries, somewhat revived demand for private sector credit.^{26,27} In addition, deteriorating financial indicators of the key borrowing sector, i.e., textiles, as well as rising raw material cost in some industries, contrary to the slight slowdown in the overall cost in various industries as mentioned earlier, also drove the demand for bank credit (Table 3.6).

Improved liquidity conditions and seasonal pattern led to retirement in few sectors

Fertilizer sector made retirements during H1-FY24 compared to substantial borrowings in the same period last year.²⁸ Retirements can be attributed to healthy fertilizer offtake in Q1-FY24, particularly of DAP, due to better crop conditions. In addition, relatively strong financial position also reduced borrowing requirement of the sector. In anticipation of hike in gas tariffs, fertilizer companies had increased prices in the beginning of the year. Hence, the delay in announcement of the hike in gas tariff till November 2023, significantly improved financial position of the sector. The improved operating margins and better liquidity conditions aided the fertilizer companies to reduce reliance on bank credit.

Similarly, cement producers also posted significant increase in operating margins. Upward adjustment in prices despite deceleration in the pace of production cost, as well as cost-efficient initiatives, improved profitability of the cement sector.^{29,30} Meanwhile, higher export volumes and a notable decline in inventories strengthened liquidity position

²⁵ Inventory levels of the firms registered significant deceleration in Q1-FY24 as compared to the same period last year (Source: SBP-Quarterly financial statement analysis of selected non-financial companies, SBP staff calculation).

²⁶ LSM registered an increase of 0.5 percent during Q2-FY24 as compared to 1.9 percent contraction last year same period.

²⁷ Capacity utilization of firms registered notable improvement in Q2 after posting decline in Q1, compared to last year (SBP's Business Confidence Survey).

²⁸ Cash flow constraints stemming from both domestic and global factors induced many firms to leverage last year.

²⁹ International coal prices declined by 62.1 percent in H1-FY24 as compared to 103.6 percent increase last year. Source: International Monetary Fund.

³⁰ Energy mix was shifted towards coal in order to gain price benefit.

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Loans to Private Sector Businesses

Table 3.6

flow in Rs billion

	Total*		Working Capital		Fixed Investment		Total Loans	
			H1				Q1	Q2
	FY23	FY24	FY23	FY24	FY23	FY24	FY24	
Total	574.5	442.6	370.1	369.3	205.4	76	-78.6	521.2
Manufacturing	503.1	307.3	343.2	279.7	161.1	29.5	-116.5	423.8
Textile	188.2	106.8	137.3	95	51.8	10.9	84.3	22.5
Cement & plaster	45.8	-18	23.6	-16.3	22.3	-1.4	-15.1	-3
Refined petroleum	42.6	-5.1	37.2	-12.3	5.4	7.2	-26.8	21.8
Paper industry	20.8	16	9.5	10.4	11.3	5.6	2.6	13.4
Basic iron & steel	7.4	33.6	4.2	37.5	3.3	-3.8	0.2	33.4
Motor vehicles	14.4	15.3	13.8	14.9	0.6	0.3	-3.8	19
Basic pharma.	10.8	6.1	9.2	-0.9	1.9	7.2	4.1	2
Fertilizers	53.7	-33.5	45.7	-32.5	8.1	-1	-47.3	13.8
Veg. & animal oils	3.2	18.9	2.6	19.1	0.6	0.1	8.6	10.3
Rice processing	67.9	82.9	68	82.3	-0.1	0.6	-19.9	102.8
Sugar	-64.6	-49.4	-59.7	-41.2	-4.9	-8.2	-120.9	71.5
Telecommunication	35	11	3.4	-3	31.6	14.1	6.7	4.4
Construction	11	10	7.5	7	1.6	-3.7	3.2	6.8
Agri. & fishing	23.5	73	9.7	28.4	13.9	44.7	30.4	42.6
Mining & quarrying	1.2	2.2	3.5	4.2	-2.3	-2	-7.3	9.6
Real estate activities	0.6	-4.7	0.2	-1	0.3	-1.2	-2.1	-2.6
Transport. & storage	-5.9	7.2	-2.2	7.2	-3.7	0.1	-0.3	7.5
Power gen. & dist.	2.7	-54.2	0.2	-27.7	2.6	-26.4	-33.1	-21.1
Wholesale & retail trade	-6.5	84.2	-2.2	73.5	-4.3	11	41.4	42.9

* Total amount may not sum up as it also includes construction finance. In terms of IH&SMEFD Circular Letter No. 28 of 2020, the data on credit/loans has been revised since June 2020 due to inter-sectoral adjustment in private sector business.

Source: State Bank of Pakistan

of the cement companies, leading to retirement of loans.³¹

Power generation also made retirement during H1-FY24. The Central Power Purchasing Authority (CPPA) made partial payment of the overdue subsidies to the Independent Power Producers (IPPs) under the Circular Debt Management Plan (CDMP) FY24. This shored up their cash

flow position, enabling power generation and distribution entities to retire their bank debt during the review period.³²

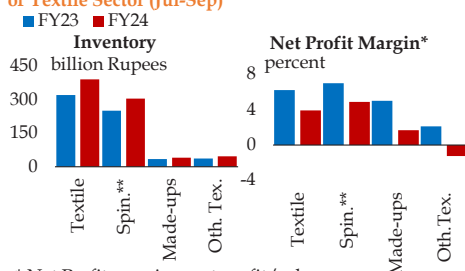
In addition, sugar sector saw seasonal retirements during H1-FY24, albeit at a slower pace compared to the same period last year. This relatively lower retirement can be traced to significantly higher than seasonal credit demand in December 2023

³¹ Cement exports posted growth of 99.7 percent in H1-FY24 compared to 56.3 percent contraction last year. Source: Pakistan Bureau of Statistics.

³² The government adopted revised CDMP for FY24 in August 2023. This plan aims at addressing the issues contributing to accumulation of circular debt (CD) in the energy sector through various measures, including continued timely adjustment of power tariffs, expediting energy sector reforms and CD stock payments to IPPs and government power producers (GPPs). IMF Country Report 24/17

**Selected Financial Indicators
of Textile Sector (Jul-Sep)**

Figure 3.19



* Net Profit margin = net profit/sales

** Spinning, weaving and finishing

Source: SBP-Quarterly financial statement analysis of selected non-financial listed companies, SBP staff calculations

due to increase in prices of sugarcane, the main raw material of the industry.³³

Elevated cost of production and challenging business environment impacted credit uptake in few sectors

A relatively less favorable business environment constrained textile production during H1-FY24, leading to slowdown in credit demand of the sector. Importantly, the discontinuation of the concessionary energy tariffs since the start of FY24 and surge in raw material prices inflated cost of production during H1-FY24.³⁴

Rising operational costs and piling up inventories created liquidity issues, driving textile firms to resort to bank finance (Figure 3.19). However, as mentioned above, declining production volumes in

the textile sector pared the overall credit demand relative to last year.

As regards iron and steel group, demand for working capital increased during H1-FY24. PKR depreciation and rise in international prices fueled increase in the cost of production, raising working capital requirements of the industry during the review period.³⁵

Strong agriculture production boosted credit offtake in related industries

Rice processing dominated credit uptake in food group. Amid a rebound in production and increased export demand, rice milling saw a sizeable increase in credit uptake during the review period.

Similarly, working capital requirement of the textile industry increased for procurement of cotton during FY24.

Consumer financing remained downbeat

Consumer financing continued to shrink with a pronounced retirement in auto financing during H1-FY24. However, credit cards maintained the rising trend witnessed for the past couple of years, whereas house building edged down after showing a rising trend since FY21 (Figure 3.20).

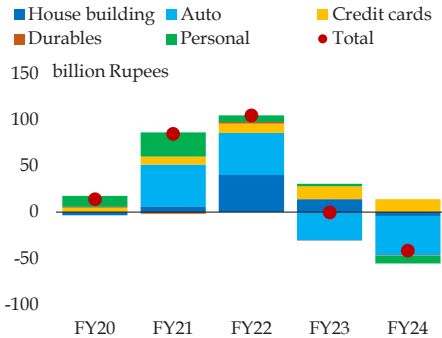
The impact of stabilization measures implemented over the course of last two years, including increased cost of

³³ Sugarcane prices rose by 53.5 percent during H1-FY24 as compared to 18.8 percent last year. (PBS)

³⁴ Wholesale price indices for woven fabrics, cotton fabrics and dyeing material rose by 24.1 percent, 40.9 percent and 50.7 percent during H1-FY24 as compared to 11.9 percent, 15.2 percent and 0.0 percent, respectively, same period last year.

³⁵ According to LSM production data, iron and steel category recorded 440 (MT) production in H1-FY24 compared to 447 (MT) last year.

Consumer Financing: Flows during H1 Figure 3.20



Source: State Bank of Pakistan

borrowing and tightened prudential regulations continued to dampen auto financing. Car sales plunged significantly despite lowering of car prices by some of the key assemblers, on relative basis, during H1-FY24.³⁶ Overall constrained economic activity and increased borrowing cost has not only affected the demand for automobiles but also led to contraction in demand for house building, personal and durable goods loans.

On the other hand, increasing use of digital technologies by consumers due to ease and convenience in making payments, has played a major role in significant credit uptick against credit cards. In addition, financial difficulties amid increase in the cost of living also might have compelled consumers to make purchases on credit.

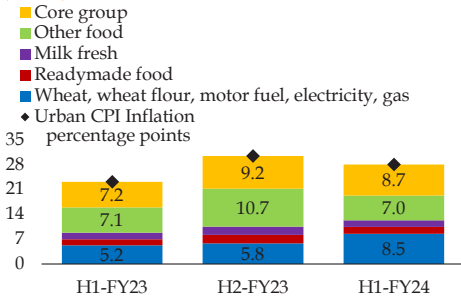
3.5 Inflation

The NCPI inflation rose to 28.8 percent in H1-FY24 as compared to 25.0 percent in

the same period last year. Although domestic demand remained subdued amid continued contractionary policies, a range of domestic structural factors, supply shocks and their second round effects via elevated input costs and wages exacerbated the inflation outcomes. In addition, PKR depreciation, which partly offset the respite provided by the declining global commodity prices, also contributed to inflation.

Hike in energy tariffs and a significant uptick in the minimum support price (MSP) of wheat, in particular, weighed heavily on inflation during H1-FY24. Similarly, domestic market imperfections that manifested in hoarding and smuggling of food commodities (particularly wheat), created artificial shortages. To put things in the perspective, the increase in prices of wheat and energy alone contributed nearly one-third to urban inflation during H1-FY24 (**Figure 3.21**).

Major Contributors to Inflation (Urban) Figure 3.21



The blue bars show the contribution of items affected from the administered prices.

Source: Pakistan Bureau of Statistics

³⁶ Some auto manufacturers announced reduction in car prices of some variants in October 2023, whereas some manufacturers offered other incentives, such as reduction in car registration charges and after-sales service packages.

Monetary Policy and Inflation

Average CPI Inflation
percent

Table 3.7

Items	Wt.*	Average Inflation during			Contribution		
		H1-FY23	H2-FY23	H1-FY24	H1-FY23	H2-FY23	H1-FY24
NCPI	100	25.0	33.0	28.8	25.0	33.0	28.8
Urban CPI	100.0	23.1	30.4	28.0	23.1	30.4	28.0
Food	36.8	30.7	44	33.2	11.8	17.0	13.5
Perishable	4.4	48.3	36.0	7.5	2.1	1.6	0.4
Non-perishable	32.4	28.5	45.0	37	9.7	15.4	13.1
NFNE (Core inflation)	53.7	14.1	18.2	18.4	7.2	9.2	8.7
Energy	9.5	38.8	38.0	47.9	4.2	4.2	5.8
Rural CPI	100.0	27.9	37.0	30.0	27.9	37.0	30.0
Food	45.9	33.6	48.0	33.7	16.0	23.0	16.8
Perishable	5.7	52.0	41.3	7.7	2.9	2.3	0.5
Non-perishable	40.3	31.3	48.9	37.8	13.1	20.7	16.3
NFNE (Core inflation)	42.6	17.4	23.5	25.9	7.1	9.4	3.5
Energy	11.4	41	37.4	27.2	4.8	4.6	9.6

*wt. = weight, Cont.= Contribution

Source: Pakistan Bureau of Statistics

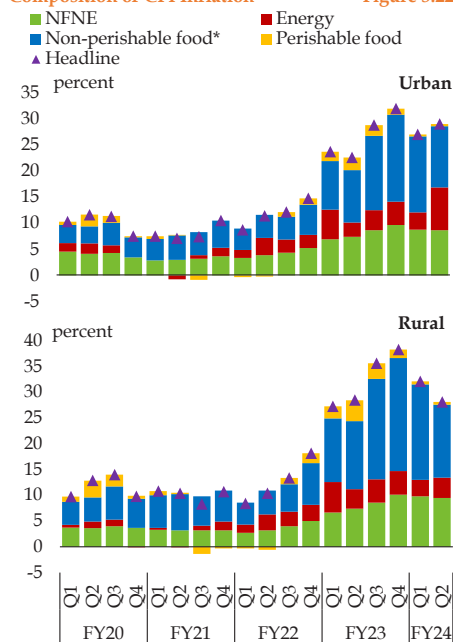
In overall terms, non-perishable food was the largest contributor to the headline inflation, followed by Non-Food Non-Energy (NFNE) and energy (Table 3.7). However, the government's administrative actions, as well as improved supply situation of some food items (especially wheat), somewhat eased price pressures during H1-FY24 relative to H2-FY23 (Figure 3.22).³⁷

Higher MSP along with market imperfections kept wheat prices elevated in H1-FY24

Wheat and wheat products were the largest contributors in the urban and rural inflation during H1-FY24. The climate change, heatwaves experienced in Mar-Apr 2022 and flash floods during Jul-Aug 2023, had raised concerns about inadequate wheat availability and caused an uptrend in wheat prices since January

Composition of CPI Inflation

Figure 3.22



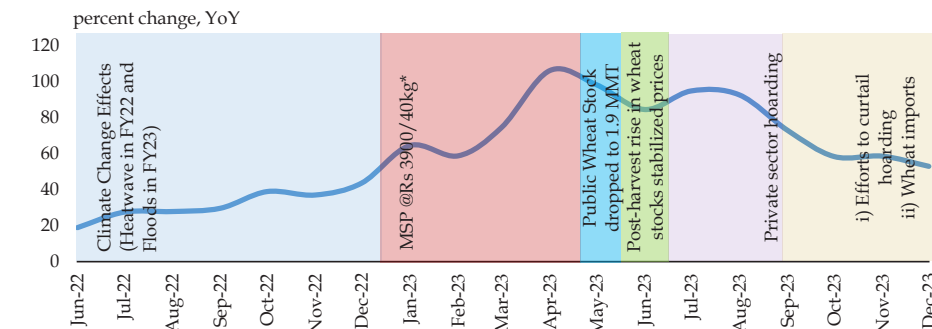
* inclusive of alcohol beverages and readymade food

Source: Pakistan Bureau of Statistics

³⁷ The average MoM inflation declined from 2.4 percent in H2-FY23 to 1.9 percent in H1-FY24.

Wheat Prices (Urban)

Figure 3.23



* Punjab MSP-Rs 3,900/40 kg and Sindh MSP-Rs 4,000/40kg

Source: PBS, Finance Division

2023. To encourage wheat production amid rising input costs, the government announced a large increase in the MSP for the crop in FY23 that further augmented the price pressures (Figure 3.23).³⁸

Although wheat production rose by 7.5 percent in FY23, it was slightly lower than the production target.³⁹ On the other hand, to meet unforeseen exigencies, the government had scaled up the target for commodity's strategic reserves.⁴⁰ Hence, despite improved production a sizeable demand-supply gap existed, which led to illegal profiteering activities such as

hoarding. This, together with smuggling to neighboring countries, created artificial shortage of wheat, thus pushing up its prices in the domestic market.⁴¹

To address these challenges, the government stepped up its administrative efforts against hoarding, smuggling and price manipulation.^{42,43} In addition, the government, together with the private sector, imported the commodity to ease supply situation.⁴⁴ Moreover, low international prices of wheat partly eased pressure on domestic prices.^{45,46}

³⁸ Minimum support price set for FY23 was Rs 3,900 per 40 kg as compared to Rs 2,200 in FY22.

³⁹ The actual wheat production (28.18 MMT) was slightly less than the target of 28.37 MMT. Source: Ministry of National Food Security and Research (2023). Year Book 2022-23. Islamabad: MNFSR

⁴⁰ The target for strategic reserves was also increased for 2023 from one MMT to two MMT in view of unforeseen circumstances. Source: Ministry of National Food Security and Research (2023). Year Book 2022-23. Islamabad: MNFSR

⁴¹ Source: Press Release: Second session of the 5th APEX committee of SIFC on September 9, 2023

⁴² FBR issued notification on November 7, 2023 stated the prevention of smuggling of essential commodities in Baluchistan and KP. Source: SRO 152(1)/2023

⁴³ Source: Monthly Report September 2023 (www.finance.gov.pk)

⁴⁴ Wheat imports during H1-FY24 stood at 1.4 million tons, compared to 1.5 million tons in the same period last year. Source: PBS

⁴⁵ On average, global wheat price was considerably lower at around Rs 87.0 per kg, relative to domestic price of Rs 124.6 per kg during Jul-Dec FY24. Sources: World Bank and Pakistan Bureau of Statistics

⁴⁶ The government allowed import of 1.0 MMT of milling wheat for the year 2023-24, through Trade Corporation of Pakistan to maintain the strategic reserves. (Finance Division's Press Release No. 478 issued on October 23, 2023).

Milk Prices (Urban)

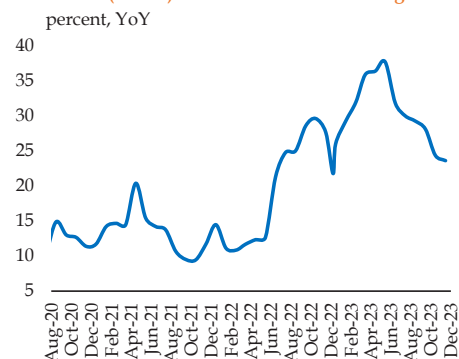


Figure 3.24

Source: Pakistan Bureau of Statistics

Amid widening demand-supply gap, fresh milk remained one of the top five contributors to inflation

Continuing the trend seen in the past few years, milk prices saw a double-digit increase in H1-FY24 (**Figure 3.24**). While soaring livestock feed cost and reduced availability of imported feed fanned increase in milk prices during FY23, the persistently elevated prices of milk also reflect longstanding structural issues in the supply chain leading to widening supply-demand gap.

This is important to mention that fresh milk is included in the list of essential commodities, subject to the government's announced administered prices. However, on account of the myriad structural issues, milk prices do not follow the official rate list. Nevertheless, the provincial governments ensured stringent implementation of milk prices at official rates, which eased milk prices during H1-FY24.

Major WPI Items Affecting Ready-made Food Prices

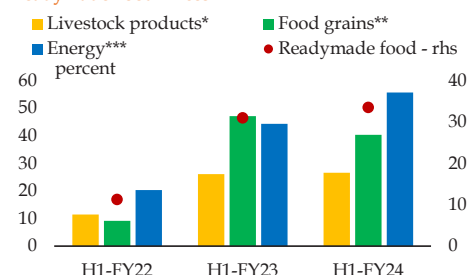


Figure 3.25

Note: Energy is calculated from Urban CPI data.

* Poultry, Raw milk Meat, ** Wheat, Rice & Pulses, *** Gas, LPG, Fuel & Solid Fuel.

Source: Pakistan Bureau of Statistics

Ready-made food prices emulated the increase in food and energy prices

Following the uptrend in prices of livestock and dairy items such as fresh milk, meat, chicken, food grains (wheat and rice), condiments and spices, sugar, and tea, the prices of ready-made food also swelled significantly. Moreover, with substantial upward revision in gas tariffs, the operational cost also soared, which further added to the price pressures in the packaged food group (**Figure 3.25**).

The hike in gas charges fanned energy inflation

Gas charges were the second largest contributor to the average headline CPI inflation in urban areas in H1-FY24. To stem the accumulation of circular debt, the government announced a large increase in variable gas charges in November 2023, in addition to increase in January 2023, primarily including the non-protected category (**Table 3.8**).

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Changes in Gas Charges
(Domestic sector) during H1 FY24

Table 3.8

	Jan-23	Nov-23	Absolute change
Variable charges (Rs/MMBTU)			
Protected category (PC) slabs (in hm ³)			
Up to 0.25	121	121	No change
Up to 0.5	150	150	
Up to 0.6	200	200	
Up to 0.9	250	250	
Non-protected category (NPC) slabs (in hm ³)			
Up to 0.25	200	300	100
Up to 0.6	300	600	300
Up to 1	400	1,000	600
Up to 1.5	600	1,200	600
Up to 2	800	1,600	800
Up to 3	1,100	3,000	1,900
Up to 4	2,000	3,500	1,500
Above 4	3,100	4,000	900
Fixed charges (Rs/MMBTU)			
PC	10	400	390
NPC	1,000 (<=1.5 hm ³)		540
	460, 2,000 (>1.5 hm ³)		1,540

* cubic hectometer refers to hundred cubic meters.

Source: Oil & Gas Regulatory Authority

Similarly, the monthly fixed charges were also increased substantially for both protected and non-protected consumers.⁴⁷ Moreover, the gas charges for the non-domestic sector, including commercial users, captive exporting units, and CNG, almost doubled from the earlier rates.

Electricity charges rose sharply amid periodic annual and quarterly adjustments

The annual adjustments, along with relatively higher quarterly adjustments and the fuel charge adjustments (FCAs), escalated electricity prices in H1-FY24. Effective from July 1, 2023, the government introduced an annual adjustment of Rs 5.75 per unit, on average, to variable electricity charges, across all consumer slabs.⁴⁸ Furthermore, two quarterly adjustments were also announced in the

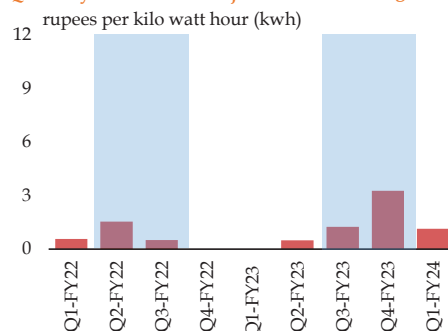
⁴⁷ Protected consumers are domestic consumers, with gas consumption less than or equal to 0.9 hm³ for the last 4 winters (Nov-Feb). The non-protected category refers to the gas usage exceeding 0.9 hm³

⁴⁸ IMF (2024). First Review under Stand-By Arrangement, published in January 2024.

⁴⁹ Source: Notification No. NEPRA/TRF-IO0/MFPA/ 13/4933-43. NEPRA

Quarterly Power Tariff Adjustments

Figure 3.26



The labels show the time period of the tariff adjustment.

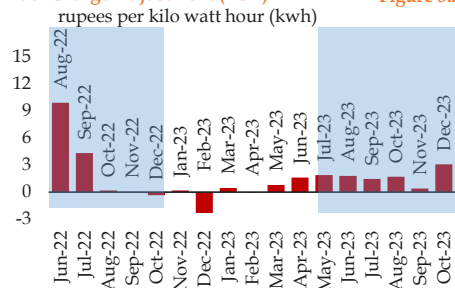
Source: National Electric Power Regulatory Authority

months of July and October 2023 for a period of three and six months, respectively (Figure 3.26).

Furthermore, FCA also increased during H1-FY24 on account of collection of the deferred payments of the flood related subsidy for the months of August and September 2022 (Figure 3.27). These postponed FCAs were collected during March-October 2023.⁴⁹ Moreover, the rise

Fuel Charge Adjustment (FCA)

Figure 3.27

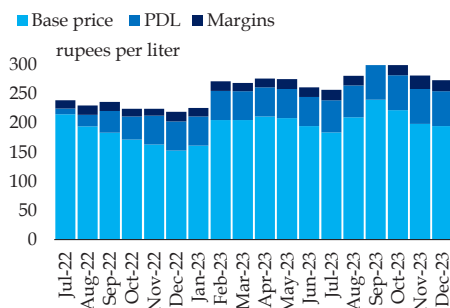


Note: x-axis indicates months for which FCA was charged; indicative months around the bars are months in which FCA was actually billed. FCA is collected with a one-month lag.

Source: National Electric Power Regulatory Authority

Composition of Motor Fuel Prices

Figure 3.28



Note: The effect of subsidies and sales tax remained zero during the review period

Source: Oil & Gas Regulatory Authority

in FCAs partly depicted the impact of weaker local currency that increased the fuel cost despite declining global oil prices in H1-FY24.⁵⁰

Motor fuel prices increased despite a decline in global oil prices

Three factors explain double-digit increase in motor fuel prices during H1-FY24 (**Figure 3.28**). First, the government increased the Petroleum Development Levy from Rs 50/litre in June 2023 to Rs 55/litre during July-August 2023 and further to Rs 60/litre in September-December 2023. Second, starting from September 2023, the government also allowed increase in margins of dealers and oil marketing companies (OMCs).⁵¹ Lastly, the PKR depreciation compared to H1-FY23 partly neutralized the impact of

moderating global oil prices, leading to increase in the base price of fuels.⁵²

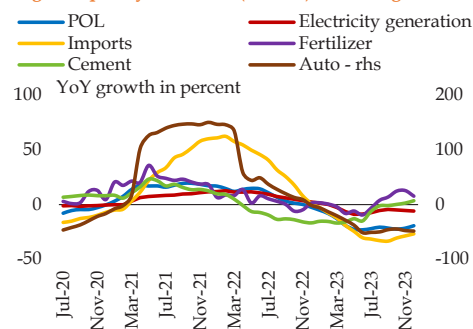
Second round effects of increase in food and energy prices drove core inflation

Although lower than the multi decade peak reached in May 2023, core inflation stayed persistently elevated during H1-FY24. This was despite a sluggish pace of domestic demand amid continued contractionary policies (**Figure 3.29**).

A host of factors were behind the stubborn underlying inflationary pressures during H1-FY24. These included: increase in tax rates and minimum wages; PKR depreciation and second round-effects of successive supply shocks and adjustments in administered price.^{53,54} These factors have resulted in plateauing of core

High Frequency Indicators (3MMA)

Figure 3.29



Note: Except electricity gen. and imports, other indicators show sales.

Sources: PBS, PAMA, NEPRA, APCMA, OCAC

⁵⁰ The PKR depreciated by 22.2 percent during H1-FY24, against 24.1 percent depreciation in H1-FY23.

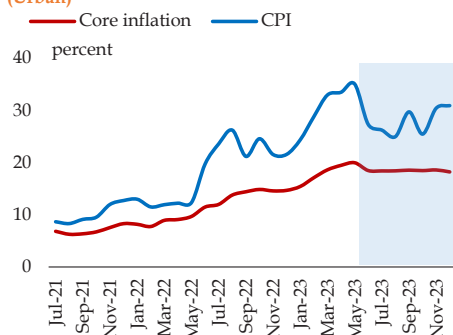
⁵¹ Source: Various issues of petrol price composition, available at www.ogra.org.pk/e-10-gasoline-prices

⁵² Despite the decline in global oil prices, the import unit prices of petroleum crude and products in rupee terms rose 12.7 percent and 17.4 percent in H1-FY24.

⁵³ Labor and Human Resource Department of Punjab, Government of Punjab, September 9th, 2023

⁵⁴ FBR Finance Supplementary Act (2023); FBR SRO No. 297(I)/2023, dated March 08, 2023, available at www.download1.fbr.gov.pk/SROs/2023382232741774SRO-297-OF2023.pdf; and FBR Finance Act 2023

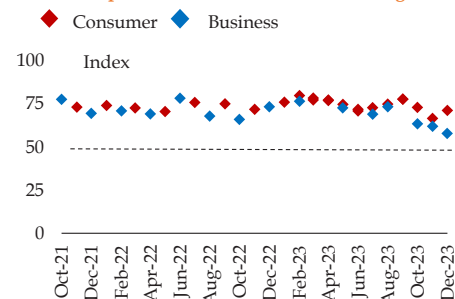
Trends in Headline and Core Inflation (Urban) Figure 3.30



Source: Pakistan Bureau of Statistics

inflation at an elevated level notwithstanding ease in headline inflation (Figure 3.30).^{55,56} The shocks to food and energy prices seep to the core and headline inflation through multiple channels. The intensity and length of these second round effects, however, varies with different structural characteristics of the economies,

Inflation Expectations Figure 3.31



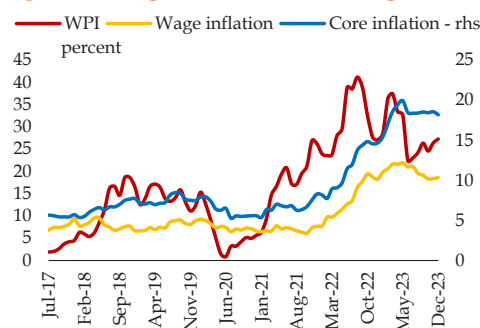
The values exceeding 50 indicates that high inflation views are more than low inflation views.

Source: State Bank of Pakistan

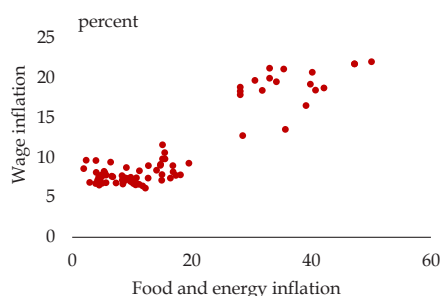
and types of shocks, i.e. food versus energy (Box 3.1).

Amid increasing food and energy prices and a general inflationary environment, the inflation expectations of households and businesses remained high during H1-FY24 (Figure 3.31). As rising inflation

Inputs Costs, Wages, and Core Inflation Figure 3.32a **Food & Energy Inflation and Wages** Figure 3.32b



Source: Pakistan Bureau of Statistics



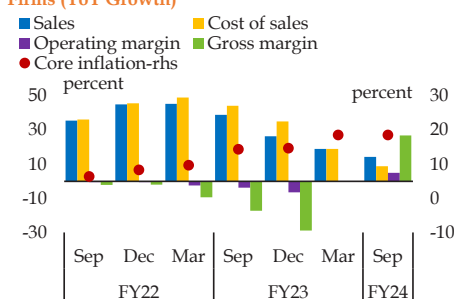
Note: In figure 3.32b, the data points range from Jul-17 till Dec-23

⁵⁵ Persistent increase in headline inflation in response to rising food and energy inflation, indicates sequential shocks to food and energy prices or presence of second round effects emanating from rising inflation expectations and wages. S. Cecchetti, G. & Moessner, R. (2008). Commodity prices and inflation dynamics. BIS Quarterly Review, December 2008

⁵⁶ Khaliq, F. (2023). An intermediate target for the SBP: Headline or Core Inflation? *International Journal of Contemporary Issues in Social Sciences*. ISSN(E) 2959-3808,2(4),1277-1287. Retrieved from <http://ijciss.org/index.php/ijciss/article/view/428>

Financial Indicators of Non-Financial Firms (YoY Growth)

Figure 3.33



Source: SBP - Quarterly financial statement analysis of selected non-financial listed companies, SBP staff calculation; Pakistan Bureau of Statistics

dampened purchasing power of households, they demanded higher wages to preserve their real incomes. The resulting increase in wages further added

to cost and hence inflation (Figures 3.32a & 3.32b).⁵⁷

Moreover, as indicated by the consistent rise in prices of core goods basket, the increase in profit margins of non-financial corporate sector, also hint at rising markups (Figure 3.33).^{58,59} Amid a confluence of domestic and global supply shocks, the corporate sector faced a significant spike in input costs in the past two years, which squeezed profitability as companies opted to partly absorb the cost increases by lowering profit margins (Figure 3.33). However, during H1-FY24 firms increased profit margins despite a slowdown in the cost of production, which may also have contributed to core inflation.

Box 3.1: Understanding Second-Round Effects of Shocks to Food and Energy Prices

The shocks to food and energy prices are transmitted to the core and headline inflation through both direct and indirect channels. The magnitude of direct transmission varies according to the respective weights of food and energy components in the CPI basket. The literature identifies numerous conduits through which, the indirect – second-round – effects are propagated to core and overall inflation. These channels, along with a host of other economic factors that impact the transmission of commodity price shocks to inflation, are discussed in the following.

Shocks to non-core prices engender second-round effects via demand-pull and cost-push dynamics

through elevated inflation expectations and rising input costs.⁶⁰ If the workers perceive the spike in commodity prices as permanent, they demand higher wages to offset the impact on their purchasing power. The ensuing increase in marginal cost of businesses and expansion in consumption transmits to core and hence overall inflation.⁶¹ In the same vein, a hike in food and energy prices inflates input costs of the firms, driving increase in prices of other goods and services, if firms decide to retain profit margins.

⁵⁷ Given the unavailability of data on wages for all economic sectors, Figures 3.32 a and b are showing data for the wages related to tailoring, cleaning and laundering, construction, garbage collection, house help, doctor clinic fees, dental and other hospital services, mechanical, and personal grooming services.

⁵⁸ Core goods baskets constitute items such as packaged consumer goods, automobiles, constructions input items (cement and steel), appliances, and personal and cleaning items (washing powder, face cream). Inflation in core goods basket rose from 21.5 percent in H1-FY23 to 31.4 percent in H1-FY24.

⁵⁹ Markup refers to the difference between selling price and cost.

⁶⁰ Rangasamy. (2011). Food inflation in South Africa: some implications for economic policy, *South African Journal of Economics* 79(2), pp 184–201;

⁶¹ Ruch, F. & Plessis, S. (2015). Second-Round Effects from Food and Energy Prices: an SBVAR approach. South African Reserve Bank Working Paper Series WP/15/05

Certain structural characteristics of the economies are more prone to spawn pervasive second round effects. First, countries with lower oil intensities tend to have relatively mild impact of spikes in global commodity prices on inflation. Second, countries with higher governance score and autonomy of central banks experience lower spillover of commodity price shocks. Third, greater uncertainty about inflation path amplifies the second-round effects of international food price shocks.^{62,63} Lastly, commodity price shocks weigh more strongly on inflation expectations in emerging economies due to less-anchored expectations, given weaker monetary policy frameworks in these economies.⁶⁴

The shocks to food prices feed much stronger second-round effects into core inflation than the hike in energy prices, because of higher weight in the consumption basket and non-availability of close substitutes.⁶⁵ Specifically, in the case of low income economies, food prices tend to have stronger, more volatile and persistent swings, which lead to stronger transmission to non-food prices.^{66,67}

Oil price increases also impact food inflation. The surge in oil prices inflates cost of production and transportation, leading to smaller but significant spillover of oil price shock to food and core inflation.⁶⁸

Commodity price shocks produce non-linear, lagged effects. The swings in commodity prices impact the overall inflation with lags. The lagged effect may arise due to contractual nature of retail prices, unlike the commodity prices, which are determined in more competitive markets.⁶⁹ The impact of shocks to commodity prices produces asymmetric effects. While an increase in prices is relatively quickly transmitted to consumer prices, price declines may only be transmitted partially. This non-linearity may arise on account of various factors including government interventions, non-competitive behavior of the market and asymmetric information.⁷⁰

⁶² Better governance structure entails higher public sector efficiency. Similarly, central bank independence is associated with higher credibility, which is instrumental in anchoring inflation expectations.

⁶³ Gelo, G. & Ustyugova, Y. (2012). Inflation responses to commodity price shocks – how and why do countries differ? IMF Working Paper, WP 12/225.

⁶⁴ IMF World Economic Outlook (2011).

⁶⁵ De Gregorio, J. (2012). Commodity prices, monetary policy, and inflation, IMF Economic Review 60(4), pp 600–633.

⁶⁶ Walsh, J. P. (2011). Reconsidering the role of food prices in inflation. International Monetary Fund.

⁶⁷ Hanif, M. N. (2012). A note on food inflation in Pakistan. *Pakistan Economic and Social Review*, 183-206.

⁶⁸ Alp, H., Klepacz, M., & Saxena, A. (2023). Second-Round Effects of Oil Prices on Inflation in the Advanced Foreign Economies, published on December 15th 2023 in FEDS Notes. Available at (<https://www.federalreserve.gov/econres/notes/feds-notes/second-round-effects-of-oil-prices-on-inflation-in-the-advanced-foreign-economies-20231215.html>)

⁶⁹ Ferrucci et al. (2012). Food Price Pass-Through in the Euro Area: Non-Linearities and the Role of the Common Agricultural Policy. *International Journal of Central Banking*, 8(1), 179-218.

⁷⁰ Alnour et al. (2023). Unveiling the asymmetric response of global food prices to the energy prices shocks and economic policy uncertainty. *World Development Sustainability*, 100083



4

Fiscal Policy and Public Debt

Fiscal deficit increased slightly in H1-FY24, as upsurge in expenditure overshadowed increase in revenue. The surge in expenditure was largely driven by higher interest payments, while primary expenditure also registered an increase. Total revenue, on the other hand, rose on the back of non-tax revenue, while tax revenue also edged up. As growth in revenue outpaced the increase in primary expenditure, total expenditure excluding interest payments, primary balance posted a higher surplus in H1-FY24. Increase in fiscal deficit, nevertheless, led to further accumulation in public debt, mostly sourced from domestic commercial banks.



4.1 Fiscal Trends and Policy Review¹

Fiscal deficit increased to 2.3 percent of GDP in H1-FY24 from 2.0 percent in the same period last year (**Table 4.1**). The increase in deficit, notwithstanding a considerable growth in revenue, was driven by a relatively larger increase in expenditure (in terms of GDP) on account of surge in mark-up payments (**Table 4.2**).² Nonetheless, primary balance posted a larger surplus of 1.7 percent of GDP in H1-FY24 compared to 1.1 percent in H1-FY23. The provinces cumulatively contributed 0.3 percent of GDP to consolidated surplus

during H1-FY24, higher than 0.1 percent in the same period last year.

The improvement in primary balance in H1-FY24 is not only consistent with the budget estimates, but also higher compared to the average of last five comparable periods (**Table 4.2**). Further, a proportionate increase in total revenue and current expenditure (in terms of GDP) helped contain the revenue deficit at 1.6 percent of GDP in H1-FY24, same as in H1-FY23.

Consolidated Fiscal Indicators

Table 4.1

	billion Rupees				Growth (percent)			
	FY23		FY24		FY23		FY24	
	H1	Q1	Q2	H1	H1	Q1	Q2	H1
1. Total revenue (a+b)	4,698.9	2,685.8	4,168.2	6,854.0	18.8	33.2	55.4	45.9
(a) Tax revenue	3,731.9	2,216.9	2,617.4	4,834.3	16.9	24.4	34.2	29.5
o/w FBR taxes	3,428.8	2,041.5	2,427.7	4,469.2	17.4	24.9	35.3	30.3
(b) Non-tax	967.1	468.8	1,550.9	2,019.7	26.4	99.6	111.8	108.8
2. Total expenditure (a+b+c)	6,382.4	3,665.8	5,596.0	9,261.8	19.8	29.7	57.3	45.1
(a) Current expenditure	6,061.2	3,172.6	5,392.0	8,564.6	29.6	25.0	53.0	41.3
o/w Mark-up payments	2,573.1	1,379.6	2,840.4	4,220.0	77.1	44.6	75.4	64.0
(b) Development expenditure & net lending	636.6	282.4	378.8	661.2	11.4	28.4	-9.1	3.9
o/w PSDP	590.9	286.5	386.7	673.2	4.5	30.7	4.1	13.9
(c) Statistical discrepancy	-315.4	210.8	-174.9	35.9	-	-	-	-
Non-interest (total)/Primary expenditure	3,809.4	2,268.9	2,772.8	5,041.8	-1.7	22.1	42.2	32.4
3. Overall budget balance	-1,683.5	-980.1	-1,427.7	-2,407.8	-	-	-	-
percent of GDP	-2.0	-0.9	-1.3	-2.3	-	-	-	-
4. Primary balance	889.6	399.6	1,412.7	1,812.2	-	-	-	-
percent of GDP	1.1	0.4	1.3	1.7	-	-	-	-
5. Revenue balance	-1,362.3	-486.9	-1,223.8	-1,710.6	-	-	-	-
percent of GDP	-1.6	-0.5	-1.2	-1.6	-	-	-	-
6. Financing (a+b)	1,683.5	980.1	1,427.7	2,407.8	-	-	-	-
External (net)	-296.3	442.4	166.0	608.4	-	-	-	-
Domestic (net)	1,979.8	537.6	1,261.8	1,799.4	-	-	-	-

Source: Ministry of Finance

¹ Fiscal balance is total revenue minus total expenditure; primary balance is fiscal balance adjusted for interest payments; revenue balance is total revenue minus total current expenditure; primary expenditure is non-interest (total) consolidated expenditure.

² Total expenditure increased by 1.2 percent of GDP, whereas, total revenue rose by 0.9 percent of GDP over and above same period last year.

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Performance of Consolidated Fiscal Indicators Compared to Last Five Years

Table 4.2

	Growth Rates - H1			As percent of GDP					
				Actual - H1			Budget Estimates (Annual)		
	FY19-23 Avg.	FY23	FY24	FY19-23 Avg.	FY23	FY24	FY19-23 Avg.	FY23	FY24
Total revenue	15.4	18.8	45.9	5.9	5.6	6.5	-	-	-
Federal tax	15.1	17.4	30.3	4.2	4.1	4.2	11.1	9.6	8.9
Federal NTR	31.9	28.5	116.5	1.2	1.1	1.8	3.0	2.5	2.8
Total expenditure	15.2	19.8	45.1	8.0	7.6	8.8	16.2	12.2	13.7
Current expenditure	19.2	29.6	41.3	7.2	7.2	8.1	-	-	-
o/w Mark-up payments	30.7	77.1	64.0	2.5	3.1	4.0	5.6	5.1	6.9
Development expenditure & net lending	5.0	11.4	3.9	0.9	0.8	0.6	-	-	-
Primary expenditure	10.0	-1.7	32.4	5.5	4.5	4.8	-	-	-
Fiscal balance	-	-	-	-2.1	-2.0	-2.3	-6.0	-4.9	-6.5
Primary balance	-	-	-	0.4	1.1	1.7	-0.6	0.2	0.4

Source: Ministry of Finance and SBP staff calculations

The increase in total revenue as percent of GDP was largely contributed by non-tax revenue, followed by a modest increase in tax revenue (**Table 4.2**). The increase in tax revenue was led by direct taxes, particularly income tax collected from the corporate profits, as well as individuals' earnings on bank deposits and investment in government securities. Contribution of indirect taxes was also substantial, largely supported by higher sales tax collection. Tax measures announced in the Finance Act 2023, including broadening of scope of super tax and increase in FED on beverages, amid higher inflation and interest rate as well as PKR depreciation, bolstered tax collection during H1-FY24. Substantial increase in non-tax revenue was mainly due to higher SBP profit and petroleum development levy (PDL) collection on the back of higher interest rates and PDL rates, respectively. In addition, provincial own tax efforts also resulted in increased tax collection, especially from sales tax on services.

Total expenditure also increased in terms of GDP, because of surge in both mark-up and primary expenditures. Increase in mark-up payments was driven by the government's increased reliance on domestic borrowings in a high interest rate environment. Moreover, the government's lack of restraint on primary expenditure warranted additional borrowing that further inflated mark-up payments in H1-FY24.

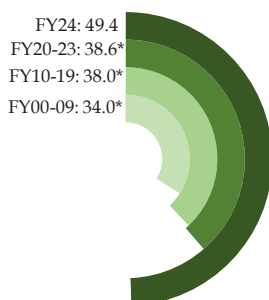
Primary expenditure saw a broad-based increase, led by subsidies, running of civil government, and grants. Increase in subsidies, the largest non-interest contributor, is mainly due to higher disbursement of power subsidies, particularly to Independent Power Producers (IPPs) to contain power sector circular debt under the Circular Debt Management Plan FY24. Development expenditure also increased, as higher provincial spending more than offset contraction in federal Public Sector Development Programme (PSDP).

In line with the trends in fiscal deficit, public debt rose by 7.1 percent in H1-FY24. Despite some increase in external financing after securing IMF's SBA, most of the accumulation was due to domestic debt. Significant increase in the issuance of long-term instruments (PIBs and Ijara Sukuks) amid retirement of T-bills lengthened the maturity profile of the public debt stock. However, the repayment capacity of the government deteriorated, as growth in domestic interest payments considerably outpaced growth in FBR taxes.

It is important to highlight that sustaining the fiscal consolidation achieved in H1-FY24 is crucial for stemming accumulation in public debt, reducing debt servicing burden, and bringing down inflation. This warrants deep-rooted tax policy interventions beyond rate changes, like expanding the tax base, to boost tax revenue up to potential. At the same time, the government needs to restrain spending on subsidies and grants to PSEs through privatization of loss-making entities. This is also critical for creating fiscal space for social and development spending.

Share of Direct Taxes in Total Federal Taxes in H1
percent

Figure 4.1



* Averages

Source: Ministry of Finance

4.2 Revenue

Total revenue grew by 45.9 percent in H1-FY24, considerably higher than 18.8 percent growth in H1-FY23 (**Table 4.1**). As a result, total revenue as percent of GDP edged above the average during the last five years (**Table 4.2**). Non-tax revenue was the major contributor, while tax revenue to GDP also inched up slightly.

Tax Revenue

Tax revenue increased by 29.5 percent in H1-FY24, compared to 16.9 percent in H1-FY23. Federal taxes continued to remain major driver, while provincial tax revenue also made positive contribution through GST on services. The federal, i.e. FBR, taxes grew by 30.3 percent, surpassing the target for H1-FY24 by Rs 1,040 billion (**Table 4.3**). Continuing the FY23 trend, direct taxes remained the main contributor. Share of the direct taxes reached almost half of the total collection in H1-FY24, highest in the last 25 years (**Figure 4.1**).

Within the direct taxes, voluntary payments showed strong growth, primarily consisting of advance taxes from corporates. Withholding taxes also witnessed robust growth, particularly on bank interest and securities, contracts, salaries, and imports. Furthermore, indirect taxes also saw a broad-based growth of 12.2 percent in H1-FY24 after remaining almost flat in the corresponding period of last year. Higher sales tax and FED collections, followed by customs, were the major contributors to growth in indirect taxes, (**Table 4.3**).

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FBR Tax Collection in H1

Table 4.3

growth in percent; contribution in percentage points

	billion Rupees		Growth		Contribution in Growth*		Percent of Target
	FY23	FY24	FY23	FY24	FY23	FY24	FY24
1. Direct taxes	1,525.7	2,148.9	49.4	40.9	17.3	18.2	119.8
Import	149.2	188.4	5.8	26.2	0.8	2.6	-
Domestic	1,376.4	1,960.5	56.2	42.4	48.5	38.3	-
2. Indirect taxes	1,903.2	2,320.4	0.2	21.9	0.1	12.2	-
Sales tax	1,272.0	1,515.3	-0.2	19.1	-0.2	12.8	87.9
Import	824.9	925.8	-7.5	12.2	-5.3	7.9	-
Domestic	447.1	589.4	16.7	31.8	5.0	11.2	-
Federal excise duty	164.3	264.6	12.3	61.0	0.9	5.3	99.4
Import	5.8	16.0	-51.9	178.0	-4.3	6.3	-
Domestic	158.5	248.5	18.3	56.8	16.8	54.8	-
Customs	466.9	540.5	-2.1	15.8	-0.5	3.9	84.2
Grand total (1+2)	3,428.8	4,469.2	17.4	30.3	-	-	101.0

* Contribution to growth is calculated on the basis of constituents

Note: Tax revenue numbers reported by FBR and Ministry of Finance may not tally exactly

Sources: Federal Board of Revenue (Provisional), and SBP staff calculations

A combination of federal tax measures introduced in FY23 and FY24 (via Finance Act 2023 in June 2023, and earlier through the Finance (Supplementary) Act 2023 in February 2023) and economic factors, like higher inflation and interest rate, and PKR depreciation, explain the federal tax performance in H1-FY24. However, it is worth highlighting that growth in FBR tax collection in real terms is not that impressive, given 28.8 percent inflation and 22.3 percent depreciation of PKR in H1-FY24 vis-a-vis last year.

a) Tax Measures

The tax measures primarily aimed at meeting higher revenue target through changes in the tax rates and rationalization of tax expenditure, given the expectation of

a subdued recovery in economic activity and increase in overall expenditure. The salient tax measures are summarized as follows.

One, the government made two amendments to super tax: (i) the scope of the super tax was widened by increasing the number of tax slabs from four to seven, and the tax net expanded by including all persons across the board (earlier it was applicable to 16 types of businesses only), ensuring progressivity and uniformity; and, (ii) purview of the super tax was extended to include capital gains on disposal of securities, with National Clearing Company Pakistan Limited (NCCPL) assigned to collect it along with capital gains tax.³ Two, the income tax

³ Super tax ranging from 2 to 4 percent was imposed on incomes of high-earning persons in FY16 with the goal to provide for rehabilitation of temporarily displaced persons. Later, in FY23, section 4B was replaced by new section 4C, "Super tax on high earning persons". For more details on the graduated new tax rates introduced under section 4C, see Chapter 4, The State of Pakistan's Economy Annual Report FY23.

slabs were revised to ensure progressivity. Three, withholding tax (WHT) on supply of goods and services and execution of contracts was increased.

Four, the WHT on import of goods by commercial importers was increased from 5.5 percent to 6.0 percent. Moreover, the mode of advance tax on large vehicles (2001cc and above) was changed from fixed amount to graduated rates, with non-ATL (Active Taxpayers List) buyers paying 200 percent higher tax. Higher taxes on local or imported cars were, in part, meant to dilute the adverse revenue impact of declining auto sales. These measures partly led to five times higher tax payments made

by domestic automobile companies in Q1-FY24.^{4,5} Moreover, withholding tax collected at import stage increased by about 25 percent in H1-FY24.

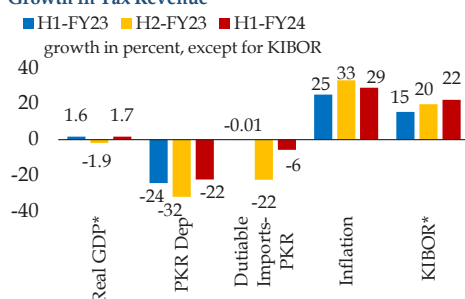
Five, the basis of the advance tax on builders and developers was changed to area and size of the building or real estate development project, rather than the sales turnover. In addition, the government further increased WHT on the sale and purchase of immovable property from 2 percent to 3 percent.⁶

Six, the general sales tax rate was raised from 17 percent to 18 percent on goods in February 2023, and from 18 percent to 25 percent on locally manufactured cars and import of over 800 tariff lines covering non-essential items in March 2023.^{7, 8}

Seven, in an effort to reduce tax expenditure, the government rationalized sales tax on the following: i) increase in concessional GST from 12 percent to 15 percent for tier-1 retailers of assorted goods⁹; ii) imposition of five percent GST on DAP fertilizer sales, which was earlier exempted from such tax. Moreover, condition of minimum covered area of shops for tier-1 retailers was removed, thereby enhancing the scope of tier-1

Key Economic Factors and Growth in Tax Revenue

Figure 4.2



Note: Most figures are rounded off to whole numbers;

* One Week

Sources: PBS, FBR, & SBP

⁴ Data source: SBP Quarterly Financial Statements Analysis for Non-Financial Companies for quarter ending September 2023

⁵ It may be noted here that these statistics represent five auto companies registered with PSX, which means imports of CBU cars are excluded. Moreover, these tax payments constitute all kinds of taxes, including corporate income tax, super tax (where applicable), WHT, sales tax.

⁶ The WHT is 200 percent and 350 percent more for non - ATL sellers and buyers of property, respectively.

⁷ Those items included complete built units of cars and appliances; juices and aerated water; confectionery; articles of jewelry, among others.

⁸ These measures contributed to a substantial increase in GST collection: domestic GST collection rose by 16.8 percent, 28.9 percent, and 31.8 percent in H1-FY23, H2-FY23, and H1-FY24, respectively; whereas GST collection at import stage showed 12.2 percent growth in H1-FY24, after posting consecutive declines in the preceding two halves.

⁹ These goods include finished fabrics, locally manufactured finished articles of textile, textile made-ups, leather and artificial leather, among others.

retailers by including more retailers in the list.¹⁰

Last, FED was imposed on fertilizers, whereas its rate was increased for sugary fruit juices and syrups. Earlier in FY23, the government had twice increased FED on cigarettes. These measures led to a sizeable contribution of FED in growth of overall taxes in H1-FY24.¹¹

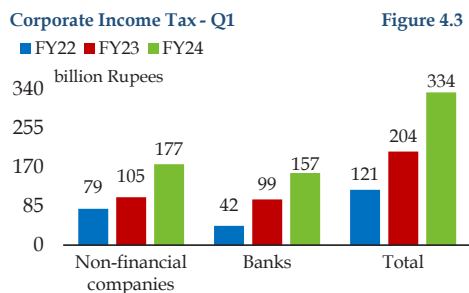
b) Economic Factors

Economic activity, as reflected by quarterly GDP and high frequency indicators moderately recovered, which supported the growth in tax collection in H1-FY24 (**Figure 4.2**). Further, PKR depreciation compared to last year and elevated inflation and interest rates had positive spillovers for tax revenue.

Data on revenue spinners shows that advance taxes contributed two-fifths in growth of overall direct tax collection in H1-FY24. Performance of these taxes is traced to a considerable increase in corporate profits (**Figure 4.3**). Interest earnings, amid higher government borrowing in a high interest rate environment, provided major boost to banks' profit, which increased by nearly 75 percent in Q1-FY24.¹² Moreover, profit of non-financial institutions also jumped by

61 percent in the first quarter in the backdrop of moderately recovering economy, softening cost of sales, and a decent growth in sales combined with elevated inflation.¹³

Prevailing higher interest rates also boosted collections from individuals' earning from profit-bearing accounts with banks, as well as investments in government securities. This is worth highlighting that individuals tend to save and invest more in government securities during the times of high interest rates, as reflected in the quarterly flows of saving deposits and the pattern of accepted non-competitive bids (**Figures 4.4a & 4.4b**).¹⁴



Note: 1) Calculated as difference b/w profit before & after tax; 2) there are 100 different entities under the head of non-financial companies
Sources: State Bank of Pakistan; Quarterly Analysis of Selected Non-Financial Companies (SBP)

¹⁰ FBR makes distinction for tier-1 retailers in order to streamline, digitalize, and automate collection of sales tax from retailers in an efficient manner, with the aim to improve tax base and collection.

¹¹ FED's contribution in total taxes increased from 0.6 percentage points in H1-FY23 to 2.9 percentage points in H1-FY24.

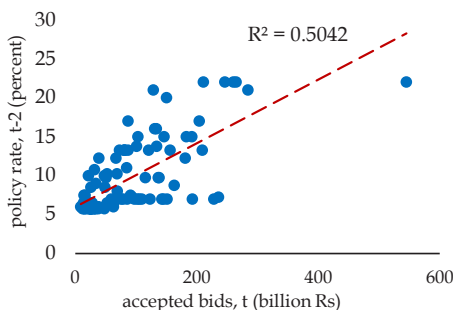
¹² It may be noted here that profit before tax of the banks, who maintain books on calendar year basis, saw 81 percent increase during Jan-Sep 2023. Data source: Financial Soundness Indicators, State Bank of Pakistan.

¹³ Cumulative sales of PSX-registered non-financial firms (100 in total) were up by 14.4 percent in Q1-FY24, whereas cost of sales rose by 9.0 percent. Data source: SBP Quarterly Financial Statements Analysis for Non-Financial Companies for period ending September 2023

¹⁴ For an illustration on relation between interest rate and saving deposits, see Figure 3.8 in **Chapter 3**.

Non-competitive Bids and Interest Rate

Figure 4.4a



Note: The scatter plot covers data from July 2015 to December 2023

Source: State Bank of Pakistan

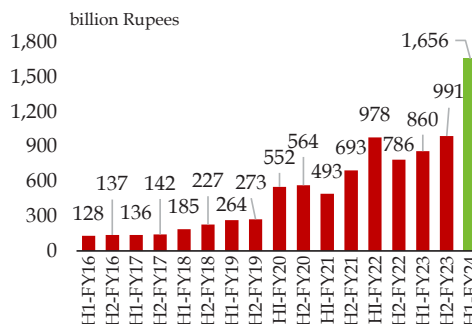
The PKR depreciation cushioned the revenue impact of falling import values in dollar terms during H1-FY24 compared to H1-FY23.¹⁵ Assuming there were no depreciation vis-à-vis same period last year, PKR-denominated dutiable imports would have declined by 26.7 percent in H1-FY24, instead of actual decline of 5.7 percent.¹⁶ This, along with tax measures taken in the budget, led import-related taxes to increase in H1-FY24, as opposed to decline last year.

Non-tax Revenue

Non-tax revenue (NTR) grew strongly in H1-FY24, on the back of SBP profit transfers, PDL collection, and mark-up receipts on federal loans to PSEs and provinces (Figures 4.5). SBP profit, the leading contributor to the NTR, reflected impact of higher interest rate and

Trend of Non-competitive Bids

Figure 4.4b

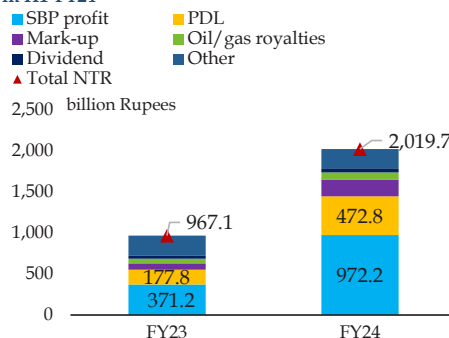


Source: State Bank of Pakistan

increased liquidity injections amid high government borrowing from banks. In case of PDL revenue, gradual increase in the PDL rate on petroleum products to Rs 60 per litre boosted collections, offsetting the impact of lower POL sales in the first half.¹⁷ Provincial NTR, however, showed

Composition of Non-tax Revenue in H1-FY24

Figure 4.5



Source: Ministry of Finance

¹⁵ Tax liabilities at import stage are calculated in PKR terms. Value of PKR against USD was 22.1 percent lower in H1-FY24 than H1-FY23. It is worth highlighting here that PKR has appreciated by end-December relative to end-June 2023, but has depreciated compared to end-December 2022 (see Chapter 5).

¹⁶ The alternate growth rate is calculated by converting US\$-denominated imports in H1-FY24 into PKR equivalent using average exchange rate of H1-FY23.

¹⁷ PDL on petrol was increased from Rs 50 to Rs 55 per litre on July 01, 2023, and Rs 60 on September 01, 2023. Levy on HSD increased to Rs 55 on October 16, 2023, and Rs 60 on November 01, 2023.

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Federal Expenditure

Table 4.4

	billion Rupees				Growth (percent)			
	FY23	FY24			FY23	FY24		
	H1	Q1	Q2	H1	H1	Q1	Q2	H1
Total expenditure (a+b)	4,567.1	2,347.1	4,491.9	6,839.0	23.2	24.2	67.8	49.7
(a) Current expenditure	4,390.2	2,263.8	4,319.8	6,583.6	31.0	22.2	70.3	50.0
Mark-up payments	2,573.1	1,379.6	2,840.4	4,220.0	77.1	44.6	75.4	64.0
Domestic	2,273.5	1,252.3	2,465.6	3,717.8	73.2	49.9	71.4	63.5
Foreign	299.6	127.3	374.8	502.2	113.4	7.1	107.4	67.6
Defence affairs/ services	638.9	343.1	414.5	757.6	22.7	9.6	27.2	18.6
Pension	321.2	203.3	201.1	404.4	27.6	18.6	34.2	25.9
Running of civil govt.	226.7	131.9	170.5	302.4	8.0	28.9	37.1	33.4
Subsidies	196.6	2.5	372.8	375.3	-37.3	-97.3	258.7	90.9
Grants (provinces/others)	433.7	203.4	320.5	523.9	-28.1	-7.4	49.7	20.8
Provinces	44.6	26.1	28.3	54.4	-17.6	27.6	17.4	22.1
Others	389.2	177.3	292.2	469.5	-29.1	-11.0	53.8	20.6
(b) Development expenditure & net lending	177.0	83.3	172.1	255.3	-50.1	127.0	22.7	44.3
PSDP	161.7	52.6	99.6	152.1	-43.9	-29.5	14.2	-5.9
Grants to provinces	25.3	11.6	10.1	21.7	-71.4	54.3	-43.3	-14.2
Net lending	15.2	30.7	72.5	103.2	-77.0	-181.1	36.5	578.1
Provinces	-30.5	34.8	80.4	115.2	-	-	-	-
Others	45.7	-4.1	-7.9	-12.0	-	-	-	-
Non-interest (total) expenditure	1,994.1	967.5	1,651.5	2,619.0	-11.5	3.4	56.0	31.3

Source: Ministry of Finance

only slight improvement in H1-FY24 compared to a year ago.

4.3 Federal Expenditure¹⁸

Federal expenditure grew by nearly 50 percent in H1-FY24, compared to 23.3 percent in the same period last year (**Table 4.4**). About 62 percent of the increase in expenditure (in absolute terms) was contributed by higher mark-up payments, followed by subsidies, defence, grants, pensions and running of civil government.

In H1-FY24, mark-up payments jumped by 64 percent to Rs 4.2 trillion, which was around 94 percent of FBR taxes and 87 percent of the total tax revenue. This reflects the impact of rising interest rates, both domestic and global, as well as accumulation in public debt in view of consistently large fiscal deficit in the past few years. Due to reduced external inflows, particularly in FY23, the government had to rely more on domestic borrowing at relatively much higher rates. The debt instruments, particularly 3-month T-bills that were issued aplenty in Q4-FY23

¹⁸ i) This section covers federal expenditure, and not the consolidated federal and provincial expenditure presented in **Table 4.1**; ii) Federal expenditure number, wherever mentioned and discussed in this section, is calculated by subtracting statistical discrepancy from "Total Federal Expenditure" published in the Ministry of Finance Fiscal Operations reports.

Ratio of Mark-up Payments to Key Fiscal Indicators

Table 4.5

average quarterly flows in billion Rupees

	FY18	FY19	FY20	FY21	FY22	FY23	H1-FY24
Mark-up payments	375.0	522.8	654.9	687.4	795.6	1,424.0	2,110.0
Domestic	330.7	455.2	578.3	631.0	707.1	1,267.8	1,858.9
Foreign	44.3	67.6	76.7	56.5	88.5	190.0	251.1
<i>Mark-up payments as percent of</i>							
Total expenditure	31.8	36.9	38.1	38.0	34.0	50.3	62.9
Current expenditure	39.3	43.5	43.0	43.3	37.7	52.4	64.1
Gross revenue receipts	31.9	47.1	45.3	43.9	43.4	64.1	65.4
Net revenue receipts*	60.5	102.6	79.9	77.9	85.1	122.3	105.2

*equals gross federal revenue receipts adjusted for NFC transfers to provinces

Source: Ministry of Finance

and Q1-FY24, matured during H1-FY24, leading to large mark-up payments.¹⁹ Primary federal expenditure also grew notably in H1-FY24, in contrast to a contraction observed in the same period last year. Subsidies, running of civil government, and grants mainly led this expansion. On the other hand, federal PSDP declined, and growth in spending on pension and defence services decelerated. It is important to note that higher interest payments have reduced fiscal space for development and social spending in last few years (Table 4.5).

In case of subsidies, the government had earmarked much larger share of FY24 budget, with power subsidies dominating the mix with 83 percent share (Table 4.6). Overall power subsidies rose in H1-FY24, despite government passing on generation cost to end-consumers in the form of regular tariff adjustments and retracting subsidies to industry. Subsidies to

Independent Power Producers (IPPs) in H1-FY24 was almost three times that of last year, mainly in respect of capacity payments.²⁰ These disbursements are part of government's plan to contain the stock of power circular debt in FY24 at FY23 level, as per the Circular Debt Management Plan (CDMP) FY24 agreed with the IMF. Furthermore, power distribution companies (especially K-Electric) also received higher subsidies in the first half under tariff differential, indicating inflated cost of power generation.

It may be noted that industries received no power and gas subsidies in H1-FY24, compared to about Rs 34 billion disbursed in the corresponding period of last year (Table 4.6). This was in line with elimination of budget allocation for these subsidies to industries, with resources diverted to power producers and distributors.²¹

¹⁹ For more details on interest payments, see Section 4.5 – Public Debt

²⁰ Capacity payments to IPPs, part of retail tariff as per the Power Purchase Agreements, are not entirely collected from end-consumers due to various structural issues in the power value chain, including T&D losses, low bill recoveries, and power theft, among others. Government provides subsidies to IPPs to compensate that somewhat, and stem circular debt accumulation.

²¹ Among these subsidies, there was only a small allocation of Rs 7.0 billion for K-Electric under industrial support package in FY24 against Rs 20 billion last year.

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Breakup of Subsidies

Table 4.6

billion Rupees

	Annual BE		Actual - H1 (p)	
	FY23	FY24	FY23	FY24
1) Power subsidies	535	880	122	325
IPPs	180	310	31	131
Tariff differential	295	513	55	194
KESC (including arrears)	60	298	11	116
Inter Disco	225	150	43	49
AJK	3.0	55	0	25
Tube wells	7.0	10	0.9	3.1
Industry support	40	7	22	0
Other	20	50	14	0
2) Non-power subsidies	129.0	184.2	74.3	50.7
LNG/RLNG (industry)	40.0	0.0	11.1	0.0
Gas (domestic consumers)	25.0	29.0	6.3	0.0
Fertilizer plants	15.0	25.0	6.7	10.0
Utility Stores	12.0	30.0	8.8	7.7
Other	37.0	100.2	41.5	33.0
Total subsidies (1+2)	664.0	1,064.3	196.6	375.3

Source: Ministry of Finance

In the case of grants, there was a trend reversal from H1-FY23, as these increased by 20.6 percent in H1-FY24. Major factors driving the increase included disbursements in respect of contingent liabilities of PSEs and reimbursement of T.T. charges for home remittances.²² In terms of budget allocation, government had set aside higher sum of grants for FY24, with major additional grants for BISP and ECP, in light of increase in BISP

outreach and General Elections, respectively.²³

Expenditures on running of the civil government grew by 33.4 percent in H1-FY24, compared to 8.0 percent in H1-FY23 (Table 4.4). This increase was because of an upward revision in the salaries of the federal employees amid high inflation.²⁴ Similarly, pension expenditure grew at a slightly slower pace at 25.9 percent in H1-FY24 compared to H1-FY23, as the government increased pensions of the federal employees by 17.5 percent.²⁵

4.4 Provincial Fiscal Operations

Provincial fiscal accounts posted a cumulative surplus of 0.3 percent of GDP in H1-FY24, up from 0.1 percent in H1-FY23 (Table 4.7). The higher surplus indicates a relatively higher growth in revenue vis-à-vis expenditure. Both higher federal transfers and increase in provincial own tax and non-tax revenues have contributed to 33.9 percent growth in cumulative provincial revenue. Substantially higher federal loans, on net basis, also contributed to overall higher provincial revenue.

²² SBP increased the reimbursement rate from SAR 20/- to SAR 30/- on September 21, 2023 (effective from 30 days later). Source: EPD Circular Letter No. 14 of 2023

²³ Number of beneficiary families rose from 7.6 million in CY2022 to 9.0 million in CY2023. Quarterly stipend under Benazir Kafaalat Program increased from Rs 7,000/- per family to Rs 8,750/-. Likewise, the number of children receiving scholarships under Benazir Taleemi Wazaif increased from 2.6 million in 2022 to 7.52 million in 2023. BISP management expects to add 300,000 more families to its main program. Source: BISP Press Release; <https://bisp.gov.pk/SiteImage/Misc/files/7-7.pdf>

²⁴ Increase in ad-hoc allowance of officers as on June 30, 2023 by cadre: BPS 1 to 16 at 35% of basic pay, BPS 17-22 at 30 percent of basic pay. Last year, it was 15 percent across the board. Source: https://www.finance.gov.pk/circulars/circular_04072023_1.pdf

²⁵ Source: Ministry of Finance (www.finance.gov.pk/circulars/circular_05072023_2.pdf)

Consolidated Provincial Fiscal Accounts in H1

Table 4.7

	billion Rupees			Growth (percent)	
	FY19-23 Avg.	FY23	FY24	FY23	FY24
Total Revenue (a+b+c)	1,868.5	2,293.1	3,070.9	2.6	33.9
as percent of GDP	3.2	2.7	2.9		
a) Federal tax transfer (NFC)	1,475.9	1,880.0	2,435.3	11.0	29.5
b) Provincial own revenue (i + ii)	299.4	373.7	444.2	10.3	18.9
i) Provincial taxes	244.5	303.0	365.1	11.7	20.5
Sales Tax on Services	134.8	186.3	230.0	27.9	23.4
ii) Provincial non-tax	54.9	70.7	79.2	4.5	12.0
Others including forest	43.8	68.5	63.8	48.6	-6.8
c) Federal loans & transfers/grants	93.2	39.4	191.4	-80.6	386.1
Loans (net)	7.0	-30.5	115.2	-	-
Grants	86.2	69.9	76.2	-51.0	9.0
Total expenditure	1,586.8	2,191.9	2,781.5	24.9	26.9
as percent of GDP	2.7	2.6	2.6		
Current expenditure	1,321.5	1,733.3	2,074.0	24.1	19.7
Development expenditure	287.0	454.4	542.8	24.2	19.4
Statistical discrepancy	-36.1	4.1	164.7	-	-
Overall balance	281.6	101.2	289.4	-79.0	186.1
as percent of GDP	0.5	0.1	0.3		

Source: Ministry of Finance

Within the provincial own revenue, provincial tax revenue grew by 20.5 percent in H1-FY24 compared to 11.7 percent in H1-FY23, mainly on account of GST on services. Provincial non-tax revenue also inched up with KPK receiving Rs 12.6 billion in profits from hydroelectricity in H1-FY24.

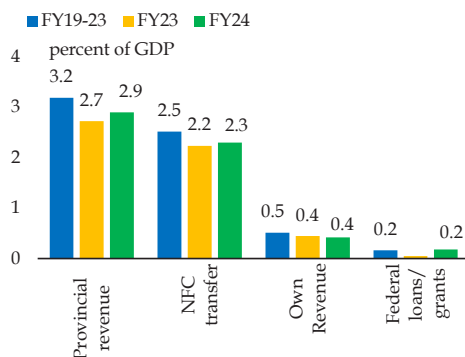
Provincial expenditure grew by nearly 27 percent in H1-FY24 compared to about 25 percent growth in H1-FY23. The growth in H1-FY24 was also broad-based, with current and development expenditures rising at almost same pace. Current expenditure rose across all provinces in line with the increase in salaries and pensions of the government employees.²⁶ Moreover, there was a notable spike in

spending on public order and safety and education affairs. On the development expenditure side, Sindh and Balochistan led the increase, whereas Punjab and KPK saw a decline. Both provinces spent more resources on agriculture and food, as well as social protection projects.

It is worth mentioning here that while provincial surplus during H1-FY24 exceeded the last year's level, it is still lower compared to the average surplus in H1 during FY19-23. This is because revenue has been falling, while expenditure has remained almost unchanged, in terms of GDP (Table 4.7). Decline in both the federal transfers and provincial own revenue overtime explain

²⁶ All four provinces increased salaries and pensions for provincial employees following the announcement of the same by Ministry of Finance for federal employees (Footnote 24).

Performance of Provincial Revenue in H1 Figure 4.6



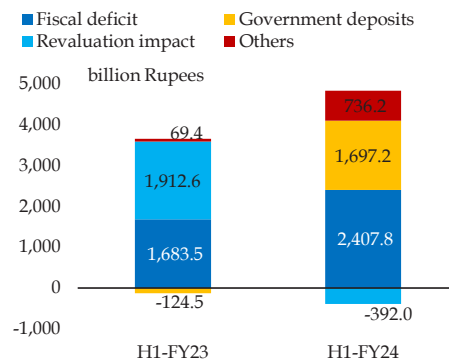
Source: Ministry of Finance & staff calculations

the squeezing revenue, and hence the lower provincial surplus (Figure 4.6).²⁷

4.5 Public Debt

Pakistan's total debt & liabilities rose at a slightly slower pace of 6.1 percent, compared to 7.7 percent increase in the same period of last year. Similarly, the pace of accumulation in public debt slightly decelerated to 7.1 percent in H1-FY24 from 7.2 percent in the same period a year ago. This was mainly because of slower accumulation of external debt, following the appreciation of PKR against the US dollar between end-June 2023 and end-December 2023.^{28,29} The increase in public debt in H1-FY24 primarily reflects the fiscal deficit, which is contrary to the last year when PKR depreciation had also

Sources of Change in Public Debt Figure 4.7



Source: State Bank of Pakistan

contributed in debt accumulation (Figure 4.7). Moreover, the government also borrowed to build cash buffers in view of the upcoming lumpy maturities of government securities.³⁰

In terms of public debt composition, the government relied more on domestic sources to finance the deficit in the wake of reduced availability of external funding. Accordingly, the share of domestic debt in total public debt increased during H1-FY24 (Figure 4.8).

Furthermore, the maturity profile of the public debt improved during H1-FY24. A substantial rise in the stock of PIBs and Ijara Sukuks amid retirement of T-bills increased the maturity profile of domestic debt, while repayment of the most short-

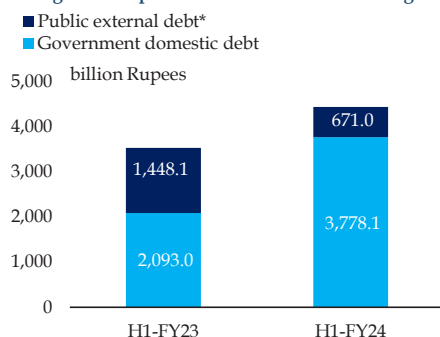
²⁷ Size of Federal NFC transfers to provinces, the largest source of revenue for provinces, depend on FBR tax collections in any given period. Lower the FBR tax, lower the NFC transfers, both in relation to GDP.

²⁸ The growth is calculated by dividing the difference of stock at the end of December 2023 and stock at End-June 2023 (End-December 2023 stock - End-June 2023 stock), by the stock at the end of June 2023 ((End-December 2023 stock - End-June 2023 stock)/End-June 2023 stock)).

²⁹ The external debt grew by only 2.8 percent in PKR terms during H1-FY24, compared to 8.0 percent in H1-FY23.

However, in US Dollars, there was a noticeable growth of 4.4 percent in the first half of FY24 compared to decline of 2.6 percent in the same period last year.

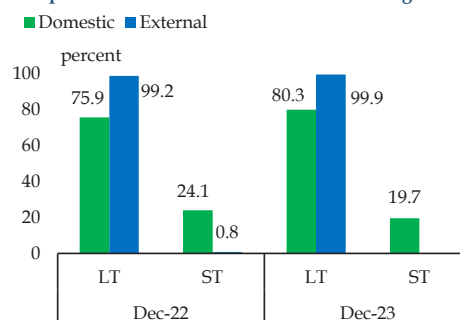
³⁰ This is evident from increase in government deposits held with the SBP.

Change in Composition of Public Debt **Figure 4.8**

* including debt from IMF
Source: State Bank of Pakistan

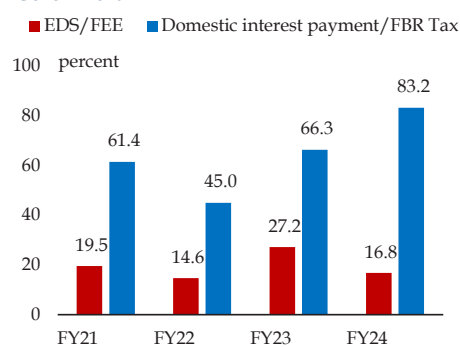
term commercial debt and the increase in relatively longer-term bilateral debt lengthened maturity profile of external debt maturity profile (**Figure 4.9**).³¹ These developments have considerably reduced the rollover risk. However, the repricing risk still persists as the bulk of domestic financing was raised through floating rate instruments.³²

The repayment capacity of the government somewhat deteriorated during H1-FY24, compared to the first half of FY23 (**Figure 4.10**).³³ In particular, the ratio of domestic mark-up payments to FBR taxes increased significantly, indicating that domestic interest payments outgrew tax revenue by much larger amount compared to the same period last year. However, the external

Composition of Public Debt in H1 **Figure 4.9**

LT: Long-term ST: Short-term
Source: State Bank of Pakistan

debt servicing (EDS)-to-foreign exchange earnings (FEE) ratio improved on the back of lower principal payments and a slight increase in foreign exchange earnings.

Repayment Capacity of Government in H1 **Figure 4.10**

Sources: Ministry of Finance & State Bank of Pakistan

³¹ The lengthening of domestic debt maturity profile by issuing more PIBs and Shariah-Compliant instruments and retiring short-term debt is consistent with the government's Medium-Term Debt Management Strategy (MTDS) FY23-FY26.

³² Floating rate instruments' coupon payments (or rental rates) are linked to 3-month and 6-month T-bills. The change in interest rates of T-bills will subsequently result in higher interest payments on these instruments. While there are expectations of no change or decrease in the policy rate, persistent inflation may cause the policy rate to rise further, leading to high coupon payments on floating instruments.

³³ Repayment capacity is gauged by two ratios: i) domestic mark-up payments-to-FBR taxes, and ii) external debt serving (EDS)-to-foreign exchange earnings (FEE).

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Government Domestic Debt and Liabilities in H1

Table 4.8

billion Rupees

	Stock		Flows		Share in Domestic Debt Stock (in percent)		Growth over June Stock (in percent)	
	Dec-22	Dec-23	FY23	FY24	Dec-22	Dec-23	FY23	FY24
I. Permanent debt, of which	23,829.6	30,889.5	2,985.9	4,868.0	71.8	72.5	14.3	18.7
GOP Ijara Sukuk	2,644.6	4,419.0	364.8	1,268.4	8.0	10.4	16.0	40.3
Pakistan Investment Bonds	20,301.2	25,608.7	2,614.2	3,599.5	61.2	60.1	14.8	16.4
Prize Bonds	381.6	382.6	7.0	0.1	1.2	0.9	1.9	0.0
II. Floating debt, of which	6,156.3	8,369.8	-647.7	-965.4	18.6	19.7	-9.5	-10.3
Market Treasury Bills	6,091.1	8,288.4	-661.3	-980.8	18.4	19.5	-9.8	-10.6
III. Unfunded debt, of which	3,073.2	2,831.6	-262.8	-94.9	9.3	6.6	-7.9	-3.2
NSS (Net of Prize Bonds)	2,961.1	2,742.0	-247.2	-76.5	8.9	6.4	-7.7	-2.7
IV. Foreign currency instruments	9.5	378.3	0.9	-5.5	0.0	0.9	9.8	-1.4
V. Naya Pakistan Certificates (residents only)	109.7	118.7	16.8	-24.0	0.3	0.3	18.0	-16.8
Government domestic debt (I+II+III+IV+V)	33,178.4	42,587.9	2,093.0	3,778.1	100.0	100.0	6.7	9.7

Source: State Bank of Pakistan

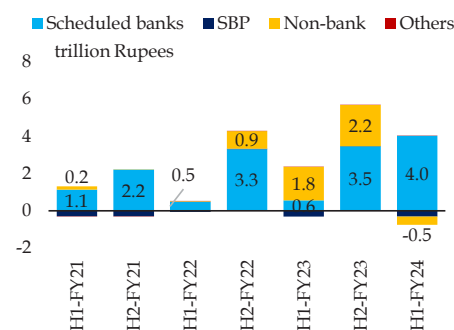
Domestic Debt

The stock of domestic debt has been rising persistently over the last few years.³⁴ This reflects higher fiscal deficit, combined with increased government reliance on domestic sources, especially banks. The increase in domestic debt during H1-FY24 was almost 1.8 times the size in H1-FY23 (**Table 4.8**).

In contrast to H1-FY23, almost entire increase in domestic debt in H1-FY24 was sourced from scheduled banks, mainly through PIBs and GoP Ijara Sukuks (**Figure 4.11**).³⁵ Meanwhile, non-bank entities also switched from T-bills and NSS to PIBs and GoP Sukuks, as the market expected either a status quo or decrease in the interest rates.³⁶ Resultantly, there was net

retirement in T-bills and National Saving Schemes (NSS).

Although the stock of PIBs increased during H1-FY24, its share in total domestic debt remained lower than last year (**Figure**

Institution-wise Holding of Domestic Debt in H1 **Figure 4.11**

Source: State Bank of Pakistan

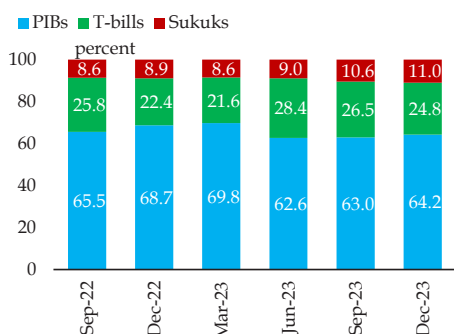
³⁴ See The State of Pakistan's Economy Annual Report FY22 and Annual Report FY23

³⁵ Although overall most of the amount in H1-FY24 was raised through T-bills, on net of maturity basis, major debt was raised through PIBs and GoP Ijara Sukuks (**Table 3.4**).

³⁶ In H1-FY23, non-banks had utilized their resources to invest in government securities, mainly T-bills, leading to rise in their share in domestic debt holding.

Outstanding Stock of Government Securities – Instrument-wise

Figure 4.12



Source: State Bank of Pakistan

4.12 & Table 4.8). This is attributed to fewer issuance of PIBs because of investors' increased interest in T-bills in the last quarter of FY23, which led to decreasing share of PIBs in the subsequent quarters.

Another reason for decrease in the share of PIBs was growing tilt of investors towards GoP Ijara Sukuks during H1-FY24, with

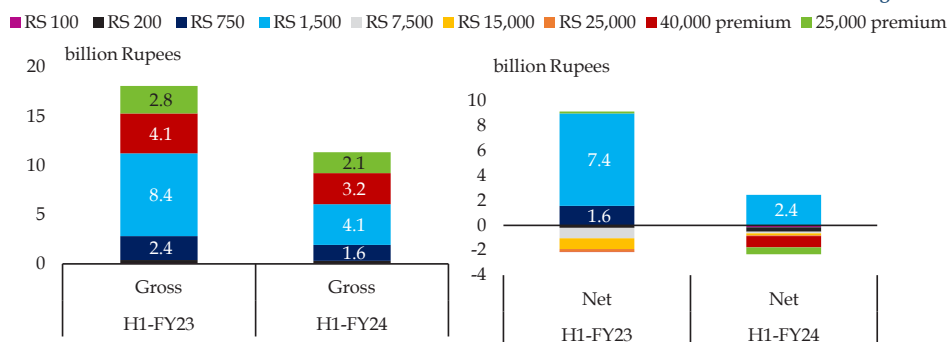
the accepted amounts concentrated in 5-year variable rental rate (VRR) and 3-year fixed rental rate (FRR) instruments.³⁷ This helped the government to maintain a mixed profile of Ijara Sukuks, which could lower cost of borrowing during times of monetary easing.³⁸

The cost of PIBs increased in the first half of FY24 compared to H1-FY23 due to higher coupon rates. Furthermore, the share of two-year and three-year PIBs declined from around 45.6 percent at end-December 2022 to 40.4 percent at end-December 2023.

The net inflows in prize bonds decelerated during H1-FY24 on the back of lower investments, as well as slight increase in outflows (Figure 4.13). As discussed earlier, this is due to shift in investment of non-bank from prize bonds and NSS to relatively high yielding government securities.

Gross and Net Inflows in Prize Bonds

Figure 4.13

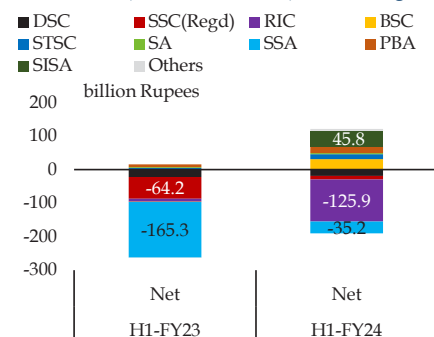


Source: Central Directorate of National Savings

³⁷ See Chapter 3 for details.

³⁸ As most of the outstanding debt in sukuks is concentrated in 5-Year VRR, decrease in policy rate will lead to reduced profit payments on Sukuks.

Flows in NSS (Net of Prize Bonds) Figure 4.14

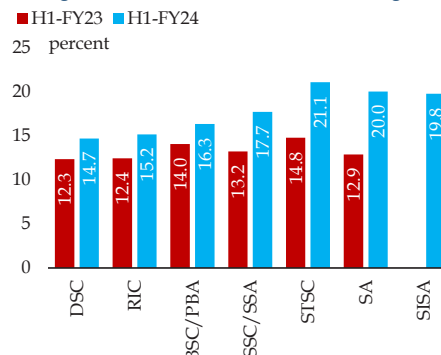


Source: Central Directorate of National Savings

Nonetheless, there were lower net outflows from NSS – net of prize bonds – in H1-FY24 due to the introduction of new instruments, along with an increase in profit rates on existing, as well as new instruments (Figure 4.14 and Figure 4.15).³⁹ There were net inflows in Behbood Saving Certificates (BSC), Short-term Saving Certificates (STSC), Saving Accounts (SA) and Pensioners' Benefit Account (PBA). However, there were net outflows from Defense Saving Certificates (DSC), Regular Income Certificates (RIC), Special Saving Accounts (SSA) and Special Saving Certificates (SSC) because these instruments offered lower interest rates compared to others. This led to overall net outflows from NSS.

To facilitate investors further, the government digitized all national saving schemes in Q1-FY24. Another initiative was raising debt through Capital Markets

Average Profit Rates on NSS Instruments Figure 4.15



Source: Central Directorate of National Savings

Institutions (including Pakistan Stock Exchange (PSX), Central Depository Company (CDC) and NCCPL, to diversify investors' base during the first half of FY24.⁴⁰ Under this initiative, the government carried out its first auction of fixed-rate 1-year Ijara Sukuk on PSX in December 2023 with a target of Rs 30 billion. The market showed keen interest by offering Rs 478 billion, with non-banks contributing about 90 percent.⁴¹ Going forward, the PSX platform can attract non-banks' investment in government securities. Nevertheless, raising debt through capital market can be more effective if primary dealers in government securities auctions are barred from bidding on PSX platform.

Interest/profit payments on domestic debt

Domestic interest/profit payments rose by 63.2 percent during H1-FY24.⁴² The

³⁹ The government introduced Shariah-complaint instruments: Sarwa Islamic Savings Accounts (SISA) and Sarwa Islamic Term Accounts (SITA) in Q4-FY23. During H1-FY24, most of the net inflows resulted from SISA.

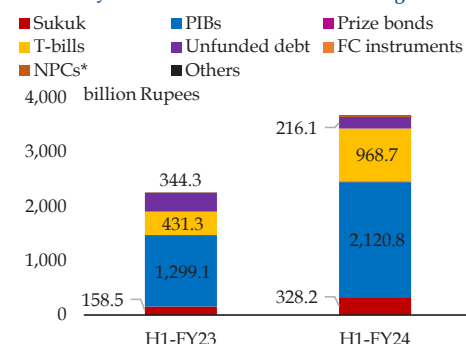
⁴⁰ This is based on public debt issuance guideline for Annual Borrowing Plan FY24.

⁴¹ Source: Annual borrowing Plan FY24, Debt Management Office, Finance Division, Government of Pakistan

⁴² The government paid around Rs 3.9 trillion in the first half of FY24 compared to Rs 2.3 trillion in H1-FY23.

Interest Payments on Domestic Debt

Figure 4.16a



*residents only

Source: State Bank of Pakistan

upsurge mainly emanated from PIBs, GoP Ijara Sukuks and 3-month T-bills, on the back of higher stock and increased interest rates (Figures 4.16a & 4.16b). However, interest payments on NSS decreased significantly due to lower stock amid continuous net outflows (Figure 4.16c).

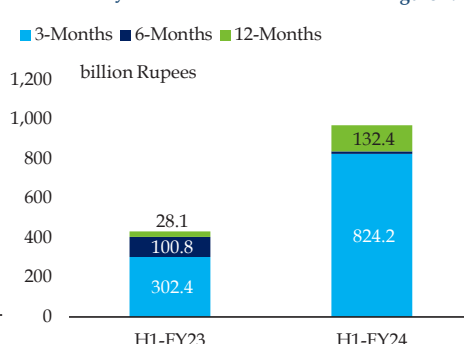
4.6 Public External Debt & Liabilities

The outstanding stock of public external debt increased by US\$ 3.7 billion during H1-FY24, compared to a decline in the same period last year (Table 4.9). Higher external financing, as well as depreciation of the US Dollar against other international currencies, contributed to addition in public external debt.

Most of the external loan was from bilateral and multilateral sources, following the IMF's SBA program. The major inflows originated from friendly countries, especially Saudi Arabia and the

Interest Payments on T-bills

Figure 4.16b

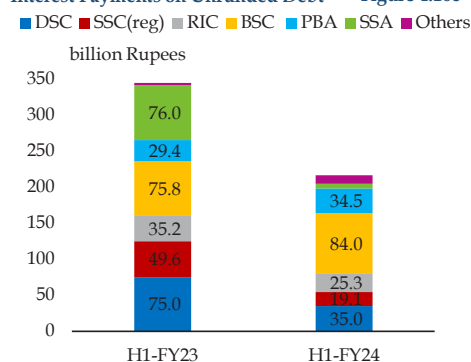


UAE, followed by multilateral sources and the IMF. The deposits of US\$ 1.0 billion from the UAE, however, became part of the foreign exchange liabilities.⁴³

After the Staff-Level Agreement (SLA) with the IMF on SBA in June 2023, the Fitch rating agency upgraded Pakistan's credit rating in July 2023.⁴⁴ This, along with

Interest Payments on Unfunded Debt

Figure 4.16c



Source: State Bank of Pakistan

⁴³ Foreign exchange liabilities are not part of public external debt.

⁴⁴ The SLA required Pakistan to make commitments with friendly countries for more financing to meet its large external financing needs. This agreement took place after Saudi Arabia and the UAE committed to deposit US\$ 3.0 billion.

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Government's External Debt in H1

Table 4.9

million US\$

	Stock		Flows		Share in Ext. Debt Stock (in percent)		Growth over June Stock (in percent)	
	Dec-22	Dec-23	FY23	FY24	Dec-22	Dec-23	FY23	FY24
Public External debt (1+2), of which	86,564.8	87,761.8	-2,273.1	3,711.6	100.0	100.0	-2.6	4.4
1. Government debt	78,948.9	80,165.4	-2,992.1	3,239.3	91.2	91.3	-3.7	4.2
i) Long term (>1 year), of which	78,261.3	80,066.1	-2,330.6	3,300.3	90.4	91.2	-2.9	4.3
Paris club	8,459.2	7,541.1	-772.5	-359.9	9.8	8.6	-8.4	-4.6
Multilateral	36,375.8	38,813.6	2,353.0	1,450.5	42.0	44.2	6.9	3.9
Other bilateral	18,034.8	19,644.1	-18.4	2,071.9	20.8	22.4	-0.1	11.8
Euro/Sukuk global bonds	7,800.0	7,800.0	-1,000.0	-	9.0	8.9	-11.4	-
Commercial loans/credits	6,894.1	5,611.3	-2,587.1	47.5	8.0	6.4	-27.3	0.9
Naya Pakistan Certificates (non-residents only)	657.7	628.3	-295.4	93.9	0.8	0.7	-31.0	17.6
ii) Short term (<1 year)	687.6	99.3	-661.5	-61.0	0.8	0.1	-49.0	-38.1
2. From IMF	7,615.9	7,596.3	719.0	472.4	8.8	8.7	10.4	6.6
i) Federal government	5,386.9	5,069.3	1,191.7	-299.8	6.2	5.8	28.4	-5.6
ii) Central bank	2,229.0	2,527.0	-472.7	772.2	2.6	2.9	-17.5	44.0
Foreign exchange liabilities, of which	10,979.3	11,938.6	-155.0	1,107.5	12.7	13.6	-1.4	10.2
Central bank deposits	2,700.0	3,700.0	-	1,000.0	3.1	4.2	-	37.0

Source: State Bank of Pakistan

disbursement of US\$ 1.2 billion by the IMF in July 2023, paved the way for inflows from other multilateral sources.

The improvement in external inflows, accompanied by decline in CAD, during the first quarter of FY24 led to decrease in Pakistan's risk premium during the first half of FY24. Consequently, the net inflows in loans/credit from commercial banks and NPCs (held by non-residents) increased in the first half. Rise in profit rates on NPCs in October 2023 also increased inflows in this category.

As per Economic Affairs Division (EAD) data, which only documents central

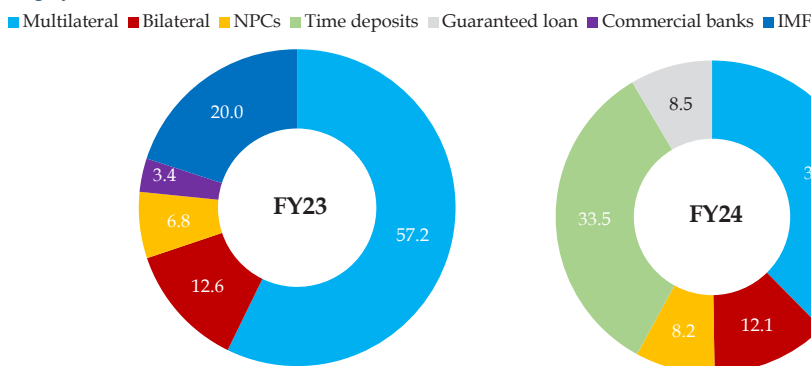
government debt, more than one-third of the inflows were from multilateral institutions, primarily World Bank (WB), Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB) and Islamic Development Bank (IDB). Another one-third were time deposits. The remaining inflows included loans from friendly countries, particularly Saudi Arabia; guaranteed loan from China National Aero-Technology Import and Export Corporation (CATIC); and NPCs held by non-residents only (**Figure 4.17 & Figure 4.18**).⁴⁵

Unlike previous years, where more than half of the external financing was meant

⁴⁵ According to EAD's data, the GoP received gross external disbursements of around US\$ 6.0 billion in the first half of FY24 compared to around US\$ 5.8 billion during H1-FY23. The US\$ 1.2 billion loan that is disbursed by the IMF and the US\$ 1.0 billion deposits of the UAE government in the central bank were not reflected in EAD's data because these are reflected central bank balance sheet. The IMF's loan was for balance of payment purposes, whereas the deposits of the UAE government was given directly to the central bank.

Category-wise Share of Gross External Disbursements in H1

Figure 4.17



Source: Economic Affairs Division, Ministry of Finance

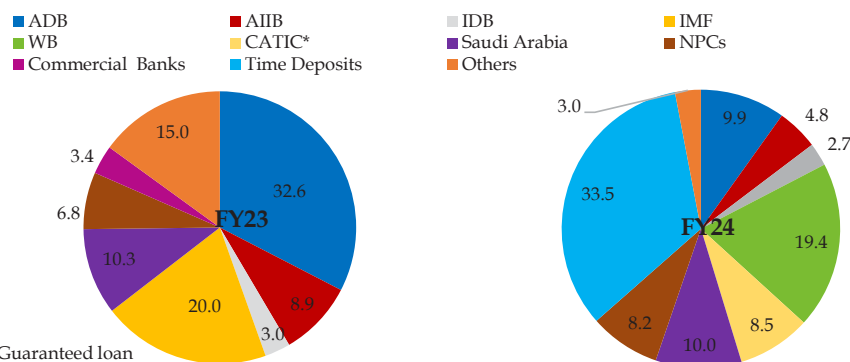
for program/budgetary support, this share decreased to below fifty percent in H1-FY24. Meanwhile, the share of project financing/aid nearly tripled to 44.3 percent during H1-FY24. Multinational institutions such as ADB and AIIB dominated funds for project financing, while the World Bank inched up its contribution to project aid (Table 4.10).

External Debt Servicing⁴⁶

The external debt servicing declined during H1-FY24 on the back of lower scheduled principal repayments (Table 4.11). However, there was a rise in interest payments largely due to higher London Inter-Bank Offered Rate (LIBOR)/Secured Overnight Financing Rate (SOFR) in the first half of FY24.⁴⁷ With around 37 percent

Breakup of Gross External Disbursements during H1

Figure 4.18



* Guaranteed loan

Source: Economic Affairs Division, Ministry of Finance

⁴⁶ External debt servicing includes both principal and interest payments.

⁴⁷ The average USD SOFR rose to 5.3 percent in H1-FY24 from around 3.0 percent during H1-FY23. Source: <https://www.global-rates.com/en/interest-rates/sofr/historical/2023/>

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Gross External Disbursement and Utilization during H1

Table 4.10

million US\$

	Project		Program/Budgetary Support		Others		Total	
	FY23	FY24	FY23	FY24	FY23	FY24	FY23	FY24
ADB	273.2	584.0	1,629.3	5.4	-	-	1,902.5	589.4
AIIB	21.4	287.0	500.0	-	-	-	521.4	287.0
IDB	16.3	60.0	-	-	161.0*	100.0*	177.3	160.0
IMF	-	-	1,166.2	-	-	-	1,166.2	-
WB	423.3	1,034.1	267.5	123.9	-	-	690.8	1,157.9
CATIC**	-	508.3	-	-	-	-	-	508.3
IFAD	14.0	17.7	21.5	5.4	-	-	35.5	23.1
China	54.9	42.2	-	-	-	-	54.9	42.2
Saudi Arabia	0.2	0.2	-	-	600.0***	595.2***	600.2	595.4
USA	14.0^	20.1^	-	5.0	-	-	14.0	25.1
Korea	18.5	12.4	-	-	-	-	18.5	12.4
NPCs	-	-	394.8	491.5	-	-	394.8	491.5
Commercial Banks	-	-	200.0	-	-	-	200.0	-
Time Deposits	-	-	-	2,000.0	-	-	-	2,000.0
Others	76.1	95.9	-	-	-	-	62.2	75.9
Total	898.1	2,641.8	4,179.3	2,631.2	761.0	695.2	5,838.4	5,968.2

Note: The total may vary due to round-off impact *Short-term credit **Guaranteed loan (China) ***Oil facility

Source: Economic Affairs Division, Ministry of Finance

of the external loans contracted on floating rate, the uptick in SOFR resulted in increased interest payments.⁴⁸

Nonetheless, the mark-ups paid on international commercial loans, short-term

multilateral debt and NPCs (held by non-residents only) declined during H1-FY24 due to reduction in stock of debt under these heads in FY23. Meanwhile, mark-up on Foreign Exchange Liabilities rose during the first half of FY24.

Public External Debt Servicing in H1

Table 4.11

million US\$

	Total		Principal		Interest	
	FY23	FY24	FY23	FY24	FY23	FY24
1. Public external debt (a + b + c)	8,908.8	5,537.4	7,512.2	3,701.4	1,396.6	1,836.1
a. Long-term govt. debt, of which	7,460.4	4,269.2	6,231.5	2,756.0	1,228.9	1,513.2
Paris Club	621.4	685.5	520.9	603.2	100.5	82.3
Multilateral	1,112.0	1,443.9	823.5	896.1	288.6	547.8
Other Bilateral	802.1	1,254.4	554.6	857.8	247.5	396.5
Euro/Sukuk global bonds	1,319.4	291.3	1,000.0	-	319.4	291.3
Commercial loans / credits	2,960.3	173.7	2,722.4	-	237.9	173.7
NPCs	645.1	420.5	610.1	398.9	35.0	21.6
b. To the IMF	623.2	1,088.3	480.1	784.3	143.2	304.0
c. Short-term govt. debt	825.2	179.9	800.7	161.0	24.5	18.9
2. Foreign exchange liabilities	111.3	152.6	-	-	111.3	152.6

Source: State Bank of Pakistan

⁴⁸ This is based on end-June 2023 data. Source: Annual Debt Review & Public Debt Bulletin (FY2022-23), Ministry of Finance.



5

Balance of Payments

Balance of payments improved in the first half of FY24, mainly reflecting the impact of subdued domestic demand, ease in global commodity prices, and successful negotiation of a nine-month SBA with the IMF. The current account deficit contracted during H1-FY24 compared to the same period last year, with higher exports and continued decline in imports offsetting the drop in remittances. However, interest payments on external debt and repatriation of profits and dividends increased sharply. Supported by the IMF's SBA and loans from other creditors, the financial account saw a net inflow during H1-FY24. As a result, gross foreign exchange reserves increased to \$8.2 billion in December 2023 from \$4.4 billion in June 2023, while PKR appreciated as compared to end-June 2023.



5.1 Global Developments

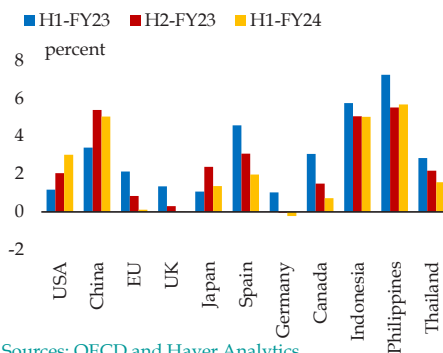
Global growth is estimated at 3.1 percent for 2023, lower than 3.5 percent in 2022, as well as the average of 3.8 percent during 2000 to 2019.¹ Tighter financial conditions, withdrawal of fiscal support and slower productivity growth mainly explain this slowdown in global growth. Moreover, multiple shocks stemming from geo-political conflicts and climate change also affected global economic activity.

Besides losing some steam, the global growth in 2023 was also uneven across regions. United States and several major EMDEs, including China, continued steady recovery with stronger than expected growth during Jul-Dec 2023. However, protracted effects of high energy prices due to geo-political tensions, and weaker consumer and business sentiments posed challenges for the euro area (**Figure 5.1**). Low-income developing countries also witnessed large output losses amid higher borrowing costs.

This, combined with the ongoing trade tensions and geo-economic fragmentation, weighed heavily on global trade. The growth in global trade volume decelerated considerably to 0.4 percent in 2023 from 5.2 percent in 2022.² Global trade tensions are also reflected in Global Trade Alert data, which shows that different countries imposed more than 3,000 new restrictions on trade in 2022 and 2023, in comparison to about 1,100 in 2019.

Average Real GDP Growth in Major Economies

Figure 5.1

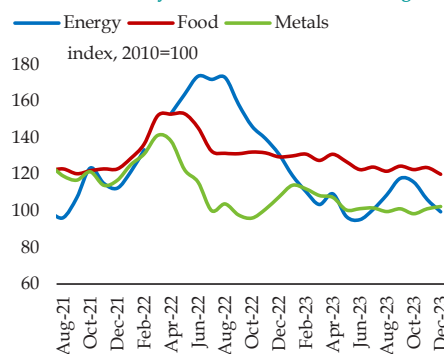


Sources: OECD and Haver Analytics

In line with the slower growth in economic activity and the trade volumes, international commodity prices mostly maintained a downtrend during 2023 (**Figure 5.2**). Resultantly, global inflation receded, falling relatively sharply in EMDEs. This provided central banks in EMDEs some room to transition to ease monetary policy stance.³ The central banks in advanced economies, on the other hand, are still grappling with the above target inflation.

Global Commodity Prices

Figure 5.2



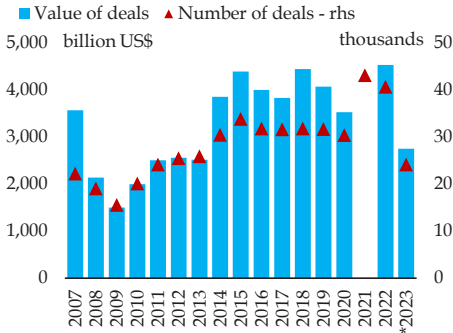
Source: World Bank

¹ IMF (2024), World Economic Outlook Update, January 2024, International Monetary Fund, Washington: IMF

² Ibid

³ See discussion on inflation and global monetary policy responses in Chapter 3.

Cross-Border Mergers & Acquisitions Figure 5.3



*estimated by PitchBook
Source: PitchBook

Still elevated interest rates, banking crisis in early 2023, and ongoing geo-political conflicts have led to a challenging macroeconomic environment for global FDI flows, particularly to emerging markets. Global mergers and acquisitions declined for the second consecutive year in 2023, falling to the lowest level in last ten years (Figure 5.3). However, investment in emerging markets' bonds and equities remained on an upward trajectory in the wake of declining US dollar index and higher interest rates (Figure 5.4).⁴

These global developments, particularly the tighter financial conditions and moderation in global trade, had implications for Pakistan's external account. The uneven global recovery impacted Pakistan's exports, especially textiles, with fluctuations in its demand across different markets. Additionally, volatility in global financial markets amid heightened domestic uncertainty influenced capital flows to the county. Pakistan navigated these headwinds by

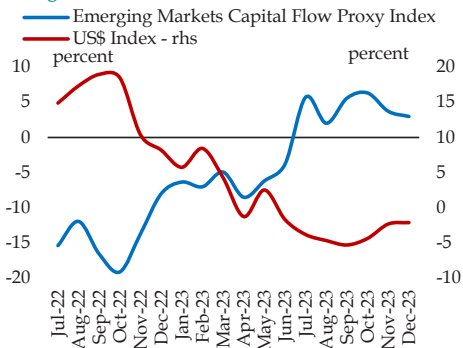
pursuing policies to contain domestic demand and ensure external account stability.

5.2 Pakistan's Balance of Payments

Pakistan's external account improved in the first half of FY24, as current account deficit (CAD) remained well contained and financial inflows increased after successful negotiation of Stand-By-Arrangement (SBA) with the IMF in June 2023. As a result, gross SBP reserves rose to US\$ 8.2 billion at end-December 2023, up from US\$ 4.4 billion in June 2023. This had positive spillovers on sentiments in foreign exchange market, which was reflected in QoQ exchange rate appreciation in the second quarter of FY24 (Table 5.1).

A considerable narrowing of CAD was mainly on account of improved trade balance, as imports declined while exports grew over the last year. Workers' remittances, notwithstanding a decline

Capital Flows and US\$ Index - YoY Change Figure 5.4



Source: Bloomberg

⁴ GFSR, IMF, October 2023

Balance of Payments

Pakistan's Balance of Payments

Table 5.1

million US\$

	H1-FY23	H2-FY23	FY24			Change in H1-FY24	
			Q1	Q2	H1	Absolute	Percent
Current account balance	-3,847	572	-1,029	107	-922	2,925	-76.0
Balance on trade in goods	-15,551	-9,268	-5,327	-4,825	-10,152	5,399	-34.7
Exports of goods	14,222	13,654	7,002	8,274	15,276	1,054	7.4
Imports of goods	29,773	22,922	12,329	13,099	25,428	-4,345	-14.6
energy imports	10,827	8,055	3,463	3,891	7,354	-3,473	-32.1
non-energy imports	18,946	14,867	8,866	9,208	18,074	-872	-4.6
Services account balance	-254	-788	-799	-357	-1,156	-902	355.1
Primary income balance	-2,672	-3,093	-1,593	-2,306	-3,899	-1,227	45.9
Interest Payments	2,079	2,533	1,188	1,711	2,899	820	39.4
Secondary income balance	14,630	13,721	6,690	7,595	14,285	-345	-2.4
Workers' remittances	14,418	12,915	6,332	7,104	13,436	-982	-6.8
Financial account (net)*	566	-98	-3,586	-937	-4,523	-5,089	-
Direct investment (net)*	282	-952	-383	-451	-834	-1,116	-
Portfolio investment (net)*	1,033	-21	-9	-62	-71	-1,104	-
Build-up in FX assets abroad	-1,375	411	-309	94	-215	1,160	-
FX Loans & liabilities	-632	-467	2,885	518	3,403	4,035	-
Banks	-145	1,386	-78	229	151	296	-
General Government	-279	-1,806	1,565	573	2,138	2,417	-
Disbursements	5,357	4,534	782	2,114	2,896	-2,461	-
Amortization	5,421	6,239	1,245	1,606	2,851	-2,570	-
Other liabilities (net)	-215	-101	2,028	65	2,093	2,308	-
Other Sector	-211	-44	399	-284	115	326	-
Disbursements	220	178	596	48	644	424	-
Amortization	792	871	260	528	788	-4	-
Other liabilities (net)	361	649	63	196	259	-102	-
Net Errors and Omissions	-188	-662	-358	-325	-683	-495	-
Overall Balance	4,284	-66	-2,239	-767	-3,006	-7,290	-
SBP's Liquid FX Reserves (end-period)	5,586	4,445	7,616	8,233	8,233		
PKR dep (-) / app (+) - YoY in percent	-24.1	-31.8	-20.1	-21.3	-22.2		
Average Exchange Rate (PKR/US\$)	223.7	273.1	291.6	283.2	287.3		
End Period Exchange Rate (PKR/US\$)	226.4	286	287.7	281.9	281.9		

*as per BPM6, negative sign means net FX inflow into Pakistan and vice versa.

Source: State Bank of Pakistan

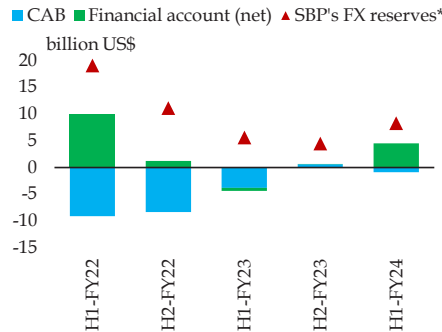
compared to H1-FY23, fully financed the trade deficit in goods and services and more than half of the primary income deficit (**Figure 5.5**). However, the primary income deficit has considerably widened on account of higher interest payments on external debt and repatriation of accumulated profits / dividends. This implies that Pakistan either needs to run

non-primary income current account surplus or arrange additional external financing for interest payments, besides meeting the debt obligations.

During the first half of FY24, the country managed to arrange sufficient financial inflows to meet external debt obligations. Financial account recorded a net inflow of

Pakistan's Balance of Payments

Figure 5.5



*end period

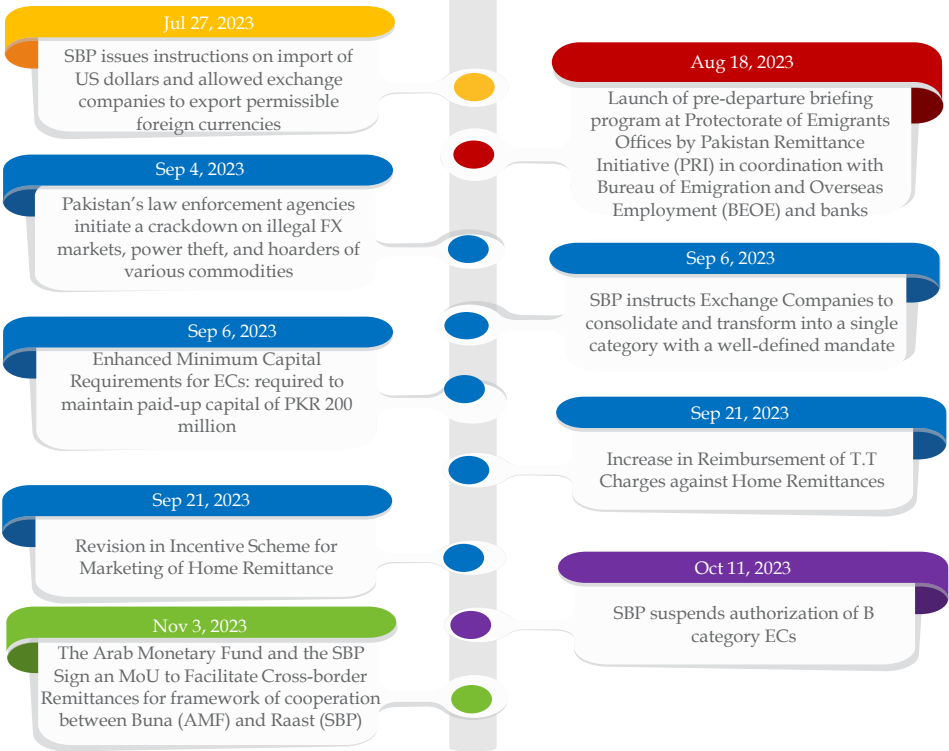
Source: State Bank of Pakistan

US\$ 4.5 billion during H1-FY24 against net outflow of US\$ 0.6 billion last year. These largely consisted of official inflows, disbursements under the IMF's SBA, as well as bilateral and multilateral flows.

Increase in FX reserves combined with the administrative measures and reforms in exchange companies, reduced pressures in foreign exchange market, with Kerb-market premium plummeting in the second quarter of FY24 (Figure 5.6). This brought confidence in the foreign exchange market, leading to a sustained

Measures Related to FX Markets During H1-FY24

Figure 5.6



Source: State Bank of Pakistan and Special Investment Facilitation Council

strengthening of the PKR since September 2023.

These developments highlight the importance of maintaining a sustainable external account through enhancing foreign exchange earnings and attracting non-debt creating inflows to reduce the country's dependence on external borrowings. More specifically, it is imperative to focus on developing productive capacity for exports, which have almost stagnated around 8 percent of the GDP during last 10 years (Figure 5.7).

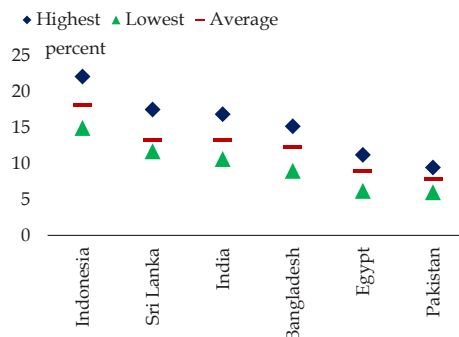
Similarly, the FDI inflows, mainly concentrated in non-exporting sectors, are burdening current account via higher profit/dividend repatriation. This underpins the need to encourage FDI into export-oriented sectors, which would not only bring much-needed foreign exchange to further strengthen debt servicing capacity, but will also aid in improving the country's production capability through associated technology transfer.

5.3 Current Account

CAD narrowed to US\$ 0.9 billion during H1-FY24, around 76 percent lower compared to US\$ 3.8 billion in the corresponding period of last year. A sizeable reduction in the trade deficit during H1-FY24, which outweighed the increase in interest payments and profit/dividend repatriation, mainly explains this improvement. Both import contraction and recovery in exports have

Exports as Percent of GDP*

Figure 5.7



*last 10 years

Source: Haver Analytics

contributed to narrowing of the trade deficit. Decline in imports by 14.6 percent, despite removal of import prioritization measures, reflects tepid domestic demand and lower international commodity prices. On the other hand, exports grew by 7.4 percent during H1-FY24, supported by increased production and higher export prices of agro-food items.

Furthermore, workers' remittances, albeit declining for the past two years, exceeded the deficit in trade in goods and services by US\$ 2.1 billion in H1-FY24, as opposed to same period last year, when remittances fell short by US\$ 1.4 billion to finance the deficit (Figure 5.8).⁵

Services Account

Services trade deficit increased to US\$ 1.2 billion in H1-FY24 compared to US\$ 0.3 billion in the same period last year. The increase was on account of both increase services import and a slight decrease in

⁵ It may be noted that during FY23, workers' remittances exceeded the trade deficit in goods and services, first time in last 20 years.

State Bank of Pakistan Half Year Report 2023-2024

Services Trade Account

Table 5.2

million US\$

	Import (M)		Export (X)		Balance (X-M)	
	FY24	YoY Change	FY24	YoY Change	FY24	YoY Change
a) Transport	2,298.9	145.9	479.0	44.2	-1,819.9	-101.7
Sea freight	1,428.1	-22.8	36.6	-32.8	-1,391.5	-10.0
Air passengers	633.3	174.3	195.1	-22.0	-438.2	-196.2
Air freight	28.8	-1.8	16.6	-0.3	-12.2	1.5
b) Travel	1,021.9	328.9	365.2	-112.7	-656.7	-441.6
Education exp.	293.1	130.4	11.5	6.4	-281.7	-124.0
Other (personal)	721.5	201.8	341.5	-126.3	-380.0	-328.1
c) ICT Services	204.1	37.1	1,455.1	120.2	1,251.0	83.1
Software consultancy services	85.6	3.1	405.1	14.2	319.5	11.1
Other Computer services	11.0	-10.4	454.7	88.8	443.7	99.2
Export/Import of Computer software	61.9	22.8	310.8	8.4	248.9	-14.4
Call centers	0.0	0.0	120.0	12.4	120.0	12.4
Telecommunications services	42.7	-19.5	158.7	-160.8	116.0	-141.3
Subtotal (a+b+c)	3,524.9	511.9	2,299.2	51.7	-1,225.6	-460.2
Total services	4,942.3	818.5	3,786.3	-83.8	-1,156.0	-902.3

Source: State Bank of Pakistan

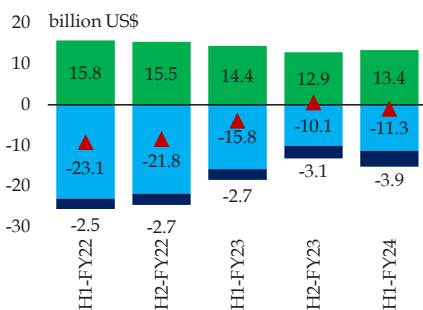
services export (Table 5.2). The increase in services imports was mainly driven by payments related to transport and travel. The surge in transport payments is attributed to increase in fares for air passengers. Whereas, increase in payments for traveling may be traced to rise in

international education fees. Hike in sea freight despite decline in merchandise imports during H1-FY24 reflects increase in shipping rates in the wake of Red Sea attacks and associated higher insurance premiums and cost of re-routing (Figure 5.9).^{6,7}

Current Account Balance (CAB)

Figure 5.8

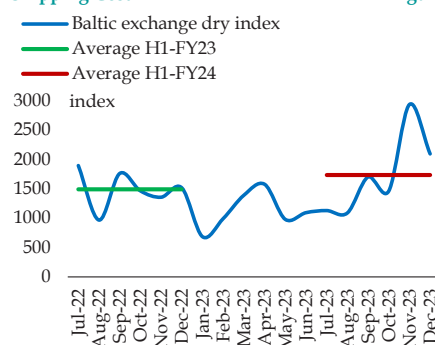
■ Primary income balance ■ Workers' remittances
■ G&S account balance ▲ CAB



Source: State Bank of Pakistan

Shipping Cost

Figure 5.9



Source: Bloomberg

⁶ As reflected by the Baltic Dry Index (BDI). BDI is a composite index of four sub-indices and measures average price paid for the transport of dry bulk materials across more than 20 routes.

⁷ Since October 2023, Houthi rebels have been targeting ships in the Red Sea.

The decline in exports of services was led by contraction in export of travel services, which overshadowed substantial pick-up in ICT exports on the back of higher exports of software consultancy, call center, computer software and other computer services. In addition to a relatively stable exchange rate, recent initiatives by the SBP also played a pivotal role in augmenting exports of ICT services.⁸

Notably, SECP data also shows an increase in registration of new IT-related companies to 2003 in H1-FY24 compared to 1951 during the same period last year. Number of IT companies registered during H1-FY23 remained on top, as compared to H1-FY22 when the real estate development and construction sector had taken the lead in new registrations.⁹

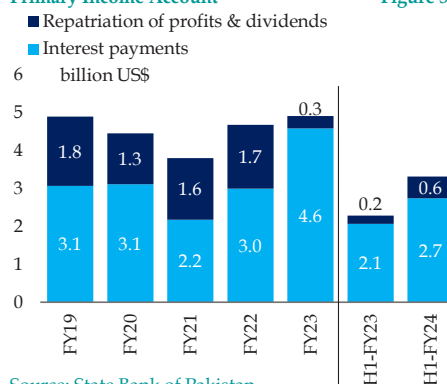
Primary Income Account

The primary income deficit rose to US\$ 3.9 billion in H1-FY24 from US\$ 2.7 billion in H1-FY23. This is mainly attributed to higher interest payments on external loans and repatriation of profits/dividends on

foreign investment (**Figure 5.10**). Surge in interest payments primarily shows the impact of rising global interest rates, as also reflected in higher Secured Overnight Financing Rate (SOFR) during the period.¹⁰

On the other hand, repatriation of profits/dividends on foreign investment substantially increased due to transfers of accumulated corporate earnings of leading MNCs following ease in FX flows. During the period, the petroleum refining sector reported the largest outflows under profits/dividends, followed by food, transport and financial businesses.

Primary Income Account Figure 5.10



Source: State Bank of Pakistan

⁸ (i) In order to facilitate the IT exporters to boost the exports of IT and IT enabled services, SBP has increased the permissible retention limit of IT exporters from 35 percent to 50 percent of their export proceeds in the Exporters' Specialized Foreign Currency Accounts (ESFCAs). Further, the usage of the balances available in the ESFCAs has been simplified by allowing the IT exporters to make their payments from these accounts without any approval from SBP or banks (EPD Circular Letter No. 17 of 2023).

(ii) To further facilitate the freelancers, the SBP has developed a comprehensive framework for opening and operations of their bank accounts. Under the framework, freelancers will be able to open an ESFCA as defined in the Foreign Exchange Manual for retention of export proceeds concurrently with corresponding primary PKR account, in-person or remotely through digital means. All Freelancer Digital Accounts (FDA) opened so far, shall be considered to have been opened under this framework (BPRD Circular No. 05 of 2023).

⁹ Number of new IT companies registered with SECP increased to 2,003 in H1-FY24 from 1,951 during the same period last year. Whereas, new companies registered under real estate development and construction decreased to 1,640 in H1-FY24 from 2,476 last year.

¹⁰ SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities in the repurchase agreement (repo) market. Average SOFR (combined for 30, 90 and 180 days) increased from 2.95 during H1-FY23 to 5.28 in H2-FY24 (Source: www.newyorkfed.org).

Country-wise Workers' Remittances

Table 5.3

million US\$

	FY20	FY21	FY22	FY23	H1-FY23	H1-FY24	Change in H1-FY24 over H1-FY23	
							Absolute	Percent
US	1,743	2,600	3,087	3,168	1,616	1,577	-40	-2.5
UK	2,569	4,091	4,493	4,073	2,000	1,988	-12	-0.6
EU Countries	1,778	2,729	3,361	3,134	1,562	1,695	133	8.5
Italy	361	607	856	840	412	477	65	15.7
Spain	330	402	513	490	246	295	48	19.7
Germany	392	432	509	553	265	274	9	3.4
France	240	423	488	444	217	240	23	10.6
Greece	145	274	365	336	172	195	23	13.4
Australia	340	598	753	593	313	290	-23	-7.3
Canada	313	595	708	552	291	223	-68	-23.3
GCC	15,135	17,223	17,226	14,387	7,824	7,072	-752	-9.6
Saudi Arabia	6,613	7,726	7,754	6,533	3,571	3,254	-317	-8.9
UAE	5,612	6,165	5,846	4,656	2,612	2,328	-284	-10.9
Other GCC	2,910	3,332	3,625	3,198	1,641	1,489	-152	-9.3
Other countries	2,399	3,489	4,015	3,563	1,892	1,771	-121	-6.4
Total remittances	23,132	29,450	31,279	27,333	14,418	13,435	-983	-6.8

Source: State Bank of Pakistan

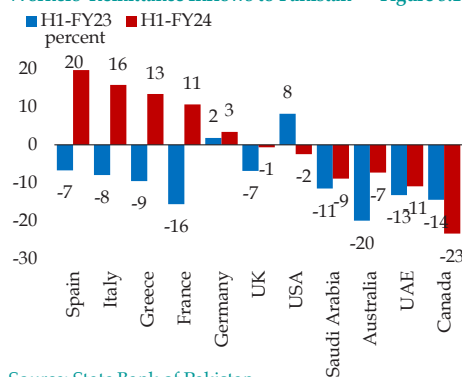
Workers' Remittances

Workers' remittances during H1-FY24 were recorded at US\$ 13.4 billion, down by 6.8 percent as compared to H1-FY23 (Table 5.3). Importantly, inflows from all major corridors (the US, UK and GCC) declined except for EU. Remittances from the EU region grew by 8.5 percent (as compared to a 10.7 percent decline last year) mainly due to reversal of trend in receipts from Italy, Spain, France and Greece (Figure 5.11).

The growth in remittances from the EU may be attributed to lingering impact of high employment growth till Q2-2023 and dampening inflation in major EU countries.^{11, 12} In the case of GCC, outward remittances to other destination countries have also declined in recent months,

despite strong employment of foreign workers in Saudi giga-projects. According to the World Bank, this may be attributed to Saudi Arabia's recent policy that allowed foreign workers to bring families –

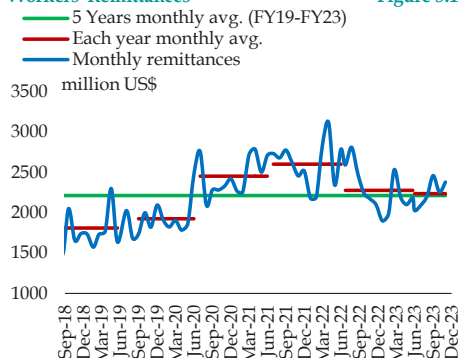
Workers' Remittance Inflows to Pakistan Figure 5.11



Source: State Bank of Pakistan

¹¹ Source: www.statista.com/statistics/1194672/employment-rate-in-europe/

¹² HICP (Harmonized Index of Consumer Prices) inflation rate of the EU declined year-on-year from 6.4 percent in June 2023 to 3.4 percent in December 2023.

Workers' Remittances**Figure 5.12**

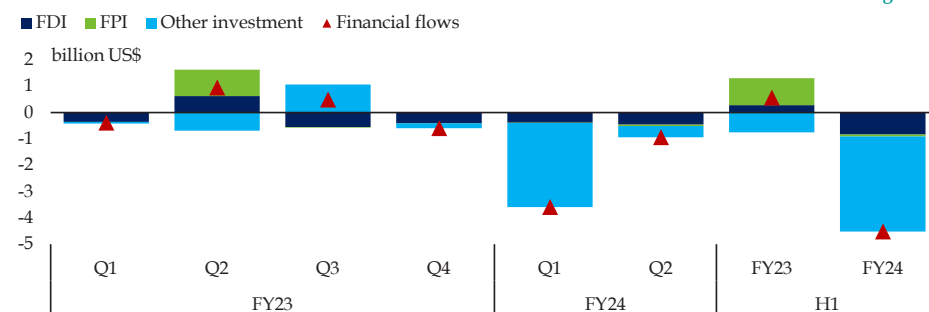
Source: State Bank of Pakistan

possibly resulting in fewer remittances back home, and a decline in GDP growth in GCC countries on the back of drop in oil prices and production cuts by the OPEC+. ^{13,14,15} In addition, high inflation in the Gulf region may also have affected workers' ability to save and remit back home.

Monthly remittances, still lower than the historical peak of April 2022, exceeded the averages during FY23, as well as last five years (FY19-23) during Q2-FY24 (**Figure 5.12**). In order to enhance the inflow of remittances through formal channels, the SBP and the Government implemented several measures during H1-FY24 (see **Figure 5.6 in Section 5.2**).

5.4 Financial Account

Net financial inflows amounted to US\$ 4.5 billion during H1-FY24, against outflows of US\$ 0.6 billion during the same period last year (**Figure 5.13**). A larger part of these inflows was in the form of official loans and deposits. The successful negotiation of the IMF's SBA also paved the way for inflows from other multilateral and bilateral sources. There was also an uptick in foreign private investment into Pakistan. Moreover, amortization of

Financial Account***Figure 5.13**

*as per BPM6, negative sign means net FX inflow into Pakistan and vice versa.

Source: State Bank of Pakistan

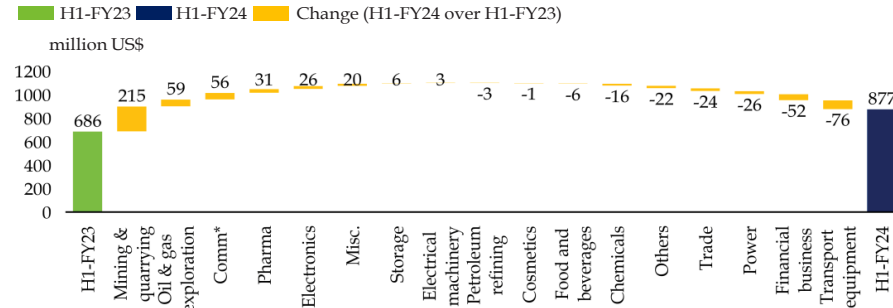
¹³ Migration and Development Brief 39, December 2023, World Bank

¹⁴ After surpassing 7 percent GDP growth in 2022, GCC's regional GDP is estimated to grow by only 1.0 percent in 2023. (Source: Gulf Economic Update, November 2023, World Bank)

¹⁵ Several OPEC+ countries announced additional voluntary cuts to the total of 2.2 million barrels per day. Available at: www.opec.org/opec_web/en/press_room/7267.htm

Sector-wise Net FDI - YoY Change

Figure 5.14



*communications, including IT and telecom
Source: State Bank of Pakistan

external debt was significantly lower in H1-FY24 compared to the last year.

Foreign Direct Investment

Net FDI inflows into Pakistan rose to US\$ 877 million in H1-FY24 compared to US\$ 686 million in the corresponding period of last year. Sectoral breakup shows that mining and quarrying, oil and gas exploration, communications, hydel power, pharmaceuticals, electronics, and storage facilities were the major recipients. Conversely, there were gross FDI outflows from transport equipment, financial business, chemicals and textiles in H1-FY24 (Figure 5.14).

The mining and quarrying sector witnessed the largest net FDI inflows in H1-FY24, mainly due to foreign investment in the Saindak Copper and Gold Mine

project, mainly sourced from China. Also, gross FDI inflows in oil and gas exploration were routed from Hong Kong. The power projects that attracted FDI inflows include Suki Kinari Hydropower Project under CPEC, and solar power projects from the Netherlands.^{16,17}

The gross FDI inflows in pharmaceutical sector were the result of efforts to streamline pharma industry to meet the domestic demand.¹⁸ Efforts included strengthening of the country's health infrastructure, applying technology to the transformation, and digitizing the overall healthcare system.¹⁹

The electronics sector saw increased gross FDI inflows from Singapore due to start of mobile assembling-cum-manufacturing in Pakistan under Mobile Device Manufacturing (MDM) regulations issued

¹⁶ www.cpec.gov.pk/project-details/15

¹⁷ www.ppib.gov.pk/upcomming-ipps/

¹⁸ www.icci.com.pk/event/federal-health-minister-assures-to-address-key-issues-of-pharma-industry.html

¹⁹ Steps have been taken to equip primary healthcare institutes with updated surgical and medical equipment, particularly in rural areas. Also, Pakistan has issued a National Digital Health Framework, promoting technological advances in the health system. Source: www.phkh.nhsrsrc.pk

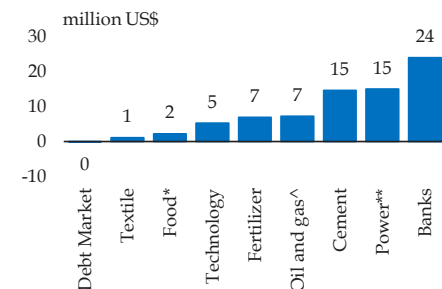
by Pakistan Telecommunication Authority (PTA).²⁰

Foreign Portfolio Investment

Net FPI inflows in Pakistan amounted to US\$ 71 million during H1-FY24, compared to the net outflow of US\$ 1,033 million last year. Sector-wise data shows that most of these inflows were in the banking sector, which is performing better in terms of profits and dividends (Figure 5.15).²¹ Power, cement, and oil and gas were other major sectors gaining attention of foreign investors.

Within the FPI, Roshan Digital Account (RDA) also recorded net inflows of US\$ 93 million compared to net outflows of US\$ 215 million last year. Most of these inflows were concentrated in Islamic Naya Pakistan Certificates, and an uptick in conventional NPCs (Figure 5.16). The

Sector-wise Net FPI in H1-FY24 Figure 5.15



*Food and personal care products **Power generation and distribution ^Oil and gas exploration and marketing

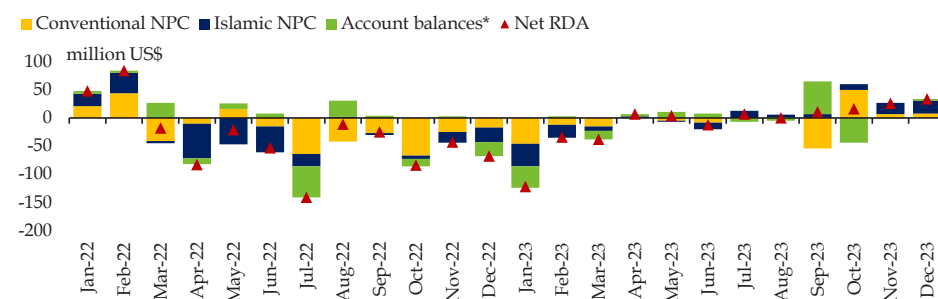
Source: NCCPL

increase was partly due to PKR stability and continued efforts to encourage inflows into NPCs.²²

FX Loans and Liabilities

Net FX loans amounted to US\$ 3.4 billion during H1-FY24, compared to net outflow

Change in Net RDA Flows Figure 5.16



*including Roshan equity investments and other liabilities (outstanding position in government securities like T-bills, Sukuk, real estate, mutual funds, etc. but exclude NPCs.)

Source: State Bank of Pakistan

²⁰ Incentives include authorization of mobile device production for 10 years, with the possibility of renewal for another 10 years. Source: PTA

²¹ This largely owed to rising banking sector profits in the wake of elevated government borrowing in a high interest rate environment.

²² Finance Division increased the rates of return on conventional NPCs, vide Gazette Notification No. S.R.O. 1191(I)/2023, dated August 31, 2023

of US\$ 0.6 billion in the same period last year. The inflows were mainly spurred by disbursements under the IMF's SBA, followed by bilateral and multilateral loans and deposits (**Figure 5.17**).^{23,24}

Under the nine-month US\$ 3.0 billion SBA approved by the IMF in June 2023 of US\$ 1.2 billion was immediately disbursed in July 2023. Saudi Arabia lent US\$ 2.0 billion to the government, and the UAE deposited US\$ 1.0 billion with the SBP. Saudi Arabia also provided an oil facility of US\$ 595.2 million during H1-FY24, and China

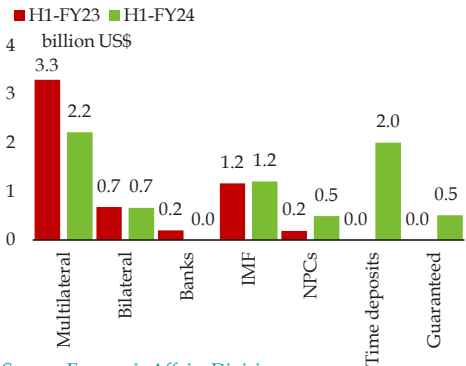
disbursed a loan of US\$ 500 million in July 2023.

Among other multilateral inflows, World Bank disbursed US\$ 1.1 billion during H1-FY24 under the second Resilient Institutions for Sustainable Economy (RISE-II) Operation, a project with the goal of strengthening fiscal management and encouraging competitiveness for both inclusive and sustained economic growth.²⁵ Out of this, the AIIB contributed US\$ 249.4 million to the project. Some of the inflows were repurposed for the Sindh Flood Emergency Rehabilitation Project and the Sindh Flood Reconstruction Emergency Housing project.^{26,27}

In addition, the ADB disbursed US\$ 300 million under the umbrella of 'Improved Resource Mobilization and Utilization Reform Program' with the aim to help Pakistan mobilize sufficient local resources, while also creating supplementary fiscal space via better expense management.²⁸ An additional sum of US\$ 100 million was lent for the 'Women Inclusive Finance Sector Development Program'.²⁹

Breakdown of FX Loan Inflows

Figure 5.17



Source: Economic Affairs Division

²³ "IMF Executive Board Approves US\$3 billion Stand-By Arrangement for Pakistan", IMF Press Release No. 23/261, Jul 2023.

²⁴ Bilateral sources mainly include Saudi Arabia and UAE; whereas multilateral sources include ADB and the World Bank.

²⁵ "Pakistan: World Bank Approves \$350 Million in Financing to Support Fiscal and Competitiveness Reforms", World Bank, Press Release, December 2023

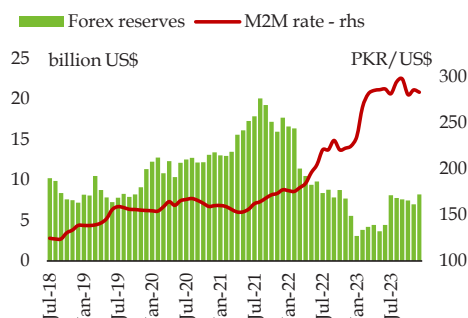
²⁶ Project ID P179981 to rehabilitate damaged infrastructure, contribute to short-term livelihood prospects, and raise the Sindh government's resilience in responding to climate change and related disasters. World Bank. www.projects.worldbank.org/en/projects-operations/project-detail/P179981

²⁷ Project ID P180008; for delivering beneficiary and disaster-resilient reconstruction of housing units. World Bank. www.projects.worldbank.org/en/projects-operations/project-detail/P180008

²⁸ 'Pakistan: Improved Resource Mobilization and Utilization Reform Program, Subprogram 1', Sovereign Project 56006-001. ADB. www.adb.org/projects/56006-001/main

²⁹ 'Pakistan: Women Inclusive Finance Sector Development Program (Subprogram 1)', Sovereign Project 54424-001. ADB. www.adb.org/projects/54424-001/main

Pakistan's Forex Reserves and Average Exchange Rate



Source: State Bank of Pakistan

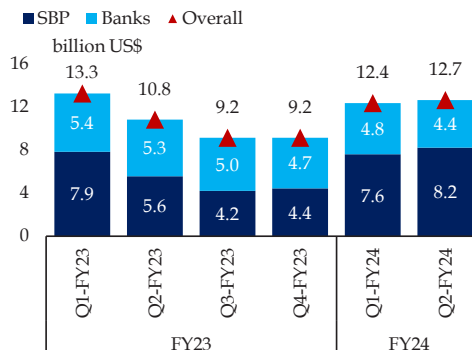
5.5 Exchange Rate and Reserves

Pakistan's FX reserves rose to US\$ 12.7 billion by the end of H1-FY24, compared to US\$ 10.8 billion in H1-FY23. The increase was largely in SBP's liquid reserves, which rose to US\$ 8.2 billion by end-December 2023 from US\$ 4.4 billion at end-June 2023 (Figures 5.18a & 5.18b).

Despite improvement in external account, PKR depreciated by 22.2 percent during H1-FY24 over the same period last year (Figure 5.19). However, after sharp

Pakistan's Forex Reserves*

Figure 5.18 b

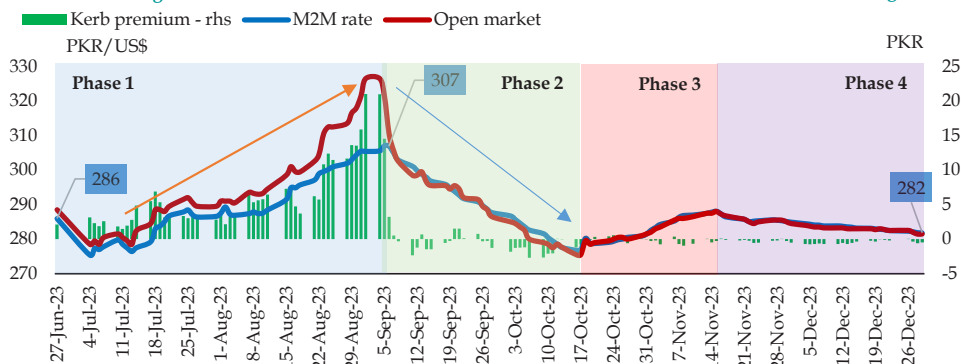


*end-period

depreciation in the first quarter, PKR recovered and gained stability in the second quarter of FY24. This is also reflected by a substantial decline in Kerb-market premium since mid September 2023. Infact, PKR was among the better performing currencies in emerging economies (Figure 5.20).

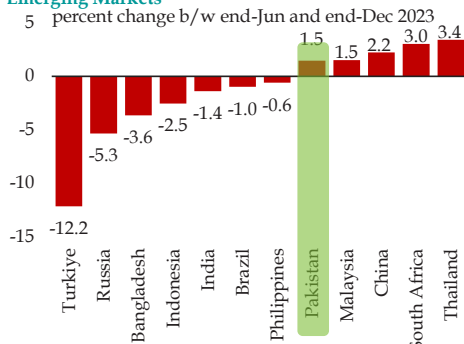
During Jul-Aug 2023, the external sector was facing several challenges, such as increasing financing gap, high volatility in FX market, tightening of global financial conditions, and heightened domestic

Trends in Exchange Rate and Kerb Market Premium



Source: State Bank of Pakistan

Exchange Rate Movements against US\$ in Emerging Markets Figure 5.20



Sources: State Bank of Pakistan and Haver Analytics

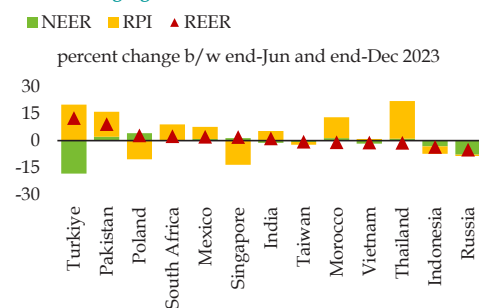
uncertainty. These adversely impacted forex reserves and increased pressures on exchange rate. However, crackdown on illegal currency activities like smuggling of foreign exchange, besides exchange company reforms introduced by the SBP in September 2023, reduced pressures on the exchange rate. This combined with sustained improvement in current account balance and reserve position following disbursements from other bilateral and multilateral sources, led to a gradual

appreciation of PKR from 5th September 2023 onwards. Supportive regulatory measures, like the imposition of a processing fee on Afghan imports of transit commercial goods via Pakistan and the suspension of B-category exchange companies' authorization, further alleviated the strains in the FX market (Figure 5.6 in section 5.2).

Some ambiguity about the first review under IMF's SBA briefly increased pressures on PKR against the US\$ in early November 2023. Nonetheless, after the successful completion of the review and rollover of US\$ 3 billion deposit by the KSA helped PKR regain stability.

Pakistan's real effective exchange rate (REER) index appreciated from 87.7 at end-June to 98.8 at end-December 2023. This was mainly due to higher domestic inflation vis-à-vis trading partners, i.e. relative price index (RPI). For countries such as Pakistan and Turkiye, the RPI contributed positively to the change in REER (Figures 5.21a & 5.21b).

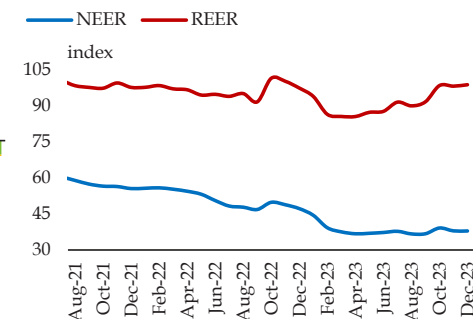
Real and Nominal Effective Exchange Rates - Emerging Markets Figure 5.21 a



*JP Morgan Effective Exchange Rates (deflated by CPI)

Source: Haver Analytics

Real and Nominal Effective Exchange Rate - Pakistan Figure 5.21 b



Sources: State Bank of Pakistan and Haver Analytics

Balance of Payments

Pakistan's Foreign Trade

Table 5.4

million US\$

	H1-FY23	H1-FY24	Change	
			Absolute	Percent
Trade Balance	-16,964.8	-11,275.0	5,689.8	-33.5
Exports	14,243.7	14,991.3	748.0	5.3
Textile	8,716.4	8,283.3	-433.2	-5.0
Apparel	4,297.8	3,871.8	-426.0	-9.9
Home textile	1,919.4	1,877.2	-42.2	-2.2
Cotton yarn	381.5	588.5	207.0	54.2
Non-textile	5,527.3	6,711.6	1,184.3	21.4
Rice	927.9	1,638.0	710.1	76.5
Oil seeds	114.0	364.0	250.1	219.4
Leather	314.8	284.3	-30.6	-9.7
Imports	31,208.5	26,265.8	-5,144.3	-15.8
Energy	9,285.5	8,005.8	-1,279.7	-13.8
Non-energy	21,923.0	18,274.5	-3,648.5	-16.6
Palm oil	2,082.3	1,388.1	-694.1	-33.3
Wheat	609.4	397.1	-212.3	-34.8
Machinery	3,235.1	3,606.1	371.0	11.5
Mobile phones	362.8	792.6	429.8	118.5
Rubber	112.4	131.4	19.0	16.9
Textile	2,108.9	1,302.1	-806.8	-38.3
Transport	1,163.0	840.8	-322.2	-27.7

Source: Pakistan Bureau of Statistics

5.6 Trade Account³⁰

Trade deficit contracted by 33.5 percent during H1-FY24, largely contributed by a considerable decline in imports, as well as a moderate increase in exports (Table 5.4). A combination of subdued domestic demand, easing global commodity prices, and higher agro-food production contributed to the improvement in trade balance.

Exports

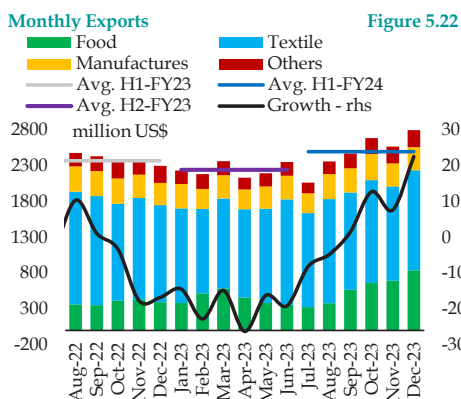
Exports grew by 5.3 percent in H1-FY24 against a decline of 5.6 percent in the

corresponding period of last year. In contrast to past years, the increase in exports was contributed by non-textile groups, i.e. food group and manufactures (Figure 5.22).

Food exports have been on rise since the start of FY24, mainly due to increase in production.³¹ Moreover, the PKR depreciation supported exporters to offer competitive prices in the international market. Specifically, there was a notable increase in the exports of rice, oil seeds, corn, and meat to Pakistan's major trading partners (Table 5.5). On the contrary, textile exports declined amidst lower unit

³⁰ This section is based on customs data reported by the Pakistan Bureau of Statistics (PBS). The information in this section does not tally with the payments record data, which is reported in Sections 5.2 and 5.3. To understand the difference between these two data series, see Annexure on Data Explanatory Notes.

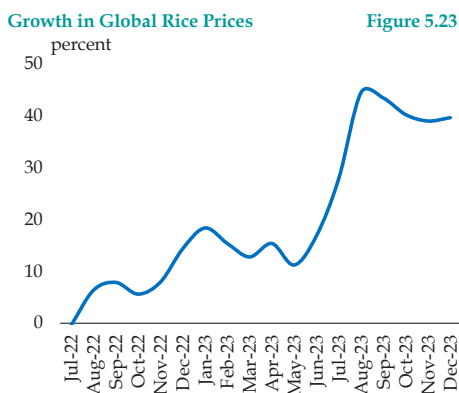
³¹ Rice production reached 8.6 million tons in FY24, well above the last year level and five-year average.



values. The decline was most pronounced in high-value added textile exports to the traditional markets, such as the EU and the US.

Food Exports

The disaggregated data indicates that food exports are driven by an increase in both unit values and export volumes (Table 5.6). More specifically, rice played a significant role in driving upturn in food



Destination-wise Exports of Pakistan Table 5.5

	Value (million US\$)		Change (percent)	
	H1-FY23	H1-FY24	H1-FY23	H1-FY24
EU-27	4,433.8	4,055.7	10.7	-8.5
Netherlands	747.8	669.8	8.7	-10.4
Spain	692.2	747.9	36.1	8.0
Italy	572.8	568.2	17.2	-0.8
Germany	881.2	731.0	2.0	-17.0
US	3,067.7	2,745.7	-7.7	-10.5
China	1,058.1	1,481.5	-20.6	40.0
UK	1,003.4	1,014.7	-12.5	1.1
UAE	726.0	1,000.9	-16.5	37.9
Bangladesh	420.8	305.4	4.6	3.6
Afghanistan	251.6	260.7	4.6	3.6
Saudi Arabia	221.4	328.2	13.1	48.3
Rest of World	3,209.4	4,136.9	9.2	28.9

Source: State Bank of Pakistan

exports, which could be ascribed to two key factors.³² First, the global rice supply disruptions amidst export ban by India during Jul-Aug 2023, due to food security concerns, exerted upward pressure on rice prices in international market. Second, recovery in rice production, supported by increase in sowing area, higher prices, as well as yields. These factors helped Pakistan to benefit from surging global rice prices by exporting higher volumes (Figures 5.23).³³

Export of oil seeds, particularly sesame seeds, was another major contributor to food exports. Export of oil seeds jumped by US\$ 257 million to US\$ 364 million during H1-FY24. Under China Pakistan Free Trade Agreement Phase II, China has emerged as a major importer of sesame seeds from Pakistan. Thus the combination of high export unit values and confirmed

³² Rice has the highest share of 24.4 percent in non-textile exports.

³³ See Figure 2.8 in Chapter 2 for rice production.

Non-textile Exports - Volume and Price Effect during H1-FY24

Table 5.6

million US\$, quantity in 000 MT

	Quantity	Value	Change in Value	Volume Effect	Price Effect
Rice	2,570.9	1,638.0	710.1	448.8	261.4
Basmati	318.	367.3	84.7	52.1	32.6
Others	2,252.9	1,270.8	625.4	347.5	277.9
Fish	92.6	199.0	-26.2	11.4	-37.6
Fruits	482.6	171.3	14.6	57.7	-43.1
Oil seeds	246.6	364.1	257.2	255.6	1.6
Meat	59.5	240.2	48.2	81.0	-32.8
Footballs*	2,454.7	117.8	-2.8	8.3	-11.2
Leather**	6131.6	284.3	-30.6	28.6	-59.2
Plastic	180.5	178.9	56.9	152.8	-95.9
Pharmaceutical products	38.5	154.8	-20.3	80.4	-100.7
Electric fans†	589.4	10.4	-0.5	0.5	-1.0
Cement	3,503.3	135.9	50.3	89.4	-39.1

Quantities in: *thousand dozens, **000SQM, †000No

Source: Pakistan Bureau of Statistics

orders provided a considerable boost in the domestic production of sesame seeds over the past few years, allowing increase in export volumes.³⁴

In the case of corn exports, a sustained increase in production, along with decline in domestic demand from the poultry industry, has resulted in higher exportable surplus during the first half of FY24.^{35,36} Amongst the major importers of corn, Vietnam imported the largest volumes, followed by Malaysia and Sri-Lanka.

Manufacture Exports

Exports of other manufactures, including rubber tyres and cement picked up during H1-FY24 compared to last year. Recently,

Pakistan has started exporting steel belted rubber tyres of heavy vehicles to the USA and Brazil, following the setting up of a new manufacturing facility by a leading tyre manufacturer in Pakistan in collaboration with China in 2022.³⁷ Similarly, the exports of cement rose in H1-FY24 due to the higher dispatches to Afghanistan on the back of rise in construction activity in the country.

Textile Exports

During H1-FY24, textile exports faced significant headwinds, primarily due to declining unit values as export volumes increased for almost all categories. As a result, textile exports decreased to US\$ 8.3 billion in H1-FY24 from US\$ 8.7 billion in

³⁴ In Phase II of CPFTA, China liberalized 1,471 tariff lines including oil and seeds resulted in a continuous rise of these products, particularly sesame seed, since its enactment in FY21.

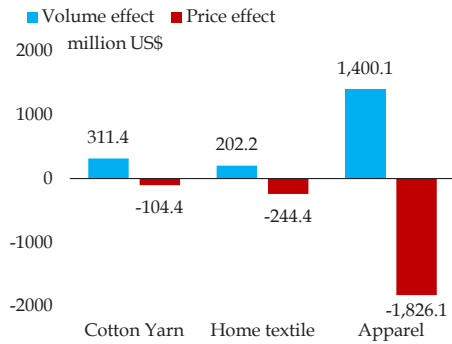
³⁵ Higher prices have dented the demand for chicken in the country, which in turn led to a decline in demand for corn – a major ingredient in the poultry feed industry. Source: USDA FAS.

³⁶ Corn exports grew by 71 percent in H1-FY24 compared to last year, mainly destined to Vietnam and Malaysia.

³⁷ In FY23, a major local tyre manufacturer signed an agreement with a Chinese company to manufacture steel belted truck and bus radial tyres in Pakistan.

Performance of Textile Exports during H1-FY24

Figure 5.24



Source: Pakistan Bureau of Statistics

the corresponding period of last year (Figure 5.24). The decrease in textile prices indicated declining unit values in traditional markets (Figures 5.25a & 5.25b).

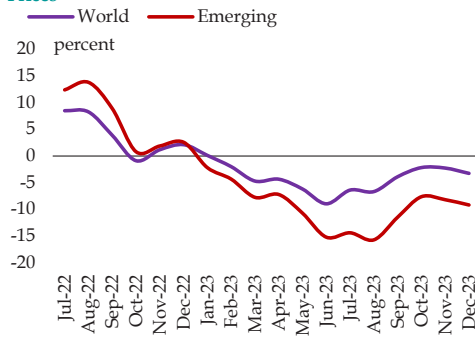
The fall in the unit values was evident in all the major textile exporting countries. This was a result of intensifying global

competition from China – a dominant supplier in the international market. Based on the declining cost of production, China has managed to offer textile products at competitive prices.³⁸ Consequently, other exporting countries, including Pakistan, were compelled to re-negotiate their export prices downward, resulting in declining apparel export receipts.³⁹ For instance, in the EU market, the unit values of apparel for China and Bangladesh recorded a decline of 14.4 percent and 14.0 percent respectively during Q1-FY24 (Figures 5.26a & 5.26b).⁴⁰

The impact of lower unit values was more pronounced in high value added (HVA) textiles. The downtrend in unit values was also evident from the sharp dip in values of apparel and home textiles, especially in EU (Figure 5.27). Contrary to the trends in unit values, the export quantities recorded an uptick during H1-FY24. The export

Trend in Emerging Economies' Export Prices

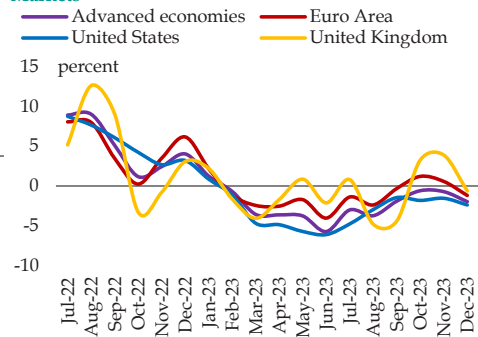
Figure 5.25 a



Source: CBP World Trade Monitor

Trend in Import Prices in Traditional Markets

Figure 5.25 b



Source: CBP World Trade Monitor

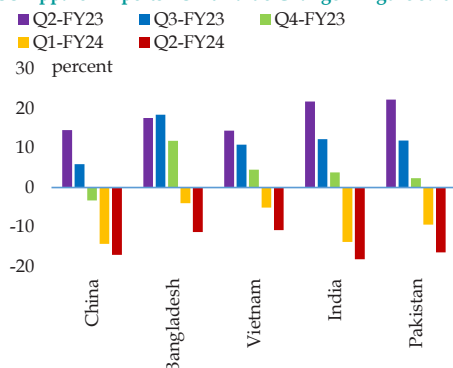
³⁸ This is worth mentioning that China was fearing deflation when all other countries were facing rising inflationary pressures.

³⁹ In addition, Pakistan had a leverage to re-negotiate prices downward due to PKR depreciation.

⁴⁰ In US market, the unit values of declined by 4 percent for China, Pakistan and India during Q4-FY24. Source: Emergingtextiles

Balance of Payments

US Apparel Imports - Unit Value Change Figure 5.26 a



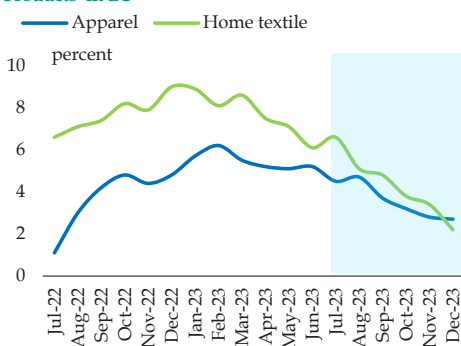
Source: EmergingTextiles

volumes of apparel and home textiles increased by 32.6 percent and 10.5 percent in H1-FY24 respectively.

Imports

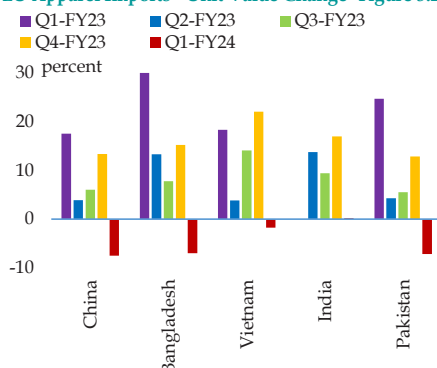
Imports saw a broad-based decline of 15.8 percent during H1-FY24, compared to 23.1 percent contraction last year. Primarily, moderating global commodity prices, particularly of crude oil, explain the contraction in imports. In addition, exchange rate depreciation also dented

Domestic Prices of Textile Products in EU Figure 5.27



Source: Eurostats

EU Apparel Imports - Unit Value Change Figure 5.26 b



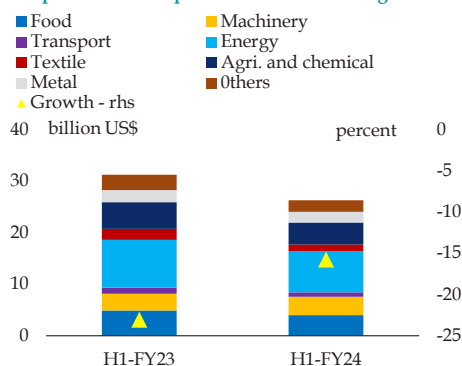
Source: EmergingTextiles

import demand and hence volumes (Figure 5.28). However, in line with the moderate recovery in domestic economic activity, import volumes, particularly of raw materials, posted an increase during Nov-Dec 2023 (Table 5.7).⁴¹

Energy

Energy imports edged down by 13.8 percent during H1-FY24, which predominantly explains decline in overall

Component-wise Imports Figure 5.28



Source: Pakistan Bureau of Statistics

⁴¹ Import volumes of raw materials such as synthetic fiber, iron and steel and rubber increased during Nov-Dec 2023.

State Bank of Pakistan Half Year Report 2023-2024

Imports during H1-FY24

Table 5.7

million US\$, quantity in 000 MT

	Quantity	Value	Change in Value	Volume Effect	Price Effect
Food		4,721.5	-1,262		
Milk	21	67	-27.1	-19	-8.2
Wheat	1,367	573	-201	-64	-137
Tea	140	391	28	33	-7
Soybean oil	84	100	-99	-41	-59
Palm oil	1,486	1,611	-835	-141	-964
Energy	9,132	9,332	-1,391	-579	-812
POL	4,838	3,621	-1,268	-812	-456
Crude	4,296	2,978	-123	234	-356
Textile		1,518	-947		
Raw cotton	84	208	-907	-862	-45
Agro chemical		5,080	-746		
Fertilizer	596	494	-14	-58	44
Others		534	-48		
Rubber crude	238	151	25	25	0
Rubber*	1,751	53	-21	-6	-15

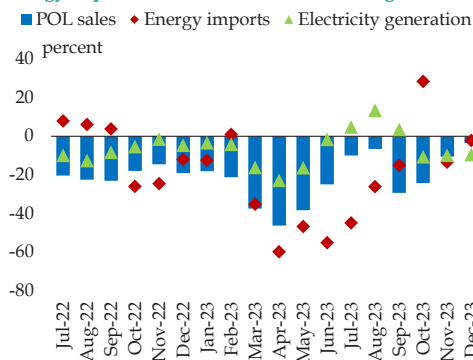
*quantity in 000 No.

Source: Pakistan Bureau of Statistics

import bill during H1-FY24. Lower global crude oil prices, continued subdued economic activity, and change in energy mix for electricity generation mainly led to this decline (Figures 5.29a, 5.29b and 5.30).

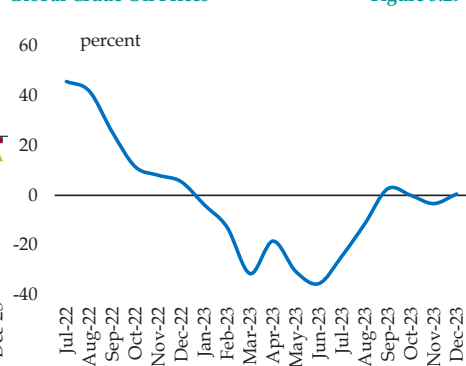
Amidst significant decline in global prices of coal and LNG, Pakistan changed its energy mix by shifting electricity generation from furnace oil to relatively cheaper sources, such as coal, hydel, etc.⁴² Moreover, decline in electricity generation

Energy Imports and Domestic POL Sales Figure 5.29 a



Sources: PBS, OCAC and NEPRA

Global Crude Oil Prices Figure 5.29 b

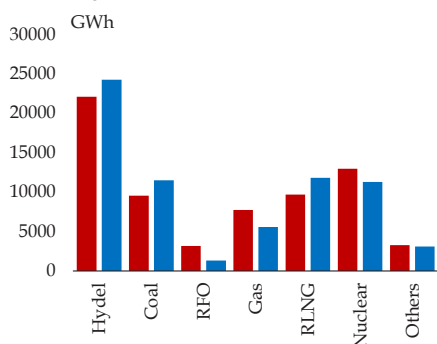


Source: World Bank

⁴² According to World Bank commodity price data, global prices of coal and LNG declined by 59 percent and 39 percent respectively during Jul-Dec FY24.

Source-wise Electricity Generation

■ H1-FY23 ■ H1-FY24



Source: National Electric Power Regulatory

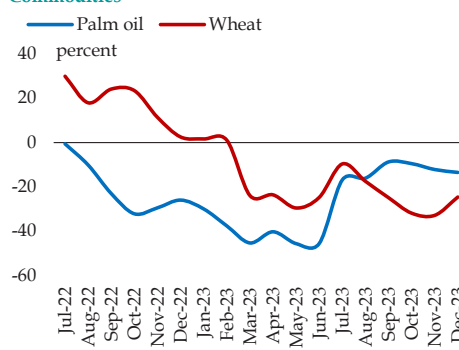
as indicated by a fall in POL sales to power sector, also contributed to volumetric decline in imports of POL products.

Food

There was a substantial decrease in food imports, particularly of palm oil and wheat, during Jul-Dec FY24. Both from lower volumes and prices contributed to this decline. Within the food group, palm oil imports – having the highest share in

Figure 5.30

Global Prices of Major Food Commodities



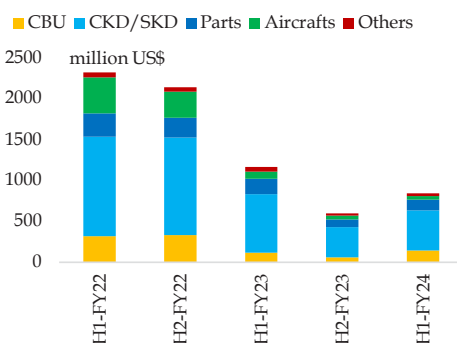
Source: World Bank

food imports – declined by US\$ 694.1 million in H1-FY24. This could partially be attributed to decrease in palm oil prices on account of excess supply from Malaysia and Indonesia amidst subdued demand in the international market.

Import of wheat contracted by US\$ 212.3 million during the review period. Both reduced import requirements following increase in domestic production and fall in global wheat prices due to increased supplies from Russia have resulted in lower wheat imports during H1-FY24 (Figure 5.31).

Transport Group Imports

Figure 5.32

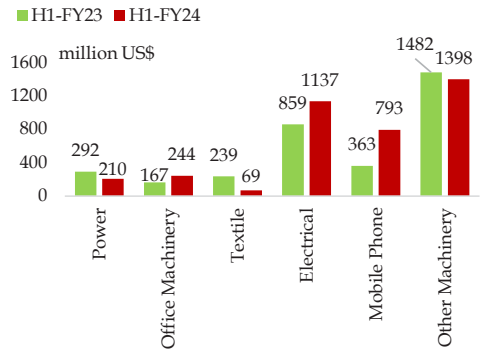


Source: Pakistan Bureau of Statistics

Transport

Import of transport group shrank to US\$ 0.8 billion during H1-FY24 from US\$ 1.2 billion in H1-FY23 (Figure 5.32). The decline was mainly driven by fall in import of CKD/SKD vehicles owing to a slump in the sales of domestically produced vehicles. The domestic production of vehicles continued to fall amid elevated borrowing cost, as well as surge in vehicle

Machinery Imports during H1



Source: Pakistan Bureau of Statistics

prices.⁴³ However, with the ease in administrative constraints, together with the pent-up demand, CBU imports posted an increase in H1-FY24, albeit lower than the average of last 5 years.

Machinery

Import of machinery increased by 11.5 percent in H1-FY24, primarily driven by an increase in import of mobile phones

Figure 5.33 a Import of Mobile Phones during H1

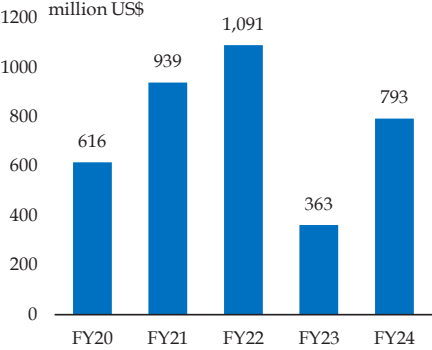


Figure 5.33 b

(Figures 5.33a & 5.33b). The import of mobile phones witnessed a significant growth, particularly in second quarter of the review period, reaching US\$ 792 million. This is largely explained by the pent-up demand for the completely built units of mobiles.⁴⁴ The removal of import restrictions, in conjunction with PKR appreciation since September 2023, created a favorable environment, leading to higher imports of mobile phones.

⁴³ See Figure 2.17 of Chapter 2 for data on auto sales.

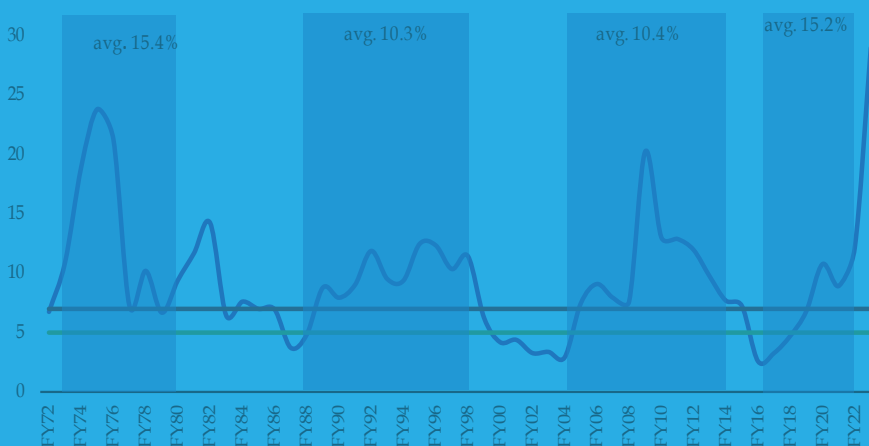
⁴⁴ Completely Built Units (CBU) refers to finished mobiles handsets imported into Pakistan. Whereas, Semi Knocked Down (SKD) are the parts that are imported in Pakistan for assembly.



6

Inflation Dynamics in Pakistan: Determinants and Structural Challenges

Pakistan has been experiencing a visible surge in inflation since 2020. Historical trends show that Pakistan's inflation has been consistently high. This is both in comparison to peer economies, and in relation to the estimates of the country's threshold level of inflation, in light of which Pakistan's inflation has been high for more than 30 of the last 50 years in four different episodes: FY73-FY78; FY89-FY98; FY05-15; and FY20 to H1-FY24. Focussing on the latter two episodes, this chapter shows that government borrowing, inflation expectations, political and economic uncertainty, and exchange rate depreciation have been the leading drivers of inflation since 2020, whereas money supply, high government borrowing and uncertainty were the most pronounced determinants in the previous episode. In addition to the macroeconomic factors that drive inflation in the short term, the chapter sheds light on key policy and structural factors that impact inflation over the medium to long term. These include: fiscal and debt policy, trade openness, administered energy prices, productivity and demographic trends. The chapter concludes that whilst monetary policy is important to contain demand pressures and prevent de-anchoring of inflation expectations regardless of its sources, long term secular decline in inflation hinges on addressing the structural challenges, strengthening the monetary policy framework to better anchor inflation expectations, and ensuring prudent fiscal and debt policy.



6.1 Introduction

Inflation has re-emerged as a global problem in recent years, with countries facing inflationary pressures across regions and income groups. Prior to the recent episode, the long-term trend in both Advanced Economies (AEs) and Emerging and Developing Economies (EMDEs) points towards a secular decline in inflation. This disinflationary path is evident across different metrics, such as headline, core, energy and food price inflation.¹

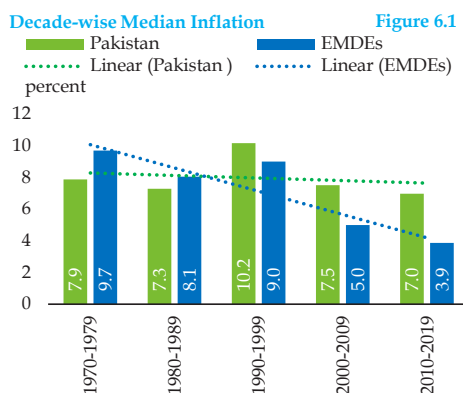
In line with the recent global inflationary trends, Pakistan too has been experiencing a surge in inflation since FY20, after having witnessed slight disinflation between 1970-2019. However, contrary to long term global trends, the decline in inflation in Pakistan has been insignificant (**Figure 6.1**) leading to considerably high inflation compared to AEs, EMDEs and Low Middle Income Countries (LMICs). Inflation in

Pakistan also tends to peak higher, even when inflation peaks in AEs, EMDEs and LMICs (**Figures 6.2a, 6.2b & 6.2c**).

Specifically, inflation in Pakistan has remained above the EMDEs' median for 61 percent of the sample period (1970-2023), and 31 percent of the time it has been on or above the third quartile. Inflation in Pakistan has also historically remained above the LMICs' median for 66 percent of the sample period, and for 21 percent it has been on or above LMICs' third quartile. The gap between inflation in Pakistan and the median inflation of AEs and EMDEs has also grown over the last two decades.

Moreover, inflation in Pakistan has been higher than the threshold inflation, estimated to be 7 percent (**Box 6.1**), during two-thirds of the sample period (1970-2023). During this period, the country has had four high inflationary episodes when average annual inflation was consistently above the 7 percent threshold for more than three consecutive years. These are: (a) FY73-FY78; (b) FY89-FY98; (c) FY05-FY15; and (d) the ongoing episode (FY20 to H1-FY24) (**Figure 6.3**).

In most of these episodes, Pakistan's headline, as well as food and energy, inflation has been comparatively higher than that of peers (**Figures 6.4a & 6.4b**). This lends weight to the notion that Pakistan's economy is vulnerable to global

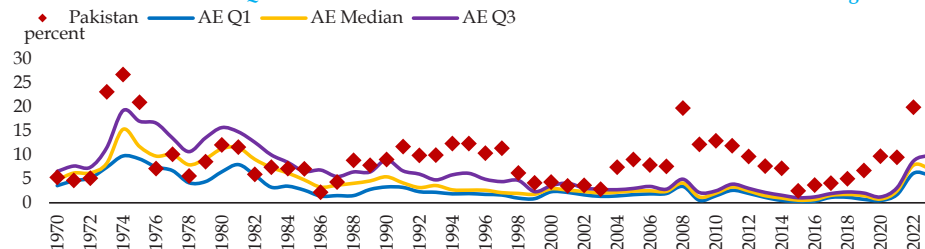


Source: Ha, J. et al. (2023)

¹ Ha, J. et al. (2019)

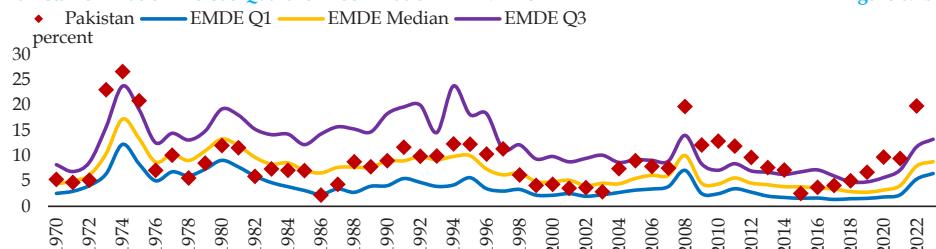
Pakistan's Inflation* versus Quartile-wise Inflation* in AEs[^]

Figure 6.2a



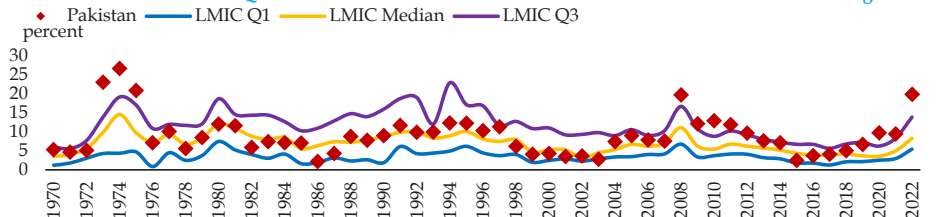
Pakistan's Inflation* versus Quartile-wise Inflation* in EMDEs[^]

Figure 6.2b



Pakistan's Inflation* versus Quartile-wise Inflation* in LMICs[^]

Figure 6.2c

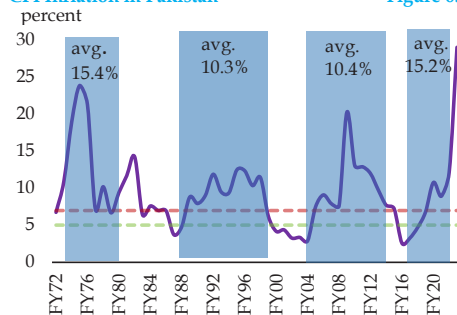


Source: Ha, J. et al. (2023)

as well as domestic demand and supply shocks. These include high global commodity prices, particularly oil prices, expansionary fiscal policy, monetary expansion, political and economic uncertainty, exchange rate adjustments, and domestic floods or droughts. However, ocular evidence suggests that each of these shocks did not necessarily appear in all of the identified episodes, whereas their intensity also varied in different episodes.

CPI Inflation in Pakistan

Figure 6.3



The red and green dotted lines denote the medium term inflation target of 5-7%.

Source: Pakistan Bureau of Statistics

Box 6.1: Threshold Level of Inflation in Pakistan

The estimation of threshold inflation, beyond which there exists a negative relationship between inflation and economic growth, varies due to several reasons. These include differences in methodologies, sample period and data frequency used in empirical analysis. It also varies from one country to another depending on country characteristics, such as size and frequency of shocks, fiscal policy, monetary policy framework and degree of trade openness. For Pakistan, the level of threshold inflation is estimated to be around 7 percent as midpoint of various recent estimates, which is in line with the upper bound of the government's medium term target of 5 – 7 percent.

Mubarik (2005), using annual data from 1973 to 2000, finds that a negative relationship between output growth and inflation in Pakistan turns significant after 7 percent, getting even worse after inflation rises above 9 percent. Arby and Ali (2017), using annual data over 1976-2017, conclude that inflation beyond 5.7 percent can hurt economic growth in Pakistan. Similarly, Hussain and Rehman (2020) estimate, based on annual data for 1976-2016, the non-accelerating inflation rate of unemployment (NAIRU)^a in Pakistan to be in the range of 7 – 8 percent. Earlier studies have estimated Pakistan's threshold inflation at 8 percent (Sarel, 1996), 4 – 6 percent (Hussain, 2005), and 5 percent (Vinayagathan, 2013). Similar to Pakistan, both the range of estimates and precise thresholds also vary for EMDEs on account of reasons mentioned above. However, recent studies estimate threshold inflation at round 5 – 8 percent for Asian EMDEs and 7 – 9 percent for Sub-Saharan African EMDEs (Ha, J. et al. 2019).

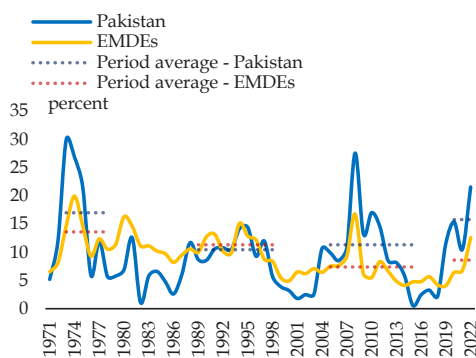
^aNAIRU is the lowest unemployment rate that can be sustained without causing wage growth and inflation to rise.

For instance, three of the four identified high inflationary episodes in Pakistan have been marked by rising global oil prices (**Figure 6.5a**). Similarly, an expansionary fiscal policy has been a recurring feature affecting inflation outturns in all these episodes (**Figure 6.5b**). Between FY76-

FY23, primary deficit existed for nearly 80 percent of the sample years, whereas fiscal deficit was 5 percent or less for only eight years (**Figure 6.6**).

Likewise, monetary expansion, appears to be a common factor. Monetary overhang,²

Food Inflation



Source: Ha, J. et al. (2023)

Figure 6.4 a Energy Inflation

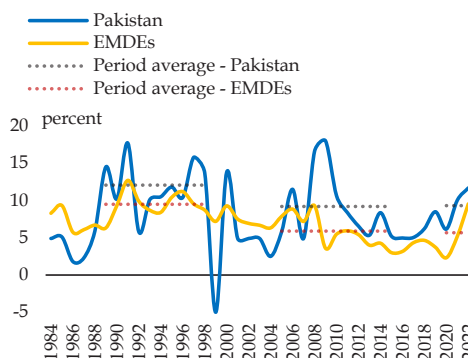
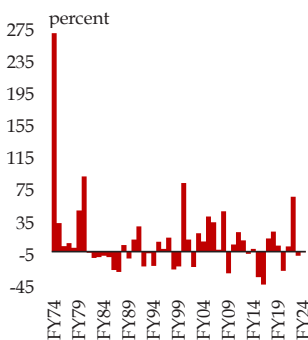


Figure 6.4 b

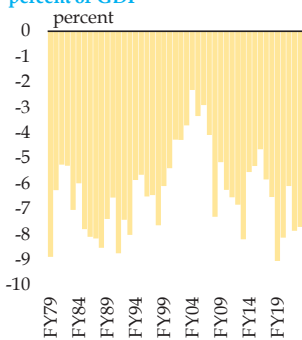
² The term monetary overhang refers to a situation of excess money supply relative to nominal GDP. Source: Moinuddin (2010)

Change in Global Oil Prices - YoY Figure 6.5 a



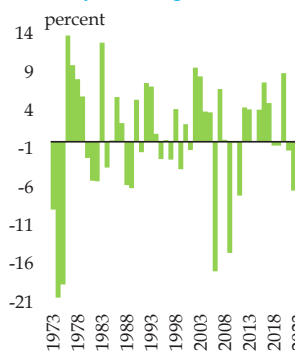
Source: Haver Analytics

Fiscal Balance as percent of GDP Figure 6.5 b



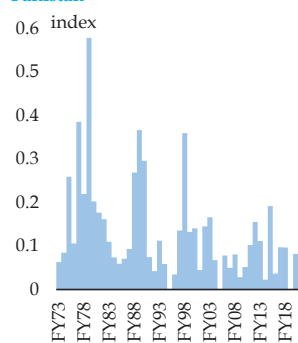
Source: State Bank of Pakistan

Monetary Overhang Figure 6.5 c



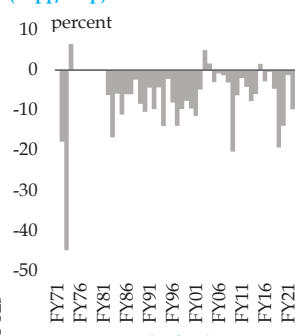
Source: SBP Staff Calculations

Uncertainty Index - Pakistan Figure 6.5 d



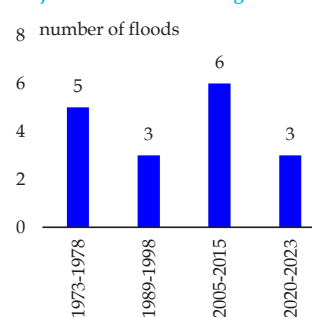
Source: Haver Analytics

Exchange Rate (+app/-dep) Figure 6.5 e



Source: State Bank of Pakistan

Major Flood Events Figure 6.5 f



Source: Federal Flood Commission of Pakistan - Annual Report 2021, Table 3.2 and UNOCHA

which typically drives inflation with a lag (Ahmad et al. 2016), was prominent in the immediately preceding years of three of the four identified high inflationary episodes (**Figure 6.5c**).

Uncertainty, which plays a strong role in driving inflation expectations and thus inflation, has also been relatively high in three of the four episodes and witnessed an increase in two of them. (**Figure 6.5d**)³ Exchange rate adjustments, on the other

hand, has been a consistent factor in each of the high inflationary episodes (**Figure 6.5e**).

Similarly, while floods are not empirically estimated to be significant drivers of domestic inflation, each of the four identified inflationary episodes have witnessed a few major floods during the period along with several smaller floods (**Figure 6.5f**). For example, there were 3 major floods during the 1989-1998 episode

³ The figure is based on World Uncertainty Index data that captures near and long term economic and political uncertainty.

and 6 during 2005-2015, as categorized by the Federal Flood Commission. However, there were five additional floods in each of these episodes.⁴

Although the impact of these floods is estimated to be short lived, especially considering that post-flood crop output is often higher due to diluvial soil enrichment, floods are found to have contributed to inflation during the years of its occurrence. For instance, severe floods in 1973 squeezed food supplies in Pakistan, with an estimated 3.6 million acres of agricultural land totally or partially damaged. This contributed to 30 percent food inflation in Pakistan during 1973, compared to an average 14.7 percent in EMDEs.⁵

In this backdrop, Section 6.2 sheds light on key macroeconomic determinants of inflation in Pakistan. Section 6.3 discusses broad policy issues and structural

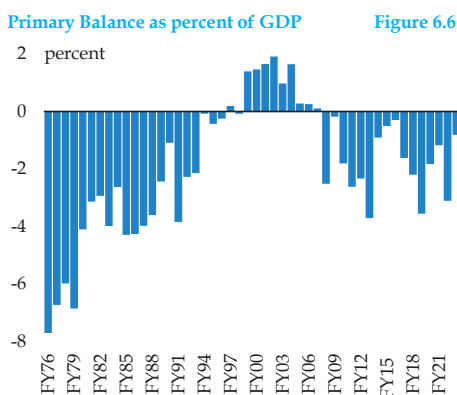
challenges faced by Pakistan's economy that impact some of the key determinants discussed in Section 6.2, and eventually manifest in inflation outcomes. Finally, Section 6.4 offers concluding remarks underscoring the importance of monetary policy to contain demand pressures and prevent de-anchoring of inflation expectations, and the need to resolve structural challenges, besides implementing appropriate macroeconomic policies, to achieve low and stable inflation over the medium to long-term.

6.2 Determinants of Inflation in Pakistan

This section first takes stock of the existing literature on key determinants of inflation in Pakistan, including the impact of global commodity prices, money supply, fiscal deficit, uncertainty and inflation expectations.⁶ The estimated impact of the determinants in these studies vary in their intensity and duration, as well as in the time they take to manifest on headline inflation numbers. The impact varies on account of, inter alia, differences in estimation techniques, data used, and the time period under study. The second part of this section draws from the latest SBP staff estimates to shed light on the determinants of the ongoing inflationary episode and the one between 2005-2015.

Findings of Earlier Studies

From the perspective of overall demand-supply shocks, Khan and Hanif (2012) find



Source: State Bank of Pakistan

⁴ Hussain, F. et al. (forthcoming); World Bank (2020)

⁵ SBP (1974), SBP (2011); Talpur, Z. et al. (2020); Hussain, F. et al. (forthcoming)

⁶ There are several other determinants of inflation, for e.g. wage growth and wheat support price. However, due to paucity of space this review focuses on major determinants common to most studies on inflation in Pakistan.

that between 1992 and 2011, supply shocks accounted for 48 percent of the changes in inflation. By comparison nominal demand shocks (monetary) and real demand shocks accounted for 42 percent and 10 percent of variation in inflation, respectively. The paper also finds that the full impact of supply shocks linger for much longer as its manifestation on inflation is slower than demand shocks. Specifically, the study estimates that 75 percent of long-term impact of supply shocks on inflation appears during the 12 months of the shock. It reaches to 85 percent in 18 months and comes to an end in 36 months. By comparison, 90 percent of the nominal and real demand shocks are realized within 12 months; the former reaches to 95 percent in 18 months and the latter dies out in 24 months.

Global Commodity Prices

Within supply shocks, domestic price levels have been found to be significantly driven by prices of global commodities, particularly of oil, which is a significant component of the global commodity price index.⁷ Literature suggests that world oil prices affect the prices of several agricultural commodities, particularly those that are inputs to alternative fuel sources, such as corn and palm oil. In line with global literature, Hesary et al. (2018) found a positive correlation between energy prices and food prices in several Asian economies, including Pakistan, over

the period 2000–2016, on account of the direct impact of oil prices on the cost of production of agricultural commodities and food products, such as fuel in tractors, fertilizers, storage and distribution.⁸

Of all the tracked global commodities, domestic inflation is found to be most responsive to global crude oil prices, followed by global food, cotton and metal prices (Hanif et al. 2017). Moreover, contrary to the widely held belief that food and energy prices are primarily affected by such shocks, core inflation also responds to shocks in global food and crude oil prices. Core inflation in Pakistan shows a relatively gradual response to these shocks compared to food and energy prices, emphasizing the importance of the second-round effects.⁹

Hanif et al. (2017) also find that the transmission of the impact of global oil price increase is quicker compared to that of global food, cotton and metal as well as the impact of growth in money supply. This finding is corroborated by Hanif et al. (2022), which reveals that growth in global commodity prices determined inflation in both medium and long-run during the period 1992-2021.

However, research also reveals that not all types of global oil price shocks impact inflation in Pakistan. Based on sample period of 2002-2021, Sardar and Hyder (2022) find that compared to global oil supply shocks, global oil demand shocks

⁷As per World Bank's pink sheet, the Global Commodity Price Index (GCPI) has two components- energy and non-energy indices. Energy indices constitute 66 percent to the GCPI. Within the energy indices, the weight of oil is approximately 85 percent.

⁸ Nazlioglu, S. & Soytas, U. (2011); Harri, A. et al. (2009)

⁹ See also Box 3.1 in Chapter 3 on "Understanding Second-Round Effects of Shocks to Food and Energy Prices"

have a more pronounced impact on domestic inflation. This distinction arises due to perception of policymakers in Pakistan that oil price increases driven by changes in global demand is a long-term phenomenon. As a result, administrative prices of domestic fuel are adjusted accordingly. In contrast, oil price increases driven by unforeseen shifts in global crude oil production are viewed as transitory in nature. The paper finds that the degree of the second-round impacts of oil demand and oil supply shocks varies accordingly.

Exchange rate

Recent empirical research, Hyder and Hussain (2019), suggest that the real effective exchange rate in Pakistan depreciates in response to increases in global oil prices, even when they are in the process of recovering from an immense fall in the preceding period. However, the impact of exchange rate depreciation itself on headline inflation is not particularly clear. A survey of firms suggests that exchange rate depreciation influences price-setting behavior of firms, more than even the strength of domestic demand, rising financing costs, and weakening of labor productivity (Khan, 2015). This is corroborated in Hanif et al. (2022) who find that the exchange rate played a significant role in explaining inflation, especially during short to medium-term.

However, most other prior studies show that pass-through¹⁰ of exchange rate depreciation is either low or unconvincingly established. For instance,

Siddiqui and Akhtar (1999) do not find any significant relationship between changes in the exchange rate and domestic prices during 1972-1998. Another study by Sattar et al. (2012) finds no long run relationship between the exchange rate and inflation during the period 1980-2009. Similarly, Hyder and Shah (2004) also find that exchange rate pass-through was low on consumer price inflation between 1988-2003, although it is estimated to have a stronger impact on wholesale price index (WPI), particularly its fuel and lighting and manufacturers baskets.

Hyder et al. (2006) finds some pass-through of exchange rate depreciation on domestic prices in the years 1977-2005, but the pass-through effect is not precisely determined and thus statistically insignificant. This echoes the finding of Choudhri and Khan (2002) that Consumer Price Index's response to exchange rate shocks was close to zero for up to 10 quarters during the period 1982-2001.

These findings seem contrary to popular opinion as exchange rate depreciation influences prices through both direct and indirect channels, such as price of both imported finished goods and raw materials for domestic production. However, there are two plausible reasons why most earlier research on the impact of exchange rate depreciation on inflation has found little to no impact: (a) earlier studies have not conducted episode wise analyses, which means impact, if any, of one-time adjustment may have been diluted over long sample periods; and (b) the data

¹⁰ Pass through is the degree to which a given absolute change in one variable causes an absolute change in other variable

analysed in these studies are mostly before Pakistan transitioned to a flexible exchange rate in July 2000, and market-based exchange rate in May 2019.¹¹

Money Supply and Fiscal Stance

Most previous empirical research suggests that inflation in Pakistan has been significantly a monetary phenomenon. For instance, in their study of the period 1971-2012, Ahmed (2013), and Ahmed et al. (2014) find that broad money (M2) has a positive long run association with inflation. Similar association is shown in Hanif (2014) using data from the period 1951-2010 and Hanif et al. (2022). This finding is also corroborated by Nguyen (2015) covering the period of 1985-2012 on some selected Asian economies, including Pakistan.

At the same time, empirical evidence suggests that fiscal stance has also been a key determinant of inflation in Pakistan. Tariq et al. (2012), in their study for the period 1972-2009, observe that domestic debt and domestic debt servicing has an impact on price levels in Pakistan. The study highlights that government borrowing from the central bank increases the money supply thereby increases the price level.

Haider and Khan (2007), covering the period 1992-2007, also conclude that government borrowing has a significant positive impact on domestic inflation. Recent evidence echoes these findings.

Raza and Mughal (2022) find both budget deficit and money supply to be significantly positively related to inflation. Using data from 2000 to 2019, the study also finds that other fiscal variables like total taxes, indirect taxes and sales taxes have a positive impact on inflation. Hanif et al. (2022) also show that government borrowing has a significant impact on inflation both in the short run as well as in long run.

Inflation expectations

The relevance of inflation expectations has increased in recent years. These are influenced by many factors, including global commodity price outlook, fuel and energy price adjustments, and recent inflation trends, especially if they persist for an extended period. In addition, while exchange rate depreciation has been found to be a significant contributor to inflationary expectations in both AEs and EMDEs, the lack of exchange rate flexibility in some EMDEs can also increase the magnitude of external shocks, which in turn contributes to de-anchoring of inflationary expectations. Moreover, higher public debt is associated with expectations of higher inflation, especially if the stock of public debt is held in foreign currency, and exacerbated when fiscal deficits are persistent (see **Section 6.4**).¹²

In Pakistan, research on the impact of inflation expectation on inflation outturns is limited, and have mostly used lagged values of various inflation indicators as a

¹¹ SBP (2020)^b

¹² Albrizio, S. et al. (2023); Moessner, R. (2022); Beckmann, J. et al. (2022); Ali, M. G. et al. (2015); IMF (2023); J. Ha, et al. (2019); Koç, U. et al. (2021); Patra, M.D. & Ray, P. (2010)

proxy. For instance, Pasha et al. (1995) have found inflationary expectations, measured by lagged values of WPI, to have had a pronounced effect on food inflation during the 1990s, which in turn impacted headline numbers given its large share in the consumer basket.

Likewise, Abdullah and Kalim (2012) have used lagged values of food price index to proxy inflationary expectations for the period between 1972-2008 that show a statistically significant impact on food inflation. Khan et al. (2007) find that adaptive expectations¹³ — measured as a lagged values of CPI inflation — significantly contributed to inflation during 2004 to 2006. Moreover, Ali et al. (2015) have also found adaptive expectations — measured as lags of Non-Food Non-Energy — to be the largest contributor to core inflation between 1985 and 2005, especially in times of high level of political and economic uncertainty.

In terms of triggers of inflation expectations, Abbas et al. (2015) find fuel and energy prices to have influenced inflationary expectations in Pakistan. This is in line with global findings that the immediate pass-through of global oil prices on domestic consumer prices is due to inflationary expectation of economic agents, whereas the increase in marginal costs and consumer prices takes time.¹⁴ Similarly, Khaliq (2023) find food price shocks to have significant impact on consumer inflation expectation in Pakistan between 2009 and 2022.

Empirical studies on the impact of exchange rate depreciation on inflationary expectations are scant. However, Khalid (2015) argue that the PKR-USD parity is seen as an anchor for consumer inflationary expectations and overall business sentiments (**Figure 6.7a & 6.7b**). Moreover, Abbas et al. (2015) find inflationary expectations to be exaggerated and more entrenched among low-income, less educated, female and younger respondents, which given Pakistan's population structure¹⁵ contributes to inflationary pressures in the country. This is in line with Conrad et al. (2021), which shows that inflation expectations globally are also shaped by experiences and socio-economic background of individuals and businesses.

Uncertainty

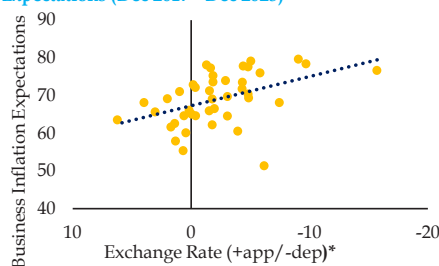
In recent years, uncertainty is increasingly understood as a major contributor to inflation. Chaudhry and Abe (1999) suggest that uncertainty of economic policies affect investment, consumption and production decisions, of businesses and households, leading to a situation in which inflation, fiscal deficit and public debt reinforce each other in a vicious cycle. Aisen and Veiga (2006) find that political instability, emerging from various factors, such as frequent cabinet changes and government crises, is strongly associated with higher inflation. This is because during times of political uncertainty the objective of price stability is often compromised. The impact of political

¹³ Adaptive expectations are backward looking as future prices are predicted based on past events.

¹⁴ Bernanke, B. (2013)

¹⁵ 67 percent of Pakistan's population is less than or equal to 30 years of age; 49 percent population is female, whereas adult literacy rate is 58 percent. SBP (2022) ^b

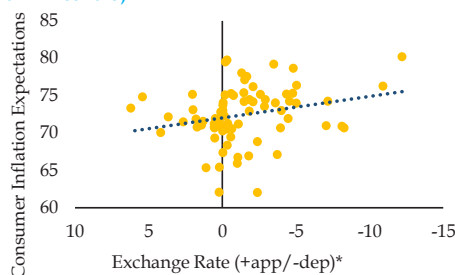
Interaction Between Exchange Rate (+app/-dep) and Business Inflation Expectations (Dec 2017 - Dec 2023)



Note: BCS conducted since Oct 2017 while CCS conducted since Jan 2012. * Exchange rate (+app/-dep) calculated for periods between surveys

Source: State Bank of Pakistan

Figure 6.7 b Interaction Between Exchange rate (+app/-dep) and Consumer Inflation Expectations (Mar 2012 - Dec 2023)



instability on inflation is more pronounced in high inflation countries, and in developing countries.

Moreover, Kazakis (2023) show that uncertainty is also associated with concentration of market power, ultimately resulting into higher inflation. Uncertainty impacts firms' decision-making on whether to enter a market or sector. This protects the established firms in the market or sector from competition, thus increasing their market power. Uncertainty also exacerbates information asymmetry, and firms with more information or resources, such as already well-established firms, exploit this advantage and strengthen their position.

Most empirical literature on determinants of inflation in Pakistan does not consider the impact of economic and political

uncertainty. One exception is Khan and Saqib (2009) that investigates the relation between political instability and inflation. The study, using three different variables for political instability (polity, cabinet changes and government crises) for the period 1951-2007, finds a high positive relation between political instability and inflation.

SBP Staff Estimates¹⁶

The foregoing literature review brings to fore three important gaps in existing research on the determinants of inflation in Pakistan. First, earlier studies have not solely focused on the high inflationary episodes as identified in Section 6.1. Second, the time period covered in most earlier studies is somewhat dated. Third, the list of determinants in most earlier studies has been somewhat limited,

¹⁶ This sub-section discusses the key findings of Hussain, F. et al. (forthcoming) as shown in Table 6.1, Figure 6.8 and Figure 6.9. For insights into annual contribution of key determinants, Figure 6.8 serves as a point of reference, whereas their contribution to monthly inflation shocks are shown in Figure 6.9. The cumulative impact or pass-through of one percent (or one standard deviation) shock to each determinant on inflation are mentioned in Table 6.1. In the interest of clarity, this note serves as a blanket reference for the graphs and tables cited herein.

preventing a systematic analysis of drivers of inflation when several factors are simultaneously at play. The SBP staff, Hussain et al. (forthcoming), addresses these gaps by estimating the contribution of a wide range of determinants on a monthly basis, and thereby closely analyse the ongoing high inflationary episode of 2020 to H1-FY24, and nearly all years of the previous episode (2005-2015).

In addition, the study uses previously unexplored proxies for five key determinants to help toward cleaner identification of their impact on inflation. First, as a point of departure from the earlier papers, the study separates the impact of money supply from fiscal expansion. Second, unlike other indicators

of fiscal policy, the study uses a proxy that offers a better handle on the analysis of determinants of inflation at high frequency.

Third, for inflation expectations, the study uses data from the SBP's Consumer Confidence Survey instead of the lagged values of inflation indicators used in most earlier papers. Fourth, it uses a high frequency indicator of political and economic uncertainty, which has been a relatively unexplored dimension in previous studies. Lastly, it assesses the impact of floods/droughts on prices. While the construction of these variables and estimation methodology is explained in **Box 6.2**,¹⁷ the key findings of the study are discussed below.

Box 6.2: Estimation Methodology

The study first identifies the main drivers of inflation in Pakistan. To this end, several domestic and external factors are considered as potential determinants of domestic inflation, followed by estimates of how shocks to each determinant impacts inflation individually. It then examines the role of various determinants on inflation, alongside quantification of their relative contribution over the sample period. Both these exercises are based on monthly data from June 2002 to December 2023.

a. Structural Vector Autoregression (SVAR) model

The authors use SVAR model to estimate the cumulative response (pass-through) of shock to each of the drivers on inflation. To identify structural shocks, the study follows recursive ordering, as suggested by McCarthy (1999), for generating impulse responses and estimating cumulative pass-through coefficients. The determinants, as proxied by respective variables, included in the analysis are ordered according to their relative degree of exogeneity i. e. most exogenous determinant comes first while most endogenous determinant (inflation) is placed at the last. Accordingly, their ordering is as follows:

Floods, global commodity prices, uncertainty, output gap, money supply, fiscal policy stance, exchange rate, inflation expectations and input costs, with CPI being the most endogenous in the system. The (SVAR) framework can be presented as under.

$$y_t = C + A(L)y_t + u_t \quad (1)$$

Where y_t , C , u_t and $A(L)$ are vector of endogenous variables, matrix of constants, vectors of innovations and polynomial of lag operators, respectively. The study finds each of the variable a significant contributor to inflation during the period.

¹⁷ Arby, M.F. & Ghauri, S.P. (2016) find that WPI food index can be a predictor of CPI food index, and that both CPI and WPI can impact each other. However, the study did not estimate WPI's impact on inflation in a multi-variable model.

b. Estimates of relative contribution of determinants to inflation

The estimation of period-wise relative contribution of shocks to various drivers on overall inflation by employing Historical Decomposition approach. This technique, developed by Burbidge and Harrison (1985), explains the path of endogenous variable(s) over the sample period in terms of innovations (shocks) in all the variables, included in the system. After simple algebraic manipulation, equation (1) can be written as:

$$y_T = A^T y_0 + \sum_{k=1}^T A^{T-k} u_k \quad (2)$$

Where first term on the right hand side of the equation, y_0 , is initial value of the concerned variable, while second term represents the cumulative sum of all structural shocks. Equation (2) represents historical decomposition, where actual data at period t is expressed as the sum of base projection and weighted structural innovations to all endogenous variables in the system.

c. Data

The study uses the following variables as a proxy for the various determinants of inflation:

- i) **Floods/Drought:** In the absence of high frequency data on floods/drought, the study measures floods/drought as deviation of rainfall in a certain month from the average of that month over the sample period.
- ii) **Global commodity prices:** Commodity prices contribute to inflation via higher prices of imported inputs and consumption goods. World Bank's Global Commodity Price Index is used to capture both the impact of oil prices as well as prices of other imported commodities, especially food items.
- iii) **Uncertainty:** To capture the impact of uncertainty, the study uses the spread between short-term and long-term secondary market interest rates in consideration of the view that the slope of yield curve is often considered as a degree of confidence on future path of the economy, incorporating the impact of both political and economic uncertainty.^a Short-term interest rates are generally sensitive to uncertainty but have relatively lower noise compared to other proxies for uncertainty. For instance, while the stock market volatility is often used as a proxy for uncertainty, it does not offer a true reflection in shallow and undeveloped markets, such as Pakistan's. Likewise, Economic Policy Uncertainty Index, based on Economic Intelligence Unit's country reports, is not a suitable proxy for uncertainty as the data for the variable is not available on monthly basis, whereas Credit Default Swaps is found to have spurious correlation in Pakistan, especially considering that it may also reflect the impact of external vulnerabilities that is better proxied by exchange rate. Lastly, data for government crisis, polity and cabinet changes only measures political uncertainty and is not available on annual basis.
- iv) **Money supply:** M3 is used as a measure of money supply, excluding government's budgetary borrowing.^b The budgetary borrowing is subtracted in order to see the impact of money supply without the influence of the fiscal policy stance.
- v) **Fiscal policy stance:** The study uses the ratio of government borrowing to FBR taxes to capture the fiscal stance. Increase in this ratio indicates expansionary fiscal policy stance and vice versa. This proxy offers a better handle on the analysis of determinants of inflation at high frequency as data for fiscal deficit is not available on a monthly basis.
- vi) **Inflation expectations:** Inflation expectation index is constructed using data on consumer inflation expectation as tracked by the SBP's Consumer Confidence Survey (CCS). Since the CCS data is available on bi-monthly basis from 2012, the missing data was calculated as the average of the adjacent months, whereas the data for the period 2002 to 2012 has been backcasted.
- vii) **Input cost (WPI):** Wholesale price index is used to capture the impact of changes in input cost, which is a useful indicator for cost-push inflation.

Inflation Dynamics in Pakistan: Determinants and Structural Challenges

- viii) **Exchange rate:** Changes in the value of PKR per USD is used to capture the effects of currency depreciation/appreciation on inflation.
- ix) **Output gap:** In the absence of monthly aggregate demand data, the difference between the cyclical and permanent components of LSM index is used as a proxy for output gap (or excess demand).

^a Cuadra, G. & Sapriza, H. (2008)

^b The results are not different from that of M2. M3 includes notes in circulation, transferable deposits, other deposits, securities other than shares, coins in circulation, deposits held with Non-Bank Financial Companies (NBFCs), National Saving Schemes - outstanding amount (Central Directorate of National Savings-CDNS) and deposits held with post offices.

With the exception of some years, shocks to money supply and fiscal policy stance have significantly contributed to inflation between FY06 and H1-FY24. Specifically, a one percent shock to money supply has a pass-through impact of 0.21 percent to inflation in the ensuing twelve months, whereas the same size of shock to fiscal policy stance has a pass-through impact of 0.01 percent in the twelfth month (**Table 6.1**). Despite this difference in pass-through impact, fiscal policy is one of the two major drivers of inflation common to both the ongoing and the previous episode of high inflation, implying that fiscal shocks are frequent and their size is

substantially larger than money supply shocks (**Figure 6.8 & 6.9**).

The next major contributor to inflation common to both the ongoing episode and the previous episodes is uncertainty, reflecting the country's checkered political and economic environment. The change in global commodity prices also has had a positive and significant impact on inflation between FY06 and H1-FY24. However, its impact on inflation waxes and wanes tracking the movements in global prices. Moreover, the cumulative pass-through of global commodity price hikes on inflation is found to be marginally positive in the

Cumulative Pass-through Impact of Key Determinants*

Table 6.1

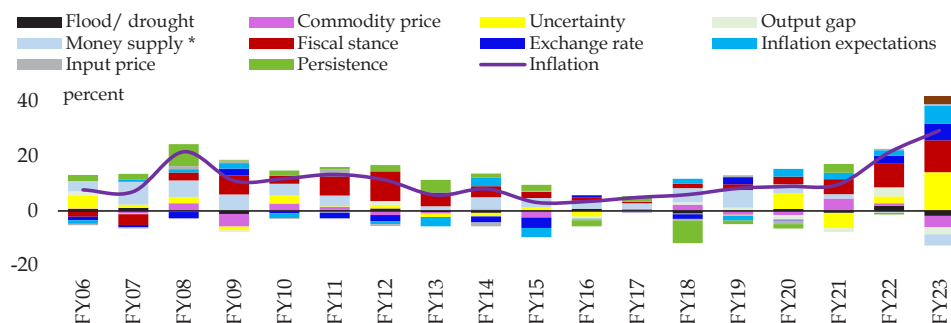
Period	Flood	Commodity Prices	Uncertainty	Output Gap	Money Supply	Fiscal Stance	Exchange Rate	Inflation Expectations	Input Price
1	0.00	0.05	0.00	0.04	-0.03	0.00	-0.06	0.02	0.10
2	0.01	0.02	0.00	0.03	0.01	0.01	-0.02	0.11	0.12
3	0.04	0.06	0.00	0.02	0.00	0.01	0.09	0.23	0.17
4	0.01	0.08	0.00	0.00	-0.01	0.01	0.14	0.37	0.28
5	0.01	0.05	0.01	0.03	0.04	0.00	0.30	0.44	0.25
6	0.01	0.04	0.01	0.02	0.11	0.01	0.41	0.48	0.25
7	0.01	0.06	0.01	0.02	0.15	0.01	0.30	0.18	0.28
8	0.01	0.05	0.01	0.01	0.15	0.01	0.34	0.23	0.22
9	0.03	0.05	0.02	0.00	0.17	0.01	0.30	0.22	0.14
10	0.02	0.05	0.02	0.01	0.17	0.01	0.28	0.28	0.17
11	0.02	0.08	0.02	0.01	0.21	0.01	0.32	0.30	0.21
12	0.02	0.08	0.02	0.03	0.21	0.01	0.30	0.30	0.17

* This table shows cumulative impact of one percent shock to each variable on inflation over a span of 12 months. Based on SVAR Model; the variables are enlisted in this table according to their relative degree of exogeneity; see Box 6.2

Source: Hussain, F. et al. (forthcoming)

Contribution in Average Actual Inflation

Figure 6.8



Note: Based on historical decomposition; see Box 6.2.

Source: State Bank of Pakistan

*Money supply (M3) excluding government

initial months (**Table 6.1**), which may be attributed to implicit and explicit subsidies on oil prices – that dominate the global commodity index.¹⁸

The results indicate that expectations about prices have highest cumulative pass-through to inflation. In particular, the pass-through of one percent shock to inflation expectations peaks (0.48 percent) in six months from its occurrence. The study also finds exchange rate depreciation to be a significant determinant of inflation. The cumulative pass-through impact of one percent shock to exchange rate peaks during the first six months (0.41 percent) and gradually decreases to 0.30 percent in the 12th month (**Table 6.1**).

The study also finds that the pass-through of floods peaks in third month, after which it tapers off. Accordingly, the floods in both 2010 and 2022 impacted inflation in the first few months after the impact. However, the impact was short-lived; it faded away after 3-4 months, and was not pronounced in annual estimates. This is in

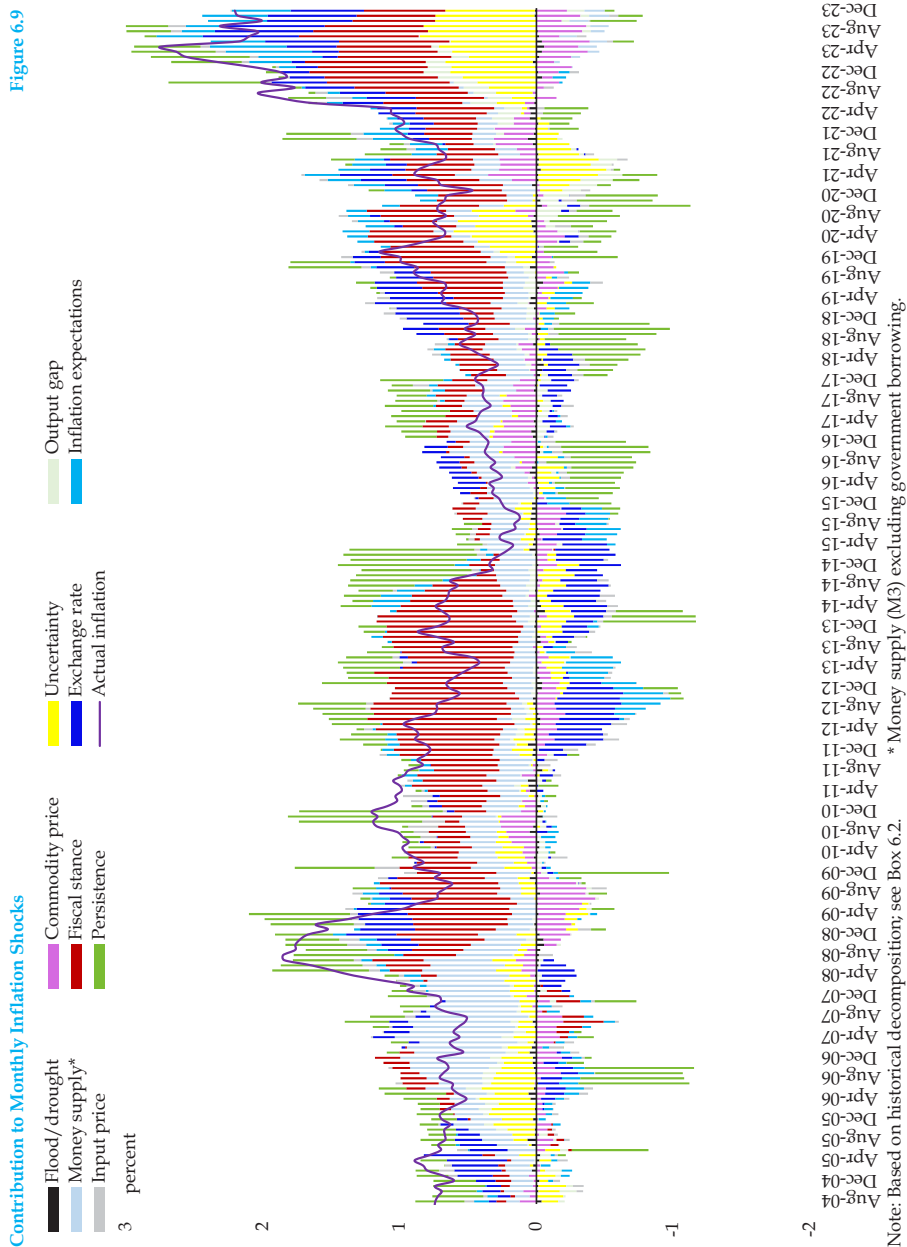
line with findings of Parker (2016) on impact of natural disasters on inflation, which suggest that unlike drought the impact of storm dissipates after a few months leaving no significant impact after a year.

FY05-FY15 episode

The FY05-FY15 high inflationary episode can be viewed in two phases: pre and post Global Financial Crises (GFC) of 2007-08. Pre-GFC money supply and uncertainty were the major contributors to inflation. The former reflects the impact of high growth in private sector credit and foreign inflows. The latter reflected the growing political uncertainty in the years leading up to the GFC, and the change of government in 2008.

In the post GFC phase, fiscal policy contributed the most to inflation, reflecting high government borrowing during the period amid increased public sector development spending. The contribution of the exchange rate was most visible after

¹⁸ Similar results have been found for Sri Lanka and South Africa. Source: Duma, N. (2008); Bhundia, A. (2002)



the post-GFC currency adjustment in FY09 amid external account vulnerabilities. However, following the resumption of IMF program and ensuing stabilization, exchange rate stabilized, and accordingly its contribution to inflation turned negative.

In both phases, the estimated contribution of global commodities was significant in the wake of rising commodity prices leading up to the GFC, and the rebound in prices after the GFC-led crash. Input prices, as measured by WPI, reflected in part the rise in global commodity prices and its contribution to inflation during the period.

Ongoing episode FY20 to H1-FY24

Unlike the previous episode, money supply (excluding budgetary borrowings) has not been a major contributor to inflation in the ongoing episode, even though its contribution was noticeable in FY18 and FY19. During the peak pandemic years FY20-21, its contribution to inflation decreased compared to the preceding two years, despite growth in private sector credit amid monetary easing. Following the reversal of monetary policy easing and continuous tightening since FY22, the estimated contribution of money supply (excluding budgetary borrowings) to inflation has turned negative.

Instead, the prominent driver of inflation during the ongoing episode has been fiscal policy, particularly after FY21 amid high fiscal deficits. Uncertainty emerged as the second largest contributor during the

current inflationary episode. While the uncertainty in FY20 may be attributed to the onset of Covid-19, that during FY22 and onward reflects heightened political and economic uncertainty in the period leading up to the General Elections of 2024.

Inflation expectations and exchange rate depreciation have also contributed significantly. In light of the literature discussed in the preceding sub-section, the former may be attributed to exchange rate depreciation, and the consistent rise in global commodity prices until the first half of FY23. The estimated contribution of commodity prices on monthly and annual inflation spiked following the post-pandemic global price hike and the onset of the Russia-Ukraine conflict in FY21 and FY22 respectively. But its impact waned following the softening of the commodity prices, particularly visible from the second half of FY23 till December 2023.

6.3 Policy and Structural Challenges

The degree to which key macroeconomic determinants, such as those discussed in the preceding section, impact inflation can vary across time and space, depending on the differences in long term structural factors. These factors include economic structure, policy and institutional environment, and other country characteristics.¹⁹

Compared to key macroeconomic determinants of inflation, the impact of the structural factors are typically slow

¹⁹ Campillo, M. & Miron, J. A. (1997); J. Ha, et al. (2019)

moving,²⁰ and can even take decades to create and strengthen underlying inflationary or disinflationary conditions. For instance, global research suggests that improvements in structural factors — including trade openness, central bank autonomy, fiscal reforms, productivity, and demographic ratios — have resulted in reducing inflationary pressures in both AEs and EMDEs over the past few decades.²¹

However, despite the consensus on their importance, quantification of the impact of structural factors remains a challenge, particularly in LMICs. This is mainly due to the slow moving nature of these variables; lack of standardized metrics and relevant historical data; rapid structural changes in different economic sectors; gaps in the knowledge of underlying structural forces; and a shortage of research expertise.²²

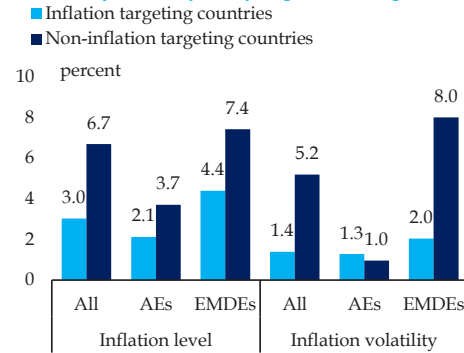
Understandably, no study to date has conducted an econometric analysis of a comprehensive set of structural factors, influencing inflation in Pakistan. In recognition of this gap, the ensuing discussion sheds light on some of the key policy and structural factors, and other country specific characteristics relevant to Pakistan that seem to be impediments to achieving and maintaining low and stable inflation over long-term horizon.²³

Monetary Policy Framework

Inflationary expectations have emerged as a challenge in Pakistan in recent years, as highlighted in the preceding section. Amongst other things, this necessitates strengthening of central bank credibility and autonomy, and adopting a clearly defined monetary policy strategy, particularly the inflation targeting regime that helps check both inflation and its volatility (Figure 6.10).²⁴

The SBP has been undergoing a transition over the last two decades, the most important of which include the abandoning of monetary target regimes; the introduction of an interest rate corridor; and a transition to a market based exchange rate (Figure 6.11). However, it is the legal amendment in 2022 that has helped the central bank gain autonomy (Table 6.2). Following the amendment, the

Inflation by Monetary Policy Regime Figure 6.10



Source: Ha, J. et al. (2019)

²⁰ Exceptions apply, such as the Covid-19 shock.

²¹ Campillo, M. & Miron, J. A. (1997); J. Ha, et al. (2019)

²² Campillo, M. & Miron, J. A. (1997); J. Ha, et al. (2019)

²³ A host of policy and structural factors may affect inflation. These include transportation, digitization, and corruption. However, the list of challenges discussed in this section is not intended to be exhaustive. It is an indicative list brought under spotlight to further public discourse, and quantitative research for estimation of their impact.

²⁴ Ha, J. et al. (2019); Youssef, H. A. G. (2007)

Central Bank Independence Index

Table 6.2

Country	2003	2013	2023
Brazil	0.494	0.494	0.686
Thailand	0.033	0.216	0.216
South Africa	0.300	0.300	0.300
Philippines	0.565	0.565	0.565
Indonesia	0.887	0.887	0.887
Romania	0.654	0.654	0.654
Türkiye	0.838	0.838	0.757
India	0.298	0.298	0.373
Argentina	0.753	0.753	0.753
Pakistan	0.262	0.356	0.799

Note: The index ranges from 0 to 1 where 0 corresponds to the lowest level of independence to 1, the highest level. The five broad categories upon which the index is calculated include: (1) provisions on the tenure of the central bank governor and board and the rules for their appointment and dismissal (20 weightage), (2) provisions on central bank fundamental objectives (15 weightage), (3) provisions on the formulation of monetary policy (15 weightage), (4) provisions on central bank lending to the government (40 weightage), and (5) accountability and transparency (10 weightage)

Source: Quality of Government Institute, University of Gothenburg, based on Jácome, L. I. and Vázquez, F. (2008). Available at: https://datafinder.qog.gu.se/variable/cbie_cwne

SBP prepared its Strategic Plan for 2023-28, under which the SBP plans to implement a

flexible inflation targeting regime by 2028 to further enhance the efficacy of monetary policy and better anchor inflationary expectations (Table 6.3).²⁵

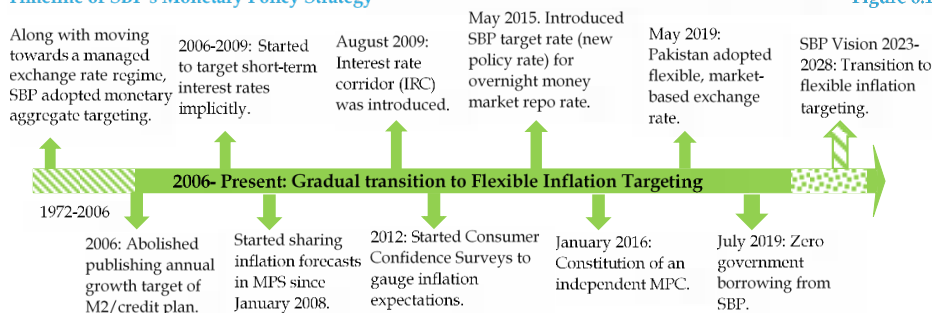
The latest amendment to the SBP Act in 2022 also spelled out a clear definition of the SBP's objectives, with price stability as its primary objective; the strengthening of its functional and administrative autonomy; and the abolishment of Monetary and Fiscal Policies Coordination Board because its terms of reference overlapped with that of the MPC.²⁶ In addition, the latest amendment has put an end to government borrowing from the SBP as well as the quasi-fiscal operations²⁷ given their inflationary implications.

Fiscal and debt policy

Growing body of academic literature suggests that imprudent fiscal and debt policy plays an instrumental role in driving inflationary pressures. At the one

Timeline of SBP's Monetary Policy Strategy

Figure 6.11



Source: SBP website; Moiniddun (2007). Choice of Monetary Policy Regime: Should SBP Adopt Inflation Targeting, SBP Working Paper Series, Karachi: SBP; SBP Press Releases; SBP (2020).

²⁵ SBP (2023) c

²⁶ MoF (2021)

²⁷ Following the 2022 amendment to SBP Act 1956, existing quasi-fiscal operations are being phased out.

Adoption of Inflation Targeting Regime Table 6.3	
Country	Adoption Year
New Zealand	1990
Canada	1991
United Kingdom	1992
Australia	1993
Finland	1993
Sweden	1993
Spain	1995
Czech Republic	1997
Poland	1998
Brazil	1999
Poland	1999
Thailand	2000
South Africa	2000
Philippines	2002
Indonesia	2005
Romania	2005
Armenia	2006
Türkiye	2006
India	2016
Argentina	2016
Pakistan*	In Transition

Sources: Central Banks and IMF website; S. Mensi et al. (2023); S. K. Jafri et al. (2023).

end, government borrowing from the central bank leads to money printing. At the other end, the fiscal theory of price level (FTPL) informs that high government borrowing to finance fiscal deficits stokes inflation. Specifically, FTPL posits that borrowing through issuance of government bonds to banks and non-banks (such as households and firms) contributes to increase in demand pressures, if bondholders do not expect government debt to be paid or paid on time or otherwise expect its value to fall in the future, and therefore spend it on buying assets or goods and services to avoid loss of real value in the future. The absence of

fiscal consolidation also undermines the effectiveness of monetary policy when central banks try to contain inflation by raising interest rates.²⁸

Moreover, high public debt to GDP has been found to have increased uncertainty and inflation expectations in EMDEs. It does so by weakening the perceptions of monetary policy credibility and independence. Studies also show that large external debt increases the economy's susceptibility to external shocks, which can cause exchange rate depreciation. In addition to increasing the domestic currency value of external debt, this raises inflationary expectations. Lastly, significant deviations — both in terms of magnitude and timing — from planned fiscal policies that impact price levels, such as indirect taxes or administrated prices, can elbow central banks to deviate from the inflation target. This in turn can affect monetary policy credibility and stoke long-term inflationary expectations.²⁹

In light of literature, fiscal and debt policy seems to be a dominant driver of inflation in Pakistan, as also identified by econometric studies discussed in the preceding section. Budgetary borrowing from the central bank has been prominent in the past, and has been found to be the most inflationary source of deficit financing.³⁰

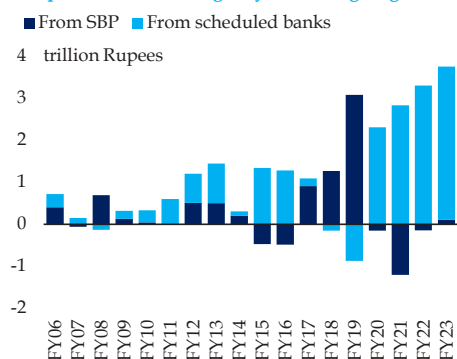
The most recent episode of deficit monetisation was between the years FY17 to FY19. (Figure 6.12). With the January

²⁸ Lubik, T.A. (2022); Fine, O. et al. (2022); Laurens, B. & Piedra, E.G. de la (1998); Leeper, E.M. (2023)

²⁹ IMF (2023); Harrison, O. et al. (2023); Jafri, S. K. et al. (2023)

³⁰ Ali, K. & Khalid, M. (2019); Sherani, S. (2006)

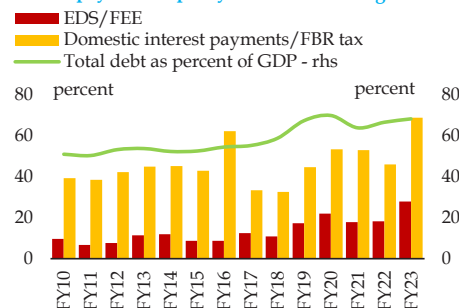
Composition of Net Budgetary Borrowing Figure 6.12



Source: State Bank of Pakistan

2022 amendment of the SBP Act, the government has relied on borrowing from scheduled banks, and non-bank sources. In light of FTPL and concerns over debt sustainability, this is likely to be contributing to demand pressures.

Debt Repayment Capacity Figure 6.13



Note: EDS stands for external debt servicing. FEE stands for FX earning.

Sources: Ministry of Finance and State Bank of Pakistan

High public debt may also have a bearing on uncertainty and inflation expectations. The total debt – as per the definition of Fiscal Responsibility and Debt Limitation Act 2005³¹ – has been breaching the limit of 60 percent since FY19, and the debt repayment capacity has been gradually waning in recent years. (Figure 6.13). The latter is mainly on account of higher interest payments on external and domestic debt, and lower foreign exchange earnings and FBR tax revenues.

Moreover, over the last two decades, the government has increasingly relied on indirect taxes, such as sales tax and customs duties, and indirect collection mode of direct taxes, such as advance taxes and withholding taxes.³² Both indirect taxes and indirect collection mode of direct taxes are found to be inflationary in nature given their cascading effect on prices.³³

At the same time, untargeted subsidies (particularly energy subsidies), and government support to loss-making commercial state-owned enterprises adds to borrowing needs (Figure 6.14). Lastly, there have been frequent instances of discretion vis-à-vis the magnitude and timing of administered prices (POL products, and utilities tariffs), which in some years has also led to deviation from the planned fiscal consolidation.³⁴

³¹As per Fiscal Responsibility and Debt Limitation Act, 2005 (FRDLA) amended in June 2017, "Total Debt of the Government" means the debt of the government (including the Federal Government and the Provincial Governments) serviced out of the consolidated fund and debt owed to the International Monetary Fund (IMF) less accumulated deposits of the Federal and Provincial Governments with the banking system.

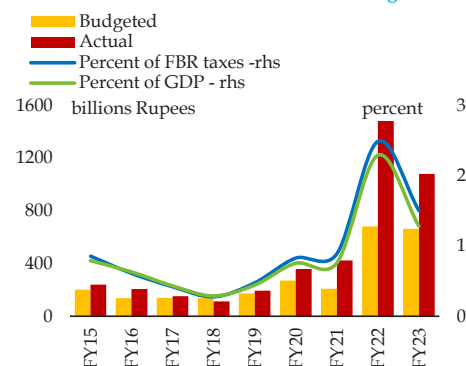
³² SBP (2023) ^b

³³ Raza, B. & Mughal, K. S. (2022); Shakeel, A. (2023)

³⁴ SBP (2014); SBP (2022)^a; SBP (2023) ^a

Inflation Dynamics in Pakistan: Determinants and Structural Challenges

Trend in Federal Subsidies



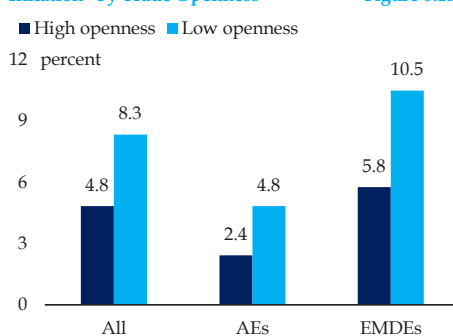
Source: Ministry of Finance

Trade openness

Literature suggests that countries with higher levels of trade openness tend to experience lower inflation.³⁵ (Figure 6.15). Some of the channels through which trade openness lowers inflation include better efficiency on account of capital imports, better capacity and resource utilization, increase in foreign direct investment, transfer of technology and technical knowledge and specialization in dynamic sectors. Trade openness often comes along with deregulation and globalization, which together forms a mutually reinforcing mix that fosters a competitive economy, consequently reducing monopoly pricing power. Expansion in output, as a result of trade openness, is also found to alleviate price pressures.³⁶

The degree to which trade openness lowers inflation also depends on country specific characteristics, such as country size, import intensity in an open trade regime, and the

Inflation* by Trade Openness



*median inflation for the period (1970-2017).

Source: Ha, J. et al. (2019)

impact on the cost structure of the various sectors of the economy. Global Value Chain (GVC), which trade openness facilitates, also plays an important role in reducing price pressures. This is mainly because the fragmentation of production and higher share of intermediate goods in total trade that follows GVC integration can weaken the response of import prices to exchange rate movements.³⁷

Empirical literature on the relationship between inflation and trade openness in Pakistan is limited, and suggests mixed results. While Zakaria (2010), Munir and Kiani (2011), and Mukhtar et al. (2019) do not find a negative relationship between trade openness and inflation, Hanif and Batool (2006), Mukhtar (2010), and Afzal et al. (2013) find significant inverse relationship between the two variables. These mixed results may be because Pakistan's transition to low import tariffs regime has been comparatively slower (Figure 6.16), whereas the impact of

³⁵ Romer, D. (1993); Sachsida, A. et al. (2003)

³⁶ Jin, J. (2000) cited in Ashra, S. (2002); Grossman, G. M. & Helpman, E. (1991); Przybyla, M. & Roma, M. (2005), Rogoff, K. (2003)

³⁷ Aron, J. & Muellbauer, J. (2007), Mayer, J. (2003), J. Ha, et al. (2019)

structural reforms becomes fully visible in the long term.

Moreover, Pakistan has not fully opened its economy for global trade despite reducing tariffs over the years. The country's taxation system continues to heavily rely on imports as a major source of revenue.³⁸ This increases the cost of imports and somewhat offsets the impact of trade openness on market prices.

Similarly non-tariff barriers remain high, giving domestic firms a privileged domestic market position. Trade-restrictive policies have also resulted in domestic prices diverging widely from the prices in international markets. Resultantly, many of the industries developed oligopolistic characteristics which has led to high volatility in price levels. Likewise, Pakistan has been unable to deepen the linkage of its manufacturing activities with the GVCs.³⁹

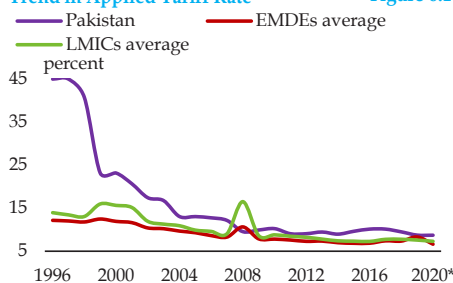
Productivity

Accelerating productivity growth helps lower inflationary pressures, whereas its slowdown increases inflation. Slower productivity growth raises unit cost of production, leading firms to raise prices to avoid shrinking of profit margins. While this may also lower aggregate demand, which can mitigate some of the inflationary pressures, the net impact of two counteracting effects is generally understood to be inflationary both in

theory and in practice. Rising productivity growth has also been found to have lowered the NAIRU, which is a key determinant of how much an economy can grow without creating inflation.⁴⁰

A variety of evidence suggests that accelerating productivity growth reduces inflation in the medium to long-term. For instance, Kim et al. (2013) found that growth in labour and Total Factor Productivity (TFP) in Korea reduced its CPI inflation between 1985-2002. Similarly, Dew-Becker and Gordon 2005 show evidence of both productivity growth lowering US inflation between 1995-2005 and its slowdown boosting inflation during 1965-80. Moreover, Schindler et al. (2004) found productivity growth to have lowered prices in China to the degree that it modestly exported disinflation to its major trading partners by lowering their import prices.

Trend in Applied Tariff Rate Figure 6.16



Note: Missing data values are assumed to have remained unchanged at previous period's level. *Latest available data.

Source: World Bank

³⁸ During FY18-FY23, tax collection on imports averaged 44 percent of total tax collection. This included indirect taxes (such as sales tax on imports and customs) and direct tax collection (such as WHT or advance tax) charged at import stage).

³⁹ SBP (2020); WB (2018); Lewis, S. R. & Guisinger, S. E. (1968); SBP (2020); Ali, S. O. (2011); SBP (2020) ^a

⁴⁰ Yellen, J. (2005); Mankiw, N.G. & Ball, L. (2022)

In recognition of its importance, several central banks, such as Bank of Canada and Bank of England closely monitor quarterly productivity trend. Weak productivity growth, particularly in the goods sector, is seen as one of the upside risks to inflation given its impact on cost of production, which is assumed to be passed through to CPI inflation.⁴¹

In Pakistan, the impact of productivity on inflation has not been empirically assessed, albeit labour productivity growth seems to have an inverse relationship with inflation (**Figure 6.17**). In part this gap may be because, unlike several AEs, official estimates of labour productivity and TFP are not available on quarterly basis in the country. Hence, the degree to which productivity may be affecting inflation is unknown. However, Pakistan's weak long term productivity trend may be seen as a major impediment to lowering of inflation.

Both capital and labour productivity slowed during 1972–2021, as a result the country's TFP growth has remained quite low compared to other Asian economies. The general decline of productivity is noticeable across agriculture, manufacturing and services sectors.⁴²

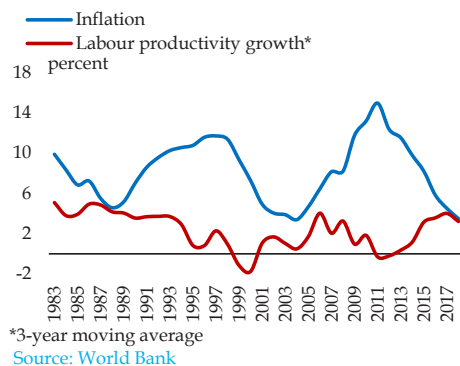
Agriculture

Large shares of food and agricultural products in household consumption basket heightens Pakistan's vulnerability to both

structural challenges faced by the country's agriculture sector, and volatility in global food commodity prices. These challenges, stemming from policy, administrative and institutional weaknesses, reflect in the usage of inputs and agriculture policy distortions that contribute to low yields, as well as weak farm to market linkages — leading to high food inflation in the country.⁴³

From the perspective of inputs, farm yields are inhibited by several factors, including poor seed usage, imbalanced use of agri-chemicals, insufficient farm mechanization, limited availability of irrigation water, inadequate agricultural extension services, land degradation and environmental hazards, such as soil salinity and water logging, and weak access to credit. Similarly, farmers often overuse or incorrectly apply pesticides, and do not use the right mix and application of fertilizer.⁴⁴

Nexus between Labour Productivity and Inflation in Pakistan Figure 6.17



⁴¹ BoE (2019); BoC (2023)

⁴² Pasha, H.A. et al. (2002); Sabir, M. & Ahmed, Q. M. (2003); Chaudhry, A. (2009); PCoP (2011); Amjad, R. & Awais, N. (2016); Saleem, H. et al. (2019); Siddique, O. (2022) ^a; Siddique, O. et al. (2023) Javid, N. & Ahmed, G. (2021)

⁴³ Rana, W. et al. (2022); Horst, A. & Watkins, S. (2022)

⁴⁴ Horst, A. & Watkins, S. (2022); SBP (2023) ^a; Jafri, S. K. et al. (2022); SBP (2014); SBP (2007) ; SBP (2014); SBP (2009); Khan, M. J. et al. (2010); Ejaz, N. & Ahmed, M. (2017)

In addition to these, there are policy distortions that lead to inefficient allocation of resources and impairs agriculture productivity. For instance, wheat procurement policy and support prices adds to the fiscal burden through commodity financing. Moreover, as a result of high procurement prices amid regulated imports, domestic wheat prices tend to exceed the import price parity levels.⁴⁵ Similarly, the policy of water underpricing is causing distortions that are preventing more efficient crop allocations and thus competitive prices.⁴⁶

As a result of inadequate inputs and policy distortions, average yields of major crops is about 55 percent lower than that of domestic progressive farmers; it is also low compared to the region. There has been some increase in yields over the years but research shows that it has been mostly driven by increased use of inputs rather than improvements in productivity.⁴⁷ Similarly, livestock yields suffer due to poor fodder quality, shortages in supply of protein and onset of diseases, which inevitably impact dairy and meat inflation (See also Chapter 3).

Low yields in conventional crops leaves little land and other resources for other crops. This, coupled with the lack of incentives, and policy and institutional focus on other crops adds to avoidable

inflationary risks channeled through high food imports, and their susceptibility to global food prices and exchange rate depreciation. For example, farmers who could potentially shift to other crops, such as pulses, palm and soybean that are mostly imported, do not do so because existing incentives and policy focus are mainly aligned with major crops.⁴⁸

Lastly, weak farm to market linkages also adds to price pressures. In the absence of adequate storage and logistics, such as cold storage chain, crop wastage is high whose cost is added to the price paid by consumers. Moreover, growers of vegetables and fruits are exploited by market agents, particularly pre-harvest contractors whose cash margins equal about a third of retail price. Unlike best practices, the long list of intermediaries in Pakistan's farming sector supply chain means that consumers end up paying inflated prices. There is also evidence of opaque trading practices and traders' collusion which distort competitive prices.⁴⁹

Administered Prices: Energy

The federal and provincial governments' policies of price administration and regulation in Pakistan are also contributing to underlying inflationary pressures in several sectors, such as pharma, dairy, and

⁴⁵ Studies show that a reduction in wheat procurement volume need not compromise wheat price and supply stability, which can be managed through trade openness and price bands based on using rules based adjustable tariffs that set floor and ceiling prices to follow world prices. Source: Ahmed, S. A. & Gautam, M. (2013)

⁴⁶ WB (2022); Ahmed, S. A. & Gautam, M. (2013); A.W. Rana (2020)

⁴⁷ Ahmed, S. A. & Gautam, M. (2013); WB (2022); WB (2023)

⁴⁸ SBP (2022) b; SBP (2019); USDA (2022)

⁴⁹ A. Khalid & Sabahat (2020); Gafoor, A. et al. (2022); Ejaz, N. & Ahmed, M. (2017); Horst, A. & Watkins, S. (2022); WB (2022)

meat, as well as agriculture produce where there are intermittent focus on regulating retail price. On the one hand, this results in sharp adjustments when price revisions become unavoidable. On the other hand, capping of prices disincentivises investments in efficient production, storage and distribution which could help increase competition and lower prices in the medium to long term. One sector, where administered prices and other regulatory challenges present a major structural factor behind high inflation in Pakistan, is energy.⁵⁰

With rising global energy prices, the share of energy in explaining variation in inflation across economies has increased over time. This is not only because energy costs raise the cost of goods and services produced thereof, but also because higher energy costs positively affects inflationary expectations.⁵¹ In Pakistan, energy prices have the third biggest direct contribution to headline inflation index after food and core inflation. However, it also contributes to both food and core components through input costs, such as electricity and transport.⁵² In addition to the rising cost of energy imports, a host of policy and structural challenges in energy sector — both power and gas — manifests as peculiar country characteristics that are driving inflationary pressures in Pakistan.

These policy and regulatory challenges impact inflation through different channels, such as untargeted subsidies and discretionary pricing policy discussed in the preceding sub-section on fiscal policy. This sub-section sheds light on supply side constraints and policy challenges that are contributing to overall costlier energy tariffs and supply shortages in both power and gas sectors for several years.⁵³

Power:

In the power sector, both policy factors, inefficiencies in generation, transmission constraints, and under-utilization of efficient plants are contributing to higher tariffs. For instance, as part of the power policy's 'take or pay' pricing model, power tariffs include capacity purchase price (CPP), which comprises fixed costs, such as land and infrastructure for power evacuation, debt servicing charges; and guaranteed return on equity which is indexed to the US dollar. In addition to the USD, other components of the CPP are indexed with various factors, such as domestic interest rates, foreign interest rates, domestic inflation, foreign inflation. The indexation is reviewed and adjusted on a quarterly basis.⁵⁴

These capacity payments are charged at the rate of full production capacity

⁵⁰ Nazar, N. (2021); Kugelman, M. et al. (2015); Khan, U. et al. (2021)

⁵¹ Abbas, H. et al. (2015)

⁵² For instance, the transport sector is the largest user of petroleum product with very high and inelastic demand for diesel and petrol, generating inflationary pressures in the country. Source: M. Omer (2018)

⁵³ NEPRA (2023); CDPR (2015)

⁵⁴ "During life of the project operations, quarterly adjustment/indexations for local inflation, foreign inflation, exchange rate variations and interest rate variations will be made on 1st July, 1st October, 1st January and 1st April each year based on latest available date with respect to CPI notified by the Pakistan Bureau of Statistics (PBS), US CPI issued by US Bureau of Labor Statistics and selling rate of foreign currencies (US Dollar, British Pound Sterling Euro and Japanese Yen) issued by the National Bank of Pakistan." Source: MoWP (2015)

irrespective of the units of electricity produced and sold which inflates unit prices.⁵⁵ This problem worsens in times of exchange rate depreciation, higher global and domestic interest rates, and rising inflation, which has been the trend in recent years.

Moreover, the insufficient and overloaded transmission system also contributes to higher capacity payments. Similarly, there are instances when the merit order list of efficient power plants⁵⁶ is not followed. This implies that consumers pay for costlier units produced by inefficient plants in addition to the capacity charges paid for the unutilized capacity of the efficient plants.⁵⁷

In addition, due to frequent electricity outages, businesses resort to costlier alternatives, such as power generation through petrol, diesel or RLNG.⁵⁸ While the cost of such private power generation is not directly tracked by the NCPI inflation, it nevertheless contributes to cost of goods and services and hence adds to inflationary pressures.

Gas:

In the gas sector, inadequate and discretionary policy both from the

perspective of pricing and usage has been a longstanding issue. Tariffs for household consumers have been kept well below those for industry, power plants and commercial users. Household consumers, which had a share of about 23 percent in total gas consumption in FY22, have been given priority access to gas compared to commercial and industrial producers.⁵⁹ This has had a two pronged affect. At one end, the pricing policy increases the cost of gas paid by commercial and industrial users who pass on the impact to retail price of goods and services. At the other end, the pricing policy as well as inefficient⁶⁰ usage of gas particularly by domestic consumers has resulted in faster depletion of the country's gas reserves.

In order to address the growing supply-demand gap, Pakistan started imported LNG in 2015. However, unlike global best practices, Pakistan did not have a policy to pool the cost of domestic and imported gas until recently, owing to the policy of subsidizing household consumers at the cost of commercial, industrial and other large consumers. As a result, producers of goods and services were paying much higher tariffs than they would have paid had Pakistan's gas price policy graduated to that of weighted average cost.⁶¹

⁵⁵ NEPRA (2023)

⁵⁶ Power generation plants listed in order of efficiency.

⁵⁷ SBP (2019); NEPRA (2022); NEPRA (2023)

⁵⁸ NEPRA (2023)

⁵⁹ CDPR (2015)

⁶⁰ For example, the ubiquitous use of gas geysers that have an efficiency of only 30 percent. The now defunct policy of gas allocation to transport sector is another example of inefficient usage. Conservation through efficient usage could potentially save up to 20 percent gas resources. CDPR (2015)

⁶¹ In 2022, the government passed a bill for weighted average cost of gas (WACOG), under which gas from all sources was to be priced on weighted average cost basis. However, the bill has not been implemented yet.

Demography

The effect of demography on inflation is noted to be a cumulative and a slow process, which has a non-trivial impact over the long term.⁶² The impact can be both disinflationary and inflationary. The contrasting nature of this impact is rooted in several factors, the most critical of which is the demographic structure. In particular, it is the nature and extent of the dependency ratio of a country's population—the proportion of young (below 15 years of age) and old population (over 64 years of age) to total population — that effects inflation outcomes.

The primary channels through which demographic structure impacts inflation is aggregate demand and aggregate supply. Both the young and old cohorts of a population contribute to aggregate demand without providing labour and thus do not contribute to aggregate supply. However, depending on a variety of factors—such as life expectancy, growth in per capita income, and the level of savings— high dependency ratio is found to be disinflationary in the presence of high old age dependency, and inflationary when high dependency ratio is driven by young dependency.⁶³

High old age dependency is disinflationary because they tend to consume less compared to young dependents, and they also typically accumulate some savings during their life-cycle, particularly during

their middle ages. The middle aged working population (MAWP) — population 40-64 years of age — is found to have a disinflationary impact given their status as net savers i.e., their income is more than their consumption. The peak of lifecycle savings also usually occur in this age bracket.⁶⁴

Moreover, if life expectancy is high, the MAWP saves for post-retirement years. The lower these years are perceived to be, the less individuals choose to save to fund their future consumption. The savings of both the aging MAWP and old population are typically invested in safer assets, such as bonds, especially government bonds, rather than riskier assets such as real estate or stocks. On the contrary, high young dependency contributes to low savings, given their net consumer status, whereas it can also increase the size of fiscal deficits because of a low direct tax base.⁶⁵

Most research at the intersection of demography and inflation has focused on developed economies. For example, early researchers studied Japan, being one of the first fast ageing AEs, followed by studies on some European economies. More recent studies focus on emerging economies, such as China, Chile and Mexico.⁶⁶ Research on Pakistan at this nexus is scant except for Jafri et al. (2016). Based on 1988-2014 data, the paper finds that population growth contributes to increase in inflation in Pakistan, whereas increase in MAWP contributes to decrease in inflation.

⁶² Han, G. (2022)

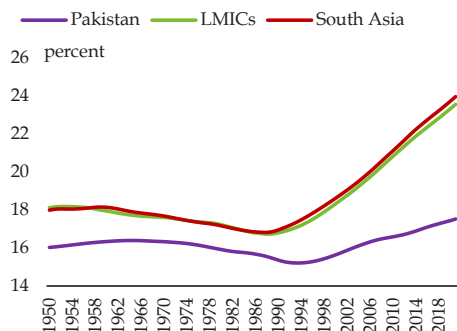
⁶³ Lee, J. et al. (2014); Han, G. (2022)

⁶⁴ Jaffri, A.A. et al. (2016); Hammer, B. et al.; Nayab, D. & Siddique, O. (2020)

⁶⁵ Anderson, D. et al. (2014); Lindh, T. & Malmberg, B. (2000); Katagiri, M. et al. (2014)

⁶⁶ Bobeica, E. et al. (2017); Broniatowska, P. (2019); Han, G. (2022)

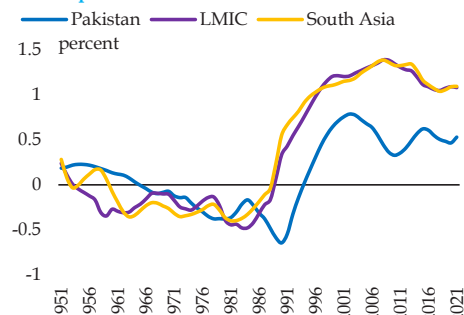
Share of MAWP in Total Population Figure 6.18



Sources: SBP Staff Calculations, United Nations Population Division

The underlying message from research on developed and developing economies is this: high dependency ratio driven by old dependency tends to be disinflationary if accompanied by increasing life expectancy and high level of savings. Conversely, high dependency ratio of a population is inflationary when youth dependency is high; life expectancy is low; and there is low level of savings. On all of these metrics Pakistan does not perform well.

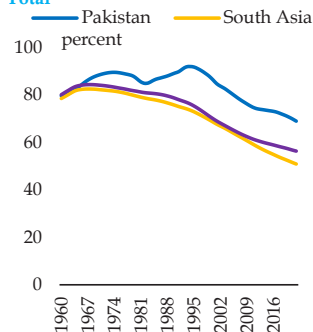
Difference of Growth in MAWP and Total Population Figure 6.19



Sources: SBP Staff Calculations, United Nations Population Division

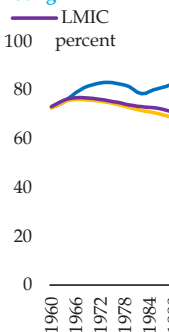
Pakistan's share of MAWP relative to its total population is low when compared to peer economies (Figure 6.18). While Pakistan's MAWP growth net off population growth,⁶⁷ rose during the 90s, it has stagnated over the last 20 years and remains low compared to peer economies (Figure 6.19). At the same time, young dependency remains high owing to high fertility rates (Figure 6.20a, 6.20b & 6.20c).⁶⁸ Likewise, while life expectancy

Dependency Ratio - Total Figure 6.20 a

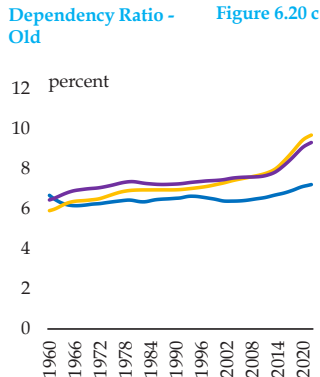


Source: World Bank

Dependency Ratio - Young Figure 6.20 b



Dependency Ratio - Old Figure 6.20 c



⁶⁷ Assuming equal impact, a positive MAWP growth net of population growth creates disinflationary pressures.

Source: Jaffri, A. A. et al. (2016)

⁶⁸ SBP (2021).

has improved to 66 years over time, it remains much lower compared to 80 years of advanced economies, which have experienced disinflationary pressures .

As a result, the life-cycle deficit, which refers to income net off consumption, persists until 29 years of age in Pakistan. This is compared to a minimum of 23 (France) and a maximum of 27 (Italy) in a sample of 10 European countries. Evidence from studies in National Transfer Accounts, which estimates the generational economy, shows that the saving age not only begins much later in Pakistan, it also ends much earlier than other countries. Moreover, the working age population, saves less than other countries indicating lower productivity or labour market imperfections.⁶⁹ These conditions may continue to stoke long term inflationary pressures.

6.4 Final Remarks

Notwithstanding the importance of various determinants of inflation, such as global commodity prices and fiscal policy, and the structural issues that need to be addressed to achieve price stability on a sustainable basis, the role of monetary policy remains instrumental given that money supply and inflation expectations have been found to be significant contributors to inflation. Nonetheless, the size of adjustments in the policy rate and its consequent economic costs can be substantially reduced by addressing the long standing policy and structural challenges.

The SBP has taken measures during the ongoing high inflationary episode to contain demand pressures and prevent de-anchoring of inflation expectations. In addition to a host of macro-prudential measures, the SBP cumulatively raised the policy rates by 1500 basis points during FY22 and FY23. Since June FY23, it has maintained the policy rate at 22 percent, as adjustments in administered energy prices, in the backdrop of longstanding structural issues, continue to impact inflation outturns. As a result of monetary tightening, supported by some fiscal consolidation, lower global commodity prices, and improved domestic crop output, the NCPI inflation came down from its peak of 38 percent in May 2023 to 29.7 percent in December 2023, whereas core inflation has also gradually started to decelerate.

Whilst the SBP will continue to anchor inflationary expectations and contain the second round impact of supply-shocks, as and when need be, further fiscal consolidation and reduction in uncertainty is imperative to achieve the medium term target of 5 – 7 percent by the end of FY25. Further, given the intensive and successive nature of inflationary pressures stemming from non-monetary sources and vulnerabilities thereof, policy and structural challenges need to be addressed as a necessary tailwind to create a conducive environment for a long-term disinflationary trend to set in and to achieve low and stable inflation on a sustainable basis.

⁶⁹ Hammer, B. et al. (2014); Nayab, D. & Kanwal, N. (2023); Nayab, D. & Siddique, O. (2020)

To effectively anchor inflationary expectations, it is important that the government sets the inflation target range in consultation with the SBP — ala the practice of joint agreements between the government and central bank in other countries, such as Canada, India and England. It also necessitates that deviations from planned fiscal policies, including the setting of administrative prices, are neither significant in magnitude nor in timing to avoid affecting monetary policy credibility and stoking long term inflationary expectations.

In addition, sectoral reforms in agriculture and energy are critical to address the issues of supply side constraints and inefficiencies, and their impact on prices. It is also imperative to relax the policy of price administration and to de-cap prices to help increase competition in the medium to long term and thereby lower inflationary pressure. Moreover, whilst productivity growth is needed to improve supplies and lower per unit costs, there is also a need to significantly lower the pace of population growth to ease underlying demand pressures in the long term.

Given the wide ranging scope of these challenges, a whole-of-the-government approach, across federal, provincial and local tiers of government and institutions, is needed as part of consistent efforts to bring down the long term trend of high inflation in Pakistan. The absence of such an approach risks overburdening the monetary policy as the sole instrument to keep inflation low and stable. Reforms to address the structural weaknesses would make monetary policy more effective and

efficient. Moreover, as flagged at various occasions in preceding sections, there are gaps in collective and up to date understanding of inflation dynamics in the country. Plugging these gaps in understanding requires concerted efforts by academia, government institutions, and policy research institutes alike.

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Annexure A: Data Explanatory Notes

- 1) **GDP:** In case of an ongoing year, for which actual GDP data is yet not available, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.
- 2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI (national, urban, or rural) from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation (}_{\text{Ht}}) = \left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation (}_{\text{YoYt}}) = \left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation (}_{\text{MoMt}}) = \left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where I_t is consumer price index in t^{th} month of a year. The CPI can be national, urban or rural.

For detailed information on the methodology, please see:
www.pbs.gov.pk/content/methodology-2

- 3) **Change in debt stock vs financing of fiscal deficit:** The change in the stock of gross public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing, whereas financing is calculated by adjusting the government borrowing with its deposits held with the

banking system; (ii) changes in the stock of debt also occur due to movements in exchange rates, both PKR and other currencies against US Dollar, which affect the rupee value of external debt.

- 4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

- (a) Government borrowing for budgetary support:

Borrowing from State Bank¹: The federal government may borrow directly from SBP either through the “Ways and Means Advance” channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). Ways and Means Advance allows government to borrow up to Rs 100 million at a time in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir (AJK) may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum. However, the Federal Government has taken over from the State Bank of Pakistan (SBP) the business of direct credit to provincial governments on 29th June 2020. In this regard, the federal government has executed tripartite agreements with four provincial governments and SBP (as executor) for extension of Ways and Means loans on account of Federal Government Central Account No.I (non-food) on 29th June 2020.

Borrowing from scheduled banks: This is mainly through (i) fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs); (ii) monthly auction of 3, 5, 10, 15, 20 and 30 year fixed rate Pakistan Investment Bonds (PIBs); (iii) fortnightly auctions of 2, 3, 5, 10 year floating rate PIBs; (iv) Sukuk and (v) Bai Muajjal of Sukuk (on deferred payment basis). However, provincial governments are not allowed to borrow from scheduled banks.

¹ This was applicable before the amendments in the SBP Act in January 2022. According to Section 9C (1) of the SBP Act (as amended up to 28 January, 2022), the SBP “shall not extend any direct credits to or guarantee any obligations of the Government, or any government owned entity or any other public entity.”

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

- 5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.
- (a) **Financing of budget deficit (numbers reported by MoF vs SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.
- (b) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on banking data, which depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record).

List of Abbreviations

A

ADB	Asian Development Bank
AEs	Advanced Economies
AFLP	Agriculture Finance Literacy Program
AIIB	Asian Infrastructure Investment Bank
AJK	Azad Jammu & Kashmir
AMF	Arab Monetary Fund
ATL	Active Taxpayer List

B

BCS	Business Confidence Survey
BDI	Baltic Dry Index
BE	Budget Estimates
BEOE	Bureau of Emigration and Overseas Employment
BIS	Bank for International Settlements
BISP	Benazir Income Support Program
BPM6	Balance of Payments and International Investment Position Manual - Sixth Edition
BPS	Basic Pay Scale
BSC	Behbood Saving Certificates

C

CAD	Current Account Deficit
CATIC	China National Aero-Technology Import and Export Corporation
CBU	Completely Built Units
CCS	Consumer Confidence Survey
CD	Circular Debt
CD	Customs Duty
CDC	Central Depository Company
CDMP	Circular Debt Management Plan
CiC	Currency in Circulation
CKD	Completely Knocked Down
CNG	Compressed Natural Gas

Covid-19	Coronavirus Disease 2019
CPFTA	China Pakistan Free Trade Agreement
CPI	Consumer Price Index
CPP	Capacity Purchase Price
CPPA	Central Power Purchasing Authority
CY	Calendar Year

D

DAP	Diammonium Phosphate
DFIs	Development Financial Institutions
DISCO	Distribution Companies
DRAP	Drug Regulation Authority of Pakistan
DSC	Defense Saving Certificates

E

EAD	Economic Affairs Division
ECP	Election Commission of Pakistan
ECs	Exchange Companies
EDS	External Debt Servicing
EE	Export Earnings
EFF	Extended Fund Facility
EFS	Exports Finance Scheme
EMDEs	Emerging and Developing Economies
EU	European Union

F

FAO	Food and Agriculture Organization
FBR	Federal Board of Revenue
FCA	Federal Committee on Agriculture
FCA	Fuel Charge Adjustment
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FEE	Foreign Exchange Earnings

FISIM	Financial Intermediation Services Indirectly Measured
FPI	Foreign Portfolio Investment
FRR	Fixed Rental Rate (Sukuk)
FTPL	Fiscal Theory of Price Level
FX	Foreign Exchange
FY	Fiscal Year

G

G&S	Goods and Services
GCC	Gulf Cooperation Council
GCPI	Global Commodity Price Index
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GIS-FRR	Government of Pakistan Ijara Sukuk – Fixed Rental Rate
GIS-VRR	Government of Pakistan Ijara Sukuk – Variable Rental Rate
GoP/GOP	Government of Pakistan
GST	General Sales Tax
GVA	Gross Value Addition
GVC	Global Value Chain
GWh	Gigawatt Hours

H

H1	First Half
H2	Second Half
HICP	Harmonized Index of Consumer Prices
HSD	High Speed Diesel
HVA	High Value Added

I

ICT	Information and Communications Technology
IDB	Islamic Development bank
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund

IPPs	Independent Power Producers
IT	Information Technology

K

KESC	Karachi Electric Supply Company
Kg	Kilogram
KIBOR	Karachi Interbank Offered Rate
KP/KPK	Khyber Pakhtunkhwa

L

LCV	Light Commercial Vehicle
LIBOR	London Interbank Offered Rate
LMICs	Low Middle Income Countries
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
LT	Long Term
LTFF	Long Term Financing Facility

M

M2	Broad Money
M2M	Mark to Market
MAWP	Middle Aged Working Population
MDM	Mobile Device Manufacturing
MIPE	Monthly Industrial Production and Employment Survey
MMBTU	Million British Thermal Units
MMT	Million Metric Tons
MNCs	Multinational Corporations
MNFSR	Ministry of National Food Security and Research
MoM	Month on Month
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
MSP	Minimum Support Price

MT Metric Tons

N

NAIRU Non-Accelerating Inflation Rate of Unemployment

NCCPL National Clearing Company of Pakistan Limited

NCPI National Consumer Price Index

NEER Nominal Effective Exchange Rate

NEPRA National Electric Power Regulatory Authority

NFC National Finance Commission

NPC Naya Pakistan Certificate

NSS National Saving Schemes

NTR Non-tax revenue

O

OCAC Oil Companies Advisory Council

OECD Organisation for Economic Co-operation and Development

OPEC Organization of the Petroleum Exporting Countries

P

PAMA Pakistan Automobile Manufacturing Association

PBA Pensioners' Benefit Account

PBS Pakistan Bureau of Statistics

PD Primary Dealer

PDL Petroleum Development Levy

PFGDS Public Food Grain Distribution System

PFLs Floating-rate PIBs

PIBs Pakistan Investment Bonds

PKR Pakistani Rupee

POL Petroleum, Oil, and Lubricants

PRI Pakistan Remittance Initiative

PSDP Public Sector Development Programme

PSEs Public Sector Enterprises

PSX Pakistan Stock Exchange

Q

Q1 First Quarter

Q2 Second Quarter

Q3 Third Quarter

Q4 Fourth Quarter

QIM Quantum Index of Large Scale Manufacturing Industries

QNA Quarterly National Accounts

QoQ Quarter on Quarter

R

RDA Roshan Digital Account

REER Real Effective Exchange Rate

RIC Regular Income Certificates

RISE Resilient Institutions for Sustainable Economy

RLNG Re-gasified Liquefied Natural Gas

S

SA Saving Accounts

SBA Stand-By Arrangement

SBP State Bank of Pakistan

SECP Securities and Exchange Commission Of Pakistan

SISA Sarwa Islamic Savings Accounts

SITA Sarwa Islamic Term Accounts

SKD Semi Knocked Down

SLA Staff-Level Agreement

SOFR Secured Overnight Financing Rate

SSA Special Saving Account

SSC Special Saving Certificate

SUPARCO Pakistan Space & Upper Atmosphere Research Commission

SVAR Structural Vector Autoregression

T

T&D	Transmission & Distribution
TFP	Total Factor Productivity

U

UAE	United Arab Emirates
UK	United Kingdom
UNOCHA	United Nations Office for the Coordination of Humanitarian Affairs
US	United States
US\$	United States Dollar
USD	United States Dollar
USDA	United States Department of Agriculture

W

WBG	World Bank Group
WHT	Withholding Tax
WPI	Wholesale Price Index

Y

YoY	Year on Year
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