LEADING ISSUES IN THE ECONOMY OF PAKISTAN:

Agenda for Reforms

Hafiz A. Pasha

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Foreword

Pakistan has suffered from chthe ronic economic crisis and has been muddling through a financial crisis currently and her economy is staggering on collapse due to a possible political crisis, the rupee plunging and inflation at decades-high levels, devastating floods, and a significant shortage of energy. Moreover, the low growth rates, high levels of debt, inflation, low productivity, and poor competitiveness have, among other factors, contributed to widespread poverty and slow development in Pakistan. Solving the key problems of Pakistan and its vibrant society, therefore, requires overcoming the economic calamities Pakistan has been facing for too long.

Economic experts think that Pakistan's economic crisis has several causes. Political instability and poor governance have been significant factors that undermine the country's fiscal position. Pakistan is also highly import-dependent, particularly with regard to energy, which renders it acutely vulnerable to hikes in global oil and gas prices.

Dr. Hafiz Pasha is highly aware of these interconnections. He is an economist who is not losing sight of society, which the economy should serve and facilitate. FES Pakistan is happy to publish Dr. Pasha's latest book "Leading issues in the economy of Pakistan" which is a wide-ranging program for economic reform in Pakistan. To overcome the crisis of the economy he insists that reform has to focus on key economic variables, but also has to actively deal with so many other fields, from health to education.

We sincerely hope that this publication will be taken up by the policymakers, economists, and by parliamentarians and their leadership of all political parties in Pakistan. Hopefully, it will be a constructive contribution to enhance the awareness of economic reform, and to demonstrate how a progressive and workable reform should look like. May it be of good use to Pakistan and help reducing the real pain of ordinary people and build a new economic consensus to overcome country's economic challenges.

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March 2023

Introduction

Pakistan finds itself today in a big financial crisis which could lead to difficulties in the honoring of the external payment obligations. There is a dire need for undertaking a careful study of the factors responsible for this crisis, the resulting impacts on the people of Pakistan and the wide-ranging reforms that need to be undertaken to emerge successfully from this crisis.

This book on leading issues in the economy of Pakistan covers these areas. In view of the topical nature of this kind of book attempts have been made to expedite the research, write the chapters, and facilitate early publication.

The first part of the book looks at the economic performance of the last three governments and the SBP. This is followed by an economic review of 2021-22 and the economic outlook for 2022-23, including the large negative impact of the floods and of physical restrictions placed on imports in the presence of very scarce foreign exchange reserves.

The second part of the book focuses on the current IMF program which was resumed in earlier September 2022. The impact of prior actions and reforms committed to by the government to the IMF up to March 2023 are highlighted. An assessment is made on implementation of reforms in the first quarter of 2022-23 as part of the ninth program review. Reasons for delays in the completion of the review are highlighted.

The third part highlights some key burning issues. The first chapter assesses the degree of vulnerability of Pakistan to a default situation and the likely depreciation of the rupee in 2022-23 if a market-based exchange rate policy is followed.

Thereafter, an in-depth analysis is undertaken of the causes of the high rate of inflation and the impact thereof is highlighted. The next chapter attempts a quantification of the impact of the floods and the contractionary policies being followed on the level of unemployment and poverty. This part concludes with the sad news that Pakistan has fallen from the middle to the low level of development according to the Human Development Index of the UNDP.

The first three parts of the book have highlighted the need for strong, urgent and wide-ranging policy measures and improvements in governance. There are four chapters in this final part of the book related to sustaining trade and the balance of payments, managing the public finances, removing impediments to growth, and improving economic governance. It is imperative that the recommended measures are implemented to salvage the economy.

Thanks are due to *Next Capital Limited* for financially supporting the research undertaken for the book. The assistance of Muhammad Imran and Muhammad Rizwanullah Khan is also acknowledged.

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PART-1

PERFORMANCE OF THE ECONOMY AND OUTLOOK

Chapter 1:

Economic Performance of Three Governments

The previous Prime Minister had asked for a comparison of the economic performance of his government with that of previous governments. Further, the PTI has recently disseminated a White Paper on *State of Pakistan's economy*. This chapter documents the performance of the economy from FY 2013 to FY 2018 when PML(N) was in power and compared with the performance of the economy from 2019 to 2022 during the tenure of the PTI government. The objective of this special chapter is to undertake an objective and unbiased comparison of the last three governments. Analysis is undertaken of the change in key macroeconomic indicators during the tenure of three governments.

The first government is the PPP government which was in power from 2008-09 to 2012-13. The second government is that of the PML(N) which held office in Islamabad from 2013-14 to 2017-18. The third government is of the PTI which was in the federal government since 2018-19 and its tenure came to an end in late 2021-22.

The assessment of economic performance is a complex and difficult exercise. There is need first to recognize the role of exogenous factors like trends in the world economy and global trade which impact on individual economies. In particular, the role of international commodity prices, especially of oil, must be fully allowed for.

There are also several domestic factors which affect performance during the tenure of a particular government. In the Pakistani context, this particularly includes the impact of power loadshedding, acts of terrorism and natural disasters. Also, Pakistan has witnessed major constitutional changes like the 18th Amendment and the 7th NFC Award after 2010 which have changed the roles and distribution of resources between federal and provincial governments.

Consequently, the report is organized as follows. Section 1.1 focuses on trends in the world economy from 2007-08 to 2021-22. Section 1.2 highlights the change during these years in domestic factors like the incidence of acts of terrorism, power outages and natural disasters.

Section 1.3 onwards focus respectively on economic growth, investment, employment, inflation, public finances, balance of payments and the international rankings of Pakistan. The analysis has been undertaken with the help of a Macro economic Model of Pakistan developed by the author with 60 equations.

1.1 Trends in the World Economy

The trends in the world economy during the tenures of the three governments are presented in Table 1.1. The conditions in the global economy appear to have been somewhat more favorable from 2013-14 to 2017-18, during the tenure of the PML(N) government. At the time of assumption to power by the PPP government, the oil price had reached the peak level of $140 per barrel, after a period of boom in the world economy. It fell to $46 per barrel in 2016-17.

Table 1.1: Trends in the World Economy (%)

	Growth Rate of World Economy	Growth Rate of Volume of World Trade	Growth Rate of the International Commodity Price Index	Growth Rate of Crude Oil Price
2008-09 to 2012-13	3.3	3.1	0.7	2.1
2013-14 to 2017-18	3.5	3.5	-5.5	-8.4
2018-19 to 2020-21	1.9	2.1	6.3	-2.0

Source: *IMF*

The pandemic, COVID-19, spread globally in early 2020. The year, 2019-20, saw negative growth in the global economy of 3 percent and fall in volume of world trade of over 5 percent. Clearly, this impacted negatively on the domestic economy in the second year of the PTI government. Fortunately, there has been a relatively strong recovery in 2021.

1.2 Negative Factors in the Domestic Economy

The big negative impact on Pakistan's economy has been the upsurge in acts of terrorism in the country after the US invasion of Afghanistan following 9/11 and Pakistan's support to this operation. The incidence of acts of terrorism and lives lost due to the attacks are given in Table 1.2.

Table 1.2: Annual Number of Terrorism Attacks and Number of Persons Killed

	Number of Terrorist Attacks	Average Annual g%	Number of Persons killed	Average annual g%
2005-06	675		907	
2007-08	2577	67.0	7997	a*
2010-11	2985	4.9	7107	-3.9
2012-13	1717	-27.6	2451	-53.2
2015-16	748	-27.7	1956	-7.5
2017-18	497	-20.4	1516	-12.7
2018-19	433	-12.9	1030	-38.6
2020-21	207	-36.9	335	-56.1

** Very large*
Source: *Institute of Peace Studies, Islamabad.*

Table 1.2 reveals that the number of attacks grew rapidly and reached a peak in 2010-11. It was only after the attack on the Army Public School that a National Action Plan against terrorism was prepared during the tenure of the PML(N) Government in 2015-16. This led to the launch of Zarb-e-Azb operation by the armed forces, especially in FATA. Thereafter, there has been a big decline in the incidence of terrorism.

The rampant acts of terrorism imposed both indirect and indirect costs on the economy of a large magnitude. The direct costs include the damage to property and loss of lives. The indirect costs consist of fall in investment due to heightened risk perceptions, negative movement in share prices, increase in expenditure of the armed forces, and in higher costs for maintaining law and order.

The Ministry of Finance has estimated in the Pakistan Economic Survey of 2013-14 that the total cost cumulatively of the war on terror from 2001-02 to 2013-14 was as high as $102.5 billion. The peak of these costs was in 2008-09 and 2009-10 of $13.6 billion and $23.8 billion respectively.

The path of acts of terror and the resulting costs indicate that the largest burden of these costs has been during the tenure of the PPP government. Costs were also high in the initial three years of the PML(N) government, but much lower thereafter following the successful anti-terrorism operation by the military. Fortunately, the PTI government has largely not been hampered by terrorism. However, there are more attacks now, especially in Baluchistan and in Khyber-Pakhtunkhwa. The magnitude of this negative factor must be kept in mind when evaluating the performance of different governments.

The other big constraining factor impacting on the economy has been the incidence of power loadshedding. Table 1.3 indicates the growth rate in the level of installed capacity and in the quantum of generation of electricity.

Table 1.3: Growth in Installed Capacity and Generation of Electricity

	Average Annual Growth Rate (%)	
	Installed Capacity	Generation
2003-04 to 2007-08	0.1	4.2
2008-09 to 2012-13	3.2	0.1
2013-14 to 2017-18	7.7	6.2
2018-19 to 2021-22	5.7	5.9

Source: *Pakistan Economic Survey.*

The Musharraf period witnessed hardly any expansion in electricity generation capacity, but the rate of utilization of available capacity reached a peak level by 2007-08. Consequently, there was little excess capacity in the initial years of the PPP government. In the last three years there was a modest expansion in capacity. The incidence of power loadshedding reached a peak in 2008-09. It is estimated that this resulted in a loss annually of almost 2 percent of the GDP.

Credit must be given to the PML(N) government for cumulative expansion in capacity for power generation by almost 47 percent, equivalent to an additional 10,742 MW, in the latter part of its tenure, Chinese investment was attracted as part of CPEC. This has contributed further to additional capacity of almost 10,000 MW up to 2021-22.

Here again, the larger component of costs of power outages on the national economy have been borne during the tenure of the PPP government. These costs declined sharply in the last three years of the PML(N) government and have been non-existent in the first three years of the PTI government. Overall, the role of negative factors has been much greater during the tenure of the PPP government.

1.3 Rate of Economic Growth

Following identification of the external environment and impact of different domestic and negative factors in the three different regimes, assessment of the performance in key macroeconomic indicators is undertaken in this section and subsequent sections.

The first performance indicator analyzed is the rate of economic growth. Table 1.4 gives an in-depth picture of the growth performance in the first and last years, as well as the average, for the PPP and PML(N) governments. This is shown for the first and the fourth years of the PTI government. There is need to emphasis that comparison over time has been rendered difficult by the change in the base year of the GDP from 2005-06 to 2015-16. The GDP series with base year of 2015-16 has been extrapolated backwards to 2007-08 in Annexure 1.

The average annual GDP growth rate has been the highest during the tenure of the PML(N) government at 4.7 percent, as compared to 2.8 percent in the period of the PPP government and 3.5 percent in the PTI government tenure up to 2020-21. These growth rates are all low by historical standards.

There has been a pattern in the annual GDP growth rates. All three governments have achieved a higher growth rate in the last year of their respective tenures. This is the consequence of the pursuit of expansionary fiscal and monetary policies prior to the elections in the case of the PPP and PML(N) governments, while the last year of the PTI government saw a strong recovery after COVID-19.

Among the productive sectors, a somewhat higher growth rate was achieved during the PPP tenure in agriculture, despite the damage due to floods in 2009-10. Industrial growth and expansion of services proceeded faster in the five years of the PML(N) Government.

The contribution from the demand side of different expenditures has varied substantially. The fastest growth among different expenditures during the period of PPP government is observed in government consumption expenditure. This is attributable mostly to expansion in the employment of provincial governments following the 7th NFC Award and to liberal wage awards to federal employees.

Table 1.4: Growth Rate of the Economy in different Governments										(%)
		PPP			PML(N)			PTI		
	2007-08	1st Year 2008-09	Average*	5th Year 2012-13	1st Year 2013-14	Average	5th Year 2017-18	1st Year 2018-19	Average	4th Year 2021-22
GROWTH RATE OF ECONOMY**										
• GDP at factor cost	5.0	0.4	2.8	3.7	4.1	4.7	6.1	3.1	3.5	6.0
BY SECTOR										
• Agriculture	1.8	3.5	2.4	2.9	2.5	2.2	3.9	0.9	3.2	4.4
• Manufacturing	8.5	-5.2	1.3	1.4	5.7	5.1	7.1	5.0	4.0	6.2
• Services	4.9	1.3	3.5	4.5	4.5	5.2	5.6	5.0	4.0	6.2
BY EXPENDITURE										
• Household Consumption Expenditure	3.6	-0.5	2.7	2.5	5.6	6.0	7.2	5.6	5.6	10.1
• Government Consumption Expenditure	-0.9	12.7	5.6	10.2	1.5	6.1	5.5	-1.6	1.3	-3.4
• Private Investment	3.9	-3.6	-2.8	2.7	5.6	5.5	7.1	-1.7	-1.2	-0.5
• Public Investment	6.4	-8.7	-6.0	-7.3	-7.1	12.4	18.5	-33.0	-5.3	12.6
• Exports of Goods and Services	-4.6	-3.4	2.0	13.6	-1.5	-0.1	10.0	13.2	7.3	8.4
• Imports of Goods and Services	5.9	-15.9	-2.9	1.6	0.3	9.5	15.7	7.6	8.2	15.6
Source: *PES*										

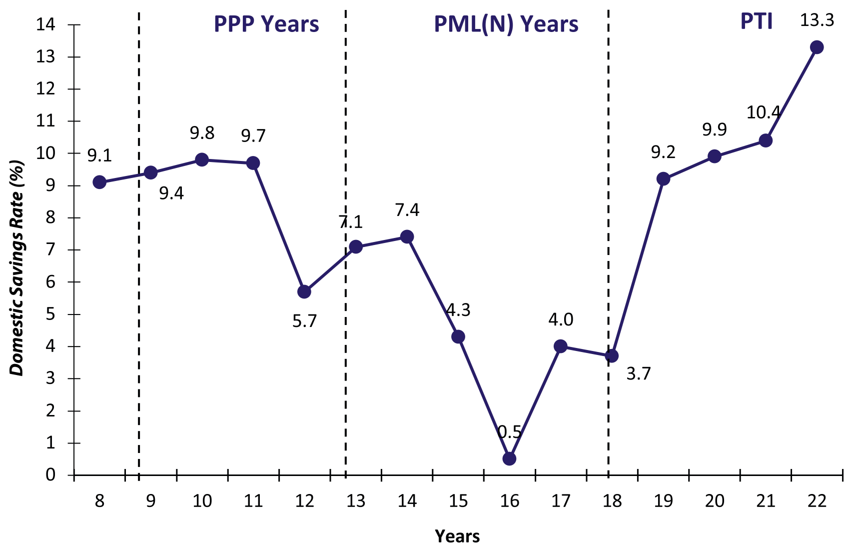
During the PML(N) tenure the fastest growth is observed in public investment of over 12 percent per annum. Also, household consumption expenditure showed relatively high growth rate of over 6 percent. One of the more redeeming features of the performance of the PTI government is the fastest growth rate among the three governments in exports of goods and services at over 7 percent.

The worrying development during the tenure of the PML(N) government is the extreme widening in the trade gap. Exports of goods and services showed no growth in real terms, while the volume of imports grew annually on average by over 9 percent.

The pattern of growth in expenditure raises some doubts about the validity of the GDP growth rate estimate from 2013-14 to 2017-18. The very unexpected finding is that almost 92 percent of the increase in the size of the GDP is due to the increase in household consumption expenditure. Such a high marginal propensity to consume is very unusual. The same pattern is visible after 2017-18. It may be because household consumption expenditure is estimated as a residual and has been overstated because other expenditures were inadequate in explaining the apparent increase in aggregate demand in the economy.

The big increase in household consumption expenditure in the five years of the PML(N) Government also implies that the domestic saving rate was low in the economy during these years, as shown in Figure 1.1. The same pattern is observed in the initial three years of the PTI government.

Figure 1.1: Domestic Saving Rate *(Derived from the Pakistan Economic Survey)* *(% of GDP)*



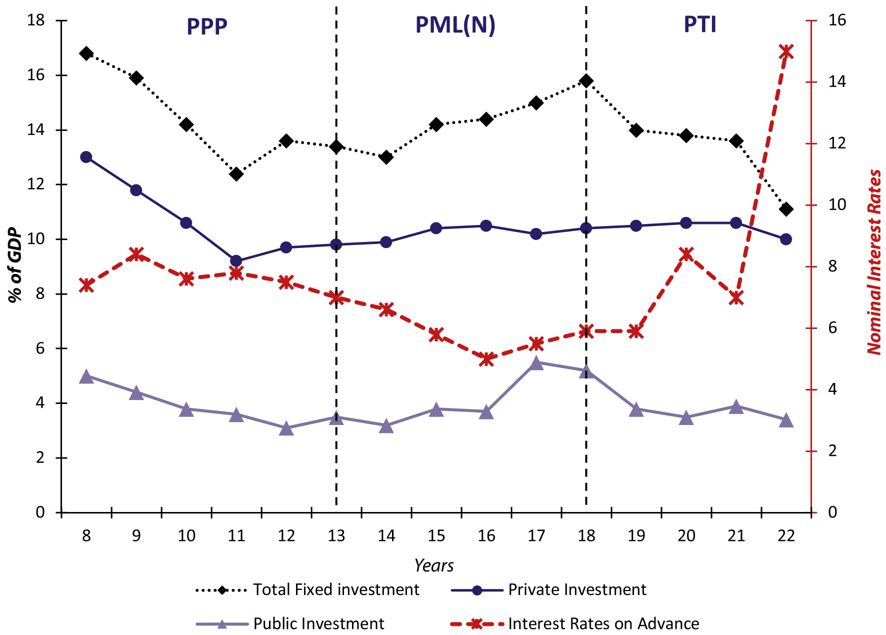
Source: *PES*

1.4 Investment

Pakistan historically has had a relatively low level of investment as percentage of the GDP. It is close to half the level in other South Asian countries. However, the incremental capital-output is lower, and this has enabled an economic growth rate on average of 4 to 4.5 percent.

The path of investment from 2007-08 to 2021-22 is shown in Figure 1.2. The high level of power loadshedding and incidence of acts of terrorism led to a big fall in the overall rate of investment during the PPP government from 18 percent of the GDP to only 12.5 percent of the GDP.

Figure 1.2: Trend in Total, Private and Public Investment and Interest Rate on Bank Advances



Source: *PES*

The negative factors ceased to pay a big role from 2015-16 onwards as highlighted in Section 1.2. Investment picked up and rose to above 15 percent of the GDP by 2017-18. After COVID-19, it had fallen again to below 14 percent of the GDP.

The level of private investment plunged to below 10 percent of the GDP during the tenure of the PPP government from almost 13 percent of the GDP in 2007-08 and has since risen to almost 11 percent of the GDP. Perhaps surprisingly, there has been a cyclical pattern in public investment. It fell from 2007-08 to 2012-13, rose sharply up to 2017-18 and has since fallen once again.

The peak attained during the PML(N) Government in public investment is partly attributable to the commencement of the CPEC. This led a big rise in development allocations especially for highway projects. Also, Chinese companies have invested heavily in coal and solar power generation during the last six years.

The Macroeconomic Model has been used to quantify the role of different factors in influencing the growth rate of real private investment in the country. The results are presented in Table 1.5.

Table 1.5: Impact of different factors on Growth Rate of real Private Investment *(%)*

	2007-08 to 2012-13	2012-13 to 2017-18	2017-18 to 2021-22
Growth Rate of Real Private Investment *(%)*	**-2.8**	**5.5**	**-1.2**
Growth Rate of Real GDP *(the 'accelerator')*	2.0	4.6	2.5
Rise in Real Interest Rate on Bank Advances	-1.1	-1.3	0.2
Rise or Fall in the Relative Price of Imported Machinery	-2.1	1.3	-2.1
Rise or Fall in the Rate of Corporate Profitability	-0.3	1.4	-0.3
Impact of Negative Factors *(Power loadshedding, terrorism, COVID-19)*	-1.3	-0.5	-1.5

During the period, 2007-08 to 2012-13, the 'accelerator' effort on private investment was more than neutralized by a rise in the real interest rate on bank advances, big jump in the rupee price of imported machinery, fall in corporate profitability, the high incidence of power loadshedding and acts of terrorism. These were indeed difficult years for the private sector of Pakistan.

In contrast, the years, 2012-13 to 2017-18, saw an average growth rate of 5.5 percent annually in the level of real private investment. The accelerator effect was stronger, import prices of machinery in rupees did not rise much due to the less depreciation in the value of the rupee and corporate profitability rose significantly.

The level of real private investment fell marginally from 2017-18 to 2021-22. Interest rates were brought down sharply after COVID-19. The largest negative impact is due to the escalation in the cost of imported machinery due to the continuing process of devaluation of the rupee. Also, the spread of COVID-19 initially discouraged further expansion in capacity.

1.5 Employment

A critical measure of performance of governments is the creation of more employment opportunities for the people.

The growth in employment hinges crucially on the rise in output in different sectors of the economy. This relationship is measured by the employment to output elasticity, which indicates the percentage increase in employment with a 1 percent increase in output. The Macroeconomic Model has enabled the determination of the long-run average elasticity, which is given below for the three productive sectors respectively:

Employment-to-Output Elasticity		
Agriculture	Industry	Services
0.601	0.545	0.721

The problem is the overstatement of employment in the Labor Force Survey of 2020-21. This is explained in Chapter 18.

Table 1.6 highlights the trends in employment in the three eras.

Table 1.6: Employment Trends						*(million)*
	2007-08	2012-13	g %	2017-18	g %	2020-21**
• Labor Force Participation Rate *(%)*	45.2	45.7	**0.2**	44.3	**-0.6**	44.9
• Labor Force	51.78	59.74	**2.9**	65.50	**1.8**	71.80
• Employed	49.09	55.01	**2.6**	61.71	**1.9**	67.25
• Unemployment Rate	5.2	6.2	**3.5**	5.8	**-1.3**	6.5
INDUSTRY DISTRIBUTION						
• Agriculture	21.89	24.49	**2.2**	23.76	**-0.6**	25.13
• Industry	9.47	12.02	**4.8**	14.62	**3.9**	16.90
• Services	17.73	19.50	**1.9**	23.33	**3.6**	25.22
EMPLOYMENT STATUS						
• Employers	0.44	0.73	**10.1**	0.36	**3.3**	0.94
• Self-Employed	16.78	18.81	**2.3**	21.47	**2.6**	23.87
• Unpaid Family Workers	14.19	14.73	**0.7**	13.21	**-2.2**	14.18
• Employees	17.68	21.74	**4.1**	26.17	**3.7**	28.25
FORMAL AND INFORMAL SECTOR*						
• Formal	7.40	8.26	**2.2**	10.62	**5.0**	11.57
• Informal	19.80	23.19	**3.2**	27.33	**3.3**	30.55

**Outside Agriculture*

***No Survey in 2021-22. Growth rate not derived from 2017-18 to 2020-21, because of overstatement of employment*

Source: *Labor Force Surveys, PBS*

The labor force participation rate of population aged 10 years and above is relatively low in Pakistan at below 50 percent, due particularly to the low rate of entry of females into the labor market. It attained a peak of almost 46 percent in 2012-13 and has since fallen below 45 percent in 2017-18. The highest rate of annual increase was apparently observed in the first three years of the PTI government.

The labor force surveys also reveal that the growth rate of employment was higher in the PPP tenure then during the period of the PML(N) government, even though the economy grew at a faster rate in the latter period. This is partly attributable to the big increase in jobs in provincial governments after the 7th NFC Award.

The only period when there was a fall in the unemployment rate was in the tenure of the PML(N) government, when it declined from 6.2 percent to 5.8 percent. After the spread of COVID-19, there was a big loss of jobs. Despite the economic recovery in 2020-21 and 2021-22, the unemployment rate remains high of 6.5 percent. This has been recently contradicted by the PBS which estimates the unemployment rate at only 5.4 percent in 2020-21. As highlighted earlier, the growth in employment between 2018-19 and 2020-21 has been consciously overstated as the employment-to-output elasticities are much higher than has historically been the case.

As development proceeds, the normal expectation is that the employment will shift from the traditional sector, agriculture, to the modern sectors of industry and services. However, the only period where this has been witnessed is from 2012-13 to 2017-18, when employment declined in agriculture. The fast growth of other sectors enabled absorption of an additional 6.4 million workers during these years.

The positive development in the five years of the PPP government was an increase in the share of employees and a decline in the share of the self-employed. This provided for greater job security. Also, the share of jobs in the formal sector has been growing steadily in the three eras.

1.6 Inflation

Another key indicator of the performance of a government is its success in restricting the rate of increase in prices, especially of food items. Table 1.7 gives the rate of inflation, overall and disaggregated, in the first and last years, as well as the average, during the tenure of a particular government.

The highest average annual rate of increase in the overall consumer price index (CPI) was during the period in office of the PPP government. It was high by historical standards at 11 percent. The assumption to office by the PML(N) government saw a perceptible drop in the rate of inflation, especially in the last three years. Consequently, the five-year average was under 5 percent. The rate of inflation has accelerated during the tenure of the PTI government, from 6.8 percent in 2018-19 to over 12 percent in 2021-22.

Throughout the period, 2008-09 to 2012-13, the rise in food prices significantly outpaced the increase in non-food prices. During its first year, the PPP government made a quantum jump in the procurement price of wheat by 52 percent to raise net incomes of farmers and boost production. As opposed to this, the PML(N) government maintained a tight lid on the wheat price. Overall, it had considerable success in keeping the increase in food prices over the five years to below 4 percent per annum. More recently, there has been a big escalation in the rate of increase in food prices to almost 13 percent in 2021-22.

Table 1.7: Trends in the Rate of Inflation *(%)*

Rate of Inflation in	PPP			PML(N)			PTI		
	1st Year 2008-09	Average	5th Year 2012-13	1st Year 2013-14	Average	5th Year 2017-18	1st Year 2018-19	Average	4th Year 2021-22
CPI	**17.0**	**11.1**	**7.4**	**8.6**	**4.9**	**4.7**	**6.8**	**9.3**	**12.2**
• Food Prices	23.1	**13.4**	7.1	9.0	**3.9**	1.8	4.8	**10.9**	13.0
• Non-Food Prices	13.4	**9.7**	7.5	8.3	**5.2**	5.4	8.0	**8.4**	11.6
• Implicit GDP Deflator	20.7	**11.9**	6.4	7.0	**3.6**	2.5	8.8	**10.3**	14.0
• Core Inflation	11.4	**9.2**	9.5	6.6	**6.0**	5.8	7.2	**7.2**	8.1
SOME KEY PRICES									
• Wheat Procurement Price	52.0	**13.0**	14.3	0.0	**1.6**	0.0	0.0	**13.6**	22.2
• HSD Oil	3.6	**7.1**	-21.3	-4.1	**8.4**	46.6	6.2	**6.7**	30.1
• Motor Spirit	-23.4	**-1.6**	-22.5	7.9	**7.2**	36.6	13.2	**11.7**	38.0

Source: *PBS*

The key administered prices are the prices respectively of wheat, motor spirit and HSD oil. They generally reflect the movement in import prices, but when these are unusually high, downward adjustments can be made in tax rates. Alternatively, when the global prices of petroleum products are low, the petroleum levy is enhanced. Table 1.7 reveals massive fluctuations in the price of motor spirit and HSD oil over the years.

The 'core' rate of inflation focuses on the rate of increase in non-food and non-fuel prices. It is considered as a better reflection of the overall demand or cost-push pressures on prices. Historically, it has guided the posture of monetary policy.

There are contrasting trends in the three periods. During the PPP years, the 'core' rate of inflation was below the overall rate of increase in the CPI. This pattern changed during the tenure of the PML(N). The core rate of inflation was higher at 6 percent. During the tenure of the PTI government, it was also operating at a lower rate.

1.7 Public Finances

The trends in public finances are presented in Tables 1.8 to 1.10. They have been derived from the information on fiscal operations released quarterly by the federal Ministry of Finance.

Sustainability of the growth process requires that fiscal deficits remain at a manageable level in terms of access to relatively low-cost financing and that the level of government debt is restricted. The Fiscal Responsibility and Debt Limitation Act of 2005 had set the limit on government debt at 60 percent of the GDP. This limit was breached for the first time in 2012-13.

Table 1.8 presents the picture of public finances of the federal and provincial governments combined. Total revenues as percentage of the GDP have shown a variable trend. They attained a peak in the tenure of the PML(N) Government. This was achieved by enhancement of the tax-to-GDP ratio to 11.5 percent. However, during the tenure of the PTI Government it has fallen to 10 percent of the GDP.

Table 1.8: Broad Trends in Public Finances
(Consolidated Position of Federal and Provincial Governments) *(% of GDP)**

	PPP		PML(N)		PTI	
	First Year 2008-09	Terminal Year 2012-13	First Year 2013-14	Terminal Year 2017-18	First Year 2018-19	Fourth Year 2021-22*
Total Revenue	**13.5**	**12.0**	**13.0**	**13.4**	**11.2**	**12.0.**
Tax Revenue	8.8	8.8	9.2	11.5	10.2	10.1
Non-Tax Revenue	4.7	3.2	3.5	1.9	1.0	1.9
Total Expenditure	**18.5**	**19.3**	**18.0**	**19.2**	**19.0**	**19.9**
Current Expenditure	**14.9**	**14.7**	**14.4**	**15.0**	**16.2**	**17.2**
Debt Servicing	4.7	4.0	4.1	3.9	4.7	4.8
Defense Expenditure	2.4	2.2	2.3	2.6	2.6	2.1
Others	7.8	8.5	8.0	8.5	8.9	10.3
Development Expenditure and Net Lending	3.6	4.6	3.6	4.2	2.8	2.5
Budget Deficit	**-5.0**	**-7.3**	**-5.0**	**-5.8**	**-7.8**	**-7.9**
Primary Deficit	**-0.3**	**-3.3**	**0.9**	**-1.9**	**-3.1**	**-3.1**

**at current prices with base year of 2015-16*

Source: *MOF*

Total expenditure has remained at close to 19 – 20 percent of the GDP in the last five years. Earlier, it had shown a rising trend from under 20 percent of the GDP in the initial years of the PPP government. The lid on total expenditure as percentage of the GDP has implied a sharp cut in the level of development spending in the presence of a rising level of current expenditure, with negative impact on the growth process. In particular, the cost of debt servicing has risen significantly as percentage of the GDP.

Budget deficits as percentage of the GDP have been relatively low during the tenure of the PML(N) government. However, the last year of both the PPP and PML(N) governments has witnessed the use of expansionary fiscal policies to improve election prospects.

Table 1.9: Trend in Tax-to-GDP Ratio *(%)*

	PPP		PML(N)		PTI*	
	1st Year 2008-09	5th Year 2012-13	1st Year 2013-14	5th Year 2017-18	1st Year 2018-19	4th Year 2021-22
A. FEDERAL	**9.4**	**8.3**	**8.1**	**9.9**	**9.3**	**9.7**
Direct Taxes	**3.2**	**2.9**	**3.2**	**4.0**	**3.3**	**3.4**
Income Tax	3.2	2.9	3.2	4.0	3.3	3.4
Indirect Taxes	**6.3**	**5.4**	**4.9**	**5.9**	**6.0**	**5.9**
Sales Tax	3.4	3.8	3.6	3.8	3.3	3.8
Customs Duty	1.0	1.1	0.3	1.6	1.6	1.5
Excise Duty	0.9	0.5	0.5	0.5	0.5	0.5
B. PROVINCIAL	**0.3**	**0.6**	**0.6**	**1.1**	**0.9**	**0.9**
C. TOTAL TAXES	**9.7**	**8.9**	**8.7**	**11.0**	**10.2**	**10.2**
Share of Direct Taxes	**33.0**	**32.6**	**36.7**	**36.0**	**32.8**	**33.3**

**With the GDP with base year 2015-16*

Source: *MOF*

The trend in revenues from different taxes is shown in Table 1.9. The peak was attained during the tenure of the PML(N) Government. A number of proposals were implemented to broaden the income tax base and raise the effective tax rates in indirect taxes. The tax-to-GDP ratio now stands at close to 10.2 percent of the GDP and the share of indirect taxes has declined somewhat.

1.8 Balance of Payments

Perhaps the most critical area from the viewpoint of management of the national economy is the balance of payments in external transactions of the country. Table 1.10 presents the trends from 2007-08 onwards in different accounts of the balance of payments. These accounts are respectively the current account, the capital account, and the financial account.

Table 1.10: Trend in Balance of Payments							($ billion)
	Current Account	Capital Account	Financial Account	Errors & Omissions	Balance of Payments	Reserves	Δ* (Reserves)
2007-08	-13.9	0.1	8.1	0.3	-5.4	9.7	-5.5
2008-09	-9.3	0.4	5.6	0.1	-3.1	10.3	0.6
2009-10	-3.9	0.2	5.1	-0.1	1.3	14.0	4.1
2010-11	0.2	0.1	2.1	0.0	2.4	15.6	2.1
2011-12	-4.7	0.2	1.3	-0.1	-3.3	11.9	-4.4
2012-13	-2.5	0.3	0.5	-0.3	-2.0	7.2	-4.5
2013-14	-3.1	1.9	5.6	-0.4	4.0	10.5	3.4
2014-15	-2.8	0.4	5.1	0.0	2.7	14.8	4.6
2015-16	-5.0	0.3	6.9	0.5	2.7	19.4	4.7
2016-17	-12.3	0.4	9.9	0.1	-1.9	17.6	-2.8
2017-18	-19.2	0.4	13.6	-0.9	-6.1	11.4	-6.2
2018-19	-13.4	0.2	1.8	-0.1	-1.5	9.3	-1.9
2019-20	-4.4	0.3	9.3	0.2	5.3	13.7	4.6
2020-21	-1.9	0.2	8.2	-1.0	+5.5	18.7	4.4
2021-22	-17.4	0.2	11.1	-0.3	-6.4	9.8	-8.9
Source: *SBP*							

The current account deficit was at a peak of almost $14 billion, due especially to the extremely high oil price in 2007-08. Thereafter, it showed a sharply declining trend up to 2015-16. After 2015-16 the exponential growth in the deficit is largely attributable to the big rise in the real effective exchange rate implying that the rupee was kept substantially overvalued. The PML(N) government apparently chose this strategy to keep the inflation rate very low especially prior to the elections. However, this led a 30 percent jump in imports from 2015-16 to 2017-18.

The bottom line in terms of the level and change of foreign exchange reserves reflects the size of the current account deficit and net inflows into the financial account. A clear cyclical pattern is visible in the level of reserves. From 2007-08 to 2010-11, they rose from $9.7 billion to $15.6 billion. They then fell to $7.2 billion in 2012-13. Between 2012-13 and 2015-16 they rose rapidly once again to reach the peak of $19.4 billion in 2015-16 and then declined sharply to $11.4 billion just before the exit of the PML(N) government. This was followed by another cycle and the year, 2021-22, closed with relatively low foreign exchange reserves of $9.8 billion.

1.9 International Rankings of Pakistan

This last section of the chapter focuses on Pakistan's ranking in key international indices. This highlights not only external perceptions of the country but also can act as a measure of the performance of different governments.

Four indices have been selected as shown in Table 1.11. The first is the human development index of the UNDP. Pakistan has had a relatively low ranking, even among South Asian countries. Unfortunately, the ranking has continued to worsen from 2008 to 2022. Pakistan was ranked 125th among 180 countries in 2008. It is ranked 161st in the latest ranking and it has fallen from medium to low level of development.

Table 1.11: Ranking of Pakistan in Different Indicators

Years	Human Development Index Ranking (UNDP)	Global Competitiveness Ranking (World Economic Forum)	Corruption Perceptions Index (Transparency International)	CPIA Economic Management (World Bank)	CPIA Fiscal Management (World Bank)
2008	125	92	134	3.0	2.5
2013	146	112	127	2.8	2.5
2018	150	107	117	3.2	3.0
2020-2022	161	110	140	3.3	2.5

The next is the Global Competitiveness Index of countries prepared by the World Economic Forum. The path of ranking is somewhat cyclical. It deteriorated significantly from 2008 to 2013; improved somewhat from 2013 to 2018 and has then worsened once again.

The third index is the Corruption Perceptions Index. The good news here is that Pakistan's ranking improved substantially from 134th in 2008 to 117th in 2018. Unfortunately, it has fallen sharply to the 140th position in 2020.

The World Bank undertakes Country Policy and Institutional Assessment (CPIA) of countries in the performance of different functions and assigns a score from a low of 1 to a high of 6. Table 1.11 gives Pakistan's score in the quality of economic management in different years.

There is some fluctuation in the scores over the years. It fell somewhat during the PPP tenure. The highest score has been in 2020, which was the second year of the PTI government. This is perhaps a reflection of the stellar job of the Government in limiting the loss of lives and livelihood after the first COVID-19 attack.

1.10 The Economic Performance Index

The economic performance of three governments from 2008-09 to 2021-22 of the PPP, PML(N) and the PTI respectively has been measured by construction of an Economic Performance Index (EPI). The index focuses on eight areas of performance as follows:

1	Achieving higher growth
2	Promoting larger investment
3	Raising the standard of living
4	Containing the rate of inflation
5	Sustaining the external balance of payments
6	Limiting the burden of public debt
7	Raising low level of social development and reducing poverty
8	Providing more and better employment opportunities

The individual indicators used to measure performance in each area are listed in Chart-1.1. Some indicators reveal a better performance if they have a higher magnitude. In other indicators, a lower value represents an improvement in performance as, for example, the rate of inflation. There is need also to emphasize that during the tenure of a particular political party at the federal level there could be a diverse set of parties in the four provincial governments who also play a role in influencing the economic outcomes.

The values of each indicator have been estimated for the following periods:

PPP	**2009-09 to 2012-13**
PML (N)	**2013-14 to 2017-18**
PTI	**2018-19 to 2021-22**

Magnitudes of the indicators are given in Annexure-2. As highlighted earlier, the base year of the GDP was changed from 2005-06 to 2015-16.

There has been conversion of the indicators into indices, with values ranging from 0 to 1, by adoption of the following methodology:

Chart 1.1: Indicators in each Area of Economic Performance	
INDEX OF ECONOMC GROWTH	**INDEX OF TRADE AND THE BALANCE OF PAYMENTS**
• Growth Rate of Agriculture	
• Growth Rate of Industry	• Growth Rate in Volume of Exports
• Growth Rate of Services	• Growth Rate in Volume of Imports
• Growth Rate of Real Per Capita Income	• Level* of the Current Account Deficit
INDEX OF INVESTMENT	• Import Cover of Foreign Exchange Reserves
• Level* of Private Investment	• Growth Rate of External Debt
• Level* of Public Investment	**INDEX OF FISCAL POLICY**
INDEX OF INFLATION	• Level* of Revenues
• Rate of Inflation in Food Prices	• Level* of Current Expenditure, excluding Debt Servicing
• Rate of Inflation in Non-Food Prices	
• Rate of 'Core' Inflation	• Level* of Development Expenditure
INDEX OF CONSUMPTION	• Level* of Primary Surplus / Deficit
• Growth Rate of Household Consumption	• Change in the Level* of Public Debt
• Growth Rate of Government Consumption	**INDEX OF EMPLOYMENT**
INDEX OF SOCIAL DEVELOPMENT AND PROTECTION	• Growth Rate in Labor Force
	• Growth Rate in Employment
• Level* of Spending on Social Sectors	• Growth Rate in Number of Unemployed
• Level* of Subsidies and Cash Transfers	• Growth Rate of Employment in the Formal Sector
	• Growth Rate of Female Employment

**as % of GDP*

In the case where increase in the indicator represents better performance

$$\text{Index} = \frac{\text{Actual Value} - \text{Minimum Value}}{\text{Maximum Value} - \text{Minimum Value}}$$

In the case where a decrease in the indicator implies better performance

$$\text{Index} = \frac{\text{Maximum Value} - \text{Actual Value}}{\text{Maximum Value} - \text{Minimum Value}}$$

The maximum value is taken as 33 percent above the maximum actual observed value in the three epochs. The minimum value is 33 percent below the minimum actual observed value in the three epochs. This ensures that the index value ranges from 0 to 1.

There are two levels of aggregation. The first is the aggregation of individual indices to a composite index of performance in a particular area. The indices of performance in different areas are then aggregated into the overall Economic Performance Index (EPI). The detailed methodology is given in the Annexure-3.

The estimated values of the indices in each area of performance in the three epochs are given in Table 1.12.

Table 1.12: Indices of Performance in Different Areas and the composite Economic Performance Index

Area of Performance	Era			Average
	PPP	PML(N)	PTI	
• Achieving higher growth	0.176	0.485	0.360	0.340
• Promoting Larger Investment	0.508	0.544	0.404	0.485
• Containing the Rate of Inflation	0.333	0.831	0.499	0.554
• Sustaining the External Balance of Payments	0.533	0.181	0.406	0.373
• Limiting the Burden of Public Debt	0.627	0.651	0.317	0.532
• Raining the Standard of Living	0.204	0.468	0.767	0.480
• Providing more and better Employment Opportunities	0.385	0.330	0.467	0.394
• Tackling Low Level of Human Development and Poverty	0.484	0.399	0.436	0.440
Overall Economic Performance Index (EPI)	**0.373**	**0.447**	**0.442**	**0.444**

A number of important conclusions emerge from the numbers in Table 1.12 as follows:

i) The overall EPI for the three tenures combined from 2008-90 to 2021-22 is 0.444. It is not even at 0.5. This implies that performance of governments during the fourteen-year period can be classified only as at the intermediate level.

ii) The EPI for the PML(N) and PTI governments is remarkably close. The EPI of the PPP government is significantly lower. This can at least be partially to the presence of more negative exogenous factors. Also, the performance of the PTI government was affected by COVID-19.

iii) The performance in different areas can be grouped as follows over the 14-year period as follows:

Poor EPI < 0.4	Intermediate 0.4 ≤ EPI < 0.5	Good 0.5 ≤ EPI
Achieving higher Growth	Promoting Investment	Containing the Rate of Inflation
Sustaining the External Balance of Payments	Raising the Standard of Living	Limiting the Burden of Public Debt
Providing more and better Employment Opportunities	Tackling the Low Level of Social Development and Poverty	

Clearly, there has been success in limiting the rate of inflation especially in the period 2013-14 to 2017-18. Also, the public debt to GDP has tended to flatten or show limited increase in earlier years.

The failure of all parties, especially the PML(N), has been in sustaining the balance of payments. It is not surprising that today Pakistan faces a financial crisis of very low foreign exchange reserves.

Finally, Table 1.13 to 1.15 highlights the individual indices of good and poor performance respectively among the 28 indices. The poor performance is when the index value is below 0.4 and good when it is above 0.5. Indices which are not highlighted for a particular government are areas of intermediate performance with index value between 0.4 and 0.5.

The areas of poor performance of the PPP shown in Table 1.13 are economic growth, rate of inflation, enhancement in the standard of living and increase in the number of unemployed. A strong performance has been shown in raising the level of public investment, sustaining the balance of payments, in maintaining a relatively small primary budget deficit, in higher expenditure on subsidies and cash transfers (like the BISP) and achieving a higher growth rate of employment, especially of females.

Table 1.13: Areas of Good and Poor Performance of PPP Government 2008-09 to 2012-13

Areas of Poor Performance (I < 0.4)		Areas of Good Performance (I > 0.5)	
1. Rate of Agricultural Sector Growth	0.333	1. Level of Public Investment	0.540
2. Rate of Industrial Growth	0.059	2. Growth Rate in Volume of Imports	0.944
3. Rate of Growth of Services	0.277	3. Average Level of Current Account Deficit	0.805
4. Rate of Growth of Per Capita Income	0.124	4. Import Cover of Reserves	0.601
5. Rate of Food Inflation	0.301	5. Growth Rate of External Debt	0.959
6. Rate of Non-Food Inflation	0.340	6. Level of Current Expenditure (excluding debt servicing)	0.606
7. Rate of 'Core' Inflation	0.359	7. Level of Primary Surplus/Deficit	0.738
8. Rate of Growth in Household Consumption	0.149	8. Change in Level of Public Debt	0.925
9. Rate of Growth in Government Consumption	0.280	9. Level of Expenditure on Subsidized Cash Transfers	0.507
10. Level of Expenditure on Social Services		10. Growth Rate of Labor Force	0.578
11. Growth Rate of Unemployment	0.250	11. Growth Rate of Employment	0.536
12. Formal Sector Employment Growth	0.157	12. Female Employment Growth	0.696

The PML (N) government was relatively successful in achieving a higher GDP growth, keeping the rate of inflation low, raising the level of investment, while managing the budgetary magnitudes relatively well as shown in Table 1.14. The weak areas were the performance of agriculture and failure to sustain the balance of payments position leading to faster growth in external debt. Also, the growth rate of employment was relatively low.

Table 1.14: Areas of Good and Poor Performance of PML(N) Government 2013-14 to 2017-18

Areas of Poor Performance (I < 0.4)		Areas of Good Performance (I > 0.5)	
1. Growth Rate of Agriculture	0.258	1. Growth Rate of Industrial Sector	0.721
2. Growth Rate of Government Consumption	0.323	2. Growth Rate of Services	0.612
3. Growth Rate of Exports	0.021	3. Growth Rate of Per Capita Income	0.688
4. Growth Rate of Imports	0.194	4. Level of Private Investment	0.512
5. Level of Current Account Deficit	0.320	5. Level of Public Investment	0.579
6. Growth Rate of External Debt	0.270	6. Rate of Food Inflation	0.897
7. Level of Expenditure on Subsidies and Cash Transfers	0.286	7. Rate of Non-Food Inflation	0.818
8. Growth Rate of Labor Force	0.216	8. Rate of 'Core' Inflation	0.781
9. Growth Rate of Employment	0.254	9. Growth Rate of Household Consumption	0.677
10. Female Employment Growth	0.107	10. Import Cover of Reserves	0.550
		11. Revenues as % of GDP	0.559
		12. Level of Current Exp (excluding debt servicing)	0.631
		13. Level of Development Expenditure	0.641
		14. Level of Primary Surplus/Deficit	0.864
		15. Change in Level of Public Debt	0.597
		16. Level of Expenditure on Social Services	0.556
		17. Growth Rate of Unemployed	0.998

The PTI government was successful in raising the growth rate of agriculture, keeping the rate of 'core' inflation relatively low, showing faster growth in household consumption, exports and spending on social sectors and employment, especially of females as shown in Table 1.15. The weak areas were growth in the industrial and services sectors, especially because of COVID-19, restricting the growth in the volume of imports and not sustaining development spending, yet seeing a rise in the primary budget deficit and public debt. Further, there was faster growth of the number unemployed. Pro-poor interventions also declined after 2019-20.

Table 1.15: Areas of Good and Poor Performance, PTI Government 2018-19 to 2021-22			
Areas of Poor Performance (I < 0.4)		Areas of Good Performance (I > 0.5)	
1. Growth Rate of Industry	0.222	1. Growth Rate of Agriculture	0.620
2. Growth Rate of Services	0.339	2. Rate of 'Core' Inflation	0.603
3. Growth Rate of Per Capita Income	0.392	3. Growth Rate of Household Consumption	0.627
4. Level of Public Investment	0.338	4. Growth Rate of Government Consumption	0.938
5. Growth Rate in Volume of Imports	0.268	5. Growth Rate of Volume of Exports	0.740
6. Level of Current Account Deficit	0.344	6. Growth Rate of External Debt	0.534
7. Import Cover of Reserves	0.302	7. Level of Expenditure on Social Services	0.573
8. Level of Revenues	0.381	8. Growth Rate of Labor Force	0.641
9. Level of Development Expenditure	0.216	9. Growth Rate of Employment	0.623
10. Leve of Primary Deficit	0.317	10. Female Employment Growth	0.640
11. Increase in Level of Public Debt	0.287		
12. Expenditure on Subsidies & Cash Transfers	0.382		
13. Growth Rate of Unemployment	0.335		
14. Formal Sector Employment Growth	0.2601		

Overall, the above areas of inadequacy should be carefully studied by each political party and reasons identified of failure. This will help in the preparation of manifestos for the next elections in 2023.

1.11 Conclusion

The years 2008-09 to 2021-22 have not been exceptional good years in the economic history of Pakistan. The average GDP growth rate has been relatively low while the rate of inflation has been relatively high. Very high levels of power loadshedding and acts of terrorism played a major role in restricting private investment and constraining productive activity up to 2015-16. The pandemic, COVID-19, then wreaked substantial damage on lives and livelihoods after March 2020.

Each of the three governments have made efforts to sustain the economy in difficult conditions. The PPP government built political consensus around the comprehensive 18th Amendment to the Constitution and the 7th NFC award. Also, greater focus was placed on agricultural productivity, human development, employment creation and poverty alleviation.

The PML-N government was able to revive private investment and accelerate growth. The constraint of limited power generation capacity was removed by the end of its tenure. Consensus was also built on the National Action Plan against terrorism, which was very effectively implemented by our Armed Forces. The CPEC program was launched in collaboration with China, envisaging investment of $60 billion in infrastructure projects. However, the current account deficit rose to a record level in 2017-18.

The PTI government first had to implement strong stabilization policies to bring down the current account deficit to a sustainable level, leading thereby to lower growth and higher inflation. The excellent job in managing the economy after the first COVID-19 attack in March 2020 has been internationally recognized, especially the various social safety nets put in place like the *Ehsaas* program.

Pakistan is close to a major financial crisis once again due especially to the rise in international commodity prices after June 2021, following recovery of the world economy and more recently after the start of the Russia-Ukraine war. This has led to exponential increase in external financing requirements. Whichever government is next in power after the 2023 elections will have to implement very strong fiscal, monetary, and other policies to restore the ability of Pakistan to fully meet these large external payment obligations and sustain the level of essential imports.

Chapter 2: SBP's Performance Since 2018

The State Bank of Pakistan (SBP) is the central bank with the responsibility of conducting monetary policy in the country. According to Section 4B of the SBP Act of 1956 the primary objective of the Bank shall be to achieve and maintain domestic price stability.

The 1956 Act says that without prejudice the Bank's primary objective, the Bank will contribute to the stability of the financial system of Pakistan. The Bank shall also support the Government's general economic policies to foster the development and fuller utilization of Pakistan's productive resources.

According to the Act the key functions shall be to:

A	B	C	D	E
Determine and implement monetary policy	Formulate and implement the exchange rate policy	Hold and manage international reserves of Pakistan	Issue and manage the currency of Pakistan	License, regulate and supervise scheduled banks

In early 2022, the new SBP amendment Act has been promulgated with greater autonomy and exclusive focus on price stability. The objective of this special report is to assess the performance of the SBP since 2018, after the induction of the PTI government.

This chapter has the following sections. Section 2.1 describes the state of the economy in 2017-18 prior to the induction of the PTI Government. Section 2.2 highlights the financial stabilization policies adopted by the SBP in 2018-19. Section 2.3 then describes the continuing search for financial stability. Section 2.4 highlights the positive role played by the SBP in the aftermath of COVID-19 attack. Section 2.5 quantifies the macroeconomic impact of monetary policy since 2018-19. Finally, Section 2.6 focuses on the incipient financial crisis that Pakistan faces today, and the role being played by the newly autonomous SBP along with other complementary actions that are required on a priority basis to avert a full-fledged crisis.

2.1 State of the Economy in 2017-18

The key macroeconomic magnitudes in 2017-18 are given below in Table 2.1, in the year prior to the induction of the PTI Government.

Table 2.1: State of the Economy in 2017-18			
1. GDP Growth Rate *(%)*	**6.0**	**4. Balance of Payments *($ billion)***	
By Sector		***Current Account***	***-19.2***
Agriculture	4.0	Exports of goods	24.8
Industry	4.5	Imports of goods	-55.7
Services	6.3	Trade deficit	-30.9
By expenditure		***Financial Account***	***13.6***
Household consumption expenditure	6.2	***Others***	***-1.1***
Private Investment	4.4	***Balance of Payments***	***-6.7***
Public Investment	28.3	***Level of Reserves***	***9.8***
Exports of goods and services	12.6	***(Months of import cover)***	***(1.6)***
Imports of goods and services	17.7	**5. Public Finances *(% of GDP)****	
2. Rate of Inflation *(%)*		***Revenues***	***15.2***
Consumer Price Index	3.9	Tax Revenues	13.0
'Core' Inflation	5.9	Non-Tax Revenues	2.2
3. Monetary Statistics		***Expenditure***	***21.8***
SBP Policy Rate (%) **	6.5	Current Expenditure	17.0
Exchange Rate (Rs/$) **	118.90	Development Expenditure	4.8
Real Effective Exchange Rate	107.48	***Budget deficit***	***-6.6***
(2010 = 100) Index		Primary deficit	-2.0

**With base year of 2005-06 | ** End of year*

Source: *PES | SBP | MOF*

The economy exhibited some strong features in 2017-18. The GDP growth rate had risen to 6.0 percent, the highest after 2006-07. All economic sectors were showing buoyancy. The rate of inflation was very low at 3.9 percent, with food prices rising by only 2.8 percent. Total investment was buoyant, especially public investment due to the peak of investment in power generation.

The SBP policy rate was relatively low at 6.5 percent in end-June 2018, close to the core rate of inflation. The exchange rate was Rs 118.90 per dollar, with a depreciation of 13 percent over the year. The currency was overvalued by 7.5 percent according to the real effective exchange rate.

The real concern was the sustainability of the growth process. The current account deficit in the balance of payments had reached the all-time peak level of $19.2 billion, equivalent to 6.4 percent of the GDP. Foreign exchange reserves which stood at $17.6 billion at the end of 2016-17, were down to $9.8 billion, equivalent to under two months of imports.

The state of public finances had also worsened. The budget deficit had reached 6.6 percent of the GDP as compared to 5.8 percent of the GDP in 2016-17, due largely to a rise in current expenditure. The Government debt to GDP ratio had risen to 66.9 percent of the GDP. This represented a major violation of the ceiling on the ratio at 60 percent of the GDP, imposed by the Fiscal Responsibility and Debt Limitation act of 2005.

2.2 SBP Policies for Stabilizing the Balance of Payments

The low reserves position at the end of 2017-18 prompted the SBP to pursue an aggressive monetary policy in 2018-19 to reduce the current account deficit, generate a surplus in the balance of payments and thereby build-up reserves once again.

Table 2.2 shows the monthly movement in the two instruments of monetary policy, namely the policy rate and the exchange rate, in 2018-19. The cumulative magnitude of the moves was very large. They led to depreciation in the rupee by almost 31 percent and a rise in the SBP policy rate by as much as 575 basis points.

Table 2.2: Monthly Policy Rate and Exchange Rate, 2018-19

POLICY RATE (%)		EXCHANGE RATE (Rs / $)	
28th May 2018	6.50	June 2018	118.90
2018-19		**2018-19**	
16th July 2018	7.50	July	124.35
1st October 2018	8.50	August	123.78
3rd December 2018	10.00	September	124.08
1st February 2019	10.25	October	130.38
1st April 2019	10.75	December	138.47
21st May 2019	12.25	January	138.69
Cumulative Change	**5.75**	February	138.53
Average	9.12	March	139.17
		April	141.16
		May	145.69
		June	155.24
		Cumulative Change	**30.6%**

Source: *SBP*

The basic question is what impact did these moves have on the balance of payments in 2018-19? A comparison is made of 2018-19 figures with 2017-18 in Table 2.3.

Table 2.3: Balance of Payments, 2017-18 and 2018-19			($ billion)
	2017-18	2018-19	Growth Rate (%)
1. Current Account Deficit	**-19.2**	**-13.4**	**-30.3**
Trade Balance	**-30.9**	**-27.6**	**-10.7**
Exports	24.8	24.2	-2.4
Imports	55.7	51.9	-6.8
Remittances	**19.9**	**21.7**	**9.0**
2. Financial Account	13.6	11.7	-13.9
Direct Investment	2.8	1.4	-50.0
Portfolio Investment	2.3	-1.3	-156.5
Government Inflow	**4.4**	**2.2**	**-50.0**
Disbursements	8.5	8.2	-3.5
Amortization	4.1	6.0	46.3
Central Bank Inflow	**1.5**	**5.5**	**a***
Others	**2.6**	**3.9**	**50.0**
3. Others	**-0.5**	**-1.2**	**a***
4. Balance of Payments	**-6.1**	**-2.9**	**-52.5**
5. Foreign Exchange Reserves	**9.8**	**7.3**	**-25.5**

** α means very large*

Source: *SBP*

The outcome was not as positive as was hoped. Despite the big moves, imports fell by less than 7 percent. Overall, the trade balance improved by less than 11 percent because exports declined despite the much better exchange rate offered to exporters.

The big surprise was the significant worsening of inflows into the financial account. The low reserves at the start of 2018-19 plus the big monetary policy moves heightened negative perceptions about Pakistan. There was a big outflow of equity funds from Pakistan and foreign direct investment fell by 50 percent. The net inflow also into the Government account was half the level of 2017-18.

The only positive development was large bilateral flows of deposits into the SBP from friendly countries like China, Saudi Arabia and the UAE adding up to $5.5 billion. However, the overall balance of payments remained in deficit in 2018-19 and reserves fell further to the critically low level of $7.3 billion, enough to provide import cover for only 1.2 months. Pakistan was left with no option but to go to the IMF.

In retrospect, the delay of over a year in going to the IMF for a three-year extended fund facility can be considered as a mistake. If there had been an umbrella of a Fund program in 2018-19 the flows into the financial account would have been larger. Also, the almost draconian increase in the policy rate and big depreciation of the rupee may not have been necessary.

2.3 The Continuing Search for Financial Stability

Pakistan entered a three-year Extended Fund Facility with the IMF in July 2019 of $6 billion. The macroeconomic projections made at that time in the Program for the period 2019-20 to 2021-22 are given in Table 2.4.

Table 2.4: Macroeconomic Projections in the IMF Program for Pakistan 2019-20 to 2020-21
(Made on July 2019)

	PROJECTIONS		
	2019-20	2020-21	2021-22
GDP Growth Rate	2.4	3.0	4.5
Rate of Inflation	13.0	8.3	6.0
Balance of Payments			
Current Account	**-6.7**	**-5.5**	**-5.3**
Financial Account	8.7	7.9	8.6
Others	0.7	0.6	0.6
Balance of Payments	2.7	3.0	3.9
IMF	1.6	0.2	0.6
Change in Reserves	**4.3**	**3.2**	**4.5**
End period Reserves	11.6	14.8	19.3

Source: *IMF Staff Report, July 2019*

Therefore, the Program projected a gradual acceleration in the GDP growth rate and decline in the rate of inflation. A reduction of 50 percent was targeted for in the current account deficit in 2019-20 with further reductions in the next two years. Consequently, the foreign exchange reserves were expected to rise from $7.3 billion in 2018-19 to $11.6 billion in 2019-20 and reach $19.3 billion by the end of 2021-22.

The SBP was expected to pursue an aggressive monetary policy with a market determined exchange rate and use of the policy rate to limit aggregate demand. The focus was on achieving sustained financial stability of the economy.

The actual moves that have taken place since June 2019 up to November 2022 are listed below in Table 2.5.

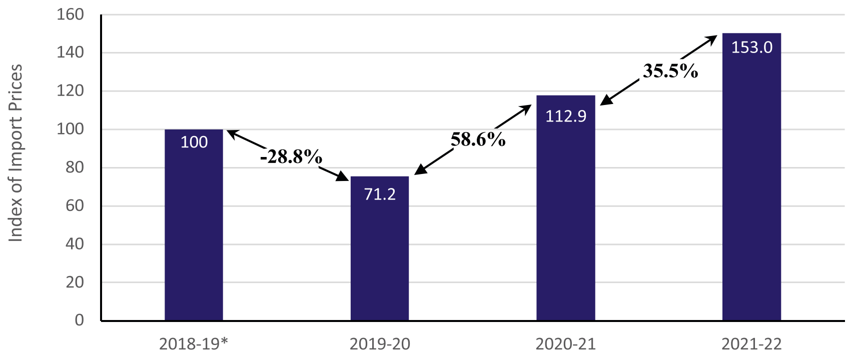
Table 2.5: Monthly policy rate and exchange rate June 2019 to November 2022 (%)

POLICY RATE (%)		EXCHANGE RATE (Rs / $) (end of month)	
June 2019	**12.25**	**June 2019**	**155.25**
17th July 2019	13.25	July 2019	158.18
18th March 2020	12.50	September 2019	156.18
25th March 2020	11.00	December 2019	154.92
17th April 2020	9.00	March 2020	158.45
18th May 2020	8.00	June 2020	165.10
26th June 2020	7.00	September 2020	165.85
21st September 2021	7.25	December 2020	160.07
22nd November 2021	8.75	March 2021	156.03
15th December 2021	9.75	June 2021	156.16
8th April 2022	12.25	September 2021	168.06
23rd May 2022	13.75	December 2021	177.17
13th July 2022	15.00	March 2022	184.18
28th November 2022	16.00	23rd May 2022	200.93
		June 2022	204.62
		September 2022	228.38
		November 2022	223.69

Source: *SBP*

The economic environment altered fundamentally in Pakistan after the country was hit by the pandemic, COVID-19, in March 2020. There was a big slowdown in economic activity. The world economy went into deep recession and international commodity prices plummeted. Pakistan's imports became cheaper because of this fall in global prices, as shown in Figure 2.1.

Figure 2.1: Index of Import Prices faced by Pakistan *(in $)*



As of June, each year, except in April of 2021-22.* | **Source: *Estimated from PBS imports data*

The overall unit value index of imports in US$ fell by as much as 28.8 percent in 2019-20.

The balance of payments position improved substantially. Imports fell by 16 percent in 2019-20 and the current account deficit declined by as much as 68 percent from $13.4 billion in 2018-19 to $4.4 billion in 2019-20. This was significantly better than the IMF Program target of $6.7 billion.

Reserves also rose by $4.6 billion, close to the Program target. However, the inflow into the financial account was smaller than in 2018-19. This was due to the flight of 'hot money' of $3 billion which had come into Pakistan when interest rates were at their peak, with the policy rate at 13.25 percent. Following COVID-19, the precipitous drop-in interest rates led to the exit of this money.

The IMF program was suspended because of the economic dislocation caused by COVID-19. A special loan was given to Pakistan in June 2020 by the IMF under the Rapid Finance Facility of $1.4 billion. The program was restored in late 2021 and the sixth review was successfully completed in February 2022. Pakistan also received a special SDR allocation of $2.8 billion in August 2021.

2.4 SBPs Role after Covid-19

There is need to fully recognize the extraordinary supporting role played by the SBP in the process of revival of economic activity after the COVID-19 attack.

The first step taken, as shown in Table 2.5, was a quantum reduction in the policy rate from 13.25 percent, which was set on 17^{th} July 2019, to 7 percent by 26^{th} of June 2020.

A scheme for facilitating new investment was introduced called the ***Temporary Economic Finance Facility (TERF)***. This was a concessionary refinance facility. The maximum limit was Rs 5 billion per project, with a 5 percent interest rate, payable in 10 years with a grace period up to 2 years, Between April 20 and March 21, Rs 436 billion was advanced as loans for 628 projects.

The second scheme was the ***loan extension and restructuring package*****,** which was essentially a debt relief scheme. The objective of the scheme was to preserve the solvency of borrowers at a difficult time. Accordingly, payment of the loan principal amount could be deferred for up to twelve months, while continuing servicing of the markup. Over 1.8 million borrowers have benefited from this scheme and the total loan amount deferred is Rs 910 billion, with Rs 121 billion to micro finance borrowers.

The third scheme was the ***SBP-Rozgar Scheme***. The objective was to prevent lay-off of workers by financing wages and salaries of employees of private sector units. The scheme was to cover the wage bill for 6 months, with the maximum loan limit of Rs 2 billion. Repayment was to be made in 8 equal quarterly installments. The amount disbursed under this facility is Rs 212 billion.

Pakistan is considered as one of the countries which has managed well the post-COVID-19 economic recovery process. A major contribution to this effort was by the SBP.

There has also been a spate of useful government innovations by the SBP in recent times. These include the *Roshan Digital Account* to connect overseas Pakistanis with local banks. Almost $4.2 billion of funds have been raised in this account. Recently the *Raast* instant and free payment system has been set up and the SBP is in the process of finalizing the *Digital Banking system.*

2.5 Macroeconomic Impact of Monetary Policy

The primary objective of the monetary policy has been to achieve financial stability especially by the augmentation of foreign exchange reserves and thereby to restrict the depreciation of the exchange rate and limit the rate of inflation.

The Macroeconomic Model has been used to quantify the impact of a 1-percentage point increase in the policy rate and 1 percent depreciation of the rupee respectively on macroeconomic variables like GDP growth and the rate of inflation. The results are shown in Table 2.6.

A 1 percentage point increase in the policy rate, leading to a corresponding rise in interest rates on advances and deposits, reduces private investment and promotes savings. It impacts on aggregate demand and reduces the GDP growth rate and the rate of inflation.

However, it also raises the cost of debt servicing on government loans and thereby leads to a larger deficit, which implies higher domestic borrowing and more rapid expansion in money supply and thereby to inflation. As such, the net impact of a hike in the policy rate on the rate of inflation is ambiguous.

A 1 percent depreciation of these exchange rate reduces private investment by raising the cost of imported machinery. Clearly, it adds to inflation by raising the price of imported consumer goods. However, it raises import-based tax revenues but raises the cost of servicing external debt.

Table 2.6: Impact of Changes in the Policy Rate and the Exchange Rate on Macroeconomic Variables *Impact * (% change)*

	Policy Rate up by 1 percentage point	Exchange Rate Depreciation by 1 percentage point
Rate of Inflation	-0.25	0.17
GDP Growth Rate	-0.31	-0.06
Budget Deficit	0.41	-0.10

**The impact coefficients have been derived by simulations of the Macroeconomic Model.*

Given the actual changes in the policy rate and exchange rate each year from 2018-19 to 2021-22 and the above coefficients the overall impact of monetary policy has been derived on GDP growth rate, the rate of inflation and the budget deficit in Table 2.7.

It may be observed that the size of the impacts is relatively large. The process of financial stabilization, especially of the external balance of payments, since 2018-19 has implied a significant reduction in the GDP growth rate and a higher rate of inflation. However, the year 2020-21 is an exception, when monetary policy played a major role in helping the economic revival process after COVID-19.

Table 2.7: Estimated Impact on Macroeconomic Variables of Monetary Policy 2018-19 to 2021-22 *(Combined Impact of Changes in Policy Rate and Exchange Rate) – (%)*

	GDP Growth Rate		Rate of Inflation	
	Actual	Impact	Actual	Impact
2018-19	2.1	-2.2	6.8	2.8
2019-20	-0.5	-1.8	10.7	1.9
2020-21	5.7	1.5	8.9	-1.8
2021-22*	6.0	0.5	12.2	2.8

**Up to April 2022*

Given that the primary objective of the SBP is to maintain price stability, the Macroeconomic Model has also been used to determine the quantitative contribution of different factors to inflation annually in Pakistan from 2017-18 to 2021-22. The estimates are presented in Table 2.8.

Table 2.8: Magnitude of Contribution of Different Factors to Inflation in Pakistan 2017-18 to 2021-22 *(%)*

	Rate of Inflation	Contribution by				
		Net Monetary Expansion*	Imported Inflation**	Inflationary Expectations***	Residual	Total
2017-18	3.9	18.7	46.2	36.3	-1.2	100.0
2018-19	6.8	33.5	37.6	19.3	9.6	100.0
2019-20	10.7	86.9	3.8	21.3	-12.0	100.0
2020-21	8.9	57.4	13.8	40.3	-11.5	100.0
2021-22	12.2	34.5	39.1	26.2	0.2	100.0

**Net Monetary Expansion = Growth of Money Supply (M2), lagged by one-year minus GDP growth rate*

***Imported Inflation = Growth Rate of Import Prices (in $) + Extent of Depreciation of the Rupee*

****Inflationary Expectations measured by the rate of inflation lagged by one year.*

The results lead to the following conclusions:

i) Rapid rate of monetary expansion is the largest factor responsible for the upsurge of inflation in 2019-20 and a high rate of inflation in 2020-21. The growth in M2 was as high as 18 percent in 2019-20 and over 16 percent in 2020-21, as compared to an annual average rate of increase from 2015-16 to 2017-18 of less than 13 percent.

ii) The rate of increase in rupee prices of imports, due to jump in dollar prices and devaluation of the rupee, is the largest contributor to inflation in 2017-18, 2018-19 and in 2021-22.

Therefore, the relatively high rates of inflation in 2019-20 and 2020-21 reflect the inability of the SBP to restrict the growth in money supply.

The above analysis has highlighted the impact of monetary policy on the headline rate of inflation. The question is the impact on the 'core' rate of inflation, which excludes food and fuel prices. The 'core' rate of inflation consists more of goods and of services which are non-tradeable and less vulnerable to imported inflation.

Table 2.9: Annual 'Core' Rate of Inflation and Rate of Change in Causative Factors *(%)*

	'Core' Rate of Inflation	Food & Energy Inflation	Headline Inflation	Rate of Monetary Expansion	GDP Growth Rate
2017-18	5.9	3.4	4.7	9.7	6.0
2018-19	7.0	6.6	6.8	11.3	2.1
2019-20	8.2	13.5	10.7	17.5	-0.5
2020-21	7.0	11.0	8.9	16.2	3.9
2021-22	8.6	14.2	12.2	13.6	6.0

Table 2.9 clearly shows that from 2017-18 to 2018-19 not only was the 'core' rate of inflation significantly lower than the headline rate of inflation but it was also less variable over the years. The variability in the latter rate of inflation is due to the higher rate of inflation generally in food and energy / fuel prices after 2018-19.

The impact of monetary policy on the 'core' inflation rate appears to be transmitted through the rate of expansion in money supply. For example, a relatively higher rate is observed in 2019-20, when there was the fastest expansion in money supply. Also, supply-side factors appear to matter more. The lowest rate of 'core' inflation in 2017-18 coincides with the faster rate of GDP growth.

A rise in the policy rate raises interest rates on PIBs and MTBs. This increases the cost of domestic bank borrowing by the government and adds more to the money supply. This tends to 'crowd out' the private sector and also put pressure on inflation.

There is rapid transmission of any change in the policy rate on the yield, for example, of treasury bills, as shown in Table 2.10. However, the secondary market has begun to anticipate future changes in the policy rate. This happened for the first time towards the end of 2021, when the yield on treasury bills jumped to 11.5 percent when the policy rate was 8.75 percent. Currently, the yield on 12-month treasury bills has approached 17 percent. This indicates that there is a high likelihood that the policy rate could be raised beyond 16 percent.

Table 2.10: The Policy Rate and Yield on Treasury Bills *(%)*

	Policy Rate	Treasury Bills		
		3 months	6 months	12 months
June 2018	6.50	6.76	-	-
December 2018	10.00	10.30	-	-
June 2019	12.25	12.74	-	-
December 2019	13.25	13.45	-	-
June 2020	7.00	6.84	6.60	6.85
December 2020	7.00	7.11	7.19	7.29
June 2021	7.00	7.29	7.56	-
December 2021	8.75	10.38	11.34	11.48
June 2022	13.75	14.66	14.95	15.15
December 2022		16.97	16.81	16.81

The best illustration of this is in 2018-19. There was a big upsurge in the policy rate. This led a big increase in the budget deficit and the expansion in money supply of 21 percent was due domestic bank borrowing by the Government. Therefore, there is a strong tendency for an aggressive monetary policy to be largely neutralized by the fiscal consequences.

Table 2.11: Federal Budget Deficit and Domestic Borrowing (adding to M2) *(Rs in Billion)*

	Federal Budget Deficit [i]	Government Domestic Bank Borrowing* [ii]	Change in Money Supply (M2) [iii]	[ii] as % of [iii]
2018-19	3634	2167	1801	120.3
2019-20	3601	2181	3110	70.1
2020-21	3716	1718	3389	50.7
2021-22	5610	4432	3305	134.1

** Figures in brackets are the changes*

Source: *SBP, MOF*

2.6 Inflation Outlook

The primary focus of the SBP remains on the rate of inflation, which is its primary goal of preserving price stability. This focus has been augmented by the new SBP Act. Consequently, the policy rate is used as the primary instrument by the Monetary Policy Committee (MPC) to tackle inflation.

There has been a fundamental transformation in the outlook towards inflation since January 21, in recent MPC statements from optimism to pessimism, as follows:

Date of MPC	Change in Policy Rate	Outlook on Inflation of MPC	Accuracy of Outlook
January 22, 2021	None, at 7%	Likely decline, due to easing food inflation	Poor. Inflation rises to 11%
July 27, 2021	None, at 7%	Headline inflation should begin to dissipate in second half of year	Poor. Inflation rises to 12.3% by December 21
September 20, 2021	Up by 25 basis points to 7.25%	Depending on the future path of fuel and electricity prices and global commodity prices	-
November 19, 2021	Up by 150 basis points to 8.75%	Upside risks due to global commodity and administered prices	Inflation shows rising trend
December 14, 2021	Up by 100 basis points to 9.75%	Average of 9-11% in 2021-22 as global commodity prices retrench	Poor Average Inflation in 11 months Exceeds 11%
January 24, 2022	None, at 9.75%	Upper end of 9-11% in 2021-22. FY 23 inflation to fall to 5-7%	Poor Average Inflation in 11 months Exceeds 11%
March 8, 2022	None	Upper end of 9-11% in 2021-22. FY 23 inflation to fall to 5-7%	Poor Average Inflation in 11 months Exceeds 11%
April 7, 2022	Up by 250 basis points to 12.25%	Slightly above 11% in FY-22 before moderating in FY-23	Poor Average Inflation in 11 months exceeds 11%
May 23, 2022	Up 150 basis points to 13.75%	Hike in petrol and energy price, inflation to remain elevated in FY-23 and fall to 5-7% in FY-24	Yes
July 7, 2022	Up by 125 basis points to 15%	Remain at current levels	Yes
August 22,2022	No Change	Peak in first quarter of 2022-23 and then fall	Poor
October 10, 2022	No Change	Rise above 20%	Yes
November 25, 2022	Up 100 basis points to 16%	Inflationary pressures Stronger and Persistent up to 21-23 inflation rate	Poor Inflation Rate higher in November at 23.8%

It is surprising how the MPC has frequently changed its own inflation expectations. In early 2021, it expected the rate of inflation to decline and kept the policy rate at 7 percent up to September 2021. The appropriate strategy would have been to gradually raise the policy rate.

Thereafter, the MPC recognized the upside risks due to rising global commodity prices and administered prices, but nevertheless expected the inflation rate to average 9-11 percent in 2021-22. This was biased downwards as the average rate exceeded 11 percent in May 2022.

The MPC on April 7, 2022, raised the policy rate by a large 250 basis points, due particularly to falling reserves. However, it still felt that inflation would moderate in FY-23. Now, in the last MPC of November 2022, the outlook is that inflation would remain elevated in FY-23.

Such rapid changes in inflation outlook of the MPC have seldom been observed earlier. However, to be fair to the MPC this is no doubt the result of the high level of uncertainty prevailing both in the global and in the domestic economy. Inevitably, this has distorted the timing and intensity of policy actions. It should not come as a surprise if the policy rate will be raised further by the MPC. This is what happened when the policy rate was raised to 16 percent in the last meeting in November 2022. This is the highest ever policy rate and much higher than in most countries.

Chapter 3: Annual Economic Review of 2021-22

The year, 2021-22, has just come to an end. It was a year characterized by considerable uncertainty both on the economic and political fronts. The new coalition government, which was inducted into power in early April 2022, took time initially to take the urgent policy actions.

However, the petroleum prices have been raised by as much as 66 percent to 85 percent in relation to the level following the price reduction by the previous Prime Minister in end-February 2022. Big increases in the gas and electricity tariffs are pending.

These steps were taken to facilitate the completion of the pending seventh review of the IMF program. The federal budget of 2022-23 had to be revised substantially to meet the IMF requirement of a primary surplus, with adequate resource mobilization and expenditure containment. The Extended Fund Facility has become operative once again.

3.1 The Global Economy

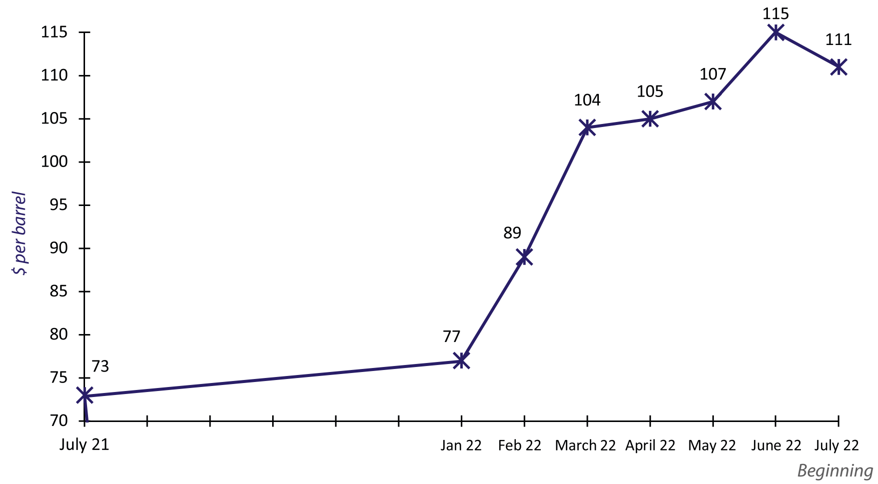
The global economy had shown a strong recovery in 2021 after the containment of the pandemic, COVID-19. The year 2022 also started on a positive note. But the onset of the Russia-Ukraine war has led to supply shortages, escalation in commodity prices and a worsening of expectations in stock and foreign exchange markets.

International agencies like the IMF have revised their economic projections for 2022 downwards as follows:

- Global growth is projected to slow from 6.1 percent in 2021 to 3.6 percent in 2022. This is 0.8 percentage points lower than projected in January.
- War induced price increases and broadening price pressures have led to 2022 inflation projection of 5.7 percent in advanced economies and 8.7 percent in developing economies, 1.8 and 2.8 percentage points higher than projected in January.

The pressure on commodity prices is amply demonstrated by the escalation in the price of (Brent) crude oil, as shown in Figure 3.1 after February 2022.

Figure 3.1: Brent Crude Oil Price in 2021-22 *($ per barrel)*



3.2 Pakistan Economy: GDP Growth

One of the unexpected, pleasant surprises is the revelation of the Pakistan Economic Survey for 2021-22 that the economy has registered a high growth rate of 5.97 percent during the year, as shown in Table 3.1. This comes after 2020-21 when the economy showed a strong recovery with a growth rate of 5.7 percent. Seldom has the country seen two consecutive years of near 6 percent GDP growth.

Table 3.1: GDP and Sectoral Growth Rates, 2020-21 and 2021-22 *(%)*

		2020-21 (Revised)	2021-22 (Provisional)
Agriculture		**3.5**	**4.4**
of which:	Major Crops	6.0	6.6
	Minor Crops	8.2	5.5
Industry		**7.8**	**7.2**
of which:	Large-Scale Manufacturing	11.5	10.5
	Electricity and Gas	6.2	7.9
Services		**6.0**	**6.2**
of which:	Wholesale & Retail Trade	10.6	10.0
GDP (fc)		**5.7**	**6.0**

Source: *PES*

Apparently, both the major crop and large-scale manufacturing sectors have shown outstanding performance with growth rates above 6 percent and 10 percent respectively in both 2020-21 and 2021-22. Similarly, the relatively large wholesale and retail trade sector has shown growth of 10 percent or more during the last two years.

The growth rate of the different expenditure components of the GDP is shown in Table 3.2.

Table 3.2: GDP and Expenditure Growth Rates 2020-21 and 2021-22 *(%)*

	2020-21	2021-22
Household Consumption Expenditure	9.3	10.1
Government Consumption Expenditure	1.8	-3.4
Total Investment	4.7	2.5
Export of Goods and Services	6.5	8.4
Import of Goods and Services	14.5	15.6
GDP at Market Prices	6.5	6.2

Source: *PES*

The numbers in Table 3.2 provide the first indication that the GDP growth rate in 2021-22 is likely to be overstated. Household consumption expenditure is shown as having increased in real terms by as much as 10 percent. This is completely contrary to trends at the ground level whereby households in Pakistan have had to cut back real consumption spending in the face of high inflation.

A deeper look also reveals that some sectoral growth rates are overstated. The preliminary estimate of the GDP of 2021-22 is based primarily on data for the first nine months. Overall, the GDP growth rate in 2021-22 is unlikely to have approached 6 percent. It is more likely to be closer to 4.8 percent. Annexure-3 has been attached on *Overstatement of the GDP growth rate in 2021-22*.

3.3 Investment

Table 3.3 shows that total fixed investment has not been very buoyant in 2021-22, with an overall growth rate of only 2.5 percent. It also shows the trend separately in private, public and government investment.

Table 3.3: Growth in real Private, Public Sector and Government Investment *(%)*

	2020-21	2021-22
Private Sector	2.5	-0.5
Public Sector	6.1	-4.5
Government	14.0	18.5
TOTAL	**4.7**	**2.5**

Source: *PES*

It is not surprising that the level of private investment has declined in 2021-22 in the presence of rising interest rates. The SBP policy rate reached the peak level of 13.75 percent by May 2022. Similarly, the investment level of public sector enterprises has contracted because of reduced access to funds.

The positive development is the high double-digit growth in government investment through the PSDP. The big increase is especially in development spending by the provincial governments in the presence of a rapid growth in revenue transfers from the federal government.

Overall, the level of investment and savings remain low in Pakistan, as shown in Table 3.4. The fixed investment level stands at 13.4 percent of the GDP in 2021-22. For a sustained 5.5 to 6 percent growth rate, the level of fixed investment will have to rise to between 16 percent and 18 percent of the GDP.

Table 3.4: Level of Fixed Investment and Savings 2020-21 and 2021-22 *(% of GDP)*

	2020-21	2021-22
Total Fixed Investment	**12.9**	**13.4**
Public	3.0	3.4
Private	10.0	10.0
National Savings	**14.1**	**11.1**

Source: *PES*

3.4 Inflation

Pakistan today is in the grip of high double-digit inflation. The increase in the CPI on a year-to-year basis reached a peak of 21.3 percent in June 2022. There have been only two times in history when such high rates of inflation were approached. The first time this happened was in the years 1973-74 and 1974-75 in the aftermath of a large devaluation of the rupee by 134 percent. More recently, the year, 2008-09, saw inflation at over 17 percent due to the big rise in international commodity prices, especially of oil.

The monthly inflation rates are presented in Table 3.5.

The overall rate of inflation has risen rapidly from November 2021 onwards and the acceleration was the highest in the month of June when it rose to 21.3 percent from 13.8 percent in May.

Food prices have risen at a faster rate, reaching 25.8 percent by June. Domestic supply shortages have contributed to very high rates of increase in prices of wheat, vegetables, fruits, meat, and

Table 3.5: Monthly Rate of Inflation in 2021-22 (Year-to-year) *(%)*

2021-22	Food Prices	Non-Food Prices	Overall CPI
June	10.6	9.3	9.7
July	8.1	8.6	8.4
August	9.5	8.2	8.4
September	9.8	8.3	9.0
October	8.1	9.8	9.2
November	9.9	12.5	11.5
December	10.1	13.8	12.3
January	13.2	12.4	13.0
February	14.4	11.3	12.2
March	15.1	11.7	12.7
April	16.9	11.8	13.4
May	17.6	12.0	13.8
June	25.8	19.2	21.3

Source: *PBS*

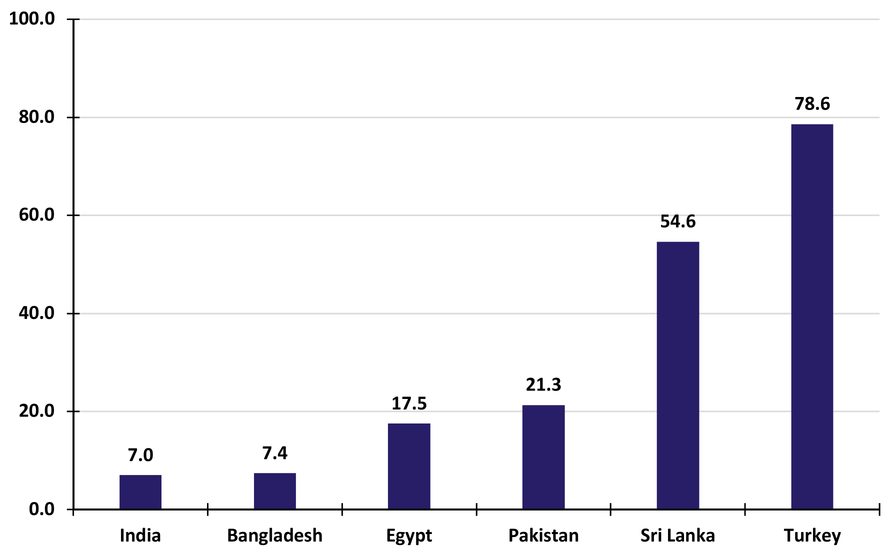
chicken. The rise in international import prices added to by the large devaluation of the rupee after March 2022, have led to big jump in price of vegetable ghee, spices, and pulses.

Within non-food prices, the big increases have taken place in electricity charges of 34.7 percent, in motor fuel of 95.7 percent, in transport charges of 34.8 percent and in liquified hydrocarbons of 63.5 percent. It is estimated that almost 30 percent of the jump in the rate of inflation from July 2021 at 8.4 percent to 21.3 percent in June 2022 is due to higher electricity and fuel prices.

Pakistan has faced a 'double whammy'. The first is due to the jump in international commodity prices, especially from March 2022 onwards. The second is the result of the rapid depreciation of the rupee also after March 2022 by almost 15 percent.

A comparison is made in Figure 3.2 of the on-going rate of inflation in some developing countries in June 2022. Pakistan is in the middle. Bangladesh and India have rates of inflation of 7 percent. Two countries, with big external debt problems, Sri Lanka and Turkey, have rates of inflation of 54.6 percent and 78.6 percent respectively.

Figure 3.2: Rate of Inflation in Selected Developing Countries



Source: *World Bank*

Inflation rates have also risen in developed countries to 8.6 percent in the USA, 9.1 percent in the UK and 8.6 percent in the Euro Area. This is leading to an increase in global interest rates which will make external borrowing even more expensive for Pakistan.

3.5 Balance of Payments

The most critical area for Pakistan today is the external balance of payments. With low reserves and without the umbrella of an operational IMF program, there are apprehensions that Pakistan will find it increasingly difficult to meet its external payment obligations.

Table 3.6 gives the BOP figures for 2020-21 and 2021-22 respectively.

Table 3.6: Balance of Payments, 2020-21 and 2021-22 *($ million)*

	2020-21	2021-22
Current Account	-2,820	-17,405
Capital Account	224	208
Financial Account	8,768	11,149
Errors and Omissions	-619	-268
Balance of Payments	**5,553**	**-6,316**
IMF	-1,080	-1,015
Change in Reserves	**4,473**	**-7,331**

Source: *SBP*

The current account deficit has risen to $17.4 billion in 2021-22. This is the second largest ever deficit after 2017-18. It was also high on a quarterly basis in the fourth quarter at $4.3 billion.

Transactions in the financial account of the balance of payments in 2021-22 were facilitated by the release of $2.8 billion SDRs to Pakistan. Consequently, the net inflow into the financial account shows an increase of 27 percent. However, this is not large enough at $11.1 billion to fully finance the large current account deficit.

Consequently, there is an overall deficit in the balance of payments of almost $6.3 billion, as compared to a surplus of $5.6 billion in 2020-21. Reserves have tumbled from $ 17.3 billion at the start of 2021-22 to only $9.8 billion as of end June 2022. This is adequate to provide import cover for only 1.5 months.

Table 3.7: The Current Account in the Balance of Payments, 2021-22 *($ million)*

	2020-21	2021-22
Current Account Balance	**-2,820**	**-17,405**
Balance in Goods	**-28,624**	**-39,681**
Exports	25,639	32,471
Imports	54,273	72,152
Balance in Services	**-2,516**	**-5,019**
Balance in Primary Income	**-4,400**	**-5,296**
Balance in Secondary Income	**32,730**	**32,591**

Source: *SBP*

A look at the current account position in Table 3.7 indicates a very big increase in the goods trade deficit from $28.6 billion to $39.7 billion, a jump of 38.6 percent. The year, 2021-22, has ended with the largest ever trade deficit. Remittances have shown a modest growth rate of 6.2 percent.

3.6 Public Finances

The salient features of the federal budgetary outcome for 2021-22 are presented in Table 3.8.

Table 3.8: Federal Budgetary Outcome, 2021-22 *(Rs in Billion)*

	2020-21	2021-22	g(%)
Total Tax Revenues	***6,269***	***7,328***	***16.9***
Tax Revenues	4,764	6,142	28.9
Non-Tax Revenues	1,505	1,185	-21.3
Transfer to Provinces	***2,742***	***3,589***	***30.9***
Net Revenues Receipts	***3,527***	***3,739***	***6.0***
Total Expenditure	***7,245***	***9,350***	***29.0***
Current Expenditure	6,349	8,452	33.1
Development Expenditure	789	701	-11.2
Statistical Discrepancy	107	197	84.1
Federal Budget Deficit	***-3,716***	***-5,610***	***51.0***
Provincial Surplus	***+313***	***+350***	***11.8***
Overall Budget Deficit	***-3,403***	***-5,260***	***54.6***
Primary Surplus/Deficit	***-653***	***-2,077***	***218.1***
Overall Budget Deficit as % of GDP	***-6.1***	***-7.9***	

Source: *PBS*

The target budget deficit for the year was 6.1 percent of the GDP. This has been substantially exceeded by almost 30 percent and the year has closed with a deficit of 7.9 percent of the GDP, the highest ever.

A number of factors have contributed to this big failure. First, non-tax revenues have declined by 21 percent, due particularly to substantially lower revenues from the petroleum levy. Second, current expenditure has shown an unprecedented increase of 33 percent, due largely to the more than doubling of the outlays on subsidies and grants.

Overall, the year, 2021-22, has closed with a relatively high GDP growth rate facilitated by expansionary monetary and fiscal policies. However, this has led to extremely large budget and current account deficits, which will have to be brought down in 2022-23.

Chapter 4:

The Economic Outlook for 2022-23

Developments during 2022-23 will be affected by a number of factors. First, the year ended with very low foreign exchange reserves of $9.8 billion with the SBP, enough for import cover of 1.5 months. Fortunately, Pakistan has been able to get back to the IMF Program which is expected to continue till June 2023. There is agreement on the macroeconomic targets and on the reform agenda for 2022-23.

Second, the global economy is moving into a recession. However, inflation is expected to be higher due to the lagged impact of expansionary policies adopted after COVID-19. Now with efforts to contain inflation, interest rates globally are likely to be significantly higher.

Third, Pakistan has been hit by the worst natural disaster in its history, the floods. Over 33 million people have been affected and the damage to the economy is estimated at $30 billion. This will impact severely on the GDP growth rate and put further pressure on the price level due to emerging supply shortages.

Fourth, efforts at restricting the current account deficit have led to a policy of restricting LCs on imports by the SBP. This is creating shortages and is impacting on domestic production and prices.

Fifth, Pakistan today faces a political quagmire, with head-on confrontation between the coalition government and the PTI. This has increased instability and risk perceptions of the economy. The incumbent government has also been constrained from taking strong policy actions.

The outlook for 2022-23 is presented in five sections. Section 4.1 gives a perspective on trends in the global economy in 2022 and 2023. Section 4.2 gives the corresponding projections for the economy of Pakistan as contained in the Annual Plan for 2022-23 and in the projections given in the IMF Program. Section 4.3 modifies these projections in light of the large negative impact of the floods. Given the vital nature of the balance of payments projections in preventing a near default position of Pakistan, the likely outcome in 2022-23 is presented in Section 4.4. Also, given the importance also of the budgetary outcome, this is presented in Section 4.5. Projections reflect the impact of the floods on the two deficits.

4.1 The Global Economy

The Russia-Ukraine War is one of the reasons for a big change in the outlook of the global economy. The resulting supply shortages have led to a large spurt in the rate of inflation in international commodity prices in 2022. As shown in Table 4.1, the overall global commodity price index went up by over 40 percent.

Table 4.1: Projections of Global Commodity Prices in 2023*

		2021	2022	g (%)	2023	g (%)
Overall Commodity Price Index (2016 = 100)		**161.3**	**227.2**	**40.8**	**225.3**	**-1.0**
FUEL						
Petroleum (Brent)	$/bbl	70.3	100.5	43.0	88.6	-11.9
Coal (2016 = 100)		199.4	516.5	159.1	485.2	-6.1
LNG	$/MMBtu	18.6	40.5	117.7	57.4	41.7
FOOD						
Wheat	$/MT	265.7	348.0	31.0	317.9	-8.6
Rice	$/MT	442.0	422.8	-4.4	438.2	3.6
Palm Oil	$/MT	1078.5	1209.7	12.2	958.4	-20.8
RAW MATERIALS						
Cotton	US Cents/lb	101.2	140.0	38.3	120.7	-13.8
Source: *IMF*	**Calendar year*					

Developed countries had earlier followed expansionary monetary and fiscal policies after COVID-19, which had a lagged impact on the rate of inflation in 2022. As such, the global economy is in the grips of 'stagflation'.

Table 4.2 indicates that the IMF expects in its latest *World Economic Outlook* that the growth rate of the global economy will come down sharply from 6 percent in 2021 to 3.2 percent in 2022 and decline further to 2.6 percent in 2023. Simultaneously, the rate of inflation will jump up from 4.7 percent in 2021 to 8.8 percent in 2022 and 6.5 percent in 2023.

Table 4.2: Projections of the Global Economy

	Unit	2021 (Actual)	2022	2023 (Projections)
Global GDP	%	6.0	3.2	2.6
Rate of Inflation	%	4.7	8.8	6.5
Trade Volume	%	10.1	4.3	2.5
Source: *IMF*				

The prospects for world trade are accordingly not positive. There was fast growth of over 10 percent in 2021 as the world recovered after COVID-19. The growth is expected to be much lower at 4.3 percent in 2022 and even lower at 2.5 percent in 2023.

Table 4.1 gives the projection of prices of different commodities. The IMF does not expect a substantial lowering of the overall commodity price index in 2023, from the peak levels attained in 2022. While the price of crude oil, wheat, cotton could fall significantly in 2023, prices of LNG and rice could be higher than the level attained in 2022.

4.2 Projections of Pakistan Economy

Prior to the Floods

Table 4.3 presents two sets of projections. The first set has been extracted from the projections contained in the IMF Staff Report after completion of the seventh and eight reviews, which was released on the 1st of September 2022. The second set of projections are from the Annual Plan for 2022-23 prepared by the Planning Commission.

The GDP growth rate in 2022-23 has been projected by the IMF at a moderate rate of 3.5 percent. This presumably reflects the impact of contractionary fiscal and monetary policies to reduce the two deficits sharply as part of the Program. The Annual Plan retains an air of optimism and expects the growth momentum to be sustained after 2021-22 with a 5 percent growth rate in 2022-23.

There is also a big divergence in the inflation rate projections. At the time when the IMF Staff Report was being finalized, the YoY rate of inflation in August 2022 had hit the peak of 27.3 percent. The IMF expects the inflation rate in coming months to moderate and average close to 20 percent over the year. However, the Annual Plan projection of 11.5 percent is completely out of touch with reality.

Table 4.3: Macroeconomic Projections of the Economy of Pakistan

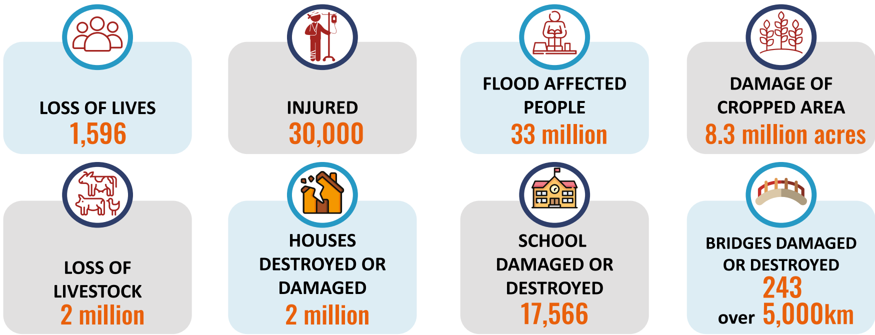
	2021-22 (Actual)	2023 (Projections)
GDP Growth Rate – *(%)*		
• Annual Plan	6.0	5.0
• IMF	6.0	3.5
Level of Investment – *(% of GDP)*		
• Annual Plan	15.1	14.7
• IMF	15.1	16.8
Rate of Inflation – *(%)*		
• Annual Plan	12.2	11.5
• IMF	12.2	19.9

Source: *IMF and Planning Commission*

Impact of Floods

A summary of the key magnitudes of the damage inflicted by the floods is presented in Chart 4.1. Over 33 million people have been affected by the floods. The damage to cropped area in the Kharif season is 8.3 million acres, which is 29 percent of the national cropped area during the season. The loss to livestock is 2 million.

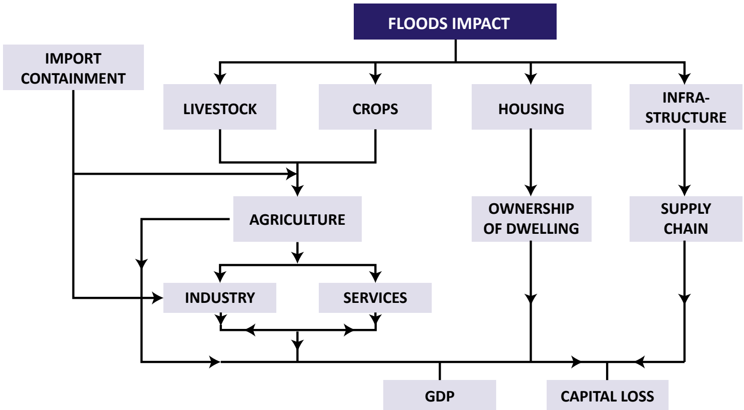
Chart 4.1: Summary of Impact of Floods



Source: *Diverse*

The economic impact of the floods on the GDP is visualized in Chart 4.2. The direct impact on agriculture translates into an indirect impact on the industrial and services sectors via the reduction in supply of inputs and on the overall level of demand for output of these sectors. In addition, the severe containment of imports of raw materials and intermediate goods will significantly reduce domestic output.

Chart 4.2: Visualizing the Flood Impact



Simulations of the negative shock to the economy via the loss of output of agricultural commodities and livestock and a policy of containment of imports of raw materials and intermediate goods are undertaken with the Macroeconomic Model.

The loss of output due to the floods in agriculture is as follows:

	% Fall in output
Cotton	40
Rice	20
Wheat	10
Sugarcane	10
Vegetables, Fruits, etc.	15
Livestock	4

This leads to the estimate of the overall loss of agricultural output of almost 7 percent.

The overall impact of the floods on the GDP in 2022-23 is presented in Table 4.4.

Table 4.4: Projected GDP Growth Rate in 2022-23 after the Floods *(%)*

	IMF Projections Pre-Floods*	Impact of Floods and Import containment	Growth Rate after Floods
Agriculture	3.0	-7.0	-4.0
Industry	4.0	-7.5	-3.5
Services	3.5	-2.5	1.0
GDP	**3.5**	**-4.5**	**-1.0**
***Assumed sectoral growth rates**			

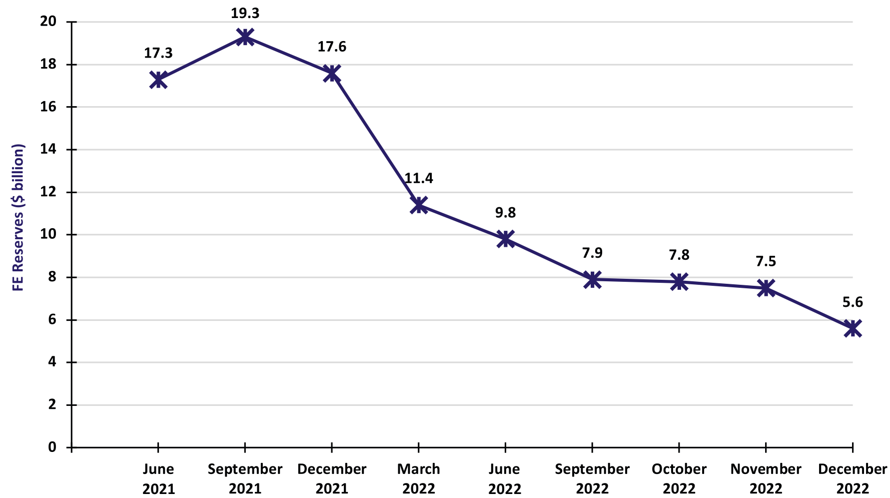
The GDP growth rate in 2022-23 which was projected at 3.5 percent by the IMF is likely to fall to negative 1 percent. This represents a loss of $16 billion in the Gross National Income.

4.3 Balance of Payment Projections

Prior to the Floods

The balance of payments projections is of vital importance as they will indicate whether starting with low foreign exchange reserves Pakistan will be able to finance the current account deficit and honor all its external interest and debt repayment obligations in 2022-23. The precipitate fall in foreign exchange reserves that has already taken place is shown in Figure 4.1.

Figure 4.1: The Path of Foreign Exchange Reserves *June 2021 to October 2022*



Source: *SBP*

The critical requirement is to reduce the current account deficit by almost half, as highlighted in the previous section. Projections in the Annual Plan and in the latest IMF Staff Report are given in Table 4.5. The IMF is anticipating a faster growth in exports and less growth in remittances as compared to the Annual Plan. However, both project a reduction in the current account deficit of almost 50 percent.

Table 4.5: Projections in the Current Account for 2022-23

	Growth Rate (%)	
	Annual Plan	IMF
Balance of Trade in Goods	**-34.0**	**-32.8**
• Exports	32.4	35.9
• Imports	-66.4	-68.7
Balance of Trade in Services	**-4.6**	**-3.5**
Net Primary Income	***-5.9***	***-4.8***
Net Secondary Income	***35.5***	***31.8***
Current Account Deficit	**-9.0**	**-9.3**

Source: *IMF, Planning Commission*

The overall projection of the balance of payments by the IMF for 2022-23 is given in Table 4.6. Accordingly, the financial account is expected to be in a surplus of $12.7 billion, due to inflow of $5.4 billion of foreign investment, including the flotation of bonds and portfolio investment, and net disbursements to the government of $7.1 billion.

Overall, the balance of payments is projected to be in surplus of $3.6 billion. The net inflow from the IMF in 2022-23 is estimated at $2.8 billion. Consequently, reserves are expected to rise to $16.2 billion by the end of the year and reach a ‘safe’ level.

Table 4.6: IMF Projections for 2022-23

	2021-22 (Actual)	2022-23	g (%)
A. CURRENT ACCOUNT	**-17,461**	**-9,280**	**-46.9**
Goods Balance	***-40,140***	***-32,856***	***-18.1***
Exports	31,877	35,900	12.6
Imports	72,017	68,756	-4.5
Services Balance	***-3,691***	***-3,507***	***-5.0***
Net Primary Income	***-5,288***	***-4,763***	***-10.0***
Net Secondary Income	***31,658***	***31,846***	***0.6***
Workers’ Remittances	30,117	28,958	-4.0
B. CAPITAL ACCOUNT	**208**	**161**	**-22.6**
C. FINANCIAL ACCOUNT	**10,355**	**12,682**	**22.5**
Foreign Investment	***2,996***	***5,376***	***79.4***
General Government	***6,074***	***7,062***	***16.3***
Disbursements	14,362	19,476	35.6
Amortization	8,288	12,414	49.8
Others	***1,285***	***244***	
D. ERRORS & OMISSIONS	-608	0	
E. BALANCE OF PAYMENTS	-7,506	3,563	
IMF + Others	36	2,842	
F. CHANGE IN RESERVES	-7,469	6,405	

Source: *IMF*

The IMFs projections are based on optimistic assumptions about capital inflows, both debt-creating and non-debt creating in nature. For example, in the presence of the IMF Program the gross disbursements of loans to Pakistan by will increase by 46 percent. It remains to be seen if this will happen. The first indications are of a large and growing shortfall.

Impact of Floods

The floods are likely to impact on the balance of payments of Pakistan in the following ways:

i) Exports of rice will be reduced by almost 1 million tons, implying a loss in export earnings of $500 million.

ii) Shortfalls in cotton and wheat of 7 million bales and 3 million tons respectively will require additional imports of up to $4.5 billion.

However, the decline in the GDP growth rate to negative 1 percent will reduce the overall demand for imports, along with the impact of a likely faster rate of depreciation of the rupee.

Further, there has been a big downgrading of the credit-rating of Pakistan by the various credit-rating agencies. Pakistan was able to get back to the IMF program, but the process of the ninth review has been delayed. This has led already to a big fall in the inflows of foreign investment and loans.

The modified projections incorporating the impact of the floods on the balance of payments and other negative developments are presented in Table 4.7. A comparison is made with the original IMF projections for 2022-23.

Table 4.7: Balance of Payments after Floods in 2022-23 *($ Billion)*

	2021-22 (Actual)	IMF Projection (pre-floods)	After Floods	Difference
A. CURRENT ACCOUNT DEFICIT	***-17.4***	***-9.4***	***-8.3***	***+1.1***
Balance of Trade in Goods and Services	***-44.7***	***-36.4***	***-33.7***	***+2.7***
Exports	39.4	42.9	39.9	-3.0
Imports	84.1	79.3	73.6	5.7
Net Primary Income	***-4.4***	***-4.8***	***-4.3***	***+0.5***
Net Secondary Income	***31.7***	***31.8***	***29.7***	***-2.1***
B. CAPITAL ACCOUNT	0.2	0.2	0.2	-
C. FINANCIAL ACCOUNT	9.9	16.2	5.1	-11.1
Foreign Investment	***3.0***	***5.2***	***1.0***	***-4.2***
Government Assistance	***2.4***	***7.1***	***0.6***	***-6.5***
Disbursements	10.7	19.5	13.0	-6.5
Amortization	8.3	12.4	12.4	0.0
Others	***4.5***	***3.9***	***3.5***	***-0.4***
D. BALANCE OF PAYMENTS	***-7.5***	***7.0***	***-3.0***	***-10.0***
Level of Foreign Exchange Reserves	***9.8***	***16.8***	***6.8***	

Source: *SBP*

There are a number of significant differences from the IMF projections as follows:

i) Despite the higher imports of wheat and cotton the import level is likely to be lower by $5.7 billion because of greater depreciation of the rupee, lower GDP growth rate and the strong containment of imports through the holding back of import LCs. Also, there has been a significant decline in the price of imported crude oil.

ii) Exports are likely to be smaller by $3 billion, especially because of the lack of growth in world trade due to a deeper global recession and reduced exports of rice and textiles. The latter will be constrained by shortage of imported inputs.

iii) Home remittances are likely to be lower by over $2 billion in the presence of a big spread between the official and open market exchange rate.

iv) Overall, the current account is likely to be smaller by $1 billion, at the level of $8.3 billion. This is consistent with the first four-month outcome in 2022-23 of a current account deficit of $2.8 billion.

v) Foreign investment, in particular the portfolio investment in Sukuk/ Eurobonds, is likely to be substantially lower. Pakistan will experience great difficulty in floating bonds. The IMF Program projection had assumed financing of $3 billion from these bonds. Also, foreign direct investment is likely to be substantially lower as there has been a restriction imposed on the repatriation of profits which will deter new investment.

vi) Disbursements of loans into the Government account are also likely to be much smaller by over $6 billion. The IMF projections assume a very large inflow of commercial loans, which is now unlikely given the higher risk perceptions of Pakistan. However, it is assumed that the IMF program will complete its tenure and $3.5 billion will become available from this loan facility.

The bottom line in the balance of payments projections is that there is the high level of risk that the foreign exchange reserves will remain at the current low level of below $7 billion, despite the umbrella of an IMF program. **There will remain the risk that Pakistan may reach a point where it will not be able to honor its repayment obligations, if external inflows are even smaller.**

4.4 Budgetary Projections

Prior to the Floods

The budgetary magnitudes for 2022-23 presented in the IMF Staff Report coincide with the estimates by the Ministry of Finance. They represent the consolidated position of the federal and provincial governments.

The key budgetary magnitudes are presented in Table 4.8.

Table 4.8: Budgetary Projections for 2022-23

	2021-22	2022-23	g (%)
TOTAL REVENUES	8,035	10,370	29.1
Tax Revenues	6,755	9,220	36.5
Non-Tax Revenues	1,280	1,150	-10.2
TOTAL EXPENDITURE	13,295	14,284	7.4
Current Expenditure	11,521	12,355	7.2
Development Expenditure	1,657	1,929	16.4
Statistical Discrepancy	116	-	
BUDGET DEFICIT	-5,260	3,914	-25.6
% Of GDP	***-7.9***	***-4.9***	
PRIMARY SURPLUS/DEFICIT	-2,077	153	
% Of GDP	***-3.1***	***0.2***	

Source: *IMF and MOF*

The salient features of the projections are as follows:

i) Tax revenues are expected to show potentially the highest ever growth rate of over 36 percent, based on taxation proposals of Rs 600 billion and a persistent high rate of inflation in the tax bases of over 20 percent.

ii) Current expenditure is projected to increase by only 7 percent. This is to be achieved, in particular, by a big cut in subsidies and single digit increase in defense expenditure.

iii) A moderate growth of 16 percent is proposed in development expenditure.

iv) A very big cut in the budget deficit is targeted for of over 3 percent of the GDP and a decline in the absolute magnitude of Rs 1,314 billion. This extent of stabilization has never been achieved before.

Impact of Floods

The budgetary outcome in 2022-23 is also likely to be negatively impacted by the floods as shown in Table 4.9, for the following reasons:

i) There will be slower growth in the tax base of imports, for reasons given above, and consequently in revenues from the sales tax and customs duty. However, domestic revenues could rise faster due to a higher rate of inflation than built into the IMF Program projections.

ii) Current expenditure growth is expected to be restricted to only 7 percent in the IMF program estimates. The target, in particular, is to reduce subsidies by over 56 percent. The current trends, in fact, indicate a rise in the outlay on subsidies.

The outcome following the floods will also be higher expenditure on relief and rehabilitation in the form of larger grants and subsidies. Also, the full emergency provision of Rs 195 billion will need to be used. In addition, debt servicing costs are likely to be larger because of the enhancement in interest rates and greater reliance on relatively high-cost domestic borrowing, due to limited access to external financing. However, there is likely to be a big cut in development spending to restrict the size of the deficit. The resulting change in projections is shown in Table 4.9.

Table 4.9: Federal Budget Projections for 2022-23 Incorporating the Impact of Floods

(Rs in Billion)

	2021-22 (Actual)	2022-23 (Original Budget Estimate)	2022-23 (Estimate Post-Floods)	Difference
Revenues	7,327	9,405	8,950	-455
Tax Revenues	6,142	7,470	7,200	-270
Non-Tax Revenues	1,185	1,935	1,750	-185
Revenue Transfers	-3,588	-4,373	-4,217	+156
Net Revenue Receipts	3,739	5,032	4,733	-299
Total Expenditure	9,350	9,579	10,008	429
Current Expenditure	8,451	8,708	9,508	800
Development Expenditure	440	871	500	-371
Federal Budget Deficit	-5,611	-4,547	-5,275	728
Provincial Surplus	351	750	400	-350
Consolidated Budget Deficit	-5,260	-3,797	-4,875	1,078
Primary Surplus / Deficit	-2,078	153	-525	-678
Consolidated Budget Deficit *(% of the GDP)*	-7.9	-4.9	-6.0	-1.1

Overall, the budget deficit incorporating the impact of the floods is likely to be over 1 percent of the GDP larger than the original deficit.

A summary is finally given of the pre-floods and post-floods outlook for the economy in 2022-23 in Table 4.10.

The perilous state of the economy is vividly highlighted by the projections.

Table 4.10: Pre- and Post-Floods Macroeconomic Projections for 2022-23

	Pre-Floods*	Post-Floods	Difference
GDP Growth Rate (%)	3.5	-1.0	-3.5
Rate of Inflation (%)	19.9	24 – 26	4.1 – 6.1
Current Account Deficit ($ billion)	-9.4	-8.4	-1.0
Foreign Exchange Reserves ($ billion)	16.8	6.8	-10.0
Budget Deficit (% of GDP)	-4.9	-6.0	-1.0

**IMF*

PART-2

THE IMF PROGRAM

Chapter 5:

Impact of IMF Targets and Conditionalities on the Economy

The seventh and eight reviews of the Extended Fund Facility with Pakistan have been completed by the IMF and a loan installment of $1.17 billion released under this facility. Further, the duration of the Program has been extended from September 2022 to June 2023 and the total amount of the loan increased by $997 billion. There will be three more quarterly reviews.

The objective of this chapter is to identify the type and intensity of impact of attempts to achieve the targets in the Program for 2022-23 and of implementing the reforms and conditionalities agreed to by the Government of Pakistan.

The chapter is in five parts. Part 1 looks in depth at the Memorandum of Economic and Financial Policies that the Government of Pakistan has agreed to implement in 2022-23 with the IMF. At this point, it needs to be emphasized that the fulfillment of IMF conditionalities through actions and reforms is perhaps more wide-ranging and structural in nature than the hitherto been the case in earlier IMF programs with Pakistan.

Part 2 presents the key macroeconomic targets for 2022-23 in the Program. An assessment is made of the likelihood of achievement of these targets in light of implementation of reforms in the Memorandum. There is need to emphasize here that these targets were finalized prior to the mammoth floods hitting Pakistan and therefore do not reflect the large negative impact of these floods on the national economy.

Part 3 highlights the quarterly performance criteria and structural benchmarks which will form the basis of the three quarterly reviews by the IMF in 2023-23. An assessment will be made on the extent to which these performance criteria are likely to be achieved.

Part 4 looks at the projection of the external financing requirements of Pakistan in 2022-23 as assessed by the IMF and the Federal Ministry of Finance along with the SBP. The proposed financing plan is highlighted and assessment made of the probability of successful implementation of this plan.

5.1 Memorandum of Economic and Financial Policies

There are seven sections in the memorandum of economic and financial policies including the following:

- Tax Policy
- Management of Expenditure
- Monetary, Exchange Rate and Financial Sector Policies
- Energy Sector Policies
- State-Owned Enterprises (SOEs)
- Improving Pakistan's Competitiveness and Business Environment
- Poverty Reduction and Social Protection

The key policies and reforms agreed to by the Government in each section are listed below along with their likely impacts.

Tax Policy: There are seven areas of reform and action as shown in Chart 5.1. Two measures have already been implemented in the budget. The complex and difficult reform to implement is the harmonization of the federal sales tax on goods with the provincial sales tax on services. In addition, a commitment has been made that there will be no future tax amnesties and concessions. If there is a shortfall in FBR revenues, a contingency plan has also been identified.

Chart 5.1: Tax Policy

ACTION / REFORM	IMPACT
• Taxation Proposals in Budget 2022-23 • Raising the Petrol Levy to Rs 50 per litre in Motor Spirit by April 2023 in HSD Oil by January 1 2023	• Additional Revenue of over Rs 600 billion • Total Revenue of Rs 855 billion in 2022-23. Depends on the extent of reduction in demand following the big price hike in POL products
• Increasing the Customs Duty on Crude Oil from 3% to 5%	• Additional revenue of Rs 30 billion
• Harmonization of the Sales Tax on Goods and Services between the Federal and Provincial Governments	• Preventing a Cascading of the tax and '*Race to the Bottom*' by Provincial Governments through lowering of the tax rate. Difficult reform to implement
• No future tax amnesties	• Reduce tax evasion
• Contingency Measures: i. Restoring GST on fuel products at appropriate rate ii. Increase excise duty on cigarettes	• A GST on petroleum products will further contract demand and negatively impact on revenues from the Petroleum Levy
• Reduce Stock of Income Tax Arrears. Existing Stock of Rs 366 billion to be reduced to Rs 225 billion by end-September	• Will improve liquidity of enterprises, but imply less revenues of Rs 145 billion in the first quarter of 2022-23
• Increasing the number of income taxpayers by 300,000	• Tried before with little success

Management of Expenditures: Seven action areas have been identified as shown in Chart 5.2 mostly from the viewpoint of improving the system of public financial and debt management. Also, a Medium-Term Budget Strategy is to be prepared. The objective is to adhere to the provisions in the Fiscal Responsibility and Debt Limitation Act of 2005.

Chart 5.2: Management of Expenditures

ACTION / REFORM	IMPACT
• Limiting Power Subsidies to Rs 570 billion, of which Rs 225 billion will be the tariff differential subsidy. Among actions to improve management of the sector, the Quarterly Price Increase in tariffs in 2022-23 will have to aggregate to Rs 7.90 per kwh	• One of the most critical areas for success of the Program in 2022-23. The power subsidy is to be reduced from the peak level of Rs 1072 billion in 2021-22 The hike in power tariff will be 40% on average
• Signing Memorandum with Provincial Governments to generate a cash surplus of Rs 750 billion	• The target surplus was Rs 570 billion in 2021-22, but the actual surplus was Rs 351 billion. More than doubling of the cash surplus in 2022-23 is a very ambitious target
• Limiting Guarantees to State-Owned Enterprises and ensuring that loans to the SOEs remain on modest downward trajectory with respect to the GDP	• The credit to SOEs stood at Rs 1340 billion at end of 2021-22, equivalent to 2% of the GDP. The contingent liabilities cost the Government Rs 269 billion in 2021-22 and are budgeted at Rs 291 billion in 2022-23 In the presence of significant cost-push inflation, losses of SOEs could be much higher and require more support
• Public Financial Management Reform, including full operationalization of the Treasury Single Account (TSA) by December 2022	• Progress already made. The issue is the merger of defense services accounts into the TSA.
• Updating and Implementing Medium-Term Budget Strategy to achieve reduction in the public debt to GDP ratio	• MTBS prepared and released by the MOF for 2022-23 to 2024-25, with the objective of reducing the public debt to GDP ratio by 2 percentage points each year
• Devising new Debt Instruments, focusing especially on Shariah compliant Bonds	
• Establishing a Debt Management Office by December 2022	In progress

Other critical steps to be taken relate to the more than halving of power sector subsidies especially by a big enhancement in tariffs. A memorandum has already been signed with the provincial governments on generation of a cash surplus of Rs 750 billion. Further, the Government has committed to limit the increase in contingent liabilities.

Monetary, Exchange Rate and Financial Sector Policies: There are five crucial action/ reform areas as shown in Chart 5.3. The Government has committed to maintaining the policy of market-determined exchange rate and a flexible policy on setting of the SBP policy rate in light of the economic conditions. Further, there is agreement on phasing out of subsidized refinancing schemes of SBP, no exchange and import restrictions and effective implementation of the AML/CFT Framework.

Chart 5.3: Monetary, Exchange Rate and Financial Sector Policies

ACTION / REFORM	IMPACT
• Continued commitment to a market-determined exchange rate	• IMF has projected depreciation of 20% of the Exchange rate in 2022-23. Actual magnitude will depend on the position of FE reserves
• Prudent and Proactive Monetary Policy ◊ The pace of future adjustments in the policy rate will depend on the inflation data, exchange rate developments, the strength of the external position and the fiscal-monetary policy mix	• With the high rate of inflation likelihood of enhancements in the policy rate during 2022-23. Already increased to 16% by 100 basis points in November, 2022
• Phasing out of subsidized refinancing schemes of SBP, including that on exports	• Mostly withdrawn. Will lead to a fall in private investment and impact negatively on exports
• Monitoring health of Financial Sector ◊ Ensuring that there is no under-capitalization of banks	• Two banks have been asked to inject more equity. These are relatively small banks
• Commitment to effective Implementation of the AML/ CFT Framework	• Review undertaken recently by a FATF team in Pakistan. Pakistan has exited from the Grey List
• New Exchange and Import Restrictions ◊ Cash Margin Requirements extended to 177 items ◊ Import ban on import of 33 luxury and non-essential items (including Cars, mobile phones and home appliances) ◊ Import Payment Authorization by SBP before initiation by banks for importing certain goods.	• Under the pressure of IMF, import ban has been withdrawn • The payment authorization system is in place.

Energy Sector Policies: This is a critical problem area of the economy. The focus as shown in Chart 5.4 is on reducing the huge subsidy and better targeting it. This is to be achieved by regular tariff adjustments and medium-term cost reducing structural reforms, including containment of losses.

SOEs: The commitments made in shown in Chart 5.4 relate to SOE legal reforms, advancing privatization and increased transparency through establishment of a Central Monitoring Unit.

Improving Competitiveness and the Business Environment: This includes a new tariff policy proposal for more import substitution and promote 'MADE IN PAKISTAN'. Strong steps to control corruption to facilitate economic transactions by the private sector.

Poverty Reduction and Social Protection: Commitment to expanded BISP program, and *Kafalat* program and *Sasta* Fuel and *Sasta* Diesel program, and rationalization of other programs.

Chart 5.4: Energy Sector Policies and State-Owned Enterprises (SOEs)

ENERGY SECTOR POLICIES

- Better targeting of subsidies
- Resuming Regular Tariff Adjustments
- Reducing the Circular Debt Stock
- Accelerating Medium-Term Cost-Reducing Structural Reforms
- Reforms in the Gas Sector
- Updating of Gas Prices

STATE-OWNED ENTERPRISES

Improving SOEs governance, transparency, efficiency as well limiting the fiscal risks:

- SOE Legal Reforms
- Central Monitoring Unit (CMU) with MOF to improve SOE performance
- Increasing Transparency
- Advancing Privatization and SOE support
    - ◊ Debt recapitalization and refinancing of two RLNG plants
    - ◊ Advancing privatization of HBFC and First Women Bank

5.2 IMF's Macroeconomic Projections for 2022-23

The IMF's macroeconomic projections fully incorporate the successful implementation by the Government of the Memorandum of Economic and Financial Policies, described in Section-1 of the report. They are presented in Table 5.1.

Table 5.1: Key Macroeconomic Targets

	2021-22 (Actual)	2022-23 (IMF Projection)
GROWTH RATE OF GDP (%)	**6.0**	**3.5**
RATE OF INFLATION (%)		
CPI – Average	12.2	19.9
CPI – End of Period	21.3	15.0
LEVEL OF INVESTMENT (% of GDP)	**15.1**	**16.9**
Private	13.1	14.7
Public	2.0	2.3
LEVEL OF SAVINGS (% of GDP)	**10.5**	**14.4**
Private	15.5	16.8
Public	-5.0	-2.4
UNEMPLOYMENT RATE (%)	**6.3**	**6.0**
CURRENT ACCOUNT DEFICIT (% of GDP)	**-4.7**	**-2.5**
BUDGET DEFICIT (% of GDP)	**-7.9**	**-4.9**

Growth: The IMF expects a big decline in the GDP growth rate to 3.5 percent in 2022-23 from 6 percent in 2021-22, largely as the outcome of the severely contractionary fiscal and monetary policies. However, perhaps surprisingly, it expects private investment to rise in real terms by as much as 12 percent, despite high interest rates and the end to concessionary project financing by the SBP.

Rate of Inflation: The rate of inflation is expected to rise to almost 20 percent in 2022-23. This will hinge, of course, on the path of international commodity prices and the exchange rate during the year. The IMF expects the rupee to depreciate by 20 percent by June 2023. In addition, the Program requires quantum jumps in the prices of fuel products, electricity, and gas. There has also been a heavy dose of indirect taxation in the budget for 2022-23. Therefore, the rate of inflation may be significantly higher during the year than 19.9 percent.

Table 5.2: BOP Projections by the IMF – *($ million)*		
SUMMARY	2021-22	2022-23
Current Account Deficit	-17,461	-9,280
Capital Account	208	161
Financial Account Surplus	10,355	12,682
Net Errors & Omissions	-608	0
Overall Balance of Payments	**-7,504**	**+3,563**
Augmented IMF Funding	36	+2,841
Change in Reserves	**-7,469**	**6,405**
CURRENT ACCOUNT – *($ million)*	2021-22	2022-23
Balance of Trade in Goods	**-40,140**	**-32,856**
Exports	31,877	45,900
Imports	72,017	68,756
Balance of Trade in Services	**-3,690**	**-3,507**
Exports	6,832	7,043
Imports	10,522	10,550
Primary Income (Net)	**-5,288**	**-4,763**
TT	2,774	2,247
Secondary Income (Net)	**31,658**	**31,846**
Worker's Remittances	30,117	28,958
Other Transfers	1,451	2,647
CURRENT ACCOUNT DEFICIT	**-17,461**	**-9,280**
FINANCIAL ACCOUNT – *($ million)*	2021-22	2022-23
FINANCIAL ACCOUNT SURPLUS	**10,355**	**12,682**
Foreign Direct Investment	2,583	2,356
Portfolio Investment	447	3,210
General Government (Net)	**6,074**	**7,062**
Disbursements	10,729	19,476
Amortization	8,288	12,414
Others	3,633	-
Others	**1,251**	**240**

Balance of Payments: The detailed projections are in Table 5.2. The current account is projected to come down sharply from 4.7 percent of the GDP in 2021-22 to only 2.5 percent of the GDP in 2022-23. This is to be achieved by an increase in merchandize exports of almost 13 percent and a reduction in imports by 5 percent. The latter is more likely, especially if the international oil price falls significantly, as is happening currently.

However, in the presence of a global recession a double-digit growth in exports in unlikely, especially with rise in cost of export financing and higher electricity and gas tariffs.

Public Finances: The detailed projections are in Table 5.3. A huge improvement is anticipated in the state of public finances, with the budget deficit being brought down from 7.9 percent of the GDP to 4.9 percent of the GDP, primarily by economy in current expenditures. This will be very difficult to achieve.

Table 5.3: IMF's Public Finance Projections for 2022-23 *(Rs in Billion)*

	2021-22	IMF Projections 2022-23	Growth Rate (%)
A. REVENUES	**8,075**	**10,371**	**28.4**
A.1. FEDERAL	**7,335**	**9,365**	**27.7**
Tax Revenues	6,283	8,430	34.2
FBR Revenues	6,143	7,470	21.6
Petroleum Levy	127	855	a*
NGDS + GIDC	13	105	a*
Non-Tax Revenues	**1,082**	**935**	**-11.1**
A.2. PROVINCIAL	**740**	**1,006**	**35.9**
Tax Revenues	612	790	29.1
Non-Tax Revenues	128	216	68.8
B. EXPENDITURE	**13,335**	**14,284**	**7.1**
B.1. FEDERAL	**9,269**	**9,478**	**2.2**
Current Expenditure	**8,5698**	**8,778**	**2.5**
Debt Servicing	3,182	4,067	27.8
Defence	1,412	1,563	10.7
Others [Subsidies + Grants, etc.]	3,974	3,148	-20.8
Development Expenditure	**701**	**700**	**0.0**
B.2. PROVINCIAL	**4,066**	**4,806**	**18.2**
Current Expenditure	2,849	3,557	24.9
Development Expenditure	**1,217**	**1,249**	**2.6**
C. BUDGET DEFICIT	**-5,260**	**-3,903**	**-25.8**
% of GDP	**-7.9**	**-4.9**	

**very large*

5.3 Meeting the Performance Criteria and Indicative Targets

An assessment is made below of the likely extent of success in forthcoming reviews in meeting the performance criteria and indicative targets. The dates are as follows:

FORTHCOMING REVIEW MEETINGS			
Review	**PC and IT* of**	**Date of Mission to Pakistan**	**Release SDRs (Million)**
Ninth Review	End-September 2022	November 3, 2022	894
Tenth Review	End-December 2022	February 3, 2022	528
Eleventh Review	End-March 2023	May 3, 2033	528 *PC = Performance criteria, IT = Indicative targets

Subject to successful completion of a review and approval of the IMF Executive Board, the equivalent of number of SDRs to be released is shown in the table above.

Performance Criteria

Floor on Net International Reserves of SBP: The end-quarter levels of net international reserves are given in Table 5.4. Net International reserves are the gross foreign exchange reserves of SBP, minus the foreign exchange liabilities and the outstanding loan amount with the IMF. The projection for the three quarters of 2022-23 is on the assumption that the foreign exchange reserves increase in a linear manner.

Table 5.4: Performance Criteria and Indicative Targets

	End-June 2022	End-September 2022	End-December 2022	End-March 2023	Assessment of Toughness
PERFORMANCE CRITERIA					
• Floor on Net International Reserves of SBP *($ billion)*	-10.78	-11.45	-10.30	-9.80	High
• Ceiling on Net Domestic Assets of SBP *(Rs in Billion)*	10,850	11,127	11,213	11,327	-
• Ceiling on general government Primary Budget Deficit *(Cumulative, Rs in Billion)*	-1,900	-339	-924	-987	High
• Ceiling on Amount of Government Guarantees *(stock, Rs in Billion)*	2,771	2,978	3,077	3,102	Medium
• Cumulative Floor to BISP Spending *(Rs in Billion)*	n.a.	70	149	232	Low
INDICATIVE TARGETS					

• Cumulative Floor to Government Education and Health Spending *(Rs in Billion)*	1,796	446	1,070	1,721	Low
• Floor on net Tax Revenues by FBR *(Rs in Billion)*	6,150	1,569	3,511	5,304	Medium
• Ceiling on Power Sector Payment Arrears *(Cumulative flow, Rs in Billion)*	536	-208	-157	30	High

PROJECTION OF NET INTERNATIONAL RESERVES OF SBP				
	End-June 2022	End-September 2022	End-December 2022	End-March 2023
FE Reserves of SBP	9.8	11.4	13.0	14.6
FE liabilities plus IMF Outstanding Loan	-20.6	-22.9	-23.3	-24.4
Net International Reserves	-10.8	-11.5	-10.3	-9.8

The foreign exchange position of the SBP as of end of December 2022 of reserves of $11.4 billion has not been met with a shortfall of almost $6 billion, even after receipt of $1.17 billion from the IMF in September 2022.

Subsequent quarters are likely to witness a bigger divergence because of the following reasons:

i) Slower growth of exports because of the global recession, some loss of competitiveness due to cost-push factors like escalation in interest costs and power tariffs and limited availability of imported inputs.

ii) Given the poor state of the economy and the political tumult, foreign investment is unlikely to be at the projected level. Already, in the first five months of 2022-23, foreign investment has declined by 56 percent.

iii) Flotation of Euro bonds will be constrained by the heavy discount that will have to be offered.

Ceiling on Net Domestic Assets of the SBP: IMF states that as of end-June 2022 the net domestic assets of the SBP were Rs 10,850 billion. However, this represents a big divergence from the actual level of Rs 8,272 billion. As such, this performance criteria will have to be reformulated.

Ceiling on General Government Primary Budget Deficit: This is an important performance criterion and is the bottom-line measure of the Government's success in meeting the public finance targets.

Achieving the reduction in the budget deficit from 7.9 percent of the GDP and 4.9 percent will be extremely difficult for the following reasons:

i) Likely higher cost of debt servicing because the high on-going rate of inflation may compel the MPC of the SBP to raise the policy rate.

ii) It will not be possible to reduce the power sector subsidy by almost 50 percent due to high fuel costs and the likelihood of public protests in the event of a big escalation in power tariffs.

iii) Failure of the Provincial Governments to generate the target cash surplus in the presence of a shortfall in revenue transfers from the Federal Government.

iv) Likelihood of a significant shortfall in Federal revenues, especially in import-related taxes and petroleum levy. The former will be limited by the contraction of imports through control over LCs of imports by the SBP.

The actual outcome of the budget deficit is likely to be closer to 6.0 percent of the GDP. Consequently, while the target is for a primary surplus of Rs 153 billion in 2022-23, it is likely to be a big deficit of over Rs 900 billion. As such, the probability of meeting this key performance criterion is very low.

Ceiling on Amount of Government Guarantees: During the first three quarters of 2022-23, the performance criteria implies that the quantum of new guarantees issued will have to be restricted to Rs 331 billion. During the same period the increase in 2021-22 was Rs 344 billion. This year there will be greater pressure on liquidity of SOEs because of cost-push inflation. Strong restraint will have to be exercised in the extension of new guarantees if the performance criteria is to be met. During the first half of 2022-23 the flow of credit to the SOEs has increased by 21 percent.

Cumulative Floor on BISP Spending: The budgetary allocation for 2022-23 is Rs 361 billion. The performance criterion requires Rs 232 billion to be spent in the first nine months, which is very likely because of the need to provide relief to the flood affected population.

Indicative Targets

Among the indicative Targets, the likely position in 2022-23 is as follows:

Cumulative Floor to Government Education and Health Spending: The spending was equivalent to 2.7 percent of the GDP in 2021-22. The expectation is that it will reach 2.0 percent of the GDP in the first nine months of 2022-23. This is likely, especially since the Provincial Governments are planning to increase their social sector expenditures by over 18 percent, according to the respective budgets of 2022-23.

FBR REVENUES			
	1st Quarter	2nd Quarter	3rd Quarter
2020-2023, Performance Criteria Level	1,569	3,511	5,304
2021-22 Actual Net Collection	1,397	2,919	4,821
Required Growth Rate	**12.3**	**20.2**	**10.0**

Floor on Net Tax Revenues of FBR: A comparison is made below of the quarter revenue performance criteria with the actual revenues in the corresponding quarters of 2021-22. The setting of the targets is defective, with a big decline in the growth rate in the third quarter. With the present numbers in the performance criteria, there may be some difficulty in meeting the criteria in the second quarter of 2022-23.

Ceiling on Power Sector Payment Arrears: The arrears of Rs 536 billion are all to be cleared in the first quarter of 2022-23. This is well-nigh impossible. It is surprising that the government accepted this target.

Overall, the position with regard to meeting the performance criteria is given above in the Table 5.4. The three performance criteria which will be very difficult to meet are as follows:

First	Second	Third
Floor on Net International Reserves	**Ceiling on the General Government Primary Budget Deficit**	**Ceiling on Power Sector Payment Arrears**

Therefore, the future of the IMF program over the next three reviews is uncertain. There will be pressure for mini-budgets or other emergency actions to meet all the criteria unless there is willingness to give waivers by the IMF through the Executive Board.

5.4 Fulfilling the External Financing Requirements

This is a very important part of the IMF report. It indicates what the total external financing requirements are in 2022-23 and how these will be met, as shown in Table 5.5. They include potential rollovers and new inflows.

The gross external financing requirements consist of the current account deficit, amortization of external debt and repayment of IMF loan.

The year, 2021-22, witnessed a big shortfall in external financing, aggravated by the absence of a functional IMF program for many months. The financing requirement was $34.3 billion, augmented substantially by the large current account deficit of $17.4 billion. The total external financing which became available was $26.9 billion, implying a big shortfall $7.4 billion, which was reflected fully in the fall in foreign exchange reserves.

The estimated external financing requirement in 2022-23 is $30.8 billion, with a smaller current account deficit of $9.3 billion and amortization of external debt of $21.5 billion. The expected inflow of financing is $37.2 billion, including $3.8 billion from the IMF. Consequently, a build-up of reserves of $6.4 billion is being projected.

The primary sources of financing will be, first, $16.6 billion from syndicated loans and Eurobonds. Second, the inflow from official creditors, both multilateral and bilateral, is projected at $14.4 billion. In effect, the projection is that external financing will increase by as much as 38 percent compared to 2021-22 in the presence of a functional IMF program.

Finally, there is a need to look at medium-term projections of Pakistan's external financing requirements as estimated by the IMF from 2023-24 onwards. The assumption is that the current account deficit will remain curtailed at 2.5 percent of the GDP.

Table 5.5: The External Financing Requirements and their Financing in 2022-23 *($ Billion)*

	Public Sector	Private Sector	Total
Gross External Financing Requirements	**25.7**	**5.1**	**30.8**
Current Account Deficit	9.3	-	9.3
Amortization	15.4	5.1	20.5
Repayment to IMF	1.0	-	1.0
Available Financing	**21.0**	**12.2**	**33.2**
Foreign Direct Investment	-	2.2	2.2
From Private Creditors	9.9*	6.7**	16.6
Official Creditors	11.1	3.3	14.4
Net Position	**-4.7**	**7.1**	**2.5**
IMF Loan Disbursement	**3.8**		
TOTAL	**-0.8**	**7.1**	**6.4**
Increase in FE Reserves			**6.4**

**Includes syndicated loans and Eurobonds.*

***Includes equity and debt portfolio inflows and borrowing by banks and other sectors.*

The gross external financing requirement in 2023-24 is $36.6 billion, an increase of 19 percent over the projected level in 2022-23. It will increase further to $39.3 billion in 2026-27. The primary reason for the increase is higher amortization payments by almost 25 percent over the level in 2022-23.

The relentless growth in external financing needs over the next few years raises a fundamental question. **Can Pakistan survive without an IMF program after May 2023, even after the successful completion of the present program? The answer unfortunately is NO**. This can only happen if the current account deficit is largely eliminated, which will require even deeper and wider structural reforms.

The time has also come for renegotiating with the IMF the targets and conditionalities for 2022-23 in light off the devastating floods.

Pakistan is in a state of multiple crises. The weak and faltering economy has been hit by a mammoth natural disaster. The external financing requirements have reached extremely high levels. Consequently, the extended IMF program requires extremely strong efforts at stabilization of the economy by over 40 percent cut in both the current account and budget deficits. The Program quarterly performance criteria are proving to be very difficult to meet and during the quarterly review process there will be high uncertainty in the foreign exchange and stock markets about the future of the IMF program.

Chapter 6:

Economic Impact of Implementation of Prior Actions

The Government presented on the 30th of December two bills, the **Finance (Supplementary) Bill, 2021** and the **State Bank of Pakistan (Amendment Bill), 2021**, in the Parliament. This is part of the process of implementation of prior actions for successful completion of the on-going review of the IMF program with Pakistan. Completion of these actions will lead to the approval by the IMF Executive Board of the release of $1 billion to Pakistan on the 12th of January 2022.

This chapter is organized as follows. The first section identifies the tax reforms committed to by the Government of Pakistan in the Letter of Intent to the IMF on the 9th of April 2021, which remained unimplemented up till the commencement of the sixth review in October 2021. The second section of the article describes the key features of the Federal general sales tax (GST) and the reforms proposed in the Finance (Supplementary) Bill, 2021. Results of the analysis of the impact on prices, growth and on different segments of the population are presented at the end of this section.

The third section focuses on the key features of the State Bank (Amendment) Bill, 2021. Analysis is undertaken of the impact of greater autonomy of the Central Bank. Finally, a summary is presented in Section 4.

6.1 Agenda of Tax Reforms

The reforms agreed to in the letter of intent issued by the Government to the IMF on the 9th of April are as follows:

Sales Tax reforms: This will include, first, elimination of all zero-rated goods in the Fifth Schedule of the Sales Tax Act, 1990, except on export and machinery, and levy of standard sales tax rate. Second, removal of all reduced rates in the Eighth Schedule and bring them all to the standard rate. Third, elimination of exemptions in the Sixth Schedule excluding a small subset of goods (i.e. basic food, medicines, live animals for human consumption, education and health-related goods) and bring all others to the standard rate. Fourth, removal of the Ninth Schedule to replace a specific tax rate for cell phones with the standard rate., These reforms are expected to yield 0.7 percent of the GDP on an annualized basis.

Increase Progressivity of the Personal Income Tax: This will include, first, reduction in the number of rates and brackets from eleven to five and decreasing the size of the income slabs. Second, reduction in tax credits and allowances by 50 percent (except for Zakat and those provided for disabled and senior citizens).

6.2 Features of the Finance (Supplementary) Bill

This bill has the primary focus on the sales tax reforms, while some changes are also proposed in the excise duty and income tax. The quantum of revenue loss currently in the sales tax system has been estimated for 2020-21 and is presented in Table 6.1.

Table 6.1: Estimated Revenue Loss due to the Different Sales Tax Schedules, 2020-21

(Rs in Billion)

Schedule	Description	Revenue Loss*
5th	Zero-rating	12.9
6th	Exemption on Imports	173.8
6th	Exemption on Local Supplies	156.1
8th	Reduced Rates	208.5
9th	Mobile Phones	27.1
	TOTAL	**578.4**

***Source:** *FBR, Tax Expenditure Report, 2021.*

The revenue loss estimated by FBR is equivalent to 29 percent of the revenues actually collected from the sales tax in 2020-21.

The Finance (Supplementary) Bill has proposed the following changes in the Schedules.

Fifth Schedule: The following omissions:

Serial No.	Description	Revenue (Rs in Billion)
3	Supplies to Duty Free Shops and Diplomatic Supplies	0.8
6A	Supplies of locally manufactured machinery to EPZ	1.9
15	Supplies to Exporters under EFS	0.1
18	Supplies to Ships	-
	TOTAL	**2.8**

The revenue foregone in 2020-21 was marginal.

Sixth Schedule

A large number of exemptions are proposed to be withdrawn including the items in the following serial numbers of the Table of the Schedule:

Serial numbers 1, 2, 3, 11, 12, 16, 20, 21, 23, 46, 49, 50, 51, 52, 52A, 53, 54, 55, 57, 58, 60, 61, 63, 71, 72, 81, 84, 92, 99, 102, 104, 105, 107, 109, 110, 113, 114, 116, 117, 126, 127, 129, 130, 131, 132, 134, 135, 136, 138, 139, 140, 141, 142, 146, 149, 150, 155 and 158 and entries relating thereto in columns (2) and (3) shall be omitted; and

From Table 2 of the Schedule:

Serial numbers 1, 2, 4, 9, 15, 16, 22, 23, 33, and 38 and entries relating thereto in columns (2) and (3) shall be omitted.

From Table 3, in the Annexure,

2, 2A, 3, 4, 5, 6, 7, 8, 9, 11, 13, 14, 14A, 15, 15A, 15B, 17 and 21 shall be omitted.

Within this long, list, the major import items on which exemptions have been withdrawn are as follows:

Serial No.	Description	Revenue (Rs in Billion)
20	Seeds and spores used for sowing	2.0
110 & 14A	Items for renewable source of energy	6.8
131 & 132	Laptop Computers and Personal Computers	4.8
141	Preparations for making Animal Feed	1.8
	TOTAL	**15.4**

These withdrawals of tax exemptions will have negative impact on the agricultural sector (especially livestock), investment in renewable energy and the development of the IT sector of Pakistan, especially exports.

The Eighth Schedule:

The Eighth Schedule has implied the largest revenue foregone of over Rs 200 billion, as shown in Table 6.1. The FBR had initially prepared a very long list of items to be shifted to the standard rate. However, this list was subsequently truncated by the Ministry of Finance. The key items retained in the Eighth Schedule are shown in Table 6.2. Fortunately, this retention has reduced the potential negative impact on agriculture, use of LNG/LPG and the chemicals industry.

However, the consequence is that there is a substantial overstatement of the total revenue impact of Rs 350 billion. It could be less by over Rs 150 billion. The question is, will the IMF be able to identify this gap and ask for more reforms in the sale tax regime or elsewhere?

Table 6.2: Major Items Retained in the 8th Schedule
(Items Excluded from the Original List Submitted by FBR to the MOF)

Section	Rate	Description	Revenue (Rs in Billion)
5	5	Raw and Ginned Cotton	1.8
22	8.5	Soya bean Seed on Import	11.0
23	5.0	Second hand clothing	3.4
25	5.0	Agricultural Tractors	2.1
43	5.0	Natural Gas supplied to Fertilizer plants	4.4
44	5.0	Phosphoric Acid	6.5
51	12.0	LNG/LPG	19.7
52	2.0	Fertilizer	87.0
57	10.0	Rock Phosphate	0.3
58	10.0	LPG	3.4
60	10.0	Fat-filled Milk	3.7
65	10.0	Ginned Cotton	12.8
67	5.0	LNG	2.3
		TOTAL	**159.4**

The major items which will be subject to the standard rate following the passage of the Bill are shown in Table 6.3.

The long list of items in Table 6.3 on which the standard rate will be applied following passage of the bill will have a negative impact on crop agriculture, livestock, fishing, steel industry, automobiles (above 850cc) sales, nutrition for infants, medicines, personal computers, etc. Private investment, especially in agriculture and renewable energy will also be discouraged. The sales tax on retail outlets will go up from 10 percent to 12 percent. Needless to say, the negative impact would have been much larger if items in Table 6.2 had also been excluded from the Eighth Schedule.

Table 6.3: Major Items to be excluded from the 8th Schedule				
4	Oil Seeds meant for sowing	5%	72	Uncooked Poultry Meat
6	Plant & Machinery	10%	81	Cotton Seed
7-14	'Exotic' Food Items	10%	84	Preparations for Infants
15	Ingredients of Poultry, Cattle Feed	10%	92	Sewing Machines
16	Machinery	5%	99	Compost
17	Temporary Export	5%	102	Machinery, materials in EPZs
20	Machinery	5%	104	Substances as Drugs
26	Agricultural Machinery	5%	105	Raw Materials from Pharmaceuticals
27	Agricultural Machinery	5%	107	Iodized Salt
28	Irrigation Equipment	5%	109	PIA
29	Agricultural Machinery	5%	110	Renewable Energy Machinery
30	Agricultural Machinery	5%	113	Irrigation Equipment
34	IT, Media	5%	114	Green House Farming
45	Poultry Machinery	7%	116	Plant & Machinery for FATA
46	Phosphoric Acid	10%	117	Ostomy Equipment
54	Battery	12%	126	Aviation
55	Fish Seedlings	5%	127	Aviation
59	Milling Industry (excluding wheat)	10%	129	Plant & machine and equipment for mobile phone manufacture
61	Silver	1%	130	Vitamins
62	Gold	1%	131	Laptop Computers, Note Books
63	Jewelry	1.5%	132	Personal Computers
64	Prepared Food, Sweetmeats supplied by Rest, bakeries & goat meat shops	7.5%	134	Gift
66A	Supplies made by Retail Outlets	16%	135	Sunflower and Canola Seed
66B	Import of Remelt-able Scrap	14%	136	Combined Harvesters
68	Frozen Meat	8%	138	Fish feed
69	Meat	8%	139	Fans for Dairy Farms
66	Retail Outlets	10%	140	Bovine Semen
70	Cars up to 850cc	12.5%	141	Inputs for Animal Feed
			146	Miscellaneous Items

6.3 The State Bank of Pakistan (Amendment) Bill, 2021

The SBP (Amendment) Bill submitted to the Parliament on the 30th of December 2021 represents one of the most fundamental attempts at institutional reform in the history of Pakistan. Comments on the different sections of the proposed Bill are given below.

2. *Preamble:* The primary objective of the SBP according to the Bill will be to achieve domestic price stability by way of regulating the monetary and credit system of Pakistan. The basic question is how much control does the SBP, in fact, have on inflation caused by rise in international prices of commodities imported by the country or due to cost-push factors like escalation in energy tariffs?

Also, for a developing country there is need for a balanced combination of the growth and inflation targets. As per the Constitution, the Annual Plan with these projections/ targets is approved by the National Economic Council chaired by the Prime Minister. The SBP Governor should ex-officio be a member of the NEC and contribute to the finalization of the Annual Plan. The SBP should also then work towards achievement of these targets.

4B. *Objectives:* This clause of the proposed legislation states that the 'Bank will contribute to the stability of the financial system.' Instead, the Bank should be responsible of the stability of the financial system.

4C. *Functions of the Bank:* Item (c): This should state that the SBP will undertake research to identify in quantitative terms the broader social and economic impacts of the use of different instruments of monetary and credit policies.

9C. *Prohibition of Government Borrowing:* This clause clearly states that the SBP shall not extend any credit to the Government. There are two comments on this proposed legal limitation.

First, there is need for an emergency provision in the event of natural disasters or territorial security concerns. Second, the drafters of the Bill are probably not aware of the phenomenon of '*seigniorage*'. This is the normal increase in the demand for money, which is estimated at 1 percent of the GDP in Pakistan. This much direct borrowing should be allowed, equivalent to over Rs 650 billion.

9G. *Governor and Minister of Finance to establish liaison:* Informal mechanisms generally do not work. The existing Act has a provision for the *Fiscal and Monetary Policies Coordination Board*. This has been an effective mechanism for development of mutually supportive fiscal, monetary, trade and other policies. This Board should be retained.

39. ***Accountability:*** The proposed Bill states that the Governor shall submit an annual report to the Parliament regarding the achievement of the Banks' objectives. Ideally, this should be twice a year. The Governor should present the report himself to the Finance Committees of the National Assembly and the Senate. Further, quarterly reports should be released by the SBP on the State of the Economy.

42. ***Distributable Earnings:*** There is need for a careful analysis of the proposed formula for quantification of distributable earning, especially that to be remitted to the Government of Pakistan. Access to SBP profits has been one of the largest sources of non-tax revenues to the Federal Government.

The focus of the above comments is on policy issues and not on operational matters of the SBP. The amended SBP Act was passed without any changes by the National Assembly.

6.4 Summary

i) A large number of items will be withdrawn from the 5th, 6th and 8th Schedules of the Sales Tax Act, 1990. The expectation is that this will lead to annual revenues of almost Rs 350 billion. However, many of the sensitive items like fertilizer, pesticides, tractors, natural gas, LNG, LPG, etc., have been retained in the Schedules. Consequently, the impact on the price level will be much less. The maximum revenue that will be generated is likely to be less than Rs 220 billion. The IMF may ask for inclusion of more items if it is able to assess the quantum of revenue from the Finance (supplementary) Bill in its present form.

ii) A large number of sectors will be negatively impacted by the rise in sales tax rates on outputs, inputs or machinery. This includes crop agriculture, livestock, fishing, electricity generation, telecommunication, information technology, retail trade, etc.

   The impact on households includes the rise in the sales tax on some food items, electronic goods, medicines, jewelry, sewing machines, personal computers, mobile phones (above $200 price), automobiles (above 860c) contraceptives, etc. The incidence is likely to be higher on upper income households.

iii) The State Bank of Pakistan (Amendment) bill envisages extreme autonomy for the Central Bank. There are serious issues related to the preamble, level of responsibility for regulation of the banking system, setting of the inflation target, prohibition of direct Government borrowing, dissolution of the Fiscal and Monetary Policies Coordination Board, nature of Accountability to the Parliament and Formula for Distribution of profits to the single shareholder (the Government).

Chapter 7:

Status of Implementation of The IMF Program

The IMF Program which had been suspended in February 2022 became operative once again in June 2022. The seventh and eighth reviews were successfully completed and a loan amount of $1.2 billion was released by the IMF. The Program has been extended to June 2023, with three more reviews.

The ninth review relates to the first quarter, July to September of 2022. The review was to be undertaken by the IMF staff from November 3 onwards. However, the review process has been delayed.

The objective of this article is first to identify the macroeconomic trends in this quarter and up to November 2022 and analyze their consistency with the IMF macroeconomic projections. This is followed by an assessment of the status of implementation of actions and reforms committed to the IMF in the Letter of Intent on Memorandum of Economic Policies issued by the Government of Pakistan. This will help in understanding why the ninth review by the IMF has been delayed.

7.1 Macroeconomic Trends

Table 7.1 highlights the trends in the first quarter of 2022-23 and compares them with the macroeconomic projections by the IMF. These projections do not reflect the large negative impact of the worst floods in Pakistan's history estimated at over $30 billion.

The IMF Staff report has targeted for a 3.5 percent GDP growth rate in 2022-23. After the floods, it is likely to fall sharply to minus 1 percent, as highlighted in Chapter 4.. The IMF projection of the rate of inflation in 2022-23 is also already off the mark. It is close to 20 percent, whereas the average monthly increase in the CPI has exceeded 25 percent in the first six months of 2022-23. This reflects the relative fast depreciation of the value of the rupee, supply shortages of food items which have emerged after the floods and the physical import restrictions.

The IMF expects a monetary expansion of 12 percent in 2022-23. However, in the first quarter there has been hardly any increase in the money supply (M2). Private sector investment has faltered because of very high interest rates and consequently the quantum of credit has remained unchanged at the same level as in the first quarter of 2021-22.

Table 7.1: Macro-Economic Projections for 2022-23 in the IMF Program and Actual Outcome in the first Quarter of 2022-23

	2022-23 (Projections)	1st Quarter (Actuals)
GDP Growth Rate (%)	**3.5**	**n.a**
Rate of Inflation in the CPI (%)		
Monthly Average	19.9	25.1
End of Period	15.0	23.1
Monetary and Credit		
Broad Money (% change)	12.0	-0.7
Private Credit (% change)	13.3	0.0
General Government Finances Growth Rate (%)		
Revenues	**29.3**	**11.5**
Tax Revenues	36.5	16.2
Non-Tax Revenues	-10.2	-14.9
Expenditure	***7.4***	***25.8***
Current	6.0	29.0
Development	17.6	-17.0
Budget Deficit	***-25.6***	***84.3***
Balance of Payments		
Current Account Balance (% of GDP)	-2.5	-0.5
Foreign Direct Investment (% of GDP)	0.60	0.04
Gross Reserves (in $ billion)	16.2	7.9
(In months of imports of goods & services)	2.3	1.1
Total External Debt ($ billion)	137.6	126.6
% Of GDP	37.0	34.1

Turning to the state of government finances there are already huge violations from the targets agreed with the IMF. Tax revenues are expected to show annual growth of 36.5 percent in 2022-23. Instead, they have demonstrated an increase of only 16 percent in the first quarter. Similarly, the growth rate of current expenditure is expected to be limited to only 6 percent, but the actual increase in the first quarter is as much as 29 percent. Consequently, while the year, 2022-23, is expected to close with a budget deficit that is almost 26 percent smaller than the magnitude of 2021-22, the actual deficit is 84 percent larger in the first quarter is larger than the deficit in the corresponding quarter of the previous year. It is not surprising that these large deviations have impacted on the views of the IMF about the likelihood of success of implementation of the Program in 2022-23.

The most crucial set of numbers relate to the external balance of payments. Fortunately, there appears to be success at least in restricting the size of the current account deficit to 0.5 percent of the GDP, which is in line with the annual target deficit of 2.5 percent of the GDP.

However, the net inflow into the financial account has been negative and consequently the overall position has been a balance of payments deficit of almost $2 billion, despite the inflow from the IMF of $1.2 billion during the quarter. Consequently, foreign exchange reserves are down to $7.9 billion. This again is in sharp contrast to the IMF projection that foreign exchange reserves of Pakistan will rise to a healthy $16.2 billion by end-June 2023.

Overall, the macroeconomic outcomes in the first quarter of 2022-23 clearly indicate that the Program is not achieving the goal of stabilizing and strengthening the economy of Pakistan and tougher actions and reforms are required. This tendency has been further confirmed by developments in the months of October and November 2022.

The most important manifestation of failure is the inability of Pakistan to attract large external inflows of assistance despite the umbrella of an operational IMF Program. The actual inflow is $4.3 billion in the first four months of 2022-23. This is only 19 percent of the targeted inflow of $22.8 billion in the year. Inflows by flotation of Euro/Sukuk bonds and by borrowings from international commercial banks have been near zero.

7.2 Progress on Implementation of Reforms

The fifth chapter had highlighted the actions and reforms committed by the Government in the Memorandum of Economic and Financial Policies. The actions taken in the first quarter or not yet in response to these commitments are listed in Chart 7.1.

Tax Policy

The petroleum levy on motor spirit has been raised to the maximum targeted level of Rs 50 per litre. The expectation is that this will also be case with HSD oil by March 2023.

The fundamental reform involving the harmonization of the provincial sales tax on services with the federal sales tax on goods has made little progress. There is no agreement yet even on the classification of goods and services and on the need to avoid the levy of the federal excise duty on services.

There has also been a shortfall in FBR and petroleum levy revenues in the first five months of 2022-23. There is a contingency provision in the Program whereby in the event of a shortfall the sales tax on petroleum products will be restored. Fortunately, the international price of crude oil has fallen recently by 30 percent compared to the level at the time of presentation of the budget for 2022-23. As such, the sales tax may be restored soon without any significant change in retail prices of petroleum products.

Chart 7.1: Progress on Implementation of Reforms

ACTION / REFORM	PROGRESS
TAX POLICY	
• Raising Petrol Levy to Rs 50 per litre on Motor Spirit and HSD oil	• Only partial progress
• Harmonization of the Sales Tax on Goods and Services	• No agreement yet on classification of goods and services respectively
• Restoring GST on POL products in the event of revenue shortfall	• Big shortfall in revenue from petroleum levy but no GST restoration yet
• Reduce stock of income tax arrears.	• Only partial achievement of quarterly target
• Increasing number of income taxpayers by 300,000	• Number of income tax returns filed for 2021-22 decreases
MANAGEMENT OF EXPENDITURES	
• Reducing subsidies in 2022-23 by 50% to Rs 570 billion	• Payment of subsidies increased in first quarter by 26%
• Limiting Guaranteed Loans to SOEs	• Big increase of 21% in the first six months
MONETARY, EXCHANGE RATE AND FINANCIAL SECTOR POLICIES	
• Commitment to market-determined exchange rate	• Demand for dollars managed by physical control by SBP on LCs
• Pace of future adjustments in the policy rate will depend on inflation rate	• Policy rate raised to 16% by 100 basis points
• **Phasing out subsidized refinancing schemes of SBP***	• Done
• **Effective implementation of AML/CFT Framework***	• Pakistan successfully exits from the FATF Grey List
ENERGY SECTOR POLICIES	
• Increase in Electricity Tariff by 7.90 Rs per kwh	• Not implemented
• Reducing the Circular Debt stock	• Circular debt has increased
• Updating of Gas Prices	• Not yet implemented
SOEs	
• **Passage of SOE's Law***	• Passed
• Central Monitoring Unit to be set up in MOF	• Not yet
• Advancing Privatization of SOEs	• No progress

** Reforms which have been successfully implemented.*

The target for increasing the number of income tax payers has not been met. Also, there has not yet been full elimination of income tax arrears.

Management of Expenditures

One of the key targets in the Program is a 50 percent reduction in the outlay on subsidies by the federal government. However, in the first quarter of 2022-23 the payment of subsidies has actually increased by 26 percent.

Monetary Policies

An explicit commitment has been made for operation of a market-determined exchange rate policy. Instead, the SBP has opted to manage the demand for dollars by administrative control over import LCs. This is a blatant violation and on inappropriate step. There is need to revert to a market-based exchange rate policy and close the gap between the inter-bank rate and the open market rate, which has led to a diversion of flows of remittances and exports into the hawala market.

The policy rate remained at 15 percent in the first quarter of 2022-23. However, it has recently been raised to 16 percent. The good news is that Pakistan has successfully exited from the FATF Grey List and all concessional refinancing schemes have been withdrawn by the SBP.

Regarding the SOEs there continues to be little progress. The full increase in electricity and gas tariffs is yet to take place. The SOE's Law has been passed, but there is no progress in the process of privatization.

Overall, progress on implementation of agreed reforms has been limited and piecemeal in character. The reluctance of the IMF to finalize the 9th review is understandable in the absence of implementation of key reforms which are clearly in the national interest.

7.3 Meeting the Performance Criteria

Various targets in the form of performance criteria have been set for the end of each quarterly review. Fortunately, this is one area of success. Many of the performance criteria have been met as shown in Chart 7.2.

Three important criteria and indicative targets that have not been met are as follows:

FIRST	SECOND	THIRD
Ceiling on SBP SWAPS	**Ceiling on Accumulation of Tax Arrears**	**Ceiling on Power Sector Payment Arrears**

Overall, the performance in the first quarter is mixed. The weakest area is fiscal policy and additional taxation will have to be resorted to and the subsidy bill reduced in a big way. The physical control over import LCs will have to be withdrawn and a full transition made to market-based exchange rate. The energy sector will need to be focused on with commensurate jump in electricity and gas tariffs such that the subsidy can be reduced. Hopefully, the IMF will accept an upward revision of the budget deficit target to especially accommodate higher expenditures on relief and rehabilitation of the 33 million people hit by the worst floods.

The Ministry of Finance and the SBP must endeavor to ensure the proper continuation of the IMF Program up to June 2023. This is necessary, as without the IMF umbrella there is the risk of a much faster move of Pakistan towards default.

Chart 7.2: Meeting the Performance Criteria and Indicative Targets in the 9th Review *(July to September 2022)*

Performance Criteria/ Indicative Target	Extent of Achievement
• Floor on Net International Reserves of - 11,450 million $	• Met. NIR at - 10,415 million $
• Net Domestic Assets of SBP Ceiling of Rs 11,127 billion	• Met. NDA of SBP at Rs 8,582 billion
• Ceiling of SBP SWAPs of -$4,000 million	• Not met. At $4,240 million
• Ceiling on the general government primary deficit in budget of - Rs 339 billion	• Met. Primary Surplus of Rs 145 billion at end-September
• Ceiling on Net Government Budgetary Borrowing from SBP of Rs 5,791 billion	• Met. At Rs 4,149 billion in end-September
• Ceiling on Amount of Government Guarantees of Rs 2,978 billion	• Met.
• Floor on BISP spending of Rs 70 billion	• Met.

Chapter 8: Drying Up of External Inflows

The fact that Pakistan is currently operating under an IMF program, under the Extended Fund Facility (EFF), should have been a source of comfort to external senders of foreign exchange either in the form of remittances, by purchase of Euro/Sukuk bonds, commercial bank loans or foreign direct investment. Unfortunately, this has not been the case since the start of the current financial year.

8.1 Causes of Decline in Inflows

Why is this the case? First, given the precarious low level of foreign reserves of $5.5 billion as of end-December 2022, when the annual external payment obligations are over four times the reserves, international credit-rating agencies have chosen to downgrade Pakistan's rating to near default level, despite the presence of an IMF program.

Second, in recent months the SBP has severely restricted the repatriation of profits of multinational companies. During the first quarter of 2022-23, the amount repatriated is only $58 million as compared to $477 million in the corresponding quarter of 2021-22. This has sent a very negative signal to potential foreign investors.

Third, the perception of low credit worthiness of Pakistan has led to a big discount of over 60 percent on Pakistani international bonds. Consequently, the cost of flotation of Euro/Sukuk Bonds has become excessively high, despite the annual target of new bonds of $3 billion in 2022-23.

Fourth, remittances have taken a big plunge recently. They have fallen by over 19 percent in December 2022. Earlier, they had declined by 6 percent in the first quarter. This may be partly due to recession in the USA and EU countries. However, the big reason is the widening of the gap in the exchange rate between the open market rate and the inter-bank rate to almost Rs 40 per US$. This has led to a diversion of remittances from official banking channels to hawala transactions.

Fifth, multilateral and bilateral agencies were unwilling earlier to extend loan facilities to Pakistan in the absence of a functional IMF Program. This happened when the seventh and eighth review was completed. The Program was extended to June 2023 with three more quarterly reviews. The Fund released a loan installment of $1.2 billion to Pakistan on the 1st of September. Prior to this in July and August the inflow had been marginal.

8.2 Size of Inflows

The overall magnitude of external inflows into Pakistan in the first quarter of 2022-23 is presented in Table 8.1. The numbers present a depressing picture as follows:

Table 8.1: External Inflows into Pakistan *July – November 2022* *($ Million)*

	2021-22	2022-23	Growth Rate
Secondary Income	**13,949**	**12,538**	**-10.1**
Workers' Remittances	13,288	12,009	-9.6
Other Current Transfers	661	529	-20.0
Foreign Investment	**532**	**232**	**-51.4**
Foreign Direct Investment	834	263	-68.5
Foreign Portfolio Investment	-302	-31	89.7
Government Assistance	**2,226**	**633**	**-71.5**
Disbursements	4,092	4,712	15.1
Amortization	1,866	4,079	118.6
TOTAL	**16,707**	**13,403**	**-19.8**

i) There has been a fall in secondary income of over 10 percent. Remittances have also declined by 10 percent while other current transfers are down by 20 percent.

ii) Total foreign investment, direct and portfolio, has largely ceased with a precipitate fall of over 51 percent.

iii) Net assistance to the Government in the form of loans has also been greatly reduced. Disbursements are up by 15 percent while the level of amortization has more than doubled.

Overall, the total inflow in the five months of 2022-23 was $13.4 billion. This is $3.3 billion lower than the inflow in the corresponding period of 2021-22, implying a big fall of 20 percent.

The IMF program includes an external financing plan for 2022-23 to ensure that not only does Pakistan meets its external payment obligations but is able to increase its foreign exchange reserves by $7 billion to a safe level by the end of 2022-23.

The estimated total required inflow accordingly is $52.5 billion. On the average the monthly inflow in 2022-23 should be $4.4 billion or $22 billion in the first five months of 2022-23. The actual inflow was $13.4 billion, as shown in Table 8.1. This represents a big shortfall of $8.6 billion. It is not surprising that the foreign exchange reserves of the SBP, instead of increasing, declined by $2.1 billion in the first five months of 2022-23. The disappointment is that there has been inadequate support to Pakistan even in the presence of an IMF Program and in the face of emergency requirements after the devastation by the floods.

The Asian Development Bank has also recently sent $1.5 billion to Pakistan largely for support to flood rehabilitation and reconstruction. However, it is not clear how much of this is a transfer of funds from other project loans committed to Pakistan. Also, the arrival of these funds was followed by lumpy debt repayment. Consequently, the impact on increasing foreign exchange reserves was limited. The Geneva Conference has led to commitments of $9.2 billion, mostly by multilateral agencies, for flood rehabilitation and reconstruction. However, most of the funding is in form of project loans spread over the next three years and some of it may be diversion from existing commitments.

The IMF Program remains in a suspended state. The ninth review which was due on the 3rd of November has been delayed. The quarterly outcome on which this review will be conducted has witnessed some major deviations from the targets as shown in the previous chapter. As such, it may require prior actions, including a Mini Budget, before the review is completed and funds released. Alternatively, if the program flounders, then the economy will be exposed to a much higher level of risk of default.

Overall, Pakistan today is one of its most difficult times. Reserves are low, new external inflows are very limited, the flood has increased the need for substantial external support and the political situation is characterized by a quagmire.

PART-3

KEY ISSUES

Chapter 9: Level of External Vulnerability

The previous articles have highlighted that Pakistan is on the verge of a major financial crisis, which is likely to lead to a growing difficulty in honoring external debt repayments and result in a 'default' situation.

Foreign exchange reserves stand at barely $5.5 billion as of the end of December 2022. Required financing for the remainder of 2022-23 is over $17 billion, with $7 billion for the current account deficit and $10 billion for debt repayments. As highlighted earlier, given the low credit ratings of Pakistan, access to external financing is becoming increasingly limited. In the first five months of 2022-23, only $5 billion of loans were made available, mostly by multilateral agencies. Private creditors are refraining from lending to Pakistan.

The objective of this chapter is show in the first Section the rising level of external vulnerability of Pakistan. Analysis is undertaken of the factors contributing to this weakening. The second Section compares the magnitudes of a set of external vulnerability indicators of a number of countries and Pakistan's ranking in terms of the level of external vulnerability among this group of countries. The last Section then highlights the magnitude of key variables like the GDP growth rate, rate of inflation, etc., in these vulnerable countries.

9.1 Trend in External Vulnerability

External vulnerability is measured based on the following two indicators:

- Size of import cover, measured in months, as the ratio of foreign exchange reserves to the level of annual imports of goods and services.
- Extent of which the foreign exchange reserves at the start of the year were adequate to meet the projected external financing requirements during the year, consisting of the current account deficit plus the total external debt repayment.

The magnitudes of the two indicators are presented in Table 9.1. The import cover ratio has followed a U-shaped curve from 2016-17 to 2020-21. It was significantly above 3 months, the minimum 'safe' level, in 2016-17 and 2020-21.

Thereafter, the ratio declined to a low of 1.4 in 2018-19 from 1.7 in 2017-18. From 2019-20 onwards Pakistan has been in a 'stop-and-go' IMF program. Fortunately, international commodity prices plunged sharply in the aftermath of COVID-19 and the import cover improved in the presence of a lower level of imports.

Table 9.1: Key Indicators of External Vulnerability of Pakistan *($ Billion)*

Year	FE Reserves	Imports of Good & Services	Import Cover (months)	Current Account Deficit	External Debt Repayment	Total External Financing Requirement (FR)	Reserves (-1)/ FR	% Actual financing of requirement
2016-17	16.1	58.6	**3.3**	-12.3	6.5	18.8		
2017-18	9.8	67.9	**1.7**	-19.2	5.2	24.4	66.0	**74.1**
2018-19	7.3	62.8	**1.4**	-13.4	8.6	22.0	44.5	**98.2**
2019-20	12.1	52.4	**2.8**	-4.4	11.3	15.7	46.5	**84.0**
2020-21	17.3	62.7	**3.3**	-2.8	11.2	14.0	86.4	**136.4**
2021-22	9.8	84.1	**1.4**	-17.4	12.1	29.5	58.6	**74.6**

Source: *SBP*

The subsequent jump in international prices due to global shortages arising from the Russia-Ukraine war has led to a jump in imports by over 34 percent in 2021-22. Consequently, the import cover ratio fell to its lowest level of 1.3 months. Currently, it is close to only one month.

The magnitude of the second indicator, viz., the level of foreign exchange reserves at the start of the year as a ratio of the external financing requirements during the year, also follows a U-shaped curve. It was at its peak of over 86 percent in 2020-21. It fell to 59 percent in 2021-22.

Table 9.2: Trend in External Vulnerability Indicators of Pakistan *(%)*

	2010	2018	2021	2022
• External Debt to Exports	220	315	360	401
• External Debt to GNI	36	28	38	40
• Debt Service to Exports	15	19	34	37
• Short-Term Debt Share	7	8	7	7
• Reserves to External Debt	23	9	15	7

Source: *World Bank, International Debt Statistics.*

The World Bank in its annual publication, *International Debt Statistics*, has identified five indicators of the level of external vulnerability of a country as shown in Table 9.2. The trend in these indicators for Pakistan from 2010 to 2022 is generally one of a process of deterioration.

The level of external debt to the GNI has increased from 36 percent in 2010 to 40 percent in 2022. The most severe deterioration is in indicators linked to exports, because of their limited growth. The level of external debt to exports has risen sharply from 220 percent in 2010 to over 400 percent in 2022. Similarly, the debt service to exports has gone up from 15 percent to 37 percent.

The relative position of Pakistan in the level of external vulnerability and South Asian countries as a group is highlighted in Table 9.3.

Table 9.3: Magnitude of External Vulnerability Indicators of Pakistan and the South Asian Region – 2021 *(%)*

	South Asia	Pakistan
• External Debt to Exports (%)	117	360
• External Debt to GNI (%)	22	38
• Debt Service to Exports (%)	9	34
• Short-Term Debt Share (%)	17	7
• Reserves to External Debt	74	15

Source: *World Bank*

Pakistan is clearly placed in a very difficult position as compared to other South Asian countries like India and Bangladesh. For example, the reserves to external debt ratio is as high as 74 percent for the latter group of countries while it is only 15 percent in the case of Pakistan in 2021. Another country in a very difficult situation is Sri Lanka, which has gone to the extent of defaulting in April 2022.

9.2 External Vulnerability Index of Countries

The objective here is to compare Pakistan with other countries which are also considered as externally vulnerable. These are countries which have population above 20 million and have been included in the *Countries with the Highest Risk of Default* prepared by the *Visual Capitalist*. Pakistan is ranked fourth in this list of 25 countries in term of the level of probability of default. The list of relatively large countries is given in Table 9.4.

The list includes 11 relatively large countries. Two countries, viz., Sri Lanka and Ghana, have already defaulted. The combined population of these 11 countries is over 1 billion. It includes two countries, Argentina, and Ecuador from Latin America; Egypt, Ghana, Kenya, Ethiopia, and Nigeria from Africa; Pakistan and Sri Lanka from Asia and Türkiye and Ukraine from Europe.

Table 9.4: The List of Externally Vulnerable Countries* (with population above 20 million)		
	Continent	Population (Million)
• Argentina	Latin America	45
• Ecuador	Latin America	102
• Egypt	Africa	102
• Ethiopia	Africa	115
• Ghana*	Africa	31
• Kenya	Africa	53
• Nigeria	Africa	206
• Pakistan	Asia	230
• Sri Lanka*	Asia	22
• Türkiye	Asia/Europe	84
• Ukraine	Europe	43
TOTAL		**1,033**

**Already Defaulted*

Source: *World Bank*

The magnitudes of the World Bank indicators in 2021 for these countries are shown in Table 9.5. Pakistan's ranking is given below in each indicator:

	Pakistan's Ranking
• External Debt as % of GNI*	7^{th}
• External Debt as % of Exports*	2^{nd}
• Reserves as % of External Debt**	7^{th}
• Debt Service as % of Exports*	1^{st}
• Short-Term Debt as % of External Debt*	7^{th}

**The lower the ranking the better*

***The higher the ranking the better*

A composite External Vulnerability Index (EVI) has been constructed from the above five indicators. The methodology is described in Annexure-4 of the book.

Table 9.5: Magnitude of Indicators of External Vulnerability – 2021					
Country	External Debt as % of GNI	External Debt as % of Exports	Reserves as % of External Debt	Debt Service as % of Exports (%)	Short-Term Debt as % of External Debt
Argentina	51	274	15	29	18
Ecuador	56	198	10	22	2
Egypt	37	242	24	32	9
Ethiopia	27	316	10	21	2
Ghana*	48	246	26	22	14
Kenya	38	347	23	21	6
Nigeria	18	144	52	16	0
Pakistan	38	360	15	$\boxed{34}$	7
Sri Lanka*	$\boxed{69}$	$\boxed{375}$	$\boxed{5}$	31	15
Türkiye	54	151	16	25	$\boxed{28}$
Ukraine	$\boxed{70}$	142	22	15	16

**Already Defaulted* $\boxed{}$ *Worst Position*

Source: *World Bank*

The resultant ranking is given in Table 9.6. As expected, Sri Lanka, which has already defaulted has the lowest EVI score of 0.343. However, Ghana, which defaulted recently, emerges as second in the ranking. Therefore, the World Bank indicators may not properly or fully capture the extent of external vulnerability.

Pakistan emerges with a low ranking of 9th and a relatively low score of 0.403. Therefore, the probability of an imminent default by Pakistan according to the EVI appears to be relatively high.

Table 9.6: Ranking of Countries in the External Vulnerability Index (EVI)
(The Higher the Index the Less the Vulnerability)

Ranking	Country	Score in EVI (0 to 1)
1	Nigeria	0.869
2	Ghana	0.547
3	Kenya	0.535
4	Egypt	0.524
5	Ukraine	0.511
6	Ethiopia	0.477
7	Ecuador	0.465
8	Türkiye	0.408
9	Pakistan	0.403
10	Argentina	0.397
11	Sri Lanka	0.224

Source: *Estimated*

9.3 State of Economy in Vulnerable Countries

The key macroeconomic indicators in 2021 or 2022 are presented for eight of the eleven countries for which information was available in Table 9.7.

Table 9.7: Trend in External Vulnerability Indicators of Pakistan *(%)*

Country*	GDP Growth Rate 2021-22	Rate of Inflation (Current) 2022	Rate of Depreciation of Exchange Rate (Dec 21 to Dec 22)	Current Account Deficit as % of GDP 2021
Nigeria	3.2	21.5	8.3	-0.2
Ghana	3.6	50.3	46.4	-5.2
Egypt	6.6	18.7	58.0	-3.6
Ethiopia	3.8	35.1	9.8	-4.5
Türkiye	5.0	84.3	58.1	-5.7
Pakistan	6.0	23.8	26.8	-4.6
Argentina	4.0	92.4	71.0	-0.3
Sri Lanka	-8.7	61.0	83.4	-4.0
AVERAGE	**2.9**	**48.4**	**45.2**	**-3.5**

**Presented by the degree of smallness of the External Vulnerability Index*

Source: *WDI, Others*

Table 9.7 indicates the very adverse consequences of default and thereafter on the economy of Sri Lanka. The economy contracted by almost 9 percent in 2021-22 and the rate of inflation was as high as 61 percent, while the Sri Lanka rupee has depreciated by as much as 83 percent from December 2021 to December 2022. This has, no doubt, contributed to a drastic worsening in living standards in the country.

The numbers in Table 9.7 are also revealing in the Pakistani context. Pakistan is placed, as highlighted above, in the ninth position among the eleven countries in terms of the magnitude of the EVI. However, it has a lower rate of depreciation of the national currency of 27 percent as compared to the average of 45 percent. This has been achieved by a managed float of the rupee by the SBP. This will be difficult to sustain if reserves remain low or decline further to perilously low level. **There is the risk that the rupee will need to fall at a faster rate if the open market rate is not to diverge too much from the inter-bank rate.**

Chapter 10: Volatility of the Exchange Rate

The exchange rate of the rupee has demonstrated considerable volatility over the years. Over the last decade, its value with respect to the US$ has fallen by 58 percent. There have been years of big depreciation and some years of appreciation. For example, in 2018-19, the rupee fell by 25 percent but in 2020-21 it appreciated by 6 percent. The last year, 2021-22, witnessed another big fall in value of the rupee with respect to the US$ of 23 percent.

The fundamental question is that if the exchange rate is market-determined, as has been the case since 2018-19 and till recently, then what are the factors in the market which influence the value of the rupee? Currently, the SBP is following a policy of slow managed float of the rupee. The question is what is the extent of divergence if it had been market-determined?

Section 10.1 describes the approach adopted in the Macroeconomic Model to determine the equilibrium exchange rate in Pakistani context. This is followed in Section 10.2 by estimating the likely exchange rate at the end of 2022-23 under different assumptions.

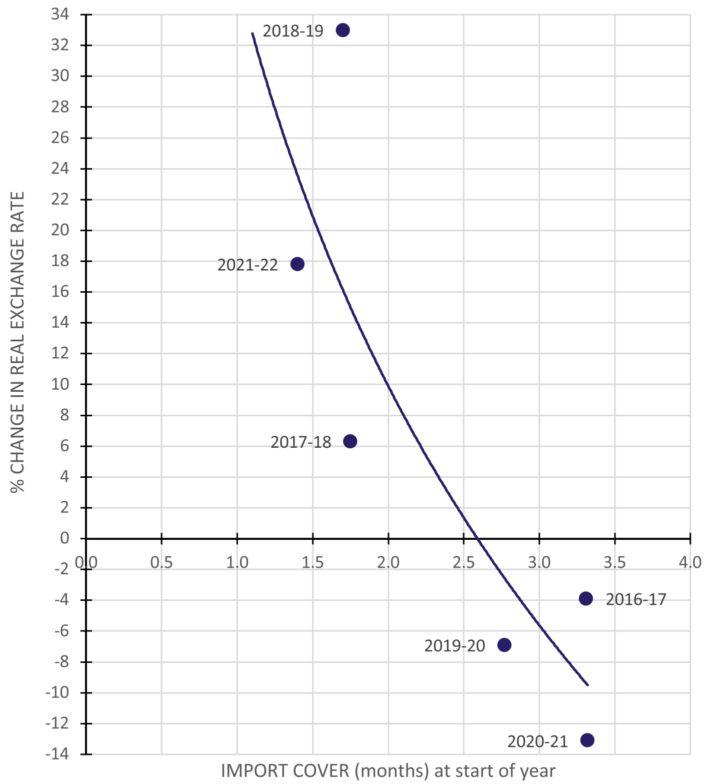
10.1 Determinants of the Exchange Rate

Based on extensive examination of the macroeconomic relationships the conclusion is that the best predictor of the exchange rate is the size of the import cover. This is the size of the foreign exchange reserves in relationship to the level of imports of goods and services.

Figure 10.1 shows the percentage change in the real exchange rate with respect to the import cover from 2016-17 to 2021-22. The real exchange rate is the nominal exchange rate divided by the domestic price index. There is clearly a strong relationship between the two variables.

The issue then is how the import cover of reserves, the rate of inflation, etc. are determined, since the exchange rate plays a big role in the outcome of the external balance of payments, especially on the level of imports and exports.

Figure 10.1: The Level of Import Cover and the percentage change in the Real Exchange Rate



Source: *SBP*

The specification of the balance of payments module and the inflation module in the Macroeconomic Model is given in Chart 10.1. The exogenous variables which drive the equations are as follows:

- Unit Value Index, in US$, of exports
- Unit Value Index, in US$, of imports
- Net Inflows of Primary and Secondary Income into the current account of the balance of payments
- Net Inflows into the Financial Account of the balance of payments of FDI, FPI, Government borrowing, etc.
- Foreign exchange reserves at the start of the year
- Inflationary expectations as measured by the rate of inflation in the previous year.

Chart 10.1: Balance of Payments Module of the BNU Macro-econometric Model

Listing of Variables

EXR =	Nominal Exchange Rate	X$ =	Exports of Goods and Services (in $)
PD =	Consumer Price Index	M$ =	Imports of Goods and Services (in $)
UVIX =	Unit Value of Exports (in Rs)	XBP$ =	Exports of Goods and Services (BoP)
UVIM =	Unit Value of Imports (in Rs)	MBP$ =	Imports of Goods and Services (BoP)
CAD$ =	Current Account Deficit	TDF$ =	Trade Deficit
DFR$ =	Net Balance of Payments	$\overline{\text{SBFI}}$ =	Other Net Inflows into Current Account
IMF$ =	Net Inflow from IMF	$\overline{\text{FAS\$}}$ =	Net Inflow into Financial Account
FR$ =	Foreign Exchange Reserves (in $)	IC =	Import Cover Ratio

BALANCE OF PAYMENTS

1. Real Exchange Rate ($/PKR):	$\frac{\text{EXR}}{\text{PD}} = (\text{FR\$}, \text{M\$BOP})$
2. Exports of Goods and Services (in $):	$\text{X\$} = \frac{\text{X. UVIX}}{\text{EXR}}$
3. Imports of Goods and Services (in $):	$\text{M\$} = \frac{\text{X. UVIX}}{\text{EXR}}$
4. Exports of Goods and Services (BOP):	$\text{XBP\$} = \text{F}\ (\text{X\$}, \text{XBP\$}_{-1})$
5. Imports of Goods and Services (BOP):	$\text{MBP\$} = \text{F}\ (\text{X\$}, \text{XBP\$}_{-1})$
6. Trade Deficit:	$\text{TDF\$} = \text{XBP\$} - \text{MBP\$}$
7. Current Account Deficit (in $):	$\text{CAD\$} = \text{TDF\$} + \overline{\text{SBFI}}$
8. Change in Foreign Exchange Reserves:	$\text{DFR\$} = \text{FAS\$} + \text{CAD\$} + \overline{\text{IMF}}$
9. Level of Foreign Exchange Reserves:	$\text{FR\$} = \text{FR\$}_{-1} + \text{DFR\$}$

Source: *BNU, Macroeconomic Model*

The key equation estimated by the Model is as follows:

$$g_{\in} - g_{p} = \frac{100.65}{\text{IC}} - 42.73$$

where,

$g_{\in}$ = extent of depreciation of the exchange rate, measured here a percentage rise in the number of rupees per $

g_{p} = rate of inflation

IC = import cover (in months), measured as the ratio of the foreign exchange reserves at end of a year with respect to the value of imports and goods during the year.

It may be noticed that.

$$\frac{\partial g_{\in}}{\partial \mathrm{IC}} = -\frac{100.65}{\mathrm{IC}^2}$$

This implies that the nature of the relationship is shaped with the rise in IC and declining at a lower rate.

10.2 Projection of the Exchange Rate

The Model is simulated several times, with the estimates of the exogenous magnitudes in 2022-23, whereby different levels of import cover are obtained. Results of the simulations are presented in Table 10.1 below.

Table 10.1: Simulations Results of Rate of Change in 2022-23 in the exchange rate

Import Cover (end of 2022-23)	% Change in the Exchange Rate** *(Measured as the number of rupees per $)*	
	Percentage	Exchange Rate per $*
1.0	57.4	322
1.2	40.7	288
1.4	29.3	264

**Per US$ in end June 2023, with the exchange rate in June 2022 of Rs 204.62 per $.*

*** From end-June 2022 to end-June 2023*

Source: *BNU Model Simulations*

Table 10.1 clearly demonstrates the large variation in the exchange rate with respect to the import cover.

Further, based on the derived monthly rate of increase the market-determined exchange rate as of the 15th of December is Rs 260 per US$. It is significant that this is close to the rate in the open market.

The exchange rate projection by the IMF for 2022-23 can be derived from the statistics presented in Staff Report of September 1, 2022. The IMF has projected a high import cover of 2.46 months of the Pakistan economy in 2022-23. Accordingly, the Model projects that with this healthy level of reserves, the real exchange rate should fall by over 2 percent, implying that there will be a 20 percent nominal depreciation of the rupee in 2022-23 taking it thereby to Rs 245 per US$.

The bottom line is that with the existing low level of foreign exchange reserves the current policy of maintaining a managed floating exchange rate at close to Rs 229 per US$ is not likely to work, while the exchange rate in the open/ black market is 15 percent higher. There is the risk of a rising gap between the inter-bank and the open market exchange rate which will lead to more diversion of remittances and exports to unofficial channels. As such, the approach adopted currently to contain imports is not sustainable. A move to a market-determined exchange rate policy is inevitable. This will not only contribute to the restriction of imports but it will also stimulate exports.

Chapter 11:

Causes and Consequences of High Inflation

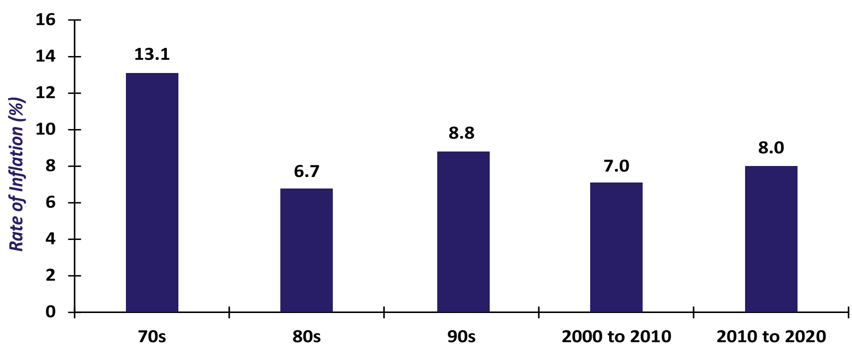
Pakistan today is experiencing one of the highest rates of inflation in its 75-year history. It is current operating at close to 25 percent on a year-to-year basis. The last time there was such high rate of inflation was in 1973-74 when it approached 30 percent in the immediate aftermath of the quantum devaluation of the rupee by 60 percent.

The objectives of this chapter are, first, to highlight both the long-term and the short-term trends of inflation in Pakistan. Second, based on econometric analysis since 1991, the quantitative contribution of different factors to inflation is determined. Third, the consequences of inflation on living standards of households in different income quintiles are identified. In the fourth section, estimates are given of the inflationary impact on various macroeconomic variables. Finally, in the last section an attempt is made to project the outlook for inflation in Pakistan.

11.1 Trends in the Rate of Inflation

The long-term trend in the rate of inflation is presented in Figure 11.1. After the double-digit inflation of 13 percent in the decade of the 70s, it has remained in the range of 6 percent to 9 percent in subsequent decades up to 2020. The lowest rate of inflation of 6.7 percent was witnessed in the decade of the 80s. Over the fifty years, 1970 to 2020, the average rate of inflation in Pakistan has been 8.7 percent.

Figure 11.1: Average Decade wise Rate of Inflation in Pakistan *(%)*



Source: *PBS*

Table 11.1 presents the rate of inflation in Pakistan in more recent years, from 2016-17 to 2022-23 (first six months). There has been a truly extraordinary acceleration in the rate of inflation. It was only 3.9 percent in 2017-18, rising to 12.2 percent by 2021-22 and reaching a peak of 25.2 percent in the first half of 2022-23.

Table 11.1: Trend in the Rate of Inflation CPI, Base Year, 2015-16 *(%)*

	Overall Rate of Inflation	Food and Energy Rate of Inflation	'Core' Rate of Inflation
2016-17	4.2	3.2	5.2
2017-18	3.9	2.1	5.9
2018-19	7.3	6.8	7.9
2019-20	10.7	13.0	8.2
2020-21	8.9	10.6	7.0
2021-22	12.2	15.5	8.6
2022-23 *(July to December))*	25.1	33.6	15.7

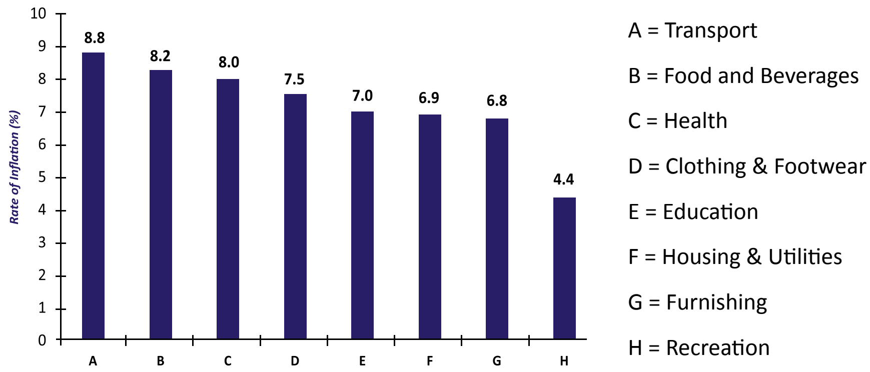
Source: *PBS*

The unfortunate reality is that food prices, along with energy prices, have risen at faster rate than the overall rate of inflation. Consequently, the 'core' rate of inflation has risen at a more moderate rate to reach its peak of almost 16 percent in the first half of 2022-23.

Figure 11.2 presents the average rate of inflation of different groups of goods and services from 2015-16 to 2021-22. The highest rate is observed in transport services, followed by food and beverages and health. One of the reasons for a low rate of inflation, especially from 2015-16 to 2017-18, is the low rate of increase in housing rents. This trend has persisted even after 2017-18. For example, according to the PBS, in June 2022, on a year-to-year basis, the rise in housing rents is only 5.6 percent in urban areas and 5.7 percent in rural areas respectively. There is a strong likelihood that the rate of inflation in housing rents is significantly understated.

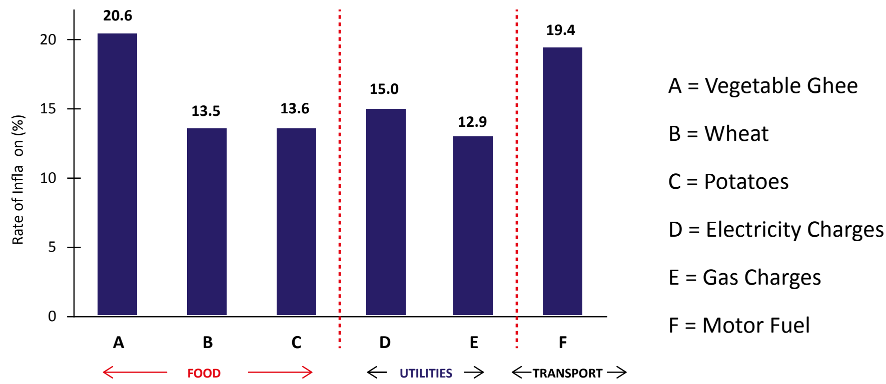
An attempt has also made to identify individual items with the highest rate of increase in price since 2015-16. These items are shown in Figure 11.3. Among commodities, the three items with the biggest increase in prices are all food items, namely, vegetable ghee, wheat, and potatoes. This is the first indication that the lower income households have been hit more by inflation. Within services, the fastest increases have been in transport costs and utility charges.

Figure 11.2: Groupwise Rate of Inflation 2015-16 to 2021-22 – *(%)*



Source: *PBS*

Figure 11.3: Items with High Rate of Annual Inflation 2015-16 to 2021-22 – *(%)*



Source: *PBS*

A comparison is made in Table 11.2 of the rate of inflation in Pakistan and in other South Asian countries, as given in the World Development Indicators data base of the World Bank. During the last decade, 2010 to 2020, the highest rate of inflation at almost 7 percent has been in Pakistan, followed by Nepal and India.

Table 11.2: Rate of Inflation in South Asian Countries *Average Annual Rate of Inflation* (%)				
Countries	1990 to 2000	2000 to 2010	2010 to 2020	Long-term Rate of Inflation
Bangladesh	5.1	6.2	5.9	5.9
India	8.6	6.1	6.0	6.9
Nepal	8.6	5.8	6.8	7.1
Pakistan	8.8	8.3	6.9	8.0
Sri Lanka	9.2	10.1	5.0	8.1
Source: *WDI*				
• Sri Lanka and Pakistan have generally had higher rates of inflation				

11.2 Causes of Inflation

There is a dire need for identification of the factors which have contributed to the relatively high rate of inflation in Pakistan in recent years and months. This has been achieved by econometric analysis of time series data from 1990-91 to 2021-22 of the impact of different factors like monetary expansion, GDP growth, import prices in $, exchange rate depreciation, hike in administered energy and fuel prices and inflationary expectations. The resulting estimates of impact on the rate of inflation are presented in Table 11.3.

Table 11.3: Factors Contributing to the Rate of Inflation	
For one percentage point increase in	Impact in % Points on Rate of Inflation
• Rate of Expansion in Money Supply[1]	0.171
• Growth Rate of Real GDP	-0.305
• Rate of Increase in Import Prices (in $)	0.172
• Rate of Depreciation of Exchange Rate[2]	0.172
• Rate of Increase in Administered Prices[3]	0.089
• Rate of Change in Inflationary Expectations[4]	0.569

[1]*Lagged by One Year*

[2] $\left(\frac{\varepsilon_t - \varepsilon_{t-1}}{\varepsilon_{t-1}}\right)$ *x 100, where* ε_t *is the exchange rate in Rs per $ in year t*

[3]*Prices of transport, electricity, and gas for domestic consumers*

[4]*Rate of Inflation lagged by one year*

1 $\bar{R}^2$ *= 0.982, D-W = 1.951, F-Stat = 320.81*

The resulting estimates are very revealing. A one percentage point in the rate of monetary expansion has the impact of raising the rate of inflation by 0.17 percentage point. A faster growth rate of the GDP by 1 percentage point has the effect on the rate of inflation of minus 0.31 percentage point. A rise in import prices (in $) or higher depreciation of the rupee by 1 percentage point increases the rate of inflation by 0.17 percentage point, and so on. The impacts over the medium term are larger.

Table 11.4 gives the magnitude of different factors contributing to inflation from 2016-17 to 2022-23, July to November. Two conclusions emerge from the numbers. First, impact of higher import prices is more visible after 2019-20 along with a higher rate of depreciation from 2018-19 onwards of the exchange rate. Second, the role of administered prices also becomes more visible from 2020-21 onwards. These are the factors which have contributed more to the upsurge in the rate of inflation from 2019-20 onwards.

Table 11.4: Magnitude of Determinants of the Rate of Inflation*

Year	Rate of Inflation	Growth Rate of Monetary Supply (lagged by one year)	Growth Rate of GDP	Rate of Increase in $ Import Prices	Rate of Depreciation of Exchange Rate	Rate of Increase in Administered Price	Rate of Change in Inflationary Expectations**
2016-17	4.2	13.7	4.6	-1.8	0.4	2.1	2.9
2017-18	3.9	13.7	6.1	0.7	4.5	4.9	4.2
2018-19	7.3	9.7	9.1	-11.7	18.1	22.8	3.9
2019-20	10.7	11.3	-0.9	-20.3	22.3	1.2	7.3
2020-21	8.9	17.5	5.7	4.7	1.3	23.0	10.7
2021-22	12.2	16.2	6.0	24.8	13.0	16.5	8.9
2022-23 *(July-Dec)*	25.1	13.6	-1.0*	43.8	33.9	33.8	12.2

**Estimated | **Measured as rate of inflation lagged by one year*

Sources: *SBP. PBS. PES*

Table 11.5 gives the magnitude of the contribution of different factors to inflation in Pakistan during the period of high and rising inflation from 2019-20 to 2022-23 (first half). The largest contribution is from inflationary expectations at 42.5 percent, followed by rise in import prices of 19.3 percent and by depreciation of the rupee by 19 percent.

The peak rate of inflation is in the first five months of 2022-23. This is attributable in a way to 'imported' inflation to the extent of as much as 53 percent in the form of higher international prices of commodities imported by Pakistan and to a large devaluation of the rupee. In addition, the near 12 percent impact of higher administered prices is also due largely to rise in imported fuel prices and higher petroleum levy. Therefore, as long as international commodity prices remain high the likelihood is low that the rate of inflation will come down substantially in Pakistan.

Table 11.5: Contribution of Different Factors to Inflation in Pakistan								*(%)*
Year	Annual Rate of Inflation	Monetary Expansion	GDP Growth	Rise in Import Prices (in $)	Depreciation of Exchange Rate	Rise in Administered Prices	Inflationary Expectations	Total
2016-17	4.2	93.2	-55.8	-12.3	2.4	7.6	64.9	100.0
2017-18	3.9	55.7	-44.3	2.9	18.3	10.5	56.9	100.0
2018-19	7.3	27.5	-15.7	-33.3	51.5	33.4	36.6	100.0
2019-20	10.7	17.3	2.4	7.6	34.3	0.9	37.5	100.0
2020-21	8.9	16.3	-19.6	9.1	2.4	23.0	68.8	100.0
2021-22	12.2	19.8	-13.1	20.5	16.0	10.5	36.3	100.0
2022-23*	25.2	9.2	1.2	30.1	23.1	11.9	27.5	100.0
Average								
2016-17 to 2022-23		34.1	-21.1	4.9	21.1	14.0	46.9	100.0
2019-20 to 2022-23		15.6	-8.0	19.3	19.0	11.6	42.5	100.0
Source: *Estimated*	** first six months*							

11.3 Impact of Inflation

The first analysis of importance is the relative impact of inflation on households in different income quintiles. Results of this analysis are shown for inflation in June 2022, when the rate of inflation had exceeded 21 percent in Table 11.6.

Table 11.6: Groupwise Rate of Inflation in June 2021 and June 2022								
	Rate of Inflation June 2021	Composition of Consumption Expenditure						Rate of Inflation June 2022
		1	2	3	4	5	Overall	
Food, Beverages	10.48	48.52	45.90	43.09	39.53	28.62	37.05	25.92
Housing & Utilities	9.10	20.09	21.17	22.23	23.91	30.61	25.81	13.48
Services	9.20	31.39	32.93	34.68	36.56	40.77	37.14	22.19
TOTAL	**9.65**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**21.32**
Quintile Rate of Inflation	June 2022	22.24	22.06	21.86	21.58	20.59	21.32	
Quintile Rate of Inflation	June 2021	9.80	9.76	9.73	9.68	9.54	9.65	
Source: *PBS*								

The rate of inflation among the three groups of food and beverages, housing and utilities and services was the highest at almost 26 percent in the case of food and beverages and the lowest in housing and utilities. The share of consumption expenditure devoted to food and beverages is the highest at over 48 percent for the lowest income quintile and under 29 percent for the top quintile.

Therefore, it is likely that the rate of inflation faced by the lowest income quintile is the highest. It was 22.2 percent for this quintile in June 2022 and declined in successive quintiles to reach a low of 20.6 percent for the top quintile. Clearly, the emphasis has to be to limit the increase in food prices.

Turning to the impact of inflation on key macroeconomic variables the estimates are considerable importance, as shown in Table 11.7. They have been derived from the BNU Macroeconomic Model.

Table 11.7: Contribution of the Rate of Inflation to Different Macroeconomic Magnitudes

Impact of 1 percentage point higher rate of inflation	Percentage Points
• Real Household Consumption Expenditure	-0.446
• Private Investment	-0.146
• Exports of Goods and Services	-0.433
• Imports of Goods and Services	0.204
• Nominal Interest Rate	0.253
• Change in Money Supply	0.813
• Revenue from Indirect Taxes	0.852
• Revenue from Direct Taxes	0.640
• Incidence of Poverty	2.742
• Level of Inequality	0.061

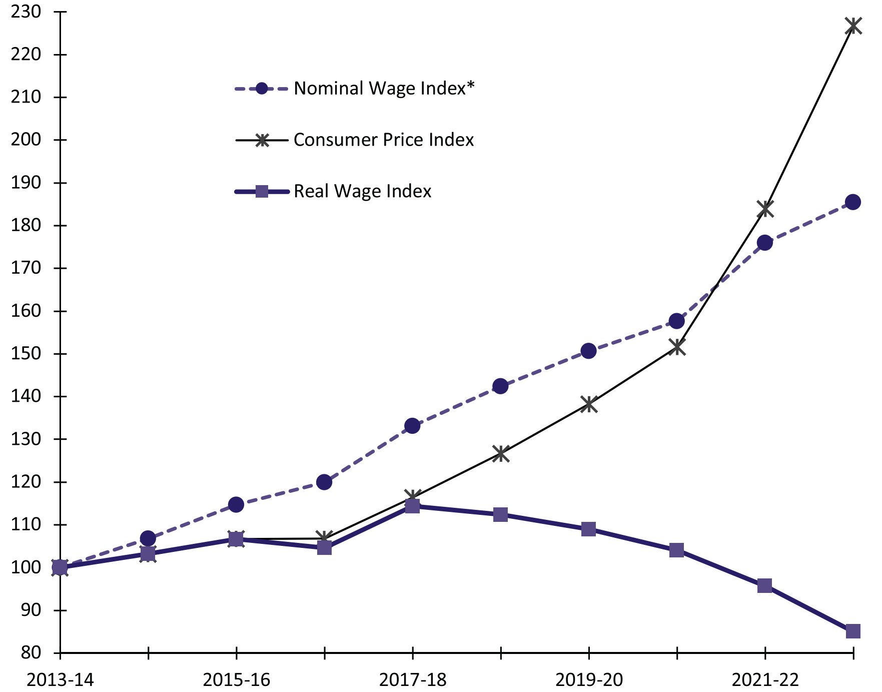
Source: *BNU Macro-econometric Model*

A higher rate of inflation leads to decline in real household consumption expenditure, fall in private investment, worsening of the trade deficit, higher nominal interest rate, tax revenues, poverty and inequality.

For example, a higher rate of inflation is likely to lead to a fall in the tax-to-GDP ratio. A one percent higher rate of inflation leads to 0.85 percent increase in revenues from indirect taxes and 0.64 percent increase in direct tax revenues. Since both are less than unity this implies a fall in the tax-to-GDP ratio. Similarly, a 1 percent higher rate of inflation can increase the incidence of poverty by 2.7 percent, other things being equal.

An analysis has also been undertaken of the impact of inflation on real wages of construction workers, both skilled and unskilled. The trends since 2013-14 are shown in Figure 11.4. In the presence of low single-digit inflation up to 2017-18 real wages rose cumulatively by over 10 percent. Since then, there has been a sharp fall in real wages due to the high inflation of over 22 percent. This will have led to increase in the incidence of poverty.

Figure 11.4: Trend in the Nominal Wage Index*, Consumer Price Index and Real Wage Index – (2013-14 = 100)



******of construction workers*

Source: *PBS*

11.4 Outlook for Inflation

The outlook for inflation for 2022-23 hinges on what happens to the rate of inflation from December 2022 to June 2023. Already, in the first five months it has averaged 25.2 percent.

Various forecasts have been made of the rate of inflation. The IMF has projected the rate at 19.9 percent. More recently, the MPC of the SBP has indicated that inflation is likely to remain in the range of 21 – 23 percent, because food prices are likely to escalate due to shortages after the floods.

There are a number of factors operating in opposite directions in terms of the impact on inflation:

i) International commodity prices are beginning to come down from the peak attained after start of the Russia-Ukraine war. For example, the price of Brent crude oil has plunged from \$130 per barrel to \$80 per barrel. However, the price of coal, LNG and wheat remain high, while the price of edible oil has also declined sharply.

ii) The Pakistani rupee has depreciated by over 23 percent from the average in 2021-22 to the current level. Efforts are being made to keep the value of the rupee artificially high in the inter-bank market. Consequently, the premium in the open market has risen to between 10 percent to 15 percent. As Pakistan continues to be on the edge of default the fall in the value of the rupee may be greater in coming months.

iii) Supply shortages not only of food items but also of raw materials and intermediate goods will persist as the SBP continues to regulate the opening of import LCs. This will exert upward pressure on the prices of finished goods.

iv) The IMF Program includes the commitment by the Government of Pakistan to raise electricity tariffs by 40 percent and more than double gas tariffs. There is also the likelihood of reintroduction of the sales tax on POL products which will fill the gap created by lower international price of oil and generate more revenues.

v) Federal borrowings to finance the budget deficit have been mostly in the form of domestic bank borrowings in the absence of significant net inflow of external loans. Consequently, there will be pressure on faster expansion in money supply, although this may be partly obviated by the suppressed demand for bank credit by the private sector.

vi) The big question is the impact of implementation of the IMF conditionalities on the rate of inflation. The combined direct and indirect impacts are given below of different measures:

IMPACT OF IMPLEMENTATION OF IMF PROGRAM CONDITIONALITIES ON THE RATE OF INFLATION

	Percentage Points
• Escalation in Electricity and Gas Tariffs	4.0
• Enhancement of the Petroleum levy and Reintroduction of the Sales Tax on POL Products	4.5
• Additional taxation of Rs 200 billion	0.5
• Transition to market- based exchange rate	3.5
TOTAL IMPACT	**12.5**

Therefore, the rate of inflation could jump to between 35 percent and 37 percent following the implementation of the IMF program conditionalities. However, if the IMF program is suspended then the rate of inflation could rise to 50 percent to 60 percent in a default situation.

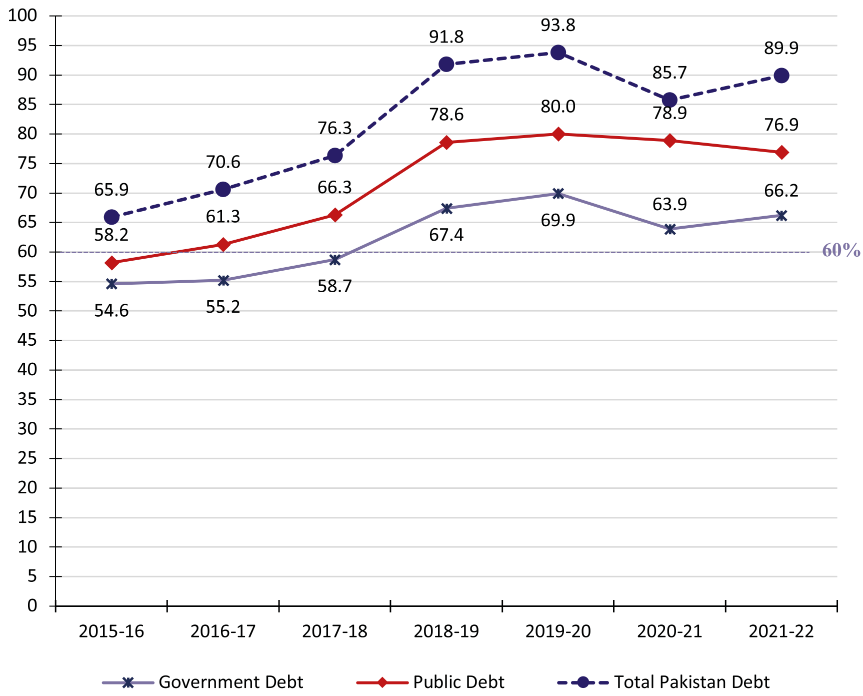
Chapter 12:

The Growing Debt Burden

The total public debt of Pakistan has risen to above Rs 51 trillion by end-June 2022. In effect, each citizen of Pakistan is carrying on his/her shoulders a debt of Rs 221,000. Five years ago, the public debt per capita was Rs 105,000.

The size of the public debt in relation to the GDP now stands at 77 percent, as shown in Figure 12.1. Five years ago, it was 61 percent of the GDP. If the GDP had not been revised upwards by over 16 percent recently, the public debt would have been close to 89 percent of the GDP, with the prospect that it will approach 100 percent in the next few years.

Figure 12.1: Level of Total Pakistan Debt, Public Debt and Government Debt *(% of GDP)*



Note: **Fiscal Responsibility and Debt Limitation Act limit*

Source: *SBP*

The consequence of the rising debt burden is that there has been exponential growth in the level of public debt servicing. It was 3.6 percent of the GDP in 2016-17 and has risen to 4.8 percent of the GDP in 2021-22. Almost 85 percent of the net federal tax revenues are being used to finance the costs of debt servicing rather than for the provision of basic services to the people.

The objective of this article is to highlight the growth in the total debt of Pakistan and the changing composition of the debt in Section 12.1. This enables the determination of the causes of growth in debt in Section 12.2. Section 12.3 highlights the impact of the rising debt on different aspects of the economy. Section 12.4 then presents a medium-term budgetary framework to achieve progressive reduction in the government debt to GDP ratio which is at over 66 percent today down to 60 percent of the GDP. This is the ceiling imposed by the Fiscal Responsibility and Debt Limitation Act of 2005.

12.1 Growth in Debt

The State Bank of Pakistan has identified three levels of debt. The narrowest coverage is of government debt, which consists of the outstanding stock of domestic and external borrowing by the Federal Government.

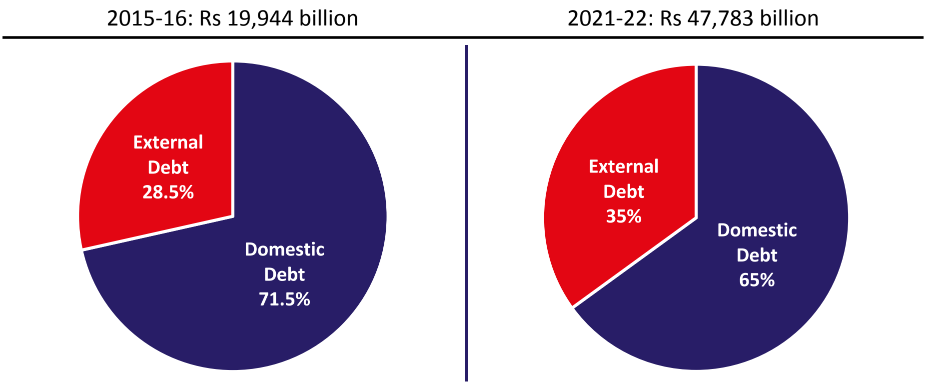
The next level is public debt. This is government debt plus external liabilities of the SBP and debt with the IMF. The highest level of debt is the overall debt of Pakistan. This includes public debt plus the debt, both external and domestic, incurred by the public sector enterprises and the private sector, along with the debt arising out of commodity operations.

The Fiscal Responsibility and Debt Limitation Act has adopted a different definition of government debt, as follows:

Government Debt = Government Domestic Debt + Government External Debt+ Debt with IMF – Government Deposits with the bank system of Pakistan

The change in each type of debt's composition is described in Chart 12.1 over the period, 2015-16 to 2021-22.

Chart 12.1: Composition of Government Debt



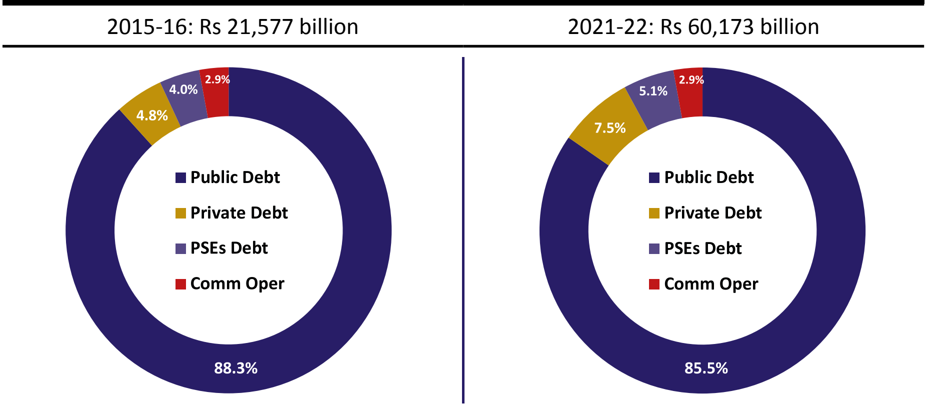
Source: *SBP*

The share of external debt in government debt has increased from 28.5 percent to 35 percent. This is a worrying development caused partially by the continuing depreciation of the rupee against the US$.

The composition of public debt does not vary substantially from government debt, as the debt with the IMF and external liabilities are relatively small.

The composition of the total debt of Pakistan is given in Chart 12.2 below.

Chart 12.2: Composition of the Debt of Pakistan



Source: *SBP*

The dominant share is of public debt, which has declined somewhat from 88.3 percent to 85.5 percent over the six-year period. The small shares of three other borrowers, viz, private sector, PSE and agencies engaged in commodity operations, have shown some modest increases.

12.2 Causes of Growth in Government Debt

There is need to determine from a policy perspective point of view causes of the increase in government debt. Three factors contribute to an increase in government debt. These are respectively the primary budget deficit, level of debt servicing and the increase in the value of the external debt due to depreciation of the rupee.

The relative contribution of these three factors is presented in Table 12.1.

Table 12.1: Relative Contribution of Different Factors to Change in Government Debt, 2014-15 to 2021-22

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	Cumulative
Increased in Government Debt	**2,076**	**1,724**	**3,444**	**7,575**	**3,320**	**3,606**	**9,078**	
Contributing Factors (%)								
Primary Deficit	14.2	28.9	21.6	20.4	29.6	26.8	26.7	21.7
Debt Servicing	60.8	78.2	43.5	27.6	78.8	76.2	35.0	49.4
Depreciation of the Rupee	25.0	-7.1	34.9	52.0	-8.4	-3.0	38.8	28.9
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: *Estimated*

The findings in Table 12.2 are very revealing. Almost half the cumulative growth in government debt is due to the cost of debt servicing. This is followed by the contribution of 29 percent by depreciation of the rupee and the remainder, 21 percent, by the primary deficit annually in the federal budget.

The two years, 2018-19 and 2021-22, when there was a relatively large absolute increase in government debt, the main cause was the big devaluation of 52 percent in 2018-19 and 39 percent in 2021-22. **Overall, almost Rs 8.6 trillion increase in government debt in the six-year period is due to the devaluation of the rupee**.

12.3 Principles of Debt Management

The Debt Policy Coordination Office (DPCO) of the federal ministry of finance publishes the annual *Debt Policy Statement*. This report contains several risk indicators with regard to management of the government debt. These include the following:

Type of Risk	Indicator	Indicative Benchmark
Currency Risk	• Share of External Debt in Public Debt (%)	40% (Maximum)
Refinancing Risk	• Average Term Maturity of Domestic Debt (Years)	3.5 years (Minimum)
	• Average Term Maturity of External Debt (Years)	7.0 years (Minimum)
Gross Financing Needs	% of Total	35% (Maximum)
Share of Fixed Rate Debt in Government Securities	% of Total	25% (Minimum)

Source: *MOF*

The actual magnitudes of the indicator as derived by the DPCO for the 2020-21, are given in Table 12.2 below.

Table 12.2: Magnitude of Risk Indicators

Indicator	Benchmark	2019-20	2020-21
Share of External Debt in Public Debt	40% Maximum	36	34
ATM* of Domestic Debt	3.5 years Minimum	4.1	3.6
ATM* of External Debt	6.5 years Minimum	7.0	6.8
Gross Financing Needs	35% Maximum	31	28
Share of Fixed Rate Debt	25% Minimum	34	30

**Average Term of Maturity*

Source: *MOF*

It is likely that the benchmarks have been set in such a manner that they have been fully complied with. This is not the case as shown next.

There is need to look at the refinancing risks associated with public external debt. This requires analysis of the composition of this debt. This is undertaken in Table 12.3.

Table 12.3: Composition of Public External Debt						
	2015-16		2021-22		Incremental	
	Level ($ billion)	Share (%)	Level ($ billion)	Share (%)	Level ($ billion)	Share (%)
Short-Term	**3.9**	**6.3**	**8.5**	**8.5**	**4.6**	**12.0**
Loans	1.7		1.3			
External Liabilities	2.2		7.2			
Medium Term	**11.2**	**18.7**	**25.2**	**25.2**	**13.7**	**35.7**
Euro / Sukuk Bonds	4.6		8.8			
Commercial Loans	0.9		9.5			
From IMF	6.0		6.9			
Long Term	**44.5**	**72.2**	**61.3**	**61.3**	**16.8**	**43.8**
Paris Club	12.7		9.2			
Multilateral	26.4		34.0			
Other Bilateral	5.4		18.1			
Other	**1.7**	**2.8**	**5.0**	**5.0**	**3.3**	**8.5**
TOTAL	**61.6**	**100.0**	**100.0**	**100.0**	**38.4**	
Source: *SBP*						

Accordingly, from Table 12.3, it appears that the stock of public external debt consisted largely of long-term debt, with a share of over 72 percent in 2015-16. This has changed significantly and the share of long-term debt is down to 61 percent in 2021-22. There has been greater resort to the flotation of Euro/Sukuk Bonds, commercial credits, and IMF Loans. The share of medium-term debt has increased to 25 percent and that of short-term debt to 9 percent.

12.4 Projection of Government Debt in 2022-23

The chapter 4 on *Economic Outlook for 2022-23* includes the following projections:

GDP growth rate:	-1.0%
Rate of Inflation:	25%
Budget Deficit:	6% of GDP,

The base projection for 2022-23 also includes the following:

Rate of depreciation of Rupee	30%
Share of Domestic Borrowing in Financing the Budget Deficit	65%
Projection of the Government Deposits with Banking System:	Rs 5,300 billion

Sensitivity analysis of the base projection is as follows:

i) Budget deficit projection increased from 6 percent to 7 percent of the GDP.

ii) Share of external borrowing to finance the budget deficit raised from 35 percent to 45 percent.

iii) Rate of depreciation of the Rupee raised from 30 percent to 45 percent.

The projected estimates of government debt in 2022-23 are given in Table 12.4.

Table 12.4: Projections of the Level of Government Debt in 2022-23 under Different Assumptions

	GDP Growth Rate (%)	Rate of Inflation (%)	Rate of Depreciation of Rupee (%)	Size of Budget Deficit (% of GDP)	Share of Financing by Domestic Borrowing (%)	Total Government Debt (Rs in Billion)	% of GDP
BASE PROJECTION	-1	25	30	6	65	54,631	66.0
• Sensitivity Analysis – I	-1	25	30	7	65	55,482	66.9
• Sensitivity Analysis – II	-1	25	30	6	55	54,671	66.0

Therefore, under the base scenario, the projected government debt at the end of 2022-23 is Rs 54.6 trillion, equivalent to 66 percent of the projected GDP, as compared to 66.2 percent of the GDP in 2021-22. If the rate of depreciation of the rupee is significantly higher than the level of debt could reach 67 percent of the GDP, somewhat higher than the level in 2021-22.

12.5 A Medium-Term Budgetary Framework

The base scenario for 2022-23 reveals that the level of government debt is likely to be close to 66 percent of the GDP, with the coverage of government debt corresponding to the definition in the Fiscal Responsibility and Debt Limitation Act. This Act also states that the ceiling on government debt is 60 percent of the GDP.

The medium-term budgetary framework is developed for the years, 2023-24 and 2023-25, such that by the end of the latter year the government debt to GDP ratio comes down to 60 percent of the GDP as required by the Act.

The macroeconomic assumptions for 2023-24 and 2024-25 are as follows:

	2023-24	2024-25
• GDP Growth Rate (%)	3.5	4.0
• Rate of Inflation (%)	15.0	12.5
• Exchange Rate Depreciation (%)	15.0	12.5
• Budget Financing share of Domestic Borrowing	60.0	60.0

The fundamental issue is the size of the budget deficit in 2023-24 and 2024-25 respectively which will ensure that the government debt to GDP ratio falls to 60 percent by the end of 2024-25. The target level of the budget deficit at the federal level will have to show a decline from 6.4 percent of the GDP in 2022-23 to 5.0 percent of the GDP in 2024-25 such that the government debt-to-GDP ratio falls to 60 percent by the end of 2023-25.

The resulting projections of government debt are as follows:

The resulting medium-term budgetary framework is shown in Table 12.5.

			(Rs in Billion)
	Federal Budget Deficit (% of GDP)	Government Debt	% of GDP
2022-23	6.4		66.0
2023-24	5.5		62.0
2024-25	5.0		60.0

The targets from 2022-23 to 2024-25 are as follows:

- raising federal tax-to-GDP ratio from 8.5 to 9 percent of the GDP.
- increasing federal non-tax-to-GDP ratio from 2.0 to 2.2 percent of the GDP.
- reducing current expenditure from 11.2 to 10.5 percent of the GDP.
- raising federal development expenditure from 0.7 percent to 1 percent of the GDP.

Table 12.5: Medium-Term Budgetary Framework of Federal Government *(% of GDP)*

	2021-22 (Actual)	Targeted		
		2022-23	2023-24	2024-25
TOTAL REVENUES	5.6	5.5	6.2	6.5
Tax Revenues	9.2	8.5	9.3	9.5
Non-Tax Revenues	1.7	2.0	2.1	2.2
Revenue Transfers	-5.3	-5.0	-5.2	-5.2
TOTAL EXPENDITURE	14.0	11.9	11.7	11.5
Current Expenditure	12.6	11.2	10.8	10.5
Development Expenditure	1.0	0.7	0.9	1.0
Statistical Discrepancy	0.4	-	-	-
Federal Budget Deficit	***-8.4***	***-6.4***	***-5.5***	***-5.0***
GDP	**66,950**	**84,942**	**101,101**	**118,288**

The overall assessment is that the targets in Medium-Term Budgetary Framework are feasible. **The primary effort will be to raise the federal tax-to-GDP ratio by 1 percent of the GDP in the next two years.**

Chapter 13: Impact of Floods on Unemployment and Poverty

The combination of a generally low GDP growth rate even in normal conditions and the two catastrophic events of the COVID-19 pandemic in 2019-20 and the disastrous floods in 2022-23 have led to mushroom growth in unemployed persons and the population below the poverty line in Pakistan.

The objective of this chapter is to project the number of unemployed in Section 13.1. The second section presents an estimate of the population below the poverty line. The base year for the projections is 2018-19 and the projections are up to 2022-23.

13.1 Rise in Unemployment

The labor force and employment estimates for Pakistan are taken from the Labor Force Survey of 2018-19 by the PBS.[1] The labor force in 2018-19 was reported at 68.75 million persons and the level of employment at 64.03 million. Accordingly, the number of unemployed was 4.72 million persons, implying an unemployment rate of 6.9 percent. This was somewhat above to the average over the last decade.

The Macroeconomic Model has derived the relationship between the growth rate of real value-added and the rate of increase in employment in three major economic sectors, viz., agriculture, industry, and services as follows:

	1% growth in real value-added leads to
Agriculture	0.60% growth in employment
Industry	0.54% growth in employment
Services	0.72% growth in employment

During the years when there is a decline in output, there is likely to be a proportionate fall in output. The projections of employment up to 2022-23 are based on the sectoral growth rates given in Table 13.1.

1 The LFS of 2020-21 overstates the growth in employment from 2017-18 onwards.

Table 13.1: Actual Sectoral Growth Rate of from 2019-20 to 2021-22 and projected for 2022-23 – *(%)*

	Actual			Projected
	2019-20	2020-21	2021-22	2022-23
Agriculture	3.9	3.5	4.4	-4.0
Industry	-5.7	7.8	7.2	-3.5
Services	-1.2	4.3	4.5	1.0
GDP	-0.9	5.7	6.0	-1.0

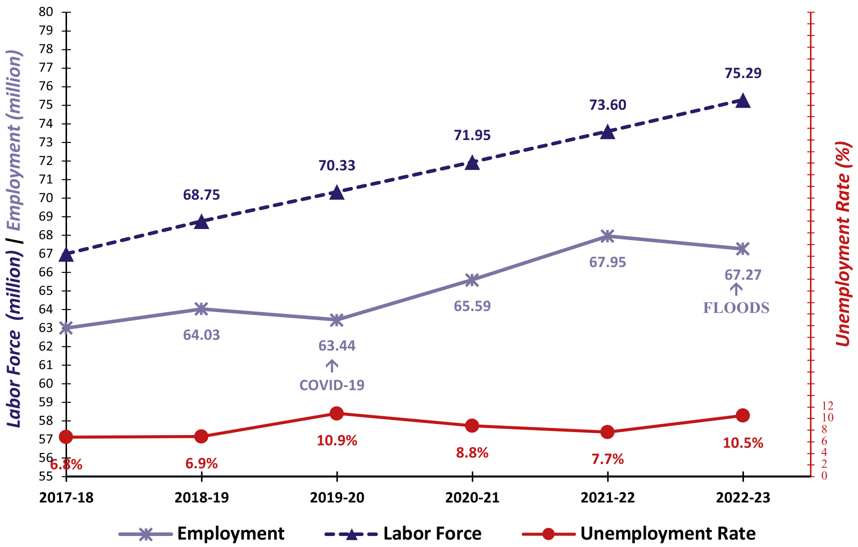
Source: *PES*

The projected GDP growth rate in 2022-23 is shown as minus 1 percent, in line with Chapter 4. During the COVID-19 attack, both industry and service sectors registered negative growth due to widespread shutdowns and supply shortages. The floods are likely to have led to a big damage to crops and livestock in 2022-23. In addition, the severe containment of imports will lead to a decline in industrial production.

Figure 13.1 presents the estimates of employment from 2019-20 to 2022-23, based on the employment to value-added growth elasticities presented above.

The level of employment has shown a fluctuating trend. Total employment declined by 590,000, in the immediate aftermath of COVID-19.

Figure 13.1: Labor Force, Employment and Unemployment Rate *(Million)*



Source: *LFS*

Therefore, with the strong recovery in 2020-21, employment rose by over 2 million. Almost 75 percent of the increase in employment was in the industrial and service sectors.

The 6 percent growth in the economy in 2021-22 sustained the rapid increase in employment again above 2 million, approaching 2.5 million. Bulk of the workers who had lost their jobs after COVID-19, regained their jobs. In addition, there was sizeable absorption of new entrants into the labor force.

However, the floods will take their toll on employment. Employment in 2022-23 680,000 less compared to an increase in the labor force of almost 1.7 million. The loss of jobs will be mostly in the agricultural sector.

The key question is what is happening to the unemployment rate? As highlighted above it was 6.9 percent in 2018-19. As shown in Figure 13.1, it spiraled up to double-digit 10.9 percent in 2019-20, after the COVID-19 attack. This is one of the highest rates of unemployment in the 75 years history of Pakistan.

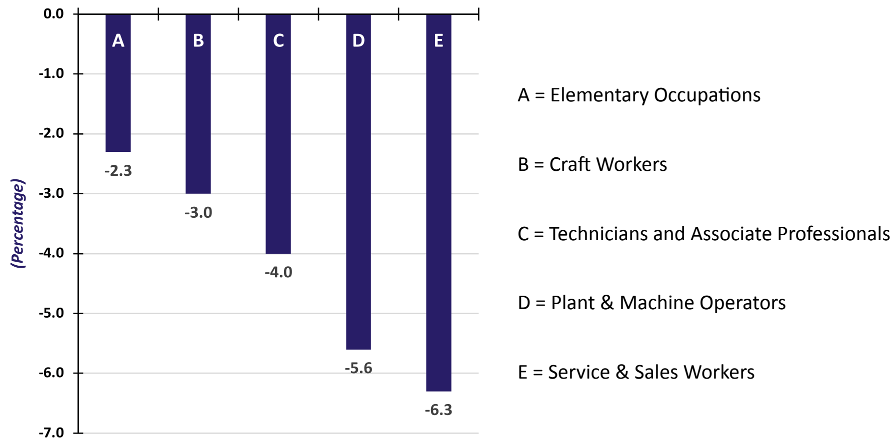
The economic recovery in 2020-21 and 2021-22 led to a significant improvement in labor market conditions. The unemployment rate is estimated to have fallen from the peak in 2019-20 to 8.8 percent in 2020-21 and 7.7 percent in 2021-22. However, it was still somewhat higher than the rate in 2018-19.

There is the likelihood of another upsurge in the unemployed in 2022-23. The number of unemployed workers is projected to rise above 8,000,000 due to the negative economic impact of the floods. This represents an increase of over 2,350,000 over the number employed in the previous year. Consequently, the unemployment rate is likely to rise above 10 percent once again. This big increase in unemployment is taking place when the economy of Pakistan is facing an acute financial crisis. Consequently, domestic resources for relief and rehabilitation unfortunately remain limited.

There are two other dimensions of the labor market which need to be highlighted. The first relates to the trend in real wages and the second to the absorption of youth. The extent of change in real wages according to the LFS of 2017-18 and 2020-21 by occupational category of worker is shown in Figure 13.2. All categories of workers suffered a decline in real wages after COVID-19. Future surveys will indicate what will have happened to real wages after the floods.

One indicator of 'decent work' is also quantified. This relates to the percentage of workers, who are employees, earning more than the minimum wage in 2020-21 of Rs 20,000 per month. **The share of workers with low wages, even below the minimum wage, was as high as 59 percent in 2020-21. Therefore, the incidence of the working poor is high in Pakistan.**

Figure 13.2: % Change in Real Wage* of Workers between 2017-18 and 2020-21



**Cumulative increase in consumer price index of 29.4%*

Source: *PBS*

An attempt has also been made to quantify the number of 'idle' male youth in Pakistan. They are more likely to be prone to religious and political extremism, violence, crime, and participation in social unrest at a time when living conditions are worsening. **The number of 'idle' male youth in 2020-21 is large at 6,780,000.** This number represents a big increase of almost 30 percent from the number of 'idle' male youth in 2017-18. Clearly, this is a matter of great concern. It is likely to rise to a above 8 million in 2022-23.

13.2 Rise in Poverty

The above findings are that in the aftermath of the floods there is likely to be a quantum jump in the number of unemployed workers and the working poor, The implication is that there will also be a big jump in the incidence of poverty in Pakistan.

The projections of the incidence of poverty from 2018-19 onwards are made since the determinants of poverty identified and their role quantified by the Macroeconomic Model, as shown in Chart 13.1.

Chart 13.1: Impact of Determinants of Poverty on the Incidence of Poverty

1% change in	Leading to % change in Incidence of Poverty
• Real Per Capita Income	-1.289
• Food Prices relative to the Overall Price Level	2.742
• Real Per Capita Pro-Poor Spending	-0.066
• Level of Income Inequality	1.262

Therefore, the incidence of poverty is very sensitive with respect to the rise in food prices relative to the overall rate of inflation. Also, the growth in real per capita income, level of income inequality and pro-poor spending matter from the viewpoint of impact on poverty.

There is need also to identify the factors which determine the level of income inequality in Pakistan. Here the modified PALMA ratio is used to measure inequality. This is the ratio of share in national personal income of the top quintile to the bottom quintile.

Determinants of the level of income inequality are shown in Chart 13.2 below.

Chart 13.2: Impact of Different Variables on Income Inequality

1% change in	Leading to % change in the Level of Income Inequality
• Real GDP	0.890
• Employment	-0.890
• Level of Corporate Profitability	0.188
• Nominal Interest Rate	0.017
• Real Level of Pro-Poor Spending	-0.061
• Direct Tax Revenue as % of GDP	-0.376
• Lagged Level of Inequality	0.367

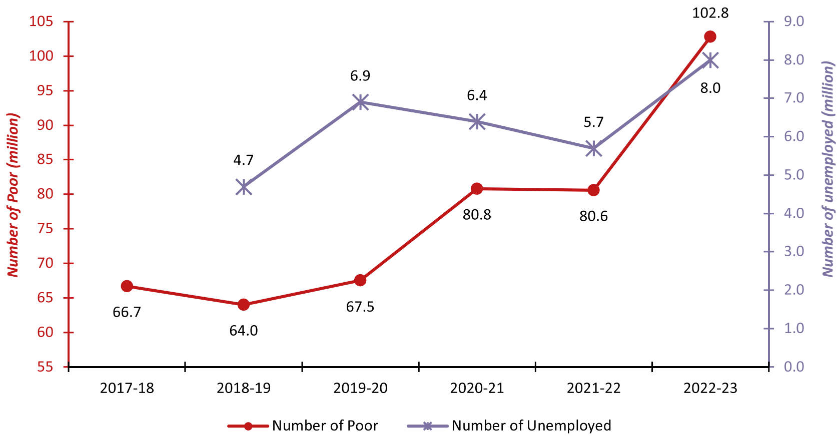
Source: *BNU Macroeconomic Model*

The chart clearly reveals that there is a big fall in inequality if there is a faster increase in employment, more pro-poor spending, and direct taxation.

The projections of the level of poverty are made from 2017-18 to 2022-23 and are highlighted in Figure 13.3. The level of employment is also shown in the Chart.

Despite the GDP growth rate of near 6 percent in 2020-21, there has been a significant increase in the number of poor. The primary reason is the big divergence of almost 4 percentage points between the rate of increase in food prices and the overall rate of increase in the consumer price index.

Figure 13.3: Estimated Number of the Unemployed and the Poor



Source: *Diverse and LFS*

A similar outcome is likely to be observed in 2022-23. Currently, in the first five months food prices are rising by as much as 35 percent while the rise in the CPI is 25 percent. Along with a 1 percent decline increase in the GDP, **there is the likelihood in 2022-23 of an extraordinarily large increase in the size of the poor population by over 22 million, the largest increase ever. It must be kept in mind that 33 million people were badly affected by the floods.**

Consequently, the projection is that the incidence of poverty will rise almost 45 percent in 2022-23. This is in comparison to the incidence in 2017-18 of 32 percent. Effectively the country will see the same high level of poverty as existed at the start of this century.

The tragedy is that as highlighted earlier this has happened after the floods when the Federal and Provincial Governments are unable to undertake larger pro-poor expenditures in the face of severe financial constraints. The time has come for substantially raising of direct tax revenues by withdrawals of the large number of concessions, exemptions and by raising tax rates on the upper most income households in Pakistan. The revenues generated should be used for larger and wider coverage of cash transfers under the BISP.

Mechanisms will also need to be devised for subsidizing food prices and for an expanded program for training and employment of youth in the country. Fortunately, the Geneva Conference in January 23 has led to commitment of $9.7 billion by Multilateral agencies and bilateral sources over the next three years.

Chapter 14

Pakistan Falls to Low Level of Human Development

The UNDP Global Human Development Report for 2021-22 was released on the 8th of September 2022. In the Human Development Index (HDI) ranking of 189 countries, Pakistan has slipped badly. It has fallen from the 154th position in 2020 to the 161st position in 2021-22. In 2020 it was grouped in countries with a medium level of human development. Now it has been placed in countries with a low level of human development. This is bound to adversely affect perceptions of Pakistan, including these of international investors.

14.1 HDI Rankings

The rankings in the HDI of South Asian Countries are given in Table 14.1 below.

Table 14.1: HDI Ranking of South Asian Countries, 2020 and 2021

Countries	2020			2021-22		
	Ranking	HDI* Value	Level**	Ranking	HDI Value	Level
Sri Lanka	72	0.780	H	73	0.783	H
India	131	0.642	M	132	0.633	M
Bangladesh	133	0.655	M	129	0.661	M
Nepal	142	0.604	M	143	0.602	M
Pakistan	**154**	**0.543**	**M**	**161**	**0.544**	**L**

**Human Development Index | **H = High, M = Medium, L = Low*

Source: *UNDP, Global HDR, 2021-22*

Table 14.1 is very revealing in nature. Pakistan has the lowest HDI ranking among South Asian countries, even below Bangladesh and Nepal, two countries in the category of least developed countries.

The difference in the HDI values from 2020 to 2021-22 reflects especially the impact of COVID-19. India has seen the biggest decline in its HDI of almost 2 percent followed by Nepal. Bangladesh has managed the biggest improvement in the HDI of 1 percent. Sri Lanka and Pakistan have experienced marginal increases in the HDI.

A long-term comparison can be made of the evolution of the HDI at the country level from 1990 to 2021. This is done in Table 14.2.

Table 14.2: HDI in 1990 and 2021-22			
	1990	2021-22	Cumulative Growth (%)
Sri Lanka	0.629	0.782	24.3
India	0.429	0.633	47.6
Pakistan	0.402	0.544	35.3
Bangladesh	0.394	0.661	67.8
Nepal	0.387	0.602	50.0

Source: UNDP, Global HDR, 2021-22

According to Table 14.2, Pakistan had a higher HDI than Bangladesh and Nepal in 1990. However, these countries are now ahead of Pakistan because of the faster cumulative growth in their HDI from 1990 to 2021-22.

The spectacular success of Bangladesh in improving the level of human development of its people must be recognized. Among the five South Asian countries it has achieved the fastest cumulative growth of HDI of 68 percent between 1990 and 2021 and now has a HDI higher than even India.

14.2 Why the Lower HDI of Pakistan?

What explains the lower level of HDI of Pakistan? The HDI has three equal components, namely, per capita income, health, and education. Health is measured by the life expectancy and education by mean and expected years of schooling of the adult population.

The magnitude of these three variables in each South Asian country is given in Table 14.3.

Table 14.3: Magnitude of Human Development Indicators – 2021			
	Per Capita Income 2017 (PPP $)	Life Expectancy (Years)	Mean Years of Schooling (Years)
Sri Lanka	12,578	78.5	10.8
India	6,590	67.2	6.7
Bangladesh	5,472	72.4	7.4
Nepal	3,877	68.4	5.1
Pakistan	**4,624**	**66.1**	**4.5**

Source: *UNDP, Global HDR, 2021-22*

Table 14.3 indicates that among the five South Asian countries, Pakistan has the lowest magnitude in life expectancy and mean years of education. The gap is very large in the latter case. With regard to per capita income, Pakistan has a higher magnitude than one other country, Nepal.

The fact that Pakistan has fallen behind even Nepal and Bangladesh is a source of great sadness. We were ahead of these countries three decades age. We have faltered since then because of the underinvestment in our people. Expenditures on health and education have been relatively low. In fact, Pakistan is the only country in the region where the expenditure on defense is higher than the combined expenditure on health and education, as shown in Table 14.4.

The tragedy is that Pakistan is in the grips of a financial crisis. Sri Lanka has already defaulted on its external payment obligation. In years to come, India, Bangladesh and Nepal are likely to continue showing a better performance in raising the HDI.

Table 14.4: Level of Government Expenditure on Education, Health and Defense – 2020-2021 *(% of GDP)*

Country	Education [1]	Health [2]	[1] + [2]	Defence [3]	$\frac{[1]+[2]}{[3]}$ x100
Bangladesh	2.12	0.46	2.58	1.27	203
India	4.47	0.99	5.46	2.66	205
Nepal	4.18	1.10	5.28	1.38	383
Pakistan	2.38	1.08	3.66	3.83	96
Sri Lanka	1.93	1.93	3.86	1.85	209

Source: *World Bank, WDI*

PART-4

THE REFORM AGENDA

Introduction

The previous chapters have highlighted the extremely fragile state today of the economy of Pakistan. Foreign exchange reserves stand at below $5 billion, barely enough to provide import cover of one month, when the minimum 'safe level' is three months. The external debt stands at $130 billion, equivalent to 40 percent of the GDP. The net external financing requirement is at least $22.8 billion in 2022-23. In the first five months of the year the gross inflow from international lenders has been only $5.1 billion, while the amortization payments have been $4.1 billion, implying a net inflow of only $1 billion.

This dire situation of the economy has led international credit agencies like Standard and Poor, Fitch and Moody's to downgrade Pakistan's credit rating from B3 to Caa1. Pakistan is now in the group of countries like Angola, Congo, Tunisia, Nigeria, etc., who are considered as perilously close to default, as described in the ninth chapter.

The domestic financial situation is not much better. By the end of 2021-22 the total public debt had risen to Rs 49.2 trillion, equivalent to 74 percent of the rebased and 16 percent higher GDP. In the absence of rebasing, it would have approached 86 percent.

The build-up of public debt is the consequence of rising fiscal deficits. The deficit approached 8 percent of the GDP in 2021-22, when the target was 6.3 percent of the GDP. This divergence has taken place despite a massive cut in federal development spending by 54 percent. The slow-down in the implementation of major infrastructure projects will inevitably impact on the future GDP growth rate.

The people of Pakistan today face the one of highest ever rates of inflation of 25 percent. This is the consequence of a rapidly depreciating currency and the phenomenal increase in international commodity prices due to the global supply shortages created by the Russia-Ukraine war. In addition, floods and physical restrictions of imports have led to domestic supply shortages.

Now the country has to contend with the worst natural disaster of floods in its history. The economic loss is estimated at almost $30 billion. This comes in the wake of the negative impact of COVID-19. There are estimates that after the poor performance of the economy and the large negative shocks, 20 million more people of Pakistan are below the poverty line today.

The time has come for a hard and careful evaluation of the economic performance over the last two decades. The objective is to identify the wrong policies, absence of structural reforms and problems of misgovernance which have brought Pakistan to a situation today of near default in its external payment obligations. God forbid, if it does happen then the rate of inflation will hit the roof. There will be widespread shortages of food and other essential items and the GDP will contract sharply. We have seen this happen in Sri Lanka after the country defaulted. Even the IMF has identified the risk of a social disorder in Pakistan.

There is absolutely no doubt that wide-ranging and strong policies will have to be adopted, along with major structural reforms and improved governance. The objective of this part of the book is to identify the big moves that will have to be made to fundamentally transform the extremely difficult situation and effectively constitute the key elements of any future 'charter of the economy'.

This part of the book has four chapters. In view of the near default situation, the focus first is on sustaining the trade and balance of payments. This is followed by a diagnosis of the poor state of public finances and comprehensive reforms identified to quickly raise the tax-to-GDP ratio and reduce unproductive expenditure, especially on large subsidies to the energy sector.

The third chapter focuses on changes in the development strategy and institutional reforms for facilitating the process of economic growth while simultaneously tackling the problems of the twin deficits in the current account of the balance of payments and in public finances. The last part identifies improvements in economic governance including the transition from 'boom and bust' cycles to a more orderly process of growth.

Chapter 15: Sustaining Trade and the Balance of Payments

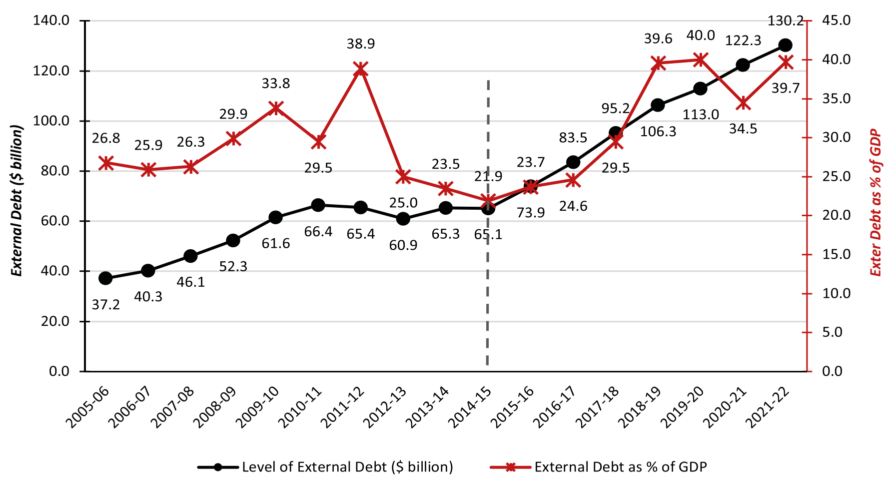
This chapter has seven parts, starting with identification of the long-term trends. The second section highlights the lack of emphasis on export led growth. The third section describes the over-liberalization of imports, followed by the fourth section on the exchange rate policy. Section five highlights the over-emphasis on textile exports, while section six highlights the need for development of service exports. Finally, section seven takes up the issue of the one-sided FTA with China.

15.1 Long-Term Trends

Pakistan has witnessed a very big deterioration its external financial position over the years as indicated by the following:

i) The external debt has *doubled* since 2014-15 to $130 billion, as shown in Figure 15.1. It was 24 percent of the GDP in 2014-15 and now stands at 40 percent of the GDP, following the recent GDP rebasing Otherwise, it would have exceeded 46 percent of the GDP.

Figure 15.1: Level of External Debt *(in Billion $)* and External Debt *as % of GDP*



**GDP has been adjusted for rebasing*

Source: *SBP*

ii) The annual external debt repayment has trebled since 2014-15. It was $4 billion in 2014-15, which increased to $12 billion in 2021-22. It is projected at over $14 billion in 2022-23, net of rollovers.

This deterioration is primarily the consequence of large current account deficit as % of the GDP. During the last seven years, the average current account deficit has been 3.5 percent of the GDP. The peak year was 2017-18 when it rose to 6.4 percent of the GDP. In 2021-22 it was also relatively high at 4.6 percent of the GDP. Cumulatively, the current account deficit over the period, 2014-15 to 2021-22, is $75.4 billion. This has been financed to the extent of $65 billion by buildup of external debt.

The main factor contributing to the large current account deficit is the rising trend in the trade deficit in goods as a percentage of the GDP, as shown in Table 15.1. It was small at 2.1 percent of the GDP in 2000-01. By 2021-22, it has risen almost six times to over 12 percent of the GDP. Fortunately, home remittances have made an increasing contribution to financing the trade deficit.

Table 15.1: Trend in Exports, Imports and Trade Deficit as % of GDP *(% of GDP)*

Years	Exports	Imports	Trade Deficit	Home Remittances	Current Account Deficit
2000-01	12.9	15.1	-2.1	1.5	-0.7
2005-06	12.0	22.5	-9.5	2.9	-4.5
2010-11	11.6	18.9	-7.3	5.2	+0.1
2015-16	6.6	14.2	-7.6	6.3	-1.6
2016-17	6.0	15.6	-9.6	5.7	-3.6
2017-18	6.5	17.0	-10.5	5.6	-5.4
2018-19	7.1	17.0	-9.9	6.8	-4.2
2019-20	7.1	14.8	-7.7	7.7	-1.5
2020-21	7.3	16.2	-8.9	8.5	-0.8
2021-22	9.9	22.0	-12.1	8.0	-4.6

Source: *PES*

There has been a continuing decline in the level of exports as a percentage of the GDP. In 2000-01 they were at almost 13 percent of the GDP, but have since declined virtually every year to come down close to 7 percent of the GDP by 2020-21. Fortunately, there was improvement to 10 percent of the GDP in 2021-22.

Imports, on the other hand, have shown a rising trend as percentage of the GDP, from 15 percent of the GDP in 2000-01 to 22 percent of the GDP in 2021-22. The average trade deficit over the last seven years has been as high as 9.5 percent of the GDP.

The rapidly increasing external debt repayment is attributable to changing composition of external debt. In 2005-06, the share of short-term and medium-term debt was 14 percent, which has increased to 35 percent by 2021-22, as shown in Table 15.2.

Table 15.2: Composition of Public External Debt *($ billion)*

	2005-06	2010-11	2015-16	2021-22
LONG-TERM DEBT	**30.1**	**45.3**	**45.9**	**65.1**
Paris Club	12.8	15.5	12.7	9.2
Multilateral	16.6	25.8	26.4	34.0
Other Bilateral*	0.7	2.4	5.4	18.0
Allocation of SDRs	0.0	1.6	1.4	3.9
SHORT-AND MEDIUM-TERM DEBT	**4.4**	**11.9**	**15.4**	**34.8**
Euro-Sukuk Global Bonds	1.9	1.6	4.6	8.8
Commercial Loans/Credits	0.1	0.0	0.9	10.5
Central Bank Deposits	0.7	1.0	0.7	2.7
SWAP Loans	1.5	8.9	6.0	6.9
Short-Term Loans	0.2	0.4	1.7	1.3
TOTAL PUBLIC EXTERNAL DEBT	**34.5**	**57.2**	**61.3**	**99.9**
Share of Short-Term and Medium-Term Debt	**12.9**	**20.8**	**25.2**	**34.6**

**Mostly China*

Source: *SBP*

The precarious financial position regarding external payment obligations is aptly highlighted by the worsening in the ratio of foreign exchange reserves at the start of a year to the magnitude of external financing requirements during the year, which is the sum of the current account deficit and net external debt repayment during the year. This was over 150 percent seven years ago. It is now down to the lowest ever level of 36.5 percent, as shown in Table 15.3.

Therefore, it is not surprising that Pakistan has been included in the list of 25 countries prone to default in their external payments by the *International Sovereign Debt Vulnerability Ranking* of Investor Education. Pakistan's vulnerability is relatively high as indicated by its fourth position in this list.

Table 15.3: Ratio of Foreign Exchange Reserves at the Start of a year and the External Financing Requirements during the year *($ billion)*

Years	FE Reserves at Start of Year	External Financing Requirement During the Year			Ratio of FE Reserves to Financing Requirement
		Current Account Deficit *(in absolute terms)*	External Debt Repayment	Total	
2015-16	13.5	5.0	3.9	8.9	1.517
2016-17	18.1	12.3	6.6	18.9	0.957
2017-18	16.1	19.2	5.2	24.4	0.659
2018-19	9.8	13.4	8.6	22.0	0.445
2019-20	7.3	4.4	11.3	15.7	0.464
2020-21	12.1	2.8	11.2	14.0	0.864
2021-22	17.3	17.3	12.1	29.4	0.588
2022-23 (Projected)	9.8	8.3	14.5	22.8	0.430

Source: *SBP, IMF*

15.2 Lack of Emphasis on Export-Led Growth

Pakistan followed an import substitution strategy of growth up to the mid-90s. This policy was reversed by a rapid reduction in the level of import tariffs as described in the next section. Initially, there was success in achieving significant export-led growth.

Table 15.4 gives estimates of the extent of export-led growth in different periods. It was as high as 48 percent in the period, 2000-01 to 2005-06. A double-digit growth rate was achieved in the volume of exports of goods and services. Thereafter, the growth rate of exports has fallen sharply. Between 2010-11 and 2015-16, the quantum of exports actually declined.

Table 15.4: Extent of Export-led Growth *(at constant prices)*				
	Annual Rate of Growth Exports* (%)	Share in GDP of Exports** (%)	GDP Growth Rate (%)	Contribution of Exports GDP Growth Rate*** (%)
2000-01 to 2005-06	10.3	14.8	5.7	48.5
2005-06 to 2010-11	2.1	18.6	2.8	24.7
2010-11 to 2015-16	-2.6	13.6	4.5	-13.9
2015-16 to 2021-22	6.7	8.7	4.0	26.1
2000-01 to 2021-22	4.0	13.6	4.1	23.8

**Volume of Exports Goods and Services | **In the first year of the period*

****Contribution =* $m \cdot s_x \frac{g_x}{g_y}$*, where is the multiplier,* s_x*= share of exports in GDP,*

g_x *= growth rate of exports,* g_y *= GDP growth rate*

Source: *SBP, PES*

Table 15.5 highlights the fact that export performance has been linked to the buoyancy in world trade.

Table 15.5: Growth Rate of World Trade and of Pakistan's Exports			*(%)*
	World Trade [2]	Pakistan's Exports [2]	Ratio [2] / [1]
2001 to 2005	13.2	13.3	1.008
2005 to 2010	7.5	6.6	0.853
2010 to 2015	1.7	1.1	0.647
2015 to 2020	1.3	-0.7	-0.538
2020 to 2021	26.6	32.5	1.221

Source: *World Bank, WDI.*

However, while Pakistan's exports kept pace with growth in world trade from 2000 to 2005, they have since fallen behind. The year, 2021, saw exceptional growth in exports due to the recovery process after COVID-19.

The falling profitability of exports has been compounded further by the policy of maintaining an overvalued exchange rate through interventions in the exchange market. The real effective exchange rate was raised by as much as 15 percent from 2010-11 to 2015-16 as shown in Table 15.6. The motivation was to reduce the component of imported inflation, but it led to a fall in the volume of exports by 10 percent and Pakistan saw a big increase in the current account deficit.

Table 15.6: Growth in Value, Unit Value and Volume of Exports in Different Periods

Annual Growth Rate (%)

	Value (in $)	Unit Value (in $)	Volume	REER
2000-01 to 2005-06	12.2	2.4	9.8	1.0
2005-06 to 2010-11	8.1	7.6	0.5	0.2
2010-11 to 2015-16	-4.3	-2.1	-2.2	2.9
2015-16 to 2021-22	1.9	-5.4	7.3	-5.3
2000-01 to 2021-22	4.6	1.0	3.6	0.0

Source: *World Bank, WDI.*

There is need for a comprehensive review of export policies. The current account deficit has risen once again to $17.4 billion in 2021-22, equivalent to 4.6 percent of the GDP. There is need to learn from the success of countries like Bangladesh and India in South Asia and Thailand in East Asia.

Chart 15.1 presents the prevailing export incentives and institutions in a sample of countries. As compared to India, Bangladesh and Thailand, Pakistan does not offer now the following for export:

- *Concessional export finance, which was withdrawn recently*
- *Full export insurance, guarantees and quality management*
- *Export cash incentive*
- *Export performance requirement for access to incentives*

There was a time when exporters of Pakistan were receiving a number of incentives as following:

- *Lower income tax*
- *Concessional export finance*
- *Lower energy cost*
- *Zero rating of domestic sales tax*

Combined, these were equal to a 12.5 percent higher export price.

The classic case of an export cash incentive is that of Bangladesh. An export cash incentive of 2 percent to 20 percent on the export price is offered on 24 export products. The rate is higher for more valued-added exports, emerging exports and on exports to new markets. India operates a duty scrip scheme. Thailand allows the double input tax deduction on domestic sales tax paid by exporters.

Chart 15.1: Export Incentives and Institutions in Different Countries	India	Pakistan	Bangladesh	Thailand
Duty Drawbacks	Yes	Yes	Yes	Yes
Concessionary Export Finance	Yes	No	Yes	Yes
Exports Insurance & Guarantees	Yes	No	Yes	Yes
Export Quality Management	Yes	No	No	Yes
Export Processing Zones	Yes	Yes	Yes	Yes
Export Performance Requirement	Yes	No	Yes	Yes
Lower Income Tax	Yes	Yes	Yes	Yes
Export Promotion Agency	Yes	Yes	Yes	Yes
Export Cash Incentive	Yes	No	Yes	Yes

Sources: *Diverse*

Clearly, Pakistan needs to greatly strengthen its export related institutions like the Trade Development Authority of Pakistan (TDAP) and The Pakistan Standard and Quality Control Authority (PSQCA).

The appropriate decision has been taken recently to levy a subsidized tariff on electricity at Rs 19.99 per kwh on export sectors. There is need also to explore the zero-rating of the domestic sales tax in export industries as was the case prior to 2019-20. Further, a cash incentive may be offered on emerging and value-added exports of 5 to 8 percent. Very importantly, the exchange rate should not be overvalued, and the REER should remain close to 95.

15.3 Over-Liberalization of Imports

As highlighted above, there has been a rapid and deep process of liberalization of imports from the mid-90s onwards. This has sometimes been undertaken under the pressure of the IMF in an on-going program.

Table 15.7 shows that in the early to mid-90s, the import tariff wall was high. There were ten slabs, and the maximum tariff was as high as 120 percent. The average tariff on imports was above 22 percent. Following six to seven moves to rationalize the tariff structure, the maximum tariff is now down to only 20 percent. There are three other slabs of 3 percent, 11 percent and 16 percent respectively. Some items have also been subjected to regulatory duties under different SROs. The average tariff on imports has now come down to only 7 percent from 22 percent two decades ago.

Table 15.7: Number of Import Tariff Slabs, Average Effective Tariff and the Average Level of Effective Protection to Domestic Production

	Number of Slabs	Minimum Tariff (%)	Maximum Tariff (%)	Average Weighted Tariff (%)	Average Effective Rate of Protection (%)	Revenues from Customs Duty (% of GDP)
Early to mid-90s	10	0	120	22.5	177	5.1
2007-08 to 2010-11	7	0	35	7.1	65	1.4
2012-13	7	0	30	5.7	52	1.6
2014-15	6	1	25	7.0	48	1.0
2015-16	5	2	20	7.2	35	1.0
2016-17*	4	3	20	9.0	33	1.4
2019-20*	5	0	20	9.2	33	1.5
2021-22*	5	0	20	7.0	33	

**Higher because of Regulatory Duties*

Source: *FBR Customs Tariffs and Estimates*

There is need to recognize also that today Pakistan has even lower tariffs then India and Bangladesh, as shown in Table 15.8, despite the much stronger export base of these two countries. The average MFN tariff is 11 percent in Pakistan, while it is 14 percent in Bangladesh and over 18 percent in India. The latter country has kept very high import tariffs on agricultural items to protect its domestic agricultural sector. As opposed to this, Pakistan, for example, has a zero duty on cotton imports.

Table 15.8: Comparison of Imports Tariffs in Pakistan, India and Bangladesh

(Average MFN Tariff)

	Year	Agriculture	Non-Agriculture	Overall
India	2021	39.2	14.9	18.3
Pakistan	**2021**	**13.4**	**10.9**	**11.2**
Bangladesh	2021	17.6	13.4	14.0

Source: *WTO, World Tariff Profiles*

The extremely large scaling down of import tariffs since the mid-90s has also implied substantial revenue losses. At its peak, the revenues from customs duty in the early 90s were as high as 5 percent of the GDP. They are now down to below 1.5 percent of the GDP. This has also implied consequential losses in revenues from the import sales tax.

Slab	Present Tariff (%)	Proposed Tariff (%)
1	3	5
2	11	15
3	16	20
4	20	30

The level of imports reached an all-time peak of 22 percent of the GDP in 2021-22, due particularly to the explosion in the international commodity prices after the start of the Russia-Ukraine war. This has now led to a global recession and prices are coming down significantly. This is an opportune time for raising the level of import tariffs without impacting significantly on the domestic price level. The recommended move is enclosed. The maximum tariff will rise from 20 percent to 30 percent. However, the import tariffs on basic food items and medicines should remain unchanged at present levels. The average level of effective protection to domestic industry will go up from 33 percent to 45 percent. This will promote 'MADE IN PAKISTAN' products.

The Customs department should develop a system of determining from different sources the latest international prices, like the UNCOMTRADE database, and comparing them with the actual prices in import invoices. There is considerable evidence of significant under-invoicing by importers.

Also, a 1 percent handling charge should be levied on the c.i.f. value of an import consignment, as is the case in India currently.

15.4 Maintaining an Overvalued Exchange Rate

The Real Effective Exchange Rate (REER) compares Pakistan's rupee against the weighted average of the currencies of its major trading partners. It is an indicator of the international competitiveness of a nation in comparison with its trading partners. A rising or high REER indicates that Pakistan is losing its competitive edge, with relatively expensive exports and relatively cheap imports.

The SBP computes the REER of Pakistan on a monthly basis. It is in the form of an index with the base year of 2010 = 100. The latest REER is as follows:

	REER
July 2021	99.6
September 2021	96.7
December 2021	96.8
March 2022	96.7
June 2022	94.0
July 2022	93.2
August 2022	94.3
September 2022	90.71
October 2022	100.19
November 2022	98.94

Therefore, the Pakistani rupee has been depreciating in relation to other currencies since July 2021. However, since end-July the rupee has appreciated by 10 percent and the REER stands currently at close to 100. This has happened recently because of the SBP move away from a market-determined exchange rate policy to restrict imports to administrative measures of controlling the LCs of imports. This has led to a big divergence between the inter-bank exchange rate and the open market rate of over 15 percent. Home remittances and exports are increasingly being diverted to unofficial channels.

The long-term trend in the nominal value of the rupee and the REER since 2000-01 is given in Table 15.9. Substantial variation can be observed in the magnitude of the REER in different periods.

The first epoch was from 2000-01 to 2004-05 when it remained significantly below 100. Thereafter, it remained close to 100 up to 2013-14. The PML-N government adopted the policy of keeping the REER very high above 100 to severely quell the component of imported inflation. As opposed to this, the successor PTI government adopted the policy of sharp depreciation of the rupee and brought down the REER to 94 from 115. The objective was to reduce the current account deficit from the highest ever level of $19.4 billion in 2017-18 and restore a semblance of sustainability in the balance of payments.

Table 15.9: Trend in the Nominal and the Real Effective Exchange Rate

Years	Nominal Exchange Rate (Rs/$)	Real Effective Exchange Rate (1990-91 = 100)	Years	Nominal Exchange Rate*	Real Effective Exchange Rate* (1990-91 = 100)
2000-01	58.44	96.47	2010-11	85.50	102.30
2001-02	61.42	98.40	2011-12	89.24	104.18
2002-03	58.49	98.42	2012-13	96.73	100.74
2003-04	57.27	95.57	2013-14	102.86	97.69
2004-05	59.36	92.29	2014-15	101.29	112.85
2005-06	59.86	101.36	2015-16	104.24	118.28
2006-07	60.63	100.00	2016-17	104.70	123.26
2007-08	62.54	98.67	2017-18	109.84	115.54
2008-09	78.49	97.09	2018-19	136.69	97.47
2009-10	83.80	99.49	2019-20	158.02	95.72
			2020-21	160.02	96.33
			2021-22	177.85	93.98

Above 98 in 13 out of 22 years

**Average for year*

Source: *SBP*

The impact on the volume of exports and imports during these two periods is given below:

Annual Growth Rate in Volume (%)				
Parties	Period	Average REER	Exports	Imports
PML(N)	2013-14 to 2017-18	113.52	0.3	11.6
PTI	2018-19 to 2021-22	95.87	6.6	4.2
Source: *SBP, WDI*				

The policy of bringing down the REER was successful in raising the growth rate of the volume of exports and reducing the growth rate of the volume of imports during the tenure of the PTI government.

Based on the above analysis, the policy ought to be to keep the REER close to 95. The over 9 percent appreciation of the rupee from the end of July to the 10th of October 2022 has raised the REER to almost 100. This has increased the risk of a widening of the trade deficit in the coming months of 2022-23 and implying even more severe physical restriction on imports.

15.5 Over-Emphasis on Textile Exports

Pakistan's exports have been characterized by a high level of dependence on textile exports. the share of textile exports in total exports stands currently at 56.6 percent. It has declined only marginally from 61.8 percent in 2005-06. The other two product groups are agricultural commodities and other manufactures with shares of 16.6 percent and 26.8 percent respectively in 2021-22, as shown in Table 15.10.

Table 15.10: Product Diversification of Exports *($ billion)*					
	2005-06	2010-11	2015-16	2019-20	2021-22
Agricultural Commodities Group	2.0 (12.0)*	4.5 (18.1)	4.0 (19.2)	4.4 (20.6)	5.4 (16.6)
Textile Group	10.2 (61.8)	13.8 (55.6)	12.4 (59.6)	12.5 (58.4)	18.4 (56.6)
Other Manufactures Group	4.3 (26.2)	6.5 (26.3)	4.4 (21.2)	4.5 (21.0)	8.7 (26.8)
TOTAL	**16.5**	**24.8**	**20.8**	**21.4**	**32.5**
Index of Export Diversification**	0.535	0.589	0.563	0.573	0.581

**Share of total exports*

***This is* $I = 1 - \sum_{i=1}^{n} S_i^2 \; where \; S_i$ *Is the share of the ith product group*

Source: *SBP*

The Index of Export Diversification is estimated at 0.581, with the maximum value of 1. It has shown only a minor improvement from 0.535 to 0.581. This is largely attributable to the rise in the share of agricultural commodities.

Table 15.11 presents the list of exports currently in the following ranges:

Traditional Export:	Above $1 billion
Emerging Export:	$500 million to below $1 billion
Nascent Export:	$250 million to below $500 million

The list has seven export items with exports above $1 billion, consisting of textile products and rice, and total exports of $18.3 billion. There are four emerging exports of sports goods, leather manufactures, chemicals and made-up textiles. They have a share of 9 percent in total exports.

The prospects for export diversification are enhanced by the ten exports in the nascent list. They include agricultural items like fish, fruit, vegetables and meat. Industrial items are art silk and synthetic textiles, surgical goods, plastic materials, pharmaceuticals, engineering goods and cement.

Table 15.11: Traditional, Emerging an Nascent Exports of Pakistan 2021-22

> 1 billion		$500 million to $1 billion		$250 million to $500 million	
Traditional		Emerging		Nascent	
Rice	2211	Made-up Articles	806	Fish	419
Cotton Yarn	1200	Sports Goods	506	Fruits	469
Cotton Cloth	2338	Leather Manufactures	649	Vegetables	274
Knitwear	4516	Other Chemicals	797	Meat	352
Bedwear	3254			Art Silk & Syn. Textile	342
Towels	1080			Surgical Goods	474
Readymade Garments	3698			Plastic Materials	440
				Pharmaceuticals	273
				Engineering Goods	313
				Cement	314
TOTAL	**18297**	**TOTAL**	**2758**	**TOTAL**	**3670**

Source: *SBP*

There is need to provide strong incentives and prepare an export development plan for emerging and nascent export items. As such, the recommendations include the following:

i) The Commerce Ministry and the Pakistan Trade Development Authority should identify the principal constraints to the growth in emerging and nascent exports, in collaboration with an international Multilateral agency like the World Bank. The steps and projects necessary for removing the constraints should be identified and implemented on a priority basis.

ii) The ten emerging or nascent manufactured goods identified in Table 15.11 should be declared as zero-rated industries and not subject to domestic sales tax.

iii) All SMEs in both the agricultural and manufactured goods categories should enjoy the benefit of special access to commercial bank loans with a special tax credit facility for the banks.

15.6 Under Development of Service Exports

Pakistan has largely failed to exploit the potential for service exports. As shown in Table 15.12, these exports aggregate to only $7 billion, and have shown a modest growth rate of only 4 percent since 2015-16. Fortunately, starting from a low base, telecom and information services have shown rapid growth rate of 20 percent and have now emerged as the largest service export at $2.6 billion. However, this still stands in sharp contrast to high level of IT exports of India of $120 billion.

Table 15.12: Trend in Export of Services *($ million)*

	2015-16	2021-22	ACGR (%)
TOTAL SERVICES EXPORT	**5455**	**6957**	**4.0**
Transport	1125	807	-5.5
Travel	323	541	8.6
Financial Services	110	112	0.0
Telecom & Information Services	788	2165	20.0
Other Business Services	1009	1644	8.1
Government Services	1946	1071	-10.0
Others	154	167	1.3

Source: *SBP*

The Ministry of Information Technology may be given special development funds to expand the capacity for basic and advanced training to undergraduate students in engineering universities and business schools in IT. Also, efforts must be made to bring the export earnings from IT into formal channels.

15.7 One-Sided FTA with China

There has been a special bilateral trade relationship between China and Pakistan since 2006, with a number of items of each country subject to zero or concessionary import tariffs. The Pak-China early harvest agreement included the lists of these items.

The Phase-II of the CPFTA was signed on the 28th of April 2019 in Beijing. The major features are as follows:

i) *Market Access:* China will immediately eliminate tariffs on 313 most priority lines of Pakistan's interest. Included are textiles and garments, sea food, meat prepared foods, leather, chemicals, plastics, oil seeds, etc.

ii) China will liberalize 75 percent of its tariff lines in a period of 10 years and Pakistan will do so in 15 years. Some safeguard measures have been included, but they have generally not been applied.

The trend in bilateral trade between the two countries is shown in Table 15.13. The FTA has resulted in a very imbalanced pattern of trade between the two countries. China exports to Pakistan over six times as much as it imports from Pakistan. It is the largest exporter to Pakistan, with a share in Pakistan's imports of almost 25 percent.

Table 15.13: Trend in Trade with China *($ Million)*

EXPORTS	2005-06	2010-11	2015-16	2019-20	2021-22
China Exports to Pakistan	2706	3534	12098	13301	17296
Pakistan's Exports to China	464	576	1670	2043	2781
Ratio	5.83	6.13	7.24	6.51	6.22

Source: *SBP*

There is need for review and renegotiation of the FTA with China. It is extremely unusual that there is so much imbalance in trade between two countries in an FTA. China should be asked to expedite the process of moving to zero tariffs, especially on the full range of textile products, on import from Pakistan.

A comprehensive review must be undertaken by the Ministry of Commerce along with the National Tariff Commission to determine if particular duty-free imports from China have inflicted severe damage to different industries. In such cases, the zero-import tariff may be withdrawn in consultation with China.

15.8 Increasing Return on Roshan Digital Accounts

Cumulative inflow under the Roshan Digital Accounts (RDA) reached $5.14 billion at the end of September, 25 months since the programme was launched, according to data released by the State Bank of Pakistan (SBP).

RDA inflows decreased by 10 percent month-on-month to $168 million in September, down from $187 million in August, 2022 and representing the lowest monthly inflow since January 2021.

Meanwhile, out of the overall $5.149 billion deposited in RDAs, $3.262 billion or almost 63.35 percent have been invested in Naya Pakistan Certificates (NPCs). Of this, $1,691 million have been invested in conventional NPCs, whereas $1,571 million have been invested in Islamic NPCs.

Overseas Pakistanis from 175 countries have so far opened some 472,023 accounts under RDA. On a monthly basis, the number of accounts opened has increased by 3 percent.

This is the first time in Pakistan's history that non-resident Pakistanis (NRPs) are being provided an opportunity to remotely open an account in Pakistan through an entirely digital and online process without any need to visit a bank branch.

The RDA is a very innovative initiative of the State Bank, in collaboration with commercial banks in Pakistan, to provide innovative banking solutions to NRPs, including Non-Resident Pakistan Origin Card (POC) holders, seeking to undertake banking, payment and investment activities in the country. The initiative was launched in September 2020 by the SBP and offered up to 7 percent profit on US dollar investment.

The central bank *increased the rate of return for investment in PKR-denominated NPCs* by up to 550 basis points (bps) in August. However, the rate of return on US dollar-dominated certificates has remained unchanged.

The rate of return on 3-Month PKR-dominated NPCs, with a minimum investment of 10,000 with integral multiples of 1,000, has increased from 9.50 percent to 15 percent, and the rate of return on 6-Month PKR-dominated certificates rose by 5.25 percent to 15.25 percent.

In addition, the rate of return on 12-Month PKR-dominated NPCs surged by 5 percent to 15.50 percent, for 3-year certificates it went up from 10.75 percent to 14 percent, while the rate of return on 5-year NPCs increased from 11 percent to 13.5 percent.

The time has also come for raising the rate of return dominated RDAs in the presence of a global upsurge in interest rates and heightened risk perceptions of investment in Pakistan. As such, the recommendation is that the rate of return be enhanced by 2 percentage points. The cost will still be lower than the flotation of Euro/Sukuk bonds.

The above comprehensive set of recommendations in the eight sections in this chapter on trade and balance of payments should facilitate faster growth of exports and restrict the rise in imports substantially. They will need to be implemented soon to restore a semblance of sustainability in the balance of payments of the country and reduce the likelihood of a default.

Chapter 16:

Managing the Public Finances

The worrying state of public finances is aptly reflected by the accumulation of Central Government Debt, as shown in Table 16.1. The Fiscal Responsibility and Debt Limitation Act of 2005 placed a limit on the size of the government debt at 60 percent of the GDP. As of June 2022, it was Rs 47.8 trillion, equivalent to 71.4 percent of the rebased GDP. In the absence of the recent rebasing of the GDP, it would have been as high as 83 percent.

Table 16.1: Trend in Central Government Debt *(Rs in Billion)*

	DOMESTIC DEBT		EXTERNAL DEBT		TOTAL DEBT	
	Level	% of GDP	Level	% of GDP	Level	% of GDP
2009-10	4653	29.2	3789	23.8	8442	53.0
2010-11	6014	30.4	4159	21.0	10173	51.4
2011-12	7637	34.9	4544	20.8	12181	55.7
2012-13	9520	38.7	4487	18.2	14007	56.9
2013-14	10906	39.1	4877	17.5	15783	56.6
2014-15	12192	39.8	4775	15.6	16967	55.4
2015-16	13626	41.6	5417	16.6	19043	58.2
2016-17	14849	41.8	5919	16.6	20768	58.4
2017-18	16416	41.9	7795	19.9	24212	61.8
2018-19	20732	47.3	11055	25.2	31787	72.2
2019-20	23282	49.0	11824	24.9	35107	73.9
2020-21	26265	47.1	12439	22.2	38704	69.3
2021-22	31036	46.4	16746	25.0	47782	71.4

Source: *SBP*

The share of relatively high-cost domestic debt has increased from 55 percent to 65 percent, while that of external debt has declined from 45 percent to 35 percent. The annual cost of debt servicing has risen from 2.8 percent of the GDP to 4.8 percent of the GDP, due also to a rise in the average interest rate. This has not only implied a higher budget deficit but has also led to a squeezing out of development spending, with the inevitable impact on GDP growth.

The primary factor contributing to the rapid increase in government debt is the growing divergence between the level of revenues and the level of expenditure, as shown in Table 16.2. Consequently, with a rising budget deficit, the financing needs through borrowing have increased exponentially.

Table 16.2: Long-Term Trends in the Public Finances of Pakistan

	TOTAL REVENUES			TOTAL EXPENDITURE		DEFICIT	
	Tax Revenues	Non-Tax Revenues	Total Revenues	Debt Servicing	Total Expenditure	Budget Deficit	Primary Deficit/ Surplus
2005-06	9.4	3.2	12.6	2.8	16.4	-3.8	-1.0
2010-11	8.6	5.4	14.0	3.5	17.4	-3.4	0.1
2015-16	11.2	2.4	13.6	3.9	17.7	-4.1	-0.2
2016-17	11.2	2.7	13.9	3.8	19.1	-5.2	-1.4
2017-18	11.4	1.9	13.3	3.8	19.1	-5.8	-2.0
2018-19	10.2	1.0	11.2	4.8	19.1	-7.9	-3.1
2019-20	10.0	3.2	13.2	5.5	20.2	-7.0	-2.5
2020-21	9.5	3.9	12.4	4.9	18.5	-6.1	-1.2
2021-22	10.1	1.9	12.0	4.8	19.9	-7.9	-3.1

Source: *MOF, Fiscal Operations*

There has been virtually no increase in the tax to GDP ratio as shown in Table 16.3. It reached a peak of 11.4 percent of the GDP in 2017-18 and has since actually fallen to 10.1 percent of the GDP in 2021-22. Simultaneously, the non-tax to GDP ratio has shown a fluctuating trend. Overall, total revenues have fallen from the peak of 13.9 percent of the GDP in 2016-17 to 12 percent of the GDP in 2021-22.

Total expenditure has been showing a rising trend. It has increased from 16.4 percent of the GDP in 2005-06 to almost 20 percent of the GDP in 2021-22. Overall, the budget deficit has risen rapidly from 3.8 percent of the GDP to almost 8 percent of the GDP in 2021-22.

Table 16.3: Trend in Individual Tax and overall Tax-to-GDP Ratio

Year	FEDERAL TAXES*					PROVINCIAL TAXES			Overall Tax-to-GDP Ratio
	Income Tax	Sales Tax	Customs Duty	Excise Duty	Total	Sales Tax on Services	Others	Total	
1999-2000	2.7	2.8	1.4	1.3	8.2	0.0	0.4	0.4	8.6
2004-05	2.5	3.3	1.5	0.7	8.0	0.0	0.3	0.3	8.3
2009-10	3.4	3.4	1.0	0.8	8.6	0.0	0.3	0.3	8.9

2014-15	3.4	3.6	1.0	0.5	8.5	0.4	0.3	0.7	9.2
2019-20	3.2	3.3	1.3	0.5	8.3	0.5	0.4	0.9	9.2*
2020-21	3.1	3.6	1.4	0.5	8.6	0.5	0.4	0.9	9.5
2021-22	3.4	3.8	1.5	0.5	9.2	0.5	0.4	0.9	10.1

**Petroleum levy transferred to non-taxes*

Source: *MOF*

16.1 Low Tax-To-GDP Ratio

As highlighted above, the tax-to-GDP ratio of Pakistan is relatively low. It currently stands at close to 10 percent of the GDP. As compared to this, the tax-to-GDP ratio of India is 18 percent. Results of research on the magnitude of the 'tax potential' of Pakistan is that it is close to 15 percent of the GDP.

The other structural problem with Pakistan's tax system is that it is heavily tilted towards indirect taxes, implying greater regressivity. Almost two-thirds of the revenue is from indirect taxes. A further complication is the reliance on withholding collections in the income tax regime, many of which are in the nature of indirect levies. Table 16.4 demonstrates the regressivity of the federal tax regime.

Table 16.4: Incidence of Federal Taxes, 2020-21 *% of the Tax Revenue*

	Bottom Quintile	2nd, 3rd and 4th Quintile	Top Quintile	PALMA Ratio*
Income Tax	5.6	30.4	64.0	11.42
Import Sales Tax	9.4	49.0	41.6	4.42
Domestic Sales Tax	8.3	49.5	42.2	5.08
Customs Duty	7.8	46.7	45.5	5.83
Excise Duty	9.0	50.9	40.1	4.45
TOTAL TAX REVENUE	**7.6**	**42.5**	**49.9**	**6.56**
TOTAL INCOME	**6.3**	**42.2**	**51.5**	**8.17**
Ratio	**1.206**	**1.007**	**0.968**	

Therefore, REGRESSIVE INCIDENCE

**Ratio of share of top quintile to bottom quintile*

Source: *Pasha (2022)*

The tax gap of 5 percent of the GDP is partly explained by the widespread 'tax expenditures' in the tax system. These are revenues foregone due to tax exemptions, reliefs and concessions. According to the FBR, the total tax expenditure was Rs 1482 billion in 2021-22, equivalent to 2.7 percent of the GDP. Therefore, even if these tax expenditures largely continue, there is still scope for raising and additional 2.3 percent of the GDP through wide-ranging and deep tax reforms. This will enable generation of an additional Rs 1500 billion and contribute in a big way to improving the state of public finances in the country.

The agenda of proposed tax reforms is given below.

Income Tax

Transition from Block to Comprehensive income: Currently, the practice is to tax blocs of income separately. This has greatly reduced the progressivity of the tax system. Usually, the tax return contains only earned income. Unearned income in the form of interest, dividends, property income and capital gains are subject to presumptive taxation separately. For example, interest income is subject to a fixed tax of 15 percent.

There is need for taxation of comprehensive income by adding all types of income. This will usually imply that the marginal tax rate on unearned income becomes higher. As such, the existing presumptive taxes should be transformed into advance withholding taxes. It will also lead to a fairer tax system with persons having total income of less than Rs 600,000 or lower marginal tax rate being able to claim a tax refund.

Capital Gains Tax: The concept of holding period has been applied on capital gains and property and shares. Beyond the holding period there is zero tax. Within the holding period, the entire capital gain will be subject to taxation, at rates given below.

Holding period < 1 year	Tax rates					
	Open Plot/ Shares		ConstructedProperty		Flats	
> 1 - < 2 years	***15%***		***15%***		***10%***	
> 2 - < 3 years	***12.5%***		***10%***		***5%***	
> 3 - < 4 years	***10%***		***7.5%***		***0%***	***(2.5%)***
> 4 - < 5 years	***7.5%***		***0%***	***(5%)***	***0%***	***(2.5%)***
> 5 - < 6 years	***5%***		***0%***	***(2.5%)***	***0%***	***(2.5%)***
> 6 years	***0%***	***(5%)***	***0%***	***(2.5%)***	***0%***	

There is a need for imposition of a minimum capital gains tax of 2.5 percent, irrespective of the holding period.

Rationalization of the Withholding Tax Regime: *The withholding tax system within income tax contributed 69 percent to revenues in 2021-22. There are at least 70 levies in the form of advance or fixed and final taxes. The top levies are on imports, contracts, services, salaries, dividends, interest, technical fees, exports, income from property, cash withdrawal from banks and on electricity bills. Collectively, they contribute 84 percent to the total revenue from withholding taxes.*

There is a strong case for reducing the number of small withholding taxes and thereby contributing to greater ease of doing business. The advance tax on electricity bills should be developed as a way of taxing incomes in the informal sector. Also, the same advance tax rates should be charged from filers and non-filers, as the latter may be genuinely exempt.

Changing the Tax Credit Scheme: *The tax credit scheme for individual and corporate taxpayers is as follows:*

TAX CREDIT ON	UP TO
• *Charitable Donations*	• *30% of individual taxable income* • *20% in the case of companies*
• *Investment in Shares and Insurance*	• *20% of individual taxable income*
• *Investment in Health Insurance*	• *5% of taxable income*

The formula for determining the tax credit is as follows:

$$\textbf{Tax Credit} = \frac{A}{B} \times C$$

where A = amount of tax assessed, B = taxable income, C = amount spent for claiming the tax credit. This favors the larger taxpayer whose average tax rate is higher. As such, a fixed tax credit should be given at a rate equal to 20 percent of the amount spent for claiming the tax credit, subject to the condition that the minimum overall income tax liability is zero, with the provision of carryover.

Further, a tax credit facility may be offered on repayment of housing loans up to 15 percent of income or 20,000 per month whichever is lower.

In addition, detection of evasion can also be done via personal (domestic) electricity bills. For unclear reasons, the exemption limit of the withholding tax had been raised enormously by FBR to Rs 75000 per month of electricity bill. The proposal is as follows:

WITHHOLDING INCOME TAX ON DOMESTIC ELECTRICITY BILLS	
Monthly Electricity Bill (Rs)	*Advance / Withholding Tax Rate*
Less than Rs 20,000	*Exempt*
Rs 20,000 to Less than Rs 40,000	*5%*
Rs 40,000 to less than Rs 60,000	*7½%*
Rs 60,000 and above	*10%*

Now, this withholding tax has been introduced only on persons who are not in the Active Tax payers list and have a bill above Rs 25000.

Progressive Corporate Income Tax: *There are many corporate entities which are favorably placed in the market situation and enjoy a degree of monopoly power. Sometimes, higher profits are also due to access to a scarce natural resource or because of rise in prices of competing imports.*

The proposal is to introduce a degree of progressivity in the corporate income tax system, as follows:

PROPOSED STRUCTURE OF CORPORATE INCOME TAX	
Pre-Tax Net Return on Equity	*Tax Rate (%) (on Net Profits)*
0% to less than 15%	*29%*
15% to less than 20%	*29% + 10% on the profit above 17.5% on equity**
20% and above	*29% + 20% of the profit above 17.5% of equity***

**For example, if the pre-tax return on equity is 24% then the effective tax rate will be 29.65%*

***For example, if the pre-tax return on equity is 30% then the effective tax rate is 31.5%*

Incentives for Filing Returns: *The following incentives may be given to induce tax filing by more income earners:*

i) An individual taxpayer who files a tax return for the first time to be exempt from audit for the first three years.

ii) An individual who has been an active taxpayer for at least the last three years to be exempt from audit if income declared is 20 percent higher than the previous year.

Prevention of under invoicing of imports: *The approach adopted should be to introduce International Trade Prices (ITPs) on imports likely to be under invoiced. These ITPs should be based on export data of the items to other countries.*

Rationalization of Tax Expenditures: *The proposals for rationalization of various tax expenditure are as follows:*

i) Large pensions are subject to taxation in most countries. As such a flat rate of 10 percent may be charged on pension amounts above 2,000,000 annually.

ii) The tax credit to NGOs should be made available only to those NGOs operating in the fields of education, health, or social safety nets.

The Initial Depreciation Allowance and the Tax Credit on BMR should be retained as fiscal incentives for higher investment. The revenue foregone will be more than recovered by the expansion in the value added tax base due to the investment. However, the first facility has been withdrawn in the budget for 2021-22.

Minimum Taxation of Rental Income: *The total revenue collected from rental income taxation is Rs 20 billion, which is not even 1.5 percent of the total revenues from the income tax. The estimated rental income on property owned by households in the top two income quintiles is over Rs 780 billion. As such, the potential revenue is at least three times the actual revenue.*

Therefore, to control the underreporting of rental incomes, it is proposed to introduce a minimum tax on rental incomes. The minimum rental value of a property may be set at 3 percent of the capital value as per the Valuation Tables of FBR for neighborhoods in the cities of Pakistan.

Income Taxation of Commercial Banks: *The credit extended by commercial banks to socially preferred sectors including agriculture, SMEs, housing, micro credit, and infrastructure is only 12 percent of total advances. There is need for raising the share of these sectors.*

A taxation scheme is proposed as follows:

FIRST PART	SECOND PART	THIRD PART
If the share is below 20% the corporate income tax rate will be higher at 45%	***For increase in credit share to beyond 20% a tax credit of 5% of the additional credit will be made available***	***The provision for tax deductibility for bad loans in these sectors will be increased to 10% of total advances to these sectors***

Taxing the Informal Sector: *The pragmatic approach to taxing sectors which are informal in nature and income earners are prone to tax evasion due to lack of documentation is to operate a regime of presumptive taxes. Proposed new measures will replace the large number of existing small withholding taxes.*

The proposed withholding tax system on electricity bills for commercial establishments, engaged in wholesale and retail trade and other services is as follows:

	Size of Monthly Electricity Bill
Exemption limit	*Rs 1,000*
Rs 1,001 – 5,000	*5%*
Rs 5,000 – 15,000	*7½%*
Rs 15,000 and above	*10%*

Some changes were introduced in this withholding tax in the latest Budget, which have since been withdrawn.

Indirect Tax Reforms

The share of indirect taxes, inclusive of income withholding taxes, is very high in Pakistan at 82 percent and it has been increasing in recent years. Therefore, the focus should be more on broad-basing and reduction in tax rates rather than on enhancement of tax rates. The implementation of direct tax reforms described above should be followed by a reduction in the general sales tax rate to 15 percent.

Recommendations

The following reforms are proposed in indirect taxes.

- *i) Move towards a nationally integrated sales tax on goods and services with VAT features. This will lead to a closer approximation of the tax to a comprehensive value added tax. Both taxpayers of sales tax on goods and services respectively will file the same tax return. There will be one tax rate throughout the country and the same for goods and services. This fundamental reform will both widen the coverage and substantially reduce evasion.*
- *ii) The time has come for the imposition of an import duty and sales tax on selected services. The 'reverse charge' principle can be applied to the collection of the tax.*
- *iii) Reduction of tax evasion can be achieved by a levy of the sales tax on more goods on the manufacturer based on the notified retail price. Most luxury consumer goods and consumer durables should be taxed on the retail price and paid for by the manufacturer.*
- *iv) The excise duty is leviable on items which can be considered as harmful. As such, it should be extended on all and services which pollute the environment or lead to the depletion of natural resources like wood products, brickkilns, chemicals, etc.*

Provincial Tax Reforms

As highlighted earlier, the total revenue from provincial taxes is only 0.9 percent of the GDP, despite the presence of large tax bases of the agricultural income tax; sales tax on services and the urban immoveable property tax.

Recommendations

*The proposed reforms in **agricultural income tax** which currently yields only Rs 3 billion in the four Provinces combined are as follows:*

The flat rates by farm size of the agricultural income tax to be set as follows given below:

*Farm Size (Acres)**	*Tax Rate per Acre*
< 25	*Exempt*
25 – 50	*Rs 250 per acre above 25 acres*
50 – 100	*Rs 6250 + Rs 500 per acre above 50 acres*
100 – 150	*Rs 31250 + Rs 1000 per acre above 100 acres*
150 and above	*Rs 81250 + Rs 2500 per acre*
**Barani acres. Twice the farm size for irrigated acres*	

*The **urban immoveable property tax** yields only Rs 26 billion annually and only Rs 10 billion in Karachi. There is significant revenue potential of this tax. Exemptions should be given on properties located on plots of up to 240 sq yds or with covered area of less than 800 sq ft.*

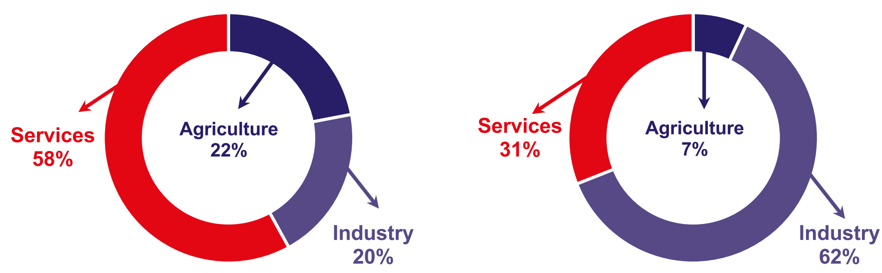
Beyond the exemption, the Gross Annual Rental Values may be assessed initially at equal to 2 percent of the capital value of properties. These capital values can be obtained at the level of localities from the nationwide comprehensive valuation of properties by FBR.

16.2 Lack of Broadening of the Tax System

The tax system of Pakistan is currently heavily skewed towards the industrial sector. Research reveals that the distribution of nominal incidence by sector is as shown in Figure 16.1.

Figure 16.1: Sectoral Share of GDP and Tax Revenue Generation

SHARE OF SECTORS IN GDP	SHARE OF SECTORS IN TAX REVENUE GENERATION



The effective tax incidence as % of value added is as follows:

Agriculture	Industry	Services
2.4	26.4	4.7

Therefore, there is a strong case for sectoral diversification of the Federal and Provincial tax systems.

Recommendations

Based on the above-mentioned reforms, the incidence of taxes on the agricultural sector and the services sector respectively will be achieved in the following ways:

	SERVICES SECTOR
i.	*Development of the Sales Tax on Services*
ii.	*Levy of withholding income tax on electricity bills of commercial consumers*
iii.	*Introduction of import duty and sales tax on imports of services*
iv.	*Higher collection from the urban immoveable property tax*
	AGRICULTURE SECTOR
•	*Development of the Agricultural Income Tax*

The additional tax revenues, with the tax base of 2021-22, from implementation of the above-mentioned tax reforms are given in Table 16.5.

Table 16.5: Additional Revenue from Tax Proposals

DIRECT TAXES	*Revenue (Rs in Billion)*
• *Introduction of Progressive Corporate Income Tax*	*75*
• *Higher withholding tax on Importers*	*60*
• *Levy of Withholding Tax on Electricity Bills of Traders*	*30*
• *Minimum Rental Income Taxation*	*50*
• *Conversion of Fixed and Final Taxes into Advance Taxes*	*100*
• *Reduction in Tax Credits and Exemptions*	*40*
• *Broadening off the Base of the CGT*	*35*
• *Higher Rate of CIT on Commercial Banks*	*65*
• *Higher Rate of the Agricultural Income Tax**	*100*
• *Higher Rate of the Urban Immoveable Property Tax**	*80*
• *Others*	*50*
TOTAL	***685 (1% of GDP)***

INDIRECT TAXES	*Revenue (Rs in Billion)*
• *Higher Rates on Import Duty*	*275*
• *Harmonization of the Sales Tax***	*150*
• *Broadening the Base of Excise Duty*	*45*
• *Levy of Sales Tax on Import of Services*	*75*
• *Levy of Sales Tax on Retail Prices*	*35*
• *Introduction of a Regime of ITPs*	*45*
• *Others*	*35*
TOTAL	***660 (1% of GDP)***
NON-TAXES	*Revenue (Rs in Billion)*
• *Higher 'Abiana' Charges**	*60*
• *Higher Tolls on Motorways*	*50*
TOTAL	***110 (0.2% of GDP)***
OVERALL ADDITIONAL REVENUE	***1455 (2.2% of GDP***
**Collection by Provincial Governments*	
***Collection by both the Provincial and Federal Governments*	

The recommendations now focus on the expenditure side of the Federal and Provincial Governments.

16.3 Increases in Employee Remuneration

The salaries allowances and pensions of government employees have increased rapidly due to periodic awards announced in the budgets. Also, the employment in the Public Administration and Defense sector has increased significantly by almost 4.9 percent per annum, especially in the social services. Pensions alone required an outlay of over Rs 1101 billion in 2021-22.

An analysis is undertaken of the trend in real incomes of government employees in Table 16.6. The perhaps not so surprising finding is that the levels of compensation, after adjusting for inflation, have risen in real terms from 2015-16 to 2020-21 by 10 percent. This has happened at a time when real wages in the private sector have tended to fall.

Table 16.6: Growth in Compensation of Government Employees			*(Rs in Billion)*
	2014-15	2020-21	Annual Growth Rate (%)
Total Bill of Compensation to Government* Employees, Civil and Military	1911	3424	11.7
% of Current Expenditure	33.0	37.7	
Employment - *(million)*	3.95	4.62	3.1
Compensation per Employee - *(Annual in Rs)*	483,800	741,000	8.5

**Both federal and provincial*

Source: *PES, MOF*

The consequence is that with a near 5 percent growth annually in employment and almost 9 percent in average compensation, the salary bill is consuming a larger part of the budget of federal and provincial governments. The share of the compensation bill has gone up from 33 percent to almost 38 percent.

The time has come for restricting the employment growth in the government sector. Barring the service departments, there should be a ban on recruitment for the next three years and all vacancies currently notified be cancelled. Further, the increase in emoluments should be restricted to a maximum of 10 percent each year.

16.4 Down-Sizing of Federal Government

Following the 18th Amendment and the potential transfer of functions to Provincial Governments, there was the expectation that the Federal Government would contract in size. But this has not happened. *There are 35 Ministries, 42 Divisions and over 369 Attached Departments/Autonomous Bodies. The number keeps increasing.*

The time has come to undertake a high priority zero-based budgeting exercise to rationalize the size of the Federal Government, starting with the handover of higher education to Provincial Governments.

16.5 Managing the Cost of Pensions

The pensions paid annually have risen to almost Rs 1100 billion (Federal and Provincial Governments: Rs 594 billion. Military: Rs 406 billion) in 2021-22, with near doubling over the last five years.

The following proposals may be implemented:

a) Setting a target of zero growth in pension liabilities over next 3 years.

b) *Extension of retirement age from 60 to 63.*

c) *Increasing superannuation minimum limit to 30 years of service.*

d) *Federal and provincial governments to establish contributory scheme for all new entrants in government service.*

e) *Establishment of Pension Funds: The Federal Government has made a small beginning this year with Rs 10 billion contribution to a Pension Fund.*

16.6 Improved Management and Privatization of SOEs

The burden placed by SOEs on the Federal Budget has become very large due to the following:

i) Subsidies to the SOEs, especially in the Power Sector.

ii) Cast of servicing guaranteed debt of the SOEs.

The cost has approached Rs 1500 billion in 2021-22 and is now even larger than the budget for defence services.

There is a strong case for privatization of some of the 85 commercial SOEs, especially the loss-making ones.

The following criteria are suggested for Evaluating an SOE for privatization:

CRITERIA FOR EVALUATING CASE FOR PRIVATIZATION					
S. #		*Score*	*S. #*		*Score*
1.	***Profit-Making***		***4.***	***Outstanding Liabilities***	
	• *If losses*	*1*		• *If no or small liabilities*	*1*
	• *If small profits*	*½*		• *If large liabilities*	*0*
	• *If large profits*	*0*	***5.***	***Performance of Core Social or Economic Functions***	
2.	***Monopoly***			• *If functions not performed*	*3*
	• *If in a competitive market*	*2*		• *If performed*	*0*
	• *If a monopoly*	*0*	***6.***	***Over employment***	
3.	***Regulatory Authority***			• *If large over employment*	*0.5*
	• *Yes* • *No*	*1* *0*		• *If no or small over employment*	*0*

The application of these criteria to a sample of SOE's reveals the following:

CASE FOR PRIVATIZATION OF A SAMPLE OF SOEs			
YES	*Score*	*NO*	*Score*
Pakistan Steel Mill	*8.5*	*Pakistan State Oil*	*4.0*
National Shipping Corporation	*8.0*	*Sui Southern Gas Company*	*3.5*
National Investment Trust	*8.0*	*Sui Northern Gas Ltd.*	*3.5*
SME Bank	*7.5*		
Heavy Electrical Complex	*7.5*	*Pakistan Railway*	*2.5*
State Life Insurance Corporation	*7.5*		
National Power Construction Company	*7.5*		
Pakistan Reinsurance Company	*7.0*		
Pakistan International Airlines	*7.0*		
TOTAL	***9***	***TOTAL***	***4***
Source: *MOF*			

Even with this limited exercise, 9 SOEs qualify to be considered for Privatization.

Management of the Power Sector: The power sector has truly emerged as the 'black hole' of the national economy. It received a subsidy of Rs 1100 billion in 2021-22 and the Government had to cover contingent liabilities of the sector of Rs 330 billion. In addition, fuel costs have increased enormously, and the Fuel Adjustment Charge reached the peak level of Rs 9.90 per kwh, which led to a phenomenal percentage increase in bills especially of small consumers. Further, transmission, distribution and billing losses remain very high by international standards. The level of circular debt has reached Rs 2.7 trillion. Moreover, despite adequate generation capacity there continues to be power loadshedding, because of shortages of fuel.

The time has come for taking major decisions about the future structure and management of the power sector. The following options may be explored.

i) Privatization of DISCOs. The experience with K-Electric needs to be reviewed.

ii) Provincialization of DISCOs.

iii) Handing back power distribution to WAPDA as was the case up the mid-90's, which will also facilitate power sector vertical integration.

16.7 Better Debt Management

The primary problem relates to the policy on and management of domestic debt. External debt inflows are primarily determined by donors and lending agencies. Given problems of declining credit-rating, external inflows are drying-up and much greater reliance is being placed on domestic debt. Table 16.7 shows the exponential increase in the annual domestic borrowing to finance the growing budget deficit.

The Table 16.7 also reveals the big changes in the pattern of borrowing in the form of additions to the domestic permanent and unfunded debt of long-term nature versus short-term floating debt. From 2005-06 to 2012-13 there was generally greater resort to the flotation of short-term market treasury bills. Thereafter, there has been variation in the annual mix of PIBs and market treasury bills. Since 2018-19 there has been extreme reliance on flotation of long-term PIBs.

One of the basic principles of proper debt management is that during periods of high inflation a ‘lock-in’ effect of high interest rates should be avoided by floating more short-term debt and having a steeper yield curve. This has been violated, for example, in 2021-22, when 104 percent of the borrowing has been in the form of PIBs. Consequently, this will imply higher cost of debt servicing in coming years, even in the presence of variable rate bonds.

The unfortunate trend has been the decline in the level of unfunded debt in 2020-21 and 2021-22. The National Savings Schemes are the source of creation of this debt. Unlike the MTBs and the PIBs, these instruments access directly the savings of households.

Therefore, they not only lead to a higher savings rate but also imply less inflationary implications of financing of the budget deficit. The instruments and current rates of return are given below:

Defense Savings Certificates	
• 5th October 2022 [Ten Years]	12.26%
Behbood Savings Certificates	
• 5th October 2022	13.92%
Regular Income Certificates	
• 7th November 2022	12.36%
Special Savings Certificates	**11.92%**

The returns offered are relatively low in comparison to PIBs. The recommendations are that the returns be made comparable and that the network of savings centres be expanded substantially.

Table 16.7: Composition of Government Domestic Debt							*(Rs in Billion)*
	Total Increase	Permanent Debt		Unfunded Debt		Floating Debt	
		Increase	Share (%)	Increase	Share (%)	Increase	Share (%)
2005-06	170	-1	0	8	5	163	95
2006-07	278	53	19	59	21	166	60
2007-08	668	58	9	80	12	530	79
2008-09	587	70	12	250	43	267	45
2009-10	798	116	15	187	23	495	62
2010-11	1362	328	24	198	15	836	61
2011-12	1624	574	35	143	9	907	56
2012-13	1879	478	25	348	19	1053	55
2013-14	1387	1825	132	158	11	-596	43
2014-15	1285	1009	79	266	21	10	0
2015-16	1438	927	64	113	8	393	28
2016-17	1223	-407	-33	82	7	1548	126
2017-18	1567	-875	-56	103	7	2339	149
2018-19	4344	7427	171	276	6	-3389	-77
2019-20	2550	1943	76	529	21	78	3
2020-21	2955	1881	64	-28	-1	1102	37
2021-22	4752	4939	104	-309	-6	122	2
Cumulative	28829	20342	71	2463	8	6024	21
Source: *SBP*							

The Debt Office in the Federal Ministry of Finance needs to be strengthened. The SBP policy rate is high at 16 percent currently in the presence of high rates of inflation approaching 25 percent. The policy on debt management should be to the extent possible increase the inflow of short-term and medium-term borrowing, instead of long-term borrowing.

The wide-ranging reforms and improved management of public finances should lead to a fundamental improvement in the budgetary position of the Federal and Provincial Governments. A feasible target is to bring down the consolidated budget deficit from close to 8 percent of the GDP in 2021-22 to 5 percent of the GDP by 2024-25. This will facilitate the bringing down the level of Government debt to 60 percent of the GDP as stipulated in the Fiscal Responsibility and Debt Limitation Act, as highlighted in Chapter 12.

Very importantly, a big reduction in the budget deficit will also lead to a strong containment of aggregate demand in the economy. This will reduce the demand for imports and simultaneously facilitate reduction of the current account deficit of the balance of payments.

Chapter 17:

Removing Impediments to Growth

The economy of Pakistan has been demonstrating a loss of growth momentum over the last two decades. Between 2000-01 and 2005-06 the GDP growth rate of 6 percent has come down in the last five years to 4 percent. Some of the decline is attributable to exogenous factors like COVID-19, floods, etc. However, much of the fall in the growth rate is attributable to negative and flawed policies which have impacted both on the level of savings and investment. Today, Pakistan has a fixed investment rate of 13.4 percent as compared to above 18 percent at the start of this century.

A series of recommendations are made in this part of the report on reviving the growth process in the economy. This is conditional, of course, on achieving stabilization of the economy to provide sustainable basis for higher growth. The first two sections of this part of the book have already focused on policies for containing the current account deficit and for reducing the budget deficit.

17.1 'Crowding' Out of Development Spending

Table 17.1 shows how the uncontrolled expansion in current expenditure has cut into development spending so as to limit the size of the budget deficit.

Table 17.1: Trend in Current and Development Expenditure *(Rs in Billion)*

	Current Expenditure	% of GDP	Development Expenditure	% of GDP
2000-01	645	13.9	72	1.6
2005-06	1121	13.2	367	4.3
2010-11	2901	14.7	514	2.6
2015-16	4694	14.3	1314	4.0
2020-21	9084	16.3	1315	2.4
2021-22	11521	17.2	1657	2.5
Δ		+3.3		-1.5*

**From the peak in 2015-16*

Source: *MOF*

Based on rapid implementation of measures identified in Chapter 15 of the book on mobilization of revenues, there is a dire need for raising the level of development spending by the Federal and Provincial governments combined to at least 4 percent of the GDP.

The priorities in the enlarged developed program should be on augmentation of water resources through early completion of dams and on investment in upgrading and modernizing the electricity distribution system. These sectors should be given higher priority and allocations as compared to highways, which have traditionally enjoyed the highest priority.

17.2 The 'Spreading Thin' of Development Spending

There are major issues today with the development planning, project approval and execution process, especially at the Federal level. The increasing budget deficit has implied large cuts in the Federal PSDP. It was budgeted at Rs 900 billion in 2021-22. However, the actual development spending was cut down by more than 50 percent to only Rs 400 billion.

Nevertheless, there continues the practice of including new projects in the PSDP. This has result in a big 'spreading thin' of implementation of projects, both in terms of financing and execution capacity.

Table 17.2 gives details of number of development projects in the Federal PSDP of 2022-23. There are in the development portfolio as many 1219 projects. The throw forward of on-going projects is over Rs 10000 billion, while the allocation to on-going projects is only Rs 516 billion. In effect, each project will take almost 19 years to be completed. This delay will lead to further increase in project costs.

Table 17.2: Key Statistics on the Federal PSDP, 2022-23 (Features of Large Investment Sector)

	No. of New Schemes	On-Going Schemes	Est. Cost (Billion Rs)	Throw forward (Billion Rs)	Allocation (Billion Rs)	Ratio*	% to New Projects
Higher Education Commission	13	138	382	271	44	7.1	13
Railways	4	35	1261	1207	33	44.7	18
Water Resources	58	74	3336	1933	181	21.5	50
National High Authority	46	64	2504	1235	117	11.0	6
Power	7	31	78	63	24	3.5	27
TOTAL OF ABOVE	**128**	**342**	**7561**	**4709**	**400**	**15.2**	**23**

***Ratio of throw forward to Allocation**

Source: *Federal PSDP**

TOTAL NUMBER IN THE PSDP	1219 Projects	TOTAL PSDP SIZE	Rs 727 Billion

The five major project sectors are highlighted in Table 17.2. Water Resource sector is perhaps the most vivid example of 'spreading thin'. The number of on-going schemes in 74 and 58 more new schemes will be added in 2022-23. These new projects will pre-empt almost 22 percent of the sectoral allocation. Consequently, despite a throw forward of Rs 1933 billion, the funds available for on-going projects are only Rs 143 billion.

Given the acute scarcity of development funds, the time has come for a moratorium on the preparation, approval and financing of new projects for at least the next three years. Maximum priority must be given to early completion of mature on-going projects so as to generate the largest development impact.

17.3 Back to Agriculture

The growth rate of agriculture has also been steadily declining. It attained a peak of 5.4 percent in the decade of the 80s, especially after the commissioning of the Tarbela Dam. Thereafter, it fell to 4.4 percent in the 90s, 3.2 percent from 2000 to 2010 and to only 2.8 percent from 2010 to 2022.

An interesting historical fact is that the economy of Pakistan between 1950-51 and 2021-22 achieved a growth rate of above 7 percent in twelve out of the 51 years. Eight of these years were years when the growth rate of the agriculture exceeded 6 percent due to bumper crops. This was transmitted to an over 10 percent growth in the manufacturing sector.

The fundamental reason for the high growth impact of improved performance of agriculture is its strong linkages with other sectors. Almost 45 percent of the manufacturing sector is agro-based. Many service activities like wholesale and retail trade and transport are also linked to agriculture. **Overall, almost 46 percent of the economy of Pakistan is directly or indirectly dependent on agriculture**.

The 'back to agriculture' slogan must be supported with the following measures:

i) Agriculture receives very low import tariff protection in Pakistan as compared to, for example, in India. The average agricultural tariff in India is 34 percent as compared to only 13 percent by Pakistan. It is truly incomprehensible that there is a zero-import duty on cotton, in the presence of a duty-drawback scheme for exporters of textiles. Barring basic food imports of pulses and wheat, the average import duty on agricultural imports must be increased to the average of 20 percent.

ii) The procurement / support policy is flawed. During the decade of the 90s there used to a price support policy for wheat, cotton and sugarcane. Thereafter, it was dropped *from cotton. This explains the large-scale substitution of the cotton crop by sugarcane, thereby converting Pakistan from being a cotton exporter to importer. Fortunately, the price support mechanism has been reintroduced recently for cotton. It should now be dropped for sugarcane.*

iii) The rise in procurement / support prices has not kept pace with the increase in input costs. With 2010-11 as the base year of the output price index to input price index with a value of 100 it now stands at 87.80. Therefore, the terms of trade for agriculture have worsened by almost 13 percent leading thereby to a significant loss of profitability to farmers and a fall in yields.

The issue currently is the setting of the wheat procurement price for the crop season, especially in the wake of the flood devastation which could delay the sowing of the crop. The latest c.i.f. import price of wheat in September 2022 is Rs 3593 per maund. Therefore, the recommended price of procurement is Rs 3600 per maund. This will increase the price by over 60 percent in relation to last season's price of, and will have to be backed up by a sizeable subsidy to PASSCO. However, it is essential in view of the likelihood of a global and domestic food shortage.

iv) The rise in input prices has been driven by the jump in fertilizer prices. During 2021-22, the price of urea has gone up by 10 percent and that of DAP by as much as 74 percent. There is need for introducing a cross subsidy for DAP by raising somewhat the concessional sales tax on urea.

All efforts have to be made to raise the growth rate of the agricultural sector from 2.8 percent during the last decade to 4 percent once again.

17.4 Underinvestment in Human Capital

Pakistan has for the first time fallen into the category of countries with 'low human development' in 2021-22 as highlighted in Chapter 17. According to the latest UNDP Global Human Development Report. The HDI of Pakistan is 0.544 and it is ranked 161st out of 191 countries. As compared to this both India and Bangladesh are in the category of 'medium human development'. India has a HDI of 0.633 and is ranked 132nd, while the HDI of Bangladesh is even higher at 0.661 and it is ranked 129th.

The basic reasons for the low HDI lie especially in education. The mean years of schooling in Pakistan is only 4.5 years of the adult population as compared to 7.4 years in Bangladesh and 6.7 years in India. Also, the life expectancy is 63.8 years in Pakistan and 65.8 years in India, and 70.6 years in Bangladesh.

Government expenditure on education is low at 1.8 percent of the GDP in 2020-21 and has fallen from 2 percent of the GDP in 2015-16 as shown in Table 17.3. The corresponding estimate, for example, for India of 4 percent of the GDP. Further, the share in expenditure of *higher education has increased despite the fact that the unemployment rate is the highest at 16 percent graduates and post-graduates.*

India levies an education cess of 3 percent on the total taxable amount of an income tax payer. There is a strong case for the levy of such a cess also in Pakistan. Revenues of up to Rs 75 billion can be largely earmarked for technical and vocational training and for training of graduate students in information technology. This will not only provide better employment of youth, but also increase the cutting edge of exports.

Table 17.3: Government Expenditure on Education and Health *(Rs in Billion)*

	EDUCATION			HEALTH		
	Primary & Secondary Education and Technical Education	High Education	Total	Preventive	Curative	Total
2005-06	89	52	141	7	32	39
	(1.0)*	(0.6)	(1.6)	(0.1)	(0.4)	(0.5)
2010-11	187	136	323	38	68	106
	(0.9)	(0.4)	(1.3)	(0.2)	(0.3)	(0.5)
2015-16	451	212	663	70	198	268
	(1.4)	(0.5)	(2.0)	(0.2)	(0.6)	(0.8)
2020-21	676	312	988	209	448	657
	(1.2)	(0.6)	(1.8)	(0.4)	(0.7)	(1.1)

**% of GDP*

17.5 'Crowding Out' of Bank Credit to the Private Sector

The exponential increase in the size of the federal budget deficit has implied much higher levels of borrowing from the banking system, leading thereby to a 'crowding out' of the credit to the private sector and consequential reduction in the level of private investment.

Table 17.4 highlights the increasing per-emption of the banking system by government budgetary borrowing. The year, 2021-22, saw the level of budgetary borrowing of Rs 3220 billion compared to Rs 1612 billion of additional credit to the private sector.

Table 17.4: Stock of Government Budgetary Borrowing and Private Sector Credit by the Banking System						*(Rs in Billion)*
	2012-13	2015-16	2020-21	Δ	2021-22	Δ
Government Budgetary Borrowing	3120	5705	9973	4268 (57.0)	13293	3320 (67.3)
Credit to Private Sector	3779	4449	7629	3180 (42.7)	9241	1612 (32.7)
Ratio	**0.825**	**1.282**	**1.307**	**7448 (100.0)**	**1.438**	**4932**

The recommendations are as follows:

i) Given the full autonomy of the SBP after the recent big amendments to the SBP Act, there is need at the start of the year for agreement with the Government on the ceiling to Government borrowing from the banking system and the quantum of SBP OMOs to support this magnitude. This should be adhered to.

ii) As highlighted earlier, the Government has greatly reduced its reliance on domestic non-bank borrowing, through the National Savings Schemes. The contribution of non-bank borrowing was 20 percent in 2015-16, which has fallen to only 9 percent in 2020-21.

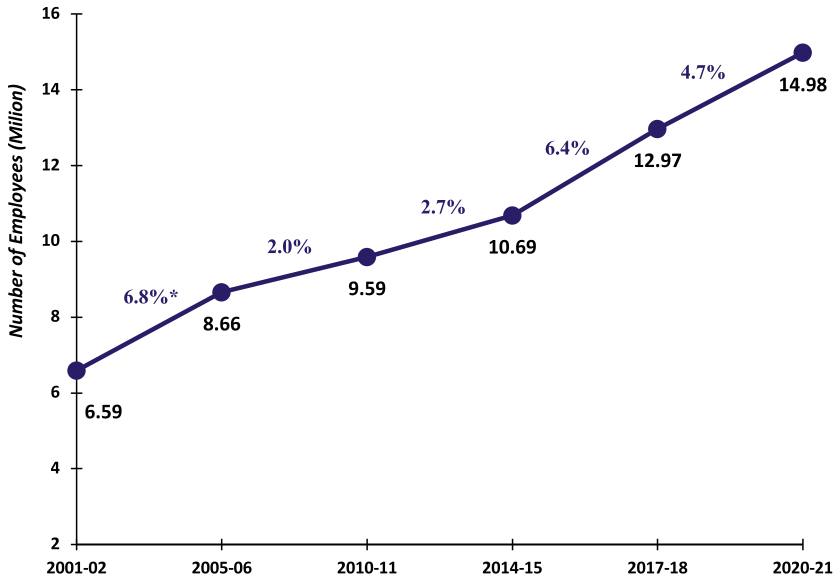
iii) The merit of developing the NSS is that they can provide an incentive for higher saving by households. There is need to make the returns more attractive and expand the network of National Savings Centres. Inflow of funds into the NSS will also reduce the need for borrowing by government from the banking system.

17.6 Lack of Support to SMEs

There are almost three million Small and Medium Enterprises in Pakistan today. According to the 2020-21 Labor Force Survey by the PBS, the total employment in SMEs was 14.9 million. This represents a share of the total non-agricultural employment in Pakistan of over 35 percent. Therefore, SMEs play as important role in the national economy.

The growth in employment in SMEs is shown in Figure 17.1.

Figure 17.1: Number of Workers in SME's



*Annual Growth Rate

Source: *LFS, PBS*

SMEs have also been at the cutting edge of Pakistan's exports, with exports like sports goods, surgical instruments, leather products, etc.

The following recommendations are made for promoting the growth of SMEs in Pakistan:

i) SMEs have a share in private sector credit of only 6 percent, despite their contribution of over 35 percent to non-agricultural employment in the country. As highlighted earlier in the book, there should be a minimum target for lending to socially preferred sectors in Pakistan of 20 percent, which if not attained by banks will lead to a higher corporate income tax rate. If the share exceeds 20 percent, then a tax credit can be made available. Also, there should be a tax credit provision for bad debt.

ii) The SMEDA and SME bank have been passive institutions up till now. The time has come to activate them and promote their role better in technology extension services, vocational training and preparation of feasibility reports for small projects in different sectors, along with arrangements for funding of eligible investors.

17.7 Wrong Fuel Mix for Power Generation

The fuel mix in power generation is given in Table 17.5.

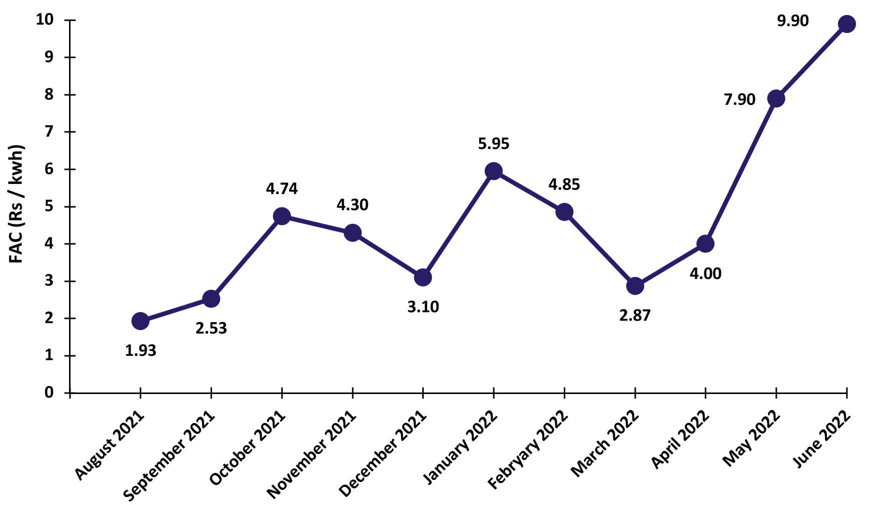
Table 17.5: Fuel Mix in Power Generation Installed Capacity *(MW)*

	Total Installed Capacity	Share of (%)								
		Thermal	%	Hydro-electric	%	Nuclear	%	Renewable	%	Total
2010-11	22471	15209	67.6	6481	28.8	787	3.6	-	0.0	100.0
2015-16	25889	17115	66.1	7122	27.5	750	2.9	902	3.5	100.0
2021-22	41557	24710	59.5	10251	24.7	3647	8.8	2949	7.0	
Change										
2010-11 to 2015-16	3418	1906	55.7	641	18.8	-37	1.1	902	26.6	100.0
2015-16 to 2021-22	15668	7595	48.5	3129	20.0	2897	18.5	2047	13.1	100.0

Source: *PES*

There has been an unprecedented surge in electricity tariffs due to the component of the fuel adjustment charge from August 2021 onwards, as shown in Figure 17.2.

Figure 17.2: Monthly Fuel Adjustment Charge (FAC)



<u>The FAC attained an all-time peak of Rs 9.90 per kwh in June 2022.</u> This was attributable to rise in imported fuel prices. The comparison with reference price is given below by imported fuel:

	June 2022 % Above Reference Price	Share in Electricity Generation (%)
Coal	187	13.6
RFO	153	10.0
Gas (RLNG)	216	24.4

i) *The enormous hike in imported fuel prices as shown above has conveyed a very important message. The time has come to invest more in domestic fuel supplies. This implies greater exploitation of Thar coal deposits and faster and bigger shift to solar and nuclear energy. Incremental capacity will need to be in these sources predominantly.*

ii) *Quarterly tariff adjustments have been delayed by NEPRA. This is one factor which has contributed to the extraordinary hike in the FAC. Accordingly, the reference price for determining the FAC should be adjusted upwards in time.*

iii) *The FAC has been fixed in absolute terms per kwh for consumers irrespective of size of electricity consumed. The domestic tariff is progressive in nature. As such, the FAC should be fixed at a percentage of the base tariff, so that larger consumers pay more in absolute terms.*

iv) *The exploration of gas and other minerals has declined. The expenditure annually used to $1 billion or more over a decade ago has come down to less than $500 million, especially by foreign exploration companies. This has been caused by negative perceptions about Reko Dik. Fortunately, this dispute has been resolved recently by the Supreme Court. Local and foreign investments must be deployed more for exploration of gas and oil in the country.*

v) *The pricing of electricity is counter to the practice as shown below in other countries. The price for industrial consumers is relatively higher in Pakistan than in other countries as compared to the price for domestic consumers. This implies that there is a case for raising the average consumer tariff and reducing it for industrial consumers, especially the exporters.*

Electricity Price (As of October 2022)		(cents/kwh)	
	Industry	Domestic	Ratio
Bangladesh	8.5	5.3	1.60
India	10.0	7.3	1.37
Thailand	10.2	9.9	1.03
Philippines	11.3	16.5	0.68
Pakistan	16.3	5.5	2.96

17.8 Loss of Momentum of CPEC

The process of contracting of loans and credits with China under the framework of CPEC has broken down since 2019-20, as shown in Table 17.6.

The total investment proposed under CPEC by China in Pakistan was $60 billion. It stands at $20.6 billion currently in terms of the value of loans and credits contracted with China for projects. In 2021-22, there was no commitment by China.

Table 17.6: Contracting of Loans and Credits with China *(As of October 2022)* *(cents/kwh)*

Years	Annual	Cumulative
2012-13	448	448
2013-14	6493	6941
2014-15	37	6978
2015-16	9422	16400
2016-17	729	17129
2017-18	500	17629
2018-19	2000	19629
2019-20	0	19629
2020-21	1000	20629
2021-22	0	20629

Absolutely the highest priority must be attached to CPEC. In particular, the focus must be on establishment of Industrial Zones at different locations to attract Chinese investment in labor-intensive projects, given the relatively low wage rate in Pakistan. Also, agricultural exports should be promoted by application of latest technology and funding from China. This will facilitate greater participation in the global value chain. Adequate fiscal incentives, including at least a five-year tax holiday and duty-free import of machinery should be offered to Chinese investors.

The above set of recommendations in eight areas should be given the highest priority and implemented rapidly. The target must be to take the economy to an annual growth rate of close to 6 percent in the next few years along with measure to ensure sustainability of this growth path.

Chapter 18: Improving Economic Governance

This chapter has four sections relating respectively on how to stop the 'boom and bust' cycle to manipulation of statistics, improvement in statistics and problems with accuracy of projections.

18.1 Stopping the 'Boom and Bust' Cycle

This section highlights the 'boom and bust' cycles that Pakistan has witnessed since the start of the 21st century. This cyclical pattern is the consequence of a cycle of expansionary and growth promoting fiscal and monetary policies leading to higher growth and increasing strongly the demand for imports. This has led to a big rise in the current account deficit causing a precipitate decline in foreign exchange reserves. At this time, there has generally been resort to an IMF program of two to three years. Thereafter, recovery of reserves leads to a premature end of the program and a return back to expansionary policy measures. This cycle is presented in Chart 18.1.

The expansionary and contractionary periods are identified below:

Years	Type of Growth Path	Years	Type of Growth Path
1999-2000	IMF Program	2011-12	Expansionary
2000-01	Contractionary	2012-13	Expansionary*
2001-02	Contractionary	2013-14	IMF Program
2002-03	Expansionary	2014-15	Contractionary
2003-04	Expansionary	2015-16	Contractionary
2004-05	Expansionary	2016-17	Expansionary
2005-06	Expansionary	2017-18	Expansionary*
2006-07	Expansionary	2018-19	IMF Program
2007-08	Expansionary*	2019-20	Contractionary
2008-09	IMF Program	2020-21	Expansionary
2009-10	Contractionary	2021-22	IMF Program
2010-11	Contractionary	2022-23	IMF Program
***Election Years**		***Election Years**	

Chart 18.1: The 'Boom and Bust' Cycle

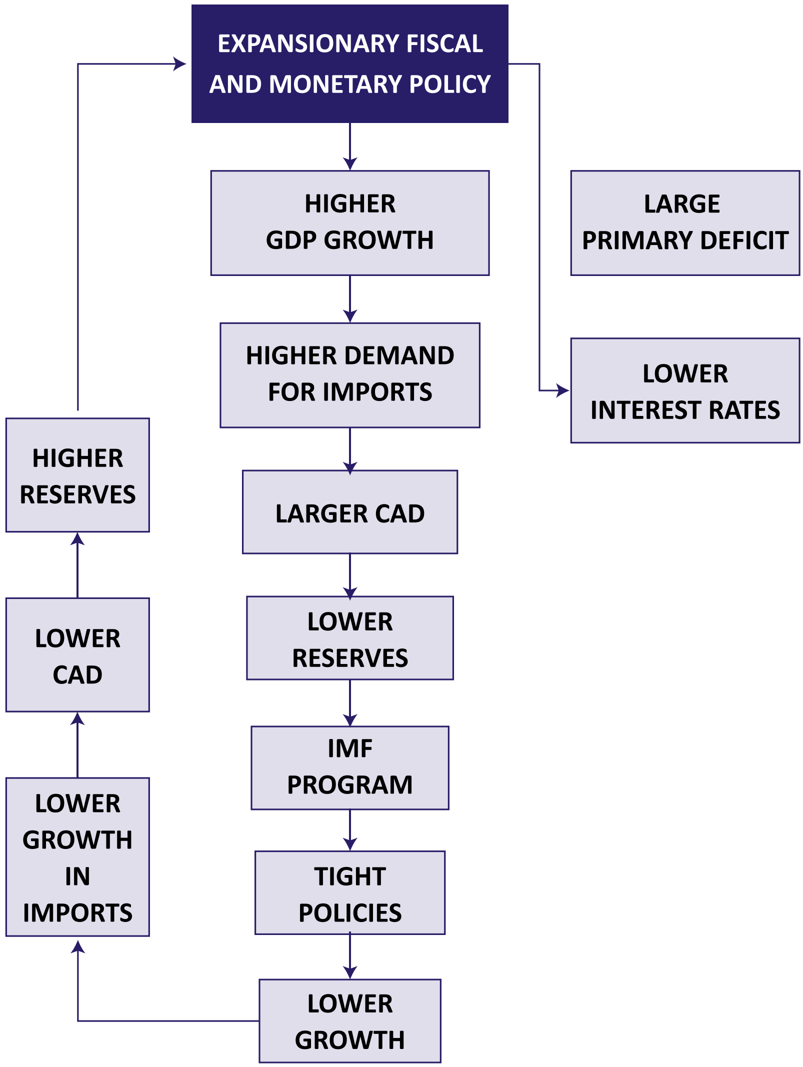


Table 18.1: Nature of Policies

Years	GDP Growth Rate	Nature of Policies* Primary Budget Deficit/ Surplus (% of GDP)	Nature of Policies* Interest Rate** (%)	Imports as % of GDP (%)	Current Account Deficit (% of GDP)	FE Reserves ($ billion)***
2000-01	2.0		13.5	15.1	-0.7	2.1
2001-02	3.1	0.1	13.4	14.4	+1.9	4.8
2002-03	4.7	0.4	12.9	14.8	+1.3	9.7
2003-04	7.5	1.0	7.8	15.9	-1.6	10.8
2004-05	9.0	-0.1	7.0	18.5	-4.5	10.3
2005-06	5.8	-1.0	10.2	22.5	-3.6	11.2
2006-07	6.8	-0.1	11.1	21.2	-4.3	13.9
2007-08	3.7	-2.6	11.6	24.4	-8.2	9.1
2008-09	0.4	-0.3	14.6	21.5	-5.5	9.5
2009-10	2.6	-1.8	13.2	19.6	-2.2	13.1
2010-11	3.6	-2.5	13.4	18.9	0.1	15.7
2011-12	3.8	-2.2	11.9	20.0	-2.1	10.8
2012-13	3.7	-3.4	11.0	19.3	-1.1	6.0
2013-14	4.1	-0.8	10.9	18.4	-1.3	9.1
2014-15	4.0	-0.5	10.9	16.9	-1.0	13.5
2015-16	4.7	-0.2	8.4	14.2	-1.7	18.1
2016-17	4.6	-1.4	7.6	15.6	-4.0	16.1
2017-18	6.1	-1.9	7.6	17.0	-6.1	9.8
2018-19	3.1	-3.1	9.8	17.0	-4.8	7.2
2019-20	-0.9	-1.6	12.8	14.8	-1.5	12.1
2020-21	5.7	-1.2	7.9	16.2	-0.8	17.3
2021-22	6.0	-3.1	9.6	22.1	-4.6	9.8

**Fiscal and Monetary Policies*

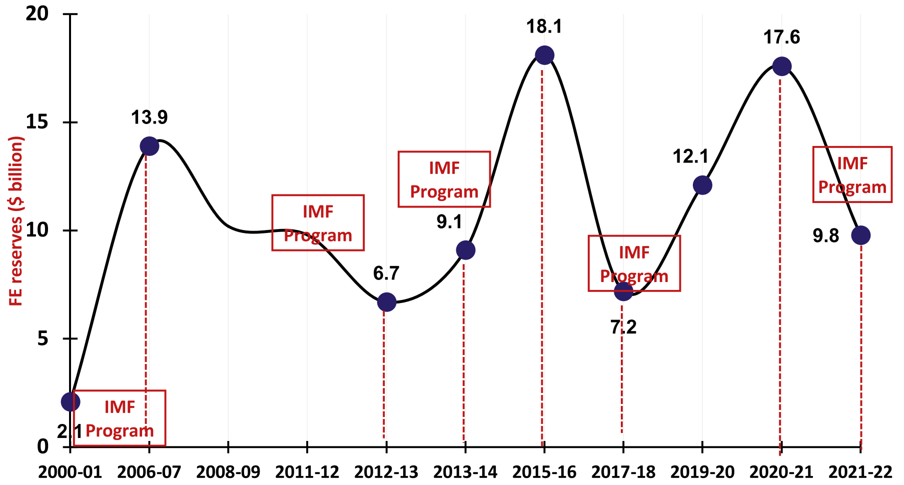
***Average Interest Rate on Advances, Mid-Year*

****End-June of Financial Year*

High growth years, with GDP growth rate above 6%

The path of foreign exchange reserves is shown in Figure 18.1

Figure 18.1: The Path of Foreign Exchange Reserves



How can the 'boom to bust' cycle be broken? The following recommendations are made.

i) There has to be a fundamental move away from Annual Plans to Three-Year Action Plans and 10-Year Perspective Plans.

ii) The Role of the National Economic Council has to be greatly enhanced. This is a Constitutional forum with the Prime Minister as the Chairman and Chief Ministers of the Provinces as members. There are four other members, one from each Province.

The NEC is required to meet at least twice a year. This has generally not been the case in the past. The NEC must concentrate on the design, approval and monitoring of implementation of major structural policies. Three-year Plans should be subject to debate and approval in the Parliament.

18.2 Manipulation of Statistics

There have been numerous attempts over the years to present through manipulation of statistics a picture of the economy better than the underlying reality.

The following types of manipulation have been observed:

i) Overstatement of the GDP growth rate. For example, the growth rate of the economy is reported as 6 percent in 2021-22. But for this to have happened, the household consumption expenditure was shown as having achieved a phenomenal growth rate of 10 percent, well beyond the realm of possibilities. The actual growth rate was probably closer to 4.5 percent, as obtained in Annexure___.

ii) The unemployment rate is a politically sensitive number. It has been understated by showing a bigger increase in employment or a smaller increase in the labor force. For example, the LFS of 2020-21 shows a faster growth in employment than the growth of output in the industrial sector. The reported unemployment rate is 6.3 percent, whereas it is close to 7.5 percent.

iii) Budget deficit estimates have been understated by including a large negative statistical discrepancy in expenditure or by including revenues which should actually have been shown below the line as financing and so on.

iv) The rate of inflation has been understated by assuming, for example, a lower rate of increase in rents and understating the rise in the electricity tariff by not including the fuel adjustment charge. The rate of inflation is reported at 12.1 percent in 2021-22 whereas it is actually closer to 14.5 percent. Similarly, the inflation rate is reported at 23 percent in September 2022 whereas it is closer to 25.5 percent.

Overall, there is need for improvement in the quality of statistics prepared and released, especially by the PBS.

The work of the PBS is overseen by the Governing Council as per the General Statistics (Reorganization) Act of 2011. The Governing Council was chaired by the Federal Minister for Finance, with six other members and four from the private sector. This created a 'conflict of interest' as the Finance Minister is the key minister responsible for the performance off the economy. Therefore, he had a vested interest in reporting better economic statistics. This was the case particularly from 2013 to 2018 and more recently in 2021-22, even though the Council meeting is now chaired by the Planning Minister. There is need for amendment of the Act such that one of the four private members acts as Chairman of the Council and ministries are represented at the Secretary level.

18.3 Problems with Accuracy of Projections

An annual Plan for every forthcoming year is prepared by the Ministry of Planning. There is a strong tendency for presenting an optimistic picture of the economic prospects as can be seen for two recent years, 2018-19 and 2021-22.

A vivid example of the bias in targets is that for the current account deficit in 2021-22 as shown in Table 18.2. The Annual Plan set the target at $2.7 billion. The actual outcome was a huge deficit of $17.4 billion.

<u>The problem with very optimistic Annual Plan Targets is that they create a false sense of complacency in economic Ministries and delayed reaction to divergent or worsening of trends.</u>

Table 18.2: Annual Plan Projections and Actuals

	2018-19			2021-22		
	Plan Projection	Actual	Divergence	Plan Projection	Actual	Divergence
GDP Growth Rate *(%)*	6.2	3.1	-3.1	4.8	6.0	1.2
Total Investment *(% of GDP)*	17.2	15.1	-2.1	16.0	15.1	-0.9
Rate of Inflation (%)	6.0	6.8	0.8	8.0	12.2	4.2
Budget Deficit *(% of GDP)*	-4.9	-7.9	-3.0	-6.0	-7.9	-1.9
Current Account Deficit *($ billion)*	-13.4	-13.4	0.0	-2.7	-17.4	-14.7

All Plans should include a clear statement of risks associated with the achievement of any macroeconomic target. The National Economic Council, a constitutional body chaired by the Prime Minister, should meet quarterly to review and suggest policy changes to facilitate achievement of the targets. The Planning Commission should act as the Secretariat to the Council.

18.4 Strengthening the Statistics

There is need to improve the quality and coverage of statistics to improve the responsiveness of economic governance institutions to challenges, crises and opportunities.

The following proposals are given below for strengthening the information base for policy decisions:

i) ***Quarterly GDP statistics***: The construction of a quarterly GDP series is vital for facilitating timely actions. A first abortive attempt was made earlier by the PBS. India has had quarterly GDP series for a long time. The key is that the link should be established with the Rabi and Kharif cycles of agriculture, as this sector impacts directly or indirectly an almost half the economy.

Fortunately, quarterly time series that are available for a large number of economic activities, including large-scale manufacturing, construction activity, generation and distribution of electricity and gas, consumption of fuel, banking transactions, government expenditure, etc.

ii) ***Provincial Gross Regional Product Estimates***: The Provincial Bureaus of Statistics must develop the capacity for annual estimates of the GRPs of their respective provinces. This will constitute a key data base for provincial planning. India also been producing

GRP estimates of the States for the last many years. Unofficial estimates are also available in Pakistan.[2]

iii) Estimating a Consistent GDP series: The base year for the GDP estimates have been changed recently from 2005-06 to 2015-16. The new estimates are available from 2015-16 onwards. There is need for backward extrapolation of this time series to enable analysis of trends over the years.

iv) Estimates of Poverty: There have been big changes in the incidence of poverty in the last few years. The last estimate of multi-dimensional poverty at the national, provincial and district level was published by the Planning Commission for the incidence up to 2014-15. The source was the Pakistan Social and Living Standards Measurement Survey carried out periodically by the PBS. Fortunately, the most recent survey is of 2019-20. As such, data from this survey should be analyzed to give more recent estimate of the incidence of multi-dimensional poverty at the regionally disaggregated level in Pakistan.

Similarly, estimates of poverty, based on fulfillment of basic nutritional requirements are of 2015-16. There has since been a Household Integrated Economic Survey in 2018-19. This should be used to update the incidence of basic needs poverty at the national and provincial levels.

Improving the Consumer Price Index: There are a number of problems with the methodology used for constructing either the Consumer Price Index or the Sensitive Price Index, as follows:

i) The largest weight is of housing rent. Housing is a very heterogenous service and requires estimation of a hedonic price index. The methodology used for deriving the rate of inflation in housing rent is not indicated by the PBS.

The problem is that the increase on a year-to-year basis in housing rent in November 2022 is reported as only 5.27 percent in urban areas of Pakistan as compared to the increase in the overall CPI of 21.56 percent. Therefore, there is the likelihood that the rate of inflation has been underestimated.

ii) Price data is collected from 17 cities and towns in the country, ranging from the primate city, Karachi, to a small town, Khuzdar, in Balochistan. For example, the price of a wheat flour bag of 20 kgs ranges from Rs 1295 to Rs 2020 in the different locations in November 2022. The PBS is not taking the weighted average by population of the locations. Consequently, the national price is wrongly determined.

Overall, there is substantial scope for improving the quality and coverage of statistics so as to enable faster and better policy responses.

2 Pasha, Hafiz A., *Growth and Inequality in Pakistan*, 2018.

TECHNICAL ANNEXURES

Annexure-1:

GDP Series with Base Year of 2015-16

The base year of the GDP estimates of Pakistan was changed from 2005-06 by the PBS in February 2022. The latest Pakistan Economic Survey contains thee estimates from 2015-16 to 2021-22.

The comparison of the three governments requires a consistent GDP at current prices from 2007-08 to 2021-22, with the same base year, that is, 2015-16. However, this has not been done yet by the PBS. Therefore, an effort is made below to construct such a series.

The methodology used is to determine the pattern of divergence in the GDP estimates based on the base years of 2005-06 and 2015-16. This shown below.

Increase in GDP estimate with base year of 2015-16 as compared with the estimate with the base year of 2005-06

Year	%
2015-16	12.55%
2016-17	11.37%
2017-18	13.21%
2018-19	14.76%
2019-20	14.40%
2020-21	16.95%

Therefore, the difference in percentage terms increases over the years. This trend is extrapolated backwards such that the estimate for 2005-06 remains, more or less, unchanged. The resulting estimates of the GDP at current prices are given in Table S-1.

Table S-1: Estimates of a Consistent GDP Series from 2007-08 to 2021-22 with the base year 2015-16		
Year	GDP at current prices with base year, 2015016	% Adjustment to Estimate with base year, 2005-06
2007-08	10,605	3.55
2008-09	13,800	4.55
2009-10	15,684	5.55
2010-11	19,482	6.55
2011-12	21,607	7.55
2012-13	24,868	8.55
2013-14	27,572	9.55
2014-15	30,162	11.55
2015-16	32,725	
2016-17	35,552	
2017-18	39,190	
2018-19	43,798	
2019-20	47,540	
2020-21	55,795	
2021-22	66,950	

Source: *PES*

Annexure-2:

The Economic Performance Indicators

GROWTH PERFORMANCE INDEX			*(Growth Rate %)*
	PPP	(PML(N)	PTI
Agriculture	**2.38**	**2.17**	**3.18**
Index	(0.333)	(0.258)	(0.620)
Rank	2	3	1
Industry	**1.24**	**5.84**	**2.37**
Index	(0.059)	(0.721)	(0.222)
Rank	3	1	2
Services	**3.72**	**5.22**	**4.00**
Index	(0.277)	(0.612)	(0.339)
Rank	3	1	2
Per Capita Income	**1.26**	**3.16**	**2.16**
Index	(0.124)	(0.688)	(0.392)
Rank	3	1	2
OVERALL INDEX			
With PCY	0.161	0.529	0.367
Without PCY	0.176	0.485	0.360

INVESTMENT INDEX			*(% of GDP)*
	PPP	(PML(N)	PTI
Private Investment	**10.21**	**10.46**	**10.25**
Index	(0.477)	(0.512)	(0.482)
Rank	3	1	2
Public Investment	**3.68**	**3.80**	**3.07**
Index	(0.540)	(0.579)	(0.338)
Rank	2	1	3
INVESTMENT INDEX	**(0.508)**	**(0.544)**	**(0.404)**
Rank	2	1	3

INFLATION			
Indicator	PPP	(PML(N)	PTI
Food Inflation	**13.11**	**4.46**	**11.42**
Index	(0.301)	(0.897)	(0.418)
Rank	3	1	2
Non-Food Inflation	**10.31**	**5.49**	**8.78**
Index	(0.340)	(0.818)	(0.492)
Rank	3	1	2
Core Inflation	**9.92**	**6.05**	**7.68**
Index	(0.359)	(0.781)	(0.603)
Overall Index of Inflation	**(0.333)**	**(0.831)**	**(0.499)**

CONSUMPTION INDEX			
	PPP	(PML(N)	PTI
Household Consumption Expenditure	**2.7**	**5.9**	**5.6**
Index	(0.149)	(0.677)	(0.627)
Rank	3	1	2
Government Consumption Expenditure	**5.9**	**5.6**	**1.3**
Index	(0.280)	(0.323)	(0.938)
Overall Index	**(0.204)**	**(0.468)**	**(0.767)**

TRADE AND BALANCE OF PAYMENT			
	PPP	(PML(N)	PTI
Growth Rate in Volume of Exports	**2.6**	**0.6**	**7.4**
Index	(0.233)	(0.021)	(0.740)
Rank	2	3	1
Growth Rate in Volume of Imports	**-2.7**	**9.4**	**8.2**
Index	(0.944)	(0.194)	(0.268)
Rank	1	3	2
Current Account Deficits *(% of GDP)*	**-1.42**	**-2.59**	**-2.53**
Index	(0.805)	(0.320)	(0.344)
Rank	1	3	2
Import Cover of Reserves	**3.57**	**3.42**	**2.68**
Index	(0.601)	(0.550)	(0.302)
Rank	1	2	3

Growth Rate of External Debt	**1.50**	**10.01**	**6.75**
Index	(0.959)	(0.270)	(0.534)
Rank	1	3	2
OVERALL INDEX	**(0.633)**	**(0.181)**	**(0.406)**

FISCAL POLICY INDEX			
	PPP	(PML(N)	PTI
Revenues as % of GDP	**12.44**	**13.26**	**11.47**
Index	(0.478)	(0.559)	(0.381)
Rank	2	1	3
Current Expenditure as % of GDP	**10.76**	**10.52**	**12.40**
Index	(0.606)	(0.631)	(0.434)
Rank	2	1	3
Development Expenditure as % of GDP	**3.62**	**4.22**	**2.55**
Rank	(0.489)	(0.641)	(0.216)
Rank	2	1	3
Primary Surplus/Deficit as % of GDP	**-1.94**	**-1.48**	**-3.47**
Index	(0.738)	(0.864)	(0.317)
Rank	2	1	3
Δ (Public Debt as % of GDP)	**2.50**	**6.20**	**9.70**
Index	(0.925)	(0.597)	(0.287)
Rank	1	2	3
OVERALL INDEX	**(0.627)**	**(0.651)**	**(0.317)**

SOCIAL DEVELOPMENT + PROTECTION INDEX			*(% of GDP)*
	PPP	(PML(N)	PTI
Expenditure on Social Services as % of GDP	**2.56**	**3.04**	**3.08**
Index	(0.357)	(0.556)	(0.573)
Rank	3	2	1
Expenditure on Subsidies & Cash Transfers as % of GDP	**2.31**	**1.68**	**1.77**
Index	(0.607)	(0.286)	(0.332)
Rank	1	3	2
OVERALL INDEX	**(0.484)**	**(0.399)**	**(0.436)**

LABOR MARKET INDEX			(%)
	PPP	(PML(N)	PTI
Growth Rate of Labor Force	**2.86**	**1.84**	**3.04**
Index	(0.578)	(0.216)	(0.641)
Rank	2	3	1
Growth Rate of Employment	**2.64**	**1.93**	**2.86**
Index	(0.536)	(0.254)	(0.623)
Rank	2	3	1
Growth Rate of Unemployed	**6.53**	**0.03**	**5.79**
Rank	(0.250)	(0.998)	(0.335)
Rank	3	1	2
Formal Sector Emp Growth	**2.34**	**4.88**	**2.85**
Index	(0.157)	(0.670)	(0.260)
Rank	3	1	2
Female Emp Growth	**4.43**	**1.56**	**4.16**
Index	(0.696)	(0.107)	(0.640)
Rank	1	3	2
OVERALL INDEX	**(0.385)**	**(0.330)**	**(0.467)**

The methodology used is construction of a groupwise index and then aggregation across the groups for a particular government.

Annexure-3:

Overstatement of the GDP Growth Rate in 2021-22

The objective of this statistical note is to highlight that there is a likelihood that the preliminary GDP growth rate estimate for 2021-22 by the PBS is overstated at 5.97 percent.

The sectors where the growth rate is probably overstated are identified below along with the collateral evidence as to why there is overestimation of the growth rate.

Major Crops

A comparison is made in Table S-3.1 between the crop-wise growth rates as reported in the Pakistan Economic Survey and the growth rates given in the July 2022 publication of *World Agricultural Production* of the US Department of Agriculture for Pakistan.

Table S-3.1: Growth Rate of Output of Major Crops in 2021-22 *(%)*

	Weight (%)	Pakistan Economic Survey	USDA
Wheat	40.1	-3.9	-3.9
Maize	16.4	18.9	6.3
Rice	12.1	10.7	3.3
Cotton	12.6	17.9	17.9
Sugarcane	18.8	9.4	9.4*
TOTAL	**100.0**	**7.2**	**3.9**

**Output of sugarcane by country not included in the USDA report. It appears that the growth in output of maize and rice has been significantly overstated in the Pakistan Economic Survey.*

Overall, the growth rate of the major crop sector is likely to be significantly lower. This is not surprising given some reduction in the availability of water and a big decline in fertilizer use, especially of phosphate.

Minor Crops

The growth rate of the minor crop sector in 2021-22 has been reported at 5.4 percent. However, as shown in Table S-3.2, there has been much higher inflation last year in the prices of vegetables and fruits. This indicates the presence of significant supply shortages. Therefore, the relatively high growth rate of 5.4 percent is unlikely.

Table S-3.2 Rate of Inflation* in Prices of Fruits and Vegetables			(%)
	Weight in food	June 2021	June 2022
Fresh Fruits	4.72	12.8	38.6
Potatoes	1.48	16.4	4.5
Onions	1.95	-5.7	124.3
Tomatoes	1.14	19.7	121.7
Fresh Vegetables	5.03	11.5	16.4
TOTAL	**14.32**	**10.8**	**45.5**

Large-Scale Manufacturing

The growth rate of the large-scale manufacturing sector is shown as exceptionally high at 10.5 percent in 2021-22. This is despite the presence of significant gas and power loadshedding, especially in recent months.

The other problem is the big divergence in the growth rate between the estimate with base year of 2015-16 and that with the base year of 2005-06, as shown in Tale S-3.3.

Table S-3.3: Growth Rate of the Quantum Index of Manufacturing with different Base Years – 2021-22

QIM Base Year	Growth Rate (YOY) – (%)	
	May	July – May
2005-06	9.9	7.1
2015-16	21.4	11.7

The big reason is the inclusion of more industries in the estimate with the base year of 2015-16. In particular, three industries have been included with extremely high growth rates of output in 2021-22, as shown in Table S-3.4.

Table S-3.4: New High Growth Industries not included in the QIM of 2005-06 but in 2015-16 (%)

	Weight (%)	Growth Rate of Industry	Contribution to Growth Rate of QIM
Manufacture of Weaving Apparel	6.08	49.7	3.02
Manufacture of Furniture	0.51	233.1	1.19
Manufacture of Footballs	0.32	43.0	0.14
TOTAL			**4.35**

The growth rates are way beyond the limits of credibility. Therefore, the growth rate with the base-year of 2005-06 is more likely.

Electricity, Gas and Water Supply

This sector is shown as having achieved a high growth rate of 7.9 percent in 2021-22. The fundamental problem is that there is an extraordinarily large increase in circular debt during the year to Rs 850 billion, compared to Rs 130 billion in 2020-21. This is bound to have drastically reduced the value-added by the sector in 2021-22, and to a big fall in the growth rate.

Construction

The prime determinant of the growth in the sector is the magnitude of increase in the input of cement. According to the PBS, there has actually been a small decline in the consumption of cement within Pakistan in 2021-22. As such, the reported growth rate of 3.1 percent ins highly unlikely.

Wholesale and Retail Trade

This is a relatively large sector. It is shown as having achieved double-digit growth rate of above 10 percent both in 2020-21 and 2021-22. However, application of the standard methodology for growth rate estimation in Table S-3.5 reveals that the growth rate is closer to 8.5 percent.

Table S-3.5: Contribution of Trading in Different Types of Goods to Wholesale and Retail Trade

	Weight in Value-Added	Growth Rate (%)	Contribution
Crops	11.8	4.0	0.47
Livestock	9.1	3.3	0.30
Large-Scale Manufacturing	52.7	7.5	3.95
Small-Scale Manufacturing	5.7	8.9	0.51
Imports	20.7	15.6	3.22
TOTAL	**100.0**		**8.45**

GDP

Overall, the estimated growth rate of the GDP is likely to be closer to 4.8 percent, as shown in Table S-3.6. This is significantly lower than the reported growth of almost 6 percent by the PBS.

Table S-3.6: Estimated GDP growth rate in 2021-22

	Value Added 2020-21	Growth Rate in 2021-22	Value Added 2021-22
GDP	**36,572**	**4.8**	**38,327**
AGRICULTURE	**8,421**	**3.5**	**8,717**
Major Crops	1,594	4.0*	1,657
Minor Crops	1,155	3.5*	1,195
Cotton Ginning	103	9.2	112
Livestock	5,269	3.3	5,442
Forestry	177	6.1	188
Fishing	122	0.4	123
INDUSTRIAL SECTOR	**6,910**	**4.4**	**7,212**
Mining & Quarrying	694	-4.5	663
Large-Scale Manufacturing	3,241	7.5*	3,484
Small-Scale Manufacturing	705	8.9	768
Slaughtering	442	6.2	469
Electricity, Gas and Water	866	0.0*	866
Construction	963	0.0*	963
SERVICES	**21,241**	**5.4**	**22,398**
Wholesale & Retail Trade	6,633	8.5*	7,197
Transport and Storage	3,818	5.4	4,024
Accommodation & Food Services	520	4.1	541
Information & Communication	933	6.0*	989
Finance & Insurance	686	4.9	720
Real Estate	2,080	3.7	2,157
Public Admin & Security	1,820	-1.2	1,798
Education	1,058	8.6	1,149
Health	585	2.2	598
Other Private Services	3,107	3.8	3,225

**Different growth rates to those estimated by the PBS*

Annexure-4:

Construction of the External Vulnerability Index

The five external vulnerability indicators are as follows

Indicator	
1. External Debt as % of GNI	Lower, the better
2. External Debt as % of Exports	Lower, the better
3. Reserves as % of External Debt	Higher, the better
4. Debt Service as % of Exports	Lower, the better
5. Short-Term Debt as % of total Debt	Lower, the better

Across the countries, for construction of an index of each indicator

$$\overline{\text{Max}}\ \text{Value} = 1.333\ (\text{Observed Max Value})$$

$$\overline{\text{Min}}\ \text{Value} = 0.667\ (\text{Observed Min Value})$$

In the case of an indicator where lower value is better, the index is as follows:

$$I_{ij}\frac{\text{Max}_i - \text{Actual}_{ij}}{\text{Max}_i - \text{Min}_i}, \text{for the ith indcator and jth country}$$

In the case where a higher value is better, the index is as follows:

$$I_{ij}\frac{\text{Actual}_{ij} - \text{Min}_{ij}}{\text{Max}_i - \text{Min}_i}$$

The External Vulnerability Index for the jth country is given:

$$\text{EVI}_j = \left[(I_{1j})\,(I_{2j})\,(I_{3j})\,(I_{4j})\,(I_{5j})\right]^{1/5}$$

Table A-4.1: Technical Annexure

Country	External Debt as % of GNI	Index-1	External Debt as % of Exports	Index-2	Reserves as % of External Debt	Index-3	Debt Service as % of Exports	Index-4	Short-Term Debt as % of Total Debt	Index-5	EVI	Ranking
Argentina	51	0.520	274	0.559	15	0.178	29	0.462	18	0.513	0.397	10
Ecuador	56	0.459	198	0.747	10	0.102	22	0.660	2	0.939	0.465	7
Egypt	37	0.693	242	0.639	24	0.314	32	0.377	9	0.753	0.524	4
Ethiopia	27	0.815	316	0.455	10	0.101	21	0.688	2	0.939	0.477	6
Ghana	48	0.557	246	0.629	26	0.343	22	0.660	14	0.620	0.547	2
Kenya	38	0.680	347	0.378	23	0.298	21	0.688	6	0.832	0.535	3
Nigeria	18	0.926	144	0.881	52	0.738	16	0.830	0	0.992	0.869	1
Pakistan	38	0.680	360	0.346	15	0.177	34	0.320	7	0.806	0.403	9
Sri Lanka	69	0.299	375	0.302	5	0.026	31	0.405	15	0.593	0.224	11
Türkiye	54	0.483	151	0.864	16	0.192	25	0.575	28	0.247	0.408	8
Ukraine	70	0.286	142	0.886	22	0.283	15	0.858	16	0.566	0.511	5
Max = 93.31		Max = 500		Max = 69.3			Max = 45.3			Max = 37.3		
Min = 23.00		Min = 96		Min = 3.3			Min = 10.0			Min = -0.3		
Max-Min = 81.31		Max-Min = 404		Max-Min = 66			Max-Min = 35.3			Max-Min = 37.6		

Annexure-5:

Specification of the Macroeconometric Model of Pakistan with Growth and Inequality

List of Variables

Policy Variables

CG	Government Consumption Expenditure
IG	Government Development Expenditure
DENC	Percentage Increase in Energy Cost
DMD	Impact of Non-tariff Measures on Imports
DIDT	Extent of Fiscal Effort for Indirect Taxes through Additional Taxation
DW	Extent of Fiscal Effort for Direct Taxes through Additional Taxation
NTXR	Non-Tax Revenue
PPE	Pro-Poor Expenditure
PROC	Wheat Support Price
RO	Extent of Roll-over of Maturity of External Debt
RW	Real Wage Rate
SUBS	Level of Subsidies
shb	Percentage of Budget Deficit Financed through Domestic Borrowing

Exogenous Variables

AG	Value Added of the Agriculture Sector
GCP	Growth Rate of International Prices on Imported Capital Goods
GMP	Growth Rate International Prices of Imports
GXP	Growth Rate International Prices of Exports
IMF	Level of Borrowing from IMF

NFI	Net Factor Income from Abroad
POP	Population
SBFI	Secondary Income Account
WT	World Import of Goods and Services

Endogenous Variables

ΔS	Changes in Stocks
BCER	Level of Real Government Current Expenditure
BDER	Level of Real Government Development Expenditure
BUDG	Budget Deficit
BUDGP	Budget Deficit (as % of GDP)
BCE	Budgetary Current Expenditure
BDE	Budgetary Development Expenditure
CPROFIT	Level of Corporate Profitability (% return on equity)
DBORR	Financing of Budget Deficit from Domestic Borrowing
DDBT	Domestic Debt
DFR$	Change in Foreign Exchange Reserves
DMS	Change in Money Supply
DPED	Rate of Inflation
DSD	Servicing of Domestic Debt
DSE	Servicing of Foreign Debt
EBORR	Financing of Budget Deficit from External Borrowing
EDBT$	External Debt
EMP	Employed Labor Force
EXR	Exchange Rate
FAS$	Balance in the Financial Account
FR$	Level of Foreign Exchange Reserves
GPCI	Per Capita Income Growth
IG	Public Investment Expenditure
INDG	Value Added of the Industrial Sector
INEQUALITY	Level of Inequality (measured by the PALMA RATIO)
IDT	Revenue from Indirect Taxes

INVR	Level of Investment (as % of GDP)
IP	Private Investment Expenditure
LABOR	Labor Force
M	Imports of Goods and Services
M$	Imports of Goods and Services in Dollar Value
MBP$	Imports of Goods and Services in Dollar Value from BOP Account
MCV	Import Cover Ratio (in months)
MM	Money Supply
NIR	Nominal Interest Rate
NTX	Indirect Taxes (as % of GDP)
PD	Domestic Price
PDBT	Total Public Debt
PDEF	GDP Deflator
PF	Food Price Index
POV	Level of Poverty
PRDF	Primary Budget Deficit
PRDFP	Primary Budget Deficit (as % of GDP)
RIR	Real Interest Rate
RIT	Revenue of Income Taxes
SERG	Value Added of the Services Sector
SVR	Level of Saving (as % of GDP)
TDF$	Trade Deficit
TXR	Tax Revenue
UEMP	Unemployment Rate
UVIC	Unit Value Index of Capital Goods Imports
UVIM	Unit Value Index of Imports
UVIX	Unit Value Index of Exports
X	Exports of Goods and Services
X$	Exports of Goods and Services in Dollar Value
XBP$	Exports of Goods and Services in Dollar Value from BOP Account
YFC	Gross Domestic Product (at constant factor cost)
YM	Gross Domestic Product (at constant market prices)

Equations of the Model

I. GDP Size and Growth

1. The Basic Keynesian Identity:

$$YM = CP + CG + IP + IG + X - M + \Delta S$$

2. Private Consumption Expenditure:

$$CP = F(YM, NFI, NIR, M, INQUALITY, CP_{-1})$$

3. Private Investment Expenditure:

$$IP = F(YM, RIR, IG, UVICM, PD, CPROFT, IP_{-1})$$

4. Exports of Goods and Services:

$$X = F(\overline{WT}, UVX, PD, YM, X_{-1})$$

5. Imports of Goods and Services:

$$M = F(YM, UVIM, EXR, PD, TXREV, RIR, DMD, M_{-1})$$

6. Change in Inventories:

$$\Delta S = F(YM)$$

7. GDP at Constant Factor Cost:

$$YFC = YM - \frac{IDT}{PD} + SUBS$$

8. Value Added of the Industrial Sector:

$$INDG = F(YFC, X, IDT, PD)$$

9. Value Added of the Services Sector:

$$SERG = YFC - INDG - AG$$

10. GDP Growth Rate:

$$YGR = \left(\frac{YFC}{YFC_{-1}} - 1\right) \times 100$$

II. Rate of Inflation

1. Domestic Price Index:

$$PD = F(MM, UVIM, YM, ITXR, DENC, INEQUALITY, PD_{-1})$$

2. GDP Deflator:

$$PDEF = F(PD, PDEF_{-1})$$

3. Rate of Inflation:

$$DPED = F\left(\frac{PD}{PD_{-1}} - 1\right) \times 100$$

4. Food Price Index:

$$PF = F(PD, PROC)$$

III. Level of Interest Rate

1. Nominal Interest Rate:

$$NIR = F(BUDG, DPED, NIR_{-1})$$

2. Real Interest Rate:

$$RIR = NIR - DPED$$

IV. Money Supply

1. Change in Money Supply:

$$DMS = F(YM, PDEF, BUDG, NIR, INEQUALITY)$$

2. Level of Money Supply:

$$MM = MM_{-1} + DMS$$

V. Level of Investment and Savings

1. Level of Investment (as % of GDP):

$$INVR = \left(\frac{IG + IP + \Delta S}{YM}\right) \times 100$$

2. Level of Savings (as % of GDP):

$$SVR = \left(\frac{YM + \overline{NFI} - CP - CG}{YM}\right) \times 100$$

VI. Budgetary Position

1. Tax Revenues:

$$TXR = IDT + RIT$$

2. Direct Tax Revenues

$$RIT = F(YM, PDEF, CPROFIT, INEQUALITY, RIT_{-1})$$

3. Indirect Tax Revenues:

$$IDT = F(CP, PDEF, M, UVIM, THETA, INEQUALITY)$$

4. Level of Real Government Current Expenditure:

$$BCER = F(CG)$$

5. Level of Budgetary Current Expenditure:

$$BCE = BCER \times \left(\frac{PD}{100}\right)$$

6. Level of Real Government Development Expenditure:

$$BDER = F(IG)$$

7. Level of Budgetary Development Expenditure:

$$BDE = BDER \times \left(\frac{PD}{100}\right)$$

8. Level of Non-tax Revenue:

$$NTXREV = \left(\frac{NTX}{100}\right) \times \left(\frac{YM \cdot PDEF}{100}\right)$$

9. Budget Deficit:

$$BUDG = (BDE + BCE) - (TXR + NTXR)$$

10. Budget Deficit (as % of GDP):

$$BUDGP = \left(\frac{BUDG}{YM \cdot PDEF}\right) \times 100$$

11. Servicing of Domestic Debt:

$$DSD = F(NIR, DDBT)$$

12. Servicing of Foreign Debt:

$$DSE = F(EDBT\$, EXR)$$

13. Primary Budget Deficit:

$$PRDF = BUDG - (DSD + DSE)$$

14. Primary Budget Deficit (as % of GDP):

$$PRDFP = \left(\frac{PRDF}{YM \cdot PDEF}\right) \times 100$$

VII. Public Debt

1. Financing of Budget Deficit from Domestic Borrowing:

$$DBORR = shb \times (BUDG)$$

2. Financing of Budget Deficit from External Borrowing:

$$EBORR = (1 - shb) \times (BUDG)$$

3. Domestic Debt:

$$DDBT = DDBT_{-1} + DBORR$$

4. External Debt:

$$EDBT\$ = EDBT\$_{-1} + \frac{EBORR}{EXR}$$

5. Total Public Debt:

$$PDBT = PDBT_{-1} + BUDG + EDBT\$ \times (EXR - EXR_{-1})$$

VIII. Balance of Payments

1. Real Exchange Rate ($/PKR):

$$\frac{EXR}{PD} = F(FR\$, M\$BOP)$$

2. Exports of Goods and Services (in $):

$$X\$ = \frac{X \cdot UVIX}{EXR}$$

3. Imports of Goods and Services (in $):

$$M\$ = \frac{M \cdot UVIM}{EXR}$$

4. Exports of Goods and Services (BOP):

$$XBP\$ = F(X\$, XBP\$_{-1})$$

5. Imports of Goods and Services (BOP):

$$MBP\$ = F(M\$, MBP\$_{-1})$$

6. Trade Deficit:

$$TDF\$ = XBP\$ - MBP\$$$

7. Current Account Deficit (in $):

$$CAD\$ = TDF\$ + \overline{SBFI}$$

8. Change in Foreign Exchange Reserves:

$$DFR\$ = FAS\$ - CAD\$ - RO \cdot UIF + \overline{IMF}$$

9. Level of Foreign Exchange Reserves:

$$FR\$ = FR\$_{-1} + DFR\$$$

10. Import Cover Ratio (in months):

$$MCV = \frac{FR\$}{M\$} \times 12$$

11. Unit Value Index of Exports:

$$UVIX = UVIX_{-1} \cdot (1 + \overline{GXP}) \cdot \frac{EXR}{EXR_{-1}}$$

12. Unit Value Index of Imports:

$$UVIM = UVIM_{-1} \cdot (1 + \overline{GMP}) \cdot \frac{EXR}{EXR_{-1}}$$

13. Unit Value Index of Capital Goods Imports:

$$UVIC = UVIC_{-1} \cdot (1 + \overline{GCP}) \cdot \frac{EXR}{EXR_{-1}}$$

IX. Labor Force and Employment

1. Level of Labor Force:

$$LABOR = F(POP)$$

2. Level of Employment:

$$EMP = F(YM, RW, X, M, EMP_{-1})$$

3. Unemployment Rate:

$$UEMP = \frac{LABOR - EMP}{LABOR} \times 100$$

X. Level of Poverty and Inequality

1. **Level of Poverty:**

$$POV = F(YM, POP, PF, PD, INEQUALITY, PPE)$$

2. **Level of Inequality:**

$$INEQUALITY = (YM\ , CPROFIT, EMP, NIR, PPE^{*}, PD, TXREV, PDEF, INEQUALITY_{-1})$$

XI. Level of Corporate Profitability

1. **Level of Corporate Profitability:**

$$CPROFIT = (YM, NIR, TXREV, PD, CPROFIT_{-1})$$

Summary of Equations

Module	Number of Equations
GDP Size and Growth	10
Rate of Inflation	4
Level of Interest Rate	2
Money Supply	2
Level of Investment and Savings	2
Budgetary Position	14
Public Debt	5
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Labor and Employment	3
Poverty and Inequality	2
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TOTAL	**58**

Notes about the Equations:

1) Variables with * on top are Policy Variables.
2) Variables with ¯ on top are Exogenous Variables.

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List of Acronyms

AML	Anti-money laundering
BISP	Benazir Income Support Program
BNU	Beaconhouse National University
CFT	Counter terrorist financing
CIPA	Country Policy and Institutional Assessment
CMU	Central Monitoring Unit
CPEC	China-Pakistan Economic Corridor
CPFTA	China–Pakistan Free Trade Agreement
CPI	Consumer Price Index
DAP	Di Ammonium Phosphate
DISCOs	Power Distribution Companies
EFF	Extended Fund Facility
EFS	Export Facilitation Schemes
EPI	Economic Performance Index
EPZ	Export Processing Zone
EU	European Union
EVI	External Vulnerability Index
FAC	Fuel Adjustment Charges
FATA	Federally Administered Tribal Areas
FATF	Financial Action Task Force
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FE	Foreign Exchange
FRDL	Fiscal Responsibility and Debt Limitation
FY	Fiscal Year
GDP	Gross Domestic Products
GNI	Gross National Income
GRP	Gross Regional Products
GST	General Sales Tax
HBFC	House Building Finance Corporation

HDI	Human Development Index
HSD	High-Speed Diesel
IMF	International Monetary Fund
IT	Indicative Targets
K-Electric	Karachi Electric
LCs	Letter of Credits
LFS	Labor Force Survey
LNG	Liquified Natural Gas
LPG	Liquified Petroleum Gas
MFN	Most Favored Nation
MOF	Ministry of Finance
MPC	Monetary Policy Committee
MTBs	Market Treasury Bills
MW	Mega Watt
NDA	Net Domestic Assets
NEC	National Economic Council
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NIR	Net International Reserves
NPC	Naya Pakistan Certificates
NRPs	Non-resident Pakistanis
NSS	National Savings Centres
OMOs	Open Market Operations
PBS	Pakistan Bureau of Statistics
PC	Performance Criteria
PES	Pakistan Economic Survey
PIA	Pakistan International Airline
PIBs	Pakistan Investment Bonds
PML(N)	Pakistan Muslim League (Nawaz)
POC	Pakistan Origin Card
POL	Pakistan Oilfields Limited
PPL	Pakistan Petroleum Limited
PPP	Pakistan People's Party

PPP	Public-Private Partnerships
PSDP	Public Sector Development Program
PTI	Pakistan Tehreek-e-Insaf
RDA	Roshan Digital Accounts
REER	Real Effective Exchange Rate
RFO	Residual Fuel Oil
RLNG	Liquefied Natural Gas
SBP	State Bank of Pakistan
SDRs	Special Drawing Rights
SMEDA	Small and Medium Enterprises Development Authority
SMEs	Small-Medium Enterprises
SOEs	State-Owned Enterprise
SOEs	State-Owned Enterprises
TDAP	Trade Development Authority of Pakistan
TERF	Temporary Economic Finance Facility
TSA	Treasury Single Account
UAE	United Arab Emirates
UK	United Kingdom
UNDP	United Nations Development Program
US	United States
USA	United State of America
WAPDA	Water and Power Development Authority

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Dr. Hafiz A. Pasha is Professor Emeritus at Beaconhouse National University, Lahore. He has served as Assistant Secretary General of the United Nations. He has been the Federal Minister for Commerce, Planning and Finance in three Governments of Pakistan. Earlier, he served as Vice Chancellor of the University of Karachi, Dean of IBA and Director of the Applied Economics Research Centre. He has received a number of international and national awards.

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